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The 1970s and now: Inflation, an unbalanced economy, and tough choices

Lynne Sladky/AP

Vanessa Correa (left) and Gigi Fiske (right) pass out gallons of milk at a food distribution held by the Farm Share food bank in Miami on July 20, 2022. Long lines are back at food banks around the U.S. as many working Americans overwhelmed by inflation look for help feeding their families.

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From the grocery store to the electronics retailer to the car dealership, Americans ask the same question: When will inflation go back down to normal?

The answer is hard, frustratingly so, because the economy looks and acts a lot like a playground seesaw. Although it's constantly in search of balance, occasionally a bully jumps on one end, tipping it toward recession or high inflation. In most periods, there's plenty of time to counteract each bully. Sometimes, though, there's a run of them, one right after the other, making balance almost impossible. That's what happened in the 1970s and that's what is happening today.

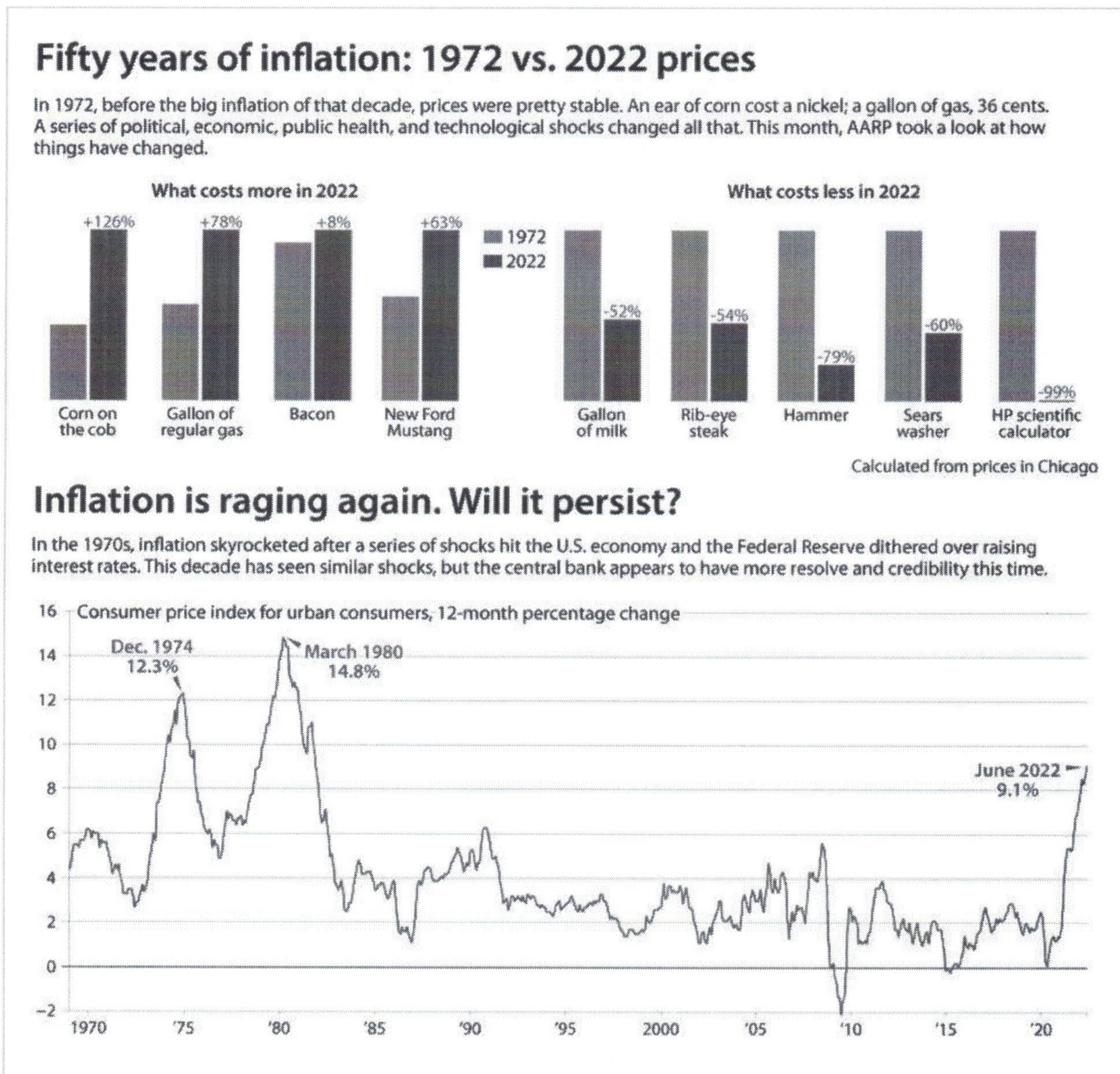
Today the economy, more globalized than it was back then, is in flux due to everything from geopolitical tensions and the pandemic to environmental stresses like drought. Curbing inflation now by boosting the supply of goods is easier said than done.

WHY WE WROTE THIS

Very often, imbalances in the economy resolve themselves in ways that appear almost seamless. Other times, like the current inflation spike, balance is hard to find. One silver lining: A Fed that knows lessons from the 1970s.

"We seem to be in a world where there is less geopolitical stability, where you're more prone to having sustained shocks to commodities," says Jonathan Millar, senior U.S. economist at Barclays investment bank in New York. "And that's just a world that is very challenging for the Federal Reserve."

On Wednesday, the central bank is widely expected to raise short-term interest rates by three-quarters of a percentage point – a hefty hike and the second such increase in a row. By raising lending rates to make economic activity more expensive, the Fed intends to slow the economy enough to beat inflation but not enough to send it crashing into recession. That's a difficult tightrope act, especially when some economists believe the United States is in a recession already.



SOURCE: AARP, U.S. Bureau of Labor Statistics, AAA, Amazon, Jewel-Osco, and Edmunds | Laurent Belsie and Jacob Turcotte/Staff

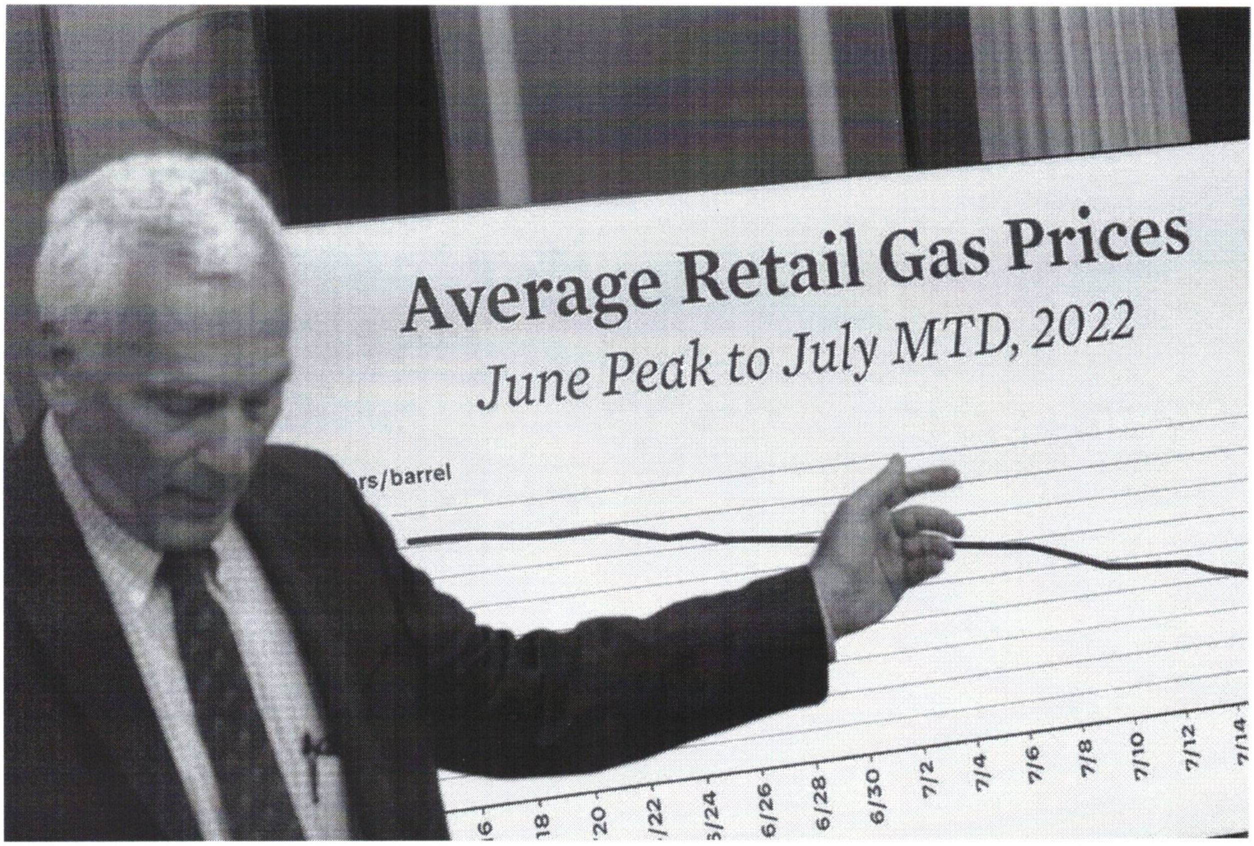
It's just the latest high-wire jump. Already in the 2020s, the central bank – think of the Fed as a playground monitor – has had to negotiate a pandemic and lockdowns around the world, a short but sharp recession, record amounts of government stimulus, and an invasion of Ukraine and subsequent boycotts of Russian energy. These shocks have led to shortages, supply-chain bottlenecks, and boycotts that have tested the resilience of producers and consumers worldwide. "If anything, we have done better than we expected in the last couple of years," says Diego Comin, an economics professor at Dartmouth College.

Up to now, consumers could take some solace in the idea that, as bad as inflation is now, the 1970s was worse. But the more researchers crunch the numbers, the more this period is looking like the 1970s. And that's not good news for long-suffering families.

When Americans complain about the inflationary '70s, what they're really talking about is the period from 1973 to 1980, when inflation peaked early on after the first Arab oil embargo, fell somewhat, then spiked even higher after the second oil embargo. In 1980, for five months in a row, year-over-year inflation stayed above 14%. (By comparison, inflation last month hit 9.1%.)

Then the Fed did something extraordinary. It drove interest rates so high that inflation fell 11 percentage points over three years – a signal achievement, even if it took a deep recession to accomplish it. But there's a caveat. The government measured inflation, specifically housing inflation, differently than it does now.

Measured the new way, that 11-point decline looks more like a 5-point fall – or about the same decline needed today to get inflation back to some semblance of normality, according to a new study for the National Bureau of Economic Research (NBER).



Andrew Harnik/AP

A monitor displays a graph showing average retail gas prices falling since June as Council of Economic Advisers member Jared Bernstein speaks at a press briefing at the White House in Washington, July 18, 2022.

There's another measurement problem: core inflation. The government reports overall inflation and then strips out volatile food and energy prices to describe the more stable, long-term rise in prices: core inflation. That worked well in the 1970s, but in the past two years the relationship between core and overall inflation has broken down, according to Laurence Ball, an economist at Johns Hopkins University in Baltimore. Alternative measures of the core work better and, while they were relatively quiescent six months ago, they've climbed steadily, suggesting that high inflation is spreading far more broadly in the economy than just a few sectors.

How long all this will last is anybody's guess. Dr. Millar of Barclays is optimistic. Barring another economic shock, so many sectors are decelerating that we are already at or near peak inflation, he says. Gas prices, for example, have been falling for a month.

Others are not so optimistic.

"It's too soon, too optimistic to say we've peaked," says Lindsey Piegza, chief economist at Stifel Financial, a wealth management and investment banking firm. "The Fed at this point is focused on inflation, but that's not going to alleviate anything from the supply side."

The central bank is doing its best to tamp down demand for goods and services in order to bring the economy back into balance, but it has no control over supply. And the global economy, which in recent decades did adjust supply relatively quickly, is moving more sluggishly now. Geopolitics and pandemic shutdowns are drowning out the purely economic signals.

That measurement change in housing – using rent instead of mortgage rates to determine costs – also suggests that high inflation could last a while. "Housing makes up 40% of the core CPI measure, and we think that that measure is only going to keep rising for the next 12 months," says Judd Cramer, author of the NBER study, a lecturer at Harvard, and former staff economist for the White House Council of Economic Advisers during the Obama administration. "So it could be the case that the core CPI has not yet peaked."

Consumers are not helpless in all this. They're showing signs of coping with high prices just as their counterparts in the 1970s did: Buying cheaper goods and cutting out purchases they don't absolutely need. Since March, for example, traffic to full-service restaurants has fallen while fast-food visits are increasing. Discount stores report fewer discretionary purchases and more one-stop shopping because gasoline is so high.

That said, the Fed has two big advantages over its counterparts in the 1970s. First, they've learned from the 1970s playbook and understand far more about how inflation works. Second, the Fed has far more credibility today. In the 1970s, the central bank acted in such a wishy-washy fashion that consumers and businesses alike expected high inflation to stay. Today, they expect inflation to fall back to normal levels.

“That is something that’s very good for the Fed: They don’t have to break the expectations” on Wednesday, says Dr. Cramer. Instead, they just have to carry out what markets expect them to.

“The U.S. economy is in a better position to deal with these shocks than we were in the ’70s,” Dr. Cramer adds.
