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Deep Dive Webinar – Global prospects in mid-2022: Stagflation and superpower rivalry?

Speakers:

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Speaker statements:

Russia/Eurasia

It is not clear what President Vladimir Putin would consider to amount to victory in Ukraine. He said recently that he wants to liberate the Donbas but also shows no intent to surrender other occupied Ukrainian territories beyond the southeast, such as Kherson. The influential security council secretary, Nikolay Patrushev, said recently that Moscow still wants "de-Nazification", which means the total defeat of Ukraine. The Kremlin has no intention of shifting course and seems intent to continue the war in the expectation of faster progress.

Regarding Russian capabilities, the troops have been badly led and are often demoralised, with units reconstituted for the current offensive in the Donbas being of lesser quality than many of those used in the initial invasion. Putin appears reluctant to introduce mass mobilisation. Since the invasion, Putin has hinted at using nuclear weapons against Western states. There is a longstanding Russian military concept, 'escalate to de-escalate', in which a nuclear weapon is used to bring a conflict to a conclusion. A nuclear weapon used almost anywhere in Ukraine would badly damage Belarus and Western Russia as well. The impact of even a single tactical nuclear weapon of 5 kilotons is unclear as Russia has not properly tested these weapons. The Kremlin has played down claims that it is basing nuclear weapons in Belarus.

Regarding the economy, high oil and gas prices have partly offset lower exports with a current account surplus of USD140bn. However, pipeline gas cannot be redirected elsewhere, and Western sanctions have impacted sectors of the economy.

Currently, there is no hard evidence of a coup being planned against Putin. While there is a disjointed military leadership, the military has shown no signs of being rebellious or even believing that the war in Ukraine is being badly managed by Putin. The security agencies including the federal security service (FSB) are monitoring each other for disloyalty to Putin. However, if Putin was to become completely incapacitated, a fast and brutal infight is likely to determine a successor.

Developed Markets outlook

Core inflation, which excludes food and energy, has already peaked in the United Kingdom, the United States and in the Euro-area. When headline inflation peaks will depend mainly on Europe's energy security, especially on Russian gas supplies to Europe, on rising oil and gas output from the US, which should rebalance the market and lower US prices, and on the rate of global economic growth and the extent that higher prices dampen demand.

Inflation rose sooner in the United States; given the country's greater energy self-sufficiency, inflation there should peak soon. In Europe, the peak will come later in the year. Slower global growth will reduce the pressures creating a wage-price spiral. Long-term inflation expectations are anchored at no more than 3.0-3.5%, and added labour cost pressures should ease in the United States and Euro-area if productivity rises modestly, which is already happening in the United Kingdom. However, new shocks such as a worsening of the energy crisis might prevent this. Without such shocks the US Federal Reserve and the European Central Bank both expect inflation to be at 2% by the end of 2024. The US economy might enter a technical recession this year, and before the Euro-area, as the US economy contracted by 0.4% in the first quarter of 2022 as stock building fell and imports surged, which reduced net GDP. Whereas, the Euro-area grew by 0.2% in the first quarter and if the same is achieved in the second quarter than a recession should be prevented for now. However, any US recession this year will be milder and shorter than one in the Euro-area, which is much more

at risk with several countries including Germany and Italy possibly entering a technical recession in the third quarter. Losers from any recession would include companies that produce goods and services that households cut back on like high-end consumer goods as well as international tourism. Winners would include major food and energy producing countries.

China

Zero-covid will remain the most important domestic issues in China for the rest of this year. COVID-19 is more prominent there now than at any time since early 2020. China has not tried to live with COVID-19, partly because its domestic vaccines are not as effective as foreign ones, which it has refused to import, its vaccination rates among the elderly are very low, and its healthcare system is not up to the standards of a developed country. The Chinese Communist Party has partly tied its legitimacy to the success of the zero-covid strategy, and officials have said that the country is prepared to continue the strategy for several years if necessary. To this end, test stations and huge quarantine facilities are being built, with mechanism becoming more targeted and refined. Households, companies and local governments are adapting to cope better in possible future lockdowns. China will not achieve 5% GDP growth this year in part because of the economic impact of the zero-covid strategy.

Regarding the economy, lockdowns have dampened consumer spending and investment. Unemployment is high, especially among youth at about 20%. Jobs data does not show migrant workers who typically have insecure employment in the sectors worst hit by the economic downturn such as construction and consumer services. The stagnant housing market has caused a negative wealth effect with saving rather than spending. Rising interest rates overseas has made it more difficult for the People's Bank of China to cut interest rates to stimulate the economy without risking capital outflows.

Regarding China-Taiwan relations, the likelihood of a war with Taiwan this year has decreased. Reasons for this include: Russia's difficulty in invading Ukraine, compared to which Taiwan is better equipped and richer, China wants to learn lessons from the war in Ukraine and apply these to its military intentions and capabilities, especially regarding Taiwan, which China knows Taiwan is also doing, and now with increased support for Taiwan from the US and Japan in particular. In addition, China was surprised by the scale of Western sanctions imposed on Russia, and it must consider this in any contingency with Taiwan, and for which its economy is likely currently too fragile to withstand long-term. While war with Taiwan is unlikely in the near future, it is still more a question of when, rather than if, it will happen.

United States

Pragmatic democrats expect to lose 20-40 seats in the House of Representatives and to possibly lose control of the Senate as well in this year's midterm election in November. Inflation and the cost-of-living crisis is the main focus for voters, overshadowing the recent Supreme Court rulings as well as the January 6th committee hearings. A possible plan B for the Democratic Party is to put Vice-President Kamal Harris forward, with Democrat state legislators, as the administration's representative on reproductive rights and to lead the Democrat fight-back against an increasingly hard-line Republican Party. Democrats want the Republicans to split between Donald Trump supporters and moderates.

Regarding the January 6th hearings, attorney-general Merrick Garland will likely only decide to pursue a trial of Donald Trump if he believed the case was winnable. Currently, a conviction of Trump on charges such as wilful blindness or of obstructing government procedure would appear anticlimactic and might actually strengthen Trump by appearing as a politically motivated decision. This is especially so if the decision was made following Trump declaring his candidacy for the 2024 presidential election, which he is likely to do, and is permitted to do even while under investigation and prosecution.

Brazil's election

Former-president Luiz Inácio Lula da Silva is narrowly ahead of incumbent President Jair Bolsonaro. Lula currently leads in twelve states and Bolsonaro in eight (with three tied), but Bolsonaro currently only leads in seven of the sixteen states he won in 2018 and Lula leads in the biggest states – Sao Paulo, Rio de Janeiro, Minas Gerais. The significant voter bloc of those on social welfare benefits intend to vote 52% for Lula and 32% for Bolsonaro. However, no incumbent has lost re-election since re-election was permitted in 1997, despite all facing major scandals and economic crisis at the time of election. Lula is most likely to win, but probably after a second round. While the business and financial community will support both candidates for various reasons, they are too small a voting group to determine the outcome, which will be determined by lower income and middle-class groups.

Bolsonaro's platform so far has been based on fiscal austerity. However, he and his supporters in Congress recently passed USD7.6bn aid package, which includes a 50% hike in monthly payments to certain low-income recipients (though only until year-end) and fuel subsidies for truckers and taxi drivers. While this is technically illegal, Bolsonaro has used a state of emergency to pass it. Bolsonaro is aware that he will likely lose the election, for which he is conducting a campaign to delegitimise the election with claims of election fraud, all of which the electoral authority has rejected. Bolsonaro knows that if he loses the election he will lose presidential immunity and likely face several corruption probes. However, with violent incidents up by 20% this year and both Lula and Bolsonaro having extremist supporters, violent protests are expected before and particularly after the election -- especially if Bolsonaro loses.

Regulation

Regulations are becoming and will remain for the foreseeable future important factors in geopolitics, especially in the technology sector. One current trend is several major powers, especially the US and China, trying to impose new domestic digital regulations to boost the market for their digital technologies and to marginalise economic competitors and geostrategic rivals. A second current trend is these several major powers trying to influence the digital regulations of partners, allies and friends. This is particularly to harmonise digital regulations around particular norms. All countries will have to deal with anticompetitive practices by platform firms, abuse of personal data and cryptocurrency volatility. Any Western digital bloc or Chinese digital bloc will both have gaps, overlaps and contradictions.

Regarding a reversal in financial globalisation, this would require major economies to move away from Western financial instruments, institutions, and policymaking which none are likely to do wholesale. Currently, most countries want regulatory convergence not a divorce from global financial systems. China is one of the major players pushing for the creation of an alternative financial system. Financial sanctions on Russia have only strengthened Beijing's resolve to develop an alternative to Western financial systems. However, this is a formidable challenge, and it is not clear that China has the will or sufficient trust of other countries to replace western ones. Ultimately, financial globalisation will not be going into reverse, but it will continue to evolve.

Asian/African crisis watch

Several south and southeast Asian economies are in debt stress with each experiencing soaring inflation and a depreciating currency as well as high debt levels. Laos particularly stands out because its annual external debt servicing requirements are barely covered by its current level of foreign exchange reserves. Also, about half Laos's public debt is owed to China. Pakistan might be attracting more attention among South Asian states were it not for the crisis in Sri Lanka. Its external financing requirements are extremely high. The good news for Islamabad is that there is now a staff-level agreement with the IMF on resumption of the 2019 bailout programme. Nepal is a wildcard risk. Forex reserves are not at a critically low level but have been falling. The government is continuing to restrict the import of several items, a typical sign that a country is in trouble. The caveat with Nepal and Laos is that these are relatively small economies which in can be supported quite easily by friendly countries if they get into serious difficulties.

According to Bloomberg Economics' market driven index three of the world's top five most distressed debt economies are in Africa - Ghana, Tunisia and Egypt. Also featured in the top 20 are Morocco, Kenya, Namibia, Angola, Senegal, Rwanda, South Africa and Gabon. To these I would also add Nigeria and Jordan. Agreements with the IMF limit the potential for a crash in a several cases such as Egypt and Jordan. However, the conditions attached can be difficult to implement without causing widespread protests and the governments scaling down its adherence to the IMF. Politics is stopping an agreement with the IMF in the likes of Tunisia and Lebanon, further raising risks. Ghana also does not have an agreement in place.

Macroeconomic factors going forward include rising current account deficits: Mozambique and the Seychelles are both forecasts to record deficits over 30% of GDP this year. While Ghana, Namibia and Zambia all have unsustainable deficits over 8% of GDP. Another is the exchange rate: Lebanon's currency has lost over 90% of its value since October 2019. Third is foreign exchange reserves – the IMF recommends that in the case of emerging economies these should cover at least 3-months' worth of imports. Burundi, the Democratic Republic of Congo, Mozambique and South Sudan all fail to meet this target.