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October 6, 1979

Twenty-five years ago, on October 6, 1979, the Federal Reserve adopted new policy procedures that led to skyrocketing interest rates and two back-to-back recessions but that also broke the back of inflation and ushered in the environment of low inflation and general economic stability the United States has enjoyed for nearly two decades. The dramatic policy actions by the Federal Reserve in 1979 represented an important break with the past, both in the way monetary policy was conducted and in the importance placed on controlling inflation. This *Economic Letter* discusses the context within which the October 6 decisions were taken, the immediate consequences of those decisions, and the lessons today's central bankers have learned from them.

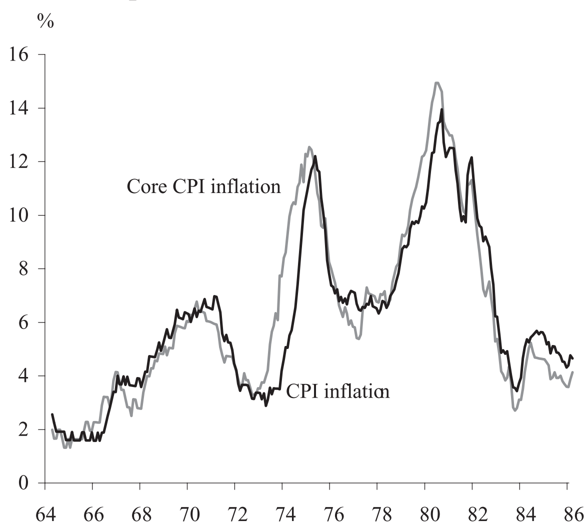
Background

Figure 1 shows two measures of the rate of inflation from 1964 to 1984—the consumer price index (CPI) and the "core" CPI, which excludes the volatile food and energy components. Over the first fifteen years in the figure, inflation in the United States ratcheted upwards, averaging 2.6% per year from 1964 to 1968, 5% from 1969 to 1973, and 8% from 1974 to 1978. Then, in the first nine months of 1979, average annual inflation jumped to 10.75%. This dramatic rise was partially due to a new round of oil price increases. But even the core CPI, which excludes the volatile food and energy components, averaged a 9.4% annual rate.

Inflation at this high level during peacetime was unprecedented in American history. And it produced a variety of policies to tame it, including President Nixon's wage and price controls, responsible for some of the temporary decline in inflation in 1971 and 1972, and President Ford's WIN (for "Whip Inflation Now") buttons, introduced in 1974.

While inflation was unusually high in 1979, unemployment was not. The United States had experienced a sharp recession in 1974 and 1975, with the unemployment rate reaching a peak of 9% in May 1975 and then declining steadily over the next four years. The unemployment rate averaged 5.8% during the first nine months of 1979. Thus, entering the fall of 1979, unemployment was slightly above its average over the previous fifteen years while inflation was at a troublingly high level.

Figure 1
Inflation as measured by the consumer price index (CPI)



Policy operating procedures

To understand the significance of the October 6 policy changes, it is first necessary to review the procedures the Fed had been using to implement monetary policy. During the late 1970s, the Fed implemented policy through procedures that were meant to control inflation by controlling the growth rate of the money supply. The basic approach was sensible—economy theory predicts that there is a close relationship between the average rate of inflation and the average rate of growth in the money supply. Beginning in 1975, the Fed was required by Congress to establish target growth rates for the money supply, to report the targets to Congress, and, if the targets were not met, to explain why not.

In practice, the Fed's procedures sent conflicting and confusing signals to the public about the Fed's desire to control inflation. Some of the confusion arose because the Fed established target ranges for several different measures of the money supply, or monetary aggregates as they were commonly called, without providing a clear statement about the relative importance of the different targets. The most important target ranges were those for M1 and M2, but target growth ranges were also adopted for M3 and bank credit. At times, one aggregate might be growing

faster than consistent with its targeted range, while another aggregate was growing more slowly than its targeted range, making it difficult to predict whether the Fed would tighten to reduce the growth rate of the rapidly growing aggregate or loosen to accelerate the growth rate of the lagging one.

Another confusing aspect was the way policy decisions were expressed in terms of money growth targets and a desired range for the federal funds rate, the interest rate in the overnight market for reserves. In textbook treatments of policies to control the money supply, the central bank decides on the level of bank reserves consistent with the targeted money supply. The federal funds interest rate is then allowed to adjust freely to bring the demand for reserves in line with the supply of reserves set by the central bank. With the Federal Open Market Committee (FOMC), the Fed's policymaking body, setting ranges for both money growth and the funds rate, it was not clear what would happen if, for example, the monetary aggregates grew faster than expected. Would the Fed stick to its interest rate target or would it stick to its money growth target?

Chairman Volcker

Paul Volcker became the 12th Chairman of the Federal Reserve System on August 6, 1979. He was no newcomer to the Fed system or to the FOMC, having held a seat on the FOMC by virtue of his previous position as President of the Federal Reserve Bank of New York. At the first FOMC meeting under the new chairman, held on August 14, committee members "expressed great concern about inflation." (For this and other quoted material below, see Board of Governors of the Federal Reserve System 1980, various pages.) Yet the FOMC seemed uncertain about how to address the inflation problem. According to the Record of Policy Actions of the Federal Open Market Committee, "Some doubt was expressed (by committee members), moreover, that further restraint could have a significant effect on inflation…. In the face of clear evidence of weakening in economic activity, it was observed, the need to balance the objective of containing the recession with the goal of moderating inflation called for a steady policy for the time being." When the Fed raised the discount rate in September after a 4–3 split vote, the press interpreted the split vote as an indication that the Fed was not going to undertake further actions to boost interest rates and restrain inflation (Lindsey et al. 2004). In reaction, commodity markets moved sharply. Gold and silver prices jumped and became more volatile once the news of the discount rate vote became public. The dollar fell in a further sign of inflation concerns.

According to Lindsey et al., Volcker returned from the annual IMF meetings in Belgrade in early October "with his ears still resonating with strongly stated European recommendations for stern action to stem severe dollar weakness on exchange markets." Volcker decided to call a special meeting of the FOMC, a meeting that was not publicly announced, to be held on Saturday, October 6.

By the time of the secret October 6 meeting, inflation continued to remain high, the value of dollar had declined significantly, and the monetary aggregates continued their rapid growth.

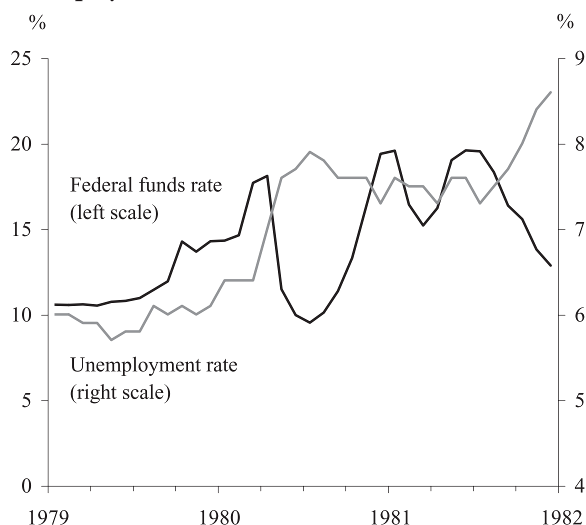
October 6, 1979

Chairman Volcker called the October 6 meeting of the FOMC to decide on better methods for controlling money, credit expansion, and inflation. After the previous FOMC meeting in September, Volcker had requested a study of new operating procedures that would place more emphasis on monetary control and less on the federal funds rate. The need for better control of money growth was clear in the third quarter data, which showed M1 had grown at an annual rate in excess of 9%, compared to the Fed's target growth rate of 1.5 to 4.5%. M2 had grown at a 12% annual rate in the third quarter, compared to the Fed's target range of 5 to 8%. According the Record of Policy Actions (p. 202), at the October 6 meeting, "the members agreed that the current situation called for additional measures to restrain growth of the monetary aggregates" and "most members strongly supported a shift in the conduct of open market operations to an approach placing emphasis on supplying the volume of bank reserves estimated to be consistent with the desired rates of growth in the monetary aggregates." The FOMC's discussion makes clear that the "principal reason advanced for shifting to an operating procedure aimed at controlling the supply of bank reserves more directly was that it would provide greater assurance that the Committee's objectives for monetary growth could be achieved."

Associated with a greater focus on monetary control was a significant widening of the range for the federal funds rate. At the meeting in September, a range of 50 basis points, from 11¼ to 11¾%, was set for the funds rate; at the October meeting, this range was increased to 400 basis points, from 11½ to 15½%. In response to these changes, the funds rate rose sharply, and by year end was close to 14% (see Figure 2). The funds rate peaked in April 1980, when it averaged 17.6%.

The rise in interest rates led to an economic recession that began in January 1980. Unemployment

Figure 2
The federal funds rate and the unemployment rate



eventually peaked in August at 7.8%. By then, as Figure 2 shows, interest rates had fallen dramatically. This reflected, in part, the impact of policies announced by President Carter in March 1980 to restrain credit directly. The Fed instituted new special reserve requirements, a surcharge on some discount window borrowing, and a program of voluntary credit restraint. Late in 1980, interest rates were pushed back up, and the funds rate averaged over 19% in June 1981. A new recession began in July, one that saw the unemployment rate reach almost 11% by the end of 1982. By that time, though, inflation, which had averaged 14.6% in the year from May 1979 to April 1980, had fallen below 4%. The era of low inflation had begun.

Lessons

In retrospect, it seems clear that inflation was the most pressing problem facing monetary policy in early 1979 and that the Fed needed to act decisively to reduce it. The adoption of a tough anti-inflation policy was delayed because FOMC members were concerned with more than just inflation. Worries about the level of real economic activity and unemployment often seemed to take precedence over inflation during the early months of 1979. In fact, even though the CPI rose at a 13% annual rate during the first quarter of 1979 while unemployment was down to 5.8% (from 7.1% in 1978), two FOMC members dissented at the May 22 meeting in favor of easing monetary policy. These members were concerned that the economy was slowing and that unemployment might rise. Attempting to balance multiple objectives prevented the Fed from concentrating on the problem of bringing down inflation.

Today, central bankers recognize that maintaining low inflation is their primary responsibility. While monetary policy can also contribute to reducing overall economic instability, there is a better understanding that maintaining low inflation is not inconsistent with overall economic stability but in fact is an important aspect of it. Second, central bankers today understand that monetary policy works best when the public is convinced that inflation will remain low and stable. The credibility of a low-inflation policy is best maintained in an environment in which central banks explain their actions and make their objectives clear. Central banks are now more likely to distinguish clearly between instruments, such as money growth or interest rates, and the ultimate objectives of policy such as low inflation.

The United States, most other developed economies, and many developing nations have enjoyed low inflation during the past twenty years. In the U.S., the October 6, 1979, FOMC meeting was a turning point in the battle against inflation. The lessons learned from that earlier battle continue to serve monetary policy well.

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