

# Is "stagflation" a real threat?

## Chief economist's comment

Author: Paul Donovan, Chief Economist, UBS GWM, UBS AG London Branch

- "Stagflation" is appearing in the media a lot, but what does it mean, and is it a serious threat for investors?
- To give something a special term, it has to be a special and relatively rare event. Slowing growth and accelerating inflation happens a lot of the time, and policy makers do not tend to do anything out of the ordinary in response.
- "Stagflation" suggests that the normal pricing mechanism has broken down, and a continuous slowing of demand for a good or service is accompanied by a continuous increase in the price of that same good or service. That is unusual, and requires an unusual policy response.
- Using this definition, there is little evidence of economic "stagflation" today. When demand slows at the level of an individual good or service, the rate of inflation also slows. While vigilance is appropriate, current economic behaviour does not suggest policymakers need to deploy an exceptional policy response.



Source: Shutterstock

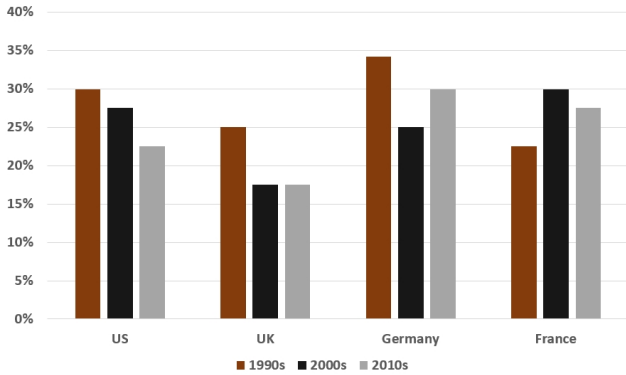
One of the many problems economists face is several popular terms used to describe economies have no precise definition. "Recession" is one obvious example. "Stagflation" is another. But stagflation is being used with increasing regularity in the media. It sounds suitably sensationalist, and sensation drives social media "likes". It also has echoes of the 1970s. The economic memory of the 1970s is what economists would term a "dominant narrative". It is a story so powerful that not only is it (mis)remembered by those that lived through it, the story is also (mis)remembered by those who were born long after the 1970s ended.

Growth has slowed from an unsustainably high level. Independently, headline consumer price inflation has accelerated to a higher level than recent historical norms. However, economists who are less concerned with social

media followers (please follow me on Twitter and LinkedIn), would probably define the term "stagflation" rather narrowly. It cannot mean "rising inflation and slowing growth" – because that happens roughly a quarter of the time. The current angst over stagflation cannot be justified by something so frequent.

### Growth often falls as inflation increases

Proportion of time an economy has quarter-on-quarter declines in GDP and increases in inflation



Source: UBS calculations

It probably also should not mean “rising inflation in a recession”. Aside from the fact that this simply raises the difficult question “what is a recession?”, rising inflation during a recession is quite a common occurrence as inflation tends to lag economic growth a little. Moreover, policymakers may not do anything exceptional if inflation is rising in a recession, if the inflation is caused by one or two prices rising (for example, a relative commodity price shock).

Stagflation is something that requires a different policy response to a normal economic cycle. US Federal Reserve Chair Volcker’s famous “shock” in 1980, when US interest rates were raised to 20%, was an exceptional policy response triggered by the exceptional economic circumstances. So what are those exceptional circumstances?

“Stagflation” can best be thought of as a breakdown in the pricing mechanism. Stagflation occurs when the price of a *good or service* continues to rise when demand for that *good or service* continues to fall. That requires a radical policy response because it is a signal that there is something more seriously wrong in an economy. The pricing mechanism can be working perfectly well if an economy has slowing growth and rising inflation, because it might reflect slowing demand for apples and rising prices for oranges. The slowing demand for apples is not supposed to influence the price of oranges, and there is nothing exceptional to justify exceptional policy reactions.

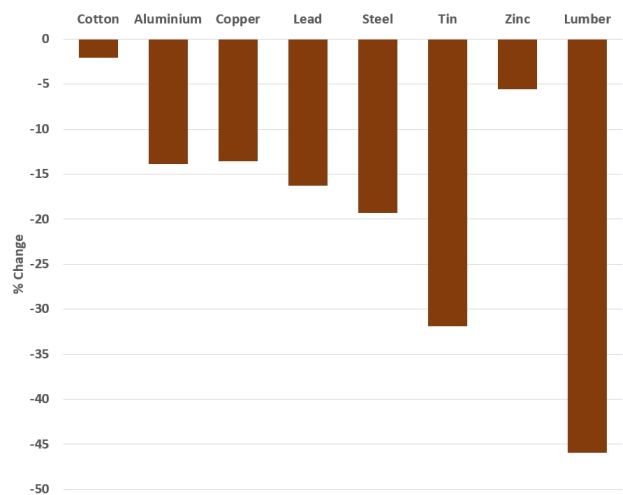
Of course if there is a supply shock, prices can rise for a period as demand falls. Diesel prices are a good example of this at the moment—the shortage of refined oil has led to higher prices, and those higher prices have led to lower demand. This is why stagflation is about *continuous* moves in price and demand. If demand for diesel continues to decline, eventually the level of demand will be below the new and more constrained level of supply, and prices will fall.

Looking at developed economies today, there is little evidence to suggest that the pricing mechanism has broken down. Several sections of the global economy are exhibiting disinflation (slowing inflation). Some sections are exhibiting deflation (negative inflation). These are generally in areas where demand has declined.

Toward the start of the supply chain, a number of commodities have begun to experience falling prices. Several commodities that experienced price increases in 2021 (on surging demand) are now experiencing price declines.

### Commodity prices can go down

Change in commodity prices from the start of 2022 (as of 1 July)

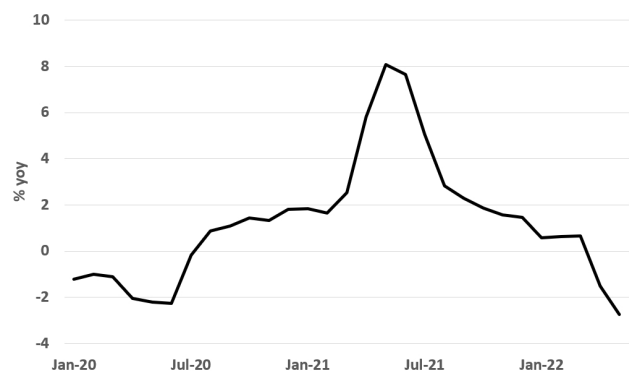


Source: FIBER via Haver, UBS calculations

At the end of the supply chain, several consumer goods are experiencing falling prices. In the United States, the goods and services that are currently in deflation have seen price changes turn negative recently—and generally as a result of changing demand patterns.

### Deflation in the US has emerged this year

Weighted average inflation rate of US goods and services currently in deflation



Source: UBS calculations from Bureau of Labor Statistics data, to May 2022

Thus, car rental prices, which were rising at 110% yoy when demand surged last year, are now falling. Television prices were rising almost 13% yoy and are now falling 9.5% yoy. This chart aggregates the inflation rates of the thirteen different sectors of the economy that are currently in deflation.

This is not to say that there is widespread disinflation or deflation. At the moment only around a quarter of the US consumer price basket by weight is experiencing disinflation or deflation. What this chart is demonstrating is that where demand weakens, prices will respond. Where prices rose on stronger demand last year, they are quick to fall when demand has weakened this year. The pricing mechanism works.

## The pricing mechanism works

The fact that the price mechanism still works means that economists cannot really categorise the current situation as being an extraordinary episode of stagflation. If what we have is the consequence of a more normal supply and demand imbalance, an ordinary rather than an extraordinary policy response would seem justified.

## Appendix

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