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Stagflation Returns

The years 2021 and 2022 were marked in the economic arena by concern regarding inflation. Much of the debate concerning the economy, both in mass media and in more specialized circles, eventually leads to the issue of rising prices. This is hardly surprising if we consider that, based on International Monetary Fund data, global inflation was 4.7 percent in 2021, with a forecast of 8.8 percent for 2022. In the ensuing years, 2023 and 2024, it is expected to start gradually slowing with rates of 6.5 and 4.1 percent respectively.[1]

Mexico has followed the global tendency closely, and after ending 2021 with a 7.4 percent rate, forecasts for 2022 and 2023 were 8.5 and 4.8 percent respectively. Although in the United States the figures are less alarming, we cannot say that the country has no problem. After reporting 5.2 percent inflation at the end of 2021, in 2022 and 2023 the general price index is expected to rise by 7.0 and 3.2 percent respectively.

This situation follows twenty years of low inflation, oscillating between 3 and 4 percent for Mexico and 1 and 2 percent for the United States. Concern regarding the sudden spike in general price indices is natural considering its negative effects. In general terms, cost of living increases affect those whose income is no longer sufficient to acquire the same quantity of goods and services as before, and the hardest hit are those in the lowest income brackets. Although wages do tend to rise under conditions of high inflation, they usually rise less than —and only after— prices. A family will have to absorb higher prices until wages catch up; however, because wage hikes come later, they are often offset by even higher prices, and although wages follow price increases, they rarely match them.

Furthermore, generalized price increases do not happen in a vacuum, and global growth forecasts are far from promising. Whereas the economy grew at a rate of 6 per-

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cent in 2021, expectations for 2022 and 2023 were 3.2 and 2.7 percent. For Mexico and the United States, the outlook is even gloomier. Real GDP growth in the United States was 5.7 percent in 2021, but forecasts for 2022 and 2023 were 1.6 and 1.0 percent. For its part, the Mexican economy grew 4.8 percent in 2021, but slowed to only 2.1 percent in 2022 with forecasts calling for 1.2 percent this year. We are facing what economists call stagflation or stagnation with inflation.

This is uncommon, but not unheard of. In the 1970s, stagflation affected many Western economies with substantial impact beyond the purely economic. The inability to explain this phenomenon presented an insuperable challenge to Keynesian theory, which at the time was dominant both in schools of economics and among government economic policymakers. It was also accompanied by a watershed crisis in the structure of Western economies and opened the door to the implementation of neoliberal policies.

Theoretically, the difficulty in explaining stagflation lies in the explanation of price increases. Conventional economic theory says that the price of an item is determined by supply and demand, so that when demand increases the price will rise. An increase in demand is normally associated with economic growth. Growing demand stimulates production, because producers will expect to place their products in the market more easily. On the other hand, growth in demand would have to have been caused by an increase in people's income, which would be understandable only in an environment of growth in production. If sales are driving growth in production, producers will be willing to pay higher wages; this will raise workers' incomes, which in turn will cause demand and prices to rise.

This is how traditional economic theory explains the relationship between economic growth and rising prices, which is why stagflation is such a peculiar phenomenon. Why do prices rise at a time of low growth rates? In the 1970s, the monetarist theory of Milton Friedman sought to answer this question by affirming that stagflation can be explained by central banks' increasing the money supply. Friedman claimed that increases in the amount of money in circulation created an increase in demand due

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to a “monetary illusion.” People perceived that their income levels had risen due to the greater amount of money in circulation; however, this was true only in the short term. After a time, the increased amount of money would spread throughout the economy, causing rising demand, which would be resolved by raising the general level of prices. Rising income is confirmed as an illusion when prices have risen; with the new prices, what consumers can really acquire with their real income is exactly the same as before. This explains why prices rise while production remains stagnant.[2]

Nevertheless, beyond the debate regarding the suitability of Friedman’s theory to explain the stagflation of the 1970s, in my view these ideas do not help explain what we are seeing today. We need to question the impact of increases in the money supply on prices. Over the last ten years, in response to the 2007-2008 crisis, the amount of money in circulation in the United States, measured by money supply, increased practically threefold; inflation, however, appeared only recently, long after the possible impact on demand of the amount of money.

To find the answer to present-day stagflation, we need to consider three factors: difficulties affecting production during the pandemic, the power of monopolies, and policies seeking to control inflation. One of the pandemic’s many negative effects was to disrupt global production chains. The normal process of production of goods –in which different parts are made in different places and assembled somewhere else to obtain a product that often will be sold in yet another market– was interrupted. With borders closing, it was no longer possible to continue producing this kind of goods. Although the restrictions were gradually lifted, reopening has not been generalized. While in some countries production rates recovered rapidly, in others the return to normalcy took longer. This created bottlenecks that drove up the cost of goods. These problems have been compounded by the armed conflict in Ukraine, which has exacerbated difficulties in global trade and access to many products, further increasing the cost of goods.

In addition, we need to consider the power of oligopolies and their response to the effects of the pandemic. Taking this factor into account forces us to rethink our explanation of price determination. In a concentrated market, where a small number of companies control the supply of goods, producers/vendors have the power to determine prices independently of demand. This characterizes many of today’s economies. On this basis, rising prices can be explained by the decision of oligopolies to maximize their profits in response to losses they absorbed in the months of lockdowns, when sales fell considerably.

Thus, we find that the increase in prices starting in 2021 can be explained by a combination of two factors: increased costs due to greater difficulty in producing and the response by oligopolies that are trying to recoup losses from the pandemic; but how does this explain stagnation? In my view, the answer lies in policies used to control inflation.

Central banks tend to operate on the assumption that inflation is caused by growing demand (the explanation given above). This means that, from their perspective, the most effective way to contain rising prices is to slow the growth rate of demand; they achieve this by raising interest rates, which increases the cost of financing loans. Because companies operate in part with borrowed money, more costly credit will make them choose to produce less, which will reduce production, demand, and, by extension, prices. The implementation of this kind of policies starting in late 2021 has had a negative impact on the economy. Production has fallen as an effect of central bank policies; however, prices have not stopped rising. In fact, the same price control policy, in addition to causing stagnation, may cause prices to increase even more. The interest rate represents a cost for companies and families, and when it rises can drive prices up even more.

The outlook for the future of economies is not optimistic. At the same time that we are facing the negative effects of rising prices on consumers, we are anticipating meagre economic growth. Low economic growth is accompanied by low employment levels. Not only must people face a rising cost of living, but they also must do so in a climate of uncertainty regarding their employment status. It is essential to reconsider our answers to inflationary problems, with a focus on assuring people’s standard of living, especially that of society’s most vulnerable sectors. VM

Notes

1 International Monetary Fund, “World Economic Outlook: Countering the Cost-of-Living Crisis,” October 11, 2022, https://www.imf.org/en/Publications/WEO/Issues/2022/10/11/world-economic-outlook-october-2022.

2 Milton Friedman, “Nobel Lecture: Inflation and Unemployment,” *Journal of Political Economy*, vol. 85, no. 3, 1977, pp. 451-472.