ECO–NOTE

The Volcker shock

Vol.01
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Rothschild & Co
Asset Management

Forty years ago, the Fed pushed the economy into a recession to stop inflation. What lessons can we learn?

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The calm before the storm

Before 1965, US inflation was stable for years, hovering around or below 2%. But President Lyndon Johnson then began implementing big increases in spending, as part of both the war on poverty and the escalating war in Vietnam. While some of that spending was funded by new taxes, much of it wasn't, leading to higher deficits. Yet, at a time when the economy was near full employment, this policy translated into higher inflation.

Furthermore, in 1973, the Organization of the Petroleum Exporting Countries (OPEC) announced an oil embargo on the West, in part as a punishment for US and other nations' support for Israel in the Yom Kippur War. The price of gas nearly quadrupled between October 1973 and January 1974, contributing to the first of two extreme surges in inflation that decade, and to a relatively long recession ending in 1975.[1]

(1) Dylan Matthews, "*How the Fed ended the last great American inflation – and how much it hurt*", Vox, 2022

Volcker comes on the scene

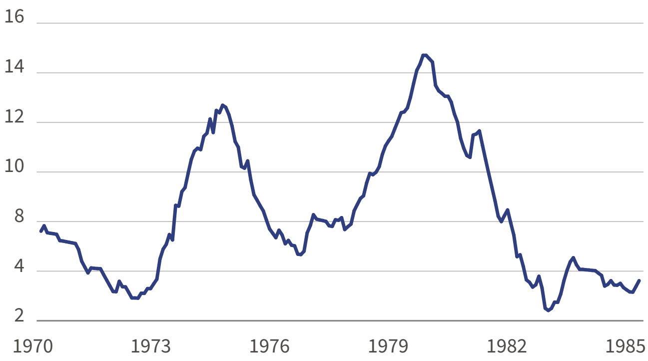
Paul Volcker
(1927-2019)

was an American economist who served as the 12th chairman of the Federal Reserve from 1979 to 1987. During his tenure as chairman, Volcker was widely credited with having ended the high levels of inflation seen in the United States throughout the 1970s and early 1980s. He previously served as the president of the Federal Reserve Bank of New York from 1975 to 1979.

Following the sharp rise in inflation in late 1970's, President Jimmy Carter shuffled his economic policy team and nominated Paul Volcker in August 1979 to become chairman of the Fed in large part because of his anti-inflation views. Indeed, Volcker had previously served as President of the New York Fed and had dissented from Fed policies as he felt strongly that mounting inflation should be the primary concern, believing the institution was facing a credibility problem when it came to keeping inflation in check.

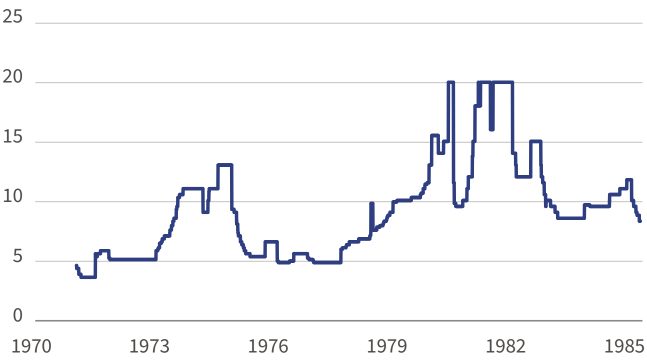
Indeed, during the 1960s and 1970s, the Fed believed it could lower unemployment through higher inflation, and vice-versa. As such, it pursued a "stop-and-go" monetary policy, alternating between fighting high unemployment and high inflation. During the "go" periods, the Fed would lower interest rates to loosen the money supply and target lower unemployment. During the "stop" periods, when inflation mounted, the Fed would raise interest rates to reduce inflationary pressure. However, the trade-off proved unstable in the long-run, as inflation and unemployment increased together in the mid-1970s. While unemployment trended down slightly by the end of the decade, inflation continued to rise, reaching almost 11% mid-1979.

US- Inflation rate
in %, CPI



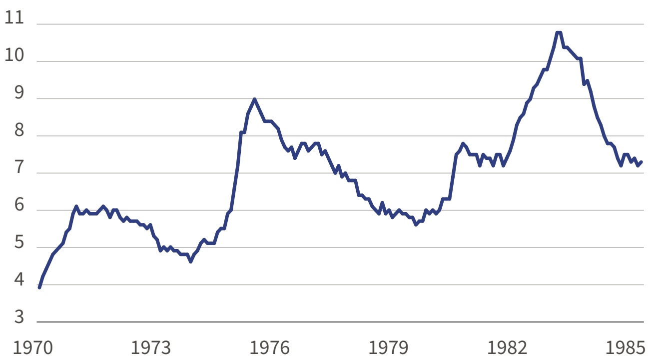
Source: Macrobond, Rothschild & Co Asset Management Europe, March 2023

US - Policy rate
in %



Source: Macrobond, Rothschild & Co Asset Management Europe, March 2023

US - Unemployment rate
in %



Source: Macrobond, Rothschild & Co Asset Management Europe, March 2023

US - 10-year sovereign rate
in %

Source: Macrobond, Rothschild & Co Asset Management Europe, March 2023

The first attempt proved insufficient...

During the December 1979–February 1980 inflation scare, the Fed took actions that raised interest rates substantially. Ultimately, however, these aggressive interest rate policy actions would only serve to contain inflation temporarily. Indeed, when the economy fell into a sharp recession in January 1980, the Volcker Fed behaved in a manner consistent with prior experiences, undertaking restrictive monetary policy in the face of rising inflation, but promptly reversing field to fight the recession as unemployment mounted, an action reminiscent of the "stop-and-go" policies the public had come to expect. By July 1980, the recession was officially over in part due to looser monetary policy, but after all the turbulence, inflation had barely been contained. In this sense, the dramatic high-profile policy actions of the first year of the Volcker era at the Fed looked not too different from previous inflation-fighting episodes.

... but the true onset of the Volcker disinflation dates to late 1980 / early 1981

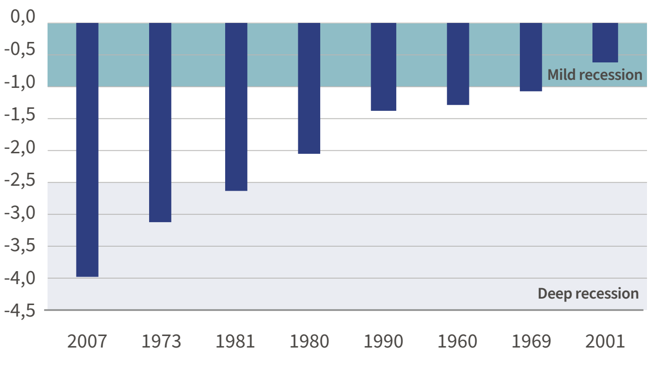
In November 1980, Reagan beat Carter in a landslide. Among other things, the Reagan administration voiced strong support for Fed monetary policy to reduce inflation, especially since the war between

Iran and Iraq increased concerns about rising energy prices and the robust recovery from the 1980 recession had stoked inflation.

In December 1980, inflation reached more than 12%. The fed funds rate reached 19% in December, with 6 percentage points of that increase coming in November and December alone. The funds rate stayed elevated through July of 1981, although it dipped due to technical factors associated the Fed's new reserve-targeting procedures and the introduction of nationwide NOW accounts in the spring. The FOMC understood that its tight policy risked a renewed recession, but Volcker argued that holding the line on inflation was warranted. Despite this, long-run interest rates continued to rise. The ten-year Treasury bond rate increased from about 11% in October 1980 to more than 15% a year later, possibly indicating that financial markets expected high inflation to return as the market believed the Fed would back down from its tight policy when unemployment rose. Long-term inflation expectations appeared to many observers to be moving up, rather than declining in the face of a restrictive monetary policy. This time, however, Volcker was adamant that the Fed not back down.

The economy officially entered a recession in the third quarter of 1981, as high interest rates put pressure on sectors of the economy reliant

US - Recessions
in %, GDP, peak to trough

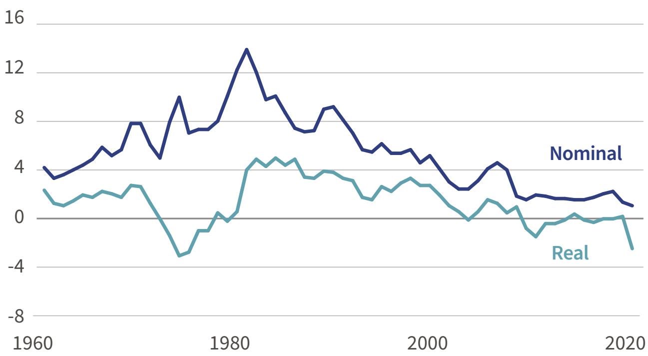


Source: Rothschild & Co Asset Management Europe, March 2023

World - Labor market flexibility
in %

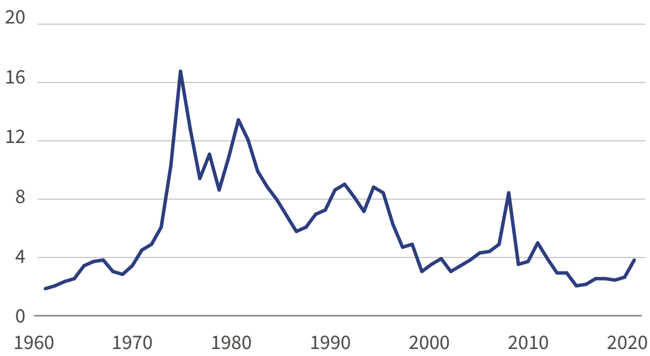
Source: WorldBank, Rothschild & Co Asset Management Europe, March 2023

World - Interest rates
in %



Source: World Bank, Rothschild & Co Asset Management Europe, March 2023

World - Inflation
in %



Source: World Bank, Rothschild & Co Asset Management Europe, March 2023

10,8%

peak unemployment rate in 1982(2)

14,8%

peak inflation rate in 1980(2)

on borrowing, like manufacturing and construction. Unemployment grew from 7.4% at the start of the recession to nearly 10% a year later. As the recession worsened, Volcker faced repeated calls from Congress to loosen monetary policy, but he maintained that failing to bring down long-run inflation expectations now would result in more serious economic circumstances over a much longer period of time.

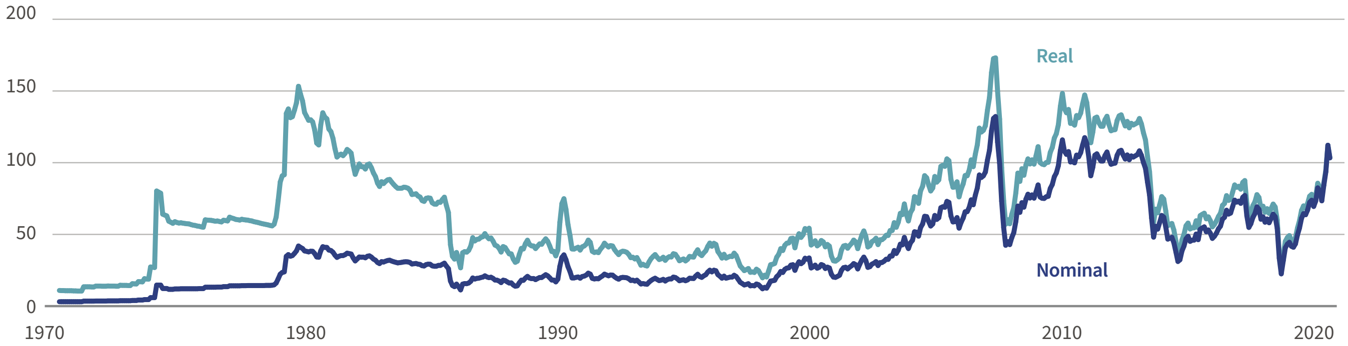
By the end of 1982, inflation had fallen to 4% and long-run interest rates began to decline. The Fed allowed the federal funds rate to fall back to 9%, and unemployment declined from the peak of nearly 11% at the end to 1982 to 8% one year later. Overall, the 1981-82 recession was the worst economic downturn in the US since the Great Depression, with the nearly 11% unemployment rate reached late in 1982 remains the apex of the post-World War II era barring the Covid crisis.

1970's: Differences and similarities

In recent decades, several forces supporting the global economy were strongly disinflationary, including technological advances, the shift of labour out of agriculture (especially in EM countries), globalization, and rapid population growth. As these fades, combined with the surge in consumer prices of the past two years in almost every country, some investors worry the global economy could face a period

(2) Source: World Bank, mars 2023.

World - Oil price
$ per barrel



Source: World Bank, Rothschild & Co Asset Management Europe, March 2023

of persistent high inflation, echoing the experience of the 1970s. Indeed, inflation has come back faster, spiked more markedly, and proved to be more persistent than most central banks initially thought possible.

Between 1973-83, global inflation averaged more than 11% a year, almost three times as high as the average during 1962-72, when large supply shocks, accommodative policies, and a fading of structural forces that promoted growth and disinflation triggered prolonged stagflation[(3)]. Today, the commodity price surge in the wake of Russia's invasion of Ukraine has exacerbated already elevated inflationary pressures driven by the pandemic's supply disruptions, both in the goods sector and labour market. In that regard, the situation resembles the 1970's supply oil shocks. Furthermore, then and now, monetary and fiscal policies were accommodative in the run-up to these shocks.

However, the 1970s were a time of considerable structural economic rigidities, as collective bargaining covered four-fifths of employees on average OECD countries[(3)]. As such, general wage indexation was a powerful force in the wage-price spiral: when consumer prices rose by 1%, wages automatically rose by 1%, which increased firms' costs in proportion to their wage bill, pushing up prices. But in the 1980's, most countries decided to stop/ban indexation clauses as these schemes

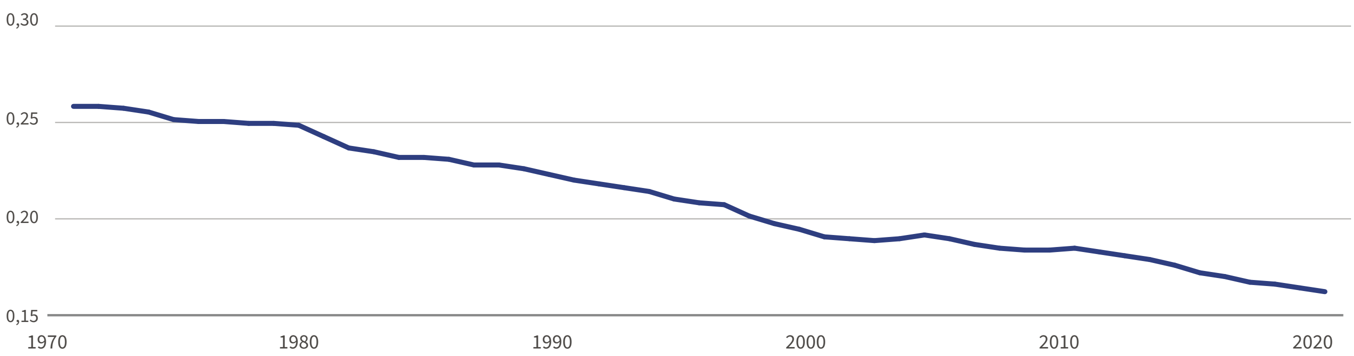
(2) Source: World Bank, mars 2023.
(3) World Bank. 2022. *Global Economic Prospects*, June 2022. Washington, DC

involve the risk of upward shocks to inflation lasting longer[4]. Greater economic flexibility, with less centralized wage setting, also allows businesses to modulate wage revaluations according to their capacity to pass on the increase in costs to their customers and they might spread revaluations over time, depending on the evolution of their margins[5].

In addition, the energy intensity of GDP has fallen considerably since the 1970s. The steady decline in the amount of energy needed to generate a dollar of income was possible as oil-importing countries have taken numerous steps to reduce their vulnerability to energy shocks, namely by technological advances and substituting to sources such as natural gas and renewables, including solar and wind.

Furthermore, there has been a paradigm shift in monetary policy frameworks since the 1970s. In the 1970s, central bank mandates incorporated multiple competing objectives, including for output and employment, and policymakers were inclined to attribute rising inflation to special factors, underestimating the pervasive and lasting impact of excess aggregate demand pressures. In contrast, today's central banks have clear mandates for price stability, expressed as an

World - Global energy intensity
tonnes of oil equivalent per $1,000 GDP



Source: World Bank, Rothschild & Co Asset Management Europe, March 2023

(4) ECB, *Monthly Bulletin*, 2008
(5) Agnès Bénassy-Quéré, "*A price-wage loop on the Christmas tree?*", DG Trésor, 2022

explicit inflation target, and have established a credible track record of achieving their targets. As a result, inflation – in particular, core inflation – has become much less sensitive to inflation shocks.

Lessons learned

Overall, synchronous policy tightening around the world contributed to the global recession of 1982, but global inflation waned to 5.4% per year, on average, in the remainder of the 1980s.

Thus, a key lesson from the 1970s is that central banks need to act in a pre-emptive manner to avoid a loss of confidence in their commitment to maintaining low inflation, specified today in their inflation targets. It is also critical to avoid inflation de-anchoring where households and businesses would base their wage and price expectations on their recent inflation experience, which would enhance the risk of wage-price spiral.

Incidentally, it remains to be seen if today's almsot unprecedented global monetary tightening will also morph into financial instability as it was the case in the early 1980's. Indeed, the Volcker shock set off a debt crisis in Latin America as many Latin American governments had borrowed from US banks, which charged far higher interest rates after Fed's hikes. As a result, Mexico defaulted on its debts in 1982, with others to follow.

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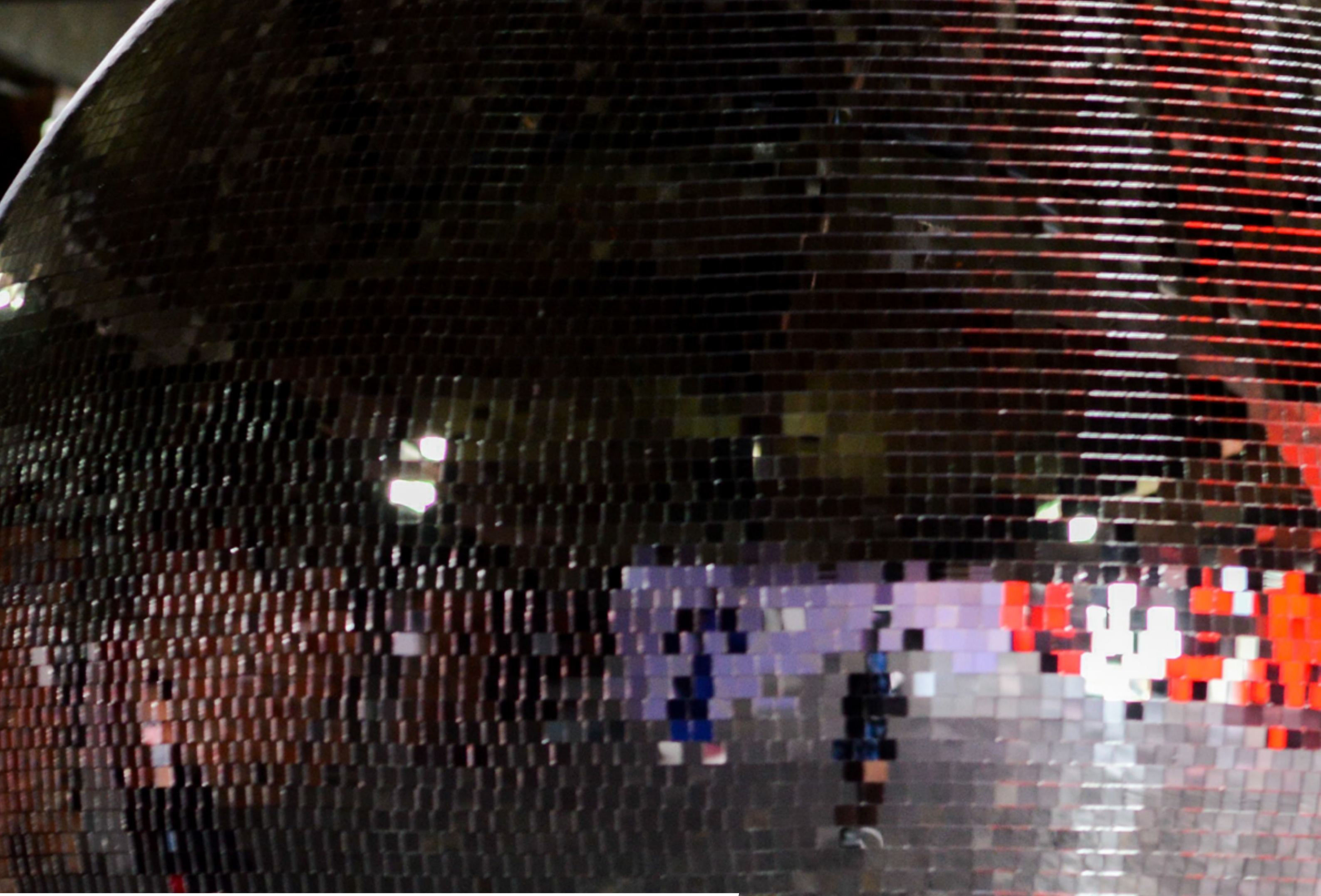

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