Collective Intelligence

Inflation and Geopolitics

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Summary

Even before Russia's invasion of Ukraine, inflation and geopolitics were critical challenges to the global economy. However, the invasion, and related supply chain disruptions, have turned inflation into a bigger geopolitical risk.

- In the wake of COVID-19, unprecedented fiscal and monetary policy support and disruption to supply chains and labor markets had already boosted the cost of living significantly, with wages rising in tandem.
- Policy initially remained supportive on the assumption that inflation would be transitory.
- After the invasion, which was unexpected in many circles, commodity and energy supply issues caused even swifter price rises, which put upward pressure on interest rates globally. Other events such as lockdowns in China have also restricted supply chains.
- In response to high inflation, central banks are tightening monetary policy, constraining economic growth, and raising the risk of recession.

This combination of circumstances may help catalyze political and social upheaval, for which organizations should increasingly be prepared.

- In the near term, developing economies will be especially susceptible to unrest.
- China and India may import more from Russia to support their supply chains, which as such will require closer monitoring from Western firms.
- Inflation and its consequences may help Republicans gain ground in upcoming US elections, which might influence US policy on geopolitical topics.
- Europe could witness growing socio-political tensions if it further restricts Russian energy use and cannot sufficiently offset the economic impact.
- For companies, Germany will be especially important to watch given its dependence on Russian gas.

Inflation in context

In just three months, the IMF has hiked its forecast of inflation this year by 1.8 percentage points in advanced economies, to 5.7%, and by 2.8 percentage points in emerging markets and developing economies, to 8.7%. It expects global growth to slow from 6.1% last year to 3.6% this year and next.

Stagflation, or a combination of economic stagnation and inflation, remains a significant risk, in central banks' official view. With monetary policy tightening significantly to combat inflation, stagflation is also increasingly seen by the financial community more broadly as one of two main base cases alongside a recession.

In the US, inflation was already 8.5% in March, its highest level in four decades, up from 0.1% at its low in May 2020. This is an even bigger leap than during the recovery from the last recession, when inflation swung from a low of -2.1% in July 2009 to a high of 3.9% in September 2011.

In 2010-2012, rising commodity and energy prices were the biggest driver of inflation. When denominated in euros and pound sterling, the Brent crude oil price peaked in 2012 – as opposed to the US dollar price, which peaked in 2008. From a geopolitical perspective, bad harvests in Russia and elsewhere in 2010 sparked food shortages that helped precipitate the Arab Spring. The same risks persist in developing economies today.

However, current drivers of inflation are much broader. In the wake of COVID-19, tight labor markets and supply chain disruptions had already pushed inflation higher, even before the Ukraine invasion and the commodity and energy price spikes that ensued. A new wave of COVID lockdowns in China has provided the most recent example.

Deteriorating global collaboration in areas like trade have made supply issues worse. Energy shortages have met with conflicting responses, ranging from calls for greater temporary use of coal to an accelerated transition to clean sources. Despite central banks' efforts to dampen inflation, it may remain high if the Ukraine crisis de-escalates and could even rise if Europe further limits Russian energy imports.

Strong demand has also been a significant driver of inflation, fuelled by unprecedented support from fiscal and monetary policy. Authorities have been cautious about withdrawing support and raising interest rates in anticipation of higher inflation, despite signs of tight labor markets last year. However, concerns over inflation's impact on vulnerable communities have superseded concerns over the impact of a withdrawal of support.

In financial markets, investors have become nervous about central banks' ability to raise rates and simultaneously engineer a soft landing for the economy. This nervousness was a key driver behind the recent fall in stocks. Weak currencies that were once seen as assisting trade are now also seen as stoking a rising cost of living.

In the 2010-2012 episode, the US Federal Reserve wasn't forced to tighten monetary policy. This year, **the Fed already raised interest rates by 0.75 percentage points**, with markets pricing in additional hikes totaling two percentage points over the rest of the year. The European Central Bank is due to conclude its asset purchase program in the third quarter and is now seen as likely to start raising rates at its July meeting.

Implications for developed markets

In the US, the Fed is trying to preserve a tricky equilibrium between reducing inflation and maintaining growth. The labor market is at its most overheated point in post-war history, according to Goldman Sachs, with a gap of more than 5.3 million between the total number of workers and jobs or job openings. The Fed is looking to moderate the pace of hiring without boosting unemployment.

The US outlook is especially important because of the US economy's impact on the rest of the world. Goldman Sachs puts the chance of a US recession at 35% in the next 24 months. In a recent interview, Jamie Dimon, the chairman and CEO of JP Morgan Chase, put the probability at 66%. Among fund managers, pessimism on global growth is at its highest level ever, according to a regular Bank of America survey.

Inflation is a key issue for this year's US midterm elections, and a recession, if it happens, would also be a critical factor in the 2024 presidential and congressional votes. Both sets of events will affect the make-up of the US government and its approach towards geopolitical issues, especially policy on Russia, Ukraine, and China.

According to one poll in late March (conducted by Harvard CAPS/Harris), Americans saw inflation as the most important midterm issue of all. They also see Republicans as better placed to tackle it – by a 19 percentage point margin, according to an ABC News/Washington Post poll in late April. Inflation is likely to exceed the Fed's target level until at least the midterms and to help support prospects for Republican candidates and policy.

In Europe, the inflation outlook hinges partly on the EU's approach towards Russia, and on whether the ECB's softer policy response is enough to help bring inflation down. A harder stance on Russian energy imports would boost inflation and reduce growth in the EU. A softer stance would cushion the economy but limit the tools at the EU's disposal in dealing with Russia. Both scenarios would increase the risk of tensions within and between EU member states.

Organizations would be especially vulnerable to a harder stance in Germany due to its reliance on Russian gas. Any slowdown in the EU's largest economy would affect other EU members to varying extents. Organizations should also monitor for the risk of Russian gas imports shutting down in individual states. However, aside from Austrian and Swedish presidential elections, the potential for broader political upheaval is constrained by a lighter political calendar this year.

In other developed markets, the implications are offset to a greater extent by other factors. In Japan, the return of inflation has been an unexpected twist in the battle to ward off deflation, although the government is reported to be preparing a package to limit side-effects. As major commodity producers, Australia and Canada are better cushioned, although Australia is still facing sharp rises in the cost of living ahead of its federal election on May 21.

Implications for developing markets

It is possible that the global economy weathers US rate rises without significant geopolitical consequences. However**, for developing economies, this risks conditions akin to the 'taper tantrum' of 2013-2016**, when the Fed tapered its loose monetary policy after the last recession. This time, a commodity and energy price spike is reinforcing the potential for volatility, as opposed to during the 'tantrum,' when a price collapse boosted volatility in commodity-exporting countries.

In 2013-2016, the taper prompted a flow of capital out of emerging market currencies and into US dollars and increased the cost of dollar borrowing. For developing economies with current account deficits, or budget deficits funded by US dollar borrowing, this combination caused economic hardship and attendant social issues.

Although other local factors were also involved, **economic pressures at around the time of the 'tantrum' helped prompt a shift in political regimes**. In 2014, Narendra Modi and Joko Widodo swept to power in India and Indonesia, respectively. In Brazil, Dilma Rousseff held onto power in elections that year but was ultimately removed from office in 2016.

In its most recent World Economic Outlook, the IMF observed that **developing economies are if anything more vulnerable today**. The difference in borrowing costs for developing economies versus developed market equivalents is higher. In the case of middle-income emerging markets, COVID-19 pushed the median ratio of debt to GDP to 60%, up from 40% during the 'tantrum.' Roughly 60% of low-income developing economies are already in or at risk of debt distress. The strength in the US dollar and anticipated US rate rises are already pressuring fragile countries.

Conditions for political change are ripe. The percentage of countries experiencing major unrest is still not close to pre-pandemic peaks, according to data cited by the IMF. Presidential or general elections are due to be held this year in a range of markets, including Angola, Bosnia and Herzegovina, Brazil, Colombia, India, Kenya, the Philippines, Senegal, and Slovenia.

Nevertheless, even beyond the twists and turns of the electoral cycle, **organizations operating in developing economies should be alert to mounting social risks**. This is especially true in countries with greater financial vulnerabilities, or in lower-income markets with greater sensitivity to commodity and energy price pressures.

Even in countries that do not experience unrest or a change in regime, inflation may play an important geopolitical role. Countries that have maintained a neutral stance on Russia's invasion of Ukraine, most importantly **China and India**, will be more incentivized to boost trade with Russia to help reduce inflationary pressures and combat supply chain issues. For Western firms, this means supply chains will require closer monitoring.

In the case of China, it will be important for organizations to monitor how the world's second largest economy copes with a cocktail of inflation, COVID lockdowns and US monetary tightening. In 2015, worries over Chinese economic growth and declines in its stock market and currency prompted wider international concerns. From a geopolitical perspective, a Chinese slowdown would weigh on fragile economies that depend heavily on China for trade.

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