Major Country Risk Developments
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By Byron Shoulton

Overview

The global economy has been sideswiped by several big shocks this year. The war in Ukraine has left countries around the world scrambling to find alternative wheat, corn, fertilizer supplies and other essential raw materials. Concerns mount around the world over food security should the Russia-Ukraine war be prolonged. China's GDP is expected to contract in the current quarter because of a two-month long Covid-19 lockdown in its major cities, which brought factory production to a halt; while travel, employment and vital deliveries were at a standstill. Meanwhile, consumers in Europe are suffering a squeeze on their purchasing power because of sky-high gas prices. In the wake of Russia's invasion of Ukraine, the world appears to be at an inflection point. Business leaders have declared the acceleration of deglobalization and sounded the alarm about a new period of stagflation. Academics have highlighted the return of conquest while hailing the renewal of transatlantic alliances. Meanwhile, many countries are rethinking their foreign policies, including trade, defense spending, and military alliances.

These shifts may have foreshadowed a transformation in the global energy system. Now, as a result of the war in Ukraine, energy and food security are at the forefront, joining climate change among the top concerns for policymakers. Together, these priorities could reshape national energy planning, energy trade flows, and refocus the safeguarding of sufficient food supplies to the global economy. Countries will increasingly look inward, prioritizing domestic energy production, encourage global food supply cooperation - even as they seek to transition to reducing carbon emissions.

In addition to economic nationalism and deglobalization, the emerging energy order will be defined by something that few anticipated: government intervention in the energy sector on a scale not seen in recent decades. After four decades during which they generally sought to curb their activity in energy markets, Western governments are now recognizing the need to play a more expansive role in everything from building (and retiring) fossil fuel infrastructure to influencing where private companies buy and sell energy to limiting emissions through carbon pricing, subsidies, mandates, and standards.

The Russia-Ukraine war is expected to continue at a high level of intensity through 2022, and possibly (at a greater or lesser tempo) for years to come. Even if the worst case scenario is avoided, the war marks a geopolitical watershed. It will result in Russia's exclusion from the Western economic and political order. Sanctions will likely remain in place indefinitely, and Russia will become a no-go area for Western businesses. The Kremlin will come to rely increasingly on China and the developing world. The West will have to reorganize its global supply chains, including for commodities supplied by Russia. Ukraine and the wider region will remain a zone of instability for many years to come.

USA

The U.S. economy had seemed resilient until rising interest rates exposed parts of the economy which are faltering, even though the Federal Reserve has just begun raising rates. New home sales fell by almost 17% between March and April. That trend is expected to remain subdued due to further increases in interest rates expected this year. Meanwhile, some U.S. retailers report having piles of unsold stock on hand- after they misjudged consumer demand.

Energy prices remain at their recent peak, while Opec+ nations, led by Saudi Arabia, agreed to increase oil production to compensate for any loss of global capacity due to tightening sanctions against Russian crude. Global oil demand is expected to remain strong over the next eighteen months. The extra production committed to by Opec+, together with additional alternate supplies from non-Opec countries, should meet expected global demand [even with some loss of Russian supplies due to sanctions]. At the same time, there is an emerging secondary market for deeply discounted Russian crude that has sprang up since the war. The aim being to get around sanctions and deliver Russian crude to the market disguised as being from elsewhere. Second tier oil traders and Chinese interests are reportedly playing an active role in this alternative oil market.

Slower growth is one element of a textbook profit squeeze. A consequence of the largely stable cost base of larger businesses is that, when sales rise or fall, profits rise and fall by a lot more. This effect boosted profits considerably last year, but as GDP slows it goes into reverse. The other element of a profit squeeze is higher costs. A variety of bottlenecks have pushed up the prices of key inputs, notably energy. Debt-service costs are rising with interest rates. And the other pressure point is wages. The U.S. jobs market remains tight. Pay increases have become more generous as a consequence. U.S. companies are in a double bind: if they pass on rising costs in higher prices for products or services- that would keep inflation high and force the Fed to raise interest rates more aggressively. If companies absorb rising costs, that will crush profits.

Since the start of 2022 U.S. bond yields have risen sharply; mortgage rates have surged; spreads on corporate bonds have widened; the dollar has climbed; and share prices have slumped. There is no escaping the squeeze ahead for the U.S. economy. Surging food and gas prices are eating into household spending. Consumer prices are 8.3% higher than last year's. Even excluding food and energy prices, annual inflation is at 6.2%. Supply- chain problems could flare up for as long as war rages in Ukraine and while China slowly emerges from Covid lockdowns. The U.S. labor market is red-hot, with two job openings for every unemployed worker, the most since 1950 when data were first collected. A measure of wage growth is at an all-time high of nearly 5.5% - a rate companies cannot bear unless they continue to raise prices fast.

The Federal Reserve promises to pour water on the fire. Markets expect the Fed to raise rates by more than 2.5 percentage points by the end of 2022. The Fed is crossing its fingers, hoping that it can hit its 2% inflation target without causing a recession. But history suggests that by acting to tame inflation, it will cause the economy to shrink. Since 1955, rates have risen as fast as they have this year during seven economic cycles. In six of them recession followed within eighteen months. The exception was in the mid-1990's when inflation was low and the labor markets more balanced.

This may help explain why U.S. consumers are now mostly pessimistic about the U.S. economy, according to a survey conducted by NORC at the University of Chicago, a nonpartisan research organization that measures social attitudes. The survey found Americans registering some of the highest levels of economic dissatisfaction in years. Some 83% of respondents described the state of the economy as poor or not so good. Some 35% said they are not satisfied with their financial situation. That is the highest level of dissatisfaction since NORC began asking the question every few years starting in 1972 as part of the General Social Survey. The share of respondents who consider their financial situation had gotten worse in the past few years was 38%.

The survey results suggest that high inflation in particular is driving the dim economic outlook. Inflation is running at close to its fastest pace in four decades at an 8.3% annual rate, one of several factors weighing on U.S. consumers and businesses. Households are digging into savings to support their spending, according to the Commerce Department, and the S&P 500 nearly closed in bear territory in recent weeks.

Still, the U.S. labor market remains an economic bright spot, with the unemployment rate close to a half-century low, at 3.6% in May. In the survey, about two-thirds of respondents said it would be somewhat or very easy to find a new job with about the same income and benefits. That is one of the highest levels on record. At the same time, employers continue to report shortages of skilled labor and companies complain of long delays in sourcing adequate supplies of raw materials and other manufacturing inputs. Despite inflation, the recovery from the pandemic induced recession has been among the strongest on record, with unemployment falling rapidly and incomes rebounding fastest for those at the bottom. If the recovery slows too much, it could undo much of that progress. The pace of wage growth has slowed a bit in recent months, although it remains simultaneously slower than inflation and faster than what is considered sustainable.

If the U.S. economy does shrink in the next year or two, it could even alter the country's long-term direction. The best response to a downturn during which inflation remained high, would be introducing pro-growth reforms such as lower tariffs, and encouraging more competition. Instead, a recession would most likely fuel populism and protectionism in the U.S.

Europe

The outlook for GDP growth in Europe has been significantly revised down for 2022 and 2023, as well as the inflation forecast. GDP growth in 2022 is now expected to be 2.3%, down from 4% forecast before the Russia-Ukraine war. This is mainly a result of cuts to projections for private consumption owing to surging inflation. Inflation is now expected to average 6.2% in the Euro area, up from a pre-war forecast of 3%.

The forecast now is for most euro zone economies to record one quarter of contraction in the remainder of 2022; some economies (including Germany and Italy) could slip into a technical recession. There is little cause for optimism in 2023, when most demand-side drivers of growth will remain subdued, and inflation is expected to moderate only gradually. If Russia were to suspend gas supplies to western Europe for a prolonged period, this would push the region into recession.

Before Russia's invasion of Ukraine, which started in February, the near-term outlook for west European economies was positive. Large, accumulated household savings from 2020-21 and an improving labor market meant that real GDP had already returned to pre-pandemic levels in some countries and was close to doing so in others.

The Russia-Ukraine war has significantly damaged the economic outlook for western Europe. Direct trade linkages between those two countries and western Europe are low (only 0.3% of the euro area's imports come from Ukraine and 1.5% from Russia, while Ukraine accounts for 0.3% and Russia 2.9% of the euro area's exports). Nevertheless, higher commodity prices and supply-chain disruptions are causing inflation to spike in Europe. This is weakening purchasing power and undermining consumer confidence. Surveys have indicated that sentiment has plummeted in recent months.

One of the sharpest cuts to GDP growth forecast is for Germany – 2022 GDP growth has now been revised to

1.3% (down from 3.2% before the war). Before the war shortages of auto components had already been disrupting the German economy (and those of other central European countries), but the war has aggravated the situation, with car manufacturers forced to pause production at some plants. As for Italy – given its heavy dependence on energy imports, including from Russia, and its substantial trade and investment ties with that country- it is likely to be one of the worst-affected economies outside of eastern Europe. GDP growth is now projected at 2%, down from a pre-war forecast of 4.4%. Moreover, growth projections have been cut for Austria, Belgium, France, the Netherlands, and Spain, by 1-2 percentage points.

Russia's Gazprom announced that it will cease deliveries of natural gas to the Netherlands' largest importer Gas Terra; and that it has also stopped supplying the largest Danish energy firm, Orsted, as well as the UK's Shell (for its contract to supply gas in Germany). The three companies have refused to pay for Russian gas imports in rubles.

Not all Russian gas supply to the Netherlands is being cut off. Russian-sourced gas accounts for around 15% of total Dutch consumption, and only one-third of this is imported directly by Gas Terra. The remainder is purchased indirectly through the Title Transfer Facility (TTF, a virtual trading platform for natural gas). Russian supply via this channel is not being cut.

In Denmark Orsted supplies around two-thirds of total Danish supply (and three-quarters of this comes from Russia), but the country has a low level of reliance on gas for energy supply, so the measure is unlikely to have significant negative consequences. This is also the case in Germany, as Shell's gas imports from Russia account for only a small share of total gas imports and other companies (including German energy giant Uniper) have been prepared to pay in rubles.

The companies had expected the decision after they refused to pay for gas imports in rubles. Alternative supply arrangements have already been made, which will limit short-term disruption. Gas Terra said it had already purchased enough gas from other sources to cover the shortfall. Orsted has also stated that it has been preparing for this scenario and that it expects to purchase sufficient gas on the European market. The Dutch Minister of Climate and Energy said Gazprom's decision would have no immediate repercussions for households or industry. Nonetheless, Gazprom's announcement will elevate uncertainty in European energy markets and drive concerns that more companies (including larger clients) could have their supplies cut off. Natural gas prices will in all likelihood remain extremely high, sustaining upward pressure on inflation across Europe.

As EU member states seek to reduce their dependence on Russian natural gas, the Economist Intelligence Unit (EIU) forecast that the EU's consumption of liquefied natural gas (LNG) will increase by 50% in 2022. The global LNG market will face a supply crunch, with additional demand from Europe being met by diverting cargos bound for other destinations, mainly Asia. The new LNG production capacity necessary to meet rising global demand will not come on stream until 2024 in the U.S. and 2025 in Qatar.

Based on current capacity and investments, there appears to be sufficient global supply to compensate for an abrupt decline in Russian gas deliveries to Europe, even if a slump in Chinese imports and high prices temper global LNG demand growth in the short-term.

So far this year the increase in LNG supplies to Europe has been more or less matched by reduced shipments to other markets, including an uncommon quarterly drop in shipments to China. Most of the increase in sales to Europe has come from the U.S., where operators have more flexibility than other major producers, such as Qatar and Australia, where long-term contracts predominate. Rising EU consumption is expected to boost prices of LNG by as much as 60% in 2022, after they rose by 30% in 2021.

Import capacity is a major constraint to Europe's pivot away from Russian gas. The EU member states imported around 244 billion cubic meters of natural gas in 2021, 155 billion cubic meters of which was from Russia (mainly by pipeline, but also including LNG), accounting for 40% of supply. About 30% came from within Europe, while the rest was imported from the U.S., Qatar, Nigeria, and Egypt. Imports of LNG by EU member states were subdued in 2021, totaling an estimated 63 million tons (equivalent to 86 billion cubic meters) – down by 12.5% from 2019.

Total LNG import capacity in EU member states is currently just over 170 billion cubic meters annually, meaning that there is room to boost imports significantly. Germany is working to add capacity of 32 billion cubic meters per year, including the installation of four floating regasification and storage units (FSRU's), the first of which is expected to be operational by the fourth quarter this year, according to German authorities. Combined with other projects, total EU capacity is expected to reach 208 billion cubic meters annually by 2026. Outside the EU, the UK and Turkey are potential sources of gas through their own imports of LNG, but interconnecting infrastructure is a limiting factor.

EU member states are expected to increase LNG imports by 50% in 2022, to 133 billion cubic meters, but this is not nearly enough to end dependence on Russia. Even this import target may turn out to be unrealistic, as pipeline links for transporting gas from Spain and Portugal to the rest of Europe are limited to a single pipeline with only 5.5 billion cubic meters annual capacity, meaning that much of the LNG capacity in those countries is useless to the wider network. The limited availability of storage at LNG import terminals is another constraint on Europe's ability to meet its gas needs through LNG imports.

Overall, the expectation is that high prices will boost investment in LNG export capacity in the medium to long term. If the U.S. and Qatar build the additional capacity as planned, the transition from Russian LNG exports will be more achievable in the longer run, and prices could potentially begin to fall from their current highs by the end of 2025.

For the remainder of 2022 at least, the EU will remain reliant on Russia to cover its gas needs. However, if the Ukraine conflict drags on and sanctions on Russia are tightened, Europe could face chronic gas shortages until at least 2025 and further increases in energy prices, although higher coal use and rising output from renewables could provide some respite.

India

For the past three years India has suffered the effects of the pandemic which took between 2.2 million and 9.7 million lives; lockdowns which caused the economy to shrink temporarily by a quarter - triggering the largest internal migrations since partition in 1947. As Covid hit, city workers fled the cities and returned to their villages. More recently, a heatwave has been baking Northern India, while high global oil and food-price shocks are battering the poor. Meanwhile, religious tensions have been simmering, stoked by the anti-Moslem chauvinism of the ruling BJP party, in power since 2014 under strongman prime minister, Narendra Modi.

Now it appears that a novel confluence of forces has the potential to transform India's economy over the next decade. If this plays out as forecast, it should help improve the lives of 1.4 billion people and could potentially change the balance of power in Asia. Over the past decade India has outgrown most other big countries, yet this has been overshadowed by a sense of disappointment. It has not engineered the manufacturing surge that enriched East Asia nor built enough big companies to marshal capital for development.

However, as India emerges from the pandemic a new pattern of growth is visible. As the cost of technology has dropped, India has rolled out a national "tech stack": a series of state-sponsored digital services that link ordinary Indians with an electronic identity, payments and tax systems, and bank accounts. The rapid adoption of these platforms is forcing a vast, inefficient, informal cash economy into the 21st century. It has turbocharged the world's third-largest start-up scene after the U.S. and China's. Alongside that, global trends are creating bigger business clusters. The IT-services industry has doubled in size in a decade, helped by the cloud services and a world-wide shortage of software workers. Where else can western firms find a half a million new engineers each year? There is a renewable-energy investment spree: India ranks third for solar installations and is pioneering green hydrogen. As firms everywhere reconfigure supply chains to lessen their reliance on China, India's attraction as a manufacturing location has risen, helped by a $26 billion subsidy scheme. Meanwhile, Western governments are keen to forge defense and technology links.

Large Indian companies with large cashflows are looking to change the country's participation in the global economy. The top 20 Indian companies earn 50% of corporate India's cashflows. These companies are making money fast enough to take risks with their earnings rather than having to borrow to excess. The ambitious giants include conglomerates – Adani (energy, transport), Reliance Industries (telecom, chemicals, energy, retail), Tata (IT, retail, energy, autos) and more focused giants such as JSW (mainly steel). These four companies alone plan to invest $250 billion over the next five to eight years in infrastructure and emerging industries. In doing so they intend to develop local supply chains, which fits with government goals. Reliance Industries plans to cut the price of green hydrogen to $1 per kilogram by 2030, from $5 today. Tata is rolling out battery plants, electric vehicles, and semiconductors. These are big, risky bets that few other firms would dare take.

India has found a work-around to distribute more to ordinary folk who vote but rarely see immediate gains from economic reforms: a direct, real-time, digital welfare system that in 36 months has paid $200 billion to about 950 million people.

The combination of engineering skills, mobile data and a national tech stack has created many start-ups. They include providing e-commerce, delivery and ride-sharing services for 10 -20 million more affluent Indians, to seeking opportunities further down the economic pyramid. In Bangalore, a low-key tech culture is fostering a new generation of companies that are closer to the global frontier of innovation including space, drones and batteries. Firms are using domestic research and development and are targeting exports for over half their sales. Local venture capitalists opine that there is a pipeline of 10,000 plausible start-ups being created each year. Mortgage applications are up at a rate not seen in 40 years. Demand for electric vehicles is booming; capital spending has started to revive, and exports are on the rise. These changes may not lead to a manufacturing boom as big as those in South Korea or China, which created enough jobs to empty the fields of farmers. They do not solve deep problems such as extreme weather or clogged courts. But they do help explain why India is forecast to be the world's fastest -growing economy in 2022 and why it has a chance of holding on to that title for years. Growth will generate more wealth to invest in the country's human capital, particularly hospitals and schools.

The Modi government gets much credit for fostering creativity and for pushing the adopting of new technologies. India did not create the Sino-U.S. impasse or the cloud but it benefits from both. Central government purchases of solar power have kick-started renewables. Financial reforms have made it easier to float young firms and bankrupt bad ones. Moreover, Mr. Modi's electoral prowess provides economic continuity. The danger is that over the next decade this political dominance could harden into autocracy. One risk is the BJP's abhorrent hostility to Moslems, which it uses to rally its political base. Companies tend to shrug this off, contending that Modi can keep tensions under control and that capital flight will be limited. Yet violence and deteriorating human rights could lead to stigma that impairs India's access to western markets.

The quality of decision making could also deteriorate. Prickly and vindictive, the government has co-opted the bureaucracy to bully the press and courts. A strongman lacking checks and balances can eventually endanger not just democracy, but also the economy. And given the BJP's ambivalence toward foreign capital, the campaign for national renewal risks regressing into protectionism. The BJP loves blank checks from Silicon Valley but is wary of foreign firms competing in India. Mr. Modi strives to restore Indian greatness. For him, that means not only bolstering Hindi pride at the expense of minorities, but also building a large, integrated, high-tech economy. So far, the two ambitions have gone together, but that may not always be so. India's entrepreneurs and tech stars are hoping that the country's economic modernization and unification can survive the BJP's and Mr. Modi's divisive politics.

Egypt

A final contract was announced on May 28, 2022, for the second phase of an Egyptian high-speed rail project, which will take the total length of this new transport network to almost 2,000 kilometers. The principal contractor is Germany's Siemens Mobility, which has disclosed its portion of the work will cost $8.7 billion. One of the Egyptian partners, the privately owned Orascom Construction disclosed that its contract is worth $1.8 billion; the other partner state-owned Arab Contractors has not disclosed the value of its contracts on the project.
The decision to go forward with this hugely ambitious project, on an expanded scale, demonstrates the government's commitment to continue investing in developing Egypt's infrastructure, despite mounting economic pressures and rising levels of public debt (90% of GDP). The project will provide a boost to real GDP growth during the construction phase and will help to enhance Egypt's logistics in the medium to long term.

The initial tender for a high-speed rail linking the Gulf of Suez to El Alamein, on the Mediterranean, was issued in 2019. Chinese companies were prominent in the bidding, but in late 2020 Siemens emerged as the frontrunner. The contract was also reconfigured from an operating franchise to an engineering, procurement, and construction plus financing (EPC+F) contract, with 15 years maintenance. The operator will be the National Authority for Tunnels, which runs the Cairo Metro, rather than Egyptian National Railways, the state body that

manages the existing railway system. The final contract for the 660 kilometer first phase, which was extended to include Mersa Matruh, was signed with the Siemens-led consortium in September 2021. The new phase comprises a 1,100 kilometer line from Cairo to Abu Simbel, south of Aswan, and a 215 kilometer line from the Upper Egypt resort of Luxor to Bur Safaga and Hurghada on the Red Sea.

Execution of the first phase is reportedly in full swing with planned completion by 2027. Operations on the first sections of the line is set to begin within three years. Timeline details for the second phase are not yet available. The expectation is that public capital works will underpin Egypt's medium to long run economic growth outlook, with real GDP growth forecast at an average of 5.5% per annum in 2023-26.

Over the course of 2022-23 the Sovereign Fund for Egypt is becoming increasingly active in promoting partial-privatization of state assets under an IMF program. Public-private partnerships are being encouraged. Military-run enterprises retain their dominance in key sectors of the Egyptian economy. It is expected that the sale of shares of state entities will pick up pace over the next several years, including the remaining shares in banks and stakes in some military-owned entities. However, one entity, the National Bank of Egypt, is expected to retain full public ownership for the foreseeable future.

Egypt is expected to register a bump in foreign direct investment (FDI) this year and next following financial pledges by Gulf states. The hydrocarbons sector in particular is a source of FDI inflows. There are efforts aimed at amending Egypt's investment law following complaints from foreign firms about delays and bureaucratic obstacles that creates barriers to prospective investors. Also, the government is introducing measures to reduce red tape and import costs via new customs regulations this year.

By 2024 remaining restrictions on imports, including tariff surcharges on goods deemed to be luxuries, will be lifted. Domestic credit conditions are also expected to improve in 2024-26 despite a small rise in interest rates. Foreign banks are expected to increase their direct lending to Egyptian projects, while leading Egyptian banks receive enhanced ratings from international agencies.

Egypt's economy is diversified, and mining, manufacturing, tourism and agriculture are all major sectors, but per capita income remains low at around $3,058. The role of the state in the economy has waned a bit in recent years, in part because of IMF-backed reforms. However, special interests (including the military) continue to hamper private-sector growth. President Abdel Fattah Al-Sisi is expected to win re-election in 2024 as he consolidates power and suppresses dissent. A top-down and centralized style of governance carries inherent political stability risks, and if unrest erupts (a heightened risk with inflation set to rise in 2022-23), the government will not hesitate to use force to quell it.

Egypt's near term economic policy is expected to be guided by a three-year funded IMF program that is to be approved later this year. This will entail a greater commitment to exchange-rate flexibility, prudent monetary policy and a primary budget surplus. High inflation (around 13%) and lower domestic demand are projected to cause real GDP growth to slow to 3.8% in fiscal year 2022/23 (July to June), from an estimated 5.2% in 2021/22. The central bank of Egypt is expected to tighten policy interest rates by 75 basis points in 2023. Assuming that interest-rate cuts are made later in the forecast period, GDP growth should pick-up in 2024-26.

Financial support from Gulf countries and timely monetary intervention are expected to prevent a balance of payments crisis, but Egypt will remain highly exposed to shifting investor sentiment towards emerging markets as interest rates in the U.S. rise. The current account deficit/GDP ratio will hit a six-year high this year as global food and oil prices soar as a result of the fallout from the Russia-Ukraine war. The deficit will trend downwards in 2023-26 as the import price shock passes. The shockwaves from the Russia-Ukraine war for Egypt extend beyond import prices. Both Russia and Ukraine have been top contributors toward tourism for Egypt, underlining the forecast that the tourism sector will remain subdued.

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