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Research Global

Five trends to drive the global economy regardless of the outcome of the war in Ukraine

- **Fragmentation, de-globalisation and the ageing of the global labour force can lead to more persistent inflationary pressures forcing central banks back to their core, price stability.**
- **ESG issues are becoming more complex when "S" and "G" gain importance in a more fractured world creating pressures for near-sourcing and shorter supply chains.**
- **Global public debt is record high, but the new focus on defence spending, on top of the green transition, will keep public spending high, and most likely force EU countries to accept that EU debt is a permanent tool.**

We believe the world is in a turning point in more than one way. The war in Ukraine has highlighted that we have seen the end of a long and peaceful era - an era where stronger economic ties were thought to lower the risk of conflicts – a thought also at the core of EU. Even if it is too early to judge what the long-term outcome of the war in Ukraine will be, there are some trends that seem quite apparent regardless of geopolitical outcomes.

Whether we are entering a period of a cold war, hot war or something more pleasant, some trends seem certain while many of their impacts and magnitudes remain uncertain. We think that at this point it is relevant to discuss these potential outcomes and impacts. In this paper, we highlight five trends that could drive the global economy over the next 5-10 years. The five drivers we identify, are:

1. A more fragmented world, a more unified west, and a more integrated EU with larger shared liabilities,
2. Increased government spending due to defence and green transition in Europe,
3. A rapidly ageing labour force in the developed world,
4. ESG issues becoming ever more complex with the rise in 'S' and 'G' alongside continued emphasis on 'E' and
5. De-globalisation driving more persistent price pressures, forcing central banks back to the core of their mandates.

These trends are often interlinked and their effects may vary depending on the geopolitical outcomes. The war in Ukraine is driving increased investments in defence and green transition while it is almost certain to lead us to a more divided world with increased rivalry, acute threat of sanctions, and the possibility of outright warfare.

Labour markets and supply chains have been (and will in the future be) affected by both the pandemic and the war. At the same time, sustainability issues are becoming more complex after economic risks linked to operating in countries managed by authoritarian regimes have realised for western businesses, while environmental issues will stay high on policymakers' agenda.

Our recent research on war in Ukraine

- *Macro Research – a new cold war could slow growth longer term*, 29 April
- *Research Russia-Ukraine – Several signals point to an escalation in the war in Ukraine as Victory Day looms*, 26 April
- *Research Russia – EU embargo on Russian energy could be a game-changer*, 23 March
- *Big Picture – Headwinds to the global economy from Ukraine war and Fed tightening*, 17 March
- *Research Russia-Ukraine – Updated scenarios and implications for commodity markets*, 9 March

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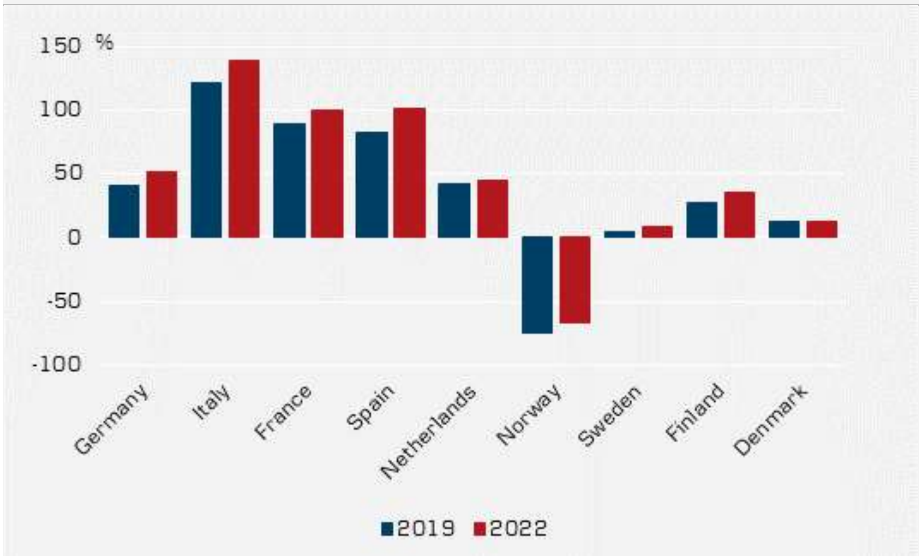
Trend #1: A more fragmented world, a more unified west, and a more integrated EU with larger shared liabilities

In our *Macro Research – a new cold war could slow growth longer term*, 29 April, we elaborate on the new world order driven by both increased longer term tensions between China and the west and now during the past months by Russia's attack on Ukraine. We see there is an increased risk of a new cold war (smaller but non-negligible risk of broader hot war as well), which would split the world into strict zones of interest, one democratic western, another autocratic eastern, ending globalisation in its current form. This extreme scenario is not our baseline but rather a milder version of geopolitical and economic blocks. In this scenario, there would still be international trade over the block borders, but integration would not continue, rather the opposite. Near-sourcing would increase in speed over the coming 10 years and supply chains would increasingly be brought home. This would all else equal put downward pressure on growth, when the positive effects from the specialisation globalisation has made possible, reverses.

Also, inflationary pressures would in this scenario be larger than during the past decades due to a less globally integrated world, less specialisation and more upwards price pressures when an increasing amount of task need to be performed in areas with rapidly ageing workforce and higher labour costs. Digitalisation and automation could ease this pressure, but these effects also come with a considerable lag.

Net public debt to GDP, % of GDP



Source. IMF WEO, Macrobond Financial, Danske Bank

In this kind of geopolitically split world, the role of the EU could potentially become even more important with its large internal market. At the same time, massive public debt will in longer term restrict the fiscal space in some EU countries, most notably those in southern Europe that need structural reforms the most.

In order to find a more stable solution longer term, we see it as likely the EU will move towards a system with a permanent EU level debt (following the temporary NGEU framework) that can be used to even out regional differences despite strong opposition to this by many of the more well governed countries in the EU. Hence, we see that the increased geopolitical tensions also call for a stronger and more stable EU. Deeper fiscal integration would enable this, but at the expense of less sovereignty of member states. EU has historically taken its largest leaps in times of crisis and this is what we expect will happen this time as well.

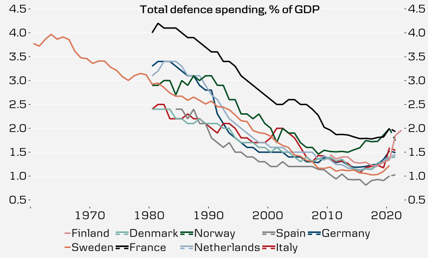
On the other hand, there is a risk of a rise in populism that cannot be excluded in this kind of scenario given that there are a lot of people who associate deeper EU-level integration and shared liabilities with economic misery. Many people also feel they have been unfairly treated during the pandemic, and at the same time, high inflation is eroding purchasing power and driving a more polarized labour market in many countries. We think success of populist parties could, if it materializes, stop the development of the federal aspects of EU and also hamper cooperation within a potential western block of countries challenging the divide between the democratic west and the autocratic block. On the other hand, this is a risk that has been imminent through the history of EU, but has yet to materialize.

Trend #2: Increased government spending on defence and green transition in Europe

After Russia launched its invasion on Ukraine, several EU countries have announced increases in defence spending going forward. We have collected information on these announcements across major European and Nordic economies. For now, only three countries, France, Norway, and Finland spend 2% of GDP on defence (in line with NATO's recommendation). For other countries, defence spending accumulates to around 1.5% of GDP and for example in Spain, defence spending is only at 1% of GDP.

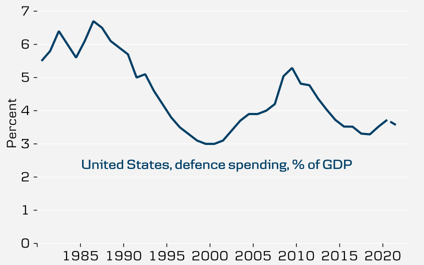
The expected rise in defence spending will have both economic and political implications. Private businesses operating in the defence sector are likely to benefit particularly if we are heading towards a new 'cold war' period (see our *Macro Research – a new cold war could slow growth longer term,* 29 April). Even in our geopolitical base case, we expect spheres of interest increasingly entering into play, which is likely to boost defence industry. Europe is likely to catch up the US in terms of their defence spending and military capacity, which, over time, should improve the power balance amongst NATO member countries. On the other hand, the post-WW2 peace dividend has allowed many other sectors to flourish, and now, higher defence spending may crowd out investments into other more productive sectors, implying a negative impact on potential growth.

Defence expenditure, % of GDP



Source: NATO, World Bank, Finnish Defence Ministry, Macrobond Financial

US defence spending is at around half the level seen during the cold war



Source: NATO, Macrobond Financial

Defence spending announced after the invasion of Ukraine	
Germany	Chancellor Scholz announced that defence spending will reach the NATO's target of 2% of GDP. The government has pledged EUR100bn in 2022 (It was EUR47bn in 2021).
France	Has not announced anything yet but the future framework of the military much depends on the upcoming presidential election as Le Pen has stated her desire for France to leave NATO.
Italy	Currently spends about 1.4% of output (EUR24.4bn) but voted in parliament to increase spending to 2% (EUR37.8bn) by 2028.
Spain	Will reach the 2% target within a "multi-annual period" according to prime minister Pedro Sánchez.
Netherlands	Nothing announced yet but opposes slacking the EU budget rules that would allow for increasing military spending.
Finland	Agrees to add EUR2.2bn to military spending spread over four years which is an increase of 70%
Denmark	Will increase spending gradually to reach 2% of output by 2033, equivalent to an increase of EUR2.45bn in annual spending
Sweden	Said it will increase defence spending EUR300m this year and reach the 2% target of GDP "as soon as possible" which will require them to spend around EUR10.62bn a year.
Norway	Pending parliamentary approval, Norway will provide an extra EUR310m towards defence

The war in Ukraine is also leading to Europe cutting their reliance on Russian energy imports. Over time, this will require massive investments in the green transition. While energy transitions certainly take time as there typically is a multi-year lag between an investment decision and the actual infrastructure investment taking place, strong political support should ensure a favourable environment for green investments going forward.

Looking at the current plans across major EU economies and the Nordics, investments will mostly target renewable energy infrastructure, energy storaging (including hydrogen technologies) and electrification of industries and transportation. While these investments are necessary in speeding up energy transition, during the transition period, other measures are needed in order to fill the gaps in energy supply. Hence, during the transition, we think governments are likely to focus more on energy efficiency by e.g. providing incentives (such as VAT discounts) on heat pumps and other energy-saving technologies. Capital inflows and investments are expected to benefit businesses that enable such technologies and solutions over the next few years.

The green transition could fuel more persistent price pressures, or at least, contribute to more volatility in headline inflation going forward. *The IEA has estimated* that sustainable development scenarios imply a scale of demand growth for metals and minerals well above the levels seen in recent decades. Electrification of western societies will require a massive amount of industrial metals such as nickel and cobalt, whose average demand growth is expected two and five times higher in the period to 2040 compared to levels seen in 2010. While renewable energy is likely cheaper than fossil energy in the long run, increased volatility in other commodity prices as a result from temporary or more permanent supply-demand mismatches could contribute to upwards inflation pressures.

At the same time, public investments in defence and green transition will support growth and can buffer economies in case we end up in a new 'cold war' period where a collapse in confidence hampers private investments and consumption. Particularly in a scenario of weaker economic growth, investments in defence and green transition need to be financed with debt, which will add further pressure on government finances. It is also possible, even likely, that some of these investments will be financed with common EU debt, which could create a public backlash as we discuss under trend 1.

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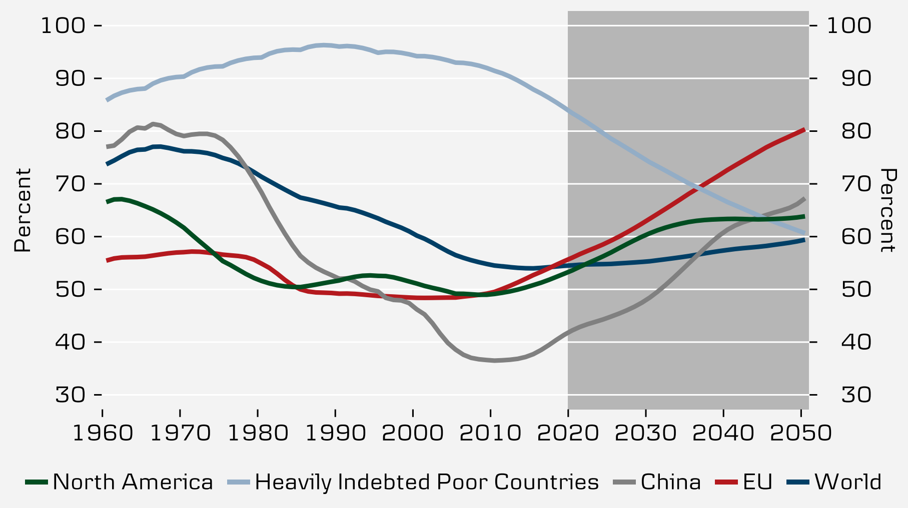
Investments in the green transition planned ahead	
European Union	Set in place the recovery and resilience plan in the wake of Covid-19 to help, among other things, advance the green transition and reach climate neutrality by 2050 by making available EUR723.8bn in total (EUR385.8bn in loans and EUR388bn in grants) to member countries. Plans approved so far show that about 40% is aimed towards climate and 26% for digital spending. It will finance reforms and investments until 2026.
Germany	Has earmarked EUR200bn to fund industrial transformation between now and 2026, including climate protection, hydrogen technology and expansion of the electric vehicle charging network.
France	The "Relaunch France" plan that was presented in the wake of Covid-19 includes EUR30bn for the green transition. Key areas in the plan are transport (EUR11bn), energy industry (EUR9bn), construction (EUR7.5bn) and agriculture (EUR1.2bn). Macron's 2030 green investment plans calls for EUR30bn to be spent on reducing carbon emmisions.
Italy	Is the largest recipient of Next Generation EU funds. At least 37% of the EUR210bn must benefit climate action. 31% (EUR69.8bn) will be allocated to the Green Revolution and Ecological Transition and more than 14% (EUR32bn) is allocated to infrastructure for sustainable mobility covering the 2021-2026 budget planning.
Spain	Will invest EUR6.9bn in renewables, green hydrogen and energy storage over the next two years through what has been called Strategic Project for Economic Recovery and Transformation.
Netherlands	Mark Rutte has put forward a proposal for a EUR35bn climate and transition fund, with EUR15bn specifically for the development of "advanced renewable energy carriers" and a proposal for construction of two new nuclear power plants.
Finland	Finland's recovery and resilience plan in 2022-2026 supports the aim to become carbon neutral by 2035 through the Climate Change Act. The plan includes EUR155m investments in energy infrastructure, EUR155m in new energy technology, EUR150m in low-carbon hydrogen and carbon capture and utilisation and EUR60m in direct electrification and decarbonisation of industrial processes.
Denmark	Government has set aside EUR940m until 2030 to assist companies that have difficulties adapting to the newly instated carbon tax. The government also aims to spend EUR33.3m in 2022, EUR53.4m in 2023, EUR44.1m in 2024 and EUR45.1m in 2025 directed towards climate and environment.
Sweden	Aims to be carbon neutral by 2045. Sweden has allocated 44.4% of its total EUR3.3bn allocation from the recovery and resilience plan towards the green transition. Key projects include EUR811m for local and regional climate investment and EUR286m to support the green transition via direct electrification and decarbonisation of industrial processes.

Trend #3: An ageing labour force

During the past decades, an abundance of skilled labour supply has played an important part for how the global economy has evolved. Outsourcing to regions with cheaper labour has been a corner stone for many corporates in the drive for increased profit. This massive wave of outsourcing has played an important role for lifting hundreds of millions of people out of extreme poverty, especially in China, but also in other countries in Asia. On the other side, the same trends have played an important role in the erosion of the middle class in the west.

Geopolitical tensions together with ageing, not only of labour forces in the west, but also in China with a delay compared to Europe and North America, this situation is up for a change. Cheap labour is only relevant if it has the right skill set and is living in areas that are politically and economically stable enough to have production facilities in. The age dependency ratio, which measures the share of working age population to total population, is not worsening considerably on a global scale during the coming decades. The problem is that the positive developments are mainly happening in still very poor countries, and is hence irrelevant on a large scale for business purposes unless substantial effort is made to create a better enabling environment for private sector. Outsourcing is only relevant if the country to which you outsource is a trusted and stable companion.

Age Dependency Ratio, the proportion of dependents as % of working age population



Source; World Bank

The ageing population, not only in the west, but also in many key developing countries, can during the coming decades play an important role in pushing up inflationary pressures due to labour shortages. If the pressure turns out to be more permanent in nature this should lead to a shift towards larger focus on capital relative to labour in the production process as capital becomes seen relatively cheaper compared to labour. More investments, automation and robotisation together with near-sourcing could in turn boost productivity growth that has been sluggish for decades, but this kind of positive outcome is far down the lane and there are many shocks and phenomena that could change the course.

Trend #4: ESG issues becoming ever more complex with the rise in 'S' and 'G' alongside continued emphasis on 'E'

Over the last decade, the global business community has met constantly rising demands from their key stakeholders on sustainability. What started as CSR (corporate social responsibility) has over time turned into ESG (environmental, social and governance) integration into a range of business activities. While green-washing and rainbow-washing still occurs, nowadays, the best-in-class responsible businesses build their business models around sustainability – not only ensuring ESG risks are appropriately managed across their supply chains and production lines, but offering products or services that contribute to solving some of the big challenges of our time, such as climate change.

We believe focus on sustainability amongst businesses will only strengthen in the future as the topic stays high on key stakeholders' agenda. However, we expect a shift in focus on sustainability-related matters with social and governance aspects rising in importance, as a result from the consequences for businesses from the sanctions against Russia but also due to higher awareness of human rights and governance issues in China.

Until now, focus on environmental sustainability and tackling climate change have dominated corporate sustainability agendas as well as the sustainability objectives of the global financial industry. The COVID-19 pandemic revealed many of the flaws and gaps in modern societies, not just in the poorer parts of the world but also in some major Western economies. Under-resourced health systems, insufficient social security nets and the unequal position of many of the blue-collar workers compared to white-collars are only some of the social problems re-identified during the pandemic.

As a result from the war in Ukraine, focus on good governance is on the rise as well. Even if sanctions would not prohibit a business from operating in Russia, reputational risks most likely do. Business leaders are likely to put more focus on country and political risks going forward as they assess which markets to target and how to organise their production. Risk assessments should include the fact that countries with authoritarian regimes resorting to constant human rights violations or countries at risk of conflicts have a higher probability of being boycotted by western businesses or targeted with sanctions by the west.

At the same time, quitting operations in any market will also have societal impacts, which responsible businesses are forced to consider as withdrawal will lead to e.g. job losses. From the viewpoint of global socio-economic development, it is undesirable that businesses would escape in masses from developing markets that are in urgent need of more private investments and economic growth.

The rising demands from key stakeholders on many businesses to do their share in tackling some of the most prominent global challenges such as climate change, loss of biodiversity and persistent global inequality will leave businesses with no other option than to integrate sustainability into their strategies and business models. Frontrunners in this field are likely to benefit in the form of more robust risk management frameworks, solid customer demand and lower cost of capital.

Trend #5: De-globalisation driving more persistent price pressures, forcing central banks back to the core of their mandates

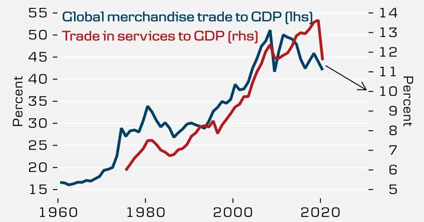
Ageing of the labour force, a broader ESG focus, the green transition and a more fragmented world with longer term geopolitical tensions all limit globalisation in some form. Supply chains that are shorter, closer and carefully chosen with the aspects mentioned above in mind, could all else equal, lead to higher price pressures also longer term.

We see that all the dominant trends right now are pushing us into a slowdown of globalisation, possibly even a reversal. The process will be gradual and be much more visible in some areas, like energy production. In the best case, many of these trends can spur innovation and investments longer term, but before this kicks in, if at all, it will create a more inflationary environment. This will in turn force central banks to give much more attention to their price stability mandates.

Over the coming year, we think central banks will do ‘whatever it takes’ to ensure inflation expectations, a key measure of their credibility, remain anchored. In both the US and the euro area, this means interest rates are soon likely to rise to levels last seen a decade, or longer, ago. How long rates will remain high, depends on the persistence of inflation pressures. Price pressures should ease if or when the global economy enters a recession, as total demand adjusts. However, in the long run, supply-side shocks discussed in this note could imply that tighter monetary policy is warranted even if growth slows down markedly.

In the best case, the pickup in innovations and productivity dominate in the long term, boosting economic growth and making tighter monetary policy less of a problem. But in the worst case, the global economy ends in a stagflation trap, detrimental not only for economic development but also for broader social cohesion. While the pandemic is fading into the background and the war in Ukraine is not causing market turbulence any longer, a lot of uncertainty prevails and only one thing is certain: the repercussions from these two ‘black swan’ events will have long-lasting implications for the operating environment of Nordic and global businesses.

Growth in global trade of goods and services has already come to a halt



Source: World Bank, Macrobond Financials and Danske Bank.

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