What Have We Learned since October 1979?

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My good friend Ben Bernanke is always a hard act to follow. When I drafted these remarks, I was concerned that Ben would take all the best points and cover them extremely well, leaving only some crumbs for Ben McCallum and me to pick up. But his decision to concentrate on one issue—central bank credibility—leaves me plenty to talk about.

Because Ben was so young in 1979, I'd like to begin by emphasizing that Paul Volcker re-taught the world something it seemed to have forgotten at the time: that *tight monetary policy can bring inflation down at substantial, but not devastating, cost*. It seems strange to harbor contrary thoughts today, but back then many people believed that 10% inflation was so deeply ingrained in the U.S. economy that we might to doomed to, say, 6-10% inflation for a very long time. For example, Otto Eckstein (1981, pp. 3-4) wrote in a well-known 1981 book that "To bring the core inflation rate down significantly through fiscal and monetary policies alone would require a prolonged deep recession bordering on depression, with the average unemployment rate held above 10%." More concretely, he estimated that it would require 10 point-years of unemployment to bring the core inflation rate down a single percentage point,[1] which is about five times more than called for by the "Brookings rule of thumb."[2] In the event, the Volcker disinflation followed the Brookings rule of thumb rather well. About 14 cumulative point years of

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[1] Eckstein (1981), p. 46.
[2] This rule of thumb was due to a number of members of the Brookings Panel on Economic Activity in the 1970s, including Arthur Okun, George Perry, and William Nordhaus, but especially to a series of papers by Robert Gordon.

unemployment above NAIRU drove core inflation down by 6.2 percentage points over the six years spanning 1980 to 1985.[3] Yes, disinflation hurt, but much less than what the pessimists envisioned. Volcker may have enhanced the Fed's credibility; I certainly think so. But that did not improve the inflation-unemployment tradeoff.

The forced march of core inflation down from 10% to 4% in the early 1980s taught us a second lesson that, I believe, is the essence of Paul Volcker's legacy: that *sometimes the central bank has to be single-minded about fighting inflation*, and that the strong will of a determined leader like Volcker is one key ingredient. When Volcker took the helm, the nation's problem was clear—too much inflation, and so was the solution—sustained tight money. It only required someone with iron will to apply the solution to the problem. Lindsey, Orphanides, and Rasche (2004) ask at this conference whether Volcker was a monetarist, a Keynesian, an inflation-targeter, and so on. They seem to answer no in each case. To me, the right short characterization of Paul Volcker as Chairman of the Fed is simple: He was a highly-principled and determined inflation hawk.

I would like to contrast these two Volcker lessons, which are the foci of this conference, with two quite different lessons that we can take away from the Greenspan era. The first is that, in apparent contradiction to what I just said, *flexibility in monetary policy is very important*. The contradiction is only apparent, not actual, because the worlds faced by Paul Volcker and Alan Greenspan were starkly different. During the Greenspan years, inflation has flared up only once, in 1990-1991, and then only briefly. Instead, Greenspan has faced, among other things, two severe stock market crashes, a period of fragile bank balance sheets in the early 1990s, the rolling international financial

[3] The calculation assumes a NAIRU of 5.8 percent, which was the actual unemployment rate of 1979.

crises of 1997 and 1998,[4] the surprising productivity acceleration after 1995, a brief flirtation with deflation, and the need to pull off several "soft landings." Excruciatingly tight money was not the right solution to any of these problems. I daresay that history will not remember Alan Greenspan as the man who took 17 years to bring inflation down from 4% to 2%. Rather, it will remember him as the Fed chairman who dealt so well with a remarkable variety of difficult challenges over a prolonged period of time.

Here's a test. Try a little mental free-association with the phrase "accomplishments of Paul Volcker as Chairman of the Fed."[5] I think all of you will immediately think of "conquering inflation," or something synonymous with that. Now try "accomplishments of Alan Greenspan as Chairman of the Fed." Here there are so many choices that I doubt that even this well-informed group could ever agree on a single answer. My own choice would be how spectacularly well he recognized and dealt with the productivity acceleration after 1995. But others will have their own favorite on the long and impressive Greenspan hit parade.

That hit parade brings me naturally to the fourth lesson, which is that *fine-tuning is actually possible* if you combine enough skill with a modicum of good luck. I began my economic education in the halcyon days of Walter Heller, when a number of economists really believed in fine tuning. By the time I started teaching at Princeton in 1971, however, this belief had been shattered. But Alan Greenspan's remarkable performance should bring it roaring back. Greenspan probably shuns the label "fine tuner." But his record is replete with delicate decisions over zero versus 25 basis point or 25 versus 50

[4] Analogously to these last two, Volcker had to devote a great deal of time and energy to the LDC debt crisis that erupted in 1982, and the consequent concentration of risks on the balance sheets of many money center banks.

[5] The last five words are important. I am in awe of Volcker's many accomplishments since leaving the Federal Reserve System.

basis point moves, with careful management of the exact monthly timing of this rate increase or that rate decrease, with several actual and attempted soft landings, with influencing markets with minor variations in wording, and so on. If that is not fine tuning, I don't know what is. And you know what? It worked. We've had only two mild recessions during Greenspan's long watch. As a result, the bar for the next chairman of the Fed has been set extraordinarily high.

My fifth lesson goes back to the Volcker years. Curiously, it seems not to have been mentioned at this conference yet. So let me say it: *Money-supply targeting can be hazardous to a nation's health*. Lindsey *et al.* (2004) have discussed whether or not we should view the money-growth rule as a "political heat shield" that Volcker selected opportunistically to fend off criticisms of excruciatingly tight money. Frankly, after reading their paper I'm not sure whether their answer is "yes" or "no." (My own view is: yes.) But regardless, two things seem clear—and I state them here, at the Federal Reserve Bank of St. Louis, of all places. First, that the Fed overdid monetary stringency in 1980-81 partly because of the misbehavior of velocity.[6] And second, that rescuing the economy in 1982 required abandoning the experiment with monetarism. I shudder to think what might have happened to the U.S. economy in 1982 and thereafter, if the FOMC had stubbornly stuck to its money growth targets. But Volcker and his colleagues were too smart—and insufficiently doctrinaire—to do that. (By the way, that's a good combination of attributes for a central banker.)

If a central bank abandons the monetary aggregates, what should it put in their place? Many experts now answer: inflation targets. But that just pushes the question back one stage to: What instrument should the central bank use to pursue its inflation target?

[6] Specifically, I do not believe the Fed ever intended to cause a recession as deep as the one we had.

After all, no matter how much theoretical models try to pretend that it is, the inflation rate is *not* a control variable. Milton Friedman taught us years ago that the nominal interest rate is a bad choice; fixing it can even lead to dynamic instability. The *real* interest rate, we have learned in the Volcker and Greenspan years, is a far better choice. And that is my sixth lesson.

Greenspan, in particular, has focused attention on an update of Wicksell's "natural interest rate" concept that we now call the *neutral real federal funds rate*. And, more by his actions than by his rhetoric, he has called attention to the *Taylor rule* as a useful benchmark. For current purposes, I write the Taylor rule as a guide for setting the *nominal* funds rate in a way that stabilizes both inflation and output:

$$i = r^* + \pi + \alpha(\pi - \pi^*) + \beta(y - y^*),$$

where i is the nominal funds rate, r* is the neutral level of the real funds rate, π is the inflation rate, y is the (log) of output, and π^* and y* are the targets for inflation and output, respectively. We think of monetary policy as "easy" when $i < r^* + \pi$, and as "tight" when $i > r^* + \pi$.

I view the Taylor rule as a useful way of thinking about monetary policy, although it is not, and John Taylor did not intend to be, a literal rule in the Friedmanite sense. Several aspects of the Taylor rule are worth mentioning. The first is that *both* α and β are positive. This means, for example, that there may be times when it is appropriate for the central bank to hold its interest rate *below* neutral even though the inflation rate is *above* target.[7]

[7] Conversely, if y is high enough, the central bank will want "tight money" even if inflation is already below target.

The second aspect constitutes my seventh lesson. The requirement that α be positive means that *the central bank should react more than point for point to changes in the inflation rate*. For example, under Taylor's choice of $\alpha = ½$, each 1 point move in the inflation rate would induce the central bank to adjust its policy rate by 150 basis points in the same direction, meaning that the real funds rate moves by 50 basis points in that direction. If α is not positive, the central bank would be allowing rising inflation to *reduce* the real federal funds rate—a potentially destabilizing policy.

My last few lessons were learned in the Greenspan era. The eighth lesson is hardly ever mentioned, but I think it should be. Three times during the Greenspan era, the Fed demonstrated that *doing nothing can constitute a remarkably effective, even bold, monetary policy*.

The first such episode started in July or September 1992 and lasted until February 1994.[8] To stimulate an economy that seemed to be fighting substantial financial "headwinds," the Fed held the nominal funds rate at 3 percent, which at the time meant that the *real* funds rate was kept at around zero, for about 18 months. This sizable and long-lasting monetary stimulus helped get the economy rolling in 1994 and thereafter. The third such episode was a similar effort to stimulate a sluggish economy. The Fed lowered the nominal funds rate to 1.25 percent in November 2002 and then to 1 percent in June 2003—and then held it there until this past June 30th, a period of 12-19 months, depending on when you want to start counting. In both of these cases, the degree of monetary stimulus was quite large and the length of time for which it was applied was

[8] The Fed cuts the funds rate to 3.25% in July 1992 and to 3% in September 1992.

very long, by the standards of central banking. In that sense, each of these periods of "doing nothing" constituted a boldly expansionary policy.[9]

The middle episode of "doing nothing" was a bit different from the other two but, if anything, was an even bolder departure from standard central banking practice. From January 1996 until June 1999, the Fed did not raise interest rates to restrain the booming economy even though the unemployment rate kept falling through any reasonable estimate of the NAIRU.[10] Janet Yellen and I (2001) have called this episode the years of "forbearance," and it constituted a real gamble that Greenspan took over the objections of a number of FOMC members.[11] Other than his oft-expressed skepticism about the NAIRU concept, the stated basis for Greenspan's refusal to raise rates was his belief—which was subsequently ratified by the data—that productivity had accelerated and would continue on a high trajectory, thereby justifying a faster trend growth rate.[12] The gamble paid off handsomely.

All three of these episodes, but especially the last, lead naturally to my ninth lesson. Another significant part of the Greenspan legacy is the demonstration that *a central bank can be strongly pro-growth without being irresponsible*. This, I think, is a genuine benefit of the Federal Reserve's much-maligned dual mandate to support *both* low inflation *and* high employment, coupled with a chairman willing to make use of it. It

[9] During much of the more recent episode, the inflation rate was drifting down, so the real funds rate was actually rising slightly. In the 1992-1994 episode, inflation was quite constant.
[10] There was actually one 25 basis point rate hike in March 1997. But the FOMC also reduced the funds rate by 75 basis points following the Russia/LTCM financial crises in the fall of 1998.
[11] For more details on this episode from an insider's perspective, see Meyer (2004).
[12] Higher productivity growth, by itself, does not lead to an ever-decreasing NAIRU. But favorable supply shocks and the related hypothesis that *actual* productivity was running ahead faster than productivity as *perceived* by workers will lead to a decline in NAIRU. On the later, see Blinder and Yellen (2001), Chapter 6.

would, I believe, have been much more difficult for an inflation-targeting central bank, or for a bank like the ECB with a mono-goal, to forbear in 1996-1999 the way the Fed did.

During these three periods of FOMC "inaction," intermediate and long rates were not marking time. Similarly, during the most recent Federal Reserve tightening (June 1999-May 2000) and easing (January 2001-June 2004) cycles, bond rates have moved around quite a bit—generally in the direction the Fed wanted. This leads to the tenth lesson learned since 1979: If the central bank lets the markets in on its thinking, *the markets can do part of the work of monetary policy*. Specifically, if the markets believe the central bank will soon be raising (lowering) rates, intermediate and long rates will rise (fall) in anticipation, thereby tightening (easing) "monetary policy" before the policymakers lift a finger.

Outsourcing part of the work to the bond market in this way has two interesting, and probably salutary, implications for monetary policy. First, and less important, the central bank should not have to move its policy rate around as much, in either direction, as would be necessary without the anticipatory behavior of the bond market. Second, and more important, the lags in monetary policy should be reduced by the bond market's reactions. Not so many years ago, central bankers and economists viewed long rates as *following* short rates with a substantial lag—which slowed down the transmission of monetary policy impulses into the real economy. Nowadays, many central bankers and economists see long rates as *leading* short rates.

This anticipatory process can work, however, only if the central bank communicates its intentions to the markets effectively. Thus, and this is my final lesson from post-1979 experience, *greater transparency can enhance the effectiveness of monetary policy*. The

old tradition at central banks was, of course, to say little and to say it cryptically. That's how the temple kept secrets. There is still far too much secrecy for my taste. But the unmistakable trend, both at the Fed and around the world, is toward greater transparency.

I could go on and on about why I think this is a salutary trend, both for democracy and for monetary policy—and I have.[13] But I think it is now time to relinquish the platform to Ben McCallum. Suffice it to say that while the Federal Reserve has often hesitated over specific incremental increases in disclosure, and while it has sometimes warned of adverse consequences from greater transparency, virtually none of these adverse consequences have ever come to pass, and the Fed has never regretted its step-by-step movements toward greater openness. At least that's my reading of the history since 1994. If they disagree, there are plenty of current and former Federal Reserve officials present here today to dispute what I have just said.

[13] On this trend, see Blinder (2004), Chapter 1.

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