Commentary

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Lindsey, Orphanides, and Rasche (2005) have covered issues involved in the hows and whys of the Fed's bold and effective policy shift of October 1979 comprehensively and very well. In my comments, I will follow their outline, thus presenting something like variations on a theme. Perhaps there will be some counterpoint. No truly discordant notes seem in the offing.

HOW

It is difficult to separate the hows and whys of the Fed's policy shift, as it is with many other seminal events, and I find the authors' division of reasons and events within those two categories, as well as my own, to be somewhat arbitrary. Their discussion of "how" encompasses events from the beginning of 1979 through the spring of 1980. It involves a time line covering the last part of the Miller years at the Fed (when Volcker served as president of the Federal Reserve Bank of New York and thus vice chairman of the Federal Open Market Committee [FOMC]), to the appointment of Volcker as Chairman of the Board of Governors on August 6, 1979 (and thus Chairman of the FOMC), to market disturbances on September 18 (when a discount rate rise was announced but with a split vote of four to three), to the famous policy announcement on October 6, shortly after Volcker returned a bit early from an annual meeting of the International Monetary Fund (IMF) and International Bank for Reconstruction and Development (IBRD) held in Yugoslavia and just a few days before the next scheduled meeting of the FOMC on October 16.

But such a relatively limited time period does not quite do full justice to the story. For instance, the whole history of unsuccessful Fed monetary policies in the 1970s as the great inflation evolved and intensified, along with unsuccessful forays by the Fed and the Treasury into foreign exchange market intervention as confidence in the dollar on exchange markets waned, were factors in how and when the policy shift of 1979 occurred. In other words, more was involved in "how" than events during the time line traced by the authors.

In discussing "how," I would also place very great stress on the appointment of Volcker as Chairman. Lindsey, Orphanides, and Rasche do not, in my reading, give enough weight to his unique contribution. Indeed, I believe the events of October 1979 represent one of the few instances in monetary history when a significant policy change—a change that was essentially a paradigm shift—would not have occurred except for the presence and influence of one individual. No doubt, inflation would have been tamed in the 1980s without Volcker as Chairman—the time was right, history was beckoning. But without him, it would have been accomplished through more traditional means, less promptly, and, in my opinion, with more economic disruption and social turmoil over time than was experienced through the short, though relatively deep, recession that the country did experience.

Such a dramatic shift as did occur was enabled because Volcker combined two characteristics not usually found in a leader. He was, for one thing, something of an artist in policy in that he could think and act beyond the normal bounds of central bank practice of the day. Second, he

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was technically so highly proficient, and also very interested, in the arcana of monetary operations that his colleagues on the Board and FOMC could be quite confident in his ability to understand the details of the complex technical process underlying the new approach. Thus, they could feel comfortable in his ability readily to oversee operations and ensure that the staff engineers of the new machinery were operating it correctly in line with FOMC wishes.

It is not easy to find both characteristics in one person. Moreover, this combination of policy artistry on a foundation of high technical capacity gave Volcker himself the confidence, and perhaps more importantly the aura, to be convincing not only to his colleagues but also to the public, whom he also had to win over to the idea that the new policy would work and that the Fed would indeed stick to it.

With regard to the specific timing triggers for the policy change, I am a little surprised by the emphasis the authors place on the events of September 18. Perhaps I am surprised because I have not retained them in mind over the years. That is not evidence one way or another, of course, but still it makes me a bit doubtful about the extent to which they were crucial. On that particular day the FOMC made a decision to tighten but, in the usage of the period, did not announce it. On the same day, the Board also announced a rise in the discount rate, but three out of seven members voted against it. (They were presumed to be doves.) The combined action seemed to have had a destabilizing effect on markets, since such a narrow vote on the discount rate was interpreted to mean that the Fed's resistance to inflationary pressures would not be strong enough.

The authors seem to suggest that if FOMC decisions had been announced immediately, as they are now, then the market might not have been so doubtful about the Fed's anti-inflationary intentions. I am not so sure of that. An announcement in the early afternoon of the FOMC decision to tighten a bit further, coupled with an announcement in the late afternoon of the narrowly voted discount rate increase, might well have been equally confusing to the market. For instance, it might have signaled that the Fed would not be eager to raise rates even further, especially so because some who voted against the announced discount rate increase had also voted for the unannounced open market tightening. As a result, markets may have been thrown into no less consternation than they in fact were.

Basically, announcements or no announcements, the whole history of Fed policy over the previous decade had led to a severe erosion in the institution's anti-inflation credibility in financial markets as well as in markets for goods and labor. Adverse expectations were occasioning mini-crisis after mini-crisis in credit and foreign exchange markets, whether fully justified or not by the actual situation at the time they occurred. In my memory, the problems were most pointed in foreign exchange markets. In any event, it was not so much a particular market event, such as the sharp rise in commodity prices of September 18, but more importantly a deteriorating trend in markets generally that was continuing into late summer and early fall, especially in the foreign exchange market, that clearly signaled the need for a paradigm shift in domestic monetary policy. Various approaches had been tried in earlier years to shore up the foreign exchange value of the dollar, including currency interventions of differing intensities and degrees of international coordination. None had worked effectively because U.S. domestic monetary policy had little credibility.

In that respect, the new approach to policy, by shifting domestic monetary policy to a more determined anti-inflation stance, could also be expected to help stabilize the dollar on exchange markets, with positive spillover effects that would help support the Fed's basic goal of containing and rolling back the domestic rate of inflation and inflation expectations. In that context, I am convinced that the major policy shift of October was well in process and probably would have taken place in any event before the next scheduled FOMC meeting on October 16, though I cannot be absolutely sure on this point. Incidentally, on this, and on other statements in this paper, I should certainly not be interpreted as necessarily reflecting the views of Paul Volcker—or, for that matter, any other member of the FOMC at the time.

The time line as I saw it may be biased by my limited perspective—which was somewhat like that of a mouse confined to a treadmill, working away at keeping the monetary machinery going. I do recall a brief discussion with Volcker, shortly after he arrived, to the effect that the staff was ready to control the money supply more directly through a reserve targeting procedure if and when he wished to move in that direction. Much of the mechanism had been worked out years earlier. As I remember, a staff subcommittee that I chaired had recommended to its parent subcommittee composed of FOMC members—and set up early in the Burns years to review the structure of the FOMC policy directive—that M1 be taken as the intermediate target for policy and nonborrowed reserves be employed as the day-to-day operating mechanism for control. The parent subcommittee did not adopt that recommendation.

I literally do not remember when Volcker came back to begin discussing operational issues more seriously with me. I do remember his telling me that I could not go to Yugoslavia with the U.S. delegation since I (along with Peter Sternlight, who managed open market operations at the New York Fed) needed to begin the preparation of a formal document to be sent to the FOMC describing how the new policy would work in practice. Since I was not the least bit surprised about the need to stay behind, I have always assumed that the issue had already been settled in his mind and that he felt confident about the outcome of an FOMC vote. Thus, my memory, such as it is, while not inconsistent with at least some emphasis on the events of September 18, would be quite consistent with the view that Volcker had made up his mind earlier and that September 18 was not much more than one more mini-crisis along the way (which is my own opinion on the matter).

For some time, Volcker must have been in the process of checking with FOMC members; I assume that later, after he was sure of going ahead, he informed a few key policymakers outside the Fed whose understanding of the policy and its implications was important to its successful public launch. His trip to the IMF/IBRD meeting in Yugoslavia (where key international finance ministers and central bankers were assembled) and early return were quite possibly the final informational step. It would have been necessary to act promptly thereafter, and before the next regularly scheduled FOMC meeting, in part because of the possibility of undesirable leaks once a number of people around the world were knowledgeable about what was in train.

WHY

I think of "why" a little differently from Lindsey, Orphanides, and Rasche. Their 12 reasons, for one thing, seem to conflate the immediate policy problem at the time with issues related to the long-run stance of policy. Moreover, their list also includes as separate reasons a number of factors—for example, more funds rate flexibility, switching away from efforts to control money through interest rates and effects on money demand to more direct money supply control, and distancing the FOMC from the day-to-day level of the funds rate—that were essentially intrinsic to targeting a reserve aggregate, that went along with making it a desirable solution to the immediate policy problem. In so structuring their list of reasons, the authors, while in effect more or less correctly identifying the particular trees in the forest planted by policy, risk losing sight of what were the basic reasons for planting this particular forest in the first place.

I would emphasize three whys for the particular decision, made on October 6, to shift from targeting interest rates to targeting a reserve aggregate in the implementation of monetary policy.

First, the Federal Reserve badly needed to regain its credibility as an inflation fighter.

A new policy regime would be a signal step toward that end; it would reinforce, in the minds of the public, the Fed's determination to bring inflation under control. By emphasizing a new approach to controlling money, the Fed was sending a message that it would not repeat the mistakes of the 1970s. In that period, the Fed indicated that the money supply was a key, if not the principal, intermediate-term operating target; however, unfortunately, its actual policy actions came to lead the market to believe that the institution was not in practice prepared to do what was necessary

to meet its stated objective. For instance, the Fed shifted the base for its money growth targets every three months or so and thus did not make up for the all-too-prevalent overshoots in growth relative to its initial intentions. One of the governors of the day, Henry Wallich, coined the apt phrase "base drift" to describe this practice. Anti-inflation credibility was soon lost, as prices kept rising and the Fed's inability or unwillingness to attain its monetary targets was perceived as a principal cause.

Second, if credibility was to be regained with minimum disruption, markets had to be convinced within a reasonably short period that the new approach would be effective.

By effective, I mean that it would in practice lead to more certain control of the money supply and, thus, of inflation. It was expected that shifting to a control mechanism that was based on the multiplier relationship between the supply of reserves and the supply of money would have a better chance of yielding closer control of the money supply than would continuing with a control mechanism based on estimating the demand for money given the various explanatory variables that could be considered (and indeed were by a large number of econometricians both inside and outside the Fed), such as interest rates, income, and the various lagged relationships involved.

Third, it would be advantageous if the natural and virtually unavoidable caution with which policymakers approach their meeting-by-meeting policy decisions became less of an impediment to effective anti-inflationary action.

This was accomplished by making aggregate reserves (and thus, in effect, the money supply directly) the day-to-day instrument for policy instead of the federal funds rate, since FOMC members would be voting on, and presumably sticking to, an operational monetary supply target and would no longer be voting on week-to-week decisions about the federal funds rate (within a broad range). Policymakers are normally not given to bold frequent changes in their chosen operational instrument. When the federal funds rate was the instrument prior to late 1979, it was moved with due caution, generally in quarter- or half-point increments—an experience repeated after 1982, when the funds rate or, for a while, its very close relative, banks' adjustment borrowing at the discount window, once again became the policy instrument.

But with the money supply in effect both the policy target and instrument (converted for operating purposes into related reserve aggregates and for day-to-day technical reserve supplying decisions into nonborrowed reserves), policymakers could retain their conservatism toward the basic policy instrument. They could maintain their initial money supply target and derived aggregate reserve instrument, with appropriate technical adjustments, meeting after meeting while distancing themselves, as Lindsey, Orphanides, and Rasche put it, from the behavior of the funds rate. Bold market action would ensue, as the funds rate would be permitted, and expected, to vary within a wide range in the process of achieving the given money supply objective.

Much, if not all, of the three points above are subsumed in the authors' first eight reasons. I will glide over reasons nine and ten. It is their reasons eleven and twelve that give me the most pause, though the problem might be largely semantic. Point eleven states that a further reason for the policy shift was to demonstrate that the Fed had more clearly assumed "full central bank responsibility for the attainment of long-term price stability," while point twelve goes on to give as another reason for the policy change that it more clearly avoids "difficult questions of overt responsibility for intermediate-term real-side developments."

I would not think about the 1979 policy shift in those terms. The central bank is always responsible for price stability and also simply cannot avoid some responsibility for intermediate-term real economic developments. I would interpret the new procedure as a practical approach for implementing the Fed's responsibility for price stability in the situation of the time—following a period when it had become clear that the Fed had failed in carrying out that responsibility. Whether the approach of the 1979 program would be suitable permanently would depend on many factors, not least of which being the further evolution of

financial technology and its implications for the role, stability, and predictability of "money" and "money-like" assets in relation to prices and the economy generally.

The new procedures were designed to reestablish the Fed's anti-inflation credibility. That was their essential purpose. In the process, the real side of the economy was subordinated for a while, but I never detected any basic lessening of concern for the real economy on the part of policymakers. As it turned out, in face of a short but deep recession, together with surprisingly rapid progress in reducing inflation, the new procedures were abandoned in 1982.

Communication Issues

The most important area of communication for making the new procedures as effective as possible was between the Fed and the market. After a hiccup or two at the start, that communication path worked well. It worked in large part because Volcker went around the country saying in one forum after another that the Fed would stick to it and because the Fed did indeed do so (and, by the way, in the face of some formidable obstacles, such as the Carter-inspired credit control program of the time). The point was to convince not only financial market participants but also business and labor that inflation would certainly come under control. If expectations could be turned around quickly, and cost and price pressures muted, the pain inflicted on the economy as reasonable overall price stability was restored would obviously be lessened. In that regard, I should note the importance of President Reagan's handling of the air controllers' strike of the period. His firmness helped convince labor and business as a whole that the economic atmosphere had changed and that restraint on wage increases, and presumably therefore on price increases, was the better part of valor.

CHARACTERIZING VOLCKER

I am not at all sure that the Lindsey, Orphanides, and Rasche paper needed to get into the questions they raise about whether Paul Volcker was a monetarist, a nominal income targeter, a Keynesian of one sort or another, an inflation targeter, or a great communicator. Nor do I see much value to the questions for drawing lessons for the present day with its very different financial, economic, and social circumstances.

In any event, I do not believe any of the economic policy slots they suggest contain the man. I would say, rather, that he was an eminently practical person, who very well understood how important it was for the health of the economy and the country to bring inflation down and to restore the Fed's anti-inflation credibility. Moreover, he also had enough political astuteness to grasp that political and social conditions in the country at the time presented him with a window of opportunity for implementing a paradigm shift in policy that might well make the process of controlling inflation more convincing and quicker. In his choice of policy instrument, he was a practical monetarist for a three-year period.

On the question of whether Volcker was or was not a great communicator, they conclude that he was not. I do not agree. They seem to base their conclusion in large part on Volcker's response to Mervyn King when the latter asked if he had some word of advice for a new central banker. Volcker, so King reports, responded with one word—"mystique." Lindsey, Orphanides, and Rasche conclude that is not the advice of a great communicator; they take this view mainly, it seems, because that advice was given by a man who also presided over a central bank that had been less transparent in announcing policy decisions (the FOMC did not in those days announce its decisions immediately) than major central banks are today.

Surely, our authors are at risk of making something akin to a category error. The mystique of a central banker would seem to me to have little to do with whether or not policy decisions are transparent (that is, announced when made). Mystique is more the product of the success of the policies actually pursued and the extent to which the public associates that success with the person in charge of policy. In that sense, Greenspan today has a kind of mystique. And in that very same sense, Volcker in his day had a kind of mystique.

The advantage of mystique to a policy chief is that public confidence in the policy he represents will be high and his word (i.e., his communications with the market, the public generally, and the Congress) will be more readily believed and accepted—with a practical effect, for instance, that market expectations more likely will reinforce rather than work against policy. That mystique, and its benefits for communication, can readily be lost, or at least eroded, when policies seem to go wrong (whether transparent in announcement or not), as, for example, appears to have been experienced by Greenspan, at least for a while, following the stock market crash at the beginning of this millennium.

In short, "mystique" is what helps turn a Fed Chairman into a great communicator, although "great" might be a bit too grand an adjective when referring to the rather mundane occupation of central banking. At any rate, to me mystique is a trait that enhances a Chairman's stature and confidence in the institution he heads, thus aiding the implementation and communication of policies irrespective of the process by which the institution itself decides to announce policies.

REFERENCES

Lindsey, David E.; Orphanides, Athanasios and Rasche, Robert H. "The Reform of October 1979: How It Happened and Why." Federal Reserve Bank of St. Louis *Review*, March/April 2005, *87*(2, Part 2), pp. 187-235.