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The history of fighting serious inflation

A year ago, government officials were saying that the sudden spurt of inflation was "transitory," the result of temporary bottlenecks arising from ending the pandemic-inspired lockdowns. The story changed last fall, as it became obvious that there is nothing transitory about the ongoing surge in prices throughout the economy. On June 2, Federal Reserve Vice Chairwoman Lael Brainard said that is it too early to say that inflation has peaked, and "We've still got a lot of work to do to get inflation down to our 2% target." Interest rate increases of one-half percent are expected in June and July, and perhaps again later in the year.

The last bout of sustained, persistent inflation happened in the 1970s. During that time the Federal Reserve followed a "go-stop" policy, lowering interest rates to fight recession and raising them to combat inflation. The error was leaving the easy money policy in place for too long, leading to still higher inflation, and then tightening for too short a period to do enough good. Because the markets observed the Fed's lack of fortitude, they had no expectations that the Fed would ever conquer inflation.

The turning point was President Carter's appointment of Paul Volcker to be Chairman of the Federal Reserve System in 1979. At his confirmation hearing, with inflation running at 9% annually, Volcker promised to make reducing inflation his top priority. The Fed pushed interest rates up slightly that fall, and unemployment rose to about 6%. Politicians were getting nervous, with some saying that interest rates would have to be cut again if unemployment reached 7%.

On October 6, 1979, the Saturday before the Columbus Day holiday, Volcker called an unusual evening press conference to report the results of an unscheduled meeting of the Federal Open Market Committee held earlier that day. He announced that the FOMC would shift its focus to managing the volume of bank reserves in the system instead of trying to manage the day-to-day level of the federal funds rate. He warned that interest rates would become more volatile as a result of the policy change. This focus on the quantity of money rather than interest rates was consistent with Milton Friedman's theories of the causes of inflation.

Inflation peaked at 11.6% in March 1980. The interest rate on Federal Funds reached a record high of 20% that year. The high interest rates lead to severe economic hardship for many, as small businesses suffered and high mortgage rates put home buying out of reach for many. There were calls for Volcker to resign or be impeached, including from the House Majority Leader. The high interest rates triggered a recession, and unemployment topped out at 10.8% in 1982. Volcker remained steadfast. As a result, inflation fell to 6.1% in early 1982 and then to 3.7% in 1983. This was followed by a long period of price stability, sometimes called the "Great Moderation," which lasted until 2007. By breaking with traditional operating procedures, and persevering despite a recession that was quite large by historical standards, the Fed re-established its credibility for maintaining low inflation.

Additional details about the Volcker efforts to eliminate inflation may be found at https://www.federalreservehistory.org/essays/anti-inflation-measures.

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