Meeting of the Federal Open Market Committee

June 30 - July 1, 1982

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 Wednesday, June 30, 1982, at 3:10 p.m., and continuing on Thursday, July 1, 1982, at 9:15 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Balles
Mr. Black
Mr. Ford
Mr. Gramley
Mr. Martin
Mr. Partee
Mr. Rice
Mrs. Teeters
Mr. Wallich
Mr. Keehn, Alternate for Mrs. Horn

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

Messrs. Boehne, Boykin, and Corrigan, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis, respectively

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

Messrs. R. Davis, Keran, Koch, Siegman, Truman and Zeisel, Associate Economists

1/ Attended Thursday session only.

Mr. O'Brien, Deputy Assistant to the Board of Governors
Mr. Gemmill, Associate Director, Division of International Finance, Board of Governors
Mr. Kohn, Senior Deputy Associate Director, Division of Research and Statistics, Board of Governors
Messrs. Lindsey and Slifman, Assistant Directors, Division of Research and Statistics, Board of Governors
Mr. Johnson, Economist, Division of Research and Statistics, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Mr. MacDonald, First Vice President, Federal Reserve Bank of Cleveland

Messrs. Balbach, Burns, T. Davis, Eisenmenger, Mullineaux, Scheld, and Stern, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Dallas, Kansas City, Boston, Philadelphia, Chicago, and Minneapolis, respectively

Mr. Broaddus, Ms. Greene, and Mr. Soss, Vice Presidents, Federal Reserve Banks of Richmond, New York, and New York, respectively

Mr. Meek, Monetary Adviser, Federal Reserve Bank of New York
Mr. Erceg, Assistant Vice President, Federal Reserve Bank of Cleveland

Ms. Meulendyke, Senior Economist, Federal Reserve Bank of New York

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June 30, 1982--Afternoon Session

CHAIRMAN VOLCKER. We can call the meeting to order and seek approval of the minutes, if someone wants to propose that.

MR. MARTIN. So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection, we'll approve the minutes. Before I go any further I want to make a remark about confidentiality. There were some articles about the last meeting; I don't know whether they were based upon any confidential information or not. I have some other indications, not very serious, of numbers that may have come from Federal Reserve meetings of this sort. I don't know where this stuff came from--maybe no place. But it presents an occasion to say again that we cannot operate, or at least I cannot operate effectively in this room, if I have the sense that there are going to be any leaks. There isn't anything much we can do about them in one sense, certainly not ex post. I would only bring this to your attention and note the great importance that I, and I'm sure you, put on this matter. There's only one recourse, which is obvious, if we have some sense of lack of confidentiality. There are a lot of people in this room and we could make it quite a few fewer; we can't make it less than the Committee members.

MR. PARTEE. We could try that too!

CHAIRMAN VOLCKER. There's no other way--except that maybe we could bring the Committee members in one-by-one!

MR. MARTIN. Secret ballot.

CHAIRMAN VOLCKER. I don't mean to make light of this because I don't think it is light. I would just note that there's no recourse if we get some sense of this happening. It's still very stultifying in any event. I will say nothing more. We can go to the agenda and the staff report on the economic situation.

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

CHAIRMAN VOLCKER. If I may just interrupt a minute, Jim: Of that roughly 4 percentage point [difference in the projections of] nominal GNP, how much of that is prices and how much is real?

MR. KICHLINE. In the Congressional budget [resolution], they have 4-1/2 percent real and 7 percent prices.

CHAIRMAN VOLCKER. And what do we have?

MR. CORRIGAN. Are those annual averages, Jim?

MR. KICHLINE. No, that's fourth quarter to fourth quarter. They have nominal GNP in '83 of 11-1/2 percent, real GNP of 4-1/2 percent, a deflator of 7 percent, and a fourth-quarter unemployment rate of 8 percent.

CHAIRMAN VOLCKER. About half the difference is real and half of it is prices.

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

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

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

CHAIRMAN VOLCKER. Well, I suppose we might as well go to you, Mr. Axilrod, even though it may be a little premature. We'll go back and discuss the economic situation after you are finished.

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

CHAIRMAN VOLCKER. Well, who would like to make some comments or ask questions, particularly about the economic situation but even general questions or comments on the strategic decisions facing us? I'm not looking to rush to a decision on this matter necessarily this afternoon, and I want to get back to the foreign side. I'll just cut this off in a while and get back to the matter we have to take up in the international area.

MR. BOEHNE. Well, if nobody wants to start, I will. I agree with the staff that we're going to have a recovery. I think that's coming. But I suspect that it will be more of a statistical recovery --one that economists can point to rather than something that businessmen are going to identify with. It seems to me that business attitudes are still pretty sour and that balance sheets are pretty well strained. So, my guess is that, given the level of interest rates, your forecast is probably pretty optimistic, with most of the risk on the down side. How would you assess the risks of a deviation?

MR. KICHLINE. Well, I would agree with you. Certainly our perception is that the risks are on the down side for real growth. Looking at the various sectors, the business sector is the one that probably worries us the most. While we have over the last several forecasts reduced the expected performance of investment outlays--as Jerry mentioned, it's about normal now--what we didn't mention is that the normal range in the postwar period is -2 to 17 percent and we're at 8 percent. So, there's a lot of room at one end or the other. Looking at the data and trying to make some allowance for that, in our judgment that 8 percent is about right. But surely the Redbook and the qualitative comments that we pick up are worrisome. I don't see any major risk of this being an explosive recovery and I perceive the risk to be on the down side. And I think the financial structure of the various sectors and the level of interest rates are real problems as we look ahead.

MR. BOEHNE. I've heard a good deal more concern expressed by bankers in recent weeks about credit quality problems going out over the next 6 months or so. If I keep hearing a story enough times, I think there's some credibility to it. They say they now think that customers they had never really thought about as being a problem are going to be a problem over the next 6 months. I don't think anybody in the room could do any better job of putting together a forecast. I believe Jim has done his usual good job. But with interest rates where they are and the weakness of the business sector, the odds are on the side that we're probably going to have a weak recovery. And while I wouldn't forecast it, I would not rule out that there is a reasonable chance the recovery could abort and that we could have another recession in 1983.

On the longer-term strategy, I would come down on the side that it's time to show some flexibility [in setting] these targets at midyear and I would raise the [M1] target. As I look out over the next 6 months, it seems to me that we would have to keep M1 [growth] at 3 percent or under during the second half in order to [lower it to] the top end of our target [range for the year]. If we get a 10 percent bulge in July, we would have to live with something like 1-1/2 percent growth from August to the end of the year. Maybe velocity will increase and maybe liquidity demands will go down, but it seems to me that there is a very large risk here and that we need a little breathing room. There is, of course, the risk on the inflationary expectations side and on credibility, but I believe our credibility would be enhanced by being realistic. It's just very difficult to sell the limits that we imposed on ourselves. So, some flexibility and some upward adjustment in the targets would make sense given the situation we're in.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I wanted to ask Jim Kichline a question on page 2 of the package of charts, which deals with the Federal budget. It comes as a surprise in a way that you and your people are looking at a much larger deficit in fiscal '83--some $60 billion larger.

MR. PARTEE. It's $60 billion more.

MR. BALLES. It's $60 billion--actually $62 billion--greater than in the official budget resolution. I have a couple of questions on that. I don't doubt that we could see an outcome like that, but is that view widely shared among independent analysts, so to speak? If it is, it will have a certain bearing on expectations, psychology, and everything else.

MR. KICHLINE. Well, we had one of our people look at some of the letters coming out of brokerage firms in New York, and among the folks who watch this I think the general perception is that a deficit in the area of $140 to $150 billion is a likely outcome. In fact, market developments after this was enacted are probably consistent with the view that the market didn't believe $104 billion.

MR. PARTEE. Yes.

MR. KICHLINE. In fact, [the market] had already discounted those actions. So, I think $140 to $150 billion is the kind of number that is being talked about.

MR. BALLES. I see. My fear is, and I'd like your opinion, that that in itself is going to be a factor damping any possible future decline in long-term interest rates or delaying such a decline and holding those rates up longer. Is that a warranted fear?

MR. KICHLINE. Well, truthfully, I don't know how to forecast long-term rates; I'm not sure I know how to forecast short-term rates either. But in any event, in our flow-of-funds accounts we do think that the picture that is emerging, given the monetary assumptions, is that this budget outlook really is consistent with crowding out. It didn't occur in 1975 in a classic sense, but we're talking about a period when we're expecting real growth in the economy associated with what would normally be some rising demand. And the Treasury pounding away and essentially taking half of the total funds raised is a situation that from a credit market point of view has to apply upward pressure on rates.

MS. TEETERS(?). John, this points up the inappropriateness, I think, of trying to establish growth rates for next year when we're right in the middle of the budget process. [It would be better] if we could wait to do this until late in the fall or even early next year. To try to establish growth rates with all the uncertainty about this particular aspect of it just highlights the problems that we have.

CHAIRMAN VOLCKER. Let me make a comment. We're supposed to be undergoing this exercise by law in the light of what the Administration is projecting and what its plans are and so forth. I don't know of any different plans in terms of any legislative initiatives. They are working on their forecasts. I don't know the exact [numbers] or, if I knew, I've forgotten. But they are subject to change anyway. They have a forecast which is I'm sure in real terms somewhat higher than the staff's forecast, but it's not out of sight. It probably has a higher [real] GNP and higher prices, which also makes--. [Secretary's note: The Chairman, speaking to a messenger who informed him of a phone call, asked "Is he on the phone?"]

MESSENGER. I don't know, sir.

CHAIRMAN VOLCKER. I guess it's not urgent.

So, they probably come up with a significantly higher nominal GNP from the combination of the two, although I don't think the differences are going to be tremendous in either element. But putting that into a budgetary picture, they are closer to the staff estimate than to the budget resolution.

MR. BALLES. Is that right?

CHAIRMAN VOLCKER. They haven't settled on it yet. But they are not down at $104 billion, where the budget resolution is, by a very considerable margin. Now, just what they're going to print, I don't know. But in general terms, apart from the economic assumptions, I don't think they would deviate widely from the kind of assumptions that the staff has made as to how much of the budget resolution's specific actions will be converted into real actions.

MR. BALLES. Thank you. In addition to the question I had, Mr. Chairman, I do have a comment. Ed Boehne has in effect already made it for me. I have been hearing essentially the same kind of talk from a very wide circle of businessmen and bankers in our District. They are more worried than I've seen them worried in my adult life about the spreading risks of bankruptcies for a great number of institutions that they would not normally consider being on a problem list. I'm tempted to follow the same strategy that Ed has already mentioned--I guess that's strategy 2 in the Bluebook--and have a temporary easing of our monetary targets. If we're going to do that without generating fear that the Fed will embark on a permanent accelerated program of rapid monetary growth, midyear is about the only time we can do it and get away with it in the sense that we concurrently could combine a modest upward move in the 1982 ranges by 1/2 point or so with a retraction of that for 1983 on a provisional basis--despite Governor Teeters' well stated comments about all the problems of setting forth 1983 ranges. If we did that, we could head off, or at least minimize, the dangers of announcing a change in an upward direction from our original 1982 ranges. That was my provisional leaning coming into the room. Ed has already stated the reasons for it and I'm still reserving final judgment on that until I've heard a full-scale presentation of views, pro and con, from the other members.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I want to pick up on Ed Boehne's comments too. It's extremely hard to believe that we wouldn't get some recovery out of a $40 billion tax cut--$30 billion in taxes and $10 billion in social security--starting tomorrow. And the inventory numbers in the aggregate, though there are some exceptions, seem favorable to a slowing at least in inventory liquidation. That ought to be enough to give us some increase in the period immediately ahead.

But I, too, am concerned about a relapse as time goes on and as we get into 1983. I note in particular that the staff's forecast for this period presumes a flattening out, relatively quickly in terms of the cycles that one goes through, in real business fixed investment. They have it dropping rather sharply through midyear and then stabilizing. I wonder what the basis is for expecting that there would be such a sudden stabilization of that number considering that it consists essentially of business plant and equipment. Almost everything I've heard--and it's in the Redbook too--about what is happening in machinery orders and equipment suggests continued deterioration there as well as in commercial construction of shopping centers and office buildings. Again, almost everything one hears suggests substantially growing problems with overbuilding in the office area. And then, finally, oil and gas well drilling, which I guess is a fair size item in the [business fixed investment] figure, has been affected by the outlook for a sharp drop in oil prices. The effect that has on drilling activity has been reported at our last several meetings. Considering that it's an item with a long lead time and considering these things and the financial state of many businesses, one wonders how [corporate] budgets could be considered and approved that would call for rises in capital spending, how the funds could be raised, and how the contracts could be let and all this would result in a stabilization of real business spending by the middle of next year. It just seems to me that instead there might be a very, very protracted and sizable continuing decline in capital spending as we go through next year. And that would greatly change the first half of the outlook.

Similarly, the residential construction industry is demoralized. They're concerned not only about the price of money, which you forecast to be remaining at 16-1/2 percent, but about the availability of funds because the savings and loans are going bankrupt, and also about the possibility that people will be pulling back from making commitments of that kind in an environment where housing prices are no longer rising appreciably and in many cases are falling. It's also an environment in which balloon payment loans will be maturing next year, and many more bankruptcies and foreclosures and takeovers of property will result from that. So, one wonders whether there would be the basis for what is, in terms of percentage rates of increase, a pretty sizable rise in residential building.

My final concern has to do with net exports. Although those charts that Ted Truman presented are very calm, I think there is a very real possibility that there won't be very much recovery abroad or, if there is much recovery abroad, that there won't be the financial capacity to hold up exports to some countries like Mexico and Canada that are important to the United States. Indeed, given the price of the dollar, the price of equipment purchased in this country is now so high that it seems unlikely that we would do very well in that area.

So, if we did have greater weakness in plant and equipment continuing in 1983, a failure of residential construction to recover, and a further deterioration in net exports, or more than forecast, I think that constitutes sufficient basis for thinking that the recovery may falter before too many months have gone by. If it does, and does so in an environment where interest rates have stayed high, I'm sure that the financial distress that the bankers are worried about will be with us in spades. It's very difficult to forecast. So, as I see it, that's our hazard. The question that I have is how we should plan a posture for monetary policy that will minimize the very real risk of a true shock to the economy later on--probably not until 1983. I'm not sure; I'd rather hear other peoples' reports.

CHAIRMAN VOLCKER. Governor Wallich. We're still at a very preliminary stage, I think.

MR. WALLICH. I see a recovery as much more likely than continued stagnation. I guess I don't differ too much in that from what others have said. There are risks on the down side, perhaps in the form of unforeseeable financial shocks or perhaps in the form of a gradual attrition of investment spending. I would remind you that, unfortunately, this is going to be the shape of the future if the budget doesn't come into better balance. There will be less investment in the economy than we normally would expect and more consumption, which we will get as a result of the tax cut. So, a shift to that posture is not all that unexpected. On the other hand, there may be some factors that do help sustain investment. The financing gap is moving toward zero. Cash flow is strong, although unfortunately not from profits. So, I see a greater prospect of a continued recovery than of a resumption of the downturn. We are probably at the bottom of the recession. At that point everything looks very bad in absolute terms, in level terms. In terms of rates of change, obviously, things have improved a great deal. Things are flattening out now. And I think one ought to look at them in terms of the rates of change rather than in terms of the levels. Meanwhile, we're shifting from a situation where we've done better so far on inflation than on growth and employment, which again seem to be becoming the less achieved objectives. I fear that we're reaching the low point of inflation and may find it rising from here on out and in this I differ somewhat from the staff forecast. We will get to a stage where we'll be telling each other at subsequent meetings that we did better on growth and the unemployment rate, but unfortunately worse on inflation. That leads me to think that we need to maintain a degree of pressure in order to continue wringing out the inflation.

CHAIRMAN VOLCKER. I thought you were going to suggest we need more than one tool of policy.

MR. WALLICH. Well, we do. We miss every conceivable goal but in the optimum manner of what we can do with one tool; we can't hit them all. As for the strategic decisions, it seems to me we should not be rigid. If we need an increase in the ranges, we need it and should do it. It's not clear to me that the loss of our credibility from overshooting is any less bad than the loss of our credibility from raising the ranges when it looks as if [we are] caving in. There is a reason for thinking that these targets may be too low. The logic of our approach involving a steady money growth and, therefore, cyclically varying interest rates is that in a recession interest rates should come down very sharply. They did in 1980; they have not done so now. And that raises the question of whether these ranges are indeed too low. But on the other side, I see factors that are likely to make them more adequate. First, going into recovery will accelerate velocity. Second, various technological changes that may be ahead ought to tend to accelerate velocity. Historically, we've been fooled more often by underestimating velocity gains than by overestimating them. I realize either risk is possible, but if I had to make a decision, I would bet on the rise in velocity. Accordingly, I would be cautious in changing the ranges.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, I guess I'm going to say about what everybody else has said, so I'll try to be brief. I would put down a forecast that doesn't look a lot different from what the staff has written down. But I, too, think the risks are predominantly on the down side. I would mention three factors on that. One is the extremely gloomy attitude that prevails in the business and financial community and to some extent, too, among customers. All of us could list a dozen different reasons for that, but I think increasingly a perception is growing and is reflected in the kind of deficit estimates that are being made now in the financial markets that we may be in a state close to paralysis in terms of finding our way out of this fiscal box. It's a very frightening situation. The second factor that has been mentioned a couple of times is the possibility that shocks--and I wouldn't call them just financial shocks, Henry, but shocks that originate in the financial sector which may be affecting primarily nonfinancial firms--may be coming along that will cause great consternation around the nation and make the attitudes still worse. The third factor is the fact that the staff's forecast depends on the expectation that interest rates won't rise as recovery begins. And that is in turn predicated on a judgment--and I think there are strong arguments for it as well as against it--that we will have a downward shift of money demand, which will permit an increase in velocity of something like 5 or 5-1/2 percent at an annual rate. That may happen and then again it may not.

What I would hesitate to see us do is to adopt a strategy now that conditions the kind of economic performance outlined here, which is really a miserable performance, on the assumption that that will happen and if it doesn't happen, the outcome will be much worse. I think we need to try to find a strategy that gets us out of that box. I look at the monetary aggregates as Henry does and say that there are good reasons for thinking that we haven't provided enough money. I think credit developments are reflecting that. In Jim's chart on funds raised by domestic nonfinancial sectors as a percent of GNP, if you take the difference between the total and the federal part, the number is down to barely over 6 percent of GNP. Now, that number has a long-term historical growth trend. If you look at a chart that plots that ratio from 1952 on and plot a trend line through it, a normative ratio would seem to be something like double that figure. That figure is as low as it is now in part because the economy is in recession but in major part because interest rates are so very high. I think we have to be very careful in trying to work our way out of this box. We can't solve all these problems, but I think we can help to solve one of them. And that is that we have more restraint on the [economic] system from the monetary side than we want at the moment. In trying to provide some way to let money grow a little faster, we ought to look over all the alternatives. One of them is to raise the targets for 1982; another is to leave them where they are but make a clear, public announcement that we're going to permit money growth to exceed that target for reasons having to do with liquidity preference or for technical reasons. The third--and here I think one can make an argument with some cogency that perhaps the idea of continuity of policy over a longer period working toward lower growth of money and credit and toward reducing inflation--could best be presented if we rebased our money growth targets for 1982, taking into account the fact that we undershot so much last year. But again, I don't know which way we can do this and best maintain credibility.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. Well, since I agree with Lyle's presentation, let me try and answer that last question, or at least give my personal view on it. My own view is that we should say that we would tolerate a modest or limited overrun in view of the NOW account behavior, that is NOW account funds not acting as transactions money. The reason I think we should choose that rather than either of the other two options--rebasing or raising the targets--is first of all that raising the target a half point to 6 percent target implies a precision that is almost ridiculous, given the possible swings in velocity in the second half of the year. If we were seriously considering 6-1/2 percent, that might make more sense. But I don't see the point of changing the targets a half point when I think it would be more consistent and better received in the markets if we simply indicated that we would tolerate a modest or limited overrun in view of the NOW account behavior.

Stepping back, I think it's worth mentioning that our forecast is significantly different from Jim's. We have significantly higher real growth in the second half and significantly higher inflation. We are almost 1-1/2 points higher on real growth, at 3.9 percent, and almost 2 points higher on inflation. We think inflation will be about 7.3 to 7.5 percent.

CHAIRMAN VOLCKER. Is that for '83 or '82?

VICE CHAIRMAN SOLOMON. No, for the second half of '82. The Board staff has inflation coming down steadily from the second quarter; it drops from 6.1 to 5.7 percent in the third quarter and then drops again to 5.4 percent in the fourth quarter, whereas we think it will be around 7-1/2 percent in the second half of the year.

CHAIRMAN VOLCKER. You're talking about the GNP deflator?

VICE CHAIRMAN SOLOMON. I'm talking about the GNP implicit deflator, yes. For what it's worth, I don't conclude anything from that except that this difference in forecasts tends to corroborate a feeling that, as has been expressed here, we should be prepared to tolerate a modest overrun or raise the target, if it were the consensus view that it had to be raised a whole point. It's just that I don't think a half-point increase makes much sense.

MR. PARTEE. You would say that very clearly to the market?

VICE CHAIRMAN SOLOMON. Right.

MR. PARTEE. Yes, so that people wouldn't keep saying that the Fed has to get money down into the range and therefore will tighten.

VICE CHAIRMAN SOLOMON. At the time that Paul testifies, I would announce it.

MR. PARTEE. An overshoot?

VICE CHAIRMAN SOLOMON. [A limited overrun] wouldn't be much of a move beyond what he said earlier when he talked about the upper part of the ranges and then he talked about the NOW account behavior and we were quite comfortable, et cetera. I think it would be less likely to be interpreted as a reversal of policy or caving in to Congressional pressures to raise the targets. Even though other people haven't discussed '83 too much, I think it would be dangerous to lower the '83 targets. In other words, I would want to stick with the 5-1/2 percent rather than do another half-point cut the way we've been doing the last couple of years. Among miscellaneous points, I believe it is worth mentioning that, like Lyle, I feel not at all confident that we will see a reversal of the strength that we've seen in liquidity preference. I think it's very possible that we will continue to see this phenomenon and that we could see a very uncomfortable pressure on interest rates if we don't give ourselves a little more room. And one reason we ought to give ourselves more room in the revision of the '82 target is that it will influence our decision on the intermeeting growth path, the targets we'll get to tomorrow. That's all I'd like to say now.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I would start by saying that as far as the remainder of '82 is concerned I would prefer alternative A, which implies an M1 growth of 2-1/2 to 5-1/2 percent--in other words, maintaining our present range but with the understanding, either tacit or stated, that M1 will be permitted to grow either at the top or slightly above the 5-1/2 percent upper limit of our range. As for the longer-run growth strategy, I would prefer strategy IV, which assumes that M1 would indeed grow at 6 percent or thereabouts this year and be reduced to 5-1/2 percent in 1983 and 5 percent in 1984.

I am really not surprised, according to the way we analyze the effect of money growth on the economy, about output. I'm not amazed or surprised about where we are at the present. I think the present extreme softness in the economy can be directly attributed to the period of approximately 6 months last year when we permitted money to grow at a very, very low rate. I believe there is a definite relationship [because of] an abrupt reduction in money growth and our keeping it at below trend for as long as a 6-month period.

In looking ahead, I think the downside risk is a very real risk because if we decide to attempt to bring growth of M1, which has been at about a 7 percent rate for the first six months of this year, significantly within our announced range for 1982, that would entail reducing the rate of money growth to about 3 percent for the last six months of the year. And if we were to fall into that trap, it's almost certain that next year we would face either a continuation or an acceleration of the recession we're presently experiencing. And that would pose a severe threat to what we've been trying to do because then those who are apostles of expansion would most certainly be on our backs and ask us [unintelligible]. If we go into another economic dip in '83, I think that could well spell the end of an attempt to control money growth intelligently--some of you might not consider it intelligently--to accomplish certain economic purposes.

Now, if we feel that we will resist the temptation to jam on the brakes over the last six months of this year in order to bring the aggregates within their ranges, we have the question of whether it's better to adjust our ranges upward and announce that now or to recognize at least among ourselves that there probably will be some overshoot beyond our stated ranges for the rest of the year. Before receiving the Bluebook, I on three occasions tested groups of people at home: our board of directors, twelve corporate treasurers of our largest companies who were in for lunch, and most recently the five heads of our major banks. I asked them this hypothetical question: If the Fed faces the inevitability of an overshoot of its present range in the last six months [of this year], do you think the Fed is better off to adjust its range upward or to tolerate the strength for the rest of the year and then say that there were certain circumstances that caused us to overshoot these stated targets slightly? And this is no exaggeration, Mr. Chairman, there was unanimity, and I underscore unanimity--not one voice to the contrary. They said: For heavens sake, don't adjust your ranges upward because if you do that, it will be interpreted as a dramatic indication that you are softening up on your anti-inflationary effort. This was just the judgment of a bunch of people, but they felt that the danger to our credibility would be significantly less if we were to allow a minor overshoot of our stated targets rather than announce an upward adjustment of those targets. So, that's where I stand.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I share many of the concerns that Lyle expressed about the risks in this economy. And I come down to the bottom line that the most likely outcome is very near to what the staff has projected. We actually come out a tad more optimistic in expecting a little more real growth, a little less inflation, and a little lower rate of unemployment. But we were assuming a 4 percent rate of growth in the money supply. So, to show our versatility and flexibility, we tried it at 4-1/2 percent and came out pretty much the same way. It really didn't change the [outcome] appreciably. But I do have a lot of differences with most of those who have spoken about what we ought to do with our long-run targets. I'm disappointed, of course, as I'm sure all of us are, that we're ending the first half with M1 and M2 apparently above the upper limits of our ranges. And depending upon what this new revision does to M1, that aggregate might be well above the upper end of its range.

CHAIRMAN VOLCKER. It can't be well above. Of course, that does depend upon what one assumes for June but it can't be well above. I don't know what your interpretation of well above is. This week we'll be within the range.

MR. BLACK. [This week M1 is] moderately down. I hope that what the staff now forecasts is what happens; in that case I don't think one can say "well above," but I don't know whether that [projection] really will hold up. I recognize the possibility that this burst in M1 may well reflect unusually strong demands for liquidity on the part of the public or it may be partly a reflection of the unusually sharp drop we had in interest rates toward the end of last year. But it's at least equally plausible that it has resulted from our having put out too many reserves, as I think John Balles' memorandum suggested very cogently. We're now in a situation, of course, that to stay within our targets we're going to have to decelerate the rate of growth in the aggregates. And that puts us between a rock and a hard place. But even though it isn't a very comfortable choice to think about having to slow down the rate of growth in the aggregates somewhat from where they've been, I think it would be a serious mistake to raise the long-run targets. It seems to me that the key to the sustained recovery has to be an improvement in the financial conditions of the business sector. And I don't really believe we're going to get that unless we have an improvement in the long-term capital markets--a reduction in long-term rates. And as you, Mr. Chairman, and others have stressed very well, we have a commitment to lowering our targets gradually over the long run to get them to a noninflationary rate. If we were to move the targets now, as Larry's survey suggested, I think most people would interpret it as an abandonment of our stated objective. And such a change in the public's perception of what they think we're doing could postpone indefinitely the strengthening in the capital markets that I think we so urgently need. So, I would opt very strongly for retaining our present targets and hope that we don't overshoot them. So far as next year is concerned, my inclination is to cut those ranges by about 1/2 percentage point.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Mr. Chairman, everything that I want to say has already been said, so I'll synthesize quickly: First, I think that the staff's forecast is probably as good as any forecast and secondly that the risk is on the down side in the latter part of 1982 simply because the forecast is based upon some downward shift in money [demand] or an increase in the velocity that may or may not occur. Those are all prospective judgments and there is no historical record really to support them. But having said that, it seems clear that we are in risky waters. There are businesses in financial stress; I don't think we should be surprised at that in view of the monetary policy we have been running. We have achieved some good on the price side.

Starting from that point, on the question of what we should do for the last half of 1982--the choices being to retain, raise, or rebase--I'm attracted by the arguments that say that we should probably retain the 1982 ranges of 2-1/2 to 5-1/2 percent and 6 to 9 percent for the aggregates, with some sort of public announcement in your testimony that growth would be at the upper end or even [that we would] tolerate some modest overshoot rather than take the affirmative step of increasing the ranges up to 6 percent, for example. As Tony has pointed out, those are very modest increases and they really are not very meaningful. And because of the credibility concern, I'd rather stay with the current ranges and make a public announcement that we're going to be flexible rather than do what is necessary to come within the 5-1/2 percent top.

As to 1983, it would be my preference to reestablish the range for M1 in 1983 at the current 2-1/2 to 5-1/2 percent with the explanation that we will indeed be at or near the top of the range for 1982 and that because of past performance we don't expect it to be within the range by the last half of this year and thus the 2-1/2 to 5-1/2 percent [in 1983] is still consistent with our professed desire to move money growth to lower levels over some extended period of time. There is a lot of flexibility between 2-1/2 and 5-1/2 percent if we achieve 5-1/2 or 6 percent for 1982. If we want to reinforce the commitment to move to lower growth rates in 1982, we might consider adjusting the M2 range down 1/2 point. If you recall, we have not had any downward adjustment in M2 for two years now, I believe. And if the [MPS] model means anything at all, it would suggest that in 1983 M2 will grow somewhat more modestly than M1 and thus a 5-1/2 to 8-1/2 percent range for M2 would be consistent with what we're looking for in M1 at 2-1/2 to 5-1/2 percent.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. To start first with the economic situation: My comments are repetitive of what I've said in the past and repetitive of what we've already heard. The situation in the Midwest continues to be very, very serious. I keep reading about the recovery that is going to occur but I am coming to the view that it is something we all hope will come but perhaps may not. Indeed, I'm beginning to have a lurking suspicion that we could be on the front edge of something much worse than we realize. Virtually all of the sectors in the Midwest [economy] are continuing to deteriorate. The capital goods figures were in the paper. All the major companies are continuing to review their capital expenditure programs and each review results in a further curtailment. The steel industry is operating at a capacity level not seen since the 1930s; that speaks for itself. In the agricultural sector, the situation is a touch better on the livestock side but not on the grain side. And the farm implement manufacturers really are in a very, very difficult state.

So, my comments, regrettably, are unchanged from what I have said before; indeed I think things are a little more serious. One CEO perhaps summed it up best by telling me the other day that in his view the situation is terrible, that it is getting much worse, and that an attitude of fright is now beginning to spread over the business community. I think perhaps we have a new problem, though I admit it's a bit anecdotal, in that I'm hearing some comments from various bankers that I've talked to about the buildup in problem assets. I've been astounded by the increase in total loans that has taken place this year in the face of the recession that we're dealing with. I have just a hunch that there are a lot of loans that are, to use the euphemistic phrase, desperation loans, and that we could be seeing some nonperforming assets resulting in some losses. Summarizing my comments about the District: The situation is very, very serious.

With regard to our strategy, unless I were to hear some very specific definitional and structural reasons to change our targets this year--and I haven't heard them so far--I think that we are the only credible game in town and that to change the ranges this year would run a very significant risk. I would leave the ranges this year as is, but I would certainly aim at the high side and wouldn't be the least bit upset if we were to miss or go over. Looking ahead to next year, in light of my comments, I think to reduce the ranges for next year would be a very serious step and I certainly would be inclined to leave them just where they are.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. Picking up on what Nancy said, I really wish that we could wish away the problem of having to decide. But as the Chairman pointed out, we have the law to contend with and we have to get up there and say something [about the ranges]. Looking at the budget picture: If you figure that this [fiscal] year, which is 2/3 behind us, the deficit has run right around $100 billion, the difference between the first projected resolution on the budget and the actual has averaged over $50 billion per year for the last three fiscal years, including this one. My feeling is that the market, as suggested in the summary we got from the staff, is looking at $104 billion as pie in the sky and that something more like what the staff put in is what the market would consider realistic, based on differences between previous first resolutions and actual performance recently. And that says that fiscal policy is very expansive and unlikely to improve in the context of an election campaign.

Were we to come in behind that and give the signal that we're purposely changing the monetary track to move to a more expansive mode by raising the targets on top of the existing fiscal situation, then we would appear to have both a more expansive fiscal policy and a more expansive monetary policy. Our so-called flexibility wouldn't achieve the results in the area we get the most heat about, which is interest rates--"the results" being a reduction in interest rates with the hope that it will relieve the pressures on peoples' balance sheets and the interest payments they have to make, for those who have to make them. We could well find it to be counterproductive in the area of interest rates because the market would simply mark up the real premium in demands in response to both fiscal and monetary expansion. So, I'd go with the group of people who have said: "Let's not change the stated range." And certainly let's not make a superficial change that has a definite signal value by adding 1/2 point. That gives a signal but it really doesn't amount to anything quantitatively; we would be throwing in the towel symbolically without doing anything substantively. Therefore, I come out for staying with the range we have for the long term. At this point I don't feel inclined to continue to drop the range in any significant way for next year. I'd rather hold off for a while on that until we get more information. So I come down with people who say--it seems like the majority of the people here--we should stick with what we have on the range that we have stated and continue to say we're trying to get within the range and pray like the devil that we're in the range this week and don't get blown out of it.

CHAIRMAN VOLCKER. It may last one week.

MR. PARTEE. Mr. Chairman, there is a fourth possibility that wasn't mentioned and that is to rebase using the second quarter as the base. That is to say, in effect, we overshot but now we're going to--

CHAIRMAN VOLCKER. There is also another possibility obviously, just mechanically, which is raising some ranges and not others. But on rebasing at the second quarter, as a matter of reporting to you if nothing else--and it may be more than reporting to you--Mr. Reuss had a suggestion for us as usual when I was testifying a few weeks ago and that is specifically what he said. He said "Why don't you rebase on the second quarter and adopt a range specifically of 2-1/2 to 7-1/2 percent for the second half of the year?"

MR. PARTEE. Well, I was thinking of the same range for the remainder of the year as earlier specified.

MS. TEETERS. But there's still a fourth possibility here and that is, if we say we're going to overshoot--

CHAIRMAN VOLCKER. We have more than four already!

MS. TEETERS. All right, I'll suggest a fifth. If we're going to overshoot, it seems to me that we have problems in explaining ourselves to the market because we leave them without any information as to what is an acceptable overshoot. One possibility is to more or less quantify what we find to be an acceptable overshoot, given all the uncertainties, which we can outline, and they have been outlined. We could stay with our ranges for this year and then give some idea as to what the acceptable overshoot would be--in the neighborhood of an extra one percentage point or something of that sort. It may turn out that as we go through the year growth will come back down into the ranges and we can just forget about the extra 1 percentage point that we've added on. I'm concerned that we never change the ranges, gentlemen, and we're supposed to be flexible. So, it would be something if we could break out of that cage, which seems to me very desirable.

VICE CHAIRMAN SOLOMON. Let's be flexible somewhere else this time.

MR. GRAMLEY. We've changed the ranges; we always change them downward. See how flexible we are!

MR. BALLES. I think she means we've never changed--I don't believe we have--by making a midcourse correction in a range tentatively announced in July for the following year. We have never changed that.

MS. TEETERS. That's right.

MR. BALLES. That's the kind of inflexibility that has bothered me also.

MR. ROOS. Prior to '79 we were probably the most flexible--

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, we've been describing the M1 box into which we have woven ourselves rather tightly here. I've heard a number of people say that they think our policy is too tight but we can't do anything about it. And it seems to me that that is indeed an unfortunate situation to be in. It has cleared my mind considerably to have arrived at a conclusion that M1 is no longer a reliable guide to policy and I would recommend that view to all of you or recommend that you at least contemplate it. It clears one's mind on such issues as contemporaneous reserve requirements and many other things. If you look at the situation, last year M1 ran low relative to the other aggregates and low relative to expectations. We didn't understand why it ran low last year. Although I don't recall debating it very much, we didn't decide to rebase our M1 guidelines for 1982.

MR. PARTEE. But we did discuss it at length.

MR. MORRIS. We did? Well, we came up with the wrong conclusion, obviously.

VICE CHAIRMAN SOLOMON. You were so indifferent to M1, you didn't care!

MR. MORRIS. Now M1 is running high relative to expectations and we don't understand that either. And now we're looking at a situation for the last half of this year, according to our official projections, in which we are projecting a resurging economy combined with an--

CHAIRMAN VOLCKER. That's rather an overstatement.

MR. MORRIS. Of course, but we are coming out of recession and going into positive real growth, a higher nominal GNP, and that is going to be accompanied by a slower rate of growth of M1 and a deceleration in interest rates. There's nothing that is impossible in economics, but the probability of having those three things come together, based on historical evidence, is very low it seems to me.

CHAIRMAN VOLCKER. If I may just interject, Frank: What were the probabilities of having an acceleration in M1, a declining economy, a declining inflation rate, and a rise in interest rates over the first half of the year?

MR. MORRIS. That was also very low. But one cannot build a case for expecting an improbability on the basis of having suffered through one in the past. If we're going to get out of the M1 box sometime--and I think ultimately we're going to--why not now? So, I propose a range for this year of 8 to 11 percent in total liquid assets.

CHAIRMAN VOLCKER. You have the statistical data to back that up, so we can all look at it carefully?

MR. MORRIS. Yes.

MR. PARTEE. What is that? Is that L?

MR. MORRIS. Yes.

MS. TEETERS. And how are you going to construct reserve paths on that basis?

CHAIRMAN VOLCKER. It has the great advantage that we don't know the figure for three months!

MR. MORRIS. Well, I think we could know the figure if we set out to get it. If we decided it was an important number, we could get it fairly currently.

CHAIRMAN VOLCKER. How has L been doing?

VICE CHAIRMAN SOLOMON. That's a cheap advantage of it: That we don't know the figures.

CHAIRMAN VOLCKER. We'll ask you to do that research for tomorrow.

MR. CORRIGAN. Steve doesn't know the answer.

CHAIRMAN VOLCKER. Mr. Martin.

MR. MARTIN. I would join those of us around the table who have pointed out the downside risks when we consider a consumer-led recovery. I think we are all aware that the consumer is in a very different frame of mind and financial frame of reference than he was previously. It's all very well to indicate the improvement in the liquid assets of consumers as a group; but in terms of consumer demand for durables, we're likely to witness in the latter months of this year and in 1983 the factor that Governor Partee brought out, which can be built on a little. When we talk about residential building and the financing thereof, I would take no exception to his comment. But when we think about the mass of consumers--those tens of millions of consumers who already have mortgages and trust deeds, many of whom for some years have been in the habit of refinancing those residential mortgages and pumping that money into durables not to mention trips to Europe and kids going to private schools and a lot of other good things--those same people are witnessing the cocktail party conversation now about how much so-and-so lost when he was transferred to Boston or whatever. And they are finding that that source of funds has definitely dried up. In fact, there are others within that group of consumers who are having difficulties now meeting the [higher-cost] refinancing that is being imposed upon them. And as that kind of conversation wafts its way through suburbia, not to mention exurbia, the tendency is to build up those good old precautionary balances and to have a liquidity preference that is a bit different from what it was when one could go and get $15,000 or $25,000 on the residential mortgage. I'm not so sure that those precautionary balances are going to be translated into spending and that we can count on the projected changes in velocity.

Indeed, as the shocks that Lyle and others mentioned here occur--and we don't need to attach a probability to failures of major corporations and failures of major financial institutions in the country because I think those failures are a certainty and will be exaggerated by the media--the effect on the consumer of these shocks is going to be significant. Talk about a multiplier! This also says to me that there are implications not only with regard to precautionary balances held by consumers on the one hand and business firms possibly on the other, but it has implications for the kind of financial climate that we maintain--a liquidity climate or availability climate, if you will--for the economy in general given that individual crises will be magnified at a time when consumer psychology and attitude are important. And it seems to me for us to skate too closely to constraint or to usual or historical norms would be very dangerous.

So, to the extent we can do so without upsetting the markets, I lean in the direction of liberality. In terms of the question of overshooting versus raising the targets, I think we have to realize--again thinking in terms of what the consumer understands and what he does not understand--that there have been improvements in the control of inflation. The consumer does not understand the [technical] matters; if you start talking to him about velocity, he becomes very glassy-eyed. I think the consumer can understand that if we raise the targets, we may be liberalizing [policy], and he may feel that's a bad thing. I don't think he will ever understand our explanations, however well expressed by anybody--excuse me, Chairman--about the overshooting phenomenon. I'd lament the raising of targets; that would communicate something we don't want to communicate. But I think we can explicate the overshooting process on and on and have good reasons and understand that it is more acceptable. I hate to see us locking ourselves into what we should call bracketmania or target madness so that we raise the targets and then say okay we raised them, now [we have to] make them. I hate to see us overstress the targeting as such and would rather see us have the flexibility of saying sure we're over, or yes we're under, and here are the reasons.

CHAIRMAN VOLCKER. Even though they don't understand them?

MR. MARTIN. I'll reserve on that. Yes.

CHAIRMAN VOLCKER. Mr. Corrigan. We have just two or three more speakers to go and I want to turn [our attention] to our friends south of the border here before we get finished today and maybe say a few things myself.

MR. CORRIGAN. On the economy, Mr. Chairman, I made a forecast that looks like everybody else's, and the fact that everybody's forecast looks essentially the same is one of the things that worries me. I think it suggests that none of us knows what is going to happen. I do agree with all that has been said on the downside risks; I think that's where the problem may lie. But there is at least a tinge of a different interpretation one could put on all that has been said, and that is that we may be losing sight of the fact that in all of this there are also some things that have occurred in the fairly recent past that aren't all bad. The inflation improvement is no longer just a statistical aberration; it's very real. We have a situation where in my judgment, for the first time perhaps in the postwar period, businesses are really looking at themselves. They are not just going through the superficial aspects of counting noses and cleaning house in the conventional ways. Beyond that, I think we do recognize that the consumer has done a reasonable job of getting his balance sheet in order. There's the prospect, if we're right about a near-term recovery, that at least the deterioration in corporate liquidity in a statistical sense could moderate.

Fundamentally, what I am suggesting is that in all the doom and gloom there are some elements that with a break or two might bode very well for the future rather than all being on the down side. However, I do agree that the downside risks are there. And they all come back to the question in some simplistic sense of the way to alter the balance of the risks that everybody has talked about. It seems to me to reduce to the proposition of: How do we get interest rates down? That's the one thing that would alter that balance of risks. I don't want to sound too agnostic on this score but my sense of things is that jiggling the money supply and the ranges that we're talking about jiggling either in real terms or in target terms isn't the answer. That is not what is going to get interest rates down. The interest rate problem, as I see it, is a combination of an expectational phenomenon partly growing out of the fact that the reality of lower inflation has not sunk in--and maybe we shouldn't expect it to have sunk in this fast--but more fundamentally a continuing reflection of this overall Federal budget situation. I think a great opportunity was missed a couple of months ago and that miss was very visible in the eyes not just of Wall Street but of Main Street. Regardless of whether the number is $140 billion or $160 billion, the sense on the budget situation is that it is in fact deteriorating. And it's very hard for me to see how, given that and the other factors I've mentioned, there's a lot we can do in jiggling monetary policy that really is going to get at that fundamental problem in the near term of lowering interest rates, which again I think is the only thing that really can alter the balance of risks.

Taking that into this strategic discussion about the targets, let me do it backwards by looking at 1983 first. I very plainly would come out in favor of leaving the 1983 targets where the 1982 targets are, across the board. I would do that partly in the context of saying that there is more than the usual amount of uncertainty. But I might also suggest, depending upon what we do for 1982, that keeping the same targets for 1983 might well produce a situation in which the actual growth of money in 1983 is lower than in 1982. But I certainly wouldn't be disposed to do anything now other than restate for '83 the targets from '82. Now, on the question of the '82 targets, I do count myself in the camp of those who would say: "Let's stick with what we have." I say that for a couple of reasons. First of all, I am willing to put my bet on the proposition that we will get some rise in velocity in the second half of the year. I say that partly because I do think that some of that NOW account activity could wind down; and I also would suggest that the kind of velocity increase that we would need to achieve in order to see the economy behaving something like Jim's forecast isn't all that big. If we had 5 percent money growth in the second half of the year, that would leave us in pretty good shape vis-a-vis the M1 target.

MR. PARTEE. And above the targets. We would be above with 7 percent for the first half.

CHAIRMAN VOLCKER. No. Well, it depends upon what your base is. If you go to June--

MR. PARTEE. Well, I mean the base is the fourth quarter.

CHAIRMAN VOLCKER. No, what I mean is that it depends on where one is going from. That 7 percent may be right for the second quarter, but looking from June to the rest of the year we're going to be very close to the target in June, if these numbers hold up.

MR. GRAMLEY. Where will we be in July?

CHAIRMAN VOLCKER. We don't know. But if you just look at [growth] for the rest of the year from June, I think--no, it depends on what you use as the base.

MR. PARTEE. Yes, I agree with you. I was looking at the fourth quarter to the second quarter.

MR. CORRIGAN. Well, I don't think we would be all that bad off. My point is that if we had something like that, it gets the kind of economy that Jim is projecting. You're talking maybe about a 4 percent velocity [increase] or something, which doesn't strike me as all that unusual in those circumstances. So, analytically, I don't find it hard to envision a set of circumstances in which we could produce that result. But beyond that, I must say, along with Tony, that even if we're talking about changing the target by a point, it strikes me as adding an element of precision to something that inherently is not all that precise. And if we get a bulge in July and we change the targets, I could be really cynical and say that then the markets are going to say: "My word, they're really going to miss." And are we any better off? I don't know. But the fact of the matter is that even if we miss by a point, that's not a lot. It's $4 billion or something like that. We get weekly changes that exceed that. So, I would stay where we are. I think changing them, particularly in the context of the fiscal situation, does entail a very high risk of some significant loss in credibility when all that has been achieved so far is so fragile. I don't want to lose that. There are a lot of different ways to skin this, Mr. Chairman, but I would hope that perhaps between now and when you ultimately have to testify we can at least find the time to look at some of the presentational aspects of those target ranges which I think hurt us as well, whether we change the targets or not. I don't want to get into that in any great detail now, but while 1 percentage point sounds like a lot, $3 or $4 billion on a quarterly average basis doesn't sound like a lot to me.

CHAIRMAN VOLCKER. Draw a chart with a zero base line next time.

MR. CORRIGAN. You could draw a line.

CHAIRMAN VOLCKER. Well, we don't want to get into that. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, Jerry in general terms said pretty much what I've been thinking. Obviously, the downside risks are there. I have a feeling that I don't view the risks as quite as great as most of you around the table. I happen to think that we're doing pretty well where we are. For 1982 I would reestablish the targets where they are. I'm very sympathetic to Nancy's point about flexibility. I would love to be flexible if I can ever find a reason for it. I think the course we've charted really isn't all that bad. In fact, I would like to see us actually come within the target range that we specified by year-end. I think it's doable. It is supported by the staff's forecast, with which I really don't have any quarrel. Looking longer term I think we will be in a much better position if that actually occurs, assuming that we still have an economy after that!

MR. PARTEE. That would certainly get a--

MR. BOYKIN. I guess I would say this, Frank: I think I know where we ought to be; the issue is whether we can get there from here.

MR. BOEHNE. Well, if a Texan makes a statement like that, I'm really scared!

MR. BOYKIN. For 1983, I would differ from Jerry. I would be inclined, much as Bob Black was, to reduce the ranges a little for '83 with a very clear understanding that whether that would hold or not would depend on developments and would be firmed up at year-end.

VICE CHAIRMAN SOLOMON. You're going to be flexible in February!

MS. TEETERS. We've never been flexible in February before.

MR. BLACK. But he's looking for a justification to be flexible, Nancy.

VICE CHAIRMAN SOLOMON. One point on flexibility between the preliminary figure given in the testimony in July and the figure adopted next February is that it's always easy to go down a half point; it's a lot harder to go up a half point if we put our preliminary target a half point lower.

MR. BOYKIN. Well, in terms of our stated long-term objective of a gradual reduction in the growth rate of money, this is an extremely critical time. That's very obvious. But I don't think anything has occurred to this point that should deter us from that over the long term. And I would have some concern if we were giving preliminary signals that it may not be the thing to do at this point. But depending on what happens between now and next February, if the circumstances certainly indicated that we shouldn't reduce the ranges or should maybe even raise them, I think it would be much more understandable and much more justifiable. The credibility issue is extremely important. I'm inclined to give quite a bit of weight to the perceptions problem myself.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, much of what I had in mind was very well stated by Jerry Corrigan. I do think the main difficulty and the main thing that puts us into the dilemma we are in is the current level of interest rates. I agree with Chuck Partee that our main objective ought to be to find a monetary policy strategy that would minimize the likelihood of shocks to the economy caused by monetary policy. But listening to the proposals that have been made this afternoon before 5:00 p.m., none of these seems really to get at the basic problem that Jerry dealt with at some length. And that is: How do we get interest rates down? In my judgment none of these proposals is likely to get interest rates down. So, I'm in a position of trying to choose the least bad of the alternatives before us, and I think the least bad is the one that Tony proposed: That is, that we stick with the current targets but allow ourselves the flexibility to come in above these targets--and in my judgment, considerably above these targets--if necessary. I want to say that I'm very gratified to see so much flexibility around the table, and flexibility in unexpected quarters in some cases. I hope we'll continue to be--

CHAIRMAN VOLCKER. You may provoke a longer discussion!

VICE CHAIRMAN SOLOMON. That's because some people didn't know the end-of-June figures. That's the only reason.

MR. RICE. I hope we will continue to be flexible and continue to be willing to do as much as we can. I'm not convinced that it will be possible to do enough. Anything we're likely to do or can do wouldn't be enough, but I hope we'll continue to be flexible enough to try to do as much as we can in the direction of lowering interest rates. In general, I go along with the staff forecast. I very much hope that it turns out to be right.

CHAIRMAN VOLCKER. Just for purposes of clarification, when you say none of these things in your opinion has a probability of lowering interest rates--

MR. RICE. Significantly.

CHAIRMAN VOLCKER. What you're saying is that there is nothing we can do by ourselves to do that; I presume that's the implication. You're not holding out on us with some other plan that would do this?

MR. RICE. No.

MR. PARTEE. How about a national usury ceiling?

CHAIRMAN VOLCKER. I guess I'm not worried about that. Governor Teeters.

MR. RICE. Excuse me. Could I just say that for 1983 I would stay with the present targets.

MS. TEETERS. My initial response when you were about halfway through the discussion was that it would be more diplomatic if I kept quiet. However, I would like to make some points about where I think the ranges should be. I can see all the arguments for not raising the ranges. On the other hand, if we just say we are going to tolerate going over them, then we will have problems with the people with sharp pencils in New York who sit down and figure out how much money can grow over the rest of the year in order to come within the targets. So, I feel fairly strongly that we have to give some indication as to what the overreach that we will tolerate will be. I think that will help them. It's the clearest way to send a signal to the market that we will tolerate lower interest rates because they probably would associate and accomplish what you're after, Emmett. So, I think we can't just go up [to the Hill] and say fuzzily that we're going to go over [the target]. We have to make some determination about what is bearable. And maybe we want to make it larger; I think the 1/2 point won't do it, Tony. A point probably would, and a point-and-a-half would be an even stronger signal to the market to bring the rates down. For next year, I see absolutely no reason to lower the ranges at this point. That's putting us into a box that we put ourselves into a year ago and we're now trying to get ourselves out of it. I think it's foolish to do that. In fact, it might be good policy as a general matter year after year to say that we're not changing the ranges at [midyear] and thus leave ourselves maximum flexibility come February.

CHAIRMAN VOLCKER. Mr. McDonald, you bring a message from--

MR. MCDONALD. Other than no baby to report.... I can pick up on President Keehn's comments about economic conditions. Ours are the same or very similar to what they are in the Chicago District. Our unemployment rate in April and May has been 12 percent. And this occurred despite a slow, steady reduction in the labor force in recent years. Comments were made about steel operating now at 45 percent of capacity; and [conditions in] the auto industry and manufacturing industry are very similar, although our banks are showing less signs of strains than their counterparts nationally. Loans and assets and deposit growth have exceeded the national average as well as the year-earlier performance. Our loan-to-deposit ratio is about 75 percent, which is about 11 points below the national average. Savings and loans, on the other hand, are plagued by continued deposit outflows. In our ten largest S&Ls, losses were at the rate of a million dollars a month over the second half of '81. There's a possibility that half of these [institutions] will have to be merged, perhaps later this year. The weak economy in Ohio has contributed to a projected billion dollar deficit in the Ohio budget by June '83 and this is going to be met by a 50 percent increase in the income tax surcharge effective tomorrow. So, for low and middle income families, the surcharge will virtually offset the reduction in the [federal] income tax.

MR. PARTEE. A surcharge on the state income tax?

MR. MCDONALD. On the state income tax, right. As for the target ranges, we agree with the [current] path. Longer run, I would agree with Presidents Black and Boykin and support, consistent with sustaining a gradual disinflationary posture, reducing them by 1/2 percentage point and staying within the targets. There are those who say it's bracketitis or that type of thing. But we are getting more and more comments from bankers and business people saying that you at the Fed set the targets and you ought to stay within the ranges. We all recognize the same thing that you do around the table, but that's seemingly very serious.

CHAIRMAN VOLCKER. Let me turn to Mexico because we have people waiting for an answer here. We distributed a paper on Mexico and people presumably had that last night.

MR. TRUMAN. No, they didn't. They got it when they arrived.

CHAIRMAN VOLCKER. Well, you have it. You've all read it and studied it carefully. Let me bring you up to date. We are providing essentially some window-dressing money and it's only window-dressing money. We'll keep it in the bank tonight. It is less than the full amount of the swap. You were asked for your approval of that yesterday or the day before, whenever it was, and that has been done. The more important question is the need for real money. I don't know that anybody knows how that stands precisely. But there's a clear possibility that they may need some money, if not today, tomorrow or the next day. These days are particularly critical with respect to Mexico because there happens to be an election over the weekend. It's their quinquennial event. It's always troublesome in Mexico not because they don't know the victor, but because they have some concern over the size of the plurality and they have a long electoral process which stretches out. They are somewhat limited before the election as everybody is. They have an electoral college vote late in July, so they don't like to upset things too much before the electoral college meets. There is a state of the union message in September by the outgoing president, who never likes to bring up any bad news or make any big policy changes; and the new president doesn't come in until December. So if you think our process of changing command is lengthy and has its inhibitions, theirs is worse. They have obviously tried some borrowing in the private markets. They spent a lot of time negotiating a big loan of $2-1/2 billion and they signed up the lead banks well over a month ago as I recall. The banks went out and tried to syndicate it. And I might say it has a very liberal margin, higher than they had been paying, but not a Brazilian standard of 2 percent or more. It was around 1 percent or a little less.

MR. TRUMAN. 1 percent.

CHAIRMAN VOLCKER. I forget the exact [margin]; it doesn't make any difference. The banks found out during this period in going out and syndicating the loan that there was very little response, which I think is symptomatic of banking attitudes toward Mexico at this point. So the leaders in the syndicate got stuck with most of the loan because they had agreed to underwrite it. The loan presumably went through today finally. It was going to be signed every week and never got signed. I presume it got signed today. But by this time there is no money left of the loan because half of it goes into refinancing short-term debt that these same banks had put on some time ago and the other half goes to repay a bridge loan that they had made when they agreed to make the loan in the first place. So, there isn't any cash from the loan. And it's all symptomatic of the international financial markets closing up pretty tightly on Mexico now.

Mexico has a program that is described in that paper. It's hard to tell, but the sense is that they're not having a big run or outflow from Mexico; such an outflow was not unlikely before the election. And the fact that they got through apparently without [outflows] of big size anyway before the election is somewhat encouraging. But the sense is that there are a lot of short-term as well as medium-term loans maturing and they can't roll them over now. So they have a cash bind. To give you some idea of the overall problem, which probably is in the memorandum, their plans were to borrow $27 billion gross this year as I recall. That's over $2 billion a month. That would lead to a net increase of about $11 billion in outstanding indebtedness, which is less than they did last year. But they have to get almost $1 billion a month net to [finance] their balance of payments [deficit], and that doesn't assume a big outflow from Mexico. Against all those numbers our swap is not overwhelming in size. It can help them get through the election; it may help them some days thereafter, if we do it, or intermittently thereafter. But they obviously have a basic confidence problem they are going to have to deal with. And they have begun to deal with it. I think it's at least a token of good faith. As was noted in the memorandum and the telegram, Mexico's finance minister and central bank governor have gone around saying more openly than in the past according to my memory: "Too bad, but no growth for a year or 18 months because we have a big adjustment problem here." And that has been said quite publicly and openly. But they have come to us; they haven't much other recourse that I know about for getting money in the short run. It's not quite clear what they are going to need in the very short run. Our problem, of course, once we get into this morass, is: How do we get repaid when they have that kind of borrowing need? And the loan is not going to be repaid unless they have access to public credit. I don't mean public credit; I mean access to the market. I don't know of any access they have to public credit in big ways. The United States government may lend them a little money, but that's not going to amount to a hill of beans.

SPEAKER(?). The IMF?

CHAIRMAN VOLCKER. Access to the market is what I mean. And, of course, from that point of view the question arises about the IMF. The IMF doesn't have enough money to take care of them for very long, but the IMF can be critically important in terms of encouraging reinforcement of their program and encouraging confidence so that the market is reasonably open to them. I might just mention that on top of all this they have the de facto bankruptcy of the biggest company in Mexico complicating all this with its many outstanding international loans.

The reason Sam Cross isn't here is because he is in Mexico City with a proposition for our lending them some real money as opposed to just window-dressing money if we can get a satisfactory commitment--to the degree one can get a commitment now as a practical matter--that the loan will be of limited duration, that in the last analysis they will borrow from the Fund as a means of repayment, and that if they are going to have to borrow from the Fund that implies some approach to the Fund before the maturity date of the loan. We have talked with the Treasury about this--both the Treasury and the Administration more generally one might say--because this obviously has broader ramifications. It is the kind of thing that we would naturally want to get their view on in terms of its other implications, and they also have some lending capacity. The Treasury has a swap agreement with Mexico of only $300 million, which is now written and has been for a number of years to say that they will only lend to them if Mexico has an IMF program in place. And there is some much vaguer language in the statute that doesn't say that an IMF program has to be in place but to some degree restricts their flexibility on how the ESF lends money. The upshot of all this is that Sam went down there to find out whether they would agree to a letter in effect saying that they would borrow from the IMF in the last analysis if they have to in order to repay this. And we have asked the Treasury whether they are willing to send us a letter that in the last analysis, assuming that Mexico has an IMF program which is consistent with their swap terms, they either would join us in lending to Mexico or help take us out if that were necessary. Probably if they do borrow from the IMF, under IMF procedures, the IMF cannot in the immediate instance lend them enough money to repay our swap in the full amount because the tranche that they would in normal circumstances be eligible for without some passage of time is what-- $300 to $400 million?

MR. TRUMAN. $300 million at the minimum, but it could be as high as $400 or $500 million.

CHAIRMAN VOLCKER. There's a little room for flexibility here, but we can't be certain. We would have to wait another quarter or six months or whatever for the next tranche. We have a [draft] letter that apparently they are prepared to write, which surprises me a little just in terms of the tenderness of the political situation there, two days before an election. That's a tough problem for any country, too. I did not mention in the background that the present president of Mexico on a number of occasions said he would borrow from the IMF over his dead body. I can read the letter to you. Did you give me a copy of that letter?

MR. TRUMAN. Yes.

CHAIRMAN VOLCKER. I will read to you. I will not go down this word for word in the sense that there may be a little room for changing it slightly, but I think it has the essential elements that we were looking for. And this would be a letter to me, presumably. "I'm pleased that an agreement has been reached in reactivating the swap arrangement. In order to bolster market confidence and strengthen Mexico's reserve position, the Government of Mexico in coming weeks will accelerate the implementation of its stabilization program that was announced on April 21..." I might say they have said that they were going to do that anyway. That's nothing new. The letter continues "and, as necessary, intensify that program. The Banco de Mexico intends to repay its drawing as soon as its reserve position permits." Now, let me just put a little gloss on that sentence. They think they're going to get a loan--what amounts to a loan, I guess, in that it's a prepayment for some oil sales in Europe --next week so we could be repaid as early as next week if that goes through. And that's the intention. But that doesn't mean they wouldn't be back. They need $2 billion a month. And all they are doing is anticipating next month's oil sales. They won't come in the normal way. So, we may get repaid next week, but it's not the end of the problem by any means. "The agreed drawing will have a maturity of one month, subject to one additional three-month renewal on mutual agreement. In any event, any and all drawings made under the swap arrangement will be finally liquidated no later than October 31, 1983." That would be the one month plus the three months. That's an earlier date than we suggested to them. I don't know why that ended up being earlier. "The Government of Mexico and the Banco de Mexico will take all actions required to meet these obligations including, if necessary to meet the final liquidation date, timely drawings from the International Monetary Fund. Accordingly, if necessary to meet these obligations, the Government of Mexico is prepared to undertake detailed discussions with the International Monetary Fund with a view to establishing an International Monetary Fund program for Mexico in the fall." Basically, the only difference in this from the letter we suggested to them is that we tried to pin them down a bit more as to when in fact they would walk in the Fund's door and say "We want to talk." This is a little fuzzier, but--

VICE CHAIRMAN SOLOMON. I think you ought to emphasize how much damage a leak from this meeting--particularly about the language that's here--would do. I can't underestimate it.

CHAIRMAN VOLCKER. It's very sensitive; there's no question about that. The other letter is a letter from the Treasury saying that they recognize this other situation and some language we haven't fully worked out to the effect that they think the drawing is appropriate and they would participate in credit to Mexico as soon as the IMF has agreed to a conditional credit program for Mexico. [Secretary's note: Copies of the letter from the Treasury and the letter to the Government of Mexico in their final form are included in the Appendix.] That's the background. I would propose approval.

MR. PARTEE. The Treasury gives an endorsement?

CHAIRMAN VOLCKER. [Yes], that in the present circumstances and with these understandings, subject to agreement, the drawing seems clearly appropriate.

MR. WALLICH. Who signs the Mexican letter?

VICE CHAIRMAN SOLOMON. Mancera.

CHAIRMAN VOLCKER. I guess the idea is that both Mancera and Silva Herzog will sign the letter.

MR. WALLICH. Is there evidence that the president has changed his mind on going to the IMF--that he isn't just going to fire those two people?

MR. GRAMLEY. Well, they could be reinstated by the new president.

CHAIRMAN VOLCKER. I don't know that I can answer that question and I'm not sure it's appropriate to ask.

MS. TEETERS. That's December.

VICE CHAIRMAN SOLOMON. What I would guess would happen--this is only a guess, of course--is that when October comes around we will be told that under Lopez Portillo they will not go to the IMF and they will ask us for a three- or four-month extension so that Miguel de La Madrid will go to the IMF.

MR. PARTEE. He takes office the first of the year?

VICE CHAIRMAN SOLOMON. The first of December.

MR. PARTEE. First of December.

CHAIRMAN VOLCKER. Well, I don't know because they changed the date [in this letter to October 31st]. Obviously, that's a possibility. Why did they advance the date? Maybe they want the outgoing president to do it.

VICE CHAIRMAN SOLOMON. I'm not sure they--

CHAIRMAN VOLCKER. Well, I don't know what--

MR. WALLICH. What is $600 million going to accomplish, granted that we owe them good relations and have ongoing relationships with them? They need nearly twice that a month. And if they don't get money from any other source, particularly until late in the year, I don't see how they can avoid either a devaluation in very chaotic conditions of inflation already, default on the debt, or exchange control.

CHAIRMAN VOLCKER. Well, I don't know how you want me to divide up my answers. For the rest of this week it avoids all that chaos that you're talking about on the eve of the presidential election. And thereafter, a number of considerations enter in. Do we have an interest in encouraging them to take further measures and to go to the IMF? I think our presumption has been "yes." Is this a lever to accommodation that is consistent with that increasing possibility? I'd say "yes." One can argue about it. If they run out of money, they can do nothing but let the exchange rate go, and nobody knows where it will go. It at least gives them a little money in the short run to maneuver and, if that's going to happen, hopefully to arrange things in a little better way than would happen otherwise.

MR. FORD. I'm inclined, obviously, not to question this decision; I think we have to do it. But I am concerned about some of the ramifications. I recall from when I used to travel and study in Mexico that there is a distinct pattern--I think you mentioned it briefly--in that normally in the heat of an election campaign, whatever else is going on in the economy, there is an outflow of funds from the country. And then after the election is over there is a reflux of their own people's money coming back in--I'm not sure about the pace of it--provided they sense that the new government is going to take hold and everything is going to be cool. It seems to me that if we're going to do this poking around--as Henry was saying this $600 million is peanuts against the magnitude of the problem--that what would be most helpful to the Mexicans, if we want to help them, is not just to give them this money, but to get together not only with our own Treasury but with the IMF so that after the elections are over we can get them to say that they have a program that's serious and that the IMF is with them and America is with them. The hope is that we could get at the element of the flight of capital so that it doesn't exacerbate the basic economic problem.

CHAIRMAN VOLCKER. I don't know what is going to happen with regard to the flight of capital. As I say, in some ways it's surprising that they haven't had more before the election. There is the theory that after the election there will be some reflux. On the other hand, one can make the argument that nobody thought anything was going to happen before the election, so the capital flight will come after the election. So, we can speculate about everything. But in terms of your general vision, I don't know how to do this, but all those bases have been touched.

MR. FORD. Have we looked at the banks? That is another concern. The last time I looked at the major U.S. banks, many of them had half their capital committed in Mexico.

CHAIRMAN VOLCKER. Mexico has become the world's largest borrower, exceeding Brazil in the past year. And what is the amount from American banks alone?

VICE CHAIRMAN SOLOMON. $20 odd billion

CHAIRMAN VOLCKER. Well, that's big.

MR. TRUMAN. It's $21-1/2 billion.

CHAIRMAN VOLCKER. And that is part of their problem--that the banks are nervous anyway. They have lots of reasons to be nervous both domestically and internationally. They are choked up to the back of the throat anyway and they feel a lot more choked up now than they did last year when they were getting there.

VICE CHAIRMAN SOLOMON. I don't think we really have any alternative. Even though $700 million is not going to solve their problem and they understand why we're pushing them toward the Fund, which would solve their problem, they--

CHAIRMAN VOLCKER. Well, of course, even that is a [unintelligible]. The amount of money involved from the Fund isn't going to solve their problem either.

VICE CHAIRMAN SOLOMON. I'm not talking about that. I'm talking about the good housekeeping seal, obviously. But it would be so incredibly misinterpreted [in Mexico] if we were to refuse to cooperate. The only grounds for refusing--and I can't see this as very legitimate--would be to pressure the Treasury to step in right away. It seems to me the only possibility is in the package approach. But I don't see how we could refuse, given the fact we have this huge neighbor to the south and all kinds of intricate interrelationships. I just can't see how the U.S. government could refuse to be helpful, particularly since they agreed to the conditions without any waffling.

CHAIRMAN VOLCKER. Who knows? I don't know these people well, but in this context I think they have been as frank and open with us as we could expect and with their own public before an election.

MR. FORD. Except that if I read the memo right, the minister overstated their reserves by--

CHAIRMAN VOLCKER. Oh, they've engaged in a little window-dressing.

MR. PARTEE. That will do the reserves--

MR. BALLES. Paul, do we know why Lopez Portillo is so opposed to going to the IMF?

CHAIRMAN VOLCKER. Well, a very similar situation arose at the time of the last election when he was the incoming president. I'm not familiar with all the details of that, but there was a long negotiation and they had some considerable difficulty. They had a big devaluation--at the time they had a fixed exchange rate--and broke a record of several decades of keeping a fixed exchange rate with the United States. And it was a troublesome program, as these always are, once the program was in effect. Whether there's any cause and effect or not [I don't know]. We had lent to them before that, too; the timing was very similar, a few months difference. We got repaid essentially out of a combination of IMF-Treasury funds. The timing wasn't precise. And the Mexican economy began doing better thereafter. Now, they were greatly helped by the fact that they happened to discover oil shortly after the IMF program went into effect. And the oil in the end may have proved to be a much better good housekeeping seal than the IMF program in and of itself. I don't know what particular scars he carries from that, but he obviously carries some.

MR. FORD. The way I understand the Mexicans' mentality is that they think of themselves as being on the brink of or already in the class of industrialized nations. And the view is that only so-called developing countries go with hat in hand to the IMF, getting instructions on how to behave. That is how I see it.

MR. MARTIN. Developing countries like the United Kingdom?

MR. WALLICH. It is a very broad political objection in Latin America. They are not at all positive with respect to the IMF, to put it very mildly. So, I don't think the president, either this one or the next one, has a great deal of leeway. He has to face a hostile political opinion.

CHAIRMAN VOLCKER. The opinion is very similar in Brazil. But as Tony was just mentioning, this kind of approach has almost a precise precedent--the last time we lent. I don't know whether we ever extended any money, but we agreed to lend to the United Kingdom prior to their going to the IMF 4 or 5 years ago. That was part of a bigger international arrangement. But the basis of it was virtually identical to this one.

MR. BLACK. Will we have the letter signed by Treasury officials before we actually extend the money?

CHAIRMAN VOLCKER. Oh, they said they will sign the letter. I suppose we will, but that doesn't--

MR. PARTEE. And this is the credit limit, is that right?

CHAIRMAN VOLCKER. I don't think we'll lend them any money today. What?

MR. PARTEE. $700 million is the [swap line] limit?

CHAIRMAN VOLCKER. Yes, that's the line, but I don't think they'll have to draw on that fully before the election. And they say they expect to repay it next week. But they will be back.

MR. WALLICH. It's a futile question.

VICE CHAIRMAN SOLOMON. Are you going to be coming back to the full Committee every single time if they repay?

CHAIRMAN VOLCKER. No.

MR. FORD. What about making the line bigger?

MR. PARTEE. That's what I was wondering about--whether that would be the next request.

CHAIRMAN VOLCKER. That may arise, but we don't have to face that now; that question has not been raised.

VICE CHAIRMAN SOLOMON. That would be equally misunderstood.

MS. TEETERS. Yes.

CHAIRMAN VOLCKER. I don't think we want to volunteer it.

MR. PARTEE. Oh, no.

CHAIRMAN VOLCKER. The question has not been raised.

MR. MARTIN. I think we should approve it based on the record of other countries with a resource base like Mexico who have finally gone kicking and screaming or however to the IMF and proceeded within certain constraints.

CHAIRMAN VOLCKER. They may not go to the IMF. But what they are saying is that they will go to the IMF if they have to. They are not admitting that they will have to.

MR. MARTIN. They'll have to.

VICE CHAIRMAN SOLOMON(?). Okay, I move it.

MS. TEETERS. Second.

CHAIRMAN VOLCKER. In the absence of any objections, we will approve it. Now, whether we actually will extend any money before the weekend is something of an open question.

MR. TRUMAN. It's traditional, Mr. Chairman, if you want to do it this way, to note that the approval is conditioned on Sam's negotiations being successful. Maybe that's implicit.

CHAIRMAN VOLCKER. I think that is implicit. The essential element is this reference to their willingness to go to the Fund.

MR. MARTIN. Yes.

CHAIRMAN VOLCKER. With that understanding it is approved. I might as well wait until the morning to make any remarks I have at this stage. Thank you. We will quit for the night.

[Meeting recessed]

July 1, 1982--Morning Session

CHAIRMAN VOLCKER. I will briefly return to the saga of Mexico. They now think they are getting their advance oil payments today, so they don't need the swap drawing before the election. That's all off, but we can assume that they may well be back very shortly under the same conditions, so I think we can let the approval stand. It doesn't look as if they will [need to draw on the swap line] this weekend.

On these long-term ranges, I detected--I think accurately--a good deal of consensus in thinking, even if there were some differences on the mechanics of how to present this. I might say initially that I have a certain sympathy for Frank Morris' suggestion of clearing the mind by forgetting about all this. I follow the philosophy that if we didn't have any of these ranges and [Congress] just left it up to us, we'd be better off. But I don't think the world is ready for that. I don't think it is going to have that requisite degree of confidence in our judgment, unencumbered by some numbers.

In that connection, I forgot to mention--I didn't exactly forget, but we haven't done much work on it--that we're going to get questioned about why we don't use a credit aggregate and what that would mean and so forth. For lack of preparation, if nothing else, I don't think we're ready to discuss a credit aggregate in great detail this morning. But I have to look at some of those numbers and see how we rationalize what we're doing in terms of credit numbers. My inclination would be to say that they are useful to look at but are not going to add much in terms of targeting--in the short run anyway. Statistics are not as readily available in the short run for us to see what we're doing. But the past evidence, so far as I remember it, is that if we look at the credit numbers we don't get much different answers than if we look at the broader monetary aggregates anyway. We will do a little more exploration to see whether I can justify that position and talk about it when I have to testify because I will have to; I've been asked to do so specifically.

VICE CHAIRMAN SOLOMON. You probably are going to get questions also on why we don't target a range of real interest rates, a monetary policy Henry Wallich has suggested at times. I think some sentiment for that is building in some quarters on the Hill.

CHAIRMAN VOLCKER. That implies we can define real interest rates. I thought we made great progress in reducing real interest rates last month. We reduced them by about 10 percent at an annual rate.

VICE CHAIRMAN SOLOMON. Well, we'd have to use a moving average of inflation on that. We couldn't do it once a month.

MS. TEETERS. On the Hill or in <u>The Wall Street Journal</u>?

CHAIRMAN VOLCKER. Somebody mentioned other ideas about getting interest rates down. It's a relevant comment in the sense that, obviously, there is a lot of concern about interest rates and a lot of ideas or non-ideas being circulated about what to do about interest rates, such as credit controls. One idea I have heard is that the Democrats are going to have a push to reinstate the Credit Control Act. We're going to have to testify on that, right? National usury ceilings and a tax on interest rates are two others; I don't know whether there are any others. I don't see much promise in those ideas, but they are circulating. It's symptomatic of the time. I don't know whether anybody around here has any bright ideas. But, that's the background in which we're working.

I don't have anything to say that differs much from what people were saying yesterday in terms of general business conditions and, indeed, the monetary side. Everybody talks about the risks on the down side and I agree that the biggest risks are clearly on the down side. But I don't think we can discount the possibility that the economy might do better than we're talking about. If we get a recovery, we may get some unanticipated inventory movements and a better GNP number than we're talking about. The important risks are on the down side, though. Nobody is going to mind if we get a flukish inventory number and GNP looks bigger than any of these projections.

People talk about interest rates being the key, and in one sense I agree with that. But I think we're talking more generally about financial constraints: the liquidity problems of the economy; the concerns that many businesses have about their own liquidity positions and investment programs and their balance sheet constraints, to the extent that they are distinguished from interest rate constraints. All those risks would be maximized by some major increase in interest rates during this period because of the psychology as well as the real effects involved. I don't know how one can be sure that that is not going to happen, but [that possibility] is tied in with the business risk and, of course, with the budget problem. In an ideal world we could do something about the budget maybe, but there is no practical chance of doing anything about it in the next six months. I found myself asked by an Administration official very recently: "Ideally, what can we do to help?" And I was almost speechless when it came to the budget because I couldn't think of anything practical that could be done in the next 6-month period.

As a matter of fact, let me say that I think the problems of the business world and financial world are partly accommodating to high interest rates and trying to cope with them and the balance sheet pressures. It's a big intermixture of problems that involve just plain adjusting to disinflation. I was struck recently by an example of that. In general terms we have a potentially serious banking problem that some of you know about arising out of a bank in Oklahoma that's teetering, or more than teetering. The bank itself isn't all that significant, but it has participated in oil loans mostly and some real estate loans all over the country in very concentrated lots and in very large amounts. It's a small bank participating in huge amounts of these loans, and we don't know quite what their quality is at this point. But there is a major question about the quality and conceivably maybe even some fraud in the situation. These participations have been building up apparently right through recent months in very large volume. I mention it not only because [the situation] is potentially serious in itself but because here we have banks making these loans overly casually, apparently. The loans are largely in the oil area, reflecting a psychology I suppose that anybody who digs a hole in the ground now or even promises to dig a hole in the ground had a bonanza because the price of oil was going to go up forever. And the price of oil suddenly doesn't go up forever and all these loans look awful. This has nothing to do with the interest rate--well, it may be modestly complicated by the interest rate--but much more with the fact that all the casual presumptions were that the price of oil would be $50 a barrel or whatever in 1984 and $90 a barrel in 1990. Those presumptions no longer look like such good bets, and there isn't any money to deal with the loans. And there were a lot of dry holes, I'm sure, at the same time. It's a striking case of people making investment plans and lending plans on the presumption that they were going to be bailed out by higher prices, and that presumption is now in doubt. I suppose it's inherent to some degree in the disinflationary process that people haven't really believed it up until now.

I share the general view about the likelihood of an economic outlook somewhere generally along the lines that everybody has been talking about. But whether we can negotiate our way through this period and whether we have a soluble problem or not remains to be seen. I can spin out this nice scenario of what is going to happen this year and later in the decade--and I think it's plausible and not even unlikely in one perspective--but there are a lot of risks. I don't know whether we're dealing with an impossible dream or an impossible problem in trying to get through this period to a noninflationary economy without still more problems than we have. And we have plenty already.

Everybody is focused on the question of whether we have enough money and what is going on in terms of liquidity demands. I don't have anything particularly to add there. I share the general feelings that have been expressed by most people, I think. I read an analysis the other day of this kind of problem, which I'll read to you: "Other things being the same, it is highly plausible that the fraction of their assets individuals and business enterprises wish to hold in the form of money, and also in the form of close substitutes for money, will be smaller when they look forward to a period of stable economic conditions than when they anticipate disturbed and uncertain conditions. After all, the major virtue of cash as an asset is its versatility. It involves a minimum of commitment and provides a maximum of flexibility to meet emergencies and to take advantage of opportunities. The more uncertain the future, the greater the value of such flexibility and hence the greater the demand for money is likely to be." That almost sounds like my recent testimony. But it happens to be from Friedman and Schwartz, <u>A Monetary History of the United States 1867 to 1960</u>. The problem is that it's one thing to look back in history and say in the light of hindsight that we had all these shifts in the demand for money, which we should have taken care of, and it's another thing to recognize them as they are taking place. And we're in the midst of trying to recognize them when they take place. I feel quite confident that we have an enlarged demand for liquidity due to the uncertain future. A greater than usual value of flexibility is attached to cash and near-cash assets. The problem in a cyclical context is largely, or maybe entirely: How do we measure that? And, of course, we have the problem of overfeeding or overaccommodating it, which can build up more inflationary potential than we want in the future. The targets for the money supply are supposed to brake that, I suppose. Their value is that we don't jump too far and we think hard before accommodating that [liquidity demand] too much.

When I look toward the longer-term targets--and this is somewhat premature, but I think we ought to have it in the back of our heads--we have had an upward trend in velocity for many years now, but that trend has accompanied rising inflation and rising interest rates generally, and one would expect to see both of those factors reducing the demand for money. If we were really successful in getting inflation down, and presumably that should be accompanied by lower interest rates over a period of time, I don't think it necessarily follows--abstracting from institutional change, which of course we're also having--that that long-term trend in velocity would disappear. The historical trend in velocity before the postwar period was toward decreasing velocity rather than increasing velocity.

As I say, it's premature to suggest that that is where we are now, when we have such strong cyclical factors, but it bears upon how indefinitely into the future one might logically reduce [the growth in] the money supply. One has to look at that factor and keep it in mind at some point along the line. When you look at the next six months, presumably velocity will go up. Everybody is more or less assuming that with respect to this year's target. But, as has been said by practically everybody, making a judgment of how much is extremely difficult. Looking at history, it is unambiguous that velocity goes up during the early stages of a recovery. This is an exceptionally weak recovery that we're projecting, as has been said; I don't know how that bears on it. Since the '54 recession, the average increase in velocity for the six months after [the beginning of] a recovery has been something like 5-1/2 percent. We are projecting something in the neighborhood of--. Wait a minute; I'm not sure about this number. If money increased something like 5 percent or a little less on a quarterly average basis during the second half of the year, with the kind of economic projection we have, velocity would be what, Mr. Axilrod?

MR. AXILROD. If money increased 5 percent on a quarterly average basis, velocity would be around 3-1/2 percent. If money increased, say, 5-1/2 percent from June to December, that would produce a quarterly average increase of more like 4-1/2 or 4-3/4 percent, which would make the velocity increase more like 4 percent.

CHAIRMAN VOLCKER. The lowest velocity increase we've had during the first two quarters of a recovery in this period is 3 to 3-1/2 percent. The highest we've had is 8 percent.

VICE CHAIRMAN SOLOMON. But that was associated with a different pattern of interest rate movements than we've had.

CHAIRMAN VOLCKER. Well, I don't know what the interest rate pattern will be in the next six months.

MR. MORRIS. And they were also stronger expansions--I'm pretty sure that's true--at least in real terms.

CHAIRMAN VOLCKER. Well, I don't say we should count on these higher velocity figures. I'm just citing the figures. We are in the neighborhood of the lowest velocity increases that we've had, if you just look at that particular set of figures mechanically. I don't think the M2 velocity is very relevant during periods when we had interest rate controls on so much of the M2 components. The only recovery in which we didn't have a lot of controls was the one in 1980, when the velocity increase in M2 was enormous. I don't think that tells us much about M2. In view of these uncertainties, a lot of people have talked about flexibility, and I think that's the key to the whole thing. We need a certain degree of flexibility in trying to judge things as they occur. The Ms at the extreme might slow down because of this liquidity desire, particularly as reflected in NOW accounts if that reverses itself. But I wouldn't want to count on that in the next 6-month period. So, that leaves a large element of uncertainty.

We have a lot of options as to what to do, as was made clear. What I would suggest at the moment is that we return to the issue of the longer term after a discussion of the shorter term because that discussion may give us a little enlightenment on what we want to do. I would also say that I'm not at all sure that I want to reach an absolute conclusion on the long-term ranges at today's meeting because there is a long time lapse between now and when I have to testify. And twice now we have had informed press reports between the time that we met and the time that I testified, which in my view is unfortunate. I'm not even sure [whether the information was leaked]; the reports may have been based largely upon speculation by the reporter rather than anything else. They happen to have been very close to the mark. I don't think it would be entirely bad to get a good idea of where we're likely to end up but I'm not sure we have to say that we made a decision. It might be good to be in a position to say we actually haven't made a decision and, if we're close enough, we can confirm it by telephone closer to the time I actually have to testify.

MS. TEETERS. When do you testify?

CHAIRMAN VOLCKER. Either the 19th or 20th of July. I was intending originally to do it earlier, precisely to cut down on the time period [between our decision and my testimony]. But now it appears that the Administration estimates that we are supposed to be considering and integrating and so forth aren't going to be available until the 15th. I was going to testify on the 14th or the 15th, so that doesn't look possible. If we put the testimony off until the following week, that creates a much more substantial gap in timing. The Administration hasn't settled on its own estimates yet, so technically in terms of our charge we're a little in the dark. I don't think there is going to be anything startling. I think they're debating about an economic outlook a bit better than ours in real terms and a little worse than ours in price terms--meaning a bit higher--as I suggested yesterday. Just where they're going to settle, I don't know. We will see in the end. But, let's go to the short term and see what enlightenment that casts upon the long term. Do you have some choice words for us in that respect, Mr. Axilrod, or are you finished talking?

MR. AXILROD. I think I'm about finished talking, Mr. Chairman, but I might just call to the Committee's attention the alternatives presented on page 10 and also note that the base from which those alternatives take off, which is June, is probably lower than presented in the Bluebook. The Bluebook had the June growth rate at about 3-1/2 percent; the data we had as of yesterday, which will be firmed up in a couple of hours--and it could change some, I'm sure--suggest that the June growth is closer to zero or maybe a small positive. Alternative A, the 5-1/2 percent growth rate, would leave M1 by September running at a 6 percent rate; with the new lower June base, alternative A would leave M1 much less above the path by September--more like at 5-3/4 percent. So, it would be 1/4 point above the top of the path. The [aggregates] should all probably be viewed as somewhat closer to the path than is indicated, with M1 moving within the range under alternative B and much more within the range under alternative C, given these weak end-of-June numbers.

I should also add, of course, that the weak end-of-June numbers, if they hold up, run the risk of July being higher in terms of growth rates if the July level that we have estimated is about right. The special factors to take into account in July, of course, are the cost-of-living increase on social security payments, which will affect the first week of July and to a minor extent the July average by maybe about a percentage point in our estimate, and the beginnings of the tax decrease. The first paychecks to reflect the tax decrease probably will start in the second week of July, and our estimate is that it will have a temporary effect within the first month of roughly 2 or 2-1/2 percentage points. So, we think those two special factors will add 3 to 3-1/2 percentage points to the July rate of growth. Our maximum estimate before we had these end-of-June weak numbers was a growth in July on the order of something like 9 percent, give or take a little, at roughly current money market conditions. So we have constructed a path for Committee consideration that is very similar to what we constructed at the beginning of the first quarter and the beginning of the second quarter. The path has a relatively large growth rate in the first month followed by very modest or no growth in the succeeding two months. Our luck will run out on that at some point but it seems to have held up in the first two quarters.

The other technical point I might add, Mr. Chairman, is that it is not so clear as it was in April that there might be an error in the seasonals because there have been high Julys and low Julys over the past several years. It isn't like April where in recent years all Aprils have been high except for the period of credit controls. So I think the jury on July is out and we can't be very certain about any verdict with regard to the seasonals [for that month].

CHAIRMAN VOLCKER. Let me just interject. Bearing on this issue--you probably didn't bring the figures along and I didn't either--just for the interest of the Committee, the staff has been experimenting with seasonal adjustments, which they were forced to do by Governor Gramley's suggestion that when we publish a four-week average we compute a new seasonal. For some reasons that are unfathomable to me, they couldn't use the regular famous Census X-11 method so they have been developing or bringing to fruition some work they have been doing that involves an entirely different method of seasonal adjustment. In seasonally adjusting the figures, one can apply the same method to the monthly figures and the weekly figures as we get them. And it results in ironing out these bumps that we get in the first month in a quarter largely by taking it out over the following month of the quarter. We've been getting big increases in the first month of the quarter, particularly in April and January, and then declines in the following month. Lo and behold, this new seasonal for this year indeed shows a sizable increase in January but about half what it was. It was a 21 percent annual rate of increase and the new method cuts it to 10 percent. And the money supply growth is almost as flat as a pancake thereafter, or rather a rising pancake. I mean that it shows a very steady growth rate after January. It takes the April bulge out completely, as I recall. And instead of having a minus in May, it shows an annual rate of increase of 3 or 4 percent in May, after an increase of 3 or 4 percent in April. I think the increase runs at an annual rate of between 2 and 6 percent. It's a trivial difference every month since January with this new seasonal. So, we've had a very steady monetary policy!

MS. TEETERS. You mean the reason the Administration is so [unintelligible] is because of our seasonal adjustment program?

CHAIRMAN VOLCKER. It doesn't make such a dramatic change last year. The major change is basically that it has a bigger seasonal adjustment factor for the first month in a quarter and a smaller one, or the reverse, for the second month in a quarter. The change is less in July than in these other quarters, but it is significant in July too.

MR. FORD. Are we going to call this the Beryl Sprinkel seasonal?

CHAIRMAN VOLCKER. Well, to the eye, it's a better seasonal pure and simple. I think there is an inherent flaw in the method we use now in that it never catches up to reality. I will present [the experimental seasonal] in an appendix to the testimony, anyway. If we didn't have the problem that people would think we were pulling a fast one, we'd change to that seasonal right now because it does look better in terms of this repetitive pattern we have involving the first and second months of a quarter. But it bears upon July because that new seasonal would show a smaller increase in July.

MR. AXILROD. If it is to be believed, it would take roughly 5 points off the July seasonal and add it to August.

VICE CHAIRMAN SOLOMON. Why not publish both of them each month and then make a switch next year?

CHAIRMAN VOLCKER. Well, we might [publish it] in a somewhat subsidiary way. In effect by putting it in the testimony we would do that. We can put it in and say that people ought to look at this and give us any criticisms they have of it. I take it that it is quite a radically new method of computing the seasonal.

MR. AXILROD. Yes, but it is the method recommended to us by the experts on the Committee on Seasonal Adjustment when they presented their report. So, it's well grounded in the current literature on seasonal adjustment.

MR. MARTIN. Steve, the Chairman mentioned its applicability this year and last year. How about some of the other years?

MR. AXILROD. Well, we carried it back and it doesn't, in some way fortunately, smooth out last year all that much.

MR. MARTIN. How about the preceding year?

CHAIRMAN VOLCKER. It does some but the basic pattern looks--

MR. AXILROD. Not nearly as much as it smooths out '82, which I think gives more credibility to the smoothing out of this year.

MR. MARTIN. How about 1980 or 1979?

MR. AXILROD. It smooths them but just a very little. There would still be the erratic movement around the time of the credit control program and that sort of thing.

MR. PARTEE. It's capturing recent information.

CHAIRMAN VOLCKER. Of course, the further back you go, just theoretically, you would expect it to make less improvement because the seasonal is adjusted as it gets later information. Allowing for a bulge or lack of a bulge or whatever, depending upon which way you look at it, obviously creates problems in setting a path for the near term. So, I guess we have to discuss two things: What kind of general growth we would like to have ideally in the next 3 months; and how to handle the uncertainties surrounding this year's seasonal and other impacts and why. What?

MR. PARTEE. I don't know that Steve was done.

CHAIRMAN VOLCKER. I don't know if he's done either. Do you have anything else to say?

MR. AXILROD. I was going to add only one thought, Mr. Chairman, which is that I don't know if it's clear that alternative A is the one that would be more consistent with a decision to run at the top of the present ranges or with possibly raising the present ranges. All of the alternatives are consistent in a sense with anything the Committee decides for the long run; the fourth quarter can always be adjusted. But alternative A is more consistent--even more so with the downward June revision--with running closer to the top. And alternatives B and C, of course, would be more consistent with retaining the present ranges and an effort to run growth down within the range rather than close to the top. Those were all the comments I had, Mr. Chairman, apart from the Bluebook.

MR. GRAMLEY. May I ask a technical question, Mr. Chairman? If one were to leave the September levels where they are and start with the new lower June base, what would the growth from June to September be?

MR. AXILROD. I had that somewhere. What I have immediately at hand, Governor Gramley, is that the new Q4-to-September growth rate would be reduced by about 0.3 percent. The level of June is down $1 billion, roughly, so that would be $3 billion. I guess it's not quite 1 percent higher on the growth rate if you kept the September level of M1 that is in here.

MR. PARTEE. Do [the new sseasonals] have an effect on M2?

MR. AXILROD. I don't have the new M2 figures, Governor Partee, but the effect on M2, if nontransactions don't change, should be roughly one-fourth the effect on M1. In answer to Governor Gramley's question, for M1 we have not quite 1 percent higher growth from the new lower June base; at the present [level] we've projected for September, M2 would be about 1/4 of a percent [higher].

CHAIRMAN VOLCKER. Let me be unduly suspicious. My vague memory is that our estimates of M2 at this point in the month are not very reliable. We don't have very up-to-date information. On that June figure I suspect there is more uncertainty about M2 than about M1, isn't there?

MR. AXILROD. They are a lot better than they used to be.

CHAIRMAN VOLCKER. I guess we're getting--

MR. PARTEE. You're using the weekly reserve accounting now?

MR. AXILROD. We have rough estimates.

CHAIRMAN VOLCKER. All right. Let me just make one further comment about what seems to me to be the nature of the problem--I think this corresponds with what many people said--with respect to the long-term ranges. Apart from focusing on the numerology, what may be equally important or more important is how we react to whatever happens, particularly given this uncertainty about the seasonal in July. We may want to be more passive in some sense in reacting, depending upon what happens or doesn't happen in the early weeks of July. Now, with that much introduction who wants to say something? Mr. Black.

MR. BLACK. Mr. Chairman, I'm very happy, as most of you might suspect, by this revision in the June M1 figure. If I've computed it correctly, this will allow us to bring M1 by September to the top of the upper band without having to slam on the brakes. The figure that I've computed from June--and what I'm doing is using the May figure for June since we're assuming a zero rate of growth--would allow us to hit the target while letting the money supply grow at 4.6 percent. I think that gets us out of the dilemma I suggested we were in yesterday--being between a rock and a hard place--because if we did that, it would preserve our credibility by coming in at the top of our target and we wouldn't have to say that we deliberately plan to overshoot the target, which I think would be [ill advised]. At the same time, we'd be aiming for a higher rate of growth in M1 than we appear to have gotten over the last three months, so I don't think we'd have to risk any severe tightening in money market conditions and the dangers that might entail. So, I would urge very strongly that we aim to be at that top part by September, and I would take whatever M2 figure Steve thinks is compatible with that. I'm guessing that a borrowing level of about $900 million might be about right and, as usual, I would like to widen the federal funds range. Just in case July is wild, I'd like to be able to go to 17 percent and then hope like the devil that we didn't have to [go that high]. At the same time, I'd like to reduce the lower end to 10 percent and hope that we get a better performance than we expect in July and could let the funds rate come down.

CHAIRMAN VOLCKER. First of all, let me say that we don't know what these numbers are late in June and we have had very large revisions in these preliminary numbers. Before we conclude this meeting we will have another reading on this week, but next week is very uncertain.

MR. BLACK. Well, let me make a couple more points, if I might. What I'm really interested in is getting back to the top of that line [shown in the Bluebook chart] by September.

CHAIRMAN VOLCKER. Yes. Assuming the June figures are right, I don't know what that translates into in terms of a growth rate.

MR. BLACK. That's 4.6 percent.

CHAIRMAN VOLCKER. From June?

MR. BLACK. It's 4.6 percent, if we figured it correctly.

MR. PARTEE. Well, assuming it's a lower June number--

MR. BLACK. Assuming June growth is zero, that means the level is the same as May. [The implied growth] is 4.6 percent, which is surprisingly good. I think that's something that we all--

CHAIRMAN VOLCKER. Let me just make sure that arithmetic is right because--

MR. CORRIGAN. Something doesn't sound right.

CHAIRMAN VOLCKER. Yes, it sounds to me like too low a growth rate, if June wasn't absolutely right, but I may be wrong.

MR. BLACK. We checked on that. If I alone had calculated it, I would be very suspicious of it; but Al Broaddus did it too, so I feel more confident. If you put the June figures at the level of May, I believe we figured it would be about 0.6 of a percentage point above the upper bound at that point.

CHAIRMAN VOLCKER. I think that's about right.

MR. BLACK. So, if approached almost asymptotically, one can see it has to be--

MR. ROOS. Approached how?

MR. BLACK. Asymptotically--a word that I learned back in high school!

CHAIRMAN VOLCKER. 6/10ths. In dollars, it's a billion above, isn't it? June would be $1 billion above the implied June target level, wouldn't it?

MR. BALLES. What is the revised number, Steve?

MR. BLACK. $451.5 billion.

CHAIRMAN VOLCKER. Yes, and I think the target for June is 450.5 billion, isn't it?

MR. CORRIGAN. Could we have the numbers, Steve? This is getting ridiculous. Could we have the June-to-September numbers for page 10 that reflect your current estimate of June?

MR. AXILROD. Well, they will change in an hour, which is why I'm a little reluctant, but--

MR. CORRIGAN. That might be better than what we have now, because right now we have--

MR. AXILROD. June is going to be a lot closer to the May level than the number that's [on page 11]. So, around $451.5 billion is about where it would come out.

MR. BLACK. Well, I know it is going to change, and that is the reason I'm stressing that what I'm interested in is hitting the top part of the range by September. Whatever that number would be, that's the rate that I think is about as high as we ought to go. One other suggestion, if I might, Mr. Chairman. At times like this when we have soft numbers for our base, I wonder if it would be worth considering using the May figure, which is a hard number, for expressing the rate so that we all have some reasonably firm number in mind. It's rather tricky to come up with rates if the number does change in the middle of the meeting and we have to make these computations. I have my calculator here, which I probably couldn't operate, but in case the number is different and I can't figure out--

CHAIRMAN VOLCKER. Well, I guess we can do either, but I suspect that that's putting undue importance on any particular number. The May number isn't very high either and the difference in these growth rates we're talking about--. As this conversation illustrates, if we get a $1 billion revision in a number, which is nothing in the larger scheme of things, and blow that up to an annual rate, it looks like something significant.

MR. BLACK. Well, that's the reason I really favor point targets. That gets back to my--

MR. AXILROD. I might say, Mr. Chairman, that President Black's calculation is certainly correct.

MR. BLACK. Boy, that's a relief! That's the best news I've heard since the money supply figures were revised.

MR. AXILROD. The September top of the range would be somewhere around 4-1/2 percent from a June base of $451.5 billion.

CHAIRMAN VOLCKER. Okay, with that clarified, let us proceed.

MR. BLACK. I was trying to be helpful, Mr. Chairman. I'm sorry if I muddied the waters on that. I happen to have been on the call, which is the only reason I had access to that figure ahead of some of the rest of you, and I thought it might be helpful to throw that number out.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I do not have my calculator and I have no doubt that I would fail to operate it if I had it, so I will not get into the billion dollar question. I would be in favor of keeping the [current] targets for the balance of 1982. I would be in favor of a relatively passive form of implementation of our policy so that if we miss the upper limit of the target by September--in due deference to my colleague, President Black--I would not be concerned, provided we went along the course suggested by Governor Teeters yesterday. One of her suggestions yesterday was to be more explicit with regard to our attitude of tolerance so that we remove from the markets fears and premonitions or the expectation that we will be coming on hard to bring the [monetary growth] numbers down, which will produce certain interest rate impacts. The reasons for my position with regard to the upper limit of the target came out, as was obvious to all of us, in the discussion yesterday. It is the downside risk; it is the unusually high degree of uncertainty; it is the peril that corporations and financial institutions confront; it is the great uncertainty of the international situation added to all of these. And as the Chairman has indicated, it will be 6 months or 8 months or X months before the Congress begins to resolve a $60 to $70 billion swing between estimates of the deficit.

I view ranges and targets as tools. My own experience in business and government has been that you use budgets and targets and ranges and brackets in your work. And in the real world, either in government or outside it, those targets, brackets, ranges, objectives, and goals are usually missed by whatever organization it is. The mature individual understands that these are tools and not the sacred writ. Now, I don't have any great insight as to whether velocity will go up enough or not enough. Frankly, I don't believe anybody else has. That is again a reason for my thesis of tolerance of results relative to goals and targets. I think we should keep our targets for the balance of '82 at this time and we should operate in a more explicit, but relatively passive, mode for the upcoming period.

CHAIRMAN VOLCKER. I hear your music and understand your music as implied in general terms to the next quarter. At some point we have to make a reserve path and come up with a borrowing number or something. I don't know whether you want to throw out a number now or later.

MR. MARTIN. I think a 4.6 percent increase [in M1] is not enough. I'm not sure that a 5-1/2 percent increase, as in alternative A, is enough. It might be enough if indeed July has a certain configuration. So I would go for alternative A, but I'd be quite tolerant if alternative A were exceeded.

CHAIRMAN VOLCKER. In the short run, anyway.

MR. MARTIN. In the short run.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I come closer to Pres than to Bob. I didn't say anything about the longer-run ranges yesterday because I'm so concerned about how we will confront the very great problems that the economy is probably going to be facing. My view of the short run is probably no different from my view of the long run. That view is that we don't know what is going to happen to velocity and we have to be flexible enough to recognize changes in velocity when they occur. The thing that we do know, though, is that the economy can't stand higher interest rates because the financial fabric of the country just won't tolerate higher rates in this environment or the environment one can see in the reasonably foreseeable future. So, what I would like to do is to have a sort of normative number for setting the path: a specification for M1 of 5 or 6 percent--we might even say of about 5 to 6 percent--and for M2 of about 9 percent. [M2] has run consistently high and there's every reason to believe that it may tend to run high if precautionary demands remain as they have and if we get any saving effect out of the tax cut. So I would say around 9 percent [for M2]. And then it seems to me that we ought to reestablish 15 percent as the upper limit on the funds rate--not as an indication to consult or anything like that. I'd say we would seek growth in the area of about 5 to 6 percent for M1 and about 9 percent for M2 provided that does not drive the funds rate above 15 percent. That's a really radical change compared to what we've done before, but it seems to me that the threat of higher interest rates is so great now that we can't tolerate it and we have to put that in as a limit.

MR. ROOS. Chuck, may I inquire, sir: If we make a strong statement in reference to interest rates, doesn't that imply a significant departure and doesn't that signal that once again we are trying to balance interest rates and aggregate growth?

MR. PARTEE. I guess what I'm saying is that I will accept any aggregate growth to keep the funds rate below 15 percent.

MR. ROOS. So you are placing primary emphasis on--

MR. PARTEE. On that upper end of the funds rate range for the time being.

MR. FORD. On a weekly, daily, or monthly basis? Well, you are proposing a significant change in policy.

MR. PARTEE. I would want to say so long as the funds rate does not move rather consistently above 15 percent. I don't mean daily; I'm not even sure I mean weekly, Bill--maybe biweekly or something like that. But I don't think we can tolerate the effect on the market of a funds rate higher than 15 percent, which is a little higher than where it has been. It gives us some [upward leeway], but I just think we need to draw the line now.

MR. BLACK. Mr. Chairman, just so I don't appear to be too much of a Simon Legree, may I say that I'm just as interested in getting rates down as anybody else but I differ on the method for doing it.

MR. PARTEE. Well, one way to do it is to crash the economy.

MR. BLACK. Well, that is not the method I am suggesting. We may have been a little too tight last year [unintelligible].

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. My thinking runs very much along the lines of Chuck's. I think it's possible that money demand may shift down again in the third quarter, but I don't think we can set forth on a course of monetary policy which starts with that as a proposition and, if it doesn't happen, lets interest rates rachet upward significantly further. I want to try to find a way of designing some specifications that will permit a bit more money growth if, in fact, this downward shift of money demand does not happen, but that will not let things get completely out of hand. One way this might be done is to leave the September levels where they are and to recalculate our June-to-September growth rates accordingly. If I understand Steve right, that would mean something like 6-1/4 to 6-1/2 percent for alternative A, 4-3/4 to 5 percent for "B," and 3-1/4 to 3-1/2 percent for "C." I would start with that. Is that right, Steve, roughly?

CHAIRMAN VOLCKER. Isn't it only 6/10ths, if this other calculation is right?

MR. AXILROD. Well, I was rounding--

MR. PARTEE. [Unintelligible] get down to the upper end.

MR. AXILROD. Yes, I was rounding to $1 billion instead of the exact $1.3 billion and for M1 I would add about a percentage point.

MR. GRAMLEY. Well, whatever the numbers are, I'd make those adjustments to M1 and whatever corresponding adjustments need to be made to M2. Then I would take the quantitative specs of "A" and the initial borrowing of "B." By doing so, we would be putting together a set of specs that say in effect that we may have more money growth than the staff has counted on if this downward shift of money demand does not happen. If, in fact, we find that money growth is falling short of this path set forth by the specs of "A," then what I would do is split the difference. I would take half of it and lower money growth and half of it and lower interest rates. That's how I would proceed, and I would get around the problem of having to put in a proviso clause that would specify a strict upper limit for the federal funds rate.

CHAIRMAN VOLCKER. What is the borrowing in "B"?

MR. GRAMLEY. Well, the borrowing would be $800 million to $1 billion; taking a midpoint of $900 million would be all right.

MR. PARTEE. And you think your strategy would keep the rates from going up?

MR. GRAMLEY. Well, it has a chance. It may not, but I would count on the Chairman to use his good offices to call us in for consultation if we had serious problems with rising interest rates.

MR. FORD. Are you proposing a 15 percent cap, too?

MR. GRAMLEY. No. I'm proposing the 11 to 16 percent range, the initial borrowing assumption of alternative B, and the quantitative specs for M1 and M2 of "A" modified as I indicated.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. Well, I want to get interest rates down. I'm not worrying about them going up, because I think that's intolerable. Therefore, I would move toward what Pres and Chuck have said but a little more strongly. If we do get some increase in velocity, we should let it carry through and take the drop in interest rates that I think we need to keep this economy going and to avoid, really, almost a catastrophe. So, I would take the specifications of "A" but raise them. I would go at least to 6 percent and perhaps tolerate 6-1/2 percent for M1. I think we need a signal in the market that we have eased or rates won't come down and, therefore, I would drop the borrowing. I would take a borrowing level preferably of $300 million, but I could settle for $400 million. And we need to handle it fairly flexibly. It's seven weeks until the next meeting. Certainly in seven weeks--and probably later in July--we will have a better reading on where we are. It's not an intolerable period of time to let policy run fairly freely. And if we're wrong, we can reverse ourselves at that point. But at least we ought to experiment to see if we can bring ourselves out of this [recession].

VICE CHAIRMAN SOLOMON. That would mean a very sudden drop to about 12 percent.

MS. TEETERS. Well, I have no--

VICE CHAIRMAN SOLOMON. If we started with $300 million borrowing, that would be a very sudden move, not a gradual one.

MS. TEETERS. But I think that's what we need to signal the market. We can phase it down over a couple of weeks, but it's going to take a fairly sharp drop in borrowing to get the message across that we are easing on monetary policy.

MR. FORD. What range of rates are you looking for, Nancy?

MS. TEETERS. Well, I can't even tolerate a 15 percent upper limit, as Chuck can. I think 14 percent is outrageous in the situation we're in. I would much prefer a cap of 14 percent and say that we are not going to go above it. We've had enormously adverse reactions over the past couple of weeks as the rate has edged back up to the 15 percent level.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Mr. Chairman, I share the feeling of most of those who have already spoken about getting interest rates down. It's a question of how to do it. The June numbers complicate the analysis, obviously, but I would probably go for [an M1] range something like Chuck has suggested but a bit lower. I would narrow it to 5 to 5-1/2 percent. Either of those accommodates some uncertainty as to what the June figures will be and what the shift [in money demand] may be in the third quarter. I would just point out that 5 to 5-1/2 percent growth is substantially greater than what we achieved in the second quarter; the June figure would indicate that we achieved an average of 3 percent for the second quarter, and moving to 5 to 5-1/2 percent is indeed somewhat more expansive. To avoid being slavish to the targets, I would retain the 5 to 5-1/2 percent top for the remainder of the year. Growth in that range in the third quarter would bring us someplace near the top end if the June figures are indeed real, but would not bring us into the range. However, we would have another quarter to deal with that. So, 5 to 5-1/2 percent seems reasonable to me. My concern is that we should have some easing in money market conditions, and I think those kinds of rates would do it providing we start out with a borrowing level, which I think may be consistent with what I'm trying to achieve, of about $600 to $700 million.

My last point is that if growth in July--which I think is the month of great uncertainty--comes in greater than the 9 to 10 percent that we're talking about, I'd tolerate that growth. So, the paths would be constructed in such a way that they would be changed in July if we got a much larger bulge than the 9 to 10 percent. And interest rates would not move up because of that excess growth that we're expecting; we just would not have the dimensions right. In conclusion, I would like to see interest rates come down and I think [M1 growth of] 5 to 5-1/2 percent for the quarter is more expansive than we have had in the [recent] past. I do not want to see interest rates go up because of some aberration [in M1 growth] that may appear in July and, thus, I would have a caveat, either implied or in the directive, that the staff would accommodate that greater growth.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. Well, I sense a rather interesting shift in the perspective of the Committee. I will talk about the things I agree with first. I was happy to hear you, Mr. Chairman, indicate that there is some chance that the economy may be getting better. I guess I'm a hopeless optimist, but I always notice that economists have a penchant for gloom and tend to acknowledge that a recovery has happened _after_ it has happened. I hold onto and cherish this ray of hope that the economy may actually be turning around now, with three upward ticks in the leading indicators and all the other positive things that one can point to if one wants to be a little optimistic. It may be improving right now. There is, of course, the downside risk that everybody has expressed. That can't be discounted or ignored.

I certainly am not a fan of high interest rates, but I very strongly oppose any shift in policy toward putting on a maximum rate cap, particularly the notion that a number of people who have already spoken have expressed of setting a rate cap at or below the present level. This week the fed funds rate is averaging around 15 percent and I'm told that it's a somewhat unusual week. But I certainly wouldn't want to vote for a policy that said that rates had to be at or below their present level, with the further notion that if they should move even a little above the present level we'd automatically validate that with whatever increase [is necessary] in the money supply. So, I guess you're going to have to put me down for being closer to Mr. Black in that I [would not] vote for something like the rest of you [have advocated]. I put most of you down for "A" or "A+" or "A-." Put me down for "B" with a borrowing assumption around where Lyle Gramley and Bob Black had it, at about $900 million. And like Mr. Black, I very strongly favor always having a range of interest rates that is broader rather than narrower. I would say we ought to allow for at least some movement in both directions from where we actually are the day we make the decision. Therefore, I'd go for a fed funds range up to 17 percent before we would get on the phone [to consult] and down to 10 percent or below if we should be lucky enough to see rates happen [to move] in that direction. So, I come out at "B" with a borrowing assumption of around $900 million and a fed funds range that is as wide or wider than we now have.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, I'm in the Martin and Partee camp, if that's the way we're dividing things up. I think the economy needs lower interest rates. At a minimum, I think we have to avoid higher rates. We have very little room to maneuver rates down, but we ought to take advantage of whatever room and opportunities we have, even to the point of probing or coaxing a little--testing the limits a little --to see if we can at least bias rates in a downward direction. So, in terms of the overall strategy, I would come out broadly in the "A" category. I would handle a July bulge passively, much the way we handled it in January and April, accepting the bulge and then trying to work it off in succeeding months rather than with a prompt active response. As for my view of the targets, I really can't improve on the way Preston said it. I think we should approach them flexibly. They are a tool of management. And if we hit them, we hit them. But our goal is the economy and we should not religiously pursue some specified number. So, I would take a rather flexible view on the targets.

MR. FORD. What is your borrowing assumption?

MR. BOEHNE. Oh, $400-$500 million.

CHAIRMAN VOLCKER. I ran out of names. Mr. Roos.

MR. ROOS. Well, I would opt for alternative A with a borrowing assumption of $900 million or something like that. But I am concerned about the implication of some of the opinions that I've heard. I don't think it's necessary to repeat that everybody around this table would like to see lower interest rates. But these interest rates are quite obviously affected by how the financial markets view the signals that we send or the signals that we are imagined to send. And I think any change of wording in the directive that could be interpreted as signaling even temporarily a return to placing primary emphasis on controlling interest rates--placing a cap on interest rates or anything like that--would be disastrous because people would say, after they've seen the effect on inflation of our 1979 change of emphasis, that we're going back to the old way of doing things. In an historical perspective I think the last thing the markets want to see --and this goes for this business of flexibility--is a return to a fine-tuning, interest-rate-control-oriented method of conducting policy. I think everybody always has to be flexible. On the other hand, I'd hate like the devil to go on the open seas and know that the captain did not set a course before we left port and that he changed signals every day. We'd be going around in circles. And I honestly believe that for almost 15 years--and I was part of it, although I disagreed with it--the Federal Open Market Committee went around in gigantic circles, which led to our present predicament and resulted in high interest rates. With that speech, I will hush up, Mr. Chairman, and opt for alternative A and a borrowing assumption of $900 million.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. For reasons based on the current economic situation, as I commented yesterday, I think we should set a target that has a reasonable possibility of getting us back down to the top of the range by the end of the year. I would not choose a target now that would deliberately put us over the range by the end of the year. And going along with Governor Martin's comments, I certainly wouldn't be slavish with regard to staying in the range. By that I mean that if we were to run over as we go from now to the end of the year, so be it. Having said that, I also wouldn't choose a target that would leave very little flexibility if the July bulge turns out to be very high. So, I end up between alternatives "A" and "B," probably "A-" rather than "B+" and an M1, say, of 4-1/2 to 5 percent. I would broaden the federal funds range from 10 to 15 percent to 10 to 16 percent. And I would be strongly opposed at this point to trying to set any kind of interest rate cap for fear that that would signal too major a change. My borrowing range would be, say, $600 to $800 million.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I indicated yesterday in the preliminary go-around that as I look back a year ago or even six months ago at what we were expecting and forecasting, it's clear that the economy is in poorer shape in terms of real growth and unemployment and that we're better off than we had hoped on the inflation side. That's really the basis on which I rationalize my departure from our longer-term program of gradual diminution of monetary growth. I feel now that we deliberately ought to plug some countercyclical considerations into short-term policy, that is, for the 3 to 6 months ahead. And it's on that basis that I am in favor either of announcing an increase in the 1982 range or permitting a modest overshoot, maybe up to a point. The difficulty with not announcing it or at least saying that we're going to tolerate an overshoot is that if we have an overshoot and the market doesn't hear us say anything about not correcting it, they are going to assume that we will correct it. And that sets up expectations of a tighter policy in the weeks and months immediately ahead. They will be anticipating some action by us to tighten up again. So, we're in somewhat of a box on that score, Mr. Chairman. If we don't decide to increase the '82 range formally, I think we have to go in the other direction, which a number of people mentioned yesterday and which I also find satisfactory, of indicating rather explicitly that we do anticipate some modest overshoot and thus by that action remove anticipations that we are about to tighten. That would be particularly true if the markets see a close to double-digit increase [in M1] in July, which I gather is not out of the realm of possibility, Steve, based on both the--

CHAIRMAN VOLCKER. It could be double-digit, I'm afraid.

MR. BALLES. --income tax reduction and social security payments. If we saw close to a double-digit increase in M1 in July and didn't say something about tolerating an overshoot or increasing the range, I think we would have set up anticipations in the market of a very near-term Fed tightening that could cause interest rates to go up significantly. And that would be a very dangerous thing to allow to happen right now. Well, in a word, I'd come down, bottom line, in favor of alternative A, with the borrowing assumption that would be consistent with that--maybe in the $700 to $800 million range.

MR. FORD. Do you want to cap interest rates, too?

MR. BALLES. No.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, as I said yesterday, I don't think any of the alternatives that we're considering now are likely to reduce interest rates significantly from their current levels. I would like to believe that alternative A would, but I don't think so. Since it's unlikely that we'll be able to do anything to get interest rates down within the limits of what we're thinking about, I think we should at all costs avoid doing anything that would likely result in an increase in interest rates. So, of course, I find myself in agreement with Pres and Chuck. That means I would [support] alternative A and would be willing to see some overshoot from alternative A. And I agree with Chuck that we need to put a cap on the funds rate. I think it's important that we send a signal to the market that there is some point at which we will begin to look at interest rates again. I do not agree with the view expressed that we can't afford to send a signal to the market that we care about interest rates or that we only care about the aggregates. To indicate to the market that beyond a certain point we care would be a very positive thing to do right now. If we announce that we would not accept a funds rate above 15 percent, that would indicate that we are flexible, that we're looking at a broad range of factors, and that we feel some sense of responsibility for the economy. So, I favor alternative A and I support the funds rate cap and whatever borrowing is consistent with that--about $500 million.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I don't think this is the time to make a fundamental change in policy. We may come to that; it may turn out that we can't stay our course. But right now we have an expected recovery; it's not in the bag but there is a broad consensus that things are turning around. So, why at this time convey signals that I think would be deeply alarming to the market? Now, I agree that interest rates are too high. But I see them as too high to allow the economy to operate at a decent level of investment. I don't believe that these interest rates necessarily are going to bring on a financial crisis. If there is a financial crisis, I think it will come as a result of some specific circumstance--whether it's the Home Loan Banks or something that happens in Mexico or something else. But I don't think the present level of interest rates is unsustainable for somewhat longer for a great majority of businesses. Furthermore, I'm not convinced at all that we would get very much benefit on interest rates if we eased now in a way that is visible to the market. At the short end, yes, for a while. But what do we do then next year when rates begin to rise again and we have to pay the bill for what we are trying to buy right now? At the long end it's very doubtful what would happen to rates. Maybe a signal that we care about rates--a signal that we're not going to tolerate an increase in rates--would be favorable, but the market could just as well react in the opposite direction if people think we are pegging rates again. They will think we are going to flood the economy with liquidity as we've done in the past; and we may be shooting ourselves in the foot. I have a similar uneasiness about announcing a tolerance for an overshoot. It's very difficult to decide whether it's better to change the ranges, which I said yesterday I might be prepared to do, or just to keep overshooting. If we declare that we're willing to overshoot, we're going in the direction of the temporary debt ceiling--the permanent debt ceiling is hundreds of billions below the temporary one--and we'll always be looking at the tolerated range, which may be very high, and have a formal range that is low. I don't think that would be a viable posture.

Given all this, I think we have a chance now of getting back on track somewhere by the fall or by the end of the year. If these new numbers hold, we could even do it by September, but I'm not all that bent on doing that. I favor alternative B with, say, $1 billion of borrowing and M1 at 5 percent--and the path set to accommodate the expected July bulge so that it doesn't drive up interest rates immediately--and the funds rate range as it is here. It wouldn't be the end of the world if the funds rate went to 16 percent. I do think that things would change very dramatically if it were known that we have capped the rate and are willing to put in any amount of reserves in order to hold it there. So, an 11 to 16 percent range seems reasonable to me.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Well, Mr. Chairman, I'd like first to ask Paul Meek: Where does the market think we want borrowings right now?

MR. MEEK. It's a little confused.

MR. CORRIGAN. Well, that's understandable, but--

MR. MEEK. Borrowings were $900 million the week before last and about $1-1/2 billion last week. I would think somewhere in the $800 million to $1 billion area.

MR. CORRIGAN. That's the market perception. Steve, could I ask you, too: Back in April, when we were looking at a similar situation in terms of a money supply burst, we adopted a path; but as I recall we had some kind of fail-safe understanding. How did we finesse that?

MR. AXILROD. I forget the exact wording but my memory of it is that we said that if April came in a little stronger than was in the path, that would be tolerable. I forget the exact wording, but we can get the April directive if that--

MR. CORRIGAN. But there was some understanding--

MR. AXILROD. I think there was some understanding, if I'm remembering right, that if April came in a bit stronger than the skewed path that it would be tolerated so long as [M2] reflected some offset to M1.

MR. BALLES. It was provided that M2 was essentially within its growth range for the year, Steve.

MR. AXILROD. As an aid to judging, that's right. That is exactly right.

MR. CORRIGAN. Well, fundamentally, I'd start off by saying that the thought of doing something that would be construed as a basic change in policy right now is totally unappealing to me. I just don't think the time is right to do that. I am very sensitive to the problem of an increase in interest rates. But if July really turns out to be a problem, I think we can finesse that, for example, by doing something like we did in April. And I would certainly want to do all the finessing we could do in that event. My instincts, in terms of the short term, are very much driven by the same considerations that I mentioned yesterday in the context of the long term. I don't think there is a heck of a lot that we can engineer that is going to produce some fail-safe reduction in interest rates, much less an absolute assurance that they won't rise. I would lean toward Governor Gramley's earlier suggestion, which if I understood it was basically to focus on the September numbers as we see them. As he worked it through, I think he was suggesting maintaining quantitative money targets that are something like those in "A," but preserving in that context the funds rate and borrowings targets that are more or less compatible with "B." That would be quite satisfactory to me. Borrowings would be $800 or $900 million, or something like that. I don't care whether we put the funds rate range at 10 to 15 percent or 10 to 16 percent; I don't think it matters a whole lot. But I would look for the possibility of putting in the directive something that does allow a little more flexibility in accommodating any real aberration in July.

CHAIRMAN VOLCKER. I am out of names at this point. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, I would line up with those who are arguing for alternative B, for the reasons they've already given, with an initial borrowing assumption of around $900 million.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. Well, let me say first that this is the strangest FOMC meeting I've attended. There seems to be a whole change or shift in mood. It's true that I missed the last meeting; I was ill. Maybe it started last time. But during the depth of the recession there was a much tougher attitude than I hear today. I don't know what is bringing about this change, although I share in that view, as indicated by my remarks yesterday. Anyway, without carrying that further, it seems to me that it's important--and here I want to emphasize what Henry said--that there not be an impression in the markets of a sudden reversal or shift toward easing. It would be very politically suspect. They see the pressure on us with widespread speculation now that we will ease. And yet at the same time there's a gloom and doom atmosphere out there and very little expectation that interest rates will fall. There's an ambivalent feeling. On the one hand, they see the pressure on us [to ease] and some people think we may ultimately give into it. But nobody expects that we're going to give into it that quickly. Therefore, I think it would come as quite a surprise if there were a sudden drop in rates. So, that is why I think we shouldn't go lower than about $800 million on the initial borrowing assumption. On the other hand, I would go along with a 5-1/2 percent intermeeting target [for M1] and an 8-1/2 percent target for M2. I don't think that has to be increased. The fed funds range is unimportant. I see no reason to cap it. And in particular, there would be no reason to cap it if we accept Jerry Corrigan's suggestion, which I agree makes sense, that if the July [M1] bulge comes in at more than we're allowing for, we accommodate it within reasonable limits. So, I would urge the Committee, even if it's going in the direction of easing--which it clearly is--to do so in a cautious way rather than in the kind of sudden movement that would be likely if we started off next week with a $300 or $400 million initial borrowing assumption.

MS. TEETERS. Tony, with $800 initial borrowing, regardless of what we do with the rates of growth in the Ms, there is absolutely no change from where we have been for the past 3 months. And we're going to have interest rates that are fluctuating between 14 and 15 percent. That's no change in policy.

MR. RICE. They may be higher.

MS. TEETERS. And they may be higher.

VICE CHAIRMAN SOLOMON. Well, first of all, borrowing was $1-1/2 billion last week.

MS. TEETERS. It's close to being--

VICE CHAIRMAN SOLOMON. It has been averaging closer to $1 billion; I think it was around $900 million in the last few weeks. It seems to me that the fact that we're building our [M1] path on as generous a target as 5-1/2 percent, assuming that there aren't some sudden flukes in the money supply, will permit rates to come down. But I just don't think we want to be perceived as coming in with a very sudden drop in the initial [borrowing assumption]. That's a matter of judgment. We can ask Paul Meek. I don't know; I haven't discussed this with him. If we do have an initial borrowing assumption of $300 or $400 million, I think we'll have a sudden drop.

MR. MEEK. I believe that would be Nancy's intent--that there be a change.

VICE CHAIRMAN SOLOMON. A sudden change.

MS. TEETERS. Well, a 14 to 15 percent federal funds rate for the next three months in my mind is absolutely no change. If it takes a drop to $300 million to get it down to 12 percent, my word, that's [only] a 2-point drop. That doesn't sound to me like a plunge in the market at this point.

MR. MEEK. Well, I think the market would be quite surprised. And I do think that we have enough credibility in the markets that accommodating a July bulge, after the January and April experience, is considered likely by the markets.

MS. TEETERS. Why are the rates going up? Why have funds been trading at 15 percent for the past month? Was it because the borrowings were well above the $800 million that we specified at the last meeting?

MR. MEEK. Well, I think we had the funds rate trading up in the last week largely because of the June 30th statement date and the pressures for banks to dress up their balance sheets for that. I would say, with the billion dollar level of borrowing that was our objective, that a funds rate somewhere around 14 percent or a little above was what was indicated; that is about where it was in May before we lowered the borrowing level to $800 million. Then the rate went down for three weeks to 13-1/2 percent; but it came back, as funds strengthened, to wind up the period roughly where it was at the beginning.

SPEAKER(?) Following the last Federal Open Market Committee meeting, the funds rate dropped from the 14-1/2 percent area down to 13-1/2 percent, and it was there for a period of 10 days or 2 weeks--I forget exactly. Was that a shock to the market? How did the market react to that percentage point drop?

MR. MEEK. Well, the market was encouraged at that point. Its expectation in May was that if the economy was weak, in fact interest rates would ease off. So dealers and others in the market accumulated positions in the expectation of being able to sell at the higher prices to others in the market. We had an abrupt reversal in June, which was not related to the funds rate or to our posture but to the prospect of [a large volume of] Treasury financing coming within a very short period of time. The Drysdale and Comark episodes also were factors and the anticipation of a July money supply bulge was a factor. But the main thing was that the Treasury expected to raise $50 to $55 billion this quarter. And being stuck with inventories that customers weren't buying at lower rates, they had to clean the decks. So, interest rates adjusted up quite sharply through the middle of last week--by 100 to 120 basis points at the intermediate and long end of the market and less than that at the short end. In the last two days, with the successful sale of the 4-year notes, a little of that ground has been retraced, with the 4-year issue having trouble at 14.96 percent and moving down to 14.68 percent or thereabouts. And the 7-year issue that is being sold today is expected to come out about 40 basis points lower in yield than it was on Monday.

VICE CHAIRMAN SOLOMON. Let me ask you a question, Paul. If we started with an initial borrowing of $800 million and an M1 growth path of 5-1/2 percent, where would you expect the fed funds rate to be in the first couple of weeks?

MR. MEEK. I think it would gradually be eased down from above 14 percent, roughly toward 13-1/2 or 13-3/4 percent or something like that.

VICE CHAIRMAN SOLOMON. 13-1/2 or 13-3/4 percent.

MR. MEEK. It would be back close to where it was in early June.

CHAIRMAN VOLCKER. I think that depends heavily on what kind of increase we get [in the money supply] in the early part of July. If we get a great big increase, the funds rate is going to stay up; if we get a small one or the expected increase, it probably will plummet. Governor Partee, you wanted to--

MR. PARTEE. I seem to have shocked quite a number of people with my suggestion that we ought to put a cap on the funds rate. First of all, I don't think that is as extraordinary a suggestion as was suggested by some subsequent speakers. We often have conditioned monetary policy on some notion of limits. We used to condition money market conditions on the basis of "so long as bank credit doesn't exceed a certain amount" and then "so long as the money supply is within a particular range." This is just simply conditioning the money supply target on a maximum funds rate expectation. In fact, it seems to me that my proposal isn't that much different from what we had prior to the fall of '79. My concern is that the market is very sensitive and nervous and that events that could lead to fright in the market may well push up the funds rate. Now, we can stop it from going up, but in the end we'll provide a lot more reserves trying to stop it from going up [as a result of] a Comark or a Drysdale or an Oklahoma City bank failure or whatever may occur in the period ahead. And it seems to me that it would be better to say that we would not expect the funds rate to exceed 15 percent in any event. It won't exceed 15 percent if we say that. And I think that would give us an upper limit that is not unreasonable. People say it's like a peg again. Well, the peg was at 2-1/2 percent, Henry, not at 15 percent. You say it's like the debt limit. We're not talking in terms of a permanent thing; we're just saying that for the time being, given the rate of inflation, given the balance of credit demands in the economy and the needs of the economy, we would not expect the funds rate to exceed 15 percent in any event. I don't think it's as radical a suggestion as other members seem to feel.

MR. WALLICH. But if it got there, we would provide unlimited reserves?

MR. PARTEE. Yes. Because I agree there is going to be a recovery, but my concern is much, much deeper than that. I believe the recovery may be very wishy-washy and that it may be followed by a collapse. And I think we ought to have a point at which we say: This is it for the time being and we're not going to tolerate--tolerate is too strong--but we would not expect the funds rate to trade consistently above 15 percent.

VICE CHAIRMAN SOLOMON. Do you think it's useful to have that in the directive that gets published? Or would you feel it would be equally--

MR. PARTEE. Yes, and I would make it in Paul's statement if I were--

VICE CHAIRMAN SOLOMON. In Paul's statement?

MR. ROOS. Chuck, how would that differ from the pre-1979 practices of our Committee?

MR. FORD. He said it would be similar.

MR. PARTEE. It's similar on the top side.

MR. FORD. Are you implying that there wasn't a change in October '79? If I understood you, you said it would be similar to pre-October '79--that there is precedent for it.

MR. PARTEE. I'm just saying that we have plenty of precedents for constraints on policy.

MR. FORD. Before 1979.

MR. PARTEE. We've had various constraints since '79 and we had some then also.

MR. MARTIN. This is not the same as pre-October '79. What we did after October '79 was to set federal funds rate limits, which for a while we regarded as fairly firm, and we said we'd have a special meeting if the funds rate exceeded a certain limit. It seems to me that is what we're saying, in effect, now except that we're saying it a little more firmly on the up side.

MR. PARTEE. Under the pressure of the monetarists, I think we changed it about a year later.

MS. TEETERS. We also had a bottom limit in the spring of '80 in that we weren't going to let the rate go below 10 percent or something of that sort. We haven't consistently stayed within the limits.

CHAIRMAN VOLCKER. Mr. McDonald.

MR. MCDONALD. I can sympathize with the desire and the need for lower interest rates, but higher monetary growth can be associated with higher interest rates. I agree with Governor Wallich's comment that it's not time to make a fundamental change in policy or to convey alarming signals to the market, and I would support the 4 percent [M1 growth target] in alternative B.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, if I had to cloud my mind again by thinking about M1, I would support Governor Gramley's formulation. While I sympathize with Governor Partee's general point of view, I think it would be a big mistake for us to announce that we were willing to peg interest rates again. One thing we've learned in the last few years is that the presence of an intermediate target for monetary policy has sheltered the central banks--not only ourselves but the Germans said the same thing at that meeting in New York [as did] the British and the Canadians and others--from a direct sense of responsibility for interest rates, and I think that has contributed to a stronger policy posture. To begin, even in a little way, to back away from that would be a serious mistake strategically. And while I think we're following the wrong intermediate target, I believe it would be a big mistake to start doing without one.

VICE CHAIRMAN SOLOMON. What do you mean we're following a wrong intermediate target?

MR. MORRIS. M1.

VICE CHAIRMAN SOLOMON. Oh, I see; I'm sorry.

CHAIRMAN VOLCKER. Well, I've completed my sheet except for Mr. Volcker, at which point I will declare a recess.

[Coffee break]

CHAIRMAN VOLCKER. The numbers we are looking at seem almost ridiculously out of proportion because they come in the middle of our discussion about the weekly figures. The figure that we have at this time, which usually holds up pretty well--within a few tenths by the time we publish--is the same for this week; and for next week it's the same as we had it yesterday. The preliminary number, which is worth very little for the next week, is down a little more than we thought yesterday. It's in that direction, but that is subject to a margin of error of a couple billion dollars. So, it tilts a bit more toward the lower side than we thought yesterday, but the significance of this is not that it changes the June level, although it may change it by a tenth or two. If anything like that happens, we get a little cushion for a bulge in the first week or two of July because we're going to be starting July from a considerably lower level than we anticipated a week or two ago anyway. And it could jump by $4 or $5 billion in the first week in July and only get back to the level of the first half of [June]. I don't know where July will actually be. And I certainly don't know where the first week is going to be. Occasionally in a week like this we've had increases of [up to] $9 billion, but it could be much less. If we get anything less than $2 or $3 billion, I imagine the market would go through the roof because--

VICE CHAIRMAN SOLOMON. The stock market would go [up] too.

CHAIRMAN VOLCKER. --it would be so much better than they thought. We have to keep in mind that this is a preliminary comment, as you obviously know, and that any of this numerology we put down either for the paths or for the federal funds rate will not be announced for 7 weeks on our present schedule in terms of any direct market knowledge, barring anything I would say in my testimony. Let me also make a note of reservation that applies to all of these targets, but I think it's relevant in terms of the concerns that have been expressed about the bulge in interest rates or financial circumstances. I do not find it at all difficult to imagine that we would have some financial events to which we would appropriately respond by putting in a large amount of liquidity--something that may turn out to be far in excess of anything we're talking about in terms of the fine distinctions that we make at these meetings. We obviously can't talk about that much, but I think it is just a fact of life. If we have a financial crisis, we have to respond to it, and those numbers have very different meanings in those circumstances than they do otherwise.

MR. WALLICH. On a net basis you're saying?

CHAIRMAN VOLCKER. Sure, it's quite possible. I'm not saying we would do it with great eagerness. We would make a judgment at the time. But if we have a crisis, we would respond to the crisis. And we may respond to it on a net basis if we think we can get by with that; if we can't, we won't. I go back to the very first lesson of central banking, which is that in a crisis you lend freely. It's a matter of judgment when that arrives. We all obviously would love to see interest rates down. Barring any great crisis now, the question is how much we can do [to achieve] that by, to overstate it a bit, force majeure--in a way that looks artificial, if that's the right word. That's because the risk is that whether we're successful or not in the short run [the effort to reduce rates] may backfire because it won't look sustainable to the market. [The market] itself will react or [the decline] won't look sustainable in policy terms or we will damage our long-term policy objectives. Put another way, to the extent we can encourage or nudge interest rates down, the more support we have from observable events, such as what is happening in the money supply or elsewhere in the economy, the better off we will be rather than trying to make it a decision that appears ex cathedra and discontinuous in terms of our own policy. It just may not be very productive however much we care.

In approaching these variables and trying to put it together, let me try to suggest--for something to shoot at, anyway--several things. Let me go directly to the interest rate question. A number of people have said that it would be a mistake to signal a great change in our structural policy. There might be some dispute over what that is, but I share that [view] implicitly for the reasons I just suggested. It may not be very productive over a period of time in terms of impressing the market and it may create more doubts and uncertainties than we want to, whether or not they see it 7 weeks from now or see it in our actions in the market. That does not mean that I don't have a lot of sympathy for the substance of what those people have said regarding their concern about higher interest rates. I'm not sure that the way to handle this isn't to keep the same [funds rate] range we have now, without changing its statement in the actual directive, but to include to a limited degree the discussion in the policy record, against the background that I myself would be very hesitant, unless there were overpowering reasons, to see the federal funds rate go above 15 percent. I would want to think twice, three times, four times, or whatever, before condoning that for any period of time. Circumstances may be such that we don't have much alternative in the end. Maybe the economy will be looking reasonably good and the money supply will be going wild or something and we would have to tolerate [a funds rate above 15 percent], but I would want to think pretty hard about it.

So, I would put in the same range we have now, 10 to 15 percent, without changing the wording but with the knowledge that I would feel very hesitant [to accept it] if in fact the market produced rates of 15 percent continuously for any period of time, and I would certainly want to consult reasonably promptly. I'm not talking about a window-dressing week or day; what I am talking about is something that looks more lasting than that. In terms of the numbers, we have to consider this a little in terms of how consistent it looks with whatever we're going to do in the long run, which we haven't fully decided on by any means. But there was a majority opinion yesterday to keep the long-run targets the same for this year. And that is my instinct, too, bolstered particularly by the other members of the Committee. And a tentative view I had of the need for flexibility and tolerance of growth above those ranges was somewhat reinforced, certainly, by our discussion and what I think was the general opinion yesterday. I doubt that we can keep the range the same and then credibly say at the same time that we fully expect to be above it. There's a nuance or more than a nuance of difference to say that we kept the ranges the same because we do expect and would like to be at the top end, let's say, but that we also would tolerate under a lot of circumstances coming in higher. I think "tolerate" is the key word; I can imagine a lot of circumstances in which we would say that. It's a loose toleration, if I can state it that way, as kind of a general background. But assuming we keep the range the same, I have the feeling that we shouldn't adopt a short-term range that on the face of it raises a question of inconsistency. Now, we're all roughly within that ballpark; it's just a question of where we come down precisely.

I'm still a little confused about the precise numbers now and we don't know those for next week for sure and all the rest. But what it comes down to is that growth around 5 percent--maybe a bit above or below--brings us very close to the top of the M1 range in September. Maybe we can tolerate a little more growth than that. It seems to me to be consistent in a visual sense as a reserve path determinant. Now, whatever we say about the long-term ranges, such as a willingness to tolerate an overshoot, we would say about the short run, too, I presume. There may be some difference of opinion about that, but certainly if July comes in high, I sense that there is a willingness not to put much weight on July alone--that we would have a sluggish or passive reaction, as a number of people have suggested. That is, July would have to be quite an extreme number to push us off whatever borrowing path we set.

VICE CHAIRMAN SOLOMON. Could we have the new seasonal adjustment in the Bluebook from now on?

CHAIRMAN VOLCKER. I don't see any reason not to put it in there.

MR. AXILROD. The old seasonal is in there.

MR. PARTEE. No, from now on he says.

MR. AXILROD. Oh, yes, surely.

VICE CHAIRMAN SOLOMON. For the next meeting.

CHAIRMAN VOLCKER. I don't know exactly how to word it, but what I'm saying, particularly if we go a bit skinnier than some people have suggested on the [M1] number--and I'm in the 5 percent area--we need in the directive itself a clear indication of tolerance for an overshoot in the next month. I'd put down a reasonably liberal figure for M2, but something that is judged reasonably consistent with that for M1.

MR. PARTEE. Both could surge here because of the tax cut.

CHAIRMAN VOLCKER. I think [M2] does reflect some of the same liquidity [preference motives] that M1 reflects and, indeed, one would expect it to. Most people when they go liquid don't actually go into transaction balances. I think we're seeing individuals do that. Businesses go into other kinds of balances.

Then we're left with the borrowing level. This is not exactly the way to express it, but we went fully--I suppose with some qualms about whether the scientific projections of the staff were right--with the staff [view] last time in reducing the borrowing level in the hope that interest rates would go down a little and the money supply would stay down. As it turned out in the end that has been correct except that we had an intervening increase in the money supply. We had a [pattern] of movement that was not the most felicitous, which sent [borrowing] up a bit in the intermeeting period. Now we are back pretty close to where we started out, and borrowing has been a little above $800 million. I would go down at least to $800 million in borrowing on the same theory; we can argue about whether we could tolerate something a little lower than that on the theory that it would be a good idea to create some conditions that presumably would be reflected in a lower funds rate and would encourage a market [rate] decline. But overdoing it would create a substantial risk that we'd have an adverse reaction ultimately, being followed up with what is deemed to be by the market, if not by us, an excessively rapid increase in the money supply; and we would lose, on balance, instead of gaining. But then the question becomes: How do we act thereafter? I wasn't exactly sure what Governor Gramley had in mind, precisely, in his suggestion. But the sense of what I think he was saying, qualitatively, I would share. I don't know how to reduce it to a formula, but if the money supply came in on the low side, we would let that be reflected in a decline in interest rates up to a point. But we wouldn't mind taking a little of it in the form of a little slower growth in the money supply, too, if interest rates were going down rapidly. We kind of [split] it, as he said. I don't know whether we can reduce it to a formula, but we might reduce the reserve path a bit if interest rates went down sufficiently and welcome a slightly slower growth in the money supply during this period. We'd be very reluctant and sluggish and passive on the up side if the money supply came in high in the short run. So, let's have a little discussion of these variables just to--

MR. GRAMLEY. May I just make a technical comment? If I've understood you right and you're going with 5 percent for M1 and the appropriate number for M2 from June to September with a new lower June base, you in effect are saying that you are prepared to tolerate a September number for M1 that is a tiny bit less than what is in "B."

CHAIRMAN VOLCKER. Well, that's what I'm not sure about. Is that what it comes out to--that at 5 percent M1 would come out a little less than the target?

MR. GRAMLEY. [The level] is $457.0 billion, if you take $451.5 billion for June.

CHAIRMAN VOLCKER. What is the target level for September?

MR. GRAMLEY. I don't know; I don't have that.

MR. AXILROD. The upper limit is $456.7 billion.

CHAIRMAN VOLCKER. I see. So we'd still be a bit above it.

MR. GRAMLEY. But again, what you're doing is assuming that the June figure is a solid one and that it signals the first of a series of downward shifts in money demand, which is built into these specifications in the first place. If that doesn't continue, unless we have some sort of understanding that we're going to operate on money market conditions, interest rates will begin to ratchet up. And that's something that I just don't think we ought to do. One way to get around this might be to go to a May base. A number of 5 percent from a May base would be a lot more satisfactory from my standpoint.

MS. TEETERS. It's the same number.

MR. GRAMLEY. If you take 5 percent from May to September--

MR. PARTEE. You have a lot more room.

MR. GRAMLEY. Yes.

MR. CORRIGAN. What is the level you get with that, Lyle, for September?

MR. GRAMLEY. It's about $459 billion. We'd have essentially what is in alternative A.

MR. CORRIGAN. I see; that's right.

MR. GRAMLEY. It's a bit less, but in round figures it would be $459 billion.

CHAIRMAN VOLCKER. Well, my concern is not so much [how] we can trace [the right number] through all these mechanics. I don't think we know down to the last billion or two. It's just a question of selecting ranges that appear more or less consistent with what we say for the longer run; obviously, there's no certain answer to that within a narrow range. Saying something like 5 to 6 percent isn't so bad. But if we said 6 percent, where does that leave us in September? Is that going to be considered consistent with the long-run target? That's my problem. I do want to say we're going to be tolerant of an overshoot. And if we make the number too high and say we're tolerant of an overshoot, what message are we conveying? That's the kind of--

MS. TEETERS. But can we say we're going to be tolerant of an overshoot without giving the market some idea of how much? Otherwise, they will be drawing out all sorts of possible--

MR. MARTIN. We can talk about the bulges we have already been tolerant of.

MS. TEETERS. Yes, but what they do, Preston, is that they sit down and figure out the rate at which the money supply has to grow for the last six months and--

CHAIRMAN VOLCKER. My sense is that that argues against [your suggestion], Nancy. One can argue it any way but if we say that's a big number, then we have a problem. If we say it's a relatively small number and in fact we overshoot it, we're right back into that calculation. If we're a little vaguer, we avoid that arithmetic or we try to avoid the arithmetic. We never avoid it.

MS. TEETERS. But we may cause more chaos by not doing it.

MR. PARTEE. No, I agree with Paul. It would be very hard to indicate the extent of the overshoot we'd tolerate, particularly since aside from this precautionary [demand for money], which could become greater actually in the next few months, we have the natural workings of a tax cut, the first effect of which is to add to household balances. And that gets to be a big number when it is annualized.

CHAIRMAN VOLCKER. I think what we have to say in terms of our tolerance--whether we're talking about the short run or the long run--is that we can only judge that at the time in the light of all the circumstances. If we observe events that suggest the overshoot is originating in a precautionary demand for balances, we are going to be more tolerant than otherwise. And how do we judge that? We judge that by what the economy is doing and what interest rates are doing--I get interest rates in through that avenue--relative to what our internal analysis of the figures suggests, as we have in the past. I don't know what else we can say.

VICE CHAIRMAN SOLOMON. That's a good way of handling it.

MR. GRAMLEY. Do you mean that if in July we appear to be getting a bulge of over 9 percent in money supply growth that you would adjust the nonborrowed reserve target upward unless there were some indications that this growth was being generated by a strengthening in the economy? If what happens is that the amount of borrowing goes up and interest rates go up, then that is not accommodating in the sense that I would use the word. And I--

CHAIRMAN VOLCKER. I mean that to the extent that the July problem is seasonal, it is not what I was just talking about. It's just pure uncertainty about July in terms of seasonals and the tax cut and so forth. At what point we accommodate that absolutely and completely, or stop accommodating it absolutely and completely, I don't know. You say 9 percent; starting from such a low level, 9 percent implies a bigger increase during the course of July than Steve was assuming in the Bluebook. The 9 percent now becomes a bigger increase for the monthly average for July than it did when the Bluebook was actually written because we're starting so low with the same--

MR. BLACK. About 11 and a fraction percent, I believe, is what we figured out.

CHAIRMAN VOLCKER. Yes. That sounds right.

MR. PARTEE. [Unintelligible] target on 11 percent.

MR. GRAMLEY. But that means targeting on quarterly levels or on the levels for the month and not on the growth rates. If we target the levels, then it seems to me what we need to do is to decide what our specifications are relative to the month of May. If we're adjusting the whole quarter downward for this fortuitous development in June and we end up having a 5 percent growth rate for M1, we're ending up with a level in September that is at or slightly below where we were in alternative B in the first place. And that, it seems to me, does not come to grips with the problem that these specs have built in them a downward shift in money demand, and if it doesn't happen, then we're in really big trouble.

MR. PARTEE. My feeling, Lyle, is that this will turn right around.

CHAIRMAN VOLCKER. My only difference with you is that we may be in really big trouble, but I don't think it's going to involve a difference of 1 percent in the growth rate from June to September.

MR. PARTEE. I think we have to allow for a bigger July because I suspect that this change in late June is just temporary and that we will get a bigger July surge.

CHAIRMAN VOLCKER. Oh, we can get that; it depends upon what you mean by a July surge. If we get the same July surge on a weekly basis, we will come out with a smaller monthly number.

MR. PARTEE. I'd say we will have a larger surge than we expect for [July] and that it will be because this is just a temporary development.

CHAIRMAN VOLCKER. We can have quite a large surge in the weekly sense in July and come out where we expected. We'd have to have quite a big increase in July now, I guess, to go above a 9 percent growth rate on average, if next week's figure is right. It's obviously not impossible. If we started out with a nice $9 or $10 billion figure, I guess we could get that. But that's what it would take, wouldn't it, because we had a $4 or $5 billion figure in [the projection]?

MR. AXILROD. For--?

CHAIRMAN VOLCKER. For the first week in July.

MR. AXILROD. Yes, we have about a $4-1/2 billion increase in the first week of July.

CHAIRMAN VOLCKER. So, it's now $3 or $4 billion lower than you expected it to be?

MR. AXILROD. Yes, about $4 or $4-1/4 billion lower.

CHAIRMAN VOLCKER. So we would have to have an $8 or $9 billion increase to have the [previously expected] July level?

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. That isn't impossible; it's quite possible.

MS. TEETERS. Steve, does this revision in the June number bring the quarterly average back down to 3 percent?

MR. AXILROD. It brings the March-to-June growth rate to 3 percent, that's right.

MS. TEETERS. So, what is happening in June is that we're reverting to what you originally expected?

CHAIRMAN VOLCKER. Yes, we're right on the target we set for the quarter.

MR. AXILROD. Yes, we're right on the target the Committee voted for.

MR. PARTEE. It's just [a different] pattern, that's all.

CHAIRMAN VOLCKER. Unfortunately, the path instead of being a U is a hump.

VICE CHAIRMAN SOLOMON. We're lucky it isn't a dromedary--a double hump.

CHAIRMAN VOLCKER. It may be. We just don't have the next quarter yet. Well, there are too many permutations and combinations to decide all of these things, I'm afraid, but I am talking about accommodating a real bulge in July should it develop. We could say 5 to 6 percent for the quarter. My only hesitancy is: Is it worth having somebody coming back at us saying 5 to 6 percent is clearly inconsistent with your saying that you are not changing the targets for the year as a whole.

MR. FORD. That's the thing to worry about.

CHAIRMAN VOLCKER. And even then I would want to put in some tolerance numbers because I don't know what the difference between 5 or 6 percent is in this kind of period. It's a shot in the dark anyway.

MR. BLACK. Well, 5 percent approaches the upper limit and 6 percent moves slightly away from it.

CHAIRMAN VOLCKER. That's right. If we were squarely on the target in June, 5 to 6 percent would be something like the right thing to say. It just says we're going to stay right around the upper end of the target.

MR. BOEHNE. What about something like "about 5 percent" with an understanding that "about" is more generous on the top side of 5 percent than on the short side of it?

MR. PARTEE. Well, I was going to say "about 5 to 6 percent."

CHAIRMAN VOLCKER. Well, I'm going a little beyond that in a sense. I'm suggesting that we say about 5 percent--and "about" may be the right word--but I would say something explicitly about tolerating some overshoot.

MS. TEETERS. Steve, how does this fit? If we use these specifications, would you think the [federal funds] rate would be about 14-1/4 or 14-1/2 percent?

MR. AXILROD. If borrowing were around $800 million, I think that would bring the funds rate to 14 percent or a little below--probably more below.

MS. TEETERS. That's what we had last time with the rates well above that.

MR. AXILROD. I would add an important caveat. In the first place, the July 4th holiday weekend often has fairly high funds rates for the same reasons as the statement date. Secondly, if financial pressures or financial problems develop and they become known, sometimes that gets associated with a high funds rate as these pressures immediately hit the banks and they have to lend or some uncertainties develop. That, too, could produce a relatively high funds rate. But in a normal situation I would say the $800 million would be [associated with a funds rate] of something under 14 percent.

CHAIRMAN VOLCKER. One way of playing this is to set the borrowing level slightly below $800 million. The more we go below, the more it increases the risk that we might have to reverse it instead of opening up room for coming down further quickly if things develop in a satisfactory way.

MR. BOEHNE. Do you have some notion as to when you would begin to get uncomfortable on the down side in terms of the federal funds rate?

MR. FORD. I'd get very nervous around 6 or 7 percent. I'm serious!

VICE CHAIRMAN SOLOMON. You want a positive real interest rate?

MR. FORD. That would still be positive.

CHAIRMAN VOLCKER. Not on last month's figure. Not on most people's figures, I don't think. There's always a question of the rate of speed and how far to go, but I suppose we would only worry about it to the extent that we thought what was going on was so temporary that the rate was just going to rebound. If we thought it was going to stay wherever it went, we wouldn't be concerned about it.

MR. PARTEE. I think 10 percent is reasonable.

MR. FORD. Well, Mr. Chairman, since you quoted one of your favorite philosophers earlier on I'd like to quote one of mine. The quote goes something like this: "I think we tended to make mistakes in the past not at the end of an expansion or the end of a boom, and not so much in a recession, but by providing too much stimulus during the early part of an expansion period when things tend to get out of control before one realizes it. I hope we don't make that mistake again." I think you know who the philosopher is that I refer to. I like that statement. That was made two summers ago. I think we're right there again.

MR. GRAMLEY. Providing too much stimulus is the least of my worries.

MR. FORD. The point of this quote is that we always realize too late that we put in too much stimulus. So, I feel strongly that we should never set a cap on the funds rate at right where it is. We have to allow at least for a little change. We're talking about putting it at 15 percent when it is already--maybe for window-dressing purposes--right around 15 percent. We have to give ourselves some room to breathe on rates and not give people a formula to work with which would allow for a very rapid expansion when we may regret it later. So, I'd be more cautious. I'd set the borrowing at over $800 million and put a wider range on the funds rate to include something above where it is. I always get nervous about setting the interest rate cap--

CHAIRMAN VOLCKER. Well, before we get to that, on the [M1 growth rate], I suppose one way of stating it is 5 percent or more. The only thing I don't like about that is the connotation that we wouldn't tolerate any shortfall; I think we would tolerate some shortfall if things went the other way, as you have suggested in--

MR. MARTIN. Or set the upper limit at 5-1/2 percent.

MR. GRAMLEY. When I was tolerating the shortfall, it wasn't from 5 percent.

MR. ROOS. Given the news about Mexico, we could say 5 percent "poco mas o menos."

MR. PARTEE. Yes, let's put that in. Mexico is in the news.

MR. FORD. I think when we say "about," everybody reads it to mean "or more."

MS. TEETERS. You know, there has been no discussion of the impact of this on the international value of the dollar. If we maintain rates at 14 to 15 percent, what is going to happen to the international value of the dollar?

MR. FORD. It's going to reduce Henry Wallich's expense account!

MR. WALLICH. It's going to reduce our exports, which is going to reduce the value of the dollar.

VICE CHAIRMAN SOLOMON. Ultimately.

MR. WALLICH. Eventually; we don't know exactly when.

MS. TEETERS. But won't this continue to keep the value at least high, if not rising?

CHAIRMAN VOLCKER. My presumption in saying $800 million is that if things behave more or less as we're thinking, the funds rate is going to be--though heaven knows what it'll be on July 4--below 14 percent and the dollar will probably weaken. Who knows? The problem is not the desirability of getting interest rates down; the question is whether by reaching too fast for that objective we may not be able to keep them down.

MR. CORRIGAN. Couldn't we put something in the directive, Mr. Chairman, that says we are shooting for about 5 percent with the understanding that we would be tolerant of unusual developments in the money supply early in the period, associated with the tax reduction and all that, and use that as--well, as our excuse?

CHAIRMAN VOLCKER. Well, I think we have to say we will be tolerant early in the period, but my tolerance extends beyond that and is not just a technical judgment affecting July. But if the whole thing looks too low after July and interest rates are under great pressure and the economy is going no place at all, I would also be tolerant apart from the July bulge to a degree.

MR. MARTIN. I agree. Why should we limit ourselves to those technical factors? Why limit ourselves in the actions that we may have to take? What is the point of boxing ourselves in?

MS. TEETERS. But by setting the borrowings at $800 million, right there we've locked ourselves in.

MR. PARTEE. I think we ought to tilt that down; make it $700 million.

MR. BOEHNE. I think we ought to tie it to something. We can tie it to something like liquidity demands that are out of the ordinary or some unusual liquidity demands, which gives us lots of flexibility in terms of what we may want to do.

CHAIRMAN VOLCKER. How will you control that--to come back to the other dimension? That's why I'd keep this federal funds range lower than some other people would. That is the occasion for considering precisely moving somewhat above the path, if we wanted to implement the judgment of being tolerant.

MR. WALLICH. Well, since Nancy mentioned the dollar, I should mention inflation. It has been mentioned no more often than the dollar has in our discussion. The economy has turned around--I'm looking at Joe Livingston's list of 54 economists who say it turned around in May--and we're now getting ready to do what we weren't prepared to do all the first half of the year.

CHAIRMAN VOLCKER. But don't be absolutely sure. Industrial production will probably decline in June.

MR. PARTEE. Also, we haven't had the financial fallout yet from the recession.

MR. FORD. It always comes late. Bank losses always peak a year after the recession. I shouldn't say they always peak; they rise after the recession develops.

VICE CHAIRMAN SOLOMON. Henry, there's a 6-month lag in FOMC reactions.

MR. WALLICH. That's right.

MR. MARTIN. Only six?

MR. FORD. That's why I gave that quote.

MR. PARTEE. My position, Paul, is that 5 percent is pretty tight unless we take Lyle's construction and make it May to September. Then 5 percent seems all right. That's the way of getting the number, if you want the number at 5 percent.

CHAIRMAN VOLCKER. Then the arithmetic is wrong.

MR. BLACK. Let me point out something that may be perfectly obvious. Anything above 5-1/2 percent moves us away from the upper limit. Anything less than 5-1/2 percent moves us toward it.

MR. PARTEE. My position is that I'd rather raise the upper limit. But if it is decided for policy or for strategy reasons that we ought to hold the limit, then I'd want to overshoot. I'm quite prepared to overshoot.

MR. GUFFEY. And those numbers are only good if June holds at zero. Growth of 5-1/2 percent will move us farther away if the June number is [higher] than zero.

MR. BLACK. Roger, it seems to me that if it's above the target, regardless of how much above, anything less than 5-1/2 percent moves us back toward it, doesn't it? Am I mixed up on this?

MR. GUFFEY. I was just focusing on your comment on 5-1/2 percent.

MR. BLACK. Well, if growth is anywhere above it [through June], anything below 5-1/2 percent is--

CHAIRMAN VOLCKER. The difference between 5 and 5-1/2 percent for the number is very small. All I'm concerned about is how to visualize--

VICE CHAIRMAN SOLOMON. Why don't we compromise by having "about 5 percent" with it understood that in drawing the path we're going to come closer to 5-1/4 or 5-1/2 than to 5 percent. In other words, "about" is interpreted liberally to start off with.

MR. GRAMLEY. But not 5-1/4 to 5-1/2 percent. A quarter of a percent at an annual rate is not [interpreting it] liberally. If you take the September levels that we have here and use 5 percent from May to September, the June-to-September implication is 6-3/4 percent. That's what I thought I was talking about when I made my proposal in the first place.

VICE CHAIRMAN SOLOMON. I thought you were proposing 5-1/2 percent.

MR. GRAMLEY. No, I was proposing keeping the September level, not paying too much attention to the fact that June was as low as it was. And what I was saying about accommodating was really designed to go in the other direction. I was saying that if in fact the money supply comes in weaker than that and the difference were not construed as evidence of a collapse in the economy, I would be prepared to compromise in the sense of taking part of that shortfall in lower money growth and part of the shortfall in lower interest rates--not accommodating in the other way by setting a number low and then letting the overrun occur.

MR. BOEHNE. It seems to me that we need to capture the spirit of what we're trying to do here and have language that does that. And "about 5 percent, allowing for unusual liquidity needs" captures it. When we start talking about shifting the base from June to May or about 5 to 5-1/2 percent, that seems to me a kind of precision that is more than we can expect. If we had been doing this twenty-four hours ago, we would be doing it some other way. We have six weeks ahead of us. We need to capture the essence and the spirit and know that we have some flexibility rather than being too precise.

MR. BLACK. But looking at Lyle's suggestion in perspective, it might be helpful to [note] that if we did use a May base, we would hit the top line by September if M1 grew at 3-1/2 percent. So, at 5 percent, we hit the top line somewhere between September and the end of the year.

MR. GRAMLEY. I'm prepared to acknowledge the possibility that we may have to overshoot this year.

MR. BLACK. Yes, I realize that. I was just trying to put that in focus because, as I indicated earlier, ordinarily I'd think the idea of using a May base was a good one. In this case I would have to be pragmatic and say I'd rather use the June base because that would enable us to do what I think we ought to do and express it in terms of a high percentage increase, which I would like to do.

MR. PARTEE. Well, could we say "about 5 to 6 percent"?

MR. GRAMLEY. The other way to do it is to make it quite clear that we're talking about an overrun and have an understanding amongst ourselves as to how much we're thinking about in very broad terms. Then we could use language such as Jerry suggested: "The target is 5 percent or somewhat more if the liquidity preference of the public remains high." The "somewhat" in my case would mean that I'd be willing to tolerate growth up to 7 percent for the quarter.

MR. WALLICH. Well, the explicit reference to liquidity preference is reasonable since we're banking on a rise in velocity here. If that doesn't come in, accommodation is appropriate.

VICE CHAIRMAN SOLOMON. And that's consistent with what Paul is going to be saying in his testimony, too. We could apply pretty much the same language to the directive that you think you would be using in your testimony [about] tolerating.

MR. PARTEE. What does it imply for the target path?

VICE CHAIRMAN SOLOMON. Well, I'm assuming that it would be somewhere in the neighborhood of 5-1/2 percent from June.

MS. TEETERS. What does it imply for interest rates? Do they still stay at 14 to 15 percent?

VICE CHAIRMAN SOLOMON. No, they don't, if things behave normally. That's the big question mark. Then it would mean that [the funds rate] probably would be around 13-1/2 or 13-3/4 percent in the initial two weeks or so. But, of course, if there's a fluke in the figures and they come in strong, then we prevent [rates] from going above existing levels. At least I understand that to be pretty much the feeling in the group. And that's what Paul says too.

MR. PARTEE. I like the idea of [the language] being consistent with the testimony. When we say "5 percent or something more, if liquidity preferences remain high," that is very much the theory of the testimony, or of the Humphrey-Hawkins report if not the testimony.

MR. CORRIGAN. If we use that argument, you can even put Milton Friedman's statement in your testimony.

VICE CHAIRMAN SOLOMON. I don't think that's better; I think that's worse! Can we agree on that?

CHAIRMAN VOLCKER. Well, I think what you are stating is where I started off.

MR. PARTEE. But I would hope that the path will be drawn fairly liberally--certainly for the month of July at 11 percent or thereabouts, and then less in--

CHAIRMAN VOLCKER. Well, let me have Steve address that because he told me the opposite. It's just an interpretation of what is liberal. I can agree with the liberality, but I take it from what Steve told me before that even 9 percent in July seems terribly liberal at this point just because we're starting at such a low level at the end of June.

MR. AXILROD. Yes. Our expectation at the moment is that July would be lower because of the very low base that we're starting off with for the end of [June]. On the other hand, August could be higher because--

CHAIRMAN VOLCKER. Yes, he's saying that July would be lower and August would be higher than he would have thought before.

MR. CORRIGAN. But doesn't it imply, Steve, whatever tendency might be there because of the fundamentals, that things should if anything be easier in early July rather than tighter?

CHAIRMAN VOLCKER. Let me word it this way. What we're talking about is that we're not setting the base from right now. We're setting the base--within limits--from whatever happens in the first week or so in July. When we talk about a borrowing level, that's what we're talking about, within limits. I hate to just throw out a figure here but, given the low level from which we're starting, if the first week or two of July came in at as much as $6, $7, or $8 billion, we're still talking about $800 million of borrowings. If it came in at less than $4 billion, considering where we're starting from, we're probably talking about a lower level of borrowings right from the start. The question of a higher level would only be relevant if [the M1 bulge] were really something extreme, such as 9, 10 or 11--

MS. TEETERS. What is 9, 10, or 11?

SPEAKER(?). Billion.

MR. CORRIGAN. The dollar increase in the money supply in early July.

VICE CHAIRMAN SOLOMON. We would get a much more favorable downward impact on long rates if the market sees a gradual and steady decline in short rates than if we have a relatively sudden drop in short rates. [In the latter case] if the numbers don't come out right, particularly in August, we'd get a rise again. The market has its own views as well. And if we get too much downward movement in short rates in July, they may not believe it is sustainable and we will not get as healthy an effect as we could get in the bond market.

CHAIRMAN VOLCKER. Or even in the short-term market. It is not just the speed of the reduction; it's whether the reduction is convincing in terms of what the market itself observes.

MS. TEETERS. We have in the past, at least once, specified a declining level of borrowing over the intermeeting period. That would get to your point, Tony, of trying to bring it down gradually over a period of time.

CHAIRMAN VOLCKER. I don't remember.

VICE CHAIRMAN SOLOMON. I don't remember, Paul.

MR. PARTEE. I don't either. That's hard to do, of course, because it depends on what happens to the aggregates.

MR. BOEHNE. It's hard to do unless we specify a range, which captures that element.

MR. MEEK. Let me just say that I think the publication of these numbers, if they hold up, will itself change some expectations in the market about what we're likely to do in July and beyond. There could be a substantial sense--

CHAIRMAN VOLCKER. I hate to try to be so precise with all the permutations and combinations but I think what we're talking about is this: Let's take $800 million, if that's the number. We have to operate a week before having any indication of what is going to happen in the first part of July. So if $800 million is the [borrowing] number, what I'm talking about is keeping that at $800 million, which would require an adjustment in the reserve path in the first week of July if the number in the first week in July is as high as X, given that the last week in June holds up. I guess that figure might be as high as $8 billion. And then take off [from there]. If it came in below $4 billion, just for purposes of example, we'd lower [borrowings] right away because it would look as if we were heading for a lower July than we expected. If it came in above $8 billion, then we'd have a question. Then we'd come to our federal funds limitation, anyway, at some point. Even then we wouldn't move very vigorously. So, we would readjust the reserve path in any event the next week, depending upon how July starts, with a very broad range of tolerance and a presumption that borrowing is going to be around $800 million; we're much more likely to lower it than raise it if the first week of July came in low. I think that's the operational significance of what we're saying.

MR. PARTEE. It sounds good. I don't know how to put it in words for the directive.

CHAIRMAN VOLCKER. Well, we don't have to bother with that in the directive, I don't think. It's just a--

MR. AXILROD. We could interpret that in light of any potential revisions of June 30th also. It could go either way.

CHAIRMAN VOLCKER. What we're saying is that we're not going to react to any figure for the first week of July, given how low [a base] we're starting from, unless it's enormously high.

MR. PARTEE. Or pretty low.

CHAIRMAN VOLCKER. Well,--

VICE CHAIRMAN SOLOMON. No, if it's low, we would permit some downward movement in the rates.

MR. PARTEE. Yes; we'd react by letting them go down.

MR. BLACK. Anything below $4 billion, you would lower it?

CHAIRMAN VOLCKER. Look, I threw that figure out, but I--

MR. PARTEE. Yes, I pretty much agree--

MR. CORRIGAN. Well, isn't the point here that if the end-of-June numbers held up and we drew the path with the monthly pattern as it is in alternative B in the Bluebook, with an initial level of borrowings of $800 million, that anything less than roughly a $10 billion increase in the money supply in early July should produce an easing of money market conditions?

MR. AXILROD. That's right; that's leaving the July level where we have it. It would imply something like a 12 percent rate of growth from June.

MR. PARTEE. That's right.

MR. CORRIGAN. So we do that and we take account of liquidity preferences and--

MR. AXILROD. We would not draw the path, if I understood the Chairman, on this July level. It would be a quite lower level, interpreted as he mentioned.

CHAIRMAN VOLCKER. You might draw the path today, but you'd change it on the basis of whatever things look like. It's not an operational path beyond this week.

MS. TEETERS. How do you decide how to draw it after that?

CHAIRMAN VOLCKER. Depending upon what happens in July, with the presumption that we start the borrowings at $800 million, if that's what we decide on--$800 million being attuned to the first week in July, not this week.

MR. GUFFEY. What does that imply for interest rates in the first week until we have to decide what to do with the borrowing path thereafter?

CHAIRMAN VOLCKER. Well, we're in a window-dressing period, so I don't know. If we were not in a window-dressing period, I would say a little lower. They probably will be a little lower anyhow with these money supply figures we're publishing. We just don't know. I'd be quite confident of that if it were not for the window-dressing and the July 4th weekend. What are we talking about--tomorrow? So, I don't know what the funds rate will be tomorrow. To give you the honest answer, God knows what the funds rate will be tomorrow.

MR. MARTIN. Seasonally adjusted.

SPEAKER(?). It's unseasonally adjusted.

MR. PARTEE. I'm not even too certain about that.

MR. BLACK. If we release our money supply figure a little earlier than usual, we might be able to move it the way you want.

CHAIRMAN VOLCKER. Release the money supply figure earlier than usual? How do we do that?

MR. BLACK. Well, I don't know what time it is firmed up, but the markets would have time to move a little if it's released earlier.

VICE CHAIRMAN SOLOMON. We can't start playing that game.

CHAIRMAN VOLCKER. Oh, you mean actually releasing the numbers.

VICE CHAIRMAN SOLOMON. We can't do that. The market will then start reading something into it every time we change the time of the release. We'll go out of our minds.

MR. PARTEE. Well, in any event, we have an agreement with the SEC that we won't release it until 4:10 p.m.

MR. FORD. Now that's being specific!

MR. BLACK. I was just being facetious. It wasn't interpreted that way.

CHAIRMAN VOLCKER. [As far as] collecting the numbers a little early, it would solve all our problems if we could collect the money numbers before the numbers existed!

MR. BLACK. My wife tells me repeatedly that people don't know when I'm joking and I've just demonstrated the validity of that.

VICE CHAIRMAN SOLOMON. Oh, I see. We apologize. After a few hours here, we lose our sense of humor anyway!

CHAIRMAN VOLCKER. Well, before I reformulate all this, does anybody else want to comment on the federal funds rate range? I drew one response out of Mr. Ford.

MR. PARTEE. Well, I would oppose Mr. Ford. I think 15 percent is plenty high. And the rate is below 15 percent now--I think it is 14 percent or a little below--so there is a little upside room. In any event, I would say what I did before. I don't care what the short-run implications for the aggregates are, we can't stand to have higher rates at this moment in time. So, I agree thoroughly with what the Chairman said. I still think it might be better to say it [publicly], but I'll withhold that until a later date when it becomes more extreme as a need than now.

VICE CHAIRMAN SOLOMON. I'd second that. I think 10 to 15 percent, using the same language we have used, is the appropriate way to handle it. And the Chairman himself has indicated that he would consult, if we got into an area that--

MR. MARTIN. I would support Mr. Ford on the basis that it's practical to have a little slack in operating and there is no sacred writ about it. A rate of 15-1/8 or 15-1/32 percent will not cause the world to spin on its axis in a different direction.

MR. GRAMLEY. I like 10 to 15 percent. And I would hope that we would have some language in the directive indicating that it's 5 percent or somewhat more if liquidity preference runs high.

MR. BLACK. I think 15 percent is [not] high enough. I think we won't have to go above it, but I'd feel much more comfortable if we had the leeway to do so if we needed to. I would hope we would not have to use it.

MR. FORD. So, you want 16 percent?

MR. BLACK. Well, I said 17 percent, but since I'm in a compromising mood today, I can stop at 16.

MR. PARTEE. 15-1/8 won't do?

MR. MARTIN. How about 15-1/32?

MR. CORRIGAN. I like the 32nd!

MR. WALLICH. I don't think anybody will go broke over the difference between 15 and 16 percent. The one area where there has been steady and really disastrous pressure of interest rates is the thrifts, and that is where precisely the least has happened.

CHAIRMAN VOLCKER. Well, I think it's more significant than that, Henry. I agree with you, in general terms, but if the funds rate gets toward 16 percent, it may trigger a 1 percentage point increase in the prime rate, which I think would have very considerable significance psychologically for the economy, for financial markets, and for other interest rates. It would not be a very happy situation.

MR. WALLICH. If we trigger what seems like a severe bulge in the money supply, interest rates would go up anyway.

MS. TEETERS. It's only because we haven't raised the long-run target that we're sitting here figuring out how much we have to make the growth rate decrease in the last six months [of the year]. If we raise our long-range targets, we can take this bulge and nobody will question it.

MR. MARTIN. Not if we indicate that we'll tolerate some bulge.

MR. WALLICH. People are sensitive to bulges not only for the week. [If we] say we will tolerate [bulges], they may be sensitive even to our saying that we will tolerate them.

MS. TEETERS. I think they'll be more sensitive if we tell them we're not going to do it because then they can figure out how much [money growth] has to go down in the last six months [of the year].

MR. CORRIGAN. In terms of this bulge issue--and I think it's worth voting on--given what has happened in the first two quarters, I don't think the market is going to be anywhere near as sensitive to--

CHAIRMAN VOLCKER. I think they've been quite sensitive to it. That's part of the reason the rates are where they are now. But they probably have discounted it pretty well. And this is enormous. Well, let me reformulate this; I'm not sure I'm saying anything much different from where I started. On the [short-term M1] range we're saying "about 5 percent." I don't know whether to put it in the same sentence or different sentences but we start with a figure of about 5 percent. We certainly add the thought "or somewhat higher" with some language not only about the arbitrariness of the July bulge for seasonal reasons but an assessment of liquidity pressures and demands or whatever in the economy. I think we'd probably do it in two sentences. We will put down an M2 figure that is reasonably liberal; I wouldn't mind putting down a 9 percent M2 figure. Does that bring us within the M2 targets by--? No, the upper end of the M2 target is 9 percent, isn't it? So it wouldn't because we're above it now.

VICE CHAIRMAN SOLOMON. M2 may run stronger for June.

CHAIRMAN VOLCKER. We're above the M2 range. Just mechanically we can't [move into the range if it grew at 9 percent]. That might be an argument for leaving it at 8-1/2 percent, but I'd say 8-1/2 or 9 percent.

MR. AXILROD. I would not expect any downward revision in M2 for June; it might even be up a bit.

CHAIRMAN VOLCKER. Obviously, we have to examine the 10 to 15 percent or the 11 to 16 percent alternatives on the federal funds range. I still prefer the 10 to 15 percent. We have borrowings starting at $800 million and they're going to remain at $800 million within a very broad range, particularly on the up side, of whatever happens in the first week of July. I mean that we will allow for a big bulge in the first week of July. If M1 for the first week of July comes in weaker than expected, we would consider reducing borrowings. We will proceed. That's about all I have to say.

MR. PARTEE. Why don't you ask for just a show of hands before we get into a vote?

CHAIRMAN VOLCKER. A show of hands on what?

MR. PARTEE. Well, as you said, we have a selection on the federal funds range and we have a selection on whether to say "5 percent or somewhat more" or just "about 5 percent" and then whether to put in another sentence. Those are two things at least. And we have the M2 question. People might be constrained to vote against it just for some little reason.

CHAIRMAN VOLCKER. Well, let's see whether we can deal with this federal funds rate range.

MR. FORD. It's now 10 to 15 percent. Do you really mean to raise the lower limit to 11 percent? Did I hear you say 11?

CHAIRMAN VOLCKER. No, 10 to 15 percent or 11 to 16 percent. Either leave it the same as it is now or raise it.

MR. FORD. Well, I'm not proposing to raise the lower limit; I want to be clear about that.

MR. BLACK. Just the upper limit?

MR. MARTIN. You're proposing 10 to 16 percent?

MR. FORD. At least 1 percentage point [on the upper limit] to allow ourselves a little breathing room from where we are the day we start, that's all.

SPEAKER(?). Yes, I agree with that.

MR. FORD. A range of 10 to 16 or 9 to 16 percent at least gives us some room to breathe.

SPEAKER(?). 10 to 15 percent toward 10 to 16 percent?

MR. RICE. It might signal a fundamental change in monetary policy.

MS. TEETERS. Yes, you mean tolerate [higher] interest rates.

MR. GRAMLEY. If we have an understanding that the Chairman is going to consult if the funds rate is over 15 percent, that ought to be the upper end of our range. We ought not to say one thing and have an understanding on something else. If you're going to wait to consult until the fed funds rate gets up to 16 percent, I'm not happy with that.

CHAIRMAN VOLCKER. Well, I must confess that I'm not either. In the end we might well have to, in some sense, let it go to 16 percent. But I feel strongly enough about it that that is a point where I would want to take a look at it.

MR. MARTIN. I think consulting if it's over 15 percent softens the rigidity, and I would go along with it.

MS. TEETERS. All we've ever done when it hits the ceiling is let it go through. [Consulting] hasn't triggered any action to keep it below that level.

MR. PARTEE. It's a different understanding, isn't it?

CHAIRMAN VOLCKER. Well, I think the understanding is basically the same. All I'm telling you is that, indeed, I would want to consult, which carries some implication that in consulting I might be biased toward making some allowance for it, as things now stand. Now, heaven knows what the conditions will be. If our money supply went up $15 billion in the first week of July, I might feel differently. But right now I don't. I would not want to let the federal funds rate mechanically go up to 16 percent, I must confess.

MR. MEEK. Mr. Chairman, if you want to start with an $800 million borrowing level, that is the borrowing level adopted at the May meeting, when the funds rate range adopted was 10 to 15 percent. That would be an unchanged--

MR. GRAMLEY. There's another good argument for keeping it where it is. It looks awfully funny to me, if we're in a meeting where we are trying to make sure that we adopt a directive that does not countenance increased interest rates, to raise the upper end of the federal funds range. That just seems rather strange.

MS. TEETERS. It seems strange to me that you're not lowering it when your objective is to lower interest rates.

MR. FORD. It's not my objective to force them down.

VICE CHAIRMAN SOLOMON. Why don't you get a show of hands?

CHAIRMAN VOLCKER. My reason, just to repeat, is that I would be concerned substantively if the funds rate went above 15 percent. Whether we ultimately permit it or not, I'm concerned enough so I'd want to consider it carefully. I also think it conveys some message of being asymmetrical. If the market interprets that as our being more concerned about an increase than a decrease, I would say that's not inappropriate. So, how many would find 10 to 15 percent acceptable?

MR. RICE. In the sense that's it's better than 11 to 16?

MS. TEETERS. Yes.

MR. PARTEE. Preferable.

CHAIRMAN VOLCKER. How many prefer 10 to 16 percent?

MR. BLACK. And I'd rather see it go down than up, as I vote that.

MR. FORD. I like the rest of the specifications; it sounds reasonable to me.

CHAIRMAN VOLCKER. Well, I don't know whether I'm talking about 8-1/2 or 9 percent on M2; I guess I don't care that much. Let me just take M2. What do you want to put in for the upper limit on M2? It seems to me it's either 8-1/2 or 9 percent.

MR. BALLES. Excuse me, Mr. Chairman, we really haven't come to grips yet with the point Jerry raised earlier: How do we, in our directive or instructions to the Desk, finesse this July bulge? I was reminding Steve, who compared it to April when we faced that bulge because of the tax payment matters, that we phrased things in a way that we would tolerate a considerable bulge in M1 provided that M2 was approximately within its growth range for the year. So, the figure we pick for M2 may have unusually important consequences.

MR. PARTEE. Well, I'm not prepared to have that kind of proviso.

VICE CHAIRMAN SOLOMON. He hasn't suggested that.

MR. CORRIGAN. The July bulge is a different finesse.

VICE CHAIRMAN SOLOMON. Exactly. He already said--

MR. CORRIGAN. The way we want to handle the initial borrowings--

VICE CHAIRMAN SOLOMON. And we wouldn't have the M2 caveat this time under Paul's formulation.

MR. BALLES. Well, that's what I'm trying to find out. What is the intent on that?

VICE CHAIRMAN SOLOMON. He already explained that.

CHAIRMAN VOLCKER. Oh, I wasn't intending a caveat of the sort we had then. We have whatever it is implied in the normal course of events; the tolerance sentence would apply to both.

MR. BALLES. Okay, all right.

MR. PARTEE. Well, I would prefer 9 percent for M2. M2 has been running strong relative to expectations almost persistently for the last year or more. And, with the tax cut, I certainly think it's likely to run strong in the period to come.

MR. GRAMLEY. If we were so fortunate as to see interest rates decline also, there would be the usual lag in the downward adjustment of yields on money market mutual funds and hence a tendency for [funds to move] into those from market instruments, which would help keep the M2 numbers up. So, I would prefer 9 percent also.

MR. MARTIN. I would also for the same reason.

VICE CHAIRMAN SOLOMON. Same here.

CHAIRMAN VOLCKER. I don't mind 9 percent; I'm not sure how valid that reason is. We exclude the institutional funds from M2 now don't we, which is why we got that May--

SPEAKER(?). Institutional--

MR. GRAMLEY. Well, it would help the individuals too.

MR. PARTEE. Household money.

CHAIRMAN VOLCKER. But presumably [for households] it will come out of other accounts that are in M2; that's a different thing.

MR. GRAMLEY. Oh, no. I wouldn't say that it will come exclusively out of other M2 accounts. I think we could get a significant transfer of individual savings out of market instruments into some funds.

CHAIRMAN VOLCKER. Some; I don't know how soon it would come in.

MR. GRAMLEY. Well, it's not [unlikely], so that 9 percent sounds better to me.

CHAIRMAN VOLCKER. Is the preference 9 percent?

MR. BLACK. I don't mind.

MR. ALTMANN. Seven [members prefer 9 percent].

CHAIRMAN VOLCKER. On M1, we're trying "about 5 percent." I suppose we say both--about 9 and about 5 percent--in that same sentence, immediately followed by a sentence saying a somewhat higher growth rate would be acceptable. What we can do is write something out and look at it immediately after lunch. But it would be something along the lines [that somewhat higher growth] would be acceptable "depending upon an evaluation of liquidity pressures in the economy" or "if demands for liquidity appear to be related to uncertainty and precautionary needs" or some language of that sort.

VICE CHAIRMAN SOLOMON. If we're going to apply the tolerance of an overshoot to M2 as well as to M1, I have a mild preference for making M2 8-1/2 percent.

MR. FORD. Use the lower number and keep pumping.

VICE CHAIRMAN SOLOMON. But I'm not going to do or die [over that.]

MR. PARTEE. Maybe 11 or 12 percent?

MS. TEETERS. Maybe zero?

MR. PARTEE. Not M2.

VICE CHAIRMAN SOLOMON. In your testimony you're also going to talk in terms of tolerating overshoots in both the Ms, right?

CHAIRMAN VOLCKER. Yes, but of course we haven't really set those targets. It depends upon what we do with M2, but if we kept the ranges the same, we would have to do something presumably. The arithmetic works out better, as you say, but you're getting within a range of tolerance where I don't really care that much. And if that makes people happier, I think we can live with that.

MR. PARTEE. I would like your sentence on some exception to refer not only to precautionary demands for liquidity but to temporary tax cut effects.

CHAIRMAN VOLCKER. Well, that has to be mentioned too. I just don't know how to construct it. It might take another sentence, such as "It is also noted that in the short run seasonal uncertainties combined with these other things might lead to a bulge in July, which would be tolerated." That's the sense of it. I think we need that in there.

MR. PARTEE. Well, of course, the tax cut effect also could be in August because some people are not going to get it until the end of July.

CHAIRMAN VOLCKER. Let's say "in the immediate future" or something like that. But both thoughts--the seasonal uncertainties with the social security and tax cut effects and the more general liquidity issue--will be in there.

MR. PARTEE. Okay.

CHAIRMAN VOLCKER. That leaves the borrowing level. Is $800 million the right number? Or conceivably $750 million--

MS. TEETERS. We've taken all the other specifications of "A" except the borrowing.

CHAIRMAN VOLCKER. Yes, what's the significance of that?

MS. TEETERS. I'm just questioning whether they are compatible.

MR. PARTEE. Well, of course, we have a revised June. I would have some preference for tilting a little to the side of ease by making it $700 million. I don't feel strongly on the $800 million. It may not make so much difference.

CHAIRMAN VOLCKER. Let me make this great refinement. We'll make it $800 million with some effort to stay with $800 million and take the risks on the low side rather than the high side of $800 million in this very short-run period we're talking about.

MS. TEETERS. Wasn't $800 million the target last time?

MR. PARTEE. Yes.

MS. TEETERS. And it averaged out well over $1 billion, didn't it?

VICE CHAIRMAN SOLOMON. We don't publish the initial borrowing figure

MS. TEETERS. No.

VICE CHAIRMAN SOLOMON. So, what are we arguing about?

MR. ALTMANN. Not at the time; it's published after the year has been completed.

VICE CHAIRMAN SOLOMON. After what?

MR. ALTMANN. It's in the annual report put out by the Desk.

VICE CHAIRMAN SOLOMON. In New York. Yes, but that's a year later.

MR. ALTMANN. At the end of the year.

MS. TEETERS. Yes, but it determines the path.

MR. CORRIGAN. We can seasonally adjust it, though.

CHAIRMAN VOLCKER. Is that clear? Should I attempt to repeat it all again?

VICE CHAIRMAN SOLOMON. No.

MR. BLACK. No, it couldn't be done twice!

CHAIRMAN VOLCKER. Let's vote.

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Balles	Yes
President Black	No
President Ford	No
Governor Gramley	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Teeters	No
Governor Wallich	No
President Keehn	Yes

Eight for and four against.

CHAIRMAN VOLCKER. Okay. What happened?

MR. TRUMAN. A folder fell off the chair.

MR. GRAMLEY. The folder was so shocked by the results!

MR. FORD. By itself.

CHAIRMAN VOLCKER. We are back on the long-term ranges. As I said, I don't think we have to push to a conclusion, but I'd like to have a little better feeling [of the consensus] than we have at the moment. I've been operating on the assumption, implicitly, that of all the various alternatives we have, which are considerable, we won't change any of the numbers for this year, but we will give a rather clear explanation that in the light of the uncertainties of the situation we are obviously prepared to tolerate some overshoots. And within that context, while we're prepared to tolerate some overshoots, we're not exactly aiming at them; otherwise we would change the target. There's a difference between tolerating and aiming. But we don't think an overshoot is wholly unlikely, and the Congress and the public ought to be duly warned that there could be an overshoot if developments continue the way they have in the first half of the year.

VICE CHAIRMAN SOLOMON. But rather than attribute it to uncertainties, wouldn't you attribute it to the behavior of NOW accounts?

CHAIRMAN VOLCKER. Well, the NOW accounts are a subcomponent. We can certainly point that out, but in that context we also would point out that we had the alternative, as indeed we said in February, of choosing a higher base and choosing the lower end of the target. And we cite that as giving some sense of the dimension of this: That if we had chosen the other base, we would still be within the range and so forth and so on. I might bring other analysis to bear, but that's the essential message that would be given.

MR. PARTEE. Yes, I wouldn't want to limit it to NOW accounts. I think it should be broader than that.

VICE CHAIRMAN SOLOMON. Okay, but I wouldn't refrain from using something like--

MR. PARTEE. I would certainly mention NOW accounts.

VICE CHAIRMAN SOLOMON. When we talk about uncertainties, that gets misread. It looks as though we'd do anything that the de facto situation pushes us to. I was just having a problem with the term "uncertainty."

CHAIRMAN VOLCKER. Well, NOW accounts are certainly going to loom in the analysis.

MR. WALLICH. Would it be a temporary overshoot so that it wouldn't in principle raise the base for next year?

CHAIRMAN VOLCKER. Well, I don't know that I want to face that problem explicitly. In a sense we're talking about temporary overshoots but with some warning that the overshoot may be long enough to extend through the end of the year. But that's a fine balancing. I don't know exactly how to word it.

MS. TEETERS. It would be useful to get some of the attention away from where we actually end up in the final quarter or the final months of the year because making it precisely in those time frames, I think, is a fallacious target.

CHAIRMAN VOLCKER. Well, that comes back to Mr. Corrigan's point about presentation, which we can think about a bit. It's a little harder this year in some sense than last year. Last year we were well within the implied annual numbers, as I remember. We ended the fourth quarter low but looking at the year as a whole it was fine. This year it won't be the reverse, I don't think; maybe it will. I wouldn't say until I look at the numbers more closely. I don't know if there's anything else to be said for this year. For next year, my own inclination is that the simplest thing to do is just to say that, as we've shown this year, there's quite a lot of question about how demand for money will go for a variety of reasons that we have illustrated, so tentatively we're just going to keep the same ranges for next year that we had this year. Obviously, that's subject to change. We consider [next year's ranges] more tentative than usual, but obviously keeping the ranges unchanged for next year allows a lot of room for slower growth next year than this year which, if velocity patterns are normal, is what we would expect.

MR. GRAMLEY. Mr. Chairman, I would strongly encourage you to develop the analytic line of reasoning you were presenting yesterday for how velocity [behavior] for the period ahead, if we succeed in bringing down inflation, can bring down interest rates. It may be a very different animal than what we've been dealing with before and we have to be sensitive to that in setting our longer-range targets. That would give us another reason for not taking a step in a downward direction for 1983.

CHAIRMAN VOLCKER. What I would suggest is that I will hear any comments you have now, but I will reduce some of this to what might be in the actual language that we would adopt and circulate it to you over the next week or so. And that will be the precise focus for a discussion over the telephone, leaving open the question of whether we have a bright idea and may want to change one of these targets. But that's the direction we seem to be going in at the moment, if I read this right. And I will give you some alternative language that we could adopt over the telephone.

MR. PARTEE. The 2-1/2 percent scares people. I think they use it more for rhetoric than anything else, but if we were to use 2-1/2 percent as a real possibility for the lower end of the range this year, it would mean zero essentially for the rest of the year. If we use it for next year, growth would be dropping from the very upper point of the range or even above the 5-1/2 percent [upper limit] down to 2-1/2 percent, which seems like a very low number. I just throw that out.

VICE CHAIRMAN SOLOMON. But you don't want to narrow the target range, do you?

MR. PARTEE. Well, I don't know. We could keep the target range equally broad by raising both the lower and the upper ends.

MR. WALLICH. We usually look at the midpoint and we're operating already at the upper end conceptually.

MR. PARTEE. But we never looked at the midpoint that seriously this year.

CHAIRMAN VOLCKER. That's right. We said in the earlier testimony that we expected growth to be in the upper part. But do we gain anything by raising the lower limit? I guess in a way if we raise the lower limit, people take it more seriously. The reason I look somewhat toward not changing the range is what everybody said, which is that we don't know how to change it without possibly getting ourselves in more difficulty. A half-point change seems trivial. If we go one point, I think we have to hit it. And we may not hit it. But then all this arithmetic will be running on full speed. The instant it's running close to 6-1/2 percent, everybody will be [focusing on] what next week's money supply figure will be. In a way, we have less flexibility if we change it than if we don't. That's my view; it's anybody's judgment, I guess.

MR. CORRIGAN. Also, by not changing it now, we may be working in a direction of creating the flexibility to be able to change one of these targets sometime later.

MS. TEETERS. Well, wait Jerry, we're just building up a precedent that we never change the ranges.

MR. CORRIGAN. No, I think this time it works the other way.

VICE CHAIRMAN SOLOMON. The Chairman is going to say that this is even more provisional than usual, that we're just leaving it where it is until we have a clear fix on it. It implies that it's not in a certain sense the usual target.

MS. TEETERS. Yes, but then it seems to me we should go back, say, in August or September and change the range.

MR. CORRIGAN. Well, for the '83 numbers I was thinking more in terms of when we have to review them again next February. If we state now that in effect we're going to leave them where they are because we don't know where to put them, that works in the direction of giving us the flexibility then to change them in February. At least that's the way I would envision the logic of this.

MS. TEETERS. Yes, but we're still going to run into the end-of-the-year problem with everybody expecting us to try to reduce monetary growth.

MR. CORRIGAN. This year?

MS. TEETERS. Yes. Nobody knows where our range is for this year, so they're going to try to figure out where it is and we have given them no indication what we're going to do.

MR. PARTEE. Except for the tolerance.

MS. TEETERS. Yes, but we're not telling them what the tolerance is.

MR. CORRIGAN. I think what Nancy is saying is that she wants to put a number on the tolerance.

MR. MARTIN. If we tell them what the tolerance is, we have a quasi bracket.

MS. TEETERS. But we're really going against the whole thrust of the Humphrey-Hawkins Act, which was in effect "Tell us what it is you're going to do so we can begin to know how to react to it." You know, we may even want to add back in the old phrase "the feel and tone of the market."

MR. CORRIGAN. That's what Governor Partee wants to do.

CHAIRMAN VOLCKER. Well, have we concluded our discussion? Okay. I'm sorry, we skipped right over the Managers' reports. Do you want to have some rapid reports by the Managers? We have to ratify the transactions.

SPEAKER(?). They want to change everything!

CHAIRMAN VOLCKER. Why don't we have somewhat abridged Managers' reports?

SPEAKER(?). Very abridged.

CHAIRMAN VOLCKER. We've had them implicitly.

MR. MEEK. [Secretary's note: Mr. Meek summarized the statement shown in the Appendix.]

CHAIRMAN VOLCKER. Why don't you go ahead, Ms. Greene, and then we'll ask questions on and discuss all markets.

MS. GREENE. I, too, will try to abridge my report. [Secretary's note: Ms. Greene summarized the statement shown in the Appendix.]

MR. RICE. Could I ask a question? How did we happen to hit on the figure of $21 million on the day of intervention?

MS. GREENE. We didn't hit on it. We responded to market conditions; we operated in relatively small size discreetly and it so happened that the rates around which we were operating tended to be resistance points in the markets and no further operations were necessary. The market felt the resistance there, accepted it, thought it was an appropriate place for the rise to peter out, and we contributed to that sense of resistance and did not have to do more.

MS. TEETERS. In other words, it wouldn't have been noticed if the [Under] Secretary of the Treasury hadn't announced it? Is that correct?

MS. GREENE. No, I think the feeling was that the resistance point was confirmed and was noticed in the market. But it was a technical reaction rather than a policy reaction at the time.

VICE CHAIRMAN SOLOMON. But they wouldn't necessarily have known that we were intervening with our own resources.

MS. GREENE. They would not necessarily have identified it as our operations. They would have identified the fact that somehow the dollar didn't seem to go above that [resistance] level.

VICE CHAIRMAN SOLOMON. And after the Under Secretary and the Secretary proudly pointed out that day that they had authorized this intervention to counter a disorderly market, the comment around Wall Street was: What was more disorderly about Monday than a lot of other days that we've had before and since?

MR. FORD. It was the death of a sovereign ruler.

VICE CHAIRMAN SOLOMON. Oh, I see. That's a good point. Particularly one with money.

MR. RICE. Was the $21 million all one operation or did you do it in steps of smaller amounts?

MS. GREENE. We took steps in smaller amounts because we were operating in amounts that are trading amounts in the markets.

CHAIRMAN VOLCKER. Typically, we don't operate with a particular amount or number objective in mind. We wanted to keep it modest if we could, but we operated when the market was moving in whatever small amounts seemed to be helpful in terms of stabilizing the market. It just happened that by the time the Desk got to $21 million the market went the other way.

MR. WALLICH. To follow up Mr. Solomon's point, in your judgment how often were there cases of disorder in the market?

MS. GREENE. I think anybody participating in the market--and it would probably be true of those of us in the foreign exchange department at the New York Bank--would have a different number. It's a matter of judgment. Certainly the markets have been subject to abrupt movements of rates during this period but it's not clear that the problems originated in the exchange market. Therefore, the question of whether intervention would be appropriate or not didn't come up.

MR. CORRIGAN. I assume, Gretchen, in answer to Governor Wallich's question, that all of these people would have a number that is larger than one.

MS. GREENE. That's a fair assumption.

MR. PARTEE. Paul, I lost track of the Comark situation. Did I understand you to say that the firm has now been liquidated?

MR. MEEK. It's in the process of an orderly liquidation.

MR. PARTEE. No market bad news coming from that yet? Nothing?

MR. MEEK. I should say there remains an uncertainty around that firm. Whether it's a call on capital through its limited partners will be answered by the partners [if they] put up capital. It appears at the present time that there was a shortage of securities. They owe customers on the order of $15 to $19 million dollars. So, it's possible that some losses could come.

MR. PARTEE. I see.

MR. MEEK. [There are amounts] due to some customers from them. But I don't think it's anything of a magnitude that would be particularly disturbing to the market as a whole.

MR. PARTEE. They're expecting to get more capital out of technically limited partners?

VICE CHAIRMAN SOLOMON. The basic partnership agreement, which we've looked at, calls for the partners to put up the money. On the other hand, there are a lot of reasons why they might delay and delay in the courts. When the management and the general partners have been guilty of very sloppy management practice, if they have been--and there's some presumption that they have been--I wonder to what extent limited partners, as distinct from the general partners, are still bound to put up the money. If some of the thrifts who had their securities lent out end up with a shortage, I assume there will be lawsuits. So, it's unclear. But what is true is that we averted the initial bad psychological impact and the seizing up of the market by getting Marine Midland to resume the clearings. The market is taking that whole thing very well and if at the end of the day there are some shortages, I don't think that is going to come in a way that will be disruptive.

MR. PARTEE. But there could be a loss to some more key lenders?

VICE CHAIRMAN SOLOMON. There could be a loss to those people who have had their securities used.

MR. BOEHNE. With respect to the French devaluation, is there some feeling that this and some other actions that were taken are largely stop-gap actions on a deteriorating path or that the deterioration is being arrested? What is the sense about the French franc?

MS. GREENE. Well, following the devaluation, the government did announce an austerity program that included wage and price guidelines. That has generated a fair amount of criticism domestically by both employers and trade unions and is giving rise to a test and debate about economic policy in France. I think the people outside of France feel that how this gets resolved is important in their assessment.

VICE CHAIRMAN SOLOMON. The only real austerity, though, is this wage/price freeze for a few months.

MR. TRUMAN. It hasn't passed their parliament yet.

VICE CHAIRMAN SOLOMON. Right, but there has been no announcement of a change in the overall fiscal/monetary approach.

MR. TRUMAN. Well, as they reinforce the notion that they would stick to this guideline of a budget deficit of no more than [3] percent of GNP--. They had said that before and [appear] to take it a little more seriously now, but the jury is still out on whether the government--I'm speaking of the government as a whole--will be able to or want to stick to that guideline. There is the question as well of whether, in a country like France which has been running for a few years a budget deficit of 1 percent of GNP, that number is really viable in terms of--

MR. MARTIN. But isn't it true that the very position that the Mitterand government is now taking is a substantial change from the first period of their operation? At least at the verbal level it's a reversal, isn't it?

MR. TRUMAN. It certainly is a necessary step, but whether it's enough to--

MR. MARTIN. But considering the rhetoric in the political campaign, it's quite a step.

MR. BOEHNE. They're coming into the real world.

VICE CHAIRMAN SOLOMON. I don't agree with that. It is simply that they have put some limits on the amount by which they're going to inflate the economy or increase the budgetary deficit. It's not interpreted--certainly not in the international business community in France or outside--as a reversal of policy. It's just putting some constraints on what the left wing of the Mitterand party might have hoped they would ultimately go to. I would say that there is a fairly widespread expectation that more devaluations will be necessary from time to time. And if they come too frequently, that's the end of the EMS. I think the word reversal is much too strong.

MS. GREENE. I think also that the action has to be seen against a background in which they have been fairly aggressive in letting interest rates decline. And that undercuts in another way the commitment to austerity. Even though as a tool of monetary policy they have relied very much on credit guidelines, the fact that interest rates are coming down--and they are the only major country where interest rates are coming down--supports Mr. Solomon's point that there is a credibility problem in the financial markets.

MR. MARTIN. Well, I certainly wouldn't use the term austerity with regard to any of this. Three percent of the GNP is hardly austerity, but still it's an admission to constraints on the left wing and that's--

MR. FORD. It's the same percent of GNP as our budget deficit.

VICE CHAIRMAN SOLOMON. Ours is higher.

MR. GRAMLEY. Prospectively much higher.

VICE CHAIRMAN SOLOMON. And a lower saving rate.

CHAIRMAN VOLCKER. Any other questions? Comments? Elucidation? We need to ratify. We'll have a joint vote, if that's conceivable. We don't have any controversy on ratifying both operations in the same sweeping action.

MR. BLACK. I move it, Mr. Chairman.

CHAIRMAN VOLCKER. Do the majority join Mr. Black? We have a motion.

VICE CHAIRMAN SOLOMON. If we don't ratify them, the staff personally out of their own pockets have to--

MR. BOEHNE. No, you do!

MR. FORD. You're the captain of the ship.

CHAIRMAN VOLCKER. Hearing no objection, they will be ratified. I will get some language to tell you what you just voted on if you don't object.

MR. PARTEE. That's a dangerous gamble!

CHAIRMAN VOLCKER. We have a sentence that starts out with the ranges that we discussed. This would be inserted: "Somewhat more rapid growth would be acceptable depending on evidence that economic and financial uncertainties are leading to exceptional liquidity demands and changes in financial asset holdings. It was also noted that seasonal uncertainties, together with increased social security payments and the initial impact of the tax cut on cash balances, might lead to a temporary bulge in the monetary aggregates, particularly M1." Well?

MR. ROOS. I think that's great, sir.

CHAIRMAN VOLCKER. You agree. Do [the rest of] you agree that that is what you voted for? I would note, just in the interest of completeness, that we will make a technical change in the boilerplate part of the directive. In referring to the long-run objectives, which we did not change at this time, we insert "At its meeting in early February, the Committee agreed" to all these things and then we add at the end "These ranges were under review at this meeting." And when we agree on them, we will insert an amendment. Is there any further action that we need to take?

MS. TEETERS. No word at all about the possible overshoot on the long term?

MR. PARTEE. Well, I think we can--

MR. ALTMANN. This will hold until the next action.

CHAIRMAN VOLCKER. This will all appear in the discussion but it doesn't say we reiterated the ranges. It says this is what we adopted in February.

MR. ALTMANN. Pending the vote later.

CHAIRMAN VOLCKER. It says we are in the midst of a review. When the directive comes out, it will have the other language. Well, with that understanding, I guess we have completed [our agenda].

[Lunch recess]

CHAIRMAN VOLCKER. We are resuming the meeting of the Federal Open Market Committee. Would you read us that resolution exactly, if you have it, Mr. Winn? You were there.

MR. WINN. I have it: "It is the sense of the Congress that if Congress acts to restore fiscal responsibility and reduces projected budget deficits in a substantial and permanent way, then the Federal Reserve's Open Market Committee shall reevaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained fiscal policy."

MS. TEETERS. Couldn't we take the position that they haven't completed action yet?

CHAIRMAN VOLCKER. Well, they've completed action on this resolution. I think this is a substantive--

MR. WALLICH. [Unintelligible] meaningful reduction.

CHAIRMAN VOLCKER. Obviously, there are several points in our discussion. [We had] an analysis of the budgetary situation and some budgetary projections presented to us that were not the same bottom line as in the budgetary resolutions. But I think we might just indicate that we were aware the resolution existed and that we had some discussion of this at the meeting but didn't fully address the issue perhaps. I just think we should be a little more self-conscious. And maybe we need do nothing more than confirm what I think was implicit or even explicit in our discussion earlier. Whatever comment people want to make about the budget situation and its relevance to the monetary targets is appropriate. Of course, we have not yet adopted the targets that are at issue here.

MR. FORD. Well, in addition to the good staff analysis, there is the difference between the $104 billion in the first resolution and the $160 billion or so that our staff comes out with based on a different economic forecast. I'm not sure how to handle it politically to make it seem non-antagonistic, but if we could find a diplomatic way to do so, I'd point to the difference between the first resolution and the actual deficit in the last three fiscal years. There has been a difference of about $52 billion, if one projects the deficit at $98 to $100 billion. With two-thirds of [the fiscal year] behind us, we come out this fiscal year--and have in the last two fiscal years--with about a $52 billion difference between the first budget resolution and the actual deficit. I don't know what you might attribute that to but I attribute it to the fact that the reasoning our staff does makes sense--not just prospectively but in fact, looking back, it makes sense.

VICE CHAIRMAN SOLOMON. What are you aiming for? Do you feel under an obligation to respond?

CHAIRMAN VOLCKER. Oh, I don't know if we have an obligation to volunteer a response. We obviously face a question as to what we thought about this and I want to be sure about what we thought about it. Let me just say that I think what we were saying implicitly earlier-- explicitly but implicitly tying into the resolution--was that there was great skepticism. We can say we welcome any restraint that that resolution signifies or will result in and we encourage the action in that respect, but we have a good deal of skepticism or questioning at this point. It could be put more strongly. Or put more politely there was no assurance, if I may put it that way, that the budgetary figure was going to come in at $104 billion or thereabouts next year. Part of that to be sure was a reflection of different economic assumptions; part of it was not. But certainly there was some concern over the net result of the resolution. It is constructive in the right direction but a concern was expressed by a number of people about the budgetary outlook. Now, anybody else can say anything they want to say. But explicitly we haven't adopted any ranges as a matter of fact. This is further background discussion for the final [decision]. We will take into account the budgetary resolution itself but, obviously, the evaluation of its practical effect and the practical budgetary situation apart from the resolution is a factor in our thinking. Different people weigh it differently, I suppose, but that's what I can say so far. I [don't] think we're subject to any further--

MR. MORRIS. The implication of the resolution is that the Federal Reserve is currently following a tighter monetary policy regime because of the very large deficits and, therefore, if the deficits are reduced, we should follow an easier monetary posture. But that in fact has not been the case historically. When we set this year's guidelines a year ago they were not set in anticipation of the kind of budget deficits that we're looking at now.

VICE CHAIRMAN SOLOMON. It's very embarrassing to say that we ignore the state of fiscal policy in making our decision on monetary policy.

MR. GRAMLEY. But I don't think we have to say it that way, Tony. If you look back at the thrust of policy since late 1979, it began with the notion that fiscal policy would be reasonably restrained, and we continue to hold to that expectation. And the continuation of targeting along these lines has been made with an eye to the expectation that fiscal policy will begin to provide the assistance that we want in bringing down inflation. We're not talking about a highly restrictive fiscal policy being put into effect. We're talking about going back [from] what is potentially a horrendously stimulative fiscal policy to where we thought we were on fiscal policy at the beginning of 1981. And we need to think about our monetary targeting and our monetary policy generally in that context.

VICE CHAIRMAN SOLOMON. Let me ask you this question: If we knew that the Congress and the Administration were going to continue to run huge budgetary deficits over the next two or three years, how would you change monetary policy? Incidently, I might say that we calculate that and we've been on the mark exactly the last two years up in New York on the budgetary deficit. We calculate, on the Board's economic assumptions, that the deficit in fiscal '83 will be $180 billion. On our economic assumptions it's only about $166 billion, but there's a lot in there aside from that--it's Bill Ford I'm talking to. The difference between the $104 billion and the $166 billion is not simply the difference in economic forecasts. For example, when we go to the specifics of these things, there's a judgment that the management savings are just nonsense; they won't materialize for various reasons. And there's some overestimation of certain revenues. But even if we assume the $20 billion, we still end up in the $166 billion range with a similar set of economic assumptions. But coming back [to my question]: If you were to assume that the deficit is going to be $166 or $180 billion in fiscal '83 and that it's going to be somewhere in the neighborhood of $200 billion in fiscal '84, how would you change monetary policy?

MR. GRAMLEY. I was asked by the Economic Advisory Council of the American Bankers Association whether the Federal Reserve would change its monetary targets, if in fact we had the kind of explosion of budget deficits implied by current law. And I said we might, but I'm not sure which way.

VICE CHAIRMAN SOLOMON. That's what I'm asking you.

MR. GRAMLEY. We talked about the possibility of adding a highly stimulative monetary policy to a highly stimulative fiscal policy. I have no doubt that that's where we would end up. The alternative of continuing on the course of a monetary restraint discipline in the face of these kinds of budget deficits has catastrophic implications for the capital markets, for business investment, for the thrift industry, for small businesses, and for farmers. It is a nightmare.

MR. PARTEE. It might require an easier policy simply to keep the structure from collapsing.

VICE CHAIRMAN SOLOMON. Yes, I understand the argument. But I'm not sure how the majority of the FOMC would come out on that.

MR. MORRIS. I think it's obvious that there is no way we can continue to reduce the rate of growth in the money supply in the face of escalating budget deficits of that size. We will run into an absolute financial wall.

VICE CHAIRMAN SOLOMON. Except there is the opposite argument that this is the one way of bringing home to the Congress that they really do have to change that.

MR. ROOS. Do you think the Congress is serious? If they knew that we were talking this seriously and not recognizing it as a political byplay, I think that would make their whole Fourth of July weekend! They didn't really expect us to do more than put together some verbiage that would be respectful and dismiss it, did they?

MR. GRAMLEY. Oh, yes.

CHAIRMAN VOLCKER. Well, I'm not really prepared to work on that assumption. I will not psychoanalyze them. But they did pass a resolution and for that reason I think we have to take it seriously.

MS. TEETERS. Don't we have a bit of an apples and oranges problem here? They are looking at our December targets, which are for 1982, and [asking whether] those are appropriate to a fiscal policy that is already established for '82. They are really working on the '83 budget and we haven't yet come down finally on what the '83 targets are going to be. I think this needs to be straightened out. And, again, we need to emphasize the inappropriateness of trying to put '83 targets into place in July of '82. They don't know what we have in mind yet for '83.

MR. MORRIS. And we don't know what they have in mind.

MS. TEETERS. I know. That's right. That's why February is a much more appropriate time than July.

VICE CHAIRMAN SOLOMON. The Congress has passed a budgetary resolution that says [in effect]: "Since we are tightening fiscal policy, you fellows ought to reevaluate and, by implication, ease." Therefore, if we conclude that the Congress actually is not tightening fiscal policy, then presumably by the same logic the Congress would not want us to ease because they haven't succeeded in taking the tighter fiscal action.

MR. WALLICH. But easing under this framework can only mean a constant monetary policy with interest rates falling because of smaller government borrowing. Looking to the distant future, any increase in money growth that isn't for a very short period can only lead to higher interest rates via higher inflation.

CHAIRMAN VOLCKER. Well, let me put the other side of this forward. I'm not talking about the substance of what they've done which, with obvious skepticism, is clear. I'm just looking at it in terms of the analytics. There is a respectable body of economic opinion that says there is some degree of tradeoff between fiscal policy and monetary policy. I'm not thinking of the structural business, but that theory is that the tighter fiscal policy is, the more room there is for increasing the money supply without any net inflationary impact. Now, individual members of the Committee may not believe that theory, but it's not a totally unrespectable body of economic doctrine. One answer to them would be that nobody in the Committee believes that particular theory. But I don't know whether you want to go that far.

MR. WALLICH. In the long run there's very little support for that view because even the people who would argue this for the short run believe in the long-run neutrality of money and that more money therefore just means higher prices, not higher output. Now, if we are told to do this for a year and then everything changes and we go back to the old targets, that is at least intellectually defensible.

MR. PARTEE. Well, definitely you have to key into your thinking the fact that we're so much below an optimal utilization rate. It might well be that a perfectly respectable economist who is a Nobel prize winner might take the view that there could be room for more expansive monetary policy [as] we are reestablishing a basis for a higher level of operations. And once we have established those operations in the market and are getting that kind of effect, then I think people would say we do have to pull back. But we might be talking about a period of several years duration to bring us back. Nancy has pointed out how low the utilization rates are and how high the unemployment rate is. Those things are not necessary. When people talk about monetary neutrality they are talking about a steady state economy also, which we don't have.

MR. MORRIS. But if you're talking about the monetary/fiscal mix, you would have to conclude that fiscal policy is going to get more expansionary from this point on. The question is: How much more expansionary?

MS. TEETERS. We don't really know, Frank, until we see what actions they actually are going to take this summer.

MR. MORRIS. Just on the basis of any set of projections we now have--

MS. TEETERS. But there is no final action. We don't know what they're going to come out with so we're left literally in limbo as to what next year's fiscal policy is going to be. We suspect it's going to be very expansionary; I share that expectation. But we don't have anything from Congress at this point on any side: on taxes, on appropriations, or anything.

MR. CORRIGAN. What we should say to them on this is not to worry too much about this mix question just yet. My inclination would be just to state that there is no evidence to speak of that the underlying structural problem of the deficit has been dealt with. And as long as we're faced with prospects for deficits [of the magnitude] that Mr. Kichline has for 1983, there's simply not room for the economy to behave in a reasonable way. This analysis-- with those flow of funds numbers, as imperfect as they are--to me is just overwhelming. We can't have the government soaking up 50 percent of the credit in the whole economy and expect that the economy is going to work well. It's an intolerable situation. That just can't work. And there is nothing we can do in terms of wiggling the money supply by a couple of percentage points that is going to make a big difference as long as we have that situation.

MR. GRAMLEY. The real problem is not so much the size of the deficit for fiscal '83; it is the continuing expansion of the deficit even in the face of a well-functioning economy.

MR. CORRIGAN. That's what I mean by the statement that the underlying structural problem simply has not been dealt with.

MR. WALLICH. And there is no way we could cure that situation by accelerating the money supply.

MR. GRAMLEY. One could argue as to whether or not there is a crowding out going on at the moment, at least in terms of the level of short-term interest rates. But there is simply no question whatever that in a well functioning economy, if the deficit rises to 5-1/4 percent of GNP, there is no way to avoid extensive crowding out.

MR. CORRIGAN. Again, those GNP comparisons are interesting; but the one that just hits me dead between the eyes is that 50 percent of the total credit flows in the economy [will be taken by government].

MR. GRAMLEY. Even better yet is to take the ratio of the net private savings. Net private savings is between 7 and 8 percent of GNP, as a rough estimate, so you're talking about 3/4 of the total being taken by the deficit.

MR. PARTEE. There has to be a current crowding out, Lyle. After all, I think anyone would agree that there would be more housing demand if interest rates were significantly lower and that, therefore, interest rates are crowding out some housing demand.

MR. GRAMLEY. Well, I have no doubt that interest rates are high. What I'm questioning is why. My theory is that I have a hard time explaining the level of short-term interest rates as a phenomenon associated with the deficit. Now, the long-term rates clearly are, and there is some crowding out from that standpoint because of the expected future interest rate impact of this deficit impinging on current investors.

MS. TEETERS. Our problem is not the current amount that is going to the federal government. It's the fact that it's going to stay that large as we move back into [higher rates of] capacity utilization.

MR. CORRIGAN. That's correct. It's going to grow. We can debate whether we have a crowding out problem today. But if we get into '83 and have any kind of growth in the economy and any kind of private credit demand building up because of healthy developments in the economy, boom, there's no place to go.

VICE CHAIRMAN SOLOMON. But, Lyle, you're aware that the high rates in the bond market are forcing companies to go much more heavily into short-term credit.

MR. GRAMLEY. I don't find that argument at all convincing. The reason why long-term interest rates are high is because investors are reluctant to buy long, so they buy short. And we're transferring the credit demand as well as the supply into the short-term markets. So, I don't see why that should have an effect on short-term rates except to the extent that the fear of deficits is generating increased demand for the aggregates that the Federal Reserve controls. And to that extent, yes, one can explain high short-term interest rates that way except that a central bank which recognizes what is going on presumably has the option to increase the growth rate of those aggregates to take that into account. So, on net, I end up saying the fear of the future deficit causes high long-term rates now but I'm not sure at all that it should affect short-term interest rates.

MR. PARTEE. Of course, the budget resolution gives as a condition, as I understand it, obtaining substantially lower or permanently smaller deficits. We don't have the crowding out problem, Jerry, if that part of the resolution comes about.

MR. GUFFEY. They haven't got--

CHAIRMAN VOLCKER. Suppose one assumes that spending or revenue [measures] of some cyclically adjusted level were going to be substantially approved by something like what is implied by the budget resolution. Would that cause people to think differently about these targets, which we haven't decided upon yet?

MR. CORRIGAN(?). Not I.

MR. PARTEE. I would--

MR. GRAMLEY. I certainly might. I would want to keep my options open. I think that could have a major effect on expected inflation rates and, therefore, on current interest rates. It could have a major effect on demands for the monetary aggregates because of what happens to the level of interest rates and expected inflation rates. I would want to keep an open mind to the possibility that complete and thorough resolution of the budget problem would give us an opportunity to follow a more expansive monetary policy. I grant Henry's point that in the long run what determines prices is the stock of money, providing one makes sufficient assumptions about the competitive character of the markets and so on. But I'm afraid that long-run period exceeds my term as a Governor; so, during the period when I'm here, I'd like to think about adjustments.

MR. WALLICH. You can write your Congressman!

MR. PARTEE. It seems to me that we could risk trying to get a fuller utilization if there wasn't so much fear and concern and crowding out and everything that comes from very large budget deficits. That would be another way of putting it.

MR. BOEHNE. We could say that, if we had a credible outlook for smaller deficits, interest rates would come down in the normal course and that the Open Market Committee would certainly be supportive of those drops.

MR. FORD. Not unless we widen the band!

MR. GRAMLEY. Let's go back to the Chairman's discussion. That decline in interest rates, together with reduced expectations of inflation, might have an important bearing on the trend increase in the velocity of money. We would need to take that into account. I think Chuck has a good point. We are a long ways from full employment of our resources. We do need to be concerned about the speed with which we get back to a higher level of resource utilization, and one of the factors we clearly need to take into account is what fiscal policy is doing in this respect.

MR. PARTEE. The chart we had yesterday shows us not getting back at all in the forecast period. As a matter of fact, it looked to me as if utilization rates were drifting off a little.

MR. ROOS. What is the purpose of our response? Is it really to offer an intelligent guide to these fellows on Capitol Hill or just to get a response done? I think they are not asking for economic analysis; they're playing politics.

VICE CHAIRMAN SOLOMON. Yes, but when Paul appears to testify he may be asked what the reaction of the FOMC was.

CHAIRMAN VOLCKER. I think I may have to volunteer.

VICE CHAIRMAN SOLOMON. Then do you want to summarize this acid discussion?

CHAIRMAN VOLCKER. I reserve the right to handle that in the way I think appropriate but I think I may have to volunteer something.

MR. WALLICH. You may get a technically oriented question along these lines: If stimulus is withdrawn through a lower deficit, is the reduction in interest rates that follows from that sufficient to counter that withdrawn stimulus? And you'd have to stretch a point considerably in order to say yes. You really have to assume that investment is enormously responsive to a decline in interest rates for that to happen. So, on a temporary basis, one cannot deny that a reduction in the deficit generates some reduction in expansion. But the difficulty of getting back on track with monetary policy is always the primary thing. And the fine-tuning that we can do for a half-year or a year seems to lead us back to where we used to be.

MR. PARTEE. If the Chairman has to say that if Congress reduces the deficit we'll certainly have a less good economy than otherwise, he might as well stop making the comment because that's a kiss of death in terms of trying to bring about more discipline on the fiscal side. So, at the very least, we would want to have a monetary effect from the combination of interest rates and targets that would equal the loss of stimulus that would come from a reduction in the deficit.

VICE CHAIRMAN SOLOMON. There's another way of approaching this. If we say that--

CHAIRMAN VOLCKER. That's what I was suggesting earlier--that there is a respectable body of economic doctrine that suggests that. And everybody said no, that's not true. I'm not sure it's altogether not true.

MR. PARTEE. No, I think--

MR. WALLICH. It's not true in the long run.

SPEAKER(?). I'll agree with it.

CHAIRMAN VOLCKER. I'm not even sure about that, but I--

MR. GRAMLEY. There's another way of approaching it, which is to say that we have to base monetary policy on the assumption of a reasonable fiscal deficit, which does not involve excessive crowding out and which is, therefore, in the neighborhood of, say, 2 to 2-1/2 percent of GNP. Accordingly, that's the fiscal policy assumption that our monetary policy is based on. Now, automatically, if the Congress doesn't hit that kind of reasonable fiscal policy, then monetary policy bites harder. And that reminds Congress of where its responsibilities are. I'm only saying that half seriously.

MR. FORD. I wouldn't put the last phrase quite that way, but the idea--

MR. ROOS. Is Congressman Fauntroy going to put you through this kind of exercise, too, at his hearing?

CHAIRMAN VOLCKER. Look, I think any Congressman would. I don't think it's entirely a political maneuver. Obviously, that is in some people's minds and some of their political coloration. But I suspect that if you ask a typical Congressman whether he thinks this is a real issue, he is going to say yes.

MR. ROOS. Because he wants to pass the buck.

CHAIRMAN VOLCKER. Who's passing the buck? He says he wants to be responsible and he asks straightforwardly: How much easing of monetary policy can we get when I commit political suicide by tightening the budget? I want to do the right thing for the country. But I'm not going to go through all this agony if I don't think it's going to make any difference in monetary policy. It's a very--

MR. MORRIS. Yes, but when the politicians--

CHAIRMAN VOLCKER. Most of the economists in the United States are telling them that is right--that it's a relevant question.

MR. MORRIS. But the issue for the Congress is not the rate of growth of the money supply; it's interest rates. It seems to me we can tell them unequivocally that if they get the budget deficit down, interest rates will be lower than they otherwise would be. And that clearly is--

CHAIRMAN VOLCKER. Well, we've told them that any number of times. They go on to say: Can you help it with increasing the growth of the money supply?

MR. WALLICH. We help by not absorbing that by a faster reduction of the money supply.

CHAIRMAN VOLCKER. Thank you, Governor Wallich.

MR. CORRIGAN. Can't you make the point that if we have this brave new world where all these nice things would--

CHAIRMAN VOLCKER. This is a view that is very widely held, I would say, in the market as well as in the halls of Congress.

VICE CHAIRMAN SOLOMON. Yes, it's in the official Democratic party approach: If you tighten fiscal policy, then there would be an easing of monetary policy.

CHAIRMAN VOLCKER. Some distinguished members of the business community as recently as last week [suggested] this approach.

SPEAKER(?). But they're not--

CHAIRMAN VOLCKER. I think they are subject to it. Well, some people have hinted at the point or approached it in a different direction. In terms of all the psychological signals we're sending, I would feel more comfortable about taking chances when we make all these tactical decisions on monetary policy against a background of a strong budget than I do when the budget is not strong. And there's something real in it too. If they suddenly cut $100 billion out of the budget, I think we would have a lot more psychological freedom, if I may put it that way.

MR. WALLICH. Perhaps we could offer not to cut the aggregates the following year.

CHAIRMAN VOLCKER. Oh, we could discuss different tactics, Henry, but I would say what I feel.

MR. PARTEE. Henry, you're getting to the point of exceeding Larry Roos in the rigidity of your position!

MR. WALLICH. Well, I listen a great deal to the accord of [1951], which is--

SPEAKER(?). That's a profane remark, Henry!

MR. WALLICH. This tradeoff of fiscal versus monetary policy exists, of course, in the old framework where monetary policy is interest rates and fiscal policy is fiscal policy. But when monetary policy is money supply, there's only one thing that influences interest rates, and that's fiscal policy.

VICE CHAIRMAN SOLOMON. Real?

MR. WALLICH. Real [interest rates], that's right. Yes.

MR. CORRIGAN. Can you make the analytical point, to give ourselves a little more movement and maneuvering room, that if this problem were dealt with, it would leave open the possibility at least that the public's demand for money--the thing we call money--might be higher at any level of interest rates? So, in those circumstances, quite apart from Henry's arguments, we might conclude that a higher money growth rate would be entirely appropriate and not in any way associated with higher inflation.

MR. MARTIN. "Might" be appropriate?

MR. CORRIGAN. Yes.

MR. PARTEE. That's awfully vague.

MR. GRAMLEY. It would certainly be my sense that it would be appropriate for us to follow a course of policy, whatever that meant in terms of monetary aggregates, that would not only let interest rates decline in the context of reduced deficits for the future but decline enough to do what Chuck says--to improve the performance of the economy. And I certainly would stand ready to follow an aggregates policy consistent with that because I do think it would take away the fears of inflation. It would give us an opportunity to shade on the up side, without nearly as much worry that we would lose credibility and lose control of the inflation problem.

CHAIRMAN VOLCKER. Are there any other comments that people would like to make? I assume that when we vote on these [long-run ranges] you will all have the Congressional considerations in mind, however you may dispose of them. I heard a variety of views. I don't think I can report a conclusive opinion on the part of the Federal Open Market Committee as to precisely what it would do if it were convinced that the budget was going to be substantially better. But I certainly hear a certain amount of opinion that it's something to be taken into account.

VICE CHAIRMAN SOLOMON. And you also can report that there's unanimity that as yet we don't see any evidence, nor do the markets, of a credible tightening [of fiscal policy].

MR. MARTIN. Do we endorse the first step that they've taken separately? At least there is a resolution, however dubious. We have to put some positive--

VICE CHAIRMAN SOLOMON. I'm not so sure that a phony resolution like this helps or is a useful first step.

MR. MARTIN. Would you rather have a phony resolution or no resolution?

CHAIRMAN VOLCKER. Yes, I think that's unfair. I don't think it's a phony resolution. They probably will pass the tax measure in the next few days in the Senate, but they wouldn't pass it without going through--

VICE CHAIRMAN SOLOMON. Yes, that's probably around $15 or $18 billion. Okay, we get that.

CHAIRMAN VOLCKER. And [there likely will be] some spending cuts that they would not have done otherwise. These are not easy decisions for them.

VICE CHAIRMAN SOLOMON. But there are some things in there that just can't possibly be achieved, such as the management objectives that they've built in and a few other things.

CHAIRMAN VOLCKER. I don't think there is any question that we can legitimately express some question about the whole thing. But that's not the same as saying: "You didn't do anything and it's a phony resolution." I don't think it is.

VICE CHAIRMAN SOLOMON. Well, they might have faced up to the problem more if they had a more realistic assessment of what went into that $103.9 billion.

CHAIRMAN VOLCKER. Well, it's a political question. There wasn't a very big margin in getting this one passed; and the alternative, I suppose, would have been to be left with nothing. They did what they could do.

MS. TEETERS. The estimates OMB is going to release on or about the 15th of July don't come to $103.9 billion, I assume. Their estimates are closer to ours.

CHAIRMAN VOLCKER. No, but I heard a lower figure recently.

MR. FORD. They are closer to ours, you say?

CHAIRMAN VOLCKER. They may be reducing their projected deficit. I think maybe they are nearer the Administration's estimates now. How much they believe it--

MS. TEETERS. So, we're not going to be the only voice in the wilderness that says $103.9 billion is a fake--or is optimistic, excuse me.

CHAIRMAN VOLCKER. Obviously, we're not alone in terms of the market and all the rest. But I tell you, the Administration faces a substantive problem, obviously, in terms of what they really think. I'm sure they will then [unintelligible] to think about what they want to say as opposed to what they think. I don't know where they're going to come out precisely on those grounds. But I think we have considered this about as much as is fruitful at this point, unless somebody wants to put anything else forward. And while we are meeting we can confirm the date of the next meeting.

MR. ALTMANN. August 24th.

CHAIRMAN VOLCKER. August 24th is the date of the next meeting and we will now conclude the Open Market Committee meeting.

MR. PARTEE. Well, it is a long time between meetings.

MS. TEETERS. Yes, it is a long time. Well, we can always meet on the 22nd of July if we all have to come back to testify.

CHAIRMAN VOLCKER. We will have to have a telephone meeting in the next two weeks. How many people are going to be on vacation in the first half of July?

[Secretary's note: The transcript ended at this point.]

END OF MEETING