

## Arks, sharks and whales

### Arks, Sharks and Whales: Navigating a world in flux

by [Jonathan Wood](#).

Global politics is entering uncharted waters. The post-Cold War liberal world order crafted by the US, Europe and their allies, which provides the framework for multinational enterprise, is increasingly threatened by both external and internal challengers.

Externally, major powers are promoting alternate visions of world order. A new global economy has emerged from rapid growth in the developing world, where large economies like China and India, or regions like sub-Saharan Africa and Southeast Asia, lead trade and investment opportunity. These economies now account for majorities of global output, investment and internet usage. They are actively contesting the military primacy, institutional dominance, and ideological attractiveness of the West, and constructing rival relationships as necessary to support and advance their interests. The ambition of an international rule of law is succumbing to nationalist ‘facts on the ground’.

Internally, Western political populism is questioning the viability and durability of the liberal world order. The recent success of nationalist, isolationist and protectionist movements in the US and Europe, often fringed with xenophobic factions, has depleted political support for global trade, foreign aid, and costly military commitments. The rarefied benefits of international institutions to peace and prosperity have manifestly paled in comparison to the tangible costs for workers and communities across the Western world.

While post-Cold War assumptions are fading away, the contours of the next world order are still being negotiated. The global public goods that facilitated the rise of international business – geopolitical stability, trade and investment liberalisation, democratisation – are getting scarcer. Rapid technological advance is disrupting industries, identities and ideas.

For many companies, political, economic, security and integrity risks have shifted from the frontier to the home front. In particular, the commercial landscape among government, private sector and non-state actors is getting more complex, as corporate regulation is increasingly ‘weaponised’ to assert national interests, whether ‘fiscal sovereignty’ or industrial policy. Over a longer horizon, when today’s political leaders are historical footnotes, climate change is likely to fundamentally alter business risks; for some industries, in some locations, it will be a literal question of sinking or swimming with the changing environment.

#### **Political populism rocks the trade boat**

Across the Western world, populist movements are eroding the consensus behind globalisation in favour of greater national control of economic and security policy. Their positions on trade and immigration, in particular, expose deep economic and social divisions between the perceived

winners and losers from globalisation. Public opinion surveys also disclose a deep distrust of established political and economic institutions, arising from the gap between government promises and actual accomplishments.

They have a point: Western lower middle classes benefited substantially less from trade than either middle-income emerging markets (chiefly in Asia) or the very wealthy. Meanwhile, mass immigration, whether economic or conflict-driven, has strained social cohesion and community identity sufficiently that humanitarian or economic arguments often fall on deaf ears. These are not revelatory developments: what's new is that populist movements are seizing specific political opportunities – from the Brexit referendum to the US election – to change the status quo. What matters is that these opportunities sit at the core of the post-Cold War order.

The global trading system, in particular, faces considerable upheaval in 2017. Of most immediate concern to many multinationals is that the incoming US administration will make good on threats to renegotiate US trade relations with China, Mexico and perhaps other countries. In addition to upending settled trade, investment and production arrangements, this would invite retaliation – whether WTO-sanctioned or otherwise – with considerable potential for escalation in the trade arena and contagion in other policy areas.

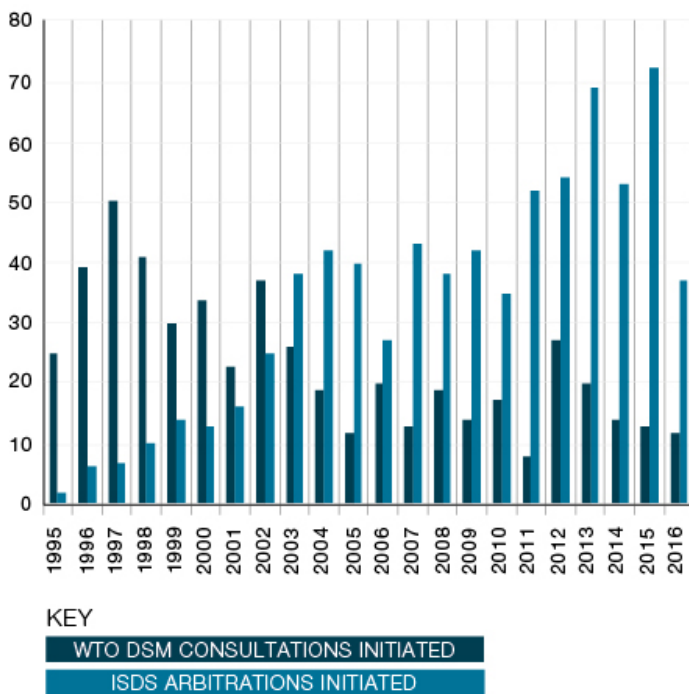
An escalating US-China trade war, specifically, would negatively affect growth in both locations beyond the capacity of fiscal stimulus to respond, and by extension damage the world economy. In extremis, it could cascade into the collapse of the global trading system. Alternately, US trade policy may hew to existing institutions and legal frameworks, with relatively cosmetic or symbolic changes. The main challenge for business is uncertainty: there is a wide range of potential outcomes and impacts that depend on US policies that have yet to be decided or formalised.

Across the Atlantic, the iconic components of the EU project – the single market and borderless travel – will remain under pressure in 2017 from populist movements. In addition to shaping Austrian and Italian polls in late 2016, populists are expected to contest pivotal elections in France, Germany, and Netherlands. The launch of Brexit negotiations, meanwhile, will crystallise the challenges of disentangling trade and investment relations in the name of sovereignty. Again, until elections occur and negotiations play out, businesses operating in Europe face significant uncertainty in the trade and investment environment.

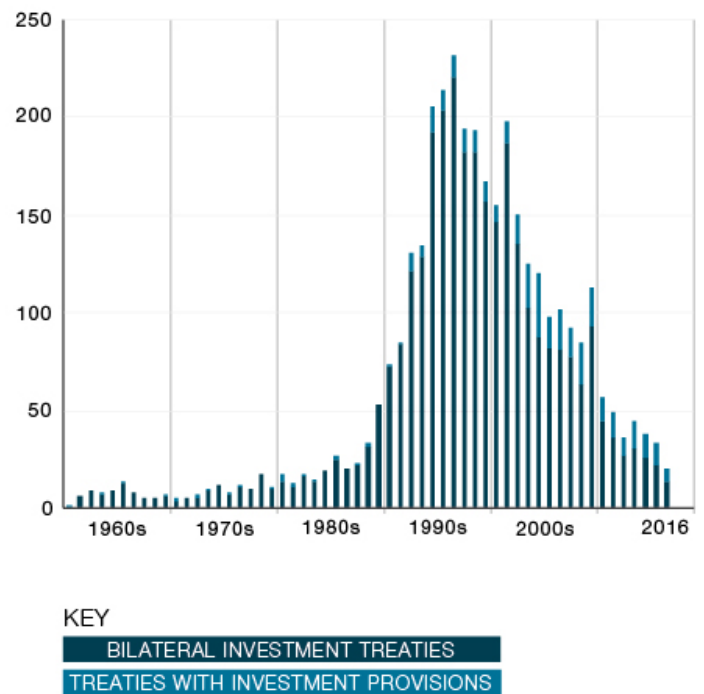
Some things are more certain: the underlying world trade and investment order remains historically open and integrated going into 2017. Indeed, the slowdown in world trade growth over the last two years is more a function of falling growth than rising protectionism. The institutions of trade and investment are functioning, if relatively steady numbers of WTO disputes and investor-state dispute settlement (ISDS) cases are any indication. The 1990s heyday of trade and investment liberalisation may have passed, but this reflects diminishing returns to further liberalisation and standardisation. Meanwhile, global levels of FDI have recovered since the financial crisis: while Western countries tighten 'national security' restrictions on foreign investment, especially driven by attempted Chinese acquisitions, investment policies in fast-growing Asian countries continue to skew towards liberalisation.

Even in the absence of major trade disputes, a more protectionist and transactional US trade policy – signalled by prospective withdrawal from the Trans-Pacific Partnership (TPP) and renegotiation of the North American Free Trade Agreement (NAFTA) early in 2017 – would break with an era of intensive US promotion and defence of trade and investment liberalisation. The free trade torch may eventually, of necessity, pass to major Asian economies such as China and India, which have benefited from and continue to support trade as an engine of prosperity. China is already pitching a series of rival trade agreements to Pacific Rim countries to fill the void left by US disengagement. More broadly, China may perceive an opportunity to substitute for the US as a reliable ally and guarantor of the so-called global commons, including the international trading system.

## TRADE DISPUTES, 1995-2016



## INVESTMENT TREATIES, 1957-2016



Source: WTO, UNCTAD

## Global economy bobbing in the shallows

Global growth is forecast to improve modestly, but is likely to remain below the pre-crisis average in 2017 and beyond. In general, global growth remains impaired by chronic underinvestment in infrastructure in both developing and advanced economies, ageing populations, rising inequality and low productivity growth. Political dynamics impairing further trade liberalisation, as well as geopolitical uncertainty, have also contributed to slowing trade and FDI. Executives cite geopolitical uncertainty and security concerns as key factors tempering investment into emerging and developing economies.

However, emerging markets are stabilising after a multi-year slowdown. Some – including India and China (assuming it continues to avoid a so-called ‘hard landing’) – will continue to deliver relatively strong growth. While FDI flows shifted back to advanced economies in 2015, they will resume their pursuit of rapid growth, economic transformation and rising middle classes in 2017 and beyond.

In addition, as anticipated, the modest recovery and stabilisation in commodity prices during 2016 helped. In combination with domestic economic reforms – including spending cuts, privatisation, subsidy reform and currency devaluation – this has alleviated short-term budget problems and improved longer-term fiscal and economic flexibility. OPEC’s return to supply management in late 2016 after a two-year hiatus will help keep a floor under oil prices, even if it also buoys non-OPEC production.

Finally, the US economy is poised to reclaim its role as a global economic driver. A more inflationary US fiscal policy comprised of corporate tax cuts and infrastructure spending, if adopted, could spur growth in 2017. It will also keep attention fixed on the US Federal Reserve, which may be forced to accelerate the pace of interest rate rises. (One consequence is that emerging markets still burdened by unsustainable debt, overpriced currencies or inflated stock markets will remain vulnerable to volatility.) Even in the EU, the economic winds seem to be shifting away from austerity and unconventional monetary policy towards fiscal stimulus.

### **Geopolitics adrift amid multipolar competition**

Nationalism, global power vacuums and proxy conflicts will continue to drive geopolitics in 2017. The pillars of the post-Cold War world order continue to erode, as nationalist rising powers seize initiative with impunity – from eastern Ukraine to Syria to the South China Sea – from the ponderous machinery of global governance. These dynamics reflect a world order in transition, unmoored from US superpower dominance and buffeted by the radical transmission of non-state threats, such as transnational terrorism, organised crime and cyber attacks.

Core elements of this environment have featured in RiskMap for several years. Several violent conflicts remain intractable, chiefly Afghanistan, Syria/Iraq, Libya, Yemen, and Ukraine. Russia and China continue to forge regional spheres of influence against perceived US-led containment. The Middle East is increasingly shaped by competition among Saudi Arabia, Iran and Turkey for regional primacy, as well as the strategic interests of external powers such as Russia and China. India and Pakistan continue to exchange artillery shells and heated rhetoric in disputed Kashmir, while Israel and Palestine drift further from a sustainable political settlement.

Across all of these issues, prospective shifts in the US’s global posture will be a source of considerable uncertainty in 2017 and beyond. Under the rubric of ‘America First’, the US could become less concerned with supplying global public goods underpinning the liberal international order, such as freedom of navigation. This could encourage more stable and pragmatic relations with like-minded emerging markets, especially around narrow, shared security interests such as counter-terrorism. Alternately, it could prompt greater confrontation over perceived national interests. At the very least, the incoming administration appears to favour a shift towards unilateral

hard power (read: military strength) over international leadership.

Other new geopolitical variables are also likely to become more prominent in 2017. First, even as international attention continues to focus on maritime disputes in East Asia, China is taking concrete steps to globalise its diplomatic and military influence. In addition to the 'Belt and Road' and so-called 'string of pearls' projects, in Central Asia and the Indian Ocean respectively, China is boosting its hard and soft power presence in sub-Saharan Africa. (Its main regional competitor, Japan, is more or less responding in kind.) More broadly, the likelihood of a US pivot away from Asia on both trade and regional alliances will create space for China and incentives in its neighbours to cultivate stronger, more stable relations.

Second, a series of energy revolutions in the US is beginning to pay strategic dividends. Thanks to hydraulic fracturing, the US has supplanted OPEC as the decisive global oil producer and emerged as a strategic liquefied natural gas (LNG) supplier to Europe. This has reduced strategic dependence on the Middle East, while marginal pricing power confers a degree of leverage over hostile petro-states. (Ironically, if unavoidably, OPEC collective action now accrues to the benefit of the US shale industry, which effectively won its standoff with Saudi Arabia over market policy.) As one result, the US has quietly resumed pipeline politics, lobbying against Russian pipelines bypassing Ukraine, while promoting pipelines in the eastern Mediterranean as a vehicle for regional peace. Meanwhile, thanks to subsidies and plummeting equipment costs, renewable solar and wind power installations have surged past fossil fuels and are verging on cost-competitiveness, even without subsidies. The incoming US administration is likely to encourage domestic fossil fuel production, and may begin to remove both policy and financial incentives for renewable energy, but will not be able to entirely blunt such strong market forces.

Third, North Korea's systematic improvement of its ballistic missile and nuclear weapons capabilities threatens to upend a relatively static regional and global status quo. Missile launches and test detonations have evolved from periodic symbolic demonstrations, designed to force recognition and concessions from the US, into a sustained race for a credible nuclear deterrent to ensure regime survival. North Korea's progress towards a nuclear-armed ballistic missile is accelerating, diminishing the window for either denuclearisation or pre-emption, which is increasingly openly discussed in Seoul and Washington. However, the incoming US administration and a prospective change in leadership in South Korea could alternately 'reset' peninsular diplomacy with a view toward slowing or altering North Korea's nuclear programme. As inscrutable as the North Korean regime remains, two things appear likely: first, Pyongyang is likely to welcome the new White House with a provocation – perhaps a sixth nuclear test – that provides an early test of its foreign policy. Second, the range of plausible positive and negative scenarios has expanded in ways that preserve significant uncertainty, but do not immediately increase the threat of major conflict.

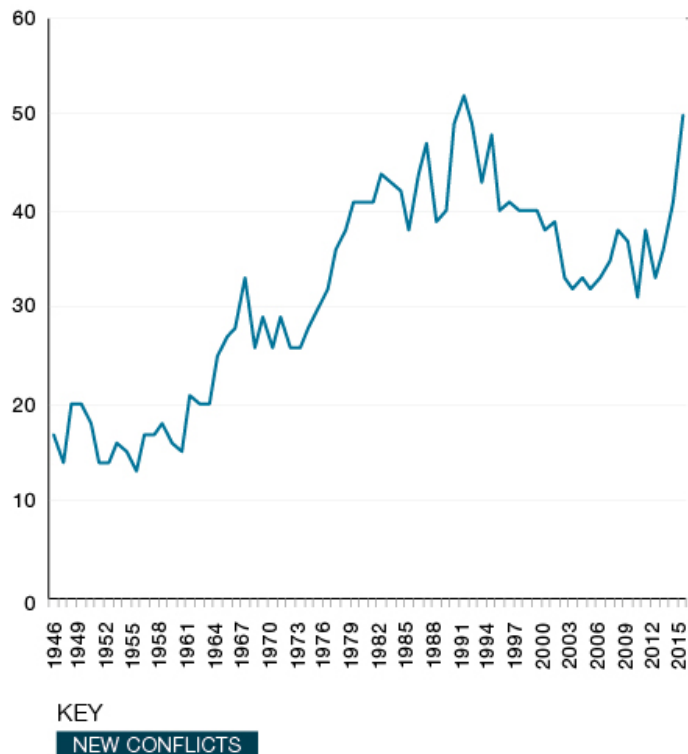
### **Security threats rippling worldwide**

The global security landscape in 2017 is likely to remain highly complicated and fraught. The number of new conflicts has surged since the 2011 Arab spring. Led by Syria, recent conflicts have been particularly violent and disruptive, resulting in the sharpest increases in battlefield deaths,

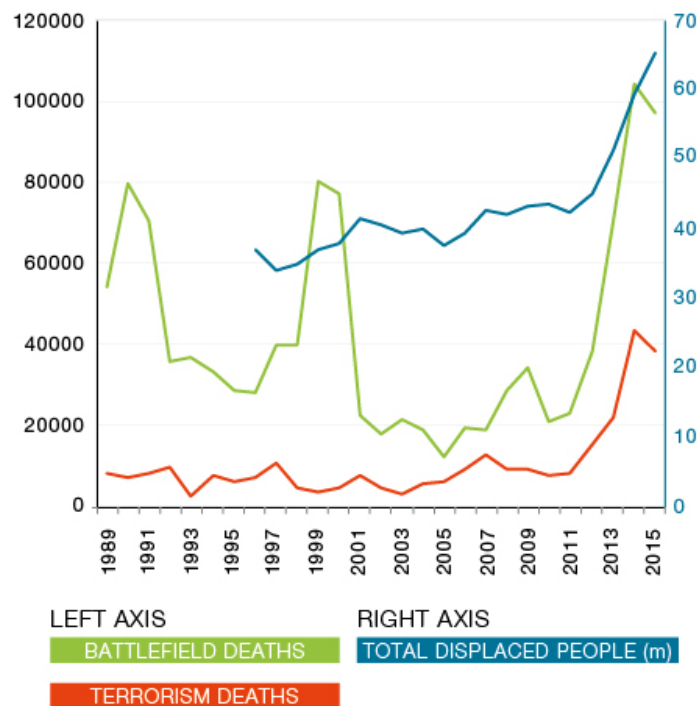


terrorism-related deaths and displaced persons since the end of the Cold War. These bleak outcomes reflect several factors, such as the aggressive ethno-sectarian dimension of recent conflicts, including in places like Central African Republic and Darfur, and widespread proliferation of both small arms and heavy weapon systems, especially out of Libyan arsenals.

## NEW CONFLICTS PER YEAR, 1946-2015



## BATTLE/TERRORISM DEATHS AND DISPLACED PEOPLE, 1989-2015



Source: UNDP/PRIIO, START Global Terrorism Database, UNHCR

The militarisation of strategic confrontations worldwide is of growing concern for business because of the rising potential for accident or miscalculation. While major conflict remains unlikely in the South or East China Seas, further militarisation of disputes among China, its neighbours and the US over territorial control and freedom of navigation is likely. Both China and the US have strategic credibility at stake in the region, and both (as well as Japan and Vietnam) are relying increasingly on military capabilities to press their claims.

Jihadist group Islamic State (IS) and its affiliates and sympathisers will pose a persistent threat in 2017 in most regions. As discussed in more detail elsewhere in RiskMap, we expect that the collapse of IS territorial control will accelerate fragmentation of the group and its global network. Specifically, it will spur an outflow of foreign fighters and experienced militants; prompt a reconfiguration of jihadist tactical and strategic alliances worldwide; and drive IS to retreat into terrorist tactics, both in the Middle East and abroad. Meanwhile, the al-Qaida network – though still under duress in Afghanistan and Yemen – has shifted its centre of gravity to affiliate Jabhat Fatah

al-Sham (JFS) in Syria. JFS has not yet directed transnational attacks, but has provided safe haven to al-Qaida operatives involved in external operations.

Similarly, Saudi Arabia and Iran will continue to avoid direct military engagement in 2017 in favour of proxy conflicts in Syria and Yemen, but also continue to jockey for position, including in the strategic Hormuz and Bab el-Mandeb straits. As anticipated, the Iran nuclear deal – while preventing a regional nuclear arms race – has emboldened Iran to challenge the US-Saudi regional security architecture. By the same token, the new US administration is likely to be much more hostile towards Iran, with the prospect of renewed sanctions threatening the integrity of the nuclear deal itself.

Russia, meanwhile, will strive to avoid a direct and unwinnable military confrontation with NATO, even as domestic political and economic factors continue to promote militarisation of foreign policy. NATO's Baltic deterrence task force will be in place by early 2017, initially under UK leadership, blunting overt military threats to Europe. However, Russia is likely to maintain a high level of air patrols in or near European airspace, and will continue to bolster its Black Sea and Mediterranean naval fleets, with a view towards securing its positions in Crimea and Syria. The reinsertion of nuclear weapons into Russian strategy is of general concern, if not imminent threat. Most significantly, the new US administration holds the possibility of another 'reset' in US-Russia relations, potentially revolving around counter-terrorism co-operation in Syria and relaxing Ukraine-related sanctions.

Perhaps more importantly for business, the latent threat of cyber war poses rising collateral risks to both physical and digital systems. First, cyber operations are increasingly normalised as tools of statecraft, as opposed to simply intelligence gathering, with a number of proof-of-concept attacks on infrastructure appearing to serve as geopolitical threats. Second, the move from clandestine to overt (if not always attributable) cyber aggression suggests decreasing restraint among key players, particularly Russia and the US. Finally, the disclosure of advanced cyber weapons – as well as the colonisation of new internet of things terrain – is augmenting the capability of all malicious cyber actors, from criminal groups to hacktivists.

### **Responding to strategic uncertainty: arks, sharks and whales**

Success in 2017 means recognising and adapting to a prolonged period of strategic uncertainty. Most companies will seek to account for strategic uncertainty by reconfiguring their businesses in one of three ways: limiting risk, seizing opportunity or positioning for future growth. [READ MORE](#)

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