Focus on

Is "stagflation" a real threat and may construction be hit by its unfolding?

February, 22nd 2008

1. Preliminary remarks

In the economic talk there is growing concern about the risk of a comeback of the so called "stagflation season". The term was coined at the time of the first two big "oil shocks" when the increase in the oil price triggered an intense and widespread inflationary rebound across the western economies. This, coupled with wrong policies and rigid economic structures, sent the world economy into a period of low growth and – in some countries – full-blown recession. We think that the recourse made these days to such term may be justified on a purely journalistic ground but the closer scrutiny carried out in this "Focus on" reveals why differences between the current situation and the stagflation period are extremely wide; together with the fact that construction activity does not seem set to suffer the same setbacks it experienced in the Seventies – early Eighties as a consequence of very severe tightening of monetary policies.

2. A reduced transmission mechanism

For a start, the ongoing prices' dynamics is by and large softer than in the Seventies. Indeed, it is true that inflation has recently accelerated at a worrying pace: to over 4% in the US, 3% in the euro area and 6% in China; and it has also bounced back in a number of emerging countries already suffering from strong price pressures[1].

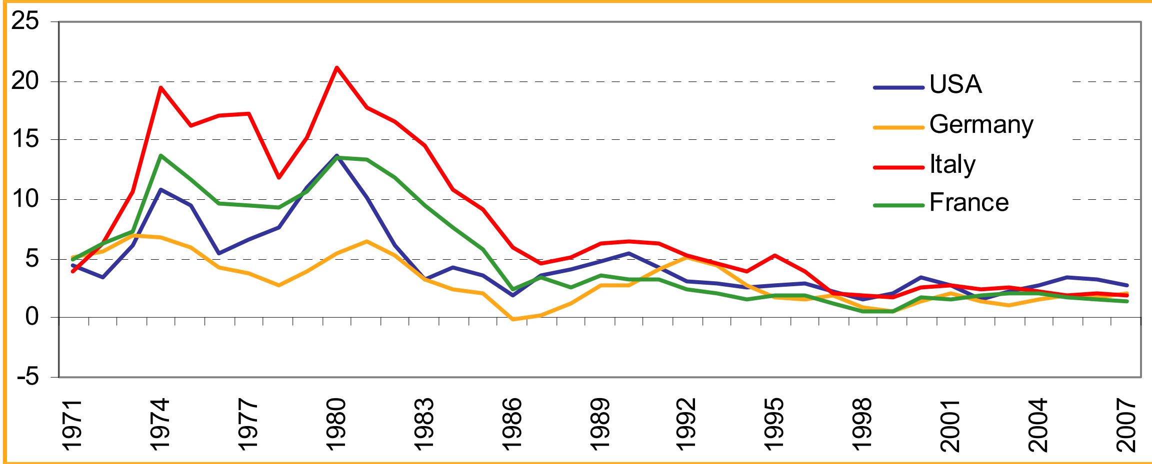
However, such increases reveal two big differences compared with the past: they are by far lower (for instance, inflation reached 13-15% in the US in 1980, *graphs 1 and 2*) and, most importantly, the so called "second round" effects – i.e. the spreading of price hikes originated in one single or in a few sectors to the overall economy – have been so far very limited, if not negligible.

The same factor, i.e. the oil price boom is in both periods at the origin of the inflationary process (it is to be added: of the same magnitude in the Seventies-Eighties and in the current decade, *graph 3*)[2].

[1] To stress some major trends displayed since the Seventies, the present analysis focuses on the US, Italy, France and Germany.

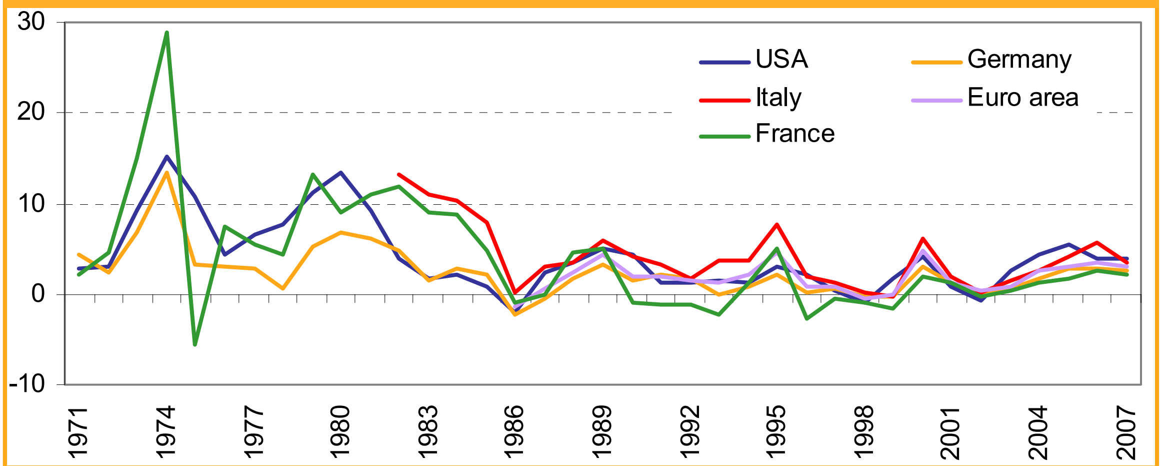
[2] However, the sharp increases of the Seventies were mainly supply-driven and occurred overnight while in the current circumstances the price has been demand-driven and the hikes have been showing up across a five-years period.

Graph 1 - **CPI** (y-o-y % ch)



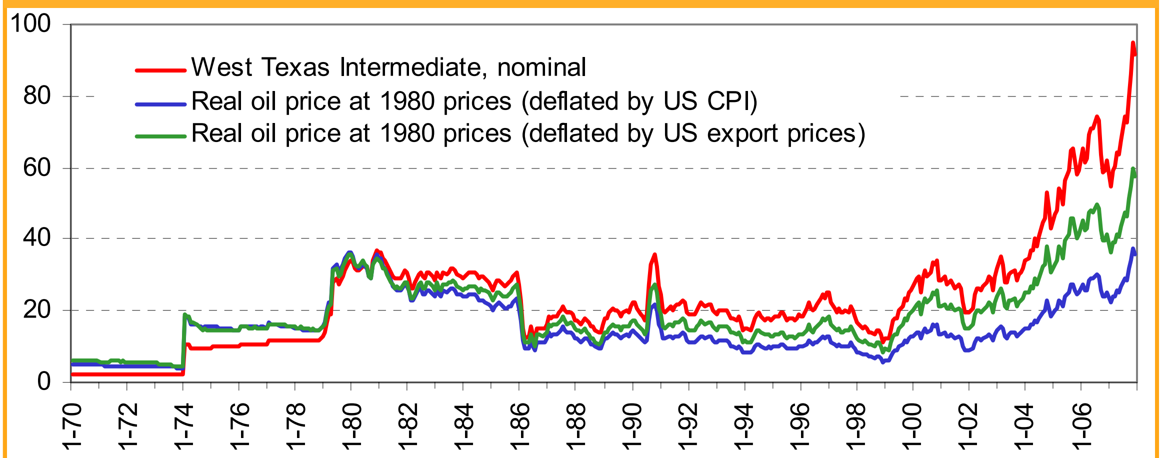
Sources: OECD, National statistics

Graph 2 - **PPI in manufacturing** (y-o-y % ch)



Sources: OECD, National statistics

Graph 3 - **Nominal and real WTI oil price** ($/b)



Sources: EIA, BLS

But here similarities end. As a matter of fact, the major industrial economies are now less dependent on oil imports than they were thirty years ago. In turn, this is because both the shift towards less energy-intensive productions (in industry as well in the service sectors) and savings in energy consumption – thanks to new technologies – have been huge. In addition, there are three other main differences as compared to the Seventies:

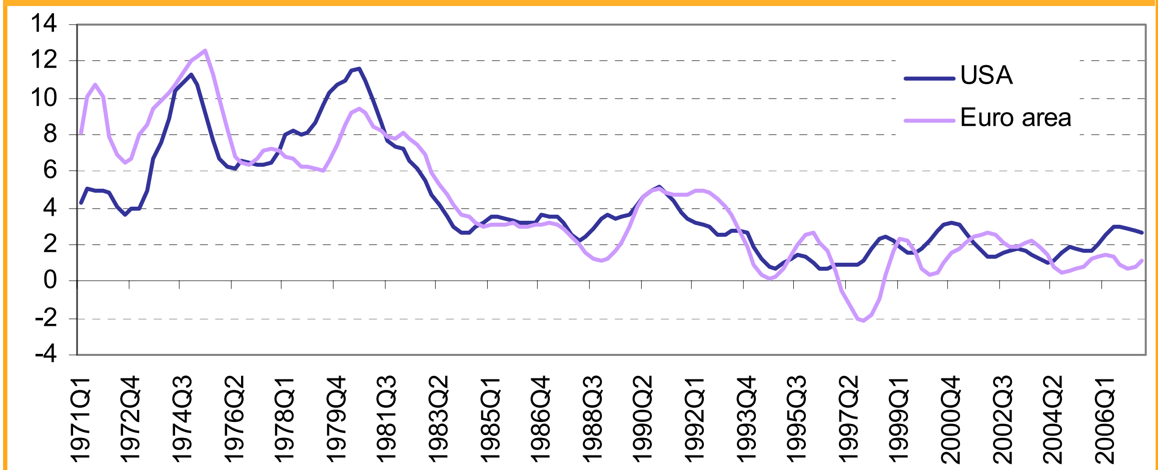
a) indexation systems on wages and a wide range of contracts have been dismantled or, in any case, strongly reduced in almost every country (think for instance of Italy). This makes much harder to disseminate and widen the inflationary response of a price hike occurred at a single point of the economic system – however important, as in the case of energy, it may be; as a matter of fact unit labour costs in the last few years have been kept largely under control, notwithstanding growing demand and employment (only in the US the pace of unit labour costs has slightly accelerated of late given a parallel – and arguably temporary – slowdown of productivity growth, see graph 4);

b) competition within sectors, and among countries has substantially increased, which means that in the value added chain there is now a lowered power to pass downwards cost increases stemming from primary commodities prices' hikes:

c) public finances – at least in the euro zone, but also elsewhere – are now less unbalanced and governments less keen on sustaining households' purchasing power through subsidies or tax rebates in order to compensate for external price shocks.

All the above is to emphasise that structural conditions have changed to such an extent that the ongoing inflationary stimuli are nowadays not likely to take root in the economic systems and seem of a more transitory nature.

Graph 4 - **Unit labour costs** (y-o-y % ch., quarterly data)

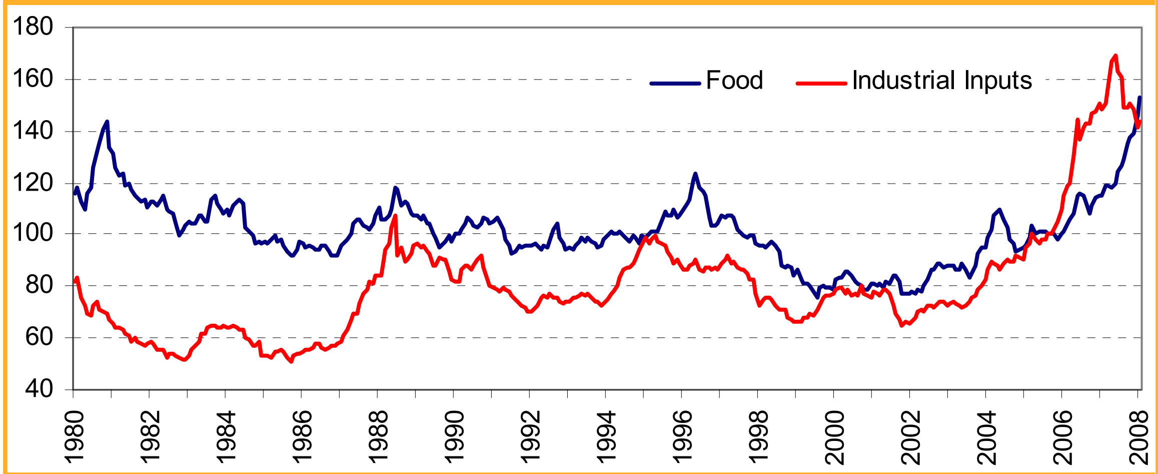


Source: OECD

3. The peak of commodity prices may have been reached

Also primary commodities' price pressures do not seem set to last. Two factors support this view. First, the boom of non-energy commodity prices appears now more under control, after doubling in dollar terms in the last few years (*graph 5*).

Graph 5 - **Commodity Non-Fuel Price Index** (index numbers, 2005=100)



Source: IMF

More in detail and as for food, the boom has been spurred – particularly in the past twelve months – by supply shortages, also given the shift of production towards more profitable – mainly thanks to government incentives – bio-fuels.

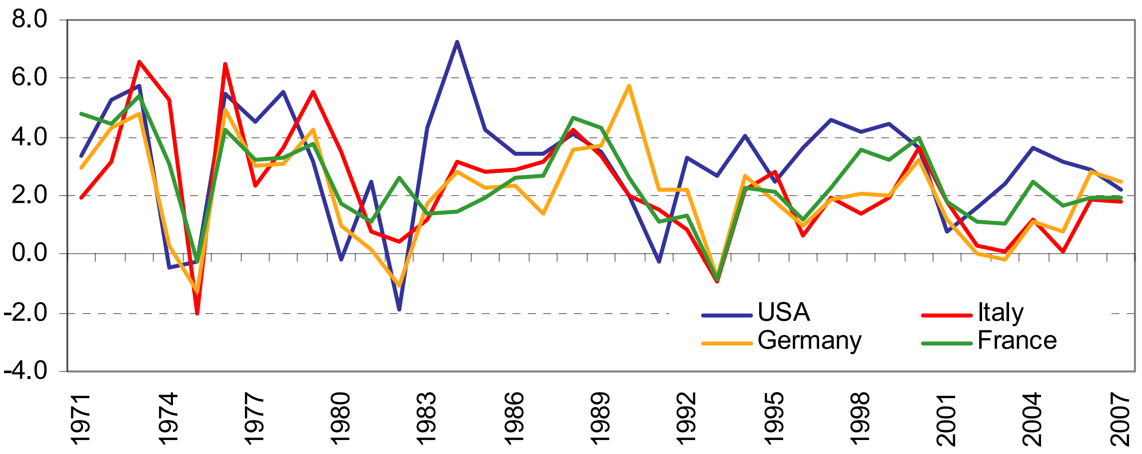
On the other hand, metals' prices have decelerated somewhat since last summer which signals that the strength of global demand may be softening (although new hikes have been observed again in the last few weeks).

As for oil prices, since 2002 they have skyrocketed under the effect of two main drivers: a structural one (demand/supply mismatch, low spare capacity, a delayed and costly flow of new investment) and a number of occasional factors (local problems at single plants' level, geo-political tensions, drawdown of stocks), while also speculation and the dollar depreciation have played a role in driving prices up. To sum up, given the ongoing weakening of the rate of growth at world level and assuming that some of the above mentioned contingent factors are going to lose steam, commodity prices – though remaining a crucial issue – should not add further pressures to the ones that are already in the pipeline.

4. Slower growth, not recession at the horizon

In the US, growth has indeed strongly decelerated in the last quarter and activity levels are likely to undergo further easing in both the present and the coming quarters. It is however far from sure that such slowdown will turn into a full-blown recession as the ones occurred in the mid-Seventies and early Eighties (see *graph 6*); furthermore, the euro area – though slowing down markedly – is still expected

Graph 6 - **GDP** (y-o-y % ch)



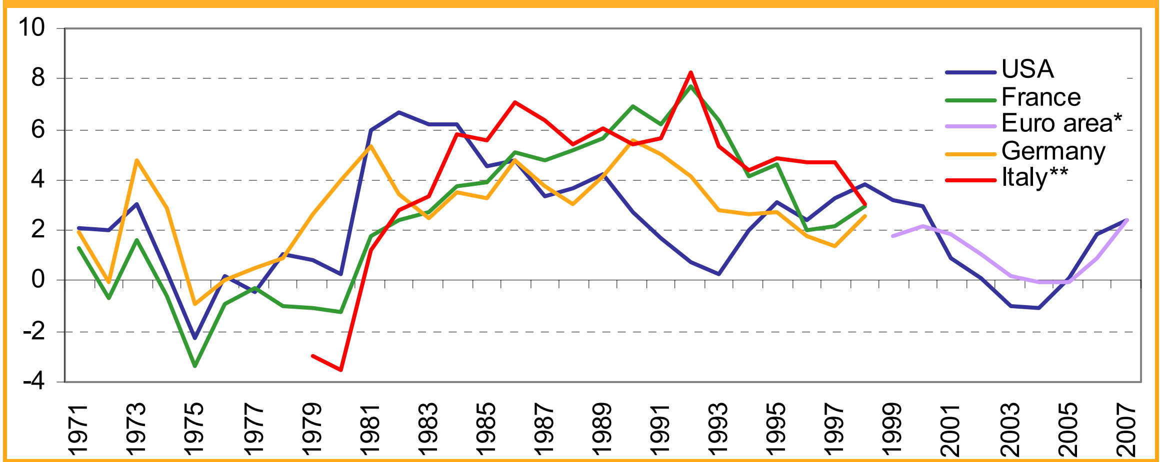
Sources: OECD, National statistics

to keep growing this year at a decent rate while the emerging area as a whole is set to grow around 7%, notwithstanding the above mentioned weakening industrial economies. In brief, once the hypothesis of a melt-down of the financial system is ruled out, only a slowdown should be felt at world level.

However, due to the existing disequilibria, a phase of more moderate growth is likely to last for an extended period. Three factors support the view that in the years to come economic dynamism will be not as brilliant as in the past five years:

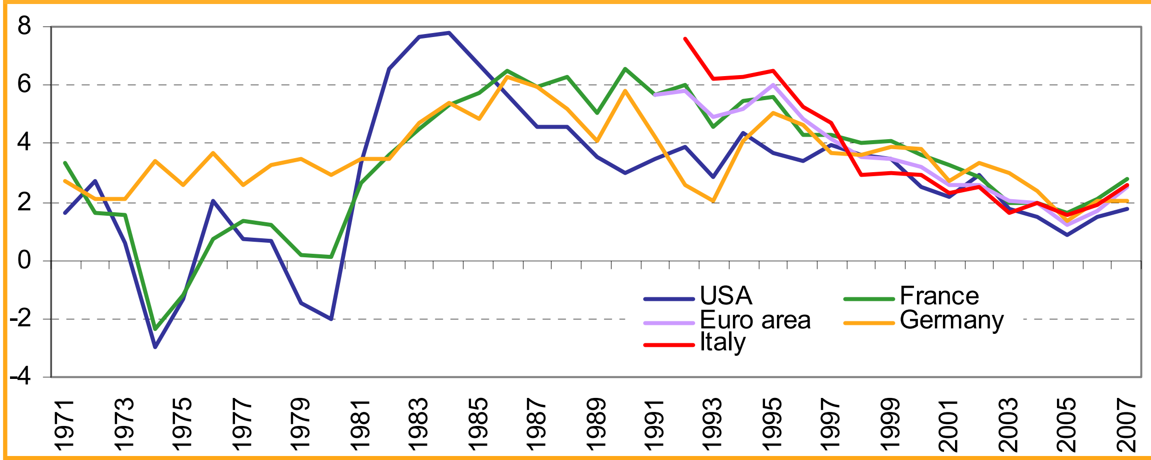
- in the recent past the world economy has benefited from growing competition and market openness from the emerging countries; in the future such support should ease as no large formerly excluded country is to be admitted to the WTO; perhaps the opposite risk of a resurgent protectionism may materialise;
- between 2002-2007 interest rates hovered around unprecedented lows and it is unlikely that they will regain comparable negative real levels in the years to come, also in a scenario of an accommodative monetary policy (*graphs 7 and 8);*

Graph 7 - **Real short term interest rates** (%)



Source: OECD. * Since 1998 3-m EURIBOR; ** Data for Italy start from 1979

Graph 8 - **Real long term interest rates*** (%)



Source: OECD. * Data for Euro area and Italy start from 1991 and 1992 respectively

- the relative currency and financial stability seen in the recent past could fade and leave the ground open for larger forex volatility, particularly as far as emerging currencies are concerned. The global economic environment could thus be marked by growing risk aversion, more severe credit standards and overall tighter financial conditions.

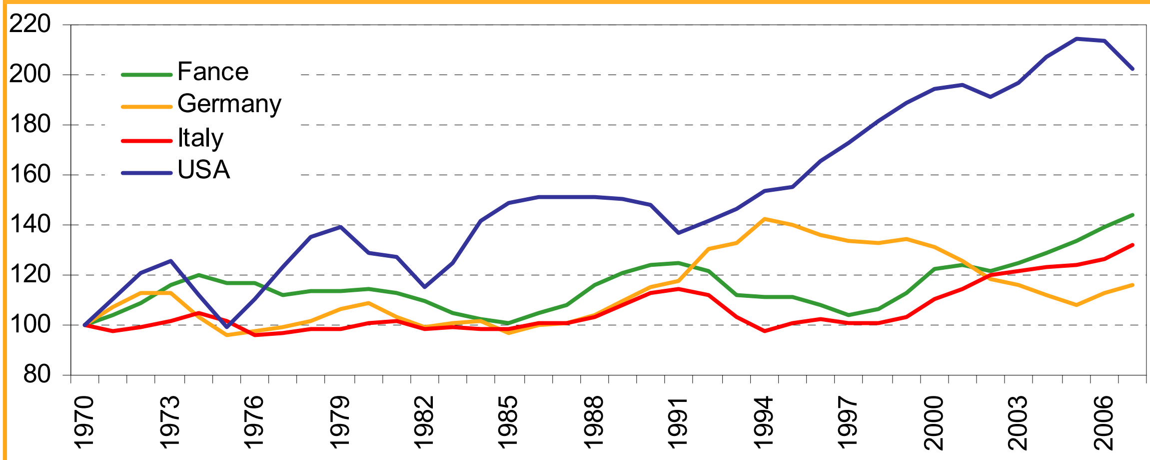
On the other hand, productivity growth – one of the most powerful engines of the latest years' strong global performances – has still large leeway as innovations in numerous sectors as well as the diffusion of new technologies into both traditional sectors – mainly in the services' area – and laggard countries may spur a robust stream of productivity gains also in the years to come.

To recap, once the ongoing financial turmoil ends, we will see the world economy moving towards a path of more balanced but less vigorous growth as compared to the previous five years. At the same time, moderate growth together with the ongoing recovery of investment in energy and non energy primary commodities' sectors is expected to contribute to ease inflationary pressures. It is in this perspective that one can consider the risks of stagflation largely overdone.

5. Is construction at risk of a severe downturn worldwide?

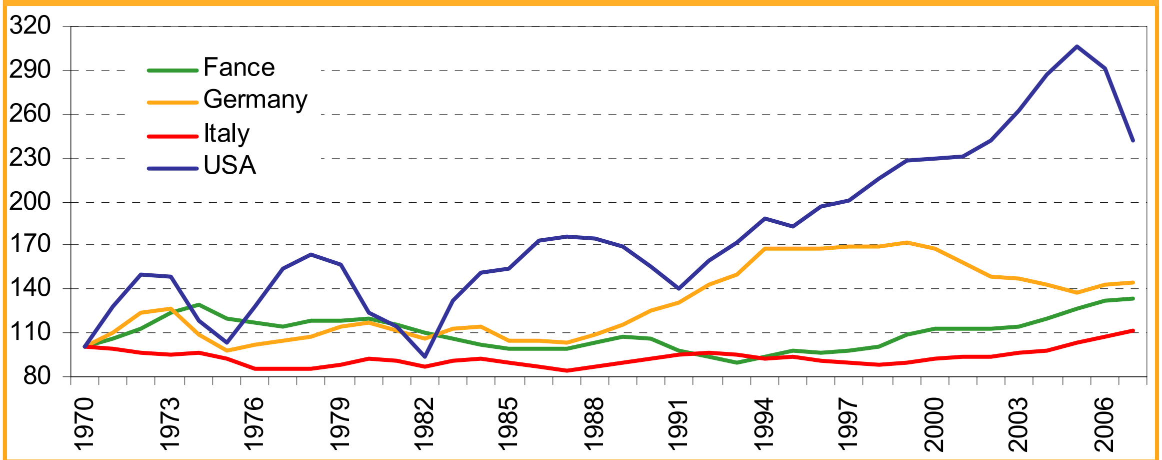
What does this mean for the construction sector? Here again, what happened three decades ago may shed some light.

In this regard, it is helpful to compare the past experience of Germany and the US with the ones of France and Italy (*graphs 9, 10 and 11*). In the first two countries monetary policy was strongly tightened – although not with the same timing – which translated into real interest rates positive and extremely high, and in turn resulted in a deep fall in construction investment (as it is well known, the construction sector is highly sensitive to borrowing conditions, particularly to the availability and cost of long term credit). On the other hand, in Italy and France, Graph 9 - **Construction investment** (index numbers, 1970=100)



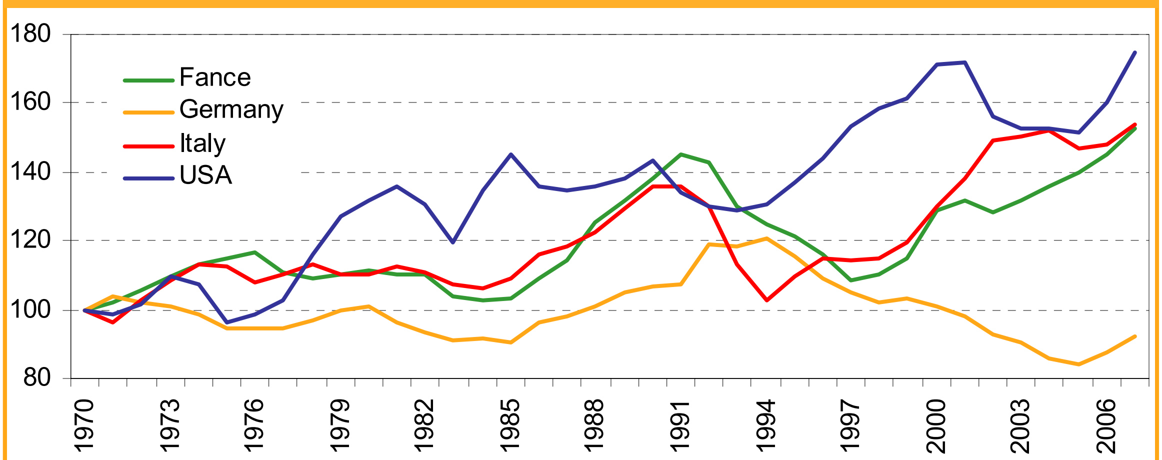
Source: OECD

Graph 10 - **Residential investment** (index numbers, 1970=100)



Source: OECD

Graph 11 - **Other construction investment** (index numbers, 1970=100)



Source: OECD

where inflation was higher and more deeply rooted, real interest rates remained below the level of the above two counties, which resulted in a smoothed profile of the construction cycle. In other words, it was not inflation to dramatically hamper construction but the monetary reaction triggered by some Central Banks.

Turning to our days, there are two conclusions that may be drawn with a reasonable level of confidence:

- given the reduced weight of commodities in the production processes as well as the removal of indexation mechanisms and overall more careful economic policies, inflation is not set to repeat the dynamics shown between the Seventies and the Eighties (when in numerous industrial countries it overcame the two digit threshold);
- long term interest rates are poised to remain in real terms quite sustainable (i.e. hovering in the 2-3% range in both the US and the eurozone). This latter point simply means that sharp contractions of the construction sector caused by abrupt and elevated increases of interest rates are unlikely to materialise.

The above conclusions strengthen the view that construction cycles will be in the future more smoothed. However, we have recently seen that even too low interest rates may hurt construction as they favour overbuilding, particularly in the residential component. The subsequent adjustment of supply to demand may thus imply long periods of subdue activity of the housing segment. To sum up, even though a stagflation risk remains negligible almost everywhere, a perspective of moderate construction activity driven by a sluggish housing sector may prevail in those countries where monetary policy has been too loose for long. Besides the US, in the euro area strong evidence of such circumstances seems to affect only Spain, where real interest rates – given one of the highest inflation rate of the euro area – have been extremely low for an extended period and stocks of unsold homes have been of late rapidly rising.