BOC Research Institute

Global Economic and Financial Outlook

2022Q3 (Issue 51) July 5, 2022

Highlights

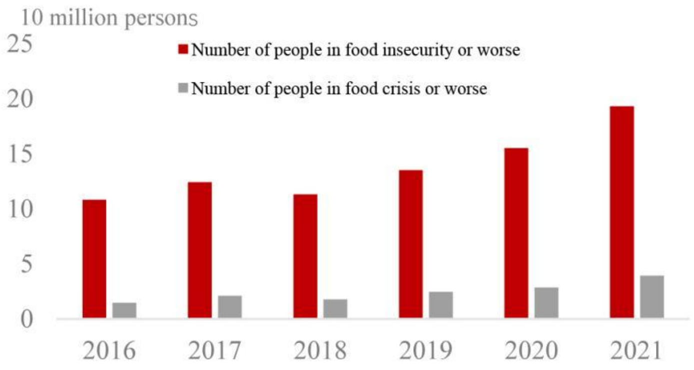
● 2022Q2 witnessed a downward pressure on both supply and demand sides of the global economy. Industrial production, corporate investment, consumer spending and international trade slowed down as economic growth softened markedly and inflation went hotter across the board.

● Global financial markets remained volatile, with the US Dollar Index going strong, major stock markets undergoing a bumpy downturn and commodity prices moving sideways at highs.

● Looking into Q3, the world economy will further slow down with stubbornly high inflation, facing a mounting risk of "stagflation". Major economies will tighten their monetary policy at a faster pace to catalyze a financial cycle shift. Higher financing costs in the market will have bigger adverse impact on the economy, leaving the world's financial markets more volatile.

● Currently, hot issues as global food trade protectionism and potential financial risks in ASEAN countries during the shifting of global financial cycle deserve attention.

Population Facing Food Insecurity



Source: Global Network Against Food Crises (GNAFC)

BOC Research Institute Global Economic and Financial Research Team

Team leader: Chen Weidong

Deputy leader: Zhong Hong

Wang Jiaqiang

Team members: Liao Shuping

Bian Weihong

Xiong Qiyue

Wang Youxin

Zhao Xueqing

Cao Hongyu

Zou Ziang

Wang Chun

Li Yingting

Lyu Haomin

Huang Xiaojun (New York)

Lu Xiaoming (New York)

Xiao Liang (London)

Li Zhenlong (London)

Wen Yingkun (Frankfurt)

Wang Zhe (Tokyo)

Contact: Liao Shuping

Telephone: 010-66594052

Email: liaoshuping@bankofchina.com

Global Dilemma of Stagflation and Financial Cycle Shift

-- Global Economic and Financial Outlook (2022 Q3)

2022Q2 witnessed a downward pressure on both supply and demand sides of the global economy. Industrial production, corporate investment, consumer spending and international trade slowed down as economic growth softened markedly and inflation went hotter across the board. Global financial markets remained volatile, with the US Dollar Index going strong, major stock markets undergoing a bumpy downturn and commodity prices moving sideways at high levels. Looking into Q3, the world economy will further slow down with stubbornly high inflation, facing a mounting risk of "stagflation". Major economies will tighten their monetary policy at a faster pace to catalyze a financial cycle shift. Higher financing costs in the market will have bigger adverse impact on the economy, sending the world's financial markets more volatile. This report provides a special analysis on the global food protectionism in the context of supply-demand imbalance and potential financial risks in ASEAN countries during the shift in global financial cycle.

I. Global Economic Review and Outlook

I.1 World economy at increasing risk of stagflation

Since 2022Q2, the Russia-Ukraine conflict has further strained the global supply chains. The prices of energy, industrial metals, food and other commodities remain high, adding to inflationary pressure on all countries. Major economies are tightening the monetary policy one after another to curb inflation, and the prospects for global recovery have darkened. The global economy is expected to slow down in Q3.

On the demand side, first, global consumption growth will subside. Most economies of the world stayed in the positive growth territory in Q2, yet gradually losing steam. The US retail and food services sales in May grew by 8.1 year-on-year (YoY), a two-month streak of increase, but dipped 0.3% from the previous month. The EU Retail Sales Index showed a similar trajectory to the US counterpart, with its YoY growth in April staying positive but month-on-month (MoM) growth turning negative. The global consumption is expected to further slow down in Q3.

Second, international trade growth will gradually soften. On the one hand, price hikes of crude oil and other energy sources will push global shipping costs higher, passing cost increase on to downstream consumers and denting import demand. On the other hand, the prolonged Russia-Ukraine conflict has significantly affected marine shipping across the Black Sea and the Mediterranean. The World Trade Organization projected a 3.0% growth in global trade in goods in May, versus a prior estimate of 4.7%. Global trade in services is set to gradually rebound as the Europe and the US are lifting COVID-19 restrictions. Given the lingering impact of COVID-19 on international business and tourist activities, however, service trade is expected to remain below the pre-pandemic level.

Third, corporate investment and inventory investment will slow down. As the global monetary policies usher in a tightening cycle, the world sees the pivot interest rate moving higher to push up the costs of corporate investment. The US Federal Reserve (the "Fed") officially kick-started its balance sheet reduction in June, pointing to a worsening global liquidity environment that will dampen corporate investing activities. In terms of corporate inventory cycle, enterprises will gradually enter the stage of passive restocking as market demand and product sales decline amid more uncertainties in global economic growth in H2.

On the supply side, first, the bottleneck on global supply chains shows modest improvements. From the perspective of energy and raw materials, Russian gas giant Gazprom has announced to suspend gas supply to European countries such as Poland, Bulgaria, Finland and the Netherlands successively, and slashed the gas flows through Nord Stream 1 to Europe by about 60% in mid-June. **From the perspective of logistics,** the container throughput at Shanghai Port, the world's largest port, declined in Q2, easing the congestion at US ports. Under geopolitical conflicts, however, the Black Sea area has seen a drop in marine shipments of various cargoes. **From the perspective of labor,** major economies are still suffering from labor shortage. The US labor force participation remains low, and UK job vacancies hit another record high in June. The bottleneck on global supply chains may ease in Q3, yet at a slow pace due to COVID-19 resurgence and prolonged the Russia-Ukraine conflict.

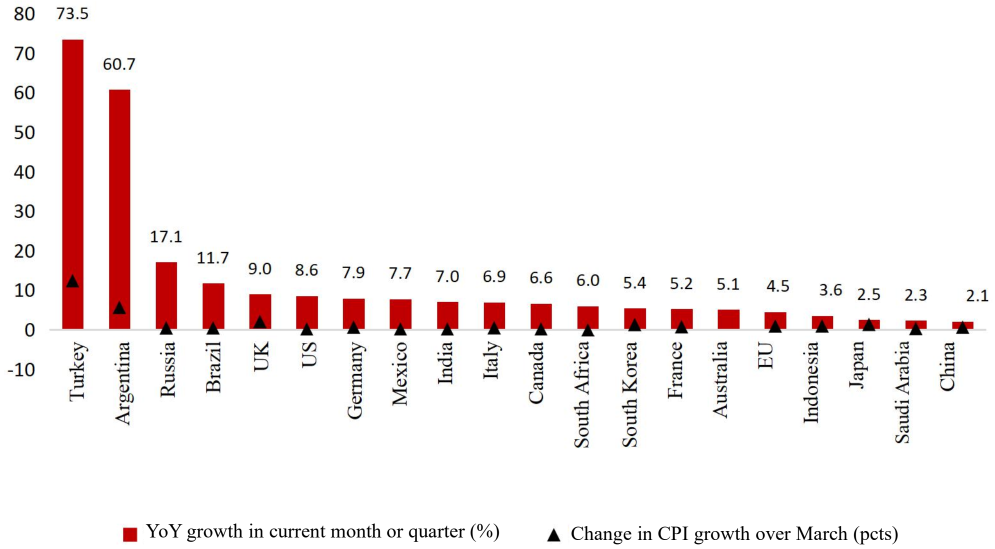
Second, global industrial production registered muted growth. The world's top 10 industrial countries, except Mexico, recorded a pullback in PMI in May from the Q1 peak, with an average drop of 2.8 percentage points. In particular, major European economies in the list had an average fall of 4.4 percentage points (Fig. 1). Against the backdrop of rising uncertainty in global economic growth, persistently high PPI and tighter financing environment, corporate investment will decelerate with a gradual contraction in market demand and corporate orders. Global industrial production is expected to further decline in Q3.

Fig. 1: PMI Drop in May from Q1 Peak in Major Industrial Nations

Source: Wind, BOC Research Institute

As shown by the price index trends, the global inflationary pressure will persist. The current inflation wave sweeping the world has reversed the low inflation trend seen in the past two decades, under the confluence of demand-supply imbalance caused by the pandemic, liquidity flood, commodity price surges and supply chain bottlenecks. Except South Africa with a slight dip in CPI, G20 economies saw the CPI inflation going hotter when compared with the end of Q1, feeling higher and higher inflationary pressure (Fig. 2).

Fig. 2: CPI Inflation Trajectory in G20 Economies



Source: Wind, BOC Research Institute

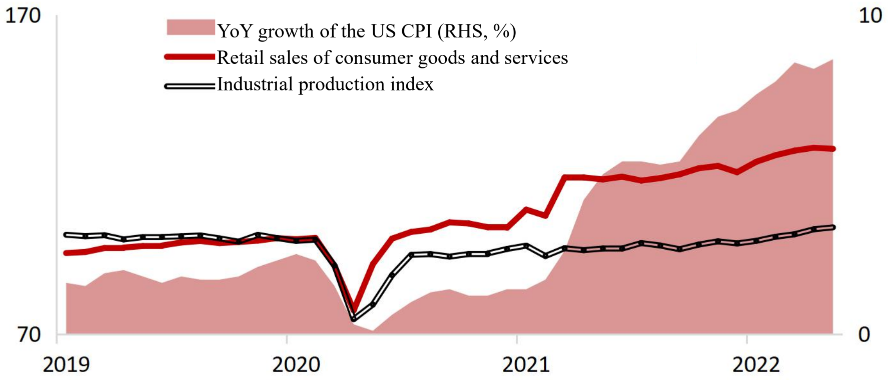
Most economies are expected to see hotter inflation in Q3, yet with national divergence. The US is under full-blown inflationary pressure as price rises are seen across food, energy, core commodities and core services. Energy and food contributed about half of CPI's jump in May, and service prices are also creeping up. The Fed's aggressive rate hikes cannot help solve supply-side problems, while financial tightening's effects on demand and consumer sides have a time lag. The euro area's inflation is mainly driven by energy prices. Energy has contributed more than half of the euro area inflation since April 2021, and the euro area is highly dependent on Russian energy. Japan's PPI rose by 9.1% in May, which will gradually pass onto consumers and push up CPI. In emerging economies, food has a bigger weight in the CPI basket, and inflation closely hinges upon food price hikes. Asian emerging economies have a food weight of about 34% in CPI, compared with roughly 30% in the Central and Eastern Europe, the Middle East and Africa, and 20% in Latin America. Countries highly dependent on the imported agricultural products, such as Morocco and Egypt, will face heavy pressure of imported inflation going forward amid the rise of food protectionism worldwide.

To sum up, the world economy will face downward pressure on both supply and demand sides in Q3, expected to significantly slow down from Q2. **The annualized Q-o-Q growth rate of global GDP in Q3 is estimated to be 2.6%, down 0.6 percentage point from Q2. The full-year GDP growth is projected to be 2.9%, down 0.7 percentage point from the March estimate.** The brewing inflation risk will continue into Q3, with a growing risk of stagflation. To tame the hot inflation, major central banks will tighten the monetary policy faster and more aggressively, putting the economy at a higher risk of recession and sending financial markets more volatile.

I.2 Economic outlook for major countries/regions

The US economy will be slowed by aggressive rate hikes in fight against persistently high inflation. Mid-2021 marked the US economy's shift from a recovery to stable expansion, but the expansion reached its middle-to-late stage in early 2022. The US economy staged a comeback in Q2, expected to remain in the positive growth territory. However, the growth is fragile as many indicators are facing a tipping point or in a downward trend. The US retail and food services sales in May grew by -0.3% MoM, pointing to the peaking of consumption. Markit manufacturing and services PMI in June fell 6.4 percentage points from the end of Q1. **Looking into Q3,** the US economy is estimated to slow again amid continuous and aggressive rate hikes. **As for consumption,** higher financing costs and stubborn inflation will erode consumers' purchasing power and affect their willingness to spend. **As for investment,** US corporate investment will shrink to become a weaker economic driver. Meanwhile, the US property market will face downward pressure as interest rates move higher. **As for net exports of goods and services,** the US imports growth will decelerate as consumer spending slows down. The US Dollar Index remaining high will also bring down import costs. Thus, the US trade deficit is expected to narrow. **As for government expenditure,** new spending plans are unlikely as the US midterm elections are forthcoming. The US fiscal policy got increasingly monetized in the pandemic era, yet also facing tightening pressure as the Fed's balance sheet reduction advances. **The US economic growth is expected to slow down to about 1.5% in Q3 and further to about 0.75% in Q4, and finish the year with an annual pace of 2%. The US economy will not slip into a recession in 2022, but exposed to a rising risk of stagflation.**

Fig. 3: US Supply and Demand Recovery vs. Inflation Trends



Source: Wind, BOC Research Institute

Europe recorded weaker-than-expected economic growth amid external shocks. Regional inflation has surged, mainly fed by higher energy costs and bottlenecks in global supply chains. The euro area inflation rose 8.1% YoY in May, a new record high. The UK inflation has stayed above 5% since November 2021, soaring to 9.0% in April 2022, a 40-year high. Supply chains have been bottlenecked in many sectors, stifling industrial output and foreign trade. According to the latest survey from the IFO Institute for Economic Research in Germany, among the respondents, 36% of retailers and 53.7% of industrial enterprises face severe shortage of raw materials. Looking ahead to Q3, high inflation and geopolitical risks will persist. The European economy will be in for deceleration, but the inflation will, to some extent, be eased by policy adjustments and energy plan implementation. **The euro area's economic growth is projected to be about 1.3% in 2022Q3, and around 2.5% for the year. The UK economic growth is estimated to be about 2.3% in Q3, and approximately 3% for the year.**

Japan's economy lacks momentum for recovery, adding to the depressiationary pressure on Japanese yen. As of 2022Q1, Japan's real GDP had not recovered to the pre-pandemic level. With an uncertain outlook for growth, the Japanese economy faces great downward pressure. On the demand side, Japan saw lackluster consumer spending, with the services sector growth inching up merely 0.06% in 2022Q1. On the supply side, performance varied across sectors. Manufacturing recovery was sluggish, with industrial PPI down 1.5% in April. Services PMI rose to 52.6% in May from 50.7% from the previous month, giving positive signals. Looking into Q3, the Japanese economy is likely to improve on the demand side as the fallout from COVID-19 fades, but will be strained by the falling Japanese yen. **Japan's real GDP is estimated to grow by 0.8% in Q3, equivalent to an annualized rate of 3.5%, and advance around 1.7% for the year.**

Emerging economies will keep expanding with regional disparities. The global surge in commodity prices has a varying inflationary effect on emerging economies. Among emerging economies, energy and food importers feel significant pressure of imported pressure, while energy exporters undergo a relatively mild inflation. In addition, the debt burden on emerging economies is soaring, and their debt service ability will be dented by the Fed's rate hikes and other external factors. Looking into Q3, emerging economies may slow down amid the world's political and economic complexities.

Table 1: Forecasts for Key Indicators of Major Economies in 2022 (%)

Region	Quarter/Year Country	GDP growth			CPI growth			Unemployment rate		
		2020	2021	2022f	2020	2021	2022f	2020	2021	2022f
Americas	United States	-3.4	5.7	2	1.2	4.7	7.5	8.1	5.4	3.6
	Canada	-5.2	4.6	3.4	0.7	3.4	6.2	9.6	7.4	5.3
	Mexico	-8.2	4.8	1.7	3.4	5.7	7.1	4.4	4.1	3.9
	Brazil	-3.9	4.8	1.5	3.2	8.3	9.5	13.8	13.6	11.2
	Chile	-5.8	12	1.7	3.1	4.5	9.5	10.6	9.1	7.7
	Argentina	-9.9	10.2	4.5	42	48.5	60.3	11.6	8.8	8.9
Asia Pacific	China	2.2	8.1	4	2.5	0.9	2.4	5.2	5.1	5.5
	Japan	-4.5	1.6	1.7	0	-0.3	1.8	2.8	2.8	2.6
	Australia	-2.2	4.4	4.1	0.9	2.9	5.3	6.5	5.1	3.9
	India	-7.4	9.2	7	6.6	5.1	6.1	—	—	—
	South Korea	-0.9	4	2.5	0.5	2.5	4.5	3.2	33.6	3.5
	Indonesia	-2.1	3.3	5.1	2	1.6	3.6	7.1	—	6
Europe and Africa	Euro area	-6.6	5.3	2.5	0.3	2.6	7	8	7.7	6.9
	UK	-9.4	7.1	3	0.9	2.6	8	4.5	4.6	3.9
	Russia	-2.9	4.7	-8.9	3.4	6.7	17	5.8	4.8	7
	Turkey	1.8	11	2.3	12.3	19.4	62.7	13.1	12	12.2
	Nigeria	-1.8	2.7	3.4	13.2	17	16.3	33.3	—	—
	South Africa	-6.4	4.9	2.1	3.3	4.6	5.9	29.2	34.3	34
Global		-3.1	5.9	2.9	3.2	4.7	6.7	—	—	—

Source: BOC Research Institute. Note: "f" stands for forecast.

II. Global Financial Review and Outlook

Global inflation has been soaring since the beginning of Russia-Ukraine conflict. Some developed economies even have hit a 40-year high in inflation. Monetary authorities of major economies have been signaling tightening and stepping up policy recalibration. In such a context, the core drivers of global financial markets are shifting. The money, foreign exchange, stock and bond markets are highly volatile and referring to present new features of cyclical movements.

II.1 Characteristics of international financial markets

Money market rates move higher, showing different change patterns among currencies. The US and the UK money markets see liquidity tightening markedly, despite the euro short-term rate (€STR) and the Tokyo Interbank Offered Rate (TIBOR) of Japanese yen staying relatively stable. The Fed's balance sheet shows structural changes. The Fed, the European Central Bank (ECB) and the Bank of Japan (BoJ) recorded slower YoY growth in assets than at the end of Q1. Since Q2, the Fed's balance sheet structure has been adjusted notably. The overnight reverse repos have spiked, with the banks' reserve ratio going down. With a tightening monetary policy, the US liquidity holders are shifting to non-bank financial institutions away from the banking system. Its impact on financial markets and the broader real economy is worth noting. The TED spread of US dollar settled back into a stable pattern after an upward blip sparked by the rate hike in Q1. The tightening pressure on offshore USD liquidity has eased significantly. Offshore euro liquidity has tightened amid growing expectations of rate increases in the euro area. In contrast, the offshore liquidity of British pound remains stable in general. The volume of SOFR-based transactions of US dollar has expanded as the benchmark rate reform advances.

The US Dollar Index jumped to as high as 105, with the Japanese yen refreshing its 24-year low. Boosted by monetary policy tightening and flight to safe heavens, the US Dollar Index kept rising, with a quarterly gain of 6.7%. Other developed economies saw their currencies weaker against US dollar. Bucking the global trend, BoJ maintains an easy monetary stance. Investors have increased their short positions in Japanese yen, and the USD exchange rate against Japanese yen exceeded 135. Japanese yen has depreciated by 14.7% YTD. Russian ruble has retrieved lost ground with a sharp gain of 28%. Some emerging markets are deep in a currency crisis. Sri Lanka, Turkey, Laos and Ghana have found their currencies falling in value against US dollar by 44.0%, 24.0%, 23.9% and 21.5%, respectively. Asian currencies are generally under pressure. The Korean won, Malaysian ringgit and Thai baht fell by 5.9%, 4.7% and 4.5%, respectively, and the exchange rate of US dollar against Indian rupee broke above 78 for the first time.

Global stock markets oscillated in a downtrend amid geopolitical conflicts, the Fed's rate hikes and soaring inflation across the world. MSCI World Index was down 18.4% from the beginning of 2022. The slide in global stocks, led by the US market, was significantly divergent among emerging markets. The US stock market had a significant drop. In Q2, the Dow Jones Industrial Average, S&P 500 and Nasdaq Composite lost 11.56%, 16.3% and 21.9% from Q1, respectively. Emerging markets as a whole lost less than developed markets, yet showing notable national disparities. MSCI Emerging Markets Index was down 13.7% from the beginning of the year. Indonesian and Argentine stock markets performed well. Vietnam and Philippines became a drag on emerging market stocks. The global stock market saw a substantial drop in IPOs and M&As. But the M&A activity was still high in North America, with the regional financial sector contributing 28% of global M&A value.

Global government bond yields generally moved higher with a changing spread picture. The yields on 10-year US, euro area, UK and Japanese government bonds increased by 101 bps, 104 bps, 81 bps and 5 bps, respectively. The yield spread between USD government bonds and EUR, JPY and GBP government bonds widened markedly, and the spread with RMB government bonds turned from negative to positive. The US real yield of a 10-year Treasury Inflation-Protected Security (TIPS) turned positive. The rising effective interest rate will have a crucial effect on the financing costs of economic entities in the US and the trends of cross-border capital flows. The US Treasury yield curve is inverted, suggesting downbeat outlook for long-term economic growth and changing the liquidity appetite of market players.

The spillover effect of the Russia-Ukraine conflict and supply chain disruptions caused by COVID-19 beefed up global commodity prices. Overall, commodity prices were range-bound at high levels in Q2. Under a strong immediate impact of supply and demand factors, global commodity prices are shaped more by commodities' nature as goods, rather than financial instruments. The negative correlation between the US Dollar Index and commodity prices deviated from the historically familiar pattern. Crude oil price oscillated at highs. Copper price fell slightly on economic growth expectations. The real yield of US Treasuries crept up, the US Dollar Index strengthened and the gold price was under pressure in general.

II.2 Analysis of factors affecting international financial markets

The international financial markets were under the influence of many factors. First, the US and European monetary policies tightened faster. 2022Q2 saw a global shortage of energy, food and other commodities under the persistent impact of the Russia-Ukraine conflict. The situation further aggravated global inflationary pressure, forcing developed economies including the US, the euro area and the UK to hasten their monetary tightening. The Fed started a cycle of balance sheet reduction by hiking its interest rate by 75 bps in June. ECB announced to raise interest rates in July and will get out of the negative territory in September. The Bank of England (BoE) announced another rate hike in June. **Second, M&As and investment of businesses were generally sluggish.** 2022Q2 saw weaker-than-expected outlook for M&As and corporate investment amid global inflation, the Russia-Ukraine conflict and the COVID-19 pandemic. The total value and number of global M&A deals dropped significantly. Global manufacturers' investment was relatively stable, yet weaker than the level recorded for the same period of last year and the 2022Q1 average. The internal driver of corporate investment has yet to strengthen. **Third, the rising global uncertainty fueled a pickup in risk aversion.** The escalation of the Russia-Ukraine crisis, coupled with tightening liquidity conditions in major economies, led to a notable rise in global uncertainty in 2022Q2. Safe-heaven assets including US Treasuries and US dollar were much sought after among investors, while overseas Russian assets remained under pressure.

II.3 Outlook for international financial markets

International financial markets are expected to show the following characteristics in 2022Q3: First, major economies' faster monetary tightening will have a significant effect on money market trends in 2022Q3. Tighter liquidity in the money market will affect interbank lending and repos in main money markets. Offshore liquidity tightening of major reserve currencies will put higher requirements on the foreign currency liquidity management of financial institutions. **Second,** the foreign exchange market faces repricing and drastic volatility. Emerging market currencies will be generally strained. The US Dollar Index will remain relatively high amid a sluggish global economy, with the Fed moving faster to tighten its monetary policy. However, the US Dollar Index will experience a drag from the increasing risk of stagnation in the US and the euro zone's exit from negative interest rates. ECB is phasing out bond purchases and entering a rate hike cycle to prop up the euro value. Unlike the European and US push for balance sheet reduction, BoJ maintains massive debt purchases. Japanese yen will linger at low levels. Emerging market currencies will remain under pressure posed by the world's persistent inflation, monetary policymakers in lockstep in hastening rate hikes across emerging markets and the mounting stagflation risk and debt burden. **Third,** the spread of a risk-averse mood poses a remarkable downside risk to global stocks. The confluence of global hot inflation, slowing economic growth, the Russia-Ukraine conflict, supply chain disruptions and central banks' rate hikes have thrown global stock markets into tailspin. Going forward, global stock markets are under higher downward pressure. **Fourth,** government bond yields will continue to rise, possibly with a sustained inversion of yield curve. In 2022Q3, the pivot interest rate will further go up, and main monetary authorities will also launch their plans to taper the balance sheet. Government bond yields will probably move higher to drive up the financing costs of economic entities. As the Fed accelerates rate hikes, the term spread of Treasury bonds is narrowing, with the term spread contraction or even inversion expected to continue. **Fifth,** commodity prices are poised for a rebound in the short run, the European energy policy is shifting from "climate security" and "energy security", and the energy shortage forces a return to traditional energy sources. Major central banks will speed up their monetary policy tightening in 2022Q3, with the uncertainty in the Russia-Ukraine conflict set to continue impacting the commodity prices over the short term. The crude oil price is expected to have a firm floor, the copper price to rebound mildly and the gold price is likely to move higher. Given the evolving of Russia-Ukraine conflict and the contagious effects of related sanctions and anti-sanctions, the Europe faces many difficulties in addressing the energy shortage. The European energy market will face a turbulent and volatile period ahead. The government, market and residents will be struggling with challenges from the structural shift of energy use, tradeoffs with suppliers, return to traditional energy and substitution of green energy. **Sixth,** as the Fed steps up balance sheet shrinkage, the market may see a rise in liquidity strain and risk. The US financial market may face a mildly higher overall risk in Q3.

III. Special Research

Topic 2: Potential financial risks in ASEAN countries during the shifting of global financial cycle

1. ASEAN countries' macro policy shift

ASEAN countries have staged an economic recovery in 2022, but under a mounting pressure of stagflation. Singapore, Vietnam, Malaysia, Indonesia, Philippines and Thailand recorded a YoY GDP growth of 3.4%, 5.03%, 4.98%, 5.0%, 8.27% and 2.2% in Q1, respectively. The Russia-Ukraine conflict and soaring energy prices have exposed ASEAN countries to persistently higher risk of imported inflation, yet with national disparities. The CPI inflation in May was 7.1%, 3.55%, 5.4% and 2.86% for Thailand, Indonesia, Philippines and Vietnam, respectively. ASEAN countries are shifting their macro policies and accelerating rate hikes amid the sluggish global recovery from the pandemic, the Fed's faster exit from an easy monetary policy and the buildup in local inflationary pressure.

II.3 Outlook for international financial markets

International financial markets are expected to show the following characteristics in 2022Q3: First, major economies' faster monetary tightening will have a significant effect on money market trends in 2022Q3. Tighter liquidity in the money market will affect interbank lending and repos in main money markets. Offshore liquidity tightening of major reserve currencies will put higher requirements on the foreign currency liquidity management of financial institutions. **Second,** the foreign exchange market faces repricing and drastic volatility. Emerging market currencies will be generally strained. The US Dollar Index will remain relatively high amid a sluggish global economy, with the Fed moving faster to tighten its monetary policy. However, the US Dollar Index will experience a drag from the increasing risk of stagnation in the US and the euro zone's exit from negative interest rates. ECB is phasing out bond purchases and entering a rate hike cycle to prop up the euro value. Unlike the European and US push for balance sheet reduction, BoJ maintains massive debt purchases. Japanese yen will linger at low levels. Emerging market currencies will remain under pressure posed by the world's persistent inflation, monetary policymakers in lockstep in hastening rate hikes across emerging markets and the mounting stagflation risk and debt burden. **Third,** the spread of a risk-averse mood poses a remarkable downside risk to global stocks. The confluence of global hot inflation, slowing economic growth, the Russia-Ukraine conflict, supply chain disruptions and central banks' rate hikes have thrown global stock markets into tailspin. Going forward, global stock markets are under higher downward pressure. **Fourth,** government bond yields will continue to rise, possibly with a sustained inversion of yield curve. In 2022Q3, the pivot interest rate will further go up, and main monetary authorities will also launch their plans to taper the balance sheet. Government bond yields will probably move higher to drive up the financing costs of economic entities. As the Fed accelerates rate hikes, the term spread of Treasury bonds is narrowing, with the term spread contraction or even inversion expected to continue. **Fifth,** commodity prices are poised for a rebound in the short run, the European energy policy is shifting from "climate security" and "energy security", and the energy shortage forces a return to traditional energy sources. Major central banks will quicken their monetary policy tightening in 2022Q3, with the uncertainty in the Russia-Ukraine conflict set to continue impacting the commodity prices over the short term. The crude oil price is expected to have a firm floor, the copper price to rebound mildly and the gold price is likely to move higher. Given the evolving the Russia-Ukraine conflict and the contagious effects of related sanctions and anti-sanctions, the Europe faces many difficulties in addressing the energy shortage. The European energy market will face a turbulent and volatile period ahead. The government, market and residents will be struggling with challenges from the structural shift of energy use, tradeoffs with suppliers, return to traditional energy and substitution of green energy. **Sixth,** as the Fed steps up balance sheet shrinkage, the market may see a rise in liquidity strain and risk. The US financial market may face a mildly higher overall risk in Q3.

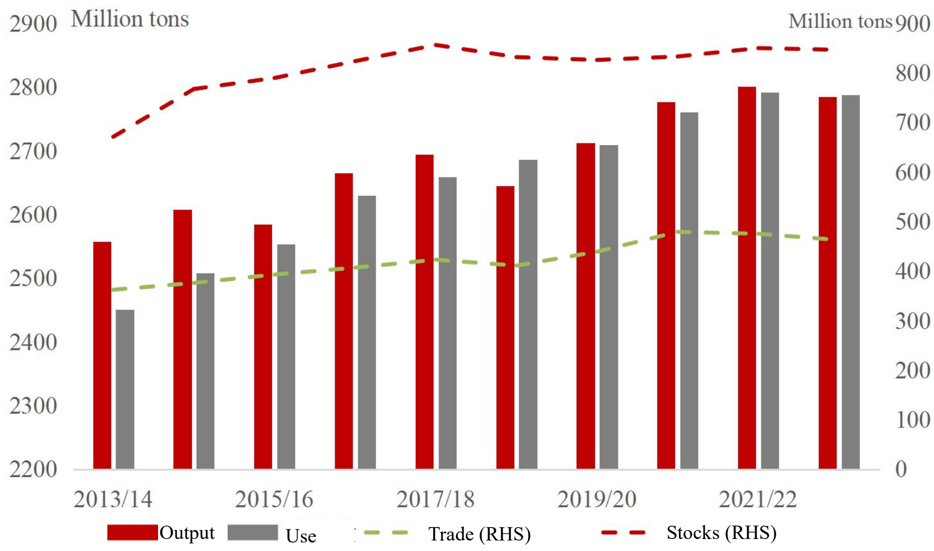
III. Special Research

Topic 1: The global food trade protectionism amid supply-demand imbalance

1. The global food supply is healthy in general, yet with structural problems on the rise.

Global food supply expanded over the past few years as the production remained high, but may experience a slight retreat in 2022. According to data from the Food and Agriculture Organization (FAO) of the United Nations (Fig. 4), the global cereal production is estimated to drop to 2.784 billion tons in 2022/2023 from an all-time high of 2.8 billion tons recorded last year after a three-year streak of growth. It means the global cereal production will be outstripped by cereal consumption again after a lapse of three years. To meet the excess food demand, world cereal stocks will fall 0.4%, and the global cereal stock-to-use ratio will dip to 29.6%, the lowest since 2013/2014. Nevertheless, the global food supply and demand have not shown any unbridgeable gap.

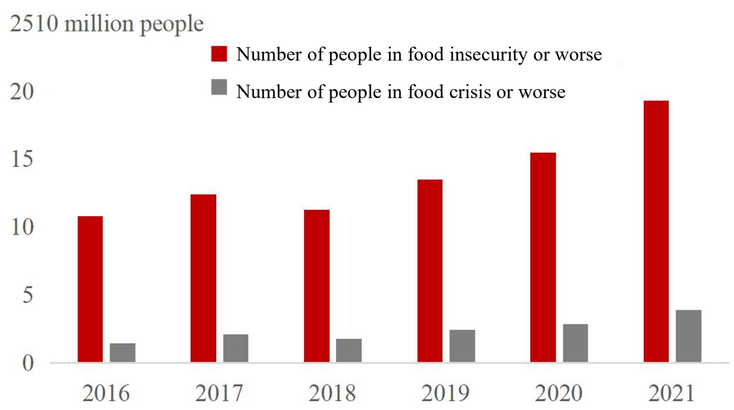
Fig. 4: Changes in Global Cereal Demand and Supply



Source: Food and Agriculture Organization (FAO) of the United Nations

Compared with the production side, problems are more prominent in food circulation and distribution in the global food market. On the one hand, cross-border flows of food have shrunk, with food prices hitting new highs frequently. The FAO Cereal Price Index averaged 169.7 points in May 2022, a record high, representing a MoM growth of 3.7, or a YoY increase of 36.7. On the other hand, the world's people exposed to food insecurity have increased substantially. The number of people in food insecurity worldwide rose from 108 million to 193 million during 2016-2021 (Fig. 5).

Fig. 5: Population Facing Food Insecurity



Source: Global Network Against Food Crises (GNAFC)

2. Global food insecurity is a combined result of many factors

First, military frictions are the principal driver of global food insecurity. The Russia-Ukraine conflict has further cast light on the war-inflicted shocks to the global food system. In 2021, the output of wheat, barley and corn in Russia and Ukraine accounted for 14.3%, 19% and 4.5% of the global output, respectively. Nearly 50 countries and regions in the world are highly dependent on Russian and Ukrainian wheat. The Russia-Ukraine conflict has disrupted the farming activity in Ukraine's main grain production areas. In addition, the blockade of ports in the Black Sea and the Sea of Azov in the Russian-Ukrainian conflict has led to the interruption of grain trade and transportation. The economic and financial sanctions imposed by the US and Europe on Russia also have crippled Russia's grain export channels.

Second, COVID-19 has aggravated the food shortage. On the one hand, the necessary inputs such as seeds and fertilizers in global grain production are sensitive to changes in global supply. The global supply chain disruptions during the epidemic have greatly curbed world grain production. On the other hand, the global grain market is an important source for some countries to make up for their domestic shortage. By restricting food trade, the supply chain disruptions directly affect these countries' demand for food imports.

Third, extreme weather and natural disasters are persistent disruptive factors to global food production. Extreme weather events in 2021 exposed 23 million people to food insecurity across the globe, up 46.5% from 2020. But the affected regions were reduced from 15 nations to 8 nations. The victims were more geographically concentrated.

Fourth, the ultra-easy monetary policy of developed economies was a significant catalyzer of food price surges. Since the onset of the pandemic, global food prices have not moved in lockstep with the changes in food supply and demand. Monetary flooding in developed economies has stoked a significant rise in commodity prices. Global food prices have started an upward trajectory since mid-2020, with the food price index hitting a new high in 2021 since 2008.

3. Food trade protectionism will further worsen the global food insecurity

Many countries have imposed restrictions on food exports as the food supply tightens and food prices stay elevated, giving a rise to food trade protectionism. After the Russia-Ukraine conflict erupted, India, Kazakhstan and other major wheat producers and exporters also banned exports of wheat. Indonesia, the world's largest palm oil exporter, suspended exports of palm oil, and the third largest price exporter Vietnam also temporarily banned rice exports. The protectionist measures in food trade will further drive up food prices, adding to the living costs or even threatening lives in countries and regions relying on imported food.

4. Suggestions on food security and trade protectionism

First, the negative impact of unilateral food policies should be lowered to protect the basic survival rights of human beings. Relevant policies should be temporary, transparent and targeted and published to the outside world in a timely manner. Necessary food exports should be retained, with the least developed countries and developing economies depending on imported food exempted from the restrictions on exports.

Second, deeper cross-border cooperation should be pursued to allocate food worldwide more efficiently. All countries should strengthen cooperation in grain production, transportation and information sharing and reduce transaction costs and information barriers to ensure unimpeded global food trade and avoid the escalation of panic over food.

Third, multilateral organizations should play a positive role in addressing food insecurity. The World Food Programme (WFP) should be supported in providing international food assistance. Developed countries and food producers with surplus should be called upon to undertake temporary excess assistance obligations.

Topic 2: Potential financial risks in ASEAN countries during the shifting of global financial cycle

1. ASEAN countries' macro policy shift

ASEAN countries have staged an economic recovery in 2022, but under a mounting pressure of stagflation. Singapore, Vietnam, Malaysia, Indonesia, Philippines and Thailand recorded a YoY GDP growth of 3.4%, 5.03%, 4.98%, 5.0%, 8.27% and 2.2% in Q1, respectively. The Russia-Ukraine conflict and soaring energy prices have exposed ASEAN countries to persistently higher risk of imported inflation, yet with national disparities. The CPI inflation in May was 7.1%, 3.55%, 5.4% and 2.86% for Thailand, Indonesia, Philippines and Vietnam, respectively. ASEAN countries are shifting their macro policies and accelerating rate hikes amid the sluggish global recovery from the pandemic, the Fed's faster exit from an easy monetary policy and the buildup in local inflationary pressure.

2. Financial market turmoil in ASEAN countries

The shift in global financial cycle has sent shockwaves to ASEAN financial markets. **In the regional foreign exchange markets,** the Fed's start of the rate hike cycle has kicked off a strong dollar cycle. ASEAN currencies are generally weaker. Malaysia and Thailand have not seen their economic fundamentals recover well due to battered tourism, with their currencies becoming the worst performers among ASEAN currencies. Vietnam keeps its currency relatively stable on robust exports and domestic economic resilience.

In the regional stock markets, ASEAN stocks have mostly gone lower amid the Fed's rate increases and slowing growth. Vietnam and Philippines led the stock crunch due to policy impact. The Vietnamese stock market has experienced a sharp loss since the Russia-Ukraine conflict began in 2022, with the Vietnam Ho Chi Minh Stock Index down 20.43% from the beginning of the year as of June 15, 2022. The Philippine central bank raised its benchmark rate by 25 bps to 2.25% on May 19, its first hike in three years. The move directly dragged the Philippine stock market down 12.3% in Q2. The Monetary Authority of Singapore (MAS) has tightened its monetary policy twice, heightening investor concerns over a recession. Singapore's stock market fell markedly in Q2, with the Straits Times Index (STI) down 8.9%. Benefiting from export of coal and nickel resources and mild domestic inflation, Indonesia stocks only dipped 0.91% in Q2, with the Jakarta Composite Index (JCI) up around 5.13% in H1. Thailand and Malaysia recorded a relatively small loss of 4.5% and 5.8% for their respective stock markets from the beginning of the year.

In the regional bond markets, ASEAN countries saw a notable capital flight amid the Fed's rate hikes. The regional bond market suffered major sell-offs with a surge in yield. As of June 15, 2022, Indonesia, Thailand, Singapore and Vietnam registered a rise of 112 bps, 105 bps, 149 bps and 122 bps in the 10-year government bond yield.

3. Potential risks in the ASEAN financial markets

The shift in global financial cycle has directly sparked the recent financial turmoil in ASEAN countries, posing potential risks to the regional financial markets. **First, the shift in global financial market affects the stability of capital flows in ASEAN countries.** Cross-border capital flows in ASEAN countries bear a close tie to the Fed's monetary policy moves, either the Fed's announcement of QE tapering in 2013 or its resumption of unconventional monetary policy during the pandemic. ASEAN has experienced temporary capital outflows amid rising US Treasury yield and hotter inflation. Compared with the massive capital flight from emerging economies triggered by the Fed's signals of shrinking its balance sheet in 2013, ASEAN countries have learnt lessons in the current adjustment cycle. Singapore and Malaysia have taken timely actions, including raising interest rates, to stabilize the market as the US monetary policy is shifting. As shown by cross-border capital flows in recent months, it is still possible for ASEAN countries to see a reversal of capital inflows ahead.

Second, risk exposures vary across countries. On the one hand, there are national disparities in economic growth and inflation. ASEAN economies keep recovering, albeit at a varying pace. In the *World Economic Outlook* published by the International Monetary Fund (IMF) in April, the 2022 GDP growth of Singapore and Philippines was projected to be 4.0% and 6.5% respectively, while its forecasts for Vietnam, Malaysia and Indonesia were revised downward to 6.1%, 5.6% and 5.4%, respectively. In addition to the COVID-19 fallout, another important contributor to the uneven recovery of ASEAN economies is their out-of-step economic policies. Indonesia and Thailand are slow to tighten the monetary policy and have not yet announced any rate hike. **On the other hand, public debt levels are different.** In the fight against coronavirus, most ASEAN countries have swelled their government spending, pushing their public debts significantly higher. Their foreign debts have edged down now, yet still above the pre-pandemic level. With the rate hike cycle forthcoming and the US dollar going strong versus other currencies, ASEAN countries will feel higher pressure in debt service.

4. Suggestions

Given the varying risks among ASEAN countries in terms of COVID-19 containment, economic recovery and financial market volatility, relevant economies should consider the following targeted countermeasures: **First, these economies should closely watch the Fed's monetary policy shift and be responsive to its monetary policy changes.** They should analyze the progress of US economic recovery, leaving more time for their policy response. **Second, the vaccination rate should be increased and the supply chain security should be ensured.** Omicron and other variants of COVID-19 have hit some countries. The vaccination rate in ASEAN nations is generally disproportionate to their severity of outbreaks, adding to their economic vulnerability. ASEAN countries should increase the vaccination supply as soon as possible to tame the virus promptly. Since some countries are sensitive to global commodity price changes, they should take actions to secure supply chains before the pandemic gets effectively reined in, thus mitigating the impact of rising commodity prices on local supply chains and industry chains. **Third, a country-specific response should be adopted according to risk levels.** ASEAN countries should retain their "domestic orientation", and adopt a monetary policy in line with domestic economic recovery to prevent risks from excessively fast tightening of monetary policy. In addition, ASEAN countries should strengthen the monitoring and early warning of cross-border capital flows. In particular, the monitoring should be more frequent and timely at the critical points of policy shift, so as to reduce the spillover effects of the Fed's policy transition and forestall a drastic reversal of cross-border flows in a forward-looking manner.

Disclaimer

中國銀行
BANK OF CHINA

BOC Research Institute
1 Fuxingmen Nei Street, Beijing, 100818 China
Postal Code: 100818
Telephone: +86-10-66592780
Fax: +86-10-66594040