TRADE IN 2023 – THE FOUR MEGATRENDS AND WHAT TO DO ABOUT THEM

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We all love a Megatrend and 2023 will be full of them: recession, inflation or stagflation, energy transition, geopolitics and global decoupling, the protracted nature of the Russia-Ukraine crisis, China's economy and foreign policy stance. We cannot ignore sustainability and the mammoth challenges ahead to prevent 2023 from being a "tipping point" in the wrong way for global climate objectives. Beyond this, we have the collapse of crypto and its impact on the tech sector more generally, America's protectionism and its stance towards Chinese technology, and of course, the impact of all of the above on supply chains.

All of this comes on the back of a 2022 that was, in the words of one commentator, "beschissen." By the author's own admission this is hardly a term that should be used in serious journalism. However, it was a general sentiment and it's hard to under-estimate the magnitude of the effects of the Russia-Ukraine crisis had, and will have, on the global economy, supply chains and of course energy and food security. Europe's self-identity of itself as a peaceful and "strategically autonomous" region with a commitment to multilateralism and enforcement of the rule of law was shaken to its core – nowhere more than in Germany where its post-war identity as a Civilian Power able to duck behind its constitution to avoid engaging in conflict was, quite literally, blown up as soon as Russia started its action in Ukraine.

Given the impact of "events" in 2022, it's of little surprise that commentators at the beginning of this year have largely stayed on the fence. It's very easy to blame global leaders for past failures to understand the strategic threat that Russia and China, as a revisionist powers, now present to the West. The key issue is how we avoid the miscalculations of the past given that we are where we are in terms of the impact of last year on everything that comes subsequently.

The most important thing that happened in 2022 was that the full impact of the 'Weaponisation of Trade' became clear. The increased use of trade for national strategic advantages morphed into an explicit use of sanctions and export controls as a weapon the West is using to constrain Russia without engaging in so-called "warfighting" because of the nuclear threat that Russia posed rhetorically, if not actually.

Much of what will emerge during 2023 therefore is about the aftermath of this process, so trade is central to the way in which defence and security professionals, economists, thought-leaders and of course trade and trade finance practitioners have to think about the world this year. So what are the key things that will drive trade during the course of the next year?

The first megatrend is the global economy, interest rates and inflation. Forecasts are mixed, with the World Bank suggesting a global recession is inevitable given upward pressure on interest rates. Much will be determined by Fed policy of course, and as the IMF is now suggesting that inflation has not peaked and that Central Banks must keep a tight hold on monetary policy, it is clear that, as any hardened economist will tell you, "inflation is sticky downwards" which is what will drive Fed policy. As Mohamed El-Erian points out, we need to avoid last year's mistake of assuming there is such a thing as "transitory inflation" – it's better to sit on the fence and say nothing in terms of inflation prediction that to suggest that inflation is going to go down.

Much of this is because the roots of inflation in this crisis are not based on things the things that are directly within the gift of Central Bankers to control. First, inflation this time around has come undeniably from the impact of Russia's action in Ukraine and the subsequent attempts to constrain that action. It was always inevitable that the West would impose sanctions and export controls – this was what happened in 2014 after Russia's annexation of Crimea. This time around the export controls have effectively meant that it is extremely difficult to use Russia as an energy supplier in Europe and the effects of the shift to alternative providers has significantly contributed to the inflation we have seen.

Second, China's attempts to recover politically and economically from long Covid were given a turbo-boost when it ended its travel restrictions. Where a few months ago the issue was whether or not China would be a threat to global trade because of its weak growth, now the issue is more directly around whether or not its manufacturing sectors can keep up with demand as staff fall sick. Given that the Chinese PMIs have been falling for the last five months, the effects of China's opening up on global inflation may yet be more severe.

The net result of all of this is that trade is the source of inflationary pressures rather than excessive demand. Volumes have not increased at anywhere near the rate of values, and this is a risk to trade and trade finance.

The second megatrend is geopolitics. The world at present is set on a pattern of economic "decoupling" although deglobalisation itself, given how interdependent the world's trading and technology systems are, is by no means obviously accelerating. Oddly, within this framework, Russia is a "known-unknown" – Putin is predictably unpredictable and we know that his relationship with the West is at best tense, and at worst destructive. The shake-out from the new sanctions regimes and export controls is only just beginning to work through but these are now factors that have become risks rather than uncertainties.

China on the other hand is an unknown-unknown and most of the uncertainty will be around how its relationship with the West pans out. There are optimistic signs of a less aggressive rhetoric and from a European perspective, this is to be welcomed. Its economy and trade are so important in the global system that any uncertainty about its economy, its technology or its foreign policy is going to add to the unpredictability of its role in the future world.

How 2023 plays out will be determined by the speed in which its economy can get back on its feet post-Covid and the resultant impact on global supply chains. It is unlikely that China will invade Taiwan because it is weak economically at present. However, as the tensions between it and Taiwan play out, it means that the Taiwan Strait, the South China Sea and the Indo-Pacific, as massive global trade routes, are going to be potentially destabilising vectors for global trade. The biggest thing, of course, is how the industrial strategy measures that the US is pursuing through the Department of Commerce actually restrict China's access to technology and therefore constrain its growth. This is already having an impact on global supply chain location as we have seen with Apple's relocation to India to circumvent some of the restrictions. This suggests there will be a trade and supply chain resilience impact.

The third megatrend is Sustainability regulation. Volumes of text have been written about sustainability and the tipping point that the planet is rapidly reaching where irreversible climate change is inevitable. There is new little to say on a subject that is so clearly devastating in every sense of the word. In a sense, the drivers for 2023 at a political and geopolitical level will be first, to ensure that climate change and net zero targets are adhered to and second to make sure that climate change regulations globally do not become a source of trade tensions or geopolitical tensions in and for themselves. The ongoing spat between the US and the EU about the Inflation Reduction Act and the EU's carbon border tax threatens trade relations and this is an unconstructive direction of travel to say the least.

From a trade and trade finance perspective the material changes are to the regulatory frameworks that will come in during the course of 2023. Companies are now bound by the European Sustainable Finance Disclosure Reporting (SFDR) standards and the EU Taxonomy reporting requirements to report on their financial allocations to areas of the Taxonomy and the associated financial risk. Correspondingly, financial institutions need to understand their capital exposure to climate risk through their portfolios and potentially use the pricing systems to mitigate the exposure and help manage the transition.

This is a large shift in the importance of ESG in the reporting frameworks and will have huge implications for trade finance practitioners: the potential tightening of AML-KYC compliance to include ESG compliance; closer scrutiny of supply chains; limitations on the number of SMEs that can access trade finance because of closer scrutiny and ultimately the tightening of trade between "compliant" and "non-compliant" countries. 2023 will be the year that all this shakes out and banks begin to assess exactly what they need to be reporting from 2024 in trade terms. It is another seismic shift and one that cannot be underestimated in its importance – expect the theme of "Capital at Risk" to go beyond compliance into climate this year.

The last megatrend is technology. The collapse of crypto may not seem to have an obvious link to trade and trade finance. That said, increasing scepticism emerged during the course of 2022 about blockchain as a panacea triggered by a number of insolvencies and mergers in Fintech businesses that illustrated key vulnerabilities in the reliance of banks on businesses funded by large equity valuations.

The technology sector as whole during 2023 will struggle. There were significant failures during 2022 as a result of over-exuberant expectations and there is now a material threat to the sector in terms of venture capital valuations and the feasibility of fundraising. Venture capital in the sector has declined dramatically while company valuations have also taken a tumble. 2023 while be a year of consolidation at best and while this is an opportunity for merger and acquisitions activity, it is also a risk to trade finance processes that rely on these technologies.

To conclude, the article describing 2023 as "beschissen" went on to use the explosion of the fish tank in the lobby of the Radisson Blu in Berlin as an analogy for what has gone wrong in the past and how we need to create a shared view of what is important in the future. It pointed out that the mere fact that a tank that size existed was a statement of first world addiction to unsustainable luxury; the fact that hairline cracks in the glass of the fish tank had been ignored for years was a metaphor for the careless exceptionalism with which we have assumed our own economic and political hegemony in the post-War period.

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If we are to avoid economic, geopolitical or climate meltdown during the course of this year, then we need to take this message on board. “Events” are a problem because we miscalculate, and strategic challenges are just that because we are not assessing their likelihood in an effective way throughout. What is clear beyond all else is that this year is the year when more than ever trade and trade finance practitioners are the “boots on the ground” of national strategies over which they have little or not control. Planning for uncertainty will be the only way to put the best foot forward!