



## Stagflation Watch

With oil prices rising, the stagflation virus threatens to strike again. As usual, economists will be befuddled on what remedies to use.

I ALWAYS TRY TO AVOID TALKING ABOUT SUPPLY SHOCKS. IT'S NOT an easy subject, even for economists. Thus, when a relative uttered the words 'stagflation', I let out a big sigh, knowing I was in for a tough time. To make it worse, economists do not agree on the remedy for stagflation. What else is new?

First, the general definition of 'supply shock'. In economics, when something happens to raise the cost of production when aggregate demand remains stable – for instance, a sharp rise in crude oil prices – we may find that economies are saddled with high prices and low national output (gross domestic product).

That means prices are rising not because there is more demand

Stagflation in the early 1970s took many economists by surprise, especially those who strongly believed in Keynesian economics. The followers of the well-known British economist, John Maynard Keynes, used to believe that a stagflation situation was impossible because a stagnant economy, characterised by high unemployment, would naturally lower demand for goods and services. Such a condition would lead to lower prices, which would mean low or no inflation.

The opposite was also held true. When economic activity is robust, unemployment would fall as the labour market becomes tight. Employers would bid up prices of their employees and as a

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for goods and services but simply because of rising production and business costs. Therefore, a negative supply shock such as a sharp increase in oil price can lead to a stagflation situation – stagnant economy with high inflation.

I use the word 'can' simply because, strictly speaking and contrary to common belief, negative supply shocks in themselves do not necessarily lead to stagflation. (The coinage of the word has been attributed to former British Minister of Finance Iain Macleod, who died in 1970.)

Among the developed countries, the United Kingdom experienced stagflation in the 1960s. A decade later, the United States and many others experienced it during the first and second oil crises – in 1974 during the Arab-Israel War and 1979 following the Iranian Revolution that ousted the Shah of Iran.

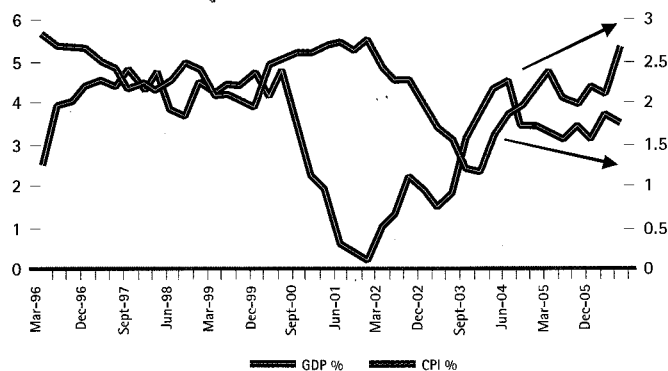
consequence, wages would rise. This in turn would lead to higher inflation.

So, low unemployment is normally accompanied by high inflation, and this relationship was commonly depicted in the so-called 'Phillips Curve'.

There has been an intense discussion among a group of economists about the present macroeconomic backdrop, which they argue resembles the stagflation period of the 1970s. Although not as serious, it poses the threat of the emergence of 'stagflation-type' economies – a situation where growth does not fall drastically but remains stagnant, with inflation surging following the increase in global oil prices.

In the US, for instance, growth decelerated to 2.5% in the second quarter from a sizzling 5.6% expansion earlier. At the same time,

## US Economy: Slipping Growth, Surging Inflation



Source: Bloomberg

the core consumer price index (CPI) shot up to 2.7% in July, above its comfort zone level of 2% in the past several months. The core private consumption expenditure index (PCE) also breached its 2% target, rising by 3.3% in the three months to June.

Although growth is expected to taper off in the second half of the year, private economists are still not convinced prices will slip back to a comfortable level, not when crude oil prices remain stubbornly high.

The same situation can be seen in the Euro region. It is true that growth picked up in the second quarter to 0.9%, a fact that has brought more confidence to the European Central Bank (ECB) policy-makers, who insist that more monetary accommodation should be removed from the system.

That means the interest rate would climb higher than the present 3% level before the year-end.

Despite some upbeat macro numbers, some economists are not convinced the current expansion has legs. One reason is that the growth is highly dependent on external sector. Exports to main markets like the US have been major growth drivers in the past one year, and that would change if the world's largest economy starts to soften.

Another reason is waning consumer purchasing power, which would affect private consumption going forward. With the end of the World Cup spending spree and a continued rise in borrowing costs, consumers would likely tighten their belts in the foreseeable future.

Corporate spending, on the other hand, would react to higher cost and slower global demand. At the same time, prices would keep escalating. The CPI has remained around 2.5% in the past few months and inflation will likely breach its 2% comfort zone for the seventh year in 2006.

Despite all these talks, there are obviously some differences between the current situation and that of the 1970s. Firstly, the oil shock in the early 1970s had a bigger impact because it happened within a much shorter time-frame. Oil prices roughly quintupled from US\$2.20 per barrel in 1971 to US\$11.50 in 1974, moving up very rapidly in 1973.

Because of such a drastic rise in a short period, global economies were scrambling to cope with a new situation; a situation that rarely happened in the past.

Secondly, the oil shock was predominantly, although not entirely, due to supply disruptions following restrictions by the Organisation of Petroleum Exporting Countries (Opec). On the contrary, the present condition is caused by stronger-than-expected physical and speculative demand for oil following the rapid growth of major economies like China, India and the US in the past few years.

So is there a special remedy for this stagflation virus?

As usual, economists disagree on the general prescription for the situation. The difficult thing about curing stagflation is that the normal over-the-counter economic remedy does not work because the economy has misaligned from its usual track.

High inflation is normally treated using higher interest rate. In fact, in the stagflation scenario, a rapid increase in 'inflation expectation' among producers and consumers is the major culprit. As such, it is crucial for policy-makers to quickly break the forward expectation by raising interest rate aggressively.

However, in this case, rising borrowing costs would exacerbate the decline in economic activity. In fact, an economy can go into a deep recession if interest rates are jacked up excessively to kill inflation expectation. This happened to the US in the early 1980s, when growth plummeted to negative territory after the Federal Reserve Bank raised the federal funds rate aggressively to 15% under its chairman, Paul Volker.

Policies that are meant to support growth may also prove disastrous if the economy is plagued by stagflation. Expansionary fiscal policy may be able to re-generate growth but will come with a serious side effect – higher inflation.

This will induce a further rise in inflation expectation and can cause a rapid increase in the general price level. An example is the fiscal expansionary effort undertaken by President Jimmy Carter's administration in the late 1970s, which proved to be unsuccessful.

So stagflation is a powerful economic virus which is difficult to kill. While economists and policy-makers have learnt from past experience in dealing with such a situation, no easy solution has been found. Most remedies come with difficult trade-offs. With rising oil prices, we only hope that the global economy will not succumb to stagflationary pressure in the near future. **mb**

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