

Meeting of the Federal Open Market Committee

October 5, 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., on Tuesday, October 5, 1982, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Balles
Mr. Black
Mr. Ford
Mr. Gramley
Mrs. Horn
Mr. Martin 1/
Mr. Partee
Mr. Rice
Mrs. Teeters
Mr. Wallich

Messrs. Guffey, Keehn, 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
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Mannion, Assistant General Counsel
Mr. Kichline, Economist

Messrs. Ettin, J. Davis, R. Davis, Koch, Prell, Siegman, Truman, and Zeisel, Associate Economists

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

1/ Entered the meeting following approval of minutes.

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Mr. James McIntosh, First Vice President, Federal Reserve Bank of Boston

Mr. Coyne, 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

Mr. Lindsey, Assistant Director, Division of Research and Statistics, Board of Governors

Mrs. Low, Secretary, Open Market Secretariat, Board of Governors

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

Messrs. Broaddus, Bisignano, and Soss, Vice Presidents, Federal Reserve Banks of Richmond, San Francisco, and New York, respectively

Mr. McCurdy, Research Officer and Senior Economist, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
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CHAIRMAN VOLCKER. We need to approve the minutes.

SPEAKER(?). So moved.

CHAIRMAN VOLCKER. Without objection. Next is the report on foreign currency operations.

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

CHAIRMAN VOLCKER. Questions or comments?

MS. TEETERS. We hear rumors through the paper about other problems in South America. How much of that can you [verify]?

MR. CROSS. Well, there certainly have been some other problem situations.

CHAIRMAN VOLCKER. That's the understatement of the day, if I must say so.

MR. CROSS. The Argentines have been mentioned a great deal, and currently they have an IMF [team] down there looking toward the possibility of a Fund program for Argentina. They also are seeking some assistance from the BIS and from commercial banks. The Brazilians feel that they are being [adversely] affected largely by the spillover effects of the Mexican and the Argentine problems. For a period they found it very, very difficult to roll over their maturing debt, but more recently they sounded a bit more encouraged [so] that situation looks a little better. But you're quite right that there are a number of these very difficult situations, with monetary troubles in the period [ahead] for a lot of countries down there.

VICE CHAIRMAN SOLOMON. I think the [Brazilian] problem is particularly sensitive with regard to their foreign exchange deposits [and whether their] backing by foreign banks will be resumed [as was the case for] the Argentine agencies. In New York we have 17 Brazilian agencies and they have been having difficulty getting new deposits or getting people to leave in the foreign deposits. We have a liquidity problem here because, like the Mexican agencies, most of that money was used to finance Brazilian borrowers, either public or private.

MR. PARTEE. Did you say you have 17 Brazilian agencies, Tony? Is that right?

VICE CHAIRMAN SOLOMON. Two of them are much larger than the others. But this is part of the whole credit contraction going on in the foreign member bank markets between--

CHAIRMAN VOLCKER. Well, I want to come back to some of these questions later. I think it's better to take them up later in the context of the whole policy problem. But immediately, we intervened yesterday, as Sam said, and we may intervene today. The market is still high. Technically we have to approve yesterday's transactions

anyway. So, do I have a motion to that effect?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection, it is approved. As for the Mexican swap [drawing], whatever our "druthers," the situation is that I don't think they have any money to pay it off. So, I don't think we have much alternative to rolling it over. As I understand it, that doesn't take a Committee action but I think you should be informed. If somebody wants to object, he or she can object, but the intention would be to roll that [drawing] over as it matures, noting that we still have first claim in effect on any Fund drawing that the Mexicans make, assuming they come to some conclusion with the Fund. We'll consider that at the time. But as to the immediate rollover, we can roll that over cooperatively since otherwise.... With that understanding, I think we can return to some of these other problems later in the midst of a more general discussion, as I said. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Comments or questions?

MR. FORD. [If] we can't get the new legislation and this ruling gains weight in the marketplace, what restructuring would you anticipate in the market with regard to day-to-day operations? How would the market accomplish that?

MR. STERNLIGHT. Well, they will be looking at different things. I think there will be some effort to see whether there's a way to restructure the basic repurchase agreements to do pretty much the same thing but in a more acceptable manner in that it would stand up better than [now]. To some extent there may just be a lessened willingness by a number of "lenders" in the market who provide funds, particularly to smaller, less well-capitalized firms. When the issue is settled--and I get a little sense of this already and that could spread with [unintelligible]--I don't think it would affect the Desk's technical ability to [make] repurchase agreements. But it could thin out the market in which we do those agreements or we could have somewhat less [access] to instruments or operations [of this kind].

MR. ROOS. Peter, do the nonbank dealers let your surveillance group come in?

MR. STERNLIGHT. Oh, yes.

MR. ROOS. On what general basis? That it's the only way--

MR. STERNLIGHT. Well, they've been cooperative right along in doing that and are particularly keen to cooperate now. They prefer the--

MR. MORRIS. Peter, is the surveillance limited to the recognized dealers?

MR. STERNLIGHT. In an [unintelligible] way, yes. We are exploring whether we would want to extend it beyond that. Certainly if we hear of any problem situations that go beyond the regular reporting dealer group, we would want to take a look quickly at those situations.

MR. MORRIS. Because that is where the problem has arisen thus far?

MR. STERNLIGHT. Thus far, yes.

MR. RICE. Peter, you said that you had the feeling that the market would be much more tolerant of increases in the money supply from the target ranges today than it would have been, say, two or three months ago?

MR. STERNLIGHT. That is my impression.

MR. RICE. What's the evidence of that? How does this manifest itself? By discussion on the part of some of the dealers at the Desk or by--

MR. STERNLIGHT. [Unintelligible] from the market who have written commentaries and from discussions with market participants.

CHAIRMAN VOLCKER. Any other comments or questions? I might say that I think this surveillance business involves a moving target [if that] is the right term; we are feeling our way.

We have to ratify the transactions.

SPEAKER(?). So moved.

CHAIRMAN VOLCKER. Without objection, they are approved. Mr. Kichline.

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

CHAIRMAN VOLCKER. I'm inclined to suggest short comments or questions and we can return again to the general problem a little later.

MR. BOEHNE. I have a question. Your forecast and almost all the forecasts have a phrase in them that says something like: "The consumer is going to lead us out of this recession," and economic logic would suggest that there's something to that. However, when I talk to people who are in the consumer business--retailers, for example, and bankers who are in the consumer loan area--they hear that statement with almost disbelief. The attitudes both on the part of the sellers, and it seems the buyers, are pretty sour. At least in the northern part of the country, one hears a lot about selling blankets and heaters and worries about oil bills and gas bills for what is supposed to be an unusually cold winter. My real question is: How do you weight these attitudinal factors versus the real factors, such as the tax cuts and personal income increases and so on. I think how one comes down on that says a lot about what one's forecast is.

MR. KICHLINE. Well, I think that's right. I would say to begin with that heaters and blankets count as consumer spending as does natural gas use, so that may be a plus in terms of the forecast. Secondly, I would say that for some time the views that have come out in the Redbook and elsewhere from retailers are fairly gloomy; in fact, one might be led to the view that personal consumption expenditures were declining dramatically, just looking at that. That is really not the case. In the first half of the year, personal consumption expenditures were up at an annual rate of 2-1/2 percent. Our estimate for the third quarter is a rise at a rate of 1-3/4 percent and we have 3-1/2 percent for the fourth quarter. So consumption will be up, in our view. But I would say that one would have to be cautious interpreting what retailers anticipate and what their results were. They have been disappointed, very clearly. [Your comment about] the consumption-led forecast is quite correct in that if two-thirds of the GNP doesn't respond in the way we have forecast, we're in a great deal of difficulty in part because of the rather poor prospects in the investment sector and the export sector. So, overall, [the consumer sector] is a source of concern. I would only remark that in our forecast we have what is a very mild cyclical upturn. It's a bit weaker than many of the other forecasts and the attitude issue, I think, is important. It's probably very important in the short run where the economic news is likely to be very negative.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. Well, coming at this confidence factor from a little different direction, since as we all know both consumer confidence and business confidence do play a key part in what really happens, and both I'm afraid are quite weak today: I was wondering, Jim, if you have given any thought--and I'm sure you have--to the likelihood that we may see a triple-dip recession. What probability would you assign to that, if you really had a chance to think it through?

MR. KICHLINE. Well, I certainly wouldn't make it the most probable outcome. Our forecast represents our highest probability [outcome]. But for the near term, and let's view that as over the next quarter or two, there are clear downside risks in that there is quite likely to be a negative [GNP] number in the third quarter or a negative number in the fourth quarter, and one might classify that as a triple-dip. I wouldn't say the same if I were to take a bit longer horizon, particularly over 1983. I'd just like to say that in the first year of recovery in the postwar period we've had rates of increase of real GNP on the order of 7 to 8 percent. The staff forecast is for 3 percent. It is 3 percent for good reason. But lowering that number, I think, begins to get a bit risky on the down side. It's very difficult when the economy, hopefully, is near the bottom of a recession to spot the potential sources of strength, but for now it seems to me that there are clear risks on the consumer side. On the business investment side, while we have had a major downturn in this cycle, it could very easily go weaker. So, I think the short-run risks are on the down side.

MR. BALLEES. Jim, one other question, if I can follow up on that: As we look back to, say, last spring--I haven't really checked the record so this is strictly my recollection but it is reasonably

clear--your forecast, our forecast, and most private forecasts were confidently expecting an upturn in the third quarter. Month after month has gone by and we haven't seen it; I still don't see it. It's still a forecast and not a fact. Do you have any insight into what has delayed that widely expected and anticipated upturn?

MR. KICHLINE. Well, in our own forecast, one of the major things that we have done is to write down business fixed investment; there has been a greater deterioration there. And in the third quarter, while we had the tax cut, it came along a bit smaller than we had anticipated earlier; nevertheless, it was there. In fact, other income didn't come along, so that we didn't have as large a growth in disposable income in the third quarter principally because of the sharp cutbacks in business fixed investment and the lingering inventory problems. So it's in these other sectors that we underestimated the weakness or overestimated the performance. I don't know of any other major area. I guess net exports is another area, as Jerry is telling me; that indeed is one of the reasons why we're much weaker than the Commerce Department in the third quarter. The expected performance of net exports is much below Commerce's estimate and the August data that have come in are even weaker than that. So, exports and business fixed investment have been quite weak relative to our expectations and actual experience.

MR. BALLE. I wonder, in the final shot at this: To what extent, in your opinion, do the still unprecedentedly high levels of real interest rates explain some of this weakness or failure to recover?

MR. AXILROD. I intend to get into this in my briefing.

MR. BALLE. I'll wait for your words of wisdom.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. You have an impressively low inflation prediction. In evaluating the impact of interest rates on investment, business, and housing, does that mean that you're also looking at a higher real rate and consequently a greater restraint on investment than other observers?

MR. KICHLINE. I have a lot of trouble with real rates--well, a lot of difficulty in terms of knowing what inflation expectations are. It seems to me that real rates are high; if inflation rates are going down and expectations of inflation allow for that, then we indeed do have higher real rates. That's one of the elements, I would say, in that some of the major commercial forecasters have assumed higher rates of growth of M1 for next year--a percent or a percent and a half faster--so they indeed have lower nominal interest rates than the staff. So, interest rates are one of the drags here, and they have been for some time, in terms of monetary constraint standing in the way of recovery.

MR. MARTIN. Let me ask a question with regard to consumer attitudes and the [role] of the consumer balance sheet, if you will, in that. Which way, if any, does the substantial improvement in the consumer's liquidity position cut vis-a-vis attitudes toward

residential [property] on the asset side? That is: Is the consumer likely to consider his wealth as a plus or a minus factor?

MR. KICHLINE. Well, that differs with individual consumers. I think you are quite right in pointing out that short-term borrowing has been rather moderate; in fact, repayments relative to income have come off from their peak in late 1978. But at the same time one of the major sources of wealth in the household sector, namely housing, has clearly become less liquid for many.

MR. MARTIN. And less valuable perhaps.

MR. KICHLINE. And the price may well have gone down. Those are offsetting factors and I don't know how one would come out, but it certainly--

MR. MARTIN. That was my question. How does one come out? You're not coming out?

CHAIRMAN VOLCKER. The answer is he doesn't know.

MR. KICHLINE. One simply has to put those two things together. One can't look at the improvement in short-term liquidity alone.

CHAIRMAN VOLCKER. I heard a commentary on the radio when I got up this morning indicating that fuel is in ample supply for this winter season. I don't know the survey, but what surprised me is that they said prices are going to be--I forget precisely what number they used--6 to 12 percent above last year. That surprised me a little because I thought that oil prices had leveled off during this period.

VICE CHAIRMAN SOLOMON. Gas has gone down.

CHAIRMAN VOLCKER. This was oil.

MR. PARTEE. Did they say that?

CHAIRMAN VOLCKER. Yes, it was about oil supplies.

MR. GRAMLEY. I think the reports have been on private home heating fuel.

CHAIRMAN VOLCKER. This was home heating fuel that they were talking about.

MR. GRAMLEY. Supplies of home heating fuel I think are rather low relative to the stock of petroleum generally.

CHAIRMAN VOLCKER. This was a two sentence comment in the news. They said they had done a little survey and stocks were ample. People were going to have plenty of fuel this winter but the price was going to be 6 to 12 percent higher.

MR. PARTEE. Being a consumer, Paul, [I recall that] the price rose as the last heating seasonal went off and it hasn't declined except by two or three cents. So, this season will start out with prices materially higher than at the beginning of last season.

MR. KICHLINE. Well, we don't have that in our forecast.

CHAIRMAN VOLCKER. I thought it had been level for a long while but it may be that it got back to where it was a year ago. It surprised me that they were up that much in a year.

MR. FORD. I have one quick question about your forecast. Looking at your forecast compared to others we track yours against--Townsend-Greenspan, DRI, Citibank, and Chase--you are uniformly the most bearish for the next three quarters, and by a substantial margin. You have far and away the lowest GNP growth rates, the lowest inflation forecast, and the highest unemployment forecast, which are all consistent in a very bearish pattern. I just want to understand if what you said in answer to a question--from John, I think--was that your next-best forecast was even more bearish.

MR. GRAMLEY. May I point out one other factor in this respect? The staff forecast has been uniformly the most pessimistic for the past year-and-a-half and it has overestimated the performance of the economy.

MR. FORD. You are saying they are right.

MR. GRAMLEY. We're looking at a situation in which I think Jim is quite right that all the risks at this point are on the down side, both from the domestic demand side and from export demand.

MR. FORD. One thing that worries me is what none of us expects. We are all very bearish and you are very bearish. Do you give zero probability, then, to the possibility of a surge in the economy? The consumer's car is getting older and older; more and more consumers are looking for a place to live as all these baby boomers get married or whatever [and create households]. With household liquidity getting stronger and stronger and with savings up, you don't see any possibility of a surge in the economy?

MR. KICHLINE. Not in the very short run. We have indeed built in a bit of an increase in auto sales. In that market, all of the news I've run across has to be viewed as rather negative. I wouldn't perceive any of these areas as bursting out on the up side in the very near term, but I wouldn't extend that forecast through 1983, as I said. We have in our forecast some pluses in these areas. It's a matter of how much. I don't know of anything at the moment that would suggest to me that we are likely to see major growth in the very short term. But these issues are debatable and I certainly wouldn't want to argue the consumer case very strongly [even] in the short term.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I was one who believed that there would be a recovery in the second half. But I must say that over the years the two indicators that I have watched and thought most consistently indicated the future were new orders for durable goods and initial claims for [unemployment] insurance. And they both have [tended] to vary significantly. We had a 4 percent decline in durable goods orders in the latest month and we had a very substantial increase in

initial claims for insurance. So I see no reason that we shouldn't predict a decline in activity in the period to come.

MR. ROOS. Mr. Chairman.

CHAIRMAN VOLCKER. Yes, sir.

MR. ROOS. Just to avoid total desperation, we have a little more positive view of [the outlook]. First of all, we weren't surprised at the fairly slow growth in output in the third quarter because we feel that it was to a great extent a reflection of the monetary contraction that occurred earlier in the year. However,--

CHAIRMAN VOLCKER. I never figured out where that expansion [went] from the monetary expansion still earlier in the year.

MR. ROOS. We think--and again it's a matter of relative value--that the contraction in output would have been even worse had there not been that expansion. However, we feel that if money is allowed to grow at, say, 5 to 5-1/2 percent or slightly above that, we will see a much more positive effect on output certainly starting next year. We observe in the record that the economy always tends to move toward about a 3-1/2 percent trend growth of output. We think, inasmuch as we've had about 3 years of very slow growth--and we blame it on monetary contractions--and price increases have finally slowed and real interest rates are approaching normal levels, that much of the adjustment that was caused by that and by foreign competition being a factor in heavy industry has been completed. We think that quite conceivably we could have a bit faster rebound next year, based on 5-1/2 percent money growth, than some others have forecast. If I'm wrong, I won't be here, Mr. Chairman; if I'm right, you'll hear from me!

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, Larry rescued us from the straits of desperation and said some of the things I had in mind. There are two things that might be helpful to remember here. One is that it always looks very, very bleak right at the bottom and we all get very pessimistic, and I'm much more pessimistic than any of my associates in Richmond. The second point is that there's a very low pickup in velocity projected over the next four quarters. And traditionally most forecasters at this stage of the business cycle--maybe I should say at this apparent stage--have underestimated the pickup in velocity. We ought to bear those things in mind as we move through the meeting.

CHAIRMAN VOLCKER. If no one else has an immediate comment, we'll turn to Mr. Axilrod.

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

MR. MORRIS. Steve, I think the answer to all your questions is "yes."

CHAIRMAN VOLCKER. We don't want to prejudge these things too hastily.

MR. ROOS. Well, isn't this similar to the NOW account situation? Didn't we adjust for NOW accounts? Can't we do the same thing and avoid the possibility that people would misconstrue this as a major change in policy?

MR. AXILROD. We could make efforts to make shift adjustments in somewhat the same way, probably with the same degree of credibility.

CHAIRMAN VOLCKER. Well, I might feel differently if I thought they had the same degree of credibility. I don't think the staff is capable of making them with the same degree of credibility, however great that was, as last time.

MR. AXILROD. I thought it was small.

MS. TEETERS. Steve, how would you actually operate? How would you draw your reserves paths [with a] wider specification?

MR. PARTEE. Run on the funds rate!

MR. AXILROD. If there were not a specification for M1 and there were for M2 or M3, we would draw them on the basis of the M2 or M3 specifications and we would draw an M1 path, unless told otherwise, that we thought was generally consistent with that.

CHAIRMAN VOLCKER. I think we may be getting a little ahead of ourselves in this.

VICE CHAIRMAN SOLOMON. I have a question on the instrument the DIDC [plans to authorize]. As I understand it, it seems that at a minimum what we're going to get out of the DIDC is an instrument that goes into M2. But it depends on how they word it. If they put out two instruments, one of which is reserveable, then the one that is reserveable would be in M1. Is that correct?

MR. AXILROD. Well, the one that is reserveable certainly would be in M1. Where the other one would be is a question one would have to consider carefully, I think. It will [allow] at least six transfers. Our present boundary line, other than for money market funds, is about three transfers.

CHAIRMAN VOLCKER. It doesn't make any difference where we put it.

MR. PARTEE. But, Tony, a ceiling-free reserveable deposit has a lot of different implications for M1 than one on which the maximum [rate] paid is 5-1/4 percent.

VICE CHAIRMAN SOLOMON. Right; I understand that. But if the DIDC words it fairly broadly, and we insist that because of the number of transactions exceeding the six--I gather it's three drafts or checks and three other forms of authorized transfers--then we could put a reserve requirement on it so that in both cases on anything over, let's say, \$5,000, they would be paying market rates, except that one would be marginally lower than the other because of the reserve requirement. It seems inevitable to me that the reserveable one would be in M1, in which case we might get a major bulge. It's

unpredictable as always. But the other one, which we're sure to get even if they word it narrowly, must be in M2. I don't see--

CHAIRMAN VOLCKER. Yes, but I'm not sure it makes any difference analytically. It makes a difference in the number, obviously. But in either case we won't know what the heck the number means.

MR. AXILROD. If it were in M2, it could lead to a very sharp contraction in M1, if NOW accounts shifted into [that instrument].

VICE CHAIRMAN SOLOMON. We would get two unknowns with enormous swings.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. I don't think you touched upon the problem that may begin in October.

MR. AXILROD. No, I didn't mention in this briefing the all savers certificates, Mr. Chairman. We mentioned in the Bluebook that this week \$22 billion of originally issued all savers certificates mature, with a maturity value of \$25 billion including interest. Our limited preliminary estimate of the likely effect on M1, which is nothing more than a very informed guess--

CHAIRMAN VOLCKER. What's informed about it? Steve did a survey of four people all of whom are going to put it into M1, including himself!

MR. AXILROD. We are at the moment guessing that there will be about a \$7 billion increase in M1 in the current week from that. But it could, depending on how long it lasts--though we think it would be temporary generally--have a very sizable effect. And there are a total of \$33 billion or so maturing in the course of this month.

MS. TEETERS. People could roll it over into another all savers certificate, couldn't they?

MR. AXILROD. Yes, if they haven't used up their \$2,000 in tax-free interest. But to the degree one is going to invest in something else, it could go into a NOW account or demand account temporarily as one waits to invest it.

MS. TEETERS. And then the all savers certificate disappears completely on December 31st? You can't go into it afterwards?

MR. AXILROD. That I'm not sure about.

MR. PARTEE. You can't go into it, but of course there could be a lot of outstandings for quite a while.

MR. BALLE. Where is that now--in M2?

MR. AXILROD. Yes, they are all in M2.

VICE CHAIRMAN SOLOMON. Do you think the country would rally patriotically, if we made a public call that maturing all savers certificates should be reinvested in M2?

CHAIRMAN VOLCKER. It's a little late, I'm afraid.

MR. MARTIN. On the theory that only the lost causes are worth fighting for?

MR. MORRIS. You ought to get your moat up and keep them out!

CHAIRMAN VOLCKER. Mr. Black, please.

MR. BLACK. Mr. Chairman, Tony touched on my question. I was just going to ask Steve if he would elaborate a bit more on conditions under which this might increase M1 as opposed to decreasing it.

MR. AXILROD. Do you mean partly the all savers certificates?

MR. BLACK. I'm talking about the money market account.

MR. AXILROD. Well, if an account were offered, let's say a Super NOW account, where you could write all the checks you wanted and that was already in M1 and it was [ceiling] free on funds over a certain amount, I would see sizable transfers out of money market funds as well as other savings deposits right into M1 from that. That would occur almost instantaneously.

CHAIRMAN VOLCKER. If we counted it in M1.

MR. AXILROD. Yes, and it would--

CHAIRMAN VOLCKER. Theoretically we could get an increase in M1, I guess, without counting it in M1 if it was so attractive that everybody went into NOW accounts for their basic account and got an automatic sweep arrangement into these new accounts. We would get more increase in the below \$5,000 portion of NOW accounts as a kind of tail on the dog of this new account.

MR. AXILROD. It's quite conceivable.

CHAIRMAN VOLCKER. I don't know how we'd ever measure it.

MR. AXILROD. We could. It's like suddenly permitting a market rate of interest on demand deposits. And to the degree the account is like that, it's in M1, which ought to increase.

MR. BLACK. I have been assuming that the instrument would not have that much in the way of check-writing privileges and it would probably depress M1.

MR. AXILROD. It may very well. I was answering your question on the conditions under which it would increase M1.

MR. BLACK. Mr. Chairman, would you comment on the likelihood in your judgment that it would have that much check-writing ability?

CHAIRMAN VOLCKER. Yes. The law says so. There's very little left to decide on this. I think the size of the check is the only thing that will be--

MR. BLACK. That's what I had in mind. That might limit its use to no more activity than present money market mutual funds, which have a very low rate of turnover relative to the NOW accounts and other kinds of transaction balances as currently defined. That's what I was thinking was the most likely outcome.

VICE CHAIRMAN SOLOMON. [The DIDC] clearly can't circumvent the intent of the Congress by putting a minimum value of \$5,000 for checks.

MR. BLACK. Even \$500, Tony, might give it characteristics more like M2 than M1. But one could certainly debate that.

MR. CORRIGAN. Even then, we still could get a very sizable buildup in M1 balances in connection with the account. It's very simple to conceive of that situation even with a \$1,000 limit.

MR. MORRIS. Is there any work being done by the staff in anticipation of the time when we will have to decide what to do with monetary policy when we finally admit that M1 is no longer a sensible target?

MR. BLACK. You're prejudging our conclusions!

MR. MORRIS. I'm talking about contingency planning.

MR. ROOS. Mr. Chairman, I would agree with Frank, strange as it may seem, that before we bury my old friend M1 at this meeting--this [new instrument] won't take effect for a couple of months--there ought to be some work done by the various economic staffs to try to project the effect. There are a lot of people who don't like my old friend M1, and whenever anything changes they say this is a good time to bury M1.

MR. MORRIS. We love it. We just can't find it!

MR. ROOS. But couldn't some study be done prior to changing our basic approach to policymaking? I'm a little paranoid--I guess I have been for most of my life with the Federal Reserve--that every time something comes up that casts some suspicion on M1, there's an awful lot of readiness to bury it. Does our policy action today require that we do something that's a significant departure from the way we've been doing things? Couldn't this matter be studied and couldn't we have a summit meeting if necessary, a la Jerry's [suggestion], prior to our next meeting of the FOMC to see what the best brains in the System think will be the result of the DIDC action and everything else?

CHAIRMAN VOLCKER. Well, yes and no is the answer, I think. Obviously, we can study the matter. I see no prospect that any amount of study is going to tell us what the behavior of M1 is going to be in the short run. It is unknowable, in my opinion, to all the best brains in the world. It's going to be an empirical question; we will discover what happens when it happens. And we have to look at it over a period of time. But I don't see that any amount of rumination--is that the right word?--is going to produce an answer to a knowable question but an unknowable answer. The wish for a study is fine; but the sense that it's going to give us an answer in a month before we

get the new instrument I think is totally unwarranted just by the nature of the problem that we face.

MR. GUFFEY. If I understand what we're discussing, you are really talking about M1. The impact on M2 would be considerably less; it is a more reliable guide.

MR. PARTEE. A little more subtle, I think.

MR. GUFFEY. More subtle perhaps but nonetheless--. And M3-type deposits--

MR. PARTEE. Other things equal, it ought to increase the value of M2-type instruments compared with market instruments. Therefore, M2 ought to be larger relative to total credit flows than before. And by the way, I think the real world effect will be fantastic shifts of funds.

CHAIRMAN VOLCKER. I don't think there's any question, however, that Roger is right. The impact is going to be much less on M2 and M3 than on M1. The only place it can come out of basically is Treasury bills.

MR. AXILROD. President Roos, I wasn't suggesting burying M1; I was suggesting that there is a problem over the next two or three months.

MR. ROOS. Well, you didn't suggest we praise it!

MR. FORD. This is sounding more and more like Pericles' oration on Caesar's burial!

MR. ROOS. It was Mark Antony's.

CHAIRMAN VOLCKER. We will get to the issue of what to do with M1 a little later, but I--

VICE CHAIRMAN SOLOMON. Just one last question on the DIDC instrument: Based on your information, what kind of rate do you think the depository institutions will pay as the so-called market rate? Will they simply be competitive and vary it with the average money market fund rate or will they pay a Treasury bill-type rate? What do you think they will pay?

CHAIRMAN VOLCKER. I think there will be a tendency among some to pay a money market funds rate plus; the question is whether the market gets driven there. I'm just guessing. Among other things, we approved what I think of as the "bucket shop relief regulation" at the last DIDC meeting, where an institution can broker all of this money. So, we'll have people advertising all over the country. These will be insured deposits and people will keep it with the guy paying the highest rate. And that will tend to force the rates higher. I would think there would be two tendencies initially: To pay a money market funds rate plus, or to pay something related to the Treasury bill rate. My guess would be that the bill rate fellows might get forced higher. In a tight money situation, I would feel rather confident of that result. With rates going down, if they are going

down, I think banks would be cautious. But I think those will be the two polarities. The question is where it will end up.

VICE CHAIRMAN SOLOMON. If there is any erosion of the banks' core deposits moving into these Super NOWs or whatever we call this new instrument, it's going to put a terrible squeeze on their profits.

CHAIRMAN VOLCKER. If this had been done three months ago, I think it would have been an utter disaster. It may just be a disaster now. You know, I joke with the banks at times. I tried it out with the banks this morning and they said fine; they haven't thought this out. But I said that the simple way to do this and be perfectly consistent with the law is to say [to a depositor] "If you have a NOW account or a savings account [with a balance] above \$5,000, it no longer has a ceiling rate and it's checkable." If a financial institution thinks of it in those terms, immediately that puts its cost of funds up by a significant amount. I'm sure when they think about it, they won't want it that way. It will take time for the savings depositors to pull out their money and go to the bank and say instead of my savings deposit, I want this new account. Some of them will never get to the bank, so the banks will retain some of their savings deposits and NOW accounts by a kind of "discrimination by ignorance" approach. And who knows how long that transition period will take!

MR. PARTEE. They don't have to pay a market rate or tie it to a market rate; they could pay the CPI plus 4 percent.

VICE CHAIRMAN SOLOMON. The European bankers look at this deregulation process going on in the United States and they react with horror. In their view, this whole deregulation is such a disaster both for monetary policy and for the stability of the banking system that I think we are once and for all--through our experiment, if you want to call it that--making sure that no deregulation process is going to be copied in foreign countries.

CHAIRMAN VOLCKER. I will mention one other aspect of this and then I want to go back to somewhat broader subjects. If there is a big drain on money market funds, there probably will be a big drain on bank CDs. Money market funds have become the major source of bank CDs for a group of major money market banks who are already in difficulty in the CD market. And since I'm almost certain that bank CDs would be the favorite instrument for money market funds to cut back on now, there is going to be a squeeze [on] banks and possibly commercial paper; there will be a squeeze in the other direction, too, on banks that are not anticipating or have not thought through that particular consequence of re-intermediation.

In any event, as a setting for reaching a policy decision or a broader discussion first, let me try what I might term from my international experience a tour d'horizon because I think we have a rather wider setting that has to be brought to bear [on our decision]. A large part of that, of course, is the domestic business situation, which we've just gone over to some extent. We can discuss it further but I don't have anything particular to add there. We have been disappointed at least on the timing of the recovery. The inflation picture is going well but the business picture certainly is not. Everybody looks to the consumer. I don't see any place else to look.

Whether he will appear or not is necessarily in some doubt. We have obvious pressures on the investment sector and the commercial building sector and the agricultural sector. It's hard to see any of those pressures going away in any short period of time, and I have to agree with the conclusion stated earlier that the risks here, just looking at the domestic economy, are quite asymmetrical.

But let me look around the world and say what somebody did mention--I guess, Sam Cross--right at the beginning: We are in a worldwide recession. I don't think there's any doubt about that. Mr. Truman's imagination may be larger than mine, but I don't know of any country of any consequence in the world that has an expansion going on. And I can think of lots of them that have a real downturn going on. Obviously, unemployment is at record levels. It is rising virtually everywhere. In fact, I can't think of a major country that is an exception to that. There are particular sore spots in the developed world. France is a leading example where they have tried to expand over the past year or more and they have been forced to reverse that. They are in increasing trouble internationally, although it hasn't been the focus of the same attention that it has in some of the countries I will get to shortly. But they have a rather massive current account deficit and heavy external borrowing needs. They have come through a couple of devaluations with the question [remaining] of whether they can hold the franc at the current level. The German situation is rather sour looking, with political uncertainties affecting that country and its prospects. The British have had momentary signs of advance off and on for the last year but the latest signs are negative there as well. Japan has caught a kind of sour despondency as well. I mention all this because it does affect the prospects for our own outlook as well as the world outlook; there is obviously a feedback among all the world markets. World trade is doing poorly and our exports are doing poorly. It also contributes to a feeling of nervous uncertainty throughout the world. And I think it all has had an influence on the exchange rate, the next subject I will get to.

One can have different opinions about the exchange rate but I think it is an obvious fact that we have had a considerable narrowing of interest rate differentials in recent months and the dollar has gone up instead of down. I saw a comment yesterday on the ticker from Jacques Delors, the French Finance Minister, who said that something has to be done because whatever news comes out of the United States the dollar goes up. If it's good news, the dollar goes up; if it's bad news, the dollar goes up. And that's about right these days. It is very hard to argue that the dollar is not out of line, with very serious repercussions for our export industries. I can't think of any advantage, really, to the rest of the world of our present situation, partly because it is obviously a factor inhibiting their own monetary policy flexibility. The only explanation that one can see of the dollar's behavior in a very nervous and uncertain world where everything looks bad is that the dollar looks less bad for political and economic reasons and may even look good. Maybe I ought to put a positive cast on that, but it is a situation that itself is an important distortion in world markets.

When I look at developing countries, there are well known problems in Poland that have not been of largely political origin in the sense that Poland has very serious economic problems but they are

terribly complicated and sui generis in terms of the political problem. There are other problems in Eastern Europe in that the Polish situation is to some degree infectious there. The problems in Eastern Europe should be manageable in magnitude, but initially the throw-off from the Polish situation affected them and they are now being affected by the more general world situation. More acutely, we have the situation in Latin America, which is an interesting panorama. We have gone over the Mexican problem as nearly as I can see on the basis of inadequate information. It may not be at dead center, but it seems to be at dead center for the moment. That's the best guess that I have in a period of very difficult political transition, strong differences of opinion within Mexico about what to do and, in the best of circumstances, an extremely difficult adjustment problem within Mexico with important social and economic consequences. Whether an orderly or halfway orderly solution to the Mexican problem, with its \$80 billion--or probably realistically \$100 billion--of external debt, can be foreseen in the next weeks or months is problematical. I hope so, but I don't think anybody can bank a lot of money on that particular situation.

When one looks elsewhere in Latin America, at the other end of the continent we have Argentina, which is basically unable to finance its needs in the markets and is in substantial arrears on its indebtedness. The financial officials there are willing to go to the International Monetary Fund. Fund negotiations are starting with rather an unknown situation as to whether Argentina has a government of sufficient strength to sign a reasonable Fund agreement even if they want to, or to carry out a Fund agreement if they do. That is a situation that in some sense doesn't look unmanageable economically, but there is a question as to how manageable it is politically. When one goes up in that continent, there is Ecuador, which may be facing an inability to service its debt in a matter of weeks. We have Chile, which as nearly as I can see is unable to finance itself at the moment and is rapidly depleting its reserves; and at the rate of depletion of reserves one can perhaps measure their debt difficulties in a matter of months, if not weeks. We have Bolivia, which has had chronic problems for years and is no better; it is basically in default. Costa Rica is in the same position. Peru is not much different. And then we come to the strong countries in the continent like Brazil! That is another \$80 billion debtor, which in my eyes has undertaken a strong adjustment program for the past 18 months, has had a recession, has had monetary restraint, and has attempted to get its budget in shape. Their balance of payments deficit is as big today as it was when they started the program, reflecting in considerable part the sourness of the world economy. Then of course we have Venezuela, the premier country in terms of financial strength of the continent. It is a relatively small country with big oil reserves, but it also is apparently unable to finance itself freely in the market currently [despite] more substantial reserves; it is not an imminent problem in the same sense that the other countries are, but it is affected by the total situation. Those countries have a collection of debt of what, Ted--about \$300 billion more or less--of which a sizable fraction is owed American banks. But every big bank around the world is more or less equally committed. All of these countries are dependent upon sustained borrowing to maintain a semblance of equilibrium during this period; indeed, all of them are dependent upon sustained borrowing simply to keep the loans that are now on the books in a semblance of good order.

All of which brings me to the banking system. We have had some rather well-known problems with respect to individual institutions, stemming largely from domestic concerns in the United States. Those particular institutions have had financing difficulties in the market for some time. They are basically unable or unwilling to sell any substantial amount of domestic CDs and are having their lines from other banks cut back in the day-to-day market. There is concern, obviously, more generally about banks with large external exposure. And when we talk about banks with large external exposures there are no exceptions among the major American banks or among a good many of the regional banks. There has been a tendency quite clearly in this circumstance not to test the domestic CD market and a feeling that everybody could run to London for the money. That [approach] is a little more anonymous; it isn't [unintelligible] futures markets, and what premium which bank is paying above the prevailing rate isn't gossiped about to quite the same extent as in the American market. But it is quite apparent that the Eurodollar market is in a state of some confusion and concern. One can see that specifically in the fact that the Eurodollar rates have a margin over domestic rates that is not explicable by normal arbitrage calculations between the two rates. And we have a situation in the Euromarket, according to my understanding, that normal trading procedures--somewhat like in the U.S. CD market--have now broken down. Trading that used to be done more or less anonymously or indifferently among banks is now done on a personalized basis with each bank rated on its own and differential rates among particular participants, and there is a sense of a contracting market. Whether it is really contracting ex post seems to be problematical. The volume is probably going up because that is where the demand is going, but there is a sense of a contraction in credit. I might say that it is complicated by the fact that some American banks that have liquidity problems have chosen to do placements in the Eurodollar market as obviously their only source of liquidity, so they're running them down.

I think we have, as I mentioned, an unwillingness to put pressure on the CD market domestically not only by the particular banks that have been in everybody's mind but much more generally in recent weeks as the international problems have gotten more severe. Tony mentioned earlier the particular problem that is beginning to stick out like a sore thumb with what I think of as motherless banks, by which I mean banks whose home country either doesn't exist in any real way or doesn't have any dollars or doesn't have any means of putting its hands on any dollars. These banks are funded in dollars or other foreign currencies but largely in dollars. Their assets are nominally in dollars but often are in effect in frozen form because they are backing a country--Mexico, Brazil, Argentina, Chile, Korea--that hasn't the money to make those debts liquid if they had to. We have had further attention to this kind of problem from the Banco Ambrosiano affair where subsidiaries of a good--at least "good" in quotation marks--G-10 country were in the position of not having a mother, so to speak, because they operated through a subsidiary. And when liquidity pressures began in that case, or when the bad loan became evident, there was no obvious recourse to provide liquidity to them.

In these circumstances, I think it's fair to say that the rates of interest on government securities that we tend to look at very frequently are not a reflection of what the rates of interest are

in the market because the spreads are substantially wider even in the quoted rates both on government rates and private rates, reflecting a tiering of successive risks or precautionary premia. There is the situation, for instance, in financing developing countries now where the CD rate is high relative to the bill rate by a considerable margin. The Euro-rate is high relative to the CD rate. These countries are financed at LIBOR plus a margin; those margins are increasing. So by the time you go from the bill rate to what a foreign developing country actually is paying, there hasn't been a decline in interest rates; the decline observed in our market has only a pale reflection in the actual interest rates paid by those countries. There is a sense, repeated to me again this morning by an ABA group that I had breakfast with--it's put quite openly on the table by some of the banks--that they are attempting to withdraw from international markets. They say "We are doing our best to do so. We realize everybody can't do that, but we have our boards of directors and that's what we are doing."

MR. FORD. Excuse me, who is this group?

CHAIRMAN VOLCKER. It was a group of ABA bankers, but that's incidental. It is going on. That is why all these South American countries together suddenly can't find financing or financing in anywhere near the volume that they were anticipating. And to the extent that that financing demand is going on, that presses more and more on a relative handful of major money market banks that are already, of course, very heavily extended. The extent to which this is going on in domestic markets is less clear, but I would sense that some of this atmosphere is developing in domestic markets. In a sense that means that market rate quotations don't mean quite the same thing as they meant some months ago, because there's a question of who can get those rates and with what degree of aggressiveness. All of this in a way, it seems to me, is explained in the velocity numbers. There is a little liquidity preference or desire, or however you want to put it, which is why the relationships that we look at all the time between liquid asset totals and money narrowly or broadly [defined] do not seem to bear the same relationship to economic activity that we might have anticipated. I find it difficult or impossible to explain that except, in part, because of a change in liquidity preference. People want to be liquid; they want to hold as many liquid balances as they are permitted to hold and the constraining factor is how many of those are made available to them.

I'd say all of this leads to a considerable feeling in financial markets and elsewhere of developing disarray, a certain floundering. And that in itself contributes to uncertainty, which feeds upon itself. And it is dangerous in and of itself. I don't mean to suggest going back to point number one about the domestic outlook and saying that the prospects as a matter of probability aren't along the lines that Mr. Kichline suggested. Hopefully, as attitudes change, it could turn out to be significantly better than that. But I do think we are in an extremely tricky period of transition that is complicated enormously by the factors not just of a period of potential transition for us, but for the world economy as a whole. There is not a single source of real strength or certainty out there.

So far as the international situation is concerned, let me just suggest that we sorely need a victory, or a series of victories, in terms of stability in some key countries. We would like to have that in Mexico. Whether that's possible or not I already expressed my uncertainty about. If it's not going to be in Mexico, there had better be dikes built pretty promptly around some of these other countries so that there is not a feeling of absolute inevitability, which is developing rapidly in the market, that all of these countries are going to go down like a bunch of tenpins. If we cannot deal with that prospect, we are going to be in sorry trouble indeed. There are obvious cases in point; Yugoslavia and Argentina are both now in negotiation with the Fund. Neither of those countries has [irreparable] economic conditions by any means, as nearly as I can understand it. The amounts of money involved are relatively small but not exactly trivial in either case. Right behind them is a country like Chile, and not very far behind that, of course, is the big one, Brazil. I don't see how any of those situations, with the possible exception of Brazil and conceivably Chile--if the dikes are strong enough around Argentina and Yugoslavia--is going to be handled without Fund assistance and without further official assistance outside the Fund. I think this is logically the Treasury's job. Whether the logic is going to prevail in the end here is something that at some point we're going to have to consider, given the stakes involved.

Domestically, I would simply say that I don't think this is any time for taking any great chances. There is a substantive need for a relaxation of pressures in the private markets in the United States. How best to achieve that seems to me is the question before the house. I will cease and desist at this point. I note that coffee is ready and maybe this is as good a time as any to have it.

[Coffee break]

CHAIRMAN VOLCKER. We can now have a general discussion. At some point I will give you some directive language that is somewhat different [than shown in the draft provided by the staff]. But before that, we can have a general discussion of the business scene, the international scene, or whatever. I would like not to neglect the international situation with respect to some of these countries. This is not a time, as I undoubtedly implied--that's a mild word--for business as usual, certainly, in the international area. I don't think it's time for business as usual in the domestic area either. Extraordinary things may have to be done. We haven't had a parallel to this situation historically except to the extent 1929 was a parallel.

MR. MARTIN. And 1931.

MR. PARTEE. 1931.

CHAIRMAN VOLCKER. And I might say that I commend you all: I detected no leaks after the last meeting. We are discussing obviously highly sensitive subjects in this particular meeting and I can't impress that too strongly upon you. I'm talking about some of these international financial problems, especially their domestic ones. Any one of these things can be blown by inadvertent comments. There is discussion going on, particularly with respect to Argentina and Yugoslavia, of central banking monetary authority packages. The

question is whether those packages are big enough for the situation in both cases. As I said, they are in negotiation with the Fund. Yugoslavia has been operating under a Fund program, but it's a rolling one-year [credit]. The third year of it is under discussion at the moment. These are in theory governmental matters and in our institutional structure more appropriate for the Exchange Stabilization Fund than for the Federal Reserve. I think the Treasury would say that, too. But they have concerns and limited amounts of money, and at some point I think it's possible that we will have to make a decision within the confines of this room as to whether we contribute to them too, simply in order to get the money big enough. And that raises issues that we have not had to face before--except perhaps marginally in the case of Mexico. I don't know if it's going to come up; I hope it doesn't. My position is that it should not come up. On the other hand, I cannot exclude it, given the nature of the problem.

MR. ROOS. How should we respond, if we are on the speaking circuit and are asked what our impression is of the international situation? How do you respond to that?

CHAIRMAN VOLCKER. Well, with difficulty.

MR. MARTIN. Very carefully.

CHAIRMAN VOLCKER. Obviously, you give some sense of confidence as best you can.

MR. PARTEE. Say "I have another appointment."

CHAIRMAN VOLCKER. Let me say in that connection--and I should have said it more clearly before--that I think this situation is manageable. In a very big sense, I think we are on the verge of victory in what we've been trying to do. It's a delicate situation, but it's also a very risky situation.

VICE CHAIRMAN SOLOMON. What kind of victory, a Pyrrhic victory?

CHAIRMAN VOLCKER. No, though it could turn into a Pyrrhic victory.

MR. PARTEE. We're going to get prices going down.

CHAIRMAN VOLCKER. But, in my opinion, it's only going to be manageable with unusual exertions. And in the end I'm afraid this institution may be called upon for unusual exertion simply because there is no other in a comparable position. It's the only possibility in terms of having the leadership and the resources necessary to deal with some of these problems. I don't know whether we can [unintelligible] that issue. But I think that is the nature of the problem.

MR. ROOS. Is it possible to assume that this international problem is not a consequence of our anti-inflationary efforts and that if our [anti-inflationary] program had never been undertaken this same sort of international situation could exist in a highly inflationary [environment]?

CHAIRMAN VOLCKER. I think all of these problems in a considerable degree emerge out the inflationary situation most broadly --a decade or more of loose practices, if that's the right term. Sooner or later Mexico was going to get in trouble. They borrowed \$20 billion last year. And they borrowed heaven knows how many billions of dollars net this year when they still could borrow--before they got in trouble. The timing of it is affected by recession, high interest rates, and all the rest. But I think it's patently obvious that Mexico was going to borrow all it could borrow and all the banks were going to give them and at some point that was going to come to an end. And it was going to be a crisis situation. I think one can say that about most of these other countries. So we may be talking about the timing, but we are not talking about the essence of the matter in that many of these countries, as are companies at home and banking practices at home, are on an unsustainable course. We can't have a banking system that's totally loaned up to Mexico, Brazil, Venezuela, Argentina and Yugoslavia, but that's the direction they were going in. And some day that had to stop.

MS. TEETERS. Will these containment efforts be done in cooperation with the BIS the way Mexico was?

CHAIRMAN VOLCKER. Yes, the current ones are under discussion with the BIS but there is the inherent management difficulty of these problems. There are very substantive economic problems and, underneath that, social problems and political problems. But from the management standpoint, the difficulty is that there are so many actors. Mexico is the extreme case, but it's only a more extreme example of reality. In Mexico, we are dealing with 1,100 banks or something like that. When you're dealing with that many banks around the world, not just all over the United States but all over the world --and I mean banks you've never heard the name of in [Saudi] Arabia or the Far East or wherever--getting all those banks to sit in the canoe together is a little difficult. The same problem exists when dealing with the BIS or in any cooperative international effort. There are a lot of actors. They don't all understand the problem in the same degree and they all see a little different self-interest in the situation. I think almost all the central banks recognize some common interest in seeing an overall solution to the problem, but they have a lot of individual interests, too, and getting them all to negotiate together is difficult. Everybody wants all the countries in; that's the tradition. And we get into this ridiculous situation where a country that is putting in \$12-1/2 million has the same voice as the United States does. That's a bit of an exaggeration, but there is that kind of problem. They are all dealing with their own institutional structure. No central bank wants to touch these situations in the sense of a traditional central banking operation. They all would take the same attitude that we probably would take: It's a governmental problem. And some of them have institutions to do it and some don't. In virtually every case the central bank has more flexibility in the short run than the government; some governments have none. Some central banks may not have any. We have this kind of problem, of course. The U.S. government itself is like dealing with four different countries! But you multiply that and the difficulty becomes geometric, I guess, even when we're only dealing with 10 or 12 countries. It's obviously important to get not just a facade but the reality of some international cooperation in these things--not just because of the money, which is significant, but because of the general

feeling of solidarity, a common problem, a common approach, and all the rest. And the banks, of course, are distributed among all these countries, too, including some countries that are not involved, and we need the support of the central banks in dealing with their own banks.

MR. WALLICH. I think a fairly persuasive way of answering a question about how all those countries are going to pay back all the money is to say that basically these countries--and I'm speaking not of the East bloc--are viable. They can produce enough to take care of their needs. They may go through a difficult time, but it's a question of the policies that they pursue and, therefore, how they can be influenced by the IMF rather than whether they can. It is possible for them to meet their obligations.

CHAIRMAN VOLCKER. I agree with that; that's another way of saying the situation is manageable. But they all do have very heavy debt burdens. And it gets into political questions as well as economic questions at some point. The country may say "Is it worthwhile to meet them?" whether they can or cannot theoretically. [The problem] is exponential for some of them; they have gotten so deeply into debt. But, of course, in that sense, there is no question that lower interest rates, to the extent that is reflected in their borrowing, are very important. For a country like Mexico or Brazil their debt service--not their total debt service but their external interest payments for a year--are \$10 billion plus.

MR. TRUMAN. \$12 billion.

VICE CHAIRMAN SOLOMON. \$12 billion.

CHAIRMAN VOLCKER. And their exports are \$20 billion.

MR. BOEHNE. I have a question. You made the point earlier that even with the drop in interest rates we've seen that very little has trickled down to the real problem cases because of the tiering on quality considerations. Just suppose that it were the view of the Committee that an effort ought to be made to have a significant drop in rates. In your judgment, how much can we realistically expect that it would trickle down to some of these countries who really need this kind of relief, in light of the experience we've had in recent months?

CHAIRMAN VOLCKER. I would not propose reducing interest rates simply as a method of getting their interest burden down. It's a by-product there.

MR. BOEHNE. I understand that. I was just asking--using that as a vehicle.

CHAIRMAN VOLCKER. Well, I don't know that I can give you an adequate answer. I suppose the answer must be that it's going to be that much less than it would otherwise be.

VICE CHAIRMAN SOLOMON. I think the indirect effect on other industrialized countries' exchange rates and their ability to lower their interest rates, and the reversing if possible of the decline in the real volume of world trade that is going on, would probably have a bigger impact on the exports of, say, Mexico and Argentina and Brazil

than the direct reduction in the interest rate burden unless that lower interest rate prevails over six months or a year.

CHAIRMAN VOLCKER. I think the more important thing would certainly be a sense that there is at least enough money to lend here, given the bank liquidity incentive that they don't have now.

MR. GRAMLEY. Isn't the more basic problem that, in order for all of these countries around the world who have severe difficulty servicing their debts to find a way out, we simply can't rely on internal adjustments within those countries to do it. We have to have some world economic expansion. That's really a necessary condition for finding a way out of this whole problem.

CHAIRMAN VOLCKER. Well, I'm not disagreeing with the thrust of what you're saying. That is very important in setting the climate of the whole thing. But I don't think one can honestly say that some of these countries [around which] you could build a dike, are totally dependent on world economic conditions. I think of Yugoslavia or Argentina in particular, where the balance of payments is not in that bad shape to start with. Wheat is a big export in Argentina; that's not, I think, terribly sensitive to world economic conditions. I don't mean to detract from your point about a climate of expansion; particularly for a country like Brazil, it's critically important. But I don't think one can argue that we can't deal with a lot of these individual situations without an absolute necessity of having strong world economic expansion, although it obviously may [help].

MR. GRAMLEY. No, I wasn't talking about strong [world expansion], and I would agree with your point on individual countries. But it's no longer a question of just one individual country and what it does to get its problem solved. It is how all of them together are going to get out that I think requires some degree of economic expansion.

CHAIRMAN VOLCKER. I don't disagree with your basic comment.

MR. PARTEE. One might say the same thing domestically.

MR. GRAMLEY. Indeed. I think growth of the U.S. economy and of the world economy is a necessary but not sufficient condition to get us out of this severe difficulty we find ourselves in.

CHAIRMAN VOLCKER. On a global basis I don't disagree with you.

MR. WALLICH. I'm sorry. I feel like turning it around and saying it is a sufficient but not absolutely necessary condition. We can find equilibrium at the level of some degree of recession.

VICE CHAIRMAN SOLOMON. Well, you're also assuming that we can have a stable level of recession in the world.

MR. WALLICH. That is true. [The world economy] doesn't have to keep going down all the time.

MS. TEETERS. The political implications of that, Henry, in some of these other countries may be much more severe than they are

here. Put a country into a situation of restraint in order to correct its external debts and I think there is the potential for political upheaval.

MR. GUFFEY. Just a related question: Has our governmental posture with respect to intervention in foreign exchange markets changed at all? I noticed we did some purchases yesterday, as Sam reported.

CHAIRMAN VOLCKER. It's a nice semantic question, I guess, of whether the attitude has changed or whether the circumstances have changed. We are certainly intervening.

MR. FORD. Any pressures?

MR. GUFFEY. Not in any size [unintelligible].

CHAIRMAN VOLCKER. Not aggressively, no. We have this not terribly aggressive [unintelligible]. But I think the attitude to begin with is that there is a concern about this repetitive appreciation of the dollar and the dollar reaching levels that seem--

SPEAKER(?). Overdone.

CHAIRMAN VOLCKER. --unusual, overdone, or whatever the right word is. So, there is a more sympathetic climate. There is no great feeling, which I share, that this [intervention] is going to revolutionize the world in and of itself, by any means. But that--

MR. GUFFEY. That together with some lower interest rates may help.

CHAIRMAN VOLCKER. And at the very minimum that at least reduces the [tensions] in international relations at a time when we don't need any more.

VICE CHAIRMAN SOLOMON. The loss of U.S. exports due to an uncompetitive exchange rate, as best as one can make rough estimates, has been estimated in work I've seen as the equivalent of 2 percent of our GNP in real terms. I don't know what the staff here has.

MR. GUFFEY. Well, my question is whether or not there is a recognition by this government of that fact. And I assume the answer is, to a greater extent, yes.

CHAIRMAN VOLCKER. Yes, but I don't want to suggest that there is great eagerness to intervene. It is a reluctant willingness.

VICE CHAIRMAN SOLOMON. There was a major surge in the dollar yesterday. To answer your question: I don't think there's any willingness in this government to try to get the exchange rate value down in terms of levels. Given Paul's talks with the Secretary [of the Treasury], there may be a tad greater willingness to be in the market on days when there are surges but not a [willingness to] sustain the effort, I don't think, to get the level down.

CHAIRMAN VOLCKER. Not yet.

MR. WALLICH. Well, it's very doubtful that we can change the [exchange rate] level substantially unless there are policies that support it.

CHAIRMAN VOLCKER. I'm afraid that this [discussion] is getting a little ahead of us in some sense. I don't know whether there are any policies that support it now. There's something to Delors' statement that whatever happens, people want to go into dollars. In the long run obviously one can change that, but whether or how changeable it is in the short run [involves] some fairly basic premises. Germany may not be able to have a stable government because it is going to get polarized politically or the French may not be able to manage their internal situation or whatever other concerns there are in the exchange markets may change rapidly but are not amenable to obvious kinds of policy measures.

MR. WALLICH. One would think that the market would observe the outlook for [some period] to come and tumble to the implications of that after a while.

VICE CHAIRMAN SOLOMON. I just came back from Europe. I am struck by the degree of malaise and of nervousness there--fears of all kind--and the willingness of players to move enormous sums of money to Switzerland and the United States on gut instinct that things are just going wrong in Europe and that the future just doesn't look good for Europe. And, of course, this was happening even in Japan where the statistics look better. There is a lot of money going out of Japan. And the exchange rate now is ridiculous; it's 270 yen for the dollar.

MR. MORRIS. Well, I find the same kind of attitude among U.S. businessmen.

VICE CHAIRMAN SOLOMON. Yes, that is pushing the money out [unintelligible] the world.

MR. MORRIS. No, no.

VICE CHAIRMAN SOLOMON. All right.

MR. MORRIS. I am seeing an attitude that I have never seen before, not even in the depths of the 1974-75 recession. There is a feeling of apprehension, a vague apprehension that maybe things are going to get out of hand. And it's leading businessmen to take a very defensive posture. I talked to the head of a quite successful company that is being cushioned by a big increase in defense contracts. But the firm's domestic business is off, and he said--and I thought this was a rather striking statement--that the objective of his company was to generate cash. If that kind of thinking is very widespread--

CHAIRMAN VOLCKER. There's no question that that thinking is widespread. Somebody was telling me the other day, a member of an investment banking firm, that he had visited a number of companies and was struck by one fact. These companies were in various businesses. Obviously, everybody is affected by the business [situation] to a greater or lesser degree; these happened to be profitable companies. And at company after company, they were all building up cash liquidity. He was just amazed at the size of their cash balances.

MR. MORRIS. So we shouldn't be surprised if liquid assets have grown relative to nominal GNP at a rate that is out of line with past experience.

CHAIRMAN VOLCKER. My mental image of the business world is that those that are profitable are sitting on cash. Those that are not profitable are being squeezed.

MR. KEEHN. But even with the profitable ones, the level of malaise is rising very dramatically. So, I sense that with the passage of time--

CHAIRMAN VOLCKER. This isn't a comment that they are not experiencing malaise; their sitting on cash is an indication of a malaise.

MR. PARTEE. There is a sense of pull-backs, though. Do you, Si and Frank, get the sense that they are pulling back on their spending plans in order to generate this cash?

MR. MORRIS. Absolutely.

MR. BALLE. Yes.

SPEAKER(?). Universally.

MR. KEEHN. At Caterpillar, for example, they are not [unintelligible], but they are being particularly hard hit. Their sales [in the third quarter] and their estimated sales in the fourth quarter of this year will be 50 percent under the sales for the third quarter of last year. That's a massive decrease. They went back through their records and the last time that they had a decrease was in '29 and in '30. And then they had their first loss year-end '32. They're going to have another loss year this year, and they are at the end of their string.

CHAIRMAN VOLCKER. Of course, the discouraging thing is that their workers are out on strike. I don't know what they're asking for, but--

MR. KEEHN. Yes, but they are not posturing for negotiations. Their comments are based on their--

MR. MARTIN. The point is the militancy in the unions despite these realities.

MR. KEEHN. Yes, the union is basing its position on '81 results, which were pretty good comparatively, and they are not being--

MR. PARTEE. That strike might run a long time.

MR. KEEHN. Also, Caterpillar is being killed by the yen-dollar rate. [A Japanese company] has just taken their ears off.

MR. MORRIS. We're seeing in New England highly successful, very rapidly growing companies such as Digital Equipment being hit. They have had traditionally a "no layoff" policy; so they announced

that in order to substitute for the cash flow improvement of a layoff they were going to have a wage freeze for 3 months. This really hit Boston. If Digital Equipment is in trouble, then the issue is: Who is doing well?

CHAIRMAN VOLCKER. I ran into a fellow the other day at dinner--unfortunately I think this is an atypical experience of a major multi-national company with a foreign base with a big U.S. operation--and asked him how things were going and what his inflationary expectations were and what else was happening. This guy is obviously quite conservative, but he said he had just come from a meeting of his American managers and the purpose of the meeting at least in part was to decide upon what he called "merit increases" next year. It sounds like the Federal Reserve! He went around to the managers and asked them what they thought was appropriate for merit increases this year. They all gave him figures of 10 to 12 percent, and according to him he started off by saying: "Are you laying off workers?" And all the managers said "yes," they were laying employees off. He suggested to them that merit increases this year should average 3 percent so long as they were laying off workers. I said to him: "Managers don't like to do that because it may affect their own salary scales. What did you do about that?" He said: "Oh, I forgot to tell you! I told them they were getting zero." Unfortunately he is a Frenchman, not an American. I don't know how typical that is.

VICE CHAIRMAN SOLOMON. He didn't want to [unintelligible]. I was shocked the other day when the head of one of the big insurance companies was in for lunch and said his company is giving wage increases that average about 10 percent.

CHAIRMAN VOLCKER. Did you give him a lecture?

VICE CHAIRMAN SOLOMON. I did. I gave him a much stronger lecture than probably was politic. He apologized but gave me the argument that it's a catch-up because their workers' wages had fallen behind. I don't know how true that is.

CHAIRMAN VOLCKER. Catch-up for the executives right now.

MR. PARTEE. Well, if they're not doing it in Boston, the insurance business will shift to Boston from New York.

VICE CHAIRMAN SOLOMON. Maybe the new form of a viable incomes policy, Chuck, is to try to put constraints only on the [pay of] top executives.

CHAIRMAN VOLCKER. I think that's right.

VICE CHAIRMAN SOLOMON. If you do that, they'll see that nobody else--

MS. TEETERS. Like the Federal Reserve.

CHAIRMAN VOLCKER. I think there's something to that. Maybe we'll add that to our directive today. [Unintelligible] salary surveys.

MR. BOEHNE. I had a similar group in to our Bank--people from Philadelphia or nearby--and their figure wasn't 10 percent but 8 percent.

CHAIRMAN VOLCKER. I'm surprised it's so common in the financial world; they give the same kind of argument. Well, what other general comments are there?

MR. CORRIGAN. With all this understandable talk about Mexico and all the rest, you didn't say a word about small banks at the other end of the spectrum. But I think it's relevant to this general conversation. We started about four or five months ago carefully monitoring the small banks in the Ninth District. The monitoring takes several forms, including literally getting an instant picture of an examination the minute it is completed, and we are compiling lists of one-bank holding companies [in difficulty]. The criteria that we used was that if a one-bank holding company will consume at least 75 percent of the bank's 1981 earnings to meet its debt service requirements in 1982, it is on the list. It's really striking, to put it mildly, to see the number of institutions that fall into that category in the case of the one-bank holding companies. The number is substantial, and that of course assumes that they have the equivalent of 1981 earnings to work with in the future to meet these debt service requirements at the holding company level. With the problem loans and the loan losses and this new instrument and all the rest, one could at least question the proposition that they're going to be able to retain those earnings. Similarly, in the case of small banks, at least the ones that seem to be scattered around the Ninth District, it's not uncommon to see that the classified loans in the recent examination versus the last one are up anywhere from 200 to 500 percent. As of yet most of that increase is in the commercial sector and the Main Street retailers. There is not yet a major increase in the problem loans reflecting the agricultural sector itself. But one has to wonder how long that can last, given what is going on right now.

The other thing that I would observe in terms of these small and medium size banks that I think is directly relevant to what was said earlier is that it is rather astonishing to me to see the extent to which these regional and small institutions have money placed in the London market. There are very logical and natural reasons why they should do that, and certainly we don't want to chase that money out of there right now. Nevertheless, it is a form of exposure even in these banking organizations that ties in with this international situation and goes in many cases well beyond our general perceptions.

CHAIRMAN VOLCKER. This situation is exposing, in my view, the structural weaknesses in the banking world of which these motherless banks are one example. But this kind of thing is another that gets these small banks in that kind of a market. The problems in the Eurodollar market to which I alluded are not confined to American banks by any means. North of the border, they have had problems in spades domestically and that has not gone unnoticed in international markets, and one can make the same comments about some banks in other areas.

If we are ready, I think we ought to return to the policy discussion. The staff can distribute this draft text that I have for discussion purposes anyway. I have not read [the directive] probably

literally for years; I don't know whether I've read it since I've been here. But for some reason I got this boilerplate part in front of me, which goes in front of the [operative part of the] directive, and it seems to me singularly inappropriate. It probably always is, but it is more so now. I think this could use a judicious sentence or two, making some allusion to the strains or pressures or whatever in the banking sector these days and to the problems of foreign lending in particular--it needs to be expressed very judiciously--just to indicate that we are someplace in the real world. And I would suggest that it might possibly be left to the Chairman to figure out a sentence or two to stick in there at an appropriate point.

MR. FORD. I beg your pardon? I don't understand where you're going to add a sentence or two.

CHAIRMAN VOLCKER. Well, I'm not quite sure where I would put it.

MS. TEETERS. What are you looking at?

MR. PARTEE. He's talking about the first several paragraphs in the directive.

CHAIRMAN VOLCKER. I'm talking about something called the general paragraphs.

MR. PARTEE. It's probably on the calm side; it's bland.

VICE CHAIRMAN SOLOMON. It's the first paragraph he's talking about.

CHAIRMAN VOLCKER. Well, I'm talking about the first two paragraphs. I think [the additional sentences] would go appropriately either at the bottom of the first page or in the top paragraph on the second page. I'd add just a sentence or two saying that the markets were influenced during this period by concern over international lending--something expressed very calmly, but not ignored entirely.

MR. ROOS. This would mean that we would set no targets for M1?

[Secretary's note: The draft directive wording circulated at Chairman Volcker's request did not include a target for M1.]

CHAIRMAN VOLCKER. You are ahead of us. I'm just referring to this general boilerplate now, which I will cease talking about with the understanding that you may see a new sentence or two in there, if that's acceptable.

MR. MARTIN. I think it's necessary.

MR. PARTEE. Well, even in terms of the facts, there is no reference here to the deterioration in employment, to the rise in insurance claims, or to any of the indicators of weakness. It is covered by "The unemployment rate was unchanged at 9.8 percent."

CHAIRMAN VOLCKER. Yes, I think--

MR. PARTEE. Nonfarm payroll employment dropped a couple hundred thousand.

VICE CHAIRMAN SOLOMON. We don't get the new [unemployment] number until Friday.

MR. PARTEE. And it's not going to be 9.8 percent.

CHAIRMAN VOLCKER. No, but we can put in something like: "The unemployment rate in August was unchanged at 9.8 percent but there were some indications of a deteriorating labor market situation."

MR. PARTEE. Yes, something like that.

MR. MARTIN. We have the initial claims.

MR. PARTEE. We know that employment went down in the nonfarm series.

CHAIRMAN VOLCKER. We can do a little editing of the whole thing. Everybody has a copy of this now, except for me I guess. I will open this for a general discussion when you're ready.

MR. FORD. I'd like to start with a technical question. If we put in this 8-1/2 to 9-1/2 percent [range for M2 and M3], where does that put the broader aggregates by the end of the year? I didn't see that projected.

MR. AXILROD. If M2 were 9-1/2 percent, for the year growth would be about 9-3/4 percent; if it were 8-1/2 percent, growth for the year would be about 9-1/2 percent. M3 looks as if it's going to be around--

CHAIRMAN VOLCKER. That's for the fourth quarter to the fourth quarter?

MR. AXILROD. Yes, that's for the fourth quarter to the fourth quarter. I don't have the year-over-year figure.

MR. BOEHNE. Does the Humphrey-Hawkins Act require any notification to congressional committees on such a change or do you simply have to explain it when you testify in February?

CHAIRMAN VOLCKER. I don't know what the Act particularly requires, but if we change the annual target rather specifically, then I think we would report it. I would not interpret this that way. We said we would run around the top or were willing to run above for a while, and this is willing to run above for a while.

MR. PARTEE. It does, however, involve the question of market interpretation of numbers that are going to be running quite high.

MR. BOEHNE. Well, aside from whether this is a good idea or a bad idea, when this directive is made public I think it is going to be viewed as a substantial change in the way monetary policy is being directed.

MR. MARTIN. A substantial temporary change or a substantial change?

VICE CHAIRMAN SOLOMON. A change to reverse.

MR. BOEHNE. No, I wouldn't say it's a reverse, but it is a substantial change. And the time horizon on the financial markets is such that whether it's a change for three months or two or three years at this point--

MR. PARTEE. It won't be until Christmas time when it is revealed to the public.

MR. BOEHNE. No, it will be revealed at the end of November.

CHAIRMAN VOLCKER. I assume there will be some occasion, probably fairly soon, for describing in general terms what we are doing.

MR. FORD. Before it's published?

CHAIRMAN VOLCKER. Certainly before it's published.

MR. FORD. The market will start to see the results of this.

CHAIRMAN VOLCKER. Long before it's published.

MR. ROOS. Mr. Chairman, why would this be preferable to continuing to specify the target for M1 but putting in a disclaimer or at least the warning that M1 might behave in an unusual manner and if that occurs, we would reserve the privilege of adjusting it accordingly? I'd prefer that for the sake of continuity. If we ignore M1 totally, despite the explanations that are given, I think people could read sinister purposes in it; it would make base drift pale in comparison to dropping one of our important targets totally. I'd rather see us say that we're doing this but it is somewhat tentative due to what might happen on these new instruments. To ignore M1 would really run the flag up that in some people's perception we are making a basic change. There is still a significant amount of debate between Frank and me and others; some of us think that M1 is not as unreliable as others do. I just think to drop it would look as though we've really retreated in that regard.

CHAIRMAN VOLCKER. Oh, I don't think there should be any implication here of more than a one-quarter problem. It may be more than that, but this isn't meant to carry any implication of that. But I would like to separate the substance from the presentation. In substance what I feel very strongly about is that it would be a mistake to have any kind of directive that would drive us deliberately or otherwise to higher interest rates. I think it was a mistake to have that kind of directive last time. I think it would be more than a mistake this time, and it's not going to be acceptable to me. Beyond that it is desirable to get some easing in this situation.

MR. ROOS. Well, doesn't alternative B for M1 as shown in the Bluebook imply roughly that the fed funds rate would remain in the 8 to 12 percent range? In other words, how would this avoid--

CHAIRMAN VOLCKER. Let me clarify my comment. A 12 percent federal funds rate currently is totally unacceptable to me.

MR. MARTIN. That's the top of the range for "B."

VICE CHAIRMAN SOLOMON. I thought you were going to say 11.

CHAIRMAN VOLCKER. Eleven percent is also unacceptable to me.

MR. PARTEE. But even so, I think you have to recognize, Larry, that the staff hasn't factored in the possibility--

CHAIRMAN VOLCKER. The central point is that whatever the [monetary variable] is that we are operating on, it is a staff guess, which may or may not be right. I'm saying that I am not willing to stake my life, so to speak, on that guess being right. The risks are too great.

MR. ROOS. How would this give you greater assurance, Mr. Chairman, that rates could not [rise]? For example, if some people felt through some complicated thinking that ignoring M1 was an expansionary or inflationary act, how would this wording assure that the fed funds rate would not increase just as substantially as setting a "B" target for M1, for example, and saying it might be right or wrong depending on how people respond to--

CHAIRMAN VOLCKER. I don't want to respond to the particular wording at this point. Obviously, we have to get into that. But what this is meant to convey is an operational approach that modestly moves the federal funds rate down. Whether it involves a discount rate change or not is something the Board is going to have to decide. But that is the tenor meant to be given here, rather straightforwardly, I might say.

MS. HORN. Mr. Chairman, this indicates your dissatisfaction with the way we handled it last time--that is, to have a target that was sensitive to--

CHAIRMAN VOLCKER. Yes, I am totally dissatisfied. What we did last time was unacceptable to me. I just want to make that plain. I think we made a mistake last time. I think we would not have so difficult a problem psychologically this time if we had not done what we did last time. It wasn't that big a mistake in some sense. But it's unfortunate that we ended up at this meeting with the federal funds rate and private rates about 1 percentage point higher than they were at the time of the last meeting because we had a high M1 figure in September. That was the only reason it happened.

MR. WALLICH. There was still some hope then that we could get within the target ranges for the year. This time it looks very doubtful that without a self-defeating effort we would get M1 within its target range.

CHAIRMAN VOLCKER. I'm not going to cry over last month's decision. All I'm saying is, looking ahead, that I don't want to end up a month from now with a 12 percent federal funds rate. I don't even want to end up with an 11 percent federal funds rate, based upon

everything I know about the market situation, the national situation, and the world situation.

MR. FORD. What you are saying quite plainly, if I hear you correctly, is that you think rates are too high now and you don't want even a tiny increase from the present rate of 10-1/4 percent on the fed funds rate. You don't want it averaging 11 percent.

CHAIRMAN VOLCKER. I surely do not.

MR. FORD. You want literally to cap interest rates where they are now, or better yet, to drive them down.

MR. PARTEE. To a 10 percent top?

CHAIRMAN VOLCKER. Drive them down? I'd like to see them a little easier, yes, if we can get by with that.

MR. FORD. I want to say, respectfully, that I'm flatly opposed to this. If we were to do this, especially now, I think it will consolidate any adverse opinions against us that are already out there about our motives for doing this at this particular time. At a breakfast meeting with the leading bankers in Atlanta 72 hours or so ago, at which Mayor Young was the guest of honor speaking to us, he volunteered in front of all the bankers in the room a comment--we were discussing the city's problems--that he was instructing his staff to issue some municipal bonds immediately in order to do a certain project in the city of Atlanta. I said: "What's the rush about this, Andy?" And he said: "You guys are going to change policy right after election day and now is the time to do it." This was Andrew Young. I've heard from more people than I care to describe to you comments questioning our integrity and our motives in the context of an election campaign.

MR. MORRIS. Yes, but Bill, we've got to do what we think is best for the economy and let those comments go.

MR. FORD. First of all, I'm not convinced that pegging interest rates at today's level or trying to push them down is best for the economy. Secondly, changing policy now in this context and saying overtly, as you said it, that we should hold interest rates where they are and try to push them down is going to make us extremely vulnerable to charges--unfounded I feel, because I don't question the motives of the people here who would vote for this. I think the repercussions of this are going to be terrible.

CHAIRMAN VOLCKER. That's an enormous concession.

MR. FORD. People are going to come down all over us.

MR. PARTEE. You know, Bill, I would put the emphasis a little differently here. Maybe the wording needs to be changed some; I wouldn't put it in terms of moving interest rates down. I think the problem is that M1 could do almost anything in the period to come. In fact, it already has done almost anything. In August and September we had a 35 percent rate of increase in NOW accounts. And that's not associated with the--

MR. FORD. I'm not trying to defend M1.

MR. PARTEE. Our problem, though, is not just that the number might be 1/2 percent too high; it might be way too high.

CHAIRMAN VOLCKER. We may have a \$10 billion increase in M1 in the first week in October.

MR. PARTEE. So, I support the idea of getting off M1 at this particular time. Perhaps there is more emphasis on it than there ought to be here. It really doesn't come through as strongly when one reads this [draft directive language] that we're trying to move interest rates down as when the Chairman talks.

MR. FORD. I'm reacting to what the Chairman is telling us, which is I think commendably honest, in that he is saying he really doesn't want to see interest rates raised. That's what I'm reacting to regardless of what it says here. And I think that will be apparent in the marketplace well before this is published and our integrity will be brought into question if we proceed along that line.

CHAIRMAN VOLCKER. Your vision of our integrity.

MR. FORD. My vision, yes.

MR. ROOS. Even if this were done, people will still measure M1 in their closets and under their beds and so forth in order to--

CHAIRMAN VOLCKER. We haven't suggested that we won't publish the number, Larry.

MR. ROOS. If, in order to keep interest rates artificially down or otherwise down, we have to inflate M1, the minute that becomes apparent we've lost the ballgame and we will have just as high--

MR. PARTEE. We're not inflating it. I think you misunderstand. These are structural shifts that are occurring that possibly are going to produce a much higher M1 for a time. And the question is: Should we resist it, which inevitably would mean higher rates, or should we recognize that there has been a structural shift? Would we be better off not looking at it so much for a little while?

MR. ROOS. Well, how does this differ, Chuck, from our experience with NOW accounts? I remember when everybody got all jumpy about NOW accounts.

MR. PARTEE. Well, I think NOW accounts are causing us an awful lot of trouble.

CHAIRMAN VOLCKER. That's right. I think we probably have not adjusted for NOW accounts correctly. The total growth in M1, almost, has been in NOW accounts this year. To what extent does that reflect real money? Who knows?

MR. WALLICH. I think we have to detach temporarily from M1 because it has become so uncertain both because of the all savers certificates bulge and the new instrument coming along. Even if that bulge were not to occur, we would have the new instrument and we

simply don't know [its likely effect]; all we know is that it could be very major. We can put more stress on the evidence of rising liquidity preference, and that gives us the opportunity to target on M2 with a proviso that if it exceeds [our expectations], we'll take this as evidence of an increase in liquidity preference and not follow up with interest rates. That seems to me perfectly defensible substantively and still within the formal framework of our policy.

MR. MARTIN. I'd like to turn the integrity argument around and argue for the second thoughts of the commentators and the analysts of our policy. If we move in this direction of minimizing or eliminating M1 temporarily--and I'm not ready to throw it overboard--and we pursue a policy that deliberately brings down interest rates, the first thoughts will be that we caved in, the election is coming, and here they go again. The second thoughts, I think, will be different. The second thoughts--which may be based on some analysis rather than on a knee-jerk reaction to what we do--would be that the integrity of the Federal Reserve is that they pursued policies with an eye to the growth of the economy, to the liquidity of the domestic and international system, and indeed, they did this despite the political consequences that occurred in the short run. They maintained their integrity as a central bank. I think that's a very different conclusion from the second thoughts on the other side which might be that the Federal Reserve should have brought interest rates down but the politics of the situation were such that they couldn't.

MR. ROOS. Well, who has been able to demonstrate any reliable relationship between the growth of the broader aggregates and economic activity? M2 was growing way above its range last year, I think, or the year before and the economy was sick.

CHAIRMAN VOLCKER. Milton Friedman wrote a big book on the subject.

MR. ROOS. I can't read, but--

MR. PARTEE. It is certainly true that velocity has been increasing for M2 but not as much as for M1.

MR. ROOS. Do you think the evidence shows that M2 is as good a predictor as M1?

MR. PARTEE. No, as M1 used to be.

MR. MARTIN. But this is short run.

CHAIRMAN VOLCKER. It depends upon which analyst looks at it.

MR. WALLICH. We have made that switch, though not quite as explicitly; nevertheless, we've made it from time to time. We have placed more weight on M2 at times.

MS. HORN. It seems to me that the [appropriate] timing might be the next meeting. In terms of setting quarterly targets, we might look at an M1 target and tolerate above target performance [now], with all saver certificates and so forth coming due. And then at the next meeting if we are looking at an instrument that is very unpredictable in terms of what it's going to do to M1--having set the quarterly

targets at this meeting--we could say that for some weeks during this part of the quarter we're going to have to look more heavily at M2.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Let me first of all say that I agree with the proposal that rates shouldn't go higher, that they should be in some way capped from this point forward for some period of time. Indeed, they should be urged to come down, not precipitously but in a modest way, over the quarter. But having said that, I look at the language that you have put before us and am trying to equate that with what the staff has in the Bluebook. It seems to me that the 8-1/2 to 9-1/2 percent range for M2--or at least the "A" proposal [of 9-1/2 percent]--and then the caveat in the last sentence would suggest that we will tolerate growth above that given some perception of liquidity needs or otherwise. I'm suggesting that in my view at least--and I will ask a question of Steve in a moment--that probably will result in rates coming down immediately following this meeting, depending upon how we build the path. And I would hesitate to associate myself with those who would want a fast drop in rates. If that's not a correct assessment, I would like to ask Steve: How would you build your path for the reserve objective based upon this kind of language? And what would you expect to happen within the next two weeks? That is rather a critical period for us.

MR. AXILROD. Well, with this kind of language, I would take M2 growth at somewhere around 9 or 9-1/2 percent or whatever the Committee sets and project the M1 that is roughly consistent with that, which by the Bluebook [estimates] would be on the order of 5 percent, forgetting these special circumstances. So, if we assume substantial increases in the first week of October and take the borrowing that the Committee says to take--

MR. GUFFEY. Well, it is important where we're going to set the initial borrowing level; that is critical to what happens to interest rates in the next two weeks.

MR. AXILROD. Well, that would be the Committee's decision. But consistent with some easing, one would assume that the initial borrowing assumption would be down [to] about \$200 million, moving back toward where it was at the last meeting and probably a little lower because that initial borrowing assumption is really pushing to move the funds rate back above the discount rate. So, in part depending on the sense of what the Committee wants, it may be below that level.

MR. GUFFEY. I guess that sort of makes my point. I'm interested in the rates coming down and not going up, but I would object to seeing a precipitous drop built upon this kind of path. It occurs to me that we may have fed funds trading in the 8-1/2 to 9 percent range rather quickly if we're going to set that kind of initial borrowing level and these kinds of targets.

MR. AXILROD. Well, at the 10 percent discount rate, if you had a borrowing of \$200 million, just to take an example--I'm not saying it should be at that level--I would not expect the funds rate to get as low as that. It would be more like 10 percent or a shade under. Peter may have another view.

MR. STERNLIGHT. I would agree with that.

CHAIRMAN VOLCKER. I might remind you of the probable setting in the next few days. Indications are that we will have a very sharp decline in the money supply for the last figure that means anything. And we probably will have an unemployment rate well over 10 percent published this week.

MR. ROOS. You said a decline in the money supply?

SPEAKER(?). In the week.

MR. GUFFEY. Those money numbers are not going to last except for the one week?

CHAIRMAN VOLCKER. No, but that is the last number that will have no distortion from all savers certificates in it.

MR. PARTEE. Steve, in setting the path now, wouldn't you regard a change or a shift in the relationship between M1 and M2 that you could identify as coming in a week or two or three sort of as a multiplier adjustment?

MR. AXILROD. Yes, if the Committee were adopting this sort of directive, those variations in M1 would all tend to be allowed for as multiplier adjustments.

MR. PARTEE. Yes.

MR. AXILROD. That would be the logic.

MR. PARTEE. So, it would depend on the setting of the initial borrowing level, but it might not in fact result in a big decline in borrowing. It would depend on their relationship as to how many nonborrowed reserves you provide.

MR. GUFFEY. But we are at a borrowing level of about \$500 or \$600 million.

MR. AXILROD. That's right.

MR. GUFFEY. And if you're going to build the path on \$200 million--

MR. AXILROD. No, I was using that as an example.

CHAIRMAN VOLCKER. We have to decide what to build the path on. Mr. Black.

MR. BLACK. Mr. Chairman, we are all in agreement on only one thing, I think: that we would like to see interest rates come down. I would like to raise the question of whether it might not be reasonable to suppose that a little resistance now to the strength we've had in the aggregates might not save us from a bigger move later on. We have engineered a pretty sharp reduction, almost 400 basis points, in the federal funds rate from its level back in July. Historically when we've had that [kind of decline], we've had an explosion of the aggregates. And if that does happen--though, of

course, all of us hope it doesn't--we may find ourselves in a position where we are going to have to move against that. We have just finished a discussion of countries that have delayed taking wise steps and they have gotten to the point where they have to take very drastic steps. I have a whole collection of quotations from members of the Board of Governors who have stated very eloquently that this is the point at which we've lost it, usually, in the past.

CHAIRMAN VOLCKER. You won't find that quotation from me. There was a quotation to that effect cited at this meeting before, which I must correct for the record. I have said upon a number of occasions that the way we have lost this game is by staying with an expansionary policy too long during a recovery period. That statement also says the mistakes were not made at the bottom of a recession.

MR. BLACK. Okay. Well, it may be a delay of timing, but I'm not going to quarrel with you.

CHAIRMAN VOLCKER. It's rather significant.

MR. BLACK. My feeling is that we can't pay too much attention to the aggregates right now but that we ought to nudge the federal funds rate [up] a little as a way of showing that we're concerned about that. I don't expect that to have much effect. But I think it could keep us from having to move [rates] a whole lot later on, which really would worry me a great deal. But maybe I am dead wrong on this. It may be that the aggregates will come into line very beautifully and we will have no worries. That would be the best of all possible worlds. But that's not what I think is the most likely case. So, I'm opposed to what you have suggested here, although I understand full well how a reasonable person could be expected to--

MR. RICE. Do I understand that you want to nudge the funds rate up?

MR. BLACK. A little. I wanted to do that between the last meeting and this meeting.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, I think the period ahead is one in which we have ample reasons not to target on M1. My own judgment, however, is that the problem we face is much more fundamental than whether we target on M1 now because of all savers certificates and the new DIDC regulations that will come out as mandated by legislation. I think the world economy is literally starved for liquidity. And I'd liken this [situation] to the dietary analogy that suggests. Fat people have good reasons to go on diets. Diets are very good things unless they get out of hand. They sometimes do. And when they get out of hand, the patient becomes anorexic and that's often a fatal disease. If it's not fatal, it's often a life-long disease. I am worried that we have gone on long enough starving the world economy for liquidity and that we may be at a point of impending anorexia.

Larry Roos mentioned earlier that he thought real interest rates were getting down toward normal levels. I must say I don't know how he reaches that conclusion. The three-month commercial paper rate is 10 percent, and my perception is that the three-month expected

inflation rate would be somewhere in the neighborhood of 4 to 5 percent. So that makes the cost of issuing commercial paper 4 to 6 percent in real terms. Private corporate bond rates for AAA issues are 13-1/2 percent and are much higher for lower-graded issues. I understand that most businesses now have a 5-to-10 year inflation expectation of something like 6 to 7 percent. So that makes 6 to 7 percent the long-term real interest rate. That simply isn't normal. It is not even close to being normal. There are all kinds of reasons for that, and I think fiscal policy is one of them. But if you look at what has been happening to the real money stock recently, I think you will find the answer largely in a very, very tight monetary policy. And it started before October 1979; it started earlier. In 1979, we had an increase in the nominal money stock of 7-1/2 percent; prices went up above 12 percent. In 1980, nominal money went up 7-1/2 percent; prices again went up around 11 to 12 percent. In 1981, money growth was 5 percent against a price increase of 10 percent. This year it will be a little closer probably. But we've had a very, very substantial drop in the real money stock in this country. It has forced the kinds of policies other countries are following. So, I think we have to do what is necessary to provide the liquidity that will permit this economy to grow and will permit the world economy to grow. I think we're right in going in the direction we are at this particular meeting of unhinging [policy] from what is likely to happen to M1 in the months ahead. I am wondering as I look at this directive if the last two sentences are necessary. This leaves the directive focused on expanding bank reserves as necessary for an orderly and sustained flow of money and credit and that leads to an expectation about M2 and M3, without these last two sentences about somewhat slower and somewhat [more rapid]--I'm sorry, I think I'm losing my voice.

MR. PARTEE. I think the last sentence particularly raises questions.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, I clearly would fall on the side of the argument that says we don't want an increase in interest rates, even by accident. An increase in interest rates in the current setting, even if it came about by accident, would border almost on being irresponsible at this point. On the other side, I'd like to think that maybe we could orchestrate a moderate and temperate and further gradual reduction in market interest rates. In the current circumstances that inevitably calls into question relationships about the discount rate and our view about what frictional levels of borrowing really are, much as they did back in July when the last reduction of the discount rate took place. But having said that, I would be somewhat uneasy to find ourselves in a situation where we are dealing with an unbridled attempt to force down interest rates as opposed to trying to nudge or orchestrate them in that direction. So, in general, I have no great problem with what is being suggested here. I would just throw out the idea, and I'm not sure how to do it, that one way we might dissipate some of the concern about the longer-run implications of this--or stated the other way, reinforce the view that it is a temporary thing--would be to put a sentence in the directive someplace that makes at least oblique reference to a continuing longer-run commitment to achieve moderate and declining monetary growth, perhaps in the context of the '83 targets or something like

that. It's not easy to do. But it might help deal with this perception problem.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. My views are well known, so I can be very [brief]. I don't think we can get a recovery with interest rates where they are, and I am very disappointed that they went back up since the last meeting. I had hoped that they would go through the 9 to 9-1/2 percent level and maybe go down again. Therefore, I would support anything that is going to bring us a generally lower rate structure and bring mortgage rates and other long-term rates down and gin up the economy not only here but worldwide. So, I'm in favor of this. I don't object to those two last sentences. I think they give the directive a very good flavor by saying that we're going to operate in the interest of liquidity in the economy.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. I would join with Governors Partee and Teeters in the view that the impending recovery is probably not as projected, given today's interest rates. I would call your attention to the rather heroic assumption, in current dollars, of the recovery in residential structures quarter-by-quarter running between plus 24 percent and plus almost 40 percent. Given today's interest rates and today's lack of liquidity in the financial system, I simply don't feel that those are obtainable growth numbers. If that's part of the consumer leading the recovery, it is not likely to occur. Much more important is the weakness in business fixed investment; it is too strong as projected. The first thing corporations have to do is to reliquify themselves; they're going to have to raise \$20 billion or \$40 billion or \$60 billion in a very short period of time. And they're not likely to be able to do that in an economy with the degree of liquidity it has today. It appears that there are not uncertainties anymore but fear out there in the capital markets. Part of it is derived from the international situation but a good deal of it is the awareness of the precarious nature of our own private corporate sector in this country. And I think the need for reliquification extends very obviously to the thrift industry and to the small banking industry as they face the changes that need to be made there. But to get back to business investment, which I think is going to decline more than our projections show, corporations face very low returns on investment after taxes despite the efforts of the Congress to change the depreciation and the cost recovery situation. As we know, the recently enacted tax revenue measure has taken back half of the benefits, plus or minus, in that area. So, we face an extended period of weakness in business investment.

I think the best thing we can do is to bring rates down and help reliquify so that sometime out in 1983 or even 1984 we will have a recovery in the private sector. I would support a temporary moving away from an M1 target. I believe that is consonant with maintaining our integrity as a central bank. We would be making a real mistake if we become too mechanical in the application of a policy in a multi-trillion dollar economy. So, I would like to see this directive, perhaps with the Corrigan codicil adding language pointing toward the reduction in the growth of the money supply over time. I would also like to see a borrowing level of \$200 to \$300 million with a verbal

directive, if you will, that interest rates be brought down, but in a gradual way, echoing a previous comment here. [Unintelligible] that we temporarily target interest rates and that we be overt and candid in our specifications.

MR. ROOS. During that temporary period, may I just inquire whether we would continue to publish weekly M1 figures.

CHAIRMAN VOLCKER. Of course.

MR. MARTIN. Yes, indeed, unless we can get the four-week numbers published one of these days in addition.

MR. ROOS. Pres, what if those weekly figures over this temporary period showed a rather unusual and alarming increase in M1? They would be out there for everyone to see. Do you anticipate that if that were to happen we would be able to move interest rates down? In other words, if the consequence of what we were doing [unintelligible]. The traditional means of bringing short-term interest rates down was to pump money into the economy, and if that was reflected in the weekly figures and they showed a bulge, assuming that everyone around this table wants to see lower interest rates--

MR. MARTIN. Larry, this is not the problem here.

CHAIRMAN VOLCKER. This isn't the problem, I'm afraid. Those figures may show a bulge and it may have nothing to do with pumping money into the economy. It may show a bulge because \$22 billion of all savers certificates are maturing, some of which are temporarily being lodged in M1. Now, what do you do with that figure?

MS. TEETERS. We go out with an announcement telling the public what happened.

MR. MARTIN. We would explain it.

MR. ROOS. Well, I would suspect, and I'd be prepared to place a small wager on it, that the all savers phenomenon will wash itself out within 60 days at the most.

CHAIRMAN VOLCKER. Oh, I agree with that.

MR. PARTEE. Then in 60 days we will have a new instrument.

MR. MARTIN. In the meantime, John Deere fails.

CHAIRMAN VOLCKER. Of course it will wash itself out. That particular phenomenon will wash itself out in less than 60 days.

VICE CHAIRMAN SOLOMON. Less than 60 days?

CHAIRMAN VOLCKER. But I don't know that for sure.

MR. BALLE. Mr. Chairman, since we're on this subject, if I can jump in here for a minute, one proviso I would make in my general support of your proposal is that we breach a second tradition here, if we are going to drop the M1 target temporarily. Normally, is it not

true, Murray, that the minutes of this meeting would not be publicly released until the December FOMC meeting?

MR. ALTMANN. No, November 19th, three days after the November meeting.

MR. BALLEES. After the November meeting. I don't think we can wait that long.

CHAIRMAN VOLCKER. No, I agree with that.

MR. BALLEES. I think we need to get out this information PDQ.

CHAIRMAN VOLCKER. We have to say something if we get a big figure in the first week of October. We have to say that so far as we know that figure is an all savers phenomenon and we're not going to pay any attention to it or to the M1 figures in the immediate future.

MR. BALLEES. Okay, I agree completely. I'm glad to hear that because to do otherwise I think would be very, very risky.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I feel very much that we would be better off if interest rates were lower. The question is: How do we get from here to there? The wisest thing, if we wanted to get there, would be that we shouldn't start from here. That option isn't open to us. We have to get there without sacrificing all that we've created in the last year in terms of credibility and a framework for giving people confidence. So, I think we should still have a money supply directive not, as this looks to me, a money market or interest rate directive. I think we should give up temporarily on M1, which is beset by all the uncertainties of the all savers certificates and the new instrument. That doesn't mean we wouldn't go back to it. Logically, M1 is the best of the aggregates. We should stress liquidity preference more than the alternative directive does by putting a reference to it at the beginning of the last sentence, indicating that there is mounting evidence that exceptional liquidity demands are upon us.

CHAIRMAN VOLCKER. At the beginning of what sentence?

MR. WALLICH. The last sentence. Instead of starting with "Somewhat more rapid," I would say "In the light of mounting evidence that economic and financial uncertainties are continuing to lead to exceptional liquidity demands, somewhat more rapid growth in the broader aggregates would be tolerated." So, we allow for an overshoot of M2, which is the one thing I would suggest that we target.

MR. GRAMLEY. Do we have evidence of that, Henry?

MR. WALLICH. Well, I think there is.

CHAIRMAN VOLCKER. It could be up.

MR. GRAMLEY. Liquidity preference?

MR. WALLICH. It seems clear that velocity, instead of rising as had been expected, is--

MR. GRAMLEY. I thought the staff said that the increase in the quantity of M1 recently is pretty much in line with a movement down the demand function, given the current interest rates, and not a shift in the demand function.

MR. WALLICH. As you look at the behavior of velocity over the year, it does not--

MR. GRAMLEY. That was a good argument last April, but I'm not sure it is now.

CHAIRMAN VOLCKER. Well--

MR. WALLICH. Well, I think it is a defensible argument. I would suggest that we drop the reference in the first sentence of the second paragraph to the expansion of bank reserves and reduced pressures but shape the M2 path in such a way that we would have a gradual decline in interest rates. We would have to formulate the borrowing assumption to make that feasible. I can't do it off the top of my head; I don't know just what that would be. I would make the funds range narrow to reflect the fact that we are backing away from money supply targets. And we could cap it at 10 percent, if that were really necessary. All it would mean is that we would consult, and at times like this we ought to consult more frequently anyway. That's how I would structure the directive.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, I think how one comes out on this depends on whether one wants to take the risks on rules or on the side of discretion. It does seem to me that we have pushed the domestic economy and the financial system and the world economy about as far as we can push them. And this is not business as usual. I think we have to take our chances on the side of discretion, which tells me that at a minimum we cannot have higher rates in these circumstances; and if we can get lower rates, that's fine. I must say, however, that whenever one bets on discretion versus rules, it depends a good bit on who is making the discretionary decisions. I believe this kind of directive puts much more than the usual amount of authority in the hands of the Chairman. And with this particular Chairman, I don't have any problems, given the circumstances. So, because of the situation and because of the person who is going to have to use a good bit of this discretion, I'm supportive of the general approach as proposed in the alternative directive language.

CHAIRMAN VOLCKER. Mr. Balles. I have you on the list, but you have already commented. Or do you have something more?

MR. BALLEs. I have one other question, Paul: Did you intend that this be the entire part of the operational paragraph--that is to say that we would have no mention of a federal funds rate range?

CHAIRMAN VOLCKER. I have an open mind about that. I didn't mean to infer one thing or the other; I don't know whether it's

necessary but I have no problem with it. I do think it has to be a bit lower than we had before if we put it in.

MR. BALLEES. Right. When you are ready to discuss that, I think we ought to get that settled because if we create too many revolutions in one directive, we're surely going to shake up the marketplace.

CHAIRMAN VOLCKER. I don't have any problem with the traditional sentence.

MR. BALLEES. I'm not sure what the better part of wisdom is; but if we stay silent on the federal funds range, that would really be a major break in tradition.

MR. BLACK. Then the issue is whether we're symmetrical around [the current level].

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Given my sense of the general economic scenery, I certainly am in the camp that thinks that we simply must bring rates down. I think we are at a point where we cannot go much longer in the way the economy is currently performing or we're going to see some very serious results emerging. Therefore, I think it's exceptionally important that we move toward bringing rates down. I certainly would understand and agree that there is a risk to this in that the markets, as we know, could see it adversely. But I would agree with Governor Martin that mature and careful thinking is likely to [bring the market] to the view that this seems to be a realistic change, given the circumstances we're dealing with. And I think the result could be positive as opposed to being negative. So, I support the directive as it has been laid out. It seems to me that the last sentence is a very important conclusion; [I'd leave it] rather than delete it. It is our view that this is a major change that we're making but one that is appropriate and very important.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I have very little to add to your tour d'horizon. I think it covers admirably the situation that we find ourselves in. I would simply want to emphasize one thing and that is the timing of the recovery; the recovery is very late indeed. We've been expecting recovery for at least six months, possibly longer. And the longer the economy stays in the doldrums, the greater the risk and the greater the dangers. In your words, the developing disarray feeds upon itself, and until we see some evidence of a turnaround, I think we're in a very vulnerable situation. So, in this environment, we should not do anything that risks rising interest rates; on the contrary, we should do what we reasonably can to get interest rates moving down. Therefore, I support this directive language. I also agree with those who would shift emphasis away from M1 temporarily at this time. I also would retain the last two sentences of the directive; they give the sense that we have not totally abandoned targeting of the aggregates and I think it's important to maintain that impression at this time. I don't know if this is the time to discuss borrowing, but if it is, I would be prepared to see borrowing in the range of \$200 million or less.

MS. TEETERS. That doesn't include those special liquidity needs of particular banks?

MR. RICE. No, it doesn't.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I also would support a change in the directive language this time. I'm perhaps a little less enthusiastic than some of you about specifying a desire for interest rates to move in a particular way because I don't really think we know that much. Every indication that we have does seem to suggest that interest rates are too high, but we just don't know that much about what determines interest rates and what they need to be to equilibrate markets. I would remind you all that we are in a situation with a deficit running at \$160 billion or thereabouts. And that really substitutes a cash flow financed by the government for a cash flow financed by the private sector. And since the government is interest-insensitive, one has to presume that higher interest rates will be needed in the private sector than would otherwise occur. That's just one of many, many analytic comments made.

But I am convinced that M1 for several months looking ahead is going to be a very poor and implausible indicator of what is going on in terms of monetary expansion. As I've said, we did have a 38 or 39 percent rate of increase in NOW accounts in July and August and we certainly are going to have an all savers certificate bulge in NOW accounts in the period right ahead. If I could think of some way to keep the M1 range, I would; but it's so implausible that we would have any idea what the number will be that I just don't know how to keep it and retain our credibility. It may well be that when the new instrument comes out we will get a low M1, depending on how we classify the new instrument, as M1 or M2. For the moment, though, we're just in total disarray and we need to recognize that fact. And I would say that we need to recognize it publicly and soon because otherwise the market will react in the way Larry says. They will see a high number and will say that the Federal Reserve is going to have to screw down on their number and therefore rates will go higher, and they will work them higher in anticipation of that event. So, there has to be some kind of communication, if we go ahead with this, soon.

I'm not a great supporter of M2, as you all know, because I think it does have very important problems of interpretation in the longer run. But for this immediate period ahead I'm not so disturbed about an M2 number of the kind suggested, 8-1/2 to 9-1/2 percent. I really can't imagine a liquidity change that is going to get us very far off that as an upper limit of what is likely to occur. The early indications are that [M2 in] October is going to be pretty low, so I think it's a fairly safe thing to go on. And mainly because we're contemplating so many things that will make our critics suspicious--and I agree that they will be very suspicious--I would drop the last sentence of the proposed directive. I understand that something could happen that would lead us off [track], but if we say here [that M2 is] expected to be in a range of around 8-1/4 to 9-1/2 percent for the September-to-December period, with the expectation that October is going to be fairly low, I think it gives us enough room without raising this additional question in people's minds.

As I think about what is bothering a lot of you, in particular this rate setting issue--and I think Bill Ford spoke out most strongly on that--it may be this phrase at the beginning of the second paragraph, "taking account of the desirability of somewhat reduced pressures in private credit markets in the light of current economic conditions." That would seem to me to be a signal that the Federal Reserve is following rates rather than a more objective measure. So, I think it may be desirable to drop that phrase and substitute instead something like "consistent with the early resumption of economic growth," which doesn't necessarily imply lower rates and easier conditions but does imply the need for an orderly and sustained flow of money and credit. That might help a little with that problem. On the suggestion that Jerry Corrigan made that we again repeat our insistence that we're going to be conservative over a long period of time, I don't know. Jerry, there's a whole paragraph that would be picked up from the past directive that talks about the long-run plans of the Committee and so forth; to force it into this paragraph seems to me so apologetic that it would backfire on us.

MR. CORRIGAN. I don't think anybody reads the boilerplate. The kind of thing I'm talking about, since I gather the Chairman intends to say something, could be dealt with in that way as well.

VICE CHAIRMAN SOLOMON. I think the way to handle it is that it would be quite easy for the Chairman to say that we expect the rate of inflation to continue to decline next year and that over the long run we will be following an anti-inflationary policy. I wouldn't say anything about the monetary aggregates next year but I'd say we expect the rate of inflation to decline even with a--

MR. PARTEE. It's difficult to handle here just in a phrase without sounding apologetic. The notion that we want to be constraining and that we are going to continue to run monetary policy pretty carefully is good, but the yardsticks have changed. We are having trouble measuring in this period using the conventional yardsticks.

CHAIRMAN VOLCKER. The existing phrase I would remind you says: "The Committee also indicated it was tentatively planning"--this is enshrined in our decision--"to continue the current ranges for 1983 but it will review the decision carefully in the light of developments over the remainder of 1982." That's not exactly the most ringing [endorsement].

MR. PARTEE. Not really, no.

SPEAKER(?). I agree.

MR. PARTEE. On the other hand, I'm not sure I would be prepared to support much more than that for the year to come.

One last comment. You spoke a little about the level of borrowings. I don't see any reason to reduce the initial borrowings so much from where they have been. If I understand it, what we have done is to allow almost all of the expansion that occurred in the monetary aggregates to show through in larger nonborrowed reserves. So, borrowings really are where they are in good part because of the need to deal with these special situation borrowings. We might reduce

it to \$400 to \$500 million, but I wouldn't take it way down to the kinds of numbers that people have mentioned, \$200 million or less, as a starting position. That's all.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, when I came to the meeting this morning I was pretty much of the view that Bob Black and to some extent Bill Ford expressed. I must say that your review of the world situation prior to the coffee break woke me up.

MR. BLACK. I demand equal time!

MR. BOYKIN. I agree in that I don't believe rates should go up. As far as the shift in emphasis on M2, that seems to me a fairly logical extension of what we did with the NOW account situation. It is a little bigger and maybe not quite as subtle, but I don't think it would be that hard to explain, really, what we are doing. There is some precedent for that aspect of it. In terms of understandability of what we are likely to be doing, [I was comforted by] the comment you made that you would have an opportunity in the not too distant future [to explain this]. That would be extremely important in terms of how this is actually perceived, certainly in the short run, before people have an opportunity to analyze the record in some detail. So, I would come out with those who certainly don't want rates to go up and who want even some decline. As far as the wording of the directive, I don't think I could make very much of a contribution to that. There are a number of subtleties being expressed and I'm not sure I appreciate all of them. I couldn't improve on any of them.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I have just a couple of observations. One is that, clearly, all the discussion around the table has been [consistent with] a money market conditions or interest rate directive. Secondly, I agree with the comments that Ed Boehne expressed with respect to the discretion that is vested in the Chairman in the intermeeting period with this kind of a directive. As a result, I'd like to ask the Chairman if he's prepared to make some statement as to the appropriate interest rate level and the pattern of getting there. Clearly, it is in the down [direction]. But in order to understand how the Chairman may exercise that discretion, it would help me to understand what you're thinking.

CHAIRMAN VOLCKER. I will respond to that shortly, after Mr. Roos and Mr. Morris get finished with their comments.

MR. ROOS. In that order?

CHAIRMAN VOLCKER. Either order; I have Mr. Roos first on my list.

MR. ROOS. All right, I'd be pleased to.

MR. CORRIGAN. There's a certain appropriateness to these two guys being last!

MR. ROOS. Let me say, Mr. Chairman, that I was both impressed and depressed with your review of the world situation, and I don't minimize that in any way. Let me also say that no one at this table would prefer lower interest rates more than I. I do take exception to any implication that recent Federal Reserve policy has wrung out the economy of this country or has been detrimental to the international economy. I think what has occurred is more a result of ten or fifteen years of irresponsible monetary policies throughout the world--as well as a well-meant effort on the part of the Federal Open Market Committee as long as I've been on it and until October 1979--to try to do just what we're doing today, and that is to lean against interest rate movements. I think that contributed in a major way to inflation, which really led to this high interest rate pattern that we have. I believe that what we're about to do today will unquestionably be viewed by those who watch what we do as a major change. I don't think it will be possible to explain away the fact that, albeit temporarily, we are moving away from [targeting] a narrow aggregate that has predicted prices and output better than other variables. It will be apparent, in spite of any disclaimers we may or may not make, that we are moving toward placing greater emphasis on controlling the fed funds rate. And I think it will be misconstrued by the markets. It will be associated with the forthcoming election; I think it will give comfort to those who, rightly or wrongly, have sat on the sidelines and implied that somewhere along the line we would cave in on our present policy posture.

Mr. Chairman, there's no question that under your leadership we have made enormous strides toward wringing out the inflationary problem and restoring the economy to at least a semblance of stability. I think our credibility and your credibility are unbelievably and deservably affirmed at present. If we fail to specify in this directive at least some M1 range, with all the disclaimers that these things that are going to happen could distort it and cause us to change, I think there will be a gross misinterpretation and misconception of what we are doing. And it could conceivably destroy much of the progress that we've made. So, although I don't have a vote, I feel it's a gross mistake to do what apparently we're about to do.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, it just so happens that we have opposite extremes finishing up this discussion. I look upon it as a great step forward that we have gotten M1 out of the directive. And I don't view it as a temporary phenomenon because I think our ability to interpret M1 is going to continue to be highly questionable for some time to come. This is not a two- or three-month phenomenon as far as I can see. But that remains to be seen. Nonetheless, I support the move at this point in time and I would hope that borrowing is set at a level that would get the funds rate down to the 9 to 9-1/2 percent area as a start.

CHAIRMAN VOLCKER. I have a late starter, Mr. Solomon.

MR. PARTEE. He hasn't said a word!

VICE CHAIRMAN SOLOMON. I think this is a rather momentous FOMC meeting. I had thought that we had until maybe 1986 before the

pace of deregulation and innovation would bring us to this point. But the Garn Bill and legislation that was [unintelligible] today--what's the name of that act?

MR. RICE. The Garn-St Germain--

MR. PARTEE. I can think of several names!

MR. WALLICH. Depository surprise.

MR. MORRIS. The destruction of M1 bill.

VICE CHAIRMAN SOLOMON. It has moved us very quickly most of the way to the deregulation that we expected by 1986. I think we have a real dilemma here today. On substance, I feel that we absolutely have to have some modest decline in rates. I believe there is a real danger of a major cracking and then we would have to go even farther; whereas with a modest decline now that stays in place for a while there is a better chance of working ourselves out of this both internationally and at home. I recognize that there will be a good deal of questioning, not only in monetarist circles but more generally. I don't think there will be an avalanche of criticism, given our credibility, but there will be major questioning as to what this means in terms of longer-run anti-inflationary policy. And it seems to me that there ought to be some words [to convey] our longer-run commitment and our expectations that inflation will continue to come down--and possibly they should be just in the Chairman's statements and other statements, not in the directive. I don't know how to do it in the directive without sounding defensive, but there ought to be some words about that.

So, I would support this. I do feel that if one reads this carefully, we are really not targeting M2. We are targeting basically money market conditions and we are saying that we expect this will involve growth of M2 in the range of 8-1/2 to 9-1/2 percent. Therefore, I'm not sure that we really need the last sentence. The last sentence simply makes more explicit what is there quite carefully [unintelligible]. I don't see that the way this is written, with the expectation of M2 growth of 8-1/2 to 9-1/2 percent, is a constraint on doing what is necessary to get the operative sentence. And if I am correct in my interpretation, I don't see why we need that last sentence. In that sense, I would agree with Chuck.

MR. PARTEE. But I also would drop the operative sentence.

VICE CHAIRMAN SOLOMON. Well, I wouldn't drop the operative sentence because then people don't know where we are.

MR. PARTEE. We're targeting on 8-1/2 to 9-1/2 percent on M2.

VICE CHAIRMAN SOLOMON. The presentation is critical. And judging from past history, the presentation is probably going to be more dependent on the Chairman's statements than it will be on the directive, particularly given the [publication] lag and the fact that we are expecting such a large bulge in the first week of October and something has to be said. Now, since the Chairman has a mind of his own, I would assume that if he gets a majority vote on the substance of this directive that it may not be worth spending a lot of time

interpreting and arguing about the more marginal sentences. We are making a major substantive decision here. And the presentation of that in a way that does not undermine our credibility is absolutely essential. But we do have a lot going for us in terms of credibility on the longer-run anti-inflationary policy.

Turning to the specifics, even with an initial borrowing assumption of \$200 million, I don't think the funds rate would get down even to 9 percent unless this action is followed by a discount rate cut. And I urge that, in the Board's infinite wisdom, that be confined to 1/2 point rather than a point. It is my reading--and I could be wrong--that if the discount rate is cut 1/2 point, the markets will expect another half point later on, almost immediately. If we do a full point, many people in the market may say that after the election there will be another full point. This election thing is a damn shame because we are not being influenced by the election. But the timing is very awkward for us. Anyway, that's another area. I would recommend that the initial borrowing be \$200 million.

CHAIRMAN VOLCKER. Well, let me make a few not so random comments. Tony Solomon and others have referred to the role of the Chairman. Let me just say in that connection that the Chairman is unable to explain and defend a policy he doesn't understand or agree with. Larry Roos referred to the concern about the interpretation of recent policy and made a short but impassioned statement that we are seeing the results of ten to fifteen years of irresponsible monetary policies around the world. I think there's a lot of substance to that. I wouldn't narrow it to monetary policies. I don't want to be associated particularly with that part, but I think what we are seeing is the culmination of ten or fifteen years or more of a set of attitudes and behavior that had to be changed. And that is difficult, but we've seen some progress.

I think we're also in a very critical period right now for all the reasons I suggested. I don't myself perceive that the risks of misinterpretation are as great as some people think. Obviously, they are there. But I don't think many people, if you take this out of the election atmosphere, are going to interpret this as a cave-in, in and of itself. Most people in the financial markets at least, to put it bluntly, think we've overstayed the course now. It gets into this great question of credibility that I suppose we're taking rather personally. At the risk of being misunderstood, following a mechanical operation because we think that's vital to credibility and driving the economy into the ground isn't exactly my version of how to maintain credibility over time. Credibility in some sense is there to be spent when we think it's necessary to spend it and we can carry through a change in approach. I don't think this is all as extreme as some have painted it. But I don't think we're just dealing with the theory here. We are dealing with a real world and assessing where the risks are. It's quite clear in my mind where the risks are. I think I made it quite clear in terms of economic developments around the world. But if one wants to put it in terms of risk to the institution: If we get this one wrong, we are going to have legislation next year without a doubt. We may get it anyway. It's a matter of judgment as to how that might come out and where the risks are, but I think I know where the risks are. I'm not sure how it looks just in strict electoral terms, since that question has been raised, to sit here in some sense artificially doing nothing and then

have to make a big move right after the election. I'm not sure that would wash very well in terms of anybody's opinion of our professional competence as an institution, if one were convinced that this [change was appropriate]. Obviously, that depends upon the substance and how strong the case is for making a change at the moment. I'd prefer that this problem didn't arise now. If business conditions looked a little better and interest rates were a little lower--and I wouldn't care where the interest rates were if the economic situation looked a little better--and if we weren't going to have to deal with a succession of sick foreign countries in this time period, if the dollar were not rising into the wild blue yonder right now, and if I thought that all these accumulating problems that we face could wait for a while, we'd have a much easier decision. Under present conditions, four weeks looks like one hell of a long time to me. I don't know what is going to happen in a number of directions over the next four weeks.

In terms of what specifically this means operationally, all I can give you is an opinion of what I had in mind in looking at this kind of language and putting a gloss on it. The first paragraph is meant to say nothing more than that we don't know what M1 means over the next quarter for two reasons, period. Therefore, since we don't know what it means, it seems a little fatuous to put down a number pretending we know what it means when we don't. It is no special prejudice against M1. If we had some experience to measure what it meant during this kind of period, we would, but we don't.

The first sentence in the second paragraph is basically meant to be the operational sentence. I think that is fair. It is meant to convey the impression that we seek some expansion, however measured, in the monetary aggregates and in reserves and it is meant to reflect and note some concern about what is going on in the private credit markets and that that will have a bearing on what we do. I think that is understood or assumed by sophisticated people in the market, at the present time anyway. They have assumed that we moved as alertly--if that's the right word--as we did during the summer because we were operating against the background of Penn Square and Drysdale and accumulating international problems. This is in a sense a confession, good for the soul, in making that a little more explicit. And it has some connotation without saying it directly that we certainly are concerned, among other indicators, about the pressures in those markets and what is going on in interest rates.

The next sentence is meant to be a straightforward estimate of what we think and is put in there to show continuity with the present approach. This is consistent with what we have been saying, anyway, about the measures that we think are the most reliable, not in any theoretical or long-term sense but during this particular quarter. That is where we get the sense of continuity with the past and that is meant to illustrate or to make that point. I might point out in that connection what somebody has already mentioned: That in the near term, in fact, my guess is that M2 growth is going to be very low and that of M3 might be low, too. My interest in that phenomenon is that I don't know what is causing it. We had a very high rate of growth for a couple of months and it may just be a statistical thing. It went up rapidly for a couple of months and now it is leveling off for a couple of months. To the extent that it reflects some sense of tightness that we don't know we have--incomes going down or banks

can't finance themselves so readily--it's an indication that we are tighter than we think we are. Now, I'm not adopting that theory. But I just point out that in the very short run, before we meet next time, my guess would be that M2 and M3 are going to be low rather than high relative to these numbers. And I don't think the numbers we put in there are terribly sensitive for that reason.

As for the last two sentences, I'm inclined to think they're optional. The flavor is this: If they're helpful, put them in; if they're not helpful, take them out. And I think it is somewhat optional whether we put in a range for the federal funds rate. If we do, I'd make it, say, 7 to 10 percent. As for what we would do operationally, and of course we'd have to discuss this a little more, I would propose that we drop the borrowing level. To precisely what level, I'm not sure; \$200 million seems to me the lower limit of what we would do; \$300 million may be an appropriate number; one could argue for something slightly higher than that. The borrowing figures are confused to the extent there is so-called special borrowing in any event. And I don't know quite how to assess that. It's like M1; there is no right answer on how to assess it precisely. We can't escape that problem. I don't have any particular interest rate in mind in setting forth this kind of directive. I've expressed the opinion that I don't think we should create an atmosphere or the reality of rising interest rates, insofar as we can reasonably avoid that. I'm not talking about every conceivable contingency that may arise in the real world. But based upon what I know now, the implication of the borrowing level is that we would get a somewhat easier tendency in the federal funds rate in any event. Where it really is would rest upon a discount rate decision and not this decision, I suspect, except within a very narrow range. I do not mean to imply any feeling as to where interest rates should be a month from now. Beyond what is implicit in what I've already said, if things look the way they do now, I wouldn't like to see an increase and I would feel more comfortable with some decrease. But I haven't any particular target in mind. The implication is that we would keep the borrowing level more or less the same until something happened to throw us off--in economic activity, in financial markets, or in the actual growth of M2 and M3. We would have to reconsider that in the light of all these factors, and consultation from time to time would probably be appropriate in those circumstances. What else can I say to be more specific?

MR. GUFFEY. In terms of the pattern that you might expect to occur: If I understood your most recent statement, you suggested interest rates would be at or near their present levels for some period of time.

CHAIRMAN VOLCKER. I think we would tend to have an easier funds rate than we had just recently if [the Board] did nothing on the discount rate. If the discount rate were reduced, I think rates would go down. Again, we have a setting here where these numbers, even when we have them on a preliminary basis, are about as reliable as I don't know what. But over the course of the period that we're talking about here--in the next couple of weeks up until the Friday when the figure is published that will include a presumed distortion from all savers certificates--we may have an M1 figure that is on target in the latest weekly figure. We probably will have an unemployment rate that is up significantly and an industrial production figure shortly--I don't

know when that comes out--that is down and, hopefully, a good price figure in there someplace, too. I don't know what other critical numbers are coming out in the next ten days.

MR. BLACK. Mr. Chairman, what does the unemployment rate look like now?

CHAIRMAN VOLCKER. Well, I don't know. I don't have any particular guess. We can turn to the staff. We know that the unemployment claims figures have shot up enormously. I think the general assumption is that it's going to be 10 percent plus, and I'm not sure that anybody can be much more specific than that.

MR. FORD. Mr. Chairman, you did say you were planning to make some kind of public statement about this rather than just waiting a month [or so] until after the next meeting. When, roughly, were you planning to say something about this?

CHAIRMAN VOLCKER. Well, I have a tentative date with the Business Council at the end of this week where I have to appear at a little press conference after I talk at any event. So, that's the easiest occasion just because it's already scheduled and comes in the normal course of events and we don't have to make any big deal about it.

What I might suggest, since it's 1:20 p.m., is that people go out and get some sandwiches. There may be some desire to discuss this further in substance. And if there is going to be some effort to fool around with the language or drop sentences or whatever, it gives us fifteen minutes or so to think about it.

[Lunch recess]

CHAIRMAN VOLCKER. This need not be taken as strikingly as some people either fear or hope, depending upon which side of the spectrum they are on. I don't consider anything in here very inconsistent with what we've been doing. We have said we are going to interpret the aggregates somewhat loosely in effect--I'm now interpolating--in the light of our judgment as to whether there are unusual precautionary demands for money and liquidity. The market has assumed we are operating that way quite comfortably and this is an extension of that idea. What it does is to take out M1 for a very particular reason. I raise the question because there is this talk about how to say it publicly. If we write a letter to the Congress, for instance, and say we've changed the targets or we have some new operating approach or some such thing, I think that makes it much more grandiose than is intended in my mind. I am reluctant to have a specially called press conference or a speech or something for the same reason. It just makes it sound as if we're off on some entirely new course. I think we have to get the message over publicly that, indeed, we're not going to be worried about the M1 figure in the short run, if we're not. We have in effect said--and we are repeating and amplifying what we said--that we would tolerate for some period of time growth somewhat above the target range should unusual precautionary demands for money and liquidity be evident. Going back to my testimony [in July], I know I had a lot of criteria--the performance of the economy, interest rates I deliberately put in, the availability of bank credit--all of which I said bear upon that

judgment. That's what I said in the testimony. We think, yes, all those things are operative now and we are willing to tolerate a bulge in the targeted growth if that is necessary in this time period. It is precisely the circumstances that we foresaw as a possibility. I don't think it's that big a deal. Other people put other interpretations on it. I just tell you that I don't think it has to be read as too big a deal. In any event, assuming that we are in this general neighborhood, let us pin down the operations more specifically, which comes down pretty much to the initial borrowing level, I think. We've had proposals from \$200 [to \$300] million and now we have proposals above \$300 million, too.

MR. PARTEE. \$400 million, I thought. What has it been running?

MR. STERNLIGHT. \$500 million is what we've been using in the path; it is actually \$560 million.

CHAIRMAN VOLCKER. I don't think it's going to be \$500 to 600 million. What was it yesterday?

MR. STERNLIGHT. \$300 million.

CHAIRMAN VOLCKER. I may not be up-to-date on it. We have more reserves in there than we should and deliberately haven't taken them out, given the market conditions so far this week. We just leave them, I guess; I don't know what borrowings will be. They can't be much below that, but the excess reserves may be very high.

MR. AXILROD. We allowed for about \$500 million and so far they are a little over \$1 billion; that could come out on its own if our projections are wrong.

MR. PARTEE. But in drawing the path you allowed for about \$500 million?

MR. AXILROD. We allowed for \$500 million because the week with the quarter-end statement date normally has well above normal excess reserves.

MR. PARTEE. And that was after having made the adjustment to provide the nonborrowed reserves consistent with the observed overshoot in M1?

MR. AXILROD. That's right, and then to allow for the [unintelligible] week statement date excess reserve averaging.

MS. TEETERS. Did the \$500 million have any special borrowings built into it, Steve?

MR. AXILROD. There is some. The Midland Bank in Dallas still is in for some; I've forgotten the exact number.

MR. BOYKIN. That's down to about \$75 million now.

MR. AXILROD. Yes, they haven't been in for a while--about a month.

CHAIRMAN VOLCKER. I don't think there is any mechanical relationship with these special borrowings. I must say that is difficult to handle; the bank in the weakest position gets hit and the markets are a little tight. If that bank didn't borrow, others would have to borrow, in part.

MR. GRAMLEY. When the staff made out the alternatives in the Bluebook, the difference in borrowing levels between "A" and "B" was rather substantial, \$150 million versus \$450 million. The \$450 million was associated with essentially no change in market interest rates and "A" was associated with some easing, but I didn't get the impression that it was that significant an amount of easing. If we were to go, say, to a number like \$400 million, it would imply hardly any change in market interest rates.

MR. AXILROD. At the present level of the discount rate, I think that's right.

CHAIRMAN VOLCKER. Well, I think \$400 million is too high myself.

MR. CORRIGAN. In terms of the range of proposals around the table, I can easily live with borrowings of \$300 or maybe \$350 million; I would have a small preference for putting a 7 to 10 percent federal funds range in the directive for no other reason than a desire to reinforce continuity at the margin.

CHAIRMAN VOLCKER. Let me get to the directive later.

MR. PARTEE. 7 to 10 percent is worse than nothing.

MS. TEETERS. I would prefer a lower--

CHAIRMAN VOLCKER. Well, how many like \$200 million? How many like \$300 million? How many like higher than \$300 million?

MR. PARTEE. Well, obviously, take \$300 million with--

SPEAKER(?). From among the others.

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. I have determined that \$300 million is the arithmetic average of--

VICE CHAIRMAN SOLOMON. If he took a weighted average, it would be \$293 million!

CHAIRMAN VOLCKER. Assuming somebody is going to vote for the directive, let's take that poll again.

MR. PARTEE. Yes, it really should only be the people who are going to vote yes [on the directive] who are allowed to vote [on this]. We've run into that problem with contemporaneous reserve accounting.

MR. RICE. We certainly have.

MS. TEETERS. That ought to--

CHAIRMAN VOLCKER. Are there other operational questions?

MR. BLACK. Would we take Midland Bank out of that \$300 million, Steve, or would we leave it in there as we did on the \$500 million?

MR. BOYKIN. They ought to be out by the end of the week.

MR. BLACK. Well, that will solve the issue then.

MR. STERNLIGHT. But on occasion we'll get another borrower, either them or somebody else, and that will raise the question of whether borrowing is going to [include or exclude that bank].

MR. BLACK. Well, as nearly as possible it ought to be there if it's interest-sensitive, it seems to me, if it's to give us any guidance on federal funds rates. That's all I was hoping we would do.

MR. PARTEE. When you say other operational questions, are you talking about the question of the federal funds range specified?

CHAIRMAN VOLCKER. No, let's get to that as part of the directive.

MR. PARTEE. Oh, I see. But other operating considerations?

CHAIRMAN VOLCKER. Yes. In effect, we're in an area of judgment depending upon that happens to the aggregates and the economy and interest rates and so forth.

MR. BALLEES. I have an operational question, Paul. For those of us who are skeptical that M2 is going to grow as fast as 8-1/2 or 9-1/2 percent, given the way that the money market funds are slowing down and so on: How is the Desk going to operate under the directive as it stands here? Are they going to be targeting on 8-1/2 to 9-1/2 percent M2 growth? I just want to make sure it's a workable directive from the standpoint of Desk implementation.

CHAIRMAN VOLCKER. Well, it's an interesting question if in fact [the M2 figures] run low for a month. There are two possibilities, I suppose. Let's assume they are running low but the evidence that we have currently is that it is a temporary phenomenon and [the rate of growth] doesn't look unreasonable for the quarter. It is stated as a [rate for the] quarter. Then, I would think we probably would not do too much. If they are running low and we thought they were actually running below these figures, the implication is that interest rates will come down. We would ease the position; that's what it says.

MR. GUFFEY. Which drops interest rates and worsens that very situation.

CHAIRMAN VOLCKER. What do you mean by "worsens"--that we would get really slower growth?

MR. BALLEES. Yes.

MR. GUFFEY. Sure, when interest rates--

CHAIRMAN VOLCKER. Well, I don't think the staff thinks so, but I would raise a very interesting question as to whether we haven't been too tight because higher interest rates bloomed--

MR. PARTEE. That next to last sentence I think has some meaning.

SPEAKER(?). Right.

MR. GRAMLEY. It not only says would be "acceptable" but would be "desirable" in the context of declining interest rates.

MR. PARTEE. I presume that was put in, Paul, because we are over the target ranges rather--

CHAIRMAN VOLCKER. Yes, but we don't have to say it. Whether that is in or out, my interpretation would be that if [monetary growth] is running low, we are not going to be pushing terribly to get it up within a limited time but would go in the direction of easing.

MR. PARTEE. Yes.

VICE CHAIRMAN SOLOMON. But hopefully we wouldn't go so far that then we would turn it around three weeks later and rates would start back up.

CHAIRMAN VOLCKER. Well, as I say, we judge this in the light of what we think is going to happen in the future too.

MR. BALLEES. But, Steve, haven't money market funds actually been shrinking in the last few weeks?

MR. AXILROD. Yes. They are up on average in the month, but the weekly data are--

MR. BALLEES. That's the phenomenon I had in mind. What happens if that trend continues?

MR. AXILROD. Well, market rates have been rising and the rates on the [money market] funds have been dropping with a lag, so they've come back together. If market rates began going down and if [money market] funds rates tended to lag the drop in market rates, [flows into money] funds would tend to go up. We have only a modest expansion projected at the moment.

MR. BALLEES. Because of all the uncertainties, I would just suggest a possibility--I'm not sure it will solve anything--of an even wider range than the 8-1/2 to 9-1/2 percent shown here [for M2]. But if we did that, it would make it tougher for the Desk to construct a reserve path, I would think.

CHAIRMAN VOLCKER. This is a matter of judgment. I don't think we would ignore M1 either if we thought it was giving us some evidence. A lot of things could happen with the all savers certificates. Suppose, after all this talk about all savers blowing M1 up, that there's a relatively modest increase. We have a big

decrease this week; suppose we get a relatively modest--say, an offsetting--increase the following week and then it falls down again the week after that. I would say that's a pretty weak M1 and it would influence my judgment as to what to do, even though we're not following it in a mechanical way.

MR. PARTEE. I think its composition matters. Suppose we have very strong NOW accounts and very weak demand deposits?

CHAIRMAN VOLCKER. Well, I think we would try to get some evidence from that as well as we can.

MR. BLACK. If that happens, Mr. Chairman, I would think you all were doing the right thing.

CHAIRMAN VOLCKER. Well, I don't know whether we can clarify that any further. Let me just look at the first paragraph as a whole, which is meant just to be a straightforward--

MR. BALLE. Would you tolerate a little nit-picking--editorial, not substantive--on your first paragraph?

CHAIRMAN VOLCKER. Sure. It's not my paragraph.

MR. BALLE. Following the dash in the first sentence, "in the very near term by investment of funds in maturing all savers certificates," one doesn't "invest in"--

CHAIRMAN VOLCKER. Well, no.

MR. BALLE. The word "in" is out of place there. Maybe it should be "reinvestment of funds now in" or "from" [all savers certificates].

CHAIRMAN VOLCKER. "Reinvestment of funds from."

MR. BALLE. I have one other suggestion, which is just a matter of reversing emphasis, I guess. In the next full sentence beginning "The probable difficulties...suggest that substantial weight not be placed on," I'd rather say "suggest little weight be placed on." Or we could say "little, if any." I don't know how strong we want to be on that since we have ended up not specifying anything for [M1].

CHAIRMAN VOLCKER. I don't know what the best phrase is there.

MR. WALLICH. We might say, "suggest that no substantial weight be placed."

MR. BALLE. I might drop "substantial." In effect, what we're doing is placing no weight, if we don't have [a target].

CHAIRMAN VOLCKER. No, I don't think we're quite doing that.

MR. BALLE. We don't have a target. I'm just trying to make the words for the first paragraph consistent with the absence of an M1 target.

CHAIRMAN VOLCKER. I just gave you my interpretation. I would want to look at M1 for what information we can get from it. What we are really saying here is that we don't want to pin a mechanical target on it or have a mechanical path for it. I don't want to say much more than that really.

MR. GRAMLEY. If I may pick a nit in the second paragraph, I would say "In these circumstances..."

CHAIRMAN VOLCKER. I'm just starting the first paragraph.

MR. PARTEE. I think that "no substantial weight" is probably better than "substantial weight not."

MR. MARTIN. Yes, "no substantial."

CHAIRMAN VOLCKER. It sounds to my ear like less, but I--

MR. BALLE. That would be good: "less weight."

MR. PARTEE. It must be "much less," though.

MR. BALLE. "Less" would be a good word in the sense of clearly implying less than we usually do.

CHAIRMAN VOLCKER. "Much less than usual weight" is all right with me.

MR. BALLE. "Less than usual."

MR. PARTEE. That leaves it in as a factor to look at.

MS. TEETERS. Now you have a problem with the last sentence, which says "much lesser."

MR. PARTEE. "Much less" and "much lesser"!

CHAIRMAN VOLCKER. You mean just an English problem.

MR. GRAMLEY. The subject should not be "these uncertainties" but "these developments."

MS. TEETERS. Say "to a small extent;" take out "much lesser" then.

CHAIRMAN VOLCKER. "Much smaller extent."

MR. WALLICH. It has to be small enough to justify not having a target for it, which is really very small.

MR. PARTEE. I think Lyle is right; it should be "these developments" instead of "these uncertainties."

CHAIRMAN VOLCKER. "These developments."

MR. WALLICH. Well, the last sentence of this paragraph leads into M2 and what one expects in the following paragraph then is an M2 target. Now, if that's not what we're going to do, it seems to me we

ought to modify the last sentence of the first paragraph. But I really would urge you, if it isn't tampering too much, to put the 8-1/2 to 9-1/2 percent M2 range early in the next sentence and then after that to say "taking account of the desirability of somewhat reduced pressures..."

MR. PARTEE. "In these circumstances, therefore..."

CHAIRMAN VOLCKER. First of all, there's an interpretation of them--of what all the circumstances means. In my mind that means the previous paragraph but more than that. I assume that this mental image includes the discussion of all the economic problems, the international problems, and all of it. This refers to everything. But it's obviously not clear when it just sits there, and that raises the question of whether it should be more explicit or not.

MS. TEETERS. Why don't we be explicit and say, "In light of domestic and international developments, the Committee seeks to maintain...?"

MR. GRAMLEY. Well, it seems to me if we're worried about changing gears radically as opposed to small degrees, in terms of public perception, we ought to leave it a little vaguer than that.

CHAIRMAN VOLCKER. Just leave something like this.

MR. GRAMLEY. Yes.

MR. PARTEE. We have sometimes used a phrase like that, but it goes back some years.

MR. GRAMLEY. That's the problem; it goes back some years.

CHAIRMAN VOLCKER. This wouldn't be put in as any echo of what happened earlier.

MR. BALLE. In that second paragraph the first sentence ends with a phrase "in the light of current economic conditions." Wouldn't there be some other part of the old directive that stresses how poorly the economy is doing now?

CHAIRMAN VOLCKER. Where are you going back to? I'm sorry, I just don't know where you are.

MR. BALLE. It's the second paragraph at the end of the first sentence. The last phrase is "in the light of current economic conditions."

VICE CHAIRMAN SOLOMON. Well, remember, Paul said that he was going to expand what we call the boilerplate to make the worsening economic situation clearer and the--

MR. BALLE. My point, Tony, is that the phrase "in the light of current economic conditions" as it stands there is a very neutral one and, in my mind, too weak. I would like to see something like "in light of the currently weak economy" or whatever, unless that is going to be made clear somewhere else.

VICE CHAIRMAN SOLOMON. Well, that's what I thought was going to be made clear earlier.

CHAIRMAN VOLCKER. Well, there would be a little more emphasis earlier. Obviously, that phrase is a term of art. What it is meant to refer to is the fact we have some pressures in private markets that aren't necessarily apparent on the surface because of all this disturbance in the financial system and we are aware of it and concerned about it. And we take that into account in the--

MR. PARTEE. Then "in the light of" is not quite right, is it? We mean "resulting from" or "flowing from" or something like that. I thought "in the light of" meant we were doing this because of the poor economy.

MR. BALLE. That's what I thought.

MR. PARTEE. But you are saying credit conditions are affected by--

CHAIRMAN VOLCKER. Well, I think one can interpret it either way. The reason we're concerned about this is because of the economy. But it also works in reverse. The economy, and the international economy in particular, is giving rise to the pressures. But we're concerned about the pressures because of economic conditions. So, I think it works both ways.

VICE CHAIRMAN SOLOMON. We could say "taking account of the desirability of somewhat reduced pressures in private credit markets and current economic conditions..."

SPEAKER(?). It's both.

CHAIRMAN VOLCKER. But we always want an orderly and sustained flow of money and credit.

MR. PARTEE. Now we have more doubt about it.

CHAIRMAN VOLCKER. I'm not sure I like it terribly, but at the risk of making the whole thing more cumbersome we can put "In all the circumstances the Committee seeks to maintain expansion in bank reserves needed for an orderly and sustained flow of money and credit...consistent with growth of M2 and M3 in a range...and taking account..." If we want to blur it a bit, we could say "taking account of the evidence of pressures in private credit markets in the light of current economic conditions. It combines the sentences.

MR. WALLICH. I think that's a great improvement. That mitigates the appearance of a shift in policy priorities.

MS. TEETERS. I don't mind if we combine the sentences, but I need the "expects that this would involve the growth of M2 and M3" down to 8-1/2 percent.

VICE CHAIRMAN SOLOMON. Well, he likes the term "consistent with."

MR. PARTEE. Well, I agree with Henry. I think it's less clearly a move to a money market conditions target.

VICE CHAIRMAN SOLOMON. Yes, I think there is something to be said for it in that it becomes a kind of quasi-target rather than simply expectations. I don't think it puts any substance in here.

MS. TEETERS. What if M2 went above a 9-1/2 percent growth rate? Does that mean we expect the staff to pull it down?

VICE CHAIRMAN SOLOMON. Well--

MR. WALLICH. With the sentences at the end it can run over or it can run under; nothing makes any difference.

MR. BLACK. But there is some sentiment for eliminating those sentences.

MR. PARTEE. How would we get a great big increase in M2?

MS. TEETERS. When we get the new DIDC instrument.

MR. MARTIN. We'd define it so that--

MR. PARTEE. That's not going to affect the [fourth] quarter that much.

MR. FORD. Well, if a portion of the money market funds currently in M3 were to shift into M2--

MR. PARTEE. Yes, but those are institutional accounts.

MR. FORD. Who says they won't like some of these new instruments the DIDC is going to invent?

CHAIRMAN VOLCKER. They could.

MR. PARTEE. That's right.

SPEAKER(?). That's a possibility.

CHAIRMAN VOLCKER. Yes, there could be some transfer out of Treasury bills or other highly liquid instruments, particularly if they pay a higher rate than Treasury bills.

MR. PARTEE. We could have a sudden drop in consumption relative to income.

SPEAKER(?). That's possible.

MR. PARTEE. It would seem about as low as it can be.

MR. BLACK. Demand is a lot lower.

MR. PARTEE. Relatively, yes. [Unintelligible] without destroying income [unintelligible].

CHAIRMAN VOLCKER. Well, one way to do it is just to say "in all the uncertainty" and leave the other wording as it is.

MR. GRAMLEY. Save that "maintain the expansion of bank reserves" and leave the rest of the phrase as it is.

CHAIRMAN VOLCKER. Yes. Just leave the first phrase as it is through money and credit comma, then "consistent with growth of M2 and M3 in a range of around 8-1/2 to 9-1/2 percent at an annual rate from September to December and taking account of the desirability of somewhat reduced pressures in private credit markets in the light of current economic conditions."

MR. GRAMLEY. Then we need to change something else in the sentence; maybe we don't. The reference to those aggregates is pretty far back. To then say "Somewhat slower growth..."

CHAIRMAN VOLCKER. You're in the next sentence. Well, tentatively that first sentence is all right. Then there are all sorts of suggestions about these last two sentences and whether to leave them in or take them out. I don't think it's too critical one way or the other if we understand the thrust of what it's all about.

MR. WALLICH. I would prefer to leave them in. They balance each other and they justify an overrun or an underrun.

MR. RICE. I agree with that.

MR. BALLE. I do too.

MS. TEETERS. I agree with Henry.

CHAIRMAN VOLCKER. You had a suggested rewording in that last sentence which I didn't think changed it much substantively but made it read better.

MS. TEETERS. Just switch one of the clauses.

MR. WALLICH. I would have put the second part of the last sentence first so that the sentence would read, beginning with the middle of the second line, "In the light of evidence that economic and financial uncertainties are continuing to lead to exceptional liquidity demands."

MR. PARTEE. If there should be evidence of something.

CHAIRMAN VOLCKER. Yes, that's what I was looking for.

MR. WALLICH. Well, I meant to say that there is evidence and that is--

MR. GRAMLEY. That, I think, is questionable, Henry; I really do.

MR. PARTEE. Well, if there is, we should have taken that into account in setting our M2 target.

CHAIRMAN VOLCKER. Yes. I think it's all right the way it is, if I understand this correctly. "In the light of evidence that economic and financial uncertainties are continuing..." We leave that open as to whether it is continuing. That does say they have happened in the past, which I have said.

MR. GRAMLEY. M2 is again very, very low. [Relative to] the targeted M2 now, the last number we have is very low. And it's just awfully hard to see why--

CHAIRMAN VOLCKER. The last month's number?

MR. GRAMLEY. Yes.

CHAIRMAN VOLCKER. But not the previous two months.

MR. GRAMLEY. I know, but the previous two months presumably were affected by the fact that interest rates came down. We have to ask ourselves whether we're talking about a movement along the demand function or a shift in the demand function. And as far as I know, the recent evidence does not strongly point toward an upward shift in demand for money. And that's the way I interpret the staff's comments in the briefing.

CHAIRMAN VOLCKER. Well, I'm not sure that's right. Their velocity is rising.

MS. TEETERS. Well, the NOW accounts are--

CHAIRMAN VOLCKER. Falling, I'm sorry. Changing, anyway!

MR. GRAMLEY. Well, velocity of M2 does have some cyclical movements to it. We sort of expect that when interest rates fall, velocity is going to go down some; now, whether it's off the function, I don't know. But I thought the staff said yesterday that the evidence of recent money behavior is consistent with movement along the function and not a shift.

MR. AXILROD. Well, I wasn't there but if they said anything, the M1 behavior might suggest that. I don't think we can say very much about M2. On M1, if you look at the models--depending upon which quarter you start with--you can interpret M1 as being roughly on the quarterly money demand model. If you start in the first quarter, it might be an upward shift instead of a downward shift; if you start in the third quarter, it's about on.

CHAIRMAN VOLCKER. Well, I'm not so sure this is any big deal. I'm not quite sure what you had, Henry, but let's change it. "In the light of evidence that economic and financial uncertainties are leading to..." That puts it in the future.

MR. WALLICH. I don't want to press this very hard. There is a parallelism between the two sentences. The first says "somewhat slower growth" and the other says "somewhat more rapid growth." And that makes it look more understandable. I would like to see something about rising liquidity demands. Granted, there are some questions about that. But that seems to me to give us a better argument for being flexible about the targets.

VICE CHAIRMAN SOLOMON. Even though both sentences have a parallelism, the bottom line of both sentences is lower interest rates. Right?

CHAIRMAN VOLCKER. Not the second one. It doesn't say lower; it just says they wouldn't be as high as they otherwise would be.

VICE CHAIRMAN SOLOMON. Well, okay. But [conditions are] easier in terms of interest rates.

MS. TEETERS. Why?

VICE CHAIRMAN SOLOMON. That's the thrust of both sentences, given the fact that we are making--

CHAIRMAN VOLCKER. No, no. I think that's unclear yet, [though they are] easier than they otherwise would be. The first sentence says interest rates would be going down and the second sentence presumably says they wouldn't be.

VICE CHAIRMAN SOLOMON. The second sentence says we would tolerate more rapid growth, which means we would have lower interest rates than we would otherwise have.

CHAIRMAN VOLCKER. Than we would otherwise have, but higher than--

VICE CHAIRMAN SOLOMON. Okay. The thrust of both sentences is for easier conditions in the markets, right?

CHAIRMAN VOLCKER. No, the thrust of the second sentence is not for easier conditions in the market.

VICE CHAIRMAN SOLOMON. Well, you are interpreting--

MR. PARTEE. We won't let it tighten the [market] up.

VICE CHAIRMAN SOLOMON. I'm talking relatively.

CHAIRMAN VOLCKER. No, there is nothing in the second sentence that says the more rapid the growth the lower the interest rate will be.

MS. TEETERS. Why don't you just take out the words "are continuing to"?

MR. BALLE. And put in instead "are leading to."

MR. CORRIGAN and MS. TEETERS. Yes, say "lead to."

MR. PARTEE. Well, I really think "in the light of" also is very ambiguous. It ought to be "if, in the presence of evidence" or that kind of thing. We used "in the light of" up above in a way that I didn't quite understand and we're using it again here.

CHAIRMAN VOLCKER. It [needs] something a little less awkward but "in the presence of" sounds like the presence of a--

MS. TEETERS. Take out that whole thing "in light of the evidence that" and just put "if." That would work.

MR. PARTEE. Or "should economic and financial uncertainties lead to exceptional liquidity demands."

MR. AXILROD. There's the language of the last directive-- "are leading to..."

MR. PARTEE. I guess nobody else shares my preference that this sentence be dropped. None of those who plan to vote for the directive shares my preference.

CHAIRMAN VOLCKER. Maybe everybody is going to vote for it! "Should economic and financial uncertainties lead to exceptional liquidity demands, somewhat more rapid..." Is that what we're saying?

MR. PARTEE. Yes, I think so.

MS. TEETERS. I don't think it really matters whether it's somewhat more rapid.

MR. PARTEE. And that, of course, has to be interpreted.

CHAIRMAN VOLCKER. Actually, that previous sentence almost goes without saying and I don't know whether that's necessary.

MS. TEETERS. Well, it gives us a little [unintelligible]. It puzzles--

MR. PARTEE. Well, I think it says that if we could do it without a lot of effort, we'd prefer to meet our targets.

MR. CORRIGAN. I think that second to the last sentence is very helpful.

VICE CHAIRMAN SOLOMON. I think we have to leave in something more or less like the last two sentences since we have now said "consistent with M2."

MR. PARTEE. Yes, we have a target.

VICE CHAIRMAN SOLOMON. Earlier, I didn't think it was necessary to leave in those sentences.

CHAIRMAN VOLCKER. Okay. What about the federal funds rate sentence? In or out?

MR. PARTEE. I'd prefer not to have it. It's enough of a change that it's difficult to know what the funds range should be. Our tradition on the funds range has been to make it above and below the present rate; apparently that's not acceptable. And the range that was suggested was a 3-point spread; we dropped it from 5 points to 4 points last time and to go on to 3 points seems to me would destroy more than it would accomplish.

MS. TEETERS. But it also gives us the trigger for a conference call, which I think is useful.

MR. PARTEE. We don't need to have a trigger for a conference call. There could be another understanding.

MS. TEETERS. The understanding could be when the federal funds rate is below 7 percent or above 10 percent. We may not have to put it in the directive.

CHAIRMAN VOLCKER. As we're meeting here, the federal funds rate is roughly 10-1/2 percent. I guess I don't have any problem with leaving in the sentence if you want to and saying 7 to 10-1/2 percent.

MR. PARTEE. Well, I'm against it.

VICE CHAIRMAN SOLOMON. It certainly seems a lot less important.

MR. WALLICH. If we drop it, that would convey less of an interest-rate-oriented directive. And I think it's desirable to avoid being very specific about our interest rate [objective] here.

MR. CORRIGAN. Who knows how the market will interpret it? I think the other argument is just as likely: That the absence of it would lead to the view that we really have zeroed in on a specific number. I don't know.

MR. FORD. How about just saying that the fed funds rate will not rise above 10-1/2 percent? Isn't that what we mean? Why not say what we mean if that's what we mean. I don't mean to be facetious, but if we wanted to convey the true feeling of the group, I think that's what we mean, so why not say it? That would be conveying accurate information to the market as to what our objective is.

MR. MARTIN. Of course, if we say 7 to 10-1/2 percent, we're conveying a little more information, which is that we might really tolerate a low rate. That 7 percent might get their attention.

MR. MORRIS and MS. TEETERS. It was in there last month.

SPEAKER(?). But of course, that's--

MS. TEETERS. They haven't seen it yet, though, Frank.

MR. GUFFEY. I would opt to have a funds rate range of 7 to 10 percent; I would hope that it will be at 10 percent tomorrow and that that would be the maximum we'd tolerate on the up side. I had a similar question.

VICE CHAIRMAN SOLOMON. Or lower.

MR. GUFFEY. Well, that's all right. We'll be there tomorrow. But the point is that the 7 percent is also an important figure to me. I would hate to see interest rates drop quickly if, for example, we get very slow growth in M2--if that's what we are targeting on or trying to use as the target. But 7 percent is equally important.

VICE CHAIRMAN SOLOMON. Following up on what Roger is implying, I think the chief advantage of having a sentence on the

range is that if--and I say if--the market reacts to this with great uncertainty, this gives some sense of reassurance that we are not thinking of simply an all-out drop. I don't see that it's important otherwise; I don't think it's much of a guide. But there is some advantage of having it in, if we get an unfortunate interpretation. I don't think, though, that we'd want to have 7 to 10-1/2 percent; I think we'd want 7 to 10 percent. I don't see what the problem is.

MR. PARTEE. I still fail to follow the logic. In the past we've said to the Manager, in effect, if in following the reserve path consistent with these aggregates, the funds rate moves enough so that it gets to the ends of these bounds, then the Chairman will decide whether to have a conference. Now you are suggesting that we set everything so that it won't get beyond those bounds.

VICE CHAIRMAN SOLOMON. That's right. It has no substantive function whatsoever now, under this [approach]. It's only a question of whether it reassures or limits somewhat the degree of uncertainty in some quarters.

MR. WALLICH. I think that might mislead the market. Following our past practice, we aimed at the middle of the range and, therefore, if we said 7 to 10-1/2 percent, we really meant 8-3/4 percent as the starting point.

MS. TEETERS. But the Chairman is going to be asked to release some of this when he meets with the Business Council, and I bet somebody asks him what the interest rate--

SPEAKER(?). You wouldn't answer.

SPEAKER(?). You won't tell them?

CHAIRMAN VOLCKER. No, I really--

MR. PARTEE. It says now "somewhat reduced pressures in private markets." It seems to me that "somewhat reduced pressures" could convey [our meaning] just as well as a range would. Indeed, 7 percent might seem surprisingly low.

MR. GRAMLEY. Well, I don't think we're going to fool anybody one way or another; when this press conference occurs, they are going to know what we did. They will just look at money market conditions and it will be abundantly evident by what happens in the interval between now and the time the directive is released.

MR. MARTIN. There may be a confetti parade.

SPEAKER(?). I don't know about confetti!

CHAIRMAN VOLCKER. Well, there are arguments on both sides. I don't feel strongly at all. Leave it out?

SPEAKER(?). Put it in.

SPEAKER(?). Leave it out.

MR. BALLE. Put it in.

MS. TEETERS. Which is more useful to the Desk?

MR. STERNLIGHT. Operationally, I don't see it as having a function during the period. When it is published and people look at it, seeing that there was a range would give them more of a sense of continuity with past procedures. If the Committee values that, I think there's an argument for keeping it in. Frankly, to leave it out I think gives more weight to the view that a change is being made.

MR. WALLICH. We are at a time when we are softening the money supply aspect of the directive; it would be a fair balance if we also soften the interest rate aspect of it.

MS. TEETERS. But on the other hand, it seems to me that we don't want to upset the market totally. The main question would be why it isn't in.

MR. CORRIGAN. I think the continuity argument has some real weight.

VICE CHAIRMAN SOLOMON. There may be some people in the market who, if they see interest rates declining, would wonder if we are going to let them decline, or push them down even, by a very large [amount].

CHAIRMAN VOLCKER. They won't know. By the time this comes out, we may have the same level or a different level.

MR. PARTEE. They will look at the way the Manager operates, as they always have, and try to conclude where the limits are.

VICE CHAIRMAN SOLOMON. Oh, why don't you take a show of hands? I don't think it's that important.

CHAIRMAN VOLCKER. How many want it in? How many want it out? A lot of people are indifferent.

MR. BLACK. Ask how many are indifferent. You might get a majority!

CHAIRMAN VOLCKER. How many are indifferent?

MR. MARTIN. The indifferents have it.

SPEAKER(?). Flip a coin.

MR. GRAMLEY. We've left it up to you, Mr. Chairman. Do what you want.

CHAIRMAN VOLCKER. I guess I'd prefer slightly to leave it in. No big deal. Okay, I guess that's it. Any other comments?

MR. FORD. Just out of curiosity, what are you leaving in--7 to 10-1/2 percent?

CHAIRMAN VOLCKER. That's what I guess is in.

VICE CHAIRMAN SOLOMON. With the half on the 10?

MR. RICE. I would go for 7 to 10. What does the half point do for us?

MR. PARTEE. That's where the rate is.

CHAIRMAN VOLCKER. It's where it is; that's all. We will have a consultation if it goes above where it is now. That is what we are saying.

MR. WALLICH. It would mean that we would be on the phone tomorrow if we say 10 percent.

MR. BLACK. It just says that the Chairman may call for a consultation; it doesn't say he has to.

MR. RICE. We have a month to get down to 10 percent.

MR. WALLICH. Well, I hope there's a strong presumption--

SPEAKER(?). That's too long.

CHAIRMAN VOLCKER. Okay. Let's vote.

MR. ALTMANN.

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

CHAIRMAN VOLCKER. Okay, is that the end of our business?

MR. ALTMANN. The date of the next meeting, which everyone knows, is November 16.

CHAIRMAN VOLCKER. November 16 is the next meeting date.

END OF MEETING