

Meeting of the Federal Open Market Committee

March 26-27, 1984

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday, March 26, 1984 at 2:00 p.m., and continuing on Tuesday, March 27, 1984 at 12:00 p.m.

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

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

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

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, 1/ Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman, 1/ Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Burns,1/ J. Davis,1/ R. Davis,1/ Kohn,1/ Lindsey,1/ Prell,1/ Siegman,1/ Stern,1/ and Zeisel,1/ Associate Economists

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

1/ Attended Monday session and Tuesday session before action to adopt domestic policy directive.

CHAIRMAN VOLCKER. Without objection, Mr. Solomon will be elected. We have a list of [proposed] officers, which is virtually identical with that of last year, with a couple of additions from the Board's staff. Do you want to read the list, Mr. Bernard?

MR. BERNARD. Okay.

Staff Director and Secretary, Stephen Axilrod
Assistant Secretary, Normand Bernard
Deputy Assistant Secretary, Nancy Steele
General Counsel, Michael Bradfield
Deputy General Counsel, James Oltman
Economist, James Kichline
Economist (International), Edwin Truman.

Associate Economists from the Board:
Donald Kohn;
David Lindsey;

CHAIRMAN VOLCKER. Those are the two additions, I think.

MR. BERNARD.

Michael Prell;
Charles Siegman; and
Joseph Zeisel.

Associate Economists from the Reserve Banks:
Joseph Burns;
John M. Davis;
Richard Davis;
Richard Lang; and
Gary Stern.

CHAIRMAN VOLCKER. As usual, the associate economists from the Reserve Banks reflect the nominations of the Bank presidents serving [as members of the FOMC]. We have two more, I think.

MR. BERNARD. They come later.

MR. PARTEE. So move.

MS. TEETERS. Second.

CHAIRMAN VOLCKER. Without objection, those will be approved. Now we have the selection of a Reserve Bank to operate the System Account.

MR. PARTEE. Time to move that around, isn't it?

SPEAKER(?). Let's bid!

MR. BLACK. New York has already got a Vice Chairman!

CHAIRMAN VOLCKER. Do you want to propose New York?

VICE CHAIRMAN SOLOMON. I propose New York.

CHAIRMAN VOLCKER. Do we have a second?

MS. TEETERS. Second.

CHAIRMAN VOLCKER. Without objection. We have the selection of the two Managers. I assume the present incumbents have been approved by their Board.

VICE CHAIRMAN SOLOMON. They have been.

CHAIRMAN VOLCKER. Do we have a nomination for Mr. Sternlight and Mr. Cross?

SPEAKER(?). So move.

CHAIRMAN VOLCKER. Mr. Cross is not here today. Second?

SPEAKER(?). So move.

CHAIRMAN VOLCKER. Without objection. No changes are proposed in the foreign policy--"foreign policy" sounds a little too grandiose to me.

MR. BERNARD. The Authorization for Foreign Currency Operations and the Foreign Currency Directive.

CHAIRMAN VOLCKER. In the various directives related to our purchases and sales of foreign currency there are no changes proposed. Are there objections? If there are no objections, they will continue in force. We have a \$4 billion intermeeting limit on changes in System holdings; that's the routine limit. I'll ask whether there are any objections to retaining that. If there are no objections, we will retain it. That doesn't mean we can't change it temporarily from time to time as we go ahead, but that's the basic authorization. I hear no objection. There is an agreement with the Treasury to warehouse foreign currencies. No change is proposed.

MR. PARTEE. That isn't being used currently. Isn't that right?

CHAIRMAN VOLCKER. It is not. But it's thought to be a good idea to keep the authority active even if the implementation is not currently active.

VICE CHAIRMAN SOLOMON. Right. Does that need a formal motion?

CHAIRMAN VOLCKER. We need at least a "no objection." Again, there is no change [proposed]. I don't hear any objections, so it is approved. The next item is security of our procedures and related materials. Mr. Solomon was the chairman of that subcommittee and we will turn to Mr. Solomon.

VICE CHAIRMAN SOLOMON. You all have copies of the report that we sent around containing our recommendation. I might summarize the key points. Before I do that, I should say that none of us on the subcommittee assumed that the leak that the GAO investigated came from the Federal Reserve System. But we felt that the GAO report did have some basis for saying that our procedures were somewhat lax, or could be tightened up, and that there was a very large number of people with

access [to FOMC materials]. So, we looked at many alternative ways of handling the access problem. Basically, our recommendations were in four major areas: first, updated security classifications, with an addition of one new category to the two old ones; secondly, refinements in the procedures for distribution and handling of classified documents; thirdly, stronger procedures for making sure that people are familiar with the rules; and finally, a reduction in the number of people authorized to see the more sensitive documents.

Briefly, the new procedures call for use of double-sealed envelopes and distinctive cover sheets and for restrictions on copying. Also, the rules will be circulated annually to each person on the access list who would sign off on them. In regard to the number of people who have access to documents, our proposal calls for certain numbers. At the Board and at the New York Reserve Bank, there is a reduction of five each in the Class I list and of six each in the Class II list. At the other Banks there is a reduction of one each in the Class I list and a limit of seven for access to Class II material. The most important switch we made in the classification of documents was classifying part I of the Greenbook as Class II. The systemwide results of these restrictions and reductions in access work out as follows: The Class I list is reduced from 86 to 67 people other than the members of the FOMC themselves; and the Class II list is reduced from 348 to 183. Even though we think these are reasonable, we did provide for ad hoc exceptions by the Chairman and exceptions for ad hoc assignments, which could be granted by governors and presidents. I should also point out that the limitations in each category--for example, seven for Class II documents at Reserve Banks other than New York--apply separately to each type of document. Those having access to Part I of the Greenbook, for example, may be different from those with access to the Managers' reports. I think that summarizes the main recommendations. We would recommend that, after discussion and questions, the FOMC adopt this.

CHAIRMAN VOLCKER. Are there questions?

MS. TEEETERS. I'd like to raise an issue that was not addressed, which is the continuation of an existing policy, and that is providing the Greenbook to the Secretary of the Treasury and four or five other people at the Treasury, the Chairman of the Council of Economic Advisers, and the Director of OMB. We have never been able to trace the leaks, but it seems to me that there is a potential there for leaks coming from outside of the System regardless of how much we tighten our own procedures.

VICE CHAIRMAN SOLOMON. Well, what we did do for the first time was recognize the de facto practice by including it in the formal proposals. But we did not feel that it was up to us--and frankly, I'm not sure it's very practical without raising more dust than it's worth--to restrict access to people in the Administration.

MS. TEEETERS. Well, there seems to be a lot of access at the Treasury and we don't have any idea what their security provisions are for these documents.

VICE CHAIRMAN SOLOMON. But they don't get the Bluebook or the Open Market directives or the policy records. What they do have are the two Managers' reports, and I think they're entitled to have

them because those are needed both in the managing of the public debt and, of course, in the foreign exchange market where the Secretary of the Treasury [has responsibility].

MR. WALLICH. Do you mean the Managers' weekly reports?

VICE CHAIRMAN SOLOMON. I think it's the weekly they get.

MR. STERNLIGHT. Just the weekly report goes to the Treasury.

MR. PARTEE. And, of course, the Greenbook.

VICE CHAIRMAN SOLOMON. What specifically would you propose to restrict, Nancy?

MS. TEETERS. I would restrict them from the Greenbook because in the past we have had some distinct and fairly specific leaks of the contents of the Greenbook.

CHAIRMAN VOLCKER. My memory may not be perfect on this, but my overall impression is that the record has been very good in terms of identifiable leaks from them. I can recall one or two occasions where a newspaper reported that the Federal Reserve staff was thinking in a certain range or reported a certain number that sounded to me as if it may well have come from the Administration. It wasn't particularly damaging or timely; it wasn't that we sent it to them and it appeared before an Open Market Committee meeting. I can recall one or two instances that made me suspicious, but generally I think the record has been pretty good. I don't know if anybody else has a different recollection.

MR. BOEHNE. When does the Greenbook go to the Treasury?

CHAIRMAN VOLCKER. Within a day or so of the time it's issued, I guess.

MR. KICHLIN. I believe it goes out on Thursday morning.

MR. GRAMLEY. We have been sending the Greenbook to those three places for at least 20 years, I think. And in the interest of maintaining an exchange of views with people in the Administration there are times, regularly, when the Chairman is provided access to information well ahead of time--about the same time the President gets it--and is one of the very few people who gets that kind of information. There are times when we are made privy to what is going on in the budgetary process, even at the staff level. I think we would be jeopardizing that free interchange of information if we didn't send the Greenbook over there.

VICE CHAIRMAN SOLOMON. The only thing I could suggest would be to advise them that we have reclassified Part I of the Greenbook into a Class II document and that the Chairman and the FOMC would appreciate it if the three principals who get it--the Secretary of the Treasury, the Chairman of the Council, and the Director of OMB--would take comparable measures to restrict access at their own agencies.

CHAIRMAN VOLCKER. We can. The point has been made to them but obviously it can be made again and probably would be useful to do so.

VICE CHAIRMAN SOLOMON. Now that we're moving [up its classification].

MR. PARTEE. In connection with the reclassification it would be a convenient thing to do. I do believe that there [has been no] difficulty, Nancy, except for a few times when the Secretary said something. We can hardly stop that. There have been occasions when it looked as if it had been circulated pretty widely on the staff. But with a redoubling of emphasis on security of the document we might be able to take care of that problem, though not the problem of the Secretary saying something.

CHAIRMAN VOLCKER. I would agree very much with what Lyle said about ongoing relationships unless there is an apparent real problem.

MS. TEEETERS. I simply wanted to raise the issue. It was something that has never been changed and is a potential [for leaks] that we can't control.

MR. PARTEE. It recognizes something that we have been doing since the middle '60s, I think, or certainly since the late '60s.

MS. TEEETERS. Certainly, in my own mind this latest leak came from the Hill. And we have a continuing problem of maintaining security if we release confidential material to someone outside of the System.

CHAIRMAN VOLCKER. I don't think anybody has proposed that we release the Bluebook to them. I don't know whether it makes any difference whether we send it to them a few days before an Open Market Committee meeting, which is the usual practice, or a day after. I don't think we've ever had a leak just before the Open Market Committee meeting. Nothing in the document is all that sensitive to issues of timing, I guess. But I don't think the particular day we send it to them is sensitive in terms of our relationship with them.

MR. PARTEE. It probably is generally sent out on Thursday now isn't it, Jim?

MR. KICHLIN. Thursday morning.

MR. PARTEE. That's right away, so they get it very early. Then the following Monday--

SPEAKER(?). The Bluebook is--

MR. PARTEE. No, not the Bluebook.

CHAIRMAN VOLCKER. They don't get the Bluebook at all.

MR. PARTEE. It might be better to send the Greenbook to them the following Monday or something like that.

MR. BOEHNE. These totals of four and seven [with access at the Reserve Banks]: Does that include members of the Committee, too?

VICE CHAIRMAN SOLOMON. Yes, it does. We did a spot check at about a half dozen of the Banks and talked with the staff here. There was one Bank that had five [on its access list] although most of them had four. As we analyzed who had a need to know--I don't mean in the formal sense of Class III, but in the sense of how the operations went at the different Reserve Banks--seven seemed a reasonable number. And then Chuck Partee, Bob Black, and I discussed that. Originally we were talking about restricting it to three but some of the presidents felt that would be excessively restrictive and that four would be a reasonable number.

MR. FORRESTAL. Tony, in that connection--this is a technical question--on page 5 you talk about limiting the Class I [materials] to the president and three other officers. Do you really intend it to be members of the official staff? I think that presents a problem in some Banks. It would in my Bank, for example, where we have some people on the research staff who are not officers who are cleared at the moment for FOMC Class I.

VICE CHAIRMAN SOLOMON. Well, that was our intention. Now, we made some recommendations on systematizing the downgrading of a document's classification. The Bluebook would be downgraded from Class I to the new Class II at the time of the release of the policy record and directive. And then it would be downgraded to Class III four months later, roughly; in other words, after a six-month period old Class II is downgraded to Class III.

MR. FORRESTAL. It's still Class I prior to the meeting.

VICE CHAIRMAN SOLOMON. It's still Class I prior to the meeting, right.

MR. BLACK. Bob, I don't think we addressed the issue of whether they had to be officers or not; it just ended up as officers.

MR. FORRESTAL. Well, I think that's something you really ought to clarify because, as I said, in my particular case I have two people who are now cleared for access to FOMC documents--and they do review the Bluebook--and they are not officials. So, that would put me in an awkward position. On a broader question, I must say that I certainly understand why you are trying to reduce the number of people cleared for access, but I really think clearing only four people is unduly restrictive for the Reserve Banks, particularly if one of those people is the first vice president. With the president and the first vice president, that leaves us with only two people.

MR. PARTEE. We were not thinking of the first vice president.

MR. FORRESTAL. You were not? Well, that's the question, I guess. That makes it a little better if you don't include--

MR. PARTEE. You can, of course, if he's going to substitute for you at a meeting. You can clear him for that purpose.

CHAIRMAN VOLCKER. It seems there may be some miscommunication here. You were thinking the first vice president would not get it?

MR. PARTEE. That's right.

CHAIRMAN VOLCKER. He's an addition to the pot.

MR. FORRESTAL. That puts a little different light on it. But again, if the first vice president is going to substitute from time to time, it seems to me he ought to be getting the material on a fairly regular basis.

MR. BLACK. Bob, in our case, since we had to give up one, we decided that the first vice president would not be one of the four unless he was substituting. He can give it up more easily. But if you were out of the Bank, you could make an ad hoc exception for him. That was the way we were planning to do it. I'm sure that will differ from Bank to Bank. It seems rather bad to have to deny access to your first vice president, but I don't think we have any alternative.

MR. FORRESTAL. My druthers would be to leave it at five, Tony.

MR. BOEHNE. On this ad hoc clearance, do you view that as being a big deal or is that just something that's handled in each Reserve Bank as it comes?

VICE CHAIRMAN SOLOMON. Each Reserve Bank would handle it but there would not be a standing ad hoc.

MR. BOEHNE. I understand.

VICE CHAIRMAN SOLOMON. And under our new procedures it would require that the Secretary of the FOMC be notified immediately.

MR. GUFFEY. Bob Forrestal has raised a question that's troublesome to me also and that is restricting the number to four, which would mean I'd have to cut out the first vice president. Under the by-laws, on all other things he operates in my stead when I'm gone, which is reasonably frequently. To go through the process of sending a wire to add him on an ad hoc basis for some indeterminate time while I'm gone seems to me unreasonably burdensome. I'd like to suggest that this be amended to permit four as designated and to permit the first vice president to have access without this special authorization at the time the president is not there. As I say, he has all the powers that I have when I'm not present.

CHAIRMAN VOLCKER. He doesn't have any powers with respect to the Open Market Committee.

MR. GUFFEY. Yes, that is true. But the fact of the matter is that he stands in my stead and ought to be able to have the kinds of information that I would have if I were there. That seems quite reasonable to me. The only thing I'm suggesting is that there be a built-in ad hoc exception without the notification process for the first vice president at the time the president is not in the Bank.

VICE CHAIRMAN SOLOMON. Well, I don't understand. Given the fact that we all have such good attendance records here, I gather that you're not talking about the very rare case when your first vice president would be attending [an FOMC meeting] in your absence, Roger?

MR. GUFFEY. No, I'm not. I'm talking otherwise.

VICE CHAIRMAN SOLOMON. He cannot participate on the morning call.

MR. GUFFEY. That's correct.

VICE CHAIRMAN SOLOMON. So, I don't understand. What does the first vice president do in your Bank in regard to the FOMC directives if he's not in on the call?

MR. GUFFEY. Among other things, he has handled my board of directors for a discount rate action when I'm not there. He certainly ought to have available to him what the Committee has done and what it is thinking about preceding that kind of action.

VICE CHAIRMAN SOLOMON. In effect, it really becomes five, doesn't it then?

MR. GUFFEY. Well, I'm suggesting that it remain four but that we have an ad hoc exemption without the clearance procedure.

VICE CHAIRMAN SOLOMON. A permanent ad hoc?

MR. GUFFEY. Yes, but only when I'm out of the Bank.

VICE CHAIRMAN SOLOMON. I see.

MR. GUFFEY. Only when the president is not available. It would seem to me to be a fairly simple matter.

MS. TEETERS. The most likely occasion would be when the first vice president would sit in for the president in a conference call. And that has been very rare.

CHAIRMAN VOLCKER. That's not all that rare.

VICE CHAIRMAN SOLOMON. I have no objection to that if that is the consensus view of the Committee and if it's clearly understood that it would only be in the president's absence.

MR. BLACK. I think it's a good improvement, Tony. I would go along with that. In fact, I was planning to send Norm a telegram saying I'd like an ad hoc exception for just that purpose when I am out of the Bank.

MR. BALLES. I'd like to support that, Tony, because I found myself in the same position as Roger. We have three people in the research department who are actively engaged in research and analysis of policy and I would not want to take any one of those off. My first vice president is on the list to receive the Bluebook now under the [current] authorization, although he never in practice gets it. The only time he would look at it would be an overt occasion when he

substitutes for me at this meeting or, alternatively, when he would participate in a conference call when I was out of town or otherwise unavailable, or on occasion when I'm out of town and he has to handle a telephone conference on the discount rate, as Roger mentioned. So, if we could somehow get that exception you're talking about carefully controlled but built-in to avoid the necessity of formally notifying the Secretary every time I'm out of town, it would surely help. We would treat it as a true exception, not just a routine everyday access to the FOMC Class I materials.

MR. GUFFEY. Yes, that's also true with regard to the upgraded [classification] of the wire from the Desk. There is information there that would be helpful if there were going--

CHAIRMAN VOLCKER. Is there consensus on this point?

MR. MARTIN. It sounds good to me.

CHAIRMAN VOLCKER. I interpret this, Mr. Solomon, as not limiting the prerogative of the Chairman to have more limited executive sessions for whatever purpose.

SPEAKER(?). And you have even more ad hoc exceptions than anybody else.

MR. PARTEE. This would be on a strict need-to-know basis. You would keep a record of when you let the first vice president have access, I take it. So, if we had to follow down a leak, he would be caught up in it. But it wouldn't be a continuous matter; it would just be for specific occasions.

MR. FORRESTAL. Special occasions. Did we settle the question I raised earlier, Mr. Chairman? Does anybody have an objection to amending this part A to indicate that Class I is limited to the president and I would suggest language such as "three other individuals designated by the president."

CHAIRMAN VOLCKER. Where is this?

MR. FORRESTAL. Otherwise, I'm going to make some new officers.

MR. PARTEE. Well, I think we'd want them to be on the payroll of the Federal Reserve Banks!

MR. FORRESTAL. Oh yes, of course.

MR. PARTEE. You said "three other individuals." That could be anybody. Let's see, Jack Anderson and--

CHAIRMAN VOLCKER. "Three other officers and employees." Is that the language?

MR. FORRESTAL. "Staff members." And they would, of course, be research staff.

CHAIRMAN VOLCKER. What's the magic word? Employees, staff members?

MR. BLACK. Staff members, I think.

MR. AXILROD. You use "persons" on Class II.

VICE CHAIRMAN SOLOMON. Use "Federal Reserve personnel."

CHAIRMAN VOLCKER. Federal Reserve personnel. There seems to be a consensus on that point. Any other comments?

MR. KEEHN. Tony, it's not part of what you've taken a look at, I'm sure, but did you also consider the way in which we distribute the Bluebooks? The point I would make is that they are distributed at a time at which our security is at its very lowest level I would think--namely, over the weekend. And each time we have to develop a procedure by which we're going to handle them. I wonder if there's a way we can distribute them to the Banks at a time when our procedures are best geared to handle them.

CHAIRMAN VOLCKER. How, in fact, do they get to the Banks now?

MR. ROBERTS. They don't get there all the time.

MR. KEEHN. They come in via something called Cannonball Express. And Cannonball Express delivers at a variety of times; it could be either Saturday afternoon or anytime on Sunday.

CHAIRMAN VOLCKER. Cannonball Express is a private delivery service?

SPEAKER(?). Yes.

MR. KEEHN. I hope it is. And we have to go through a procedure to deal with that.

VICE CHAIRMAN SOLOMON. The alternative, though--to do what you have suggested--is giving out the Bluebooks on Monday morning. We checked around and there were objections to that because presidents and members of the Committee would not have a chance to consult with their three other people. So, I don't know what the alternative is.

MR. KEEHN. I suggest it as a possible alternative because we have some problems. If they were distributed Thursday night by pouch, I think that would eliminate all the problems and deal with the concern we were suggesting.

MR. PARTEE. They're not ready on Thursday night.

MR. ROBERTS. It is a problem. For example, I didn't get mine this time. Usually I have it delivered late Sunday, so I don't have any time for consultation except while flying on the airplane.

CHAIRMAN VOLCKER. I looked at mine a half hour ago.

MR. BLACK. Don't your people work on weekends, Ted?

MR. ROBERTS. Up until Sunday at about midnight!

VICE CHAIRMAN SOLOMON. Of course, if it's the consensus view here, I'd go along with that. But there is one disadvantage to sending it out Thursday night and to all the Banks having it Friday morning: We'd be adding one critical weekend of possible leaks. And that two- to three-day period before we have a meeting is when the media is the most focused. On the other hand, with the general view--

CHAIRMAN VOLCKER. Just looking at it from the production side, what is the problem in getting it out a day earlier?

MR. AXILROD. It would have been impossible before the money supply started coming out on Thursday night. It's more possible now to do it Thursday night, but I would say it runs the somewhat needless risk of errors. But it's certainly possible now, whereas it wasn't possible before.

CHAIRMAN VOLCKER. I don't know whether we should someday review the magic day upon which we hold Open Market Committee meetings. We wouldn't get into this weekend problem if it--

VICE CHAIRMAN SOLOMON. If it were on Wednesday instead of Tuesday or instead of Monday and Tuesday.

MR. PARTEE. We've discussed that too at other times.

MR. GUFFEY. There's one other problem associated with this. The way the Bluebook is sent, two copies come to our Bank that are put together in one package and we have to designate somebody in the Bank either Saturday night or Sunday to open that material and repackage it, with one going to Tom Davis and one to me. If each were packaged separately with our name on it, we'd eliminate that.

MR. AXILROD. Normand knows better than I do, but my impression is that distribution of the Bluebook is a continuing, miserable problem. And I think Cannonball Express is probably only the latest in the efforts to find a reliable delivery service.

MR. BERNARD. That's primarily because the main delivery services just don't deliver on weekends. Given that it's ready only on Friday evenings, we have to rely on--

MR. BALLES. Well, that's exactly--

MR. ROBERTS. In view of all this stepped-up security, Tony, maybe the [additional] day is not that much exposure.

MR. AXILROD. We were very close, Mr. Chairman, to having it ready this Thursday night. With a little more experience and if we don't have last minute data that would involve [revisions], it may prove possible. But I would--

CHAIRMAN VOLCKER. Let me just give you a reaction to it. It has the problem of another day, which means the weekend, which I think is a problem. We have an existing problem of relying upon these carriers, which doesn't make me feel all that happy on the other side. In terms of substance, let me just raise a question with you: What is the point of getting it so early? You are supposed to be making up

your own minds before Mr. Axilrod prejudices your view. Maybe it's a good idea to get it late!

MR. BALLES. I'll speak to that. I think it's a good idea to get it early because we do have people at the Reserve Banks--whether it's one, two, or three--who spend a good deal of their time on analysis of policy options and so forth. As things now stand, if the Bluebook doesn't come in until Sunday, they never do get a chance to read it or provide input or advice to the principal who comes to the meeting, at least in my case.

CHAIRMAN VOLCKER. Why can't they give you that advice without the Bluebook?

MR. BALLES. Well, they can; it's just better if they know all the nuances and the considerations that are in the Bluebook. I think they would benefit from knowing those before they render advice. And on the other point, Mr. Chairman, Norm knows we have had some real horror stories in terms of security in getting this material to the West Coast. It wasn't just a matter of it not arriving but a matter of it getting lost in the mail. It was out there floating around and we didn't know where it was and Norm didn't know where it was. We finally retrieved it after extra copies were sent out to us. He and I were both very, very much concerned about the security problem of it just getting lost in the mail because of this unreliable weekend delivery service. I'm very nervous about that.

CHAIRMAN VOLCKER. How does the ordinary pouch go, whatever the pouch is? I keep hearing about it. What does it consist of?

MR. BLACK. We would get it Monday morning that way.

CHAIRMAN VOLCKER. Who delivers it?

MR. BERNARD. Well, I'm not sure.

MR. CORRIGAN. It's our check couriers.

MS. TEETERS. It goes in the afternoon, right? It [can't] come out Thursday night.

MR. BERNARD. The problem with the pouch is that we would have to have the Bluebook ready by about 5:00 p.m. or it's just too late to make it into the pouch.

MR. GRAMLEY. On what day, Friday or Thursday?

VICE CHAIRMAN SOLOMON. Thursday to get it to us on Friday.

MR. AXILROD. Well, we'd never make the Thursday night pouch. We could make the Friday night pouch if that would get it delivered any better. But I doubt that it would.

MR. BERNARD. I don't believe that delivers until Monday.

MR. AXILROD. Yes, I know. As I said, I don't think that will help one bit. But if we tried for Thursday, we'd be through

about midnight. As it is we could get it out in the course of the day on Friday earlier than we used to get it out.

CHAIRMAN VOLCKER. Whom does the pouch go with--our check couriers?

MR. CORRIGAN. Yes.

CHAIRMAN VOLCKER. How do they get to Washington?

MR. CORRIGAN. It goes out of Richmond; it doesn't go out of or come in to Washington. Everything that goes by pouch in and out of Washington goes through Richmond.

VICE CHAIRMAN SOLOMON. What you're saying is that if we were to try and get the Bluebook out to the Reserve Banks on Friday and you don't finish preparing it until midnight on Thursday, then you are not talking about the pouch but some kind of special express service that will get it to us by Friday afternoon. I don't think we'd all get it by Friday.

MR. AXILROD. Well, that's what we do now. We have an express service special that goes out whenever it's ready on Friday.

VICE CHAIRMAN SOLOMON. I know, but it comes in over the weekend. What I'm saying, though, is that if it doesn't go out until sometime after midnight on Thursday, I don't think everybody would get it on Friday in time to--

MR. CORRIGAN. There may be a better solution to this. Last Saturday we tested for the first time this new high speed facsimile transmission among all 13 of us, the Federal Reserve Board and the 12 Federal Reserve offices. This thing really works fast and produces a very good copy, and it may be that we can use that. That would eliminate the carrier and it would also eliminate the security problem upon receiving it at the Reserve Banks.

CHAIRMAN VOLCKER. How do you control the number of copies?

MR. CORRIGAN. I don't know where the machines are in most other Fed offices, but at least in my Bank--and for precisely that reason--it's right next to my office and it's very tightly controlled.

MR. PARTEE. There's a really good suggestion. We could say at 2:00 p.m. Friday afternoon or something like that.

VICE CHAIRMAN SOLOMON. It's fairly easy to deal with. All Mr. Bernard would have to do is call that number and say "We're about to transmit" and some designated person would just stand there and physically take it off the machine.

CHAIRMAN VOLCKER. Is that in operation now?

MR. CORRIGAN. Yes.

CHAIRMAN VOLCKER. Can it take charts?

SPEAKER(?). Yes.

MR. CORRIGAN. It really makes good copies.

MR. AXILROD. We could try that, Mr. Chairman.

CHAIRMAN VOLCKER. Is it secure?

MR. CORRIGAN. It's more secure than Cannonball!

MR. AXILROD. We have gone through that, Mr. Chairman, with the Federal Reserve Bank of New York in getting comments from Mr. Sternlight. The transmission has been terrible.

MR. CORRIGAN. Not with this new one.

MR. AXILROD. I don't know. The new one may work. It's the old one that doesn't work so well.

MR. CORRIGAN. It really is good.

MR. GUFFEY. Will it print a blue cover? [Laughter.]

MR. ROBERTS. It could be transmitted that way and then we could pick up the regular report when we come down here.

MS. HORN. Mr. [Vice] Chairman, would you speak just a minute to the security [unintelligible]?

VICE CHAIRMAN SOLOMON. Our report doesn't get into this question. It seems to me that if the Chairman wants, he can authorize a trial run on it next time.

CHAIRMAN VOLCKER. Yes, let me look at it and we'll see whether we can make some alteration next time. This doesn't enter into this report. Are there any other issues? Should we reconsider when we meet? I won't do it now, but--.

MR. PARTEE. It seems to me that we once went through all the days of the week and it turned out that Tuesday was the only possible day.

CHAIRMAN VOLCKER. I don't know.

VICE CHAIRMAN SOLOMON. Yes, but that had to do with the day of the directors' meetings and the last day of the settlement week.

CHAIRMAN VOLCKER. Actually, I thought that Tuesday was a particularly awkward day in terms of the data flow.

MR. PARTEE. Yes, it had to do with directors' meetings.

VICE CHAIRMAN SOLOMON. Do all Banks have their directors' meetings on Thursday?

MS. HORN. Thursday.

MR. FORRESTAL. We have a lot of ours on Friday.

VICE CHAIRMAN SOLOMON. So, it's either Thursday or Friday. No Bank has a day different from that for directors' meetings?

CHAIRMAN VOLCKER. I thought one Bank had them on Monday or Wednesday, but that could have changed. Well, we'll look into these things. Meanwhile, I guess we can approve the report with the two amendments that were made. Do I have a motion?

SPEAKER(?). Move to approve.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection.

MR. PARTEE. Mr. Chairman, did we take up item 7 on the agenda?

MR. GRAMLEY. Not yet. You skipped it.

CHAIRMAN VOLCKER. I don't know where we are [on the agenda].

MR. GRAMLEY and MS. TEETERS. Bankers acceptances.

MR. PARTEE. Yes. There was a Manager's recommendation very different from [the recommendation in the memo], and I thought we ought to have some discussion of that.

CHAIRMAN VOLCKER. Where am I? I'm following--

MR. PARTEE. You were on number 8. Somehow item 7 got lost.

CHAIRMAN VOLCKER. Let's go back to bankers acceptances. I skipped it because it's not on this [summary] memorandum. Anyway, let's consider bankers acceptances.

MR. PARTEE. RPs on bankers acceptances.

CHAIRMAN VOLCKER. Mr. Sternlight, you have a memorandum.

MR. STERNLIGHT. As noted in my memo to the Committee, Mr. Chairman, I felt the decision on whether or not to continue doing repurchase agreements in BAs was a very close one. In fact, I had initially written a summary for my own staff summarizing the pros and cons, which came out marginally for staying with the operations. We kicked it around for a while and were persuaded, with varying degrees of enthusiasm, to come out on the negative side. But again, for some of us anyway, quite narrowly. That was our evaluation of, on the one side, the modest usefulness of continuing the operations and, on the other side, a small but nonnegligible risk of continuing those operations.

CHAIRMAN VOLCKER. What is the modest usefulness?

MR. STERNLIGHT. Well, that we do part of our operations in them when we do repurchase agreements. For the System Account it has worked out in the last year that about 7 percent was in BAs. When this issue was reviewed a year ago the average had been more like 10 to 15 percent. When Mr. Axilrod and I presented a memo just a year

ago on this subject we also thought the decision was close and came out narrowly for continuing the operations. One factor that weighed in that narrow balance was that our withdrawal might add to general market anxieties about the banking system, which we regarded then as less acute than in the previous summer and fall--that is the summer and fall of 1982--but still present in some measure. We are now another year past that relatively sensitive period of 1982, so that reason for not withdrawing seems to carry a bit less weight. In the meantime the use of BAs in our repurchase agreements has diminished somewhat further. So, in my view, those factors tip the scale from narrowly in favor of continuing to narrowly for withdrawing. But as our recommendation stated: If the decision is to withdraw, it should be with several months' notice to the market.

MR. PARTEE. Peter, am I right in thinking that if you knew some very, very compellingly bad information about a large bank that you wouldn't want to make RPs on their bankers acceptances?

MR. STERNLIGHT. We would try to duck it. If it were known in the market, then I think the market would not present us with such a name because that just wouldn't be a good name circulating in the market. But if we had some information and the market in general didn't, then we would hate to make the waves that would be made by rejecting it, so we probably would take it.

MR. PARTEE. And that would also include a foreign agency or branch?

MR. STERNLIGHT. It could, yes; and that tends to be a fairly sizable proportion of what we do.

MS. TEETERS. Are you typically offered more of these than you accept?

MR. STERNLIGHT. Yes, but Governor, we don't really have that choice. When we are doing RPs, we will make agreements with the different firms to do an even \$5 million or \$10 million and so on. It's only late in the day that we find out what actual acceptances are being presented. They don't present us with a million at such and such a rate in a particular bank that is named then; the names usually come up later.

VICE CHAIRMAN SOLOMON. What rationale would you give in your public announcement that gives a few months' notice?

MR. STERNLIGHT. Well, that we have found this of limited usefulness and that the market is mature and certainly doesn't need our participation for support purposes, but so as not to be precipitate we are making the change as of 3 months hence or 6 months hence or whatever. I'd say something like that.

CHAIRMAN VOLCKER. My reaction to this is that the issue doesn't turn at all on its usefulness to open market operations, which seems to me close to nil one way or the other. We were in there historically because of some idea that this market ought to be nurtured and supported and for a kind of regulatory coloration--that we determine what is an eligible acceptance and all that business. And there may be some usefulness there yet. I don't know what it is

but maybe there is. But against that, and given what I know or have found out about the bankers acceptance market recently--that it is operating in a high, wide, and handsome way--it strikes me that I don't particularly want to endorse that. And we get into the messy regulatory question as well--this question you described: If something goes wrong, do we do it or not do it or what kind of signals are we sending? We may be well advised to get out. My only reservation is: Are we really losing something on surveillance on the regulatory side?

MR. PARTEE. Well, of course, we got out of buying and selling them some time ago. Isn't that right, Peter?

MR. STERNLIGHT. The outright [purchases and sales], yes.

CHAIRMAN VOLCKER. We don't examine them anymore.

VICE CHAIRMAN SOLOMON. There are some people, I think, who misinterpret the Federal Reserve eligibility as a good housekeeping seal. We learned more about bankers acceptances when we looked into the Mexican line than we did at any other time.

CHAIRMAN VOLCKER. Well, that's what worries me: that we give this implicit blessing and we don't really use it to see whether the market is behaving within certain parameters yet there's this assumption that we do. If we don't use it, get rid of it.

VICE CHAIRMAN SOLOMON. But can we really have an announcement that we will be discontinuing this within a few months without raising questions that we think some banks are shaky or without the market wondering what lies behind our doing this?

MR. MARTIN. Deregulation. And we're relieving the reporting burden on financial institutions.

MR. PARTEE. Well, we say we have plenty of government securities and no probability of any shortage any time soon. We say we don't need it for open market operations and we say the market is strong on its own and therefore--

MR. MORRIS. The market has matured.

CHAIRMAN VOLCKER. We don't use this now for any surveillance purposes or any that I can understand.

MR. STERNLIGHT. It's not used in a significant way.

MS. TEETERS. If we stop using it for repurchase agreements, could we drop that distinction between eligible and ineligible now?

MR. STERNLIGHT. I think that's a distinction that still applies for re-discount at the discount window, and relief from reserve requirements would still hinge on that aspect. I don't think that would be affected.

CHAIRMAN VOLCKER. You haven't made that distinction in your operations, have you?

MR. STERNLIGHT. No. We have a requirement for what is eligible for our purchase but that goes to the market acceptability or tradability of the name.

CHAIRMAN VOLCKER. The more I hear, the more I think we ought to get rid of it.

MR. PARTEE. I do too.

MR. MORRIS. As far as the regulatory aspect, the New York Reserve Bank could still exercise some surveillance over the market even though we were not operating in acceptances as RPs. Is that dependent upon--

CHAIRMAN VOLCKER. Well, I don't think it is absolutely dependent but I may be wrong. Historically when we used to buy them outright--maybe not in recent years but going back to the '20s, '30s and '40s--somebody would sit there and say: Is this a good acceptance? Has it got the document attached? Does it meet the criteria of eligibility? That has faded away through the years. I think that was part of the purpose of our being in there: That we would only buy the good stuff and the idea was that the market would then gravitate toward the good stuff because that's the only thing we would buy.

MR. GUFFEY. Wasn't there a time, though, in the recent past when we used bankers acceptances when collateral was otherwise short?

MR. STERNLIGHT. Going back some years, yes. When government securities were in short supply it was helpful but it hasn't been that critical.

MR. GUFFEY. But that's no longer present. The market is mature; I don't see why we don't get out of it.

VICE CHAIRMAN SOLOMON. We could have a line in the announcement that says that if the budgetary deficit--

MR. PARTEE. It is conceivable that we might have some embarrassments looking ahead. We don't have any now. We can get out gracefully now. And it won't present a possible issue later on.

MR. BOEHNE. To me, the marginal reasons for being in this have gotten weaker and weaker over the last few years and there aren't any good reasons that I can see.

CHAIRMAN VOLCKER. Is there any point in putting this out for comment? What do our lawyers say?

MR. OLTMAN. You don't need to.

CHAIRMAN VOLCKER. We've said that about some other things.

MR. MARTIN. You're asking for a legal opinion.

MR. BLACK. It might make it a tad easier to resist buying something else if we are going to get any pressure to buy something we don't want--some favored security somewhere.

VICE CHAIRMAN SOLOMON. You are recommending, though, that you continue to have the authority just as you have the authority, although you haven't used it, to buy them outright?

MR. STERNLIGHT. Yes.

VICE CHAIRMAN SOLOMON. Does this require a formal vote? Or what does it require?

CHAIRMAN VOLCKER. What are we doing? We would still have the authority to buy but we're not going to exercise it? I didn't understand that.

MR. STERNLIGHT. That's what was done when we withdrew from the outright [market]. There was no formal change in the authorization.

MS. TEETERS. Did we announce it when we withdrew from that?

MR. STERNLIGHT. I think we did.

MR. PARTEE. I think all it takes is Committee acceptance of the manager's recommendation, which is to stop in practice doing RPs on bankers acceptances over the next several months in a graceful way.

CHAIRMAN VOLCKER. I really have no problem with that but it raises the question of why we have the authorization. But we can face that down the road.

VICE CHAIRMAN SOLOMON. Well, one could conceive of a situation in which we would want to use the authority and we might want to use the authority without waiting for the next FOMC meeting. Presumably the Executive Committee could authorize that if there were some reason.

MR. PARTEE. Executive Committee on what?

VICE CHAIRMAN SOLOMON. There is an Executive Committee on foreign currency.

MR. PARTEE. No, I think it would have to be a wire by the Chairman or a notification vote.

CHAIRMAN VOLCKER. For the time being we don't have to face that. If there is no objection, we'll leave the authorization for the time being and review it later.

MS. TEETERS. Are we going to have an announcement?

CHAIRMAN VOLCKER. Yes. Well, I guess we're up to [agenda item 9], the minutes.

MR. AXILROD. Mr. Chairman, do you want to decide whether there should be a length of time between indicating to the market that we're not going to be in and actually not being in?

CHAIRMAN VOLCKER. That is the presumption isn't it?

MR. STERNLIGHT. Yes. But I don't know whether agreement was reached on what that time interval should be. I would suggest about 3 months.

CHAIRMAN VOLCKER. You can delegate that to the Chairman and the Manager if there is no objection. We have to get to the minutes in a minute. The thought occurred to me in our discussion of confidentiality that we have a request--I guess from Mr. Fauntroy, but I'm not sure how hard it is being pressed by Mr. Fauntroy--that we give his staff rather than the whole subcommittee on the House Banking Currency Committee Part II of the Greenbook modified to redact those very few sentences that have some confidential projection or policy implication. There is very little of that in Part II. It is mostly a pretty straightforward rendition of the business picture and the financial picture and so forth. There is an obvious problem with it at least in the sense that we did it recently for the Redbook and it becomes a question of whether conceding some of these things to them is helpful in terms of harmonious Congressional relationships, assuming it's harmless, or whether it only encourages the next request. The fact is that it is a little hard to make a big intellectual case about this because there isn't much in [Part II of] the Greenbook that is not in the public domain anyway.

MR. PARTEE. But it's our analysis of the statistics, of course, which may differ from other analyses from time to time.

CHAIRMAN VOLCKER. It's a pretty straightforward analysis, I think, for the most part.

MR. GUFFEY. When is that released--if ever?

MR. AXILROD. After five years.

SPEAKER(?). Except for the parts discussing foreign banks.

MR. GRAMLEY. What about the parts from the international division?

CHAIRMAN VOLCKER. That is one place where some deletions would have to be made.

MR. GRAMLEY. If we do this, it might be wise to put a different cover on it and stop calling it an FOMC document.

MR. ROBERTS. Stop calling it a Greenbook. That's how they identify these things. They hear there's--

CHAIRMAN VOLCKER. That's what we did with Redbook.

MR. GRAMLEY. Make this one beige too!

MS. TEETERS. But Lyle, if we do that, then it is not being limited to Fauntroy and his staff. It becomes almost a public document and not an FOMC document.

CHAIRMAN VOLCKER. I think one would have to assume this is virtually a public document anyway whether they promise not to

reproduce it. Copies go to every member [of Mr. Fauntroy's subcommittee] of the House Banking Committee.

VICE CHAIRMAN SOLOMON. Why not give them a Blackbook?

CHAIRMAN VOLCKER. They already think it is accompanied by a black file.

MR. PARTEE. If I were sitting down in Mr. Kichline's chair, I would object strenuously because I think it would affect the way it is written. I think the Redbook has been greatly affected by becoming the Beigebook and I think the Greenbook would be affected by becoming a public document. One is just much more careful--much more stylistic and formalistic--in the way things are said. For example, the staff wouldn't point out that there's something wrong with the GNP figures because of the treatment of PIK or they would say it in such a subtle way that no one could understand what they were saying. And I think there would be a loss of capability to communicate with the Committee.

MR. MORRIS. Couldn't all that be brought over to Part I?

MR. PARTEE. Well, I suppose so. You remember, there didn't used to be a Part I; there was just a Part II. Part I came about because we thought we would do those projections and that they ought to be more confidential than Part II.

CHAIRMAN VOLCKER. It didn't used to have any projections at all?

MR. PARTEE. It had no projections at all when I came here. But I must say, I think it is a way of communicating. What you'll probably have to do is develop a Part I supplement or something that has more of the material that used to be in Part II.

CHAIRMAN VOLCKER. Well, I think you're right in worrying about some inhibition on the way the document is written. I don't know how great that is and I don't know whether there is any general impression that the Redbook has diminished since it is written to be distributed or whether in fact that has led to any difference in the way people write it. Is that a common appreciation? We do delete these sections--they are distributed separately.

MR. GRAMLEY. I have the perception from reading the Beigebook that apart from some certain stylistic changes--taking out comments such as one director said something and taking out the view of panelists--that the content of the Beigebook is not materially different from what the Redbook was before.

MR. BOEHNE. Another way to approach this is to ask: What will be the next request and is it easier to say no at that point than to say no at this point?

CHAIRMAN VOLCKER. Well, we took a very strong line that Part I was verboten and that has not been pressed at this point. Now, what they will do six months from now or a year from now--.

MS. TEETERS. Just looking at the current Greenbook, I think the very first sentences of Part II would have to be totally

rewritten. That reads: "The pace of activity picked up vigorously early this year. Housing activity surged, auto purchases and other retail sales rose strongly, and industrial production advanced rapidly in both January and February." There's no question about where the Federal Reserve staff views the first quarter as a result of that. Practically every one of those adjectives would disappear.

MR. KICHLIN. We didn't try to leave any doubts in that document.

MS. TEETERS. That goes to Chuck's point about communication.

MR. MARTIN. You wrote 4 headlines.

MR. BOEHNE. That would become: "The economy grew in the first quarter on several fronts."

MR. KICHLIN. I think there is some concern. When you go through these with a little time lag, it's pretty difficult to spot a whole series of things that are a potential problem. They come up in Ted's area particularly. On the domestic side, in the past there have been occasions when the monetary data we had were not for the full month and we put in rates of growth for the full month. Or we have put in our corporate bond and stock markets forecasts of various things going out several months. With time, I think the sensitivity declines. I do remember for many years I was assigned the unpleasant chore of writing the Quarterly Report for Mr. Proxmire's Joint Economic Committee and that report was very different from the Greenbook. It supposedly said the same thing--it was on current financial conditions--but it was quite a different animal. When you write something you have in mind the nature of the audience and it makes you more sensitive.

CHAIRMAN VOLCKER. I think there is something to that. But of course you are risking that if they really press, we'll tell them we will reinstate the Proxmire-type reports.

MR. KICHLIN. Well, I'm not adverse to that. And if I have to do this, I would like to get some double mileage out of it. For example, we can get some bulletin articles out of doing that and save some staff time to do something else. If we put a public document out but beef up Part I in a selected way to cover other things, it's conceivable that the Committee might be better off with a different Part I and a Part II that we use [as a public document].

CHAIRMAN VOLCKER. Well, I don't want to probe all your minds, but how many people read Part II?

VICE CHAIRMAN SOLOMON. Now you have to ask how many people read it some of the time.

MR. BALLES. Once a year.

MR. PARTEE. [The Governors] don't have the personal staffs that the Presidents have to give us all that information. We have to read Part II.

CHAIRMAN VOLCKER. I don't think we have to linger on this any more. We won't do anything immediately but I think we ought to review the whole issue. I don't have any particular feeling that Part I should be longer. But we'll get the answers to Part I when we discuss Part II. We won't do anything for the moment. Now I'll go to the minutes. Do we have a motion?

SPEAKER(?). So move.

MR. MARTIN. Second.

CHAIRMAN VOLCKER. Without objection, the minutes are approved. Foreign currency operations, Miss Greene.

MS. GREENE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Questions or comments?

MR. BOEHNE. I have two questions in two quite different areas. The first question: When the chart show was given in January, as I recall there was a chart that forecast some decline of the dollar this year. I don't think it was given with a great deal of confidence but as I recall the chart the dollar was down. The Greenbook forecast is a good bit stronger and I gather that whatever your interest rate forecast was two months ago it is probably higher now. How would you draw the chart on the dollar now, if you had to do it, compared to two months ago?

MR. TRUMAN. Fortunately, since we do the forecasting for that purpose on the basis of quarterly averaging, it allows us to smooth out some factors. The chart show forecast was based on projections from the fourth quarter of 1983 through the end of the projection period and we had particular numbers for the intervening quarters just because we do that for the convenience of it. In fact, we had felt that the dollar was going to stay up longer than we have in this forecast although we have left the projection mostly the same for the balance of the period--going out after the third quarter of this year. So it is the same for the fourth quarter of 1984 and the fourth quarter of 1985. For the first and second quarters we moved it down just slightly, from 131 to 130 on average for the first quarter and 129 or something like that to 126 or so for the second quarter, because it looked like interest rates, if anything, could have firmed a bit--and also because we have been burned so badly, if I may put it that way, as you alluded to President Boehne. We had felt that it might be some time before the cumulative effects of the current account would begin to show through; in fact, they have come in somewhat sooner and stronger than we had implicitly projected at that time.

MR. BOEHNE. My other question has to do with the debt situation. Is there anything that can be said about that at this point?

CHAIRMAN VOLCKER. You're looking at me rather than at the people at the other end of the table. Well, I think the answer to that is "Yes." Most of the attention right now is focused on Argentina where, as you know, they have a new government and a very difficult external problem. The amount of indebtedness is large; it's

half the size of Brazil's or Mexico's, but it is still fairly large. The new government has had a lot on its mind to say the least internally as well as externally and they were not moving very rapidly toward an external--or internal for that matter--economic adjustment program. In a sense they lost a quarter or so while they were pursuing other priorities. As a result, there are possibilities at least of more substantial problems. I suppose it's fair to say that the possibility of getting a letter of intent this week before the end of the quarter is at the vanishing point. It seems very unlikely under those conditions that interest [arrears] will be brought up to date through the fourth quarter of last year, which means those loans will become nonperforming early in April and will affect earnings statements early in April.

But more important than that: This is the first time, I think, that this has happened to any of these major borrowers. And what psychological reaction it will have on the banks' attitudes or on the market, and indeed on Argentina, remains to be seen. That would be amplified further if it is followed by a classification of the loans, which isn't automatic and which seems to be natural unless activity picks up pretty rapidly with the [International Monetary] Fund. There are some indications that it is picking up now and there has been a reasonably straightforward effort going on to reach agreement with the Fund just in the last week--in terms of actual discussions with the Fund even in the latter part of last week, to be more precise. There are indications that the government wants to reach an agreement. Certainly, the Fund wants to reach an agreement. There are discordant voices within Argentina and some very real difficulties on such little matters as how far they can reduce the budget deficit, to take one example. Wage policy traditionally enters into these negotiations. They have been following an ad hoc policy from month-to-month of increasing real wages. Inflation is accelerating; monetary policy is lax; and the [peso] is probably a little overvalued. And two-thirds of their exports would be eaten up by the need to pay interest. Otherwise there wouldn't be any problem!

I might say in just looking at the Argentina problem that they have a big trade surplus, very largely based on agricultural exports. The country is reasonably self-sufficient. Part of their big debt reflects some recent current account deficits, but not half of it and maybe not more than two-thirds of it. In rough numbers they have had proportionally an exceptionally large amount of capital outflow, and like some of these other countries they finance private capital outflow by the government borrowing the money back. But the assets have flown. They don't generate any income for Argentina because the income stays abroad as well as the assets, and it puts a very large burden on their current account to manage their external debt. We have a problem within Argentina and, of course, we have the contrary problem that whatever happens to Argentina--which in and of itself might be a manageable situation--how can you expect a situation to remain manageable or what are the risks that it will spread to other borrowers and we will have a much bigger problem on our laps? So, that is the focus of concern.

Now, there are continuing concerns with other countries. Peru lost a finance minister recently. Mexico continues to look good from the external side but it still has sluggish growth. However, it does look as if they may be approaching a situation where they will

not have to rely much, if at all, on net new external expansion. Brazil, on the other hand, is just in the middle of what has finally become, I think--there are still some questions about it--a pretty forceful internal adjustment program, tightening their monetary policy. But the success of that is still not clear.

MR. BOEHNE. Do you think there will be interest rate concessions forthcoming from the banks?

CHAIRMAN VOLCKER. Well, I don't know what you mean by concessions. It's a very foggy word. The idea of giving what one might term a subsidy, which Argentina no doubt would like, would be an extremely difficult one for the banks and in itself would raise a lot of questions of precedent for the other countries. Certainly, the Argentines will at the very minimum go for whatever concession--more narrowly defined as a low spread--they can get. That would give banks some heartburn too on the theory that the Argentine payments are not as large as the payments of other countries and why do they deserve as narrow a spread as Mexico has gotten. The Argentines probably won't be very happy with the Mexican spread. That poses a problem.

VICE CHAIRMAN SOLOMON. On those 22 reschedulings that have been held up, one went through; it was controversial. The new government came in and they basically want better terms. On those, what the banks have offered them is to reconsider the maturities but not the spreads, and so far there has been no movement because everything is held up in Argentina. It's not only the IMF thing, which of course is the key. There is also still that billion dollars of money that they could make available to Argentina that would be coming back to them as interest. Then there are the 22 reschedulings on which there is no movement. So, there is an impasse.

CHAIRMAN VOLCKER. One can say increases in interest rates in the United States don't help any of these problems.

MR. PARTEE. It's close to a six month give-up of interest for them. I think the last payment was October 12th.

CHAIRMAN VOLCKER. It was October 3rd or something.

MR. TRUMAN. It was the 13th.

CHAIRMAN VOLCKER. However, some banks have told me that they have gotten scattered payments since then.

MR. TRUMAN. They are [not] paying the interest. They have been paying some of their trade arrears, which in some cases involves payments to banks.

MR. PARTEE. I see.

MS. TEETERS. In these renegotiations, Tony, are the rates being offered these countries a spread over LIBOR or prime and then the rate moves as those rates move? Is that the way they transmit the change in rates in the United States?

VICE CHAIRMAN SOLOMON. Or in the Eurodollar market.

MR. GUFFEY. How much of that Argentina debt resides in U.S. banks and how much in non-U.S. banks?

CHAIRMAN VOLCKER. It's \$9 billion dollars or something like that for U.S. banks.

MR. TRUMAN. It's something like \$9-1/2 billion for U.S. banks out of the \$25 billion.

VICE CHAIRMAN SOLOMON. I looked at the hit that the New York banks would take if the loans become nonperforming on March 31. It doesn't add up to a lot. ^{is the most vulnerable} but the numbers still are not terribly large yet, although it has a definite impact.

MR. GUFFEY. When the loans go nonperforming, what percentage do the banks have to charge off?

VICE CHAIRMAN SOLOMON. They don't have to charge off anything automatically just because a loan is nonperforming.

MR. BOEHNE. They have to take out what they put in, I guess. Don't they?

CHAIRMAN VOLCKER. They would have to not record the accrued interest for the first quarter and also subtract out from the first quarter earnings what they already had accrued from the fourth quarter. So they get a double hit in the first quarter.

MS. TEETERS. Do they have to put up reserves?

CHAIRMAN VOLCKER. No, not at this point. They don't have to but the process is beginning that leads to classification and then to further classification and at that point they would have to.

MR. TRUMAN. Our investigation, Mr. Chairman, suggests that not all banks would automatically in all cases back out the fourth quarter [accrued interest] under those circumstances. It's not explicitly required by the instructions. It's an acceptable practice.

MR. PARTEE. They would deduct it from their reserve for bad debts, wouldn't they?

MR. TRUMAN. They don't always. That's the form in which they often would take out the fourth-quarter [accrued interest] if they were doing the fourth quarter. But at least my information suggests that they don't always do that in all cases. They do stop accruing after 90 days but the previous period in some cases--

MR. ROBERTS. The previous period is usually a reserve adjustment and the current period is a reversal.

MR. PARTEE. That's the way they are supposed to do it according to the Call Report.

MR. TRUMAN. That's right. That's the so-called acceptable way of doing it: to deduct it against loan loss reserves and then replenish the loan loss reserves to that extent. That, in effect,

takes the income hit in the first quarter. But in some cases, I understand, banks have declined to do that--or their internal accounting people have chosen not to do that.

MR. ROBERTS. If you had an adequate reserve you wouldn't have to replenish it?

MR. PARTEE. Yes. You might have to later on.

VICE CHAIRMAN SOLOMON. Adequacy is in the eye of the beholder.

MR. ROBERTS. That's right. The bank is the beholder.

MR. PARTEE. Banks are supposed to have some outside accountants that tell them.

MR. BALLES. Mr. Chairman, I have a request that may be too delicate for you to comment on--I'm not sure--but I'm going to read it anyway. I'm scheduled in early April to give a talk to a banking association for foreign trade, as Chuck knows. They tried to get him and had to settle for me. In any event, the point may come up at that meeting in terms of comments that have been made in the press that you have had a role, and maybe a leading role, in urging the banks to reduce the interest rate that they are charging these troubled Latin American countries. If that question comes up, is it true or not? What should I say? No comment? I don't know? Maybe?

CHAIRMAN VOLCKER. I don't think you want to get drawn deeply into that subject, but I haven't made any great secret of the fact that in the situations where there has been clear improvement I think that ought to be taken into account in setting terms--whether interest rate terms or maturity terms or the size of the package or whatever. But we haven't gone around on a case-by-case basis [unintelligible] drawing out interest rate spreads. A clear case of improvement is Mexico.

MR. PARTEE. I think it was stated quite a bit more broadly than that in the article in The Wall Street Journal that you probably are referring to.

MR. BALLES. It was. That's the article I was referring to.

MR. PARTEE. I don't know. As a matter of fact, I called to find out if anybody knew whether you had been doing this or not after I read that article and I couldn't find anybody who did. I think it was more broadly stated in terms of a considerable interest rate give-up. It reminded me of the days when they used to say that the Fed told the banks they ought to continue with those REIT loans. We never said it, but that was what all the bankers said we said.

VICE CHAIRMAN SOLOMON. Well, if interest rates keep going up, the question is going to arise as to whether the [unintelligible] banks are capable of devising some kind of new relationship in regard to the increase or whether the financing put together by the IMF is going to have to be revised in the middle of the year, although that could create consequences. In other words, there has been some talk, but it has only been in general terms, about the banks and a cap on

payment of interest rates; and any rise in interest rates would be capitalized so that it wouldn't disturb the cash flow projections and the financing that has been arranged for the year. So far there is nothing very concrete, even though there has been a good deal of talk.

CHAIRMAN VOLCKER. I detect an interesting phenomenon in this area. When you talk to the banking statesmen, if there are such people--or to those who would like to think they are banking statesmen at large banks or small banks or American banks or foreign banks--they talk very freely about reducing interest rates and the need for concessions, for caps, or whatever. When their delegates arrive at the banks' advisory committee meetings that atmosphere seems to be noticeably absent. I think it's fair to say that we can have formal conversations that probably encourage larger thinking but it doesn't get transmitted very much in their--

MR. BALLES. That's surprising, because I know that at least at two of our big banks on the West Coast

those at the top level have stated that they feel concessions ought to be made on interest rates. I wasn't aware that the people who show up at these meetings are taking a different view.

CHAIRMAN VOLCKER. show up at these meetings. by and large does not does. In some cases where banks were not at these meetings, I could only report an impression. I don't try to track all these down. Bankers who have talked in rather sweeping terms are also reported to be with banks that don't want to participate or want to raise the interest rate when the telegrams go out. They think the terms are too narrow. I don't think I'm completely misreading this situation: There's a difference between the guy [whose] bonus is being determined by the performance of these loans and the interest rates on them and the executives who are somewhat above those levels.

MR. BOEHNE. Some of the regional bankers in my territory have said that they won't kick another dime into these but they would talk about interest rate concessions. Apparently what you are saying is that they will talk about it, but that's about as far as it goes.

CHAIRMAN VOLCKER. Well, a lot of very tricky problems arise in interest rate concessions or roll-ups or whatever in maintaining any sense that these loans are then currently performing and [unintelligible]. That raises a whole range of other problems about how many reserves and so forth and it changes the whole nature of the negotiation with foreign countries. There's a legitimate fear that once they began making concessions, where does it stop?

MR. BOEHNE. Right. I was told by the regional bankers in my territory that regional banks around the country were getting together to come up with a uniform approach to the next round when they would be asked to kick in more. But I never did actually hear the result of that get-together. Have you heard anything about that?

VICE CHAIRMAN SOLOMON. No, and I don't think it's very likely, or practical either, for them to organize and talk that way because among the banks that aren't coming along there is a mixture. There are very few of the important regional banks that don't come along eventually, although there may be 30 or 40 of the smaller banks.

MR. BOEHNE. I think the next time you try to get them to come along it's going to be a heck of a lot tougher than the last time.

CHAIRMAN VOLCKER. It gets a lot tougher not just for them; it gets tougher for the bigger banks and for the European banks. The whole process is getting tougher. But if you want to look at the other side of it and hold this thing together a while longer, it is quite feasible, as I suggested earlier, that Mexico will come back next year and we can forget about all those regional banks and smaller banks. And maybe the bigger banks wouldn't have to provide anything either. That doesn't say there isn't a lot of refunding to be done. But I think it's easier if we can make a distinction between restructuring or refunding and new money. Mexico might be getting close to becoming a country that in some sense has made the adjustment and isn't totally dependent upon these greatly ginned up programs. And then people will begin saying yes, conceivably they are beginning to see the end of the process--"end" is stretching a little, but at least an end of the process of a mass draft of new money for one country--and we can begin looking more hopefully at other countries. But we have to hold it together for a little while longer before that can happen.

MR. FORRESTAL. There was some talk in my District, Mr. Chairman, about the banks getting together in connection with the Brazilian situation to resist any kind of new money going in but that never did materialize either. I was going to ask some--

CHAIRMAN VOLCKER. The basic arithmetic here, of course, is still very strong. They can sit there and talk about not getting any new money. The fact is that they're getting more interest out of all these countries and they're putting in new money. It may be nice to say the choice is no new money, but the response of the [debtor] country is no interest.

MR. FORRESTAL. In that connection, if the Argentineans don't make an accommodation with the IMF and these loans are put into a nonperforming status, does that automatically trigger a technical default on the part of Argentina?

CHAIRMAN VOLCKER. Well, it could. In some sense they're in technical default now. They're in a position where a lot of banks could say Argentina is in default if they wanted to take action.

MR. FORRESTAL. Are the Europeans likely to do that, for example? That's what I was thinking about.

MR. ROBERTS. It just takes one, doesn't it?

CHAIRMAN VOLCKER. There is a mixture of opinion in Europe and a mixture of opinion in the United States. So far they've held ranks, but I think the nonperforming status will give some of them that idea. It will be an event. We will see what happens.

MR. GUFFEY. Is there any significance to the fire in your ashtray?

MR. GRAMLEY. He's an arsonist!

CHAIRMAN VOLCKER. No.

MS. HORN. Mr. Chairman, just a point. When these loans are renegotiated and when regional banks do express reluctance on various grounds, is it sometimes appropriate when that happens for presidents to make calls and just state the Federal Reserve's position?

CHAIRMAN VOLCKER. We were trying to avoid that.

MS. HORN. Yes, and so am I. Sometimes we get calls from staff members from various places and it's a little hard--at least speaking for myself--to read the seriousness of the problem and whether it really does warrant a Fed president stepping in or whether to tell these staff members that they really ought to try the regular channels [through] the correspondent banks. It's a little hard to read the calls we're getting from the System to the banks.

CHAIRMAN VOLCKER. From the System?

MS. HORN. From the Federal Reserve System to the banks. Sometimes I get calls from staff members either in Washington or New York suggesting that I call this, that, and the other bank.

CHAIRMAN VOLCKER. Recently?

MS. HORN. No, during these negotiations.

VICE CHAIRMAN SOLOMON. But even then, wasn't it couched in terms of asking the banks what their view was on this matter and whether they were going to go along or weren't going to go along? [Unintelligible] stating the Board's policy as we saw it but saying that, of course, they have to make up their own mind.

CHAIRMAN VOLCKER. You are raising the specter in my mind that there are more such calls than I was aware of. And I hope that's not the case.

MR. PARTEE. Always a disturbing thought.

CHAIRMAN VOLCKER. I have not been encouraging such calls.

MR. PARTEE. Unless we are prepared to guarantee the loans.

VICE CHAIRMAN SOLOMON. Well, we did those about a year ago.

CHAIRMAN VOLCKER. In the case of Mexico I can recall that there were a few calls of inquiry. I'm not aware of any since then, but maybe I'm--

MR. ROBERTS. Yes, Brazil.

VICE CHAIRMAN SOLOMON. Yes, in the case of Brazil there were a few but not very many.

CHAIRMAN VOLCKER. I didn't think there were any on this recent Brazilian exercise. I'd be interested in knowing where that came from. Any other questions in this area?

MR. PARTEE. What did happen with the dollar this morning, Gretchen? You seemed to allude to a decline.

MS. GREENE. It eased somewhat from Friday.

MR. PARTEE. Just somewhat?

MS. GREENE. Yes.

VICE CHAIRMAN SOLOMON. A four-pfenig drop.

CHAIRMAN VOLCKER. Just to revert to the other issue: I have told the banks when they have asked that it's their job to round up all these things. I've made some statements about general support for the program, which they can use in public, but not in terms of contacting individual banks. [Let's turn to] domestic open market operations.

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

MS. TEETERS. Peter, do you anticipate a situation like we had in September when we had all that money just pouring into our--

MR. STERNLIGHT. It looks very much as though it could be that large or even a little larger.

MS. TEETERS. Do you expect the total balance to go up into the \$30 to \$40 billion area?

MR. STERNLIGHT. Our figures have it up to about \$40 or \$42 billion, something like that. I think the Board staff's projections are not quite that high, but not far from it.

MS. TEETERS. And there's no indication on the part of the Treasury to cut back on their borrowing to compensate?

MR. STERNLIGHT. They cut back a little on Treasury bills a couple of weeks ago. I've been having conversations suggesting a review of that. But I don't think we'll get very much help there.

MR. RICE. Does it seem likely that these funds will stay with you as long as they did last year?

MR. STERNLIGHT. [The Treasury balance] comes down again in early May, fairly fast. I don't have a very clear time profile, Governor Rice.

MR. PARTEE. There could be a debt limit problem couldn't there?

MR. STERNLIGHT. In early May I think there could be debt limit problem, yes.

MR. PARTEE. I move it.

MS. TEETERS. I second.

CHAIRMAN VOLCKER. If there is no objection, we will approve [the recommended leeway increase] with a note in the commentary that this is in reaction to a very large increase in the Treasury balance and not monetary policy. We have to ratify the transactions since the last meeting.

MS. TEETERS. We didn't ratify the foreign currency ones, did we?

VICE CHAIRMAN SOLOMON. There were none.

CHAIRMAN VOLCKER. Do I have a motion?

VICE CHAIRMAN SOLOMON. Motion.

MS. TEETERS and MR. RICE. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Kichline.

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

CHAIRMAN VOLCKER. The [next] item on my agenda says: Committee discussion of economic situation and policy implications. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, the Eleventh District economy is growing, although somewhat unevenly. The weakness in the energy sector has caused manufacturing to be sluggish, but most economic reports indicate that both residential and nonresidential construction have continued their strong growth. In the District, the S&L situation, which has been in the national news, is a matter of concern. In Texas the S&Ls had a 32 percent increase in assets in 1983 and the federally insured S&Ls from Texas closed about \$20 billion in loans in 1983 as compared to \$9 billion in 1982. Of course, we had the closing of Empire Savings in Mesquite, Texas, which is out where I had mentioned earlier the land switching that was going on.

MR. PARTEE. You never said it was Mesquite.

MR. BOYKIN. Well, it's right out there next to the cowboys. It's the largest S&L closure in the history of the corporation. My notes say that it was caused by funding questionable real estate development loans with a deposit base that consisted of 90 percent jumbo CDs and 10 percent core deposits and that about \$9-1/2 million, or roughly 3 percent, is uninsured. Office construction continues strong. Just to cite Dallas as an example: In January we had 15 million square feet of office space under construction compared to a 3-year average rate of about 8 million square feet. Vacancy rates in Dallas are around 22 to 23 percent and in Houston are 26 percent. Most people we talk to seem quite concerned about the whole real estate picture, particularly that there has been so much built in the multifamily area; but a lot of that concern is now beginning to shift to single-family construction, although the pace of activity doesn't seem to slow down. There are anecdotal comments such as that the Mesquite situation was the tip of the iceberg and that there are some real problems in the making out there. Land prices continue to jump--and jump daily.

land in downtown Dallas for a parking lot. The owner was asking \$40 a square foot. He offered \$38 and the seller didn't take it and two weeks later he bought it for \$52. So, it's moving pretty fast.

On the agriculture side--and on the call the other day some question was raised about agriculture--our feeling is that credit conditions at our District agricultural banks are characterized by mostly improved cash flows for District farmers who are cotton farmers and ranchers who are livestock producers; both now enjoy profitable price levels for their products. The feed, grain, and wheat farmers are probably faced with over-production. The rate of loan repayment seems to have quickened and farmers are requesting fewer renewals and extensions right now, although the longer-term outlook still causes us a little concern, Mr. Chairman.

CHAIRMAN VOLCKER. Your comments raise a number of questions in my mind. Let me just cite some of them and other people can comment on them. On this last issue, the agricultural situation, your comments are not what I am getting from some people in the Midwest. They say the banks are liquid enough but the ability to repay after a few years is getting less. Land appraised values have declined and land price [declines] if anything are accelerating and a lot of farmers are getting increasingly stuck. On this energy situation that you started out with, my impression is that in recent months it has been getting a little worse or going downhill instead of uphill for some reason.

MR. BOYKIN. Well, Mr. Chairman, we did get an improvement in the rig count; it has backed off a little but it seems to be coming back slightly. It's still a difficult situation but what I see at least is that whatever movement there is seems to be a little on the positive side. I'd say that there is not further deterioration.

CHAIRMAN VOLCKER. Prices of unused rigs went up a little from a very low level and have begun receding again.

MR. BOYKIN. Well, I would think that reflects the demand. We had a little uptick in drilling and that has slackened off a bit. I don't have any specific knowledge of the price but I know there is an abundant supply stacked up in the yards. So, if the price is trending down, people might not be able to hold those things forever.

CHAIRMAN VOLCKER. I guess I just don't comprehend what is going on down there with all this land speculation and the S&Ls and all of that. I'm confused [unintelligible] exposed.

MR. BOYKIN. It's difficult for me, as I say, to get a feel for this. The banks tell us that they don't feel exposed--that what they are doing is good and that it will be all right. The S&Ls, I think, have fully anticipated that there will be fallout from Mesquite and that there are a number of other S&Ls--

CHAIRMAN VOLCKER. There are almost 50 S&Ls down there that have grown by more than 100% in the last year.

MR. BOYKIN. Right. And the largest increase was a thousand and some odd percent.

MS. TEETERS. Are these brokered deposits?

MR. BOYKIN. Mostly it seems to be brokered deposits, and about half of the money is going into construction loans as opposed to just the mortgages at the end. They are taking equity positions. They are--well, like Mesquite. They were building up the value daily, two or three transactions a day, and getting it up to the price where they wanted it and then packaging it and selling it out to less sophisticated small S&Ls out in the country.

CHAIRMAN VOLCKER. And in many cases apparently making no attempt to sell the houses.

MR. PARTEE. Less sophisticated!

MS. TEETERS. The most recent housing starts figures showed a very large increase in multifamilies in the Southern and Southwestern areas. And you seem to have an increase in commercial building also.

MR. BOYKIN. Yes.

MS. TEETERS. What is your vacancy rate?

MR. BOYKIN. The vacancy rate is about 22 percent in office buildings; I was told by a broker that the warehouse construction seems to be doing a little better. Prices had been going for about \$2.00 a square foot right before the first of the year and now those prices are up to \$2.35 to \$2.50 a square foot. I'm trying to remember what the absorption rate percentage is and I really can't, but the feeling is that the absorption is picking up.

CHAIRMAN VOLCKER. How do you explain this record or near-record volume of office building in a city that has a 25 percent vacancy rate?

MR. BOYKIN. A lot of optimism and the fact, first of all, Mr. Chairman, that the funds are available. Take the big build-up in funds in S&Ls, for example. We know they are going to have to do something with that money and they are trying to shove it out as fast as they can. On the office building side, there seems to be enough activity to continue to encourage developers and builders.

CHAIRMAN VOLCKER. What is happening to the price on all these existing buildings that have all these vacancies?

MR. BOYKIN. Well, there have been a lot of concessions made. If you want a year's free rent, that's not too hard to get on a five-year lease. There has been some shaving of prices but I would say the price is pretty well holding at around the \$20 a square foot level but with incentives such as paying moving costs or maybe a year's free rent or something like that. That is the way they have been doing it. I heard fairly reliably that a small insurance company went out to the Los Galenos area close to Dallas-Fort Worth and took a very long-term lease and got the first 5 years free.

CHAIRMAN VOLCKER. I don't think you can build a new building any place at these interest rates and expect to rent it at \$20 a square foot.

MR. BOYKIN. No. We just started a hole for the first of two of our Twin Towers. The excavation is underway. There is a bank that's going to be the lead tenant of that. A 55 story building was just topped off for [unintelligible]. Mercantile Bank has announced their 60 story building. The InterFirst building is a 70 story building; the steel is about half way up. There continue to be new announcements about an area we call the "crescent development." They just dug the biggest hole that has ever been dug in Dallas and it's on the north side outside the loop. It's going to have a really first class hotel and three office buildings of over 20 stories, another hotel, shops, and an underground parking garage for about 2600 cars. And that [project] is underway.

MS. TEETERS. Are there vacancies in the residential area or are the sales of new houses--?

MR. BOYKIN. New houses are selling. Used houses are turning over now. Three of four sold in my neighborhood that had been on the market three or four days.

MS. TEETERS. You don't have the same evidence of excess capacity in the residential sector?

MR. BOYKIN. No, but now in the multifamily area it does seem to me that we really are overbuilt. The condos built at Faulkner point, which the Mesquite Empire Savings & Loan was behind, consist of over 6,000 units, which is estimated to be about a 7- to 12-year supply. They have over 6,000 vacant and they are selling them at a rate of about 20 a month.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I thought I might amplify a bit on the comments that I made on the phone last week about the agricultural sector. In our area there are some parts of the District where the agricultural problems are getting somewhat on the serious side but there are some contradictions that are developing on the positive side. Commodity prices have improved from what were very low levels. The opportunity for exports seems improved, particularly to the Soviet Union and to Africa, and certainly that picture ought to be improving rather than deteriorating. And we expect that the participation in the 1984 grain program will be higher than we might have thought several weeks ago. So, in the short term, the situation seems to be better and would provide for an improved situation. But having said that, there are some serious longer-term problems. I think it is fair to say that some parts of the area are going through a significant transition. In Iowa, for example, 50 percent of the farm land is debt free and for 35 percent [more] the debt level is reasonable. Then you get down to the 15 percent where the troubles really are developing. There the debt levels are high and the debt was created as a result of purchasing land at values that were exceptionally high. The land values had gotten out of the economic production scheme and were really pretty much relating to inflation. As inflation has backed off, farm values have gone down and the debt has built up. That, as a consequence, is causing the problems that you see [reported] so much in the press, which are not necessarily reflective of the agricultural sector as a whole. There are also a couple of timing considerations. First, this is line renewal time for most of the agricultural banks and I think

the banks put a pretty special focus on their credit exposures. Also, it's a time when farm auctions are typically taking place so that the whole problem and the emotionalism that is involved with that comes back into focus. And then, frankly, it's a slow time of the year. It is February or March before things begin to pick up and as a consequence that gives people an opportunity to talk about it. I don't in any way suggest that the problems aren't serious. They are. But I think they are not necessarily reflective of the conditions throughout our District as a whole.

CHAIRMAN VOLCKER. If you look at the aggregate figures--I don't remember them offhand but somebody here collects data and makes an estimate--there are a lot more than 15 percent that have these heavy debt burdens. It's a minority but it's very sizable.

MR. KEEHN. Well, I'm really referring to Iowa particularly.

CHAIRMAN VOLCKER. Iowa is probably better off. The calculation of average farm income relative to assets is 2 percent. If a farmer has 25 percent of his farm mortgage at 13 percent, the 2 percent is gone. I don't know what the correct number is, but it doesn't take very much.

VICE CHAIRMAN SOLOMON. You're talking about 2 percent gross, before servicing debt?

CHAIRMAN VOLCKER. Yes. All expenses before interest--

MR. PARTEE. Your investment sector has done quite a bit better?

MR. KEEHN. Yes, Chuck. I think it's a fair comment with regard to the industrial sector that those parts that are susceptible to a cyclical improvement are indeed experiencing it. Many of them, particularly those that are consumer-related, are doing very well. In fact, many are right up to the top on capacity. The sectors that are having a problem are those that are dealing with some pretty secular problems; they are doing better this year than they were last year but nowhere near as well as some of the other parts. But I think they are beyond the scope of monetary policy. They have some special problems all their own.

I must say I've been very impressed with the continued progress on the wage side. People I talk to are still settling contracts in the 4 to 5 percent area but nearer 4 than 5. And they expect to have a pretty good year this year, although they are all very, very apprehensive about the auto negotiations. They can do well now but if the auto negotiations go badly, that would create a different environment. On the price side, though, those sectors that are doing well and are up toward the top of their capacity are beginning to move through price increases with some success. They feel growingly encouraged that they are going to be able to put the price increases in and make them stick. So, particularly in those sectors that are doing well, the price pressures are beginning to grow; and with the passage of time that could be a significant risk. Broadly, I think the answer to your question is that the industrial outlook in the Middle West is far better than it has been.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, Si said some of what I was going to say. My District, particularly the Pennsylvania part of it, has been one of the slowest in the whole country. Every time we have looked at it, the District as a whole has only been 10th, 11th, or 12th [among the Federal Reserve Districts]. And yet as we look over what has been happening, there really is a broad base to our recovery. In manufacturing, it looks to us as though we have been having the most significant growth period since 1977-1978. Manufacturing has been expanding now for about a year and a quarter. We are also noticing the same kinds of things that Si reported. We do an informal survey among the biggest manufacturers in our District. About a year ago, for example, only about 5 percent were reporting any kind of price pressure. What we find now is that about 40 percent of them are reporting higher input prices. We see it particularly in the fabricated metals area and some in printing. So, it really is a recovery that is hitting our manufacturing area. We've tended to come up last in these areas, yet it's clearly the strongest in a half dozen years.

Outside manufacturing I have just some anecdotal evidence. I've gone to a couple of shopping centers over the last several weekends and I couldn't find a parking place. Sales volumes are very high; they are running something like 20 percent over a year ago. Real estate [activity] is quite brisk. It's about average with the rest of the country and that's really quite good for our area traditionally. The banks are reporting rather substantially higher increases in consumer loans, in particular, and to some extent in business loans. On the agriculture side--Pennsylvania is a big agriculture state, although most people tend to think of the Midwest--the big problem in recent months has been the Avian flu problem with poultry. That has turned around. What we hear about weakness is in the export business. Again, just to add on to what Si said, unemployment is still high in some of the industries that have more than cyclical problems--those with secular problems. However, I did find as I talked to a lot of people around the District, that they are much happier than they were, obviously, with this pretty good increase over the last year but they almost plead "Don't end the party so soon." They say it has been a half dozen years of pretty rough times and it has been especially rough from about 1980. It has just been a very long dry spell and they are beginning to feel better about it. Most of them see a relationship between their own business and interest rates. There is much more awareness of [the effect of] interest rates on their business than I have seen. They talk a lot about the deficit. But even though business is much better, they continue to think it's not going to last very long because they see interest rates going up.

CHAIRMAN VOLCKER. What did you hear about wages when you talked to them?

MR. BOEHNE. The same as Si. I think the wage increases generally have been fairly modest. We're seeing that in the public sector. Philadelphia, with its new mayor, has taken a pretty hard line this year with the public area. There is concern that the auto [negotiations] might set a new pattern, but so far wage increases have not shown any material increase. As I indicated a moment ago, there

are some inflationary pressures on the price side, especially in those industries that have had some cyclical upturn.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. The Tenth District has enjoyed some of the strength that has been evident in the economy elsewhere. There are two or three areas to mention, and I'll focus largely upon your question with respect to the agricultural sector. As you know, we do a rather extensive quarterly agricultural survey of bank lending and the most recent one indicates that there is some stability felt among the bankers--stability in the sense that things are not getting worse and that they are manageable. But there's a very long period of adjustment [ahead] for the agricultural sector. In terms of specificity, they look to the projections for net farm income in 1984 that are now running some 50 percent greater than net farm income in 1983. Part of that is the PIK program that has come early in 1984 in which the sales have taken place of grain that has been shipped to the producers themselves. So, some of that income has already taken place. They have serviced the current debt and as a result the banks are feeling somewhat comfortable about the upcoming period. But the point that I think should not be lost is that there is nothing on the horizon that they can see, absent a Russian grain deal or some other magnificent event, by which the agricultural situation is going to improve from this rather low stable level--in particular in the debt service area. Farm liquidations were a very small percentage of farm holdings; that has gone up modestly. There has been some voluntary liquidation--that is, encouragement by the lender to liquidate in order to service debt--but that again has stabilized. I think you have to understand when you're talking about the agricultural community that, as Si indicated, January, February and March are times that they sit around the hot stove and talk about problems. It's only when the sun begins to warm things up and the sap begins to rise that optimism comes back into that area. There has been a pickup on Main Street of small ticket farm equipment sales but the large machinery sales are still very weak. But there is some encouragement on the agricultural input side--I'm talking particularly of [sales of] chemicals and fertilizers, which have been very brisk. In other words, the producers are anticipating large plantings this year and have the money to put into fertilizers and chemicals.

Energy and mining are still very weak, particularly energy. Just to give you a benchmark: The last report that I have is that the number of oil rigs working in the Tenth District is 716; that's up from a low level of 574 a year ago contrasted with 1981 levels of about 1600. So, there is some modest exploration and production going on but it is indeed modest. With respect to the general aviation sector, there is a good deal of optimism. They are not producing but they think and still hope that production is going to increase in the latter part of the year. In the commercial construction field, Denver is beginning to have an absorption rate of their overbuilt situation that looks very favorable. Kansas City and Omaha have what might be characterized as a commercial construction boom. In Kansas City there have been seven major downtown office buildings announced within the last 90 days and two or three of them have holes in the ground and are ready to come out. That is in contrast to Tulsa and Oklahoma City, which essentially are overbuilt in the commercial area. We have seen no real evidence of pressures in the area of wage increases.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. We are approaching capacity in a number of our industries. In autos, given the current mix of demand, we're at capacity for the larger types of cars. Those steel products related to eventual consumer products are going at capacity. Aluminum is very much using its capacity. Alcoa is talking now about doing a lot of ingot importing because they are so backed up. They are at capacity relative to the current plants and construction. Of course, all these companies have plants that they closed down during the last recession. They are at this point deciding not to reopen them. Heavy trucks are going full out--light trucks a little less--as are [the companies that produce] the equipment that goes into these heavy trucks. The tire industry is at more than capacity, working every shift their unions will let them. Of course, we have our weak points. One is electrical machinery. Foundries--the ones that are still open, which are very few--still haven't gotten their first order, so to speak. Machine tool orders are up, though that is not yet really reflected in terms of their production strengthening a great deal. The reaction to all this strength seems to be, as I mentioned earlier, not reopening the old capacity but concentrating on more efficiency within the current capacity and not bringing back workers but doing a lot of overtime or sub-contracting. All of these reactions I think come from a couple of causes. Number one is a skepticism about the future--fear of high interest rates and so forth. Another reason for these reactions is one that I view as very healthy. I think we are seeing some reaction to the intensity of foreign competition and people are now beginning to manage their businesses a little differently. We really hear about inventory control, about schemes to change the way of manufacturing from having huge plants and more people than they can manage efficiently to having smaller plants. They are working on set-up times and on the quality of the final product and so forth. We're hearing a lot about those adjustments and the new manufacturing techniques, if you will. And, of course, these techniques are used in service industries as well in order to meet competitive pressures. So, while I don't believe in discontinuities and in sudden and drastic changes in productivity and quality, I do think we really are seeing some significant differences in this recovery that I think represent a beginning of a trend.

What all this has to do with prices is less clear. I certainly agree with a comment that was made that these people want more time in the recovery. Of course, these folks that I'm talking about particularly may have waited a long time to take part in the recovery as their industries are being affected at this stage in the recovery. They will talk about concern about future inflation but there is less support when you say this may be the point in the recovery when we need to do something about it. They say "But give us a little more time." So the public opinion out there is that, yes, there is a problem of future inflation but don't do anything too soon about it. Now, when we ask these people what effect this is having on their prices right now and what effect it will have in the future, I'm not sure the story is completely believable. What is happening now, of course, they are honest about. We see so far some little increase in prices in these industries. There is a dissatisfaction with profit margins and they don't expect too much cost pressure on that side in the future. And then they say they are not going to increase prices--that they aren't going to be able to. And I think that's just a

current pessimism. They are dissatisfied with their margins and I think they are just waiting for the moment. We've seen a little narrowing of the discounts in steel but that isn't very broad yet. In autos we've seen some shifting between models and some restoration of dealer margins and so forth.

I might just make a comment looking to the auto contract. The one piece of information I can add to the discussion is on the industry side. Of course, with the new union leader, the union is making the expected strong sounds. I have from a private source in the industry--however, a source that I think wouldn't involve too much posturing by the company--that, in fact, the company is ready to stand for a very long strike and that this management is making quite derogatory comments about previous managements giving the shop away, which might lend credence to the company's willingness to stand strong.

Finally, in machine tools there is no price movement but that's an industry where we don't have capacity pressures. Real estate prices have firmed and maybe increased a little. So, we haven't really seen the price movement yet but the dissatisfaction that is expressed by a lot of these people and the closeness to capacity makes me think that their comments--pessimism from their point of view about future price increases--may not reflect what will come to pass and that we may get those price increases sooner rather than later.

CHAIRMAN VOLCKER. I'm sure that they are never satisfied with their profit margins but if you can believe the figures that we have this morning, profit margins in corporate business are higher now than at any time in the last decade.

MS. HORN. We have a lot of industries in the Fourth District that I would think are on the bottom side of that average.

CHAIRMAN VOLCKER. There must be quite a few of them elsewhere.

MR. GUFFEY. They are all in Dallas!

MR. MORRIS. It was also a pretty lousy decade for corporate profits.

CHAIRMAN VOLCKER. That's right--not much beyond the first year of recovery. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I have a question for Mr. Kichline. I've been going around New England giving speeches against the deficit and I argue that the problem with a deficit that doesn't decline as the economy expands is that at some point in 1985 we are likely to see a capital goods boom--which is clearly showing signs of developing great momentum now and by a year from now ought to have enough momentum so that the corporate sector will have to come into the credit markets to take a substantial amount of the total credit flows. And at that point in time interest rates are going to have to go up enough so as to squeeze back the interest sensitive sectors of the economy--namely housing and automobiles--sufficiently to make room for the increased corporate demand for credit. Now, I look at your

projection through '85 and I don't see any squeeze on the interest sensitive sectors. Sure, housing starts come down a bit from what we have now but throughout '85 they are running at about the same level as in '83. And the automobile industry is projected to show a substantial continued rise throughout the period to a level substantially above the '83 level. Paul Craig Roberts might look at this and say "Gee, that's not too bad. What are you guys worried about the deficit for?" My question is: Should I revise my speech?

MR. KICHLIN. Well, maybe you should leave out '85 and let the time horizon be a bit fuzzier. I think it's very hard in an environment where rates are not regulated to pinpoint the time at which it all will explode. But I think our forecast really has in it those sorts of pressures building. In part, the impact of the deficit is showing up even now in our view, and it has been for some time, in terms of the current level of interest rates. And it shows up in the export sector where in a sense exports are being crowded out via the foreign exchange value of the dollar. You are right that this forecast still has growth sustained in '85. In part, you're really looking at continuing fiscal stimulus pushing up incomes. We do have housing as rather the weak sector. As you mentioned, it doesn't collapse but it doesn't grow. Autos we have growing. Business fixed investment, which we have growing quite a lot in '84, slows a bit in '85; but it certainly doesn't go downhill. I guess my concern with the deficit is not so much the crowding out argument in a given period of time but that we are looking at a structure that over time is not desirable. As a part of this process, business fixed investment is going to be a smaller part of GNP over the longer run than it otherwise would have been and interest rates are going to be higher and the interest sensitive sectors are going to get squeezed. Pinpointing it, I think, is a problem. I might note too that in '85 we do have built into this forecast a very small cut in the deficit; it's about a \$20 billion dollar package. But if you envision that as part of something that would be going on in '86 and '87, presumably you would have beneficial effects in '85.

MR. MORRIS. But the question is: When do we reach a level of total demand for credit that will require a substantial contraction in housing? That's what I would like to know.

CHAIRMAN VOLCKER. We have demand for credit well above our target already.

MR. MORRIS. I know. That's right.

MR. KICHLIN. Well, I have difficulty answering that question. I really have difficulty answering the housing question because I think there are some very funny things going on. Dallas may be one part of it but the funny things are more widespread, with adjustable rate mortgages and institutions quite willing today to offer discounts. I have a concern that as interest rates rise we may indeed find that housing will change more than we have forecast. In part, as we get into '85 all these neat things such as discounted mortgages for the first year will be at an end. That first year will have ended and, depending on rate levels, we may find lots of pressures in '85 that we have not been able to readily define. But I suspect the housing number, if anything, is on the high side rather than the low side.

MR. MARTIN. Frank, I would join Jim in that hypothesis of the [likely] scenario. What is going to happen to housing will be a credit loss not an interest rate replay of the old disintermediation process, because the thrift institutions can pay the market rate. They can go buy the money.

MR. MORRIS. The issue is that if rates go high enough, they won't be able to find enough customers who are eligible to borrow.

MR. MARTIN. Oh, yes. Look at the builders that they are working with. The Pulte homes people have now issued \$4 billion worth of builder bonds so far and it's on a stairstep going up. The builders and the developers they are working with will simply put up the points on the front and raise the price of the house. They can set the loan payment in accordance with whatever it takes to move the merchandise. But I think we will have severe credit problems, maybe in '85 or '86 or whenever, and substantial thrift institution loss problems. And that's what will cut off the housing--not the availability of funds.

CHAIRMAN VOLCKER. We've reached this advanced stage of economic development--and I'm serious about this--where you don't even need a buyer for the houses in order to build them. You see that going on in Dallas. It's a process of self levitation.

MR. MORRIS. May I suggest that Dallas is not the United States? Certainly, I don't see a lot of speculative building in housing going on in New England.

CHAIRMAN VOLCKER. I hope Dallas is the exception.

MR. MORRIS. I just have a hard time reconciling myself to this picture of another year and three quarters with no serious problem in either housing or automobiles. I hope it works out that way, but it just seems to me too good to be true.

MR. CORRIGAN. Let me just add a few comments on this agricultural situation. I too am a recipient of a lot of war stories flowing in from directors and other people with whom I come in contact. But it's very, very hard to pin down whether this is just what Mr. Keehn has called a "hot stove league" or something more than that. My conclusion is that it is more than that, but I can't be certain how much more. To give you a couple of insights into the crosscurrents of information one gets: We too have a quarterly survey of agricultural credit conditions. In the fourth quarter of 1982, 74 percent of the survey respondents indicated that collections were much slower than normal. In the fourth quarter of 1983, 37 percent said collections were slower than normal, which makes it sound like things are getting better. If you look at the year-end Call Report data--and we did this just for state member banks for the December 31, 1983 report--only 13 percent of the loans listed as past due 30 days or more are agricultural loans whereas in that same population of banks about 24 percent of the total loans were agricultural loans. Again, that doesn't sound all that bad. We then looked at 76 state member banks that we examined in 1983, and roughly 50 percent of those showed particular problems with agricultural credits but the other 50 percent showed no particular problems with agricultural credits. We talked to a dozen or so former directors and other people we know who are

presidents of agricultural banks, and 50 percent of them said things were soft but not serious. The other 50 percent said it was very serious. I got some data having to do with national agricultural lenders, mainly insurance companies. Ironically, it's almost exactly the same story: about 50 percent of them reported improvement in delinquency rates and 50 percent reported serious deterioration. I got hold of some data from the Farmers Home Administration covering case loads of 422,000 agricultural loans of which 236,000 are delinquent, which of course is a very substantial percentage. Two-thirds of the delinquent total and two-thirds of the dollars are in emergency disaster loans of one kind or another essentially growing out of some kind of weather-related phenomenon during 1983.

So, it looks as though it's a situation where it's either pretty good or it's very bad. In our District we tried to look at it in terms of geographic pockets, classes of farms, and particular types of businesses, and we could find no patterns whatsoever geographically or by particular crops or products. We do see more of a credit problem with Main Street businesses than we see with farms, if that is possible. We do see that land prices on average are probably still falling, although at a slower rate. Somewhat consistent with the hot stove league philosophy: The glow of the PIK program has come off, and as the realization of that has sunk in it has made people feel worse. Certainly, the widespread expectation of a year ago or six months ago of generalized strengthening in agricultural prices--grains in particular--has not materialized. So, while people thought things were going to get better they are not getting better. If there is a common denominator, I think it's the one that Mr. Keehn indirectly referred to earlier. These problems, if they are concentrated in any one area, do seem to be concentrated in situations where there was a lot of debt taken out in the late '70s and early '80s either in connection with acquisitions of land or substantial acquisitions of very, very expensive capital machinery associated with farm operations.

I have just a couple of other anecdotal comments from the District. While the Ninth District is certainly not a major energy operation, there is a belt of oil and gas activity in North Dakota and Montana which is about one fourth the size that Mr. Guffey spoke of in the Kansas City District. But in that Williston Basin area drilling activity is now about 80 percent back to where it was at the peaks of 1980 and 1981, although it does appear that a fair amount of that resurgence is being undertaken simply because rigs are available at such favorable prices. People are going out and seeing what they can find. If they find something, they cap it and move on down the road and stick another hole in the ground. But, certainly, the pace of activity has picked up very significantly from a year ago.

On the office space situation, I don't pretend to understand this at all but in Minneapolis as well there is a tremendous amount of commercial office construction going on. I don't have the foggiest idea who is going to fill all these buildings, particularly when Northwest Bank and Oxford Development start this massive project that they are going to build in place of the building that burned down a year ago or so. But certainly, given the size of the Twin Cities, there is a tremendous amount of commercial construction activity going on in the area. I continue to get some reports of delivery stretch outs, particularly in the high-tech industries. On the retail side,

the encouraging thing that I hear from [unintelligible] and others is that despite the fact that sales have been very, very strong they say they are going to stick with the very rigorous types of inventory control policies they put in place over the last couple of years.

In terms of the overall national business situation, I still look at the [unintelligible] situation as being strong to very strong even if consumer spending does recede a bit in the second quarter, as it seems to me it must simply because the car sales and the car capacity situation is going to produce that result. But even allowing for that, I still think that in the next quarter or two anyway the risks are that the economy will be stronger than projected. And unfortunately--and Frank this may help your speech--I personally think the implications of that are that the following quarter may well be weaker than projected. It is interesting to note that both the unemployment rate and the capacity utilization rate in manufacturing are now at the points where we began to see the building of price pressures in the 1976-77 recovery period. The big difference between now and then is that we've had some rise in interest rates earlier in this cycle than we had then and certainly the wage situation, as has been pointed out, looks better now than it did then. Unfortunately, the other side of that coin is that at least to date the productivity side is weaker this time than it was in that earlier episode. I think this wage situation is very, very important. I don't know what is going to happen in autos but I think that's key, as is the dollar, as it pertains to domestic price level pressures. It's also unfortunate but true that we now have a situation in which there is some anticipatory buying taking place in the expectation of either higher prices or higher interest rates or both, and I think that makes our problem a little more difficult. I am very troubled at the prospect in Jim's forecast of an inflation rate of 6 percent in the second half of 1985. Once it gets into that range it's going to be very difficult to hold the inflation rate anywhere near that level. I would just conclude by saying that, at least as I view it, money and credit are growing pretty rapidly and velocity is growing. I'm not sure what the policy implications are right now because I'm not sure where policy is. Mr. Axilrod will tell us that later.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I'd like to comment on the thrift industry and housing and very briefly on this situation with regard to commercial property development and the syndication process, the limited partnership process. Accepting the staff projection of interest rates, we have a situation in the thrift industry in which the losses could run between \$700 million and \$2-1/2 billion, depending on certain aspects of the sale of assets by these institutions. As we all know, the sale of assets has been one way in which they have kept their profitability and avoided losses. Of course, what is happening is that the interest rate increase that has already occurred is affecting the turnover of the 30-month obligations, many of which are coming due now. And the weaker institutions may have 40 or 50 percent of their nonbrokered--I say that carefully--funds in and around that maturity category. So, we are seeing the beginning of a conversion of 30 or 40 percent of the liabilities at a time when that conversion of assets can run perhaps 10 percent of the assets. These interest rate increases, of course, are likely to continue at least in the near term. The nonoperating

income of these institutions, which one could look at as 15 basis points or 20 basis points against the asset, is becoming increasingly difficult for them to accomplish. As there is more discussion of the credit risks and the overbuilding and the question of values, it is going to be more difficult for them to attain that 15 or 20 basis points. That could push them toward the upper end of that range of losses. And here I'm talking about 1984. Before, at lower levels of interest rates, there was an expectation of turning over the 30-month paper at lower rates than face rates. Of course, the outlook for that industry was one of reasonable profitability for this year. That, of course, tends to push these savings banks into very deep operating losses. It tends to produce some reliance upon the Federal Home Loan Bank System. Perhaps not unduly, it tends to force even more frantic efforts to attain fee income by originating loans without, let's say, complete or careful credit analysis and risk analysis.

That means, of course, that the housing numbers that are in the Greenbook could be supported with an increasing exposure of risk for these institutions, with what that means down the road. We've already seen the Mortgage Bankers Association delinquency figures. The foreclosure losses continue. That is almost never talked about in the financial press, but the rate of foreclosure is substantial as the rate of bankruptcy continues to be on a very high plateau; [so], in another segment of the private economy the foreclosure losses are very substantial. With regard to the comments on commercial development, of course, the new element in housing is the builder bonds. As I've indicated, in one case that is a rather large number. The newer element in commercial development is, of course, the limited partnership syndicate that the Congress has been trying to address in some of the so-called "loophole closing" proposals. Those syndicates continue to flourish; the limited partnership sales are substantial. Down the road that is going to mean that these heavy vacancies are going to cause those partnership interests to be of little or no value, with a resulting impact on the commercial development process. My only point is that as we witness the interest rates unfolding as given in this scenario here, we're building up a future problem in housing, in development companies, and in the commercial real estate sector of the economy. All those things inevitably will produce losses and close thrift institutions and commercial banks and other kinds of enterprises down the road.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I'd like to comment briefly about developments in the Atlanta District and then turn to the national picture and the projections of the staff and the implications as I see them for policy. The situation in the Sixth District is not entirely dissimilar from what you've heard from other Districts. The expansion seems to be pretty broadly based at this point. There are some areas of the District that are still experiencing difficulties but everywhere I go, notwithstanding difficulties in certain areas and certain sectors of the economy, there's a good deal of confidence and a good deal of bullishness on the part of business people generally. In a broader sense, almost all the indicators are quite good. Employment in most parts of the District is up and unemployment is down; even in those places where we still have rather high unemployment rates, they are down from their earlier double-digit rates. That's particularly true in Alabama. The industries that are

doing very well in our District are pulp and paper, carpet, and textiles generally. Interestingly, phosphate and farm chemical industries are doing quite well, notwithstanding the weakness in the agricultural sector. And that seems to be because of anticipation of increased farm acreage in 1984. Phosphate mining in Florida is also doing very well. Consumer spending is very, very good in most parts of the District, particularly in the major cities, and that includes auto sales, which have been extremely robust. As a matter of fact, some of the General Motors and the Ford assembly plants in and around Atlanta are planning to recall a little over 4,000 workers.

Prices, on the other hand, are moving up a bit more in most of our cities than the national average, and that seems to be primarily in the areas of food and beverage costs and transportation. Construction also has been very, very strong in the Atlanta District generally. In the residential area, we've seen substantial increases in permits and in sales of existing houses. In fact in the Atlanta area, prices are escalating tremendously. As in the Dallas area--and I've seen this personally in my own area--house prices are escalating very, very fast and the houses don't remain on the market more than two or three days. In some cases I've seen bidding wars going on where somebody will put a house on the market, for example, at \$170,000 and before the day is over people are offering more than the contract price. And it's not unusual for a single house to have five or six contracts on it within the space of 48 hours. So, that's a very unusual situation it seems to me. Multifamily building, on the other hand, seems to be moving in the other direction. Multifamily permits are down and the explanation that I get from people in the real estate business is that more and more first-home buyers are taking advantage of being able to buy a house and are moving out of the multifamily areas. Office construction is also an anomaly in some of our cities, particularly Atlanta. They are building office buildings or office condominiums at record rates. I, too, don't know where all the people are going to come from to fill them up. So far they are doing it, but some concern is beginning to develop in the Atlanta business community about overbuilding and the vacancy rate that could develop later this year. The other cities in the District don't seem to be experiencing that kind of overbuilding. The financial services industry, particularly the S&Ls, are doing very well and I suppose that's a reflection of the strength in the housing market. Mortgage commitments around the District rose 66 percent at S&Ls as of December 1983, which is the latest information I have. Commercial bank deposits are going up and loan demand is going up as well. One of the weak sectors is tourism, and it's weak because of unusually cold weather in Florida and reports of cold weather, which perhaps were exaggerated. Interestingly, travel agents tell me that some of the weakness in tourism in south Florida and indeed around the District is due to the fact that people are taking advantage of the exchange rate and going to Europe instead.

The agricultural sector that other people have mentioned is a source of pretty deep concern in our District as well. It seems to be concentrated in the Florida and Georgia areas, although some other states such as Mississippi and Alabama also are affected. Just looking at the Farmers Home Administration delinquency rate, we find that in Georgia and Florida it's running in excess of 50 percent and that's among the highest in the nation. In Florida those delinquencies represent about 4 percent of the state's farmers and in

Georgia about 10 percent of the farmers. The conventional wisdom that I'm hearing from so-called experts in the agricultural area--and that includes some Congressmen who represent agricultural areas--is that the highly leveraged marginal operations are not going to make it through 1984. The other people who are better operators--usually the larger operations even though they are heavily in debt--are probably going to make it. There seems to be a feeling that if they can get through the next 12 to 18 months, the situation will improve radically.

There are two major areas of concern that I hear voiced over and over again in the District among people I talk to. First of all is inflation. They are seeing inflation demonstrated in higher prices and in backlogs and capacity constraints in their particular industries. They, unlike some other people's comments that I heard, wish that something could be done about this sooner than later. They all feel that their businesses are very good and they would like more of the same but they are fearful of inflation down the road and they do hope that something is done about that. The other thing that is getting the attention of people in my District--and I hope around the country, Mr. Chairman--is the deficit situation. There is more and more talk about it in all of the functions and activities that I attend. My personal view is that the message is getting out to the people and, in turn, is getting back to the Congressmen. I don't know what that means in terms of action this year, but I think the message that the people want something done is being heard by Congressional delegations. One concern that I have personally--this is just a hunch and I keep asking people about this--is foreclosure rates and delinquencies on loans generally, especially in the installment area. Bankers and S&L people tell me that they're not particularly concerned and that their statistics don't indicate any particular problem. But I look at the number of adjustable rate mortgages that are being put out in my part of the country, and I think around the country, and with interest rates tending to back up I think we're looking at an explosive and dangerous situation down the road as some of these ARMs begin to move toward the time of the balloon payments.

Let me turn just very quickly to the staff projection in the Greenbook. I have a slightly different view than the Greenbook in three areas: economic growth, inflation, and unemployment. Outside of those areas, I'm entirely in agreement or don't have much problem! But I've changed my tune a little. At the last meeting I was saying that I thought the economy was going to move ahead at a faster clip than had been predicted. But this time I don't see the economy moving, especially in the first quarter, at quite the level that the Greenbook does--namely, 8 percent. I realize that the Greenbook is probably put together with the benefit of the Commerce flash report, and the private forecasts that I looked at didn't have that advantage. Nevertheless, it seems to me that we're not going to get the kind of growth even in the first half that the Greenbook is projecting. One of the reasons I say that is that I think there might have been some distortions reflected in the January and February numbers. We did have some pretty adverse weather in November and December, which might account for the rapid growth in January and February. And we had some changes in the PIK program, and so on. The other area where I would differ, again based on what I'm hearing around my District and some of the national figures, is that I think inflation is apt to be higher in 1984 than the Greenbook indicates. Some of the indicators I looked at

to support that view include: commodity prices, which are moving up and have been trending up for some time; the price of gold, which is moving up; and the value of the dollar, which is coming off. We are at an 80-81 percent capacity utilization number and monetary growth has been fairly strong. I hope I'm wrong, but it looks to me as if inflation might be higher than the staff is predicting. And because of my view about the lack of robust strength in the economy as compared to the Greenbook forecast, I would think that unemployment will not be as low as in the Greenbook. Summarizing all that in terms of policy implications--and I guess we can talk about this more tomorrow--it all adds up to me to one word and that is caution. I think we have to be very careful and very cautious as we formulate policy tomorrow for the next period.

CHAIRMAN VOLCKER. I don't know how much time we're going to have tomorrow. As you know, I have to testify in the morning and I don't know when I will get back. We may have to go to or after lunch. I'd like to get a little more done tonight, but I also am conscious of time passing and I would ask those remaining to concentrate on points that have not been made before. Mr. Roberts.

MR. ROBERTS. I think most points have been covered. I'll make a very brief statement. In the Eighth Federal Reserve District there's a very broad general feeling of optimism, confirmed by surveys that we've done, meetings with our board and branch boards, and sessions I've had with large and small companies, commercial construction people, and business economists. I find no real exception to that general pattern, whereas maybe a fourth of those people three months earlier would have had some remaining pessimism. There are rising expectations of price increases to come later this year on the heavier industry side. We hear talk in the chemical industry in particular about major price increases to come later on. On the consumer side, all the evidence we've picked up is of continuing confidence in spending. [Representatives of] three very large nationally-based department stores indicated to me that sales slowed down a little in February but since then, in 10-day sales reports, each has indicated that sales have picked up again and that they think the earlier slowdown was weather-related. Housing is very strong in our District. In all the major cities we're seeing some increases in prices in the 7 to 10 percent range after stability for quite a while. Autos are very strong. Added capacity is being planned in the large-car category and in special areas. Chrysler just announced an expected \$350 million expenditure to produce more mini-vans, which is a red hot product in their line that they are producing in the St. Louis area. Business loan demand, according to bankers that I've talked to, is beginning to pick up now in the major cities of the District after having picked up some earlier in the outlying areas. None of this is related to merger activity. In the wage area, the only indication of change that I've seen is at TWA and Ozark where concessions have been made by employees. I don't think that relates to the general economy; it is a reflection of the pattern of deregulation in that industry. I would certainly concur with the view that Governor Martin expressed about the shift of risk in the mortgage area from the savings and loans to the borrowers. This is a rising concern on the part of the major savings and loans in my District. Even though they're shifting a lot of the risk away from themselves, they are worried about the impact generally from rising interest rates on the variable rate loans. If there are any problems in my District,

they seem to be a residual from the past and they would be in areas of excess real estate financing, coal mining, agriculture, and the foreign area.

CHAIRMAN VOLCKER. Mr. Balles, what do you have to say that will add to our sum of knowledge.

MR. BALLES. I will try to make this very brief. The business statistics in the West are quite good. The aerospace industry, which I don't think anybody has commented on, is very strong. Boeing is adding workers back after cutting back for two years in a row. Electronics demand is strong in Silicon Valley. One curious thing I've noted is that business statistics are better than the business attitudes, at least among some of our directors. And that requires a word of explanation. Housing and lumber, of course, are so important in the Pacific Northwest that I think some of the pessimism of the people in that industry is based on their lack of faith in the sustainability of the uptick we've had. They see interest rates about to rise even more and they fear that will just cut off the resumed demand that we've seen in recent months in housing. So, they really are not holding their breath waiting for a sustained uptrend in that area. On the matter of what is going on in the mortgage area, in the West we find that almost half of the mortgages made last year in California, Nevada, and Arizona, which is the area of the Federal Home Loan Bank of San Francisco, were based on adjustable rates. That, of course, leads right back to where the risk has shifted. That may be the salvation of the housing industry if it keeps up and borrowers can continue to be encouraged to go along with adjustable rate mortgages. You asked about agriculture and that's awfully difficult to say anything about now.

CHAIRMAN VOLCKER. We've heard a lot about it since then.

MR. BALLES. In that case I won't add to the pessimism that has been [related]: that there is the overhang of previous debt and that some agricultural borrowers are having real trouble. I think I'll stop at that point.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, Mr. Chairman, I don't know anything about what is happening in the agricultural sector but I do share Jerry Corrigan's concerns about where the economy is going. I think the dangers are very great that the economy may grow faster than the staff is forecasting for this year. The two areas where that is most likely to happen are business fixed investment and the change in inventories. The staff projection for business fixed investment essentially says that, after slightly faster growth than had been anticipated earlier, the growth rate continues from the second half on through all of 1985 just where we thought it was a month ago. And indeed, it's a markedly lower rate than we're seeing currently. Business fixed investment was growing at a 23 percent annual rate in real terms in the later half of 1983 and that tools right down to 5 percent by the latter half of 1985. I think we probably are going to see a major revision in capital spending plans develop over the first half of this year as a consequence of the fact that the economy is growing so much more strongly than had been widely anticipated. And I think we're going to see, even in the Cleveland District, the beginnings of some desire to

increase capacity. On the inventory side, the Board staff briefed us this morning and showed us a chart on the ratio of inventories to sales, which is as low now as it was in early 1973. Of course, part of that is a consequence of better techniques of managing inventories. But it's also true that the number of companies reporting slower deliveries is back to where it was in late 1972. And my guess would be that during the course of this year we'll see some efforts to build up inventories relative to sales, so we'll see a bigger kick from inventory investment.

On the price side, the thing that stands out most is the staff forecast for prices relative to unit labor costs. There is only a 0.2 difference there, with 5 percent projected for the fixed-weight deflator for gross business product as opposed to 4.8 percent for unit labor costs. That isn't even enough to take into account the effects that depreciation would bring. And the ratio of corporate profits to GNP declines during the course of 1984 from the peak in the first quarter despite very active markets and relatively stable unit labor costs. I just don't think that's the way businesses are going to price this year. I think they're going to have the opportunity to improve their profit margins and will do so. The big sleeper, however, in the price area is one that I've talked about before. I don't know whether it's going to happen, but the labor force projection that the staff has included in its forecast is for growth of 2.4 million from the fourth quarter to the fourth quarter. That compares with a 1.2 million increase during 1983. Now, last year's increase was very, very small. We did not see the kind of cyclical increase in the participation rate that we usually get. The staff forecast has one thing going for it now: namely, that in February we did get a big increase in the labor force and an upward movement in the participation rate. If this proves to be the beginning of a trend, then that forecast may be right. If it's a one-month phenomenon and we were to see the continuation of the slow growth in the labor force that we had last year, we'd be down to an unemployment rate below 6 percent by the fourth quarter and then we'd have a big problem. The word that Bob Forrestal put out is "caution." I certainly would agree with that and I may even be going toward a red light.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I just wanted to comment on one aspect of the Greenbook projections. As we look at the very high first-quarter real growth and the tapering off very rapidly for the rest of the two-year period, one gets the impression that perhaps not too much has happened. But there is a distinction here between the level at which the economy operates and the rate of growth at which it operates. And we have now raised the level very substantially. If we have 8 percent instead of, let's say, 4 percent for the [first] quarter, I think that [produces] 1 percent more GNP at an annual rate. And if the 6 percent [projected] for the second quarter were to materialize, that would be another 1/2 percent of GNP over a 4 percent growth rate. That means there's \$50 billion or so more GNP in the economy. The capacity data seem to bear that out from the fourth quarter to the second quarter; in the forecast we're chewing up almost 4 percentage points out of capacity and we're really getting into the range where pressures become strong. The same is true of the unemployment rate. We're now moving close to what is technically known as the equilibrium rate of

unemployment. And at the same time we're encountering a very substantial speed effect in the sense that unemployment is coming down very rapidly. So that factor adds to inflationary pressures. It seems clear, finally, that inflation expectations have increased over the last few months. That means that real interest rates, despite the rise in nominal interest rates, may not have increased. They may indeed have come down, if one could make so precise a calculation. So on net the economy is operating at a higher level with greater pressures, perhaps less interest rate constraint and, in a sense, more momentum even though we see that the projected rates of growth from the summer on are now lower than they were in the previous forecast.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, the question, of course, is whether in the future [those growth rates] are going to be that low. I agree with your concerns and I agree with Lyle's. Clearly, the economy has been too darn strong for several months now and if it continues very much longer, we will have used up any slack we have and will be backed into a period of a substantial inflationary pressure. We're at 81 percent capacity utilization, I think Bob said. Even using the staff projection, we get up to 85 percent in a not very long time. The only time that level exceeded 85 percent in recent years was around the end of 1977 and early 1978. And, of course, that was a period when high inflation conditions were developing. So, we have used a lot of our capacity and unless we do get this slowing growth in the economy that the staff has forecast, before we know it we will be into a period of growing inflationary pressures. And that's the thing we haven't faced. Now, certainly, fiscal stimulus has been a problem with the economy. But I have some feeling that another problem has been that there is too much credit. If you look at the credit ratios, they are high compared with earlier cycles. For consumer credit and even for business credit they are showing sharp increases and are getting up to the upper end of previous ranges. Somebody who is well positioned in the home building industry said to me not long ago that he hated to tell me this but the difficulty in the home building industry was that the lenders were throwing money at the builders. They were calling them up and saying "Come on, why don't you use my money? Why not have some more starts?" And that wasn't in Dallas either, Bob. It's an indication, I think, of conditions that are just too accommodative--given the backlog of demand that we perhaps have developed for houses and durables and things like that and certainly given the optimism of consumers, which is just too strong to have that kind of money availability around. So, I see the danger much more clearly than I have at previous Committee meetings over the last year as being the danger of expansion over the staff projection rather than below the staff projection. And I think the danger of that is much greater than before because of having used up the unused resources that we previously had available.

CHAIRMAN VOLCKER. If nobody else wants to pronounce the benediction, we will quit for the evening.

[Meeting recessed]

March 27, 1984--Morning Session

CHAIRMAN VOLCKER. Mr. Axilrod.

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

CHAIRMAN VOLCKER. Are there any more or less technical questions for Mr. Axilrod?

MR. RICE. Steve, the Bluebook says that the alternative B proposal is consistent with the staff forecast of GNP. Does that mean that alternative B takes into account the rise in interest rates that has already occurred? Or does it mean that it will result in an additional rise in interest rates over and above what has occurred?

MR. AXILROD. It assumes a funds rate--well, it says 10-1/2 percent, but I'd say on the order of 10-1/4 to 10-1/2 percent. We had a 10-1/4 percent funds rate for a few days. We don't have that today and we didn't have it yesterday, so I think that really assumes a further rise in interest rates. Today funds are--

MR. RICE. You mean a further rise from today but not from--

MR. AXILROD. I would say from the average of the last two weeks.

CHAIRMAN VOLCKER. I don't think we should over-estimate Mr. Kichline's ability to predict the economy and even more Mr. Axilrod's ability to project interest rates!

MR. RICE. But it's helpful to know what they have in mind.

CHAIRMAN VOLCKER. Are there any other questions?

MR. MORRIS. Steve, I'm surprised at the very small estimate that you came up with on M2 with respect to the IRA accounts. We are talking about an awful lot of money here.

MR. AXILROD. That was a small estimate of the distorting effect on the seasonal. We might have gotten some of the seasonal but it could be more; I really don't know. But that was an estimate of how much we thought the seasonal might be off in some reasonable way.

CHAIRMAN VOLCKER. What is the estimate?

MR. AXILROD. Well, a quarter to a half [percentage point], but I would take all of that--

CHAIRMAN VOLCKER. Is that an annual rate?

MR. AXILROD. Yes. We don't think it is very large, but that's just another way of saying we don't think we made a big error in the seasonal.

MR. MORRIS. Do we have very good data on the IRA accounts?

MR. AXILROD. We have IRA accounts at banks; unfortunately, we don't have them outside banks. No, we don't have very good data and that's a big problem.

CHAIRMAN VOLCKER. Are there any other questions?

MR. PARTEE. Do the data you have indicate that they are going up faster this year than last year?

MR. AXILROD. Don may have [numbers on that].

MR. KOHN. I don't have the numbers, Governor Partee, but they are growing faster this year than last year. The big jump was from the year before that.

MR. AXILROD. Our problem was not only the IRA and Keogh accounts but we had to make an estimate of how much the MMDA shifts early last year in January should be allowed for in calculating the seasonals so as not to distort the seasonals. That, as much as the IRA/Keogh accounts, was a problem to us in estimating the seasonals. We tried to make some sense of how far we could be off if we made different assumptions and we came up with this rather minimal number. But that doesn't say that the IRA/Keogh accounts didn't have big effects in and of themselves.

MR. CORRIGAN. You also have this big [unintelligible] in these old, maturing 30-month certificates.

MR. AXILROD. Yes, that's right.

MR. ROBERTS. On this large increase in reserves in February to accommodate the build-up in excess reserves: I notice that you say excess reserves are subsiding and that pretty much takes care of itself. But if loan demand is rising and the excess reserves go into loans, what is the effect of that prospectively?

MR. AXILROD. As a matter of fact, the excess reserves seem to be running high in this two-week period in the latter part of March as well. But we think the excess reserve build-up has been accompanied by a high funds rate, so it isn't as if people are taking excess reserves and have gotten rid of them aggressively into market instruments or things like that. I don't think that the build-up of excess reserves is pushing loans out or pushing money out. I think it is really rather transitory.

CHAIRMAN VOLCKER. Do you have an estimate for reserves and the monetary base for March handy?

MR. AXILROD. Yes. Our estimates indicate a relatively low [or slightly negative growth] and assume excess reserves a little lower than I think is going to be the case at the end of this month. For March we would have a drop in total reserves but I think it is best to assume that reserves are about unchanged following the 19 percent increase. And the monetary base is falling to only a small increase of 2 to 3 percent.

CHAIRMAN VOLCKER. What do you have for nonborrowed reserves?

MR. AXILROD. Well, we have a drop there also, and it may even have dropped a little more than [our estimate]. We have a drop of around 7 percent, but I think a lot of that is the distortions of the excess and required reserves in March. It looks as if they are increasing about the same as they increased in February--at about an 8 percent annual rate. So this variation is largely the variation in excess reserves and some variation in borrowing. It's a sort of sustained expansion in the reserves that is providing the base for the deposit expansion.

CHAIRMAN VOLCKER. Any other questions? Well, let me sum up what I think is a difficult situation in terms of arriving at our policy judgment. Drawing upon what you people were saying yesterday, on the surface we certainly have a strong expansion. We haven't had much change in the inflation picture. The wage picture to date--I make no statement other than to date--looks surprisingly good. There really is no evidence, looking backward, of a real change there. Attitudes seem to be carrying over. Obviously, the issue is how to sustain progress, not just where we stand now. I think we have some very large distortions in the economy that are becoming more apparent --they may not be apparent in quite the way many predicted--arising out of the deficit. We have this enormous foreign trade deficit. I don't know how big the housing industry is these days--maybe you know, Governor Martin--but I don't think it is much bigger than our foreign trade deficit.

MR. MARTIN. \$100 billion.

MR. PARTEE. It's more or less that.

CHAIRMAN VOLCKER. Just to illustrate the problem: We have this decline, by whatever it has declined, and it is equivalent to losing half or more than half of the housing industry in terms of GNP. Another way to look at it is that domestic demand has been expanding considerably faster than GNP.

VICE CHAIRMAN SOLOMON. What is the estimate of domestic demand--at least 1 percent more than GNP?

CHAIRMAN VOLCKER. It's more than 2 percent if you take domestic private demand. Do you have that figure handy, Mr. Zeisel? You computed it for me the other day.

MR. ZEISEL. I'm sorry I just came walking back in.

MR. KICHLINE. For the first quarter it is 10 percent.

CHAIRMAN VOLCKER. That figure you gave me excludes government, doesn't it?

MR. KICHLINE. It excludes government but it includes inventory investment and it allows for an adjustment of this PIK distortion.

CHAIRMAN VOLCKER. And it would be less if you included government?

MR. KICHLINE. Right.

CHAIRMAN VOLCKER. This agricultural problem is obviously mixed. If you don't have any debt, you haven't any problem. But quite a few farmers have debts and the problem gets bigger. This housing market could be living on borrowed time. There are very funny things going on in Texas and I suspect a few other places. One of the disturbing things to me for the future is that I think there is a reluctance to add to capacity for several reasons. As you mentioned yesterday, [manufacturers] have been through a sluggish period and they have had a lot of instability. And interest rates bite when you're talking about a new factory or something. I don't know whether to be encouraged or discouraged about the future of the country. I was in Winston-Salem last weekend and there's a huge new factory down there for cigarettes. It's the only big factory of that sort that I've seen for a while, and it is big. But all these distortions seem to be interrelated with interest rates. The economy [unintelligible] when demand moves very rapidly; I don't think that's so surprising in view of the deficit. But I also think interest rates are not in the short run--I don't know about the long run--a very effective brake on many sectors in this deregulated world that we live in. People go ahead for a while anyway, except in some areas like new plant, without responding. And I think it raises a question of how the shape of the economy will look in the future.

I would add to Mr. Kichline's view that he gave yesterday in response to Mr. Morris as to what may happen. He has a good traditional, and I think fair, view of what one ordinarily might expect: low investment, low housing, and foreign trade problems. But on top of that we have lots of vulnerability. This thrift situation can rapidly turn negative and is turning negative. We were talking about their throwing money at builders and I think they are going to continue to throw money at builders whatever the interest rates are. They will pay whatever they have to pay and raise the interest rates, but they probably will continue to throw money at them or engage in speculative investments. It's a sign of weakness not strength. We have this LDC problem. There is an interesting article in The Washington Post this morning which is not new news but indicates the kind of psychological treatment this problem may get. We have the foreign exchange rate problem. If the dollar declines and the foreign trade picture improves, it pushes all these pressures--bottles them up in the economy--and we will see more results there. I observed that a lot of you reported that businessmen don't want us to take away the punch bowl; they don't want us to tighten now. I think there is some real fear about interest rates and the question is, in part, whether these little changes in interest rates necessarily do all that much. I don't think they do. Maybe it's just not very visible but if you scare people enough, there is a risk of a discontinuity [in their response] here. They may suddenly say "Oh my gosh, we are going back to 1980 or 1982." And people could draw in their horns quickly. I say that because when I talk to people about interest rates they don't seem to be worried about a small increase. What they are worried about is that it is the first step toward a big increase that they consider very serious; they have that pattern in their minds. We are operating in an atmosphere where interest rates are considered the problem and we are considered interest rates. Whatever we say about the budget, [unintelligible] doesn't reflect the budget or the economy. It's a very simplified view--that we can control interest rates. So, we're dealing with that kind of atmosphere and I think

we're living to some degree with all these distortions on borrowed time.

Broadly, I guess we have three options. I don't know whether my comments exactly conform to the statistics of Mr. Axilrod, but I think one can take the view that the economy is going to slow down by itself and inflation will remain under control and we don't have to do much--we can luck out and avoid adding strains in the short run. I don't know what you think about the reliability of that [scenario]. I think it is possible but how reliable it is is a question. The middle option, in a sense, is that we can help nature along by making sure we resist any excessive money and credit growth. Under the circumstances we have at the moment that's a middle course but it raises the question of whether it's enough. Or one can take a more aggressive and what might be considered therapeutic approach that certainly is going to be reflected in short-term changes in interest rates and we will be face to face with some of these risks--the international negotiations and the psychological risks that I referred to, of course. If things don't go well, we are going to face those sooner or later anyway. Those are the options that I see. We can proceed.

VICE CHAIRMAN SOLOMON. It seems to me that it's very difficult to have as useful a discussion, and ultimately a decision on whether and how much to tighten open market operations, if we don't factor in what the Board of Governors may do on the discount rate. Let's say we tightened along the lines of alternative B and presumably got a fed funds rate in the neighborhood of 10-1/2 percent. If then the Board were to move the discount rate a half point, we might not get a full 50 basis points out of that move coming on top of this because there is some expectational component. But I think we would get very close to that. So, we really would end up with something virtually close to alternative C. It seems to me that we have this problem that doesn't usually arise. This time we have a combination of circumstances where the markets are expecting a discount rate move. There are some good arguments for that. There are some arguments against it, I'm aware. If we want to be in the posture of not sending a strong signal that we're taking the initiative--that we are simply not resisting the market's tendency to drive up interest rates--there is an argument against a discount rate move. If we want to indicate a more forceful view, then there is an argument for it. All I'm saying, though, is that I don't see how we can know whether to talk in terms of the objective as alternative B or alternative C unless we have some sense as to whether there is going to be a discount rate change. I realize that you would be reluctant to talk about that in a large group but I don't know quite how to address this question.

MR. PARTEE. You're talking about the rates, not the aggregates?

VICE CHAIRMAN SOLOMON. I'm talking about rates.

MR. PARTEE. I don't see how this changes the aggregates.

CHAIRMAN VOLCKER. I am certain that we are not going to arrive at a discount rate decision at this meeting. In making your comments you may want to make whatever observations you want from your particular perspective about the discount rate and how it might affect your judgment as to what should be done on monetary policy.

MR. GUFFEY. To join Tony, I have the same dilemma with respect to which of the alternatives to select if indeed a discount rate action may be forthcoming. But the more important part as far as I am concerned is how the Desk would react to a discount rate increase and whether it would use the post-1979 operating regime or the post-1982 regime. In other words, the latter approach would involve adjusting the borrowing level in some measure to moderate the increase, if I understand [that regime]. If we go with the post-1979 regime then we're going to get a one-for-one result--a half point discount rate increase produces a half point rise in the federal funds rate. If we use the post-1982 practice, we moderate it by adjusting the borrowing level. I think Steve appropriately raised this issue of whether it will be incorporated in some measure in the directive. But some expression from the Desk or the Chairman as to how they would react to a discount rate increase is important to deciding whether to go with alternative A, B, or C.

CHAIRMAN VOLCKER. Well, I'm not so sure it is so important if one looks at it in terms of the monetary growth, which is the initial focus here. But I will accept any comments anyone wants to make here as to how one manages one's affairs in the interim.

VICE CHAIRMAN SOLOMON. But a considerable number of people on this Committee have an interest in interest rates not just in the monetary growth. And I cannot see that this isn't an extremely relevant factor. Now, we can always give two votes, I suppose: one on one assumption and one on the other assumption.

CHAIRMAN VOLCKER. Let us proceed.

MR. GUFFEY. If I look at "B," for example, it may be attractive to me at least in terms of a 10-1/4 percent or maybe 10-1/2 percent funds rate. But if we get a discount rate increase on top of that and use the post-1979 procedures, that would get it up to 11 percent.

CHAIRMAN VOLCKER. In the first instance, I will repeat: If you are talking about "B," I don't see an interest rate there and I don't see a borrowing assumption there. So, I think we can do a certain amount of talking. And I would suggest that we proceed. Mr. Black.

MR. BLACK. Mr. Chairman, I agree with those yesterday who indicated that they think the economy is currently very strong and that we will be lucky if we hold inflation down to the level that the Greenbook is forecasting. Accordingly, it seems to me that our main objective ought to be to deal with the aggregates. I would focus, of course, mainly on M1 and try to get that to the midpoint of our 4 to 8 percent range and hold it there in order to reduce the risk that inflation would really be a problem in 1985. I like the M1 path of "C" because that would get M1 to the midpoint by midyear. But the Bluebook associates that with a federal funds rate of 11 percent or more and I would feel a little more comfortable--and here I am assuming no change in the discount rate--if we let the federal funds rate move up to the neighborhood of 10-1/2 percent and hold it there until we have some additional information on the behavior of the aggregates. I like the "B" specifications for the federal funds rate and the borrowing. I have to say, though, that I have no confidence

in my ability to tell you what kind of growth in the aggregates we're going to get under current procedures if we push the federal funds rate to that level or indeed to any other level. I just don't think that there is really any way for us to know under our current operating procedures. But we've now had 2 months of experience, roughly, under contemporaneous reserve accounting and I was happy to hear Steve suggest that he thought there might be some merit in looking at the idea of introducing some automaticity into that. I would strongly endorse that and would express the hope that somewhere along the way we get as close as we can to something approaching total reserves. If we do get to that point, we ought to think about the discount rate as a penalty rate at all times. I think that kind of procedure would greatly enhance our chances of controlling the aggregates and inflation and help us maintain this hard-won credibility that we have finally gotten.

MR. PARTEE. Do you mean a penalty rate above the funds rate?

MR. BLACK. Yes. That's right--in order to control total reserves more closely.

MR. MORRIS. Mr. Chairman, I would support alternative B. I don't have the confidence in the behavior of M1 that Steve suggests he has--that, after not having served as a very useful target in '82 and '83, it is somehow going to revert to its old historic norm in '84. But I think the rate of growth of debt is quite clearly excessive. That growth plus the extraordinarily strong economic numbers that have come in tell me that we have to move now to moderate the rate of advance in the economy. I think moving to "C" and having a funds rate possibly as high as 12-1/2 percent is a little overkill. It seems to me that we need more feedback from the effect of interest rates than would be implied in alternative C, and the idea of returning to the old automaticity sends a chill up my spine. I certainly would like to restrain the funds rate range to no higher than the "B" level.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Several people commented yesterday to the effect that the potential for inflation accelerating down the road is now increasing, unfortunately. Certainly, the work that we've done in our Bank strongly supports the same conclusion: that inflation begins to accelerate as we approach the unemployment range of 6 to 7 percent or the operating capacity range of 80 to 83 percent. And I fear that may be down the road. So, for that reason I also would come out in support of alternative B and would suggest a borrowing assumption--since it isn't listed in the Bluebook table though it is listed in the text of the Bluebook--of about a billion dollars. That would seem reasonable to me. I think we should not shrink from letting the funds rate creep up to 10-1/2 percent in the near future for starters, and I would hope that it wouldn't have to go much above that. But I think we are going to have to do something more than we've done recently to slow down the generally rapid thrust of all these aggregates, especially M1. I was glad to hear Steve's remarks--and perhaps I'm reading more into them than he meant--but it almost sounded, Steve, as if you're ready to take M1 off probation, which I would welcome.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. This is a real predicament, to put it mildly. I guess I would come out supporting alternative B, with the borrowing number and so on that go with it in the Bluebook, even though I must confess that I like the aggregate profile in "C" better than that in "B." But at this point "C" scares me a little in that it could actually make things worse in the short run. That is what I see as the great dilemma. If we went with "B" and that meant that the federal federal funds rate had to get up to 10-1/2 percent or so, like John, I would say "So be it." But in the context of "B," I would favor the directive variant 2 that Steve has in the Bluebook. Personally, I would favor an asymmetrical directive that would say that we would strongly resist money and credit growth above the specifications of "B" and be tolerant of shortfalls in the growth of money and credit below "B."

MR. PARTEE. Did you say "strongly resist"?

MR. CORRIGAN. I think I said "strongly." I'm not sure what that means, though, Chuck. I won't try and define that. I am very troubled by this credit growth, in particular. Those numbers are really very, very strong. I certainly would favor an asymmetrical directive, one that would--

CHAIRMAN VOLCKER. On those credit growth numbers, I don't know if the number was touched upon yesterday but that shouldn't change the general comment: February growth was swelled by these mergers and is accompanied by a decrease in equity, which isn't a very healthy thing. The equity is not in the number whereas the debt is, and that makes a difference of 2 percentage points or so for one month, if I remember correctly. It's still strong, however you look at it. But it doesn't show an acceleration; it just shows strength.

MR. CORRIGAN. I don't know the right adjustment for the mergers, but if you look at bank credit or total credit--

CHAIRMAN VOLCKER. It's strong, no question. There's just that extra bulge.

MR. CORRIGAN. And it's partly for that reason. Also, when we set these targets for 1984 we seemed to say that if velocity was growing, the Committee was thinking in terms of M1 in particular being about at the middle of the range. So, I certainly would not resist any shortfall in the growth of money and credit during the second quarter relative to the specifications of alternative B.

CHAIRMAN VOLCKER. Mr. Rice.

MR. RICE. Mr. Chairman, when [we face] an economy [that] is expanding as rapidly as it is and the outlook is that it probably will slow down because of its own internal dynamics and, on the other hand, the economy may continue to expand rapidly and slow only a little, I think it's a good time to rely on what we consider to be acceptable rates of growth in the money supply. I would do that and let the dynamics of the economy--the rate of expansion--determine pretty much what interest rates will be. In other words, if we set the course of growth for money at rates of expansion within target ranges that we believe to be appropriate, then we should stick with that. And if money and credit demands in the economy intensify and force interest

rates up, then we should accept that. On the other hand, if the [growth in the] economy moderates as we hope and expect, that leaves scope for interest rates either to stay at current levels or perhaps even fall somewhat. I think alternative B is the alternative that is most consistent with that way of looking at things. So, I would accept the rates of growth for the aggregates set in alternative B and would accept the federal funds rate fallout from that.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I agreed with Emmett all the way up to where he said that alternative B was his choice. I start with the view that the staff forecast is not an unreasonable one but that if it is wrong it's likely to be that growth will tend to exceed the 5.3 percent rate the staff has forecast for the fourth quarter to the fourth quarter and that we will have somewhat more price pressures. I would be happy with the kind of growth the staff was forecasting a month or two ago-- 4 to 4-1/2 percent or somewhere in that neighborhood. But 5 to 5-1/2 percent and possibly more in the second year of a recovery when we're moving rapidly toward much higher rates of resource utilization for both capacity and labor is something that I find disturbing. Now, "B" is essentially the alternative that is consistent with the staff forecast. And that means, I presume, that in the second half of the year if we stayed with "B" and extended it with the same interest rates that we are talking about as consistent with "B," we would find that money growth would slow with the slowdown in the pace of the economic expansion that is forecast. And this is a policy that I would call leaning with the wind. It's providing enough money in the first half to keep interest rates from going up too much and then letting the money growth come down a little as the economy begins to slow down of its own natural processes. If we are in the second year of a recovery and are willing to supply the kinds of increases in the Ms that are involved in "B" and to permit credit to grow by more than 11 percent, when are we going to get back to a policy that is designed to bring inflation down over a long period? So, I just don't think "B" is the right alternative. I share your worries and concerns about the economy, but I think we've got to go further than that. Now, "C" is a bit of a shock perhaps, but I think we ought to move in that direction; something between "B" and "C" is where I would come out.

CHAIRMAN VOLCKER. Let me ask a question inspired by your comments. It really wasn't developed yesterday, and I will direct it to Mr. Kichline. We face various probability distributions of the outlook. I saw in the paper this morning that somebody is projecting 2 percent growth in the second quarter. I guess a lot of people are still projecting 4 or 5 percent. Can you explain to me the probabilities and the kind of profile of that kind of slowdown?

MR. KICHLINE. I saw the 2 percent number but--

CHAIRMAN VOLCKER. You don't have to explain the 2 percent figure necessarily, but what are the chances of that and what is the evolution of events that would produce it? In your view how probable is it that we will see what you have projected? Did you project 6 percent or so?

MR. KICHLINE. We have 6 percent for Q2. Are you talking about the second quarter?

CHAIRMAN VOLCKER. Yes. Suppose it were in the neighborhood of 4-1/2 percent. How likely or how unusual would that be and what would have to happen to get that?

MR. KICHLIN. Well, I don't view that as inconceivable at all. We struggled with this whole issue. There are some technical reasons that the number could readily come out below 6 percent and there are some rather substantive reasons that it could come out below 6 percent. My personal view is that 6 percent is a good number. If it's wrong--and I'm assuming that interest rates don't decline in this environment but perhaps are where they are now or rise a bit--I think the odds favor a smaller number than 6 percent. One example is in the auto area where we have production levels that we think are sensible. But GM is closing several plants. At the moment the way the Commerce Department is going to measure the numbers, they are not inclined to change the seasonals; and if they don't do that, we're going to find auto production declining substantially. That's a technical reason but it shows up in the numbers. There are a number of cases where some of the retail sales may well have come early in the year due to weather effects and we may be facing a situation where the economy is not that strong. So, I feel very comfortable with the 6 percent number; but if I were to bet that it's not 6 percent for the second quarter alone, I would bet on a little lower number.

CHAIRMAN VOLCKER. The major vulnerability, if that is the right word, is that retail sales may develop less buoyantly than you have forecast?

MR. KICHLIN. Well, I think housing is the other area. Those housing numbers may well be in the process of change as well. We have seen a half point increase in the VA rate with the general, even mild, rise in interest rates. It seems to me that some of the attitudes in the housing industry may change and take a little of the edge off what was really an extraordinary increase in residential expenditures in the first quarter. I do feel comfortable looking for a very strong number for the full year, but your question was really on Q2 and my assessment of what the odds would be.

MR. PARTEE. If retail sales fell below your projection in the second quarter--I'm talking right ahead--wouldn't the result be just a larger increase in inventories? It would seem to me, especially with the inventory/sales ratio so low, that it wouldn't affect production.

MR. KICHLIN. Perhaps some, but we do have inventory increases in this forecast.

MR. PARTEE. Yes.

MS. TEETERS. In answer to your question: In the second year of the recovery from the mid-1970s recession, the quarterly pattern was a boom and bust pattern, essentially. It averaged out to a good year. I haven't looked to see whether they have revised that particular pattern out, but there was a good quarter followed by a bad quarter followed by a good quarter and it was [primarily] in the automobile sector of the economy.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. I would like to join those who indicated yesterday that there are number of signposts leading us to something like an 85 percent capacity figure as in 1978 and 6 percent unemployment--putting us at or even below the natural rate of unemployment. But I think there may be some merit in qualifying those trends. In talking about 80 or 85 percent capacity in this second year of recovery I think probably all of us are keeping in mind that the importance of imports both to the business sector and to the consumer sector is different this time. Capacity of 81 or 82 percent in the United States doesn't mean 81 or 82 percent capacity in Germany or the United Kingdom or Japan or for the steel producers in Brazil or for the exporters to the United States in Mexico and so forth. In terms of our stress on industrial production, I think it is appropriate. These are rather spectacular increases but the context is that manufacturing--I'm varying my element here a bit--accounts for something like 25 percent of the labor force. In the short run, it isn't so much a matter of industrial production as it is perhaps production of value in services and employment in the services industry. I recognize that that has shown a strong increase also, but I don't think we are talking about 81 percent of capacity of offices or of computers or telephones or the other tools in the services area. So, I think it needs to be qualified a little.

Secondly, the vulnerability of some sectors has been mentioned. I have some difficulties going from the staff forecast to the alternatives on page 6. My difficulties are--let me characterize it unfairly--the gaps between the rates of growth in alternatives A, B, and C. I have a little difficulty moving from a 6-1/2 percent growth in M1 to an 8 percent growth. That's a rather heroic jump to me. My druthers are for an "A prime" where we look at the 7 percent that we've just been told is the [projected] rate for M1 in March. We might wind up at 7-1/4 percent or somewhere in between [the 6-1/2 and 8 percent rates of Alternatives B and A]. I don't have any marvelous econometric approach here to give you. I'm just going in the middle [of the Bluebook ranges]--for the M2 figures and the M3 figures and a federal funds rate that perhaps would stop at 11 percent and not at 11-1/2 percent. I'm impressed by the hints of the lagged effect of the interest rate increases we've already had. One mentioned yesterday was of 125 basis points on CDs and 100 points in this maturity and 80 points in that maturity. We haven't seen the effects of the lag response to those numbers. So, I would vote for an "A prime," if you will, with borrowings around \$800 million, not a billion, and a 10-1/4 to 10-3/4 or even 11 percent range on fed funds. I agree with Governor Rice that we ought to be a bit flexible with regard to fed funds. The market is moving and we should to some degree validate the moving. But I think too much of a slowing now might indeed be a shock, considering the vulnerabilities and the potential softness that we face, as noted by the Chairman in his usual, very good summary statement. So, I vote for an "A prime."

MR. PARTEE. "A minus."

MR. MARTIN. "A minus." Thank you.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. Well, I would like to point out one thing that is remarkably different in this expansion: We don't have any pressure

on oil prices. During the 1970s we always had upward pressure on oil prices and the threat of very large increases in prices, and in my mind that takes a great deal of the inflationary pressures out of the situation. As regards the aggregates versus interest rates: Having sat here, I don't believe in the aggregates except in a very broad sense as an indicator that is as good as some of the others that are around. But to run monetary policy with highly volatile interest rates in order to obtain a rate of growth in the money supply which we don't really control directly seems to me really bad. So, I come to the conclusion that what is important is the interest rate. That doesn't mean that it's an interest rate on fed funds which we say is 10 to 10-1/2 percent and it comes in at 10-1/4 percent. I think some variation in that interest rate is good. I think we also can follow the market with it. I have a great deal of sympathy for Tony's and Roger's point of view that what we decide today is not independent of the discount rate. I don't want to get [unintelligible] because I have to vote on both of those decisions. I want to come out with a policy that somehow puts those two together. If we vote as a Committee to go for alternative B and then as a Board to raise the discount rate, we're going to end up with 11 percent on the fed funds rate. On the other hand, if the Board decides to raise the discount rate, then we get trapped. If we raise the fed funds rate to 10-1/2 percent, the staff may come back and say the fed funds rate is 10-1/2 percent and as a result the borrowings are going to be a billion and half dollars because [banks] are going to utilize the discount [window]; we may then have to raise the discount rate to keep the borrowings at a certain point. There is a certain amount of circularity going on here. We have raised interest rates already; the [funds rate] average of the last two weeks is 10.36 percent. I think it was probably the proper move. I would go with a fed funds rate of about 10-1/2 percent.

CHAIRMAN VOLCKER. I object a little. You say we raised--

MS. TEETERS. Well, we didn't resist it.

CHAIRMAN VOLCKER. That's a little different.

MS. TEETERS. I am assuming that we are going to raise the discount rate to 10 percent if we decide on alternative B.

MR. PARTEE. Raise the discount rate to 10 percent?

MS. TEETERS. It's at 9-1/2 percent isn't it?

SPEAKER(?). 8-1/2 percent.

MS. TEETERS. Raise it to 9 percent.

MR. PARTEE. All right.

MS. TEETERS. If we raise the discount rate by a half percentage point, then it seems to me that the specifications should be the federal funds rate at 10-1/2 percent and the borrowings at \$800 million. If we raise the discount rate, we want to offset the impact of that to some extent because if we don't we're going to get 11 percent on the fed funds rate. If we don't raise the discount rate, then it seems to me that we can go with "B" and have borrowings of \$1

billion and have the fed funds rate fluctuating in the neighborhood of 10-1/2 percent. But I don't think one can disconnect those two decisions at this point.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I think we are in a critical phase. There is some danger of the economy getting away from us on the up side in the mid-passage. If this is a long expansion, this is the middle of it and the economy is accelerating when it ought to be moderating. I think the market sees that and expects some kind of action. And unless we do something, we're going to lag behind rather than be with it. I'm not arguing that we ought to lead the parade but we shouldn't be hanging back. Moreover, if we do less now, we have to anticipate the possibility that this economy will continue very strong and we may have to do more later on. So, we would be saving ourselves some agony later if we take action now. I realize all this isn't targeting on the aggregates; it's targeting on the economy. I do think the aggregates should be our focal point. I would not want to go back to automaticity of M1. The idea of having to chase after some blip, as we did at one time, is just too alarming. But then one has to be a little firmer on the other means by which we steer. We've already allowed some tightening and if we now move up a second step, I don't think the second step needs to be a very big one. We would be taking two steps in succession. We could at least afford for a while to see if this doesn't work. Like Lyle, I feel that's somewhere between B and C. I would say M1 at 6 percent, M2 at 7-1/2 percent, M3 at 8 percent, and the funds rate range at 8 to 12 percent. I don't want to discuss the discount rate but it's like the word "hippopotamus" in that once it is dropped into your mind it's very hard not to think of it. So, I do make my borrowing assumption with some thought about that; if we go to \$1 billion on the borrowing, that probably would produce the right effect overall.

CHAIRMAN VOLCKER. I think we can go to lunch.

[Lunch break]

CHAIRMAN VOLCKER. If we are reassembled, we ought to proceed. What I would like to do is complete this general go-around. Then I think it might be appropriate to go into a more limited session of the kind we have had before. After we finish the comments by people generally, I would appreciate the staff leaving and we will go into that kind of session. We will proceed with Mrs. Horn.

MS. HORN. For many of the reasons that have been stated, I would like to see the monetary aggregates closer to the middle of the ranges. And I'd like to see that happen sooner than alternative B would bring it about, in part because I do have real concerns about the strength of the economy. But I also think there are significant risks in the future on the down side and that moves me more toward "B." While the other reason moves me away from "B" toward "C," that moves me back toward "B." I must say I like the Chairman's words on his second option "help nature along." In my view a "B-" path does that. By a "B-" path I'm talking about a borrowing assumption of about \$1.2 billion but I'd not quibble on decimal points there. And then just one comment on Henry's hippopotamus: When I say "B-" I am assuming no change in the discount rate; I'm assuming that we'd be

moving with open market operations rather than with the discount rate. So, I would be for a "B-" path.

CHAIRMAN VOLCKER. Does that imply, as a matter of curiosity, that you think that's better than changing the discount rate?

MS. HORN. Yes, it does.

CHAIRMAN VOLCKER. [Your Bank] having proposed one.

MS. HORN. It does. I feel, as someone who doesn't take part in that decision, that there are several reasons why one might want to change the discount rate. It could be done to make a statement or drive home a point or because of real difficulties at the window with too much of a gap between the fed funds rate and the discount rate. I would not be in favor of changing it to make a strong statement at this time. The political situation is such that I'd like to see the move made on the open market side, presuming that the gap doesn't become too big between the fed funds and discount rates and that maybe we could just live with leaning on the open market side.

VICE CHAIRMAN SOLOMON. May I make a comment at this time? There's a danger in a discount rate rise in the sense that the political critics in the developing countries in Latin America may be able to get somewhat more ammunition from the Federal Reserve actively raising interest rates than from a posture of it being the market [raising rates]. But I think that's very marginal. From a purely domestic point of view, I would say that it would be better to raise the discount rate--if you're talking about alternatives. I'm giving my personal view in response to your hypothetical question to Karen.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I said yesterday that I thought the risk to the economy was on the down side and I expressed some disagreement with the staff's forecast for growth for the first and second quarters. Nevertheless, it seems to me that we definitely are looking at a pretty strong year, and associated with that are the inflation dangers and the inflationary expectations that many of us talked about yesterday. For that reason, I think we need to have some movement even to validate what the market has been doing, but I don't think it ought to be very much at this time. I don't think we ought to be overreacting to a few months' economic figures. So, my preference would be something between alternative B and alternative A, and I'd call it "B+" or "A-." It seems to me that the specifications for that would be an M1 figure of around 7 percent with an associated federal funds rate of [around 10] percent and a borrowing number of \$800 million. I think that kind of movement would give us enough restraint in the economy, along with what has happened in the short term, until we get additional data or some other indications of what is actually going to happen in the economy. At the same time I'd keep the monetary aggregates about where they are; they should be within our targets but moving a little more toward the center of the range. Just a quick comment on the discount rate: I really don't get very hung up on that, and in this particular meeting it seems to me that the Committee ought to be making its judgment based on the aggregates and so on. I'd leave the decision on the discount rate to the Board. In other words, if you think that enough has been done, you don't move

the discount rate. But if you don't think enough has been done, then you can do something with the discount rate. So, I'm not particularly concerned about that relationship.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. I agree that the economy is quite strong at the moment, although I wouldn't be surprised to see some moderation in its growth by midyear. And I think that will be a function of these capacity constraints that have been mentioned, a slowdown in some of these high growth rates that are predicted on seasonals like housing, and the lagged effect [on economic activity] of the reduced money growth the last half of last year. On the other hand--and I think we should deal with these lags--the lagged effect of the very large growth in money in late '82 and the first half of '83 should be showing up in higher prices by later this year, which fits into our other discussion about the economy. So, it's important not to aggravate this higher inflation that I expect by raising the growth of the aggregates beyond the trend line. Therefore, I think our original objective of staying in the center of the 4 to 8 percent range, or about 6 percent, is an appropriate policy at this time. I don't see why we should be concerned about the natural consequences of increased credit demand relating to a good and adequate supply of money. It's normal that if activity is strong, interest rates will rise. And that's not something that is likely to kill the economy; it's simply an evidence of the strength of the economy. I would prefer to see us operate on alternative B, with perhaps a small minus on that, in order to accomplish those objectives.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I basically agree with Governor Gramley's description of the economy and what he thinks is likely to happen. I agree that if the staff forecast is wrong, it's probably on the conservative side. It seems to me that the increase in interest rates that has occurred recently is really a reflection of economic strength rather than any policy actions. I remain quite concerned about the long-run implications for inflation; I sense that inflationary expectations are building. I think timing in terms of a policy move is very critical. Intuitively, I would go to alternative C. But I also agree that it would be quite a shock at this time and would probably be a bit strong, so I would come out between "B" and "C." Mention has been made of the discount rate, so I'll go ahead and put in my two cents' worth. Frankly, I think there should be a discount rate change. I could be persuaded to accept alternative B if there were some feeling that there would be a discount rate change, but I'd leave the alternative B specifications as specified, which effectively--as you said, Nancy--would take the fed funds rate probably to 11 percent.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I think the risks in the economy have shifted toward too much growth. But that long list of vulnerabilities--which you started with, Mr. Chairman, and others have added to--is an impressive list as well. It is the time in the cycle, I think, for some restraint. How I would do it at this point is to accept the greater restraint that has become apparent in recent weeks but keep an

open mind about whether additional restraint is needed in the coming weeks, depending on how economic activity comes in. I don't think I would load the dice or load the directive to tilt it more toward overt [restraint]. I would accept what we've done but not much more. It seems to me that a move toward alternative C really would be too much too soon. On the question of automaticity and additional reliance on M1, I'm not in favor of that. It seems to me that the crosscurrents that we're dealing with are just too complex to return to some automaticity or to rely on a rule. Whether we like it or not, I think we're just stuck with using a lot of judgment. On the discount rate, I'm lukewarm at best on raising the discount rate. One argument, if I were making one, would be that as we go through a cycle the longer we wait and don't move the discount rate the more we can't move it later on. So, there is some argument for doing it, if only to keep the option open in the future. If the Board in its wisdom should decide to raise the discount rate, I would be in the camp that says the borrowing figure ought to be reduced so as to offset pressure on the funds rate. And since I only have one vote and not two as Nancy does, in order to get a little better coordination here and a little firmer grip on what we're voting for and its implications, I would feel more comfortable with an 11 percent ceiling on the funds rate. That would seem to me to keep it more in the spirit of alternative B, given the uncertainty as to what the Board might do with the discount rate.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. For all the reasons that have been stated, I certainly think it's an appropriate time to be taking some action. Inflationary pressures are clearly building, and I think it would be very, very unfortunate to see these pressures and not do something about them. So, it seems to me that the timing is appropriate despite the risks--and there are many, and they are serious. I think we'd be better off taking some action now rather than waiting and perhaps having to react a bit more vigorously. I certainly think that we should be aiming toward alternative C over a period of time but, like others, I would find that a pretty abrupt step to be taking today. As I was thinking about this earlier, I frankly wrote down the numbers that Henry Wallich has suggested as a course between "B" and "C," with M1 at about 6 percent, M2 something under 8 percent, M3 under 8-1/2 percent, borrowing about \$1 billion or a little over and the fed funds rate between 8 and 12 percent.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. As I said yesterday, I think that there is now a danger of an overheating of the economy in the foreseeable future. And that, of course, will materialize rather quickly if the staff projection of a moderation in economic growth does not come about. It may well come about, but it's a risky business. I also am impressed by the extent to which debt expansion has played a role in this more rapid growth in activity. When we had to use a variant of Frank's favorite number--private domestic nonfinancial debt--at the meeting of this Committee on January 26 we were estimating for the fourth quarter that it would increase at a 9.2 percent annual rate. The quarter was already over by 26 days. The revised estimate that we have this time is 10.9 percent--an increase of 1.7 percentage points for the fourth quarter. For the first quarter, the estimate we were looking at last time was 8.4 percent. Now we are looking at 11.1 percent--an increase

of 2.7 percentage points from the [previous estimate], some of which is due to these oil company takeovers but not more than a point, I think. Clearly, it seems to me, there is an excessive rate of expansion in domestic debt that can't be attributed in a first effect sense at least to the deficit but to private borrowing. I have the sense--and I only look at the Washington papers and maybe to some extent New York--of a tremendous amount of momentum in the drive to extend consumer credit to the public on the part of the banks and of the drive to put out mortgage credit. There are radio ads and all kinds of ads--a lot of them deceptive--about the terms and conditions of borrowing, and people are responding to those ads. Businesses are too. They have variable rate loans and whether people know what that means I have no idea. But there has been too much debt expansion, I think.

I wouldn't be as aggressive as Lyle in saying that it's time not only to pull the punch bowl a little distance away but to turn it partly over because I'm not that certain of the future. And I do think there are some structural weaknesses of the kind that the Chairman mentioned. I'm worried about the thrifts. The thrifts are going into a deficit situation very shortly now with this level of rates. And the higher the rates, the greater the deficit. It may turn out, as I told some of them, that 1980-81 was just a dress rehearsal to what is going to happen to them in future, in which case we have a whole industry that will be very, very shaky in the economy. I'm worried about housing. Those are housing starts, not housing sales, and it's not customary for builders to line up their buyers before they start a house. I'm worried about the change in psychology in the consumer market that would turn people off housing so that the housing inventories would be sitting on the market as unsalable items the way they are in Dallas. And I'm worried about the LDCs who I think will react quite adversely to a major increase in interest rates in the United States economy and will be very, very sorely impacted. So, I just don't have the courage to move as aggressively as an aggressive fellow like Lyle Gramley would at this stage. Therefore, I come down to alternative B as not being unreasonable. If we take that in terms of the aggregates, that's not a modest ambition for the second quarter. The reason that M1 is as low as it is in alternative B for the second quarter is that there's one relatively low month, and that may or may not materialize. It's not a slow rate of expansion as you look over the quarter as a whole; it's going to be a rather hard thing to accomplish. I'm particularly impressed by Steve's comment, which I happen to believe, that after a quarter where velocity increases sharply it's more likely that in the next quarter velocity won't increase so sharply because the money supply increases a lot more than it did before. I think the danger is going to be that whatever of these alternatives we set, money is going to run higher. That's why I questioned Jerry on "strongly resist" because to resist strongly, if we really mean that, could mean very high interest rates by the end of the second quarter. I think we need to lean and lean pretty hard and look at the aggregates more seriously than we have before, but I don't want to lean all that hard.

In sum, I would buy alternative B; I certainly wouldn't buy anything tighter than alternative B for the period to come. Considering what I think may happen, 11 percent on the funds rate seems to me too much of a near-term constraint that will require a telephone call and I would use the full funds rate range. On

borrowings, \$1 billion seems okay to me; \$1.2 billion seems awfully high. We're starting to move up toward the levels of borrowing that are associated with fairly tight money periods as we get well above \$1 billion. And, what's that rate, Henry? I don't know what to do about the hippopotamus rate!

MR. WALLICH. 50 basis points for \$200 million on borrowing.

MR. PARTEE. That's not a decision that can be made here or that can be made readily. There are lots of strategy questions involved in [the discount rate decision], so we shouldn't really talk about it.

CHAIRMAN VOLCKER. There are a couple of outliers or people not heard from yet, anyway.

VICE CHAIRMAN SOLOMON. Well, in order not to be repetitious, my bottom line is alternative B. I would strongly oppose recasting the directive in the direction of automaticity. And I would assume that the Board of Governors in its wisdom, if it did decide on a discount rate hike, would lower the borrowing assumption somewhat. I have no problems with alternative B.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I would select a "B+", which would be something with the following specifications: 7 percent growth for M1; 8-1/2 percent for both M2 and M3; and a borrowing level of about \$900 million. And if there were a discount rate increase, I would suggest a drop in the borrowing level to about \$700 million to accommodate some of that upward pressure on the funds rate.

CHAIRMAN VOLCKER. I think we can go into [an executive] session now. I have some wording that Steve or Mr. Bernard might distribute. This is no great attempt to be radically different but it seemed a little more coherent to me than some of the others. It accepts the notion of putting the aggregates first. That may be ducking a bit, but it reflects the comments made by a number of people that this is probably a time when we don't want to be too precise about knowing where we want interest rates, within limits. I don't want to prejudge where the limits are put. I'd start off with that foot rather than the other. It's fairly symmetrical. I put in a mention that we would want to take some account of the rate of credit growth, which I think is of concern. A number of people have mentioned it. So far as the numerology and assumptions are concerned, clearly the center of gravity and indeed the majority is toward "B" whether one takes the limited group or a wider group. But there are feelings on both sides of that in varying degrees. I rather share many of the feelings that Governor Partee just expressed, including the possibility that if the economy is as strong or stronger than Mr. Kichline has suggested, there may be considerable difficulty whether we take "A," "B," or "C." We could run into a deviation in the real aggregates from the assumed aggregates that will overshadow any fine-tuning of whatever precise numbers we put down. And presumably we would have to respond to it if the economy were all that strong and the aggregates were all that high. But, based on past patterns, we could get a high month or two. I have no projection of that sort but I just know that that could happen. Even if the economy goes toward

the lower side of Mr. Kichline's projection, which I think is less likely, I still think it's possible that we could have a rather high money figure--or rather that we're much more likely to be faced with that contingency than the opposite. But that remains for the future. As I say, I suspect that to a degree that will overshadow any half point or one point differences in the numbers we put down here.

MR. BLACK. Mr. Chairman, one comment: There might be some [complication] in April. It looks as if there might be a seasonable adjustment problem on M1; that came in so weak last year and that was more than made up--

CHAIRMAN VOLCKER. I think we have a seasonal adjustment [problem] in M1 every month. I don't think you have to worry about April. I trust that number about as much as--I was going to say my grandmother, but I would trust her if she were alive.

MR. BLACK. That's precisely my point. I think we're going to see a number we really can't trust in April--maybe even more so than in most months.

CHAIRMAN VOLCKER. I don't trust them much in any month.

MS. TEETERS. If you don't trust M1, why are you putting it up front?

VICE CHAIRMAN SOLOMON. We're not only putting it up front but also we have gone back to a monetary aggregates directive.

MR. RICE. It's not just M1; it's M2 and M3 as well.

CHAIRMAN VOLCKER. I have no particular feeling about where M1 is put in this list. We can put it the way it was before. I put it there because I think that's basically what we are concerned about. I'm talking about not trusting it in narrow one percents. I trust it if it shows a big increase or a big decrease. And it gives us the best excuse in a real sense and in an excuse sense. But I think in this particular situation if these aggregates continue to run high, we should in substance react to them. I just don't think my judgment is so fine as to know what we should do when it gets down to the + or - one percent area [of differences in growth rates].

VICE CHAIRMAN SOLOMON. But the bigger problem is the real economy; that's what we're concerned about. It's not so much where the monetary aggregates stand that we are all concerned about in the end. I think you're leading us right back in the direction of automaticity in this directive.

CHAIRMAN VOLCKER. I'm not talking about automaticity in the sense that I take it Mr. Black was talking about.

MR. PARTEE. This is really reserve restraint. It isn't an algorithm of the amount of overage.

VICE CHAIRMAN SOLOMON. Yes, I understand. You know, the market tends to over-interpret, and I think the changes in the wording of the directive are reinforced by putting M1 in front. Okay, we put M1 further back. But I think this will tend to awaken expectations

that we may once again be on that roller coaster. Nobody is going to believe necessarily that this is the last ride, particularly if the economic data continue relatively strong. And then there would be expectations of [rates] going to very high levels. I just think it's disturbing to move back in that direction. I realize we haven't moved back 100 percent in terms of the way the short run feeds back with the nonborrowed reserve paths.

CHAIRMAN VOLCKER. Where is the old directive?

MR. MARTIN. The old directive also put the aggregates up front.

MS. TEETERS. No, it didn't. It's the same as variant II on page 13.

VICE CHAIRMAN SOLOMON. Right.

CHAIRMAN VOLCKER. I have a little technical problem, but it's a very great problem, in starting out with reserve pressures, which is partly what convinced me [to start with the aggregates]. I don't know how we'd describe the current degree of reserve pressures. It's a meaningless concept. Well, the concept isn't meaningless but if you look at borrowings or if you look at net borrowed reserves or free reserves, you're going to get entirely different answers for the month of March. You get borrowings up to what--\$1 billion?--with net borrowed reserves probably a minus. What does maintaining the existing degree of reserve pressure or increasing it or decreasing it mean in that circumstance?

VICE CHAIRMAN SOLOMON. Well, what does it mean then to have your second sentence?

CHAIRMAN VOLCKER. That's precisely why I put the second sentence in brackets. Maybe we can drop the whole thing.

VICE CHAIRMAN SOLOMON. No, I mean the third sentence where you have "greater reserve restraint." What does that mean then?

CHAIRMAN VOLCKER. Greater from wherever we start; we don't have to describe where we start. The problem exists. But at least one avoids it in the directive by dropping the second sentence.

VICE CHAIRMAN SOLOMON. Well, I don't think that is a strong enough reason to convey such a strong [unintelligible] impression, which is what I think will be conveyed by recasting it.

MR. GRAMLEY. Well, because of this problem of not knowing how to interpret borrowing numbers, I'd like to hear--when we get to the point of getting down to specifics--what we're going to mean with this directive or any other in terms of how far we're willing to let interest rates go up. I would not be shocked to contemplate a federal funds rate of 11 percent. I take it that others would be. But if the idea is to run a monetary policy which in effect says that what we've done so far is let the federal funds rate and associated rates of interest go up in recent weeks and we will just hold them there, I'm not going to be happy with that. I just don't think that's the way we ought to go. But I'd like to have a translation.

CHAIRMAN VOLCKER. Well, I'm just looking over what people said here. I don't think anybody, except maybe Governor Teeters, has said that they wanted a lower upper limit--for whatever that means, since we waive it when the rate gets there--than 11 percent. I don't know about Governor Teeters. Nobody else who spoke to that point directly--and there were some who did not--[said less than 11 percent].

MR. BOEHNE. I spoke to it.

MR. PARTEE. Yes, I didn't want to--

MS. TEETERS. I don't think I spoke to it, but I--

CHAIRMAN VOLCKER. I have you marked down as saying an 11 percent ceiling.

MR. BOEHNE. Yes.

CHAIRMAN VOLCKER. That's what I just said. Nobody was below an 11 percent ceiling.

MR. BOEHNE. Oh, below. Okay.

MS. TEETERS. I didn't speak to it, but I would accept an 11 percent ceiling.

CHAIRMAN VOLCKER. There is disagreement above that point, but nobody said less than 11 percent. Well, if it's nothing, we can get to the wording of the directive. Maybe we have the cart before the horse and people are going to want different emphases, which are going to have to be blended in the directive. That's the fact of life. But in terms of the specifications, I'll take them up backwards starting with the funds rate. Apparently we have established that nobody wants to put the upper limit below 11 percent. Some people want to put it above that. Well, the limit is irrelevant, I guess. What we had before was 6 to 10 percent. If we keep the 4 point range, 7 to 11 percent would be the minimum that anybody is talking about. And a lot of people are talking about [a higher range], but I don't know if those are outliers. Is that generally acceptable or not?

MS. TEETERS. Keep the 4 points.

MR. PARTEE. I think it ought to be higher.

MR. GRAMLEY. I do too.

MR. ROBERTS. So do I.

CHAIRMAN VOLCKER. Well, quite a few people have expressed the opinion that it ought to be higher and the question is whether--

VICE CHAIRMAN SOLOMON. I don't feel strongly whether it's 7 to 11 percent or 7-1/2 to 11-1/2 percent. I'm always bothered by 1/2 points.

MR. BOYKIN. 8 to 12 percent.

VICE CHAIRMAN SOLOMON. The markets may overread what that new ceiling is going to mean.

CHAIRMAN VOLCKER. I myself would think 8 to 12 percent is too high in the directive. We may be under pressure to release this directive early. You might have that in mind. I don't intend to do so, but--.

VICE CHAIRMAN SOLOMON. What do you mean? What kind of pressure?

CHAIRMAN VOLCKER. Congressional pressure. I intend to resist that but I can't guarantee it. My own feeling is that putting down 8 to 12 percent and having this come out will be interpreted as a much stronger step than we would want it interpreted. Knowing that if we use something less and get to that point and think the situation justifies going higher, our record has been 100 percent, I'd say that we've never felt constrained when it came to that point.

MR. BOEHNE. What is the guide? What is the needle on the compass here? I think Lyle has put his finger on a good point. I don't think anybody--well, some people may--would put a lot of faith in M1 or M2 for any given month if we don't know what reserve restraint or ease means.

CHAIRMAN VOLCKER. Maybe we can define what it means for us, but it's a little hard to describe to the market simply [in terms] of putting out the directive.

MR. BOEHNE. What is the meaning of this? It seems to me that we have more or less been using the real economy with some sense of what reserve restraint means. That's pretty messy, but from my point of view at least I have some sense of what it means and what causes changes. But I don't really know what using M1, M2, and M3 means. Is it a different ball game than we've been playing over the last few months?

CHAIRMAN VOLCKER. I don't know what ball game you think we've been playing in the last few months, but I don't see much difference here, frankly. It says we're going to set a restraint level and we're going to stick to it depending upon how these aggregates go, but we are going to look at what is going on in the economy before we change it. I think that's what we've been saying.

MR. MORRIS. Except that you have promoted M1.

CHAIRMAN VOLCKER. Well, that's a separate decision.

VICE CHAIRMAN SOLOMON. I think there is a difference between starting off the way the Chairman has been talking about on the degree of reserve restraint and then saying the Committee believes these to be consistent with intermeeting monetary targets of X and Y or whatever, and putting it this way. The substance of what we do may not be different, but I think it will be the impression in the markets that we are returning toward much more emphasis on the monetary aggregates, and more volatility in interest rates then becomes a possibility. And I don't think that's a helpful thing at this time.

CHAIRMAN VOLCKER. I think you're back at the wording of the directive. Let me see whether we can sort this out.

VICE CHAIRMAN SOLOMON. Well, in substance I said I could live with either 7 or 11--

CHAIRMAN VOLCKER. I understand. I'm just trying to sort this out. Let me try 8 to 12 percent. I sense that there's a lot of resistance to that. Is that true?

MR. MARTIN. I would not go along with 8 to 12.

MS. TEETERS. I would not go along with 8 to 12.

MR. BOEHNE. I wouldn't either.

VICE CHAIRMAN SOLOMON & MS. TEETERS. Do you want a show of hands?

CHAIRMAN VOLCKER. I don't think we need a show of hands. I think as a practical matter we are between 7 to 11 percent and 7-1/2 to 11-1/2 percent.

MR. CORRIGAN. The way this directive is written, Mr. Chairman--

CHAIRMAN VOLCKER. Let's resolve the numbers.

MR. PARTEE. I think [we should use] 7-1/2 to 11-1/2 percent. Somehow 12 percent does sound awfully rich--doesn't it?--although it may not be. It's just a culture shock.

MR. BOEHNE. It's called rate shock!

MR. MARTIN. We were at 9-1/2 percent a long time. There is a little arithmetic one can do vis-a-vis 11-1/2 percent.

MR. GRAMLEY. I would go back to the comment the Chairman made earlier. We are living in a world in which interest rates have become the cutting edge of monetary policy.

MR. PARTEE. Yes.

MR. GRAMLEY. In a world of deregulation, they have to move a lot more. I know that causes potential damage here, there and elsewhere in terms of the LDCs, the thrifts, and so on. But the point is that if we want to get any restraint on the economy we have to let interest rates go up. And in this kind of world we have to let them go up more than we used to. If we sit here and let these interest rates creep up by 1/4 percentage point per FOMC meeting, we are never going to get the job done.

MR. PARTEE. A rate of 11-1/2 percent, though, Lyle, is a reasonable amount above where we are at about 10-1/4 percent. And as the Chairman points out, we never have let that stop us if in fact something were going on that called for more restraint.

MR. BOEHNE. I don't think we're letting it go up 1/4 of a point. Three weeks ago the funds rate was around 9-3/4 percent.

CHAIRMAN VOLCKER. It wasn't very long ago that it was 9-1/4 percent.

MR. BOEHNE. It's not as if we're just moving along here at 1/4 point [per FOMC meeting].

MR. GRAMLEY. My point, Ed, was that the rate has been close to 10-1/2 percent in recent days and if we have a ceiling of 11 percent, that tends to leave no room to operate unless we say the ceiling doesn't have any meaning. And if it doesn't have any meaning, then I don't know why we'd want to put that kind of ceiling on it. It just leaves almost no room to maneuver at all starting from where we are now, if we have a federal funds range with an upper limit of 11 percent. If it's going to mean anything at all, then it's very, very restraining in terms of the amount of interest rate movement we will contemplate. If it doesn't have any meaning, then it's just purely for publicity purposes, so then let's decide among ourselves what we really think it ought to be and keep that a secret.

MR. BOEHNE. I wouldn't consider 50 to 75 basis points a meaningless move.

VICE CHAIRMAN SOLOMON. I think Lyle is right that we probably need a little more movement and, therefore, even though I could live with either I would have a slight preference for 7-1/2 to 11-1/2 percent myself.

MR. GRAMLEY. I could live with that.

MR. CORRIGAN. I'd join that.

CHAIRMAN VOLCKER. We'll go on to the next numbers. Assuming we are somewhere in the neighborhood of "B," does anyone have a more felicitous series of numbers than "B" pure and simple? And one that they also think will command wide support?

MR. GRAMLEY. I was going to offer a series of numbers, but now with that stipulation--.

MR. PARTEE. I think they look pretty good.

VICE CHAIRMAN SOLOMON. If we don't take them too seriously, I think they're fine.

MR. PARTEE. If we could actually come out there, I'd be pretty happy.

CHAIRMAN VOLCKER. Are there people who can't live with "B" as put down in the Bluebook?

MR. BOYKIN. I would prefer 6, 7-1/2, and 8 percent, Mr. Chairman.

MR. GRAMLEY. I would go with Bob.

MS. HORN. I'll go with that.

CHAIRMAN VOLCKER. Those in combination are awfully low numbers.

MS. HORN. Lead off with 7-1/2 and 8 percent, not 6 percent.

MR. CORRIGAN. In terms of the numbers, could I ask my question now? Do you interpret the third sentence as a symmetrical or asymmetrical sentence?

MR. PARTEE. It's symmetrical.

CHAIRMAN VOLCKER. I interpret it as a symmetrical sentence. The reality I don't consider very symmetrical, but I consider that sentence symmetrical.

MR. BLACK & MS. HORN. Somewhat.

CHAIRMAN VOLCKER. Well, I guess it's slightly asymmetrical as written.

MR. MARTIN. Somewhat.

MR. CORRIGAN. This is the area where I have the greatest worry. Whether we use Mr. Boykin's numbers or those in alternative B doesn't matter all that much to me because I don't have the same problems with the numbers that everybody else has. But I must say that I would really get scared if the outcome for money and credit growth in the second quarter were in any material way above the alternative B numbers. In other words, I really think of those "B" numbers as a ceiling. And if we got too far beyond them, I think we'd have a very, very difficult problem on our hands--more difficult than the problem we have on our hands today.

MS. TEETERS. What sort of velocity assumption are you making, Jerry? That's vital here to what you think the GNP is going to be.

MR. CORRIGAN. Well, as I've said many times, Nancy, I think the economy is likely to be stronger rather than weaker in the very near term. Unfortunately, I also think if that's true, that the longer-run implication is that the economy is going to be softer because we're going to get more interest rate pressure coming from the demand side of the economy. So, by implication I am suggesting that I think the velocity factor in the second quarter could be larger than what is implicitly built in here.

MS. TEETERS. But if you rigidly take these numbers, you begin to get all sorts of volatility in interest rates. It's not worth the price.

MR. CORRIGAN. I don't want to do that, Governor Teeters.

VICE CHAIRMAN SOLOMON. When you say you want asymmetrical wording, what you are really saying is that you want a stronger interest rate response if there is continuing excessive strength in the economy and the monetary aggregates.

MR. CORRIGAN. That's correct.

MR. BOYKIN. In just a presentational sense, Jerry, if you accepted the numbers that I'm suggesting, the asymmetry is less important. You could get it more the way it is worded if you just reduced the numbers.

MR. CORRIGAN. Again, I'm such an agnostic about these numbers that I don't get visibly moved by 1/2 point differences in the numbers. The question that I'm concerned about, regardless of whether we use your numbers or the "B" numbers, is: What happens if we get into the quarter and we're running ahead of them?

MR. BOYKIN. Oh, you're talking substance now!

MR. CORRIGAN. Yes.

MR. BOEHNE. It seems to me that the gut issue here is how much you load the dice in terms of higher rates. When you start moving the numbers toward "C" and when you have an asymmetrical presentation and an 11-1/2 percent funds rate limit, you might as well vote for moving the funds rate up to 11 percent.

MR. PARTEE. It wouldn't load it, though, toward a higher rate. I understood Jerry to say he was more concerned about getting indications of a significant overshoot of these targets than he is about a significant undershoot. And I think I agree with him on that.

VICE CHAIRMAN SOLOMON. Yes, but even if you're more concerned as I think we all are--that's where the risks are--why does that argue necessarily for an asymmetrical articulation in the directive?

MR. PARTEE. We've often used it before. I don't know why we would throw it out now.

MR. GRAMLEY. There's good reason for asymmetry if the risks are stacked on the side of stronger growth and more inflation. That way we don't expose ourselves to a circumstance in which, even though the economy is going along fairly strongly, we for some reason have a downward shift in money demand and overreact and let too much ease take place. An asymmetrical arrangement makes very good sense under present circumstances.

VICE CHAIRMAN SOLOMON. I would agree with you if we were simply going to react mechanically to an easing of money growth. But I'm interpreting that there's not going to be a substantive change in our policy [approach]--that we're still going to be looking at money in the context of the business expansion and inflationary pressures. But I would agree: If we were going to be reacting more to money growth in the future, then we have to word it asymmetrically for the reasons that you just indicated, Lyle.

MR. BOEHNE. I think there is a subtle difference in how we phrase this. We can be quicker on the trigger on the up side or we can be slower on the trigger on the down side. Where I come out is that I can't imagine a situation in the next month where one would want to lower rates. Well, I guess I could imagine it. But at the

same time, I don't want to build in some automatic forces that are going to push rates up.

MR. PARTEE. I agree with that.

MR. CORRIGAN. I don't want the automaticity either. But I don't want to be sitting here in June looking at a second quarter in which money, the economy, and everything else are stronger than we think they are going to be--stronger than we know they should be.

MR. PARTEE. You may well have to do that. We can't really--

MR. CORRIGAN. I think we can try to minimize the risk of it. We would really be in the soup then.

MR. PARTEE. If that were the case, then I think we should have moved. But you could have a stronger money quarter, a stronger GNP quarter, and everything, but--

CHAIRMAN VOLCKER. Well, let's get back to these numbers. I would feel a bit reluctant, to say the least, to lower the M2 and M3 numbers any further. We have said all along that we expected to be in the top part of those ranges. I think on M1 we can horse around between 6-1/2 and 6 percent, but it makes little difference. I think it will make no practical difference in the way we operate, but this gets to be a visual point.

MR. BOEHNE. What if for M1 we said something like "around 6 to 7 percent"? That [includes] the 6 and the 6-1/2 but it doesn't make it sound quite as precise as 6-1/2 percent.

MR. GRAMLEY. Do we mean 6-1/2 percent by that? Would we accept up to 7 percent before we would react? Then what do we do with--

CHAIRMAN VOLCKER. That doesn't worry me terribly, but I don't know whether other people like it.

VICE CHAIRMAN SOLOMON. I wouldn't.

MS. TEETERS. Just as a point of information: Have we ever hit a target?

CHAIRMAN VOLCKER. We came pretty close this time.

MS. TEETERS. Have we ever hit a target on a short-term basis?

CHAIRMAN VOLCKER. Within 1/2 of a percent?

MR. AXILROD. On M1 do you mean?

MS. TEETERS. Yes.

MR. AXILROD. Well, it's about 8 percent over the 3 months as against [a projection of about] 7 percent.

MR. CORRIGAN. Well, the fourth quarter M3 has been--

VICE CHAIRMAN SOLOMON. I think there probably is a majority for these numbers. Maybe you ought to get an informal showing.

CHAIRMAN VOLCKER. I was going to suggest that. It seems very close to that. Let's assume that for the moment.

MR. AXILROD. Mr. Chairman, maybe I answered Governor Teeters wrong. We are within the long-run cone. The weekly figures we're going to publish will be below the weekly figure consistent with the [target]. If the number that we're not publishing--the one we have a tentative estimate for at the end of March--holds up, it will be above the long-run cone. But month-to-month, on average it's just below.

MR. MARTIN. The 7 percent that you're estimating would take us above?

MR. AXILROD. No, it's all right on the month; the end of the month is ticking up, if that number holds up. It's just another way of saying that it's very near the top.

CHAIRMAN VOLCKER. Let me move to the borrowing level where I think there is, in fact, a bigger range of opinion. I suspect that reflects in part that we don't know whether where we are is because of contemporaneous reserve requirements or other expectational factors. We have a classic case in this two-week period of the way one would think things might happen frequently with a two-week reserve adjustment period. Everybody thought that perhaps [markets] were getting tighter earlier in the period and they borrowed a lot. They built up excess reserves and now they end up the period with big excess reserves and the market is getting easy. In previous weeks, I guess the opposite happened. This used to happen with the weekly reserve pattern and now it can happen with considerably more amplitude because [banks] have a two-week period before they get caught up short. So, those who would like to calibrate the federal funds rate in their thinking down to a gnat's eyelash have a bit of a problem. I don't know what this means for the level of borrowings this week and for the federal funds rate, particularly during a period when it might be higher [initially] and then turn out to be lower at the end or vice versa, depending upon the pattern during the period.

MR. MORRIS. Isn't what we're seeking a borrowing level that will be compatible with a 10-1/2 percent funds rate?

CHAIRMAN VOLCKER. Well, I'm not sure. Let's assume that's the case just to get an analytic [framework].

MR. GRAMLEY. Could we just expand the range of estimation? What is the borrowing level for 11 percent, too, so I know where another option might be.

MR. PARTEE. These are educated guesses of the staff?

MR. GRAMLEY. Yes.

CHAIRMAN VOLCKER. That's what I'm about to ask. I'm not sure I have a great deal of faith in them.

MR. AXILROD. We think a billion and a half will get a funds rate close to 11 percent, with all the uncertainty.

CHAIRMAN VOLCKER. Without any change in the discount rate?

MR. AXILROD. Without a change in the discount rate. In the Bluebook, we said borrowings of \$1 billion or a little more get a funds rate of 10-1/2 percent. If you look at the experience in the last couple of days, with the funds rate dropping off fairly substantially, that will change market attitudes a little and I would be inclined to say--Peter may disagree--that it might take a little over \$1 billion to get 10-1/2 percent. And if you used \$1 billion in borrowings, I would feel safe in thinking of a wider range in the funds rate--10-1/8 to 10-1/2 percent or something like that.

MR. STERNLIGHT. I agree with a little over \$1 billion--say, \$1.1 billion--for 10-1/2 percent. I think borrowings of \$1-1/2 billion would produce more than 11 percent [on the funds rate].

MR. AXILROD. Yes, that's what we said: 11 percent or over.

CHAIRMAN VOLCKER. Well, I would take just the opposite point of view. The federal funds rate, with a billion dollars of excess reserves--though not during the early part of the period and I don't know what it will average--averaged well over 10 percent. And we will have a billion dollars or slightly more borrowings and we happen to have a billion dollars worth of excess reserves. If we have \$650 million of excess reserves, I don't know what we will get.

MS. TEEETERS. What role do we see excess reserves playing? Are they precautionary? Or are they an accident because of CRR?

MR. AXILROD. In this two-week period I think the market created them on its own, not knowing they were doing it in effect. That is, they borrowed. We were somewhat behind the NBR path much of the time. Now we're actually slightly over it and the market borrowed and generated excess reserves in addition to the nonborrowed reserves; and now if they end up with excess reserves they don't want, those reserves have to come out. Before, the level of excess reserves of around \$600 to \$650 million was probably fairly close to what they wanted, given the prevailing market conditions.

CHAIRMAN VOLCKER. During the introductory period of CRR--we can go back before that because we had a little change in reserve requirements there--the average level of excess reserves was around \$400 million.

MR. AXILROD. I think it was a little higher than that.

MR. STERNLIGHT. It was \$600 million in January and \$500 million in November and December.

MR. MORRIS. So we could see a low funds rate tomorrow?

CHAIRMAN VOLCKER. Oh, I think it will be lower.

VICE CHAIRMAN SOLOMON. But won't they be influenced by the carryover? If they see that they have run very large excess reserves,

won't they be inclined to avoid such high excess reserves the following period because of the carryover?

MR. AXILROD. That's the idea, but we haven't seen much effect.

MR. STERNLIGHT. We don't have experience with that.

MS. TEEETERS. Well, excess reserves ever since October of 1979 have been trending upward and I interpret that as security against erratic Federal Reserve behavior.

MR. AXILROD. No. It seem to have more to do, Governor Teeters, with the fact that country banks now don't have with us the required reserves that they need to hold. They leave their reserve balances in there for a while for whatever reason. Some even hold excess clearing balances, which get into our excess. All that is a little irrational, but we can account for \$50 to \$100 million dollars of those sorts of things.

VICE CHAIRMAN SOLOMON. Weren't they also influenced by widespread expectations that rates would rise or the possibility of a discount rate rise?

MR. STERNLIGHT. That probably induced some of the borrowing.

VICE CHAIRMAN SOLOMON. And I think that influenced the level of excess reserves. I don't think we should assume, Paul, that it's going to continue at these levels.

CHAIRMAN VOLCKER. I don't assume that it is going to continue at these levels; I don't know all the reasons that contributed to it but I certainly would not assume that it will continue.

MR. AXILROD. I should be clear, Mr. Chairman, when we said a billion dollars or more borrowing gets you a 10-1/2 percent funds rate that we were, of course, assuming excess reserves on the order of \$550 to \$600 million. That was the assumption within that. We were assuming net borrowed reserves of \$400 to \$500 million.

MR. GUFFEY. And that's consistent with the last two-week period?

MR. AXILROD. Yes. Actually, I'm assuming it could even be lower.

CHAIRMAN VOLCKER. I would guess that as well as people can understand this--and I don't think any of us can be very sure--that what many people are talking about as a center point is a billion dollar level of borrowing with that much lower excess reserve assumption. I'll say \$500 million just to put a round number down, which [unintelligible] for this past week in a total reserve position sense is tighter than anything we have had by a considerable margin. Let me take out the adjective: tighter than what we've had. You can interpret the adjective yourself. I assume that's more or less what people are talking about but I don't have any great judgment as to whether that means a 10-1/4 percent funds rate or 10-1/2 percent or

10-3/4 percent. To some degree I care, but if it meant a greatly easier federal funds rate, I don't think it is consistent with the substance of what we're talking about and it would be inappropriate.

MR. AXILROD. As a technical point, I should mention that quarter-end and mid-April we could get some fairly high rates relative to even this average. That's just in passing.

CHAIRMAN VOLCKER. Let me just try this: With all the uncertainties associated with it and subject to the risk that we may find out we're crazy but within limits, we're talking a billion dollars worth of borrowing and assuming something like \$500 million in excess reserves, which is less than we've had at any time since contemporaneous reserves. That number may be too low.
[Unintelligible] Mr. Axilrod?

MR. AXILROD. It is less than we've had in quite a while. That's a shade below the October-to-December average.

CHAIRMAN VOLCKER. Let me say \$1 billion of borrowing, and \$600 million of excess reserves and see how that goes.

MR. MARTIN. Isn't the federal funds rate under 11 percent then? You quoted 10-3/4 and 10-1/2 percent.

CHAIRMAN VOLCKER. Well, I assume. But it's nothing more than an assumption. I'll accept the notion just hypothetically that if one had to guess, it means a federal funds rate in the 10-1/4 to 10-1/2 percent area.

MR. MORRIS. And this would be revised to reflect any discount rate changes?

CHAIRMAN VOLCKER. I'll get to that question. Let's assume just for purposes of discussion that it's in the absence of that. Well, let me get to that. I'll just raise a question: If the discount rate went to 9 percent, is that assumption still good?

MR. GUFFEY. Not if you've mentioned borrowing at \$1 billion.

CHAIRMAN VOLCKER. Different people may have different opinions about things.

MR. WALLICH. Only on the condition it seems to me that one billion dollars borrowing is right. For that reason I like your paragraph.

MR. PARTEE. You were asking a technical question, weren't you? I don't know. The funds rate has gone up a bit relative to the discount rate. Technically, there would be room for it to move a half point and not have a much different funds rate, I should think. But of course, there is the expectational [element]. We have an 8-1/2 percent discount rate as against a 10-1/4 to 10-1/2 percent funds rate. I would submit that a 9 percent discount rate would not--

VICE CHAIRMAN SOLOMON. It's not going to change the fed funds rate?

MR. PARTEE. It would not have to, except the expectational--

VICE CHAIRMAN SOLOMON. Well, I think it will. Peter?

MR. PARTEE. Let's get some views.

MR. STERNLIGHT. I think that the funds rate did have some of that expectational element. But I still think that much of the discount rate would be translated into a higher funds rate unless you did something to borrowing.

MR. PARTEE. Do you agree with that, Steve?

MR. AXILROD. Given the gap we now have [between the two rates], I would think it might have less effect than maybe Peter is inclined to believe, but we will find out if the change occurs.

CHAIRMAN VOLCKER. I think the answer is: We don't know how much of that expectational influence is in the funds rate already.

MR. AXILROD. I think it got to 10-1/2 percent on the expectation of a 9 percent discount rate. So it may be that you will have 10-1/4 percent and it will move a little.

CHAIRMAN VOLCKER. I can't quantify this but I think it is fair to say that at the minimum everybody around this table is not talking about giving the market some false sense of easing at this stage and that, whatever this [borrowing] number is, it ought to work out that way. Maybe there will need to be a little flexibility to assure that result.

MR. MARTIN. I think you're right, Chairman. But isn't there some difference of view here as to how much tighter or less accommodative [we should be]?

CHAIRMAN VOLCKER. I made the minimum statement that I don't think anybody wants to misspecify here in the sense that it gives the market some notion that, in the newspaper parlance, there is an easing of policy.

MR. WALLICH. That would be contrary to expectations and very confusing.

CHAIRMAN VOLCKER. Let me just say that whatever [borrowing] number we arrive at here, I think we need some flexibility to manage things so that at the minimum that impression is not created.

MS. TEEETERS. On the other hand, with some exceptions, I don't think there's strong sentiment to ratchet the rate rapidly.

CHAIRMAN VOLCKER. That is an entirely different question. I don't want to disagree. But could I at least assume by my very modest statement that if by some development the borrowing turned out to be quite consistent with a 9-3/4 percent federal funds rate, that we haven't got enough borrowing?

MR. GRAMLEY. Well, I think the market is expecting more than this.

CHAIRMAN VOLCKER. Now, that's the other question--how much to go beyond.

MR. GRAMLEY. I think we're in very serious danger of losing credibility as an agency that is trying to hold down inflation. It seems to me that the numbers have been coming in very strong on the real economy. We have been looking at money and credit numbers that are very large in any kind of historical perspective. We are doing so in the second year of a recovery when expectations have been greatly exceeded. We are doing so in the context of a fiscal policy that is the most stimulative we've ever seen. I just don't know how we can talk about making sure we don't ease. The situation calls for more than that. It calls for more, in my judgment, than just confirming for the market the fact that interest rates have gone up in recent weeks.

MR. MORRIS. Also, Mr. Chairman, with a 2 percentage point spread between the discount rate and the funds rate, I think a discount rate increase of only a half point would be interpreted by the market as acting a little tentatively.

MR. PARTEE. How about a quarter point?

MR. MORRIS. I'm talking about 1 point. We have a 2 point spread.

VICE CHAIRMAN SOLOMON. I don't think so. A half point is what the market is going to--

CHAIRMAN VOLCKER. I will tell you: In this particular city a half point will be an explosion. It will carry a certain message.

MR. MARTIN. And in some foreign capitals.

VICE CHAIRMAN SOLOMON. In fact, a quarter point move would carry an interesting message. If we went back to quarter point moves, it would be interpreted as meaning that we're not going to have a lot of volatility in the next year--that basically we are thinking in terms of more cautious moves and that that will be the likely pattern over the next year. I don't think we want that interpretation either, for the reasons that Lyle has pressed so strongly. I think a half point is--

CHAIRMAN VOLCKER. I think I have established a bare minimum on the substantive objective for the borrowing, but the question is whether we start with this. We certainly [can] raise it. This may well be consistent with a tightening. It is the strongest net borrowed reserve position we will have had.

VICE CHAIRMAN SOLOMON. And you do have the flexibility you're going to need in case we are wrong on the borrowing and for some reason the fed funds rate that falls out of the borrowing assumption is on the down side. I think that's pretty clear.

CHAIRMAN VOLCKER. That is right. And [the Board] obviously has the flexibility to raise the discount rate.

MR. WALLICH. Some tightening I think has to come or [the funds rate will] fall below expectations. It doesn't have to be a very large one, and I could see that there would be another step some time in the future. But I don't think we can just stabilize things because the rates have gone up somewhat.

MR. MARTIN. I don't think anybody is arguing that we should do that, Henry. And that may be the bare minimum. I remind the group that the staff forecast is still geared around a statement that the risk of error is on the down side not on the up side, and there is considerable merit in my view in that position. So, we do need flexibility in both directions. I haven't any problem with a directive--either draft of the statement--that emphasizes the tightening side and not the more accommodative side, but I think both sides need to be in there.

MR. PARTEE. I would agree with Pres. I think this is tending to go too far. Who is it that we are trying to satisfy? The gnomes of Zurich? There are a lot of people who don't want to see a tightening. As a matter of fact if you went out and took a poll, you would find that a vast majority of the American public would be opposed to a tightening.

MR. WALLICH. But they expect it.

VICE CHAIRMAN SOLOMON. Chuck, I was telling Paul that my board of directors had indicated already that we should not tighten -- not raise the discount rate--in their view until we actually see increased inflation. They argue that at this point it's too early to take away the punch bowl. They want us to wait until we actually see it; I say we may be too late then.

MR. PARTEE. We heard a lot of expressions like that as we went around the table.

CHAIRMAN VOLCKER. Let me just suggest that there is going to be no formulation that is going to take care of all the contingencies that I see in the next two weeks much less in the period until we meet again in 8 weeks. In the interest of testing: The minimum sense that I have is that we don't want to convey any chance of easing. We start off with \$1 billion on the borrowing assumption and something like \$600 million more or less as the excess reserve number. That could bring some tightening in and of itself but I'm sure it doesn't bring any easing. We have the discount rate issue. I don't know what [the Board is] going to do but it is clearly an option and we don't make any automatic decision here that we will reduce the borrowing simply because we raise the discount rate. If things come in such that we want to reassess this in the next couple of weeks, we can.

MR. BALLEZ. I think that makes eminent sense, Mr. Chairman.

VICE CHAIRMAN SOLOMON. Presumably, there is some sense of an upward limit. If the Board raised the discount rate and we found out by not reducing the borrowing assumption that fed funds were trading in the neighborhood of 11 percent--.

CHAIRMAN VOLCKER. I'd be a little concerned.

MR. BOYKIN. Technically, Mr. Chairman, can the borrowing assumption be changed other than by the Committee?

CHAIRMAN VOLCKER. We change it all the time.

MR. BOYKIN. All the time?

CHAIRMAN VOLCKER. I say we change it all the time. We don't fiddle around with it from week to week, but we get a sense of what the directive says. This time we would change it if the money supply were coming in stronger and business remained strong or whatever.

MR. BOYKIN. My point is that those of us who don't vote on the discount rate would have nothing to say about what was done with the borrowing assumption.

CHAIRMAN VOLCKER. Unless there were a consultation. If something drastic happened, presumably there would be.

MR. BOEHNE. I think what you're saying is that you are going to look through the borrowings to the funds rate--not that you would be fixing the funds rate, but that with all this uncertainty one is not oblivious to what happens to it.

CHAIRMAN VOLCKER. Not oblivious, that's right. If I had a sense that we were getting a lot more tightness out of this than I judge we were really looking for, we would redo it. That I can assure you. You may certainly take it for granted that if there were a little easing out of it, we would adjust it.

MR. GUFFEY. And that's starting from the benchmark of accepting "B" with borrowing of a billion dollars and \$600 million in excess reserves and someplace between 10-1/4 and 10-1/2 percent on the funds rate, as indicated in the Bluebook?

CHAIRMAN VOLCKER. Well, excepting your last statement. I would accept the others.

VICE CHAIRMAN SOLOMON. It could easily be between 10-1/4 and 10-3/4 percent.

MR. GUFFEY. No, I'm talking about [the funds rate] without a discount rate [increase].

VICE CHAIRMAN SOLOMON. No. Without a discount rate increase.

MR. GUFFEY. If you accept the commentary in the Bluebook, it's 10-1/4 percent with \$1 billion borrowing and some possibility of--

CHAIRMAN VOLCKER. I'm not going to accept a federal funds target that narrow.

MR. GUFFEY. Well, no. I'm just trying to get a benchmark, though.

CHAIRMAN VOLCKER. That's what we are told is the most likely outcome. If we get less than that, I think the discussion says something is the matter. If we have a sense of easing, something ought to be tightened up; if we get a little above that, I'm not sure I would have that sense.

MR. GUFFEY. I agree on the easing, but I guess I'm concerned about approaching that 11 percent rate--whether with \$1 billion borrowing without a discount rate increase or some other level with a discount rate increase. That 11 percent triggers some real concern.

MS. TEETERS. Let me see if I can restate it, Roger. The "B" specification with the \$600 million excess reserves, in my mind, has a federal funds rate that fluctuates between 10 and 11 percent. And if it were persistently at 11 percent, you would adjust to bring it down. If it were persistently at 10 percent or below, you would adjust to bring it up.

CHAIRMAN VOLCKER. I would modify that. If I assess this discussion correctly, I would wait for it to be [persistent]. I'm not talking about [the funds rate on] a particular day but some judgment about the whole atmosphere. It wouldn't be below 10 percent and I don't think it would be down to 10 percent.

MS. TEETERS. But I don't want to see it go above 11 percent and stay there.

CHAIRMAN VOLCKER. Well, I'm not talking about getting up above 11 percent either.

MR. MARTIN. I join Roger if Roger is still where Roger was after this discussion--no offense, Roger. To have 11 percent after the number of weeks we were at 9-1/4 to 9-1/2 percent and to have it hold any length of time at all I think would be an undue [increase].

CHAIRMAN VOLCKER. In the very short run if nothing else happens, I'm talking about misspecifying on the low side. I would interpret that in the very short run as misspecification on the high side.

MR. WALLICH. You said, Mr. Chairman, that in the case of a discount rate increase [there would be] no automatic change in borrowing.

VICE CHAIRMAN SOLOMON. Depending on where the fed funds rate is.

CHAIRMAN VOLCKER. Yes. Obviously, it's consistent with what was just said. If things were very tight, we would take that into account in changing the discount rate. We may want to change the discount rate but we might not want to do it without some offsetting adjustment, and we could consider that at the time if it appeared necessary. But I don't think there's any presumption that that's going to appear necessary. If it seemed to be a little too easy, in the wisdom of the Board we can raise the discount rate and that would be one factor bearing upon that decision. Let's come back to that funds rate question we left dangling--this 1/2 percentage point question. My own preference, knowing that this presumably isn't going

to be published for a month or more, is to raise the funds rate range a full percentage point to [7 to] 11 percent in the comfort that if we wanted to go higher, we would. But I'm not sure I want the larger headline implied unnecessarily, on the order of [another] 1/2 percentage point on the range [by going to 7-1/2 to 11-1/2 percent]. I might well want to go there, but I can go there without the extra headline of saying we had that [in the directive but didn't implement it.] It's like that very asymmetrical directive that we had worked out all right in December. Nothing happened; it never was triggered. But it became a fact of life that the directive was written that way. If, contrary to expectations, the economy began levelling off and we never got to the 11-1/2 percent, I'd just as soon not have it in the record.

MR. GUFFEY. I would agree that 7 to 11 percent makes more sense. It has never constrained us in the past.

MR. PARTEE. Are we back to talking about the funds rate? I thought we had decided that.

CHAIRMAN VOLCKER. No, we left [open] this 1/2 percentage point.

MR. BOEHNE. Things have a way of coming back to the front.

MR. MARTIN. And for those who feel there isn't room for action, there is some some distance between 11 percent and 7 percent.

CHAIRMAN VOLCKER. I have a preference. It's not an overwhelming one, but it is very relevant. My preference is purely how it plays in the press. If we exceed the 11 percent before the next meeting, it won't make any difference. We will have exceeded it by the time [the directive is published].

MS. TEETERS. You are proposing alternative B with the fed funds rate range of 7 to 11 percent?

CHAIRMAN VOLCKER. Yes, but I could probably live with M1 at 6 percent as a round number. But that's visual, too; it's not going to affect operations.

VICE CHAIRMAN SOLOMON. As I said earlier, I can live with either 7 to 11 percent or 7-1/2 to 11-1/2 percent. I don't feel that strongly about it. And I think you have a majority for the numbers on the three Ms as they are.

CHAIRMAN VOLCKER. I can live with any of them, but I am expressing this vague cosmetic preference.

VICE CHAIRMAN SOLOMON. And we have \$1 billion on borrowing?

MR. PARTEE. I'd be inclined to vote against this 7 to 11 percent. I just don't think there's enough room from where we are.

MR. GRAMLEY. Well, what you're trying to do is to hold the funds rate in the 10-1/4 to 10-3/4 percent range.

MR. PARTEE. Well, I understood all that conversation to be only the initial word.

CHAIRMAN VOLCKER. That is correct.

MR. PARTEE. And the question is: What do we do if the aggregates come in stronger? I think we have to have some room to move the rates and ought to have enough room to move the funds rate up above 11--in the 11-1 $\frac{1}{4}$ to 11-1 $\frac{1}{2}$ percent range.

MR. CORRIGAN. I don't care about the numbers, but I surely care about having a clear understanding--whether it's in the directive or not--of a willingness to move in that direction if we have to move.

VICE CHAIRMAN SOLOMON. But arguing the other side, if we have a range of 7 to 11 percent and the funds rate persistently for a week or longer goes above the 11 percent, then we'll have a consultation. So, I don't know that we're really blocking any action, Jerry, if we use 7 to 11 percent. Do you think there would be a significant public relations impact of having 11-1 $\frac{1}{2}$ percent as the upper bound when it comes out?

MR. PARTEE. It depends on what the rates are.

MR. RICE. Only if we don't have to go that far.

CHAIRMAN VOLCKER. Significant, I don't know.

MR. CORRIGAN. The only problem I see, Tony, with staying with the 7 to 11 percent is that if we run into the [situation] where we have to move and operate above 11 percent persistently, then we're left with the decision of having to change it.

MR. BOEHNE. Well, the last time the range was 6 to 10 percent and that didn't in any way interfere with going over the 10 percent.

MR. CORRIGAN. No, but we suspended it.

CHAIRMAN VOLCKER. In some sense, the only difference it makes is if we don't get up there.

MR. BOEHNE. Right.

CHAIRMAN VOLCKER. Because when we get up there I assume we're going to exceed it.

MS. TEEETERS. There has never been any press comment when we have exceeded the ceilings, at least as I [recall].

MR. ROBERTS. No, there was this last time.

MR. CORRIGAN. You may see some on Friday.

MR. BOEHNE. Yes.

VICE CHAIRMAN SOLOMON. Yes. They are going to see that we suspended the ceiling a week before. I had not noticed the market paying a lot of attention to these changes in the range.

CHAIRMAN VOLCKER. The only thing I am reacting to is that when they get the directive the press will say "Federal Reserve tightens because they raised the federal funds rate range. And this says they would tighten a little more." The only contingency I'm guarding against is that we never get there and some article says, "Oh, they were all prepared to go up; what they wanted to go to was 11-1/2 percent"--or whatever interpretation they put on it. They don't know whether that's--

MR. FORRESTAL. There is the risk of the press reacting to that 11-1/2 percent if we don't get to it. If we have 7 to 11 percent, we still have the freedom within two weeks to have a consultation.

CHAIRMAN VOLCKER. That's why my preference is not all that strong.

MR. FORRESTAL. To me, 7 to 11 percent really makes a lot of sense.

CHAIRMAN VOLCKER. It really depends I suppose in substance--forgetting about my point--on whether the Committee wants to have a consultation if the rate gets there. That's what it mechanically does.

MR. FORRESTAL. It's a long time between meetings.

MR. PARTEE. Well, this seems to me an entirely different matter than the December meeting vote, as I interpreted that. The market was surprised to read that we would have been prepared to tighten if business had been strong. And, of course, they were reading this at a time when business was strengthening. Therefore, it's not so unreasonable to assume that if we were prepared then, we must be prepared now. That's quite different from a technical top to a range before we have a consultation.

CHAIRMAN VOLCKER. Based upon all the experience, I don't interpret it as a barrier anyway. But it is a mechanical point that means we have a consultation. So, where do you want the consultation?

MR. GUFFEY. At 11 percent.

MS. TEETERS. At 11 percent.

MR. MARTIN. At 11 percent.

MR. PARTEE. At 11-1/2 percent.

MR. GRAMLEY. I'd rather have the consultation now. I don't think we will see anything in the next two weeks that is going to be convincing on where the economy is going to go. And two weeks more on the money numbers is not going to tell us anything about longer-term trends of money, which is what really matters. I think we're pussy-footing. I think we've been sitting here for some months now looking

at an economy that continues to exceed everybody's expectations. This is going to come back to haunt us if we don't decide to act. And we can't act by just confirming what happened in the market in the past couple of weeks.

MR. FORRESTAL. Do you interpret alternative B as just validating that?

MR. GRAMLEY. I do indeed. That's what we're saying.

MR. BOYKIN. That was the question I wanted to ask: If we take "B" as specified and say 7 to 11 percent, have we done anything?

MR. GRAMLEY. Not in my judgment.

MR. BOYKIN. That's the way I'm reading it.

SPEAKER(?). That's a matter of opinion.

MS. TEEETERS. We haven't done anything today, but the rates have gone up 3/4 of a point in the past two weeks.

MR. BOYKIN. Yes, I know, but--

CHAIRMAN VOLCKER. Look, I think we've done something today-- depending upon how one looks at it. You keep looking at the federal funds rate. We are now operating on a directive that says we are not that far over it; it says no free reserves and no net borrowed reserves, basically. And we just changed that. We now say we are operating on a net borrowed reserve directive. Whether the market really has anticipated that in its movement is the real question. But I don't think there's any question that we have tighter specifications than we are now operating under.

MR. MARTIN & MR. GUFFEY. That's right.

MR. GRAMLEY. I just don't translate net borrowed reserves as restraint on the economy. I think the more relevant consideration is what happens to interest rates.

CHAIRMAN VOLCKER. Well, you can argue that interest rates have already anticipated that.

MR. GRAMLEY. That's my view. What I want is a larger movement in interest rates.

MR. WALLICH. I agree. We need some move and the only visible thing is interest rates.

MR. MARTIN. But it has only been six weeks and rates have gone up 125 points. How fast do you want to move?

VICE CHAIRMAN SOLOMON. I'm assuming that the direction we're moving, with alternative B, is going to give us at least a 25 basis point further move, in addition to what the market has done in interest rates. And I think the Chairman is going to make darn sure that it comes out that way. In other words, there is going to be an

impression in the market that we have tightened if we come out with alternative B.

CHAIRMAN VOLCKER. By no means would I say that it's not a valid view that we should be tightening and that one might just want to get interest rates up--period. But I don't think we can be in a conceptual position of saying that every time the markets anticipate a move we have to ratchet it up one step further.

MR. GRAMLEY. I agree with that, certainly.

MR. MARTIN. I would agree with Tony, but I don't think it's 25 basis points; it's more likely 50. I think we're talking [about going from] 10-1/4 percent to 10-3/4 percent.

VICE CHAIRMAN SOLOMON. Okay, we can't pin it down that much. But I'm assuming that there will be some upward movement if we go in this direction. Are you saying that you don't believe that or are you saying that's too little?

MR. GRAMLEY. Well, if I interpret the Chairman's comments correctly, he doesn't want to see the fed funds rate get down toward 10 percent and he would be uncomfortable with it getting up to 11 percent. And he's thinking about playing the net borrowed reserve objective so that the federal funds rate stays in a 10-1/4 to 10-3/4 percent range. Now, that has a midpoint of 10-1/2 percent and we're not far from that now, which means that I don't see much change.

CHAIRMAN VOLCKER. If the federal funds rate stayed at 10-1/2 percent, just to put it there [unintelligible]. A perfectly good example: I don't think it would be long before the prime rate went up another half point.

MR. AXILROD. Mr. Chairman, the funds rate in this two-week period so far is averaging just over 10 percent. That's how it's going to come out tomorrow--say, 10-1/8 percent or somewhere around there. We only had a 10-1/2 percent rate in passing for a couple of days. I think if borrowing of \$1 billion with normal excess reserves gets you a funds rate of 10-1/2 percent, that will be viewed as a significant tightening because it's sustained.

CHAIRMAN VOLCKER. I think it will be too.

MR. MARTIN. Of course it will.

MR. GUFFEY. Just to reinforce that, last week the rate was just about at 10 percent; it was 10.04 percent. And it has gone up this week if it comes out to 10-1/8 percent. Now you're talking about 10-1/2 percent. That's where you're going to get some--

CHAIRMAN VOLCKER. Yes, I think Steve is absolutely right about this thing.

MR. GRAMLEY. It's just that I'm not trying to hide the move, you see. I think the economy needs to be told that monetary policy has tightened because the economy is growing much too fast for comfort. I think we need to do something that's rather obvious and decisive.

MR. GUFFEY. As recently as two weeks ago it was at 9-3/4 percent.

CHAIRMAN VOLCKER. I think maybe you have the wrong instrument in mind.

MR. GRAMLEY. Oh no, I have both instruments in my mind. I just haven't got the right forum to talk [about the discount rate].

MR. MARTIN. It's way too fast for one quarter.

VICE CHAIRMAN SOLOMON. Well, why don't we presidents walk out of the room while you fellows--

MR. PARTEE. If we were to have a discussion, I don't think you'd get an immediate decision.

MR. GRAMLEY. Well, we used to time these matters in three or four weeks.

VICE CHAIRMAN SOLOMON. We're all going to be at the Wye Plantation.

CHAIRMAN VOLCKER. For these purposes, you are discussing the wrong instrument, I think. I would reinforce what Steve said; I don't have much question about it.

MR. CORRIGAN. I agree with Governor Gramley. I still think that when the decision of last week to suspend the federal funds rate range is publicized this Friday, that in itself is going to be seen by the market as--

VICE CHAIRMAN SOLOMON. As confirmation of what they suspect.

MR. CORRIGAN. --symptomatic of the kind of thing they're looking for.

MR. PARTEE. Why don't we leave it suspended?

MR. BLACK. That makes sense to me, but I didn't want to say it again.

MS. TEETERS. Alternatively, we can take out the specifications for M1, M2, and M3.

MS. HORN. Maybe.

MR. BLACK. No, that would be very bad!

CHAIRMAN VOLCKER. Look, as I think you know, there is not much in this difference between 7 to 11 and 7-1/2 to 11-1/2 percent. Which way do you want to make it?

MR. MARTIN. 7 to 11.

MR. GUFFEY. 7 to 11.

MR. BOEHNE. 7 to 11.

MR. PARTEE. 7-1/2 to 11-1/2.

CHAIRMAN VOLCKER. Just Committee members: How many want it 7 to 11 percent?

MR. BERNARD. Five.

MR. GRAMLEY. I currently get seven.

CHAIRMAN VOLCKER. Hold up your hands again.

VICE CHAIRMAN SOLOMON. I'm going to vote for both sides.

CHAIRMAN VOLCKER. How many want it 7-1/2 to 11-1/2 percent? It can't be much closer. Can we live with 7-1/2 to 11-1/2? Let's hope we can. Now, we have this other number to worry about. I think the only one that's relevant to worry about there is M1. How many can live with or want it just the way it is: 6-1/2, 8, and 8-1/2 percent?

MR. BERNARD. Five.

CHAIRMAN VOLCKER. You're only going to get two choices here. The other side is: How many want 6, 8, and 8-1/2 percent. I came out that it goes the other way--6-1/2 percent.

MR. PARTEE. Let's try again.

CHAIRMAN VOLCKER. I think the 6-1/2, 8, and 8-1/2 percent had the majority. It's a perfect balance. Those who wanted the higher federal funds rate won, and those who wanted the higher M1 won. How can we get a better consensus than that? Now we can return to the language of the directive.

VICE CHAIRMAN SOLOMON. The trouble with this whole process is that there's no quid-pro-quo bargain. I would trade my vote on some of those last votes for the wording of the directive you're saving. The way you're slicing us off, it's a salami tactic.

MR. PARTEE. Paul's saying no salami goes with it!

CHAIRMAN VOLCKER. I don't know how to word this directive with reserve pressures [unintelligible]. I'm not opposed to it in principle; after listening to this other discussion, I just don't know how to do it.

MR. BOEHNE. I'd like to suggest that we use Variant II on page 4.

MR. PARTEE. Variant II on page 4 of the draft directive?

MR. BOEHNE. Yes.

MR. GUFFEY. Well, that's misleading to begin with.

CHAIRMAN VOLCKER. I don't know what it means. I literally do not know what that means. If I had to explain that in public, I would be absolutely lost.

MR. GUFFEY. It's misleading.

CHAIRMAN VOLCKER. My only problem with it is that I just don't understand it.

MR. MORRIS. We've been using this language for quite some time.

CHAIRMAN VOLCKER. Yes, but I didn't have this problem when excess reserves were going up and borrowings were going up at the same time. That's why I say it's just a little technical problem.

VICE CHAIRMAN SOLOMON. But if you thought of it that we are under net borrowed reserves--.

CHAIRMAN VOLCKER. Well, we're not talking about that. We're saying there's a significant increase in net borrowed reserves.

MR. PARTEE. It goes from 0 to \$400 million, so we have to say that we're going to tighten.

VICE CHAIRMAN SOLOMON. We'd have to say Variant I, then. Would you have the same problem with not knowing what Variant I means?

CHAIRMAN VOLCKER. Yes.

VICE CHAIRMAN SOLOMON. "To increase."

MR. MARTIN. "Increase somewhat."

CHAIRMAN VOLCKER. Well, I think that's a little better, but I obviously interpreted it in terms of net borrowed reserves.

MR. WALLICH. I think there's some merit in referring to the increase in reserve positions that has recently emerged. But it doesn't swear that we'd maintain that. I think it should be increased above that recently emerged level.

CHAIRMAN VOLCKER. Well, what has emerged recently in the net borrowed reserve sense is no different than what it was beforehand.

MS. TEETERS. "Emerged" is the problem.

MR. PARTEE. That's the problem.

CHAIRMAN VOLCKER. That is the problem, I think.

MR. MARTIN. Because it moved from 0.

MS. TEETERS. Well, no. Actually, it has been fluctuating between plus and minus \$200 million; it averages out to 0.

CHAIRMAN VOLCKER. That's because we don't hit the--

MS. TEETERS. I know.

CHAIRMAN VOLCKER. In a borrowing sense it's going up, if it is interpreted as borrowing.

MS. TEETERS. In a net borrowed reserve sense it is going up.

VICE CHAIRMAN SOLOMON. Since you can live with Variant I, then the real issue, it seems to me is: Do we stay with that kind of wording in the directive or do we go to the new wording? What I'm concerned about is that this new wording leads us in a direction of more automaticity in the monetary aggregates.

MR. MARTIN. I would share that concern. I think we need to move up front the language with regard to the economy. That's what we've been discussing here--the economy.

MR. PARTEE. Well, we certainly ought not to keep M1 at the end of the list, as M2, M3, and then M1. I would buy your proposal that we can make it M1, M2, and M3 as just a more logical way to express it.

CHAIRMAN VOLCKER. This is to me almost a purely cosmetic point, but I think we're walking into difficulties. The whole attack on the Federal Reserve is that we're trying to manage a good growth situation and that leaves us extremely exposed.

MR. PARTEE. Because we've tightened. We say here "to retain."

CHAIRMAN VOLCKER. We say we're tightening because the economy is growing too fast. I'm not talking substance now; I'm saying that we are walking into--.

MR. CORRIGAN. I'm very sensitive, Tony, to your concerns about--

CHAIRMAN VOLCKER. Well, he may have this great concern about the market; I have a very considerable concern that we are walking directly into the trap of our most vociferous critics.

VICE CHAIRMAN SOLOMON. But there's also going to be a heck of a lot of concern if people think that we are going back to the kind of volatility we had in interest rates, which I think is damaging both substantively and perception-wise.

MR. MARTIN. And may have interest rate effects itself.

MR. ROBERTS. I think it's a very great leap to say we're going back to volatility. My impression of the market is that it would receive this favorably, Tony. In fact, the market has already discounted an increased emphasis on M1, which it monitors very, very closely, as you know. I think all these arcane issues of the placement of one thing somewhere else are viewed by the market as rather silly.

VICE CHAIRMAN SOLOMON. If we follow the Chairman's suggestion on the directive as shown on the paper he passed out, we would be encouraging an increased emphasis on weekly volatility. Moreover, I think the impression that we are going to be more influenced than we have been by money growth is going to lead to expectations that maybe by the end of the year we won't have seen just

a point or point and a half move, but something significantly larger than that.

MR. ROBERTS. Of course, the real question is: Suppose we have 10 percent money growth--pick your own aggregate--for a while. What would we do except to let interest rates go up if the market was demanding that level of credit? Since that's all we can do, why is that such a concern?

VICE CHAIRMAN SOLOMON. I feel that we did a lot of damage to the economy by the enormous swings [in interest rates] from 8 percent to 20 percent and then down again. I think if we had stayed longer at tighter levels, we wouldn't have had to go up to 20 percent. Now, I understand the rationale, but I think the notion that we don't influence interest rates--that all we are doing is targeting money growth--has gotten very thin in the country. We moved away from that and we used the excuse that the velocity of circulation was no longer in a typical traditional relationship. What would you say? You have to say that we're back again in a period where the velocity of circulation is a little more dependable. And this all fits in with the feeling that we would get in the market that we're returning to the pre-summer of 1982 [approach to policy].

MR. ROBERTS. Well, in fact our language has been suggesting just that: that we have been assuming we would get a more normal pattern of velocity. It does appear to be emerging. We are charged legislatively with managing the aggregates. This takes us away from this accusation that we're trying to downplay the growth in the real economy. I think this is an excellent statement in the right direction.

MR. BOEHNE. I think Tony is right that it is wearing thin in the country. I don't think the rationale that interest rates are going up because of the money supply cuts much ice anymore. It served a useful purpose in the late '70s and early '80s, but I don't think it will fly to try to go back to using that as a rationale.

MR. ROBERTS. We don't in fact use it as a rationale. We say that is our policy--that what we control is the money supply and if demand rises, the effect of that is that interest rates move--instead of saying that we set an interest rate independent of its response on the aggregates. [The latter] doesn't seem to be very rational in a period when we all agree that the inflationary danger is rising.

MS. TEETERS. We were legislatively instructed not only to watch the aggregates but interest rates, real growth, inflation, and unemployment. And the sentiment on the Hill is toward managing the real economy, not the monetary aggregates, at the present time. I agree with Tony. If we go back to emphasis on M1 and put it up front and at the beginning of the road, we could create very unstable conditions in the economy. And interest rates will be transferred into the economy.

MR. GRAMLEY. I don't think anybody's--

CHAIRMAN VOLCKER. I think our theology is in full swing on both sides.

MR. PARTEE. Everybody so far has taken a predictable point of view--100 percent predictable. I was wondering whether we could fuzz this up a little.

CHAIRMAN VOLCKER. Let's fuzz.

MR. PARTEE. In the first place, we could make it "broadly consistent" as a way to fuzz the annual rates of growth in M1, M2, and M3. That's what has to be done--make it broadly consistent--because we don't know what those multiplier changes are or what excess reserves are going to be and all that.

CHAIRMAN VOLCKER. We could take the radical step of putting a range around all the aggregates.

MR. PARTEE. I was thinking we could say annual rates of "around." That would be one other way.

MR. MARTIN. We could actually use ranges.

MR. PARTEE. The trouble with that is that it makes the edge points of the ranges pretty sensitive.

CHAIRMAN VOLCKER. You know, we're really exaggerating the difference between these two languages. The first says "maintain/increase somewhat/ decrease" and that gets into this problem of what it is now. It is possible to say in variant I "anticipating that this approach will be consistent." This says "consistent".

MR. BALLES. Mr. Chairman, apart from the possibility that you may for some reason I didn't understand release this prior to the normal time, I don't understand what all the fuss is about. By the time the directive comes out at the normal time it is all history. The next meeting has already been held. The May meeting would have been over by a week. Am I missing something?

CHAIRMAN VOLCKER. The argument is what people will read into that for the next meeting. But there must be some language that doesn't raise the sharpness of the concerns on both sides.

MR. WALLICH. Well, putting a range around these short-term money aggregates I think would make sense. I'm not very happy with going back to M1 in first place.

CHAIRMAN VOLCKER. I have no feeling about that one way or the other.

MR. PARTEE. I don't know, Henry. I think the range makes it somewhat more difficult.

MR. WALLICH. Because we might miss it?

MR. PARTEE. Yes. There's a pretty fair chance that M1 is going to be at 10 percent or something like that. And if we set a range of 5 to 7 percent, 10 percent is way above the range.

MS. TEETERS. It's going to be above 6-1/2 too, if it's 10.

MR. PARTEE. I know, but the range makes it--

CHAIRMAN VOLCKER. Does it help anybody to say "In the short run the Committee seeks a degree of pressure on bank reserve positions consistent with...?"

MR. GRAMLEY. I was just hunting for something like that too: "The Committee seeks to maintain pressures on reserve positions consistent with..."

MR. BOEHNE. Well, I think that has a lot of merit toward fuzziness!

MR. PARTEE. It even has the great word "maintain" in it.

MR. WALLICH. "Maintain" suggests that there was no change.

VICE CHAIRMAN SOLOMON. [Unintelligible] the plural: "maintains."

MR. PARTEE. I really think "seeks a degree of" is better than "maintain."

CHAIRMAN VOLCKER. "Seeks a degree of pressure"?

MR. PARTEE. Yes, because we have to test, to probe.

MR. BOEHNE. And then if we put in "broadly consistent"--

MR. PARTEE. And "over time."

MR. GUFFEY. "As may be modified."

CHAIRMAN VOLCKER. "Over time" sounds a little funny when we talk about--

SPEAKER(?). "Broadly consistent."

CHAIRMAN VOLCKER. "Broadly consistent" is all right but that makes it [a change]. Last month we were consistent. This month we will be broadly consistent.

MR. PARTEE. "At annual rates of around..."

MR. GRAMLEY. Or we could go even so far as to say "during the period from March to June." We don't hit it from June to July.

CHAIRMAN VOLCKER. We have to leave out the "broadly" and put in the "around 6-1/2, 8, and 8-1/2 percent." Is that what we have? In the next sentence, though, do we want to clarify precisely what we're doing initially on borrowings?

MR. GUFFEY. The sentence in parenthesis?

CHAIRMAN VOLCKER. Yes. I think it reads all right without that.

MR. PARTEE. I have trouble understanding just what that means when I read it.

VICE CHAIRMAN SOLOMON. Well, I don't have any trouble understanding it in view of our discussion. I think it is going to look a little strange because, after all, it's not unusual for there to be fluctuations of borrowing in one direction somewhat unexpectedly. And yet I don't think we have noted that before in directives, have we?

CHAIRMAN VOLCKER. Well, I think we have used reserve pressure or reserve restraint as a synonym for borrowing. This just says borrowings because of the confusion about what the heck we mean. It raises questions, I suppose, but it depends upon how fully we want to describe what we decided. It reads perfectly well without it.

MR. CORRIGAN. I'd just as soon take it out.

MR. BOEHNE. So would I.

MR. CORRIGAN. It gives us more flexibility without it.

CHAIRMAN VOLCKER. We can leave it out and point out all these problems in the text [of the policy record]. That's one way of handling it.

MR. PARTEE. Yes. It's just that when we say we're seeking the degree that allows for changing that pressure--

CHAIRMAN VOLCKER. Yes, but it's kind of funny when you look at it. Maybe it will have to be changed. We say "The Committee seeks a degree of pressure." That's a perfectly general statement. Then it says "greater reserve restraint." Well, that's implied already. There is something logically lacking when you leave out the second sentence. I have no great desire to leave the second sentence in, but it raises a question about the next sentence.

MR. CORRIGAN. Could we change the parenthetical statement to read "should take account of" rather than "be consistent with"? It says "initially the reserve path and the associated ranges should be consistent with." Instead of that say "would take account of."

CHAIRMAN VOLCKER. I don't know what that means.

MR. PARTEE. I don't know either.

MR. CORRIGAN. Well, I'm concerned with the way the sentence reads now. It's subject to the interpretation, indeed the meaning, that all we are doing and are prepared to do is ratify what has already happened. And I understand this discussion to say something more than that.

CHAIRMAN VOLCKER. What it's saying is that all these people have raised questions. I think what we understand it to mean is quite clear: a billion dollar borrowing assumption.

MR. CORRIGAN. I think it's a little more than that. It's a billion dollar borrowing assumption in which we go to \$400 to \$500 million of net borrowed reserves.

CHAIRMAN VOLCKER. That's right.

VICE CHAIRMAN SOLOMON. I think there is going to be a variety of reactions in the market as to what that sentence means--

CHAIRMAN VOLCKER. I think that is true too.

VICE CHAIRMAN SOLOMON. --because they haven't seen it before. Therefore, they are going to have a field day with it.

CHAIRMAN VOLCKER. I just have a small logical point. Where are we starting from when we say "greater restraint or lesser restraint"?

VICE CHAIRMAN SOLOMON. We know what we're starting from; we haven't told them before anything about whether the initial borrowing assumption is--

CHAIRMAN VOLCKER. Well, what is the meaning of the next sentence: Greater reserve restraint than the degree of pressure on bank reserve positions consistent with? We're not saying that.

MR. BOEHNE. Well, you could leave out the word "reserve." We could just say "greater restraint would be acceptable in the event" and so on.

CHAIRMAN VOLCKER. I think we are better off to make the sentences hang together. Let's go back to Lyle's language: In the short run the Committee seeks to maintain pressure on bank reserves consistent..."

MR. GRAMLEY. But use "anticipate will be consistent."

CHAIRMAN VOLCKER. That's right--"anticipate will be consistent with."

MR. GUFFEY. That's just an alteration of variant I.

VICE CHAIRMAN SOLOMON. So that's what we're ending up with. Would you put M1 last in the order? Do you want M2, M3, and M1?

MR. WALLICH. I would prefer that, although it's very small symbolism. To put M1 first has some meaning.

VICE CHAIRMAN SOLOMON. Every little bit of symbolism counts.

CHAIRMAN VOLCKER. Should we start with M3 and say M3, M2, and M1? Is that what you're saying?

SEVERAL. No. M2, M3, and M1.

CHAIRMAN VOLCKER. That just looks so peculiar. We could leave it as separate sentences, I guess.

VICE CHAIRMAN SOLOMON. That's the way we've been doing it.

MR. PARTEE. Once we had it in there like that.

CHAIRMAN VOLCKER. I think we ought to leave it this way or say M3, M2, and M1.

MS. TEETERS. If you do it backwards--

CHAIRMAN VOLCKER. Why don't we leave it this way.

MR. MARTIN. You could say M1 from a range of 1 to N!

MR. GRAMLEY. M1 from 1 to [unintelligible].

SPEAKER(?). Just say consistent with the various Ms.

VICE CHAIRMAN SOLOMON. Let me ask this: Are you saying that if you were asked by a Congressional committee whether we are giving equal weight to M1 these days with M2 and M3, you would say yes?

CHAIRMAN VOLCKER. I think I would say at this particular meeting "Broadly, yes."

MR. MARTIN. That's the fact of the matter. That's the way we've been discussing it. We have been talking about M1 all the time; we haven't been talking about M3 much.

CHAIRMAN VOLCKER. That's because the market gives 90 percent of its attention to M1; and I don't think it is going to change much.

MS. TEETERS. Aren't you just encouraging that after-hours trading?

CHAIRMAN VOLCKER. I don't think it makes the slightest bit of difference.

VICE CHAIRMAN SOLOMON. They are now trading U.S. government securities in London on an increasingly large scale, so in New York offices are now opening at 4:00 in the morning, as soon as the London market opens. There is around-the-world trading in government securities.

MR. ROBERTS. They can take the time they gain on Fridays!

CHAIRMAN VOLCKER. I now have "In the short run the Committee seeks to maintain pressures on bank reserve positions judged to be consistent with growth in M1, M2, and M3 at annual rates around 6-1/2, 8, and 8-1/2 percent respectively during the period from March to June." Skip the next sentence. Now we go to the next sentence. There is a slight bias in this thing.

MR. PARTEE. You could make it a little more by making the second one "might" instead of "would."

MS. TEETERS. If you want to make it absolutely symmetrical take out the word "significant."

MR. CORRIGAN. I don't want it to be symmetrical.

MS. TEEETERS. It's already symmetrical the way it is.

CHAIRMAN VOLCKER. Put a comma after "business expansion" and take out the big substantive change.

MR. PARTEE. You really don't want this last sentence in here, do you?

CHAIRMAN VOLCKER. I think we can take out the last sentence. We have a two sentence directive. Put in the word "might."

MR. MARTIN. Isn't the rate of credit growth the end of the parade here? We've been bringing it up in our consideration a good deal more, it seems to me, at this meeting.

CHAIRMAN VOLCKER. Well, I guess the question is whether to put a separate sentence in about it. I don't know whether that's good or bad. I don't know exactly what the sentence would be but I thought it might depend on whether we put another sentence in up above.

MR. MARTIN. In our discussions we certainly have given it a good deal of consideration.

VICE CHAIRMAN SOLOMON. If you don't think this gives it too much importance, we could simply say "more substantial growth in the monetary aggregates and the rate of credit growth" in that second sentence.

MR. CORRIGAN. If there is a difference, any more substantial credit growth from where we are now is different from even--

CHAIRMAN VOLCKER. We get in trouble if we put it in the first half of the sentence. It's logical in the first half of the sentence, but you have to put it in the second half too, I guess.

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. Monetary and credit aggregates.

MR. WALLICH. Shouldn't it be "or credit aggregates"? Otherwise you're diluting it; everything has to go up if you say "and."

MR. PARTEE. I think it is fairly highlighted where it is. We could use the technical term for it, "the rate of growth of domestic nonfinancial debt" to show that we're really looking at that.

CHAIRMAN VOLCKER. Somehow that makes it sound so technical. I think it would be the first time we've had that in the directive; it has some significance just putting it in.

VICE CHAIRMAN SOLOMON. The market knows that we don't get data on the technical classification--total domestic nonfinancial debt--until after a considerable lag. We get some indications of various types of credit growth with less of a lag and, therefore, by leaving the rate of credit growth we are making it a little more

general and a little more operative. Otherwise, they know it's not that operative since we don't get that particular data.

CHAIRMAN VOLCKER. I think it's better that way. If we want to highlight it more we could say "the rate of credit growth, which has been excessive recently." Are we ready to vote? We have a sentence here with the federal funds rate range of 7-1/2 to 11-1/2 percent, the standard sentence for that.

MR. BERNARD.

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

CHAIRMAN VOLCKER. Okay.

VICE CHAIRMAN SOLOMON. You are going to let Lyle [unintelligible] your explanation and you are going to be set free.

MR. BALLES. May I ask one question just so we don't misunderstand the new ground rules here on access to this material? Do I understand now that we are not to inform even our economic advisors of the numbers in the directive? This is for the Presidents only?

CHAIRMAN VOLCKER. I think you can inform them and follow the rule. The numbers in the directive are all right, I think.

VICE CHAIRMAN SOLOMON. The recommendations of our Committee said specifically a "normal" type of meeting. We didn't get into any recommendations on what is executive only [material]. The Chairman is saying handle it in the usual way.

SPEAKER(?). It's all right to tell them? Your memo says only the Presidents receive the directive.

MR. PARTEE. The directive. That's true.

SPEAKER(?). The written directive.

CHAIRMAN VOLCKER. Whatever the rule on that says.

MR. AXILROD. Mr. Chairman, the rule says that the directive should only go to the President, so the other people who would have been here won't know the specifications. Unless they see the directive, they will not know the specifications.

SPEAKER(?). Unless the President tells them.

MR. AXILROD. What I assume you're saying is to act--

MR. PARTEE. Do you want to do that?

CHAIRMAN VOLCKER. I'm not sure I would say that they have to have [this information].

SPEAKER(?). You can reproduce the Bluebook.

END OF MEETING