Meeting of the Federal Open Market Committee

October 5-6, 1981

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., starting on Monday, October 5, 1981, at 4:30 p.m. and continuing on Tuesday, October 6, 1981, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Boehne
Mr. Boykin
Mr. Corrigan
Mr. Gramley
Mr. Keehn
Mr. Partee
Mr. Rice
Mr. Schultz
Mrs. Teeters
Mr. Wallich

Messrs. Balles, Ford, Timlen, and Winn, Alternate Members of the Federal Open Market Committee

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

Mr. Axilrod, Staff Director
Mr. Altmann, Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, General Counsel 1/
Mr. Oltman, Deputy General Counsel
Mr. Mannion, Assistant General Counsel 1/
Mr. Kichline, Economist

Messrs. Burns, R. Davis, Ettin, Keir, Mullineaux, Prell, Scheld, Truman, and Zeisel, Associate Economists

1/ Attended Tuesday session only.

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

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Siegman, Associate Director, Division of International Finance, Board of Governors
Mr. Lindsey 2/, Assistant Director, Division of Research and Statistics, Board of Governors
Mr. Simpson, Chief, Banking Section, Division of Research And Statistics, Board of Governors
Mrs. Deck 1/, Staff Assistant, Open Market Secretariat, Board of Governors

Mr. Monhollon, First Vice President, Federal Reserve Bank of Richmond

Messrs. Balbach, J. Davis, T. Davis, Keran, Koch, and Parthemos, Senior Vice Presidents, Federal Reserve Reserve Banks of St. Louis, Cleveland, Kansas City, San Francisco, Atlanta, and Richmond, respectively

Messrs. Fieleke and Syron 1/, Vice Presidents, Federal Reserve Bank of Boston

Mr. Duprey, Senior Economist, Federal Reserve Bank of Minneapolis

1/ Attended Tuesday session only.
2/ Attended Monday session only.

Transcript of Federal Open Market Committee Meeting of
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October 5, 1981--Afternoon Session

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

CHAIRMAN VOLCKER. Any comments or questions? Mr. Winn.

MR. WINN. Just one question: To what extent did the Libyan pull-out [of funds] from this country affect the rate movement?

MR. CROSS. The impact on the rate movement?

MR. WINN. Yes. If I understand, there was a big withdrawal of Libyan funds from this country.

MR. CROSS. There was a large withdrawal--well, not a withdrawal, but a--

MR. WINN. Transfer.

MR. CROSS. There was a run-off of securities--Treasury bills and notes that the Libyans held here--of a fairly substantial amount. But I don't think and have not heard that it was an important factor in the exchange rate situation. But as Treasury bills and notes matured, the Libyans have drawn down their holdings.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Do you find that the closeness of contact and quality of information with European central banks and with the market in general is being maintained at present?

MR. CROSS. Well, we're certainly doing everything we can to maintain it. It's always a little easier if we're more involved in the operations, I think. But we're trying to do what we can, of course, to keep in close contact and to get all the information we can. There had been some talk by one or two of the lower level people in some of the European central banks that if the United States isn't going to be in the game, so to speak, perhaps we should not participate to the extent we have in the exchange of information. At this point, it has not been anything other than a statement by one or two officials, and I don't see any reason at this point that they would not continue [to exchange information].

CHAIRMAN VOLCKER. Let me just raise one thing informally and I'll ask for your comment, if you have any, tomorrow morning so you can think about it a little. We have had an informal inquiry from one central bank not in the swap network to be placed in the swap network. It is a small country

MR. CORRIGAN.

VICE CHAIRMAN SOLOMON. We turned down

CHAIRMAN VOLCKER. They have been given no particular encouragement, but I told them I would raise it for a general reaction, not for a decision. I told them I thought there was a certain reluctance to extend these arrangements, partly because of the inquiries that would trigger from still others. I think it's fair to say, Mr. Truman, that the

They are on their own, so to speak. [Participation in the swap network] would be of some assistance to them in their reserve management and, I would suspect--although this weighing is mine and not theirs--even more assistance in terms of their prestige and as a member of the in good standing. Weren't those about all the considerations they raised, Ted? They've raised this from time to time in the past. I will not ask for your comment this minute, but apart from Mr. Corrigan's let you reflect on it for a very brief period [and ask] tomorrow for any comments you want to make.

MR. SCHULTZ. I'll make a bet that it took longer to ask for it than you just outlined it.

CHAIRMAN VOLCKER. Yes. Their numbers are smaller, they are an Article IV country or whatever it is, and they are in the EMS. Article VIII is what we're looking for, isn't it? Article IV is those other guys. So, it depends upon one's attitudes toward this kind of thing. Domestic open market operations, Mr. Sternlight.

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

CHAIRMAN VOLCKER. How much did the bond market go up today?

MR. STERNLIGHT. By the end of the day 1/2 to 3/4 of a point. It had been up more than that earlier, but [the gain] got trimmed back.

CHAIRMAN VOLCKER. Was this a rally that hasn't been accompanied by any lightening of spirits?

MR. STERNLIGHT. I think attitudes are still mostly cautious. They're not really seeing extensive investor buying [though] there has been some. Until they see more of that, it has more of the characteristics of a technical rebound with short covering and not a lifting of spirits.

CHAIRMAN VOLCKER. Any further comment?

MR. WINN. I'd just raise a question about the margin and the valuation [for System repurchase agreements]. What is the margin requirement?

MR. STERNLIGHT. Well, there's a whole scale of valuations when we value securities for repurchase agreements. And it's a sliding scale; it depends on the maturity of the issues. For example, with Treasury bills over one month [in maturity] we went from 10 to 25 basis points. That is where we would value the securities against the current quoted market. In very rough terms it was about a doubling of the margins.

MR. CORRIGAN. Is that commonplace in the market now, Peter?

MR. STERNLIGHT. A lot of lenders have been raising their margins, and I'd say our margins are in line with those of the more conservative lenders. I wouldn't say everybody is up there. Some lenders still rely primarily on whom they're lending to rather than looking to the margin itself for protection.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I just wanted to get Peter's thoughts, if he has any, on what happened to M-1B shift adjusted in the last two weeks, in that it suddenly fell out of bed and gave us an unexpected, at least to me, 4 percent decline. Earlier in [September] it looked as if it would be coming in close to 2 or 3 percent.

MR. STERNLIGHT. Right. Well, I don't know. Steve might have a comment on it. I have given up trying to explain short-term variations in the money supply.

MR. MORRIS. A shift in the demand for money.

MR. PARTEE. Of course!

MR. GRAMLEY(?). We're possibly moving along--

MR. BALLES. Well, maybe I should ask Steve.

MR. AXILROD. We don't have any very obvious explanation. There is nothing special that we can see. Just as a word of caution, I would hold my breath a little until October 7th. We're not projecting a large increase in that week; we're projecting something on the order of $2 or $3 billion, but it's not impossible that it could come in quite a bit larger and could begin to make up for that decline. So far as the economics of it go, it could indicate some weakening in real GNP, which is quite consistent with the nonfinancial data that are coming in. But again, that's somewhat speculative.

MR. SCHULTZ. Mr. Kaufman is projecting a large increase [for the week of] October 7th.

MR. STERNLIGHT. A lot of market people expect it because it's one of those weeks in which we have the Social Security payments on Friday in the first week of the month. Often in the past that has been accompanied by large increases.

CHAIRMAN VOLCKER. We don't know what [last] week's figures are much less the figures for the 7th. These preliminary figures have gotten very [unreliable]. One of the strange things is that currency is so weak. Does anybody know why currency is so weak?

MR. MORRIS. Maybe the drug business is slowing down. We're about to publish an article that indicates that a large part of the net increase in currency is not related to any normal economic activity, but is--

CHAIRMAN VOLCKER. M1 has really been lower, drug adjusted!

MR. MORRIS. That's right.

CHAIRMAN VOLCKER. Any other comments or questions? If not, we shall adjourn. But first we have to ratify the transactions.

SPEAKER(?). So move.

MS. TEETERS. Second.

CHAIRMAN VOLCKER. Without objection, we'll ratify the transactions and adjourn until 9:00 a.m. tomorrow.

[Meeting recessed]

October 6, 1981--Morning Session

CHAIRMAN VOLCKER. Well, gentlemen--lady and gentlemen--we can resume and spend just a few minutes on any reactions or comments or feelings you have about swaps, with particular reference to not necessarily confined to that.

VICE CHAIRMAN SOLOMON. Well, let me make a point. The argument that and, therefore, should have a swap line, has some weaknesses in it because becoming a member.

CHAIRMAN VOLCKER. Their answer to that is is not becoming a member but also--. Are they an Article VIII country?

VICE CHAIRMAN SOLOMON. Yes, they are.

MR. TRUMAN. No, they are not an Article VIII country; they are not part of the consultation in the EMS and they're not part of the VIII group. So that's their distinctive--

CHAIRMAN VOLCKER. But they are Article VIII?

MR. TRUMAN. They're not Article VIII.

CHAIRMAN VOLCKER. They're not Article VIII?

VICE CHAIRMAN SOLOMON. They're not Article VIII? I thought Article VIII meant simply that a currency is convertible.

MR. TRUMAN. That's right. And is not a convertible currency in that sense.

VICE CHAIRMAN SOLOMON. I see. You mean there are certain types of formal exchange--

MR. TRUMAN. Well, they haven't given up the right to have [exchange controls].

VICE CHAIRMAN SOLOMON. Oh, I see, even though in practice there are no exchange controls on at the moment. Still, I don't think that ought to be the main reason for giving a swap line to Have they presented a reason other than prestige why they should have a swap line--a substantive reason?

CHAIRMAN VOLCKER. Well, the argument is that we turned them down ten years ago or thereabouts apparently on the basis that they were members of the sterling area and that they ought to look to London for assistance. They are no longer members of the sterling area so that reason is no longer valid for turning them down. They do have independent reserve management, and it would be of at least modest help to them in reserve management to know they have this backstop.

VICE CHAIRMAN SOLOMON. So, if we went ahead with came in again, would this change your attitude about giving one to

CHAIRMAN VOLCKER. Clearly, a major problem with this is the precedent we create for others. It's not ; we also get asked by countries.

MR. TRUMAN. Some of which are [now] Article VIII countries, like whom we turned down in '67 solely on that ground. There are also who might think that they were on the right side.

CHAIRMAN VOLCKER. Turned them down solely on what ground?

MR. TRUMAN. Primarily on the Article VIII grounds of 1967; but subsequently they've become part of our [unintelligible] article.

CHAIRMAN VOLCKER. Oh, they've become a member.

VICE CHAIRMAN SOLOMON. My [view] would be that unless there's a substantive reason, we open up more problems by agreeing to it. I think we ought to be in a posture that unless it's one of the countries that we deal with [and is] important to the [effective functioning of the international] monetary system, the extension of a swap line ought to have a substantive reason behind it.

CHAIRMAN VOLCKER. Any other comments?

MR. PARTEE. I agree with Tony. I think it opens up a can of worms. I don't know how we could turn down the countries that are bigger trading partners and bigger countries and everything else-- --if we let in

MR. WALLICH. I would think we could perhaps [say no] on the basis that this is not the right time. I don't want to preclude this for all eternity.

MR. PARTEE. They could get a closer tie with sterling and then have--

CHAIRMAN VOLCKER. They could take it up in 1990.

VICE CHAIRMAN SOLOMON. That is possibly the correct--

CHAIRMAN VOLCKER. Well, I don't detect any enthusiasm. They have already been told that a major problem is the precedential character of it. Well, we can proceed to the staff reports on the economic situation.

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

CHAIRMAN VOLCKER. Maybe we should just pause here and get reactions on the business scene as such. You made the comment that you don't see any precipitous drop likely. That's one question that I suppose arises. Comments on that or other points about the business scene are in order at this point. Mr. Boehne.

MR. BOEHNE. I think the economy does have a downward tilt to it. I doubt that we're in for a precipitous drop but I do think that financial conditions have worsened. The small business situation--the stretch-out of accounts payable--has put considerable strain on these companies and I'm hearing more and more cries of complaint from them.

MR. SCHULTZ. From whom? Where are you getting that? I keep trying to get a feel for this--I've talked to bankers all over the country--and it's hard. In general, when I talk to big bankers, they say things don't look so bad; they look pretty good. Even the ones that have special divisions that lend to small businesses say they have checked and the people they have loaned to are under a lot of pressure but none seems about to break. Then when I talk to the little bankers, they say the cataclysm has arrived.

MR. BOEHNE. I'm getting this not from the biggest banks in our District but from, say, the $1-1/2 billion size ones who tend to specialize in lending to small and medium size businesses. Their cries of concern are getting louder. I'm also hearing this directly from the small and medium size businesses. I've talked to a number of them; I had a luncheon last week with people from small and medium size firms in manufacturing, services, and consulting type businesses, and they're talking about accounts receivable that are going out 120 days and higher. The worst offender appears to be the federal government, which is very slow in paying its bills. The kind of comment I heard at the luncheon was: "I'm just hanging by the tips of my fingers over the edge of the cliff; I can see the edge of the cliff." We had a go-around and almost to a person they mentioned this cash flow problem as being very, very serious. It was in various degrees depending on who was talking. But the tone of "Am I going to survive or not?" was clearly there. That was a real question.

MR. SCHULTZ. Just to be specific about your District, I had lunch with who has a very good program for small business lending. He said the small businesses are all under pressure but he didn't see any that are going [under]. That's the problem that I have. The [small businesses] all are saying that they're in really difficult condition but if you ask the banker who has lent to them, he says he thinks they're going to make it okay.

MR. BOEHNE. I've tried to keep in touch with this and my reading is that the seriousness of the slippage in financial conditions is significantly greater now than it was a couple of months ago.

MR. PARTEE. Would this affect their inventory attitude, though?

MR. BOEHNE. Some of them mentioned that even if the [demand] were there, they wouldn't be stocked up to take care of it because they can't handle the inventory.

MR. PARTEE. The reason I asked is that Jim had the conclusion that inventories weren't a sensitive sector. But it does seem to me that if a firm's cash flow is poor and if the costs of carry are very high, it could liquidate inventory. We have different circumstances than in the past for judging these stock/sales ratios and so forth.

CHAIRMAN VOLCKER. Anyone else?

MR. MORRIS. I can confirm Ed's finding. I've talked to a number of small and medium size bankers who have reported that just recently, in the last few weeks, for the first time this year they're looking at some loans that are turning sour. It's a very recent development. Bankers not only in Massachusetts but in New Hampshire and Maine have said the same thing. But they've mostly been the small and medium size banks, not the big ones.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I don't know how much this adds or how much light it throws on it. I had a meeting with about a dozen business leaders in New York City and, even though they tend to be larger size businesses, many of them have companies or product lines that have been very adversely affected by current conditions. The curious thing I noticed was that even the ones who said they were in great difficulty in regard to those particular product lines all said that there were other product lines that displayed some strength, as proof of the fact that they didn't feel they were near any cliff. These are not huge companies; they are what I guess we call medium size companies; some have sales as small as $200 or $300 million. But to a man all of them--even the ones who said that were [hurting]--said they hoped the Fed would continue its tight monetary policy. They said they thought it would eventually work. As I say, it probably doesn't throw any light on this, but it's the only contact [of this kind that] I've had.

MR. WALLICH. We have some data on bankruptcies and failures which throw some light, don't they, on the degree of strain? My impression is that they are up significantly, about 40 percent, but that this is also influenced by the new bankruptcy law. Certainly [that affects] the bankruptcies; less so perhaps the failures. Do you have any more data? Is 40 percent unique historically?

CHAIRMAN VOLCKER. Your people had some data yesterday, Jim, relating to failures--I forget whether the term used was failures or not--per 10,000 firms. It wasn't all that much, was it?

MR. KICHLINE. Right, it was failures--Dunn and Bradstreet's failure index, which tries to adjust for the size of business population. That was up substantially; I don't have in mind the percent. It's still below the peak in that series, which occurred in 1960-61.

CHAIRMAN VOLCKER. It was high, but it didn't look so high historically.

MR. KICHLINE. There are other indicators, such as adverse dividend actions or ratings changes. They are looking more adverse now compared with a year ago, but they're all well below what happened in 1974-75, which obviously was extraordinary. Nevertheless, they have been creeping up in recent months, and one gets a sense that the corporate sector is experiencing some deterioration. But it's not dramatic at this point.

MR. SCHULTZ. The bankruptcy rate is up 41.5 percent over last year. But one has to remember that the new bankruptcy law has this new Chapter 13, which is very attractive for these smaller businesses who can go into that and keep running under their management. It's a different kind of animal than they've ever had to work with before.

MR. PARTEE. Of course, that was in effect last year, too.

MR. SCHULTZ. Well, only in the latter part of last year.

MR. PARTEE. No, it [became effective] in late '79.

MR. SCHULTZ. That's right; it was late '79.

MS. TEETERS. I think I read someplace that 30 states have overridden it.

MR. SCHULTZ. Yes, that's right.

MR. GRAMLEY. One wants to remember also that historically numbers of failures have not been procyclical; they were countercyclical for many, many years. The reason was that when business activity speeded up, the rate of business formation accelerated and there were so many new firms coming out that there tended to be more failures. But when there is a prolonged period in which the rate of net business formation is low and there's a very sharp acceleration in failures, I think it is an indication of growing difficulty. The other thing that ought to be said is that one knows just from raw logic about interest rates that small businesses will have difficulty when they are paying 20 percent for credit and are looking at a rate of increase of basic industrial and service prices of between 8 and 9 percent. You can talk all you want about how the interest cost is less taking taxes into account; but as a firm gets closer and closer to the edge, the less relevant this tax calculation becomes and the more the firm is going to be staring at the need to pay 20 percent for credit. So, just abstracting, the problem has to grow and grow and grow as time goes on. It's not surprising that Ed is finding more and more signs of this.

VICE CHAIRMAN SOLOMON. And now you can sell your tax credit.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. We had a group of people from about 20 medium and large size businesses in last week and the reaction we had was very similar to what Fred reported. In some specific fields and areas there are relatively serious problems, but by and large we got the feeling that there is an underpinning of strength. And there was unanimous sentiment--as has been the case in the past--that if the Fed were to do a flip-flop and become really expansive, it wouldn't solve their problems. In other words, their message to me was: For heaven's sakes hang in there. And we didn't sense any danger of a precipitous decline. Of course this is a diversified Midwestern area.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. We're getting the same picture. In terms of specifics, the optimistic points I found are the high-tech companies in the Southeast, such as and so on, which I visited in the last few weeks. They are all super optimistic about the way things are going. Their earnings are growing in the 20 to 30 percent range or higher. The technical service industries of that type are doing very well. The weaknesses that we find are in the areas that one would expect. We're seeing more and more classified loans to developers. We also have in our section of the country--in Atlanta, for example--a very high office vacancy rate that is beginning to approach the problems we had in the mid-1970s in terms of percent of vacant floor space and things like that. So, we're finding significant signs of weakness both in commercial and residential construction and in the lending institutions other than banks, i.e. the thrifts. I find these days that just about every S&L executive carries around in his pocket a schedule of weeks to go or months to go in terms of how long the S&L's equity will last based on its current earnings. There's a lot of worry in that industry. The tourist industry in southeast Florida is way off. The state had its slowest [tourist] season in the last ten years in the southern part of Florida and that also affected related industries. The lumber industry, which is big in our area, is also in dire straits because of the housing situation; the carpet industry in Georgia, where we have the capital of the world's carpet business, is beginning to come under some stress. Putting all of this together, my feeling is that overall we have a mixed picture. The economy is moving sideways. Some of the industries are prospering and the ones we would expect to be hurt are being hurt.

CHAIRMAN VOLCKER. I must say that among the bankers I have talked with there's a growing sense of concern about small and medium size businesses. Several of the bankers have commented that there are bankruptcies that are in [train]--that at this point, nothing can be done to defer them and they're just plain going to happen. Despite that, just to echo Tony's comments, I haven't talked to anybody I would regard as a responsible individual who would suggest that we ought to change what we're doing. [They think] the course is certainly the right one.

I just want to comment a bit on bankruptcies. Though that is a statistic that is available and is followed, there are also a lot of people who are just quietly going out of business at this point, and that is not a statistic that we can follow very easily. And there are a lot of people who feel that some of these small and medium size companies are simply getting what they can out of the business before they actually have to go into bankruptcy. So, this is having an adverse impact on that group.

Let me ask Jim Kichline something on what he said about construction. My impression is that major construction is holding up pretty well in terms of orders and that kind of thing. Is that right?

MR. KICHLINE. You mean nonresidential?

CHAIRMAN VOLCKER. Yes, big construction.

MR. KICHLINE. Yes, the orders in the last couple of months have bounced up. On average they had been about flat from last winter through much of the summer. But in the last couple of months we've had two really big increases; it's a very volatile series. I'd say the longer-term trend is rather flat in real terms.

CHAIRMAN VOLCKER. It seems to me a little surprising not to see some weakness there, in the orders anyway. I understand there's a lot in the pipeline. Mr. Winn.

MR. WINN. I'll say a couple of things. One is that many of the small businesses are holding on and as such they're delaying or [canceling] any orders for new equipment and delaying expansion, so we're going to get some secondary effect from this curtailment. Many of them have worked out financing arrangements at under prime so they get a little relief on that score, and the banks have been cooperating with them on that to hold them together. They complain about the large companies not paying their bills more than [about] one another; they say the large [companies are] carrying themselves through the impact on some of the smaller companies. And this is a source of complaint. Strangely enough, none of them that I've heard really [favors] a change in Fed policy. They realize it's tough, but they want us to hang with it still. Another point is that if we look at large capital investments and that sort of thing, it's interesting to see the changes that are taking place in the debt/equity ratios. It used to be that a firm financed a building [entirely with] debt and no equity and now the ratio is up to about 50/50, which is an interesting turnaround in terms of the financing arrangements in our area. My concern is largely that the crunch is going to come with some of the financial institutions, not with some of the business firms, and that the unexpected fallout or the repercussions may send shock waves through the system. They talk about months until the end of the line.

MR. PARTEE. You're talking about thrifts?

MR. WINN. Yes.

MR. PARTEE. Not banks.

MR. WINN. No, there are a few banks.

CHAIRMAN VOLCKER. Well, it's a large other subject, but one can get a bit concerned about what one sees going on in the banking system: companies being held alive by not very good lending and loans to foreign countries being rescheduled with loans on top of loans.

MR. WINN. That's right. That is the thing I think is the real [unintelligible] side of it.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. We also see evidence that soft spots are spreading, and it's not necessarily limited to small business. In the Pacific Northwest, of course, there has been a long period now where all kinds of small lumber mills have either closed their doors permanently or have gone on indefinite furlough, but things are spreading now even to the commercial side in the aerospace business. Employment is down noticeably from where it had been at its peak earlier in the year. Big aluminum companies are cutting back. These are suppliers for housing, automobiles, and so forth. Even some of the bigger companies are reporting capital spending cutbacks. Agricultural prices--and agriculture is one of the big industries in California--have been dropping partly due to a slippage in overseas demand because of the strength of the dollar. We get fairly widespread reports from our directors about further slowdowns in retail sales. This pretty much confirms the prospect that we've been looking at for some time now of a soggy economy. I'm not sure it adds up to a cumulative serious downward spiral, but it's enough to give some cause for concern.

MS. TEETERS. John, I noticed that 3 or 4 small banks in Oregon are on the troubled bank list. Is Oregon particularly hard hit at this point?

MR. BALLES. It really is. I think with one exception all of our so-called problem banks are in the state of Oregon. And that's a direct feedback from the very high unemployment rates, the closings of these lumber mills, and so forth.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I don't think there's any doubt that in the last month or two or so the signs of the long awaited credit quality problems have begun to emerge in ways that bankers and other people can see them. Frankly, I run into that point of view from virtually all the bankers that I have had an opportunity to talk to. Indeed, one prominent banker told me not too long ago that any banker who says he's not seeing that either isn't looking or is lying. Be that as it may, the one somewhat qualitative thing that I would add is that, in a number of cases where people are willing to talk about these problems, they tend to tell me that these were semi-marginal to marginal credits to begin with. Maybe they shouldn't have extended to begin with; and if they were having trouble at 10 or 12 percent, certainly they're going to have trouble at 18 or 20 percent. I run into that kind of attitude with some regularity, the point being that it's not just the question of, say, housing or wood products or farmers, it's also a question of the well-run business versus the not-so-well-run business almost regardless of the nature of the business. But I don't think there's any question that the problem is increasing.

Two other quick comments: One I find very curious, and that is that throughout all of this I begin to sense a little backing away, if I can put it that way, in terms of people's outlook for inflation over the next months, which I can't attribute to anything except that some of the euphoria of those really good consumer price index numbers earlier in the year has worn off and people are now starting to get back to reality. Those wage rates are there and those medical prices are there, and the view is that, indeed, the next step on the road is going to be a damn tough one. I perceive that now that we've gotten to the point where businesses are starting to look hard at the question of "Where do we go from here?" They are coming back to reality, as it were, in terms of what still lies ahead with regard to their own pricing decisions in an environment in which they obviously all are looking for every opportunity they can find to pass through costs to try to regenerate cash flow and profit margins. And I think that is a curious thing to find at this point--the reevaluation of how far we can really expect to go in the near term on inflation, given all the forces that they see pushing on them in terms of their own wage and price decisions.

On the economy, I would certainly agree that it's moving downward. I don't see at the moment any evidence of a pervasive or precipitous decline, but I would align myself with Willis Winn in suggesting that the potential for that is clearly there. The biggest single vulnerability in my judgment would be not so much that something will happen to the thrift industry--I think that's all been discounted--but that some other sizable financial shock may be looming out there and none of us seems to know quite where it is or where its ugly head might pop up. I think that risk is there. And if that kind of thing were to happen, that might well change my view as to whether or not there is some potential on the down side beyond what one would find just by looking at the numbers in front of us today.

CHAIRMAN VOLCKER. You touched upon the wage picture. I must say I get a little discouraged sometimes when I look at wage attitudes. The gentleman on my left is very optimistic on this score. We had some big bankers in here a month or so ago who are all planning to increase clerical salaries in a range of 11 to 15 percent next year and who I understand believe this is typical of industry generally. I suspect it is. How that is consistent with getting inflation down, if this generalizes very far, I don't know. Not many people have commented on that. If there are any additional comments to lend insight as to how business or labor are reacting in this situation in terms of prospective wage settlements, that's an interesting variable.

MR. SCHULTZ. Well, you said I was optimistic; I am optimistic. I'm optimistic because of just what Jerry Corrigan said. I have never felt that there was any way to get inflation down without putting pressure on business and labor. Put pressure on business and they have to find a way to cut those costs because they don't have [available] the path of least resistance of raising prices. And if you put pressure on business, labor begins to get the point that if they get too much in wages they won't have a business to work for. I think that really is beginning to happen now and that's why I'm more optimistic. Every business I know of out there is doing everything it can to cut costs. When the Teamsters open the master contract because they see some of their truckers going under, when the UAW talks about job security instead of wage increases, and when Pan Am workers are willing to take 10 percent cuts because the airlines are in trouble, I think those are signs that we're at the point where something can really start to happen. So, that's why I tend to be optimistic on the subject.

CHAIRMAN VOLCKER. There's no question that there are some scattered signs. I won't prejudice [the discussion]. The question is how widespread they are.

MR. PARTEE. Scattered here and there.

VICE CHAIRMAN SOLOMON. I tend to feel the way Fred feels. At that same lunch of business leaders I raised this question: What kind of wage increases do you expect to pay next year? And much to my surprise a lot of them who had factories that were in very depressed conditions said they had already quietly begun to renegotiate and were coming in with very low settlements. For those who had factories that were doing much better, it was a different story. But there was a rather selective approach; they were implying that if it was kept quiet, they were getting trade union cooperation in the area.

MR. CORRIGAN. In terms of my own remarks, I didn't want to leave [the impression] that all of it was on the wrong side of things. In one sense I was trying to suggest that it was on the right side of things because people were aggressively thinking about what to do. And that in itself says something, because heretofore I think the decision was almost automatic when the corporate business plan came up. They just filled in the numbers and didn't even think about it. So, I was trying to suggest that it's not all bad.

CHAIRMAN VOLCKER. Well, [unintelligible] the typical big businessman up until recently--he may be changing his mind--was ready to give a 10, 11, 12 percent wage increase like falling off a log. He thought that was a normal thing to do. That may be changing, but I--

MR. WINN. Some of our large national companies have quietly renegotiated the COLA contracts out of their labor agreements. I think that's a very positive step.

CHAIRMAN VOLCKER. It sounds to me--

MR. WALLICH. Well, it has to be seen in the light of the fact that there's a big tax cut in 1982. Nobody seems to take that as a reason for having a lower wage increase. There would be more of a real income increase than one would otherwise expect.

VICE CHAIRMAN SOLOMON. You're right; nobody relates a wage increase to the fact that taxes are coming down.

MR. PARTEE. It comes from different parts.

MR. CORRIGAN. In most years that would get us in a lot of trouble.

MR. WINN. Does anybody have a feel for what federal government policy is going to be on this score?

CHAIRMAN VOLCKER. Well, the federal wage increase is set at 4.8 percent or something like that. Oh, you mean in the private [unintelligible]. I meant in the government itself. They broke the comparability link, so it moves in that direction. Of course, I think the attitudes on the controllers' strike have had some bearing on this climate in general, accidentally or otherwise. Mr. Boykin. We have the good news coming up!

MR. BOYKIN. I'm a little embarrassed; I was trying to hold off for a while. It's obvious from our comments in the Redbook that the Eleventh District economy continues to be a bit of an outlier. We haven't really seen any major change in economic activity down our way in recent months. It's still pretty strong. The drilling boom for oil and gas just seems to keep right on going. We don't see any signs of weakening there.

CHAIRMAN VOLCKER. You have so many holes in Texas that after a while, it's going to--!

MS. TEETERS. You're talking about Texas [unintelligible]?

MR. BOYKIN. No, it's the [unintelligible].

MS. TEETERS. It's far and wide; it's headquartered out of Houston is what it is.

MR. BOYKIN. Yes.

MR. SCHULTZ. There have been more oil wells drilled in the continental United States than in the rest of the world put together.

MR. BOYKIN. The unfortunate thing is that they don't always [succeed]. I know of one plot that was a dry hole.

Nonresidential construction continues very strong. And there are a number of local government construction projects under way. Just as an example, in Dallas at the end of last year we had a little over 41 million square feet of office space. We are projecting an additional 29 million in the next four years. Most of that is under construction or firmly announced, so we'll be up to 70 million square feet. Houston, of course, is now as strong as Dallas or even stronger. It's going on in San Antonio [and] even out in Midland, Texas, in the western part of Texas; a lot [is related to] oil activity. On the [unintelligible] they're putting up a 40-story building; I just hope it will stand up when a sand storm comes. As for manufacturing strength, it's just concentrated in those industries supplying the energy and nonresidential construction sectors. On the financial side, I've not heard what Ed has heard. I will say, as opposed to questions of immediate concern, that I do sense that people are beginning to wonder a bit about what the next few months are going to hold down our way. But, as far as any specifics, we don't have any. I was talking to one small businessman in the franchising business and he said they've slowed down a bit because they're trying to franchise nationwide and it's a little slow in other parts of the country but in Texas they're still opening new stores.

CHAIRMAN VOLCKER. You need a McDonald's by every 70-story office building!

MR. SCHULTZ. You mean an oil well by every 70-story building!

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I'd just like to follow Bob to say that one half of our District--the western part comprised of two or three states plus Oklahoma--would fall in the category that he has just described, and it's largely related to energy and energy development. They continue to put down holes, successfully finding gas and oil in Wyoming, Colorado, and in Oklahoma. There is a commercial building boom in Denver, as Bob has described in Dallas and Houston, whereas the rest of our District--and I'm speaking largely of Kansas City and the Omaha area--does not share in that particular activity. On the other hand, in the agricultural sector we've enjoyed one of the best crop seasons that the District as a whole has experienced in many years. The cattle and hog industries, although marginally profitable, appear to have a somewhat brighter outlook. However, the--

CHAIRMAN VOLCKER. You think the cattle is marginally profitable?

MR. GUFFEY. Yes, marginally profitable at the moment.

CHAIRMAN VOLCKER. Thank you. I had a bunch of cattlemen in here on Friday and they weren't very happy.

MR. GUFFEY. Well, some of them say they're losing from $30 to $100 a head, but they continue to lose that every year and remain in business and drive Cadillacs. It's a rather strange operation. But the fact of the matter is that the outlook for the profitability of the red meat industry [in] the high plains area is much brighter than it was, say, a year ago. By the same token there just does not appear to be any evidence of additional upward pressure on food prices stemming from the cattle/hog meat prices that may result from the [somewhat brighter outlook].

CHAIRMAN VOLCKER. What do you see going on in land prices--I was asking those fellows on Friday about that--and in house prices too? These cattlemen who were very upset conceded that land prices weren't going down and might still be going up a little because of all the outsiders coming in and buying land.

MR. GUFFEY. The latest information we have is that farm prices have gone up but only marginally. They have been essentially flat recently, with some increases in prices but not nearly to the extent that they rose over the last 3 or 4 years. The rise has slowed considerably. And residential prices are flat or actually decreasing, at least in the eastern part of the District. In the western part of the District, they can't build houses fast enough to accommodate the growth, particularly in the Denver area. So, prices have not subsided there.

MR. PARTEE. They're still building houses in Denver, Roger?

MR. GUFFEY. Yes. As a matter of fact, within the last 30 days there was an announcement of one of the largest developments in the Denver area--the project is over $1 billion--to be undertaken. It's well financed, no question about it being--

MS. TEETERS. You have some boom towns, don't you? Up in the Wyoming and Montana areas, don't you have some towns that are starting from scratch and--

MR. GUFFEY. Perhaps not from scratch, but some of the areas are [unintelligible]. In the coal or other energy-related industries, both oil and gas, we have some camp cities where people are housed essentially in temporary housing simply because they are in boom communities. That's particularly true in Wyoming and on parts of the western slope of Colorado. One thing that I would like to mention is that I have met with the homebuilders in our District and probably the rest of the presidents at least and perhaps the Board members will have an opportunity to meet with homebuilders also. I hear two curious comments. One is that they're about to go out of business and they need some relief. By the same token, and almost in the same breath, they say that they believe Federal Reserve policy to be the correct policy and thus they feel uneasy about even coming to talk with us. They recognize that the relief they need is legislative relief rather than an easing of interest rates through monetary policy. It seems to me a rather curious turn. I understand that today is the day they're going to present keys to everybody. I met with them last week and their message is for the Federal Reserve to hold tight but that they need relief.

MR. SCHULTZ. That's the [view] nationwide. It's everywhere. It's really remarkable. I have been meeting a lot with homebuilders; I went up to Boston to talk to the board of directors of the National Association of Homebuilders. Would you believe that their board of directors is 1800 people? That was exactly the [sentiment]: I'm dying, what are you doing to me? But you have to hang in there and get rid of inflation.

MR. GUFFEY. As a matter of fact, I know that you were up there. Our homebuilders spoke of your speech to the board of directors.

MR. BOEHNE. They talk about the federal deficit. I've met with some of them and they talk about how the deficit ought to be shrunk. They realize that's not the Fed's problem but they just want us to listen. I found the same thing, actually. They were remarkably understanding; there was a commitment to what the Fed is doing [along] with these same cries that something has to be done. But when you talk to them they tend to push the blame off on Congress or wherever and not so much on the Fed. In their more emotional moments, they--

MR. CORRIGAN. You have to understand, though, that when they talk to Congress, they turn the whole thing around.

CHAIRMAN VOLCKER. Don't kid yourself. I think without question there's a lot of support now. There's a lot of concern about the budget deficit and a lot of understanding among business leaders and association leaders in many areas. But there's a lot of anger growing out there. It tends to be: The Federal Reserve controls interest rates and the Federal Reserve ought to do something about them. It's not exactly below the surface. And when it will erupt like Mt. Vesuvius, I don't know.

VICE CHAIRMAN SOLOMON. But the reaction in the Congress since they came back is exaggerated in terms of business opinion for the reasons that have been talked about. The Congress is frustrated and is receiving an enormous amount of criticism, much of it having to do with the budget deficit. And when members of Congress talk to you and other members of the Board here in Washington I think they are reflecting not a focused criticism of the Fed but a general criticism of conditions by their constituents. I'm not saying that the Fed is exempt, not by any means, but I wouldn't interpret the Congressional complaints regarding how their constituents feel about the Fed and conditions as being focused on us. That is the way it comes out of Congressional mouths. I have talked to a few Congressmen up in the New York area and we got into this shading--

CHAIRMAN VOLCKER. Well, I think you have to make a distinction. A lot of [the criticism] has been focused on the budget deficit, fortunately, which is where it should be. On the other hand, for both political and real reasons, I'm very skeptical of how much progress is going to be made on the spending side. The Democrats don't have much incentive; they're fairly happy. The Republicans are worried; they feel they've cut spending. It's going to be very hard to make the next cuts. There will be some but how much relative to the size of the problem is very questionable. I think you've talked to fairly sophisticated people; I'm talking about the people who are a little less sophisticated perhaps. And they're just getting angry.

MS. TEETERS. It's compounded by the fact that the original rounds of cuts are just being felt. Most of them just started the middle of last week so that the reactions, particularly by state and local governments and recipients of transfer payments, are just now being felt.

MR. BOEHNE. I had 8 or 9 people in for lunch a couple weeks ago and I asked them how many of their Congressmen who voted for the tax and budget cuts last time would vote for them this time. I found about eight Congressmen represented and the group thought that two would not support another round of budget cuts. It wasn't a very big margin at the beginning, so two out of eight represents--

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I want to make just one additional comment about the agricultural sector because it's a change from what I have reported at previous meetings. I have commented in the past that rates have had a negative impact, but within the last few weeks there has been a growing wave of pessimism. I'm really now talking about the grain side as opposed to the meat side. Production figures keep going up and, therefore, prices keep coming down. And net cash income for the farmers in our area is being reduced rather continually. It now looks as if income for this year will be lower than in any year since 1977. And that's unadjusted for inflation. If you adjust for inflation, you have to go back a long, long way to have a year that is going to be like this year. About 40 percent of the farms are debt free and are not impacted by [high interest rates]; 60 percent have some debt and, therefore, this is a very significant problem for them. Here again, the lenders are beginning to get very uneasy about their agricultural credits. They're worried about debt coverage ratios, the leverage, etc. So, the farm industry in our area is getting very concerned.

CHAIRMAN VOLCKER. Well, we've exhausted this subject. We can turn to Mr. Axilrod.

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

CHAIRMAN VOLCKER. The subtleties of Mr. Axilrod's analysis may not be fully grasped by the Chairman in all respects, but we can perhaps clarify [them in] the discussion. Mr. Roos.

MR. ROOS. Steve, would you repeat the part near the end of your statement where you spoke of an increased demand for M-1B having some effect on the necessity of trying to get M-1B up to the lower end of the range? I was lost.

MR. AXILROD. I was just thinking that in the last 3 months of the year it's possible that there may be some rebound from this very low growth that we have had in M-1B. The rebound in itself could tend to increase M2 because I was assuming that it wouldn't necessarily mean that people were taking deposits out of other components of M2 and putting them in M-1B but simply were putting more money in M-1B in general that they would have put other places because they realized their cash was low relative to what they normally would expect it to be in relation to income.

MR. ROOS. In terms of positioning ourselves, Mr. Chairman, it seems to me that we have to think of our vulnerability from a public opinion point of view if the economy remains soft, as it probably will, to the end of the year. If we visibly fail to bring M-1B into its range, won't people who are exaggerating the effect of so-called tight policy by the Fed have something to hang us with when they actually see that M-1B has come in below [its range]? I don't know whether that's a greater danger than the possibility of some misinterpretation of [the growth that] would be necessary to bring it into the range. It seems to me, if we are thinking of public opinion --and maybe we shouldn't be--that the question is whether the heat of coming in below the range and being accused of precipitating a recession is greater or less than the possible misinterpretation of a degree of temporary expansiveness to bring M-1B into the range. Those are two fundamental issues [that bear on] public response. But maybe we shouldn't be concerned about that aspect of our policy.

MR. PARTEE. Steve, didn't you say 12 percent growth from September to December does not get us back to the range? That is, December is back to the track, but people will still be able to read the fourth-quarter-to-fourth-quarter growth even then, as I read the Bluebook, as 3 percent rather than 3-1/2 percent.

MR. AXILROD. That's right, given the patterns of the months within the quarter. If it so happened that October was a very strong month instead of November and December, you might hit [the lower limit of the range]. We were assuming October will be--

CHAIRMAN VOLCKER. This arithmetic gets rather drastically changed by the estimates of the money supply for the past two weeks, of which one week is still doubtful. And the first week in October may also be doubtful; we don't know very much about it. Let me ask one purely statistical question, Mr. Axilrod, so we know what we are talking about here. It may be covered in the Bluebook. Even in alternative C, let's say, which is 9-1/2 percent for M2, we are above the range. That half percent is your estimate of a somewhat extraordinary impact of all savers certificates or something?

MR. AXILROD. Well, the best we could come up with is that the range of impact would probably be on the order of 1/4 to 3/4 of a percentage point.

CHAIRMAN VOLCKER. There is some assumption that [money] comes into all savers out of what would otherwise be in M2. Where is that from and what evidence would you have for it when it happens?

MR. AXILROD. We have virtually no evidence.

CHAIRMAN VOLCKER. You haven't any evidence; you wouldn't have the evidence now because you don't know the statistics. But where would you find that evidence?

MR. AXILROD. Well, we are going to ask questions in the Michigan survey of an admittedly small sample. We are going to ask those who have all savers certificates, what was the immediate source of those funds. That would be the only direct evidence we would have; otherwise it would be a matter of analyzing the data that we have available.

CHAIRMAN VOLCKER. Well, presumably, you would look where: for individual holdings of Treasury securities or something?

MR. AXILROD. We would want to look for unusual behavior of time and savings deposits and money market funds. If they began to behave unexpectedly relative to what--

CHAIRMAN VOLCKER. Yes, but they are all in M2, let's say.

MR. AXILROD. Oh, yes. But if we could account for everything that happens to all savers certificates from that, that doesn't leave much residual for [funds coming from] elsewhere. Essentially in this assumption we have assumed that in the fourth quarter only about $3 to $5 billion comes out of non-M2 assets other than retail RPs, and we have assumed that two-thirds of the retail RPs--$10 billion out of $15 billion of RPs--goes into all savers certificates. The reason that I am uncertain between the 1/4 and the 3/4 of a percentage point is that we have to make a further assumption regarding how much of those retail RPs would have come out of M2 to begin with or how much would have come out of non-M2 type assets. We have essentially assumed very little, really, coming out of non-M2 assets. It's practically negligible if you eliminate the retail RPs and they were in M2 in any event.

CHAIRMAN VOLCKER. Will you assume those are in M2? And you say apart from that you are only estimating $5 billion or so.

MR. AXILROD. Yes, $3 to $5 billion. About a 1/4--

CHAIRMAN VOLCKER. That only makes 1/4.

MR. AXILROD. That only makes 1/4 added to this.

MS. TEETERS. Is that an addition to this 9-1/2 percent [growth for the year] in alternative C or is that [included]?

MR. AXILROD. No, [M2 growth for the year] would be 9-1/4 percent, abstracting from that.

MR. RICE. Steve, did I hear you say that if we tried to increase M-1B so that it moves back toward the lower end of the target range from where it is now, given the demand for M-1B, that would in effect be inflationary because we would be giving people more money presumably than they want to hold? Is that correct?

MR. AXILROD. Well, what I said was there's a degree to which it would be; we think it would entail a sharp drop in short-term interest rates over the next 2 or 3 months.

MR. RICE. Any increase in M-1B?

MR. AXILROD. No, [raising its growth] to that 12 percent, which would be needed to get it back [into the range]. And if you happen to think that there's a sizable pent-up demand for goods and services, as some of us on the staff think--some may not--then we could have a very sharp rebound in spending and a sharp rebound in interest rates later in order to keep money under control. And if that large money growth sets off a sharp rebound in spending, I think the progress made in curbing inflationary expectations would be lost. That's one analysis that one could make. If you think the economy is extremely weak in any event and no one is going to do much when short rates go very low, then you might not come to that conclusion. That's what I was saying at the end of my statement.

VICE CHAIRMAN SOLOMON. Steve, does it make sense to continue doing the adjustment for the shifts into NOW accounts?

MR. AXILROD. Well, I think it made a lot of sense earlier, obviously. It has been making a degree of less sense, but I think we need to have a shift adjusted series to evaluate the year properly. Therefore, it has been our thought that we might as well continue at least until year-end, just because that is what we have done for the last several months, and at that point change over. We would have to keep presenting a shift adjusted series even if we didn't shift adjust each month. If we said the shift adjustment was now in effect zero, we would still need a shift adjusted series for the year. So it just seems simpler to continue on to year-end; the differences are small now.

CHAIRMAN VOLCKER. Do you have currently any direct evidence of what the basis for this shift adjustment is?

MR. AXILROD. Very little. We are getting less frequent data on the shifts and we have not changed our assumption. One piece of evidence is that we do have data that new NOW accounts are still being opened at a sizable pace. But we can't tell what is happening to the deposits in the NOW accounts that were opened earlier this year. That money could be going out.

CHAIRMAN VOLCKER. But you have evidence that new NOW accounts are still being opened and that some significant proportion is coming from outside of demand deposits?

MR. AXILROD. Well, we have stuck with our past assumptions; we only get survey data on that about every three months now instead of every month, so I'm not exactly up to date on it.

MR. CORRIGAN. Steve, I have a technical question on a different subject. I can't quite understand the recent relationship between the reserve numbers and the money numbers. One of your tables shows, for example, that you estimate that total required reserves in September grew by 17.9 percent. I know we have all these shifts going on in terms of reserves phasing up and down and across and all the rest, but when I look at the components across the board, it's very hard for me to see where one can find anything that would account for that much of an increase in required reserves.

MR. AXILROD. Well, in September, in terms of amounts--this is under a lagged accounting regime--we have a $592 million dollar increase in required reserves, which is the 17.9 percent at an annual rate that you referred to. Of that amount, $319 million is in savings and time deposits, which is mainly large CDs in that period. [Most of] the rest of it is in transactions deposits, which include OCDs, demand deposits, U.S. government deposits, net interbank deposits, and telephone transfers. And the remaining $4 million--I had to do this accounting--was in nonmember commercial banks and others and can be accounted for, with the large bulk of the increase coming from items that are not in M-1B. If you pretend that the accounting was contemporaneous--

MR. CORRIGAN. Oh, that's right; you're picking up that big August jump.

MR. AXILROD. That's right. It would be a quite smaller increase.

MR. PARTEE. But in September M-1B went up not at all.

MR. AXILROD. That's right; it's only the last two weeks of August and the first two weeks of September that get into this. If you pretend that it's contemporaneous, then the transactions deposits part is in September and instead of being [an increase of] $269 million it's only $49 million. Don't forget that currency was quite negative. So, if the rate of growth in total reserves in September on a contemporaneous basis, so to speak, is 7 percent, [growth in] total required reserves is 7 percent. Total reserve [growth] on a lagged basis is much higher.

MR. CORRIGAN. Those large CDs are still at what--3 percent?

MR. AXILROD. They're phasing down to where they're 5/8ths of whatever they were originally, which was, I keep forgetting--maybe 6 percent.

MR. PARTEE. I think it was 6.

MR. AXILROD. 5/8ths of 6.

MR. CORRIGAN. Oh, that's right.

MR. AXILROD. They're down now. Starting in September they are 5/8ths of 6 percent.

CHAIRMAN VOLCKER. Is it 5/8ths of 6 or 5/8ths of the difference between 3 and 6?.

MR. AXILROD. It's 5/8ths of the difference between 3 and 6--that's where we are--slipping to zero.

CHAIRMAN VOLCKER. You may be interested--this sounds like a little more reliable report--that Mr. Sadat clearly was hit, but they say no vital organs were hit and he's being operated on and said to be not critical.

The observation was just made--it's a peculiarity and I don't know if anybody has a logical explanation--that the weakness in M1 partly reflects an extraordinary weakness in currency in terms of general trends. Governor Gramley.

MR. GRAMLEY. Well, I want to compliment Mr. Axilrod on his statement this morning. I've heard him and his predecessors make many statements over the years, but I don't think I've heard a more weighty or meaty set of comments given to this Committee. I particularly liked his comments about the need to look at what is going on in the real economy to make some ultimate judgment.

MR. PARTEE. We do tend to forget that.

MR. GRAMLEY. That's particularly apropos when these monetary aggregates are so slippery and so difficult to interpret. I think we have ended up with an economy that has had more restraint on it during the course of this year than we had expected earlier. And, frankly, we have had more restraint than I personally would have wanted in the sense that I think our objectives over the long run are not likely to be maximized by permitting the economy to slip into a couple quarters of negative growth like this. If we could somehow fine-tune--and I'm not suggesting we try--and keep the economy growing at zero or a slightly positive rate, I think we would be better off. The pressures to do something to turn it around are going to intensify if we continue to have negative growth. The structural damage that is being created is also growing, and I strongly agree with Ed Boehne that we have a real problem there.

[Steve's] comments about M2--as to why M2 can be a very slippery guide--I thought were particularly interesting. When we watch M2 and try to limit it, we induce innovations that in turn tend to make M2 continue to grow. As a consequence, interest rates go up and that weakens the economy. So, if we slow the growth of M-1B even more--. I look back at the past couple of months and I wish I had listened to my colleague, Governor Partee, about why we need to pay more attention to M-1B in a period like this. I think one of the things we need to do in our decisions today is to make sure we don't do what in effect we have done in the past couple of months, which is literally to ignore M-1B. We have given almost entire weight to M2, the way the period worked out. That wasn't what we intended, but that's the way it happened. I don't think we can adopt a policy today that is designed to make M-1B get back up in the target range by the fourth quarter or by December. That would just induce a collapse of interest rates. We would have the economy growing like gangbusters in the first half of next year and then we would be in real trouble. But what we do have to do, I think, is to make sure we pay more attention to M-1B than we have in the recent past.

CHAIRMAN VOLCKER. Let me just pick up on one point you made. I have no doubt about the enormous weight of Mr. Axilrod's presentation. But the point about M2 I must confess went right over my head.

MR. GRAMLEY. Maybe we ought to have him repeat it. It was a good point.

CHAIRMAN VOLCKER. He can repeat it, but he's going to have to repeat it in different words so far as I am concerned.

MR. AXILROD. All I had in mind, Mr. Chairman, was that M2 is increasingly becoming like that because it has money market funds, money market certificates, and small savers certificates in it. If the System is holding back on reserves, let's say, in a period of strong money demand, interest rates go up. If the return on these instruments that are in money deposits doesn't go up, then you'll get restraint on money relatively easily, in effect, because people will shift out of deposits into something else.

CHAIRMAN VOLCKER. You'll get restraint on M2 relatively easily.

MR. AXILROD. If the money definition covers only things that have market interest rates on them, then as we hold back on reserves in the face of [strong] money demand, market rates tend to go up. The banks and other financial institutions raise their offering rates on these deposits so that the gap between the market rates and the deposit rates, in effect, doesn't change very much. People still demand those things because that gap hasn't changed. We have to hold back on reserves even further; that forces rates up more.

CHAIRMAN VOLCKER. I understand all that; M2 doesn't decline the way it used to when we would run into deposit ceilings.

MR. AXILROD. Well, no, I didn't mean that. What I meant was that interest rates move more rapidly than they used to.

CHAIRMAN VOLCKER. And interest rates may move more rapidly as a result of that. I don't understand that it follows that M2 is in some sense artificially swelled by this and gives you a--

MR. AXILROD. No, I didn't say that. I said the nontransactions component will rise relative to M-1B in this present environment.

CHAIRMAN VOLCKER. That I agree with. It rises relative to M-1B. But I don't understand that it follows that M2 is in some sense artificially--

MR. AXILROD. No, no.

CHAIRMAN VOLCKER. Artificially isn't the word. I don't understand that the expansion in M-1B is giving a false signal as to the credit growth in the economy or the monetary growth in the economy.

MR. AXILROD. No, my only point was that given this behavior of the assets in M2, if there was increasing need in the context to constrain M2, it would follow that M-1B would be weaker than one might have "expected." I also think short rates might have been somewhat higher than the staff was predicting all along. They probably are a bit higher. And my only evidence that this was real restraint is that the short rates in real terms were quite high. They are not only nominally high short rates; they are also high, in quotes, "real" short rates.

CHAIRMAN VOLCKER. I guess I don't see the conclusion from what has happened that in some sense we were tighter than we intended to be. Also, if I may just make a point here, I don't think it is accurate to say we haven't been following M-1B. The borrowings have gone way down, particularly with the sinking spell at the end of September. M-1B obviously isn't as high as we intended, but I think that is why borrowings have gone down. We didn't make some discretionary adjustments we could have made. But, certainly, the fact that pressures on reserve positions have eased as much as they have is because we were looking at M-1B.

MR. AXILROD. No, what I was saying is that to the degree the Committee gives more weight to an aggregate that has market rates as offering rates, you get a prompter response in interest rates, I think, than you would if you give weight to something that doesn't have such rates. And in the limit--

CHAIRMAN VOLCKER. I [don't] know if it's prompter; you certainly get a larger one.

MR. AXILROD. That's right. And, in the limit, if you had an aggregate that only had market rates in it, I would see almost no way to control it except through control of the economy itself. If you conceive of something where rates kept going up, finally you'd get GNP so weak that the transactions demand for that aggregate or the savings demand--. But, obviously, we are not at that stage.

MR. ROOS. What is the rationale that if short-term interest rates decline that might result in stimulus to the economy beginning next year? And what were the negative consequences of that? I don't know whether it was Lyle or someone else who said that.

MR. GRAMLEY. Well, I can tell you what I would regard as the negative consequences, and that is that I agree with Governor Schultz that we have the potential for a big breakthrough on union wages next year. Union wages have gotten way, way out of line with non-union wages. You close that gap in one or two ways: Either non-union wages catch up or union wage growth slows down. We need a very sluggish economy in 1982 to make reasonably certain that that gap is going to be closed by a slowdown in union wages. But I don't want an economy that's sluggish by having it nosedive and then come roaring back again.

CHAIRMAN VOLCKER. We have all kinds of problems. You mentioned one kind of perceptual problem, Larry. I guess Lyle and others are worried about both perceptual and real problems in other connections more related to interest rates. Let me tell you just from a public relations standpoint that there is great restiveness and anger, as I said before, growing out there. That would be relieved, obviously, by some decline in interest rates. But in some way the worst thing that could happen to us is to have a great sense of relief for a month or two or three that interest rates are coming down--I'm now talking public reaction and not policy--and then have them racing up again. I think the public patience for climbing up the hill very rapidly again may be extremely limited.

MS. TEETERS. Public patience for staying on top of the hill won't last.

CHAIRMAN VOLCKER. Hence, public patience is getting limited in all directions. It's a question of--

MR. PARTEE. A technical point on M2 that I would make, Paul, is that we have to remember that we are factoring in new elements of market-related rates as time goes on. That can give a first difference in M2 that we are coming to a steady state.

CHAIRMAN VOLCKER. Well, to the extent funds come in from outside M2.

MR. PARTEE. They tend to because we have more [components of M2] that are at a market rate, and the staff didn't take that into account when they gave us their ranges at the beginning of the year. And, by the way, the Committee didn't take those ranges; we reduced the ranges, as Nancy often points out.

CHAIRMAN VOLCKER. It's a simple common sense analysis that I have used on many occasions. There are some institutional changes that have depressed M1 and increased M2. It must be the case since there is a discrepancy between them. We didn't have to operate on both of them, I suppose, but certainly the discrepancy is bigger than expected. Governor Rice.

MR. RICE. Well, Mr. Chairman, first of all I'd like to say that I agree with a lot of what Governor Gramley said the first time. I'm not sure about his second statement.

MR. GRAMLEY. Why not all?

VICE CHAIRMAN SOLOMON. What he said the second time he said the first time, too.

MR. RICE. No, not quite. I think the staff forecast is about right. I agree with their view that there's no solid evidence at present that the economy is in the process of a sharp downturn, despite the softening tendencies that we see. But it seems to me there is a danger that the weakening that we see in progress will gain momentum and could possibly become cumulative. That is just a possibility. I don't see it, but it's possible. And much of what I've heard this morning increases my anxiety that there may be more financial strain out there than we recognize at the moment. One possible result of that is that a downturn could gather momentum. In the circumstances, I think our policy should seek to avoid encouraging any process of a cumulative downturn. It would not do that, I believe, if we accepted a much lower rate of growth in M-1B than was targeted. On the other hand, I think policy should avoid any attempt to achieve a precipitous easing of money and credit at this time. What we should do is to aim at maintaining current conditions while gradually trying to nudge M-1B back in the direction of the lower end of its target. It may well require some slight reduction in interest rates to maintain current conditions, but I think that would be desirable at the present time. This suggests to me that alternative B would make the most sense in the current situation.

CHAIRMAN VOLCKER. Let me just suggest that we can break pretty soon for coffee but that anybody who wants to make some general comments of the sort that have been made do so. I think that is useful. Let's dispose of that before asking everybody to make a [specific policy] comment. If the spirit doesn't move anyone, we'll go and have some coffee and come back and get more specific.

MR. WALLICH. Well, it seems to me we're seeing again what is the nature of a stable money supply target. It leads to very wide swings in interest rates. That in turn leads to possibly wide swings and very quick swings in the economy, with a ceiling placed over expansion and a floor probably placed under any contraction, but unfortunately with a great deal of damage being done to the machinery while these gyrations proceed. So, I'm concerned about a move to get back on track with M-1B. I think we're better off considering that as progress against inflation and money in the bank and not trying to undo it. I think we're in danger of repeating 1980. And back in 1980 I said that we were in danger of repeating 1971-79. We didn't do that; we did much worse. [I'd] preclude any risk on this score here. I do have to say, contrary to the implication of what I've said so far, that if I understand Steve correctly about M2, it sounds as though he is saying it's perversely interest elastic. That is, the higher interest rates go, the faster it grows. For that there is a precedent in the British experiment with sterling M3. They made that their number one target and it kept growing very fast. The implication seems to be that it attracted funds from outside the monetary aggregates, out of non-monetary assets, and so it grew faster the higher interest rates went and, therefore, substantially misled them. Evidently the aggregate they should have looked at was more nearly M1.

CHAIRMAN VOLCKER. I'm not quite sure I heard Steve saying that.

MR. AXILROD. No, I was saying--

CHAIRMAN VOLCKER. I thought I might have heard him say that the first time around; the second time around, I don't think so.

MR. AXILROD. No, I was saying that there would be a tendency for that to occur because the depository institutions would raise the rates pari passu with market rates. And to the extent to which the Committee was determined to hit M2--and it probably could--that meant that rates would have to move up even faster, at the limit to the point where income was so affected that there wasn't enough savings to put in M2.

MR. WALLICH. Well, that's exactly what happened in England. Income was affected so much by high rates that M2, which after all is largely a function of income, slowed down as they achieved their sterling M3 [objective]. They got it under control but precisely by the route you described.

MR. PARTEE. Which was a big recession.

MR. WALLICH. It was a big recession. Now, on the other hand, I see M-1B--

CHAIRMAN VOLCKER. I'm not sure that's saying anything but that that's the way monetary policy works whatever M you use.

MR. WALLICH. No, it worked excessively. In other words, had they been guided by M1, they probably would not have been as tight as they were in pursuit of an ever rising sterling M3.

MR. PARTEE. I think that's right.

MR. WALLICH. Well, I have the same doubts about M-1B. However, I think it is underspecified, whether you call that a very strong demand shift, high velocity growth, or whether you say that some part of money market mutual funds or other [liquid assets] ought to be included as transactions balances. In any event, it seems to me that it is potentially misleading to take it at face value and, therefore, some undershooting of M-1B as now specified doesn't seem to me to be as important as it would otherwise. That gets one back, of course, to looking at the real economy and looking at interest rates. Now, as I see the real economy, I recognize that we've had a very poor growth performance. But we've not had that bad a performance in unemployment; 7.5 percent is bad but it isn't as bad as one might have thought we would get from this degree of restraint; presumably, productivity is the main cause. So, I think we have to resign ourselves to low and occasionally negative growth for a while. Interest rates presumably will come down somewhat. I think if the public perceived that as an easing action, we would throw off altogether the wrong signal; we would get people saying that we've stopped fighting inflation and are starting to fight recession. And, I think the businessmen and bankers who say "We're hurting, but hang on" are precisely conscious of that. Then we would get another round and face the same problems at higher rates of inflation and, therefore, higher rates of interest. It's better to sit it out this time.

CHAIRMAN VOLCKER. Governor Schultz.

MR. SCHULTZ. Well, I want to take off from a comment that Mr. Roos made on the subject of credibility. That's an issue that all of us have wondered about and thought about, particularly in view of the fact that there is a lot of pressure on this institution. We've had a lot of bills introduced in the Congress to restructure the Federal Reserve or to do away with it or, perhaps the one that makes the most sense, to impeach all members of the Open Market Committee! At any rate, it strikes me that our credibility is not at issue when it comes to whether we hit the bottom of the target on M-1B or not. Our credibility is really at issue in the more basic question of whether we are going to do the job that I think we were in essence created to do. It seems to me that the basic function of a central bank is to avoid deflation on one hand and inflation on the other. And I'm not terribly sure how successful we can be fine-tuning in between. My feeling is that maybe we shouldn't call this the moment of truth because it's going to be a lot longer than that. It's going to be a period of truth. I don't fear all of these bills that are in the Congress to change the Federal Reserve if we do our basic job of finally getting inflation under control. If we don't do that job, then what the heck is our reason for being? How do we justify our existence under those circumstances? It seems to me our basic raison d'etre would be gone. So, I think that's where the credibility issue is: whether we are in fact going to do the job that we were created to do. We've been criticized in the past, and I think a lot of that criticism is proper. But now we're at the point where we have to carry through and get the job done. I'm certainly not attempting to say that we ought to crush the economy but we just can't lose sight of the basic fact that what we're trying to do is to keep that steady pressure on--we have some luck here in food and fuel prices--and if we keep the pressure on, we can get some movement in the wage-price structure and begin to get this spiral going in the other direction.

So, I for one think alternative C is the one that makes the difference. I agree that M-1B has problems and that M2 has problems, so it seems to me sensible to look at both of them and in some way to incorporate both of them in the directive. I would get terribly worried about going much faster than [alternative C] on M-1B because what happens, then, when we get to January? Not only do we run the risk of stimulating these latent demands--. Mr. Roos asked what difference interest rates make. Well, it strikes me that we've been keeping the interest-sensitive sectors of the economy under a great deal of pressure. And if interest rates do go down, that has a stimulative effect on those sectors of the economy. And then what do we do when we get to January if we're not going to pick targets that are lower than what we have here? If we're going to go to 6 percent or even faster [M-1B growth at this point], what happens then? Do we then tighten the screws and get the up and down effect again? So, anything that's faster than "C" would worry me.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. Well, I'll just make a general comment.

CHAIRMAN VOLCKER. Pardon me? We're just making general comments.

VICE CHAIRMAN SOLOMON. Yes, I understand. The conventional Wall Street view that you can't get inflation down without a significant recession is still heard in the financial community, but they all admit that if it's a typical short, sharp recession--six to nine months of downswing--it probably won't do much for inflationary expectations. People in the financial community and in the business community would expect that when the economy recovers the inflation level would then be back again at somewhere near the earlier level. I feel very strongly--I think many of us do, and I think Lyle and Henry were both saying this although in slightly different sounding ways--that we really need a sustained period of zero or very low real growth to change inflationary expectations. And, politically, in terms of the tolerance for our monetary policy, it also is somewhat better than the roller coaster. In addition, this time, given our present techniques, if we have a roller coaster in the real economy, we're likely to see the Henry Kaufman thesis prove true: That if we have a sustained upswing next year, interest rates will go to levels even higher than they did in the earlier peak.

From all that, I conclude that we should try to follow a policy that focuses on what interest rate levels [we need] over the next few months and what path we should take to give us an economy that is neither in significant recession--or not even in technical recession if possible--and yet avoids the kinds of conditions that will lay a basis for an explosion later on. There is an enormous amount of pent-up demand. I find [staggering] the amount of bond issues that corporate executives passing through my office talk about being ready to start placing if interest rates come down just 2 or 3 points. Now, obviously, some of that will recede when interest rates do come down, if they do, 2 or 3 points in the long end of the market; some of them will want to wait for another 1- or 2-point drop. Even so, there will be an enormous volume of activity in the bond market and activity in the economy if we have too big a decline, if we repeat the 1980 pattern. So, given the confusion in the aggregates--given the fact that we're undershooting one and overshooting the other and all these changes that have been talked about--it seems to me that we ought to be a little more sensitive to the implications of interest rate movements in terms of their impact on the real economy in order to achieve, hopefully, the zero or slightly positive real growth that we've been talking about.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Mr. Chairman, I would mention the fact that the fiscal outlook has changed rather substantially since our last meeting, and that's going to have an expectational effect that will probably put us to a much greater degree at the friction point here in terms of our struggle. I don't think we should ignore that aspect.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I just have a quick comment. I agree with Tony that what we have to do is run our strategy for the long pull because it's going to take the long pull to get inflation down. I think it would be a very serious indictment of the Federal Reserve if it encourages a recession of size in this environment. I read the history of the Federal Reserve as indicating it was set up to provide an elastic currency, not that it was set up to stop inflation and pay no attention to the economy, Fred. Indeed, I think that's the thrust of the whole first 50 years of the System and its origins. What we have to do is to avoid seeming to add to a strong recessionary thrust, because I think we will lose the ball game if we do that. Now, I believe that serious protracted shortfalls from the lower end of our targets will give us exactly that image. I would not be so worried if M-1B in the next three months goes up 7 or 8 percent. That would be all right; we'll be below the target, but that's all right. What I'm worried about is that we'll have another 5-point shortfall from what we expect in the fourth quarter as we did in the third. And I think we have to guard greatly against that problem.

CHAIRMAN VOLCKER. If nobody else is thrusting their hand upward or whatever, we'll go have a coffee break.

[Coffee break]

CHAIRMAN VOLCKER. [In response to your question about Mr. Sadat,] he's either dead or alive, and that's all we know.

MS. TEETERS. Has there been a market reaction?

CHAIRMAN VOLCKER. The dollar was up some, but not all that much. The gold price is up pretty far. Our intervention policy isn't associated with it.

Well, I think we can proceed with somewhat more precise comments at this point. I don't know right now if I have anything in particular to add. I don't have much faith in any of these projections, I must say, as to the statistical relationships between borrowings and the money supply or interest rates or whatever. I think we have to assume that those relationships are highly unstable, to say the least. And the probability distribution around these estimates, if they are perfect as a measure of the central tendency, is enormously wide. I don't think anybody really has the faintest idea what the money supply is going to do on its own in the next month or three months. And I think we have to take that into account in making our decisions. The volatility of interest rates is a problem. The economy is soft; in some sense in the very short run there may be some risk of it getting softer rather than stronger. But there is a major risk, which a number of people have alluded to, of a yo-yo performance of the economy. That isn't going to be very helpful in terms of our longer-range objectives if it gets up a head of steam again in a time perspective of 6 months or so. Having said that much, let's proceed. Mr. Ford.

MR. FORD. Building on the remarks that a number of people have made, including what you just said, I would come down on alternative B. Our feeling in Atlanta, in looking at behavior of the aggregates, is that the alleged undershoot on M-1B is probably overrated as a worry. We feel that some adjustment should be made for the money market funds. Even if we put it at a tiny fraction of the money market funds, we would say that M-1B has been somewhat stronger than it appears in the adjusted figures. So I'm not too concerned about the undershoot, although the direction of the shift would be toward getting us back into the range. Looking at the alternatives that the staff has prepared, the one that looks most reasonable to me is something like "B" with a side constraint of some sort on M2 so that we stay around the upper end of M2 while we are at it. The fed funds range, if we are going to continue with the process, is sort of centered on where the fed funds rate has been in the last day or two, so that doesn't look bad to me either. So, I'd pretty much go with the targets of alternative B.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Well, Mr. Chairman, before we get into my specific comments on the alternatives, I'd again like to raise the question I brought up last month, which has to do with the relative weighting of M2 and M1. Yesterday I was asking Peter and Steve whether they had any particular insight about what looks to be a sudden very sharp collapse in M-1B. Steve made a very germane comment --I think we've often noticed this before--that these monetary aggregates may be telling us something about spreading weakness in the economy. One never knows that until well after the event. In any case, I would again like to refer to the way we used to give about equal weight in a judgmental sense to both M1 and M2. It seems to me that over the past several months, with the way the proviso clause has worked, there has been a risk of what I would view as overemphasis on M2, and I would hope to get back to a more equal weighing of those two [aggregates]. If we don't, we may have a real problem--at least in a public relations sense and possibly in an economic sense--of letting M1 go down too far.

CHAIRMAN VOLCKER. Let me just inject that there is an official report here that Mr. Sadat is dead.

Did you complete your comments?

MR. BALLES. At the moment, yes sir.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Yes, Mr. Chairman, I would associate my views clearly with Governor Schultz. I think alternative C is where we should be. He did a very fine job expressing the reasons, so I won't be repetitious by going through them again. But I'm strongly for "C."

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. It seems clear, at least to me, from the discussion around the table that the informational value of M-1B particularly--and maybe M2 or all the aggregates--is suspect. As a result, I think we have to refer to what I believe Governor Gramley first cited, and that is the state of the economy. The fact that we are at zero or thereabouts in real growth seems to be exactly the objective we set out to achieve. The risk may be for a further downturn in the economy; I think it's a risk that we must take. To back away from it now would be a great mistake for the Federal Reserve. Having said that, my prescription would be for something similar to the current money market conditions and, in my view at least, alternative C comes closest to setting forth what we [recently] have been experiencing. Alternative C would be my choice, with the fed funds range that is shown there of 13 to 18 percent. On the other hand, I would prefer to have a borrowing level someplace in the $850 to $900 million range, at least initially, to insure that if weakness in the aggregates does show up very quickly in October, we won't precipitously push the funds rate down and, thus, other interest rates down.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I would come out for alternative B; I think we have been too tight. If we go for "C," we might see the funds rate go back up to the top of the range, and I don't want to see the funds rate go up. I would like to see it in the 14 to 15 percent range. I think most of you who have been opting for the tighter alternatives also had the higher growth rates. I'm not sure that you have readjusted your perception of how slowly the economy is actually growing to the degree of tightness that has been prevailing over this year. So, I would opt for "B" with an average funds rate of about 14 percent, and I'm not worried about the $200 to $300 million in borrowing. I think that's about right because they will pay back as they have the opportunity. If we go with "B," we will get some easing in the long-term rates, which is what we need very badly at this point, particularly in the mortgage area and in bond rates.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I think that the economy is already in a recession and that the fourth quarter is likely to be weaker than the staff has projected, which is not a very good climate for inducing rapid growth in M-1B. But I like the objectives of alternative B, and if we could come out with a result that showed us with a small shortfall in M-1B, a slight overrun in M2 and M3, and with bank credit in the range--and if I'm right about the recession bank credit should be well within the range--it seems to me that that package should be defensible to Congress and the public.

CHAIRMAN VOLCKER. We have more than a slight overrun in M3.

MR. MORRIS. What I mean is that if the economy is weaker than the staff projection, then we will have a run-off of big CDs, which should bend the M3 line down. I would, however, change the Federal funds range to 12 to 17 percent. It seems to me that before we go below 12 percent on the funds rate, we ought to have a conference call to discuss the state of the economy. I would agree with Lyle: I would be very reluctant to see us repeat the mistakes of the spring of 1980 and in our monetarist zeal allow interest rates to get to levels that produce the big reactions. That's why I pick 12 percent as the floor.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I would go with "C." I observe that there is no alternative this time that would allow for a tightening from where we are now. It's not offered on the menu and I wouldn't know how to go about producing it.

MR. PARTEE. Just reduce all those numbers for the aggregates.

MR. WALLICH. But 6 percent on M-1B is a slight reduction from the 7 percent we were aiming at last time--though, of course, not achieving--and it seems to me fairly safe from being misconstrued. On the funds rate, I would note that a survey of 38 market people projects the funds rate by the end of 1981 at 15-1/2 percent, up slightly from where it was when the survey was taken. So, the market doesn't seem to be expecting a large decline, and the 13 to 18 percent range of alternative C, therefore, seems to me quite reasonable. I'm also reassured that these paths are likely to produce reasonable looking--in fact very tight looking--paths for nonborrowed reserves and total reserves. In retrospect, this 20 percent growth of nonborrowed reserves for the last three months looks peculiar, even though there were reasons why it had to be so in constructing the path. But a nonborrowed path of 4 percent and a total reserves path of 3 percent look extremely moderate. I think that's a plus for this alternative. My inclination for borrowed reserves would be on the high side of the $900 million to $1.2 billion range. Thank you, Mr. Chairman.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, I'm worried about the economy going down deeper than what the staff has forecast before it comes back again. I don't disagree with the overall forecast, which goes to 1982, but I think we are looking at a prospective weakness that may be of larger dimensions than the staff has put down on paper yet. In adopting a directive this time, I think we've got to give more weight to holding up the growth of M-1B and focusing less on M2 than we have in the past. I would do that by going back to a formulation in which we incorporate both M-1B and M2 into the initial stipulation rather than having a proviso clause for M2. We ought to avoid a 1980 kind of drop in interest rates, but I don't think any drop in interest rates is going to be damaging to us. Some drop in interest rates in the context of a weakening economy and very slow growth in M-1B is essential if we are going to maintain a public posture that it isn't very heavy handed inflexibility on the part of the monetary authorities that is causing all this damage. So, if we could get to an agreement on directive wording which places some additional weight on M2 [rather than have M2 in a proviso clause], then I could buy something like halfway between "B" and "C." I think Frank has made a good point: That lower limit on the funds rate in "B" of 11 percent is quite low. I could go with something like a 12 to 17 percent range.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I feel most comfortable between "B" and "C" and balancing the need to get some more growth in M1 while avoiding a bulge. Also, I'd like to align myself with those who would drop the proviso clause for M2 and put it in the Committee's initial stipulation. I think we have to give M1 and M2 equal weight and I would underscore that.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Given where we are now, and supporting Governor Schultz's comments about the possibility of making significant gains [on the wage/price front] next year, if I had to come down on one of the alternatives, I would come down on "C." But if there is a growing feeling that we could have something midway between "B" and "C," I would opt for that. I sense that there is enough noise and confusion in M2 that I would put greater emphasis on M-1B and would suggest that when we set the target for that aggregate we really try to achieve it.

CHAIRMAN VOLCKER. Mr. Schultz.

MR. SCHULTZ. Well, I've made my general comments. I feel that the economy is going to be weaker in the fourth quarter than the projection. I think we are going to have trouble keeping M-1B even at the level of alternative C. I don't see that alternative as being very restrictive, frankly. So, I would come down on alternative C, with initial borrowing at $800 million, an M2 proviso, and a fed funds range of 12 to 17 percent.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Well, Mr. Chairman, I would preface my remarks by saying that I still consider myself to be as hawkish in my desires to give top priority to dealing with the problem of inflation as one could be. On the other hand, as I recall when we set our annual target ranges this year, they represented a gradual reduction from the previous year and they were intended as an anti-inflationary program. By opting for alternative B, which I would prefer, I don't think I would in any way be relinquishing my underlying concern about inflation. On the other hand, if we are too restrictive--if we go for "C" or more of an undershoot of our targets than that--we are really digging our own grave because I think there is a relationship between the rate of M-1B growth and real output; and if real output continues to [weaken] significantly, we are going to have in our economy and in our body politic a reaction for strong stimulus next year to get ourselves out of a recessionary situation. And that poses a real threat to our long-term efforts to cope with inflation. So, alternative B is a reasonable middle ground. We will be getting up toward the lower end of our target, which was an anti-inflationary target. We cannot be accused of tolerating a continuing and persistent undershoot, which in many people's minds would be a factor in causing a further softening of the economy. I think "B" is the best solution, remembering that it is an anti-inflationary and not an expansionist alternative.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, I am not as disturbed as some members of the Committee are by the so-called shortfall in M-1B, even though I would concede in the ideal order of things that M-1B is probably what we should be looking at. When I look at that aggregate this year, shifts into money market funds, mutual funds, and even the possibility that all savers money might come out of there leave me quite comfortable with the general pattern of its behavior, particularly in the context of the broader aggregates, and in the context of what it would take to get it back near the bottom of the range for this year.

Somebody mentioned earlier that we should be conducting policy with an eye on the long haul and I certainly agree with that. I very much agree that we must avoid another of the very sharp swings in interest rates. And the point that Governor Schultz made about the trajectory for 1982 is rather critically important in that context. In the current setting, obviously, there is a great deal of attention and sensitivity focused on this Committee. [There is] a particular element of sensitivity out there to any major signs of some give on the part of the Fed. That sensitivity is particularly important among the group of people who really are important in determining what happens over the next couple of years: the business leaders who set prices; the union leaders who negotiate wages; and the institutional money managers who have to make decisions whether to buy some long-term paper or not to buy some long-term paper.

Given all of that, when I look at alternative B and see that the staff says, for what it's worth, that "B" would involve monthly growth rates of M-1B shift adjusted of 7-1/2, 10-1/2, and 11-3/4 percent out through December, I am very, very troubled by that. I think that pattern of monthly behavior, even in the context of the shortfall that we have seen earlier in the year, would run a real risk of compromising what has been achieved to date in this effort to get inflation down. And in the context of that trajectory question, it might well leave us in the worst of all worlds. In that light, I think that we clearly should be taking a very, very go slow attitude. That is reinforced, in my judgment, by the recent behavior of the reserve aggregates. And on a less technical note, it's also reinforced by a thought that the law of averages is running against us in some sense. One of these months interest rates and everything else notwithstanding, the money supply is going to jump for whatever reasons. And, in terms of the economy itself I draw some consolation from the fact that there are very sizable latent demands out there that will resurface as interest rates come down and will have a tendency to surface in any event in the environment of the tax cuts that are now on board and will be coming on line next year.

In the light of all that, I come out rather squarely on alternative C, with some disposition toward initial borrowings of around $1 billion or so. As usual, the big question is what do we do if we are not on that track as the period unfolds. There is one other comment I would like to make, too. We've all been talking about this credit problem and financial shakiness or whatever it is out there, and obviously we should be talking about it. When I think about that, the worst of all situations there for me would be for us to find ourselves getting blindsided by some development that we have totally missed in our intelligence gathering and other activities. That, too, could compromise our ability to hang in there. I also would suggest that there are things that we can do, at least in our intelligence gathering activities, to try to minimize the likelihood of getting totally surprised. And I for one would like to see some efforts made in the direction of redoubling that intelligence apparatus to try to sensitize ourselves fully to what may be out there.

CHAIRMAN VOLCKER. Mr. Balles, I guess we're back to you.

MR. BALLES. I didn't express myself on the alternatives earlier, Mr. Chairman. But I do want to allude to what I thought was very interesting work that the Board's staff has done on the likely downward shift that is taking place in money demand. Our staff was taking a look at that and pretty much concurs. What that says in practice, to me at least, is that observed M-1B may in fact be about where we are in terms of the effects of money. That takes some of the sting out of the apparent undershoot in shift adjusted M-1B. But having said that, I would hate to see us fall further behind in the transactions component. In view of my hunch that there has in fact been a significant downward shift in money demand, I would be in favor of alternative C to get us up to the lower end of the range for shift adjusted M-1B by year-end. Again I would urge that in following those paths we ought to give equal weighting, as I mentioned earlier, to both M1 and M2.

MR. ROOS. May I add one [comment]?

CHAIRMAN VOLCKER. Yes.

MR. ROOS. I think it's important that we think ahead to the end of the year into February when we're going to have to set our targets for next year. If we opt for "C" and M-1B really comes in as projected in "C," we'd have average money growth of M-1B for this year of about 1.9 percent. Then what are we going to do in February when we have to set next year's targets? Are we going to indicate at that time that we've all of a sudden become very expansive and set the ranges up to where they would be 1 percent below this year's announced targets, or are we going to reduce them further from the 1.9 percent average growth this year? In other words, if we don't bite the bullet now--if we don't get [M-1B] up there in the range--we're going to face that same concern of public perception of an expansive policy next February. And it will be even more dramatic when we set annual rates if we set them from a very low growth rate for this year.

MR. SCHULTZ. Larry, that's not the problem, though. If we did "B," M-1B would be running at a 12 percent annual rate in December. Then we'd go into the new year and let's say we set [the midpoint of the target for M-1B growth] at 4 or 5 or 6 percent or whatever we want to do for next year. That's a lot of leeway; then we'd really have to turn that screw. That's the problem we run into: If [M-1B growth] is going up like that and all of a sudden we have these lower targets, then we really have to shut down on the economy. And it seems to me that's what we want to avoid. We want the continuity of running along from here rather than getting into the kind of box that you're thinking about.

MR. ROOS. Well, I think there's a middle course between the expansionists--I won't use the expression you did--a difference between going high and going low. I do see a problem next year. If our growth has been very slow this year, we're going to have to raise it next year, aren't we? Even though it would only be in the last month, we'd have to explain if we took a more expansive approach that it was merely to get us to or near the lower end of our anti-inflationary targets for the year 1981. I may be off base. Am I?

MR. SCHULTZ. I just want to avoid this yo-yo.

MR. ROOS. We got ourselves into the problem by permitting ourselves to undershoot to the extent that we did, I would guess.

CHAIRMAN VOLCKER. Well, on that point, Larry, I think one has to average through. We can face the question when we get to February as to what we say. One thing would be to base it on the fourth quarter of 1980 and look at the two years combined if we're way short. That would also tend to take care of your problem, Fred. I agree with Jerry that we're going to have volatility in the money supply. I just wish we would have some volatility on the up side because it has been quite a while--April I think was the last month when there was a really strong [M-1B] number--and we're about due. I'm a little concerned that we may not get it because if we are in fact moving into a somewhat faster decline in business--I avoid the word "recession"--it seems unlikely that we're going to have strong money growth. So, we may in fact be facing this over the next several months. As I said before, I think we have to fall short on the year. We just can't ask for a 12 percent increase in M-1B from September to December, and even that won't quite get us there. The public wouldn't understand. It's just too radical. I could accept "B." I could shade M-1B in "B" to 8 percent, which I think would be a reasonable objective. I don't think the monthly pattern the staff has in those numbers means anything. We could have an 11 percent growth rate for December or we could have 3 percent or 18 percent. We don't have any idea what the month of December is going to bring. But I think the central thrust of our policy ought to be to begin to return to the bottom of the M-1B range, and 8 percent seems to me suitably fast to plan for. I'd consider ourselves very lucky if we get that high of a number in those last three months.

I would also agree with several who have suggested that maybe the federal funds rate range ought to be 12 to 17 percent. That's not because I don't think rates are going to come in low. Let me point out to you that the staff projection for the rate of inflation next year is 7.1 percent. Now, assume they're wrong. A lot of people think they're too low. Assume it's 8 percent. Still, these rates are too high for that rate of inflation. And in a recession environment we can't have much of a real rate and expect to get the stimulus to the economy that will bring it back. So, we might have a temporary problem with borrowers coming into the market because rates are lower than they have been. But I don't think it will last if, in fact, the rate of inflation does tend to wind down, as most forecasters now are anticipating. So, we really have to get from where we are to a level of rates, it seems to me, of about 8 to 10 percent. It's a question of how we manage that reduction in the rate level over a period of time if we want to have a reasonably bland economy. And I would, of course, change the emphasis, as suggested, away from too much emphasis on M2. I think the way that Lyle suggested is a good way of doing it. That $200 million for borrowings is at the end of the period, I believe. Steve has left the room, but I think the idea is that borrowings might work out to be $200 or $300 million by the end of the period. I think the [initial level] ought to be about $800 million or something like that.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Mr. Chairman, I get a little nervous about the 42-day gap before our [next] meeting with any of these specifications. I don't know how to assess the Sadat situation. I don't know whether we're faced with the problem of increasing retardation in business activity or whether this is temporary and the economy will bounce back. I'd hate to see us with any of these limits with a negative rate of growth of M-1B in October. That's not viable in terms of the political side. On the other hand, I don't want a precipitous rate decline. I'd rather put some sort of limit on the M-1B growth and a narrower funds range and in 20 days consult again as to what the implications some of these rather dramatic events are going to have for us. To set up wide specifications for a 42-day period I think is a mistake at this juncture. I'd prefer something between "B" and "C" in terms of the aggregates and I'd like to consult at the 13 percent level [on the funds rate]. But I'd sure hate to see that [rate] go up over 16 percent at this time until we have a better feeling as to which way to turn. By the end of the period we may have to make changes on both of these.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. Well, following up on what I said earlier, and I think a lot of other people had the same kinds of objectives: If one makes the assumption in this most uncertain of uncertain worlds that a gradual interest rate decline of a couple of points over the quarter provides the best chance of maintaining an economy that avoids recession and yet avoids an upsurge for the next quarter or so, then I would prefer the objectives of alternative B. But I don't think we will achieve the objectives of alternative B if the economy is as weak as I think it is. We have a curious situation. If the economy is as weak as I think it is, we're not likely to get even the growth that is outlined in alternative C. And, I don't want to see too big a drop in interest rates. I don't know quite how to reconcile this. It seems to me that we have to start off with something that is not a precipitous change in borrowing. So, we have to start off with something like $800 million. It's perfectly all right to have a target [for M-1B growth] between "B" and "C", say, 7 to 7-1/2 percent. I don't think it's too meaningful. It's more meaningful if we relax the constraint of M2. I wasn't quite sure how Lyle wanted to formulate the relaxation of the M2 constraint. How did you want to formulate that?

MR. GRAMLEY. I'd take it out of the proviso and put it up on a collateral basis with M-1B.

MS. TEETERS. Does that include a target?

MR. PARTEE. Yes.

MR. GRAMLEY. Oh, yes. We'd specify reserve aggregate behavior consistent with growth of M-1B and M2 at such and such percentages, respectively, taking into account NOWs and all savers.

VICE CHAIRMAN SOLOMON. Okay. But I have a problem there because I think M2 is likely to be stronger than the 10 percent indicated here for alternative C. I think it's still likely to be about 11 percent.

MR. PARTEE. That's "B."

MR. SCHULTZ. If you did that, would you also put in this language about the all savers?

MS. TEETERS. Yes.

MR. PARTEE and VICE CHAIRMAN SOLOMON. Yes.

MR. GRAMLEY. Your worry that we may have a weaker economy is a real one, Tony, and I share it. And we don't want a precipitous decline of interest rates. What would happen is that it would trigger a consultation.

VICE CHAIRMAN SOLOMON. Right.

MR. GRAMLEY. We would have to ask ourselves at that point if the incoming news was sufficiently weak that we ought to lean in the direction of slightly lower interest rates or not. So, we'd revise our targets.

VICE CHAIRMAN SOLOMON. That's why I would recommend a fairly tough [floor]--in other words, a 13 to 18 percent range--in order to have a consultation. Even 13 percent represents a drop of about 2-1/2 points and I think we ought to have a consultation at that point to avoid just following it blindly all through the quarter if it looks as if it's going to press way below 13 percent. In summary, where I stand is a 7 to 7-1/2 percent target in M-1B, relaxing the M2 constraint language somewhat--although I'm not sure that we should put in a numerical target if there's another way of doing it--a 13 to 18 percent fed funds rate range, and an initial borrowing level of $800 million. I don't think we're going to end up anywhere near these numbers if the economy is as weak as most of us, including the staff, think it is.

MR. PARTEE. Well, M2 could still be pretty strong, but M-1B could fall well short.

VICE CHAIRMAN SOLOMON. Yes, that's right. The reason I'm so confused is that we've pumped in nonborrowed reserves at the rate of 20 percent but we have had an increase of only 1.8 percent in M-1B. And I'm thoroughly confused. I know what I want in the way of objectives; I don't see how to have these paths lead us there.

MR. PARTEE. Lags kill you every time!

CHAIRMAN VOLCKER. Mr. Monhollon.

MR. MONHOLLON. I'm encouraged by some of the price statistics and the prospect that union settlements next year may be smaller than they have been.

CHAIRMAN VOLCKER. What are you encouraged by? Tell me.

MR. MONHOLLON. Oh, by some lower rates of growth in the consumer price indexes. And I certainly wouldn't want to do anything that would worsen inflationary expectations. But, as has been discussed around the table, I think there's some danger that the liquidity bind that a number of businesses are in could produce a wave of bankruptcies that might result in a sharp slump. My concern on this score is reinforced by the extremely sharp and sustained reduction we've experienced in shift adjusted M-1B this year. As for M2, the possibility that it will come in over target doesn't disturb me as much as it does some. As has been discussed, there is a great deal of noise in the nontransactions component of M2 and it's difficult to interpret what it means. In addition, it's difficult to control the nontransactions component of M2. Given the changing composition of this component, I wonder if we can be sure whether it's positively or negatively correlated to the funds rate. In some way the work that we're doing suggests that it may be positively related and that efforts to hold down [M2] may produce the principal result of keeping M-1B well below the lower limits of its range. And that would be unfortunate. So, I would concur with the idea that the M2 proviso be dropped from the directive. I think there are some distinct risks in failing to get M-1B growth up fairly close to the lower end of our target range.

The issue of credibility has been discussed. I don't know on what credibility hinges exactly, but I think there's some risk to our credibility in failing to hit the 3-1/2 percent [lower end of the] target range that we announced in July. There's a risk, too, of contributing unnecessarily to what appears to be a developing recession. And there's a risk, as was discussed earlier, that a very low rate of growth for M-1B in 1981 will complicate our targeting for 1982. So, this leads me to suggest that we try to get as much growth in M-1B as we can by the end of the year without unduly upsetting the markets.

CHAIRMAN VOLCKER. That's impossible, if I may say.

MR. MONHOLLON. We certainly wouldn't want to encourage people to think that we've thrown in the towel on the inflation fight. How much we can do, I don't know. But maybe "B" is about the best we can do, starting off with a borrowed reserve target of around $750 million and pushing it down as we find necessary to accelerate the growth of M-1B.

CHAIRMAN VOLCKER. Mr. Rice, you expressed yourself earlier, I believe, and so did Mr. Guffey.

MR. RICE. On M-1B I would go along with raising the lower end of the federal funds range up to 12 or even 13 percent and I would like to see borrowing fall no lower than, say, $500 to $600 million.

VICE CHAIRMAN SOLOMON. You don't have a very clean-cut alternative.

MR. PARTEE. Not that that makes a difference.

CHAIRMAN VOLCKER. I'm sorry, I didn't catch all these.

MR. RICE. Well, I said I'm for alternative B. I said that earlier.

CHAIRMAN VOLCKER. Right.

MR. RICE. But in light of the discussion I would go along with raising the lower end of the federal funds range under alternative B from 11 to perhaps as high as 13 percent. And I would not want to see the borrowing fall below $500 million or maybe even $600 million.

MR. PARTEE. You mean no matter how weak M-1B is? You'd put a floor on borrowing?

MR. RICE. On borrowing I would be inclined to want to do that.

CHAIRMAN VOLCKER. Look, I think we've been through the list. I just want to take care of another matter for about three minutes, if you will just excuse me, and we will come back to this.

MR. WINN. Maybe we should resolve never to meet on October the 6th.

MR. PARTEE. It is a bad day, isn't it?

CHAIRMAN VOLCKER. It's a matter of whether we should intervene in this market. [The dollar] went up a bit, a percent or more, on President Sadat's death. Since then it has come back. I don't see any urgent need at the moment but we will be in contact with the Bundesbank and make sure that they know we're willing to be helpful if we can be of any help. But at the moment we're doing nothing.

MR. WALLICH. It was up to 2.29--

CHAIRMAN VOLCKER. I may have to talk to the Bundesbank, so if I get interrupted again, that's what it is.

There may be some thread to all of this, for all of the confusion. The problem is that none of us can rely very well on any of these statistical projections. Certainly this is a time when we may have to stay closely in touch because we don't know what is going to happen. Things will look quite different than they look today. We had a 7 percent increase in M1 in August, and September looked as if it would be up until we got some [new] figures, one of which hasn't even been confirmed yet. And, if we had the pattern that Mr. Corrigan is suggesting that was in the paper, I think it would look awful. If we had growth, but because it was a big bulge suddenly in October which we didn't have to react to, it would look quite different. I think [the money growth numbers] are just plain unpredictable.

So far as the threat of recession is concerned--it depends upon how you define recession--that's not the forecast that has been given to us, which people did not take great exception to, but I share the feeling that there's a danger in balancing the risks in the very short term. There could well be a risk that things will get significantly worse rather than better in terms of that forecast. I'd just repeat that in a sense I think those are the risks we have to take. We have a very restrictive policy; I think those risks were there all along. That doesn't mean we should go out of our way to aggravate it or create a provocation, but I don't think we should be surprised if those risks arise, given the configuration of economic policy generally and the kind of problem that we have. Indeed, it would probably be a miracle if we get through this without a recession--something that goes in the books at least as a mild recession--because everybody loves to have recessions and they're very quick about calling things recessions. There is an automaticity in all of our policies in that as this pronounced sluggishness remains, interest rates should tend to go down as short-term rates have been tending to do for a couple of months. And, presumably they would continue to do so under those circumstances. The big problem, and maybe the only question there, is that an enormous amount of Treasury financing has to be done. We've had a glorious period of short-term rates going down 2 or 3 percentage points and long-term rates going up, which is not very helpful in some sense, and there's nothing we can control just by pumping out money. It may have the opposite effects, but we have the hard reality of all that Treasury financing out there.

VICE CHAIRMAN SOLOMON. Aren't they projecting $50 billion for the next quarter?

CHAIRMAN VOLCKER. Well, we're projecting $37 billion, I think; it's only about $3 billion a week or something of that kind! Well, I'm including the off-budget finance to the Treasury, but I'm not including the other. But it's an enormous amount of financing.

MR. STERNLIGHT. You're talking about the financing need in the fourth quarter?

VICE CHAIRMAN SOLOMON. Yes.

MR. STERNLIGHT. I think the Treasury looks for something in the mid-$30 billion area; $35 billion or so is what the market expects.

CHAIRMAN VOLCKER. Or it just could get higher. In any event, frankly, getting M-1B in the range is very much a two-edged proposition so far as I'm concerned. It has the moderate merit of looking great when we're testifying, but it doesn't look great even when one is testifying if M2 and all the other aggregates are above the range. I'd rather have [M-1B] below the range if the others are above, quite frankly, just in the pure presentational sense. But a great big increase [in M-1B] is not going to look good to what I will call the market or to people wondering what we're doing and whether we're easing aggressively in the face of sour business news. Also, just in terms of the performance for the year as a whole, while it's very hard to evaluate the quantitative magnitude, there are reasons to believe that M-1B should be lower than we thought when we set the targets, particularly in light of the effects money market funds, which have only doubled or more this year, have on that particular aggregate. I also recognize that it may have the other kind of effect on the other aggregate. But the interpretation that is going to be put on this and its real effect depend upon whether we have to push or whether we accept it, and that's what we've been struggling with here. I think there is--if I detect it correctly--some fair reluctance to push M-1B growth too high. It's a matter of judgment what too high means. On the other hand, there's quite a willingness to accept a high number if it can come without pushing too hard. I don't know whether that's possible or not. That's about where I am anyway, and I suspect that sums up the feeling that a lot of people have. If we take this backwards, what is your infamous borrowing number at the moment--$875 or $884 million or thereabouts?

MR. AXILROD. $880 million is the present implied level.

CHAIRMAN VOLCKER. And that has come down a lot, of course. As a matter of instinct, although it is alleged to be inconsistent with alternative C in being too low, it doesn't seem to be inconsistent with interest rates where they are and moving lower if M-1B continues weak, which is the normal repercussion we would have to that. So, starting out around that level may tempt us to be slightly lower than where we are and it seems to capture the midpoint of what is proposed anyway. The same thought is reflected in all these feelings; [namely], that we should have a consultation if the federal funds rate gets around 12 percent. I don't have any problem with that. In some sense, those are the two most operational decisions we will make here. We'll see what happens with that approach.

MR. PARTEE. A beginning [borrowing] level of what?

CHAIRMAN VOLCKER. Around $800 million.

MR. PARTEE. And a funds rate [lower limit] of 12 or 13?

CHAIRMAN VOLCKER. Well, I've not specified that at the moment. One or the other.

MS. TEETERS. Does that give the staff enough information to construct the reserve path?

CHAIRMAN VOLCKER. I'm not going to stop there, but I'm just saying that the operational [decision] that's important would be how we handle the concern. Just in terms of these various alternatives, I myself think the weight of the argument is on something like "C" in terms of its presentational and other effects. That doesn't mean that if we got a burst--if October turned out to be the long awaited month of some bulge in M-1B--we would react. It would imply to me that we wouldn't react to that at all fast or at all, if it's just in October.

If we ended up above the "C" specifications as a result of a bulge in October, it's not going to make anybody terribly unhappy. On the other hand, I don't really want a specification that forces us to ease and push so hard that it conflicts with what I think was the tone of what people said--in effect, that they don't want to push that hard simply to get within a range. And I would attach some importance to M2. Now, whether that's put in the form of a proviso or of equal weighing, which some people have suggested, isn't a crucial issue to me. I think that's what it amounts to anyway.

MS. TEETERS. I would prefer the equal weighing.

CHAIRMAN VOLCKER. I suppose that would leave me at something like "C," with borrowing of $800 million; and if you want to make it equal weighing of the two aggregates, that doesn't bother me. I don't know, but 13 to 17 percent is fine with me as a benchmark to trigger a consultation, which is what [the bottom of the "C"] range is. I do not have a strong feeling that if money were really weak we would stop at 13 percent. That's not my gut feeling at the moment. But if that's an appropriate place for consultation, it's perfectly satisfactory to me.

MR. ROOS. Mr. Chairman, could we have an understanding of consulting but at the same time not narrow the fed funds range in the directive to a 4-point spread? That's going to be interpreted as our moving back toward concentrating on controlling interest rates rather than what we've really said we're doing.

CHAIRMAN VOLCKER. Well, it's a pretty subtle point, but we have sometimes had 4-point ranges and sometimes 5-point ranges.

MR. ROOS. It's been 5 or 6 most of the time.

MR. CORRIGAN(?). [13] to 18 percent?

MR. PARTEE. [I prefer] 12 to 17 percent. Do you really want a target of as low as 10 percent on M2 and 6 percent on M-1B?

VICE CHAIRMAN SOLOMON. [We could] continue last quarter's intermeeting target of 7 percent. I don't think it's very important, frankly, this time; it's not as important as the other decisions.

MR. PARTEE. We could say "7 percent or somewhat more," or something like that.

MR. BOEHNE. I'd have some preference for that. If we said 7 percent last time and say 6 percent this time, I think we're saying the wrong thing.

MR. PARTEE. After having missed 7 percent so clearly.

CHAIRMAN VOLCKER. Well, I think one can argue just that. It's what we said before and that [will be announced soon]. It's not going to surprise anybody if we say 7 percent again. I'd be a little concerned about the "or somewhat more" if that implied that 7 percent was the minimum to which we were going to push at all cost.

MR. WALLICH. It's a very high number anyway.

MR. PARTEE. Well, I was thinking of accepting a higher number. That's why I asked.

CHAIRMAN VOLCKER. As I said, we just cannot predict. If the higher number came about without our pushing it that hard, that's one thing. We'd accept it and say: That's fine, we were low on the target; there's no great strain here and we don't have to tighten up promptly because it's above 7 percent or whatever.

MR. GRAMLEY. Does a 10 percent number for M2 mean that we take out of the actual number whatever we're attributing to all savers in there and the 10 percent means an underlying growth of less than that? We'll get, I think, very [unintelligible].

CHAIRMAN VOLCKER. How much impact, just on a quarterly basis, say, are we talking about here?

MR. AXILROD. Well, if you took our lower estimate of 1/4 of a point for the year, it would be 1 percentage point on a quarterly basis.

MR. GRAMLEY. Quarterly average, Steve, or for 3 months?

MR. AXILROD. No, that's 3 months.

MR. BOEHNE. How about "10 percent or somewhat more" for M2 to convey the idea of a less constraining influence of M2 on M1 growth.

VICE CHAIRMAN SOLOMON. I don't think it's a good idea to put the numerical target for M2 in the directive. I think we ought to relax the constraint very slightly by saying "at or slightly above," which gives us some leeway.

MR. PARTEE. At or somewhat above the range for the year? That's 9 percent.

VICE CHAIRMAN SOLOMON. Right, "at or somewhat above the range." So, I'd say we're talking about up to 10 percent. I don't think we're going to hit the 6 percent [lower end of the range], so even though 10 percent is low if we were figuring on reaching 6 percent, I doubt we're going to hit the 6 percent with the economy as weak as it is.

MR. GRAMLEY. But if we stick that in the proviso clause, then in effect what happens is that the weakness in M-1B has a very, very small influence on what happens at the Desk. I think we have to give more weight to what is going on in M-1B. The danger that you worry about we handle with the consultative process by specifying the federal funds rate more tightly.

CHAIRMAN VOLCKER. I must say that I see little difference between numbers and the proviso. They're both there in the directive.

MS. TEETERS. Well, does it make a difference in the way the Desk operates as to whether it's in a proviso?

MR. AXILROD. The difference would be only if it reflected a different understanding of what the Committee preferred. That's what it would depend on. It wouldn't be a matter of wording but what the Committee actually prefers.

MR. PARTEE. Well, as I said last time, technically a proviso is much more limiting than giving equal weight. A proviso means you give total weight when the proviso is in effect. Now, that may not be the understanding that everybody has. But reading the English, that's what one would conclude it means.

CHAIRMAN VOLCKER. In fact in this last period, M2 would have been significantly--I guess that's the right word--above the proviso except for the information we got a week ago. It suddenly revised downward in September 10 days ago.

MR. PARTEE. But we had decided last time, you remember, that even though it was a proviso, we were going to regard it as not a proviso.

CHAIRMAN VOLCKER. I do not accept that language, but in fact it was running higher than the top end of the range and we did not cease providing more nonborrowed reserves for that reason [unintelligible].

VICE CHAIRMAN SOLOMON. Why didn't it act as more of a constraint in August when M2 was growing at 12.1 percent? Why didn't it result in a change in the nonborrowed reserve path?

CHAIRMAN VOLCKER. It was sort of in the range that was expected for August at the time of the meeting.

MR. AXILROD. The Committee accepted a high M2 in--

MR. STERNLIGHT. The path for M2 was something like 14 percent.

CHAIRMAN VOLCKER. Oh, I'll be back in just a second.

VICE CHAIRMAN SOLOMON. Based on the last quarter, you're saying that it was running at what, about 9.4 percent? Was that the highest it reached in August?

MR. AXILROD. Yes, over the fourth quarter. It probably was a little less than that; but if we put retail RPs back in, it would be more like that.

MR. PARTEE. But we don't have any idea how many all savers certificates have been sold, or where they're coming from. We're buying a "pig in a poke" if we constrain ourselves with M2.

MR. GRAMLEY. I think the argument was reasonably solid a month ago--what Governor Partee put forth--but I just didn't go with it. But the argument seems to me overwhelmingly strong now when the M2 number is being affected by something that we simply cannot measure. We will have no idea for some months, if then, what the all savers certificate has done to that number.

MR. BOEHNE. Whatever weight we put on M2 at the last meeting, we have to put less on it now, I would think, because of the all savers distortion. And we have less information to guide us on an all savers adjustment than we did with the NOW account adjustment for M1. We really have nothing to go on for all savers. What we could do is publish an adjusted M2.

VICE CHAIRMAN SOLOMON. Steve, adjust it.

SPEAKER(?). You want to publish an adjusted M2?

MR. AXILROD. No, please.

MR. PARTEE. Take out half the all savers.

VICE CHAIRMAN SOLOMON. Is there another nonquantitative way, or non-numerical way, of formulating M2 other than with the phrase "at or slightly above" that I suggested earlier? Lyle, can you reach your objective without putting in a numerical target?

MR. GRAMLEY. Well, if we don't put in anything for M2, then no one knows definitely how to interpret any words we might use. If we use words and M2 growth goes up to 15 percent, what do we do given those words? If it goes to 10 percent, what do we do? We have to be able to specify what specific action will follow upon a particular pattern of growth of M1, otherwise M2 will be totally ignored. If we totally ignore M2, then what will happen is that M-1B will become the only target of policy. And then we have the possibility of having a tremendous decline in interest rates. So, it seems to me that the reasonable way out of this is to put M1 and M2 on a collateral basis in the directive and specify something about the uncertainty with which the M2 number is going to be [viewed].

MR. PARTEE. We can say "about" or "around," and fuzz the actual numbers.

MR. CORRIGAN. There is another option, which I don't think much of, but we could do it. And that is to start out the way that Chuck and Lyle are saying but to put in the directive that to the extent M2 departs significantly because of all savers certificates or for whatever reasons we would have a consultation. So, it would be couched in terms of triggering a consultation rather than triggering a shift in the reserve path.

MR. GRAMLEY. Well, if we narrow the fed funds range somewhat, that's in effect what happens.

MR. CORRIGAN. Not if it's all because of all savers certificates.

MR. AXILROD. We tried to allow for that with the suggested wording in the directive that says: "It is recognized that the behavior of M2 must be evaluated in the light of effects of recent regulatory and legislative changes, particularly the public's response to the availability of the all savers certificate."

CHAIRMAN VOLCKER. Whatever way it goes in there, there ought to be some sentence to that effect. We have to evaluate that.

MS. TEETERS. Steve, do you have enough of a gap between M1 and M2? For the year it looks as if the differential is going to run about 7 percent and none of these for the fourth quarter is coming anywhere near that much of a difference.

MR. AXILROD. Well, we do think there will be some rebound in M-1B relative to M2, which will narrow the gap that has developed thus far this year. We could well be wrong on that, but that's our view at the moment.

CHAIRMAN VOLCKER. Let me just go back. I still don't see particularly that it makes any difference how this is worded, frankly. What we did last time was that we didn't react very fast to M2 being high, and the Committee understood it would be high in August. What we did was pretty directly to follow the reserve path for nonborrowed reserves, which left total reserves short. We would have had--if we were just operating on M-1B--a greater case for making a so-called discretionary judgment to push up nonborrowed reserves even faster. They were going up at a rate of 20 percent a year. For several months we did not take that discretionary action, partly with an eye toward the proviso; but since we thought it was strictly above the annual target until 10 days ago, the fact that it was slightly above the annual target didn't stop us from continuing on the full nonborrowed reserve path. This business of a shortfall, if it holds up in September, brings us almost exactly to the top of the annual target.

MR. PARTEE. But, as was pointed out, it doesn't include retail RPs.

CHAIRMAN VOLCKER. That's right, and we were aware of that, so--

MR. PARTEE. A lot of those are going to go into all savers.

CHAIRMAN VOLCKER. But the recorded M2 figure undoubtedly understates the functional M2 figure because it just doesn't happen to have retail RPs defined in it and they should be in it. So, we're really running above. And that will be reflected when we talk about the change to the all savers; part of that looks like an artificial jump that's real. It's just catching up to the recorded shortfall on M2 already.

MS. TEETERS. Which means we should take a higher number for the M2 specifications at this time.

CHAIRMAN VOLCKER. It depends upon whether you're worried about M2 running high enough. The fact is that it's running high in a real sense.

MR. PARTEE. Well, if there has been a shortfall, Paul, we already have had it; and therefore if it comes in high, we shouldn't respond to it. My point is this: Let's say we had $6 billion in retail RPs and we accepted them; now we shouldn't react if the $6 billion in retail RPs goes into all savers.

CHAIRMAN VOLCKER. I certainly don't think we should react in that week in which they go in. One can still be worried about M2 being a little high.

VICE CHAIRMAN SOLOMON. In addition to saying "at or slightly above," could we leave that proviso and then go on to say that the Committee would tolerate an overrun in M2 due to the movement of funds from RPs into all savers certificates?

CHAIRMAN VOLCKER. I don't think I would say it that way. What we really should be tolerating is the movement into all savers certificates from funds that aren't and shouldn't be in M2.

VICE CHAIRMAN SOLOMON. Yes, that's right. That's a more concrete way.

CHAIRMAN VOLCKER. We need some sentence to that effect in there, whichever way we do it. We have to say we will evaluate M2 in the light of this. I see nothing the matter with the language that [the staff] wrote here. But some language to that effect, whatever it is precisely, should be there; people ought to notice that we may get an artificial bulge in M2 that we are in a sense discounting. I have no problem with that, whether we put in the numbers for M2 and M1 directly or put it in the form of a proviso indicating a range around the annual equivalent or slightly above, if that's what you're suggesting.

VICE CHAIRMAN SOLOMON. I'm just uneasy about coming up with some numerical target that we're not going to hit.

CHAIRMAN VOLCKER. We won't have any difficulty making a numerical target, presumably, for M2.

MS. TEETERS. You're afraid of going over the target for M2?

CHAIRMAN VOLCKER. We are much more likely to be close to this number for M2 than we are for M1, just in terms of the randomness of the numbers. We can argue about it; I frankly don't think it makes a lot of difference. We can say: "In the short run the Committee seeks behavior of reserve aggregates consistent with growth of M-1B from September to December at an annual rate of 7 percent after allowance for the impact of the flows into NOW accounts and growth in M2 around"--I don't know what are we saying.

MS. TEETERS. Why don't we take the 11 percent from alternative B and at least allow some leeway.

CHAIRMAN VOLCKER. I'd rather put in a lower number and say "or slightly higher."

MR. PARTEE. Sure, why not say "10 percent or somewhat more"? And then we have a proviso later about taking account of all savers certificates. That seems all right.

CHAIRMAN VOLCKER. Even 10 percent or somewhat more bothers me a bit. If we are going to say "somewhat more," we can always use a lower number.

MR. PARTEE. Oh, come on, Paul, you know it's going to be a big number.

MS. TEETERS. You are going to get the relationship between the two growth rates so far off--!

CHAIRMAN VOLCKER. Does the 10 percent include the all savers or not? Is that where your--

VICE CHAIRMAN SOLOMON. It isn't clear. This language simply says that it has to be evaluated. That's why I said "tolerate."

CHAIRMAN VOLCKER. We can say "10 percent or slightly more, recognizing that the behavior of M2 will be affected by the recent regulatory and legislative changes."

MR. BOEHNE. That sounds reasonable.

MR. PARTEE. October will probably be a good-sized month, and then growth may fall off. But October will be a good-sized month--maybe 13, 14, 15 percent.

CHAIRMAN VOLCKER. Recognizing particularly that in October.

MR. PARTEE. Yes, and that [unintelligible] forecast of interest rates.

MR. GRAMLEY. What would go with that, then: an $800 million initial borrowing level and a fed funds range of what?

VICE CHAIRMAN SOLOMON. 13 to 18 percent.

MR. RICE. 13 to 17 percent.

MR. GRAMLEY. Well, the Chairman said at one time either 12 or 13 percent at the bottom.

MR. SCHULTZ. I have some sensitivity to what Mr. Roos said about narrowing that range.

MR. PARTEE. Yes, I do too.

MR. SCHULTZ. I think we really ought to retain a 5-point range anyway, and I would have no problems with 12 to 17 percent.

MR. FORD(?). Even that seems to me to be restrictive because funds are trading at 14 percent today; they were down in the 13 percent range yesterday. We don't want to have to call each other up tomorrow with 12 percent.

MR. SCHULTZ. Well, I think we would want to if it got down that fast. How precipitous the decline occurs is of some importance, don't you think?

CHAIRMAN VOLCKER. We have had trading at 14 percent as the low but the 14 percent range may be a little artificial today. We have too many reserves out. You are selling today, I take it?

MR. STERNLIGHT. Right. We are absorbing the excess.

VICE CHAIRMAN SOLOMON. We had excess reserves, Bill, because of the move to same-day settlement.

MR. FORD. Yes, but we have had a number of days in the last two weeks when it has been down around 13 percent, haven't we?

MR. STERNLIGHT. 14 percent.

MR. FORD. All I'm saying is: Let's not lock ourselves in so tightly. Let's go in with something like the alternative B range.

CHAIRMAN VOLCKER. It wouldn't lock us very tightly anyway.

MS. TEETERS. What do you expect the borrowings to do, Steve? If we start at $880 million, do you expect them to drop off?

MR. AXILROD. Well, the degree of error around this is vast. We've assumed that that level of borrowing implies a funds rate of something like 14-1/2 to 15-1/2 percent. I don't know if Peter thinks it is exactly in that range. We probably are going to get M-1B growth on the order of 6, 7, or 8 percent; so if that's right, I wouldn't assume any further drop in borrowing and the funds rate.

CHAIRMAN VOLCKER. Steve, you may be right. I hope you are right in this sense. But what we are probably running into here is this: If the low money figure for publication this week is confirmed and next week is low, this $800 million that we started with will probably be lowered pretty promptly. If we get a bulge in the first week of October, it won't be. But if the first week in October is another low number--meaning it might be positive but only $1 billion or so--we'll probably get the borrowings down further.

MR. AXILROD. Yes, in constructing this path we have allowed for an increase on the order of $2-1/2 billion in the first week of October.

CHAIRMAN VOLCKER. I don't know what the number is. But let's say it's distinctly below $2-1/2 billion; we will probably gradually be lowering the borrowing right off. If it's $4 or $5 billion, we wouldn't be.

MR. SCHULTZ. I'd be very nervous about not consulting if the funds rate got down to 12 percent in such a short period of time. That could be misinterpreted by the market.

CHAIRMAN VOLCKER. Well, we can do what we want to do there. We can put in 12 to 17 percent; there's nothing to stop us from consulting before that if we don't like what is happening.

MR. PARTEE. Depending on the behavior of the pattern.

MS. TEETERS. We could also put in a range for the fourth quarter instead of coming down on [a specific growth rate].

MR. PARTEE. For the aggregates?

MS. TEETERS. For the aggregates, yes.

CHAIRMAN VOLCKER. That bothers me a little just because if we put in a range it sounds as if we are really in trouble on either side of that range.

MS. TEETERS. I just thought that's about where we are.

MR. PARTEE. But the staff has to construct a path, you see. We choose the number and then they construct the path.

MS. TEETERS. They can take it out of the center of the range, which apparently is where we're coming down.

CHAIRMAN VOLCKER. If we put in even a 3-point range, the probability, at least early in the period, is that it would not occur. And as a result, [I would like to suggest that] we set the initial borrowing at something near the $880 million we have been experiencing--say, $850 to $900 million--rather than going to $800 million and risking a drop to 14 percent very quickly and having to take some action on the discount rate.

MR. AXILROD. I should just give the figures. In the last three complete statement weeks the funds rate averaged 16.09, 15.33, and 15 percent. That 15 percent was for the week ending September 30, the quarterly statement date. For this week to date, I don't have the figure, but it must be over 15 percent.

CHAIRMAN VOLCKER. We had borrowings over a billion dollars with the first figure, right?

MR. STERNLIGHT. Yes, because we had high funds rates.

MR. AXILROD. We had a high funds rate early in the week so the average level of the funds rate hasn't really gotten below 15 to 15-1/2 percent, if you take out the exception week.

MR. GUFFEY. An exception week being what?

MR. AXILROD. September 30th, which might have some funny--

MR. STERNLIGHT. The borrowing was higher than the $900 million or so.

CHAIRMAN VOLCKER. I have no problem with $850 million.

MR. WALLICH. If we do all this, we may get to a position very similar to last year where it looks as though we cut the funds rates in half; other rates won't have moved quite that much, but it will look like a very big drop.

MR. PARTEE. So what?

MR. WALLICH. Cutting interest rates in half is just showing that we are giving up on inflation and are starting to fight recession; that's very much what it seems to me we are tempted to do.

MR. FORD. We're not cutting them in half, Henry. The funds rate never averaged over what, 20 percent?

MR. WALLICH. It was 21 percent, I think.

MR. RICE. The estimate in the Bluebook is that $200 to $300 million of borrowing is consistent with a 14 percent funds rate. That's not cutting interest rates in half.

MR. WALLICH. We are letting it go to 12 percent before we consult, which indicates that we are willing to let it go very far.

MR. RICE. But if we keep borrowing up at $800 million, we are not going to have to worry about a 12 or 13 percent funds rate.

MR. WALLICH. It moves pretty fast.

MR. PARTEE. But maybe the 20 percent was way too high. We shouldn't have let it go to 20 percent. If we're going to control interest rates rather than aggregates, maybe we shouldn't have let it go to 20 percent.

MR. WALLICH. No, I'm concerned with the picture that we present if interest rates drop sharply. You can say all you like about the fact that we are below target on the money supply, but the public will perceive this as easing and 90 percent of the commentators will say that the Fed has eased very substantially.

VICE CHAIRMAN SOLOMON. I think the one comment that everybody agreed on here is that we didn't want a precipitous decline in interest rates. I don't see why we can't have a consultation at 13 percent. It's quite a move down from the current 15 or 15-1/4 percent level.

MR. PARTEE. I would rather post it at 12 to 17 percent and just agree [on when to consult]. I don't like the idea of narrowing this range to 4 points. We really are not supposed to be paying that much attention to it, although I know we are.

MR. ROOS. Some of us are.

VICE CHAIRMAN SOLOMON. Would you have a consultation at 13 percent even though the range is 12 to 17?

MR. PARTEE. Because it would be approaching it--moving down to 12 percent--and before it got there we would have a consultation.

VICE CHAIRMAN SOLOMON. All right, that's a reasonable compromise.

CHAIRMAN VOLCKER. I don't think we have to decide that with any precision. If it reached 13 percent in mid-November and everything is weak, nobody is going to be disturbed about it. If it reached 13 percent two weeks from now, people would be disturbed. You have to assume a certain amount of competence, some minimum level, in the Chairman.

MR. SCHULTZ. That's the weak part of the whole thing!

MR. BALLES. Paul, I understood a while ago that you were leaning toward putting a numerical target in for M2, with cautionary language following it.

CHAIRMAN VOLCKER. I'm not leaning either way.

MR. BALLES. If that were done, followed by the cautionary language that evaluation of M2 would have to be made in light of all savers, etc., one way the directive could handle it would be at the end of the last paragraph that calls for consultation when the funds rate is persistently outside a range to add a phrase "or if M2 growth is substantially higher than currently projected." So, consultation would be triggered [either] by the departure of the funds range persistently from whatever range we end up specifying or by M2 growing faster than the numerical target, if one is put in.

CHAIRMAN VOLCKER. What I am suggesting is one version; let me just run this one up the flag pole and see who salutes: "In the short run the Committee seeks behavior of reserve aggregates consistent with growth of M-1B from September to December at an annual rate of 7 percent after allowance for the impact of flows into NOW accounts and 10 percent or slightly higher for M2, recognizing that behavior of M2 will be affected by recent regulatory and legislative changes, particularly the public's response to the availability of the all savers certificate." I will modify my proposal slightly to say borrowing at $850 million and a federal funds range of 12 to 17 percent. If the funds rate dropped out of bed here and got around 13 percent promptly, we would probably have a consultation. We won't necessarily have a consultation if that arises at the end of October or the beginning of November when we have a lot of weakness in the aggregates and it's obvious why it is down there.

MR. SCHULTZ. I don't mind that. I prefer a little less than 7 percent on the growth, but I prefer a little less than $850 on the borrowings, so they balance off.

MR. PARTEE. I would prefer 8 percent on the growth, but I'll buy 7 percent.

MR. GRAMLEY. That's quite acceptable to me.

MR. BOEHNE. Acceptable to me.

MS. TEETERS. I accept it.

CHAIRMAN VOLCKER. Well, unless somebody has a strong preference for the proviso type language, we will proceed with this language. Call the roll, Mr. Altmann.

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boehne	Yes
President Boykin	Yes
President Corrigan	Yes
Governor Gramley	Yes
President Keehn	Yes
Governor Partee	Yes

Governor Rice	Yes
Governor Schultz	Yes
Governor Teeters	Yes
Governor Wallich	No

Eleven for, one against.

CHAIRMAN VOLCKER. Okay, thank you. We can proceed to lunch.

END OF MEETING