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Economic Viewpoint

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Why Is the Word Stagflation Missing from 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 a 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 $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 traditional measures, such as the CPI, have been largely supplanted by core or headline inflation numbers that are specifically designed to exclude volatile items like food and energy. Inflation perils might be considered small if these price components don't rise further. 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.

Could we be underestimating the inflation risks? 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, all indicators point to slow growth. 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 rebates to reverse consumer expectations or motivate 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 compared to previous energy price outbursts. The Fed's recent actions were prompted by a desire to prevent financial contagion rather than to use monetary policy as a stimulus. Nevertheless, the very low interest rates could be sending a signal of laxity according to ex-Chairman Volcker. 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 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 or not to reverse the oversized deficit. In the short-term, fiscal restraint could be seen as also limiting the needed recovery; however, fiscal prudence would be a welcoming signal to those seeking to gauge the future level of inflation. Getting the balance wrong could well produce the poor combination of low growth and higher inflation. Even if one doesn't use the S-word, that confluence of tepid growth and price pressures comes pretty close to what we once called stagflation.

*The views expressed here are personal and do not represent necessarily the position of either the World Bank Group or its Board of Executive Directors. Comments can be sent to *Dannyleipziger@gmail.com.*