Global Economic Viewpoint

Global rate cuts lost at (Red) Sea?

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Global

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Middle East geopolitical risk premium back on the rise

Middle East geopolitical tensions represent tail risks to the global economy. Geopolitically induced spikes in commodities or freight costs can be among the most challenging exogenous shocks for markets due to their potential stagflationary impact. Sustained Red Sea Houthi attacks could disrupt shipping costs and supply chains in Europe, Asia and the US. In turn, this may lead to renewed inflation pressures, especially in destination countries, and give rise to downside risks for trade volumes. A potential military conflict, if prolonged, could have more seriously damaging consequences.

Acute but potentially temporary Red Sea trade disruptions

We think the Red Sea trade disruptions could prove temporary, but the situation is volatile and may worsen before that. The international community is formulating a response. Options reported in the press include diplomacy (sanctions; a decrease in the Israel/Hamas conflict intensity), expansion of patrols to military escorts, or targeted military strikes. Approaching US elections and the risk of a potential regional military conflict suggest the international response could be calibrated, but risks are high.

A potentially short-lived but sizable inflation shock

Since Red Sea disruptions affect shipping costs to a different extent depending on the route, inflationary pressures are heterogeneous. Based on recent literature, the observed 70% increase in freight costs in US-bound routes could lead to a modest inflation pickup of about 0.2% over a quarter. However, the tripling of shipping costs in Europe-bound routes seen over the last month could see an uptick in European inflation of 0.6% over a quarter if disruptions were to persist. Inflation pressures should be more muted in Asia.

Red Sea to keep doves at bay?

The current shock to freight cost is taking place right at the time when most major global central banks are deciding when to start cutting rates following their unprecedented hiking cycles. As long as it proves transitory, the shock is unlikely to deter the Fed from cutting rates this year, but it could risk a later start to the hiking cycle than we currently expect (March). For the ECB, the current shock further increases our conviction that the ECB will stick to a fist cut in June 2024, rather than move earlier as markets price. Risks for Asia should be more contained absent further escalation.

Middle East: Egypt, Saudi most at risk from disruptions

Saudi Arabia could be economically affected by an escalation in the Red Sea through two main channels: a) resumption of Yemen hostilities could pressure fiscal accounts; and, b) increased geopolitical uncertainty could impact economic diversification. The bulk of Aramco's oil exports is shipped through the Hormuz Strait rather than the Red Sea; its East-West pipeline provides it with export route flexibility. In Egypt, Suez Canal disruptions could further widen external funding needs, but we expect a likely upsized International Monetary Fund (IMF) program to provide a near-term backstop.

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Red Sea disruptions: A global chokepoint

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The Red Sea (extending from the Suez Canal to the Bab-al-Mandab Strait) is an important global chokepoint. Nearly 15% of global seaborne trade passes through the Red Sea, including 8% of global grain trade, 12% of seaborne-traded oil and 8% of the world's Liquefied Natural Gas (LNG) trade. Re-routing cargos around the Cape of Good Hope in South Africa would add significant cost and weeks of delay to the delivery of goods (equivalent to 18 days to a voyage from the Middle East to Northern Europe).

Houthi attacks are escalating

The Iran-backed armed proxy group in Yemen - 'Houthi movement' - has launched attacks against a number of container ships in the Red Sea since mid-December, with particularly stepped-up escalation since early January. The Houthis say their attacks are in response to the Israeli/Hamas war. No hydrocarbon tankers have been targeted so far.

The US has, until recently, displayed a defensive posture, by establishing on 18 December 2023 the "Prosperity Guardian" coalition of 20 states to secure shipping lanes in the Red Sea. In response to Houthi escalation, the US and 12 other countries issued on 3 January 2024 an ultimatum in a joint statement stating that the "Houthis will bear the responsibility of the consequences should they continue (…)" with disruptions.

Diplomatic efforts have been conducted

US Secretary of State Blinken has been traveling across the Middle East for the past several days, accompanied by US Special Envoy for Yemen Tim Lenderking. The Israeli chief military spokesperson suggested on 8 January that the Israeli military would shift towards a more targeted phase in the Hamas war by end-January, although the timeline may change. Local press suggests US mediation efforts to prevent extension of the war towards Lebanon, given the ongoing clashes between Israel and Hezbollah.

Limited US options to address Red Sea disruptions

The press highlights the US and international actors have been considering a number

Exhibit 1: Map of the Middle East's transit chokepoints
The Red Sea is a strategic route for global shipping

Source: US Energy Information Administration. SUMED = Arab Petroleum Pipelines Company.
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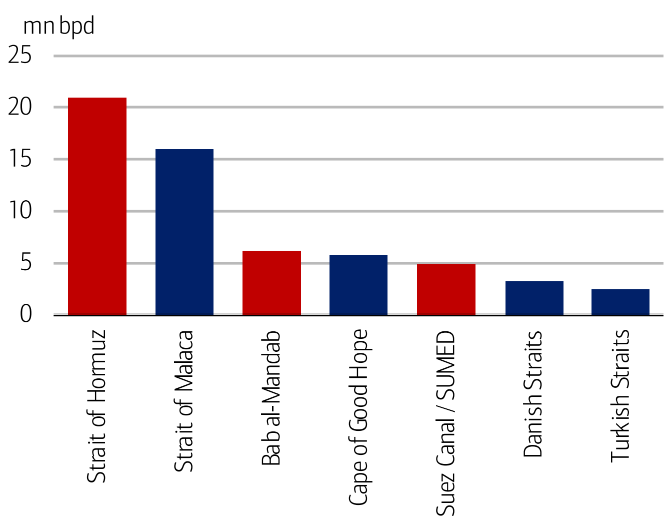
Exhibit 2: Global energy transit chokepoints
The Middle East is home to 3 of the global transit chokepoints (in red)



Source: US Energy Information Administration (EIA), BofA Global Research. As of 2019. SUMED = Arab Petroleum Pipelines Company.
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of options that include: a) diplomacy and sanctions (re-designation of Houthis as a terrorist entity after its de-listing in 2021, financial sanctions); b) military escorts; and, c) targeted strikes to degrade Houthi disruption capabilities.

A United Nations Security Council (UNSC) resolution was issued on 10 January 2024. The resolution condemns the Houthi attacks as they "undermine navigational rights and freedoms as well as regional peace and security". The resolution *takes note* "of the right of member states, in accordance with international law, to defend their vessels from attacks, including those that undermine navigational rights and freedoms". The language was watered down from the initial draft that *recognized* the right of member states to defend their vessels from attacks in accordance with international law.

Military escorts could help normalize shipping, but are no panacea

Significantly expanding the mandate of Operation "Prosperity Guardian" to allow for military escorts could help reduce shipping disruptions, especially if there is an anticipation among policymakers of significant and sustained global trade disruptions in a status quo scenario.

However, setting up such a mechanism with international coalition partners could take some time. The mechanism may nevertheless build on the International Maritime Security Construct (IMSC) formed in September 2019 to maintain order and security in the maritime Arabian Gulf area. It will also likely require coordination with cargo operators and could run against coalition capacity constraints.

1980s precedent offers a sobering message

The precedent of the 1980s Tanker War could offer a sobering message, in our view. US unilateral efforts to provide military escorts to selected tankers took six months to set up over 1H87. The Tanker War was a low-intensity conflict generally, but involved an intense yet short-lived direct US-Iranian military confrontation. This occurred in retaliation to the mining of a US frigate (which injured US sailors) in April 1988.

Any potential military strikes could raise regional risk premium

According to the press, United Kingdom (UK) Prime Minister Sunak authorized joint military strikes with the United States (US) against Houthi rebels. Targeted/chirurgical strikes could increase the probability of retaliation and of an unwanted regional conflict, according to local press. This could affect the United Nations (UN) brokered ceasefire that took effect in Yemen in April 2022, according to the press.

Shipping costs could slow disinflation

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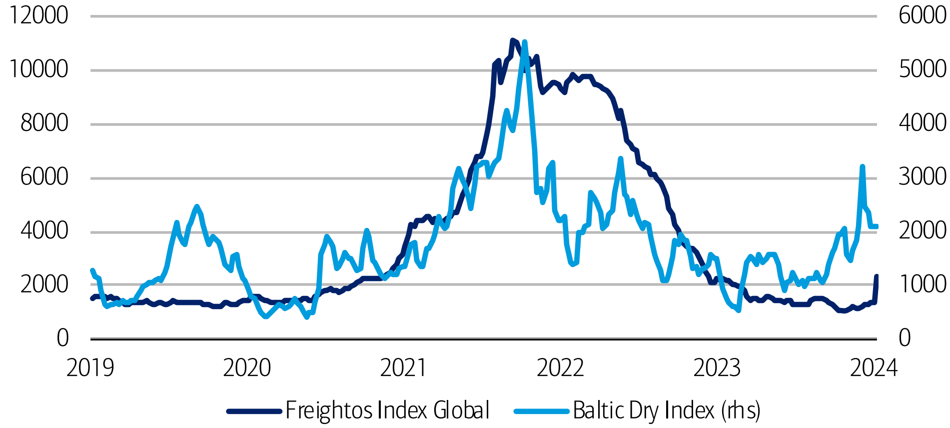
Trade disruptions arising from the current geopolitical volatility in the Red Sea bring back bad memories of pandemic-era supply shocks. By mid-2021, freight shipping costs had increased well over five-fold, contributing to the largest global inflationary episode in four decades (Exhibit 3).

The Freightos Global Index (FGI) measures the cost of ocean freight for a 40' container. Similarly, the Baltic Dry Index (BDI) measures the freight cost for transporting dry bulk materials across oceanic routes. Both indexes are highly correlated.

Freight costs have increased up to three-fold over the past month

While the uptick in global freight costs driven by the Red Sea conflict is nowhere near the magnitude of that witnessed in 2021, shipping costs have soared over the past month. Measured by the FGI, the average cost of shipping a container has increased over 50% last week alone, and more than tripled for some routes since December (Exhibit 4).

Exhibit 3: Global shipping costs (Freightos Index Global, Baltic Dry Index)
Shipping costs skyrocketed following the onset of the pandemic, and are spiking again



Source: BofA Global Research, Bloomberg.
Note: rhs = right-hand side

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Increasing freight costs are the direct consequence of Red Sea disruptions. IMF PortWatch tracking data suggests Suez Canal 7-day moving average of shipping volumes dropped 28% yoy in the first week of January 2024, while those at South Africa's Cape of Good Hope increased by 63% yoy over the same period due to re-routed cargos. Furthermore, the announcements in early January of international ship operators with operations in the area suggest this trend could strengthen.

While supply chains have mostly normalized and are not nearly as stretched as during the pandemic, the disruptions to trade flows can still have implications for activity and, more so, inflation. Increased shipping costs may pressure consumer prices in destination countries, while potentially hurting export volumes on the margin for exporters.

In this sense, Europe may be most directly impacted by higher freight costs as shipping costs from Asia to Europe have increased three-fold (Exhibit 5). However, the US may also see some smaller price pressures with shipping costs rising over 50% from Asia to both East and West coasts. The widespread increase in freight costs shows the global nature of the shock, as substitution effects affect prices for alternative routes.

For trade volumes, while we believe supply chains are significantly more resilient than following the pandemic, increased costs could lead to somewhat lower export volumes. In this sense, Asia is the region of origin where cargo is most directly affected. However, the effect of the Red Sea conflict on trade volumes should be driven by the price elasticity of demand and, in our view, a severe impact on trade volumes is unlikely.

A potentially short-lived but sizable inflation shock

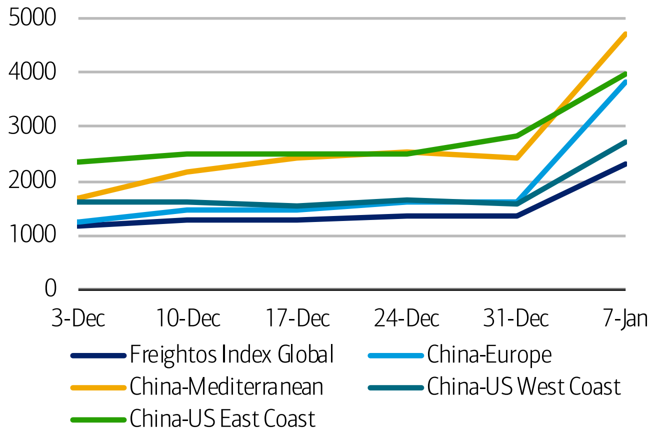
In contrast, we believe that a sustained increase in shipping costs can ultimately impact consumer prices. In fact, a recent study led by IMF economists finds that a doubling in shipping costs lead to a 0.3% increase in headline inflation over a quarter, or 0.7% over a year[1]. Given the uncertainty about the evolution of the situation in the Red Sea, we prefer to focus on the shorter-term impact and focus on the one-quarter-ahead gauge.

Since shipping costs have been affected to a different extent depending on the route (Exhibit 5), the resulting inflationary pressures are also likely to be quite different across regions. Using the aforementioned measure, the (roughly) 70% increase in freight costs in routes to the US could lead to an inflation pickup of about 0.2% over a quarter. In

[1]Using the local projections methodology, Carrière-Swallow et al (2022) find that a one-standard deviation shock in shipping costs as measured by the BDI (a 21.8% increase) leads to an increase in headline inflation of 0.064% over a quarter, and 0.147% over a year, before gradually fading.

Exhibit 4: Shipping costs have soared over the past month

Routes from Asia to Europe are most affected, but also US-bound routes



Source: BofA Global Research, Bloomberg

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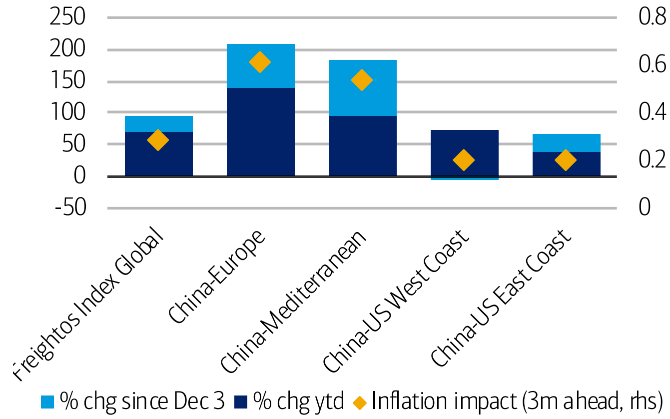
Exhibit 5: Shipping costs have increased up to three-fold

Inflationary pressures may be larger in Europe, but non-negligible for the US



Source: BofA Global Research, Bloomberg, IMF estimates

Note: chg = change. ytd = year-to-date. 3m = 3-month.

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contrast, with the tripling of shipping costs in Europe-bound routes, the region could see an uptick in inflation of 0.6% over a quarter if disruptions were to persist.

It is worth noting, however, that there is a large degree of uncertainty around estimates measuring the inflationary impact of shipping costs. While different authors have found similar results to those we cite above, other studies have found more muted impact of shipping costs on inflation[2].

Red Sea could keep doves at bay

Inflationary pressures arising from a shock to shipping costs would generally be considered transitory, and central banks would tend to look through these likely short-lived inflationary pressures. However, the current shock to freight cost is taking place right at the time when major global central banks, including the Fed and the European Central Bank (ECB), are deciding when to start cutting rates following their unprecedented hiking cycles. At the margin, a resurgence of inflationary shocks could alter the timing of easing cycles, depending on the magnitude.

Should a military conflict take place and be prolonged, global risks could increase. Geopolitically induced spikes in crude oil tend to be among the worst exogenous shocks for markets due to their stagflationary impact. Global growth would be hit, but at the same time inflation expectations could actually increase, especially if there was some expectation that the shock could last for a while.

US: inflation more insulated than most

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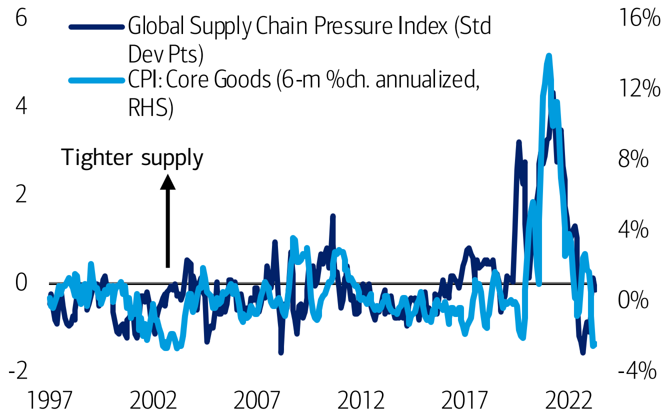
The recent spike in shipping costs owing to the ongoing conflict in the Red Sea and drought-conditions at the Panama Canal pose modest upside risk to our US inflation forecasts. Core goods prices have been an important driver of disinflation seen over the past year as supply chains unclogged, with core goods prices falling in six of the last seven months through December. That said, higher shipping costs could limit or even reverse further declines (Exhibit 6).

[2] For instance, Herriford et al (2016) suggest a 15% increase in shipping costs leads to a 0.1% increase in US core PCE over a year. Similarly, OECD (2021) finds a 50% annual increase in shipping costs to be increase inflation by 0.2% over a year. In contrast, back in 2021, ECB chief economist Philip Lane cited internal work indicating that the impact of shipping costs on consumer prices is overall very limited.

Exhibit 6: CPI Core goods vs. Supply chains
Core goods prices have moved lower as supply chain conditions improved



Source: Bureau of Labor Statistics, Federal Reserve Bank of New York, Haver Analytics
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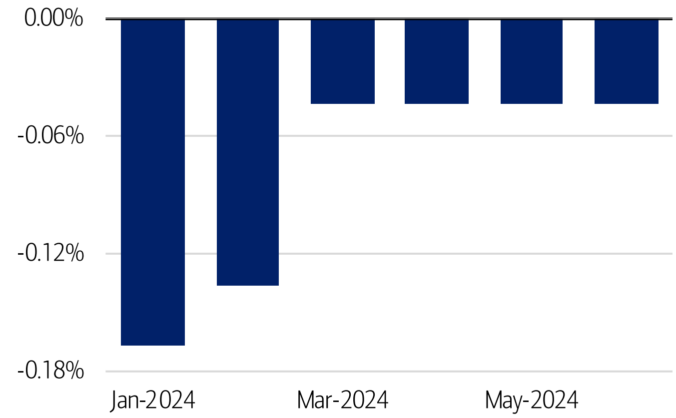
Exhibit 7: Core goods % m/m expectations
We expect core goods prices to continue to decline over the next six months



Source: BofA Global Research
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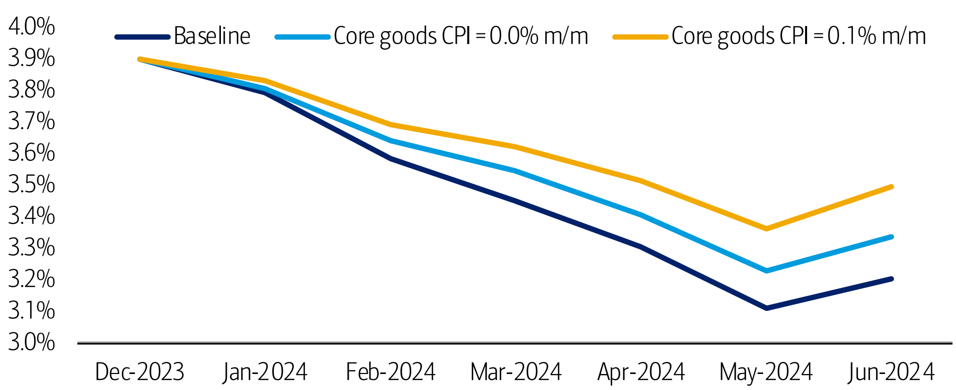
Currently, we expect core goods price deflation to continue over the next six months. Used car prices should see significant declines in the next two months due to the end of the UAW autoworkers strike, leading to larger declines in core goods in these months. From March onwards we expect more moderate declines in core goods (Exhibit 7). Higher shipping costs pose an upside risk to this outlook. To illustrate this point, we plot the y/y path for core CPI assuming different paths for core goods prices (Exhibit 8). If core goods prices increase over the next six months by 0.1% m/m then inflation would still moderate but more gradually. It would take a meaningful reversal of core goods prices to change the path for y/y inflation which we do not think is likely for the following reasons.

First, we suspect that the ability of producers to pass through higher shipping costs to consumers has weakened over the past year. During the pandemic, constrained supply chains, limited inventory, and fiscally fueled demand enabled firms to pass on higher costs. But today inventories are at healthier levels, supply chains are unclogged, and demand for goods is easing. Therefore, producers may be forced to absorb much of the increased shipping cost.

Second, shipping costs in the US are not only a function of water-based shipments. Goods are moved across the US domestically by rail and truck. A large portion of shipping is done using trucking, which is a function of diesel prices that have been easing. If we start to see diesel prices spike owing to conflicts in the Mid-east, then that would make us re-think our view.

Exhibit 8: Core CPI (% y/y)
Inflation will moderate more gradually if core goods prices are firmer due to higher shipping costs.



Source: BofA Global Research
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Third, the US is a service-based economy and services comprise roughly three-fourths of the core CPI basket. Therefore, even if shipping costs do lead to firmer core goods prices, overall inflation may continue to move lower depending on the evolution of services inflation.

Finally, we note that US trade in goods is heavily weighted towards trade with China, Asia ex-China, Mexico, and Canada. In other words, it is not clear that higher shipping costs driven by factors in the Panama Canal and Red Sea will have the same effect on US-related trade than, for example, trade between Europe and Asia. Not only is trade a smaller share of US activity and, in turn, inflation, but the shipping lanes for US trade in goods is less at risk from Red Sea trade disruptions.

Should higher shipping costs materialize in a firmer path of inflation, then members of the Federal Reserve Bank are likely to take notice. Goods price deflation has helped inflation fall quickly over the past year. An end to that or even a partial reversal, even if temporary, will likely make the voices of Hawkish members on the committee louder. While the situation in the Red Sea is unlikely to deter the Fed from cutting rates this year, since it is likely to prove transitory, it could risk a later start to the hiking cycle than we currently expect (March)

Euro area: food for hawks, but no obvious conclusions yet

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Recent increases in shipping costs could clearly create upside risks to Euro-area inflation in the next few months if the move were to persist. Having said that, we highlight several important factors: i) estimates of the potential impact of shipping costs on consumer price inflation vary a lot across empirical work and are highly uncertain; ii) as with oil price changes, the persistence and size of the impact clearly depend on whether the shock is supply- or demand-driven and the shift in price levels permanent or temporary; and iii) initial conditions matter.

On initial conditions in particular, similar to what we argued when oil prices spiked in 2023, the strength of demand and the orientation of policy matter for the pass-through of a cost-push shock. With demand now weaker within the Euro area, and policy in restrictive territory, margins are more likely to absorb a significant part of a persistent move in shipping costs than a couple of years ago. Weaker global demand (including in China), evidence of continued inventory unwind (so companies might actually be able to afford to delay deliveries vs initial plans to get more clarity on the longevity of the shipping cost rise) and oil and natural gas prices moving the opposite way to shipping costs could all help to reduce the impact of freight cost increases on consumer price inflation.

Still, the ECB is likely to take notice, particularly the hawks. Developments in freight costs add another reason to be cautious on the timing of the beginning of the cutting cycle. Nervousness that the geopolitics triggering the rise in shipping costs could eventually also impact oil and gas prices could also play a role. That further increases our conviction that the ECB will stick to June 2024 for the first cut, rather than move earlier as markets price.

This is particularly the case because progress on core inflation in the next few months will be driven more by services than goods than it was throughout 2023. Why? Core goods have made a significant contribution to disinflation in the past few months. Services are meant to lead the way from here, but will move more slowly in our view. Even a modest reversal of goods disinflation could put the progressive decline of core inflation in the next few months at risk. In an extreme case, if the move in shipping prices is larger and very persistent, it could postpone the cutting cycle further into 2024.

But absent much larger shocks we doubt that the ECB would restart hikes given the evidence of domestic disinflation by now.

Asia: Inflation risks more at bay absent further escalation

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For the exporters in Asia, the initial vessel diversions away from the Red Sea could lead to a one-off capacity shock in 2H January and 1H February, as vessels scheduled to return to Asia from Europe for new cargos would be delayed, causing extremely tight supply for a few weeks and higher freight costs.

However, such impact should fade beyond the Lunar New Year. First, exports and shipping demand tend to slow for 1-2 months post the LNY. Additionally, the container shipping industry will receive about 10% new deliveries in 2024, which should gradually arrive to ease the capacity tightness. Overall, we expect the impact on export volume to be limited, as shipping capacity should remain sufficient to support exports, even if the Red Sea disruptions persist.

China: Inflation not a problem right now, limited impact on select imports

Given China's weak inflation numbers at the moment, we wouldn't be too concerned about any inflationary impact stemming from the Red Sea disruptions. However, there could be a limited impact to certain imports from Russia (e.g., oil, grain, coal), with Russia accounting for around 4% of China's total imports. China has high self-sufficiency ratios in grain and coal, while crude oil imports from Russia accounts for 15% of China's total annual purchases.

Japan: Muted impact unless an escalation ramifies to commodity prices

In Japan, the impacts on domestic inflation should be muted, as imports from Europe account for just about 10% of Japan's overall imports, and are mainly industrial goods. Additionally, Japanese corporates have lately found it more difficult to pass-through cost pressure to consumers.

Therefore, the incremental cost pressures resulting from the Red Sea conflict should be limited on CPI inflation. However, if the conflict were to escalate and lead to a material increase in commodity prices or USDJPY movement, then it could have a more meaningful impact on Japanese inflation and the BoJ.

On the exports side, there could be a marginal impact on export volumes to Europe and on corporate profit margins, especially in the auto and machinery industry who are the main exporters to Europe. Still, considering that the share of exports to Europe is about 10%, we don't believe it would visibly damage Japan's economy.

India: Exporters withholding shipments, inflation risks to remain muted for now

India is engaged in about USD 225–250bn worth of trade per year via the Red Sea route. Almost 90% of western hemisphere cargo that used to go through the Red Sea is now getting re-routed through the Cape of Good Hope, both inbound and outbound, according to the Federation of Indian Export Organization.

Given heightened tensions and spiking of freight costs, about 25% of exporters in India are withholding their shipments. This could shave off about US$30bn worth of exports in the current financial year, according to domestic sources. The key export items that could potentially be affected include automotive parts, agricultural products, chemicals, textiles, readymade garments and pharmaceutical products.

On the imports side, the Red Sea route is significant for crude oil & LNG imports, especially for Russia's oil shipments to India, which make up nearly one-third of India's oil imports. As India heavily depends on imports for close to 87% of its oil needs, the risk of increased energy costs is looming. However, as most energy contracts lock-in future prices, any immediate impact on domestic prices could be ruled out.

Additionally, the government still has some buffer in the form of excise duty on both petrol and diesel, ranging between 17-19% of retail price. There were recent chatters that government could cut the domestic prices at the pump, but those rumors were quickly dismissed amidst deepening tensions in the Red sea.

Middle East – North Africa: Egypt and Saudi most at risk from disruptions

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Escalation could weigh on Saudi fiscal and business environment

Saudi Arabia could be economically affected by an escalation in the Red Sea through two main channels: a) a resumption of hostilities in Yemen could pressure Saudi fiscal accounts; and, b) increased geopolitical uncertainty could impact economic diversification efforts under Saudi Vision 2030.

Any increased military spending should the Yemen war resume could add to spending pressures on the Saudi budget, similar to the 2015-16 period. On-budget defense spending is a risk item in this regard. The US$5.3bn (0.8% of GDP) disclosed increased military and security projects over 2015 amounted to a US$15mn per day cost. The 2016 actual budget spending recognized SAR25.9bn (1.0% of GDP) in military overspending (US$6.9bn or US$19mn per day cost), compared to SAR20bn (US$5.3bn) in 2015. There may have been additional off-budget spending pressures.

Saudi policy-making pronouncements suggest a key focus on economic diversification and attracting Foreign Direct Investment (FDI) in the coming period. A stable geopolitical outlook is likely to be necessary for that, in our view. A number of mega-projects (including in the tourism sector in the Red Sea) are due to open their doors this year. The Regional HeadQuarters (RHQ) program with preferential treatment in Saudi government procurement has taken hold from 1 January 2024. The revision to FDI statistics following methodological changes endorsed by the International Monetary Fund (IMF) paints an improved picture, but greater access to foreign capital is needed to fund the ambitious domestic investment plans, in our view.

Only minority of Saudi oil exports cross the Red Sea

We note that, for now, there has been no disruption to Saudi oil tankers. The Strait of Hormuz and the Suez Canal are key shipping routes for Saudi Aramco products. Saudi Aramco's East-West pipeline provides it flexibility to export from the East and West coast of the country, and has capacity of 5-6.5mn bpd. Following a rehabilitation and upgrade program, the Yanbu oil terminal on the Red Sea (West Coast) has seen its average handling and export capacity increase in 2018 by 3mn bpd to over 4mn bpd.

We understand that Saudi Arabia exports only c10% of its total crude exports through its Red Sea terminals to Europe. The bulk of Aramco's oil exports is instead shipped through the Ras Tanura and Juaymah terminals (across the Hormuz Strait). We note however that the Hormuz Strait has itself been the target of Iranian disruption to shipping in past episodes of regional tensions.

Suez Canal disruptions widen Egypt's external funding needs; IMF to help

Suez Canal disruptions could further increase the impact of regional geopolitical volatility on Egypt (see MENA – booms and busts), but we expect resumption of the International Monetary Fund (IMF) program to provide a near-term backstop.

The Suez Canal revenues represent 7% of total fiscal revenues or 1% of GDP annually, and represented US$9.1bn in trailing current account inflows as of 3Q23. As such, an illustrative loss of 25% of traffic over a quarter would widen the current account deficit by US$0.6bn (0.2% of GDP), all else being equal.

Large external debt amortizations to keep external picture tight

External funding requirements are likely to be at their peak over FY24 and FY25. On top of a normalized current account deficit of US$6-8bn, short-term external debt stands at US$28.9bn (including US$14.9bn in Arab deposits), while medium- and long-term external debt amortizations stand at US$19.4bn in FY24 (including US$3.9bn in bilateral non-rescheduled debt, US$9.3bn in multilateral debt, US$6bn in Gulf Cooperation Council (GCC) deposits) and US$20.2bn in FY25 (including US$8.4bn in bilateral non-rescheduled debt, US$9.1bn in multilateral debt, US$5.0bn in GCC deposits).

IMF program resumption to provide near-term backstop

Local press suggests an in-person IMF mission to Cairo sometime in January (following a virtual mission late 2023). Discussions could revolve around an upsized program size to US$7-10bn and conclusion of the first and second reviews, in our view. The program may further be extended to conclude in 2028, as the currently off-track Extended Fund Facility (EFF) was due to expire in September 2026.

We would expect some Egyptian Pound (EGP) flexibility in the period between a Staff Level Agreement and the Executive Board approval. However, IMF pronouncements suggest more leniency on EGP, with a greater focus on inflation instead. As such, while recent price hikes for state services are positive from a fiscal perspective, Egypt's reform momentum may fizzle out later in the year due to the likely difficulty to adopt more structural reforms. As such, credit risks are unlikely to fully dissipate over the medium-term, in our view.

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