War in Ukraine
The ripple effect on the Global Economy

LOCKTON RE SPECIALTY REPORT
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REINSURANCE

Confidentiality

The War in Ukraine's ripple effect on the Global Economy

The war is far from being over.

The war on COVID-19 that is.

Still, many of us are back in the office, and lockdowns seem like a distant memory. But with everyday life slowly returning to pre-pandemic days, the economic and social impact of COVID-19 is only now beginning to be felt across the globe.

Inflationary pressures

In spring 2020 global trade ground to a halt. To save economies from a free fall, central banks embarked on an expansive monetary policy, pumping money into starved financial systems, ensuring individuals and companies survived. These policies have inevitably led to the current inflation levels, not seen for over a generation in developed economies.

In March, US inflation rate reached a 40 year high of 8.5%[*], with the Eurozone and the UK trailing closely behind with rates of 7.5%[†] and 7%[‡] respectively, rates last seen in the early 90s. The Bank of England is projecting UK inflation to hit 10% by the end of 2022[¶]. To make matters worse, inflation is disproportionately hitting those economically disadvantaged, with prices of basic food items and energy being the main contributors to the increased inflation rate.

But central banks' quantitative easing is only half the story; the other side of the equation is the global supply chain, which is still reeling from prolonged periods of lockdown. If you are looking to buy a new car, you better join the queue, as current waiting times are anywhere between 6 to 12 months.

The world finds itself in a unique situation – while global demand dropped sharply in 2020[§], the cash injections are now driving demand back up, while the supply chain has not been able to catch-up with demand, creating a perfect storm, pushing inflation rates up rapidly.

And then Russia invaded Ukraine.

The Russia-Ukraine conflict

Many columns have been written about Russia, Putin and the "new world order". But while current news focuses on daily gains either side makes on the ground, there is a much bigger story in the background which is slowly unravelling.

Russia is the world's largest country. It has 11 time zones. It's almost twice the size of the world's 2nd largest country (Canada). Russia won the commodities lottery.

Russia is a top 5 producer of many raw materials including aluminium, cobalt, gold, iron ore, magnesium, nickel, palladium, rare earth, steel, and titanium, amongst other. In terms of energy, Russia is the world's 2nd largest producer of both oil and gas. Touch anything around you, and there is a good chance at least part of it came from Russia. The recent sanctions intended to cut Russia's access to global markets have pushed up commodities prices and will continue to do so in until alternative suppliers are found, if at all.

Raw materials are only part of Russia's export mix. Russia is crucial to many countries' food security both directly and indirectly. A report published by the United Nations Conference on Trade and Development in March highlighted African nations' dependence on Russian and Ukrainian wheat; more than 25 African nations depend on Russia and Ukraine for at least 30% of their total wheat imports. The likes of Burundi, Burkina Faso, Congo, Madagascar, Rwanda, Tanzania, DRC, Sudan and Egypt import at least 50% of their wheat from Russia, with Benin being completely reliant on Russian grains (see image 1).

(*) US Bureau of Labor Statistics:
https://www.bls.gov/news.release/archives/cpi_04122022.htm

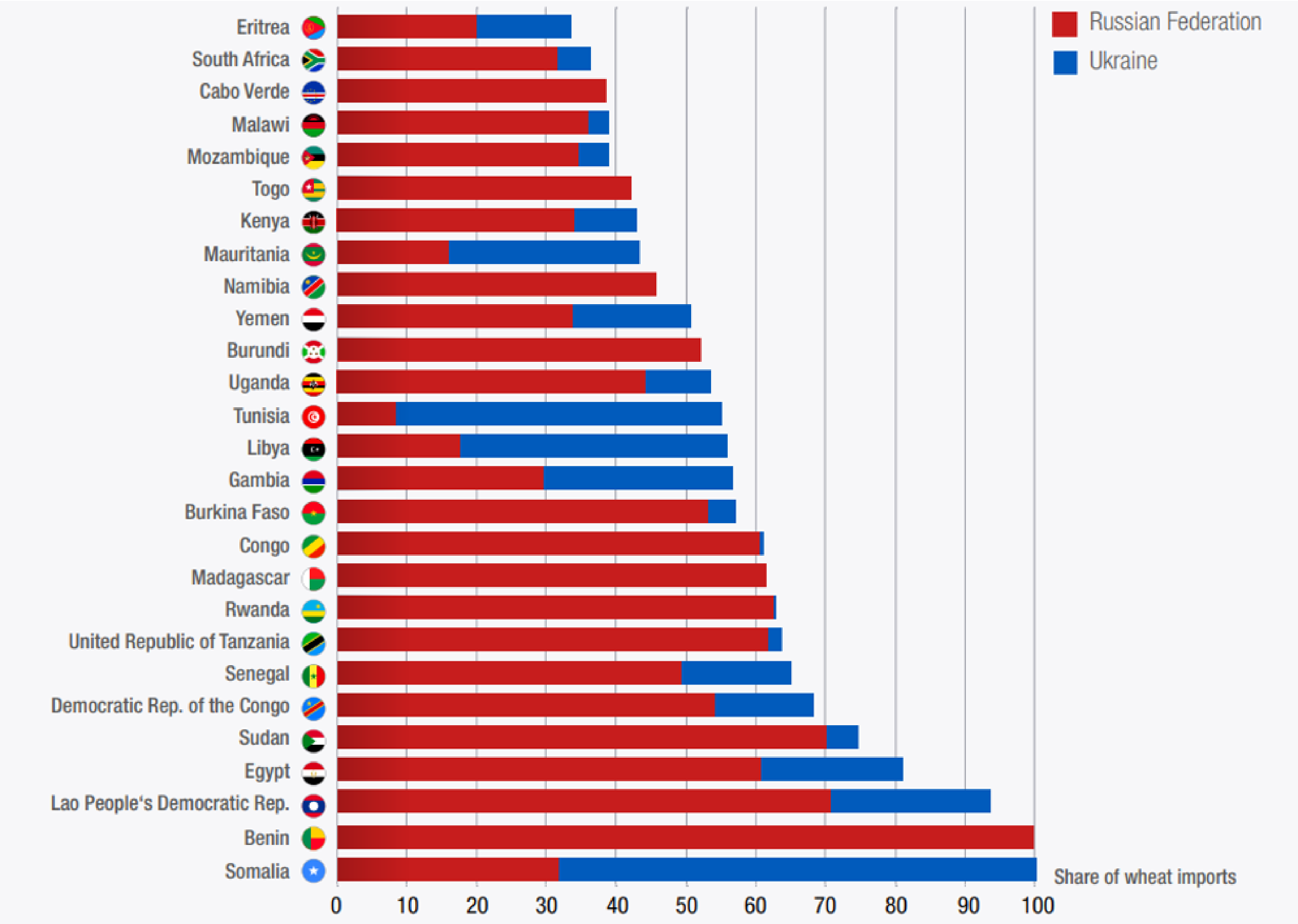
(†) European Central Bank:
https://www.ecb.europa.eu/press/pressconf/2022/html/ecb.is220414~fa5c8fe142.en.html

(‡) Office for National Statistics:
https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/march2022

(¶) Bank of England:
https://www.bankofengland.co.uk/knowledgebank/will-inflation-in-the-uk-keep-rising

(§)OECD:
https://data.oecd.org/trade/trade-in-goods.htm#indicator-chart

Image 1 – Wheat Dependence in Africa and Least Developed countries (percentages)



Source: UNCTAD calculations, based on data from the UNCTADstat database (accessed 4 March 2022).

The Russia-Ukraine conflict (cont.)

Granted, wheat may not be the main staple across the entire African continent, but it is crucial for many Northern African diets. Last time grain prices were at the current level was in spring 2010, which culminated in the Arab Spring. Ukraine might be Europe's breadbasket, but Russia is certainly Africa's.

For countries not directly beholden to Russia for food imports, there is still an indirect dependency on Russian exports in the form of fertilisers. Russia is the world's largest producer of urea, the third largest producer of potash (with Belarus being the second largest) and the 4th largest producer of phosphate – all key components for industrial fertilisers, and all currently at their highest prices since the Global Financial Crisis. As such, even those economies not buying Russian wheat directly are experiencing increased inputs costs. This is particularly problematic in countries which use large amounts of fertilisers per hectare of crop land.

The Food and Agriculture Organisation of the UN highlights the over dependence on fertilisers by Bangladesh, China, Malaysia, New Zealand, and Vietnam in Asia-Pacific; Bahrain, Egypt, Kuwait, Oman, and the UAE in MENA; and Brazil, Chile, Costa Rica, Ecuador, and Guatemala in Latin America[#] (see image 2). The current commodities price environment – which many analysts believe is here to stay - will put further pressure on farmers in emerging countries as well as those governments subsiding fertilisers, as is the case in many Sub-Sharan African countries.

Demand Cooling

Traditionally, central banks are meant to be an anti-cyclical force, either cooling-down or kick-starting the economy using monetary policy. To fight inflation, central banks can increase their base rates, as indeed the Federal Reserve and the Bank of England have done in recent months, with the European Central Bank expected to raise rates for the first time in over a decade in the summer, as suggested by Christine Lagarde during a recent press conference in Ljubljana.

While such a move will hopefully bring inflation back within the OECD's common 2% target rate, continued base rate increases can have a devastating effect on emerging economies, and investors are already pricing further increases into equity prices.

Many nations' sovereign borrowing rates are directly linked to the US-LIBOR rate, as interest rates on sovereign loans are often stated as "LIBOR + X%". Further hikes by the US Fed will mean higher interest payments, further stressing many nations' already stretched US-Dollar reserves.

Add to this the expected weakening of these emerging markets' currencies as the US-Dollar strengthens, coupled with an increase in the cost of fuel and food imports will be a test for many emerging markets' economies. A new wave of global sovereign defaults is an ever-increasing possibility for which there is no obvious silver bullet.

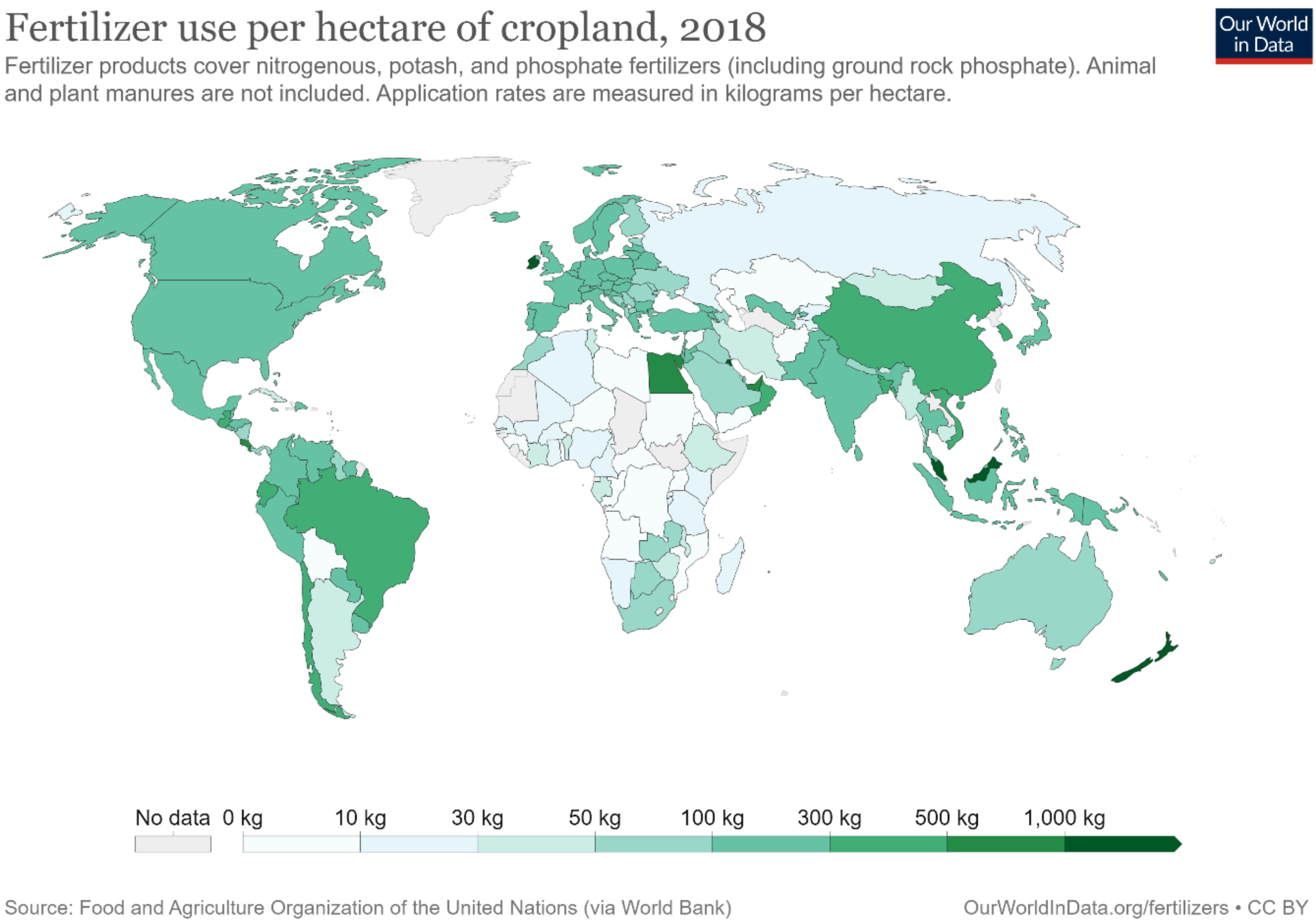
The Insurance Context - CF

COVID-19 prompted credit and political risks insurers to shift their book away from private obligors (CR) toward sovereign obligors (CF), as many feared COVID-19 will have disastrous consequences for private companies. The market is currently sitting on substantial exposures to sovereign debt risk, which arguably has been under-priced in recent years, as many insurers were shifting their books simultaneously.

Sri Lanka – which declared a "temporary" debt default on April 12th – could be the canary in the mine. Ghana – downgraded by Moody's' to CCC February, Ethiopia – fighting a civil war since November last year, and Kenya – looking to issue more Eurobonds later this year, are all facing challenging times in the short-to-medium term. Any one of these nations – or potentially all three – could default soon, and see the need for long term restructurings tying up valuable underwriting capacity.

(#) Our World in Data
https://ourworldindata.org/fertilizers

Image 2 – Global dependence on fertilisers



The Insurance Context - CR

Private companies are also not out of the woods just yet. Thus far, monetary interventions worked as intended as we did not experience a systemic meltdown. In fact, global insolvencies rate in 2020 and 2021 were lower than previous years. Those days are now gone, with government support schemes all but stopped. For the majority of borrowers, the times of cheap loans are over, and many companies are faced with higher debt levels then pre-pandemic. Analysts anticipate a sharp rise in insolvency rates in 2022, prompted by the increased input costs and higher interest rates private companies must come to terms with. Where possible, companies will look to pass on these costs further down the supply chain, inadvertently increasing inflationary pressures.

Of particular concern are (again) the travel and leisure industry; despite the lifting of COVID restrictions, tougher economic times will see consumer spending diverted away from these sectors as people focus on more basic needs. Tech companies are also coming under scrutiny - the NASDAQ being currently down more than 25% year to date - after many flourished when many switched to work remotely. Somewhat unexpectedly, traditional oil and gas energy companies have done exceptionally well on the back of the higher oil price. So have defence companies, as NATO members committed to increase defence spending in the coming years. As always, opportunities are out there, and insurers will need to continue and monitor the industry mix of their portfolios.

The Insurance Context - PV

And then there is the direct impact on people's everyday lives. The UN estimates that more than 6.2 million refugees have fled Ukraine since the war began, mainly to Poland, Romania and Hungary[♠]. Housing refugees longer-term will test the patience and the existing infrastructure of host nations. We can expect xenophobic voices will find a new audience, as is often the case in times of economic hardships. A frustrated population during a recession can quickly turn violent.

The cost-of-living crisis is real and will only get worse in coming months. Hungry and cold individuals can quickly become an angry mob.

With many - especially those on low incomes - struggling to adapt to the new cost of living reality, we are likely to see a sharp increase in civil unrest across the globe as people take to the streets to protest. An "Arab Summer" is not something to be ruled out. Losses to both political risks and political violence policies are likely to be heading insurers way.

So what's next...?

As we enter a new era of higher interest rates and soaring inflation, governments across the globe will need to come to terms with a new economic reality and adjust accordingly. So will insurers. With losses likely to arise from different directions and different products, insurers could in for a rough ride for the next few years.

Risk and Insured selection will remain key as the market hardens and as insurers continue to (re)shape their book. The Lockton Re Specialty team is strongly positioned to provide impartial and holistic review of insurers existing portfolios. With years of direct market knowledge, Lockton Re is focused on supporting insurers wanting to future-proof their business, creating bespoke reinsurance programmes for our clients.

Historically, insurers viewed crisis management products as low frequency/high severity classes. Is it time to reassess that assumption? With there being 3 separate major global economic events since the Global Financial Crisis - the commodity crisis in 2014, COVID-19 and now the current crisis – can insurers afford to continue to assume low frequency events in these lines? And what about severity? Is it still correct to assume a single event creates a market wide loss, or will we see insurers suffering multiple independent, yet cumulatively painful losses? As the saying goes - you cannot change the past, but you can change the future.

For Lockton Re Specialty, the most important aspect of product development to protect against these future loss trends is providing opportunity for both sides of the buyer/seller divide. To discover how we are proposing sustainable and executable solutions, please contact any of our team members.

(♠) UNHCR:
https://data2.unhcr.org/en/situations/ukraine/location

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“Our Specialty division has seen great growth over the last 18 months across multiple classes of business, there is a real need to provide a differentiated approach and solve for the lack of choice in reinsurance advice and broking in the ever important and complex political risk and credit class.“

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