

ECONOMY

We face the mother of all stagflation crises

BY NOURIEL ROUBINI

INFLATION IS BACK, AND IT IS RISING SHARPLY, ESPECIALLY over the past year, owing to a mix of both demand and supply factors. This rise in inflation may not be a short-term phenomenon: the Great Moderation of the past three decades may be over, and we may be entering a new era of Great Stagflationary Instability.

Unless you are middle-aged and gray-haired, you probably hadn't heard about the term *stagflation* until very recently. You may have barely heard about inflation. For a long time, until 2021, inflation—the increase in prices year to year—was below the advanced economies' central banks' target of 2%. Usually inflation is associated with high economic growth. When aggregate demand for goods, services, and labor is strong, coupled with positive animal spirits, optimism about the future, and possibly loose monetary and fiscal policies, you get stronger than potential economic growth and higher than target inflation. Firms are able to set higher prices because demand outstrips supply, and workers receive higher wages given a low unemployment rate. In recessions, on the other hand, you have low aggregate demand below the potential supply of goods, which leads to a slack in labor and goods markets, with ensuing low inflation or even deflation: prices go down as consumers' spending declines. *Stagflation* is a term that refers to high inflation that happens at the same time as stagnation of growth or outright recession.

But sometimes the shocks hitting the economy, rather than coming from changing demand, can come from the supply side: an oil-price shock, say, or a rise in food or other commodity prices. When that happens, energy and production costs rise, contributing to lower growth in countries that import that fuel or food. As a result, you can get a slowdown of growth, or even a recession, while inflation remains high. If the response to this negative supply shock is loose monetary and fiscal policy—banks setting low interest rates to encourage borrowing—to prevent the slowdown in growth, you feed the inflation flames by stimulating rather than cooling demand for goods and labor. Then you end up with persistent stagflation: a recession with high inflation.

IN THE 1970S we had a decade of stagflation as two negative oil shocks and the wrong policy response led to inflation and recession. The first shock was triggered by the oil embargo against the U.S. and the West following the 1973 October War between Israel and the Arab states. The second shock was triggered by the 1979 Islamic revolution in Iran. In both cases a spike in oil prices caused a spike in inflation and a recession in the oil-importing economies of the West. The inflation was fed by the policy response to the shock because central banks did not rapidly tighten and impose strong monetary and fiscal policy to contain the



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inflation. So we ended up with double-digit inflation and a severe recession that doomed the presidencies of Gerald Ford and Jimmy Carter. It took a painful double-dip recession in 1980 and again in 1981–1982 to break the back of inflation when Fed Chairman Paul Volcker raised the interest rates to double-digit levels.

Coming after the stagflation of the 1970s and early 1980s, the Great Moderation was characterized by low inflation in advanced economies; relatively stable and robust economic growth, with short and shallow recessions; low and falling bond yields (and thus positive returns on bonds), owing to the secular fall in inflation; and sharply rising values of risky assets such as U.S. and global equities.

This extended period of low inflation

is usually explained by central banks' move to credible inflation-targeting policies after the loose monetary policies of the 1970s, and governments' adherence to relatively conservative fiscal policies (with meaningful stimulus coming only during recessions). But more important than demand-side policies were the many positive supply shocks, which increased potential growth and reduced production costs, thus keeping inflation in check.

During the post–Cold War era of hyperglobalization, China, Russia, India, and other emerging-market economies became more integrated in the world economy, supplying it with low-cost goods, services, energy, and commodities. Large-scale migration from the poor Global South to the rich North kept a lid on wages in advanced economies;

technological innovations reduced the costs of producing many goods and services; and relative geopolitical stability after the fall of the Iron Curtain allowed for an efficient allocation of production to the least costly locations without worries about investment security.

The Great Moderation started to crack during the 2008 global financial crisis and then finally broke during the 2020 COVID-19 recession. In both cases there were severe recessions and financial stresses, but inflation initially remained low given demand shocks; thus, loose monetary, fiscal, and credit policies prevented deflation from setting in more persistently.

BUT THIS TIME it's different, as inflation has been rising since 2021, and many serious and important questions are now emerging and being debated by economists, policymakers, and investors. What is the nature of the current inflation? How persistent will it be? Is it driven by bad policies—loose monetary and fiscal policies—or bad negative aggregate supply shocks? Will the attempt of central banks to fight inflation lead to a soft landing or a hard landing? And if the latter, will this be a short and shallow recession or a more severe and protracted one? Will central banks remain committed to fight inflation, or will they blink and wimp out and cause persistent long-term inflation? Is the era of Great Moderation over? And what will be the market consequence of a return to inflation and stagflation?

First question: Will the rise in inflation in most advanced economies be temporary or more persistent? This debate has raged for the past year, but now it is largely settled: “Team Persistent” won, and “Team Transitory”—which included most central banks and fiscal authorities—has now admitted to having been mistaken.

The second question is whether the increase in inflation was driven more by bad policies (i.e., excessive aggregate demand because of excessively loose monetary, credit, and fiscal policies), or by bad luck (stagflationary negative aggregate supply shocks including the initial COVID-19 lockdowns, supply-chain bottlenecks, a reduced U.S. labor supply, the

impact of Russia's war in Ukraine on commodity prices, and China's zero-COVID policy). While both demand and supply factors were in the mix, it is now widely recognized that supply factors have played an increasingly decisive role. This matters because supply-driven inflation is stagflationary and thus increases the risk of a hard landing (increased unemployment and potentially a recession) when monetary policy is tightened.

That leads directly to the third question: Will monetary-policy tightening by the U.S. Federal Reserve and other major central banks bring a hard landing (recession) or a soft landing (growth slowdown without a recession)? Until recently, most central banks and most of Wall Street were in “Team Soft Landing.” But the consensus has rapidly shifted, with even Fed Chair Jerome Powell recognizing that a recession is possible and that a soft landing will be “very challenging.”

A model used by the Federal Reserve Bank of New York shows a high probability of a hard landing, and the Bank of England has expressed similar views. Several prominent Wall Street institutions have now decided that a recession is their baseline scenario (the most likely outcome if all other variables are held constant). Indeed, in the past 60 years of U.S. history, whenever inflation has been above 5%—it is now above 8%—and the unemployment rate below 5%—it is now 3.7%—any attempt by the Fed to bring inflation down to target has caused a hard landing. So, unfortunately, a hard landing is much more likely than a soft landing in the U.S. and most other advanced economies.

THE FOURTH QUESTION: Are we in a recession already? In both the U.S. and Europe, forward-looking indicators of economic activity and business and consumer confidence are heading sharply south. The U.S. has already had two consecutive quarters of negative economic growth in the first half of this year, but job creation was robust, so we weren't yet in a formal recession. But now the labor market is softening, and thus a recession is likely by year's end in the U.S. and other advanced economies.

Now that a hard landing is becoming a

ILLUSTRATION BY PETE RYAN FOR TIME

baseline for more analysts, a new fourth question is emerging: Will the coming recession be mild and short-lived, or will it be more severe and characterized by deep financial distress? Most of those who have come late and grudgingly to the hard-landing baseline still contend that any recession will be shallow and brief. They argue that today’s financial imbalances are not as severe as those in the run-up to the 2008 global financial crisis, and that the risk of a recession with a severe debt and financial crisis is therefore low. But this view is dangerously naive.

THERE IS AMPLE REASON to believe the next recession will be marked by a severe stagflationary debt crisis. As a share of global GDP, private and public debt levels are much higher today than in the past, having risen from 200% in 1999 to 350% today. Under these conditions, rapid normalization of monetary policy and rising interest rates will drive highly leveraged households, companies, financial institutions, and governments into bankruptcy and default.

When confronting stagflationary shocks, a central bank must tighten its policy stance even as the economy heads toward a recession. The situation today is thus fundamentally different from the global financial crisis or the early months of the pandemic, when central banks could ease monetary policy aggressively in response to falling aggregate demand and deflationary pressure. The space for fiscal expansion will also be more limited this time, and public debts are becoming unsustainable.

Moreover, because today’s higher inflation is a global phenomenon, most central banks are tightening at the same time, thereby increasing the probability of a synchronized global recession. This tightening is already having an effect: bubbles are deflating everywhere—including in public and private equity, real estate, housing, meme stocks, crypto, SPACs, bonds, and credit instruments. Real and financial wealth is falling, and debt and debt-servicing ratios are rising.

Thus, the next crisis will not be like its predecessors. In the 1970s, we had stagflation but no massive debt crises, because debt levels were low. After

2008, we had a debt crisis followed by low inflation or deflation, because the credit crunch had generated a negative demand shock. Today, we face supply shocks in a context of much higher debt levels, implying that we are heading for a combination of 1970s-style stagflation and 2008-style debt crises—that is, a stagflationary debt crisis.

The fifth question is whether a hard landing would weaken central banks’ hawkish resolve on inflation. If they stop their policy tightening once a hard landing becomes likely, we can expect a persistent rise in inflation and either economic overheating (above-target inflation and above-potential growth) or stagflation (above-target inflation and a recession), depending on whether demand shocks or supply shocks are dominant.

Indeed, while currently the debate is on soft vs. hard landing and how severe the hard landing will be, that assumes that central banks that are now talking hawkishly will stick to their commitment to return to 2% regardless of whether that policy response leads to a soft or hard landing. Most market analysts seem to think that central banks will remain hawkish, but I am not so sure. There is a chance that central banks will wimp out and blink, and not be willing to fight inflation. In this case the Great Moderation of the past 30 years may be over, and we may enter a new era of Great Inflationary/Stagflationary Instability fed by negative supply shocks and policymakers—as in the 1970s—being unwilling to fight the rising inflation.

On the demand side, loose and unconventional monetary, fiscal, and credit policies have become not a bug but rather a feature. Between today’s surging stocks of private and public debts (as a share of GDP) and the huge unfunded liabilities of pay-as-you-go social-security and health systems, both the private and public sectors face

growing financial risks. Central banks are thus locked in a “debt trap”: any attempt to normalize monetary policy will cause debt-servicing burdens to spike, leading to massive insolvencies and cascading financial crises.

With governments unable to reduce high debts and deficits by spending less or raising revenues, those that can borrow in their own currency will increasingly resort to the “inflation tax”: relying on unexpected price growth to wipe out long-term nominal liabilities at fixed rates.

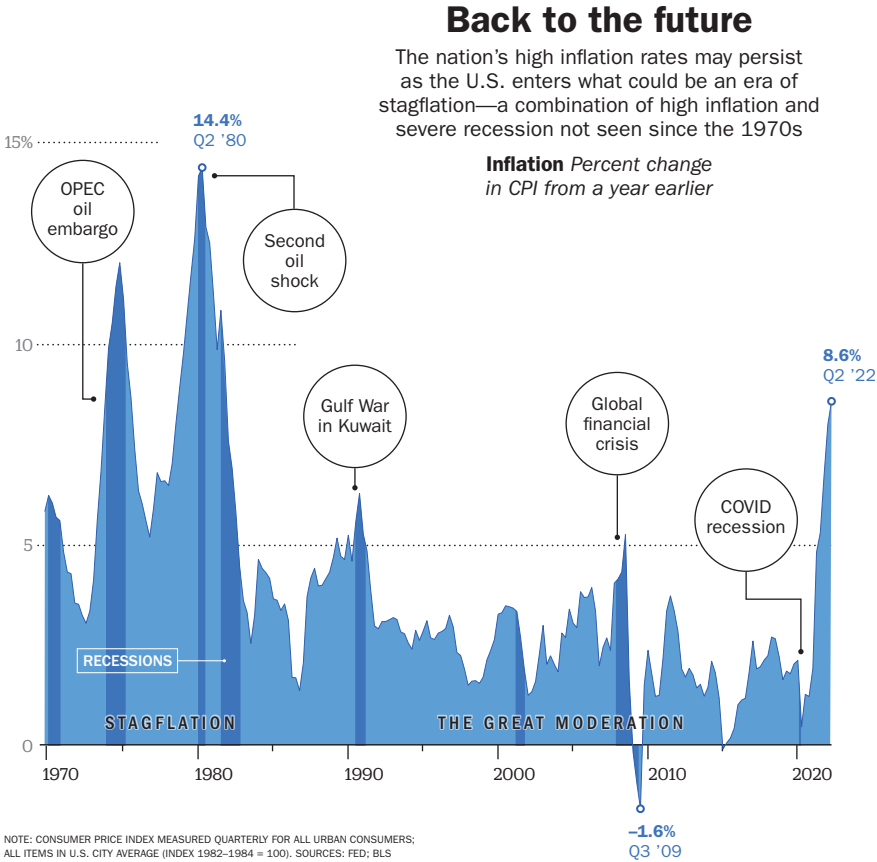
Early signs of wimping out are already discernible in the U.K. Faced with the market reaction to the new government’s reckless fiscal stimulus, the Bank of England has launched an emergency quantitative-easing (QE) program to buy up government bonds (the yields on which have spiked).

Monetary policy is increasingly subject to fiscal capture. Central banks will talk tough, but there is good reason to doubt their willingness to do whatever it takes to return inflation to its target rate in a world of excessive debt with risks of an economic and financial crash.

On the supply side, the backlash against hyperglobalization has been gaining momentum, creating opportunities for populist, nativist, and protectionist politicians. Public anger over stark income and wealth inequalities also has been building, leading to more policies to support workers and the “left behind.” However well intentioned, these policies are now contributing to a dangerous spiral of wage-price inflation.

Making matters worse, renewed protectionism (from both the left and the right) has restricted trade and the movement of capital. Political tensions, both within and between countries, are driving a process of reshoring. Political resistance to immigration has curtailed the global movement of people, putting additional upward pressure on wages. National-security and strategic considerations have further restricted flows of technology, data, and information.

This balkanization of the global economy is deeply stagflationary, and it is coinciding with demographic aging, not just in developed countries



but also in large emerging economies such as China. Because young people tend to produce and save, whereas older people spend down their savings, this trend also is stagflationary.

The same is true of today’s geopolitical turmoil. Russia’s war in Ukraine, and the West’s response to it, has disrupted the trade of energy, food, fertilizers, industrial metals, and other commodities. The Western decoupling from China is accelerating across all dimensions of trade (goods, services, capital, labor, technology, data, and information). Other strategic rivals to the West may soon add to the havoc. Iran’s crossing the nuclear-weapons threshold would likely provoke military strikes by Israel or even the U.S., triggering a massive oil shock.

Now that the U.S. dollar has been fully weaponized for strategic and national-security purposes, its position as the main global reserve currency may begin to decline, and a weaker dollar would of course add to the

inflationary pressures. A frictionless world trading system requires a frictionless financial system. But sweeping primary and secondary sanctions against Russia have thrown sand into this well-oiled machine, massively increasing the transaction costs of trade.

On top of it all, climate change, too, is stagflationary. Droughts, heat waves, hurricanes, and other disasters are increasingly disrupting economic activity and threatening harvests (thus driving up food prices). At the same time, demands for decarbonization have led to underinvestment in fossil-fuel capacity before investment in renewables has reached the point where they can make up the difference. Today’s large energy-price spikes were inevitable.

Pandemics will also be a persistent threat, lending further momentum to protectionist policies as countries rush to hoard critical supplies of food, medicines, and other essential goods. After 2½ years of COVID-19, we now have monkeypox.

Finally, cyberwarfare remains an underappreciated threat to economic activity and even public safety. Firms and governments will either face more stagflationary disruptions to production, or they will have to spend a fortune on cybersecurity. Either way, costs will rise.

Thus, as in the 1970s, persistent and repeated negative supply shocks will combine with loose monetary, fiscal, and credit policies to produce stagflation. Moreover, high debt ratios will create the conditions for stagflationary debt crises; i.e., the worst of the 1970s and the worst of the post-global-financial-crisis period.

THAT LEADS to a final question: How will financial markets and asset prices—equities and bonds—perform in an era of rising inflation and return to stagflation? It is likely that both components of any traditional asset portfolio—long-term bonds and U.S. and global equities—will suffer, potentially incurring massive losses. Losses will occur on bond portfolios, as rising inflation increases bond yields and reduces their prices. And inflation is also bad for equities, as rising interest rates hurt the valuation of firms’ stock. By 1982, at the peak of the stagflation decade, the price-to-earning ratio of S&P 500 firms was down to 8; today it is closer to 20. The risk today is a protracted and more severe bear market. Indeed, for the first time in decades, a 60/40 portfolio of equities and bonds has suffered massive losses in 2022, as bond yields have surged while equities have gone into a bear market. Investors need to find assets that will hedge them against inflation, political and geopolitical risks, and environmental damage: these include short-term government bonds and inflation-indexed bonds, gold and other precious metals, and real estate that is resilient to environmental damage.

The decade ahead may well be a Stagflationary Debt Crisis the likes of which we’ve never seen before.

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Investors need to find assets that will hedge them against inflation