

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

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VLI Maui
January 2023

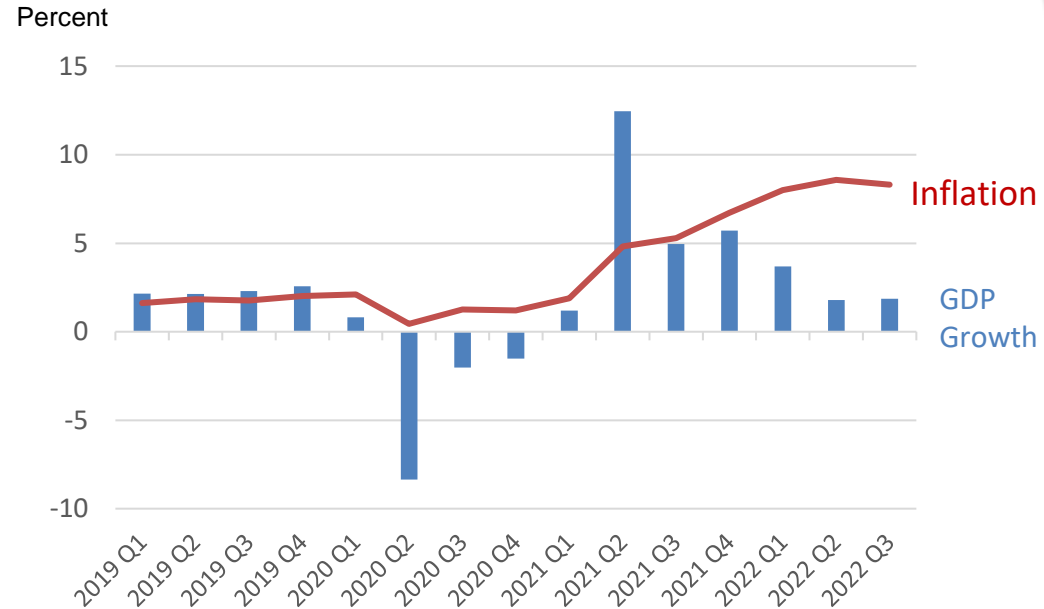


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The inflation problem

- 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*?

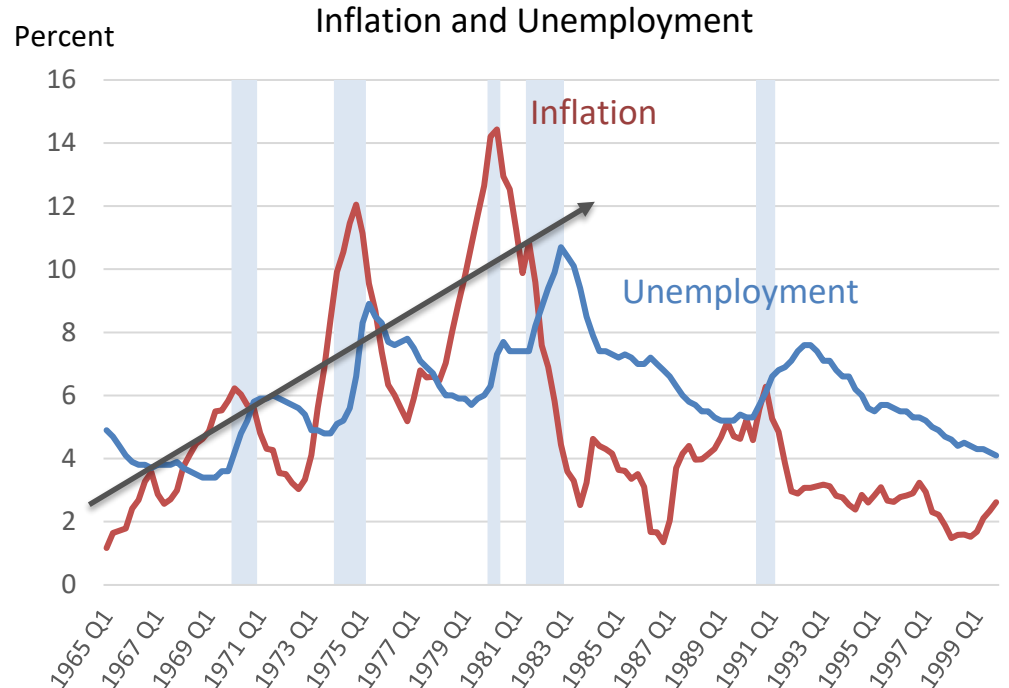
Inflation and Growth



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

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



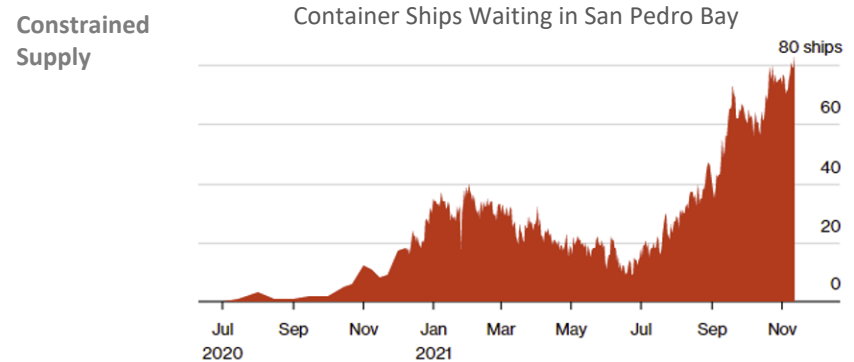
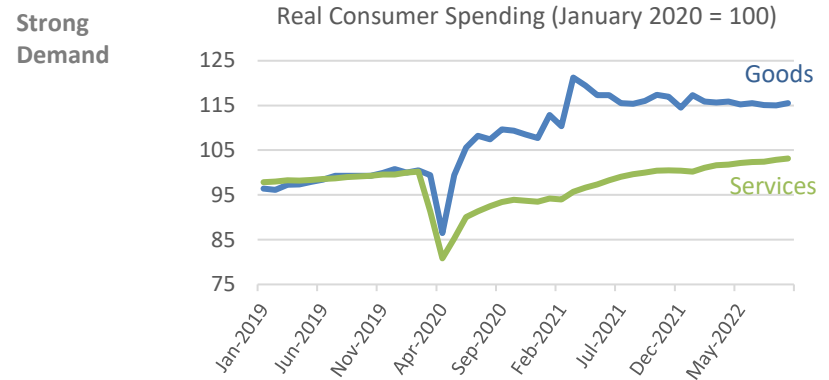
Source: BLS via Fred data site.

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 very bad growth performance and high unemployment
 - This is particularly painful macro situation

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

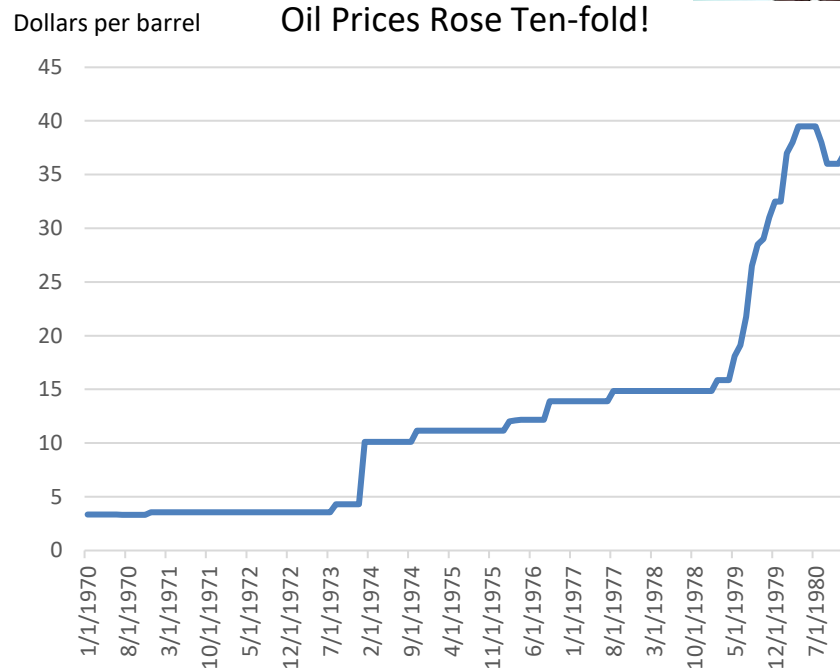


Source: Marine Exchange of Southern California & Vessel Traffic Service L.A./Long Beach Bloomberg.com, Nov. 13, 2021

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

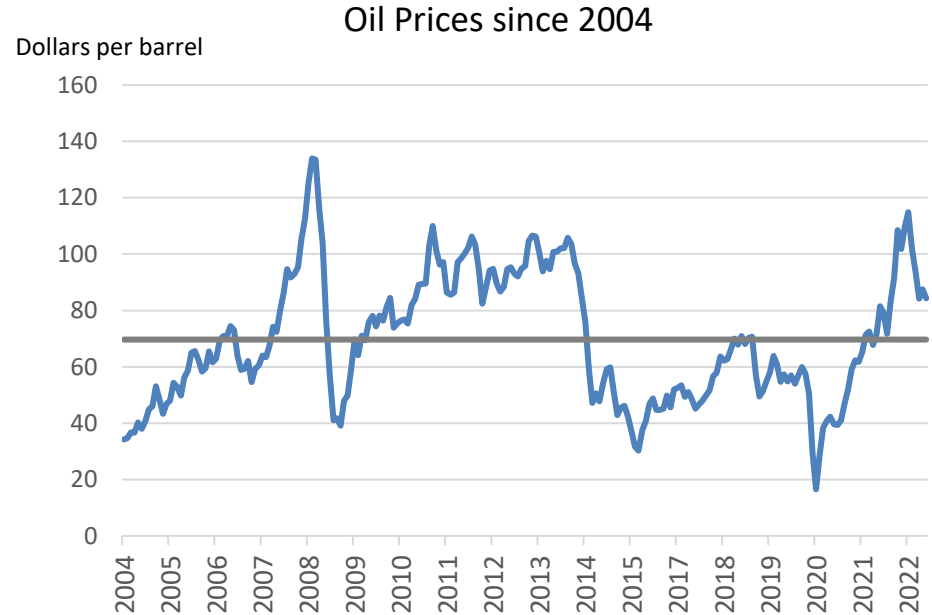


Source Fred data site.

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What's different this time around?

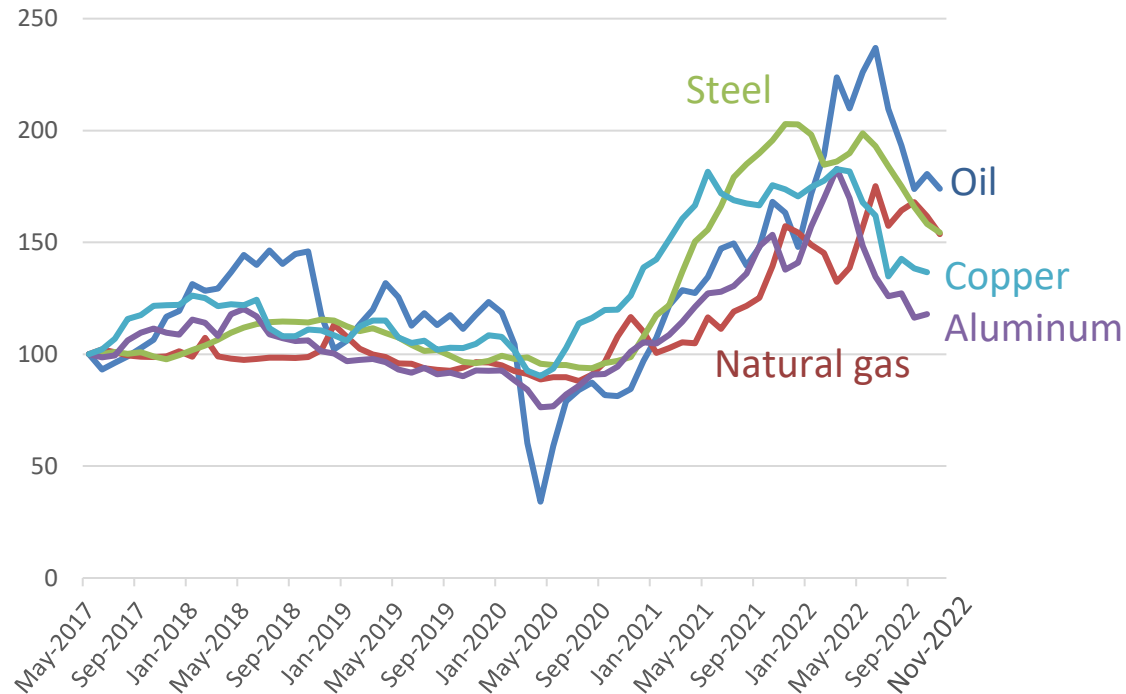
- Much smaller commodity shock: oil prices surged “only” 65% above their 2004-2021 average
 - But the supply chain issues are unique this time
- And expectations of future inflation have remained fairly benign
 - We’ll come back to this.



Source Fred data site

Commodity prices have already pulled back

Index, May
2017 = 100



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.

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Supply constrains have eased a lot

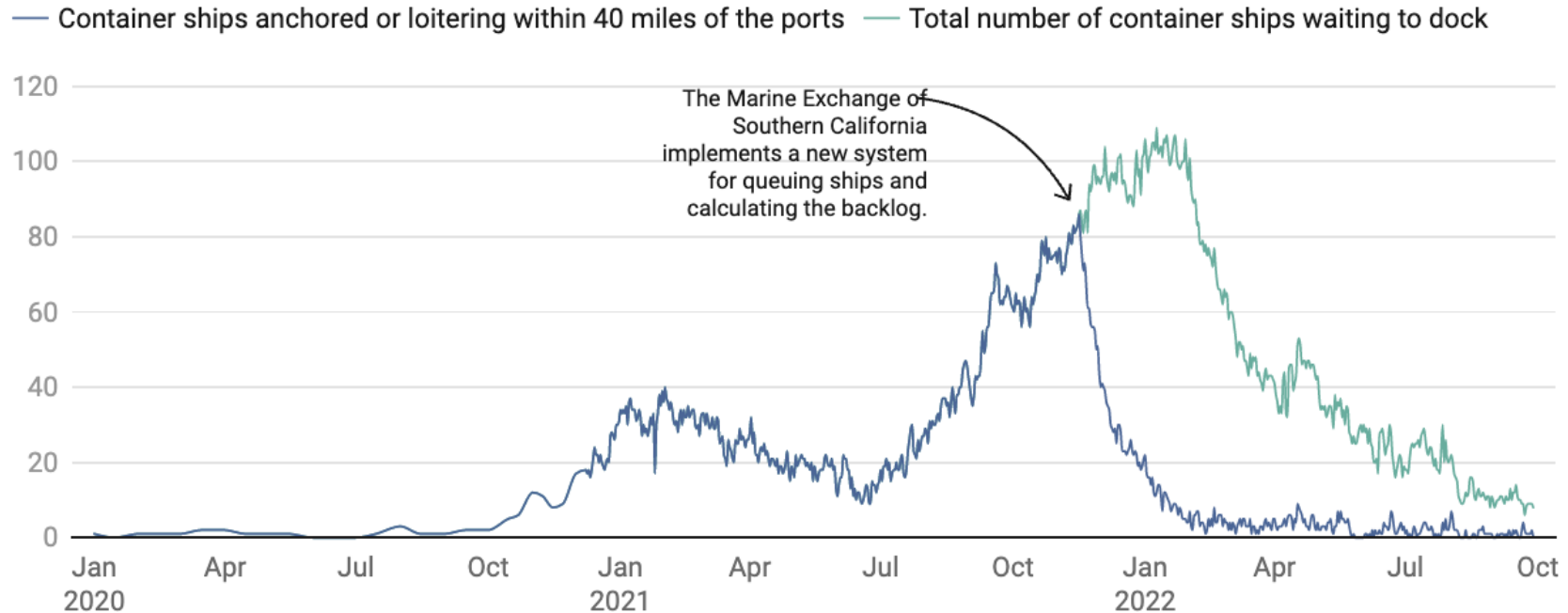
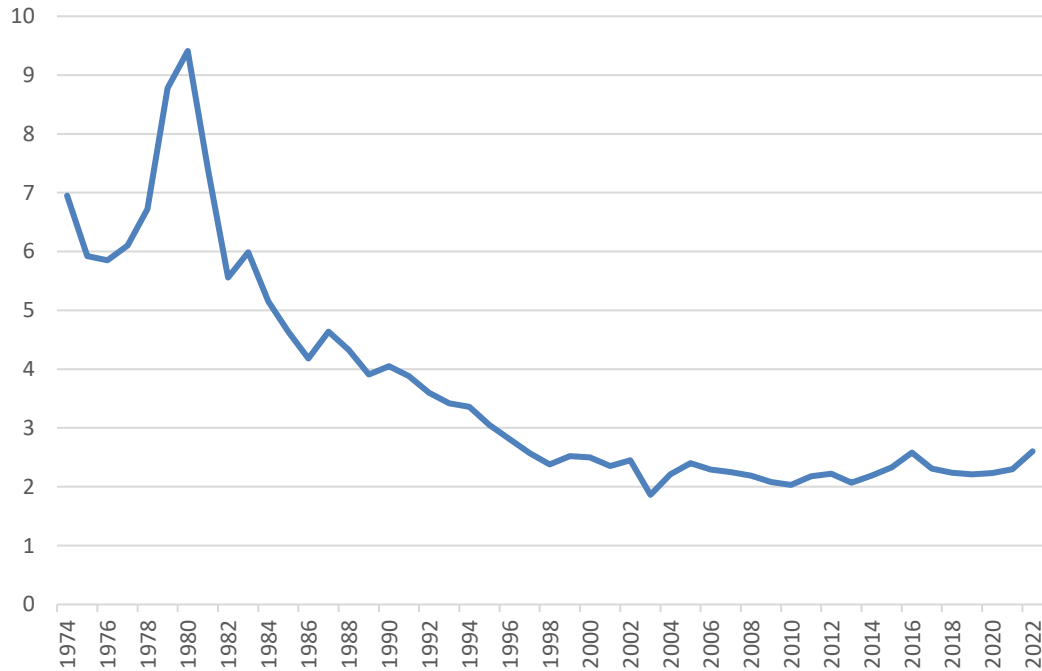


Chart: Dylan Miettinen • Source: Marine Exchange of Southern California

Inflation expectations are nothing like the 1970s

Expected Inflation Two Years Out

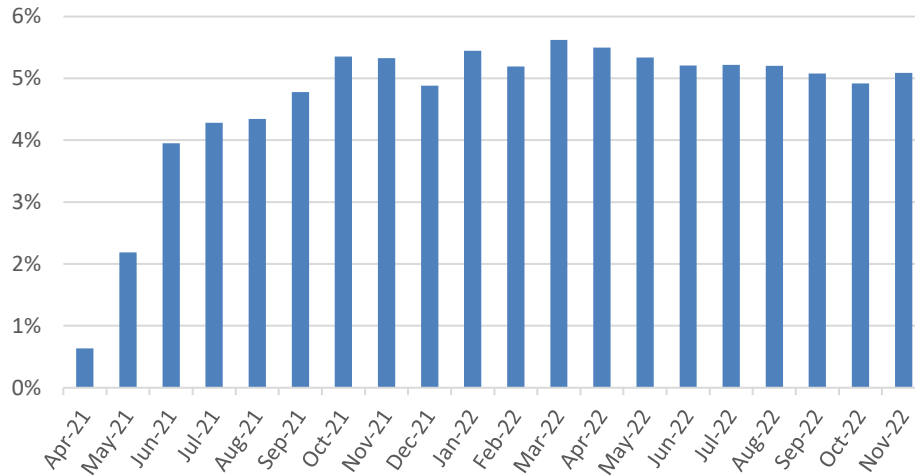


Source: FRB Philadelphia, Livingston Survey.
2022 value is an estimate based on FRB Cleveland model.

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Why might we still worry?

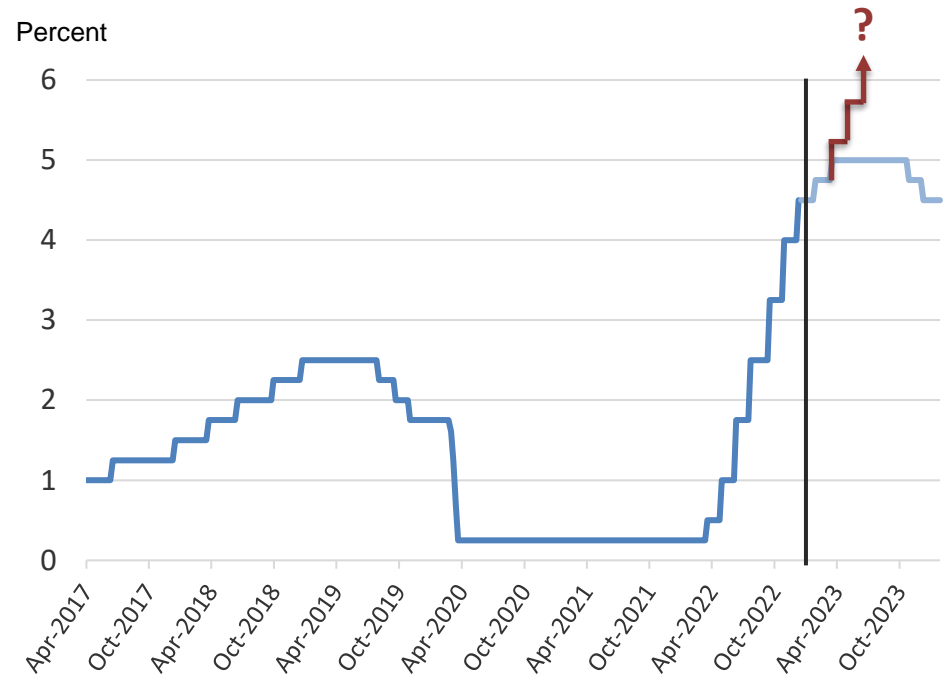
- Wage appreciation remains rapid



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

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And a short, mild recession



Source: UHERO Fourth Quarter 2022 Forecast



On sale now!

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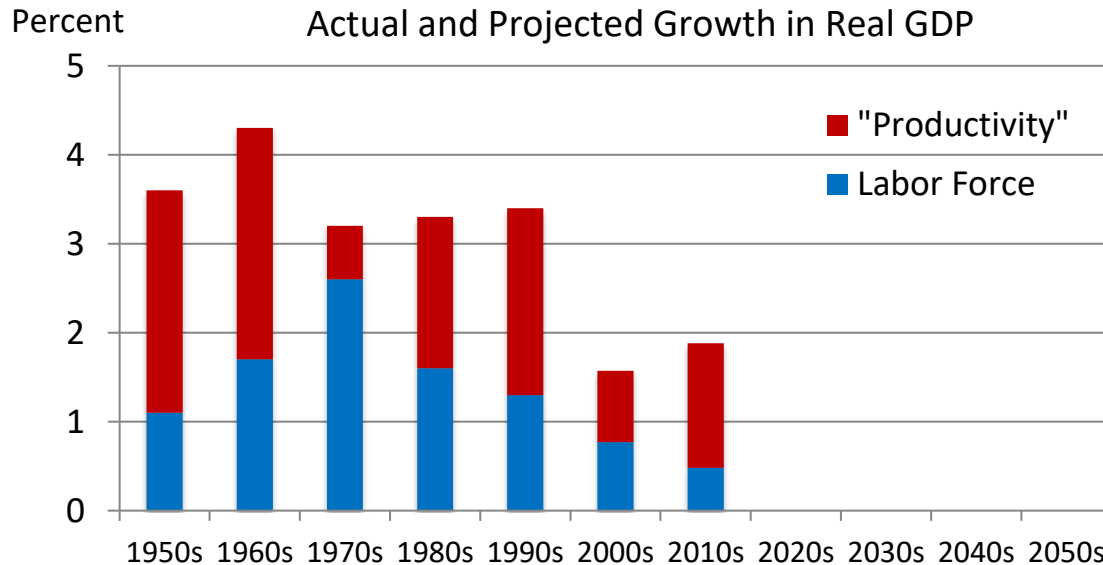
Long-term supply-side challenges

- 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?

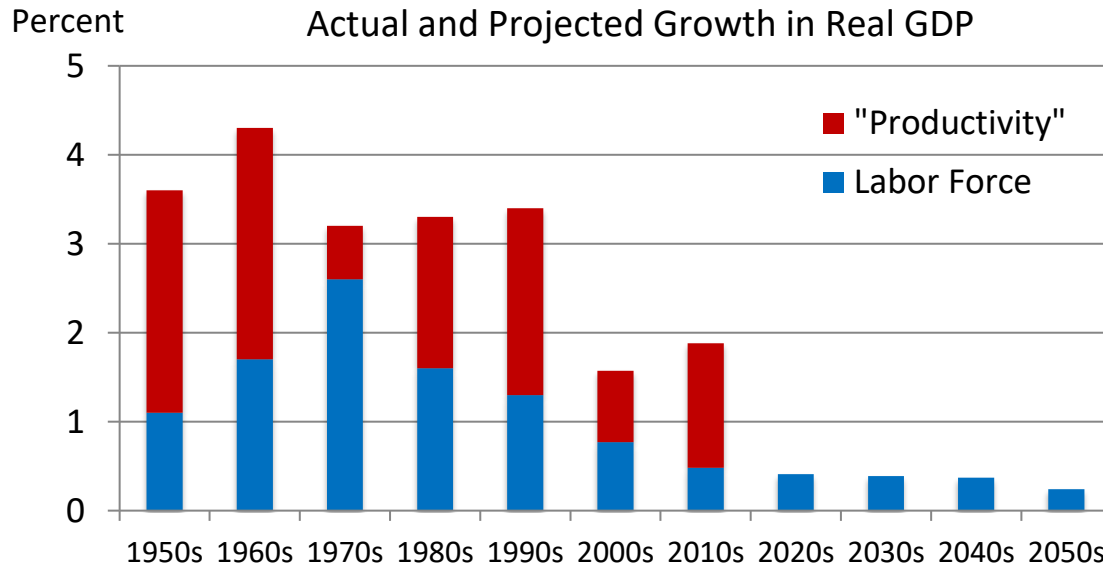


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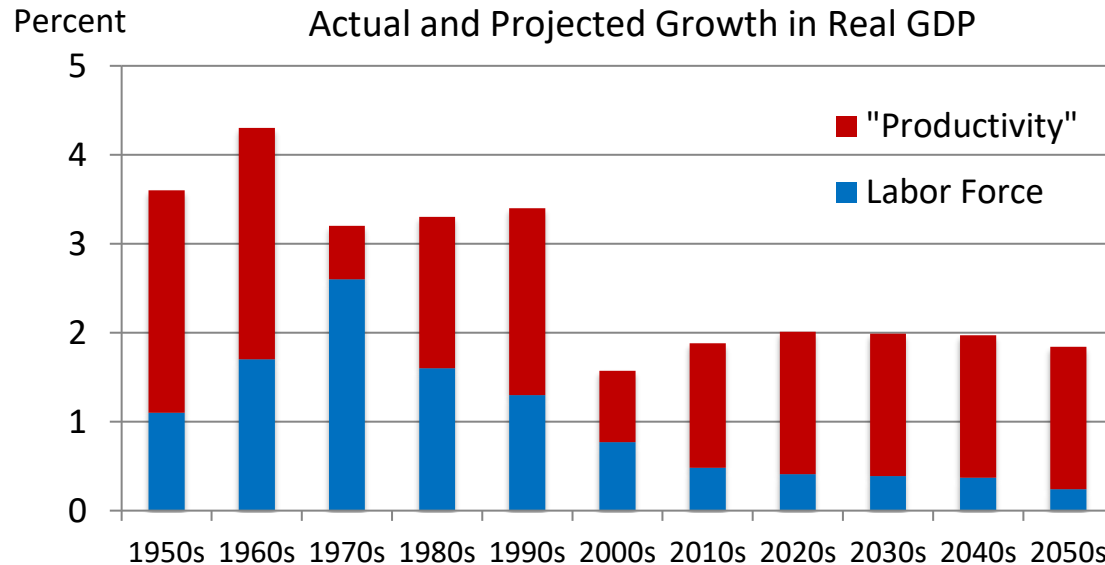
Effect of slower labor force growth



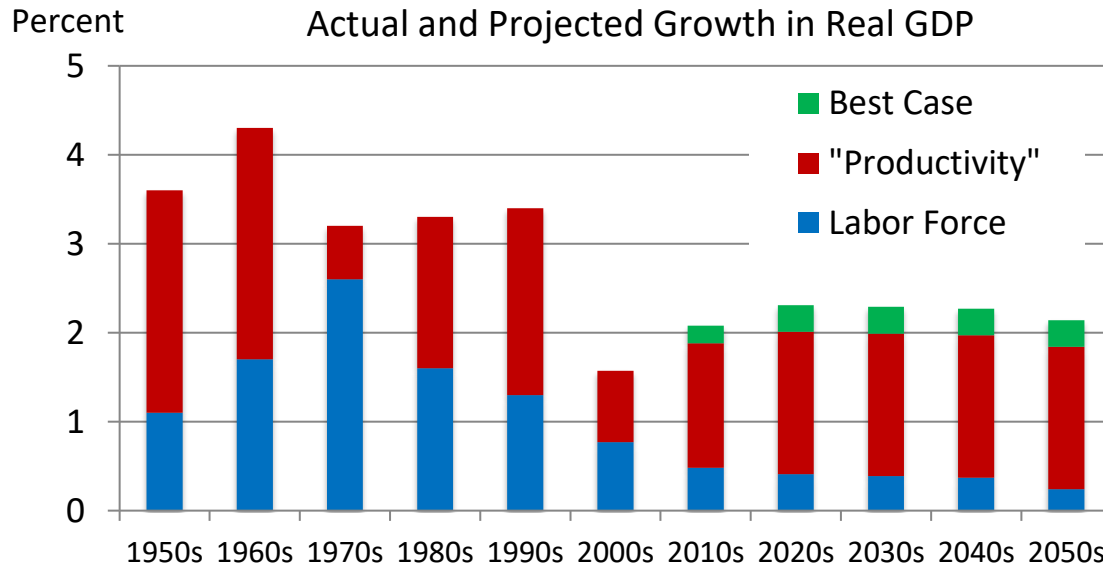
Effect of slower labor force growth



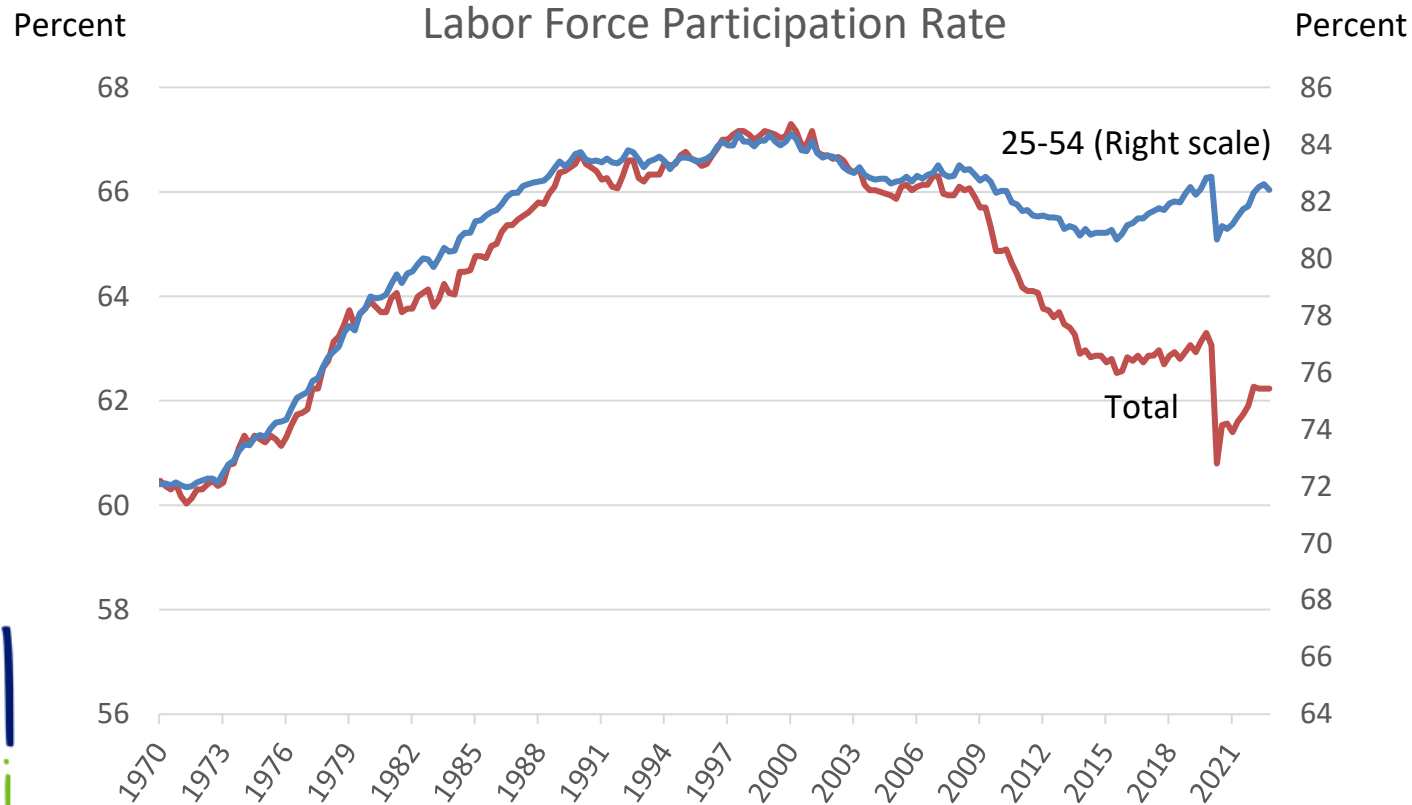
Effect of slower labor force growth



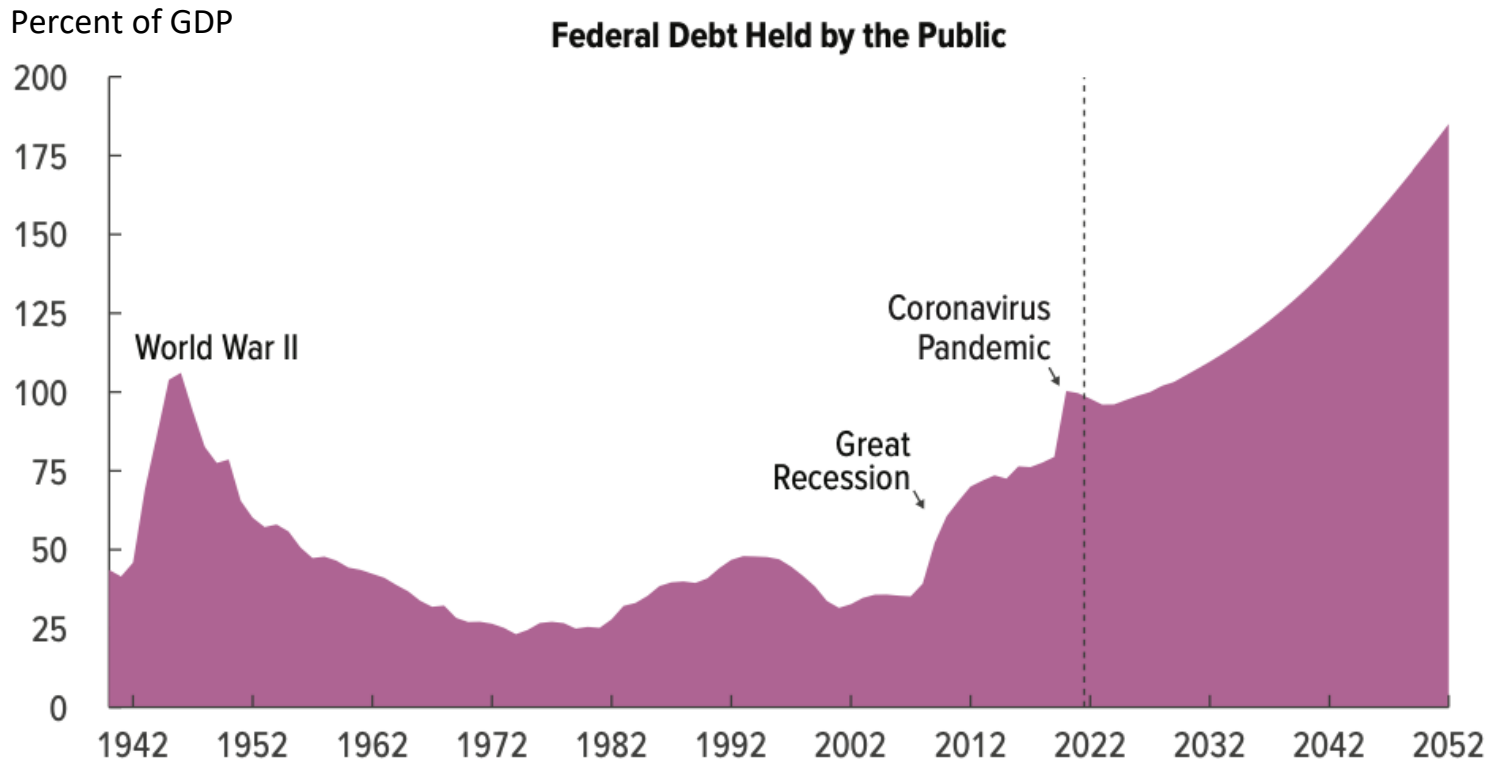
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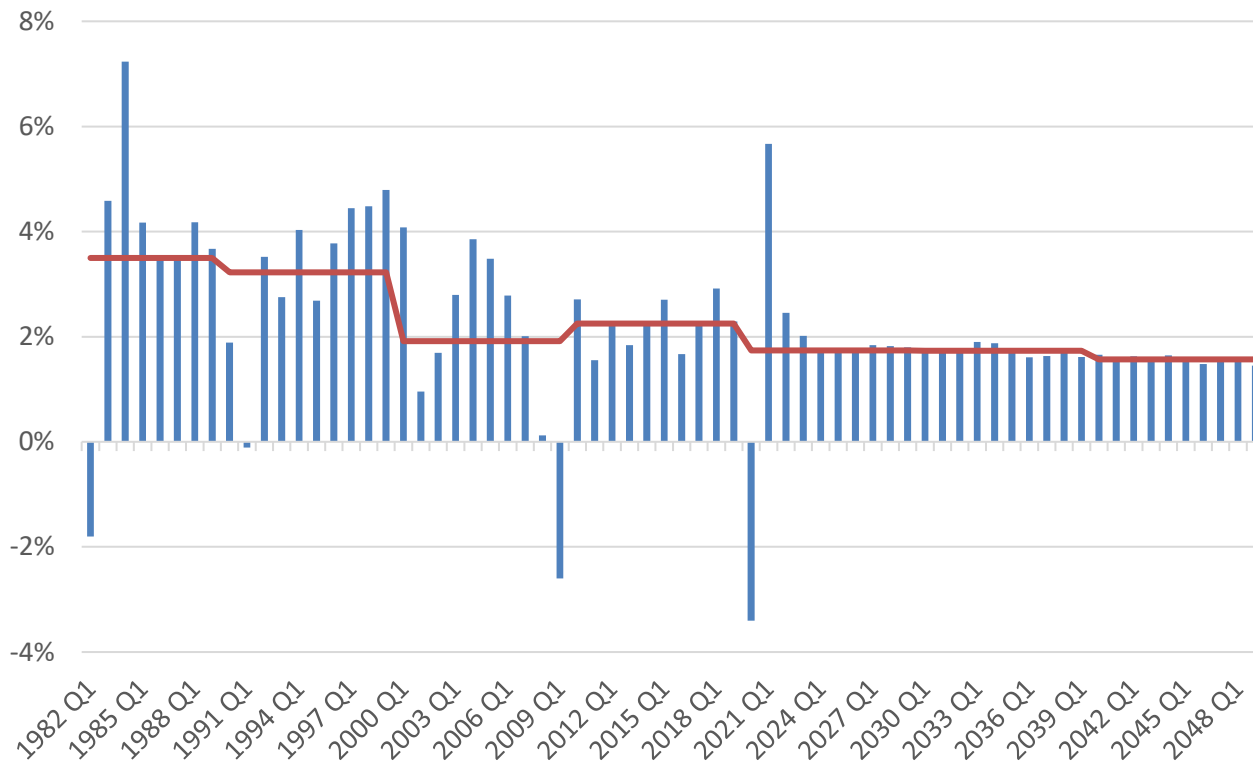
An Aside: Older workers are behind current LF lag



Fiscal burdens



In any case, expect slower trend growth



UHERO Long-Run Forecast, 2021Q2



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

Disco is here to stay!

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Hawaii

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