How different are the 70s from today?

Inflation is high, and while there are many similarities with the 70s so are the dissimilarities. Here I discuss a few important dissimilarities

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The war in Ukraine has raised significantly the odds of a recession in the near term, but also the likelihood to move into a new inflation regime as in the 70s. How real this risk is, depends on the key differentiating factors between now and then.

In a nutshell, textbooks would tell that a sequence of oil crises (rooted, like now, in geopolitical factors) permanently increased the cost of production for firms and, by extension, the cost of goods and services. This subsequently triggered a wage-price spiral (as households were trying to catch up with rising prices) which led to ever-increasing inflation. Such past experience places a material probability that a similar mechanism triggered by the same factors (oil shock and high inflation) might re-emerge with the Fed or all other major central banks unable to control inflation.

A closer look, however, at the underlying factors that underpinned the mechanism behind this wage-price spiral would suggest that this time is different. In short, the structurally weaker bargaining power of workers and its dependency on the economic cycle is effectively putting an upper limit to any catch-up of wages with extreme inflation. The direct implication of this key differentiating factor alone is that a) any wage-price spiral is likely to be short-lived relative to the 70s, especially when growth would start to slow down and b) the cost-push shocks are unlikely to turn into permanent supply shocks as then.

In the rest of this post, I will mostly focus on discussing this argument in more detail, along with a few other, more known, key dissimilarities between then and now. In my mind, I have mostly the US economy, but some of the arguments are relevant to other countries, too.

The 70s and now

One obvious difference between now and then, is that this wage-price spiral that unfolded during the 70s was heavily relying on the structurally strong bargaining power of workers that is absent today. Workers at the time were unionised and their bargaining power did not necessarily depend on the tightness of the labour market or the state of the economy as now. Currently, a recession or a slowdown in economic activity (either due to monetary policy tightening or a negative shock such as now with oil prices) is almost automatically reducing the bargaining power of most workers, and this in a fashion that nominal wages might not necessarily catch-up with inflation without legislation.

An exception here might be the high-income high-skilled households who nevertheless tend to consume less energy-intensive products (with declining overtime cost of production due to technological advancements) while their high marginal propensity to save diminishes the strength of aggregate demand on prices (formally flattening of the Philips Curve). This also highlights that in the absence of trade unions the degree of (wage or income) inequalities is another confounding factor that stops wages from catching up with inflation and implies that, on the aggregate, real wages most likely would fall. This effect in turn can help offset the (often reversible) production costs due to higher energy prices and help prevent the cost-push shocks to turn permanent.

Put more simply, the structurally weaker bargaining position of workers in effect implies that any temporary cost-push shocks are less likely to manifest themselves into the permanent supply shock of the 70s, especially since oil is now a less important input to production compared to the past.

New modes of work arrangements and the ability of multinationals to either outsource or reallocate abroad (expensive) labour-intensive functions are two other factors that can reduce the persistence of cost-push shocks. For example, competition might force firms to contain their labour costs and among the available options they have is to offer indefinite work-from-home arrangements. This new mode of working could lift some of the pressure for workers to catch up with inflation when they are given the option to indefinitely move to less expensive regions. On the other hand, multinationals might choose to react more aggressively if they think their profitability is severely distressed. For example, they could choose to outsource some of their labour-intensive high-skill functions or reallocate their workers abroad. Given their size in the economy and the limited availability of quality jobs for high-skilled workers in advanced economies, this might further reduce the bargaining power of workers when economic growth slows down.

Excess saving, secular stagnation, low-interest rate and all that

Secondly, the world now is structurally very different from the 70s. We live in a world where the global economy (perhaps for the first time in its history) is producing an excess amount of savings with record-low real investments. With governments around the world not really solving this problem, it is extremely unlikely to see any change in this structural issue in the foreseeable future. This dearth of investments contains, therefore, a very strong deflationary process that was totally absent during the 70s.

The forced coordination across countries to transition to net-zero, or the accidental coordination to increase defence spending (which has little to no influence on r^*, the natural interest rate), is unlikely to outweigh the strong incentives to save that come from demographics, higher inequalities, structural weaknesses in labour markets combined with a weaker welfare state, and government or private market schemes, such as private pension schemes or other unfunded social security programs. These schemes typically raise the incentives to save, but at the cost of depressed returns on capital and higher financial risk. This further reinforces the incentive to save to reach target wealth levels by retirement, which in turn further depresses returns, and so on (a "savings trap"). We now know from experience that in this world, financial markets have a stronger incentive to keep most of the liquidity in the financial system (in search of yield) rather than finance real investments that depend on a very weak long-term growth outlook.

Other key differences

There are a few other more nuanced differentiating factors that are worth highlighting here. First, the degree of financialization together with the prevalence of idiosyncratic financial risks to households unveils other strong deflationary forces.

For households, is safe to assume that it is more challenging now to insure against the risk of employment, career and job displacement risks, health shocks etc. So, the most important insurance mechanism against bad outcomes is to build up buffers of savings and more wealth. Such a (structural) precautionary savings motive might be stronger today than in the past for a number of reasons:

- Much weaker welfare states and employment protection that increase the severity of possible negative income shocks (which academic economists showed also explain the skewness of, much more uneven today, wealth distribution)
- More leveraged households are extremely susceptible to negative wealth shocks mainly due to the housing market
- More individualistic societies that make people rely more on their own feet than expect the help of others. Having money and building up wealth becomes then a high-order priority for most households to survive any adverse outcome or to increase their quality of life.

Second, the degree of financialization, as is captured by what economists might call market incompleteness, has increased since the 70s due to the liberalisation of capital flows and the availability of more hedging instruments. Now, the degree by which investors can hedge against risks is substantially greater today than before. In a world in which liquidity is abundant, this reinforces the incentives of the financial system to allocate more money into (risky) financial assets rather finance real investments (which as said before rely on a weak long-term growth outlook).

Final thoughts

Although this analysis is anything but comprehensive and the future is always uncertain, I highlighted here a few crucial differentiating factors that play a dominant role in most economies today and are important for the inflation regime. The deflationary forces from the structurally weaker labour force not only put an upper limit to the wage-price spiral (that is central to many peoples' arguments for inflation to go out of hand) but also limit the extent by which a cost-push shock can turn into a permanent supply shock. This, together with the legacies from the "excess savings world", unleashes a strong deflationary process that can only be reversed by either a serious escalation in the war in Ukraine (a largely unpredictable factor) or by some serious policy mistake from now on.

All these suggest that the Fed can still control inflation, albeit at the cost of a recession or slow economic growth in the near term. In addition, the structural characteristics in the labour markets also imply that the deflationary process might be asymmetric and less synchronised across countries (i.e. the opposite case with the existing inflation dynamics).

For Eurozone countries, which also inherit other critical similarities with the 70s such as the "fixed exchange rate" regime, rising public debt, and current account imbalances, as well as, feature higher sensitivity to oil prices, inflation might become a source of a new political conflict due to ECB's hawkish turn. This adds a greater uncertainty in Eurozone countries around the long-term inflation outlook and does not rule out the possibility that some countries might indeed experience relatively long stagflation given the ECB's asymmetric (recessionary) implications and their different structural characteristics, and the imperfect political and fiscal union.