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IN FOCUS

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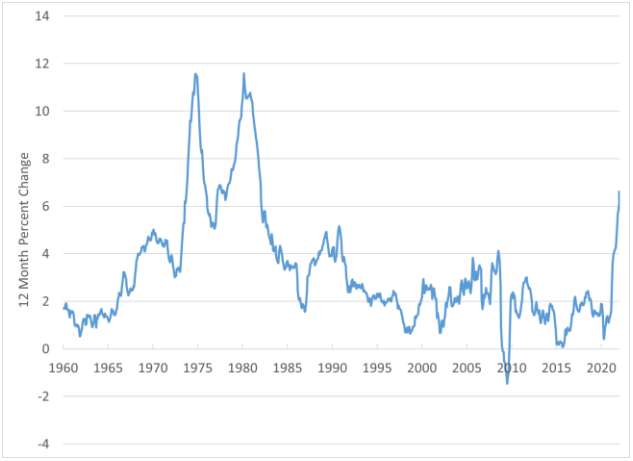
Back to the Future? Lessons from the "Great Inflation"

Since April 2021, the U.S. economy has grappled with high inflation, which reached 6.3% in May 2022, as measured by the Personal Consumption Expenditures (PCE) index. (For more information, see CRS Report R46890, *Inflation in the Wake of COVID-19*.) Many have drawn parallels between the current situation and the "Great Inflation"—the period of high inflation from the mid-1960s to early 1980s, as shown in **Figure 1**. Annual inflation exceeded 4.5% in 1970 and was around 10.5% in 1974 and 1980—the highest in peacetime in the nation's history. Inflation then began declining rapidly, falling below 4% in 1984 and below 3% from 1992 to 2020. In March 2022, the Fed began raising interest rates in an effort to reduce inflation.

Figure 1. Inflation (PCE), 1960-2022



Source: U.S. Bureau of Economic Analysis (BEA).

As policymakers consider strategies to lower inflation, this In Focus compares lessons from the Great Inflation to the present day situation and considers why those lessons may not hold based on experiences in the subsequent 1992-2020 low inflation era.

Inflation Can Be Triggered by Low Unemployment

At the start of the Great Inflation, unemployment dipped as low as 3.4% and inflation rose from 2.5% to 4.5% in 1968-1969. Based on this experience, economists theorized that there was a *non-accelerating inflation rate of unemployment* (NAIRU) and that inflation would rise when unemployment dipped below the NAIRU. But in the low inflation era, low unemployment in 1999-2000, 2006-2007, and 2018-2019 did not trigger a sustained increase in inflation, and policymakers came to view the link as weak.

This new view was reflected in the Fed's 2020 policy shift to no longer raise interest rates solely because unemployment was low. This new policy was in contrast to the previous consensus that, to prevent inflation from rising, the Fed should preemptively raise rates when unemployment was too low. But with unemployment averaging less than 4% in 2022, the relationship between tight labor markets and rising high inflation has resurfaced.

High Inflation Can Become Entrenched

NAIRU theory predicted that inflation would fall once unemployment rises above the NAIRU. However, while inflation fell following recessions beginning in 1970, 1973, and 1980, it did not reach low levels again until the late 1980s. Inflation rose from 1976 to 1979, although unemployment remained between 5.7% and 7.8%. Economists attribute this to increases in the NAIRU and to individuals beginning to expect that inflation would be high, causing persistently high inflation to be a self-fulfilling prophecy.

By contrast, from 1992 to 2020, low inflation expectations and low inflation perpetuated a mutually reinforcing cycle. The question of whether inflation expectations will remain low today—evidence is mixed—is key to how quickly inflation might fall.

Not Reacting to Price Shocks Can Worsen Inflation—Sometimes

Oil shocks in 1973 and 1979 caused inflation to reach its highest points during the Great Inflation. In isolation, a *one-time* oil price shock would not result in permanently higher inflation (i.e., prices *continually* rising at a faster pace). And yet inflation remained persistently higher after both shocks because of monetary policy. The Fed faced a tradeoff—it could raise interest rates to mitigate the inflationary effects of the shock or "accommodate" inflation to mitigate the negative effects on growth and employment. The Fed largely chose the latter option throughout the decade. With high inflation expectations, this strategy caused high energy prices to pass through to overall inflation.

By contrast, periodic energy price spikes from 1999 to 2011 did not lead to any lasting increase in overall inflation, even when interest rates were held at zero from 2008 to 2011. (The Fed was generally raising rates during the earlier spikes in that period.) As a result, when supply shocks caused by the pandemic caused prices to rise in 2021, the Fed initially decided to accommodate them on the grounds that price rises were transitory and the Fed should not react to them by raising rates. (See CRS Insight IN11926, *Supply Disruptions and the U.S. Economy*.) The Fed may have also underestimated the strength of demand, boosted by monetary and fiscal stimulus, as the economy normalized. Had the Fed given more weight to the lessons of the Great Inflation instead, it might have started raising rates when inflationary pressures first emerged instead of waiting a year. Even if that had not succeeded in fully containing

inflation, it might have resulted in a more gradual and less economically disruptive increase in rates.

Only Monetary Policy Effectively Reduced Inflation

Policymakers took several actions to lower inflation during the Great Inflation, but most proved unsuccessful. One of the largest attempts was the price control policy put in place by President Nixon during the early 1970s. These controls froze prices, rents, and earnings until 1974. While the controls were in place, inflation did fall but then spiked to double-digit rates after the controls were dismantled (see **Figure 1**) as pent-up demand put further pressure on low supply. Other unsuccessful attempts to curb inflation during the Great Inflation included the Whip Inflation Now (WIN) program under President Ford and credit controls enacted briefly in 1980 under President Carter. The WIN program was a set of voluntary measures to encourage lower spending, and while it initially had public support, the program was not taken up at a rate high enough to lower aggregate demand significantly. The 1980 credit controls restrained the use of spending and investing via credit in an attempt to lower spending in the economy. During the months in which the credit controls were in place (March-July), consumer spending dropped notably and interest rates became very volatile, in part resulting in a brief recession from February to July. As with price controls, once the credit controls were removed, pent-up demand resulted in an increase in spending, increasing inflationary pressures in the economy once more.

It was not until the Federal Reserve began aggressive monetary policy tightening under the leadership of Fed Chair Paul Volcker (1979-1987) that inflation fell and remained low. As a result, most economists credit monetary policy with ending the Great Inflation.

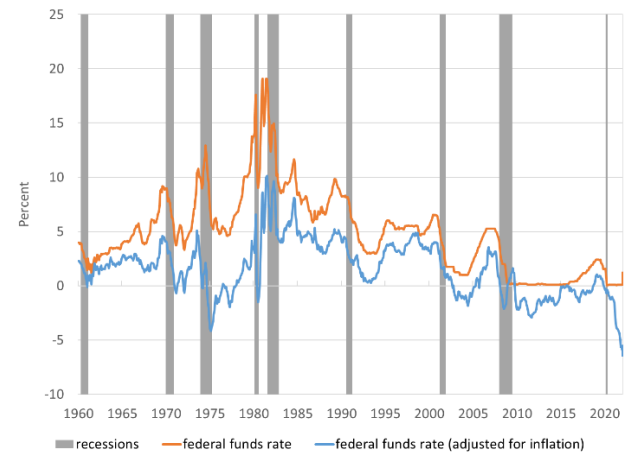
Higher Interest Rates May Be Needed

In the 1970s experience, inflation did not fall when *nominal* (i.e., not adjusting repayment value for inflation) interest rates were high because *real* (inflation-adjusted) interest rates were low. Nominal rates rose at times but not quickly enough to keep up with inflation (see **Figure 2**). Thus, real rates were low or even, at times, negative. The high inflation period eventually ended when Volcker tightened monetary policy to the point that real rates were no longer low. The average effective federal funds rate rapidly increased from about 11% when he took office to about 18% in April 1980. It peaked at over 19%, and the economy entered another recession from July 1981 to November 1982. The federal funds rate remained in double digits until 1982, as inflation had far to fall before price stability was restored.

Following the 2008 financial crisis, the Fed faced the opposite problem—even at zero, nominal rates were not low enough to prevent inflation from falling below its 2% target. As a result, its monetary policy strategy emphasized raising low inflation over preventing high inflation.

Interest rates today are much lower than in the 1970s in nominal and real terms. As during the Great Inflation, the Fed has to date maintained negative real interest rates as inflation has risen and believes that inflation can be reduced without rates becoming much higher. Fed leadership's June projections of the "appropriate" path for interest rates envision additional rate increases in 2022. Nonetheless, their appropriate rate would still be negative in real terms at the end of 2022 even if inflation falls as they forecast. Real rates would become slightly positive in 2023 but only because they believe that inflation would be low again (2.6% is the median forecast). Furthermore, they project that low inflation can be restored with unemployment remaining below 5%. Skeptics refer to this scenario as the "immaculate disinflation."

Figure 2. Federal Funds Rate, 1960-2022



Source: CRS calculations based on data from Fed and BEA.

Can Inflation Recede Without a Recession?

The aggressive tightening of monetary policy under Volcker came with the tradeoff of relatively high unemployment that recovered slowly. During the recession of 1981-1982, inflation decreased by over 6 percentage points while unemployment increased by over 3 percentage points and stood at 10.8% in November 1982. Some economists argue that low inflation expectations and the Fed's credibility on inflation could not have been restored if it had not kept rates high despite rising unemployment.

Since inflation has risen, the Fed has repeatedly pledged that it is "strongly committed to returning inflation to its 2% objective." If individuals find this pledge credible and inflation expectations remain low, then inflation might be reduced relatively quickly without triggering a recession. If not, inflation may remain high for an extended period of time, at which point a more serious economic slowdown could become necessary to lower inflation. (See CRS Insight IN11963, *Where Is the U.S. Economy Headed: Soft Landing, Hard Landing, or Stagflation?*) Unlike the situation that Chair Volcker faced, inflation expectations may remain low and stable today because inflation has been high for only about a year and was preceded by decades of low inflation. The extent to which inflation expectations remain anchored depends in large part on whether, going forward, the Fed is willing to raise interest rates as much as is necessary to rein in inflation. Since the Fed believes it can reduce inflation without triggering a recession, its resolve has not yet been tested.

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