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Geopolitical Crisis and Its Economic Impacts

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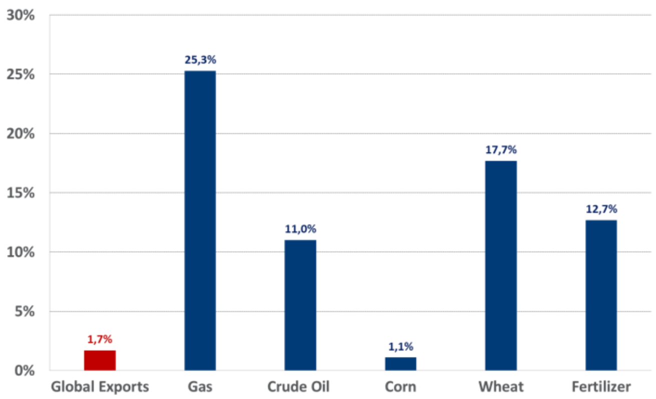
Throughout the last couple of weeks, the escalation of geopolitical tension between Russia and Ukraine, culminating in Russian invasion of Ukrainian territory, has represented a drastic change in the economic risks scenario. Some countries, such as China, were already showing clear signs of slowing down, while others, such as the United States and Europe, were rehearsing a reduction in fiscal and monetary stimulus during the pandemic. The war comes at a time when global economic growth converges at lower rates, in sync with high inflation in both developed and emerging countries. In the United States, for example, the Fed is expected to begin its hikes cycle as early as March, in addition to the likely start of the reduction of its balance sheet, making international financial conditions more restrictive.

It is too early to know what the outcome of this war will be – such as whether it will be temporary or if it will last, its lethality and the intensity of its destruction – but the economic effects are already beginning to be felt. Among the sanctions, seen by many as extremely severe in historical perspective, is Russia's exclusion from the SWIFT payment system and the blocking of its dollar reserves. In response to concerns about liquidity in the financial system, the Russian central bank raised the interest rate to avoid an even bigger bank run.

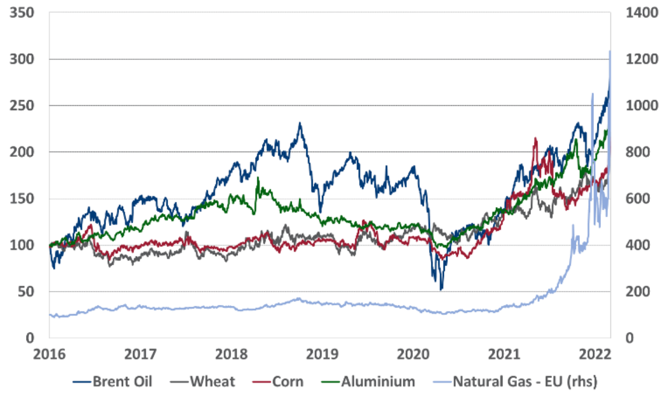
Figure 1 - Share of Russia on Global Exports - 2020



Source: World Bank, British Petroleum, International Trade Centre, BOCOM BBM

But the effects of the war and the sanctions imposed should not be confined only to Russia and Ukraine. Russia is an important energy supplier to the European continent, and the reduction in supply directly impacts the activity of the continent's economies, with spillover effects on the price of energy commodities (Figure 1). Russia is also an important producer of grains, such as wheat and corn. Reducing grain supply adds pressure to food inflation. Finally, the reduction in fertilizer exports, as well as some metals from the region, has the potential to reduce agricultural productivity and affect industrial goods production chains, again contributing to even higher inflation (Figure 2).

Figure 2 - Commodities Prices (Jan/16=100)



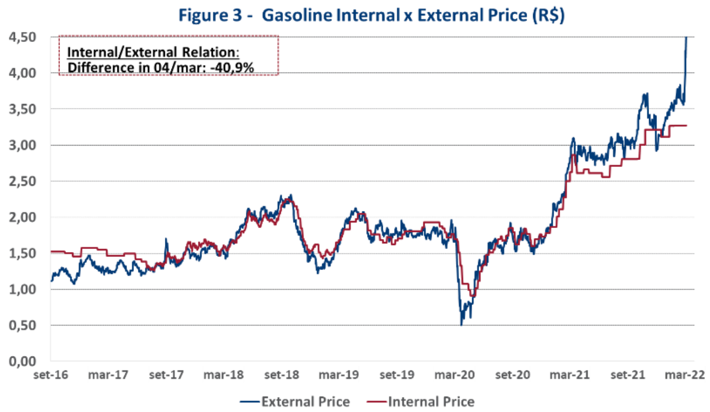
Source: Bloomberg, BOCOM BBM

There is also the indirect effect of war, that increases uncertainty and negatively affects the price of assets, such as the stock exchange. Consumption is reduced by the wealth effect and investment decisions are postponed, leading to economic recession. Through this channel, the war continues to be contractionary for activity, but with deflationary effects.

It is difficult to predict which channel will prevail, but at the current level of global inflation, which after successive shocks is beginning to raise concerns about its more inertial components and risks of de-anchoring of expectations, the inflationary channel seems to have more traction, being the cause for monetary tightening plans to be maintained or revised upwards.

Emerging countries, such as Brazil, suffer all the chain effects, such as energy and food inflation, but also in the production of goods, due to bottlenecks in the production and distribution of intermediate goods. For them, there is the additional aggravating factor that the scenario of global uncertainty directs financial flows to safe assets, which usually affects the currency of emerging countries, with consequent depreciation against the dollar, adding even more fuel to inflation in these countries. So far, this movement has been quite contained, but the war brings risks in this direction.

Our inflation scenario presents asymmetric upside risks, considering the implications of the war on energy, food and tradable goods prices in a context of global cooling and tight financial conditions, and its implications for the exchange rate. Further or persistent increases in energy commodity prices or eventual exchange rate depreciation will bring about upward revisions to inflation, and further contractionary monetary policy (Figure 3).



Source: Bocom BBM, Bloomberg

Our projection for the IPCA is 6.2% for 2022. On the fiscal front, the record results bring relief to public accounts, but possible tax breaks, such as the reduction of IPI and fuel taxes, dilute all the gain and add uncertainty to debt sustainability, given low long-term potential growth and higher interest rates.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F
GDP Growth (%)	1,1%	-4,1%	4,6%	0,3%	1,7%
Inflation (%)	4,3%	4,5%	10,1%	6,2%	3,3%
Unemployment Rate (eoy ,%)	11,7%	13,9%	11,1%	13,2%	13,0%
Policy Rate (eoy, %)	4,50%	2,00%	9,25%	12,25%	8,00%
External Accounts					
Trade Balance (US$ bn)	48	32	36	49	40
Current Account Balance (US$ bn)	-65	-24	-28	-23	-43
Current Account Balance (% of GDP)	-2,8%	-0,9%	-1,8%	-1,3%	-2,6%
Fiscal Policy					
Central Government Primary Balance (% of GDP)	-1,2%	-10,0%	-0,4%	-0,9%	-0,9%
Government Gross Debt (% of GDP)	74,3%	88,8%	80,3%	81,5%	86,4%