What Caused Stagflation and Can It Happen Again?

**Definition:**Stagflation is when the economy experiences stagnant [economic growth](https://www.thebalance.com/what-is-economic-growth-3306014), high unemployment, *and* high [inflation](https://www.thebalance.com/what-is-inflation-how-it-s-measured-and-managed-3306170). It's an unusual situation. A sluggish economy usually reduces [demand](https://www.thebalance.com/what-is-demand-definition-explanation-effect-3305708) enough to keep prices from rising. As workers get laid off, they buy less. As a result, businesses lower prices to attract whatever customers remain. Slow growth in a normal [market economy](https://www.thebalance.com/market-economy-characteristics-examples-pros-cons-3305586) prevents inflation.

What Causes Stagflation?

Policies that caused stagflation also created [hyperinflation](https://www.thebalance.com/what-is-hyperinflation-definition-causes-and-examples-3306097).

Government or central banks expanded the [money supply](https://www.thebalance.com/what-is-money-supply-3306128) at the same time [supply](https://www.thebalance.com/aggregate-supply-what-it-is-how-it-works-3306216) was constrained. Government [fiscal policy](https://www.thebalance.com/what-is-fiscal-policy-types-objectives-and-tools-3305844) printed currency. Central bank [monetary policies](https://www.thebalance.com/what-is-monetary-policy-objectives-types-and-tools-3305867) increased the money supply. That boosted consumer demand. But other policies, or supply constraints, prevented companies from producing more.

This situation occurred in Zimbabwe in 2004. The government printed so much money it went beyond stagflation and turned into hyperinflation. Stagflation in the United States only occurred during the 1970s. The Federal government manipulated its currency to spur economic growth. At the same time, it restricted supply with wage-price controls.

Stagflation in the 1970s

Stagflation got its name during the 1973 - 1975 [recession](https://www.thebalance.com/what-is-a-recession-3306019). There were six quarters when [Gross Domestic Product](https://www.thebalance.com/what-is-gdp-definition-of-gross-domestic-product-3306038) (GDP) shrank. Inflation tripled in 1973, rising from 3.4% to 9.6%. It remained between 10-12% from February 1974 through April 1975.

(Source: BEA, 1970-1979 GDP; BLS, Chart of 1970-1979 Inflation)

How did this happen? Many experts blame the [1973 oil embargo](https://www.thebalance.com/opec-oil-embargo-causes-and-effects-of-the-crisis-3305806). That's when [OPEC](https://www.thebalance.com/what-is-opec-its-members-and-history-3305872) cut its oils exports to the United States and prices quadrupled. That triggered oil price inflation. But it was a combination of fiscal and monetary policy that created stagflation.

It started with a mild recession in 1970. Unemployment was at 6.1%, a result of the economy contracting for three quarters. [President Richard Nixon](https://www.thebalance.com/president-richard-m-nixon-s-economic-policies-3305562) was running for re-election. He looked for a way to boost growth without triggering inflation.  On August 13, 1971, he announced four economic policies that got him re-elected. Without realizing it, he also sowed the seeds for stagflation.

First, Nixon instituted wage and price controls. That prevented businesses' from changing domestic prices. When import prices rose, U.S. companies couldn't raise prices to remain profitable. Instead, they had to reduce costs. Since they couldn't lower wages, they had to lay off workers. That increased unemployment, reducing demand and slowing economic growth.

Import prices rose because of Nixon's second action. He removed the United States from the [gold standard](https://www.thebalance.com/what-is-the-gold-standard-3306137). It had kept the dollar's value tied to a fixed amount of gold. Nixon did this to prevent a run on the gold reserves at Fort Knox. Under the [Bretton Woods Agreement](https://www.thebalance.com/bretton-woods-system-and-1944-agreement-3306133) (post WWII), most countries [pegged](https://www.thebalance.com/what-is-a-peg-to-the-dollar-3305925) the value of their currencies to either the price of gold or the dollar.

That turned the dollar into a [global currency](https://www.thebalance.com/world-currency-3305931). As a result, demand for the dollar rose. The crisis occurred when Great Britain tried to redeem $3 billion for gold.

When Nixon took the United States off of the gold standard, the price of gold skyrocketed -- from $35 an ounce to $120 an ounce. At the same time, the [value of the dollar](https://www.thebalance.com/value-of-us-dollar-3306268) plummeted. The result? Import prices rose.

To fight inflation, the Fed kept raising interest rates, reaching a peak of 20% in 1979. Instead of signaling the market and being consistent, the Fed did so in a "stop-go" fashion. This confused businesses, many of whom kept prices high. (Source: "A Monetary Explanation of the Great Stagflation of the 1970s," Robert B. Barsky, University of Michigan and NBER,  Lutz Kilian, University of Michigan and CEPR, 2000. "[The Nixon Shock Heard 'Round the World](http://online.wsj.com/article/SB10001424053111904007304576494073418802358.html)," *The Wall Street Journal*, August 15, 2011.)

Can Stagflation Reoccur?

In 2011, people became concerned about stagflation. They worried that the Fed's [expansionary monetary policies](https://www.thebalance.com/expansionary-monetary-policy-definition-purpose-tools-3305837), used to rescue the economy from the [2008 financial crisis](https://www.thebalance.com/2008-financial-crisis-3305679), would cause inflation. At the same time, Congress approved an expansive [fiscal policy](https://www.thebalance.com/what-is-fiscal-policy-types-objectives-and-tools-3305844). It included [the economic stimulus package](https://www.thebalance.com/what-was-obama-s-stimulus-package-3305625) and record levels of deficit spending. Meanwhile, the economy was only growing at about 1-2%. People warned about the risk of stagflation if inflation worsened and the economy didn't improve.

This massive increase in global [liquidity](https://www.thebalance.com/liquidity-definition-ratios-and-how-it-s-managed-3305939) prevented deflation, a far greater risk. The Fed won't allow inflation to go beyond its [inflation target](https://www.thebalance.com/inflation-targeting-definition-how-it-works-3305854) of 2% for the [core inflation rate](https://www.thebalance.com/core-inflation-rate-3305918). If inflation rose above that target, the Fed would reverse course, and institute [contractionary monetary policy](https://www.thebalance.com/contractionary-monetary-policy-definition-examples-3305829).

Other unusual conditions that created stagflation in the 1970s are unlikely to reoccur. First, the Fed no longer practices stop-go monetary policies. Instead, it clearly signals a consistent direction. Second, the removal of the dollar from the gold standard was a once-in-a-lifetime event. Third, the wage-price controls that constrained supply wouldn't even be considered today.