Global Inflation & Growth: Lessons From The 1970s

Sharmila Whelan, 9 June 2022

The global economy stands at a precarious juncture, characterised by heightened geopolitical tensions and escalating inflationary pressures. Whether advanced economies can navigate these challenges without descending into a deep and protracted recession remains uncertain. The similarities with the twin oil shocks of the 1970s are as worrying as the dissimilarities. The level of debt is higher, and so is liquidity in the system. The latter taken together record low interest rates argue that advanced country central banks are even further behind the curve than back then and that the risks of recession as monetary policy normalises are higher.

The ongoing conflict led by Russia in Ukraine has triggered a deepening global crisis, exacerbating energy and food shortages and fuelling broader geopolitical tensions. This has resulted in soaring prices globally, with many countries experiencing rising interest rates. The resilience of economies is waning, compounded by high levels of leverage in both advanced country governments and corporate sectors. Meanwhile, China faces its own set of challenges. The critical question now is whether the economic downturn will be shallow or profound enough to necessitate a significant reset, a scenario that fiscal and monetary policies have managed to defer since the Global Financial Crisis (GFC).

Rather than imposing a singular viewpoint, this report invites readers to draw their conclusions based on presented facts and analyses. Focusing on advanced economies, the report examines parallels and divergences between current policy responses, inflation trends, and growth outcomes, drawing comparisons with the oil price shocks of the 1970s. History often repeats itself, and many policy missteps from that era have resurfaced on a larger scale today, adversely affecting global growth and inflation dynamics.

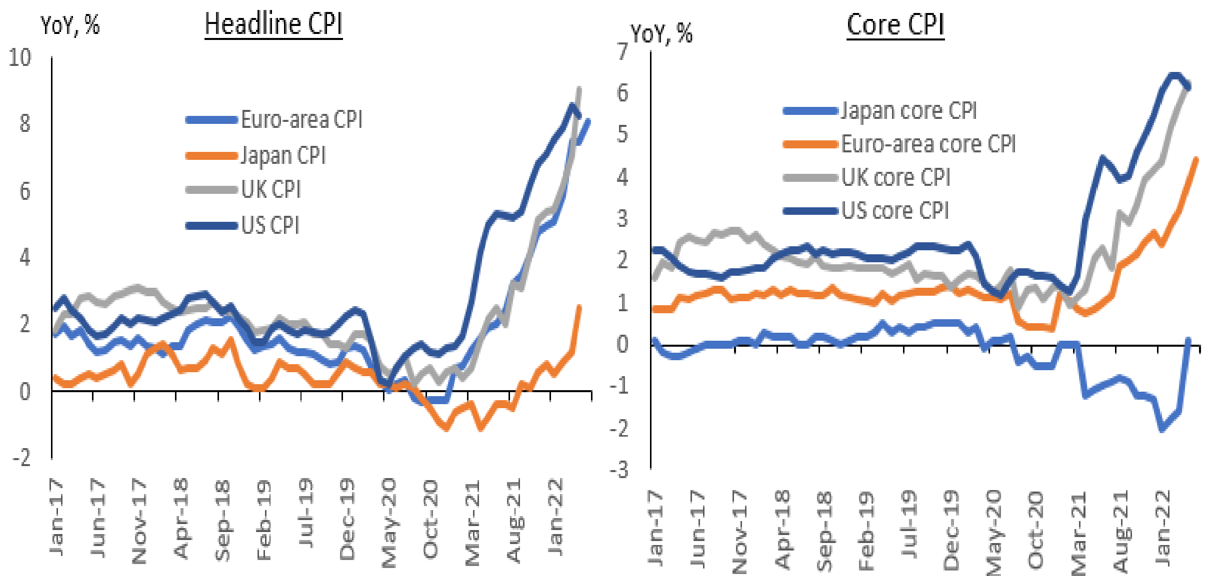
Generalized Price Escalation Amidst Slowing Money Supply Growth

Nearly a year ago, we argued that inflationary pressures stemming from post-COVID supply-demand imbalances were not transitory. Contrary to expectations, inflation has persisted and intensified in the post-COVID world due to cyclical and structural factors. The injection of COVID emergency monetary stimulus directly into the real economy to shield firms and consumers has led to a breakout of inflation from asset markets. Moreover, liquidity remains abundant, and interest rate normalisation is progressing slowly. Persistent COVID outbreaks, uneven economic recoveries, high debt levels across public and corporate sectors, and increasing tolerance for inflation among advanced country central banks continue to shape economic policies. Structural shifts such as environmental commitments and increased fiscal activism suggest that Modern Monetary Theory will likely see further implementation. Additionally, China's stance on allowing the yuan to strengthen domestically implies a future trend of exporting inflation rather than deflation to global markets. The fragmentation of the global goods and services market further complicates the scenario, diminishing the historical price benefits enjoyed by Western consumers.

High Inflation Levels Amidst Monetary Policy Adjustments

Nine months on consumer price inflation rates in advanced economies are at levels last seen in the case of the US after the second oil shock, the UK in 1990, Japan during the Asian crisis and never in the history of the euro-area. Figure 1 illustrates that while the Ukrainian war and sanctions on Russian oil and gas exports have exacerbated price hikes this year, underlying inflationary pressures were evident well before these events. Moreover, the surge in prices has been broad-based, not solely driven by higher food and energy costs.

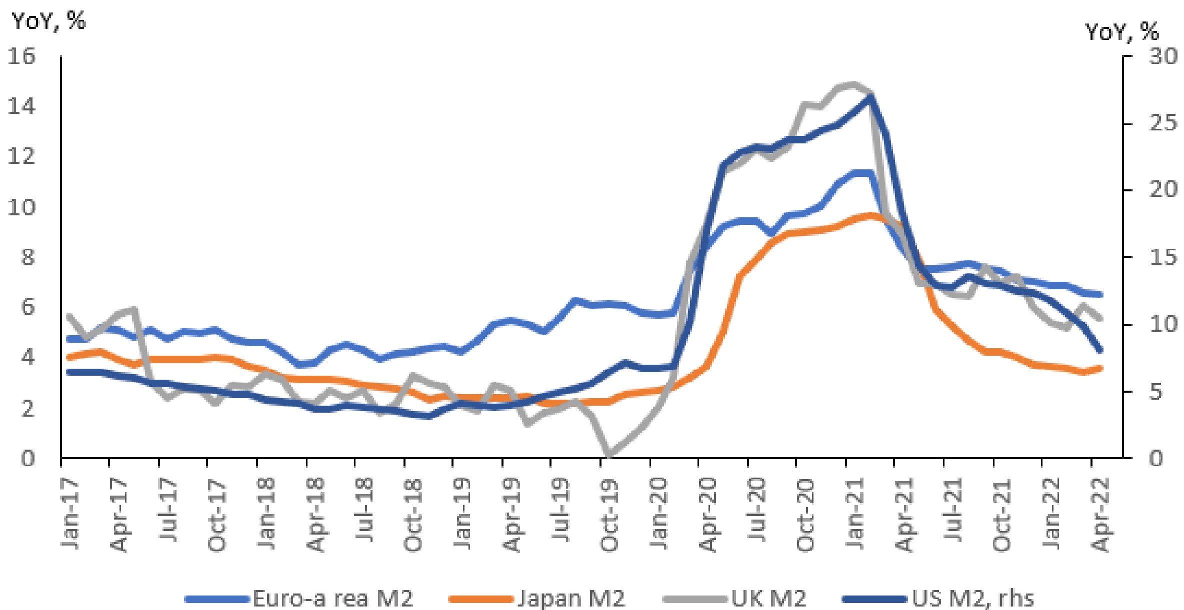
Figure 1:Headline and core consumer prices – Rise in prices generalised



Source: Haver Analytics

High levels of liquidity and the continued easy monetary and fiscal stances of advanced country central banks and governments have led to a generalised rise in prices of goods and services globally. Liquidity conditions are becoming less expansive. Figure 2 show following massive pandemic emergency liquidity injections into the real economy broad money growth has been slowing steadily in major advanced countries (Figure 2).

Figure 2: Broad money growth – Slowing



Source: Haver Analytics

The US Fed and Bank of England are raising policy interest rates, and the ECB has ended its asset purchase programme. This will dampen credit and money supply growth further. Even so, it will be challenging to get inflation under control, judging by experiences of the 1970s.

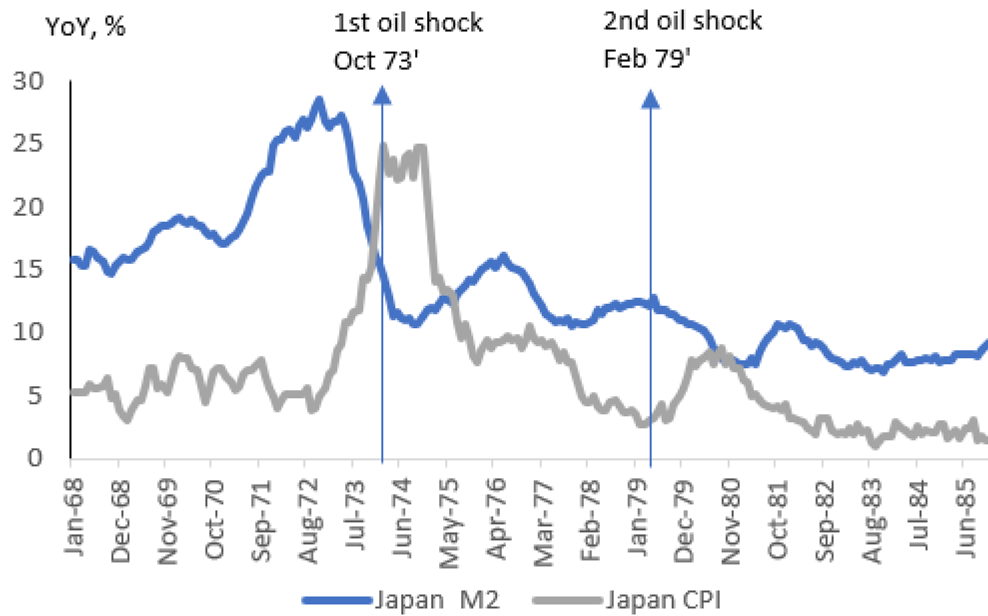
Comparing Today's Crisis with the 1970s Oil Price Shocks

The 1970s were marked by two oil price shocks that precipitated inflationary spikes, rising interest rates, and economic stagnation. The first crisis in October 1973 saw Arab OPEC members impose an oil embargo, leading to a three-fold increase in oil prices. The second shock in 1979, triggered by the Iranian Revolution and the Iraq-Iran conflict, further disrupted oil production and escalated prices significantly. Contrary to the 1970s, today's energy price shock encompasses both oil and gas, coinciding with sharp increases in food prices, making it a broader and more acute cost-of-living crisis. The UN Food and Agriculture World Food Price Index is at a historical high in nominal terms, with real food prices rising by 48% since 2020, compared to a 12.8% increase during the first oil crisis of the 1970s.

A notable similarity between the current crisis and the 1970s is the accommodation rather than containment of exogenous price shocks through monetary policies (Figures 3-5). Japan, the UK, and the US during the first oil price shock of the 1970s experienced strong pre-shock money supply growth rates, which amplified inflationary pressures. Even as money supply growth moderated post-shocks, inflation remained elevated, demonstrating the prolonged effects of initial monetary conditions on inflation dynamics.

Take Japan, after cutting policy interest rates from January 1971 through March 1973, the Bank of Japan had begun, in April 1973, to tighten monetary policy, months before the first oil shock hit in October 1973. But as Figure 3 money supply was growing strongly in the run up to the first oil shock. M2 growth picked up from 17% YoY in early 1971 to peak only at 28% YoY in November 1972 and was still rising at double digit rates on the eve of the first oil price shock. Inflation had started to accelerate well before then, in early 1972, and was rising by 25% YoY by 4Q74. Even as broad money growth slowed inflation remained elevated and only eased with a considerable lag. The second oil shock was like the first accommodated by the easy liquidity. The difference was that because money supply growth was lower so was the increase in the rate of consumer price inflation, underscoring the point that initial monetary conditions determine the extent to which an exogeneous price shock is amplified.

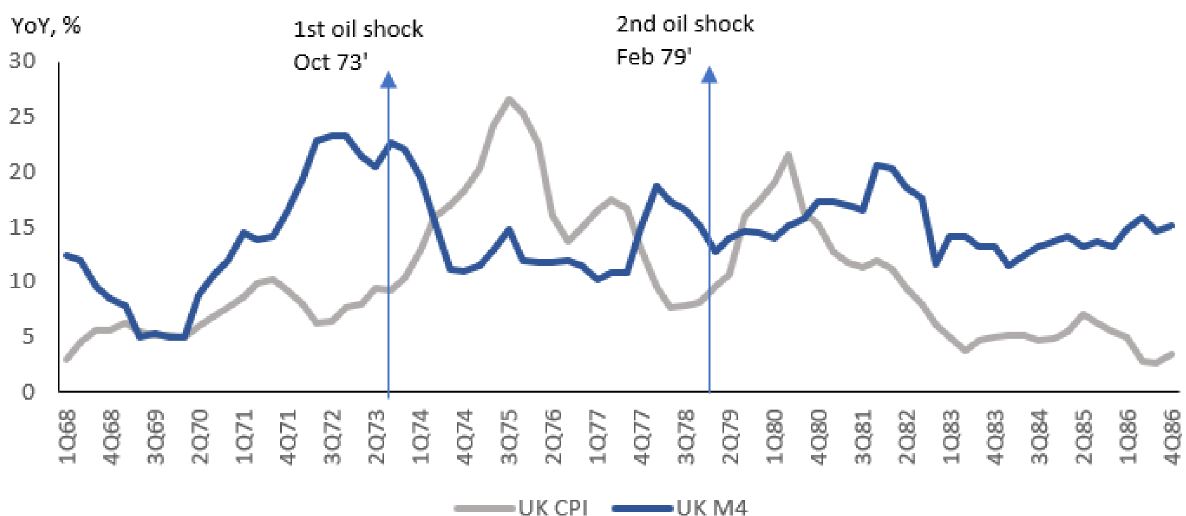
Figure 3: Japan M2 and CPI – First oil price shock accommodated by plentiful liquidity



Source: Bank of Japan, Haver Analytics,

The UK's experience during the 1970s oil shocks confirms the same (Figure 4). In the periods preceding both crises money supply growth had been expansive and even though liquidity conditions were tightening before the crises it was too little too late. Plentiful liquidity supported a sharp rise in consumer prices. In the UK's case adding fuel to fire was fiscal policy which turned extremely easy during the Barber Boom. In 1972 then Chancellor of Exchequer, Anthony Barber delivered a budget designed to return the Conservatives to power in an election expected in 1974 or 1975. Government budgetary spending picked up from 13% YoY in 3Q72 to 38% YoY by 4Q74. The budgetary measures further fuelled inflation and wage demands from public sector workers.

Figure 4: UK M2 and CPI – Barber boom and easy monetary policy worsens oil price shock

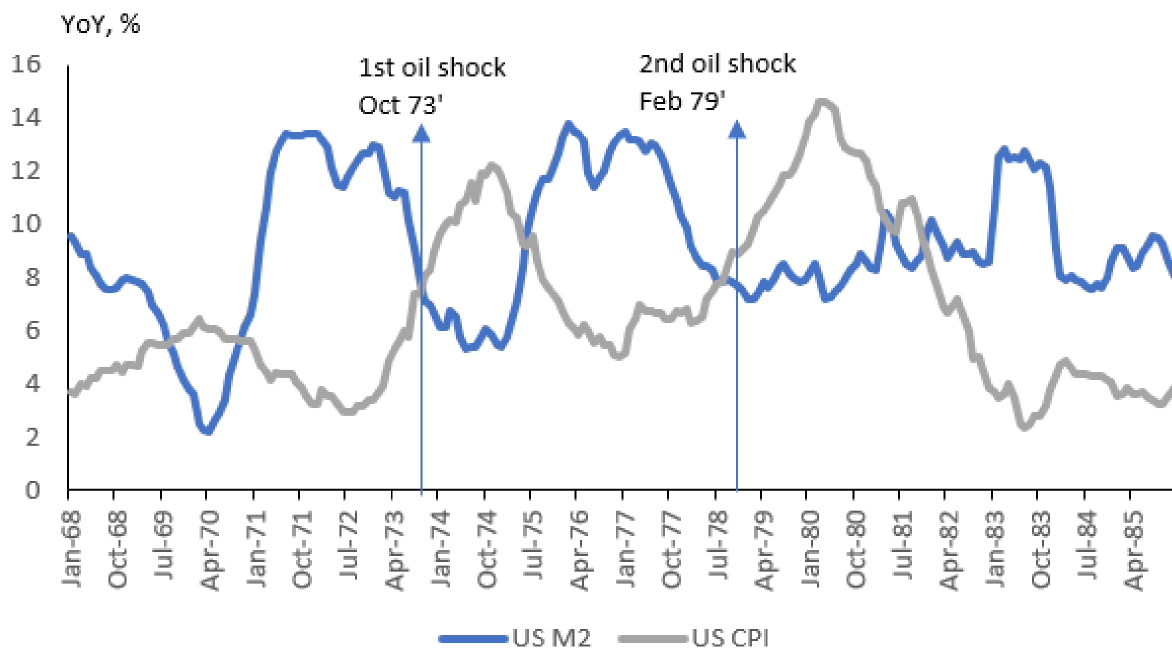


Source: Bank of England, Haver Analytics,

The UK's fiscal (mis-) management through the first oil shock highlights the importance of targeting fiscal support to the most vulnerable households and companies, that an across the board increase in fiscal largess can lead to unintended consequences. And yes, we are thinking of Europe here – specifically the €800bn EU Next Generation Recovery programme and the recently announced €210bn spending programme to reduce dependence on Russian fossil fuels, speed up the transition to green energy and bolster defence. Europe's fiscal spending plans risks adding to inflation pressures. Separately it is worth highlighting that minimum wages are expected to rise substantially in many euro-area countries in 2022 and 2023, with increases expected in 12 of 19 member countries in 2022, according to the ECB.

US money supply and inflation trends through late 1960s until mid-1980s reinforce the key takeaways from Japan's and Britain's experiences during the 1970s oil shocks. What is clear from Figure 5 and particularly relevant today is that the lags between monetary policy decisions and changes in money supply growth and inflation are long and variable. So, while broad money growth maybe moderating in the US, euro-area, UK and Japan and YoY CPI inflation rates could ease somewhat as weak base year affects kick in, getting prices truly under control is going to take much longer than currently anticipated and are for structural reasons not going back to the pre-Covid levels.

Figure 5: US M2 and CPI – Lags between monetary policy & inflation are long and variable

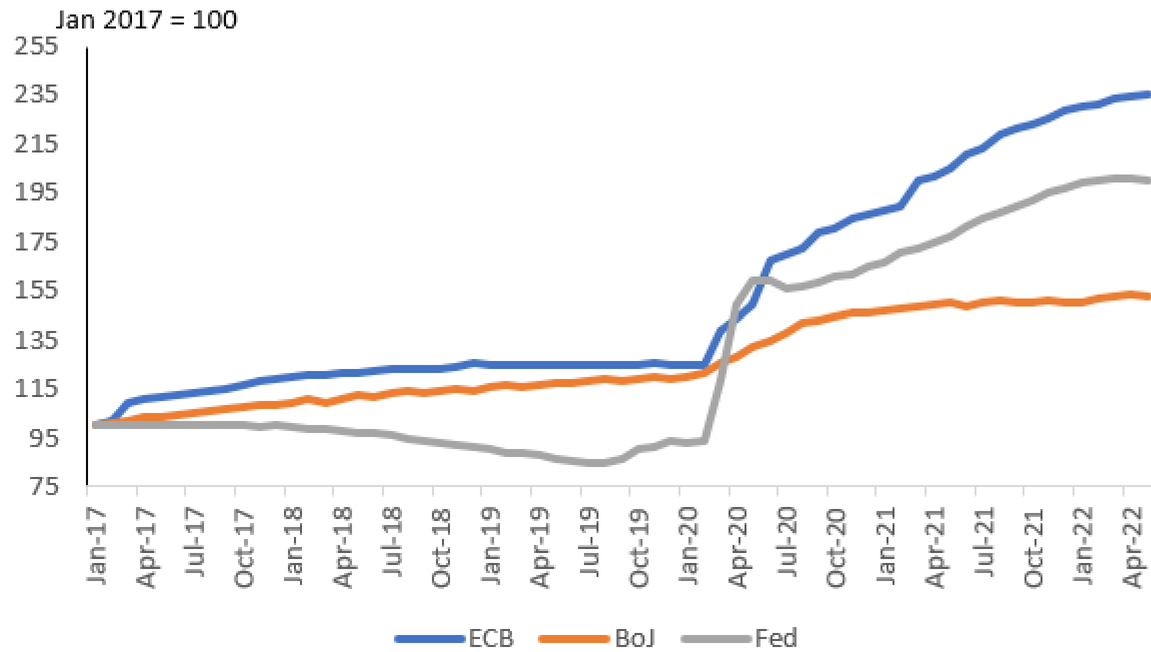


Source: Haver Analytics

The difference between then and now is the amount to liquidity already in the real economy. A decade and more of experimenting with extraordinary monetary policy measures and more recently the emergency measures introduced during the pandemic to support households and companies has left financial systems flushed with cash. Figures 6 and 7 are illustrative. Figure 6 shows the US Fed's balance sheet as of May was 114% larger than on the eve of the pandemic, the ECB's 89% and the BoJ's 29%. Borrowing costs are rising in the US and the UK but neither

the BoE nor the Fed are withdrawing excess liquidity created during the pandemic. For that balance sheets need to contract, fast.

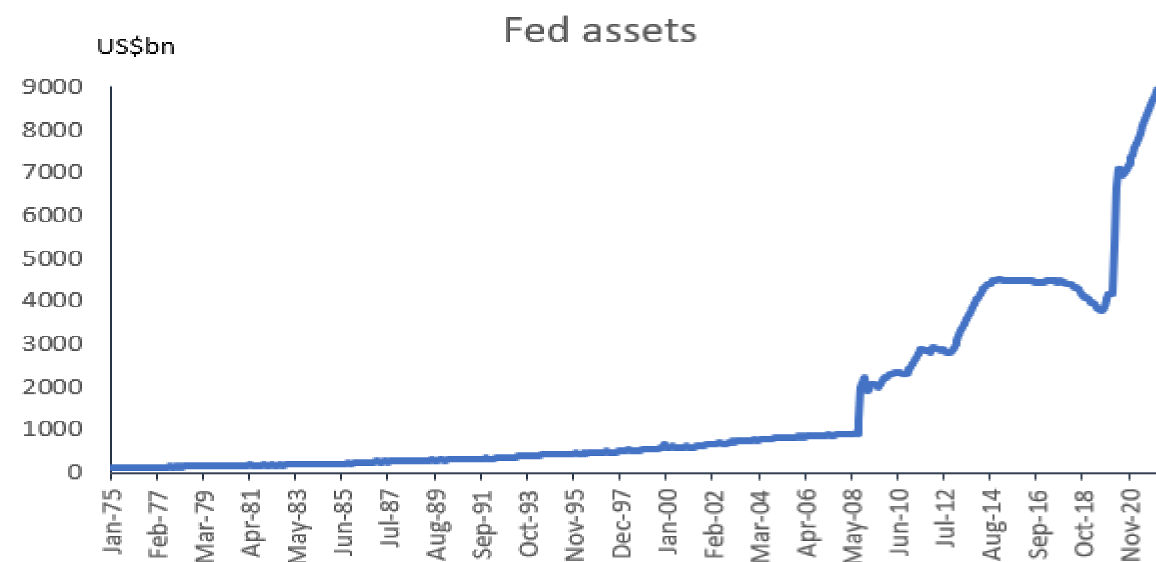
Figure 6: Central bank assets – Points to the wall of money already in the economy



Source: Haver Analytics

Figure 7 puts the wall of money in perspective and explains why inflation is likely to remain elevated for some time.

Figure 7: US Fed assets – Very different compared with the 1970s

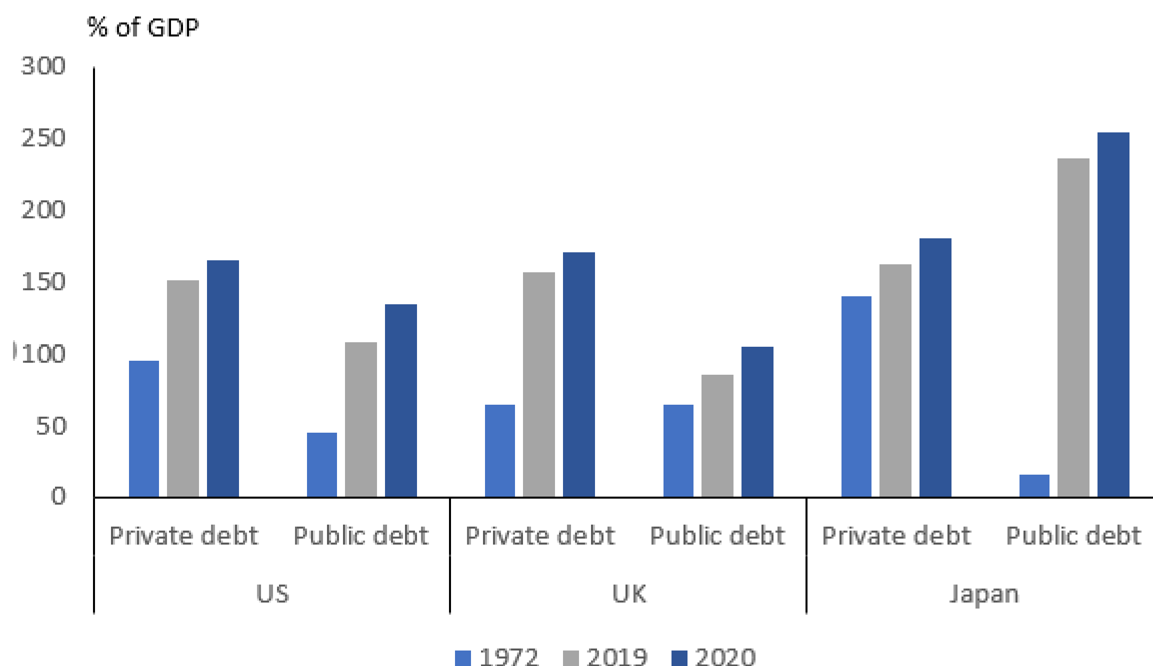


Source: Haver Analytics

The other difference is the level of debt in advanced countries then and now (Figure 8). Both private debt (loans and debt instruments) and public debt, measured a percentage of GDP, had

by the end of 2020 risen above pre-pandemic levels and were notably higher than on the eve of the first oil shock. There has been some deleveraging in 2021 but the private sector like governments is still highly leveraged. In the euro-area for instance corporate debt stood at 148% of GDP in 4Q21 and government at 96% of GDP. Unlike in the 1970s debt today, thanks to financial deepening is more widely held and has since the GFC has been accumulated at record low borrowing costs. High debt at the best of times is a drag on growth, in an environment of rising prices and interest costs the downside risks posed to growth are magnified.

Figure 8: Private and public debt – Highly leveraged

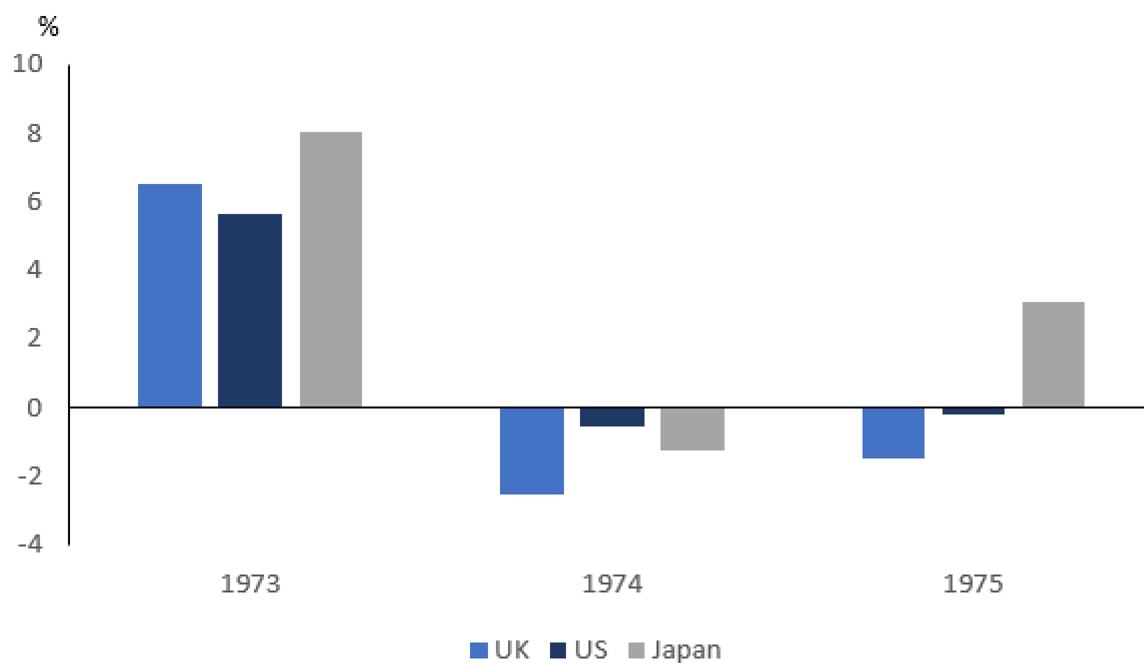


Source: Haver Analytics

Implications and Outlook: Recession Risks and Policy Responses

The two energy price shocks of the 1970 combined with rising interest rates to tip advanced economies either into outright recession and/or dragged down growth. Figure 9 shows the economic damage wrought during the first oil price shock. The recession in the US and UK lasted two years. In Japan, the fastest growing among the three in 1973, the downturn was short-lived/ The economy had recovered by 1975 but growth at 3% was sharply lower and was dragged down again during the second oil price shock. Still Japan's fortunes were better than its peers. The US economy contracted again 1980 while the UK went into recession for two years.

Figure 9: GDP growth – First oil shock tipped countries into recession

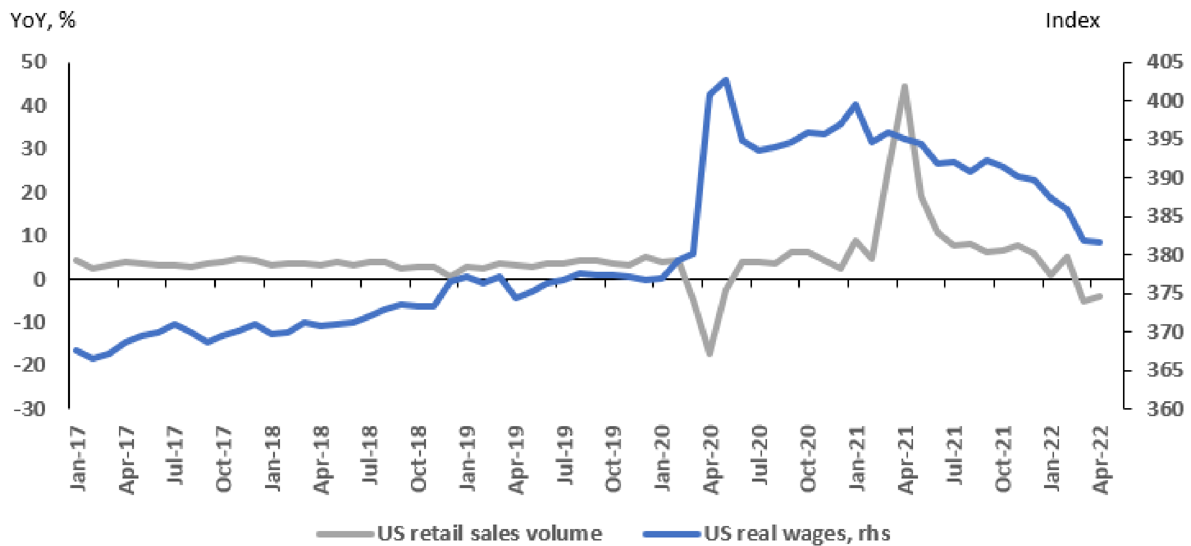


Source: Haver analytics

A looming recession threatens global economies, particularly advanced nations facing simultaneous shocks from rising food and energy prices. This has led to an unprecedented rise in the cost of living for households worldwide, while companies grapple with squeezed profit margins. Emerging and developing countries, reliant on food imports, are disproportionately affected by escalating food prices, exacerbating global economic disparities.

Twelve years and more of easy monetary policy is coming back to bite as excessive liquidity fuels inflation, depressing real wages and discretionary spending. Figure 10 is a case in point. US wages in real terms are falling steadily while retail sales volumes are now contracting on a year-on-year basis. Europe is no better off. Real monthly wages in Germany and Italy have been falling since 3Q20 with the downward trend steepening through last year. Real wages in the UK are still rising but consumers are already tightening their belts. Understandably. The cost-of-living crisis is eating through savings accumulated during the pandemic at an alarming speed. This is true for European and American households as well.

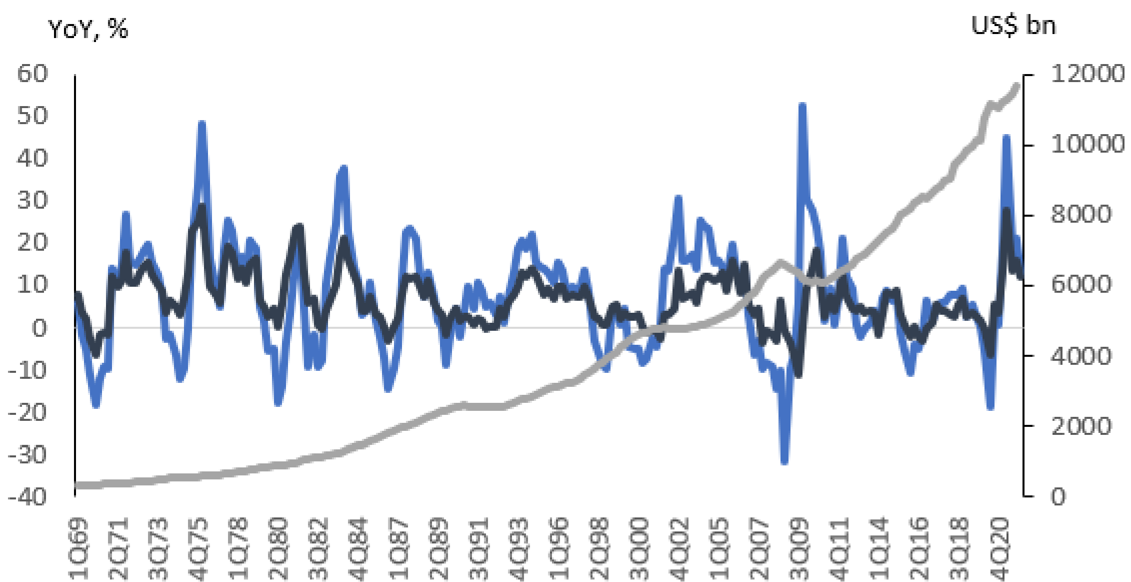
Figure 10: US real wages and retail sales – Households under pressure



Source: Haver analytics

Corporate profits rebounded strongly in the US and Europe in 2021. Figure 11 shows US corporate profit growth though is already softening. This is just the start. 1Q22 corporate profit growth was still well above the ten- and twenty-year average rates, suggesting that moderation was always on the cards. Add to this record high corporate debt, rising interest rates and slowing sales revenue growth, and the prognosis is not positive. If households are erring on the side of caution so will firms when it comes to investment spending.

Figure 11: US corporate profits, surpluses and debt – Vulnerable

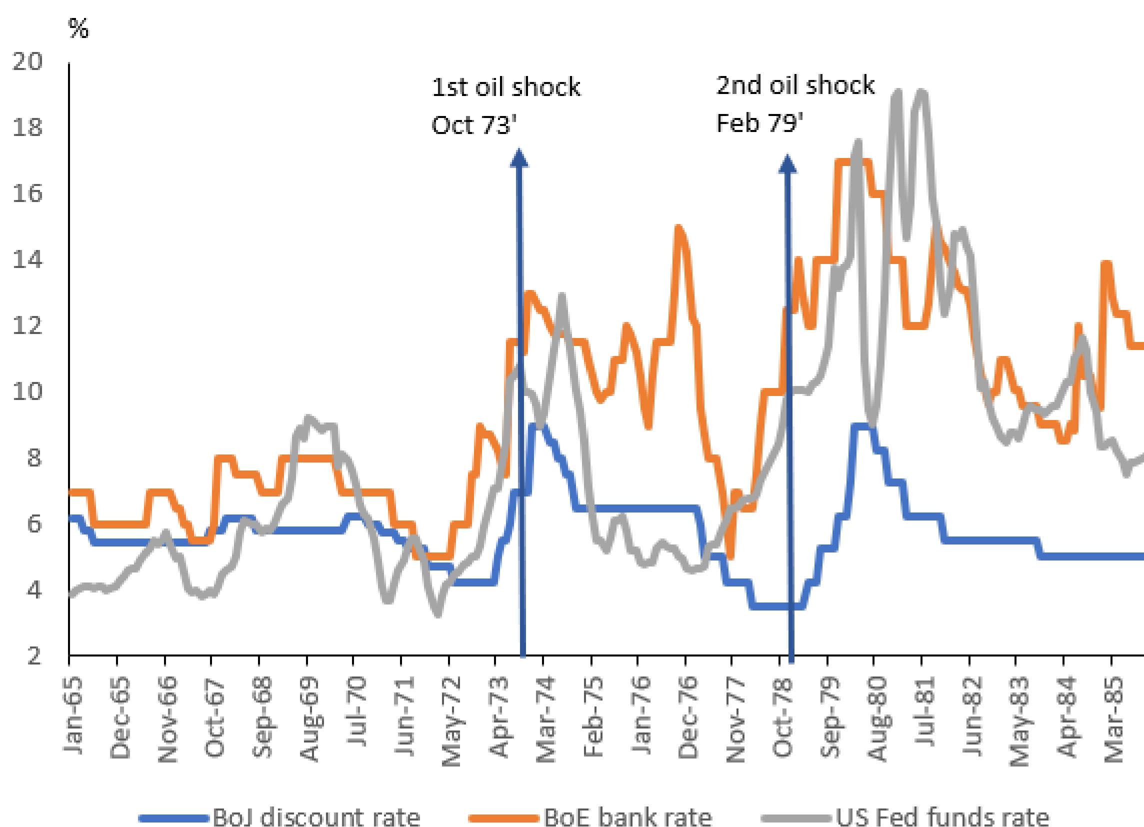


Source: Haver analytics, Aletheia Capital

The US Fed, BoE and ECB are in inflation fighting mode but how far will policy interest rates rise? Figure 12 shows that during the inflation spikes of the 1970s advanced country central banks were behind the curve, and consequently had to raise policy interest rates sharply to catch up and tame inflation. To rein in the Barber boom and in response to the first oil price shock the Bank of England had no choice but to lead. UK interest rates only peaked in November 1978 at

an eye watering 14.75%. Under the stewardship of inflation busting Fed Governor Paul Volcker US Fed funds rate ended even higher after the second oil shock, at 19% in July 1981.

Figure 12: Policy interest rates in the 1970s – Rates rise to painful levels during the oil shocks



Source: Haver Analytics, Aletheia Capital

If advanced country central bankers were slow to act during the two high inflation episodes of the 1970s, their current peers are even further behind the monetary tightening curve. Policy rates are today rising from historical lows while central bank balance sheets have expanded to unprecedently levels. This would argue that interest rates need to rise sharply, to well above neutral rates, whatever that is.

No one, including central bankers have a clue what the neutral policy rate is but there is growing consensus that it is lower than in the past. What this implicitly suggests is a greater tolerance for a higher rate of inflation if the trade-off is between growth and inflation. Nothing new there. Repeatedly since the GFC advanced country central bankers have ignored asset price inflation in favour of boosting economic performance. It is different this time around in that inflation has spilled out of asset prices into the real economy. Even so we rather suspect that as growth ratchets down, corporate defaults rise, and public finances come under pressure the appetite of advanced country central banks to keep raising policy interest rates will wane. The BoJ has reiterated again and again that it has no intention of changing of its monetary policy stance, although circumstances may lead to some adjustments at the margin. The ECB, always sensitive to growth, will probably raise its policy interest rate twice this year, the BoE by another 75-100bps and the US Fed by a further 100-125bps before pausing.

In conclusion, the global economy stands at a precarious juncture, characterised by heightened geopolitical tensions, escalating inflationary pressures, and mounting debt levels. Whether advanced economies can navigate these challenges without descending into a deep and protracted recession remains uncertain. The next few quarters will be critical in determining the path forward, as policymakers grapple with exogenous shocks beyond their control, amidst a backdrop of weakened economic resilience compared to previous crises.