

The Economics of Stagflation, Part II

di Paul Krugman

In last week's primer I wrote about what stagflation is, the logic behind it, and its history. Here's a brief list of what I covered:

- Stagflation is a combination of inflation and high unemployment
- What it means for inflation to become *entrenched* in the economy: companies and workers raise their prices because they expect everyone else to do the same.
- Taming the inflation of the 1970s required extreme measures by the Federal Reserve, resulting in a severe period of stagflation in the US during 1979-1984, because inflation had become entrenched in the economy
- In contrast, taming the post-Covid inflation of 2022 to 2024 did not require the same harsh medicine because inflation had not become entrenched in the economy. As a result, the Federal Reserve was able to bring inflation down without inflicting high unemployment on the economy.

Today I'll look forward. Stagflation is very much on people's minds again, for good reason. The Trump administration's tariff and deportation policies are creating a significant inflationary shock. They're also imposing a significant drag on economic growth. Today, it's likely that the United States would be heading into a recession under the weight of higher prices and slower growth if the economy weren't being supported by a huge boom in AI-related investment. And this danger remains: if the AI boom goes bust, the odds are high that the US economy will be plunged into a recession.

In talking about stagflation, it's important to acknowledge that its effects can range from run-of-the mill bad to devastating. For example, in the early 1990s, there was a burst of inflation and an extended period of elevated unemployment. It was bad — but not *that* bad. That is, there was a mild recession, not a deep and devastating one. But there are also episodes like 1979–1984 (which I covered at length in last week's

primer). In that episode, it took a severe and lengthy recession — many years of high unemployment — for the Federal Reserve to bring inflation under control. Last, as we experienced in the post-Covid period, there can be times when stagflation can be avoided altogether.

What accounts for the difference? That is, what determines if a period of inflation will result in a devastating recession rather than a merely mild recession, or perhaps no recession at all? The answer, as I wrote in last week's primer, is due to whether inflation or not has become entrenched in the economy. When it has, the Federal Reserve has to send the economy into a severe recession by raising interest rates substantially to purge the price spiral from of the economy. If inflation hasn't become entrenched, the Federal Reserve can tame inflation without needing to cause high unemployment.

Which scenario will it be this time? I don't know. The Federal Reserve doesn't know. Trump administration officials *definitely* don't know. But we can talk about the factors affecting how it goes — and what policies might make it better or worse.

Beyond the paywall I'll discuss the following:

1. The Trump shock and how it's playing out
2. How will we know if inflation is becoming entrenched?

I'll reserve discussion of policy — and the crucial role of the Fed's credibility — for yet another stagflation primer, next week.