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ECONOMIC VIEWPOINT

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Why is the World Stagflation is no Longer in our Economic Lexicon?

It is rather surprising that it has taken so long for the S-word to be uttered. Paul Volcker's testimony in front of the Joint Economic Committee now allows mere mortals to take at look at similarities between 2007/2008 and the early 1970s and assess the chances that stagflation will reappear in the economists' lexicon.

At first glance, there are no doubt striking parallels. The 1973 oil price shock sent energy prices through the roof—a phenomenon that has been repeated with oil prices surging to well above the $100 per barrel for the first time. This is compounded by the largest food price increase in decades, perhaps aided and abetted by bio-fuels subsidies in the US. Moreover, the US economy is registering close to zero growth for successive quarters and consumer confidence is shot as housing prices plummet in the wake of the sub-prime crisis. Given the importance of housing as a measure of real wealth, this can only serve to lower consumer demand in successive quarters. So on the surface, we see both drivers of stagflation potentially at work—costs are rising and the economy is stalled.

One might also argue that the fiscal policy stance then and now are broadly similar. In the early 1970s, the Johnson years produced large increases in expenditures unmatched by revenues and currently we see a sizeable fiscal deficit emanating from large tax breaks. If expectations are formed by the fiscal stance, the American public should have been expecting inflationary pressures even without newly arrived cost drivers. Even the cheap dollar adds to inflation to the extent that imports matter in the public's consumption basket. So the question remains: why are economists not talking about stagflation?

Let's first look at the inflation risks. One impediment to gauging inflation perils is that measures that were traditionally used, such as the Consumer Price Index, have been largely supplanted by core or headline inflation numbers that are specifically designed to exclude volatile items. The problem is that the most volatile items these days are food and energy and they are limited in their coverage in inflation numbers currently in fashion. This might be defensible if the current bout of price increases were considered cyclical; however, no one really expects oil prices to climb back down, and projections show food prices remaining high for some time. Inflation perils might be considered small if these price components don't rise further, probably true for food but not so for energy. Nevertheless, there are the pass-through effects of higher energy prices on transport and logistics and the food price spike will be transmitted to other consumables, reduce disposable incomes and add to expectations of future inflation.

Looking at comparisons with the 1973-4 period, one sees a three-quarter (12/72-9/73) CPI rise of 8.7% leading to double digit inflation in 1974 of 12.2%. Over the same period in 1972-73, excluding food and energy yields a modest 4.4% increase in 9 month prices. Could we too be looking at the wrong inflation measure? Could expectations of further price increases fuel expectations? Some argue that the wash of liquidity will ultimately rekindle economic activity before it ignites further price increases. Others, including John Lipsky, the Deputy Managing Director of the IMF, have argued in the context of emerging economies in particular that cutting off inflationary pressures may be in order. Of course, that train may already have left the station, and raising interest rates might slow the one segment of world demand that is buoyant.

Coming back to the US, looking at real production is tricky because much is derived from expectations of future demand and inventory behavior, not to mention the impact of housing on backward linkages. All this points to slow growth for some time, however. Employment numbers are disappointing, with fewer people holding jobs than six months ago. It has been argued that this six month employment pattern is an accurate predictor of recession. Moreover, new and existing home sales have fallen by a third on a seasonally adjusted annual rate. And few expect the income tax refunds to reverse consumer expectations or moti-

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vate a spending spree. So even if the technical definition of recession can be avoided, the prospect of flat output haunts policymakers who have already provided both monetary and fiscal stimuli.

There are of course major differences with the situation during previous global energy price outbursts.. For one, today's actions of the Fed were prompted by a desire to prevent financial contagion rather than to use monetary policy as a stimulus. Of course, the Fed's objectives of both containing inflation and promoting economic activity are broader than that of the ECB, which is a pure inflation-fighter. Nevertheless, the very low interest rates could be sending a signal of laxity in the current circumstances according to ex-Chairman Volcker. It was Volcker's Fed after-all that clamped down on monetary growth in 1979-82, following the second oil price shock, that ushered in much lower inflation rates in the ensuing years, albeit with a growth consequence. In the current context, the real conundrum will probably emerge later in the year if economic activity starts to rebound, since the Fed will have to opt to either keep its incredibly low interest rates and risk adding to inflationary expectations or hike rates and risk choking off an incipient recovery.

A similar dilemma will face a new US administration, whether to reverse the oversized deficit or not. In the short-term, fiscal restraint could be seen as also limiting the needed recovery; however, fiscal prudence would be a wel-