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Return of 1970s era high inflation?

20 May 2022

- Inflation in the US has risen to the highest level since the 1980s and wages are rising, too. Similarities in conditions between now and the late 1960s, of rising inflation and wages, are fuelling fears of entrenched high inflation.
- In the late 1960s, the policy responses of the Federal Reserve (FRB) led to a protracted period of economic overheating. Inflation and rising wages altered people's inflationary expectations, leading to the subsequent acceleration of inflation from the 1970s onwards.
- The post-Covid wage increase was in part caused by a short-term economic boom, which may come down as economic growth slows. This time, the Fed has been quick to act to tighten monetary policy and, thus, inflation expectations have stabilised; we are not likely to see a repeat of the high inflation of the 1970s this time.

In the US, the March 2022 CPI in core terms (excluding energy and food) rose to 6.5% year-on-year, the highest inflation rate since the 1980s. The Fed, which until the middle of last year had viewed inflation as transitory, has pivoted dramatically to a hawkish stance, becoming increasingly alarmed by high and persistent inflation and taking aggressive tightening measures in 2022. In addition to raising interest rates and implementing quantitative tightening policies ahead of schedule, the May FOMC also raised the policy rate significantly by 50 bps in a single meeting.

The sharp rise in inflation over the past year has triggered fears in financial markets that not only has the era of low inflation that began in the mid-1990s come to an end, but that a protracted period of high inflation, similar to that of the 1970s and early 1980s, is about to return.

We will discuss the Fed's policy response, the risk of a return to high inflation and high wage growth, as in the 1970s in this report.

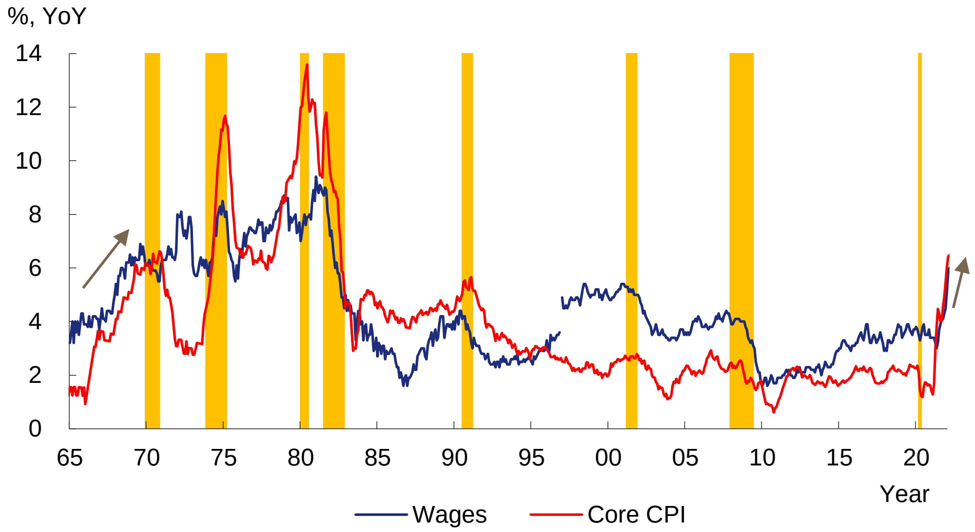
Naoki Murakami
Senior Economist

“Looming fears of high inflation of 1970s”

Let's look back at inflation and wages in the US in the late 1960s, which are considered the remote cause of the high inflation of the 1970s. Inflation was very subdued in the US until the early 1960s. From around 1965, inflation rose gradually, and by 1966 inflation was in the 3% range and nominal wage growth was around 4% year-on-year. Then, with rising inflation, wage growth accelerated further to the 6% level from early 1967 to mid-1968, and to the 7% level in 1969. We believe that during this period, people's expectations of higher wages built up and inflation run its course. Subsequently, from the 1970s onwards, wages remained firmly above 7% and a regime of high inflation became entrenched (Figure 1).

"Comparison of recent wage increases with late 1960s"

Figure 1: Wages and Core CPI



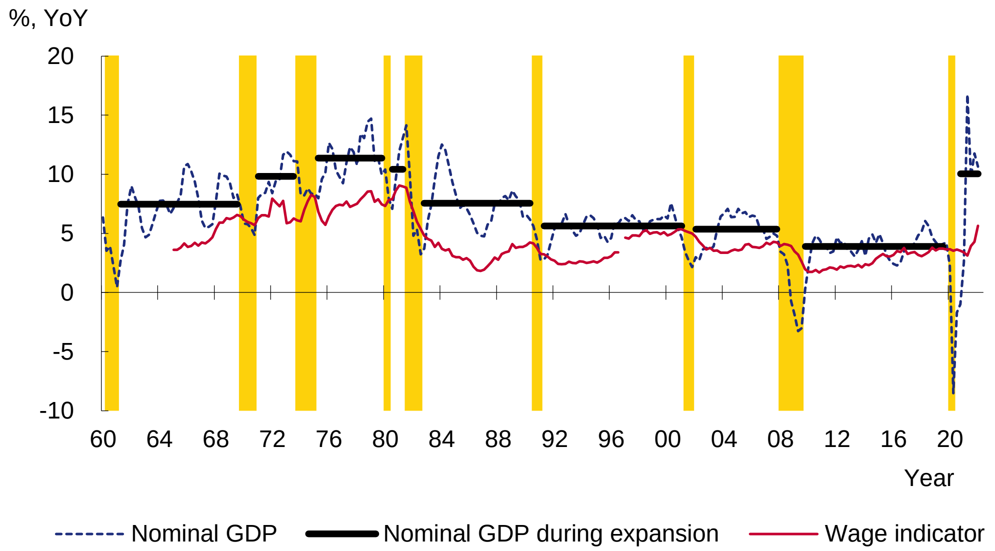
Source: US Department of Labor, Federal Reserve Bank of Atlanta
Period: Monthly data from January 1965 until March 2022
Note: Shaded period represents recession.
Average wage until 1996 and wage growth tracker thereafter.

The wage tracker calculated by the Federal Reserve Bank of Atlanta, which accurately represents the recent wage situation, has grown from 3.4% year-on-year in January 2021 to 6% in March 2022. This is the first time that there has been such a significant increase in a time span of just over a year since statistic was first published in 1997 - the wage growth rates around 1967 and in 2020 are almost identical, and this simple comparison raises concern about the risk of a further increase in inflation in combination with higher wage growth in the future.

However, there are some differences between now and then. The current post-Covid economic recovery has been exceptionally strong because of the massive scale and efficacy of economic measures by the government. Nominal GDP expanded by about 10.0% on an annualised basis over the 18-month period from October-December 2020, immediately after the rebound from the Covid pandemic had subsided (Figure 2).

"The unprecedented post-Covid economic boom and supply constraints"

Figure 2: Nominal GDP and wage growth



Source: Dept. of Commerce. Fed Reserve Bank of Atlanta
Period: Quartelry data from 1Q1960 to 1Q2022. Wage data from 1Q1965.
Note: Shaded period represents recession.
Nominal GDP during expansion is average of annualized QoQ growth for 2020-2022, data before is average YoY growth.
Average wage until 1996 and wage growth tracker thereafter.

The recent expansion in economic activity, accompanied by inflation, is a considerably larger increase than in previous economic expansionary periods. From the company's point of view, sales are increasing rapidly, and in this economic environment, the current wage increase of approximately 6% can be absorbed.

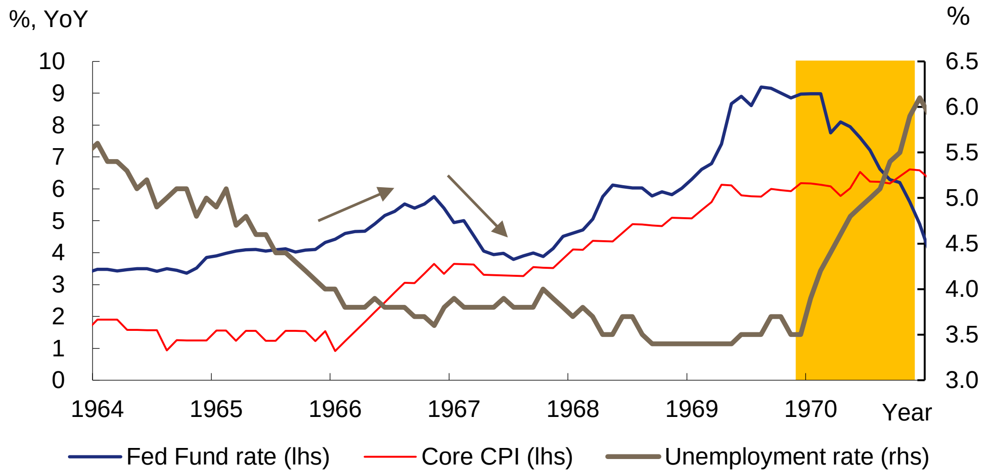
We believe that the significant supply constraints in the labour market caused by the short-term economic boom after the Covid-pandemic has been a major factor in the rise in wages in the US. Going forward, nominal GDP growth is expected to return to a sustainable growth path as the economy normalises from the pandemic. In this context, labour market supply constraints are likely to ease and wage growth, which has increased in the short term, is likely to come down.

The late 1960s, on the other hand, was characterised by inflation and high wage growth occurring over time as the recovery dragged on: nominal GDP expanded by an average of 7.5% during the recovery phase of the 1960s, but nominal economic wage growth increased in the late 1960s as wage growth approached the pace of expansion. It is estimated that household and business inflation expectations increased over time, with wages and inflation rising in a reciprocal manner.

One of the factors that may have contributed to higher wage inflation at the time was the long-standing accommodative monetary of the Fed, which once raised its policy rate to around 6% in 1966, but then cut rates in 1967 and briefly brought them back down again (Figure 3). As a result, the Fed's interest rate cuts at the time appear to have further heated up the labour market.

"The Fed's response to inflation in the 1960s"

Figure 3: Inflation, policy rate and unemployment in late 1960s



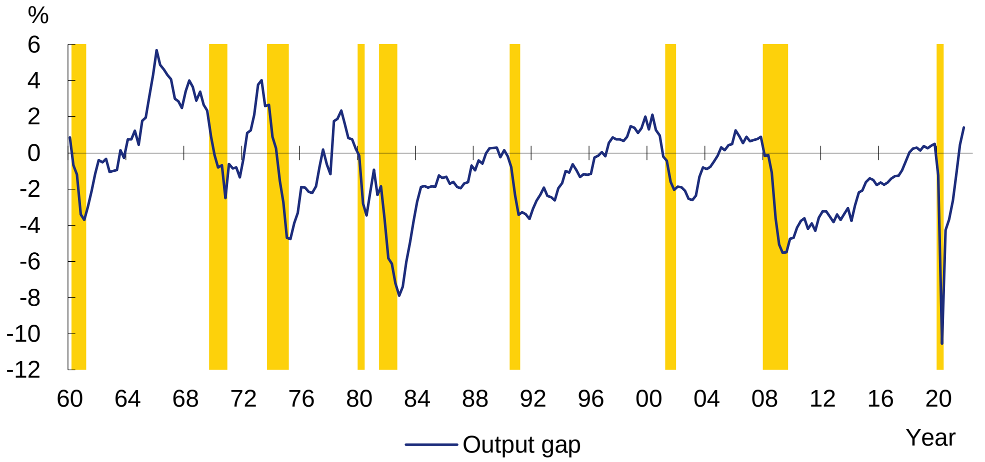
Source: Bloomberg
Period: Monthly data between January 1964 and December 1970
Note: Shaded area represents recession

In the late 1960s, the Fed's accommodative monetary policy overheated the labour market for two to three years. The failure to explicitly adopt an inflation-targeting policy in the Fed's monetary policy management at the time appears to have contributed to the failure to control inflationary expectations: the Fed was forced to raise its policy rate significantly in 1969, which led to the subsequent economic stagnation and high inflation in the 1970s.

The Congressional Budget Office (CBO) also estimates that the output gap in the late 1960s remained in significantly positive territory for four years. At that time, from 1964, expansionary fiscal policy was intensified by the Johnson Administration, indicating that both monetary and fiscal policies may have been working to overheat the economy for several years (Figure 4).

“Protracted period of economic overheating in the late 1960s”

Figure 4: Output gap



Source: CBO
Period: Quarterly data between 1Q1960 and 4Q2021
Note: Shaded area represents recession

Although it is difficult to accurately estimate, the supply-demand gap as of 2022 has only just turned positive. The US government continued to launch unprecedented fiscal policies in response to the Covid pandemic but they have yet to overheat the overall economy as of 2022 to the extent of causing future high inflation, as was the case in the late 1960s.

In retrospect, the Fed has focused on the economic recovery for a year and a half, from April 2020 to mid-2021 during the recovery phase. It was optimistic about inflation outlook and took a gradual approach to end the monetary easing.

“Fed's quick pivot, focus on inflation targets”

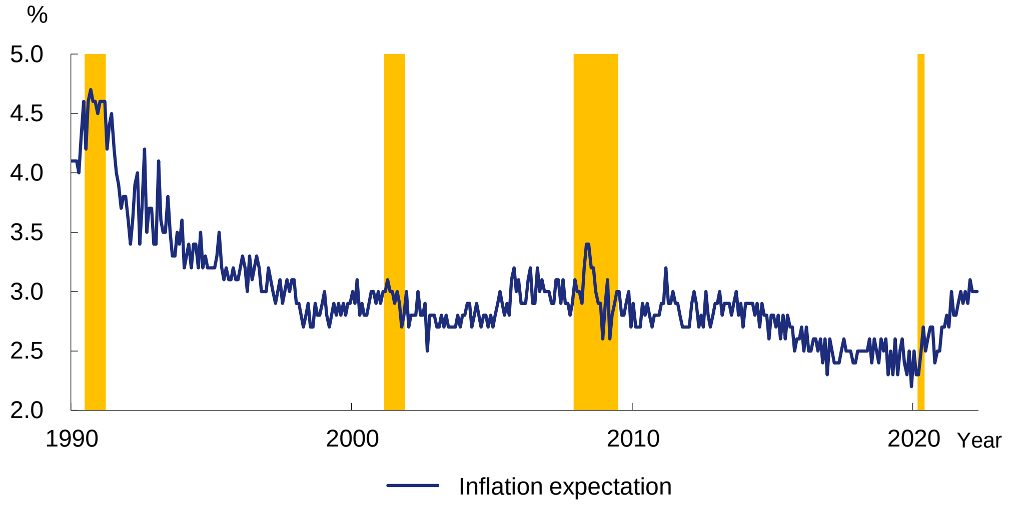
However, from early autumn 2021, its assessment of the risk of inflation changed and policy stance quickly pivoted to hawkish. Compared with the late 1960s, when the FRB continued to pursue an accommodative policy stance for two to three years, this can be regarded as a quick pivot to tightening.

The current rise in wages in the US is largely a consequence of the rare booming of the economy that followed the Covid pandemic. Therefore, as the phase of high post-Covid growth is coming to an end, wage growth, which has increased over a short period of time, may slow down in the future.

In addition, we do not at present appear to have reached a wage-price spiral type situation, accompanied by rising inflationary expectations, which appears to have occurred in the late 1960s. Surveys of households show that while inflationary expectations have risen in the year ahead, which tend to be influenced by petrol prices, longer-term (5-10 years ahead) inflationary expectations remain stable at around 3% (Figure 5).

"High inflation unlikely to return"

Figure 5: Household's inflation expectations for next 5-10 years



Source: University of Michigan
Period: Monthly data between January 1990 and April 2022
Note: Shaded area represents recession

And compared to the late 1960s, when accommodative policy response was entrenched, monetary policy has quickly pivoted in the early autumn of 2021 towards quelling inflation in a short period of time. We expect that the Fed's quick policy shift led by Chairman Powell will be partly responsible for the success, and that we will not experience high inflation in the future, as we did in the 1970s.

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