Is 1970s Stagflation Back? Can Disco be Far Behind?

Byron Gangnes

Professor Emeritus of Economics

UHERO Senior Research Fellow

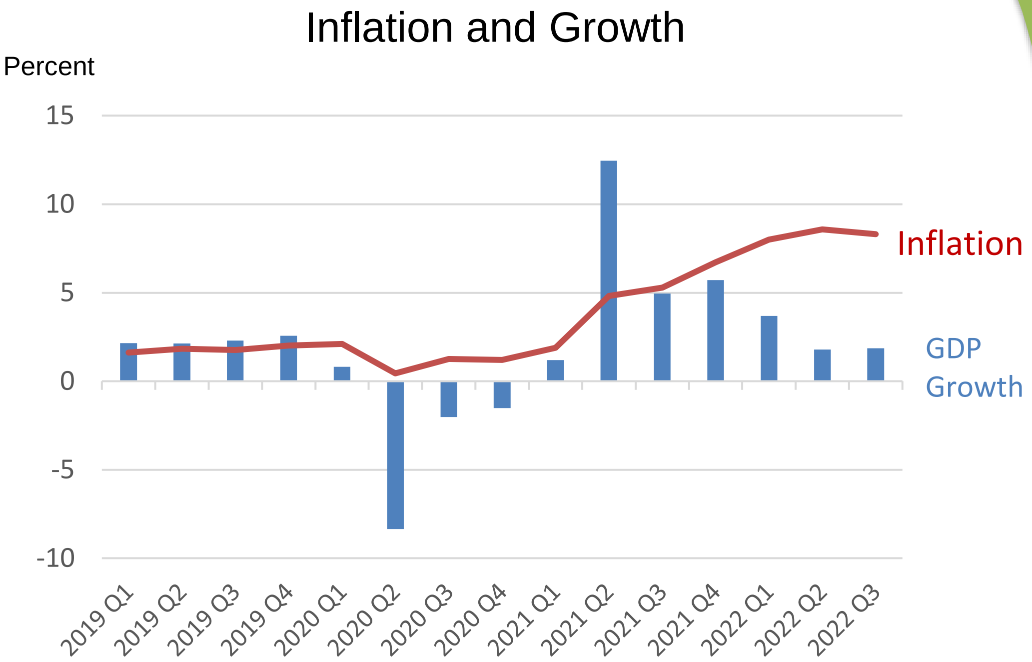
University of Hawaii at Manoa

VLI Maui

January 2023

The inflation problem

- Inflation has proven surprisingly persistent
- It has eased back from its 9% peak in June
  - But at 6.4% it is still at its highest level in four decades
- The effects of inflation & interest rates has begun to slow the economy
- Might we also be in for a 1970s style sustained period of inflation and stagnant growth—*Stagflation?*

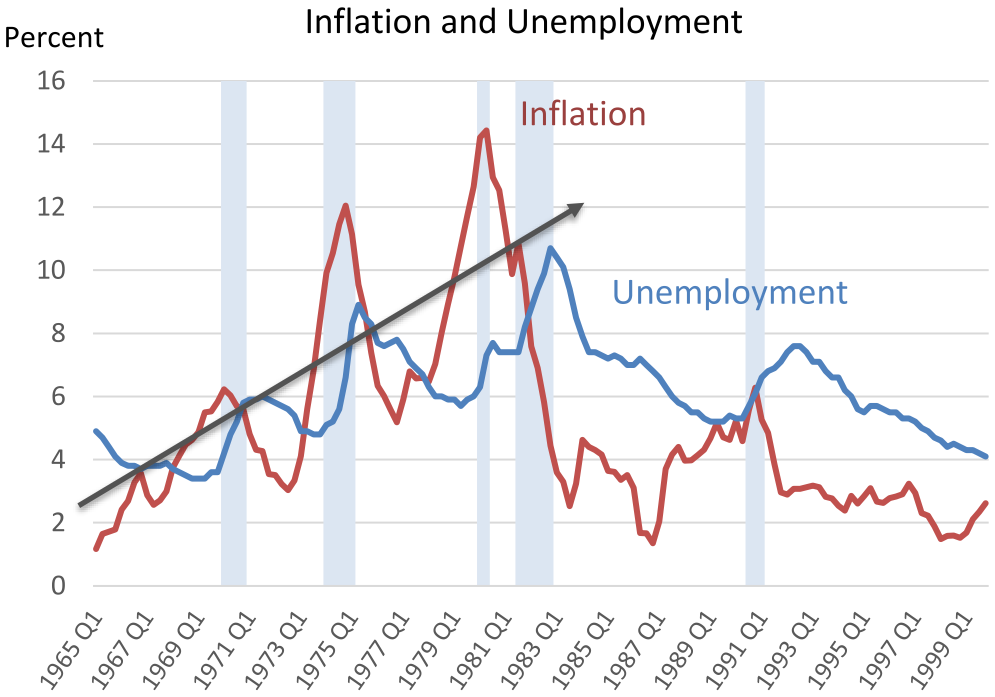


Source: US Bureau of Economic Analysis & Bureau of Labor Statistics.
GDP is year-on-year growth

VLI Hawaii

1970s *Stagflation*

- Postwar experience was that when the economy weakened, inflation would slow
- But in the 1970s, high inflation persisted even as unemployment continued to mount
- It wasn't until the early 1980s that inflation was brought under control
  - And the late 1980s before unemployment receded



Source: BLS via Fred data site.

Not all inflation is created equal

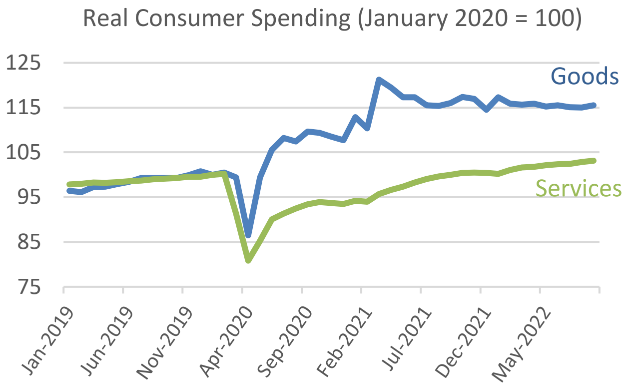
- Demand-pull inflation
  - Strong demand pushes up wages and prices
  - Inflation will tend to fall back as the economy cools
- Cost-push inflation
  - Higher production costs get passed into inflation
  - But this also tends to cause weak output growth and rising unemployment
  - And the need to fight this inflation may lead to <u>very bad</u> growth performance and <u>high</u> unemployment
  - This is particularly painful macro situation

VLI Hawaii

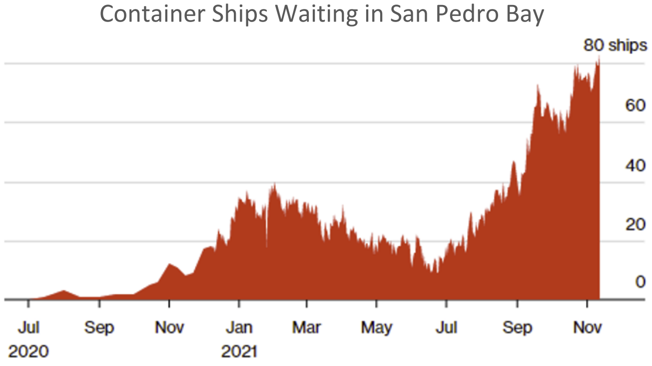
COVID: Both demand and supply at work

- This time around, there have been both demand and supply factors at work
  - COVID pushed up demand for goods, and recovery demand for services.
  - COVID disrupted production and distribution

Strong Demand



Constrained Supply

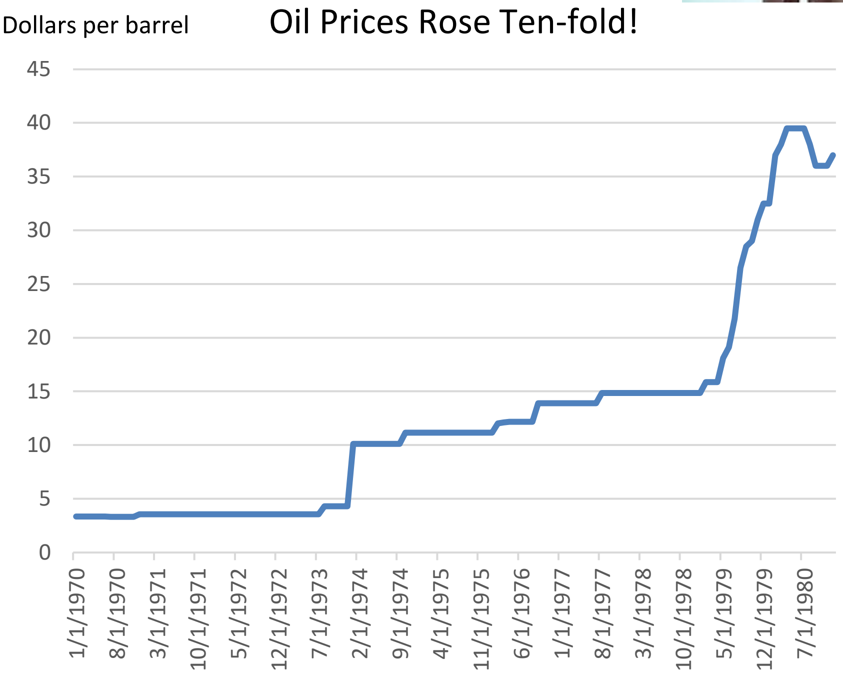


Source: Marine Exchange of Southern California & Vessel Traffic Service L.A./Long Beach Bloomberg.com, Nov. 13, 2021

VLI Hawaii

What caused the 1970s Stagflation?

- No single universally-accepted explanation
- The main culprits
  - Historically **massive** oil price shock
  - Failure of the Fed to choke off inflation early on
  - People came to expect higher inflation and built it into contracts
  - And the massively higher oil prices imposed a high cost of industrial retooling
- But also some other supply-side challenges
  - Rust belt manufacturing decline
  - demographics

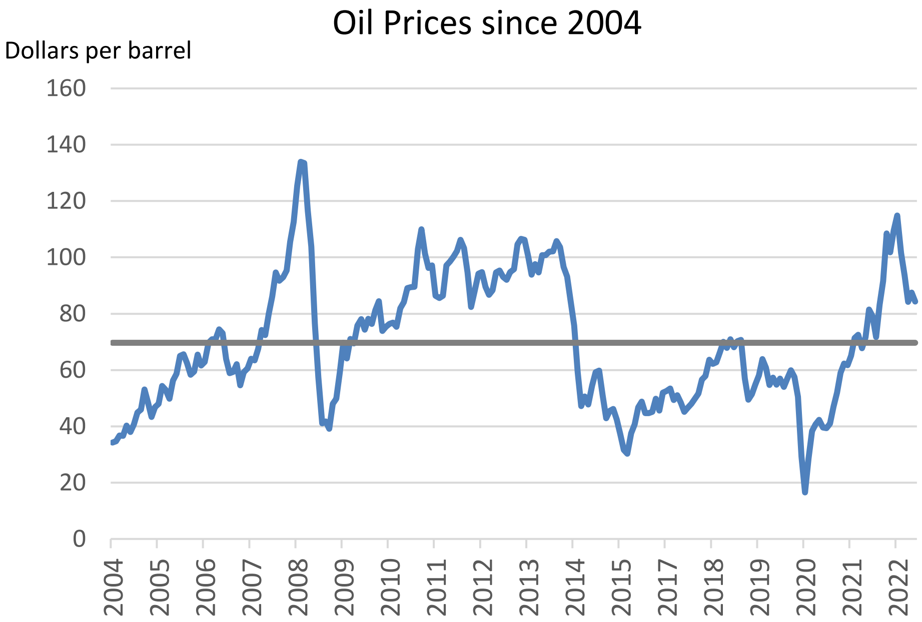


Source Fred data site.

VLI Hawaii

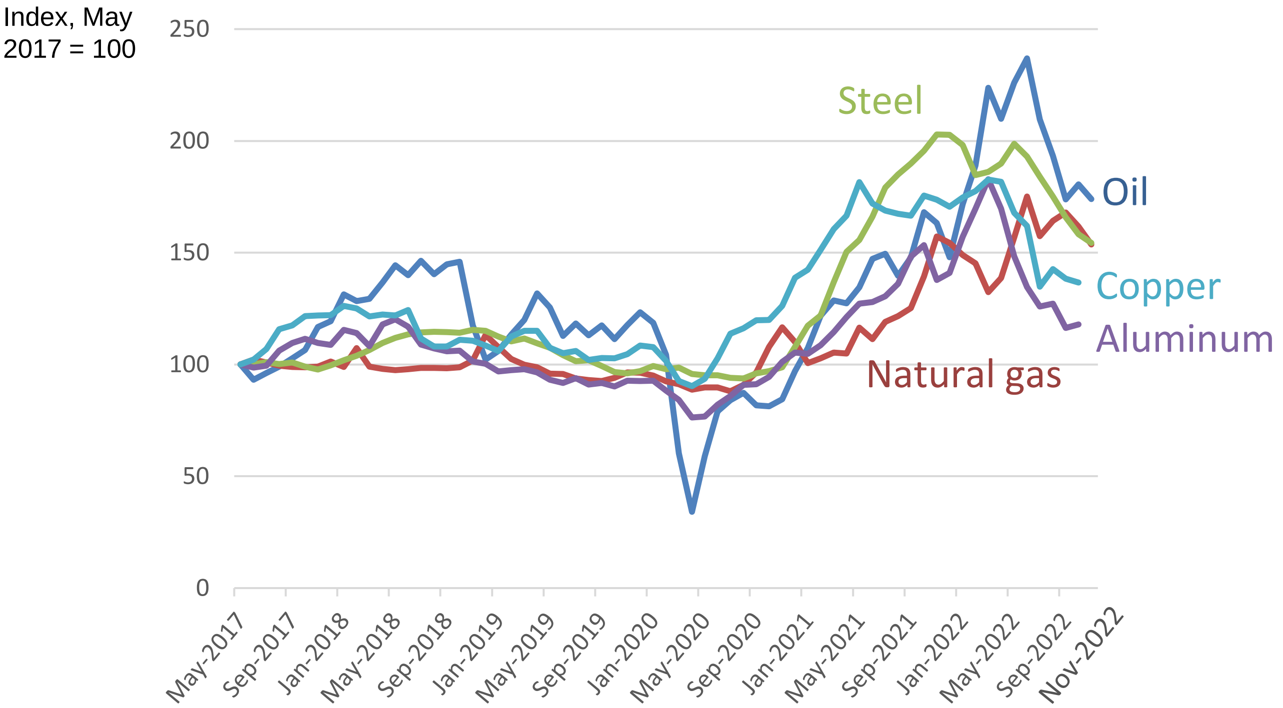
What's different this time around?

- Much smaller commodity shock: oil prices surged "only" 65% above their 2004-2021 average
  - But the supply chain issues are unique this time
- And expectations of future inflation have remained fairly benign
  – We'll come back to this.



Source Fred data site

Commodity prices have already pulled back



Source: Federal Reserve via https://fred.stlouisfed.org/ and author's calculations.
Oil is West Texas Intermediate; Natural gas and steel are US producer prices;
Copper and aluminum are global prices.

Supply constrains have eased a lot

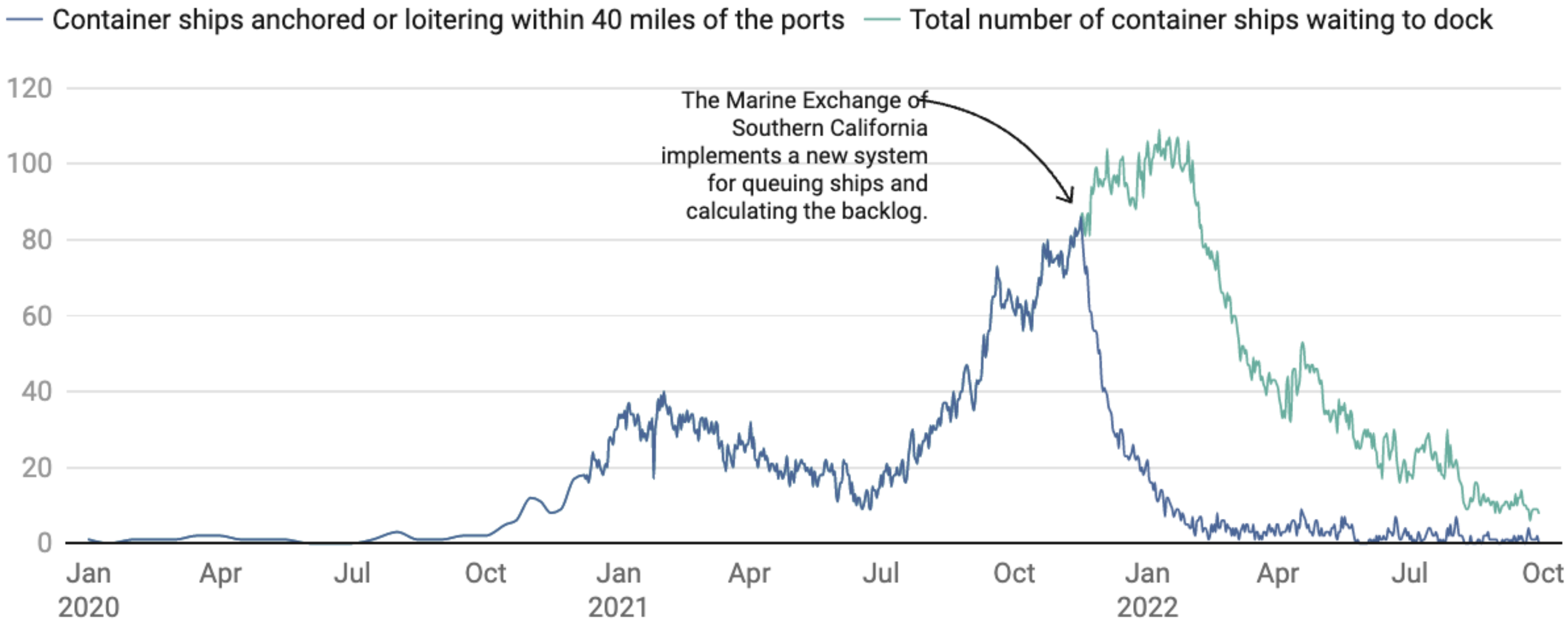
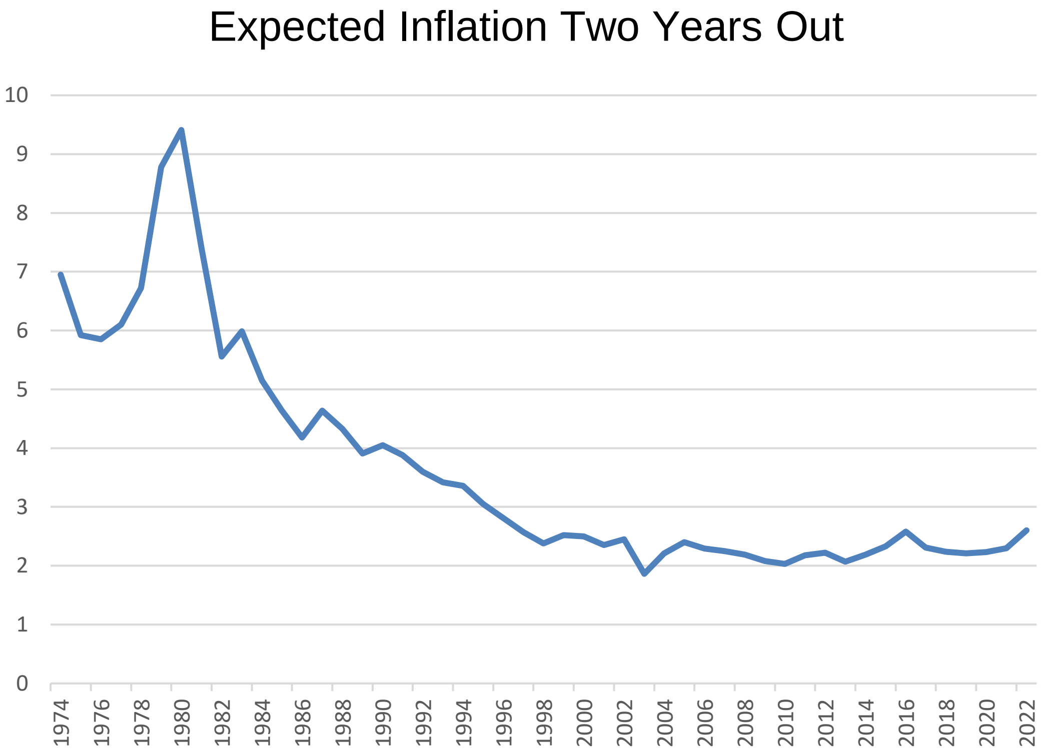


Chart: Dylan Miettinen • Source: Marine Exchange of Southern California

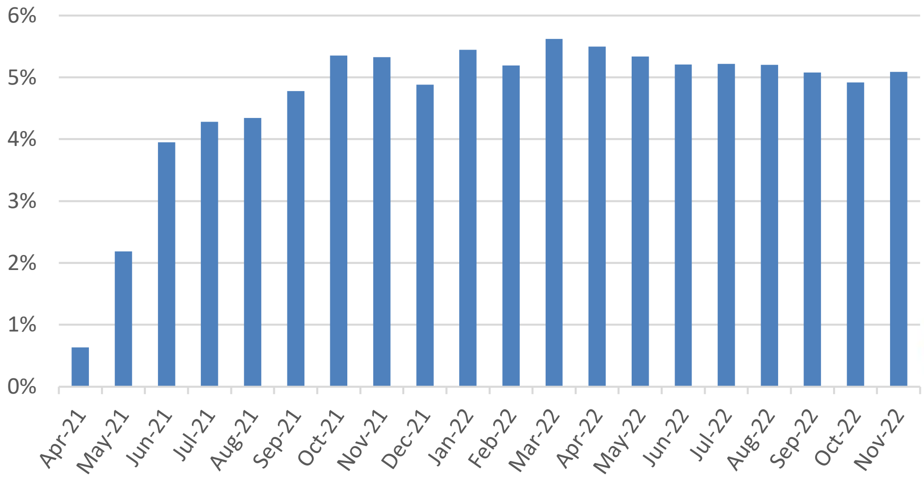
Inflation expectations are nothing like the 1970s



Source: FRB Philadelphia, Livingston Survey.
2022 value is an estimate based on FRB Cleveland model.

Why might we still worry?

- Wage appreciation remains rapid

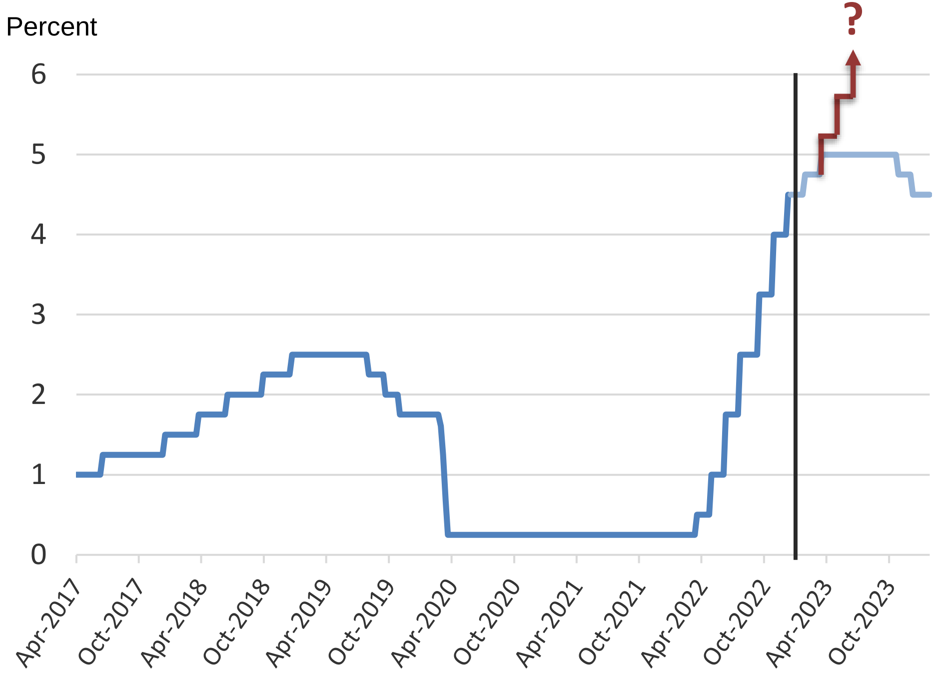


VLI Hawaii

Fed is clear that it will get 2% inflation

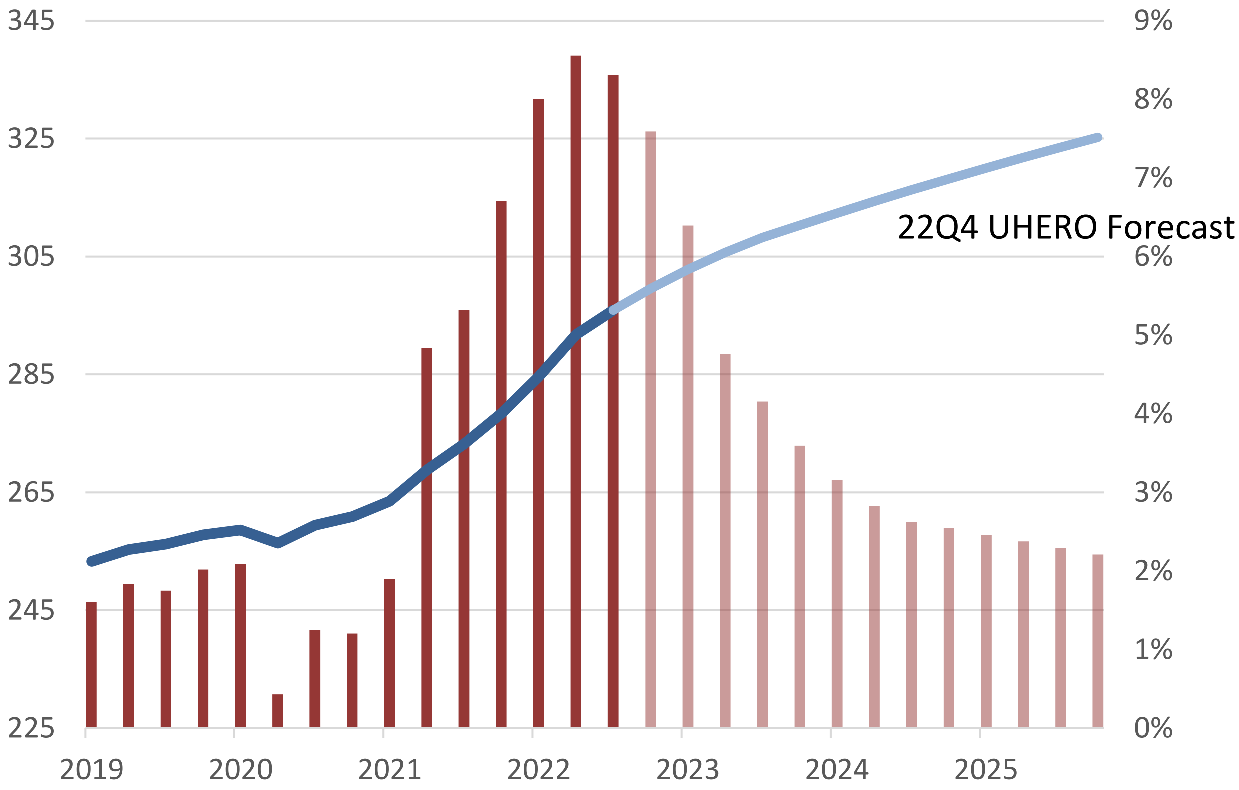
- If the federal funds rate needs to go well above 5% then they will do so:
  - "We will stay the course, until the job is done,"
    J. Powell, Dec 14, 2022
- Of course, that could mean a steeper downturn in the short run
- But no reason to think that inflation will get baked into the economy

Federal funds interest rate (upper bound) and financial market's projections



Source: Federal Reserve via https://fred.stlouisfed.org/
CME *FedWatch Tool*, January 12, 2023

Still our best guess



And a short, mild recession

Source: UHERO Fourth Quarter 2022 Forecast

On sale now!

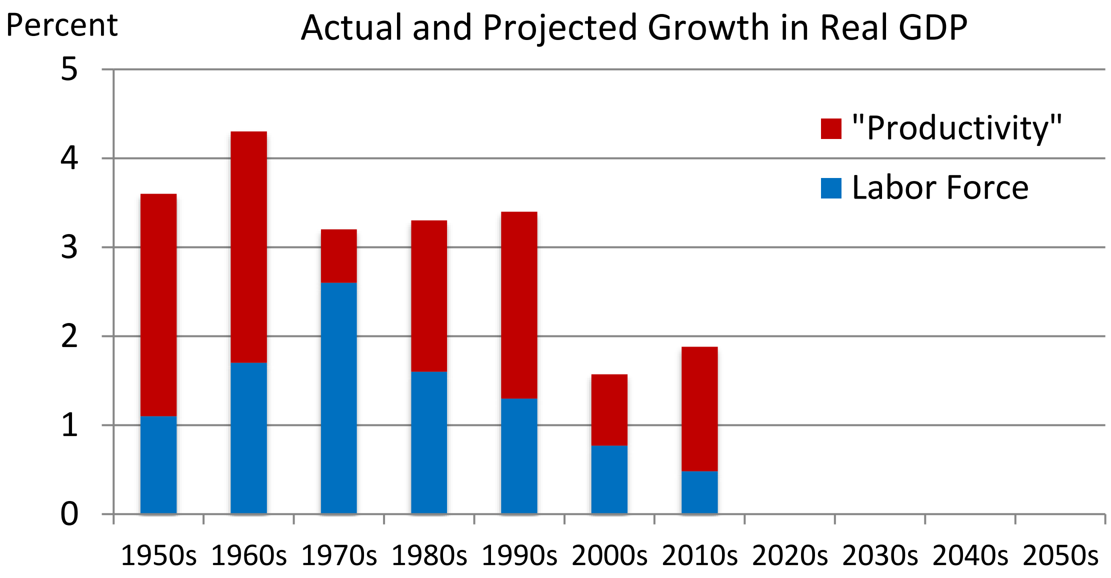
Long-term supply-side challenges

- End of rapid globalization period
  - End of period of downward trade prices
  - New protectionism—*deglobalization?*
- Slower labor force growth and unfavorable demographics
  - Low fertility and labor shortage
  - Incentives for further shift to labor-saving technologies
  - Aging and fiscal burdens
  - Immigration restrictions problematic in this respect
- The Big Unknowns
  - Climate change prevention & mitigation—*Greenflation*
  - Geopolitical risks
    - Nuclear war?

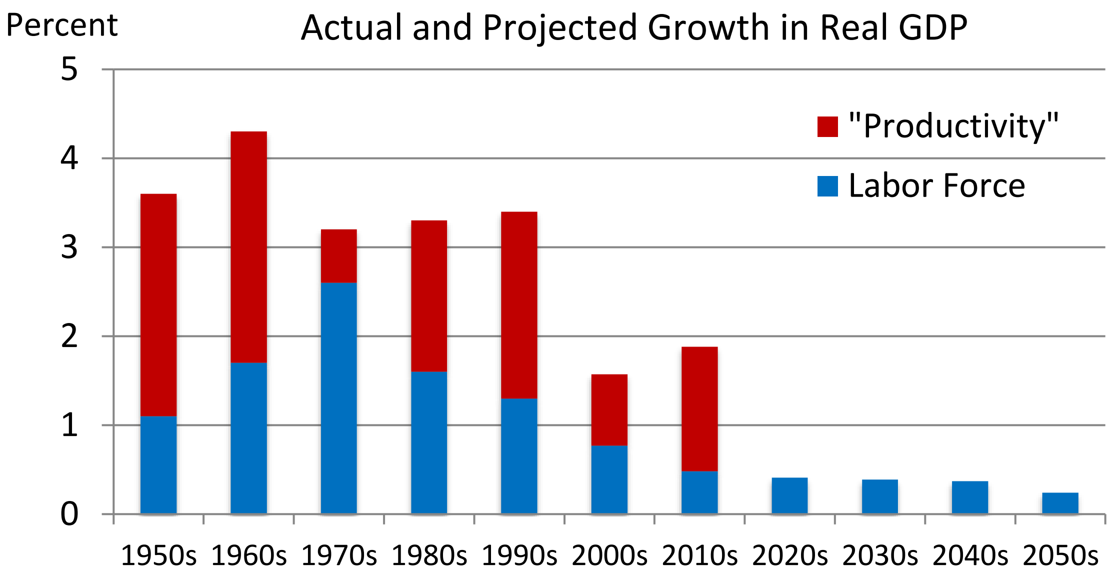
On sale now!

VLI Hawaii

Effect of slower labor force growth

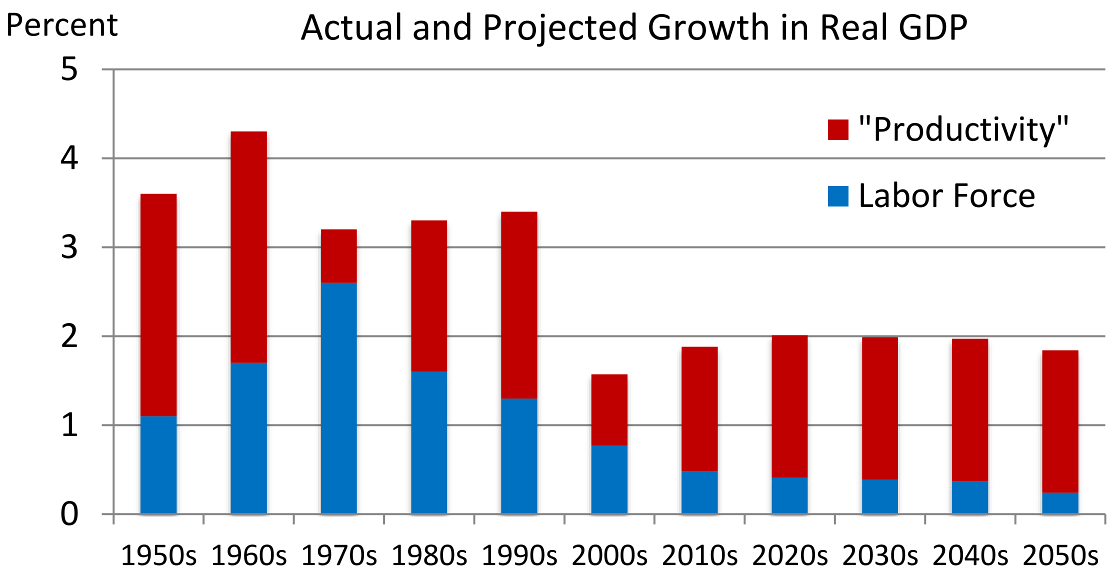


Effect of slower labor force growth

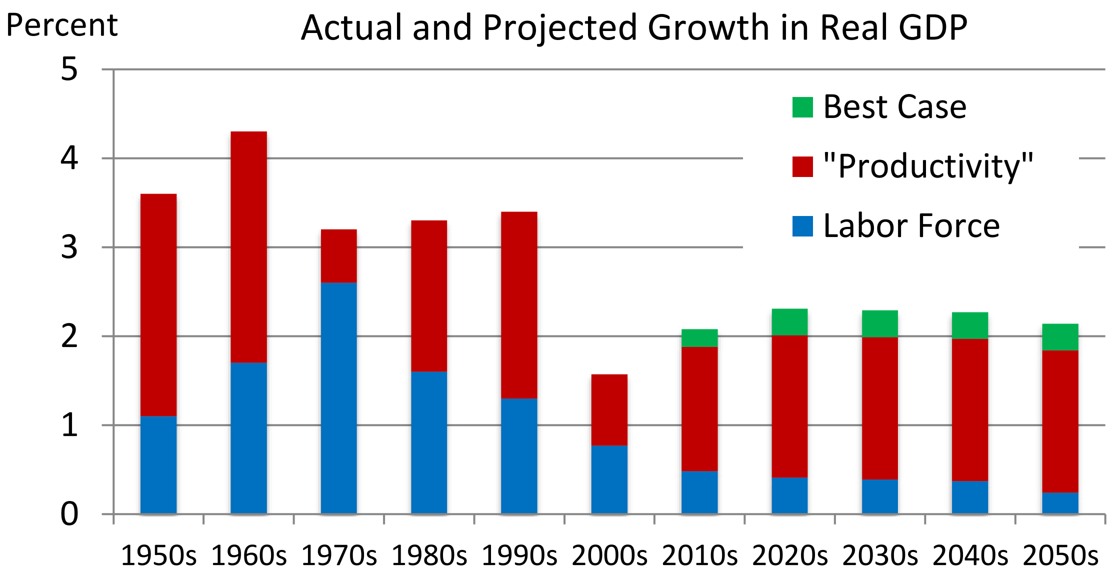


VLI Hawaii

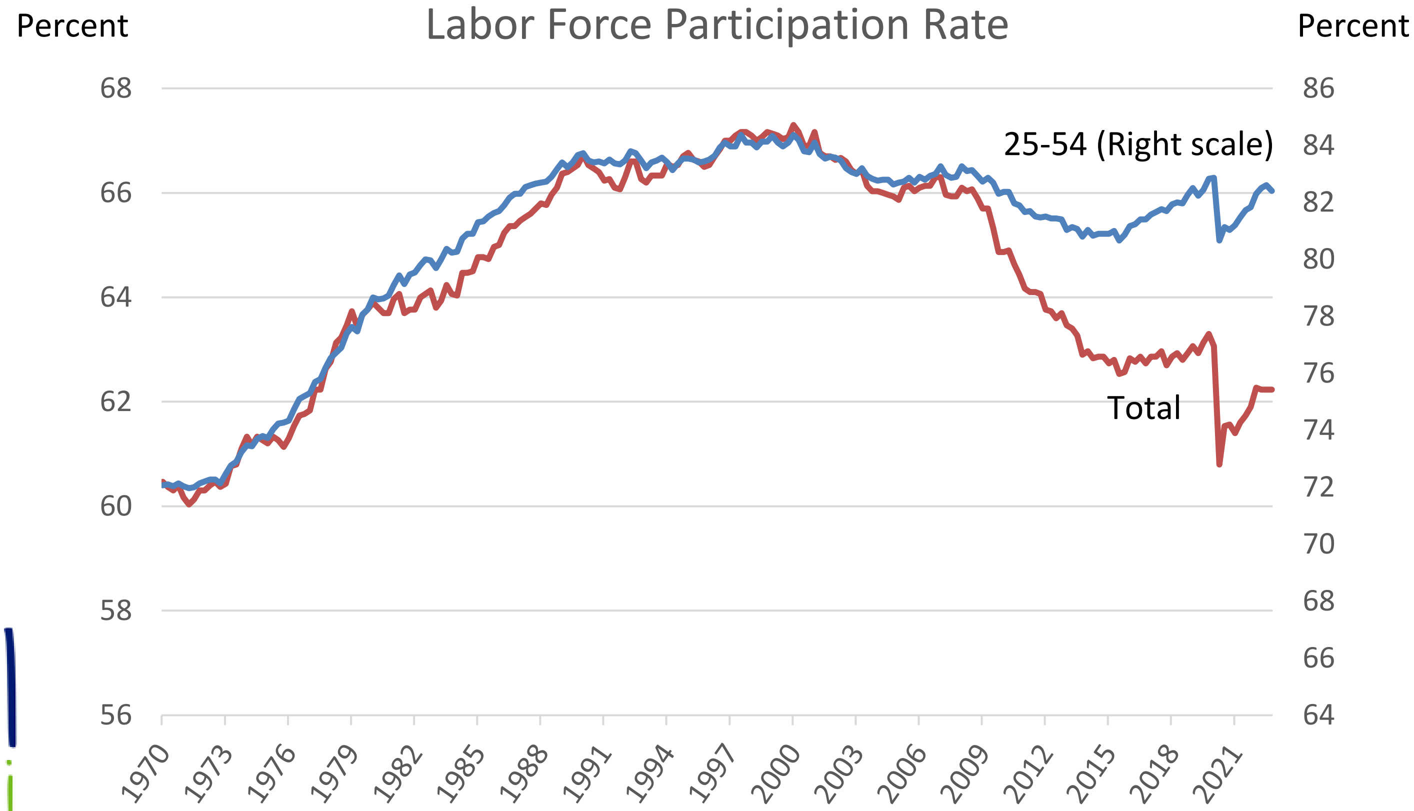
Effect of slower labor force growth



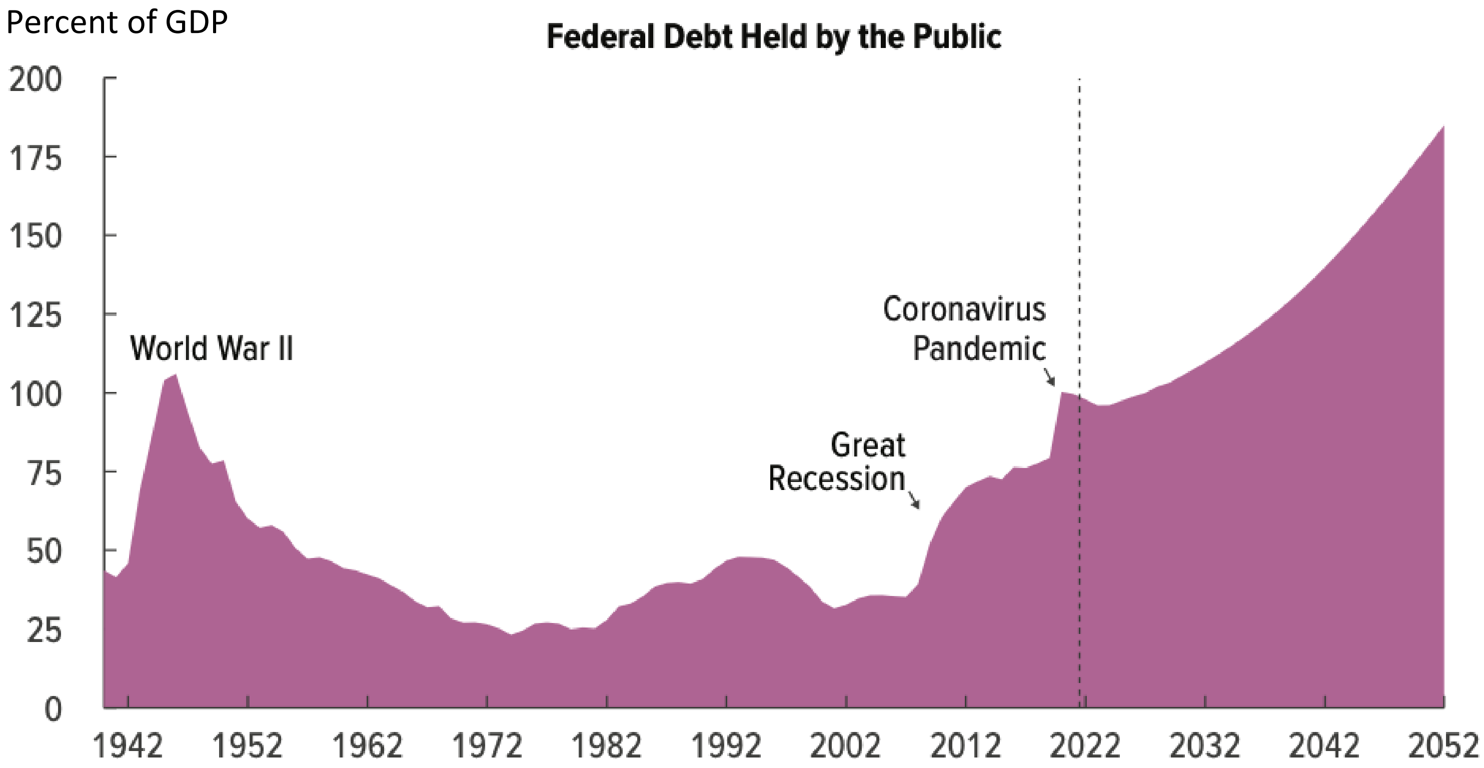
Effect of slower labor force growth



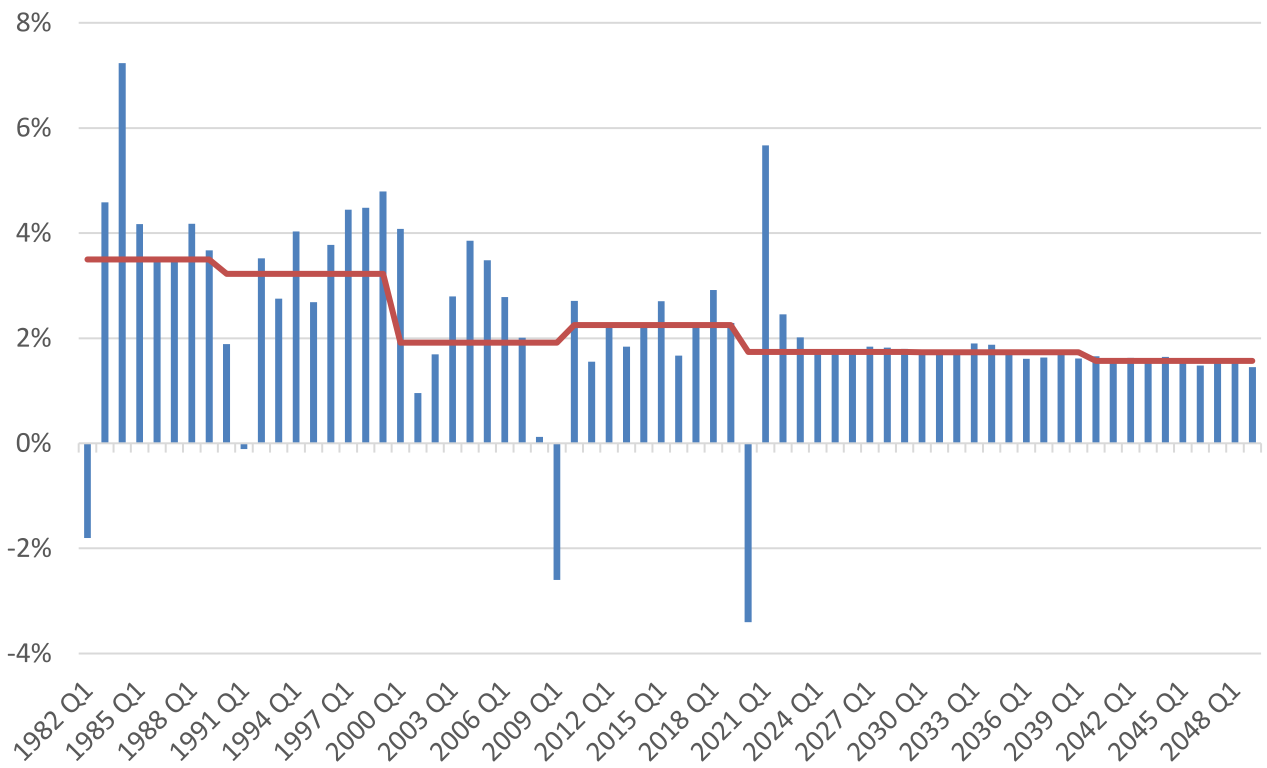
An Aside: Older workers are behind current LF lag



Fiscal burdens



In any case, expect slower trend growth



UHERO Long-Run Forecast, 2021Q2

VLI Hawaii

But Stagflation?

- Probably not*
  - High unemployment is very unlikely in a labor-short economy
  - Underlying inflation drivers are not there
    - And little reason to think the Fed will allow persistent inflation

*But the Fed's need to restrain supply-side pressures may aggravate the already relatively poor growth outlook

VLI Hawaii

Disco is here to stay!

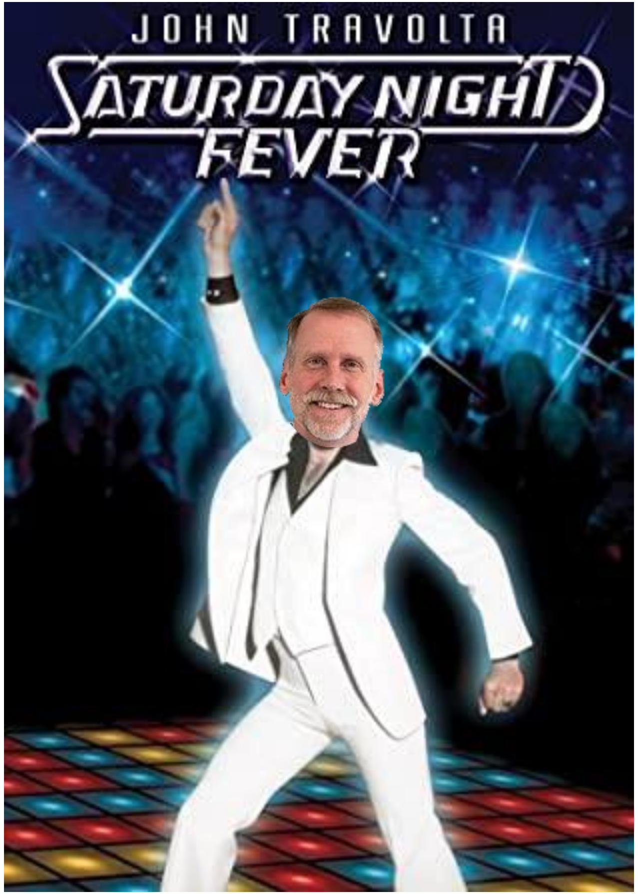
Byron Gangnes

Professor Emeritus of Economics

UHERO Senior Research Fellow

University of Hawaii at Manoa

gangnes@hawaii.edu



Hawaii