Stagflation [UPSC Economy Notes]

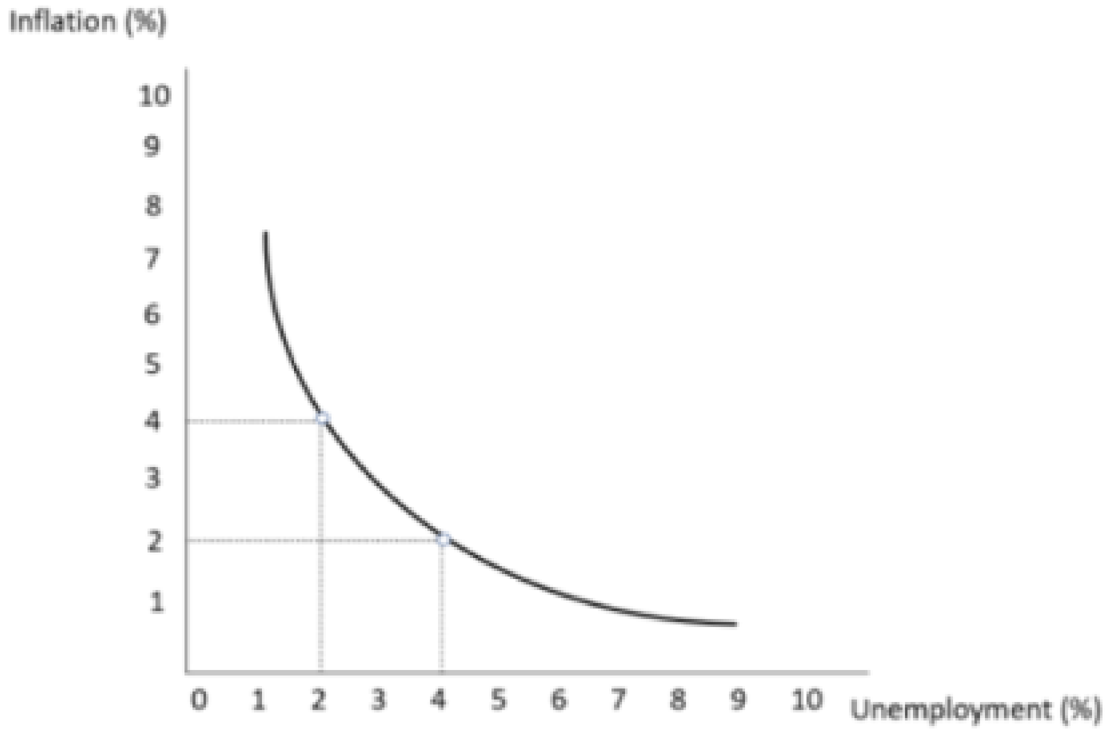
Stagflation is a term often seen in the news with respect to the economy. What is stagflation? How is it related to inflation? How does it affect the economy of a country? Get answers to all these questions in this article. This is an important topic for the UPSC economy section.

What is Stagflation?

Stagflation is an economic condition when stagnant economic growth, high unemployment, and high inflation combine together. Simply put, stagflation is a portmanteau of stagnant growth and rising inflation.

Peculiarity of Stagflation:

- Based on popular economic theories, typically, inflation rises when the economy is growing fast. This is because, with economic growth, people earn more and more money and have higher disposable incomes resulting in higher demand in the economy. This higher demand results in higher prices for the goods. Also when the economy stalls, inflation tends to dip as well as there is less money now chasing the same quantity of goods. Stagflation characterized by high inflation rates and low economic growth rate varies from this trend.
- Also, stagflation counters the economic theory of the Phillips Curve, which proposes an inverse relationship between inflation and unemployment. The theory claims that with economic growth comes inflation, which in turn should lead to more jobs and less unemployment and vice versa. Stagflation with a high inflation rate and a high unemployment rate goes against the Philips curve.



Philips Curve

What Causes Stagflation?

Although there is a lack of consensus among economists on the causes of stagflation, there are broadly two main theories: supply shock and poor economic policies.

Supply shock:

- As per the supply shock theory, stagflation occurs when an economy faces a sudden decrease in the supply of a commodity or service (supply shock), such as crude oil. In such a situation, prices surge, making production costlier and less profitable, thus slowing economic growth.

Poor economic policies:

- Stagflation can be a result of a poor economic policy of the government.
- The government can create a policy that harms industries (harsh regulation of markets, goods, and labour), while growing the money supply (expansionary monetary policy, printing currency to increase the money supply in the economy) too quickly. The simultaneous occurrence of these policies can lead to slower economic growth and higher inflation.

- Generally, stagflation occurs when the money supply is expanding while supply is being constrained. Simply put, when conflicting expansionary and contractionary policies occur, it can slow growth while creating inflation, leading to stagflation.

History of Stagflation

- In 1973, the Organization of Petroleum Exporting Countries (OPEC) decided to cut supply. This sent oil prices soaring across the world.
- The rise in oil prices constrained the productive capacity of most western economies that heavily depended on oil, thus hampering economic growth. This resulted in a decreased output of the industries dependent on these energy resources and thus contributing to a rise in unemployment. On the other hand, the oil price spike also led to inflation and commodities became more costly.
- The net result was lower growth, higher unemployment, and higher price level.

Stagflation Concerns in India

The COVID-19 pandemic and its impact on the Indian economy had raised fears of stagflation in India. The lockdowns during the pandemic resulted in a fall in economic growth and increasing unemployment even as the price of commodities increased due to supply constraints.

- However, some economists have ruled out stagflation in the Indian economy based on the following reasons.
- While the Indian economy contracted during the pandemic years, this would be only a temporary phenomenon and India is expected to grow faster in the coming years.
- Though retail inflation has been quite high, core inflation – that is inflation without taking into account food and fuel – is still benign. The spike in inflation rates is likely to flatten out in the coming months.

Concerns associated with stagflation:

Double pressure:

- With stalled economic growth, unemployment tends to rise and existing incomes do not rise fast enough and yet, people have to contend with rising inflation. So people find themselves pressurised from both sides as their purchasing power is reduced.

Difficulty in countering:

- Stagflation characterized by low economic growth rates and high inflation rates results in an unfavourable combination and can be a dilemma for governments since most actions designed to lower inflation may raise unemployment levels, and policies designed to decrease unemployment may worsen inflation.

Countering Stagflation

Though there is no definitive solution to stagflation, the consensus among economists is that productivity has to be increased to the point where it would lead to higher growth without additional inflation. This would then allow for the tightening of monetary policy to rein in the inflation component of stagflation.