

**Jim Bullard**, President and CEO  
Federal Reserve Bank of St. Louis

## Fed's Bold Actions Harken Back to Volcker Era

Elsewhere in this issue, you will find an article titled “This is not your father’s recession ... or is it?” It compares today’s recession with those of the past 40 years. In the same spirit, I would like to compare today’s Fed, and the challenges we face, with the Volcker Fed of 1979.<sup>1</sup>

During the 1970s, monetary policy had followed a gradualist approach: fine-tuning interest rate moves in an effort to avert economic slowdowns. By 1979, it had become apparent that such a strategy was inadequate as inflation and inflation expectations continued to march upward and the real economy deteriorated. Inflation rose steadily from about 2 percent through much of the '60s to more than 13 percent in December 1979. The Federal Reserve was not seen by the public as credibly fighting inflation.

A drastic change in the approach to monetary policy was needed by the Fed in order to regain its credibility, tame inflation and restore confidence in financial markets. The plan had to allow for substantial increases in short-term interest rates while, at the same time, reassuring financial markets that this new policy approach would be effective and the cost of disinflation would be minimized.

On Oct. 6, 1979, the Fed, under Paul Volcker’s leadership, shifted its focus from targeting nominal interest rates to targeting non-borrowed reserves to control the money supply. Volcker’s “monetarist experiment” was ultimately successful in stabilizing inflation and anchoring inflation expectations. The economy experienced a sharp recession, but was then set for a long period of stable growth. For more than two-and-a-half decades following the monetarist experiment, the economy grew in long stretches, punctuated by just two relatively mild recessions.

The situation we face today is not that faced by the Volcker Fed in 1979. One

important difference is that U.S. inflation and long-term interest rates are currently very low. In fact, market-based indicators of inflation expectations may be drifting toward deflation. Still, there is a clear atmosphere of crisis. Financial turmoil continues to impact a wide range of financial markets and institutions around the globe. The Fed has lost its usual ability to signal to the private sector via nominal interest rates as the policy rate has reached the zero bound.

As in October 1979, the Fed has reacted to the crisis situation with an aggressive change in policy. Like the Federal Reserve in Vol-

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cker’s time, today’s Fed has taken unprecedented actions, departing from its traditional approach to monetary policy—interest-rate targeting—and focusing on quantitative measures instead. Beginning in December of last year, the FOMC shifted its focus for future policy to the Fed’s balance sheet.

In some ways, our current environment parallels the Japanese experience after 1990.



The Japanese banking system encountered difficulties with “troubled assets,” and the intermediation system broke down. Eventually, persistent year-over-year deflation was observed in core measures of inflation, and average economic growth stagnated. In Japan, policy rates have been below 1 percent for 14 years, and deflation was observed for more than a decade. An outcome of sustained deflation and extremely low nominal interest rates, as happened in Japan, is sometimes referred to as a deflationary trap.

To avoid the Japanese experience, the Fed will need to provide enough sustained growth in the monetary base to offset downward pressure on inflation coming from the very sharp recession. At the same time, the Fed cannot provide such a sustained high level of monetary growth that medium-run inflation takes hold. Either way, the signals that the Fed sends about its future intentions have to come from quantitative measures of policy and not from interest rate movements.

This is a very different mode of operation than what the Fed and the financial markets have been used to over the past two decades. By acting aggressively, the Fed may be able to replicate the success of Volcker’s Fed 30 years ago. <sup>1</sup>

<sup>1</sup> See “Reflections on Monetary Policy: 25 Years After October 1979,” Federal Reserve Bank of St. Louis *Review* March/April 2005, for a compilation of the conference proceedings as well as personal reflections commemorating Oct. 6, 1979. Go to <http://research.stlouisfed.org/publications/review/05/03/part2/MarchApril2005Part2.pdf>.