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A WHIFF OF STAGFLATION IN THE AIR?

Recently the U.S. economy has slowed markedly, to a pace verging on stagnation, perhaps recession. Yet, despite this economic slowdown, inflation still remains higher than desired, fueled by sharp increases in food and energy prices. In the past (particularly in 1974–75), a constellation of stagnant growth and high inflation was termed “stagflation.” In the following, we will examine:

- What exactly is “stagflation,” what it looked like in the mid-1970s, and how financial asset markets performed during that period;
- Likely explanations as to why “stagflation” occurred back then;
- Current economic conditions to see exactly what has been happening to economic growth and inflation recently; and
- Whether the U.S. economy is currently in a “stagflation” and what are the prospects for growth, inflation, and financial markets over the near term (say the next two years).

Let’s first define some terms. “Stagflation” is a situation where an economy shows little or no growth [that is, real gross domestic product (GDP) is growing very slowly and the economy may even be slightly in recession] with overall inflation (a rise in the general price level) being high. The term “stagflation” was basically coined in the mid-1970s as an outgrowth from what the U.S. economy experienced during that time, although other economies had similar bouts of “stagflation” then.



Following an oil shock in 1973–74, the U.S. economy stagnated and experienced high inflation in 1974–75. Specifically, the economy saw no growth in that period, with real GDP actually declining 0.5% and 0.2% in 1974 and 1975 respectively. And at the same time, inflation soared, with annual consumer price inflation averaging about 10% over those two years.

Furthermore, the entire 1970s were not generally good times for financial markets. Stagnant real growth in some periods and only trend like growth on average over the entire period coupled with persistently high inflation (averaging near 8% per year during the decade) resulted in corporate earnings being fundamentally unimpressive and in the purchasing power (“real” value) of earnings being sharply diminished. As a result, we saw average equity and bond returns come in significantly below average inflation during the 1970s. In short, average financial asset returns, after adjusted for inflation, were significantly negative during the period.

In addition, the stagflation of the mid-1970s was counter to the prevailing economic wisdom of the 1960s and early 1970s, when a concrete tradeoff was thought to exist between the pace of economic activity and inflation. In other words, economists generally thought that weak economic growth led to low inflation, contrary to the constellation of low growth and high inflation we actually experienced in the mid-1970s. What arose from that experience was a rethinking of theory and policy that concluded that there is no significant long-run trade-off between inflation and growth, once shifts in inflation expectations are taken into account.

Unfortunately, even today, there is no concrete indisputable explanation as to why stagflation occurred. However, a little bit of economic history suggests some possible explanations, particularly regarding the mid-1970s experience. First, stagflation can result from sharp supply side shocks. For instance, the late 1973 politically motivated oil embargo (by certain Middle East nations) cut off critical energy supplies to Western nations (especially the United States). This cutoff caused U.S. output (real GDP) to stagnate and the price level to soar, resulting in double digit inflation. Second, faulty economic policies could also contribute to stagflation. During the 1970s much of the U.S. economy was highly regulated, which limited competition and

productivity growth, and allowed firms (and labor unions) to “pass through” supply shock induced cost increases. [Also, wage-price regulations (a.k.a. “controls”) were implemented by the Nixon Administration in the early 1970s, the effect of which was to “store up” inflationary pressures that were ultimately released when controls were lifted in the mid-1970s, contributing to the burst of inflation we saw during that period.]

Moreover, some central banks engaged in excessive money creation, which, with a lag (in part due to wage-price regulations), resulted in inflation moving higher. In the early 1970s, U.S. money growth was very strong (M2 grew about 13% per annum during 1971–72), an artifact, in part, of running a “guns and butter” economy during the Vietnam War. That money growth partially set the stage for the sharp inflationary decline of the U.S. dollar early in that decade (when the post-WWII Breton Woods gold standard disintegrated) and, with that, the “supply side” oil stock of late 1973 (in part, oil suppliers may have raised prices to recoup some of the purchasing power lost from the sharp decline in the dollar).

In fact, all of these factors interacted in the 1970s in such a way to reinforce each other in a “stagflationary” manner: rapid money growth increased inflationary pressures, which fed into wages and prices and set off an inflationary wage-price spiral. Again, shifting inflation expectations, together with the institutions and policies then in place, played a crucial role in neutralizing any tradeoff between inflation and growth and in producing the “stagflation” all so evident in the mid-1970s.

Indeed, some have pointed to recent U.S. economic events and drawn similarities to the “stagflation” experience of the mid-1970s. Certainly, we have seen a significant slowdown in the economy in recent months, with real GDP growth probably close to zero, perhaps slightly in negative territory (barely in recession). But despite this muted, stagnant growth, inflation remains elevated compared to the recent past, with overall CPI inflation currently about 4% year-on-year. Moreover, the Federal Reserve has been cutting short-term interest rates aggressively and money growth has picked up significantly recently (M2 has grown at a slightly more than a 10% annualized pace since November 2007). In some people’s minds, all of this spells “stagflation” in the not-too-distant future, if we are not there already.

However, it is probably not very realistic to think we are headed towards a mid-1970s style “stagflation.” Indeed, as you can see from the recent economic data cited above, inflation is currently running near 4%, far from the double-digit inflation seen in the mid-1970s. So, even though we are experiencing stagnant real growth now, inflation is not yet high. Hence, without inflation being high, there is no full-blown stagflation evident at least for now.

Then, the issue turns on whether major “stagflation” lies just around the corner. It could be the case that the massive monetary stimulus put in place recently results in higher inflation without much of a growth pickup. The main reason for this is that recent monetary stimulus has driven the dollar exchange rate sharply lower and caused commodity prices to soar. It is completely possible that the lower dollar causes inflation to pick up before Fed rate cuts click in to improve real net exports and aggregate demand more generally. If that’s the case, we may get a “whiff” of stagflation in the not-too-distant future.

However, even if that occurs, it still will likely only be a “whiff” modest in dimensions compared to the 1970s experience and short-lived, since the economy and economic policies have changed radically since the 1970s. Many sectors of the economy have been deregulated, and have become more competitive and

cost conscience. Most labor unions have long lost their economic clout to force wage increases, even when they may be justified by increases in the cost of living. Hence, there is little risk of getting into a wage price spiral like we saw in the 1970s.

Moreover, the Fed, after its experiences in the 1970s, is now much more focused on keeping inflation under control to keep inflation expectations low and well anchored. The Fed simply will not tolerate anything close to the double-digit inflation rates of the mid-1970s. To do so would seriously jeopardize its hard-won credibility as an inflation fighter. The Fed would be very bothered by inflation moving much beyond the rates we have seen recently (CPI inflation at 4% overall and 2.5% excluding food and energy). Therefore, it is highly unlikely that the “flation” part of “stagflation” would sustain for very long. Hence, even if the economy is stagnant, full-blown “stagflation” is not likely to persist going forward, despite perhaps getting a “whiff” of it along the way. This of course means that real financial market returns will likely not chronically be weighed down by high inflation over the near term, unlike what we witnessed on average in the 1970s.

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