

Editorial



Dr Gustav A. Horn,
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the Business Cycle, asks:

"Same Shock – Same Mistakes?"

Industrialised countries are facing another oil-price shock. Oil prices have risen from about 12 US-dollar per barrel to 30 US-dollar. This increase of more than 100% in a short period of time clearly deserves the label 'shock'. For the third time since 1973 the industrialised countries face significantly rising import prices, which feed into energy, raw material and subsequently into producer prices. An initial rise in inflation will result. For the EMU countries the impact is exacerbated by the devaluation of the Euro.

The important question is whether this shock will lead to stagflation – simultaneous inflation and recession – as its predecessors did. There were two developments which triggered severe recessions in 1974 and 1981. Firstly, workers tried to compensate for the initial rise in inflation by higher wage claims. Secondly, in expectation of accelerating inflation central banks raised interest rates to curb inflation. It was a combination of unjustified wage hikes with an overly tough monetary stance which led to recession and a steep rise in unemployment. So are we heading once again into a similar crisis or are we now better prepared?

The answer is ambiguous. On the one hand, against the backdrop of a still dismal employment situation, wage settlements in Europe are rather moderate, hovering around 2% for the EMU countries on average. At least in Europe but, albeit to a lesser extent, also in the USA, this is a marked difference from previous oil price shocks. If – as seems highly probable – wage moderation continues there is no reason to fear that price stability targets will be violated and that inflation – which is currently far lower than in the two previous oil price shocks – will accelerate permanently.

On the other hand, despite wage moderation central banks have embarked on a course of raising interest rates, so the second element observed during previous oil price shocks is present. Whereas this may be justified in the USA, after the long boom with unemployment now low, Europe is in a totally different situation. This year will be the first since the mid-1990s in which growth rates may be around 3%. Simultaneously, wages are moving upwards slowly and will do so for some time. Most inflation forecasts take this into consideration and see inflation rates decreasing in the course of this year. Nevertheless, the European Central Bank (ECB) is acting as if the threat of inflation were imminent.

Consequently, the real danger of the present oil price shock, at least for Europe, is that it could be misinterpreted by the ECB as a signal for inflation. Under present circumstances higher interest rates do not fight inflation but growth. Although one mistake made on previous occasions – adjusting wages upwards to offset temporarily higher inflation rates – has not been committed this time, one cannot be too sure that the ECB will not act as if it had. The result could be a reduction in the growth so desperately needed to get unemployment down. Same shock – different mistake.