Stop Stagflation Speculation

Dean Croushore, University of Richmond

In the late 1970s and early 1980s, the United States suffered from stagflation, with the economy growing slowly between severe recessions and inflation rising to higher and higher levels, despite weak economic growth. Now, in early 2008, as we are standing on the precipice of a recession, numerous commentators are speculating that we are heading for stagflation. They are wrong to raise such a specter, and should stop speculation about stagflation.

A look at the data clearly illustrates how far we are from stagflation in 2008. First, the “stag” part—is there evidence that the U.S. economy is stagnating, as it did in the late 1970s? Let’s look at the historical data on the unemployment rate, to see where we stand. Figure 1 shows the data and we can see that at an unemployment rate of 4.9%, the unemployment rate is a bit higher today than it was in mid-2007, and might be pointing to a recession. But if a recession materializes in 2008 (or began in late 2007), it is not likely to be anywhere near the magnitude of the recessions in the 1970s and early 1980s (recessions are shown by the vertical gray bars). The Fed understands the importance of the flow of credit in the economy, and instead of constraining credit as it did in the recessions of the 1970s and 1980s, the Fed is doing all it can to make sure that sound borrowers can get access to credit from sound banks. There is no stagnation now; there is no stagnation coming.
What about inflation? Inflation hit double-digit levels in the mid-1970s, retreated in 1975 and 1976 after a severe recession, and then rose again sharply in the late 1970s, exceeding 14% in early 1980, as Figure 2 shows. These ridiculously high levels of inflation convinced macroeconomists and monetary policymakers that the damage from high inflation was severe and that they needed to get inflation under control and never allow it to reach such high levels again. Today, inflation has temporarily hit the 4% level (comparing the January 2008 CPI to that of one year earlier). But that is mainly a feature of high oil prices. It is possible that oil prices could keep rising as sharply as they have in recent years, but not likely. Research shows that high energy prices cause a temporary, but not a permanent jump in inflation. In fact, the overall CPI inflation rate has a strong tendency to return to the inflation rate excluding food and energy prices, the so-called
core inflation rate. If you want to forecast the future overall CPI inflation rate you should just look at what the core inflation rate is today.

![U.S. Overall CPI Inflation Rate Since 1960](image)

If we look at the core inflation rate in Figure 3, we see that it is much more stable than the overall inflation rate. There is not much evidence of a significant rise in inflation in the core inflation rate. In fact, we are still well below the core inflation rate of 2006. And while the 2.5% core inflation rate over the past year might be above the optimal range of 1 to 2% that many members of the FOMC would like to see, it is far, far below the double-digit levels of the 1970s and early 1980s.
With no sign of high inflation in the data, the soothsayers of stagflation point to easy monetary policy and forecasts of higher inflation in the future. But the economy has a fairly high probability of entering a recession, if it isn’t already in one. The Fed is easing monetary policy, as it should. If the economy enters a recession, what will happen to inflation? Well, just look at Figures 2 and 3 and you will see that the inflation rate declines substantially after every recession. So, if the economy enters a recession, you really need not worry about inflation at all.

The Fed should not think at all about stagflation—it simply will not happen. The difficulty the Fed faces is how much it should further ease policy. If the Fed does not ease enough, then credit constraints could turn the current situation into a severe recession (after which inflation would fall substantially). If the Fed eases too much, then the economy will grow too rapidly in the second half of 2008 and in early 2009, and inflation
could rise somewhat. The incoming economic data and the flow of credit will determine how much easing the Fed engages in and how low the funds rate will go. No doubt in a few months there will be a vigorous debate inside the FOMC about when to stop easing policy. But fear of stagflation will play no role in the Fed’s deliberations.