HSBC Global Research

4 February 2022

The energy crunch

The global growth, inflation and policy implications

Economics
Global

- Russia/Ukraine tensions have pushed oil and wholesale gas prices even higher…
- …adding to the pressure on inflation, the squeeze on real incomes and the downside risks to growth…
- …but wage pressures could still mean a more aggressive policy response from some central banks

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Here we go again

With inflation currently at multi-decade highs and uncertainty surrounding the inflation outlook already unprecedented, the last thing the recovering global economy needs is another leg higher in energy prices. Yet that is what it is getting. And just as many of the retail gas price increases driven by last year's wholesale price rises have found their way onto household energy bills, Russia/Ukraine tensions have pushed oil and gas prices higher and more hikes and further rises or even outright supply outages are possible. Should the tensions escalate, sanctions could be imposed, the impact of which could be more broad ranging, potentially extending to other commodities such as metals and foodstuffs, particularly wheat.

Energy inflation and forecasting uncertainty

Energy inflation was already very high at the end of 2021, accounting for more than half of the total consumer price inflation for a broad range of economies from much of Europe to Japan. Energy accounted for a much smaller share of the 7% inflation print the US registered in December, but we forecast it will help to lift it higher in early 2022. Forecasting eurozone inflation is an even bigger challenge given the widely differing approach of governments regarding the timing and caps on utility price rises. The task is set to get even harder with food price inflation reviving too. The last time Europe imposed sanctions against Russia, in 2014, inflation was low and energy inflation was deeply negative. This time, any additional upward pressure on energy prices and inflation could have a much more severe impact on consumer spending.

Policy implications

There are clear policy risks if energy prices stay high or move up even further. We know from the past that big rises in energy prices squeeze real incomes and can result in a sharp slowdown – or even an outright contraction – in consumer spending. But in the past, US households did not have a stock of savings of the scale accumulated during the pandemic that they could draw down as living costs rose. Growth is slowing, but there is still a big risk of a sustained wage response as headline inflation moves higher in which case some central banks would need to tighten more aggressively in 2022. Hopes of a US soft landing could fade, but given the current high and rising rate of inflation, a more marked economic slowdown might be the necessary price to pay for maintaining central bank credibility.

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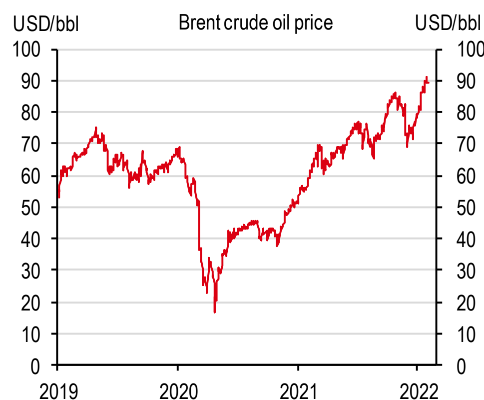
High energy

Only a brief reprieve

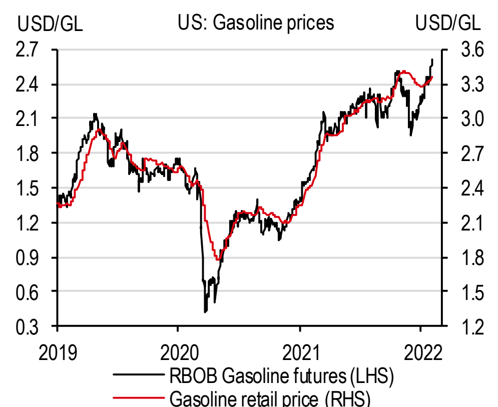
Just two months ago, the US, China, India, Japan, Korea and the UK announced the release of some oil reserves, helping oil prices to trade briefly below USD70/bbl by early December. The reprieve was brief though. The start of 2022 has been met with higher energy prices in much of the world. Some of this has been due to the resilient oil demand as the global economy continues to recover (see: *Oil in 2022: It's not all upside*, 14 January 2022), but the Brent crude price has clearly reacted to the increased tensions between Russia and Ukraine (*Oil markets: Russia/Ukraine tension – implications for supply and price*, 25 January 2022), hitting USD90/b.

1. Oil prices have moved higher again …



Source: Refinitiv Datastream

2. … pushing up pump prices



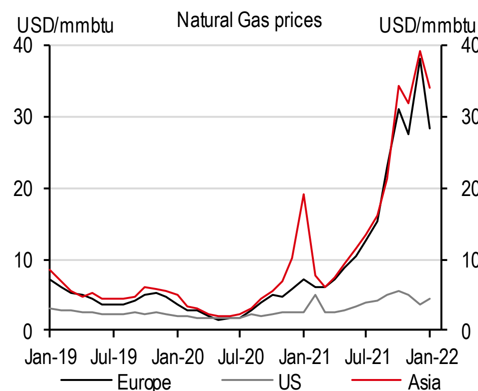
Source: Refinitiv Datastream. Note: RBOB futures are market prices for gasoline in the US, whereas the gasoline retail price reflects pump prices for US consumers.

Western consumers have already been paying more to fill their cars with fuel in early 2022, and in some economies, the scheduled retail gas price rises driven by last year's wholesale increases are starting to find their way onto household energy bills. Now 2022 forward gas prices have risen sharply in Europe and Asia (see *Gas Markets: What might happen if Russia/Ukraine tensions rise*, 25 January 2022), threatening even more utility price hikes. Any further increase in tensions would likely impact gas markets more than oil markets, and Europe is much more dependent on physical flows of Russian gas than Russian oil with more than 40% of total gas supply coming from Russian pipeline imports.

Wholesale gas price forecasts rising and risks are to upside…

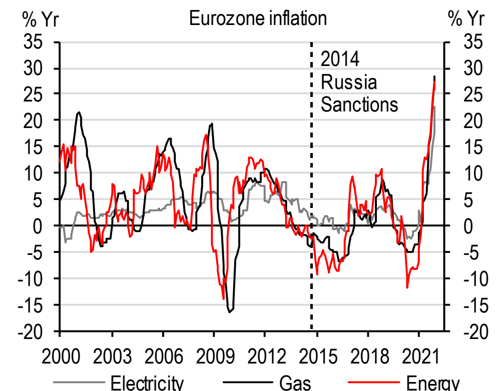
While HSBC energy analysts have maintained their forecast of the oil market moving into balance in the coming months, they raised their Europe/Asia wholesale gas price assumptions in early January as the gas crunch looks set to continue through most of 2022. The updated Europe gas price forecasts are USD21/mBtu in 2022e, triple the historical average, and USD11.5/mBtu in 2023e. However, they have warned that in a scenario of increasing tensions, there would be meaningful upside to near-term gas prices: month-ahead prices could potentially rise by ~50%, implying prices around USD40s/mBtu, in their view. Moreover, we could see 2023 forward prices shifting up from the current levels of USD13-14/mBtu to >USD20/mBtu (in line with 2022) – in effect prolonging the current gas crunch.

3. Gas prices are extremely elevated in Asia and Europe…



Source: World Bank, Refinitiv Datastream.

4. …which could not have come at a worse time for European consumers



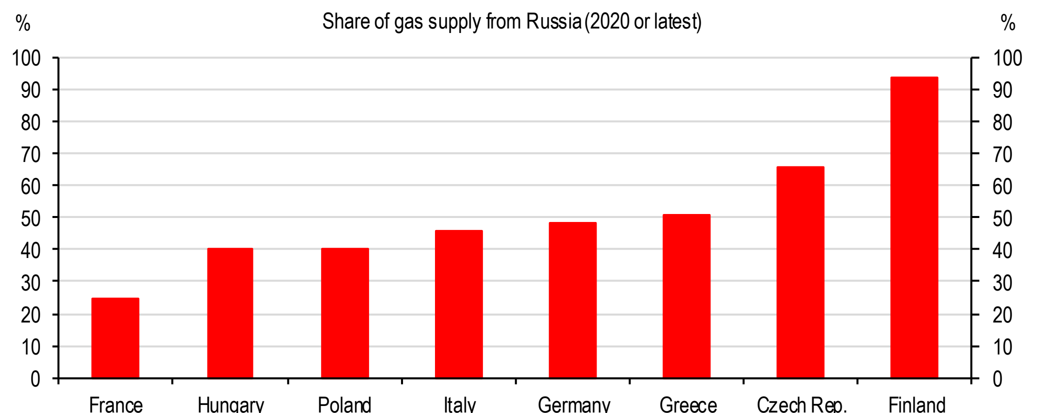
Source: Refinitiv Datastream.

…at a time when energy price inflation has already spiked

Energy inflation in Europe is already surging

The prospect of further retail gas prices could not be happening at a worse time for European consumers given that energy inflation is already surging. It is very different from when sanctions were imposed on Russia in 2014, which happened at a time when global energy prices were at cyclical lows (chart 4). Some European economies may see more uncertainty around prices given the reliance on Russia for gas. Chart 5 shows the larger European economies where Russia is a major source of gas with others more reliant on a combination of Norway, smaller suppliers or domestic production.

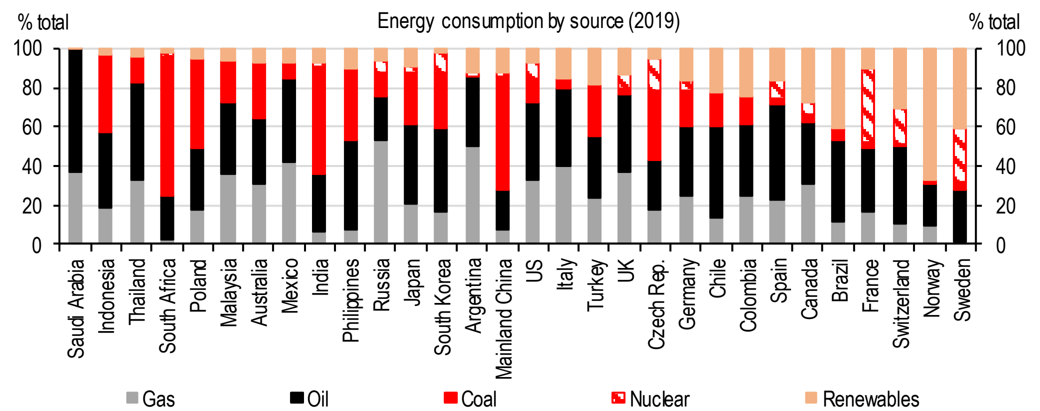
5. …with many economies very reliant on gas from Russia



Source: European Union Agency for the Cooperation of Energy Regulators.
Note: Data is provided for the top three suppliers so, for example, the UK and Spain don't have Russia among their top three sources, which includes domestics production.

With gas prices rising in Europe, Asian gas prices are being lifted higher, too. This, coupled with higher coal prices shifting demand to alternative fuels and the fact that the majority of long-term liquefied natural gas (LNG) supply contracts are priced off crude has led wholesale gas prices to soar. And, for some parts of the world, the rise in gas prices matters more than what is happening to other fuel prices in terms of household utility bills. Chart 6 shows the energy consumption mix by economy – and the split is clear between those reliant on gas, coal and oil.

6. Most of the world is very reliant on fossil fuels for energy



Source: Our World in Data. Note: ranked from left to right in terms of highest to lowest reliance on fossil fuels.

Risks of escalation

In the event of any incursion/invasion, the impact would inevitably be more broad ranging, potentially extending to other commodities such as a range of different metals – particularly copper and aluminium – and foodstuffs, particularly wheat. The impact could be via sanctions on supplies and individuals imposed by the US and Europe or by Russia in retaliation, and could even involve the West removing Russia's access to the Swift payments system to facilitate trade[1].

A detailed analysis of the impact of any sanctions that could be applied is beyond the scope of this report, but in order to give a rough idea of the relative impact that major economies' would face in terms of trade disruptions, we have shown the share of each economy's direct trade with Russia. However, because the biggest impact via trade and energy, particularly gas prices and supplies, would be on European growth, we have also shown the economies' trade exposure to the EU. As we discuss below, the last time Europe imposed sanctions against Russia, in 2014, inflation was low and energy inflation was deeply negative. However, this time, any additional upward pressure on energy prices and inflation could have a much more severe impact on the ability of already stretched consumers to keep spending, at least in the early part of the year.

It is also worth noting that it is possible that should the US and EU impose any sanctions on Russia, some governments in other regions may opt to bypass them.

[1] Financial Times, 30 January 2022. "Will Russia be cut off from Swift if Moscow invades Ukraine?"

7. While much of the world isn't highly exposed to Russia, if higher energy prices weigh on European growth, the global impact would be greater

	Exports to Russia as % GDP	Exports to Russia as % of total	Imports from Russia as % total	Exports to EU as % GDP	Share of energy imports from Russia*
Poland	1.7	3.0	6.0	41.0	51.6
Hong Kong	1.2	0.7	0.2	11.8	0.7
Vietnam	1.1	1.0	0.7	13.3	4.4
Germany	0.9	1.9	2.5	24.5	16.8
Turkey	0.9	2.7	11.0	13.5	34.9
Switzerland	0.7	1.0	0.2	27.2	0.4
Sweden	0.6	1.3	2.6	24.9	19.3
Korea	0.5	1.3	2.9	3.6	9.2
Italy	0.5	1.6	3.4	16.2	21.6
France	0.4	1.2	1.4	16.9	12.1
Mainland China	0.4	1.9	2.9	2.8	12.2
Chile	0.3	0.9	0.1	2.6	0.0
Singapore	0.3	0.1	4.5	14.3	6.0
Spain	0.2	0.7	1.0	21.3	6.0
UK	0.2	0.7	2.1	14.2	11.5
Malaysia	0.2	0.3	0.5	5.6	2.7
Argentina	0.2	1.1	0.5	2.2	0.6
Thailand	0.2	0.3	0.9	4.5	3.4
India	0.2	0.9	1.3	2.6	1.9
Japan	0.2	0.9	2.0	1.6	6.4
New Zealand	0.1	0.5	1.0	1.5	8.5
Norway	0.1	0.4	2.3	20.4	11.6
South Africa	0.1	0.4	0.6	5.3	0.4
Indonesia	0.1	0.6	0.7	1.5	0.7
Brazil	0.1	0.7	2.1	1.9	1.9
Colombia	0.1	0.3	0.5	1.9	0.0
Australia	0.0	0.2	0.1	0.8	0.6
US	0.0	0.3	0.9	1.9	6.5
Mexico	0.0	0.1	0.3	1.7	0.4
Canada	0.0	0.1	0.3	1.7	2.1
Philippines	0.0	0.1	0.9	2.9	1.0
Saudi Arabia	0.0	0.0	0.6	4.0	6.2
Russia	-	-	-	9.6	-

Source: IMF WEO, IMF DOTS, UN Comtrade.
Note: *Share of imports of HS code 27: "Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes", which includes gas.

Energy inflation

The immediate impact of the latest leg higher in oil prices will be on inflation. As explained in some detail in *The Energy Shock* (25 November 2021), the scale of the direct impact of higher energy prices on inflation depends on energy's share of the basket; the energy mix; the level of taxation on fuels; and the scale of any subsidies.

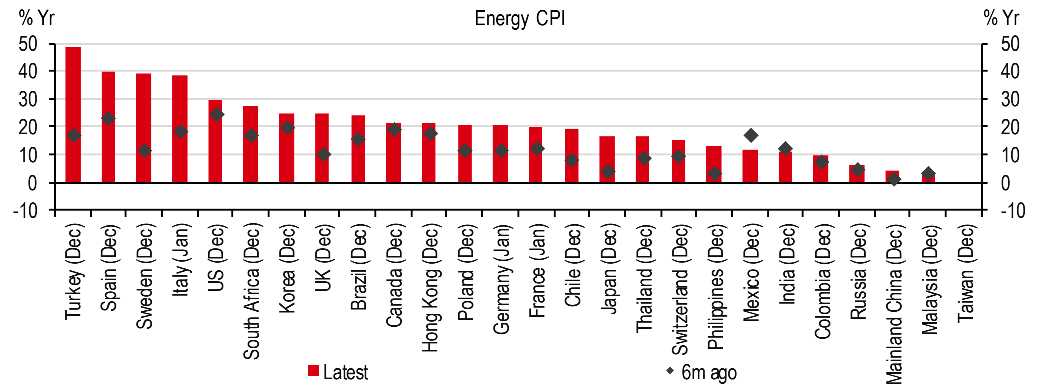
Energy inflation has already more than doubled in the past six months in the UK, Germany and Japan

Hence, energy inflation has already picked up sharply in many places – with the annual rate more than doubling over the past six months in the likes of the UK, Germany and Japan. In other advanced economies, such as Spain and the US, taxes make up a small share of the petrol pump price so the pass-through of any given change in the crude or wholesale cost has a bigger impact. Despite not experiencing the same utility price rises, the US still has one of the higher rates of energy inflation in the world (chart 8) at nearly 30% y-o-y in December, primarily reflecting higher gasoline prices. Given recent moves, we now expect US inflation to peak in February (see: *US inflation briefing (Dec): Stickier price increases in 2022,* 13 January 2022).

In the eurozone, the very near-term outlook for inflation is opaque

In the eurozone, even the very near-term outlook for inflation is very opaque. November had been widely anticipated to be the inflation peak but – despite a drop in the energy contribution – food prices saw inflation move higher in December and hefty hikes in household gas and electricity prices in Germany, Spain and, particularly, Italy drove an even bigger surprise move higher to 5.1% in January. In Italy, gas bills jumped more than 40% and electricity bills 55% (see: *Eurozone inflation (Jan, flash): So what about that drop?,* 2 February 2022). Energy prices

8. Energy inflation has surged in much of the world



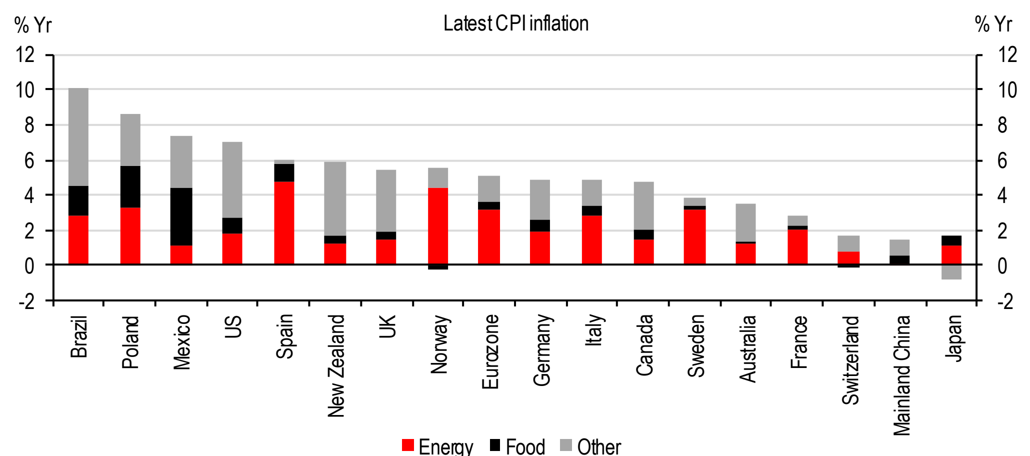
Source: Refinitiv Datastream. Note: Parentheses show latest month that data are from.

will have less of an impact on inflation in France as regulated gas prices are frozen at their October 2021 levels until the end of 2022 while the rise in regulated electricity prices is capped at 4% in February. In the UK, the impact of the last wave of the 2021 wholesale price rises will not be felt until April with prices set to rise by 54%. But the impact on inflation will be determined by how energy companies and statisticians treat the additional fiscal support measures announced by the government (see *UK energy bill update: Implications for inflation and fiscal policy*, 3 February 2022).

To put all of these energy effects on inflation into context, we have illustrated the share of total inflation that is accounted for by energy in chart 9. In parts of Asia, the impact of energy has been much smaller and in mainland China, it has been negligible. In Italy, energy accounted for 2.8ppts of the 4.8% inflation print (national measure) in December. The share is even higher in the likes of Spain, Sweden and Norway where the pass-through from wholesale to retail prices is faster.

The more interesting point is that in some economies where inflation is much higher than in Europe, energy accounts for a much smaller share of the current higher inflation. In the US, it accounted for only about 2ppts of the 7% inflation print in December.

9. The share of CPI made up by household energy varies greatly around the world



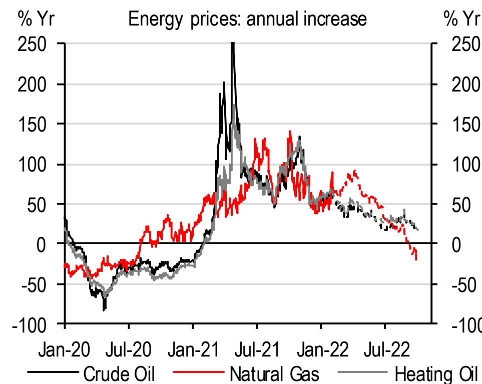
Source: HSBC, Refinitiv Datastream, National Statistics Offices.
Note: Data are for December 2021 for all apart from Australia and New Zealand (Q4) and eurozone and member states (January 2022).

What is the impact of a renewed leg up in energy prices?

Of course, the chart is just a snapshot of inflation at the turn of the year. Several economies, like the UK, will already look different in the coming months due to the earlier wholesale price rises feeding through. But what about the impact of the renewed leg up, and the risk it goes higher still? In terms of the direct impact, the contribution from energy should still edge lower although not as rapidly as seemed likely previously.

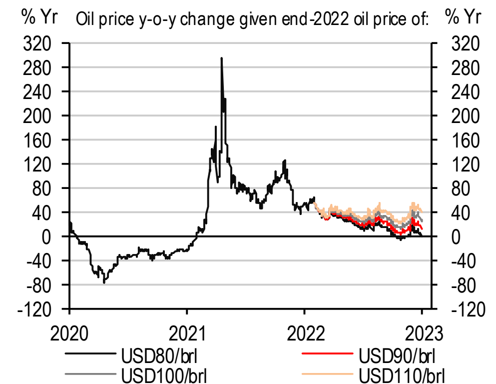
Chart 10 shows that if energy commodity prices stay at the current high levels, there would be a slow decline in the annual increases through 2022. Even if the oil price crosses USD100/bbl, we would still see a lower rate of change than we see today (chart 11). For the annual increase in the oil price to be the same at the end of 2022 as it is today (~60%), the oil price would need to reach USD125/bbl. While that provides some comfort, even if the *direct* impacts of higher energy prices fade, having fuel costs remaining at a relatively high level for longer would have broader implications for inflation.

10. The annual increases in energy prices looks set to diminish slowly



Source: Refinitiv Datastream. Note: Dotted lines show the trajectory if prices remain the same as current levels. Series are based on production weights and are wholesale prices in USD.

11. Even if oil prices rise, the direct inflationary impact may reduce



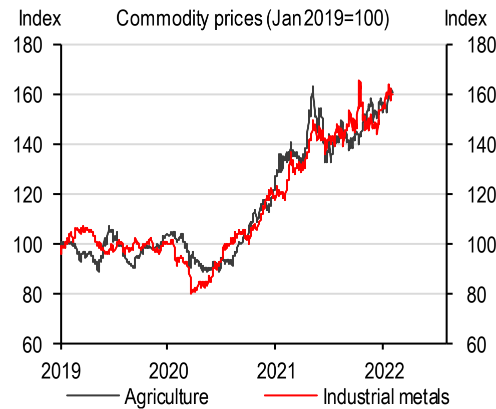
Source: Refinitiv Datastream, HSBC. Note: Assumes linear move towards given price on 31 December 2022 and then annual growth rate calculated from that

Indirect impacts of higher oil prices

Higher energy prices raise costs of producing other goods

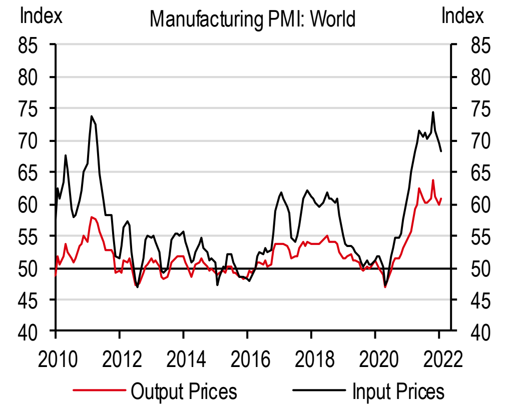
Higher energy prices have already been pushing up the costs of producing other goods. Some of this is through the higher cost of extraction or production, such as for industrial metals, while higher prices for fertilisers can also feed into higher food prices. It is worth noting that Russia is a big producer of some of the other key ingredients for fertiliser, such as urea and potash, so there could be big impacts beyond gas in the event of any further deterioration in relations or even outright sanctions. The global manufacturing PMI input price index may have edged down in recent months, but it remains very elevated, and this is feeding into higher output prices that firms are charging for goods (chart 13).

12. Other commodity prices are rising …



Source: Refinitiv Datastream

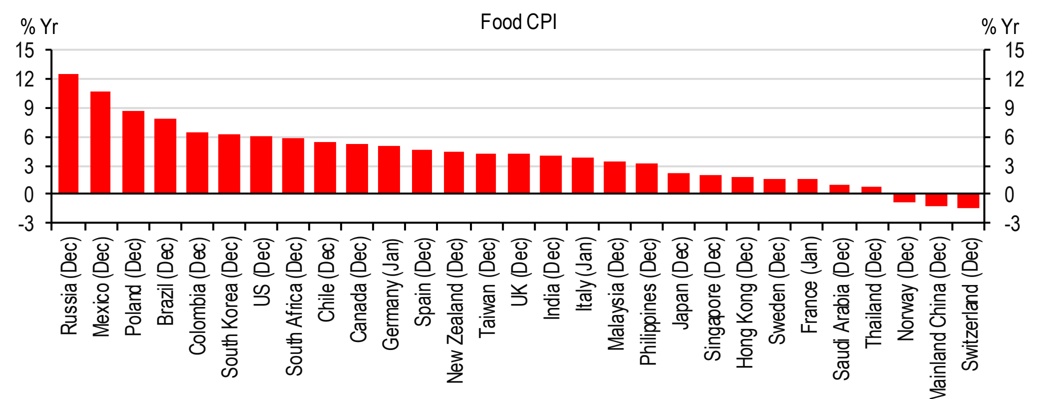
13. … and input costs are still elevated



Source: Refinitiv Datastream

Energy is not the only factor that has been pushing up the price of food commodities, which have been supported by strong demand and continued capacity constraints. Adverse weather in South America, robust demand and geopolitical developments have affected grains prices as well as energy. Russia and Ukraine are both leading exporters of wheat and sunflower oil. Meat prices are also up due to supply constraints (see *Commodity prices snapshot: A rise in January, with geopolitics in focus*, 1 February 2022). The impact of higher food prices will most likely be seen in those emerging markets in which the share of the CPI basket that food makes up is substantially larger. As we can see in chart 14, the annual pace of food inflation remains elevated in many parts of the world. In the likes of Mexico, food prices have added more than twice as much to inflation in December as energy.

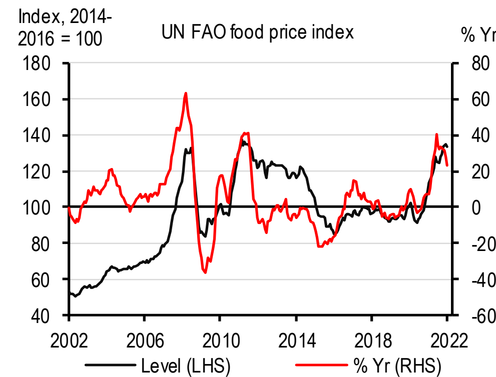
14. Food price inflation is rising in much of the world



Source: Refinitiv Datastream

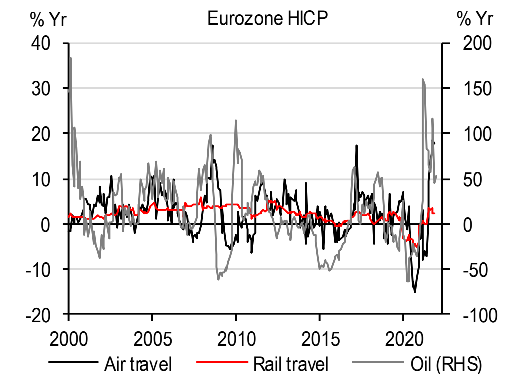
We may also see a direct impact through other costs that rely on fuel within transportation. Airfares have had, until the pandemic, a good relationship with the oil price in terms of inflation, but that appears to have broken down as border and travel restrictions have affected the sector. But with demand returning and oil prices up, airfares could move higher. Costs for other forms of transportation, such as rail, have historically had a much weaker relationship with the oil price.

15. Geopolitical tensions have contributed to higher agricultural commodity prices



Source: Refinitiv Datastream

16. Airfares typically move with oil price but other public transport costs less so

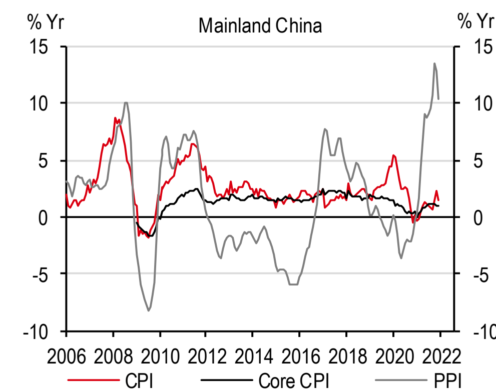


Source: Refinitiv Datastream

From PPI to CPI

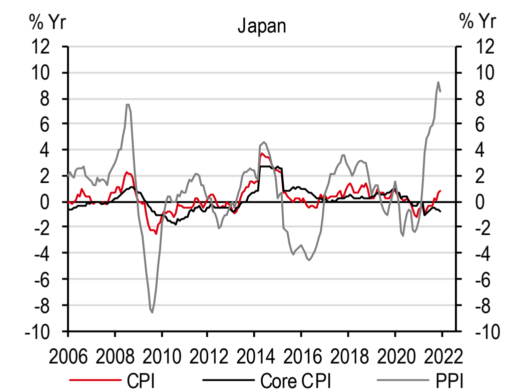
More broadly, these rising input costs are likely to feed into higher costs for firms with producer prices in many places currently rising by more than 10% year on year (see chart 32). While some of this is due to energy prices, cost pressures from shipping and logistics as a result of jammed global supply chains are also contributing to the issue. The magnitude and the timing of the pass-through has been variable, but the divergence between Asia and the advanced economies continues.

17. Producer prices have surged in mainland China without CPI spiking…



Source: Refinitiv Datastream

18. …and the same has so far been true in Japan



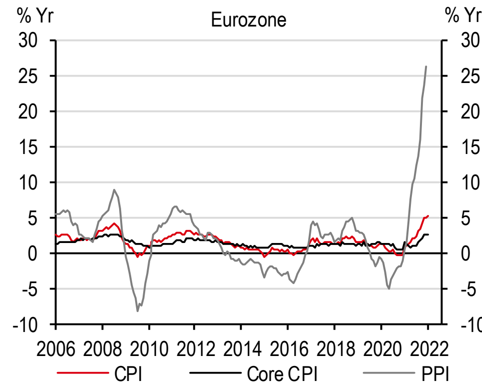
Source: Refinitiv Datastream

In economies such as mainland China and Japan, big spikes in producer prices – which have recently shown signs of topping out – have shown little sign of feeding into consumers' costs yet. This is likely the result of subdued pricing power for firms given the weakness of domestic demand, particularly consumer spending, but the impact of regulated prices, particularly for the likes of household electricity costs in mainland China, has also played a role as have falling food prices.

Rising producer prices add to the raft of uncertainties surrounding inflation in 2022

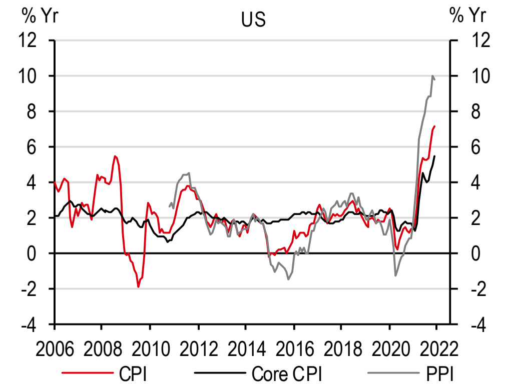
However, in the advanced economies, there are signs that the surge in PPI – which had been particularly benign in the eurozone – is translating at least somewhat into higher CPI inflation, particularly in the US (charts 19-20). The extent to which firms will be able to pass on these cost rises or accept some squeeze on margins is likely to vary among sectors, adding to the raft of uncertainties surrounding inflation rates in the course of 2022.

19. In Europe, PPI has surged and CPI is heading higher …



Source: Refinitiv Datastream

20. … while the US is seeing the impact clearly



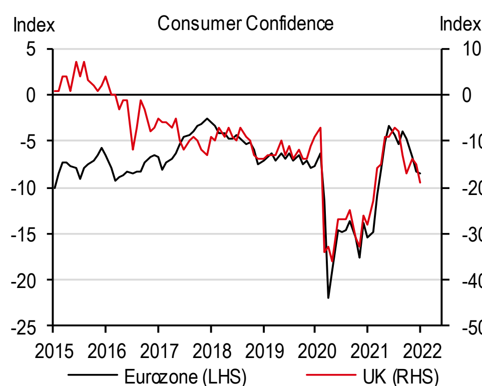
Source: Refinitiv Datastream

The growth impact

Inflation or Omicron?

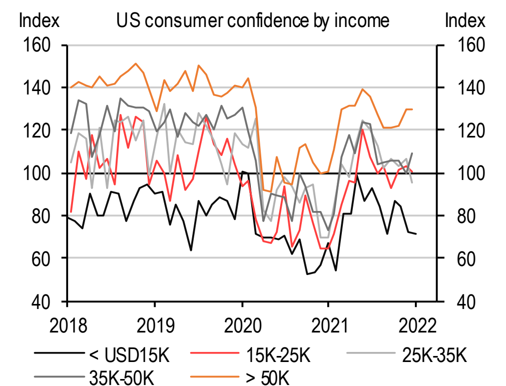
As we outlined in *Energy shock*, 25 November 2021, households may be able to weather the storm of higher energy prices, which amounts to a de facto tax on consumers' purchasing power. Some combination of a reduction in savings, higher wage growth (evident in some sectors, notably leisure and hospitality in the US) and/or higher borrowing can allow them to smooth their spending. There are, however, some signs that higher prices may already be weighing on consumer confidence although it is hard to disentangle the impact of Omicron at this stage.

21. Consumer confidence is fading…



Source: Refinitiv Datastream

22. …particularly among lower income households

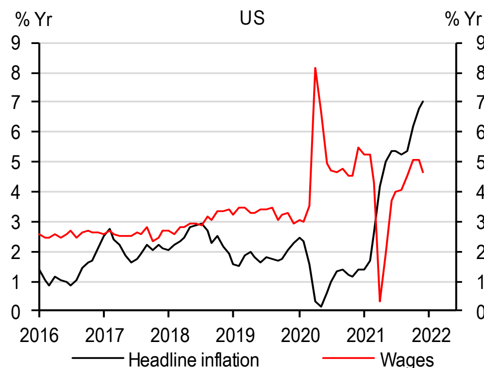


Source: Refinitiv Datastream

The real wage squeeze…

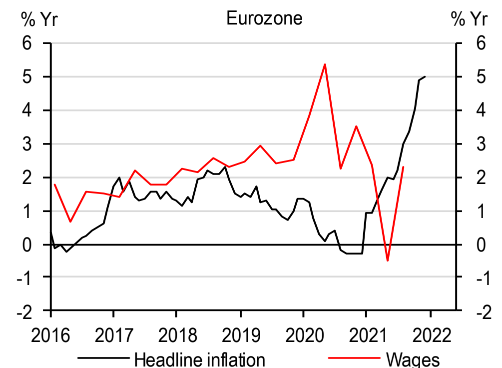
For consumers, even in the absence of the pandemic, the squeeze on real incomes is likely to weigh on confidence as well as the willingness and ability to spend on discretionary items. Inflation has soared above the rate of wage increases in much of the developed world in recent months (charts 23-24). And this may be feeding into weaker spending. We saw this come through in December in both the US and the UK as households held back and retail sales figures dropped sharply in the month (chart 26). The drop in retail spending in December was even more severe in Germany where sales volumes fell 5.5% m-o-m after two fairly solid months, which also supports the notion that it was driven more by Omicron than inflation but there can be no doubt that the real wage squeeze is intensifying.

23. US inflation has surged above wage growth



Source: Refinitiv Datastream. Note: Wage series is average hourly earnings

24. In the eurozone, the real wage squeeze is intensifying



Source: Refinitiv Datastream. Note: Wage series is "Hourly Labour Cost, Wages and Salaries". The latest data is to Q3 2021

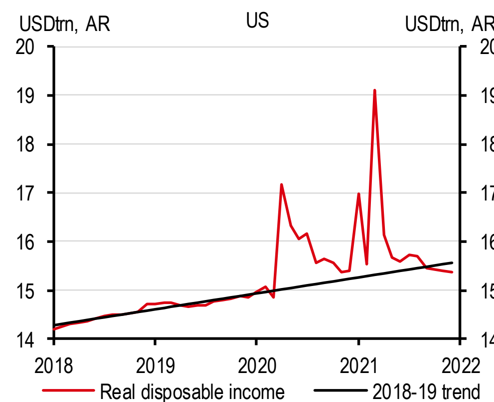
… is intensifying

Inflation and end of fiscal support has lowered US real disposable income…

The aggregate level of US household real disposable income, which surged during the various waves of fiscal stimulus delivered by the Trump and Biden administrations in 2020 and early 2021, has fallen back sharply in recent months. The halt to supplemental federal unemployment insurance at the end of September combined with hefty monthly rises in inflation in October and November pushed aggregate real household income increasingly below the pre-pandemic trend in the final quarter of 2021 (chart 25). And the January picture is likely to be bleaker still given that the Child Tax Credit payments have expired due to a failure to pass the proposed Build Back Better plan.

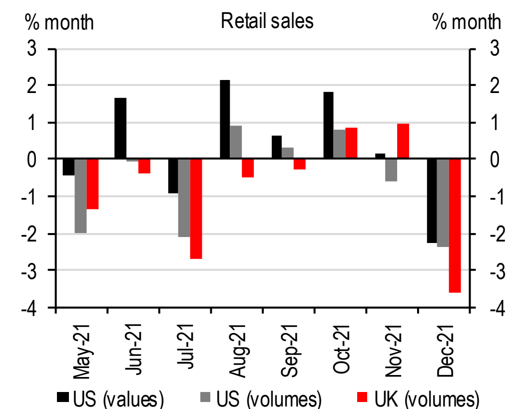
European consumers will not face the same waning fiscal support but household incomes are being squeezed even though countries have been intervening through tax cuts and direct transfers to soften the blow to the population. As discussed above, the last time Europe imposed sanctions against Russia, in 2014, inflation was low and energy inflation was deeply negative. However, this time, given the higher starting point for inflation, any additional upward pressure on energy prices and inflation could have a more severe impact on consumer spending at least in the early part of the year, though, of course, more government interventions to cap the increases might happen in the coming months.

25. Real incomes came under pressure in Q4, particularly in the US …



Source: Refinitiv Datastream.
Note: AR = Annualised rate, as the data is reported

26. … but was the drop in retail sales in December due to inflation or Omicron?



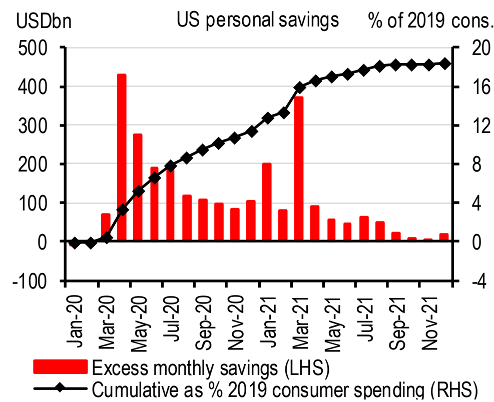
Source: Refinitiv Datastream. Note: The US volumes series is deflated by CPI and is presented as calculated by the Federal Reserve Bank of St. Louis.

Sustaining spending?

…but will households sustain spending by drawing on their savings?...

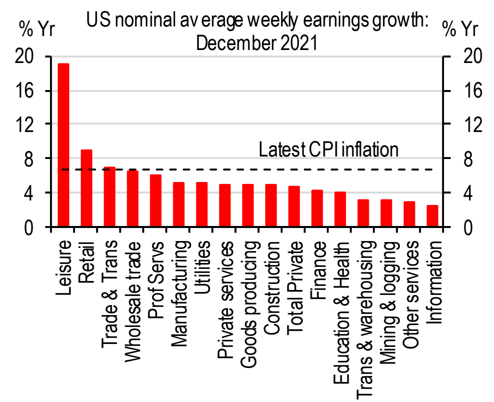
It may not be all bad news though. Consumers may be in a better place, in aggregate, to ride this out than at many points in the past. The accumulated stock of savings that households have built up during the pandemic may cushion some of the blow, particularly for higher income households that are more likely to have been able to save. For some households with lower incomes, a combination of higher hourly wages and more hours worked may mean much more in people's pockets, particularly for those working in the US leisure and hospitality sector.

27. US households have built up a stock of savings…



Source: HSBC, Refinitiv Datastream.
Note: Excess savings are relative to the same month in 2019.

28. …and incomes are rising quickly for lowest-wage earners



Source: Refinitiv Datastream, HSBC.
Note: Weekly earnings shown, which combines hours worked with hourly earnings

…or raising their borrowing?

And there is of course scope for consumers to smooth their spending through higher borrowing. Household balance sheets in many economies are in a better place today than they have been in a long time. Household debt levels may have picked up as a share of GDP, more due to the denominator (GDP) than soaring debt levels. Households are less indebted than they were a decade ago. Equally, more timely data from the Federal Reserve Bank of New York suggest that US households have trimmed their credit card debt since the start of the pandemic and fewer debt obligations are becoming delinquent although some of the latter may reflect payment holidays. While this strength is not universal across income groups and individual situations, in aggregate households may be relatively well placed to weather this storm. Given this backdrop, what looks set to be a very weak start to the year for consumer spending may not persist given current wage growth and labour demand so there could be some improvement in consumer spending as long as inflation starts to come down and COVID-19 cases fall back.

Policy risks

Inflation risks dominate downside growth risks

Despite the softening economic activity data at the start of 2022, there are clear policy risks if energy prices stay high or move up even further. We know from the past that big rises in energy prices squeeze real incomes and can result in a sharp slowdown – or even an outright contraction – in consumer spending soon resulting in rate cuts. But prior episodes had substantial differences from the current situation under which inflation is already at multi-decade highs and Western households have accumulated a sizeable savings that can be drawn down as living costs rose. Equally, labour markets are much tighter today than in other similar periods.

Higher inflation for longer likely means more wage pressures too

There will clearly be a distributional element though. As we mentioned above, at least in the US, employees in the lowest paid jobs, like leisure and hospitality, are currently receiving the biggest pay gains as businesses seek to retain or entice workers back into the labour market, but it is still

the lowest paid households that spend a larger share of their incomes on energy and food. Given that many will also have depleted their savings, their reduced purchasing power would hit other areas of consumer spending growth. However, it is the price of the most frequently purchased items that tend to have the biggest impact on household inflation expectations. In a tight labour market that would in turn imply demands for higher pay, which companies might be willing to meet, especially those having some success in passing on price increases to their customers.

So at this point, the bigger risk of the latest rise in energy prices is that there is a wage response to ever higher inflation in which case central banks would need to tighten earlier or more aggressively in 2022. Clearly markets are already pricing in five 25bps rate rises from the Fed in 2022 and more than 25bps of tightening from the ECB. While we have not chased the market higher, we do have more sympathy with the market pricing for the Fed than for the ECB given that FOMC policymakers have repeatedly stressed their intention to do what is needed to bring inflation lower.

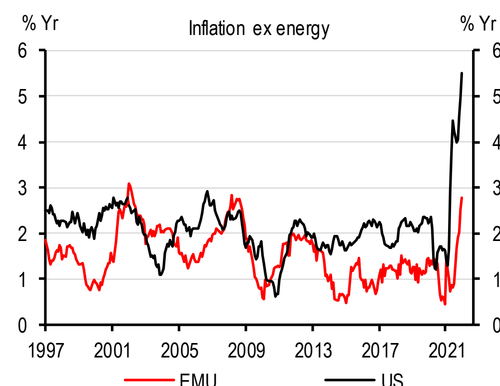
Eurozone inflation picture still calls for patience

German inflation is not eurozone inflation

We recognize the view of ECB President Christine Lagarde that the ECB has “every reason not to act as quickly or as ruthlessly as the Fed”. Not that the Fed is currently acting ruthlessly, at least not yet. It is still buying assets although only for a little while longer and is set to deliver in March its first well-flagged rate rise since the onset of the pandemic. But as we illustrated above in chart 9, the importance of global factors, such as food and energy prices, in pushing up inflation has been much smaller in absolute and relative terms in the US than in Europe. Excluding energy, inflation is much lower in the eurozone than in the US (chart 29), and market expectations regarding the ECB would appear to be driven more by current German inflation data than that of the eurozone for which based on the flash estimate for January, core inflation slowed to 2.3%. As shown in chart 30, inflation ex-energy in the eurozone is now slightly lower than it was when the ECB raised rates in 2008 and lower than when the ECB was cutting rates in 2001.

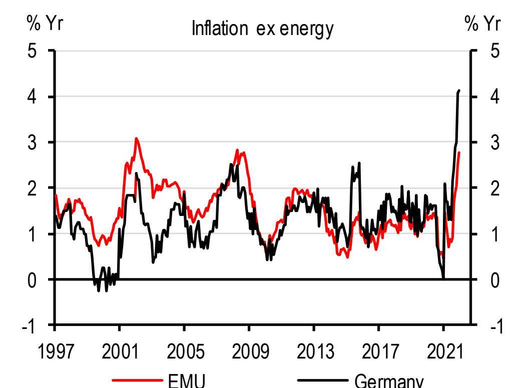
Moreover, despite reports of increasingly widespread labour shortages, our European economists believe the concerns about imminent broad-based sharply higher wage growth are overdone (see *Is the eurozone different? What the data tell us about the eurozone wage outlook*, 20 January 2022). If wages start to rise more meaningfully in the coming months, it could force the ECB to act faster than we currently anticipate (we see the first 10bps rate rise in H2 2023), but with the ECB having reiterated clearly in the February meeting that the sequencing between the end of QE and the first rate hike is not up for negotiation, we still see believe the market has priced in too much (see: *ECB press conference (Feb): Halfway house*, 3 February 2022).

29. Underlying inflation in the US is much higher than in the eurozone…



Source: Refinitiv Datastream

30. …where inflation ex energy is much lower than German headlines imply



Source: Refinitiv Datastream

Can the Fed engineer a soft landing?

After the January FOMC press conference, financial markets were rattled at the prospect of aggressive policy action from the Fed. Should inflation continue to surprise on the upside through higher energy prices or otherwise, markets may increasingly anticipate a bigger policy response. But, given the given the scale of the asset price gains and more importantly the multi-decade high rates of inflation, it appears the Fed may have a bit more tolerance for weakening financial markets than in the past. As long as domestic economic conditions are on a firm footing, the Fed might continue to normalise policy even in the face of adverse global developments, which have tended to make the US central bank more cautious in the past. With inflation already set to edge above 7%, the Fed's priority is to maintain its own credibility even if some of the major factors pushing up inflation from global bottlenecks to higher food and energy prices are beyond its control.

At the January meeting, Fed Chair Jerome Powell refused to rule out more aggressive rate rises. While clearly not our central scenario (see *FOMC Reaction: Marching to a hike*, 26 January 2022), interest rate rises at every meeting this year are certainly possible if inflation stays stubbornly high even if this gives rise to stagflation-like conditions. In the event of much more rapid tightening, hopes of a soft landing would fade, but given the current high and rising rate of inflation, a sharper slowdown in growth and even some kind of economic contraction might be the necessary price to pay for maintaining the central bank's credibility.

Risks to EM

Policy risks are more broad ranging in emerging markets where many have already tightened aggressively over the past year. The fastest pace of tightening has been in Brazil where the policy rate has been lifted by nearly 9ppts already in this tightening cycle, and there may be more to come (see: *Brazil Monetary Policy: Validating the beginning of the end*, 3 February 2022), which poses a clear downside risk to the already weak growth in the economy. In the rest of Latin America, we have seen central banks in Chile and Colombia raise rates more quickly than expected in recent months, too, as inflation is uncomfortably high. For Mexico's Banxico, any additional tightening from the Fed may mean more to come there on top of the 150bps of tightening already in our forecast for the next year or so.

In Asia, the story is slightly different as weaker domestic demand has meant lower inflation and central banks aren't expected to react as strongly. Our forecasts for the region typically expect 50bps or less of rate rises in most economies, something that could change if central banks start to worry about any energy-led inflation either being more persistent or broad based. The worry is that central bankers, who currently aren't too concerned about the inflation risks, have a sudden change of heart if their inflation rates rise, especially if the Fed is moving more aggressively too. A good useful example of a sudden change in the reaction function in recent months has been in Poland, where expectations were for no tightening through 2022 (at 0.10%) and yet our latest expectation is for the policy rate to rise to 3.25% in March this year (see: *Poland NBP preview: Double-digit wage growth turns NBP more hawkish*, 2 February 2022).

The risks, therefore, may be skewed towards higher rates and smaller capital inflows, which could hinder the nascent recoveries in many EM that haven't yet had a post-vaccination reopening surge in activity like that in the west. Higher energy prices, too, could act as a drag to growth for many – either on the fiscal side as governments offset the impact on household energy bills – or via the impact on the terms of trade. Of course, however, for those oil exporters, there could be some benefits, such as increases in publicly funded development projects in Saudi Arabia and other parts of the Middle East (see: *CEEMEA Economics: Playing defence as pressures build*, 11 January 2022).

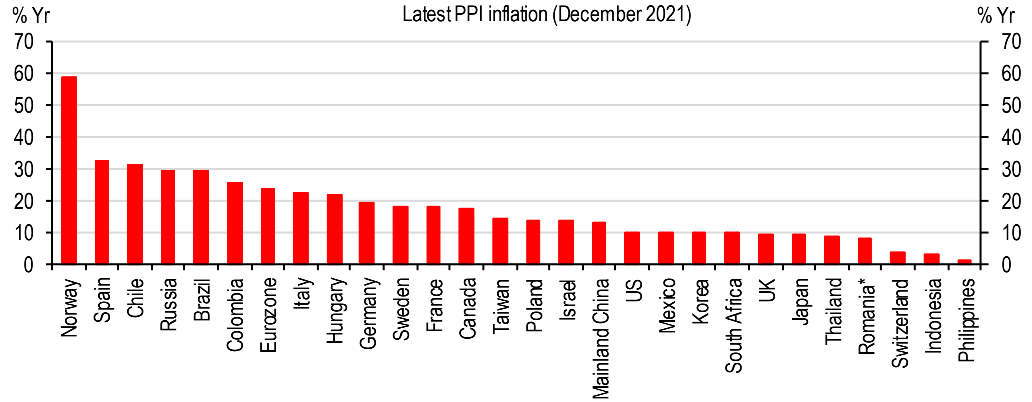
31. Oil price sensitivities*

	Current account (% GDP change)**	Inflation (pp change)***	Fiscal impact for subsidy (% GDP pp change)****
Argentina	0.01	0.53	-0.17
Brazil	0.07	0.60	-
Chile	-0.26	0.83	-
Mainland China	-0.12	0.17	-
Colombia	0.40	0.39	0.38
Czech Republic	-0.29	0.14	-
Egypt	0.12	0.36	-0.12
Greece	-0.04	0.30	-
Hungary	-0.12	0.24	-
India******	-0.40	0.35	-
Indonesia	-0.30	0.10	-
Israel	-0.27	0.09	-
Korea	-1.16	0.20	-
Malaysia	0.71	0.30	-
Mexico	-0.16	0.61	0.50
Nigeria	0.70	-	0.10
Peru	-0.11	0.28	-
Philippines	-0.79	0.40	-
Poland	-0.40	0.21	-
Romania	-0.09	0.26	-
Russia	1.00	0.16	-
Saudi Arabia*****	2.07	-	1.84
South Africa	-0.30	0.20	-
Taiwan	-0.19	0.10	-
Thailand	-1.33	0.40	-0.10
Turkey	-0.54	0.18	-
UAE*****	1.38	-	1.19
Vietnam	-0.50	0.10	-

Notes:
*See Appendix 8 of GEMs Investor: Emerging Markets in 2022: Darkest before dawn, 20 January 2022, for details.
**For a 10% rise in global crude oil prices, estimates are based on net crude oil trade.
***PP fall in inflation for a 10% rise in oil-gas prices in local currency terms.
****For a 10% rise in oil prices where subsidy regulates end-user oil prices that are lower than the market price, estimates are based on latest available information; "-" implies no direct impact on the fiscal side
*****In these markets, oil prices feed into both current account balances and nominal GDP so the effects of a 10% move in oil price won't be linear in % GDP terms
******For India, numbers reflect USD10/ barrel increase in oil prices
Source: *Asia Economics Comment: Swoosh, smash, splat: oil!*, 9 March 2020; HSBC and national estimates

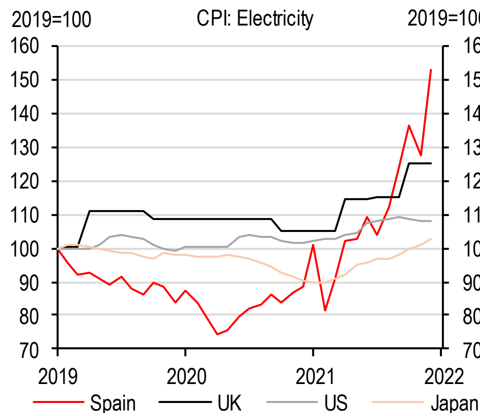
Appendix: Additional charts on the impact of higher energy prices

32. PPI inflation is elevated across most of the world …



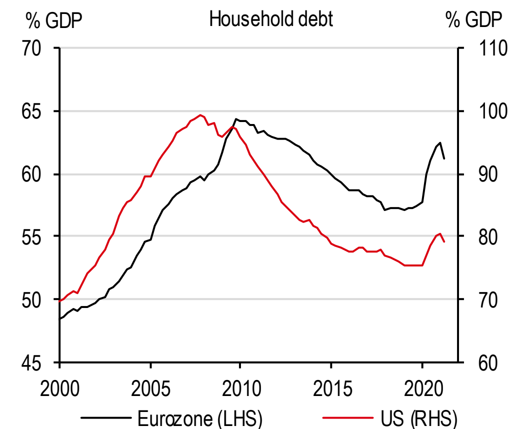
Source: Refinitiv Datastream. Note: *indicates November 2021 data.

33. … and electricity prices have soared in many places



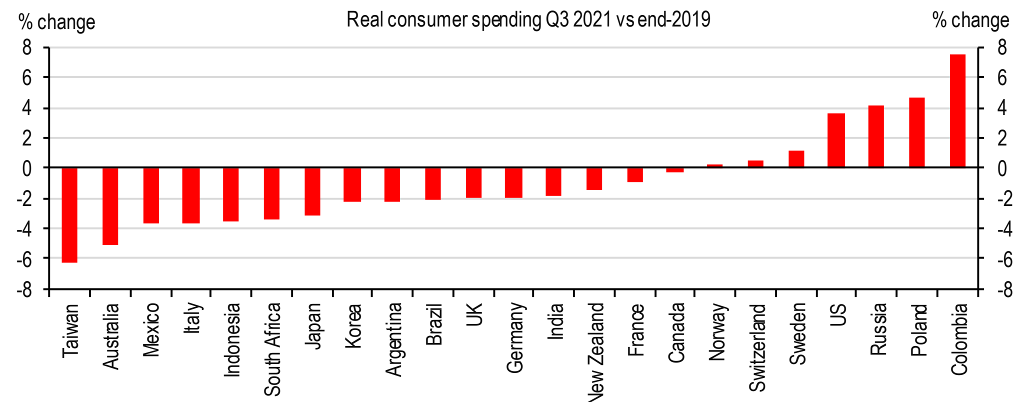
Source: Refinitiv Datastream.
Note: CPI indices in level terms, indexed to Jan 2019 = 100

34. Household debt had been coming down prior to the pandemic …



Source: BIS.
Note: Spikes in 2020 due to collapse in GDP

35. … which may mean that consumer spending can keep recovering



Source: HSBC, Refinitiv Datastream

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