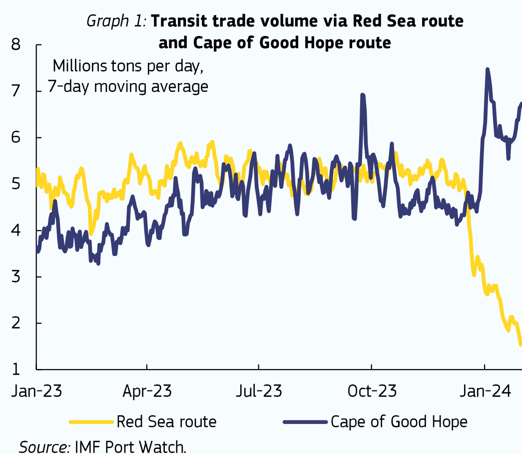
Box 1.1: **Impact of the Red Sea crisis on the EU economic outlook**

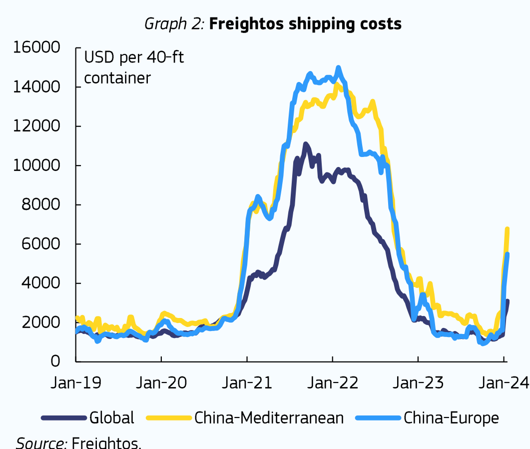
The Houthi rebels' attacks in the Red Sea are disrupting one of the major shipping routes for the global economy, affecting delivery times, shipping costs and supply chains. Approximately 12% of global trade volumes go through the Red Sea and the Suez Canal. This includes *inter alia* 30% of all container shipping, 12% of seaborne oil, 8% of seaborne liquid natural gas (LNG) and 8% of world grain trade. In 2022, around 23% of all EU goods imports came by ship from Asia, most of them travelling through the Red Sea. Disruptions in this key trading route may therefore have a significant impact on the EU economy. This box reviews the available evidence and concludes that – bar a significant escalation – companies should be able to avoid widespread production bottlenecks. Still, higher transport costs will inevitably be passed on to consumers, but the direct impact on inflation is set to be relatively small.

Shipping through the Red Sea has been re-routed, resulting in longer shipping times and skyrocketing shipping costs. Between the start of the attacks (19 October 2023) and end-January, the 7-day moving average transit trade volumes through the Red Sea fell by 70%, while trade volumes through the Cape of Good Hope increased by 30% (Graph 1). Shipping times between Asia and Europe increased by 10-15 days and freight costs for containers on several China to Europe routes increased by around 400%. The disruption is affecting shipping costs worldwide. Since the Autumn Forecast, the Freightos Global Container Freight Index – a weighted index of spot shipping freight costs along major routes – increased by 210% (Graph 2). [1]



Graph 1: **Transit trade volume via Red Sea route and Cape of Good Hope route**

Source: IMF Port Watch.



Graph 2: **Freightos shipping costs**

Source: Freightos.

The impact on commodity markets has so far been limited. The increase in non-OPEC oil supply and high stockpiles in the US in a context of weak demand continue to prevail over trade disruptions. The same applies to gas, where high gas inventories and overall reduced demand in the EU continue to push the wholesale price of European gas (TTF) downward, despite the Red Sea representing an important artery for LNG shipments. Food and metal prices have also continued to moderate on the back of abating supply concerns and/or weak demand.

Firms in the EU are expected to manage the extension of delivery times without disruptions to output. According to the PMI survey, suppliers' delivery times in the US and in the euro area have increased for the first time since the winter of 2022 (Graph 3). Input prices, however, were broadly unaffected, while inventories of purchased goods remained at relatively high levels. According to the EU Business and Consumer Survey, in January industry managers reported that the role of shortages of material as a factor limiting production was either broadly unchanged (construction) or continued to decrease (industry), converging further towards the pre-pandemic long-term average. Capacity utilisation is also currently low (Graph 4). The Federal Reserve Bank of New York Global Supply Chain Pressures Index remained flat in January, after increasing in the prior months, and stood at about its long-term average. Available data suggest that neither global nor EU supply chains are currently under strain.

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[1] According to Freightos, the cost of freight from China to the US East Coast and West Coast increased by 180% and 160%, respectively.

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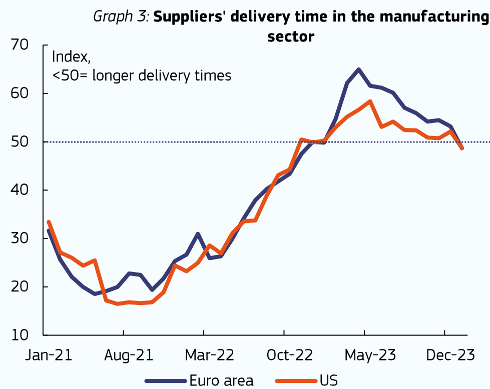
Box (continued)

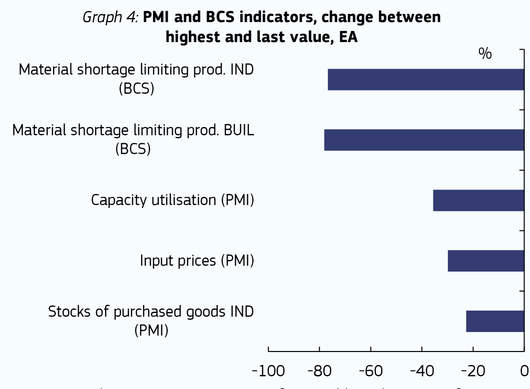
The freight market is also now significantly different than during the post-pandemic rebound and disruptions are set to be re-absorbed. The strong pullback of global demand for goods and tighter financial conditions have weighed heavily on global trade and the demand-supply imbalance that characterised the post-pandemic expansion has by now been reversed. Considering the glut in container and vessel capacity after the pandemic adjustment, shipping firms should progressively be able to absorb the shock of longer delivery routes. Firms may also use alternative vectors. In terms of price pressures, freight and insurance costs are typically low for most product categories, while land or air transport are often an alternative should shipping costs inflate excessively ([2]). The current surge in shipping costs is therefore set to be re-absorbed. As the supply overhang in vessels and containers prevails over the surge in delivery time, shipping prices are expected to fall back on their declining trend.

Graph 3: **Suppliers' delivery time in the manufacturing sector**



Source: S&P Global.

Graph 4: **PMI and BCS indicators, change between highest and last value, EA**



Note: Last data point is January 2024 for monthly and Q1-2024 for quarterly indices.
Source: S&P Global, European Commission.

Still, higher shipping costs are set to exert a limited upward pressure on inflation. Private sector analysts expect upward pressure on EU inflation to be in the range of 0.2-0.3 pps. ([3]). This range appears broadly plausible, considering recent estimates of pass-through of freight costs to headline inflation, the origin of EU imports and alternative scenarios of progressive normalisation in shipping costs as overcapacity in containers and vessels absorbs extended time at sea. The pass-through should be more visible in the second quarter of this year, after annual shipping contracts are agreed. The impact may be higher on those inflation categories which have higher import intensities, mainly industrial goods and certain food categories ([4]). In addition, the impact on inflation may be higher if shipping costs were to remain permanently higher and global demand were to pick up more strongly than projected. Further escalation is a clear risk for the economic outlook, in particular if the conflict disrupts energy supplies, causing oil and gas prices to surge.

([2]) Maritime transport costs are typically higher (above 5% of Freight On Board price) for low value to weight/volume products that are normally transported in bulk (e.g. crude oil, natural gas, grains) or require special conditions for transport (e.g. meat, vegetables and fruits, live cattle). Above a certain value to weight/volume, shippers switch to land or air transport. See Ferrari, E., P. Christidis and P. Bolsi. (2023). "The impact of rising maritime transport costs on international trade: Estimation using a multi-region general equilibrium model". *Transportation Research Interdisciplinary Perspectives Volume 22.*

([3]) JPMorgan estimates a 0.27 pps. add to global core CPI in response to a roughly 150% sustained increase in container shipping costs. ABN Ambro finds that the rise in shipping tariffs may raise euro area goods inflation by 1 pp. and overall inflation by 0.3 pps. Goldman Sachs suggests that the increases since December could raise global core prices by 11 bps., with larger effects in the euro area (0.21 pps.) and smaller effects in the US (6 bps.). The OECD estimated that a 50% rise in shipping costs increases import price inflation by 2 pps. and consumer price inflation by about 0.2 pps., after a year. *Sources:* JPMorgan (2024). *Shipping disruptions reignite supply chain woes.* Global Emerging Markets Research, January; ABN Amro (2024). *Will the Red Sea disturbances throw disinflation off track?* Global Monthly, January; Goldman Sachs (2024). Global Economics Comment: *Higher Costs Due to Red Sea Shipping Disruptions Imply Modest Upside to Global Inflation.* Economics Research, January; Organisation for Economic Cooperation and Development (OECD) (2021). "Rising container shipping costs could push up near-term inflation in OECD countries." In *OECD Economic Outlook*, Vol 2021 Issue 1, No. 109, pp. 31-33, May.

([4]) ECB (2022). "A new indicator of domestic inflation for the euro area." In *ECB Economic Bulletin*, Issue 4, Box 7.