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The incredible Volcker disinflation[☆]

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Abstract

The reduction in inflation that occurred in the early 1980s, when the Federal Reserve was headed by Paul Volcker, is arguably the most widely discussed and visible macroeconomic event of the last 50 years of U.S. history. Inflation had been dramatically rising, but under Volcker, the Fed first contained and then reversed this process. Using a simple modern macroeconomic model, we argue that the real effects of the Volcker disinflation were mainly due to its imperfect credibility. In our view, the observed upward volatility and subsequent stubborn elevation of long-term interest rates during the disinflation are key indicators of that imperfect credibility. Studying transcripts of the Federal Open Market Committee recently released to the public, we find—to our surprise—that Volcker and other FOMC members likewise regarded the long-term interest rates as indicative of inflation expectations and of the credibility of their disinflationary policy. Drawing from the transcripts and other contemporary sources, we consider the interplay of monetary targets, operating procedures, and credibility during the Volcker disinflation.

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1. Introduction

In August 1979, when Paul Volcker became chairman of the Federal Reserve Board, the annual average inflation rate in the United States was 9%. Inflation had risen by 3 percentage points over the prior 18 months and there were indications that it was poised to continue to rise (as it did, rising to a peak of 11% in early 1980). The Fed had pursued restrictive monetary policy to stabilize inflation on a number of occasions in the prior two decades but, each time, inflation moved higher shortly thereafter. Against the backdrop of a volatile international and domestic situation in the early 1980s, the Fed brought the inflation rate down to 4% by the end of 1983. During this period, the U.S. experienced two recessions generally attributed to disinflationary monetary policy, the 1981–1982 recession exhibiting the largest cumulative business cycle decline of employment and output in the post-World War II period.

The “rise and fall” of inflation in the post-war period, and the Volcker disinflation in particular, are central events that attracted many economists to macroeconomics and have been the subject of a huge body of research. We first met Bennett McCallum in the late 1970s and have discussed these events many times during a friendship of a quarter century. In these conversations, Ben always stood for three practices: a careful review of the macroeconomic facts, the elaboration of small forward-looking linear macroeconomic models linking the core variables in macroeconomics, and an appraisal of events in light of these models. In this paper, we study the Volcker disinflation using this approach.

We think of the disinflation as “incredible” in three senses. First, looking backward, Volcker initiated a change in the average rate of inflation that has been large and sustained, so that the inflation peak in early 1980 stands out dramatically in the U.S. experience shown in Fig. 1. Second, relative to the perspectives of many contemporary observers in 1978, including ourselves, it is remarkable that a reduction in inflation took place since inflation seemed to be a permanent feature of the U.S. economy at the time and the costs of reducing it seemed so large. Third, we believe that “imperfect credibility of monetary policy” was a core feature of the disinflation on several dimensions that we highlight further below.

Prior to the disinflation, most economists thought that there would be large and protracted output losses from reducing the long-term rate of inflation in the United States. Notably, Okun (1978) surveyed six macroeconomic Phillips curves with two common features: (i) “all...are essentially accelerationist, implying virtually no long-run trade-off between inflation and unemployment,” and (ii) “all point to a very costly short-run trade-off.” Specifically, Okun reported that the average estimate of “the cost of a 1 point reduction in the basic inflation rate is 10 percent of a year’s GNP, with a range of 6 percent to 18 percent.” Thus, if it had led to a downturn lasting four years, the 6 percentage point reduction in inflation engineered by the Volcker Fed would have led to a modern Great Contraction, with output averaging 9–27% below capacity for a total loss of 36–108%.

In fact, the real consequences of the disinflation were sharply smaller than Okun’s predictions. Fig. 2 shows the decline in inflation and in real activity during the

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