GlobalData. TS Lombard

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The View

HOW THE 60s BECAME THE 70s IS RELEVANT

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- Today's combination of fiscal and monetary policies invokes memories of when the Fed cut short progress on inflation to avoid recession -- today is not a mid-90s policy.
- What turned 60s inflation into 70s inflation was the shock of Bretton Woods collapsing on global commodity prices and subsequent policy errors.
- Commodity shocks are much less meaningful today, capital shocks now have greater impact, and today's policy missteps could create one.
- Downward adjustments to payrolls + Upwardly revised GDP = higher productivity but also the likelihood the Fed's target rate is too low.

Summary

The economy of the 1960s is not exactly the economy of today, but the similarities including the direction of monetary policy are what's troubling. The 1960s mismanagement of domestic policy within a fixed-exchange rate system and growing global trade led to the collapse of Bretton Woods and 60s inflation turned into a series of global commodity shocks that sent 70s inflation spiralling upward. Today, with net inflows of capital equalling 4% of GDP, the notion of a stable system of global capital flows may yet be challenged if the Fed must choose between shoring up the current system at the expense of near-term economic growth.

That a fixed-exchange rate system would eventually fail given sharply divergent inflation trajectories was always obvious to some, sustainable with adjustments to most, but failure should have been recognized as inevitable when "The Gold Pool" collapsed in 1968 when sterling crashed out. This set off a contagion from sterling to the dollar that put into motion diminishing credibility that the dollar/gold parity would hold. In response, Congress ended the gold-backed requirement of the dollar, active gold pool countries agreed to stop supplying gold to the private market, and the SDR was born. That year, the US also refused to raise the official gold price from $35/ounce because hiking would be paying a "ransom to international speculators".

Nevertheless, as we read in the January 1969 Economic Report of the President quoted above, written by CEA Chair Arthur Okun, the Administration believed that "the international monetary system was strengthened in 1968", aided by an improved US balance of payments thanks, in part, to capital controls and demand that our partners buy their defence equipment from US firms. It was not.

The problems were not fixed because the root cause of inflation remained in place. The degrees of freedom for the Fed were, at the time, small. While Johnson argued that fiscal balance should lift the weight of economic decision making from the Fed alone, he added that the independence of the Fed was "within government". He also believed the Chair's term should be "geared to that of the President". Trump is far from first in demanding that his people run things.

The end of Bretton Woods saw DXY drop from 120 in March 1971 to 92.87 by August 1973. The DM/$ traded at 0.4657 in the 1950s, revalued to 0.489 for the 1960s, and jumped to 0.8371 by July 1973. The price of oil, in response, went from an annual average of $3.60 in 1971, and around $3/barrel for most of the 1960s to $10.11 by January 1974. From there, the inflation race was off and running, until Volcker, with the backing of the White House and the international community looking for a stable dollar, jammed up real rates, tanked the economy, and held firm until Reagan tired of him by the mid-1980s.

1961?

Then, the Bretton Woods structure could impact domestic policy to some extent, although stresses were always viewed as something to be managed, rather than reverse the domestic agenda. Until it could not. Today, exchange rates are no longer fixed but essentially managed by central bank policies and the impact of capital flows on domestic rates is mitigated by the size of the Fed balance sheet – no longer are high real rates necessary to keep the dollar strong. Domestic policy can consequently become more focused on protecting domestic industries.

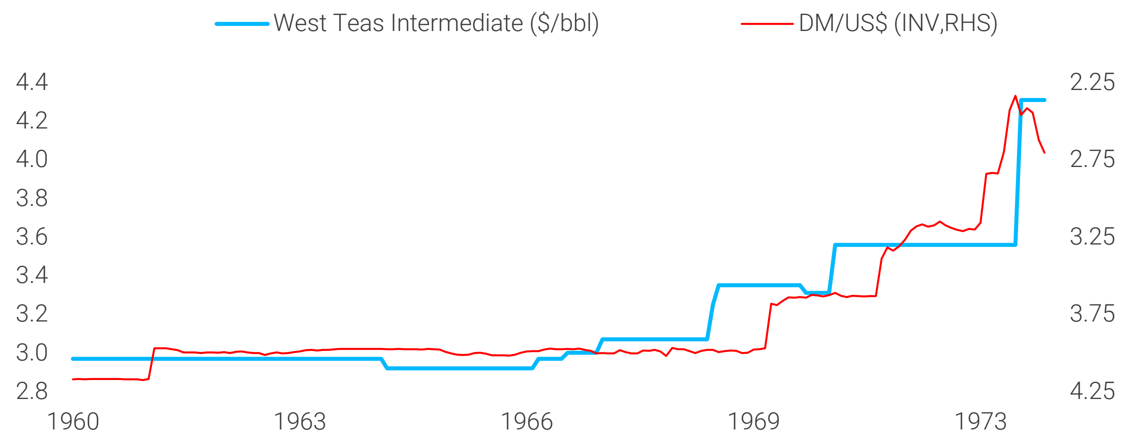
Keep in mind, however, that the US is a net importer of capital to the tune of 4% of GDP versus 2% pre-Covid. To what extent can the Fed ignore the potential impact on global capital flows of a domestic policy agenda that inevitably means higher inflation and a weaker dollar? The current structure impervious to pressure considering how there is no large-scale alternative for global capital -- especially with the dollar so ubiquitous to global economic activity, even when the US is uninvolved.

I have no crystal ball as to where funds could flow otherwise, but I do believe the current policy mix, if it continues in the current direction, eventually tests the stability of the current structure. At that time, the Fed could be faced with choosing between a global capital shock and a domestic growth agenda supported by the White House. Better productivity could bail out the Fed, but not if they lag on policy and keep r* too low. That 70s show was about the Fed not being able to have it both ways, it is on the way to learning that lesson, again.

Commodity shock then, capital shock next?

What turned 60s inflation into 70s inflation was how US policy dealt with the rolling commodity shocks from the sharp sudden depreciation of the dollar – the result of inflationary policies in the 1960s. After decades of currency stability, and contracts built around that, the sudden sharp depreciation in the dollar was going to impact global commodity pricing, especially because they were mostly denominated in dollars (Chart 1).

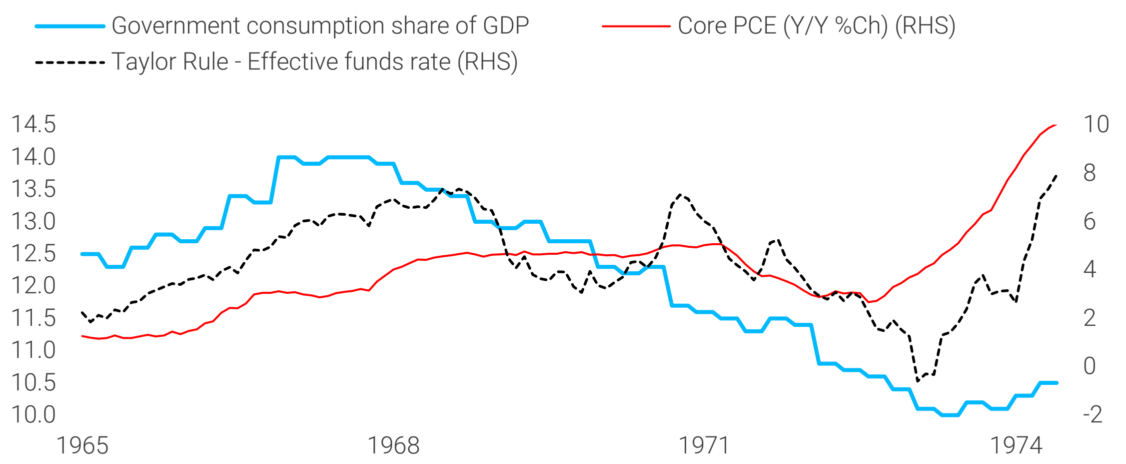
Chart 1: Sharp dollar depreciation inevitably led to a commodity shock, including oil



Source: BEA, Federal Reserve, GlobalData. TS Lombard

Heading into the late 1960s, the Federal government's share of GDP from 12.5% in 1965 t. o 14% in 1967, a combination of defence and non-defence spending, and pretty much stayed at that high level into 1969 (Chart 2). Monetary policy tightened, eased, tightened, and eased again during this period, but the "Taylor Rule" level (then unknown) nevertheless rose from 200BP above the actual funds rate to 700BP in early 1969. Inflation, in response, rose from 1.2% to 4.7%. A recession hit in 1969, the Fed eased, cutting the recession short (the soft landing of its day, and monetary policy quickly fell behind again, eventually leading to the breakdown of Bretton Woods and the start of the 70s commodity driven inflation.

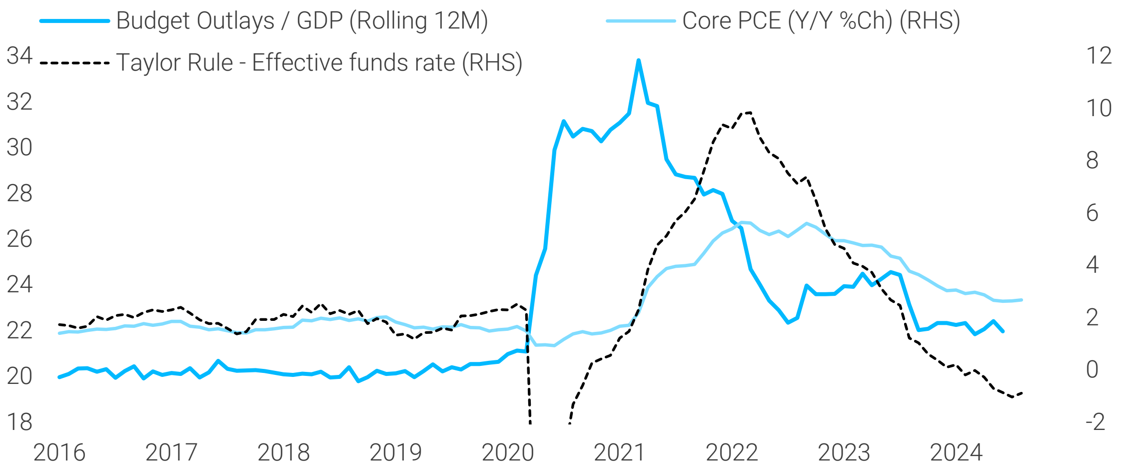
Chart 2: Easy money and rising government spending were behind late-60s inflation



Source: BEA, GlobalData. TS Lombard

While the pattern is not the same in the current period because of COVID, there was a similar combination of rising budget outlays and easy money that were slow to unwind. Outlays are still a higher percentage of GDP than pre-COVID, the Fed funds rate is now above the Taylor Rule but less so than a month ago, and inflation is running about 150BP above pre-Covid levels (Chart 3). More so, because of QE, the overhang of the excess deposits created by government transfers remains in the economy. Ownership of the deposits has obviously changed, but the funds are still in the banking system, or held by money funds, and can be converted into loans once the curve flips positive and confidence in growth is steady.

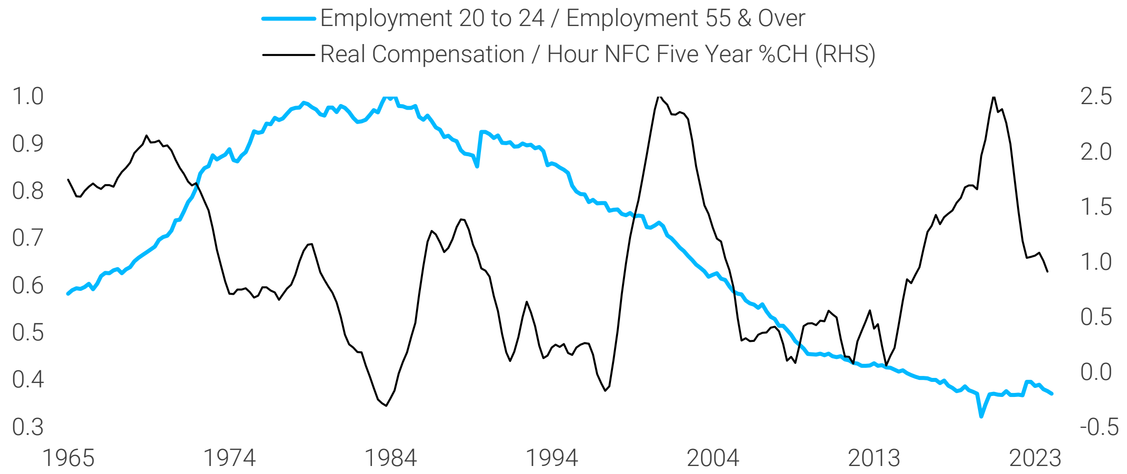
Chart 3: As in the late 60s, strong spending and easy money raised the base level of inflation



Source: BEA, Federal Reserve, Treasury, GlobalData. TS Lombard

Interestingly, the surge of new entrants into the labour market from the mid—60s through the 1970s was inflationary to the extent that government wanted to make sure the economy grew fast enough to create enough jobs. Then there was the issue of domestic production being able to meet higher demand – productivity growth in the decade slowed. Yet, in looking back, the inflation story got a bit of a break because the labour surge dropped real compensation per hour (Chart 4) – and the explanation for favouring labour over capital and lower productivity growth during that period (Chart 5). Since the mid-80s peak, the long trend in real wages has been up. Looking forward, slow growth in the younger age cohorts suggests a sustained an upward tilt to real wage growth.

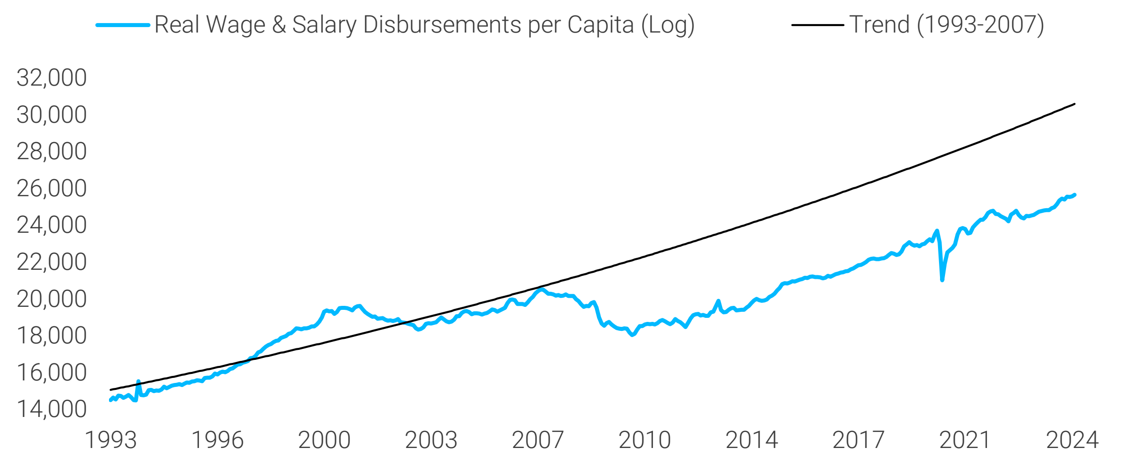
Chart 4: Low levels of new workers gives an upward bias to real wage growth



Source: BLS, GlobalData. TS Lombard

The productivity response will be interesting, but also not all encompassing in terms of creating non-inflationary real wage growth. I do not want to hijack this View with the productivity story, but it is relevant to inflation going forward as higher wage costs will boost domestic replacement of labour with capital – here and globally. To the extent production stays outside the US, the source of much of US productivity growth, it is problematic for boosting domestic real growth through higher real wages (Chart 5). This leads to the eventual conflict between White House goals to restore real growth and the Fed using high real rates to support the dollar and, in turn, sustain sourcing of foreign labour and capital.

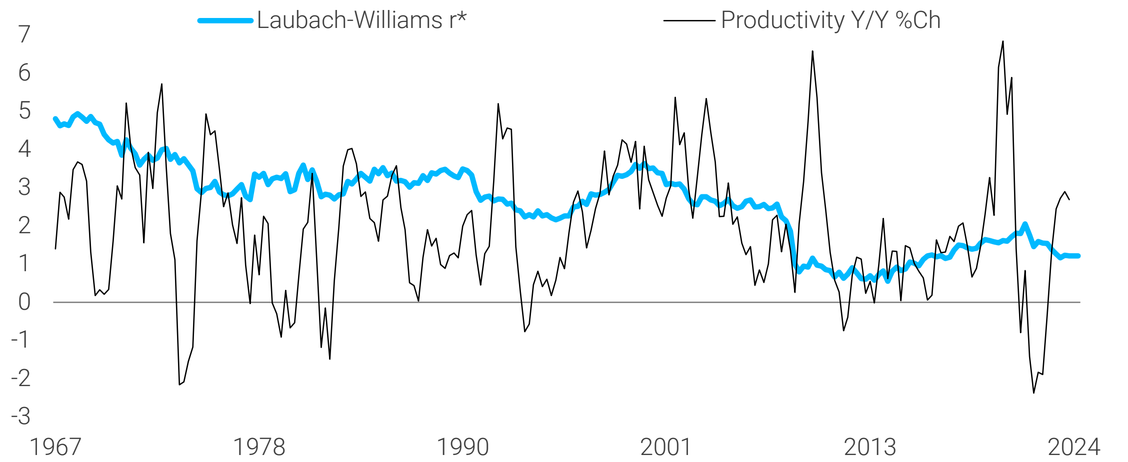
Chart 5: The growth gap in real per capita total wages is real and polices are trying to close it



Source: BLS, GlobalData. TS Lombard

To the extent that productivity is truly on the rise, and the recent data updates say it is, r* reflects productivity (Chart 6), and if the Fed lags in recognizing the increase, inflation will ensue – there is more than ample liquidity to finance inflation. Remember that in the 1990s, Greenspan kept real rates higher than 2%, allowing for productivity induced growth (including the further ramping of the trade sector as a percent GDP) to raise real incomes without inflation. That this Fed is still holding to a 90BP real rate suggests that they are already lagging – if the soon to be updated productivity data are raised as expected.

Chart 6: R* travels with productivity growth

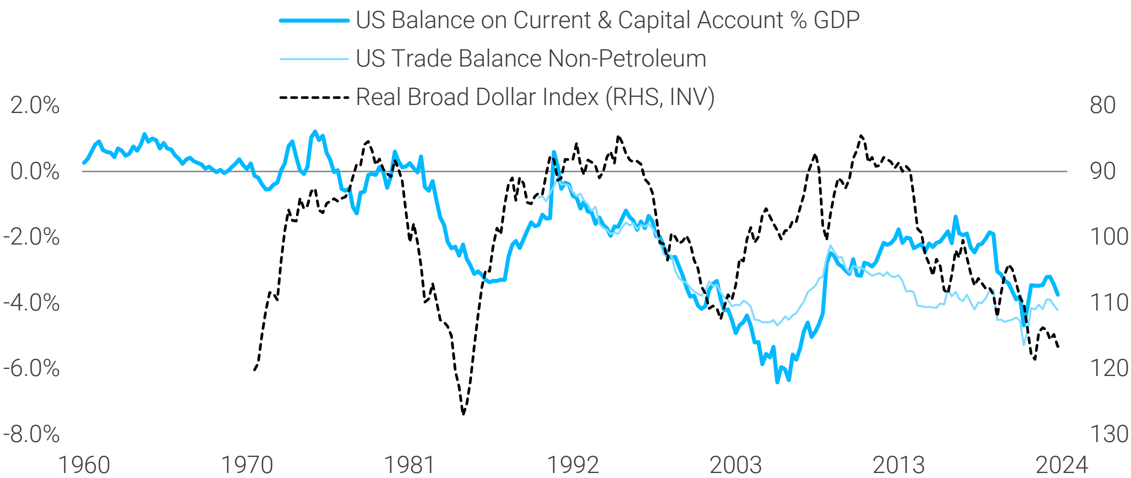


Source: BLS, NY Fed, GlobalData. TS Lombard

The governing force in the 60s that eventually gave way was fixed exchange. Today, instead, the governing force is managed FX regime where central banks use their balance sheets to determine capital flows and, in turn, keep the global system functioning without undue volatility.

In 1971, the US negative balance on its current account was around 1%, the dollar was at 120 and depreciated to 85, with the worst imbalance being 1.3% of GDP in 1978. But then the 1980s happened, and value of foreign sourcing to reduce US inflation took hold. With the "strong dollar" mantra taking hold after the Louvre Accord in 1987, the world has been more than happy to hold strong dollars in exchange for selling the US its overproduction. As a consequence, today's real broad dollar index is at strong 116 with the current account deficit sitting at 4% of GDP.

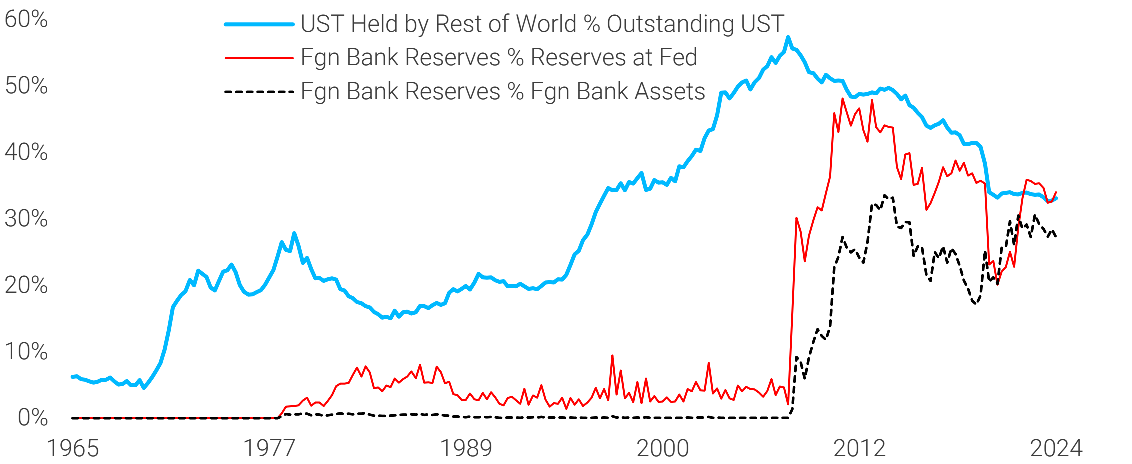
Chart 7: World will bid dollars in exchange for selling its overproduction into the US



Source: BEA, Federal Reserve, GlobalData. TS Lombard

With the US budget deficit large and growing, there is a limit to how high the Fed and government are willing to let real rates rise to keep this monetary/goods quid-pro-quo working. This was not an issue in the 1990s when the deficit was morphing into a surplus and the volume of outstanding UST was shrinking. Faced with the opposite situation, QE the Fed effectively disintermediates foreign buyers of directly holding US Treasury debt, but, in turn, foreign banks own the debt by holding deposits at the Fed (Chart 8).

Chart 8: Foreign ownership of UST has shifted from direct holdings to holdings through the Fed B/S



Source: Federal Reserve, GlobalData. TS Lombard

In sum, therein lies the inherent instability should current Fed policy lead to higher inflation and the weaker dollar that is deemed necessary to meeting the policy goal of restoring domestic production to boost real incomes. Foreign banks are intermediaries, and their depositors could, in an inflationary regime where dollar stability is no longer paramount, decide to move their assets elsewhere and leave the Fed in the untenable situation of balancing outflows against the need to keep real funding rates lower than where they would be if the current account deficit was being funded without the Fed.

This is, in some ways, Bretton Woods of a different order. The current system is, in the end, less stable that it seems at present. The risk is not immediate, but the timeline to problems is also not of an infinite length. Productivity can be a bailout, only if it means increased production rather than a larger tradable goods sector – on this the jury is still out. Further, even with better domestic production, the Fed could still set the funds rate too low, lagging in recognition that the real rate is higher than they are targeting.

Global funding of large volumes of US debt is accepted as long as it means there is place for the world to sell its goods and services well beyond what their domestic economies can purchase. The 40 years of this strategy has created a global demand for dollars far beyond the need to finance any activity with the US. For the US to now push against the inflow of goods to protect its domestic economy is a fair enough policy position to take, but the risk is that the dollar financing side of the arrangement becomes untenable for lenders.

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