Meeting of the Federal Open Market Committee

August 21, 1984

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, August 21, 1984, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Boehne
Mr. Boykin
Mr. Corrigan
Mr. Gramley
Mrs. Horn
Mr. Martin
Mr. Partee
Mr. Rice
Ms. Seger
Mr. Wallich

Messrs. Balles, Black, Forrestal, and Keehn, Alternate Members of the Federal Open Market Committee

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

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Oltman, Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Burns, J. Davis, Lang, Lindsey, Stern, and Zeisel, Associate Economists

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Promisel, Senior Associate Director, Division of International Finance, Board of Governors
Mr. Henderson, Associate Director, Division of International Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Fousek, Executive Vice President, Federal Reserve Bank of New York

Messrs. Balbach, T. Davis, Keran, Parthemos, Scheld, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, San Francisco, Richmond, Chicago, and Atlanta, respectively

Mr. McNees, Vice President, Federal Reserve Bank of Boston

Mr. McCurdy, Research Officer, Open Market Operations, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
August 21, 1984

CHAIRMAN VOLCKER. If we can come to order, I need a motion to approve the minutes.

MR. MARTIN. Move approval.

CHAIRMAN VOLCKER. Without objection. You have received a report on the examination of the System Open Market Account. I assume you all have examined that with care.

MR. PARTEE. It's very straightforward.

CHAIRMAN VOLCKER. Are there any comments? In the absence of any comments, we could have a motion to accept it.

MR. MARTIN. Move approval.

CHAIRMAN VOLCKER. Without objection.

CHAIRMAN VOLCKER. Mr. Cross,

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

CHAIRMAN VOLCKER. Comments or questions? It left everybody speechless! We have nothing to approve, right?

MR. CROSS. Nothing to approve.

CHAIRMAN VOLCKER. Let's turn to Mr. Sternlight.

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

CHAIRMAN VOLCKER. Any comments or questions about the earlier part? Mr. Black.

MR. BLACK. Peter, do you regard this recently widening spread between the discount rate and federal funds rate as a transitory phenomenon that's likely to be reversed fairly soon? If so, how would the Desk react to that?

MR. STERNLIGHT. I consider it transitory in the sense that I don't regard it as permanent, but I have some real question about whether it will reverse very soon. I think it might tend to narrow gradually but I don't have a strong sense of confidence as to the timing or extent of that.

MR. BLACK. If it did happen pretty soon, would you hold to your borrowing target and let the federal funds rate come down?

MR. STERNLIGHT. Well, that would depend a good deal on the nature of the discussion around the table here. I think [the answer is] mechanically, yes, but there are nuances in the day-to-day execution of policy in that we'd want to take guidance from the Committee's sentiment.

MR. BLACK. That would be the mechanical [response].

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Peter, I too am sort of mystified by this up-creep in the funds rate relative to borrowings. It's really quite obvious and seems to be rather enduring. You mentioned Continental's borrowing in a negative way--as not being a factor--but I'm inclined to wonder whether in fact it isn't a factor. I seem to recall that we observed the same kind of phenomenon when Franklin borrowed sizable amounts in the summer of 1974, and I'm wondering whether there isn't something about the channels of distribution that could have some marginal impact on the rate relationship.

MR. STERNLIGHT. I mentioned the reluctance to borrow as the most reasonably clear and persuasive reason to me. I didn't mean to dismiss entirely the Continental borrowing and the cutting of new channels. I'm not thoroughly persuaded; that has some plausibility to me, but I can't really pin down well in my mind just how the whole process worked.

MR. PARTEE. You seem to have the same view that I do. I feel that there might be something there too but, of course, one can't prove it and the arithmetic doesn't support it. But, still, there are quite different channels. The reason I mention it is that it doesn't look as if Continental is going to be out of the [discount] window anytime soon; in fact, they may borrow substantially more over the weeks and months to come. So, if there is a tendency for that [to occur], it could be exacerbated. And if we had to [unintelligible], I don't know what to do about it. But I wonder whether it isn't a factor.

MR. BLACK. We took a cursory look at it--and this is by no means definitive--and it looked as if there was reluctance to borrow by large Chicago banks more than anything else.

MR. PARTEE. Well, of course, one thing that happens when we count it as nonborrowed is that what used to be Continental's borrowing from time to time automatically gets excluded. Now, that can't be quantitatively very big. That would be one factor.

MR. BLACK. We figure the Chicago banks wanted to make darn sure nobody felt they were in the same situation as Continental and they might be more reluctant to borrow.

MR. KEEHN. The big banks have not been in.

MR. BLACK. That was the most striking difference that we found in just a quick look at it.

MR. KEEHN. In fact, proportionately the District borrowings are down.

MR. AXILROD. We had reports that one or two banks--for sure one New York bank--were told by their executives to stay out of the window.

MR. BLACK. I can imagine some of them are reacting that way.

MR. STERNLIGHT. We've had that information from two or three of the very large banks. And some of them think that it's true of others, but not everyone admits to it in a direct way.

MR. BLACK. We might see some more, given Financial Corporation of America's problems.

MR. STERNLIGHT. That is possible.

CHAIRMAN VOLCKER. Any other comments?

MR. KEEHN. This is really an observation. With Continental's large and prospectively even larger borrowing and with Financial Corporation of America likely to come in, several people have asked the basic question of what our technical limitation is by way of a borrowing level. What is the operational limit? If there is a possibility of a problem, it might be helpful if we had a rather uniform statement as to how we might reply to this type of inquiry.

CHAIRMAN VOLCKER. Well, I don't think we want to give any impression that there is any limitation under these circumstances. Unfortunately there is, which surprised me. We have a collateral requirement for Federal Reserve notes which cannot be met by lending to banks unless the loans are secured by eligible paper. So, we may have to put in a little effort to get some eligible paper to secure those borrowings and to keep track of it. The limits are not all that far away, if we get another big bank coming in to borrow or if Continental's borrowing keeps going up. It depends upon circumstances elsewhere on a day-to-day or week-to-week basis. That troubles me.

VICE CHAIRMAN SOLOMON. The way I've heard the question is not so much the way Si has heard it but: At what level will distress borrowing complicate open market monetary policy operations? Will there be a limit on the amount of borrowing the System can make available to banks that need liquidity because of the problem it creates for our open market operations?

MR. PARTEE. I think the answer is that Paul has [noted] something that is going to hit before the limit on open market operations hits.

VICE CHAIRMAN SOLOMON. It's going to hit earlier?

MR. PARTEE. Yes. That hits early. Hardly anybody knows about it, but we have to collateralize those notes and it's a criminal offense to issue them without proper collateral. So, it would come up with another ten billion in borrowing.

MR. BLACK. When banks are out of Federal Reserve notes we just send them coins!

MR. PARTEE. Well, that's what we would have to do--just withdraw currency from circulation.

MR. MORRIS. Maybe that's how we can get the Susan B. Anthony coins in circulation!

CHAIRMAN VOLCKER. It depends upon what the market circumstances are. If market circumstances are disturbed, as they might be in those circumstances, we couldn't offset it. But it may be that we wouldn't want to [do that] in some circumstances.

VICE CHAIRMAN SOLOMON. There are a lot of questions of that sort floating around and there is a lot of uneasiness. And if FCA comes into the [discount] window, I think we're going to see a significant increase in concerns. You know [about] the actions that took to help FCA out--they are a very tough bunch, strictly profit oriented--and for the first time I heard them saying that part of their motivation was their worry that the FCA situation would extend to other thrifts and just cause general problems which, of course, would affect them, too.

MR. BALLES. Mr. Chairman, so everybody will be up to speed on the FCA situation, it's quite likely that they will be in to the window this week, though not in a big way in the sense that we've been pressuring them hard to get lots of collateral with us and all they have come up with so far is $2 billion. And that is all very large denomination commercial real estate loans. We have a team analyzing and evaluating this on a crash effort basis but initially, if they do request accommodation, we're going to take at least a 50 percent margin on that stuff and may never go above that margin. So, for collateral reasons, we couldn't go above $1 billion right at this moment. And it's doubtful that they are going to be able to get much more collateral into our Bank--at least this week. I might add that none of it, of course, is eligible commercial paper. It's all large denominations of commercial real estate loans. So, it won't help that particular aspect of [our collateral] problem.

MR. MARTIN. Yes, it may be that it will require a FHLB or FSLIC guarantee behind even a collateralized loan to provide enough liquidity even in the very short run on a day-to-day basis.

MR. ROBERTS. Can we lend to the Home Loan Banks?

MR. BALLES. Well, that's an issue I've raised and I hope we will get a firm answer to that pretty quickly. We may need it. It's under discussion now, I understand, but I don't know what the answer is. We did raise the issue of whether we could lend to the Home Loan Bank based on collateral promissory notes that they have from their customers. FCA has been scrambling hard to get billions of collateral into the Home Loan Bank; that's where they put their big effort. But even there they may run out of gas, in terms of acceptable and available collateral. We hope to avoid the loans [to] the HLB itself; it would make many less waves in terms of all sorts of things if we could lend to FCA, but we are exploring direct loans to the Home Loan Bank as a fallback position. We've asked our staff along with the Board's staff to explore the legal and other aspects of such loans.

MR. PARTEE. I'm sure it can be done. That's a paragraph 3 loan.

MR. AXILROD. Unless things have changed, by law at the moment a loan to a Home Loan Bank--unless it's secured by something interpreted as government securities--would require a 5-man vote of the Board and a declaration that it is because of unusual and exigent circumstances. It's technically possible by law but it would need at the moment to be within those confines.

MR. FORRESTAL. The press is reporting $800 million borrowing from the Home Loan Bank. Is that accurate?

MR. PARTEE. No.

MR. MARTIN. No.

MR. ROBERTS. Paul, if borrowing burgeoned, let's say, to $25 billion in the System and we didn't have the collateral to sell, just technically isn't it possible that we could raise reserve requirements? I understand the psychology, but that would be the mechanical way to resolve it, wouldn't it?

CHAIRMAN VOLCKER. Mechanically, yes, we could resolve it that way.

MR. ROBERTS. If we announced that that was the purpose.

CHAIRMAN VOLCKER. It depends on the circumstances; I can't see offhand that that's likely to have any advantages over selling in the market.

MR. ROBERTS. But if we didn't have anything to sell--.

MR. BLACK. That's not the problem, I don't think.

MR. STERNLIGHT. We have plenty of short-term securities to sell.

CHAIRMAN VOLCKER. Well, actually, that might be a way to maintain the assets that we need. I suppose that's what we could be driven to in order to maintain the assets we need to collateralize the currency. That could make all the banks love us!

VICE CHAIRMAN SOLOMON. But at that point we probably would need some ease in the financial markets and, if anything, in the banking system.

MR. ROBERTS. We could ease. If we're expanding reserves by the borrowing, we could less than offset them by the reserve requirements and still ease.

CHAIRMAN VOLCKER. No, you could get the same mechanical result. I guess we could do it--protecting our assets that we need to back currency.

MR. PARTEE. That's hard to explain, though. Can you imagine saying that on account of the financial crisis, we're raising reserve requirements?

MR. ROBERTS. It's better than the alternative, Chuck, of saying "We can't accommodate you at the window."

CHAIRMAN VOLCKER. We would have to raise the reserve requirements quite a lot, I guess.

MR. MARTIN. Bob, back to your question again, the last figure we had yesterday on the American Savings & Loan borrowing from the HLB--and I can be corrected by staff--was about $2.3 billion. There was a reduction because of the payback out of the
credit extended on a portfolio of single-family residential mortgages. So, they paid down part of a HLB balance that was running about $3 billion. They--temporarily, I stress--paid it down to about $2.3 billion yesterday. Of course, this morning at 9:00 a.m. California time, they may be right back to that or even higher.

MR. FORRESTAL. Is the HLB's limitation basically collateral or their own funding problems?

MR. MARTIN. It's a combination of things, including the bit more autonomy that a HLB Board of Directors has compared to a Federal Reserve Bank Board of Directors.

VICE CHAIRMAN SOLOMON. Do they have a run on?

MR. MARTIN. Of course they have a run on. They have had a run on now--

VICE CHAIRMAN SOLOMON. I see comments in the press. First, they talked about the institutional deposits they were losing. Then in the last few days, ever since the revised earnings report, I saw that it was retail deposits.

MR. BALLES. Tony, that's totally inaccurate. That New York Times story was especially bad yesterday about their losing only $200 million and that most of it was retail. In fact, in the last 4 or 5 business days the net loss has been a half billion dollars a day on average and the great bulk of it is in these jumbo accounts.

MR. MARTIN. So, the so-called retail is very frequently a result of telephone solicitation in a city like Washington, D.C. by an employee of FCA or by American. That's so-called retail. It's not from Merrill Lynch. That makes it retail.

MR. BLACK. They had 300 people doing that, didn't they?

MR. MARTIN. 1,000.

MR. BLACK. It's 1,000 now?

MR. MARTIN. Counting everybody.

MR. BLACK. The press reports have been inaccurate on that too, then.

MR. MARTIN. The only matter that one could say was well done in this whole thing--and not from a moral point of view--has been the management of news by these folks.

MR. BALLES. They lie very well.

MR. MARTIN. I was trying to avoid that term, John.

CHAIRMAN VOLCKER. We have this question of limits. Are you [unintelligible] convinced by Mr. Sternlight's analysis?

MR. PARTEE. He's in a better position than we are.

CHAIRMAN VOLCKER. [I need] somebody to make a motion.

MR. STERNLIGHT. Again, it's very uncertain and a lot depends on the extended credit. If I were sure that that were going up substantially, we wouldn't really need the [additional] leeway and I would just wait until the situation arises. I'm just asking as a matter of prudence because I see the possibility at this point.

CHAIRMAN VOLCKER. What are you asking for specifically?

MR. STERNLIGHT. An increase from $4 to $6 billion, Mr. Chairman.

MR. PARTEE. And this will be in reserve absorbing--

MR. STERNLIGHT. That more or less assumes extended credit unchanged.

CHAIRMAN VOLCKER. That isn't exactly likely to happen. Do we have a motion?

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. Do we have a second?

MR. MARTIN. Second.

CHAIRMAN VOLCKER. Do we have any opposition? If not, it's approved. We have to ratify the transactions. Without objection. Mr. Kichline.

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

VICE CHAIRMAN SOLOMON. I have a question about your projection on inflation. You are projecting, as you just said, 1 percentage point higher inflation in '85 compared to '84. But if I understood correctly your analysis 6 weeks ago, you are projecting about a 1 percentage point rise in unit labor costs. Now, that alone could account for a 1 point rise in inflation but on top of that you're also factoring in a 10 or 15 percent reduction in the exchange rate, and presumably you'll get some some increase in utilization of capacity. I don't see how, based on your assumptions, you end up with only a 1 percentage point increase in inflation in '85 over '84.

MR. KICHLINE. We now have unit labor costs rising in 1984 at about 2-1/2 percent and for 1985 we have them up in the neighborhood of 4-3/4 percent. It's a substantial rise, in part because compensation is rising and in part because we have smaller gains in our forecast for productivity. So, we get a substantial rise in unit labor costs, but from a level in 1984 that is quite moderate. With respect to the dollar, you are quite correct that we have the adverse effects there but they really show up very late in the year. As time has gone on, in fact, two things have happened. One is that Ted keeps saying the dollar in our forecast should come down 15 percent. The thing we don't talk about is from what level; and the level always is higher in the short run. So, in part what we're dealing with is more favorable prices from the dollar occurring early on in 1985; it's really in late 1985 that the adverse [dollar] effect occurs.

VICE CHAIRMAN SOLOMON. But don't the price effects show up a lot earlier than the trade effects?

MR. TRUMAN. They certainly show up earlier, but Jim is certainly correct. If you had [a dollar decline of] 15 percent for the fourth quarter of the year--which is not what we're projecting--by the fourth quarter of next year you would only have half of the price effects of that. And if you spread out that 15 percent decline over the next 5 quarters, then you're really talking about having a relatively small component of the price effects of the dollar [decline]. In fact, we have nominal import prices going up over the 4 quarters in 1985 by about 14 percent, so even there we don't have all this coming through, with lags and so forth, until after the projection period.

MR. WALLICH. But even if the dollar stays where it is, since it has been rising over time we have some benefit for inflation from that rise if it stops.

MR. TRUMAN. That's Jim's point.

MR. FORRESTAL. Mr. Chairman, I wonder if I could follow on this with a similar question. I generally agree with the staff forecast but, if I understand your analysis correctly, you have revised your growth forecast upward and you have revised the inflation number downward for 1985, whereas the unemployment rate associated with both of those is unchanged. There are obviously several explanations for this--the strength of the dollar, perhaps increased productivity, and so on. But, frankly, I'm a little confused about what seems to me to be a somewhat inconsistent forecast. Can you enlighten me?

MR. KICHLINE. First of all, I would say that given the margin of error I view our real side forecast as not significantly different from what we had before. But you're quite correct that to the extent we made changes over the 6-quarter period they are up--especially for 1985, where it's a quarter point or so higher. On the inflation side, I'd mention several things. One is very important: food prices. Indeed, we now have a food price increase of about 5 percent projected for this year and next. That had been in the range of 6-1/2 percent and earlier it was up to 7-1/2 percent. That's a big number in terms of the overall price picture. There we think we just missed; it may show up later but frankly we've held onto that forecast in making downward revisions along the way. But, again, it's very important. The dollar we have talked about. In the very near term there is energy; we had gasoline prices dropping at something like a seasonally adjusted 12 percent annual rate in the third quarter. That has lagged in the PPI; we haven't really seen much of that in the PPI and it should be showing up. When we get the CPI it ought to be showing up soon; so, in the very near term, we think energy markets are quite weak. We have noted that also spilling over into coal and natural gas prices. The only thing that seems to be happening is that electricity rates are going up. But that's important for us in the shorter run. More so, I'd say, is our assumption on oil prices which is that in fact they will be drifting down a little in real terms. So, we have taken a more optimistic view on some of those things. I would also note that on the wage side, the numbers that came in on the GNP revision over the last 3 years tended, especially in 1983, to revise down rates of increase in compensation. Part of it is on the benefit side but as more information became available, compensation increases in the past now look different--that is, lower and more favorable. On the wage data, we had been expecting fairly good numbers and they were better than we thought. The employment cost index now is running at 4 percent over the first half of the year. It's down more than a percentage point from 1983. The contracts that have been settled to date so far this year are averaging a 3.8 percent increase for the first year. Basically, we sat down and looked at a broad range of information from many different sources and concluded that it would be prudent to knock some tenths off of various things, which we did. And it added up to a more favorable picture.

CHAIRMAN VOLCKER. I don't know as we can stand all this good news!

MR. BLACK. Just one short question, Jim. [Unintelligible.] Do you have a gross domestic business product fixed-weight index for the second quarter now?

MR. KICHLINE. Here comes the bad news. It was revised up to 4.1 percent; the preliminary number had been 3.3 percent. I would say that that is of virtually no concern because nearly all of it occurred in the residential structures component. The Commerce Department now says that prices associated with the residential construction area rose at an 11-1/2 percent annual rate in the second quarter. At this point, much of that is really fiction as much as fact. They don't have very much information.

MR. PARTEE. How do they get it?

CHAIRMAN VOLCKER. It seems like an extraordinary rate of increase in prices of residential construction.

MR. KICHLINE. Well, keep in mind that there was something like a 2 percent increase, I believe, in the first quarter. They reported a 5-1/2 percent increase initially in the second quarter and now they have 11-1/2 percent. If history rings true, they could have zero or minus 3 percent for the third quarter. That number really just flips about. So, it's not in an area that we think is a real problem, but it was revised up.

MR. BLACK. They're probably capturing improvements in quality, as I understand it. What do you think?

MR. KICHLINE. I don't know. At this point they really do have limited information and they have a great deal of trouble with mix problems. We have been getting a lot of increase in multifamily construction and they may well end up revising that away later on.

CHAIRMAN VOLCKER. If I understand, all the construction materials prices are steady or down and wage rates are steady.

MR. BLACK. And there are no changes in the implicit deflator. It's an unusual phenomenon.

MR. MARTIN. In support, Jim, of our outlook for inflation, I think we need to be careful not to assume that the projected changes in the value of the dollar--I'm being serious now--will have the kinds of impact on domestic producers and on prices of both business goods and consumer goods as was true in many other expansion periods. It seems to me that the loss of share of the market to foreign suppliers --to the out-sourcing entities--is to a large degree a fairly long-term loss of those markets. Domestic producers and domestic sellers may get those markets back or they may not, and those are important market gains to the foreign producer. He is going to hold on to that market share if that means price concessions or price steadiness. I think the American consumer will benefit from that. So, the loss of share of the market has a positive impact on domestic inflation in this country.

CHAIRMAN VOLCKER. On the other hand, although there may be something to what you say, we're going to get some protectionist measures that may lead to some direct price [effects] in steel and copper and other things.

MR. MARTIN. And those industries will find all kinds of ingenious ways to get around those measures unless they are very, very broad and firm indeed.

VICE CHAIRMAN SOLOMON. I'm not sure that your basic proposition is clear because [foreigners had] even a much smaller share of the [domestic] market in 1978 when the dollar was down [unintelligible], and other exporters were giving discounts to keep their share of the market. What you're really saying is that because the foreign share of the market is larger than it was, they are going to be more willing to make concessions.

MR. MARTIN. They are going to have slow growth in their own economies, Tony. Their own markets are not expanding the way their share of our markets is expanding. They have a very great incentive to hold their prices or not increase them much, and that puts pressure on our price setters. These are administered prices and it is very important to keep them steady because they have just gotten that share of the market. If you have just penetrated it, you are going to be very careful in your pricing. These are cartel mentalities from these other countries. They have a different legal scheme where they are going to administer those prices carefully, I think, to maintain their market share in the world's biggest market.

MR. PARTEE. Do you think they would tend to hold their dollar prices and eat the change in the exchange rate profit?

MR. MARTIN. I do, sir. We're talking about the short run.

VICE CHAIRMAN SOLOMON. Empirically what they do, Chuck, as I had occasion to follow it very closely, is that they don't hold their dollar prices but typically will split with their distributor half the costs of the exchange [rate change]. The distributors also have an interest in preserving the volume and share of market, so they will cut their own [profit] and the manufacturer will [unintelligible] and be willing to accept some of the smaller profits.

MR. MARTIN. For a while.

MR. PARTEE. For a while. This is part of the lag that Ted is talking about.

MR. MARTIN. I think we'll have more lag.

MR. WALLICH. It troubles me that most of the good news about inflation does seem to be reversible over time--not all of it, but most. It's reminiscent of the early '50s when we were telling ourselves that we had finally achieved price stability and what was happening was that food was coming down for several years and everything else was going up and the net was stability. This is likely to catch up with us again after a year or two.

MR. MARTIN. In a recession?

MR. WALLICH. I hope that will give us some boost. I was just assuming that the economy would be growing at a stable rate.

VICE CHAIRMAN SOLOMON. If you analyze what happened to inflation in the last recovery which was almost a 5-year period going from the third quarter of '75 to the first quarter of '80--and I'm not saying I've done it scientifically, but I've asked a lot of questions about this--we hit double digit inflation problems. Part of that, of course, was a very large drop in the dollar. First of all, I would put the oil shock as [unintelligible] and then the drop in the dollar. And part of it, I guess, was monetary policy. Even though the money supply numbers looked pretty good for most of that period, interest rates really did not rise and in hindsight the experts tell me that there was a shift in the demand function--whatever that means, I don't know.

MR. PARTEE. Unexplainable!

VICE CHAIRMAN SOLOMON. The interest rates would not keep the rise [unintelligible] agreed-upon proposition. Until the dollar began declining, which forced some major rises in interest rates, [unintelligible] interest rates probably did not keep the economy from overheating. It's interesting to analyze when you look back if there is any way to give weight to these certain factors. Was the System more to blame than the Arabs and OPEC? I don't know. It's true that we probably are not going to have an oil shock. That looks to be the case. It looks as if there are going to be a lot of assurances against another oil shock almost permanently--I mean by permanently in the next 5 to 10 years. And presumably we're running monetary policy now somewhat more tightly. We are more sensitive to an inflationary threat during a recovery. On the other hand, we don't really know how the dollar will behave and what the impact of that would be. So, it seems to me that there's a useful lesson to be learned from doing more scientifically what I was trying to do--analyzing what is different in the factors affecting inflation in this recovery than in the last one. That is relative to Henry Wallich's kind of pessimism about [unintelligible]. Are we going to end up doing any better or not? It seems to me that there are two things going for us that may make a significant difference. One is the likely absence of any oil shock and the other is the way we are running monetary policy now.

MR. WALLICH. Well, I was speaking about an even more distant period. In the early '50s we had no particular oil shocks; we had a food shock. As I look at the numbers for the future, capacity utilization now has been upgraded in this staff projection by almost 1 percentage point for the end of '85. Nominal GNP is about the same, but real GNP is significantly higher in the latest projection. I don't know what happens to unit labor costs but they certainly rise very sharply from '84 to '85. And in that environment, to think that inflation will rise by only 1 percentage point is on the optimistic side.

MR. FORRESTAL. And nobody has mentioned fiscal policy.

MR. WALLICH. Right. There is an increase of $20 billion in the full employment deficit--in other words, something we would have regarded as enormously stimulative some years back.

MR. AXILROD. Governor Wallich, do you think interest rates will rise in that scenario?

VICE CHAIRMAN SOLOMON. We tend to think there might be some rise in interest rates in '85, which would hold things back a little.

MR. ROBERTS. Well, it's interesting how the deficit has disappeared from the market's thinking. It was pervasive and now it's somewhere in the background.

MR. MORRIS. The one positive factor that you didn't mention, Tony, is that if you compare this expansion to the one of the late 1970s, the rate of wage advance is substantially lower now than it was at the same stage of that expansion.

MR. MARTIN. And the rate of productivity increase is much higher.

MR. MORRIS. Not yet.

MR. MARTIN. Relative to the 1970s.

MR. MORRIS. I don't think we can really document that yet.

MR. MARTIN. 2.9 percent and 3.3 percent are the numbers.

MS. SEGER. [Unintelligible] in the early '70s.

MR. GRAMLEY. Well, the trend was. But Frank is talking about the same period of expansion. We had a very substantial improvement in productivity as we came out of the 1974-75 recession.

MR. MORRIS. Unit labor costs are doing much better now but primarily because the rate of wage advance is much lower.

MR. PARTEE. And, of course, real interest rates are much higher.

MR. BLACK. But, Frank, it's interesting if you look at consumer prices. So far in this expansion they have been 5.6 percent, which is the second largest amount of increase in any of the 6 postwar recoveries. And the fixed-weight price index is up 6.2 percent versus 6.5 percent in the 1970-72 period, which means more is going to profit despite wage restraint. It doesn't look that different. It's rather scary as a matter of fact looking at some of these, which I have done on a preliminary basis but not as thoroughly as I need to. Producer prices look a lot better; they are half as much so far as in 1970-72--2.3 percent versus 4.6 percent for the first six quarters. That has food in there; if you look at the nonfood part you might get a different impression. I just happened to run across these right before the meeting.

MR. WALLICH. Why is it that the projection for the output per hour--that is, productivity--is so pessimistic for 1985? I missed that; it goes from 2.5 percent in 1984 to .8 percent.

MR. MARTIN. I'm glad you asked that question, Henry.

MR. KICHLINE. Because we think that we've overshot trend. The way these things are done, in looking back at history one would assume that over time we would get down to a trend rate of growth. Our view is that in 1984 we're dealing with trend growth of productivity of around 1-1/4 percent. That's subject to debate, but that's the number we used. We're getting more than that and we expect we will slowly be approaching trend, so that in 1985 we fall below 1-1/4 percent.

CHAIRMAN VOLCKER. In looking at these summaries of District business conditions, I thought I detected a considerably more cautious tone than had been reflected earlier. Did I detect wrongly?

MR. GRAMLEY. Do you mean on the price side or business?

CHAIRMAN VOLCKER. No, on the business [side].

VICE CHAIRMAN SOLOMON. In my District I noticed that my board reflects that more cautious tone. They are heavily influenced by retail sales, car loans--the [industries] they are in--and they seem to feel that [business conditions] are not quite as ebullient as they were. Still, that's just a nuance of tone, I think.

MR. BOEHNE. Part of that is that in the business community there is nothing very tangible except the old conventional wisdom that what goes up comes down. Things have been going along pretty well and they think it has to come to an end sooner or later, so I think that makes them cautious. Looking at it from an analytical point of view, while expansions vary all over the lot in terms of length, we are moving up toward an average life for this recovery. And I think Pres made a point on the inflation outlook that things are going along pretty well right now. As you look out, you can see certain possibilities of being ambushed but one that hasn't been talked about is the possibility of a recession. We have a great reluctance to project recessions around the table. In fact, most people do. But I think at least some mild recession out over the 1985-86 horizon is a reasonable possibility. And that is clearly a negative as far as inflation turning around. Being this far [into a recovery] with the positive signs that we have--. We really have made a remarkable downward adjustment in inflation from the last cycle to this one. And it seems to me that most of those gains are going to be maintained, largely because we have circumstances that are favorable and also just because expansions wear out in time and finally they die. That, I think, is the basic assurance of it really [not] getting away from us.

MR. PARTEE. I really don't understand how you can say that, Ed. We're 2-1/2 years into the recovery. At 2-1/2 years into the middle 1970s recovery, we didn't have much inflation. Bob was giving those figures.

CHAIRMAN VOLCKER. We're only 21 months, I guess, by a generous interpretation.

MR. PARTEE. It took quite a while for that inflation to heat up in the middle 1970s.

MR. BOEHNE. Yes, but that really got going, I think, as a result of the oil shock.

MR. PARTEE. Well,--

MR. BOEHNE. It contributed to it, but was not a factor to [unintelligible].

MR. PARTEE. Yes. The oil increase was about early 1979, wasn't it?

MR. BOEHNE. No. Which one are you talking about?

MR. MARTIN. The first one was in 1973.

MR. PARTEE. I'm talking about the second oil shock.

MR. BOEHNE. The second part of the 1970s?

MR. PARTEE. Yes.

MR. WALLICH. That was in '79 and in '74 we had one.

MR. PARTEE. I'm talking about the second half of the '70s. It took some while for the inflation to really accelerate. Then once it accelerated, it accelerated fast.

MR. WALLICH. But that was not oil, I think. Oil came after that, in '79.

VICE CHAIRMAN SOLOMON. I think what happened was this: In the first years of the Carter administration basic inflation was running only around 6 percent but they admitted privately that there were a lot of built-in factors in the policy that was being followed that would bring that inflation rate up substantially even without the oil shock. But it probably would not have gone to double digit rates; it probably would have gone to 8-1/2 percent without the second oil shock.

MR. BOEHNE. I think we have much less room here for inflation to get going as it did then because of the level of interest rates. If we had a turnaround in inflationary psychology, I think we would get a big push-up in long-term rates. And I don't think there's that much room between where we are now and what it would take to trip the economy into a recession. So, I think it would take less of a change in inflationary expectations now than it did then to get the impact on interest rates that would give us the slowdown.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. Just responding to this question of attitudes, we've been surveying people in our District and I would say the consensus is that no one anticipates a downturn this year. They are all feeling comfortable. They are a little more cautious as they sense the slowdown. We've been asking them what they think about prices and they give us two responses. One is that there are no price pressures out there from their suppliers and they are not able to raise prices in the market. Every time they try, they get knocked down. Looking ahead, however, to the year-end or the fourth quarter--not next year--they are all trying to raise prices about 4 percent.

VICE CHAIRMAN SOLOMON. This brings up something that I want to check with Jim Kichline on. My people project that even by the end of 1985, assuming these growth figures that we more or less are in agreement on--let's say 3 percent real GNP in 1985--that utilization of capacity should not exceed 85 percent because they believe that capacity will be growing in 1985 at about the same rate. Therefore, even though we're up now to the 83-84 percent area--I don't know exactly where in there--we probably will not see 85 percent even by the end of 1985. Is that correct? Is that your assumption?

MR. KICHLINE. That's right. We're at 82.5 percent now and that is our view. It moves up a little but we are assuming that capacity growth is increasing perhaps at a 3 to 3-1/2 percent rate now and we have growth of output slowing, so that our number at an endpoint is around 84-1/2 percent. So, our view would be consistent.

VICE CHAIRMAN SOLOMON. That would make a big difference also, because as I remember the Carter period we got up to 88 percent and that [utilization rate] was putting on a lot of pressure.

MR. CORRIGAN. There is somewhat of an inevitability here too in the context of the ballpark range of numbers that we are looking at for unemployment and capacity utilization for 1985. We could be lucky and get the kind of inflation picture that people are talking about. But it is also true, inevitably true, that we're getting near the point in both capacity utilization and unemployment rates where it wouldn't take a heck of a lot to get a worse result. And with all the good things that are going on--and there are a lot of them--if we hit those points, whatever they are, in capacity and unemployment, we will start to get price pressure. It's as certain as the day is long.

CHAIRMAN VOLCKER. Well, it seems to me the major risk on the price side is the dollar. Let me examine the proposition that the economy may turn out to be a little softer in the near term than Mr. Kichline has projected. We have housing definitely going down now and I think we have some momentum in business spending with the latest number--though it may not mean anything--but the latest consumption figures are not so great.

MS. HORN. In the Fourth District, Mr. Chairman, we do have reports of some lessening in steel, which is definitely in that category of housing--

CHAIRMAN VOLCKER. Steel still is showing no pickup from this little slump in the spring?

MS. HORN. Yes, but you were referring to business spending. We are getting a lot of reports of a great deal of enthusiasm on the business investment side of things. That sort of goes on with an attitude that good times will go on forever--forgetting underlying problems such as the exchange rate, deficits, and so forth.

CHAIRMAN VOLCKER. Well, that seems to be the strongest thing. I suppose for the short run the economy is going to be determined by inventories as always.

MR. GRAMLEY. The one thing we do know in that respect, though, is that the revisions of the second-quarter statistics make that picture look a little better. The upward revision of GNP was accompanied by a downward revision in the rate of inventory accumulation. So that looks a little better. In terms of the prospects for too much of a slowdown, I think one needs to take into account the fact that the 7.6 percent rate of growth in the second quarter took place despite a drop in auto inventories. If you take into account the drop in auto production, you're looking at an underlying rate of over 9 percent. The staff has it going down a long, long way and I think the basics that we've been looking at for the past year--including the thrust of both monetary and fiscal policies--would suggest to me that worries about an excessive slowdown would seem premature at this point.

VICE CHAIRMAN SOLOMON. We've had the shift of the tooling up in the automobile industry.

MR. GRAMLEY. Yes. It isn't going to add a lot to the third quarter, but it's going to stop taking off so much.

CHAIRMAN VOLCKER. I was told it was going to add quite a lot to the third quarter.

MR. GRAMLEY. It took out 2 percentage points or thereabouts in the second quarter and the amount of upward thrust in the third quarter I don't think is quite that large.

MR. KICHLINE. [It depends on] what you are talking about. If you talk about the auto sector in total, it's a little more than 2 percentage points difference from Q1 to Q2. If you go through the exercise of saying "If GM had behaved as the rest of the industry," then it's around a percentage point or a little more that it reduced [GNP] in the second quarter and it adds about a little more than a percentage point in the third quarter. So, there are [different] questions and different numbers. But we have a little more than a percentage point on that basis.

CHAIRMAN VOLCKER. The GNP figure ought to look pretty healthy in the third quarter, but I'm not sure that means anything. It has this bloop in it. Mr. Keehn.

MR. KEEHN. I would certainly support your observation that there is a more moderate tone out there. Certainly, in the Middle West, those sectors of the economy that have been doing well--

CHAIRMAN VOLCKER. I was observing on your observation.

MR. KEEHN. Thank you. Those sectors that have been doing well are continuing to do well but in terms of output, employment, income, and orders, there is far less optimism than has been the case in the past. But as always, to repeat a comment, I continue to be impressed by how uneven all of this is. The folks in the capital goods industries--those impacted by both a high level of imports and a reduced level of exports--and anybody who is at all involved in the agricultural sector are continuing to be very, very gloomy about how things are going. And I suppose to say the obvious with regard to the inflation outlook, the UAW negotiations are quite key. And I can't get a very good feel as to what is going on out there. Those I talk to conjecture that there's a pretty good opportunity of getting through [the negotiations] without a strike and they say that if there is a settlement, it will be in the 4 to 6 percent area and [the companies] can make that up on productivity. But on the other side of that coin, the strike fund is at a record level. The union leadership that negotiated the concessions by and large has been voted out and on top of that the negotiations are described as being terribly, terribly complicated. I think that's an uncertain scenario, and certainly key to the wage outlook would be the results of that particular negotiation.

MR. MARTIN. Mr. Chairman, I think any effort to try to isolate factors that might result in a sharp slowing [of the expansion] or, as you put it, even an indication of a possibility--I won't even say probability--of recession should take into account the possibility of greatly increased nervousness on the part of consumers/savers/depositors with regard to the thrift industry and to some extent the heightened concern about commercial banking. I'm prepared to expand on that theme, as I'm sure you're all delighted to hear. We have a major holder of household deposits--$900 billion or a trillion or whatever the number is, including the savings banks--and the news and the facts with regard to those industries are going to be very negative. I would guess, not out of any expertise, that the media will find the ongoing saga of difficulties in thrift institutions and questions about the efficacy of the deposit insurance system a potentially depressing factor on consumer behavior. I'm only saying this in response to your suggestion that we examine some of the downside factors, and this to me is a real one. I don't know what probability to attach to it.

MR. ROBERTS. Pres, I'm sure that's a possibility; I don't deny that at all. But the experience I had was that the stress in the thrift institutions in Chicago was [met with] a yawn. We had one situation involving a panic in a small S&L where they made people line up. But whenever they were working [these situations] out in mergers, people seemed to be totally indifferent.

VICE CHAIRMAN SOLOMON. They certainly aren't yawning out in California.

MR. ROBERTS. Well, what is happening there? Are the under $100,000 accounts actually being withdrawn?

MR. MARTIN. Yes.

MR. BALLES. Yes.

MR. ROBERTS. So that's a real change.

MR. BALLES. In two days they lost between a hundred and two hundred million just in retail accounts.

VICE CHAIRMAN SOLOMON. In an ideal response world, Pres, if you had your say in the Congress what would you do about it, if there were a financial crisis?

MR. MARTIN. I would appropriate between $5 and $10 billion dollars for the FSLIC and whatever billion the actual analysis showed me for the FDIC.

MR. PARTEE. Of course, we do have the New York Savings Banks yet to deal with. Following FCA, we will have to go East and there will be something in New York City with two or three of them.

CHAIRMAN VOLCKER. This FCA situation is extremely difficult. It is so big I don't know if we can handle it smoothly.

MR. MARTIN. It's a $33 billion dollar savings and loan holding company.

MR. PARTEE. That, by the way, could have an effect on the asset side too. They have an awful lot of commitments to buy mortgages and if they don't deliver on those commitments, there is going to be quite a scramble among builders to find alternative funds. I don't know if it will have an effect or not all over the country.

VICE CHAIRMAN SOLOMON. Chuck, you will be interested to hear that the CEO of one of the major money center banks in New York said at a meeting in my Bank with S&Ls and quite a few industrialists, [unintelligible] "You would think that the regulatory authority would be able to prevent a situation like that." And I said to him that my understanding was that they had--that the whole reckless expansion had been frowned upon very seriously by the regulatory authorities but they didn't have the legal authority [to stop it]. I said that we couldn't too easily in our system, given all the emphasis on deregulation, issue a cease and desist order simply because of imprudence or what we judge to be imprudent expansion when the chickens haven't come home to roost yet. [The question is] whether we really could prove that in court. What is the ability of the regulatory authorities to slow down an expansion that they think is imprudent?

MR. MARTIN. They'd have to resort to Section 207 of the Act in the Home Loan Bank System and find that it was unsafe and unsound. I shouldn't try to practice law here, but they would have to go further than imprudent and that's quite a finding, as we all very well know.

CHAIRMAN VOLCKER. And you can ask where the bank regulators are too.

MR. MARTIN. Regulation is ex post. Supervision of financial institutions is always ex post, by the nature of it.

CHAIRMAN VOLCKER. Miss Seger.

MS. SEGER. I would like to make a couple of comments about the auto negotiations, following up on Si's comments. I know most people seem to be betting that there won't be a strike, but there is also a chance that there will be. I think the primary risk is that the cast of characters has changed dramatically. Doug Frazier, of course, has left as head of the UAW and this has triggered a lot of movements within the union. Mr. Beaver is not Doug Frazier and no one knows exactly how he will come down in the final days of negotiations next month. Furthermore, if there is no strike and if they settle for a "modest" in quotes 4 to 6 percent, maybe the auto industry can make that up with productivity gains; but to the extent that these settlements are duplicated by other industries that cannot make it up by productivity gains it can have an inflationary impact. I think, by the way, that the auto executives are more aware of that this time around than they used to be when they just went zipping along on their own, not giving a darn what they left in their wake. I think they have come to their senses a little.

MR. BLACK. Except on their own salaries!

MS. SEGER. Actually, if you compare what some of them make to what some top people in banks make, including some banks that got into trouble, I don't think the comparison is that adverse! [Laughter.] Also, if there is a strike--as I said, the jury is still out--I think we will have to pay some attention to this in our forecast for the remaining months of this year. I know that the econometric models show that that is quickly made up, but those of us in the trenches who don't just go by models know that there is an adjustment period that isn't smooth necessarily. It does mean a loss in momentum, particularly at the time of the year when the new models are being introduced, and this could have an effect. I generally agree, Jim, with your forecast on auto sales, etc. but that's assuming there isn't a strike.

A second point about inflation prospects that I don't hear mentioned very much around this table involves the changing attitudes on the part of business management. A lot of these people were really beaten up in these two recessions we had back to back and I think they have gotten new religion about cost control. Again, the old notion of who cares--the attitude of write a blank check to the unions or to anybody else because we can always pass these higher costs along--if it hasn't been completely eliminated is 90 some percent on its way out. I think we are going to see the effect of this different attitude. In line with that is a greater commitment to improving the efficiency of production. This is tied in, by the way, to the good capital spending numbers. A lot of those capital expenditures are for equipment that will allow them to operate more efficiently--expenditures on robotics, for example. I know it's nice to look back at historical trends but when things of this nature are developing that are different from history, I don't think extrapolating past trends is necessarily going to tell us what's coming up. So, on the one hand, I'm more encouraged about inflation prospects than some of you; on the other hand, looking at the auto side, I'm concerned about what that could do.

CHAIRMAN VOLCKER. That auto industry settlement is the second biggest threat to the inflation outlook, next to the dollar.

VICE CHAIRMAN SOLOMON. The 4 to 6 percent settlement does not include the COLA, which they are going to maintain. Therefore, if inflation goes up, say, 5 percent altogether, then we're talking about a 10 percent increase in compensation. Am I incorrect?

CHAIRMAN VOLCKER. No, I think--I hope--when they are talking 4 to 6 percent they are including the COLA.

MR. KEEHN. They are.

VICE CHAIRMAN SOLOMON. How can that be?

CHAIRMAN VOLCKER. Well, it's a guess.

VICE CHAIRMAN SOLOMON. I had a presentation which said that they were not.

CHAIRMAN VOLCKER. A 4 to 6 percent increase without the COLA would be bigger than what they used to get.

VICE CHAIRMAN SOLOMON. But if we're figuring inflation is going to be up in the neighborhood of 5 percent, are you talking about only a 1 percent [real] increase?

CHAIRMAN VOLCKER. Well, they don't get a full passthrough on the COLA, I guess.

MR. PARTEE. I don't think it's quite full.

CHAIRMAN VOLCKER. It's pretty big.

MS. SEGER. They toned down the formula--not the last time around but two times ago--so that they don't get a complete percentage [passthrough].

VICE CHAIRMAN SOLOMON. I wonder if the staff knows the answer to this.

MR. KICHLINE. I don't know the answer. It is the case that when you're talking about these numbers of 6 percent or so that those are associated with the COLA. I know that the COLA requirements that they get are less generous than what they used to get. They used to get something close to 90-95 percent, but I don't know what the number is [currently].

MR. MARTIN. If you recall the Chairman's data on recent major settlements that he gave us six weeks ago, there was a string of no COLA, no COLA, no COLA, small COLA, and so on in that.

MR. KICHLINE. He came up with a little over 3 percent in the first year on the collective agreements.

MR. MARTIN. But the COLAs were almost all absent.

CHAIRMAN VOLCKER. Those figures are apart from COLAs. Not all those agreements had COLAs. Mr. Guffey.

MS. SEGER. But when the auto industry talks about their costs they have to think in terms of total costs.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. With respect to your question "Is there more pessimism?" I'd say things perhaps are more pessimistic in the Tenth District. It's a very unbalanced recovery in the sense that in manufacturing, particularly auto assembly, aircraft, and other manufacturing, together with construction, things are going very well. I don't know that there's been any damping of those sectors of the economy. On the other hand, I'd just note that the good projection for inflation in the period ahead is tied largely to the energy and agricultural food sectors, which will have an effect of lowering the outlook for inflation. In each of those cases--in the energy sector, for example, the dropping of oil prices and the dropping of natural gas prices will impact the discovery and extraction of petroleum products in the Tenth District rather dramatically. There has been no increase in rig counts in the most recent time; it's fairly level and some ten to thirteen percent higher than it was April of '83, which was a low point in the rig count. If energy prices fall further, we're quite likely to see that sector turn down again, and it's already in trouble. At the same time, as all of you know and as has been recited around this table, the agricultural sector is in trouble and there is no prospect in the sense of exports or other factors that will raise commodity prices. That's the salvation and the hope, [but] there is nothing out there. As a matter of fact, there is a good crop assured at this point and that has a continuing depressing effect. The one tangible number that I can recite to you is out of a survey of farm land prices; they have decreased another 2-1/2 percent in the second quarter of 1984. That has an impact, obviously, that rolls back into the financial system that we quite likely will see around the first quarter of 1985. I think we're talking about the thrifts, for example, and potentially a segment of our financial industry that supports the agricultural sector that could be in really serious trouble late this year or in the first quarter of 1985. Again, I don't think the interest rates in and of themselves hold out much hope. Lower interest rates would help, to be sure, but that isn't what will extract the agricultural sector; it will be commodity prices, and nobody has any real hope that that will come to pass.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, in the Sixth District, I don't think you would find very much caution. There seems to be a good deal of optimism and bullishness on the part of most business people. To the extent that there is a cautionary psychology creeping in, I think it can be attributed to three basic things. One is the weakness in the housing sector and related industries. That sector is definitely coming off in our District and is giving cause for some concern. On the price front, we have an interesting dichotomy, it seems to me. On the one hand, there are a lot of people who are still concerned about inflation. They look into 1985 and they see capacity constraints; they see labor-wage negotiations perhaps bringing us out of this period of moderation; and they are a little worried about a precipitous decline of the dollar, which would hurt us on the inflation side. But on the other side of the coin, there are other people who are concerned about deflation. I've had a lot of questions about that, I guess in light of the newspaper articles that have appeared. So that's an interesting kind of schizophrenia, if you will, in the market psychology. Some people are afraid of higher prices and others are afraid that the bottom is going to drop out. A third thing that has emerged very recently is a very, very real concern on the part of most people about the financial system. When I was here 6 weeks ago I said in my comments that there was a "ho hum" attitude about Continental at that time. That has definitely been reversed. There is now a very definite concern about spillover effects of Continental and of course now a very, very great concern about the thrifts. So, those are the three areas of concerns that are beginning to emerge in our part of the country. And for what it's worth, the automobile people that I have talked to recently who have made their annual pilgrimage to Detroit and have come back are reporting that in their opinion there will be a strike. There doesn't seem to be any question in the minds of the people that I have talked to about that.

CHAIRMAN VOLCKER. I'm not sure a strike is the worst thing in the world that can happen, if the alternative is a high labor settlement.

MR. FORRESTAL. Incidentally, they think it's going to be relatively short--4 to 6 weeks.

MR. PARTEE. A strike followed by higher wages.

CHAIRMAN VOLCKER. That's the worst--if we get the high wages and a strike. If no one else has any pressing comments, why don't we hear from Mr. Axilrod?

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

CHAIRMAN VOLCKER. We'll take some brief questions now and maybe have coffee. Before that, let me just say that when I look at this directive I'm a little hard pressed to see why we're running below [the specifications for the aggregates]. I know we're running below the track a bit on M1; that's fine. I don't know why. The question that occurred to me right off is: Why reduce the target for M1 for the quarter when we're running a little low--or reduce it so much, anyway? Then, if it went back up and we got the target we were looking for before, we'd have to tighten. That's a little odd to me.

MR. PARTEE. We have a tradition of not changing much, too.

MR. MORRIS. My question for Mr. Axilrod is: We're seeing a period of relatively modest growth in the monetary aggregates accompanied by a period of sustained, very excessive rates of growth in total credit. How do you interpret these different growth rates and what policy implications do they have?

MR. AXILROD. One of my problems in answering your question, President Morris, is that I really would not ever have thought of running policy on total credit. But I would--

MR. PARTEE. It makes it hard to communicate.

MR. AXILROD. I would tend more, if I were looking in that direction, to be looking through it to the economy.

MR. MORRIS. Well, put it this way, then: Relative to the nominal GNP, the monetary aggregates have been running very low and the credit aggregates are about in line with what one would have now. Put it in those terms.

MR. AXILROD. If we do get a 6 to 7 percent growth in August and September, the monetary aggregates--according to our always shaky equations--will be running about as we expected based on the quarterly model; on our monthly model, not quite. The quarterly model would have predicted for given interest rates and GNP enough money demand to create this much money growth without much different interest rates. So, that wouldn't be far off. What is far off, as you're suggesting, is the credit growth. I had in my head two reasons that I haven't quite been able to demonstrate statistically. One is that with the government being such a large element in borrowing--when the government is spending more than it's taking in--it has no real option to reduce assets. It really has to borrow. So, I think its borrowing propensity is [virtually] one for any amount of deficit spending. Whereas if other sectors are spending in excess of what they're taking in, they have the option of cutting down on assets, which doesn't get reflected in our credit figures. So, I have a feeling that the large persistent role of the government is raising credit relative to GNP. Also, and I think Governor Gramley mentioned this at a discussion earlier here, we're in a period where we have much more freedom for credit to flow at any price relative to earlier periods; there is more deregulation. And that may then be permitting a greater flow of credit at the high [rates], and the higher interest rates are exerting the pressure more than the restricted availability. Those are the only two factors I have, particularly.

CHAIRMAN VOLCKER. I'll suggest another factor too.

MR. AXILROD. Well, right. One other is the stock market. I'm not forgetting stock market.

CHAIRMAN VOLCKER. Well, we went over that last time. I think the growth of domestic demand has been a lot faster than that of GNP. And those imports have to be financed too.

MR. PARTEE. I looked at that yesterday afternoon. It makes some difference, but not a great deal. What happened really is that there was less GNP rise last year relative to credit growth than you would have expected and this year it's more normal.

MR. AXILROD. We've had a difficult time isolating these various circumstances, but we could go back and look at it. But those are the elements I could think of so far.

CHAIRMAN VOLCKER. Why don't we have a coffee break.

[Coffee break]

CHAIRMAN VOLCKER. Let us proceed. Let me indicate that I have some bias for not making radical changes in these monetary target numbers in the middle of the quarter unless there's a very good reason to do so. What's more important than those numbers may be what we actually do, reflected in the borrowing and the reserve assumptions. So, let us proceed.

MR. PARTEE. I had a thought, in the nature of a question for Steve: If one did feel that there had been some change in the demand for free reserves--as you say in the technical jargon--that was going to persist for a while, the way to deal with that technically would be to change the initial borrowing. Is that the way that one would deal with it?

MR. AXILROD. Well, that would be one way to do it. Clearly, another way would be not necessarily to change it but, as we observe what is happening in the course of operations, to adjust in the way we might adjust if we observed more excess reserves and a change in borrowing attitudes. We would be more willing to oversupply nonborrowed reserves to accommodate it. We would end up with a little less borrowing than was plugged into the path. There would be two ways of going at it and getting the same result: one prejudging and one not prejudging.

VICE CHAIRMAN SOLOMON. Chuck, even though we did end up with a higher Fed funds rate than we would have expected for a $1 billion borrowing assumption, it seems to me we'd be imprudent now to reduce that borrowing level. It seems to me a little premature, given the strength of the expansion, to move down, say, to $700 or $800 million of borrowing.

MR. PARTEE. Well, I was asking this as a technical matter. If you thought that there had been a shift in the demand, the way to address it would be to change the borrowing level.

VICE CHAIRMAN SOLOMON. But we don't know how long that shift will persist. The usual--

MR. PARTEE. But if you thought it was going to endure for a while--. And we do have now the possibility that FCA and Continental are not done borrowing. They are going to be with us for some months to come--maybe years--with, I think, a steadily larger number. So, it could be that it will persist.

CHAIRMAN VOLCKER. Continental's borrowing is going to go up at least until that stockholders meeting. There may be a chance of getting it down then; I don't know. I would just note, to put it in your mind, that on this international debt situation a portion of it seems to be going as well as could be hoped. That Argentine situation could still go very much either way.

MR. PARTEE. Is all of that special credit washed out now?

CHAIRMAN VOLCKER. Well, they still have $100 million. Is that what you mean?

MR. PARTEE. Yes. And then did they pay back the other Latin American countries?

CHAIRMAN VOLCKER. Yes. They either paid them back or made other arrangements to pay them back.

MR. CROSS. They paid them $125 million.

VICE CHAIRMAN SOLOMON. But, you know, that situation had really looked [unintelligible]--without getting into too much detail. Even though the risks are that there will be a higher level of uneasiness about the banking system and the international system than a relaxation of these special tensions, which probably have been causing the fed funds rate to be higher than we had originally expected, it seems to me that that situation is very unpredictable. Even though we want flexibility to cope with that kind of thing, if it shifts in the other direction, it seems to me that at this point if we were to reduce the borrowing because we ended up with a higher fed funds rate than we expected, that would be sending a premature policy signal. The market would interpret that as a fairly significant easing of the fed funds rate. It would be attributed to a shift [toward an] easing of policy. It would not be attributed to a change of bank attitudes in regard to reluctance to borrow. Do we really want to bring about that kind of policy signal at this point?

MR. PARTEE. Well, the rate had drifted up by 1/2 or 3/4 of a point or something like that.

VICE CHAIRMAN SOLOMON. 50 to 75 basis points.

MR. PARTEE. There's nothing in the aggregates that would have warranted that, and the economy has been moving broadly in the direction we expected it to--although maybe not as far--and the price numbers are even better. So, I don't see any reason why the rate should have drifted up.

CHAIRMAN VOLCKER. I don't know if you expressed an opinion on these specifications. If you would like to do so while you have the floor, Governor Partee--

MR. PARTEE. Well, all right. I would like to retain the specifications we had last time and view them somewhat broadly. We don't have to be slavish about it. That's none of these alternatives, is that right?

CHAIRMAN VOLCKER. That's none of these. The only difference of any significance, I think, is on M1.

MR. PARTEE. Yes, I think that's right.

VICE CHAIRMAN SOLOMON. What would you do about the borrowing?

MR. PARTEE. I would reduce the borrowing number by $200 million to [a level of] $800 million [unintelligible]. Although I don't like to talk too much about the funds rate, I would expect [it to decline] but I would want to manage its decline. That is, I would want it to drift down only [gradually], the way that it drifted up, rather than suddenly adjust it down by 3/4 of a point the day after tomorrow.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, if I understood Tony right, I would stay right where we are. I would leave the borrowing assumption right where it is and I wouldn't change the specifications. I agree that this is not the time.

CHAIRMAN VOLCKER. You would make the specifications about where they were last time?

MR. BOYKIN. Yes.

VICE CHAIRMAN SOLOMON. And the borrowing?

MR. BOYKIN. And the borrowing at the same level.

MR. RICE. So would I, Mr. Chairman.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I'd like to just say a word or two about what I think we ought to be worried about for a longer period. I have been worried, as everybody knows, about the prospects of worsening inflation. I haven't been right; the staff has been a lot more right than I. But I do think we could make a very big mistake if we don't recognize the potential for that. This was called to my attention by Tony this morning when he talked about the Carter period. There were two very large mistakes made then. One of them was misestimating the natural rate of unemployment; we thought it was around 5-1/2 percent. So, when the actual unemployment rate was 7 percent we thought the economy had all kinds of room to grow. The other was a failure to recognize how poor productivity really was. Let me just read to you what the actual productivity figures were showing in that period. From the fourth quarter of '74 to the fourth quarter of '75 we had a 3.8 percent increase in productivity; in '76 we had 2.2 percent; in '77 we had 2.6 percent. It looked like we were doing beautifully. In fact, those were all cyclical improvements in productivity, not secular trends. And we didn't recognize how bad things really were. So, I think we ought to be very, very careful in looking at the recent productivity statistics not to get overly optimistic.

The other thing I want to mention is that if you look at what has been happening to monetary policy and take what I would regard as the best view of how stimulative it is, you have to look at real increases in the money stock. When you do that, you find that real M1 is going up at about twice the rate of the trend rate of increase, which is about 1 percent a year. It's going up at over 2 percent a year. So, I would like to take some of the benefits of the recent slowdown in money growth [incorporated] in the lower specs of "B." I note in this connection that if we stick with "B," according to the staff we will end up with about a 6-1/2 percent increase in M1 fourth-quarter-to-fourth-quarter, which is about the midpoint of the range we set at the beginning of the year. And that would be reasonably satisfactory. So, I would stick with the specs of "B" with $1 billion in borrowing, and I would accept a lower aggregate growth for the third quarter.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I think I understand the advantage of keeping the same specifications as last time.

CHAIRMAN VOLCKER. I don't want to be absolutely rigid on that.

MR. MORRIS. No, without specifying exactly why, I think that's a good idea. On the other hand, I think it would be a mistake to lower the borrowing guideline because the market has now caught on to how we are running policy. If in following a $1 billion borrowing guideline we were to see interest rates drift down to where we thought they would be at the last meeting, then I think the market would understand that we were not pushing rates down but that rates were going down because of the smaller rate of growth in the economy--if that eventuates. If we pushed the guideline down, then I think the market would have a great deal of difficulty understanding why we chose this particular time to move to an overtly easier monetary policy.

VICE CHAIRMAN SOLOMON. It would spark another rally in the bond and stock markets and it would look, I think, like politics if we were to do it at this time.

MR. MORRIS. Yes, exactly. Also, if there's any risk of error in the staff forecast, I think the risk lies in the economy being stronger than forecast. Therefore, even though the July specifications would seem to be incompatible right now, if the economy is a little stronger then they could become compatible. So, I would go along with the same package we had last time.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I too would like to stay where we are in terms of the borrowing level, money market conditions, and so on. I'd like to take the shortfall in M1 and to some extent the other Ms in July and put it in the bank and save it for a rainy day. I like the idea of not changing the darn aggregate specifications at the mid-quarter meeting. I don't know exactly how to get this directive language to satisfy that objective while satisfying the larger objective of staying where we are. But I assume we could figure out a way to do that.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I would support a policy which would suggest no change at this time. In my own thinking, that really comes out to alternative B. I think that would be the right specification at this time to bring us back to the midpoint of the range down the road. I don't think we need to be unduly concerned about weak monetary growth because it's likely to be temporary. I don't know what the August numbers will turn out to be, but I think July was abnormally low. But more importantly, perhaps, I too would like to associate myself with those who would not want to change that borrowing number. To bring the funds rate down would send the wrong signal to the market. I think it's very important at this point that we not give any evidence or any hint to the market of easing or have them interpret our policy as one of easing. If the shift in borrowing that we've seen is going to continue, as it might, the funds rate will continue to drift upward. I would assume, Mr. Chairman, if that were to happen and we don't change the borrowing number, that we would have a consultation as the rate hit that 12 percent level. If the borrowing pattern were to shift back to a more normal pattern, then I would be willing to validate an increase in the funds rate, which in turn would suggest to me some consultation at the 12 percent level.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. Well, as I said earlier, I think we ought to keep the $1 billion borrowing. I think the advantage of keeping the same M1 monetary aggregate target that we had in July is that if conditions weaken in the economy, then it's perfectly appropriate for us not to be locked into as tight a policy. I would keep the range of 8 to 12 percent [on the funds rate]. I would not change that even though the rate is around 11-7/8 percent now; I'd have a consultation if we have to. And I would change the directive so that it's symmetrical. You remember that it leans slightly, through the judicious use of "would" as against "might," in the direction of our being quicker to restrain than to ease depending on what happens. And it seems to me that at this point we probably are justified in moving to more symmetrical language.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I think we're acting under the impact of somewhat temporary factors. We've had a bad month and we are very much concerned about the banks, the thrifts, the LDCs, and the farmers. If we weren't acting under these constraints, I at least would favor a tauter policy. That seems to me appropriate for the situation where we have a strengthening economy--looking ahead for 1985, anyway. We have a lower rate of inflation, which to me suggests that the money supply should grow more slowly on account of the lower need for money. The staff sees ahead that interest rates will rise in '85. So, the question really is: Should this happen earlier or later? And if it happens earlier, wouldn't it reduce somewhat the degree of the rise? In that sense, we're really just buying time now by taking account of the undoubted problems that the System faces. I would favor something like a "C+" alternative and I would go to borrowing of $1-1/4 billion. I'd raise the funds rate range 1/2 percentage point at each end, to 8-1/2 to 12-1/2 percent. I think then it would be logical to be symmetrical again. If that [range] is lower, it seems to me we ought to stay asymmetrical.

CHAIRMAN VOLCKER. I'm sure the staff appreciates that note of confidence that you see in their forecast.

MR. PARTEE. [Henry is] trying to bring it about by his specs!

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I appreciated Lyle's brief analysis of the difficulties of estimating productivity. He does well to remind us of the errors we've all made in the past. Maybe the staff has made fewer than the rest of us; I don't know. I think we're making a corresponding error today: We are underestimating. The 1-1/4 percent trend line is not the trend line; it's more like 2 percent. I think we're returning to the trend line, but I have a different trend line, Jim. My reason is that we're a services and information workers society now, not manufacturing. Yet we are--maybe not overly obsessed, but--overly concerned with manufacturing output. Finally, I think that software works. Finally, an ordinary human being, not a wizard, can work a personal computer or a terminal or something like that. And that has permeated the services side of our economy--the sector from which people said we could not get productivity increases just as they used to say about restaurants before McDonald's came along and showed productivity in that area. This will be the surprise on the productivity side of our society--the rising output in services. I'm not saying the services are going to be anything we really need, but I think we're going to have a lot more of them, however you measure that. So, I believe that will keep inflation at the staff's [projected] level or even a touch better.

The other factor that is going to contribute to less inflation is one that I deplore, and that is the impact on the financial system of failing thrift institutions against a backdrop, of a government institution--namely the Federal Savings & Loan Insurance Corporation--that is too small. Whatever has to be done about that as institutions fail--whatever receivership or conservatorship pattern we will suffer through in the next few years from that side of the economy and maybe some additional failing banks, given the rate at which banks are failing--will change the consumers' outlook. I don't think the American public is prepared for the kind of questioning that will result from these failures. And it may well result from substantial volumes of uninsured deposits at one or more institutions having to be paid back at less than 100 cents on the dollar out of asset administration which takes many years. If it is thrift institutions, these tend to be long-term assets and the payout period is long and the interest is lost. I believe this is going to be a material factor in the thinking of the American public with regard to their own finances and their own consumption function, if you will, over the next few years. I think that will affect inflation in a positive direction now, though it's unfortunate that it's coming from that side.

To translate that into policy, I would go along with the Chairman's suggestion, which he says he didn't want to make too firmly, to keep policy where it is in terms of the directive of a few weeks ago with the exception that I would join my esteemed colleague, Governor Partee, in favoring $800 million in borrowing. I would leave the range on fed funds alone and would prefer the $800 million on borrowing to give us more flexibility--not only because of the aforementioned change or possible change in the commercial banks' attitude toward excess reserves, but because I feel that the financial failures will not only affect the attitude of consumers toward saving and spending, but will affect the attitude of commercial banks and other institutions with regard to borrowing from their respective central banks.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. At the risk of sounding somewhat complacent, I think our policy for 12 months has been just about as good as anybody could have dared hope it would be. We came pretty close to the midpoint of our revised target range in the last half of last year and, with the behavior of the figures in July, we're heading pretty close to the midpoint of the present target range. So, we're in a good position to finish the year somewhere near that, regardless of which of these alternatives we adopt. And with velocity apparently picking up, it looks to me as if that's about where we ought to come out. I really prefer the [aggregate] specifications of "C" because they get us a little closer; by the same token I recognize there's not a whole lot of difference in these things. So, in my usual display of eclecticism I would opt for the other specifications of "B," which would leave the federal funds range unchanged and the borrowing target unchanged. And, like Tony, I would prefer that we go ahead and make this directive symmetrical.

CHAIRMAN VOLCKER. Miss Seger.

MS. SEGER. I would go along with the idea of keeping the specifications the same as they were at the last meeting. As I read Steve's words here on page 5 [of the Bluebook], they suggest that alternative A comes closest to those adopted at the last meeting. So, that would be the one I would go along with. For reasons of concern about the health of the financial system, I would be reluctant to have the fed funds rate go above where it currently is, again because I think there are some special and technical reasons that are keeping it up there. If it could be allowed to back off a bit, I would certainly welcome that. In terms of the borrowing target, I would go with Mr. Partee's $800 million number.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, I would agree with Bob Black. It seems to me that we happen to be in one of those times when everything seems to be going very, very well--indeed, just about right. The comments at our last meeting suggested that the economic expansion was going to be a bit more robust than perhaps has been the case with the passage of time. I have some feeling that our comments today may suggest a greater degree of moderation than may be the case. I do think there is an element of moderation out there. Nonetheless, it seems to me that the outlook is excellent; there are inflation risks but the outlook seems to be favorable. Therefore, I would suggest--since we happen to be at about the midpoint of the range for M1--that continuing that as an objective and as a target between now and the end of the year is a very desirable alternative. That would put me in the camp of suggesting that alternative B would be the most appropriate. The borrowing level would be, say, $1 billion. I would leave the fed funds range as it is. I do think that the directive should be balanced but also that it should be worded in a way that would clearly suggest that we didn't change our basic objectives at this point; some of the wording could be adjusted accordingly.

CHAIRMAN VOLCKER. All these comments that things are going nicely brings to mind that I just read a book about the battle of Midway where the Japanese sailed there with their whole fleet thinking everything was going nicely and one day later they thought it was not so nice. Mr. Boehne.

MR. BOEHNE. I came in to this meeting with some bias toward "B," but as I listen to the discussion, I agree that there is some virtue in keeping the quarterly specifications where they were in July. But I think those specifications are inconsistent with a billion dollar borrowing figure. There is no great virtue in consistency but I think there is that problem. My own sense is that there is something to this business with reserves. As to how much we should want to adjust for it, I don't think we should do it in any specified way but we ought to at least have a bias that attempts to correct for it. My bias would be for borrowings of less than $1 billion; I think $800-$900 million makes some sense. We have let the funds rate drift up over the last several months; we start out thinking where it's going to be and it ends up being higher. So, I don't think there would be any disaster to the economy or expectations about what we're doing if it had some downward drift; in fact, that would be my bias. I would keep the funds range at 8 to 12 percent and I would have a symmetrical directive.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Overall, I've been pretty well satisfied with the posture of our policy. In view of the ongoing strength of the economy in most, if not all areas, I think it would be premature to ease overtly. On the other hand, I'm particularly aware on the West Coast right now of the fragility of our financial system and what the repercussions could be of another major institution in serious trouble--and this time possibly involving outright losses to holders of uninsured deposits. Unless or until that situation clarifies, I would be reluctant to see anything happen to push the federal funds rate up higher. So, I come out favoring alternative B but along with four others who have already spoken on the subject, I also would be in favor of reducing the borrowing level to $800 million and would favor additionally the so-called symmetrical directive.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. It seems to me that the present policy is producing about the right results. We had 7 percent growth in money in the first quarter and 6 percent in the second quarter. So, I wouldn't change the borrowing target. I think we ought to pay less attention to the fed funds rate and, therefore, I would like to see the band widened by 1/2 percentage point to accommodate the probabilities there. At this stage of the cycle and with the past pattern of money growth, it seems to me that the odds favor some pickup in inflation notwithstanding the anecdotal information that we have. I would favor alternative B, indicating growth of about 5-1/2 percent in M1 in the third quarter. This also would have the advantage of avoiding the base drift and would set us up in a good position in the fourth quarter to start our plan for money growth for next year. In terms of the concern in the marketplace, we have to think about what concerns might arise if we were to ease at this time, causing concern about inflation and possibly creating the opposite result than we intended, which would be higher long-term rates. Long-term rates have eased some at this point and if we hold firm in our policy, the probability is that they could ease some more. I don't think that just a slackening of growth in the business cycle necessarily should be associated with lower inflation. We could have the worst of all worlds--a slackening growth and rising inflation, as we've had in the past.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I also would opt for the B alternative. My concern is with the current federal funds level. I would hate to see it go any higher and thus would maintain the 8 to 12 percent range. But my real concern is: What happens if Financial Corporation of America does indeed affect the financial markets and create a flight to quality and, as a result, the federal funds rate balloons far beyond the 12 percent? What is the proper response of the Federal Reserve under those circumstances? Do we try to keep the funds rate within the 8 to 12 percent range or at the top of that range? Or do we pour in reserves in order to liquify the financial system and in order to contain the damage that might be done by the Financial Corporation of America situation on top of Continental? I pose it in the form of a question. What would be the proper response? How should this Committee and how should the Desk react to that? It seems to me there is more potential of that than of the fed funds rate falling rapidly and giving some indication to the market just before an election that we have eased. I would keep the billion dollar level, to be sure, and the 8 to 12 percent range, but I pose as a question: How should the Desk react if the Financial Corporation of America affects the funds rate and pushes it up far beyond the 12 percent for some period of time? I guess I'm posing that question to you, Mr. Chairman, since you have daily contact with the Desk.

CHAIRMAN VOLCKER. Well, I think we'll deal with that question later.

MR. GUFFEY. Well, I still opt for "B" at the moment until we find out something different.

CHAIRMAN VOLCKER. I'm left without a comment from Mrs. Horn.

MS. HORN. I feel that M1 should come in at the end of the year at the midpoint of its range for a lot of reasons that have been previously stated, and I'm pleased to see that it's near there now. Either alternative B or alternative C or something in between I think would work toward achieving that goal by the end of the year. I would be in favor of maintaining the $1 billion borrowing level and I think it would be a mistake to give the markets a signal through the fed funds rate of any real change. For that reason, I would like to protect against our producing a reduction in the federal funds rate.

CHAIRMAN VOLCKER. Well, I guess everybody has spoken. Oh no, Governor Rice. No, I have your comment here. We have some differences of opinion, I would say.

MR. PARTEE. Since I'm guilty of throwing in the $800 million dollar figure on borrowing, let me just say that I must have picked that off the wall. I don't know whether that's the figure or not. The point that I wanted to make is that if there has been a shift in the demand for excess reserves, I think we ought to recognize that and make some adjustment. And in my view if that results in a downward drift in the funds rate, we were certainly all content to see it drift up, so why shouldn't we be prepared to see it drift down? After all, the aggregates are on the weak side and there's nothing inconsistent in that. But I don't know whether $800 million is the right figure for what I'm talking about.

VICE CHAIRMAN SOLOMON. Each $100 million represents about a quarter of a point. So, if you put it at $800 million instead of $1 billion, you would be bringing down the fed funds rate 50 basis points, in theory.

MR. PARTEE. Well, that's a very horseback kind of thing. I would rather have somebody who is technically proficient with the numbers indicate what they think.

CHAIRMAN VOLCKER. Well, let me take off from your comment and suggest what may lie somewhere in an area of consensus. Looking at the borrowing first, I guess it would be consistent with leaving that first sentence of the directive unchanged and nominally start off with something around $1 billion. Maybe in the old fashioned nomenclature--particularly if the market seems sensitive or somewhat disturbed in view of all these financial things or if the business news softens or if the money supply continues to come in low or all of the above--we should start off with some bias toward erring on the side of somewhat lower numbers but we don't aim at those.

MR. GRAMLEY. When you say "bias toward lower numbers," are you talking about borrowing or interest rates or aggregates?

CHAIRMAN VOLCKER. I'm talking about borrowing now. I'm not saying aim at a lower number right now. I'm saying that when we make all these decisions for the next several weeks--[taking into account] the specific reserve averaging periods--we are willing to err a bit in that direction, depending partly on our guidance on the funds rate and how tight things look. I'd keep the funds band where it is, which is what most people have suggested. Then we would aim more overtly for a lower number if in fact the money numbers came in low or we had some of these other contingencies developing; but we wouldn't do that without that evidence. In terms of the numbers for the various aggregates, I don't think M2 or M3 are at issue, if I understand [the comments], except maybe for those who wanted "C." They are so close that it doesn't make any difference. I'm a little troubled by the thought that somehow we would aim as low as 4 or 4-1/2 percent [on M1] even overtly and with that kind of symmetrical approach without knowing a little more about the economy and other things than I know now. I would at least go higher on M1 than any of those alternatives suggest. That's interrelated with how we word the directive. With a higher number we certainly can make it symmetrical, recognizing that we're starting below so we already have this slight bias toward easing. If we end up with a lower number, I don't know what we do. I would make it asymmetrical in the other direction and, therefore, end up in the same place anyway.

MR. CORRIGAN. You lost me on the last loop.

CHAIRMAN VOLCKER. Well, if we started off with an M1 figure of 4 percent and we began running above it, depending on where we are, I would not be very anxious to raise the borrowing level.

MR. CORRIGAN. That was the second point. I understood that. On the one after that you lost me.

CHAIRMAN VOLCKER. I don't remember the one after that.

MR. PARTEE. I think it was that you would make it asymmetrical in the other direction. If you put [M1] at four percent, then you wouldn't tighten if it came in higher but you would ease if it came in lower.

CHAIRMAN VOLCKER. Well, I just think that in terms of the visuals you get more or less the same result. Why change the number and raise all the questions about whether we had a different number than we had last time?

VICE CHAIRMAN SOLOMON. Exactly. And then you can have symmetrical language too.

CHAIRMAN VOLCKER. I don't know whether it's worthwhile or not, but we can even off all these numbers and make them 5 percent, 7 percent, and 9 percent. I don't know what words of art we have; it already says "around."

MR. PARTEE. We can't use "around" because it's already there.

MR. GRAMLEY. How would you interpret this 5 percent if you could have an asymmetrical calculation [for the] 3 months? If you took that 5 percent literally, it would imply a growth rate of 8-1/4 percent for August and September and that's way too high for me to be comfortable with. If you wanted to add -1.5, 5.5, and 8.1 percent together and [say that] averages [roughly] to five, then that's the sort of asymmetrical calculation I could agree with.

CHAIRMAN VOLCKER. [Unintelligible.] I don't understand.

MR. GRAMLEY. My point is that we start from a low base; July was negative. If you use 5 percent for the period from June through September, it implies an August-September increase averaging 8-1/4 percent.

CHAIRMAN VOLCKER. I'm assuming your arithmetic is correct. Is that correct?

MR. AXILROD. Well, pretty close. I think it might be more like 8 percent with the compounding, but it's right in that area.

MR. PARTEE. Well, that's always the case. Of course, [earlier] everybody accepted a minus 2 percent for July, which was really a very unusually low number. I presume we would accept a 10 or 12 percent for September, which is very well what it might be if the economy is reasonably strong. I think we would want to put them all together and say the average was not bad.

MR. GRAMLEY. Putting my point differently: If the staff is correct, a specification of $1 billion in borrowing to start with--and holding to that with the kind of federal funds rate which would be implied if the current demands for borrowing relative to that funds rate prevail--would not give you 5 percent growth. It would give you something more like 4 percent. So, if you were aiming for 5 percent, in fact, what you would do is proceed to lower levels of borrowing, lower levels of the funds rate, and more increase in the aggregates over time. And I don't think that would be appropriate.

MR. PARTEE. You're talking about the difference between accepting and seeking.

MR. GRAMLEY. Yes.

MR. PARTEE. I think that is an important difference. I guess my feeling is that the market determines what the money number is going to be in the short run a lot more than we do. And, as you know, it's a highly volatile number.

MR. GRAMLEY. If one were willing to play that game and put in a 5 percent for visual purposes only, then I wouldn't have any problem with it.

VICE CHAIRMAN SOLOMON. I have assumed that the 5 percent becomes meaningful only if conditions weaken.

MR. GRAMLEY. In the economy?

VICE CHAIRMAN SOLOMON. In the economy, right.

MR. GRAMLEY. Beyond what the staff is talking about?

VICE CHAIRMAN SOLOMON. That's right. Otherwise, the borrowing assumption would prevail and we'll see more or less a continuation of the present fed funds rate. But if conditions weaken, then I don't think we should have locked ourselves in to a 4 percent target, because I think it would be justified that the fed funds rate would come off somewhat on its own. What I'd be opposed to is for the market to perceive a clear and overt easing of policy by a move now to $800 million [on borrowing].

CHAIRMAN VOLCKER. Well, we're in an area of nuance. That is not unimportant, but I'm not sure it's going to be reflected adequately in any directive. I don't know whether this is the best way to do it, but look at it sentence by sentence. It says "In the short run the Committee seeks to maintain"--the same language we've had. Let me as a first approximation either leave [the numbers] the same or round them off to the lower levels. Make them 5, 7, and 9 percent or where they are. What I would almost do--I wouldn't necessarily suggest this because I don't know that I'd want to give that much of a signal--is reverse the whole next sentence. So "Somewhat lesser restraint would be acceptable if growth in the monetary aggregates slowed significantly, while somewhat greater reserve restraint would be acceptable in the event of more substantial growth. In either case, such a change would be considered...." We don't have to reverse the sentence but I certainly would make it "would" instead of "might."

MR. MARTIN. If we reverse it, we need to reverse the sentence that shows that we did contemplate the downside risks in the financial system that we perceive could occur.

VICE CHAIRMAN SOLOMON. I realize we're nitpicking, but even so it seems to me that if we move to symmetry by changing the "might" to "would," that's sufficient. If we go ahead and reverse the order of this, we'd look a little silly if the economy turns out stronger than we think. It looks as if we're really getting into semantic signals by reversing those, don't you agree?

CHAIRMAN VOLCKER. Heck, I don't [know.] It might raise some questions about attaching more significance to little tiny wording nuances than we want to tolerate through time. That next sentence I certainly think should stay.

MR. PARTEE. Yes, I do too.

CHAIRMAN VOLCKER. It's probably considered boilerplate at this time. We have 8 to 12 percent down below [for the funds rate range].

MR. FORRESTAL. Mr. Chairman, while you're on nuances, on line 74, given what has happened in July, is it--

CHAIRMAN VOLCKER. I don't have any line 74 on my copy.

MR. FORRESTAL. The way it's written, right after the "while somewhat lesser restraint might be acceptable" it says "if growth in the monetary aggregates slows significantly." Since we've had significant slowing in July already, I wonder if it wouldn't be helped by adding the work "further" or something like that.

MR. ROBERTS. Well, it has just bounced around month-to-month. April was down, May was up, June was up, July was down, and the quarter is up.

MR. PARTEE. Well, then it gets into ambiguities, Bob. Slow significantly further than minus 2? I think it is stated in terms of the quarterly numbers. And the "slow significantly" means relative to whatever number is in there.

CHAIRMAN VOLCKER. Actually, the two sides of that are not symmetrical as written. The first half is quite clear. "In the event of more substantial growth of the monetary aggregates" I assume means more substantial quite clearly than what is in the previous sentence.

MR. PARTEE. Yes.

MR. GRAMLEY. Yes. It probably would be wise, though, given Bob's point, to change that "slightly" to "were significantly slower." That would use parallel language to what was in the first part of the sentence and would deal with Bob's point.

CHAIRMAN VOLCKER. Use what?

VICE CHAIRMAN SOLOMON. "Were substantially slower," if you want to use exact symmetry.

CHAIRMAN VOLCKER. "In the event of significantly slower growth." That's symmetrical with the top part of the sentence.

VICE CHAIRMAN SOLOMON. It's like the Delphic oracle!

MR. MARTIN. But "were" implies it isn't going to happen.

CHAIRMAN VOLCKER. "Of significantly slower growth." Now, what numbers do we put in up above?

MR. MARTIN. 5, 7, and 9 percent.

MR. PARTEE. I'm attracted to try it with the 5, 7, and 9 percent; maybe it has been more on our minds than anybody else's that we [typically] don't change these rates.

CHAIRMAN VOLCKER. Well, we've changed them in the past and sometimes we haven't changed them. I just have a brief record here. It looks like when we've changed them--well, there's one exception where we changed [M1] from 7 percent to 5 to 6 percent and kept the other two the same. Others we have not changed at all. Once we had 6 to 7 percent and we changed it to well above 6 to 7 percent; once we changed one from 6 percent to 7 percent and we changed some of the others by 1/2 point, basically. A 1/2 point is the maximum we've changed the others. What we've done before is change the adjective in front of it. We've said "This action is expected to be consistent with growth of M1, M2, and M3 at annual rates of" and following some previous pattern we changed it to "somewhat less than" or "around" or something like that. That's the kind of thing we've done before. I suppose that may be an alternative--just to change the adjective in front of it--but I don't think it makes a lot of difference. We can say "This action is expected to be consistent with growth in M1 of around 5 percent or a little less and growth in M2 and M3 at 7 and 9 percent, respectively."

MR. GRAMLEY. That sounds all right.

CHAIRMAN VOLCKER. Does that sound better to people? "This action is expected to be consistent with growth in M1 at around 5 percent or slightly less and in M2 and M3 at annual rates of 7 and 9 percent, respectively."

MR. PARTEE. We had 7-1/2 percent for M2.

CHAIRMAN VOLCKER. Well, we can leave 7-1/2 percent. Do you want to leave 7-1/2 percent? Either way you like: 7-1/2 or 7 percent.

VICE CHAIRMAN SOLOMON. I'd leave it at 7-1/2 percent.

CHAIRMAN VOLCKER. How many have a preference for 7-1/2 percent? One, two, three, four, five, six.

SPEAKER(?). Seven.

MR. BOEHNE. I'll make it eight; I don't care.

MR. RICE. I don't either.

CHAIRMAN VOLCKER. We have six "preferences" and at least two "don't cares." All right, let's try this for the language and then we'll discuss the nuances. "In the short run, the Committee seeks to maintain existing pressures on reserve positions. This action is expected to be consistent with growth in M1 at an annual rate of around 5 percent or slightly less, and in M2 and M3 at annual rates of around 7-1/2 and 9 percent.... Somewhat greater reserve restraint would be acceptable in the event of more substantial growth in the monetary aggregates, while somewhat lesser restraint would be acceptable in the event of significantly slower growth. In either case...." All the rest is the same, including the 8 to 12 percent [funds rate range]. We are aiming at $1 billion of borrowing. We recognize that we're starting out at least with growth a bit on the slow side. If we got evidence of some slowing in the economy--I guess in terms of the earlier discussion, I'm forgetting now about these special financial problems--and there are further upward pressures on the federal funds rate, we probably would be heading below $1 billion; but if we don't have those signals, we wouldn't, barring this other financial market question.

MR. GRAMLEY. Are you talking about slowing in the economy beyond expectations?

CHAIRMAN VOLCKER. Yes. I don't know exactly what they are, but that's what I'm talking about.

MR. PARTEE. It's hard to [quantify].

CHAIRMAN VOLCKER. If we get a weaker employment number, weaker this number or that number--broadly lower than expectations, yes. If we have financial problems that are great enough, we would provide some liquidity. I don't know how one judges that in advance; I think we have to play it by ear. We had this problem for a very short period of time with Continental when their borrowing went way up and the market was disturbed and we didn't take the money out right away, day-by-day, because the market was tightening up on its own. I certainly would take into account if this were all reflected, as you put it, in a flight to quality and in fact the federal funds rate and the CD rates were going way up--and to make rather extreme assumptions --the prime rate were going up. I would interpret that as getting a much tighter effect on policy than we calculated in making these assumptions on policy right now.

MR. GUFFEY. And, therefore, you would react by providing substantially greater reserves.

CHAIRMAN VOLCKER. Yes. If they really got substantial, we'd have a Committee consultation. Well, that question certainly would be raised.

VICE CHAIRMAN SOLOMON. Well, you wouldn't have any alternative.

MR. PARTEE. I'm unclear as to what would happen to the funds rate. I could certainly see a widening spread--CD rates going up and bill rates going down--as an indication of a flight to quality. I'm unclear about what would happen to the funds rate.

MR. AXILROD. Our experience has been, Governor Partee, that when that has happened it has tended to put upward pressure on the funds rate--[recently], in any event.

CHAIRMAN VOLCKER. I think that is right in this cycle. I think what we're getting, and it wasn't mentioned earlier, is restraints on the supply side of federal funds as well as a reluctance to borrow from the Federal Reserve. People are cutting back on lines.

MR. CORRIGAN. I think there's a husbanding of federal funds going on.

MR. GUFFEY. Dislocation.

MR. PARTEE. I guess that could happen, if they really became sensitive. Otherwise, it's a very liquid instrument to put your money into.

CHAIRMAN VOLCKER. It's a liquid instrument if you have a good borrower. People are a little nervous about the borrowers these days. I think you see that in the Euromarket and you expect that to put more pressure on the domestic funds market.

VICE CHAIRMAN SOLOMON. The spread had gotten up to 160 basis points in Treasury bills and 3-month CDs. Then it went down a little to about 60 or 70 basis points and now it's back up to about 100.

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. I don't know in these disturbed periods how good those quotations are that we get on CD rates.

VICE CHAIRMAN SOLOMON. Okay.

CHAIRMAN VOLCKER. They are probably people's imagination; they are rates they would like to aim at for CDs.

VICE CHAIRMAN SOLOMON. Well, give or take maybe 10 basis points, I think they're probably fairly accurate.

CHAIRMAN VOLCKER. Well, they're accurate for some banks that can operate; some just can't operate in these markets. Anyway, it's understood what we're voting on and the nuances have been adequately explained? If there are no other questions, we will vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boehne	Yes
President Boykin	Yes
President Corrigan	Yes
Governor Gramley	Yes
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	No

CHAIRMAN VOLCKER. I guess that completes [our agenda]. I might say one other thing. This is of no substantive importance, but I have found it convenient in defending why we don't release minutes right away among my other arguments to say that when we have a basic policy decision we typically do announce it right away. These other things are just implementing policy that we've already decided upon. And that broadly is reflected in the directive, it so happens. We speak about a policy directive but that refers to the whole thing, which has all the long-range targets. When it comes to what we were just discussing--the language is probably right here--it's called an operational paragraph [in the Bluebook]; I forget what it's actually called in the directive.

SPEAKER(?). It's about that word.

CHAIRMAN VOLCKER. The phrase "in implementing policy" often appears. I'd just like to sharpen up the language a bit in the earlier discussions to make some distinction between policy with a capital P and implementing policy. This paragraph is implementing policy.

MR. BOEHNE. Do you find that a convincing argument?

VICE CHAIRMAN SOLOMON. It is useful. Is it credible?

CHAIRMAN VOLCKER. Actually, I think it is a useful distinction. I don't think it's just purely to handle the substantive points. People can say "I want to know what your operational approach is." But in terms of our own thinking we ought to make the distinction. I don't think we have changed anything here.

VICE CHAIRMAN SOLOMON. Yes, but we do say--and it's a little inconsistent with that--that one reason we don't want to release the minutes right away is that if conditions change during the intermeeting period we may want to adjust the standards. Right?

CHAIRMAN VOLCKER. I think [unintelligible] policy.

VICE CHAIRMAN SOLOMON. That also sounds like an adjustment of policy.

CHAIRMAN VOLCKER. Well, we're talking about semantics. What do you call policy and what do call something else? I think there is a distinction between--to use another phrase--longer-term strategy, which is a more basic approach, and these more tactical decisions. [Unintelligible] be tactical.

MR. WALLICH. What would be a "basic approach" short, say, of changing the annual ranges?

CHAIRMAN VOLCKER. Well, obviously, [what we did] in October, 1979--

VICE CHAIRMAN SOLOMON. And the middle of 1982.

CHAIRMAN VOLCKER. --and in late '82 or October of '82. And we did announce that very promptly. We didn't change the ranges but we said we were deemphasizing M1 and we announced it--not clearly, I guess. It was a more strategic decision.

VICE CHAIRMAN SOLOMON. Isn't this [directive] technically a communication to my Bank?

CHAIRMAN VOLCKER. Yes.

VICE CHAIRMAN SOLOMON. It is.

CHAIRMAN VOLCKER. Yes, and I think it's written that way. It says--

MR. PARTEE. It's a directive to the Manager.

CHAIRMAN VOLCKER. It's a directive to the Manager and it says "In implementing policy, follow this operational approach." That's what it says. I think that distinction is in the directive now; it could be sharpened a bit. The whole thing is called the policy directive, but it repeats all the basic stuff.

MR. BOEHNE. I have the impression--and it's just an impression--that we have fewer and fewer friends who come to our defense on our current release procedure and that we have gotten more defensive, say, over the last year or so than we have been in a number of years. Is that accurate or inaccurate?

CHAIRMAN VOLCKER. Oh, I think it's probably true. There's certainly a lot more noise about it. It's the kind of issue that the Kemp group has seized upon and they make a lot of noise about it. Certainly, the in-depth analysis is much greater now than it was. It's one of these things that's like fighting motherhood. Just like freedom of information, it's very hard to argue against it, even though you know it's a bad idea.

MR. BOEHNE. Yes, I'll agree with that.

VICE CHAIRMAN SOLOMON. All newspaper reporters, even the ones who are supportive of us, start off with a presumption that the maximum amount of disclosure is something good. It's very hard to argue otherwise.

CHAIRMAN VOLCKER. Steve has just pointed out something that we can put in this directive we just approved, with your approval. The previous paragraph says "The Committee understood that policy implementation would require continuing appraisal" and so forth. The insert would be: "In implementing policy in the short run" or "In implementation of policy in the short run."

MS. SEGER. Since I'm still intrigued by this fed funds matter, would it be possible to request the research people at the individual Federal Reserve Banks to call around to some commercial banks to see if, in fact, they are more carefully analyzing the banks that they will sell fed funds to or if they've changed their approach in the last couple of months?

MR. ROBERTS. I could give you the answer. They are.

MS. SEGER. Yes, I've talked to two individual banks that have. I have not done a survey.

CHAIRMAN VOLCKER. I'd be a little reluctant to do a survey simply because if we do, that itself becomes [an issue]. They begin asking why we're making a survey.

VICE CHAIRMAN SOLOMON. They interpret that as a signal that they should borrow less.

MR. BOEHNE. The Continental situation made a lot of [our District banks borrow less] even before that.

CHAIRMAN VOLCKER. I think it's something to keep our ears open to rather than taking a survey.

MS. SEGER. I didn't mean a written survey, just some--

CHAIRMAN VOLCKER. But even if you just call around in an organized way, it becomes a [survey].

MR. RICE. It's still increasing [reporting burdens].

CHAIRMAN VOLCKER. Our manager of reporting burdens points out that that becomes a survey too. But apart from that, I think it's just the kind of thing that would raise more questions than we are prepared to answer. I have had that comment reported to me--not by any banks, but by nonbanks. Peter mentioned that it was attributed to a deliberate effort on the part of the Federal Reserve to police the discount window more rigidly. And I assume that isn't the case.

VICE CHAIRMAN SOLOMON. We checked up on that. There's no evidence of that at all.

CHAIRMAN VOLCKER. You've checked with other Reserve Banks too?

VICE CHAIRMAN SOLOMON. Yes. I had my discount officers call some of the other discount officers.

MR. STERNLIGHT. It was a conference call among the discount officers, and there was no substantiation of that.

VICE CHAIRMAN SOLOMON. This reluctance to borrow is not just at the larger banks. At least two of the larger banks said to us that some of the regional banks were more reluctant to borrow. I don't know whether you would find any in your area being more reluctant to borrow. Because of the rumors in the market, every bank leans over backwards.

MR. ROBERTS. I think they are torn. This wide spread makes them want to have mechanical errors on Friday and that sort of thing.

MR. GUFFEY. I find it strange under those conditions that we seem to be hitting the targets not only on borrowed but on excess reserves. I should think that excess reserves would be ballooning under these circumstances.

VICE CHAIRMAN SOLOMON. They're not.

MR. GRAMLEY. Why would a bank want to hold additional cash assets that are [earning] nothing?

MR. GUFFEY. I'm talking about the fact that there's a dislocation. In other words, there's a reluctance in regional banks to sell to money center banks.

MR. GRAMLEY. But they could put it in other assets.

CHAIRMAN VOLCKER. Well, presumably there's some fine balance here. I'm just thinking out loud. They try to hold excess reserves and not borrow; then we provide enough reserves to satisfy [their demand for excess reserves]. And the equilibrium happens to be at an 11-3/4 percent funds rate. [Unintelligible]--well, the M2 is not.

MR. PARTEE. I don't think there's any evidence that we're providing reserves more generously.

CHAIRMAN VOLCKER. Well, the money supply has gone down.

MR. PARTEE. And the reserve numbers are on the weak side rather than strong. So, it's something that we're doing here that is not ginning up the numbers but ginning them down. In other words, if there's something we're doing--

MR. ROBERTS. Why do you say the money supply has gone down? It hasn't gone down year-to-date; it hasn't gone down quarter-to-quarter; it was just down in July.

CHAIRMAN VOLCKER. It was down in July.

MR. ROBERTS. It's back up already in August.

CHAIRMAN VOLCKER. But it's going down--

MR. BALLES. As a matter of fact, I wanted to ask Steve whether that July figure is for real--that is to say meaningful--or whether it might be a seasonal problem.

MR. AXILROD. Well, we run concurrent seasonals just to see how we're tracking once the revision is in. I don't have the figures in front of me but my memory is that the current seasonal through July would change that rate of growth from minus 1/2 percent to plus 2 percent and would change some of the others. There's a little evening out. So, it's still relatively low but it was--

CHAIRMAN VOLCKER. I am not suggesting that a minus 1-1/2 percent is reflective of the trend of M1 growth.

MR. AXILROD. It doesn't change the trend.

CHAIRMAN VOLCKER. I hope it does not.

MR. WALLICH. Well, it seems to reflect that M1 is not as reliable as we had hoped it would be.

CHAIRMAN VOLCKER. Well, it is [unintelligible] you have unrealistic expectations of month-to-month fluctuations. We had a zero in April and a big May, and a big June balanced by a small July. If you take the four months together, it doesn't look too bad.

MR. ROBERTS. It's very stable quarter-to-quarter.

CHAIRMAN VOLCKER. The sandwiches are out there.

END OF MEETING