Meeting of the Federal Open Market Committee

February 10-11, 1987

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, February 10, 1987, at 3:00 p.m. and continuing on Wednesday, February 11, 1987, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Guffey
Mr. Heller
Mr. Johnson
Mr. Melzer
Mr. Morris 1/
Ms. Seger
Mr. Keehn, Alternate for Mrs. Horn

Messrs. Boehne, Boykin, Stern, and Timlen, 2/ 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. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Balbach, J. Davis, T. Davis, Kohn, Lindsey, 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

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1/ Entered the meeting after action to approve the minutes from the December meeting.

2/ Attended Tuesday afternoon session only.

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
Ms. Kusko 1/ and Mr. Moran, 1/ Economists, Divison of Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Office of Staff Director for Monetary and Financial Policy, Board of Governors

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

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

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

Mr. Keleher, Research Officer, Federal Reserve Bank of Atlanta

Ms. Meulendyke, Manager, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting
of February 10-11, 1987

February 10,1987--Afternoon Session

CHAIRMAN VOLCKER. [The minutes for the December meeting have been moved and seconded and are approved] without objection. Now we will get our report on foreign currency operations out of the way.

MR. CROSS. [Statement--see Appendix.] Thank you, Mr. Chairman. Also, we need approval of intervention of $50 million that we did on one day.

CHAIRMAN VOLCKER. We ought to approve that and then go to the questions and answers.

MR. ANGELL. I move we approve it.

MR. MELZER. Second.

CHAIRMAN VOLCKER. Without objection. Now, let's turn to the discussion. You recited all this and a lot of it sounded like ancient history. History repeats itself about every 3 days.

MR. BOEHNE. What have you noticed about the inflow of investment funds from abroad through all of this?

MR. CROSS. The Japanese tell us that their total long-term capital outflows are continuing at the same level as last year. We don't know, but there seems to be more diversification; to a greater extent there is Japanese investment in Australia and Canada and in sterling also. There is also more diversification in the types of instruments, we think. But we don't have very good information. Another problem is that there is a tendency by Japanese investors to engage in hedging operations. Even if they continue the long-term capital outflows, they may at the same time be hedging on the exchange rate side and that has effects on the exchange market. There seemed to be a considerable amount of hedging during the period when the dollar/yen rate changed from the 158-159 level where it had stood for a while. As it broke through that level, a number of Japanese investors seemed to engage in some hedging. To summarize, the Japanese capital outflows seem to be more diversified, but there might be other things that are taking place which are offsetting some of the exchange market effects.

MR. STERNLIGHT. If I could add to that: There was a lot of focus in our bond market on what the weak dollar might mean to foreign interest, especially Japanese interest, in the current Treasury refunding. That turned out finally, after some backup in rates as the auction approached, to be pretty good interest.

A footnote to that, though, is that with these firms becoming more internationalized not every thing they take is necessarily for resale back in Japan; but, certainly, the great bulk of it is.

MR. FORRESTAL. Do you see any shift by the Japanese from the bond market to the stock market? Is there any evidence of this?

MR. STERNLIGHT. Certainly, we hear those same comments on diversification that Sam referred to: either into the stock market or from Treasury issues into other securities such as Ginny Mae's or corporate issues--even some of the higher-yield corporate issues.

MR. BOEHNE. Sam, did your reference to diversification mean diversification within the U.S. or diversification among countries?

MR. CROSS. Both kinds are going on. There is diversification among countries in the sense that more Japanese investment is going into Canada, Australia and into sterling--we don't have very good information [unintelligible]--than before. Secondly, there is diversification in the sense that Peter mentioned: that instead of the very heavy concentration on Treasury bonds, there is a greater tendency to buy corporate bonds, equities, real estate, or other forms of investment. So, we see both types.

CHAIRMAN VOLCKER. No other questions? There probably should be, because if we ever reach this great international understanding--with or without a meeting--I presume there might be a lot more intervention.

MR. CROSS. Well, I think so. There has been a great deal of discussion of that possibility [here] and perhaps elsewhere, with the deal presumably being more intervention on our side and more moves by Germany and Japan and others to stimulate their economies. There's some question about what the Germans could do at the present time, given the fact that they just got through their election and are still in the process of trying to put together a government. The market has taken some encouragement from the fact that the party that had a greater belief in stimulating the economy seems to have done well. But what that will lead to, if anything, is the point that--

CHAIRMAN VOLCKER. Meanwhile, the economy is doing less well.

MR. CROSS. That is another point; the German economy is clearly doing less well than it appeared to be a month ago.

MR. BOEHNE. This talk about the Germans and Japanese stimulating their economies in exchange for our intervention has surfaced off and on for months. Is there any reason to believe that we are any closer to some kind of understanding now than we have been in the past?

CHAIRMAN VOLCKER. Closer, yes. Close enough, I don't know. Partly, I think, as a result of the election there is more pressure in Germany politically to do something. Plus, the economy quite visibly is not doing so well. seems very resistant to changing what the economy is doing in any short period of time; he is not exactly a fine tuner. Nonetheless, he is bound to put somewhat more pressure on that side. And I think the Japanese are more worried than they were. These countries get really worried about their exchange rates but they sure don't move very fast to take what seem to be the necessary steps. Actually, neither of them is going to do anything very dramatic. What you hear talked about in both cases is probably a tax reform program--fixing it up so there is some revenue loss over the next year.

MR. CROSS. If it is just a nod in the direction of stimulation, then the chances of any meaningful success from intervention, I think, would be a good bit less than if it were something more stimulative.

CHAIRMAN VOLCKER. It depends upon what you think of the exchange rate anyway--whether there's a reasonable, potential equilibrium or not. But obviously, it has implications for the conduct of monetary policy not just here but abroad.

MR. HELLER. It seems that the Germans are emphasizing [domestic demand] a lot as well as the GNP numbers that we focus on and that look pretty discouraging. Domestic demand is expanding at 4 to 4-1/2 percent and the difference is going to imports. I think that's where our perspective and their perspective are really different. They say as long as we have a 4 to 4-1/2 percent domestic demand expansion, we don't mind the low production figure at home as long as the rest goes into imports. That way we make our contribution to international adjustment.

SPEAKER(?). [Unintelligible].

MR. HELLER. With the mirror, right.

MR. JOHNSON. They are also starting to admit that their domestic demands may not be as strong as they had thought.

MR. HELLER. Their GNP number is a lot lower. The 1-1/2 percent they are talking about now is a lot lower than the 2 percent they were talking about a couple of weeks ago.

CHAIRMAN VOLCKER. Three percent domestic demand is not much in terms of what we would like to see. They'd have to get to five percent or something like that; four is better than three.

MR. HELLER. With a shrinking population they'll say that is tough to do.

CHAIRMAN VOLCKER. They have all those great terms of trade in their favor. That helps them to consume more, but they are not big consumers.

MS. SEGER. Export some credit cards to them and help them out.

MR. HELLER. Credit cards?

MS. SEGER. To be better consumers.

MR. HELLER. Yes, but there are no credit companies in--

MS. SEGER. I am saying we could export some of ours to them so they could use them.

MR. HELLER. Oh I see! Well, as part of the Bank of America sale to BAI, they got a big credit card operation over in Deutscheland.

CHAIRMAN VOLCKER. Are there any more questions? If not, we will turn to the domestic report.

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

CHAIRMAN VOLCKER. Any questions?

MR. MELZER. Peter, with regard to these expectational effects that you were just referring to, I agree with you that what you described there is a major shift in psychology. Can that have a permanent effect on the level of the funds rate for a given borrowing target?

MR. STERNLIGHT. I think it can have a lasting effect. I would hate to say that anything is permanent, given the changeability of things. I wouldn't be totally astounded if the funds rate drifted back to something under 6 percent. Maybe that would come about as seasonal borrowings picked up more. But, at least barring some new factor right now, as I said, I tend to think more of a funds rate in the 6 percent area in association with $300 million of borrowing.

MR. HELLER. If you had expanding credit demands--it is clear how that can happen as it did in that year-end period--under our operating procedures you just can't adjust your projections of required reserves quickly enough to adapt. On an on-going basis and in a more orderly fashion, can that phenomenon create greater pressures in the funds market?

MR. STERNLIGHT. In more normal times the revisions don't occur with such speed. So, one can fold in the new revisions in an orderly way and they wouldn't have the impact that they had in that December period.

MR. HELLER. So, in theory, you ought to be able to keep up with it if it is more or less orderly.

MR. STERNLIGHT. Yes.

VICE CHAIRMAN CORRIGAN. There is a question as to whether you always want to keep up with it.

MR. HELLER(?). Oh, I understand that.

VICE CHAIRMAN CORRIGAN. Just from my own perspective--and this is obviously one person's view and one person's alone--I frankly regarded that whole year-end thing as pretty darn wild. And there is a question that arises in my mind--not that I have an alternative idea. To find ourselves in a position where we have to throw $20 billion dollars into the market for individual banks, between open market operations and the discount window, seems to me to raise a question as to how far we should go in sanctioning the kind of behavior that we were seeing in that time frame.

MS. SEGER. Where would the funds rate have gone if we hadn't--101 percent or something?

VICE CHAIRMAN CORRIGAN. I guess.

MR. JOHNSON. I think it leaves--

VICE CHAIRMAN CORRIGAN. In no circumstances would it be the end of the world if the funds rate did go to whatever level. I don't know; I am just saying that from my perspective the whole thing was pretty wild.

MR. BOEHNE. Peter, I hear in the business community, among financial types, a little more talk about inflation accelerating and at least some questions about how firm we might be. I noticed, I believe it was in that Drexell Burnham survey, that there seemed to be some uptick in inflationary expectations. Is that noticeable at all in the bond market or in the conversations that you have?

MR. STERNLIGHT. There has been a little of that. A lot of it came in the wake of the oil price [moves] by OPEC and the other countries lining up with OPEC in the last couple of months. Then the dollar weakening also fed those views that there was more to be concerned about prospectively on inflation. I wouldn't say it was a very major factor but it was there.

MR. PARRY. Peter, my impression is that the price performance of the long-term tax exempt market has been a lot better than the taxable market in this period. Is that due to supply or the fact that, with the new tax law, investors really don't have as many opportunities to shelter income as they did before?

MR. STERNLIGHT. My impression is that it would be both of those factors. There was some abatement of the supply of tax exempts and, as you stated, there are fewer alternatives for sheltering income.

MR. BLACK. Peter, I guess that you would say the degree of pressure on reserve positions is essentially unchanged, despite the higher federal funds rate.

MR. STERNLIGHT. Well, it depends upon your standard of measurement. Measured by the borrowing target that we are aiming at, it has been unchanged. But I have to admit that a somewhat higher level has emerged, even screening out the super high levels around the year-end.

MR. PARRY. The fact that the Bluebook alternative B has a 6 percent funds rate I guess means that you agree, Don.

MR. KOHN. Yes, for the $300 million in borrowing, I agree with Peter's analysis. I think there is, as Peter says, some risk that it might stick a little above 6 percent; but we are so uncertain about it that 6 percent seems like a good center of gravity.

MR. JOHNSON. What is in our directive? We don't specify a borrowings number in our directive. We have an understanding of about $300 million or whatever we decide. But if we say constant reserve pressure, what is that going to mean to us? Maybe we ought to institutionalize the borrowing number or the funds rate. Are we going to--

CHAIRMAN VOLCKER. I think we have institutionalized the borrowing number.

MR. JOHNSON. Borrowing number, yes.

CHAIRMAN VOLCKER. There's some allowance for excess reserves when they are very abnormal, I suppose.

MR. JOHNSON. Well, that's what I had assumed. An answer to your question would be that we haven't changed reserve pressures.

CHAIRMAN VOLCKER. If you look at it another way and measure it by the increase in the money supply it has been rather enormous.

VICE CHAIRMAN CORRIGAN. To say nothing of the increase in reserves.

CHAIRMAN VOLCKER. The funds rate has been where it has been because of a $27 billion increase in the money supply in three weeks.

MS. SEGER. Doesn't it take pressure on reserves to move the fed funds rate as it has moved? I realize that there were unusual circumstances; nevertheless, there must have been some temporary reserve pressure to have pumped it up so. I think you said the rate was 38 percent at one time; that doesn't sound like it was excessively easy.

CHAIRMAN VOLCKER. There were $2 billion of excess reserves that week.

MS. SEGER. Yes, but maybe they needed $2.1 billion.

MR. HELLER. Zero in the evening!

MR. MELZER. And there is probably one guy out there who bought them at 38 percent and sold them at zero.

MR. BLACK. He's not with that company any more.

CHAIRMAN VOLCKER. It puts us in a real dilemma. How much do we think this demand for economic activity [unintelligible]? If we were under our old operating procedure, aiming for the money supply, the federal funds rate would have been 60 percent or 75 percent for a few days.

MR. ANGELL. Peter said he was playing it by his gut. I understand that, but my reaction is that you didn't do too badly, Peter. Given all the forces, it seems to me that you follow directions very well.

MR. BLACK. I didn't mean to imply otherwise by my question. I felt that was the way you were going to answer, but I just wanted to make sure that you still view it the same way. Because of the high spread between the discount rate and the federal funds rate, there might be a little more demand for those borrowings, so there might be a little more pressure.

MR. JOHNSON. It would be interesting to know eventually why people aren't borrowing with the higher spread. I would like to know that answer. I am not--

CHAIRMAN VOLCKER. How much can you identify this simple distribution of reserves that you have been talking about? We know the seasonal [unintelligible]. Do you see appreciably less borrowing by banks under $1 billion or--?

MR. KOHN. We have looked at those data, Mr. Chairman. The division that we have looked at is banks over and under $1 billion. You can see, actually, some [difference] all year--and I think this has been connoted by the fact that the seasonal borrowing has been less, to some extent--and then a widening of the gap over November and December. It is not a lot, but you can see--

CHAIRMAN VOLCKER. Suppose you look at banks under $10 billion or so.

MR. KOHN. We haven't done that. All we have done was over and under $1 billion. We can try other breaks, I think.

MS. SEGER. What is happening to the administration of discount windows?

MR. KOHN. As far as I know, nothing.

MS. SEGER. I see.

MR. KOHN. They are instructed not to do anything.

MS. SEGER. No new personnel?

MR. JOHNSON. One little clerk who's doing it all.

MR. MORRIS. I think we started, maybe a year or two ago, to get tougher with the big banks. We instructed them that they could come in on Wednesday, on a settlement day, if they really had a case. And that was it. My impression is that, at least in our District, we had more borrowing from the big banks before that--before we started this Wednesday-only routine.

MS. SEGER. I am glad you said that because I told Don that I hear stories from bankers, too. And he tells me faithfully that we haven't changed.

MR. MORRIS. [We haven't] as far as the smaller banks.

MR. BOYKIN. In his District, big banks don't borrow because they do not want it known that they may have come to the window for other reasons. So, the big institutions don't come in.

VICE CHAIRMAN CORRIGAN. The big banks seldom, if ever, borrowed other than on a Wednesday anyway, though.

MR. MORRIS. I don't know what the numbers would show, but I have a feeling that the big bank borrowing is less now than it was a couple of years ago.

MR. KOHN. I have looked at data over the last several years, and it doesn't--

CHAIRMAN VOLCKER. Borrowing is less than it was a couple of years ago.

MR. MORRIS. That's true.

MR. KOHN. You would have to normalize on the interest rate spread, and it hasn't shown any [tendency to run lower] for banks over $1 billion, which is the break we've been using. It hasn't shown anything, particularly in the last couple of years; it may be a little lower but not much. Now, it is true that when we went to contemporaneous reserve requirements (CRR) we said--as we always have said and as President Corrigan just noted--that most of the big bank borrowings are supposed to happen on Wednesday. That is when they have gone out and sought funds. And now it happens every other Wednesday. So, that may be what you are referring to. But in terms of their frequency of borrowing, or the amount they are allowed to borrow relative to deposits, and that sort of thing, there was an attempt made in the switch to CRR and the two-week reserve period not to change the standards. There was an attempt made to keep the standards roughly comparable. Perhaps it wasn't successful, but that was an explicit goal.

MR. JOHNSON. I don't see how that would explain the change at the end of the year and the continuation now. I think there is something over and above that CRR that is making them hesitant, because the funds rate was behaving fairly consistently before.

VICE CHAIRMAN CORRIGAN. One thing that is probably at work is that they have more surprises now than they used to have. Just in recent weeks the speed at which the turnover is taking place is continuing to grow. I am sure that they have more surprises that have nothing whatever to do with the discount window. They just don't know where they are going to end the day.

MR. MORRIS. This would make them more reluctant to use the window.

MR. BLACK. A couple of our banks reported that they couldn't find the federal funds. The market had dried up, as far as they were concerned.

MR. ANGELL. It increases the demand for excess reserves.

VICE CHAIRMAN CORRIGAN. It would also be consistent with their being more reluctant to come to the window. They want to save that for when they really need it. I think that is part of the explanation.

CHAIRMAN VOLCKER. Moreover, I wouldn't exaggerate the significance of this moving around one quarter of a percent or something like that.

MR. JOHNSON. It probably has been very timely, given what has happened to the dollar.

CHAIRMAN VOLCKER. We are going to vote to ratify these transactions. [Without objection.] Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.] We have had a lot of focus on the international side, so we are going to do something different than we have done over the last decade; we are going to invite Mr. Truman to speak next.

MR. TRUMAN. [Statement--see Appendix.] Mr. Prell will now continue our presentation.

MR. PRELL. [Statement--see Appendix.] Mr. Kichline will now conclude our presentation.

MR. KICHLINE. [Statement--see Appendix.] That concludes our presentation, Mr. Chairman.

CHAIRMAN VOLCKER. If anybody still remains wide awake, are there any questions? Or was the presentation so complete that no questions--?

MR. BOEHNE. I have at least one question. First of all, I think you fellows did an outstanding job. This is not an easy task and I think you outdid yourselves. Having said that, let me ask my question. The key to this forecast is what happens to the international sector--to the turnaround in the trade deficit. I guess if we have been disappointed, we've been disappointed because the turnaround hasn't come faster. So often things happen more slowly than we think in economics; but then when they do begin to happen, they sometimes surprise us in that they happen so quickly. This is my question: Even though what we are dealing with in the trade deficit is outside historical experience, is there anything in our own history or the history of other countries to suggest that once the turnaround comes--even though it may have come more slowly than expected--that it may occur faster than we think?

MR. TRUMAN. Some time ago we looked at one part of that question--whether anyone ever had a turnaround of this magnitude. We found a number of examples of countries that had turnarounds in a space of 3 to 5 years of 3 percent or more of GNP. So that is not unheard of. The question is whether we would have for the forecast period as much of a turnaround as we have projected here. In fact, a passing allusion to that is 1978, which was shown on the first chart. In 1978 and 1979, as a share of GNP, there were slightly larger swings. Basically, from the first quarter of 1978 to the first quarter of 1979 there was an improvement of something like 1-1/3 percent of the GNP. And we have essentially 1 percent over several quarters. In that sense, we have less of an improvement stretched out over a slightly longer period. However, I think it is fair to say that we had a more conducive external environment in those periods. Both abroad and in the developing countries, particularly, [growth] was much more rapid in the late 1970s than we are seeing at the moment. That certainly is one reason why we had to scale back our projections somewhat. The other factor I would mention is that in putting projections like this together we look at what various historical equations tell us, and maybe because we are a little gun-shy, we have chosen not to go with what the straight econometric equations tell us in terms of how much of an improvement we would have over this period. That's for a number of reasons, some of which I think everybody knows, including the fact that we are coming back from such a strong position. The third point I would make relates to whether this is disappointing. I guess in some sense it is disappointing. But as I look back at the forecast that we gave a year ago, the forecast for the U.S. current account for last year, given all the conditions, was reasonably close to what we came out with. Maybe people hoped there would be more of a turnaround, but I don't think the staff forecast as a whole was substantially outside any normal range of error in terms of 1986.

MR. JOHNSON. Ted, what are some of the models actually projecting? I agree with you, I wouldn't--

MR. TRUMAN. We would have another $20 billion in real net exports over this period if we went with historical equations for the volume of nonagricultural exports. As anybody who has done this knows, all equations have errors and it is partly a function of what you do with the errors that happened in the most recent period. There has been some error in the most recent period, and in putting the forecast together we have chosen, implicitly, to increase rather than to reduce its size. That's partly because, given the relatively soggy environment in the rest of the world, we feel that there are limits on the rates at which U.S. exporters can penetrate some of those markets. Looking back at it--and with the big qualification that the fourth-quarter numbers are still partly estimated--I think it is clear that there was a substantial improvement in our nonagricultural exports in 1986. That's something that was borne out in the Reserve Bank surveys and also by the statistics.

MR. JOHNSON. I think that the biggest issue is that a lot of people you talk to expect most of the gains to come on import substitution, but we don't really show much there at all.

MR. TRUMAN. Well, we have it coming on import substitution in the sense that we have a still growing economy. In fact, in some sense you want to look at the production side, not the demand side. Production is growing at 2-1/2 percent, and normally that would be associated with an increase in imports of 2-1/2 percent or more over the course of the next two years. We essentially have none of that. So the substitution effect comes, in some sense, against a two-year 6 percent import growth that otherwise would be there. That is quite a large number, but we are not looking for an actual decline.

MR. FORRESTAL. How much did the volume of non-oil imports go up last year?

MR. TRUMAN. [Unintelligible.]

MR. FORRESTAL. So, non-ag exports have been a little slower.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. I have a question for Mike Prell on personal income and savings, chart 14. I think it may have some implications for the PCE forecast. The saving rate clearly has been coming down in recent years. Your forecast would have that saving rate trending down--not looking at the quarterly pattern, but on average--in 1987 and 1988. Of course, if that did not occur there would be some implications, potentially, for the growth of consumption. With disposable income rising more slowly, I can understand why it might be a difficult environment in which to build savings, but at the same time I have difficulty seeing the rates coming down to those levels. I don't know if you can ever find saving rates down at those levels. Continuing that trend would be of considerable interest and significance.

MR. PRELL. Well, the periods in which you find sustained low saving rates are not periods that you would necessarily want to use for purposes of analysis at this time--the Depression, for example, or the early postwar period. I think you put your finger on one of the factors in our thinking: that as real wages are eroded, there will not be an immediate adjustment of spending patterns. We have durable goods purchases growing at a very low rate. Our consumption growth is historically very low and we are assuming that this wealth increase that we have seen at least is not erased. So, on the basis of those wealth and income levels, we ought to be able to sustain a relatively low saving rate. But certainly, we are in somewhat uncharted territory and it's a potential risk in the forecast. We decided not to look back at [unintelligible] and say that's a potential risk. They are two sides of the same coin.

CHAIRMAN VOLCKER. You are assuming a little increase in the saving rate in 1987.

MR. PRELL. If you look at the annual totals it's gyrating around.

CHAIRMAN VOLCKER. It's a difference between the annual average and--

MR. KICHLINE. The saving rate in the fourth quarter of last year was 2-3/4 percent. If you are visually looking at this chart, it depends on the point you look at. One other thing that conditions our thinking is that, historically, the income side tends to get revised up in the national income accounts in July. They tend to find income with these revisions. We have looked at these data, and history would tell us that the 2-3/4 percent number for the fourth quarter is likely to be over three percent, and perhaps appreciably over three percent; but we will know that a couple years from now. So, conditioning our thinking is the fact that these numbers tend to understate the saving rate.

MR. PRELL. This is where we were a year ago; it was essentially the same sort of situation. It has happened repeatedly that they find income and the saving rate does go up.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, I was stimulated to ask two questions, Mr. Chairman. First, given the relatively favorable numbers at the end of the year, I think there is some expectation that the GNP for the fourth quarter might be revised upward. And some people are suggesting that it might even be revised substantially. If that were to happen would that change your outlook for the year as a whole? In other words, do you think you might revise your forecast?

MR. KICHLINE. We had in mind when we put the forecast together that the fourth quarter would be revised up somewhat. The question would arise if the revision were much larger than we had anticipated. The major source of the change is our expectation that net exports will look a lot better, perhaps $8 to $10 billion better, than in the accounts now. But some more recent information coming out on business fixed investment and some other areas suggests that maybe by the time they put all of the numbers together the upward revision will be something smaller than that. So, our sense is that we might get a 2-1/4 to 2-1/2 percent number instead of 1-3/4 percent. Implicitly, we had that expectation in mind when putting together this forecast.

MR. FORRESTAL. You have that built in. My second question is for Ted Truman. I guess I am not quite clear why you think you are going to get depreciation of specific Korean and other Far Eastern currencies against the dollar. I ask that given their propensity to keep their currencies at a low level relative to the dollar. I guess they haven't exactly pegged it but--

MR. TRUMAN. Well, most of the action in this area comes from Korea and Taiwan. They have already begun depreciating slightly for the last three or four months. And basically, that's what we have built into this forecast. They depreciate by 5 to 6 percent in real terms while some of the Latin American countries, essentially Brazil and Mexico, [unintelligible] percent over the two-year period, [unintelligible].

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Jim, or Mike, I forget which one of you mentioned [in the presentation] that if you had had the employment report you probably would have upped your forecast a little. If you add to that the National Association of Purchasing Manager's Report, would that cause you to change your figures?

MR. KICHLINE. No, we had that information in hand. The only major piece that came out that we did not include in our thinking was the employment report. We have 2-1/4 percent now, and I think if we had had that report, we would probably have a number in the 2-3/4 to 3 percent range for the first quarter.

CHAIRMAN VOLCKER. Governor Heller.

MR. HELLER. Mr. Truman, you have the interesting chart 5 there, with real interest rate differentials and the U.S. dollar plus your forecast for the real interest rate differentials.

MR. TRUMAN. Forecast of the dollar.

MR. HELLER. Pardon me?

MR. TRUMAN. The red line is the forecast of the dollar.

MR. HELLER. I'm sorry; I totally misread the chart. I was going to ask if you forecasted real interest rate differentials what the underlying actual rates implied by that chart were.

MR. TRUMAN. The interest rate differentials?

MR. HELLER. Well, the actual interest rates that you were looking at.

MR. TRUMAN. We have long-term interest rates in the United States that are trending up slightly over the forecast period in nominal terms and real coming down slightly now. And that is about offset by the differential in inflation over the period. Essentially, you have the same midpoint, which is about 3/4 of a percent there.

MR. HELLER. So it's a flat line.

MR. TRUMAN. Basically, it will be flat. That's one of the reasons why I didn't put it in the chart.

MR. JOHNSON. So why do you get the further depreciation?

MR. TRUMAN. Economists argue about whether negative real interest rates cause depreciation. If you have a lagged structural model, I think you would argue that they probably do. At some point, however, it implies that you are going to have appreciation. In this context, I think it would be a negative factor, on balance. The major point is that, while we think there will be at least continuing downward pressure on the dollar, the current account will not move fast enough as some combination of market participants and market [unintelligible] think is necessary.

MR. PARRY. Mr. Truman, on chart 6, that wholesale price chart, if that were net of oil, am I correct that probably you would have seen more of a depreciation in the United States than you would in the foreign countries?

MR. TRUMAN. We have more [unintelligible]. As a matter of fact, we have it going the other way.

MR. PARRY. But oil is denominated in dollars, so the depreciation of their currencies must have had a very large impact on those indices.

MR. TRUMAN. In some sense you can see it in the next chart where you have the Economist Index of all commodities. You have essentially [unintelligible] over the last couple of years; prices have been flat in dollar terms. So likewise, in the oil case, you had a combination of a declining dollar price and it's magnified by the exchange rate.

MR. PARRY. So net of oil, our inflation improvement probably was better.

MR. TRUMAN. No, I would say net of oil, probably our inflation improvement is not as good. Because if all of the other commodity prices were fixed in dollars, and the dollar was declining against deutschemarks, yen, and so forth, and you take oil out, you have [unintelligible].

MR. PARRY. I see.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. My question is somewhat related to an earlier question regarding Japanese investors in long-term Treasury obligations, and you probably have no chart or number for it. You have given the interest differential. Normally that's what we are [unintelligible]. But given the tremendous decline in the dollar [unintelligible], broadly how are those long-term investments looking over any period of time? I guess the question is: Is there a way that they have been protecting themselves against a [depreciating dollar]?

MR. TRUMAN. There are three things to say. One is that the statistics do not show much in the way of net Japanese purchases of Treasury securities over the past year. The statistics may be wrong, but they do not show it. Secondly, as I commented and as I think was implicit in what Sam was saying earlier, even if they buy them you don't know what else they are doing and to what extent they are selling them. As to the question of whether there is going to be enough foreign investment in the United States over the next two years, I think it's a question of the price at which that investment takes place. Investment is going to be made in the United States. They don't have much choice. The question is what combination of interest rates or exchange rates brings that forth. If the Japanese want to invest abroad but insist on protecting themselves, then basically they are saying [unintelligible]. They have to place yen-denominated investments abroad and someone is going to have to take the other side of that currency position. If there are not enough people to take that at the current exchange rates, the rates are going to go lower. That's how I think of the model.

VICE CHAIRMAN CORRIGAN. There is another way of looking at that. Chart 10, I think, is kind of interesting. Roughly speaking, if you take the three years 1983, 1984, and 1985, the cumulative current account deficits for those three years are something like $280 billion; but the cumulative current account deficits for 1986, 1987, and 1988 are something like $410 billion. So we are looking at a situation where in the three years that we are in now, we have to finance 50 percent more than we financed in the three earlier years--but in a context in which interest rate differentials and exchange rate relationships are very, very different than they were in the three-year period when we were only financing $280 billion as opposed to the $410 billion or whatever it's going to be. It could get a lot tougher. The conclusion one draws is that it could very well be tougher--especially in the kind of interest rate/exchange rate environment we have right now--to finance what lies ahead than to finance what came before us.

MR. HELLER. In my mind there are always two possible outcomes. The one is like the scenario that you are outlining--that the dollar will really plunge; the other possible outcome is that you say okay, the balance is not turning and, therefore, there will be more exports and that will give confidence.

VICE CHAIRMAN CORRIGAN. That's already built into those numbers.

MR. HELLER. So then you are stuck with the first one.

VICE CHAIRMAN CORRIGAN. You are not stuck with it. I think it just says that the potential risks of that adverse scenario are probably greater prospectively than they were retrospectively.

MR. PARRY. I think something of an offset to that, Jerry, is that because of the depreciation of the dollar the foreign investor is, in effect, buying at a cheaper price.

MR. TRUMAN. That's the other point that came up in my conversation with Governor Johnson. In some sense, the closer you are to the bottom the more attractive it is to buy. In fact, the expectation of appreciation makes it look cheap now.

CHAIRMAN VOLCKER. Still, in those markets people will buy. Do we have any more questions or comments? If not, I think we can go on to people discussing anything they want to lay out about the general view of the outlook and the potential risks therein. [In the forecasts you submitted prior to this meeting] everybody is positive in a certain range, but there is considerable difference for some people. Mr. Parry isn't one of them; he agrees with the staff so his comments can be brief.

MR. BLACK. I hope the converse of that doesn't necessarily apply!

MR. PARRY. I didn't hear you.

CHAIRMAN VOLCKER. Comment briefly on the outlook.

MR. PARRY. I would start out by saying that our forecast is not very different from that of the Board staff. But I do want to comment a bit on the risks that I see to the forecast because I think they could have implications for policy. It would appear to me that the risks as far as inflation is concerned are on the up side. We have assumed that the recent decline in the value of the dollar is largely permanent and that the dollar will end 1987 at a lower level than we had in our previous forecast. The pass-through of price increases resulting from the dollar's decline has been slow to date, but I believe profit margins of many foreign suppliers of goods to the United States are really quite narrow at the present time and, therefore, future pass-throughs could be considerably greater. Secondly, it seems that the momentum of oil prices at the present time is in the direction of rising oil prices, or at least not declining. Thus, our assumptions about oil prices could turn out to be too low and inflationary pressures more intense. The dollar and also the oil price issue are largely factors that one would presume would be temporary as far as inflation is concerned. But a third risk for inflation would be more prolonged, I think, in its impact. The staff projection of the unemployment rate at year end is around 6-1/2 percent. By some estimates that rate gets close to full employment and thus any positive shock to demand could produce more serious price pressures than are included in the forecast.

On the real side, I am basically comfortable with the staff's estimate of just under 3 percent, although there is a risk to the projection, probably, on both sides of the forecast. I would like to note two risks on the downside. The first one I really was hinting at when I asked the question about the saving rate. It seems to me that it is conceivable for the saving rate not to deteriorate from these levels. If that were the case, it's possible that consumption would grow at a somewhat slower pace than is incorporated in the forecast. Obviously, another major uncertainty on the real side is net exports. We have talked about that considerably, but to me a conservative stance would be to assume that the failure of the dollar to decline relative to currencies of numerous important trading partners will lead to an improvement in net exports that is somewhat less than the Board staff's number.

On the regional front, we continue to see growth a bit faster than the rest of the nation. Last year we saw employment up 3.5 percent compared to 2.3 percent nationwide. We also saw a huge jump--67 percent--in California building permits in December, but that was a response to a large builders fee that went into effect January 1. It's interesting to note that the increase significantly added to the national totals; it probably caused about 17 percent of the increase in the December leading indicators. So it was not an insignificant development. A couple of other points in the District: We had a rather interesting experiment regarding the effects on consumer behavior of the removal of the sales tax deduction. Oregon does not have a sales tax, and consequently, one of the things that we observed was that there was no surge in car sales in Oregon in contrast to the year-end surge in other states with sales taxes. We also heard from a member of our small business and agricultural advisory council that apparently one major Japanese car maker is beginning to ship stripped down models to the U.S. I think that is interesting because it may mean that the volume of Japanese car imports may not decline as much as had been expected and that, conceivably, price competition in the industry may turn out to be more intense. Finally,
pointed out to us that he was having much greater success in selling to the Canadians because they were now substituting our exports for French exports. We have been focusing on the failure of the Canadian dollar and the currencies of [unintelligible] countries to appreciate and thus to enable us to cut down on our imports. One thing that is sort of interesting is that the failure of their currencies to appreciate relative to ours is probably raising some export opportunities that perhaps we have not been focusing on.

CHAIRMAN VOLCKER. It also has diminished some imports when you [unintelligible] to France. The problem is your precise indication of the risks. Let that be a model to others when they approach this thing.

Just in terms of inflation, I meant to ask a question of you, [Mr. Kichline]. We have all of these GNP deflator projections; how much do you have to add to that, roughly, to get a consumer price index projection?

MR. KICHLINE. For 1987, fourth quarter to fourth quarter, we have forecast a CPI increase of 3.8 percent; it was 1.3 percent on a fourth-quarter basis in 1986. So that's 0.9 percentage points above the deflator in 1987.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I will be very brief. One of the noticeable differences in the forecast of people around the table has to do with inflation. There seems to be a trend: the more you are in Washington the lower you think inflation will be; and the more you are out in the country the higher you think it will be. I have been surprised in travels around my District by questions about inflation. I would have expected questions to be more on the dollar or whether the economy is going to go into a recession or what have you. I have found in recent weeks that the greatest concern is that inflation is going to get out of the box. And if you push, and ask if [the basis for the question] is wages, or imports, or that you are raising your own prices, you find that it doesn't seem to be analytically based. It seems to be more of a gut feeling that somehow we are just going to let inflation out of the box again. I think it's just a general worry at the gut level that causes that. But it is there. And I think that has some implications for how monetary policy is stated in addition to what it actually is. In general, I agree with the staff forecast; I'm perhaps a touch higher on inflation.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, before I talk about the forecast in general, I thought I would tell you about some interesting numbers I came up with. Ninety percent of the New England high tech manufacturer exports are flown out of Boston Airport because of the low weight to value ratio, so I thought I would ask the port authority to give me some figures on air freight exports and imports. I thought it might be an indicator of how this high tech industry is doing because I have been getting a lot of optimistic feedback and I wanted to see if it was confirmed by the numbers. The numbers are in pounds so you don't have any exchange rate problem. What they show is that our air freight exports bottomed out in the first quarter last year and have been rising pretty substantially. In the three months ended in November of 1986 they were running 29 percent higher than the same months of 1985. Air freight imports, which are still larger than exports, were running 7 percent higher than a year ago. Now that's pounds and that can be misleading because I know that we shipped a lot of tuna. Lobster don't weigh much, but we ship a lot of tuna to Japan. We don't eat fresh tuna and we ship the whole fish in a specially prepared box because they like fresh tuna. It could well be that a good part of this increase reflects a 40 percent decline in the cost of fresh tuna to the Japanese. But I think it does tend to confirm the idea that the high tech industry is doing a lot more business overseas than it has been. So, I will keep watching those numbers and see what intelligence I can get from them.

I am inclined to think that if the forecast is wrong on real growth it's going to be wrong on the low side. I had a long argument with my staff about what number to give you. They wanted me to give you 2 percent real growth. I thought that was a bit on the low side. I hated to offend them because their forecast has been better than mine in recent years, so we compromised at 2-1/2 percent after they saw the January employment numbers. I am impressed with the very widespread strength in the leading indicators in November, December, and January. Three months back-to-back strength of this sort leads me to think that at least the first half may be considerably stronger than we are projecting. So I come out on the optimistic side of the risks.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. On the real side, our forecast is just a touch higher than the Board staff's. I would be inclined to agree with Frank Morris; I feel good about the current statistics that we are seeing, although I am not inclined to read too much into that. I certainly don't pick up anecdotally the idea that people are consciously recognizing a significantly strengthening picture right now. The only thing I would say on the price side--just to pick up on what Ed Boehne said--is that in general in our discussions, particularly of late, we tend not to place too much weight on the effects of M1 growth and so forth. But just to pick up on this year-end phenomenon, one way that you could conceptualize that is that what we have done is monetize or liquify a lot of unrealized capital gains. And that has been done largely through an expansion of bank credit that hasn't run down significantly. That money is sitting there and some of it certainly will go back into other investments; but some of it could well be spent. I just think that at some point, when money has run at such rapid rates, we are going to see some impact in prices that may not really be built into the forecast we are looking at. So, we're higher on the price side; we are at the high end of that range.

CHAIRMAN VOLCKER. If the relationship is the same as the staff's, your kind of price [forecast] would have to produce about a 5 percent CPI. Mr. Forrestal.

MR. FORRESTAL. If we have a difference with the staff, it's on the inflation side as well. We see pressure on prices probably occurring more towards the end of the year than at the beginning, and we are attributing that basically to a greater impact from import prices than we had thought earlier. We have done some studies that suggest that the decline of the dollar is going to affect these import prices somewhat. Those studies are certainly not definitive by any means, but my hunch is that they are probably right. So we are looking at the deflator to be at about 3-1/2 percent; we think it is really somewhat unrealistic to see the deflator stuck at 3 percent, which is what the staff is forecasting for three quarters. On the GNP side, we are closer to the staff but a little lower; therefore, our forecast is a little less sanguine than the Board staff's. Some of that activity that we saw in December could very well have been tax related. I hope it's more than that and that there is some momentum in the economy; but we will just have to wait and see on that. But we think that GNP is probably going to grow around 2-1/2 percent. Consistent with that slower rate of growth, we have a slightly higher unemployment rate at year-end, although it's not significantly different. So the real difference that we have is on the inflation side.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. As far as the real economy is concerned, my forecast is the same as the staff's but I tried to build into that some allowance for this fourth-quarter borrowing phenomenon--that is, I assumed the fourth quarter was going to take some strength out of the first half of 1987 for tax reasons and so forth. I must say that I am not sure that was a wise adjustment. It seems to me, at least, that the risk--risk is probably not the right term--that the range [of error] around the forecast is probably symmetric at this point. I am quite impressed with the momentum with which the economy ended the year. I am not just referring to the December statistics. Looking at the payroll data or the household employment data going back to September or October, we see a string of consecutive sizable increases in the statistics on a monthly basis that, as far as I am concerned, are about as reliable as any we have to look at. And there are some other developments one can add to that as well, relating to the year-end improvement in housing starts and the tone of the purchasing managers' survey and so forth. As far as inflation is concerned, I am at the high end of the range, based on the reasoning that we have benefitted from some special factors in 1986 that are not going to be with us in 1987 and that, in fact, will be reversed through higher import prices of oil and other things. So, I suspect we are going to see a somewhat more rapid rate of inflation.

A couple of interesting things have happened in the District lately that I might just comment on. We run a quarterly agricultural credit conditions survey, and for the fourth quarter that survey had the most positive tone reported in a long, long time, both with regard to farm earnings and to the pace of farm debt repayments. One quarter obviously doesn't establish a new trend, but there seemed to be some inkling there that, at least in our District, we are seeing some real turnaround. I would also comment that the labor market in the Twin cities, which has been quite tight for some time, has apparently tightened further. We got reports from one of our directors that for jobs that would have to be characterized as requiring modest skills, but where the compensation is really pretty decent--total compensation of $20,000 to $25,000 a year--they just cannot find people to fill them. There are no takers.

CHAIRMAN VOLCKER. If I am right that an inflation rate of 4 percent in the GNP deflator means something close to 5 percent on the CPI--and that is the middle of the range--your number means the CPI could be over 5 percent.

MR. STERN. It could be, but that's only 0.4 percent a month annually. It doesn't strike me--

CHAIRMAN VOLCKER. A turning point--

MR. STERN. The CPI last year, excluding food and energy, was averaging about 0.3. It's that kind of deterioration.

CHAIRMAN VOLCKER. I wasn't saying it couldn't happen. I just wanted to talk about it. Mr. Keehn.

MR. KEEHN. Our numbers are very consistent with the staff forecast. We are a touch higher on real GNP, but perhaps from a lower fourth-quarter base, and our deflator number is a little higher. With regard to risk--and I think we have covered it in some detail--it seems to me that so much is dependent on the trade side that the risks really have to be in that area. I must say, nonetheless, that I think we are probably going to come out about right on that. From talking to people in the District, I do sense that probably one of the more significant changes that we have had in the last month or so is on the trade side, more as it relates to imports than to exports. Certainly, the environment for exports is better and there are some industries--chemicals and paper products, for example--that are doing better. But on the import side, I think an awful lot of the domestic people who have been supplying the domestic markets that have been so very, very hard hit are sensing better opportunities now--particularly for people such as the integrated manufacturers who had typically gone to foreign markets for their out-sourcing. I think they are beginning to look more at domestic markets for their sources and, therefore, that's an improvement also. It's nothing dramatic, but I do think we are perhaps at a turning point on this. Because of the importance of the trade sector to our outlook for the year, in my mind that has to be the big risk.

On inflation, I think the risks are a little on the up side. People I talked to say that wage costs are continuing under very good control. Their contract settlements are excellent in terms of cost as well as work rule changes, etc. And the market pricing is very tough; conditions continue to be very, very competitive so they are able to maintain pressure on that. There is this bet that imported products will begin to go up in price. I think we are going to see that show through and the CPI number is going to be a little higher than we might have expected. And because of the sheer publicity--the visibility that the CPI gets--it seems to me that it is going to begin to get one's eyes focused on this problem, perhaps more than has been the case in the last couple of years. So, I think inflation is the other risk area.

I have just a couple of quick comments on the District. I echo what Gary Stern was saying about the agricultural sector. I have been out a couple of times over the last two weeks, and I sensed that we might, I hope, be at the bottom of that particular problem, or in the zone of stability, as I call it. That's a bit of a positive. On the negative side, we are continuing to see plant closings, something that I keep a count on. Caterpillar has announced the closing of three additional plants in the Midwest in the last month or so. GM has announced one more plant closing over and above that big string that they had a couple of months ago. They are now beginning to shut down some of their [plants producing] parts used in assembly and, again, they are going to out-sourcing. So that's one on the negative side. Generally, conditions in the District seem to be pretty much unchanged from what has been the case over the last few months.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, we are more on the optimistic side, like some of our brethren are, I am comforted to see. We may have been overly influenced by the signs of a turnaround in manufacturing in recent months than by the flurry of good statistics that has just hit in the face of a great deal of liquidity in the economy. We put in 3-1/2 percent as the rate of growth in real GNP, and we have the unemployment rate coming down to 6.4 percent. So far as our analysis is concerned, we are pretty much in agreement with the staff on the forces that are at work in that we think there is going to be a marked improvement in the net export picture and that it's going to be a major contributor to growth. We also agree with the conclusion that gross domestic purchases are going to grow more slowly, but we differ mainly in that we think that there are going to be more real personal consumption expenditures. The staff has projected just 1-1/2 percent growth fourth quarter to fourth quarter. It is certainly true that we have a lot of debt there, but we also have some factors that offset that negative in the growth of wealth. So our guess is that PCE is going to be somewhat higher than their forecast. Coincidentally, I suppose, we had about the same kind of growth in real disposable income last year as they are projecting for 1987 and we had a 4 percent rise in real consumer expenditures. Against this more optimistic forecast, we have inflation near the high side, at 3.8 percent. I am a little comforted to see that someone else is there and even more comforted by one of the Board member's forecast of real GNP of 4 percent. For once I am not the high one on that. We think that inflation is going to stem from this stronger projection of real growth; that ought to tend to reduce this remaining slack in labor and product markets, particularly in the second half of the year. Insofar as the risks are concerned, I would say that the risks are that the numbers are going to come in somewhere between our forecast and the Board staff's.

CHAIRMAN VOLCKER. Not much of a risk. Mr. Corrigan.

MR. BLACK. It's an averaging of two misses, probably.

VICE CHAIRMAN CORRIGAN. My forecast is again almost identical with the staff's forecast. It probably means that we are both wrong. As a number of people said, the trade sector is obviously crucial. And frankly, I blow hot and cold on that. Sometimes I think we have a good shot at doing better than the forecast and other times I say "no way". I guess right now I am, to some extent, in the cold camp as opposed to the hot camp. And that came about in part from listening to President Poehl and Governor Sumita over the weekend in Basle, both of whom were really distinctly more cautious about economic prospects in Germany and Japan. Clearly, in terms of the favorable world economic situation--

CHAIRMAN VOLCKER. How are the Japanese talking now?

VICE CHAIRMAN CORRIGAN. Well, they start with the government forecast which is 3 percent plus--say, 3-1/2 to 4 percent. Then they talk a little about the Bank of Japan forecast and shave a half point off that. Then they start wriggling in terms of their own forecasts, so with the body english, I ended up with 2 percent or less.

CHAIRMAN VOLCKER. That is where the Germans are. It's not very exciting.

VICE CHAIRMAN CORRIGAN. And some worry, especially in the Japanese case, that they are really taking a terrible beating in their manufacturing sector now. So, as I said, I guess today I am a little influenced by that.

CHAIRMAN VOLCKER. A terrible beating by Japanese standards.

VICE CHAIRMAN CORRIGAN. By their standards. On the import side, the question I keep asking myself is: If we have a shortfall from this kind of consensus forecast on the export side, is there any good possibility that we can make up the difference on the import side? That to me is a tough one. Indeed, it's a "Catch-22" because when I look at the nature of the import situation here in the United States now, with the infrastructure that goes with it in so many product lines, it just seems to me that to break out of that mold that Ted has in his forecast, we are probably going to have to have pretty sharp price increases for imports. That's something we haven't seen yet; and if we start to see it, it's just going to add that much more pressure on the domestic inflation side. So, I am not sure we can make up any shortfall on the export side. But if we do, I am afraid that we are going to make it up at the cost of higher inflation. So, as I said, right now I am a bit on the cold side of the trade situation, but that will change next week, I suspect.

On the purely domestic side, like Mr. Stern and a couple of others, I've got to say I am impressed with not just the January employment numbers, but the collection of numbers over the past three or four months which, net, have been stronger than I would have expected, especially in the circumstances of the tax change. Those developments will probably lead me to be marking up my forecast a little. Putting it all together, I would say that the risks are about symmetric at this point. I have a little of that nagging sense of unease that Ed Boehne spoke about in terms of the inflation situation, although I can't pin it down either. If you go through unit labor costs and productivity exercises, you still get numbers that look respectable, at least in terms of deflators. But there is at least that nagging feeling that this tremendous amount of liquidity that we put into the economy ought to do something at some point. And right now all it seems to be doing, in some sense, is feeding the financial sector. That in itself constitutes a risk because I continue to see a rather sharp--and in some ways an ever sharper--dichotomy between the financial sector of the economy and the real sector of the economy. And I just don't see how that is sustainable. I think there are risks right there in terms of something going astray which, in turn, could impair confidence in the world in a detrimental way.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, optimism or pessimism is a relative thing. Having been through a series of meetings over the last several weeks--with our own board of directors, our advisory councils for small business and agricultural, our financial institutions' advisory council, and a few others--I thought I was being rather optimistic in sending in [a forecast of] 2-1/2 percent real GNP because that isn't what I was hearing anecdotally from our people. However, based on what I have seen, it's probably under the others; it's certainly a little under the staff forecast. My own staff, I think, would encourage me to shave that up slightly, based on their analysis and, certainly, the current information. One thing that is tending to influence us in the Eleventh District is the fact that in the survey that we just did on the effects of the decline in the value of the dollar, we probably have not received the benefit--or certainly not the same benefit--that other Districts have been reporting. There is optimism, although it's cautious optimism; it's a sense that we just don't think we are going to slide down any further and we can see a few glimmers of hope. If anything, I have been a bit pessimistic in terms of the 1987 performance on the real economy and inflation, although we are not seeing a great amount of indication that inflation is getting to be a problem. To me, at least, it's time to observe that very, very closely, because the possibilities are such that we could see a little pickup there. I don't know whether it will materialize or not; we will just have to wait and see. But it's something that I would hope we'd be observing very closely.

CHAIRMAN VOLCKER. Well, Mr. Angell, is going to tell us how good the inflation outlook is.

MR. ANGELL. No, I think it's pretty bad. I think my forecast for the CPI is 100 basis points higher than it was last year after I had been here 7 days. So I got worse on that.

CHAIRMAN VOLCKER. Relatively worse.

MR. ANGELL. Yes, relatively worse, right. In a sense, I suppose my forecast, at 1.9 percent real GNP, is optimistic in that the non-U.S. world output would seem to be hardly higher than 2 percent and it would seem appropriate that we would be a little less than the rest of the world. So I guess I feel very comfortable that if we can do it that wouldn't be bad at all. As I looked at the export side, I noted from St. Louis' recent publication that U.S. export prices over the last six years have risen a total of 11 percent, which would be less than 2 percent a year. Our staff forecast has an 11 percent increase in export prices over the next two years. In the world that I see, it is somewhat unlikely that that kind of increase in export prices would occur. On the import side, I also noted in that same study that U.S. imports as a percentage of GNP have been so constant; they just don't change very much. So I just don't hold much hope for any reduction of imports by relative pricing. That is, the price elasticities seem to be such that we are not going to make much gain there. Frankly, I don't see that we are going to make quite as good a move on the trade side as even the staff forecast, and that's not very good.

When I look at dangers, I suppose there are two kinds of dangers. I tend to set aside the stagflation scenario; I don't see that as very likely. On inflation, my estimate is only 1/2 of a percentage point different from the staff, and I don't see that to be very large. But if we both missed, if there was higher growth and more inflation, I guess that would provide us a very decided monetary policy option which would be, I presume, higher U.S. interest rates; and that would be good for the dollar. If we had higher growth, it would be good for a lot of sectors of the domestic economy. So I assume that if we missed in that direction we would have a response that would be appropriate both domestically and internationally. The problem I see would be if we get too slow and the world gets too slow. And if the U.S. gets too slow, then I wonder what the policy response might be because that might put downward pressure on U.S. interest rates. I'd hate to see that happen with equity prices maybe going even higher than they are today, which might be an unsustainable path. So that's the kind of worry that I have: that we might get too slow [economic growth] and get declining interest rates. This would put the dollar in a precarious position, and we might not have good policy options. So, I guess I do worry some.

CHAIRMAN VOLCKER. You are paid for worrying. Mr. Heller.

MR. HELLER. The pay shows that Governor Angell is not worrying very much.

CHAIRMAN VOLCKER. Spoken like the private sector fellows.

MR. HELLER. Overall, I very much agree with the staff. My numbers are almost indistinguishable from the staff forecast, but on the trade picture I agree more with Jerry Corrigan. Having been through Europe only a day or two before him, I think the hand-delivered Wall Street Journal article, courtesy of Manley Johnson today, says it all: "Fed Official Finds Little Sympathy in Germany on Trade Deficit." It will be difficult to get the very optimistic progress on the export growth front. On the other hand, on the import substitution side I think there probably is a lot more room for progress. So the net outcome may well be very much the same as forecast by the staff but the composition would be very different.

On the inflation front, I think the key is not the direct effect of the depreciation of the dollar but the response of U.S. manufacturers to the increase in prices by their competitors. And if the U.S. automobile industry and their pricing behavior is any indication, I think we are in for a hard time. I hope that not everybody will follow that example but will instead hold prices and go for the market share. If the auto example were followed it would clearly be very detrimental on the trade front, because we would not get the relative price effect and the trade picture would be very bad.

One last brief comment: a lot was made out of the difference between the CPI and the GNP deflator. I think there is good reason to assume that next year that discrepancy will be bigger than it has been in the past because the prices from imports will show up in the CPI while they are going to be subtracted out of the GNP numbers. So there is going to be a bigger discrepancy there. I think that is basically a statistical quirk that we have to be aware of but shouldn't overemphasize.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. Wayne Angell and I have been having a horse race in the last year to see who could be the most pessimistic. And, believe it or not, looking at actual numbers for 1986, neither of us was low enough. Wayne, do you realize that?

MR. ANGELL. Yes, and my inflation [forecast] was also too high last year.

MS. SEGER. Well, having said that, I am in his camp again with a low number for real GNP growth--something on the order of 2 percent, which is below the staff's. I have two main reasons for departing from the staff forecast. One is that I continue to be concerned about the auto industry. On the one hand, I watch the pricing behavior, as Governor Heller indicated; but also, I really think that the fundamentals of the auto sales picture are weaker than the dealer delivery figures may suggest. There was a surge at the end of 1986, and I think much of that surge should be attributed to the tax changes that were going into effect January 1. We know that there was a substantial decline in January. But, as someone pointed out to me, even that overstated the strength of true retail demand because many fleet sales were processed in January. And, of course, that's not a function of showroom traffic, and so forth; that is a deal that is struck between large purchasers and the corporations. So, the fundamental demand for automobiles is probably even weaker than it looks. Auto manufacturers are watching February numbers very, very carefully. One person told me that they were in the process of revising down their production schedules as we spoke, which was this morning. Anyway, I don't think that they are going to continue to wait for a miracle to occur that will somehow or other eliminate these high inventories, particularly in certain lines and certain makes. is the company with the worst inventory situation. They have excessive--that's my word, not theirs--and extensive incentives out right now. If they don't get the results they expect--and there is a great deal of concern that they won't--then they will have to make really substantial production cuts. I hope that isn't the case, but I am concerned that we may not have [forecast] enough weakness coming from that particular sector.

The other area of my concern involves the trade turnaround. I asked at the [Board staff] briefing on Monday where the additional exports in this country were going to go and what the products would be. I also asked what imports were going to be curbed or curtailed, and I haven't gotten very good answers to those questions. I just think it's going to be much more difficult to accomplish this. The deterioration, I would remind people, went on for a number of years--five or something like that. And I think that there have been adjustments made in the economy to these changes and that they are not going to be easily reversed. Although I would like to see a quick and substantial turn, my suspicious nature suggests that it won't take place. So, I put those two differences together, and that's why I think that we are going to have a slower rate of growth.

On the inflation side, I am just a touch more optimistic, perhaps, that we will be able to keep inflation under control. Here I guess my main difference comes from what I view as a real change in business behavior--not in all business behavior but in the behavior of a number of significant businesses--in that they are finally addressing the efficiency question. They are really trying to skinny down. I just heard of one request by an organization that is working with its suppliers over a five-year time horizon and telling them that in order to be assured of business in this period ahead, they will have to agree to cut their prices, not increase them, by one percent per year over the next five years. That's pretty hard bargaining. And I think a lot of things like that are going on that have mainly resulted from the intense import competition. I think it has been a [unintelligible] factor. I certainly can't put an exact number on it; I don't pretend to know. But I think that that kind of behavior is going to help us keep these inflation numbers looking better than they otherwise would.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Mr. Chairman, I didn't hold up my hand, but--

CHAIRMAN VOLCKER. Well, I got your name on a piece of paper and I will delete it if you don't want to say anything.

MR. GUFFEY. Well, I think that since I am about the last [speaker], I will say something. Our forecast is very much like the Board staff's on the growth side; we are a touch higher on the inflation side. If one were to make a forecast from the Tenth District perspective, none of those figures would be very satisfactory; they would be much more pessimistic. On the forecast itself, the growth is largely dependent, as everybody has already noted, upon the turnaround in the net export sector. If that occurs, then growth much as we experienced in 1986 seems to me to be quite reasonable. On the other hand, on the price side it seems to me that our foreign competitors' import prices will have to rise since their profit margins have been squeezed over the last year and a half as the dollar has declined vis-a-vis their currencies. And that should start to show through together with an increase in imported oil prices. If that were to occur, and as that is passed through, it would seem to me that inflation would be a bit higher than we experienced last year. Having said that, I think it is noteworthy, as Governor Heller mentioned, that the CPI--which will incorporate those higher import prices--quite likely will be in the 4 to 5 percent range. And it's going to take some explanation, I guess by the Chairman, of the contrast between the slow CPI numbers posted in 1986 with what likely will happen in 1987 and why this may not be all that significant--why it looks very high and should [not] give us all cause for concern.

CHAIRMAN VOLCKER. I agree with you. I am willing to explain something about the forecast--up to 3.9 percent. When it gets above 4 percent, it may get a little difficult to explain.

MR. GUFFEY. That's the reason they pay you that big money, Mr. Chairman! In summary, our forecast is very close to the Board staff's forecast with the exception that we think prices may be a touch higher.

CHAIRMAN VOLCKER. Governor Johnson, a benediction here.

MR. JOHNSON. I will try to be brief; just about all of the issues have been covered. Like Jerry, I just got back from Basle and, after talking to the other G-10 governors, I am a little less optimistic, I think, than I was when I left.

VICE CHAIRMAN CORRIGAN. Just remember what you did to them the last time you were there!

MR. JOHNSON. I'll admit to being the guilty party among the Board members who estimated the higher real GNP growth rate. I have been looking at the numbers, and I have been fairly impressed with several months of fairly good data. There are some end-of-the-year problems there, but I think there is enough evidence to say that things are starting to pick up. The staff's forecast on the trade deficit is looking pretty good. As I said, I was even more optimistic before I left to talk to the Germans and Japanese about it, so maybe I would cut that back a little now. But I do think things are looking better. On the tax side, I will make one point: one reason why demand may hold up a little better than some expect is that some people, I think, are overestimating what tax reform is going to do. There was a big surge to avoid the elimination of the sales tax deduction at the end of the year. I went back and checked the law and found that you really don't lose the sales tax deduction unless it's a special sales tax item. Any generalized sales tax is still deductible--at least that is what it says in the books. If you calculate your sales tax from the state tax tables, you can still deduct it.

MR. BOEHNE. I don't think that's right.

MR. JOHNSON. Well, I went back and from what I could see it's still there.

CHAIRMAN VOLCKER. We will have somebody look into this over night.

MR. BLACK. I sure hope you are right.

MR. JOHNSON. It will be interesting to know because that's what the accounting firms say in the books they put out.

CHAIRMAN VOLCKER. Well, I don't think we have to resolve this right now.

MR. JOHNSON. No. I am just saying that it's interesting. A few people may find that their deductions--

MR. MORRIS. I have looked in two [publications] that said exactly the opposite.

CHAIRMAN VOLCKER. If they can ever fill out their W-4 forms.

MR. MELZER. A good point along those lines, Manley, is that the withholding went down for a lot of people and a number of retailers, particularly the ones that compete on price. I view that as a real positive.

MR. JOHNSON. A lot of the interest deductions are being phased out, so it's not really a big hit all at once. That issue aside, I am reasonably optimistic about a turn in trade but it may not be as strong as I originally had thought because I am a little gloomier about the growth prospects abroad. It's going to be interesting to see.

On the inflation side, I am a little more pessimistic. I have marked up my estimate about a percentage point, I think, from last July but that's basically a function of the oil picture as much as anything. The nominal inflation picture doesn't look that bad to me. There will be some pressure from import prices. But looking at the wage situation and the shift toward manufacturing--so at least there is some productivity away from the service area--I think it's going to be a little better. So, I am fairly consistent with the staff on the inflation forecast but I do think we have to be extremely cautious in that area. I agree with everyone else here that the psychology seems to be tilting the other way a bit. What's been happening in the financial markets with the dollar and some of the nervousness in the bond market should be watched very carefully. That's about it.

CHAIRMAN VOLCKER. That ends today's session.

[Meeting recessed]

February 11, 1987--Morning Session

CHAIRMAN VOLCKER. We can proceed with Mr. Kohn this morning and discuss the long-run ranges.

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

CHAIRMAN VOLCKER. I think we probably ought to turn to M2 and M3 first and see whether we can resolve those. But I have one question, just to isolate it, on M1. If I understand correctly, you're saying it's a matter of judgment but, for what it's worth, you're reluctant to say that growth would be less than 10 percent for M1; however, the model shows half of that.

MR. KOHN. The model shows rates on the order of 5 to 7-1/2 percent for M1 for 1987.

CHAIRMAN VOLCKER. You just don't believe your models.

MR. KOHN. That's correct. Some of these models showed rates only a little above that for 1986. Others were closer to the mark but implied such a marked slowdown, especially in the OCD component, that I have trouble believing them.

MR. JOHNSON. You have to put in a set of interest rate assumptions to make it--

MR. KOHN. No, these model results are based on the interest rate assumptions behind the Greenbook forecast--that is, essentially very little changed.

CHAIRMAN VOLCKER. Yes, but growth greatly exceeded what they said for last year. Is that before or after the actual declines in interest rates that took place last year?

MR. KOHN. Even after the actual declines in interest rates, several of the models underpredicted money growth last year. Our quarterly model didn't do too badly; it was under by about 2 to 2-3/4 percentage points--that is at about 12-3/4 percent.

CHAIRMAN VOLCKER. And that model shows what for next year?

MR. KOHN. That model shows about 5 to 6 percent, depending on the assumptions about offering rates and--

CHAIRMAN VOLCKER. We will return to M1, but it's more productive to look at M2 and M3 first as we did last time. Does anybody want to say something about M2 and M3?

VICE CHAIRMAN CORRIGAN. Alternative II is for me for M2 and M3.

MR. JOHNSON. Alternative II is all right with me, too. But I think it's important to give some signal that we're moving toward a little more restraint on the broader aggregates; at least, that is consistent with continuing to try to keep inflation suppressed. And I think there is enough room in that target to allow for that in a fairly significant way. Given what M2 did last year, with an explosion in M1 and the decline in interest rates, it doesn't seem that it's that sensitive. So, I think alternative II would be able to handle just about any event.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. I prefer alternative II also. It would seem to me that the accommodation of 1986 is not as apt to occur; so 8-1/2 percent, even under a declining velocity scenario, does give us an equal opportunity to snug up a bit. But I do think, as we proceed with alternative II, that this year we should be aware of the fact that market forces are even more important. That is, if long-term bond rates and intermediate bond rates were to rise, it seems to me that, given the problem with the dollar, we ought to be particularly sensitive to those interest rates--on the down side also. I want alternative II with a proviso that interest rates ought not to be managed by the Fed much differently than the market forces would indicate.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I like alternative II, but I get there by asking myself the question: What kind of a message ought we be sending? Monetary policy has largely been on a one-way street toward ease over the last two or three years, particularly last year. I think it's time to send the message that monetary policy operates on a two-way street: There are circumstances in which we might loosen some more but there are also circumstances in which we might tighten some more. And I think alternative II does send that two-way street message.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I don't really see a great deal of difference among these various alternatives but, for psychological reasons, I would prefer alternative II. I think it is important that we send a signal to the public and to the markets that we are continuing to observe inflation. That will be particularly important this year and next year if the estimates of increasing inflation are accurate, which I think they are. So, I would prefer alternative II.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Mr. Chairman, I would favor alternative II as well. And I would make a suggestion as far as sending a message about the commitment to price stability. Some work that we've done indicates that it's quite likely that M2 will grow at the lower end of this range and, from reading the Bluebook, I got the feeling that some of the quantitative work the Board staff has done would suggest that as well. It seems to me that one thing we could do is have 5-1/2 to 8-1/2 percent for M3 and 5 to 8 percent for M2. That change, as far as M2 is concerned, would represent a full percentage point decline from what we had in 1986. And I think that would send a message.

CHAIRMAN VOLCKER. Would you? Which way did you have this? The 5-1/2 percent would be for what?

MR. PARRY. Have M2 at 5 to 8 percent--

CHAIRMAN VOLCKER. M2 at 5 to 8.

MR. PARRY. And M3 at 5-1/2 to 8-1/2 percent. Some of the work that we've done would support that and--maybe Don can comment on this--I think some of the quantitative work the Board staff has done suggests that M2 would grow in the low end of the range.

CHAIRMAN VOLCKER. Let me just pin that down. I read the opposite someplace--maybe you had it--that M3 would grow less than M2.

MR. PARRY. No, no.

MR. KOHN. Actually, that was our judgment given what we expect for bank and thrift credit growth, which tends to drive M3 because of the managed liability component; we expect that to decelerate substantially. We had M3 at 7 percent or a tick below, between 6-1/2 and 7 percent. M2 at 7 percent was judgmental. Mr. Parry is absolutely right in the sense that our quarterly model, as I tried to indicate in the briefing, was showing something on the order of 6 to 6-1/2 percent for M2 growth, which is in the lower end of the range. I think his model is showing more like 5 to 5-1/2 percent.

CHAIRMAN VOLCKER. This is between models and judgment. Governor Heller.

MR. HELLER. Well, I'm in favor of alternative II but now you've got me a bit confused. First of all, let me remark on the short-run alternatives. I realize we may want to discuss it later, but the target for the first three months is rather high. It's at the high end of the range for M2 and the lower end of the range for M3. I think that's what Chairman Volcker was just talking about. But San Francisco also got me confused. You are in favor of discount rate cuts yet you want to have a tighter monetary target?

MR. PARRY. I don't vote on the discount rate.

MR. HELLER. I'll stick to alternative II.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I would definitely not favor alternative I. The choice, in my view, is between "II" and "III". We have established a pattern over the last few years of reducing the range on a yearly basis and alternative I would certainly break that. Between alternatives II and III, I see no particular reason not to choose alternative II, which we adopted [on a tentative basis] last summer. Certainly, there seems to be an expectation that we can hit that and alternative III might suggest a change in policy that we don't really intend at this particular point. So, I'd end up with alternative II.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I'd be reluctant to reduce the ranges a full percentage point as alternative III suggests, and I think we'd risk confusing the market if we went with alternative I. Besides, I think the staff has made a good case for alternative II as encompassing, probably, all the reasonably likely behaviors that we might see in velocity of M2 and M3. So I can go with "II" like everyone else.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. I'll try to keep this short: alternative II.

MR. BLACK. Well said.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I vote for alternative II as well. One thing we ought to keep in mind is that the elimination of IRA accounts is likely to drive up M2 relative to income. That's why I'd be concerned about moving the M2 target down to 8 percent. We may need a little more room for that. The Bluebook says you don't expect much effect in 1987; I'm not sure why you feel that way.

MR. KOHN. Well, I agree with you on the direction. The question is the magnitude. Our feeling was that we might have stronger inflows early in the year both from people who might have postponed putting money in last year, partly because of all the uncertainty with the tax law, and from people who wanted to make sure they took full advantage of their ability to use IRAs under the 1986 law since it was going to be the last chance. Flows later in the year would indeed be lower, but this might be offset by the--

CHAIRMAN VOLCKER. You can still put money in an IRA for last year, can't you?

VICE CHAIRMAN CORRIGAN. Yes.

MR. KOHN. That's correct--through the 15th of April.

MR. BLACK. Up until April 15th.

MR. MORRIS. The last one.

CHAIRMAN VOLCKER. I don't see why it should affect this year much; it may affect 1988.

MR. MORRIS. But in 1988 it clearly would be a factor.

MR. KOHN. Yes.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Alternative II.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. I don't see a big difference, frankly, between alternatives I, II, and III. We're talking about 1/2 of a percentage point between each one. When we discussed this last summer in July, one of the points I made when I opposed changing from the ranges we had for 1986 was that I didn't think we had the predictive tools to come up with these fine gradations of economic impact. Six months have gone by and I guess I'm still not convinced that we can readily say with great confidence that there's going to be a major difference in impact on the economy with "I" versus "II". So that leaves me with the psychological side. I guess if you think that this is the kind of thing that will send a big message to the world out there that we're tough rather than weak on inflation--I happen to think they look at a lot of things and not just our ranges--I could reluctantly go with "II". But I still think a more honest presentation would be just dealing with round numbers, say, 6 to 9 percent.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I favor alternative II as well. For what it's worth, our model suggested that M2 growth would probably turn out to be near 8 percent in the year ahead. But our model also has a somewhat stronger picture of the economy than the Greenbook forecast; if you were to plug in something akin to the Greenbook forecast I think you'd get something comfortably within that alternative II range for M2.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I would also favor alternative II. I don't have a great deal of faith in M2 or M3 as a guide to policy. If you look back over the history of M2, for example, over the last 5 or 6 years it has varied between 8 and 9 percent except, I believe, for 1983. Many things have happened--policies have changed, interest rates have dropped--and still growth comes out to be 8 to 9 percent. As a result, it doesn't seem to me that it's a very reliable guide.

CHAIRMAN VOLCKER. Like M1.

MR. GUFFEY. We expect to see--

MR. BLACK. All guides are unreliable; some are just more unreliable than others.

CHAIRMAN VOLCKER. Mr. Hendricks, do you have something to add from Cleveland?

MR. HENDRICKS. We also believe it would be appropriate to adopt the same ranges for 1987 that were set in July, so we would favor alternative II.

CHAIRMAN VOLCKER. Well, we seem to have great unanimity. I, personally, could make a case for alternative III. I thought the Bluebook set that out rather convincingly but I won't make the case. Alternative II is obviously the easy thing to do; it's a nice compromise. I interpret this to mean, without being very rigid about it, that we expect growth to be someplace in the middle of the range; this time it's a target set reasonably symmetrically around where growth should be.

Let us turn to M1 with this caveat--that if we wanted something like variant I [in the Bluebook], which I think has some informational content, I'm not crazy about the particular language proposed. I think it needs a little work, and I'm a little reluctant to rewrite it in detail right now rather than during the break. I haven't got another proposal to put in front of you, if we end up with that one. I'm making an assumption that we're going to end up there, which may be wrong. I think we ought to discuss it. But if we think something like variant I is correct I would just defer final consideration until we get some possible modification to the language in front of us. It would be along these lines, but not precisely this language. I may be wrong about whether that's where we'll want to end up, but let's see. We're open for discussion on M1.

VICE CHAIRMAN CORRIGAN. I'll try. And this is going to muddy the waters right off the bat, so I apologize.

CHAIRMAN VOLCKER. Well, after all--

VICE CHAIRMAN CORRIGAN. Just looking at it in terms of variant I and variant II, predictably, I come out somewhere between the two. I don't think I have to restate the reasons why that's where I am. But I would like to suggest that at least we start out with something like the first sentence in variant I.

CHAIRMAN VOLCKER. That would be the part in the first bracket or something?

VICE CHAIRMAN CORRIGAN. No, the first sentence. And then put in something like this: "Looking to 1987, in the context of moderate economic growth, continued moderation in inflationary forces, and absent major changes in interest rates and exchange rates, the behavior of M1 relative to income and prices might return to more normal relationships. In those circumstances, growth of M1 in a range of 4 to 8 percent--or 3 to 8 percent or 3 to 9 percent-- would be appropriate." Then I would say: "Because of the continuing uncertainties, the Committee decided not to establish such a target at this time, but would be prepared in appropriate circumstances to reestablish such a target range." Now it stops short; clearly, it's not a target. I don't even really think of it quite as a monitoring range. Nevertheless, we have a couple of numbers there in a context of an economic scenario. And we're saying that, in that context, those numbers mean something. So I think of it as a combination of "I" and "II".

CHAIRMAN VOLCKER. That's all you would say?

VICE CHAIRMAN CORRIGAN. Well, we'd have all that other stuff.

CHAIRMAN VOLCKER. All what other stuff?

VICE CHAIRMAN CORRIGAN. Some flavor of the language at the bottom of Don's current variant I. In other words, put in some of this language here that would deal with what we would do--meaning probably nothing--if one of those assumptions were widely off the mark. Clearly, if the exchange rate fell out of bed, signals would be off. If the economy were very sluggish, signals would be off. I said it would muddy the waters.

MR. MORRIS. This assumes that we know what the normal relationship of M1 to income is.

CHAIRMAN VOLCKER. Yes, I have great doubts about that. Mr. Morris, we'll let you talk.

MR. MORRIS. I think we still persist under the delusion that there is a normal relationship between M1 and nominal GNP that is going to reassert itself at some point. The mistake in this kind of thinking is that this is a brand new aggregate. It's not like M1 was; interest is being paid on these deposits. And I think it's going to be a number of years before we know what the normal relationship of this new aggregate is to nominal GNP. So I still think it just does not make sense to set a range, given this level of ignorance about this new aggregate. I don't think we know any more about it now than we did last year and we had a miss of more than 7 percentage points. I think that's a testimony to the fact that this new aggregate, which we call M1, has behavioral characteristics that it's going to take us a long time to understand. To set any kind of a range for it for 1987 would be a mistake.

CHAIRMAN VOLCKER. In general, you like the kind of language that's in variant I?

MR. MORRIS. Yes.

CHAIRMAN VOLCKER. Let me just make the case for this because, as I obviously indicated earlier, this is the way I'm leaning. I think we ought to take M1 seriously in a sense--in a certain economic context that isn't fully predictable--and we ought to tell people that. We can't be very precise about the numbers. But I think it is saying something. We could say: If inflation is building up or the dollar is very weak we would expect M1 to be quite low and that would be appropriate. In other circumstances, we would expect it to be quite high without getting worried about it. That is saying something. We ought to try to say something about it and if muddies the waters--. It seems to me that to suggest some normality over a very wide range doesn't mean much.

MR. JOHNSON. What you're basically saying is that if velocity starts to rise we need to pay attention to it. If it goes down we don't.

CHAIRMAN VOLCKER. Well, one way of putting it is that we would expect velocity to rise under certain circumstances or we might even force it to rise, in a sense, and that would be entirely appropriate. What we really want to say is: You shouldn't be surprised by a low M1 number; on the other hand, we wouldn't get concerned in certain circumstances about it remaining high. I'm not sure what sticking a number in there that we don't know much about adds to that. We end up with a range so wide that it's meaningless. What we really want to say is that we think a low number would be appropriate under certain circumstances and we think a high number would be appropriate under other circumstances. But we've got to describe the circumstances in which that would be true. It gets complicated, and that's what makes writing the precise words difficult. But I think that's the sense of what we ought to say.

MR. KEEHN. Would you go on in those circumstances to suggest that if certain events transpired that, at a later date, we would think about a range?

CHAIRMAN VOLCKER. Well, I think we could say that more generally. It's hard to put it in the directive. I think we could put in a sentence later on. I don't know what we would say because I have some sympathy for Mr. Morris' point that if it's going to be very interest-rate sensitive we're always going to be saying that it's going to be high or low depending upon the trend in interest rates. And I'm not sure what that's saying. I guess the point we ought to make is--we can't put this all in the directive but we could put it in the other discussion--that we have a much more highly interest-sensitive aggregate here. And the message we ought to be emphasizing is that, depending upon circumstances, M1 might vary widely into the extended future based upon what we know now.

MR. ANGELL. I think that's an excellent way of doing it. It seems to me that in a reemergence of an inflationary environment in which interest rates were trending up the range should be as low as maybe 2 to 6 percent. On the other hand, if deflationary forces were to pick up speed again and we had this demand for financial assets it might very well be that 8 to 13 percent would be right. Whatever the case, I think it ought to be less than last year. But I like the suggestion. I think it would be appropriate for us to suggest that since we've had a period in which M1's growth has been very, very strong, we realize that there must be another period in which M1's growth path is indeed going to be below what we would ordinarily expect it to be.

CHAIRMAN VOLCKER. That is part of my concern. We may well run into such a period whether it is this year or not. But we're [not] going to want people jumping off wildly if M1 is very low for a while because it might be entirely the reflex of what we've had in the past and be entirely appropriate. On the other hand, I don't want to give Mr. Proxmire too many hostages--just to name one, that we think it's a disaster that it has been as high as it has been under the particular circumstances that have prevailed to date.

MR. ANGELL. If M1 growth were to be low and deflationary forces were to pick up again and the dollar was not weak, that's another matter.

CHAIRMAN VOLCKER. That's the way I see it. I just don't see that you add much by putting in a figure which could be exceeded in either direction from an already large range.

VICE CHAIRMAN CORRIGAN. As I hear this, I think the difference between what you're saying and what I said is a fairly narrow difference, because all I was trying to say is use a number to indicate where we thought M1 might be if everything were, in a sense, working right. In other words, if the economy were growing at a reasonable rate and nothing was happening on inflation, exchange rates, or interest rates, this is a kind of central tendency where we think M1 will come out. But if any one of those conditions is not present, M1 could come out way above or way below it.

CHAIRMAN VOLCKER. I'm not arguing that the difference is huge. This is an extreme example, but suppose we really thought the situation was such that inflationary forces were picking up, the economy was at the high end of all the ranges of projected growth, and the dollar was weak--we put in all these assumptions--and M1 really came out very low for a few months, anyway. I'm not sure I want people hollering at me that we have a range that is 4 to 9 percent or something and the middle of that is 6-1/2 percent and M1 is only coming in at 4 percent and saying oh my heavens [policy is] way too tight! Because I'm not sure it would be way too tight.

MR. ANGELL. But under some circumstances it might be way too high because if we come down the demand curve for money with interest rates falling, if interest rates were to rise it has to hold that our growth path would have to be much, much less than we normally would have thought.

MR. JOHNSON. Well, I think that's the problem--it would change that interest rate differential even if we hadn't acted to change short-term interest rates because of inflationary expectations affecting the long end; we could get a decline in the aggregates or a slowdown even if we hadn't tightened at all. And we might want to tighten, and everybody would think that we had.

MR. ANGELL. Yes. Or, if we had not accommodated last year and the discount rate were still at 7-1/2 percent, it seems to me that we would have had a macroeconomic result of a lower real GNP growth path than we had and we still would have had dramatic declines in velocity.

CHAIRMAN VOLCKER. Well, does somebody else want to add to this? Mr. Melzer.

MR. MELZER. Basically, I like this language or the concept of it. I might just suggest an extension to what you've suggested. What you have suggested makes a lot of sense. In general, I have some problem with the signaling effect of abandoning a narrow aggregate altogether. As I said at the last meeting, I'm not sure that we have the right one in M1 as it is now. Also, I'm not sure that we can really pick another right one right now. I think we have to let this unwinding of inflationary expectations that's been in process sort of run its course. I don't think any of us is confident that it has done that, so I don't think it's a good time to pick another narrow aggregate. Roger Guffey commented before, and I agree with him, that what we do with respect to M2 and M3 doesn't have much of a signaling effect at all. I'm afraid that not setting any target at all for M1 could potentially have a negative signaling effect. And as you've observed, Mr. Chairman, it could have a negative effect on Mr. Proxmire. I would suggest that we consider setting a target along the lines of what Don suggested based on what we know now. We could set a target range for M1 of, say, 7 to 13 percent, but with language surrounding it indicating that we might miss that on the up side or the down side. Now, when I thought about this, I was concerned about what the implications of that might be. But if we add to that the kind of language that's in variant I with respect to missing that substantially on the down side--and also recognize that we've got to approach this target flexibly and we ought to be prepared to change it--I think that there's some advantage to having the target out there. As I said, not having a narrower aggregate--which is what we can really exert some control over based on our behavior and what we do with reserves--could send a negative signal. What you're suggesting could potentially be misread in the other direction as well. The 7 to 13 percent range certainly puts out a clear message in the market that we expect the very rapid growth rates in money that have occurred in the last two years to come down. We expect, and intend in a way, to commit ourselves under certain circumstances to bring those down.

CHAIRMAN VOLCKER. Boy, 7 to 13 percent sounds to me--and this is part of the problem--wildly high in terms of sending out a message right now. It may not turn out to be.

MR. MORRIS. And the 7 percent could turn out to be much too high.

MR. MELZER. Oh, I understand that.

MR. ANGELL. But I thought Tom Melzer was saying that 2 to 6 percent under certain circumstances might be the right range, but 7 to 13 percent under other circumstances might show restraint compared to what happened in 1986.

MR. BOEHNE. Well, I think putting a number--

MR. MORRIS. It doesn't sound very restrained to me.

CHAIRMAN VOLCKER. That is precisely the trouble. If we talk about a range that high I don't know what we can say. We have a problem with what we say if we use something like variant I. It could be misinterpreted; I have no doubt about that. A lot depends upon what we say. My own gut feeling is that, ideally, by putting it in a more realistic context we're putting more weight on M1 than by putting out a target like 7 to 13 percent and saying it may go below it or above it.

MR. MELZER. In a way, with inflationary expectations on the rise right now, somehow I would like to see the message out there that we've noticed that.

CHAIRMAN VOLCKER. But 7 to 13 percent doesn't give that message to me.

MR. JOHNSON. I think something like variant I in combination with ratcheting down M2 and M3 at least gives that signal.

MR. BOEHNE. I agree with that.

MR. JOHNSON. It conveys that message.

MR. BOEHNE. Yes, I agree with that. I think putting a number in gets in the way of what you're trying to explain.

CHAIRMAN VOLCKER. That's my point.

MR. BOEHNE. People are going to have to think a bit about the implications of what is in variant I. If we put a number in there people are going to look at the number and forget about what we're really trying to say. That's why I like variant I without a number.

CHAIRMAN VOLCKER. You have expressed my gut feeling. I think that we send a better substantive message without a number--and we don't know what the number means anyway.

MR. MELZER. Okay, if you accept that part, how do you get away from the fact that we're walking away from a narrow aggregate target at all? It's not that M1 is the right one, but how do we get back into that ball game down the road?

CHAIRMAN VOLCKER. Well, I don't interpret it that way. Given all the difficulties of explaining this, that is not my feeling. Unfortunately, the fact of the matter is that we are in a situation where we can't interpret M1 in terms of anything like an appropriate growth rate. So we're going to be very vague anyway.

MR. JOHNSON. If it's as interest sensitive as it appears to be--

CHAIRMAN VOLCKER. We can't evaluate M1 without taking account of what's going on elsewhere, and that's what we ought to be telling people. We want to take it into account but only in the context of specific economic circumstances. And that's what we ought to be trying to tell them.

MR. ANGELL. Tom, doesn't that say more precisely that if we return to a period of inflation actually being there--and with the behavior in regard to preferences for financial assets waning--that we would then expect to come in with some rather conservative numbers?

MR. MELZER. Yes. As long as abandoning the concept of setting a target does not take away the fact that we think it's important to pay attention to what M1 does and that it has to be evaluated under certain circumstances, that's fine. As a matter of fact, on that point I asked our people to look at what would happen if velocity went back to what it was--roughly a level of 7 at the beginning of 1982--over a two-year period. If that were to happen, based on the liquidity that's in there, we could have roughly 5 percent nominal GNP growth each year without adding any more money.

MR. ANGELL. That's right. Zero would be appropriate.

MR. MELZER. I'm very sensitive to the problem on the down side. I just also am very concerned about the signaling effect--making sure that the message out there is that we can't set a range but we're paying close attention to this narrow aggregate in the context of what's going on more broadly.

MR. JOHNSON. If M1 is really symmetric, interest-sensitive wise, we could be sitting around trying to ignore 2 percent M1 growth--

CHAIRMAN VOLCKER. Exactly.

MR. JOHNSON. --when the economy was growing, just like we're trying to ignore 15 percent now when the economy is sluggish. I think that lends some weight to what Bob Black has been talking about--more of a price rule. I'm not sure how you do that either, but in a period like this it seems to me that we have to be more sensitive to some sort of price signal.

MR. ANGELL. It also supports what President Morris has been saying, and I think he's right: that we haven't seen all of the reshuffling that will take place under the deregulated environment that we're in. But at some point in time, those savings accounts are going to get reshuffled with the transactions account to the extent that they're going to be. And I think that--

CHAIRMAN VOLCKER. I think it's quite specific. What I think we ought to be able to say when we are attacked [and accused of] being wildly expansionary now and building up inflationary pressures and all the rest, is: Look, [we will act] if we see evidence that that's true, which we haven't seen heretofore with the weights, trends, and a lot of other things. But we recognize all those dangers. We agree with you that we couldn't keep feeding out M1 like this and we ought to be prepared, and you ought to be prepared, to see M1 level off rather abruptly under those circumstances. We contemplate that under that particular set of circumstances. On the other hand, if there are no inflationary pressures, and the economy is weak, and we haven't got any particular dollar problem, and we have not seen the dangers of this kind, and M2 and M3 are behaving all right, then we don't think your criticism that we're unduly easy is valid.

MR. ANGELL. Would you want that check list to be in there?

CHAIRMAN VOLCKER. Yes. I think we have to be quite careful about how we put it in there--that's why I have some quibbles about this language here--but that's what I want to convey.

MR. ANGELL. Yes, it seems to me that we do need to draft that [unintelligible] because we need to indicate what might occur in that check list that would bring back these M1 targets in a meaningful way. The market has to expect that, if those things occur, we will act. Of course, if the market believes this and those things start to occur, then we're going to have a market forced interest-rate response based upon that expectation, and we will have achieved our objective.

MR. MORRIS. I think a 7 to 13 percent range would be telling the market that we don't intend to push interest rates up this year no matter what happens, because as soon as there is a little rise in interest rates the growth of M1 has got to swing pretty rapidly.

MR. BLACK. Mr. Chairman, I think this variant I as you've suggested is really the one that we ought to use for the reasons that you indicated. I was inclined to be sympathetic to Jerry Corrigan, but you made some pretty tough points on that. At the same time, I think Tom Melzer has a point, too. In a period when the risk of inflation seems to be increasing and the risks of [rising] inflationary expectations also are increasing, there could be concern about the dropping of M1 [as a target]. That's the reason, really, that we put forth that idea of putting an inflation target in there to reassure the public that we had not lost our determination to deal with inflation.

CHAIRMAN VOLCKER. Well, a lot depends upon the language that we use in the testimony and so forth. I would see at least as much danger there. It will be delicate to write it. I could easily write this in a way that locked us in more than we might want to be locked in to a lowering of M1 if we saw any sign of increasing inflationary pressures. I don't want us to be locked in too much either.

MR. ANGELL. Well, I think we should create that expectation.

CHAIRMAN VOLCKER. I think people have to be warned. My principal concern is that we should warn them that under those circumstances, which may or may not eventually occur, we expect a pretty low M1.

MR. ANGELL. And I think a continued depreciation of the dollar should be included among those.

MR. MELZER. The question is the difference between expectations and actions, too. It may go beyond just expecting it; we might be prepared to take steps to achieve it.

CHAIRMAN VOLCKER. Sure.

MR. MELZER. That is the desirable aspect of a narrow aggregate [target] because we can affect its behavior.

MR. PARRY. If it's written with that warning, the fact that we dropped a specific range won't be interpreted as meaning that we're dropping M1 as something of significance or potential significance in the future.

MR. ANGELL. And it avoids this problem of where we would start off the year if we used any M1 range. Where we would start off the year when we're so far behind in the cone? We'd have that problem to look at.

CHAIRMAN VOLCKER. I visualize, in just describing policy as the year progresses, that if we put in some range, we'd be stumbling all over ourselves to say there's a range but it doesn't mean anything under certain circumstances. I don't think that does us any good.

MR. ANGELL. What we'd be saying, I presume, is that at a future FOMC meeting we might announce a short-term target range for M1. It might be the case that that would even be announced prior to the next FOMC meeting, in some circumstances.

CHAIRMAN VOLCKER. Yes, I don't think that would exclude that at all. I haven't thought about that, but I think that's right--that in particular circumstances as the year progresses we might want to stick in an M1 target. And I think we can even say that.

MR. MELZER. Well, that goes a long way in addressing my concern.

CHAIRMAN VOLCKER. I'm not saying that I can't anticipate the situation in which we would do that, but--

MR. MELZER. Right.

CHAIRMAN VOLCKER. But I think we can certainly say that in certain circumstances we might, in the short run, name a target for M1.

VICE CHAIRMAN CORRIGAN. To put this in a slightly different context: If you took the sentence in variant I that people are focusing on and the Committee decided not to establish a range--not a target, not a monitoring range, nothing--it's as though we're putting M1 lower on the ladder than debt. That's the danger.

CHAIRMAN VOLCKER. Operationally, I don't think it has to be interpreted that way.

VICE CHAIRMAN CORRIGAN. I agree with that, but that's the danger.

MR. ANGELL. But the language should be changed. The language should be changed to say that and [to indicate] the circumstances under which M1 will be established rather than that we're not establishing it.

MR. STERN. Well, if we have a full paragraph devoted to M1, I doubt that people will view that as downplaying the significance from where it is.

MR. FORRESTAL. I think we need to be clear in this discussion that we're not really abandoning M1. I don't interpret this language as doing that. In fact, quite the contrary. This does indicate that there will be continuing observation and surveillance of M1. And I would think that, as the Chairman has indicated, the market would respond favorably to this because I think basically now they're just ignoring M1 completely. In this variant I, no matter how we change the language, the thrust of the language is important to get out to the market. I think that this really is just going to be a confirmation of past events and that they'll respond favorably. I don't interpret this at all as being an abandonment completely of M1 nor do I think, if the language is done correctly, that it puts M1 lower than the debt aggregate.

MR. JOHNSON. Well, I like variant I with maybe a proviso that we might bring M1 back on an intermediate-term basis if we need it and if conditions arose.

MR. GUFFEY. I have a little problem with the thought that we would, at a particular meeting, resurrect M1 for some limited period of time or forevermore. I don't think we know enough about it to do that unless we got into a real bind in which we needed to call upon M1 in order to move interest rates to 20 percent. I wouldn't want to use--

MR. JOHNSON. I don't think it's very likely that we would.

CHAIRMAN VOLCKER. I don't think we're going to move to 20 percent, but I can visualize a circumstance--suppose M1 were rising rapidly and some of these were moderating at a time when we were increasingly worried about inflation and saw some signs of the economy doing pretty well and, say, we wanted to tighten up. In that context I could well see a change in the particular arrangement we're doing.

In the Committee's operating directive presumably we'd say we're putting more pressure on reserve positions and the Committee is looking toward a slowdown in the rate of growth of M1. I can quite see that.

MR. GUFFEY. That's a bit different than establishing a target for an intermediate period.

CHAIRMAN VOLCKER. Well, we might want to say the Committee is looking toward a slowdown to no more than [unintelligible], if we felt strongly enough in a particular circumstance. There's some variance between putting in 7 percent or 5 percent or something and saying we're looking for a clear slowdown. And all those [options] are open to us.

MR. JOHNSON. What would you say if the long end of the bond market had been deteriorating because of building inflationary expectations from a decline in the dollar or something like that and M1 was already decelerating quite rapidly because of the change in the interest rate spread. I don't know what you should say.

CHAIRMAN VOLCKER. We welcome the slowdown in M1 under the circumstances.

MR. JOHNSON. But we may want to tighten under those circumstances and yet M1 is decelerating sharply.

MR. ANGELL. But under those circumstances M1 is going to slow down later. Bond buyers are not going to be very pleased by that circumstance and rush into long bonds until they think the recession is tightly--

MR. JOHNSON. We might see a rush out of liquid balances--if there's an interest sensitivity there--into CDs fairly quickly; I don't know. When that change in interest rate spreads develops and all of a sudden M1 starts falling quite sharply, that would have an expectational effect on the long end.

MR. ANGELL. I always wished that the bond buyers would behave that way, Manley, but I never found that they did. Once interest rates start up on the short end bond buyers get scared that it's going to continue. So it takes a while before that response--

MR. JOHNSON. Well, that's their response to a tightening move. I think that you can see bond buyers move on inflationary signals without moving the short rates at all.

CHAIRMAN VOLCKER. Does somebody else want to add to this discussion?

MR. HELLER. I think the bottom line still is that we have no idea what the demand for money function looks like. And to put in a quantitative target--

CHAIRMAN VOLCKER. I think you're overstating it a bit. In precise terms, I agree with you. But I think we do have a sense that it's very interest sensitive.

MR. HELLER. Yes, but there are a lot more factors in it too. There's the whole deregulation angle still in it. And, as Mr. Morris said earlier, that makes it very difficult to do. The one trouble I have with the different economic scenarios in defining the alternative growth path is that if you mention the dollar--if the dollar should go down or if the dollar should do this--you're hooking yourself.

CHAIRMAN VOLCKER. The trouble is there are too many "ifs". I agree, but I think all we can do is give some sense--

MR. HELLER. But what are you going to do if some senator then says: Well, what do you expect the dollar to do? And what will you do if the dollar goes down by 10 percent? And then what if it should do this? That's--

CHAIRMAN VOLCKER. We're going to have at least three variables and, fortunately, they're not all likely to be moving in the same direction. We have growth, inflation and inflation expectations, and the dollar. And it leaves us open to all kinds of questions. If growth is weak but inflation is strong and the dollar is mixed, what do you do? Those questions are just unanswerable.

MR. HELLER. I trust you can dress it up well in the testimony. But I think one of the things we really should do is redouble our efforts to study M1 and the proper definition of M1 so that we will be able to sort out some of those behavior patterns. Maybe we'll be able to do that in a better way than we're able to do it right now. In any case, I would avoid setting a figure for M1 growth.

CHAIRMAN VOLCKER. Let me say if we don't set a figure, presumably we will say, in some words, that we're not going to establish a range for the year as a whole at this time--which is what this says. Probably some general language that we expect it to be lower this year than last year is appropriate. And then we give some clear flavor about the conditions in which we would expect it to be either high or low without being definitive about it. Those are the essentials we want to get in this paragraph.

MR. MELZER. And the idea that it might be or could be targeted [later].

CHAIRMAN VOLCKER. And at a particular time during the year, the implication is that we may specify a target. Those four thoughts somehow we should get in the paragraph. I know that's pretty vague. We'll come back with [specific] language; I think it needs a little massaging. Is that acceptable, generally?

MR. GUFFEY. I assume also that this M1 performance would be evaluated in view of the other aggregates that we have set targets for.

CHAIRMAN VOLCKER. Yes, that point would be made. The context in which rapid or slow growth would be appropriate would depend upon the other aggregates.

VICE CHAIRMAN CORRIGAN. Let me see. I think I've got five points. You have four, you're saying?

CHAIRMAN VOLCKER. You can get but so many in the paragraph.

VICE CHAIRMAN CORRIGAN. No, no I think I've got it. You're saying: first, there's no target as such; second, there is some broad expectation that M1 will be slower this year than last year; third, you loosely specify some conditions under which it could be very high and loosely specify conditions under which it could be very low; and then--

CHAIRMAN VOLCKER. I would say "should be." That's one of my language changes here: not just passively "could" but "should."

VICE CHAIRMAN CORRIGAN. Then you have some language that would suggest there are also conditions in which we would react to it.

CHAIRMAN VOLCKER. Oh yes, I think that's clearly the case.

MR. JOHNSON. That's if the "should" doesn't come about.

MR. PARRY. Just a point of clarification. The way it has been discussed it's almost as though we're not talking about an operational target but we're talking rather about predicting M1 on the basis of the economy.

CHAIRMAN VOLCKER. Well, it has that flavor. But, as I see it, it's more operational than setting out a target that we don't know whether we should exceed or undershoot. In my view, I am trying to make it operational.

MR. PARRY. Yes.

MR. JOHNSON. If the "should" provisos are violated, it would make it operational.

CHAIRMAN VOLCKER. That's right. As I see it, we face just the mere fact of complexity here. Now we look upon M1 differently depending upon what's happening. That's what we have to try to describe. And it is operational; it's not operational in a 2 percent range or something because we don't know that much about it. But we're pretty clear that we want it low under certain conditions or high under certain other conditions. If there are no violent objections to that, why don't we move on. We have to try and write this in a way that's precisely acceptable. But if we assume that that is the framework in which we will modify or fool around with this language a bit, we'll try to fool around with it. That's better than sitting around the table doing it, in my opinion. Somebody's got to be a draftsman, namely me. I'll try to get something typed up and you can look at it after the break. But why don't we pass on. I will assume that the M2 and M3 targets are going to be those in alternative II with the surrounding language saying that we think these are reasonable targets and the midpoints are appropriate. I think that temporarily closes the long-term ranges to which we will return. Let's turn to the short-term ranges. Mr. Kohn, do you have something to say about the short term?

MR. KOHN. A little, sir. [Statement--see Appendix.]

CHAIRMAN VOLCKER. I will only comment that when I look at this, we are now in the middle of February and so little of what happens between November and March depends upon what we do now. That raises a little question in my mind about whether it's appropriate and whether it's conveying much information to stress these objectives in terms of a November-to-March period that included all this very exceptional stuff at year-end. Maybe we want to say something about M1, at least in terms of its direction, given that enormous bulge over the year-end. With the completely neutral statement that we have in the directive now, in line with the conversation we just had, I don't think we can be very precise. I don't know; it would be totally unconventional, but maybe this is the time we want to have a forward-looking range for M2 and M3 rather than one that encompasses almost 2-1/2 or 3 months of history and only a month and a half that is forward looking.

MR. ANGELL. It might be better to say January to March than it would to say November to March.

CHAIRMAN VOLCKER. Or else even make it--

MR. MORRIS. Go to April.

CHAIRMAN VOLCKER. Yes.

MR. JOHNSON. Go into the second quarter.

CHAIRMAN VOLCKER. We could almost put it as the second-quarter objective or February to June or something. I don't know.

MR. BLACK. That has a lot of appeal.

MR. HELLER. We could just set one for the first half of the year, January to June. Set the whole thing--

MR. ANGELL. Well, it seems to be that there's a lot that we don't know. I hate to look that far ahead. It seems to me that we're going to know more about what we would want it to be in June when we get to March than we do now.

MR. JOHNSON. I think we'll be looking at the second half.

MR. HELLER. [March is] only two or three more weeks.

MR. BOEHNE. I agree with Wayne on that. We just set our long-run targets. And the purpose of these meetings twice a quarter is to set policy for the next six weeks, really. I think that's what we ought to do: set policy for the next six weeks rather than try to set it for the first half of the year.

MR. ANGELL. We can call it January to April, which would be under the control of this--

MR. JOHNSON. But with April--

CHAIRMAN VOLCKER. I don't know; the thought just occurred to me. But, is it so bad saying the first half of the year? Obviously, we can review that again, but right now that's what we're saying is consistent with our stated objectives for the year as a whole.

MR. ANGELL. I hate to get us in the position of having to back off or of having to change that. What we were saying previously would indicate that conditions might be such that what we say now would need some adjustments. So, I'd rather not stretch the time period out and then have to alter it. In the past we've found that once we set it and then needed to alter it that that created expectations--

CHAIRMAN VOLCKER. Well, I've been sitting on the side of being against altering it in the past from a quarterly period, although we do that now infrequently. We would do it this time if we--

MR. BLACK. If we did it for the first half of the year would we use December to June?

CHAIRMAN VOLCKER. Oh, no. We could do it from January to April but that's unorthodox, too, in getting in the middle of a quarter.

MR. ANGELL. I know.

MR. BLACK. I think it would be best to use January for the base because that's really the latest date.

CHAIRMAN VOLCKER. It's kind of unorthodox, but in some ways it makes more sense than using November as a base in this particular case.

MR. HELLER. If you take the end of December as a base then you have a good chance that--

CHAIRMAN VOLCKER. Let me approach it differently. Let's discuss what we actually want to do in terms of reserve pressures.

MR. JOHNSON. I don't know, given what's been happening with the dollar and the stronger data we've had--although I think there's a lot of year-end influence on those data, and we don't have a clear picture yet. But I think, as Ed Boehne and some other people mentioned yesterday, there are some expectational effects out there that are starting to develop from a lot of this move in the dollar and some of the things that have been going on in the international sector. So, I don't know. I'm not for any major changes but I am for going back to tilting our nuances.

CHAIRMAN VOLCKER. The other way?

MR. JOHNSON. Keeping a $300 million borrowing target but shifting the nuance back to asymmetrical language toward the tighter side.

MR. BLACK. That's exactly the way I'd come out, I think.

MR. BOEHNE. I agree with that, too. I think that's just right.

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. Well, maybe we don't have to go around the table. Is that the [consensus]?

MR. ANGELL. That's good.

MR. HELLER. That sounds good.

MR. MELZER. I'd like to make some comments. I came in somewhat predisposed to leaning toward a greater degree of reserve restraint. But I really wanted to hear the discussion; it has been a long time since we've gotten together. And I was really struck by the discussion yesterday [unintelligible] really the whole time I've been sitting in. I would characterize people's general feeling on the real side as one in which the risks, if anything, are that the staff's projections might be a little low. But I wouldn't put too much weight on that or necessarily too much weight on the December economic numbers. What struck me more was the broad expression of concern, made in a number of different ways, about inflation and inflationary expectations. There are some things that trouble me right now and there are some things down the road that I think could put us in a difficult position, possibly. The things that trouble me now are the extraordinary growth of money, reserves, bank credit, etc. over a three-month period--November, December, and January. Some of it has washed out but, still, over a three-month period it's quite extraordinary. We all know about the year-end factors, but I just have this feeling that there may be something more afoot than that. As I said yesterday, even some of those special year-end factors have the effect of liquefying unrealized profits. And that money is in there; that's grandfathered.

The other thing that has been troubling me right along, as I have been saying, is that I'd be concerned about continued rapid growth in M1 against a backdrop of stable to rising rates. We still could have some lagged effects from earlier declines in rates, but basically we have been pouring in reserves at an extraordinary rate to try to hold funds somewhere around 6 percent, although some market observers have interpreted it differently. Now, that really begins to bother me in the context of these other things. There are some pressures building up, and as Jerry Corrigan pointed out, we're really pumping in reserves at an extraordinary rate to try to hold the line. Again, that's a straw in the wind that troubles me. I don't think I need to comment about the dollar, and we've talked about the buildup in liquidity before. As I look down the road, what bothers me is the box we could be in--really, as early as later in the first quarter. The staff's projection on the CPI is 4.6 percent; it wouldn't take much of a miss on the upside for us to be looking at a 5 percent CPI in the first quarter. Secondly, I really think that this year Congress will not be able to come up with anything close to credible in terms of that $108 to $118 billion Gramm-Rudmann-Hollings deficit target. Now, maybe this would come a little later than these CPI numbers, but I think we very likely could see--even though the progress on deficits might be in the right direction--a need to walk away explicitly from the Gramm-Rudmann-Hollings legislation and the general concepts and guidelines there. And that, too, I think could have a negative psychological effect. So, basically as I look at these straws in the wind now and then look at the position we could be in down the road--and I don't think we're ever absolutely sure at times when we have to move--what I say to myself is that if we don't start to lean against this now we very likely could be in a position where we're going to have to do a lot more down the road if we lose control of these inflationary expectations.

One final comment I would have is that if we were to have tightened policy last summer and last fall there would have been a dramatic impact, in my judgment, on short-term rates--markets were discounting the possibility of further ease. I think all of that has been washed out now. The three-month bill is trading essentially even with the funds rate on a yield basis, whereas I suspect that at points in time it might have been 50-60 basis points below the funds rate. Would that be about right, Don?

MR. KOHN. I think it's still a bit below where funds have been most recently.

MR. MELZER. Okay. But it's around 6 percent now?

MR. KOHN. That's right.

MR. MELZER. It might have been trading substantially below the funds rate in the summer and fall--maybe 50 basis points. So, a little snugging on our part now, in my judgment, is not going to have a major adverse impact on short-term rates. It could have a salutary effect on long-term rates, although we haven't really seen the same kind of negative signals in the long-market to the extent that we did earlier in the year, at least in terms of the yield curve.

MR. JOHNSON. I think, Tom, that because of this supposed shift in the borrowing function--which may be permanent from what we know--we've added to reserve pressures and done some snugging without changing our borrowing target. We've seen Treasury bills edge up toward the higher funds rate. We've actually achieved that, I think, without having to change our borrowing target.

MR. MELZER. Well, I don't think we have achieved that, really. I think what has happened is that we are pouring in a tremendous amount of reserves to try to avoid it, and the market is sending us a signal. To the extent that we keep trying to do that, I think we are really going to create some problems in the longer-term market.

CHAIRMAN VOLCKER. I just want to be clear. You started out by saying that you came into the meeting thinking maybe we ought to tighten up a little; it sounds to me like you are ending up there, too.

MR. ANGELL. Sounds like alternative C.

MR. MELZER. I am for alternative C.

CHAIRMAN VOLCKER. The difference, I suspect, between what you say, which is very eloquent, and what others have said, by implication, is that right at this moment in time the short-run business situation is not all that clear. It could turn south on us and [some feel that] we better wait a little while before [tightening]. You are quite persuasive; but it's a question of moving now or waiting for some more confirmation of the business situation over the next few weeks.

MR. ANGELL. There is a scenario that could develop in the next month that I would feel exactly like you do, Tom, but I would hate to think about releasing the minutes six weeks from now with that scenario in there after it didn't develop. I would rather have alternative B, as Manley specified, but with an understanding that our symmetric language would cause us--

CHAIRMAN VOLCKER. Our asymmetric language.

MR. JOHNSON. Asymmetric language.

MR. ANGELL. --asymmetric language, which would give us a little flexibility over the six weeks if that were to turn out to be the real scenario.

MR. BOEHNE. Yes. I was one of the ones who brought up inflation yesterday, but I am not yet ready to stand up and say let's tighten. I like the idea of preparing ourselves to tighten and having asymmetrical language, but I think we ought to be cautious about the [unintelligible] at this point.

MS. SEGER. Remember a few months ago, though, we voted not to change policy but then when the minutes were released with asymmetrical language everybody jumped to the conclusion that we had. So I think we have to be sensitive about what we say.

MR. BOEHNE. But in this context, I think that asymmetrical language would send a very healthy signal, because I think we have to convey to the markets that, yes, we are prepared to tighten in the right circumstances. And we ought to be clear about that message.

MR. HELLER. One thing we might want to keep in mind also is that our last directive was asymmetric in the other direction and that's what will be released.

CHAIRMAN VOLCKER. I am not sure that is going to make a lot of difference because in this particular instance I will be testifying.

MR. BLACK. That's another factor.

MR. HELLER. In the testimony, do you release the language?

CHAIRMAN VOLCKER. No. But <u>de facto</u> I do, yes.

MR. HELLER. Okay. And the minutes from the last meeting are going to be released when?

SPEAKER(?). This Friday.

MR. HELLER. Friday.

CHAIRMAN VOLCKER. Now, there may be a little confusion because they are being released on Friday and I don't testify until next Thursday. I don't think that's bad if, in fact, we decide not to change anything between now and the time I testify. But the testimony--

MR. HELLER. You are going to get that whammy--the market is going to see the earlier language and a week later the tighter.

CHAIRMAN VOLCKER. I would guess, given where the funds rate is and so forth, that they will simply assume that we didn't do anything, which is correct. And I would confirm that, but I would add some warning language about the future.

MR. JOHNSON. Yes. I don't think that's a problem given where the funds rate is.

CHAIRMAN VOLCKER. Well, we have one point of view expressed. And we have other points of view expressed. Does anybody have any other point of view?

MR. STERN. I think Mr. Melzer makes a persuasive case. I wouldn't go as far as alternative C, but one thing that would have some appeal to me that we might want to look at is a borrowing target of $300 to $350 million, on the argument that we don't want the funds rate to slip back down below 6 percent for any successive number of days. That should help, if in fact it's true, that what really has been going on here is some change in the preference [for excess reserves] and the way banks are managing their reserve positions. I happen to think that there is probably more to it than that, but if that were the case, we could build ourselves a little protection that way.

CHAIRMAN VOLCKER. A more modest way of stating that is just that we don't lean over backwards simply to get the federal funds rate below 6 percent again, I'd say.

MR. ANGELL. That's right. The $300 million is what we aim for and I would not expect the funds rate to go below 6 percent with that, given the preference for excess reserves and given--

CHAIRMAN VOLCKER. I think where the funds rate goes will be dominated by the expectations in these very short-run circumstances. If we got some weak business news and the expectations turned toward more easing, the federal funds rate could easily go below 6 percent. If the markets don't have that expectation, then it probably wouldn't. If they have the expectation that, if anything, we would tighten up, the federal funds rate probably would stay higher.

MR. ANGELL. Gary Stern is saying that he would like us to take action to stop it from occurring in the face of weak business news.

MR. JOHNSON. But if the weaker business news develops, I am not sure that we would want to stop it.

MR. STERN. We always write the directive, though, with all of those caveats, in any event. So I don't think that what I am suggesting would preclude us from changing our views if we did get a lot of weak business news. It would seem to me that it is going to take a minimum of a month before we have enough evidence to change views on that; but even if we did, we still have those caveats in the directive.

MR. BLACK. Well, we are not going to have much between now and next Thursday.

MR. STERN. We certainly aren't going to have much between now and next Thursday.

MR. BLACK. That's what we are going to be listening for.

MS. SEGER. How many weeks has it been, though, since the federal funds rate averaged below 6 percent?

MR. STERN. You have to go back into October, actually.

MR. STERNLIGHT. To October for 5-7/8 percent.

MR. ANGELL. Mr. Chairman, it looks to me like maybe we need a vote.

CHAIRMAN VOLCKER. Well, I think we are pretty close. I think we ought to look at this. If nobody else has anything to add to this discussion, why don't we turn to the language and how we want to phrase it. I assume that the prevailing view is not to change the [stance] anyway, which will be reflected immediately in this first sentence, but to be asymmetric. I am not saying there's unanimous agreement for that, but I sense that's where the central tendency is. In that case, I presume that we would simply say maintain in the first sentence. I am eliminating nuances now, which we can return to when we return to this question of how we express it. What projection do you have for M2 and M3 if we began in January and went through April?

MR. KOHN. Well, I don't have a specific projection in front of me for April, but I would be tempted to maintain M2 and M3 at about their March growth rates. I don't see why they would deviate substantially, so that means 7 percent for M2 and 6 percent for M3. So January to April--

CHAIRMAN VOLCKER. It would be 7 percent for both?

MR. KOHN. No, I was thinking 7 percent for M2 and 6 percent for M3. It could be 7 percent for both, too. So January to April might be 6-1/2 percent, or a range of 6 to 7 percent for M2 and around 6 percent for M3.

CHAIRMAN VOLCKER. Well, that gives us one alternative--I am not sure that this is the way we want to say it--but if we wanted to say January to April, we would say we expected the growth of M2 and M3 over the period from January to April to be at annual rates of 6 to 7 percent.

MR. ANGELL. That's narrow.

CHAIRMAN VOLCKER. I don't think we ever make it wider than that.

MR. ANGELL. 6 to 7 percent?

MR. BLACK. I sure do like that idea of using the January base.

CHAIRMAN VOLCKER. Well, it's unusual and I would resist it ordinarily on the basis that we normally use quarters, but that great distortion at year-end--

VICE CHAIRMAN CORRIGAN. The way you could present--

CHAIRMAN VOLCKER. It looks like the only way we could really get rid of that distortion is to use February as the base, but I--

VICE CHAIRMAN CORRIGAN. Couldn't you preserve your position by just saying 6 to 7 percent over the balance of the quarter? That's right where all the numbers are anyway.

CHAIRMAN VOLCKER. Well, you use one month.

VICE CHAIRMAN CORRIGAN. Use two months.

MR. BOEHNE. Two months: February and March. Vote for two.

VICE CHAIRMAN CORRIGAN. We are only talking about M2 and M3, so theoretically, the weekly numbers don't matter.

MR. KOHN. Last April, we did have a big jump in the M2 and M3 numbers; it is the tax period and there has to be--. Of course, we had reduced interest rates in March and April, so--

MR. PRELL. We always run into a lot of uncertainties at that time in terms of how fast tax payments are made. And this time we will have capital gains taxes that will have to be paid, so it's a very uncertain period.

CHAIRMAN VOLCKER. That's the argument for saying January to June or something.

MR. ANGELL. Or January to March.

CHAIRMAN VOLCKER. January to March gives you what kind of a number?

MR. KOHN. That would be around 6 percent. Under alternative B January to March would be 6-1/2 percent for M2 and 6 percent for M3.

CHAIRMAN VOLCKER. Those numbers were 6 percent and 6-1/2 percent?

MR. KOHN. 6-1/2 percent for M2 and 6 percent for M3.

MR. ANGELL. I think that makes the best choice.

CHAIRMAN VOLCKER. What about February and March?

MR. KOHN. Well, that would be 7 percent for M2 and 6 percent for M3.

MR. BLACK. That pretty well covers the intermeeting period, too.

MR. ANGELL. Don, are you expecting February to come in as high as you have here now?

MR. KOHN. We got some information yesterday that suggested that M1 might be a little lower, but we didn't get any new information on M2.

CHAIRMAN VOLCKER. I am sorry: what are you projecting for February and March?

MR. KOHN. On page 14 [of the Bluebook], Mr. Chairman, for M2 I have about 6-1/2 percent for February right now and 7 percent for March. For M3 I have 6 percent for both months.

CHAIRMAN VOLCKER. It sounds like we say 6 to 7 percent, whatever months we pick.

MR. GUFFEY. It doesn't make any difference.

MR. BLACK. Aim at 6 to 7 percent for whatever month you pick.

CHAIRMAN VOLCKER. Well, I don't think it makes a lot of difference. I guess somebody might argue that nothing we are going to do now is going to affect February or March anyway. That's the argument for going through June, but I--

VICE CHAIRMAN CORRIGAN. That's the problem with M2 and M3 in general.

CHAIRMAN VOLCKER. I don't think it makes a great deal of difference. Do you want to say from January through March? The real choice, as I see it, is to say January through March or January through June. We could say April, but there's a seasonal problem in April.

MR. ANGELL. Yes, but that seasonal problem doesn't affect the three-month growth rate that much, does it, Mike?

MR. PRELL. It could, depending. Last year, if I remember, we also had a delay in tax refunds due to IRS processing speed.

CHAIRMAN VOLCKER. The seasonal adjustment factors are supposed to take care of the seasonality, but I guess what you are saying is that it's very uncertain. It could be high or low.

MR. ANGELL. There's a high standard deviation, you mean.

CHAIRMAN VOLCKER. April is just an uncertain month. But the numbers are going to be the same anyway. Do we want to say January to March, January to April, or January to June?

MR. KEEHN. January through March.

CHAIRMAN VOLCKER. Through March.

MR. GUFFEY. Isn't that the same as January to April?

CHAIRMAN VOLCKER. Is that what we want to say?

VICE CHAIRMAN CORRIGAN. January to March, 6 to 7 percent.

CHAIRMAN VOLCKER. The preference is to say January to March, 6 to 7 percent? We don't need the "respectively;" the range covers both of them. Now what do we say about M1? I think with respect to M1 we ought to say something. It's very easy to say that in the current circumstances we expect it to slow from the extraordinary rates of recent months. Maybe that's it: simply say that growth in M1 should slow from the extraordinary rates of recent months--period.

MR. ANGELL. "Should" is stronger than "expected." I think "expected" is a little better.

CHAIRMAN VOLCKER. We expect it to slow appreciably from the high rate of recent months, or of earlier months. Is there anything else anybody wants to say about M1? "Appreciably" or "substantially"? Decrease substantially from the rate of growth of 30 percent.

MR. ANGELL. I thought "substantially" went with "chiefly" but--

MR. HELLER. Also say "primarily."

CHAIRMAN VOLCKER. Growth in M1 is [unintelligible]. We probably should say "substantially," it's so high. Does anybody have anything to add about M1? Then we fiddle around with--

MR. ANGELL. The nuances.

CHAIRMAN VOLCKER. "Somewhat greater reserve restraint would or slightly lesser reserve restraint might"? Does that do it?

MR. MORRIS. I thought we agreed to make this [asymmetric].

MR. ANGELL. That's what we just did.

CHAIRMAN VOLCKER. "Somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable."

MR. MORRIS. I would like to make it even more asymmetric and not mention the possibility of lesser reserve restraint because I can't see that as a possibility for the next six weeks unless the business numbers come through very much differently than we expect.

CHAIRMAN VOLCKER. It's perfectly reasonable to discuss that. I don't think we have ever done that. Or have we?

MR. ANGELL. Ever done what?

MR. BOEHNE. Yes we have on one or two occasions; but it is highly unusual.

MR. KOHN. Not recently.

MR. JOHNSON. It gives the right connotation.

MR. ANGELL. Well, let's suppose oil prices broke down; let's suppose Germany announced that they were going to grow at zero. You could--

VICE CHAIRMAN CORRIGAN. Which way would that work?

CHAIRMAN VOLCKER. The way I wrote this, the language has two asymmetrical words: one is "somewhat" as opposed to "slightly;" and the other is "would" as opposed to "might."

MR. BOEHNE. It's the double whammy nuance.

VICE CHAIRMAN CORRIGAN. Somewhat greater than an [unintelligible].

MR. JOHNSON. I think the markets are tuned in to this language.

VICE CHAIRMAN CORRIGAN. Right.

MR. BLACK. They can use this double asymmetry. I can see the caption on that now. That may be symmetric double negatives.

CHAIRMAN VOLCKER. Does anybody have any further comments? I take your silence as saying double nuance asymmetry is about right.

MR. ANGELL. That's plenty.

CHAIRMAN VOLCKER. Well, let me assume 4 to 8 percent down in the federal funds range clause. Is there anything else in this language? It would then read: In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2 and M3 over the period from January through March at annual rates of about 6 to 7 percent. Growth in M1 is expected to slow substantially from the high rate of earlier months. Somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable depending on the behavior of the aggregates, taking into account, etc. Then 4 to 8 percent [on the range for the federal funds rate]. Any other comment? If not, we can vote on this one and adjourn while we work on the language of the other one. When we turn to the long term, this is highly consistent with what we would be saying in the long run. Ready to vote? If so, we will vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
Governor Heller	Yes
Governor Johnson	Yes
President Keehn	Yes
President Melzer	No
President Morris	Yes
Governor Seger	Yes

CHAIRMAN VOLCKER. Okay. Let's [break and come] back on the [long-run].

[Coffee break]

CHAIRMAN VOLCKER. Let me just describe the market today. We won't discuss this but the federal funds rate is 6-5/16 percent and we anticipate 6-5/8 percent. Oh! Now it is at 6-5/8 percent, not 6-5/16 percent, despite the fact that, according to the estimate, we are running $500 million or $600 million over target in providing reserves. So we decided to do nothing. Unless there is a wild reserves miss, we will end up way over target with a high federal funds rate, at least until the 7th.

MR. BLACK. Mr. Chairman, many years ago--20 to 25 years ago --the market at one time had a sentence that said, "The federal funds rate is hanging at this level apparently out of respect for what the market thinks the Open Market Committee has done."

MS. SEGER. That's when rates never moved anyway.

MR. BOEHNE. They had better respect then.

CHAIRMAN VOLCKER. Well, if the federal funds rate doesn't come way down this afternoon there really is something screwy.

MR. MORRIS. While we have a little time here, Paul could tell us about this story about Mr. Baker pushing target zones for currencies.

CHAIRMAN VOLCKER. Well, I think that's putting it in a more permanent or long-range context than he, or really his staff, would admit. There is, obviously, discussion about some agreement. You see something in the paper every day about his being more forthcoming about saying he is relatively content with the broad range [of exchange rates] currently prevailing and there ought to be a willingness to--I will say "defend" but that may be too strong a word --to engage in joint and reciprocal actions in the markets. That obviously, as I mentioned yesterday, has implications beyond just what has been mentioned, if one really believed it. [It would] demonstrate that we are altogether content with the broad present range of exchange rates depending upon reasonable satisfaction that the other countries will do something to grow.

MR. MORRIS. We are not thinking in terms of a formal system.

CHAIRMAN VOLCKER. No, no. But having taken that step, obviously it is consistent with and will be read by many, anyway, as a step toward something more permanent. Whether they are called targets or some levels of resistance, the word would be "resistance." There won't be any formal expression of that kind but, obviously, there won't be a lot of speculation. This is a step, at the very least, in that direction. Indeed, I think it is a tentative step in that direction without any sense of commitment.

MR. JOHNSON. You can bet the currency markets will try and search for those levels.

CHAIRMAN VOLCKER. Then there will be [unintelligible]! One of the problems, I think we ought to remind ourselves, is that there is a rather broad range--a much broader range than the currency markets will be probing for in the short run. So there is lots of room for misunderstanding. One of the problems is that without making a commitment--even to discourage a loose arrangement--it becomes more difficult in the short run because people want to make payments. You get caught unless you're willing to make a full-blooded commitment. The French might be willing to but I don't think anybody else is willing to [unintelligible].

MR. ANGELL. Did the markets ever pick up broadly our intervention before?

CHAIRMAN VOLCKER. I don't think they did right at first because they thought it was the Japanese. But they do have the impression that we intervened [unintelligible]. They assume that there was some.

MR. CROSS. Well, it got reported. The last time there were reports in Japan and also elsewhere.

CHAIRMAN VOLCKER. Oh, the Japanese said so! I forgot that.

MR. ANGELL. But another low-key move like that, if it worked as well, together with heavy Japanese and German [intervention] wouldn't be too bad an environment.

CHAIRMAN VOLCKER. Well, that is the kind of thing they would look for, but the problem that I foresee is that that intervention took place well above where I would conceive the lower part of any broad range would be. I am not saying there is anything the matter with it; I think it is fine. But we don't want the market to think we are defending 152 yen per dollar, or something, with our life's blood if we are not, and then have market participants greatly disappointed when they see the exchange rate go above that. In my mind it's a very tricky, psychological, thing. I have no problems with what they are trying to do but it is a very tricky problem, operationally--that the market doesn't read much more into ranges or zones, whatever you call them, than anybody has in mind.

MR. ANGELL. But isn't there a case that could be made that, for the foreseeable future, that is about as high as the yen ought to go?

CHAIRMAN VOLCKER. The trouble is that we are in a range where that is debatable. It is just a question of whether you say 150 is the limit, which implies that on the other side--assuming you retain the concept of a broad range--you probably wouldn't mind if it was at 170.

MR. ANGELL. Whether you would want it that high--

CHAIRMAN VOLCKER. Whether you wanted it that high [unintelligible]. Personally, I think 150 is fine, but I don't want to make that the absolute low point, probably because I wouldn't want to see it go all the way to 170. But I don't want to get caught with 150 to 155 or something like that.

MR. ANGELL. How about 150 to 160.

CHAIRMAN VOLCKER. That still seems to me to be pretty narrow. I suppose substantively it may be all right. But it is narrow and when people talk about these, even on [unintelligible]. I don't want to get trapped into thinking something narrow.

MR. CROSS. I don't think we would find it easy to get the others to start intervening on the other side at very low levels if this was to be cooperative.

CHAIRMAN VOLCKER. Even if there is a judgmental agreement to this kind of thing, it is still a good idea to argue about where the range should be set.

MR. GUFFEY. Isn't a precedent condition of this arrangement that they agree to stimulate their economies? And is that to be a public announcement of some sort.

CHAIRMAN VOLCKER. I think it is very much a condition in Mr. Baker's mind for both substantive and symbolic reasons. But I think there is a real question as to what they would do, in fact, that would make much difference. Our talking in terms of concerted action against the background that their economic outlook seems to be deteriorating--

MR. ANGELL. But is a Japanese discount rate cut likely?

CHAIRMAN VOLCKER. It certainly would be in the context of this.

MR. ANGELL. Well, that certainly would make a difference regarding the spread between capital flows, I think.

VICE CHAIRMAN CORRIGAN. It can't make much difference in terms of growth in the Japanese economy.

MR. ANGELL. I know, but it will make a difference in regard to capital flows.

VICE CHAIRMAN CORRIGAN. I should hope.

CHAIRMAN VOLCKER. I don't know what the Japanese did. I think one of their problems before was [unintelligible] as much as they did, but their savings deposit rates are close to zero now. I know they were close to zero before they reduced the discount rate last time. I don't know what happened after they reduced it. That's the big savings vehicle for Japanese citizens as opposed to people with access to the money markets. They may be [unintelligible] but there are some very close to zero and some deposits may have--

MR. JOHNSON. What is their postal rate?

MR. TRUMAN. The discount rate is above the postal rate, I think.

CHAIRMAN VOLCKER. I think they have a variety of rates.

MR. TRUMAN. There has been some responsiveness.

MR. JOHNSON. If they are going to deflate, a zero rate [unintelligible].

[Secretary's Note: A draft of proposed directive language, labeled "Variant I for M1" was circulated to the meeting participants at this point. See Appendix.]

CHAIRMAN VOLCKER. Just as a technical matter, where is this paragraph we are talking about inserting to be placed--before or after the discussion of the broader aggregates?

MR. KOHN. I guess after the discussion of the broader aggregates in the longer-run part of the directive: between the broad aggregates and the short-run part.

CHAIRMAN VOLCKER. So you have this paragraph above stating that the FOMC seeks all these things.

MR. KOHN. Right.

CHAIRMAN VOLCKER. Then: "In furtherance of these objectives the Committee established growth ranges of--" What are we talking about, 6-1/2 to 8-1/2 percent?

MR. KOHN. 5-1/2.

CHAIRMAN VOLCKER. 5-1/2 to 8-1/2 percent for both M2 and M3. Total nonfinancial debt was set at what?

MR. KOHN. 8 to 11 percent.

CHAIRMAN VOLCKER. 8 to 11 percent, the same as for 1987. With respect to M1, why don't we take a minute to peruse this? I don't argue that it is a literary masterpiece.

MR. ANGELL. On page 2 is the word excessive--?

CHAIRMAN VOLCKER. Why don't we just give everybody a chance [to read this]. Have you all had a chance to get some flavor of it?

MR. ANGELL. I think it very well reflects what we suggested. On page 2, I wonder if the word "excessive" in front of weakness of the dollar is a little strong. Would it be better to leave the word out or maybe use the word "continuing." I wouldn't want to indicate to the markets that it really has to be pretty bad before anything happens.

MR. PARRY. How about "significant"?

MR. ANGELL. Yes, that would be better, I think.

MR. MELZER. In citing those conditions it is possible to use an "and/or" structure. In other words, I could imagine circumstances where you wouldn't necessarily have all four of those.

CHAIRMAN VOLCKER. Obviously. Oh, I--

MR. JOHNSON. That's why velocity is such a useful word. It captures all those things.

MR. ANGELL. Well, it seems to me, since that is an "and" list, that you could take "excessive" out and just say "weakness in the dollar." If all those other three--

CHAIRMAN VOLCKER. Of course, that is the problem. I was about to say that it is easier to list when all those things are going in the same direction than when you have some going in one direction and some going in another direction. I was just going to summarize our discussion in terms of the broad message we are trying to give. The message I would try to give is: It is not that M1 is meaningless, but that it can only be evaluated in the context of the surrounding circumstances. I can't read my own writing. It is not meaningless; it can only be evaluated in the context of the surrounding circumstances. That can't be a mechanical judgment but rather a qualitative judgment. [Unintelligible] enter into the qualitative judgment. We can [not] get a formula that can take all four of these factors and weigh one 20 percent and the other 32 percent.

MR. MELZER. You could use "in the context of signs of" or "in the context of surrounding circumstances" and you could use an "including" structure and an "or" at the end.

MR. KEEHN. At the end of the sentence rather than using the word "and" I wonder if you used the word "or" if that would deal with the possible alternative situations.

CHAIRMAN VOLCKER. I don't think you can quite say "or" because we are not saying that any one of these factors is going to--

MR. KEEHN. It gives you a little more flexibility.

CHAIRMAN VOLCKER. Now, what was this other suggestion rather than "or"?

MR. MELZER. I was suggesting that we could say: "It would be appropriate in the context of surrounding circumstances, which could include, for example," and then just list the four and put an "or" there. If they are given as examples it doesn't necessarily imply that there will be just one or all four.

MR. BLACK. You could say: "In the context of signs such as..."

MR. JOHNSON. You could say: "In the context of many of the signs" or something like that. Or use a word that is all encompassing: "necessarily" before the "appropriate."

CHAIRMAN VOLCKER. Accumulating signs.

MR. JOHNSON. Accumulating signs, or many of the signs, or intensifying, or growing, signs.

MR. BLACK. I think that "such as--"

MR. HELLER. With the "such as" language the only thing I am not too happy with is the last statement: "In the context of signs such as continuing economic expansion." That does not cause us to reduce growth. It would have to be something like unsustainable economic expansion.

MR. JOHNSON. Well, you could say all these other things "in the context of continuing economic--"

CHAIRMAN VOLCKER. Without repeating the words "in the context."

MR. JOHNSON. Oh yes, I'm sorry; that is already there.

MR. MELZER. You could say: "which might include a combination of..."

MR. JOHNSON. Or "along with continued economic expansion."

MR. HELLER. Or "in the framework."

MR. ANGELL. I think it is better as it is with the "and."

MR. JOHNSON. But I have a big problem, too, with implying tightening just because the economy is expanding and none of the other things are occurring.

MR. ANGELL. But "and" answers that question.

MR. JOHNSON. No, it is overly reactive.

MR. MORRIS. With price pressures.

CHAIRMAN VOLCKER. It was meant to encompass it, but this get's [complicated]. Suppose we said: "Much slower monetary growth will be appropriate in the context of continuing economic expansion accompanied by..."

MR. JOHNSON. Okay. That would do.

MR. KEEHN. Rather than using "continuing"--not to stir the soup here--how about "strong economic expansion." We could get continued economic expansion in a modest proportion.

MR. PARRY. How about "rapid"?

MR. JOHNSON. Don't stretch it too far. If all these other things were happening, even if the economy weren't growing I wouldn't mind doing something about it.

CHAIRMAN VOLCKER. There is something the matter here as I see this; something is garbled. "In that connection the Committee believes, particularly in light of the extraordinary expansion of etc., much slower monetary growth would be appropriate in the context of continuing economic expansion accompanied by signs of intensifying, strong growth in this aggregate in recent years." That doesn't belong there. The whole thing is crazy.

MR. BLACK. We're talking about slower M1 growth in the first line and the broader aggregates in the second line, aren't we?

CHAIRMAN VOLCKER. Maybe I have two different pages, because mine doesn't read right.

MR. ANGELL. No, I think it is okay. I think you just have that clause there in front of the--

CHAIRMAN VOLCKER. I've got the wrong first page. That's what's wrong. "In that connection, the Committee believes etc. Much slower monetary growth would be appropriate in the context of continuing economic expansion."

MR. ANGELL. Do you want "accompanied by increased price pressures" or "signs of"?

MR. MELZER. You could say "accompanied by some combination of" and then use the "and" structure, which could mean all or it could mean one or two.

MR. ANGELL. Yes, it seems to me that there could be some circumstance in which the dollar, given strong economic growth--. Frankly, I just don't quite see how the inflation is going to come about unless we get a further [decline in the dollar]. It seems to me that the whole inflation scenario is dependent upon the dollar's position.

MR. JOHNSON. Then what you are saying is that there may be times when we want to deal with the psychology, if nothing else.

CHAIRMAN VOLCKER. We can't cover every contingency here, but I can imagine that if the price pressures or some of the other things were bad enough we might have to tighten up even if the economic growth didn't look very satisfactory. But it is just impossible to cover every combination of circumstances here.

MR. ANGELL. The fact of the matter is that if economic expansion slows to a negative rate, it does limit you somewhat.

CHAIRMAN VOLCKER. Oh, it limits you!

MR. STERN. It could be a very slow expansion.

CHAIRMAN VOLCKER. Say "continuing economic expansion." We've got a choice here. If we just leave it "and" it seems to me we are giving a pretty clear unambiguous signal that we would tighten under all these circumstances. If we begin saying "such as" or "or," which is better in some respects, it is also vaguer.

MR. ANGELL. But with the "and" there, can't we take the "excessive" out before the "weakness of the dollar"?

CHAIRMAN VOLCKER. Well, I put a "significant" in.

MR. HELLER. But you are putting "continuing economic expansion" ahead, right?

CHAIRMAN VOLCKER. I don't know that it is perfect now. It reads: "Much slower monetary growth would be appropriate in the context of continuing economic expansion accompanied by signs of intensifying price pressures, relatively strong growth in the broad monetary aggregates, and significant weakness of the dollar in exchange markets."

MR. MELZER. Did you say "or"?

CHAIRMAN VOLCKER. No, I said "and."

MR. ANGELL. [Unintelligible] sounds like a bit of weakness doesn't bother us. If it doesn't, it's okay.

CHAIRMAN VOLCKER. Another way of doing it is to say "signs of intensifying price pressures, perhaps related to significant weakness of the dollar in exchange markets and relatively strong growth in the broad monetary aggregates."

SPEAKER(?). That's how I would like it.

SEVERAL. Yes.

MR. STERN. That probably [improves it] a little; because otherwise it sounded like you'd need all three.

MR. ANGELL. I like that.

MR. HELLER. "Related to"?

CHAIRMAN VOLCKER. "Perhaps related to." I didn't want to say that is the only source of--

MR. MORRIS. All of this suggests that the relationship of nominal GNP to M1 is indeterminate. The stronger the economy the lower the growth rate of M1.

MR. JOHNSON. Well, I think it's fair to say that if you could stabilize this interest differential that has created such a sensitivity and swings you would expect to see it run consistently. I may be wrong, but under a stable differential I would guess that would be the thing more than anything else probably would be.

CHAIRMAN VOLCKER. Anybody want to focus on any other sentences?

MR. PARRY. Yes, just a minor point in the last sentence of the first paragraph. Isn't "appropriate changes" a little misleading? Wouldn't it be better just to say "changes"?

VICE CHAIRMAN CORRIGAN. We could say "the appropriateness of..."

MR. PARRY. That would be better. Or just leave it out. And if that is the case, it's the same thing in the last sentence of the second paragraph where it refers to appropriate growth. It is a little misleading--we are going to evaluate growth in M1 from time to time as to whether or not it is appropriate.

CHAIRMAN VOLCKER. It is a minor point, but why would you want "appropriate" in there? Let's have some sense of: we are going to evaluate whether we are going to have a short-run target for M1, which implies some appropriateness.

MR. PARRY. No, it says here "appropriate changes in M1 during the course of the year will be evaluated in light of" etc. We are going to be evaluating changes as to whether or not they are appropriate.

CHAIRMAN VOLCKER. Yes, so I changed that to "the appropriateness of changes." I made just a couple of errors reading it; it reads a little more smoothly. This is only changing clauses. "With respect to M1 the Committee recognized that, based on experience, the behavior of that aggregate and appropriate growth must be judged in the light of other evidence with respect to economic activity and prices; fluctuations in M1 have become much more sensitive in recent years to changes in interest rates among other factors." Put "among other factors" at the end of the sentence. Then start the next sentence by saying: "During 1987 the Committee anticipates that growth in M1 should slow." [Unintelligible] in the next sentence. We're just trying to avoid repetition.

MR. MELZER. On the last sentence of the second page: "[The Committee] will evaluate appropriate growth in M1 from time to time in the light of circumstances then prevailing, including the rate of growth of the broader aggregates." That says evaluate; it doesn't necessarily imply very explicitly that we might set a target. I am just wondering if we could add a phase "and under certain circumstances might establish short-run target ranges." That is very explicit about it.

CHAIRMAN VOLCKER. That makes it much more explicit. I don't know if that is desirable or not since we always miss these short-term target ranges. I mean to hint at that, but I don't know what the advantage is of being absolutely explicit. I don't know if there is anything inconsistent with it--

VICE CHAIRMAN CORRIGAN. This doesn't tie [together]. How about if we said "The Committee during the course of the year will evaluate the appropriate role and growth."

CHAIRMAN VOLCKER. Rule out M1. It has no role any more.

VICE CHAIRMAN CORRIGAN. No. I was thinking of the option.

CHAIRMAN VOLCKER. It is not the appropriate role of M1; it would be the appropriate role of M1 in our decision-making.

VICE CHAIRMAN CORRIGAN. It already says that: "The Committee hasn't reached any operational decisions."

MR. STERN. Maybe we can find a somewhat stronger word than evaluate. But I must say I am at a bit of a loss.

MR. MELZER. This sounds like stuff we say all the time.

CHAIRMAN VOLCKER. It does sound like what we been saying; I guess I put that on the other side of the ledger. There is no difference in some respect from what we've said before. Well, I am sure this isn't perfect but I am struck with the fact that it is cumbersome enough. That last sentence is certainly repetitious but I don't know if it hurts anything, with the last sentence in the first paragraph. We could use another word than evaluate, but I don't know what.

MR. ANGELL. Would it be appropriate to have continuing sizable increases in M1 with the continuing weakness in the dollar?

CHAIRMAN VOLCKER. [Unintelligible.]

MR. ANGELL. I know. I would just like to have it be--

VICE CHAIRMAN CORRIGAN. You don't know which way it will work. What are you trying to guard against?

CHAIRMAN VOLCKER. What he is saying, I guess, is that he doesn't want all that sizable an increase in M1, if we have some growth and the dollar is very weak.

MR. ANGELL. That is right.

MR. MELZER. What if you replace "will evaluate" with "may target"? I think you want to stay away from that, but I am just--

MR. ANGELL. Now we are on page 2?

MR. MELZER. The last sentence.

CHAIRMAN VOLCKER. You can say "continuing sizable increases in M1 could be accommodated in circumstances characterized by sluggish business activity, maintenance of progress toward underlying price stability, and international stability," or something vague like that.

MR. ANGELL. I like that.

CHAIRMAN VOLCKER. And "progress toward international equilibrium." How about that?

MR. TRUMAN. Fine, if you can define it.

MR. ANGELL. That's pretty wide. But that is all right.

CHAIRMAN VOLCKER. That brings in the trade balance as well as the dollar.

MR. ANGELL. Yes, I like that better than not having it in there at all.

MR. JOHNSON. Equilibrium could be a much lower rate of growth.

MR. ANGELL. I am afraid that is what it is.

CHAIRMAN VOLCKER. I am a little worried about the repetitiousness of these two sentences. Maybe it doesn't hurt anything. I suppose this implies that the Committee in reaching operational decisions during the year might target appropriate growth in--

MR. MELZER. I think that is the statement that adds something to what has already been said. Otherwise, you're right that it doesn't--

MR. GUFFEY. That presumes that we'll know what the appropriate growth is.

CHAIRMAN VOLCKER. We'll only know it in the light of the circumstances then prevailing. Does that sound better to people?

SPEAKER(?). Yes.

SPEAKER(?). It does to me.

MR. JOHNSON. They'll pay attention to the things that cause us to pull it off the shelf.

CHAIRMAN VOLCKER. Maybe I better read the whole thing while we are having our last thoughts here. This would follow the rather conventional paragraph, to say the least, regarding the 5-1/2 to 8-1/2 percent for growth in M2 and M3 and 8 to 11 percent for the debt. Then it goes on to say "With respect to M1 the Committee recognized that, based upon experience, the behavior of that aggregate and its appropriate growth must be judged in the light of other"-- I'm just stumbling here, and I wonder whether we need the behavior of that aggregate and its appropriate growth. Why don't we just say: "With respect to M1, the Committee recognized that, based on experience, the behavior of that aggregate must be judged in the light of other evidence with respect to economic activity and prices; fluctuations in M1 have become much more sensitive in recent years to changes in interest rates, among other factors. During 1987 the Committee anticipates that growth in M1 should slow. However, in the light of its sensitivity to a variety of influences, the Committee decided not to establish a precise target for its growth over the year as a whole at this time. Instead, the appropriateness of changes in M1 during the course of the year will be evaluated in the light of the behavior of its velocity, developments in the economy and financial markets, and the nature of emerging price pressures." If I can make an editorial comment, I wrote this "the nature of emerging price pressures" rather than "emerging price pressures" because we all concede that there are likely to be some emerging price pressures that we have already taken into account. "In that connection, the Committee believes that, particularly in the light of the extraordinary expansion of this aggregate in recent years, much slower monetary growth would be appropriate in the context of continuing economic expansion accompanied by signs of intensifying price pressures, perhaps related to significant weakness of the dollar in exchange markets, and relatively strong growth in the broad monetary aggregates. Conversely, continuing sizable increases in M1 could be accommodated in circumstances surrounded by sluggish business activity, maintenance of progress toward underlying price stability, and progress toward international equilibrium. As this implies, the

Committee in reaching operational decisions during the year, might target appropriate growth in M1 from time to time in the light of circumstances then prevailing, including the rate of growth of the broader aggregates."

MR. MELZER. That's fine.

MR. ANGELL. Good.

CHAIRMAN VOLCKER. I hope you people are satisfied on the other side there. There is no other--we have a consensus on the other paragraph.

VICE CHAIRMAN CORRIGAN. Could I just raise a quick non-M1 point about the long-run part? In terms of what we are saying about monetary policy, I am getting more and more concerned about that debt variable, even though nobody pays any attention to it. We are sitting here again this year saying we are going to monitor it, which implies a kind of quasi-sanction. We monitor a growth in debt up to 11 percent with GNP growing [2 or 3] percent. I know we can't do a darn thing about the variable, but for four or five years now running we have been monitoring it while it's behaving in a way that just does not make sense for the long term.

CHAIRMAN VOLCKER. Well, I am just thinking out loud--we might say, as you just noted, that we have had a fairly liberal monitoring range for this variable. It has exceeded the range; this year we really expect it to be within this range that we are talking about and we would be increasingly disturbed--

MR. ANGELL. But what would we do if were disturbed?

CHAIRMAN VOLCKER. I guess what we would do is tighten up.

MR. ANGELL. Is anyone suggesting that that is what we should have done during 1986?

VICE CHAIRMAN CORRIGAN. I wouldn't suggest that. But I do think that when you look at the way growth in debt has departed from the growth in GNP over a period now of five years or so, there is simply a point where those chickens are going to come home to roost.

MR. ANGELL. But any time a preference for financial assets explodes like it has during this deflation, as well as every deflation in our history, you can't have financial assets expanding without debt expanding.

MR. MORRIS. And the problem with the corporate debt sector, anyway, is that we have had, in large part, no corresponding growth in corporate assets. The offset to the debt has been a decline in equity; so we haven't had an increase in assets.

MR. JOHNSON. We have had a run up in the price of assets--equity.

VICE CHAIRMAN CORRIGAN. Whether it is sustainable or not is the question.

CHAIRMAN VOLCKER. If you look at it on the basis of market values it doesn't look bad; if you look at it on the basis of balance sheets it looks pretty awful.

MR. JOHNSON. It depends upon how much weight you put on market value.

CHAIRMAN VOLCKER. I suppose nobody is saying that this is going to be our single judge, but I think it does lend some weight to our tightening. I would be very happy if we said something like that.

VICE CHAIRMAN CORRIGAN. The only other choice is to drop it all together as something we in some sense monitor.

MR. ANGELL. I understand the monetary aggregates and I understand the validity of monitoring. But once those explode, the other side is going to explode too. The other side's problem is based upon the quality or the ability to pay. It is a microeconomic judgment, company by company.

CHAIRMAN VOLCKER. If we have exploding monetary aggregates.

VICE CHAIRMAN CORRIGAN. That's precisely the reason why I have this concern--because there is [impairment in] the ability to pay at some point. That is why in balance-sheet terms this is dangerous to the economy and I think there is a point where the chickens could come home to roost. Then the question for the Federal Reserve is going to be: What were you doing here?

MR. ANGELL. But, Jerry, it almost seems to me as if we are saying we've got a danger out here, so what should we do? Well, we should tighten. We are afraid people can't pay, and if we tighten then we guarantee they can't pay.

VICE CHAIRMAN CORRIGAN. I did not say we should tighten. I said that, at the very least, we ought to express some sensitivity to this. I think there is a danger in just letting that sit out there in a way that at least subtly carries the implication that we are prepared to sanction or underwrite that kind of behavior indefinitely.

MR. HELLER. In my mind at least, debt should be more among the categories of things we are monitoring: prices, growth, interest rates, exchange rates. Debt should be in that category rather than as a target variable.

VICE CHAIRMAN CORRIGAN. I am not trying to make it a target variable. I am just concerned that we have had it in there, in effect, as a target variable. And it has been behaving in ways that I think over the long run raise some very difficult questions.

MR. ANGELL. I don't know what handle we have. There isn't any margin requirement handle that would work. I don't know where we would begin.

VICE CHAIRMAN CORRIGAN. I am suggesting simply that we be prepared in some appropriate words to acknowledge that there is a potential problem here.

CHAIRMAN VOLCKER. That is what we are doing anyway, in some sense. It doesn't have any operational significance.

VICE CHAIRMAN CORRIGAN. Look at the nonfinancial corporate sector: since the end of 1984, $230 billion in equity and $480 billion in debt has been retired. Now, some of that is the retiring of short-term debt with long-term debt. I know all the circumstances. But you just can't have that kind of thing indefinitely, in my judgment.

MR. ANGELL. Well, our tax law changes help because in the past it paid to not pay dividends, and to pay it out in the form of leveraging out and--

VICE CHAIRMAN CORRIGAN. That should mean that debt growth should be--

MR. ANGELL. It should be less. I think the tax law will reduce debt growth.

CHAIRMAN VOLCKER. But not by that much; the basic incentive is still there. It is now less than it was.

MR. ANGELL. And people who have learned to benefit from the other one will continue to behave that way as long as an economic incentive is there.

MR. JOHNSON. I'd be happy for us to carry on a campaign to allow [tax] credits for the dividends.

CHAIRMAN VOLCKER. Yes, but you can't use that. I have been carrying on that campaign in a not very effective way for some time. But I suppose your concern about it is more the corporate debt; that is one area. You have made your point. I don't know how operational it is.

VICE CHAIRMAN CORRIGAN. It is not. I feel better having made it.

CHAIRMAN VOLCKER. If there are no other points to be raised, I guess we can vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
Governor Heller	Yes
Governor Johnson	Yes
President Keehn	Yes
President Melzer	Yes
President Morris	Yes
Governor Seger	Yes

CHAIRMAN VOLCKER. You can always send in revisions of your projections. You are strongly encouraged, if you are so minded, to get them in and get them here in a hurry so they can be [incorporated in the group] projections.

END OF MEETING