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MURPHY: Setting the stage for stagflation

By

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Prices rose 2.7 percent during 2009, according to the Bureau of Labor Statistics' recent update of the Consumer Price Index (CPI). This is a worrisome fact because last year's unemployment rate averaged more than 9 percent. This trend may signal a return of "stagflation," a merger of stagnation and inflation.

In the 1970s, stagflation shocked traditional Keynesian economists, whose models said the economy could not suffer from both high unemployment and rapid inflation at the same time. Unfortunately, the Keynesians were wrong, because an economy obviously can experience both evils simultaneously.

Ever since the worldwide financial panic started in September 2008, the financial press has drummed into Americans' heads the notion that we are poised on the edge of a deflationary cliff, just as in the early 1930s. It was fear of a falling price spiral that spurred the Federal Reserve into making extraordinary interventions, such as a near tripling of the Fed's balance sheet and the cutting of short-term interest rates to virtually zero. Under normal circumstances, such "easy" Fed policies would be very dangerous, but the experts continually assure the public that high unemployment denotes "slack" in the economy and thus no danger of price inflation.

Throughout most of 2009, the financial press would report that the "year over year" change in the CPI was negative. Although technically true, such statistics were misleading. What really happened was that prices fell very sharply in the final months of 2008, giving the backward 12-month comparison the appearance of deflation. Now that this one-year window has moved past the sharp drop of late 2008, the standard measures show inflation is back.

To underscore that the U.S. economy has not been in deflation for some time, consider this: In the past decade, there were five years in which prices rose less than they did just last year. Does that sound as if the U.S. is still balanced on the edge of a deflationary cliff?

The typical view is that an economy in a deep recession is in no danger of price inflation. This belief is wrong both in theory and in practice. The classic explanation of price inflation is too much money chasing too few goods. During recessions in the postwar period, the Fed typically opens the monetary spigots at the same time that the output of goods and services is falling. Therefore, other things being equal, we would expect inflation to go up during recessions.

The historical data are generally consistent with this conclusion. The worst bout of inflation during the postwar period occurred during the economic slump of the late 1970s and early 1980s. More recently, consider that in 2006, the inflation rate was slightly lower than last year's figure even though the unemployment rate in 2006 was only half of the average for 2009.

These considerations underscore the fundamental weakness in the Keynesian theory that grips our financial press. Economic growth doesn't necessarily cause inflation, and high unemployment doesn't necessarily prevent it.

Some readers may remember the "misery index," the sum of the unemployment and inflation rates. The official unemployment rate in 2009 averaged 9.3 percent, for a total misery-index rating of 12.0. This is the highest misery rating in 26 years, going all the way back to 1983 when it was 13.4.

The tricky thing about price inflation is that it's largely tied to people's expectations. If everyone thinks inflation will be high, they will rush to dump their dollar holdings by buying stocks, real estate, gold and other items that will maintain their value better than cash. Yet this very behavior will itself cause prices to rise, turning the expectation of inflation into a self-fulfilling prophecy.

It seems every week the Obama administration announces some new tax or mandate that will further handicap businesses. Regardless of the official definitions of recession, the economy will remain sluggish for years to come. But if the Federal Reserve continues with its reckless policies, Americans will experience high inflation on top of high unemployment. As in the late 1970s, Americans will see that the pundits are wrong, because stagflation is very real.

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