

Financial Services Leadership Summit

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FSLs

VIEWPOINTS

Macroeconomic and geopolitical volatility are moving to the top of the risk agenda

Financial institution leaders have been managing heightened expectations from a range of stakeholders, including increasing scrutiny of where they operate, with whom they do business, and how they treat customers. In this context, they now face formidable macroeconomic and geopolitical headwinds. The macroeconomic outlook includes persistent inflation, rising interest rates, ongoing economic shocks from supply chain disruptions and the war in Ukraine, and the looming threat of a global recession. These are coupled with resurgent economic nationalism, sanctions, shifting alliances, and increasing tensions between China and the West. These forces are causing a reassessment of operational and risk management strategies for a world that looks radically different from what institutions have experienced over the last few decades.

At the Financial Services Leadership Summit on June 8–9 in New York, directors and executives from large financial institutions, regulators, and other subject matter experts discussed evolving macroeconomic and geopolitical contexts and the implications for their firms, as part of a broader agenda about how financial institutions are meeting heightened stakeholder expectations. Summit participants were joined by Dr. Richard Berner, clinical professor of finance, professor of management practice, and co-director of the Stern Volatility and Risk Institute at New York University, and Gordon Orr, board director of Lenovo, Meituan, and Swire Pacific and vice chair of the China-Britain Business Council. This *ViewPoints* synthesizes discussions held in advance of and during the summit and is structured around the following themes:¹

- **Financial institutions face a challenging macroeconomic climate**
- **Geopolitical tensions are creating operational complexities for financial institutions**

Financial institutions face a challenging macroeconomic climate

Rising inflation and its consequences—including the impact of central banks’ attempts to bring inflation under control—and the potential for an accompanying global recession represent significant risks for financial institutions. While many observers initially predicted that inflation would be transitory, driven by price adjustments in the wake of the pandemic, inflation has proven more enduring.

Supply chain constraints resulting from the impact and responses to the COVID-19 pandemic coupled with “a huge surge in demand for goods” driven by fiscal stimulus and consumers’ pent-up demand initially triggered inflation. Russia’s invasion of Ukraine in February 2022 accelerated it by spurring what the Bank for International Settlements termed “soaring commodity prices—notably energy and food.” By April 2022 more than three-quarters of the world’s economies were experiencing inflation of 5% or more.²

Persisting high energy costs will impose social costs

While high energy costs have recently been due to supply shocks from the war in Ukraine, Dr. Berner pointed out that “some of the supply constraints originated at home, coming from investors who, unsatisfied with their returns pushed for oil and gas companies to return money to shareholders rather than investing in infrastructure.” Characteristics of energy markets mean that adjustments will come slowly: “Supply and demand for energy commodities are inelastic in the short run, so the risk is that we will have rising and high energy prices for the next several years.”

High energy prices will have a disproportionate impact on lower-income consumers and small businesses, and concurrent efforts to combat climate change could worsen those effects. One director said, “A carbon tax is quite regressive, so we need to understand how to think about that. Income inequality will be exacerbated.” Dr. Berner agreed: “It’s easy to say that we will have a carbon tax and return revenue from that to lower-income populations, but calibrating that is hard. There is potential collateral damage from the energy transition, so we need to think about unintended consequences and damage that can result.”

Recession and stagflation could be on the horizon

Central banks and governments are working to address the causes of inflation, but policy responses are likely to further hinder growth. Central banks around the world raised rates sharply over the first half of 2022: the US

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“The risk is that we will have rising and high energy prices for the next several years.”

– Participant

Federal Reserve, Bank of England, and European Central Bank all raised rates and signaled that further rate increases were likely in the future.³ Like many economists, Dr. Berner suggested that the policy response *“hasn’t been sufficient so far. But the good news is that central banks around the world are starting to acknowledge they were late and are catching up.”*

Despite these increases, the Bank for International Settlements suggested in late June 2022 that more aggressive central bank action might be needed, noting that despite rate increases by central banks across the world, real interest rates remained negative: *“Gradually raising policy rates at a pace that falls short of inflation increases means falling real interest rates. This is hard to reconcile with the need to keep inflation risks in check.”*⁴

“The Fed and other central banks can bring inflation down eventually, but not without pain or volatility.”

– Participant

Efforts to fight inflation will likely cause economic dislocations, Dr. Berner warned: *“The Fed and other central banks can bring inflation down eventually, but not without pain or volatility and abrupt changes in asset prices.”* Federal Reserve Chair Jerome Powell acknowledged the challenge facing central bankers: *“What we can control is demand, we can’t really affect supply with our policies. And supply is a big part of the story here. But more than that, there are huge events, geopolitical events going on around the world, that are going to play a very important role in the economy in the next year or so. So the question whether we can execute a soft landing or not, it may actually depend on factors that we don’t control.”*⁵

Recession seems likely and stagflation is a possibility. Dr. Berner said, *“Given supply issues, there is a risk of either very slow growth or a recession, maybe not deep, but protracted, as central banks work to bring inflation down and supply shocks continue.”* But the depth and length of economic woes depends largely on productivity growth. *“The recipe for stagflation hinges on whether or not we can improve productivity growth and devote resources to things that improve productivity growth,”* Dr. Berner noted, adding that *“productivity in this environment may suffer due to lack of investment and lack of optimism.”*

A director noted that there is still room for productivity-enhancing technology advancements, but Dr. Berner cautioned that relying on technology advancement is no panacea. Instead, he said, leaders need to coordinate in *“how we think about implementation of new technologies for productive purposes. One risk in new technologies is that they are not aimed at improving productivity.”*

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Financial institutions will confront pressure to carefully manage distressed customers

A director said, *“High inflation is bad for all, but especially for poor people without savings, who haven’t benefited from the rise in asset prices. Income inequality will be exacerbated.”* Participants expressed concern about the potential social and political implications of a negative economic outlook. A director cautioned, *“We are clearly going to face an inordinate squeeze on living standards”* due to slow growth and inflation—especially increasing energy prices, *“which have doubled in the last six months and will double again in the next six months in some places.”* A participant noted, *“If you are driving 75 miles to a job, now it costs you three times more to fill up your tank. You have no access to daycare, no available public transportation. These are huge issues that no one knows how to solve.”*

How financial institutions manage the consequences for customers could have significant operational and reputational implications. *“We are going to see an enormous wave of bad debts, and there will be huge pressure on banks as to how they deal with those bad debts and enforcement against people with things like overdrafts. These will be big issues in many countries over the next two years. There will be pressure from government to try and make sure that social problems don’t become too great, forcing trade-offs between prudential regulation and avoiding social unrest,”* predicted a director.

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– Director

Economic shocks are exposing deeper vulnerabilities

The current macroeconomic crisis could expose more fundamental vulnerabilities in the global economy and in markets. Dr. Berner observed, *“The shock from the pandemic was largely about liquidity and market structure, so it raised the question of how to make nonbank financial institutions more resilient and how to make critical financial markets more resilient. Such markets lack resilience, which means that macroeconomic shocks will be amplified in markets, so counterparty risk in nonbank financial intermediaries needs to be looked at carefully.”* In addition, he said, inflation could expose struggling economies: *“Inflation could spill over into geopolitical issues by affecting low-income countries’ capacity to service sovereign debt when they are already in debt distress.”*

One executive noted that monetary policy had covered up fundamental flaws in the economy over the past decades, setting the economy up for a major correction: *“Growth in the money supply over the past decade or more has been breathtaking. It’s led to great GDP numbers, because any time the*

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economy has threatened to turn bad, governments have pumped money into the economy. By eliminating little pains, they may have set us up for a major discomfort. The fundamental imbalances in the global monetary environment will lead to a bad outcome.”

Geopolitical tensions are creating operational complexities for financial institutions

Financial institutions are also balancing the relative reputational and geopolitical risks of operating in once-promising growth markets. Conflicts over issues like technological dominance, copyright protections, and territorial disputes have compounded in recent years. Human rights issues, and now outright war, led to calls for companies to reconsider operations in some countries. Ian Bremmer, president of Eurasia Group, described the 2022 World Economic Forum meetings in Davos as “the most driven by geopolitics” because of the “crisis-rich environment,” with the war in Ukraine at the center.⁶ As a result, geopolitical risk is rising on board agendas. One participant said, *“Geopolitical risks are creating real operational challenges. We have to ask ourselves, What are we doing to manage this stuff?”*

“I don’t think we have a plan to operate in a more fragmented world.”

– Director

Deglobalization is reshaping the operating environment

Predictions of the end of globalization, or at least the end to the period of “hyperglobalization,” are now common. The emergence of vigorous nationalist political movements in a range of countries, growing tensions between China and the West, and, most recently, Russia’s invasion of Ukraine are reshaping the global economic order. In the face of rising geopolitical tensions, US Secretary of the Treasury Janet Yellen recently called for a new approach to international trade, saying, “We cannot allow countries to use their market position in key raw materials, technologies, or products to have the power to disrupt our economy or exercise unwanted geopolitical leverage. So let’s build on and deepen economic integration and the efficiencies it brings ... with the countries we know we can count on. Favoring the friend-shoring of supply chains to a large number of trusted countries ... will lower the risks to our economy as well as to our trusted trade partners.”⁷

Deglobalization raises real operational challenges for financial institutions as they consider not just where they locate physical operations but the customers with whom they do business, their third-party relationships, and their talent acquisition and outsourcing. One bank director said, *“We don’t fully calibrate the real risks of deglobalization. Everyone is familiar with the issue, but in risk and audit committees, I don’t think we have a plan to operate in a more fragmented world. I think people in the back of their minds know of*

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deglobalization, but I don't think anyone has a plan around how to raise and allocate capital and manage people that accounts for what's realistically going to happen." This can require new approaches to risk management: *"With growing pressure in Hong Kong, along with overall deglobalization and the need to shift out of Ukraine, there is no country you want to have all of your risk in,"* said a participant.

Managing moves toward digital sovereignty

Ownership and residence of data and critical technologies like cloud computing represent increasing sources of geopolitical tension. One summit participant said, *"In terms of data flows, there will be a rapid decoupling over the next couple of years; the barriers will get higher and higher."*

The EU has advanced the concept of digital sovereignty in the face of the dominance of US technology firms. Speaking of the concentration of cloud providers, one participant noted, *"The biggest problem is not that there are three main cloud providers; the biggest problem is they are all American."*

This focus on digital sovereignty includes supporting the development of European technology "champions"—especially local alternatives to US cloud-service providers—and limitations on the extent to which European data can be transmitted across the Atlantic. While one participant said, *"Europeans want a European cloud,"* another said the real question is, *"Is this going to be a world that's powered by US tech and cloud or Chinese tech and cloud?"*

Regulations, including new rules in Europe,⁸ governing where data resides and how it flows across national borders create significant operational complexities for financial institutions. One participant said, *"The world is getting more complicated from a regulatory perspective. We face a conflicting and toxic combination of regulations. With the move from globalization to nationalism, we've seen a political agenda around data residency emerge—the idea of the sovereign cloud—which adds complexity and tripwires that give you no competitive advantage. So we have to be thoughtful about how we work through that and construct our digital infrastructure so it can stand shifts in the regulatory environment."*

Acting as enforcers of sanctions

Financial institutions can get tripped up as nation-states deploy economic weapons such as sanctions and tariffs in a geopolitical conflict. A participant said, *"As sanctions work their way through a world in which some countries impose clear sanctions against Russia and some countries do not, there will be the question of diversion through the neutral countries. There will undoubtedly be pressure on all financial institutions operating in countries*

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– Participant

trying to make sanctions work to have a very intrusive AML [anti-money laundering] sanctions regime. There will be problems of leakage and trying to interpret what the rules are. And we saw what happened to European banks that ran afoul of US sanctions on Iran.”

Sanctions create uncertainty for global organizations. One participant said, *“The question is always, Who will the US sanction next? Under Trump, we’d have to, for example, get out of a \$1 billion supplier in 30 days.”* And sanctions can persist, even through changes in administrations: *“Sanctions and tariffs, once in place, are hard to remove. We just assume they will be there in perpetuity.”*

Accelerated decoupling between China and the West

Within the broader trend of deglobalization, significant decoupling of China from Western economies raises major challenges for global financial institutions. One participant said, *“There is a lot of integration with the Chinese economy, but the system is fragmenting. If we all have significant operations in China, then we need to rethink all of that.”* The participant added that it’s important to consider scenario planning: *“If you have to get out of Hong Kong or Shanghai in 30 days, what does that look like? What do I do with the talent there? You should be challenging your teams in Asia to get closer to those conversations.”*

Western financial institutions are facing a more hostile operating environment in China. President Xi Jinping tightened rules on foreign listings, which has limited the ability of global banks to sell stock in Chinese companies in offshore markets, previously their most profitable business in China. And Chinese regulators earlier this year demanded detailed reporting on executive compensation from Western banks while warning them not to pay their top executives too much, putting pressure on their ability to recruit and retain top talent.⁹

Capital flows into and out of China risk interruption. One participant said, *“You may have to adjust your scenario planning to think about two capital structures, developing a separate capital structure for China”* in the face of potential restrictions on capital flows. And financial institutions face risks in accepting Chinese capital: *“There’s the question of should I take Chinese capital into my fund? Will there be sanctions, or will people react negatively if I do?”*

Financial institutions also face questions about Hong Kong’s role as a global financial center. One executive said, *“It feels like the time has passed to get out. There are things I can’t trust in Hong Kong anymore.”* Financial leaders

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“Sanctions and tariffs, once in place, are hard to move. We just assume they will be there in perpetuity.”

– Participant

may have been slow in waking up to the risks of operating in Hong Kong. *“Hong Kong should not be anyone’s Asia headquarters; that’s lazy legacy thinking. Security issues, technology theft, intellectual property are all legitimate risks, but there’s no evidence that it’s increased in recent years,”* said one participant.

China’s internal economic and geopolitical ambitions add further complexity

China’s economic challenges and geopolitical ambitions in Taiwan also elevate the risks financial institutions face in operating in China. One director said, *“We are used to thinking about China as a great source of talent and great source of growth. Now it is about geopolitical issues—we need to think about China differently going forward.”*

The looming prospect of direct conflict with Taiwan

China has shown increasingly aggressive action toward Taiwan over the last two years, and several US officials have warned that Taiwan faces a serious threat from China over the next decade. The bar to a Chinese invasion of Taiwan remains high; however, there is some concern that the 2024 elections in Taiwan and in the US could result in leaders who more vocally support independence, which could force President Xi to act. *“That’s a red line, and Xi will not want to back away,”* a participant said. But if Xi does act against Taiwan, the same participant added, *“he will want to do it, if possible, through economic levers versus military ones—and he might have those levers.”*

If China does invade Taiwan, Western companies would face economic disruptions akin to those that resulted from Russia’s invasion of Ukraine, but at a potentially larger scale. Given Taiwan’s importance as a manufacturing center for semiconductors and other microchips, one director said, *“If Taiwan is inaccessible, how can you continue to operate? Do you create two separate supply chains?”*

A slowing domestic economy

Alongside challenges arising from geopolitical tensions between China and the West, internal macroeconomic headwinds are also making China a less attractive market for global financial institutions in several ways:

Ongoing pandemic-related disruptions. China’s commitment to a zero-COVID policy has led to severe economic disruptions, which persisted through the first half of 2022. When factories in East China shut down following the COVID surge in early 2022, *“the supply of goods coming out of China was disrupted—not just goods manufactured in East China, but*

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“We are used to thinking about China as a great source of talent and great source of growth. Now it is about geopolitical issues—we need to think about China differently going forward.”

– Director

any goods where anything in the supply chain flowed through East China because they couldn't get components," one participant said. While COVID-related disruptions appeared to be easing by mid-2022, President Xi's firm commitment to zero-COVID means that future surges could result in further major lockdowns and economic disruptions.

"There are almost two Chinas; high-end consumers are spending, but many low-end consumers have no income because of the lockdowns, so they have to recover the income to spend."

– Participant

- **Slowing growth.** There is little chance China will hit its economic growth targets of 5%–6% this year, predicted several participants. Although manufacturing output has begun to recover, it seems unlikely that consumer spending will rebound fast enough to drive growth. One participant noted, *"There are almost two Chinas; high-end consumers are spending, but many low-end consumers have no income because of the lockdowns, so they have to recover the income to spend. It's going to take time to get spending back."* The economy is struggling to create enough jobs for the 11 million young people graduating college this year, and youth unemployment remains high, especially in cities, where it is nearly 20%.¹⁰
- **Demographic challenges.** One summit participant noted that there has been a 50% reduction in births in China over the last decade. With enough places in Chinese universities for everyone who wants to attend and little immigration, the Chinese economy will struggle to fill low-paying jobs. At the other end of the spectrum, Chinese workers tend to retire early, so there may be capacity to expand the workforce if workers can be induced to stay in the workforce longer.

With rapid inflation, rising interest rates, and the potential for recession and stagflation, global financial institutions are facing a dramatically altered macroeconomic landscape, forcing them to reassess strategy, operations, and risk management. At the same time, economic nationalism, growing tensions with China, and the war in Ukraine are unsettling long-held assumptions about globalization and global financial markets. As a result, a summit participant said, leaders of financial institutions *"are preparing for tougher times ahead, and the priorities are changing."*

Appendix

The following individuals participated in these discussions:

Participants

- Homaira Akbari, Non-Executive Director, Santander
- Michael Alix, Americas Chief Risk Officer, UBS
- Jeff Barbieri, Vice President, Corporate Governance/ESG Research, Wellington Management
- Drew Barker, Senior Vice President, Head of Climate Risk Management, Truist Financial
- Richard Berner, Clinical Professor of Management Practice, Department of Finance and Co-Director, Volatility and Risk Institute, NYU Stern School of Business
- Sarah Beshar, Non-Executive Director, Invesco
- Howard Boville, Head of IBM Cloud Platform, IBM
- Jan Carendi, Non-Executive Director, Lombard International Assurance
- Bill Coen, Non-Executive Director, China Construction Bank
- James Cole, Non-Executive Director, AIG
- Kristen Dickey, Non-Executive Director, Somerset Re
- Dianne Dobbeck, Head of Supervision, Federal Reserve Bank of New York
- Beth Dugan, Deputy Comptroller for Large Bank Supervision, Office of the Comptroller of the Currency
- Eliza Eubank, Managing Director and Global Head, Environmental and Social Risk Management, Citibank
- John Fitzpatrick, Non-Executive Director, AIG
- Emily Gaston, Analyst, SASB Standards Financials Sector, Value Reporting Foundation
- Mike Gibson, Director of the Division of Banking Supervision and Regulation, Federal Reserve Board
- Jay Grayson, Chief Executive Officer and Co-founder, Surround Insurance
- Carlos Gutierrez, Non-Executive Director, MetLife; Chair and Chief Executive Officer, Empath
- Carlos M. Gutierrez, Chief Marketing Officer, Empath
- Bob Herz, Audit Committee Chair, Morgan Stanley and Fannie Mae
- Brad Hu, Executive Vice President and Chief Risk Officer, State Street
- Tim Keaney, Audit Committee Chair, Unum
- Sandra Krieger, Non-Executive Director, Deutsche Bank USA

- Joan Lamm-Tennant, Chair, Equitable Holdings and AllianceBernstein; Non-Executive Director, Hamilton Insurance Group
- Christine Larsen, Non-Executive Director, CIBC
- Marc Lindsay, Managing Partner and Director of Research, Sustainable Governance Partners (SGP)
- Nick Lyall, Non-Executive Director, USAA Savings Bank
- Michel Madelain, Non-Executive Director, China Construction Bank
- Callum McCarthy, Nomination and Compensation Committee Chair, China Construction Bank
- Tracy McKibben, Audit Committee Chair, USAA
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- Diane Nordin, Audit Committee Chair, Principal Financial; Compensation and Human Capital Committee Chair, Fannie Mae
- Gordon Orr, Non-Executive Director, Lenovo, Meituan, Swire Pacific
- Andy Ozment, Chief Technology Risk Officer and Executive Vice President, Capital One
- Marty Pfinsgraff, Risk Committee Chair, PNC Financial
- Chris Pinney, President and Chief Executive Officer, High Meadows Institute
- Bruce Richards, Vice Chair, Credit Suisse Holdings USA
- David Sidwell, Non-Executive Director, Chubb
- Nick Silitch, Senior Vice President and Chief Risk Officer, Prudential Financial
- Bob Stein, Audit Committee Chair, Assurant and Talcott Resolution

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- Jan Bellens, Global Banking and Capital Markets Leader
- Peter Davis, Americas Financial Services Markets and Solutions Leader
- Matt Handford, Principal, Climate Change and Sustainability
- Ed Majkowski, Americas Insurance Sector and Consulting Leader
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- Eric Baldwin, Principal
- Tucker Nielsen, Principal
- Andre Senecal, Associate

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ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

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The FSLs is an annual meeting addressing key issues facing leading financial institutions. It brings together non-executive directors, members of senior management, policymakers, supervisors and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring and trustworthy financial institutions. The FSLs is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of FSLs discussions and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of senior management, advisers and stakeholders who become engaged in this leading-edge dialogue, the more value will be created for all.

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Endnotes

- ¹ *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of summit participants and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made by summit participants and guests.
- ² Bank for International Settlements, "[No Respite: BIS Annual Economic Report 2022.](#)" BIS, June 26, 2022.
- ³ Nick Timiraos, "[Inflation Fears Drove Larger Fed Rate Increase in June.](#)" *Wall Street Journal*, July 6, 2022; Elliot Smith, "[Bank of England Hikes Rates for the Fifth Time in a Row as Inflation Soars.](#)" *CNBC*, June 16, 2022; European Central Bank, "[Monetary Policy Decisions.](#)" news release, June 9, 2022.
- ⁴ Tom Fairless, "[Central Banks Should Raise Rates Sharply or Risk High-Inflation Era, BIS Warns.](#)" *Wall Street Journal*, June 26, 2022.
- ⁵ Kai Ryssdal and Marketplace staff, "[Fed Chair Jerome Powell: 'Whether We Can Execute a Soft Landing or Not, It May Actually Depend on Factors That We Don't Control.'](#)" *Marketplace*, May 12, 2022.
- ⁶ Ian Bremmer, "[Forcibly Decoupling Russia.](#)" GZERO Media, May 25, 2022.
- ⁷ Russell Napier, "[If China Is No Longer in Our Friend Group, What Does That Mean?'](#)" *Toronto Star*, May 9, 2022.
- ⁸ Richard Waters, "[EU-US Data Wrangle Tests Digital Sovereignty.](#)" *Financial Times*, February 24, 2022.
- ⁹ Cathy Chan, "[Wall Street's China Problems Multiply with Warning on Banker Pay.](#)" *Bloomberg*, June 12, 2022.
- ¹⁰ Bloomberg News, "[China Youth Unemployment Rises Even as Broader Rate Declines.](#)" *Bloomberg*, June 14, 2022.