Up, up and away

by the St. Louis Post-Dispatch

Along with disco music, bushy sideburns, angry ayatollahs and other things we'd just as soon forget, the 1970s brought us a new word: stagflation.

Stagflation describes a miserable combination of economic stagnation and inflation. Now, thanks to some scary headlines in the financial press, the word is making a comeback.

Consumer prices jumped 4.1 percent last year, the biggest jump in 16 years. The economy began wheezing and sputtering. Gross domestic product grew at a barely-visible 0.6 percent rate in the fourth quarter. Job creation is down, and gasoline prices are up. Does all that mean the '70s are coming back?

Hardly. Inflation is nowhere near the double-digit levels of the disco years, and chances are that it soon will be headed down, not up. Still, a little deja vu is probably helpful at the moment, if only to remind banks and businesses what's at stake. The financial markets, stung by the credit crisis, are crying for the Federal Reserve to further lower interest rates to stimulate the economy. Fed Chairman Ben Bernanke on Wednesday indicated that he's in a mood to comply. He's already cut rates several times since summer.

But the Fed must make sure that in encouraging spending, it also keeps prices under control. The word "stagflation" reminds us of what can happen when the government ignores inflation.

That's what happened in the 1970s. The guns-and-butter federal policies of the Vietnam War years started inflation rising and the Fed let it happen. Then came the oil shocks, pushing prices up while stalling economic growth. An inflation psychology took hold, with wages racing to keep up with prices and vice versa.

It took the severe recessions of the early 1980s - the worst since the Great Depression - to finally get inflation under control. Unemployment hit 10.8 percent. No one wants to go through that again.

Oil prices play half the role in the U.S. economy that they did in the 1970s. Still, oil and food prices account for the bulk of recent inflation. Lately, there have been signs that other prices are rising as well, and that's worrisome. Core inflation, a measure that excludes food and energy, is running at a 10-month high, up 2.5 percent over the past year.

Right now, the Fed is betting that the slowing economy will bring inflation back to earth. After all, it's hard to raise prices when jobs are getting scarce and credit is hard to come by. So the Fed is busy cutting interest rates to head off a recession.

"In the short run, you've got to pay attention to the predominant factor, and that's the downturn in the economy," says Jack Strauss, economist and director of the St. Louis University's Simon Center for Regional Forecasting. "I wouldn't worry about inflation at the moment."

That moment could pass quickly. Some economists, including former Fed Chairman Alan Greenspan, think the inflation battle could be tougher in the future. Some unique factors - such as the explosion of cheap imports from China - helped keep American prices down over the past few years. Now those trends are leveling off.

If inflation doesn't ease as expected over the next few months, the Fed will have to do something about it. The memory of stagflation will haunt the moment. If the choice is between a mild recession and rebounding inflation, recession is the lesser evil.

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