Are We on Course for 1970s-Style Stagflation?

Fuel prices are reaching record highs globally and supply chains have been disrupted by constrained production and backlogs in shipping. Consequently, according to business surveys on the planned expansion and Bank of England's predictions, recovery in the third quarter slowed down disappointingly[1]. Simultaneously, UK inflation, at 4.2%, is at its highest since 2010 and still climbing. Reminiscence of those circumstances to the 1970s has not passed unnoticed.

Fifty years ago, slowing growth, climbing production costs, and increasing inflation accompanied by the energy crisis led to decade-long stagflation: stagnant growth alongside double-digit inflation.

Whilst financial markets and certain analysts are concerned we are on the same course, should we really worry about the return of the 1970s scenario? Not exactly.

Under the Surface, a Lot Is Different

Despite the symptoms being virtually identical, the nature of the problems fifty years ago was different.

The most pressing issue today – inflation – is not as dangerous as it used to be. Primarily, this is because the conditions inducing a sustained upwards spiral of prices have been largely eliminated[2]. In 1973 when the costs of fuel and food in the USA, much like today, began soaring, workers demanded raises to cover climbing living costs. In turn, employers increased prices to make up for the higher labour costs. Consequently, real incomes did not improve, leading to further price-wage rises.

Today, such a spiral is unlikely to be triggered merely by the current price growth[3]. Whilst in the 1960s a third of American workers were unionised, and thus possessed a large collective bargaining power, today this share has declined to 6.4%. Consequently, workers are less capable of negotiating repetitive raises. In fact, gradual worldwide de-unionisation has allowed for relatively high employment without high inflation over the past three decades[4]. Therefore, we currently live in very different economies which are not as susceptible to inflationary spirals.

Paradigm Shift and the Supply-Side

The break with the past also results from the two entangled issues: the supply-side conditions and the attitudes of the central banks.
The 1970s were preceded by 'the Golden Age' – a period of post-war high investment, productivity improvements and rapid economic growth. Central banks preferred full employment over price stability and were used to pushing demand to utilise the ever-increasing potential output[5]. In the 1970s the post-war productivity growth was exhausted. Slowing growth, effectively caused by this supply-side issue, was nonetheless still addressed by stimulating aggregate demand. Consequently, economies pushed beyond their potential output suffered rapid inflation alongside slow growth.

Today, central banks are aware that their primary objective is price stability. Despite the painful experience of the Covid-recession, the Bank of England's governor signalled readiness to increase interest rates, and this is expected to happen in December[6].

In addition, contrarily to the 1970s, today's supply-side issues do not necessarily forecast a prolonged period of stagnation either.
Economies are currently struggling with post-Covid supply-chain disruptions, shipping backlogs and the energy crisis due to the extraordinarily high post-pandemic demand. These reduce growth in the short run, with the most illustrative example being a German Opel factory closing due to a lack of supplies[7]. Although drastic, these could be temporary hardships and, therefore, do not rule out high growth ahead. Especially as it is estimated that accelerated digitisation and mechanisation induced by the pandemic has the potential to increase productivity growth by one pp over the coming years (double the pre-pandemic growth rate)[8].

Optimists believe that supply chains will recover soon ending the "transitory" jump in inflation and allowing for growth[9].

We Have Our Problems

Although we are not dealing with the 1970s' economic problems, the current hardships are a serious threat in their own way.
The looming hike in interest rates and the expiry of stimulus packages are expected to reduce aggregate demand. Increasing fuel and food prices reduce consumers' real income and increase firms' costs. These factors will likely harm output.

Simultaneously, economists are puzzled by another phenomenon: rapid wage growth exceeding pre-pandemic trends (especially in the US), despite unemployment exceeding pre-Covid levels[10].

The most worrying explanation suggests that workers looking for employment, whose previous jobs were shut down due to Covid, are unable to take up the abundant vacancies; this could be because they lack the necessary skills. Consequently, the equilibrium rate of unemployment increases, and the labour market turns out to be tighter than previously believed. As employers need to bid for an overly scarce workforce, workers' bargaining power improves and a wage-price spiral becomes possible.

So, whilst mere price increases cannot induce the 1970s-like inflation today, a persistently tight labour market could[11]. Therefore, policymakers must monitor whether there are permanent structural labour issues, and ensure that wage growth does not fuel inflation uncontrollably.

Conclusions

Today, our economies do not have the structure that led to decade-long, disastrous stagflation fifty years ago. The supply-side issues are possibly temporary and the central banks are ready to fight inflation.

However, whilst the 1970s provide a poor point of reference, we still have our own, potentially dangerous, problems.

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[3] Ibid.

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