The Ukrainian crisis and European inflation

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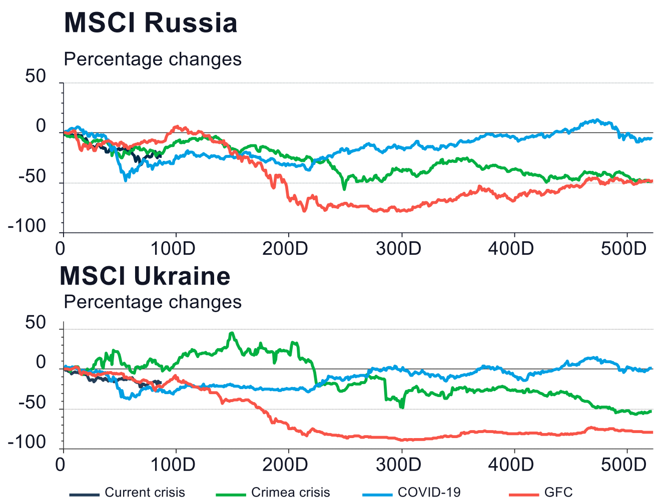
Russian and Ukrainian equity markets have sold off in reaction to mounting tensions on their border. Comparisons with previous shocks — the COVID-19 pandemic, the annexation of Crimea, and the Global Financial Crisis — suggest there is ample room for further declines should the situation deteriorate further. However, the ramifications from a full-blown Ukrainian crisis could spread far beyond eastern Europe should it lead to tit-for-tat punitive measures between the EU and Russia. This provides a potential source of upside risk to euro area inflation.



Source: Refinitiv Datastream / Fathom Consulting

Western governments have threatened to use economic coercion in response to escalating tensions. Such sanctions could come in many forms, but the most likely is for the West to attempt to cut Russia out of the dollar-based financial system with targeted actions against state-backed banks. While decisions by the US will be key with regards to financial sanctions, decisions by the EU will be key with regards to trade. More than one third of Russia's goods exports are bound for the EU, with gas and oil the main products.

If sanctions are imposed on Russia, it is possible that it will respond in kind. Despite being only a mid-sized economy — its GDP is smaller than the UK's, when measured at market exchange rates — Russia is a major commodity exporter and decisions made in Moscow could still have large effects on the euro area. Indeed, despite the recent boom in liquified natural gas (LNG), transport difficulties mean that gas markets remain more localised than the markets for oil, and Russia remains the primary source of European gas imports even though its share of global production has fallen.

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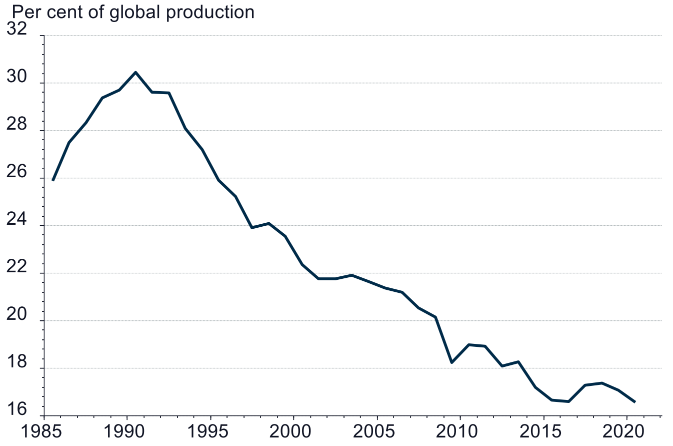
Russia gas production

Per cent of global production

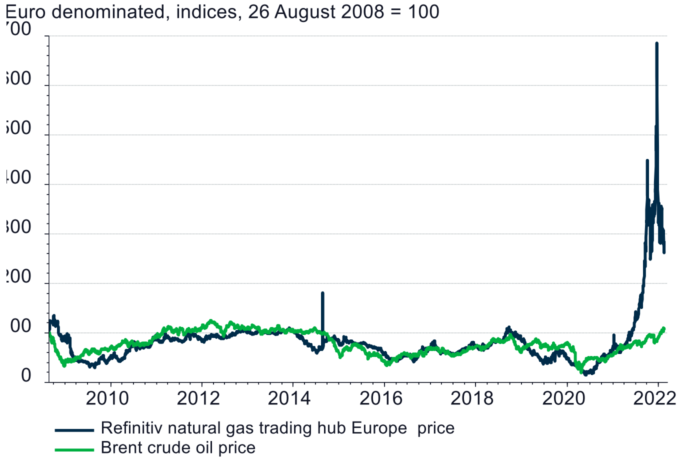


Source: Refinitiv Datastream / Fathom Consulting

Reflecting the regional nature of gas markets, European gas prices decoupled from crude oil prices last year while those in other regions did not. The surge in prices began in the summer due to lower-than-usual outflows from Russia, and shows few signs of easing amid increasing tensions over Ukraine. Benchmarks in other regions — such as the Henry Hub in the US — do not reflect this dislocation.

Commodity prices

Euro denominated, indices, 26 August 2008 = 100



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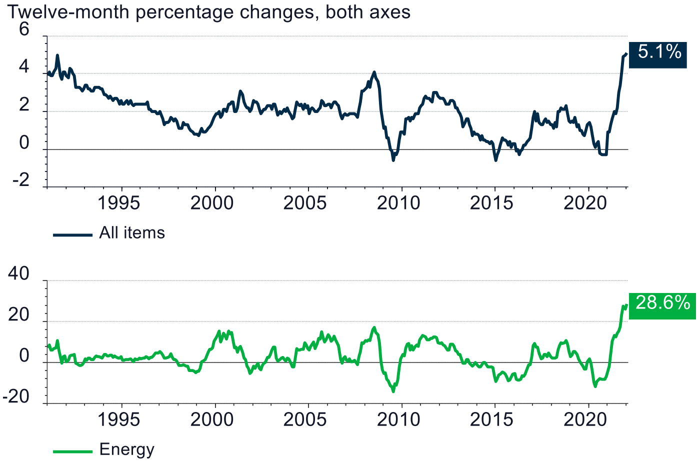
Higher energy prices are already producing a notable impact on euro area inflation, with the energy component in HICP increasing by nearly 30% in the twelve months to January. This has pushed the headline inflation rate above 5% for the first time since the euro's creation. Clearly, where energy prices go from here will have a big impact on euro area inflation.

Euro area HICP

Twelve-month percentage changes, both axes



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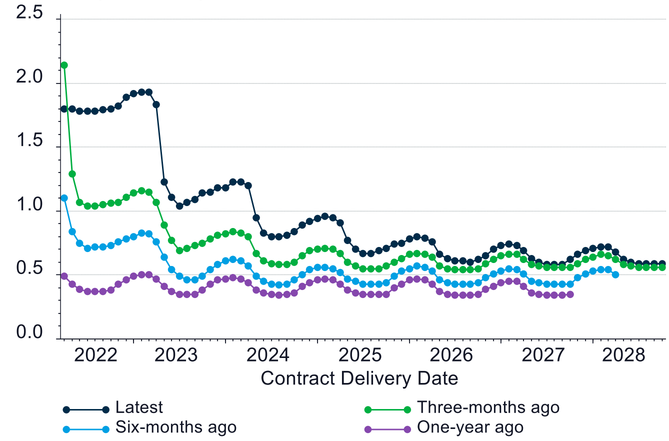
Futures prices suggest that investors expect energy prices to remain high through to the middle of 2023. In other words, they do not foresee that tension over Ukraine will lead to a worsening in gas shortages, but nor do they expect shortages to ease rapidly. What does this mean for inflation? To answer that question, it is important to recall the difference between the price level (a levels concept) and inflation (which reflects how rapidly that price level is changing, typically over a twelve-month horizon). Thus, what matters for inflation is how energy prices compare relative to a year prior. In this context, futures prices imply that investors' expectations are consistent with the impact of energy on inflation fading through 2022. Indeed, if investors are correct, energy prices could even weigh on inflation through much of 2023.

ICE UK natural gas futures

Settlement price, GBP per therm



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Of course, even at the best of times, futures prices are far from a perfect forecast of where energy prices will go. At the current juncture, where prices are likely to be driven as much by geopolitical developments as by economic fundamentals, this could hardly be any truer. Thus, while futures may be a reasonable starting point for those thinking about the passthrough from energy prices to inflation, any change in the situation in Ukraine could materially alter this trajectory.

Further reading on inflation:

Doubling down on forecast errors

GEMO 2022 Q1: Credibility stretched

Is Brexit fuelling UK inflation?

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