Rodney's Take

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Stumbling Toward Stagflation

The Federal Reserve has been hell-bent on beating inflation since March of 2022, but as we've discussed many times, the central bank took on fixing a problem that it didn't create. Yes, the bankers created a financial asset bubble through near-zero interest rates and by printing an additional $5 trillion, but that wasn't what drove higher prices in day-to-day life. From fiscal policy that showered our economy with cash during COVID as supply chains broke down to energy prices determined in the Middle East and on the battlefield in Ukraine, there were several major sources of changing demand and higher prices that had nothing to do with borrowed money.

But that reality won't stop Fed Chair Powell and his fellow bankers from using their one-size-fits-all tool—interest rates—to battle inflation. Unfortunately, inflation might remain stubbornly above the Fed's 2% target even as they destroy demand. That could usher in an unwanted period of stagflation. It all comes back to oil.

Just when it looked like we might get a Fed pause and a reprieve from higher prices, OPEC+ announced a surprise supply cut of more than one million barrels per day, which has pushed oil and gas prices higher. Oil prices are back above $80 per barrel, even as many economists forecast a recession in the U.S. starting this summer and the IMF lowered its 2023 global growth estimate to just under 3%. IMF President Kristalina Georgieva noted that this is the lowest medium-term growth forecast since 1990. The problem, as

we know from the 1970s, is that the price of oil affects everything but takes time to work through the economy.

Saudi Arabia and other OPEC members appear to be gaining confidence in turning away from policy moves that mollify the U.S., instead charting their own course. The latest move to shrink supply and, therefore, raise prices is exactly the opposite of what the current administration has asked for. The move will put more revenue into the pockets of oil producers, including Russia, at the expense of consumers around the world. Apparently, our stated goal of ending the world's reliance on their main export and fading military support has Saudi Arabia and other OPEC members rethinking their alliances. The latest supply shock wasn't huge, amounting to about 1% of global demand, but it was a shot across the bow. We no longer have similar goals.

The Saudis are happy to sell oil to anyone and have turned a blind eye to "blending," in which importers buy Russian crude, mix it with other inventory, and then sell it on the global market. This allows Russia to keep the oil and revenue flowing even with sanctions in place. Saudi Arabia also has reached a détente with both Iran and Syria in recent weeks, restarting relationships with two U.S. adversaries in the region. It's clear that Saudi Arabia and other nations are breaking their bonds to the U.S., the exchange of petrodollar oil trading for military security, that kept oil prices mostly in check for the past half-century.

As we go through this period of change, we're likely to find oil prices recentered around $100, or about 25% higher than today. The higher energy costs will drive up the price of everything from transportation to manufacturing, even though our demand won't change. Higher costs with low or no growth equals stagflation, minus the high unemployment.

Unfortunately, it could get worse. If we don't go into a recession or if China recovers more quickly than expected, then global growth might move higher. That would be great, except that now we can expect OPEC to let prices rise with demand. If the price of oil climbs toward $115 to $120 per barrel, it

might push prices higher on a broad range of products, which would compel the Fed to keep up its fight against inflation.

Consumers will be the biggest losers, as they will pay more in interest to borrow money for cars, credit cards, and homes, while sending more of their cash to the Middle East.

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