Global Economy

Why US strikes in Middle East are rekindling fears over oil and inflation

While immediate economic hit from crisis is limited, concerns of spillover from of a broader conflict are growing

Sam Fleming, **Aiden Reiter** and **Delphine Strauss** in London 8 HOURS AGO

A US-led barrage of strikes on Houthi rebels in Yemen has reawakened fears of a wider conflict in the Middle East that could inflame price growth just as inflation appears to be subsiding.

Dozens of Houthi attacks, which the Yemeni Islamist movement began carrying out in October, have already led to mass diversions of shipping from the Red Sea.

Economists had expected the wider impact on goods prices to be relatively contained. But concerns are now mounting over more significant knock-on effects for commodities, including oil, should US forces get sucked deeper into a regional crisis raging since Hamas's October 7 attack on Israel.

Ana Boata, head of macroeconomic research at Allianz Trade, said the situation was not yet a "red flag" for the global economy, but added that "the impact on global supply chains could become more severe" if the crisis drags on beyond the first half of the year.

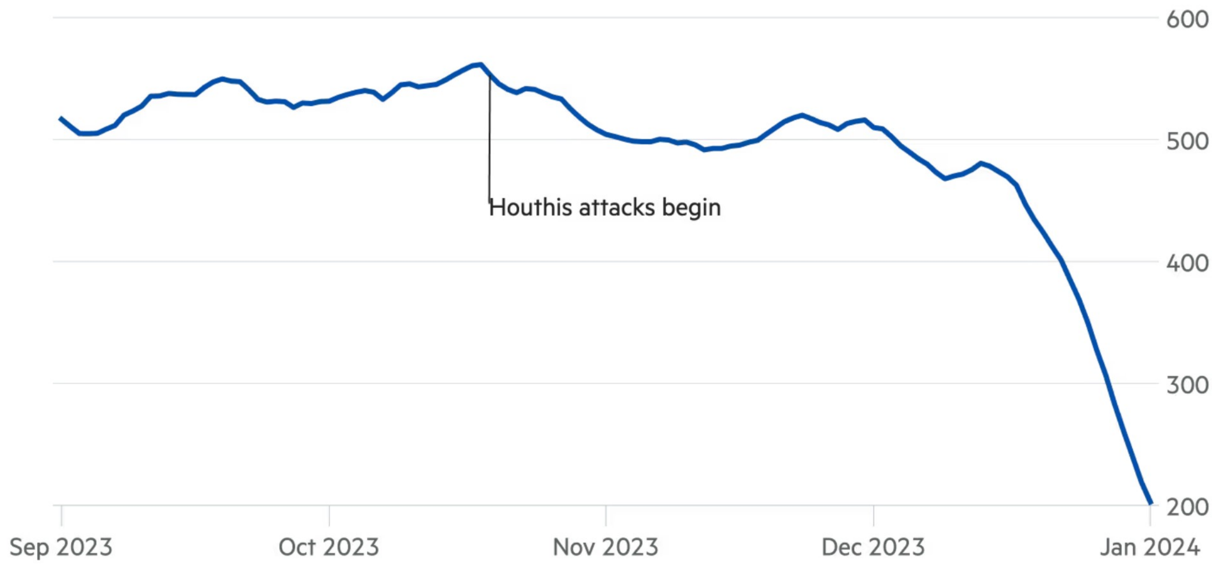
What are the effects of the Houthi attacks so far?

The Red Sea is a vital commercial shipping lane, typically accounting for 15 per cent of total global sea trade, including 8 per cent of grain, 12 per cent of seaborne oil and 8 per cent of seaborne liquid natural gas. Since the first Houthi attack on October 19, Red Sea traffic has dramatically fallen.

The latest monthly Kiel trade indicator, published on Thursday by the Kiel Institute for the World Economy, showed that following the onset of Houthi attacks, container flows through the Red Sea were less than half the usual level in December and fell below 70 per cent of usual volumes in early January.

Freight carried by container ships through the Red Sea fell sharply in December

Daily freight capacity in 20-foot equivalent shipping containers ('000)



Source: Kiel Institute
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With the detour around Africa taking ships an extra seven to 20 days, this has pushed up freight rates for a standard container transported from China to Northern Europe from about $1,500 in November to more than $4,000.

Some economies are already feeling the effects. Egypt is likely to be one of them, given its reliance on shipping via the Suez Canal, which raised more than $9bn in transit fees in the last fiscal year.

Companies are also reporting strains. Tesla's German factory has halted production until February 11 because it is missing components as a result of the longer shipping times around the Cape of Good Hope.

How serious is the shipping disruption for the wider economy?

The disruption is significant enough for the US and its allies to take military action against the Houthis. Ever since the Israel-Hamas war broke out, economic policymakers have flagged a wider Middle East conflict as a key "upside risk" to inflation, which currently appears to be receding in major economies.

But central bankers have sounded relatively sanguine about the wider macroeconomic implications of conditions as they stand. The Bank of England's governor Andrew Bailey said last week that "from an economic point of view — if you take the oil price, which is an obvious place to look — it hasn't actually had the effect that I sort of feared it might".

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Freight rates are still far below the peaks of up to $14,000 reached during the pandemic. Julian Hinz, director of the Kiel institute's Trade Policy Research Center, does not expect noticeable consequences for consumer prices given that freight costs are a small proportion of the value of high-priced goods such as consumer electronics.

"Eventually companies will learn to manage their inventory and pricing for longer shipping timelines," said Hinz.

Houthi conflict threatens ocean trade through crucial shipping canal

Simon MacAdam of consultancy Capital Economics said even the far-bigger spike in spot container freight rates during the pandemic had boosted global inflation by only a few tenths of a percentage point; most goods were transported at contractual rates set for a year or more.

He argued that inventory levels should allow most companies to cope with longer shipping times. Slower consumer demand following the spate of interest rate increases may meanwhile limit companies' ability to raise prices and pass through higher shipping costs to customers.

So does that mean economic policymakers can relax?

Not necessarily. Analysts say a protracted disruption would be a more serious problem. The consultancy Oxford Economics said last week — before the US-led strikes — that if the Red Sea remained closed to commercial traffic for several months, higher shipping rates could add 0.7 percentage points to annual CPI inflation rates by the end of 2024.

In this scenario, global inflation could continue to slow and central banks would be able to start cutting interest rates from the middle of the year, Oxford Economics said. But rates might not fall as far as investors were expecting.

Tomasz Wieladek, chief European economist at T Rowe Price, noted that global shipping has also been under pressure from a drought in the Panama Canal, which has reduced transit slots. This could make the inflationary threat more significant, he argued. "Two of the world's most important shipping lanes are affected at the same time . . . [so] shipping rates will probably stay elevated for some time," he said.

What is the biggest economic danger?

The more serious risk to inflation, say analysts, is that oil and gas markets take fright at the prospect of a much wider Middle East conflict. To date the oil price has declined throughout October, November and December even as the Israel-Gaza conflict raged.

Christian Keller, head of economics research at Barclays, said high levels of spare capacity, slowing demand and robust non-OPEC+ supplies have so far contained concerns about a material disruption to oil supplies.

However, a jump in the oil price late last week in the wake of the US-led strikes, which took Brent crude up by 4 per cent to $80.50 a barrel, underscored fears in financial markets that the US-led response could herald more trouble ahead.

Falling energy costs have been a key driver behind declining inflation, so any interruption to that descent would present a setback to central banks' efforts to quell price growth. Wieladek estimates a 10 per cent rise in the oil price can raise eurozone inflation by 0.4 per cent within a year.

US President Joe Biden told reporters on Friday that he was "very concerned" about the impact of hostilities on oil prices, adding "that's why we've got to stop it".