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"The Great Inflation: A Historical Overview and Lessons Learned"

October 2012

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Prepared by Scott A. Wolla
Economic Education Group of the Federal Reserve Bank of St. Louis

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The Great Inflation: A Historical Overview and Lessons Learned

David A. Lopez, *Senior Research Associate*

"Once an independent central bank does not simply tolerate a low level of inflation as consistent with 'stability,' but invokes inflation as a policy, it becomes very difficult to eliminate."
—Former Federal Reserve Chairman Paul Volcker, September 18, 2011

The recent expansion in the monetary base (currency in circulation and bank deposits), brought about by the Federal Reserve's **quantitative easing** measures, has stoked fears of high inflation. Critics argue that by flooding the economy with massive amounts of **liquidity**—by expanding its balance sheet—the Fed may have set the stage for a possible surge in the future price level. Fears of high inflation are grounded in memories of the Great Inflation, which remain fresh in the minds of many. Soaring inflation battered the U.S. economy in the 1970s, ending only after the Fed, under Chairman Paul Volcker, applied contractionary (tight) monetary policy to rein in inflation. Though initially painful, this bold step eventually returned the inflation rate and expectations of future inflation to low and stable levels. In addition, the Fed reestablished its credibility for fighting high inflation.

Inflation is a rise in the general price level for goods and services. That is, inflation occurs when there is a sustained increase in prices across the board and not simply an increase in the price of one particular good or service. The Bureau of Labor Statistics (BLS) measures inflation by creating a weighted price index from a representative sample of goods and services consumed by households. The inflation rate is then determined by observing the yearly changes in that price index.[1]

Low and stable levels of inflation—usually around 2 percent—are consistent with what economists consider **price stability**.[2] Ever-increasing (or unexpected) bursts of inflation, however, can have some detrimental consequences. For instance, creditors may charge higher interest rates to protect themselves from the costs of high inflation (i.e., being repaid in less-valuable dollars), which can hurt borrowers and curb lending. In addition, prolonged inflation can raise the public's expectations for future inflation. Consumers who expect higher inflation in the future may demand higher wages now. In response, firms may charge higher prices, leading to a vicious cycle where expectations of higher inflation lead to further increases in the general price level.[3]

In the past century, inflation in the United States was particularly high during World Wars I and II and the Korean War. The most recent spike in inflation occurred during the Great Inflation. The Great Inflation, which started in the mid-1960s, lasted for almost two decades and only began to dissipate in the early 1980s. During that time, the inflation rate soared from

a mere 1.6 percent in 1965 to 13.5 percent in 1980 (see top chart). Inflation has been relatively tame since its rapid decline in the early 1980s; the highest rate observed was only 5.5 percent during the commodity price boom in July 2008.

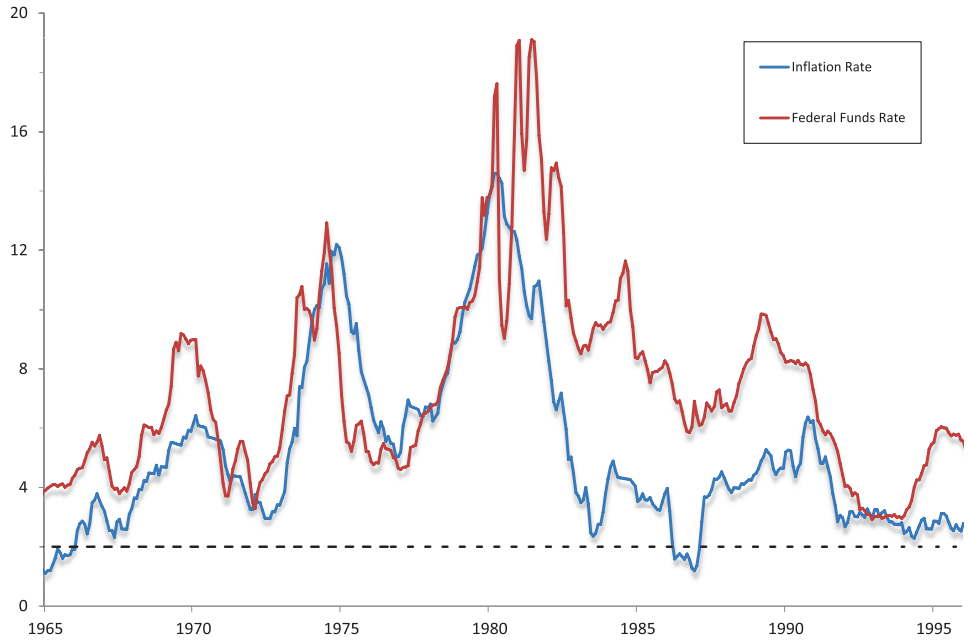
Certain economists attribute the Great Inflation primarily to monetary policy mistakes rather than other purported causes, such as high oil prices and defense spending during the Vietnam War. In the 1960s, Fed officials—and prominent economists—generally believed expansionary monetary policy could propel the economy toward full employment. In other words, they believed that elevated levels of inflation brought about by expansionary monetary policy would be tolerable *as long as* the policy spurred economic growth and brought unemployment down to its **natural rate**. Underlying this policy was the Phillips curve, which suggests that a trade-off exists between inflation and unemployment. Because some policymakers believed unemployment was above its natural rate at that time, they were more inclined to allow inflation to rise and move the economy toward its **potential output**. However, the natural rate was often underestimated: Economist Athanasios Orphanides (2002) found that the Fed may have overcommitted to its expansionary monetary policy stance because it was constantly aiming for—but never able to achieve—an "optimal" 4 percent unemployment rate.

Inflation ticked up throughout the 1970s until the Fed, under Chairman Volcker, took drastic measures to promote greater price stability. A special Federal Open Market Committee (FOMC) meeting on October 6, 1979, put in motion unique policy actions to combat the persistent surge in inflation. The Committee decided to target (i.e., reduce) specifically the growth rate of the money stock in the economy. Consequently, the federal funds rate soared from 10 percent at the start of 1979 to 19 percent by the middle of 1981, signaling the effects of tightening monetary policy designed to reduce inflation.

The Volcker disinflation, along with other factors, severely weakened the U.S. economy and resulted in two recessions in the early 1980s. Real (or inflation-adjusted) output remained stagnant from 1979 to 1982, and unemployment rose to more than 10 percent (see bottom chart). In addition, businesses failed in large numbers as access to capital became constrained due to higher interest rates. Specifically, almost 25,000 businesses failed in 1982—a postwar high that climbed to over 52,000 failures by 1984 (Samuelson, 2008). Credit-dependent sectors of the economy felt an even stronger pinch; sales of homes and cars suffered dramatically. Volcker's medicine was a tough pill to swallow at first, but it eventually had the desired effect.[4] By the mid-1980s, inflation started to dip below 5 percent and has remained relatively stable ever since.

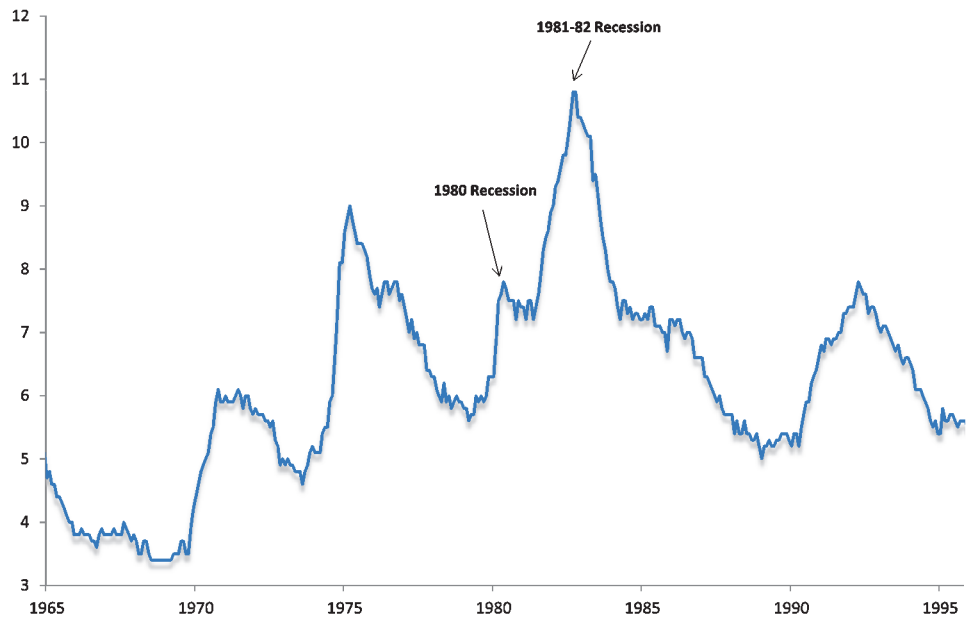
Two key lessons from the Great Inflation era remain relevant for the Federal Reserve today.[5] First, price stability is paramount for a strong and growing economy. The Great Inflation showed that tolerating high levels of inflation in an effort to stimulate the economy would ultimately prove detrimental.[6] Second, the public must be confident in the Fed's ability to lessen inflationary pressures—both now and in the future. In the 1970s, tepid policy responses by the Fed caused the public to lose faith in the Fed's ability to keep inflation in check. It was only after Chairman Volcker and the FOMC maintained a difficult policy stance that people began (slowly) to expect lower and less volatile inflation in the future—that is, price stability. With such hard-won trust, central bankers have been able to use monetary policy aggressively to stabilize economic conditions during the recent financial crisis. Low and stable inflation expectations continue to be evident; as long as this persists, we can infer that confidence remains strong in the Fed's ability to keep inflation at an appropriate level for the future. ■

Inflation and Federal Funds Rates During and After the Great Inflation



SOURCE: BLS; Board of Governors of the Federal Reserve System; and Federal Reserve Economic Data (FRED), Series ID = CPIAUCLS & FEDFUNDS.

Unemployment Rate During and After the Great Inflation



SOURCE: BLS and FRED, Series ID = UNRATE.

NOTES

[1] Other measures of the inflation rate can be obtained by using the personal consumption expenditure or gross domestic product deflator price indexes. Month-to-month changes in those indexes can also be used in place of year-over-year changes to provide additional indications of short-term price changes.

[2] See Bernanke (2010) for the Fed Chairman's rationale for having moderately positive levels of inflation.

[3] Other downsides of skyrocketing inflation include shoe-leather costs (i.e., the costs associated with more frequent cash withdrawals) and menu costs (i.e., the costs associated with constantly changing the prices of items during inflation, akin to printing a food menu multiple times); see Krugman and Wells (2009).

[4] There exist some ethical issues on whether the benefits of Volcker's policies outweighed the social and economic costs of two recessions; see Avent (2010).

[5] See Bullard (2009).

[6] Bartlett (2012) discusses one view of inflation and growth in the current environment, while Rajan (2011) presents another.

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GLOSSARY

Liquidity: The quality that makes an asset easily convertible into cash with relatively little loss of value in the conversion process.

Natural rate of unemployment: The unemployment rate that stems from economic factors unrelated to changes in aggregate demand.

Potential output: The level of full gross domestic product that the economy would produce if all prices, including nominal wages, were fully flexible.

Price stability: A low and stable rate of inflation maintained over an extended period of time.

Quantitative easing: A monetary policy in which a central bank makes large-scale asset purchases designed to bolster financial market conditions.

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Name_____ **Period**_____

Federal Reserve Bank of St. Louis *Page One Economics Newsletter*: **"The Great Inflation: A Historical Overview and Lessons Learned"**

After reading the article, answer the following questions.

1. Inflation Basics

What is inflation?	
How is inflation measured?	
What is the inflation rate?	
What level of inflation is consistent with price stability?	

2. How did the inflation rate change between 1965 and 1980?

3. How do many economists explain the increase in the inflation rate during the Great Inflation?

4. Describe the drastic measures used by Chairman Paul Volcker and the FOMC to promote price stability.

5. What effects did the Volcker disinflation have on the economy?

6. What two key lessons remain relevant for the Federal Reserve today?

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Teacher's Guide

Federal Reserve Bank of St. Louis *Page One Economics Newsletter*: "The Great Inflation: A Historical Overview and Lessons Learned"

After reading the article, answer the following questions.

1. Inflation Basics

What is inflation?	Inflation is a rise in the general price level for goods and services.
How is inflation measured?	The Bureau of Labor Statistics (BLS) measures inflation by creating a weighted price index from a representative sample of goods and services consumed by households.
What is the inflation rate?	The inflation rate is determined by observing the yearly changes in the price index.
What level of inflation is consistent with price stability?	An inflation rate around 2 percent

2. How did the inflation rate change between 1965 and 1980?

The inflation rate soared from a mere 1.6 percent in 1965 to 13.5 percent in 1980.

3. How do many economists explain the increase in the inflation rate during the Great Inflation?

In the 1960s, economists generally believed expansionary monetary policy could propel the economy toward full employment. This belief made them more inclined to allow inflation in order to move the economy toward its potential output. The Fed may have overcommitted to its expansionary monetary policy stance because it was constantly aiming for—but never able to achieve—an "optimal" 4 percent unemployment rate.

4. Describe the drastic measures used by Chairman Paul Volcker and the FOMC to promote price stability.

Chairman Volcker and the Federal Open Market Committee decided to reduce the growth rate of the money stock in the economy. Consequently, the federal funds rate soared from 10 percent at the start of 1979 to 19 percent by the middle of 1981, signaling the effects of tightening monetary policy designed to reduce inflation.

5. What effects did the Volcker disinflation have on the economy?

The Volcker disinflation severely weakened the U.S. economy and resulted in two recessions in the early 1980s. Real output remained stagnant from 1979 to 1982, and unemployment rose to more than 10 percent. Specifically, almost 25,000 businesses failed in 1982—a postwar high that climbed to over 52,000 failures by 1984.

6. What two key lessons remain relevant for the Federal Reserve today?

- Price stability is paramount for a strong and growing economy. The Great Inflation showed that tolerating high levels of inflation in an effort to stimulate the economy would ultimately prove detrimental.
- The public must be confident in the Fed's ability to reduce inflationary pressures—both now and in the future. In the 1970s, tepid policy responses by the Fed caused the public to lose faith in the Fed's ability to keep inflation in check. It was only after Chairman Volcker and the FOMC maintained a difficult policy stance that people began (slowly) to expect lower and less volatile inflation in the future—that is, price stability.

For Further Discussion

Read the following or distribute the handout to your students, then use the visual to lead a classroom discussion on the importance of central bank independence.

Governments borrow money for similar reasons that people do—they want goods and services now but are unable to pay the full amount immediately. Just as households might borrow to buy a house and pay for it over time, a government might borrow to build a bridge and pay for it over a number of years. The United States has accumulated vast amounts of debt over the decades, including debt added in recent years as the country has dealt with the aftermath of the financial crisis and the most recent recession.

How should governments pay for debt?

Answers will vary but might include the following: cut government spending, raise taxes, or print more money.

Imagine you could print your own money. Governments have that ability. There might be very legitimate temptations for governments to print money, for example, to feed the hungry, house the homeless, build a strong national defense, or simply to pay the bills or pay off debt from past spending. Even though it may sound like an easy solution, printing money can wreak havoc on an economy.

Germany in the early 1920s, Hungary in mid-1940s, and more recently Zimbabwe in the late 2000s all chose to print money to pay debt. In each case, the resulting episode of hyperinflation—an extremely high rate of inflation—caused severe damage to the economy and wiped out people's savings in the process. Hyperinflation usually ends with the government abandoning the old currency (making it worthless) and introducing a new currency.

The Federal Reserve System has successfully managed the money supply and inflation for most of its history because it was designed to be both accountable to the people of the United States and independent. Economists agree that an inflation rate that is low and stable creates the best conditions for economic growth and prosperity. So, why is independence important? When the central bank of a country is too closely aligned to the political process, the temptation to abuse the money supply—print money—can become too great. As a result, most governments have chosen to tie their own hands when it comes to monetary policy. They have delegated the task of managing the money supply to a nonelected group of individuals—a central bank. In fact, research has consistently shown a strong correlation between the degree of independence a central bank has and its ability to produce a low and stable inflation rate for its country.

Use the visual, which includes questions, to discuss the relationship between central bank independence and inflation.

1. **What variable is on the horizontal axis?**

   Index of Central Bank Independence

Tell the students that this index is a measure of the extent to which the central bank is independent of the central government. This means that central bankers make decisions regarding the money supply with relative freedom from potential pressure from politicians and government leaders. This allows the central bank to make policy decisions based on what is good for the long-run health of the nation. A higher number indicates more independence. Germany, Switzerland, and the United States have the highest numbers.

2. What variable is on the vertical axis?

The average inflation rate from 1995 to 1988

Tell the students that the inflation rate is the change in price level determined by comparing the percentage increase or decrease in the price level of goods and services from one time period to another. A low and stable inflation rate creates an environment that is conducive to economic growth and stability. Remind students that the Federal Reserve System has a longer-run goal for a 2 percent inflation rate.

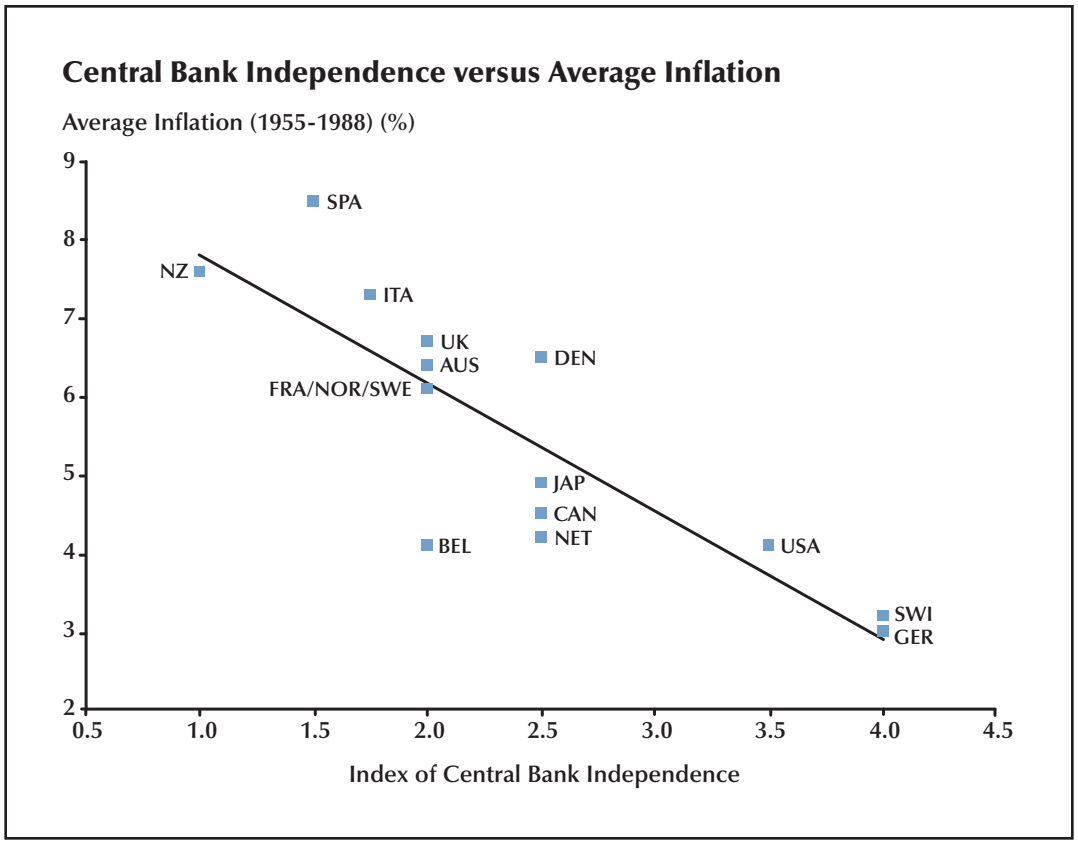
3. What is the relationship between central bank independence and the inflation rate?

A high rate of inflation is related to a low degree of central bank independence. A low rate of inflation is related to a high degree of central bank independence.

In a recent paper,[1] Christopher Waller, Research Director at the Federal Reserve Bank of St. Louis wrote, "The key point to remember is that giving the central bank independence is the best method for governments to tie their own hands and prevent them from misusing monetary policy for short-term political reasons."

[1] Waller, Christopher J. "Independence + Accountability: Why the Fed Is a Well-Designed Central Bank." Federal Reserve Bank of St. Louis *Review*, September/October 2011, *93*(5), pp. 293-301.

Visual 1



SOURCE: http://research.stlouisfed.org/publications/review/11/09/293-302Waller.pdf.

1. **What variable is on the horizontal axis?**

2. **What variable is on the vertical axis?**

3. **What is the relationship between central bank independence and the inflation rate?**

"The key point to remember is that giving the central bank independence is the best method for governments to tie their own hands and prevent them from misusing monetary policy for short-term political reasons."

—Christopher Waller, Director of Research, Federal Reserve Bank of St. Louis

Handout

Name_____ **Period**_____

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Common Core State Standards

Grades 6-12 Literacy in History/Social Studies and Technical Subjects

- **Key Ideas and Details**

  RH.11-12.1: Cite specific textual evidence to support analysis of primary and secondary sources, connecting insights gained from specific details to an understanding of the text as a whole.

  RH.11-12.2: Determine the central ideas or information of a primary or secondary source; provide an accurate summary that makes clear the relationships among the key details and ideas.

- **Craft and Structure**

  RH.11-12.4: Determine the meaning of words and phrases as they are used in a text, including analyzing how an author uses and refines the meaning of a key term over the course of a text (e.g., how Madison defines *faction* in *Federalist* No. 10).