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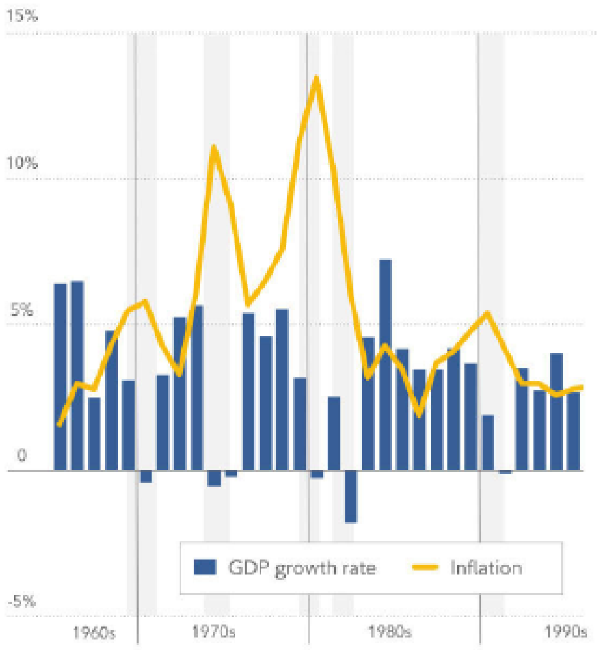
Stagflation and Why It has Economists Worried

The term “stagflation” was coined roughly 50 years ago during the 1970s to describe the period from 1966 through 1982 marked by stagnant growth, higher inflation (reaching more than 14% in 1980) and high unemployment. Over the 17-year period, the Consumer Price Index was 6.8% annualized, while real GDP grew at a 2.2% annualized rate.



Source: Bureau of Economic Analysis, Bureau of Labor Statistics

In part, historians believe that stagflation was prolonged by expectations. Expecting continued increases in the cost of goods, people bought more and increased demand pushed prices higher. This led to demands for increased wages, which pushed prices higher yet. Labor contracts and government benefits such as Social Security began to include cost of living increases, further fueling inflation. The federal government’s need for funds increased government borrowing, which increased the budget deficit, which pushed up interest rates, which increased costs for businesses and consumers further.

During the period, the U.S. economy suffered another jolt in October 1973, when the Organization of the Petroleum Exporting Countries (OPEC) declared an oil shipping embargo to the United States and Israel’s European allies in response to Western support of Israel during the Yom Kippur War. The embargo caused oil prices to jump by over 300%.

Combined with high energy prices, business investment stalled, and unemployment increased. The stock market performed exceptionally poorly in period, lagging intermediate-term bonds.

Stagflation ended in a deep recession between 1980 and 1982. A primary cause was the disinflationary monetary policy adopted by the Federal Reserve.

On a theoretical basis, stagflation should not happen. In a normal market economy, slow growth prevents inflation. Consumer demand drops enough to keep prices from rising. The developing theory after the 1970s was that stagflation can only occur if government policies disrupt normal market functioning. Regardless of cause, stagflation makes it harder for many to meet basic needs, especially those among the unemployed. For those who are employed, stagflation can lead to risks of job losses and lower wages, which would decrease consumer confidence and purchasing power.

Is stagflation possible in today's economy? No one really knows.

Our current inflation originated in higher demand for goods, possibly fueled by government Covid subsidies and the shutdown of service industries. That demand ran head on into supply disruptions from shuttered economies during the first year of Covid, a broken supply chain, and a lack of employees to meet production demands. Rising inflation fueled demands for higher pay and triggered cost of living increases. Higher wages and cost of living increases are unlikely to go away as the economy recovers, adding fuel to the inflation spiral.

Unemployment is another puzzle. Yes there are jobs, but millions of people are missing from the employment market. They have not returned to work as the economy recovered. Where are they and will they return?

An estimated 3 million of the disproportionate number of older Americans pushed out of the workforce by the combined health crisis and economic downturn retired earlier than expected.

Millions of women have not returned to the workforce. With the loss of daycare and closed schools, many found their time demanded at home with children. While most schools have reopened, others continue remote learning because of a shortage of teachers. The unpredictability of Covid policies and quarantining of children at home have also made it difficult for women to return to work.

According to the Brookings Institute, around 7 million American men between the ages of 25 and 54 – mostly too old to be in school and too young to retire – are neither working nor looking for work.

The loss of workers adds pressure to wage increases and reduces the productivity of businesses who are unable to staff up to meet demand, slowing growth and fueling inflation.

That brings us to government policies disrupting normal market functioning. Has government intervention gone too far or not far enough? One way or another, we are going to find out in the coming years.

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