

#### 4.1 Early Explanations

Two early conflicting explanations for the run up of inflation from the mid 1960s to 1980 were the monetarist views of Milton Friedman and others who blamed the inflation on overly expansionary monetary policy; and the supply shock view of Alan Blinder, Robert Gordon and others who attributed the high inflation of the 1970s to a series of oil and other supply shocks.

**Poole, Rasche and Wheelock.** The run up of inflation beginning in the mid 1960s led to criticism by the monetarists, Milton Friedman, Anna Schwartz, Karl Brunner and Alan Meltzer who attributed it to expansionary monetary policy. Brunner, Meltzer and Schwartz established the Shadow Open market Committee in 1973 to monitor and critique the actions by the FOMC. Using a simple quantity theoretic model based on stable demand for money function, the SOMC proposed that a gradualist monetary rule reducing the monetary base by 1% per year would achieve price stability with minimal variability in output and employment. The authors simulate such an SOMC rule using a modern New Keynesian model with rational expectations and forward looking agents. Their analysis shows that price stability could have been successfully achieved in the 1970s and with a much lower cost in real output than the ‘cold turkey’ strategy followed in 1979-81 by Paul Volcker.

**Christina Romer** in her comments suggests that a better counterfactual comparison would have been between the SOMC rule and the interest rate control procedure actually used. Her comparison of the prescriptions for monetary aggregate growth given at each of the SOMC biannual meetings with the actual aggregate growth rates reveals that the only period between 1973 and 1990 that the SOMC prescription would have significantly outperformed the Fed was in the mid 1970s under Burns and Miller.

**Blinder and Rudd** revisit the supply shock explanation for the Great Inflation in the 1970s using revised data and new theoretical and econometric techniques. They show that the OPEC I oil price shocks combined with rises in food prices and the end of the Nixon wage price controls account for the rapid run up of headline inflation between 1973-1975 followed by a quick reversal. A second price hill from 1979 to 1980 is explained by OPEC II, food price shocks and other exogenous supply side factors.

Using Phillips curve analysis they also show that some of the supply side shocks passed through via wages and prices to the core CPI which followed a more muted drift upwards. The shocks also largely explained the recessions of 1973-75 and 1979-80. According to these authors, monetary policy only played a minor role in accommodating the exogenous shocks.