Of Inflation, Pandemics and Wars

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Nobody predicted the Covid pandemic, which hit the world in February 2020, causing the second global recession of the 21st century and taking millions of lives around the globe. Two years on, as we start seeing the light at the end of the pandemic tunnel, nobody predicted one of the most significant consequences of the pandemic, i.e. the return of 1970s-style price inflation. Only one year ago, most central banks around the world were forecasting only a temporary spike in inflation, with the European Central Bank seeing price increases at 1% for 2021 and its counterpart on the other side of the Atlantic, the Federal Reserve, a more pronounced 1.8%. As things are turning out, inflation in Europe is now consistently above 5% and in the US around 7%.

While initially this was mostly attributed to transitory supply chain disruptions (or rather supply chains re-starting following the stop caused by the pandemic, and finding their feet in the new, less globalised, world economic order, with commodities and product components trickling into the economy, against a stronger demand) it is now clear that elements of “permanence” are becoming more entrenched in global price trends.

Commodity and energy prices have been driving such increases, from oil and gas to metals to grains to cotton. On top of this, freight rates i.e. the cost to transport such commodities to their intermediate or final destinations have also increased exponentially. Some of these increases were initially related to specific factors (for example a lower-than-usual production of wind power in Europe), however it is becoming more and more evident that the widespread increase in prices is driven by a significant expansion in aggregate demand. This is also, partially, a consequence of the pandemic, or rather of the various measures put in place by governments to revive economies following the onset of the pandemic. Such measures included protracted quantitative easing, large public deficits and ultra-low interest rates, which injected vast amounts of liquidity into the global economy, artificially creating purchasing power and causing inflationary pressure.

On a global level, it is possible that Covid relief measures were in place for longer than necessary, as GDP growth recovered fast from the sharp but short Covid-induced recession, igniting inflation. As monetary and fiscal policies started tightening in recent months (with the notable exception of the Eurozone) inflationary pressure should start correcting itself. The higher cost of commodities and product components will also act as a brake on economic growth, preventing the economy from overheating. The risk now shifts to finding the right balance in the pace of tightening which – if too aggressive – can thwart the nascent global recovery.

Fast forward to February 2022 and, as in the case of the pandemic and subsequent inflation, nobody predicted that Russia would undertake a military invasion of Ukraine – while there were signals of increasing tensions in the region, the markets did not expect this would escalate into a full-blown boots-on-the-ground war. Apart from the deplorable trail of destruction and loss of human lives that every conflict brings about, war in Ukraine also consolidated pressure on global energy prices, increasing further inflationary expectations and lowering the economic growth outlook, raising the spectre that this conflict might tilt the global economy into a stagflationary environment (high inflation, low growth).

Lower growth - than that expected only a few months ago -, will have various implications on a number of European economies. Amongst these, a slower return to lower levels of debt/GDP caused by smaller tax revenue than expected (although inflation could “eat” into debt levels). Public investment in alternative energy sources – to reduce dependence from Russian oil and gas, a strategic must for the years ahead – and higher spending in the defence sector – also spurred by Mr Putin’s aggressive posture towards the West and the NATO alliance – will also contribute to slower deleveraging of government debt levels, acting as a brake on growth in other economic activities.

By the time this article is published, I hope that the Ukraine conflict will have come to a ceasefire and a diplomatic, peaceful solution been negotiated (although other much darker scenarios are still possible). Until then, heightened geopolitical uncertainty, sky-high energy and commodity prices and undecisive central banks’ response to this latest crisis will act as a drag on global economic growth prospects– just when we thought post-Covid recovery was about to take hold.