

# The Inflation of the 1970s

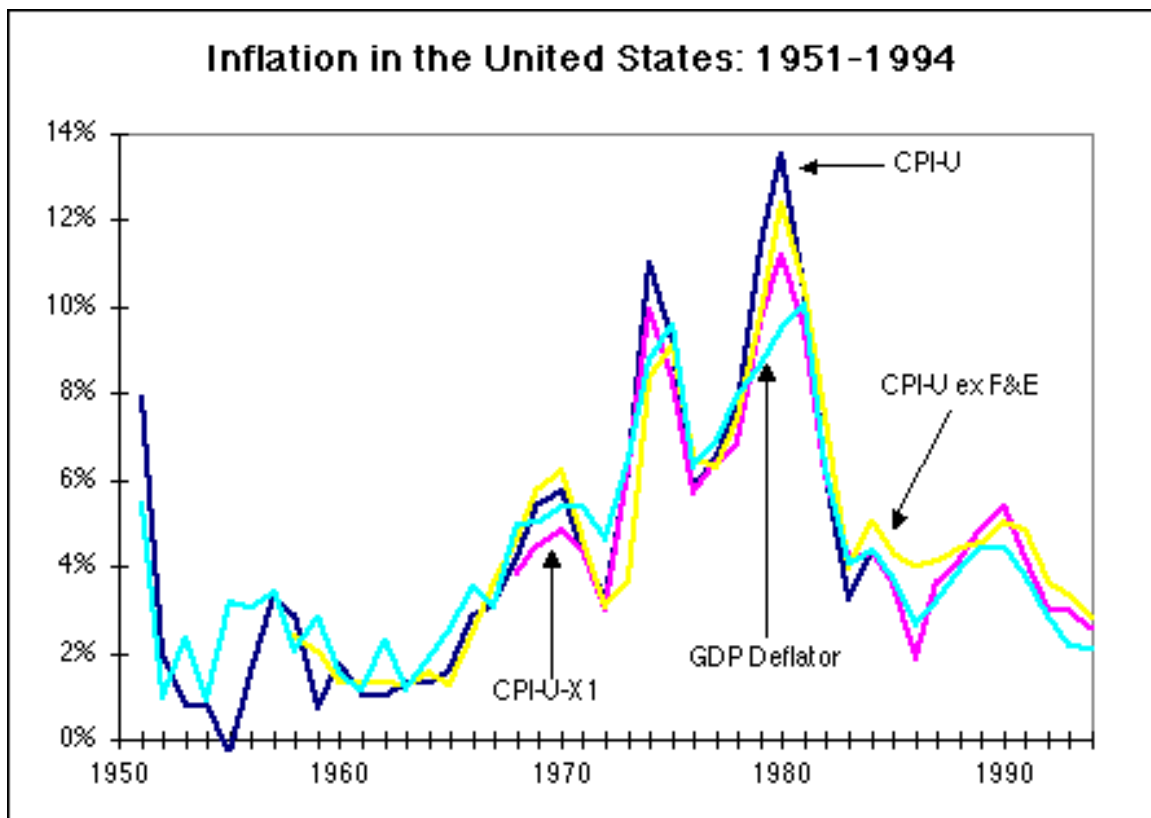
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## I. Introduction

The decade of the 1970s marked America's only significant peacetime inflation: the only time when uncertainty about prices made every business decision a speculation on monetary policy. During the 1970s, the annual inflation rate in the United States rose from the zero-to-three percent per year typical of America in peacetime to the five-to-ten percent per year range. The total increase in the price level as a result of this jump in peacetime inflation in the 1970s was as large as the jumps in the price level resulting from either World War I or World War II.

[Figure 1 about here: inflation, 1951-1998]



Now that this burst of inflation has been over for nearly two decades, we can look back and assess its causes. Why did the American economy undergo a sustained episodes of moderate inflation in the 1970s?

If you were to ask a representative sample of economists why it is that inflation is often higher than is desirable, most of them would refer you to the reasons laid out in Kydland and Prescott (1977). Kydland and Prescott argue that higher-than-desirable inflation springs from the inability of central bankers to completely commit themselves to low-inflation policies in the future. According to their argument, central banks benefit from workers, firms, and investors having confidence that inflation will be low; but they also benefit—production is higher and unemployment is lower—from having inflation turn out to be just a little bit higher than expected. But workers, firms, and investors know this, and so they lack complete confidence in declarations that policy is such as to make future inflation low. And it is this lack of credibility and commitment that makes inflation high.

The problem with his argument as an explanation of the inflation of the 1970s is that it explains much. It explains why inflation would in general be higher than desirable. It does not explain why inflation would be higher than desirable for one particular decade—the 1970s—while remaining low in the surrounding decades of the 1950s, the 1960s, the 1980s, and the 1990s. Thus it is necessary to look elsewhere for an explanation of why America underwent a significant peacetime inflation in the 1970s.

The inflation in the 1970s had three causes, depending on how deeply one wishes to look into the underlying situation.

At the first, surface level, the United States had a burst of inflation in the 1970s because until the 1980s no influential policy makers—until Paul Volcker became Chairman of the Federal Reserve—placed a sufficiently high priority on stopping inflation. Other goals took precedence. Thus Presidents, Congressmen, and members of the Federal Open Market Committee accepted the risk of increasing inflation to achieve other goals.

At a second, deeper, level, the United States had a burst of inflation in the 1970s because economic policy makers during the 1960s dealt their successors a bad hand. The policies of the 1960s left economic policy makers of the 1970s with painful dilemmas. And bad cards coupled with bad luck made inflation in the 1970s worse than anyone expected it might be.

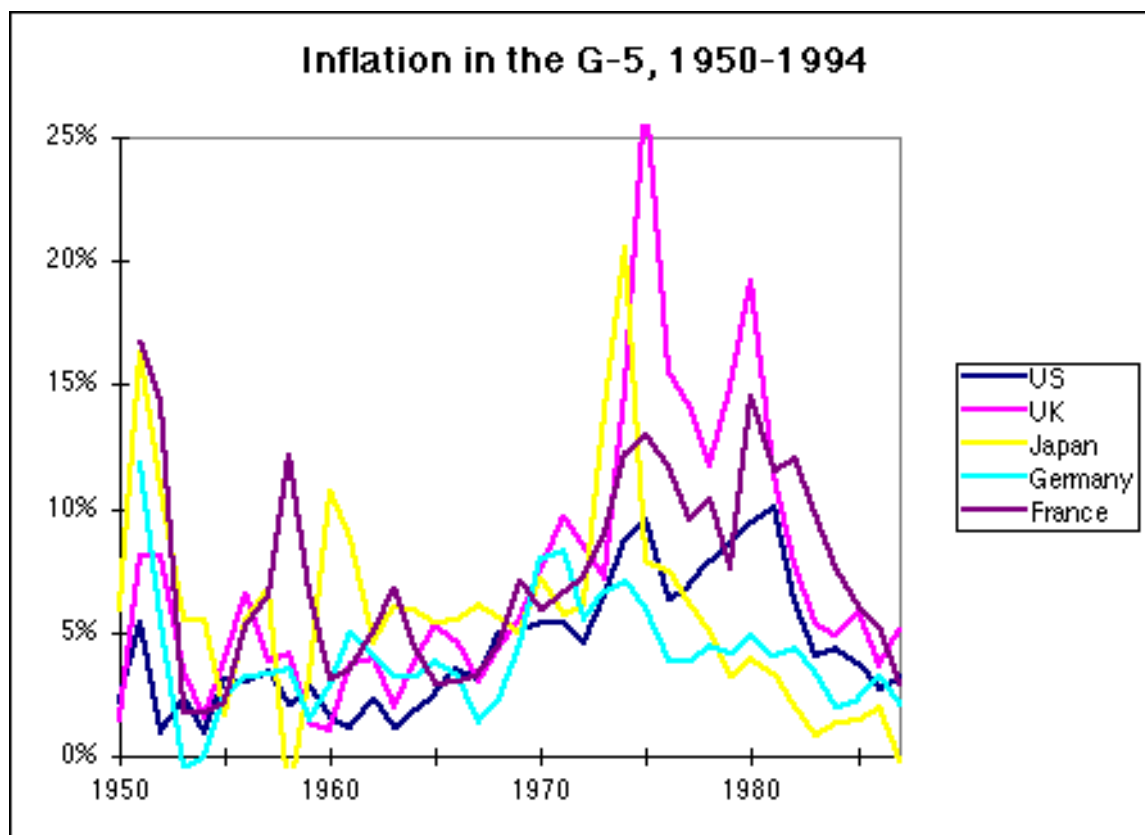
At a third, deepest level, the truest cause of the inflation of the 1970s was the shadow cast by the Great Depression. The Great Depression made it impossible for a while to believe that the business cycle was a fluctuation *around* rather than a shortfall *below* potential output and potential employment. Only after the experiences of the 1970s were policy makers persuaded that the minimum sustainable rate of unemployment attainable by macroeconomic policy was relatively high, and that the costs—at least the political costs—of even moderate high one-digit inflation were high as well.

## II. At the Start of the 1970s

At the very beginning of the 1970s—in fact by 1968 or 1969—the United States had finished its experiment to see if it was possible to push unemployment below four percent without accelerating inflation. The answer was “no.” Nonfarm nominal wage growth had fluctuated around or below four percent per year between the end of the Korean War and the mid-1960s. It was more than six percent and rising during calendar 1968.

Could U.S. monetary policy makers have responded to rising wage inflation at the end of the 1960s, and ended the inflation of the 1970s before it started? At a technical level, of course. Consider West Germany, the first economy to undertake disinflation. The peak of German inflation in the 1970s came in 1971: thereafter the *Bundesbank* pursued a policy of making inflation reduction its first priority. The mid-1970s cyclical peak in inflation was lower than the 1970 peak; the early-1980s cyclical peak in West German inflation is invisible.

[Figure: Inflation in the major industrial economies, 1951-1998]



But in the U.S. there were obstacles. One of them was Richard Nixon, who was extremely wary of economic policies that promised to fight inflation by increasing unemployment, because he attributed his defeat in the 1960 Presidential election to the unwillingness of Eisenhower and his

economic advisors to stimulate production and employment at the risk of triggering increasing inflation (see Nixon, 1962). Thus Herbert Stein (1984) describes how he and his colleagues at the Nixon-era Council of Economic Advisers were "surprised and unhappy" when they learned that President Nixon had authorized Labor Secretary George Shultz to tell the AFL-CIO that the Nixon administration would "control inflation without a rise of unemployment."

A second obstacle to a policy of disinflation in the early 1970s was that Federal Reserve Chair Arthur Burns's heart was not in it. He was not confident that monetary policy could control inflation. In 1959 Arthur Burns (1960) had given his presidential address to the American Economic Association: "Progress toward Economic Stability." Toward the end of his speech, Burns spoke of how:

During the postwar recessions the average level of prices in wholesale and consumer markets has declined little or not at all.... Nevertheless, wages and prices rose appreciably even during the recent recession, the general public has been speculating on a larger scale in common stocks, long-term interest rates have risen very sharply since mid-1958, and the yield on stocks relative to bonds has become abnormally low. All these appear to be symptoms of a continuation of inflationary expectations or pressures...

Before World War II such inflationary expectations and pressures would have been erased by a severe recession, and by the pressure put on workers' wages and manufacturers' prices by falling aggregate demand. But Burns could see no way in which such pressures could be generated in an environment in which workers and firms rationally expected demand to remain high and recessions to be short.

But the most important obstacle to inflation-reduction in the early 1970s was the lack of support *anywhere* for such a policy. Nixon had no taste for it. Congressional Republicans' calls for more aggressive fights against inflation were muted. If Nixon and Burns were wary of monetary restraint, they had the wholehearted approval of Congressional Democrats. Herbert Stein (1984) cites former Democratic Council of Economic Advisers Chair Walter Heller, testifying before Joint Economic Committee on July 27, 1972 on how Nixon administration policy was too contractionary:

As I say, now that we are again on the [economic] move the voice of overcautious conservatism is raised again at the other [White House] end of Pennsylvania Avenue. Reach for the [monetary] brakes, slash the [fiscal] budget, seek an end to wage-price restraints...

### **III. Bad Luck During the 1970s**

On top of the unwillingness of any political actor to support monetary restraint in the early 1970s

came bad luck. Alan Blinder (1982) has argued that double-digit inflation in the 1970s had a single cause: supply shocks that sharply increased the nominal prices of a few categories of goods, principally energy and secondarily food, mortgage rates, and the "bounce-back" of prices upon elimination of the Nixon controls program. Such shocks were arithmetically responsible for the large upward swings in inflation during the 1970s. But such arithmetic decompositions of the rise in inflation into upward jumps in the prices of special commodities were never convincing to those working in the monetarist tradition. As Milton Friedman asked:

The special conditions that drove up the price of oil and food required purchasers to spend more on them, leaving them less to spend on other items. Did that not force other prices to go down, or to rise less rapidly than otherwise? Why should the *average* [emphasis in original] level of prices be affected significantly by changes in the price of some things relative to others? (Friedman (1975), cited in Ball and Mankiw (1995))

Ball and Mankiw (1995) argue that the missing link in Blinder's argument can be provided by menu-cost models of aggregate supply. To the extent that firms and workers ignore small changes in prices as not worth the cost of figuring out how to respond to, yet do adjust their prices and wages to large changes, a concentrated sharp increase in the nominal prices of a few commodities can produce a much larger effect on the *average* level of prices and inflation than a more diffused increase in the nominal prices of money commodities

But it is very difficult to sustain any argument that the root of the U.S. inflation problem in the 1970s was the interaction of one-shot upward supply shocks with a backward-looking wage-price mechanism. The baseline core price inflation rate was some five percent per year in the early 1970s *before* there were any supply shocks. Even if the rate of nominal wage increases had stayed constant in the 1970s, the baseline core rate of price inflation would have been pushed up by a further two percentage points as a result of the mid-1970s slowdown in productivity growth.

Take the rate of wage and price inflation at the start of the 1970s, add to it the effects of the productivity growth slowdown, and find that the baseline price inflation rate would have been nearly seven percent per year in 1980 *even had the supply shocks and other disturbances of the 1970s had no effect on inflation at all*. Thus the contribution of bad luck during the 1970s to that decade's rise in inflation has to be accounted as less than the contribution of the bad situation faced by economic policy makers at the start of the decade.

#### **IV. The Mid 1970s**

The recession of 1974-1975 did not increase the relative priority placed on inflation control. Instead, it pushed the political nation in the direction of calling for reductions in unemployment--no matter what the inflation cost. Near the trough of the recession, Hubert Humphrey and Augustus Hawkins sought to require that the government reduce unemployment to 3 percent within four years after passage, and that the government become the employer of last resort—that it offer employment to all who wished at the same "prevailing wage" that Davis-

Bacon mandated be paid on government construction projects.

The House version of the original Humphrey-Hawkins bill gave individuals a cause of action against the government: the right to sue in federal court for their Humphrey-Hawkins jobs if the federal government did not provide them.

In early 1976 the highly-respected *National Journal* assessed the chances of the passage of the original Humphrey-Hawkins bill as quite good (though principally as veto bait to create an issue for Democrats to campaign against Gerald Ford, rather than as a sound policy). The version of the Humphrey-Hawkins bill that was passed and signed in 1977 was considerably weaker. It:

- Set a target of reducing unemployment to 4 percent by 1983.
- Elevated price stability to a goal equal in importance to full employment.
- Set a goal of zero inflation by 1988.
- Required the Federal Reserve Chairman to testify twice a year.
- Called for the reduction of federal spending to the lowest level consistent with national needs.

Thus as passed the Humphrey-Hawkins bill gave the Federal Reserve no direction at all. What was the Federal Reserve to do if attaining zero inflation by 1988 was inconsistent with achieving the target unemployment rate of 4 percent? The bill gave no guidance.

The Humphrey-Hawkins bill as originally proposed serves as a marker of the political climate in the mid-1970s. It tells us that returning the economy to full employment had the highest priority: reducing inflation, or keeping inflation from rising, remained a secondary goal until the very end of the decade.

Only with the acceleration of inflation toward the end of the decade did political sentiment begin to shift. For rising inflation did become a severe political problem in 1979. And Paul Volcker was then nominated and confirmed as Chair of the Federal Reserve in a political environment in which control of inflation—rather than reducing the unemployment rate—was the highest priority for economic policy. The Volcker-led Federal Reserve quickly signalled its intention to place first priority on controlling inflation by shifting its operating procedures to place a greater emphasis on money supply targets.

Yet it is far from clear how large a shift there was in the political mandate given to the Federal Reserve to control inflation, even at the risk of a deeper-than-usual recession. Some have denied that the President and Congress had any idea that a Federal Reserve chaired by Paul Volcker would follow different policies than one chaired by G. William Miller. For example, Stuart Eizenstat--President Carter's Assistant for Domestic Policy—has always claimed that Miller's departure from the Federal Reserve and his replacement by Paul Volcker was a pure accident:

The President "accepts" the resignation of [Treasury Secretary] Blumenthal. Blumenthal is known as a voice against inflation, and this adds to the confusion. So we were without

a Treasury Secretary. So the President makes calls. Reg Jones of General Electric, Irv Shapiro of Du Pont, David Rockefeller of Chase Manhattan--all are asked and turn it down. This becomes a grave situation. The idea surfaces--I'm not sure where--that Bill Miller take the job. Bill takes it. That then creates a hole at the Fed. And that makes the financial markets even more nervous... (Grieder, 1986)

Eizenstat's account appears to have credibility: it is an astonishing admission-against-interest when one considers its implications for the competence and foresight of President Carter and his White House Domestic Policy staff. If accurate, Eizenstat's account suggests that the Federal Reserve could not have undertaken any earlier the inflation-reducing policies it undertook at the end of the 1980s. Eizenstat strongly suggests that the political consensus to support inflation-reduction barely existed even at the time of Paul Volcker's nomination to the chairmanship.

## V. Conclusion

But it is not enough to explain the inflation of the 1970s to say that the U.S. economy had bad luck during the 1970s, that the political consensus to support a policy of inflation reduction did not exist until the very end of the 1970s, and that economic policy makers in the 1960s dealt their successors a bad hand. The questions remain: Why did the political consensus not exist until the end of the 1970s? Why did makers of economic policy during the 1960s watch with little concern as inflation crept upward, and as expectations of rising rates of price inflation became embedded in labor contracts and firm operating procedures?

The source of these attitudes and frames of mind is, in a sense, the truest cause of the inflation of the 1970s.

Thus the truest cause of the inflation of the 1970s was the shadow cast by the Great Depression. The Great Depression made it very difficult to believe that the business cycle was a fluctuation *around* a growing level of potential output and sustainable employment. Instead, the Great Depression created a presumption that business cycles were shortfalls *below* potential output and sustainable employment. The memory of the Great Depression made everyone very skeptical of taking the average level of capacity utilization or the unemployment rate as a measure of the economy's sustainable productive potential.

Thus in the early 1960s economists as prominent as Paul Samuelson and Robert Solow (1961) could write of how 4 percent was an "interim" target for the unemployment rate—and that they saw no reason that the "final" target for unemployment might not be lower without producing unacceptable consequences for the rate of inflation. As long as the average level of capacity utilization and the unemployment rate was not a guide to the long-run sustainable level, there would be strong pressure to "close the gap"—to see if unemployment could not be pushed even lower and capacity utilization higher.

Only after the experiences of the 1970s were policy makers persuaded that the costs—at least the political costs—of even moderate high one-digit inflation were high as well. Only after the experiences of the 1970s were economic policy makers persuaded that the flaws and frictions in

American labor markets made it unwise to try to use stimulative macroeconomic policies to push the unemployment rate down below percent, and to hold it there.

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