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Asset Allocation

TODAY'S INFLATION – COMPARED TO MASSIVE INFLATION OF THE 1970s

By Michael Chu, Senior Wealth Advisor

The combination of persistent inflation and rising interest rates is a hot topic these days. Both the U.S. Federal Reserve and the Bank of Canada have been hiking interest rates to combat inflation – but they risk hurting the economy if they raise rates too much or too fast. They're in a tough spot. The alternative would be to act too late, and risk inflation getting so bad they'd have to bring the hammer down even harder.

But what, exactly, are they so scared of? In the 1970s inflation was persistently high for the entire decade. Both Fed Chair Jeremy Powell and Treasury Secretary Janet Yellen are quoted saying it was a "terrible period" and "no one wants to see that happen again."

From 1970 to 1981, the average inflation in the U.S. was nearly 8% per year for the decade. In that period there were also four recessions. Canada's inflation boom occurred a few years later, but averaged around 9% for 10 years. That means if a chocolate bar originally cost $1, it would cost more than $2.37 after 10 years, thanks to inflation.

So is that where we are heading? There certainly are similarities. Both in the 1970s and today, we have seen lots of government spending and an increase in money supply. Both periods also experienced food and energy shortages, as well as rapid wage growth. The latter is a big worry for central banks as there's a strong relationship between wage growth and inflation, which makes sense as we'd all spend more money if we made more money.

But there are many differences as well. One of the simplest reasons there likely won't be a repeat is that Fed officials have studied that period and the mistakes their predecessors made. Similarly, there wasn't a replay of the Great Depression in the 2008 financial crisis because Fed officials studied *that* period and the mistakes made. Our knowledge of the 1970s and the scars it left will be one of the biggest reasons a '70s-like outcome probably won't be repeated.

Through the 1960s and '70s, Fed officials and politicians were opposed to raising interest rates to a level that would slow inflation. It wasn't until Paul Volcker took over as Chair in 1979 that the Fed decided enough was enough. Volcker promptly raised interest rates from 10% to over 20%, causing two recessions in three years and sending the unemployment rate to double digits. In the 1960s and 1970s, the Fed originally focused on jobs over inflation. But by the early 1980s, Volcker decided inflation was more important than jobs.

During the pandemic, the Fed decided that keeping businesses alive and people working was its top priority, which succeeded. But now the Fed has shifted its focus to inflation. The new Fed plan has had little success so far – but we must remember these things take time.

We've all noticed the rise in oil prices in last two years, especially at gas stations. However, it's nowhere close to what people had to deal with in the 1970s. Oil prices went from $2/barrel at the start of the 1970s to $34 by 1981. That's a 17-fold increase. In 2020, oil was around $60. To match the 1970s increase, oil would have to go to more than $1,000/barrel! It's about $90/barrel today. Energy also comprised a greater proportion of household budgets in the 1970s than it does today, averaging around 70% back then to 35% today.

There's also a lot of other structural forces at play today that make it unlikely we're in for a repeat of the 1970s. Technology is a huge deflationary force and the pace of technological improvements has been exponential. Labour unions were much more powerful in the 1970s, leading to more rapid wage hikes while limiting the supply of competing labour. Globalization has also reduced costs. Although we might see less globalization going forward, it's not like we're heading back to the way things were in the 1970s.

Demographics is another big factor. In the 1970s, the baby boomers were reaching their prime working and spending years. But they also dwarfed every other demographic, so there was no other generation to offset their spending. Today, millennials are the biggest demographic, and are now entering their prime working and spending years. But the baby boomers still exist and are in or entering their retirement years. In other words, there's a countervailing force to the millennials that didn't exist for the boomers in the 1970s.

It's difficult to predict in the short term how inflation will turn out. It could remain stubbornly high for another year or two. But it's unlikely to be a repeat of the 1970s. There are significant differences in the structure of the economy. And, central banks today have the big advantage of having seen this movie before – its lessons are still fresh in their minds.

CIBC WOOD GUNDY | The Stan Clark Financial Team
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Phone: 604 641-4361 | Toll-free: 1 800 661-9442 | Fax: 604 608-5211 | Email: stanclarkfinancialteam@cibc.ca | www.stanclark.ca