

Will Stagflation Ever Return?

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Fed Chairman Ben Bernanke may be facing a central banker's nightmare this year, "a mild dose of stagflation", as Allen Sinai, president of Decision Economics said. Wikipedia defines stagflation is a term in macroeconomics used to describe a period characteristic of high inflation combined with economic stagnation, unemployment, or economic recession. Surging oil and commodity prices, a falling dollar and mounting doubts about the Fed's willingness to keep price pressures in check are all increasing the risks that inflation will quicken. At the same time, the Fed's two-year credit-tightening campaign is beginning to take hold; with the housing market sagging and consumer confidence wavering, the result may be slowing growth.

Stagflation, last seen in the 1970s is bad news for consumers, companies and investors. Consumers find themselves squeezed by rising prices and diminishing job prospects. Profits take a hit as companies face mounting costs and diminishing demand. Investors' portfolios shrink with a swooning stock market. No one is predicting a return of the 1970s when unemployment and inflation both soared to post-World War II highs. According to Bloomberg, the jobless rate peaked at 9 percent in May of 1975 while inflation topped out at 13.3 percent in 1979. One big difference now is strong productivity growth, which has helped keep inflation in check and the economy growing. Non-farm productivity grew 2.7 percent last year, while during 1979-80 actually productivity shrank.

Some economists are seeing a risk of growth slowing to 2 percent later this year, from almost 6 percent in the first quarter. Brian Wesbury, chief economist at First Trust Advisors in Lisle, Illinois, talks of the possibility that "core" inflation, which excludes volatile food and energy costs, will rise above 4 percent next year, close to double last year's level.

If they are both right, it may prove very uncomfortable for Bernanke, who took over leadership of the central bank in February. Just as in the 1970's, oil prices are surging, tripling over the past three years. While energy costs so far haven't fed through much into core inflation that may be changing. Through the first four months of the year, core inflation rose at an annualized rate of 3 percent vs. 2.2 percent last year. Meanwhile, back-to-

back years of 3.5 percent-plus growth leave less slack in the U.S. economy. In April, U.S. industry operated with less spare capacity than at any time since July 2000.

Additional pressure is coming from the rise of inflation around the globe. In the UK, inflation has risen to 2.2%, above target ceiling of 2%. New Zealand inflation rate has hit a six year high. Euro-region inflation exceeded the ECB's 2 percent ceiling for a 16th straight month in May, accelerating to 2.5 percent from 2.4 percent in the previous month. China's annual rate of inflation hit a seven-year high in April, underlining fears that the economy is overheating. The result of this increase in inflation around the globe is that it is forcing central banks to increase interest rates. These increases will put pressure on the US dollar and may lead the Fed to have to continue to raise rates to support the Dollar.

Consumer confidence tumbled this month by the most since last year's hurricanes. A University of Michigan survey found that consumers are less inclined now to buy a home or an automobile than at any time in more than a decade. Wal-Mart Stores Inc., the world's largest retailer, said May 16 that earnings may suffer this quarter as near-record gasoline prices cause consumers to cut back on other purchases. If the scenario of sub-par growth and too-high inflation comes about, Bernanke and his colleagues will face unpalatable choices. Do they raise interest rates to squelch rising inflation and risk sending the economy into a tailspin? Or do they forgo increases in rates -- even cut them -- to cushion the declining economy and in the process run the danger of letting inflation accelerate?