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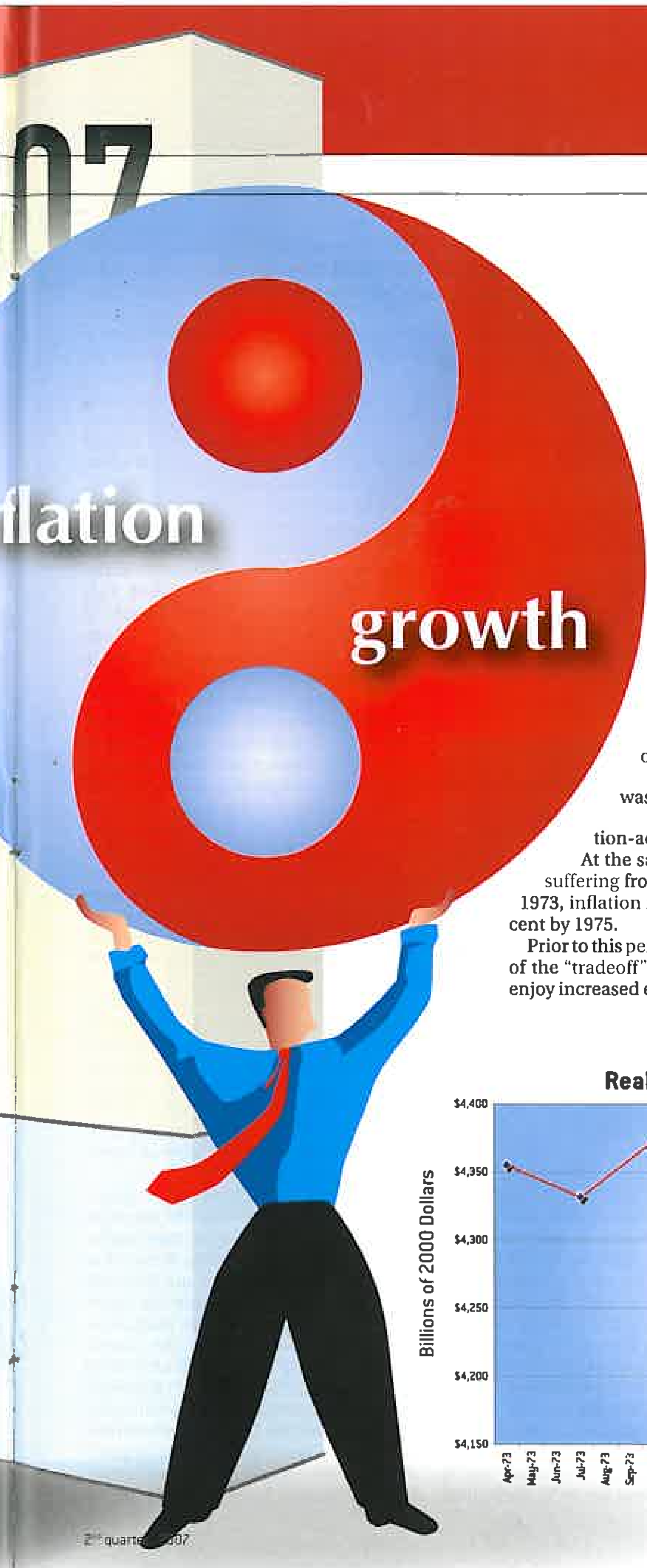
Is 'Stagflation' Back?

BY DR. MIKE BRADLEY



The new buzzword in macroeconomic forecasting and policy circles is "stagflation," a term that has not been heard for at least a couple of decades. Back in the 1970s and early 1980s the economy suffered the difficult combination of declining real output and rising inflation. This double whammy of concurrent bad economic outcomes was called stagflation — indicating a period of economic stagnation but rising inflation. An excellent example of stagflation is given by the 1973 to 1975 period. As Figure 1 shows, during this period the economy was in recession as real economic activity was contracting. Because of this prolonged recession, inflation-adjusted GDP was smaller in 1975 that it was in 1973.

At the same time, inflation was accelerating, so the economy was suffering from the "worst of both worlds." Already high at 5 percent in 1973, inflation more than doubled in just two years and was over 10 percent by 1975.

Prior to this period, macroeconomic policy was usually described in terms of the "tradeoff" between inflation and growth. In this tradeoff, we could enjoy increased economic growth at the cost of higher inflation or we could

Figure 1

Real Economic Activity in the 1970s

reduce inflation by suffering reduced economic growth. The Federal Reserve's job was to shift the lever back and forth between the two extremes in its effort to keep the economy on course. Stagflation blew this approach apart. Because both a recession and accelerating inflation were happening at the same time, the Fed could no longer choose between the two traditional alternatives. Policies designed to halt inflation would make the recession worse and anti-recession policies would kick inflation into hyperdrive. Starting with Paul Volcker's tenure at the Federal Reserve, a new approach to macroeconomic policy was formulated and a good part (but certainly not all) of the economic success in the past fifteen years can be attributed to this new approach.

With the disappointing performance of the economy in the first quarter (real GDP grew by only 1.3 percent) the economy is approaching a potentially important, if disconcerting, milestone. If we calculate the average growth rate over the last four quarters (second quarter 2006 through first quarter 2007), we find that the economy's average growth has fallen to just 2.05 percent. This important because in the past fifty years, the economy has hit or just fallen through the 2.0 percent average growth rate barrier seven times. Six of those seven times were followed by a recession. Moreover, as Figure 3 shows, every recession we have had in the past fifty years have been preceded by a slowdown in growth like the one we are currently experiencing.

Figure 2

Inflation During the 1970s

Now, however, concern is arising that the old foe may be arising again. Certainly no one is anticipating that we will soon be facing conditions as severe as those in the 1970s anytime in the near future. (Although this quick look back should make us appreciate just how good economic conditions have been over the last fifteen years.) But the economy could be facing stagflation's new millennium cousin. Recent concerns arise from the coincident sharp deceleration of economic growth and persistent upward movement in "core" inflation.

The good news is that one exception occurred recently, at the end of 1995 when the economy was able to avoid a recession and resume its steady growth path. The ability of the economy to work its way through the slowdown, with the help of the Federal Reserve, was a key factor in sustaining one of the longest recessions on record. Yet, one advantage the Federal Reserve had in 1995 was that the inflation had recently decelerated and the Fed thus had an opportunity to lower interest rates in its attempt to stave off a recession. This is not the case today. Since January 2004, the economy has experienced a steady upward progression in the inflation rate whether measured by the regular Consumer Price Index or the "core" Consumer Price Index. As shown in Figure 4, the regular CPI shows an increase in inflation from a low of about 1 percent in 2002 to a high of over 4 percent last year. Much of this increase was driven by rising energy prices and last fall's energy price reductions have moved overall inflation back to about 3 percent. Nevertheless, there is a clear positive movement to the growth in the price level and recent movements in gasoline prices suggest that the recent respite from rising inflation might be short lived. This negative assessment is reinforced by growth in core inflation. The core Consumer Price Index omits two volatile components of price change: food prices and energy prices. Removing these two components can provide a clearer look and the underlying trend in prices across the economy and can help avoid mistakenly interpreting short run price movements as changes in the direction of overall inflation. For example, a hard freeze in Florida or California could temporarily drive up citrus prices and cause an increase in the regular CPI. However, because this price change will be reversed next season it is not really inflation and doesn't reflect the overall trend in prices in the economy.

Figure 4 also presents the core inflation rate which reflects a more modest but steadier increase in the inflation rate. At the beginning of 2004, the core inflation rate had slipped to 1 percent and it peaked at 3 percent in the middle of last year. While it has retreated a bit since then, the underlying upward pressure is clear in the figure.

A review of all of the figures in this article shows that our current situation is nowhere near, in degree, the stagflation of the 1970s and 1980s. Output has not yet started to contract and although rising, inflation is way below the levels in those days. In this sense, stagflation is not "back." Nevertheless, the combination of falling real growth and rising core inflation raises some important policy issues for the monetary authority. The usual tool the Federal Reserve uses to stimulate the economy is lower interest rates, counting on firms and households to react by borrowing and spend-

Figure 3

Sustained GDP Growth Below 2 Percent Has Usually Preceeded A Recession

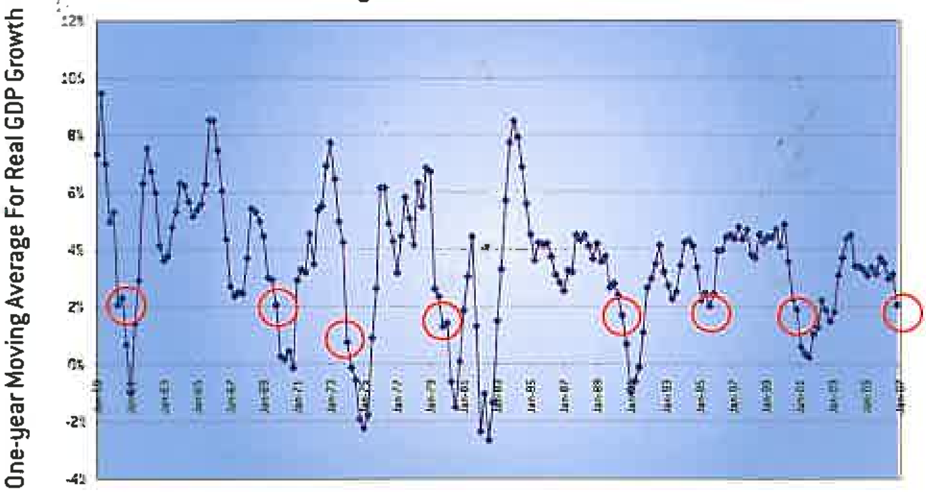
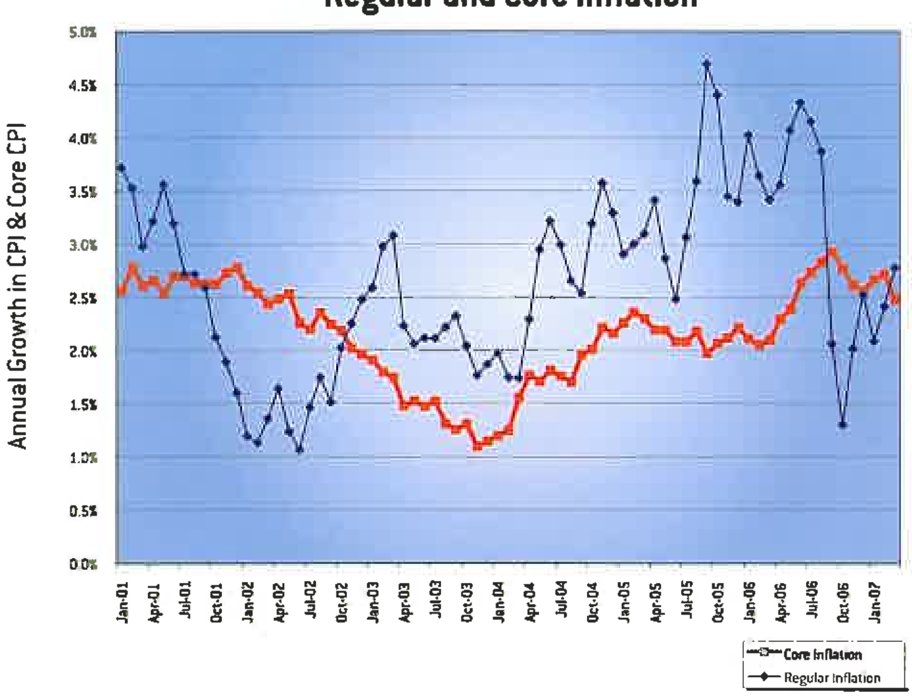


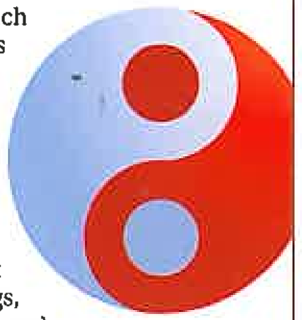
Figure 4

Regular and Core Inflation



ing more. The additional spending helps stimulate economic activity, particularly in interest-sensitive sectors. However, the fact that the Fed faces rising inflation just when the economy is slowing limits the amount of freedom it has to use this tool. Rising spending is associated with higher prices, so only moderate interest rate declines are available to the Fed if it wishes to avoid creating real stagflation.

But there are a number of current conditions that limit the potential effectiveness ofmoderate interest rate declines. First, much of the slowdown has been in the investment sector. Consumers have continued to spend at an average growth rate of 3.3 percent over the last year. In contrast, investment (purchases of buildings, equipment, and software) has contracted at a 7.5 percent rate over the last three quarters. Much of that contraction has been caused by a sharp decline in residential construction which itself has fallen by nearly 20 percent in the last year. It is well known that his decline has little to do with interest rates but has been caused by excessive borrowing and the inability of households to sustain their large debts. Moderately lower interest rates will not cure this problem and, in the short run, will not stimulate this sector. Similarly, the slowdown in equipment purchases in the industrial sector has been keyed by slowing profits and the weakness in the manufacturing sector. Moderate declines in interest rates are unlike to have much impact in this sector either. Finally, slower real growth and higher prices have been caused in part by declines in productivity growth. When productivity is not rising, additional output requires additional inputs and this leads to both higher costs and, eventually, higher prices. Again, moderate interest rate declines are not going to reverse a productivity slowdown. These conditions mean that the Federal Reserve face the real possibility that any expansionary policy it undertakes may not be effective in stimulating real output growth but, perversely, could increase inflation. Thus the Fed must be careful to avoid driving the economy into stagflation.



While we aren't yet suffering from stagflation, its presence is being felt. The current leaders of the Fed are keenly aware that poor monetary policies contributed to the pain the economy felt in the 1970s and 1980s. They also know that avoiding a repeat of those conditions requires the Fed's to limit its response to the current growth slowdown. From the Federal Reserve's perspective, the net has been removed from below the tightrope walker. ☐