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The world waits for a climbdown

The war in the Middle East is forcing us to play a game we can't just walk away from. The longer it goes on, the worse things will become for consumers and companies. And central banks are facing their worst challenges. Carsten Brzeski is trying to make sense of it all



President Donald Trump descending Marine One last week

Our new base case scenario

It was 1983 when the movie WarGames taught a generation that the only winning move in a nuclear standoff is not to play. Forty-plus years later, economists find themselves in a similar bind, except we don't have the luxury of walking away from the board. Wars have become our subject matter, and the 2020s have been unforgiving.

War is not a game. Lucky as I am to have only experienced the Cold War as a child, it is still almost unimaginable that we economists now have to become experts on war, or at least on the economic impact of conflict. The biggest lesson I've learnt is that predicting how military conflicts develop is close to impossible. And that's why, instead of having strong conviction calls, the best thing we can offer is scenario analysis. We're trying to understand the mechanisms and transmission channels at play, not to pretend we know when or how the war in the Middle East or Ukraine will end.

In our new base-case scenario, we assume negotiations between Iran and the United States

will drag on, prompting renewed tensions and even limited, calibrated military actions. It will take another 2 to 4 weeks before a deal is reached, uncertainty begins to retreat, and the Strait of Hormuz reopens. But don't forget that once that does happen, it will take a while before traffic returns to pre-war levels; insurers and shipowners will be cautious, at first. In this scenario, we see oil prices gradually retreating to below 90 USD/b by the end of the year.

The 2022 playbook, with one big difference

It is obvious that with every passing day of a de facto blockade of the Strait of Hormuz, the risk of knock-on effects for the global economy grows. Consumers around the world are already feeling the sting of higher energy prices. Companies will be next, facing either new supply chain constraints or energy costs too high to make production viable, or both at once. It's the 2022 playbook, but at the risk of sounding like a broken record, one big difference between then and now is that four years ago, the global economy was emerging from lockdown with healthy balance sheets and an almost unstoppable consumer appetite to go out and spend - the perfect breeding ground for fast-spreading inflation.

This time, the inflationary impact of an energy price crisis is likely to be more muted, as consumers will be far more reluctant to open their wallets. You can already see that reluctance in reported willingness-to-spend indicators, which are currently well below 2022 levels. At the same time, the hit to economic activity could be sharper than in 2022: Asia will be harder hit by potential energy supply constraints, and public finances on both sides of the Atlantic are more stretched, leaving less room for fiscal stimulus. Watch out for companies in the middle of supply chains: they may end up squeezed the hardest.

One of the worst challenges for central banks

The six weeks of war in the Middle East have created a new stagflationary drag on the global economy. This wave will vary somewhat across regions and intensify the longer the conflict lasts, but it poses one of the worst challenges central banks can face. As in 2022, we will increasingly see the return of "team transitory" versus "team structural", the former arguing that monetary policy can do very little about a genuine supply-side shock, the latter pushing for pre-emptive rate hikes to prevent price-wage spirals from taking hold. Our view is that a transatlantic divide will open up again: a Fed joining "team transitory" and still cutting rates later this year, and an ECB half-heartedly siding with "team structural", at least one insurance hike, more symbolic than inflation-stopping. Don't forget that since 2022, the word "transitory" is as forbidden in Frankfurt as "Voldemort" is in the Harry Potter series.

But before Voldemort brings too much darkness, Europe has had some genuine good news. The election results in Hungary should end the country's role as the permanent - if occasionally necessary - thorn in the EU's side. Despite the daily struggles of both the German and French governments, Europe now has no excuse or scapegoat for failing to approve the agreed loans for Ukraine and push forward on the single market and common energy policy

commitments made back in February.

I suspect this ING Monthly won't be the last one filed under "war and economics." There was a time when the biggest macro risk on an economist's desk was a central bank meeting. Those days feel like a different game entirely. And unlike Matthew Broderick, we can't just unplug the computer.

□ Our key calls

- In our new base case, we're assuming energy flows gradually recover through the second quarter, though remain below pre-war levels until at least year-end. That sees oil prices averaging 96 USD/bbl through the second quarter.
- We now expect a single ECB rate hike in June. Headline inflation at 4%, core inflation above 3% and a surge in survey-based inflation expectations would make inaction increasingly difficult to justify.
- We still expect two rate cuts later this year. Moderating shelter inflation should mitigate the energy-driven rise in inflation, shifting the focus to weaker consumer spending.
- In China, the CNY has stood out as a surprise winner in the currency space, despite the focus on China's oil imports. We are adjusting our USD/CNY fluctuation band forecast to 6.70-7.05, down from 6.85-7.2, and risks are now broadly balanced to this forecast.
- We're sticking to our call for no Bank of England rate hikes. A weak jobs market and the fact that policy is still restrictive reduce the need for action.
- Developed Asia – Taiwan, Japan, Korea – are better positioned to weather this crisis, helped by stronger energy buffers. Developing Asia looks more exposed.
- CEE central banks remain cautious after the Middle East energy shock, but rate hikes are not imminent. We think Poland and the Czech Republic will stay on hold as inflation risks remain manageable, while Hungary turns more hawkish amid weaker growth and delayed easing.
- Our baseline EUR/USD call for 3Q (1.18) and 4Q (1.20) remains unchanged from last month. The backbone of our bearish USD view into year-end remains our expectation of two Fed cuts, which should reopen USD hedging channels by easing front-end rates.
- We think US 10-year yields will rise back towards 4.5% in the second quarter.



What the Middle East war means for the global economy right now

The war in the Middle East is starting to have serious consequences for economies around the world. We're not yet predicting a recession, but it's going to hammer growth and increase inflation. Carsten Brzeski says accurately predicting what's going to happen next, however, is a fool's game

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Author

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

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THINK economic and financial analysis

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