ECONOMIC COMMENTARY

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Controlling Inflation: A Historical Perspective

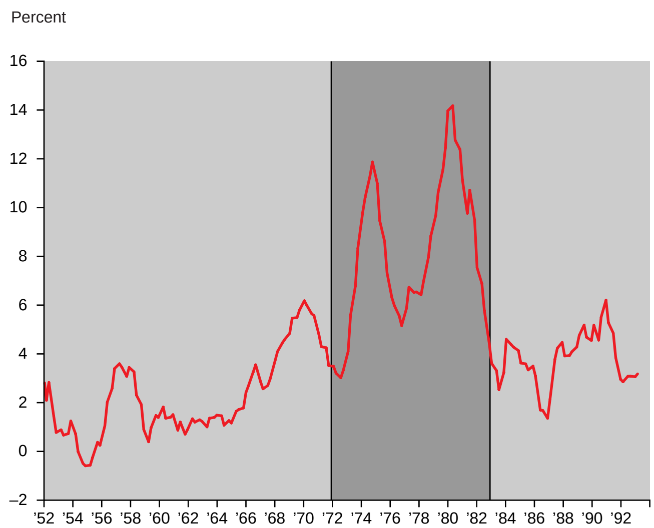
Although inflation in the United States has been moderate and stable during the past few years, history offers us no guarantee that such stability will continue. Just how fragile is the current situation? There are no simple answers, but history suggests that our current monetary regime requires unwavering central bank vigilance if the value of our nation's currency is to be maintained. This lesson underscores the importance of Federal Reserve independence.

U.S. inflation rates for the post–Korean War period are plotted below. On the basis of several economic and political events, the behavior of inflation over this period can be divided into three periods: 1953–71, 1972–82 and 1983–93.

The first period, which extends from the end of the Korean War through 1971, reflects inflation rates that were low and stable until the late 1960s. During this time, the United States operated under the Bretton Woods monetary system whereby other countries pegged the value of their currencies to the U.S. dollar. The dollar, in turn, was convertible into gold at $35 per ounce. This system worked well as long as the United States maintained the supply of dollars relative to gold consistent with this price.

As the costs of the Vietnam War and the Great Society programs escalated, however, the U.S. government financed much of these costs by printing more dollars, as well as by creating more government debt. Consequently, the supply of dollars increased worldwide as Americans traded goods and capital with other countries. As foreigners converted their dollar holdings into their domestic currencies, many foreign central banks began to doubt the U.S. commitment to convert dollars into gold. During the late 1960s, U.S. gold stocks began to dwindle as foreign central banks converted their dollar holdings into gold. Finally in 1971 as U.S. gold stocks waned, President Nixon suspended convertibility, and the world's industrialized countries moved to a monetary system of flexible exchange rates that remains in place to this day.

U.S. Inflation Since the Korean War
(Four-quarter moving average)



NOTE: Data through March 1993.
SOURCE: Bureau of Labor Statistics, Consumer Price Index.

The second period depicted in the chart extends from 1972 until 1982. After 1971, there was no real commodity, like gold, backing the value of the dollar. Without the discipline this backing had imposed on money growth, the responsibility for maintaining the value of the nation's currency fell entirely to the policymakers at the Federal Reserve. Unfortunately, two developments made this responsibility difficult to fulfill. First, during this period many influential macroeconomists thought a stable trade-off existed between economic activity and inflation. Furthermore, these economists believed that fiscal and monetary policies could be used to exploit this trade-off. Policymakers at the Federal Reserve were swayed by these views and increased the money supply at a rate too rapid to be consistent with low or moderate inflation. Second, several large oil-price shocks during the 1970s put upward pressure on the price level and downward pressure on the potential growth of real economic activity. The Federal Reserve attempted to counter the real effects of these shocks with higher money growth, which only exacerbated inflation.

As inflation accelerated during the 1970s, many economists began to recognize the extent of inflation's harmful effects on economic growth and began to doubt the existence of a stable trade-off between economic activity and inflation. Economists recognized that a nation's rate of growth is determined by the goods and services that private industry produces, not by the amount of paper currency government prints. Simply put, money printed is not money earned.

In 1979, President Carter named Paul Volcker chairman of the Federal Reserve and gave him a mandate to bring inflation under control. Under Volcker, the Federal Reserve initiated policies to lower the inflation rate by more directly controlling the growth rate of the money supply.

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By the early 1980s, these policies had led to substantially lower inflation, which is reflected in the chart. Over the past decade, policymakers at the Federal Reserve have maintained their resolve to keep inflation low. This resolve is partly the result of the view that maximizing potential output and employment growth entails avoiding the damaging effects that high and variable inflation can have on investment, productivity growth and, more generally, the price system as an allocative mechanism.

Although policymakers at the Federal Reserve are resolved to keep inflation low and stable, there will always be outside pressures for easy money policies. This is especially true when large government deficits create the temptation to substitute government currency for government debt. Easy money policies, however, only result in potential short-term gains at the expense of long-term growth.

The lesson to learn from our monetary history is twofold. First, the move to a currency that is not backed by a real commodity requires that the Federal Reserve be insulated from outside pressures. These outside pressures often originate from those who have short-term interests in conflict with our nation's long-term welfare. Second, policymakers at the Federal Reserve must make price stability their primary goal. Maintaining the value of our nation's currency is the most important contribution the Federal Reserve can make to maximizing our nation's potential output and employment growth.

If we have learned what history teaches, future historians will view the 1970s as an aberration: a period when a central bank and a nation learned about the discipline required to maintain the value of a currency that is not convertible into a real commodity.