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OPINION

Markets Insight

For lessons on fighting inflation, skip Volcker and remember 1946

How the Federal Reserve was able to rein in a spike in prices triggered by postwar pent-up demand

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The recent surge of inflation has led the media and market pundits to look to economic history for relevant comparisons. America has suffered through bouts of inflation before, but many "experts" only consider the precedent from their lifetime — that is the inflation of the late 1970s and early 1980s that was conquered by the draconian interest rate policy measures of the Paul Volcker-led Federal Reserve.

While that period's inflationary rise may invite comparisons to today, its root causes — funding the Vietnam war and the Great Society social policy initiatives of Lyndon B Johnson, delinking the dollar from gold, and an energy crisis — were a different set of circumstances.

A more appropriate corollary from history is 1946-48, the post-second world war inflationary episode resulting from supply shortages during peacetime refits of manufacturing plants, rebounding demand for consumer goods, high levels of savings and soaring money growth.

This sounds a lot like today. As for how the 1940s inflation ended, supply and demand ultimately came back into balance, and a more primitive version of the Federal Reserve — which did not have the targeting of a benchmark fed funds rate in its toolkit — slowed the economy by curbing money and credit growth and shrinking its balance sheet.

Price increases slowed in 1948 and actually declined in 1949, and a brief, mild recession ensued. Equity prices generally remained stable. This would be a welcome outcome today, but the execution of monetary policy over the coming months will determine whether inflation ends gently or with a serious recession and more market turbulence.

The pent-up demand of postwar America was extraordinary: Between 1945 and 1949 — a period when the US population was approximately 140m — Americans purchased 20m refrigerators, 21.4m cars, and 5.5m stoves. This was quite a rebound from the shortages of wartime America.

At the same time, excess savings generated during the war and the increased postwar credit demands of borrowers in 1946 and 1947 — by farms, homeowners, real estate investors, and industry — further stoked inflationary pressures.

CPI inflation, which was 3.1 per cent in June 1946, peaked nine months later at 20.1 per cent in March 1947. The spike in inflation followed a period of explosive growth in the monetary base and in securities held on the balance sheet of the Federal Reserve, which grew 300 per cent to $24.5bn in 1945 from $6.2bn in 1942. This wartime rise was not unlike what we have seen recently in the central bank balance sheet in response to the pandemic.

How did the inflationary period end after the March 1947 peak? First, pent-up demand subsided and supply came on board as prices rose and manufacturing transitioned from wartime to peacetime activity. In other words, the market's "invisible hand" worked.

Second, monetary policy tightened, but using a few different elements than what we see today. As explained in the 1948 Fed Annual Report: "Federal Reserve policies during most of 1948 . . . were directed toward exerting restraint on inflationary credit expansion while at the same time maintaining stability in the market for government securities." Notably missing is any talk of interest rate management.

With the Fed likely to embark on a path of reducing its balance sheet while simultaneously raising rates, the risk is much greater that the result will not be a quick, mild recession like we saw in 1949, but a much more serious downturn, greater market volatility and a potential financial crisis.

No one can control both the supply and price of any commodity, including credit. Given the record corporate debt levels, the rich valuation of financial assets and surging prices for speculative investments, the prospects for policy error are high.

Policymakers would be wise to look to the past. Attempts to contain inflation in the 1970s were focused on targeting short-term rates instead of limiting credit creation by controlling the Fed balance sheet and the money supply. This policy was an obvious failure. After the financial crisis, policymakers seem to have lost faith in the power of markets to set prices and balance supply and demand, and have gained too much faith in their own ability to do the same.

Perhaps a rational and disciplined approach adhering to monetary orthodoxy as demonstrated in the 1940s would greatly reduce the risk of policy error, avoid the inflation spiral of the 1970s, and reduce the risk of yet another financial panic.

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