UNITED STATES GOVERNMENT

memorandum

DATE: September 9, 1982

REPLY TO ATTN OF: Paul Krugman, Larry Summers

SUBJECT: Inflation During the 1983 Recovery

TO: Martin Feldstein, William Poole

I. The Inflation Time Bomb?

We believe that it is reasonable to expect a significant reacceleration of inflation in the near future. Much of the apparent progress against inflation has resulted from the temporary side effects of tight money and high real interest rates. These side effects must be expected to reverse themselves as real interest rates decline and the economy expands. They include:

- A U.S. real exchange rate well above reasonable estimates of a long-run equilibrium level. The real exchange rate is now 35.4 percent above its 1980:I level, and 23.7 percent above its average level during the period 1973-1981.

- Very low real commodity prices. The IFS index of non-oil commodity prices has fallen 33 percent relative to the U.S. CPI since early 1980. Real crude food prices have declined 15 percent over the same period. These low commodity prices are at least in large part a result of unsustainably high real exchange rates and real interest rates.

As real intrest rates decline and the economy recovers, we can expect the real exchange rate and real commodity prices to return to approximately their historical levels. Our very rough guess is that correction of these distorted relative prices will add five percentage points to future increases in consumer prices and about two percent to the GNP deflator. This estimate is conservative in that it assumes stable oil prices.

II. How Much Real Progress Has Been Made Against Inflation?

The foregoing suggests that a significant portion of the slowing of consumer price inflation since 1980 does not represent a reduction in the underlying rate.

- The underlying rate of inflation was never in double digits. The peak rates of inflation in 1979 and 1980 were importantly due to dollar depreciation, mortgage interest rates, and OPEC II.

OPTIONAL FORM NO. 10 (REV. 7-76)

- o Consumer price increases in the last year and a half have been below the underlying rate because of real appreciation and declining real commodity prices. Even if these relative prices level off, the inflation rate will rise, because of the removal of this bonus.

- o All the econometric evidence suggests that changes in inflation depend on the rate of change much more than the absolute level of slack (however measured). We have benefitted from the economy's precipitous decline; we should expect a bulge as the economy recovers.

- o A harrowing reminder -- CIF inflation surrounding the last recession followed the pattern.:

1974	12.2%
1975	7.0%
1976	4.8%
1977	6.8%
1978	9.0%

cc: WN, EH, AW