



Editors' Introduction

Athanasios Orphanides and Daniel L. Thornton

On October 6, 1979, the Federal Reserve implemented a monetary policy reform of profound significance for the U.S. economy, marking the beginning of the end of the inflationary malaise that permeated the economy at the time. Starting with its policy actions that Saturday afternoon, the Federal Reserve reaffirmed its responsibility to restore and maintain an environment of price stability in the economy, thereby restoring confidence and setting the stage for a period of lasting economic prosperity. This prosperity has been interrupted only by two mild and shallow recessions over the past two decades.

A conference held in St. Louis on October 7 and 8, 2004, provided the opportunity to reflect on the history of monetary policy in the United States 25 years after the events of that October. Over the two-day period, three papers were presented and discussed, followed by two panel discussions revisiting and distilling the policy lessons surrounding the events of October 1979 and those that can be drawn to safeguard good policy practice going forward. This conference volume is a compilation of the conference proceedings as well as personal reflections commemorating October 6, 1979.

With the passage of time, the significance of that moment for our nation's economic history and continuing prosperity will surely fade. Nonetheless, we hope that this conference volume will help preserve the lessons from the October 1979 episode. As Chairman Greenspan noted in his introductory remarks: "We should strive to retain in the collective memory of our institution the

ensuing lessons of that period. It may be the most fruitful and proper way to commemorate the events of October a quarter-century ago."

ORIGINS OF THE GREAT INFLATION

In the first conference paper, Allan Meltzer offers a historical analysis of the economic and political forces that generated and sustained the Great Inflation of the 1960s and 1970s and necessitated the forceful disinflationary actions of October 1979. Various explanations have been advanced as possible causes of the policy errors of that period. Some are based on the political business cycle and dynamic consistency problems relating to the limited independence of the Federal Reserve at the time from the political process. Other explanations stress the role of misinformation or misinterpretation of economic theories, models, and/or data.

Meltzer reviews these explanations and discusses their limitations in providing a complete account of the historical experience. His analysis leads to his conclusion that not one but multiple elements must be identified as critical to understand the policy errors of the 1960s and 1970s. Meltzer stresses the role of leadership and beliefs of Federal Reserve policymakers, particularly the Chairman. According to Meltzer, during the 1960s, Chairman Martin placed excessive emphasis on reaching consensus among Federal Open Market Committee (FOMC) members before changing policy, a factor that contributed to unfortunate delays in taking prompt anti-inflationary action

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at the early stages of the Great Inflation, allowing it to gather momentum. Second, adherence to apparently flawed theories of inflation adversely influenced policy deliberations. Over many years, disregard of the fundamental long-run relationship between money growth and inflation steered analysis toward nonmonetary explanations of inflation. Meltzer argues that for many years Federal Reserve staff and policymakers denied that inflation had either begun or increased: They believed instead that inflation was the consequence of transitory factors that did not require a forceful policy response. Third, and perhaps most important, the presence of institutional arrangements that stressed policy coordination between fiscal and monetary policy compromised the independence of the Federal Reserve during the 1960s and 1970s. This, according to Meltzer, hindered the Federal Reserve from taking timely and effective disinflationary action throughout the period and is arguably the most significant factor in his analysis. Meltzer suggests that such political factors importantly influenced the thinking of both Chairmen Martin and Burns and argues that those two Chairmen held a rather restrictive view of Federal Reserve independence. Meltzer notes that bad luck, in the form of lower productivity growth starting in the mid-1960s, also contributed to the inflationary problem. Ultimately, however, Meltzer suggests that the inflationary problem could not have persisted in the absence of the other factors he identifies—importantly, the presence of flawed economic reasoning and the compromised independence of the Federal Reserve.

In her discussion of Meltzer's paper, Christina Romer agrees with many of the points in Meltzer's analysis but argues that his emphasis on the role of politics may be unwarranted. Instead, Romer argues, the Great Inflation occurred primarily because both fiscal and monetary policymakers were constrained by the misguided economic framework of the time. In her view, inflation persisted during that period because policymakers relied on flawed models of the economy. Romer stresses that views regarding the economy were not stagnant during this period but rather were changing. She provides an outline of the evolu-

tion of the dominant framework for policy analysis from the 1950s to the late 1970s, but argues that, during the Great Inflation, policymakers replaced one bad model with another, thus failing to recognize the actions needed to restore price stability. A major implication of Meltzer's emphasis on political constraints on Federal Reserve behavior, according to Romer, is that the Federal Reserve understood that the policy actions of the late 1960s and 1970s were inflationary. Citing forecast errors made by the Federal Reserve staff at the time, Romer argues that this may have not been the case. In her view, the policy change in October 1979 simply represented the triumph of better ideas over worse ones.

HOW AND WHY DID THE OCTOBER 1979 REFORM HAPPEN?

David Lindsey, Athanasios Orphanides, and Robert Rasche offer a historical review of the monetary policy reform, discuss the influences behind it, and gauge its significance. The authors lay out in detail the policy record from the start of 1979 through the spring of 1980, drawing extensively on the recently released transcripts of FOMC meetings during 1979, Federal Reserve staff analysis, and other contemporaneous sources. They then examine the reasons behind the Committee's decision to adopt the reform and the communications challenge presented to the Committee during this period.

The paper argues that the reform was adopted when the FOMC became convinced that its earlier gradualist strategy using finely tuned interest rate moves and aiming to avert economic slowdowns had proved inadequate for fighting inflation and reversing inflation expectations. Throughout 1979 and leading to the October reform, the FOMC faced a deteriorating inflationary outlook as well as a deteriorating economic outlook. During much of the year, Federal Reserve staff, private forecasters, and policymakers projected that recession was about to start. Within the gradualist framework in place, such concerns suggested caution against restrictive policy actions. As the year

progressed, the Committee increasingly realized that its inaction led to a deterioration of inflationary expectations and instability in financial markets. The Committee decided to embark on a tightening path as early as July 1979 within its existing operating framework. The Federal Reserve's move toward tightening was reaffirmed by President Carter's appointment of Paul Volcker as Chairman of the Federal Reserve. However, financial markets' reactions, especially following the FOMC meeting on September 18, 1979, suggested that the Federal Reserve's resolve to tighten policy sufficiently remained in question. This rift reinforced the new Chairman's beliefs that more drastic steps toward restoring confidence were needed, and such plans were prepared at his initiative. It was recognized that the new plan had to break dramatically with established practice, allow for the possibility of substantial increases in short-term interest rates, yet be politically acceptable and convince financial markets participants that it would be effective. The new operating procedures satisfied these conditions and were adopted for the pragmatic reason that they would likely succeed.

An element *not* suggested by the historical evidence as being important for the reform was monetarist ideology. According to Lindsey, Orphanides, and Rasche, the "monetarist experiment" of October 1979 was "not really monetarist!" Indeed, after examining various alternative frameworks, including monetarism; new, neo, and old-fashioned Keynesianism; and nominal income and inflation targeting, the authors conclude that the Committee's actions cannot be easily identified with any of them. Rather, they interpret the evidence as suggesting that in October 1979 the Committee simply accepted that, under prevailing circumstances, controlling monetary growth presented a robust approach to taming inflation and adopted the new operating procedures because of its determination to achieve that objective.

In his discussion, Stephen Axilrod suggests that the appointment of Paul Volcker as Chairman, specifically his unique contributions to the policy environment, deserves greater attention for understanding the events of October 1979. While inflation would surely have been tamed eventually,

Axilrod stresses that the paradigm shift that took place following Paul Volcker's appointment in the summer of 1979 would not have taken place without him. Axilrod thought two characteristics not usually found in a leader were important. First, Volcker could think beyond the bounds of central bank practice of the day. Second, he was technically highly proficient and interested in the operating details of implementing central bank policies so that the Committee could have confidence in his leadership and ability to guide policy in a new complex environment.

Among the reasons for the policy change identified by Lindsey, Orphanides, and Rasche, Axilrod stresses three: first, how badly the Federal Reserve needed to regain its credibility as an inflation fighter; second, the need to minimize the cost of disinflation by convincing markets quickly that the new procedures would be effective; and third, the desire to make the necessary disinflationary policy actions more automatic and less dependent on the meeting-by-meeting policy decisions of the Committee. Axilrod agrees that making aggregate reserves the operating instrument and tying policy more closely to the money supply accomplished these aims.

THE POLICY DEBATE SINCE OCTOBER 1979

In his contribution, Marvin Goodfriend reviews the evolution of monetary policy theory and practice over the past 25 years and examines how both theory and policy have been shaped by the earlier experience of the Great Inflation and the reform of October 1979. A large part of this story, he writes, is that central bankers and academic economists learned from each other and both learned from the historical experience with inflation and disinflation.

Goodfriend points out that much of the macroeconomic theory developed before October 1979 remains at the core of policy models used today—including elements such as the discrediting of the notion of a permanent trade-off between inflation and unemployment and the importance of expectations for understanding inflation dynamics. He

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notes, however, that there was much less consensus regarding some of these elements a quarter-century ago than there is today.

The experience of the 1970s, and the ensuing lessons, shaped importantly some of the policy choices, strategy, and tactics during and after the disinflation. As a result of the high and volatile inflation at the beginning of the disinflation in October 1979, Goodfriend suggests that the Federal Reserve experienced a “loss of room to maneuver”; that is, it lost the leeway to choose between stimulating employment and fighting inflation over the business cycle. In essence, the Federal Reserve was perceived by the public as having lost its resolve to combat inflation. As a consequence, inflation expectations were driven by recent experience, rather than being anchored by the Federal Reserve. Containing inflation in such an environment is much more difficult. Goodfriend cites the recurrence of “inflation scares” for several years following the October 1979 reform as evidence that regaining credibility was a gradual and costly process and identifies the successful practice of preemptive tightening as a means to combat such inflation scares as an important lesson from that experience. This success, Goodfriend argues, was the key to restoring the Federal Reserve’s ability to stimulate employment during downturns without compromising price stability.

Indeed, perhaps the most important lesson from the experience of the past quarter-century identified by Goodfriend is that success in stabilizing inflation and in anchoring inflation expectations, with an explicit commitment by the central bank to pursue and maintain price stability, improves the stability of both inflation and output.

With regard to modern policy practice, Goodfriend identifies three developments as most important. First has been the rise of what he terms *implicit* inflation targeting as the core of the Federal Reserve’s policy strategy. Second is the increase in policy transparency, specifically the Committee’s practice of announcing its target federal funds rate immediately following each FOMC meeting. Third is the broader increase in transparency in communicating the Committee’s concerns and providing information regarding

its intentions for monetary policy. Goodfriend also identifies and briefly reviews some open questions relating to monetary policy practice, such as whether the Federal Reserve should adopt an inflation target and the extent to which FOMC communications could be further refined.

Goodfriend identifies the modern New Neoclassical Synthesis or New Keynesian model as the consensus model for monetary policy analysis at present; however, he identifies a number of continuing controversies regarding the consensus model that remain unresolved.

In discussing the paper, Laurence Ball expresses his agreement with parts of Goodfriend’s discussion but also the view that the consensus model used to analyze monetary policy is flawed and not likely helpful for understanding the policy success of the Federal Reserve relative to other central banks over the past 25 years. Ball is particularly critical of the model’s formulation of the Phillips curve and the emphasis on expectations in Goodfriend’s analysis. Regarding the Phillips curve, Ball argues that some of the empirical implications of Goodfriend’s consensus model are counterfactual and that the accelerationist Phillips curve, which lacks any explicit role for expectations, may provide a better characterization of the empirical evidence. Given his disagreement with the Goodfriend paper regarding the importance of gaining credibility and anchoring expectations, Ball also investigates alternative explanations for why U.S. monetary policy has been relatively successful in the past quarter-century.

LESSONS AND REFLECTIONS

In after-dinner remarks, John Taylor reviewed the international implications of the 1979 reform. In his view, the October 6 reform was a critical step in restoring stability not only in the United States but around the globe. Knowledge and key lessons from the U.S. experience spread around the world, leading to salutary shifts in monetary policy in numerous other countries that had experienced high inflation and instability during the 1970s. As a result of these improved policies, reductions in the variability of both inflation and

output have been noted in the United States and several other countries.

The conference concluded with two panel discussions. In the first, Ben Bernanke, Alan Blinder, and Bennett McCallum addressed the question “What Have We Learned Since October 1979?” In the second, Roger Ferguson, Charles Goodhart, and William Poole discussed the issue of “Safeguarding Good Policy Practice.” Inevitably, the two panels overlapped somewhat and participants noted that identifying and safeguarding the salient characteristics of good policy practice depends sensitively on the lessons drawn from the improved policy environment of the past quarter-century over that prevailing before the reform of 1979. Perhaps the most frequently cited lesson was the recognition of the profound importance of low and stable inflation for maintaining economic prosperity and the central bank’s unique responsibility to attain this goal. Panelists also stressed the importance of credibility in central banking and the benefits associated with well-anchored inflation expectations for enhancing a central bank’s flexibility to stabilize real economic activity. An improved understanding of the macroeconomy, better ideas and models,

an institutional environment favoring central bank independence, more systematic monetary policy with improved communications, and greater transparency were mentioned as factors conducive to good policy practice. The critical role of leadership for successful policymaking was also stressed.

Included in this volume are also ten personal reflections contributed after the conference, presenting different perspectives of the events of October 6, 1979. Anna Schwartz and Benjamin Friedman revisit the academic debate surrounding Paul Volcker’s policy reform and assess the aftermath of the monetarist controversy that surrounded the reform.

Together with Charles Goodhart’s comment, the essays by Charles Freedman, Otmar Issing, and Georg Rich offer a glimpse of the global climate during the period and as seen by officials at other central banks. Lastly, Robert Black, Philip Coldwell, and Frederick Schultz offer first-hand accounts of the policymaking environment during the turbulent period surrounding the reform; Edwin Truman and Joseph Coyne complement this insider view with their perspective from the Federal Reserve trenches.

