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BNY MELLON

Global Economics & Investment Analysis team (GEIA):

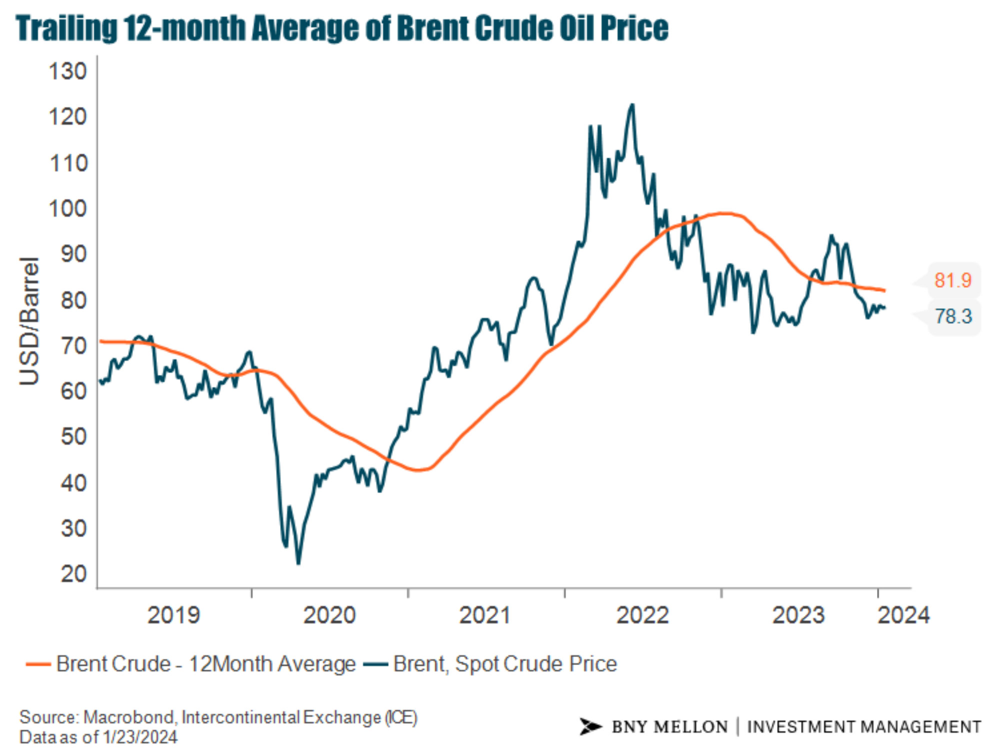
Inflation pressures may grow from Red Sea actions

January 2024

Key Points:

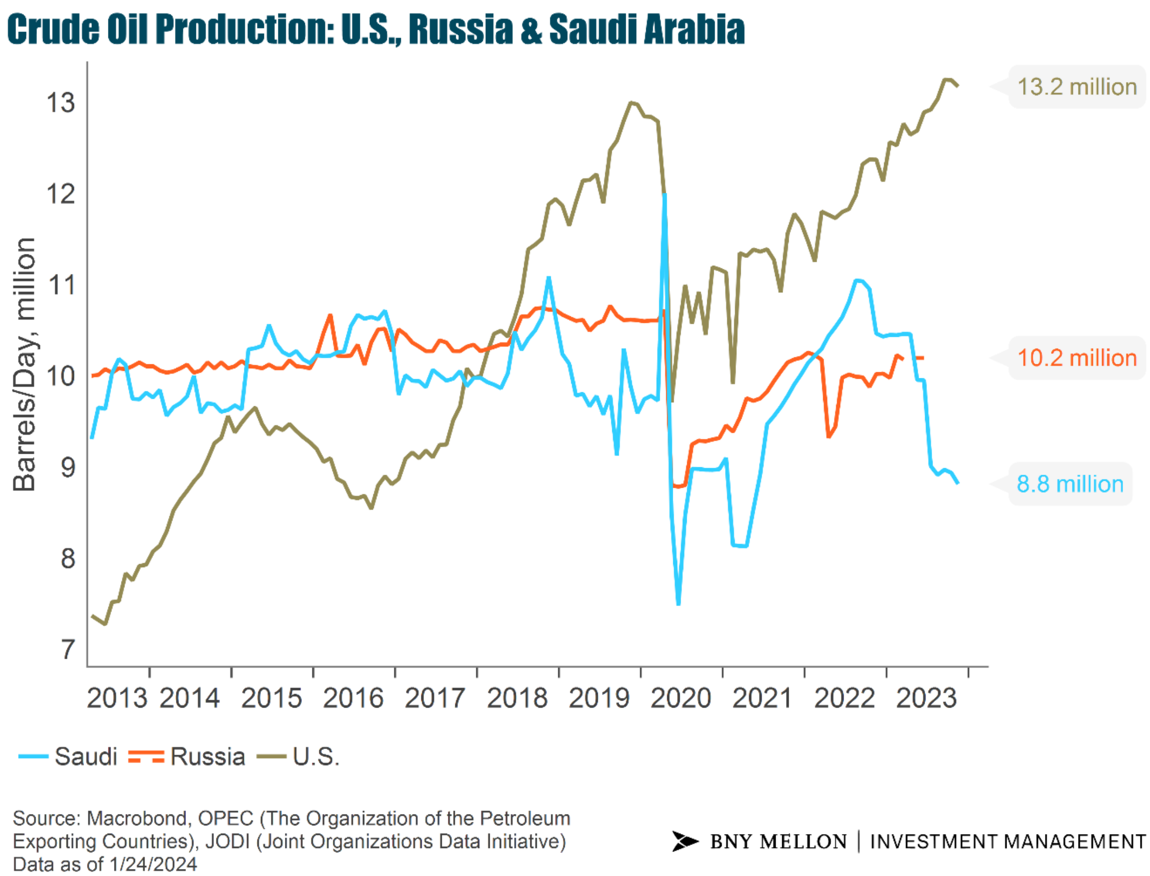
- Chronically constricted Red Sea shipping lanes could raise the cost of Europe-Mid-East-Asia trade and slow the disinflation process at major economies.
- We think the inflationary risks are stacked higher for European economies and Asian importers because of their dependence on Mid-East and Indian Ocean shipping lanes.
- While the Israel-Hamas conflict has not yet undermined the demand-supply balance in global energy markets, risks have edged higher as both Israel and Iran have sought to bolster their deterrence capabilities across the region.
- These actions have not only ensnared Israel's northern borders and the 'axis' of Iranian regional proxies but have also spread across Indian Ocean shipping routes.
- Still, these broadening flashpoints currently (as of 23 January) fall below the threshold of a major conflict.

Chart 1: The 12-month average crude oil price has barely budged since the onset of the Israel-Hamas conflict.



The Israel-Hamas conflict has been underway for over 100 days now, but it has not undermined the demand-supply balance in global energy markets. As a result, the one-year rolling average price of (Brent) crude oil has barely budged. This is, firstly, because global demand continues to ease on tighter credit conditions and a fiscal pull-back at several (though, not all) major advanced economies. Secondly, U.S. energy production has surged even as the Saudi authorities seem to have done all they can to prop up prices and, now, seem unwilling to institute deeper cuts. They would otherwise risk losing long-term market share among major oil producers. Moreover, U.S. energy production is geographically not at risk of blockades or shipping disruptions unlike their Gulf-Arab counterparts.

Chart 2: U.S. oil production has surged, and the Saudis cannot afford to cut much further.



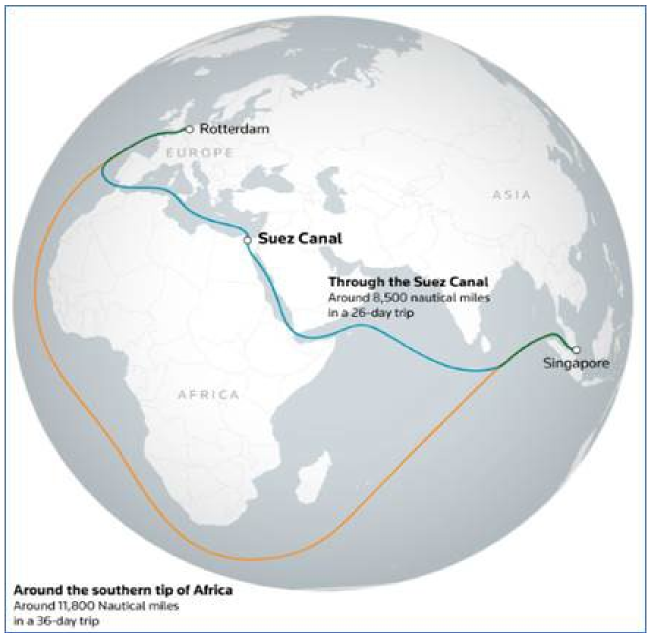
We believe that it is important to not be complacent as the geopolitical risks are widening across the region. Both Israel and Iran have sought to bolster their deterrence either by way of covert operations around the region or by using proxies to pull off surprise drone, missile and naval operations. Covert or surprise actions by one party tends to fuel the need for retaliation for re-establishing deterrence by the opposing party in any direct dispute or proxy conflict. The risk, though not a certainty, is one of further open-ended escalation.

What we have seen of late is a broadening of the conflict with Iranian attacks in neighboring countries which, itself, followed a terrorist attack in Kerman. Again, while these incidents have all remained below the threshold of a full-blown conflict, the tit-for-tat responses have grown in frequency and geographic breadth. In particular, it has constricted shipping through the Red Sea and led to enhanced security measures across large swathes of the Indian Ocean. These have already caused a sizable portion of European shipping and cargo (for trade with Asia and the Mid-East) to be re-directed, over much longer distances, around the Cape of Good Hope rather than traverse the increasingly treacherous waters of the Red Sea.

Needless to say, these developments have pushed up shipping costs and, if persistent, could raise inflation with a 10–11-month lag. Studies from the International Monetary Fund (IMF)[1] indicate that a 50% increase in shipping costs can push up global inflation by 0.2 percentage points within four quarters.

We hasten to add the broader cyclical and policy backdrop is also important. Unlike at the time of the pandemic disruptions, most major economies are no longer being boosted by large-scale fiscal stimulus. Nor are major central banks hoovering up government bonds to reduce the cost of long-term funds and, further, fuel the stimulus. Quite the contrary. But even then, we fear that prolonged disruptions of shipping lanes could slow the disinflation process in future months and this risk does not look like it is currently priced in.

Chart 3: Re-routing Euro-Asia shipping routes may result in delays and prove expensive.



Source: Reuters, downloaded by author via Google on January 23, 2024.

We (the GEIA team) believe the magnitude of the inflation risk depends on the duration and the scale of shipping disruptions. We are not geopolitical experts, but it is hard to spot an endgame in Israel's ongoing conflict with Hamas or Iran's regional ambitions. We think the inflationary risks are stacked higher for European economies and Asian importers because of their dependence on Mid-east and Indian Ocean shipping lanes.

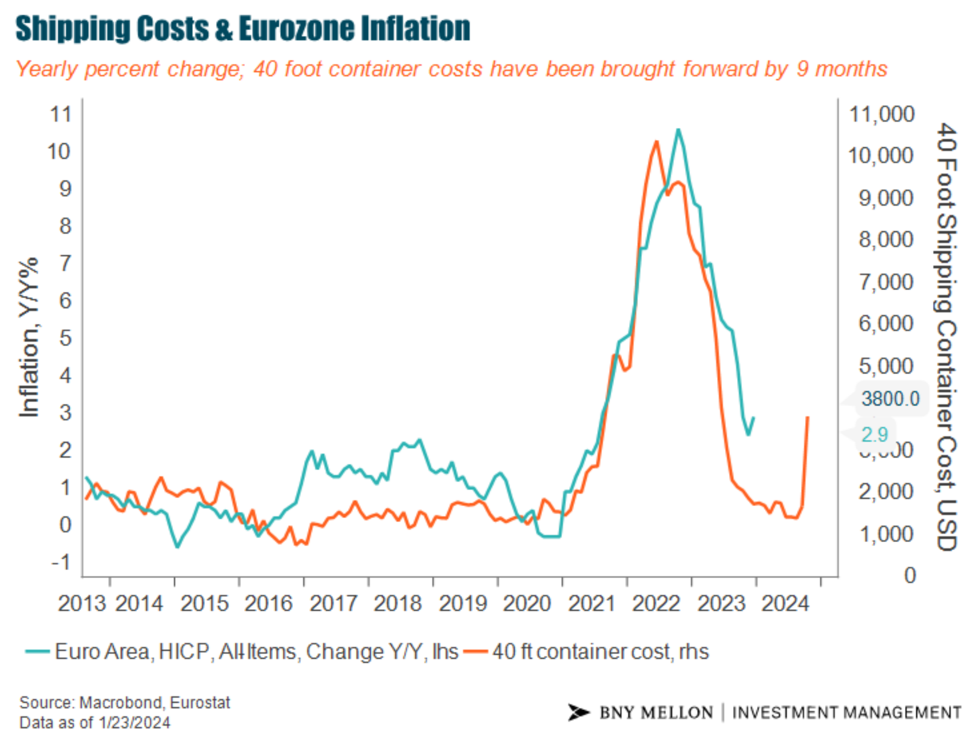
By contrast, the U.S. trade with much of Asia is through the Pacific Ocean may be less susceptible. But a prolonged shortage of containers - because of longer journeys around the southern tip of Africa- could raise prices in other geographic sectors as well.

At the Global Economics& Investment Analysis (GEIA) team, our macro forecasts are scenario-based and probability weighted – and which currently account for 90% of likely outcomes. The remaining 10% makes a small (<10%) allowance for the probability of energy price spikes in response to geopolitical events. This tends to skew our inflation forecasts upward and growth projections a bit lower, relative to market consensus.

Please refer to Shifting Tides, our latest (Q1'24) Vantage Point for more detailed insights.

[1] Shipping Costs and Inflation, International Monetary Fund (WP/22/61), Yan Carrière-Swallow, Pragyan Deb, Davide Furceri, Daniel Jiménez, and Jonathan D. Ostry, March 25, 2022

Chart 4: A prolonged shipping cost spike carries inflationary risks down the road.



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