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.

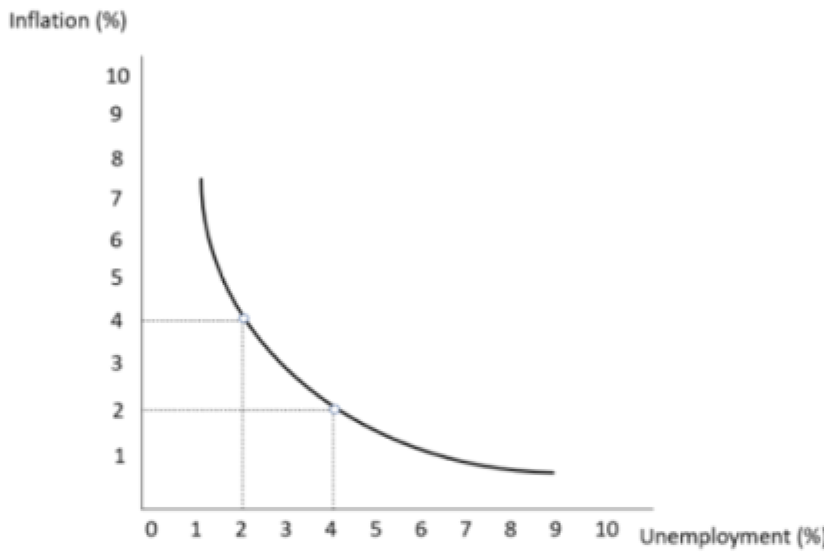
What is Stagflation?

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.

- Stagflation is a difficult economic condition to address because the traditional tools used to combat inflation, such as raising interest rates, may exacerbate the economic slowdown and increase unemployment. At the same time, policies that are designed to stimulate economic growth, such as increasing government spending or cutting taxes, may further fuel inflation.
- Stagflation was a significant economic challenge during the 1970s, particularly in the United States, as oil prices spiked and the country faced high inflation and high unemployment. Since then, the term has used to describe similar economic conditions in other countries and at other times.

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?

- **Supply shock:** A sudden disruption in the supply of critical resources, such as oil or food, can cause prices to rise while economic growth slows down. For example, a significant increase in oil prices can increase the cost of production and transportation, leading to higher prices for goods and services.
- **Cost-push inflation:** When businesses face higher costs of production, they may pass those costs on to consumers in the form of higher prices. This can lead to a spiral of rising prices and stagnant economic growth as consumers cut back on spending.
- **Demand-pull inflation:** A strong demand for goods and services can lead to higher prices, which can cause inflation. However, if the economy is unable to keep up with demand, it can result in stagnant growth and high inflation.
- **Structural issues:** Structural issues such as a lack of investment in infrastructure, inadequate education, and skills training, or inefficient government policies can hinder economic growth and lead to inflation.
- **Monetary policy:** In some cases, monetary policy can contribute to stagflation. For example, if a central bank maintains a loose monetary policy to stimulate economic growth, it can lead to inflation. However, if the economy is unable to grow, this can result in 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.

Why Stagflation is Bad

- **Reduced purchasing power:** Stagflation leads to a decrease in purchasing power as prices rise, but incomes do not. This means that individuals and businesses can buy fewer goods and services, which can lead to a decline in their standard of living.

- **Higher unemployment:** In many cases, stagflation leads to higher unemployment as businesses cut back on production and hiring in response to higher costs of production and decreased demand for their goods and services.
- **Economic instability:** Stagflation can cause economic instability as businesses struggle to adapt to the changing economic conditions. This can lead to bankruptcies, layoffs, and other negative consequences for individuals and communities.
- **Limited policy options:** Stagflation can limit the policy options available to governments and central banks. The traditional tools used to combat inflation, such as raising interest rates, can worsen the economic slowdown and increase unemployment. At the same time, policies that are designed to stimulate economic growth, such as increasing government spending or cutting taxes, may further fuel inflation.
- **Long-lasting effects:** Stagflation can have long-lasting effects on the economy, particularly if it is not addressed promptly. The longer stagflation persists, the more difficult it can be to reverse its effects and restore economic growth and stability.

Possible Steps to avoid Stagflation:

- **Targeted monetary policy:** Central banks can use targeted monetary policy tools, such as adjusting the money supply or interest rates, to address the specific causes of stagflation. For example, if stagflation is caused by supply-side factors, such as a disruption in the supply of critical resources, a central bank could adjust interest rates to reduce the demand for goods and services.
- **Fiscal stimulus:** Governments can use fiscal stimulus policies, such as increasing government spending or cutting taxes, to boost economic growth and create jobs. This can help to counteract the negative effects of stagflation.
- **Structural reforms:** Structural reforms aimed at improving the supply side of the economy, such as investing in infrastructure, education, and skills training, can help to increase productivity and reduce costs. This can lead to increased economic growth and help to reduce stagflation.
- **Price controls:** Governments can implement price controls to limit the rise in prices for critical goods and services, such as food and fuel. However, this approach can have unintended consequences, such as shortages and reduced quality.
- **Wage and price controls:** Governments can also use wage and price controls to limit the rise in wages and prices. However, this approach can lead to reduced productivity and supply, as well as increased black market activity.
- **Long-term planning:** Governments and businesses can engage in long-term planning to prepare for and mitigate the effects of stagflation. This can include investing in new technologies, diversifying supply chains, and developing new products and services.

Conclusion: We are living in a globalised world and hence stagflation presents a dangerous situation before the global economy. It has the potential to provoke political tension and stagnation of SDG achievement. Hence, it requires global cooperation to avoid this dangerous economic situation. However, as per the RBI report, India is in a better position than many competing economies and is likely to avoid stagflation as the rebound has gathered momentum.

Frequently Asked Questions about Stagflation

Q. What happens during a stagflation?

Ans: Stagflation is a term coined in the 1970s to refer to a combination of high inflation and high unemployment. Recent surveys show economists and fund managers see increased risks of stagflation on the horizon.

Q. What causes stagflation to occur?

Ans: Stagflation is an economic condition that's caused by a combination of slow economic growth, high unemployment, and rising prices. Stagflation occurred in the 1970s as a result of monetary and fiscal policies and an oil embargo.

Q. What is the difference between stagflation and inflation?

Ans: A recession is a normal part of an economic cycle and is painful as the economy slows and unemployment rises. But it historically lasts a year or so and isn't marked by inflated prices for everything. Stagflation is prolonged slow economic growth, with ongoing layoffs and high inflation.