



Lessons of the “Great Inflation” and its Aftermath: A conversation with Robert Samuelson

By Wyatt Crumpler, Gene Needles, Bill Quinn and Kirk Brown

The U.S. government has pumped an extraordinary amount of liquidity into the financial system and taken on a large amount of debt. This combination is spurring debate about the prospect of inflation – are we headed for it, how can we prevent it and how bad could it be?

It makes sense to ask if history offers any guidance. To help assess these issues, Wyatt Crumpler, Vice President for Asset Management of American Beacon Advisors, recently joined his colleagues in a conversation with Robert Samuelson, author of a “must-read book” *The Great Inflation and its Aftermath: The Past and Future of American Affluence*. In his book, Mr. Samuelson, who is a columnist for *The Washington Post* and *Newsweek*, argues that the rise and fall of double-digit inflation over the last half century is the most important economic event of that period – and one all investors should be mindful of going forward.

Wyatt Crumpler: The title of your book refers to “the Great Inflation.” What was the Great Inflation?

Robert Samuelson: The Great Inflation was the rise of double-digit inflation in peacetime, something Americans hadn’t ever experienced before for a prolonged period. Between the 1960’s and early 1980’s, inflation went from a range of 0.5-1.5% to about 13%. Even worse than the inflation rate itself, people didn’t know how much higher it would go.

It’s my belief that the 20 years in which inflation went from essentially zero to 13%, and then the subsequent 20 years in which it declined from 13% back to zero again, are together the most important economic event of the last half century.

Gene Needles: What were the underlying causes of the rise?

Robert Samuelson: The basic cause was faulty economic doctrines and ideas, which were believed and promoted by leading economists at the time. We call these ideas “Keynesian” now. The idea was that through the manipulation of the budget deficit and surplus, and of interest rates, government economic policy could essentially eliminate business cycles and maintain full employment.

The objective was to get rid of the age old problem of capitalism – instability. It was a belief that we could reduce economic management to a technology.

Kirk Brown: How did this lead to trouble, considering the aim was stability?

Robert Samuelson: Well, in trying to put these ideas into practice we got policies that in hindsight we know were simply inflationary. We had loose money for too long. We also had budget deficits, which by themselves didn’t create inflation, but were a part of the broader political symbolism in support of inflationary policies. In other words, expansionary budget policies paralleled expansionary monetary

policy. The result was an old-fashioned inflation of “too much money chasing too few goods.” Once it started, it turned out that it was very difficult to stop.

Wyatt Crumpler: How did the U.S. get out of the Great Inflation?

Robert Samuelson: What finally got us out of the Great Inflation was the repressive recession of the early 1980s, instituted by Paul Volcker, who was then Chairman of the Federal Reserve, and backed by President Ronald Reagan. Volcker was very determined and willing to put up with nearly 11% unemployment. He instituted a savage monetary repression, raising interest rates, cutting money and credit growth. He needed the political support to maintain this.

In my view, Reagan was the only politician of either political party in the early 1980s who would have provided that political support. They didn't have a close working relationship, but according to Volcker, Reagan had something that none of his predecessors had – a visceral dislike of inflation and a strong belief that it was fundamentally threatening to the country.

Bill Quinn: What were the consequences of higher inflation? How did it affect the economy and stock market?

Robert Samuelson: As Kirk suggested, the economy ironically became less stable. It was supposed to become more stable, but it became less so. Between the late 1960s and early 1980s, we had four recessions of growing severity. During the last one, unemployment peaked at 10.8%. Rising inflation, also counter to expectations, clobbered the stock market. In 1982, the Dow Jones Industrial Average was essentially unchanged from 1965. Rising inflation also, in my view, reduced productivity growth and therefore contributed to a slowdown in the rise of living standards in the U.S.

Bill Quinn: In your book, you suggest that the consequences of falling inflation were just as important as the consequences of rising inflation. Can you explain that?

Robert Samuelson: The consequences of falling inflation were enormous and to a large extent explain the last 20 years of America economic history, including the current economic and financial crisis. As inflation fell, money flowed into the stock market, prices took off, and we had a 20-year boom. We went from the Dow being under 1,000 in 1982 to reaching over 10,000 in the 2000s. The same thing happened to some degree in the housing market. The result was a long period of economic stability and the longest expansion in American history.

Wyatt Crumpler: This would seem a positive thing.

Robert Samuelson: It was. But too much of a good thing turned destructive, and people got used to these conditions and they became complacent and careless.

There are so many villains when it comes to the financial crisis. Greenspan held interest rates too low for too long. The Chinese depressed long-term interest rates by buying so many Treasury bonds. Mortgage bankers made lousy loans to homeowners who shouldn't have been borrowing. Investment banks packaged these loans into securities that shouldn't have been sold, and rating agencies blessed those securities.

But what's missed is that all of these things occurred in a climate in which people expected sustained low inflation, prosperity and rising asset prices because that's what they had experienced for the last two decades. People are conditioned by their own experiences. Prolonged prosperity and rising asset prices perversely led to “bubbles” and the current economic crisis.

Gene Needles: Volcker is now advising the current administration. We have low interest rates and high debt. Is a resurgence of great inflation possible?

Robert Samuelson: It's possible, but as of now, I'm not worried about a resurgence. There is so much slack in both the national and world economy. And, more importantly, people believe the Fed will contain inflation. Inflationary expectations are very low. It's possible the government might try to inflate away the debt. But even if the White House and Congress want to do this on a temporary basis, they'll need the

concurrence of the Fed. In addition, it may not be so easy to inflate away the debt because most of the federal debt is very short term. It has to be rolled over frequently.

Kirk Brown: What factors on the horizon could cause inflation?

Robert Samuelson: One danger, which is serious but difficult to evaluate, is that if there is a change in inflation expectations, there might be some turn against the dollar. If that happened, and the dollar dropped dramatically, imports could get a lot more expensive. Another danger is more political. There are forecasts for unemployment to remain as high as 7.5% in 2014, even as the economy improves. You can imagine by the 2012 presidential election if unemployment is that high there will be a lot of hue and cry to do something about this. That something starts with the Fed.

Gene Needles: For investors, what's the lesson of the Great Inflation and its Aftermath? Was it just a historic period of interest, or is there some relevance to today?

Robert Samuelson: Individual investors trying to understand the economy's performance over the past two decades have to understand this backdrop of rising and falling inflation, and the consequences it had for the economy and the financial system.

If inflation comes back, I doubt it would be good for asset prices. Some assets might benefit temporarily, such as commodity prices. But every Great Inflation ends sooner or later -- because people won't and can't sustain it -- and the ending is usually very ugly.

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