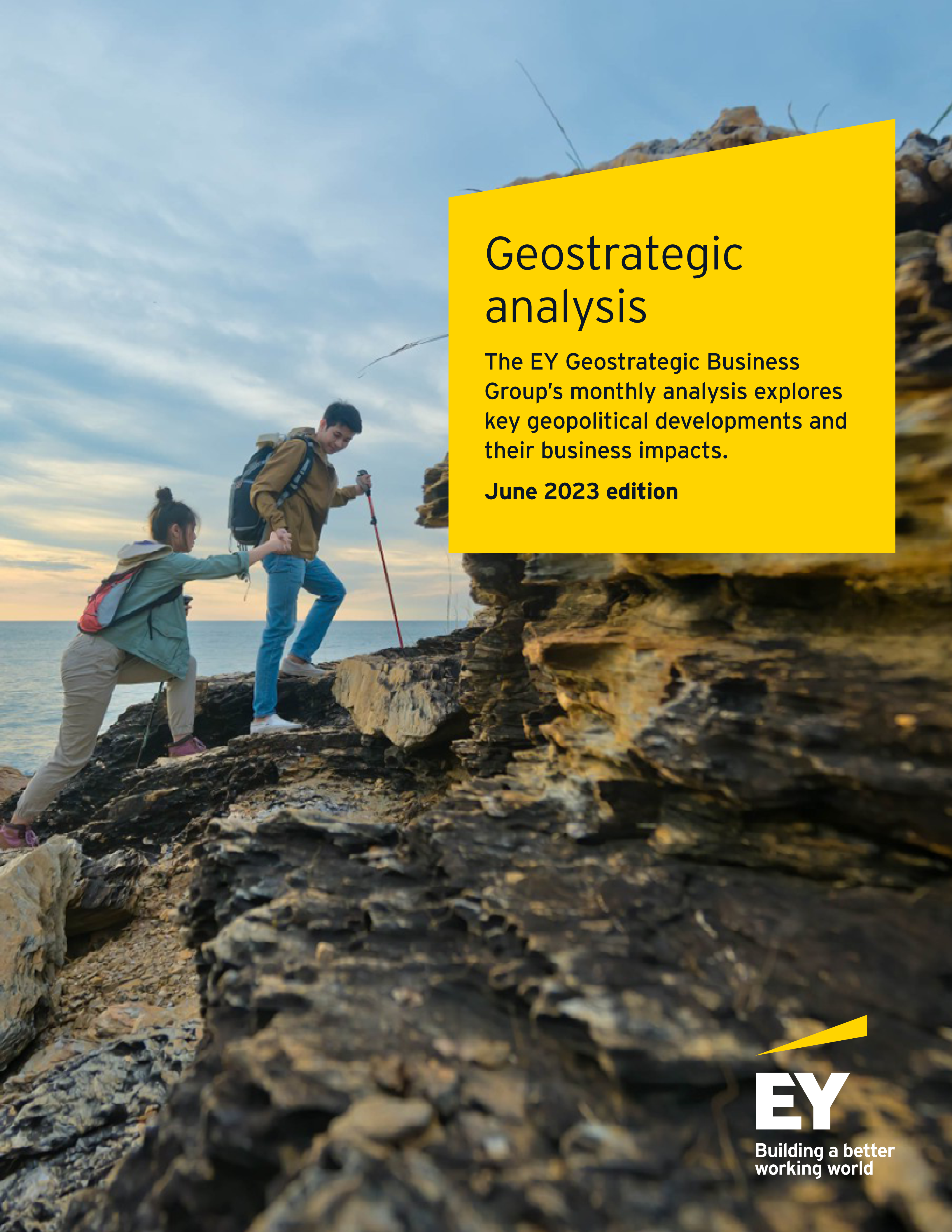

Geostrategic analysis

The EY Geostrategic Business Group's monthly analysis explores key geopolitical developments and their business impacts.

June 2023 edition

Building a better working world

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Translating geopolitical insights into business strategy

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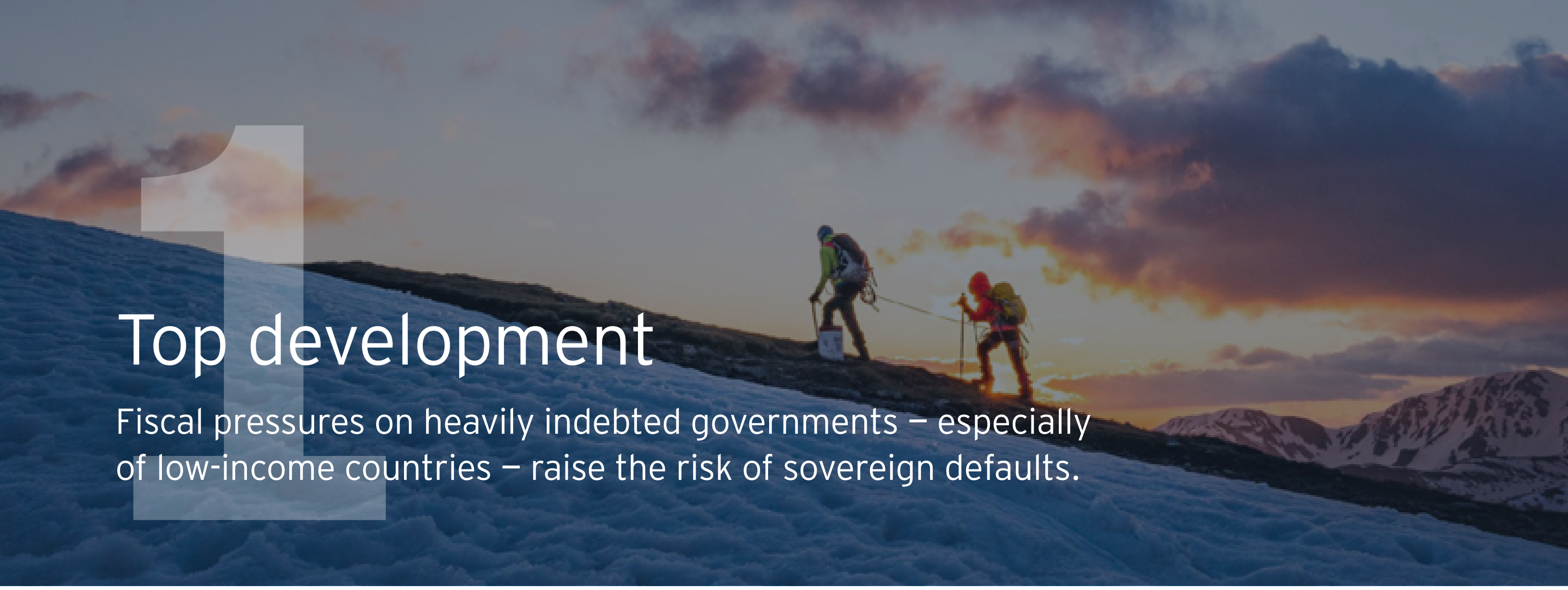


Top development

Fiscal pressures on heavily indebted governments — especially of low-income countries — raise the risk of sovereign defaults.

What happened

In 2022, public debt in emerging markets rose to 65.7% of GDP, driven in part by spending related to the pandemic and the war in Ukraine, including measures introduced to tackle the energy crisis.[1] The tightening of global monetary policy has also increased interest payment costs, particularly for the poorest countries.

The 2023 Spring Meetings of the World Bank Group and International Monetary Fund (IMF) dealt with concerns about a potential wave of debt restructuring requests. According to the IMF, nine low-income countries (LICs) are in "debt distress" and another 27 are at "high risk."[2]

China — which, by some estimates, holds more than 50% of developing countries' official debt[3] — recently announced it is willing to collaborate on the implementation of the G20's Common Framework for debt restructuring.[4]

What's next

While central banks have already reached or are nearing a peak in their tightening cycle, borrowing costs are expected to remain high amid continued elevated interest rates and macroeconomic uncertainty.

Heavily-indebted governments will likely struggle to issue additional debt to finance countercyclical fiscal policies to prevent economic stagnation and help households deal with inflation — while also seeking to mitigate climate change and invest in infrastructure.[5]

Lebanon, Sri Lanka, Suriname and Zambia will continue seeking a deal with creditors to restructure their debt, after defaulting in recent years. Several other emerging and frontier markets are expected to remain at high risk of default.

The "Summit for a New Global Financial Pact" on 22-23 June aims to expand fiscal room for debt-distressed LICs to fight climate challenges through the global adoption of the G20 debt-relief Common Framework.[6] Other initiatives that will be discussed include expanding advanced economies' contributions to the IMF's reserve assets and channeling private investments to fill development funding gaps, including those related to climate change.

As a major lender, Beijing's collaboration with other official creditors will be key to unlocking debt negotiations. Debt restructuring would enable financially vulnerable governments to improve their fiscal sustainability and possibly access new IMF funding programs and loans from other lenders.

Longer term, high interest rates and rapidly aging populations are also likely to weigh on public finances through increased pension and healthcare costs, which could lead to a deterioration in credit ratings for many advanced-economy governments.[7]

Business impact

Major sectors affected include financial services, government and infrastructure, private equity and energy and resources.

Elevated interest rates will continue to make it harder for some companies to obtain credit and meet existing debt obligations. However, this may present opportunities for private equity firms and non-traditional lenders.

As governments' cost of borrowing increases, there will be pressure to raise taxes, particularly in emerging markets in the near term. Food and fuel subsidies will also likely be reduced or removed in emerging markets, which will further add to the cost of doing business for companies across sectors and weigh on consumer demand.

Mounting public pressure on lenders to accept debt relief conditions for certain LICs could reduce the returns of private bondholders. However, better fiscal sustainability, as well as improved access to IMF financing, would decrease the risk of sovereign defaults and increase economic growth prospects.

As donor countries and financial institutions reiterate commitments to finance climate change adaptation and the energy transition in low-income countries, there may be more growth opportunities for companies to invest in green infrastructure and renewable energy projects in these markets.

For more information, contact Angelika Goliger, Courtney Rickert McCaffrey, Famke Krumbmüller

Additional reading: Five ways changing finance can finance sustainable change

[1] Fiscal Monitor (April 2023) — Gross debt position (imf.org) https://www.imf.org/external/datamapper/G_XWDG_G01_GDP_PT@FM/FM_EMG

[2] LIC DSA Comprehensive List (February 2023) (imf.org) https://www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf

[3] Policy Brief | Peterson Institute for International Economics (piie.com) https://www.piie.com/sites/default/files/documents/pb21-10.pdf

[4] China says it will co-operate on sovereign debt restructurings | Financial Times (ft.com) https://www.ft.com/content/6fc457a0-f1f6-4cda-b3d3-a945e722e5ba

[5] China and the Sovereign-Debt Bomb by Anne O. Krueger — Project Syndicate (project-syndicate.org) https://www.project-syndicate.org/commentary/debt-restructuring-china-paris-club-imf-by-anne-o-krueger-2023-01

[6] Summit for a New Global Financial Pact: towards more commitments to meet the 2030 Agenda? (focus2030.org) https://focus2030.org/Summit-for-a-New-Global-Financial-Pact-towards-more-commitments-to-meet-the-1030

[7] Ageing populations 'already hitting' governments' credit ratings | Financial Times (ft.com) https://www.ft.com/content/f434c586-db1f-4d81-8b29-989db5c78f72

2 Sector in focus: Financial services

Banking turbulence will prompt tighter credit conditions and an expansion of regulations.

What happened

A confluence of economic, monetary policy and bank management factors, as well as prior regulatory changes, created liquidity and solvency challenges that led to the failure of three regional US banks and one large Swiss bank in recent months, prompting the intervention of regulators to prevent contagion and a broader banking sector crisis.

The US Federal Reserve[8] and the Federal Deposit Insurance Corporation[9] (FDIC) issued reports that called for an extension of the coverage of some regulations, such as capital requirements and liquidity coverage ratios, to reinclude midsized banks following a loosening of regulations in 2018.

What's next

Banking sector stress will persist, especially in the US, leading to tighter credit conditions even as the US Federal Reserve nears the end of its monetary policy tightening cycle.

New US banking regulations are unlikely in the short term, as Congress is unlikely to act. But US regulators will tighten oversight for midsized banks and prioritize regulations that can be implemented without Congressional action.[10]

The plurilateral Basel Committee on Banking Supervision will also continue to assess whether changes are needed in its global regulatory standards and how they are enforced, as well as potential increases in the supervision of non-bank financial institutions.[11]

Business impact

Idiosyncratic bank risks, limited contagion and rapid policy responses mean a banking "crisis" is unlikely to occur, although pressure on small and midsized US banking institutions will persist, which will increase the potential for consolidation in the sector.

The cumulative effect of historically high inflation, rising interest rates, and tighter credit conditions in the wake of banking sector developments will likely lead to lower consumer spending, housing activity and business investment across most sectors, particularly in the US — which could have a negative effect on the global economy as well.

For more information, contact Gregory Daco, Courtney Rickert McCaffrey and John Hallmark

Additional reading: 8 areas of change for financial services regulatory policy in 2023

8 Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf
9 FDIC'S supervision of signature bank https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf
10 Fact sheet: President Biden Urges Regulators to Reverse Trump Administration Weakening of Common-Sense Safeguards and Supervision for Large Regional Banks | The White House https://www.whitehouse.gov/briefing-room/statements-releases/2023/03/30/fact-sheet-president-biden-urges-regulators-to-reverse-trump-administration-weakening-of-common-sense-safeguards-and-supervision-for-large-regional-banks/
11 Press release: Basel Committee to review recent market developments, advances work on climate-related financial risks, and reviews Basel Core Principles (bis.org) https://www.bis.org/press/p230323a.htm

3 Other issues we are watching

EU efforts to enforce sanctions will increase pressure on global supply chains.

EU has increased cooperation with G7 allies to monitor sanctions implementation and is expected to finalize in the coming weeks measures to penalize several entities based in third-party countries — mainly in Asia and the Middle East — for allegedly helping Russia to evade Western sanctions. But fears of potential retaliations from targeted countries is likely to limit the scope and magnitude of any new EU sanctions.[12]

Business impact: Growing pressure on companies to ensure compliance with Russia-related sanctions will likely increase supply chain due diligence costs and heighten reputational risks, especially for producers and traders of dual-use goods and technologies such as semiconductors. Sanctions on entities based in third countries, and potential retaliatory measures from host governments, will likely drive Western companies to consider further diversifying supply chains to manage political risks.

For more information, contact Famke Krumbmüller

G7 summit reinforces "friendshoring"

The May G7 Leaders' Summit[13] reinforced the G7 as the Western powers' preferred venue to address critical transnational issues — while also seeking to forge partnerships with several strategic emerging markets and Indo-Pacific countries.[14] In addition to the war in Ukraine and associated sanctions, summit leaders discussed China's role in the global economy, artificial intelligence (AI) and data regulation, and climate change mitigation and adaptation. The US reportedly used the meeting to push countries to consider outbound investment restrictions similar to the regime it is expected to announce later this spring.

Business impact: The G7 summit outcomes suggest the world is continuing to move toward a scenario in which governments prioritize strategic supply chains within their alliances, and companies shift toward "friendshoring" key operations and supplies. Expanded sanctions on Russia reinforce the restructuring of trade flows along geopolitical fault lines. And Japan's effort to harmonize digital regulations could help companies manage their digital efforts across the G7 markets. Calls to regulate generative AI through "guardrails" will likely lead to joint efforts on how to approach this challenge, but any progress is likely to be slow.[15]

For more information, contact Douglas Bell

Sudan conflict threatens Red Sea stability

Since fighting broke out between the Sudanese Armed Forces (SAF) and the Rapid Support Forces (RSF) on 15 April, more than one million Sudanese have been displaced.[16] In May, Saudi Arabia and the US mediated an agreement by the SAF and RSF to minimize civilian harm and allow humanitarian aid to flow into the country.[17] But repeated cease-fire violations raise the risk that the conflict will cause Sudanese farmers to miss the current planting season, as the UN warns Sudan is at increased risk of famine.[18]

Business impact: Port Sudan, which is estimated to account for 90% of the country's international trade and 30% of imports for Sudan's land-locked neighbors, has been effectively closed since the onset of the crisis.[19] Sudanese oil production may deteriorate and logistical challenges are likely to impair South Sudanese oil from flowing to Sudanese ports. International supply chains traversing the Red Sea — which currently facilitates 10% of global trade, including nearly all maritime trade between Asia and Europe — could face costly delays and service interruptions.[20]

For more information, contact Angelika Goliger

[12] EU gets more cautious on hitting third countries over Russia sanctions | Reuters https://www.reuters.com/world/draft-new-eu-sanctions-update-more-cautious-hitting-china-document-2023-05-16/
[13] Communiqué | Summit Documents | G7 Hiroshima Summit 2023 https://www.g7hiroshima.go.jp/documents/pdf/Leaders_Communique_01_en.pdf
[14] Participants | Summit Information | G7 Hiroshima Summit 2023 https://www.g7hiroshima.go.jp/en/summit/members/
[15] G7 leaders call for 'guardrails' on development of artificial intelligence | Financial Times (ft.com) https://www.ft.com/content/1b9d1e21-ebc1-494d-9cce-97e0afd30c2d
[16] Sudan | Situation Reports (unocha.org) https://reports.unocha.org/en/country/sudan/
[17] On the Declaration of Commitment to Protect the Civilians of Sudan — United States Department of State https://www.state.gov/on-the-declaration-of-commitment-to-protect-the-civilians-of-sudan/
[18] Sudan crisis: UN launches record country appeal for 18 million in need | UN News https://news.un.org/en/story/2023/05/1136737
[19] Sudan's Economic and Supply Chain Problems Continue to Escalate (ismworld.org) https://www.ismworld.org/supply-management-news-and-reports/news-publications/inside-supply-management-magazine/blog/2022/2022-03/sudans-economic-and-supply-chain-problems-continue-to-escalate/
[20] The Complicated Nature of Red Sea Geopolitics (arabcenterdc.org) https://arabcenterdc.org/resource/the-complicated-nature-of-red-sea-geopolitics/

Geostrategic indicator of the month

Share of global GDP and population in 2023

The indicator

Foreign ministers from the BRICS (Brazil, Russia, India, China and South Africa) are meeting in Cape Town in early June to discuss the possible accession of up to 19 countries which have applied, formally or informally, to join the coalition.[21] Most of these emerging markets are "geopolitical swing states," which are seeking to maintain relations with multiple global powers to minimize economic damage and avoid diplomatic entanglements. These countries' economies and population sizes demonstrate how much more influential the BRICS could become with additional members.

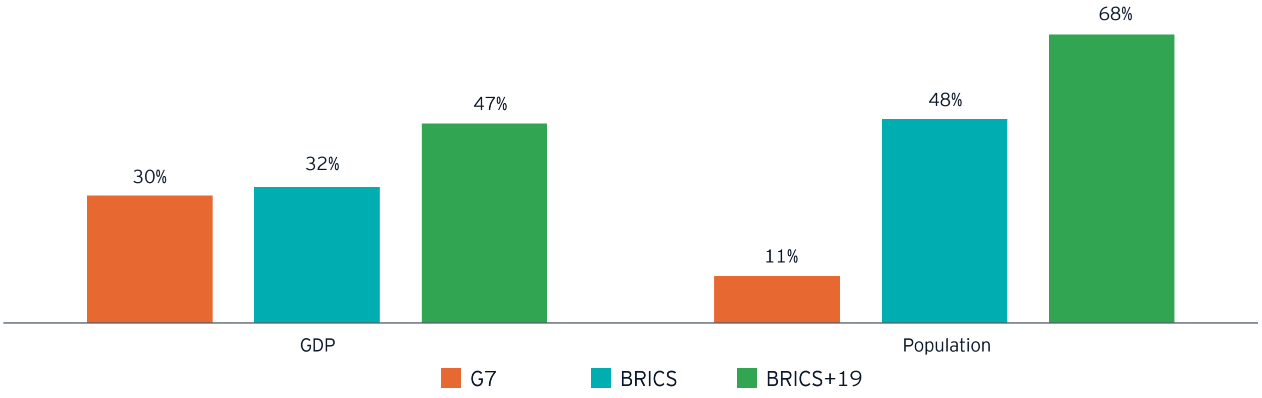
Business impact

The BRICS group is often seen as an alternative to Western-led institutions, such as through their New Development Bank, which was created in 2015. Many of the BRICS — or the BRICS+19 — are likely to play an increasing role in global supply chains and provide growth opportunities for companies in a variety of sectors.[23] At the same time, these countries' foreign policies could lead to sudden shifts in pressures from companies' stakeholders and changes in reputational risks, depending on the geopolitical positioning of companies' home-country governments.

Additional reading: How to shift strategy for a new geostrategic era in 2023

The current and potential BRICS countries account for a larger share of the global economy than the G7

Share of global GDP and population in 2023, by country grouping



Sources: World Economic Outlook Database — IMF.org, April 2023.[22]

Note: GDP is measured at purchasing power parity. This list of 19 potential new BRICS members was composed using multiple news reports (including state-run media outlets). Countries that have reportedly applied, formally or informally, are Afghanistan, Algeria, Argentina, Bangladesh, Bahrain, Egypt, Indonesia, Iran, Kazakhstan, Mexico, Nicaragua, Nigeria, Saudi Arabia, Senegal, Thailand, Turkey, United Arab Emirates, Uruguay and Zimbabwe.

[21] BRICS Draws Membership Requests From 19 Nations Before Summit — Bloomberg (Bloomberg.com) https://www.bloomberg.com/news/articles/2023-04-24/brics-draws-membership-requests-from-19-nations-before-summit#xj4y7vzkg

[22] World Economic Outlook Database — IMF.org, April 2023 https://www.imf.org/en/Publications/WEO/weo-database/2023/April

[23] BRICS Investment Report | UNCTAD https://unctad.org/publication/brics-investment-report

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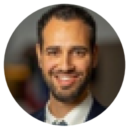
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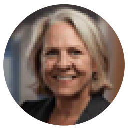
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