War in Ukraine becomes the main factor determining the global economy

The duration and depth of the conflict will determine its consequences to Chile. So far, the most significant impact will be on inflation, driven up due to the rise in commodity prices.

Highlights

- **Global financial markets experience high volatility.** International stocks have shown sharp drops in reaction to the military action's escalation and the sanctions imposed by the international community on Russia. The long-term interest rates of the US and Europe sovereign debt instruments have retreated, and the dollar has appreciated.
- **Russian markets have suffered a dramatic plunge.** The Rouble has depreciated, and some agencies have downgraded the country's credit rating. Even though the western banks' direct exposure to Russia is limited, an eventual financial crisis in this country could have ramifications on many economies.
- **The main impact on the global economy in the short term will concern inflation.** Rises to commodities' prices (oil and grains primarily) caused by logistic disruptions and sanctions could add pressure to an already high global inflation.
- **The financial tensions, the rise in energy costs, and the conflict's impact on trust will affect global activity.** It is still early to quantify the effect, which will depend on the length of the contention. Nevertheless, it is possible to anticipate a relevant downward correction in this year's global growth prospects.
- **In Chile, the climb in the price of essential goods has led to sharp corrections to inflation prospects.** As a result, we estimate that the CPI will substantially grow in the months to come, ending the year with an 8% variation, higher than the 6.2% on our previous report.
- **Local financial assets have been subject to the fluctuations of foreign news, though they have benefited from the high copper value.** The exchange rate marginally depreciated in the month, while the stock market recovered after an initial plunge and ended with a slight gain.
- **The activity began the year with more moderation than anticipated.** Compounded with the international conflict's effects, it has corrected downwards this year's growth prospects, which would reach approximately 1%.
- **In reaction to the higher inflation prospects, the MPR will climb between 7% and 7.5% in the coming meeting in late March.** Then it would rise again in May if prices continue to surprise on the upside. As inflation and activity tend to moderate in the second half of the year, the Council will have the opportunity to reduce rates.

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The extension of the military confrontation and the severe sanctions to Russia have driven commodity prices up and fostered acute financial volatility.

The Russian invasion on Ukraine initiated the last week of February is, without a doubt, the event with the highest global repercussions in what is to come. The effects are varied and linked to the logistic disruptions of the conflict, from the sanctions imposed by several countries on Russia and Belarus to the financial volatility and the impact it may have on consumer and investors' trust, in a period where the world was just beginning to recover from the pandemic.

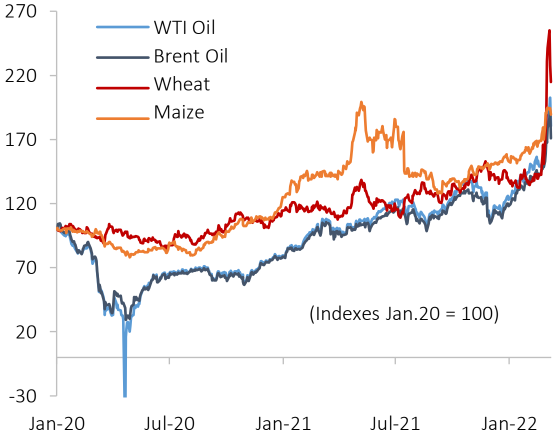
In the short term, the most significant impact has been observed on the prices of commodities exported by the countries directly involved in the conflict. Russia is one of the world's largest exporters of oil and gas, and together with Ukraine, they are key actors in the worldwide supply of grains and cereals (both countries constitute 25% of wheat exports globally). The dependence on Russian energy is particularly relevant in Europe, the highest regional importer of oil (2.7 million barrels per day of oil and 1 mbpd of other by-products) and gas (40% of Europe's fuel consumption comes from Russia).

Since military action began, the price of Brent crude oil rose by 20%, while wheat did so by 50% and maize by 12%. In the case of oil, costs had started rising before current events due to the several sources anticipating the military conflict already in January. Furthermore, the US president's announcement to ban its Russian imports added further upward pressure on prices, which reached US$ 120 per barrel. Once the conflict ends, the value of crude oil should recede, but it is still not clear when this will happen due to geopolitical sequels which could be lengthy. As a working supposition, we expect the value to end the year approximately at US$100 per barrel, and to continue to shrink gradually in 2023.

The hikes in commodity prices have renewed inflation pressures worldwide, in a context where prices were already displaying sharp increments since last year due to the demand's recovery on leading economies.

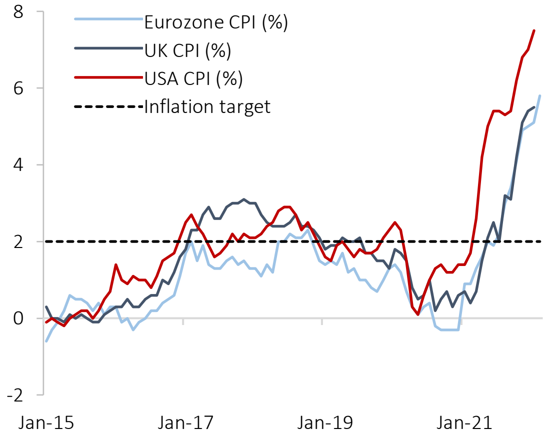
Beyond the price escalation in grains and oil, other commodities have also experienced sharp upturns. For example, copper temporarily escalated to levels as close as US$5 per pound, a new historical peak, while the price of other metals also rose strongly. The hike of copper was caused by both fears of disruptions on the offer's side –Russia produces 4% worldwide –and due to a more generalized spill over effect between commodity prices and the higher risk aversion in markets. In times to come, historically low levels of inventories and a demand that will remain relatively solid will cause the price of this metal to remain high, though it should decrease to levels coherent with its fundamental trends in the long term. Considering the above, the copper price should reach around US$ 4.5 per pound during the year's first half, to then end the year closer to US$ 4.2 per pound.

Military conflict leads to an intense hike in the price of commodities...



Source: Bloomberg and Santander

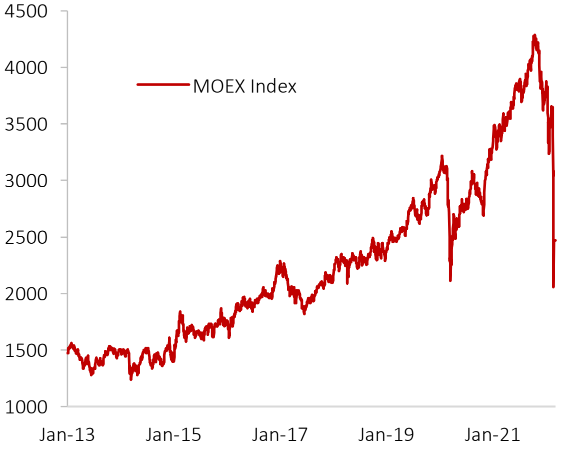
... which adds pressure to an already high inflation



Source: Bloomberg and Santander

The economic sanctions imposed on Russia (the exclusion of a large number of banks from operating through the SWIFT system and the freezing of the Central Bank of Russia's foreign assets) led the Rouble to plummet, which lost 50% of its value. The Russian stock market, in the meantime, after plunging by almost 20%, has remained closed. Until now, it is not clear if these sanctions could lead the country into a financial crisis, though the credit rating agency Fitch—joining the prior actions of S&P and Moody's— again downgraded this country's default rating to junk status (C level: highly speculative) already this week, warning of an imminent bond default. Even though the direct exposure that the banks of leading western countries have to Russia is limited, a larger financial crisis in this nation could have ramifications in other economies.

Russian assets reacted strongly



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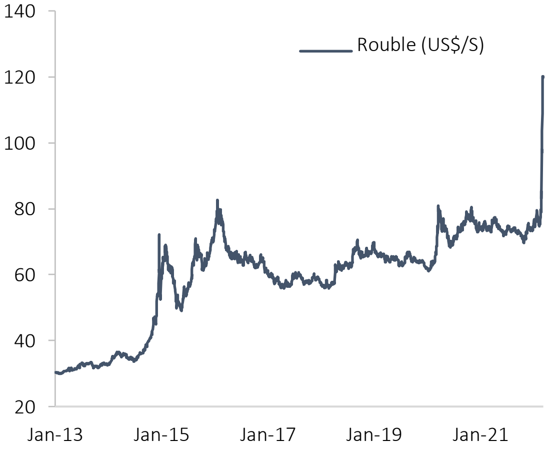
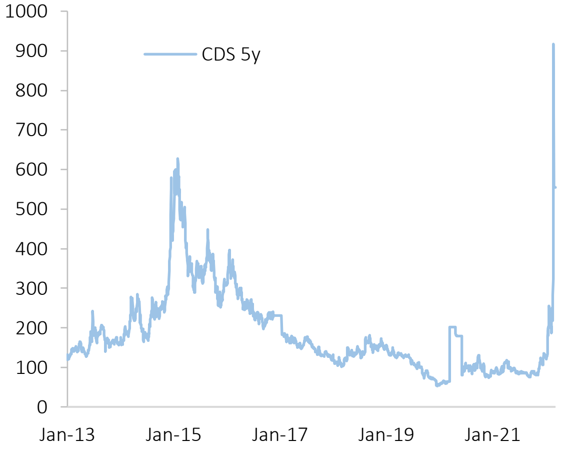
Source: Bloomberg and Santander

The currency loses half its value



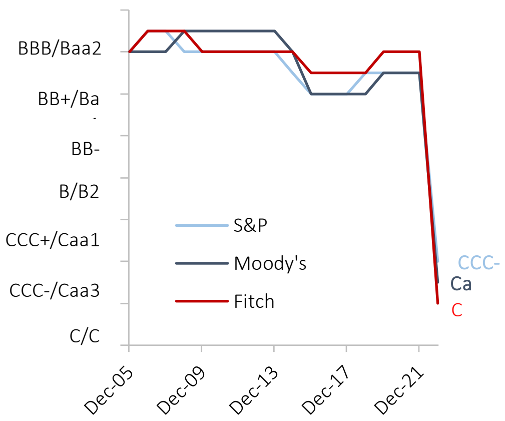
Source: Bloomberg and Santander

Russian risk prime jumps to levels unseen since the end of 2014



Source: Bloomberg and Santander

The primary risk-assessment agencies warn of the possibility of this sovereign debt's default



Source: Bloomberg and Santander

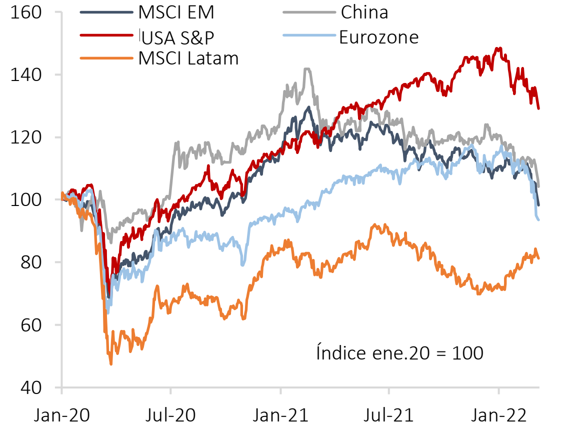
The vigorous jump in the price of oil and other fuels (mainly gas), compounded with the uncertainty fostered by the war and its impact on trust and expectations, could provoke a worldwide recession. This will be primarily determined by the depth and extension of the conflict, which seems lengthy the more days go by.

As a result, the global markets have seen a substantial rise in volatility (VIX: +8 points), with generalized falls in the month (global MSCI: -6%: MSCI Emergent markets: -12%). The most affected have been the European stocks due to their proximity to the conflict and their dependence on Russia's energy. Thus, the European Stoxx 50 had a close to 10% retreat. On the contrary, the stocks of several economies geographically far from the military epicentre that export primary sources -Latam particularly- have had gains (Latam MSCI: +1%). The dollar has tended to strengthen (DXY: 2%), and the long-term rates of foreign sovereign debt instruments have shrunk at the pursuit of investors for safety (-5 bps in average).

Even though it is possible that inflation will rise globally in the short term, markets have bet that the leading central banks will be cautious in their monetary strategies. Overall, just like a month ago, the Fed is expected to raise on at least six instances their ruling rate to drive it beyond 1.5% by the end of this year due not only to the inflation rise but also to the activity's buoyancy and the positivity of labour figures (February's unemployment rate: 3.8% vs previous 4%; nonfarm payrolls: 678,000 vs 423,000 expected; ADP job creation: 475,000 vs 375,000 anticipated). In the case of the European Central Bank (ECB), in general terms, the dovish outlook conveyed several times by President Christine Lagarde has not been modified.

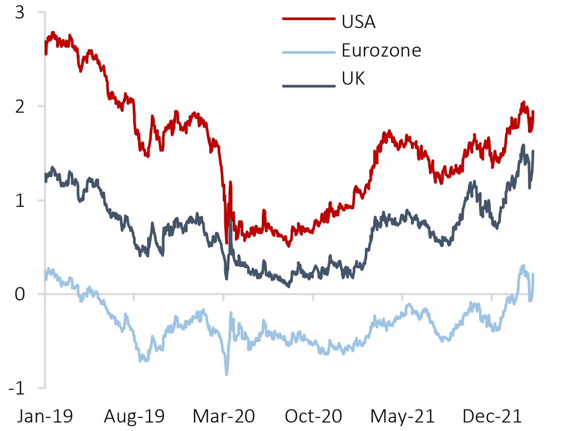
Beyond the short and medium-term implications of the war, the long-term economic consequences can be substantial and will be determined by the geopolitical rearrangement fostered by the conflict. It is still early to estimate the type of results to come.

Stock indexes plummet, particularly in more exposed economies



Source: Bloomberg and Santander

Long term rates shrank at the higher aversion to risk but then partially reversed

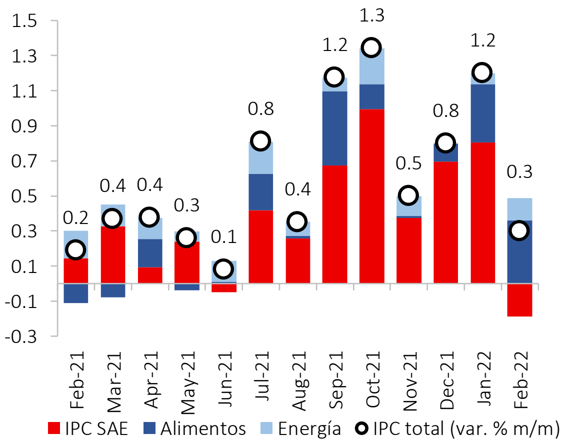


Source: Bloomberg and Santander

Implications of the conflict for Chile

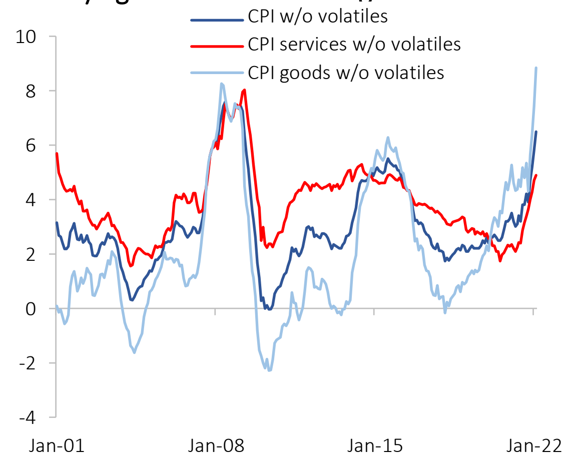
Like the rest of the world, the effects on Chile will depend on the war's reach and extension. The most considerable impacts will derive from the international movements in commodities' prices and other financial variables, as our country's direct commercial exposure to Russia is limited. Indeed, in the last years, this country's average imports have been just US$60 million annually (0.1% in total), while exports have fluctuated at around US$ 700 million (1% of the total figure). Maybe the only sector with a relevant direct exposure is the aquaculture one, in which salmon exports to Russia have exceeded the US$ 300 million annually (7.5% of total salmon exported).

February's CPI surprises on the downside



Source: INE and Santander

Underlying inflation remains high



Source: Central Bank and Santander

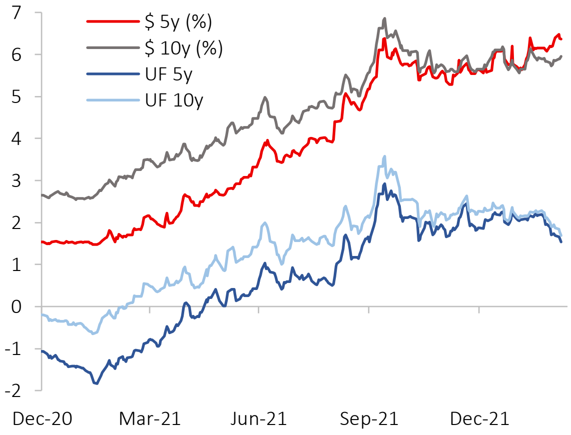
For now, the main impacts are observed in the sharp increases in inflation prospects in the months to come caused by the commodities' higher prices. Thus, if the market expected the CPI to end the year with a 6% rise before the invasion, the expectations now point towards an increment close to 8.5%. Moreover, this consideration comes after the downside surprise of February's figures (Bloomberg: 0.3% vs 0.7%;

Santander: 0.6%), which were affected by the reversal of some volatile components (airline fares and tourist package).

After initially losing value, risky assets have recently recovered (Local Stock Index IPSA: 2.5% since the start of the conflict) due to the contention's lower relative impact on them and the favourable prospects for copper. The currency, in turn, has been subject to high volatility and has had a moderate depreciation since the conflict began (0.7%).

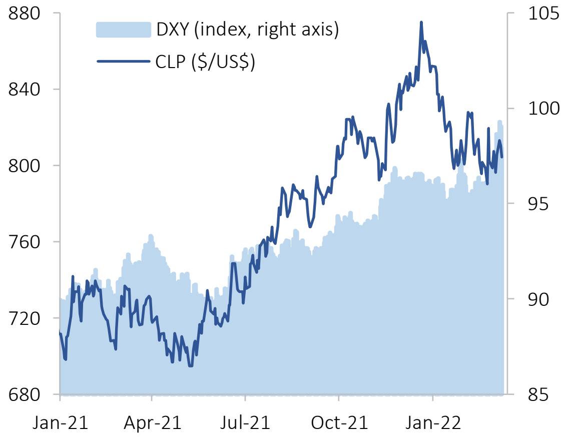
Long-term nominal interest rates have remained stable (BTP10: 5.9%), diverging from their foreign peers, while short-term ones display increments in the month (BTP2: 7.4%, +14 bps), due to expectations of a more aggressive withdrawal of the Central Bank's monetary stimulus and higher risk premia. Thus, the reversion of the yield curve intensified. The UF rates, in turn, have plunged (about 60 to 70 bps, UF5:1.5%) in reaction to the higher inflation prospects in the short and medium-term. Recent purchases of debt instruments by pension funds have also contributed to relieving state affairs. Swap rates showcase similar movements, remaining stable for the longer sections and presenting hikes of up to 80 bps MoM in the shorter section of the curve (*swap* 10y: 5.8% and *swap* 1y: 8.5%), therefore pointing towards relevant hikes to the MPR in meetings to come.

Real rates decrease at higher inflation prospects



Source: The Central Bank, RiskAmerica and Santander

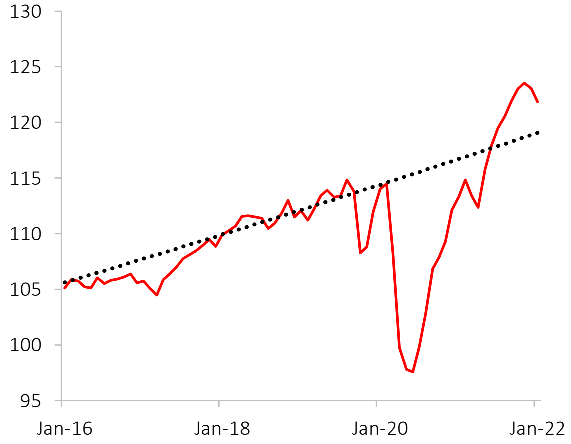
The exchange rate has been liable to volatility, displaying no clear trend



Source: Bloomberg and Santander

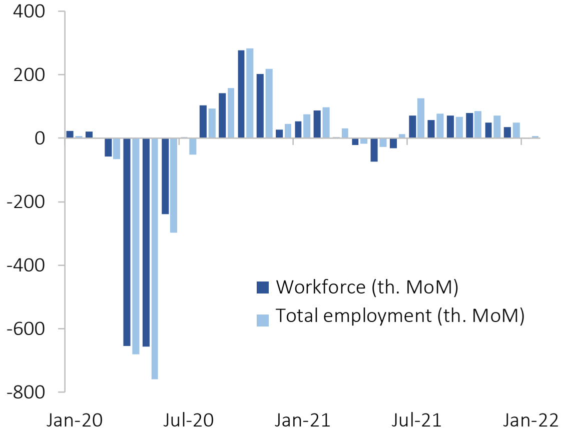
Even though the price of copper has risen, the hike to oil prices and other imported commodities will entail a fall to the country's terms of trade. Furthermore, a slow down to the global economy is expected, with a downwards correction to the world's growth that could reach 0.5% or more if the conflict prolongs for many months, affecting our exports sector. Finally, the narrower financial conditions due to the rate hikes and higher volatility, compounded with the uncertainty the conflict fosters, will undermine the internal demand. This takes place after the economy had already begun showing signs of a slowdown, as reflected by the month's drop in January's Imacec (-1% MoM seasonally adjusted) and the slackening of the job creation pace. Given the above, we have downgraded our prospects for the year's growth to 1%, with a downward bias conditional to the military conflict.

The activity slows down in January, for the second month in a row



Source: Bloomberg and Santander

Job creation has lost buoyancy in recent months



Source: INE and Santander

Regarding inflation, we estimate that we will see a substantial escalation in months to come, both due to second-round effects of recent price hikes, as well as the impact of international grains' price rising. Operations on behalf of MEPCO (Fuel Prices Stabilization Mechanism) will prevent sharp rises in fuels, but the higher oil figure will impact costs along the production chain. Thus, the CPI's annual variation could reach around 9.5% mid-year. Then, as the prices of foreign commodities recede and the internal demand loses drive, the CPI rise will moderate during the year's second half. Therefore, we estimate it will end 2022 somewhat below 8%, quite above the 6.2% figure we had contemplated in our previous report. In 2023 the CPI trends will continue to decrease gradually to end the year near 4.7%. The 3% target would be met only in mid-2024.

Implications to the monetary policy in Chile

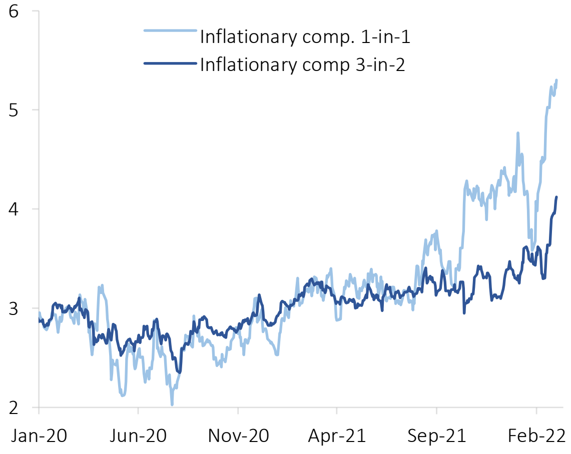
Just before the war, the Central Bank was in the process of raising the Monetary Policy Rate, gearing to curb the demand to induce a descent in inflation. One of the critical discussions concerned the eventual de-anchoring of expectations, as the market's two-year inflation projection surpassed 3%. Thus, the Council was expected to aggressively raise the MPR in the two upcoming Monetary Policy Meetings to drive it to range between 7.5% and 8% by the middle of the second quarter. Then, as activity slackened and inflation shrank, there was room for a quick MPR cut towards the end of the year.

The war and its short-term impact on inflation pose a significant challenge to the monetary direction now. Contrary to what happened in 2021 when there was a buoyant demand alongside the price hikes, the new inflation pressures stem from a shock to the offer caused foreign prices rising. In principle, the monetary policy should not be affected as long as the shock proves temporary and inflation expectations are anchored. Even if the shock fosters negative impacts on the activity, which is the likely scenario, the Central Bank could even have room for monetary adjustments, just as it is expected to take place with the Fed. Unfortunately, we find ourselves at a juncture where expectations have substantially veered away from the 3% target. For the same reasons, the Council's future decisions will be very complex.

Given that in the central scenario prior to the war it was still necessary to continue raising the MPR, from a tactical standpoint it is likely that a significant 150 to 200 bps increment in the meeting coming in late March –which will drive it between 7% and 7.5%– will allow the Central Bank to move ahead of the curve once more. This would help align the expectations to the target and give the Council time to assess the conflict's impacts in the medium term and direct the future rate movements. If evidence piles up of a relevant downwards effect on the activity, which can foreshadow a descent in the price dynamics, new raises to the rate might be necessary. On the contrary, if the geopolitical tensions and the price dynamic cause the CPI to continue to surprise on the upside and expectations to remain way above the target, a new increment to the MPR in the meeting in May of 100 bps cannot be ruled out, driving it between 8% and 8.5%.

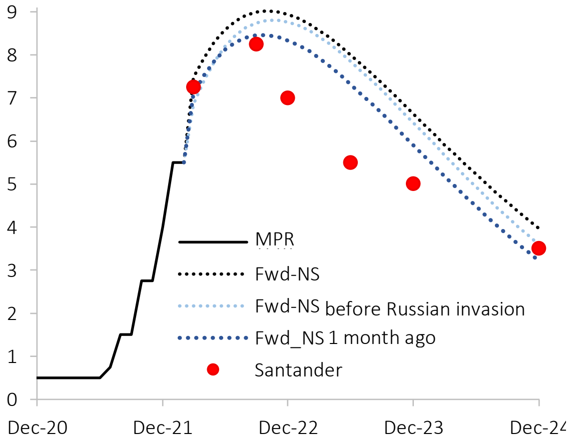
All elements considered, we anticipate that as the inflation enters a descending trend in the second half of the year, the Council will finally have room to consider decreasing the MPR. The rate would then end at 7% by the end of 2022, to continue shrinking up to 5% by December 2023.

Inflation expectations once again rise due to new external pressures



Source: Bloomberg and Santander

The MPR will continue to climb, but it could descend in the second half of the year



Source: Central Bank, Bloomberg and Santander

Macroeconomic Projections

National Accounts	2016	2017	2018	2019	2020	2021 e	2022 P	2023 P
GDP (real var. % YoY)	1.7	1.2	3.7	0.9	-5.8	12.0	1.0	1.0
Internal demand (real var. % YoY)	1.8	2.9	4.5	1.0	-9.1	21.2	-0.8	0.7
Total consumption (real var. % YoY)	3.5	3.6	3.7	0.8	-6.9	18.6	-1.5	-0.1
Private consumption (real var. % YoY)	2.7	3.4	3.8	1.0	-7.5	20.6	-1.5	-0.3
Public consumption (real var. % YoY)	7.2	4.6	3.3	-0.2	-3.9	11.0	-1.4	0.9
Gross fixed capital formation. (Real var. % YoY)	-1.3	-3.1	5.1	4.4	-11.5	17.2	-1.2	0.1
Exports (real var. % YoY)	0.5	-1.5	5.3	-2.6	-1.0	-0.9	1.2	2.1
Imports (real var. % YoY)	0.9	4.6	8.1	-2.4	-12.7	30.3	-4.6	1.2
GDP (US$ billions)	250.6	277.1	298.2	279.8	253.7	310.0	315	320
GDP per capita (US$ thousands)	13.8	15.0	15.9	14.6	13.0	15.7	15.9	16.0
Population (millions)	18.2	18.4	18.8	19.1	19.5	19.7	19.8	20.0

Payment Balance	2016	2017	2018	2019	2020	2021 e	2022 P	2023 P
Trade balance (US$ billions)	4.9	7.4	4.2	3.0	18.3	11.0	17.5	13.3
Exports (US$ billions)	60.7	68.8	74.7	68.8	73.4	94.7	86.5	85.0
Imports (US$ billions)	55.9	61.4	70.5	65.8	55.1	83.8	69.0	71.7
Current account (US$ billions)	-5.0	-6.4	-11.6	-10.5	3.4	-18.6	-9.2	-8.0
Current account (GDP%)	-2.0	-2.3	-4.0	-3.7	1.4	-6.0	-3.0	-2.5
Price of copper (annual average, US$/lbs.)	2.21	2.80	2.96	2.72	2.80	4.2	4.4	4.1
WTI oil price (annual average US$/bbl.)	43.2	50.9	64.8	57.0	39.0	68	117	95

Money and Exchange Market	2016	2017	2018	2019	2020	2021	2022 P	2023 P
CPI Inflation (var. YoY, % by December)	2.7	2.3	2.6	3.0	3.0	7.2	7.9	4.7
CPI Inflation (var. YoY, average %)	3.8	2.2	2.4	2.3	3.0	4.5	7.7	4.5
CPI sans food and fuel inflation (IPC-SAE) (var. YoY, % by December)	2.8	1.9	2.3	2.5	2.6	6.4	5.8	4.5
CLP/US$ exchange rate (year's exercise)	667	615	696	745	711	852	840	850
CLP/US$ exchange rate (year average)	677	649	640	703	792	759	816	844
Monetary policy rate (year's exercise, %)	3.50	2.50	2.75	1.75	0.5	4.0	7.0	5.0
Monetary policy rate (%, year average)	3.5	2.7	2.52	2.48	0.8	1.2	7.3	5.5

Fiscal Policy	2016	2017	2018	2019	2020	2021 e	2022 P	2023 P
Public expenditure (real var. % YoY)	3.8	4.8	3.5	4.1	11.0	31.6	-24.3	-2.1
Central Government balance (% GDP)	-2.7	-2.8	-1.7	-2.9	-7.3	-7.6	-2.8	-0.9
Central Gov. gross Debt (US$ billions)	53.4	68.9	70.2	74.4	91.6	102	119	122

Source: BCCh, INE and Santander.

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