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Economic Update

NBK Economic Research Department I 21 March 2022

International Scene

Russia-Ukraine war provides major new threat to global economy

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Highlights

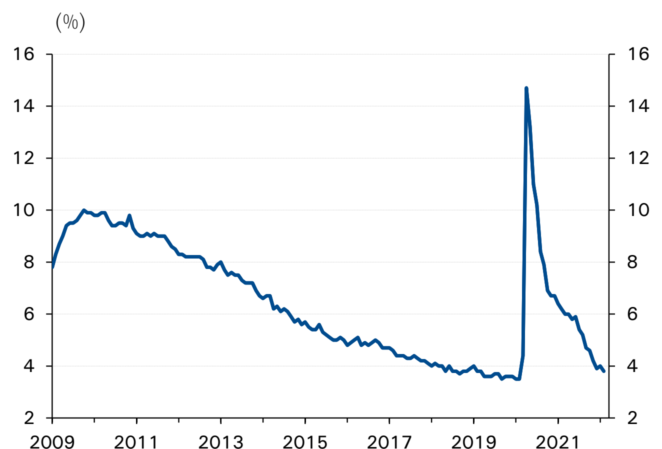
- **Russia's invasion of Ukraine has overtaken Covid as the key source of market and economic worry, causing heavy disruption to trade, extensive economic sanctions against Russia and spiking commodity prices that will hit the global recovery.**
- **The US economy will be affected less than Europe's, but growth is still likely to slow due to higher inflation and the weaker global backdrop. Still, the Fed kicked off its rate hike cycle and signaled it would proceed with multiple hikes this year.**
- **Eurozone growth is expected to slow to a crawl and it could even face a recession, given potentially severe disruption to energy supplies. The ECB speeded-up the end to its QE program, but could wait longer before raising rates.**

Russia's invasion of Ukraine in late-February and the ongoing military conflict has swiftly overtaken the Covid pandemic as the key source of market and economic worry, upending hopes of a smooth continuation of the global recovery this year. Aside from the human cost, the war has brought about heavy disruption to trade flows, financial market turbulence, extensive economic sanctions against Russia and spiking commodity prices that are set to be felt in countries well outside Europe, including poorer countries now facing higher food and energy costs. The IMF has warned that the global economic impact will be 'severe'. The near-term economic 'gainers' have been commodity exporters including those in the GCC, with Brent oil prices initially surging to 14-year highs of $128/bbl in early March before selling off, but still settling by mid-month well above earlier levels at over $100/bbl. The spike in prices has also complicated life for major central banks, who so far seem prepared to tighten monetary policy to control inflation, despite fears that growth will weaken in the face of a major new global supply shock.

Fed presses on with rate hikes despite risk to growth

The US will obviously not escape unscathed from the Russia-Ukraine war, though the impact is expected to be much less than in Europe, given lower energy dependence (the US imported from Russia 8% of its oil and refined product needs in 2021), less trade relations, and geographical remoteness. However, higher inflation and a weaker global economic backdrop will translate into softer economic growth in the US, though a recession is not the base-case expectation at this stage. Current estimates point to around 2.5-3% growth this year (versus +5.7% in 2021), though 1Q22 will likely be softer at sub-2% q/q annualized. However, a further worsening of the global economic backdrop on the back of the ongoing war could pressure growth further, increasing the odds of a recession, especially in the context of aggressive monetary policy tightening by the Fed. While high inflation and subdued consumer confidence (University of Michigan's consumer sentiment index is at the lowest since 2011) are headwinds to growth, the improving Covid-19 situation is a main tailwind. The labor market continued its robust recovery with solid payroll gains, bringing the unemployment rate down to 3.8% by February and labor participation up to 62.3%, both at their best since the pandemic began. (Chart 1.)

Chart 1: US unemployment rate

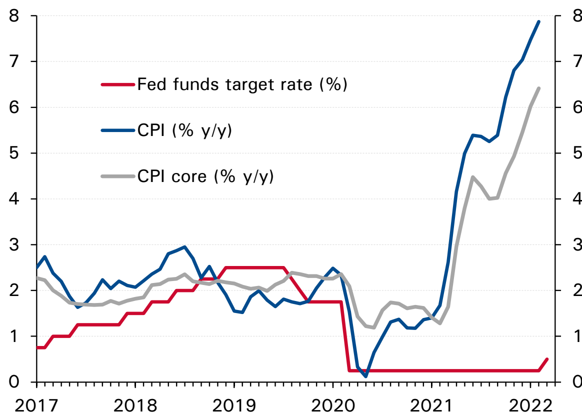


Source: Haver

Consumer price inflation edged up to 7.9% y/y through February (core rate at +6.4%), the highest since January 1982 and is set to accelerate further given higher commodity and food prices globally. (Chart 2.) In this context, the Fed kicked of its rate hiking cycle with a 0.25% increase in its March 16 meeting with the widely followed dot-plot indicating six additional hikes this year,

while the futures market is currently reflecting seven further hikes before the end of the year. The bank could also start quantitative tightening as soon as May. The Fed now sees PCE inflation at 4.3% in 2022 (latest at 6.1%) and 2.7% in 2023, compared with 2.6% and 2.3%, respectively, in their prior projection. Chair Powell emphasized the strength of the US economy, its ability to handle rate hikes, and believes the odds of a recession in the US are not elevated.

Chart 2: US CPI inflation and policy interest rates



Source: Haver

Meanwhile, President Biden signed an executive order banning Russian oil/oil products imports, among other measures. The US imported from Russia around 700k barrels/day of oil and refined products in 2021, and the ban introduces the challenge of finding alternative supply avenues. Finally, Congress passed a $1.5 trillion budget for the remainder of the current fiscal year (to end-September), broadly evenly-split between defense and other spending, including nearly $14 billion in aid to Ukraine.

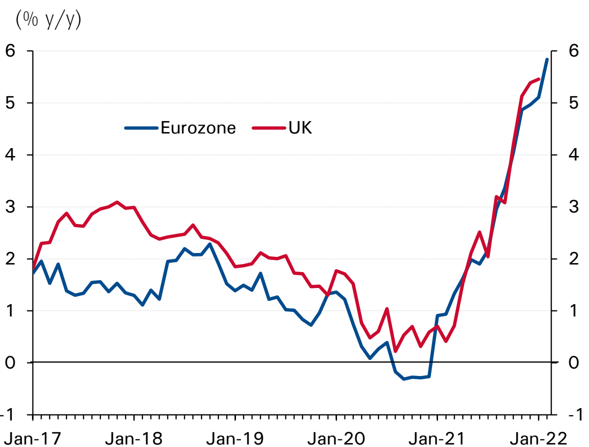
Ukraine war jeopardizes Europe's economic recovery

Russia's invasion of Ukraine has upended what should have been an improving economic climate for 2022 in Europe driven by fading pandemic pressures. While the full economic implications will depend on how the war plays out, a combination of trade disruptions, disrupted energy supply, surging commodity prices, weaker business confidence and refugee inflows will inevitably lead to weaker growth across the Eurozone, with recession a possibility. While it is too soon to see the impact in most high frequency indicators, European stocks were initially hit much harder than other key markets, down 12% in the days following the invasion due to the relatively large expected economic impact, though have since recovered. Quarterly Eurozone growth could now be close to zero through the rest of this year, versus a previous projected average of 0.8% across Q2-Q4.

The European Central Bank is now confronted with a serious policy dilemma, given the prospect of weaker growth and at the same time higher inflation due to the supply shock. At its March meeting, the bank indeed revised down its projections for economic growth in 2022 to 3.7% from 4.2% in December, and revised up its average inflation forecast to 5.1% from 3.2% before. Both of these still might prove optimistic. In the near term, the bank opted to accelerate its planned monetary policy normalization by announcing a slowing in its QE bond purchases to €20 billion per month by June. This is three months sooner than previously outlined and a signal that it remains focused on bringing down inflation that spiked to 5.8% in February (nearly three times' the bank's 2% target) and is now seen moving much higher in the months ahead. (Chart 3.) But at the same time, it left open possibility of a longer gap between the end of QE and the first interest rate hike. The bank is likely buying time before it can assess more fully the war's economic impact: its next policy meeting is on April 14.

Chart 3: Eurozone/UK HICP inflation

(% y/y)



Source: Haver

The UK faces similar issues to the Eurozone, although the direct economic effect of the war is potentially a little smaller given its lower dependence upon Russian oil and gas (for example gas imports from Russia account for only 5% of UK consumption versus 40% for the EU). However the rise in inflation part driven by the war is a material risk to the outlook. Inflation hit 5.5% y/y in January and is set to jump to 8-9% in April as energy price hikes filter through. The Bank of England has already stopped its QE program and raised policy interest rates three times in successive meetings (from a starting 0.1% to 0.75% by March). Monetary policy tightening, together with pre-announced tax rises in April, the squeeze on consumers from higher prices and a likely hit to confidence from the war will reduce growth over coming quarters. While the surprisingly strong January GDP figure (+0.8% m/m) signals a robust start to the year supported by fading Omicron pressures, growth could slip from 1% q/q in 1Q22 to barely positive through the rest of the year.

Japan's growth to slow in Q1 amid latest Covid wave

Japan's annualized economic growth in 4Q21 was cut to 4.6% from 5.4% in the initial estimate, on downward revisions to private consumption and business expenditures. Full-year growth came in at 1.6%, a modest rebound from the 4.5% contraction recorded in 2020. Japan's recovery continues to lag that in many of its developed market peers, and the fresh

Covid wave in early 2022 has compounded the near-term risks. Although new cases peaked in early February the decline since has been slow and the impact on PMI activity gauges has been noticeable. The services measure fell from 47.6 in January to 44.2 in February – the sharpest contraction since August – and manufacturing dropped to 52.7 from 55.4 in January, though still in expansion territory for the thirteenth consecutive month. Given fresh uncertainties caused by the war in Ukraine, growth in 1Q22 is seen slowing compared to the previous quarter, but should stay positive.

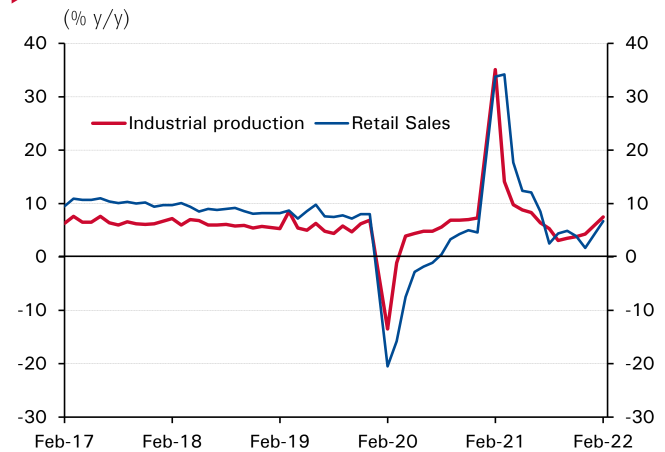
Meanwhile, current account data for January showed Japan's deficit increasing significantly to ¥1.2 trillion ($16 billion) from ¥371 billion a month earlier. This was due to surging fuel costs, which drove up the value of imports (+40% y/y) and outpaced the increase in exports (+15.2%). Rising energy and commodity prices are likely to further impact the external account, putting further downward pressure on the currency, which is already under strain due to the Bank of Japan's ongoing accommodative monetary policy stance. However the bank is expected to maintain its ultra-loose monetary policy, undaunted by the anticipated multiple interest rate hikes in the US. Consumer price inflation was negligible at 0.2% y/y in January, though February's reading of producer prices, which jumped by 9.3% y/y on the back of higher global commodity prices, could begin to wind its way into the consumer sector, possibly as early as the February CPI reading.

'Zero Covid' approach weighs on China's economy

China's economy rebounded in 2021, growing by a respectable 8.1% y/y despite energy shortages and property market woes that came to the fore in the second half of the year. Growth was mainly export-led, as countries began to ease Covid-restrictions and economic activity returned. However, the economic outlook for 2022 is looking weak or uncertain at best amid lagging Chinese domestic consumption, surging commodity prices, geopolitical uncertainty and rising Omicron cases. The most recent flare up in March was the largest since the initial Covid-19 outbreak in Wuhan in 2020, and with the authorities persisting with their 'Zero Covid' policy of citywide lockdowns, economic activity is bound to suffer. The government has lowered its target for GDP growth in 2022 to 5.5%.

Still, both industrial activity and retail sales growth data in January-February surprised on the upside at 7.5% y/y and 6.7%, respectively. (Chart 4.) However, both are likely to be affected by the surge in Covid cases in March, with multiple cities under lockdown and factories forced to close. Meanwhile, producer price inflation, a significant worry for the government following last year's energy crunch, continued to moderate (+8.8% y/y) in February. Consumer price inflation, however, remained steady at 0.9% from a year earlier, signaling as yet limited pass-through from higher producer costs. Relatively low and stable inflation, moderating growth and weak business sentiment prompted the People's Bank of China to cut rates multiple times in both December and January. With domestic inflation low and economic output likely to be negatively affected by both repeated Covid-linked lockdowns and potentially weaker external demand due to high global inflation and the Russia-Ukraine war, the authorities may opt to loosen monetary policy further in the coming months.

Chart 4: China industrial output and retail sales



Source: Haver

Omicron wave stalls India's recovery

India's GDP growth eased further to 5.4% y/y in 4Q21 (3Q of FY21/22) on softer growth in government spending and private consumption and as the low base from 2020 started to fade. A further deceleration is likely in 1Q22 as the recent wave of Covid cases weighed down on mobility and employment, as implied by the weaker January and February services PMI readings (51.5, 51.8 respectively). However, new cases had dropped dramatically by mid-March to the lowest since May 2020, boding well for growth in the coming quarters.

Meanwhile, the Russia-Ukraine war has added new uncertainties, likely worsening supply chain disruptions and inflationary pressures (6% in January) not least due to surging commodity prices. The higher import bill will also weaken the current account deficit, which averaged 0.5% of GDP in 1Q-3Q 2021. This in turn could add downward pressure on the rupee, which recently touched a record low of just below IRP77/US$1. The IMF in January revised down India's FY21/22 growth outlook to 9% from 9.5% previously, and revised up the FY22/23 estimate to 9% from 8.5%. However a downgrade looks likely in April when the Fund updates its forecasts.

On the fiscal front, the FY22/23 budget outlines an increase in capital spending and a narrower deficit of 6.4% of GDP versus 6.9% in FY21/22, still well above pre-pandemic levels of around 3.5%, but on track towards a deficit target of 4.5% in FY25/26. This should help stabilize the high central government debt (90% of GDP), but a rising interest rate environment is expected to apply fiscal pressure over the medium term, albeit sustainable given India's relatively high growth rates.

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