Economic Insight

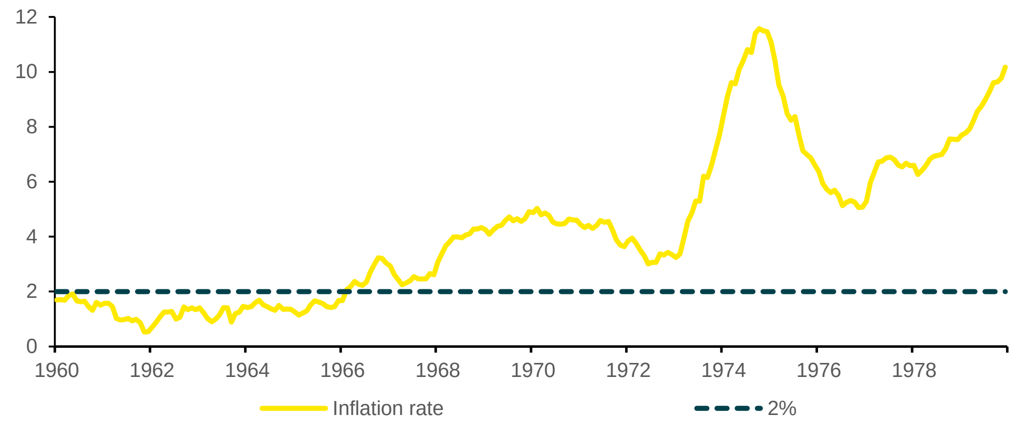
19 April 2021

Inflation – US lessons from the 1960s

US inflation began to rise already in the mid-1960s – long before the 1973 oil price shock. The parallels with the present are obvious.

Money supply is rising rapidly, countries are running horrendous budget deficits and reliance on markets is out of fashion. In this environment, many investors fear a return of inflation. The US experience in the 1960s shows that these fears are probably justified. After US inflation had remained stable below the two percent mark until the middle of the decade, as it does today, it began to rise significantly. At the end of the 1960s, long before the oil price shock of 1973, the inflation rate was already five percent (Chart 1).

Chart 1 - The "Great Inflation" begins in the mid-1960s
PCE deflator, annual rate of change in %, monthly data.



Source: Global Insight, Commerzbank Research

Why US inflation started to rise in the mid-60s

The unexpected rise in inflation is mainly due to three factors:

Firstly, the Vietnam War and the expansion of the welfare state under President Johnson cost a lot of money. The US federal budget, which had previously been largely balanced, turned into a deficit. Despite the booming economy, it amounted to more than one percent of GDP, which was high by the standards of the time.

Secondly, the US Federal Reserve partly financed the government spending. While the Treasury issued new government bonds, the Fed had to keep bond prices stable, which often forced it to make extensive bond purchases. As a result, a lot of money came into circulation and the M2 money supply grew too much compared to trend growth (Chart 2).[1] The central bank allowed this to happen – partly because it felt obliged to help the cash-strapped government. The US economist Allan Meltzer described the central bankers' state of mind at the time in an **essay.**

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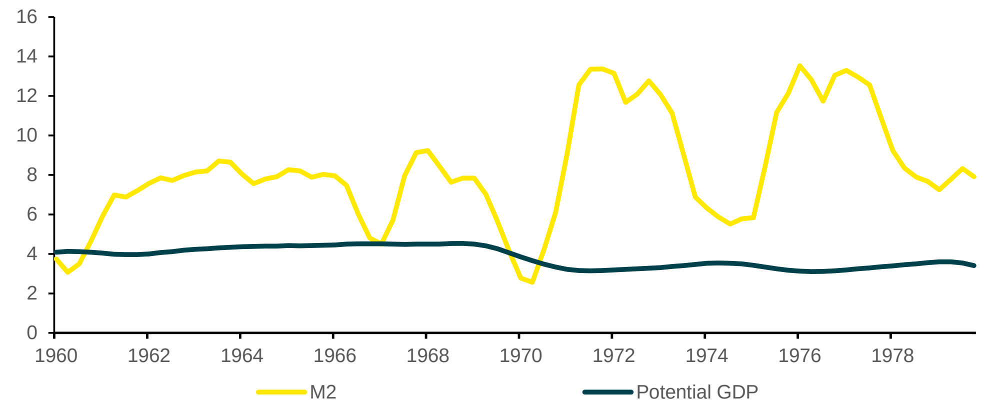
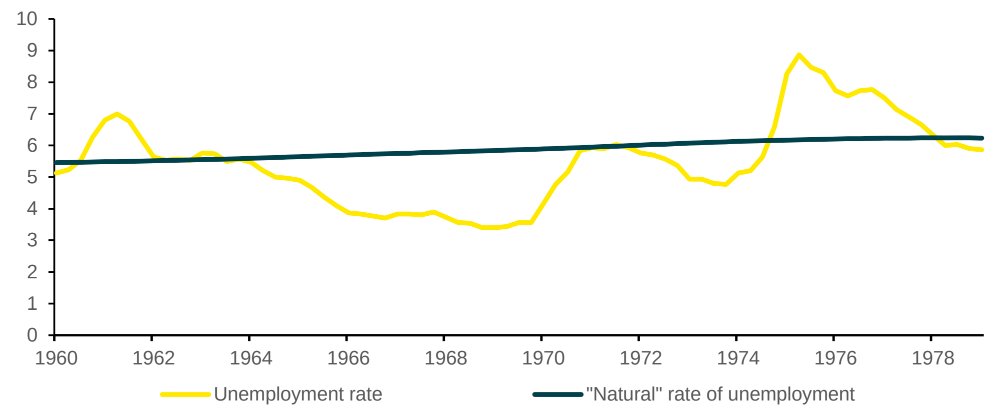
Chart 2 - Money supply increased too rapidly
M2 money supply and real potential GDP (as estimated by the CBO), annual rates of change in %, quarterly data.



Source: Global Insight, Commerzbank Research

Thirdly, the unemployment rate was exceptionally low. There was hardly any spare capacity in the economy, but those in charge, stuck in the Keynesian thinking of the time, did not realise this (Chart 3). After a while, labour costs began to rise sharply. The excess supply of money began to be reflected in rising inflation.

Chart 3 - Labor market in the 1960s overheated
Unemployment rate and CBO estimate of natural rate of unemployment, quarterly data in %.



Source: Global Insight, Commerzbank Research

The parallels to the present are striking

If one compares the US of the 1960s with the present, the parallels are striking. In many Western countries, the states' appetite for credit is still very high today – and it is likely to stay that way, because people accept Big Government after the experience of the Corona crisis. As then, central banks are again cooperating closely with governments. This is especially true in the euro area, where the ECB's bond purchases almost completely financed the budget deficits of the euro states last year.

What is still missing is low unemployment

The only thing that is still missing on both sides of the Atlantic is low unemployment. Therefore, apart from special and base effects, there is probably no real inflation problem this year or next. But in perhaps four or five years, driven by loose monetary policy, labour markets could be tight again and wage costs could rise significantly. This will be helped by the fact that the share of the working-age population in the economically active regions of the world is increasingly falling.[2] In addition, China, whose rising supply of goods had long dampened inflation worldwide, will gradually withdraw from the international division of labour. Unfortunately, the widespread concerns about higher inflation are justified, at least in the longer term.

[1] The velocity of money was largely stable then, unlike today. [back]
[2] Charles Goodhard, former MPC Member of the BoE, stresses this argument in his recent book "The Great Demographic Reversal". [back]

In accordance with ESMA MAR requirements this report was completed 19/4/2021 08:42 CEST and disseminated 19/4/2021 08:42 CEST.

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