

Economic Research note

Global inflation: that 60s show

- **Rising inflation, surging commodity prices, and slowing growth prompt comparisons to 1970s stagflation**
- **However, the severe wage/price spiral of that period is not operative now**
- **A more apt comparison is to the 1960s, when policymakers sowed the seeds of the 1970s crisis**

The combination of soaring commodity prices, rising inflation, and slowing global growth is raising concerns about a replay of the 1970s. Although the current backdrop does bear some similarities to that era, the dissimilarities are more striking. In particular, the severe wage/price spiral in train prior to the OPEC price shock of October 1973 is absent today. Instead, the current environment most resembles the 1960s, when the foundation was laid for the “stagflation” of the following decade.

In both the 1960s and 2000s expansions, a sustained period of rapid growth—supported by real policy interest rates close to zero—led to a sharp rise in resource utilization. At the same time, policymakers in both periods were slow to recognize a fall in potential growth. And at least through the mid-1960s, there was little hint of the inflation problem to come, whether gauged by trends in core inflation, unit labor costs, or key market variables, including long-term bond yields. Nor is there clear indication of one today.

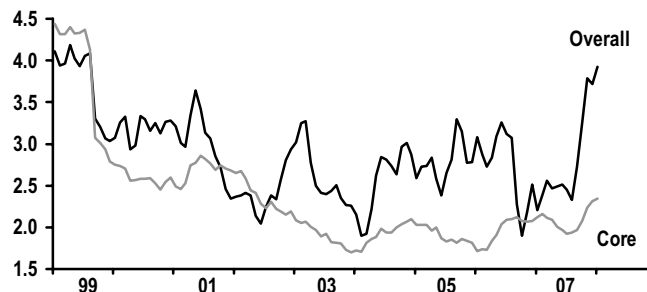
Despite the similarities between these periods, there is no prospect of a return to the high inflation of the 1970s. Central banks will not allow it, if only because most of them now have mandated inflation targets. To be sure, in many instances, these targets have been breached in recent years, leaving one to wonder whether the lessons of the 1960s have been forgotten. If the US economy falls into a deep recession, an extended period of subpar global growth will reduce inflation pressure. However, if the US recession is as shallow as it was in 1969-70 (or there is no US recession), global growth could quickly return to trend or higher, producing a further climb in inflation. In this event, central banks would be forced to tight policy sharply, threatening a deeper economic downturn in the future.

Not that 70s show

In the early 1970s, the combination of a booming global economy and bad harvests unleashed a powerful surge in global commodity prices. Initially, the surge was focused in metal and agricultural commodities. Then in October 1973,

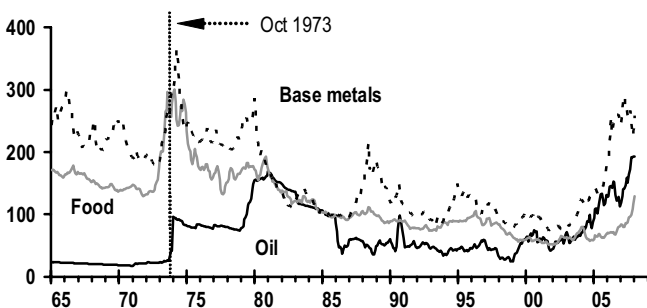
Global consumer prices

% change over 12 months



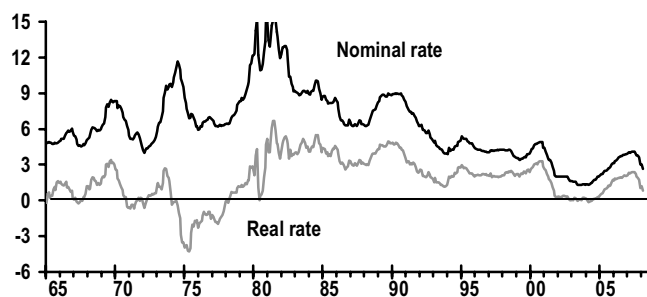
Real global commodity prices

1985=100, US\$ commodity price deflated by G-7 core CPI in US\$ terms



Monetary policy rate in the G7

% p.a.; incl Mar08 fcst



Note: Pre-1970 rate based on G3, real rates calculated with %oya core CPI.

From the 1974 Economic Report of the President¹

For eight years economic policy and the news about the [US] economy have been dominated by inflation. The story has been a frustrating one Inflation seemed a Hydra-headed monster, growing two new heads each time one was cut off. The problem was not confined to the United States; indeed inflation was worse in most other countries. *There is now a great deal of inflation built into our system.* For one thing, both workers and employers are now used to high increases in money wages which reflect the expectation of rapid inflation The public is highly sensitive to inflation and reacts in an inflationary way to any news which confirms its expectation of inflation.

1. January 1974, Chapter 1. Italics added for emphasis.

the OPEC oil embargo led to a quick quadrupling of the price of oil. The shock to household purchasing power, combined with tighter financial market conditions, drove the major economies into recession in 1974-75. At the same time, inflation in the G-7 economies reached new heights of 10.4% annualized in 1974-75, popularizing the term “stagflation.”

Viewed through this narrow lens, the 1970s stagflation experience is often, but wrongly, attributed solely to a series of adverse supply shocks. However, before commodity prices began to surge, a wage/price spiral was already entrenched, owing to sustained policy stimulus. Indeed, G-7 core inflation ran at an average annual rate of 6.2% from 1971 through 1973, alongside an 11%ar increase in labor compensation and a 7.5%ar gain in unit labor costs. Labor markets were drum-tight, with the unemployment rate in the OECD falling to just 3% in late 1973. In this environment, rising commodity prices acted as an accelerant in an already overheated economy.

While the 2000s acceleration in commodity prices has not been as abrupt as that of the early 1970s, the rise is still striking. However, most other aspects of the current backdrop are different, suggesting that what lies ahead will turn out to be, at worst, a faint echo of the 1970s. Although the OECD unemployment rate is at its lowest level in almost three decades, it is still several percentage points higher than in the early 1970s. Of more importance is that labor market tightness has yet to translate into a surge in compensation or unit labor costs (the latter rose just 1.7%ar on average in 2006 and 2007). While G-7 inflation is posting decade highs, the 1.9%oya gain in core prices is a far cry from the early 1970s.

There have been positive structural changes too. Most central banks now target inflation, an unheard-of policy in the 1970s when central bank independence was rare. Moreover, labor markets have become more efficient as unionization has fallen and inflation indexing and long-term contracts are rare. Combined with greater trade openness and lower energy intensity, adverse supply shocks have relatively smaller consequences for growth and inflation.

That 60s show

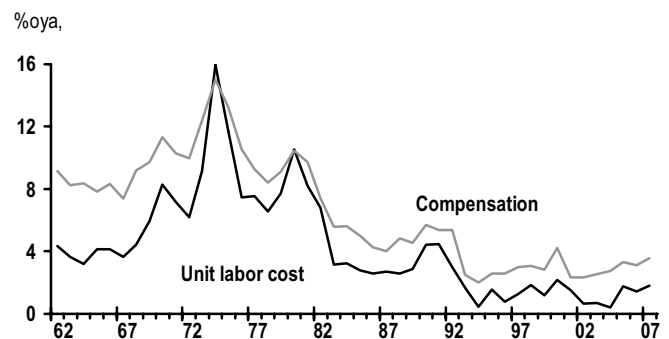
The 1960s are often thought of as a golden era of sustained rapid growth and low inflation, the halcyon days that preceded the tumult of the 1970s. Yet, a closer examination suggests that the seeds of inflation in the 1970s were sown in the 1960s, when a long period of policy accommodation gradually eroded inflation expectations. Moreover, there are a number striking similarities between the 1960s and the most recent expansion. Consequently, while there is

G-7 economic environment: 1971-75 versus 2006-07

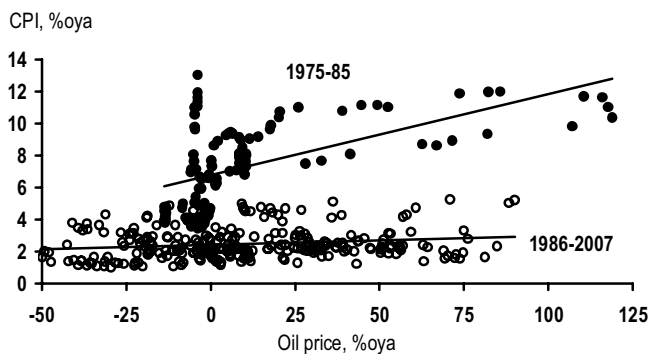
	1971-73	1974-75	2006-07
GDP	5.3	1.0	2.5
Unemployment rate	-0.5	2.3	-0.3
Unit labor costs	7.5	13.8	1.7
Compensation	10.9	14.1	3.1
Crude oil price	21.4	86.0	29.7
Agriculture prices	29.4	-7.8	31.5
CPI	6.2	11.3	2.7
Core CPI	5.4	10.4	1.9
Monetary policy rate	5.6	8.9	3.7
...less core CPI	0.2	-1.5	1.8

Note. The unemployment rate is reported as the %-point change over the period, and monetary policy rates are reported as the average % p.a. (the real rate subtracts the change in the CPI). All other values are annualized %-changes over the period. The 1971-73 period ends in September 1973, the 1974-75 period begins in October 1973.

G-7 unit labor costs and compensation



Oil price passthrough to developed market CPI



little chance that central bankers would, or could, permit a replay of the 1970s stagflation, they may be repeating the mistakes of the 1960s.

In the 1960s, economic growth was exceedingly strong, averaging over 5% per annum in the OECD, accommodated by particularly stimulative monetary policy. In the G-7, real policy rates averaged less than 1% before falling below zero in 1974-75 (chart on first page of note). Easy monetary policy was complemented by highly expansionary fiscal policy in the United States.

At the same time, policymakers failed to recognize a steep fall in productivity growth. Between 1961 and 1973, annual labor productivity growth fell about 2% points. The result was that, as growth in aggregate demand picked up steam throughout the 1960s, resource utilization rates moved to a record high. Indeed, by the end of the decade, the unemployment rate in the G-7 had fallen to 2.5%.

The combination of extremely tight resource utilization and accelerating aggregate demand set off a wage/price spiral that was damped only slightly by the 1970 US recession. Although unemployment rates rose during that slowdown, gains in compensation continued to strengthen while productivity growth continued to wane across the G-7. Inflation did fall during the 1970 slowdown but the decade-long trend upward in price gains barely skipped a step.

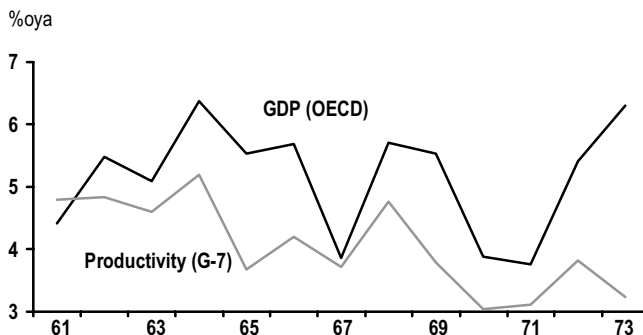
The quagmire the policymakers had gotten into was impossible to ignore by late 1973, even prior to the commodity price shocks. As the 1974 Economic Report of the President (published in January 1974) indicated, the Fed had lost control of the situation, with inflation expectations completely unanchored and “a great deal of inflation built into the system” (excerpt on the first page of this note).

Turning to the current expansion, global monetary policy has been as, if not more, accommodative than in the 1960s (third chart on first page of this note). After maintaining roughly a zero real policy rate between late 2001 and early 2005, the Fed finally returned policy to a neutral or slightly restrictive stance in 2006. However, most other central banks only began their rate normalization process in earnest in 2006, and this process was interrupted when the credit market turmoil erupted last summer. As a result, global policy interest rates were maintained at an unusually low level deep into the expansion.

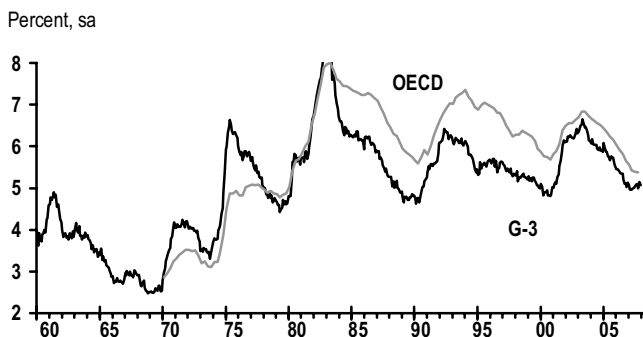
Moreover, similar to the 1960s, potential output growth is downshifting. Whereas the 1960s slowdown owed to falling productivity growth, the current slowdown reflects a fall in labor force growth owing to the aging of the population. In addition, productivity growth will be damped in coming years by an aging of the capital stock due to a waning of capital investment, particularly in the United States.

The consequences of easy monetary policies combined with weakening potential output growth remain unclear. Inflation has consistently breached most central banks’ objectives since 2004, but core inflation only moved above target beginning in 2006. Although unit labor cost growth remains moderate, inflation expectations—as measured by breakeven rates on inflation-protected government securi-

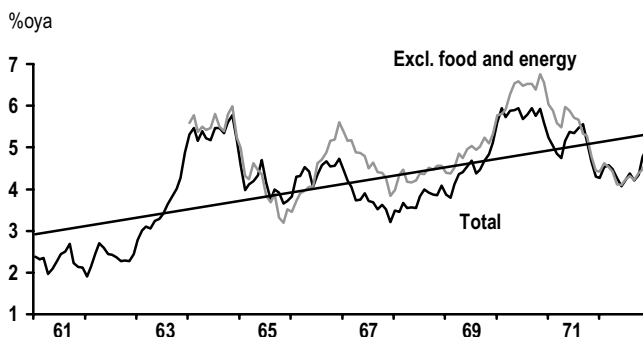
Real GDP and labor productivity, developed markets, 1961-73



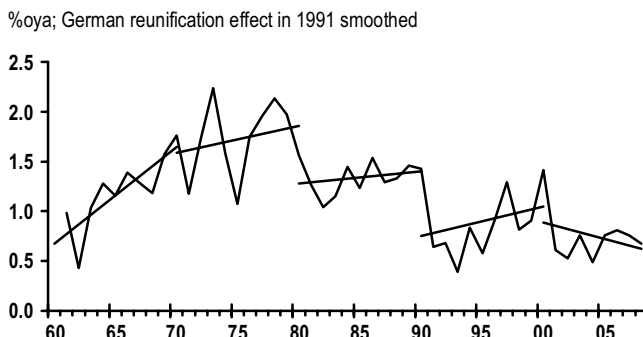
Unemployment rate



G-7 consumer prices, 1961-72



G-7 labor force growth, with 10yr trends

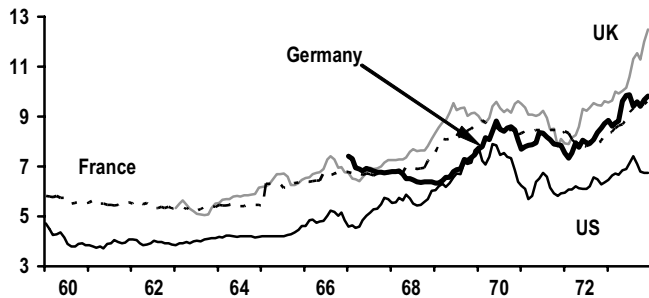


ties—have moved up in the past year. If the 1960s is any guide, inflation expectations can change quickly. In the 1960s, bond yields remained remarkably flat through the middle of the decade before breaking out of their range in 1968-70, giving little warning of the inflation problem to come.

If the global economy is now poised for an extended period of subpar growth, then policymakers are on the right track and inflation pressures will subside. However, if the US avoids recession, or if the US recession is shallow, the risk is that global growth will move back above trend without creating much slack. In this event, there will be little relief on inflation, forcing central banks to reverse course and adopt restrictive policies, implying the likelihood of a much deeper recession further down the road.

Yields on long-dated sovereign debt, 1960-73

% p.a.



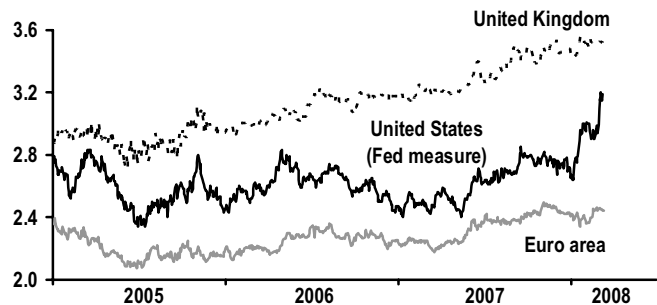
G-7 consumer prices, 2004 to Jan 2008

%oya, both scales



Derived 5y/5y forward breakeven inflation rate

% p.a.; derived from yields on inflation-protected securities



A G-3 Phillips curve tour: 1963-2007

The narrative from above can be retold through the lens of the Phillips curve, a relationship that links the unemployment rate with inflation and was famously documented in 1958 by A.W. Phillips. Upon Phillips' discovery, the Keynesian economists of the 1960s quickly adopted the notion of a permanent exploitable tradeoff between price inflation and unemployment. As shown in the chart, the Phillips curve of that era was relatively flat, which led policymakers to believe they could boost aggregate demand with little inflation consequence. As told above, this proved woefully incorrect as inflation expectations and a productivity slowdown wickedly combined to rotate the Phillips curve from near-flat to near-vertical by the early 1970s (prior to the commodity price shocks). The 1974-75 slowdown helped to flatten the curve but the growth-inflation tradeoff in the 1970s and early 1980s clearly worsened in that a given unemployment rate then implied a higher rate of inflation than in the 1960s. In the early 1980s, Paul Volcker of the US Fed caused a deep recession in order to regain control of inflation expectations. His success is reflected in the re-flattening and shift down in the Phillips

curve through the 1980s. With Alan Greenspan at the helm of the Fed throughout the 1990s, combined with a broad-based shift to more formal inflation targets by central banks around the world, credibility further improved and inflation expectations became anchored at a very low rate, as indicated by the further shift down in the Phillips curve. Whether this 45-year cycle will be replayed by central bankers today who believe an exploitable Phillips curve has returned remains to be seen.

G-3 Phillips curve

CPI excl. food and energy, %oya

