

# [Comment] Are we returning to 1970s stagflation?

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EUOBSERVER / COMMENT - Economists and financial journalists, like financial markets, are notoriously prone to the herd instinct - to following the leader regardless of where the herd is headed.

The orthodox flavour of the month is that Britain and the major Eurozone economies are headed for 1970s-style stagflation, a bleak combination of low growth and high inflation. Of these two evils, inflation is proclaimed to be the worse. Fix inflation and growth will follow is the current mantra of the professionals.

In consequence, the Bank of England (BoE) head, Mervyn King, has refused to cut interest rates despite the credit crunch induced collapse of the housing market. In Frankfurt, Monsieur Trichet has hinted that the ECB might actually tighten its monetary stance.

The view that Europe should give precedence to the fight against inflation is not only wrong but it could prove deeply dangerous.

A few financial journalists have even warned that unless monetary policy is tightened, we could experience hyperinflation. Such people need reminding that hyperinflation means a rate of price-level increase of 'over 100% per annum'. Three points are important in this respect. First, in the 1970s, no European country experienced anything approaching hyperinflation: true, the large European economies went from single digit to double digit inflation for some years but, at its height, inflation reached 35% in Britain (1975), 20% in Italy (1977) while in Germany in no year did it reach 10%.

Secondly, today's inflation is mainly imported through higher fuel and food prices. In the 1970s, the main European economies had stronger industrial sectors and better organised workers than is the case today. Workers' militancy meant that imported inflation could readily be turned into wage-push domestic inflation.

Today's situation is quite different; in Britain, for example, the share of manufacturing in GDP has fallen from above 40% in the 1970s to about 13% today, while trade union membership has fallen from 13 to 7 million. This decline mirrors falling union membership throughout the EU over the past 20 years. More and more workers are employed in the low-wage service sector, or else are part-time or self-employed. In short, the structural features facilitating double digit inflation thirty years ago have all but disappeared today.

## **Two minority groups suffer**

Headline inflation (which includes food and other seasonally fluctuating prices) is currently running at around 3-3.5% in the large European countries. This is no higher than the average

experienced in the post-war boom years. What is all the fuss about and why should we be worried if inflation runs at over 2% per year?

The answer is that two minority groups suffer: fixed income earners---pensioners and the like who could in principle be compensated though tax breaks--- and, critically, the financial sector. One major group gains: residential and other mortgage holders. The latter gains because mild inflation erodes the cost of their main liability. But bankers lose because mortgages and other fixed interest securities are assets: inflation eats into the profits of the financial sector.

And here is the key point. Mild inflation (as opposed to double digit inflation) favours the majority of citizens (including many small businessmen who are in debt to banks). It also helps oil the wheels of the labour market by helping maintain real wage differentials between low- and high-productivity wage earners. But because mild inflation erodes financial sector profits---and because the financial sector has become increasingly important and politically vocal in the advanced economies---mild inflation is decried as an enemy which must be fought and defeated. It is no accident that inflation targeting as espoused by neo-liberal monetarists has become the orthodoxy of the financial world and of so many financial journalists.

Why is such orthodoxy positively dangerous in today's climate? Tightening monetary policy at a time when the housing bubble has burst in the US, Britain and Spain makes a deep and prolonged period of EU stagnation more likely. After the stock market bubble burst at the turn of the new century, the US Federal Reserve cut interest rates drastically and adopted fiscal stimuli (the right medicine) while the ECB under Wim Duisenberg sat on its hands and did nothing. In consequence, by 2003, Germany France and Italy went into technical recession and some even warned against the danger of Japanese-style deflation (ie, falling prices).

### **Excessive anti-inflationary zeal**

Today, the US housing market has gone into freefall and consumer and investment demand are contracting. A US recession is imminent; given the size of the US trade deficit, such a recession could be greatly compounded by a further serious fall in the dollar. Such a recession in the US--- and few economists doubt its likelihood---will inevitably spill over into Europe; the OECD has already revised its growth projections for 2008/9 downward and will probably need to do so further. In short, the outlook today is considerably darker than it was in 2001.

To make matters worse, in 2001 the US was running a budgetary surplus and could afford to loosen the fiscal reins; today, the room for fiscal manoeuvre is far more limited. In Britain, Brown's 'golden rule' is in tatters. The Eurozone continues to call for fiscal restraint at member-state level; at supranational level, the Eurozone has failed to create the basis for counter-cyclical fiscal policy by insisting that the annual budget balance. Eurozone governance is seriously flawed.

In sum, given these dire trends, it is highly unlikely that we shall witness a repeat of stagnation with double-digit inflation (stagflation). What is more likely is stagnation with low inflation. The worst possible scenario for the EU is that excessive anti-inflationary zeal will lead to Japanese style deflation lasting a decade or more.

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