INFOCUS

MACRO COMMENT

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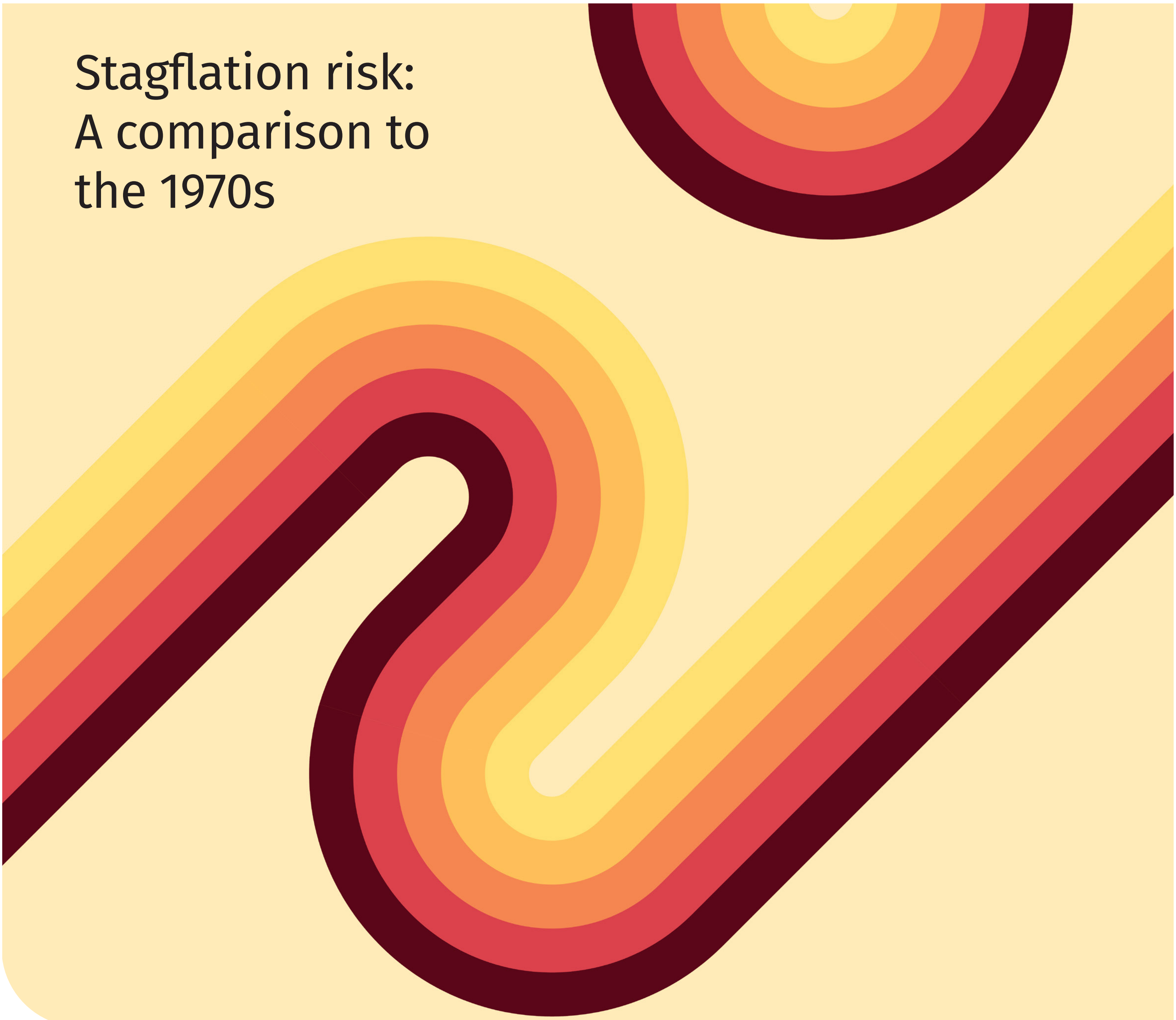
Stagflation risk: A comparison to the 1970s



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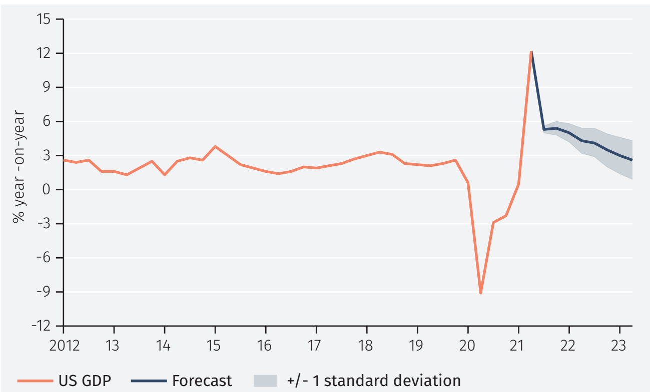
With energy prices and inflation at a decade high and economic growth moderating, many commentators fear the return of stagflation. In this edition of *Infocus*, GianLuigi Mandruzzato looks at the differences in the institutional and economic framework to 50 years ago.

Surging commodity prices, including energy, and moderating economic growth have led many commentators to warn about the risks of stagflation, a situation where the economy grows below its potential and inflation is persistently high or rising.[1] However, comparing today's economic and institutional framework to the 1970s, the return of stagflation seems remote.[2]

Growth is above potential

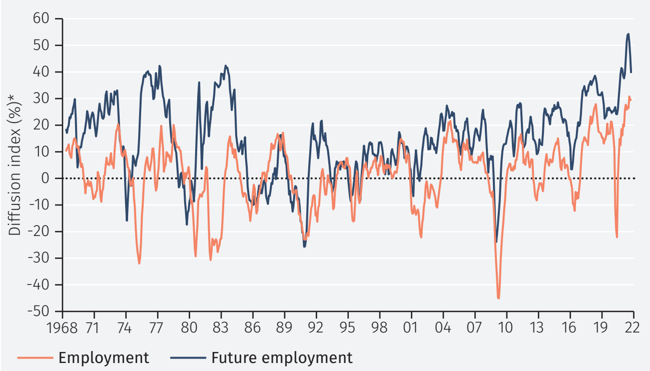
First, there is no stagnation. Despite issues linked to bottlenecks in global supply chains, the global economy is not weak. Thanks to a supportive policy mix, growth is expected to remain above potential in 2022 in most economies, including the US where the Congressional Budget Office estimates potential GDP growth of around 2% (see Figure 1a). These projections are underpinned by abundant private sector savings and pent-up demand for leisure and durable goods amid high demand for workers (see Figure 1b).

1a. US GDP



Sources: Refinitiv, Federal Reserve Bank of Philadelphia and EFGAM calculations. Data as at 9 November 2021.

1b. Philadelphia Fed Manufacturing Survey



*The diffusion Index is computed as the percentage of respondents indicating an increase minus the percentage indicating a decrease. Sources: Refinitiv, Federal Reserve Bank of Philadelphia and EFGAM calculations. Data as at 9 November 2021.

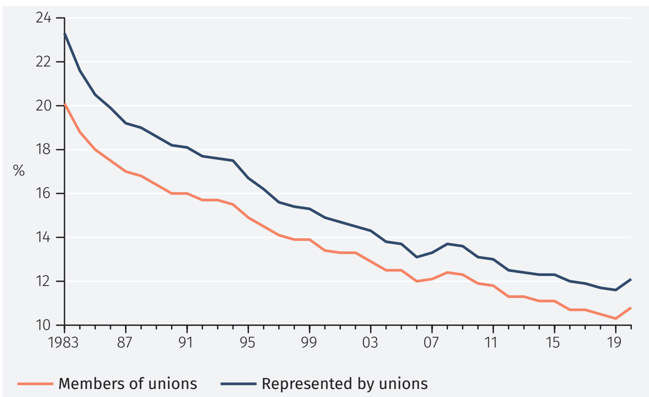
The risk of an inflation spiral is low

Turning to inflation, many commentators fear that rampant price and wage increases will force central banks to tighten policy at the risk of pushing the economy into recession. However, differences in the institutional framework compared to the 1970s suggest that the current commodity price shock is unlikely to get entrenched in the price formation process.

Today, most central banks in developed countries are independent and pursue an explicit inflation target of about 2%.[3] By contrast, in the 1970s monetary policy was set by governments in most European countries and even the Federal Reserve accommodated the government's focus on growth over controlling inflation. Today's institutional framework should anchor inflation expectations, reducing the risk that the current price shock will lead to second-round effects on wages.

The risk of a wage-price spiral is also limited because workers' bargaining power is hampered by a gradual decline in unionisation rates (see Figure 2). Data from the US Bureau of Labor Statistics, available since 1983, show the share of workers that are either members of or are represented by unions has halved in the last 40 years. Academic research shows that peak unionisation was reached in the 1950s at about 35% and has been in decline since then.[4] Furthermore, automatic wage

2. Share of unionised workers in the US



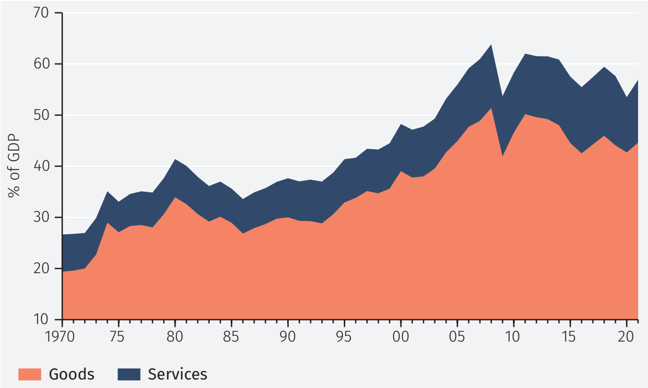
Sources: Refinitiv and US Bureau of Labor Statistics. Data as at 9 November 2021.

[1] See *Infocus*, 'Stagflation:US experiences', November 2021. https://tinyurl.com/fc89eptn
[3] This issue of *Infocus* refers mainly to the US economy because it leads the global business and financial cycle and because of the availability of long time series of data, but similar trends are characterised in most of the other economic areas.
[3] In the emerging markets, also, most central banks pursue an inflation target, often of less than 5%, and are formally independent, although in practice government oversight is often evident. See also de Haan et al., *Central Bank Independence Before and After the Crisis*, Comparative Economic Studies, 2018.
[4] See Farber et al, *Unions and Inequality Over the Twentieth Century: New Evidence from Survey Data*, NBER Working Paper n. 24587, April 2021.

indexation to inflation is now virtually absent while it covered about 60% of US unionised workers in the 1970s.[5]

Additionally, the increased degree of globalisation and competition in goods and services markets, together with low and stable inflation, limits the pass-through of commodity price shocks to consumer prices. Despite stalling since the onset of the Global Financial Crisis, the ratio of global trade to GDP is twice that in the early 1970s (see Figure 3). Competitive pricing also stems from the establishment of strict antitrust policies in most countries and the widespread use of online shopping which facilitates easy price comparison.

3. World trade volumes

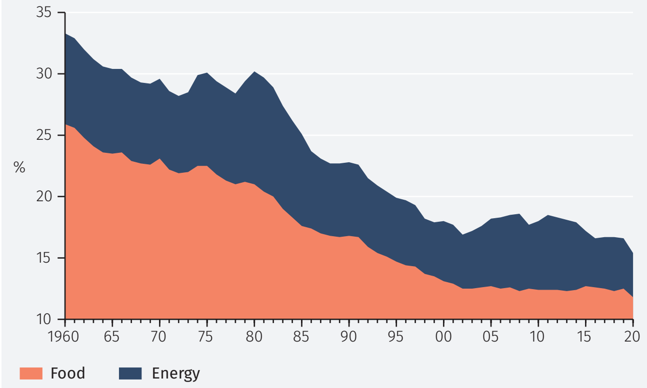


Sources: Refinitiv and US Bureau of Labor Statistics. Data as at 9 November 2021.

It is also important to note that structural changes in households' consumption habits limits the impact of commodity price shocks to overall inflation. Over the last 50 years, the combined share of energy and food in US total personal consumption expenditure (PCE) has fallen from about 29% to about 15% (see Figure 4). This mechanically reduces the direct impact on the inflation rate of a commodity price shock compared to the 1970s. Furthermore, the production of goods has also become more energy efficient, limiting the effect of energy prices on production costs.

Finally, the nature of the energy price shock is different to those of the 1970s. The first oil crisis followed the OPEC embargo between October 1973 and March 1974: OPEC halted exports to oil-dependent Western countries as retaliation for supporting Israel in the Yom Kippur War. The second oil crisis followed the sharp drop in OPEC oil production after the Iranian Revolution in 1979 and the start of the Iran-Iraq war in 1980. The shortage of energy inputs pushed inflation higher and restrained production, exacerbating the negative effects on the economy. These increases were thus caused by political rather than economic factors.

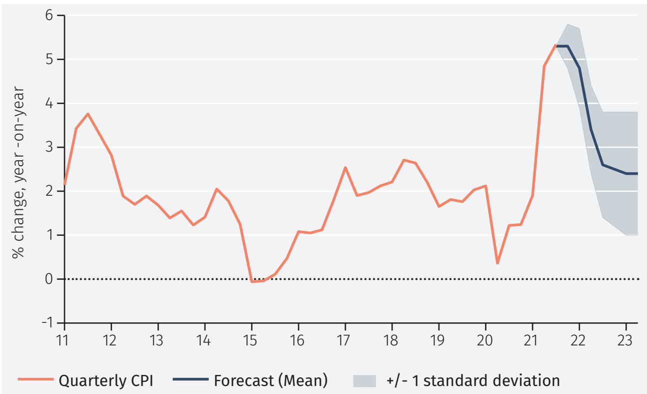
4. Food and energy shares of US PCE



Sources: Refinitiv and US Bureau of Economic Analysis. Data as at 9 November 2021.

Today, high energy prices reflect strong demand as the global economy is recovering from the pandemic. However, international institutions, including the International Energy Agency and the US Energy Information Administration, expect the oil market to be well supplied in 2022, which should lead to a moderation in prices. This will contribute to a decline in inflation in 2022 (see Figure 5).

5. Quarterly change in US CPI



Sources: Refinitiv and EFGAM calculations. Data as at 9 November 2021.

Conclusions

Despite concerns raised by many commentators, the risk of stagflation is limited. Economic growth is strong and is expected to exceed potential for several more quarters. Meanwhile, although inflation in many countries has risen to a ten year high and will stay above central banks' 2% inflation targets for some time, it will moderate in 2022. In this context, the balance of risks for the global economy is tilted towards somewhat higher-for-longer inflation rather than stagflation. After a decade of too low inflation, that should be a welcome development for the global economy and markets.

[5] See Devine, *Cost-of-living Clauses: Trends and Current Characteristics*, Bureau of Labor Statistics, December 1996.

APPENDIX

Main institutional and economic differences between the 1970s and 2021

	1970s	2021
Growth and employment outlook	Rationing of energy inputs reduced employment exacerbating the adverse impact on the economy	Firms signal high demand for workers and increasingly hard to fill jobs
Central bank independence	Central banks subject to explicit government oversight	Central banks are independent from governments and pursue an explicit inflation target
Workers unionisation	High degree of unionasation compounded with widespread wage indexation mechanisms	Little representation of workers by unions and wage indexation
International competition	Limited international integration, most markets were closed and antitrust directives were less established	High openess of trade in goods and services, consumer protection practices well established
Commodity price sensitivity of CPI	Food and energy absorbed more than one third of households' annual consumption	Food and energy absord less than 15% of households' annual consumption
Nature of commodity price shock	Energy price shock due to OPEC halt of oil exports as retaliation on the West	Surge in commodity price largely due to higher than expected demand recovery from Covid

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