National
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THE GREAT INFLATION

The Rebirth of Modern Central Banking

Edited by Michael D. Bordo
and Athanasios Orphanides

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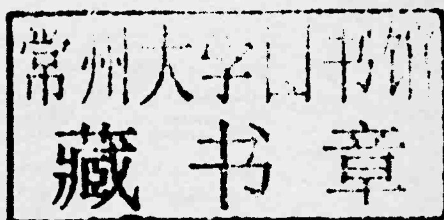

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MICHAEL D. BORDO is professor of economics at Rutgers University and a research associate of the National Bureau of Economic Research. ATHANASIOS ORPHANIDES is former governor of the Central Bank of Cyprus.

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The Great Inflation

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8. Unless otherwise determined by the Board or exempted by the terms of paragraphs 6 and 7, a copy of this resolution shall be printed in each NBER publication as described in paragraph 2 above.

Preface

The idea for this conference came from several conversations Michael Bordo had with Athanasios Orphanides in the early 2000s at the Board of Governors of the Federal Reserve System. We were encouraged to go forward with the project by Ben Bernanke, who at that time was a governor of the Federal Reserve. Marty Feldstein, then president of the NBER, was most supportive of the project from the outset. We would like to thank Marty and the NBER Conference Department for all their efforts in creating a memorable conference. The conference was generously funded by the Smith Richardson Foundation, and we would like to thank Mark Steinmeyer for his guidance in preparing the grant proposal.

The conference was held on September 26–27, 2008, at the Woodstock Inn in Woodstock, Vermont, shortly after the collapse of Lehman Brothers and the bailout of AIG—the most critical episode of the subprime mortgage crisis. As a consequence of the fast-emerging global banking crisis that followed these events, some of the participants from central banks could not make the conference. Meryvn King, governor of the Bank of England notified us a few days before the conference that he would not be able to attend. Lucas Papademos, then vice president of the European Central Bank, canceled his flight from Frankfurt at the last moment but subsequently sent us the remarks that he had already prepared. Remarkably, Don Kohn, then vice chairman of the Federal Reserve, managed to arrive from Washington, DC, on time to participate in the closing panel on Saturday. The late Anna Jacobson Schwartz, despite declining health, also attended the conference, her last NBER event after close to seventy years of service.

The financial crisis, the Great Recession, and the European debt crisis delayed the publication of this conference volume. Despite the delay, we believe the subject of the Great Inflation will continue to be of great inter-

est to both scholars and policymakers. While inflation in most countries is at present subdued, the risk of a run-up of global inflation in the not too distant future is not negligible in the light of the extraordinary monetary accommodation that was engineered by central banks around the world to contain the crisis. And some of the challenges facing central banks today have parallels to those faced in the period leading to and during the Great Inflation. We hope that the lessons learned from the historical experience of the Great Inflation in this conference volume will be a reminder of the costs of allowing high and persistent inflation to reoccur.

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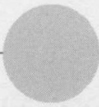

Introduction

Michael D. Bordo and Athanasios Orphanides

> For eight years economic policy and the news about the economy have been dominated by inflation. . . . Many programs have been launched to stop it—without success. Inflation seemed a Hydra-headed monster, growing two new heads each time one was cut off.
>
> —Council of Economic Advisers (1974, 21)

Overview

Maintaining an environment of low and stable inflation is widely regarded as one of the most important objectives of economic policy, in general, and the single most important objective for monetary policy, in particular. The reasons are clear. An environment of price stability reduces uncertainty, improves the transparency of the price mechanism, and facilitates better planning and the efficient allocation of resources, thereby raising productivity.

The Great Inflation from 1965 to 1982 caused significant damage to the US economy and to the economies of many other countries and was a serious policy concern. Inflation in the United States rose from below 2 percent in 1962 to above 15 percent by 1979. Attempts to control it in the early 1970s included the Nixon administration imposition of wage and price controls, which were largely ineffective but that added to distortions in the US economy and likely contributed to the deep slump of 1974. The inflation rate in the 1970s also contributed to a marked decline in the US stock market and volatility in the US dollar, including a serious exchange rate crisis in 1978 and 1979. The period was also coincident with a marked decline in productivity growth, which by the end of the 1970s was only a fraction of its performance during the 1960s.

Since the early 1980s, the United States, as well as other industrialized and

Michael D. Bordo is professor of economics at Rutgers University and a research associate of the National Bureau of Economic Research. Athanasios Orphanides is former governor of the Central Bank of Cyprus.

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some emerging countries, has been highly successful in controlling inflation. This is evident in the ability of the monetary authorities to stick to their basic low inflation objectives in the face of significant recent oil price shocks and other supply shocks.

By the end of the twentieth century, a consensus view had developed that the Great Inflation represented the most costly deviation from a period of stable prices and output growth in the period between the Great Depression and the recent financial crisis in the United States, as well as many other developed countries. It would appear self-evident that understanding the fundamental causes of this event, and avoiding its repetition, should be viewed as an important issue for macroeconomists. Many attempts to understand what happened can be identified, but over the past three decades there have been substantial disagreements, misconceptions, and misunderstandings of the period, which makes it quite hard to compare even seemingly reasonable and plausible alternatives and to draw useful lessons. In addition, recent research has produced new useful perspectives on what might have led to the unprecedented peacetime run-up in inflation.

The objective of the conference was to bring together this research, helping put the pieces together and to draw the important policy lessons necessary to help avoid the repetition of the Great Inflation. Because of the likelihood that once the present recession is past, inflationary pressure may return, this would seem an opportune time to revisit the Great Inflation. The findings of the research in this volume could have lasting influence on policy.

This introduction briefly describes the dimensions of the Great Inflation. The next section surveys the themes that have dominated the research on the Great Inflation from the 1970s to the present. We summarize the conference proceedings in the final section.

The Dimensions of the Great Inflation

The Great Inflation was a worldwide phenomenon, experienced throughout the developed world. As can be seen from a plot of inflation in the G7 countries (figure I.1), inflation started to trend upwards in the second half of the 1960s, although the defining decade when its virulence was better understood was the 1970s. Two sharp increases resulting in two peaks, one in the middle of the 1970s and the second around 1980, are evident in all countries. The second peak was followed by disinflation, sharp in some cases, during the first half of the 1980s. Though the contours of inflation were similar, there were significant differences in the extent of the problem. Inflation exceeded 20 percent in the United Kingdom and Italy, reached double digits rather briefly in the United States, but did not exceed single digits in Germany.

In addition to the adverse developments in inflation, the 1970s saw increases in unemployment and a notable slowdown in growth, relative to

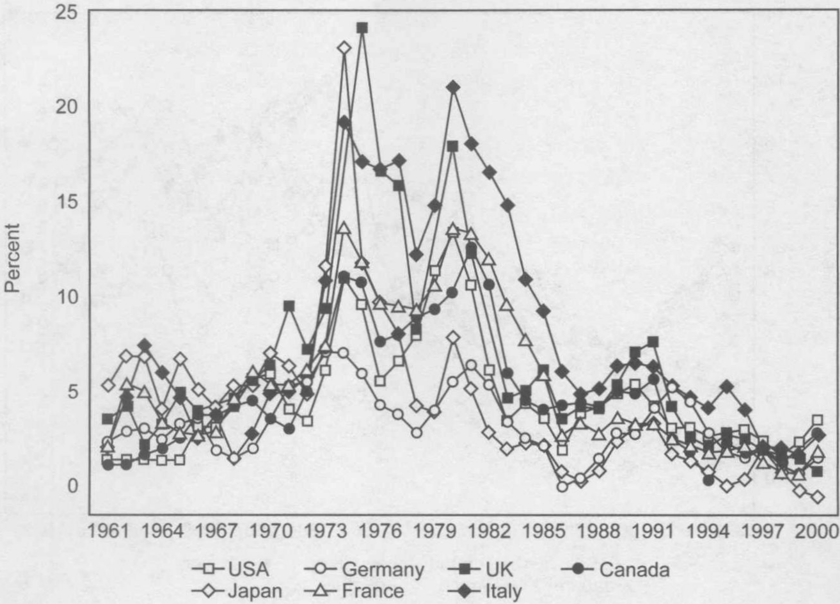

Fig. I.1 Inflation

what had been experienced earlier in the post–World War II period (figures I.2 and I.3). Unemployment levels were historically low in the 1950s and 1960s and productivity increased rapidly. In this light, the relative stagnation of the 1970s, together with the increases in inflation, raised alarms that the worst of both outcomes was being observed, popularizing a description of the period with one word—stagflation.[1] Following a long period of relative stability, the Great Inflation developments surprised policymakers and academics alike. Inflation ran higher than anticipated for long stretches. In the United States, survey data indicate that business economists were notably biased in their forecasts, expecting lower inflation than materialized for several years. Similarly, policy forecasts proved over optimistic. For example, at the Federal Reserve, the staff forecasts prepared for (Federal Open Market Committee) FOMC meetings and shown in the Green Book were on average predicting lower inflation.

The surprises did not end with developments in inflation. Another area where a deterioration was slowly recognized was in productivity. In the 1950s and 1960s rapid productivity growth in much of the developed world raised expectations of the prospects for sustained increases in prosperity. In this environment, estimates of potential output growth—the natural rate of growth that could be expected to be achieved with price stability—were

1. See Nelson and Nikolov (2004) for the origin of the word in the United Kingdom.

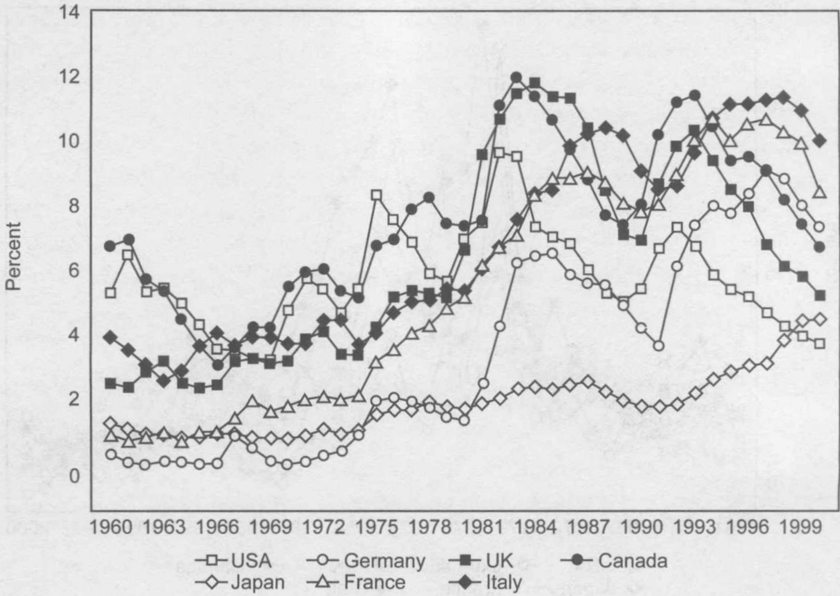

Fig. I.2 Unemployment rate

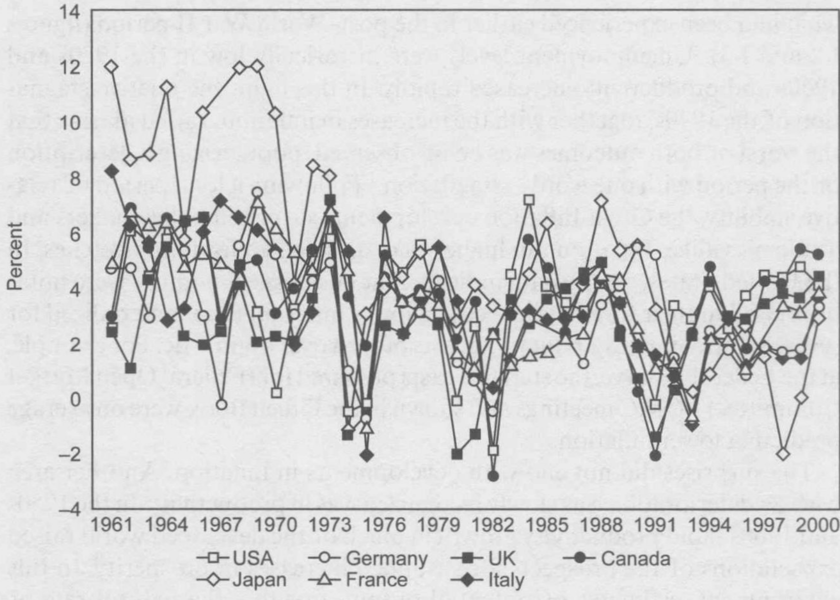

Fig. I.3 Real output growth

increased. But, as was noted in an Organization for Economic Cooperation and Development (OECD) report by a group of independent experts headed by Paul McCracken (OECD 1977), throughout the developed world subsequent developments disappointed and potential output prospects were marked down as the 1970s progressed. In the United States, suspicions that productivity was slowing down were already expressed by some before the end of the 1960s but the degree of deterioration and successively more pessimistic assessments of productivity and potential output became common as the 1970s progressed.

The malaise was also evident in deteriorating outcomes on employment during the period. During the 1970s, a secular upward trend in the rate of unemployment became evident. In the United States, whereas during the 1950s and 1960s it was increasingly accepted that an unemployment rate of 4 percent or so corresponded to the economy's full employment potential, by the end of the Great Inflation 6 percent of even higher unemployment rates were considered more appropriate reflections of the natural rate. Similar developments were observed elsewhere, and in Europe, in particular, the deterioration in what constituted full employment was even more dramatic.

The deterioration in both inflation stability and economic growth and employment prospects experienced during the Great Inflation were disappointing but also perplexing as they challenged the view prevailing during the 1960s regarding advances in the understanding of the workings of the economy and associated improvements in policy conduct. The timing of the deterioration was especially disheartening to policy economists as it came following a period of what was thought to be a great advance in doctrine. In the United States, the "New Economics" that guided economic policy starting with the Kennedy administration was seen as a period of great promise. (See the accounts of some of the protagonists: Heller 1966; Tobin 1966, 1972; and Okun 1970.) Whereas before the 1960s, policymakers appeared content to ensure that the economy was growing satisfactorily and recessions were avoided, starting with the 1960s, active management of aggregate demand counteracting any shortfall or excess relative to the economy's potential was pursued. As Arthur Okun, whose work on the measurement of potential was critical for the implementation of this strategy explained: "The revised strategy emphasized, as the standard for judging economic performance, whether the economy was living up to its potential rather than merely whether it was advancing" (Okun, 1970, 40). Following many years of growth and declining unemployment with relative price stability, the Great Inflation proved a tremendous letdown. Characteristic of the sentiment were the titles of some postmortems written after the destructive forces of the Great Inflation were fully recognized. Arthur Burns titled his 1979 Per Jacobson lecture delivered shortly after he stepped down as Federal Reserve chairman, *The Anguish of Central Banking.* The title of an essay

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