Economic Insight

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.

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.
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.

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 %.

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. 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 Goodhart, 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.

This document has been created and published by the Group Research department (GM-R) within the Group Management division of Commerzbank AG, Frankfurt/Main or Commerzbank's branch offices mentioned in the document. Commerzbank AG is a provisionally registered swap dealer with the CFTC.

If this report includes an analysis of one or more equity securities, please note that the author(s) certify that (a) the views expressed in this report accurately reflect their personal views; and (b) no part of their compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or views expressed by them contained in this document. The research analyst(s) named on this report are not registered / qualified as research analysts with FINRA. Such research analyst(s) may not be associated persons of Commerz Markets LLC and therefore may not be subject to FINRA Rule 2241 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

It has not been determined in advance whether and in what intervals this document will be updated. Unless otherwise stated current prices refer to the most recent trading day’s closing price or spread which may fluctuate.

Conflicts of interest

Disclosures of potential conflicts of interest relating to Commerzbank AG, its affiliates, subsidiaries (together "Commerzbank") and its relevant employees with respect to the issuers, financial instruments and/or securities forming the subject of this document valid as of the end of the month prior to publication of this document:

Please refer to the following link for disclosures on companies included in compendium reports or disclosures on any company covered by Commerzbank analysts: https://commerzbank.bluematrix.com/sellside/Disclosures.action

*Updating this information may take up to ten days after month end.

Disclaimer

This document is for information purposes only and does not take into account specific circumstances of any recipient. The information contained herein does not constitute or imply an offer or recommendation to buy or sell any property transaction with US persons must be effected in accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Some products and swap transactions with Commerzbank AG. Commerzbank AG is a provisionally registered swap dealer with the CFTC. Any derivatives transaction with US persons must be effected in accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Some products or services may be unavailable in the United States.

Conflicts of interest

Disclosures of potential conflicts of interest relating to Commerzbank AG, its affiliates, subsidiaries (together "Commerzbank") and its relevant employees with respect to the issuers, financial instruments and/or securities forming the subject of this document valid as of the end of the month prior to publication of this document:

Please refer to the following link for disclosures on companies included in compendium reports or disclosures on any company covered by Commerzbank analysts: https://commerzbank.bluematrix.com/sellside/Disclosures.action

*Updating this information may take up to ten days after month end.

Disclaimer

This document is for information purposes only and does not take into account specific circumstances of any recipient. The information contained herein does not constitute or imply an offer or recommendation to buy or sell any property transaction with US persons must be effected in accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Some products and swap transactions with Commerzbank AG. Commerzbank AG is a provisionally registered swap dealer with the CFTC. Any derivatives transaction with US persons must be effected in accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Some products or services may be unavailable in the United States.

Conflicts of interest

Disclosures of potential conflicts of interest relating to Commerzbank AG, its affiliates, subsidiaries (together "Commerzbank") and its relevant employees with respect to the issuers, financial instruments and/or securities forming the subject of this document valid as of the end of the month prior to publication of this document:

Please refer to the following link for disclosures on companies included in compendium reports or disclosures on any company covered by Commerzbank analysts: https://commerzbank.bluematrix.com/sellside/Disclosures.action

*Updating this information may take up to ten days after month end.

Disclaimer

This document is for information purposes only and does not take into account specific circumstances of any recipient. The information contained herein does not constitute or imply an offer or recommendation to buy or sell any property transaction with US persons must be effected in accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Some products and swap transactions with Commerzbank AG. Commerzbank AG is a provisionally registered swap dealer with the CFTC. Any derivatives transaction with US persons must be effected in accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Some products or services may be unavailable in the United States.
province or territory of Canada in which such offer or sale is made. Under no circumstances is the information contained herein to be construed as investment advice in any province or territory of Canada and is not tailored to the needs of the recipient. In Canada, the information contained herein is intended solely for distribution to Permitted Clients (as such term is defined in National Instrument 31-103) with whom Commerz Markets LLC deals pursuant to the international dealer exemption. To the extent that the information contained herein references securities of an issuer incorporated, formed or created under the laws of Canada or a province or territory of Canada, any trades in such securities may not be conducted through Commerz Markets LLC. No securities commission or similar regulatory authority in Canada has reviewed or in any way passed upon these materials, the information contained herein or the merits of the securities described herein and any representation to the contrary is an offence.

European Economic Area: Where this document has been produced by a legal entity outside of the EEA, the document has been re-issued by Commerzbank AG, London Branch for distribution into the EEA. Commerzbank AG, London Branch is authorised and regulated by Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) and the European Central Bank. Authorised by the Prudential Regulation Authority and with deemed variation of permission. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the Financial Conduct Authority’s website.

Switzerland: This is an advertisement in the meaning of FIDLEG. The financial instruments mentioned in this publication do not constitute a participation in a collective investment scheme in the sense of the Swiss Collective Investment Schemes Act (CISA). This publication, the information contained herein as well as any other publication in connection with the financial instruments mentioned herein may be distributed exclusively to qualified investors as defined in the CISA and may only be made available to such qualified investors.

Singapore: This document is furnished in Singapore by Commerzbank AG, Singapore branch. It may only be received in Singapore by an institutional investor or an accredited investor as respectively defined in section 4A of the Securities and Futures Act, Chapter 289 of Singapore (“SFA”) pursuant to section 274 or section 275 (as applicable) of the SFA. Nothing in this document constitutes accounting, legal, regulatory, tax, financial or other advice and/or recommendations to the recipient of this communication. Further, the communication/information provided herein does not constitute a “financial advisory service” within the meaning of the Financial Advisers Act, Chapter 110 of Singapore (“FAA”) and therefore, the regulatory requirements and duties that may be owed to a client pursuant to or in connection with the FAA are not applicable to the recipient in connection with this communication. Recipients are advised to seek independent advice from their own professional advisers about the information contained herein.

Hong Kong: This document, may only be made available in Hong Kong by Commerzbank AG, Hong Kong Branch to ‘professional investors’ within the meaning of the Securities and Futures Ordinance (Cap.571) of Hong Kong and any rules made there under, and persons whose ordinary business is to buy or sell shares or debentures.

Japan: This information and its distribution do not constitute and should not be construed as a “solicitation” under the Financial Instrument Exchange Act (FIEA). This information may be distributed from Commerzbank international branches outside Japan solely to “professional investors” as defined in Section 2(31) of the FIEA and Section 23 of the Cabinet Ordinance Regarding Definition of Section 2 of the FIEA. Please note that Commerzbank AG, Tokyo Branch has not participated in its preparation. The instruments recommended in this report cannot be introduced by the Branch. You should contact the Corporate Clients division of Commerzbank AG for inquiries on availability of such instruments.

Australia: Commerzbank AG does not hold an Australian financial services licence. This document is being distributed in Australia to wholesale customers pursuant to an Australian financial services licence exemption for Commerzbank AG under Class Order 04/1313. Commerzbank AG is regulated by Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) under the laws of Germany which differ from Australian laws.

People’s Republic of China (PRC): This document is furnished by Commerzbank AG and is only intended for institutions that are eligible for financial transactions. No-one else may rely on any information contained within this document. Any derivative transactions by PRC persons may only be entered into by PRC financial institutions which are permitted to conduct derivatives business in the PRC and have obtained all necessary regulatory approvals in the PRC.

© Commerzbank AG 2021. All rights reserved. Version 21.01