"The Fed from the Treasury–Fed Accord (1951) until the End of Monetary Targeting (1982)"

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Session title = assigned topic

- There has been a huge volume of research on the topic of this session, which includes the “Great Inflation” and the “Volcker disinflation”
- Comprehensive economic histories (eg: Bremner, Hetzel, Meltzer)
- Narrative histories of periods and FOMC decisions (eg: Goodfriend, Romers)
- Quantitative histories (eg: Bordo, Friedman-Schwartz)
- Econometric histories (eg: Primiceri, Sargent, Sims-Zha)

How do I proceed and what's my take on this period?

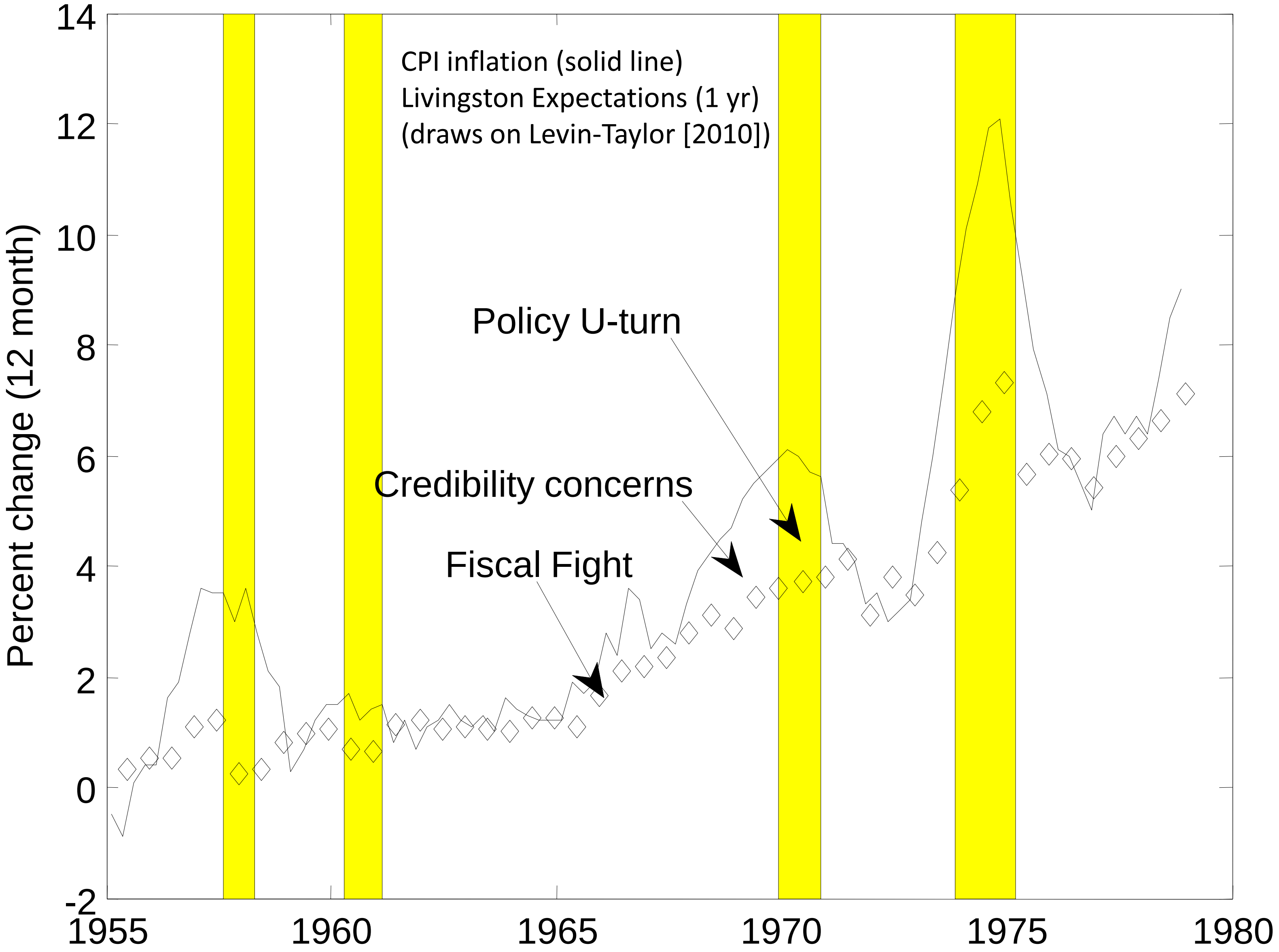
- **Method:** Construct "snapshots" of FOMC decisions, two are focus of talk (red)
  - Martin's Fiscal fight (Fall 1965)
  - **Credibility concerns (Summer-Fall 1969)**
  - **Burn's monetary policy U-turn (Spring 1970) and the Accord of 1970**
- **Common elements:** each is a period when declining policy credibility is arguably important. Hence, my paper title is "**U.S. Monetary Policy in the 1960s and 1970s: Tracking an FOMC confronting declining credibility**". This continues my work on credibility dynamics with Goodfriend on 1979-84 in "The Incredible Volcker disinflation" using basic theory and FOMC transcripts. This is also stimulated by my current research interests in theoretical and quantitative models of optimal policy and imperfect credibility.
- **Underlying theory that ended inflation**: as explained in Volcker (1977), it was "**practical monetarism**".
- **One key question and answer:** **when did the Fed start to think this way**? My conclusion is **that important elements are in 1969 perspectives and policies of the Martin FOMC**, deepening the tragedy of Burns-Nixon policies

Volcker's practical monetarism (1977)

- the long-run connection between excessive **money growth and inflation** as stressed by Friedman and Schwartz [1963] and Brunner and Meltzer [1976], while tempering that view with a recognition of the difficulty of precise monetary control in the short-run and an imperfect understanding of the transmission mechanism between money and economic activity.
- the **natural rate hypothesis for unemployment and inflation** (as articulated by Phelps [1967] and Friedman [1968]), but with a recognition of the difficulty of closely tracking the unobserved natural rate;
- a recognition of the **limits of fine tuning monetary, fiscal , and other policies** in a "world in which the future is never known, the lags between action and response are long and uncertain, and markets adjust to current expectations as much as to current facts";
- the **distinction between the nominal and real nominal interest rate** (as developed by Irving Fisher and then stressed by Friedman [1963]), with the effects of expected inflation on economic behavior of credit market participants and bond market participants;
- The central **role of expectations about policy in credit, bond and other financial markets**, with a stress on the role of credibility;

Implementing practical monetarism

- **Part of established practice:** "within our Federal Reserve councils, the longer range money supply projections have already provided a useful discipline for our debate", a view for which the snapshots provide ample evidence.
- **Tensions with adopting explicit targets:** "there was a certain initial reluctance to adopt this approach. Given that the relationship between money and other variables is imperfect, the reasons are understandable. Central bankers share a human desire to hedge against an uncertain future. They also want to retain the ability to respond flexibly as new developments emerge, to probe experimentally with new policy measures, to test market reactions and to learn from those reactions before committing themselves to follow a set course. Indeed, this flexibility to act and react has long been considered a great strength of monetary policy."
- **Communication and credibility**: "whether to the political authorities in Congress and the Administration, or to business, labor and the marketplace. It is one thing to repeat, again and again, as central bankers are apt to do, our dedication to the general proposition that, while encouraging growth, we also want to encourage a gradual return to price stability. It is quite another thing to present, defend, and stick to specific numbers for money growth consistent with that objective. Obviously, credibility in that respect is crucial. It can only be earned over time. That process will be speeded if we continue to specify our objectives and to defend our approach in public debate."


CPI inflation (solid line)
Livingston Expectations (1 yr)
(draws on Levin-Taylor [2010])
Policy U-turn
Credibility concerns
Fiscal Fight
Percent change (12 month)
14
12
10
8
6
4
2
0
-2
1955
1960
1965
1970
1975
1980

Snapshot #1: Fall 65

- Great inflation was started when the Martin-led Fed kept the interest rate low and made money growth high, on the insistence of the Johnson administration
- The Johnson administration more broadly pursued policies that led to a substantial decline in the *credibility* that households and firms attached to announced government plans. Idea of *credibility gap* was introduced, first attached to military activity in Vietnam then other aspects of policies.

Snapshot #2: Credibility Concerns

- *What I knew:* By Fall 1969, there were increasingly strong reasons <u>for academics </u>to believe in the twin components of Milton Friedman's presidential address of December 1967: (i) the Fisherian link between expected inflation and the nominal interest rate and (ii) the idea that expected inflation was important for wage and price determination (also stressed by Phelps [1967]).
- In Spring 1969, Martin had begun speaking out on the importance of imperfect monetary credibility as part of more a more general government credibility gap.
- Throughout 1969, the FOMC actions raised rates; this was tough to maintain as real economy started to slow in late summer, early fall.
- *What I learned:* The FOMC repeatedly discussed
  – the importance of keeping **policy tight until inflation expectations** ebbed rather than permitting a continued rise
  – its own imperfect credibility, with reestablishing it as a central goal. **Many members provided such statements, not just Martin**.

Example of FOMC discussion: VC Robertson December 1969

- “It is obvious that we are moving through a crucial testing period for monetary decision-makers. The signals coming from the real economy, while not all unambiguous, appear on balance to indicate some further slowing--and actual sizable cutbacks in output in the industrial sector.”
- “But this slackening pace of real economic activity has not yet been sharp enough or sustained enough to compel any significant curtailment of the inflationary pace of price and wage increases. It would be unwise to base monetary policy action at this juncture on a forecast of a future calming of wage and price pressures; inflationary anticipations seem too deeply ingrained, and too much related to longer-run expectations, for us to be sure of how they will react.”

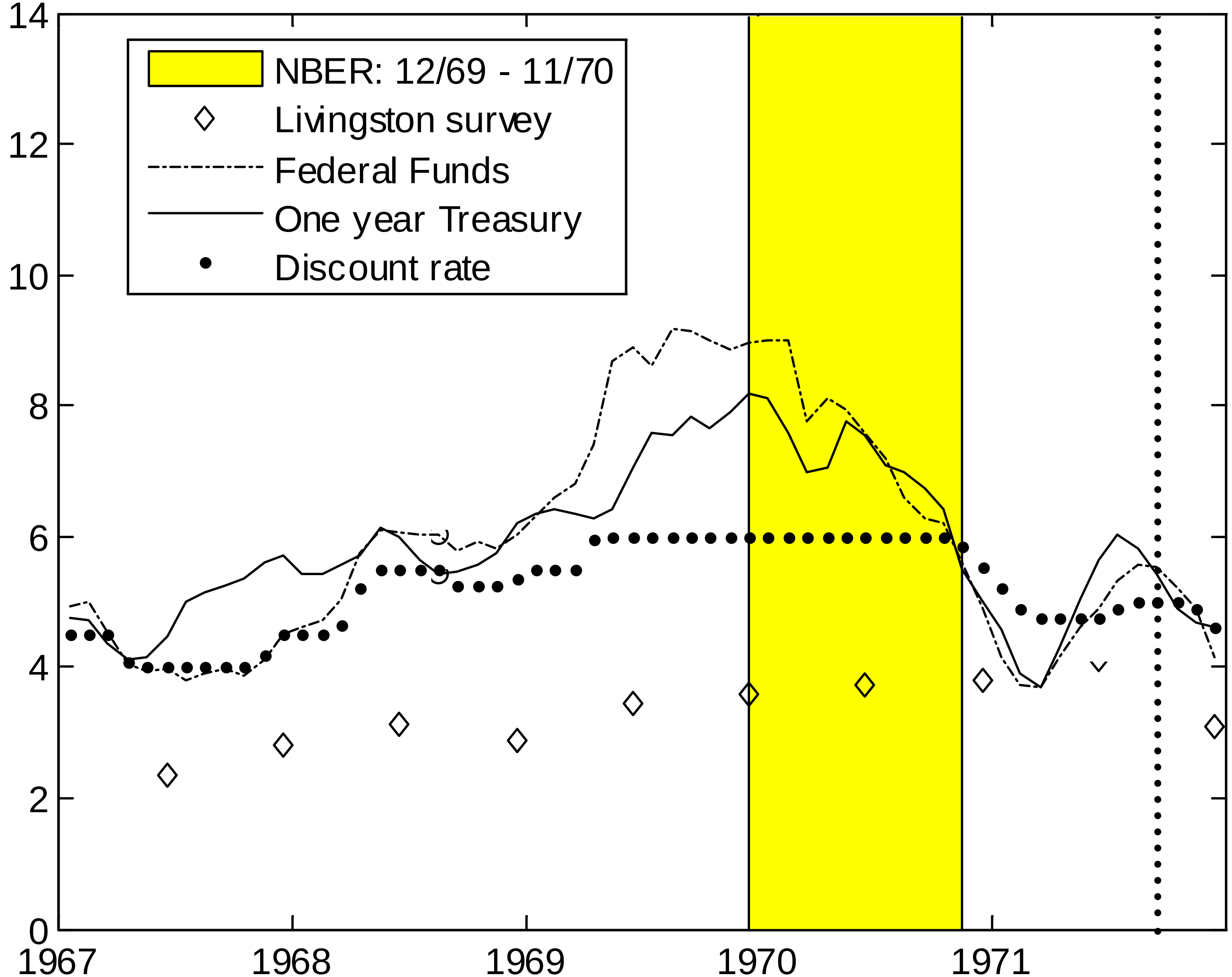
What did the Fed understand about macroeconomics at this juncture?

- *What I thought:* FOMC and Fed staff was committed to LR Phillips curve based on presentations in October 1970 Eckstein conference and did not really understand distinction between real and nominal interest rates.

- *What I learned:* Martin spoke out about links between expected inflation and interest at CBC in March 1969.
- Martin spoke out publicly about links between inflation expectations, wage-price setting and credibility at JEC in Feb 1969.
- While FOMC did not use “real interest rate” and “natural rate of unemployment” jargon, they were taking actions consistent with those views through 1969
- While some staffers were surely committed to LR trade-off, the FOMC materials in 1969 contained one clear Greenbook memo that interpreted ongoing experience as possibly consistent with expectations-augmented Phillips curve and suggested role of expectations shifts in the 1950s

Martin March 1969 CBC testimony,
echoing Friedman's [1963,1967] Fisherian arguments

- "I do not mean to argue that the interest rate developments of recent years have had no relation to monetary policy. We know that, in the short-run, expansive monetary policies tend to reduce interest rates and restrictive monetary policies to raise them."
- "But in the long-run, in a full-employment economy, expansive monetary policies foster greater inflation, and encourage borrowers to make even larger demands on the credit markets, while lenders pull back from taking positions in fixed-income securities — since they fear that both interest and principal will be eroded by rising prices.
- "Over the long-run, therefore, expansive monetary policies may not lower interest rates; in fact, they may raise them appreciably. This is the clear lesson of history that has been reconfirmed by the experience of the past several years."


14
12
10
8
6
4
2
0
1967
1968
1969
1970
1971
NBER: 12/69 - 11/70
Livingston survey
Federal Funds
One year Treasury
Discount rate

Martin on inflation, expectations and credibility (JEC Feb 1969)

- **Nature and consequences of expectations and credibility problem:** "many spending decisions are motivated now by the fear that prices will be even higher next year or by the conviction that inflation will bail out even the most marginal speculation. The price component of our national product has advanced with increasing rapidity, from an average of less than 1 1/2 per cent at year in the early 1960s, to 2% in 1965, 2 1/2 percent in 1966. 3 percent in 1967, and close to 4 percent last year. Public skepticism about the Government's ability to 'do something' about prices has its roots in this history of ever-quickening inflation."
- **Mistakes on part of FOMC earlier:** "the Federal Reserve was overly hasty last summer (1968) in expecting an immediate impact from fiscal restraint. As the published record of the Board and FOMC deliberations indicates, monetary policy moved promptly to an accommodative stance at mid-year, ... permitting a resurgence in bank credit to finance both Federal and private borrowing. Federal Reserve open market operations provided the reserve base... The business statistics that emerged over the summer and early Fall indicated far less of an impact of fiscal restraint on aggregate demands than had been earlier indicated and, as the pace of inflation quickened, monetary policy moved back to a posture of restraint. This intensification of restraint has been gradual, rather than abrupt, in keeping with our assessment of the economy's needs over the longer term."

Martin (JEC Feb 69 cont'd)

- **Strategy of gradual disinflation (gradualism):** "Over the next few months, therefore, the economy's advance should be at a more moderate pace, and that should provide a start on alleviating some of the demand pressures underlying the advance in price levels.
- **Importance of sustained restraint:** "Expectations of inflation are deeply embedded, however, and speculative fervor is still strong. A slowing in expansion that is widely expected to be temporary is not likely to be enough to eradicate such expectations. The experience of early 1967 is a lesson in point. Moderation in economic activity at that time did indeed produce a significant slowing in the rate at which prices advanced. But the moderation was short-lived. As economic activity accelerated after mid-year, so did prices. The rate of increase in the GNP deflator, which had slowed to about 2 per cent by the spring of 1967, almost doubled by the end of that year."

FRBG staff alertness to 1969 developments (Gramlich Greenbook appendix)

- Steeper trade-off when estimated with 1969 data
- Evidence of shifts during highest inflation episode of 1950s and in recent quarters.
- Openness to accelerationist view (emphasis added)

- "Recent high rates of inflation have led many observers to question whether we are still confronted by the same order of tradeoff between price inflation and unemployment witnessed earlier in the post-war period. One school of thought argues that *as inflation accelerates, implicit or explicit cost-of-living escalators are built more and more into wage bargains and price determinations, with the result that the rate of inflation tends to accelerate at relatively low unemployment rates."*

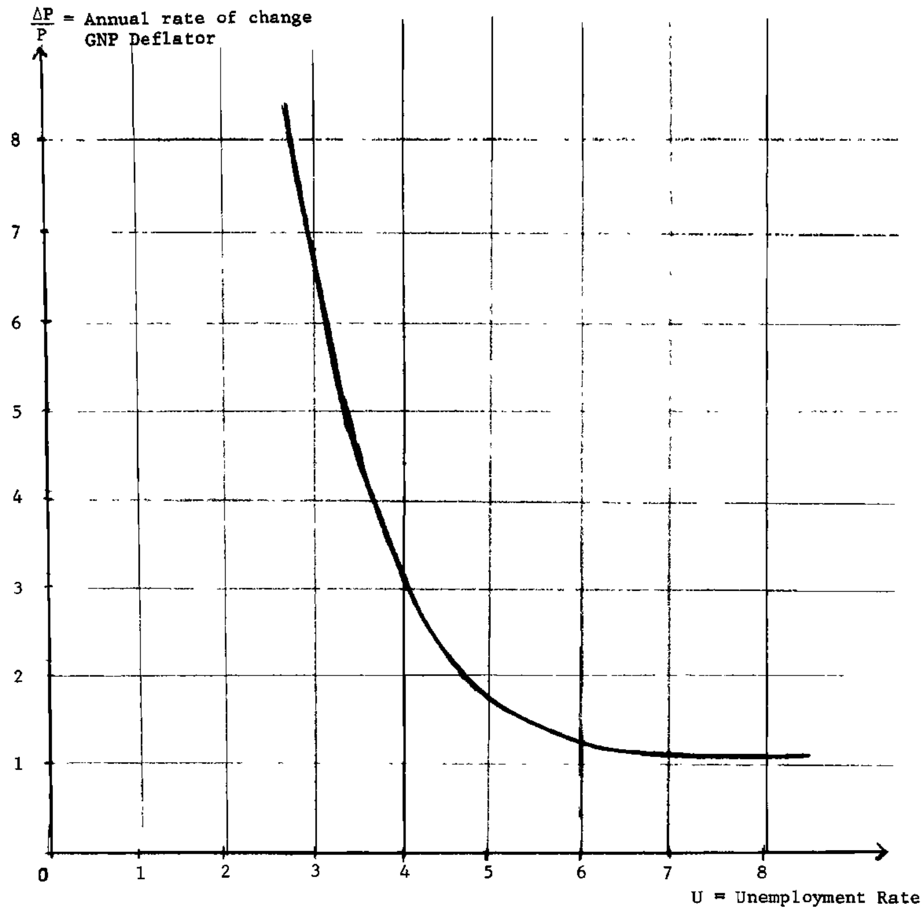
- "Even if one does not accept this proposition, *it still may be true that recent inflation has altered the trade-off between unemployment and inflation*--or in technical terms, shifted the Phillips curve--*in ways that will produce a less favorable relative performance over the next few years*."

Staff alertness

- **Limits** - "This Phillips curve *indicates little present possibility of keeping the unemployment rate below 4 per cent without perpetuating rather large rates of inflation*. Again, however, the points on the curve below unemployment rates of 3.3 per cent should be questioned because there were no sample observations in this range. On the whole, this Phillips curve is steeper than others in the literature which did not include 1969 in their data sample--suggesting that prices begin to rise rather rapidly at relatively low rates of unemployment. But this might also be interpreted to mean that moderately higher unemployment rates than we have experienced in 1968 and 1969 would ultimately succeed in reducing inflationary pressures substantially."

Plillips Curve, Based on 1954-1969 Data
Long-run relation, assuming
no change in Federal pay rates,
farm prices, and materials prices.

$$\frac{\Delta P}{P} = 3.3329 - \frac{35.2340}{U} \qquad \frac{136.9314}{(U)^2}$$



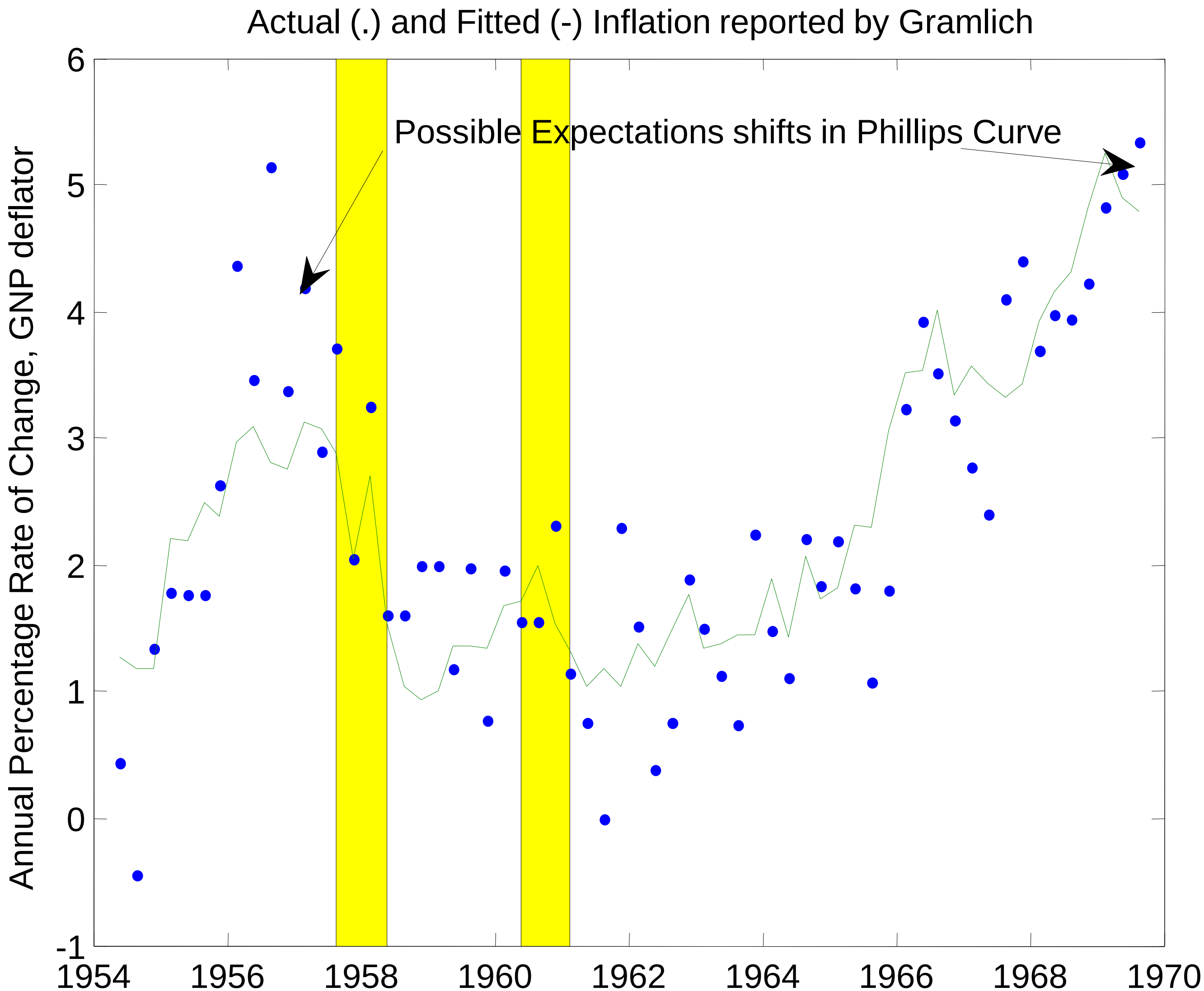
Staff alertness

- **Shifts – "***Evidence that the unemployment--price inflation trade-off could be worsening* may be gained from an examination of the residuals of the equation, which are shown in Chart 2 [reproduced as Figure 12]. Comparison of the predicted and actual values indicates that there is no systematic bias in the equation in any period except 1956-1958. *In 1956, which was the most inflationary year before 1969, the equation does seem to have gotten out of line, possibly because of a shift in inflationary expectations, and it seems to have stayed out of line throughout the entire 1958 recession. Thus, the equation under predicted inflation in 1956 and went on to under predict inflation in the subsequent recession.*

  There is no firm evidence that a similar tendency is at work now, but it is instructive to look at the three residuals for 1969. It can be seen that *the equation began the year over-predicting rates of inflation by a small amount, and since then it has been predicting declining rates of inflation because of the gradually rising unemployment rate (measured on a quarterly average basis). But actual rates of inflation this year have shown just the reverse pattern, rising from 4.8 per cent in the first quarter to 5.3 per cent in the third*. Thus, although the equation did not make significant errors over the first three quarters of 1969, it looks as if it soon may."

R.G.King, conference on 100th anniversary of the Federal Reserve System (Jekyll Island):
"Monetary Policy in the 1960s and 1970s: Tracking an FOMC Confronting Declining Credibility"

December 1969 Greenbook



Silence in the FOMC memorandum of discussion

- After Francis 1968 elaboration of “real rate”.
- After Gramlich 1969 memo on
  – PC limits: unemployment below 4% will lead to accelerating inflation;
  – PC shifts: inflation may rise given unemployment
- Was this a failure of analysis? Was it a caution about using terms that would not be part of directive?
- My readings suggest the latter. Given the politics of the times, it was tough to state that one would:
  – Raising real rates to fight inflation (Patman)
  – Raising unemployment to fight inflation (Nixon)

1970 ERP also contained“practical monetarism”

as did 1969 testimony by CE head Paul McCracken

- **Credibility:** Nixon letter in ERP articulated seven basic principles for economic policy social policy in his administration, one of which was "*Government must say what it means and mean what it says. Economic credibility is the basis for confidence, and confidence in turn is the basis for an ongoing prosperity“.*
- **Expectations, price dynamics, and output costs:** ERP also contained more nuanced statements from his economic advisory team. On the subject of expectations, inflation and credibility they wrote: "The Administration in 1969 recognized that the speed of the disinflationary process would depend in part upon how quickly business and labor became convinced that the economic climate was changing*. If business and labor continued to expect demand and prices to rise rapidly, and if they pushed up wages and prices in anticipation, disinflation would come slowly and more painfully*. This meant that the public's understanding of the determination to check inflation, of the policies being pursued and of the progress being made would be important to success. There would be room and need for efforts to inform the public. But first there would have to be evidence that the new policies were actually working.“

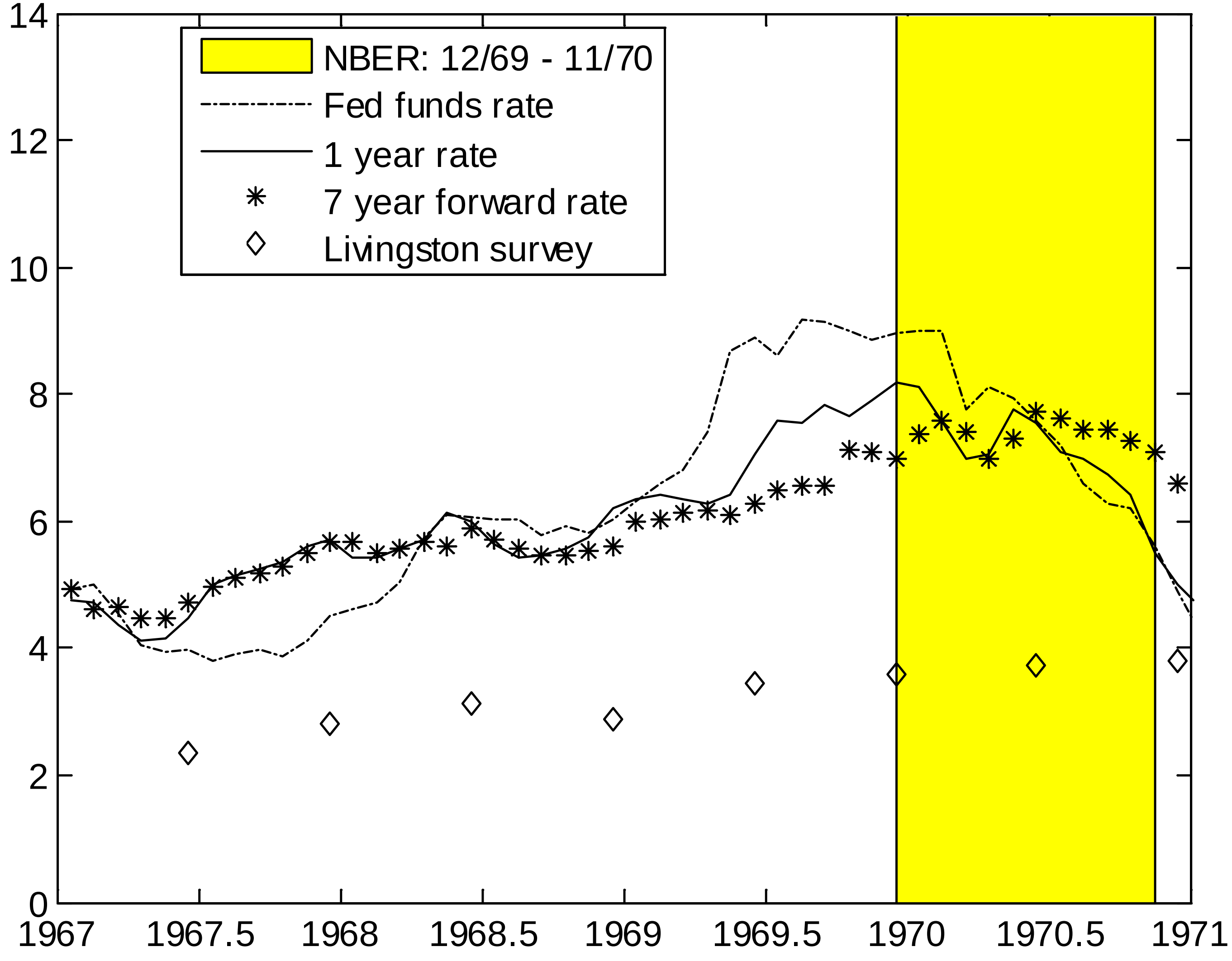
ERP (cont'd)

- **Real versus nominal interest rates:** ERP also noted: "one way in which the monetary restraint was transmitted to the economy was through its effect on the supply of credit…. This restraint in the amount of credit being supplied occurred in the face of an *unusually strong private demand for credit*. In addition to the strong demand which ordinarily accompanies a high level of economic activity, the expectation of more inflation acted as a further stimulus to borrowing. The fact that inflation had been accelerating since 1965 intensified expectations of future price increases. Individuals and businesses, seeing an opportunity to invest in real assets that would be expected to increase in money value with inflation, were eager to borrow in the expectation of repaying with dollars of reduced purchasing power. They were willing to pay high interest rates because they believed that inflation would substantially reduce the real cost of those rates. *On a loan made at the beginning of a year at an 8-percent interest rate and repaid at the end of a year in which prices have risen by 4 percent, the return on the loan in real purchasing power is, of course, about 4 percent. "*

Contrasting statements from the Nixon administration

- In his first news conferences as president (January 27 1969), Nixon stated that his administration's approach to reducing inflation would not lead to a major rise in unemployment. The New York Times headline the next day reported that he'd indicated that there was "no jobless trade-off" in his anti-inflation policy; the Times editorialized its support later in the week.
- CEA chief Paul McCracken's February 1969 testimony to the Joint Economic Committee was page 1 news in the Times: he laid out "laid out before Congress today a strategy aimed at gradually curbing inflation without a substantial rise in unemployment."

My prior disinflation analysis stressed evolving long-term inflation expectations reflected in term structure. Was this important in 1967-71?



The Accord of 1970

- “In the past days economic policy speeches by President Nixon and Chairman Arthur F. Burns of the Federal Reserve Board, we are witnessing the emergence of what should go down in the history books as the Accord of 1970.”
- “Two critical issues are involved in the Accord. First, whether the Federal Reserve will feed enough money to the economy to bring down the level of unemployment as fast as the president wants; and, second, whether the Nixon administration will develop and pursue an incomes policy strong enough to curb cost-push inflation, as Dr. Burns has been urging for months against the opposition of Mr. Nixon’s White House economists.”

Summary and conclusions

- Nature of analysis is to look at FOMC decisions periods of declining credibility; focused particularly on 1969 in this talk, with some discussion of 1970.
- The Martin FOMC sought to curtail **inflation expectations**, was aware of and alert to considerations of **practical monetarism**, and understood its **partial credibility.** Actions were consistent with this gap and designed to improve it.
- However, perhaps due to due to dissonant statements from President Nixon throughout 1969 and the prospect of the change in chairmanship in 1970, inflation expectations deteriorated throughout the year and the anti-inflation campaign was not successful. A year of high inflation and rising unemployment followed, with more in the future.