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Source: *The American Economic Review*, May, 2006, Vol. 96, No. 2 (May, 2006), pp. 185-188

Published by: American Economic Association

Stable URL: https://www.jstor.org/stable/30034639

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From Inflation to More Inflation, Disinflation, and Low Inflation

By Allan H. Meltzer*

Volume 2 of *A History of the Federal Reserve* (forthcoming) covers the years of inflation and disinflation, followed by a return to relatively low inflation. It addresses four questions: Why did inflation start? Why did it continue for 15 or more years, from 1965 to about 1982? Why did it end? Why did it not return?

As we look back to the 1950s and 1960s, two of the many changes in the Federal Reserve System affecting inflation deserve comment. First, in the 1950s, the goal was price stability and zero reported inflation, not inflation of about 2 percent. The 1959–1960 disinflation brought reported consumer price index (CPI) inflation, measured as a 12-month moving average, to less than 1 percent from March through August 1959. This measure, again, was below 1 percent through most of 1961 and it did not reach 2 percent until early 1966. Properly measured and adjusted for biases in the price index, the true price level probably declined modestly during this period. This period of deflation was also a period of sustained economic growth. It, and several periods of deflation discussed in volume 1 of *A History of the Federal Reserve* (2003), show no evidence of the liquidity trap that absorbed much recent attention in the United States and Japan.

A second major change is the role of economists and economic research at the Federal Reserve Board and in the Federal Reserve banks. In the 1950s, the Board had no economists as members and there were few economists as bank presidents in its history. Sherman Maisel, appointed in 1965, was the first academic economist appointed to the Board since Adolph Miller, who served from 1914 to 1936. He was followed by Andy Brimmer in 1966.

The chairman of the Board, William McChesney Martin, Jr. (1951–1970), did not believe economic analysis was useful for making monetary policy, and he forbade econometric forecasting by the staff until about 1966. By December 1968, when the Federal Reserve decided to act against inflation, the 12-month moving average rate of CPI increase was above 4.5 percent and rising. It was not sustained below 3 percent until 1983.

Monetary policymaking lacked more than today's sophisticated econometric models (with rational expectations and sticky prices). Many of the policymakers accepted the short-run Keynesian model with adaptive expectations and a permanent trade-off between inflation and unemployment.

Along with this framework, and perhaps as part of it, many policymakers and academics accepted two propositions that have now disappeared. First, many claimed that a modern economy could not reach full employment without inflation. Guideposts, guidelines, or some official interference in wage and price setting—including price and wage controls—was believed to be required if policymakers in a market economy wanted to reach full employment with minimum inflation, or wanted to prevent inflation from rising before the economy reached full employment. That idea disappeared sometime over the past 25 years. Evidence in support of this proposition was never supplied, as was demonstrated from 1961 to 1964.

Second, the need for coordination of fiscal and monetary policy seemed obvious. The meaning of coordination varied. To Gardner Ackley, Chairman of President Lyndon B. Johnson's Council of Economic Advisers (CEA), coordination meant the administration chose fiscal policy and the Federal Reserve financed the deficit to keep interest rates from rising (Irwin C. Hargrove and Samuel A. Morley, 1984, pp. 286–87).

Edward Nelson (2003) has an excellent summary and critique of several explanations of the Great Inflation. These include the Federal Reserve's failure to raise interest rates enough to maintain positive real rates, mismeasurement of the output gap with the result that the inflation

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rate remained persistently above the forecast, and belief in a long-run trade-off that lowered the unemployment rate, especially for minorities. Christina D. Romer and David H. Romer (2002) add reliance on an inappropriate theory to the list. Nelson (2003) argues for neglect of, or too little attention to, money growth.

A problem with many explanations of the Great Inflation is that inflation continued and rose periodically from 1965 to 1981. Although Milton Friedman, Karl Brunner and I, and others criticized the models used during the 1960s and 1970s and the explanations given at the time, I do not believe that wrong theory alone is a sufficient explanation. And while I agree measurement errors were large and persistent, as Anthanasios Orphanides (2003) showed, and that they contributed to the Great Inflation, the largest errors came late in the inflation period.

More important, perhaps, is the failure of the Federal Reserve to respond to persistent, one-sided errors. The members of the Federal Open Market Committee (FOMC) knew that the inflation forecasts were persistently too low. They even attempted, in the mid 1970s, to set targets for money growth, in part to remedy the problem of monetary control. Late in the decade, Congress required the FOMC to announce money-growth targets. FOMC members knew that money growth was often above target. Instead of removing the excess, the FOMC started the next target from the higher-than-predicted level, thereby building in excessive money growth. An explanation of inflation should account for this and other perverse behavior.

Two central beliefs changed when Paul Volcker became Fed chairman. Volcker insisted on independence from administration interference, and he changed the weights that the FOMC gave to inflation and unemployment. He allowed the unemployment rate to rise above 10 percent, the highest rate in the postwar period and, no less important, he did not ease policy despite an unemployment rate that had been between 7 and 10 percent for 28 months. The independence of the Federal Reserve kept him from coordinating policy. The historically high fiscal deficits of the early Reagan years had to be financed in the debt markets. Giving most weight to inflation, despite high unemployment, eventually convinced the public that the Federal Reserve would succeed in permanently reducing the inflation rate.

I. Why Inflation Started

In the 1950s and 1960s, the members of the FOMC did not have a common view or theory about how inflationary impulses were released, and most of them rejected a monetary explanation of inflation. They did not agree on how to express their intentions to the open market desk in New York. Directives often referred to the "tone and feel of the money market" or to free reserves. No one attempted to reconcile the various measures or targets; the account manager had considerable discretion.

The interpretation of interest rates and money market conditions encouraged procyclical policy. The FOMC interpreted relatively low nominal interest rates as evidence of monetary ease, despite slow growth or even declines in money and credit. This was the same error the Federal Reserve system had made in the Great Depression. Its consequence was that the Fed permitted money growth to fall in recessions and rise excessively in expansions. Chairman Martin never tried systematically to relate current decisions or actions to longer-term influences on output, employment, and prices.

To the extent that Martin had a theory of inflation, inflation was caused by budget deficits. Out of concern for coordination, he delayed the interest rate increase until December 1965. In a four-to-three vote, the Board increased the discount rate.

Delay was Martin's first mistake. The next mistake was more important: after raising the discount rate, monetary policy became more expansive. Annual growth of the monetary base increased to 6 percent.

Misled by the decline in free reserves and a modest increase in interest rates, the majority ignored rising money growth. By the summer of 1966, 12-month CPI inflation reached 3.5 percent, a rate then considered highly inflationary. The Great Inflation was underway.

II. Why Inflation Continued

The Federal Reserve tried several times to reduce or end inflation. Each time, it reversed

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direction when unemployment rose or real activity faltered. In part, this was based on a political judgment that the public, Congress, and the administration would not accept the temporary increase in unemployment necessary to bring a permanent reduction in inflation.

The error that was more important for policymaking came from the Phillips curve. Arthur Okun, CEA chairman at the end of the Johnson administration, was clear. He thought that policy had moved down the Phillips curve and that the 1968 tax surcharge would induce a reversal. He realized, too late, that ending inflation would be costly.

Economists in President Richard Nixon's administration accepted Friedman's (1968) "natural rate" argument and also that inflation resulted from excessive money growth. What they didn't accept was that ending inflation would require more than a 4.5-percent unemployment rate. Their president, Nixon, had promised to end inflation without a recession.

The economy then experienced a series of large shocks to oil and food prices that carried the 12-month CPI increase to an annual rate of 11.5 percent in May 1974. Neither the administration nor the Federal Reserve had learned to separate one-time price-level changes from a maintained rate of price change. It called for both inflation and restrictive policy. President Jimmy Carter's administration began in 1977 and called for expansive policies. The Federal Reserve started to lower the funds rate a year earlier when the unemployment rate was between 8.5 and 9 percent.

Economists have offered several reasons for continued inflation. I accept that many of them are correct, partially. None explains why it took 15 years to correct these mistakes. The inflation rate was available at every meeting; FOMC members knew that, over time, inflation and the unemployment rate increased together, contrary to the Phillips curve.

After he left the Federal Reserve, Arthur Burns gave a cogent explanation of the persistence of inflation and the "anguish" of central bankers. By training and disposition, they opposed inflation. "Despite their antipathy to inflation and the powerful weapons they could wield against it, central bankers have failed ... utterly in this mission in recent years" (Burns, 1987, p. 688).

Burns expressed the two main reasons for persistent inflation: policy errors and the relative weight that the public, Congress, and most administrations gave to unemployment and inflation. The first includes mistaken theories of inflation; the second is a political argument.

Central banks were not helpless, Burns said. "Viewed in the abstract, the Federal Reserve had the power to abort the inflation at its incipient stage fifteen years ago or at any later point, and it has the power to end it today. At any time within that period, it could have restricted the money supply and created sufficient strains in financial and industrial markets to terminate inflation with little delay. It did not do so because the Federal Reserve was itself caught up in the philosophic and political currents that were transforming American life and culture" (Burns, 1987, p. 692).

My reading of the detailed record finds strong support for both claims—policy error and political concerns. In the 1960s and 1970s, the Federal Reserve ignored or denied the role of money growth for inflation, did not distinguish between real and nominal interest rates, continued procyclical policies, and used a backward-looking Phillips curve that the members believed permitted inflation to bring a permanent gain in employment. When oil and food prices rose in the 1970s, it did not distinguish between one-time, possibly permanent, increases in the price level and sustained inflation driven by sustained excess money growth.

During the Great Inflation, the Federal Reserve also held the view that more than a modest increase in unemployment, even if temporary, was unacceptable as a way of reducing inflation. As Burns said, in principle, the Federal Reserve could have slowed money growth to end inflation at any time. In practice, it reduced its independence by acceding to the fashion that interpreted the Employment Act as giving greater weight to unemployment and lesser weight to inflation.

III. Why Inflation Ended and Did Not Return

By 1979 or 1980, several changes brought an end to the inflationary regime. Most important, in my judgment, was a change in the public

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attitude about inflation. Polling data suggest that in the 1979–1980 period, the public listed inflation as the most important national problem. This change was not limited to the United States; it occurred about the same time in many other countries. And it made possible a sustained anti-inflation policy.

The public tolerated the increase in the unemployment rate. The chairmen of the banking committees and principal congressional members did not threaten the Federal Reserve until 1982, when the unemployment rate rose to a new postwar high above 9 percent. By the time the Federal Reserve ended its anti-inflation policy in the fall of 1982, CPI inflation had fallen below 5 percent.

The main change was in the weights assigned to unemployment and inflation. Volcker and a majority of his colleagues were willing to accept unprecedented increases in interest rates and a long period of high unemployment. Long-term nominal interest rates remained above 10 percent until November 1985, long after inflation had fallen to 3 or 4 percent.

Disinflation did not require sophisticated economic theory or careful implementation, and it did not have them. It required enough persistence to convince the public that high inflation would not return. And it required political and public support for the transitional effects on unemployment, homebuilding, and other durable assets. Volcker and most of his colleagues supplied the persistence. The public, members of Congress, and two presidents provided the political support. And it continued because it succeeded. This is a large part of the Alan Greenspan's legacy.

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