Meeting of the Federal Open Market Committee

September 23, 1986

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, September 23, 1986, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Guffey
Mr. Heller
Mrs. Horn
Mr. Johnson
Mr. Melzer
Mr. Morris
Mr. Rice
Ms. Seger
Mr. Wallich

Messrs. Boehne, Boykin, Keehn, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Black, Forrestal, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

Mr. Bernard, Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman, Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Balbach, T. Davis, Kohn, Lindsey, Ms. Munnell, Messrs. Prell and Siegman, 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, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Loney, Economist, Office of the Staff Director for Monetary and Financial Policy, Board of Governors
Mr. Simpson, Deputy Associate Director, Division of Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

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

Messrs. Broaddus, Lang, Rolnick, Rosenblum, Scadding, Scheld, Thieke, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of Richmond, Philadelphia, Minneapolis, Dallas, San Francisco, Chicago, New York, and Atlanta, respectively

Mr. Skaperdas, Assistant Vice President, Federal Reserve of Cleveland

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CHAIRMAN VOLCKER. We need to approve the minutes. Do I have a motion to approve?

MS. SEGER. I'll move it.

VICE CHAIRMAN CORRIGAN. I'll second it.

CHAIRMAN VOLCKER. Without objection. Now we'll turn to Mr. Cross.

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

CHAIRMAN VOLCKER. The lesson is that we have too much official discussion.

MR. CROSS. I don't disagree with that.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I was told by a knowledgeable source that the reason the dollar did not go down when we cut the discount rate was that the long rate did not go down with it and that the exchange rate is more sensitive to long rates than to short rates. Is that a plausible explanation to you?

MR. CROSS. I would think that certainly it's a factor. I wouldn't give it total weight but, obviously, much of the effect on the dollar is in the investment instrument and there's certainly a lot of attention paid to the long-term rates. And it's well known by everybody in the market that those long-term rates have not been declining with our discount rate cut. So, I think it is certainly a factor.

MR. MORRIS. It does raise questions about our ability to influence the exchange rate at this particular juncture.

CHAIRMAN VOLCKER. If the long-term rate goes up because of concern about inflation, I wouldn't think it would help the exchange rate.

MR. MORRIS. You wouldn't think so. On the surface we seem to have a perverse reaction. The domestic market is saying this is inflationary and the international markets have a different view. But this is the only concept that I've heard that has tied the two together. I don't know.

MR. TRUMAN. President Morris, research done by people here does suggests that in econometric terms you get more of an explanation of the dollar's movement from real long-rate differentials, as the Chairman commented, than short rates. But they don't explain very much of the total. So, although by themselves they seem to provide more [of the explanation] over the longer term than [do short rates], it's not decisive. It is one of the factors, but presumably not the only one.

MR. WALLICH. But isn't the long-term prospect more durable than the short-term prospect? I'm speaking now of half a year or two years?

MR. TRUMAN. You get more of that, Governor Wallich. That's presumably what you're trying to pick up with the so-called econometric exercises. But I don't think they are very useful in explaining wiggles from discount rate changes. You need other things.

MS. HORN. So much of the public discussion about the exchange rate seems to center on the mark and the yen and yet we focus from time to time on how little the dollar has moved with respect to other important currencies--those of Korea, Taiwan, Hong Kong, and so forth. Is there any effort, nonpublic effort, being made with these governments?

MR. CROSS. Well, there's certainly an effort being made by the Treasury and others to talk to the Taiwanese and Koreans on some of these trade issues and other matters. Of course, it cuts both ways. The Taiwanese currency, for example, went up with the dollar and back down with the dollar. So it hasn't affected the present exchange rate very much either way. If you draw charts including more of these [other countries] you'd have a higher movement in the charts than we typically see when we focus on industrial countries. But the pattern is quite similar.

MR. TRUMAN. President Horn, there is a proposal by the Taiwanese to apply U.S. trade legislation in reverse. For countries with which they had big trade surpluses they would cut the tariffs on imports rather than seek a depreciation or appreciation of the currency. That has not had any effect; it's one manifestation of this kind of pressure.

MR. CROSS. There's certainly a lot of discussion underway with them to try to do something.

CHAIRMAN VOLCKER. Taiwan strikes me as rather a special case. They have an enormous surplus, enormous reserves. Their big surpluses, fortunately anyway, are with the Germans and Japanese.

MR. CROSS. Taiwan has the biggest surplus of any of these.

CHAIRMAN VOLCKER. Current account surplus.

MR. CROSS. By a long shot. And they also have very, very high reserves. Korea is different.

MR. TRUMAN. We don't regard Taiwan as a country [unintelligible] this large surplus, [unintelligible].

CHAIRMAN VOLCKER. We ought to make it a 51st state if that would help!

MS. SEGER. Did I hear you right that the Germans were on both sides of the market within a fairly short period? Are they trying to target the dollar-mark relationship?

MR. CROSS. I'm not sure I would read all that into it. They have not intervened on the low side. They did intervene when the dollar rose to 2.10; it did jump up very suddenly and that occurred at a time when we were closed--at 5:00 or so in the morning here--and they undoubtedly felt that they were taking a helpful step at that point. A lot of the pressure on the other side has come from the other Europeans who feel stress and strain resulting from the strong DM. As the dollar is weakening against the DM, the DM is tending to strengthen against all currencies, particularly the EMS currencies. And, as I said, they sold $4-1/2 billion worth of DM last week and that begins to hurt them. So, they are the ones who have been pressing, I suspect, for these understandings on the joint intervention--that efforts should be made in order to prevent a further sliding of the dollar, not that we should let go. At least that's the way I interpret it.

CHAIRMAN VOLCKER. They get a lot of pressure within Europe when the Germans don't reduce their interest rates; that is one way of reading it. Nobody wants a revaluation within Europe so they were driven to this intervention idea as a method of relieving pressure within Europe against the general background of concern about the dollar. But that's not what led to that particular decision.

MR. JOHNSON. Is there any notion of what the Germans will do with all these marks that are being sold? Will they just let them stay out there? It would be fundamental to their monetary policy.

MR. CROSS. These are basically coming out as marks that are in Euromark holdings. They have not allowed the Europeans to build up marks within the Bundesbank.

CHAIRMAN VOLCKER. Better get some--

MR. GUFFEY. Does that mean it's not inflationary the way they're doing it?

CHAIRMAN VOLCKER. Indirectly

MR. TRUMAN. Yes, indirectly.

MR. CROSS. It has no [direct] effect.

MR. TRUMAN. Monetary [effect].

CHAIRMAN VOLCKER. Somebody else in the market has to hold them.

MR. JOHNSON. Yes, somebody's got to be holding them.

MR. TRUMAN. Yes, but it doesn't have an effect on bank reserves within Germany.

MR. CROSS. That's the only point I was trying to make.

MR. JOHNSON. But if somebody else within the European--

MR. CROSS. It doesn't affect the Bundesbank.

MR. HELLER. But Sam, the other Europeans are intervening mainly in deutschemarks and not in--

MR. CROSS. Almost entirely. There has been very little dollar intervention by the other Europeans. There has been a little; the Spanish have been picking up a few dollars as they position themselves for entry to the EMS or one thing or another. But basically it has been overwhelmingly DM intervention and not dollar intervention.

CHAIRMAN VOLCKER. As Sam mentioned, and I would just emphasize, there has been quite a pickup in the German economy after a very sluggish performance. Nobody knows how long it will last. But at the moment their domestic demand is doing very well. That, together with fairly rapid monetary expansion, is why any ideas they had of reducing their discount rate have been turned off. From the standpoint of results, if what we're interested in is growth in the German economy, the most recent performance has been good; although it's hard to know if it will carry them, at the moment it is good.

MR. PARRY. Do we anticipate that that growth will continue? I noticed that the assumption about growth for the OECD countries has a fairly sharp fall-off in the second quarter.

MR. TRUMAN. Well, it's certainly yet to be known, but we anticipate the second quarter will continue at the rate the Chairman has expressed which, depending upon which numbers you use, is either 8 or 14 percent at an annual rate. But on average, we don't see much difference from the trend that they've had over the past couple of years of something under 3 percent. If anything, we see some tailing off as we get into 1987.

CHAIRMAN VOLCKER. Mr. Sternlight.

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

CHAIRMAN VOLCKER. No questions?

MS. SEGER. I have one: Why was it that we didn't know until the last day about this tremendous additional need for required reserves?

MR. STERNLIGHT. Well, under the system of contemporaneous reserve accounting we depend on reports and revisions during the reserve maintenance period. And sometimes we get sizable revisions. If there is a revision midway through the period we can cope with that fairly well, but we are vulnerable to hearing something as late as the last day. And we can even get a report after the period is over that requirements were materially different from what we thought they were on the last day we had an opportunity to operate. I wouldn't say that a revision of this size on the last day is typical but it's not unheard of to get a pretty big revision very late in the period.

MR. BLACK. But it has to be in the non M1-type deposits because you already know those required reserves.

MR. STERNLIGHT. Well, I think we're getting some changes even in the M1-type.

MR. BLACK. But aren't they based on deposits earlier in the period?

MR. KOHN. The non-M1 reserves are based on earlier deposits, right. The M1 reserves, of course, are based on contemporaneous deposits and that's where this large revision is.

MR. BLACK. Yes, I said it backwards, I'm sorry.

MR. STERNLIGHT. Only the M1-types of deposits--

CHAIRMAN VOLCKER. If there are no other comments or questions on that, we will return to Mr. Sternlight and the topic we covered to some degree last month about operations in coupon issues. I'm sure we have all thought that through. I think what the issue comes down to is whether we do it reasonably routinely two or three times a year, the way we've been doing it, or whether we do it when we think there's some purpose in doing it.

MR. RICE. Why don't we do both? Could we do it in both circumstances?

CHAIRMAN VOLCKER. Yes, we can do it in both circumstances; we could do it routinely and also when there's some purpose.

MR. RICE. That's the point.

CHAIRMAN VOLCKER. Then we buy more longer-term securities.

MR. RICE. Not necessarily.

CHAIRMAN VOLCKER. It is, necessarily, if literally you go in that market routinely and also--

MR. RICE. You'd go in the market more frequently but you wouldn't necessarily buy more.

MR. ANGELL. But that also might mean that you would sell at times when--

CHAIRMAN VOLCKER. Well, this question of selling arose last time. I don't know whether there's anything more to be said on that. The observed practice is that we don't sell.

MR. ANGELL. It might have an announcement effect.

CHAIRMAN VOLCKER. There's no doubt about that. That's why we don't sell--because we expect an announcement effect.

MR. BOEHNE. On this issue of liquidity, which is one of the main reasons for reducing the holdings of long-term securities: That table that Peter sent out shows that we have something like--this is not an exact number--$90 billion in Treasury bills.

MR. STERNLIGHT. Very close to $100 billion.

MR. BOEHNE. All right, close to $100 billion. Total reserves in the entire System are around $50 billion, aren't they?

MR. STERNLIGHT. Right.

MR. BOEHNE. A good chunk of that $50 billion would be vault cash, so actually the deposits at Federal Reserve Banks would probably be what--$25 to $30 billion?

MR. STERNLIGHT. Yes.

MR. BOEHNE. Or something like that. So that means in terms of liquidity that we already have in our portfolio something like three times the amount of total reserves on deposit at Federal Reserve Banks. Unless I'm missing something I don't see a liquidity issue here.

MR. STERNLIGHT. I think the liquidity is very ample now. I don't know if I'd draw that [conclusion] just from the comparison that you made, but there has been ample liquidity. And it seems to me that liquidity has grown, even, with the policy of recent years. But we have done a moderate proportion of our long-term provision [of reserves] with occasional purchasing of coupon issues.

MR. GUFFEY. If two or three large banks get into trouble and we're providing reserves through the discount window, though, there could be a liquidity problem even with these numbers.

CHAIRMAN VOLCKER. Yes, I don't think this [unintelligible]. Now, we do have other constraints than that [unintelligible]. We lend dollars to--

MR. STERNLIGHT. Twelve.

CHAIRMAN VOLCKER. Twelve.

MR. JOHNSON. If we run into a $90 billion problem we might as well turn in our badge.

MR. BOEHNE. We may not be routinely mopping up reserves.

CHAIRMAN VOLCKER. We can turn in the badge but still handle the problem.

MR. BLACK. It does suggest, though, that if we get a chance we ought to get rid of that collateral requirement on notes just in case.

CHAIRMAN VOLCKER. That I think we can do. But I think it is right to say that one issue is the liquidity crisis and the other is whether we see any purpose in buying coupons.

MS. HORN. I guess my view on this is that the folks in the Treasury Department ought to be in the debt management business and that some sort of neutral stand by the Federal Reserve is an appropriate one. Having said that, I think you could define policy as neutral if either we pursued a bills only approach or if we routinely went in for preannounced, preagreed, purchases in the long-term area.

And since both long-term and short-term [securities] count as collateral that doesn't help make the decision either. But those are the two policies that I can define as neutral, if you will.

MR. JOHNSON. If we could get the Treasury to stop extending the term structure of the debt, it seems that a neutral policy would be to buy whatever they issue in the same proportion. But they keep extending the number of long bonds without a real rationale that I can tell.

CHAIRMAN VOLCKER. You find a portfolio distribution you like and the Treasury is maintaining a distribution that it likes. I have no doubt of the volume this could involve should it never involve buying, just rolling over what we have.

MR. JOHNSON. Yes, I guess that's right.

CHAIRMAN VOLCKER. I [unintelligible] this with it. We might buy in proportion to what their--

MR. JOHNSON. In proportion to what their needs were, which would mean we would be in the market on a regular basis but for small amounts.

MR. RICE. It seems to me that it's a potentially useful tool that we might not want to give up.

CHAIRMAN VOLCKER. I'm not talking about giving it up; I'm talking about--

MR. RICE. You give it up if you don't use it every once in a while.

CHAIRMAN VOLCKER. Well, that's the question. That's what the issue comes down to.

MR. RICE. I can imagine times--not often--when there might be a shortage of bills and we don't want to increase that shortage of bills in the market and there may be some long-term securities available.

CHAIRMAN VOLCKER. I have no objection to buying long-term securities when there's a good reason for buying them. My question is whether any particular purpose is served when there's no reason to buy them. I think you want to argue that this [routine buying] keeps the machinery oiled or something. That's the argument.

VICE CHAIRMAN CORRIGAN. A corollary argument to that is that if you completely stop doing it except in extraordinary circumstances, that too involves an announcement effect. At some point you're going to have to answer the question: Why aren't you buying long-term securities anymore?

CHAIRMAN VOLCKER. I have no trouble answering that question as to why we're not buying. If we wanted to adopt that policy we would say we're not buying them anymore except when some purpose is served in buying them.

MR. MORRIS. I think the idea that we control a long-term position by not rolling over completely all of the maturing issues--

CHAIRMAN VOLCKER. Certainly, that helps you.

MR. MORRIS. Is that something that the Treasury would be upset about?

MR. STERNLIGHT. They would not be bothered by our leaning more toward the short-term option.

CHAIRMAN VOLCKER. I would do that if we're going to continue buying. I would go very short and pretty soon.

MR. RICE. Would buying smaller amounts have an announcement effect?

CHAIRMAN VOLCKER. Well, we'd [unintelligible] if we buy small amounts now, and even if we can, if we're going to do it at all. That is my impression.

MR. STERNLIGHT. I wouldn't see any significant announcement effect from leaning toward the shorter options. I don't think [unintelligible].

SPEAKER(?). No, no. From buying smaller amounts?

CHAIRMAN VOLCKER. No, I don't mean that. From buying smaller amounts in the market when we buy.

MR. STERNLIGHT. I don't know how much "smaller" would be--

CHAIRMAN VOLCKER. We don't buy.

MR. RICE. What's the average amount?

MR. STERNLIGHT. In typical trips to the market recently it has been something like $1 billion or $1-1/2 billion, in that kind of range. We only did $4 or $5 billion [unintelligible]. We could certainly buy a couple of billion.

MR. RICE. You could certainly buy a couple of hundred million.

CHAIRMAN VOLCKER. You can buy it if you [unintelligible]. Even $1 or $1-1/2 billion isn't very much; it's pretty trivial considering the volumes in the Treasury market.

MR. MORRIS. But you could generate that leeway very easily by just failing to roll over part of our holdings.

CHAIRMAN VOLCKER. No doubt you can protect the liquidity position by going shorter on the rollovers.

MR. MORRIS. If the Treasury doesn't object, it seems to me that would be the answer. You could have your cake and eat it too.

CHAIRMAN VOLCKER. Well, there's no question you could do that. That is kind of in between. It just leaves the question--. It's not like it's [unintelligible] every time we buy a coupon issue. I personally wonder why we're doing it. There is no other reason. The answer I get is: to keep the machinery oiled. I don't know what that means.

MR. RICE. To keep people from being surprised.

CHAIRMAN VOLCKER. If you have a purpose, you want to surprise.

MR. ANGELL. It seems to me that if we do not want to sell, and that presumably is the consensus, we ought not to buy as long-term as we've been buying. That would maintain more liquidity. If you can never sell then there is merit in shortening the maturities that you do buy.

MR. MORRIS. But presumably we learn something about the functioning of the long-term market by seeing a response to our operations. I assume that's where Peter--

CHAIRMAN VOLCKER. That, I think, is one argument.

MR. MORRIS. It's not a matter of oiling the machinery; it's really having a test that we participate in to see how the machinery is working.

SPEAKER(?) But in general the Treasury market is very broad and very deep. If you just keep--

CHAIRMAN VOLCKER. I don't want to prolong this discussion or add to it. Ordinarily, it's working just fine. There's a lot bigger volume going through the market every day than what we're doing. We might want to know how it's working at some point of strain or whatever. Then I have no problem. I have no compunction about buying long-term securities when there's a purpose here.

MR. JOHNSON. Have we bought coupons for a purpose at times?

CHAIRMAN VOLCKER. Not for a long time. Historically, yes, but not recently.

MR. STERNLIGHT. I might point out that sometimes in those periods of strain, we feel constraints--that we should not get in the market because we don't want to be seen as interfering with the market's own adjustment process.

VICE CHAIRMAN CORRIGAN. That's the concern that I have: If you withdraw from the market completely, do you create a situation where you're so inhibited about going into the market that in precisely the circumstance that you might want to go in you are just scared to death to do so because the announcement effect would be bigger then? I don't know.

CHAIRMAN VOLCKER. Well, I will give you an example. Ordinarily, if we had a strong reason for going in, the announcement effect might be welcomed. If we really thought the market was in a panic, say, and we wanted to show some support in the market, we would want an announcement effect. An announcement effect would have been more important in July. But taking the last few weeks, I don't know whether we had any particular reserve need which was suitable--

MR. JOHNSON. I think we did.

CHAIRMAN VOLCKER. But we might have argued we were going to buy anyway and with the long-term rates backing up and the new rate [unintelligible] it might have been quite reasonable to have bought long-term securities. Now, would we have been better off or worse off if we had decided in the last few weeks to do that against the background of a reserve need when we had no purpose--just a matter of having been in there and only been in for periods of that sort. That's an arguable point.

VICE CHAIRMAN CORRIGAN. Just to take your example and make it a little more pointed: My personal instinct is that if that very touchy interval a week ago, last Thursday-Friday, also had been one of those intervals when the market in the normal course might have expected us to be doing something, I think it would have been easier to do something.

CHAIRMAN VOLCKER. That's what I'm saying: you could get in between cases of that sort. But we're so constrained now, we could [only] do it when we're supplying reserves permanently. Anyway, the chances of that arising coincident with a period of that sort are remote.

VICE CHAIRMAN CORRIGAN. I don't think they are that remote at all.

CHAIRMAN VOLCKER. Well, does anybody else want to express a view on this subject? If not, the issue having been raised we'd better arrive at some conclusion. One option is merely to do more or less what we have been doing, which doesn't exclude, obviously, doing it on special occasions and [leaning toward] the shorter [maturities] in refundings. The other option would be to [cut back] in our already pretty limited operation of being willing to do it--I don't hear anybody saying we never should do it or even that we should be all that reluctant if there is a need or some positive rationale--but confine ourselves as to when there is some positive rationale other than that we haven't done it for six months. These are the two choices. Who prefers option one, continuing fairly routine [purchases of coupons]? Most people prefer that so we'll continue that fairly routine--

MR. JOHNSON. But we will go short on the refunds [unintelligible]? At what pace are we going to roll them over?

MR. ANGELL. That's not [unintelligible] three years.

MR. JOHNSON. We could thin out the market [unintelligible], depending on the pace that we--

CHAIRMAN VOLCKER. I don't think it makes much difference in the market because now they have allocated these securities especially to us anyway and we can--

MR. STERNLIGHT. Yes, that's [unintelligible] in the market.

CHAIRMAN VOLCKER. We can just go to shortening, which doesn't affect the market at all.

MR. JOHNSON. Okay.

MR. STERNLIGHT. As to how short we would be, I don't know. On this last quarterly rollover when the Treasury was offering roughly equal amounts of 3-year, 10-year, and 30-year issues, we did about 2/3 in the short option and correspondingly small amounts in the two longer options. I think leaving those longer options still smaller but keeping some minimal contact with the--

CHAIRMAN VOLCKER. [Why do you] say you're keeping contact with [the market] if you're buying them directly from the Treasury and never selling them?

MR. ANGELL. Yes, I don't think they are being sold. I don't think there's any reason to be in the 10- and 30-year issues if you're not going to be able to sell.

MR. STERNLIGHT. Well, having some small holding of them can be useful in our lending securities program. I wouldn't make a whole lot of that, but after Drysdale it was useful to have securities that we could lend just to help sort out delivery problems in the markets.

MR. HELLER. Where do you plan to be, roughly, if you talk about the percentage of total portfolio? Now we have 48 percent, which is about a record high. Two or three years from now where do you think we'll be?

MR. STERNLIGHT. I think the proportion of bills will continue to creep up.

MR. HELLER. To 55, 60 percent?

MR. STERNLIGHT. I think it will continue to creep up, continuing what we are doing.

CHAIRMAN VOLCKER. In bills. Coupons would presumably get shorter?

MR. STERNLIGHT. Yes, the coupon holdings would tend to shorten on this rollover--

MR. HELLER. So you're taking about every two years or so another 5 percentage points up there. Is that roughly the result of--

CHAIRMAN VOLCKER. It depends upon whether the money supply continues to expand at the rate of recent years. The marginal increase will rise with more bills, but as he said--

MR. HELLER. Is it by a large rise or--

CHAIRMAN VOLCKER. It depends upon--

MR. HELLER. It depends on the rollover, the runoff of the coupons.

CHAIRMAN VOLCKER. No, because they'll be rolled over into coupons.

MR. HELLER. They're going to the short end.

CHAIRMAN VOLCKER. Short coupons, but they'll still be in coupons.

MR. GUFFEY. Traditionally, or within the last few years, we've done a couple of bill purchases in providing longer-term reserves and the market expects that.

MR. STERNLIGHT. [You mean] a couple of coupon purchases.

MR. GUFFEY. Yes, coupon purchases. Does this in any way alter that policy? Would we not do a coupon pass if--

MR. STERNLIGHT. I understood the consensus to be to continue what we've been doing.

CHAIRMAN VOLCKER. The consensus was to continue to do it in small amounts.

MR. GUFFEY. And you'd just shorten it up by not taking as much on new issues then?

MR. STERNLIGHT. By not taking as much of the long options.

MR. GUFFEY. Yes, on new issues.

MR. STERNLIGHT. Right.

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

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. The inventory pattern that you have for the third and fourth quarters I know is related to autos, but what indication do you have that that disinvestment in the third quarter is likely to come about--particularly in light of the numbers that we have for inventories in July?

MR. KICHLINE. What we have in terms of nonfarm inventories in the third quarter is a runoff of nearly $12 billion, annual rate, in constant dollar terms. We have nonfarm inventories excluding autos rising about $9 billion. So the story is really very much an auto story, with a decline in auto stocks of about $21 billion in real terms in the third quarter. The numbers in the report in July were a little curious in the auto sector. They run counter to this and, as far as we know, the folks at BEA have other information they use in putting the numbers together. As you know, inventories are a wild card in all of this and I don't have any particular faith in a given number. But we do know what's happening to measures of auto stocks. And I would say that we have this forecast of a $21 billion runoff and an increase of $12 billion in the next quarter within a few billion.

I think it's safe to say autos are largely driving that. Outside of autos we have small increases.

MR. PARRY. The other issue is on net exports. You have roughly a $17 billion growth in the second half coming from net exports. Going to the July data again, the fact that you get an improvement of roughly $7 billion in the third quarter looks a little suspect at this point.

MR. KICHLINE. I have a colleague who has answered many of these questions.

MR. TRUMAN. I agree that the July data were disturbing. In fact, as far as the trade balance itself, the trade deficit in the third quarter would be larger than in the second quarter, which was essentially unchanged from the first. In terms of GNP accounts, however, two things are operating. One is the deflation; prices are rising for imports and in some sense that's taking back, so quantities are not rising as rapidly. On the other hand, when you're going through the trade numbers to the GNP accounts, there's about $3 billion at an annual rate that's accounted for by gold. Gold comes out of trade, both imports and exports, when it goes into GNP accounts. The negative swing is because of what's been going on in gold trade going from second quarter to third quarter; that swing isn't reflected at all in the GNP accounts. So I think it's fair to say that while we don't know what the revised figures will be when they come out at the end of this month they could well show worse numbers for July than the preliminary estimates. Our sense is that those are odd numbers and we are assuming they will be offset in part by August and September in the trade balance.

MR. PARRY. I get the impression that your level of confidence is not the highest on that one.

MR. TRUMAN. I think Jim summarized our sense of a lack of confirming evidence.

MR. PARRY. Okay.

MR. TRUMAN. On the other hand, to the extent that other aspects of the forecast are beginning to fall into place we had hoped that this one, too, would turn--

MR. PARRY. The improvement in, let's say, the period from the fourth quarter of '86 to the fourth quarter of '87 certainly looks reasonable; it's that pattern in the last half.

MS. HORN. Staying on the trade number for just a moment: If for some reason that projected trade number didn't come to pass, there might be implications for the inflation number. If you get more stimulus from the deficit than you're projecting and less from the trade accounts, then that might cause you to revise your inflation number. Inflation would be worse then.

MR. KICHLINE. Yes, to some extent our view is that some of the inflation coming from the dollar is a matter of timing. We've been seeing those price increases and it's a question of how they feed through. Obviously, we have weaker domestic markets. Out of the forecast of 3 percent real growth next year, a little over a third of that comes from net exports. So if you took away those exports the direct effect is rather large; and you can clearly have indirect effects, feedback effects, in domestic income. So, if you were to assume no improvement whatsoever, I think you're talking about a pretty sick domestic economy unless we have other things wrong.

MR. PARRY. Yes, it's other things equal.

MR. BLACK. Jim, do you have a CPI figure for all items other than food and energy?

MR. KICHLINE. It's up 3/10ths.

MR. BLACK. 3/10ths. Thanks.

MR. FORRESTAL. Jim, can I ask about the unemployment numbers? I would have thought that the unemployment numbers would be a bit lower than they are in your forecast for those two quarters. Are those [unintelligible]? Or are the numbers about right, do you think?

MR. KICHLINE. Well, I don't think I'd make big changes. We have a number for August of 6.8 percent and an average of 6.9 percent in the third quarter. If anything, I might change it a tenth, clearly on the downside. I think that's what you're asking.

MR. FORRESTAL. Yes.

MR. KICHLINE. The question as we go into the fourth quarter is whether we're going to continue to see that sort of improvement in a major way. We have assumed that we'll continue to have employment growth but at a somewhat lesser rate than we've been seeing recently. So, we have the unemployment rate drifting down only a tenth on a quarterly average. If that's wrong, and given what we know now, I'd bend in the direction of knocking another tenth or two off. I don't feel particularly uncomfortable [with our forecast] but I think the weighting of the evidence would be in the direction of a lower rather than a higher rate.

MR. BOYKIN. Jim, one question on your forecast. The positives are fairly heavily weighted on the improvement in exports. As I think you know, our folks have been doing a little research trying to figure out what has really happened to the dollar and our judgment seems to be that it has declined somewhere between 7 to 9 percent as opposed to 25 to 30 percent. If that should be true, that would tend to postpone this improvement. I would just raise--

MR. TRUMAN. But, President Boykin, we don't say this is our forecast for the weighted average dollar and put that into an equation and ignore the rest of the world. So, just because we use that as an indicator of where the dollar is going does not mean that we have ignored in this forecast the fact that the Taiwanese or the Korean [currencies] have not been depreciating appreciably against the dollar. We have gone back and looked at this more carefully over the last several months and, in fact, I am much more comfortable than I was before--at least to the extent that history can be any guide in these matters--that in the forecast we have adequately taken account of the lack of depreciation against the fixed [exchange rates of certain countries] in the judgmental adjustments that we have been making. Before, when we went back and looked at it, the whole scientific evidence suggested that, if anything, we were going too far in the direction of slowing down [the adjustment] for that reason rather than not far enough. So there is something in the forecast that takes account of the lack of depreciation against those currencies explicitly, and it is based upon scientific evidence as well, if you want to call it that. Now, we have a big problem in terms of how we forecast what's going to happen to those currencies. Basically what we have assumed is that they would maintain their value in real terms against the U.S. dollar. So there would be no net real appreciation or depreciation versus those currencies, on balance. Given the fact that we're dealing with some countries who have rather severe debt problems, that may or may not be appropriate. On the other hand, we have enough trouble doing the forecasting we do. So there is an explicit assumption, essentially, about both the behavior of those currencies and economies and an assumption about the course of their exchange rates in our forecast [unintelligible].

MR. JOHNSON. You have marked down some the G-10 countries' growth?

MR. TRUMAN. A touch, yes.

MR. JOHNSON. I haven't read the export numbers carefully enough to know: Have they been changed much since the earlier forecast?

MR. TRUMAN. No, this forecast basically is the same as the previous one.

MR. JOHNSON. Okay, so something had to give there. The growth abroad slowed. Is that made up in what has happened to the exchange rate since that time?

MR. TRUMAN. No, the exchange rate forecast for once didn't change at all just because we have the growth down by a tenth, or two tenths if you combine the two years. This would tend to give us a little more depressing effects on exports, as you suggested. Basically, the order of magnitude would be about the same as the last time. As for the impact on the overall forecast, on balance, I think we took a little out of the 6-quarter change from where we were last time.

MR. PARRY. I'd like to ask a question about the inflation rate that you have, the implicit deflator, and the dollar. The very small increase in inflation in the fourth quarter we talked about last time and you mentioned that it's primarily the fact that the deflator on imports is rising. That's part of the story in the sense that in subsequent periods one would expect that as profit margins get narrow the [price increases] would get passed on in terms of higher domestic prices on goods that use imports as raw materials, and also in terms of domestic goods that compete with imports. How do you explicitly capture that? Do you do deflators by sector or is this a judgment?

MR. KICHLINE. No, we do it by sector. And where that shows up explicitly is in private domestic final purchases. So you look at consumption, you look at investment. For example, we have that total, excluding food and energy, rising next year at a rate close to 4 percent. So that's sort of an explicit recognition that these imports prices are feeding through into final goods prices.

MR. PARRY. So that would be adding how much--roughly a percent?

MR. KICHLINE. I think we have something like 3/4 of a percent or 0.8 percent.

MR. MELZER. Jim, how would you view the declines in the consumer confidence indexes? Would you attach much significance to that, what do you think the causes might have been, and so forth?

MR. KICHLINE. I have a hard time reading some of those. They have bounced around. They're still at a high level but clearly they are not as high as they were a number of years back. Some of these reports--depending on whether you look at the Michigan or the Conference Board surveys--tend to be sort of "things are good now but they're going to get worse." In the Michigan case what often happens, and what I think was happening in August, is that it reflects an increase in inflationary expectations that's very highly correlated with food prices. Given the past behavior [of the index], whenever food prices go up Michigan seems to pick up the view that things aren't quite as good as they once were. So, at the moment I wouldn't read a lot into the declines, given that the levels are still high and given what we see going on in terms of actual expenditure patterns--that consumers have been quite happy to spend.

MR. MORRIS. The Michigan people also say that the index is very sensitive to changes in interest rates, particularly the mortgage rate, and the backing up of the mortgage rate may be [a factor].

MR. KICHLINE. Yes.

MR. MORRIS. Jim, if I could ask you: You mentioned that nondefense capital goods orders were down somewhat. What about total durable goods orders?

MR. KICHLINE. The total was little changed. It was up 3.4 percent in July and down 2.6 percent in August. There was a big drop in defense orders.

MR. PARRY. Was there a revision in the--

MR. KICHLINE. No, the revisions, I think, are very small. On nondefense capital goods alone it's virtually unchanged. That was up 3.7 percent in July and down 2.8 percent in August.

MR. MORRIS. So we didn't get any confirmation of the employment numbers in manufacturing?

MR. KICHLINE. No. Part of what's going on, though, is that the aircraft area has been extremely volatile. It was up very sharply in July and went down in August. Nondefense capital goods orders excluding that aircraft component are still down in August but the level is 3-1/2 percent above the second-quarter average. So I would read that as something very helpful. The other development that is encouraging is that office and computing machinery orders rose again. They are now, as you know, at a low level; but they are 25 percent above where they were in the second quarter. So there seems to be a little life coming back in that high-tech area.

MR. MORRIS. Yes. I was told by one computer company that they are selling a lot to Korea and Taiwan, so maybe we'll--

MR. PARRY. Do I remember correctly that you said most of those major Boeing and McDonnell-Douglas orders were not booked yet?

MR. PRELL. Yes, that is true.

MR. PARRY. So there could be even greater strength coming along.

MR. PRELL. They indicated in their release this morning that those orders still aren't showing up in these latest figures.

MR. PARRY. And they're big orders.

CHAIRMAN VOLCKER. Do we have any general comments on the economic outlook?

MR. WALLICH. Could I say something about how difficult it seems to be at this stage to [look] forward? It's difficult for me to [elaborate on] that, but I just want to make that clear.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, our view of the near-term outlook is still pretty close to that of the staff. This upward revision in growth of GNP in the second half makes sense to us in view of the domestic automobile sales incentives and what appears to be some improvement in the manufacturing sector in general. I think the longer-term prospects are a little harder to call. We're still generally optimistic and we think the staff is perhaps about right in projecting a moderate 3 percent rate of growth for next year. In fact, we tend to think that consumer spending and probably business fixed investment might be a tad stronger. One reason is that we don't think there will be quite as much of an increase in the cost of capital and, therefore, that the new tax law will be less damaging to capital spending than some economists believe--if you take into consideration that the top corporate tax rate has come down and also consider what has happened to individual income tax rates of dividend recipients.

But all of this depends, I think, on interest rates and inflation remaining relatively stable. And I think the risks have increased that such might not be the case on both fronts. In particular, the prospect for progress in reducing the federal deficit looks a lot less favorable now. I think the financial markets sense this and that's one of the reasons we had the recent backup in interest rates, which probably affected the decline in the stock prices. The markets also are clearly more concerned now about the possibility of a revival of inflation and neither of these kinds of [developments] is good for the markets and neither is good for the economy. I hope we'll do everything we can to keep these things from gaining momentum.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Conditions in our part of the Midwest, I think, are very much unchanged. The trends that have been in place most of the year continue at about the same level. But I continue to be struck by this incredible dichotomy between the good sectors of the economy and those that are relatively weak. There is nothing new about that but that dichotomy certainly continues. I think the automotive sector, which Jim referred to, is rather phenomenal. Here we have had the third year in a row of auto sales over 10 million, which I think is a pretty good record, yet even now these incentive programs just have a phenomenal effect because sales have literally taken off. Construction activity in the Midwest continues at a pretty high level. Residential construction throughout the District is really quite strong; that's particularly true in Illinois where the numbers are running well over the national average. We are perhaps slightly different from what Jim said on the commercial side; we are stabilizing in our commercial construction but nonetheless stabilizing at what seems like a pretty high level.

On the negative side, the heavy manufacturing news continues to be pretty somber. There is no particular improvement. More and more companies are continuing to shift their production offshore to take advantage of lower wage rates. They admit that they are late in doing it but nonetheless see an opportunity to take advantage of that trend. On the tax bill, those that I talk to on the heavy manufacturing side are pretty glum as to the near-term effects that the bill, assuming it gets passed, is likely to have. Our agricultural directors report that we have had, really, a perfect growing season and we're bracing for record production; the stories one hears about the storage problems and what they're going to do with all this are really quite phenomenal.

On the inflation side, I think the general outlook continues to be favorable but there are just those few worrisome signs there. As I suggested, housing starts in the Midwest are pretty strong. In some suburban Chicago areas we're having significant prices increases --15 to 20 percent in the first six months of this year. It's a very, very, strong housing market and the prices are going up. We anticipate that apartment rents will be up 5 to 10 percent in the Chicago area. And, I think everybody expects that the prices of imports, particularly cars, are going to begin to go up. Offsetting that, the labor news, as Jim suggests, continues to be good. Three-year contracts are prevalent and annual costs are very moderate. I talked to somebody last week who settled a three-year contract with costs over the three-year period of 1 to 1-1/2 percent. And the companies are getting very, very significant work rule changes--that's the big push now, of course. On the pricing side--perhaps not in services, but certainly in manufacturing--there are pressures.

As to the [national] outlook, certainly our outlook is consistent with the staff forecast. But I agree with Governor Wallich that it's a very, very hard time to call it. Everybody anticipates that we're going to see export activity pick up and that at some point imports will be under some constraint; but these events are certainly getting to be long overdue. Therefore, I think it is a tough call to judge just how strong the underlying strength of the economy really is. Perhaps this is one of those times that we just have to stand back and see how things come in.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. The economic situation in the Twelfth District is basically unchanged from the last meeting, but I think there are a few more signs of strength in the District. In August, growth of employment in California was very rapid. And the July-over-July increase for the entire District, which of course includes 9 states, was a full percentage point greater than the national average, with only Alaska and Oregon being under that average. Even in a few of the problems areas of the District we see some glimmers of greater strength. The mining industry got a boost recently in Utah with the signing of a 4-year contract by Kennecott with the mining union that is going to result in a resumption of production and will probably add about 2,000 workers between now and the middle of next year. The lumber industry is doing quite well at the present time. It has been helped by several developments, including strong domestic demand for lumber and a 22 percent increase in exports in the first half. There's also an industry strike in British Columbia which is affecting the Pacific Coast lumber industry positively. And there is an expectation, in the industry at least, that the International Trade Commission is going to find that British Columbia has subsidized soft-wood exports and that that's going to accrue to our benefit. On the negative side, as far as the District is concerned, most of the talk centers around the tax bill and is basically in line with what Si Keehn mentioned.

Our forecast is similar to that of the Board staff's with the exception that we don't have quite the same pattern for net exports and inventories, particularly in the second half of 1986, and for inflation over the entire period. We agree that the trade account is likely to be an important source of growth in 1987 but we are not very confident that the turnaround will occur in the third quarter or that we'll get as much strength in the entire second half as indicated by the Board's forecast. We looked at some data that we have for Pacific Coast customs districts, which represent about 25 percent of all trade. Those data have a lot of problems, including the fact that they are nominal--we don't have any deflators in them--but they do indicate that the trade balance has deteriorated consistently through July. It appears as though that deterioration is a result of greater imports from Canada, Mexico, and perhaps also the Pacific Basin mix. In the inventory area, we see more strength in the third quarter and perhaps a little less in the fourth. I must admit that the contribution to growth of $25.8 billion in the fourth quarter in the Board's forecast is quite a bit more than we have. Also, we do not have such a sharp fall-off--going from 5.6 to 0.9 percent--in final sales. So, there's quite a difference in pattern but we end up with a real GNP growth which is not that much different for the second half. Finally, I have a somewhat greater concern about inflation through 1987 than is in the Board staff's forecast. We talked about that a little in the discussion. I think there is a chance that we'll see more of an effect in other sectors of the passthrough of the higher dollar cost of imports. I also wonder if the growth rate of the economy, averaging 3 percent between now and the end of 1987, would enable producers to pass along larger price increases than are incorporated in the Board staff's forecast. As a result, our inflation rates have a tendency to be running about a percentage point higher than those shown by the Board staff.

CHAIRMAN VOLCKER. What happened in that Weyerhauser strike? Is it settled?

MR. PARRY. We still don't know. It's mainly in British Columbia and that's why it seems to be accruing to the benefit of--

CHAIRMAN VOLCKER. Weyerhauser in British Columbia?

MR. PARRY. The one domestically has been settled.

CHAIRMAN VOLCKER. It has been settled?

MR. PARRY. Yes.

CHAIRMAN VOLCKER. On what terms?

MR. PARRY. It was mainly rules. I don't know what it was on wages. is not nearly as optimistic as because it is apparently accruing very much to the benefit of is not as much affected--

CHAIRMAN VOLCKER. He didn't get a good settlement?

MR. PARRY. Yes.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I think the staff's forecast is a good one. I expect, as they do, that the economy will pick up in this quarter and in the fourth quarter. However, I can't help noting some areas of concern. The first is that the two areas of strength in the economy--consumption spending and single-family residential construction--while likely to maintain their strength, will be contributing less to the economy. That is, their rate of growth will be decelerating and residential construction in the single-family area will be offset by what's happening in multifamily housing construction. And I'm mindful that the two components that we are relying on to provide this pickup--that is, inventory accumulation and an improvement in the external accounts--are areas that in the past have proven difficult to forecast. As has been pointed out, we may not see the degree of improvement in these components that we would hope for. Therefore, I would see the risks of the forecast on the down side. I'm gratified, however, by the recent evidence of improvement in the economy, particularly in the employment area, and also by the anecdotal evidence that has come in. There seems to be an improved sentiment in the business community as well. But I do see the risks at this point on the down side.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. The District continues to operate at a higher level of business activity than the nation as a whole. Just one indicator of that is unemployment, which for the District as a whole has been running around 6 percent and around Philadelphia closer to 5 percent. But we have noticed in the last couple of months that the rate of change has slowed somewhat. That has not affected attitudes, however, which I think are generally upbeat because of the higher level. While people don't feel great about the future, they think it's pretty good.

As I look at the national economy, I do think that the statistics have improved a touch. I'm not sure how much I would make of that but I think that is there. Largely because of the foreign sector, how the economy in fact will turn out is very tough to call. As a result, my convictions, and I sense the convictions of others, do not run very deep about the economic outlook. I think we see this more dramatically in the financial markets, which seem to act on changes in sentiment, more than on the goods side. There is that level of uncertainly and lack of conviction as to where we're going. On the inflation side, I sense that there has been perhaps more than a subtle change--that the concern about inflation as expressed in the long bond market, and to some extent in the commodities market, is there. And I think the message there for those of us who make monetary policy is that perhaps we have run into some resistance point on what we can do. Trying to bring all that down to a bottom line, I would come out about where the staff is as far as numbers; but I would emphasize that there's not a whole lot of conviction that lies behind those numbers.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Looking first at the District, I think I could say, Mr. Chairman, that conditions in the Southeast reflect pretty much the imbalances that we see in the rest of the economy. The energy states are especially weak, particularly Louisiana. We're seeing a lot of out-migration from that state to other states, particularly Mississippi, and that's causing unemployment rates in those states to move up as well. We now have the distinction, dubious as it may be, of having the highest unemployment rate in two states--in Louisiana and Mississippi it's over 13 percent. The agricultural sector is also in bad shape, partly as a result of the drought that I reported on before. We have had some recent rains in the area but they've come too late to help most crops. The corn and soybean crops are destroyed. We've had some marginal benefit to some other crops from that rain. The apparel and textile producers still are reporting that they're not getting any particular benefit from the decline in the dollar. They still say that foreign competition is coming in very strongly and, of course, they are continuing their protectionist cries, particularly from Congressman Jenkins. And I think we'll hear more of this bill that the President vetoed. At the same time, some of the apparel and textile people who have tried to carve a particular niche in the market are doing better, particularly those who have not only carved that niche but have improved their productivity through greater automation. So it's a mixed picture in that industry; I wouldn't say that it's completely negative.

General business conditions continue to be very good in the urban areas, and this has given rise to more and more talk in a number of states in the District of this dichotomy that somebody else has talked about--where we have the rural areas not participating in the general beneficial economic conditions and the urban areas doing quite well. That seems to be consistent throughout the entire District. We have seen a leveling off of single-family housing, but it's still at fairly high levels and I think will continue to be a source of strength in the local economy. Business attitudes are still fairly positive, although I detect on the part of some people I've talked to a waning of confidence just a bit. That's particularly related to uncertainties about the tax bill and the trade sector. Interestingly though, I don't hear at all any concerns about recession in the District; and I don't hear very much concern about inflation, notwithstanding what the markets seem to be telling us.

On the national level, I agree generally with the staff forecast. I might have some marginal difference with respect to unemployment, as I indicated earlier, and perhaps to inflation. But those are very minor differences. I, too, would share the great uncertainty that others feel about the direction of the trade deficit and what that means for overall economic activity in 1987. But in general, I think the forecast is on target. And we can only hope that the trade deficit will turn around in a short period of time.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, on the national level I'd be slightly less optimistic than the staff's forecast, but it's pretty close. On the District level, I'm having a little change of heart; I think my attitude is changing from one of pessimism to cautious optimism. I don't want to damn this by faint praise but I, too, think that we are seeing signs that we may be reaching the trough in the Eleventh District. The big increases in unemployment rates seem to be over. In Texas, in both July and August, rates were below the rates for May and June. Those July and August rates, however, were very high: August was 9.2 percent compared with the 6.8 percent national average, but that's down from the 10+ percent that we had a little earlier. Unemployment rates [are high] in Louisiana; Bob Forrestal mentioned that. New Mexico is about the same as Texas. Our nonfarm employment may be near the end of its major decline. We did see a little rise in July in Texas and New Mexico and that comes after five consecutive months of decline. So, hopefully, we're seeing a turn there. The manufacturing sector remains weak but may be close to bottoming out. Some areas of strength we're seeing include electrical and electronic equipment as well as aircraft and parts. Our construction contracts seems to be stabilizing, at least for now. Construction values remain about 20 percent below year-ago levels. The most pronounced reduction in the energy sector activity also appears to be behind us. Our rig count is flat or rising slightly--from very low levels, of course. Our energy sector employment now is declining slowly in contrast to massive layoffs just a few months ago. Even in agriculture, the livestock producers are feeling a little better because of higher beef prices. So in summary, Mr. Chairman, I would say that maybe we have a little cautious optimism for the Eleventh District now.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. In the Tenth District I'm not sure that the cautious optimism is present. The District as a whole, as I think the Committee knows, has not performed as well over the past year or two as the national economy--measured by either total employment or unemployment numbers, personal income gains, and things of that nature. There is the difference between the urban and the rural that I've spoken of before. However, in my most recent meetings with businessmen, I found the views of urban businessmen across a fairly wide range of activities a bit more pessimistic than in the past. That is to say, they understand that the economy even in the urban areas is operating at a fairly low level, but they don't have any great optimism that there is any light at the end of the tunnel that gives them much hope that it's going to improve over the near term. That seems to me to be a bit of a change. The other side of that coin is that they have apparently no concern, or little concern, that inflation or inflationary expectations will be revived. As a result, in the urban areas activity is rocking along at kind of an unsatisfactory rate but at least on the positive side.

On the agricultural side on the other hand, there is very little improvement other than in the areas Bob Boykin just referred to--that is, in the red meat sector prices of both hogs and cattle have come up and are at very good levels. There are good profit margins simply because the [cost of] feed that is necessary to put those animals to market is less; as a result the profit margins in red meat industries are very good. If you look at net farm income, however, you could build a fairly good case that it will be about the same level in 1986 as it was in 1985. If you look a little deeper you will find, however, that the net farm income is largely attributable to government programs. It's merely a transfer from the federal Treasury to the producers that gives you net farm income that is nearly equal to last year. On the other hand, the net exports of agricultural products will be at the lowest level in 20 years. We will have a net export position of agricultural products that is something over $7 billion; a couple of years ago that was in the $30 billion range. So, the impact of the dollar hasn't hit, and probably won't hit, in that sector simply because there is production beyond the U.S. boundaries that is supplying the demand that we used to supply. So the outlook in the farm area is not very bright.

In the energy area, much as Bob Boykin has indicated, there is a little activity but there's still a great reluctance to do very much exploration simply because of the uncertainty of what OPEC's impact will be on energy prices. They are afraid not that the oil price will go to $20 but rather that it will go back down to $8 or $10 and they will be in the midst of drilling a well that will not pay off if they are successful in hitting oil. So, overall, the District is rocking along at a very low level. But in a sense the tenor seems positive, except for the foreclosures in the agricultural sector and the lack of activity in the energy sector.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Thank you. I find the staff forecast in the Greenbook conservative--not in the sense that I think the outlook for real growth is too low, but in the sense that the very heavy reliance on improvement in net exports is accompanied by what I judge to be some conservative assumptions about performance of some of the other sectors in the economy. In particular, I have in mind consumer spending, government purchases, and possibly investment a bit. My point is that even if the improvement in net exports turns out to be delayed, or more modest than envisioned here because of some of the other conservatism built into this forecast, it seems to me that we have a good chance of realizing something like the outlook expressed in the Greenbook, or perhaps even something a touch better. It seems to me that at the national level the latest statistics are a bit stronger. I am not sure how much to make of all of that. We have seen these little spurts in the past; the most recent one, I think, was late last year and maybe into January. It is certainly too early, as far as I can tell, to know if that will be sustained.

In the District, though, a more upbeat tone--I might say almost distinctly more upbeat--has emerged in the last couple of months. A variety of factors are contributing to it; of course, the national auto sales situation that [unintelligible]. In the District in general, retail sales have been good and the retailers I have talked to said back-to-school sales were reasonably strong. The wood products industry, which is very important, is in general doing well. Summer tourism was good, if not great. Defense spending has provided a lift in some locations in the District, and I think there is a growing conviction that the problems in agriculture are close to bottoming out. Now that's not to say that the emergence from the bottom is at hand or that it would be significant emergence. But I think people are taking some comfort simply in the fact that it looks like the bottom may have been reached. The economy in the Twin Cities, which accounts for a good deal of what goes on in the District, continues to do very, very well. So, in general, I would say that attitudes are improving, at least, in the Ninth District and that there are some signs of economic activity improving.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. I would say about the same for the Eighth District. The most recent indicators we have all would show an improvement, particularly in July. For example, nonagricultural employment was up over 9 percent and we even had an improvement in manufacturing of 1-1/2 percent or so. Retail sales over the second quarter were quite strong, at a 7-1/2 percent annual rate of increase. Also, both residential and nonresidential construction were strong in July, although looking at those sectors over the period of a quarter, they declined somewhat, as you might expect. In terms of conversations I have had, there has been an improvement in sentiment among businessmen; retailers said the same kinds of things Gary was referring to in terms of good back-to-school sales.

On a broader basis, one of the things I have given some thought to is the question of whether this concern about inflation is something that is just reflected in the markets or whether it has perhaps what some people would consider more solid underpinnings. The first observation that I would make is that while often markets overact in the short run, I think we are looking at something that has been developing over a period of some months--going back to early April--with respect to how long rates have performed relative to short rates. So I am not inclined to think that this is just a passing fancy, particularly when you look at the kinds of volumes that are traded--for example, $100 billion a day in the government securities market. I tend to think of that as condensing the best odds and expectations of a broad cross section of people, so I am inclined to put some credence in that. Also, one of the things you read about is the Commodity Research Bureau Index and I asked some of our people to take a look at that. Since June that overall index of about 27 industrial and agricultural commodities is up at an annual rate of, say, 11 to 12 percent. If you take out the 7 grains in the index, which tend to be very much influenced by the government's support programs, it is up at an annual rate approaching almost 30 percent. So, just on that score, I think there are some things happening with respect to underlying commodity prices that go beyond pure speculative influence. What I have been trying to pick up, and haven't really picked up yet in talking to people, is whether the behavior of purchasing managers who are running inventories has changed at all. Going back over a period of time when I have asked these questions there has been really no expectation of inflation; accordingly, people aren't really building any inventories. That is one of the things I am going to be looking for in talking to people but I haven't picked up any evidence of that yet.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. In terms of the general outlook, I'd piggy-back on a comment Mr. Stern made earlier: my GNP forecast on balance looks a lot like the staff's but it looks that way notwithstanding the fact that we have a smaller improvement in the trade deficit than is in the Greenbook. On the trade deficit question, I have been on the skeptical side in terms of the rate at which that could turn around, and I still am. But for what it is worth, our people did a little informal survey this past week of a cross section of a couple dozen firms, major and minor; and for the first time that survey does suggest some things that are consistent with at least a stabilization, if not some improvement, on the trade side. It comes through both in terms of export opportunities being there in ways that they were not there before and in terms of import price pressures beginning to work their way in. One of the surprising things we found in the process of doing this survey--at least surprising to me--was the emphasis that people on both sides put on commitments and long lags in orders and processing. One example of that was even in soft goods--clothing and that type of thing. The lags are a year or more, growing out of commitments and contractual obligations that are standing in the way of adjustments being made even in the face of more favorable conditions. Now, there is nothing spectacular there--no hard evidence--but at least it is a bit of an indication that maybe the tide is turning, notwithstanding the horrible July number and the prospect for the third quarter as a whole still probably being pretty lousy.

On the inflation side, I have some of the same concerns that Bob Parry and Tom Melzer talked about. Our forecast is one in which we have the inflation rate roughly a half percentage point higher than what is in the Greenbook. In some sense that is not altogether alarming, but what bothers me is that it wouldn't take a whole heck of a lot to make me want to mark up that price forecast. Looking around, one of the things that really has disturbed me of late is this pattern that we see in domestic automobile prices--Ford, I guess it was, last week announcing price increases on domestic models of up to 9 percent. In the context of the anecdotal reports that people have referred to, I think that is, to some extent, a matter of concern. In the staff forecast, by the end of next year they have the CPI, excluding energy, at 4-1/2 percent. I don't know what the threshold is but my hunch is that if that were above 5 percent, or if the deflator were above 4 percent, we would have a very, very difficult situation on our hands by the end of next year. In that setting I, too, don't think that what we are seeing in the financial markets is completely irrational. There is some basis for concern there, notwithstanding the fact that, as Emmett Rice and others have said, there are some downside risks in the economy itself. It goes without saying that these patterns that we have seen in the last couple of weeks in the financial markets serve as a reminder of the vulnerabilities that are there--whether in terms of just volatility or these very, very sharp changes in financial asset prices over periods of weeks and months. That in itself has the potential to undermine confidence in ways that could be quite counterproductive in terms of economic performance. So, I can't disregard what the financial markets are doing at all, and I think what they are saying is that you better be careful here boys.

CHAIRMAN VOLCKER. Are you prepared to be careful, Mrs. Horn?

VICE CHAIRMAN CORRIGAN. That was a [generic] term.

MS. HORN. Well, taking off on that lead, the numbers in the Cleveland forecast look quite a bit like the Greenbook forecast. But perhaps, whereas I sense from the Greenbook that the Board staff tends to look at those numbers and see the glass as half full, I see the glass as half empty. I suppose that is a result number one, of the situation in the Fourth Federal Reserve District, and number two, of my growing disappointment that the expectations I had earlier in the year for lower interest rates, a higher stock market, and low oil prices coming through haven't yet materialized. Or, if they have materialized, they haven't been in the quantity that I expected.

From the Fourth District vantage point I am unable to report developments that suggest a step-up in the pace of expansion over the balance of the year. The flat economy has meant a flat capital goods market and that is key for the Fourth District. Given that, together with strong competition from imports, many District producers--notably of steel--are tempering their optimism and are starting another wave of restructuring and serious consideration of cost cutting. I see this attitude not only in steel, but in autos, auto-related industries, machine tools--what is left of them--and machinery-making in general. Although we are not talking about declining production--things aren't that bad--we are talking about decreasing market shares in intense competition. All of that is making people think about survival: about shutting down less efficient facilities and basically consolidating and down-scaling operations generally. I don't think the mood is bleak, but I think there is much less optimism on futures markets and the future ability to gain market share than there was, say, a year ago when there was more hope for what the exchange rate would do for our world in the Fourth Federal Reserve District. So, I would say that in this next year in the industrial Midwest--or what is left of it--we would have a turbulent time, with the next steps being toward restructuring.

Businessmen and the directors in our District talk more and more about their disappointment with the budget process. I am not sure how to evaluate that because there are the two sides--one is the deficit reduction and the other is the tax increase they are about to be hit with, or may be about to be hit with. That is something that I hear talked about more and more as time passes. I think the overall effect of these factors is working in the direction of weakening the foundation for the expansion next year. With the additional drag on capital goods that we will see from the tax package, I see little likelihood of a strengthening in the traditional capital goods market. I don't yet detect nervousness about inflation; people seem prepared to watch prices go up and attribute that to the end of the oil price contribution to the indices. Cost control efforts really are already intense and they will intensify. One could argue on the good side from that, but even among businessmen I find skepticism from pushing too hard or relying on that on the inflation front. Of course, on the inflation front, if the deficit is not going to be brought down then the load will fall once again on monetary policy.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. I certainly welcome all the comments about market commodity prices. I would review just a minute by suggesting that we have a severe commodity price deflation on our hands and I think it is encouraging that our accommodation of the world's demand for financial assets has, in a sense, blunted this deflationary move. It seems to me that there are ample signs that the accommodation of this demand has worked. But it is very difficult to stop the deflationary move without creating some changes in expectations, which are most apt to show up in precious metal prices. And any index that has those precious metals in it is going to show that kind of movement, which I think is what you might expect. But the index numbers that I look at do not show any appreciable change. I think it would be appropriate for us to recognize that there is a tremendous supply side force out there in regard to commodity supplies worldwide. I don't think that has changed. I would agree, however, that we are undoubtedly somewhat vulnerable to any outside force that might create a particular kind of shortage that might produce a price rise. It seems to me that Si Keehn had it exactly right when he said that this is probably the time to wait and see what happens. I am very impressed by the fact that the United States and Canada now have the best record in year-over-year wage changes. That is, our 3 percent wage increase, year-over-year, is only beaten by Canada's 2.9 percent. A couple of Scandinavian countries are very close, whereas many of our major trading partners are running much heftier wage rate increases. I am somewhat encouraged by those wage rate movements, which may provide some stimulus abroad. That is, those wage rates along with their low inflation rates, it seems to me, are going to provide some real substance to better final demand in Germany and Japan. So I think that is encouraging. I am in tune with the staff's forecast both for GNP and prices. I think there is a grave variation in terms of accuracy of these forecasts dealing with the inventory numbers and the export timing change; but I feel--

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I have sensed a change in the spirit of my directors and businessmen in New England in the last month. There is a much more upbeat feeling than there was in the summer. I find some evidence now that some of our high-tech companies have begun to say that maybe the yen has gotten to a level where they can compete with the Japanese and they are planning to try to get back some of the market that they have lost to the Japanese in the past few years. It is the first sign of that sort that I have heard.

who has a very unusual company called and their sole business is making equipment and special He said that on what he calls his consumer products, are a very good economic indicator; and he has noted that in the past two weeks they have had a big increase in orders for the

CHAIRMAN VOLCKER. American products?

MR. MORRIS. American products. But he also sells abroad and his European orders are going up, too, for whatever that is worth. Boston seems to be the one exception in this downward trend in commercial office building. Our boom is still going on. I went to a meeting a week or so ago on new office buildings and hotels planned for Boston and, despite the fact that we have a lot of space coming on stream in the next six to eight months, we still have a tremendous array of office buildings and hotels planned. It is sort of like Dallas and Houston used to be. I figure we're going to have our glut but it is a ways off. For people renting space in our building we have a new program in which we are trying to stretch out leases to nail down today's high rental values because we would like to have everybody locked in when the glut hits.

CHAIRMAN VOLCKER. That is a great expression of confidence about inflation as well as probably an escalator! Mr. Heller.

MR. HELLER. I think we are making amazingly good progress this late in the recovery. Overall, I agree with what most people have said: that there is a more balanced economy than there was last year and very little in excesses actually developing. I agree with the staff that consumer spending is very well sustained and I think consumers are going to get a second wind next year when the tax cuts become effective. We see behavioral changes taking place already, both in the financial markets and as far as planned purchasing is concerned. Investment will be slow in coming, but at least we have bottomed out, especially in the agricultural and energy area; so we don't have any more drag from those sectors in the future. And the government deficit reduction program, disappointing as it is, will be a positive contribution that should be particularly good in the financial markets.

I am less optimistic on the trade front, as I said previously. I think our exports won't increase very rapidly but at least the erosion in GNP due to imports will tend to stop. So, overall, the export sector will tilt a bit more in our favor and that also reduces some of those imbalances. On the inflation front, I am amazed by the good news that came in this morning. It is very heartening. And I fully agree with what Wayne was saying about wage increases. When you look at the European wage increases, given the high unemployment rates, it is amazing that they are all running in the 5 percent range--much above the 3 percent range that we heard here in other comments before. Overall, I think it is a very satisfactory performance with fewer imbalances than we have had in the past.

CHAIRMAN VOLCKER. I don't know about those wage increases; those wage increases are low but so is productivity.

MR. ANGELL. Productivity in the service sector is low but I don't think we know how to measure it. Productivity in the goods producing sector remains right at the 3.2 percent level that it has been at for some time.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I have just a couple of comments since I have heard just about everything said that I was going to say. In general, I am probably a hair more pessimistic than the staff, primarily because when I look at the auto industry I just have a feeling that we are going to give back more next year than the staff is assuming. I am impressed with the current sales level--no doubt about that--which, I guess, shows what low interest rates will do and how inattentive a lot of consumers are. But I think that this is not all a net gain. I think the give-back will show up, particularly in the first quarter. Also, I am just very nervous about the impact of tax reform on a whole lot of things, but particularly on business spending on new plant and equipment and on office buildings which, of course, are already under the gun. I think that is just going to provide one more discouraging influence.

We have been talking about this trade turnaround for a number of months and expecting that to provide quite a bit of support for the economy, and I certainly hope that happens. But Senator Riegle sent me a little story which, with your permission I would like to tell, because I think it demonstrates how difficult it is to turn off the import competition. This involves one of his constituent companies out in Michigan; they produce Being non-mechanical, I have no idea what those are, by the way, but apparently they are very important in the production of engines. The company supplies parts for about three-fourths of the engines produced in this country and the Japanese had been their primary competition. They have revamped their entire operation, they have spent heavily on R&D and on new equipment, etc., they have gotten wage concessions, and they have tried to imitate the Japanese in the labor-management relationship. They have done remarkably well in dealing with the Japanese [competition] and they are now selling their main part for $5.50. Now, all of a sudden, the Koreans are calling on their major customers in this country and are offering them very similar products at $3.50. This isn't something I picked up; it came from Don Riegle. But I think it is very indicative of how tough this job is going to be, particularly when we haven't seen the dollar deteriorate vis-a-vis the Korean currency. I just hope and pray that we can get some movement in the currencies of these newly industrialized countries, particularly in the Far East, or I don't think we are going to see this big turnaround that we are counting on. Thank you.

CHAIRMAN VOLCKER. You think that big improvement in [unintelligible]. How are they going to pay the interest on their debts?

MS. SEGER. That's somebody else's problem.

MR. ANGELL. I think we should note these prices are not [unintelligible].

MS. SEGER. No, they were for

MR. ANGELL. It must have been per

MS. SEGER.

CHAIRMAN VOLCKER. Anybody else want to say anything?

MR. JOHNSON. I guess I should put in my two cents worth. I really don't have much to add; I think everybody has covered most of the basics.

CHAIRMAN VOLCKER. From every point of view.

MR. JOHNSON. That is right. My own views are not that much different from the staff's, either. I am a little more pessimistic on the trade side. And looking a little further down the road in 1987, I worry about how this automobile situation is finally going to work itself out. They are making a big contribution in sales this quarter, which is going to drain inventory and have a fairly neutral effect on GNP. Even in the fourth quarter, it appears that their inventories are going to build back up because the incentive programs will go off and demand will slide. What comes after that is somewhat of a concern. Are they going to cut prices, which doesn't appear to be the case, or are they going to build in deeper incentive programs? How much have they borrowed from the future? My concern is that there may be some bigger production cutbacks ahead in autos, perhaps in the 1987 period. The numbers are working out about right for 1986, it appears.

The third-quarter trade just doesn't look like it is going to meet our expectations, at least if the July numbers are half correct. I realize there is a gold sale phenomenon in the accounts but that does not make me feel that comfortable. So I am a little more pessimistic, but I do see a turnaround. I don't think you can have a depreciation of the dollar of around 40 percent against the major industrial countries' currencies and not see some improvement. I think that we are getting close to the peak of the trade deficit and that some improvement will start showing up. If it just stopped increasing, we could see a good improvement in the GNP growth rate. I am a little concerned, too, as I have mentioned before, about some of the changed environment in the financial sector. I do think a lot of it is associated with the turmoil over who is going to contribute to world growth. There has been a good bit of expectation developing about interest rate reductions in Europe and Japan, which haven't materialized. That has added to the argument of some policy makers in the United States that the only way to solve the trade deficit, as a result of this resistance, is through an ever lower dollar. Obviously, that is going to create some anticipation in the financial markets that trying to solve the trade deficit through a substantially weaker dollar ultimately could be inflationary. I think that is a factor contributing to the turmoil of financial markets. Hopefully, if growth is stronger in Europe than we are thinking that will improve the situation and calm the environment a bit and exports will pick up. I think that is the only thing that ultimately is going to calm that environment. The outlook doesn't look that good in Japan; I think we have to place most of our hopes on Europe and hope that Germany is right unless they are planning to reduce their interest rates a little later. Maybe this European exercise to support the dollar will help but I am still concerned about the mechanics of that and how that's all going to work out. That is my two cents.

CHAIRMAN VOLCKER. Mr. Kohn.

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

CHAIRMAN VOLCKER. Let's break for donuts.

[Coffee break]

CHAIRMAN VOLCKER. When I look at this economic forecast of the staff, I don't know how good it is as a forecast, but it looks to me in a less than perfect world to be about as good an outcome as one could wish for. It has a nice tapering off of domestic demand, a good boost from the export side, real progress toward our longer-range objectives and we escape without too much inflationary pressure. So, if we can achieve that result we would be fine. Now, the question is: How do we achieve that result? I will just make a forecast that we are not going to have very startling policy moves arising out of this meeting, so I would be glad to hear about your nuances. You can prove me all wrong. Who would like to comment? Mr. Morris.

MR. MORRIS. Well, I have a little nuance, Mr. Chairman. I agree with you that we are sort of locked into a no-change situation here at the moment, but I am concerned about the increase in liquidity that we are building into the system here. If you look at the security holdings of the commercial banks over the past four months, they have risen by $31 billion of which $21 billion is in government securities. So, with loan demand so weak, we actually are pumping in reserves and the banks are placing them in fairly liquid form. It seems to me that if we ever do get the economy reaccelerating that we are going to have to lean against this liquidity growth at a fairly early stage. At the moment I would support alternative B.

CHAIRMAN VOLCKER. That doesn't sound too nuanced. Mr. Melzer.

MR. MELZER. I also would favor alternative B. Policy has been moving in one direction for some period of time and I don't think it's appropriate to turn it around on a dime. I have some concerns, as you know, about some of the developments on the inflation and inflationary expectations front. Looking down the road, I think we have to be mindful of the fact that the operating regime that we are pursuing now provides the reserves that are demanded, so pressures aren't really going to show up in the funds rate. After things have had time to settle out--and I guess by that I mean the effects of the decline in interest rates and so forth, all things being equal in terms of the economy--if we don't begin to see some of the slowing in the aggregates that Don has referred to, then I think we have to be prepared to move to a firmer stance. As I say, the pressures are not going to show up in the funds rate, and I think we cannot continue to provide reserves at the rate we have been under the circumstances I just brought up.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Alternative B would be my choice. We have been expecting the fundamentals to produce a pickup in economic activity, and it appears from the recent data that that is occurring. At the same time, I think financial markets are concerned about inflation and the effects of a particularly easier policy on long-term rates and the value of the dollar would be adverse at this point. I share Tom's concern about overshooting our targets for M2 and M3. If I had to introduce a nuance, it would be at least in terms of verbiage leaning slightly toward greater restrictiveness.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I would first like to endorse your statement that this would be a pretty darn favorable outlook. In particular, considering that this is the fifth year of an economic upswing I don't think we would have expected to have done any better than that. As I indicated earlier, I think the biggest risk is the possibility that this present pessimism that we have in the bond markets will gain momentum, with long-term interest rates backing up further. Obviously, that would not be a very healthy development from the standpoint of the domestic outlook. I think a lot of the concern in the market is stemming from some reduced hope that the Gramm-Rudman procedures and the reduction in the deficit will be possible. There is certainly nothing we can do about that from the standpoint of monetary policy, but I think some of these developments clearly stem from a change in attitudes and a feeling that there has been an increase in the possibility of inflation. I think that stems, in turn, from at least two factors. One is the recent action of OPEC; but I think it is also probably nourished by some growing uneasiness about the substantial growth in money and liquidity that we have provided recently from the highly publicized moves of the System toward greater accommodation. So, I think this is a time when we really ought to pause and take stock and convey a posture of caution to both financial markets and to the public in general, and I would favor alternative B.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I, too, favor alternative B. Like several others, I must say I am troubled by what has happened in the bond market in recent weeks. It seems to me that, for whatever reasons, there has been some deterioration in inflationary expectations, as Mr. Melzer and others have suggested. Beyond alternative B, and maybe by way of a nuance, I think we need to find some way to signal more clearly to the markets that we have a mechanism in place that will enable us to respond, should that become necessary, with a somewhat more restrictive policy. I think we will need some accompanying language in the directive to make that clear. It seems to me that such a stance would help to assure market participants and perhaps would be positive in terms of its ultimate impact on long-term interest rates; it also would be desirable from the perspective of the way fiscal policy is turning out. I must say that that situation looks worse than even I thought it would be, and I have been pessimistic all along. So, I would say that while alternative B is a fine starting point, we need to think a little more about the process by which we respond to the behavior of M2 and M3 in this.

CHAIRMAN VOLCKER. If I can just interrupt a second: There has been a lot of talk about the fiscal situation. I don't know what's optimistic and what's pessimistic. I think it's Mickey Mouse what they are going through to get $154 billion; it isn't realistic.

But I guess I would just as soon that they didn't get to $154 billion from $220 billion all in one fell swoop. If you believe the staff forecast, which is what?--$225 billion to $177 billion--that doesn't sound too bad to me as a change from a year ago. It's not quite $50 billion less but $40 billion or so anyway.

MR. JOHNSON. $230 billion is about the forecast.

CHAIRMAN VOLCKER. Oh, I thought the forecast was about $225 billion--whatever. That may be about as much as it should be in one year in my view, if you really believe that number. Now, I don't know how solid that number is; I would guess it may be higher than that, I suppose. However, what do you allow for in the farm program?

MR. KICHLINE. It was $32 billion last year and we have $26 or $27 billion in fiscal 1987; the Administration has something like $18 billion.

CHAIRMAN VOLCKER. Well, good luck.

MR. JOHNSON. That's a good point. The smoke and mirrors that they are going through right now likely will add to that $50 billion and--

CHAIRMAN VOLCKER. If you believe the $50 billion, I don't think it's all that bad. But I don't fully believe the $50 billion.

VICE CHAIRMAN CORRIGAN. As far as a lot of the markets are concerned the smoke and mirrors, to use Governor Johnson's term, just reinforce the out-year problem. I think that's what nagging at--

CHAIRMAN VOLCKER. Some day they may have to think about even increasing taxes; maybe that's what you go through to prove you can't reduce expenditures. I don't want to get off on this subject. Mr. Forrestal.

MR. FORRESTAL. I, too, would support alternative B, Mr. Chairman, without any nuance at all. I think we are at a point in time where we need to pause in monetary policy. As we pointed out, the numbers coming in are not all that bad; the forecast is a reasonably good one. And, while I don't think that markets are infallible, I think that we do have to pay some attention to what has been going on in the markets recently. To ignore the steepening of the yield curve would be perilous for us, but I think we need to stop and assess the situation for another three or four weeks and let previous actions work their way through and hope that we get the kind of improvement that we want. One of the things that may be bothering the markets as much as inflationary expectations is their feeling that we have not only abandoned M1 but that perhaps we are in the process of setting aside monetary targeting all together. I think the markets are asking what kind of an intermediate target we have, and I think that is something we will perhaps have to take into account. I don't have any answers, certainly, at this point, but I think this kind of pause is desirable. So, I would favor alternative B with borrowing at around the level of $300 million.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I am for alternative B without any nuances. But that is against the background that we have been on a one-way street toward ease. We have pumped in a huge amount of liquidity by these various measures that we look at in terms of the Ms and reserves and credit--although some of those can be "funny" numbers. But the conclusion is that we have put in a lot. We can analyze what the market is telling us, but I think they know that it's a lot easier for a central bank to ease than to tighten, and they may be beginning to wonder how much we are going to overshoot and whether we will have the kind of backbone, when the time comes, to show that we can operate monetary policy on a two-way street. I think for now we should stay where we are but we ought to begin to think about what might happen to all of this liquidity and how we might deal with it.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I would join those in favor of alternative B without a tilt one way or another. It seems to me that there are conflicting trends regarding the strength of the economic outlook and conflicting trends with regard to the inflationary situation. To a large extent we have done our thing over the last few months. Clearly, the markets are beginning to resist these changes. Perhaps the decision the next time is going to be harder than it is this time; but for now I would simply stand back and see how events develop.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I am for alternative B. As we have been easing policy over time, with each subsequent move we have increasingly asked ourselves the question: Can monetary policy really help the situation of the imbalances and so forth? For the last couple of moves, which I have been in favor of, I have found it harder to answer the question that monetary policy will help. I think we probably have gone about as far we can with monetary policy and now it is time to stop and watch the developments.

CHAIRMAN VOLCKER. With no nuances?

MS. HORN. No nuances.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. Alternative B.

MS. SEGER. Alternative B straight.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. I will join the landslide. Alternative B, no nuances.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. My view is the same, "B."

MR. JOHNSON. I am in favor of alternative B. I'm torn about nuances. I wouldn't mind having some language describing why we are pausing and seeking no change--language that would be associated with the yield curve and with commodities and the dollar to at least provide some sort of criteria for a guideline. Somebody else mentioned the fact that one problem is that people are starting to wonder in the financial markets what the guideposts are. They don't think that we are paying that much attention to the aggregates, which we are not, and I think we ought at least to tell them what is important to us to some extent. I don't know quite how to engineer that language, but I think it would be useful.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, having heard people, I have come to the conclusion that alternative C is what we are after.

CHAIRMAN VOLCKER. You want to tighten up a little?

MR. WALLICH. If you have to do something, you do something.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I will join those who prefer "B" notwithstanding some of the comments I made earlier in the discussion with respect to M2 and M3 and the concern that we should be expressing to the market, either verbally or otherwise, that we are not abandoning the aggregates. I share some of those feelings, but if we are going to rock along at 2-1/2 or 3 percent growth, I would hate to be focusing on M2 and M3 going marginally above the top of their range and take some action to tighten up. So, I conclude that "B" is the appropriate course now and I would not be very receptive to any movement in the period ahead if M2 and M3 are going to exceed their targets in just a marginal way.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. I will go for "B" but I have a nuance. It's a little more than a nuance. I think at this juncture that we have to be prepared to pave the way for the possibility that we might have to tighten. Paving the way doesn't mean that we have to go down that road; but to be positioned to do that if the need arises strikes me as important. So, I would lean a little in that direction. The question of what we would do over the balance of the year if M2 and M3 burst out on the upside of those ranges is a question that has to be faced. We don't have to face it decisively right now, but I think we have to have that possibility in mind. I, for one, think that we'll be faced with that situation; we are not going to be able to sweep it under the rug.

CHAIRMAN VOLCKER. I don't know what all that means [for policy].

VICE CHAIRMAN CORRIGAN. It means "B" with a little bias in the direction of snugger rather than easier.

MR. BLACK. It probably means more emphasis on "woulds" than "mights."

VICE CHAIRMAN CORRIGAN. More emphasis on what?

MR. BLACK. On "woulds" than "mights."

CHAIRMAN VOLCKER. Mr. Heller.

MR. HELLER. Alternative B without comment or reservations.

CHAIRMAN VOLCKER. I better read what alternative B says. Well, something like $300 borrowing is fine and I don't have any problems with alternative B. The question is what happens if, let's say, the business situation goes along pretty much as expected but the monetary numbers continue to run high or the dollar is weak, and [unintelligible] are weak. To use a word I picked up from Mr. Sprinkel in a different context when he made a comment about the business outlook gathering strength--that's not what I am referring to--we do expect that the inflation rate is going to "ooze up." The question that I raise is: Under what conditions should borrowings ooze up?

MS. SEGER. Hasn't he been expecting that for three years, though?

CHAIRMAN VOLCKER. I think it's [unintelligible] the oozing up word.

MR. BLACK. What kind of increments are we going to use to measure ooze, Mr. Chairman--$50 million, $25 million?

CHAIRMAN VOLCKER. Well, we have the current problem that the borrowings are so low that every time something unusual happens they get higher. The first question is whether we are bothered by that; I'm not. If somebody's computer goes out or they get caught late in the day by some withdrawals or something what do we do? Leaning over backwards to try to offset that seems not to be the order of the day. We haven't been doing that and I would think that we don't want to do that. We don't do anything at the moment but the question is beyond that. A number of people raised the issue of liquidity. If, for instance, the aggregates continue to run pretty high--higher than what alternative B straightforwardly suggests--and the business news continues reasonably on the firm side and let's say, just to put another thing in, that the dollar doesn't look all that great, should we ooze up on the borrowings more or less deliberately? I interpret what some people said as certainly in that direction, but I am not sure about the others. Many people just said they were neutral. I don't know what they meant by neutral. That's what a straightforward interpretation of the directive permits.

MR. JOHNSON. My interpretation is not so much that I think how much attention we pay to the aggregates still depends on what velocity is doing; it's whether the economy seems to be catching on in the face of growth in the aggregates. I am not that troubled by the aggregates performing strongly. If we have another huge negative velocity number, I think the third quarter is going to come in about like the second quarter. Given evidence of that, if commodity prices kept rising and the yield curve kept steepening and the dollar was still under pressure, that would be criteria for oozing up the borrowings a little in my opinion.

CHAIRMAN VOLCKER. Well, it would in mine, too. I don't know whether I would necessarily expect the yield curve to continue to rise; it might or might not. But a sense of inflationary expectations would be a factor, however measured. In those conditions, with the aggregates running high, I would ooze a bit.

MR. JOHNSON. Are you suggesting that we have a $300 million target that we just [unintelligible]? Are you saying that we work harder not to offset these other leakages?

CHAIRMAN VOLCKER. Well, I wouldn't offset those right now. I figure actually changing [borrowings] a little, not very much. Oozing is meant to convey that you lean with a slight drift, which wouldn't carry borrowings above $400 million, I don't think. But you might ooze by less than that.

MR. JOHNSON. So you're just saying leave some discretion on the borrowings.

CHAIRMAN VOLCKER. Yes, and mostly on that side. I see it less likely, given where borrowings are now, that we would want to ooze on the down side.

MR. ANGELL. I certainly believe if commodity prices were to make a move upward by a significant amount, [precipitated] by some unforeseen event, that it would require us to look more carefully at the monetary aggregates and to tighten slightly; and I would take the borrowing up to $400 million. I don't know how likely it is that that event is going to occur, but I think it would be appropriate for us to have an understanding that a move would take place if it needs to.

MR. JOHNSON. Well, what is "C"? I don't want to ooze into alternative C.

MR. MORRIS. One way of doing it, Mr. Chairman, using last month's directive, is to change "somewhat greater or lesser reserve restraint" simply to "somewhat greater reserve restraint," indicating a bias.

CHAIRMAN VOLCKER. That's the kind of thing we could do.

MR. ANGELL. I am not sure that we want to have greater reserve restraint. I don't want greater reserve restraint right now. I would only want it under certain spelled-out conditions.

CHAIRMAN VOLCKER. Yes, spell out all the conditions in great detail. If we can get a sense of that and then do it--. I am assuming there is no change now from what we have been doing, right at the moment.

MR. MORRIS. We would have but one direction of ooze.

CHAIRMAN VOLCKER. We could have another direction of ooze if something went wrong. If the economy was clearly weak, the dollar was clearly strong, and the aggregates were behaving just fine, we would move in the other direction.

VICE CHAIRMAN CORRIGAN. The anatomy of an ooze.

MR. BLACK. But you wouldn't go as far as "C" because that would be a trickle instead of an ooze.

MR. ANGELL. The markets would interpret that as more than a trickle--

SPEAKER(?). If the yield curve steepened, policy would be tighter.

CHAIRMAN VOLCKER. You may get some argument about that.

VICE CHAIRMAN CORRIGAN. [It could] go the other way first. [Unintelligible] what we care about.

CHAIRMAN VOLCKER. I am not talking about anything that will be a very overt move. Anything we are talking about is within the range of natural fluctuation anyway, but it's a little sense of where we are aiming over time and in certain contingencies. Why don't we just look at the wording and that will resolve the problem: "Maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2--" What numbers do we have here?

MR. ANGELL. We had 7 to 9 percent the last time.

MR. GUFFEY. That's still okay.

MR. ANGELL. I would think so.

CHAIRMAN VOLCKER. Is 7 percent too low or not as an estimate?

MR. ANGELL. I think 7 to 9 percent is fine.

CHAIRMAN VOLCKER. Well, the midpoint is 8 percent; 7 to 9 percent encompasses the midpoint. We won't say "respectively;" we just say--

MR. ANGELL. Yes, it refers to M2 and M3.

CHAIRMAN VOLCKER. It refers to both at annual rates of about 7 to 9 percent.

VICE CHAIRMAN CORRIGAN. 9 percent is above--

CHAIRMAN VOLCKER. Well, 7 percent is below. What the staff says is 8, 8-1/2 percent; that's roughly in the middle of 7 to 9 percent. We have this great choice of whether we say "about 8 percent" or "7 to 9 percent." The "7 to 9 percent" doesn't bother me given the behavior of these things anyway.

MR. PARRY. Isn't this the same discussion as last time? I think it was 7 to 9 percent, the same numbers.

CHAIRMAN VOLCKER. What we did was encompass different numbers for the two. I don't care: either 7 to 9 percent or about 8 percent.

MR. ANGELL. 7 to 9.

CHAIRMAN VOLCKER. I detect no realistic difference between "about 8" and "7 to 9." This says "about 7 to 9" and maybe that is a difference. We have a nuance of difference.

MR. JOHNSON. "About" goes with 8 and not with 7 to 9.

CHAIRMAN VOLCKER. Do we always say "about" even when we use a range?

MR. ANGELL. You could take the "about" out, if you want to be more specific. We put "about" in there for fuzziness at one time.

VICE CHAIRMAN CORRIGAN. I don't think this is decisive, but if you say 7 to 9 percent for the balance of the year, you are saying that you are prepared to tolerate growth outside the boundaries for the year for both M2 and M3, though not by a lot. If we had 9 percent growth in M2 and M3 for this period, we would end up about where "A" is, and on the charts "A" is outside the cone. It's a trivial amount.

MR. ANGELL. If we are looking here at 9 percent, with about 9 percent you are going to stay on there.

MR. JOHNSON. "B" would stay right on the cone.

MR. ANGELL. But the 9 percent stays on the cone.

MR. JOHNSON. That's what I am saying, 9 percent would be "B." It would be moving right along that cone line, since we are right on it now.

MR. ANGELL. That's right. And M2 is slightly under it.

MR. KOHN. It doesn't quite work that way because of the compounding problems that--

MR. JOHNSON. I guess you are right.

MR. KOHN. In other words, you need a slightly lower growth rate--like the 8 or the 8-1/2 percent--to keep you moving along 9 percent from last November's base. Of course, you are talking about tenths of a point here.

CHAIRMAN VOLCKER. I don't understand how these lines [unintelligible].

MR. JOHNSON. I assume that we are on the line and if we're on the line and the line says 9 percent--

MR. PRELL. It's more on a linear scale than a log scale. It wouldn't be much if you did it on a log scale.

CHAIRMAN VOLCKER. That's because it's not logarithmic.

MR. MORRIS. The deviation is trivial.

MR. ANGELL. This is splitting hairs over something that we know nothing about.

CHAIRMAN VOLCKER. That's right. I think it's either "about 8 percent" or "7 to 9 percent." What are the preferences? Who prefers 7 to 9 percent? I count 9. I guess we have a majority for 7 to 9 percent. I am a little embarrassed by continuing this sentence on M1 about this great expectation that doesn't materialize.

MR. RICE. Sooner or later we will be right.

CHAIRMAN VOLCKER. I don't know what we can do with it. In the interest of variety we might express the same sentiment, but do we have to express it in exactly the same words?

MR. ANGELL. Yes, let's stay with it until we--

SPEAKER(?). We can put it lower in the--

CHAIRMAN VOLCKER. All right, we'll leave it the same, as embarrassing as it is. Now we get to the nuances. Let me--

MR. JOHNSON. That one still leaves the door open. We can ooze in that way.

CHAIRMAN VOLCKER. No we can't. No, I wouldn't want to ooze in this language. If we wanted to make it a little more explicit I guess we could say something like "slightly greater" instead of "somewhat greater." We could say: "Slightly greater reserve restraint would be acceptable should the aggregates exceed expectations depending upon the strength of the business expansion, developments in foreign" etc., and "somewhat lesser reserve restraint might be acceptable" and so forth and so on.

MR. MORRIS. I think we need an asymmetrical statement this time.

CHAIRMAN VOLCKER. I made it non-symmetrical just by changing the "would"--

MR. JOHNSON. Changing the "would" and putting "might."

CHAIRMAN VOLCKER. We have done that lots of times. We can do it all in one sentence which is what we have often done. But if we want to put a little more emphasis on the aggregates, we could just say "somewhat greater reserve restraint would and somewhat lesser reserve restraint might be acceptable depending upon" just what you have here.

MR. JOHNSON. Split the two out.

CHAIRMAN VOLCKER. But that would put them both in the same sentence. I tried to make a little distinction that the aggregates would trigger this depending upon the other things. We could still say "depending on the behavior of the aggregates, taking account of the strength of the business expansion" and so forth. That's our rather traditional way of doing it.

MR. ANGELL. I would suggest we add international credit and commodity markets.

CHAIRMAN VOLCKER. I don't want to get too many things in there.

MR. HELLER. What would we really do differently if international credit markets would change unless it's [unintelligible] to the exchange rate?

CHAIRMAN VOLCKER. I think international credit markets is meant to be a code word for--

MR. JOHNSON. If the Germans lowered their interest rate--

MR. ANGELL. Or the dollar depreciates.

CHAIRMAN VOLCKER. I thought it was, frankly, a reference to the international debt situation. Let's change "somewhat" to "slightly" and say "somewhat greater reserve restraint would be acceptable or slightly lesser reserve restraint might"--. I guess "slightly" should go after the would, too: "slightly greater reserve restraint would or slightly lesser reserve restraint might be acceptable depending upon the behavior of the aggregates and taking account of..."

MR. MELZER. "Taking account of" probably does it.

CHAIRMAN VOLCKER. Your way without the "and"; comma, "taking into account the behavior of the aggregates," etc. Is that all right?

MR. MORRIS. I question, Mr. Chairman, how many people would really want to support the condition of lesser reserve restraint. I don't know; conceivably there could be conditions that would generate--

CHAIRMAN VOLCKER. Well, let me ask the question this way. I will give you the most extreme test of that. This doesn't rest on anything very dramatic in the economy. In this period of a few weeks, suppose the Germans and Japanese say: We will reduce our interest rates, but you have to reduce your discount rate again to help us along. Think of it as good politically, or for some reason or other. I don't think they will say that, but suppose they do.

MR. ANGELL. Suppose the Japanese stock market went down dramatically and suppose oil prices started heading lower dramatically and we got some other kind of movements there and a pessimism prevails--if M2 was growing at 5-1/2 percent and M1 was at 6 percent, I think you might want to have lesser restraint.

MR. MORRIS. I would rather leave it out now and have the Chairman call a telephone conference.

CHAIRMAN VOLCKER. You can make extreme assumptions about the business situation which are not inconceivable, but which I don't think are very likely during this particular period. I think it's more likely that the question I raised could arise, but I don't consider that very likely--don't misunderstand me. But suppose it did occur?

VICE CHAIRMAN CORRIGAN. On the merits, the best outcome would be that they lowered their rates and we didn't.

CHAIRMAN VOLCKER. I have to question their [unintelligible].

VICE CHAIRMAN CORRIGAN. That would be where I would start; that's for darn sure.

MR. JOHNSON. I don't think it's likely that we would need to use the alternative for ease. It just doesn't look like that alternative is going to materialize. But I certainly wouldn't want to leave it out as a possibility; you never know. The "might" and "would" nuance deals with it okay; I wouldn't want to just leave it out completely.

MR. ANGELL. I don't think there is any reason to make it appear in the minutes [for this meeting] that we know what's going to happen in this atmosphere. I think we ought to leave it balanced, but we can imagine in our minds what is likely on either of these or what might be.

MR. RICE. I think we balanced it just right.

MS. SEGER. Wasn't it back in May that we put in the asymmetrical language? And when those minutes were reported some people in the media were saying that we almost tightened and they made a big thing of that.

MR. JOHNSON. Well, I don't mind giving signs that we didn't like what we saw in the financial markets. I would like people to be able to look back and see that in the discussion.

CHAIRMAN VOLCKER. Well, does Mr. Morris have any following for leaving [the easing alternative] out entirely?

MR. MELZER. I would support that.

CHAIRMAN VOLCKER. You have a following but not [a majority]. I think we appear to be for an asymmetrical nuance.

MR. GUFFEY. Mr. Chairman, I would like to raise a question on the other side--that is, with regard to the language of 7 to 9 percent on M2 and M3 and the importance of that language with regard to snugging up a bit or oozing up a bit. We are at the top of those ranges now and I guess I have an operational question as to how either you or the Desk would respond. What would you do if M2 and M3 started coming in at 9-1/2 or 10 percent and the economy was working along without much problem? Would you then ooze up? Unless you saw some real strength in the economy, I would hope you wouldn't ooze up until M2 and M3 burst out as Jerry Corrigan described it.

CHAIRMAN VOLCKER. I think I just gave you my interpretation. We are not talking about a great [unintelligible]; we are not talking about one week or two weeks. We are talking about some sense that it is indeed running high and that if other things were proceeding as expected--if we didn't get any weakening in the economy, didn't get any strengthening really in the exchange rate, the oil price was not going down another $3--yes, we would ooze. But it's only an ooze.

MR. GUFFEY. It's not triggered off 9 percent; it's something higher than 9 percent.

CHAIRMAN VOLCKER. I think it can go higher than 9 percent by some figure in one week or, necessarily, by one month's figure. But if it was one month, the fact that it was continuing--as best we can make these appraisals--and there weren't any signs of tapering off, yes, we would ooze. But it's only an ooze and, given all those other things, it's not much of a quibble. Do we have enough understanding of what we are talking about to vote on this? It's: maintain; 7 to 9 percent; slightly greater reserve restraint would and slightly lesser reserve restraint might be acceptable depending on the behavior of the aggregates, taking into account all these things; and 4 to 8 percent.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
Governor Heller	Yes
President Horn	Yes
Governor Johnson	Yes
President Melzer	Yes
President Morris	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	I'd be against it. I have this view of what we can do but it shouldn't be in this context.

CHAIRMAN VOLCKER. Okay, you want to tighten a little. I guess we are finished.

END OF MEETING