



Reflections

Edwin M. Truman

My reflections on the new operating procedures that were adopted by the Federal Open Market Committee (FOMC) on October 6, 1979, derive from my responsibilities at the Federal Reserve Board at the time. Those responsibilities included preparation of the international component of the staff forecast, analysis of economic and financial developments in other countries, and assisting the Chairman and members of the Board (primarily Henry C. Wallich) with international responsibilities in connection with their attendance at international meetings. Therefore, mine was and is an international perspective. I was not involved in the design of the new operating procedures, although I was informed that the project was under way.

The decision on October 6, 1979, was very much part of an international policy coordination process that played out with our partners abroad, principally in Europe, as well as within the U.S. government, in the late 1970s. In thinking about such episodes of policy coordination, I find it useful to try to answer a sequence of questions: (i) Was the diagnosis of a need for policy action correct? (ii) Was there agreement on the model or framework used to analyze the situation? (iii) Were the right policy choices made? My reflections are organized around those three questions. My answers are as follows: (i) Eventually the correct diagnosis was made. (ii) Agreement on the analytic framework was loose at best. (iii) The right choices were made, but in retrospect at a high price that probably would be higher today.

CORRECT DIAGNOSIS?

The Carter administration came into office dissatisfied about U.S. economic growth and determined to lead an international effort to promote U.S. and global expansion—the locomotive theory. Economic activity did accelerate in the United States in 1977, and so did the price level, but most of the rise was in increases in prices of food and energy. The U.S. current account deficit also widened, which was seen as sapping the U.S. expansion. This situation prompted Treasury Secretary Blumenthal in June 1977 to make his comments on the unsustainable U.S. deficit at the Organisation for Economic Co-operation and Development (OECD). These comments established his reputation for “talking down” the dollar.

By the fall of 1977, the Federal Reserve was intervening quite heavily (by the standards of the time) in foreign exchange markets to resist the dollar’s decline. That decline was seen at the Federal Reserve and in other policy circles as adding to U.S. inflation. We on the international side of the Federal Reserve at this time used to joke that the view at the Federal Reserve seemed to be that inflation was caused by rising prices; Federal Reserve policy had nothing to do with it.

With the transition from Arthur F. Burns to G. William Miller as Chairman, the situation did not improve, though Miller was more effective in dealing with the administration. He succeeded where Burns had failed—in convincing the U.S. Treasury that the Treasury could absorb the potential financial costs of issuing foreign currency-denominated debt (what came to be known as Carter bonds) as a cost of issuance.

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Truman

The dollar continued to decline after the Bonn Summit in July 1978, at which the grand bargain was struck to stimulate growth abroad in return for a U.S. pledge to reduce its dependence on imported oil. The decline turned into more of a free-fall in October in reaction to the announcement of President Carter's program of budget restraint and voluntary wage and price guidelines.

The Federal Reserve under Chairman Miller anticipated this reaction, and a plan was developed to correct "the excessive exchange rate movements" that followed the announcement. The plan called for a cooperative \$30 billion package of foreign currency resources to finance Treasury and Federal Reserve intervention. However, it was noteworthy that the Bundesbank would not agree to the package, which included doubling the Federal Reserve's swap line with it and cooperation on the issuance of Carter bonds, until the Federal Reserve agreed to a decisive monetary policy move that took the form of an unprecedented 1-percentage-point increase in the discount rate to 9¹/₂ percent.

The President's announcement of the overall package tightly linked the decline in the dollar to U.S. inflation. However, there was little recognition at the time in Washington that the United States had a serious underlying inflation problem. One of my least pleasant experiences at the Federal Reserve was in July 1978, when I represented the Federal Reserve on the U.S. delegation for the OECD's review of the U.S. economy. Lyle Gramley, who had moved to the Council of Economic Advisers (CEA), argued that if the Federal Reserve raised interest rates another 25 basis points, it would plunge the U.S. economy into recession.¹ I said the Federal Reserve would act "appropriately."

The November 1, 1978, package boosted the dollar for a while. However, in June 1979 it began to decline again, in particular in terms of the Deutsche mark. Petroleum prices were also rising along with U.S. headline and core inflation. During the summer of 1979, the principal response both inside and outside the Federal Reserve was to

call for stepped-up U.S. intervention in foreign exchange markets. It was felt that the economy was headed for recession, so the scope for raising interest rates was limited.²

During that summer, the FOMC did push up the federal funds rate at the same time it was participating in foreign exchange market intervention. By September, it was becoming increasingly clear that we were behind the curve. The new operating procedure was under development in-house.

Paul Volcker, who was appointed as Federal Reserve Chairman in 1979, traveled to the International Monetary Fund/World Bank annual meetings in Belgrade on the Treasury plane. On the way, they stopped in Hamburg for conversations with their German counterparts. One interpretation of that stop was that Treasury officials were trying to drum up German support for a new rescue package for the dollar. In fact, they received a harangue from the German authorities about getting the U.S. economic house in order. It was on this trip that Volcker informed the Treasury and the CEA about his thinking. My impression at the time was that the Treasury (Secretary Miller and Under Secretary Solomon) was broadly supportive of Volcker's plans. My impression was that the CEA (Chairman Schultze) was more skeptical about the technique but not about the need to do something. Most were convinced that everything else had been tried and had failed; it was necessary to have done so in order to bring them around to accepting the need for fundamental monetary policy action.

Volcker also shared some of his thinking in general terms with Bundesbank president Otmar Emminger. Emminger relied heavily for advice on my good friend and counterpart at the Bundesbank, Wolfgang Rieke. Consequently, during our walks around Belgrade, Wolfgang and I had several long conversations about the proposals and the chances of their success. We thought we understood how the new procedure would work, but we were uncertain about how successful it would be.

Volcker left Belgrade early to return to

¹ By the time Lyle Gramley came back to the Federal Reserve in May 1980 as a governor, he was one of the strongest anti-inflation hawks.

² At the time, real GDP recorded a decline during the second quarter of 1979, but the data today show no decline until the second quarter of 1980.

Washington to finalize plans for the October 6 meeting of the FOMC. Henry Wallich and I flew back the afternoon of October 5 and immediately went into a conference call to cover recent economic and financial developments, getting them out of the way before the FOMC meeting the next day. It was noted that the Pope would be in Washington at the same time, which might give the Reserve Bank presidents and their colleagues some cover as they slipped into town.

By October 6, 1979, the FOMC had become convinced that the United States had an inflation problem that could be addressed only at home through monetary policy, and the U.S. administration, some very reluctantly, did not object. The inflation problem had its origins inside the United States and inside the Federal Reserve, not in foreign exchange or petroleum markets. Eventually the correct diagnosis was made.

AGREEMENT ON THE ANALYTICAL FRAMEWORK?

In Belgrade, Arthur F. Burns delivered the Per Jacobsson lecture, named after a former managing director of the International Monetary Fund. His title was “The Anguish of Central Banking.” He argued implicitly that the fault for high U.S. inflation lay not primarily with the Federal Reserve but in policy decisions made elsewhere in the U.S. government that limited the central bank’s capacity to bring down inflation, especially once it had risen.

Burns presented a four-part proposal for how the U.S. government should deal with its inflation problem: (i) revision of the budget process, (ii) a comprehensive plan for dismantling regulations impeding the competitive process and modifications where regulations were driving up prices and costs, (iii) scheduled reductions in business taxes to stimulate the supply side of the economy, and (iv) “a binding endorsement of restrictive monetary policies until the rate of inflation has become substantially lower.” Volcker arrived late at the lecture, sat on the floor leaning against a wall, picked up a copy of Burns’s speech, skimmed through it, and tossed it back on the floor with the

comment, “I’m doing it all wrong.” I was sitting a few feet away and was one of the few who heard him and understood what he really meant.

However, Arthur Burns was not the only person who did not embrace the unilateral approach to monetary policy that the Federal Reserve was about to unveil. The members of the FOMC only gradually arrived at a common diagnosis of the problem. They were concerned about inflation, but they were also concerned about the real economy. There was less than full agreement that a greater focus on the monetary aggregates was appropriate in the context of ongoing changes in the financial system. The Federal Reserve had embraced the framework of monetary targeting, and it was enshrined in the Humphrey-Hawkins Act, but the embrace was far from warm or universal.

Even for those who embraced the monetarist framework, there was considerable dissatisfaction with the current operating procedures and doubts about whether they could achieve the monetary targets. Of course, considerable attention was paid to interest rates. However, my memory is that the term “real short-term interest rates” was rarely used at the time. Through the third quarter of 1979, the real federal funds rate (adjusted for headline consumer price index [CPI] inflation over the following four quarters) had been positive for only 2 of the 19 quarters starting in the first quarter of 1975. This experience has led me, for example, in the context of the Mexican program in 1995, to favor use of the real short-term interest rate as an indicator of monetary restraint.

The new operating procedures were regarded generally as a monetarist framework, but many monetarists disowned it either immediately or soon thereafter. Moreover, during the period through the middle of 1982, in which the new operating procedures were more or less operational, there were discussions at every meeting about how wide or binding the federal funds constraint should be, though it was generally not binding. Of course, during the second quarter of 1980, the entire program was disrupted by the imposition of credit controls along with the negotiation of a new package of budget cuts.

On balance, there was more agreement in 1979 that “something” should be done about U.S. infla-

tion than about “what” should be done or “why” it should be done. Thus, I conclude that agreement on the analytic framework underlying the new operating procedure was loose at best. While the disinflation objective was clear, substantial uncertainty remained about how best to achieve that objective, which itself was unspecified.

THE RIGHT POLICY CHOICES?

The Federal Reserve was right to turn its attention directly to the underlying inflation problem in the U.S. economy rather than treat its symptoms (via exchange market intervention) or complaining about them (oil prices). The device of the new operating procedures, with its focus on nonborrowed reserves, was widely viewed at the time as a smokescreen for pushing up real short-term interest rates. Even if that was not the motivation, high interest rates were the result. It might have been preferable to announce an explicit inflation goal, but that was not among the central banker’s bag of tricks at the time. Moreover, it was pretty clear that substantial disinflation was the Federal Reserve’s broad objective.

The cost of that disinflation was very high—certainly higher than expected by those who argued that choosing a tough monetary target and sticking to it would magically lead to an adaptation of expectations of inflation, with no loss in output. It was even higher than others, such as myself, who suspected that it would be a long and painful process, thought it would be. Of course, other developments messed up the experiment: the continued rise in oil prices, the credit controls, and the fiscal policy of the Reagan administration, for example.

Criticism of Federal Reserve policy from Treasury Secretary Regan and Treasury Under Secretary Sprinkel helped to foster the most harmonious period within the Federal Reserve that I experienced in my 26-plus years. It is noteworthy, however, that the new operating procedure and associated actions were intended to increase confidence abroad as well as home in the System’s determination to curb inflation by moderating expectations of inflation; this was expected to strengthen the dollar. Yet, the foreign exchange

value of the dollar did not really turn around until the end of 1980, both on the G-10 average that we were then using and against the Deutsche mark; the dollar hit new lows in January 1980 and came close to those lows again in July. The foreign exchange markets remained skeptical, although to some extent pressures for the dollar to appreciate were resisted by other countries who were worried about “importing inflation” in the context of the surge in global energy prices.

I recall that, at a Congressional hearing shortly before the end of his tenure at the Federal Reserve, Paul Volcker was asked whether he would have done it—that is, tried to persuade the FOMC to adopt something like the new operating procedures—if he had known how long and painful it would be to get the process of disinflation going in the U.S. economy. His answer, as I recall, was a rather crisp “I am not sure.” At the same time, he left no doubt that action was necessary and inevitable. The only issue was the timing.

Coming back to the international perspective, one consequence of the sequence of the Federal Reserve’s decisions, which had the effect of pushing up real interest rates to very high positive levels after a long period of negative real rates, was the international debt crisis that started in 1982 and lasted through the decade of the 1980s. One can properly argue that the 1982 crisis was also a consequence of lax U.S. monetary policy in the late 1970s as well as a number of other institutional factors. However, some of us felt an obligation to help manage the adjustment process that Federal Reserve policy and its failures had helped to necessitate. It was, perhaps, prophetic that at the August 1979 FOMC meeting the Committee authorized an increase in the Federal Reserve swap line with the Bank of Mexico from \$360 million to \$700 million.

I have my doubts whether today, when the Federal Reserve is even more the central bank to the world and despite the more widespread adoption of floating exchange rate regimes, the Federal Reserve could “get away with” imposing such a draconian policy on the global economy without more consultation, or at least warning. Thus, in broad terms, the right policy choice was made in 1980, given the circumstances, but the price was

higher than anyone expected at the time. To delay any longer would have raised the price, but greater knowledge of how high the price was likely to be might well have contributed to further delay.

In conclusion I offer three comments about the relevance of that experience for the world today. First, I observe that the real short-term federal funds rate (again, adjusted for headline CPI inflation over the following four quarters) has been negative since the fourth quarter of 2001. On the present trajectory it is not likely to turn positive until the second half of 2005 or later. Second, it is important that the Federal Reserve never again promotes or experiences such an inflation process. Through the end of 1998, when I left the Federal Reserve, I felt that the FOMC continued to internalize the painful lessons of the 1977-82 period of inflation and disinflation; I hope that is still true. Third, in this spirit, I support the adoption of inflation targeting as a framework for the management and evaluation of U.S. monetary policy, not only to help prevent a replay of the experience of 25 years ago but also as a communication device that would alert the rest of the world if we should go off course and warn them that ultimately the return to price stability would be painful not only for us but for them.

