MACROECONOMIC *view*

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Bruno Cavalier – Chief Economist ODDO BHF
bruno.cavalier@oddo-bhf.com

THE ECONOMIC CONSEQUENCES OF THE WAR

KEY HIGHLIGHTS

- The war in Ukraine is a triple shock for the European economy. It is eroding morale, stirring up inflationary tensions and accentuating the risk of shortages.
- Europe's dependence on Russian energy is a major vulnerability to which there is no painless short-term solution.
- The world economy is out of sync. Europe risks falling back into recession, the US are overheating, and China is constrained by its zero-Covid strategy and real estate crisis.

There will be a before and after February 24, 2022. The day the Russian army invaded Ukraine marked a break in geopolitics and the economy.

Before… the European economy was supported by several major tailwinds. The powerful stabilisation measures in the face of the pandemic had allowed employment to bounce back and avoided credit rationing. The Omicron variant wave was in sharp decline, paving the way for the lifting of the last health restrictions on the continent and the firming up of service expenditure. The logistical disruptions that had held back industrial production were showing signs of easing. There was reason to believe that inflationary pressures were close to their peak and about to recede. After returning to its pre-pandemic level of activity by the end of 2021, the euro zone had every reason to extend its recovery into 2022 at an above-trend pace.

After… the European economy is experiencing a strong headwind. At the very least, we can expect growth to drop back below trend. The alternative scenario, should tensions with Russia worsen, would simply be to slip back into recession. **There are three reasons to view the "Putin-shock" with great concern.**

First, the war is unfolding right on our doorstep, delivering alarming images daily. It is pitting us against a country on which we depend for a large part of our energy needs. In Europe, around 40% of gas consumption and 20% of oil consumption are covered by Russian imports. To depend on a hostile country is a weakness. To what extent can we sanction it without first penalising ourselves? With good reason, European leaders are looking to reduce this dependence but achieving this will require a lot of investments in infrastructure and a lot of time. If Europe suddenly decided to ban Russian gas or Russia to close the tap, a major disruption in production would ensue. Although possible, a partial substitution would imply higher prices to attract providers from other regions of the world. In short: the energy crisis is far from over.

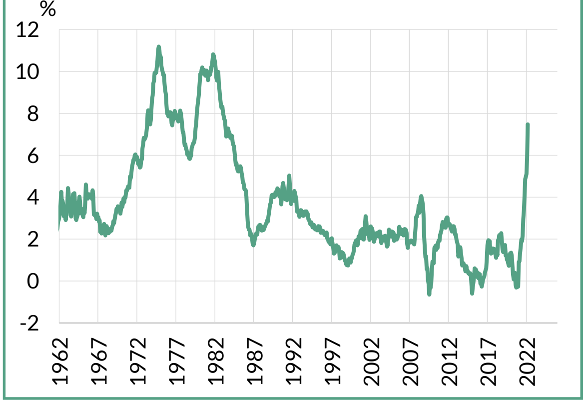
Second, this shock introduces a considerable amount of uncertainty which can delay investment or hiring plans. Just when the Europeans were beginning to shake off the fear of the pandemic, here they are faced with no less anxiety-provoking threats, for example a possible rationing of electricity or an escalation towards chemical or nuclear war. As with the pandemic, a war introduces barriers to trade, causing delays in delivery or shortages. The war in Ukraine may cause the same kind of disruption to trade and production as lockdowns. Germany is more exposed than France because of its geographic proximity to the conflict zone, the strong integration of Eastern European countries in its industrial value chain and its extreme dependence on Russian gas.

Third, the ability (or willingness) of European leaders to put in place a stabilising counter-shock is more limited than at the start of the pandemic. The reason for that is simple. Two years ago, inflation wasn't a threat. Everything was pushing to revive the economy as strongly as possible by relaxing all the levers of economic policy. The danger was to do too little, too late, not to do a lot, too quickly. This time around, inflation is already excessive. Central bankers and fiscal authorities are pursuing opposite goals. How can we support activity without stoking inflationary pressures? How to fight against inflation without breaking the recovery? Is there an order of priorities? Is it the same three months and twelve months down the line? How to coordinate monetary policy and fiscal policy? So many difficult questions to answer. Typically, this is a situation conducive to mistakes in economic policy.

Six weeks after the invasion of Ukraine, what do we know about its impact on the economy? Energy prices have reacted immediately. On average in the euro zone, they have jumped 13% between February and March, pushing the yearly inflation rate to 7.5%, a record over several decades.

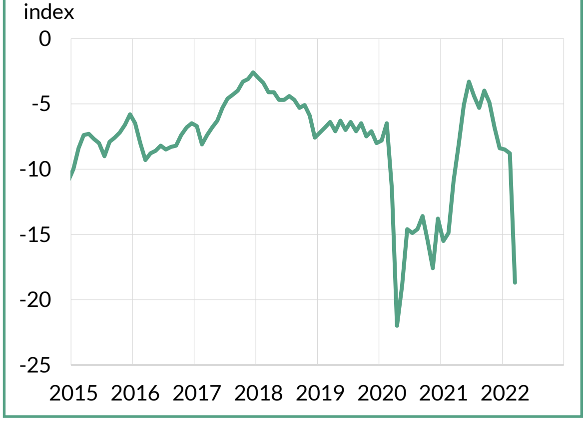
(chart 1).

1. EUROZONE: INFLATION RATE



As a result, households are suffering a heavy loss of purchasing power. The European consumer confidence index took a dive last month, almost as steep as at the start of the pandemic (chart 2). On the business side, the business climate is also deteriorating. Current business conditions remain good at this stage, but expectations have fallen sharply, particularly in Germany.

2. EUROZONE: CONSUMER CONFIDENCE



The war in Ukraine is hitting Europe while the rest of the global economy is dealing with its own problems.

In the US, the economy is overheating. The labor market is experiencing such a lack of available workforce that wages are soaring (+5% per year). The residential real estate market is showing price increases higher than during the subprime bubble (close to 20% per year), fortunately without excess debt this time. The central bank has embarked on a cycle of monetary tightening which promises to be very sustained. The goal is a soft landing for the economy but there is no guarantee of success. The risk of a US recession is low in the short term but increases for 2023.

In China, on the other hand, the economy is slowing down. There are two main hurdles, neither of which will disappear in the short term. First, the country continues to enforce severe mobility restrictions to contain the number of Covid infections. This health policy is not only stifling domestic demand, but also contributing to the disruption of global supply chains. Then, the construction sector, which had experienced an unsustainable expansion, is in a phase of correction. The best that the authorities can do, is to ensure this adjustment is not too abrupt, but there is no question of an unbridled stimulus.

Sources :Thomson Reuters, ODDO BHF

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