NATIONAL TAXPAYERS UNION FOUNDATION

Issue Brief

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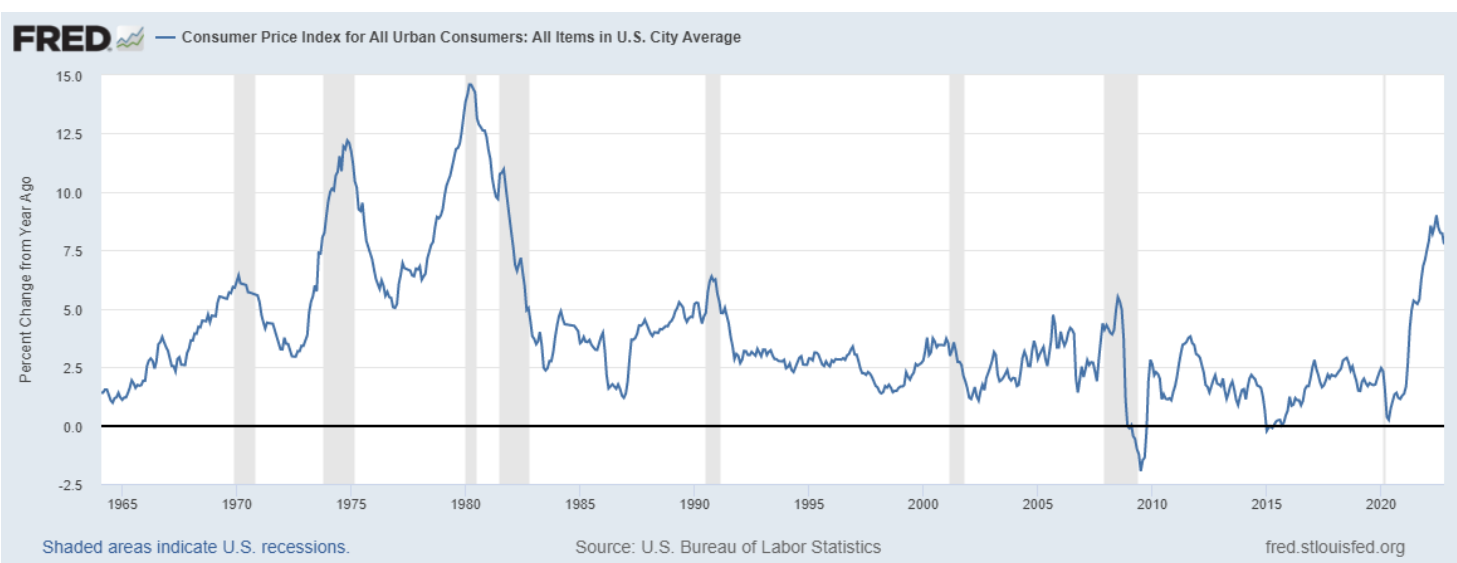
Lessons from America's Great Inflation of the 1970s and Their Relevance Today

Recent Consumer Price Index for All Urban Consumers (CPI-U) data from the U.S. Bureau of Labor Statistics show that inflation is up 7.1 percent compared to 12 months ago. Increasing CPI-U – a leading indicator of inflation – has sparked comparisons to the Great Inflation of the 1970s and the recessions that stemmed from it. Although the causes of inflation during that period were different than some of the factors contributing to inflation now, policymakers can learn lessons to combat continued high rates of inflation today.

Background: The Great Inflation



From 1965 to 1982 the U.S. experienced a macroeconomic event that included four different economic recessions, energy shortages, and the unusual implementation of wage and price controls known colloquially as the "Great Inflation." As the graph shows, the U.S. hasn't experienced these levels of inflation since the early 1980s.

During the Great Inflation, the U.S. economy saw a 14-percent inflation rate that many economists attribute to expansionary fiscal and monetary policy. At the time, the Great Depression was still fresh in the minds of policymakers and American consumers, and the primary goal of Congress and the Federal Reserve was to maintain a low unemployment rate.

The operating assumption was that a modest increase in the money supply would lead to lower unemployment rates. Although this is true, the Federal Reserve and Congress didn't know that there is a limit at which the increase in money supply starts to exponentially increase inflation. Economists at the time such as Milton Friedman and Edmund Phelps warned against this thinking, as they knew that expansionary monetary policy was not a sustainable approach to maintaining low unemployment rates. History has proven Friedman and Phelps right.

Background: Inflation Today

Inflation today has not yet come close to the runaway rates of the late 1970s and early 1980s, but is the highest it has been since that time. The Congressional Research Service (CRS) outlines two general types of inflation:

> "*Demand-Pull* inflation occurs when demand for goods and services within the economy exceeds the economy's capacity to produce goods and services."
>
> "*Cost-Push* inflation occurs when the price of input goods and services increases."

Demand-pull inflation in the current context boils down to higher consumer spending currently than during the earlier parts of the COVID-19 pandemic. While consumers are ready to spend money on both goods and services, the supply side of the economy has not recovered as quickly as demand. CRS reports the supply disruptions stem from "ongoing labor shortages, temporary business disruptions linked to COVID-19 outbreak, and commodity shortages linked to the 2022 Russian invasion of Ukraine," among other factors.

The most recent CPI report attributes housing to over half of the month-to-month inflation increase, with gasoline and food prices also increasing. Removing food and energy, CPI increased by just 0.3 percent in October, down from the 0.6 percent increase in September. Although the index is still rising, there is optimism that so-called "core" inflation will start to slow.

Interest Rates Past and Present

The most reliable tool to curb inflation in the U.S. economy is for the Federal Reserve to raise interest rates. To settle inflation today, the Fed has raised interest rates across six straight meetings. The current target interest rate of the Fed is between 3.75 and four percentage points, a height not reached since 2008. It doesn't look like the Fed will stop there. As Chairman Jerome Powell mentioned in a recent speech, the interest rate is expected to climb higher to "a level that is sufficiently restrictive to return inflation to 2 percent."

It may seem that rising interest rates are a definitive way to end inflation, but a lesson learned from the Great Inflation proves that high interest rates often do not come without economic consequences. In 1982, in part due to rising interest rates, almost 25,000 businesses failed, the highest number of business failures at the time since WWII. By 1984, this number reached an astonishing 52,000 failures.

The Fed is using this historical experience as they increase interest rates today. The sudden spike in interest rates in the 1980s showed that, although raising interest rates can be an effective tool to reduce inflation, they can also have major consequences for businesses and workers. It is ultimately the Fed's responsibility to ensure the negative effects of rising interest rates are not as severe as they were in the 1980s, to achieve what some at the Fed called a "soft landing" for the economy. Otherwise, policymakers and taxpayers could lose faith in the Federal Reserve.

Policies

Using extensive power to control wages and prices in the markets, as U.S. policymakers tried in the 1970s, is often seen as a drastic measure to control inflation. This policy failed during the Great Inflation, and may have actually prolonged the country's fight with high inflation. Inflation today is partly the result of excessive government spending, specifically the waning effects of hundreds of billions of dollars in taxpayer subsidies and government spending in the American Rescue Plan of 2021. The consensus today is that the rescue plan was a short-term success in expanding GDP, but has led to an increase in inflation that is larger than previously expected.

The pause on student loan interest, payment, and collections under the Biden administration has also likely contributed to inflation, and President Biden just extended the pause due to pending litigation against his student loan forgiveness program. The extension of the pause will likely increase consumer spending compared to the baseline scenario in which payments resume, given millions of Americans will have more disposable income to spend. NTUF has previously stated that resuming payments for student loans would have an indirect effect on slowing down consumer spending, signaling to the Federal Reserve that fiscal policymakers are serious about tackling inflation and hopefully reducing inflation expectations among policymakers and consumers broadly.

The price controls implemented in the 1970s were intended to combat inflation and stabilize prices. However, these policies ultimately proved to be ineffective for a number of reasons. At the time, President Nixon implemented price controls that froze prices, rents, and earnings until 1974. When the government sets a price for a good or service below the market equilibrium price, there is always an increase in demand for that good or service. Due to the artificially low prices set by the Nixon administration, supply could not meet demand and caused shortages. Although the inflation rate fell during the price freeze, once lifted, it skyrocketed back to double-digit figures.

The Biden administration's major action so far to reduce inflation has been the recently-enacted Inflation Reduction Act of 2022, which NTUF's Andrew Lautz reported ironically will not make any meaningful reduction in inflation in the short term. As witnessed during the Great Inflation, fiscal policies that subsidize consumer demand or aim to influence economic decisions years into the future are ineffective at combating near-term inflation. The Federal Reserve is traditionally known as the institution that can make the most meaningful changes to inflation rates. That said, Congress and the Biden administration can still play an important role in contributing to inflation reduction through fiscal and regulatory policy changes.

Recommendations

NTU Foundation has previously presented an anti-inflation agenda that included the following:

- Making it easier and less expensive for energy producers in America to quickly increase domestic energy production and supply, including the permitting reform proposal expected to be considered by Congress this year;
- Establishing incentives for consumers to save now for the long term, such as in tax-advantaged retirement accounts, rather than spend in the short term;
- Providing an inflationary update to a number of provisions in the tax code, as a means of mitigating the effects of inflation for middle-class households;

- Resuming the payment of federal student loans sooner than summer 2023 may have small direct effects on reducing inflation but larger indirect effects in terms of signaling a slowdown in consumer spending;
- Repealing or suspending protectionist policies that restrict supply chains and increase costs for consumers and taxpayers, including the Jones Act and "Buy American" restrictions;
- Repealing or suspending tariffs, especially the large-scale tariffs placed on goods from China by the Trump administration and maintained by the Biden administration;
- Rescinding tens of billions of dollars in unobligated funds from the COVID-19 relief bills of 2020 and 2021; and
- Reaching a significant, short-term deficit reduction agreement that actually decreases deficits by tens of billions of dollars in the next one or two fiscal years, rather than playing the classic Washington game of promising deficit reduction years from now.
- These recommendations, if enacted in tandem, could make a significant impact in addressing near-term inflation. The recommendations would combat both the large consumer spending driving inflation and offer solutions to address supply-side disruptions. With these policies in place, taxpayers would see lower costs for goods and services now and in the future.

Conclusion

The Great Inflation brought about many changes to the way economists think about monetary policy in the United States. Learning from the mistakes of the past and adopting working policies are essential for getting the United States economy back on track. It is up to Congress and the Biden administration to cease implementing harmful policies that could prolong the inflation fight, such as some of the consumer subsidies in the Inflation Reduction Act. Instead, policymakers should row in the same direction as the Federal Reserve, which will continue to play a primary role in combating high rates of inflation with increased interest rates. History has proven that it is possible to maintain a target two-percent inflation rate while keeping unemployment low and growing the economy. Taxpayers and consumers are increasingly affected by persistently high inflation, and policymakers must look to what has worked in the past to bring inflation back to manageable levels.

About the Author

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