UNITED STATES: WHICH INSIGHTS FROM THE 'GREAT INFLATION' OF THE 1970s?

The 'great inflation' of the 1970s had many causes. The policy objective of full employment had already led to high inflation by the end of the 1960s. Two oil shocks and the depreciation of the dollar caused additional increases. The key factor was monetary policy, which was not adapted to the circumstances. It reflected the view that the Fed did not have a mandate to tolerate the sizeable increase in unemployment that might have ensued from the aggressive tightening needed to bring inflation under control. In addition, inflation was considered to be a cost-push phenomenon that could be addressed with wage and price controls. Today's situation is very different. The Federal Reserve is an independent central bank and inflation expectations are well-anchored. However, letting the economy run hot is reminiscent of the 1960s. Should inflation be above target for too long, the Federal Reserve will need to have the courage to tighten policy sufficiently despite the potential cost to the economy.

"Other goals took precedence: people wanted to [...] maintain a high-pressure economy... As a result, policymakers [...] were willing to run some risk of non-declining or increasing inflation in order to achieve other goals." When, at the annual Jackson Hole symposium in August last year, Jerome Powell presented the move to average inflation targeting as a key outcome of the Federal Reserve's strategy review, it was interpreted as a signal that the central bank was seeking to let the economy run hot. Reaching a low unemployment rate would only trigger a tighter policy stance to the extent that inflation would be above the target rate for a sufficiently long time. Yet, the quote above is not from 2020. It is from an academic analysis written in 1997 of the causes of the 'great inflation' in the 1970s.[1] The narrative of a bygone era can influence the debate on economic policy many years later. This is clearly the case today where in the US, based on a combination of strongly accelerating growth, mounting evidence of inflationary pressures and ongoing monetary and fiscal stimulus, increasingly references are made to the 1970s. Commenting on Jerome Powell's assessment that higher inflation will be a temporary phenomenon, former Treasury secretary Larry Summers argued *"He might be right. But the Fed chairmen who did the most talking about transitory factors were the Fed chairmen we had in the mid-70's and that's when inflation was accelerating very rapidly"*.[2] Nouriel Roubini, a professor at New York University and renowned economic commentator, focuses on the combination of inflation risks and potential negative supply shocks related to the Covid-19 pandemic that could end up causing 1970s-style stagflation.[3]

1. J. Bradford DeLong, *America's Peacetime Inflation: The 1970s, in Reducing Inflation: Motivation and Strategy*, Christina D. Romer and David H. Romer, Editors, NBER, University of Chicago Press, 1997. http://www.nber.org/books/rome97-1. The full quote is: *"Other goals took precedence: people wanted to solve the energy crisis, or maintain a high-pressure economy, or make certain that the current recession did not get any worse. As a result, policymakers throughout the 1970s were willing to run some risk of nondeclining or increasing inflation in order to achieve other goals."*
2. Summers sees signs of scarce workers as harbinger of inflation, Bloomberg, 30 April 2021.
3. Nouriel Roubini, *Is Stagflation Coming?*, 14 April 2021, Project Syndicate.

Supply shocks played an important role in the 1970s. The narrative of inflation in that period tends to focus on the two huge, permanent increases in the price of oil, triggering a jump in inflation (chart 1). The depreciation of the dollar following the collapse in 1973 of the Bretton Woods system of fixed exchange rates centered around the dollar and gold, also contributed to a faster pace of price increases (chart 2)[4]. However, inflation was already on a rising trend, well before these shocks hit the US economy. In the first half of the 1960s, headline inflation was below 2% but by the end of that decade, it was close to 6.0% (chart 3). DeLong (1997) explains how the prominent role of the narrative of the Great Depression and its high unemployment rate had made achieving a low unemployment level the key objective of economic

4. The Bretton Woods system already had been under intense pressure in 1971 following the unilateral decision of the US administration on 15 August 1971 to end the convertibility of US dollars into gold.

US: INFLATION VS CRUDE OIL PRICE

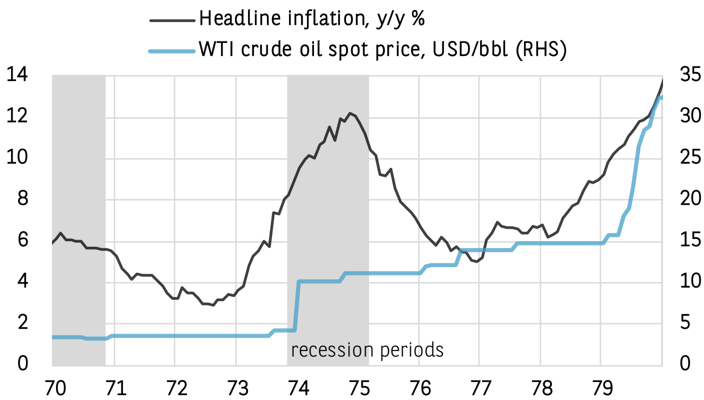

CHART 1 SOURCE: BLS, FEDERAL RESERVE BANK OF ST LOUIS, NBER, BNP PARIBAS

> The willingness of the Federal Reserve to let the economy run hot is reminiscent of the 1960s when a similar policy paved the way for high inflation in the 1970s. Although today's situation is very different, the Federal Reserve will, if necessary, need to have the courage to tighten policy sufficiently despite the potential cost to the economy.

policy. This was particularly the case under Richard Nixon, who became president in January 1969 and *"was extremely wary of economic policies that promised to fight inflation by increasing unemployment."*[5] Rising inflation caused an acceleration of wage growth, which in turn pushed up inflation considering that productivity growth was slowing. Moreover, an *"obstacle to a policy of disinflation in the early 1970s was that the newly installed chairman of the Federal Reserve Board, Arthur Bums, did not believe that he could use monetary policy to control inflation."*[6] This reflected a view that bringing down inflation permanently would come at a huge cost in terms of unemployment. The Federal Reserve didn't have the mandate for such a policy. Its *"'independence' not just from the executive branch, but from the rest of government in total, was purely theoretical"*. Policy was tightened but, compared to the path of inflation, the increase in the federal funds rate was insufficient (chart 4). Another consideration was that other instruments should be used to bring inflation under control, such as wage and price controls. This view reflects the 'monetary policy neglect hypothesis' whereby inflation is a cost-push phenomenon, rather than being driven by monetary factors[7]. However, wage and price controls made things worse by creating expectations of a jump in inflation once the controls would be lifted.

In summary, the 'great inflation' of the 1970s can be attributed to a combination of factors. The policy objective of low unemployment had already led to high inflation even before the decade had started. Two oil shocks and the depreciation of the dollar caused an additional increase. Monetary policy was inappropriate and reflected the view that the Fed did not have a mandate to tolerate the sizeable increase in unemployment that might have ensued from the aggressive policy tightening needed to bring inflation under control. In addition, inflation was considered as a cost-push phenomenon that could be addressed with wage and price controls. Today's situation is very different. The Federal Reserve is an independent central bank with, as one of its objectives, price stability, which means average inflation in line with its target. Inflation expectations are well-anchored, which shows that its policy is credible. Letting the economy run hot is reminiscent of the 1960s although today it is based on the view that the natural rate of unemployment can't be determined with enough precision to warrant a preemptive monetary tightening when unemployment is declining. It implies that, should inflation be above target for too long, the Federal Reserve will need to have the courage to tighten policy despite the potential cost for financial markets, public finances and the economy in general.

William De Vijlder

US: INFLATION VS EFFECTIVE EXCHANGE RATE

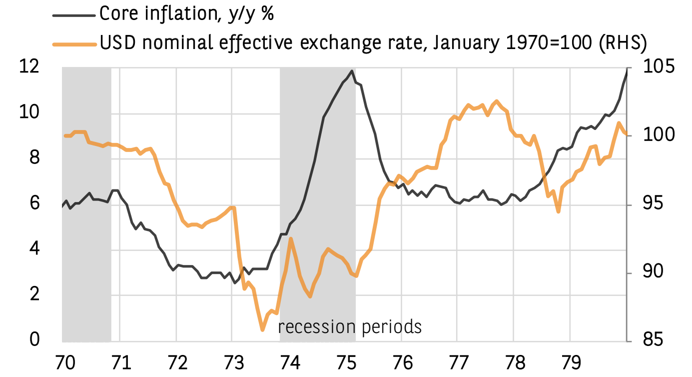

CHART 2 SOURCE: BLS, NBER, JP MORGAN, BNP PARIBAS

US INFLATION

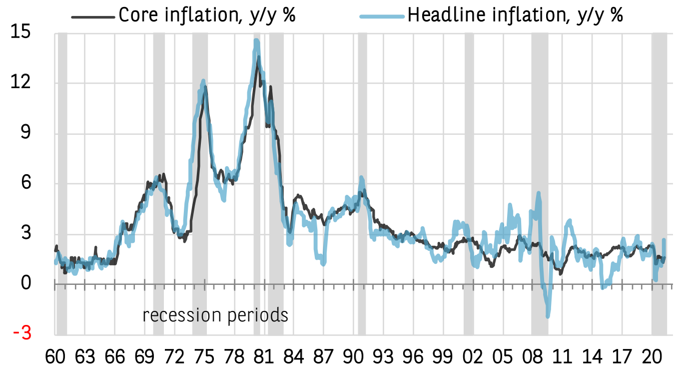

CHART 3 SOURCE: BLS, NBER, BNP PARIBAS

US: INFLATION VS INTEREST RATE

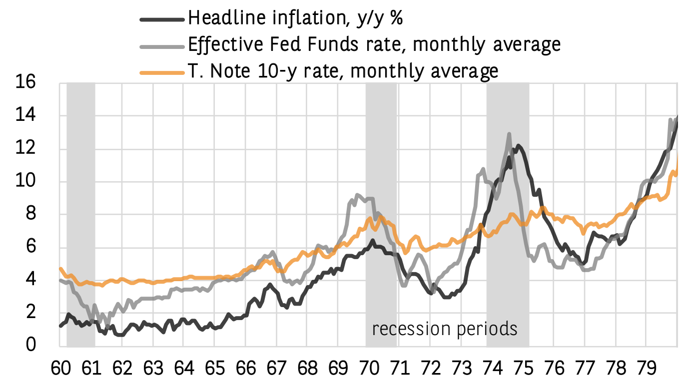

CHART 4 SOURCE: BLS, FEDERAL RESERVE, NBER, BNP PARIBAS

5. DeLong (1997).
6. DeLong (1997).
7. Edward Nelson, *The Great Inflation of the Seventies: What Really Happened?*, Federal Reserve Bank of St. Louis Working Paper 2004-001. The author considers this to be the key explanation for the great inflation in the seventies.