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CHAPTER 3

The "Great Inflation" Arrives

3.1 The "Great Inflation" and Domestic US Policies

Overlapping with the latter part of the very gradual demise of gold-backed or gold-pegged monetary systems, the so-called Great Inflation was one of the defining macroeconomic period of the second half of the twentieth century in the US (and, by extension, of the rest of the world). Usually dated as having lasted from 1965 to 1982—albeit initial signs of an inflationary acceleration were already observable as of the early 1960s, it ultimately led to (another) revision of global monetary policy frameworks. Given the centrality of the US dollar to the global monetary system, and the large share of US GDP in global terms, this chapter will initially describe this process with a US focus, later covering other economies.

While Chap. 2 described the policy mistakes and external framework and constraints for monetary policy due to the usage of gold-derivate monetary systems, inflationary pressures in the US were also linked to purely **domestic economic policy choices and their direct and indirect effects on price dynamics and monetary policy**: those would lead US inflation to go from below 1% *pa* (per annum) in 1959 to almost 14% in 1984 (Fig. 3.1).

But let's start with a little more on the history of the US institutional framework for monetary policy. As said previously, the Federal Reserve, a US federal body, was only created in 1913, after a series of bank panics in

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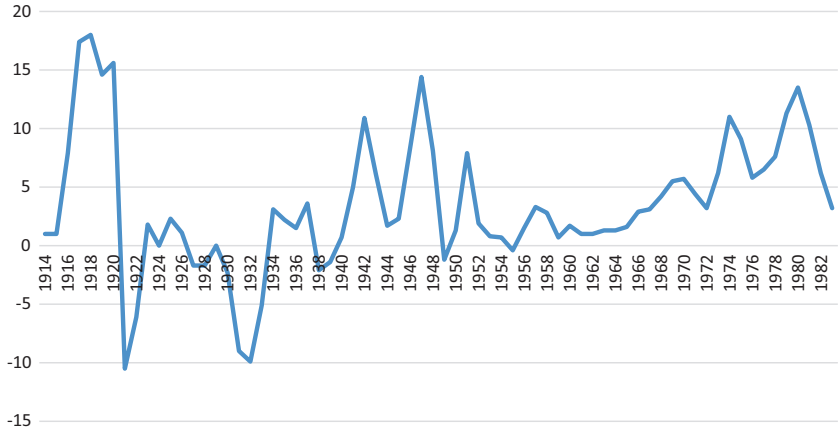

Fig. 3.1 US CPI inflation, eoy. (Source: US Bureau of Economic Analysis [BEA])

1873, 1884, 1890, 1893 and finally 1907 (when a single private citizen, namely, J. P. Morgan, used its personal resources to stabilize the whole US financial system)[1] made apparent the need of a "central bank", for example, a body to assure *financial and banking stability* (as the US was then still under the gold standard, the automatic mechanism of that system determined price dynamics, see Annex 2.A), which happened with the "Federal Reserve Act" of 1913[2]: this parallels the large expansion of Government powers in many different areas throughout the 20th Century. Importantly, the Fed was created as a "system" of largely autonomous regional "reserve banks" that would be coordinated by a secretariat-like body, based in Washington, DC.

After the initial bouts of large Great Depression–related institutional changes mentioned earlier, the Fed would experience further major changes with the "Employment Act" of 1946, which still largely defines its current institutional features: namely, this act declared it a responsibility of the US federal government "to promote maximum employment" (beyond price and financial stability), which is the basis for the Fed somewhat unusual "dual mandate" (only in 1977 the US Congress actually amended the original Fed 1913 Act with the so-called Humphrey-Hawkins Act

[1] Bruner, R. and Carr, S. (2009) "The Panic of 1907", Darden Case No. UVA-G-0619, University of Virginia, Darden School of Business.

[2] It is noteworthy to reflect that the US experienced most of its history as country *without a formal monetary authority* (the same is true for other nations in the Americas, for instance, Brazil, as we will see later in this book).

specifying explicit unemployment and inflation goals: this is the *formal* basis for the Fed dual mandate).

Now, the dominant economic policy framework used in most market economies—including the US, since the Great Depression was the active management of the business cycle by fiscal policies (usually referred to as Keynesian policies, in a reference to John Maynard—Baron—Keynes and his "*opus magnum*", and which provide one of the key analytical justifications for the expansion of Government powers in the economic arena mentioned above).[3] One of the *erroneous* assumption of those policies was that there exists a stable "Phillips curve"[4] that could be exploited to deliver the dual mandate of maximum unemployment and price stability. However, the empirical observation of increasing inflation mentioned above led to two separate but almost simultaneous analytical breakthroughs by US economists Edmund Phelps and Milton Friedman, who explained this dynamics via the **embedding of expectations into the behavior of economic agents**.[5] Therefore, mistakenly attempting to exploit an incorrectly assumed lack of trade-off between unemployment ("managed" largely via fiscal-side Keynesian policies) and prices would ultimately lead to inflationary spirals. Crucially, for this to happen, **one would need accommodative policies by a monetary authority.**

How did it actually happen? First, US government expenditures increased constantly, from around a quarter to a third of US GDP,[6] between the early 1960s and the early 1980s (while receipts remained largely constant: Fig. 3.2).

[3] This strand of the profession is best represented in the US by the group of economists linked to the Kennedy and Lyndon Johnson administrations, collectively referred to under the "New Economics" tag: using Keynesian models, they were characterized by a trust in the level of development of economic science that would enable the active technocratic management of aggregate demand, by counteracting shortfalls or excesses relative to the potential of an economy (alas, this type of hubris will also reappear later…). For (an arguably sometimes rose-tinted) view of this period, see Tobin, J. (1972), "New Economics One Decade Older", Princeton University Press: Tobin, who was a member of this group, even uses the word "Camelot" to describe the period in the Kenedy Administration.

[4] The Phillips curve supposes a negative statistical relationship between nominal wage growth (as a proxy for inflation) and the rate of unemployment. It is named after New Zealander economist Alban Phillips (see Phillips, A., (1958), "The Relationship between Unemployment and the Rate of Change of Money Wages in the United Kingdom 1861–1957", Economica, 25(100): 283–99).

[5] Phelps, E. (1967), "Phillips Curves, Expectations of Inflation and Optimal Unemployment Over Time", Economica, 34(135): 254–81 and Friedman, M. (1968), "The Role of Monetary Policy", American Economic Review, 58(1): 1–17.

[6] Compare that with the about 5% of GDP when the Fed was created.

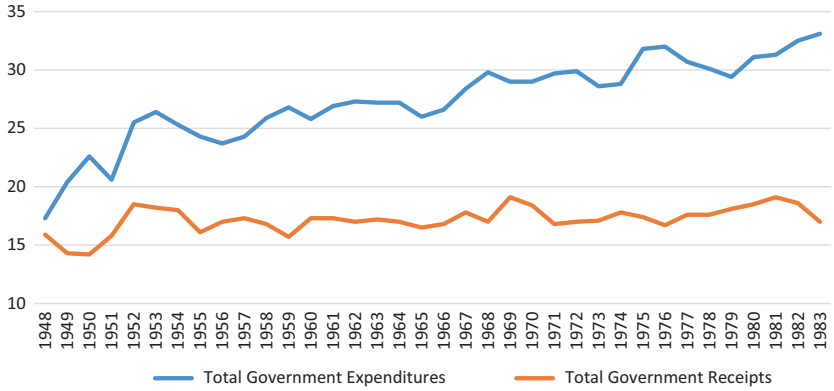

Fig. 3.2 Total US Government expenditures and receipts (% of GDP). (Source: US Office of Management and Budget [OMB])

It is worthwhile to point out that these developments were largely driven by a very significant expansion of social policies (and not by military expenditures, even as the US was involved in major military operations in Northeast and Southeast Asia from the 1950s till mid-1970s): **from 1960 to 1980, expenditures with social policies in the US increase by a factor of 12 in nominal US dollars, roughly doubling as a share of government expenditures and reaching over 53% of the total** (Fig. 3.3).[7]

As Phelps and Friedman could have said, it takes two to tango: faced with these fiscal developments, the US monetary authority openly pursued a deliberately accommodative behavior, formalized in the so-called even-keel policy, which effectively meant not rising rates as not to disrupt the (now larger and more frequent) issuance of US federal debt necessary to finance those bigger fiscal expenditures.[8]

[7] One feels tempted to assess the effectiveness of this very large and continued increases in social expenditures, but that is not the objective of this book.

[8] The "even keel" policy evolved progressively since the 1951 Fred-Treasury accord that marks the end of the post–World War II "financial repression" policies in the US (see Annex 5.B), replacing it with a policy in which the Fed would "support" Treasury actions around the period in which debt auctions would take place, via, for example, avoiding interest rate moves. For more on the "even keel", see Meltzer, A. (2002), "Origins of the Great Inflation", Federal Reserve Bank of St. Louis *Review*, 87(2): 145–75. Other works have a somewhat kinder take on the "even keel" policy: see Consolvo, V., Humpage, O. and Mukherjee, S. (2020), "Even Keel and the Great Inflation", Federal Reserve Bank of Cleveland, Working Paper n. 20–33.

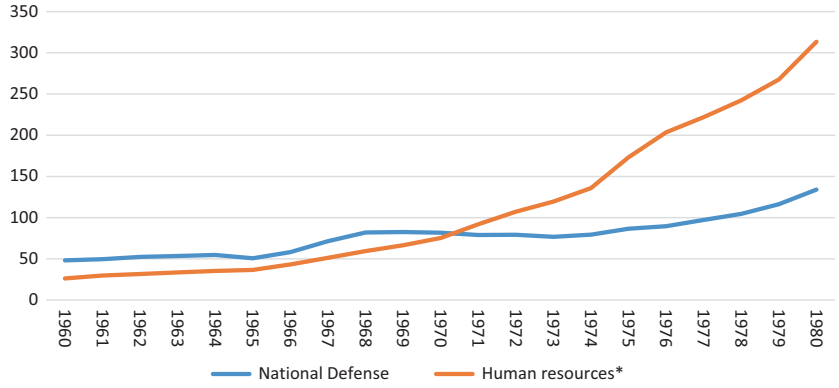

Fig. 3.3 Total US Government military and social expenditures ($ billions). Source: OMB *This aggregate budget item includes education, training, employment, social services, health, Medicare, income and social security programs.

3.2 External Price Shocks

Added to this domestic policy developments (and choices) were the effects of two external energy price shocks caused by actions of major oil-producing countries in the Middle East.[9] The first one started from an oil export embargo that began in October 1973 by the members of the Organization of Arab Petroleum Exporting Countries (OAPEC, the forebear of OPEC), initially targeted at the nations that had supported Israel during the Yom Kippur War (which was fought that year between Israel and a coalition of Arab states)—for example, Canada, Japan, the Netherlands, the UK and the US: **the upshot was that between 1972 and 1974 average global oil prices increased by a factor of 6**. This was followed by a second oil price shock in 1979, this one brought about by the so-called Iranian revolution, where the Imperial State of Iran was replaced by the theocratic Islamic Republic of Iran, which further increased oil prices **by a factor of 3**. **As a result, between 1972 and 1980 nominal oil prices grew over 20 times** (Fig. 3.4). These were truly global shocks, with inflationary implications throughout the world (Annex 3.A).

[9] Interestingly, Barsky and Kilian (2004) argue to the possibly (partial) **endogeneity of the 1970s price shocks**, linking those to excess demand create by the expansionary fiscal actions that were sanctioned by monetary policies (including those in the US): see Barsky, R. and Kilian, L. (2004), "Oil and the Macroeconomy Since the 1970s", Journal of Economic Perspectives, 18(4): 115–134.

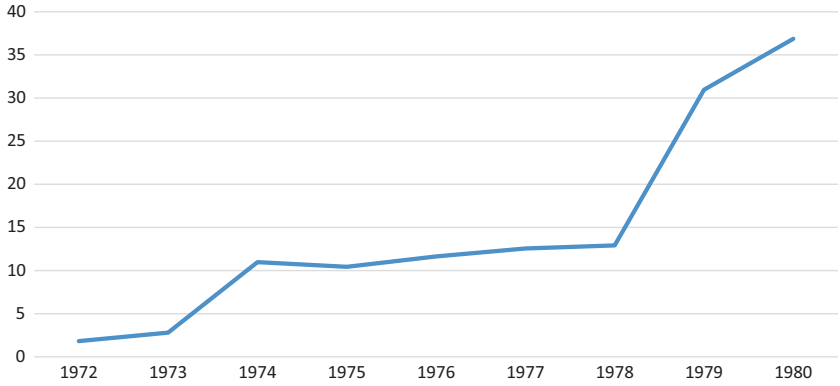

Fig. 3.4 Crude oil, average ($/barrel). (Source: World Bank)

The fiscal policy actions of the US government described in Sect. 3.1 were what economists would now call a "demand side" shock, which resulted from policies that created a level of demand in excess of what the economy could supply—an apparent case for a straightforward non-accommodative monetary policy stance. However, if oil price shocks were interpreted as global exogenous "supply shocks", those could present a more complex analytical case, especially in the case of a monetary authority with a dual mandate[10]: namely, as global supply shocks, they reflected one-off changes in relative prices outside of the control of monetary authority, so a case could potentially be made for policy inaction (or "looking through"), while, on the other hand, potential long-lasting increases in unemployment resulting from these relative price changes could call for a more accommodative response, but, however, second-round effects in terms of wages and price increases could suggest a non-accommodative policy (so, to the further distress of former US President Harry Truman, who once famously clamored for a one-handed economist, this central banking advisor unfortunately had three).

[10] Gordon, R. (1975), "Alternative Responses of Policy to External Supply Shocks", Brookings Papers on Economic Activity, 1:183–204, and Phelps, E. (1978), "Commodity-Supply Shock and Full-Employment Monetary Policy", Journal of Money, Credit and Banking, 10: 206–221.

3.3 Domestic US Monetary Policy Responses

Leaving aside those admittedly complex analytical considerations, the US Federal Reserve policy choice was to **expand money supply, ultimately leading to an inflationary spiral (while, incidentally—*dixit* Phelps and Friedman—failing to reduce unemployment).** This happened notably during the Chairmanships of William McChesney Martin Jr., who remained as Chairman of the Federal Reserve for almost 20 years, from 1951 to 1970, and of Arthur Burns (of business cycle fame, as described earlier), Chairman of the Federal Reserve from 1970 to 1978.

Martin[11] (who famously would frequently make a point of saying "I am not an economist"), while a fiscal conservative who understood the needs of stable money and external balance, did not follow formal models to guide policy actions: the same is true in general for the Fed Board secretariat and its Members, the district Governors.[12] A tendency to short-term "data dependency" on potentially random movements and a lack of reflection on how their short-term decisions related to the Fed long-term aims compounded the earlier largely atheoretical approach.[13] Finally, governance frameworks, namely, Martin's belief in the importance of coordinating Fed actions with the US Government—mainly the Treasury and the President's office, leading to a progressively overriding importance of the "maximum employment" component of the Fed's 1946 Employment Act dual mandate (Martin's prized policy coordination became "one sided", that is, the US President and its Treasury expected the Fed to coordinate its actions with theirs, but not necessarily the other way around…).[14] Ultimately, the combination of those three elements, especially notable during the final five years of Martin's mandate (e.g., 1965–1970) led to the *start* of the Great Inflation (*and* the run on the US dollar that led to the ultimate collapse of the Bretton Woods system).[15]

[11] Martin served under US Presidents Truman, Eisenhower, Kennedy, Johnson and Nixon. Not only the "Great Inflation" actually started under his Chairmanship of the Fed, but the pressures of the US external position in the Bretton Woods framework were also already clear. In his earlier as a US Treasury official, Martin was also involved in the development of the "even keel" policy (from the Treasury side).

[12] Of course, the same cannot be said of the group of economists belonging to the "New Economics" group: they did have a model in their minds.

[13] Which, remarkably, even conveyed a lack of perceived difference between nominal and real rates in FOMC decisions. Beyond that, Martin had established what he called a "Riefler rule", stating that the Fed Board "**didn't make or discuss forecasts**" (Meltzer, 2002, ibid.: the name refers to Winfield Riefler, assistant to Martin and Secretary of the FOMC).

[14] Meltzer, A. (2002), ibidem.

[15] Meltzer, A. (2002), ibidem.

How the "Great Inflation" continued (and grew…) after starting is a different but related story. Burns became Chairman of the Fed in February 1970, and he was the first economist to hold that position (and a distinguished one at that). However, as a policy maker in this function, he was notable for his effective **adherence to "maximum employment" as the main mandate of the US monetary authority** and for a seemingly limited concern with the independence of the central bank.[16] Contrary to Martin's atheoretical approach, Burns, like the "New Economics" group, also did have a model for assessing monetary policy actions, albeit one that also reflected his personal and political beliefs and that unfortunately was incorrect: the same Keynesian model based on a stable "Phillips curve". This, among other things, led him to interpret the energy price shocks (endogenous or exogenous) not as one-off relative price adjustments but as causing long-lasting unemployment increases that "needed" to be counteracted.

The eventual (in the US English usage of the word, therefore as a process "ultimately resulting" in an outcome, and not as a probabilistic, possible result) consequence was that economic agents of all types now expected prices to continue to increase and adjusted their behavior accordingly (in central bank lingo, their inflation expectations had become "unanchored"). So, a prolonged and significant domestic fiscal expansion and large and persistent external price shocks were *both* consistently accommodated by US monetary policy decisions, resulting in changes in agents' expectations: with this, the "Great Inflation" was now in full swing.

Annex 3.A Was the "Great Inflation" Global?

Yes, to a degree, at least when it comes to the (global…) oil price shocks, be those endogenous or exogenous: to show that, the graph below compares the CPI dynamics in the US with the other developed economies of the OECD and developing regions for the period 1970–1983 (Fig. 3.5).

As one can see, the price increases linked to the *two global oil price shocks* are indeed largely common among the depicted countries/regions, both Developed and Developing ones. However, there are important differences on the persistence of the shock: for instance, in Germany—where

[16] On this, you can read Burns in his own words: Burns, A. (1979), "The Anguish of Central Banking", Per Jacobsson Lecture, reprinted at Federal Reserve Bulletin, September 1987, 73(9):689–98.

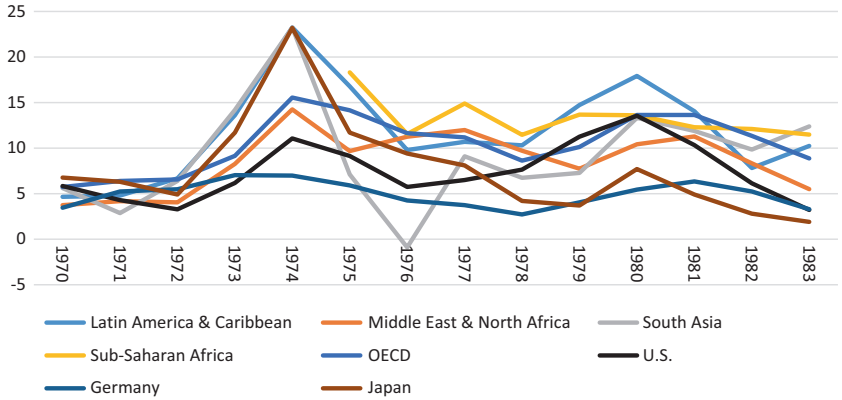

Fig. 3.5 CPI in different regions of the world. (Sources: OECD and World Bank)

the (then west) German monetary authority, the Deutsche Bundesbank, run a more non-accommodative policy, with the result that the effects of the price shocks were considerably more muted[17]—and in Japan,[18] where, after a punctual jump during the first oil shock, inflation was speedily brought under control (additionally, one must remember that both these countries are much more dependent on energy imports than the US was or is).

[17] Lehment, H. (1982), "Economic policy response to the oil price shocks of 1974 and 1979: The German Experience", European Economic Review, 18 (2): 235–242 and Beyer, A., Gaspar, V., Gerberding, C. and Issing, O. (2009), "Opting Out of the Great Inflation: German Monetary Policy after the Breakdown of Bretton Woods", Discussion Paper Series 1: Economic Studies, Deutsche Bundesbank (the latter paper also makes the point that Switzerland also followed the German example and equally eschewed the "Great Inflation"): The Bundesbank (an institution that this author twice visited as a Fellow) was a price stability single-mandate monetary authority consistently following a targeting of monetary aggregates (which the Beyer *et al.* paper models as a Taylor-like rule).

Of course, several other factors beyond just monetary policy–from the pricing of oil imports in US dollars to the usage of energy per unit of GDP, the energy mix of a given country and its reliance on import hydrocarbons—potentially also explain the different price sensitives to external oil price shocks (see Summers, P., (2005), "What Caused The Great Moderation? Some Cross-Country Evidence", Federal Reserve Bank of Kansas City, Economic Review).

[18] Ito, T. (2013), "Great Inflation and Central Bank Independence in Japan", in Bordo, M. and Orphanides, A. (eds), *The Great Inflation: The Rebirth of Modern Central Banking*, University of Chicago Press, pp. 357–387.

Also noteworthy is the continued increase of inflation in some Developing regions, and notably in Latin America and the Caribbean **after the oil price shocks**. This is another significant observation that points to the importance of specific regional/national dynamics, and will be elaborated on in Chap. 4, which discusses the so-called Great Moderation.