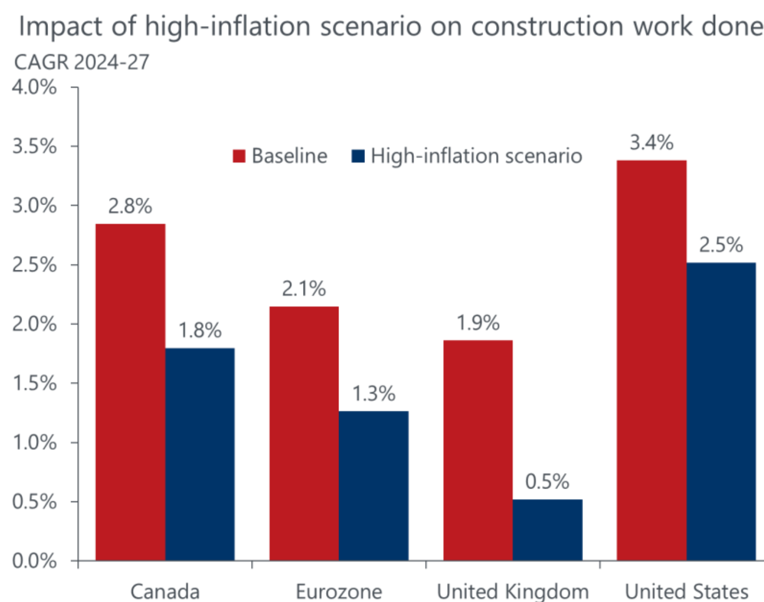
Construction Research Briefing | Global

Persistent inflation could blow hole in construction markets

- **Many factors, ranging from demographics to broader economic growth to government spending priorities, have large impacts on construction activity. But one dependable pattern that may have been forgotten during the ultra-low interest rate environment of the past ten years is that large changes in interest rates signal eventual turning points in construction activity.**
- **Past experience would suggest a construction downturn is imminent—we are expecting real terms decline in construction work done in the US, and flat to declining markets across much of Europe.**
- **A scenario where long-term inflation expectations become de-anchored from central bank targets and cost and price pressures remain persistently elevated could cause a US$2 trillion blow-out for construction globally.**

Cost and availability of financing are critical to the health of construction markets. With interest rates at historically low levels across the developed world for most of the past decade and inflation remaining comfortably benign, policy makers and businesses alike may have forgotten the importance of this fundamental relationship. Depending on the trajectory of inflation and monetary tightening, they may be in for a rude awakening.

Chart 1: De-anchoring of inflation expectations would impact construction into the medium term



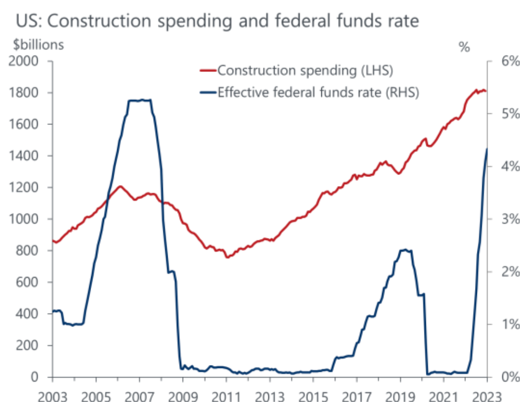
Source: Oxford Economics

Jeremy Leonard - Managing Director - jleonard@oxfordeconomics.com

Clearly many factors, ranging from demographics to broader economic growth to government spending priorities, have large impacts on construction activity. But one dependable pattern that is visible in the data despite these crosscurrents is that large changes in interest rates signal eventual turning points in construction activity.

The US over the past two decades provides ample evidence (Chart 2). The defining characteristic was a construction downcycle that began at the onset of the 2008-09 financial crisis. While lax mortgage lending standards epitomised by the subprime mortgage market were clearly a major trigger by inflating housing demand, the sharp rise in the Federal funds rate from 1% to 5% several years prior had an important contributing role, with construction spending turning downward in early 2006, two years after the beginning of monetary tightening and well before the broader problems in financial markets.

Chart 2: Big moves in policy rates are a leading indicator of construction weakness



Source: Oxford Economics/Haver Analytics

Even during the US construction recovery over the past decade, we can see a similar pattern, though less pronounced, during the monetary tightening cycle of 2017-18. The scale of the tightening was much less pronounced than in 2004-06, but a mini-downcycle is clearly evident, with a near-6% drop in construction spending in the second half of 2018. The subsequent easing cycle resulted in a resumption of the construction uptrend, with disruption during the height of the pandemic lockdowns in mid-2020.

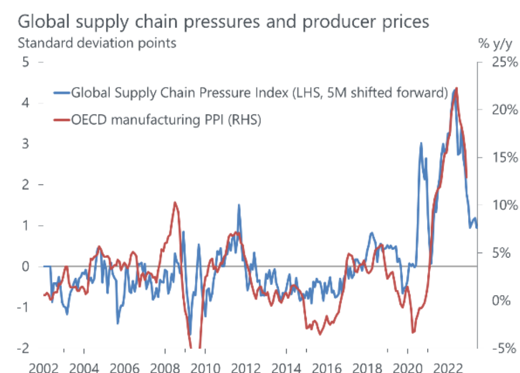
The monetary tightening we have seen so far in the US and in other major developed economies is not unprecedented in the context of the past two decades, but it has already resulted in a flattening of construction spending. Past experience would suggest that a construction downturn is imminent—we are expecting real terms decline in construction work done in the US, and flat-to-declining markets across much of Europe.

The problems of lax lending standards, overbuilding, and financial stresses that buffeted construction markets at the time of the global financial crisis are largely absent today, but the problem of soaring inflation poses a different set of challenges to policy makers and construction firms alike. Central banks must now thread the needle between bringing down inflation before it becomes entrenched without triggering a deep recession, and—depending on their success or failure—construction firms may be trading one obstacle to growth (higher material and wage costs) for another (higher borrowing costs).

Our baseline view is for core headline inflation to come down steadily as central banks succeed in calibrating monetary tightening to slow the economy sufficiently to ease price pressures, and we think there are several pieces of evidence that back this up.

First, supply chain pressures continue to ease, and this has proven to be a good leading indicator of goods-price inflation (Chart 3). Prices of manufactured goods have declined dramatically in year-on-year terms and are likely to continue that decline in coming months. Nonetheless, they will likely still be above the upper end of rates seen over the past 20 years.

Chart 3: Goods inflation likely to come down further in coming months



Source: Oxford Economics/Haver Analytics

Second, measures of core headline inflation appear to have peaked in the US, which is where

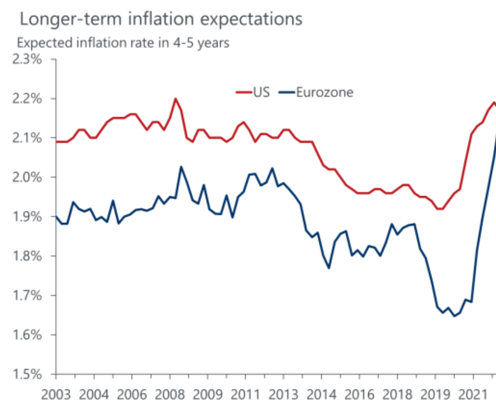
OXFORD ECONOMICS

monetary tightening began the earliest. US core headline inflation (as measured by the deflator for personal consumption expenditures, the Fed's preferred measure) peaked at 5.4% in February 2022. It remained around the 5% range for most of the summer but has been decelerating steadily since September—suggesting that the impact of tighter Fed policy is being felt. Core headline inflation in the eurozone has continued to increase through January (reaching 5.3%), which may reflect the fact that the European Central Bank began its tightening cycle three months after the Fed. Eurozone core headline inflation actually declined in January in sequential month-on-month terms, which may signal that monetary tightening is beginning to have its intended effect.

Despite these encouraging signs, there are risks that high inflation could be stickier than we expect. Even though we have seen goods disinflation across most countries in the past several months amid easing supply chain pressures, service-sector inflation continues to accelerate, driven by a combination of labour shortages in sectors hard-hit by the pandemic such as hospitality and travel, as well as a shift of consumer spending away from goods toward services as households become more comfortable enjoying activities that were long shunned in the pandemic and its immediate aftermath. Given that the service sector accounts for more than two-thirds of economic activity in most developed economies, there is only so much that easing supply chain bottlenecks can do to bring down broader inflation. We expect construction materials prices to be at least 15% higher than pre-pandemic levels when prices bottom out, as expressed in our box—Firms must brace for higher 'new normal' construction materials prices—within our Global Construction Futures report.

A final point is the status of inflation expectations. Exceedingly difficult to measure accurately, if they continue to drift upward, they risk fuelling a destructive wage-price spiral of the sort last seen in the 1970s. Widely-used measures of longer-term expectations have risen in both the US and Europe (Chart 4), but not to levels that would suggest markets are expecting a significant rise in the roughly 2% inflation rate that has been the implicit or explicit target of most central banks across the developed economies. But the longer inflation stays significantly above 2%, the higher the risk of de-anchoring.

Chart 4: Inflation expectations rising, but not de-anchored yet



Source: Oxford Economics/Haver Analytics

Using Oxford Economics' integrated suite of macroeconomic and sectoral models, we examine a scenario where central bank credibility is threatened by the ongoing period of elevated inflation. Despite the rapid central bank tightening underway, long-term inflation expectations become de-anchored from central bank targets and cost and price pressures remain persistently elevated. Financial markets are rocked. Globally, monetary policy tightens more rapidly, accompanied by rises in government bond yields and sharp falls in equity prices.

Not surprisingly, the construction sector suffers much more than the broader economy as access to finance becomes more difficult amid turmoil in debt and equity markets. Globally, the high inflation scenario deepens the construction downturn expected this year and cuts the growth rate of global construction activity nearly to zero (just 0.3%, compared to 2.5% in our baseline).

But the more important consequence of the scenario is its persistence well into the medium term. The 150 basis point spike in 10-year government bond yields narrows only modestly in subsequent years, resulting in a permanent increase in borrowing costs. As a result, growth rates for construction activity remain below baseline through at least 2027. This implies that cumulative foregone construction activity would be about US$2 trillion globally through 2027, underscoring the critical importance of central banks getting monetary policy normalisation right.