Presentation notes to accompany slides for "U.S. Monetary Policy in the 1960s and 1970s: Tracking an FOMC confronting declining credibility"

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<u>Slide 1:</u> It is a great honor to be asked to speak at this 100th anniversary of the Federal Reserve system. It is also a great pleasure to visit Jekyll Island.

The conference organizers asked me to write a paper on "The Fed from the Treasury–Fed Accord (1951) until the End of Monetary Targeting (1982)". I am doing so, although I have not yet completed a draft that I feel comfortable sharing with the public. Nevertheless, I will deliver today two core messages that will be embodied in the completed paper.

<u>Slide 2:</u> The first is that a central episode in the history of US monetary policy -- the interval of monetary restraint conducted by the Fed toward the end of the chairmanship of William McChesney Martin -- is best understood in terms of imperfectly credible policy, both in terms of FOMC actions and the accompany macroeconomic events.

The second is that the Fed approached this episode using concepts surprisingly consistent with modern macroeconomic analysis.

In my paper, I will elaborate on the response of policy to declining credibility, during other episodes in 1965-1978.

There has been, of course, tremendous amount of research on the 30 years of US monetary history which is my assigned topic. *In fact, it was precisely economic history that first drew me into the field of economics.* [1] When I accepted this assignment as a good opportunity, I planned to use modern time series econometrics tools to study the relative explanatory power of various competing theories of the rise and fall of inflation.

<u>Slide 3:</u> However, as I read various studies in preparation, somehow my inner economic historian won out. *I decided to instead to work on the narrative history of Federal Reserve decision-making using the transcripts and other materials. I was drawn to do so partly because of ongoing theoretical work concerning the design of monetary policy in settings with imperfect credibility:* I wanted to understand how the FOMC was thinking at various junctures when I thought that it faced declining credibility. To be clear, I read historical materials with the "prior" that imperfect credibility was important to macroeconomics, not necessarily to the Fed.

As I read, I increasingly focused on the events of the early 1960s and then more specifically to 1969. My specific narrative history approach is to construct a series of snapshots of Fed decisions during periods of declining policy credibility, with Summer-Fall 1969 being a key one. During this interval, the Federal Reserve under William McChesney Martin's leadership sought a disinflation, but did so

[1] Throughout this document, italicized elements are statements that I will likely leave out in the interest of a presentation within the time constraint. The slide packet also includes some items that were provided to the discussant but will not be items that I can include in the presentation due to time constraints.

recognizing that it and other government institutions had declining credibility – in the sense that households and firms were becoming skeptical about announced fiscal, monetary, and other government plans -- and, in particular, that it faced rising expected inflation. The title is carefully chosen: I view the FOMC as confronting declining credibility, not fully of its own making.

I have previously studied implications of imperfect and evolving credibility employing basic models and FOMC transcripts, with Marvin Goodfriend, examining the 1979 – 84 interval that we described as "The Incredible Volcker disinflation." So this paper represents a prequel of sorts to that earlier analysis.

<u>Slide 4:</u> The underlying macroeconomic theory which ended inflation was described by Volcker in 1977 as "practical monetarism". Prior to the current work, I thought that Fed officials began to think this way only in the late 1970s.

But my conclusion now is that important elements of "practical monetarism" are present in the 1969 perspectives of Martin and other Federal Reserve officials. To my mind, this finding deepens the tragedy of the Burns-Nixon policies.

<u>Slide 5:</u> Practical monetarism in Volcker's sense contains a number of now-standard elements:

(1) the long-run connection between money growth and inflation;

(2) the natural rate hypothesis for unemployment and inflation;

(3) the limits of fine tuning macroeconomic policies;

(4) the distinction between real and nominal interest rates; and

(5) the central role of expectations about policy in credit, bond and other financial markets and the consequent importance of credibility.

<u>Slide 5:</u> In his 1977 article, Volcker discussed the difficulties of implementing practical monetarism, which he indicated was already employed by some within the Federal Reserve system. He stressed tensions with adopting explicit monetary targets – principally, the possibility of imprecise linkages, targeting errors and the loss of flexibility – and the challenges of communication in environment of imperfect credibility.

He also stressed that private agents would be learning from observed inflation and other experiences.

As is now well understood, I think, these were central dimensions of the 1979 to 1984 disinflation experience.

<u>Slide 6:</u> The rise in US inflation occurred between 1965 and 1982.

The strategy of looking at "snapshots" is illustrated in this figure for the three which I will refer to in this talk: the fiscal fight between the Fed and the Johnson administration in fall of 1965; the restrictive monetary policy with rising inflation expectations and explicit credibility concerns in summer and fall 1969; and the policy U-turn in the spring and summer of 1970.

<u>Slide 7:</u> In my view, the Great Inflation started when the Martin-led Fed kept the interest rate low and made money growth high during 1965, on the insistence of the Johnson administration. The Johnson administration's behavior led to a substantial decline in the credibility government plans, first attached to military activity in Vietnam then with aspects of fiscal and other policies.

<u>Slide 8:</u> Approaching 1969, in retrospect, I knew that there had been increasingly strong reasons for <u>academics</u> to believe in two components of monetarism stressed in Friedman's 1967 presidential address to the AEA: the Fisherian link between expected inflation and the nominal interest rate; and the idea that expected inflation was a crucial determinant of wage and price setting (so that a version of the natural rate hypothesis obtained, as also in Phelps more Keynesian analysis).

I knew as well that Chairman Martin had discussed imperfect monetary policy credibility and that the Fed had substantially raised short-term interest rates during summer 1969.

As I've read much more about the episode, I've learned how centrally connected these were: not just Martin, but many other FOMC members made statements within the committee and in public forums on the importance of maintaining monetary restraint until inflation expectations ebbed, rather than tolerating a continued rise. I've also learned that the FOMC understood imperfect credibility and had a goal of raising it, both via its actions and information in financial markets and the effects on the broader economy.

<u>Slide 9:</u> The paper will contain many quotations that will document these points (perhaps too many). My quotations are also frequently long because I want to assure the audience *and the readers* that short phrases are not taken out of context: I highlight the take-home points in a different color, when the phrases are long.

During Spring, Summer and Fall of 1969, President Alfred Hayes of the Federal Reserve Bank of New York repeatedly produced opening statements at the FOMC stressing inflation expectations and credibility. The quote that you can see is from Vice chairman James Robertson in December 1969 and representative in terms of language and content. Together, Martin, Robertson and Hayes were the senior members of the FOMC and they did not always agree: but their views were mainly aligned on these topics.

I also don't want to pretend that FOMC memoranda of discussion did not contain many other elements during these times that muse be separated out: the status of foreign exchange markets and related lending activities; the links between reserves, interest rates and the money supply; bank regulation and a host of other topics. One can readily see during this period, for example, the origins of Bill Poole's classic QJE paper on the instrument choice problem between an interest rate and a monetary quantity. But I also believe that these credibility and inflation expectations issues were fundamental for the FOMC, even as they argued about details of policy implementation and the related wording of the directive.

<u>slide 10:</u> What did the Fed understand about macroeconomics at this juncture? Going in, I thought that the staff advice to the FOMC was heavily conditioned on a long run Phillips curve trade-off, *based on presentations at the 1970 Eckstein conference by system economists*. I also thought that the FOMC did not understand <u>or act as if it understood</u> the distinction between real and nominal interest rates in 1969.

I've change my mind on both of these topics.

Thus, while the FOMC did not use "real interest-rate" and "natural rate of unemployment" jargon, it looks to me as if they were taking actions consistent with those views throughout 1969.

I've also revised my sense of what at least some members of the staff thought about the Phillips curve and presented to the FOMC, in ways that I'll describe further below.

Slide 11:

Martin spoke out about the links between inflation expected inflation and nominal interest rates in a well-publicized testimony at the Committee on Banking and Currency (CBC) in March 1969. He could've been reading from parts of Friedman's presidential address.

Martin stated at the CBC that "over the long run, 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."

Slide 12: The experience that Martin had in mind is captured by the first portion of this chart which shows Livingston survey measures of inflationary expectations increasing throughout 1967 and 68, despite rising nominal interest rates.

It also shows that that the FOMC took actions during summer and fall of 1969 that led the funds rate to rise from 6% to 9%.

Interestingly, during summer 1969, it took some time for one-year treasury rates to similarly rise, suggesting the importance of another element of Volcker's practical monetarism: the financial markets may be skeptical at times about whether monetary ease or restraint will be maintained. *The FOMC discussed matters in these terms at the time and also when one-year rates started to move down in advance of the change in chairmen in early 1970.*

Finally, the monetary restraint arguably raised the real interest rate during this period, certainly if the Livingston survey measure is a close to accurate guide (since this is a one-year forecast, the one year interest rate is the relevant measure).

Many have suggested that this monetary restraint contributed to the recession of December 1969 through November 1970.

<u>Slide 13:</u> Martin also spoke out publicly about the links between inflation expectations, credibility, and wage-price setting in the Joint Economic Committee in February 1969: the speech is among his best-known and I now see fine details that I did not see previously.

As suggested above, Martin's JEC testimony also the importance of expectations of inflation and public skepticism about policies. He acknowledged a mistake in 1968 in a midyear move from restraint to ease.

<u>Slide 14:</u> At the JEC, Martin also outlined a strategy of moderating the real growth rate of the economy and undertaking a gradual disinflation. He argued that "slowing expansion that is widely expected to be temporary is not likely to be enough to eradicate such expectations" and referred to the lessons of the immediate past.

Slide 15: A skeptical academic might think of these as just words from a central banker and believe that deeper analysis was required. The staff at the Board provided some of that at the time: as part of my reading, I've noted an appendix to the December 1969 Greenbook prepared by economist and later governor Edward Gramlich, who was then a young staffer. Rather than being hostile to the inflation-augmented Phillips curve, Gramlich entertained it as a serious hypothesis. He sought to explore the implications of new data (for 1969) and new theory for the behavior of inflation in 1969 and in previous episodes.

Slide 16: Gramlich's memo indicated that recent data on unemployment and inflation had suggested a sharply reduced trade-off, even without accelerationist terms: "This Phillips curve indicates little present possibility of keeping the unemployment rate below 4 per cent without perpetuating rather large rates of inflation."

Slide 17: According to Gramlich's curve, a decline of unemployment from the then-prevailing 4% unemployment rate to 3% was indicated to produce an increase of inflation by 4%.

Slide 18: Gramlich also suggested that the unemployment and inflation trade-off could be worsening. In ways that might well have spoken directly to long-standing FOMC members including Martin, he noted that the inflation experience of 1956-58 was not consistent with the Phillips curve: this earlier period is one in which the FOMC under Martin was successful in containing inflation. More specifically, Gramlich suggested that this Phillips Curve failure in 1956-58 could be explained by a shift in inflationary expectations.

Slide 19: This chart reproduces the fitted Phillips curve and actual inflation time series from Gramlich's memo and highlights intervals that he suggested as potentially attributable to shifts in inflationary expectations.

Slide 20: There were at times substantial silences in the FOMC memorandum of discussion. After Darrell Francis of St. Louis spelled out the concept of the real interest-rate 1968, for example, no FOMC member followed up. And no one discussed the Gramlich memo in 1969.

I'm not sure why.

One possibility is that FOMC members did not understand these concepts or their relevance to monetary policy. But this is hard to square with Martin's testimony quoted above and other parts of the FOMC record.

It might be a caution about using terms that would not be part of the directive the open market desk in New York. But the discussions were frequently wide-ranging, suggesting that this was not the case.

Most plausibly, it might be a reluctance to use phrases that would be politically damaging, particularly with the President.

Slide 21: The Nixon 1970 Economic Report of the President contained a lot of the language of practical monetarism -- it stressed the importance of money to inflation, the importance of policy credibility and the linkages between expectations, price dynamics and output costs.

Slide 22: The ERP recognized that higher expected inflation would drive up the demand for credit at a given nominal interest rate, using language similar to that which FOMC members employed. Further, it did an explicit real interest rate calculation.

<u>Slide 23:</u> However, 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...a strategy aimed at gradually curbing inflation without a substantial rise in unemployment."

<u>Page 24:</u> All of this suggests important reasons for the private sector to be skeptical about 1969 monetary policy, i.e., for it to be imperfectly credible in their eyes. In my prior work on the Volcker disinflation, I stressed that evolving long-term expectations were reflected in the term structure and that these moved adversely during 1981, complicating Volcker's disinflation.

I think a similar mechanism was at work during 1969. The stars in this graph represents seven-year forward rates of interest and these increase significantly during the year of 1969.

<u>Page 25:</u> SKIP

<u>Page 26:</u> Another of my snapshots describes the policy U-turn took place under the new chairman Arthur Burns beginning in February 1970. Burns opened by stating that "a rethinking of monetary policy was in order.... *Just as military*

campaigns had been lost because the generals were fighting yesterday's wars, monetary policy could go wrong if it were formulated on the basis of past rather than current and prospective conditions."

The FOMC voted to ease policy. The completed paper will elaborate on this episode. However, I want to note that the initial decline in interest rates was consistent with the arguments of Keynesian and Monetarist economists, including FOMC members, who pointed to a dramatic decline in various monetary growth rates in 1969.

[SKIP slides 26-27]

<u>Slide 28:</u> Over the next year, the funds rate fell to 4.9%. In December 1970, New York Times analyst Leonard Silk wrote of a New Accord in which Federal Reserve easy money was traded for Nixon's support of incomes policy.

SKIP slide 29

<u>Page 30:</u> The nature of my analysis is to look at FOMC decisions during periods of declining credibility. I've focused particularly on 1969 in this talk, with some brief discussion of 1965-1970.

In my view, the Martin–led 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 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.*