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The Emerging Global Stagflation: A Different Malaise from the 1970s[1]

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The sharp jump in the prices of food, energy and commodities in 2008 inevitably brings back haunting memories of the 1973 OPEC price shock and the 1972-75 generalized commodity boom that were followed by a protracted period of stagflation. Is history repeating itself?

If what is happening in 2008 is the same as in the 1970s, then we are in luck because so many excellent post-mortems have been done on the earlier crisis episode that we now know enough to ensure a much happier ending. However, such optimism would be misplaced because this would be akin to generals always preparing to re-fight the last war. The causes of the present burst in global inflation are sufficiently different from the past that the world has to be more imaginative and use new policy recipes.

The subprime crisis, the surge in commodity prices, the rise in core inflation, and the slowing of the US economy are of course related but there is no silver bullet for the policymaker to use because they were not generated by one dominant variable. These developments were produced by the interaction among several independent trends (e.g. economic globalization, Asia's emergence as a major economic power), inappropriate economic management and the ever-present human elements of hubris, fear and greed. In short, there is enough blame to go around and no one ingredient by itself would have been capable of producing the soup that the world is wading (but not yet sinking) in.

Unlike the 1970s, we cannot blame negative supply shocks like El Nino and OPEC for the mess. Ironically, we have been done in by positive supply shocks. Economic globalization accelerated sharply beginning in 1990 with the unwinding of the Soviet empire in January 1990, the retreat by India from stifling state regulation and near autarky in December 1991, and the start of the rush toward capitalism in China in February 1992. The productive capacity of the global economy was therefore greatly increased by this integration of the underemployed labor force in these countries; exemplified by cheap manufactured goods from China and migration of Eastern European workers to Western Europe.

Also beginning in the early 1990s, the pace of technological progress accelerated, especially on the information and communication technology (ICT) front, greatly increasing the productivity of the global economy. In many cases, the technological innovations enhanced economic globalization. For example, the ICT revolution has greatly expanded the trade in services: setting up various types of call centers (like trouble-shooting software problems, and booking air tickets) abroad, and the outsourcing of X-ray image reading and the preparation of business accounts. There were also substantial technological breakthroughs in transportation, manufacturing processes, and medical procedures that lowered costs in these sectors.

The New Thinking on Monetary Policy and Financial Supervision

Optimism was the natural outcome of these positive supply-side developments, but it was allowed to morph into irrational exuberance by a monetary policy that was based on the new fad of inflation-targeting. Despite the low US interest rates, credit did not seem loose when examined from the narrow prism of CPI inflation because the excess credit was pushing up the prices of items not included in the CPI, notably, financial assets and real estate.

When the dot-com bubble inevitably exhausted itself in March 2000, the Nasdaq Composite Index fell from nearly 5,000 to less than 2000 in 2001, the concern for potentially contractionary consequences led to a further lowering of interest rates. The froth from the NASDAQ market was thence transferred and added on to those in the other asset markets.

To be fair, the complacency of the Federal Reserve (Fed) toward asset bubbles and the lone obsession with the movements of consumer prices were widely shared by other major central banks and by the economics profession. Over the years, the central banking community and the economics discipline had become increasingly infatuated with the self-correcting powers of enlightened self-interest as evidenced by the ever-growing academic paeans to the efficiency of the financial markets. The fact that some of the leading exponents of financial engineering (based on the assumption of financial market efficiency) were awarded the Nobel Prize lent confidence to the Panglossian view of financial markets.

The unintended but inexorable consequence of this faith in the collective judgment of the millions of investors, who (thanks to the internet) are constantly incorporating the latest news into their assessments of asset prices and acting on them, was that prudential supervision by the financial authorities lagged behind the development of new financial instruments. The fact that the financial industry could afford effective lobbying in Congress certainly helped to enshrine the view that self-policing was adequate, a view that is particularly soothing when it is pointed out that more regulation could result in loss of competitiveness to foreign stock markets. Hedge funds proliferated, the securitization of mortgages and derivatives of various sorts sprung up, and the subprime mortgage market boomed.

Greed, Hubris and Fear

The lapse of stock market sentiments into occasional bouts of exuberance and melancholia is such a well-documented historical phenomenon that Paul Volcker had described this unstable trait as "built into the human genome." We would add, in the same vein, that greed is built into the institutional genome of the financial markets. When mortgage lenders could easily unload their loans in the secondary market, they faced reduced incentive to conduct thorough background checks and prudent financial evaluations of their clients. The gatekeeper function of the bond-rating agencies was compromised by the incentive to boost earnings by advising issuers on how to bundle loans to attain the maximum rating that was just barely consistent with the wording of the rating guidelines. The upshot, as Ben Bernanke concluded, was that "far too much of the lending in recent years was neither responsible nor prudent."

The Fed's decision to adopt a narrow definition of price stability to guide credit policy, and the regulators' belief in the self-corrective powers of financial markets reflect another evergreen human element, hubris. When official hubris meets private greed in a setting characterized by occasional sizable mood swings, the outcome is an accident in the making.

The first crash occurred in 1998 when the Fed organized a bailout of the Long-Term Capital Management (LTCM) after it suffered major losses from the financial panic that ensued following the default by the Russian government on its bonds. Clearly, this action by the Federal Reserve reflected its opinion that LTCM was too big to fail, a failure that could cause a 1929-style chain reaction in the financial sector culminating in severe production dislocation in the real sector. This was one risk that any Fed Board would want to minimize, and the incentive to preserve reputation in a setting that is not profit-maximizing would bias any assessment of this risk towards extraneous pre-emptive intervention.

The cost of preventing this meltdown risk, however, was the creation of the moral hazard that the biggest financial houses might thence become even more reckless in their speculations because of their faith in being rescued in some form by the government should their investments go awry. Another operational principle of the Federal Reserve in meeting its mandated role of "macroeconomic stabilizer" has now become transparent (in addition to its monetary policy of targeting the CPI inflation rate): the Fed would also intervene to keep major financial companies from collapsing. The commitment to this operational principle was confirmed on March 14, 2008 when the Federal Reserve responded to the subprime mortgage crisis by extending its role as the lender of last resort beyond the commercial banks to include investment banks as well.

The Broken System

While the Fed's judgment that an abrupt collapse of Bear Stearns would have caused large-scale financial panic and failure, and an economic destruction on the scale of the 1997-98 Asian Financial Crisis is likely to be correct, one cannot help wondering if this truly humongous subprime bubble was not partly encouraged by the earlier risk-averse policy reactions to the LTCM crisis and to the bursting of the dot-com bubble. The fact that the stock prices of the other investment banks leaped up considerably in the wake of the Bear Stearns rescue could only exacerbate moral hazard by solidifying investors' belief that the "too big to fail" mentality has indeed been entrenched in the Fed, just as it had been entrenched earlier in many central banks in East Asia (a condition oft-mislabeled "crony capitalism").

The contrast drawn by the astute financial market analyst, Henry Kaufman, between the increasing opacity of the actions of the financial institutions and the growing transparency of the intentions of the financial authorities captures, arguably, the most fundamental problem with the US financial system and its fragmented regulatory bodies. The fast proliferation of complicated financial derivatives and of hedge funds means that the amount and distribution of risk in the financial system is not sufficiently monitored by the regulatory agencies. The now transparent operational principle of saving the largest financial houses in crisis while exempting them from the regulations that apply to commercial banks is folly. The US international system (in fact, the global financial system) is an accident waiting to happen because of the outmoded prudential supervisory system in place.

It is instructive to point out that the economic fallout from a large financial collapse is not necessarily marked by falling goods prices as in Japan after its stock market meltdown in 1992, it could be marked by rising goods prices instead. The latter occurs when the central bank administers a large liquidity injection into the economy to reduce bank failures, housing foreclosures and consumer loan default. The usual outcome is a plunging exchange rate, an inflationary spurt that greatly reduces the real value of the bad loans, and a moderate drop in output. The liquidity injection is in effect the use of the inflation tax to pay off the bad loans; and its likely side effect is stagflation.

Given the excessive credit creation in the last fifteen years, the aggressive liquidity injection by the Fed in reaction to the subprime crisis, and the high commodity prices that will ensure higher consumer prices for some time, we think that a stagflation awaits the next president of the United States. The best response to this malaise, we will argue, will require not only new initiatives at home but also abroad.

Changing External Circumstances

One could make the plausible case that the global inflation of the 1970s was the result of US monetary expansion to build the Great Society and to fight the Vietnam War. The resulting US balance of payments deficits distributed this flood of liquidity around the globe, igniting the global inflation. Stagflation came because the OPEC price increases of 1973 and 1979 were large negative supply-side shocks.

It would be incorrect, however, to claim that the excessive credit expansion in the US over the last decade and a half bears primary responsibility for the present global inflation. First, the Bretton Woods exchange rate system is gone, and so there is no easy link between US monetary expansion and monetary expansion elsewhere. Second, almost all of the countries that continued to peg their currencies to the US$ (most of the time) have devised ways to achieve monetary independence. The recent housing bubbles in many countries and the commodity inflation have their roots in different independent causes in these countries.

Take the case of China for example. It is the claim of many China-watchers that the high money growth rates since 2003 were caused by the mounting balance of payments surpluses generated by pegging the Renminbi (RMB) at an undervalued level.[2] This simple-minded accounting approach is wrong because such a direct link is institutionally impossible. All Chinese banks are state-controlled and they face individually-set credit quotas, and since all their managers are career-maximizing rather than profit-maximizing, credit growth could not have stayed high

[2] We note that one could also say instead that the overly expansionary US monetary policy had rendered the pegged level to be undervalued.

without continual large upward adjustments of the credit quotas by the People's Bank of China (PBC).

The reason for the large upward adjustments of the credit quotas (until December 2007) is the exercise of political patronage by Hu Jintao, who became the head of the Chinese Communist Party in November 2002, to consolidate his position. The flood of investment loans was politically useful as long as CPI inflation was quiescent, which was the case until production bottlenecks started appearing in the last half of 2007. (A part of the newly-created liquidity flowed into the stock market and the housing market, creating record booms in 2006 and 2007.) With the end of the 17th Party Congress in November 2007, the Chinese government has been taking serious steps to slow the growth of aggregate demand (e.g. by raising interest rates and bank reserve requirements, and appreciating the RMB), and the first prominent casualty is share prices.

However, the Chinese fight against inflation has been made harder by two negative supply side shocks that began in summer 2007. The first has domestic origins: the summer flood and the winter storm reduced grain and vegetable production, and the blue-ear disease decimated the pig population. The second shock supply shock is external in origin: the swingeing rise in the prices of industrial commodities like crude oil, iron ore, and palm oil. If we now also factor in the growing recession in the United States, China is also headed for a stagflation, albeit of a milder version than the US.

The commodity inflation of 2007 and 2008 is the product of the accelerated pace of industrialization in Asia and Latin America in the 2000s. It cannot be attributed either to the actions of commodity cartels or to just China's growing imports of commodities. The commodity inflation is a supply-side shock to the importers of primary commodities e.g. US and Japan. As commodities are inputs, high CPI inflation will continue for a while because it takes time for the higher input prices to pass entirely through the production chain to be fully incorporated into consumer prices.

The U.S. Policy Agenda Going Forward

The following six items should be on the US policy agenda to address the causes of the emerging global stagflation.

First, given both the destructive potential of a financial crisis and the frequent use of public money to save failed financial houses, the financial system has to be better regulated to prevent financial failures, whose frequent byproduct is stagflation. The U.S. should consolidate the regulation of the entire financial system within a new financial market regulator. To use Henry Kaufman's terms, instead of passively regarding the biggest financial institutions to be "too big to fail", this new market regulator should actively improve the prudential supervisory techniques to render the biggest financial institutions to be "too good to fail." The U.S. must jettison the practice where the profits of the biggest financial houses are privatized but their losses socialized.

Second, given the growing and tightening of economic linkages among countries, and the real possibility of a race to the bottom in financial regulation, the next president should quickly engage the European Union (EU) and Japan in raising and harmonizing the regulatory standards in their financial markets.

Third, the present US financial agencies are geared toward preventing financial contagion within US borders, and are grossly inadequate for limiting international contagion. The IMF has at best a mediocre record in handling international contagion, and its present governance structure does not give it the legitimacy to coordinate the concerns of the global community on this matter. The next US President should call for an international conference (possibly, under UN auspices) to design an international financial architecture that is appropriate for present circumstances.

Fourth, the Federal Reserve should become a more specialized agency. It should focus on its monetary policy role and give up its regulatory role. The Fed must refine its inflation target to include asset price inflation. It was famously said by a former Fed chairman that a competent central banker is someone who takes away the punch bowl just as the party gets going. Right now, the Fed is ascertaining the mood swing in the party by staring at only one specific corner of the room, which is clearly not the optimum way to identify the tipping point of the mood within the room.

Fifth, in the short-run when output is limited by existing production capacity, the higher prices of commodities mean that the net real national income of a commodity-importing country, e.g. US and EU, has to fall via lower wages and reduced profits until capital accumulation and technological improvements have raised income enough to cover the additional payments to the commodity exporters. In this transition period, its is important to suspend any automatic indexing of wages to inflation in order to avoid a further squeeze on profits which would then slow down capital accumulation and prolong the transition phase (and keep unemployment higher). During this transition phase, the government must increase its welfare budget in order to ensure that the poor segments of society do not fall below the minimum living standard.

Sixth, Asia and Latin America will continue their convergence to the living standards of the OECD. The expected large rise in Asian and Latin American income really means an anticipated large increase in industrial production in these two regions, and a coming large rise in greenhouse gases. Given the rapidly growing global worry about climate change, a global CO2 ceiling is a very likely outcome in the medium run, and such a ceiling would be a much larger supply-side shock to the US (and the world) than the present high commodity prices, i.e. a worse stagflation would follow the present one![3]

The global climate change agenda is very important to the United States on many fronts beside the economic one. The development of clean energy is fundamental to addressing the problem. The next president should mobilize not only a domestic state-university-business coalition to work for a breakthrough in alternative energy but also an international scientific coalition to maximize the probability of an early breakthrough.

[3] The "good" news for the next president is that a global CO2 ceiling would probably not materialize within the next eight years.

Clearly, if the U.S. cannot achieve the international cooperation required for effective financial supervision to alleviate the present stagflation, it is highly improbable that the U.S. can achieve the international cooperation to prevent the worse stagflation created by climate change. The next president had better be a good consensus builder at home and abroad.