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Stagflation: making a comeback?

Economists seem better at inventing catchy terms than they are at predicting the outlook. The "Goldilocks Economy" was neither too hot (growing too fast) nor too cold (growing too slow). I'm not sure about the rest of the analogy because in the end, Goldilocks ate the bears' porridge! A while back I looked at the "soft landing" scenario in which the economy slows but still grows following interest rate hikes by the Federal Reserve.

Recently, I've been hearing that "stagflation" might be making a comeback. This term almost always refers to 1970s and early 1980s when stagnant real economic growth and escalating inflation created the worst U.S. economic environment since the 1930s. Thank goodness that the consensus forecast for the coming year is much more pleasant.

The *Wall Street Journal* survey taken in April sees 2.4% real GDP (Gross Domestic Product) growth this year and a 2.7% rise in the CPI (Consumer Price Index). While growth is modest, this is hardly a stagflation scenario. And those who think that stagflation could be lurking around the corner really don't mean return to the 1970s. Rather, they are probably worrying that real GDP (Gross Domestic Product) could rise somewhat less and inflation increase somewhat more than the consensus. Nonetheless, it is worth taking a look back.

The 1970s and early '80s:

From 1970 to 1982, there were four recessions, two of which were very severe. And as measured by the CPI, inflation hit "double digits" with 12% in 1974 and 13% in both 1979 and 1980. Unemployment went from 3.5% in 1969 to 10% by 1982.

Maybe we wore those awful clothes and terrible hair styles to forget what was happening around us. For a while, gasoline was rationed, resulting in long lines at the pumps. New York City went to the brink of bankruptcy, and Congress had to bail out Chrysler. Back then, the late economist, Arthur Okun, devised the "Discomfort Index" to underscore the real pain inflicted by stagflation. He simply added together the unemployment and inflation rates. By 1980, his index hit 20% (13% CPI and 7% unemployment). Contrast this with today's 2 ½% CPI and 4 ½% unemployment.

Financial markets were reeling. The Dow Jones average fell more than 40% between 1972 and 1974. It then took nearly a decade to get back to the previous peak. Interest rates hit record levels. By 1980, the prime rate was an incredible 21 ½%, the 30-year fixed-rate mortgage cost 18% and the "risk-free" 10-year Treasury bond yielded 16%. Today, these rates are 8 ¼%, 6% and 4 ¾%, respectively. These huge disparities reflect a much different legacy of inflation and much different expectations. By the late '70s, people were believing that inflation would remain in double digits for years to come and were adjusting their behavior accordingly.

How did things get so bad? It took a long time and a combination of poor economic policy, bad luck and geopolitical upheaval. The early seeds for the inflation flare-up were sown in the 1960s when President Lyndon Johnson attempted to fight the war on poverty and the war in Vietnam at the same time without raising taxes. The result was that the Goldilocks economy of the early 1960s eventually overheated badly by the end of the decade.

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Musings & Amusings

One of my favorite comedians was Professor Irwin Corey, "the World's Most Foremost Expert" on everything. Here are some of his one-liners:

"Wherever you go, there you are."

"You can get further with a kind word and a gun than you can with just a kind word."

"If we don't change direction soon, we'll end up where we're going."

Inflation was fanned further by President Nixon. His imposition of wage-price controls in 1971 did little more than suppress inflation that was released several years later. Wage-price controls dealt with the symptoms of inflation but not the causes. It is widely believed that Arthur Burns, who was Chairman of the Federal Reserve, used monetary policy to stimulate the economy excessively in order to assure Nixon's re-election. And no matter what the merits, the move from fixed to floating exchange rates by the U.S. in 1973 produced a devaluation of the dollar that further fed inflation by raising the price of imports.

Then there was the bad luck. In 1973, the Humboldt Current off the coast of Peru shifted, drastically curtailing the catch of anchovies that were used for fertilizer. This helped trigger a steep rise in food prices.

Oil became a political weapon. In retaliation for Western support of Israel in the Yom Kippur War against Egypt and Syria, the Arab-dominated OPEC quadrupled the price of oil and instituted an embargo on oil shipments in late 1973. These actions helped plunge the U.S. into one of the deepest recessions of the post-WWII period. OPEC then doubled prices in the late 1970s, causing yet another "oil shock."

For much of the 1970s, U.S. economic policy was incapable of dealing with the emerging stagflation. Widespread expectations of high future inflation were becoming firmly embedded. In wage negotiations, workers were trying to make up for the erosion of living standard due to higher energy and food prices. Since complete makeup was impossible, this only produced more inflation.

At the time, economists noted that reducing inflation expectations was similar to getting people to sit down at a sporting event. Nobody sees any better when everyone stands up. So if you can get the folks in front to take their seats, then maybe the rest will follow. However, this is easier said than done. President Ford tried to "talk" inflation down with his "WIN" campaign: Whip Inflation Now. Not enough people paid serious attention.

By 1979, the situation was becoming hopeless. The Federal Reserve seemed powerless to deal with what was rapidly becoming the worst economic crisis since the Great Depression. President Carter appointed Paul Volcker as Fed Chairman and gave him carte blanche to deal with the problem. And he did. Volcker realized that he would have to beat inflation expectations back down. He did this by raising the Fed funds rate to levels never before seen. He knew that the unfortunate consequence would be serious recession, but saw no alternative. Volcker deserves tremendous credit for reducing inflation and for reestablishing the credibility of the Federal Reserve.

Can it happen again?

Can we undergo another period of debilitating stagflation like the one of the 1970s? While one should never say never, I am quite confident that a replay is highly unlikely.

There are some important parallels with the 1970s. Chaos in the Middle East could easily send oil prices above $100 per barrel. And the unusual weather patterns of recent years could push food prices up. But there are a number of important differences between the present and the 1970s.

At home and abroad, economic participants believe that the Federal Reserve and the world's other major central banks would not allow inflation expectations to get out of hand. If this credibility, which is based on more than a quarter century of Volcker-Greenspan-Bernanke leadership, works the way it is supposed to, any inflation pickup is apt to be quite modest simply because people do not believe that permanently higher inflation is likely! Infllation expectations work both ways, i.e., to keep inflation up and to keep it down. Future oil price jumps, like the ones over the past couple of years, will cause a temporary blip in the CPI but not a dramatic rise in the inflation rate for an extended period of time.

In addition to the credibility of the Fed, we have what some have labeled the "bond market vigilantes." During much of the 1970s, bond yields lagged the acceleration of inflation, doing little to restrain the rise in prices. I have no doubt that bond yields would climb very quickly should inflation look like it is taking hold. This would reinforce any tightening actions by the Fed to combat inflation.

The 50 or so economists who responded to the April *Wall Street Journal* survey said they thought that the odds of a recession starting during the coming year were roughly 1 in 4. What if inflation is 1-2 points higher than they are forecasting? Then the Federal Reserve would most likely have to raise interest rates by more than the acceleration of inflation. Why more? Otherwise, real (inflation-adjusted) Fed funds would not rise and restrain the economy. The end result, unfortunately, would likely to be a recession. However, any downturn is more apt to resemble the two brief and mild ones of the past 25 years rather than the deep contractions of the 1970s and early 80s.

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