Managing risk in a global energy crisis

Geopolitical risks have been on the rise and reached a new high with the conflict in Ukraine – the dominant risk in 2022. The conflict had multiple repercussions on the global economy and political risks. Global economic and financial conditions deteriorated fast. Europe landed in an energy crisis, the global economy experienced a slowdown, inflation levels rose, and we saw a sharp monetary tightening. The end of cheap money combined with record-high debt levels and weakened macroeconomic fundamentals for many countries, paved the way for a potential wave of debt distress and restructuring.

War in Ukraine: a significant political risk

On 24 February 2022, a geopolitical earthquake shook up political risks in Europe when Russia started a war against Ukraine. The return of a major conflict in Europe has had many repercussions and raised risks of various kinds. It is a game changer. First, it unified EU states, brought US and EU allies closer to each other, and accelerated the fragmentation of our world order on political, security, economic, technological and monetary sides – e.g. China's no-limit partnership with Russia, and Iran's weapon supplies to Russia. Far-reaching EU and US sanctions against Russia's energy and financial sectors amplified this trend as many emerging countries increased their trade with Russia. Since they were using alternative payment systems and currencies, this weakened the US dollar hegemony in trade and capital flows. The new multipolar world shaped by a US-led and a China-led bloc promises to be more volatile, risky and costly, and to fuel lasting shifts in (de)globalisation. Sharp US restrictions on chip exports to China and a deepening cooperation between non-Chinese chipmakers illustrate this trend. A second consequence of the war in Ukraine was obviously that it raised security risks and highlighted rising global geopolitical risks for the future. Its full fallout remains uncertain as it depends on the geographical extent beyond Ukraine, the brutality and the duration of the war.

Taiwan is the other main worrying geopolitical risk. During the summer of 2022, China made unprecedented, intense military drills around Taiwan following US house speaker Pelosi's visit to the island. As tensions have escalated, those live exercises can be interpreted as a rehearsal for a potential future invasion, which could have a huge global political and economic impact. The record number of missile launches in North Korea, worsening security risks in the Sahel, heightened tensions in some Balkan countries and the first long landslide protests in decades against the mullah's regime in Iran were the other major (geo)political risk events of 2022.

The war in Ukraine has had a major impact on the global economy. It has led to an energy crisis, which was particularly acute in Europe – given its reliance on shrinking Russian gas supplies – and challenging for European companies' competitiveness. Moreover, the conflict raised commodity prices and brought inflation to high levels worldwide, which triggered a rapid and strong synchronised monetary tightening in the USA, Europe and many emerging countries. At the same time, China's continued zero-Covid policy and real estate crisis harmed the world economy and global supply chains. In this overall context of inflation and slowdown, corporate costs went up and investment decisions fell, whereas household consumption soared because of the high cost of living.

PASCALINE DELLA FAILLE,
Country and Sector Risk Manager at Credendo

"The Russia-Ukraine conflict raised commodity prices and brought inflation to high levels worldwide, which triggered a rapid and strong synchronised monetary tightening in the USA, Europe and many emerging countries."

Even though global GDP growth halved in 2022, the Middle East and North Africa (MENA) was the only region to perform more strongly thanks to high hydrocarbon prices. Europe and the CIS countries – the ones most affected by the conflict in Ukraine – recorded the weakest regional results.

In many emerging and developing countries, high fuel, food and fertiliser prices widened food insecurity, and instigated social protests and political instability. Indeed, governments had ever less room for manoeuvre as their public finances, borrowing capacity and external debt servicing were harmed by higher interest rates and a stronger US dollar. The heightened risk of a public debt crisis amid persisting record-high debt levels and deteriorated macroeconomic fundamentals after two major global shocks, led several countries (such as Sri Lanka and Ghana) to default on their sovereign debt. Ukraine, Russia and Belarus also defaulted but for other reasons.

Looking ahead, a wave of defaults in the public sector – as well as in the private sector – is to be feared in the coming years. This is also explained by the fact that many countries – to support their weakening economy or to prevent a default – have sought IMF assistance. However, IMF support is made conditional on debt restructuring if the return to long-term debt sustainability is not guaranteed. Therefore, long and complex public debt restructuring negotiations are to be expected. Limited or slow progress witnessed over the past years in the context of the Common Framework for debt treatments beyond the DSSI – whether referring to the G20 Debt Service Suspension Initiative (Chad, Ethiopia and Zambia) or not (Sri Lanka and Suriname) – demonstrates the high challenges expected for the many countries that might fall into debt distress. Those difficulties lie mainly in the broad diversity of creditors, particularly the high share of private creditors and large emerging countries, especially China.

In what increasingly looks like a polycrisis world, 2022 showed how much climate change is part of it. It was indeed another record year with higher temperatures and more extreme natural disasters across all regions, from heatwaves and droughts in Europe and China to floods in Pakistan and Brazil. In itself and by exacerbating other risks – such as the energy crisis and food insecurity – the intensification of climate change will continue to be a dominant and permanent political risk for the global economy.

Evolution of Credendo's country risk classifications

General trend for MLT, ST and business environment risk ratings in 2022

While 2021 was a year of recovery in risk ratings as the Covid-19 pandemic impact waned, the war in Ukraine was a new big shock affecting risks worldwide. The impact was mostly negative for the short-term (ST) political risk as 24 downgrades were recorded – among which Georgia, Belarus, Ukraine and Russia by more than one notch. The highest number of downgrades was seen in Sub-Saharan Africa (7 countries) as liquidity eroded due to higher food and fuel imports. Sub-Saharan Africa was followed by the CIS region, with a wave of downgrades (6 countries) reflecting the fallout of the Russian-Ukrainian conflict, then by Asia (5 countries), Latin America and the MENA region (3 countries).

A total of eighteen upgrades (including 8 very small economies) was recorded, mainly in Latin America (12 countries), as many small Caribbean islands benefited from the recovery in tourism revenues, and some in Sub-Saharan Africa (3 countries). The business environment risk showed a more positive note as the number of upgrades (64 countries, including 18 very small economies) exceeded the number of downgrades (48 countries, including 10 very small economies). Indeed, the trend of partially reversing the tsunami of 2020 downgrades related to Covid-19 continued in 2022, underpinned by high commodity prices. This was particularly the case in Latin America (28 countries) and Sub-Saharan Africa (12 countries). Asia (12 countries) and the MENA region (8 countries) also displayed a good number of upgrades. On the other hand, the EU (17 countries, of which Estonia and Germany by 2 notches, and Lithuania by 3 notches) was hit hard by the war in Ukraine. Besides the CIS region (8 countries, of which Russia by 2 notches), also Asia (10 countries among which 5 small economies) and Sub-Saharan Africa (6 countries) recorded several downgrades, mainly due to currency depreciation and high inflation pressures.

As for the medium- to long-term (MLT) risk, the trend remains negative for the third consecutive year with seven downgrades against three upgrades. The fallout of the armed conflict in Ukraine explained the downgrade to category 7/7 for Ukraine, Russia and Belarus. Egypt, Ghana and Sri Lanka were indirectly affected too, as they saw the resulting high commodity and food prices and deterioration of global financial conditions exacerbate their macroeconomic imbalances. For country-specific

reasons, namely political instability and a worsened security situation, Burkina Faso was downgraded to category 7/7. Oman and Guyana on the other hand, were upgraded thanks to the favourable impact of higher oil prices on their economies. Moreover, Brazil was upgraded after years of gradual improvement in its macroeconomic fundamentals.

Asia

Although the Covid-19 pandemic in Asia eased during the year, China's continued zero-Covid policy kept it in the spotlight. Economic activity was disrupted by recurrent strict containment measures in large cities and the country ended up in a property crisis. These events brought China's real GDP growth to a 40-year low of 3%, i.e. under the regional average for the first time in decades (excluding 2020 due to Covid-19). However, as from December, Beijing decided to abruptly end this three-year-long policy after rare landslide protests. Outside Asia, economies slowed down amid a detrimental economic environment. Inflation picked up as a result of the war in Ukraine and led to a cycle of monetary tightening, also aimed to fight against currency depreciation pressure vis-à-vis a strong US dollar.

Externally, a weakening Western demand started to bite exports in a largely open region. South Asia was the subregion that was by far the most affected by the less favourable external climate. Greater vulnerability to more expensive fuel and food imports led to higher inflation levels, widening current account deficits, a sharper liquidity and currency decline, which resulted in sociopolitical instability. Sri Lanka and Pakistan were the biggest victims. The former fell into sovereign debt default – a unique case in Asia this century – due to unsustainable public debts and tumbled foreign-exchange reserves. The shortage of basic goods and a steep rise in the cost of living led to a deep economic and sociopolitical crisis. As a result, Sri Lanka was the only Asian downgrade (from category 6/7 to 7/7) for the MLT political risk in 2022. Even though it temporarily avoided a similar fate thanks to external financial support and a relatively less unfavourable macroeconomic situation, Pakistan shared most of Sri Lanka's risks. On top of that, Pakistan was hit by devastating floods causing huge economic losses. Hence, Pakistan's ST political risk rating was downgraded from category 4/7 to 5/7, while keeping a negative outlook on its MLT rating (category 6/7).

In the region, the ST political risk rating of other South Asian countries (Bangladesh, Bhutan and Sri Lanka) and of Mongolia was also downgraded. As for the business environment risk, the number of countries upgraded (7 – excluding very small economies) exceeded those downgraded (5 countries), reflecting the post-Covid economic and tourism recovery.

RAPHAEL CECCHI,
Country and Sector Risk Analyst at Credendo

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Latin America

After a strong economic recovery in 2021, Latin America continued its robust recovery despite global headwinds. The main reasons are higher commodity prices – for Central America as it consists mainly of food exporters, and for South America as it has diversified commodity exporters – and skyrocketing tourism arrivals on the Caribbean islands after a hiatus of two years. On top of that, global monetary tightening has not led to large capital outflows nor to large depreciation pressures as we saw in previous periods of rapid global monetary tightening. The quick and aggressive monetary policy tightening in the region – well ahead of the curve – while macroeconomic fundamentals are historically relatively strong, is the main explanation. On the downside, as in other parts of the world, inflation reached double digits in many countries and hit a 15-year high, triggering violent unrest amid pre-existing grievances such as high wealth inequality.

The ongoing economic recovery, in combination with strong-performing currencies, was reflected in a wave of 28 countries – mainly Caribbean islands – seeing an upgrade of their business environment risk ratings. Moreover, the jump in tourism revenues buoyed the Caribbean islands' liquidity, resulting in a wave of upgrades of the ST political risk ratings of twelve countries. Also oil exporters Mexico and Ecuador were upgraded amid higher current account revenues. On the downside, three countries were downgraded: Haiti was downgraded to category 6/7 due to a deteriorating security situation, while El Salvador was downgraded to category 5/7 as foreign-exchange reserves decreased to meet sovereign external debt service payments. Chile's ST political risk was downgraded to category 2/7 as an elevated current account deficit weighed on the country's liquidity. Besides, as macroeconomic fundamentals clearly improved in the past years in diversified commodity exporter Brazil, its MLT classification was upgraded to category 4/7, and Guyana – the world's newest oil producer – was also upgraded to category 4/7.

Looking forward, the opening of China in December 2022 will support commodity exporters. Moreover, inflation has reached its peak in the second quarter of 2022 in many countries, providing room for central banks to loosen their monetary policies. That being said, fiscal policies will remain in the spotlight with potential sovereign debt defaults. Public debt has reached high levels in many countries after Covid-19, while an angry population has been requesting more social spending. The extreme polarisation in Latin America will keep unrest high while climate change-induced natural disasters (more fierce hurricanes and droughts) might adversely affect economies.

LOUISE VAN CAUWENBERGH,
Country and Sector Risk Analyst at Credendo

"A foremost concern relates to bloated public debt stocks and high debt servicing costs resulting in a severe risk for sovereign default in a growing number of African countries."

Sub-Saharan Africa

Sub-Saharan Africa's economic recovery following the Covid-19 pandemic was disrupted in 2022 by internal and external shocks. Regional economic growth reached 3.6% in 2022. The economic impact of the war in Ukraine was mixed, as on the one hand the sharp rise in commodity prices in 2022 bolstered revenues for commodity exporters, while on the other hand the severe slowdown in global demand, high inflation and soaring external borrowing costs weighed negatively on the region's economic performance. Deteriorating terms of trade exerted downward pressure on local currencies, while the overall current account deficit widened and foreign-exchange reserve levels dwindled in many countries. Commodity importers, including the major East African economies and members of the West African Economic and Monetary Union (WAEMU) took the hardest hit.

Despite adverse global conditions, there were still more upgrades than downgrades in terms of business environment risk classifications for the region. This substantiates a slower yet ongoing recovery from the huge number of downgrades during the Covid-19 crisis. The balance for changes in the ST political risk classifications was nevertheless negative, with downgrades for countries like Ghana, Tanzania, Uganda, Mali and Burkina Faso. For the MLT political risk, Burkina Faso was also downgraded to category 7/7 and Ghana to 6/7, while we went off cover for the public sector.

Regional economic growth in 2023 is expected to reach 3.7%, weighed down by depreciated local currencies, high international borrowing costs and slow global demand. Limited fiscal policy space constrains governments' options for additional spending to deal with slow growth, social unrest (related to the higher cost of living) or unforeseen shocks. In 2023, global demand for Africa's resources will remain high, inflation should ease compared to the 2022 peak, yet domestic policy rates will remain elevated while access to international capital will be limited. A foremost concern relates to bloated public debt stocks and high debt servicing costs resulting in a severe risk for sovereign default in a growing number of African countries. Today, countries like Ghana, Zambia, Mozambique, Chad and Ethiopia are considered to be in default, while risks are high in for example Kenya and Nigeria. Other major 2023 risks are connected to tense election cycles, social unrest, spreading jihadist violence and food insecurity related to adverse weather conditions. Short-term pressure on external balances of payments and limited financial options will drive even more countries to seek IMF support in 2023.

Middle East and North Africa (MENA)

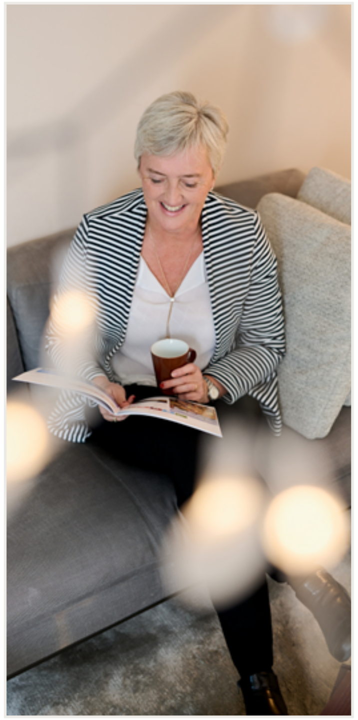
In 2022, the MENA region experienced its strongest economic performance in years. The economy grew by an estimated 5.4% in real terms. Main driver: the high hydrocarbon prices that supported economic performance and improved the fiscal and external balances of the many oil exporters in the region. Moreover, some countries, like Oman, used their higher hydrocarbon revenues to improve their fiscal standing and to step up their diversification efforts. Still, the positive regional performance hides important macroeconomic pressures and disparities across countries. While net oil exporters profited from a high oil price, net oil importers faced important pressures due to high commodity prices and tightening global financial conditions. This led to substantial pressure on fiscal balances and balances of payments in a context of vulnerable public finances for many countries (e.g. Egypt and Tunisia).

Overall, the region was also confronted with inflationary pressure, as the countries in the region are net food importers. Such inflationary pressure especially hit net oil importers with little fiscal space due to their limited buffers. In this context, the degradation of socioeconomic conditions, among other factors, has led to increased social discontent and unrest in some countries (e.g. Iraq and Tunisia). Moreover, many currencies in the region are pegged to the US dollar, so countries do not have independent monetary policies and simply follow US monetary decisions. Therefore, due to inflation pressure and tightening financial conditions in the US, many countries – such as the Gulf countries and Egypt – tightened their domestic financial conditions.

The divergent trends experienced by oil exporters and oil importers are reflected in the rating changes for 2022. In this context, eight countries were upgraded for the business environment risk – mainly oil exporters as their economies benefited from high hydrocarbon prices. Countries very vulnerable to fallouts from the war in Ukraine, such as Egypt and Tunisia, were downgraded. Important pressures on external balances from high commodity prices and tighter financial conditions also put pressure on liquidity, and as a result these two countries also saw their ST political risk downgraded. Oman, however, benefitting from higher hydrocarbon revenues, was upgraded. The same trend was observed for the MLT political risk. Given important macroeconomic imbalances exacerbated by the impact of the war in Ukraine and the very weak public finances, Egypt was downgraded from category 5/7 to 6/7, while Oman was upgraded from category 6/7 to 5/7.

Emerging-market (EM) Europe and CIS countries

The war in Ukraine is the first war on the European continent since WWII, and it has shaped economic and political developments in the region. The most impacted country was clearly Ukraine, which was downgraded to the worst country risk category (7/7) for its ST and MLT political risk. The conflict's economic repercussions are large and stretch out far beyond Ukraine, as the country is a major grain producer as well as an important producer of some specific products such as car parts and noble gases. Following the invasion of Ukraine, the EU and the USA imposed severe sanctions on Russia and to a lesser extent on Belarus. As a result, we downgraded the ST and MLT political risk of both countries to category 7/7. Russia's



real GDP contracted by 2.2% in 2022. Despite severe Western sanctions, the contraction of the Russian economy was lower than during the pandemic and in 2009. This is largely explained by Russia's very sound macroeconomic policy as well as the very high commodity prices. Despite the large trade and investment links between Russia and its neighbours, the CIS economies performed strongly. For energy exporters this was thanks to high oil prices, and for other countries thanks to the fact that they benefitted from the trade transit and Russian money inflows.

The ST political risk of Moldova – one of the most affected countries given its reliance on Russia for trade and energy – and Georgia was downgraded to category 5/7 as both requested EU membership and are likely to be hit in case of an extension of the conflict beyond Ukraine's territory. This is especially true for Moldova.

Whereas the war in Ukraine dominated the agenda, political tensions in other countries rose too, notably in the Caucasus, with heightened tensions between a heavily militarised Azerbaijan – an important gas producer – and Armenia in the Nagorno-Karabakh region. The year ended with an unresolved blockade of the only road to Nagorno-Karabakh. During the year, border disputes between Tajikistan and Kyrgyzstan led to numerous clashes while social tensions in the region were already high, as shown by the large wave of protests in Kazakhstan in January 2022. Turkey – a NATO member and maintaining a good relationship with Russia – mediated between Russia and the UN to put in place the Black Sea grain export deal. This deal allowed for a resumption of Ukrainian grain exports via the Black Sea. On the economic front, 2022 was again marked by very high real GDP growth in Turkey, while domestic and external imbalances are high (very high inflation, large current account deficit, weak liquidity), leaving the country very exposed to external shocks. Looking forward, 2023 will be marked by general elections in the country.