THE PRICE OF WAR

ECONOMIC BRIEF 22.032022

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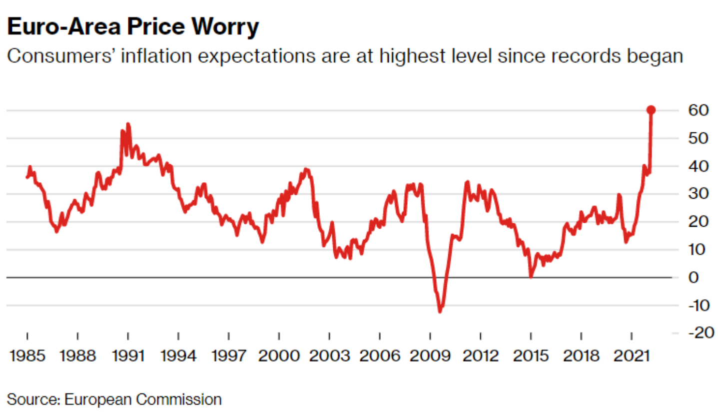
On March 16th the Federal Reserve raised interest rates for the first time since 2018, kicking off a tightening cycle that it expects to continue well into next year. Moreover, the retreat in oil markets in recent days could offer relief.

Nevertheless, surging prices for everything from wheat to nickel threaten to add to inflation. And rolling lockdowns in parts of China could exacerbate strains on global supply chains. Consumer-price inflation in America already stood at a 40-year high in February, at 7.9% year on year; the rate in the euro area, meanwhile, exceeded 5%.

In late January the expected rate of inflation over the next year was 3.5%. On March 15th it stood at 5.4%. Expectations in the euro area have seen similar, if slightly steeper, trends. The one-year inflation swap rate rose to 5.9% on March 8th.
The follow-up is what central bankers choose to do about rising commodity prices. The received wisdom of the past few decades is that policymakers should avoid over-tightening in the face of oil shocks. Indeed, surging energy prices can act as a drag on consumption, which is a particular concern for Europe.

But with real interest rates deeply negative in both America and Europe, central banks still have a long way to go to rein in inflation, whatever happens to commodity prices. On March 10th the European Central Bank surprised markets by announcing that it would wind down its bond-buying more quickly. And according to the Fed's projections, its quarter-point rate increase is likely to be the first of seven this year. Central banks are, for now, sticking to their pre-war plans.[1]

1. Costs of War Mount in Europe as Inflation Soars and Growth Sags

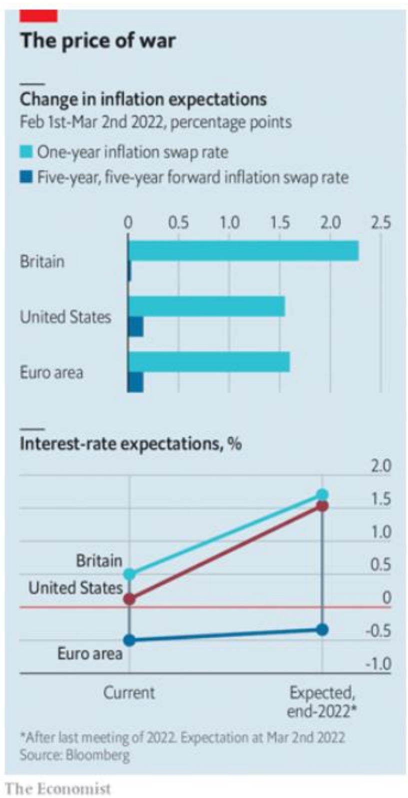


The economic damage from the war in Ukraine is worsening across Europe as already-record inflation soars further and Germany faces a danger of recession because of its dependence on Russian energy.

[1] The inflationary consequences of Russia's war will spread | The Economist

ECB officials have dismissed talk of stagflation, saying expansion in the 19-member euro zone will still top 2% even in their “severe” scenario for 2022. But the latest data show increasing traction for the forces that would produce such an outcome. What’s more, several policy makers are pushing for a rate hike this year that could weigh on output. At its March meeting, the ECB indicated that its primary focus is on tackling inflation that’s almost three times the 2% official target. Investors are looking carefully at prices, reacting to Wednesday’s unexpectedly large jump in Spain by bringing forward bets on the central bank’s deposit rate returning to zero to October from December.[2]

2. War and Sanctions Means Higher Inflation



Since February 1st investors’ inflation expectations, as revealed by the price of swaps, have risen sharply at a one-year horizon for Britain, America and the euro zone. Yet expectations for longer-term inflation, as measured by long-dated forward swaps, have not changed much (see chart). Projections of the ecb’s policy rate at the end of the year have barely changed. Investors have priced in another quarter-of-a-percentage-point rise in interest rates this year in both Britain and America. On March 2nd Jerome Powell, chairman of the Federal reserve, indicated that it would still raise rates.

There have, however, been sharp movements in bond yields at longer horizons. In mid-February yields on five-year German government bonds had been in positive territory for the first time since 2018. They have since fallen to about -0.25%. On March 1st and 2nd the yield on an American ten-year Treasury bond fell from nearly 2% to 1.7%, a greater fall than in any two-day trading period since March 2020, before recovering slightly to 1.9% the next day.

In other words, investors are betting that today’s inflation, even once exacerbated by the war in Ukraine, will be temporary—and that over the long term interest rates are likely to be a bit lower than on past projections.[3]

[2] Costs of War Mount in Europe as Inflation Soars and Growth Sags - Bloomberg
[3] War and sanctions means higher inflation | The Economist

A worst-case outcome would see Europe's gas supply cut off, triggering a recession, while the U.S. would see significantly tighter financial conditions, a bigger hit to growth, and a markedly more dovish Fed.

Scenarios For Economic Impact of Ukraine Crisis

Possible paths for the Russian, European and U.S. economies

Severe Moderate Mild

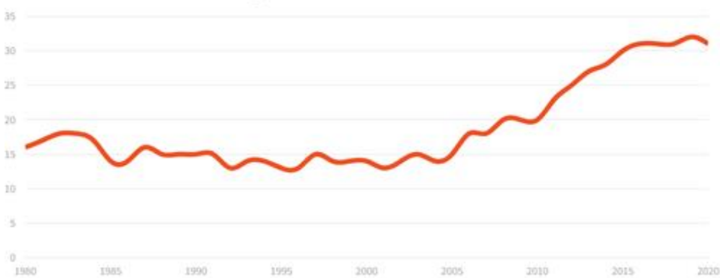
Scenarios	Oil and gas keep flowing, markets settle	Energy supply disrupt ed, oil and gas prices up, risk-off in markets	European gas supply halted, oil disrupted, significant global risk-off shock
Sanctions	Broad. Sanctions on major banks, curbs on FX transactions and access to tech components.	Universal. Russian corporates and banks cut off from global markets, with carveouts for oil and gas.	Maximal sanctions or Russian retaliation cut off flow of gas to Europe.
Russia Impact	Falling ruble and rising inflation force big rate hikes. Sanctions hit trade, economy shrinks.	Combined impact of weak ruble, market turmoil, and disruptions to trade trigger deep recession.	Deeper crisis as Russia's budget and energy sector take an additional hit.
Europe Impact	Higher energy prices and moderate negative spillovers to growth. End-2022 ECB hike still in play.	Energy price surge, negative spillovers, and financial turmoil prompt mild downturn. ECB hike postponed to 2023.	Combined impact of energy shortages, negative spillovers and elevated uncertainty triggers a recession.
U.S. Impact	Higher energy prices and tighter financial conditions take most hawkish seven hike path for Fed off the table.	Higher energy prices and global risk off shock mean more dovish Fed heading into second half.	Worst case: energy spike combines with unanchored inflation expectations and Fed has to tighten as demand slows.

Source: Bloomberg Economics

3. The Coming Spate of Debt Crises

The world's poorest countries have taken on an increasing amount of variable rate debt as a share of their total debt — increasing their vulnerability to rate hikes.

Variable Rate External Debt as a Percentage of Total External Debt



Source: Analysis by World Bank Macroeconomics, Trade, and Investment Practice Group - Late March 2022. • "Poorest countries" defined as the 74 countries who are eligible for support from the International Development Association, which depends first and foremost on a country's relative poverty, defined as GNI per capita below an established threshold and updated annually ($1,205 in the fiscal year 2022). Further information on IDA eligibility and a list of countries: https://ida.worldbank.org/en/about/borrowing-countries

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In recent weeks, Russia's invasion of Ukraine has exacerbated global economic risks. There is a fourth element, however, that could make the mix combustible: the high debt of emerging markets and developing economies. These economies account for about 40 percent of global GDP. On the eve of the war, many of them were already on shaky ground. Following up on a decade of rising debt, the COVID-19 crisis expanded total indebtedness to a 50-year high—the equivalent of more than 250 percent of government revenues.[4]

[4] Are we ready for the coming spate of debt crises? (worldbank.org)

4. North Macedonia and Western Balkans

The European Bank for Reconstruction and Development (EBRD) projects an annual growth of 3% for North Macedonia's economy in 2022 and 2023, it said on Thursday.

In November, the EBRD said it expects that the country's economy would grow by 4% in 2022.

For the Western Balkans region, the EBRD forecasts an economic growth of 3.2% in 2022, about 0.9 percentage points lower than previously projected, it said in a special emergency edition of its Regional Economic Prospects report.

All Western Balkan countries would be adversely affected by higher oil prices, some by rising gas prices, while North Macedonia and Albania are more exposed than others to an increase in electricity prices as they import a significantly higher amount of power than they export, the EBRD said. Indirect effects on Western Balkan economies from a wider European and global recession could be significant, given the close interlinkages between the Western Balkan and eurozone economies, in particular in the automotive sector where North Macedonia, Serbia and Bosnia and Herzegovina might be the hardest hit.[5]

[5] EBRD cuts N. Macedonia's GDP growth projection for 2022 (seenews.com)