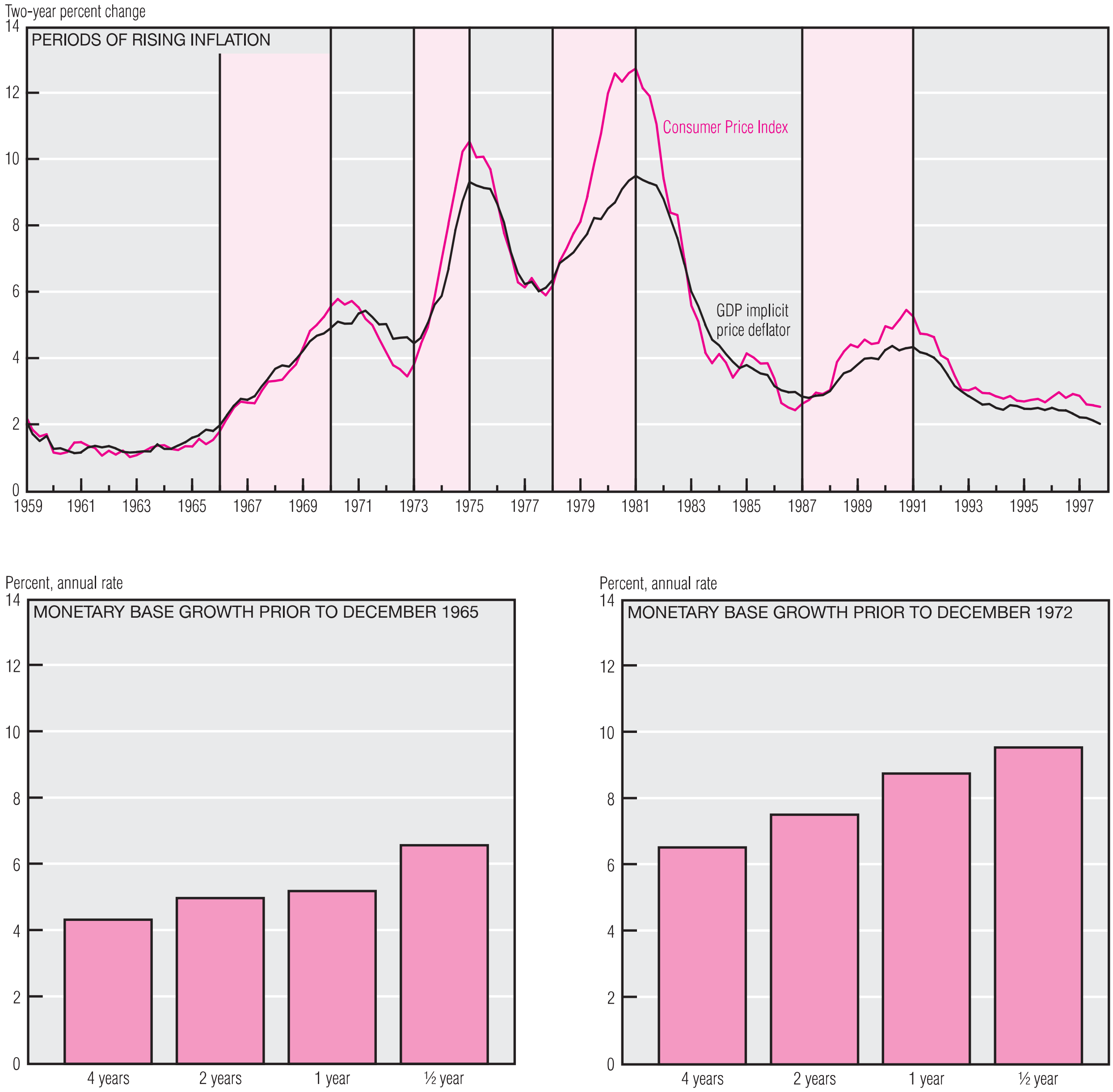
Rising Inflation



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

Since 1959, there have been four distinct periods of persistently accelerating inflation. Although it is difficult to date their beginnings and ends, they correspond roughly to the years 1966–70, 1973–75, 1978–81, and 1987–91. In each of these periods, the inflation rate was substantially higher at the end than at the beginning.

The dominant issue facing monetary policymakers today is whether action is necessary to prevent yet another period of accelerating inflation. In the light of past episodes, two natural questions arise: Have the years preceding each earlier period of accelerating inflation shown a characteristic pattern? And if so, does the recent performance of the economy fit that pattern?

The answer to the first question is yes, there have been broad similarities among the economy's performances before periods of accelerating inflation. The two years preceding each of the four earlier run-ups were characterized by strong output and employment growth. In addition, the growth rate of the monetary base had been rising steadily over the four years prior to each period, most notably in the six to 12 months just before inflation began to accelerate.

These similarities do not imply that strong economic growth causes rising inflation, or that accelerating money growth necessarily results in spiraling prices. The crucial point is whether money supply growth exceeds the increase in a strong

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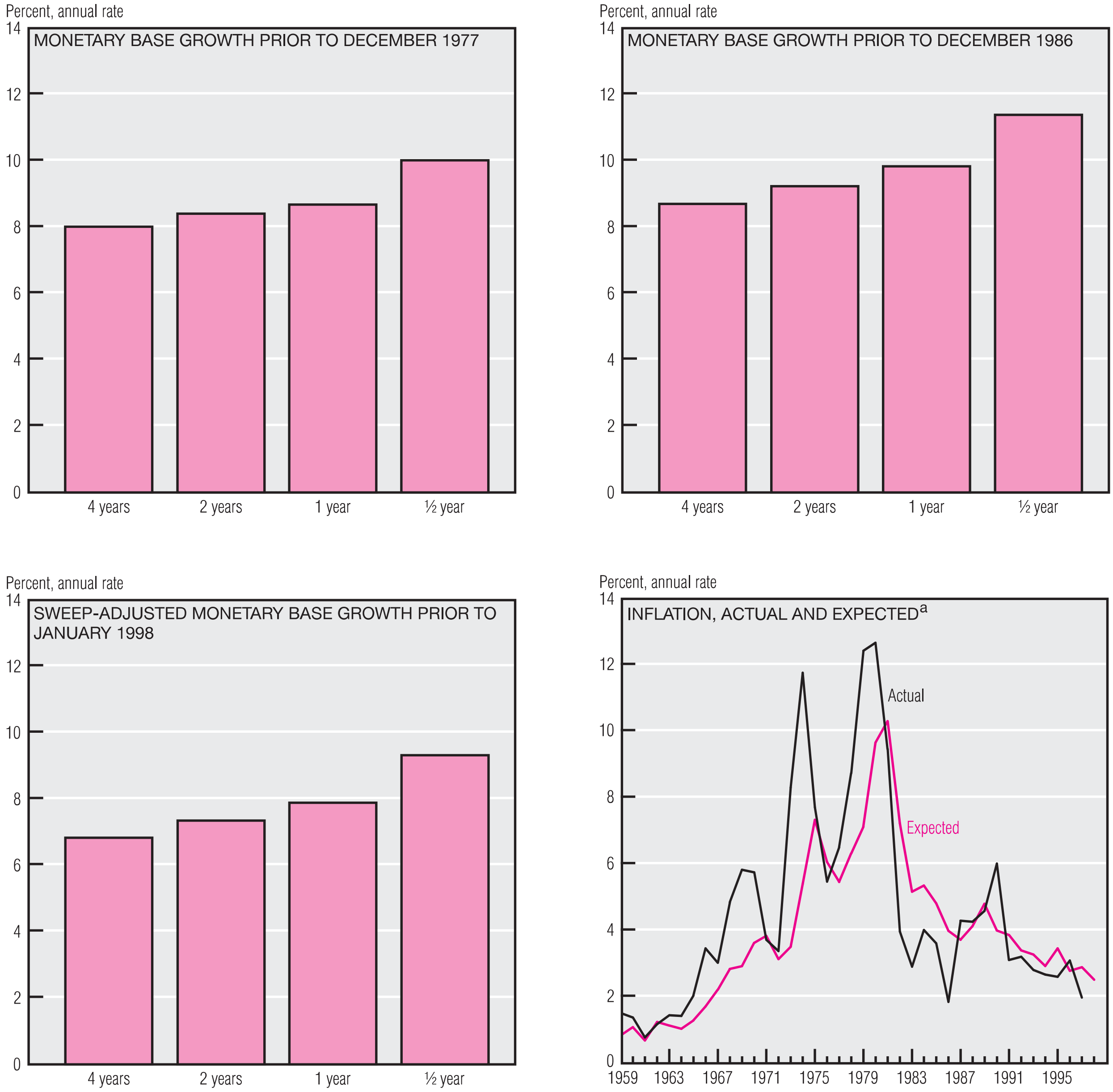
Rising Inflation (cont.)



a. The actual and expected inflation for a given year correspond to the increase and expected increase in the Consumer Price Index for all urban consumers (CPI–U) from October of the previous year through December of the given year.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and the Federal Reserve Bank of Philadelphia, Livingston Survey.

economy's demand for money. The periods discussed do suggest that robust growth has frequently been accompanied by overexpansion in the money supply.

Does the economy's recent performance fit the pattern of those earlier periods? From a very general perspective, the answer is yes. Output and employment growth during the past two years have been strong, and the growth rate of the sweep-adjusted monetary base has increased steadily. Recent years' similarities to earlier preacceleration periods indicate that present concerns about inflation are not unfounded. Furthermore, the fact that inflation is widely expected to remain low cannot comfort those who observe that a similar expectation prevailed before previous run-ups.

As mentioned earlier, similarities between today and earlier preacceleration periods do not guarantee that rising inflation is at hand. There have also been instances in which strong economic growth and rising monetary base growth were *not* followed by increasing inflation.

In the most recent example, base growth accelerated briskly through 1992, a year of fairly strong output growth, yet inflation did not subsequently increase. This may have been the result of an effective monetary policy strategy that responded to current conditions and prevented base growth from exceeding money demand. Moreover, some of the increase in the monetary base may have reflected factors, such as larger currency holdings abroad, which have little connection with domestic economic activity.