



March 14, 2008

Stagflation fears are exaggerated Inflation risks will not put a premature end to the Fed's monetary easing

INTRODUCTION

At a time when the globe's primary economy—the United States—is facing an impasse, inflation's resilience and persisting high commodities prices are reawakening fears of stagflation. The consequences are important as overly rapid inflation could destabilize the anchoring of inflation expectations. Work by the U.S. Federal Reserve (Fed), which is currently trying to kick-start the economy, would be disrupted by the desire (not to say need) to maintain price stability:

[...] Should high rates of overall inflation persist, the possibility also exists that inflation expectations could become less well anchored. Any tendency of inflation expectations to become unmoored or for the Fed's inflation-fighting credibility to be eroded could greatly complicate the task of sustaining price stability and could reduce the flexibility of the FOMC to counter shortfalls in growth in the future. [...]

Ben Bernanke, February 27, 2008.

In this *Economic Viewpoint*, we show that, despite similarities to the 70s and 80s (sharp increases in commodities prices, economic slowdown), the risks of stagflation are low and should not bring the Fed's monetary easing to a premature end. The housing market correction, economic slowdown, liquidity crunch and tightening credit conditions should make inflation pressures ease by the second half of this year. As a result, with much bad economic and financial news still to come, we can expect further key rate cuts in the next few months.

STAGFLATION: COMBINATION OF WEAK GROWTH AND STRONG INFLATION

Stagflation, a hybrid of stagnation and inflation, is the word used to describe an economy that is suffering from weak growth and elevated inflation at the same time. The word appears to have been coined in 1965 by Iain Macleod, the British Conservative Party's economics spokesperson:

[...] We now have the worst of both worlds—not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of “stagflation” situation. And history, in modern terms, is indeed being made. [...]

House of Commons, November 17, 1965.

Until then, the very idea of stagflation had been dismissed due to the Keynesian macroeconomic theory, and especially the theory of the Phillips curve, which combined elevated inflation with a low jobless rate, and vice versa. In front of inflation that was higher than 15% and a sharp contraction by economic activity (Graph 1), economists agreed that the Phillips curve theory was unstable (see box). Now, we believe that the relationship between inflation and unemployment only works in the short term. Over a longer period, unemployment tends to return to its natural level, and a consistently accommodative monetary policy only maintains inflation pressure.

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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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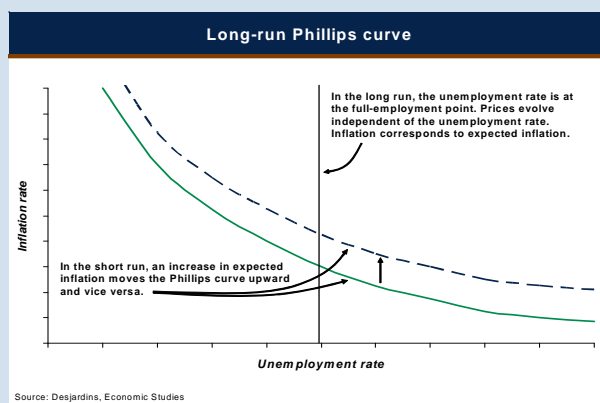
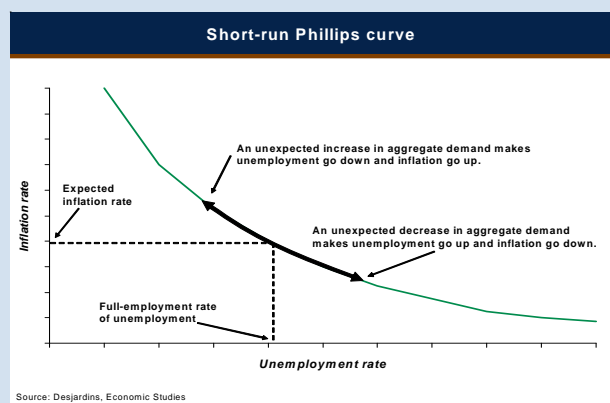
Phillips Curve¹

Fundamentally, the Phillips curve shows the relation between inflation and unemployment. The curve indicates that a low inflation rate is associated with a high unemployment rate, and that a high inflation rate is associated with a low unemployment rate. Over time, the concept of the Phillips curve was refined to take inflation expectations and supply shocks into account.

Modern debate about the connection between inflation and unemployment really began after the publication of a study by economist Alban William Phillips. It demonstrated an inverse, non-linear, stable relation between the rate of change in wages and unemployment in the United Kingdom. Since then, the concept of the Phillips curve has evolved substantially. The modern Phillips curve pinpoints three sources for inflation: “expected” inflation, the gap between unemployment and its natural rate and supply shocks (e.g., oil shock). We now also distinguish between the short-run Phillips curve and the long-run Phillips curve.

In the short term, the Phillips curve shows the relation between inflation and unemployment for a given expected inflation rate and a given natural unemployment rate². When aggregate demand unexpectedly goes up, companies raise the prices of their products to prevent an inventory shortage and use more inputs (workers, raw materials, etc.) to increase output. Stronger demand for workers makes unemployment go down, but also tends to make wages go up. The same logic applies to the other inputs: their prices tend to rise with demand. An unexpected increase in demand thus pushes the inflation rate up and brings the unemployment rate down. Using this logic, an unexpected decrease in demand will push the inflation rate down and make the unemployment rate go up.

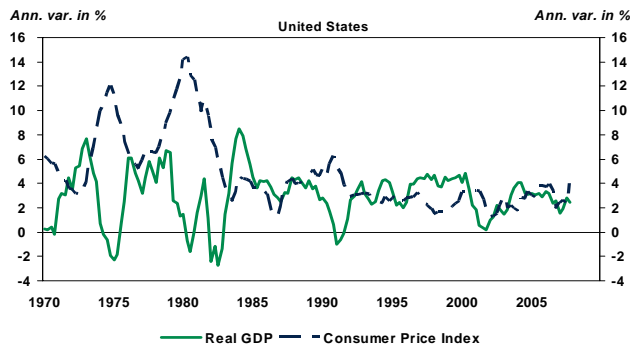
An increase in expected inflation makes the Phillips curve move up, while a decrease in expected inflation takes it down. An increase in the natural unemployment rate pushes the curve to the right, while a decrease in this rate pushes it to the left. Supply shocks can also make the Phillips curve move up or down. In the long run, as the economy is at full employment (natural employment rate), the unemployment rate no longer has an impact on the inflation rate. It will depend on economic agents’ expectations.



¹ DESJARDINS, ECONOMIC STUDIES. *Practical Guide to Economic Concepts and Theories*, 1st ed., 2007, 220 pages, [http://www.desjardins.com/en/a_propos/etudes_economiques/dossiers/concepts-theories/index.jsp]

² The natural unemployment rate is the unemployment rate that is recorded with a full-employment economy.

Graph 1 – We are nowhere close to the stagflation we've seen before



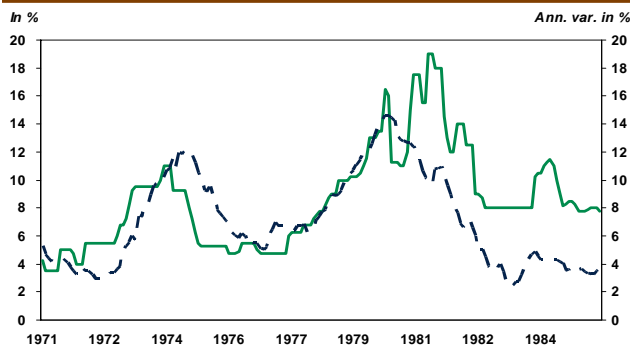
Sources: Datastream and Desjardins, Economic Studies

STAGFLATION: CAUSES AND CONSEQUENCES

The stagflation of the 70s can mainly be explained by two phenomena, the combination of a supply shock on oil prices, and a poor response to the crisis by government authorities. In 1973, the embargo ordered by Arab petroleum exporting nations against states that backed Israel pushed crude prices up by more than 350% from 1973 to 1974. A sharp increase in consumer and producer prices followed. The loss of consumer purchasing power due to limited real disposable income and a decline in business profitability due to the increase in input costs led to a marked slowdown in economic activity. The situation was exacerbated by the response from monetary authorities, which by providing too much stimulus to the economy, created an inflationary wage spiral.

U.S. government bodies were quick to learn from their mistakes. In 1979-80, when oil prices exploded when Iranian production halted due to Iranian revolution and then the Iran-Iraq war, Paul Volker, then Fed Chair, responded to the crisis by raising nominal interest rates to almost 20% to combat the inflation surge (Graph 2). This, however, occurred at the cost of a major contraction in economic activity. The result was two back-to-back recessions, in 1980 and 1982.

Graph 2 – The Fed raised key rates to almost 20% in 1981 to bring inflation back to a more desirable level



Sources: Datastream and Desjardins, Economic Studies

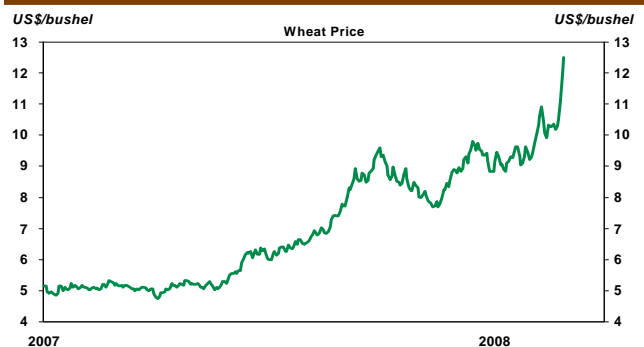
TOTAL INFLATION IS RESILIENT ...

With the economic slowdown underway in the United States, inflation's recent resilience and the achievement of record oil prices have reawakened stagflation concerns. Should we be alarmed?

The facts:

- 1) After three months of strong growth, the consumer price index (CPI) stabilized in February. The annual change decreased slightly, but at 4.0%, inflation remains elevated.
- 2) Despite the U.S. slowdown, commodities prices are defying gravity. Oil prices hit more than US\$110 in March; gold set a new record at over US\$985 an ounce; wheat prices have more than doubled from last year, reaching a record of US\$12.00 a bushel in February (Graph 3).

Graph 3 – Wheat price has more than doubled over the past year



Sources: Datastream and Desjardins, Economic Studies

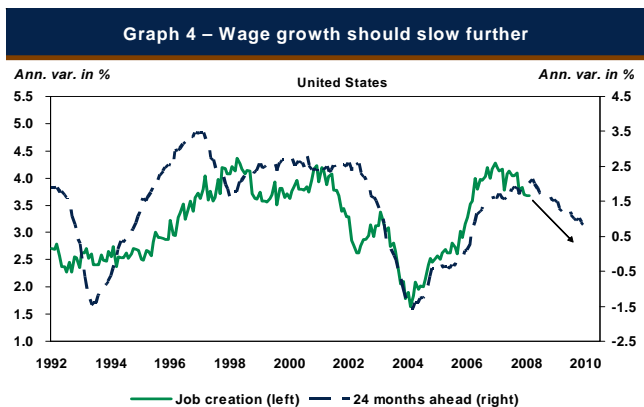
... BUT CORE INFLATION IS STILL CONTAINED

Although there is reason for concern, in our opinion, there is no reason to panic. First, the CPI increase primarily reflects the marked increase in the prices of energy and some foods. If we exclude food and energy, core inflation is more stable, up 2.3% from last year.

Moreover, energy prices rose by close to 60% in 2007 and, at over US\$100 a barrel, there is little chance this situation will happen again in 2008. For now, oil prices are shattering one record after another, but this only seems to be a reflection of market speculation. Due to the current economic slowdown, we expect oil prices to gradually fall until the summer.

Under these circumstances, it is unlikely the situation will result in an inflation spiral. One of the key elements in a sustained surge by all consumer prices is wage behaviour. Wages have, in fact, been decelerating from the cyclical peak reached in December 2006, and the job market's deterioration

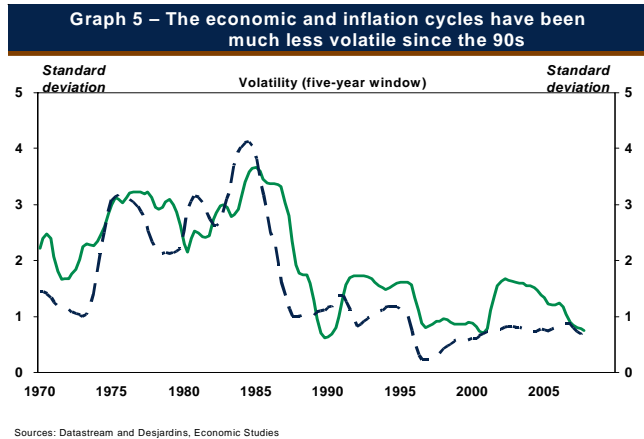
shows that pressure on wages will continue to slide over the next few years (Graph 4).



Sources: Datastream and Desjardins, Economic Studies

NO REPEAT OF THE 70S ON THE HORIZON

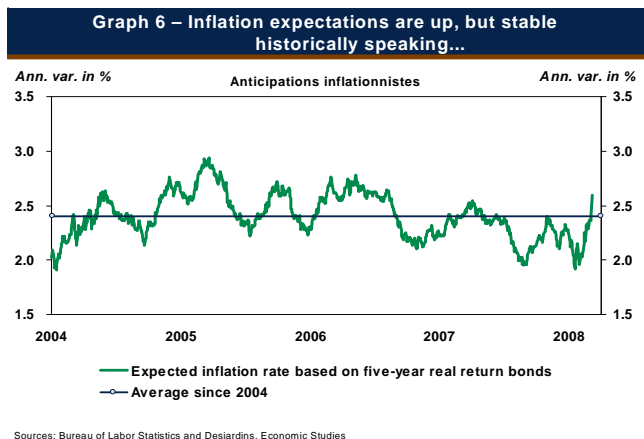
Today, market globalization and greater central bank credibility when it comes to inflation control have resulted in a better anchoring of inflation expectations and a gradual reduction in the volatility of economic growth and inflation since the 80s (Graph 5).



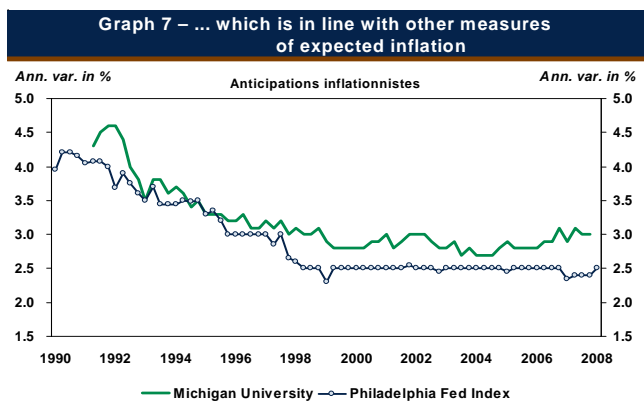
Sources: Datastream and Desjardins, Economic Studies

Expectations derived from U.S. real return bonds (*TIPS* : *Treasury Inflation Protected Security*) show that inflation expectations have gone up in the last few weeks, but are still oscillating within a tight range, close to the Fed’s implicit inflation target, i.e. close to 2.5% (Graph 6). What’s more, other measures, such as household and business surveys, show that inflation expectations remain stable (Graph 7).

Also, unlike the 70s, the increase in oil prices reflects a demand shock (not a supply shock) resulting from the economic boom of the last few years and, in particular, from runaway demand by developing countries in Asia, with China and India front

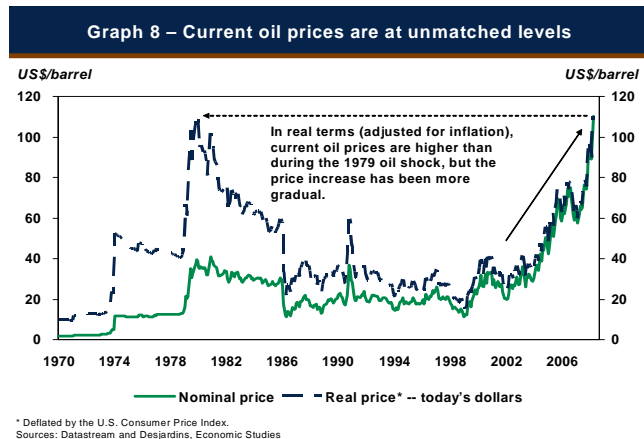


Sources: Bureau of Labor Statistics and Desjardins, Economic Studies



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

and centre. Thus, although crude prices are at the same level, in real terms, as they were during the 1979 shock, the current price increase, spread over more than five years, has been much better assimilated by the world’s economy (Graph 8).

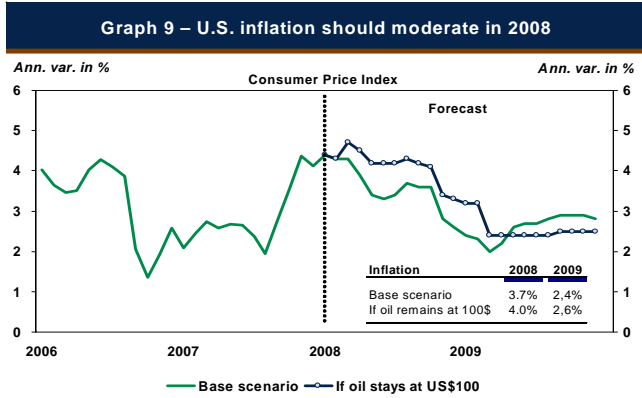


* Deflated by the U.S. Consumer Price Index. Sources: Datastream and Desjardins, Economic Studies

FURTHER KEY RATE CUTS ARE ON THE WAY

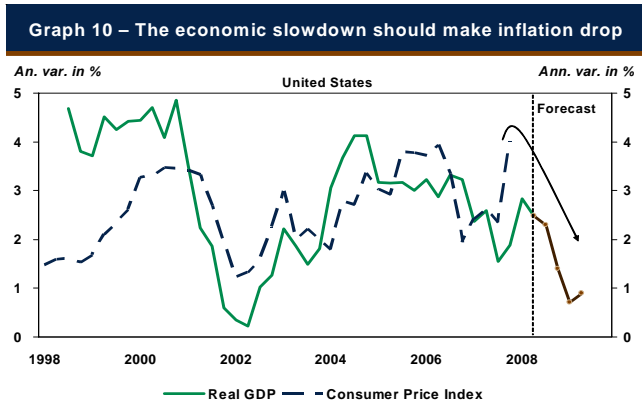
In our opinion, with growth risks predominating, inflation’s current level should not undermine the Fed’s work, and further rate cuts can be expected in the next few months.

Of course, skyrocketing energy prices could push back the forecast deceleration by total inflation. We believe that, if oil prices hold at US\$100/barrel all year, annual inflation will go up 0.3 percentage points to 4.0% for 2008 (Graph 9).



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

However, this will not keep total inflation from dropping back below 2.5% by the beginning of next year. Inflation is a lagging indicator of the economic cycle. The economy's slowdown and stability of inflation expectations argue in favour of a decline by current pressures and slower price growth for the rest of the year (Graph 10).

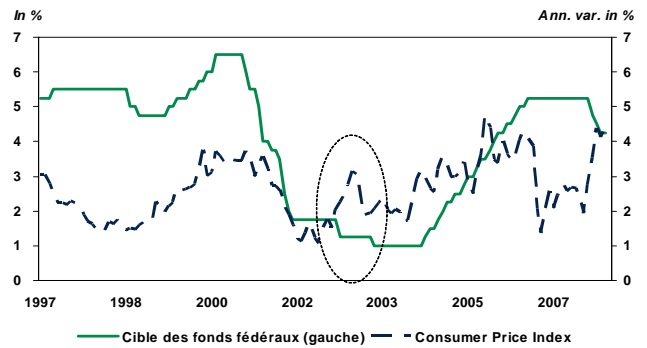


Sources: Datastream and Desjardins, Economic Studies

Thus, somewhat as in 2001, while inflation is elevated, the Fed will not refrain from easing its monetary policy further. At that time, the Fed had cut its key rate by 50 basis points, from 2.25% to 1.75%, despite inflation at 2.7% and rising (Graph 11).

Under these circumstances, with more bad economic and financial news to be expected, it is likely the Fed will push the target for the federal funds rate to less than 2.0% this summer, to limit growth risks.

Graph 11 – As in 2001, the recent surge by inflation will not keep the Fed from proceeding with further rate cuts



Sources : Datastream et Desjardins, Études économiques

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