US Daily: Inflation and Overheating in the 1960s and 1970s (Mericle/Nicolae)

- The overheating debate has cast a spotlight on earlier episodes in US history when inflation rose sharply in a booming economy. We recently looked at the inflation surge after World War 2 and concluded that it was a unique event caused by factors with little contemporary relevance. Today we discuss the other major modern US example of high inflation, the 1960s and 1970s.
- Inflation and inflation expectations were low and stable in the first half of the 1960s. But in the second half of the decade, the labor market became very tight as fiscal policy turned quite expansionary and monetary policy remained inappropriately easy. Wage growth and inflation spiraled upward as inflation expectations became unanchored and followed close behind.
- What went wrong? First, policymakers had a flawed framework: they initially thought that they could permanently lower the unemployment rate by tolerating higher inflation, and later they persistently underestimated NAIRU and too readily dismissed high inflation as temporary rather than as evidence of overheating. Second, the Fed was too hesitant to hike, at times because it worried about overtightening and at times because it thought fiscal measures would be enough to solve the inflation problem. Third, the Fed faced heavy political pressure.
- How relevant is this episode to inflation fears today? There are some parallels: there will always be some uncertainty about the sustainable rate of unemployment or the slope of the Phillips curve at very low unemployment rates, bringing inflation down will always come at a high social cost, fiscal policy has again turned highly expansionary, and policymakers have again adopted an aggressive definition of maximum employment. But three key differences with the past make a repeat very unlikely today. First, the era of successful inflation targeting has better anchored inflation expectations on the Fed's target, making inflation less persistent as a result. Second, having learned from past mistakes, Fed officials see keeping inflation expectations anchored as a paramount goal and monitor them actively with a wide range of measures. Third, politicians better understand the cost of high inflation and the importance of central bank independence.

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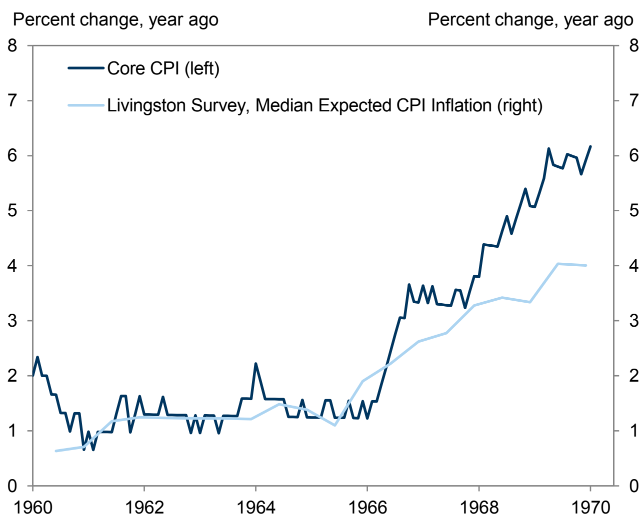
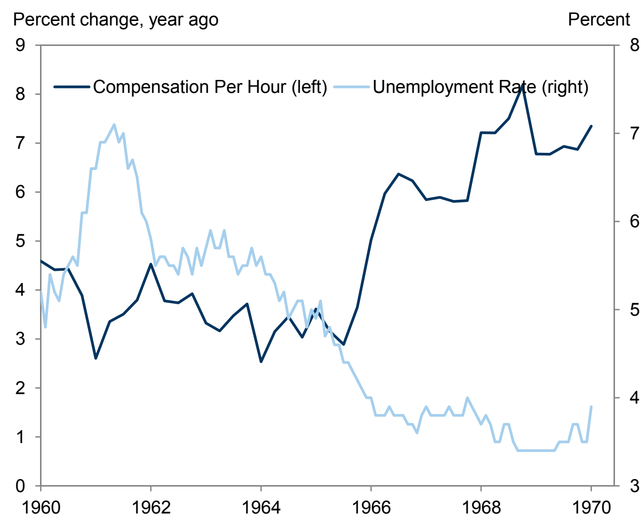
Inflation and Overheating in the 1960s and 1970s

The overheating debate has cast a spotlight on earlier episodes in US history when inflation rose sharply in a booming economy. We recently looked back at the inflation surge after World War 2 and concluded that it has little contemporary relevance because the rise in inflation was caused mainly by food shortages and the removal of wartime wage and price controls, and because the Fed was largely prevented by the Treasury Department from raising interest rates at the time. Today we look at the other major modern example of overheating in US history, the 1960s and 1970s.

Exhibit 1 tells the basic story. During the first half of the decade, inflation and inflation expectations were low and very stable, and wage growth remained in the 3-4% range. During the second half of the decade, the unemployment rate fell below 4% to an eventual bottom of 3.4%[1], driven in part by several years of expansionary fiscal policy. Wage growth and inflation quickly spiraled upward as inflation expectations became unanchored and followed realized inflation higher.

Exhibit 1: Inflation Was Low and Stable in the Early 1960s, but Then Wage Growth, Inflation, and Inflation Expectations Rose Steadily in the Late 1960s in a Very Tight Labor Market



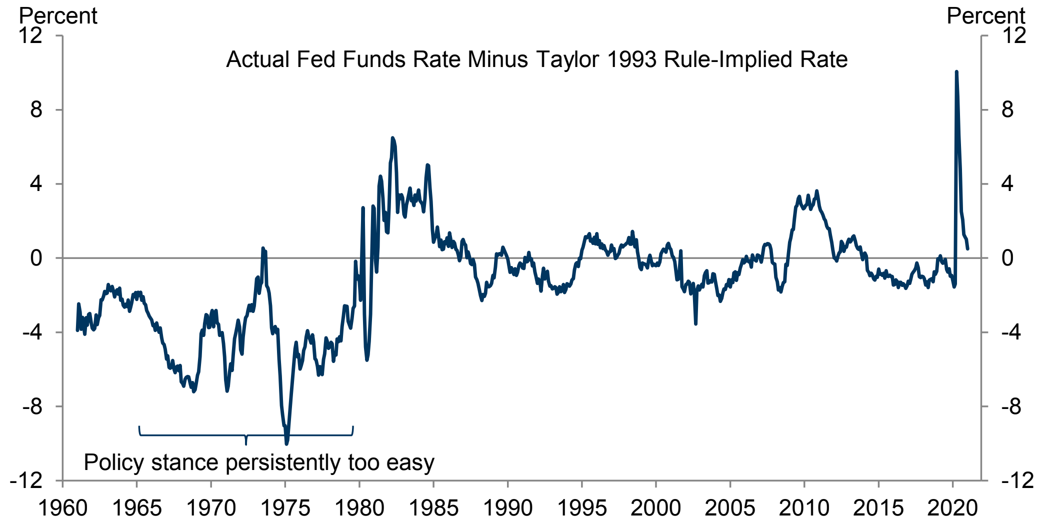


Source: Department of Labor, Department of Commerce, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 2 shows that the Fed persistently kept the funds rate much lower than a standard policy rule would prescribe during this period.

[1] The Congressional Budget Office and the Fed estimate that NAIRU was 5.5-5.9% in the 1960s and is 3.5-4.5% today. Shifts in demographic, industrial, and occupational composition are among the reasons for the decline.

Exhibit 2: The Fed Persistently Kept the Funds Rate Too Low in the Late 1960s and the 1970s



Source: Goldman Sachs Global Investment Research

What went wrong during this period? A large body of research[2] highlights three main problems:

Problem 1: Policymakers had a flawed framework: they misunderstood inflation dynamics, persistently underestimated NAIRU, and too readily dismissed high inflation as temporary rather than as evidence of overheating. Initially, as DeLong, Meltzer, and Romer and Romer all emphasize, White House and Fed economists assumed they could permanently exploit the temporary trade-off between unemployment and inflation captured by the Phillips curve. Only later did they realize that persistently high inflation would raise inflation expectations, resulting in stubbornly high inflation without the benefit of lower unemployment. Even then, Orphanides and Williams show, policymakers persistently overestimated potential output and underestimated NAIRU and so kept policy too easy for too long. When inflation rose, they repeatedly dismissed it as the temporary result of idiosyncratic factors rather than as evidence that they had pushed the economy too far. And even when they tightened, they tended to miscalibrate because they failed to distinguish between real and nominal interest rates. Coupled with ceilings on deposit rates imposed by Regulation Q that blocked the transmission from a higher funds rate to depositors, as noted by Drechsler, Savov, and Schnabl, this left real interest rates for households much too low and meant that Fed officials overestimated the likely economic impact of their efforts to tighten policy.

[2] See J. Bradford DeLong, "America's Peacetime Inflation: the 1970s," 1997; Christina Romer and David Romer, "The Evolution of Economic Understanding and Postwar Stabilization Policy," 2002; Athanasios Orphanides, "The Quest for Prosperity Without Inflation," 2003; Athanasios Orphanides, "Monetary Policy Rules, Macroeconomic Stability, and Inflation: A View from the Trenches," 2004; Allan Meltzer, "Origins of the Great Inflation," 2005; Athanasios Orphanides and John Williams, "Monetary Policy Mistakes and the Evolution of Inflation Expectations," 2013; Andrew Levin and John B. Taylor, "Falling Behind the Curve: A Positive Analysis of Stop-Start Monetary Policies and the Great Inflation," 2013; Harold James, Markus Brunnermeier, and Jean-Pierre Landau, "Who's Right on Inflation?" 2021; and Itamar Drechsler, Alexi Savov, and Philipp Schnabl, "The Financial Origins of the Rise and Fall of American Inflation," 2020. There is some disagreement among these authors about which of the problems discussed here were most important.

Problem 2: The Fed was too hesitant to tighten, both because it worried about overtightening and because it thought fiscal measures would solve the inflation problem. Levin and Taylor note that the Fed responded to rising inflation in "a series of stop-start episodes" and failed to tighten enough to bring inflation down. The FOMC stopped and reversed its first effort at tightening when the housing sector slowed in 1966. As Meltzer notes, this reversal diminished the Fed's inflation-fighting credibility. Again in 1970, the FOMC abandoned and reversed its second effort at tightening on the thought that a looming recession would solve the inflation problem. Fed officials also at times saw less need to tighten because they thought fiscal measures would be enough. Romer and Romer note that Chair Martin counted on as a long-delayed and ultimately temporary tax hike in 1968 to stop inflation, and James, Brunnermeier, and Landau note that Chair Burns similarly counted on wage and price controls.

Problem 3: The Fed faced heavy political pressure. White House officials and members of Congress criticized the Fed harshly when it began tightening in 1965, and Fed officials continued to face heavy political pressure through the 1960s and 1970s. Members of Congress threatened to change the Federal Reserve Act, and presidents nominated governors to the Fed Board who supported their goal of pushing unemployment lower. Some Fed officials also felt obligated to coordinate with fiscal policy objectives by pursuing a very low unemployment rate and stabilizing bond yields in the face of large budget deficits.

The unraveling that occurred in the second half of the 1960s paved the way for double-digit inflation in the 1970s as political pressure on the Fed continued and spikes in energy prices spilled over to broader price pressures in an environment where inflation expectations had become unanchored. As DeLong notes, by then the employment cost of getting inflation under control would have been enormous, and it took years until politicians and Fed officials were willing to accept it.

How relevant is this episode to inflation fears today? It is somewhat unsettling that an inflationary spiral emerged from a lengthy period in which inflation and inflation expectations were so stable. And some of the challenges of the earlier period are timeless. For example, key variables for monetary policy—such as the sustainable rate of unemployment or the slope of the Phillips curve at very low unemployment rates—remain somewhat uncertain, and bringing inflation down will always come at a high social cost. Some aspects of the earlier period also have modern parallels, at least to some degree: fiscal policy has again turned highly expansionary, though this time the boost will be shorter-lived, and policymakers are again adopting an aggressive definition of maximum employment, partly in response to the experience of low unemployment alongside low inflation last cycle, and partly in response to political shifts.

That said, there are key differences with the past that make it very unlikely today that inflation will rise sharply, expectations will become unanchored, and the Fed will persistently fail to respond adequately. First, the era of inflation targeting has successfully changed the inflation process—inflation expectations are more firmly anchored on the Fed's target and less responsive to swings in realized inflation, inflation is in turn better centered on long-run expectations and consequently less persistent, and a wage-price spiral is less likely with fewer workers covered by unions that could push for wage contracts indexed to inflation. Second, Fed officials have learned from the mistakes of the past and better understand the critical role of inflation expectations. As a result, they are highly attentive to many high-frequency measures of household, business, economist, and financial market inflation expectations, and they see keeping expectations anchored as a paramount goal. Third, politicians better understand the cost of high inflation and the importance of central bank independence.

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