UNIVERSITY OF WESTMINSTER

A Comparative Analysis of the COVID-19 Pandemic and The Great Inflation of the 1970s – Can it Happen Again?

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Executive Summary

This report explores the post-pandemic financial crisis and compares it to the great inflation period in the 1970s-1980s in the US macroeconomic environment. The Great Inflation and the COVID-19 pandemic witnessed significant supply chain disruptions, causing increased production costs and higher consumer prices. The 1980s were characterised by oil shortages and geopolitical tensions, while 2022 struggled with the impacts of the COVID-19 pandemic and the Ukraine war, resulting in parallel disruptions. Both periods saw phases of expansionary fiscal policy aimed at stimulating the economy, potentially intensifying inflationary pressures. However, contemporary central banks, possessing a stronger understanding of inflation dynamics, acted more promptly, implementing aggressive interest rate hikes in 2022 to curb demand and cool the economy.

The report also assesses the substantial impact of COVID-19 on the stock, bond, and commodity markets of the United States, United Kingdom, and Germany. The initial shock led to declines in stock markets, but the recovery trajectories varied. The US experienced remarkable rebounds, while the UK and Germany faced differing paces, with Germany's DAX recovering faster than the UK's FTSE 100. Bond markets experienced complexities influenced by economic, financial, and policy factors. The UK saw earlier rises in yields due to expansive fiscal stimulus, raising concerns about debt levels, while Germany adopted a more measured approach. The commodity market faced disruptions, with oil price volatility and higher demand for safe-haven assets like gold. The UK, reliant on imported energy, struggled to stabilise its energy market, while Germany's manufacturing focus facilitated a quicker recovery in demand for industrial metals. Central bank interventions and regulatory reforms were crucial in mitigating severe financial outcomes during the pandemic uncertainties.

1. Introduction

Economic uncertainties often lead to heightened volatility across financial markets. Investors become more sensitive to new information and react swiftly to changing economic conditions, leading to larger price swings in various asset classes. In the archives of economic history, two distinct periods stand out on global financial landscapes—The Great Inflation of the 1970s and the unprecedented challenges posed by the COVID-19 pandemic.

The Great Inflation, characterised by soaring inflation rates, economic stagflation, and geopolitical upheavals, gripped the world throughout the 1970s. Conversely, the COVID-19 pandemic, which erupted in 2019, triggered widespread economic disruptions, prompting lockdowns, supply chain interruptions, and unparalleled fiscal and monetary responses.

This report compares these two inflationary periods, highlighting their similarities and differences and extracting valuable insights from both economic shocks. The report is structured as follows: summarising the literature on the Great Inflation Period and the COVID-19 pandemic period in Sections 2 and 3, respectively. Section 4 examines the impact of both periods on critical macroeconomic factors, inflation and unemployment, outlining similarities and differences in overall economic conditions between 1980 and 2022. Section 5 analyses the effects on the stock, bond, and commodity markets across the US, UK, and European economies before, during and after the outbreak of COVID-19. Section 6 estimates the chances of high inflation happening again. Section 7 details the regulatory changes implemented after the COVID-19 period to tamper with inflation, followed by exploring potential benefits from such an inflationary period in Section 8. A conclusion in Section 9 summarises the explanation.

2. Overview of “The Great Inflation” Period

The Great Inflation, lasting from 1965-1982, resulted from a prolonged surge in inflation across the United States and major economies. Primarily triggered by food and energy price shocks, coupled with government price controls, it led to episodes of "double-digit" inflation in the US (Blinder, 1982).

The origins of the Great Inflation were bad Federal Reserve policies – particularly the monetary policy- that allowed excessive money supply growth. Post-World War II, Congress introduced policies like the 1946 Employment Act, aiming for economic stability. These policies, motivated by post-WWII conditions, led to mistaken assumptions that slightly higher inflation rates could permanently lower unemployment, known as the "Phillips curve" (Bryan, 2013).

During World War II, in July 1944, forty-four nations in Bretton Woods, New Hampshire, established a global monetary system for economic stability and peace, fixing exchange rates and anchoring the US dollar to gold at $35 per ounce (Humpage, 2013). Fueled by global trade, the resulting demand led to a balance of payments shortfall as foreign central banks amassed more dollars than the US had in gold. The collapse of Bretton Woods in 1971, known as the "Nixon Shock," marked economic actions prioritising US growth. In the post-Vietnam War era, Nixon suspended dollar convertibility to gold, initiated tax cuts, froze prices and wages, and proposed a 10% tax on applicable imports (Kenton, 2022), driving stagflation[1] in the 1970s as the US Dollar devalued.

The Vietnam War had further strained the US fiscal situation, and subsequent budgetary imbalances complicated monetary policy. Energy crises in the 1970s, notably the Arab oil embargo[2] in 1973 and the Iranian Revolution[3]-induced crisis in 1979, raised oil costs, affecting US growth (Bryan, 2013) (Office for National Statistics (ONS), 2022). While rising oil prices were beyond monetary policy control, attempts to mitigate unemployment accelerated money supply expansion, fueling overall price increases.

In 1979, Federal Reserve Chairman Paul Volcker fought high inflation with higher interest rates and slower reserve growth. The Monetary Control Act in the 1980s, introducing credit controls, eventually slowed inflation, leading to reduced unemployment and sustained growth and stability, marking the end of the Great Inflation era (Bryan, 2013).

3. Overview of the COVID-19 Pandemic

COVID-19, caused by the novel coronavirus SARS-CoV-2, is a highly contagious respiratory illness that emerged in late 2019 in Wuhan, Hubei Province, China. The World Health Organization (WHO) declared COVID-19 a pandemic on March 11, 2020 (World Health Organization, 2023), reflecting its spread and escalating cases worldwide.

The COVID-19 crisis prompted swift and robust monetary and fiscal responses from policymakers. Shortly after the WHO declared it a pandemic, the Federal Reserve (the Fed) lowered its target rate to the effective lower bound on March 15, and the CARES Act, providing over $2 trillion in stimulus to

[1] Stagflation is persistently high inflation combined with high unemployment and stagnant demand in a country's economy.
[2] The 1973 Arab Oil Embargo, triggered by the Yom Kippur War, involved Arab oil-producing nations imposing an export embargo on the United States and other Western countries perceived as supporting Israel.
[3] The Iranian Revolution 1979 resulted in the overthrow of the Pahlavi dynasty, establishing an Islamic Republic in Iran and significantly impacting its political, social, and religious landscape and international relations.

small businesses and lower-to-middle income households, was signed into law on March 27 (Armantier, et al., 2021).

The pandemic caused abrupt and severe disruptions to global economic activity, starting as a health crisis. Measures like stay-at-home mandates, temporary business closures, and workforce infections led to reduced consumer spending, particularly affecting sectors like restaurants and hotels. Supply chain disruptions due to employees' inability to reach workplaces safely impacted productivity, making the economic system more fragile (Shapiro, 2020). Global supply chains are heavily reliant on interconnected networks for producing goods and become fragile with any disruptions, impeding cost efficiency and increasing the risk of inflation (Kim & Shin, 2023).

Another driving factor behind the surge in US inflation post-COVID period is the substantial rise in energy prices. The global oil supply decline after the Ukraine war, coupled with the US, UK, and EU's ban on Russian crude oil, contributed to soaring crude oil prices from around $40 per barrel in 2020 to a peak of $115 in June 2022. Analysis by (Breman & Storm, 2023) indicates that although energy price inflation directly drove consumer price inflation, the financial speculation activity, betting on rising prices of oil futures, was also a significant contributor to the sharp increase in oil prices during 2020-2022. Speculation has driven up oil prices, and higher oil prices, in turn, have pushed the inflation rate, as oil is a crucial intermediate input in the production of most goods and services.

On May 5, 2023, the WHO Emergency Committee on COVID-19 concluded that the disease no longer convened the definition of a public health emergency of international concern, signifying an ongoing situation but not the end of the pandemic.

4. Key Macroeconomic Factors Affected by The Great Inflation and COVID-19 Pandemic – Analysis of the United States Market

4.1. Inflation

Both the 1970s Great Inflation and the COVID-19-induced inflation significantly impacted the US market, sharing some similarities yet distinct causes and dynamics.

Similarities:

Supply shocks were a common factor in both inflationary periods. The 1970s experienced the oil crisis and Bretton Woods collapse, while the pandemic led to widespread lockdowns and global supply chain disruptions, causing higher energy and raw material costs and escalating the consumer price index.

Also, both periods led to increased government spending. In the 1970s, fiscal expansion aimed to stimulate the economy but fueled inflation due to demand surpassing supply. During the pandemic, government support programs, such as unemployment benefits and stimulus checks, injected significant liquidity, contributing to demand-driven inflation as the economy reopened (Kose, et al., 2022).

Differences:

While both inflationary periods faced demand shocks, the causes for demand shifts differed. The Great Inflation faced significant demand-side pressures due to expansionary monetary policy, characterised by low interest rates and increased money supply, driving excess demand and inflationary pressures in the economy. Conversely, the pandemic initially led to decreased demand as businesses closed and people lost jobs, putting downward pressure on inflation. However, as the recovery progressed, the demand rebounded, contributing to the current inflationary pressures.

Additionally, the Federal Reserve's policy responses differed significantly in each period. In the 1970s, the central bank eventually implemented aggressive interest rate hikes to curb inflation, triggering a recession. However, during the pandemic, the Fed initially maintained low interest rates to support economic recovery but has gradually raised rates to combat inflation, though at a more gradual pace than in the 1970s.

Another distinction between the 1970s and 2020s inflation is its duration and severity. Figure 1 (in Appendix) depicts the movement of US inflation across the two inflationary periods from 1965 to 2022, indicating that the inflation of 1970-1980 was much higher than the 2022 inflation. The Great Inflation was a sustained, decade-long period, while pandemic-related inflation is expected to be more temporary, though its duration and severity remain uncertain. Additionally, 1970s inflation resulted from two major oil shocks over a decade, whereas pandemic-related inflation started sharply in late 2021.

4.2. Unemployment

The Great Inflation of the 1970s and the COVID-19 pandemic both significantly impacted unemployment in the US but in contrasting ways.

Similarities:

Both periods witnessed substantial increases in unemployment. Figure 2 illustrates that during the Great Inflation, unemployment peaked at 10.7% in 1982, while the pandemic saw a record high of 14.7% in April 2020, reflecting economic and labour market disruptions.

Also, the Government policies played a significant role in shaping unemployment in both cases, but with distinct outcomes. During the Great Inflation, expansionary fiscal policy aimed to stimulate the economy but led to demand imbalances and subsequent job losses. Conversely, swift monetary easing and fiscal stimulus during the pandemic averted a prolonged economic slump, facilitating a faster job recovery.

Differences:

The key difference in resulting unemployment between the two periods was the nature and causes of unemployment. The Great Inflation saw primarily *structural unemployment*, arising from economic slowdowns due to policy choices and oil price shocks. The pandemic, however, caused *cyclical unemployment*, resulting from temporary business closures and restrictions in specific sectors.

The policy focus also differed. During the Great Inflation, the Federal Reserve prioritised controlling inflation, even at the cost of higher unemployment, involving aggressive interest rate hikes, triggering recessions and job losses. However, during the pandemic, the focus shifted to mitigating economic damage and protecting jobs, leading to quicker action to counter unemployment.

Moreover, the unemployment recovery from the pandemic was much faster than the Great Inflation. Many pandemic-related job losses were due to temporary shutdowns and reversed once restrictions eased. Additionally, government policy interventions targeted direct support for impacted businesses and individuals, facilitating rehiring and economic recovery. The robust technological advancements also contributed significantly to a faster economic recovery, as remote work and digital platforms eased the transition for some workers during the pandemic, potentially accelerating re-employment compared to the 1970s.

5. The Global Impact of COVID-19 Pandemic – with Focus on UK and Germany Markets

The global commodity market has been hit hard due to the outbreak of COVID-19. Prices of commodities like oil and natural gas have increased globally. The bond and stock market experienced heightened volatility as economic uncertainty, changing outlooks, and evolving pandemic-related developments influenced investor sentiment. (Fortin, et al., 2023) examined financial and economic uncertainty indices, focusing on the impact of both local (country-specific) and global (US) uncertainty shocks on industrial production, employment, and the stock market for the euro area, France,

Germany, the UK, and Austria. The authors determined a significant negative impact of global financial and economic uncertainty on all economic variables across the sample regions.

5.1. Impact on the Stock Market

The prices of stocks in a stock market and a nation's economy are correlated, with the stock market positively influencing economic growth. The outbreak of COVID-19 has significantly shocked economic activities worldwide (Sheth, et al., 2022). Travel, leisure, and hospitality sectors were severely affected, while healthcare and technology stocks initially gained from increased demand for their products and services. Emerging and developing countries faced substantial challenges, experiencing currency shocks even before the pandemic reached its full force.

The pandemic's shockwaves hit the UK and German stock markets hard, as depicted in Figure 3, showcasing the FTSE 100 and DAX indices alongside the S&P 500. FTSE 100 (UK) and DAX (Germany) plummeted in March 2020, losing over 30% of their value in weeks as lockdowns, economic shutdowns, and fear gripped the world. However, the US stock market rebounded swiftly, surpassing pre-pandemic levels by mid-2021. However, the FTSE 100 and DAX followed divergent recovery paths. Germany's DAX exceeded pre-pandemic levels by late 2020, outpacing the UK's FTSE 100 until June 2023 to surpass its pre-pandemic peak. Germany's export-oriented economy and targeted fiscal stimulus contributed to its rapid recovery compared to the UK.

5.2. Impact on Bond Market

The COVID-19 impact on the bond market was substantial, marked by widespread economic disruptions and a sell-off in various financial markets during the pandemic's early stages, as investors sought liquidity and engaged in a "flight to safety". Heightened economic uncertainty led investors to traditional safe-haven assets like US Treasuries, causing increased demand and declining yields.

Central banks, including the US Federal Reserve, implemented aggressive monetary policies such as interest rate cuts and large-scale asset purchases to stabilise financial markets. Some central banks engaged in yield curve control to support borrowing costs and market stability, while riskier assets, like corporate bonds, faced increased scrutiny, and investors demanded higher yields to compensate for perceived higher risks.

The UK and Germany witnessed complex dynamics in their bond markets, influenced by economic, financial, and policy factors. Declines in government bond yields were observed initially in both countries due to heightened risk aversion. However, yields diverged later (Figure 4).

In the UK, yields began rising sooner than in Germany due to a more expansive fiscal stimulus, raising concerns about future debt levels and inflation. Increased demand for UK government bonds led the Bank of England (BoE) to implement aggressive monetary measures, including interest rate cuts and an expanded asset purchase program. The European Central Bank (ECB) in Germany also played a crucial role in supporting financial markets through measures like interest rate cuts, expanded asset purchases, and targeted longer-term refinancing operations (TLTROs) to provide liquidity to banks.

The BoE and the ECB announced measures to include corporate bonds in their asset purchase programs, supporting the corporate bond market. The significant widening of the spread between UK and German government bond yields during the pandemic suggested that investors perceived higher risk in the UK economy. However, this gap narrowed as economic conditions improved and investor confidence in the corporate sector strengthened.

5.3. Impact on the Commodity Market

The commodity market faced significant disruptions from pandemic-induced uncertainty, causing supply chain disturbances and a demand shortage. Oil prices surged to all-time highs with increased volatility, while gold thrived as a safe-haven asset. This increased the demand for gold and triggered unprecedented market reactions, with gold reaching record highs and oil hitting record lows. Government policies stabilised the market, but uncertainty about the pandemic's duration and market volatility complicated investors' perspectives (Sheth, et al., 2022).

As depicted in Figure 5, gold prices have remained higher during the pandemic, as investors consider it a safe-haven investment during periods of uncertainty, while the price of crude oil declined at the start of the pandemic and increased in 2022 due to the Russia-Ukraine war.

The impact of COVID-19 on the UK and German commodity markets was complex, with varying effects across sectors. During the initial stages, the sharp decline in global oil prices affected UK energy companies and caused disruptions in the metals and mining sector due to supply chain issues. Reduced industrial activity and construction projects led to decreased demand for metals, while restaurant closures and transportation disruptions affected certain agricultural products.

As an export-oriented economy, Germany faced disruptions in its commodity markets due to global trade disturbances. Reduced demand for German goods impacted associated commodities, and supply chain disruptions affected the automotive and manufacturing sectors. Germany's focus on renewable energy influenced the demand for commodities related to green-energy projects. Economic stimulus measures supported businesses and individuals, influencing overall economic activity and commodity demand.

While both countries import significant amounts of commodities, the UK's heavier reliance on imported energy makes it more vulnerable to price fluctuations. Germany's emphasis on manufacturing industries facilitated a quicker recovery in the demand for industrial metals compared to the UK's service-oriented economy. While some markets are recovering to pre-pandemic levels, reports indicate the energy market is yet to stabilise, not matching its pre-pandemic levels.

6. Chances of High Inflation Happening Again

The world is much more interconnected today than in the 1980s. This means that inflationary pressures can spread more quickly across borders, and policy responses can have a broader impact.

As we enter the post-pandemic era, several key challenges and uncertainties persist. Rising inflation, driven by supply chain disruptions, energy price shocks, and pent-up demand, is a significant concern. Although central banks are attempting to raise interest rates to curb inflation without triggering a recession, the massive increase in government debt during the pandemic raises concerns about long-term fiscal sustainability. In addition, the war in Ukraine and ongoing global security threats add to market volatility and disrupt energy supplies. Lastly, changes in consumer behaviour, such as the shift to online shopping and remote work, have lasting implications for various industries.

While central banks' rapid response undoubtedly prevented a worse outcome, concerns remain about the long-term consequences of loose monetary policy, such as asset bubbles and inflation.

7. Regulatory Changes Post COVID-19

In response to COVID-19, Governments and central banks swiftly intervened with unprecedented fiscal and monetary stimulus packages. Interest rates were slashed to near zero, quantitative easing programs were ramped up, and direct financial aid was provided to businesses and individuals. These measures helped stabilise markets and prevent a more profound economic depression (International Monetary Fund, n.d.).

Following the initial shock, markets embarked on a remarkable recovery, fueled by the combined effect of pent-up demand, fiscal stimulus, and loose monetary policy. Equity markets in the US and UK soared to new highs, although Europe lagged due to slower economic growth. Bond yields, while initially low, began to rise amid emerging inflation concerns. Commodity prices rebounded, witnessing substantial gains in energy and agricultural products. However, the recovery was uneven, with sectors like technology and e-commerce thriving while travel and hospitality faced significant challenges. This divergence contributed to widened income inequality, exposing vulnerabilities in supply chains.

Despite the pandemic exposing vulnerabilities, the financial system ultimately demonstrated resilience, thanks to regulatory reforms implemented after the 2008 financial crisis.

8. How to Profit from Ongoing High Inflation

Profiting in a high-inflation period involves strategic financial decisions. Amid the uncertainties brought by the COVID-19 era, wise investors diversify across asset classes like stocks, bonds, real estate, and commodities.

Diversification helps mitigate risks linked to specific asset classes while still allowing for potential returns in others. Investing in real assets, such as real estate and commodities like gold, serves as a hedge against inflation, given their intrinsic value that may endure even in the face of currency devaluation.

Additionally, considering TIPS (Treasury Inflation-Protected Securities) is prudent. TIPS, being US Treasury bonds, are designed to shield against inflation, with their principal value increasing with inflation and decreasing with deflation. Investing in TIPS during periods of higher expected inflation can offer protection against rising prices. Short-term securities, like short-term bonds and money market instruments, are recommended to reduce exposure to interest rate risk.

Observing the significant rise in yields from UK Gilt bond data in 2022-2023, securing a long position in UK Government Bonds can be a profitable and secure investment. However, reassessing the portfolio is crucial to promptly adapting to new opportunities and risks.

9. Conclusion

The Great Inflation and the COVID pandemic saw significant supply chain disruptions, raising production costs and consumer prices. The 1980s dealt with oil shortages and geopolitical tensions, while 2022 faced disruptions from the COVID-19 pandemic and the Ukraine war. Both periods had expansionary fiscal policies potentially fueling inflation, but contemporary central banks acted more promptly in 2022, implementing aggressive interest rate hikes.

The impact of COVID-19 on the stock, bond, and commodity markets of the US, UK, and Germany was substantial. The US stock market rebounded remarkably, while the UK and Germany varied in recovery pace. Bond markets saw complexities influenced by economic factors, with the UK experiencing earlier yield rises due to fiscal stimulus, while Germany adopted a measured approach. The commodity market faced disruptions, and central bank interventions were crucial in mitigating severe financial outcomes during the pandemic uncertainties.

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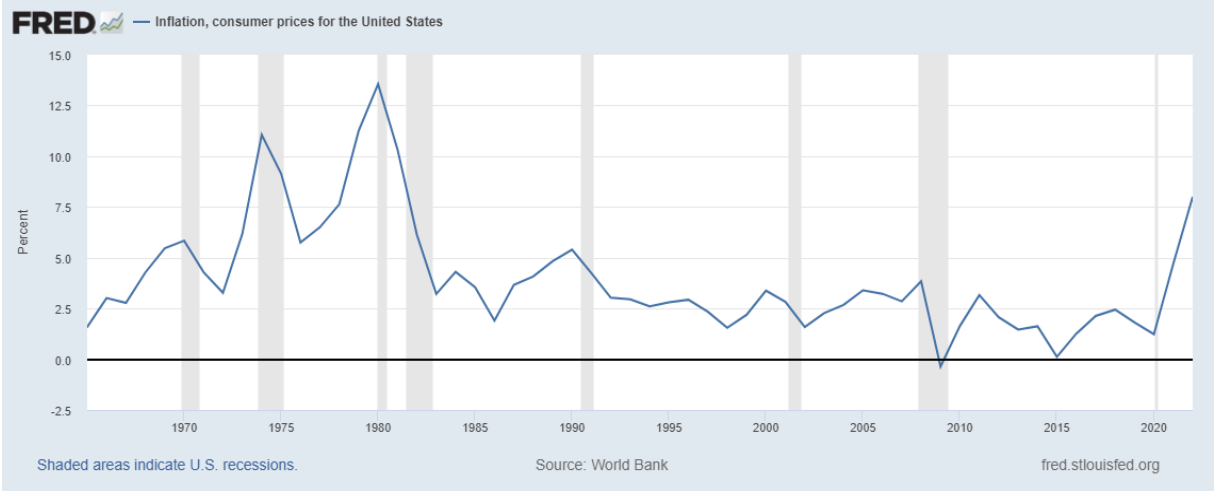
Appendix

Figure 1

Figure 1 shows the trend of the US Inflation rate during the Great Inflation Period and the COVID-19 pandemic (refer to Section 4.1). It is depicted that inflation during the 1980s was higher than during the pandemic era.

Figure 1: US Inflation (Consumer Price Index), 1965 - 2022

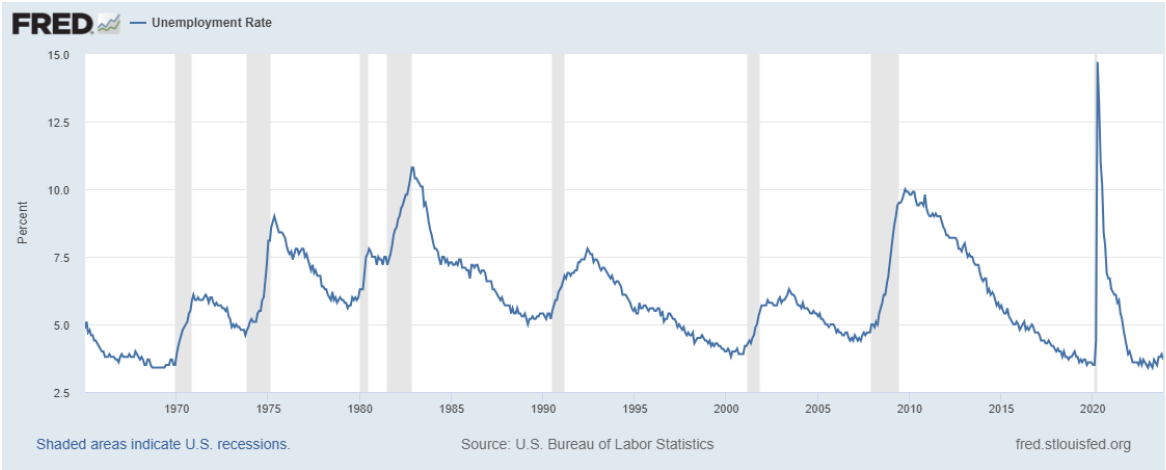


Source: (FRED, 2023)

Figure 2

The chart below compares the US unemployment rate during the Great Inflation of the 1980s and the COVID-19 period in 2020-2022. It reflects that the unemployment rate surged more than in the 1980s during COVID-19. However, the recovery from economic shock on the labour market was abrupt compared to the 1980s. (Refer to Section 4.2.)

Figure 2: US Unemployment Rate 1965 - 2023

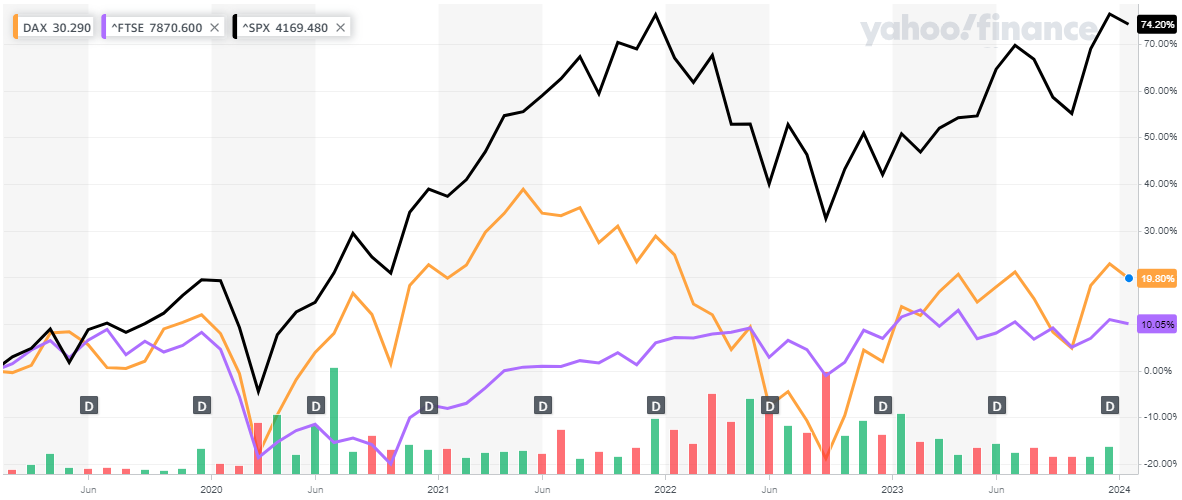


Source: (FRED, 2023)

Figure 3

Figure 3 compares the stock market performance of the United States, the United Kingdom, and Germany during the pandemic, and it is evident that the US stock market (SPX 500) recovered faster and has been performing at a higher level than the UK and German stock indices.

Figure 3: Stock Market Performance Comparison Between United States (S&P 500 index), United Kingdom (FTSE 100 index), and Germany (DAX index) – [2019 – 2023]

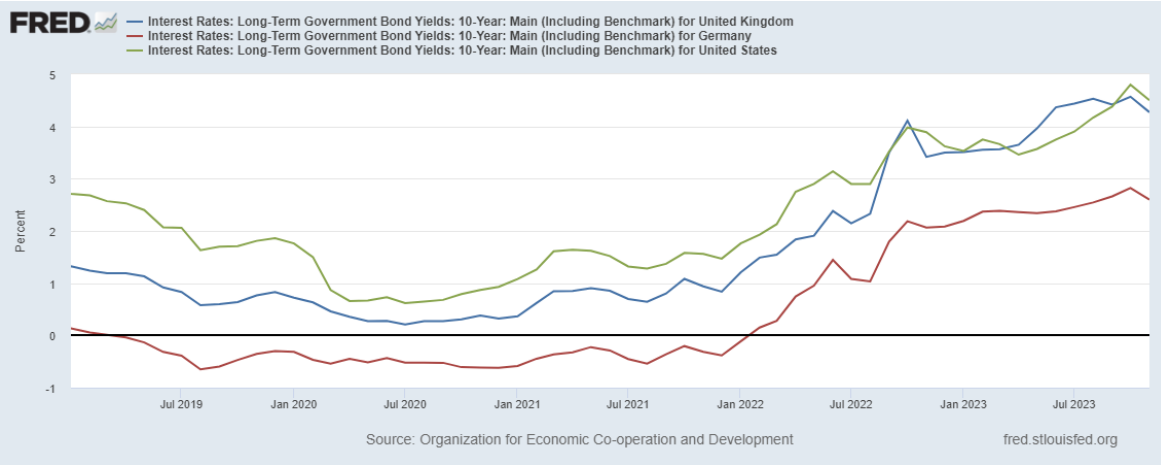


Source: (Yahoo Finance, 2023)

Figure 4

As shown in Figure 4, the interest rate (yield) is lowest for the German 10-year government bond, while interest rates for US and UK government bonds have been at the same higher level during the pandemic 2019-2023. (Refer to Section 5.2.)

Figure 4: Comparison between 10-Year Bond Yields of US, UK, and Germany, 2019 – 2023

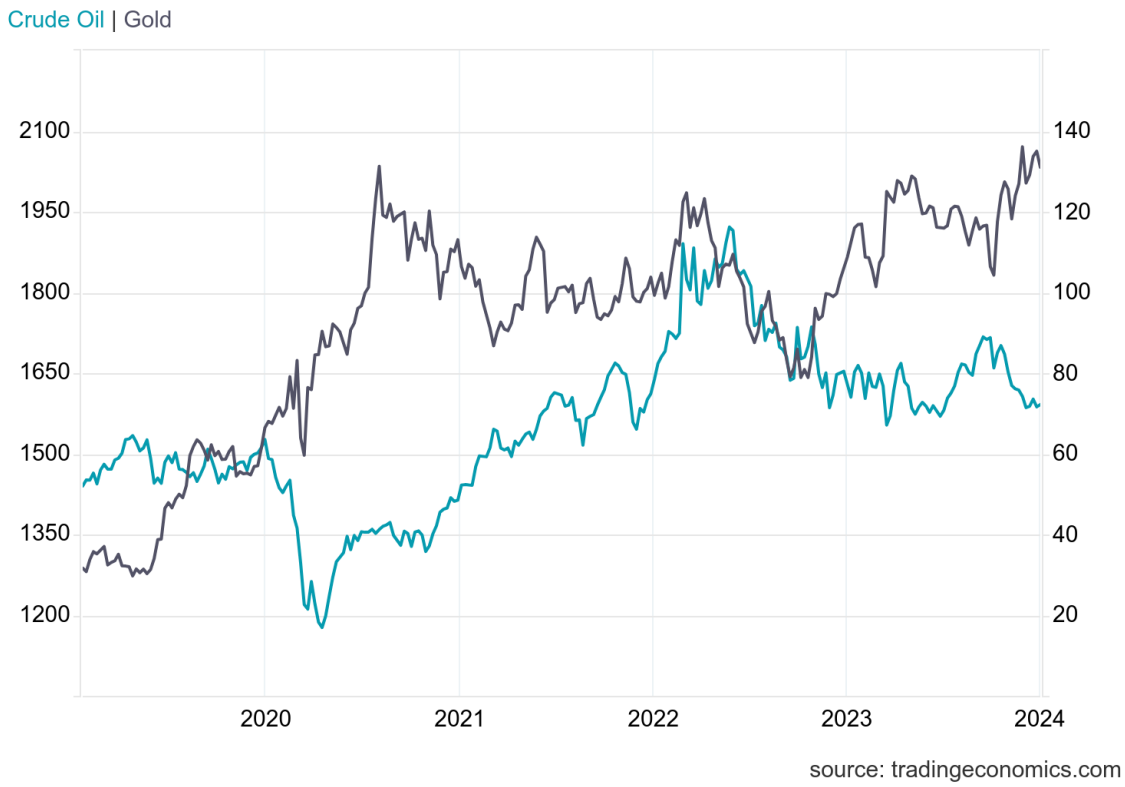


Source: (FRED, 2023)

Figure 5

The figure below illustrates the movement of Crude Oil prices against the gold prices during the COVID-19 pandemic. It shows that during most of the period when oil prices were low due to economic stress, the gold prices went high as the investors considered Gold a safe haven in their "flight to safety". (Refer to section 5.3.)

Figure 5: Comparison between Crude Oil and Gold Price Movement during the COVID-19 Period, 2019 – 2023



Source: (Trading Economics, 2024)