Growing pains

Neil Hodge ponders the most hated term in the economist's dictionary

Following the collapse of the US sub-prime mortgage market last year and the heavy hit that the world's banks have taken as a result of their former lax approach to lending, it is unsurprising that the flow of money is slowing to a trickle, prompting governments to tighten their belts, cut growth forecasts and raise interest rates to stem rising interest rates.

Even the US Federal Reserve – the bell weather of the world economy – has hinted that interest rates may have to rise. It has also hinted that, if needs be, it would favour prolonging a period of stagnation, rather than risk stagflation.

So far, no country has admitted that they are actually undergoing "stagflation" – high inflation rates combined with low growth – but it seems likely that it is only a matter of time before either a central bank governor or finance minister does so. And it is unlikely that the count will stop at one. Furthermore, the first country that utters the "s" word could as easily come from Europe as it could from the developing world, though economists agree that the impact of stagflation on the latter will be more acute, politically as well as economically.

According to June figures released by four countries in the region, inflation is accelerating in Asia, raising the likelihood that central banks will be obliged to increase interest rates in spite of rising fears of slowing growth. Furthermore, Asia remains home to two-thirds of the world's poor, and protests over soaring prices are threatening to further weaken governments that are struggling to contain unrelated unrest, such as ethnic tensions in Malaysia and protests over beef imports in South Korea.

With signs that an economic slowdown might already be taking place, South Korea's central bank cut its 2008 growth forecast to 4.6 percent – well below the six percent promised by Lee Myung-bak when he took office as president in February. South Korea's finance minister also said that the country could be heading towards stagflation. "It's premature to say we are experiencing stagflation but the economy is moving that way," said Mr Kang Man-soo.

In Japan, the closely watched Tankan survey showed confidence among manufacturers at its lowest level in four years, while in Vietnam, one of Asia's fastest-growing countries, the government said first-half growth was the slowest in at least seven years at 6.5 percent.

Provoking action

"I think we are definitely crossing a threshold and the kind of inflation numbers that we are seeing will have to provoke central banks into tightening policy," said Duncan Wooldridge, Asian Chief Economist at UBS. "Ultimately there is a risk of stagflation if central banks don't have the stomach to tighten more aggressively."

Adding to the growing concern about economic downturn, the IMF warned that surging food and oil prices could "severely weaken" the outlook in about 75 developing countries, including populous Asian nations such as Pakistan and Indonesia.

Thailand has also said inflation had risen to a 10-year high of 8.9 percent in June from 7.6 percent in May, while South Korea said consumer prices were 5.5 percent higher than a year earlier – the biggest annual jump since November 1998. In Kazakhstan, inflation accelerated to 20 percent year-on-year in June, the highest in more than eight years. A similar scenario is developing in Sri Lanka, where inflation rose to 28.2 percent in June – its highest in more than five years.

At the beginning of July, Bank Indonesia raised its key interest rate 25 basis points to 8.75 percent in a move designed to control soaring inflation, which hit a 21-month high in June. Boediono, the central bank's governor, hinted strongly that further rate rises would be necessary, saying that year-on-year inflation could rise from 11.03 percent to 12.5 percent by year end because of "economic uncertainties".

Relying on reserves

Analysts expect the bank to sell dollars to support the country's currency, the rupiah, which has fallen 2.2 percent this year, in addition to raising rates to control inflation. Boediono forecast that economic growth would slow to 6.1 to 6.2 percent, from 6.3 percent last year. Most economists believe rates will have to rise to about 9.5 percent by the end of the year but that the central bank will be reluctant to go much higher than this because it expects inflation to fall to below eight percent next year. Inflation began climbing after the government raised the price of subsidised fuel, which accounts for 95 percent of consumer use, by 28.7 percent in May. The month-on-month inflation rate in June was 2.46 percent. Increasing oil prices are going to pressure the government even more.

But such pressures are not limited to Asia and its developing economies. Europe is also showing signs of struggling with the spectre of stagflation. The ECB raised interest rates in the Eurozone for the first time in more than a year in July as it stepped up efforts to control mounting inflation pressures. The ECB lifted its main interest rate by a quarter percentage point to 4.25 percent – the first rise in Eurozone borrowing costs since June last year.

The increase came just days after official figures showed Eurozone inflation had hit four percent, the highest since the launch of the euro in 1999 and more than double the ECB's target of an annual rate "below but close" to two percent. Based on reconstructed-historic data, Eurozone inflation was last higher in May 1992.

Ahead of the ECB announcement, the Riksbank in Sweden – which is not part of the Eurozone – said that it was increasing its main interest rate by a quarter percentage point to 4.5 percent, adding that it expected to tighten monetary policy twice more during the year.

Still, Eurozone growth is showing clear signs of slowing, especially in Member States such as Spain and Ireland, hit by property market corrections.

The Spanish economy grew at its slowest quarterly pace in nearly 13 years between January and March, as a tumbling housing market and the global credit crunch brought a sharp

deceleration in economic activity. The economy expanded by 0.3 percent in the first quarter of this year – the lowest rate since the third quarter of 1995, the National Statistics Institute said.

The slowdown appears to have caught the recently re-elected socialist government by surprise, even though the Círculo de Empresarios, Spain's biggest business lobby, warned only in June about the risks of stagflation. Pedro Solbes, Finance Minister, recently lowered the official growth estimate for 2008 from 3.1 percent to 2.3 percent. But on the basis of the economy's recent performance, even that revised forecast looks optimistic, say analysts.

Grim outlook

Economists are worried about the impact of the slowdown on employment and government revenues. Between 2004 and 2006, Spain created one-third of all new jobs in the EU, many of which were filled by Spain's 4.5m immigrants, who make up 10 percent of the population. Unemployment is now rising as construction and services industries shed jobs – in June it topped 2.3m, 15 percent higher than a year ago.

Although slower growth could reduce inflationary tensions, the Eurozone economy appears to be slipping towards stagflation, say manufacturers based in the region. In the latest example of such trends, the German chemicals association said it expected chemicals prices to rise by 3.5 percent this year, rather than the two percent it had previous expected. At the same time it revised down its forecast for growth in production – to just 2.5 percent, compared with the three percent it had previously expected.

Such announcements are hardly inspiring investors to part with their cash, and manufacturers and fuel-reliant industries, such as the automotive and aviation sectors, are finding that the flow of money from investors and customers is drying up. According to a recent poll of global fund managers carried out by stockbroker Merrill Lynch, investors are more pessimistic now about equity markets than at any time in the past decade. The survey also found that sentiment towards equities is even more negative than between 2000 and 2003 when the sell-off in global stocks was much sharper.

Merrill Lynch's survey of 204 asset allocators and fund managers found that investors have cut their exposure to both equities and bonds and are moving into cash as fears of stagflation grow. A net 27 percent of investors surveyed (the net figure is the balance between those respondents who favour an asset class and those who do not) were underweight in equities relative to other asset classes, while a net 42 percent were overweight in cash, up from a net 31 percent in May.

Rotting at the core

The outlook for global growth and profit expectations is deteriorating as investors brace themselves for higher inflation and interest rates, the survey noted. A net 81 percent of respondents believe that consensus earnings estimates for the next 12 months are too high. Europe has borne the brunt of investors' shift from equities, with the Eurozone moving from investors' most favoured region to least favoured over the past 12 months. A net 22 percent of investors are underweight in Eurozone equities. But the bearish stance towards the eurozone is dwarfed by the negative view of the UK. A net 38 percent of respondents are underweight UK equities, the most negative stance in a decade. A net 62 percent of respondents are overweight oil and gas, while a net 62 percent are underweight in banks.

"Investors don't know where to go. They are favouring oil and commodities plays in equity markets, which shows that inflation is playing havoc," said Karen Olney, Chief European Equities Strategist at Merrill Lynch. ■