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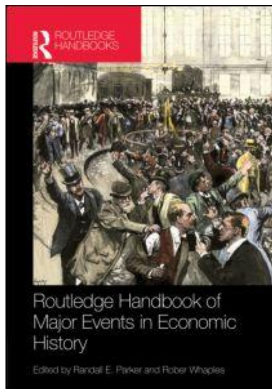

Routledge Handbook of Major Events in Economic History

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Publication details
https://www.routledgehandbooks.com/doi/10.4324/9780203067871.ch24
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Published online on: 28 Jan 2013

How to cite :- Allan H. Meltzer. 28 Jan 2013, *Disinflation, 1979–1982 from:* Routledge Handbook of Major Events in Economic History Routledge
Accessed on: 02 Dec 2023
https://www.routledgehandbooks.com/doi/10.4324/9780203067871.ch24

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DISINFLATION, 1979–1982

Allan H. Meltzer[1]

Disinflation from 1979 to 1982 is a unique event in U.S. economic history. All previous disinflations – reductions in the inflation rate – followed wartime inflations. The disinflation that began in 1979 occurred almost a decade after the Vietnam War ended, and it was unrelated to the end of that war. Also, the disinflation came after several earlier attempts failed because the Federal Reserve, federal government and many in the public considered the cost of disinflation too high. By 1979, the public, and their representatives, were willing to accept temporarily higher unemployment to reduce inflation.

Start of the disinflation

Disinflation started in October 1979, a few months after President Carter appointed Paul Volcker Chairman of the Board of Governors of the Federal Reserve System. At the time, Volcker served as President of the Federal Reserve Bank of New York, but he had served earlier as Undersecretary for Monetary Affairs in the Nixon Treasury Department and, earlier, as a Treasury official in the Kennedy administration. He was critical of the Federal Reserve's policy and had dissented in the spring of 1979. The New York president is ex officio vice-chair of the Federal Open Market Committee (FOMC) that decides on monetary policy. Dissent by the vice-chair is rare, possibly unique on these occasions.

Paul Volcker dissented because he was opposed to the rising rate of inflation and the costs inflation imposed on the economy. In August 1979, when he assumed leadership of the Federal Reserve, the reported annualized inflation rate reached 11 percent, the highest peacetime rate to that time. His appointment not only put a committed anti-inflationist in charge of monetary policy but gave responsibility to a trained economist who accepted that inflation resulted from money growth that exceeded growth of real output. He described his view as "practical monetarism."

The appointment was a major change for President Carter. His administration had never shown much commitment to price stability or low inflation. Its prior anti-inflation efforts consisted mainly of rhetoric urging restraint by business and labor unions supported by guidelines for less inflationary private actions. These actions had little, if any, effect, but guidelines and administrative action were the main recommendations he received from his advisers.

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When the president interviewed Paul Volcker, Volcker told him that he intended to act more determinedly against inflation than his predecessors had done. President Carter assured him that he wanted less inflation. Neither the president nor Volcker thought at the time that the Federal Reserve would raise the federal funds rate to 20 percent or that the unemployment rate would reach 10.8 percent.

President Carter's acceptance of disinflation led by the Federal Reserve probably had two principal origins. First, polling data at the time showed the public believed inflation was the principal domestic problem. That had not happened during the long rise in the inflation rate. President Carter planned to run for reelection, so the public's concern became his. Second, he lost confidence in the advice he received about inflation. He replaced Secretary of the Treasury Blumenthal, his chief economic spokesman, with Federal Reserve Chairman Miller. The exchange rate crisis in October 1978 may have convinced him that rising inflation and a depreciating exchange rate responded to excessive monetary growth. The first U.S. response to exchange rate depreciation of 14 percent against the German mark and 23 percent against the Japanese yen between May and October 1978 failed. In late October, the administration announced policy changes to strengthen the dollar. The new policy called for fiscal changes and voluntary wage-price guidelines.

The market's response came swiftly. Following the policy announcement, the dollar quickly fell 1.7 percent against the mark and the yen and about 4 percent in the week against an index of developed country exchange rates. The United States responded by raising the Federal Reserve discount rate by 1 percentage point and by offering bonds denominated in foreign currencies. The Federal Reserve also raised reserve requirements for large time deposits.

The market's reaction to these monetary changes reversed the decline in the dollar exchange rate. The dollar index rose 5.3 percent and continued to rise. Tighter monetary policy convinced market participants that the United States intended to strengthen the dollar. President Carter learned that monetary policy achieved what earlier actions did not.

The president's Domestic Policy Adviser, Stuart Eizenstat, described Volcker's appointment this way: "With inflation raging and the president's popularity plunging the president believed the economic situation was dire, and he wanted someone who would apply tough medicine" (Meltzer 2009: 1009).

First steps

Soon after taking office, the Volcker FOMC raised the discount rate. The market did not consider the action a harbinger of sustained anti-inflation policy. Volcker understood that more decisive, sustained action was required, but he was skeptical that the FOMC would vote to raise interest rates high enough, fast enough to succeed. Further, he did not know how high to raise rates, so he decided to let the market decide. This meant controlling bank reserve growth and had the benefit that he could shift responsibility for higher interest rates to the market and away from the Federal Reserve.

On a trip to Belgrade for the International Monetary Fund meeting, he explained his plan to control reserves and reduce money growth to Treasury Secretary Miller and Council of Economic Advisors Chair Schultze. En route the plane stopped in Germany where Chancellor Schmidt strongly endorsed the plan. After an early return from Belgrade, Volcker called a special meeting of the FOMC for Saturday, October 6. Volcker proposed reserve targeting as a temporary change to show that the FOMC would make a determined effort to reduce inflation. He insisted on adopting a program at that meeting that would alter expectations. He did not insist on reserve targets.

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The October 6 program had three parts. First, the FOMC adopted reserve targeting to reduce money growth (M1) to 5 percent in fourth quarter 1979. The actual vote was 8 to 3, but the 3 who initially opposed changed their votes so the vote could be recorded as unanimous. The committee voted to let the federal funds rise from the prevailing 11.5 percent to as high as 15.5 percent. Second, the Board approved a 12 percent discount rate for New York, a one percentage point increase. All other Reserve banks followed. Third, the Board raised marginal reserve requirements by 8 percentage points for banks with $100 million of managed liabilities. The Board avoided Congressional criticism by limiting the increase to large banks.

The Board hoped that these actions would generate a positive market response. That didn't happen. The market had difficulty in interpreting reserve targeting, so long-term interest rates rose. The Federal Reserve had announced its commitment to anti-inflation action several times before, but it had not followed through when unemployment rose. Markets were not convinced that this time would be different, that the Federal Reserve would maintain the program once recession started.

The commitment to reserve targeting was never absolute. Volcker did not propose to leave the federal funds rate unconstrained. At the October 6, 1979 meeting, he told the members that "in practice the kind of range we have is one-eighth of a point roughly" (Meltzer 2009: 1028, fn. 24). The range would increase. Volcker did not say what the limits would be. He left that to his judgment. In subsequent months, the rate reached 20 percent, a record. Volcker and most others did not anticipate that response. To his credit and the FOMC's determination, they did not prevent the rise.

Markets reacted negatively to the administration's budget proposals in January. Influential members of president's party in Congress criticized monetary policy because it raised interest rates and unemployment. Many had long favored controls that restricted credit. They urged President Carter to change course. The president brought together a group of advisers to discuss credit controls and reductions in government spending. Paul Volcker was a member of the group, despite the Federal Reserve's much discussed independence. The group agreed on some spending reductions and requested the Federal Reserve to impose credit controls. The president submitted some spending reductions to Congress and asked the Federal Reserve to impose controls on consumer and business credit. He left the decision about the types of controls to the Federal Reserve. Since Volcker was part of the advisory group, he supported the recommendation. Only Governor Henry Wallich voted against it.

The Board adopted very modest controls. It exempted credit cards and most consumer borrowing. The public wanted lower inflation, so they acted eagerly to reduce new credit extension. They cut up and mailed credit cards to the Federal Reserve and the Treasury, and they reduced spending and borrowing drastically. Policymakers were surprised, then alarmed, by the response. Controls began in March 1980. Real GDP fell by an annualized rate of almost 8 percentage points in the second quarter. Early in the summer, the Federal Reserve ended controls and began an expansive policy to limit or reverse the decline.

The policy reversal lowered interest rates and increased money growth. Markets reacted by increasing expected inflation. They believed the Federal Reserve had ended its anti-inflation policy to prevent the rise in the unemployment rate. They had seen this response several times; they expected it; and now it was confirmed.

Anti-inflation policy restored

In the fall of 1980, before the November election, the FOMC raised interest rates and renewed its decision to reduce inflation. This time would be different. Paul Volcker was determined

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to reduce inflation. Ronald Reagan ran for office on a program that promised lower inflation, lower tax rates, renewed economic growth, and increased defense spending. Despite warnings from his aides that high market interest rates would hurt his prospects, President Carter rejected calls for stimulus and did not criticize the Federal Reserve during the 1980 campaign.

Reagan won a decisive election victory including a Republican majority in the Senate. Soon after inauguration, he announced the Economic Recovery Plan. It called for tax rate reduction, spending reduction, and slower money growth.[2]

President Reagan stood firmly behind the anti-inflation policy. His administration was divided. Some "supply-siders" at the Treasury wanted increased money growth to assure that reduced tax rates increased spending for consumption and investment. "Monetarists" wanted slower money growth. The internal argument raged, but President Reagan did not participate. He told the Federal Reserve to continue its policy. For his part, Paul Volcker chose to ignore the divided advice from different parts of the new administration. He proceeded as he wished to proceed.

One impediment to improved monetary control came just at the time the Federal Reserve decided to focus on control of money. After lengthy negotiation, Congress repealed interest rate regulations. Time deposits at commercial banks and thrift associations had been subject to controls whenever market interest rates rose above posted ceiling rates. Removing controls with market interest rates at historic highs caused changes in the public's allocation of deposits that added variability to the portfolio response to high inflation. Money growth rates were very variable and difficult to interpret.

Three Federal Reserve decisions added to the problem of interpreting monetary changes. First, a great deal of attention focused on reported weekly growth rates that are subject to large random variation because of weather, changes in Treasury balances and many other sources including Federal Reserve actions. Second, the Federal Reserve did not have a useful model for member bank borrowing. The Board was reluctant to raise the discount rate it charged for bank borrowing as the federal funds rate rose. At times the banks could borrow at a rate 3 or 4 percentage points below the funds rate. This subsidy increased borrowed reserves and money growth, reducing control. Third, the Federal Reserve adopted lagged reserve accounting in the late 1960s. Required reserves depended on deposits two weeks earlier. If a bank's reserves were insufficient to meet requirements, the bank borrowed from its Reserve bank.

Despite many proposals from its staff and outsiders, the Board did not eliminate lagged reserve accounting until after its experiment with reserve control ended and it no longer mattered. The Board continued the, at times, large subsidy to borrowing. The result: reserve control was erratic. Also, some careful empirical studies suggest that the account manager retreated to interest rate control at times (Schreft 1980).

Volcker made an important change that was critical for success of his policy. He abandoned forecasts of inflation based on the Phillips curve. He insisted that by reducing inflation he would reduce the unemployment rates. The Phillips curve assumed there was a tradeoff; higher inflation reduced the unemployment rate. Volcker pointed out publicly and internally that in the 1970s inflation and unemployment increased together. His policy would lower both, he said.

Early in his chairmanship, he was asked on a popular television show, *Face the Nation*, what he would do when unemployment rose. He replied that the question assumed there was a tradeoff between inflation and unemployment. He believed, to the contrary, that he would lower both. He maintained this position throughout his chairmanship. His successor continued his policy, but the Phillips curve returned as a policy guide after Alan Greenspan retired in 2006.

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By abandoning Phillips curve forecasts, Chairman Volcker could make a significant change in Federal Reserve policy. He directed efforts mainly toward reducing inflation. Once credit controls ended, the main policy objective shifted from preventing an increase in unemployment to achieving lower inflation. By insisting that the Federal Reserve controlled reserves, not interest rates, market rates could rise to reflect public concerns about inflation.

Leading Keynesian economists criticized the disinflation policy. James Tobin (1983: 297) said, "I would expect the process to be lengthy and costly, characterized by recession, stunted recoveries, and high and rising unemployment." He was right about cost and rising unemployment, but his estimate that disinflation would take ten years was much too pessimistic and greatly overestimated the cost. Only two years elapsed from the time the Federal Reserve renewed its disinflation policy in October 1980 to the end of the experiment in October 1982. And most of the disinflation ended a few months earlier, but the unemployment rate reached 10.8 percent at its peak in November 1982.

Public support for disinflation helped considerably to make high interest and rising unemployment politically acceptable. The public voted for Ronald Reagan, committed to reducing inflation, and leading members of Congress, including chairs of the House and Senate Banking Committees supported the policy. Criticism rose as the 1982 Congressional election approached. By that time, most of the work had been done. Many observers claim that the high rates paid on time and saving deposits and bank certificates of deposit contributed to some public willingness to support disinflation.

Sustaining anti-inflation policy

Federal Reserve commitment to reduce inflation had happened before. FOMC members spoke about the importance of controlling inflation several times. In previous episodes, their commitment vanished when unemployment rates rose. A comparable change occurred in 1980, when credit controls interrupted the anti-inflation policy.

Volcker made many speeches and testified in Congress to his continuing commitment. He was eager to assure his audience that he did not intend to change direction until inflation fell to low levels. An example from a 1980 press conference illustrates his effort.

> Question: How high an unemployment rate are you prepared to accept in order to break inflation?
>
> Answer: That kind of puts me in a position of I accept or unaccept or whatever. You know my basic philosophy is over time we have no choice but to deal with the inflationary situation because over time inflation and unemployment go together. … The growth situation and the unemployment situation will be better in an atmosphere of monetary stability than they have been in recent years.
>
> (Volcker papers, Federal Reserve Bank of New York, Box 97657, January 2, 1980, 6. Quoted in Meltzer 2009: 1034)

Volcker's statement, made repeatedly, changed Federal Reserve policy in two major ways. First, it looked ahead months or years to a time when the policy had its effect on the economy. One of the FOMC's frequent errors is that it responds to current events ignoring the future. Second, Volcker discarded the Phillips curve and greatly reduced Federal Reserve concern about the unemployment rate. Unemployment would fall when inflation fell.

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The problem was that market participants and many of the public remained skeptical that the FOMC would maintain the anti-inflation policy. Past experience reinforced by the expansion following the credit control program strengthened these concerns. Despite a return to recession in 1980, interest rates remained high. The ten-year constant maturity Treasury bond reached 13.2 percent in February 1980. Forecasts of expected inflation one quarter ahead reached 9.98 percent in second quarter 1980. The GDP deflator reached a peak at 12.1 percent in fourth quarter 1980.

The Federal Reserve's initial failure to control money growth added to general skepticisms. In October 1979, at the start of the new policy, money growth reached a 14 percent annual rate, against a 4.5 percent rate target for fourth quarter 1979. This was an inauspicious start. The FOMC let the federal funds rate rise to 17 percent, the highest level reached to that time. This painful experience of surges in bank borrowing, money growth, and interest rates would be repeated many times.

The Federal Reserve traditionally gave most attention to current changes in the economy and the financial markets. Volcker recognized that the disinflation policy had to persist for an indefinite time. Presidents Willes (Minneapolis) and Roos (St. Louis) wanted to announce money targets for the next three years to condition market expectations and recognize that disinflation would take time. Governor Teeters led the opposition, pointing out that they did not have enough information to look three years ahead.

Financial deregulation added to the difficulty of interpreting monetary changes. The Fed staff responded by setting monetary targets for a quarter ahead that were consistent with annual growth rates announced in Congressional hearings. But the FOMC never announced the inflation goal it sought to achieve, and it did not discuss whether its objective was to slow or stop steady-state inflation or whether it included one-time price level changes as part of its objective. It did not discuss either objectives or how it defined inflation. In this, it continued to plod along the bumpy path set by current data. The members continued to argue over small differences. They did not respond to President Willes' comment that the best procedure would be to choose a non-inflationary rate of money growth and continue to produce it.

Control of short-term money growth raised concerns about the Fed's ability to reduce inflation. Volcker looked longer-term. His was an eclectic pragmatic position:

> When I look at all these risks, what impresses me is that the greatest risk in the world is not whether we miss our targets or not. I don't want to miss our targets, but we have to put that in perspective of what is going on in the rest of the world.
> (quoted in Meltzer 2009: 1057, at the May 20, 1980 FOMC meeting)

At the meeting Governor Wallich noted that many observers thought the desk had returned to an interest rate control policy. The desk staff agreed.

FOMC members did not have a common way of forecasting future inflation and unemployment. Some like Governor Teeters and the Board staff used a Phillips curve. Others believed the inflation rate depended on expectations and credibility. Volcker was the leader of this group. Once the market became convinced that the FOMC would sustain its policy, expected and actual inflation would fall, and unemployment rate would move toward full employment. No one expressed any belief about when that would happen. As usual, no one attempted to reconcile the different views. Volcker's view proved to be correct.

For 1980 as a whole, M1 growth (currency and demand deposits) was 7.1 percent against a target of 4.0 to 6.5 percent. At one campaign stop, President Carter responded to a question

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by saying he wished the Federal Reserve would give more attention to interest rates, but he added that the Federal Reserve was an independent agency. That is his only criticism of the policy after credit controls. And he rejected staff proposals for fiscal stimulus, especially an investment tax credit.

Although the FOMC in practice did not exercise tight monetary control, remained uncertain about interpretation of financial market changes, subsidized bank borrowing at times, and did nothing to improve monetary control, the major change remained a shift from adjusting policy to reduce unemployment to reducing the inflation rate. In response to a question about how weak the economy would be allowed to become, Volcker responded:

> We have been put in a position or have taken the position … that we are going to do something about inflation maybe not regardless of the state of economic activity but certainly more than we did before … It is a very important distinction.
>
> (Meltzer 2009: 1074)

Persistence succeeded. Early in May 1981, the Board approved an increase in the discount rate to 14 percent and a federal funds rate between 18 and 22 percent. By June, the funds rate was above 19 percent, the highest rate ever recorded. At the time, the unemployment rate was 7.5 percent and rising. The increased interest rate was a strong signal that Volcker's FOMC did not intend to respond to the unemployment rate until inflation fell. Market expectations changed. Within a year, inflation fell to about 4 percent. The evidence of policy persistence was rewarded. In April 1981 the twelve-month rate of CPI price rise fell below 10 percent for the first time in two years.

Fiscal stimulus took the form of reductions in marginal tax rates especially in 1982 and 1983. The rate reductions brought the conflict within the administration to the fore. Supply side proponents wanted faster money growth to increase the response following the tax cuts. Monetarists opposed. They wanted better inflation control. The conflict left Volcker and the FOMC free of administration pressure. They could do as they wished supported by President Reagan, who did not interfere. Volcker continued to claim that lower inflation would reduce unemployment.

The dollar was the world currency. The anti-inflation policy brought a major appreciation of the exchange rate. From its July 1980 trough to its February 1985 peak, the trade-weighted dollar index appreciated 87 percent. Since many loans are dominated in dollars and commodities are priced in dollars, costs of refunding and costs of production rose everywhere. The FOMC discussed intervention, especially coordinated intervention with the Germans, but Volcker was hesitant, and nothing happened.

International loans to developing countries became a major problem. Many developing countries borrowed in dollars to pay for increased oil prices and for other purposes as well. As the dollar appreciated, refunding costs rose. Starting with Mexico in 1982, countries defaulted on debt service, adding a major international dimension to the economy's problems.

A moving average of four-quarter changes in the rate of change of nominal hourly compensation reached a peak of 11 percent at the beginning of 1981. It then began a steady decline until it reached about 4 percent by early 1983. The compensation series is much less influenced by one-time changes in energy and food prices or other discrete events. The FOMC decisions to raise the funds rate in spring 1981 despite 7.5 percent unemployment reinforced the growing belief that the Federal Reserve would continue disinflating. The prompt response of wage growth to the renewed disinflation policy in autumn 1980 contradicted the many computer models showing very slow response to disinflation.

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By early 1982, to the extent that the FOMC had a consensus on policy, it fractured. Monthly money growth rates fluctuated over a wide range. Frank Morris (Boston) wanted to continue disinflation but end monetary targets. Governor Nancy Teeters wanted to expand enough to reduce the unemployment rate. Pressure for policy change also came from Congress. These pressures increased as the mid-term election approached.

Paul Volcker acknowledged the control problems, but he remained committed to the policy and procedures. The data suggest that beginning in February 1982, the Federal Reserve used an interest rate target (Meltzer 2009: 1099–1100). Nevertheless, despite a 9 percent unemployment rate, in March 1982, the FOMC voted 9 to 2 to keep the federal funds rate between 12 and 16 percent.

Volcker actively defended the policy before many different groups. One of these was the homebuilders, one of the industries most adversely affected by high interest rates. Volcker told their convention that the Federal Reserve had to continue the policy until inflation fell to low levels. Relaxing restraint postponed disinflation. The Federal Reserve would have to start over. Skepticism about its commitment would have to be overcome again. Despite their financial losses, the builders applauded his forthright statement.

Ending "practical monetarism"

The retreat from "practical monetarism" differed from its start. In October 1979, the Federal Reserve wanted to publicize the major changes. From July to November 1982, it avoided explicit announcements. Volcker directed the decisions and actions, changing slowly in a series of stages after observing market and public responses.

Second, FOMC members wanted to reduce interest rates. Governor Teeters was the most strident, but she had support from Governors Gramley, Rice and Partee. Events appear to have been more important than the Governor's criticisms. At the July 1, 1982 Board meeting, the Board approved a $700 million loan to Mexico under the "swap" program. Both central banks concealed the loan by transferring the loan on the day before reserves were added and returning the money the next day. But there was no doubt in Volcker's mind that continued Mexican debt service was at risk. Loans to Mexico from nine major U.S. banks amounted to $60 billion, 45 percent of the banks' capital. And Mexico was not alone. Loans to all Latin American countries amounted to twice the lending banks' capital. Most of the countries seemed likely to follow Mexico into default.

Heightened domestic financial fragility added to the problems that policy had to confront. In May, a small securities firm, Drysdale, was unable to pay interest on the government securities it had sold short. Drysdale had about $20 million in capital but $6.5 billion in securities; it owed $160 million in interest payments to nearly 30 financial lenders. In late June an Oklahoma bank, Penn Square, became bankrupt. It had large loans to oil companies that became worthless when oil prices fell. Major banks had bought some of Penn Square's loans. Continental Illinois held $1 billion. It had financed its lending by borrowing in the short-term market. Foreign banks were among the lenders to Continental. The problem seemed likely to grow.

In July, Volcker began to shift back to targeting the federal funds rate. At its May meeting, the FOMC lowered the funds rate to a 10 to 15 percent range voting 11 to 1 for the lower rate.

Real long-term rates remained as high as 7.5 percent. Real GDP growth rose 1.2 percent in the second quarter but fell at a 3.2 percent rate in the third quarter. As election approached, Congress became more active. Legislation setting money targets or putting a ceiling on interest rates gained supporters but did not pass. White House Chief of Staff, James Baker, hinted that perhaps Federal Reserve independence should be curtailed.

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At the FOMC meeting, talk was about bankruptcies, banking distress, and the difficulty of interpreting money growth rates. Pressed by economic events and political pressures, the FOMC moved to lower the funds rate. Volcker urged gradual steps fearing that a large change would arouse inflationary expectations and force reversal. On July 19, the Board approved a 0.5 percent reduction in the discount rate to 11.5 percent followed by further reductions that reached 10 percent on August 26. The funds rate followed. By late August nominal Treasury bond yields fell to 12.5 percent, the lowest rate since January 1981.

The disinflation was over, but the announced end did not come until October. Between July and October, the FOMC continued discussions of the desirability of policy changes. A principal argument against was that the move would be interpreted as a response to rising pressure from Congress ahead of the election. One example was a bill introduced by Senator Byrd (WV) requiring the Federal Reserve to lower interest rates and end reserve targeting. Many senators joined in the attack on independence.

Volcker steered between the two extremes. He gradually lowered the funds rate and, at a telephone conference on September 24, he proposed targeting member bank borrowing. This returned the FOMC to the indirect interest rate target it used in the 1920s, similar to the free reserve target of the 1950s.

The market was slow to recognize that policy changed in July. When money growth rose in early September without a response by the Fed, stock price indexes rose 4 percent in a week. The disinflation policy ended. But no announcement came from the Fed until October.

At the October 5 FOMC meeting, the few remaining vestiges of reserve targeting and monetary control ended. Volcker spoke first to state his concerns about foreign trade, financial fragility internationally and domestically, and dollar appreciation that exacerbated the Latin American debt problems.

In August he had asked the committee to give him authority to prevent an increase in market rates. They refused, so rates rose. At the October meeting, he again requested that authority. He would not accept a renewed restriction on his freedom to implement “an operational approach that modestly moves the funds rate down” (Meltzer 2009: 1119.)

M1 rose at a 20 percent annual rate in October. The Federal Reserve did not respond. When Volcker spoke to the Business Council, he insisted that policy had not changed. Special factors affecting monetary aggregates became the explanation. Volcker continued to claim that the rejection of money targets was a temporary change. The Federal Reserve did not announce a new operating tactic.

Conclusion

The 1979–82 disinflation differs from most Federal Reserve postwar actions in two principal ways. First, it gave principal emphasis to inflation control and much less attention to unemployment. Volcker believed and often said that inflation and the unemployment rate would fall together. He dismissed forecasts based on a Phillips curve tradeoff. Time proved him right. By the mid-1980s, the economy began the longest period on record with steady growth, small recessions, low inflation and low unemployment rates.

Second, the Volcker Fed focused on a goal – lower inflation – that could be reached only if policy continued to pursue that goal. The Federal Reserve before Volcker was overly responsive to near-term events over which it could have little influence. After 2004, the Fed returned to its former policy.

The end of reserve targeting and a return to rapid growth in 1983 did not end skepticism. Real interest rates on long-term Treasury bonds remained elevated until 1985. Markets

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seemed convinced that with growth, inflation would return. When that didn't happen, Federal Reserve credibility strengthened.

The recovery after 1982 began with historically high real interest rates. As on many other prior occasions, real base growth dominated real interest rates. Real base growth declined before every recession from 1920 to 1991. Real interest rates often do not rise in advance of recessions. And as in the recovery after 1982, the economy recovered and grew despite historically high real long-term interest rates. Economists and central bankers have been slow to read that message.

The 1979–82 policy succeeded because the Volcker Fed persisted. Many skeptics who doubted that the Fed would ignore the rise in unemployment changed their opinion when the FOMC raised interest rates in spring 1981 despite high unemployment. Many of the public supported the policy. They wanted an end to high inflation. Most members of Congress supported the effort. President Reagan actively encouraged Volcker.

Volcker's commitment was an essential reason for success in lowering inflation. Economists err, however, if they neglect public and political support. Congress and the administration can hinder or prevent the Federal Reserve from achieving its objectives. One lesson from the Volcker disinflation is that models of optimal policy err seriously if they neglect politics and political economy.

Notes

1 Volume 2, Book 2 of Meltzer (2009) is the basis of this chapter and has much supporting detail.
2 I wrote a draft of the section on monetary policy. The administration moderated my proposal at the Fed's request.

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