Breaking out of stagflation: Some regional comparisons

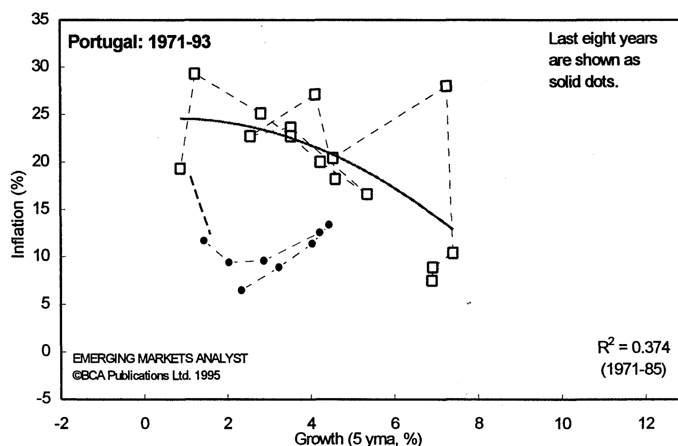
Stagflation has been a fact of life in regional economies, although this is now changing as a result of structural reform and deregulation. During the transition, faster growth does not necessarily imply higher inflation, or vice versa.

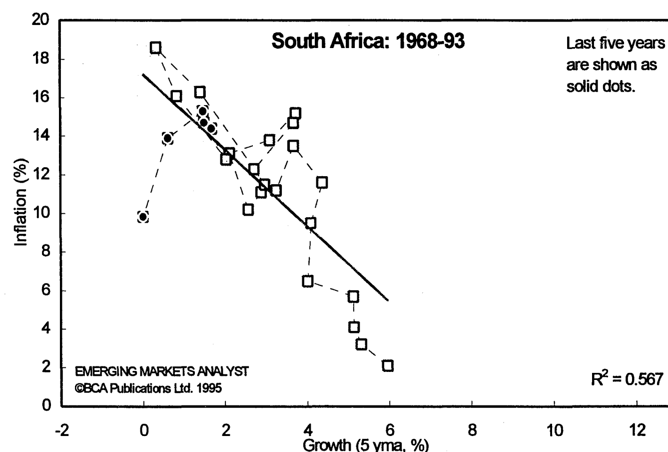
Emerging markets in Europe, Middle East and Africa have typically been associated with low growth and high inflation, a combination which economists call "stagflation." This is mainly because they have traditionally sustained a relatively high standard of living within a protected local market with a large public sector financed by high public debt and other foreign capital inflows.

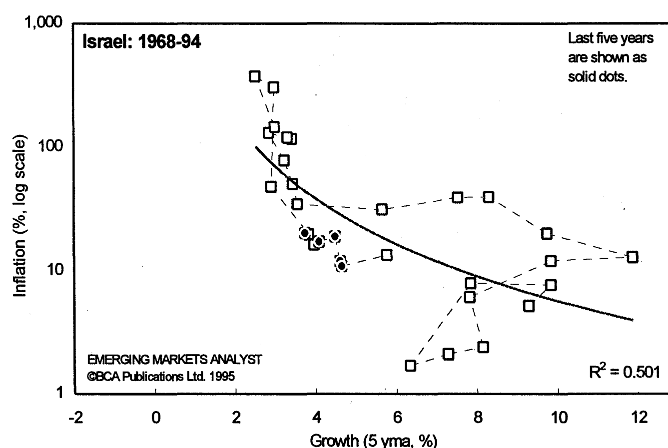
In such circumstances, the classical trade-off between high growth and low inflation does not often apply. Quite the reverse: *higher* growth is generally associated with *lower* inflation. The charts alongside and on page 8 demonstrate that for Portugal, South Africa, Israel, Turkey and Greece, the more rapid the sustained rate of economic expansion (represented by a five year moving average of the real GDP growth rate), the lower the rate of price inflation.

There are a number of explanatory factors at work. Higher growth reduces the burden of cyclically driven social spending and thereby keeps budget deficits and public borrowing in check. Higher growth is also associated with higher corporate profitability and a reduced corporate borrowing requirement. Because public borrowing plays such a dominant "crowding out" effect in credit markets, monetary policy tends to be pro-cyclical: i.e. it is relatively loose during an expansion and tighter during a recession. Furthermore, many of these economies are dominated by heavy corporate concentration, so that during periods of low growth, the only method for maintaining earnings growth is to raise profit margins.

However, the traditional pattern is being broken in a number of countries. In the case of Portugal, the experience since 1986 is clearly at odds with earlier patterns. Since joining the EU, Portugal has sustained a radical restructuring which has reduced its debt load and trimmed its budget deficits. Increased competition from imports has reduced oligopolistic behavior. Inflation has become positively correlated with growth.



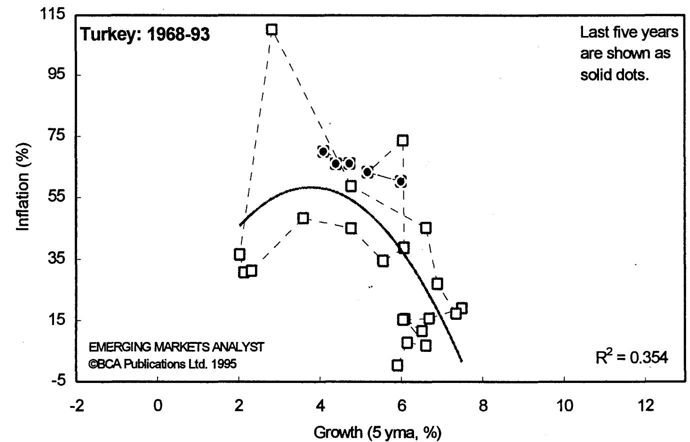




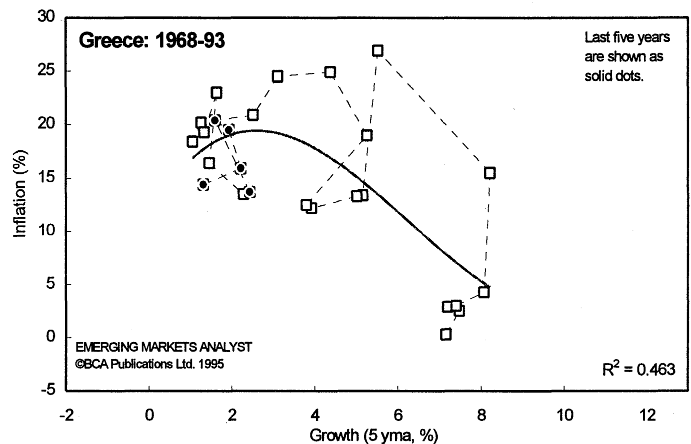
South Africa's deflationary experience in 1993 -- when both inflation and long-term growth dropped at the same time -- could well be the first step towards breaking its very tight stagflationary relationship. The experience of 1994 seems to confirm that a pick-up in growth is being matched by higher inflation. Fundamental structural change is taking place in an economy which still has plenty of spare capacity.

These reforms are underpinned by support from the corporate sector (see the "Political Economy of Peace" on pages 9-10.)

However, even when driven by a major political shift in economic policy, an apparent breakout from the stagflationary mold is not necessarily permanent. In the early 1980s for example, the Turkish economy made what looked like a break with its stagflationary past under the reformist administration of Turgut Ozal. The government ran successive budget surpluses, kept a tight monetary stance and encouraged rapid export-led growth. The chart alongside shows that during this brief period, there was a positive relationship between inflation and growth. Subsequent backsliding on reform, and the failure to either restructure or privatize loss-making state enterprises have resulted in the Turkish economy reverting to its stagflationary tendencies.



Greece displays similar tendencies. As is the case in Portugal, the Greek government has also been encouraged by the EU's convergence criteria to inject some semblance of order into its public finances. Like Portugal, therefore, there has been less of a stagflationary tendency in Greek economic cycles in recent years, as illustrated by the chart alongside. However, Greece's fiscal reform is still in its infancy compared with Portugal's. The tax base is still very narrow, the public sector borrowing requirement remains over 12% of GDP and debt to GDP ratios are alarmingly high.



Israel, on the other hand, has not yet shown signs of breaking out of its stagflationary straitjacket. The economy remains highly concentrated and oligopolistic. Foreign aid inflows have permitted the government to consistently ignore prudent fiscal constraints over a long period.

Low growth in such circumstances have always been associated with higher inflation. Israel's chance to change will likely arise from the prospects for peace in the region. The arrival of substantial foreign competition in the domestic Israeli market and the enhanced opportunities for local companies to generate export-led growth suggest that stagflationary tendencies may be weakened in the future.

Investment conclusions

- In the absence of effective structural reforms, it is misleading to assume that faster growth is inflationary. Therefore, "rote" forecasts (e.g. that bonds will outperform equities as growth decelerates) are not necessarily appropriate.

- Israel's tight monetary environment will not, *of and by itself*, bring about disinflation. Conversely, a peace-driven export boom could well succeed, where the central bank has failed, to cut inflation.

- Portuguese disinflation is now likely coming to an end as its economy picks up steam. Greek disinflation is likely to end as its economy slows down.

- The collapse in Turkish domestic economic activity does not imply an end to its serious inflationary problems. Turkey will remain mired in stagflation until it can restructure its public sector.