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. 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. 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. 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.
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.

REFERENCES


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.