



Professor Norbert Walter

A spectre returns

What tough luck. First the subprime crisis, then the talk of recession in the US. And to cap it all comes yet another piece of bad news: the return of stagflation.

It is a term that has been gathering dust for so long that we need to remind ourselves what it actually means. Stagflation is the simultaneous occurrence of stagnation and inflation. The term had its heyday during the 1970s. Both then and now, the spike in oil prices contributed to high inflation – but back then it was triggered by the imposition of artificial supply constraints. The current skyrocketing of oil prices, by contrast, is the result of a dramatic rise in demand. Unlike in the 1970s, however, the current situation is being exacerbated by the structurally induced increase in the price of many food-stuffs, which has been partially stoked by the use of several agricultural commodities as biofuels.

The figures certainly are impressive: eurozone consumer prices are rising at over 3% and are thus much higher than the ECB target rate of just under 2%. In the US the inflation rate is above 4%. And in China inflation is completely out of control at well over 8% at present. In many commodity-producing countries, too, inflation is flirting with double-digit rates.

While the return of inflation is a fact, talk of stagnation still raises hackles in Europe – and especially in Germany. Granted, the latest numbers did provide further evidence that exports, company turnover and production continue to do well. But what is also clear is that all around us economic activity is waning. Britain, Spain and Italy in particular are faltering. There is no denying that most forecasters and business leaders believe the US economy is already in recession. It is only the emerging markets and developing countries that are largely still in good economic shape.

As things currently stand, the downturn in the US looks set to spread soon from the real estate market via the construction and financial sectors to consumer expenditure and the labour market. Europe will be affected a bit later by the fragility of the US

economy and the acute weakness of the US dollar – contrary to what German politicians and entrepreneurs believe – and the resulting damage will prove painful in 2009. Exports are unlikely to rise overall, even though we can expect continued growth in specialised segments and in deliveries to commodity-producing countries.

So will there be stagflation after all – albeit at a somewhat later date? Yes, that risk does exist. On the other hand, however, no-one can be absolutely certain that the economic travails in the rich countries will not generate problems for those attempting to pass on higher input prices. In turn, this also means that profit margins will be squeezed. This is the most likely scenario to my mind. I expect that soon a number of orders with German companies will be cancelled or that there will be agreed postponements of the delivery of some exports. And there are strong indications that higher wage increases will be granted which will weigh on profits and employment prospects. But weaker economic perspectives of course have their good side as well: for the customers. Or haven't you noticed that car and furniture salespeople in Germany have never ever been as friendly as they are at present, offering discounts that are virtually irresistible even for the most stereotypical Scot? So at least inflation for the Old World will not last for ever.