Name ______________________ Date ____________________ Class ______________________

PRIMARY & SECONDARY SOURCES Reading 21

FROM STAGFLATION TO THE GREAT MODERATION

Inflation eats away at purchasing power and has other negative effects on the economy. Yet, for many years, inflation was viewed as a necessary trade-off to keep unemployment low and prevent recessions. A change in monetary policy at the Fed in 1979 demonstrated that taming inflation and promoting economic growth go hand in hand. As you read about the Fed's decision that year, think about the effect that rising prices have on you and your family. Then answer the questions that follow.

When Paul Volcker returned early from an International Monetary Fund meeting in Belgrade on Oct. 2, 1979, everyone sensed that something was afoot. Volcker, the newly installed Chairman of the Federal Reserve Board of Governors, had called for a special meeting on Oct. 6, which was 10 days ahead of the regularly scheduled Federal Open Market Committee (FOMC) gathering. Average inflation had rocketed to 10.6 percent in the first eight months of 1979 from 7.6 percent in 1978. In September, inflation soared to a high of 11.9 percent over the previous year.

Worried about those trends, Volcker believed that the Fed had to change its policies, sharply and decisively. He opened that fateful meeting with this observation: "We wouldn't be here today if we didn't have a problem."

More than a quarter of a century ago, the Federal Reserve took a dramatic turn in monetary policy that sent interest rates soaring to their highest levels on record and triggered two recessions. But the move also finally arrested inflation's insidious rise and set the stage for a long period of prosperity in the United States.

The "Incredible Volcker Disinflation," as economists Marvin Goodfriend . . . and Robert King . . . hail this period, was "incredible" because the Fed was able to successfully bring down inflation from a high of 13.5 percent in 1980 to less than 4 percent in just a few years, and to keep it low for the next two and a half decades. This was a remarkable feat at a time when inflation seemed so well-entrenched in the economy and the costs of reducing it were deemed very large. . .

But Goodfriend and King also call this period "incredible" because . . . [t]he public's deep skepticism of whether policymakers were serious about taming inflation and whether they would stay the course made it extremely difficult for the Fed to earn the credibility that was necessary to effectively rein in prices.

One of the Fed's missions is to conduct monetary policy in the pursuit of maximum sustainable growth. In many ways, The Reform of October 1979, as it has also come to be known, has led to the recognition that the Fed can best achieve this goal through its principal mission: keeping prices stable. . . .

. . . At the meeting on Oct. 6, [Volcker] presented the committee with two possibilities for attacking inflation: the traditional method that would involve targeting a significant increase in the fed funds rate; or, a radical change in operating procedures.

The Fed has at its disposal two main approaches for conducting open market operations: It can target the price of balances—the federal funds rate—that banks hold at the Federal Reserve. Or it can target the quantity of those balances. The operational shift that Volcker was proposing would mean the Fed would stop directly targeting the prices of reserve balances and instead aim at a specific level of "nonborrowed reserves." Under the plan, the Fed would target a level of balances that would fall short of demand at the prevailing fed funds rate, thus causing banks to bid up the rate—accomplishing the same monetary policy goal but in a different way. . .

. . . The two possibilities were put to a vote and the outcome was unanimous—switch to the new operating procedures. . . .

The Fed hoped that this dramatic shift would send a firm signal of its resolve to fight inflation and its intention to return the economy to more stable times. The question, however, was whether the Fed would stick to this policy. . . .

[The Fed's] move . . . finally arrested inflation's insidious rise and set the stage for a long period of prosperity in the United States.

The first test of the Volcker Fed's determination to stabilize prices came on what Goodfriend identifies as the "inflation scare" of December 1979 to February 1980. During this period, the 10-year bond rate, an indicator of inflation expectations, soared from 10.5 percent to 12 percent. The inflation rate in February over the previous year was around 14.2 percent. At the same time, there were indications that the economy was weakening, which once again put the Fed in a bind. But the Fed forged ahead with its tightening stance, and within two weeks of the March 1980 FOMC meeting, the fed funds rate shot up to 19 percent. . . .

Still, nothing could stop long-term inflation expectations from climbing higher, as they did when the 10-year bond rate peaked to more than 15 percent in October 1981. Average inflation for 1981 was running at 10.4 percent. This second inflation scare, say Goodfriend and King, was a pivotal moment in U.S. monetary history "because it convinced the Fed that the cost of a deliberate disinflation in 1981–82 was acceptable in light of the recurring recessions that would be needed to deal with inflation scares in the future. . . ."

Finally in October 1982, Volcker announced the end of the new operating procedures that were put in place three years earlier. Inflation had begun to weaken in the spring of 1982 and by that fall, inflation had slipped to around 5 percent, the long rates dropped by 2 percentage points since that summer, and the fed funds rate fell to around 9 percent from more than 14 percent in July. . .

Volcker's monetary policy experiment established the credibility that the Fed sorely needed to stabilize inflationary expectations. A time of unprecedented low inflation and steady economic activity has ensued in the decades since the Volcker disinflation, a period which has been called the "Great Moderation." Most observers agree that improved monetary policy since Volcker deserves much of the credit for this era of stability. . . .

Sumo, Vanessa. "From Stagflation to the Great Moderation." *Region Focus*, Summer 2006

ANALYZING THE READING

1. Why do economists Goodfriend and King call the Volcker disinflation (attack on inflation) "incredible"?

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2. What did the "Reform of October 1979" show is the best way for the Fed to achieve its goals?

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3. What two possibilities for attacking inflation did Volcker present to the Federal Open Market Committee during its meeting of October 6, 1979? Which option was chosen?

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4. What was the first test of the Volcker Fed's determination to stabilize prices? How did the Fed respond?

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5. What is the period since the Volcker disinflation sometimes called? Why?

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