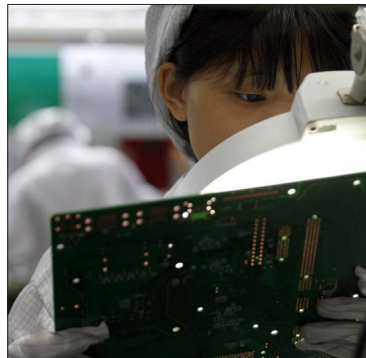


Eurasia Group Global Trends Quarterly



Executive Summary

In collaboration with PricewaterhouseCoopers, Eurasia Group is monitoring and assessing major trends shaping the global business environment. This document summarizes the findings of five white papers. The extraordinary breadth and depth of the current worldwide economic turmoil and its gradual stabilization create new uncertainties in international and local political environments. Now, more than ever, it is crucial to understand emerging global trends.

Brave New World: Political Risks Threaten Global Confidence and Growth

The Eurozone: An Enduring but Unhappy Union

More Trade-Offs for Foreign Firms Entering the China Market

Political Risks are on the Rise in the Mining Sector

The African Consumer Class is Changing the Business Landscape

Brave New World: Political Risks Threaten Global Confidence and Growth

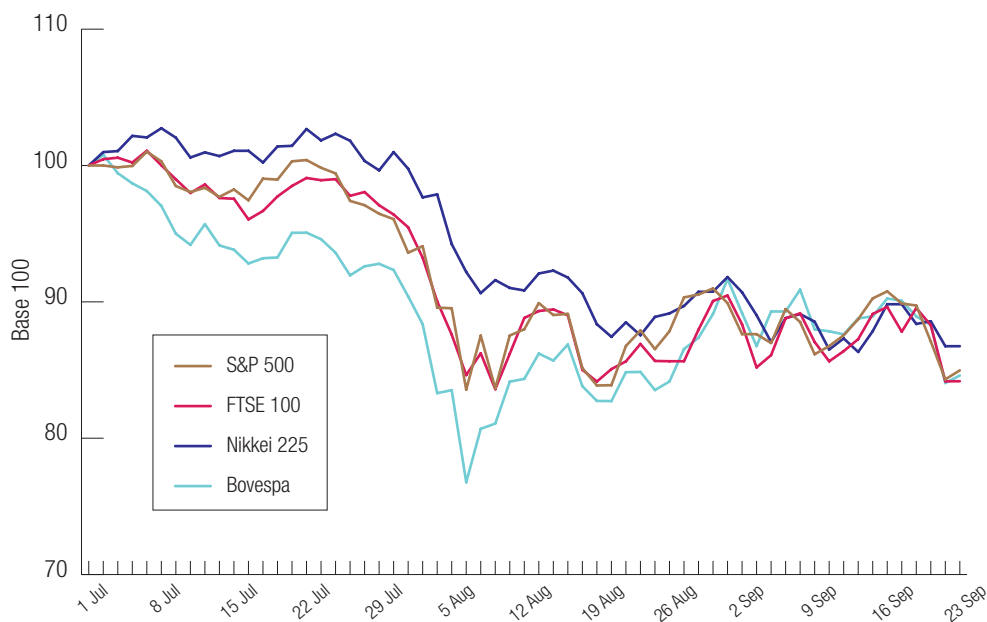
Key points

Political dysfunction in the US, the eurozone, Japan, and the Middle East is sorely mismatched with pressing global economic challenges such as excessive sovereign debt, a looming banking crisis, possible recession, and a slew of natural disasters. Efforts to stem these crises are undermined by political gridlock, institutional weaknesses, and a lack of resources and legitimacy, all of which are contributing to a lurking suspicion that no one is in control—or that those who are do not have what it takes. Markets alone cannot fix what ails the global economy, and effective political governance is absent. Political risk is undermining investor and consumer confidence, exacerbating the global economic situation. As a result, the world finds itself in a highly unstable moment, characterized by weak leadership, sharp market volatility, and slow growth in developed markets. Opportunities for expansion exist in emerging markets, however, and understanding the political forces behind economic governance there will be key to finding “pockets of opportunity.”

Business implications

- Market sentiment and business confidence will continue to be volatile in the near to medium term:** While not necessarily predictors of growth, market sentiment and consumer confidence act as barometers of—or votes of confidence in—policymakers’ efforts to stimulate growth. As such, the dismal market performance in August was a message to policymakers as much as a reaction to negative economic data. Even following the resolution of the debt ceiling crisis and a eurozone bailout package, markets were still indicating that they did not believe governments could generate growth. Although market sentiment does not always translate into profits or losses for corporate clients, it does reflect confidence levels—and as confidence wanes, businesses hire less and consumers save more.
- Optimism is more likely in emerging markets:** The palpable economic and political malaise in the US and Europe will be less prominent in emerging markets. The IMF has projected 6.6% growth this year for emerging markets, and policymakers and consumers there are likely to be more buoyant about their economic prospects.

Volatility in global equity markets



Note: The value of each index on 1 July 2011 is equal to 100
Source: Bloomberg

2011

The Eurozone: An Enduring but Unhappy Union

Key points

Although the sovereign debt crisis facing a number of eurozone countries has raised doubts about the monetary union's ability to weather the storm, political support for the eurozone will ensure its survival. At the same time, domestic political constraints along with the competing interests of national governments and European institutions will prevent a systematic solution that fully addresses underlying fiscal pressures facing countries such as Greece. As a result, a "muddle-through" scenario will persist, in which European actors struggle to contain the crisis by enacting marginal solutions. If Greece spirals downward, significant spillover effects would hit the rest of the eurozone, where the near-term economic outlook is already weakening. Medium-term economic expansion is bound to be uneven, because of the differences among member states. Sovereign debt concerns are reinforcing the divide between core and peripheral countries, and positive average growth forecasts at the eurozone level mask substantial divergences at the country level. Europe's debt-ridden countries will be forced to slash government spending and to either raise taxes or reform their tax systems in the coming months. Such moves could sap consumer spending, while improving cost structures for companies. Peripheral countries are also likely to implement measures to make labor markets more flexible, possibly presenting important opportunities for companies.

Business implications

- **Macroeconomic uncertainties will persist:** Businesses will face an uncertain operating environment for at least the next two years. Ongoing worries about contagion and a collapse of the eurozone will weigh on GDP growth prospects throughout the region, dampening investment and consumer spending. Not all countries present the same risks: The growth outlook will likely vary considerably from country to country, particularly between the core and the periphery. While the economies of top-tier countries such as Germany, Finland, and Luxembourg may continue to expand, countries such as France, Belgium, and the Netherlands will have to work hard to correct their sizable public sector and current account deficits. The prospects are even more dire for countries such as Greece, Italy, Portugal, and Spain, which will continue to struggle with weak growth, high unemployment, and fiscal imbalances.
- **Austerity programs will curtail growth and household spending:** Spending cuts in a number of countries will set back the pace of economic recovery and could offset near- to medium-term gains in household expenditures. As a result, businesses selling to the European market should expect a prolonged recovery.

The eurozone's three growth tiers

	Top tier	Medium tier	Bottom tier
Countries	Austria, Estonia, Germany, Finland, Luxembourg	France, Italy, Belgium, Malta, the Netherlands, Slovakia, Slovenia	Cyprus, Greece, Ireland, Portugal, Spain
Main features	<ul style="list-style-type: none"> • Robust growth, current account surpluses, and small government deficits 	<ul style="list-style-type: none"> • Better performing than the peripheral countries but lagging behind Germany • Some (France, Italy, and Slovakia) have sizable public sector and current account deficits 	<ul style="list-style-type: none"> • Struggling with weak growth, external imbalances, and large public sector deficits • Two linked problems: a loss of competitiveness, giving rise to external imbalances, and large public sector deficits

Source: Eurasia Group

More Trade-Offs for Foreign Firms Entering the China Market

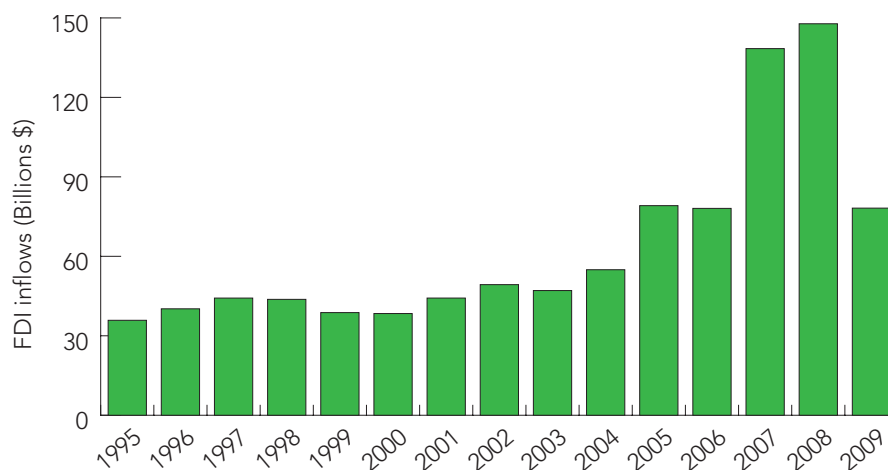
Key points

As Beijing embarks on its ambitious Five Year Plan (FYP) for 2011–2015, it is seeking to exert more control over the role that foreign investment plays in the Chinese economy. China is no longer the capital-starved country it was three decades ago, when multinationals’ capital or technological advantages could secure market share in China. Chinese firms are becoming competitive much more quickly than foreign firms anticipated, and funding from domestic sources is now more readily available. As a result, Beijing can afford to be selective in its treatment of foreign capital. A slew of recent changes to China’s investment guidelines and M&A review procedures reflect the country’s new industrial goals as well as its changing attitude toward foreign investment. Foreign participation will therefore be prioritized only if it meets Beijing’s goals: to support Chinese firms’ climb up the industrial value chain, to promote domestic human capital, and to develop additional sources of renewable energy. Beijing is also encouraging a move away from the country’s eastern seaboard by facilitating investments in central and western China, especially in labor-intensive sectors. Businesses will need to recalibrate their strategies to align them more closely with these goals.

Business implications

- **The new rules will open up additional sectors to foreign investment:** Foreign firms are now encouraged to participate in a wider range of Chinese sectors, including high-tech manufacturing, renewable energy, and new materials such as light alloys and carbon fiber composites. Beijing and provincial-level governments are likely to introduce incentives such as preferential tax or land policies to investors in encouraged sectors, especially in central and western China. But many of these investments will require partnering with a leading Chinese firm.
- **Uncertainties relating to vague investment approval procedures and review mechanisms will persist:** China’s investment guidelines and M&A security review procedures remain vague on several fronts. Regarding the security review process, for example, Chinese authorities have published only a broadly worded and non-exhaustive list of affected sectors. Since the procedures remain relatively opaque, foreign investors will be required to navigate among the various authorities and procedures (at both the regional and central levels). This will lead to higher transaction costs and could delay deals.

Net FDI inflows into China



Source: World Bank Group Database

Political Risks are on the Rise in the Mining Sector

Key points

As governments around the world seek to address the fiscal imbalances that emerged after the 2008 financial crisis, minerals-rich countries are taking a more interventionist approach to their mining sectors. Governments have to balance their desire to extract additional revenue, however, with the need to maintain an overall business-friendly environment that ensures that investment and revenue and job creation persist. This stance has given rise to a pragmatic set of resource nationalist policies, although as mining companies continue to enjoy record profits while other sectors falter, the risk of more drastic policies is on the rise. The most common type of intervention is resource nationalism, which encompasses taxation and royalty changes, mining code or contract revisions, outright nationalizations or expropriation of assets, and the promotion of national champions. These policies are prevalent in places as diverse as Australia, Peru, and Zimbabwe. In addition, local and community opposition and the ability of companies to address their “social license to mine” can be as challenging as federal-level resource nationalism. Mining companies also have to contend with macro-political risks, including general government stability in a place such as Guinea, and government transparency challenges in countries such as Kazakhstan. Companies are advised to consider the wide spectrum of political risks when operating or planning investments in a given country.

Business implications

- **Global economic conditions are heightening the risk of resource nationalism:** As governments struggle to get their fiscal houses in order, mining and its record profits will offer an attractive source of revenue for the public sector. Given that the type and degree of political risk varies considerably from country to country, however, it is critical for firms to understand the political and economic characteristics of each producer market in order to assess their own level of exposure.
- **Coordinated lobbying efforts can pay off:** As demonstrated by the modified tax proposals in Australia and Peru, coordinated efforts by mining companies to modify policy can pay off. In Australia, the vociferous advertising and lobbying campaign that mining companies led against the Resource Super Profits Tax resulted in major revisions to multiple aspects of the tax, including the headline rate, the number of companies that would fall under it, and the trigger point at which the tax takes effect.

Political risks in mining

Type of risk	Country examples
Taxation and royalties	Australia, Peru, Zambia, Tanzania
Mining reform/contract revisions	Brazil, Zimbabwe, Mongolia, Guinea
Expropriation/nationalization	Venezuela, South Africa
National champions	Russia, Brazil, South Africa, Canada
Domestic market obligations/value-added production	Brazil, India, Kazakhstan
Local environmental/social opposition	Panama, Guatemala, Colombia, Philippines
Security	Mexico, Cote d'Ivoire, Papua New Guinea, Niger
Government stability and transparency	Kazakhstan, Guinea, Zimbabwe, Indonesia, Cote d'Ivoire

The African Consumer Class is Changing the Business Landscape

Key points

Robust rates of urbanization and population growth, as well as prudent economic policies, are contributing to the development of an indigenous African middle class. Rising affluence across the billion-person continent—a trend on which a number of large multinationals have already capitalized—presents a number of business opportunities, particularly in the fast-moving consumer goods sector; increasing GDP per capita strengthens consumer purchasing power. The sustained growth of the middle class will change cultural preferences and tastes, while deepening democracy. This segment of the population will be more likely to support the rule of law, property rights, and a sound tax regime to finance the improved provision and delivery of public goods essential to securing their well-being.

Business implications

- **Understanding local consumer preferences is essential:** Despite the growing number of middle class households in sub-Saharan Africa, most of these consumers would be considered lower middle class in the global context. Product categories that are sold readily in de-

veloped and emerging market countries may therefore not find a base among sub-Saharan African consumers. Market entry strategies for fast-moving consumer goods companies should recognize that some product markets will be nonexistent among the African middle class. Companies should commission extensive market data surveys and focus groups—which are notoriously lacking in sub-Saharan Africa—in order to adequately capture the needs of the local consumer.

- **New forms of marketing and branding should be explored:** The fact that the African middle class is overwhelmingly urban suggests that companies should tailor their advertising to the cosmopolitan consumer. African urban life is constantly changing: It is highly aspirational (with influences from the conspicuously affluent West), while traditional (many rural cultural practices are maintained in the city). In Nairobi, the lingua franca among urban youth across all socioeconomic classes is Sheng, a mix of English, Swahili, and indigenous languages such as Kikuyu and Luo. Further, the pervasive use of cell phones and the rise of the informal economy are bringing many products' points of sale closer to the customer, meaning that advertising must extend beyond television and radio.

Distribution of the African population by sub-classes

Sub-class	1980	1990	2000	2010
1st poverty line (<\$1.25/day)	49.00%	49.65%	47.82%	44.15%
2nd poverty line (\$1.25–\$2/day)	19.05%	19.09%	18.51%	16.70%
Floating class (\$2–\$4/day)	11.61%	12.59%	14.07%	20.88%
Lower middle (\$4–\$10/day)	9.41%	9.14%	8.04%	8.74%
Upper middle (\$10–\$20/day)	5.17%	5.22%	5.06%	4.70%
Rich class (>\$20/day)	4.77%	4.32%	6.49%	4.84%
Poor	68.05%	68.74%	66.33%	60.85%
Middle Class	26.19%	26.95%	27.17%	34.32%
Rich	4.77%	4.32%	6.49%	4.84%

Source: African Development Bank, *Middle of the Pyramid: Dynamics of the Middle Class in Africa*, April 20 2011

Photo credit: Reuters

This material was produced by Eurasia Group in collaboration with PricewaterhouseCoopers. This is intended as general background research and is not intended to constitute advice on any particular commercial investment or trade matter or issue and should not be relied upon for such purposes.

© 2011 Eurasia Group