WEEKLY ECONOMIC COMMENTARY

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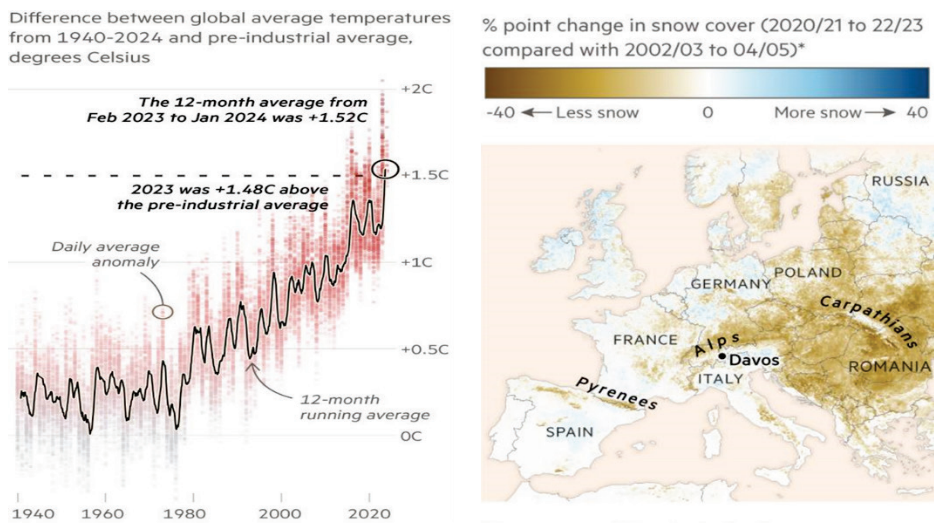
IN THIS ISSUE:

- **Climate Risk Heats Up**
- **Feeding Discontent**
- **The WTO Fights To Remain Relevant**

I am struck by how regularly I was able to run outside last month. Chicago's harsh winter conditions typically limit outdoor activity; even hardy, warmly-dressed runners will stay indoors to avoid injuries from the frozen ground. But this year, locals did not need to spend as much time on treadmills. Most of the U.S. had its warmest February on record, while the rest of the world logged the second-warmest February in history. Weather patterns are shifting, and the consequences go far beyond planning exercise routines.

We are economists, not meteorologists. We must take the changing weather as an exogenous shock, and make plans to deal with the commercial and policy implications of these changes. And the outcomes are starting to show up everywhere we look.

The increasing prevalence of droughts, wildfires and heavy storms are adding to the risks faced by food industries. Crop failures have become more common. Livestock eat a lot of grains and grass; higher input costs will raise the price of meat. Fish are also under stress, with changes to the temperatures and acidity of the oceans causing species to move or be depleted.



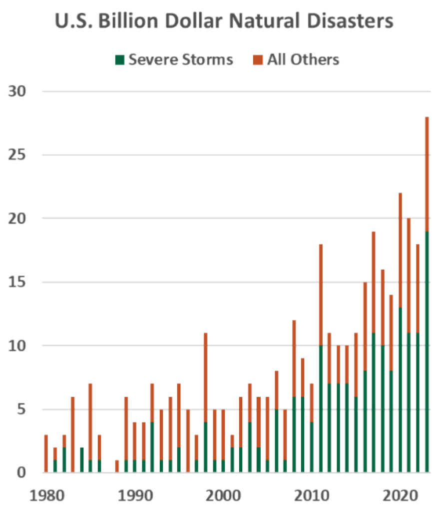
Sources: ERA5, C3S/ECMWF, National Snow and Ice Center, FT

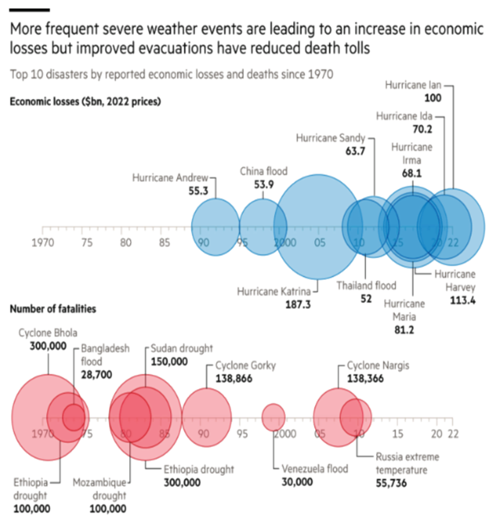
Ensuring a secure supply of food is a minimum requirement of the governments of most nations. Imports can compensate when local producers are impaired: in 2022, food shipments helped to compensate for the loss of commodity output from Ukraine. But if the whole world's harvests are at risk, governments will need to contemplate more comprehensive responses.

Food is not the only supply chain at risk. The Panama Canal was designed to use nearby freshwater lakes to fill its locks. A drought has diminished available water, preventing larger vessels from crossing the canal. Ships must instead traverse the length of South America around Cape Horn, slowing shipments and adding to costs. (This challenge mirrors the rerouting away from the Middle East due to tensions in the Red Sea.) We do not anticipate the COVID-era challenges of everything going awry in supply chains, but the episode did teach us the difficulty of restoring normality once a disruption begins.

Those seeking respite from stress will have to get creative, as well. Warmer tourist destinations will need to contend with shifting shorelines and limited fresh water supplies. Colder climes will also need to adapt: snowfall has become more limited, reducing the number of viable destinations for skiing and winter exploration.

Climate risks are not distant; they are with us today.





Sources: National Oceanic and Atmospheric Administration, Haver Analytics, EM-DAT, FT

The tangible costs of climate change can feel far-off or overstated. After all, store shelves are still full of food, and anyone who has experienced a blizzard will not be too upset by warmer winters. But the actual effects are becoming harder to ignore, especially in the costs of insurance.

The frequency and severity of major storms is rising, in large part due to warmer oceans bringing more energy into storm systems. Even events like thunderstorms, once considered “secondary perils” to insurers, are showing potential to cause catastrophic damage. Many homeowners are finding themselves priced out of insurance, and living at risk of total loss of their homes.   Studies have estimated seven percent of U.K. homes and one in 25 Australian homes will be forced to forego insurance in the decades to come. In the U.S., insurers are simply terminating policies and withdrawing from hurricane-prone markets like Florida and the Gulf Coast.

Private sector initiatives like ESG investing are doing their part, but that part is small. Governments must act to arrest overheating. Policy responses to climate change have had mixed success. Emissions trading schemes did not see global adoption, allowing rich nations to continue buying from polluting exporters.

The European Union has started implementing a carbon border adjustment mechanism (CBAM) to levy an import tax on carbon-intensive imports like steel, cement and fertilizers; the tax will take effect in 2026. The European Commission is also considering a corporate sustainability due diligence directive (CSDDD) that would require companies to include environmental and human rights considerations in their governance. In the U.S., the Securities and Exchange Commission has just finalized a rule requiring firms to report their emissions, climate targets and risks as part of their financial disclosures. The U.S. remains a significant polluter, alongside India and China—all nations that have done little to curb their emissions.

Climate-related rules will come from more than just the environmental regulators.

Central banks are also contemplating climate risks. While it may seem beyond central banks' remits, climate events can affect the economy, markets and the banking system. The European Central Bank's vice-chair of supervision gave a speech last year anchored on climate jeopardizing financial stability. Bank of England governor Catherine Mann defended the role of central banks in climate policy, as both climate events and mitigating strategies like carbon taxes will impact inflation. Mann keenly observed that central banks often think in terms of risk scenarios, but in this case, "there is no 'no climate change' scenario to fall back on." The Federal Reserve has begun a pilot of climate risk scenario analysis, though Chair Powell has expressed caution that the Fed will not be a climate policymaker.

The challenge of climate change requires global coordination. Even in times of peace, this would be a tall order; in the current era of high polarization, any response will be fraught. But the time for risk identification and mitigation is upon us, and will inform many aspects of our work indefinitely. Despite the greater window for training, we cannot run from this risk.

Eating Into Confidence

"What goes up, must come down." That elegant summary of Newton's second law applies in the physical world, but it does not apply to economics. And that is currently a source of consumer discontent.

In most major economies, inflation is much lower than it was a year ago. The target of 2% is within sight, which should allow interest rates to moderate. Unemployment has not risen much, creating the makings of a soft landing. Asset prices have also been very strong. This combination of outcomes would have been assigned a very low probability a year ago.

Nonetheless, households aren't at all happy with economic circumstances. Consumer confidence is at low levels in major markets, despite better-than-expected results. Some of the poor sentiment is political, as views about the outlook vary with party affiliation. But some of it is based on markets: supermarkets, not stock markets.

The pandemic affected food prices more than almost any other category. Quarantine forced a shift in distribution from restaurants to grocery stores; illness disrupted processing and distribution. Concerns over food security led to a decline in exports and scant supplies for some commodities.

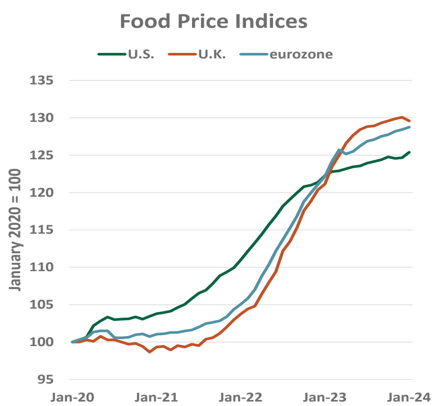
Other supply shocks piled on. The war in Ukraine hindered shipments of fertilizer used by farmers around the world. An outbreak of avian flu in the United States affected the poultry industry. Across developed markets, grocery prices are about 30% higher than they were at the beginning of 2020. "Shrinkflation," where product quantities are reduced while prices remain stable, and "skimpflation," where product quality is reduced, add insult to injury.

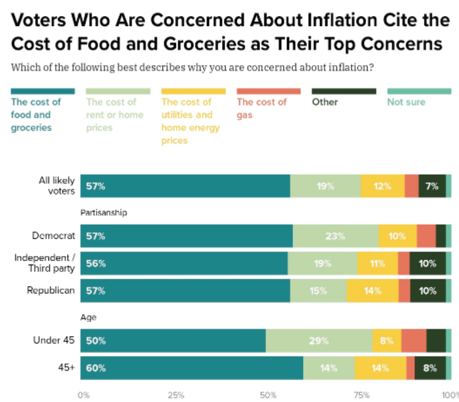
Food is a substantial portion of the average family's budget, and it therefore plays a significant role in perceptions of inflation. (Most people know the prices of milk and eggs, but not the prices of medical care.) Further, while economists focus on changes in prices (inflation), the average person is more attuned to the level of food prices. To many, therefore, inflation hasn't improved much.

With food supply chains largely back to normal, why haven't food prices descended toward pre-pandemic levels? A combination of factors are at play:

- Overall demand remains strong. High prices can be a cure for high prices in the grocery aisle, as shoppers trade down to house brands or cheaper ingredients. But rising income levels and asset markets have dulled price consciousness for some households.
- Prices of some food commodities have moderated only slightly from the peaks seen in early 2022. Wholesale prices of most grains are back to price ranges seen prior to the pandemic, but proteins remain expensive. Herds and flocks are smaller than they were four years ago, as the costs of raising them have increased.
- Processing, packaging and transporting products make up about 85% of food costs. Those elements all rely on labor; wages in the industry have escalated faster than the pace of wage gains in the overall labor market. These industries have high levels of turnover and are more likely to rely on immigration than other sectors. Ironically, the high cost of food has led workers in the field to demand higher wages to keep pace.

Food costs have a heavy influence on perceptions of inflation.





Sources: Haver Analytics, Data for Progress

- A significant fraction of food spending is devoted to eating out. Inflation at those venues is higher than for meals eaten at home, as another layer of labor and distribution costs is involved.
- Some have suggested that increasing concentration in the retail grocery industry has supported "greedflation," but evidence supporting this is not conclusive. In fact, supermarkets traditionally have very low profit margins, and have been investing heavily in technology to maintain them. Applications range from self-checkout kiosks to AI-driven inventory management systems.

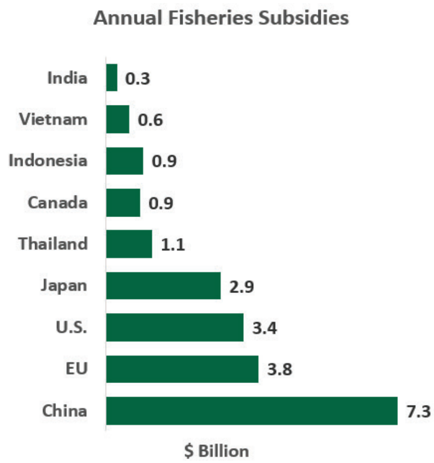
The cost and availability of food has contributed to political change frequently throughout history. There are a lot of elections on the calendar this year; if the price of Newton's apple doesn't come down to earth, incumbents may find themselves shopping for new jobs.

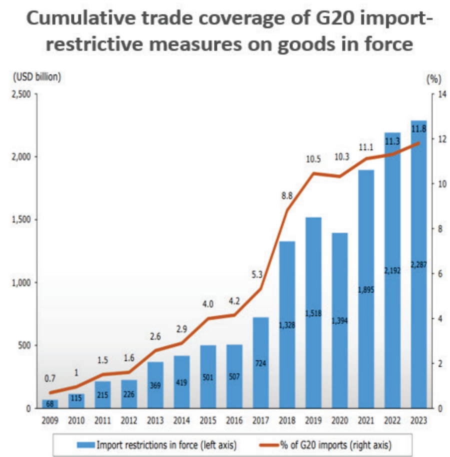
Unfair Playing Field

Free trade has been a force for good over the past few decades, but international commerce without rules will be an unmitigated disaster. Members of the World Trade Organization (WTO) recognize this. Yet, they are unable to agree on reforms that would enable the WTO to deal with modern-day challenges.

Attempts to revive the body met a dead end again at the 13th ministerial conference of the WTO this month. Serious divisions remain among the 166-member body. Brinksmanship over aid for farmers and fishing subsidies remained the biggest hurdles in progress on a broader agenda. Subsidy disputes and countervailing duty investigations at the WTO have increased steadily over the past decade and a half. Yet, the main functions of the world trade body—negotiation and dispute settlement—have been paralyzed since 2019. Appeals cannot be heard and disputes are left in limbo as the WTO's appellate body lacks adequate members to adjudicate trade grievances. China, which benefitted the most from the WTO, also stands to gain from its decline as Beijing seeks to reshape trade terms with developing nations through its own trade deals.

Last week's conference, however, delivered an extension of the moratorium on customs duty on e-commerce by two years. The development is significant, considering that about 25% of all global trade is now conducted digitally and is expected to continue rising.





Sources: OECD, Science Direct, WTO

Getting major achievements was going to be tough, given elections in major economies from America to Asia. Washington remains the biggest roadblock in the restoration of the appellate body, as both political parties have moved toward domestic production and protectionism. India — where two-thirds of the population lives in rural areas — is also set to go to polls this spring. While the WTO is questioning India's agriculture subsidies, a large number of farmers (a significant voting bloc) are demanding legal guarantees for minimum support prices for their crops.

Fragmentation is threatening the WTO's relevance.

Protectionism and fragmentation are on the rise due to varying interpretations of trade laws and enforcement, thanks to the dysfunctional dispute settlement body and increasing prevalence of bilateral free trade agreements.

At a time of when geopolitical tensions are dictating the terms of trade, multilateral co-operation and rules that govern global trade are the best guardrail against further economic fragmentation.

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