Milton Friedman and the Second Wave of the Great Inflation, 1976–1980

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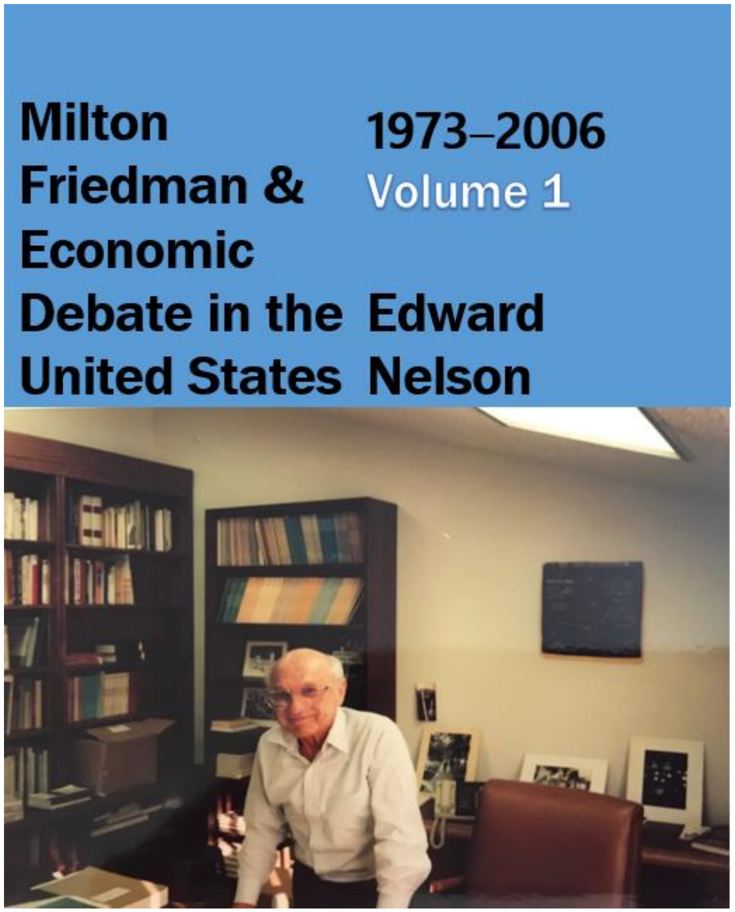
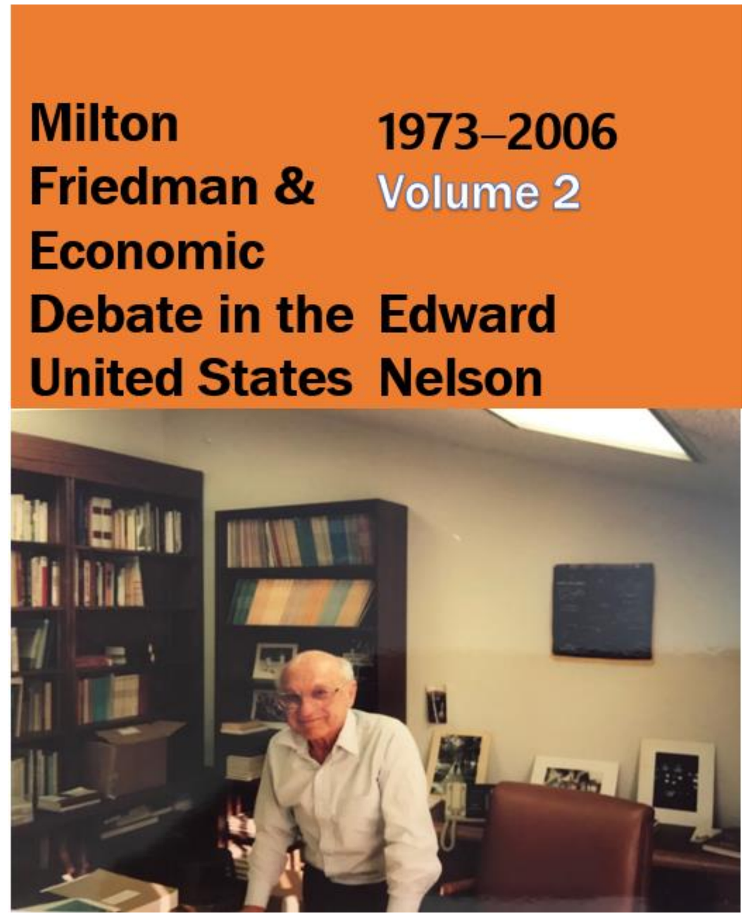
Federal Reserve Board
May 2024

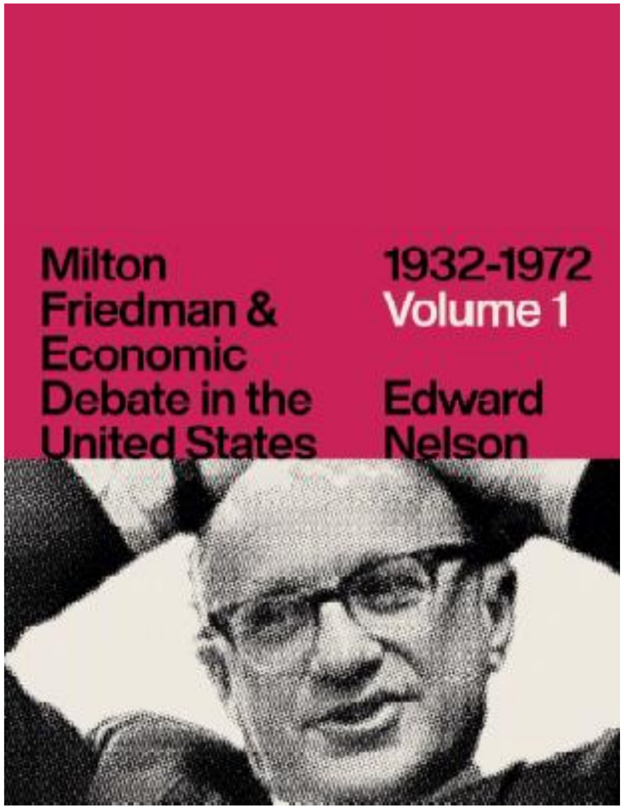
Prepared for Hoover Monetary Policy Conference, Hoover Institution, Stanford University, May 2–3, 2024. The views expressed here are those of the author and should not be interpreted as official positions of the Federal Reserve System or the Board of Governors.

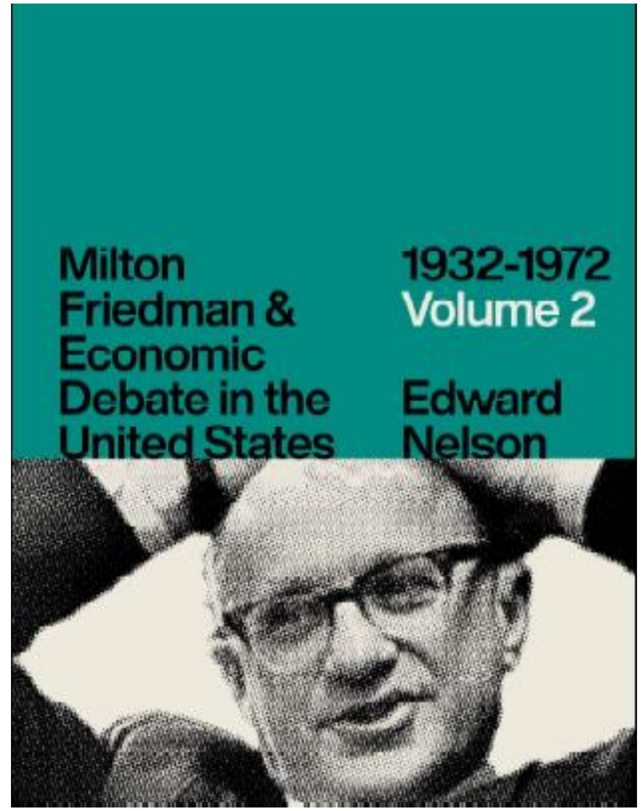
Milton Friedman and Economic Debate in the United States, 1973–2006
(continuation volumes, full drafts downloadable)





Milton Friedman and Economic Debate in the United States, 1932–1972
(University of Chicago Press, 2020)

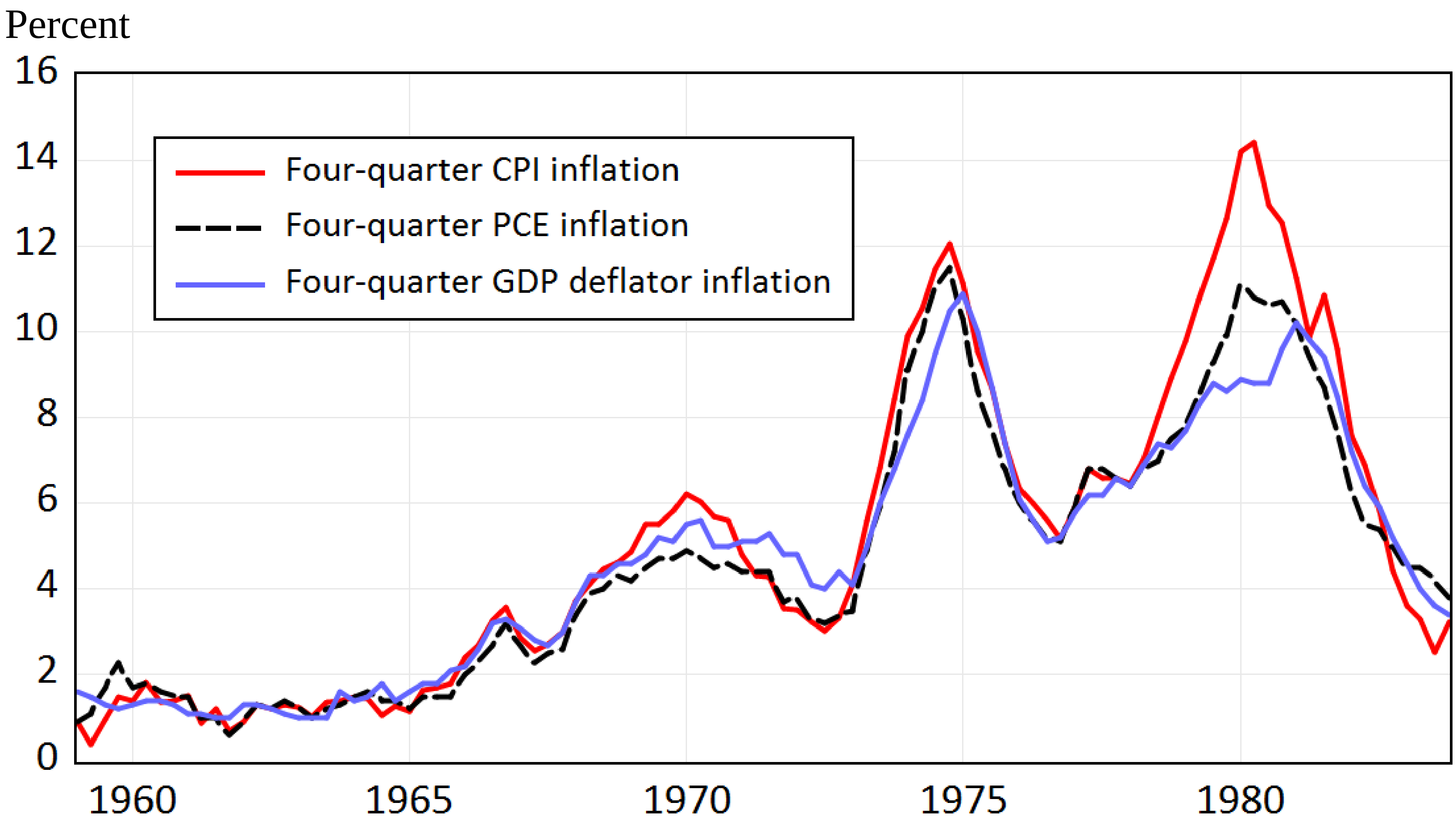




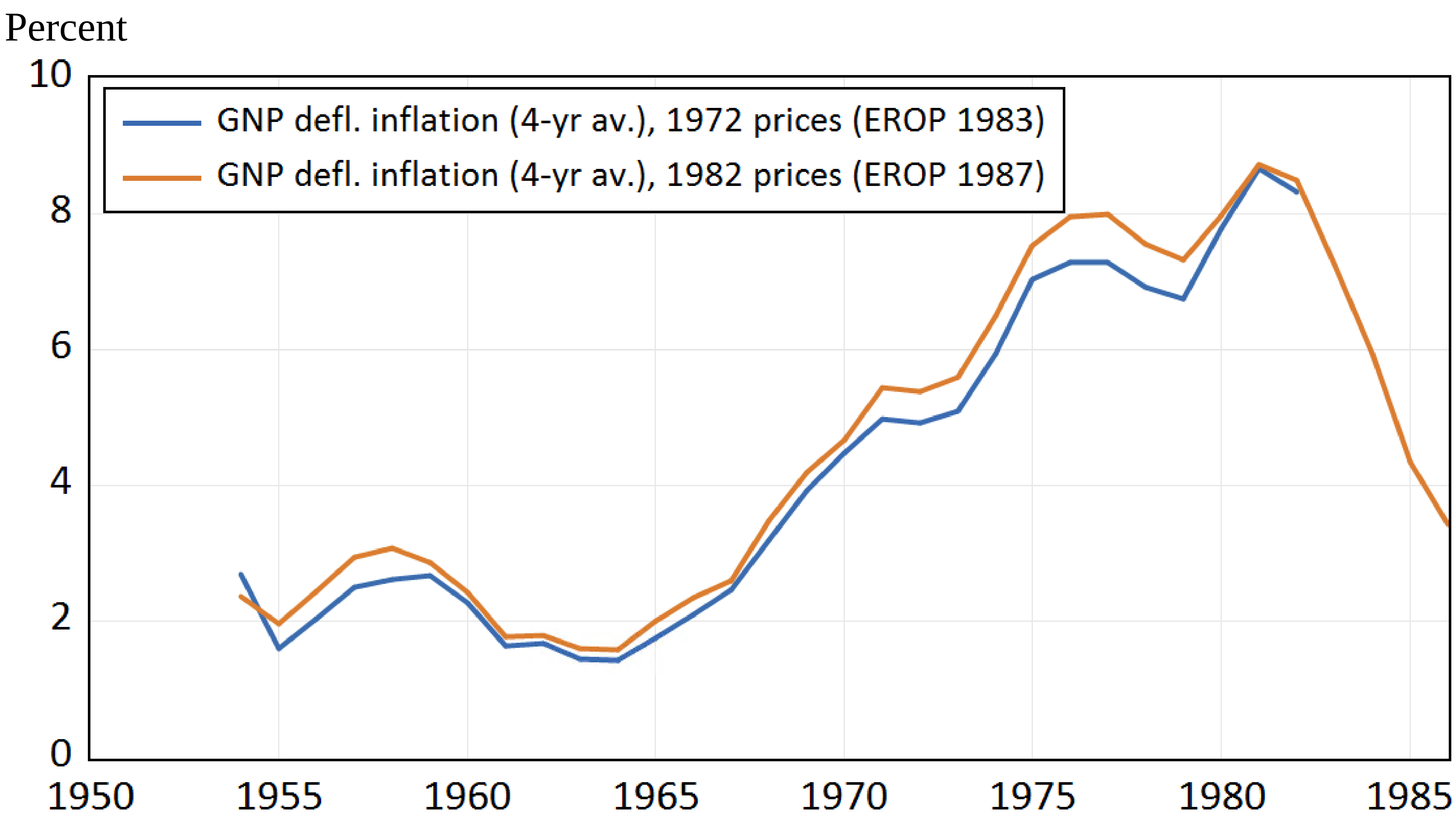
Outline of this talk

- I will deal with a specific aspect of Friedman's public-policy activity in the late 1970s.
- The key Friedman statements were in media outlets.
- But they rested on monetary framework in his research—including his work with Anna Schwartz.
- Friedman's viewpoint contrasted with—but helped reshape—professional thinking during the late 1970s, in leadup to Volcker disinflation.

The second wave of the Great Inflation: post-1976



The second wave of the Great Inflation in perspective



The second wave of the Great Inflation—expected or not?

- *Business Week*, March 3, 1975: "it is highly unlikely that double-digit inflation will recur in this decade."
- Testifying in 1981 about U.S. budget forecasts submitted at the end of 1977, a government official stated: "Nobody predicted the double-digit inflation that actually occurred in the 1979–80 timeframe. Those were not predicted to occur."
- "In your ongoing 'debate' about econometric models, it was particularly disturbing to read Michael Evans' comment… that no one correctly forecast inflation for 1978 and 1979. He's wrong, because Milton Friedman did." (Charles Brunie, *Wall Street Journal*, October 1, 1979.)

Highlights of Friedman's inflation predictions: I

- First-half Dec. 1976: Stated that inflation would trough around Feb. 1977.
- 4.8 percent, Dec. 1976 CPI 12-month, proved to be the actual trough.
- Dec. 1976: Saw average inflation rate as likely to average 7 to 9 percent in Feb. 1977- to mid-1979.
- Apr. 1977: "I expect it's going to step up in the next year or two to 7 percent or 8 percent."

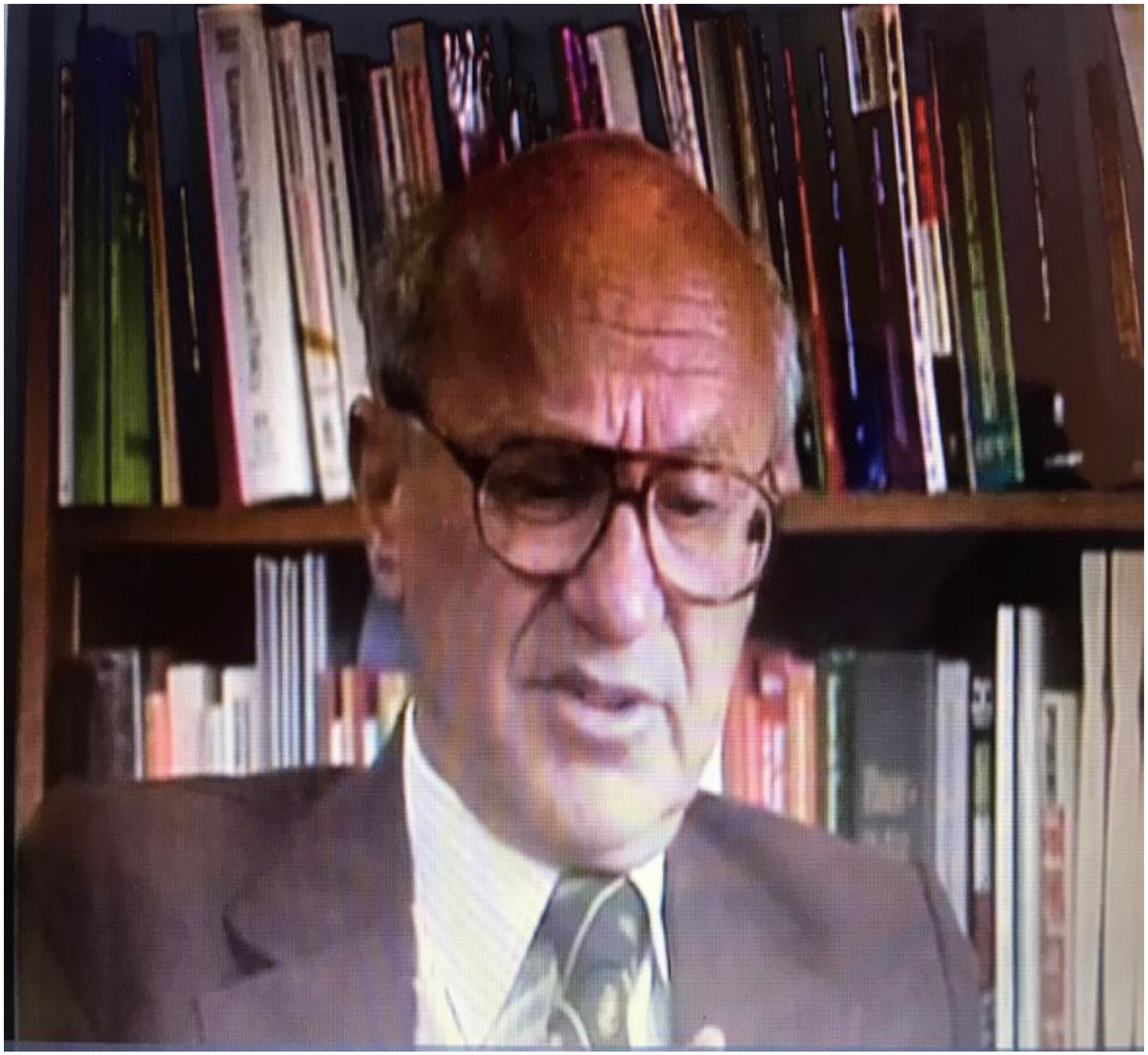
Highlights of Friedman's inflation predictions: II

- Oct. 3, 1977 *Newsweek* column (in wake of 1976's double-digit M2 growth continuing that year): saw return of double-digit inflation in 1979 or 1980.
- Similarly, *Chicago Tribune* Nov. 14, 1977:

  10% inflation in 1980?

  NOBEL PRIZE Laureate Milton Friedman, a University of Chicago economist, predicted in San Francisco over the weekend that inflation in the United States will approach 9 per cent next year and reach 10 per cent by 1980.
- Oct. 26, 1977—Friedman briefing to financial firm: he saw 1978 inflation as 7 to 10 percent (U.S. consensus forecast was 6 percent).

Highlights of Friedman's inflation predictions: III



- Apr. 24, 1978 *Newsweek*: 02/1977–10/1979 average inflation 7–10 percent.
- Mid-1978: "it would be a miracle if inflation peaked below 10 percent, and 10–12 percent or 10–13 percent would be more likely," with peak assessed as likely occurring in 1979:Q4 (actual peak: 1980:Q1).

The contrast with the professional consensus

- Friedman's views on inflation were still encountering strong resistance, notwithstanding:
    - His recent Nobel Prize in economics (Oct. 1976).
    - Statement by FRBSF president Balles, Jan. 1977: "Milton Friedman has altered the course of economic thinking."
- Resistance (in practical discussions) to Friedman's views on inflation in fact went ***up*** over the years 1977–1978.
- During 1977 and 1978, his stand on the analysis and control of inflation was greatly out of step with that of policymakers—and many economists.

Stabilization policy in 1977—the mainstream view

CBO. A. Rivlin (January 1977): "With excess capacity and high unemployment continuing, demand pressures do not seem likely to lead to an acceleration of inflation... [Aggregate demand] stimulus to get the rate of [real GNP] growth up to 5 or 6 percent would probably not add greatly to the problem of inflation."
***Admin*.** B. Lance/C. Schultze (Jan. 1977): "the overwhelming majority of 'serious macroeconomists' have called for expansionary economic policies." C. Schultze (Sept. 1977): "Ample resources are available to permit further expansion…"
***Federal Reserve*.** Burns: "there is now considerable slack in the economy" (Feb. 23, 1977) and "[s]ubstantial amounts of idle capacity and manpower" (Mar. 22, 1977). Board Governor C. Partee: "sizable unused resources exist" (Oct. 1977).

Stabilization policy in 1977: Friedman's dissent—I

- As of 1977:Q1, the reported U.S. output gap estimate stood at about –9 percent. This greatly overstated slack (Orphanides, 2003; Orphanides, Porter, Reifschneider, Tetlow, 2000)—which was also ***rapidly diminishing***.
- Friedman emphasized the fragility of such estimates (notably that of u*) and eschewed them in his policy analysis.
- James Tobin criticized Friedman's Oct. 3, 1977 *Newsweek* column (on monetary policy being too loose)—Tobin suggesting that it implied an extreme view that there was now zero slack.
- Whether Friedman had that view or not, it ultimately became mainstream: the CBO now sees U.S. output as crossing U.S. potential GDP around 1977:Q3.

Stabilization policy in 1977: Friedman’s dissent—II

- Although his perspective aligned with an augmented Phillips-curve framework, Friedman relied principally in his quantitative analysis on reduced-form linkages between ***nominal*** series (monetary growth, nominal income growth, inflation).
- Dec. 6, 1976 *Newsweek* column: “take it easy. Hold down govt. spending. Hold down the rate of monetary growth. Let the recovery proceed as it then would, at a moderate pace. As the recovery proceeds, reduce the rate of monetary growth still further, so that we can force down the rate of inflation gradually over a few years.”

Lessons unlearned (as of 1977) about the first wave of the Great Inflation—I

- Many other economists did not see the first-half 1970s experience as an instance of monetary policy generating high inflation.
- Or even of expectational Phillips-curve dynamics in action.
- Although it partially underlay his 1976 Nobel, in many practical circles in the late 1970s the Friedman-Phelps story was seen mainly useful in understanding ***the 1960s***.
- The ***1970s inflation*** was seen as different—as being ***overwhelmingly cost-push***.

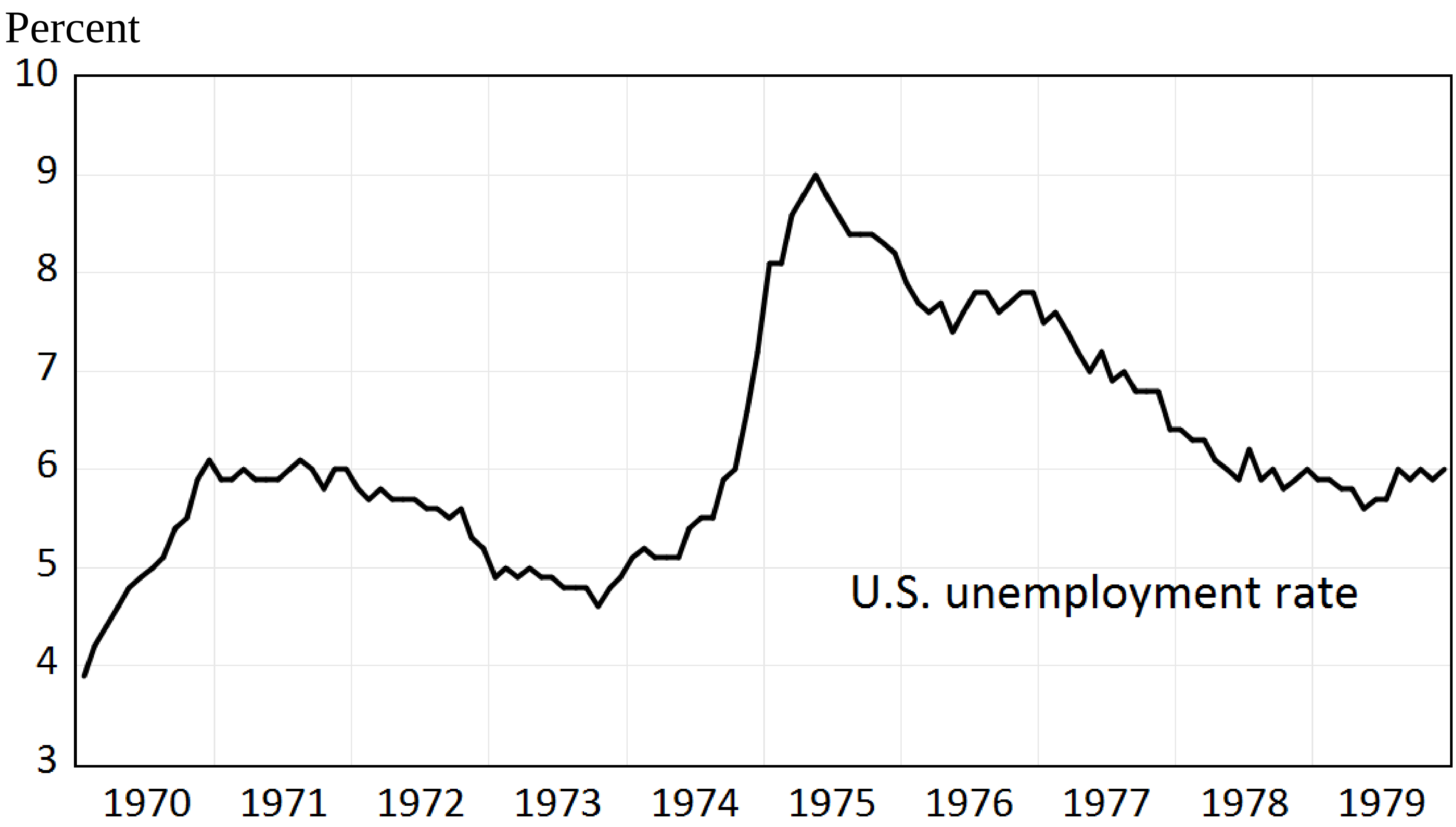
Lessons unlearned on Great Inflation as of 1977—II

CBO. Rivlin (Jan. 1977): "If we get double-digit inflation in the next year or so, it is much more likely to be from extraneous causes that have nothing to do with excess demand. We are not in an excess demand situation now. We have a great deal of unused capacity." Also: "The output gap and its attendant higher levels of unemployment and excess capacity explain relatively little of this reduction in inflation. The principal factors… have been the ending of the effects of the one-time shocks which hit the economy in 1972–74."

Admin. Blumenthal (Jan. 1977): "much of the acceleration of inflation during the first half of this decade was due to such outside shocks as the higher energy price imposed by the OPEC countries and severe weather…"

Federal Reserve. Many Burns & Miller statements.

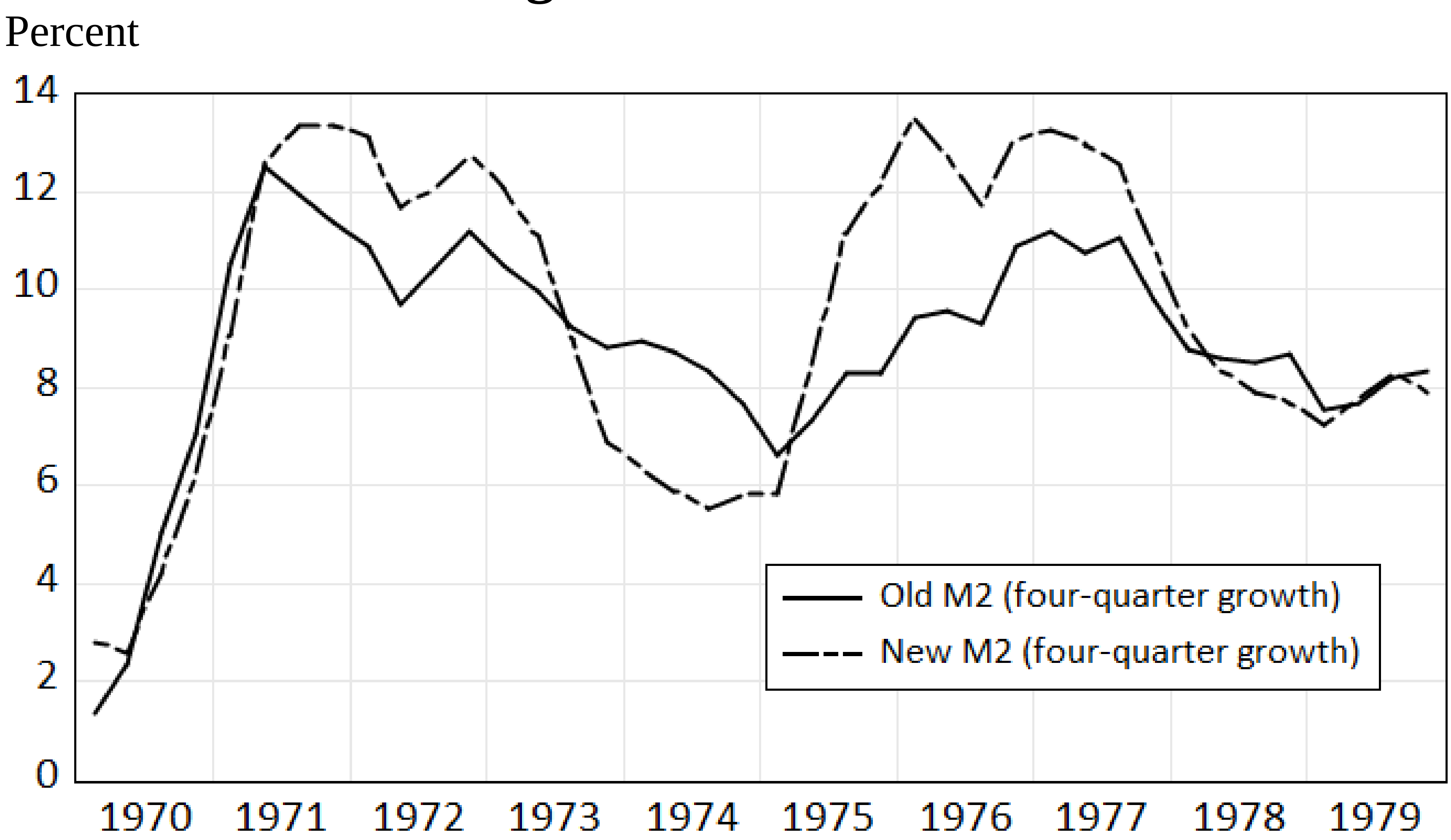
The unemployment rate in the 1970s



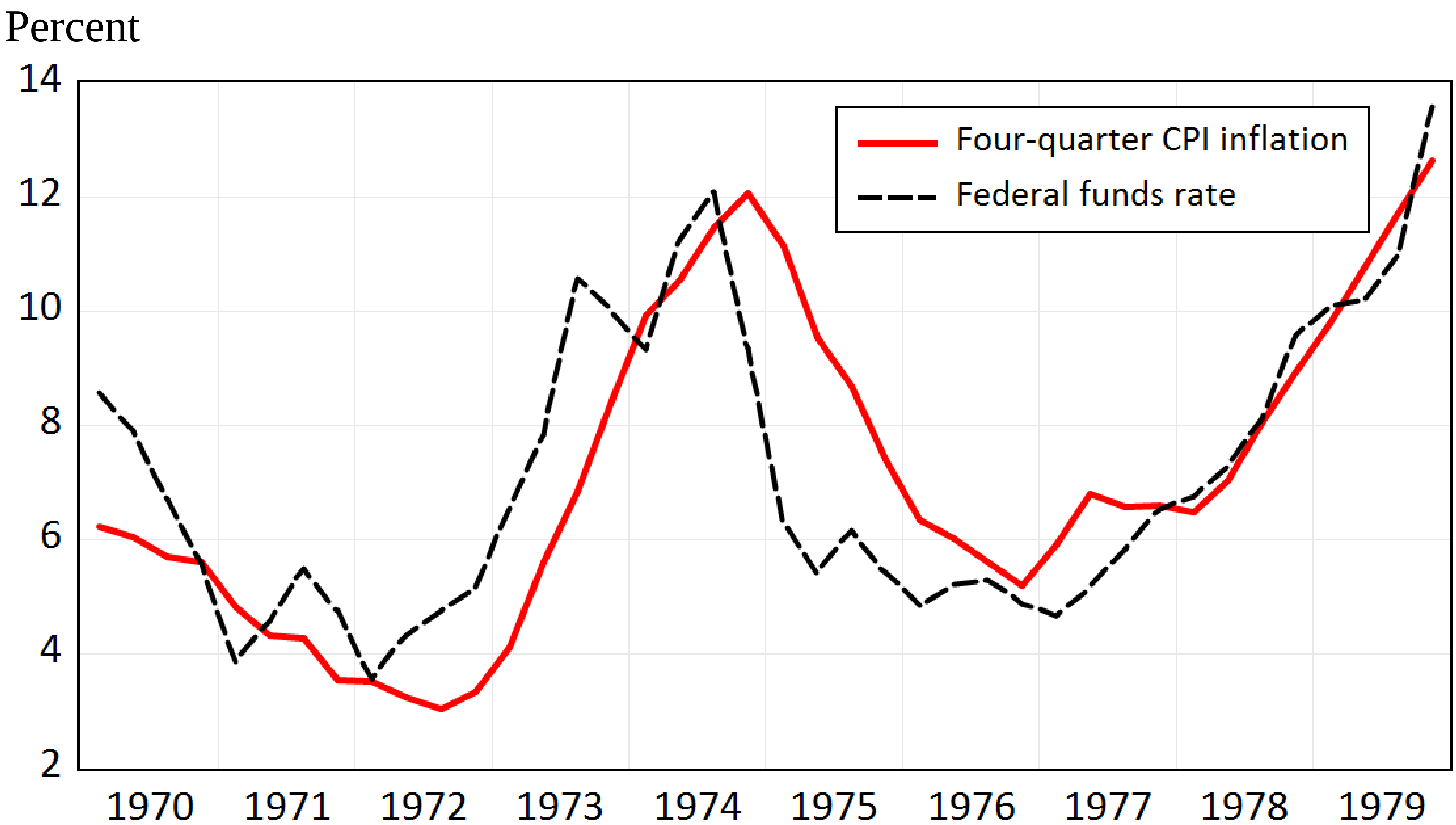
Who was most responsible for the second wave?

- Inflation troughed in the last full month of the Ford Administration.
- And inflation's big surge in 1978–1979 occurred under the Carter-nominated successor to Burns, G. William Miller.
- But Friedman attributed the second wave of the Great Inflation overwhelmingly to the ***Burns Federal Reserve***—which had presided over the 1970s' second monetary explosion (in 1976 and 1977).

M2 growth in the 1970s

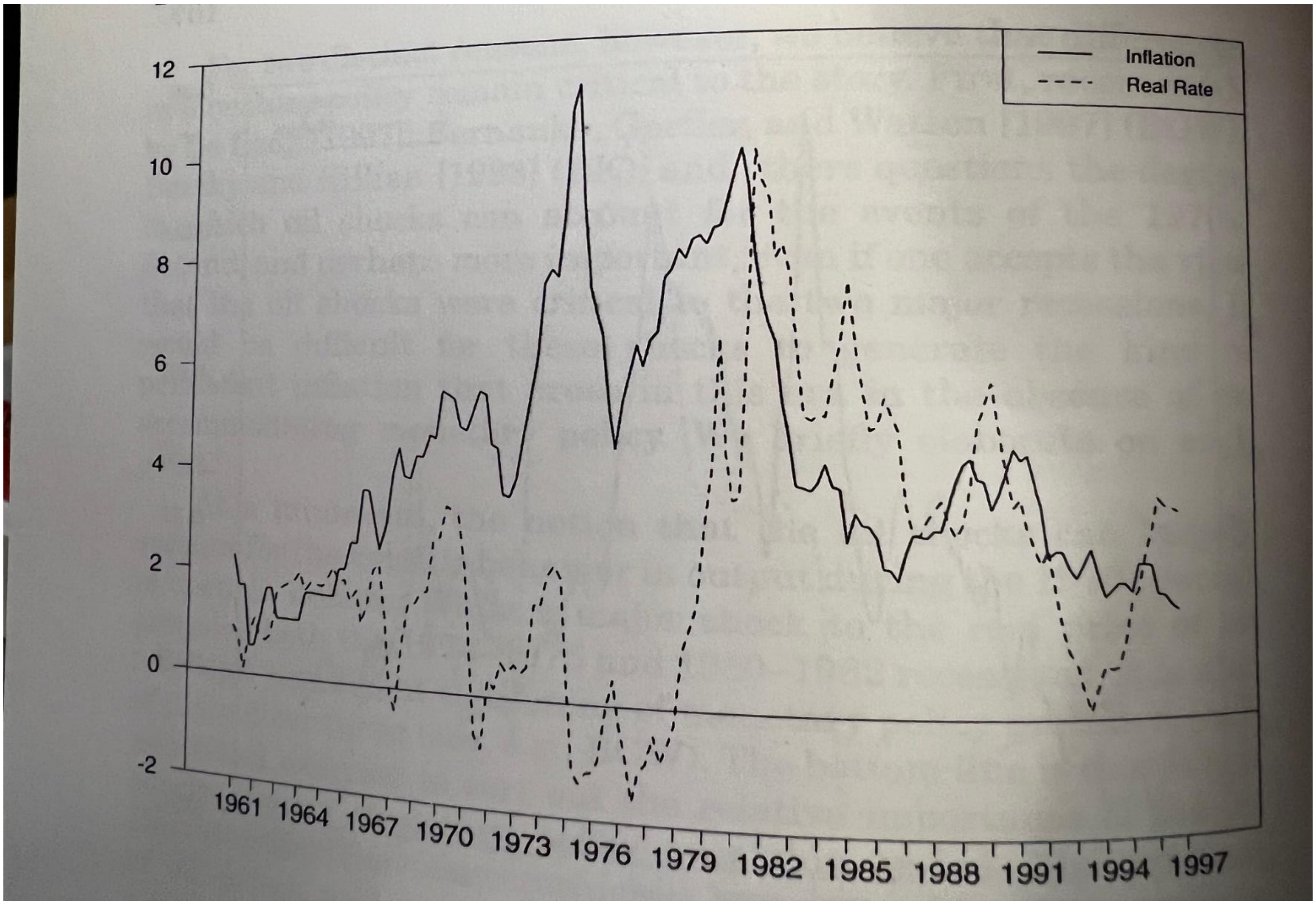


The federal funds rate and inflation in the 1970s



Note: Calculated as monthly-average federal funds rate minus current 12-month CPI inflation rate.

Real interest rate—estimate of Clarida, Galí, and Gertler (2000)



The Miller Federal Reserve and inflation

- Although he viewed high inflation in 1978–1979 as having been locked in by the Burns policies, Friedman became critical of the Miller Federal Reserve.
- Like others, he criticized its tightening as being mostly too leisurely.
- But Miller also had a cost-push outlook on inflation.
- Miller: "The Federal Reserve is limited to what it can do about inflation." (*U.S. News and World Report*, Aug. 7, 1978.)
- "In sum, our arsenal of weapons against inflation is somewhat restricted…" (Miller letter to Committee on Ways and Means, U.S. House of Representatives, Jan. 17, 1979.)

Miller on Friedman

- Miller (May 1978): "In the last section of his article, Dr. Friedman asserts that 'We need a long-term program dedicated to eliminating inflation.' I agree wholeheartedly."

- The difference with Friedman was brought out by Miller's next observation, "Monetary policy has a critical role to play, but it cannot alone bear the whole burden of combating inflation."

Inflation and the Carter Administration—I

- Blumenthal (Jan. 1977): "Reduction in the rate of inflation is one of the goals of this administration."
- But it saw inflation largely in cost-push terms and criticized much of the 1978 Federal Reserve tightening.
- Friedman at times expressed incredulity: "Secretary Blumenthal knows as well as you and I do that inflation does not come from trade unions." (Apr. 27, 1978.)
- But the admin. indicated that it indeed saw things like this.
- Schultze (Mar. 1978): "We can't wring this inflation out of the economy through measures which promote unemployment and economic slack. Such policies have only a limited impact on the kind of inflation from which we now suffer…" And Jan. 1979: "fiscal and monetary restraint, *used alone*, are unlikely to brake the momentum of inflation."

Inflation and the Carter Administration—II

- Especially before 1979, the Carter Administration traced inflation to special or autonomous factors:
  - Specific prices: U.S. exchange-rate depreciation (especially in 1978), weather (1977), food prices (1978), and then food plus oil (1979).
  - And much wage-push emphasis throughout.
- Its nonmonetary outlook was reflected in its anti-inflation measures:
  - Jan. 1977: Carter urged prenotification of price increases.
  - Apr. 1977: Carter announced set of specific measures designed to bring inflation to 4 percent by mid-1979.
  - Feb. and Apr. 1978: Attempt to launch incomes policy.
  - Oct. 1978: Voluntary wage and price guidelines; proposed real wage insurance via a tax-based incomes policy.
  - Carter (Apr. 1978): "Reducing the inflation rate will not be easy… We will not solve inflation by increasing unemployment. We will not impose wage and price controls. We will work with measures that avoid both extremes."

Inflation and the Carter Administration—III

- Faced with the endurance of cost-push views, Friedman reiterated his criticisms of them.
  - He was a longstanding critic of wage-push ideas. Apr. 22, 1981: "To say that wages are a cause of inflation is somewhat like saying that wet streets are a cause of rain. Wage rises are a manifestation of inflation."
  - Apr. 26, 1978: "President Carter's [anti-]inflationary package is like Hamlet without the Prince of Denmark… Inflation is not caused by trade unions, business interests, consumers, or oil… [It] has been around 1000 years and, in all that period, only one medicine to cure inflation has been found: to hold down the rate of monetary growth and hold down governmental spending."
  - Nov. 12, 1978: "The great confusion in this area is to confuse particular prices with prices in general. Why is that people point to food prices as a cause of inflation, but I have seen nobody point to the sharp decline in the cost of computers, or hand-held computers, or computing services? Has somebody been pointing to that as a cause of deflation?"

The situation in 1979

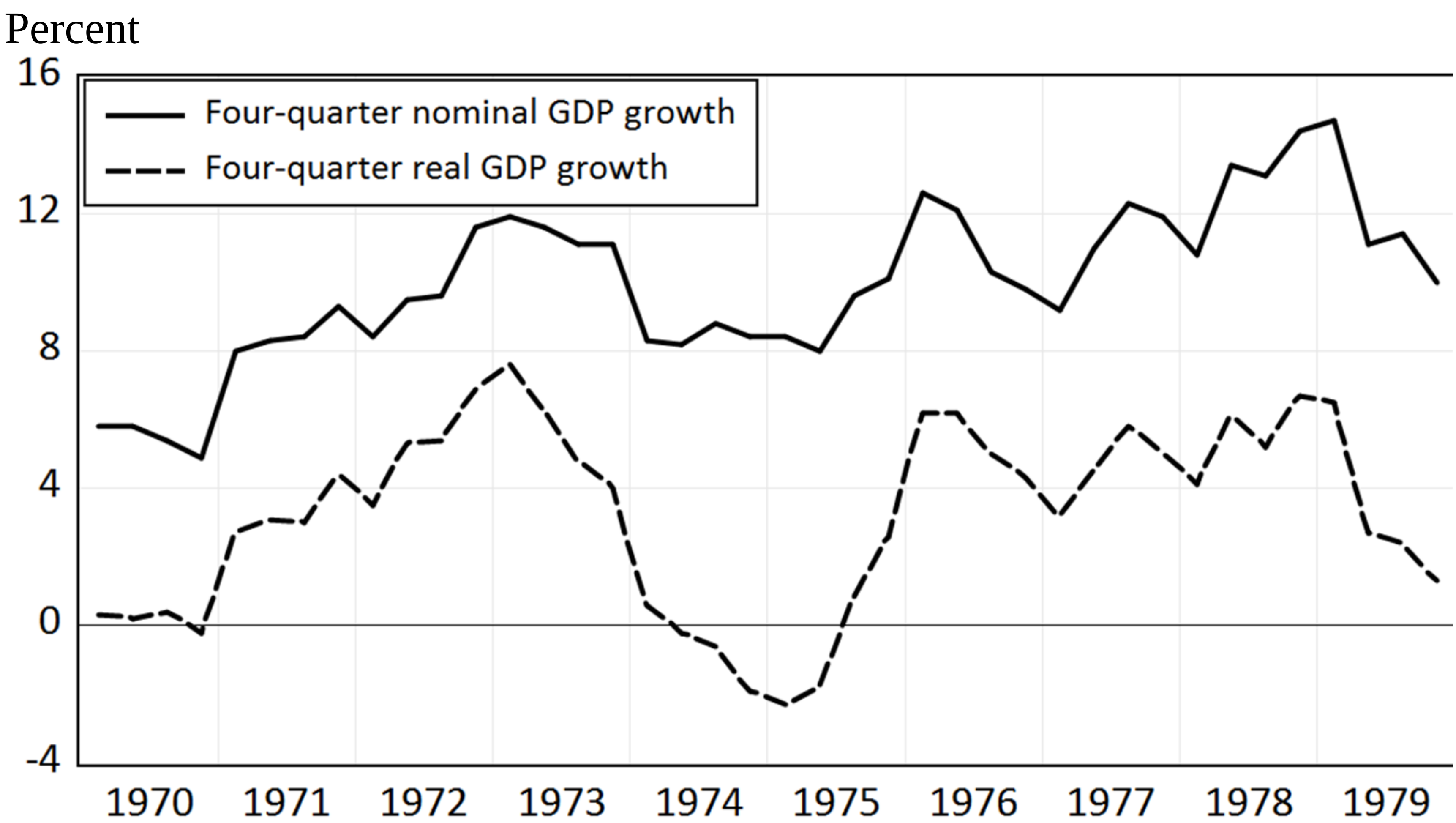
- 1987 *Economic Report of the President*: The late-1970s expansion "ended in a double crescendo of rising inflation and interest rates and falling economic activity."
- Friedman in *Newsweek* (Aug. 20, 1979): The problem is not, as President Carter asserts, a lack of confidence. The problem is rather that the public is very confident that the government will produce inflation and will mismanage the economy. We do not need more confidence in bad policies. We need better policies."
- By then, changes were afoot in policymaker and professional thinking:
    - ♦ Major ***output-gap revisions*** helped reconcile 1970s inflation with an excess-demand account.
    - ♦ ***Volcker became Federal Reserve chair*** (Jul. 1979) viewing inflation as monetary in nature.

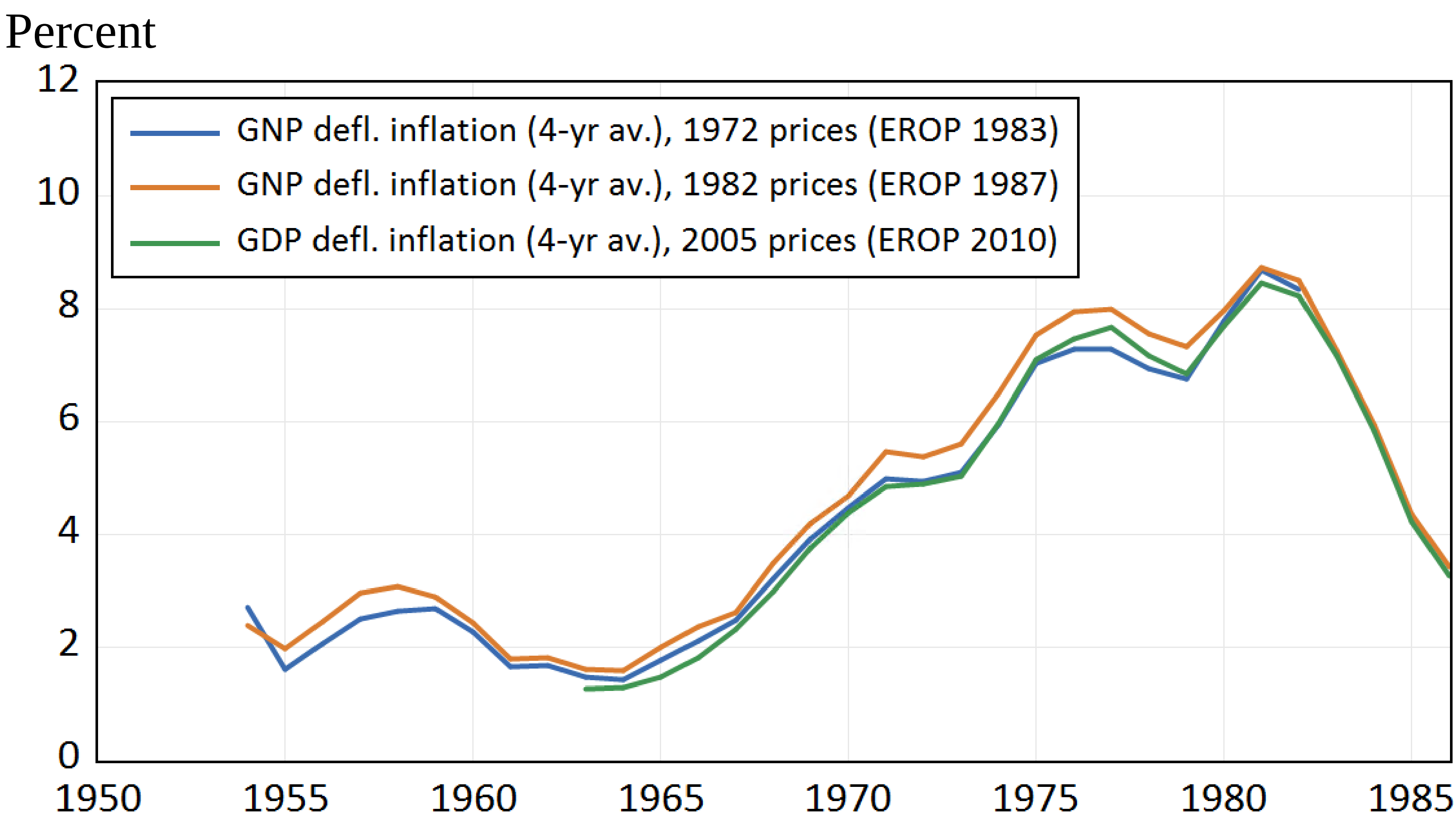
The Volcker perspective on monetary policy and inflation

- There were many divergences between the Volcker Federal Reserve and Friedman's prescriptions. But a lasting official shift occurred in 1979: monetary policy now had special responsibility for inflation.
- Volcker (Aug. 3, 1983): "We have to be particularly sensitive to inflation: that is a monetary phenomenon; that's more directly in our bailiwick."
- Earlier, in his appearance in 1982 alongside Anna Schwartz in New York, Volcker gave a negative verdict on monetary policy in 1976–1977: noninflationary expansion "went on in the early '60s: and [then] the Vietnam War came along and all the rest, but we did have a five-year period where that happened. It began to happen [again], in my judgment, in '75 and '76, coming out of the recession. And then, for a variety of reasons, we blew it."

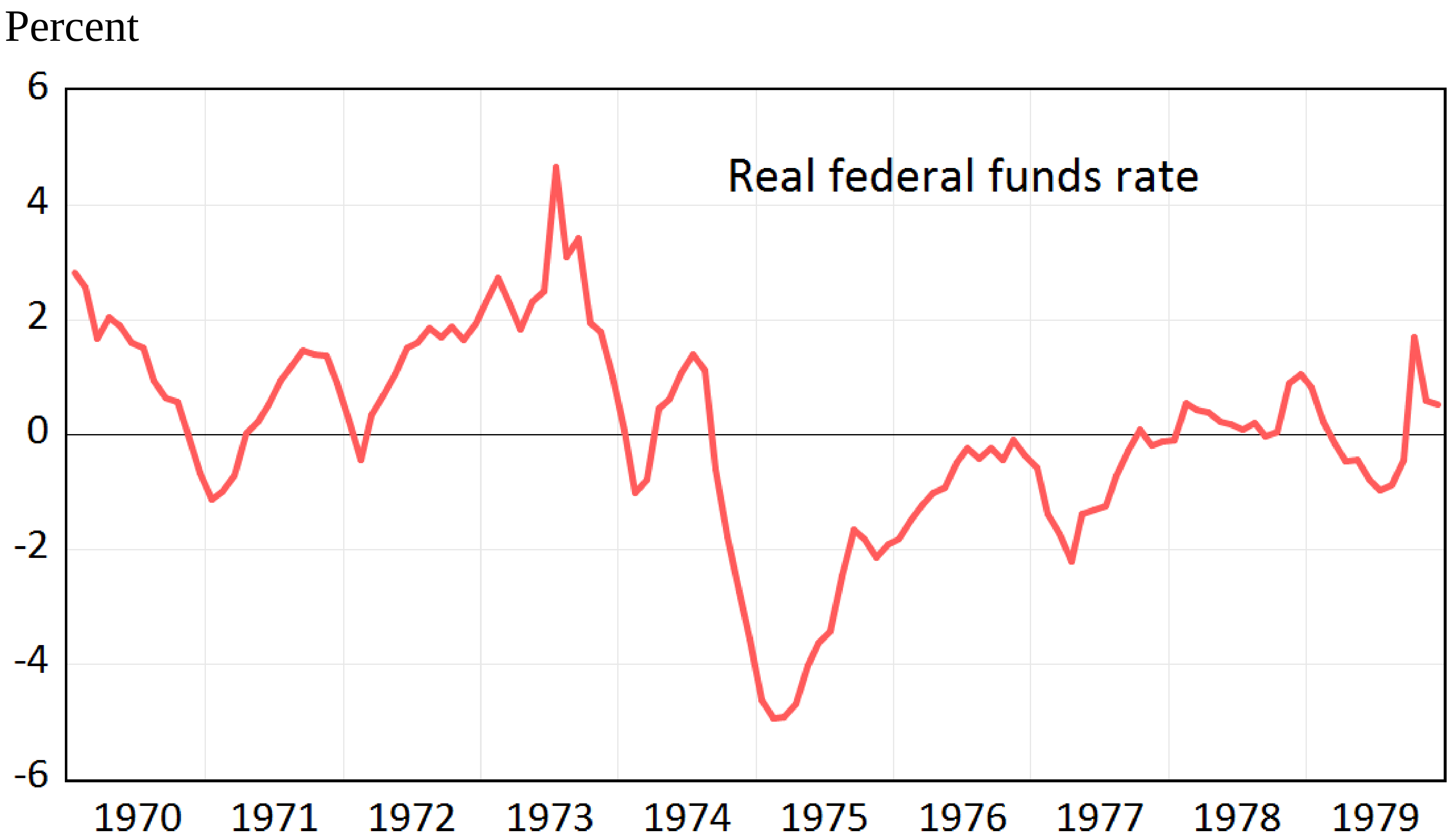
Supplementary slides

Selected key figures in U.S. government, 1976–1980	
Gerald R. Ford	U.S. president, 1974–1977
Jimmy Carter	U.S. president, 1977–1981
Michael Blumenthal	U.S. Treasury Secretary, 1977–1979
Charles Schultze	CEA chair, 1977–1981
Bert Lance	OMB director, 1977
Alice M. Rivlin	CBO director, 1975–1983
Arthur F. Burns	Federal Reserve chair, 1970–1978
G. William Miller	Federal Reserve chair, 1978–1979; U.S. Treasury Secretary, 1979–1981
Paul A. Volcker	FOMC vice chair, 1975–1979; Federal Reserve chair, 1979–1987
Alan Greenspan	CEA chair, 1974–1977 (in the private sector, 1977–1987)

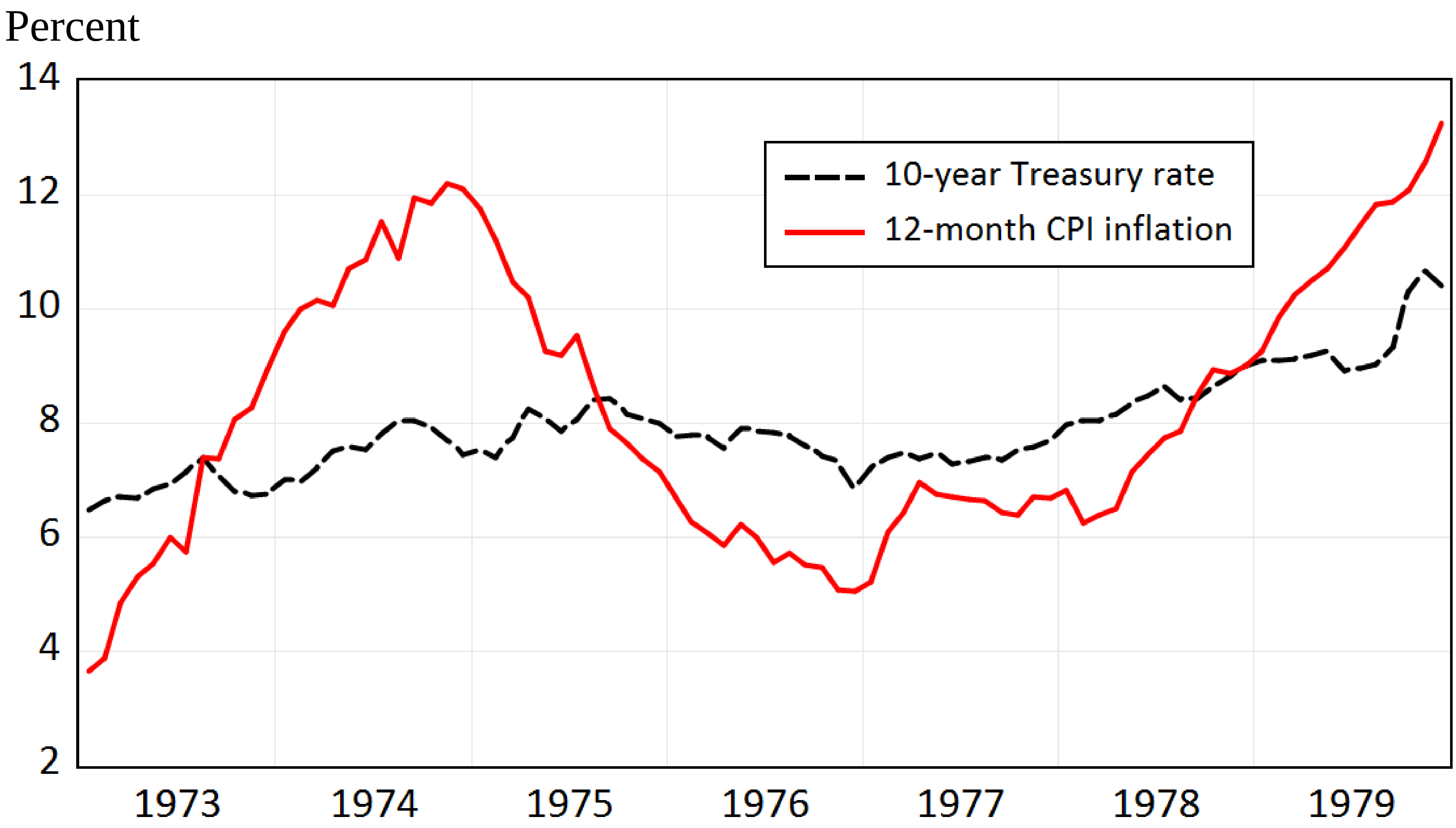

Percent
16
12
8
4
0
-4
Four-quarter nominal GDP growth
Four-quarter real GDP growth
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979


Percent
12
10
8
6
4
2
0
1950
1955
1960
1965
1970
1975
1980
1985
GNP defl. inflation (4-yr av.), 1972 prices (EROP 1983)
GNP defl. inflation (4-yr av.), 1982 prices (EROP 1987)
GDP defl. inflation (4-yr av.), 2005 prices (EROP 2010)

The real federal funds rate in the 1970s



Long-term interest rates and inflation



Kansas City Times, October 12, 1979

Long-Term Bonds Set Record

NEW YORK (AP) — The Treasury sold long-term bonds at a yield above 10 percent for the first time ever Thursday as interest rates continued to climb.

The Treasury sold $1.5 billion of bonds at an average yield of 10.17 percent, far above the previous record of 9.25 percent on bonds of 10 years or longer.

The bonds will have a coupon rate of 10.125 percent but will sell at a discount to earn the 10.17 percent yield.

The record rate on the bonds, which mature in 1994, followed other interest

Board last week adopted fresh anti-inflationary moves.

The Federal Reserve action caused bond prices to tumble across the board, with yields rising sharply and setting records.

Among the issues hit the worst was the new $1 billion in notes and debentures sold last week by the International Business Machines Corp.

The yield on the notes due in 1986 rose to 10.6 percent Thursday, far above the original 9.62 percent and up slightly from Wednesday. The debentures due in 2004 climbed to about 9.7 percent, also up slightly from Wednesday and above the original 9.41 percent.

The price drops have caused large losses to the underwriters, led by Salomon Brothers and Merrill Lynch White Weld. Some Wall Street estimates of the loss ranged up to $40 million, but Salomon Brothers on Thursday called such figures "greatly exaggerated."

"We estimate the losses to be substantially less than $10 million," said Jon Rotenstreich, a general partner at Salomon. He said that the figure covered all the underwriters and that virtually all the losses were assumed by Salomon and Merrill Lynch.

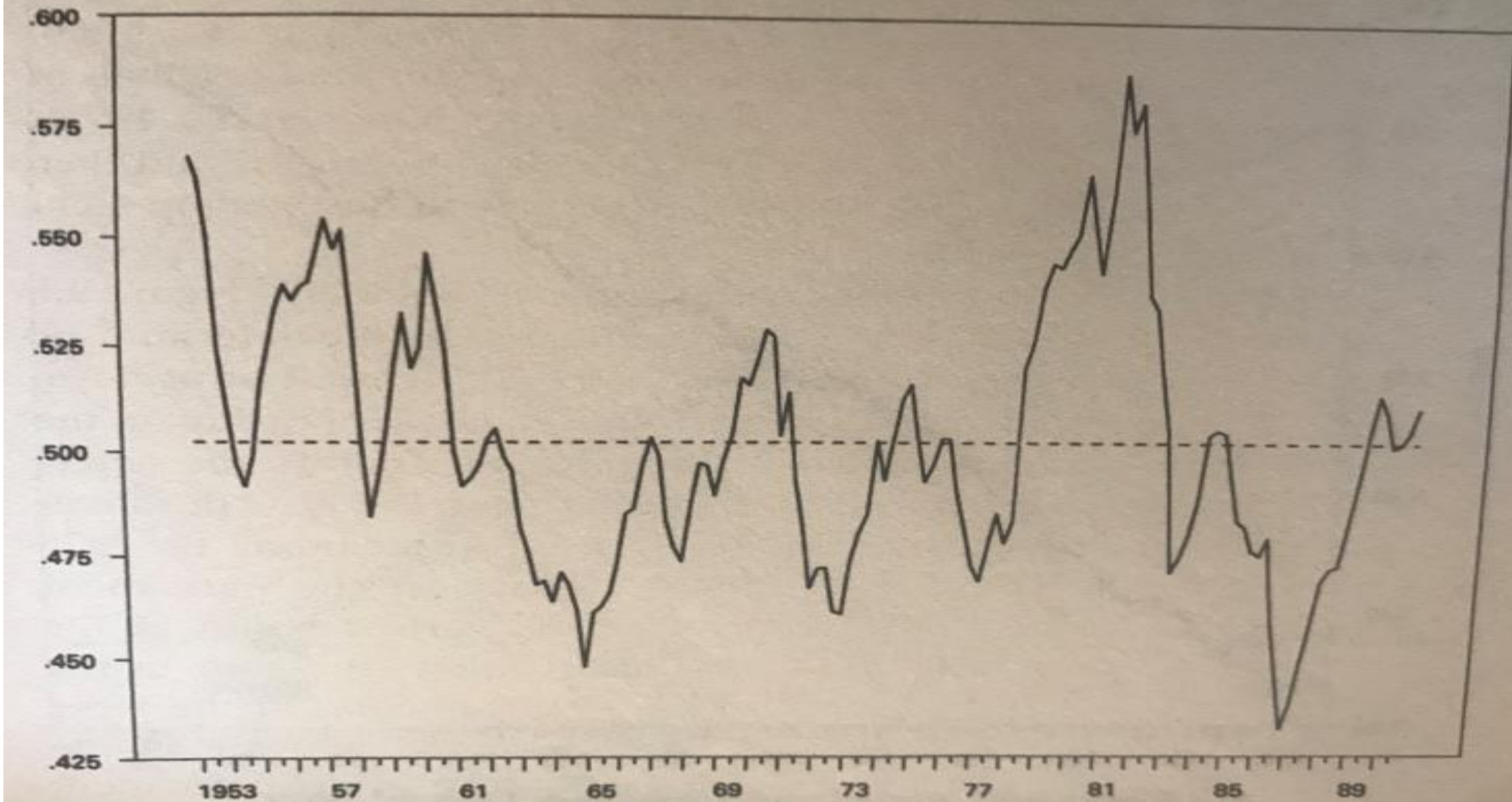
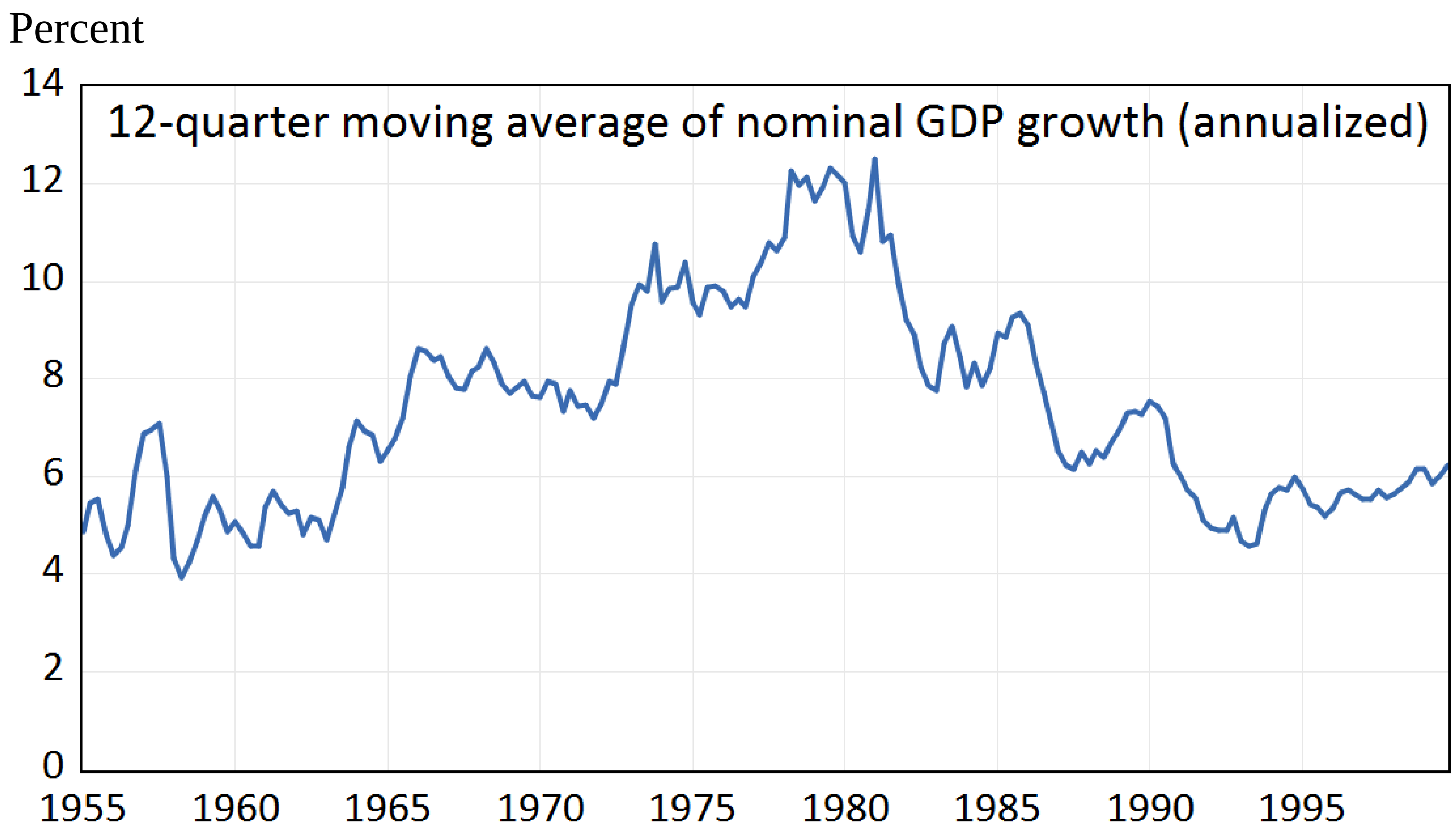
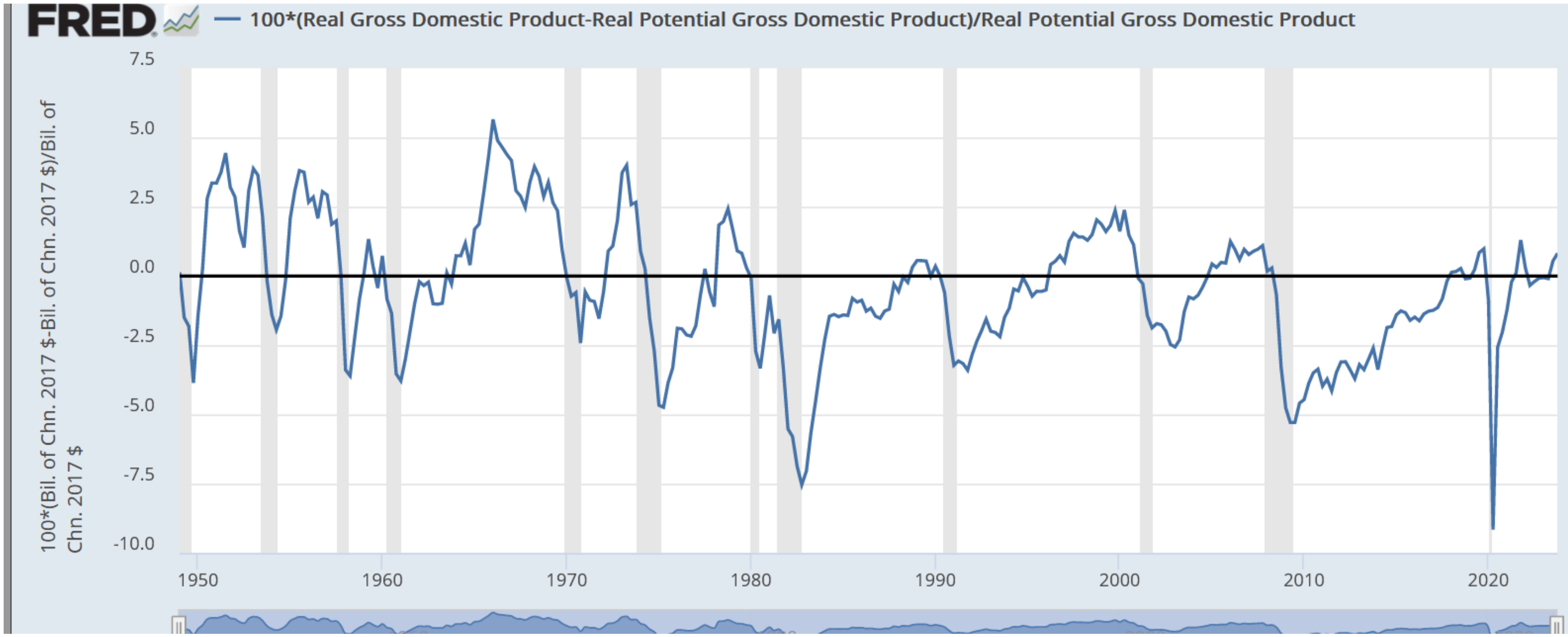
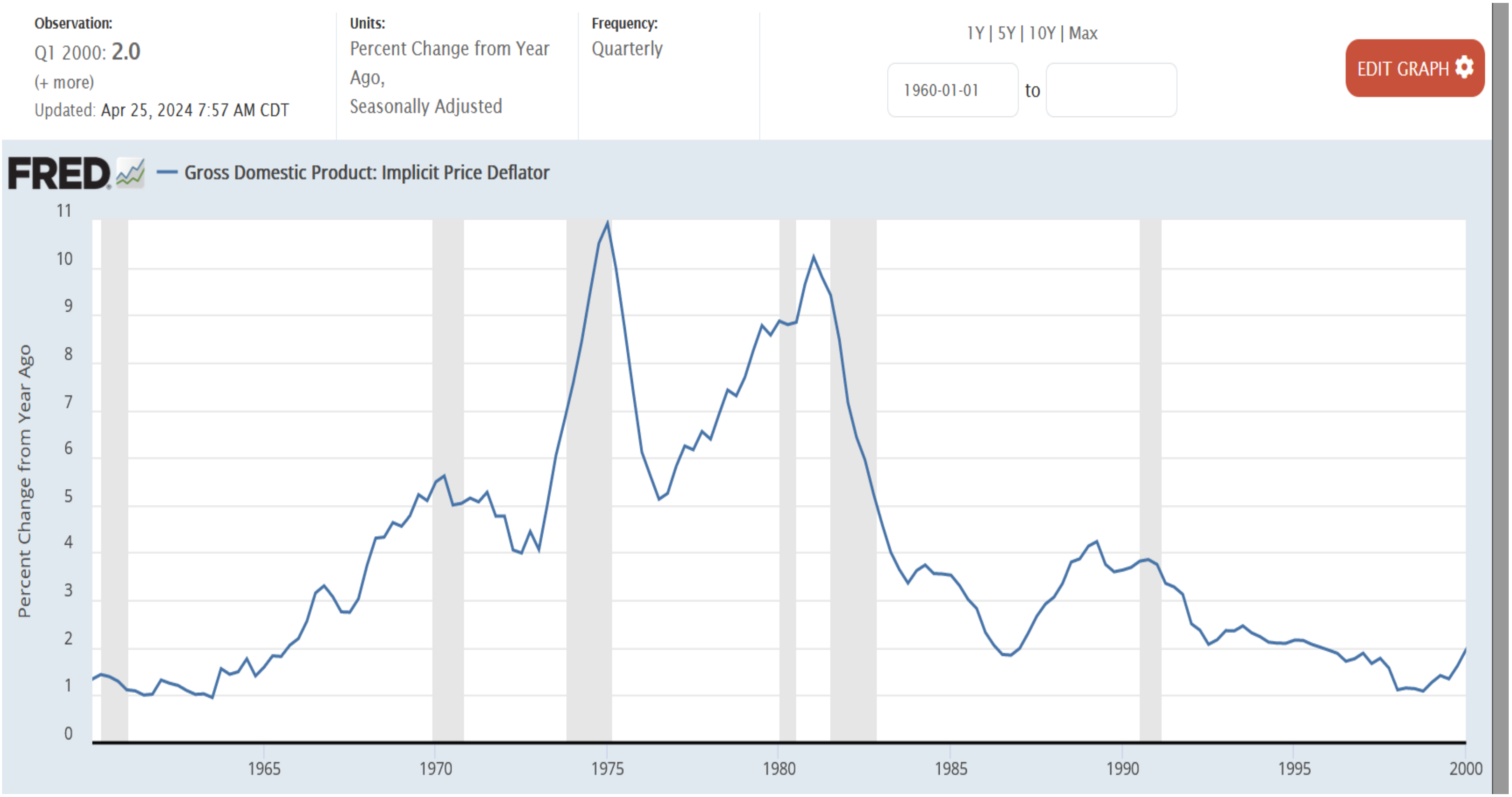


Figure 9.3 Log US M2 velocity and mean: quarterly

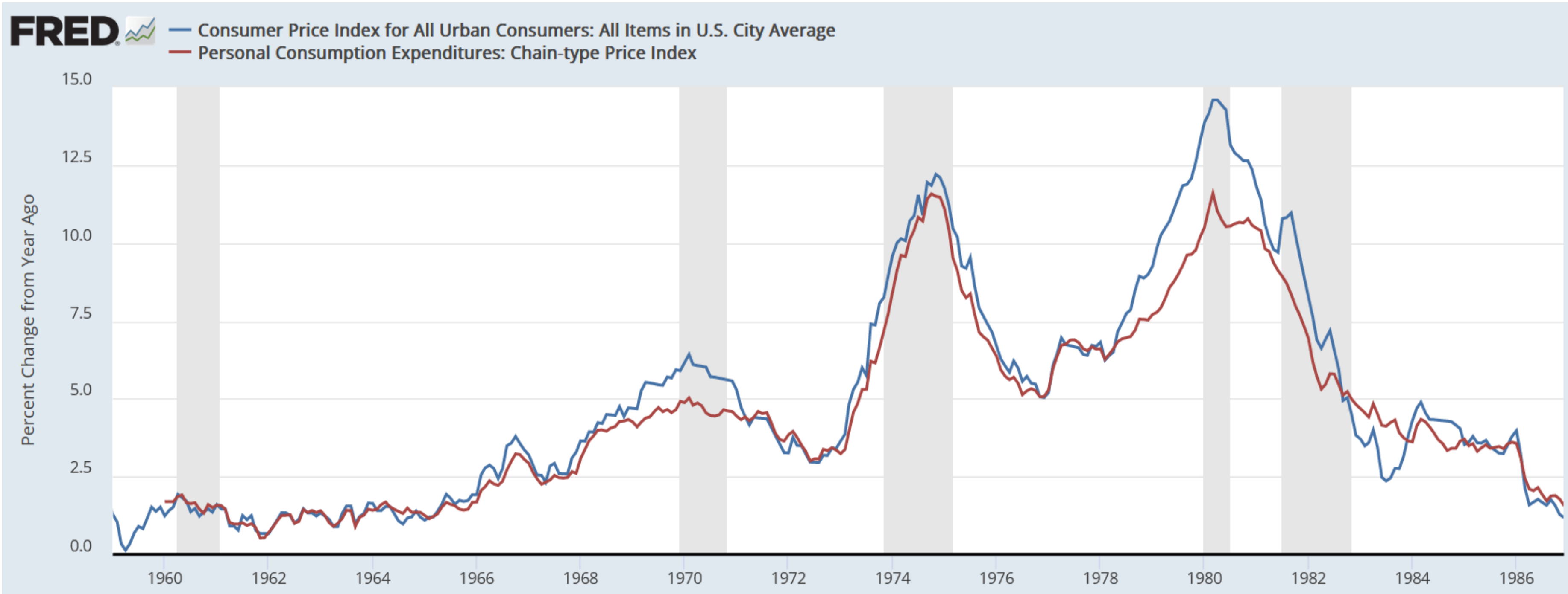

Percent
12-quarter moving average of nominal GDP growth (annualized)
14
12
10
8
6
4
2
0
1955
1960
1965
1970
1975
1980
1985
1990
1995

Output gap (modern series)





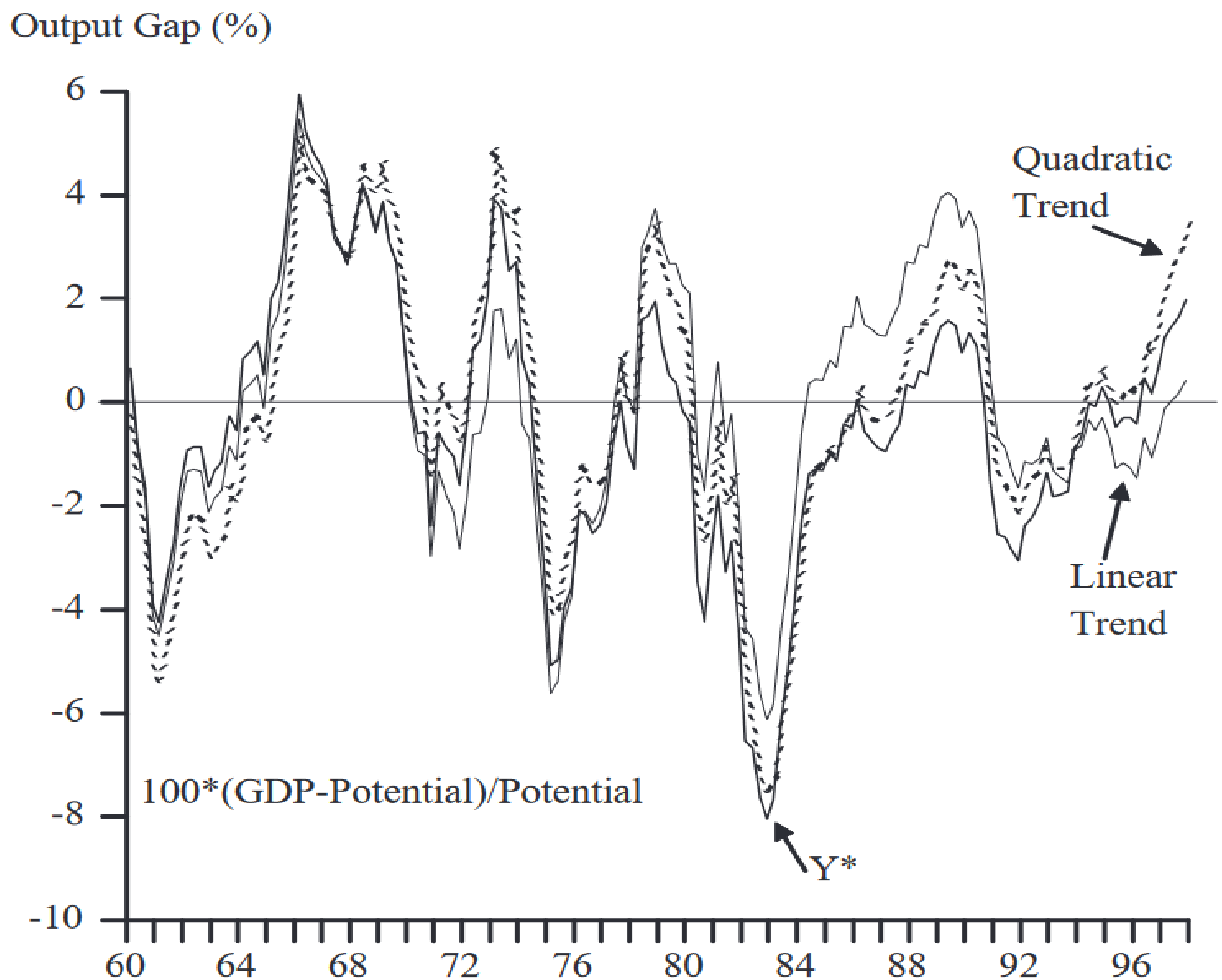
Observation:
Q1 2000: 2.0
(+ more)
Updated: Apr 25, 2024 7:57 AM CDT
Units:
Percent Change from Year Ago,
Seasonally Adjusted
Frequency:
Quarterly
1Y | 5Y | 10Y | Max
1960-01-01
to
EDIT GRAPH
FRED
Gross Domestic Product: Implicit Price Deflator
Percent Change from Year Ago
11
10
9
8
7
6
5
4
3
2
1
0
1965
1970
1975
1980
1985
1990
1995
2000



March 1980 rates (modern data):

14.6 percent CPI, 11.6 percent PCE prices

Output gap—alternative estimates (Judd and Rudebusch, 1998, Fig. A1)



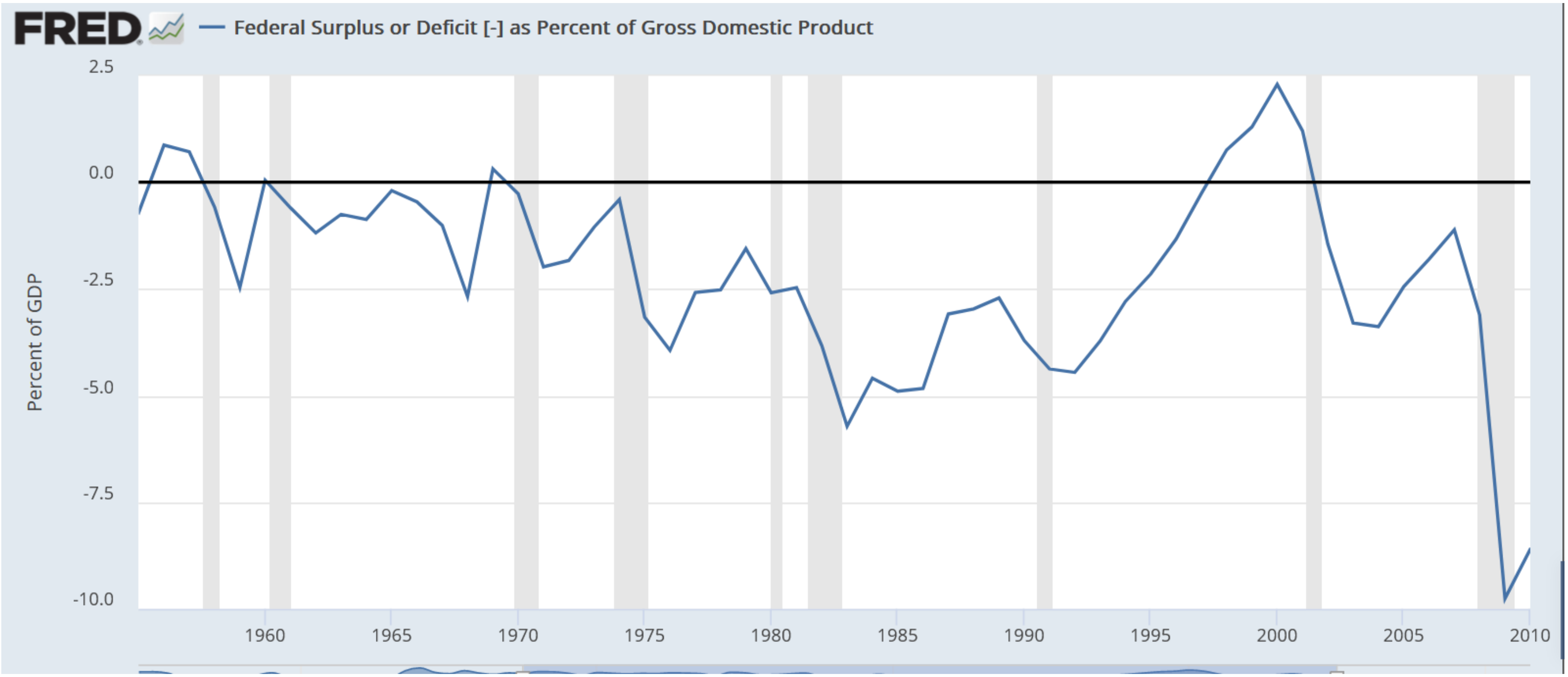
Note: "Linear Trend" is segmented linear trend (break in trend in 1973:Q1).

Carter Administration's evolving attitude to monetary policy

- Schultze (*Houston Post*, October 11, 1979): "What cannot be disputed is that actions on the monetary front are needed. The Federal Reserve policies are designed to keep the bulge in oil prices from spreading to the rest of the economy."
- Stuart Eizenstat (2018): "It took too long for the president's key economic advisers… to come to the realization that in a high-inflation environment we had given too little emphasis to monetary policy."

Friedman’s view on fiscal policy’s role in inflation control

- Friedman did not regard the late-1970s inflation breakout as closely linked to fiscal policy developments.
- But he did connect major historical inflations to budget deficits—and he associated inflationary potential with open-ended budget deficits.
- In *Newsweek*, Apr. 24, 1978: “pressures from Congress and the administration to finance rising government spending… are a major reason for high monetary growth” over time.
- On *Wall Street Week*, Feb. 21, 1992: “structural deficits over a long period are a great danger and should be avoided.”


FRED
Federal Surplus or Deficit [-] as Percent of Gross Domestic Product
2.5
0.0
-2.5
-5.0
-7.5
-10.0
Percent of GDP
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010

Stabilization policy in 1977: Friedman’s dissent—III

- He rejected “the implicit assumption of so much current talk that we know how to fine-tune” (*Newsweek*, Jan. 10, 1977).
- Remained skeptical about numerical estimates of fiscal multipliers.
- Also stressed how the monetary policy stance implied by particular settings of nominal and real interest rates can change.

Professional backsliding and wavering in 1978

- Two economists who, by 1977, had come to share Friedman's views on inflation were Alan Greenspan and Rudiger Dornbusch.
- But, by 1978, both of them showed signs of wavering.
- Greenspan testified (January 19, 1978) that he shared widely held assessment that 5.25 percent unemployment was full employment. At the time, unemployment was 6.4 percent. (*u** now regarded as about 6+ percent in this period: Orphanides and Williams, 2005.)
- Believing 1977–1978's inflation surge occurred amid much slack, Greenspan in 1978 gave credence to the view that U.S. inflation had become disconnected from demand (Romer and Romer, 2004) and saw the U.S. as headed for a rising-unemployment, inflation-ridden ongoing state (*Miami Herald*, September 19, 1978).
- And Dornbusch (testimony, Mar. 7, 1978): "The first priority should be continued expansion in aggregate demand." Also: "Interest rates should *not* be allowed to rise and, indeed, a rollback is desirable." Saw this as consistent with inflation of 6 percent and with proceeding to lower inflation via nonmonetary measures.

Inflation and the Carter Administration—IV

- In October 1978, Carter made Alfred Kahn, known for his deregulation initiatives, the administration's "anti-inflation czar."
  - ♦ Carter: Kahn to be "my new partner in controlling inflation in this country."
- Friedman (*Newsweek*, Nov. 20, 1978): Kahn had done a "remarkable job" on deregulation—but "sheer delusion" to see deregulation as key to disinflation.
  - ♦ Carter June 21, 1979: "The best anti-inflation medicine, in my opinion, is real competition under the American free-enterprise system."
- Friedman was also concerned that in propounding the administration's incomes policy, Kahn in new job would move to ***stifling*** market forces.
  - ♦ Borne out by an early news report on Kahn's views: "If forced to choose, the administration's new inflation czar would opt for mandatory wage and price controls, rather than a recession…" (Oct. 1978 report on Kahn TV appearance.)