

Is 'stagflation' back?

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The recent acceleration in inflation around the world, driven as it has been by rising energy and food prices, in the context of a clear slowing in the rate of global economic growth, has put the concept of 'stagflation' back into the vocabulary of contemporary economic discourse.

'Stagflation' refers to the unpleasant combination of persistently weak economic growth (stagnation) and persistently high inflation, a combination which many economies (including Australia) experienced during the 1970s and early 1980s, after the first two oil-shocks of 1973 and 1979-80.

'Stagflation' is something more than simply the simultaneous occurrence of rising inflation and slowing economic growth. That can occur merely as the result of inflation typically lagging the business cycle. Just as a pie which has been put into an oven will continue to get hotter for a while even after the oven has been switched off, inflation will continue to accelerate in an economy which has been 'over-heating' even after appropriate policy responses have induced a slowdown in economic growth, without that amounting to 'stagflation'.

Rather, 'stagflation' is the logical result of a 'negative supply shock' – something which reduces an economy's potential growth rate, but which policy-makers (central banks and governments) fail to perceive, so that when they respond to a downturn in economic activity in the conventional manner by cutting interest rates or taxes in order to stimulate demand, much of the increased demand is dissipated in higher prices rather than inducing increased output.

This is essentially what happened in the mid-1970s and early 1980s. From the mid-1960s onwards, there was a massive expansion in the size of the State in most Western countries, both in the sense of a rising share of government spending as a proportion of GDP (in many cases of more than 10 pc points) and in the extent of regulation of business activity.

Though usually well-intended, this huge increase in the size of the State inevitably led to a decline in potential GDP growth. When the first oil shock led to a slump in economic activity, central banks and governments throughout the Western world tried to stimulate a return to pre-1974 growth rates, only to find that inflation accelerated anew while economic growth remained weak and unemployment remained high.

It wasn't until inflation was 'wrung out' by one (or in Australia's case more than one) episode of tight monetary policy followed by deep recession, and 'micro-economic reforms' explicitly directed towards reversing the previous decline in economies' potential growth rates were implemented on a sufficiently broad scale, that Western economies were again able to enjoy the felicitous combination of low inflation and strong growth.

The 'negative supply shock' represented by the massive expansion in the State from the mid-1960s to the late 1970s was, in its macro-economic consequences, the mirror image of the more recent 'positive supply shocks' associated with globalization, the information technology revolution and in at least some respects the emergence of China and India, which have had (for Western countries) the effect of enabling faster economic growth with lower inflation than previously thought possible.

Conceptually, the expansion in the regulatory reach of the State since the beginning of this decade, ostensibly with a view to improving 'national security' and enhancing standards of corporate governance, amounts to a 'negative supply shock'. There's no doubt that they have detracted from productivity growth and hence from potential economic growth. But these effects have been at the margin, and are in no way comparable in terms of magnitude to what occurred in the 1960s and 1970s.

If we really were experiencing 'peak oil' – that is, if global oil production were declining precipitously – that would amount to a 'negative supply shock'. But it does not appear to be the case that global oil production is declining precipitously, or indeed at all.

Rather, what seems to be happening is that the favourable effects of the 1990s supply shocks are beginning to fade, and instead the world economy is being buffeted by a series of 'demand shocks' – negative ones, such as the US sub-prime mortgage market meltdown and the ensuing global 'credit crunch', and positive ones such as the rapid growth in emerging market demand for petroleum products.

In this context, it's not surprising that we are observing rising inflation and slowing economic growth simultaneously. But it doesn't amount to stagflation.

The unpleasant combination of rising inflation and slowing growth will persist only if central banks and governments between them allow it too. So far, all the indications are that they don't intend to repeat the mistakes their predecessors made three decades ago.

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