For abrdn clients only.

Research Institute

The war in Ukraine: Commodity prices and the risks to growth.

15 March 2022

Executive summary

- Escalation of the Russia-Ukraine conflict, and increased concerns over supply disruptions have fed into sharply higher commodity prices, raising near-term risks for the growth and inflation outlook.
- Assessing the growth hit from higher energy prices is complex given the multiple channels through which the shock will operate. Estimates range from -1 to -3ppt drag on GDP depending on how much oil prices rise. Broader disruptions to gas, food and metals will amplify the shock.
- In this paper we outline the multiple channels through which rising commodity prices may impact growth, and list what to watch over the coming weeks, in order to monitor growth and inflation developments.
- Historically, geopolitical episodes have triggered temporary price spikes in commodities that swiftly unwind. However, the scope for sanctions to be extended further suggests there could be a more persistent lingering risk premium.
- Research suggests that oil price rises driven by supply factors (rather than stronger global growth) exert a larger negative drag on the global economy. Economic and financial uncertainty, can exacerbate the impact on consumption, trade and investment decisions at a time when inflationary pressures are already elevated.
- Households are already feeling the squeeze as the share of disposable income spent on energy has steadily increased in recent months. Consumers may reign in some spending in the coming months, although the stock of savings built up during the pandemic will act as a buffer, dampening some of the negative impact.

- Countries experiencing tight labour markets may be less negatively impacted. However, for many countries, wage growth has not kept pace with inflation, and real wages have been eroded as fuel costs surged. Thus raising downside risks for consumption over the coming months.
- Net oil importers face a greater squeeze on consumption as the deterioration in terms of trade erodes purchasing power. However, benefits to exporters may also be limited if revenues are funnelled back to sovereign wealth funds rather than distributed through consumption and there is significant damage to global growth.
- Medium term inflation expectations remain anchored for now. However, the broader rise in raw material costs increases the risks of second round effects. Against the backdrop of already elevated inflation and wage growth, there is greater potential for firms and household inflation expectations to increase.
- Central banks face a challenging backdrop and have signalled a firm intention to prevent second round effects taking hold. In economies where supply and demand imbalances have been particularly acute, central banks are likely to prioritise inflation management over demand destruction and push ahead with policy tightening amid geopolitical risks.
- As a result, monetary and financial conditions are set to become tight over the coming year, which will at the very least act to slow global growth below trend within our forecast horizon. There are few historical instances where central banks have successfully landed the economy softly after such an adjustment. The chances, therefore, that the global expansion is brought to an end prematurely have increased significantly and it is now our second most likely scenario after our base case.

Risks to growth from the energy shock

As policymakers joined forces to impose restrictions on Russian energy exports, concerns over supply disruptions pushed a broad range of commodity prices higher. Alternative sources of oil such as coordinated increase in Strategic Petroleum Reserves (SPR), a potential deal with Iran and some additional output from OPEC may provide some relief to supply constraints, but will not be able to provide a complete offset.

Fears of supply disruptions swiftly spread to food and metals reflecting the importance of Russia and Ukraine in the global supply of wheat, fertilisers and key raw materials such as palladium and titanium. In our latest Global Economic Outlook we flagged the risk of oil breaching the $125-150 range in the event the conflict intensified, the potential impact on our growth and inflation outlook, as well as related scenarios.

This latest shock not only comes at a time of already elevated inflationary pressures, but it is very different to previous shocks related to the pandemic. As a purely supply side phenomenon, demand destruction is highly likely over the coming months. The magnitude of the growth hit will vary by country as the oil price spike will work through multiple channels.

To ascertain the impact on growth, it is necessary to consider a range of factors which will differ across regions:

- Rising energy consumption as a share of personal disposable income could start to weigh on consumption growth over the coming months.
- Curtailment of trade, further rise in input costs and heightened uncertainty all have the potential to erode corporate margins and investment.

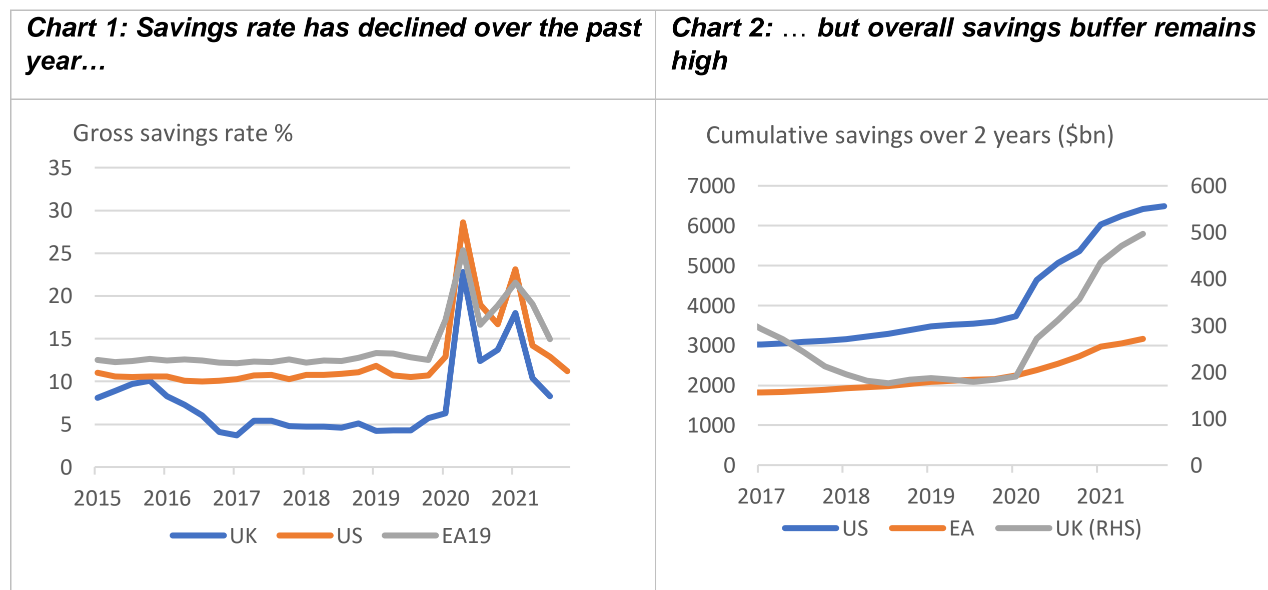
- The ability of fiscal policy to support growth depends on the size and scale of further government subsidies and support measures.
- Size of the precautionary savings buffer built up during the pandemic varies across regions. The extent to which households start to run down these savings to offset the rise in cost of living will also vary according to idiosyncratic drivers.
- The terms of trade channel will vary depending on whether the country is a net exporter or importer of oil. Net oil exporters may benefit from a trade balance perspective, but if revenues are funneled back to sovereign wealth funds then the benefits will not be felt through consumption and growth.
- Risk of second round effects taking hold will increase if medium term inflation expectations shift meaningfully higher.
- The policy response will prove most important. Central banks remain adamant that second round effects will be prevented. This also raises the risk that household incomes will experiences the simultaneous hit of higher energy and borrowing costs.

Households feeling the squeeze:

Energy consumption as a share of personal disposable income has risen sharply in recent months. The overall share has only returned to pre-pandemic levels in the US, but the latest shock to energy prices will undoubtedly squeeze households further. Some of the pain maybe offset by the sizeable precautionary savings buffer built up during the pandemic.

The savings rate has declined steadily over the past year as the flow of savings normalised, however, the cumulated stock of savings remains elevated across advanced economies. Foregone consumption, combined with generous fiscal policy support strengthened household balance sheets during the crisis. Meanwhile, the monetary policy response helped support real estate and financial markets, boosting net wealth. The question now is, to what extent do households start to run down these savings in response to the higher cost of living.

Chart 1: Savings rate has declined over the past year…	***Chart 2: … but overall savings buffer remains high***



Source: Haver, abrdn Research Institute. March2022

It is worth noting that the impact of an exogenous oil shock is asymmetric, as a fall in oil prices does not lead to an equivalent economic expansion. An oil price *increase*, leads to a reallocation of resources as higher economic and financial uncertainty reduces investment. Lingering uncertainty can dampen expansions after oil prices decline, but worsen recessions after oil prices rally. The monetary policy response is also different, as rising commodity prices lead to policy tightening, while the reverse may see no policy response at all.

History shows that episodes of energy price spikes have been followed by increased precautionary savings as employment uncertainty increases. This seems less probable now given the already elevated stock of savings, and is even less likely for countries with tight labour markets and increasing wage pressures. In the UK for example, a survey conducted before the Ukraine crisis suggested that almost a third of respondents had **adjusted their spending patterns** in response to rising energy costs. While a quarter of those surveyed stated they had already **started to spend savings** (LINK) to offset the rising costs.

Income distribution effects of the shock will also determine the overall impact on consumption. A number of studies have found that across DM economies, the energy cost burden is much higher for lower income households. These households also have the highest propensity to consume and a lower accumulation of savings, suggesting the overall impact from the energy shock maybe more negatively skewed for consumption.

Government policies to protect households from fuel poverty may also act as a buffer. A number of measures were announced across the UK and Europe late last year during the early phase of the winter. However the scale of the crisis in the coming weeks may prove challenging for public policy. Fiscal support may also be needed for businesses and industries most impacted by sanctions and disruptions to trade.

Tight labour markets, but wages are not keeping pace with inflation: Labour shortages have plagued a number of countries, with shortages most severe in the US and UK. Workers moving off support schemes seem mismatched to available vacancies. Behavioural changes following the pandemic has meant labour force participation has not returned to pre-pandemic levels.

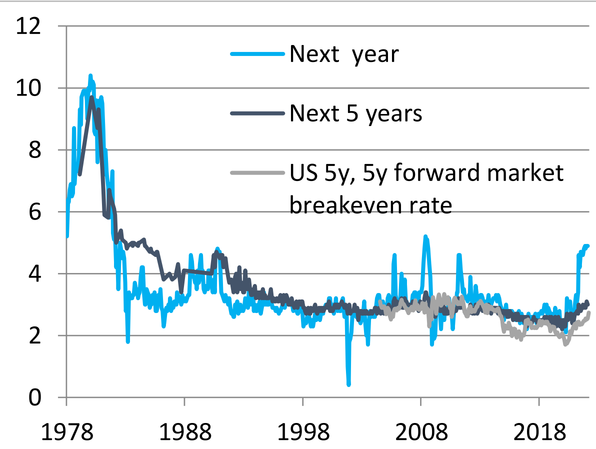
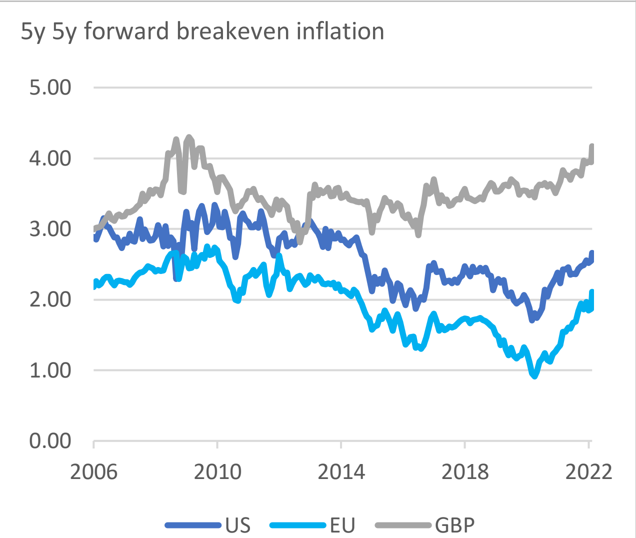
Wage pressures have increased across a broad range of sectors and skill levels, however, these are not keeping pace with inflation pressures. There is no evidence of an inflationary wage price spiral as longer term inflation expectations remain stable. However, the erosion of real wages as fuel prices continue to surge, is likely to weigh on consumer spending over the coming months.

On an international scale, the impact on growth will also depend on whether the economy is a net importer or exporter of raw materials from Russia and Ukraine. As commodity prices rise, net oil importers experience a deterioration in terms of trade and purchasing power falls. Meanwhile net oil exporters may benefit from a trade balance perspective, but if revenues are funneled back to sovereign wealth funds, then the benefits will not be felt through consumption and growth. The distributive effect of trade may dampen the growth support for net exporters.

Rise in broader input costs and raises risk of second round effects. As we have seen in recent days, concerns over Russian energy supplies swiftly spread to other raw materials, with nickel and palladium prices surging on fears that sanctions could spread to key metal exporters. Broader rise in input costs could squeeze corporate margins further. If wage pressures start to rise faster than productivity growth, then firms will come under increasing pressure to pass these costs on. Against the backdrop of already elevated inflation, this raises the risk of inflation expectations becoming unanchored.

Central banks face a challenging backdrop and have signaled a firm stance against allowing second round effects taking hold. So far, medium term inflation expectations remain well anchored for consumers, corporates and markets (Charts 3 and 4), one year ahead expectations have increased sharply, but this is in line with the historic relationship between near term expectations and gasoline prices.

Smoothly applying the brakes to tame inflation is a difficult balancing act. Acting too slow will necessitate more aggressive action further down the road. Consumers may face a situation of a simultaneous hit from rising energy and borrowing costs.

Chart 3: Consumer surveys show longer term inflation expectations remain stable	*Chart 4: Market long run expectations have risen, but remain within post GFC range*
	

Source: Bloomberg, Haver, Abrdn Research Institute. March 2022.

Estimating the growth impact:

Overall it is very difficult to provide a rule of thumb estimate for the growth impact given the multiple channels through which the shock will operate. In the wake of the Arab Spring in 2011, the rise in energy prices were followed by a number of studies examining the potential impact on global growth. **Estimates from the OECD's Global Model suggested a $10 increase in the price of oil could reduce activity in the OECD area by 0.2 ppts in the second year after the shock**. These estimate did not include the impact of dynamic effects such as balance sheet repair on households and corporates, however, for many DM economies, these remain in much healthier shape today than they were in 2011, recovering from the GFC.

JP Morgan modelled scenarios specifically tailored to the impact of Russian oil sanctions. A complete shut-off of Russia's 4.3 mbd of oil exports to US and Europe is estimated to shave off 3ppts from global GDP. The results suggest that alternative sources of oil supply will provide an offset for oil, but neither the OECD or JP Morgan study cover the impact of natural gas supply.

Table 1: Oil shock scenarios

	Base	Scenarios (full year):			
		Russia loss	Iran*	SPR**	OPEC
Oil supply shock (mbd)	-0.6	-4.3	+0.8	+1.7	+1.6
Price (%chg)					
Immediate	25.0	187.0	-35.0	-74.0	-70.0
Post-demand destruction	17.0	127.0	-24.0	-50.0	-47.0
GDP (% to level)					
Global	-0.4	-3.0	+0.6	+1.2	+1.1
DM	-0.4	-2.6	+0.5	+1.0	+1.0
EM	-0.5	-3.7	+0.7	+1.4	+1.4

Source: J.P. Morgan; * 180mn bbl plus production ramp up, ** Assumes 50mn bbl per month

Sanctions on natural gas exports will prove more problematic, as there are no immediate alternative sources of supply. The impact will be most severe for Europe given the reliance on Russian gas supply.

The European Commission have agreed to reduce Russian gas imports by around 70% over the rest of this year. It is possible to source alternative LNG and natural gas but a higher price may be required to attract LNG cargoes away from other countries. The scale of the price rise will likely depend on Asia demand and decisions made regarding their energy needs and inventories.

Around 13% of the replacement is attributed to wind and solar sources and assumes a faster roll out of capacity. Even if this ambitious target is achieved, supply is notoriously intermittent and weather dependent.

What to watch for the energy shock

Assessing the impact of the commodity price shock on growth is complex and varies across countries. But there are a number of waymarks that can be tracked to provide early signals for the direction and magnitude of any impact.

Developments across commodity markets will obviously be critical to watch. Energy and wheat prices have pulled back from the recent highs on speculation of increased supply from OPEC, and a USDA report which revised global crop yields higher as Australian and Indian exports were predicted to rise. Waymarks will rely heavily on some of the supply and demand data listed:

- OPEC oil supply decisions.
- LNG and natural gas inventories and demand across Asia, as Europe will need to compete for alternative supplies.
- Potash supply for fertilisers, from alternative key producers such as Canada, China and Germany.
- Wheat stockpile estimates.
- Palladium – used by autos and semiconductor sectors. Russia accounts for 44% of global supply, so this is hard to digest. However, alternative supply across South Africa (36%), Canada and US (14%) should also be monitored.

Early signs of the growth hit are likely to be seen in consumer spending patterns.

- Changes in high frequency credit and debit card spending data will provide some early signals of behavioural shifts
- Monthly consumer confidence and retail spending measures.
- Changes in monthly stock of household savings, a potential buffer for consumption.

Any signs of inflation expectations becoming unanchored.

- Measures of medium term inflation expectations across consumer and business surveys and as well as inflation breakevens.

Changes in labour market dynamics

- Labour force participation rates, inflation pressures may speed up post pandemic return to work
- Vacancy rates
- Measures of wage growth and monitoring for signs of more aggressive wage negotiations.

Possibly the most important of all the indicators will be central bank communication. So far the signal has been very clear, and firmly focused on prioritising inflation. However, this is a fine balancing act. Braking too slowly could require more aggressive policy action further down the road and amplify recession risks and market turmoil.

Important information:
For abrdn clients only.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by abrdn**. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes any fund or product to which Third Party Data relates. **abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. abrdn reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither abrdn nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

This content is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:
(entities as at 1 January 2022)

Europe, Middle East and Africa:
United Kingdom (UK): abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised authorised and regulated in the UK by the Financial Conduct Authority. **Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Gibraltar, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden**: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland:** Aberdeen Standard Investments (Switzerland) AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM"):** Aberdeen Asset Middle East Limited, 6th floor, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only.

Asia-Pacific:

Australia and New Zealand: abrdn Australia Limited ABN 59 002 123 364, AFSL No. 240263. In New Zealand to wholesale investors only as defined in the Financial Markets Conduct Act 2013 (New Zealand). **Hong Kong:** abrdn Hong Kong Limited. This document has not been reviewed by the Securities and Futures Commission. **Malaysia:** abrdn Malaysia Sdn Bhd (formerly known as Aberdeen Standard Investments (Malaysia Sdn Bhd), Company Number: 200501013266 (690313-D). This document has not been reviewed by the Securities Commission of Malaysia. **Taiwan:** Aberdeen Standard Investments Taiwan Limited, which is operated independently, 8F, No.101, Songren Rd., Taipei City, Taiwan Tel: +886 2 87224500. **Thailand:** Aberdeen Asset Management (Thailand) Limited. **Singapore:** abrdn Asia Limited, Registration Number 199105448E.

Americas:
Brazil: abrdn Brasil Investimentos Ltda. an entity duly registered with the Comissão de Valores Mobiliários (CVM) as an investment manager. **Canada:** abrdn is the registered marketing name in Canada for the following entities: abrdn Canada Limited, Aberdeen Standard Investments Luxembourg S.A., abrdn Private Equity (Europe) Limited, abrdn Capital Partners LLP, abrdn Investment Management Limited, Aberdeen Standard Alternative Funds Limited, and Aberdeen Capital Management LLC. abrdn Canada Limited is registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada as well as an Investment Fund Manager in the provinces of Ontario, Quebec, and Newfoundland and Labrador. **United States:** abrdn is the marketing name for the following affiliated, registered investment advisers: abrdn Inc., Aberdeen Asset Managers Ltd., abrdn Australia Ltd., abrdn Asia Limited, Aberdeen Capital Management LLC, Aberdeen Standard Investments ETFs Advisors LLC and Aberdeen Standard Alternative Funds Limited.

GB-160322-167752-2