17 March 2022

Big Picture

Headwinds to the global economy from Ukraine war and Fed tightening

- **In our base-case of a frozen conflict in Ukraine, we think that the global economy will see weaker growth but escape a recession. In a downside scenario, where there is an escalation of the war possibly beyond the borders of Ukraine, the risk of recession in Europe increases significantly.**
- **Euro area consumers will see the biggest real income erosion in decades this year, with headline inflation topping rates at 8-9% in the coming months. We see significant headwinds to growth over the coming quarters and have revised down our 2022 euro area GDP forecast to 2.5%, but see scope for a rebound in activity with GDP growth of 2.8% in 2023. We expect ECB to continue on its path of gradual policy normalisation.**
- **The US economy is more insulated from the Ukraine war repercussions, but strong stagflation dynamics will keep the pressure on Fed to tighten financial conditions. Overall, we now expect US GDP growth of 2.8% this year and 2.0% next year, but cannot rule out a 1990-91 kind of recession.**
- **China is walking a fine balance in the Ukraine conflict. With economic headwinds piling up, we have postponed our expectation of a recovery to the second half of 2022 and now look for GDP growth of only 4.7% this year. More monetary and fiscal stimulus should support the recovery in H2 22.**

Ukraine war clouds macro outlook

The Russian attack on Ukraine and the swift sanction response from the West has triggered the biggest geopolitical crisis in Europe since the Second World War. Key commodity prices have soared from already elevated levels following tightened sanctions on Russia and uncertainty prevails about its supply of commodities to the world market, including oil, gas, precious metals and grain. This has re-awakened fears of stagflation or even a global recession similar to the oil price shocks in the 1970s. In this note, we discuss the implication of the war for global growth and inflation.

Stagflation but no global recession

		2022		2023	
GDP	Euro Area	2.5% (3.8%)	↘	2.8% (1.9%)	↗
	China	4.7% (5.0%)	↘	5.3% (5.0%)	↗
	US	2.8% (3.5%)	↘	2.0% (2.2%)	↘
Inflation	Euro Area	7.0% (4.7%)	↗	2.0% (1.6%)	↗
	China	3.0% (2.0%)	↗	2.5% (2.2%)	↗
	US	7.2% (6.4%)	↗	3.0% (2.8%)	↗

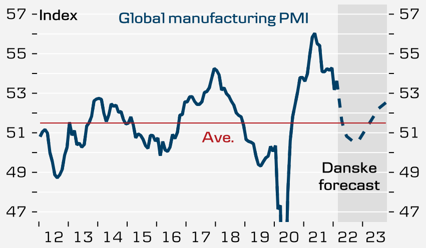
Previous projections in parenthesis

Source: Macrobond Financial, Danske Bank

Other readings

- *Research Russia-Ukraine - Updated scenarios and implications for commodity markets*, 9 March
- *Research Global - Rising recession risk as yet another supply shock hits*, 9 March

Global manufacturing activity to slow from a high level



Source: Markit, Macrobond Financial, Danske Bank

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The economic impact of the war depends on how quickly the conflict can be resolved and whether it escalates further. We updated our view on the different scenarios for the war and how commodities will be affected in *Research Russia-Ukraine - Updated scenarios and implications for commodity markets*, 9 March. Our main scenario foresees some level of conflict to remain in Ukraine, despite a potential truce and uncertainty will remain elevated. However, the war will in our view not spread beyond Ukraine. We do not expect sanctions against Russia to be removed any time soon. On the contrary, there is still room for the West to step up sanctions. This also means that although commodity prices will probably not surge much further, they will remain at elevated levels compared to the pre-war levels. In case of an escalation of the conflict beyond the Ukrainian borders and the involvement of NATO forces, global risk sentiment could take a massive hit, which together with a surge in commodity prices, could severely impair the growth outlook in Europe and more broadly for the global economy.

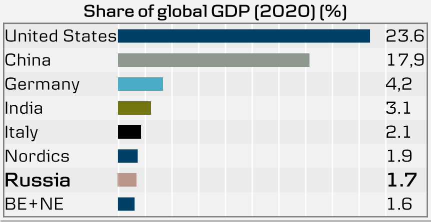
In our base-case of a frozen conflict in Ukraine, we think that the global economy will face stagflation, but escape a recession. First of all, the global economy was seeing a relatively strong momentum ahead of the Ukraine war. Given its relatively small size in the global economy, exports to Russia are limited except for some Nordic and Eastern European countries. The biggest impact on global growth will come through the impact of higher commodity prices on inflation (and hence disposable income of households) and investment decisions of companies. Given the sharp rise in both gas and oil prices for European countries, the inflation impact and hit to real income will be biggest on this side of the Atlantic. Overall, we have lowered our real GDP forecast for the euro area from 3.8% to 2.5% this year. The hit to growth is somewhat smaller in the US and China, where we have lowered our growth forecast to 2.8% and 4.7%, (from 3.5% and 5% respectively) in 2022.

Already high inflation and further price pressures from higher commodity prices pose a dilemma for Western central banks about how to mitigate the weakening growth outlook. We have raised the inflation trajectory for both US, euro area and China. We expect both the Fed and ECB to continue their normalisation of monetary policy, perhaps at a slightly slower pace than prior to the start of the war. This adds to the current tightening of financial conditions weighing on economic growth. The exception is China, where much more muted inflation pressures provide room to stimulate growth through modestly expansionary monetary and fiscal policies. However, near-term headwinds from COVID-19 outbreaks, property sector stress and weakening export demand will weigh on China's recovery.

In our base-case of a frozen conflict in Ukraine, with elevated but stable commodity prices, we see a modest rebound in late 2022 and 2023. In Europe, we expect public and private investments to pick up speed, to boost the green transition and energy efficiency to reduce dependency on fossil fuels. In the US, investments in shale oil are also expected to pick up. Moreover, real incomes should recover as inflation declines and wage growth accelerates. Furthermore, helped by the stimulus in China, strengthening economic activity will also spill over to higher export growth in the US and euro area. As a result, we see real GDP growth increasing to 2.8% (1.9% previously) in the euro area in 2023, and 5.3% in China (5.0% previously), while the US is now expected to grow by 2.0% in 2023 (2.2% previously).

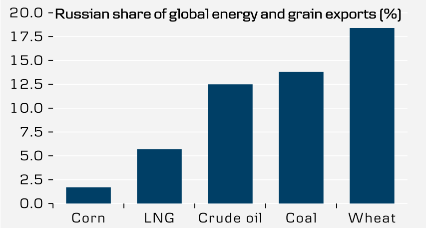
In a downside scenario, where there is an escalation of the war possibly beyond the borders of Ukraine or Russian application of non-conventional weapons, the risk of recession in Europe increases significantly. Global risk sentiment will likely take a beating, while sharply rising commodity prices would provide a sharp hit to private consumption and investment. The euro area will be most at risk given the geographical

Russia has a relative small size in the global economy…



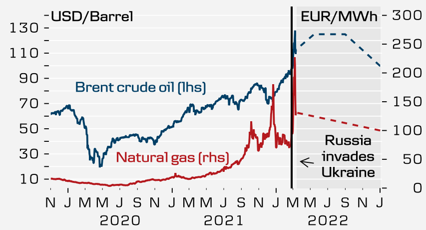
Source: IMF, Macrobond Financial, Danske Bank
Note: "Nordics" include Sweden, Denmark, Norway and Finland. "BE+NE" denotes Belgium and Netherlands

…but is among the most important commodity producers



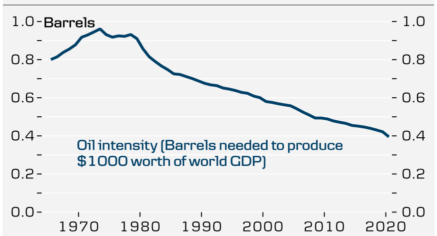
Source: Macrobond Financial

Sanctions and uncertainty will keep commodity prices elevated



Source: Macrobond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future results.

Global economy has become less sensitive to oil shock than in the 70s



Source: BP, World Bank, Macrobond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future results.

exposure to the conflict and the hit to energy supplies, possible production cuts and further spikes in gas and oil prices.

Euro area: in the eye of the storm

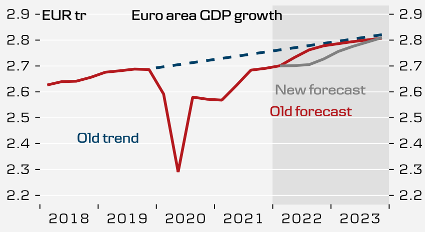
In *Research Euro Area - Rising stagflationary headwinds from Ukraine conflict*, 28 February, we have discussed the channels how the Ukraine war is impacting the euro area economy. Since then sanctions on Russia have been tightened further and a significant surge in commodities prices have worsened stagflation fears.

That said, **an euro area recession is not a foregone conclusion in our view**, especially if commodity prices come somewhat off their recent highs, as laid out in our baseline scenario. Economic momentum rebounded strongly with the turn of the year, driven by stronger activity in both the manufacturing and services sectors. Retail sales figures for January pointed to resilient consumer demand, despite growing inflation headwinds, also helped by the favourable labour market situation. Investments – especially in construction – increasingly underpinned growth at the end of 2021 and should see a further acceleration in 2022 with NGEU funds starting to flow and investments in renewables, energy efficiency and defence stepped up. Fiscal support measures should also help cushion the blow consumer's wallets. Revenues from EU carbon permits have doubled to EUR 30bn in 2021 and 'excess profits' from energy companies (estimated at up to EUR 200bn by the EU Commission) could be re-channelled to consumers via lower taxes on household energy items or price controls as laid out in the EU's ambitious *'REPowerEU' plan*, which aims to cut reliance on Russian gas imports by two-thirds this year. In light of the significant investment needs, calls for another round of joint EU debt issuance have resurfaced, although the EU Commission seems keen to encourage countries to make use of untapped NGEU loans (ca. EUR 200bn) as a first step.

That said, **euro area consumers will see the biggest real income erosion in decades this year, with headline inflation topping rates of 8-9% in the coming months** in our view. This will dampen private consumption growth, especially from H2 22 onwards. While inflation pressures should still abate in 2023, the risk remains on the upside with lagged impacts on core inflation from higher input prices working their way through the pricing chain. Negotiated wage growth remained moderate at 1.6% in Q4 21, but inflation rates well above the ECB's target throughout the year raise the risk of higher inflation expectations fuelling wage adjustments down the line and we now see core inflation close to the ECB's 2% target in 2023. In sum, **we revise our forecast for HICP inflation up to 7.0% in 2022 and 2.0% in 2023** in light of higher commodity prices and more pro-longed cost-push pressures.

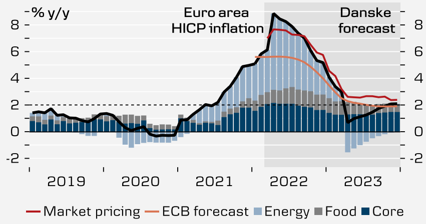
More protracted supply chain bottlenecks will also weigh on net exports and sanctions uncertainty combined with tighter financial conditions could dampen business investments. Especially Germany's industrial sector looks vulnerable to a renewed hit to supply chain problems and some car manufacturers and steel factories have already idled production due to material shortages and high energy costs. Studies trying to model the impact from the commodities and trade channel find output losses of approx. 0.4-0.5pp (see for example *here* and *here*), although it might be difficult for general equilibrium models to capture all the different channels accurately. **Overall, we revise our 2022 euro area GDP forecast down to 2.5% (3.8% previously).** This a is a larger economic hit than foreseen by the *ECB* in its baseline scenario, but we also assume more persistent disruptions to energy supplies and global supply chains. **For 2023, we still see scope for a rebound in activity with GDP growth of 2.8% (1.9% previously)**, driven by stronger public investments, recovering consumer demand and easing supply bottlenecks supporting industrial activity. We do not expect the Ukraine war to lead to a material deterioration of the labour market,

Euro area recession not a foregone conclusion



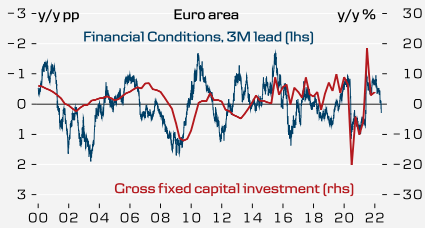
Source: Eurostat, Macrbond Financial, Danske Bank

Inflation significantly above target in 2022



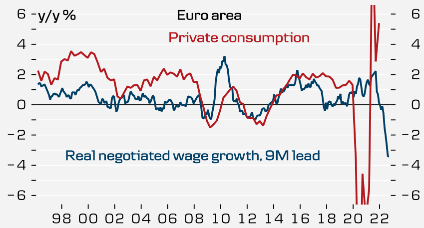
Source: Eurostat, ECB, Macrbond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future results.

Investments to take a hit from tighter financial conditions



Source: Goldman Sachs, Eurostat, Macrobond Financial, Danske Bank

Major real wage squeeze for consumers

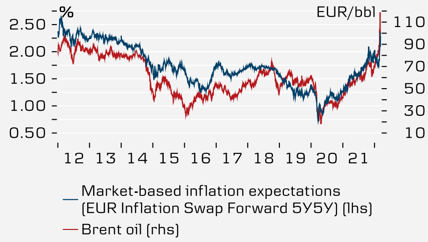


Source: ECB, Eurostat, Macrobond Financial, Danske Bank although furlough schemes might be used to a greater extend in some affected sectors, especially manufacturing.

In light of elevated inflation pressures and the potential for further upside surprises in the coming months, **we expect ECB to continue on its path of gradual policy normalisation.** We look for an end of the QE net purchases in July and a first 25bp rate hike in December 2022, followed by another one in March 2023, but risk are skewed towards a faster tightening pace, especially if inflation expectations are becoming unanchored as seen in the US. However, in light of the protracted uncertainty, optionality and flexibility will remain key features of ECB's monetary policy calibration and all meetings will be 'live' and could carry changes to the policy instruments if data warrants.

In the downside scenario, we expect the euro area to enter a recession, with the gravity and duration depending on the scope of the military conflict between NATO and Russia, but widespread production outages, disruptions to trade flows and adverse effects on confidence could be expected. **In the positive scenario, where some sanctions are removed and trade links rebuild, we see upside risks to growth of ca. +0.5-1pp**.

Market inflation expectations are rising with surging commodity prices



Source: Bloomberg, Macrobond Financial, Danske Bank

Note: Past performance is not a reliable indicator of current or future results.

US: Stagflation pressures to accelerate Fed tightening

There are four main channels where the US may take a hit from the Russian invasion of Ukraine and the tough Western sanctions: direct trade with Russia, elevated uncertainty, higher energy and food prices and financial ripple effects.

The US does not trade a lot with Russia, as goods imports from Russia account for approximately 1% of total goods imports, while the goods exports share is 0.4%. In addition, the US economy is relatively closed compared to e.g. Germany and the UK, so the impact from slower global growth should also be manageable in our view. The majority of US imports from Russia is oil (7% of total oil imports), but we expect the US can get its oil elsewhere.

It is much more difficult to estimate the impact of elevated uncertainty on business and consumer confidence, especially since we are in unprecedented times without any good historical benchmarks. We notice, however, that any hit to consumer and business confidence indicators during periods of elevated geopolitical uncertainty was relatively small and short-lived. The exception was the Gulf War, where the US economy fell into recession just ahead of the Iraqi invasion of Kuwait, which is very different from the current situation, where the US was in the middle of a boom prior to the Russian invasion.

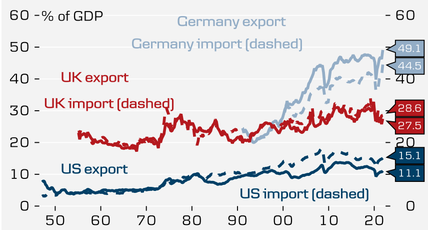
The biggest shock to the US economy probably stems from the commodity and food price channel, which means more headwinds for both consumers and businesses because of rising costs. We are in the middle of the biggest negative real wage growth shock since the early 90's, only surpassed by the two oil crises in the 70's and early 80's. We would like to emphasise, however, that three things pull in the other direction: Firstly, US savings rose during the COVID-19 crisis, so households are in a stronger financial position compared to a couple of years ago. Secondly, the US is in the middle of a boom with rising employment, so more people get higher wage income. Thirdly, the energy consumption share has been trending downwards for several decades. On the other hand, tighter financial conditions are likely to weigh on business investments.

Overall, we now expect US GDP growth of 2.8% this year (3.5% previously) and 2.0% next year (2.2% previously). We expect a smaller hit to US growth than to euro area growth, but unfortunately the economic impact is highly uncertain in the current environment. The only thing we know for sure is that the current environment is very inflationary, as commodity and food prices have jumped recently. Already before the

US does not trade a lot with Russia

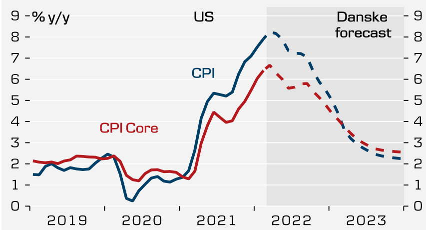
Source: Census Bureau, Macrobond Financial

US economy is relatively closed



Source: BEA, Destatis, ONS, Macrobond Financial

We expect US inflation to gradually decline, but remain elevated

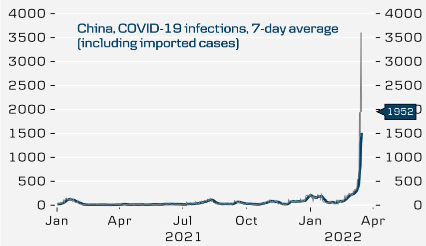


Source: BLS, Macrobond Financial, Danske Bank

Russian invasion, both actual inflation and inflation expectations were high and unlike the commodity price shocks of 2008 and 2011, we are in a situation where the output gap is closed. This means a higher probability that inflation becomes more persistent. Hence, **we expect the Federal Reserve to tighten monetary policy a lot this year in order to get inflation back down**. In our baseline scenario, we expect both headline and core CPI to gradually decline over 2022-2023, but remain above Fed's 2% target. The near-term outlook depends largely on how oil prices develop, but the increasingly broad-based price pressures as well as the pick-up in wage growth suggest that inflation is unlikely to come down rapidly, even if we do not see further strict sanctions on Russia.

For the economic outlook in general we see downside risks rising, as the Russian invasion and sanctions may get worse before they get better. **We cannot rule out a 1990-91 kind of recession, which, however, is considered one of the mildest and shortest recessions in modern times**. Recession risks were already increasing because of the need of significant Fed tightening and in a worst case, the US is heading for a 70's or early 80's oil crisis recession.

COVID-19 outbreak a rising challenge to growth



Source: CNHC, Macrobond Financial

China: Headwinds piling up

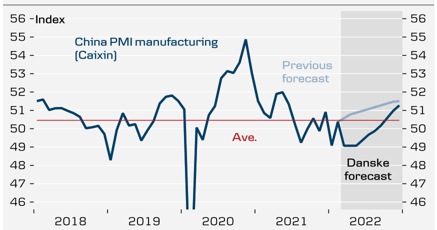
China is trying to strike a middle way in the Russia/Ukraine war, but is walking a fine balance. On the one hand, China has criticized Western sanctions on Russia and criticized the West for having partial responsibility for the conflict, due to continuous NATO expansion towards east and perceived disregard of the need for all countries (read Russia) to have security guarantees. It has also moved China closer to Russia in recent years, partly because they have both faced strong confrontation from Washington. On the other hand, China has stated that the territory of sovereign states should be respected and have appealed for de-escalation and peace talks to stop the humanitarian crisis. President Xi Jinping has suggested China could play a role in security talks together with EU, Russia and Ukraine. It does not seem likely, in our view, that China would take on a mediator role on their own, as it carries risks too. If talks would fail, China could be held responsible and face an international defeat. China will continue to buy Russian goods within the limits of the sanctions and Chinese companies will likely be very careful not breaking any rules, as it could put them in line for similar sanctions. In the long term, though, China will likely increase purchases of gas and oil from Russia and provide demand that substitutes for Western markets are shunning Russian energy.

Developers still struggle from lack of liquidity, pushing stress to new highs

Source: Bloomberg, Macrobond Financial.
Note: The index is dominated by developers. Past performance is no reliable indicator of current or future performance.

The stars were aligned for a Chinese recovery in the coming quarters. Stimulus has picked up and the credit impulse is moving higher. However, recently new headwinds have piled up. China is seeing its biggest COVID-19 outbreak since the pandemic started two years ago, which is set to weigh on private consumption. The property crisis has not eased to the extend expected. On the contrary stress has moved to new highs recently with offshore high yield rates now above 25% and more developers likely to default. A moderate housing rebound is likely to be postponed. Exports are also now facing stiff headwinds from the war in Ukraine and a record strong trade-weighted CNY. Finally, rising commodity prices and sharp declines in Chinese stock markets are set to weigh on business sentiment and weak manufacturing performance will put a dampener on private business investment. That leaves stimulus-driven infrastructure spending as the sole engine in the short-term.

PMI to stay subdued in H1, recovering in H2 22



Source: Markit, Macrobond Financial, Danske Bank

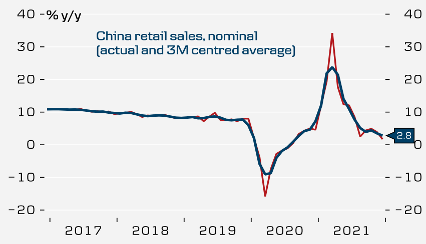
We have therefore postponed our expectation of a recovery to the second half of 2022 and revised down growth for 2022 to 4.7% from 5.0% previously. This is clearly below the new ambitious government target of 5.5%. We do believe China will step more on the gas through both monetary and fiscal policy to support growth. However, we doubt they are willing to step hard enough to get growth up to 5.5%. China has for some time focused increasingly on long-term objectives and stated that major stimulus is a thing of the past. It follows the post-financial crisis experience where China provided massive stimulus, which later led to issues with high debt and bad investments.

Looking into 2023, we expect growth to rebound and have lifted our forecast to 5.3% from 5.0% previously. It is based on a scenario where the effects of the Ukraine war fade somewhat and pave the way for higher exports. We also expect China to recover from the slump in housing, driven by easing measures and that state-driven infrastructure spending will continue to underpin growth.

In contrast to the global trend, Chinese CPI inflation has stayed subdued around 1%, partly helped by low food price inflation. Looking ahead, we look for inflation to rise to 3% during 2022 as food price inflation goes up and commodity pressures feed through to some extent. It is still in line with the governments' target of 3%, though, so should not be a hindrance for stimulus. **We look for People's Bank of China (PBoC) to cut rates and the reserve requirement ratio twice over the coming quarters**. Despite monetary easing and the Fed set to raise rates, the CNY has moved to record strong levels as fundamental flows are very strong (high trade surplus, no outgoing tourists and FDI still going into China). EUR/CNY trades with high link to EUR/USD and we expect that to continue.

In our downside scenario, we look for the Chinese economy to move down to around 2-3% y/y in H1 (from 4.0% y/y in Q4 2021). Inflation will rise in the short-term before falling back again in 2023. The economy should recovery somewhat in 2023, but it depends on the severity of war actions. **In our upside scenario we see growth rising around 5.25% this year and 5.5% in 2023.**

Consumer engine is sputtering



Source: Macrobond Financial

Disclosure

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Ad hoc.

Date of first publication

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