Finance Essentials: Stagflation 101

Stagflation, a combination of the words stagnation and inflation[2], is a phenomenon in which economic growth declines while prices increase. Often, slow economic growth coincides with high unemployment rates and stagnant wages. Skyrocketing prices and sluggish job growth have the potential to be disastrous for the economy, even if unemployment rates stay relatively flat.

“The pain of stagflation could persist for several years, with potentially destabilizing consequences for low- and middle-income economies,” says World Bank chief David Malpass.[3]

In the U.S., high prices for consumer goods, coupled with weak economic growth and increased unemployment, would lead to tight household budgets, reduced consumer spending, and limited business growth (if any). Increasingly expensive products, limited supply, and job loss would be a frightening scenario for people worldwide.

In normal circumstances, the Federal Reserve could raise interest rates to fight inflation, but in the case of stagflation, this may further debilitate an already weakened economy. While stagflation *could lead* to a recession, “a recession is a risk scenario, not a baseline”, according to Allianz’s chief economic advisor, Mohamed El-Erian[4].

What causes stagflation?

In the mid-1970s, America entered a period of stagflation. Many experts blame the 1973 oil embargo, the War in Vietnam, and the decline of the manufacturing sector. However, that alone was not enough to cause stagflation; “conflicting contractionary and expansionary fiscal policies” also had a significant role.[5]

Roughly 50 years later, in 2022, the threat of stagflation is looming. The war in Ukraine, together with the coronavirus pandemic, has significantly disrupted global supply chains. Food and energy prices have shot up, while the market has declined.[5]
The exact cause of stagflation is a culmination of several different factors. But by looking at history, we can observe that geopolitical chaos, a sudden suspension in supply chains, and policy errors seem to act as catalysts for stagflation.[5]

Ultimately, the power to prevent stagflation is in the hands of the central banks, and they’re currently backed into a corner. While the Federal Reserve continues to raise interest rates, there is the potential risk of putting the economy into a recession. But if they had not raised interest rates, consumer prices could have spiraled further out of control.

Sources

[1] https://www.cnbc.com/2022/05/30/no-global-recession-yet-but-brace-for-stagflation-economists-say.html
[2] https://www.thebalance.com/what-is-stagflation-3305964#:~:text=Stagflation%20is%20a%20combination%20of,to%20keep%20prices%20from%20rising.
[3]https://blogs.worldbank.org/voices/supply-solution-stagflation
[4]https://www.thenationalnews.com/business/money/2022/06/13/mohamed-el-erian-us-inflation-could-reach-9-and-lead-to-a-recession/
[5] https://www.thebalance.com/what-is-stagflation-3305964#:~:text=Stagflation%20is%20a%20combination%20of,to%20keep%20prices%20from%20rising.

Disclosure