Box 1.3: **Stagflation risks in Europe: Are the 2020s different from the 1970s?**

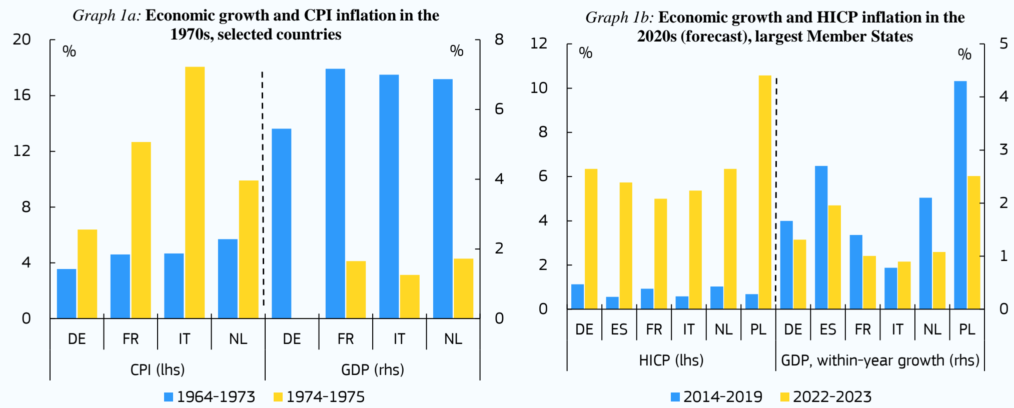
High rates of inflation and the considerable slowdown in economic activity are awakening memories of the 1970s. This box looks at features characterising European economies in the 1970s and now, highlighting similarities, differences and new features.

Key features of the 1970s and similarities at the current juncture

The 1970s were characterised by sharply increasing inflation and weak growth. Almost half a century ago, the Yom Kippur war of 1973 triggered a first sharp increase in the price of oil, later followed by a the second oil price shock at the end of the decade in the wake of the Iranian revolution. The first oil price shock led to a protracted period of high inflation and considerable low GDP growth (Graph 1a), a combination that went under the name of 'stagflation'. Currently, the supply side of the EU economy is impacted by a combination of similar shocks that originate from lingering pandemic-related disruptions and are exacerbated by Russia's war of aggression against Ukraine. These shocks have primarily driven up the prices for oil and gas, but have also pushed up the prices of several other raw materials and agricultural commodities. The resulting surge in inflation is going hand in hand with a projected sharp slowdown in economic activity (Graph 1b).

Graph 1a: **Economic growth and CPI inflation in the 1970s, selected countries**

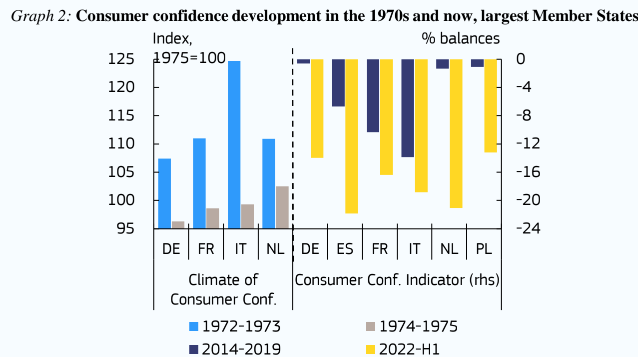
Graph 1b: **Economic growth and HICP inflation in the 2020s (forecast), largest Member States**



High inflation rates weigh on consumers' purchasing power and confidence. In the aftermath of the first oil shock, consumer climate deteriorated significantly, as has been the case with consumer confidence since spring this year in large Member States (Graph 2). This heralded weaker consumer spending and contributed to slowing economic growth, as it does now.

In the 1970s and now, European economies were not only hit by higher oil prices but also increasing prices of other commodities. In both episodes the price of natural gas also increased

Graph 2: **Consumer confidence development in the 1970s and now, largest Member States**



Sources: Data for the 1970s, European Economy, Supplement C, March 1979 (http://aei.pitt.edu/84510/1/1979.C1.pdf), data for the 2020s, European Commission, BCS database (https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/business-and-consumer-surveys_en).

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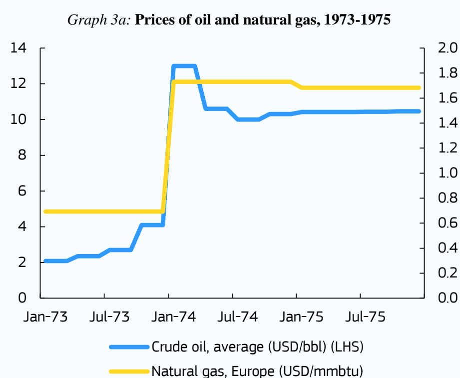
Box (continued)

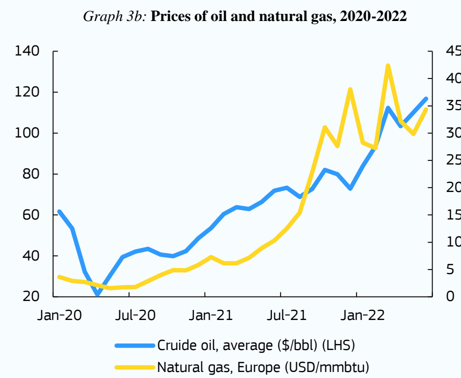
markedly. Cost of companies, made some energy-intensive capital obsolete, reduced aggregate supply and created price pressures. Since the EU economy is a net importer of oil and gas, the energy price shock in both cases triggered a terms-of-trade loss. Inflationary pressures emerged also from food prices with the Food and Agriculture Organization (FAO) food price index up by 95% between 1972 and 1974 by 95%, and by 66% between 2019 and May 2022.

Graph 3a: **Prices of oil and natural gas, 1973-1975**



Source: World Bank Commodity Price Data (The Pink Sheet).

Graph 3b: **Prices of oil and natural gas, 2020-2022**

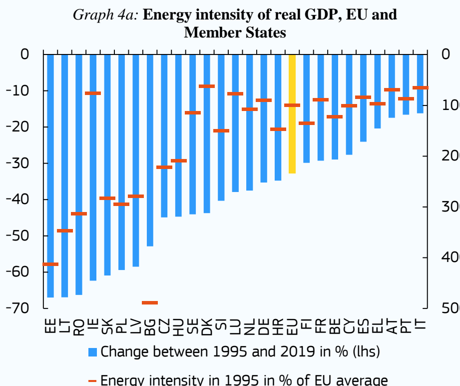


Source: World Bank Commodity Price Data (The Pink Sheet).

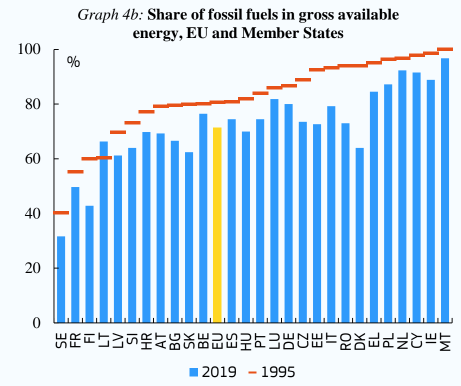
Differences between the 1970s and the current situation.

However, there are structural reasons why the 2020s can be expected not to see a rerun of the 1970s. These include the role of energy in our economies, labour market institutions, and monetary policy frameworks. ([1])

Graph 4a: **Energy intensity of real GDP, EU and Member States**



Graph 4b: **Share of fossil fuels in gross available energy, EU and Member States**



First, the EU's energy intensity of output and the share of fossil energy have declined over recent decades. A more efficient use of energy, the development of renewable energy sources, but also structural changes in the EU, including a growing share of services in gross value added, imply that increases in energy prices today are likely to cause less damage to the economy than they did five or three decades ago. As compared to the 1970s, economic activity in the EU has become much less energy-intensive (Graph 4a), and the weight of fossil fuels such as oil has declined, too (Graph 4b). ([2]) In the past 25 years, the EU energy intensity fell by a one third. The declines were much larger in

([1]) See also OECD (2022). 'Differences between the current situation and the aftermath of the 1970s oil price shocks'. *OECD Economic Outlook* 101, June, pp. 39-9; Andersson, M. et al. (2022). 'Does the private sector foresee a stagflation episode?'. *ECB Economic Bulletin* 4, p. 69-73; and for a global analysis Ha, J., Kose, M. A. and F. Ohnsorge (2022). 'Global stagflation'. *World Bank Global Economic Prospects*, June, pp. 51-77.

([2]) Rühl, C. and T. Erker (2021) 'Oil intensity: the curiously steady decline of oil in GDP'. *CGEP Report* (Center on Global Energy Policy, Columbia University), September.

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Box (continued)

Eastern and Central Europe, where the initial energy intensity had been much higher than on average in the EU. At the same time, the still high share of fossil fuels in the national energy mix is a reminder of the policy challenges ahead. ([3])

Second, structural reforms have made EU product and labour markets more resilient to shocks. In recent decades, structural reforms have made product markets in the EU more flexible and more competitive. ([4]) This has eased adjustment to shocks such as the ones currently observed. Moreover, a long period of labour market reforms in the EU left its marks. Real wage rigidity, identified as one of the factors behind the higher inflation and the weaker growth in the 1970s, appears to have become less strict, also thanks to less use of automatic wage indexation. ([5]) This provides options for better balancing the targets of preserving jobs and increasing wages, thus lowering the trade-off between output and inflation. While wages have started to increase in the context of a strong labour market recovery, there are currently no signs of a wage-price spiral in the euro area.

Finally, in the EU, all central banks are now independent and pursue price stability. For most of the 1970s, many central banks were constrained by fixed exchange-rate arrangements (e.g., Bretton Woods, the "Snake", and the European Monetary System) and central bank independence was limited. Today, central banks in the EU are independent and price stability is their primary objective. The ECB has built up credibility from delivering on its price stability mandate since the introduction of the euro. At the current juncture, with central banks having started to embark on a normalisation and/or tightening cycle, the differences from the 1970s are clearly visible.

New features in the 2020s that matter for economic growth and inflation

Several features that characterise the current situation were not seen in the 1970s. For instance, after a long period of historically low interest rates, private and public debt is now much higher than in the 1970s, which may complicate the adjustment of the EU economy to the normalisation of monetary policy. The current strength of labour markets in the EU coupled with labour shortages could strengthen wage pressures in certain key sectors. Finally, following two years of on-and-off pandemic-related restrictions, many households have extra savings available which could help smoothing consumption and keep price pressures higher than would otherwise be the case.

Policy efforts can help to avoid a protracted period of high inflation and low growth. To bring inflation down it is indispensable to keep inflation expectations anchored as envisaged by the ECB. Coordinated policy action at the EU level and in Member States can help supporting economic growth and strengthen resilience. Policy initiatives at the EU level (e.g., SURE, InvestEU and NGEU/RRF) have become an important part of these efforts. Moreover, targeted policies to reduce the root causes of the inflation shock, notably the dependency on fossil fuels, should have a dampening impact on price pressures.

([3]) See Blanchard, O. J. and M. Riggi (2013). 'Why are the 2000s so different from the 1970s? A structural interpretation of changes in the macroeconomic effects of oil prices'. *Journal of the European Economic Association* 11:5, 1032-52 (October).

([4]) See e.g. ECB (2015). 'Progress with structural reforms across the euro area and their possible impacts'. ECB Economic Bulletin 2, p. 59-71; E. Canton et al. (2019). 'Structural reforms for growth and resilience in the euro area'. *Quarterly Report on the Euro Area* 18:2, Institutional Paper 119, pp. 85-99.

([5]) See Koester, G. and H. Grapow (2021). 'The prevalence of private sector wage indexation in the euro area and its potential role for the impact of inflation on wages'. *ECB Economic Bulletin* 7, p. 63-66 (Box 7).