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Inflationary Psychology Has Set In. Dislodging It Won't Be Easy.

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There is a high probability that a self-perpetuating wage-price spiral will develop in the next few years. Households have already become less resistant to paying higher prices and firms have become less resistant to offering higher wages. Prices and wages will continue to spiral upward until the cumulative erosion in inflation-adjusted incomes causes the economy to collapse in recession. It is like the children's game of musical chairs: Everyone knows the game will end, but they feel compelled to keep racing around the circle at an ever-faster pace hoping their forced exit will leave them in the best possible position—even if it still means an inflation-adjusted loss.

This situation has been termed "inflationary psychology." Consumers purposely advance their purchases in order to beat anticipated future price increases. Firms readily pass along higher costs to consumers, including the future cost increases that they anticipate. That's what happened in the last inflationary age, which started in 1965 and ended in 1982: Expected inflation became a self-fulfilling prophecy. Many commentaries assert that the current situation is nothing like the situation faced in 1978-80. That's true, but irrelevant. The more apt comparison would be to the five to ten years prior to that period, when inflation had not yet reached crisis levels. Government officials claimed they had the policy tools that could easily reverse inflation, just as they claim now.

Those policies, however, repeatedly failed across administrations, from Lyndon B. Johnson's surtax, to Richard Nixon's wage and price controls, to Gerald Ford's public relations "Whip Inflation Now" campaign, and Jimmy Carter's fireside pleas to diminish material aspirations. Only after Paul Volcker was appointed Federal Reserve chair and raised the fed funds rate to 20% in 1980 did inflation begin to fall. He pushed up rates aggressively, by 10 percentage points in just six months. The resulting 10% unemployment rate was needed to reduce inflation by 10 percentage points.

Today's mantra is, "This time is different." Supply disruptions were said to be transient, and the inflation rate would soon fade. The University of Michigan's survey confirmed that shortages were important, and those shortages played an initial role in raising inflation expectations. Awareness of shortages has remained high, mentioned by half of all consumers in the past nine months. Nonetheless, shortages are no longer associated with higher inflation expectations—their inflation expectations now differ by less than one-tenth of a percentage point.

Consumers quickly adopted the notion that inflation had multiple causes, focusing on the growth in federal spending and expansionary monetary policy as the dual driving forces. Pandemic transfers and relief payments produced extraordinary increases in household incomes. The income gains meant that household budgets could easily withstand higher prices. These transfers meant survival for many households, with some quickly exhausting their funds. Most workers still remained employed and boosted their spending. A good deal of those funds were added to their savings and reserves, which will constitute a more-lasting offset to higher prices.

Several other associated findings from the University of Michigan's consumer sentiment survey are also relevant. Although consumers have increasingly expected higher inflation, they have also expected a strong job market and rising wages, especially among consumers under age 45. In the year ahead, wage gains will continue to reduce resistance to rising prices among consumers, and the ability of firms to easily raise their selling prices will continue to reduce their resistance to increasing wages. Thus, the essential ingredients of a self-perpetuating wage-price spiral are now in place: rising inflation accompanied by rising wages.

The Federal Reserve has the difficult task of balancing reductions in inflation against job losses. When consumers were recently asked which was the more critical problem facing the nation, nearly nine-in-ten cited inflation. The erosion in living standards due to rising inflation was the most common complaint when consumers were asked to describe in their own words how their finances had recently changed. While the initial rise was among the lowest-income households, those complaints have rapidly spread to middle- and upper-income households. Surging gas, food, and housing prices have forced nearly all families to go through the painful process of deciding which normally purchased items they could no longer afford.

Importantly, the majority of today's consumers did not experience the accelerating inflation of the 1970s. Most have personally experienced only very low inflation, with a few short-lived spikes in oil prices. This lack of experience has magnified their reactions to the higher inflation rate that now prevails. Another critical characteristic of the earlier inflation era was frequent temporary reversals in inflation, only to be followed by new peaks. That same pattern should be expected in the months ahead.

Most consumers expect the government to undertake policy actions to curb inflation. Indeed, the largest proportion of consumers in the past half-century have expected the Fed to hike interest rates. Given that the fed funds rate had lingered for an extended period near zero, that was not a hard call to make. What was perhaps more surprising was that the quarter-point hike the Fed adopted in March was simply too small to signal an aggressive defense against rising inflation. Instead, it signaled the continuation of a strong labor market along with an inflation rate that would continue to rise.

Much more aggressive policy moves against inflation may arouse some controversy. Nonetheless, they are needed. Adam Smith's legendary invisible hand describes how individuals acting in their own self-interest can create unintended benefits for the entire society. Unfortunately, the country now faces the potential for an inflationary hand that can transform self-interested decisions into losses for the entire economy.

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