Elston

25th March 2022

Elston Insights

Inflation revisited: lessons from the 1970s

- Inflation should moderate in the long-term
- Current circumstances are different to the 1970s
- The focus should be normalising rates and supporting growth

*In a recent CPD webinar, Elston's **Henry Cobbe** interviewed **Patrick Minford**, Professor of Applied Economics at Cardiff University and economic adviser to Margaret Thatcher in the late 1970s and early 1980s to ask about the fight with inflation in the 1970s and any comparisons for today.*

While it is tempting to look for similarities with the energy shock and period of sustained inflation that the UK suffered in the late 1970s and early 1980s, Professor Minford highlighted some significant differences. The lower risk of a wage-price spiral, central bank independence and a track record of manging inflation means lower risk of inflation getting out of control in the long-term. But the short- to medium-term remains under pressure. In Minford's opinion, the risk to the growth is the bigger risk: and this would be the right time for HM Treasury to worry less about debt ratios, and turn on Government spending taps.

Wage-price inflationary spiral was lethal

The first of these is the absence of any formal link between inflation and wages in the present-day environment. Minford explains, "The big inflation problem that Mrs. Thatcher had to deal with really got going at the start of the 1970s when the Heath government was in power and was very focused on curbing rising unemployment. It therefore went in for some extremely expansionary policies and as part of those policies, it indexed wages to inflation. However, in order to make that work, you have to be very tough on the economy and you have to damp inflation right down. But by introducing this indexation policy and refusing to stop expanding the economy, when we then had the oil crisis in the mid-1970s, it triggered enormous cost-push inflation which in turn prompted rising wages due to the indexation situation, and everything transmitted through to everything else. It was a huge wage-price spiral."

Central Banks are now independent

Another key difference he sees is the fact that central banks now operate independently from the government and have proven experience in navigating adverse economic circumstances. Minford recalls, "Central banks weren't independent and had no decent track record of dealing with

inflation. In fact, there was a terrible track record of governments running central banks to stimulate the economy in a thoroughly Keynesian way over a long period of time, prompting the complete destruction of any anti-inflation credibility."

The situation today is quite different, in Minford's view. "Firstly because central banks have this (positive) track record. In fact, their problem in the last decade has been getting inflation up. That's how different it is from the 1970s. Nobody doubts their ability to push inflation down – it's almost too easy."

Risk of policy error

But Cobbe notes that on the subject of the current inflationary period, "Last year, the Fed was insistent that it was transitory and then suddenly they conceded that it might actually be quite persistent". The policy U-turn came at the start of 2022, when it became clear that central banks were preparing to implement rate rises came just in time, according to Minford. "Central banks started to realize that if they kept on saying "transitory", no one would expect them to react to the situation and then they would be caught with a lack of credibility in terms of their willingness to confront inflation. They realised this in the nick of time and changed their story."

Short-, medium- and long-term expectations

Minford's view of the current burst of inflation is relatively sanguine over the long-term. "Markets are expecting near-term inflation to stay high for a time but then they're expecting it to come down. My sense of it is that we'll see the worst of it this year and then some of the commodity prices that rose in previous years will come back down and that will help the rate to subside."

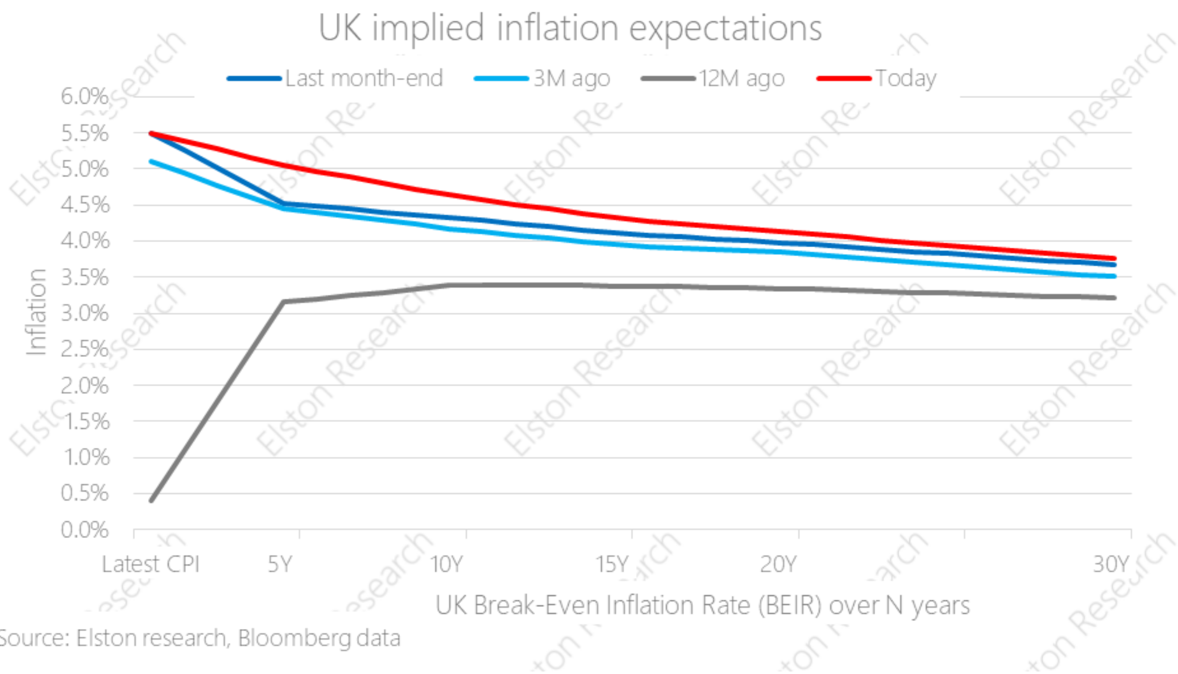
"We know that the bottlenecks are going to be eased, as always happens with these commodity cycles. After the First World War there was a huge one which in a couple of years came right back down again. In general, they have huge peaks and are then followed by troughs."

"Predicting the exact frequency is hard because the Covid recovery is playing out over quite a long period. We've also got the Russia-Ukraine war, which sees another supply-side commodity wave being unleashed. This will probably feed into inflation and prolong it. Exactly how these things will all play out is very hard to fine tune."

Charting inflation expectations over different terms

To help visualise this, the Elston research team put together a chart showing break-even inflation rates over different time frames. Whilst the 30 year implied inflation rate has not materially increased (to Minford's point), the 5 and 10 year implied rates have.

Fig.1. UK inflation-rate expectations "BEIR curve"



Source: Elston research, Bloomberg data, as at 9th March 2022

Risk to growth is the bigger risk

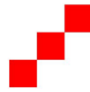
Minford believes that it is not inflation that should be the primary cause for concern at present in the UK but the risk of a misguided return to austerity prompting a prolonged recession.

"I think we could easily get back into the post-financial-crisis slump mode with interest rates going back down to zero and growth declining. That's the thing that worries me most about the present debate in the UK and the US. If the economy starts to seize up as it could easily do in response to rising interest rates, then central banks might just call off the show and go back to quantitative and low or zero interest rates which would be a disaster in my point of view. Because it would then feed the depression mentality."

Get spending

Minford feels the key to avoiding this lies with Treasury policy. "It's so important that the Treasury wakes up and realizes that its job in an environment of negative real interest rates is to spend and cut taxes and get the economy rolling so that central banks can do their job of raising rates to normal levels. I'm not at all worried about inflation taking off because I think central banks have got that firmly under control. My worry is that the government is being feeble in using this savings glut we've got to spend and push the economy along. They really don't have to worry about their credibility and solvency and so on. Their job now is to spend at these negative real rates. If they won't spend now, when will they?"

Marina Gardiner, Elston Research



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