GLOBAL ECONOMICS UPDATE

Shipping disruption unlikely to alter inflation's course

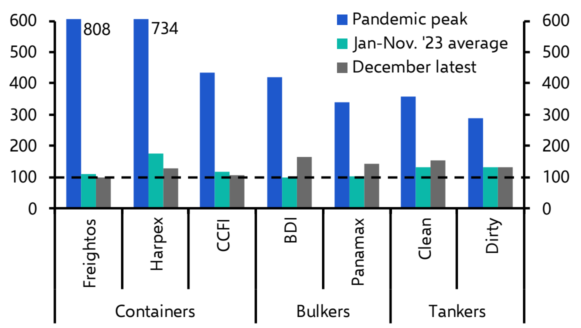
- **The rerouting of trade ships away from the Red Sea has come at a time of disruption to shipping elsewhere in the world, but it is unlikely to alter the broad pattern of falling core inflation in 2024. We expect the recent rise in oil prices to prove temporary, goods shortages should be avoided, and shipping costs do not look set to surge. Even if shipping disruption did cause a significant increase in firms' input costs, soft demand and replenished stocks have weakened their pricing power to pass them onto end consumers.**

- The halting of maritime transit through the Red Sea due to security concerns makes for a trio of disruptions to global shipping, alongside low water levels in the Panama Canal and the collapse of the Black Sea Grain Initiative. At a time when investors are moving swiftly to bet on a major central bank pivot in the coming months, disruption to global shipping is arguably just the sort of inflationary supply shock that will frustrate efforts to get inflation down to 2% sustainably and thus hinder rate-cutting plans. We are not convinced.

- **Admittedly, oil prices have risen this week, but we think that this is unlikely to be sustained.** After all, the production of commodities will be unaffected by the rerouting of trade ships around the Cape of Good Hope. The materials will arrive, they will just take longer to get there.

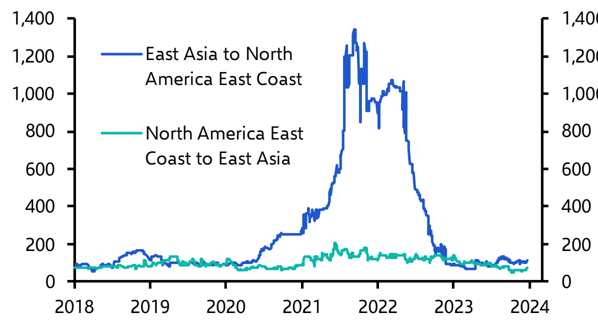
- **Of course, the longer journeys may cause transport costs to rise. However, so far, there hasn't been a big rise in sea freight and charter rates, especially for container shipping.** (See Chart 1.) The cost of chartering container vessels has actually continued to fall back to pre-pandemic levels, and container freight rates have risen only on affected trading routes and even then, only marginally. For example, increases in container rates on the Asia-American-East-Coast route via the Panama Canal barely register. (See Chart 2.)

Chart 1: Global Shipping Costs (2019 = 100)



Sources: Refinitiv, Capital Economics

Chart 2: Spot Container Freight Rates (2019 = 100)



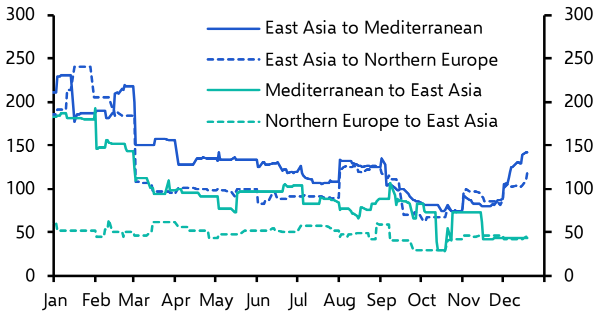
Sources: Refinitiv, Capital Economics

- In terms of the Rea Sea route affected by the Houthi attacks, there have so far been small increases in East-to-West freight rates, but no change in shipping costs in the other direction. (See Chart 3.) The rise in bulker and – in the past week – 'clean' (petroleum) tanker rates could signal higher cost pressures for intermediate processors of commodities. But experience suggests that such costs are absorbed along the supply chain, leaving the raw commodity price as the key driver of energy CPI inflation faced by end consumers.

- **Of course, if the disruption endures, shipping costs could rise further. But they are unlikely to do so by enough to register at the macro level.** What matters for inflation is the change in *total* shipping costs, which mainly comprise contracted rates, not spot rates. And given that shipping futures are consistent with the disruption lasting only a few months – until Panama's rain season, in the case of panamax bulkers (see Chart 4) – higher spot rates are unlikely to feed through into contracted shipping rates much in the near term.

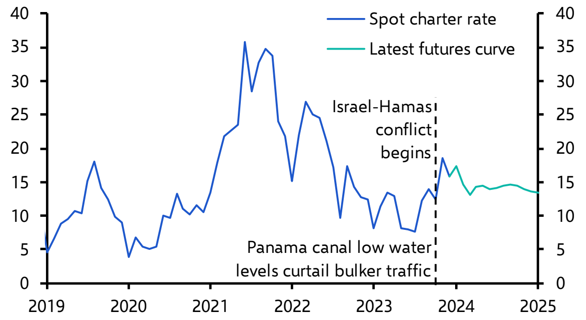
Simon MacAdam, Senior Global Economist, simon.macadam@capitaleconomics.com

Chart 3: Spot Container Freight Rates in 2023 (2019 = 100)



Sources: Refinitiv, Capital Economics

Chart 4: Baltic Dry Shipping Time Charter Rates for Panamax Bulker Vessels (Thousands USD per Day)

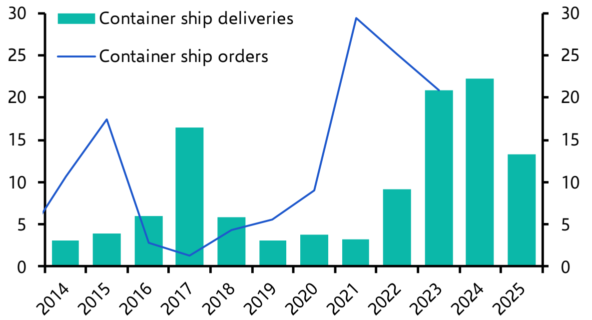


Sources: Refinitiv, Capital Economics

- Even if the disruption endures longer than is currently implied by shipping futures, excess shipping capacity should limit how far costs increase. Massive orders of new container ships during the pandemic have been coming online in 2023 and scheduled deliveries are set to rise further in 2024. (See Chart 5.) Net of demolitions, the global fleet is set to grow by 7% in 2024, having grown by 9.3% in 2023, compared to average growth of just 3.6% in the 2016-22 period. The stronger supply and weaker demand fundamentals that undercut the pricing power of shipping firms in 2022 are still present heading into 2024. With shipping company profit margins still running at 20-30% globally, compared to 0-10% margins in the two decades leading up to the pandemic, there is still ample scope for competition to compress margins.

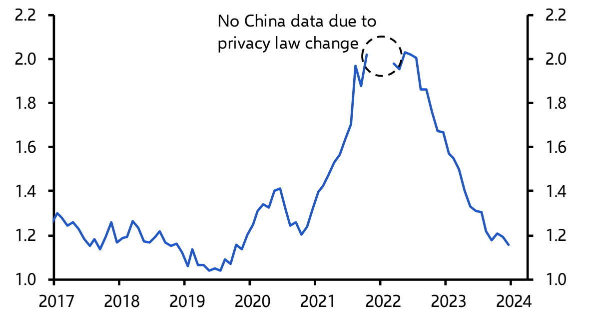
- Not only are the conditions probably not in place for shipping costs to rise enough to affect inflation, but if they did, it is doubtful that the conditions are right for such cost hikes to be passed onto end consumers. For one thing, **global supply chains and logistical networks are in a strong place to contend with pressures that may arise from diverted shipping**. In the past two years, port congestion has returned to pre-pandemic norms (see Chart 6), meaning that ports will have little trouble coping with demands for quicker turnarounds to get delayed goods shipped off quickly.

Chart 5: Annual Container Ship Orders & Deliveries (Millions Deadweight Ton Capacity)



Sources: Refinitiv, Capital Economics

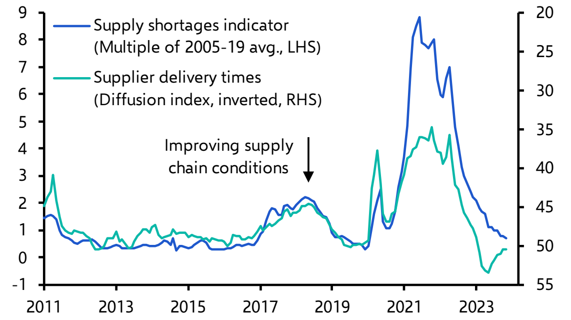
Chart 6: Global Container Ship Congestion at Anchorages & Ports (Millions of 20-Foot Equivalent Unit Containers)



Sources: Refinitiv, Capital Economics

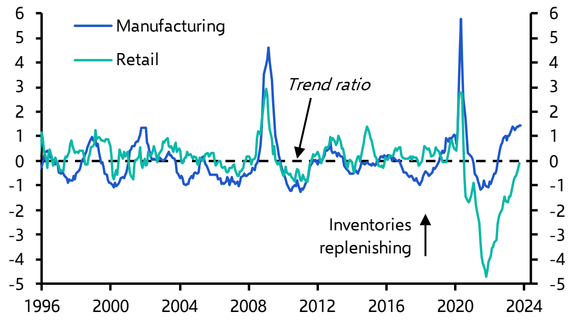
- **Moreover, firms are awash with commodities and parts.** Reports of product shortages from manufacturers globally are less prevalent today than they were before the pandemic. And a net majority of firms report that supplier delivery times have shortened throughout 2023. (See Chart 7.) Manufacturers' stock levels are historically high relative to sales, and retailers' inventories have also recovered. (See Chart 8.)

Chart 7: S&P Global Supply Shortages Indicator & Global Manufacturing PMI Supplier Delivery Times



Sources: S&P Global, Capital Economics

Chart 8: G7 Average Inventory-to-Sales Ratios (Z-Scores, standard deviations from long-run trend)



Sources: Refinitiv, CE. Mix of hard (US & Can.) and survey data (other G7).

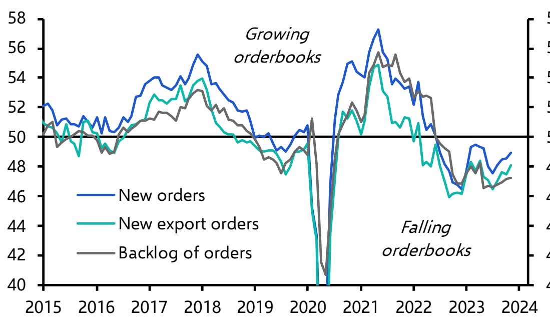
- **In addition to favourable supply conditions, the demand environment for goods remains weak.** This is particularly true in Europe, where the Red Sea is a key trade route with Asia. According to the manufacturing PMIs, global new orders – especially export orders – have been contracting for two years, allowing firms to work through their backlogs. (See Chart 9.) Even if the PMIs are not taken literally, there is no escaping that goods demand appears to be soft by past standards, meaning that firms would struggle to pass on costs to consumers (if input costs were in fact to rise, despite all the factors discussed above).

- **Even when there was a huge increase in shipping costs at a time when firms had pricing power to pass them onto consumers in 2021, we estimated that the overall impact was to boost global headline inflation by just 0.3%-points over 2021-22. Even allowing for knock-on price effects from exacerbating shortages, the lesson was that extreme shipping disruption is needed to move the needle on global inflation.**

- When the Ever Given got stuck in the Suez Canal in March 2021 (yes, that was almost three years ago!) the global context was one of booming demand, logistical logjams, and emerging shortages. So, as we argued at the time, had it taken much longer than the few days it took to free the 20,000 container-carrying vessel, the conditions were in place for that disruption to contribute to goods shortages and possibly even inflation. It is much harder to argue that those conditions are in place today.

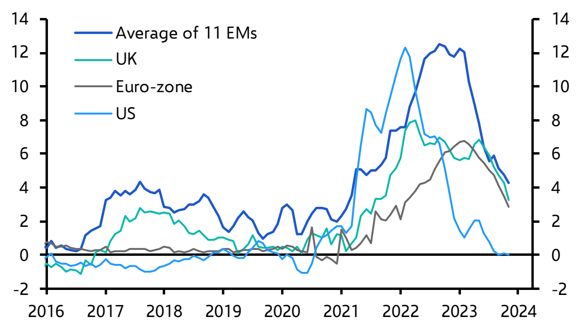
- **The upshot is that while the impact of current disruption will of course depend on its ultimate scale and duration, we doubt that it will fundamentally alter the broader pattern of falling core inflation – particularly for goods – in 2024.** (See Chart 10.) **If investors are on the lookout for something that will frustrate global disinflation and hence interest rate cuts, this is probably not it.**

Chart 9: Global Manufacturing PMI: Orders



Sources: S&P Global, Capital Economics

Chart 10: Core Goods CPI Inflation (%)



Sources: Refinitiv, Capital Economics

TORONTO NEW YORK LONDON SINGAPORE

Email **sales@capitaleconomics.com** Visit **www.capitaleconomics.com**