Should we worry about stagflation?

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Stagflation Is a term used to describe a period of no growth but with high inflation(1). This normally happens when an external shock sends prices higher , such as the oil price crises of the 1970s. Interest rates are then generally raised in reaction which lead to a slowdown in demand. Consumption and investment inevitably drop and a period of weak growth follows until inflation is brought back under control. But because that shock is external and not a result of market forces, the whole episode often lasts longer than it should, causing serious damage to he world economy. Stagnant growth and inflation=stagflation.

We have just been through a different type of exogenous shock, Covid, which led to a global demand and supply slump but accompanied by deflation rather than inflation in many countries. Before vaccines started offering hope the prospect was for a long slump in production and demand, rising unemployment, heavy price discounts, and ultra low commodity prices. The authorities responded with a strong cocktail of monetary and fiscal stimulus measures slashing interest rates to record lows .That didn't immediately stop oil prices going negative but it helped the upswing that then followed. And here we are now in the recovery phase which has not surprisingly been accompanied by supply disruptions, dislocation of activities, , increased transport costs ,imbalances in the labour market and rising prices that occur when demand suddenly outstrips supply. One would normally expect that after a while the markets will find their new equilibrium and governments will also revert to something resembling the pre-crisis mode.

But as the peak of the recovery phase seems to have been passed a few months ago and price pressures are intensifying globally, the talk now is once again of 'stagflation'. How realistic is that? Exogenous factors sending supply and price shocks have occurred this time too but much less than in other periods of rising inflation. True OPEC + did cut its output to stabilise prices last year but although prices were already beginning to react to higher demand through 2021 the recent price rise to over $80 a barrel happened a good deal of time after the group announced a reversal of that policy(2). And yes , the lack of Russian gas being offered on the spot market, possibly for political reasons, as demand rose through 2021 may well have contributed to the recent sharp increase in gas and electricity prices that has shaken industrial and household sectors worldwide. But wholesale gas prices were rising for quite a while anyway, reflecting reductions in gas storage capacity and a 'dash for gas' as a less polluting alternative on the way to net zero carbon emissions commitments.

Of course there are supply bottlenecks and some of the pressures will probably take some time to be resolved. But the likelihood of a long period of stagflation remains small. Why?

First, despite some hiccups, the world economy is in fact still growing albeit at a slower pace and is still expected to see GDP rise by 6% this year and some 4.9% next year(3). These are annual rates not seen since before the financial crisis of 2008/9. It is true that global manufacturing PMIs probably reached their peak in around April/ May this year and that emerging markets are still suffering from lack of vaccine distribution and Covid closures which are affecting their relative growth performance In China which in fact posted positive growth for 2020 as a whole growth is also plateauing after the strong early spurt. Japan is now witnessing some drops in industrial production partly because of the China slowdown but also due to rise in Covid infections . But in any case no one would characterise Japan as a high inflation country. Meanwhile the ECB has revised its EU growth forecast for this year up to 5% . And although US growth in recent months has disappointed, the economy is already above pre-pandemic levels and likely to show growth of 6% for 2021 as a whole.

Second the world monetary authorities are unlikely to react by raising interest rates in a hurry as they did in previous inflationary crises. All the indications in fact most central banks consider many of the inflationary measures to be transitory though they are beginning to hedge their bets a bit in their various pronouncements.

Third fiscal authorities are unlikely to withdraw economic stimulus and revert to austerity any time soon. Yes, the UK has exited the furlough scheme which cost it some £70b(4) and is withdrawing other support such as the Universal Credit uplift it offered during the pandemic . It is also raising some taxes that will hit both individuals and businesses. But it is at the same time put in m ore than it takes with borrowing this year, after a post war record of £325b last year, expected to be in the region of £200b, a mouth- watering amount given that the original planned borrowing for 2020/21 as Covid started to hit was just £55b. The EU is embarking on a Euro 750b Recovery and Resilience spending programme that will benefit many countries, particularly in Southern Europe with extra investment and infrastructure support. The US under Biden is pushing trough new multi- trillion stimulus packages, to improve social provision, reduce inequalities, improve infrastructure and bolster innovation. Even China, which had put the breaks on its fast growth and tried to rein in some of its overindebted businesses, is now easing once again.

But where stagflation seems to be more of a concern is in the UK. The OECD, while upgrading its inflation forecasts for most advanced nations, believes that supply chain and hence cost and price pressures are likely to be more acute and to persist longer in the UK, with problems 'at least to an extent compounded by Brexit(5) . We have also seen a slowdown in the rate of growth, a sharp drop in business confidence(6), retail sales falling for a number of months now, serious worries about the energy crisis being more pronounced in the UK(7) and much uncertainty about the impact on unemployment of the end of the furlough scheme. Perhaps we are beginning to see more clearly how the UK's post-Covid, post- Brexit existence is finally unfolding.

References

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