FEDERAL RESERVE BANK of ST. LOUIS

President's Message: Volcker's Handling of the Great Inflation Taught Us Much

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Unbeknownst to many, last fall was the silver anniversary of a watershed moment in Fed history and the economic history of the country. On Oct. 6, 1979, Fed Chairman Paul Volcker took dramatic steps to rein in the runaway inflation that had been sapping the strength of our economy since the mid-1960s. Without his bold change in monetary policy and his determination to stick with it through several painful years, the U.S. economy would have continued its downward spiral. By reversing the misguided policies of his predecessors, Volcker set the table for the long economic expansions of the 1980s and 1990s.

How bad was the period of the Great Inflation? The inflation rate, a mere 1 percent in 1965, hit 14 percent by 1980. Unemployment trended up from a low of 3.5 percent (annual average) in 1969 to 9.7 percent in 1982. The stock market was in the dumps. Oil prices jumped off the charts. Presidents Richard Nixon and Jimmy Carter became desperate enough to tinker with price controls, the results being disastrous.

Volcker, in office only two months, took the radical step of switching Fed policy from targeting interest rates to targeting the money supply. The days of "easy credit" turned into the days of "very expensive credit." The prime lending rate exceeded 21 percent. Unemployment reached double digits in some months. The dollar depreciated significantly in world foreign exchange markets. Volcker's tough medicine led to not one, but two, recessions before prices finally stabilized.

We've learned a lot from that period.

For starters, ideas matter. Bad economic advice, much of it from economists, contributed greatly to policy mistakes in the pre-Volcker days. Keynesian economics had been in vogue by then for decades. This school argued that the government could tax and spend its way to full employment. Inflation was acceptable if it put more people to work. Thankfully, such thinking has been discredited today, although our economic models still need improvement.

The Fed also learned that to be effective, it must have the confidence of the markets and the public. During the 1960s and early 1970s, various Fed chairmen made rumblings about fighting inflation, but they always backed down when the complaints about the resulting higher cost of credit grew loud. Fed Chairman William McChesney Martin, for example, was no match for President Lyndon Johnson, who depended on cheap credit to finance the Vietnam War and his Great Society. Because the markets observed the Fed's lack of fortitude, they had no expectations that the Fed would conquer inflation. It is extremely costly to bring inflation down if inflation expectations don't come down. Not until Volcker showed that the Fed could take the heat did the markets believe that the Fed was serious this time.

Another lesson from the Great Inflation is that the Fed can only achieve its goal of maximum sustainable employment if it is successful in achieving its goal of price stability. The idea that we can let down our guard on inflation to increase employment is unwise in the long term because higher inflation eventually destroys rather than creates jobs.

We've also learned our lesson to speak up. In the 1960s and 1970s, not everyone in the Fed System believed that an inflation/employment tradeoff would work. But these people didn't forcefully vocalize their worries. Everyone connected to the Fed today must be vigilant in ensuring that all sides of a debate are given a forum. I think we do a good job at airing debates today, but I believe the public should also be privy to this communication. If we are transparent in all that we do, we will have the public's support when tough medicine is needed again.

Last, we learned that we need strong leaders. Paul Volcker was vilified for years because of the steps he had to take to break the back of inflation. "Wanted" posters targeted him for "killing" so many small businesses. Yet he remained resolute, doing what he knew was best for the country in the long term. We are also fortunate that President Ronald Reagan supported Volcker and the cause of price stability.

Let's hope we always have such strong leaders at the helm.