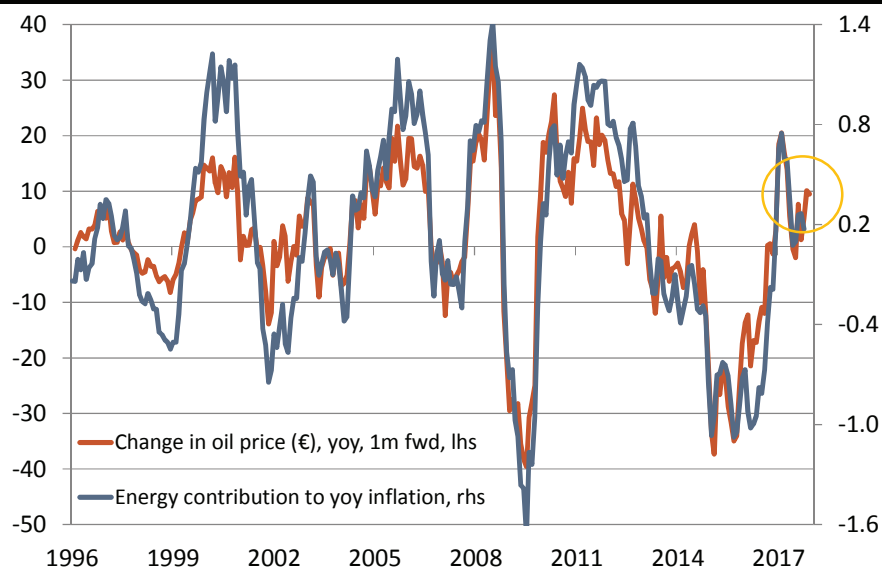


10 November 2017

Time to worry? Oil prices and geopolitical risks

Direct impact of changes in the oil price on Eurozone inflation (in ppt)



Yoy change in the real price for Brent crude, in € per barrel, 2005 base year, versus the impact of energy prices on the yoy rate of headline inflation in the Eurozone. Source: Eurostat, Bloomberg, Berenberg

- **A resilient economic recovery:** After years of mostly moderate economic growth in a post-Lehman age of caution, the business cycle has picked up momentum. Supported by a healthy expansion of world trade, still accommodative monetary policies and a growing readiness of households and businesses to consume and invest, demand is expanding above its trend rate in the US, the Eurozone and Japan. Sentiment indicators project more of the same for 2018. Because the upswing seems to be broad based and well entrenched, it would take a major economic or political shock to derail it.
- **The return of geopolitics:** Credit growth and wage inflation remain moderate (US) or subdued (Eurozone and Japan). Central banks have no reason to end the good times soon. Instead, risks could potentially stem from political accidents or geopolitical events such as the tensions sparked by North Korea or those between Saudi Arabia and Iran.
- **A matter of confidence and oil:** Short of the ultimate and highly unlikely tail risk of a major war not confined to a small region, geopolitical risks affect the world economy through two major channels, the oil price and confidence.
- **The oil factor:** Partly reflecting tensions in the Middle East, the oil price has risen from an average of \$52.7 (€44.3) per barrel Brent crude in August to \$63.6 (€54.7) now. As our chart above shows, a surge in the oil price by €10 per barrel raises the price level in the Eurozone by 0.3% through its direct impact on energy inflation. Headline inflation could rise modestly in the Eurozone in November, probably from 1.4% to 1.6%. As a result, we raise our call for 2018 average Eurozone inflation from 1.4% to 1.5%. With some consumption smoothing, this should not affect overall demand growth very much. As long as tensions between Saudi Arabia and Iran do not escalate far beyond their current proxy wars in Yemen and parts of Syria and the Strait of Hormuz remains open, a further sustained spike in oil prices looks unlikely. Higher prices would elicit a significant rise in supply from the US. In turn, this should put a cap on oil prices.
- **Risk of US-Chinese tensions looms less large:** North Korea poses a grave hypothetical risk especially to its immediate neighbours, notably to South Korea. But for North Korea, starting a military conflict would be suicidal. Hopefully, that remains extremely unlikely. For the global economy, a key issue is that the tensions around North Korea do not disrupt relations between the two biggest national economies of the world, the US and China. Judging by the way Chinese leader Xi Jinping charmed US president Donald Trump in Beijing this week, that risk no longer looms as large as it did a year ago right after Trump had won his election campaign with fiery rhetoric partly directed against China. This should be good news for economic confidence.

Economics

Chart of the week



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