Risks of Stagflation in the European Economy in 2012 and 2013[#]

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2012 and 2013 will be very difficult years for the European economy, with a long list of diverse risk factors threatening the region. We must expect that separate events are very likely to exert a very strong influence over each other, and one can assume that these influences will intensify, rather than set off, each other. This article aims to assess the possibility that the cumulative effect of these risk factors may lead to "stagflation", i.e. a combination of relatively high inflation and recession, which will, in effect, result in unemployment rates that may exceed, even substantially, the natural rate of unemployment.

Several past periods in specific countries or regions have been labelled as periods of "stagflation", a phenomenon that has been used to describe US economy in nearly the entire 1970s and in 1981[1]. What is interesting in this respect is that despite displaying different symptoms to a considerable degree, both these periods are deemed similar from the economic perspective.

"Stagflation" as a phenomenon has been explained from various perspectives. In this article, we will attempt to formulate a new definition that would reflect the reality of today's European economy more accurately. Relying on the new definition, we will then assess various risks currently observed in Europe, including, without limitation, the common currency's instability, the fact that although formally separated from the Euro, the region's other currencies are in effect and in absolute terms strongly linked to the Euro, the demographic risks (that have already begun to exert some influence – although their effect will be felt for a very long time, and the time when they assume a crucial role in the European economy is far ahead of us). We will assess the risks of recession and the issues of demand, debt (both sovereign and private) and some other issues. We will also look at the development of the US economy and the BRICS (Brazil, Russia, India, China, and the Republic of South Africa) economies, and their effect on Europe. It will also be necessary to address the effect of the continuing and rather intensifying regulation on the increasing risk of stagflation.

We will attempt to discover correlations among these problems and the mechanisms through which they will translate into the real economy.

On these findings, we will formulate our final conclusion to answer the question whether the risk of stagflation in the European economic area in the short and medium run is real, or not.

[#] This article forms one of the outputs of the research project of the Faculty of Business Administration entitled *"New Theory of Economy and Management in Organizations and Their Adaptation Processes"* under reg. no. MSM 6138439905.

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[1] The term "stagflation" is sometimes absurdly used to denote the Japanese economy after 1991, although this use is simply confusing – Japan at that time really was a deflation economy.

Defining Stagflation

First of all, we need to make clear what the term "stagflation" actually stands to describe, i.e. what conditions must be met for us to label a specific period in the observed country or region as a period of stagflation. It is generally known that "stagflation" is a combination of the words "stagnation" and "inflation". Therefore, it is assumed by definition that the economic performance does not grow, or tends to drop, during periods of stagflation. The matter is clear[2] in this respect because we have become used to measuring economic performance in year-on-year or shorter comparisons, primarily using the aggregate gross domestic product. Following this tradition, it will be suitable to use this method[3] in our case, too.

Using the term "stagflation", we must also take account of the issue of unemployment: the unemployment rate plays a very important role in many stagflation approaches. These approaches use the term "natural unemployment rate" – a very vague term that is not defined in the form of a specific number as a general constant. Therefore, we will have to ask what is the natural unemployment rate in the EU Member States prevalent at the given time.

The definition of "natural inflation", i.e. the level that must be exceeded for inflation to be deemed "high", also entails certain problems. The science of economics often uses terms like "natural inflation" or "common rate of inflations"; however, these terms have different contents in different periods and different regions. To talk about stagflation in Europe at the beginning of the 21st Century, we will have to define a rate of inflation deemed "natural" or "expectable" for this precise time in history.

Having said that, the very first step that must be taken in this regard is to analyse the two most frequently mentioned periods of stagflation and discover the reasons why the US economy witnessed rising prices and high unemployment, i.e. economic stagflation, in certain years[4].

1970s in the United States

The Keynesian theory assumes that economic growth means two things: reduced unemployment, and accentuated inflation tendencies. What ensues is the following inverse relation: low unemployment means high inflation, and high unemployment thus brings low inflation. This is fully in line with the Phillips curve [1], formulated at the turn of the 1950s and 1960s, which was taken very seriously by President Nixon's administration, as well as others. It was believed, in essence, that a country could buy lower unemployment if it accepts the price of higher inflation. "Stagflation" was first used by Iain McLeod, a British politician, in a speech to the Parliament in 1965, and the newly coined word soon caught on: as the 1960s progressed, situations that the advocates of the traditional Keynesian theory could not explain began to occur with ever-increasing frequency. The correlation between inflation and unemployment (or growth) in various countries did not develop as assumed by the Phillips curve. Instead of dropping as unemployment rose, prices did not even stagnate but kept rising, in some cases even accelerating their rise.

In other words: stagflation had become a known phenomenon before the combination of stagflation and inflation found its fullest expression in the USA. However, the intensity of the

[2] Rising prices accompanied by even larger economic recession have been called "slumpface".
[3] Despite all the doubts to what extent can the gross domestic product truly quantify the performance of an economy.
[4] It must be noted that the stagflation hit more or less all the developed countries in the 1970s; nevertheless, the United States were undoubtedly the centre of this development.

US stagflation, which introduced a period of ten years of economic hesitation, exceeded all prior cases of stagflation, and, in addition, influenced the entire developed world at the time and lead, in effect, to the oil crisis, which in turn further accentuated stagflation tendencies.

Let us summarise the reasons that are usually blamed for making the seventies so difficult for the United States.

Two fundamental reasons of the stagflation are usually mentioned. The first is based on the idea that inflation has two components – real inflation and inertial inflation. If the inertial inflation is too high, for instance after a price shock, inflation tends to remain on the same inertial level. Therefore, inflation does not cease to exist and is actually higher than it would have been without this inertia even after the shock fades away. This is also due to the fact that the price of labour is not created on a clean (i.e. an auction) market, but on a market heavily distorted by state regulation[5] and by the influence of labour unions as an element that strongly regulates the labour market environment. Therefore, the price of labour does not respond to demand and supply in the same way a commodity does on an auction market[6]. Due to inertial inflation, prices may thus rise even as unemployment witnesses a rise or as the economy enters a period of stagnation or even recession. The revised Keynesian theory and the adjusted Phillips curve are derived from this idea.

State intervention and incorrect economic policy are the second traditional culprit. Rising monetary aggregates in the area of monetary policy and the economic policy's regulation of prices and the labour market may lead to simultaneous rise of prices and unemployment.

Both these traditional reasons of stagnation have a shared component: regulation. If we look at the course of the US stagflation in the 1970s, it is hard to overlook certain correlation between regulatory measures and the course of the stagflation. However, theory does not make a sufficient distinction between two phenomena: regulation as a general measure with principally the same impacts on all market participants, and intervention, i.e. selective aid to specific enterprises or specific business fields.

The relation between inflation and unemployment virtually copied the Phillips curve during the entire sixties. Unemployment dropped from about seven percent in 1961 to 3.5 percent in 1969. The gross domestic product deflator rose from about one percent in 1961 up to five percent in 1970. The decade that followed really saw no logical curve to speak of whatsoever: the rebuttal of the Phillips curve reached its climax in 1975 with 8.5 percent unemployment rate and prices rising by almost ten percent. Neither the eighties did much to confirm the validity of the classic Phillips curve [2][7]. What 1970 development was so crucial that its effects defied any resolution in the decade that followed?

The first culprit was the rising level of regulation as such: the second half of the 1960s was primarily a time of significant interventions by the US federal government in many fields of business, and this practice was retained in the entire seventies. In principle, these interventions included, without limitation, aids to specific corporations, e.g. aircraft manufacturers and primary and secondary sector producers, or interventions on the road, railway and air transport market. A number of federal regulations, spanning from pharmacology to building project supervision, gradually came to being. Apart from that, the government invested substantial funds in the military industry in relation to the Vietnam war,

[5] For instance, the minimum wage and many other provisions common in developed countries.

[6] To some limited extent, this also applies to the prices of goods and services, which are also affected by certain administrative machine of corporations and do not display behaviour common on an auction market. Nevertheless, these mechanisms are undoubtedly vastly more flexible than the labour market mechanisms.

[7] The relevant data can be found, for instance, in *Economics* by Samuelson and Nordhaus (p. 342), which also describes the arguments and the defence of the revised curve.

or in the space programme, which yielded results in the form of the first human landing on the moon. Investments and interventions have substantially changed the face of the US economy without anyone really noticing. However, the rate of regulation witnessed unparalleled rise, and the scope of the interventions went far beyond all prior experience.

The details of the aforementioned process are a matter for study of the historians of economics. Nevertheless, its roots can be traced back, for instance, to 1964, when Lyndon Johnson, enjoying a strong majority in the Congress, pushed through Medicare as the basis of a state-funded healthcare system (although the full objective has not been ultimately achieved). The fact remains that Johnson made substantial effort to primarily centralise the United States, which caused a number of diverse disputes, power struggles, and faced opposition in many states of the Union. Richard Nixon came with a plan of new decentralisation, but was not really successful in his effort. Some monopolies and regulatory systems that were impervious to the Republicans' efforts to revise the results of the New Deal and the war economy were inherited from previous years, especially from the WWII years and the first post-war years. Some of these regulations were revised exactly in the second half of the 1960s – with some regulation programmes replaced by even worse programmes. During Nixon's first and his incomplete second presidency, Medicare expenses and other direct transfers from the federal government to citizens rose from 6.3 to 8.9 percent of the GDP. The volume of food subsidies to citizens, for instance, rose from 6.6 billion dollars to more than nine billion dollars in that time. These seemingly unimportant figures[8] must be seen in the context of the fact that the Vietnam war cost about 150 billion dollars, with more than one million of US soldiers deployed in Indochina and in other backup areas abroad when Nixon assumed office. The increase in transfers to the citizens and businesses, enormous for its time, did not cause a dramatic growth of public deficit just because the costs spent on defence dropped from 9.1 to 5.8 percent of the GDP in the same timespan.

Nevertheless, the steep growth of unemployment from 2.5 percent in 1969 to five and then six percent in 1970 and 1971 was not accompanied by decreasing inflation, which exceeded five percent per year throughout these years.

The problem of the US economy, which started in 1970 and climaxed several years later, was thus caused by a combination of multiple phenomena, with the growing rate of regulation and state intervention in the economy being the original and first trigger of events. However, the true impulse for the real stagflation was, first and foremost, the departure from the Gold Standard of 15 August 1971, which Nixon accompanied by a series of tough regulations – not only did he refuse to exchange Britain's and France's dollar reserves for gold in the US depositories, but also introduced wage and price controls in an effort to tame inflation in the USA.

The 1971 collapse of the Bretton Woods system was inevitable: during the second half of the 1960s, the value of US gold reserves dropped from 25 billion to 10.5 billion dollars. The fast-growing economies, especially the economy of the Federal Republic of Germany, sucked in enormous investments, thus appreciating their currencies, which the dollar simply could not withstand. The dollar witnessed an unusually fast depreciation against other currencies: for instance, the 1969 USD-DEM exchange rate was DEM 4 per dollar. Before the collapse of the Gold Standard, the dollar fell to DEM 3.66, falling to DEM 3.22 in response to the events of August 1971, and then depreciating even further to DEM 2.83 per dollar. The dollar again lost its value during the seventies and at the beginning of the eighties: at the turn of the eighties

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[8] According to the "CPI Inflation Calculator", nine billion 1971 dollars today yields the purchasing power of 50.5 dollars. (The CPI Inflation Calculator is available at the United States Department of Labor website at http://www.bls.gov/bls/inflation.htm)

and nineties, the exchange rate was about DEM 1.8 per dollar. The depreciation of the dollar and the quick appreciation of the Deutsch Mark against other currencies, including the Pound Sterling or the Scandinavian currencies, were the main reasons why the West German economy cooled down in 1971 and shortly afterwards and why the dynamic boom slowed down in 1973.

Although the US economy had never been a heavily export-oriented economy, the departure from the Gold Standard and the adoption of the floating exchange rates mechanism drove export tendencies and, on the other hand, increased the prices of imports on the US market.

That is also why both oil shocks of 1973 and 1979 created strong impulses for stagflation. As regards the first crisis, the formal impulse for the Arab countries' decision to cut down oil production by five percent and, primarily, to impose an embargo on selected countries, was the support and aid provided by these countries to Israel during the Yom Kippur war. Nevertheless, technically, the embargo should not have had devastating effects for the USA, although the prices of oil on the global markets rose quickly[9]. However, the United States' dependence on oil imports only amounted to about one third of its consumption at that time[10], and its dependence on Arab oil was very small – the embargo had a much greater economic impact on some European countries. Nevertheless, the impacts of the oil crisis were aggravated by some steps of the US Administration[11], including, without limitation, the regulation of petrol sales to citizens, and other price control attempts. This lead to greater uncertainty of the consumer, which multiplied the effects of the embargo – petrol shortages lead to lines in front of petrol stations, and the government even attempted to introduce a rationing system. The situation calmed down, at least in this area, in the second half of 1974 when this regulatory policy was abandoned. Subsequently, the rate of inflation rose from six to ten, and later even to twelve percent[12].

We could go on listing the reasons of the US stagflation in the 1970s and detailing and analysing the steps that aggravated the combination of high inflation and stagnation witnessed in the US at that time. Nevertheless, the fundamental reasons remain clear:

- Significant increase in regulatory steps in the years leading to the stagflation, and increased number of state interventions in the economy, attempts to control prices and wages in the first stage of the stagflation, which did reduce inflation in the short run, but only intensified the inflationary pressures later.
- The fading economic growth impulses caused by the previous engagement in the Vietnam war, dramatic scaling back of US presence in this conflict, and a vast reduction of war expenses.
- Departure from the Gold Standard, and thus the creation of space for fundamental loosening of the government's monetary policy, loss of the currency's purchasing power against other currencies of business partners.

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[9] From three to five dollars per barrel and up to 12 dollars per barrel in 1974.

[10] Nevertheless, it was known that the maximum production in the oil extraction areas known at the time was reached in 1971 due to existing oil reserves, and increased productions could not be expected without further exploration and investments. However, this exploration and development was impossible with the price of oil so fundamentally low. Therefore, the effort of the Arab countries has, among other things, slowed down the growth of demand for oil, and motivated the developed world's increased effort in the area of production technology and exploration.

[11] This was still Nixon's administration, and later the cabinet of its Vice-President, Gerald Ford.

[12] For historical US inflation data, visit InflationData.com operated by the United States Department of Labor (http://inflationdata.com/Inflation/Inflation_Rate/HistoricalInflation.aspx)

- External price shocks caused by reduced supply of oil, and the ensuing demand pressure on prices.
- Inconsistent economic policy of the US administration at the time, which mixed decentralisation efforts and planned economy approaches.
- Restriction on trade through the introduction of import premiums, i.e. essentially the creation of customs barriers.

Rome, year 200 AD

Nevertheless, the world economy witnessed a period of stagflation that was much older and much longer than the US economy's stagflation in the 1970s – namely the last few centuries of the Western Roman Empire. Of course, the sources available from that time are much less accurate and incomparably less exact than the outputs of statistical offices in the past century or two. Nevertheless, we can still formulate a number of specific reasons that caused the stagflation in the declining Roman Empire. An attempt to thoroughly summarise and analyse these reasons was presented by Bruce Barlett in How Excessive Government Killed Ancient Rome [3].

This text offers some fascinating insights. Relying on very trustworthy sources, the text asserts, for instance, that[13]: *"Beginning with the third century B.C. Roman economic policy started to contrast more and more sharply with that in the Hellenistic world, especially Egypt. In Greece and Egypt economic policy had gradually become highly regimented, depriving individuals of the freedom to pursue personal profit in production or trade, crushing them under a heavy burden of oppressive taxation, and forcing workers into vast collectives where they were little better than bees in a great hive. The later Hellenistic period was also one of almost constant warfare, which, together with rampant piracy, closed the seas to trade. The result, predictably, was stagnation. Stagnation bred weakness in the states of the Mediterranean, which partially explains the ease with which Rome was able to steadily expand its reach beginning in the 3rd century B.C. By the first century B.C., Rome was the undisputed master of the Mediterranean. However, peace did not follow Rome's victory, for civil wars sapped its strength."* We can undoubtedly find very interesting similarities to the development in the United States and some other countries after WWII, when a substantial part of the world either opted for an explicitly planned economy, or at least made efforts to find a "middle ground", i.e. chose a "combined" economy.

Please take note of another element: the fact that this period was a time of increasingly strong and significant regulation: *"Under the dictatorship of Sulla, the grain distributions were ended in approximately 90 B.C. By 73 B.C., however, the state was once again providing corn to the citizens of Rome at the same price. In 58 B.C., Clodius abolished the charge and began distributing the grain for free. The result was a sharp increase in the influx of rural poor into Rome, as well as the freeing of many slaves so that they too would qualify for the dole. By the time of Julius Caesar, some 320,000 people were receiving free grain, a number Caesar cut down to about 150,000, probably by being more careful about checking proof of citizenship rather than by restricting traditional eligibility."* The distribution of grain at a controlled price, and later eventually for free, is also interpreted as a welfare measure of its kind and, above all, as a form of pre-election populism, a social benefit granted to the majority. As indicated by the next quote, a similar approach had an increasingly corrupting effect: *"The distribution of free grain in Rome remained in effect until the end of the Empire,*

[13] This quote and the quotes below are taken from the aforementioned work by Bruce Barlett.

although baked bread replaced corn in the 3rd century. Under Septimius Severus (193-211 A.D.) free oil was also distributed. Subsequent emperors added, on occasion, free pork and wine. Eventually, other cities of the Empire also began providing similar benefits, including Constantinople, Alexandria, and Antioch."

Nevertheless, the Republic, and subsequently the early Empire, was based on a dynamic development of Rome's foreign trade, as illustrated by the number of shipwrecks dating back to these "golden" ages of Rome from the economic perspective. The economy probably witnessed its first shock in 33 AD, when Emperor Tiberius ordered the enforcement of the usury law (which had been valid for many years but had not been enforced). The dramatic business development helped some classes and specific individuals to amass substantial wealth in a short time; these people possessed substantial capital and offered it to others for appreciation. Tiberius attempted to stop this rising inequality and the creation of new affluent classes by restricting their business, i.e. by regulation. What followed was a financial crisis and shortage of cash on the market after the owners of money withdrew from the market for fears of restrictions. However, misguided economic policy, increasing regulation and costly social policy, and a general rise in the costs of the state went ahead anyway. The Empire stopped expanding, and its income thus failed to rise, which should have triggered (but did not trigger) a change in the fiscal policy of a state that had become used to ever-increasing influx of incoming bounty. What changed, however, was the monetary policy, and the currency, to date based on a guaranteed proportion of gold or silver in each coin, began to be "counterfeited" by the emperors themselves. The proportion of precious metals in issued coins was decreasing, which was reflected in rising inflation. As the general discontent grew, so did the pressure for a general regulation of economic life. It makes no sense to describe the development in its entirety, but the following quote illustrates the problem rather well: *"Despite the fact that the death penalty applied to violations of the price controls, they were a total failure. Lactantius, a contemporary of Diocletian's, tells us that much blood was shed over ′small and cheap items′ and that goods disappeared from sale. Yet, ′the rise in price got much worse′. Finally, ′after many had met their deaths, sheer necessity led to the repeal of the law′."* As the years passed, the need for regulation went far beyond the regulation imposed by the Communist regimes in Eastern Europe or in Russia in the second half of the 20th Century. The situation resembles the alleged conditions in states such as North Korea, Cambodia under Pol-Pot's rule, or Cuba: *"The result was a system in which individuals were forced to work at their given place of employment and remain in the same occupation, with little freedom to move or change jobs. Farmers were tied to the land, as were their children, and similar demands were made on all other workers, producers, and artisans as well. Even soldiers were required to remain soldiers for life, and their sons compelled to follow them. The remaining members of the upper classes were pressed into providing municipal services, such as tax collection, without pay. And should tax collections fall short of the state's demands, they were required to make up the difference themselves."*

It hardly makes sense to list further arguments. Nevertheless, let us summarise the reasons of the phenomenon witnessed in the last centuries of the Western Roman Empire, which we call, using the parlance of our time, stagflation:

- The number of regulatory interventions in the economy rose substantially; free food market was curtailed through price controls in favour of some customers, with grain and subsequently other products distributed for free later on. People were deprived of the right to choose their occupation freely.
- The Empire reached the maximum of its expansion, which limited further income of the state budget, and the state was unable to respond by cutting costs – partly because it needed to finance its military, partly due to the ever-increasing welfare costs.

- The currency was stripped of its “golden” or “silver” standard, i.e. depreciated by ever-increasing issues of new money that was not covered by goods.
- The economic policy witnessed substantial fluctuations, and the fluctuation cycles were getting shorter. In the times of the Republic and in the early Empire, the cycles of legible policies lasted for decades; they began to shrink dramatically from about 100 AD, and later the emperors ruled for single years, sometimes even months. However, their economic concepts differed substantially.
- The Empire faced ever-increasing external pressure, to a large degree due to the increasing aggression in the border regions, but restricted trade, i.e. export of Rome’s problems beyond the Empire, also played a role – the trade was curtailed, among other things, by the low quality of the currency and by various administrative barriers and customs measures.

A Mere Coincidence?

Making a direct comparison between the fundamental features of the two historical cases, one preceding the other by about 1700 years, we will find a disturbing similarity: many aspects are identical, and many others can be interpreted as essentially identical. Nevertheless, what is alarming is that at least in this somewhat vague verbalisation, we will find a number of similarities to the current development in the European Union, as well.

A plethora of new regulatory measures is being adopted in Europe (just like the United States and other developed countries) today. And similarly to the United states in the 1970s or to the Roman Empire in the 2nd to 4th Century AD, these regulatory measures are justified by the interests of the “majority” – restrictions are being imposed on bank fees, investment opportunities; antitrust laws and air pollution laws have been put into place, minimum wage has been adopted (which, in principle, is similar to mandatory occupation succession in male-line descent); hundreds and thousands of restrictions of increasing power are imposed on human decision-making, regulations are adopted to curtail business endeavour etc. Looking back at the few past decades, we can say that the number of these regulations has been rising continuously, eventually multiplying during the crisis of 2008 through 2010.

All this is happening while the expansion of the “developed countries” has apparently came to an end: it is impossible to imagine these countries expanding their territories today; in addition, they are facing the hard pressure of a population crisis – they are running the risk of a true, absolute population decrease in a few decades’ time [4]. This has already entailed, and will continue to entail in the future, a factual decrease of tax income.

We have also witnessed unparalleled rise of another phenomenon that has not yet been mentioned: a striking differentiation of income, and with it the standard of living. With some overstatement, we can say that something similar could be observed in the Ancient Rome and in the United States at the turn of the sixties and seventies: the standard of living of the richest and affluent groups dramatically pulled apart from the lower middle classes and the poorest segments of the population. We mostly understand this phenomenon as a social or sociologic one; nevertheless, it clearly is important in economic terms, too – at least by structuring consumer demand in a substantial manner and by parcelling the formerly more homogenous markets with many types of goods into multiple markets that, while still formally markets with the goods of the same denomination, they are markets on which the price and quality are worlds apart. Taking the liberty of using a somewhat literary overstatement, the economic

segregation of today's society seems to resemble French feudalism rather than a democratic company of equal citizens.

Looking for a similarity in terms of the "Gold Standard", we must realise that this standard has ceased to exist decades ago. Therefore, it is now impossible to find a shock similar to the currency depreciation in the Western Roman Empire or the fall of the Bretton Woods system. However, currencies are now facing an essentially uncontrollable expansion of "quasi-money", i.e. money that come into existence through bank operations and various derivatives to financial and other products. Any factual control over the quantity of money in circulation has ceased to exist. This opens more and more space available for inflation – it is important that this has been occurring without this inflationary tendency having any real or even direct relationship to unemployment. The situation is aggravated by the policies adopted by the countries that have tried to stimulate their economies through budget deficits or by printing new money.

The stability of democratic governments in developed countries is in danger. Here, too, one can find similarity to the events in the Ancient Rome and, with some exaggeration, to the breakthrough years in the United States that gave us desegregation on one hand, and Watergate, probably the biggest scandal in US political history to date, on the other. Looking at the present developments, we can firstly see that the frequency of government shifts is increasing, and the economic visions offered by the main political movements have been diverging with increasing intensity. The problems of the present world and the consequences of globalisation have been so dramatic that even moderate political movements cannot find common ground sufficient to take on a consensual economic policy. In other words, the speed of the shifts in the developed countries' economic policies follows the speed with which their societies replace their political representatives.

Secondly, we see extremist solutions on both sides of the political spectrum gaining momentum, which has triggered further distinctions between the political movements that have been traditionally more balanced. For instance, US conservatives must inevitably move "to the right" under the influence of the Tea Party movement, while the Democrats will use "more leftist" arguments in an effort to gain the protest votes of the "Occupy Wall Street" supporters.

The similarities between the Ancient Rome in the years 100 through 450 AD, the 1970s in the USA and the present situation are not a mere coincidence but the effects of the unforgiving logic of each development of events. What we see are similarities and identical mechanisms in action.

European Reality of Our Times

Of course, all this does not mean that the developed countries are bound to collapse just like the Western Roman Empire did. The cornerstones of our civilisation have been solid so far, and the society has shown some ability to defend itself. The question is whether that's enough. If we were to look for a political difference between the Ancient Rome and Washington in 1973, we will find a clear one: democracy has shown that it is able to purge, to resolve its problems. The Roman tyranny did not have, and could not have had, this ability. Whether the present society will find the ability to cope with its crisis and find a democratic and free-minded resolution still remains to be seen.

However, the key issue of the European economy in late 2011 is the analysis and decision whether the Union will or will not go trough a period of stagflation, i.e. a period of relatively

high inflation combined with stagnating economy, expressed primarily by the unemployment rate. The answer has, in addition to its economic dimension, a very important political dimension, which can be formulated as an exceptionally burning question: Can the societies of developed countries, having hardly absorbed the unpleasant experience of the 2008 through 2011 crisis, withstand further psychological pressure and another period in which these states will potentially have to deal with high unemployment and substantial inflation, i.e. a likely drop in their standards of living?

We can in no case forget that we live in a time of the greatest debt crisis ever experienced in known history, a crisis caused by the debts of governments, municipalities, governmental institutions, towns, families, and in many countries by the highest debt of private businesses in (modern) history.

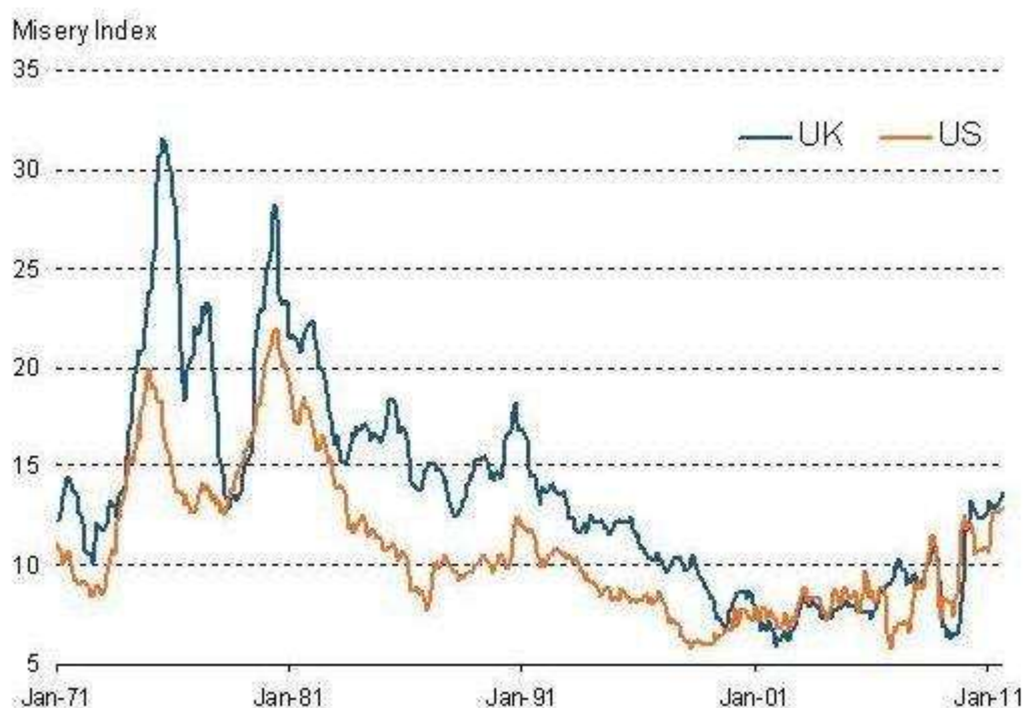
Economic Conditions for Stagflation

So far, we have found many similarities among the situation of the Western Roman Empire, the United States in the 1970s and our European presence – however, these similarities were found primarily in simple, descriptive terms. To assess the real risks of a stagflation, we must work with real data, especially inflation and unemployment data.

The stagflation potential in the United States was convincingly summarised by Ronald McKinnon (professor of economics at the Stanford University) in its text for the Wall Street Journal [5], among others. Similar texts about the situation in Europe were published, for instance, in the Financial Times and in other reputable and important daily newspapers. As we can see, the discussion of this issue is not entirely new, and the predominant opinion expressed in these works of popular journalism is that the upcoming years (2012 and 2013) will form a period of stagflation.

However, the real statistical data of European countries do not provide any dramatic evidence confirming this view. Let us start by looking at the "misery index", i.e. a simple sum of the rates of unemployment and inflation in the given period. If we took the Phillips curve word for word, this index should in principle remain on the same level at all times (with some oscillation, of course), as rising inflation would be offset by dropping unemployment etc. Of course, this is a far cry from the reality.

Fig. 1: Misery index for the USA and the United Kingdom



The chart clearly shows the 2011 trend: the sum of the rates of inflation and unemployment closes in on the level prevalent at the beginning of the 1990s in the United Kingdom and in the 1980s in the United States. This figure matches the level shown by both countries in mid-seventies after the first oil crisis faded away. The chart ends with the first quarter of 2011[14]. Further data is shown in the table that follows.

Tab. 1: Rate of Inflation, Unemployment and Misery Index in selected countries

	Inflation		Unemployment		Misery index	
	10/2010	09/2011	10/2010	08/2011	10/2010	09/2011
Euro 17	1.9	3.0	10.2	10.0	12.1	13.0
EU	2.3	3.3	9.7	9.5	12.0	12.8
Czech Republic	1.9	2.1	6.9	6.7	8.8	8.8
Germany	1.6	2.9	6.7	6.0	8.3	8.9
Greece	4.8	2.9	14.2	17.5	19.0	20.4
Spain	2.3	3.0	20.6	21.2	22.9	24.2
France	1.8	2.4	9.7	9.9	11.5	12.3
Italy	1.9	3.6	8.5	7.9	10.4	11.5
Hungary	4.0	3.7	11.1	10.3	15.1	14.0

[14] It is necessary to point out one of the problems associated with the "misery index" and its practical application: various unemployment and inflation indicators are quite often used. As regards unemployment, we have, above all, the harmonised unemployment rate used by Eurostat. In addition, various national statistics are used. For instance, the harmonised unemployment rate in the Czech Republic reported in August 2011 reached 6.7 percent; nevertheless, the Czech Statistical Office published the figure of 8.2 percent for the same period of time. Inflation data is riddled with a very similar problem: in addition to various methodologies, the specific approach to measuring inflation must be clearly identified, i.e. whether the inflation rate is based on year-on-year data (i.e. the month or quarter compared to the same month or quarter a year earlier), or compared to the previous period, or whether it represents the average rate for a specific period etc. Therefore, if we look at the "misery index" throughout certain periods of time, we must clearly identify the data from which the final figures were derived. Therefore, it is not suitable to compare two time series of the index if they have been obtained from different sources.

Slovakia	1.0	4.4	14.2	13.4	15.2	17.8
United Kingdom	3.3	4.6	7.8	8.2	11.1	12.8

Source: Eurostat, http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&language=en&pcode=teilm020&tableSelection=1&plugin=1 , http://epp.eurostat.ec.europa.eu/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=teicp000&language=en

As we can see, the misery index has been slowly rising in the European countries, adding about one percentage point between October 2010 and September 2011. This is given primarily by the rising inflation, which has witnessed a relatively robust growth and can be blamed for the entire growth of the index on the European level, with inflation dropping ever so slightly when taking Europe as one whole. In any case, the rise in inflation exceeds the reduction of unemployment, and without having the luxury of a long-term view of this data in the mutual correlations in the context of the European Union, we can claim that the importance of the rising inflation has been higher, and its influence on the national economies much stronger, than the decreasing unemployment rate. In most states, the decrease has been marginal, or non-existent in some states, while unemployment has been still rising in some economies despite the rising consumer prices.

Looking at table 1, we can see that some countries truly face the threat of stagflation – certainly United Kingdom, along with Slovakia, France or Spain. The data for the entire European Union and for the entire Eurozone essentially show a dynamic rise of inflation and a very slow decrease of unemployment. However, can these signs, i.e. the fact that the macroeconomic data of some specific countries truly show signs of stagflation and that unemployment in the entire EU does not drop fast enough to offset the rise of inflation – justify any general conclusions for Europe as a whole?

Probably not.

There are several reasons why the risk of stagflation – regardless of the fact that it has been very strongly accented in some media and in academic circles – cannot be deemed a factual and urgent threat at the moment.

First of all, inflation is a monetary phenomenon – therefore, there is a substantial difference between the Eurozone and the rest of Europe, including EU Member States. The key difference is the diversity of policies and the number of economic policy tools in the hands of the countries inside and outside the Eurozone. Second, it is crucial that we can hardly speak of stagflation where the total unemployment rate and the rate of inflation are relatively low. The stagflation periods in the Ancient Rome and, primarily, in the 1970s' United States were characteristic for dynamic depreciation of money (in Ancient Rome, inflation in many periods reached tens and sometimes even hundreds or thousands of percent each year, while the inflation in the 1970s' United States reached tens of percent annually). This is not the present case: although inflation has risen, it is still in low single-digit numbers, well below five percent.

The case is similar with unemployment. In the Western Roman Empire, the unemployment rate may have reached dozens percent of employable workforce, despite the fact that the Empire was in a state of constant war, and the military drew away substantial portion of employable workforce. The US unemployment rate tripled between the end of the sixties and mid-seventies from less than four percent to well beyond ten percent. Neither Europe as a whole nor the Eurozone are facing such prospects, or at least this development cannot be assumed based on the current data and knowledge.

We can interpret all this as follows: there certainly are some stagflation pressures in Europe that are even reflected in the real economic development figures. In qualitative terms,

the parameters of stagflation have been met, admitting – with some overstatement – that prices have been rising and the unemployment has been rising or stagnating in 2011. Nevertheless, these signs have been very small in quantitative terms: the rates of inflation and unemployment are substantially lower than those witnessed in the historical periods labelled as periods of stagflation.

Conclusion

In light of the foregoing, it seems that we cannot support the notion that Europe as a whole is under a threat of stagflation, at least not in the true sense of the word. Although the term has been used by important economists and investors, the quotes must be seen in the context of the media in which they were uttered, i.e. in the context of popular journalism.

In addition – although stagflation is a somewhat mysterious economic phenomenon that combines rising inflation with rising unemployment, we will probably reserve the term to identify more distinctive periods in which the rise in prices and in the number of people without jobs is still much higher than what we're witnessing in Europe at this time.

Nevertheless, we cannot ignore the fact that the potential for this stagflation does exist, and is even implied by some statistics. And we must not ignore the fact that the future development can and is likely to be increasingly influenced by the debt crisis, the effects of which, when combined with stagflation trends, are very hard to predict. Of course, the need to repay debts and limited lending opportunities should in theory play against the potential stagflation; however, the current economic situation is very unclear, and various phenomena are appearing in correlations that were formerly unheard of. Moreover, the rising inherence of the states in the economy may cause many complications that are now hard to predict. It is apparent that similarly to the responses to the terrorists attacks of 11 September 2001, which have reduced civic comfort and, to some degree, curtailed citizen rights and, above all, some freedoms, the responses to the 2008 through 2010 crisis have reduced economic freedoms, increased regulation and strengthened the role of the state in economic policymaking. We can observe many efforts to pursue further and deeper regulations that can be deemed adequate [6], and many efforts that cannot yield any benefits in the long or even short run – such as the proposal of the European Commission to regulate the publishing of the rating agencies' ratings, which the popular media have labelled as the Brussels institutions' attempt to introduce censorship.

As we can see, the defining feature of the situation in Europe today is that it is unclear. The lack of clarity increases the weight of the risks, because the threat that a risk will be overlooked or underestimated gets serious exactly when the situation is unclear. That is why stagflation is not a phenomenon we should ignore, although the risk of stagflation is relatively low at this time.

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Key words: Stagflation; Inflation; Phillips curve; Unemployment; Economic crisis.

JEL classification: E31, J64