The Financial Origins of the Rise and Fall of American Inflation

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March 2020
The Great Inflation (1965–1982)

1. A defining event in economics
   - inflation got out of control despite high interest rates
   - Keynesian toolbox stopped working: high inflation without low unemployment → a crisis of understanding

2. Standard narrative blames the Fed
   - did not raise rates aggressively enough
     (Taylor coefficient < 1; e.g., Clarida, Gali, & Gertler 1999)
     ⇒ Fed lost credibility → higher inflation expectations → inflation spiral

3. Ended by Paul Volcker who restored Fed credibility
   - raised rates and kept them high despite severe 1981–82 recession
   - credited with lower inflation and longer expansions that followed
     ⇒ credibility view underlies monetary policy theory and practice today
The Great Inflation

1. Fed funds rate and CPI inflation, annual over following year:

<table>
<thead>
<tr>
<th>Year</th>
<th>Fed funds rate</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965.I</td>
<td></td>
<td>0.04</td>
</tr>
<tr>
<td>1980.IV</td>
<td></td>
<td>0.16</td>
</tr>
</tbody>
</table>

2. Inflation rose from 2% in 1965 to 14% in 1979, back to 2% in 1982
   - 1965.I: start of Great Inflation
   - 1980.IV: Volcker’s credibility-restoring rate hike

Drechsler, Savov, and Schnabl (2020)
This paper

We propose and test a new explanation for the Great Inflation

1. Due to imposition and repeal of Regulation Q
   - an important law that placed hard ceilings on bank deposit rates
   - deposits were the main form of saving for most households
     → Reg Q suppressed the return to saving
   - disabled the transmission of monetary policy to households:
     → no passthrough of Fed funds rate to deposit rates
1. 1965.I: Reg Q deposit rate ceiling becomes binding
2. No passthrough of Fed funds rate to deposit rates
1. 1965.I: Reg Q deposit rate ceiling becomes binding
2. No passthrough of Fed funds rate to deposit rates
3. Real deposit rate increasingly negative:
   - from +2% in 1964 to −8% in 1979 (real Fed funds rate ∼ 0)
   - real deposit rate × deposits/consumption ≈ 4% of consumption
2. How does Reg Q raise inflation?

- suppressed return to saving $\rightarrow$ higher incentive to spend (aggregate demand $\uparrow$) $\rightarrow$ upward pressure on prices $\rightarrow$ higher inflation

- spiral: higher inflation $\rightarrow$ lower real deposit rate $\rightarrow$ demand increases further $\rightarrow$ inflation increases further . . .

- similar to nominal rate peg as in Friedman (1968), but with Reg Q as the relevant peg
A new explanation for the Great Inflation

3. What broke the inflation spiral?
   - Reg Q effectively repealed in late 1978–79 with the introduction of new, deregulated deposit accounts
   - deposit rates immediately shot up far above the old ceilings
   - households poured vast sums into the new accounts:
     $462$ billion $= 16.2\%$ of GDP ($\sim$ $3.5$ trillion in 2019)
   - removed incentive to spend, no more upward pressure on prices
Repeal of Regulation Q

2. Passthrough restored from near 0 to almost 1
3. Deposit rates immediately shot up far above the old ceilings
Repeal of Regulation Q


2. Passthrough restored from near 0 to almost 1

3. Real deposit rate shot up from −8% in 1979 to 0% in '80 and +4% in '81
1. Timing: quarterly inflation peaks 3 quarters before Volcker’s hike in 1980.IV, inflation already down to 7.3% by 1980.III

2. Inflation expectations: 10-year rate remained at pre-Volcker levels until 1985!
   ⇒ investors expected inflation to return, goes against credibility view
The transmission view of monetary policy

➢ The Great Inflation was due to a failure of monetary policy transmission, not the Fed’s policy rule

- inflation spiral resulted from a large friction in the financial system and ended when the friction was removed
Empirical results overview

1. Aggregate time series

2. Cross-sectional tests using data on local deposits and inflation
   - use CPI and wage inflation data at the MSA level
   - local deposit data from Call Reports and Savings and Loans (S&Ls) Financial Reports

3. Use four plausibly exogenous sources of geographic variation in exposure to Reg Q
   - due to staggered imposition and repeal of Reg Q across different types of deposits, and for banks vs S&Ls

⇒ All four tests show a large cross-sectional impact of Reg Q on inflation; magnitude and timing can explain Great Inflation
Related literature

1. **The Great Inflation**: Friedman (1968); Sargent and Wallace (1975); Kydland and Prescott (1977); Barro and Gordon (1983); Romer and Romer (1989); Taylor (1993); Clarida, Gali, and Gertler (1999)
   - emphasize Fed credibility and expectations, our focus is on transmission through the financial system

2. **Regulation Q**: Samuelson and Skidmore (1967); Tobin (1970); Friedman (1970); Kane (1980); Wojnilower (1980); Burns (1988); Gilbert (1986); White (1991)
   - believed Reg Q reduced inflation by constraining money and credit, we find the opposite is true, due to suppressed return to saving

   - deposits important for credit supply, our focus is on inflation

4. **Liquidity trap and ZLB**: Krugman (1998); Eggertsson and Woodford (2003); Svensson (2003); Woodford (2012); Summers (2014); Farhi and Werning (2016); Guerrieri and Lorenzoni (2017)
   - emphasize ZLB (deposit rate floor), analogous to Reg Q (deposit rate ceiling)
History of Regulation $Q$

1. Enacted in 1933 following Depression bank failures

2. In order to prevent “excess competition” for insured deposits by banks wanting to take risk

3. Until 1965: the Fed kept the ceiling rate well above the Fed funds rate $\rightarrow$ non-binding
   - only prevented banks who wanted to pay anomalously high rates

4. In 1965: Fed stopped raising ceiling, letting it bind to slow money and credit growth to prevent economy from overheating

$\Rightarrow$ Fed believed Reg $Q$ was reducing inflation
Empirical strategy

Did Regulation $Q$ increase inflation?

⇒ Analyze cross-sectional variation in exposure to Reg $Q$ to control for aggregate economic conditions and monetary policy, e.g. Fed credibility

Identification challenge:

Exposure to Reg $Q$ and inflation may be reacting to local economic conditions (omitted variable)

⇒ Four natural experiments covering rise and fall of inflation:

1. Regulation $Q$ first becomes binding (1965–66)
2. NOW Account Experiment (1974–80)
3. Deregulation of small time deposits (1978–79)
4. Local interest rate passthrough (1966–84)
Data

Deposits:


Inflation:

1. CPI inflation (BLS, 25 largest MSAs, 1965–90)

2. Wage inflation (nominal wage growth):
   - all private sector employees (BLS, 316 MSAs, 1975–90)
   - manufacturing employees (BLS, 169 MSAs, 1972–90)
Measures

We compute local deposit rates and inflation

Inflation:

1. Compute MSA-level inflation using local CPI/nominal wages
2. Computed over 1- and 2-year period, rolled over quarterly
3. Data shows substantial differences in local inflation

Deposit:

1. Deposit supply limited to local banks/S&Ls (pre interstate banking)
2. Compute local deposit rates and quantities using all banks/S&Ls in the given MSA

Drechsler, Savov, and Schnabl (2020)
1. Reg Q became binding for banks in 1965.1

2. S&Ls were exempt from Reg Q until September 1966
   - due to being regulated by FHLBB, not Fed

⇒ Reg Q less binding in S&L dominated areas over 1965.1–66.III
   - these areas should see less inflation increase

3. Identification assumption: S&L share is predetermined, not correlated with unobserved factors affecting inflation in 1965-66
   - historically determined and highly persistent
S&Ls and inflation, 1965–66

\[ \pi_{i,t-1\rightarrow t+1} = \alpha_t + \beta_t (S&L \text{ Share})_{i, 1966.III} + \epsilon_{i,t} \]

1. Shows inflation increases less in S&L-dominated areas once Reg Q becomes binding for banks in 1965.I

2. Gap disappears once S&Ls become subject to Reg Q in 1966.III
### S&Ls and inflation, 1965–66

<table>
<thead>
<tr>
<th></th>
<th>Inflation (1966.I)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>S&amp;L share</td>
<td>−0.028**</td>
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<tr>
<td></td>
<td>(0.012)</td>
</tr>
<tr>
<td>Deposit growth</td>
<td>0.035</td>
</tr>
<tr>
<td></td>
<td>(0.092)</td>
</tr>
<tr>
<td>Asset growth</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>0.063***</td>
</tr>
<tr>
<td></td>
<td>(0.005)</td>
</tr>
<tr>
<td>Obs.</td>
<td>25</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.198</td>
</tr>
</tbody>
</table>

1. Shows inflation was 2.7% lower in 1966.I in S&L-dominated areas
2. National inflation rose by $\sim 2.7\%$ between 1965.I and 1966.III, when Reg Q became binding everywhere
   → Reg Q can explain the increase in aggregate inflation

*Drechsler, Savov, and Schnabl (2020)*
NOW Account Experiment (middle of Great Inflation)

1. In 1972, a small bank in Worcester, MA, created the “NOW Account” (interest-paying checking account, 0 → 5%)

2. Violated Reg Q → other banks sued for “unfair” competition

3. In surprise move, MA Supreme Court authorized NOW accounts for state-chartered banks

4. National banks now lobbied D.C. to allow NOW accounts → in 1974, Congress authorized NOW Accounts in MA and NH only

5. Hugely popular: 80% penetration rate in MA

6. Staggered roll-out to neighboring states by geographic proximity
Staggered roll-out in North East

- NOW Account Experiment starts in MA and NH in 1974.I
- Expands to rest of New England in 1976.I
Staggered roll-out in North East

- Expands to New York in 1978.I

Drechsler, Savov, and Schnabl (2020)
Staggered roll-out in North East

- Expands to New Jersey in 1979.I
Staggered roll-out in North East

- Expands to all of U.S. in 1980.IV
Empirical strategy: NOW Account Experiment

1. A partial repeal of Reg Q

2. Sample: all MSAs with CPI or nominal wage data, 1971–83

3. Exploit staggered roll-out for identification:

   \[ \text{Inflation}_{it} = \alpha_i + \gamma_t + \beta \text{Deregulated}_{it} + \varepsilon_{it} \]

   \( \text{Deregulated}_{it} = \) Indicator variable if MSA\(_{it} \) allows NOW accounts

4. Identification assumption: Roll-out driven by geographic proximity, not local inflation or economic activity
Results: NOW Account Experiment

\[
\text{Inflation}_{it} = \alpha_i + \gamma_t + \beta_t \text{Deregulated}_{it} + \varepsilon_{it}
\]

1. Introduction of NOW Accounts lowers inflation rate
   - effect is largest in earlier states, where NOW account penetration was highest
   ⇒ Economically large given partial repeal of Reg Q

Drechsler, Savov, and Schnabl (2020)
Results: NOW Account Experiment

\[ \text{Inflation}_{it} = \alpha_i + \gamma_t + \beta \text{Deregulated}_{it} + \varepsilon_{it} \]

<table>
<thead>
<tr>
<th></th>
<th>Inflation</th>
<th>Wage inflation (all)</th>
<th>Wage inflation (manuf.)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deregulated</strong></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td></td>
<td>-1.203***</td>
<td>-1.228***</td>
<td>-1.400***</td>
</tr>
<tr>
<td></td>
<td>(0.426)</td>
<td>(0.406)</td>
<td>(0.358)</td>
</tr>
<tr>
<td><strong>Empl. growth</strong></td>
<td>0.173***</td>
<td>0.407***</td>
<td>0.192***</td>
</tr>
<tr>
<td></td>
<td>(0.035)</td>
<td>(0.041)</td>
<td>(0.071)</td>
</tr>
<tr>
<td><strong>Time FE</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>MSA FE</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Obs.</strong></td>
<td>1,300</td>
<td>1,300</td>
<td>10,021</td>
</tr>
<tr>
<td><strong>MSAs</strong></td>
<td>25</td>
<td>25</td>
<td>315</td>
</tr>
<tr>
<td><strong>R^2</strong></td>
<td>0.903</td>
<td>0.910</td>
<td>0.603</td>
</tr>
</tbody>
</table>

⇒ Introduction of NOW Accounts lowers inflation rate by \( \sim 1.2\% \)

- Robust to controlling for employment growth
The Repeal of Reg Q (the end of the Great Inflation)

   - response to pressure from households and competition to banks from nascent money market funds

2. New deposits paid close to the Fed funds rate $\rightarrow$ deposit rate jumped from 5% in 1978.II to 12% in 1979.IV

3. Households responded en masse: $462$ billion in 2 years $\sim 50\%$ of deposits $= 16.2\%$ of GDP $\sim 3.5$ trillion in 2019

$\Rightarrow$ Effective repeal of Reg Q, restores passthrough of monetary policy
Empirical strategy

1. Examine impact of take-up of deregulated accounts on inflation
2. Identification challenge: take-up could be correlated with economic activity
3. Use share of small time deposits in 1975 (three years prior):
   - checking, savings, and time deposits differ in their maturity and liquidity → imperfect substitutes
   - deregulated accounts most substitutable with other small time deposits
   ⇒ take-up should be larger in areas with traditionally more small-time deposits
4. Identification assumption: 1975 small time deposit share only affects inflation through take-up of deregulated accounts
   - economic conditions in 1975 (low inflation) are very different than in 1978 (high inflation)
OLS regression: inflation

\[ \Delta \text{Inflation}_{i,78.\text{III} \rightarrow t} = \alpha_t + \beta_t \text{MMC Share}_{i,t} + \epsilon_{i,t} \]

1. Inflation drops much more in MSAs with high MMC take-up
   - coefficient peaks at \(-0.4 \rightarrow 40\%\) less inflation in 100\% vs. 0\% take-up MSAs

\[ \Rightarrow \] Agg. MMC share 0.28 \rightarrow 11.2\% decline in agg. inflation

Drechsler, Savov, and Schnabl (2020)
OLS regression: inflation

\[ \text{Inflation}_{it} = \alpha_i + \delta_t + \beta \text{MMC Share}_{it} + \varepsilon_{it} \]

<table>
<thead>
<tr>
<th></th>
<th>Inflation (1978.III = 0)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>MMC share</td>
<td>$-0.240^{***}$</td>
</tr>
<tr>
<td></td>
<td>(0.064)</td>
</tr>
<tr>
<td>Inflation, pre-period</td>
<td>0.200</td>
</tr>
<tr>
<td></td>
<td>(0.140)</td>
</tr>
<tr>
<td>Employment growth</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Time FE</td>
<td>Yes</td>
</tr>
<tr>
<td>MSA FE</td>
<td>No</td>
</tr>
<tr>
<td>Obs.</td>
<td>300</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.577</td>
</tr>
</tbody>
</table>

1. Table shows average effect over 1978.III–1981.III

2. Large, very significant relation between MMC take-up and inflation
   - robust to controlling for pre-period inflation and employment growth

Drechsler, Savov, and Schnabl (2020)
IV first stage

1. Use small-time share in 1975.III to instrument for MMC take-up
2. Binscatter plot, 316 MSAs

3. Large variation in small-time deposit share and MMC take-up
   - 10% higher 1975 small-time share $\rightarrow$ 4.2% higher MMC take-up
**IV second stage: inflation**

\[
\text{Inflation}_{it} = \alpha_i + \delta_t + \beta \widehat{\text{MMC Share}}_{it} + \varepsilon_{it}
\]

<table>
<thead>
<tr>
<th></th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>MMC share</td>
<td>-0.243***</td>
</tr>
<tr>
<td></td>
<td>(0.086)</td>
</tr>
<tr>
<td>Past inflation</td>
<td>0.227</td>
</tr>
<tr>
<td></td>
<td>(0.148)</td>
</tr>
<tr>
<td>Empl. growth</td>
<td>-0.174</td>
</tr>
<tr>
<td></td>
<td>(0.159)</td>
</tr>
<tr>
<td>Time FE</td>
<td>Yes</td>
</tr>
<tr>
<td>Obs.</td>
<td>300</td>
</tr>
<tr>
<td>Weak IV p-val</td>
<td>0.00</td>
</tr>
</tbody>
</table>

1. IV coefficients are very similar to OLS
   - robust, economically large, and highly significant
Reduced form: wage inflation

1. Binscatter plot, 316 MSAs


2. 10% higher 1975 small time deposit share $\rightarrow$ 1% lower wage inflation
IV second stage: wage inflation

\[
\text{Wage inflation}_{it} = \alpha_i + \delta_t + \beta \text{MMC Share}_{it} + \epsilon_{it}
\]

<table>
<thead>
<tr>
<th>Wage inflation</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>MMC Share</td>
<td>-0.159***</td>
<td>-0.157***</td>
<td>-0.144***</td>
<td>-0.143***</td>
</tr>
<tr>
<td></td>
<td>(0.026)</td>
<td>(0.027)</td>
<td>(0.026)</td>
<td>(0.028)</td>
</tr>
<tr>
<td>Past wage infl.</td>
<td>-0.015</td>
<td></td>
<td>-0.008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.048)</td>
<td></td>
<td>(0.045)</td>
<td></td>
</tr>
<tr>
<td>Empl. growth</td>
<td></td>
<td>0.137**</td>
<td>0.138**</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.057)</td>
<td>(0.057)</td>
<td></td>
</tr>
<tr>
<td>Time FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Obs.</td>
<td>3,615</td>
<td>3,555</td>
<td>3,615</td>
<td>3,555</td>
</tr>
<tr>
<td>Weak IV p-val</td>
<td>0.009</td>
<td>0.005</td>
<td>0.004</td>
<td>0.002</td>
</tr>
</tbody>
</table>

1. Large, highly significant impact of MMC take-up on wage inflation
   - 100% increase in MMC take-up → reduces wage inflation by 16%

⇒ Agg. deregulated share 0.28 → 4.5% decline in agg. wage inflation
   (similar to actual decline)
Inflation: timing

\[ \Delta \text{Inflation}_{i,78.III \rightarrow t} = \alpha_t + \beta_t \text{MMC Share}_{i,1981.III} + \epsilon_{i,t} \]

1. Cross-sectional effect of take-up occurs right at time of deregulation
   - leads aggregate by 3 quarters

Drechsler, Savov, and Schnabl (2020)
Wage inflation: timing

\[ \Delta \text{Wage inflation}_{i,78.III \rightarrow t} = \alpha_t + \beta_t \text{MMC Share}_{i,1981.III} + \epsilon_{i,t} \]

1. Cross-sectional effect of take-up occurs right at time of deregulation
   - leads aggregate by 3 quarters
S&Ls and deposit passthrough

1. Average deposit rates of banks and S&Ls:

2. S&Ls had even lower passthrough than banks during Reg Q period
   - by regulation they had longer-duration assets (mortgages) → issued more long-term time deposits
   - after Reg Q was repealed (MMC line) passthroughs equalized

⇒ Inflation should be less responsive to Fed funds rate changes in S&L-dominated areas
   - difference should disappear after Reg Q was lifted

Drechsler, Savov, and Schnabl (2020)
First stage: S&Ls and local deposit passthrough

<table>
<thead>
<tr>
<th></th>
<th>Average deposit rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>S&amp;L share × Fed funds</td>
<td>−0.301***</td>
</tr>
<tr>
<td></td>
<td>(0.045)</td>
</tr>
<tr>
<td>S&amp;L share</td>
<td>0.019***</td>
</tr>
<tr>
<td></td>
<td>(0.005)</td>
</tr>
<tr>
<td>Empl. growth</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(0.007)</td>
</tr>
<tr>
<td>Inflation, lag</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Obs.</td>
<td>1,079</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.890</td>
</tr>
</tbody>
</table>

1. S&Ls had $\sim 0.3$ lower passthrough than banks
   ⇒ use S&L share $\times$ Fed funds rate to instrument for deposit rate
Reduced form: S&Ls and local deposit passthrough

<table>
<thead>
<tr>
<th></th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td><strong>S&amp;L share × Fed funds</strong></td>
<td>0.452***</td>
</tr>
<tr>
<td></td>
<td>(0.171)</td>
</tr>
<tr>
<td><strong>S&amp;L share</strong></td>
<td>0.036*</td>
</tr>
<tr>
<td></td>
<td>(0.021)</td>
</tr>
<tr>
<td><strong>Empl. growth</strong></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td><strong>Inflation, lag</strong></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>Time FE</strong></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>MSA FE</strong></td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Obs.</strong></td>
<td>1,079</td>
</tr>
<tr>
<td><strong>$R^2$</strong></td>
<td>0.066</td>
</tr>
</tbody>
</table>

1. When Fed tightens by 1%, inflation is $\sim 0.5\%$ higher in areas with S&L share of 1 vs. 0
   - robust to controlling for employment growth, lagged inflation

*Drechsler, Savov, and Schnabl (2020)*
**IV: S&Ls and local deposit passthrough**

<table>
<thead>
<tr>
<th></th>
<th>Inflation</th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td>Deposit rate</td>
<td>−1.503**</td>
<td>−1.779***</td>
<td>−1.357**</td>
<td>−1.637***</td>
</tr>
<tr>
<td></td>
<td>(0.619)</td>
<td>(0.590)</td>
<td>(0.642)</td>
<td>(0.631)</td>
</tr>
<tr>
<td>S&amp;L share</td>
<td>0.064***</td>
<td>0.060***</td>
<td>0.008**</td>
<td>0.010**</td>
</tr>
<tr>
<td></td>
<td>(0.018)</td>
<td>(0.019)</td>
<td>(0.004)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>Empl. growth</td>
<td>0.179***</td>
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</tr>
<tr>
<td></td>
<td>(0.038)</td>
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<td>Inflation, lag</td>
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<td></td>
<td>(0.063)</td>
<td>(0.064)</td>
</tr>
<tr>
<td>Time FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>MSA FE</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Obs.</td>
<td>1,079</td>
<td>904</td>
<td>1,075</td>
<td>900</td>
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<tr>
<td>Weak IV F-stat</td>
<td>45</td>
<td>74</td>
<td>26</td>
<td>40</td>
</tr>
<tr>
<td>p-val</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
</tbody>
</table>

1. 1% increase in deposit rate lowers inflation by $\sim 1.6\%$
   - can account for Great Inflation: $1.6 \times 6\% = 9.6\%$ increase in inflation
S&Ls and local deposit passthrough

\[ \Delta \text{Inflation}_{i,t} = \alpha_t + \beta_t (\text{S&L share})_{i,t} + \epsilon_{i,t} \]

1. Inflation responds less to Fed tightening in S&L-denominated MSAs
2. Relationship disappears after Reg Q is repealed (MMC line)
Takeaways

1. Propose and test a new explanation for the Great Inflation

2. Due to Reg Q, which disabled monetary policy transmission

3. the Great Inflation was the result of a serious financial friction, not the Fed’s policy rule

⇒ post-1982 low inflation/interest rates may be much less dependent on aggressive interest-rate policy than is argued by the standard narrative

- once the friction was removed, inflation went back to low levels
- inflation and interest rates were very low prior to the Great Inflation
- and for most of history

- Explains why high inflation is not “just around the corner”
Appendix
Historical context

Yield on 10-Year U.S. Government Bond

Source: Homer and Sylla (2005), Global Financial Data

1. Inflation was low before and after the Great Inflation
2. The Great Inflation is a historical anomaly
Median household asset allocation

1. Data from first Survey of Consumer Finances (1983):
   - 94% of 5th decile households had deposits vs 15% stocks, 4% MMF

2. Median household had 28% of total assets in deposits

3. 76% of liquid assets → important for marginal savings

Drechsler, Savov, and Schnabl (2020)