Inflation: are we going back to the 1970s?

For several months now, fears of stagflation (a period of high inflation without economic growth) have resurfaced, similar to the situation we experienced in the 1970s. But is this fear credible?

The 1970s were marked by an unprecedented oil crisis, with prices increasing more than tenfold between 1973 and 1980 (source: Bloomberg). For comparison purposes, this would equate today to the price of a barrel of oil rising from 60 dollars (the average price over the last five years) to over 600 dollars. Back in the 1970s, this price hike was linked to a supply problem (the end of the Bretton Woods agreements, reprisals linked to the Yom Kippur War in 1973), which had significant consequences: an increase in production costs, a rise in prices coupled with a reduction in profits, a fall in purchasing power and consequently, a decrease in demand. This crisis led to France and other countries embarking on extensive nuclear power plant construction programmes to limit their dependence on fossil fuels.

The problem of stagflation, as experienced in the 1970s, was therefore essentially a supply-based problem, which, as we will see below, seems quite different from the current state of affairs.

To begin, let us cast an eye on the situation in America.

The United States should see domestic inflation exceed 6% by the end of the year (source: Cacib), a level that has not been reached since the early 1990s. This increase cannot be solely attributed to an increase in the prices of services, as inflation in this segment is fairly stable compared to the pre-Covid scenario. On the other hand, it is essentially due to an increase in energy prices, mainly resulting from highly favourable base effects on oil. Oil prices have been driven up not by a supply problem - as OPEC has excess production capacity - but by a sharp increase in demand. Inflation has also been fuelled by a new phenomenon: the rise in prices in the goods sector (for example, vehicles). This increase can be explained by both supply and demand issues.

Finally, for there to be stagflation, there must be a strong slowdown in growth, which is not currently the case in the United States and its growth forecasts for 2022 standing at 4%.

As such, the American situation can be clarified as follows: inflation is mainly linked to strong demand and actual growth being above potential growth, which does not correspond to a stagflation scenario.

What about inflation in the euro area? The inflation rate should reach 4.25% at the end of the year (source: Cacib). Once again, this will be driven by an increase in the price of a barrel of oil as well as a significant increase in gas and electricity prices. While the oil issue is essentially a demand issue, the gas market is suffering from serious supply problems due to the dispute between Russia and the European Union about Nord Stream 2. Another marked difference to the US is that inflation on goods is more contained, which should allow inflation in Europe to fall faster than in the United States.

In terms of growth, we envisage the same scenario as in the US, with actual growth in 2022 expected to exceed potential growth by more than 4% (source: Bloomberg). However, this figure could be revised downwards due to the negative impact of rising gas prices on growth. A stagflation scenario could therefore eventually emerge if gas prices continued to soar, but this would require the situation to play out over several quarters, which at present seems unlikely.

The most probable scenario therefore seems that both inflation and growth will remain high. In this scenario, central banks should gradually withdraw some of their monetary support, leading to higher rates (especially in the US) and a continuation of the sectoral rotation currently underway in the equity markets.

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