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Charles L Weise

Gettysburg College

May 2008

Online at http://mpra.ub.uni-muenchen.de/8694/
MPRA Paper No. 8694, posted 9. May 2008 17:51 UTC

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POLITICAL CONSTRAINTS ON MONETARY POLICY DURING THE U.S. GREAT INFLATION

Charles L. Weise
Department of Economics
Gettysburg College
cweise@gettysburg.edu

May 2008

Abstract. The U.S. Great Inflation of the 1970s was characterized by repeated, failed attempts at disinflation by the Federal Reserve as well as periods of inaction despite rising inflation. Previous research has attributed these failures to policymakers' "misperceptions" about monetary policy and the macroeconomy. This paper argues instead that the Fed's behavior during this period can be explained as a response to political constraints. Members of the Fed understood that a serious attempt to tackle inflation would be unpopular with the public and would generate opposition from Congress and the Executive branch. The result was a commitment to the policy of gradualism, under which the Fed would attempt to reduce inflation with mild policies that would not trigger an outright recession, and premature abandonment of anti-inflation policies at the first sign of recession. The Fed managed to disinflate successfully under Chairman Volcker only when the political constraints on Fed policy were lifted after 1979, allowing the Fed to abandon the policy of gradualism and knowingly take actions that risked recession. Evidence for this explanation of Fed behavior is found in Minutes and Transcripts of FOMC meetings and speeches of Fed chairmen.

1. INTRODUCTION

From the late 1960s to early 1980s – the period known as the Great Inflation – the U.S. economy experienced rising inflation and instability in real activity as shown in Figure 1. During periods of expansion in 1967-68, 1972 and 1976-78 the Federal Reserve delayed too long in raising interest rates. Several times – in 1969, 1973, and 1974 – the Fed attempted to extinguish the flames of inflation, but each time the attempt ended before success had been achieved.

Uncovering the sources of the Fed's failures during this period has been the focus of a great deal of research. A number of authors have located the source of the Fed's failure in policymakers' "misperceptions" about the nature of the economy. One strain of the misperceptions theory is associated with the work of Orphanides (2002, 2003, 2004) and Orphanides and Williams (2004). According to this view – which Nelson (2006) refers to as the "mismeasurement" hypothesis – during the period of the Great Inflation the Federal Reserve placed excessive emphasis on maintaining low unemployment and strong growth relative to its other goal, low inflation. At the same time staff economists at the Fed were consistently producing estimates of the natural rate of unemployment and level of potential output that were too low, causing the Fed to overestimate the amount of slack in the economy. The result was that monetary policy was consistently overexpansionary. Control began to be exerted over inflation in the early 1980s when policymakers began operating according to a more realistic estimate of the natural rate.

Romer and Romer (2002) and Nelson (2006) offer another version of the misperceptions view based on the evolution of policymakers' beliefs about the relationship between monetary policy and the real economy. I refer to this as the "misunderstandings" view. Their argument is that prior to the early 1980s policymakers subscribed to a variety of beliefs about the economy that led them to underestimate the inflationary impact of monetary policy. These beliefs included the idea that there existed a permanent tradeoff between inflation and unemployment; that the natural rate of unemployment was very low; and that monetary policy did not have a substantial effect on inflation. According to this view, the turning point in the battle against inflation came when policymakers in the early 1980s adopted a modern view of the role of monetary policy in controlling inflation.

Other authors have emphasized features of the political environment of the 1960s and 1970s that made it difficult for the Federal Reserve to sustain an anti-inflation policy. Meltzer

(2005) argues that the desire not to cause disruption in bond markets during Treasury auction periods (the "even keel" policy) prevented the Fed from pushing back against expansionary fiscal policy during the 1960s. DeLong (1997) offers a number of explanations for the Fed's failures during the 1970s, among which was the lack of a political mandate for inflation reduction. Empirical studies have shown that monetary policy actions were correlated with "signals" from the executive branch (Havrilesky, 1993, and others) and the private sector (Weise, 2008) during this period.

Support for the misperceptions views has been found in the historical record – Federal Open Market Committee documents, Economic Reports of the President, newspaper articles, public speeches, and the like. Advocates of the political constraints view have not plumbed these sources as extensively. Meltzer's work focuses on the years up to 1969, ending with William McChesney Martin's departure as Chair of the Federal Reserve. DeLong draws mostly on secondary sources. Several histories of economic policy in the 1970s (Kettl, 1986; Wells, 1994; Matusow, 1998, for example) incorporate primary source documents, but cover a much broader set of issues than the conduct of monetary policy during the period. In this paper I ask whether Federal Reserve documents from the 1970s support the hypothesis that political constraints played a role in the formation of monetary policy that led to the Great Inflation. I find that the answer is a definite yes: there is as much or more evidence in Federal Reserve documents for a political explanation for the Great Inflation as for any of the misperceptions views.

The study is based on an analysis of Federal Reserve documents from 1969 to 1981, including speeches of the Fed Chairmen (available online through the Federal Reserve Bank of St. Louis in the Federal Reserve Archival System for Economic Research); Records of Policy Actions (RPAs) from the Federal Reserve Bulletin; Memoranda of Discussion from FOMC meetings (*Minutes*) for 1969 to 1975 (provided by the Board of Governors of the Federal Reserve System); and transcripts of FOMC meetings (*Transcripts*) for 1976 to 1981.[1] My approach to analyzing the historical documents differs from that used by other authors in that I focus on the reasons for the Fed's policy actions at key turning points during the Great Inflation.

[1] Transcripts for the years 1978 to 1981 were obtained from the Board of Governors website. These are verbatim transcripts edited by Board staff. Transcripts for 1976 to 1977 were obtained from the Gerald Ford Presidential Library. These are the raw, unedited transcripts; where necessary I made minor changes marked in brackets to clarify what I took to be the speaker's meaning. Forecast data shown in the figures that appear in the paper are from Greenbooks prepared for each meeting of the FOMC. These were provided by the Board of Governors. The federal funds rate target series was compiled from attachments to the Memoranda of Discussions and the Records of Policy Actions.

I seek not merely to demonstrate that the Fed recognized the political constraints on its actions during this period, but that those constraints actually affected its policy actions.

The FOMC documents tell the following story. During the 1970s, policymakers at the Federal Reserve struggled to reconcile their duty to maintain stable prices with the fact that there was little political support from the President, Congress, or the public for definitive action to control inflation. Under these conditions, the monetary policy strategy that evolved was one in which the primary responsibility of monetary policy was to maintain a healthy rate of economic growth rather than a stable price level. The Fed would attempt to control periodic bouts of inflation with a "gradualist" policy. Under this policy, growth was allowed to fall modestly below the rate of growth of potential output but must at all costs remain positive. Monetary policies aimed at deliberately causing or increasing significantly the risk of a recession were not seriously considered. When recessions did develop, whether as the unintended result of previous monetary policy actions or because of exogenous shocks, the Fed's primary responsibility was to promote economic recovery.

A logical outcome of this strategic approach to monetary policy was an interest in macroeconomic policy coordination. Because the effect of moderately contractionary monetary policy on inflation was understood to be modest, the heavy lifting in any fight against inflation was to be done by the President and Congress through fiscal, incomes, and regulatory policy. It was understood that monetary policy should support – or at the very least not counteract sharply – the macroeconomic policies of the Administration and Congress.

In its meeting-to-meeting implementation of this monetary policy strategy, the Fed found itself navigating a treacherous political terrain. Members of the FOMC frequently expressed displeasure at the persistence of inflationary pressures, but were always aware of the limits imposed on the Fed's anti-inflation efforts by political reality. During periods of moderate growth and relatively subdued inflationary pressures, the Fed was reluctant to head off inflation with a pre-emptive tightening. When growth strengthened and inflation rose, the Fed could take advantage of support for tighter policy. But when growth slowed, the Fed found it necessary to ease policy quickly. The result was the stop-go policies that characterized the 1970s. This cycle was finally broken in 1979 when inflation reached a crisis level and a public mandate formed to take painful measures to reduce it. During 1979 and 1980, the Carter Administration's declaration that inflation was "public enemy number one," combined with the public's

perception that the Administration's economic policies were ineffectual, created an opening for the Federal Reserve to take the lead in fighting inflation. Paul Volcker skillfully used this opening to create a new role for the Federal Reserve as the independent guardian of price stability.

The message of this paper is not entirely inconsistent with Orphanides' mismeasurement hypothesis. According to the mismeasurement hypothesis, an overly optimistic view of the sustainable pace of real activity affects inflation only if unemployment or output growth enters into the Federal Reserve's policy rule. Orphanides finds that monetary policy was more responsive to changes in real activity during the 1970s than in later periods, with the result that mismeasurement had a large effect on inflation. This paper offers an explanation for the Fed's intense concern with unemployment and growth in the 1970s and the shift in focus towards control of inflation in the 1980s. At the same time, however, I find that at key turning points during the Great Inflation monetary policy actions were taken in response to political pressures despite strong evidence available to members of the FOMC that the consequences would be inflationary. Thus, while mismeasurement played a role at times, at other times political pressures or constraints played an independent role in sustaining the Great Inflation.

I find little support for the misunderstandings hypothesis as it applies to policymakers within the Federal Reserve. Throughout the period of the Great Inflation there is ample evidence that the Fed Chairmen and members of the FOMC understood that overly expansionary monetary policy was the root cause of inflation and that monetary restraint was the key to reducing inflation. Paul Volcker's beliefs about the economy did not differ substantially from those of Arthur Burns. The key difference was in their understanding of the political constraints under which the Fed operated: Burns had little room for maneuver in monetary policy while Volcker understood that he had a political mandate to control inflation. Romer and Romer and Nelson make a stronger case for the idea that policymakers outside the Federal Reserve held views of monetary policy that blinded them to the effects of policy on inflation. This paper provides evidence that the Fed responded to pressure and constraints from Congress and the executive branch, thereby explaining how the views of those entities affected monetary policy. While Romer and Romer and Nelson interpret the transmission of these beliefs to monetary policy as a problem of economic understanding, I interpret it primarily as a political problem.

Section 2 of the paper describes the views of the Fed chairmen – Burns, Miller, and Volcker – regarding monetary policy. This section provides some evidence against the misunderstandings view and in favor of the idea that political constraints helped shape monetary policy strategy during the period of the Great Inflation. Section 3 constructs a history of monetary policy from 1969 to 1981 with a focus on the turning points between attempts at disinflation and growth promotion. This section describes how the political environment in which the Fed operated constrained its monetary policy choices. It also discusses the events that led to the policy changes under Paul Volcker's chairmanship. Section 4 concludes.

2. THE VIEWS OF THE FED CHAIRMEN

This section summarizes the views of the Chairmen of the Federal Reserve during the period of the Great Inflation based on their public speeches. I have two objectives. First, I provide evidence contrary to Romer and Romer's and Nelson's argument that policymakers believed that monetary policy could not be used to bring inflation under control. I argue that the Fed chairmen considered the main impediments to the effectiveness of monetary policy to be political rather than structural. Second, I argue that these political impediments shaped the Fed's approach to monetary policy throughout the period. Specifically, the Fed adopted a "gradualist" approach to controlling inflation and deferred to the President and to a lesser extent Congress when setting the stance of monetary policy. These two strategic choices provide a framework for understanding monetary policy choices at key turning points during the Great Inflation.

According to the misunderstandings hypothesis, during the period of the Great Inflation monetary policymakers held a variety of views about the macroeconomy that we now know to be incorrect. Romer and Romer and Nelson provide evidence that policymakers believed that monetary policy was incapable of reducing inflation or was capable of doing so only at a cost that was vastly overestimated, and that inflation was mainly caused by "supply-side" or "cost-push" factors rather than monetary policy. Nelson refers to these beliefs as a "nonmonetary" view of inflation.[2] The Fed did not use monetary policy to control inflation, according to this theory, because it believed that structural rigidities in the macroeconomy had weakened the link between monetary policy and inflation. My reading of the speeches of the Fed chairmen and

[2] Romer and Romer also emphasize the belief that the natural rate of unemployment was very low, a belief that I have characterized as the mismeasurement hypothesis.

FOMC documents, however, suggests that Arthur Burns adhered to a fairly modern, “monetary” view of inflation. The limitations he saw in the effectiveness of a monetary policy led disinflation program were primarily political, not structural. The nonmonetary view can more readily be ascribed to G. William Miller, but he too was as likely to mention political impediments to a successful disinflation policy as structural impediments. Paul Volcker’s views of the effectiveness of monetary policy did not differ sharply from those of his predecessors, but his understanding of the political environment facing the Fed was radically different.

The most complete articulation of Arthur Burns’ understanding of the origins of the Great Inflation and the role of monetary policy is in his often-quoted Per Jacobsson speech shortly after his term in office ended (Burns, 1979). Burns argued that “philosophic and political currents” that had begun in the 1930s had created a bias toward inflation (p. 9). The result of all of these developments was an increase in aggregate demand (of which federal government deficits were an important component), increased rigidity in labor and product markets, and an intolerance of government inaction in the face of even mild recession.

Burns acknowledged that throughout the 1970s the Fed technically had the ability to control inflation through monetary policy, but that political realities forced the Fed to accommodate the stated macroeconomic goals of Congress and the President.

> Viewed in the abstract, the Federal Reserve System had the power to abort the inflation at its incipient stage fifteen years ago or at any later point, and it has the power to end it today. At any time within that period, it could have restricted the money supply and created sufficient strains in financial and industrial markets to terminate inflation with little delay. It did not do so because the Federal Reserve was itself caught up in the philosophic and political currents that were transforming American life and culture.
>
> … Every time the Government moved to enlarge the flow of benefits to the population at large, or to this or that group, the assumption was implicit that monetary policy would somehow accommodate the action… If the Federal Reserve then sought to create a monetary environment that fell seriously short of accommodating the upward pressures on prices that were being released or reinforced by governmental action, severe difficulties could be quickly produced in the economy. Not only that, the Federal Reserve would be frustrating the will of Congress to which it was responsible – a Congress that was intent on providing additional services to the electorate and on assuring that jobs and incomes were maintained, particularly in the short run.
>
> … Facing these political realities, the Federal Reserve was still willing to step hard on the monetary brake at times – as in 1966,1969, and 1974 – but its restrictive stance was not maintained long enough to end inflation. By and large, monetary policy came to be governed by the principle of undernourishing the inflationary process while still

accommodating a good part of the pressures in the marketplace...

> … As the Federal Reserve … kept testing and probing the limits of its freedom to undernourish the inflation, it repeatedly evoked violent criticism from both the Executive establishment and the Congress and therefore had to devote much of its energy to warding off legislation that could destroy any hope of ending inflation. This testing process necessarily involved political judgments, and the Federal Reserve may at times have overestimated the risks attaching to additional monetary restraint. (Burns, 1979, p. 15-16)

The monetary view of inflation that is clearly presented in this speech was reflected in Burns' public speeches throughout the 1970s (for example, Burns 1970, p. 4; Burns 1974, p. 17; Burns 1977, p. 4-6). Romer and Romer and Nelson marshall their own quotations in support their claims that Burns downplayed monetary factors at certain times. They argue that the views of Burns and other policymakers changed from a nonmonetary view in the early 1970s to a monetary view in the mid-1970s and back to a nonmonetary view in the late 1970s before the Fed under Volcker adopted a modern view in the 1980s; their chronologies are summarized in Table 1. Such high-frequency changes in beliefs about the structure of the macroeconomy seem implausible.

On the other hand, a consistent theme in Burns' statements at the FOMC, detailed in the next section, is the presence of political constraints on the use of monetary policy to quell inflation. Political constraints took two forms. At times, Burns was concerned that an independent, monetary policy led attempt at disinflation would invite direct retaliation against the Fed from Congress or the executive branch. At others, Burns argued that Congress and the executive branch would respond to any monetary policy induced recession with expansionary fiscal policies that would counteract the Fed's policy. Implicit in this second argument was the assumption that ultimately the Fed would have to conform its policy to that of the government. For the most part Burns did not acknowledge these political constraints in public statements while he was Chairman (he was quite explicit about them, of course, in his Per Jacobsson speech cited above). An exception came in his speech to the American Bankers Association in 1970.

> An effort to offset, through monetary and fiscal restraints, all of the upward push that rising costs are now exerting on prices would be most unwise. Such an effort would restrict aggregate demand so severely as to increase greatly the risks of a very serious business recession. If that happened, the outcries of an enraged citizenry would probably soon force the government to move rapidly and aggressively toward fiscal and monetary ease, and our hopes for getting the inflationary problem under control would then be

> shattered. (Burns 1970, p. 12)

Burns was more likely in his public statements merely to note the severe economic consequences of monetary contraction as a reason for inaction. A statement in Congressional testimony in July 1974 is typical.

> From a purely theoretical point of view, it would have been possible for monetary policy to offset the influence that lax fiscal policies and the special factors have exerted on the general level of prices. One may therefore argue that relatively high rates of monetary expansion have been a permissive factor in the accelerated rate of inflation. I have no quarrel with this view. But an effort to use harsh policies of monetary restraint to offset the exceptionally powerful inflationary forces of recent years would have caused serious financial disorder and economic dislocation. That would not have been a sensible course for monetary policy. (Burns 1974, p. 17)

Similar views were expressed in a number of public statements (for example Burns 1972, p. 11; Burns 1973, p. 2-4). Throughout his tenure, in his public statements and in deliberations at the FOMC, Burns consistently made clear that the goal of reducing inflation was secondary to the goal of preventing recession. This attitude came not from misunderstandings about the effect of monetary policy on inflation, but from his own philosophical inclinations and his perception of the political constraints on the Fed's freedom of action.

Burns' successor, G. William Miller, seems to have held to a view of inflation in which monetary policy took a back seat to supply-side forces. Nelson (2005, p. 26-27) provides some evidence of this nonmonetary viewpoint. But even Miller did not entirely dismiss the importance of monetary policy. In a speech in December, 1978, for example, Miller detailed the role of monetary policy in reducing inflationary pressure.

> Finally, a word about monetary policy in the war against inflation. Of course, monetary policy must play a key role. The Federal Reserve therefore moved early and progressively this year to apply monetary restraint and reduce the growth of money and credit…. We are determined to see that the inflation rate is pushed in the right direction – down toward zero – and that it is kept moving in that direction until we reach that level. The short term goal of all these policies has been to effect an immediate slowdown in the growth of the U.S. economy, while maintaining balanced conditions… Our objective will be to maintain slower growth for a considerable period of time, working off inflation but avoiding disruption of international economic progress. (Miller, 1978c, p. 11-13)

In cases where Miller seemed to suggest that monetary policy could not be effective in reducing inflation, he was as likely to cite political constraints as structural economic rigidities.

A speech in July, 1979 is a typical example.

> Moreover, inflation has become resistant to the old-fashioned remedy of recession. During the 1973-75 recession, prices continued to rise nearly 11 per cent. The effects of recession operate to divert us from our basic course: recession entails automatic increases in Federal deficits; increases pressure for additional Federal spending; produces strains from increased unemployment. Recession cannot solve the inflation problem; it only makes it more intractable. Consequently, we need to be steadfast in our efforts to ensure that the present recession remains moderate and does not develop into a more serious downturn. (Miller 1979, p. 3)

Importantly, Miller argues that recessions do not help reduce inflation, not because of structural rigidity in the economy, but because of the policy response a recession could be expected to provoke. Recession produces (political) pressures for more government spending, which feeds the fire of inflation in the future.

In the final analysis, the message of Burns' and Millers' speeches is not that monetary policy cannot control inflation; rather, it is that the economic costs of controlling inflation with monetary policy alone would be greater than society was willing to bear. This understanding shaped two key elements of Burns' and Miller's strategic approach to monetary policy. First, the Fed would pursue a gradualist approach to reducing inflation rather than attempting to contract monetary policy so hard as to effect a rapid disinflation. At FOMC meetings in the late 1970s, for example, Burns mentioned that the Fed's objective was to squeeze inflation out of the economy over a ten year period (*Transcript*, 7/19/1977, Tape E, p. 1). Second, inflation needed to be attacked using a multi-pronged effort with monetary policy consigned to a supporting rather than leading role. This explains Burns' advocacy of price controls in 1971 and of nonmonetary strategies to control inflation throughout his tenure.

Miller took this idea to the extreme. In a number of speeches, Miller outlined a comprehensive anti-inflation policy that would include expanding training for unemployed workers, adopting a national energy policy, using tax policy to stimulate savings and investment in physical capital, reducing government spending as a fraction of GNP, reforming government regulatory activities, and promoting exports (Miller, 1978b; Miller, 1978c). The subordinate role of monetary policy in such a program was outlined in testimony before the Senate in April 1978.

> The Federal Reserve believes that its determination to hold monetary growth within the ranges just adopted will work to curb inflation over the longer run and at the same time provide adequate money and credit for continued eonomic growth. However under current conditions – when inflationary pressures are to a great extent embodied in the

> structure of the economy – any deceleration in monetary growth rates has to be undertaken with caution. The pace of deceleration cannot proceed much more rapidly than the pace at which built-in inflationary pressures are wrung out of the economy if satisfactory economic growth is to be maintained. Thus, bringing inflation under control urgently requires the co-operative efforts of the Administration, the Congress, the Federal Reserve, and the private sectors of the economy. The Federal Reserve should not be left to combat inflation alone. (Miller 1978a, p. 12)

Statements by Burns and Miller emphasizing the presence of structural rigidities that increase the cost of contractionary monetary policy have been cited as evidence for the misunderstandings view. It is important to note, then, that similar statements can be found in the speeches of Paul Volcker. Repeatedly in speeches, testimony and in discussions at FOMC meetings Volcker acknowledges the same sorts of nonmonetary pressures on inflation as did his predecessors. In remarks to the National Press Club in 1981, for example, Volcker argued that

> The inflationary process, after continuing for years, is embodied in a whole pattern of economic, social, and political behavior that tends to sustain – and accelerate – its own momentum. We see the process at work in the pattern of three-year wage bargaining, building in rising levels of costs into the future; in aggressive pricing policies, justified by the proposition that everyone is doing it; in attempts to protect one's own position by indexing, usually to a consumer price index that is itself distorted; in demands for inflation premiums in financial markets and interest rates; in the search for inflation hedges in real estate or elsewhere. To be sure, starving the inflationary process by restraining money and credit long enough can ultimately curb that behavior – and there are signs it is beginning to do so now. But to rely on that course <u>alone</u> would surely delay the process of correction, and pose more risks and exact more pain than a balanced approach. (Volcker 1981, p. 4)

Volcker repeatedly called for a comprehensive approach to controlling inflation so that monetary policy would not be left to deal with the problem on its own. This was the point he made in House testimony in November 1980.

> The point is sometimes made that, in theory, monetary restraint, sustained strongly enough and long enough, can alone do the job of restoring price stability. Perhaps so – in the long run. But over what period of time and at what unnecessary cost, in recurrent pressures on financial markets, in inhibiting investment and dampening productivity, in lost output and deferred growth? … What we must do is convey a general sense – and make good on that message – that excessive money and credit creation will not underwrite the inflationary process. Taken alone… that commitment implies an extraordinarily heavy burden on monetary policy. So equally, we need the perception and reality that essential monetary restraint will be combined with persistent and effective policies in other directions so that monetary restraint can be tolerable and sustainable. (Volcker 1980, p. 9-10)

These other policies included putting off any plans for tax cuts until they could be matched by spending restraint, reducing dependence on foreign sources of energy, and increasing competition by reducing government regulation of some industries. The subtle difference between Volcker's views cited above and those of Burns and Miller is that Volcker placed monetary policy at the forefront of the fight against inflation, with other policies treated as complementary. In similar statements, Burns or Miller promised that monetary policy would support fiscal and supply-side policies, not the other way around. Volcker, unlike his predecessors, was willing for the Fed to fight inflation by itself if necessary. For Burns and Miller, the fact that monetary contraction alone was so costly made it necessary for government to take the lead in reducing inflation through fiscal and regulatory policies. Monetary policy would contract at a pace dictated by the government's success in those areas. Volcker, by contrast, was determined to contract monetary policy in spite of the high costs, challenging government to implement reforms in order to make the transition to low inflation as painless as possible.

To summarize, the lack of a political mandate for a harsh assault on inflation forced the Fed in the 1970s to adopt a temporizing strategy. During periods of expansion the Fed turned a blind eye to incipient inflationary pressures. When inflation became a problem, the Fed deferred to Congress and the President for direction; to the extent that the Fed took action against inflation, this action took the form of "gradualist" policies that sought to "undernourish" inflationary forces while maintaining a positive rate of growth. Success against inflation came only when the Fed perceived that Congress, the President, and the public were willing to tolerate harsher measures. The following section shows how the Fed's monetary policy strategy shaped the decisions it made at key turning points during the Great Inflation.

3. MONETARY POLICY DURING THE GREAT INFLATION

I divide the period of the Great Inflation into six subperiods: the 1969-70 disinflation; the expansion of 1971-73, the disinflations of 1973 and 1974-75; the expansion of 1976-78, and the 1979-82 disinflation. In each of these episodes there came a point in time at which the Fed's actions or its failure to act constituted a key turning point. In 1972 and 1977, the Fed chose to continue with policies of expansion despite evidence of rising inflationary pressures. In 1970, 1973, and 1974, the Fed abandoned disinflation programs before there was any evidence of a

substantial reduction in inflation. In each case, the Fed's failure to control inflation set the stage for a future inflationary outburst and led to a steady ratcheting up of inflation over the course of the decade. In 1981, by contrast, the Fed stuck to its policies of disinflation despite high costs, dealing a decisive blow to inflation.

The Fed's premature abandonment of disinflationary policies in 1970, 1973, and 1974, and the success of the Volcker disinflation, are of particular interest.[3] Figure 2 shows the path of the federal funds rate, inflation rate, unemployment rate, and GNP growth rate during each of these episodes. The data is quarterly, and for each episode the variables are normalized to zero for the quarter preceding the start of the disinflation (period 0). In the case of the first three episodes an attempt to restore price stability was terminated at the first sign of economic weakness with inflation higher than it was when the episode began, setting the stage for a resurgence of inflationary pressures. By contrast, the 1979-82 disinflation was much longer (13 quarters) than the preceding attempts. The Fed eased monetary policy only after inflation had fallen 4 percentage points below its initial level. Importantly, the Fed maintained its tight policy through a period in which GNP fell two percentage points below its initial level and the unemployment rate increased by over four percentage points.[4] Had the Fed maintained a tight policy in 1970, 1973, or 1974 it might have struck a definitive blow against inflation. To understand why inflation was allowed to continue until the end of the decade we need to find out what motivated the Fed at these critical moments.

3.1 The first disinflation attempt, 1969-1970

The origins of the Great Inflation in the mid-1960s have been discussed at length elsewhere (Kettl, 1986; DeLong, 1997; Meltzer, 2005; and others). After a number of false starts, the Fed finally committed itself to monetary contraction in December 1968. The disinflation continued until February 1970, at which point the Fed began to ease aggressively. Figure 3 shows the evolution of key variables during this episode. The upper left panel shows the weekly average of the federal funds rate and (beginning in February 1970) the midpoint of the Fed's target range for the federal funds rate. The upper right panel shows actual inflation as measured by the GNP deflator along with the Greenbook forecasts of current quarter and two-quarter-

[3] The precise begin and end dates of these disinflations and details of how particular dates were arrived at are provided in the Appendix.
[4] The drop in the federal funds rate in the third and fourth quarters of the disinflation (1980:Q2-Q3) was a response to declining money demand during this period, not an abandonment of the disinflation effort. Further analysis of this period is provided in the appendix.

ahead GNP deflator inflation. The lower panels show comparable figures for the unemployment rate and real GNP growth.

While there is a tendency to lump the 1969 disinflation together with the failed disinflations of 1973 and 1974, there was a crucial difference. In contrast to 1973 and 1974, during meetings of the FOMC in 1969 Chairman Martin and others on the Committee made it clear that they were willing to stick with the disinflation attempt even at the risk of triggering a recession. As shown in Figure 2 and discussed above, the willingness to persevere despite recession was ultimately the key to ending inflation in the early 1980s. My reading of the historical record is that had Martin not been replaced by Arthur Burns in 1970, the disinflation of 1969 may have been continued to a successful conclusion.

In making the decision to tighten at the end of 1968, the FOMC under Chairman McChesney Martin saw itself as making a conscious break with the policy of gradualism favored by the incoming Nixon Administration. The break was noted by Governer Maisel in the meeting of April 1969.

> Mr. Maisel hoped that the System would not alter its basic monetary strategy at least as he had understood it. It should stick with the policy of maintaining a slow but adequate growth in the monetary aggregates. Specifically, the System's policy should be one of maintaining the growth of the monetary aggregates somewhat below normal for a considerable period of time in order that it might obtain the greatest anti-inflationary impact possible from monetary policy…
>
> … he did not think the System should adopt such a goal [to curtail bank lending] at this time. Officials of the new Administration had made it clear in nearly every speech on the subject that they thought such a goal would be a mistake. They had been publicly critical of the 1966 experience. They had made clear that they wanted to attempt a gradualist approach to the ultimate goal of price stability They had repeatedly stated their hope that the Federal Reserve would cooperate in such an approach…
>
> Finally, he gave considerable weight to the publicly expressed view of the new Administration. National goals and national priorities when expressed by the President and his Cabinet should be considered as of major importance and should be given a heavy weight by the Federal Reserve in determining its own goals and strategy. (*Minutes*, 4/1/69, p. 66-69)

Maisel's view, which might have been Chairman Martin's a few years previously, was now in the minority. In the meeting of May 27, Martin made clear his determination to persevere with the restrictive policy.

> Chairman Martin said he thought the present was a critical period… He was also disturbed, the Chairman remarked, by the continuing skepticism regarding the determination of policy makers to cope with inflation. It was widely assumed that the Federal Reserve was prepared to bail out those who might find themselves in financial difficulty if they complained loudly enough; and that a ½ point increase in the unemployment rate would result in an abandonment of fiscal restraints and a large increase in Federal spending.
>
> He hoped no member of the Committee would underestimate the seriousness of the situation, Chairman Martin continued. In view of existing problems … he thought the only responsible course for the Federal Reserve was to maintain the prevailing pressure… (*Minutes*, 5/27/69, p. 73-75)

The tough talk continued into the summer of 1969. In the August meeting Martin argued that the Fed could not afford to retreat from its anti-inflation stance until there was visible evidence of a break in inflation expectations.

> [Chairman Martin] had reread with considerable care the Committee's records since last August and had come to the conclusion that the System had been misled into premature easing in 1968… [G]iven the prevailing inflationary climate… he felt that it was important for the System not to get into a position of validating the expectations of numerous skeptics who believed the System would ease its policy as soon as it heard the words "recession" or "overkill." (*Minutes*, 8/12/69, p. 77-78)

Martin continued to resist the temptation to ease even when staff economists raised alarm at the prospect of an imminent recession in the September and October meetings. In the January 1970 meeting (Martin's last as Chairman), the FOMC continued with its restrictive policy despite unmistakable signs of a slowdown.[5] The federal funds rate, which was close to nine percent in the week of the meeting, stayed above nine percent for the rest of the month. Thus Martin's term ended with the Fed still committed to a contractionary course, despite the fact that by that time the economy was in recession.

The disinflation effort that had begun at the end of 1968 was abandoned in 1970 as a result of the efforts of Martin's successor at the Federal Reserve, Arthur Burns. Much has been written about the circumstances of Burns' appointment as Chairman of the Federal Reserve. Burns' inauguration ceremony as described in Wells (1994, p. 42) reveals the expectations that President Nixon for the new Fed chairman.

[5] In adopting the directive in this meeting, the Committee rejected language in the Bluebook's Alternative B indicating a marked easing ("System open market operations… shall be conducted with a view to achieving slightly less firm conditions in the money market") in favor of a slightly stricter statement ("System open market operations… shall be conducted with a view to maintaining firm conditions in the money market").

> Nixon made his expectations of Burns brutally clear: the economist was to reduce interest rates and avoid recession. When the new chairman took the oath of office in January 1970, the president remarked, "I have some very strong views on some of these economic matters and I can assure you that I will convey them privately and strongly to Dr. Burns… I respect his independence. However, I hope that independently he will conclude that my views are the ones that should be followed." When Burns received a standing ovation, Nixon interjected, "You see, Dr. Burns, that is a standing vote of appreciation in advance for lower interest rates and more money." In private the president was, if possible, blunter. He told Burns, "You see to it: no recession."

Burns ultimately delivered the monetary policy that Nixon desired in 1970, but he had to prevail over the more hawkish members of the FOMC. To some degree, Burns' decision to ease must have arisen from the philosophical views described in the previous section: namely, his belief that the public would not accept a recession, and that if a recession did unfold as a result of the Fed's actions, either the Administration would adopt inflationary fiscal policies or the Fed's autonomy would come under attack. At the same time, it is clear from the *Minutes* that direct pressure from the Administration, and to a lesser extent from Congress, added urgency to Burns' desires to see a resumption of growth.

Burns achieved his first victory in the struggle to ease monetary policy in the meeting of February 10, 1970, his first meeting as Chairman. Wells (1994, p. 55) describes this meeting as "one of the most raucus in the institution's history." Following the presentation of Greenbook forecasts that indicated a slight deterioration of economic conditions since the January meeting, the staff presented the Committee with two alternatives. Alternative A would continue the current policy of restraint with money supply growth rates in the 3 to 4 percent range for the first quarter and a federal funds rate just over 9 percent. Alternative B represented a modest easing move with the federal funds rate falling to 7.5 to 8.5 percent and money supply growing at a rate of 4 to 5 percent.

In the discussion that followed, only one member spoke in favor of Alternative B; all the other members spoke either in favor of Alternative A or for something between A and B. Burns capped the discussion by offering what he interpreted as a consensus position that was in fact close to Alternative B. Two members of the committee objected strenuously, arguing in effect that Burns had mischaracterized the views of the majority. In the end Burns' recommendation prevailed in a split vote. In the weeks following the meeting, the federal funds rate fell from an average of 9.2 percent the week of the meeting to 8.3 percent by the first week of March.

The Minutes of the February 1970 meeting provide little evidence for any of the "misperceptions" theories. There are no statements indicating that participants held "nonmonetary" views of inflation or were excessively pessimistic about the inflation-unemployment tradeoff. To the contrary, most of the Committee members argued that economic slack was necessary to reduce inflationary pressures. For those who pointed out that inflation had become somewhat impervious to economic slack, the lesson was that the Fed needed to continue the course of monetary restraint all the longer in order to make gains against inflation. Mr. Clay's statement in the go-around is representative:

> In most respects, Mr. Clay continued, the results of economic policy [i.e. the slowdown], while slow in coming, had been those which constituted the essential forerunner to correction of the price inflation problem. The price inflation impact would be expected to lag, but the price problem had proven to be particularly stubborn. The severity of the price inflation problem was related to the momentum that had been built into the economy in the years of accelerating inflationary developments, and the inflationary expectations that had come to be established. It also was related to the institutional arrangements whereby wage patterns and the prices that flowed from them became established in negotiations between powerful labor unions and large business corporations and were then transmitted throughout the economy. Presumably the fuller impact of the policy actions that had been taken would bring increasing restraint on price inflation over time, but the process probably would be slow… Mr. Clay commented that monetary policy had been very tight for a long time. So far as he could foresee, it would need to be a restrictive force for a considerable period ahead. (*Minutes*, 2/10/70, p. 67-68)

Did the Fed ease aggressively in 1970 because in overestimating the amount of slack in the economy members believed that inflationary pressures were falling? In retrospect, it is not clear whether Committee members were right or wrong to be concerned about a developing recession. The most recent estimates of the NAIRU and output gap from the Congressional Budget Office (2007) offer conflicting evidence about the amount of slack in the economy in 1970: the CBO estimates the NAIRU to be 5.9 percent in 1970 compared to an actual rate of 5.0 percent, while at the same time estimating an output gap of -0.78. Statements by some members who argued for a modest amount of easing suggest that they believed that an unemployment rate of five percent would put downward pressure on inflation (see statement by Mr. Galusha, *Minutes* 2/10/70, p. 73). But the majority of Committee members argued that the Fed should not ease until there were clear signs that inflation was falling. And the Greenbook forecasts show that there was no sign of falling inflation: forecasts of current and two-quarter-ahead inflation were 4.2 and 3.9 percent respectively and had been rising since October 1969.

Chairman Burns did not elaborate in the February meeting on his reasons for pushing a policy reversal. Minutes from subsequent meetings, however, show that strategic-political calculations were an important motivating factor. Two types of political considerations were paramount. First, Chairman Burns was concerned that a failure by the Fed to act against recession would cause the Administration and Congress to adopt expansionary fiscal policies that would worsen the inflationary problem in the long run.

> Chairman Burns commented that in his opinion fiscal policy currently was strongly restrictive. However, in response to a question by Mr. Galusha he expressed the view that, if the weakening in the economy became pronounced and monetary policy remained highly restrictive, within a few months there was likely to be an increase in Federal spending so large as to carry a real danger of a resurgence of inflationary pressures. He made that statement with confidence on the basis of intimate knowledge of the thinking of members of the Administration and some knowledge of Congressional thinking. (*Minutes*, 3/10/70, p. 61)

Implicit in this argument is the assumption that the Fed would be compelled to accommodate a fiscal expansion. Second, Burns was worried that the President and Congress would retaliate against the Fed if it was seen as insensitive to the needs of the real economy.

> In sum, Chairman Burns said, he thought there were clear and present problems of both inflation and recession. Those problems were being interpreted in one way by business and financial people, particularly those in the great money centers; quite differently by the great mass of the public; and certainly quite differently by Congress. There was a piece of legislation before Congress now which had grown out of judgments that there was a clear and present problem of recession in the economy and of depression in the housing industry – and that Congress had to do something about the latter. He was referring to the omnibus housing bill containing the Proximire Amendment [this would require the Fed to make low interest housing loans to qualified borrowers]. In all likelihood the bill would be enacted, and unless the Proxmire amendment were dropped or modified it would be only a matter of time before the Federal Reserve would find itself in the position of some Latin American central banks. (*Minutes*, 4/7/70, p. 52-53)

Throughout 1970 the economy continued to weaken steadily while inflation remained stubbornly high, and Burns pushed the FOMC to adopt a more expansionary stance than many members felt comfortable with. By December the federal funds rate had fallen to just under 5 percent from its high of over 9 percent at the start of the year. The Nixon Administration and members of Congress continued to push for a more expansionary policy. The President's Council of Economic Advisors argued that the Fed should aim for a nine percent increase in the money

supply (Wells, 1994, p. 61). Burns did not go this far, but he began to argue that the Fed needed to make up for the sluggish growth in M1 earlier in the year.

At the meeting of January 12, 1971, Burns made a plea for the Committee to take further aggressive actions to fight recession. The issue for Burns was "credibility" with the Administration; by this he seems to have meant that if the Fed was not perceived to be pursuing a strong growth policy, the Administration would resort to an expansionary fiscal policy.

> One thing the System could do, Chairman Burns remarked, was to strengthen the Administration's confidence in the Federal Reserve. As far as society as a whole was concerned, confidence in the Federal Reserve appeared to be strong and growing. However, the Administration's confidence in the System was weakening as a result of the shortfalls that had occurred in the rates of monetary growth. He was not concerned so much about the loss of System prestige and credibility as he was about the possible impact on other Governmental policies… The credibility of the Federal Reserve would be greatly strengthened if it became apparent that the Committee was seeking to make up the recent shortfalls [in money growth]. (*Minutes*, 1/12/71, p. 36-37)
>
> … Chairman Burns said he might add a word on the subject of credibility. It was important that System officials never lose sight of the fact that the Federal Reserve was a part of the Government, and that whatever the Federal Reserve did or failed to do would have an influence on the actions of the Administration and the Congress. He had good reason to think that the fiscal policy now being developed in the Executive Branch was being influenced by certain interpretations which Administration officials were making – rightly or wrongly – of System policy. He had defended that policy to the best of his ability, but there was a limit to what one could do in defending the unwanted results of a policy. (*Minutes*, 1/12/71, p. 64-65)

The Committee complied, and by the spring of 1971 monetary policy was on a more firmly expansionary path with the federal funds rate below four percent by March. At the April 6 meeting, Burns seemed to indicate that the measures the Fed had taken since January had satisfied the Administration.

> Chairman Burns said it was now recognized within the Administration to a much greater degree than earlier that the monetary authorities had done their job well, and that if any further stimulation was needed it would have to be provided by fiscal policy. (*Minutes*, 4/6/71, p. 22)

The decision to embark on an expansionary monetary policy in 1970 meant that the effort to confront the problem of inflation was suspended. By the end of 1970 inflation was running at an annual rate of 5.0 percent and the Fed's forecasts of inflation were right where they had been at the end of 1969.

3.2 The expansion of 1971-73

From 1970 to 1971 the economy struggled through a period of high unemployment, slow growth in real GNP, yet stubbornly high inflation. By 1972 economic growth was running at annual rates exceeding five percent and unemployment was falling rapidly from its peak of six percent in 1971:Q3. Inflation remained subdued in the four to five percent range, largely because of the price controls imposed in August 1971, but began to accelerate toward the end of 1972. In retrospect, the failure to raise interest rates more aggressively in 1972 was a critical mistake. Why did the Fed fail to act?

One factor during this period may well have been that Committee members misjudged the degree of slack in the economy. In May of 1972, for example, with the unemployment rate at 5.7 percent, the staff economic report noted that an acceleration of real GNP growth to 8 percent for the second half of the year was a welcome development that would reduce excess capacity in the economy, bringing the unemployment rate down to 5.2 percent by the end of 1972. At the same time, several Committee members expressed concern throughout 1972 that excessive growth was fueling inflationary pressures despite the perceived degree of slack in the economy, and advocated a modest tightening (Mr. Kimbrel, *Minutes*, 4/18/72, p. 60; Mr. Hayes, *Minutes*, 5/23/72, p. 32; Mr. Winn, *Minutes*, 6/20/72, p. 79; Mr. Robertson, *Minutes*, 8/15,72, p. 54.)

Previous authors have cited statements by policymakers during this period that seem to reflect a belief that inflation, having been caused by cost-push factors, could not be contained with monetary policy. Most of the statements to this effect in the FOMC records, however, make clear that the constraint on monetary policy was not a structural one, but the willingness of the public and political actors to tolerate the amount of unemployment that a monetary solution would entail. Mr. Heflin's comments in the July 1972 meeting were typical.

> Mr. Heflin said he agreed with Mr. Leonard that current monetary policy was about right and that the accolades in the press were deserved… It was important, however, to keep the limitations of monetary policy in mind. To a large extent the inflation that was currently being experienced was of the cost-push variety, and monetary policy could not act to correct that sort of inflation without fostering a level of unemployment that would be unacceptably high in the present political and social climate. (*Minutes*, 7/18/72, p. 28-30)

Strategic-political considerations were arguably the most important reason for the Fed's failure to act in 1972. The root of the problem facing the Fed was the Nixon Administration's

New Economic Policy, announced in August 1971. The key elements of the plan included a tax cut, reduction in government expenditures, a devaluation of the dollar, a ten percent import tax, and a 90-day wage and price freeze. Wage and price controls were continued in various forms until the spring of 1974. As it happened, spending cuts were never implemented and so the main thrust of the NEP was to stimulate growth. Throughout the fall of 1971 the FOMC debated whether the Fed's obligation was to support the price stability objectives of the NEP or the growth objectives. At the same time, the Nixon Administration was pressuring the Fed to pursue an expansionary policy. The Administration's actions, including leaks to the press falsely accusing Burns of demanding a pay raise in the summer of 1971, are well-documented (see Ehrlichman 1982; DeLong 1997; Wells 1994; Kettle 1986). Congress was applying pressure as well: a bill was under consideration in the fall of 1971 that would stimulate the economy by creating half a million public service jobs (Wells, 1994, p. 84).

In the meetings immediately following the announcement of the NEP Committee members sought to frame monetary policy recommendations as supporting the Administration's program. Since the program was aimed at both reducing inflation and stimulating growth, however, advocates of contractionary and expansionary policies were able to take this tack. Mr. Hayes, for example, advocated using the breathing space provided by the wage and price freeze to take a stand against inflation in the meeting of August 24.

> … the System should not create the impression of having abandoned its anti-inflationary stance simply because a 90-day freeze has been proclaimed. Longer term wage and price restraints are yet to be developed, and with a tendency for fiscal stimulus to increase, monetary policy will continue to be needed as an ally in the Administration's efforts to check inflation. (*Minutes*, 8/24/71, p. 89)

Chairman Burns and the majority of Committee members, however, opted to allow interest rates to drift down in order to support the growth objectives of the NEP. In the months that followed the possibility of raising the federal funds rate in order to contain growth and inflation was raised repeatedly, but rejected in part because of concerns that the Administration would see interest rate increases as an attempt to thwart the growth objectives of the NEP. Several Committee members, including Mr. Hayes and Mr. MacLaury, were under the impression that the Nixon Administration would create problems for the Fed if it allowed interest rates to rise above their mid-August levels (*Minutes*, 9/21/71, p. 58,60). This concern as well as a general desire to follow the lead of the Administration on macroeconomic policy led the FOMC to pursue a fairly

expansionary policy through the end of 1971. The thinking of the majority is well represented in statements by Mr. Maisel and Mr. Kimbrel in the September meeting.

> In his view, Mr. Maisel continued, the desirable growth rates at this time were those that would best complement the Administration's new economic program. In particular, funds should not be supplied at a pace below the normal growth of demands. (*Minutes*, 9/21/71, p. 68)

> Mr. Kimbrel observed that in his opinion the Committee's options were somewhat limited. On the one hand, it probably should not allow interest rates to go above their mid-August levels. On the other hand, if it permitted too rapid a rate of money supply growth it could undermine anti-inflation efforts and risk a loss of confidence which could be ill afforded. He favored a cautious and neutral policy--one that avoided injecting large amounts of reserves and producing sharply lower money market rates. (*Minutes*, 9/21/71, p. 70)

Despite the Committee's efforts to maintain an expansionary policy, money supply growth weakened in the fall of 1971. In the December meeting, Chairman Burns called the Committee's attention to the money supply figures, noting the political problems that this posed for the Fed.

> Chairman Burns said he would like to make a brief final statement before the go around on policy. As the Committee knew, the new economic program the President had announced on August 15 was designed not only to stabilize the price level but also to stimulate growth in the economy. What had been the record of monetary policy since August? If the staff's projections for December were realized, over the last four months of the year M1 would have grown at an annual rate of 0.8 per cent, M2 at a rate of 6.2 percent; and total reserves at a rate of 3.5 per cent...

> Indeed, in light of the behavior of the aggregates some people were now asking whether the Federal Reserve was deliberately moving to a restraining policy so as to nullify what the Administration, with the support of Congress, was attempting to accomplish. (*Minutes*, 12/14/71, p. 48-51)

In January 1972 Chairman Burns took the unusual step of calling the FOMC together a week before the regularly scheduled meeting to address the money supply figures. There were no significant changes in macroeconomic conditions or the Greenbook forecasts that could have motivated the change in the timing of the meeting. Instead, it appears that Chairman Burns's urgency in addressing the money supply figures was motivated by his upcoming testimony before Congress at which he would be expected to justify the Fed's performance in light of the NEP. Chairman Burns was frank about the political consequences of failing to get monetary growth rates up.

> In his view, Chairman Burns continued, it was important that the performance of monetary policy improve rather promptly. In that connection, he might note that he was scheduled to testify before the Joint Economic Committee on February 9. In essence, his task would be to give an accounting to the Congress on how the Federal Reserve had been contributing to the national objectives of economic growth and orderly reduction in the rate of inflation – that is an accounting of the contribution the System had been making to the success of the new economic program which the President had announced on August 15. That program had the support not only of the entire Administration but also of both political parties in the Congress, as the passage of the Economic Stabilization Act and the Revenue Act of 1971 clearly attested. (*Minutes*, 1/11/72, p. 5)
>
> … It was the virtual absence of growth in M1 in the fourth quarter that he thought was difficult to justify, the Chairman continued. He believed, and was fully prepared to argue, that no damage had been done to the economy as yet in view of the liquidity the Federal Reserve had supplied earlier. However unless the aggregates now began to grow at adequate rates he would become fearful about the future of the economy, and he would also feel that there might be some validity in a charge that the System was not supporting the policies of the Administration and Congress. (*Minutes*, 1/11/72, p. 62)

At the conclusion of this meeting the FOMC adopted a highly expansionary directive ("to promote the degree of ease in bank reserve and money market conditions essential to greater growth in monetary aggregates over the months ahead") which resulted in a reduction in the federal funds rate from over four percent in December to around 3-1/4 percent by early February.

The debate over the Federal Reserve's responsibilities vis-à-vis inflation and growth in the context of the New Economic Policy was settled by the meeting of February 1972. At this meeting Chairman Burns reported to the Committee that in his Congressional testimony he had committed the Fed to using monetary policy to foster economic growth. He read portions of his testimony to the Committee:

> At this stage of the business cycle it is essential to pursue a monetary policy that will facilitate good economic recovery. Supplies of money and credit must be sufficient to finance the growth in consumer spending and in investment plans that now appears in process. Let me assure this Committee that the Federal Reserve does not intend to let the present recovery falter for want of money or credit. And let me add, just as firmly, that the Federal Reserve will not release the forces of a renewed inflationary spiral.
>
> We are now in a favorable position to provide the monetary support needed for a quickening pace of production and employment… (*Minutes*, 2/15/72, p. 46-47)

By 1972, then, the Fed had committed itself to supporting the growth objectives of the NEP and in general deferring to the Administration in the setting of monetary policy goals. This

attitude continued through 1972. In the meeting of April 18, Mr. Maisel was explicit in adopting the Administration's growth targets as his own:

> In his judgment, Mr. Maisel continued, to accommodate GNP growth in the second half at the projected rate [10 to 10-1/2 percent] would be consistent with the nation's goals. The Administration had indicated that GNP should grow by at least that much, if not more, and Congress would view such a rate as low. If a problem of excessive expansion developed in 1973, it would not have been created by the Federal Reserve…
>
> Chairman Burns then remarked that he wanted to endorse Mr. Maisel's comments... (*Minutes*, 4/18/72, p. 53-54)

In the same meeting, Mr. Brimmer argued essentially for an abdication of the Fed's responsibility for fighting inflation in light of the NEP.

> Mr. Brimmer observed that there also was a continuing problem of inflation, despite the control program that had been in effect since mid-August 1971. However, no one should have expected to see the problems of inflation and unemployment simultaneously resolved within the eight months that had elapsed since last August 15. The significant point was that the Administration had decided at that time – with the support of the Congress and the Federal Reserve – that the way to solve the problem of inflation was to apply direct controls rather than to slow the rate of economic growth and increase excess capacity. If more effective means of fighting inflation were needed they should be sought in tighter controls, perhaps along the lines the Chairman had suggested, and not through monetary policy. (*Minutes*, 4/18/72, p. 57-58)

An additional barrier to any impulse the Committee may have had to tighten monetary policy in 1972 came from the Committee on Interest and Dividends. In the face of rising aggregate demand, the public was chafing at the Administration's wage and price controls. Controls on interest rates and dividends through the CID were seen as a signal that the burden of price controls would be shared equally across income classes. Members of the FOMC understood that, were the Fed to tighten enough to increase interest rates, the price controls would come under attack. In that event, the Nixon Administration would push back against the Fed, with uncertain consequences for the Fed as an institution. In August Chairman Burns, while downplaying any explicit political constraints on Fed policy, acknowledged the difficulties that the Fed would face through the CID if it began raising interest rates.

> With respect to Mr. Brimmer's earlier remarks concerning constraints on interest rates, he [Chairman Burns] commented that there were no political constraints. Nevertheless, the Federal Reserve System was a part of the Government. At present the Government had an incomes policy that applied to prices, to wages, and to profits; and through the

> Committee on Interest and Dividends, it also applied – on a voluntary basis – to dividends and interest rates. That committee had already anounced that the guideline limiting increases in dividends to 4 per cent a year, which had been respected by virtually every corporate enterprise in the country, would be extended into 1973…
>
> Given the framework of the Government's incomes policy, Chairman Burns continued, there was widespread opposition to higher interest rates. Thus far the record on interest rates had been extraordinarily good, and while the System could claim only a small part of the credit for that record, it had made its contribution. Nevertheless, voices had been raised to advocate ceilings on interest rates. Fortunately, resistance to ceilings had come from the President and from the Secretary of the Treasury as well as from himself, and so far resistance had succeeded. In the circumstances, the Federal Reserve should not be eager to raise interest rates. (*Minutes*, 8/15/72, p. 74-75)

These concerns were reiterated in the following meeting in the course of an extensive discussion of the desirability of a modest tightening. Mr. Hayes shaded his recommendation for tightening in light of the price control issue

> Ordinarily, in view of the inflationary risks, he would lean toward a half-point rise [in the federal funds target], even though that might have some further effect on short-term market rates. On the other hand, he was quite aware that the System was in a delicate position in a period of wage and price controls, so that discretion in the form of a quarter-point move might recommend itself. (*Minutes*, 9/19/72, p. 47)

Mr. Coldwell and Mr. MacLaury argued for raising rates despite these concerns, prompting Burns to make a forceful argument for standing pat.

> Chairman Burns said he had not planned to comment further until the remaining members had expressed their views on policy. In light of Mr. Maclaury's concluding remarks, however, he might say a word at this point about the Committee on Interest and Dividends which as the members knew was a Government-wide Committee including only one representative from the Federal Reserve Board. A rather strong body of sentiment was developing within that committee in favor of a public statement admonishing lenders in all categories to act prudently in setting interest rates, and suggesting gently – but still suggesting – that if they failed to do so the Committee would establish guidelines for interest rates. The proposal for such a statement was facing some opposition, but it might be approved. If guidelines were established the result would be a confontation between the Federal Reserve and the Executive establishment – a prospect that was extremely disturbing. (*Minutes*, 9/19/72, p. 70)

And with that, the FOMC kept the federal funds target range essentially in place until the end of 1972.

3.3 The 1973 disinflation

By the end of 1972, the unemployment rate was nearing five percent, economic growth was still in excess of six percent, and inflationary pressures appeared to be intensifying. The Fed finally decided to move to a more restrictive policy in January 1973. The decision to tighten resulted in a steady increase in the fed funds target rate from 5.125-5.875 percent in December to a peak of 10-11 percent in August 1973.

A number of changes in the political environment facilitated the Fed's decision to tighten. First, the unemployment rate had fallen to a level (five percent) that the public, Congress, and the Administration would accept as close to full employment, so the Fed could not be accused of strangling the recovery prematurely. Second, the 1972 election was behind them. Finally, the uncertainty about the likely reaction of the Committee on Interest and Dividends to an interest rate increase seem to have been resolved in a way that gave the Fed more leeway than it had had earlier (Burns, *Minutes*, 1/16/73, p. 24).

Nevertheless, the Fed consciously rejected an aggressive attack on inflation in favor of a "gradualist" approach. The more aggressive option was presented to the Committee at the meeting of March 19, 1973 in the form of simulations of alternative monetary policy strategies using the staff's econometric model. The table is reproduced as Figure 5 below. The staff economists presented three alternative monetary policy strategies for 1973-1974: an expansionary policy with M1 growth at 7 percent per year, a tight policy with a 4 percent growth rate for M1, and a moderate policy (an extension of the current stance) with a 5.5 percent growth rate. The inflation rate was expected to be 4.0 percent and the unemployment rate 4.9 percent in 1973:Q2 regardless of the target set for M1. From there, the expansionary policy was expected to reduce unemployment to 4.5 percent by the end of 1974 at a cost of allowing inflation to rise to 4.7 percent. The contractionary policy would push inflation down to 3.5 percent at a cost of 6.2 percent unemployment. The moderate policy would stabilize inflation and unemployment at 4.0 percent and 5.4 percent respectively, avoiding outright recession but foreswearing any attempt at reducing inflation below 1973:Q2 levels.

Here is clear evidence that monetary policymakers understood that there was a way to reduce inflation involving a reduced rate of growth of the money supply and a mild recession. According to Romer and Romer and Nelson, one reason the Fed did not act more aggressively against inflation in the 1970s was that it overestimated the cost of disinflation. This hypothesis can be tested by examining the figures corresponding to the four percent money growth option in

Figure 5. According to the staff's projections, a half-point reduction in inflation after seven quarters would come at a cost of 3.2 percent excess unemployment (assuming a normal rate of 4.9 percent), implying a sacrifice ratio of 6.4. By comparison, when the Fed finally did undertake a more aggressive tightening in 1974:Q2, the result was a decline in inflation from 9.1 percent to 7.3 percent seven quarters later at a cost of 14.9 percent-quarters of excess unemployment (from a base unemployment rate of 5.2 percent), for a sacrifice ratio of 8.3.[6] It is certainly true that the Fed shied away from an aggressive approach to inflation because of the projected costs, but it is not fair to say – on the basis of this document at least – that these costs were overstated.

After considerable debate, the FOMC approved a long run target range for M1 of 5-5.5 percent, just slightly tighter than the moderate scenario. In doing so, the Fed adopted a gradualist policy whose objective was merely to prevent inflation from worsening rather than to achieve a meaningful reduction. As before, the Fed's choice was driven by the strategic-political calculation that the public, Congress, and the Administration would oppose a more meaningful effort.

Mr. Partee laid out the gradualist approach in the March meeting, emphasizing that the alternative of an all-out effort against inflation would be politically unsustainable.

> To adopt a substantially more restrictive policy that carries with it the danger of stagnation or recession would seem unreasonable and counterproductive. As unemployment rose, there would be strong social and political pressure for expansive actions so that the policy would very likely have to be reversed before it succeeded in tempering either the rate of inflation or the underlying sources of inflation…
>
> The best solution in the present difficult situation, I believe would entail a slowing in the economic expansion to the minimum sustainable rate which would appear to be in the 3 to 4 per cent range. The unemployment rate would tend to drift upward once this slower growth rate had been sustained for a while. Even so, progress in reducing inflaton would probably be modest – all that can be expected in today's environment from aggregate demand management measures. (*Minutes*, 3/19-20/73, p. 16-17)

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[6] The formula for computing the sacrifice ratio using quarterly data is $SR = \left| \frac{\sum_{t=0}^{6} (u_t - u_0)}{\pi_0 - \pi_6} \right|$. For the staff estimate, t=0 is 1973:Q2 and the data is from Figure 8. For the "actual" sacrifice ratio, t=0 is 1974:Q2 and the data is quarterly averages of GDP deflator inflation and unemployment rate from the Haver Analytics database.

The Fed's decision to pursue a gradualist policy was driven at least in part by the Fed's understanding of the range of unemployment rates deemed politically and socially acceptable. The fear expressed by many Committee members was that an unemployment rate in excess of five and a half or six percent would trigger demands for a more expansionary fiscal and monetary policy that would ultimately derail the Fed's long-term efforts to control inflation. The determination to keep unemployment within acceptable bounds became so ingrained in the Committee's deliberations that staff economists did not even present the Committee with monetary policy alternatives that would have a realistic chance of reducing inflation. At the meeting of June 18, for example, the economic staff forecasted a slowdown in economic activity from its current, unsustainable level, together with rising and persistent inflation, under a policy of "continued moderate growth in the money supply" (*Minutes*, 6/18/73, p. 22). Under this scenario, the unemployment rate was projected to rise to 5-1/2 percent by the end of 1974, which the staff deemed "unacceptable" (*Minutes*, 6/18/73, p. 26). The staff ran simulations with unemployment constrained to be in what it considered an acceptable range of 4-1/2 to 5 percent. In the final analysis, Mr. Partee warned the Committee that if it chose to maintain its current target of 5-1/4 percent for the growth in M1, it would be forced to ease significantly at a later date in order to keep unemployment from rising out of the acceptable range. Mr. Morris and Chairman Burns applauded the staff's decision to constrain the Committee's choice set in this way, citing the political repercussions of higher unemployment rates.

> Mr. Morris expressed the view that the staff had been quite realistic in framing its unemployment and price constraints within a fairly narrow range. He was afraid that if a 6 per cent unemployment rate were to be generated, the consensus between the Administration and the Congress calling for restraint in Federal expenditures might well be destroyed. A 5 per cent unemployment rate might be tolerated for an extended period of time but not a 6 per cent rate.
>
> Chairman Burns agreed that a 6 per cent unemployment rate could well lead to a massive Federal budget deficit and also to a marked easing in monetary policy, thereby laying the foundation for further inflation in the future. To achieve price stability it was necessary to avoid recessions, because it was during recessions that the forces of inflation were released. Accordingly, he agreed that the constraints imposed by the staff in its model simulations were probably realistic. (*Minutes*, 6/18/73, p. 33-34)

As the Fed gradually raised interest rates to fight inflation, Committee members repeatedly gauged the degree of support the policy was attracting from Congress and the Administration. Some degree of restraint was clearly required in light of the fact that inflation

had risen to 6.8 percent by 1973:Q2 and 7.9 percent by 1973:Q3, but unemployment could not be allowed to rise past the 5.5-6 percent threshold. At the June meeting, Chairman Burns remarked that the Fed appeared to be operating within politically-acceptable bounds:

> Under other circumstances, the recent extraordinary rise in interest rates and the early-June increase in the discount rate to its highest level in more than 50 years might well have brought the Federal Reserve under sharp attack in the press and in Congress; the fact that there had been no such attack was an indication that confidence in the System itself was high. (*Minutes*, 6/19/73, p. 110)

The same political calculus was acknowledged by several Committee members in subsequent meetings.

> Inflation was a fact of life, Mr. Sheehan remarked, and the issue at the moment was whether monetary policy should finance it or starve the economy and precipitate a recession. Experience suggested that the Government could not permit the kind of recession that might serve to bring inflation under control without giving rise to political pressures that would result in a massive Federal Government deficit. He, for one, did not want to incur the risk associated with a relatively deep recession. (*Minutes*, 7/17/73, p. 43)

> The urgent task is to ensure that aggregate demand slows somewhat further, and then remains at a moderate pace long enough for the inflationary processes of recent years to unwind. But it is equally urgent to accomplish this without precipitating a recession. If economic activity weakens too much next year, the pressures to reopen the monetary spigot would almost certainly become too powerful to resist. (Mr. Gramley, *Minutes*, 9/18/73, p. 13)

> Projections made by his [Mr. Eastburn's] staff suggested that the rates of monetary growth under alternative C would result in a recession in 1974. Even if the Committee were willing to accept that, it was not a practical alternative. As soon as a recession began to develop and unemployment began to rise, pressures would become irresistible to reverse course and generate rapid rates of monetary growth. The resulting stop-and-go policy would be the worst approach of all. (*Minutes*, 9/18/73, p. 48)

By the fall of 1973, with projected growth in GNP falling, Chairman Burns and others on the Committee began to express concern that the Fed had perhaps carried tightening too far. From October to December the Fed backed away cautiously from its policy of restraint, ending up with a policy directed at reducing the severity of the recession that appeared to be unfolding by early 1974.

The reason for this policy reversal was clearly not a belief on the part of the Committee that it had achieved gains against inflation. The Greenbook forecasts had current-quarter inflation rising from 6 percent in August to 6.4 percent in October and 7 percent in December.

Two-quarter-ahead forecasts, meanwhile, rose from 5.8 percent to 6.65 percent. Nor was the Committee under the illusion that further monetary restraint would be ineffective against inflation: as in March, in the November meeting Mr. Partee summarized the staff's analysis of alternative monetary policy paths showing that only a reduction in money supply growth from current ranges would allow for a reduction in inflation (*Minutes*, 11/19/73, p. 18). Rather, the Fed began easing in October because of concern about a slowdown in the growth of monetary aggregates. By December, in the wake of uncertainties and a weakening economy following the Arab oil embargo, the decision to ease was motivated primarily by a desire to soften the impact of recession.

The concern about monetary aggregates had a political dimension. In a conference call on October 10, Chairman Burns had expressed concerns about the absence of growth in M1 in the third quarter. This, he argued, violated a commitment to positive growth in the aggregates that the Fed had made to Congress and the public.

> System officials had repeatedly stated to Congress and the public that the Federal Reserve intended to pursue a monetary policy that would permit moderate growth of the monetary aggregates. If the System were to allow the period of very low or negative growth in the money stock to continue much longer, it would not only be damaging its credibility; it would be failing to meet its responsibilities to the economy and to the nation. (*Minutes*, 10/10/73, p. 4-5)

Mr. Morris reiterated the argument in the meeting of October 16:

> The immediate goal should be to spur growth in the monetary aggregates. He wanted to pursue that goal not only because he believed it was the correct policy but also because the credibility of the System might turn on its attainment. Market participants and the public at large had been assured, through statements by the Chairman and in other ways, that the Federal Reserve would not permit the monetary aggregates to contract for a prolonged period, and he was concerned about the possible reactions to a failure to make good on that commitment. (*Minutes*, 10/16/73, p. 47-48)

Likewise, some members – including Mr. MacLaury – were motivated to act against recession out of concern for the Fed's political standing if it persisted with a moderately tight monetary policy.

> In concluding, Mr. MacLaury said it was his impression that the Committee had been concerned last winter about possible reactions in the Congress if interest rates had been allowed to rise rapidly at that time. It seemed to him that there would be even greater grounds for concern about reactions if the Committee should fail to evidence in some way its recognition of the change in the economic outlook. The directors of the

> Minneapolis Reserve Bank did not believe that discount rate action would be appropriate at this time, but they did feel that – to use the words of Chairman Burns – a modest and cautious easing of monetary policy would be desirable. (*Minutes*, 12/18/73, p. 81)

Ultimately the Committee eased cautiously, voting to raise the long-run growth target for M1 to 5-1/4 percent and allow a further modest reduction in the federal funds rate. The federal funds target rate, which had been 10 to 11 percent in August 1973, was reduced to 9.25 to 10.25 in the October meeting and again to 8.75 to 10 in December. By February the Committee had reduced its target to 8.25 to 9.5 percent. Thus while the Fed never eased aggressively, the aggressive attempt to restrict the economy in order to reduce inflation had been suspended.

3.4 The 1974 disinflation

While the Fed pursued its policy of cautious expansion, inflation began to rise dramatically in the early months of 1974. The Fed's estimate of current quarter inflation, which had been at 6.1 percent in early December 1973, rose to 7.0 percent at the end of December and to 8.1 percent in January 1974. At the same time the unemployment rate was rising from 4.6 percent (the Fed's early December estimate) to 5.0 percent in January. GDP growth, which had been estimated to be 3.8 percent in early December, was estimated to be -1.3 percent by late January. The Fed now faced a choice between easing further in order to fight recession or tightening to fight inflation. Gradually in the early months of 1974 the emphasis turned to fighting inflation.

The shift toward a policy of disinflation was enabled by the Committee's reappraisal of the willingness of the public and government to tolerate a modest tightening. As a result, the Fed once again adopted a gradualist approach to fighting inflation. This policy was described by Mr. Wallich in the March meeting.

> … the objective should be to pursue a path of monetary growth such that economic activity continued to expand, but at a rate not necessarily much faster than its potential and perhaps even below. Although that might lead to political problems, real GNP would be rising and the economy would not be going into recession. At the same time, excess capacity would be increasing somewhat, providing some possibility of a gradual reduction in the rate of inflation. He would reject as both substantively and politically unsound a policy of so tight a rein that economic activity failed to recover at all and excess capacity built up rapidly. (*Minutes*, 3/19/74, p. 134-135)

Burns likewise noted that the Fed could withstand any political opposition to an anti-inflation policy, and that in fact the opposition had been slight thus far.

> Because the System had substantial independence, the Chairman observed, it could resist political pressures to pursue inflationary policies, and it should do so. Moreover, at the present time neither the Administration nor the Congress was urging the Federal Reserve to pursue a more expansionary course. One of the distinguished liberal members of the Congress recently had commented to him that the System was not exercising with sufficient determination the independent power that the Congress had deliberately granted to it. (*Minutes*, 3/19/74, p. 139)

With this understanding of the political environment in which it was operating, the Fed began raising the target for the Federal funds rate. Throughout this period of contraction, the Committee continued to monitor the policy's political support. The April 16 meeting featured a discussion about Congress' likely response to the Fed's restrictive policies, with Mr. Morris and Chairman Burns agreeing that Congress was not currently in opposition.

> Mr. Morris observed that over the past 2 months there had been a very sharp rise in interest rates and indications of the beginning of disintermediation. In the past such events had precipitated strong protests about restrictive monetary policy in the Congress, but he had seen no evidence of such a reaction as yet. He wondered if the Chairman expected that situation to persist.
>
> The Chairman observed that he would not be willing to predict that the absence of protests would continue indefinitely. However, he might note that, although he regularly received a great deal of protest mail from the public, he had not as yet received any communications from Congressmen critical of the recent increase in interest rates. (*Minutes*, 4/16/74, p. 72)

Chairman Burns added that since January the Administration had made fighting inflation a priority in its fiscal policy deliberations, implying that the Fed's policy was not inconsistent with that of the Administration.

> Chairman Burns remarked, with respect to the current political environment, that the Administration's position at the beginning of the year was that a recession must be prevented and that whatever neded to be done would be done. Members of the Administration – including the President – had been weighing the economic situation, and in view of signs of improvement in economic activity and of intensification of the inflation, the present position was that a tax cut – such as had been proposed by some members of the Congress – must be opposed. That was a clear and deliberate decision reached by the Administration. (*Minutes*, 4/16/74, p. 85)

Again in the June meeting, Committee members noted strong support for the Fed's restrictive stance among Congress and members of the public. Mr. Kimbrel mentioned support for Fed policy from the businessmen in his district (*Minutes*, 6/18/74, p. 54-55). Mr. Balles

reported that Congressman Ullman, ranking majority member of the House Ways and Means Committee, had expressed his consent to a tight policy in a recent speech. More generally,

> Mr. Balles expressed the hope that the Committee members would not underestimate the extent of Congressional support for its present posture. He thought a majority of the Congress would concur in the System's efforts not only to slow the actual rate of price advance but also to dampen inflationary expectations.
>
> Chairman Burns said he might offer his appraisal of the existing support for current Federal Reserve policy. He agreed that the support in the Congress was strong; he had been receiving almost no critical mail from that source. (*Minutes*, 6/18/74, p. 61-62)

Mr. Wallich's remarks suggest that he saw limits to public support for the Fed's anti-inflation efforts. While the public, in his view, would support a reduction in growth, it was not likely to tolerate an outright recession. Hence he recommended continuing the gradualist path.

> The country was prepared to accept a certain amount of economic slack in the effort to combat inflation, and the amount that was tolerable would be greater if it developed gradually. It might well turn out that an inflation of the present type could not be ended without a recession, but the System certainly had to try; accordingly, he would favor aiming for a growth rate in real GNP of 2 or 3 per cent. While he recognized that it might not be possible to fine tune to that extent, he would not want to restrain the real sector any more than that. (*Minutes*, 6/18/74, p. 68)

The debate over the political acceptability of slow growth was carried on again in the July meeting. Though the economic staff had suggested a slight easing because of forecasts of real GDP growth of around one percent for the next year, several Committee members expressed their belief that Congress and the public would tolerate such a low rate of growth if it were necessary to reduce inflation.

> Mr. Mayo remarked that he found himself in basic agreement with the staff's analysis of the outlook. However, he would question Mr. Partee's judgment that a real growth rate of less than 1 per cent would be unacceptable to the public. Until a few months ago he (Mr. Mayo) would have agreed with that statement, but it now seemed to him that a substantial body of support for inflation control had developed throughout the nation, even among those who were adversely affected by anti-inflationary policy. He thought the public at present would be prepared to accept a 1 per cent growth rate in GNP over the next year if that were required for better control of inflation…(*Minutes*, 7/16/74, p. 25)

Mr. Mayo's analysis was supported by Mr. Hayes and Mr. Francis, while Mr. Gramley argued that there was no public support for an outright recession. (*Minutes*, 7/16/74, p. 32-33). In the end, Chairman Burns sided with those who saw substantial political support for the Fed's mildly restrictive stance.

> Chairman Burns remarked that he had received a different impression in his appearance before the House Ways and Means Committee yesterday. He had expressed his view that little or no economic growth could be expected for some months, and that that outlook should be accepted as a matter of policy under present circumstances. None of the members of the Ways and Means Committee, not even the more liberal members, expressed any shock or criticism. More generally, in his many recent conversations with Congressmen he had found widespread acceptance of the need for slow economic growth; they reported that their constituents were more anxious about inflation than about unemployment. (Minutes, 7/16/74, p. 34)

Though others on the Committee, Mr. Bucher and Mr. Sheehan among them, warned that public opinion could turn sharply against the Fed if a recession developed, the arguments of the more anti-inflation members prevailed.

The end of the disinflation attempt occurred in October 1974 when the Committee began reducing the federal funds target range significantly, from 11.5-12.5 in August to 9-10.5 in October, and eventually to 4.75-5.75 by March 1975. As in 1973, the Committee was under no illusion that the fight against inflation had been won: the two-quarter-ahead inflation forecast in October was 8 percent. Nor was there a belief that monetary contraction would not be effective in controlling inflation – the program of gradualism was specifically designed to reduce inflation by holding GNP growth to a rate slightly below potential. And whatever the Committee's estimate of the NAIRU was, at 6.8 percent (in subsequent meetings 7.0, 7.5, 8.1, and 9.35) the forecasted unemployment rates were well above what we now believe to be the natural rate. Instead, the Committee's decision to end the disinflation attempt before inflation had been reduced reflected its paramount concern with avoiding recession – which in turn had its origins in the Committee's understanding of the Fed's room for maneuver in a delicate political environment. Committee members repeatedly cited an unemployment rate of 6 percent or so as a kind of a trigger point beyond which the Fed would come under pressure to ease.

> …Mr. Morris observed that the most desirable course of economic activity – if policy could be fine-tuned – would be one that moved the unemployment rate up to 6 per cent and held it there for the next 2 years. The American people now would be willing to accept a 6 per cent rate as a cost of combatting inflation. More slack than that would not make much of a contribution toward achieving price stability, and it would run the risk of generating political forces in favor of efforts to reduce the level of unemployment – efforts which might then result in the more typical rapid recovery in activity. It would be better to pursue a policy of restraint that could be maintained for a while. (*Minutes*, 9/10/74, p. 83)

Mr. Wallich and Mr. Sheehan concurred, Mr. Wallich arguing for a policy that would keep real GNP growth at around 2 percent per year and Mr. Sheehan expressing a willingness to see the unemployment rate rise to 6.5 to 7 percent (*Minutes*, 9/10/74, p. 68-70).

In the October meeting, Mr. Morris and Mr. Partee argued that the coming recession would erode public support for the Fed's anti-inflation policy. Furthermore, the Administration could be expected to adopt policies that would counter the Fed's efforts and, in the long run, lead to more inflation (*Minutes*, 10/15/74, p. 31). Mr. Morris drew the implications for monetary policy.

> Mr. Morris said he believed that monetary policy had to be formulated on the assumption that the deeper the recession proved to be, the greater were the probabilities that Government policies adopted to combat it would produce too sharp a recovery. In order to restrain the contraction in business activity to the sort of mild recession that would be productive in reducing the rate of inflation over the longer run, the Committee had to be willing to tolerate enough of a reduction in the Federal funds rate to raise the rate of monetary growth. (*Minutes*, 10/15/74, p. 69)

Mr. Sheehan also advocated a substantial easing, noting that "the System was particularly vulnerable because of the way in which members of Congress perceived current monetary policy" (*Minutes*, 10/15/74, p. 73). Burns argued that the Fed should tolerate unemployment up to seven percent, the level it had reached in the recession of 1957-58 (*Minutes*, 10/15/74, p. 67). In the end, the Committee adopted a directive calling for "the resumption of moderate growth in monetary aggregates," the more modest of the two easing alternatives that had been presented to the Committee.

The modest easing was continued in the months following, turning to a strongly expansionary policy in February. The February decision was arguably justified by the severity of the recession that was unfolding, and the Fed may have felt that it had some leeway to ease because it projected inflation to fall slightly (inflation did in fact fall, from 12.5 percent in the fourth quarter of 1974 to 9.5 percent in 1975:Q1 and 6.2 percent in 1975:Q2). But at the same time the Committee felt pressure from various sources for a pro-growth stance.

Chairman Burns opened the February meeting with an acknowledgement that Congress was placing considerable pressure on the Federal Reserve. He pointed in particular to a concurrent resolution proposed by Senators Proxmire and Humphrey instructing the Federal Reserve to increase the growth rate of the monetary aggregates. Chairman Burns said that he was

prepared to argue in testimony before the Senate Banking Committee that this legislation was unnecessary, since the Fed had been pushing for higher growth in the money supply in any case (Minutes, 2/19/75, p. 7-9). Mr. Balles urged a reduction in the federal funds rate in part as a response to Congressional concern that the Fed was failing to achieve its monetary growth targets

> For many months M1 had fallen below the Committee's targets, and now both the economics of the situation and Congressional concern pointed in the direction of pursuing the monetary growth rates under alternative A. To achieve those rates of growth, both for the short run and the longer run, he would accept whatever decline in the Federal funds rate was necessary. (Minutes, 2/19/75, p. 61)

Chairman Burns argued that the Committee should not cave in to political pressures (*Minutes*, 2/19/75, p. 61-62), but this statement brought a rebuttal from Mr. Eastburn.

> Finally, while the Federal Reserve System was an independent entity, its actions were being closely observed. He [Mr. Eastburn] was concerned that there would be critical public reaction to continuation of a monetary policy that had produced very little growth in the narrow money stock over the past 6 months, a period in which the economy was moving into the worst recession since the 1930's. Continued pursuit of such a policy and failure to stimulate the desired rates of monetary growth promptly could have some undesirable long-run implications. With those thoughts in mind, Mr, Eastburn said, he favored alternative A. He would press to achieve more rapid monetary growth as quickly as possible. Concerning the discount rate, he would – in the absence of any unforeseen development – recommend a cut of one half of a percentage point to the directors of the Philadelphia Bank at their meeting tomorrow. (Minutes, 2/19/75, p. 68)

In the end the Committee adopted the most expansionary language suggested by the economic staff and the federal funds rate was allowed to drift down further – the target range was reduced to 5-1/4 to 6-1/4 percent.

3.5 The expansion of 1975-1979

As shown in Figure 7, from 1976 to 1979 the U.S. economy experienced strong growth, falling unemployment, and relentlessly increasing inflation. In retrospect it is clear that the Fed should have begun to tighten seriously toward the end of 1976, when the annual inflation rate topped six percent, or the end of 1977 when it reached 6.8 percent, or towards the end of 1978 when it reached 7.3 percent, or early in 1979 when it topped 8 percent. But the Fed waited until October 1979 to launch an aggressive assault on inflation.

The case for the misperceptions view as an explanation for the failure to act against inflation during this period is fairly weak. The transcripts do show that Committee members had

an arguably low estimate of the natural rate of unemployment – estimates tended to fall in the range of 5.5 to 6.0 percent or a little higher. But these underestimates did not translate into large forecast errors for inflation. Table 2 shows average errors, by year, in the Greenbook forecasts of current and two-quarter-ahead inflation, unemployment, and GNP growth. The forecast errors for inflation from 1976 to 1978 are positive but considerably smaller than in earlier high inflation periods such as 1970 and 1973. While Figure 7 shows that inflation was generally expected to moderate during this period (the two-quarter-ahead inflation line is usually below the current-quarter inflation line), the transcripts show continual concern about inflation throughout the period. At no point is there evidence from the FOMC documents that Committee members were convinced that inflation was moderating significantly. Committee members frequently expressed concern about "cost-push" factors driving the inflationary process, as noted by Romer and Romer and Nelson. However, there are very few statements suggesting that because cost-push factors were contributing to inflation monetary policy would be ineffective in combatting it. Rather, the vast majority of statements on the subject noted that the presence of cost-push factors raised the cost of combatting inflation beyond what Committee members were willing to accept.

As in earlier periods, there is considerable evidence that the Fed's failure to tighten in the face of rising inflation can be attributed to the compromises forced upon the Fed by the political environment. Early in the expansionary period, the Fed was able to maintain a slow recovery that pushed inflation down considerably. It was able to do this largely because of support from the Ford Administration and to a lesser degree from Congress. This support evaporated in 1977 when the President Carter took office, and in 1977 the Fed shifted to a policy more accommodative of growth. Beginning in early 1978 inflation accelerated, but the Fed appeared paralyzed as it waited for the Carter Administration to come up with an anti-inflation program. As inflation reached crisis levels in 1979 the Fed gradually came to the realization that it would need to act aggressively to prevent inflation from spinning out of control. The first steps in this direction came when Paul Volcker took over as Chairman in summer 1979.

Early in 1975 the Fed was under considerable pressure to pursue a strongly expansionary monetary policy. Congressional Democrats had made huge gains in the 1974 election and the new chairs of the Senate and House Banking Committees – William Proxmire and Henry Reuss – introduced legislation to force the Fed to ease substantially (Wells, p. 153). At the same time,

the Fed may have believed that it had "cover" from the Ford Administration, which strongly supported the thrust of the Fed's policy (Kettl, pp. 131-134).

Through 1975 and the first half of 1976, the Fed pursued a policy that would achieve a reduction in inflation without creating a serious confrontation with Congress. In practice, this meant attempting to achieve the highest rate of growth for the economy consistent with a downward path for inflation (*Minutes*, 6/16/75, p. 27-28). The Minutes from this period are replete with references to or concerns about the political acceptability of this policy. In the May meeting, for example, several Committee members debated whether a continuation of the Fed's cautious approach to stimulating the economy would provoke Congress into attempting to stimulate the economy through fiscal policy.

> Mr. Coldwell remarked that he was sympathetic to Mr. Hayes' view concerning the desirability of a slow recovery. However, there was a risk that Congress would not be inclined to accept the levels of unemployment being projected and might respond by enacting excessively expansive measures…
>
> Chairman Burns observed that in their budgetary planning the Budget Committees of the Congress were assuming a mid-1976 unemployment rate of about 7-1/2 per cent. It was significant that any Congressional committee was willing to tolerate a rate that high over so long a period. (*Minutes*, 5/20/75, p. 30)

Similarly, in the July meeting the FOMC wrestled with how its monetary targets would be perceived in Congress. As in May, Chairman Burns concluded that the Fed's policy was still in the bounds of acceptability.

> In that regard, Mr. Morris continued, he had been concerned about the conclusion of the recently published report of the Congressional Budget Office that money supply growth within the Committee's published target ranges would not be adequate for the economy but that the Federal Reserve would recognize the insufficiency and allow M to grow at a rate of about 8-1/2 per cent over the next 18 months. That report was representative of the problem of maintaining the credibility of the Federal Reserve with Congress. In his judgment, narrow ranges for the aggregates – allowing too little leeway on the upside – could involve a price in terms of the System's Congressional relations.
>
> Chairman Burns said it was possible that a problem with Congress would arise. He might note, however, that the recent report of the Senate Banking Committee had strongly endorsed the target ranges adopted by the FOMC. He found that endorsement quite encouraging. (*Minutes*, 7/15/75, p. 58-59)

Aware of the tightrope it was walking with Congress, the Fed maintained its cautious policy through the first half of 1976. In the meeting of May 1976, in fact, the Committee

authorized an increase in the federal funds rate in order to contain excessive growth in the monetary aggregates – despite the fact that unemployment was still above 7 percent and expected to continue at that level into 1977. But when some members of the Committee advocated a further modest tightening in the July meeting, Chairman Burns dug in his heels, arguing that the public and Congress would not accept a tightening at this time.

> … I think it's only fair to recognize that the real economy has recently shown some signs of hesitation… Now I believe that these uncertainties are likely to be resolved on the side of renewed rather vigorous expansion in the late summer and fall… But the general public would not understand, really, a move toward a restriction at the present time and once renewed expansion, renewed vigorous expansion, once that evidence is in three months later, I think the public would interpret, I think would be a more appropriate time to move towards a firmer monetary policy, and it would understand what we are doing better. (*Transcript*, 7/20/76, Tape 1, p. 3)

After a number of Committee members expressed support for a modest firming, Chairman Burns reiterated his objections:

> Well, I must give you a thoroughly candid response. I think I can explain it [a tightening] to your satisfaction, and even to my own. But I do not think I can explain it to the satisfaction of the general public, including Congress and the international [?] community. (*Transcript*, 7/20/76, Tape 2, p. 9)

As it happened, the economy continued to cool off somewhat in the fall, and the unemployment rate crept up. In November, with the unemployment rate still near 8 percent (but with the Greenbook estimate of inflation over 6 percent) the Committee eased modestly: the federal funds rate target range fell from 5.25-5.75 percent in June 1976 to 4.25-5 percent in December.

Jimmy Carter's victory in the 1976 election put an end to the Fed's attempt to contain inflation. In the campaign, Carter had criticized the Ford Administration and the Federal Reserve for the sluggishness of the recovery. It was not clear whether Carter would provide the Fed with the political cover against pressure from Congress that President Ford had provided. And Carter had proposed a fiscal stimulus package in the campaign that was bound to work against the Fed's anti-inflation policies. The Fed's position was complicated further by the fact that Chairman Burns' term of office would end in January 1978, and by all accounts he had a strong desire to be reappointed.

Members of the Committee began to express concern about the Fed's room for maneuver under the new Administration as early as the meeting of December, 1976 (*Transcript*, 12/20-

21/76, Tape 6, p. 5-6). By the meeting of January 1977 it was clear that the Carter Administration's main priority was to stimulate the economy. This caused Chairman Burns to back off from an attempt to continue the economy on a moderate disinflationary path. In the discussion of long-term monetary targets, Chairman Burns proposed a strategy that he hoped would eke out the maximum amount of tightness that was feasible without attracting opposition from the new Administration.

> Burns: … And finally, we need to consider the degree to which, if any, our monetary policy should contribute to unwinding the inflation from which our economy has been suffering since the mid-1960s… no other branch of government, certainly not the executive, certainly not the Congress, has anything approaching an articulate policy for bringing down the rate of inflation. Now if we at the Federal Reserve should fail to persevere in bringing down our monetary growth rates,… there would be no chance whatever for reestablishing a foundation for economic stability in the future. Now recognizing this basic principle, this Committee during the past 21 months has moved very gradually, but rather consistently toward lower monetary growth rates. Our moves may have been too gradual, but they at least have been in a salutary direction.
>
> Now in approaching the problem of setting monetary growth rates for the year ahead, I start with the basic thought that if at all feasible, we should once again make this small move in the direction of establishing monetary growth rates that are tolerably consistent with eventual return, or eventual restoration of a stable price level. Now this basic thought in my own mind is clouded, however, by other considerations, namely, unemployment is still unduly high; we have a new administration – the new administration has proposed a fiscal plan for reducing unemployment and any lowering of monetary growth rates at this time would I'm quite sure be very widely interpreted, and not only in the political arena, as an attempt on the part of the Federal Reserve to frustrate the efforts of a newly elected President, newly elected Congress, to get our economy, to use a popular phrase, "moving once again."
>
> I've tried… to bring these two sets of thoughts into some sort of harmony. And accordingly, my recommendations to the Committee are as follows. First, that we leave the projected growth range for M1 as is, namely, 4-1/2 to 6-1/2 per cent for the coming year. Second, that we modify the growth ranges for M2 and M3 – specifically, that the growth range of M2 be set at 7 to 10 per cent, instead of 7-1/2 to 10 per cent; also that the growth range of M3 be set at 8-1/2 to 11-1/2 per cent, instead of 9 to 11-1/2. Now the proposal to leave M1 unchanged has at least this advantage. You would avoid any charge that the Federal Reserve is indifferent to unemployment, or, and this is more serious, it would avoid the charge that we are seeking to frustrate the efforts of the new administration… Now I realize that the lowering of the lower limit of M2 and M3 might evoke some criticism. But on this point, I would say the following. First, no matter what we do there will be some criticism and this is an inevitable accompaniment of central bank action. I would say secondly, as we all know, far less attention is paid by the general public, by the Congress, even by economists, to M2 or M3 than to M1. M1 is still the

> magnitude that is widely followed and respected. And I would say finally, that even after lowering the lower limit of M2 and M3, the midpoint of the range for M2 and the midpoint of the range for M3 would still be precisely what it was 6 months ago. Therefore, no lowering from where it was 6 months ago, and that this would be duly noted in our statement to the Congress. (*Transcipt*, 1/18/77, Tape 7, p. 1-4)

In the discussion several members of the Committee remarked that the reduction in the lower bounds for M2 and M3 growth was purely cosmetic (*Transcript*, 1/18/77, Tape 7, p. 17; Tape 8, p. 5,9). The upshot of the proposal, which the Committee ultimately accepted, was that the Fed abandoned its policy of making progressive reductions in the long-term target ranges for monetary aggregates.

For the next three months there were no significant moves in the federal funds rate target, despite the fact that the Fed's forecasts showed that growth was picking up and inflation was accelerating. In the spring, responding to signs of accelerating growth and rising inflation, the Carter Administration announced a fiscal policy package aimed at reducing inflation by two percentage points by the end of 1979. In the April meeting several Committee members suggested that the Fed take advantage of the Administration's shift in policy to reduce the money growth rate targets. But Chairman Burns argued that the political situation was too uncertain for the Fed to take any bold actions. Once again, he limited his proposal to cosmetic adjustments in target ranges.

> Burns: … Now in view of what I have learned about the energy message and the uncertainty that that introduces to my own mind, I am inclined to make a much milder recommendation to the Committee. I think that we should make another small move towards reducing our monetary growth ranges today. But I think the move should be small indeed, and of the kind that would arouse a minimum of controversy thereby adding to the uncertainty that is likely to prevail… We would still be working very most gradually towards the objective of bringing the monetary growth rates down so that in time they will be consistent with the general price stability… I think that is now entirely consistent with what the President has stated, and the way to go or an objective for the inflation rate bringing the inflation rate down by something like 2 percentage points by the end of 1979. (*Transcript*, 4/19/77, Tape 5, p. 3)

Mr. Volcker agreed. In the current political environment he would have to be satisfied with the minimum possible step in the direction of tightening.

> Volcker: … If I really had my druthers and didn't have to – if we were living really in an apolitical climate I suppose – I would have bought both ends of your [Burns'] thinking. I would have liked to see the M1 range reduced by half a percentage just on the low side and some reduction on both sides of the M2 and M3… Putting all this together I do think

> we ought to have some reduction in something. The easiest thing is the upper end of the range and the most meaningful thing, as minor as it is, the upper end of the range on M2 and M3 by a half as you suggested… It's not very extreme in the context that we're talking, but just a half a per cent on the upper end of M2 and M3 is my margin of being satisfied that we have taken the minimum steps that we should take at this time. In a way I wish this meeting was a month later, one month removed from the rebate decision. I think we would not then be clouded by that psychological circumstance. (*Transcript*, 4/19/77, Tape 5, p. 11)

The Chairman's recommendation was adopted again. In the months that followed the Fed allowed only a slight drift upward in the federal funds rate while inflation continued to accelerate. By the end of June the Fed was estimating second quarter inflation to be 7.2 percent, up from 5.9 percent at the beginning of the year.

During the summer, economic growth remained strong and inflation continued to rise. Several members of the Committee expressed alarm and advocated a serious tightening. Once again, however, Chairman Burns proposed only cosmetic adjustments in the target ranges. In the discussion that followed, the political constraints on the Fed took center stage.

Early in the discussion, Chairman Burns proposed a very modest reduction in monetary targets. He acknowledged that at the current pace it would take ten years for money supply growth to reach a level consistent with price stability; nevertheless, he proposed only a half-percentage point reduction in the lower limit of M1 growth (*Transcript*, 7/19/77, Tape E, p. 1-3). Even this was too much for Mr. Wallich, who would only support the plan with the understanding that the Fed would be tolerant of overshooting the targets, since the economy was too weak to withstand a large rise in interest rates. This rather cynical attitude towards monetary targets – the use of "base drift" as a conscious strategy to get around money growth targets – was repeated on numerous occasions in subsequent meetings.

> Wallich: I would agree with the proposed proposal, Mr. Chairman, that you've made… But as a matter of principle, I think we are maneuvering here somewhat. We're not hitting our targets and we're using base drift to avoid being confronted with situations where interest rates would rise very sharply. I don't think this is the kind of expansion that can stand sharp increases in interest rates and so I would like to see us take this action with the understanding that if we overshoot, well then, we'll take another look. We do not absolutely hold to this target… I think one cannot take for granted that we can steadily continue this course without [loosing?] a rise in interest rates. That could be very troublesome. (*Transcript*, 7/19/77, Tape E, p. 5-6)

Responding to arguments in favor of a more aggressive tightening, Chairman Burns highlighted the political difficulties that the Fed faced, in particular the effect an announcement of serious reduction in target ranges would have on legislation (presumably the bills that became the Federal Reserve Reform Act of 1977) pending in Congress. He ended the discussion with a final plea for inaction.

> Burns: … Gentlemen, we're faced with a very hard decision. Speaking personally for a moment, I wish I could join my colleagues who would – were inclined to move towards somewhat lower growth rates. I have to – I wish I could. Tempermentally, yes. That's what I would prefer to do. But I do have an obligation to this Committee and to the System, as well as to the country. I'll have to testify before the Committee, I will have to defend whatever this Committee decides… Now the – as is, moving the lower limit down to 4 per cent will subject us to having attacks. I don't mind being attacked, but I want to be in a position, really, to answer the attacks in an effective manner. And I find it very difficult to do that at the present time because of the hesitation that some people are going to read into the economic events. Well I interpret the economy differently. Well, that will change – influence the thinking of some, and I am concerned about the legislation that we have before the Congress. (*Transcript*, 7/19/77, Tape F, p. 1-3)

For the next two months the economy continued to expand at a healthy pace. With money demand rising, the Fed allowed money supply growth to exceed targets while at the same time allowing the federal funds rate to drift higher. Members of the Committee were well aware that the Fed's policy boiled down to an accommodation of rising inflationary pressures, but still felt under pressure not to take any action that would reduce economic growth. In October, for example, Chairman Burns argued that promotion of growth would have to be the Fed's number one priority, and that this would take precedence over the attainment of monetary targets.

> Burns: … I think we should have certain very specific objectives. First, to indicate to the Congress and to the general public that we at the Federal Reserve are as determined as ever to gradually bring down the rate of growth of the monetary aggregates… second… to assure the Congress and the general public that the monetary aggregates to the extent that we can control them will grow sufficiently to facilitate orderly expansion of our national economy… third… that satisfactory performance of our economy is the basic goal before us and that we do not have the slightest intention to sacrifice or compromise this goal or objective in the interest of attaining or approximating the particular long range projection that we set. (*Transcript*, 10/18/77, Tape 5, p. 9)

Later in the fall, as the economy strengthened and inflation increased, there were more calls from Committee members for tightening. Mr. Balles proposed that the Committee consider moving to a reserves target in order to tighten control of monetary aggregates, with the

implication that the federal funds rate would be increased. Chairman Burns criticized the proposal on the grounds of the opposition it would generate from Congress.

> Burns: You know I follow everything you [Mr. Balles] say with a great deal of sympathy until you get into the political part of the argument. We had a reserve target and if in the process of applying interest rates moved up believe me the Congress would respond in just the way it has been doing. And it may well be great advantage in what you suggest but as for the politics of it, I think you're off base. (*Transcript*, 12/19/77, Tape 3, p. 9)

By the end of 1977, it is clear in retrospect (and was clear to some of the Committee members at the time) that monetary policy had lost its barings. The Committee, focused intently on maintaining a strong rate of economic growth, had essentially given up trying to control inflation. Concern about inflation was downplayed in a number of exchanges throughout the second half of 1977. In September, for example, Mr. Morris suggested that the Fed needed to tighten in order to maintain its credibility vis-à-vis its monetary targets.

> Morris: … It seems to me that we've got to make a move at this meeting if we're going to maintain credibility in Federal Reserve policy. Particularly in the light of the fact that next month we'll have to set long term targets. I think our setting of the long term targets next month will be very awkward, it seems to me, if we act as if we were not terribly unhappy with the successive rates of growth we've gotten in the last 6 months… I think maintaining our credibility here is very critical…
>
> Burns: To maintain our credibility, what does that mean? First we want the market and the country at large to take seriously our protestation since we believe in it seriously as we are determined to do what we can to help unwind the inflation. All right, that's essential to maintain credibility. There is equally essential to be alive to what is happening in the real economy; to the extent that you have elements of weakness in the economy, if we ignore those there will be no gain in credibility for the System. That people, responsible people across the country will scratch their heads and say don't these people know what is happening in the real economy. Don't they care. So it's not a one way street. Credibility requires that we work on both dimensions and achieve as wise a compromise if that be the right term, take into account both factors as we just have. (*Transcript*, 9/20/77, Tape 7, p. 15).

In numerous exchanges at this meeting and others, Mr. Roos expressed exasperation with the Committee's behavior. In the September meeting he pointed out that the members of the Committee were acting as if they had no control over growth in the monetary aggregates. On the contrary, he argued, the Fed could control money supply growth if only it was willing to accept the consequences this implied for the real economy. The response from Chairman Burns and Mr. Partee reveal how low on the list of priorities control of inflation had sunk by this time.

> Roos: … Aren't we in conducting monetary policy, and I ask this sincerely, I'm new and I really am mixed up on this, aren't we supposed to really exert some control on these events or do we in effect react after the fact to things that have happened that we're sorry happened. In other words, is it not possible by the adroit conduct of monetary policy for this Committee really to have a very real effect on the trend of M1 and M2, instead of explaining afterwards why they did expand beyond what we wanted – what were our targets. I don't know if I'm making my question clear, but I find myself frustrated sometimes in this regard.
>
> Burns: … Let me rephrase your question… We set, let us say a certain goal for ourselves for rate of growth in M1. And if we were determined to achieve that rate of growth without regard to other factors or consequences, I think we could come very close to that… But I don't think that we have that degree of determination with regard to a given targeted figure. And I would question whether we should. Our job is not to worship at the shrine of a specific number that we agree upon at a given time. To the extent that we are going to worship at any shrine, our shrine is the performance of the economy. And we're doing our very best, you see, by tolerating some excesses, tolerating shortcomings, using our best judgment, which may be mistaken.
>
> Roos: Mr. Chairman, I'm not – if our stated, and I assume understood objective is to gradually inch down the rate of inflation, and this has been often repeated, don't we have some commitment to that goal even if it means some temporary dislocations of interest rate levels and things like that. I mean, in other words, isn't that part of our mission too?
>
> Burns: I'd say it is, but there is a question as to how much dislocation which you'd be willing to cause and at what time.
>
> Partee: Well, it's just not interest rate levels either. It's output and demand and employment and profits and the whole fabric of the economy, that has to be taken into account.
>
> Roos: And inflation.
>
> Partee: Yes, in dealing with the inflation problem which was your question. (*Transcript*, 9/20/77, Tape 6, p. 1-2)

By early 1978 signs of rapidly increasing inflationary pressures were becoming impossible to ignore. There is a noticeable shift in the tone of the discussions at the FOMC meetings. The tone in the summer and fall of 1977 was one of obliviousness to inflation. By early 1978, Committee members were expressing concern about inflation with much greater frequency. They were unwilling, however, to act against inflation in the absence of leadership from the Carter Administration. The result was policy paralysis.

One major source of concern was the acceleration in the depreciation of the dollar. In the January 1978 meeting, Mr. Roos asked whether there were actions that the Fed could take to strengthen the dollar. Burns' response indicates that he thought that the Administration needed to take the lead on this; the Federal Reserve would not be the primary agency in charge of conducting macroeconomic policy with an eye toward stabilizing the value of the dollar:

> Burns: … As for fundamental corrective actions, I can see only four paths. One is the passage of an energy bill… Second, I think we need an anti-inflation policy on the part of the Administration, something we don't have at the present time. Third, we need tax legislation that is designed to stimulate foreign investment in this country… Now, these three roads to a fundamental cure are available to us; they are within our power in this country. The fourth avenue is outside of our power – namely, faster economic expansion in the economies in the rest of the world. So, there is something that the Federal Reserve can do. And I think we've taken significant steps in that direction directly and by way of stimulating the Treasury and the Administration, but I think what has happened so far is only the beginning of what needs to be done. (*Transcript*, 1/17/78, p. 5)

By the March meeting the increase in inflation had become so severe that, according to Chairman Miller (who had just replaced Burns), there was growing support in the Administration for a slowdown in growth (*Transcript*, 3/21/78, p. 6). Yet the discussion within the FOMC over the appropriate monetary policy response shows a hesitancy to have the Fed take the lead.

> Miller: … As an aftermath of a series of events over ten years, it's hard to coalesce leadership in the government. It's nobody's fault, but there has been a fractionalization of leadership after all these events. Therefore, Congress doesn't stick too much to anybody's program. They all have pet ideas, which is still good in many ways but bad in terms of getting action. And the Administration has many factions pushing it in this direction and that direction. I personally think time is very short for them to take some more believable steps in fighting inflation and if it's not done, inflation is going to be left to the Federal Reserve and that's going to be bad news. I don't think we really have the capacity to avoid the consequences of the inflation. We can do some things but they inevitably are not going to work out with a scenario that any of us will like. (*Transcript*, 3/21/78, p. 33)

Mr. Roos responded by stating the obvious, that it was within the Fed's power to reduce inflation by reducing money growth. But Chairman Miller was cool towards this idea.

> Roos: Mr. Chairman, if I understood you correctly, I understood you to say that there are very limited things that we can do. If we were to gradually slow down money growth, as have publicly said in the past we wanted to do, wouldn't this be a signal to the world and to this country and to everybody that the Federal Reserve is really serious about doing something [about inflation]? Don't you think that would possibly have some effect on correcting inflation? (*Transcript*, 3/21/78, p. 34)

> Miller: If other actions aren't taken, we would have to continue the process, which we will no doubt do. And if we do, inevitably that will lead to a slowing down in capital investment and in homebuilding and it will lead to a recession. That's why I hope that other actions can be taken, not just ours.

In the spring the Carter Administration adopted another anti-inflation program. Despite their concerns about inflation and the sense that the Administration was finally taking the problem seriously, however, the Committee made no major moves toward restraint. One issue, revealed in the July meeting, was that Chairman Miller still did not believe that the Administration and Congress would not quickly adopt expansionary policies at the first sign of an economic slowdown.

> Miller: It has been easy to see all of that in a period when the economy was growing rapidly in real terms and there was considerable slack. Now we have had restraint on for some time. I guess my concern here is that continued restraint, while logical in economic terms, is likely to trigger a recession at this time. And if [we have a recession], I think the stimulating effects of fiscal policy that will [occur as a result] will take away our restraint and we will have accomplished nothing except to leave the Federal Reserve probably in a less effective position to deal [with the situation]. That is why I think this is a very difficult period. If we do what the textbook would tell us to do, we may start a chain of events that will work against us. If we fail to do it, we may regret it, so it is a [difficult decision]. We get paid here for making tough judgments. (*Transcript*, 7/18/78, p. 42)

The Committee was presented with alarming inflation figures in the meeting of September 19. Inflation had been 10.7 percent in the previous quarter, and while it had declined to 7.0 percent in the current quarter it was expected to rise to 7.7 percent within the next two quarters. Mr. Roos expressed frustration with the Committee's acquiescence to these high rates. Chairman Miller's response suggests that he was satisfied that the Fed had done all it could do short of precipitate a recession, that recession was unacceptable, and that control of inflation was really the Administration's job:

> Roos: I have a question, Mr. Chairman, and it's not asked in a cantankerous vein. But I'm concerned. As we went around the table, we all seemed to recognize that we do face a 7-1/2 to 8 percent rate of inflation now. Do we as a group feel that this is preordained because of circumstances that we can't control? I'm concerned that we seem to feel well, it may be 8 percent, and if it's 8 percent we've done our job well. I'm really not trying to be critical, but is our monetary policy responsibility such that we should maybe discuss whether we're satisfied to see the economy drift into an 8 percent inflation rate? And if not, are there things that we can do to affect this? I really ask that in a genuine, innocent, and physically recovering vein. Are we in any way the masters of what happens, or are we merely observers on the sidelines? I'm lost.

Miller: I take the fifth.

Partee: I don't want to comment.

Baughman: Yes, there is a relevant observation that may be made, which is that the Administration has said that they are going to bring forth a new anti-inflation proposal. If that should appear to be a program of substance with some possibility of having a significant impact, it could provide a basis for a wave of optimism through both the business and consumer sectors of the economy. That would be quite positive. If, on the other hand, it appears to be quite transparently meaningless – mostly talk and nothing that is likely to have a substantial impact on the wage-price push – then I think there is a strong possibility that the effect will be quite the opposite.

Miller: Let me make a couple of brief comments… One, when I came here six months ago the outlook for the growth of the economy in real terms for the current calendar year was 4.7 percent. The staff projection is now 3.5. I would say that one of the main forces in that reduction has been monetary policy. So, have we had any positive contributions to the slowing of the forces of inflation? I would say there has been a conscious effort, Larry. I would say, in the argument that the Federal Reserve should not be left to do it alone, that the fiscal plan for stimulus in the next fiscal year has been changed by $20 billion less stimulus. I would have to say that's substantive. Maybe some of you would argue for more or less but I would have to say that these are substantive consequences of the exercise of monetary policy in pointing out the dangers of monetary policy and getting, therefore, a response from the Administration and from the Congress to spread the burden.

So I think in isolation we are suffering from the inflation buildup over twelve years and in my opinion some misguided steps over twelve years. If we think we have been able to turn it as much as I have just described in six months, in terms of the outlook and the mix of things, I wouldn't exactly be critical. And I would be very cautious to restrain the system more in the face of the pessimistic comments we already have and [precipitate] a recession just to make us all feel that we have done something more. I don't think that would contribute enough to solving the problem. You know, we are already down to growing at or below the trend line. Really, is there more that we can do short term? And don't we have to live through the cycle? I don't know. (*Transcript*, 9/19/78, p. 17-18)

With the Administration's announcement of another anti-inflation program at the end of 1978, the Committee began to lean more toward tightening. The main impediment now was a reluctance to risk throwing the economy into recession. In the September and October meetings Committee members had talked about the desirability of achieving a "soft landing." Several members worried, however, that any attempt to reduce the growth of money supply might inadvertantly tip the economy into a severe recession as had occurred in 1974 (Miller, *Transcript*, 10/17/78, p. 23; Balles, *Transcript*, 10/17/78, p. 48). But in the November meeting

the Committee agreed to tighten somewhat to support the new anti-inflation program that the Administration had announced days before. The Committee increased the midpoint of the fed funds target range from 9.0 to 9.875 percent and followed this up with a further increase to 10.125 percent in December. But even this modest attempt to confront inflation caused some members to get cold feet, including Mr. Guffey and Mr. Willes.

> I don't know whether it's Christmas or what, but I feel as I listen to the Committee that I am rapidly turning from a hawk into a dove because I am starting to get nervous about repeating what has been a fairly typical mistake for the Committee. And that is that once it gets religion it goes too far. As anxious as I am to get [the aggregates] down, I want to get them down slowly precisely so we don't precipitate the recession that I think we can avoid if we are careful. (*Transcript*, 12/19/78, p. 14)

In the first half of 1979 inflation reached levels that constituted a true crisis. Inflation in the second quarter was 10.2 percent, up from 8.7 percent in the fourth quarter of 1978. The Greenbook forecasts show that the Fed consistently forecast inflation to be above eight percent in the second quarter; at the same time, the Greenbook forecasted a slowdown in growth that continued to raise concerns about recession. Because of its unwillingness to risk recession, the Committee made no changes in the target ranges for the federal funds rate (9.75-10.5 percent) from December through the July meeting.

Committee members expressed a number of reasons for what in retrospect appears to be an outsized fear of recession, ranging from fear of the response from the Administration and Congress to fear of social unrest. In the meeting of February 1979, Ms. Teeters argued that the Committee ease in order to bring its policy stance in line with what the Administration was advocating in the Economic Report of the President.

> Teeters: … I know that the Administration has forecast, for the first time on record, a decline in interest rates over the coming two years. So in a way they've really put the monkey on our backs. If we relax interest rates we get better results; we get closer to the Administration's projections though we don't make it completely… On the other hand, it seems to me that the unemployment rates [in the staff's forecast] are going to be politically unacceptable. If we force them up, the Congress will force upon us an extremely [expansionary] fiscal policy, which I really don't think we need at this point. As a result, I guess I'm more willing to ease a little on interest rates and let the money supply grow. (*Transcript*, 2/6/79, p. 13)

In the March meeting Mr. Partee – at this point a member of the Board of Governors – relayed the concerns of a powerful member of Congress that the Fed was doing too little to steer the economy away from recession.

> Partee: Mr. Chairman, last week I appeared before the House Subcommittee on Monetary Affairs to discuss monetary policy in the context of our Humphrey-Hawkins report, but the discussion soon turned to current monetary policy… I'm obliged to report to you that the Chairman of the Subcommittee, Parren Mitchell, wants the FOMC to know that he is concerned. He says he's concerned not as an economist because he isn't an economist, not as a monetarist because he doesn't understand the arcane area of monetarism, but as an historian because he has noted that every time there is substantial and sustained weakness in the money supply, a recession follows. He wonders why the current situation would differ from previous situations.
>
> Now, I must say that I'm not a monetarist either, but I do have some sympathy with Chairman Mitchell's view of this. It does seem to me that we've had a sustained period of weakness in the money supply… So, I would have to say, looking at the real economy as well as the monetary numbers, that I now believe a recession is very likely – a recession which at this point the Federal Reserve will have done nothing about. We will have made no effort to block it in any way. We will have sat here again, seeing very weak monetary aggregates as a precedent to the recession phase. I believe we're in considerable danger of that happening.

And in the May meeting, Mr. Winn expressed concern about the social impact of a recession.

> Winn: Mr. Chairman, I sense a growing ugly mood in our society. I don't know whether the reaction is going to be in the political sector or in the economic sector or in the racial area, but I suspect it won't be a moderate reaction. So I think we are in for some rather volatile times ahead that could throw these estimates off, but I certainly don't want to predict them. My feeling would be that this is not the time to tighten. But in view of the uncertainties and the inflation problem and other problems, I would say that we would be well advised to stay where we are in terms of the current status of policy. (*Transcript*, 5/22/79, p. 24)

But the mood began to shift in June and July. In these meetings Committee members expressed an increased willingness to take action against inflation even if that meant risking recession. In a conference call on June 27, Mr. Rankin proclaimed the Richmond Bank's readiness to endure a recession as the price of reducing inflation.

> Rankin: Mr. Chairman, our concern is oriented more toward the inflationary picture than the apparent increasing recessionary tendencies that we see… Our position here at the Richmond Bank is that we should continue to give a high priority to the inflation problems; even though the economy may be moving into a recession, we think it's important to hold a tight rein on the aggregates at this time. And in view of the recent rapid growth in the aggregates we think we should be prepared to demonstrate a readiness to resist any further short-term bulges by allowing the funds rate to move up another notch. (*Transcript*, 6/27/79, p. 6)

Two meetings and a conference call were held in July as the inflationary crisis worsened. At the meeting of July 11 the calls to tighten – and risk recession in doing so – became widespread.

> Miller: We are going to be on trial and have a test in this country for a longer period of time on whether we have the will and the capacity to wind this [inflation] down. I rather think that there is a more sober sense of the urgency and the peril [involved] – a more sober sense that we‘re all going to have to give up something. There is going to have to be some loss of real income in the short term if we‘re ever going to get real income going up again in the long term. But that remains to be seen.
>
> Wallich: Second, I very much agree with what the Chairman said just now. Bringing inflation down under these deteriorating circumstances is not just a question of taking more time to do it but it will be more costly in terms of real income. And the cost of that real income means less growth, higher unemployment. It need not mean more social problems from unemployment, if that's properly compensated, but it does mean less output. (*Transcript*, 7/11/79, p. 15)
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> Coldwell: The sense I get out of this forecast is almost a sense of hopelessness. There's nothing anybody can do. We have a high rate of inflation, a rising rate of unemployment, and a low rate of growth. And you tell me that you want to hold this for three to five years. I don't think that's politically [feasible]. I strongly doubt that this country is willing to stand still for five years, much less a year. So I guess my answer, Mr. Chairman, is that it may take some more difficult medicine than what we have on the horizon right now. Whether this body wishes to contribute its share of that castor oil or leave that to the political side of life, I don't know. I wish we knew what the President will be coming out with in his proposals; I think those might have an important bearing.
>
> Miller: Well, you see, he cancelled his speech because he wanted to hear what the FOMC would do! Everyone was wondering what the reason was.
>
> Coldwell: If he wants to play the game that way then I'm perfectly willing to step up to the policy [plate] and say that it's time for us to quit – not validate these things. (*Transcript*, 7/11/79, p. 17)

At a conference call on July 17, the Committee discussed initiating a major tightening following financial markets' poor reception of President Carter's latest economic plan. The Committee held off, however, in part because of concern that such a move would be interpreted as a vote of no confidence in the President's plan (*Transcript*, 7/17/79, p. 6). Dramatic action was postponed at the meeting of the 18th – Chairman Miller's last meeting – in light of uncertainty over the Administration's response to the crisis. But by this point the writing was on the wall. In August Paul Volcker was appointed Chairman and the Carter Administration threw its weight behind an aggressive attempt to control inflation.

3.6 The 1979-82 disinflation

A detailed history of the 1979-82 disinflation is beyond the scope of this paper. One important point needs to be made, however. That is that from the first meeting at which Paul Volcker was chair he and other Committee members recognized the importance of public support for any serious attempt at controlling inflation. Throughout the disinflation period Committee members remained concerned about political support and took comfort in their perception that that support was forthcoming. Political support took two forms: a willingness of the public and political community to tolerate a recession as long as there was significant progress toward controlling inflation, and acceptance of the idea that the Federal Reserve would exercise its responsibilities as guardian of price stability independently of the rest of government. This section provides support for this argument.

Chairman Volcker spoke at length about the challenges facing the Fed in the August meeting. He laid out a strategy in which the Fed would make a small move towards tightening immediately, but hold off on a larger move until an opportunity arose in the form of a crisis that would galvanize public support (*Transcript*, 8/14/79, p. 22-23). An important consideration for Committee members as they geared up for an attack on inflation was their perception that the President, Congress, and public would support such a move. Mr. Mayo, for example, argued that since the President and Congress had declared inflation to be the number one problem in the economy, the Fed had more room to tighten now than it had in the past, and it should take advantage of this opportunity.

> Mayo: Inflation is our number one enemy. This has been declared far and wide, by the President of the United States and the leaders of the Congress as well as by the Federal Reserve… We will be blamed for high interest rates and for causing the recession regardless of whether we move [rates] up a percentage point or down a percentage point at this juncture. We tend to be too thin skinned about that. I don't think we can take it seriously as long as we act within a reasonable margin, which is a much greater margin than this Committee has typically envisioned. (*Transcript*, 8/14/79, p. 31)

In the September meeting Chairman Volcker noted that there was political support for tightening from the Congressional Black Caucus, a group that would ordinarily not be expected to make hawkish statements about inflation.

> Volcker: … I also share the view that has been quite widely expressed that we have to show some resistance to the growth in money. I would note that that remains a source of political support for us. It's not every day that we get a letter from the leader of the Black Caucus [in the House] exhorting us to show more restraint on the money supply side. So

I'm going to carry that letter close to my heart, whatever we decide today. And [he was] speaking on behalf of the whole subcommittee, at least, of the House Committee on Banking and Currency – the Subcommittee on Domestic Monetary Policy. So, I do think that those two ingredients at least ought to be in whatever policy we decide here. (*Transcript*, 9/18/79, p. 34)

When the decision to tighten dramatically was made in the October meeting, Chairman Volcker made a point of informing the Committee that there was strong support for a strong policy shift from the Administration.

Volcker: … I should report to you that obviously I discussed the whole problem on the international side and inevitably on the domestic side with the Administration. I think I can say flatly that they are ready for a strong program; they would have no disagreement with that conclusion at all. (*Transcript*, 10/6/79, p. 9)

Following the meeting Volcker made a number of public appearances at which he emphasized the political support for the Fed's actions. Three days after the meeting, for example, Volcker spoke with the press following an address to the American Bankers' Association.

I do not claim any special expertise in reading public opinion. But the dramatic swelling of national concern about inflation – a concern that seems to transcend economic, social and indeed political philosophies – seems to me unmistakable…

We have been assailed almost daily for months with learned and not so learned analyses about the prospects for a downturn in business activity. I understand the reasons for concern… But the Administration and the Congress have united in clearly rejecting the seductive course of budgetary easing and tax reduction in recognition of the ultimately greater threat to stability inherent in the inflationary process. Restrictive monetary policies are never calculated to win popularity contests; yet there has been acceptance of the need of restraint even at rates of interest that are almost outside the range of our historical experience.

Indeed, the Congressional committees responsible for oversight of the Federal Reserve have been among the strongest voices urging that we set forth and adhere to monetary targets, reducing them over the years ahead as an essential part of the effort to restore price stability… I would note too that the "National Accord" recently reached between the Administration and American labor leadership plainly recognized the threat to full employment, incomes, investment, and growth inherent in the inflationary process, and for those reasons gave "top priority" to the "war on inflation". (Volcker 1979, p. 5-6)

Maintaining political support for the program remained a priority and concern once the new policy was in place. In March, further signs that the economy was headed for a recession prompted a discussion about whether it might be prudent to pull back on the degree of restraint.

Chairman Volcker argued that with the political support the Fed had for its current policies, such a move would be disastrous.

> Volcker:…The worst thing we could do is to indicate some backing-off at this point when we have announced anti-inflation program. We have political support and understanding for what we have been doing. People don't expect it to be too easy. There is an understanding that a lot of burden has been placed on credit policy, and there's a willingness to be supportive for the moment in that connection. I would not give all that much weight to the degree of support we're going to get if this is dragged out in-definitely and we have to go through this process once again. (*Transcript*, 3/18/80, p. 36)

In the winter of 1980-81, gloomy economic statistics prompted a discussion as to whether it was time for the Fed to reverse course. Chairman Volcker responded that there was still sufficient support for a reduction in monetary targets in Congress and in the Administration, and the Committee needed to resist the temptation to back off.

> Volcker:… There is a general question, which I guess is the most important question, of how serious we are about dealing with inflation. I got a little feeling, as I listened to the conversation, that we're like everybody else in the world on that: Everybody likes to get rid of inflation but when one comes up to actions that might actually do something about inflation, implicitly or explicitly, one says: "Well, inflation isn't that bad compared to the alternatives." We see the risks of the alternative of a sour economy and an outright recession this year. So, maybe there's a little tendency to shrink back on what we say we want to do on the inflation side. I don't want to shrink back very far: that is my general bias for all the reasons we have stated in our rhetoric but don't always carry through on. The history of these things in the past, as we all keep telling ourselves, is that when we come to the crunch, we back off. In a general sense the question here is whether we should back off.
>
> In terms of the general setting that we have, my own guess would be--and I suppose it can't be anymore than a guess--that almost any range we set that shows a reduction will be readily accepted by the Congress and the Administration and everybody else because we've said we're going to do that. Everybody has [understood] this little lesson that we've got to reduce the ranges in order to deal with inflation, and we're not going to run into a lot of flak in the short run about anything we're talking about or what has been set before us. I obviously can't be sure of that, but that would be my assumption.

Chairman Volcker's argument carried the day, and in the end the Committee continued its policy of progressive reductions in monetary targets.

The Reagan tax cuts put the Fed in a familiar bind. In the past, the Committee had usually deferred to previous administrations regarding the general thrust of monetary policy. As shown in previous sections, the Committee did not want to be perceived as counteracting the Administration's policies. Furthermore, the argument that appears in FOMC documents

throughout the 1970s that overly contractionary monetary policy would provoke an expansionary fiscal policy response that would increase inflation in the long run assumes that the Fed would not respond to the fiscal expansion by tightening monetary policy even more. The Reagan tax cuts put the Fed in exactly this position, but this time the Committee did not defer to the Administration's priorities. An exchange from the May 1981 meeting is revealing.

> Solomon: Well, unless the president told you this morning that he's willing to change his fiscal policy and have a balanced budget in fiscal 1982 by forgetting about tax cuts and cutting back on defense increases –
>
> Volcker: The question answers itself.
>
> Solomon: Unless you could tell us that, I feel that we have to go even further this way…. I think that we have to have a fed funds range going up to 22 percent… It seems to me that we are better off to be very firm and vigorous in our responses early in the game… I'm also influenced by the fact that if the President's program goes through, even with a compromise on the tax cut package, the fourth quarter is likely to be much stronger, and the third quarter probably somewhat stronger, than the present quarter. And in those circumstances we might have major problems [achieving] our fourth-quarter targets. I feel we are better off trying to nip this now than trying to be more gentle in our approach… (*Transcript*, 5/18/81, p. 25)

The meeting of July 1981 also saw a vigorous discussion of how long the Fed could hold out in its fight against inflation. Mr. Schultz argued that the public was growing impatient with the lack of success against inflation, and that the Committee needed to make a major push over the next four quarters to reduce inflation or see support for its program fall apart (*Transcript*, 7/6-7/81, p. 45). Mr. Guffey argued that at this point, given support from the Administration, the Committee should not make the type of mistake it had always made in the past.

> Guffey: … Secondly, it does seem to me that we've made some real progress against inflation and that the public is at least willing to accept that… And one last observation… Historically, the Federal Reserve has always come up to the hitching post and then backed off simply because the Admistration and the Congress have thrown bricks at us or have not been supportive of a policy of restraint. Through the course of recent history at least, we've backed off and we've made a mistake each time. I think we have an opportunity this time to carry forward what we should have done before because for the first time ever we do have, for whatever length of time, the support of the Administration at least. So, we ought to take advantage of that opportunity. (*Transcript*, 7/6-7/81, p. 55)

By the end of 1981, Committee members were firm in their determination to carry through with the disinflation despite a serious recession that had already pushed the unemployment rate past 8 percent, and despite the lack of cooperation from the Reagan

Administration. The contrast with 1970, 1973, and 1974 could not be more stark, and reflects the fact that by this time the political environment was such that the Fed now had a mandate to fight inflation at high cost and almost entirely on its own. The inflation rate began to fall quickly beginning in the first quarter of 1982, and by the end of the year the Fed was able to switch to an expansionary policy with inflation finally under control.

4. CONCLUSION

This paper has presented voluminous evidence that political constraints prevented the Federal Reserve from initiating a serious assault on inflation during the 1970s. As Arthur Burns noted in his 1979 speech, the Fed was well aware that it had the ability to control inflation if it was willing to subject the economy to recession. Inflation could have been brought under control at any time during the Great Inflation through a simple, technically feasible policy: raise interest rates, and keep them high until the inflation rate fell to the Fed's target level. Members of the FOMC understood that such a policy would succeed in reducing inflation, at a cost; the policy did not require that the Fed have accurate estimates of the natural rate of unemployment; and it was essentially the policy advocated by Chairman Martin as recession loomed in 1969. Such a policy was not attempted prior to 1979, however, because the political environment would not have permitted it.

In the early 1970s, perhaps because of memories of the Great Depression as DeLong (1997) argued, or perhaps because a decade of social upheaval had reduced the public's threshold for pain, neither the public nor political actors were willing to support anything more than the most modest attempts at controlling inflation. The severe inflation of 1974 increased support among the public, in Congress, and in the Ford Administration for a more vigorous attack on inflation. But this support was limited, and in any event evaporated during the election season in 1976 and with the arrival of the Carter Administration. Faced with these political constraints, the Fed adopted a policy of gradualism which amounted to sacrificing the goal of price stability for full employment. The Fed deferred to Congress and the executive branch in setting macroeconomic policy priorities, thus forsaking its role as the ultimate guardian of price stability.

The political environment was dramatically different after 1979. Inflation had reached crisis levels, there was widespread support for painful measures to control inflation, and the

Carter Administration was unable to come up with a credible response of its own. The way was clear for the Federal Reserve to take the lead in reducing inflation. By the end of 1981, members of the FOMC had accepted a new role for the Federal Reserve, neatly encapsulated in an impassioned plea by Mr. Schultz in the October meeting. After a long slog through the Minutes and Transcripts of the 1970s, Mr. Schultz's statement is inspiring.

> MR. SCHULTZ: Well, I want to take off from a comment that Mr. Roos made on the subject of credibility… We've had a lot of bills introduced in the Congress to restructure the Federal Reserve or to do away with it or, perhaps the one that makes the most sense, to impeach all members of the open Market Committee! … Our credibility is really at issue in the more basic question of whether we are going to do the job that I think we were in essence created to do. It seems to me that the basic function of a central bank is to avoid deflation on one hand and inflation on the other. And I'm not terribly sure how successful we can be fine-tuning in between. My feeling is that maybe we shouldn't call this the moment of truth because it's going to be a lot longer than that. It's going to be a period of truth. I don't fear all of these bills that are in the Congress to change the Federal Reserve if we do our basic job of finally getting inflation under control. If we don't do that job, then what the heck is our reason for being? How do we justify our existence under those circumstances? It seems to me our basic raison d'etre would be gone. So, I think that's where the credibility issue is: whether we are in fact going to do the job that we were created to do. We've been criticized in the past, and I think a lot of that criticism is proper. But now we're at the point where we have to carry through and get the job done. I'm certainly not attempting to say that we ought to crush the economy but we just can't lose sight of the basic fact that what we're trying to do is to keep that steady pressure on… and if we keep the pressure on, we can get some movement in the wage-price structure and begin to get this spiral going in the other direction. (*Transcript*, 10/5-6/81, p. 28-29)

APPENDIX: TURNING POINTS DURING THE GREAT INFLATION

The begin and end dates for the four disinflations from 1968 to 1981 are listed in Table A1 below. The beginning of a disinflation is the date of the FOMC meeting at which the Committee decided to tighten monetary policy in response to inflationary pressures. The end of a disinflation is the date at which the Committee decided to loosen policy in order to combat economic weakness. The primary source for my determination of these dates is the FOMC *Minutes*, *Transcripts*, and *RPAs*. In each case, the decision to tighten or loosen was accompanied by a substantial change in the target for the federal funds rate. As a check, I compared my begin and end dates with changes in the index of monetary policy stance constructed by Boschen and Mills (1995), and found substantial agreement.

Table A1. Dates of monetary policy turning points during the Great Inflation

FOMC meeting date	Ease/Tighten	Notes
December 17, 1968	Tighten	RPA: "The Committee was unanimously of the view that greater monetary restraint was required at this time in light of the unexpected strength of current economic activity, the persistence of inflationary pressures and expectations, and the recent rapid rate of growth in bank credit." BM: -1 (from 0 in Nov 68) FF (actual): week of 12/4/68 = 5.71%; week of 12/25/68 = 6.25%
February 10, 1970	Ease	RPA: "The Committee concluded that, in light of the latest economic developments and the current business outlook, it was appropriate to move gradually toward somewhat less restraint at this time." BM: 0 (from -1 in Jan 70) FF (actual): week of 2/4/70 = 9.21%; week of 2/25/70 = 8.41%
January 16, 1973	Tighten	RPA: "The Committee agreed that the economic situation continued to call for growth in the monetary aggregates over the months ahead at slower rates than those recorded in the second half of 1972." BM: -1 (from 0 in Dec 72) FFT-mid: 6.06 (from 5.5 in Dec 72, 5.125 in Nov 72)
October 16, 1973 – December 17-18, 1973	Ease	RPA (Oct): "…the Committee agreed that the economic situation and prospects continued to call for moderate growth in monetary aggregates over the months ahead… likely to require some easing in money market conditions." RPA (Dec): "The Committee concluded that the economic situation and outlook called for a modest easing of monetary policy." BM: -1 in Oct (from -2 in Sep), 0 in Dec (from -1 in Nov) FFT-mid: 9.75 in Oct (from 10.25 in Sep), 9.375 in Dec (from 9.75 in Nov)
March 18-19, 1974	Tighten	RPA: "The Committee concluded that the economic situation and outlook continued to call for moderate growth in monetary aggregates over the longer run… pursuit of that objective would be likely to entail a further tightening of bank reserve and money market conditions in the near term and some further increases in interest rates in general." BM: -1 (from 0 in Feb 74) FFT-mid: 9.75 (from 8.875 in Feb 74)

October 14-15, 1974	Ease	RPA: "The Committee concluded that the economic situation and outlook called for a resumption of moderate growth in the monetary aggregates over the longer run… money market conditions would have to ease somewhat further in the period immediately ahead." BM: 0 in Nov (from -1 in Oct and Sep) FFT-mid: 9.75 (from 11.25 in Sep)
October 6, 1979	Tighten	RPA: "In the Committee's discussion of policy for the period immediately ahead, the members agreed that the current situation called for additional measures to restrain growth of the monetary aggregates over the month ahead… 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 monetary aggregates, while permitting much greater fluctuations in the federal funds rate than heretofore." BM: -2 (from -1 in Sep) FFT-mid: 13.5 (from 11.5 in Sep)
October 1982 [1]	Ease (decline in fed funds rate from mid-1981 reflected decline in inflation expectations, weakening economy; not switch to growth promotion)	RPA: "The Committee agreed that in all the circumstances, it would seek to maintain expansion in bank reserves needed for an orderly and sustained flow of money and credit… taking account of the desirability of somewhat reduced pressures in private credit markets in the light of current economic conditions." *Compare with more qualified statement in RPA Aug 24, 1982: "The Committee decided that somewhat more rapid growth in the monetary aggregates would be acceptable depending upon evidence that economic and financial uncertainties were fostering unusual liquidity demands for monetary assets…"* *Compare with continued emphasis on containing inflation in RPA Nov 17, 1981: "[Committee members] wished to set objectives for monetary growth over the period ahead consistent with achieving further progress in reducing inflationary expectations…"* BM: +1 (from 0 in Sep; moved from -1 to 0 in Nov 81) FFT-mid: 8.75 (from 9.0 in Aug, 12.5 in Jun)

RPA: Record of Policy Actions, paragraph summarizing Committee decision (just before directive)
BM: Boschen-Mills (1995) index
FF (actual): weekly average effective federal funds rate
FFT-mid: midpoint of federal funds target range (FRB New York and FOMC Minutes)

[1] The federal funds rate target moved sharply downward between April and September 1980. This is not considered an easing (hence a premature end to the disinflation begun in 1979) for a number of reasons: (1) FOMC transcripts and RPAs show that Committee members saw the decline in the federal funds rates as a result of reduced money demand following adoption of the credit control program in March 1980. (2) Though the Fed increased its short-term monetary targets beginning in the May meeting, it did this only to correct a shortfall of money supply growth relative to the long-run targets it had adopted in the December 1979 meeting, not as a conscious attempt to ease. (See Gilbert, R. Alton and Michael E. Trebing, "The FOMC in 1980: A Year of Reserve Targeting," Federal Reserve Bank of St. Louis *Review*, August/September 1981, p. 2-22.) (3) Boschen and Mills (1995) characterize monetary policy in 1980 as moving from a strong emphasis on reducing inflation (-2) to a moderate emphasis (-1) rather than a move to an emphasis on growth.

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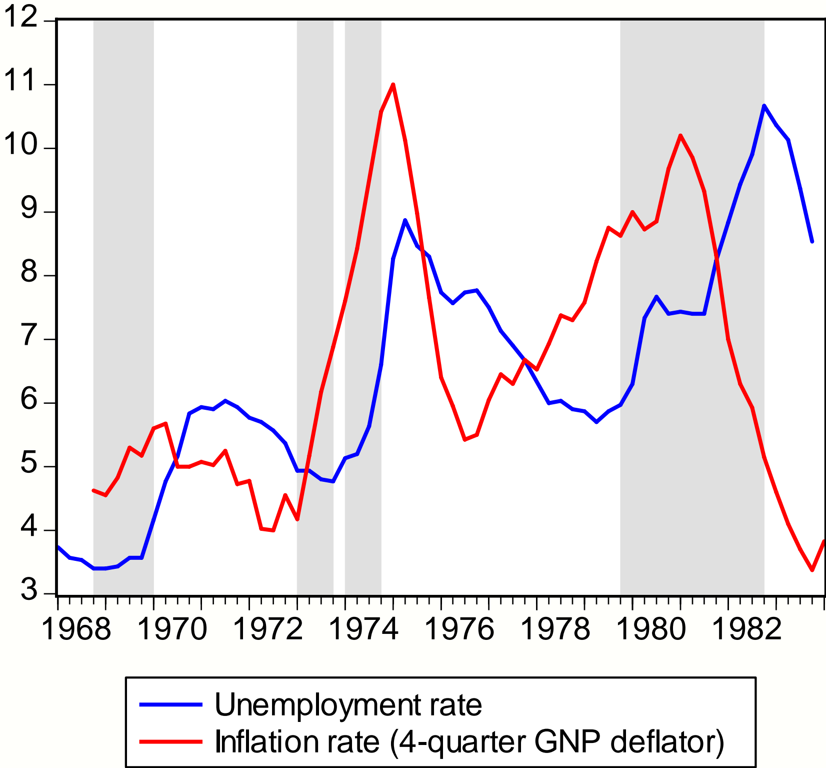
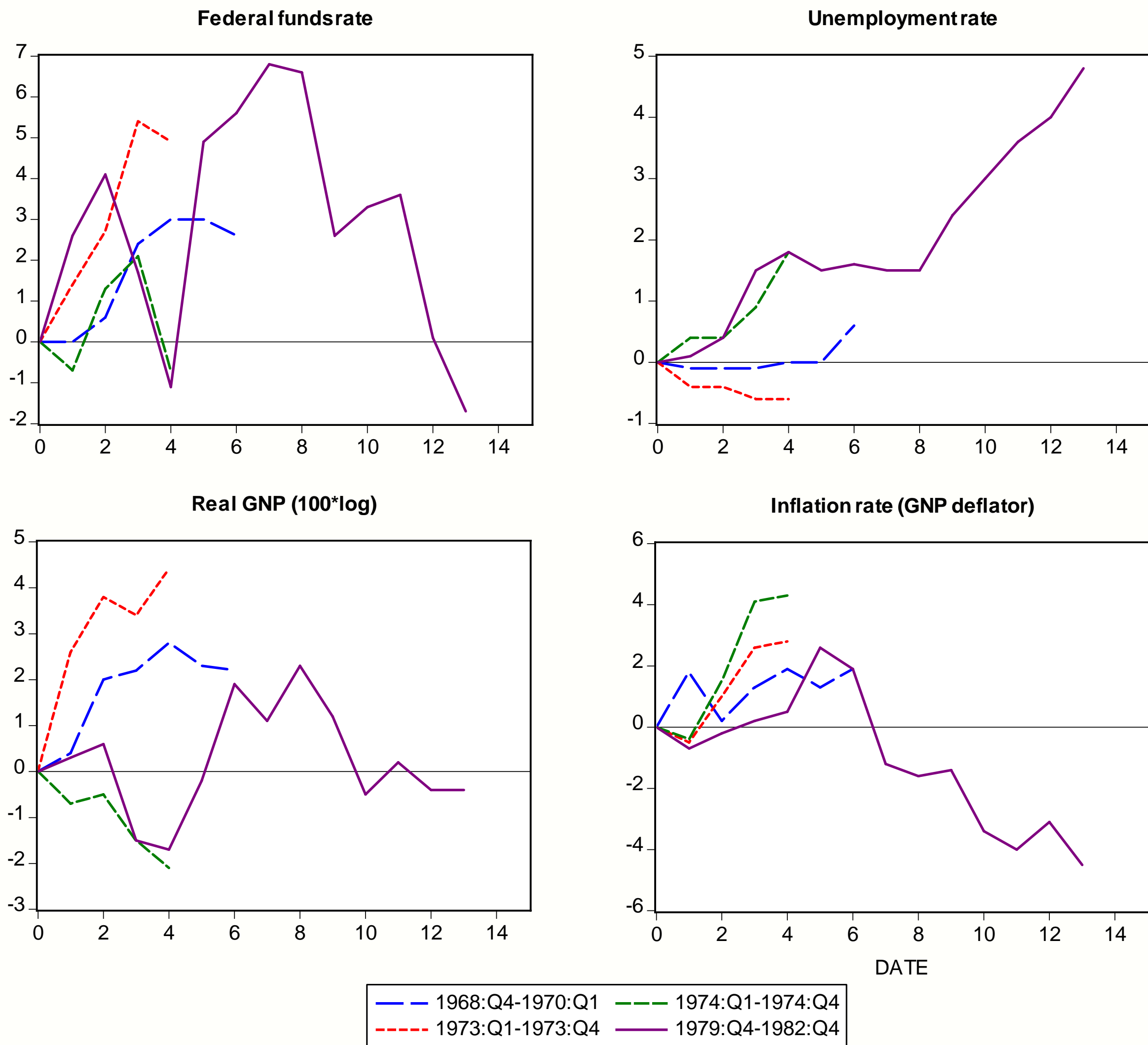
Figure 1. The Great Inflation.



Shaded areas are periods of attempted disinflation.

Figure 2. Comparison of economic variables during three disinflations.



Data are normalized to zero in quarter 0, the quarter before the start of the disinflation.

Figure 3. The 1969-70 disinflation.

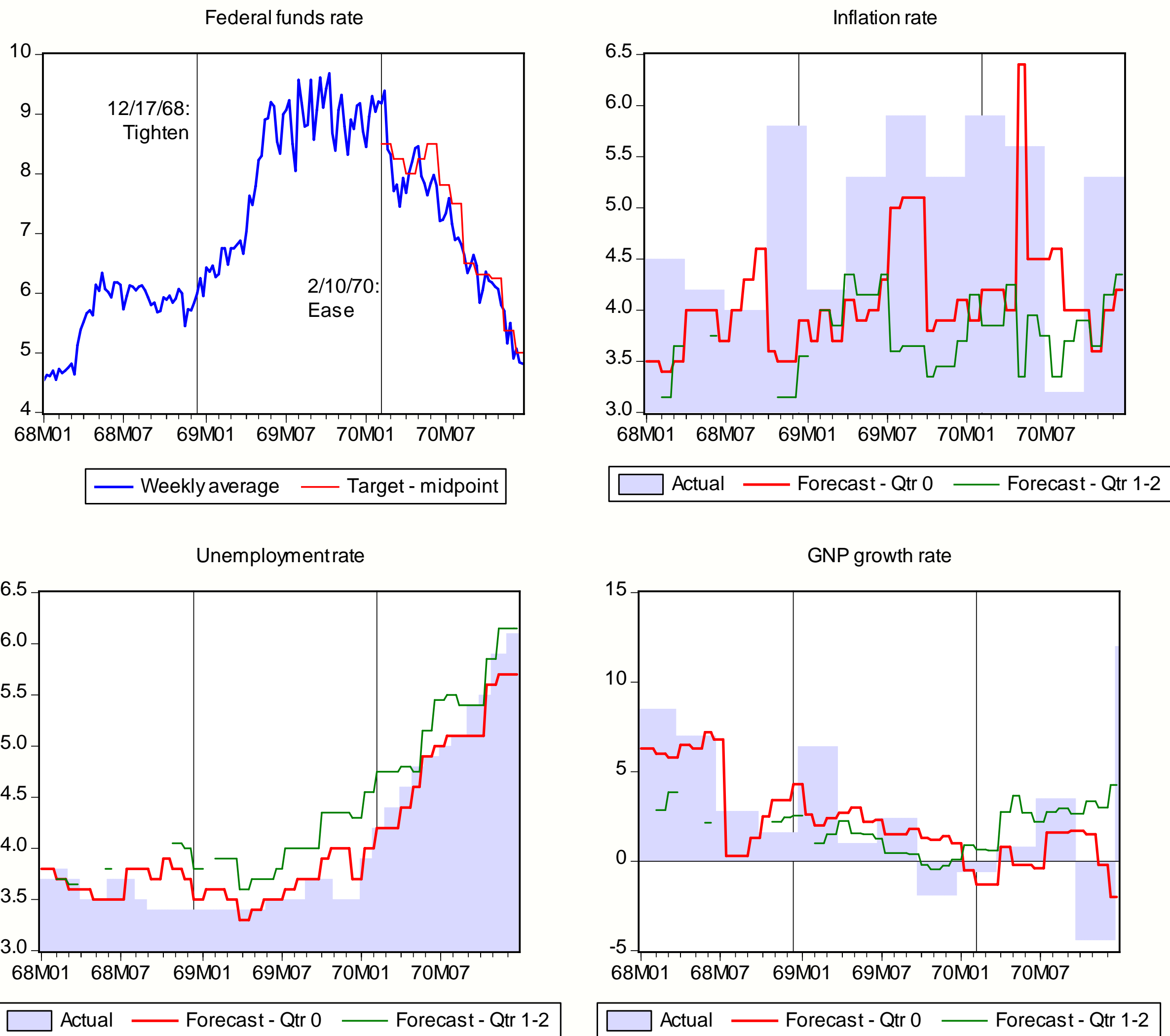
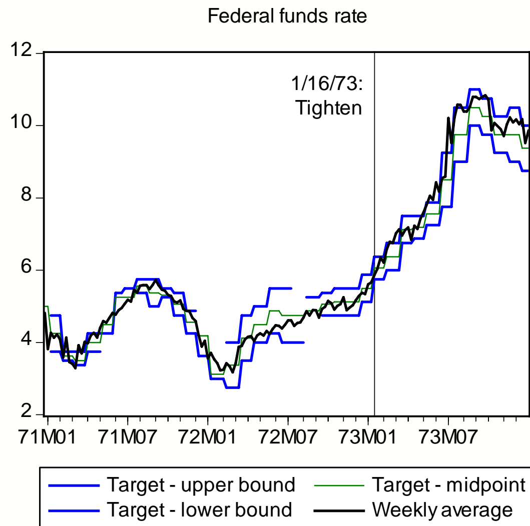
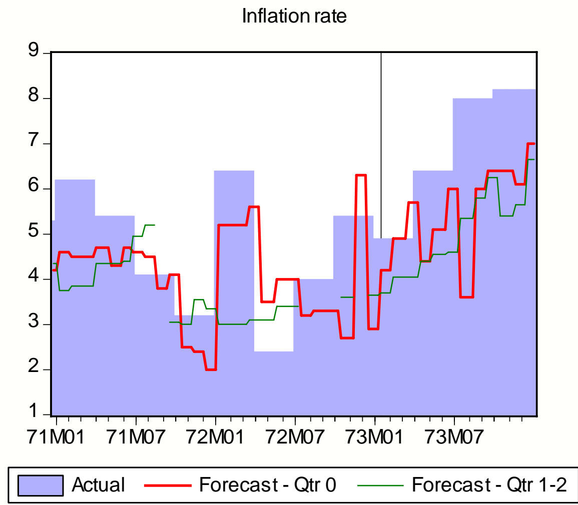
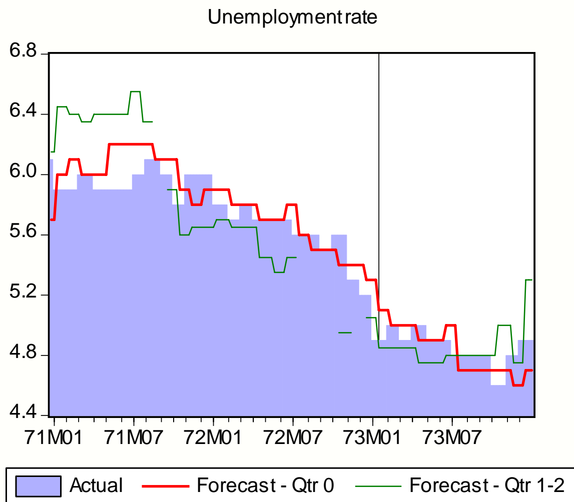


Figure 4. The 1971-73 expansion.







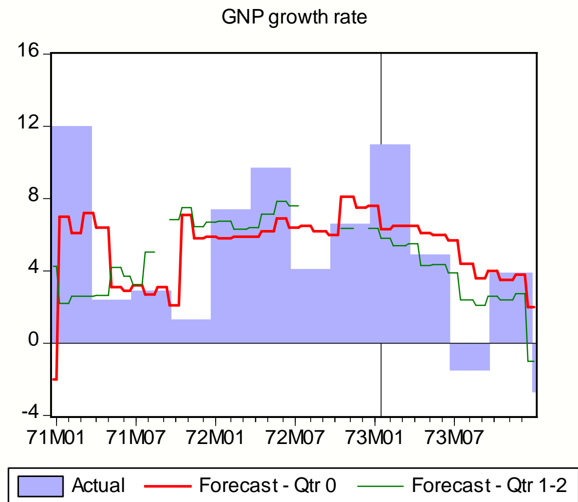


Figure 5. Document presented at the March 1973 FOMC meeting

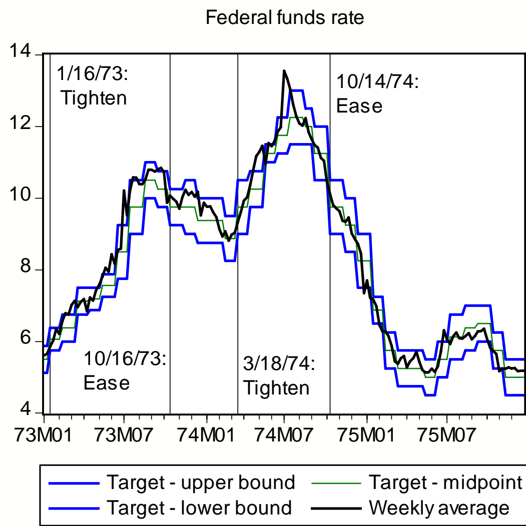
Table 8

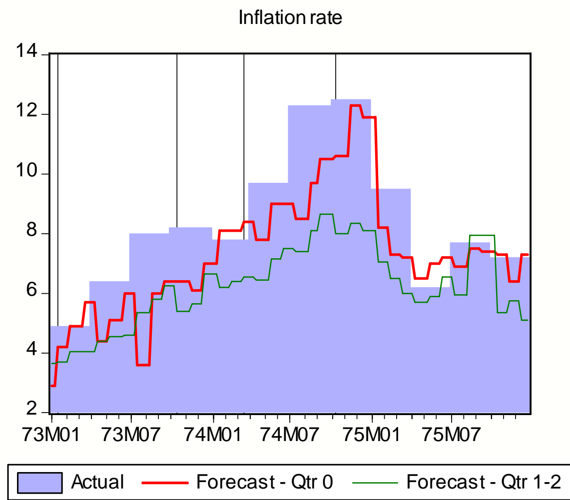
Rates of Growth in Selected Economic Variables
Under Four Different Policy Alternatives

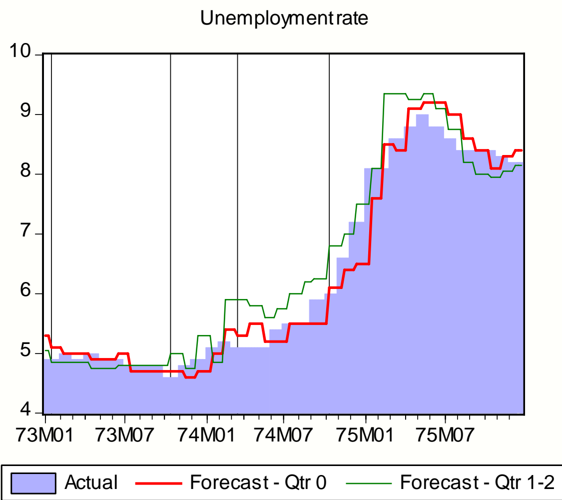
		Policy Alternatives			
		1	2	3	4
		Following a growth rate of 5.5% in 73QI, M_1 is assumed to grow at a steady annual rate of:			M_1 is assumed to grow at a 5.5% rate in 1973 and 7.0% in 1974
Annual Rates of Growth		7.0%	4.0%	5.5%	
Nominal GNP	1973 I	12.3	12.3	12.3	12.3
	II	10.4	10.0	10.2	10.2
	III	9.6	8.4	9.0	9.0
	IV	9.4	7.4	8.4	8.4
	1974 I	9.8	7.0	8.4	8.6
	II	9.6	5.9	7.7	8.2
	III	9.1	4.7	6.8	7.8
	IV	8.3	3.8	5.9	7.3
Real GNP	1973 I	6.5	6.5	6.5	6.5
	II	6.4	6.0	6.2	6.2
	III	5.2	4.1	4.8	4.8
	IV	4.7	2.9	3.9	3.9
	1974 I	4.2	1.6	2.9	3.1
	II	4.9	1.7	3.2	3.8
	III	4.3	.6	2.4	3.3
	IV	3.5	-.2	1.6	2.9
Fixed Weight Deflator	1973 I	5.1	5.1	5.1	5.1
	II	4.0	4.0	4.0	4.0
	III	4.4	4.3	4.3	4.3
	IV	4.6	4.4	4.6	4.6
	1974 I	4.6	4.2	4.4	4.4
	II	4.6	3.9	4.2	4.3
	III	4.7	3.7	4.2	4.3
	IV	4.7	3.5	4.0	4.2
Unemployment Rate	1973 I	5.0	5.0	5.0	5.0
	II	4.9	4.9	4.9	4.9
	III	4.9	5.0	4.8	4.8
	IV	4.6	4.9	4.7	4.7
	1974 I	4.6	5.2	4.9	4.9
	II	4.5	5.5	5.0	4.9
	III	4.5	5.8	5.2	5.0
	IV	4.5	6.2	5.4	5.1

March 19, 1973

Figure 6. The 1973-74 disinflations.







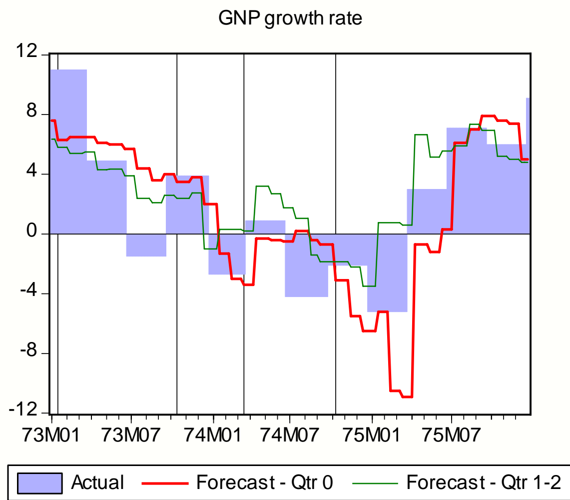
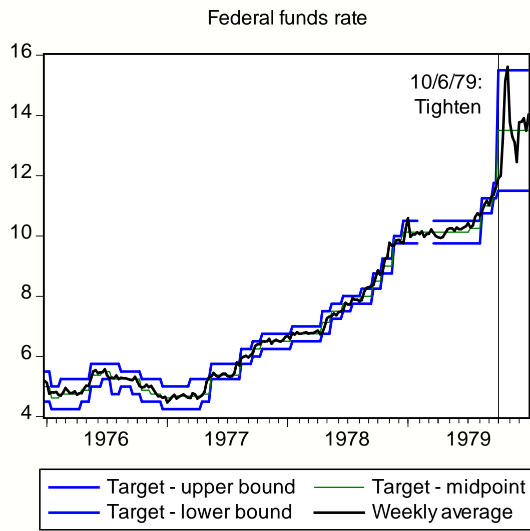
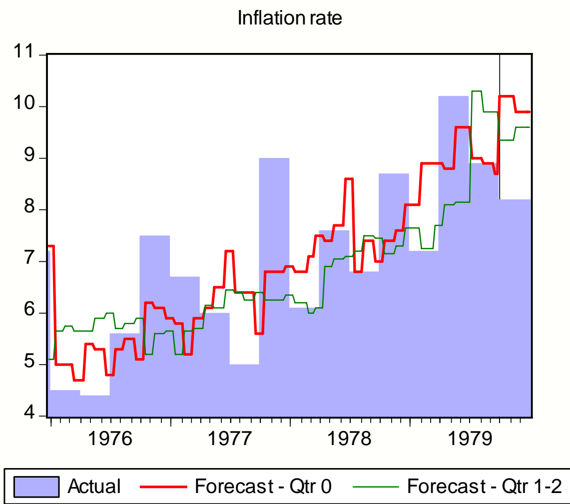
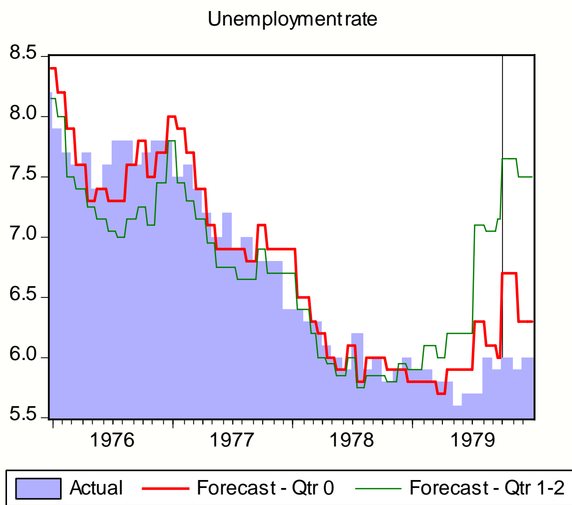


Figure 7. The 1976-78 expansion.







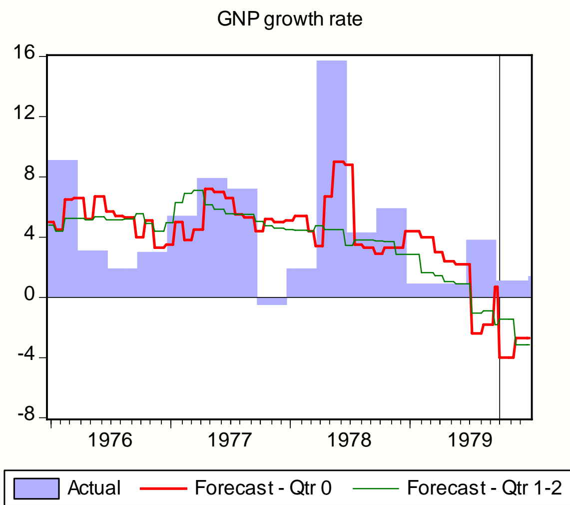
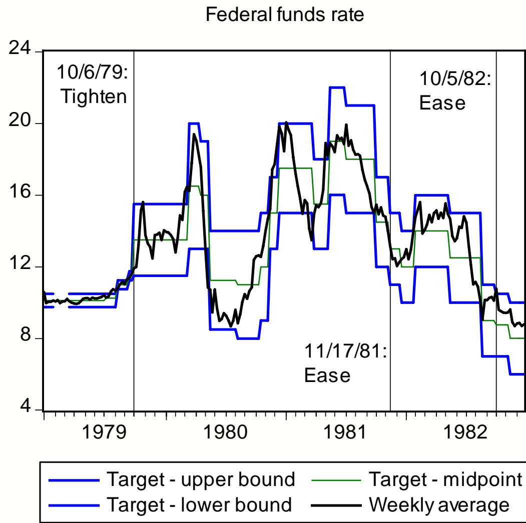
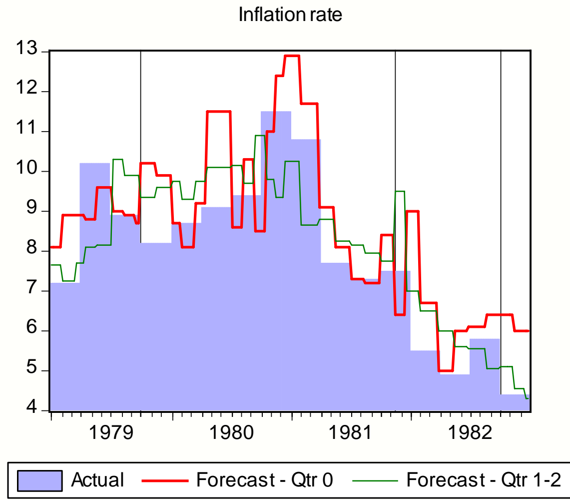
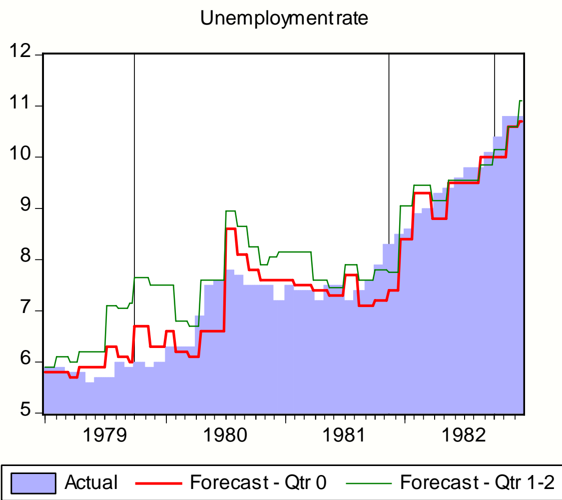


Figure 8. The 1979-82 disinflation.







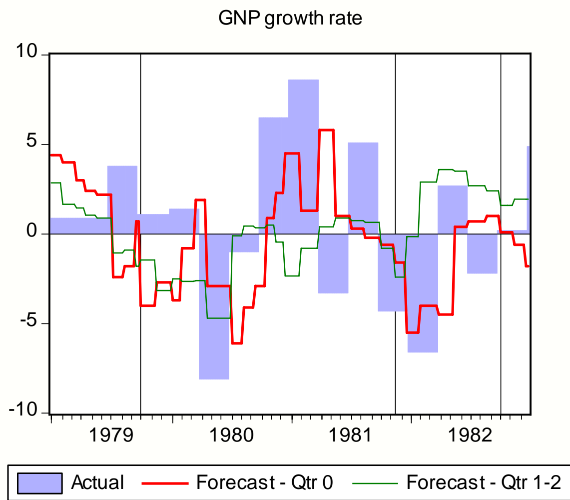


Table 1. Chronology of "evolution of beliefs" from Romer and Romer (2002) and Nelson (2005)

Romer and Romer	Nelson
Early 1970s: belief in a natural rate of unemployment, but one that was very low; inflation caused primarily by nonmonetary factors such as the wage-price spiral	1969-71: rise of the "cost-push" view of inflation as opposed to the monetary view
	1971-74: inflation not caused primarily by monetary policy; incomes policy gains favor
Mid 1970s: estimates of the natural rate of unemployment revised significantly upward; inflation primarily due to monetary policy	1974-75: more orthodox view emphasizing the monetary caues of inflation; rejection of cost-push view and incomes policy
	1975-78: return to cost-push view of inflation, pessimism about the ability of monetary policy to control aggregate demand, and belief in the efficacy of incomes policy
Late 1970s: estimates of natural rate revised down somewhat; more emphasis on nonmonetary causes of inflation	1978-79: acceptance of monetary view of inflation; continued acceptance of cost-push view and incomes policies
	1979-: full embrace of monetary view

Table 2. Greenbook forecast errors during the Great Inflation (annual averages)

	Inflation	Unemployment	Growth
1969	1.55	-0.11	-0.60
1970	1.05	0.25	0.48
1971	0.58	-0.23	-0.05
1972	0.79	-0.04	0.34
1973	2.47	0.06	-2.23
1974	2.68	0.60	-1.70
1975	-0.04	-0.29	2.01
1976	0.37	0.18	-1.08
1977	0.52	-0.24	-0.51
1978	0.70	-0.06	1.24
1979	-0.16	-0.43	0.89
1980	-0.06	-0.22	3.07
1981	-1.38	0.32	-0.76
1982	-1.21	0.37	-0.06

Forecast error is actual value minus Greenbook forecast. Figures in table are average forecast error at each FOMC meeting for current and succeeding two quarters, averaged over each year.