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Abstract:	The article discusses the possible impact of stagflation on the global economy. Like the disco era it dominated, stagflation has a distinctive beat: slow growth, rising inflation, high oil prices and weak labour markets. In the 1970s this nasty combination haunted the global economy. Could it be making a comeback? Today's world economy does seem to be playing some similar tunes. In the statement accompanying its latest interest-rate hike on May 3rd, America's Federal Reserve fretted about both price pressure and a slowdown in spending. On May 4th, the European Central Bank kept interest rates unchanged, but worried aloud about oil prices and slowing growth. The evidence is mounting that global growth has slowed. Yet even as growth is slowing, price pressures are looming. In America, consumer prices rose 3.1% in the year to March, up from 1.7% a year ago. In Britain, inflation jumped unexpectedly in March. And in the euro zone, consumer prices are still rising faster than the 2% goal that the European Central Bank targets. With output slowing and inflation stubborn, it is small wonder that the concerns about stagflation are back in fashion. But the modern remix still poses problems. Steering monetary policy when growth is slowing and prices are accelerating is never easy.
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The global economy

Stagflation, the remix

It's not the 1970s, but the modern version could prove equally tricky

LIKE the disco era it dominated, stagflation has a distinctive beat: slow growth, rising inflation, high oil prices and weak labour markets. In the 1970s this nasty combination haunted the global economy. Could it be making a comeback?

Today's world economy does seem to be playing some similar tunes. In the statement accompanying its latest interest-rate hike on May 3rd, America's Federal Reserve fretted about both price pressure and a slowdown in spending. On May 4th, the European Central

Bank kept interest rates unchanged, but worried aloud about oil prices and slowing growth.

The evidence is mounting that global growth has slowed. In America, output grew by an annualised 3.1% in the first three months of 2005, the slowest pace for two years. More recent figures, from weak retail sales to soggy consumer confidence, suggest this "soft patch" may be getting softer by the day. In Britain, the latest numbers--in retail sales and manufacturing--point to weaker growth. And in the euro zone, sluggish economies are looking ever more lethargic.

Yet even as growth is slowing, price pressures are looming. In America, consumer prices rose 3.1% in the year to March, up from 1.7% a year ago. In Britain, inflation jumped unexpectedly in March. And in the euro zone, consumer prices are still rising faster than the 2% goal that the European Central Bank targets. With output slowing and inflation stubborn, it is small wonder that the concerns about stagflation are back in fashion.

In fact, today's version of stagflation bears scant resemblance to the 1970s. In 1979, for instance, America's core inflation, which excludes oil and food, was rising at over 7% a year, while the economy grew barely more than 1%. Recent core inflation, at 2.2%, is only just above the central bank's comfort zone, while GDP growth is pretty close to the economy's sustainable rate. There is a tad of "flation", in other words, but not much sign of "stag". The euro zone, by contrast, has plenty of stagnation, but--despite the ECB's nervousness—there is little sign that its inflation is getting out of control (see Making a point).

Just because things are not as bad as the 1970s does not, by itself, give much cause for comfort, however. How far history repeats itself hinges on two other factors. The first is central bankers' determination to retain their credibility as inflation fighters. The 1970s stagflation resulted, in large part, from extended periods of loose monetary policy pursued to accommodate the demand-crippling effect of oil shocks by printing money. The credibility-obsessed folk at the ECB clearly have no intention of repeating that mistake.

But the Fed's governors have played a riskier game. They have, thus far, run an extremely loose monetary policy--even after this week's rise, real interest rates are barely positive. But thanks to the central bank's reserve of inflation-fighting credibility, long-term inflation expectations have barely shifted. At issue is how long that remains the case. At the very least, the measured march to higher rates must continue unabated.

The other wild card combines labour costs and productivity growth. In the 1970s, productivity growth fell sharply and unexpectedly. Added to this, strong trade unions, little international competition and those accommodating central bankers created a pernicious wage-price spiral. There is little of this dynamic today. Although productivity growth has slowed from its recent peaks, it has not slumped. Global competition has left little room for excessive wage demands. This suggests that a return to classic stagflation is unlikely.

Stayin' alive

But the modern remix still poses problems. Steering monetary policy when growth is slowing and prices are accelerating is never easy. It is particularly hard in today's unbalanced world economy, where too much depends on continued spending by American consumers who, in turn, are counting on an unsustainably frothy housing market. At some point, America's heavily indebted consumers will need to cut back spending. And when that happens, those in the rest of the world will have to start spending more to keep the world economy growing. The real risk is that Washington's central bankers will be too worried about stagnation and Frankfurt's too worried about inflation to allow that to happen.

GRAPH: US growth and inflation