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INFLATION IN THE 1980s:
A PERSONAL VIEW

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ABSTRACT

This paper, which was written as a part of the NBER project on American economic policy in the 1980s, reviews some of the major changes in monetary policy during that period. The paper tries to explain why policies changed in the way that they did and looks particularly at the role of economists and economic analysis in shaping those developments.

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Monetary Policy and Inflation in the 1980s: A Personal View

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This paper is part of a longer essay on American economic policy in the 1980s. The other parts of that essay will appear as three NBER working papers that deal with: tax policy; government spending and budget deficits; and the dollar and international trade.

These essays are not intended as a detailed history of economic policy during the decade. Excellent analytic histories have been written as part of the NBER project on American Economic Policy in the 1980s. The study of monetary policy for that forthcoming book was written by Michael Mussa.

My own essays, which will be combined in the first chapter of that book, are an attempt to analyze some of the reasons for the policy changes that occurred in the decade and to offer my judgements about some of those changes. I have not tried to comment on the paper by Mussa or on other published discussions of monetary policy during this period. I do provide some bibliographic references to my own publications, particularly nontechnical ones, in order to incorporate their content into this paper.

1. Attitudes about Inflation

In 1980, opinion surveys identified inflation as the problem of greatest concern to the American public. The widely reported rate of consumer price inflation was over 12 percent in both 1979 and 1980, up from about four percent in the early 1970s and less than two percent

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in the first half of the 1960s. Many Americans felt that inflation was out of control and might spiral to higher and higher levels.

Two years later, after the deepest recession of the postwar period, inflation had been reduced to four percent. Except for fluctuations in the price of energy, the inflation rate remained at approximately that level for the remainder of the decade while the economy enjoyed above-trend growth of real GNP and employment.

An analysis of this dramatic reversal of inflation can illustrate the complex way in which public opinion, politics, and technical economics interact in the shaping of monetary policy.

The public's strong aversion to inflation contrasted with a rather widespread view among economists in the 1960s and 1970s that inflation was not a serious problem and that it was probably better to live with inflation than to pay the price in terms of lost output of reducing it. The oversimplified models used to analyze inflation indicated that the only cost of persistent inflation was that individuals would be induced to hold too little cash. No less an economist than James Tobin warned those economists who worried aloud about inflation that we would be embarrassed if the public ever discovered that the only real cost of inflation was the de minimis "shoe leather" costs of going too frequently to the bank to withdraw currency. Indeed, in a major address to the Econometric Society, Tobin went further and argued that a higher rate of inflation could be desirable because it raised real incomes by inducing people to substitute claims on real capital (bonds and stocks) for cash in their portfolios, thus reducing the yield required on investment in plant and equipment.

Nevertheless, the rising inflation of the 1970s increased the public's opposition to inflation and their willingness to support a presidential candidate who promised tough action to

reduce inflation. No doubt some people opposed inflation because of fallacious reasoning: they thought that they "deserved" the full real value of the nominal wage increases that they had received and resented having the purchasing power of those increases eroded by inflation. But the public's opposition cannot be attributed to this logical error alone.

People resented the fact that the combination of inflation and an unindexed tax system was pushing them into higher tax brackets, forcing them to pay a higher share of their real incomes in taxes. Many prospective homebuyers knew that the rise in mortgage interest rates from less than six percent in the 1960s to more than 12 percent in 1980 prevented them from qualifying for a mortgage or being able to make the monthly payments even if they could find a willing lender. Pensioners saw the real value of their corporate pensions and personal savings eroding rapidly. Businessmen understood that the real value of depreciation allowances was sharply reduced by the high inflation rate, raising the effective rate of tax and discouraging investment in plant and equipment. And shareholders, who had been paying capital gains taxes on nominal gains even though the real value of their stocks had been declining, were shunning common stock, depressing the stock market and raising the cost of equity capital.²

Some economists might argue that these distortions were not inherent in inflation, but reflected institutional details that could be corrected by indexing tax laws and pensions and redesigning mortgage payment schedules. But a decade and a half of rising inflation had occurred without such institutional corrections. By 1980, the public was ready for a tough

² I discussed these issues in a series of technical papers published in the 1970's and collected in Feldstein (1983a).

anti-inflationary policy and an increasing number of economists (although certainly not all economists) were becoming convinced of the high real costs of inflation.

The Federal Reserve had, of course, been aware of and unhappy about the rising rate of inflation throughout the decade of the 1970s, but did not act forcefully enough to stop it. This may be because they underestimated its adverse effects or thought it could be reversed at some future time at relatively low cost (Feldstein, 1982a). But a significant part of the blame must also be attributed to the Fed's focus on nominal interest rates as a measure of the tightness of monetary policy.

As inflation rose, interest rates rose as well, although more slowly. Thus real interest rates actually fell while nominal interest rates were rising. Federal Reserve officials who saw nominal interest rates rise thought that they were increasing the cost of funds when in fact the real cost of those funds was declining. The mismeasurement was even worse when taxes were taken into account because nominal interest payments are deducted in calculating taxable income.

To see this effect of the interaction of inflation and tax rules, consider for example the effect on the real net cost of mortgage borrowing. Between 1965 and 1975, the interest rate on fixed rate mortgages rose from 5.8 percent to 9.0 percent while inflation rose from 1.4 percent to 6.2 percent. The real interest rate thus fell from 4.4 percent to 2.8 percent, a decline of 1.6 percentage points. A taxpayer with a 30 percent marginal tax rate in both years would have paid a real after-tax rate of 2.7 percent in 1965 but only 0.1 percent in 1975, a decline of 2.6 percentage points. Such calculations may be a commonplace now, but the logic eluded the Fed in the 1970s (Feldstein, 1980).

2. An Unsuccessful Disinflation

Paul Volcker became Chairman of the Federal Reserve in August 1979. Two months later, he persuaded his colleagues on the Federal Open Market Committee (FOMC) that a strong commitment to reduce inflation and a radical change in the Fed's operating procedure were needed.

It could have been otherwise. The surge in inflation from nine percent in 1978 to more than 12 percent in 1979 could have been attributed to the jump in oil prices rather than to excess demand. But Volcker seized the opportunity of an inflation surge to attack the inflation problem that had been festering for more than a decade.

The Federal Reserve announced in October 1979 that it would focus on slowing the growth of the money supply and would be willing to tolerate much greater movements in short term interest rates. Interest rates then rose dramatically and the economy slowed.

The interaction between the Federal Reserve and the Carter Administration has not been fully documented. What is clear is that Paul Volcker had told CEA Chairman Charles Schultze and Treasury Secretary William Miller about his intentions in October and had presumably received at least the tacit consent of the Carter administration. But when the short rates reached over 15 percent in March 1980, the Fed lost the support of the Carter Administration. President Carter, with less than nine months to the 1980 presidential election, authorized the Fed to use credit controls to constrain consumer spending and effectively forced them to do so by going on television to exhort consumer restraint in the use of credit.

During the next three months, the economy weakened dramatically. The Fed responded to a drop in the money stock by cutting short rates nearly in half. At the time, this looked like

an attempt to reverse the recession during an election year rather than the inevitable interest rate effect of the Fed's new policy of targeting the monetary aggregates. The drop in interest rates was followed by an economic recovery in the third quarter of 1980. The very short period of tight monetary policy and weak economic activity was not enough to reduce the rate of inflation.

3. The Reagan-Volcker Disinflation Policy

Ronald Reagan's 1980 presidential campaign had emphasized the need to fight inflation and return to price stability. It was hoped that a gradual tightening of monetary policy combined with the fiscal stimulus of the 1981 tax cuts would permit inflation to be brought down slowly and without a recession.

To the extent that "credibility" of policy was thought to be helpful in accelerating the decline of inflation, the analysis was based on old common-sense propositions that had been put forward over the years by William Fellner and Henry Wallich rather than on the more extreme version of those views embodied in the new rational expectations theories that claimed that even very tight money would not hurt the real economy at all if the policy change were correctly perceived. Nor was any credence given by either the Fed or the new Administration to those extreme supply-siders who argued that reducing inflation did not require a contraction of demand since prices would fall once the supply side policies had succeeded in increasing the supply of goods and services.

The Fed tightened monetary policy sharply immediately after the election, raising the Fed funds rate by 600 basis points in less than two months. This monetary contraction pushed the economy into a deep recession, a recession that was worsened by the very unusual drop of velocity in 1982. The unemployment rate rose from 7.5 percent in January 1981 to 10.2 percent

in September 1982 when I joined the Administration as Chairman of the Council of Economic Advisers. On that occasion, my Harvard colleague, Ken Galbraith, commented to the Boston Globe that I had just signed on for a ride on the Titanic.

Despite the dramatic increase in interest rates and in unemployment, President Reagan supported the Fed's tough policy. A firm opposition to inflation was part of his overall conservative economic philosophy. Moreover, he believed that the public understood that the high interest rates and the recession were necessary to correct the inflation that he had inherited from the Carter years. It was indicative of his attitude, but nevertheless remarkable, that the President chose "Stay the Course" as the 1982 election campaign motto at a time when the unemployment rate was rising every month to higher levels than had been seen in the years since World War II.

It was also a remarkable indication of the public's concern with inflation that the President's "approval rating" in the opinion polls conducted by the White House turned up sharply in the second half of 1982 as it became clear that inflation had been brought down even though there was no sign of an economic upturn.

4. Monetary Easing and Recovery in 1982

Although the broadest measure of inflation (the GNP implicit price deflator) fell from nearly nine percent in the final quarter of 1981 to only 4.5 percent in the first half of 1982, the Federal Reserve kept the Federal funds interest rate over 14 percent. The Federal funds interest rate was actually slightly higher in the first half of 1982 than it had been in the final quarter of 1981.

I argued in a Wall Street Journal article in the summer of 1982 (Feldstein, 1982b) that a "one time" increase in the money stock would, at least in theory, be appropriate at that time to reverse the recent rise of real interest rates. Without an injection of additional money, the increase in the real money stock required to return the interest rates to a sustainable equilibrium level could be achieved only by several years of depressed economic activity that kept the rise in prices significantly below the rise in the nominal supply of money. But I cautioned in that article that injecting additional money would run the risk of frightening financial markets that the Fed was reverting to its old inflationary ways and that the "one time" money supply increase was just the beginning of a new period of faster money growth. I hoped at the time that if the rationale for a one time injection of money could be communicated effectively to the financial markets, it might be possible to reduce short-term interest rates without arousing fears of renewed inflation.

Some time after I wrote that article and after my subsequent nomination as CEA chairman, but before I went to Washington in early September, I met with several people in the New York financial community to ask how they would respond to such an injection of liquidity by the Fed. There was virtual unanimity in this sophisticated financial group that the market would welcome a sign of easing by the Fed.

Paul Volcker and his colleagues dealt with the perception and credibility problem by easing without saying that they had done so. Interest rates fell sharply with the Federal funds rate dropping from over 14 percent to below nine percent by the end of the year. The Fed took no credit for easing, but said only that the Fed funds rate was moving in parallel to other short term market rates and that this general downward movement of rates reflected the fall in

inflation. The sharp increase in the narrow money stock (M1) was explained away by references to the expiration of All-Saver Certificates, a technical factor that could probably account for only a very small part of the jump in the growth rate of M1 in late 1982.

In 1983 and 1984 the economy enjoyed stable inflation and rapidly increasing real GDP. The overall pace of nominal GDP growth was not in any way surprising in the wake of the Fed's substantial easing that had begun in mid-1982. The division of the nominal GDP rise between real growth and inflation was, however, more favorable than would have been expected on the basis of past statistical relationships. The primary reason for this, I believe, was that the fiscal expansion caused the dollar to rise, reducing import prices and putting downward pressure on the prices of domestic products that must compete with foreign products. The result was lower inflation and therefore more room for faster real GDP growth within the same total nominal GDP. (See Feldstein and Elmendorf, 1989)

5. Presidential Support for the Fed

As the newly arrived CEA Chairman in the fall of 1982, I heard loud complaints from businessmen and from members of Congress about the state of the economy and about the need for lower interest rates. Even with the easing of monetary policy that had begun during the summer of 1982, real short-term rates remained quite high. The real rate on 6 month Treasury bills was more than 5.5 percent in the third quarter of 1982. Moreover, the prime rate charged to business borrowers came down more slowly than market rates; the gap between the prime rate and the 6-month Treasury bill rate widened from less than three percent at the start of 1982 to four percent in September. The unemployment rate was over ten percent and was continuing to rise every month.

Although the NBER eventually identified November 1982 as the bottom of the recession, the fact that the economy had begun expanding was not clear until February 1983. During the months before the 1982 Congressional election, the economy looked very weak and Fed policy appeared unnecessarily tight to many observers.

Some of the President's staunchest allies in Congress complained bitterly that excessively tight monetary policy was preventing the rapid growth that should have resulted from the supply side tax cuts of 1981. On one occasion in October 1982, soon after I had joined the Administration, a leading member of that group met with the President in the Oval Office. The President listened politely to his plea to lean on the Fed to achieve an easier monetary policy, but then explained that that would be wrong because it would jeopardize the progress on inflation. The President then added that it would in any case be inappropriate to interfere with the Fed's independence.

The President's comments in that meeting were quite consistent with his later actions and statements on monetary policy. On many occasions over the next two years, when the press reported that "the Administration" was criticizing Federal Reserve policy, the criticisms were never coming from the President or being made at his request. The Fed's critics were either in the Treasury (Secretary Donald Regan or Undersecretary Beryl Sprinkel) or among the White House political staff. The White House officials who criticized the Fed wanted to protect the Administration from any future criticism if the economy faltered by blaming the Fed in advance and distancing the President from Federal Reserve policy. On several occasions, when I thought that the criticism had gotten loud enough to worry about, I mentioned it to the President who soon went out of his way at a news conference to express support for the Fed.

The ultimate measure of the President's support for the Fed's policies was his decision to reappoint Paul Volcker in 1983 for another four year term as Fed chairman. Volcker's critics urged the President to dissociate himself from the 1981-82 recession by not reappointing the man most closely identified with the policy of high interest rates. They urged him also to "have his own man" at the Fed to assert his control of that institution. But the President accepted the advice of those who said that Volcker had done a good job in reducing inflation and that his reappointment at the Fed would be a sign of the President's continued commitment to low inflation.

6. The Determinants of Monetary Policy in the 1980s

It is difficult to generalize about the determinants of Federal Reserve monetary policy. Federal Reserve actions do not represent the views of the Chairman alone, but reflect a consensus among FOMC members or at least a majority of those voting at the FOMC meeting. Moreover, each FOMC member has his own implicit weights on a variety of considerations. I am nevertheless confident that Federal Reserve decision making in the 1980s was quite different than it had been in the 1970s or 1960s.

At a minimum, the difficulty and pain of reducing inflation in the early 1980s made the FOMC members more concerned about policies that could allow a resurgence of inflation. The emphasis was therefore on restraining the pace at which unemployment declined so that the recovery would not be fast enough to overheat the economy.

Monetary aggregates played a more central role in making and judging monetary policy than they had in the past although probably not as substantial a role as the Fed's annual reports to Congress suggested. Nevertheless, it is surely more than a coincidence that M2 was within

the target range in almost every year from 1983 through 1989. And although the Federal Reserve paid more attention to the Fed funds rate after mid-1982 than it had in the previous two years, it did not go back to the narrow 50 basis point range that it had used prior to 1989.

Monetarist critics accused the Fed in 1983 of abandoning monetary targets and allowing too rapid a growth of the monetary aggregates. In fact, however, the change in Fed rules permitting banks to pay interest on checking accounts that took effect in early 1983 changed the demand for money in two fundamental ways that temporarily made continuation of the previous money growth rates inappropriate. First, it made the difference between M1 and M2 much less meaningful, eventually forcing the Fed to abandon M1 targets and focus on M2. Second, the interest available on checking accounts caused a sharp increase in the demand for M2 relative to nominal GNP.³

The monetarist critics (including Treasury Undersecretary Beryl Sprinkel and many distinguished academic and business economists) were not convinced. They complained about the sharp acceleration of M2 in early 1983 and the deceleration that followed. They predicted that the spurt of money growth would cause inflation and that the subsequent sharp deceleration of money growth would cause an economic downturn. Since neither prediction materialized, the episode reduced the already weak support among economists and financial experts in general for focusing on monetary aggregates in deciding monetary policy, a case that had previously been undermined by the sharp decline of velocity in 1982.

³ In the months before this regulatory change occurred, Paul Volcker told me privately that the Fed was expecting a substantial increase in the demand for M2 balances. The Fed staff had studied the experience in New England where such interest bearing checkable deposits had been introduced earlier and concluded that for a few months the Fed should abandon the aggregate targets and stabilize nominal interest rates.

In chapter one of the 1983 Economic Report of the President, I had previously argued that a strict policy of targeting monetary aggregates was less appropriate than one of targeting nominal GNP, using monetary aggregates as important intermediate targets or indicators in a way that reflected observed changes in velocity. I had tried to persuade Paul Volcker that an explicit statement of such a policy would allow the Federal Reserve to vary the growth of monetary aggregates without causing financial markets to fear that the Fed had lost control or was returning to old inflationary ways. Volcker and his colleagues were never willing to be quite so explicit. Perhaps that was because they believed that the public and the Congress would not permit the Fed so much freedom of action if they understood the extent to which the Fed could actually influence nominal GNP and thus short-run movements in real economic growth. The Fed preferred to disguise its influence on both interest rates and nominal GNP, speaking instead about its policies to change "pressure on reserves."

In reality of course, the FOMC members know that their policies affect aggregate demand and thus both real income and inflation in the short run so that any decision to change the level of interest rates is at least an indirect way of influencing real income and inflation. Indeed, because the staff presents model simulations of the effects of alternative policies on both the price level and real output, they are in effect inviting the FOMC to choose among alternative pairings of real GNP and inflation when they set the Federal funds rate and the targets for the monetary aggregates.

7. A Correct Strategy

In my judgement, the basic strategy of monetary policy in the 1980s was correct: tough medicine to reduce inflation quickly while the public's support permitted the necessary

contractionary policy, followed by enough monetary easing to achieve a moderate paced recovery that would avoid overheating demand. The tough recession reduced inflation at substantially lower cost in terms of lost output than many critics of tight money had predicted at the start of the decade and the restrained pace of expansion permitted a substantial decline of unemployment without any increase in inflation.

The Fed's reaction to the 1987 stock market crash was also appropriate -- both in providing immediate liquidity and in rapidly withdrawing it once the markets had become calm. But while I believe that the broad sweep of monetary policy was correct, there were many periods in the 1980s when the Fed's fine tuning seemed to me inappropriate.

The Fed's unwillingness to focus on a nominal GNP goal may also have led at times to an inappropriate monetary policy. For example, monetary policy was tightened sharply in 1987, contributing to the collapse of the stock market. The Fed explained at the time that its policy was aimed at preventing a decline of the international value of the dollar. If this is an accurate description of the Fed's motivation, it shows the disadvantage of trying to target the exchange rate rather than the growth of nominal GDP.⁴

More generally, the problem that the Fed faced as the decade of the 1980s came to an end was that the economy had been expanding at too fast a rate for too long. A relatively easy monetary policy throughout the post-1982 period had cut the unemployment rate to 5.2 percent by the start of 1990. As a result of this policy, the rate of inflation (measured by the CPI

⁴ It is, of course, difficult to know whether the Fed's statements that monetary tightening in mid-1987 was designed to prevent a sharp fall of the dollar should be taken at face value. It is perhaps equally plausible that the Fed was using the international system as a way of obtaining Administration support for a decision to restrain economic activity that the Fed judged was increasing too fast.

excluding energy) rose from 3.9 percent in 1985-86 to 5.2 percent in 1990. The Fed then shifted to a pattern of tightening aimed at continuing the previous decline of inflation without an actual downturn of employment. Whether that strategy would have worked will never be known because of Saddam Hussein's invasion of Kuwait.⁵

⁵ See Michael Mussa's excellent chapter in American Economic Policy for the 1980s for a detailed discussion of monetary policy actions throughout the entire decade. Feldstein (1992) discusses monetary policy in the last few years of the decade and the early part of the 1990's.

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