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A Close VIEW

Stagflation: How Real Is the Risk?

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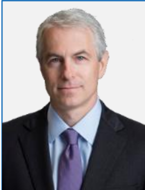

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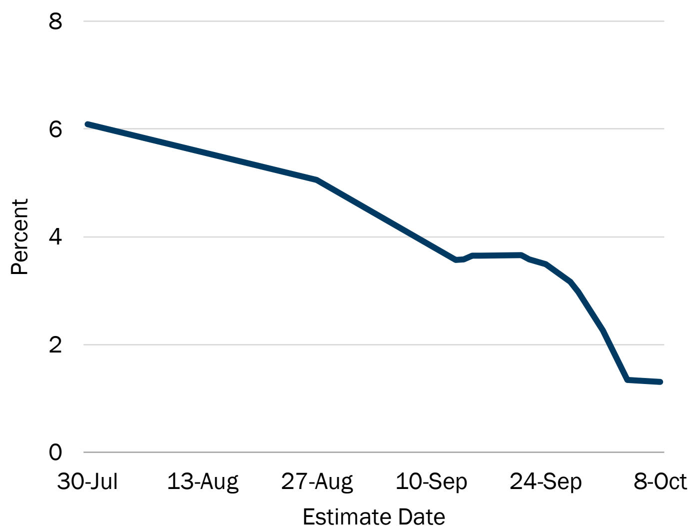
Recent market chatter about stagflation risk is understandable, given disappointing economic data and continuing price pressures. But over the next few years the US economy is much more likely to experience a robust expansion, with strong growth, a tight labor market and moderately higher inflation compared to the prior expansion. Further down the road the risk of stagflation will rise if the FOMC needs to respond to persistent price pressures with much tighter monetary policy.

With inflation already running high, a decline in estimates for third-quarter GDP has raised the specter of stagflation, a period of persistently high inflation and low growth. Accommodative monetary policy and rising oil prices have also played into the narrative, given that both were contributors to the stagflation of the 1970s.

FIGURE 1: 3Q 2021 GDP ESTIMATE FROM THE ATLANTA FED



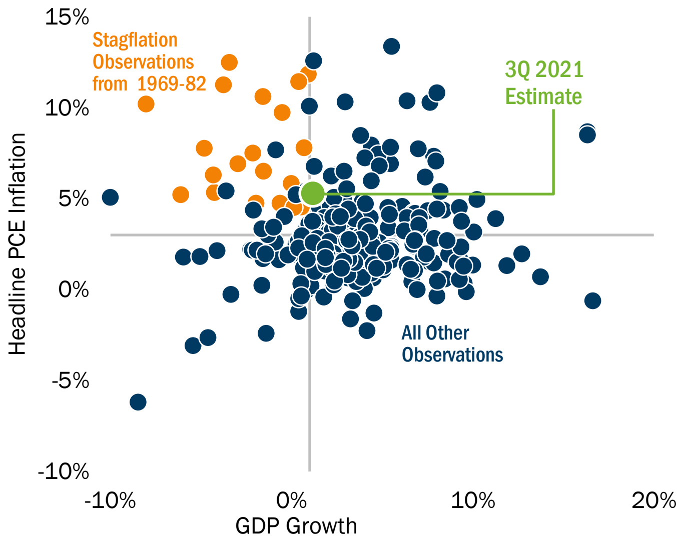
Source: GDPNow, Federal Reserve Bank of Atlanta.

Whether we are on the cusp of another stagflation era is not just a question of semantics. Stagflation is painful for households, especially at the lower end of the income distribution, because it combines reduced purchasing power with weak employment opportunities. It also raises challenges for central bankers, as attempts to rein in inflation will further hurt growth and the labor market in the short run.

To assess stagflation risk, it's useful to put some definition to the term. A simple rule of thumb might be to consider the combination of quarterly annualized inflation above three percent, and quarterly annualized real GDP growth below one percent, as stagflation. Growth need not be negative – a rate moderately below trend would likely weaken the labor market. Importantly though, under stagflation, weak growth and high inflation are *persistent*. Stagflation is, ultimately, a period of stagnation in overall economic wellbeing, one that becomes defined by its pernicious combination of rising prices, weak growth and limited employment outcomes. It is not a point in time, but a trend that impacts household and business decisions about spending and saving.

How often has the US experienced stagflation? Figure 2 below shows all combinations of quarterly growth and inflation since 1948. The upper-left quadrant denotes stagflationary outcomes, as defined above. What stands out is that in US post-war history, stagflation mainly occurred in one period, from 1969 to 1982. During these years, over a third of the time the US economy registered a stagflationary outcome.

FIGURE 2: QUARTERLY REAL GROWTH AND INFLATION OUTCOMES (AR) | 1947 - 2019 AND 3Q 2021



Source: Bureau of Economic Analysis, MacKay Shields.

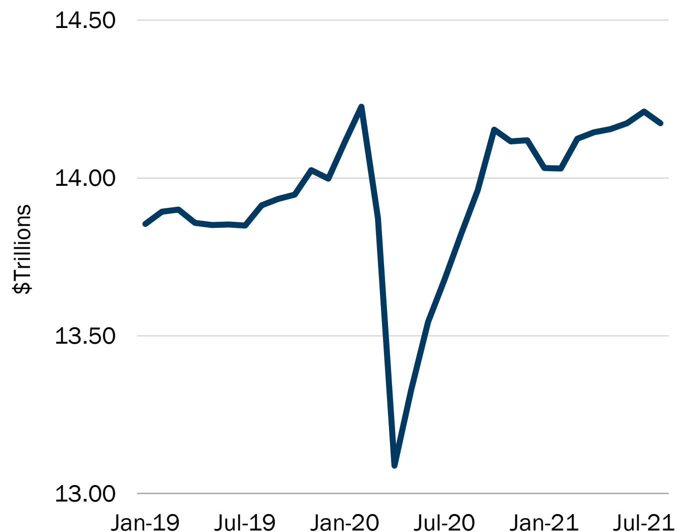
The stagflation of the 1970s was most importantly characterized by a negative supply shock resulting from two sustained oil price increases, one starting in 1973 and the other in 1979. These oil price shocks served as a significant tax on household income that weakened consumer spending. Meanwhile, businesses pulled backed on production and hiring due to higher energy costs. Other factors contributed to the high inflation at the time. Both monetary and fiscal policy had been very accommodative for years as the 1970s began, and the Bretton Woods system that linked the dollar to gold collapsed in 1971. In addition, the Federal Reserve largely looked through the first oil shock and focused on supporting economic activity. This policy response may have alleviated some of the growth and employment consequences of the negative supply shock, but added to inflation pressures.

That the stagflation of that era was driven in large part by a persistent and negative supply shock holds lessons for today. Certainly a good portion of the current mix of elevated inflation and slowing activity stems from supply constraints. Globally, output has been slow to pick up after the systematic lockdowns of early 2020. That some countries still resort to lockdowns, even if on a targeted basis, continues to hinder global production and supply chains. And the ongoing health crisis stands in the way of a more robust recovery in labor force participation, not least in the U.S. Meanwhile, higher prices are now weighing on household spending in some goods categories.

But importantly, these factors should be temporary. Over the course of the next year or so, global output should continue to recover, and logistics and supply chain bottlenecks should clear. Labor force participation will likely rise as vaccine rollout continues and better treatments become available. At the same time, the strong demand for cars, household furnishings and other durable goods that has contributed to supply-demand imbalances should fade in the absence of additional household stimulus checks and as spending rotates back towards services. All of this will take time, but there is little reason to think that current supply constraints represent a long-term negative supply shock for the global economy.

In contrast to a persistent 1970s-style supply shock, the years ahead are much more likely to see a robust expansion, with both growth and inflation above pre-pandemic trends. If anything, the outlook is reminiscent of the 1950s and early 1960s, with fiscal policy used more assertively to support household income, and monetary policy putting more weight on growth and employment than on inflation. And while the recent rise in energy prices will cut into household spending on discretionary goods and services, the magnitude of the rise needs to be kept in perspective. In comparison to the ten-fold increase in nominal crude oil prices during the oil shocks of the 1970s, this year prices have risen just 70 percent, less than double their starting point. The inflationary impact of this rise will be measured in tens of basis points, not full percentage points. Further, even with strong inflation this year, real personal income excluding government transfer payments has roughly returned to pre-crisis levels. And high levels of household savings, due in part to those transfer payments, should support household spending for the foreseeable future. Strong labor demand should support spending as well.

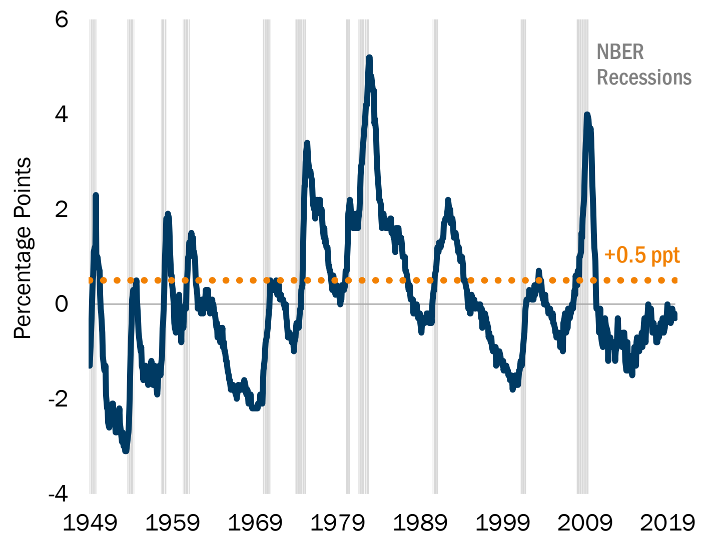
FIGURE 3: REAL HOUSEHOLD INCOME EXCLUDING GOVERNMENT TRANSFER PAYMENTS



Source: Bureau of Economic Analysis

If the 1950s and early 1960s, with its combination of strong growth and firm inflation, is a better analogy for the years ahead, it raises the question of how well the Federal Reserve can manage the associated risks. As noted in a **previous report**, if inflation shows signs of persisting above policymakers' comfort level, it could set the stage for more forceful policy tightening over the medium term. Unfortunately, the FOMC's track record of cooling off a hot economy and engineering a soft landing is less than stellar. Historically, when the economy slows and the unemployment rate rises by half a percentage point over the span of a year, a recession has invariably followed. And if that recession comes with inflation still running strong, there's a significant risk of at least a short period of stagflation.

FIGURE 4: ONE-YEAR CHANGE IN UNEMPLOYMENT RATE



NBER = National Bureau of Economic Research

Source: Bureau of Labor Statistics

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