Many fear that a recession is looming in the United States. Despite consistently strong job growth in recent quarters, cracks in the global economy and concerns over a possible bursting of the tech bubble are causing economists and ordinary people alike to see a potentially dark future for the U.S. economy. In fact, some have articulated a more specific concern that the U.S. will soon face another case of stagflation. Though the stagflation of the 1970s was several decades ago, its impact continues to haunt many U.S. citizens who remember all too well the difficulties of that time. By looking at what exactly caused the stagflation of the 70s, the U.S. may be able to insulate itself from (or at least mitigate) future stagflation.

This paper begins by explaining what stagflation is as well as why it was so unexpected at the time. Next, I’ll address stagflation’s impact in the United States. Third, I’ll introduce an internal contributor to stagflation in the form of the Employment Act of 1946. Finally, I’ll analyze an external contributor in the two oil shocks of the 1970s.

### The Worst of Both Worlds: What is Stagflation?

Most people are familiar with the general concept of inflation. Simply put, it occurs when the supply of money in an economy outpaces the production of goods and services.\(^1\) This in turn results in the prices of goods and services increasing.\(^2\) In this context, stagnation references an economic environment with high unemployment. Normally, inflation and unemployment share an inverse relationship. Stagflation reflects when these two trends move in the same direction. As British politician Iain Mcleod (the man who coined the term) put it: “We now have the worst of both worlds — not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of 'stagflation' situation, and history in modern terms is indeed being made.”\(^3\) He was right to describe it as “history being made,” because many economists at the time believed stagflation was not possible.\(^4\) This unprecedented condition, in part, explains why it was so dominant for at least a decade in the U.S. It’s hard to fix something that no one knew was possible in the first place. So, considering how unlikely this event seemed, what did stagflation actually look like in the United States?

### Stagflation Hits Home: Stagflation in the U.S.

For average Americans, the impacts of stagflation were easy and frightening to witness. The prices of basic necessities rose continuously, and many consumers felt forced to buy now as they feared prices would rise even higher in the future.\(^5\) This in turn spurred even more inflation as consumer demand seemed to rise everyday. The government tried to mitigate some of the harm by pegging certain payments (like the ones for social security) to the consumer price index, as this was one of the best tools for taking inflation into account.\(^6\) In fact, the annual rate of consumer price increases in 1965 was 1.07% but would rise to 13.70% by 1980.\(^7\) The annual rate would not subside to levels seen in 1965 until 1986.\(^8\)

---

1. [What is Stagflation](https://personalfinance.com/what-is-stagflation), Personal Finance (2022)
2. Id.
3. [What is Stagflation](https://personalfinance.com/what-is-stagflation), Personal Finance (2022)
4. Id.
6. Id.
8. Id.
Ironically, one of the major contributors to this ever-increasing inflation (and thus ever increasing unemployment) was the Employment Act of 1946.

A Call to Action Taken Too Far: The Employment Act of 1946
As noted in the previous paper on the Great Depression, The Employment Act of 1946 gave the government the explicit responsibility to promote “employment, production, and purchasing power.” This mandate was also applied to the Federal Reserve, which was tasked with creating the monetary conditions to achieve these goals. This prerogative would help lead to inflation in the United States for two main reasons. First, as noted above, it gave the government an obligation to be proactive in trying to maintain the best economic conditions. Second, given that this law came out of the Great Depression where government intervention in monetary policies proved helpful, it became the focal point of the government in satisfying their obligations to the public.

However, the problem actually arose from the government assumption that a certain monetary policy would always work. There was a dominant assumption that a “stable, exploitable relationship between unemployment and inflation” existed. Specifically, it was believed you could keep unemployment at low rates by allowing slightly higher rates of inflation. This assumption, known as the “Phillips Curve,” was criticized by leading economists Edmund Phelps and Milton Friedman who feared that a higher than anticipated inflation would be needed to keep unemployment low, which in turn would exacerbate unemployment perpetuating a dangerous cycle. Unfortunately, Phelps and Friedman’s concerns came true as the government tried to rectify the inflation crisis with further increases in interest rates in the hopes that this would stabilize unemployment. The economic hardships of this policy were compounded by a major external shock.

Liquid Gold Beats the Dollar: The Oil Shocks of the 1970s
Few commodities in the modern era hold as much sway over the global economy as oil. Even as countries today move away from traditional fossil fuels, the reverberations of oil and gas price fluctuations were most recently seen following the outbreak of the war in Ukraine. Still, few oil and gas shocks reach the same magnitude as the ones that occurred in the 1970s. The first shock came in October of 1973. There are two likely causes of this shock. The first coincides with U.S. aid to Israel. In response to $2.2 billion dollars of emergency aid being made available to Israel during the Yom Kippur War, OPEC issued an oil embargo against the United States. At the same time the devaluation of the U.S. dollar throughout the 1970s caused OPEC to stop quoting oil prices off of the dollar and start using the price of gold. This rapidly raised the price of gold and damaged the value of the dollar. In turn, the U.S. domestic oil industry lacked the production capabilities to make up for the shortfall caused by the embargo. This contributed significantly to unemployment and inflation as it both made the costs of production higher for many consumer items and stretched the already limited resources of American citizens. Worse still this was only one of the oil shocks the U.S. faced in the 1970s. The second oil shock of the 1970s occurred between 1978 and 1979. Unlike the embargo of the 1973 oil shock, this crisis was caused by the 1978 revolution in Iran. The infighting and subsequent regime change in Iran resulted

---

9 The Great Inflation, Michael Bryan (2013).
10 Id.
11 Id.
13 Id.
14 Id.
in a 7% decline in world oil production. Between 1979 and 1980, oil prices doubled.\textsuperscript{16} Despite the added pressure caused by this shock, the Federal Reserve remained concerned that attempting to slow inflation would hurt unemployment. This concern combined with oil prices rising contributed to a 9% increase in the Consumer Price Index by the end of 1979.\textsuperscript{17}

The Necessary Costs: Escaping Stagflation
By the 1980s, stagflation had become a way of life and the Philip’s Curve’s promise had been shattered. To escape stagflation, the Federal Reserve accepted that they had to choose combatting inflation or unemployment alone and let the other suffer, at least for the short term, to rectify the economic situation. The Reserve went with inflation and slowly worked to raise interest rates and slow monetary reserve growth. This resulted in a particularly hard recession from 1981 to 1982.\textsuperscript{18} Unemployment reached a peak of 11% but annual inflation was back down to 5%.\textsuperscript{19} Thanks to the change in course of inflation, public confidence in the economy rose again and unemployment retreated.

The Stagflation of the 1970s fundamentally changed how the U.S. government viewed the economy. Particularly at the macroeconomic level, the stagflation crisis exposed major blind spots in how the economy was assessed. The role of public expectations shifted from a backdrop consideration to a key takeaway in determining how the economy will perform under certain policies. For example, the absolute faith in the Philip’s Curve encouraged early policymakers to ignore the fact that consumers and business owners quickly began anticipating future inflation which only compounded the unemployment problem rather than helping to resolve it. Another change came from the use of time-consistent policy choices. Time-consistent policies describe policies that do not sacrifice long-term benefits for short-term gains.\textsuperscript{20} The absence of these kind of policies formed the backdrop of early stagflation policies, which instead focused on slow, small policy changes that did not hurt the economy in the short-term, but allowed the underlying problems of inflation to fester. The final change relates to public expectations: policy credibility.\textsuperscript{21} Returning to the Philip’s Curve, the policies clear shortcomings gave the public (and likely many government officials) no reason to believe in the Federal Reserve’s continued endorsement of it. In turn, this led to skepticism about new policies that hurt the adoption of the policy and weakened public confidence that the economy was changing for the better.

Conclusion
It is eerie to see some of the parallels between the economic conditions of the 1970s and our world today. However, it is just as important to note the differences in terms of economic mentality especially at the government level. Further, where inflation continued to rise over the course of several years in the 1970s, recent inflation has come down considerably from its 2022 spike. Further, the external shocks that compounded many of the existing problems in the 70s seem to have been less impactful on the health of the global and U.S. domestic economy under current conditions. Nonetheless, there are important lessons to draw from the stagflation of the 1970s, and they can hopefully be applied today to ensure we can avoid such a crisis again.

\textsuperscript{16} Id.
\textsuperscript{17} Id.
\textsuperscript{18} The Great Inflation, Michael Bryan (2013).
\textsuperscript{19} Id.
\textsuperscript{20} Id.
\textsuperscript{21} Id.