What we're watching

Geostrategic outlook

Geostrategic Business Group | February 2019

Building a better working world

Since the end of World War II, businesses have positioned themselves to take advantage of globalization. They have entered new markets, organized supply chains across borders, hired an international workforce, and attracted global capital. They have been operating on the hypothesis that the integration of global markets would promote political cooperation and the harmonization of the rules of the game around the world.

But businesses have recently come to understand that this is no longer the world they operate in. Geopolitical tensions, nationalism, populism and trade wars fill the headlines every day, resulting in significant disruption to once-efficient and effective complex global operations.

We are living through a paradigm shift, a Transformative Age in geopolitics that is impacting the outlook for the global economy and global businesses. In January, the International Monetary Fund (IMF) downgraded its global growth projection for 2019 and 2020, citing a sharp rise in uncertainty over trade policy, Brexit and other geopolitical tensions. According to the IMF Global Financial Stability Report, published last October, further escalation of trade tensions, rising geopolitical risks, and policy uncertainty in major economies could trigger a broad-based correction in global capital markets and a sharp tightening of liquidity. For the time being, the global economy remains strong not because of positive geopolitical developments — but despite negative ones. That resilience will be tested as the global economy enters a new cycle and geopolitical tensions continue to increase.

Few doubt that geopolitical risks are challenging global business operations, but most have yet to address them as a strategic management challenge. Henry Kissinger once noted: "An issue ignored is a crisis invited." In the increasingly connected, fast-paced Transformative Age, global business can no longer afford to ignore geopolitical disruption.

To this end, this brief outlines key risks the EY Geostrategic Business Group is watching around the world — drawn from EY professionals as well as a number of external resources.

In the increasingly connected, fast-paced Transformative Age, global business can no longer afford to ignore geopolitical disruption.

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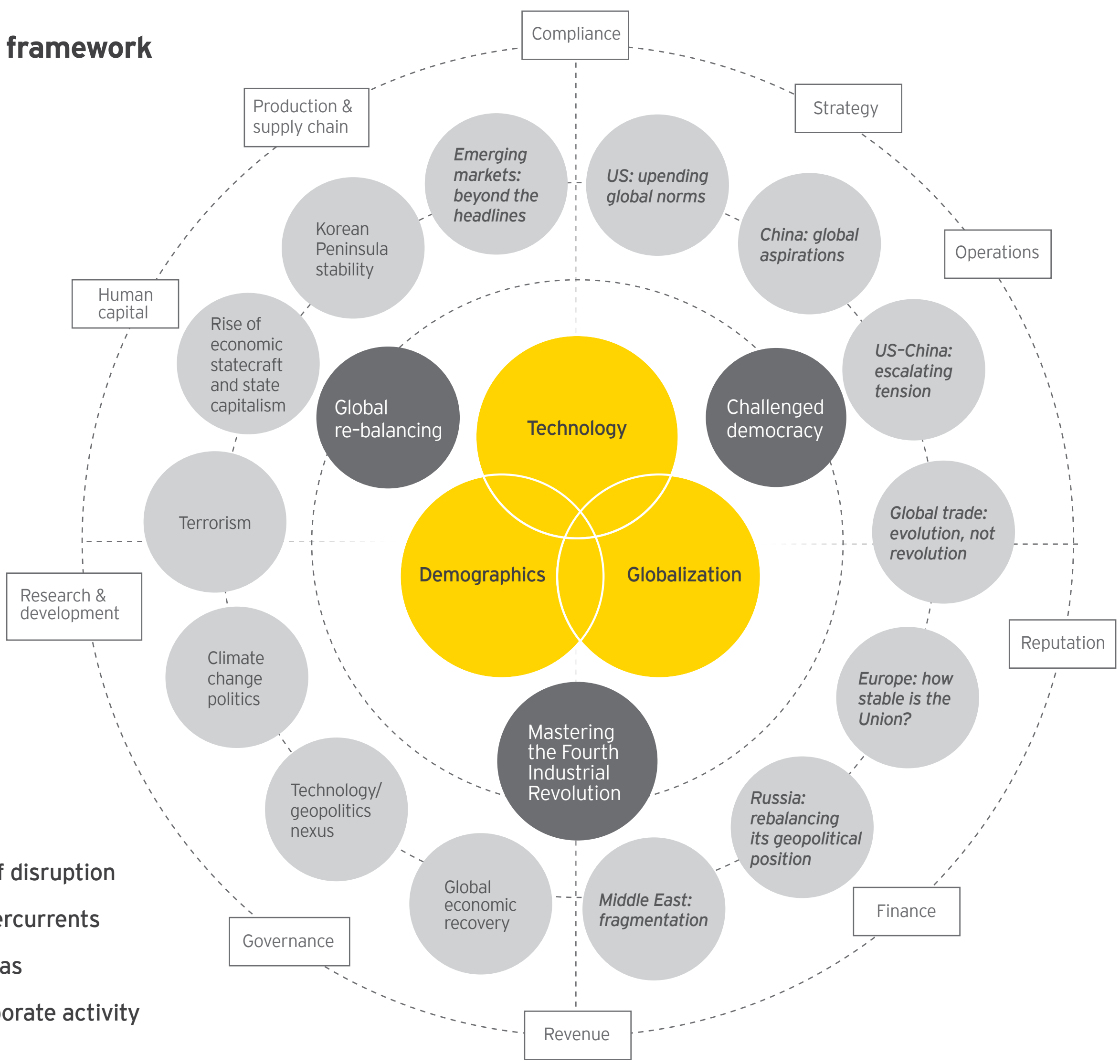
Mapping the landscape

In *The upside of disruption: Megatrends shaping 2018 and beyond*, EYQ isolated three primary forces driving economic, social and political disruption globally: technology, globalization and demographics. These primary, and interrelated, forces are shaping a number of longer-term **disruptive geopolitical undercurrents** that drive and generate the breaking news we see every day, rising through to the surface as political instability, protests, trade tensions, power rivalries or market volatility. These **geopolitical undercurrents** affect established norms of doing business and global governance, causing uncertainty in the business environment and adding complexity for long-term planning.

Geopolitical risk framework



- Primary forces of disruption
- Geopolitical undercurrents
- Geopolitical arenas
- Elements of corporate activity

Global re-balancing — Globalization, as we know it, has mainly unfolded in the 1990s and 2000s when the US enjoyed a position of global dominance (also known as its "unipolar moment"), and international institutions set and defended global norms. This arrangement is beginning to erode, in part due to globalization's successes (growth in emerging economies) and its failures (growing inequality and political discontent in developed markets).

As a result, we may be moving to a multipolar world, a world in which geopolitical rivals set the rules of the game in their respective "spheres of influence." This process, from global political integration to fragmentation and geopolitical competition, will result in profoundly higher levels of complexity for businesses that span the globe.

> As a result of global re-balancing, we are moving from a unipolar to a multipolar world, creating complexity for businesses that span the globe.

Challenged democracy — As part of this re-balancing, Western democratic models are being challenged. Western democracies that championed global economic integration in the late 20th century believed that a prospering world would trend toward democratic transformation and overall stability. What we see today is that alternative political systems have proved resilient and are often seen by their proponents as more stable, less fractious, and able to appropriately and judiciously deal with global challenges. We did not reach the end of history: Competition between political systems instead is again on the rise, exacerbated by rising nationalism and populism.

Expansion into new markets, free trade deals, economies of scale, and technology-driven growth have created conditions for growth — but not for everyone. Since 1990, globalization and international development have lifted 1.1 billion people out of extreme poverty,[1] but they have also displaced workers, challenged growth in manufacturing communities, and led to considerable inequality. Globally, almost half of the world's wealth is now owned by the top 1%.[2] The Fourth Industrial Revolution (automation and robotics) has the potential to further exacerbate the income and related opportunity/skills gap with reductions in low-skilled jobs.

Mastering the Fourth Industrial Revolution — Global leadership has always been anchored in technological superiority. The future will be no different. The Fourth Industrial Revolution (4IR), combining big data, analytics and technology, promises not only to disrupt industry structures, wealth distribution and labor markets, it will also reshuffle the geopolitical order. Countries' ability to shape the ways in which critical technologies are developed, their deployment in enhanced forms of cyber statecraft, their ability to set global tech standards, or to facilitate spillover effects across other industry sectors are going to be the Great Power trump card in that game.

We believe that these undercurrents continue to manifest themselves particularly strongly in eight systemically relevant policy arenas, and generate outcomes that profoundly shape the operating environment of companies.

US: upending global norms

The fundamental tenets of American economic policy since World War II, including broad-based political support for free trade, investment and immigration, have been profoundly challenged in recent years. The White House is employing a more confrontational approach toward traditional allies (such as Western Europe) and global competitors (such as China and Russia) while toughening its policy toward Iran and engaging in an unconventional approach with North Korea, the results of which remain unclear.

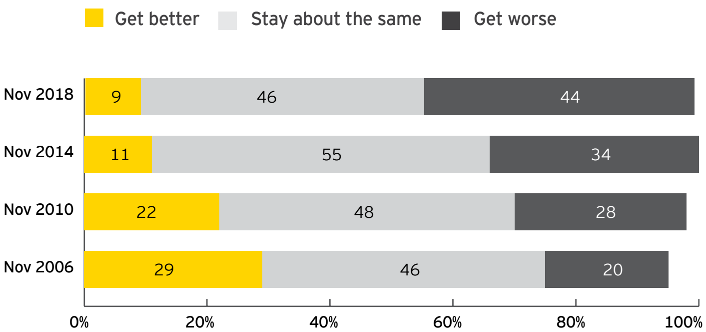
As its global role transforms, the US is an increasingly divided society. Income inequality has reached its highest levels since the 1970s and remains highest across the industrialized economies of the OECD.[3] The partisan divide on political values continues to grow.[4] From a governance perspective, domestic gridlock persists, with the federal government shutdown being the latest example. The space for bipartisan compromise, while tenuous, has increased in the US on issues such as on infrastructure, drug pricing and data privacy. Increased uncertainty over US global political leadership emerged as a key theme in the debates of the World Economic Forum's annual meeting in January 2019.

The Trump administration has adopted a more transactional economic and security policy approach, at times merging economic competitiveness and national security concerns, which is playing out in its unconventional trade policy. The administration appears to be adopting a "managed trade" philosophy and is renegotiating or abandoning long-standing multilateral agreements in favor of more transactional bilateral agreements. Its restrictive views on immigration continue to challenge global companies and present a threat to talent sourcing.[5] So far, the impact to US growth has been minimal, though the IMF expects this approach and the continued uncertainty surrounding it to put pressure on growth in 2019 and 2020.

The US is also restructuring the framework around Chinese investment in the US economy. Concerns over increasing Chinese influence drove the August 2018 passage of the US Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), which expanded the scope and operations of the Committee on Foreign Investment in the United States (CFIUS). An expanded CFIUS is expected to broadly impact cross-border transactions, including M&A, divestitures, joint ventures and other forms of foreign investment.[6] At the same time, expected new US export control regulations (also driven by concerns over Chinese acquisitions) called for under the Export Control Reform Act would cover broad forms of emerging and foundational technologies, potentially stifling US R&D in these technologies.

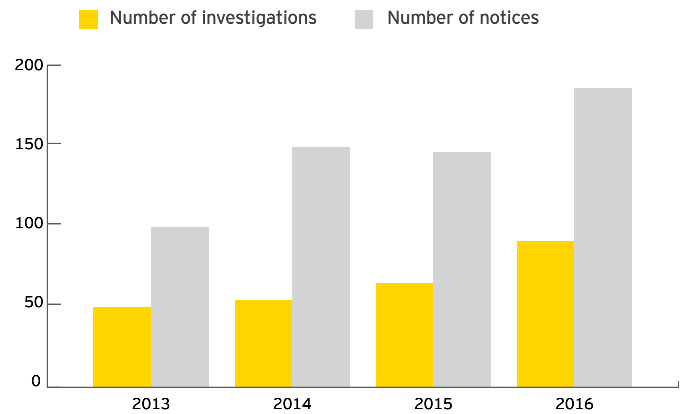
The US is an increasingly divided society

Percentage of who say relations between Republicans and Democrats will ____ in the coming year



Note: Bar chart not summing up to 100% as "No Response" not considered
Source: Pew Research survey of US adults, Nov. 7-13, 2018

Bipartisan support emerging to scrutinize foreign investment



Source: Committee on Foreign Investment in the United States

Business impact

Production/supply chain – Shifting US trade policy, including the escalating US-China dispute and the renegotiation of major agreements (e.g., United States-Mexico-Canada Agreement), illustrates how exposed global supply chains have become. No value chain appears to be wholly protected. Any company impacted by recent tariffs as an importer or an exporter should model the impacts, as well as any potential expansion of the scope or escalation of the rate. Companies should also scan the horizon for rising non-tariff barriers to business and trade, such as more aggressive regulatory reviews, inspections, investigations and "Buy American" pressures.

Finance/investment – CFIUS reviewed over 50% more transactions in 2016 than in 2011; recently passed FIRRMA legislation is expected to lead to further investment scrutiny (with a particular emphasis on "critical technologies" and "critical infrastructure"). CFIUS reviews should be built into the analysis of US investment strategies by foreign companies as well as US companies considering joint ventures with foreign partners.[7]

Human capital – Given the administration's advocacy for a "hire American" approach and increasing border security, companies should consider how shifting policies might impact their talent strategies and operations.

Reputation – In an environment of low trust in all institutions – government, business and media[8] – consumers and investors are focused on the role of business in society, with organizations increasingly expected to go beyond corporate social responsibility and address societal challenges.

Localization pressures – Foreign-owned firms may feel pressure to provide "American" credentials.[9] Meanwhile, US firms should be prepared to manage the political and reputational risks of downsizing or offshoring their American operations, as well as other moves that may have social and political sensitivity.

Sanctions – The US government's increased use of sanctions (principally against Russia, Iran, North Korea and Venezuela) impact both US and non-US companies. In addition to restrictions on US individuals and businesses, secondary sanctions[10] may have profound implications for non-US businesses. Watertight compliance standards are essential to avoid potentially harsh judicial consequences.

> The fundamental tenets of American economic policy since World War II, including broad-based political support for free trade, investment and immigration, have been profoundly challenged in recent years.

Issues to watch

- With a divided Congress and increased level of investigations into the Trump administration, will foreign policy (e.g., China, Venezuela, Iran, North Korea) be the space through which the administration appeals to its base and seeks to maintain momentum?
- Will the Democratic Party platform in 2020 embrace nationalism?
- What are the consequences of waning Trump administration support for the rules-based multilateral order (e.g., Paris Accord, Iran nuclear deal, WTO), and what might signal further US withdrawal from global leadership in 2019?

China: global aspirations

China's economic rise has not been accompanied by a further opening up of its political system, as anticipated by the West.

At the 19th National Congress of the Chinese Communist Party (CCP) in October 2017, President Xi Jinping stated that China would become a leading nation with "comprehensive national power and global impact by 2050." A new political doctrine, the "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era," detailed the centrality of the CCP not only in Chinese political and social development, but also in the country's long-term economic development. The National Congress also consolidated a more expansive foreign policy, including continued support for the Belt and Road Initiative (BRI) and the Asian Infrastructure Investment Bank (AIIB). To seek to accomplish these objectives, the government has paved the way to turn China into a "cyber-superpower"[11] by rolling out its 10-year road map to develop, acquire and deploy advanced technologies.[12]

China's rise and global aspirations also face challenges and potential obstacles. Domestic economic issues include debt growth that the IMF has called "still-unsustainable"[13]; high levels of pollution and other public health risks; an aging population; and ongoing further reforms needed to its health care system. Risks from abroad include increasing reservations over Beijing's IP acquisition strategies, questions over aspects of Belt and Road projects, and use of Chinese businesses to project national policies internationally.

Yet, China's influence over emerging markets and, increasingly, over developed economies globally is proving at least tacitly effective, resulting in the setting of new standards for commerce the world over.

Belt and Road Initiative

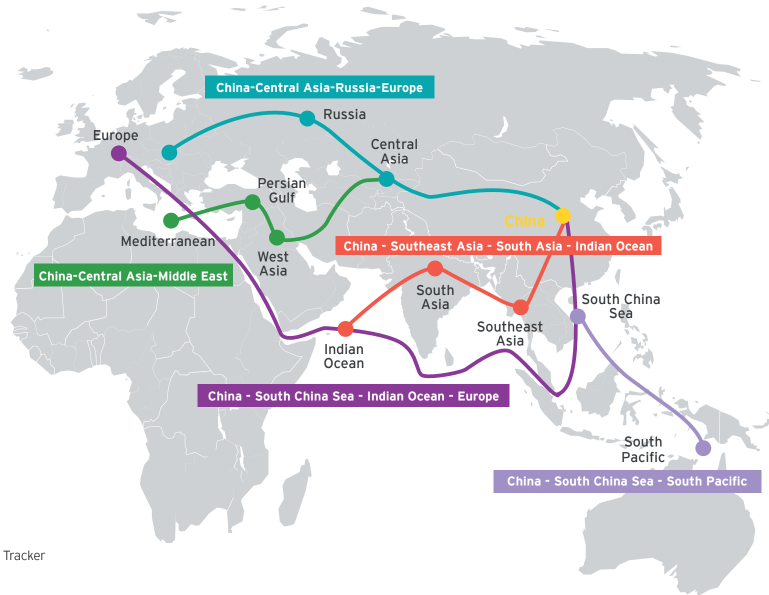
65+ countries

30% of global GDP

62% of world population

75% of known energy reserves

$420 billion of investment/construction by Chinese companies
October 2013–July 2018



Source: EY's China Overseas Investment Network; World Bank; American Enterprise Institute's China Global Investment Tracker

Business impact

Research and development – One of the key issues for foreign companies operating in China is the authorities' commitment to protecting intellectual property. Geopolitical competition will test the robustness of such commitments over the long run. The resulting risk might lead to a more strategic approach with regard to the location of companies' research hubs.

Finance/investment – Chinese overseas investments have been subject to increased scrutiny in the Americas, EMEIA and Asia-Pacific. Chinese investors should exercise political risk diligence in the initial phases of overseas investment projects.

> China's economic rise has not been accompanied by a further opening up of its political system, as anticipated by the West.

Reputation/license to operate – Growing resistance to Chinese communications technology in Western economies, rooted in alleged security concerns, is an example of the challenges Chinese companies may encounter in key markets abroad. On another level, five years following the launch of the Belt and Road Initiative, amid indications of increasing Chinese influence and debt levels in host countries, there are growing calls for Chinese companies to invest more in corporate social responsibility (CSR) efforts. Chinese companies should commit further to CSR and broader stakeholder management practices to help reduce political risk and enhance overall completeness in BRI investments.[14]

Issues to watch

- How will global businesses balance their interests of maintaining access to the vast Chinese market while mitigating the strategic risks of operating there?
- How risky are deals with Chinese partners in today's increasingly geopolitically fraught world? Consequential increases in unexpected policy and regulatory moves in Beijing as well as elsewhere are possible.
- How robust are China's external alliances going to be when they are built more on economic incentives rather than ideological or cultural alignment?

US-China: escalating tension

The US' relationship with China during the past few decades has largely been built on the assumption that China's economic development would be followed by a gradual opening up of its political system. Given the direction of the National Congress of 2017, that assumption is being challenged, causing a shift in the US perspective on the future of that relationship. Today, the US faces a strategic competitor who not only challenges US global dominance, but whose political vision and ideology may challenge its own.[15]

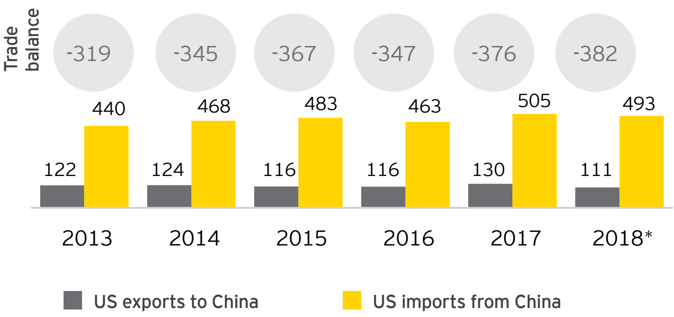
The economic relationships between the two largest economies are marked by a high degree of interdependency. Imports from China have increased from just above US$100 billion in 2001, when China joined the WTO, to US$505.5 billion in 2017. Exports to China totaled just under US$20 billion at the time. By 2017, US exports to China increased to US$129.9 billion.[16] As of October 2018, China held US$1.12 trillion in US treasury securities (though slightly falling due to an expected trade conflict).[17] The tensions resulting from corroding political relations between the US and China, and the high degree of economic interdependence between the two, create an operating environment that companies with exposure both to the US and China are finding increasingly challenging to navigate.

These tensions have resonated throughout 2018 and driven US policy toward China in its trade and industrial policy dimensions. Having initially focused on reducing the trade deficit, the Trump administration began raising a broader array of issues: concerns over challenges to US firms doing business in China, such as restrictions on FDI; requirements such as mandatory joint venturing and technology transfer; regulations seen as challenging competitiveness; and intellectual property protection. Further, the US administration has voiced concerns over aspects of US national security, including China's stronger presence in Asia, together with its plans to develop and expand the use of critical technologies, and claims of cyber threats emanating from China.[18] China has responded by restating a willingness to work with the US to achieve mutually beneficial outcomes through non-confrontational and mutually respectful cooperation.

Despite growing concerns on both sides about the potential consequences of escalating conflict, and attempts to resolve it, geostrategic competition will continue to drive US-China relations and cause global volatility.

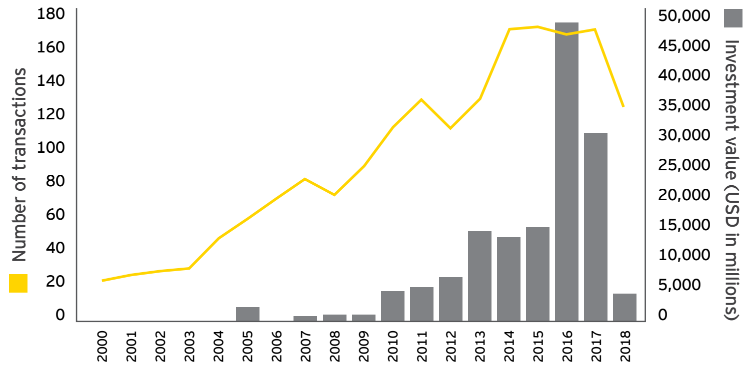
US / China merchandise trade deficit

US-China bilateral trade, US$b



Note: *2018 data is up to Nov'18
Source: US Census Bureau

Chinese FDI into the US dropped 84% in 2018



Source: Rhodium Group

Business impact

Strategy – As the geopolitical rivalry between the two largest global economies intensifies, and as technology is increasingly considered a key asset in shaping the outcome of that conflict, access and control over strategic technologies will become an even more central aspect of US-China relations. This will have serious implications for the arena in which US and Chinese companies are going to compete.

Production/supply chain – Beijing has shown readiness to respond in kind to US trade moves, causing executives on both sides of the Pacific to act to mitigate rising costs and keep goods and services moving. In a heated trade environment, companies should scan the horizon in China for rising non-tariff barriers to business and trade, such as more assertive regulatory reviews, inspections, investigations and "Buy Chinese" pressure. Overall, businesses should evaluate supply chain vulnerabilities.

Reputation – Organizations operating in China and the US face the unique challenge of balancing their "Western" identity with compliance requirements in China.

Finance/investment – Chinese companies and investors interested in US assets will face greater scrutiny following recently enacted FIRRMA legislation. While the legislation does not explicitly reference China, scrutiny of investment from China has expanded significantly in recent years. Further scrutiny is likely as the Trump administration has signaled its intent to use the CFIUS process to screen Chinese foreign direct investment more closely as a countermeasure to FDI restrictions in China.[19]

> Despite growing concerns on both sides about the potential consequences of escalating conflict, and attempts to resolve it, geostrategic competition will continue to drive US–China relations and cause global volatility.

Issues to watch

- Presidents Trump and Xi agreed to a 90-day reprieve on tariffs at the G20 summit in Argentina. With a deadline of 2 March, will US and Chinese trade negotiators make enough progress to hold off on additional tariffs?
- Will there be opportunities for US-supported investment to counter China's Belt and Road Initiative?
- How will the US relationship with China factor into the 2020 US presidential campaign?

Global trade: evolution, not revolution

Despite the significant attention global trade received during the past two years, evolution, not revolution, has been the overriding paradigm in global trade relations. In fact, the G20 summit in Buenos Aires emphasized trade considerations directly and indirectly, and closed with an affirmation statement that "trade and investment are important engines of growth, productivity, innovation, job creation and development" and pledged its support for reforms to the WTO.[20] In doing so, the G20 recognized the transformation underway across the globe, as well as the importance that trade reform and moderations to established protocols will play in collective economic growth.

The US administration has been at the center of events in the trade arena near and far. In one of his first official acts, President Trump withdrew the US from the long-anticipated Trans-Pacific Partnership (TPP), which was originally intended to connect the markets of the Pacific region, introduce a common set of standards, and geopolitically bolster US influence in the region. The remaining 11 members moved on without the US, setting up a transformational Comprehensive and Progressive Trans-Pacific Partnership (CPTPP),[21] covering 480 million people and a combined 13.3% of global GDP.[22]

The Trump administration also set in motion a protracted renegotiation of the 24-year-old North American Free Trade Agreement (NAFTA), which ultimately resulted in the United States-Mexico-Canada-Agreement (USMCA). USMCA now addresses a number of areas within NAFTA that had become outdated or unbalanced in terms of the current global landscape. The agreement retains the critical trade flows in the region with a modified set of rules and varied impact by industry sectors. Further, it set the stage for other trade negotiations and has defined the administration's objectives and goals in other agreements.

Simultaneous to the NAFTA renegotiations, the administration took up other agreements and trade actions, as well. In September 2018, the US and South Korea signed the KORUS FTA, exempting Korea from US steel tariffs, increasing US auto imports to Korea, and allowing the US to keep a 25% tariff on Korean truck imports.[23] This was the result of the US initiating a renegotiation clause in the 7-year-old KORUS, affirming the administration's views on correcting "flaws" in prior negotiated trade agreements that it sees as negative toward US interests. The administration also formally notified Congress of its intentions to enter into bilateral trade agreement negotiations with Japan, the EU and, ultimately, the United Kingdom following the country's exit from the European Union.

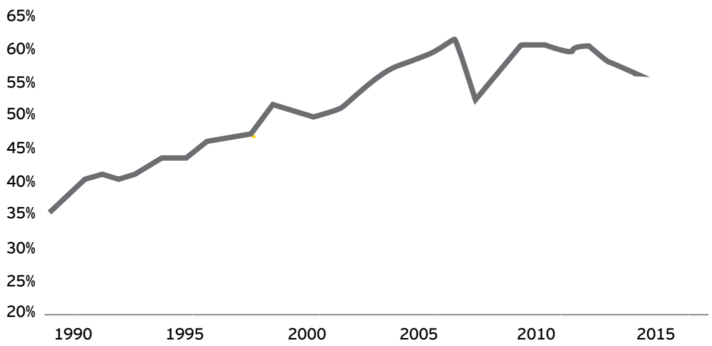
Concurrent with its actions to renegotiate various trade agreements, the administration exercised existing, but little-used, provisions of trade law statutes allowing the President to impose tariffs on national security grounds or for unfair and competitive practices. This resulted in multiple and unpredictable tariffs on imported steel, aluminum and myriad other goods from China, which triggered multiple retaliations of punitive duties on US-origin goods exported to various countries.[24]

Further, the WTO's Appellate Body, which hears trade disputes, continues to be challenged by the administration's ability to withhold renewals or appointments of new arbitration judges as a form of protest over what it views as unfair outcomes or biased judges adverse to US interests, thus risking the shutdown of relied-upon WTO processes.[25]

In this regard, leaders and businesses must remain vigilant on the shifting global trade landscape and relations. Three factors among others are important to note in 2019 strategic decisions — new and reframed trade relationship negotiations, the growing relevance of emerging markets to nations and industries, and increased complexity and scrutiny of trade and capital investment on national security grounds.

Trade has become more important to global growth ...

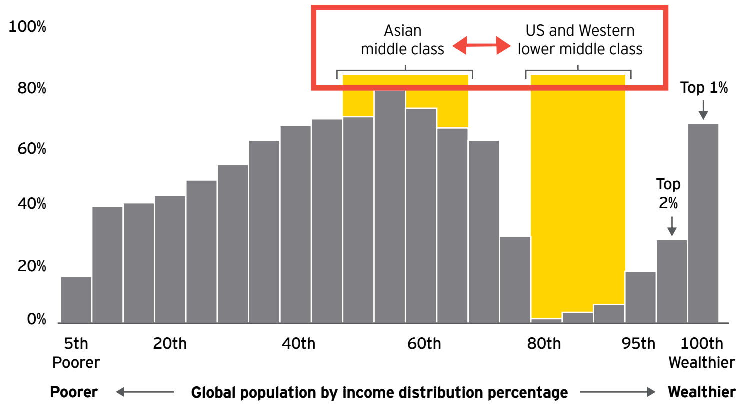
Global trade as a % of world gross domestic product



Source: World Bank

... yet the distribution of gains from trade has been uneven

Real income gains (%), 1998 to 2008



Note: Incomes are real, PPP-adjusted, in 2005 dollars.
Source: Harvard Business Review

Business impact

Strategy – Multinational firms have been built on the assumption that the global trading architecture would reduce transaction costs and increase market access. Given current trade tensions, companies should consider an assessment of the risks and opportunities of their overall geographic footprint.

Revenue – Trade tensions could have an overall growth impact. An EY survey from September 2018 showed that a majority of surveyed US business executives (62 percent) believed that a trade war could have a negative impact on growth, even pushing the US into a recession.[26] A large majority (73 percent) of US business executives believe free trade is generally very good for their business or industry, yet concerns over tariffs, taxes and uncertainty is growing, hurting projects and investment.[27]

Production/supply chain – Trade disruptions may have severe consequences for global supply chains. Monitoring, scenario planning and mitigation strategies to modify and further optimize company and industry supply chains are needed and should become new norms.

Compliance and governance – Trade compliance will become an increasingly relevant subject if global trade fragments further. Stricter control by governmental authorities due to customs issues, more complex rules regarding import and export controls, and higher penalties applicable to international trade activities require companies to rethink how to adjust their trade compliance capabilities. Compliance and tax topics must now become even greater elements of political and business risk management.

Issues to watch

- How will geopolitical rivalry and strategic security considerations shape the future of the global trading architecture?
- Will the US continue to evolve restrictive trade policy and regulations under a protectionist lens that limits global operations, sourcing and market flows?
- Given geopolitical tensions, how resilient is the global trading architecture – and, more specifically, the WTO, its custodian?
- Which markets, emerging or developed, will become new hubs of trade and business value chains? And will these value chains be globally organized or regionally focused?

> Though trade and protectionism have been overriding themes, the substance and direction of global trade have only marginally changed as of now.

Europe: how stable is the Union?

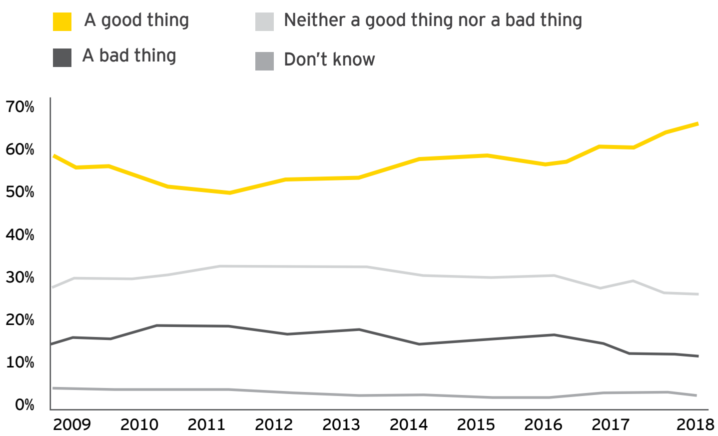
The European integration process was the success story of the second half of the past century. Today, that project is challenged. At its heart, the political battle across Europe pits populist euro-skeptics and liberal integrationists against each other, while the political center struggles to find middle ground. Claude Juncker, president of the European Commission, tellingly suggested in his 2018 State of the Union Address that "European sovereignty [the capacity to play a role, as a Union, in shaping global affairs] is born of Member States' national sovereignty and does not replace it. Sharing sovereignty — when and where needed — makes each of our nation states stronger."[28]

The nationalist challenge to EU cohesion[29] has driven the negotiations over the UK's withdrawal from the EU, the ascendance of the Five Star Movement and the Northern League coalition government in Italy, and the standoff between the EU and Poland over the supremacy of EU law. Meanwhile, Angela Merkel, who has mediated critical European crises over the past 10 years, stepped down as the leader of her party and announced she will end her political career in 2021. French President Emmanuel Macron, who positioned himself as a pro-European integrationist, is facing stiff resistance against his ambitious domestic reform agenda.

However, EU cohesion has proved resilient. The EU has demonstrated a remarkable degree of unity during the Brexit negotiations, and the Italian government has finally agreed to a compromise with the European Commission in its standoff over its expansive fiscal policies. Also, pro-European and liberal civil society movements have provided a strong counterbalance against nationalist and euro-skeptic movements. At the same time, the European integration process is not advancing quickly enough to convince Europeans of its irreversibility. A European reform agenda proposed by President Macron fails to gain traction.

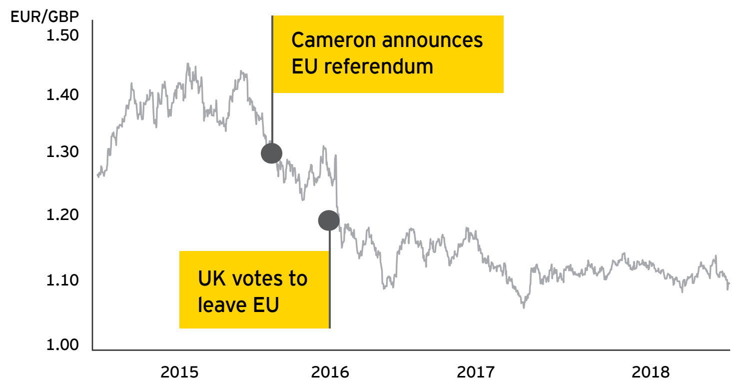
While Europe faces profound internal challenges, external ones loom large. Immigration and refugee flows have been managed in an ad hoc manner at best, and Russia's military and cyber threats have grown. European leaders have been flummoxed by the US: President Trump has repeatedly questioned the need for NATO; the US has imposed tariffs on European steel and aluminum imports and threatened tariffs on automotive imports; and it has expressed support for Brexit, suggesting the UK would be "better off" without the EU,[30] prompting European leaders to question US commitment to shared transatlantic objectives. Acknowledging this growing divide, the EU adopted a new Global Strategy[31] that formally called for strategic autonomy, the ability to pursue its own interests without being constrained by other states.[32] But do European policymakers have the wherewithal to go it alone?

Despite challenges, support for EU membership remains high



Source: European Parliament 2018 Parlemeter Survey

Devaluation of British Pound following EU referendum



Source: S&P Capital IQ

Business impact

Production/supply chain – A looming Brexit and eroding transatlantic relations have caused the EU's external trade relations to become more fragile, challenging European companies to increase their resilience against trade-related risks.

Finance/tax – European tax authorities have taken a proactive stance against profit shifting by multinationals. Business executives need to think through how a more competitive geopolitical and economic environment will affect their tax strategies.

Compliance – In 2018, the EU implemented strict privacy and data protection rules. Companies need to assess how strictly these are enforced, and what critical learning will emerge in the first year of implementation.

Finance/investment – The EU will soon be able to coordinate scrutiny of investments from third countries in strategic sectors to check that they do not threaten security or public order.[33] This regulation will require foreign investors to go through distinct investment screening processes.

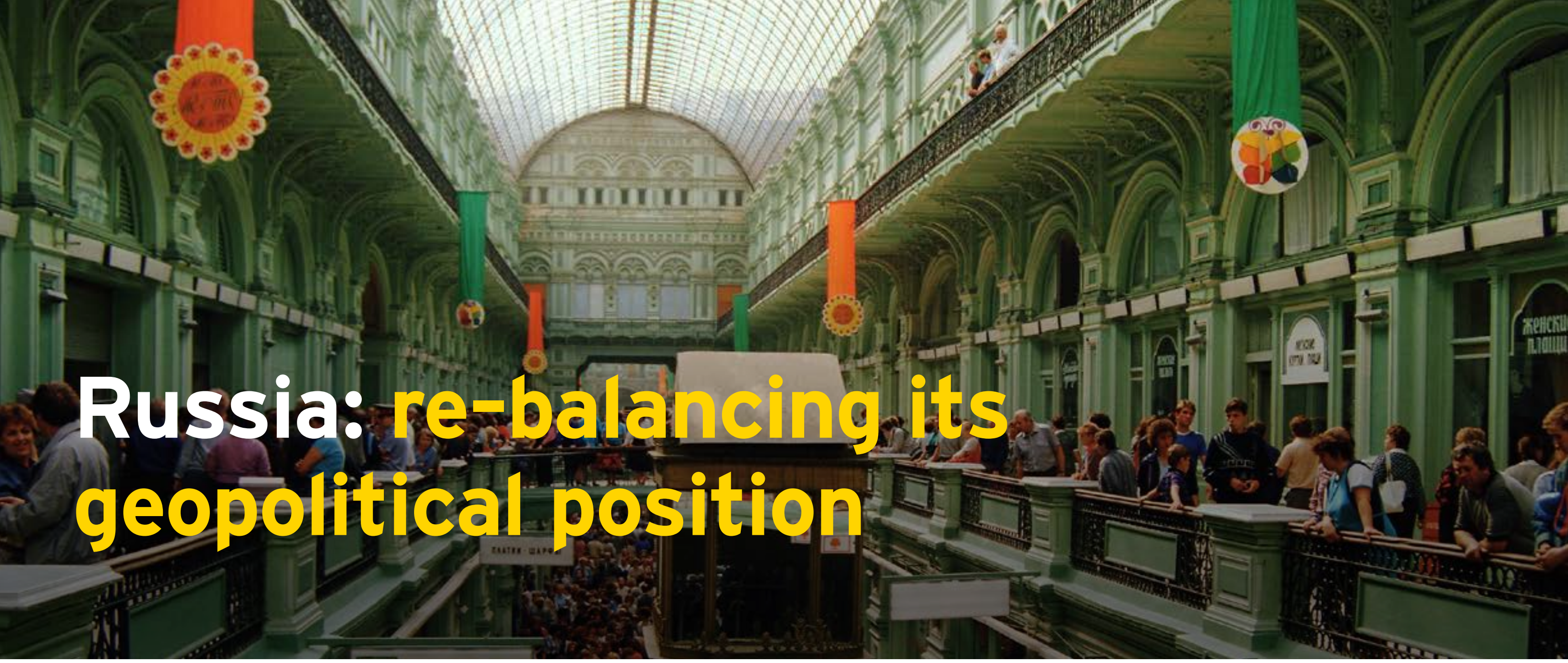
Reputation – With a strong commitment to basic values, and a growing expectation of company stakeholders to uphold these values in their operational dimensions, European companies will find it increasingly difficult to engage with countries who do not share these.

Human capital – As nationalist sentiment grows across European societies, European companies will be challenged to attract the international workforce required to outbalance demographic challenges and maintain their competitive position in industries requiring cultural diversity and innovation.

> At its heart, the political battle across Europe pits populist euro-skeptics and liberal integrationists against each other, while the political center struggles to find middle ground.

Issues to watch

- Now that Merkel has announced her political departure, will Germany continue to serve as a stable political and economic anchor for Europe? What are the priorities of a new generation of political leaders emerging in the post-Merkel era?
- How resilient is the domestic and EU reform agenda of President Macron, given his political troubles at home?
- Could the disorderly Brexit process actually serve to strengthen the Union?
- Europe faces several important votes in 2019: elections to the European Parliament and parliamentary elections in Belgium, Denmark, Greece, Poland and Portugal.[34] How strongly will populist and nationalist sentiment resonate with voters in 2019?



Russia: re-balancing its geopolitical position

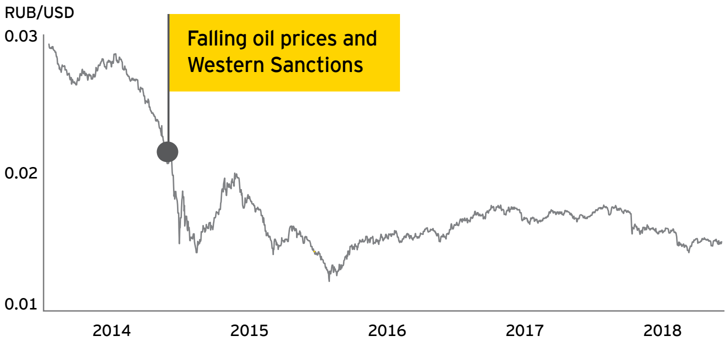
Since President Vladimir Putin's speech in Munich in 2007, in which he confronted the United States' dominance of global affairs,[35] Russia has been searching for its new global role. Endowed with rich natural resources but a comparatively weak industrial base, with the legacy of a global superpower but comparatively limited global political influence, Russia has opted to pursue an opportunistic foreign policy and diversify its external relations away from the West. It has built deeper economic, political and military relationships with China and across the Middle East, while taking a more antagonistic approach toward Europe and the US. Though a long-awaited summit between US President Trump and President Putin took place in July 2018 in Helsinki, neither side has been able to present a diplomatic initiative that could put Russia's relations with the West on a more cooperative track.

Over the last year, tensions have heightened over the conflict in Syria, cyber interference in elections and online platforms, the poisoning of former military officer Sergei Skripal and his daughter in the UK, and the blocked passage of Ukrainian ships through the Kerch Strait in late November.[36]

And sanctions, which were initially imposed in response to Russia's annexation of Crimea and the conflict in Ukraine, have been steadfastly maintained and selectively tightened. The US expanded sanctions through the Countering America's Adversaries Through Sanctions Act (CAATSA) in 2017, followed by sanctions on the assets of senior officials and leading Russian businessmen in 2018. Additional sanctions were adopted by both the EU and the US in response to the Skripal affair in the UK.

Though Moscow strives to modernize the Russian economy, confronted with blocked access to Western markets, it has turned to import substitution and the pursuit of a parallel financial and trade architecture outside the dollar system.[37] In addition to sanctions, structural constraints — including a large economic footprint of the state, excessive regulation, governance and institutional weaknesses, and inadequate infrastructure — combined with tight monetary policy to bring inflation down, have stalled Russia's transition to advanced economy status.[38]

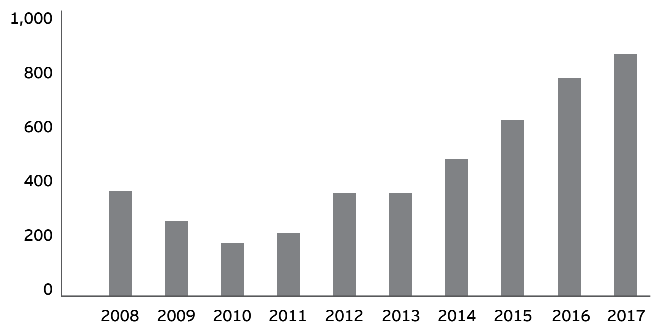
After facing devaluation in 2014, the Russian Ruble stabilized...



Source: S&P Capital IQ

Russia crude oil exports to China

Thousand barrels per day



Note: 2017 data are January through September

Source: US Energy Information Administration

Business impact

Production/supply chain — Companies with significant value chains in Russia need to develop adequate contingency plans in case onerous sectoral sanctions are imposed.

Revenue — Should oil prices remain weak in 2019, it could have serious implications for Russia's macroeconomic outlook and reflect on the revenue trajectory in particular of retail and consumer firms operating in Russia.

Compliance and governance — Fragile public governance in Russia provides the backdrop against which illicit commercial activities proliferate. Good corporate governance and watertight compliance standards are essential when operating in Russia.

Finance — Russian investors over the past decades have sought to diversify holdings outside Russia, including acquiring important stakes in Western companies. A tightening Western sanctions regime could mean adverse corporate financing conditions for Russian investors.

> Given the limited space of political options but eager to re-establish a position as a global power broker, Russia has continued to test its adversaries.

Issues to watch

- Is Russia searching for the "red lines" of the West? Will an aggressive move by Moscow or the investigations into the ties to the Trump administration trigger more onerous sectoral sanctions again Russia's oil or financial services industries in 2019?
- What are the options for constructive engagement between Russia and the West that could signal a shift away from the present hostile stances?
- To what extent is Russia capable of further diversifying its economy away from the West, and what alliances can it develop? What are the business implications of deepening Russia-China economic ties?
- How will oil price developments in 2019 impact Russia's economy and the nation's ability to project power abroad?

Middle East: fragmentation

The Middle East has been dramatically fragmenting over the past decade, profoundly compromising the region's ability to reform its economies.[39] The regional dynamics in 2018 have revolved around the politics of three countries and the roles that external parties to the region are playing.

Saudi Arabia has reinforced its position as a counterbalance to Iranian influence. It continues to proactively combat competitors on the Arabian Peninsula diplomatically and economically (blockade of Qatar) and militarily (intervention in Yemen). Domestically, it has sought to promote an ambitious reform agenda, the Vision 2030, which is designed to diversify its economy away from oil.

Iran was bound to engage with the international community after the conclusion of the nuclear deal in 2015. At the same time, it also built its regional influence across Syria into southern Lebanon. After the Trump administration abandoned the Iran nuclear deal and re-imposed sanctions, Tehran is challenged to maintain its domestic economic stability and its relationships with the other parties of the deal and, over the longer term, decide about its nuclear commitments.

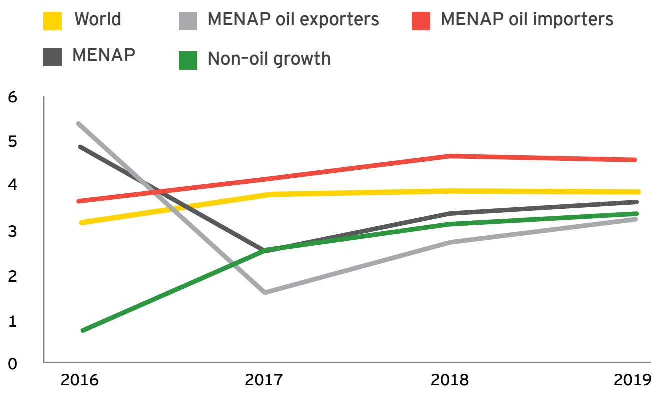
In Syria, after several years of civil war and the consequential humanitarian crises, the government has reasserted control over most of the country, supported by Russia and Iran. Gaining full control will remain a key objective of the Assad regime. How the country is going to be rebuilt, and what relationships it will develop in the region and abroad, remains inconclusive.[40]

External powers are continuing to determine the regional dynamics. After abandoning the nuclear deal with Iran, the US has anchored its regional influence in Israel and Saudi Arabia. Turkey remains a power broker in Syria and maintains influence in the Gulf region through strong linkages to Qatar. Russia has consolidated its military presence in Syria but also begun to build ties with Gulf countries through financial diplomacy. China has become the largest consumer of Saudi crude oil and is set to broaden its regional footprint, driven by a more assertive foreign policy.

Regional fragmentation and conflict suck up resources needed to set the path of a sustainable economic reform and growth trajectory, with the region's economic prospects still anchored in the trajectory of global oil and gas prices. The IMF has argued that, given stunted growth prospects, the region needs to accelerate structural reform agendas and move to a new growth model that promotes diversification and private-sector development.[41] However, because of geopolitical competition and the need for a strong state, government-owned or government-influenced companies will dominate the business landscape in most countries.

Middle East economic outlook, real GDP growth

Real GDP growth 2016-2019



Note: MENAP refers to Middle East, North Africa, Afghanistan, and Pakistan.
Source: National authorities, IMF staff calculations

Refugees have become a dominant driver in the region

2.9 million people

For the third consecutive year, Turkey hosted the largest number of refugees worldwide, with 2.9 million people. The main countries of asylum for refugees were:

Turkey	2.9 million
Pakistan	1.4 million
Lebanon	1.0 million
Islamic Republic of Iran	979,400
Uganda	940,800
Ethiopia	791,600

55%

More than half (55 percent) of all refugees worldwide came from just three countries:

Syrian Arab Republic	(5.5 million)
Afghanistan	(2.5 million)
South Sudan	(1.4 million)

Source: "Global Trends: Forced Displacement in 2016," UN High Commissioner for Refugees

Business impact

Reputation/strategy — Human rights incidents represent a stark reminder of the reputational risks associated with engaging in the region. Companies need to carefully balance commercial opportunities and reputational risks in their overall Middle East operational strategies.

Production/supply chain — Given the volatile geopolitical situation, companies must have contingency plans in place, increasing the resilience of their supply chains and buffering against the risks to their operations.

Revenue — Oil prices remain a foundation for the region's economic health, driving local investment and spending. Any fluctuation of oil prices will determine the overall attractiveness of consumer markets in the Middle East and, in particular, the Gulf region.

Human capital — The drive for employment of nationals rather than expats creates challenges across the Gulf Cooperation Council (GCC). Saudi expat remittance dropped by 18%[42] year over year, a direct result of hundreds of thousands of lower-paid expats leaving. It remains to be seen whether nationals will want to fill these jobs and, if not, how economic activity and talent sourcing strategies will be affected.

Compliance — The renewal of sanctions by the US against Iran requires companies to diligently maintain or, if necessary, upgrade their compliance standards and effectively manage the risks of secondary sanctions.

Finance — Over the past decades, investment funds of Arab oil producers have diversified their financial assets across asset classes. They have begun to build important stakes in the global corporate community — and increasingly so in private equity, most notably in the tech sector. Since these investors are accountable to government, their investment behavior will have to correspond with the political preferences of governments.

> Regional fragmentation and conflict suck up resources needed to set the path of a sustainable economic reform and growth trajectory.

Issues to watch

- How vigorously is the Saudi leadership going to advance its Vision 2030 reform agenda in 2019? What are the structural impediments to success that bear watching? Should oil prices remain weak, how will this impact the country's economic trajectory in 2019 and in the Vision 2030 plans?
- Turkey's economy came under pressure in 2018 amid growing concerns about creeping authoritarianism and the government's counterproductive interventions in the economy and banking system. Will President Erdogan and his government bolster or undermine investor confidence in 2019?
- What are the economic and business risks associated with heated political infighting in Iran? Given this, will Tehran continue to abide by the nuclear deal in good faith and sustain the support of the remaining parties to the deal in 2019?
- How is the diplomatic and economic blockade against Qatar going to play out over the coming year, and what further relationships will Qatar build to manage the adverse effects of the blockade?

Emerging markets: beyond the headlines

The beginning of 2019 has been marked by a more cautious outlook for the global economy, potentially disproportionally compromising the economic prospects of emerging markets (EMs). Global interest rates are expected to continue rising in 2019, and currency volatility will constrain policy latitude and add to budget pressures across EMs. Equity, bond and currency markets in key EMs were volatile in 2018. This uncertain environment will drive EM policymakers' willingness and ability to navigate domestic political constraints. Given their size and systemic relevance, Mexico, Brazil, Argentina, Venezuela, South Africa, India and Turkey are especially exposed to global macroeconomic instability and currency volatility. Their prospects will largely be shaped by global economic conditions and trade developments, domestic electoral politics and reform agendas. They will also be affected by their alignment with the centers of the emerging multipolar world order.

Latin America could see some pivotal domestic developments in the coming year. In July 2018, Andres Manuel Lopez Obrador won **Mexico**'s presidency with a resounding mandate for change. **Brazil**'s new President, Jair Bolsonaro, took office in January 2019, leaving bullish investors betting on the success of comprehensive pro-market policies. The Macri government has been trying to turn **Argentina** around as it faces high fiscal and current account deficits, a tumbling currency and surging inflation. Its efforts at structural adjustment, welcomed by investors but deeply unpopular at home, have put the government in a bind, and its staying power will be tested in national elections in October. Despite economic chaos, the **Venezuelan** government of President Nicolas Maduro has demonstrated its ability to remain in power over the course of 2018. Its demise would send a powerful message about the failures of leftist populism across the region.

With GDP growth projected to remain slightly below 2 percent in the medium term, **South Africa** will struggle to raise per-capita income significantly and effectively combat unemployment, which stands at a stunning 27.5%. Outcomes of general elections in May 2019 will determine the future path of a comprehensive reform agenda. In **India**, the government of Prime Minister Narendra Modi has been pursuing an ambitious policy agenda that includes the promotion of manufacturing and exports, the improvement of infrastructure, the fight against corruption and red tape, and the bolstering of India's military and geopolitical stature. A crucial general election for Modi and his Bharatiya Janata Party scheduled for the spring will determine if he remains in power until 2024. In **Turkey**, large current account and fiscal deficits have spooked investors, interest rates have risen, and inflation has spiked. Risk perceptions are likely to remain high in 2019 if the Erdogan government continues its efforts to exert control over the central bank, judiciary, press and businesses.

More broadly, emerging markets will need to respond to the pervasive forces of the emerging global multipolar order. Great-power politics will be focused on creating spheres of influence. Individual EMs will make a careful cost/benefit analysis as they opt to align themselves with any one center of global power. The reconfiguration of global trade relations and the recognition of commercial standards will become key aspects of this process.

Election timing

India | April/May 2019

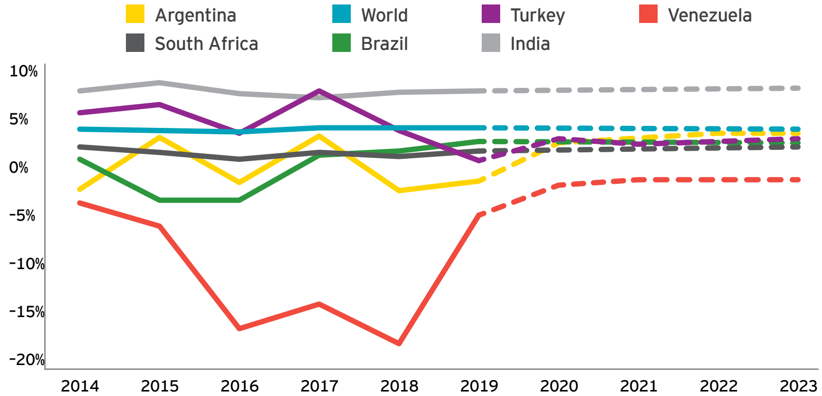
South Africa | May 2019

Argentina | October 2019

Source: EY analysis

GDP growth forecast

Real GDP growth (annual percent change)



Note: 2018 represents mix of historical and projected figures. 2019 through 2023 represent projections."
Source: International Monetary Fund, October 2018

Business impact

Strategy – Emerging markets have traditionally been seen as high-opportunity markets. But growth rates across EMs have slowed. Companies need to carefully assess market attractiveness in an uncertain global economic and geopolitical environment, and which policy shifts would signal a buying opportunity or a signal to sell.

Production/supply chain – The fragmenting geopolitical space and the new alignment of EMs might inform a shift in global supply chains. Companies should carefully assess how such realignments might affect their own supply chains and diversify them accordingly.

Finance and investment – As interest rates in the US have risen and as global and EM growth has slowed, many EM currencies have depreciated, and concern about debt burdens has risen. Market participants should assess EM resilience and the strength of financial buffers and policy flexibility to manage a shifting external environment and sustain growth.

Reputation – Emerging markets often present great growth opportunities, but these markets are characterized by weaker institutions and rule of law. Companies engaging across EMs should strike the right balance among economic and environmental, social, and governance performance, and assess whether nationalism, populism and authoritarianism represent reputational risks.

Issues to watch

- Will rising risk perceptions across the globe in 2019 hit EMs relatively hard?
- How will upcoming elections across many EMs shape countries' economic policy trajectories?
- Can political leaders deliver on promised economic reforms? Are the reform agendas sustainable in an uncertain economic context?
- How will EMs recalibrate their economic relations with China and the US, given slowing growth in that market and rising geopolitical tensions?

> Global interest rates are expected to continue rising in 2019, and currency volatility will constrain policy latitude and add to budget pressures across EMs. Equity, bond and currency markets in key EMs were volatile in 2018. This uncertain environment will drive EM policymakers' willingness and ability to navigate domestic political constraints.

Authors

Sven Behrendt, PhD
Senior Consultant
Geostrategic Business Group — Ernst & Young LLP

Mary K. Cline, PhD
Director
Office of the Chairman — Ernst & Young LLP

Kyle P. Lawless
Assistant Director
Geostrategic Business Group — Ernst & Young LLP

Jonathan Shames
Global Leader
Geostrategic Business Group — Ernst & Young LLP

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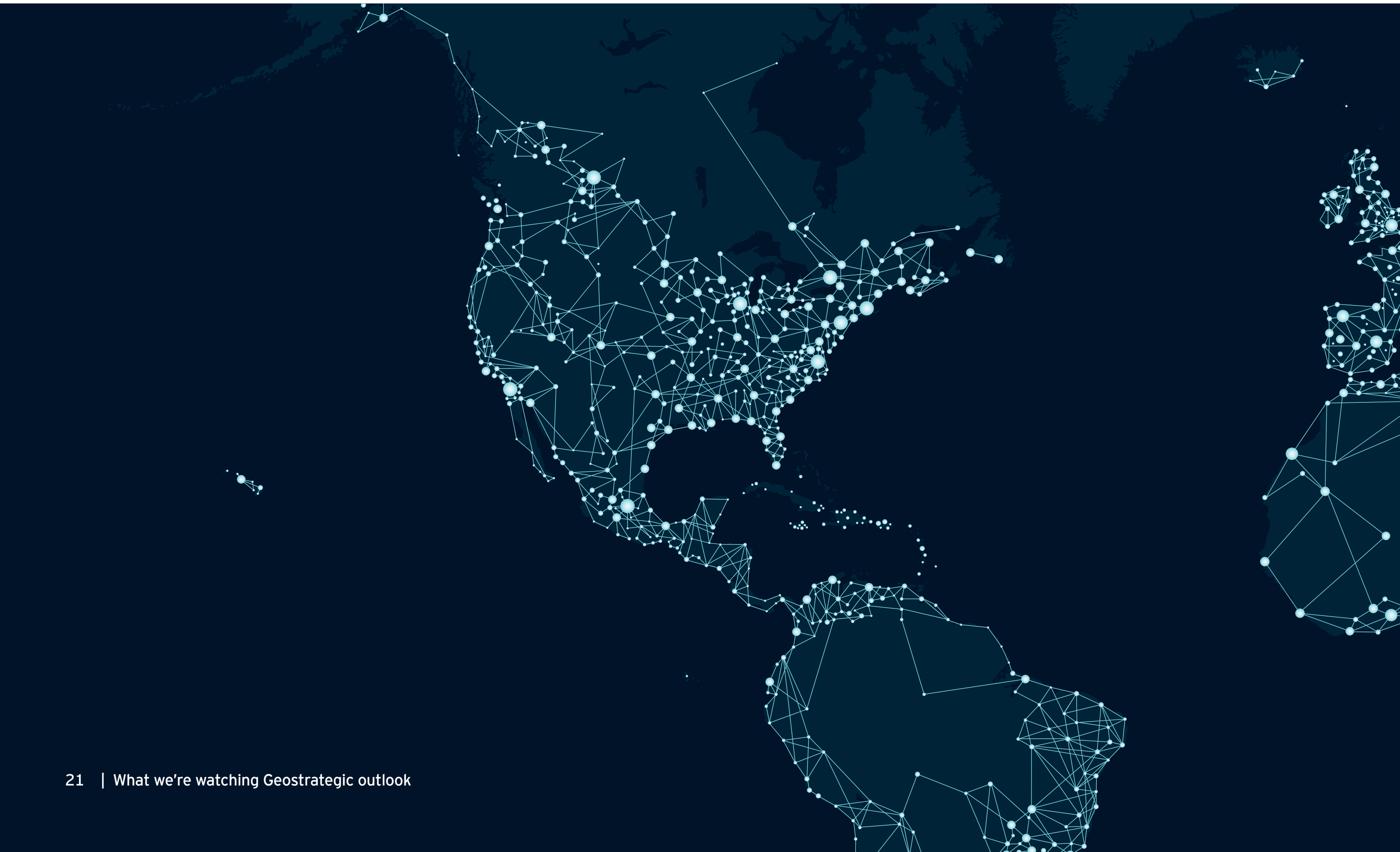

Contact

Adam Barbina
Trade Leader
Geostrategic Business Group – Ernst & Young LLP
adam.l.barbina@ey.com

Mary K. Cline, PhD
Director
Office of the Chairman – Ernst & Young LLP
mary.k.cline@ey.com

Cherie Faiella
Global Deputy Leader
Geostrategic Business Group – Ernst & Young LLP
cherie.faiella@fr.ey.com

Oliver Jones
TAS Leader
Geostrategic Business Group – Ernst & Young LLP
oliver.jones@uk.ey.com

Nobuko Kobayashi
Asia Pacific Leader
Geostrategic Business Group – Ernst & Young LLP
nobuko.kobayashi@jp.ey.com

Kyle P. Lawless
Assistant Director
Geostrategic Business Group – Ernst & Young LLP
kyle.lawless@ey.com

Marc Lhermitte
EMEIA Leader
Geostrategic Business Group – Ernst & Young LLP
marc.lhermitte@fr.ey.com

Scott Sarazen
Global Deputy Leader
Geostrategic Business Group – Ernst & Young LLP
scott.sarazen@ey.com

Jonathan Shames
Global Leader
Geostrategic Business Group – Ernst & Young LLP
jonathan.shames@ey.com

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