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Interview of Lyle Gramley

Conducted by Robert L. Hetzel

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Robert L. Hetzel: Could you tell me where you did your graduate work?

Lyle Gramley: I did my graduate work at Indiana University.

Robert L. Hetzel: And where are you from originally?

Lyle Gramley: Illinois. Troy, Illinois.

Robert L. Hetzel: So, a number of people went to Indiana University. Ed Behney, and Al Broaddus...

Lyle Gramley: Chuck Partee was an undergraduate student there, Pres Martin got, I believe, his BBA degree from there, so Indiana has a history of some fine people through the Federal Reserve.

Robert L. Hetzel: I'm from Evansville, Indiana.

Lyle Gramley: I see.

Robert L. Hetzel: So, I'm...

Lyle Gramley: And did you go to Indiana University also?

Robert L Hetzel: Actually, I went to the University of Chicago, so I was an export, but I did grow up in Indiana.

Lyle Gramley: Well, I got my job at the Federal Reserve back in Kansas City which is where I started, through more or less an accident. I was in Detroit at the annual meeting of the Economic Association, and Finance Association, and I bumped into a colleague of mine who'd gotten out a year early. His name was Charlie Gray [phonetic]. And Charlie Gray is, was, just happened to be another graduate student while I was there, and his brother Roger Gray, as I remember what the University of Minnesota had been a good friend of a fellow by the name of Wilbur Billington [phonetic] who was an economist at the Federal Reserve Bank of Kansas City. Charlie Gray and Wilbur Billington happened to be talking together and I approached Charlie to greet him, since I hadn't seen him for a year, and he introduced me to Will Billington and he said to him, "Aren't you people looking for a monetary economist?" And Will said, "Well, yes we are." And he said, "Well, Lyle's a monetary economist." The fellow said, well, if you're interested come on up to room such and such and give us your resume, we'll schedule and interview for you. So I did. And I ended up getting a job at the Federal Reserve Bank of Kansas City.

Robert L. Hetzel: So you hadn't thought about working for the Fed, before this, before this serendipitous...

Lyle Gramley: No, I was interviewing mainly for academic jobs.

Robert L. Hetzel: So, Kansas...

Lyle Gramley: This was quite a...

Robert L. Hetzel: Quite a career, fork in the road.

Lyle Gramley: Right.

Robert L. Hetzel: Well, the Kansas City Fed is been a sort of training ground for more people, Fred Strugel [phonetic] was there, perhaps

Lyle Gramley: The Board today--Mike Kohn [phonetic] and Mike Prell [phonetic] were both from the Federal Reserve Bank of Kansas City. Sam Chase [phonetic], I don't know if you know his name or not, he...

Robert L. Hetzel: Oh sure.

Lyle Gramley: Sam was there at Kansas City when I was there. And he and I came to Washington at the same time. Now, you're interested in how I got back to the Fed and how I managed to get to the Council of Economic Advisors and into the Board again as a Governor. When I was at Kansas City, I wrote a couple of articles that caught the attention of Dan Brill who was, at that time, Chief of the Capital Markets section. And...

Robert L. Hetzel: Could you tell me first, the year that you went to the...

Lyle Gramley: Right. I went to Kansas City in 1955 and then I came to Washington in 1962 to teach at the University of Maryland. During my period at Kansas City, I, oh, I bumped into a number of people from around the system, but I caught the eye of Dan Brill, who thought that my work was interesting. And, so, when Dan became director of the Division of Research and Statistics, we had by that time become quite close friends. He called me over one Sunday morning and said, "Lyle, I'd like you to come back to the Federal Reserve Board as a monetary economist." And I hadn't enjoyed my teaching at University of Maryland all that much and after some thought I agreed and went back to the Board as a staff member in, obviously, 1964. How did I get from there to the Council of Economic Advisors? Well, at the University of Maryland, I got to know Charlie Schultze quite well. And Charlie and I become both personal friends as well as professional colleagues.

Robert L. Hetzel: This was in '64. Well, when did he become director of Bureau of the Budget? Was he teaching evenings at the University of Maryland or was he...

Lyle Gramley: I think he was teaching full time at the time.

Robert L. Hetzel: Then it must have been the next year, I guess, in about '65, that he came there.

Lyle Gramley: Yeah, somewhere around there. Somewhere around there. But when he went to the Council as Chairman of the Council of Economic Advisors, he asked me to come over and be his macroeconomist. Which I did. And then it was Charlie who recommended me to the President for appointment to the Board.

Robert L. Hetzel: When you say that you studied, you were a monetary economist and you graduated in 1955 from University of Indiana. The profession wasn't exactly aware of money at the time, so...

Lyle Gramley: I had a professor, however, who had his PhD from the University of Chicago.

Robert L. Hetzel: And he was?

Lyle Gramley: Bill Cleveland was his name.

Robert L. Hetzel: So when did he get his degree from Chicago?

Lyle Gramley: I can only guess. Probably would have been some time in the 1930s. When, at that time, I went to Indiana in 1951 and he would have been a man of 55 years of age, something like that. So his degree would have come from the 1930s.

Robert L. Hetzel: Most economists when they were studying monetary economics, and were studying costs and availability of credit and which was more important, and later on that interest served you because when you, about the time you went to the Board, the Board was gearing up to develop the financial sectors of the large scale econometric models so, you must have been involved with Gramlich and some of the other people who were...

Lyle Gramley: I didn't do much of the modeling. The guys who did the, the biggest input on the financial side of the model was Fred Delano.

Robert L. Hetzel: Yeah.

Lyle Gramley: But there were others at the Board who were working at the time and been modeling at the economy and got involved in the project of the Social Science Research Council and in the development of that model although it became the Ten, what did he call it? The Ten Emory [phonetic] PSSRC Model, I think?

Robert L. Hetzel: Yeah. So, I know that you did some work on the new view of money with Sam Chase on time deposits and the money process, but you must also have done most of your day to day work on the forecasting, the Greenbook, the first Greenbook with forecasts I think was November, 1965, so that's how you would have, you would have begun or spent most of your day involved with the, with the economic statistics and the forecasting part?

Lyle Gramley: Yeah. I was, I worked for awhile in flow of funds section. And did that work with Sam Chase at that time. But then I moved over to the banking section as a Senior Economist in the banking section. Then I went from there to a position of a Junior Officer in the Division of Research and Statistics. So my work was primarily with credit analysis and economic forecasting. That sort of thing.

Robert L. Hetzel: When did you first begin to attend FOMC meetings?

Lyle Gramley: I attended some FOMC meetings in the late 1960s when we were putting on the VFOMC chart show, which we did quarterly. I had a lot of responsibilities with the organization of the work leading up to the chart show, so I would go to VFOMC meetings on those occasions. But I didn't begin going on a regular basis until somewhere around 1972.

Robert L. Hetzel: At the time, were you familiar enough with Chairman Martin that you felt like you had some, some knowledge of what he was like as an individual and as a chairman or was your contact with him mainly at a distance?

Lyle Gramley: It was fairly distant, yes. I never felt that Chairman Martin understood anything beyond the barest essentials about our monetary policy. He had an intuitive feel for how the economy worked but, he was not interested in a lot of detail of how the various pieces of the economy fit together.

Robert L. Hetzel: His view was as a money markets trader first and he saw the world through the eye of a financial markets; the way the New York Fed saw it at the time and inflation was caused by inflationary psychology [00:10:00], but at the same time, he was willing to support a rather considerable staff effort in terms of developing the large scale econometric model and making the Greenbook more informative, turned it into a forecasting tool rather than a tool for summarizing the economy.

Lyle Gramley: I don't think he gave active support to that so much as he let it happen. The principal player in that effort to build a really powerful staff at the Federal Reserve Board was Dan Brill. And he became a very close confidant of Bill Martin's. And told Martin that the Federal Reserve ought to have the top professional research staff in the world, that it had once had such a staff in the 1920s, and the early 1930s and that staff had run down over the years and it needed building up. Martin said fine, then do it. Mike Ghan [phonetic] is the person that deserves the most credit for having the vision that led to that build up of staff. Then, Dan did it, of course, for the investment division. And when Dan first began, the person that was heading the Division of International Finance was Ralph Young who was, had relatively little interest in trying to engage in what you would call moderate analytical model building and that sort of thing. But he was then replaced by Bob Solomon. And Bob Solomon then, in effect, did for the International Division, or began at least for the International Division, what Dan did for the Division of Research and Statistics.

Robert L. Hetzel: Ralph Young was a man who could keep the secrets. He was a man who was important in terms of negotiating with, in the international negotiations, spot lines and that kind of thing. Of course, a lot of it was done by Charlie Coombs, out of New York, but he was more of a whole administrative, he was the Riefler and with the great…

Lyle Gramley: Of great abandon.

Robert L. Hetzel: ...of that vintage. They were a very strong group of individuals and they were tough on, you know, they disliked inflation so they, I think they had good instincts, but they were not of the modern, the modern group. So you worked most closely with Dan Brill?

Lyle Gramley: Right.

Robert L. Hetzel: From, did he leave over the reduction in interest rates in the summer of 1968 or the forecast that there would be a recession and we didn't have a reduction in interest rates, do we know the details of how he departed?

Lyle Gramley: Yes, I do, but it wasn't that. Dan had worked very closely with Bill Martin and didn't think he would get along terribly well Arthur Burns. So, when Arthur Burns was appointed the Chairman of the Board, Dan left. He left in '66. Now wait a minute. No, no.

Robert L. Hetzel: No...

Lyle Gramley: He left when David was in there.

Robert L. Hetzel: Burns came in in February, 1970.

Lyle Gramley: It was before that.

Robert L. Hetzel: [unintelligible 00:13:50] in early '69. Well, we can check that.

Lyle Gramley: The dates elude me, but I remember quite distinctly that Dan began looking for an out when he realized that Martin wasn't going to be reappointed. And that the probable appointee would be Arthur Burns.

Robert L. Hetzel: So, in the early '70s, you continued to work on forecasting primarily. What section, you were in...

Lyle Gramley: I was in a section at that point and I was a division officer.

Robert L. Hetzel: Of?

Lyle Gramley: Of, at one point I had all of long range, all of the long range research reporting to me. And I was at one point, I think, that they offered me the line officer for the banking and government security sections. I'm a little, my memory's a bit hazy.

Robert L. Hetzel: You began to do some briefings for the FOMC, as you recollect, [00:15:00] and you think it was '72?

Lyle Gramley: Well, there were, before, oh, you mean, I'm thinking of board briefings, no, FOMC briefings. It probably would have been around 1972 when I began to do the FOMC briefings.

Robert L. Hetzel: So, at that time you could see Burns interact with the whole of FOMC and did he come to the board briefings? Is it like today where there are briefings every Monday morning on the economy? And when was that started?

Lyle Gramley: It's been going on a long, ever since I've been there, the Monday morning briefings. Ever since I can remember.

Robert L. Hetzel: It must have been rather intimidating to give your briefing before Burns, wasn't it? He's not much of a statistics...

Lyle Gramley: I had a very, very close personal working relationship with Arthur Burns. I was his Chief speech writer, testimony writer for seven years and he and I worked very, very closely together and I could talk very bluntly to Arthur Burns and it wasn't at all intimidating for me to do so because I knew him quite well.

Robert L. Hetzel: Then, perhaps you can help me understand some things about how he looked at the world. When he came in, in February of 1970, and through, oh probably, through at least through early '73, he was interested in a strong economic recovery, strong, strong growth. But he, the difference between him and the administration was over how to do it. He thought that the major problem was inflation, the uncertainty it created, the uncertainty it created in the mind of the businessmen over what their future profits would be and the depressing effect on investment and he thought, and this is where he viewed himself as parting company with the Keynesians, he thought that if you could address the problem of inflation directly, at least in part through an incomes policy, then you could get a reduction in inflation and strong economic growth at the same time, that you weren't bound by the Keynesian Phillips curve, so he wanted a broad variety of economic policies that would work directly on the confidence of the businessmen and on inflation and for that reason, he was very broadly concerned in the economic policies within the administration. Monetary policy was important, but it was something that would reinforce our recovery. It wasn't something that in itself would power economic activity and there, he clashed with the council and with George Schultze and the OMB and that was a source of--does that sound familiar?

Lyle Gramley: Well, I'm not sure I would fully agree with that interpretation. Burns is a very hard guy to figure out in terms of what his theory of how the world worked was. He was also under enormous pressure from the Administration, almost constantly, to try to pump up the economy with faster growth of money. So, he used to say some of these things by way of putting these people off. That the real source of economic expansion wouldn't come from just creating more money. It would come from somewhere else.

Robert L. Hetzel: Right. He would say things like, "The problem is a shortage of confidence, not money." And that would send Richard Nixon through the ceiling because Nixon would say, "Hey, you don't have confidence in our policies, you're sowing doubt, you're a doom cryer."

Lyle Gramley: But some of this was an effort to try and protect himself and the Fed from the pressures that were being put on him by the Administration.

Robert L. Hetzel: Relatively early, he began to push publicly for an incomes policy and in May of 1970 he gave a speech to the American Banker's Association [00:20:00] in Washington D.C., which would have been a very high profile event and argued for a wage price review board and the proposals themselves seemed relatively innocuous and he was not arguing for controls, on the other hand, it was a very sensitive area with the administration because it looked like this is what , it went along, dovetailed with congressional Democratic attacks on the Administration. Were you involved in that speech?

Lyle Gramley: I wrote everything after the very first speech he made.

Robert L. Hetzel: Now, in terms of...

Lyle Gramley: Mind you, when I did that at the very early stage, I was thinking much less about where is this guy coming from and why is he writing this speech, then I was trying to demonstrate that I could perform for him as a staff member, putting his thoughts on paper in a way that he wanted them. So, I really wasn't thinking as I wrote that speech about what is this guy all about.

Robert L. Hetzel: He wasn't using you as a sounding board in terms of...

Lyle Gramley: No, not at that point. Not at that point.

Robert L. Hetzel: Somebody to argue over his ideas with.

Lyle Gramley: Not at that point.

Robert L. Hetzel: Did it strike you at the time, or later on, that he would go public when he felt like he was losing in his arguments within the Administration? That he felt like he was being ignored and that's when he would go public?

Lyle Gramley: I wasn't as aware at that time of the amount of pressure he was under as I was later. So, I wouldn't have put that kind of an interpretation on it in most cases because I wasn't thinking in those terms. I only became aware later that he was under great pressure.

Robert L. Hetzel: The other sort of way of trying to understand when he went public with his criticisms and when he was silent, is that when he was under pressure as when the Administration especially wanted something from him, that's when he would go public. And it could be, as you said, either as a form of protection as a way of creating some countervailing force, or it's hard to know. It could have been his way of, I hate to use the word trade, but if the Administration wants a more expansionary monetary policy, well, if you want that without inflation then, you know, something else has to change and this seems to be as maybe the first example as of May of 1970, Administration had become very concerned about the Fall congressional elections, and had decided it was time to move away from the gradualist monetary policy and so Burns was feeling the pressure. That was the first time he began to really feel the pressure to pursue a more expansionary monetary policy. And then again, after the 1970 elections, Nixon ran on a program of socially conservative values, basically ran against the demonstrators and he didn't do very well. So, that turned attention back, that didn't work, that focused attention back on the economy and it became all that much more important that the economy do, do well and so he, so he came under pressure again toward the end of 1970s. Did you write the Pepperdine Speech for him? This is the second example where he...

Lyle Gramley: I wrote every one except the first one he gave and one when I was on vacation. The 1970-71 to '77. I wrote every speech and every testimony except two. The very first one which was to the Senate Banking Committee and then one, and I don't remember which one it was, I was on vacation.

Robert L. Hetzel: And so, did he in general just kind of tell you what he, give you some general ideas or did he do a draft, did he explain the logic of, you know, where he was trying to go? Do you mean, for example, the Pepperdine Speech, this was a fairly [00:25:00] important speech because the President had just announced that there was going to be no incomes policy and so by giving the speech shortly after Nixon made that announcement, I mean, it was like sort of a challenge in this big league politics. So it was an important speech.

Lyle Gramley: Well, the way we operated together, he would call me down to his office, we would sit and talk for half an hour, forty-five minutes and he would go over basically what he wanted to do. I would then go back and write up an outline, send it down to him, he would call me down and I'd make some revisions to the outline according to his suggestion, and I'd go back and write a draft and he'd, send it down to him, he would bring me down, ask me to do some reorganization and I would normally do maybe two to three drafts before he began to work on it himself. But, his speeches were very much his own speeches in terms of the content he wanted to put in, the organization he wanted, the transitions from one idea to the other and indeed down to the very words that were chosen, the individual paragraphs and sentences. He worked on his speeches very, very hard. I was a draftsman who was useful to him largely because I could help him get to a final draft more quickly than others could. I wrote fairly well, and I could sort of after some practice doing this, think like he did in terms of figuring out what was the kind of outline and logical organization he would want and the kinds of words he would choose to express himself. So they weren't my ideas, [inaudible 00:27:02].

Robert L. Hetzel: In terms of logic of the argument for incomes policy, he had seen that up until that point when you had a peak in the business cycle and a falloff in the economic activity, the price level would fall. And so, in the 1970s, suddenly everything's up for grabs. You have a recession but you have no, no reduction, and you have a rise in the unemployment rate but you have no reduction rate in the inflation rate, so he drew the conclusion that there had been a rise in union monopoly power on the part of the unions. Up to that point, he had basically, at least to the extent that he expressed himself, he had thought, had rather, really rather conventional ideas that government deficits caused inflation. But this was kind of a turning point where he began to focus on the power of labor unions and he thought a wage price review board would moderate that and allow more expansionary monetary policy. Were you at all involved in the Greenbook forecast at this time, or just as a consumer?

Lyle Gramley: I can't remember exactly when I got involved in the Greenbook Forecast. It would have been somewhere around 1971, '72 or thereabouts, but my recollection is too vague to give you a specific date.

Robert L. Hetzel: Do you remember the, well, so, at this period of time then, when the Nixon people, Nixon wants more aggressively to pursue economic policy to make sure that the unemployment rate is down to 4.5% by December 1972, the Council comes up with the figure for GNP that will do that, 1065, then there's an intra-administration debate, OMB and George Schultze says 6% M1 growth will do it. The Council says eight or nine and you're caught in between. Do you remember the staff reaction to the 1065?

Lyle Gramley: Yeah. Yeah. I remember that I was asked to formulate a staff response and I put my finger on Jim Pierce and he, somebody else worked with him, it may have been Tommy Houmpton [phonetic] and somebody else. But Jim Pierce was [00:30:00] the essential author of that response to the Council's position. We thought, at the time, that we'd blown them out of the water. We were quite proud of our effort.

Robert L. Hetzel: Of course, their argument was that, well, it's a contingent forecast and if they just get the money growth that they need, then they'll get the--the speech then Burns gave congressional testimony early in the year, 1971, when he's more emphatic than ever about the need for an incomes policy. And states it as a Board position and so, at the time there was really, I mean it really was a board position, all the governors pretty much supported that position, there was no one who said, oh that's free-markets or that's, basically that was a...

Lyle Gramley: [unintelligible 00:31:25]

Robert L. Hetzel: There was no, there was not much internal debate about that.

Lyle Gramley: Again, I think it was growing frustration over the stubbornness of inflation and hopes that you have some other solution of this kind that could help out.

Robert L. Hetzel: Did you have much contact with individual governors at the time, or was your contact mainly with...

Lyle Gramley: Mostly with Burns.

Robert L. Hetzel: The governors at this time were fairly, well they were pretty much completely supportive of a, of expansionary monetary policy, Robertson became more and more kind of hawkish on inflation but at least to this point Brimmer and Mitchell were always very strongly oriented toward [inaudible 00:32:24]. So, at least through, through this point, there's not a, there's really not much internal debate. Well, there's always internal debate, there's not much division of opinion about which way to go. In the first half of 1971, was a very interesting period, toward the end of '70, the money growth falls off and the Fed comes under lots of pressure from the Administration but then it begins to pick up very sharply in '71. In fact, it turns out to be up 10% from January of '71 through August of '71. So, in fact, the Administration does get high rates of money growth although there's more than the Fed intended then, I think. But by May, you start getting the consequences of that money growth without the reduction in unemployment yet. There's an international financial crisis, you know, the dollar comes under attack and the markets floated and the stock market falls, long term bond rates begin to rise, so at this point, the Fed becomes, Burns becomes more aggressive about raising interest rates and so that's a key point. The Administration basically, it's getting the monetary policy it wanted, but what it's getting is the bad side effects, the inflationary expectations, so, and, then the Administration itself becomes more receptive to waging price controls. It seems like the only [00:35:00] realistic way of getting the kind of unemployment rate it wants without inflation, does that sound? Does that sound right?

Lyle Gramley: Yeah. Yeah. Sounds very familiar. Sounds very familiar. Sounds very familiar.

Robert L. Hetzel: The, a lot of this is not, kind of, things that weren't known at the time or known now because of the Holden diary and memos, and so on, but Nixon, in his, I'm sorry, well, Arthur Burns throughout the Spring continues to give public speeches where he abdicates an incomes policy. I think he gives a speech in Munich, perhaps, I think, and but especially in July he gives a speech before the JEC which is critical. He thinks that the Administration needs to be pushed out of its passivity and needs to be much more active, much more aggressive in pursuing its economic policy. Does, and then Nixon reacts and Colson and Hallman [phonetic] plant the rulers about the pay raise. Were you at all aware of that other than through newspapers at the time?

Lyle Gramley: No. No.

Robert L. Hetzel: Just what you knew is basically whatever was reported in the newspapers at the time. And were you at all aware that the Administration had begun talking about wage and price controls? So, you know, Camp David, you learned about Camp David on the Sunday...

Lyle Gramley: Everybody else did.

Robert L. Hetzel: What about your own views at this time? You'd been studying monetary financial economics since 1955. If you had argued with Burns up to this point, what would you have argued with him about or were you pretty much...

Lyle Gramley: I did strongly argue with him, but later. It was in the middle of 1972 and I had a long argument with Arthur Burns. And it's a very memorable occasion in my mind. I was called down to Burns' office and he said, "Lyle, I've got a wonderful opportunity. I've been invited to give the luncheon speech at the joint lunch meeting at the AFA and AEA at the meeting in Toronto in December." And he said, "I want to make a really hard hitting speech on inflation." Of course, he was going to really give it to them. And he went on and told me what he wanted to say and I finally stopped him and I said, "Mr. Chairman, you haven't asked for my advice but I'm going to give it to you anyway. Don't do it." And he said, "Well, what do you mean?" And I said, "Well, pick another subject." He said, "Well, Lyle, what do you say that for? You know I've been, all my life I've been deeply concerned about the problems with inflation." And I said, "Yeah, and you're running a monetary policy that's blowing the economy right out of the water."

Robert L. Hetzel: Now, it was early in July...

Lyle Gramley: It was in June. June of, I think around June of 1972.

Robert L. Hetzel: Okay, so this isn't even before, the big pickup in money growth comes in early July of '72.

Lyle Gramley: But I was...

Robert L. Hetzel: Nixon was already expansionary, but then there's a period of July and August and September where...

Lyle Gramley: We also got some very big revisions in the money supply numbers late that year. So, we found out that the money stock was going a lot faster than the original numbers that we had...

Robert L. Hetzel: Right. But you were still clearly over the, clearly over the targets the FOMC was setting...

Lyle Gramley: We never were over the targets...

Robert L. Hetzel: So the FOMC, everybody markets faster, it wasn't like you were hitting your targets and then later on you discovered, oh no, we're missing the...

Lyle Gramley: Right. But, you know, I just strongly smelled that the economy was growing much too fast, that inflation was being suppressed by, that is measured inflation was being suppressed by wage and price controls. That by the time we learned that we were going too fast, we were going to have an explosion of inflation. And I had a long, detailed argument with Burns in which he told me, "Listen to me," he said, "Lyle," he said, "you know I have great respect for your views, but," he said, "you're just plain wrong. Nothing wrong with the monetary policy we're running." [00:40:00] He said, "We've got 5.5% unemployment. That's an unemployment rate I associate with a recession, M1 is going," he said, "No faster than real GDP, there's absolutely nothing to worry about."

Robert L. Hetzel: Let me ask you about, that argument's in the minutes a number of times. The argument is that if M1 is growing no faster than real GDP then money supply is not quite accommodating money demand and therefore monetary policy is...

Lyle Gramley: I don't know where it came from.

Robert L. Hetzel: But you see it quite a bit, but it's not...

Lyle Gramley: It was strictly a Burns notion. No staff member ever bought it. And I told him at that time that he used that argument on me and I said, look, I don't know of any analytic basis to support the hypothesis that money is not going any faster than real GDP, you don't have a problem. But, he wanted very badly to bring the unemployment rate down. He wanted very badly to see the President re-elected and he was quite prepared to pull the wool over his own eyes.

Robert L. Hetzel: I've had different comments on that. It's hard to know how credible different people are, whether they, depending on how well they did or did not get along with Arthur Burns, for example, Sherman Maisel told that in early 1972 he was at a meeting with between Arthur Burns and new regional bank directors and Arthur Burns told the directors, "I hope you all understand how important it is to re-elect Richard Nixon." Could Burns have said something like that?

Lyle Gramley: Probably. Probably.

Robert L. Hetzel: Maisel said he put it in his book and when he sent the, sent the, he would tell you this, by the way of an anecdote or something he thought was amusing, so when he sent the book to the Board for review, of course the staff picked it out and said Burns was very angry with him. Well, Burns, I might ask you about Burns' relationship with Nixon. It's hard to forget, I mean, it's hard to remember unless you lived through this period, how divisive a period it was because of the war and militant civil rights leaders, the bussing, the demonstrations, that whole business, and Burns has written, is writing these letters to Nixon saying that this is a time of great national trial and the country needs a great leader to lead us out of the wilderness. And it sounds like he's writing these red x's, when he writes these things, so you get the feeling that Burns really did believe that the country was in a state of crisis. It had to have strong leadership to get through this period and that leadership would come from Nixon and that he was the, he was the most qualified person to be Nixon's advisor and if you think about it, if you think about all the men in Haldeman, Colson, Connelly and some of the people he surrounded himself with, but it's not too hard to imagine Nixon feeling that, well, you know...

Lyle Gramley: That's right. You could certainly, not hard to understand why Burns believed that he ought to be the most influential advisor for the next--he didn't have a great deal of respect for White House people. He had a lot of respect for George Schultze, even though he...

Robert L. Hetzel: Schultze was Burns' protégé.

Lyle Gramley: Yeah.

Robert L Hetzel: Other than Schultze and McCracken, I think probably he respected, I think there was some tension at times.

Lyle Gramley: I think he didn't view McCracken as particularly high powered individual.

Robert L Hetzel: As a heavy-weight. Yeah. McCracken was, just from reading the memos seemed more along the lines of a business economist who was, you know, was knowledgeable about the statistics, and had basically conservative ideas, but I don't, he didn't have this sort of personality George Schultze did or kind of a, although he did, I don't know, he hung in there for three years [00:45:00] so, he gets some credit...

Lyle Gramley: Yeah.

Robert L. Hetzel: **...**for being, working in a difficult, a difficult situation.

Lyle Gramley: [unintelligible 00:45:04]

Robert L. Hetzel: And of course, Burns thought Connelly was a disaster especially in the international area, thought that Connelly could bring on a 1930's style recession with his protectionism and break down of [unintelligible 00:45:24], didn't happen that way, but it could have. I mean, before the fact, you know, he might have been right. So, let's go back to your discussion with Burns in 1972. That would have been, you said, in June?

Lyle Gramley: Somewhere around there.

Robert L. Hetzel: So this was before the problems with the FOMC began to arise, especially in August when money growth didn't come down.

Lyle Gramley: Right.

Robert L. Hetzel: And then Burns actually had the desk lower the funds rate in September because the markets were expecting the Fed to raise the funds rate. And so they were, interest rates were rising on everything in anticipation and Burns wanted to send a signal and got calls to even people like Brimmer who had been, who were very, and Mitchell, who were very hawkish on unemployment. I mean, these guys thought 4% unemployment was a temporary, was you know, just a mile post on the way to 3%.

Lyle Gramley: [unintelligible 00:46:35].

Robert L. Hetzel: And they, they partly covered the, the party began to argue with Burns about, but you know, and certainly you know, Milton Friedman was distressed by early '72, but, in the profession, the mainstream economics profession, as late as December of 1972, they were, they were, they were much more aggressive than the Fed. I mean, they were looking at the unemployment rate and they were saying it's not 4% yet, how can you, how can you tighten? And this was the, the [unintelligible 00:47:21]

Lyle Gramley: And main street...

Robert L. Hetzel: This was the great mass of...

Lyle Gramley: What needs to keep in mind, that people still believed at that point, the bulk of them.

[00:47:29]

[END OF TAPE 32, SIDE A]
[START TAPE 32, SIDE B]

[00:47:33]

Lyle Gramley: So if you thought strongly that full employment and the unemployment rate was 4%, and that the only thing was a little inflation getting in the way of getting there, it didn't really make all that much difference, anyway. You could go ahead and argue for a more expansionary monetary policy. And I, you know, in my conversations with Burns, I was well aware of the political pressures he was under. I was well aware of how badly he thought, the importance he assigned to the re-election of Nixon and to the problems he was having in terms of potential conflict between his position as Chairman of the Federal Reserve Board and Chairman of the Committee on Interest and Dividends. But I was never able to determine to my satisfaction whether he really believed these arguments he was giving me that 5.5% unemployment was a recession level, that so long as we didn't let money go faster than real GDP we had no problems, or not. I didn't know whether those were covers or whether they were things he genuinely believed.

Robert L. Hetzel: Well, it's hard to say. At the July or August 1972 meeting, he presented a table showing 5.5% unemployment and going back to 1954 and 1962, you know, post-war, and showing the level of interest rates at that level of 5.5% and showing that interest rates at the current time were higher than that and arguing, therefore, that monetary policy was not expansionary. And did he believe that?

Lyle Gramley: I don't...

Robert L. Hetzel: I don't know. He had a way of marshalling facts that was very impressive. He could say, well, you know, since 1887 inventories have always fallen at this point in the business cycle and was hard to challenge him because you couldn't challenge him with the facts, but I think it was just intimidating. But whether it was really, you know, completely germane to the issue of whether interest rates were too low or to high was...

Lyle Gramley: I wonder if you've ever heard the story of Burns' first FOMC meeting.

Robert L. Hetzel: Well...

Lyle Gramley: And the intimidation of Al Hayes.

Robert L. Hetzel: Let me ask you about that. Maisel, in his book, says it was the bitterest FOMC meeting that he'd ever attended. In his book he says that it was very contentious. And other people have said that Burns never forgave Hayes for challenging him at that first February 1970 meeting. And I've also read that, accounts, where Burns said that, well, if you don't lower interest rates we're going to have a 1930's style depression. But yet, you go back and you read the minutes and they don't seem particularly …[unintelligible 00:50:46].

Lyle Gramley: Why I was at that FOMC meeting, I don't know. But it made a very vivid impression on me. It was a very contentious meeting. I don't recall that statement, but I mean, I recall the sequence of comments by Burns that lead to the invite, the interchange with Hayes, that led to the ultimate humiliation of Hayes. Hayes, when you have an FOMC, we have a go-round. Hayes got his hand up early and he gave a speech about, to the effect that the unemployment rate hadn't gone up at all yet. Price inflation had showed no signs of moderation, we had to hang tough, Burns...

Robert L. Hetzel: In fact, the unemployment rate was still at 3.5% as of December. It had gone up a little bit and then fallen down, so that it looked, if you were looking at the unemployment rate, it looked like it had made no progress.

Lyle Gramley: So, Burns said he wanted to take the floor and respond to Hayes' comments and what he did was to go through a bit of old fashioned business psychoanalysis, there are certain indicators that are leaders, there are certain indicators that lag, others are contemporaneous, and the unemployment rate is a lagger, prices are laggers, and he went through a number of the leading indicators showing that the economy was weakening, so it was time for the Fed to think carefully about backing out from its tight monetary policy. He goes on and proceeds a little bit more. Hayes puts his hand up a second time, essentially repeats the same speech he made the first time. Burns again asks for the floor to respond and he said, "I think I ought to tell you, that before I came over here I asked the National Bureau to do an independent assessment of the stage of the business cycle. And he said their conclusion is that the data at the moment are consistent with the hypothesis that we're already in recession. The go-round begins. Hayes gets the floor again he makes the same speech a third time, or starts to, and Burns stops him in mid-sentence and he says, "Mr. Hayes, you could have made this same speech in October of 1929." I mean, it was just the ultimate humiliation and I don't think the two people ever could look at one another without remembering what had happened.

Robert L. Hetzel: Yeah, well, he could humiliate people. He could embarrass people because of his knowledge.

Lyle Gramley: And he didn't hesitate to do it when he thought he needed to, when it served his purpose.

Robert L. Hetzel: And he was also aware that, probably, that New York had been in the primary, other center of power was in the system. And that's changed completely now. And people don't remember that, but at the time, there were still people around who remember the Sproul …

Lyle Gramley: Right.

Robert L. Hetzel: … independent position as New York, New York. Hayes continued to, Hayes, Hayes was especially concerned about the international situation and there were various incidents, especially in the Spring of 1971, but also in December of 1971 after the, around the time the Smithsonian and afterwards, where the New York Directors wanted to raise discount rates in response to a run on the dollar. And Burns was never willing to raise interest rates. I mean, there's a lot of irony here, because Burns believed fervently that we had to have fixed exchange rates, but he was never willing to raise interest rates to defend the dollar. But that's where he and Hayes clashed and I think Burns, at various times, very much resented the fact that the New York bank was in for a discount rate increase at times when he was under pressure. But, Hayes, he would make his case, well first of all he would read a statement that his staff had written. And it would be a beautiful statement, but if you read something it's not very effective. You can't keep people's attention. So he would read a prepared statement and then after all the drama, you know, talking about the attack on the dollar, he would talk about, well, let's move the funds right up an eighth of a percentage point or a quarter of a percentage point. So, in a way, he would come out with Burns in that Burns didn't want sharp changes in interest rates that would affect confidence. So, even when Burns and Hayes disagreed, it seems like Hayes was never a challenge because Hayes never wanted to move the interest rates very much.

Lyle Gramley: Hayes is not a forceful man. Not at all a forceful man. His reading of those speeches, though, because I remember, stopped shortly after Burns took over as Chairman. It was common before Burns arrived for everybody to read their piece. Burns thought, "What a waste of time," because a lot of the pieces that were written were simply on district business conditions and so what he did was to, it was his idea that became the genesis of what is now the Beige Book. He said, "Look, what you do, is you write all the stuff in about your district and you send it in ahead of time. You put a cover on it, a cover sheet, circulate it within the system and then we can just have an informal interchange on the problems of the monetary policy and we can save time that way." And as I remember, the only reserve bank president who really didn't go along with this was Darryl Francis of St Louis. He didn't feel sufficiently confident in his own abilities, and so he would put his statement on his lap and sit with his head down like this and read.

Robert L. Hetzel: There are some beautiful statements of the quantity theory in the FOMC minutes read by Darryl Francis, but they sort of, they just [00:57:28] come, there's no, there's nothing to before there's nothing after, they're just there.

Lyle Gramley: There were prepared things about this guy.

Robert L. Hetzel: And so, he surely was right in what he said, but they don't, you can tell from reading it, if no one picks it up and refers to it, or if it doesn't, if it seems disconnected from the discussion, you could tell it could not have been effective.

Lyle Gramley: It wasn't.

Robert L. Hetzel: And some of the individuals with forceful personalities who could have been effective in terms of challenging Burns, I mean, they were really sympathetic with him. Frank Morris, for example, who was a very competent economist, about money markets and unemployment and you know, basically looked at the world a lot like, Burns had a very unique way of looking at the world, but there was nothing in the way he looked at the world that would have caused him to challenge Burns. I guess, later on, late in '77, he then became more assertive [inaudible 00:58:36]. So, in '72 you were looking at basically the growth of the economy, you know, how things were growing very, very strongly, you weren't impressed, the argument was that, well, we won't, we won't come down to, we won't have excess capacity until the end of '73. That was the argument, so it's all right. So why didn't you buy that argument?

Lyle Gramley: I just had an intuitive sense that the government was a lot stronger than what people thought, that I had an intuitive sense that full employement/unemployment rate had gone up even more and I didn't express it that way at that time. And by 1972, I had a strong intuition that price controls were suppressing the evidence of worsening inflation.

Robert L. Hetzel: Burns was very much concerned that if interest rates rose, then it would be more difficult to get support for a reduction in the wage guideline. The wage guideline was 5.5%, he wanted it lowered and he was afraid that if you had a sharp rise in interest rates, then the issue of fairness would come up and he couldn't, so the…did you feel that was a constraint on the policy or sometimes the Congress...

Lyle Gramley: That I don't remember.

Robert L. Hetzel: Congress might, might push the administration into naturally using the powers it had to, I mean, with the Stabilization Act, the Administration did have the power to set interest rates, so it could use [inaudible 01:00:29]. So, well, you, did you stay at the Fed until the time you left for the Council?

Lyle Gramley: Hm-hmm. [affirmative]

Robert L. Hetzel: And so, policy, monetary policy goes through cycles. It starts out very, in '69 at least, I mean, well, in '69, monetary policy was dominated by Chairman Martin and he simply was going to keep interest rates up until he got inflationary psychology under control. But in principal, the idea was the gradualist policy you'd have [inaudible 01:01:14]. You'd exert a moderate pressure area nominal to man and bring the inflation rate down. But then, so finally, in '73 when inflation rate surges, then the Administration, things come back to this sort of policy where you're going to try to work the budget deficit, keep the budget deficit low on work, money growth, and under the Ford Administration I get the feeling that pretty much Ford let his economic advisors, he trusted their judgment.

Lyle Gramley: Right.

Robert L. Hetzel: And...

Lyle Gramley: All the tension that existed, that had existed, between the Fed and the Administration, seemed to disappear under the Ford Administration.

Robert L. Hetzel: And basically Ford let, let Burns run, run monetary policy. Did you begin to work for the Council just January 2, 1977 or when?

Lyle Gramley: Right. I had no [inaudible 01:02:24]. Well, I had, I, when I was a Director of the Division of Research and Statistics, I used to talk with the Council people for a while. Just on every two weeks or so, I'd open and I'd talk about the economy and where it was going.

Robert L. Hetzel: When was this? In, that would have been in '68?

Lyle Gramley: Well, '68, yeah, and no…

Robert L. Hetzel: Art Okun was Chairman at...

Lyle Gramley: Now I mixed up my Congresses. Art must have been continuing to call me as a...private

Robert L. Hetzel: He was definitely active. He testified before Congressional Committees, and was...

Lyle Gramley: Well, I'm mixed up on my times. By the mid-70s, I had relatively little contact with the people in the Administration. Some, but not a lot.

Robert L. Hetzel: In terms of setting the background for the Carter Economic Policy in 1977, the stall-out in the economy, the weakness in recovery in the second and third quarters of 1976, at the time do you remember feeling concern? Did you share the feeling of the Council later on that the recovery was stalling out and that when the Carter Administration took office that its first priority had to be energizing and rejuvenating...

Lyle Gramley: I did share, yeah, I did share the view that we ought to do things like a fifty dollar tax rebate.

Robert L. Hetzel: The tax rebate was almost entirely Charlie Schultze's...

Lyle Gramley: It was Charlie's idea.

Robert L. Hetzel: And he, it was a combination of wanting to jumpstart the economy, but not giving up tax revenues that later on could be used in a more fundamental way to get tax reform. But, so, Schultze persuaded Carter, he must have done that one on one.

Lyle Gramley: The deal was cooked before I joined the Council.

Robert L. Hetzel: So that was cooked as part of the transition plans. And I guess Carter, Carter's economic, Carter's political advisors were inexperienced, too inexperienced to realize the kind of opposition that that was going to create. I mean, there was nobody politically who seemed...

Lyle Gramley: [unintelligible 01:05:16].

Robert L. Hetzel: It seemed people were saying, oh the government, it kind of reinforced all the stereotypes about government giving money away.

Lyle Gramley: This is a bunch of new people who had never been to Washington before. Charlie Schultze being an example to the contrary, but Carter had brought with him a very large number of his people from Georgia. And the idea that this wouldn't go over with the public just didn't, well it wasn't considered seriously. Mike Blumenthal, as I remember, was the one guy in the administration who thought it was a very bad idea from the beginning.

Robert L. Hetzel: But, Blumenthal was not an economist, right?

Lyle Gramley: Right.

Robert L. Hetzel: He was a CEO.

Lyle Gramley: Right.

Robert L. Hetzel: So he didn't, he never carried the weight of let's say George Schultze carried because he didn't have the same analytic capabilities that you know, George had.

Lyle Gramley: Also, the people around Carter that were close to him, considered Mike to be less than a full team player. So, they would caution the president that he shouldn't listen too carefully to Mike Blumenthal.

Robert L. Hetzel: Because he wasn't on the same philosophical wavelength? Or because he would talk...

Lyle Gramley: He wasn't one of the Georgia crew. He seemed to have an independent streak, he didn't always support the positions that had been arrived at internally 100%. He was considered to be a bit of an outsider.

Robert L. Hetzel: He wasn't a team player.

Lyle Gramley: Yeah.

Robert L. Hetzel: That's got to be the most difficult thing about being a policy advisor. Outside of the Federal Reserve System that is you're part of the team and you know, it's understood that whatever the decision is, that you really accept it wholeheartedly and defend it and I suppose that accounts for the fact that a lot of very good people go to the Fed because you can, if you don't agree with something, well, you don't have to defend it publicly, you can [00:20:00] you know, do what you think is right and you can continue...

Lyle Gramley: Right.

Robert L. Hetzel: ...arguing you know, at the next FOMC meeting or pre-FOMC meeting or whatever, you can go right back and say what you think. Charles Schultze was a very experienced policy maker. You know, he had been on the troika from starting in mid-1960s, he'd been in policy for a long time. Did, and at this point there had been several cycles of inflation and recession. Did, did the Council come in saying that we're going to do things differently this time that, you know, given the experiences especially the inflation recession cycles of '70 and '71 and '73, '74, '75. Did it come at all saying, you know, we're going to, we've learned from this. This is going to be different the way we do things. Or did it come in primarily concentrating on the fact that the unemployment rate was 7.8% and the first order of business was just to do something to get it down.

Lyle Gramley: The latter. The latter. It was felt that there was a lot of slack in the economy. It was felt that therefore, the inflation problem of the time was not, to the extent that there was an inflation problem wasn't an aggregate demand problem. It was a holdover from the past that inflation would gradually unwind even if we took steps to speed up the growth of the economy. There was a lot of effort given to trying to understand what was happening to productivity at that time.

Robert L. Hetzel: Still is.

Lyle Gramley: Yeah, still is. And I remember we had an economist by the name of Peter Clark who did a good a good bit of econometric work and we managed to persuade ourselves that productivity growth had been set back in 1973 and that maybe it was an energy crisis phenomenon, maybe not. We didn't really understand what that was all about. But that, there hadn't been any major devolution in the growth rate of productivity. Productivity could still grow quite rapidly.

Robert L. Hetzel: So you were still looking for 4% real growth of the economy.

Lyle Gramley: I can't remember the number, but...

Robert L. Hetzel: That was sort of the standard figure...

Lyle Gramley: ...in retrospect they were much too high.

Robert Hetzel: ...through the '60s. A 4% real growth. So, you saw excess capacity and an economy growing, seemed to be growing, below it's...

Lyle Gramley: it's potential, yes.

Robert Hetzel: So, then the problem became well, you know, what's the mix of monetary and fiscal policies and monetary policy basically the Administration wanted the Fed to keep interest rates unchanged and then you would use a, you know, varied fiscal policy. Did Carter come in with any ideas of his own on economics other than sort of conservative ideas and was it a kind of a struggle to educate him or was he interested and wanted to talk over...

Lyle Gramley: Not really. Not really. He seemed to buy what the staff cooked up for him. One of the things that I think explains what was going on back then, in that era, was in regard to fiscal policy, but then he had made an awful lot of promises during the campaign. Do this kind of thing, do that kind of thing, for this program and the other program, and he strongly believed he didn't break his promises. So, a lot of what was done was not just with a reason of trying to run a fiscal policy that, to stimulate the economy, but to honor these campaign promises he had made. We were also concerned about reducing the level of government spending as a share of GDP. That was a thought that was behind much of what Charlie and the Council used to recommend it because it was always at some point down the road, not right away.

Robert L. Hetzel: Well, but there was still some feeling at the time that there would be some dividend from reduction and expense, defense expenditures.

Lyle Gramley: Yeah.

Robert L. Hetzel: It wasn't until the Russian invasion of Afghanistan [01:12:31] December of '78 that that pretty much, obviously, became that that was not, not going to materialize. Was-was-was Carter willing to give Schultze time to, on a regular basis, to talk to him so he felt like he had enough access, so that was never a problem?

Lyle Gramley: Yeah, Charlie used to see the President once a week. And he also weighed in with the President directly in memos on-on-on specific issues, policy issues that were coming up at the time. He had good access to the President.

Robert L. Hetzel: You'd had a sort of, you'd not had a sort of a common Keynesian education at the time, it's not like you had gone through Harvard, you explained you-you went to Indiana, had a background in monetary, you'd come through the Federal Reserve system, did you view yourself as fundamentally philosophically on the same wavelength as Charlie Schultze as far as Keynesian economics went?

Lyle Gramley: In terms of basic philosophy, yeah. But I...

Robert L. Hetzel: So you never argued about philosophy.

Lyle Gramley: No. Where I differed with Charlie was that he wanted to explain where all the inflation grounds other than excess aggregate demand. It was always food prices or energy prices or inheritance from the past, and given the fact that there was sufficient slack in the economy all of us were unwanted and I kept arguing that it wouldn't, that we were trying to get too much done, we were trying to force the economy too hard. It wasn't a popular position in the administration.

Robert L. Hetzel: Do you remember at the time your contacts with staff members at the, Board and other governors, were they, was there much disagreement at the time, did they basically view things the same way you did or do you remember a heated discussion?

Lyle Gramley: I had relatively little to no contact with board staff or board members of that period.

Robert L. Hetzel: Were you doing troika forecasts?

Lyle Gramley: Yeah.

Robert L. Hetzel: And those you would have done with...

Lyle Gramley: With the Treasury, OMB, and we brought the Commerce and Labor in, too. So we...

Robert L. Hetzel: So a Fed representative didn't sit in on those?

Lyle Gramley: No. Burns stopped the Fed participation and the government's forecasting exercise shortly after he came to the board. He thought it tended to undermine the present economists.

Robert L. Hetzel: Did you get a copy of the Greenbook while you at council, did they send one over to you?

Lyle Gramley: I'm quite sure they did, yeah.

Robert L. Hetzel: Did, was there much discussion of incomes policy, why didn't the council initially push harder for an incomes policy given that they thought that they were getting inflation for a wide variety of reasons unrelated?

Lyle Gramley: We did. We had two incomes policies back to back. One that nobody ever knew about, I don't think anybody knew about the second one either.

Robert L. Hetzel: Well, there was the second one after the oil price shock right? Then it became a more highly visible sort of public relations network, but before...

Lyle Gramley: Before that, we had what we called the deceleration standard. Businesses were supposed to adopt wage increases and price increases that were less than what they had put into effect years before. And the deceleration standard as I remember was the brainchild largely, Barry Bosley. And no one ever knew about it. And then later on when Bob Strauss was hired as, to be the inflation czar, we began to push harder for restraint in the private sector but it all went for naught.

Robert L. Hetzel: Did you have the feeling in 1977 that Arthur Burns was cooperating because he wanted to be reappointed or...

Lyle Gramley: Yeah, definitely.

Robert L. Hetzel: Because he made...

Lyle Gramley: The Administration didn't want him to stay.

Robert L. Hetzel: It's hard to understand how Burns could have believed that he would have been reappointed given the opposition of if nothing else, [01:17:31] George Meany. I mean, given the amount of labor bashing that...

Lyle Gramley: There was opposition in the Congress as well, by the democrats in Congress.

Robert L. Hetzel: Now why would there have been opposition in--that was because of the recession and you know, Proxmire and Royce and...

Lyle Gramley: Partly because...

Robert L Hetzel: ...that group.

Lyle Gramley: Not Proxmire. Not Royce as I remember. Humphrey was strongly opposed to Burns' reappointment.

Robert L. Hetzel: So that was because of his connection with labor, organized labor.

Lyle Gramley: Probably. It's probably most of where the opposition came from.

Robert L. Hetzel: And economists within the administration, or Charlie Schultze didn't particularly want, but even at this time, Burns still used his professorial style when he met with the President. He would lecture him. Was there, you said at this time there began to be a lot of discussion in the natural rate of unemployment and you simply kind of took over the figure that had come from Ford Council, I think 4.9%. Was there much discussion of that, or do you remember?

Lyle Gramley: As I remember we had a number that was somewhat higher than that. But, whatever it was, it was well below the actual rate at that time.

Robert L. Hetzel: Were you following after your, the Fed under Burns spent a lot of time looking at money growth. Maybe because that's what the Administration was looking at, but for whatever reason, a lot of effort was spent looking at money growth. Especially M1 growth. Did you become concerned yourself at some point in '77 and then '78, was that something you were watching more closely than the rest of the Council?

Lyle Gramley: Yeah, yeah, right. I thought that money growth was being suppressed by the [unintelligible 01:19:54] and money demand. I was well aware of the arguments that were going on at that time.

Robert L. Hetzel: But if money demand was falling, and money supply was rising relatively rapidly, then the monetary policy was even m lore expansionary.

Lyle Gramley: Yeah, right.

Robert L. Hetzel: Burns seemed to somehow argue that, well we shouldn't look at money demands unstable, but if you know money demand is shifting left, then with high money...

Lyle Gramley: Burns, Burns would invent arguments when he found it convenient to do so. I remember during the, the onset of the 1974-75 recession, we had a period, as I recall it, of rather sharp deceleration of money growth. Maybe even negative money growth for awhile. Burns simply argued that doesn't mean anything. There's so many different measures of money, so we don't have to worry about that.

Robert L. Hetzel: When was this again? This was in...

Lyle Gramley: Late '74 early '75, somewhere around there. And he began to publish...

Robert L. Hetzel: Oh, the last half of '74, money growth became negative, by I think February of '75...

Lyle Gramley: Because [unintelligible 01:21:03]

Robert L. Hetzel: ...we'd had several months of negative money growth, so you'd gone from 7% M1 growth to, you know, it was a big deceleration.

Lyle Gramley: And he dismissed all of this as being irrelevant because one could always find a measure of money that was still going up if one looked hard enough.

Robert L. Hetzel: Do you agree with the Council's forecast that there might be a slowdown in economic activity in 1978 and that could be a problem?

Lyle Gramley: In the middle of 1977, we perceived somehow, I perceived some degree of weakness. I was not worried it was going to develop into a serious weakness. You may remember we had a lot of forecasts around the middle of 1977 that the economy was going to head into a recession shortly and I didn't buy that. But I always tended to be somewhat more optimistic about the outlook for the economy, than almost anybody else in the Administration, and more worried about the fact that aggregate demand was a source of inflationary problems that we had been dealing with, but I was a pretty lonely voice. I didn't, firstly, the argument is a hard problem to solve I wished I hadn't in retrospect.

Robert L. Hetzel: Were you looking at things mostly as a business [01:22:31] economist or looking at leading indicators and that kind of thing, or were you, did you think of yourself as Keynesian or monitors, how did you view yourself at this point in terms of how you looked at things?

Lyle Gramley: I was very much an eclectic. I did a little bit of old-fashion business psychoanalysis, I looked at it through Keynesian eyes, I looked at monetary, I still tend to be a very eclectic, judgmental-type forecaster.

Robert L. Hetzel: And even through '78 there was concern about the economy, wasn't, I'm trying to remember with the coal strikes and the winter of '78, so even then there was concern about the health of the economy and I can remember around the FOMC table there was lots of, the catch-phrase was "We can't abort the recovery." You know, the feeling was the recovery was fragile and we had to be careful about how much we raised the interest rates. Did you have any contact with Miller before he became Secretary of the Treasury?

Lyle Gramley: While he was board chairman?

Robert L. Hetzel: Yeah.

Lyle Gramley: Almost none.

Robert L. Hetzel: Did you ever...

Lyle Gramley: I've heard stories about his conduct that he was [inaudible 01:23:47] but I had very little contact [unintelligible 01:23:49].

Robert L. Hetzel: Did you have any sense of with whom he was close in the Administration? Apparently he was close to Mondale?

Lyle Gramley: I wasn't aware of that then, nor am I now as far as that goes. That may be true, I just don't know.

Robert L. Hetzel: I had just heard that. The Council becomes concerned, very concerned, about inflation and the effect of aggregate demand policies on inflation beginning, oh I would say, summer of 1978 and especially in the fall when the dollar begins to appreciate rapidly and the Fed raises the discount rate. At that time there was a...

Lyle Gramley: That was a coordinated effort at that time. Around, I remember around the first of November somewhere.

Robert L. Hetzel: Right. Right. There had been a, sort of a bungled series of statements on the part of the Treasury that the dollar should fall. There's a sort of standard kabuki play where the United States wants Japan and German to pursue more expansionary monetary policies so we say, well, you know, we're going to push the dollar down if you don't, and people make sort of loose statements, then the dollar does fall and then it falls too far and then they want the Fed to intervene, you know, foreign exchange intervention, it's just, we seem to cycle through this all the time and that one ended then too. I guess part of the problem is maybe there's not the same degree of continuity at the top in places like the Treasury as there is in the Fed. That would be part of the problem.

Lyle Gramley: Well, I can quite clearly recall that the Council of Economic Advisors was very much behind the idea of letting the dollar sink during the course of 1978 up until it got to rapid in the fall. Bill Nordhouse was strongly arguing that [unintelligible 01:26:05] don't worry about it. And whether the Treasury Advisors took a similar view or not, I don't know, but Mike Blumenthal was not on the stump behind them talking down the dollar and it got to be a real problem.

Robert L. Hetzel: I didn't realize that Bill Nordhouse was involved in macroeconomic discussions. I assumed his major focus would have been regulatory.

Lyle Gramley: But he was also, he also did the international side.

Robert L. Hetzel: Okay, I didn't know that. So I should talk to him, too. Okay, I assume he's still at, was it the University of Rochester?

Lyle Gramley: No, he's at Yale.

Robert L. Hetzel: Yale. I'm sorry, I knew that, sure, sure. Then, the, at the end of '78 a split develops with the Council and Blumenthal on one side and with Miller and then ultimately Carter on the other side over whether policies, monetary and fiscal policies should become restrictive to kind of concentrate on inflation. And so, curiously think the head of the Fed ought to be on the other side, but he wasn't.

Lyle Gramley: On the side of the [unintelligible 01:27:27] but he wasn't, no.

Robert L. Hetzel: But Carter came down on [01:27:31] his side and the Board staff was forecasting a recession for early '79 and apparently that's what he concentrated on. Do you remember, I remember Charlie Schultze gave an interview with the Washington Post reporter Barry and kind of that made the debate public. Do you remember that at all?

Lyle Gramley: No.

Robert L. Hetzel: Okay.

Lyle Gramley: I do remember the growing tension within the administration. But Council wouldn't, Blumenthal, wanted more emphasis on inflation and almost everybody else in the Administration.

Robert L. Hetzel: It's not really until the increase in oil prices that the Administration realizes it has to focus on inflation. How did the Council view the Fed's October 6, 1979 change in operating procedures where it would concentrate on non-Federal Reserve...

Lyle Gramley: We were very worried. Very worried.

Robert L. Hetzel: Did it come out of the blue to you, you know, you got a call from Volcker and saying, you know, this is what we did, I gather the meeting was on a Saturday and everybody went there secretly checking into different hotels so nobody would know...

Lyle Gramley: Charlie Schultze found out about it a day or so before I did. But I found about it just before the public announced it. Then Charlie asked me to sit down and think through the implications of this for interest rates and [unintelligible 01:29:37]

Robert L. Hetzel: There could be only one implication, just...

Lyle Gramley: Well, the question was how much.

Robert L. Hetzel: Yeah, sure.

Lyle Gramley: What would the effect be on the economy. And I recall Charlie trying to intervene through the President to stop it from happening, but he was totally unsuccessful. And I remember that I wrote a memo at the time, but what the contents of that memo are, most of it's forgotten. I never felt that was a good idea even in retrospect I have always thought that, and I think Volcker would acknowledge it if you got him in a quiet room somewhere...

Robert L. Hetzel: I'll try sometime.

Lyle Gramley: …it was pure façade. That what Volcker knew was that there was no way in the world that he could ever raise interest rates enough to slow down inflation. [unintelligible 01:30:25]. So they only way to do this was to hide behind a monetorist approach to it and say, well, the interest rates are not my fault.

Robert L. Hetzel: Sure. He had two problems. He had that problem, but he also had a problem with his own Board; getting people on his own Board to go along.

Lyle Gramley: He had fair support though, with the Reserve Bank presidents.

Robert L. Hetzel: Right. And the vice-chairman supported him, but there were individuals like Nancy Teeters who would have been very disturbed...

Lyle Gramley: Very upset.

Robert L. Hetzel: So it was one way of not having to get consensus within the full FOMC on an interest rate target. So he only let the FOMC talk about the broad reserves target, and then he set the funds rate. So, it gave him an extra degree of flexibility to move the funds rate around also within the system not just critically. Plus, he could move it around with the discount rate, too, and as long as he had a majority on the Board, then he could move the funds rate without having to go through the full FOMC, so you could basically run the show and I think he wasn't setting the funds rate down to the tenth of a percentage point, but he was not, he knew very well what the funds rate was.

Lyle Gramley: Yeah, he didn't, he didn't turn lose control of the funds rate completely, but the driving force was the target set for non-[unintelligible 01:32:09] reserves and the growth for non-[unintelligible 01:32:12] reserves had the actual, were relative to that target. Volcker might have moderated day to day movements, but the bigger swings from month to month were the consequences of the basic strategy pursuit.

Robert L. Hetzel: Well, we spent a lot of time investigating [01:32:31] that and there are two discretionary ways to intervene in that process. One is through changes in reserve requirements, and the other is through changes in the discount rate and when you divide things out into what changes in the funds rate were due simply to having a given target for non-borrowed reserves and having reserves vary relative to that target, and the discretionary changes which came through things like the discount rate, the surcharge on the discount rate, changes in reserve requirements, a majority of changes in the funds rate are, were due to the discretionary actions. So, it's-it's true, that-that you know, a lot of the changes were coming from this automatic procedure, but the procedure was not nearly as automatic as it was presented to the public. And Volcker was so smart. He-he understood how, exactly how this worked and it took everybody else about six months to catch up with what was really going on and how things were being manipulated and controlled, and so...

Lyle Gramley: Well, Volcker never foresaw even closely, however, the magnitude of changes in interest rates that would take place.

Robert L. Hetzel: Right. The funds rate got up to, I think, 21%. And it was, that was clearly not something that he...

Lyle Gramley: Yeah, and he argued it, I recall going over to see Paul before, shortly after, maybe it was before I'm not quite sure exactly when, but either shortly before or shortly after the day of the implementation policy. And we talked about what this was going to result in and I told him it was going to just drive interest rates through the roof. It was going to happen to both short and long term rates. He said, no it won't. He said this will affect confidence to the point that short term rates will go very high, but long term rates won't. And I said, you wait and see.

Robert L. Hetzel: Yeah, well the problem was that he had other things going on at the same time, and the markets really lost their bearing on what was an equilibrium interest rate and the markets thought, well, gee, maybe the interest rate necessarily contain inflation has risen dramatically and if the Fed thinks, you know, the Fed thinks it's risen, maybe it has and so people didn't know how to set interest rates, so, and you have the same thing later on, then with the Reagan tax cut. People lost a sense of what interest rates were going to do with that size deficit. So they're looking to the Fed and the Fed is saying, oh, the market...

[01:34:59]

[END TAPE 32, SIDE B]
[START TAPE 31, SIDE A]

[01:35:03]

Lyle Gramley: ...that's the reason I recommend for money with respect to income and then you use plausible lags. The isolation would be more likely damped than explosive. Even then nobody knows for sure. That was a terribly, terribly exciting time. Much too exciting for my taste. But you know, let me tell you a little story about inflationary expectations, and how difficult they are to deal with. When I went to the Board, after I had sat through a couple of FOMC meetings, I realized that this was a different set of policy makers then had been there when I was a staff member.

Robert L. Hetzel: Well, you were different yourself. We remember just, I don't know, watching with amazement is the right word, but, you know, Richmond was concerned about inflation and when you came on board, we just viewed you as a solid rock as, you know, in no way were you going to compromise that inflation.

Lyle Gramley: Well, I had been, I became increasingly uncomfortable with what was going on under the Carter administration the longer I was there. But, my voice was not being heard. And when I went over to the Fed, I was absolutely determined that I was going to do whatever I could to work with Paul and help get on top of this conflict. And, after seeing what the mood of the group was, the FOMC members, I was absolutely convinced that this time, the Fed was going to stay the course. So, I felt it incumbent upon me to go out and talk to the public and tell them it was going to be different this time. And so I would go out, and I would make speeches and I would lay out what the Fed was trying to do, it was determined to get money growth down to thus and so, and it agreed with the trajectory for nominal GDP would be thus and so and unless inflation come down we were going to sink into the depths. And so inflation just had to come down, there wasn't any two ways about it. After I would make a speech, there would be a Q&A and I would take the opportunity to ask members of the audience what their planning, with what giving their planning horizon five to ten years or whatever it was, what was the expected inflation rate that they were basing their business plans. And I would say, how many of you think it's going to go over 10%, 25%, and the hands would go up. And I would say how many of you think it's going to be 17 or 40%, how many of you think it's less than 5%? A few scattered hands go up, and I'd say you completely haven't heard what I just said. What's the matter? What's, why don't you believe me? And their response was, well we heard this stuff before. Bill Martin was going to be a fighter of inflation, but it never happened. Arthur Burns was, in words, the greatest fighter of inflation you've ever heard, but it didn't happen. And you guys will check out on it too. And it wasn't until fall of 1981, when we started heading into the deep recession, when that response began to change, and they began to realize that we were dead serious. So, yes, these things die hard.

Robert L. Hetzel: It was an especially difficult period for the Fed and it wasn't just the change in operating procedures, the change in operating procedures occurred on October 6, 1979. And then, the Russians invaded Afghanistan in December of that year and the Carter Administration submitted a budget to Congress which was not considered realistic because of the assumption that the defence expenditures were not realistic, so there was a feeling that the deficit would be much higher than people had thought. And that was unsettling to financial markets. So, even when the monetary policy was being restrictive, long term bond rates were rising when you thought, hey, restricting monetary policy, inflation ought to come down, so you had these things pulling in an opposite ways. You're right, I think it wasn't really until the summer of 1982 when you began to see some reduction [01:40:00], actual reduction, in inflation and people beginning to say, yeah, maybe they're getting serious, so. I can remember, you know, I was just a kid then, but I went to a party where I talked to the head of the Merrill Lynch office in Richmond and he was talking about sending his people to South America to learn how to deal with Brazilian rates of inflation so that they could then come back and plan strategies accordingly. So, people had, you know, people didn't know what to expect. What was the origin of the credit controls? The Carter Administration had decided by early 1980 that it was going to have to pursue conventional monetary and fiscal policies, balance the budget, low money growth and, of course they never would have, I don't think anybody ever would have said, you know, let's raise the unemployment rate, but that was the...

Lyle Gramley: [inaudible 01:41:13] public.

Robert L. Hetzel: That was the implication. So, you basically had this decision to go to a conservative set of mac weak economic policies, and then the credit control seemed to come up. What was the origin of those?

Lyle Gramley: In terms of the person who thought it up, I think probably it was Charlie Schultze more than anybody else. But, he and I talked about it a lot and the idea was that interest rates could go up so high as to cause severe dislocation in particular industries, like housing, small businesses, and maybe what you could do is put a little sand in the machine to kind of slow down the extensions of credit and give more of the restraint that way and less to higher interest rates. And this was in the context of interest rates that were pushing up in the high end of the double digit numbers at the time.

Robert L. Hetzel: So, it was like what the Johnson Administration did in the summer of 1966 when it was clear that the Fed was going to raise interest rates and after it was clear that Johnson wasn't going to raise taxes, then the Board worked out with the Council that the Fed would send out a letter to banks asking them to ration credit so that you would get some of the effect through rationing rather than simply through an increase in interest rates and then I guess the housing wouldn't have been affected as much as it would have otherwise. That was the idea, so it was a similar sort of, and I suppose Schultze looked to this. Schultze was, he'd been in the center of things and so I suppose he was thinking back to that period also, although nobody at that time anticipated what a sharp reaction he would get on the financial market, so, banks panicked and they sold off municipal securities and the same thing happened in 1980. The banks really panicked, they thought, you know, oh my God, maybe we're going to be over these limits and all kinds of awful things will happen, so they suddenly pulled back on credit extension and, you know...

Lyle Gramley: Consumer reaction was amazing. That probably was the most surprising thing of all.

Robert L. Hetzel: Yeah, maybe we can't use our credit cards.

Lyle Gramley: An awful lot of people took out their scissors and cut their credit cards in half. I recall when the final package was put together, we had a young woman who was working as our Chief Monetary Economist and was the point man for the Council of Economic Advisors in our negotiations.

Robert L. Hetzel: She was in negotiations with...

Lyle Gramley: With the Fed over the details on the credit controls. We didn't really have much say in what they did. But they kept us posted and we could interject some thoughts here and there [inaudible 01:44:16].

Robert L. Hetzel: So the Fed worked out the details with the banks pretty much by, because it had the staff to do so. Yeah, who was the point person?

Lyle Gramley: For the Council it was a gal by the name of Burke Dillon.

Robert L. Hetzel: Burke?

Lyle Gramley: Burke Dillon.

Robert L. Hetzel: Brooke?

Lyle Gramley: Burke. B-U-R-K-E.

Robert L. Hetzel: Dillon.

Lyle Gramley: She had been at the International Monetary Fund and came over to work for us as a monetary economist for a year and then went back to the Fund. She may still be there as far as I know, and she came back just fuming, those fools, they put together a program that has got holes all over it. It will have no effect whatsoever. Don't they realize that people are sufficiently sophisticated, they won't react to a program that's got as many loopholes in it has this one's got.

Robert L. Hetzel: Well, I think that was the feeling that the Fed thought that this was more cosmetic than anything, and that it would not have a big effect. I think that was the feeling.

Lyle Gramley: Yeah. We were surprised as hell. That's just a reminder that I'm supposed to, I put that there, I'm not supposed to go yet. That's there to tell me don't go home tonight.

Robert L. Hetzel: Ordinarily, the Chairman of the Fed maintains very good contact with the treasury and with the Council, but when Volcker came in as Fed Chairman, according to staff members, he asked them to begin working almost immediately on the change in operating procedures, but nothing was said at all to the Council. That seems surprising.

Lyle Gramley: Yeah, we didn't hear about that until, I'm not quite sure when Charlie heard about it, but it wouldn't have been, let's say, before the first of October. It was just a few days before the implementation date and I heard about it a day or so later and I had had an opportunity to do a little work on Charlie's behalf so he could talk to the President in hopes of dissuading the Fed, but it was to no avail.

Robert L. Hetzel: That was Volcker's personality, or he just thought the situation was such that the Fed, the concern with inflation was such that the Fed had a lot of leeway in basic [inaudible 01:46:41] of moving independently.

Lyle Gramley: I think he felt he had no choice. He had no choice. He had, as far as he was concerned, cleared the decks for Carter when he was appointed.

Robert L. Hetzel: So he had said to Carter, I mean, it was understood when he was appointed, that policy would be restrictive, so he felt like he had...

Lyle Gramley: He told Carter, I'm going to be tough with inflation and I'm going to be independent. And you should know that before you appoint me. Carter said, that's fine, that's what we need right now, our economy is in trouble, we've got to get inflation down, that's great. He had no idea what he was approving.

Robert L. Hetzel: Well, nobody did.

Lyle Gramley: No, that's right.

Robert L. Hetzel: Volcker, I mean, in retrospect, it's clear that Volcker, you know, he had spent his life defending Bretton Woods, he had cared very deeply when we [inaudible 01:47:28] Bretton Woods, but he had always worked for other people, and in meetings he talked to people, well, what did Volcker feel, well, you know, he kept his thoughts to himself. You know, he was a very good democrat.

Lyle Gramley: Two of the background stories that might be of interest, Volcker wasn't the Carter Administration's first choice. The first choice was the guy who was then head of CEO of the Bank of America. His name was...

Robert L. Hetzel: Houghton?

Lyle Gramley: No. Forgot who CEO, not Connors, it's, the name is back there somewhere, but I can't bring it up. He turned down the Administration. They went to Volcker next and Volcker had, was recommended to the President by Mike Blumenthal, I think. I think somehow Mike Blumenthal, that's a vague recollection, but that's my recollection, that he called the President and put Volcker's name in the pot. During this period, Charlie Schultze got sick.

Robert L. Hetzel: So this would have been summer of 1979.

Lyle Gramley: Summer of 1979. Charlie was sick for about eight weeks. He had spiking fevers that the origin of which were never found. Final diagnosis was fever of unknown origin. They even operated on him one day, they thought he might have cancer. And had Charlie been there, he was, he did not prove wrong when it came to Volcker, he thought that was a very bad idea. He knew Volcker would be very independent, that Volcker would go his own way, but the Administration would promote and say whatever as to what would happen and he didn't approve of it. Had he been active and well, it's conceivable that he could have turned the President around. But, he wasn't.

Robert L. Hetzel: Well, later on, when, when was it that Reagan was shot? Do you know? Whatever that date was?

Lyle Gramley: It's around March of '81 or something like that.

Robert L. Hetzel: And that's when monetary policy became so very restrictive. So Volcker was really on his own during much of this period. Because at that point there was no one who could challenge him. Monetary policy was the most restrictive at this [inaudible 01:50:06]. I'm not suggesting it was [inaudible 01:50:10], but that's what I'm saying, there was no one there to challenge him.

Lyle Gramley: Reagan, wait, Paul said to me many, many times the Fed could not have done what it did...

Robert L. Hetzel: Without Reagan's approval.

Lyle Gramley: ...without Reagan's approval. At least without Reagan keeping his hands off. That whatever the pressure was being put on him by Don Regan and Beryl Sprinkel and people like that. He could take that. That was just words. As long as he had, Reagan kept his hands off it, he was all right.

Robert L. Hetzel: So Regan and Sprinkel did try it.

Lyle Gramley: Yeah. Yeah.

Robert L. Hetzel: That, I figured as much. I haven't talked to them to, that's good. That's good to know. That's basically what I heard that Reagan was influenced by his advisors, Milton Friedman, and other people who were telling him that you have to get money worked out, of course they didn't approve of the way they did it, but Reagan was one to leave the Fed alone. The, of course, when the controls came off in the summer of 1980, then the economy surged again. And, inflationary expectations took off again and that was part of the problem not having credibility. Not having, it wasn't like Volcker in 1986, you know, where people, or Greenspan in 1996, where people say, yeah, you know, well, yeah, the economy is strong, but...

Lyle Gramley: But you see, this is inherent in the way that that strategy was being pursued. I can remember to this day, at my first FOMC meeting, in May of 1980, I was arguing strenuously, for God's sakes, stop dropping interest rates. I mean, how can you argue that the funds rate of 21% was not high enough in March and here you are in May and an 8% funds rate is not low enough. The economy doesn't change that violently. Don't you see what you're going to do? You're going to blow the economy right out of the water with this kind of policy. And Volcker says to me, well, you are some kind of hawk, after the first meeting. I said, no, Paul, I'm not a hawk, I just got my head screwed on straight. I mean, I could see what was happening and I, as soon as we got into this, the second half of the economy going right back up again, you know, everybody was for letting it go and I kept saying, oh no, people, this isn't what you want to do, you want to temper this thing. Slow it down. But...

Robert L. Hetzel: Well, on the way back up it was a difficult situation because I don't think Volcker cared so much about money growth, he cared about the expectations of the market and the markets at that point were looking at money growth, so he thought he's got to get it under control and if interest rates go up to 21%, well, that's -- and then he begins to back off in the Spring of '82.

Lyle Gramley: But he, you see, he committed, the Fed, to what was happening in the Fall of 1981, by what happened in the Spring of 19, I'm sorry, what happened in the Fall of 1981 to what happened in the Spring. Once you didn't, if you didn't temper the downward movement of interest rates, then you inevitably set yourself up for another turnaround of the economy and a run up of both GEP and one. And then, of course, you had to stick with the strategy, otherwise you're...

Robert L. Hetzel: You're willing to let rates fall. You've got to let them rise, otherwise people will see it's not symmetric, it's sort of business as usual. That must have been a very difficult time for everybody right before the elections. The Fed raises the discount rate and this is not Arthur Burns' 1972, this is a very different situation.

Lyle Gramley: I remember we were getting blamed--

Robert L. Hetzel: Yeah, all sides.

Lyle Gramley: --by the Democrats for raising the interest rates and by the Republicans, too.

Robert L. Hetzel: Because of the high money growth, yeah, absolutely, both sides were jumping up and down at that point. It wasn't clear what the Fed should have done. Do you remember, do you remember when the, Volcker first became concerned about the international situation in 1982? I mean, obviously, August 1982, Mexico announces it's in default, but by then, the Fed is already beginning to lower interest rates. We had the feeling at the time, that [01:55:00] Volcker felt as though the international banking system was under stress and that things could crack if we didn't begin to ease off, so that, it was done over kind of a groping or a [inaudible 01:55:18] process. We lower the funds rate a little bit, see what long term bond rates would do and if they didn't respond adversely, we would push a little more and we pushed until December of that year when bond rates started going up. Do you have any recollection of when you first became aware that we had a real international problem on our hands?

Lyle Gramley: Well, at some time during the Summer of 1982, but I don't know if it was August or July, or June, what worried me at least as much was the fact that there were widespread expectations that the economy would turn up in the second quarter and it didn't. And then there were widespread expectations that it would turn up in the third quarter and as the numbers began to come in from July, June and July, it became evident that there was no upturning involved there, either. And what I was deeply concerned about, was that the business community which had begun to build inventories in expectations of the mid-year turnaround in the economy, was going to get this, this illusion yet once again and then we were going to head downstream really big time. I was more concerned at that time with the domestic economy than I was with the delicacy of the international situation, but they, of course, were self-reinforcing.

Robert L. Hetzel: Right. In terms of trying to understand Volcker's psychology at the time, do you think he was more concerned about the international banking situation or it was just a combination?

Lyle Gramley: I think it was a combination of things. He thought the whole world was in very big trouble and the Fed really had to take leadership.

Robert L. Hetzel: So at that point, he was willing to accept, when he started the disinflation process, he didn't know where he was going to end up. It really was to try to push it down as long as he could and then back off. So there was no clear, so, basically he got inflation down from 13% to 4%, 4.5% and then decided it was time to quit.

Lyle Gramley: I remember the [inaudible 01:57:37] he made his speech. He started the meeting that day by saying, look, you know, I don't usually talk first, but I'd like to today.

Robert L. Hetzel: Which one is this?

Lyle Gramley: It was the August '82 meeting at which the Fed abandoned the whole entire [inaudible 01:57:56] and what he said was that I'd like to do a little walk toward a horizon.

Robert L. Hetzel: Yeah, toward a horizon, yeah.

Lyle Gramley: And he began to talk about the state of the U.S. economy, what's going on in Western Europe, international banking situation, the Latin American crisis developing, Mexico, who knows who's next, and he said, look, we haven't gotten where we want to on the inflation rates, but we can't go on like this, we're going to drain your whole [inaudible 01:58:22] if we're not careful. And he had, there really wasn't any opposition. Everybody had come to the same conclusion.

Robert L. Hetzel: By September of 1982, there were a raft load of resolutions in Congress threatening the Fed. Some of them, I think the one in the House, had supported the Speaker and was seeming pretty serious. Do you think those had any effect at all, or was the entire...

Lyle Gramley: I think Volcker felt that he could get through the period in terms of withstanding political pressures.

Robert L Hetzel: Because he had the support of the administration.

Lyle Gramley: Support of the President. And he thought he had the support of the public and there were lots of interest groups that hated him. He felt that the public was behind this. And as long as the public and the President were behind it, he brought it out. The Fed brought it out. But then the domestic economic and the domestic and international financial situation were crying out for some support.

Robert L Hetzel: How long were you on the, on, did you remain on the Board?

Lyle Gramley: Till September of '85.

Robert L. Hetzel: So, in June of 1983, the Fed does something very remarkable, just trying to remember from my own experience. The unemployment rate is still, well maybe 10% [02:00:00] and we raise interest rates. Incredible.

Lyle Gramley: I like to think that I was one of the prime reasons for this, primary reasons for this. I began to just see real problems developing when investment kept inflation rates from growing...

Robert L. Hetzel: Yeah, and [inaudible 02:00:19] had began to come very rapidly.

Lyle Gramley: Well, I remember at that time, I wrote a memo to Paul Volcker and I said, this is in the second quarter and it was before the, I think the FOMC meeting was in May when we did that, and we had the April numbers on employment and aggregate hours worked and they were up some huge amount, 8% annual rate in the first quarter average. And I wrote a little memo to Paul which said, look, one of the rules of thumb is that you can get a rough approximation of GDP growth by starting with the aggregate labor impulse. And I said if you did this today, you assume such and such for May and June, you made reasonable assumptions about the, what happens outside of the non-farm sector, you're going to get a GDP increase of something like 10% for the second quarter. I remembered at the meeting...

Robert L. Hetzel: Real GDP.

Lyle Gramley: Yeah.

Robert L. Hetzel: That's pretty high

Lyle Gramley: I argued vociferously, we had to do something about this.

Robert L. Hetzel: Long term bond rates were going up.

Lyle Gramley: I remember, Nancy Teeters was saying "It's all inventory. You don't have to worry, it's all inventory." I said, "You are just dead wrong, Nancy." This is fundamental, it's everything is coming up roses for the economy we've got to stop this before it breaks out into wild inflation here. So, I like to take credit for that one.

Robert L. Hetzel: [inaudible 02:01:55]. I think that was the key point in establishing Fed credibility. The idea that the Fed would raise interest rates when unemployment was so high.

Lyle Gramley: I thought so, too, at the time.

Robert L. Hetzel: And this gets off the subject, but I think it's of some concern when the Fed gets to the point, like, we are right now, when the unemployment rate is 5.3% and we, you know, we act like it's a matter of a national crisis if we raise interest rates. I hate to be so cautious, I wish we could go back and relive some of those days, because...

Lyle Gramley: I think Gary's steering us on the right track. I [inaudible 02:02:39] in July.

Robert L. Hetzel: Well, we should, those were our procedures. Because the economy was growing very strongly, long term bond rates were rising and that's the signal to raise interest rates. That was basically, those were the set of procedures that Volcker left us and it's always true that you can, maybe if you get a shot that's transitory, you can luck out and you can ride through it, but if you don't it's like '94 all over again where then interest rates really have to go up and the financial system is stressed and you know, banks borrow short and lend long and you know, we took a gamble and we won and you know, Doc Greenspan looks like a hero, but we sent all the wrong precedents and in the hands of a lesser person, a person of lesser credibility, next time around, it's a problem. I hate to see, after what the Fed went through in the early '80s to establish its credibility...

Lyle Gramley: It will be too bad to lose it.

Robert L. Hetzel: Yeah, you know, at this point it's relatively easy to keep.

Lyle Gramley: Well, I think that the Fed staff has been partly culpable in the sense that they're announcing in the Greenbook and obviously, I read the minutes of the FOMC. And they were forecasting as late as fall of last year that the economy would continue to grow in 1996 at a pace at or somewhat below the economy's long term growth potential. And so, they sort of dismissed what was happening in the first two quarters as an aberration of some kind that one didn't need to worry about.

Robert L. Hetzel: That's right.

Lyle Gramley: And I thought this was a, you know, a forecast that didn't really assess the balance and risks quite right.

Robert L. Hetzel: But staff has become very, very hawkish. It's, this is, you know, this is not the staff...

Lyle Gramley: Not now.

Robert L. Hetzel: Yeah, this is the Clinton appointees...

Lyle Gramley: This is Greenspan's [unintelligible 02:04:47]

Robert L. Hetzel: Greenspan [unintelligible 02:04:49].

Lyle Gramley: There's no question...

Robert L. Hetzel: I mean, the Fed's problem, and I think this is the problem with the procedures, but if the Fed feels like it's under attack as an institution, then [02:05:00] in this kind of a situation where you get strength in the economy, you don't know whether the shock is transitory or permanent, so the temptation is to ride through it because if you raise interest rates, it's a transitory shock then you lower them, well, that's funny, that's just the price system working, but the political system sees that as a mistake and they see the subsequent reduction in interest rates along with weakness in the economy as the Fed causing the weakness because it raised interest rates. And when, in fact, we're just letting the crisis unfold the way it should. So, when the Fed's under attack as an institution, when it becomes very cautious and, you know, we have threats of GAO audits and hearings and the Mexico thing, and reappointment, I mean, everything converged on the Fed this summer and I don't think Greenspan felt like he could take a risk of that sort of reversal in interest rates. He was right, but again, it sets the wrong precedents. And what the precedent sets is, it, well I think, you know, Greenspan's a, Greenspan a…I don't need to record this.

[02:06:10]

[END OF RECORDING]