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Stagflation: Definition, Causes & Consequences

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Stagflation is an economic phenomenon that is defined by periods with considerable inflation, little to no growth, and high unemployment. Prior to the 1970s, the dominant economic theories suggested inflation nearly always increased when the unemployment rate was low and decreased when the unemployment rate was high. Economists have since had to refine their economic theories.

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What Is Stagflation?

Stagflation is a term used to describe an economy experiencing significant inflation, high unemployment, and slow to no economic growth. The term is a portmanteau that combines the words stagnation in GDP and inflation.

Periods of stagflation were prevalent in the 1970s and 1980s in most major economies. This surprised economists as the dominant economic theory of the time, Keynesian macroeconomic theory, posited that increases in inflation and unemployment couldn't happen at the same time.

This was partly based on the *Phillips Curve*, an economic model that was used to argue that there was an inverse relationship between unemployment and inflation. Economists have since identified many potential factors that influence stagflation including a sudden supply shock and harmful government policies.

> ***Note:*** *While stagflation was prevalent in the 1970s during the oil crisis and in the 1980s, it hasn't been a problem in recent times. Governments have been working closely with central banks to monitor and intervene to control inflation without causing economic output to decrease and avoid policies that are likely to support stagflation.*

What Causes Stagflation?

The causes of stagflation are heavily debated by economists as prevalent economic theory before the stagflation-fueled 1970s didn't believe that it was possible since the Phillips Curve supported the theory that unemployment and inflation were inversely linked. However, economists have suggested a number of theories for what causes stagflation.

1. Supply Shock

The supply shock theory posits that stagflation occurs as a result of a sudden decrease in the supply of a service or commodity. This causes prices to increase dramatically which usually reduces profit margins for most companies and slows economic growth.

2. Bad Monetary Policies

The bad policy theory believes that stagflation is often the result of bad economic policy. The central bank's and government's attempt to regulate the economy often leads to them making the wrong choices. For example, prior to the 1970s, the U.S. was focused on maximum employment across their economy after the Employment Act of 1946, which inadvertently caused inflation to increase and impacted employment and growth.

Government policies regulating the economy can also have an impact as shown by the Nixon strategy of devaluing the dollar and instituting wage and price freezes known as the Nixon Shock. Ultimately, central banks and legislators struggle with how to tackle stagflation since interventions to support their objectives of price stability, low unemployment, and economic growth can conflict.

3. Differential Accumulation

A theory created by economist Jonathan Nitzan and Shimshon Bichler, the differential accumulation explanation of stagflation argues there is a relationship between mergers and acquisitions, stagflation, and globalization. Similar to the supply shock theory, they posit that differential accumulation drives mergers and acquisitions which concentrate the power to limit the supply of commodities and accumulated capital in fewer hands and leads to higher risks of stagflation.

4. Demand-Pull

Proposed by economist Eduardo Loyo, the *demand-pull stagflation theory* suggests that stagflation can occur exclusively from monetary shocks without the need for a supply-related shock. This occurs when governments institute monetary tightening regulations such as raising the federal interest rate or a reduction in the money supply.

5. Cost-Push

The *cost-push inflation theory* sees supply-side inflation as a key driver of stagflation. In this case, rising prices lead to unemployment since they usually reduce profit margins for companies which leads to reduced economic output. Supply-side inflation can also be impacted by things like tariffs, increases in wages, or labor shortages.

6. End of the Gold Standard

Historically, Nixon's ending of the convertibility of U.S. dollars to gold, which prompted the end of the Bretton Woods System, is theorized as one driver of 1970s stagflation. The gold standard made the U.S. vulnerable to runs on gold as there were more dollars in foreign hands than gold reserves in the U.S. In 1971, Nixon closed the gold window that allowed for the exchange of dollars for gold. In 1976, the value of the U.S. dollar was officially decoupled from gold. Both moves devalued the dollar which impacted inflation and economic growth and led to stagflation.

> ***Takeaway:*** *Economists don't all agree about what causes stagflation. It continues to be heavily debated. But most agree stagflation is a problem.*

Consequence of Economic Stagflation

What are the consequences of stagflation on regular people? When stagflation occurs, it has a direct impact on affordability making it harder for many to meet basic needs, especially those who are among the unemployed. For those who are employed, stagflation could lead to risks of job losses and lower wages, which would decrease consumer confidence and purchasing power.

Investors also suffer from stagflation. Stagflation generally results in lower profit margins due to higher input prices and lower sales. That has an impact on the stock market, as the S&P 500 in the last 60 years has returned an average of **2.5% per quarter** but historically returns **-2.1% during times of stagflation**, according to a Goldman Sachs report. Stagflation can directly impact investors by decreasing the growth in companies' earnings per share, which impacts stock prices.

Dividend investors may also be negatively affected as companies reduce or suspend their dividends to conserve cash. For those who invest in growth stocks, there could be significant losses as many investors may have expected growth targets that stagflation would make it harder to meet.

If stagflation occurs long enough, some companies might go bankrupt causing significant investor losses. The inability of companies to repay their debts would likely also affect bond prices. However, there are ways that investors can hedge the risk of inflation, including funds that are designed specifically to navigate high inflation periods.

Investors worried about the impact of stagflation on their portfolios might want to shift their investment strategy or decide to remain in blue chip stocks in staple industries with steady earnings that are likely to weather stagflation or recover quickly.

Stagflation could impact international trade by increasing global commodity prices for everything including food, making it much more expensive to do business and increasing inflation further. National or global unemployment can also reduce global economic output, consumer confidence, and spending — increasing unemployment in more areas because of the interconnectedness of global trade.

Different national policies for tackling stagflation might also impact global trade as these policies create different conditions for recovery that might conflict. This often affects emerging and developing economies more, since many of these countries don’t have the capacity to institute the kinds of monetary or stimulus policies other nations use to tackle stagflation due to their high deficit-to-GDP ratios.

1970s Stagflation Example

The most commonly cited example of stagflation is the 1970s oil crisis. In October 1973, the Organization of the Petroleum Exporting Countries (OPEC) declared an oil shipping embargo to the United States and Israel's European allies in response to Western support of Israel during the Yom Kippur War.

The oil embargo caused oil prices to increase immediately by over 300%. That caused huge issues in the car dependent United States where oil prices remained elevated even after the embargo ended in March 1974. This coincided with a move of manufacturing jobs outside the U.S. to save on labor costs and the rising expense of the Vietnam war and led to a prolonged period of stagflation where elevated oil prices caused inflation to rise rapidly, unemployment to increase, and the economy to stagnate.

The pivot of the U.S. economy from manufacturing to less well-compensated service jobs caused real wages to stop growing and led to decreased consumer confidence and reduced spending — further exacerbating the crisis.

President Richard Nixon tried to mitigate 1970s stagflation by devaluing the dollar and declaring price and wage freezes. However, that strategy did not work and is considered among the great failures of American macroeconomic policy by Jeremy Siegel, a prominent economist. Many economists now believe that the growth of the money supply by the Federal Reserve was the main factor in the stagflation crisis of the 1970s.

At the time, there was a belief that high inflation led to low unemployment but during the 1970s unemployment and inflation both rose. A recalibration of economic policy to focus on low unemployment and price stability was necessary to halt stagflation.

> ***Takeaway:*** *Not all economists believe that the oil embargo and oil shortages were the primary reason for 1970s stagflation.*

Responses to Stagflation

Responding to inflation is difficult for both central banks and policymakers since targeting one aspect of the problem can have a negative impact on another aspect of it. For example, increasing interest rates elevates the cost of borrowing and reduces demand which reduces inflation but also causes slower GDP growth.

Monetarist Responses

A monetarist response to stagflation would be to reduce inflation even if it causes a short-term increase in unemployment and a decrease in economic growth. This strategy was used by the UK Conservative government between 1979 and 1984 and led to a recession.

Supply-Side Responses

Increasing aggregate supply via policies designed to support business to reduce costs and increase efficiency like deregulation and suspending tariffs could be used to address cost-push inflation. But these strategies are often ruled out as they are national policies to address global supply shortages.

Wage Control Responses

If stagflation is caused by rising wages, wage control could be implemented to limit rapid wage increases which are causing price inflation and reducing profit margins.

Neoclassical Responses

Economist Friedrich Hayek proposed that governments fight inflation by ending expansionary monetary policies and waiting for prices to adjust via the free market. That means cutting back on things like expansions in the money supply and interest rate reductions.

Waiting Responses

Many economists believe that the best thing to do in the face of stagflation could be nothing. Stagflation can sometimes correct over time and interventions to try to end it could lead to recessions with dramatic declines in GDP.

Hedging Against Inflation

Investors worried about the impact of stagflation on their portfolios might want to shift their investment strategy or decide to remain in blue chip stocks in staple industries with steady earnings that are likely to weather stagflation or recover quickly.

There are other ways that investors can hedge the risk of inflation, including investing in funds that are designed specifically to navigate periods of high inflation. As is the case in any market or economic environment, long-term investors are wise to maintain diversification and to continue dollar-cost averaging and periodic portfolio rebalancing.

Bottom Line

Economists have long struggled to understand what causes stagflation and how best to intervene when it happens. While there are many theories, they are heavily contested. Stagflation is a challenging problem to face, making it difficult for central banks and policymakers to respond effectively.

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