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.

Another Year of Uncertainty for the Eurozone

Key points

The economic troubles underlying the eurozone's sovereign debt crisis will continue to put the region under considerable pressure in 2012. A two-speed economy will likely persist throughout the decade. Some countries on the periphery, such as Greece, have entered deep and lasting recessions, whereas core countries such as Germany and the Netherlands are better positioned to bounce back once immediate uncertainties are resolved. From a financial standpoint, the large rollovers of sovereign debt in the first half of 2012 pose a significant challenge and the banking sector also has considerable funding needs in early 2012. Despite speculation, though, Greece remains unlikely to exit the monetary union. Across central and eastern Europe, growth forecasts for 2012 have been slashed in anticipation of negative spillovers from the eurozone crisis. Governments across the region have been busy devising regulatory and fiscal safeguards. The hallmark of these measures remains austerity, however, undercutting the popularity of ruling center-right parties.

Business implications

- **Countries will face different risks.** The particular challenges of structural reform and the growth outlook vary from country to country. The economies of top-tier countries (such as Germany, Finland, and Luxembourg in the west, and Poland and Slovakia in the east) are set for continued expansion throughout 2012, but countries such as France, Belgium, and the Netherlands will have to work harder, reducing their sizable public sectors and current account deficits. The prospects are even more dire for economies caught in the center of the sovereign debt crisis (Greece, Italy, Portugal, and Spain). Governments there will continue to struggle with weak growth, high unemployment, and fiscal imbalances, despite the renewed commitments of the local elite to near-term reform.

- **With no systemic solution forthcoming, many large corporations have begun contingency planning for a eurozone break up.** Eurozone fragmentation or disintegration will be extremely unlikely in 2012 and beyond, however, given elite support for the euro in both core and peripheral countries. If any country were to seriously consider exiting the eurozone, it would require a fundamental shift in the preferences of mainstream parties.

2012 financing needs (Billion Euros)

	Net financing 2012	Bond redemptions	Total financing need
Austria	8	14	22
Belgium	13	28	41
Finland	7	6	13
France	83	99	182
Germany	25	157	182
Italy	32	193	225
Netherlands	12	34	46
Spain	40	50	90
Total	**220**	**581**	**801**

Source: Credit Suisse

Arab Spring Gives Way to Diverse Business Challenges

Key points

The Arab Spring continues to resonate throughout the Middle East and North Africa, but country-specific challenges will vary depending on the effectiveness of opposition movements in overthrowing governments or forcing change. The greatest business risk stems from the possibility of botched transitions in Egypt, Tunisia, and Libya, while the risk of expanded civil conflict is greatest in Syria and lowest in Tunisia. In Egypt, macropolitical instability and the prospect of government collapse or paralysis is the biggest risk, along with ongoing social unrest and macroeconomic imbalances. The post-revolutionary government in Tunisia will make some concessions to Islamist groups, but the commercial and banking regulatory environment will likely be maintained. In Libya, international energy companies appear reassured by the new government's commitment to restore their presence in the country, but political and security uncertainties will continue to deter non-hydrocarbon FDI. Across the region, the fallout from the Arab Spring has been less extensive than many governments initially feared and, in some cases such as Saudi Arabia and Kuwait, has even had a positive impact on the business environment, despite ongoing security challenges.

Business implications

- **Macro risks will dominate the investment landscape.** In Libya, international energy companies appear reassured by the new government's commitment to restore their presence in the country, pending security approvals. Beyond the hydrocarbon sector, however, the lack of adequate legislation coupled with political and security uncertainties will continue to deter non-hydrocarbon FDI flows until an elected government takes power, probably in 2013. In Egypt, macropolitical instability and the prospect of government collapse or paralysis is the biggest risk, along with the ongoing social unrest.

- **The rise of Islamist parties will have only a modest impact on the business environment.** The post-revolution government in Tunisia will make some concessions to Islamist groups in order to shore up its support base, potentially sparking concerns among investors, but the commercial and banking regulatory environment will likely be maintained. Similarly, radical legal changes under an Islamist majority government in Egypt are unlikely, especially given the dire macroeconomic imbalances that the government must address.

GDP growth in oil exporting states (Percent change)

	2000–2005 avg	2006	2007	2008	2009	2010	2011
Algeria	4.5	2	3	2.4	2.4	3.3	2.9
Bahrain	6	6.7	8.4	6.3	3.1	4.1	1.5
Iran	5.5	5.8	10.8	0.6	3.5	3.2	2.5
Iraq		6.2	1.5	9.5	4.2	0.8	9.6
Kuwait	7.1	5.3	4.5	5	-5.2	3.4	5.7
Libya	4.3	6.7	7.5	2.3	-2.3	4.2	
Oman	3.3	5.5	6.7	12.9	1.1	4.1	4.4
Qatar	8.7	26.2	18	17.7	12	16.6	18.7
Saudi Arabia	4	3.2	2	4.2	0.1	4.1	6.5
Sudan	6.3	9.4	10.2	3.7	4.6	6.5	-0.2
UAE	8.1	8.8	6.5	5.3	-3.2	3.2	3.3
Yemen	4.5	3.2	3.3	3.6	3.9	8	-2.5

Source: IMF

Capitalizing on Emerging Market Ties

Key points

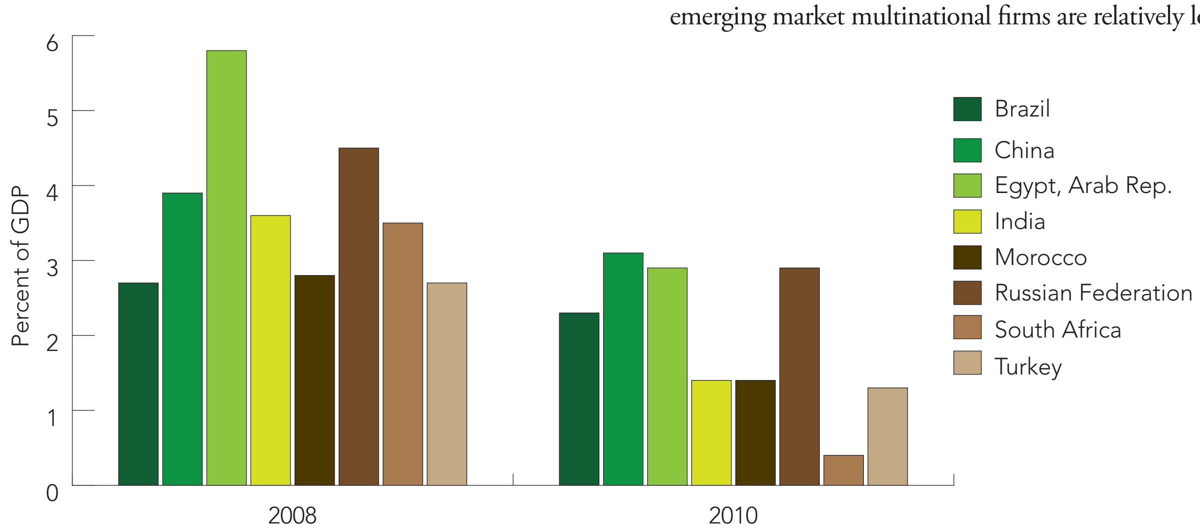
The proliferation of south-south economic ties (a phrase used to describe trade and investment between emerging markets) is becoming an important trend presenting new business opportunities. The main promoters of south-south trade and investment will likely be the strongest emerging market economies, the BRICS. China will be particularly important, as Beijing has been at the forefront of a series of regional and bilateral trade pacts both within Asia and globally over the past few years. A key driver of south-south trade and investment over the next few years will be the political imperative for emerging market governments to diversify their economies away from the West. And given the low likelihood of a renewed global initiative through the World Trade Organization in the near term, trade deals will probably be confined to bilateral and regional agreements. Nonetheless, there are still risks for multinational businesses. Pushback is possible in emerging markets against perceived unfair trade practices by competing economies. At the same time, persistent imbalances in the global economy raise the likelihood of slowing emerging market growth over the next few years, and with it south-south trade and investment.

Business implications

- **South-south trade will mean shifts in global supply chains.** As trade and investment levels grow among emerging markets, multinational companies—especially those in shipping and logistics—will need to broaden their footprints in new markets. This push will not be easy, given that domestic logistics industries are often viewed as strategic sectors and receive considerable state support. Competition from domestic competitors and unfavorable policies will complicate business strategies for foreign firms. These dynamics could also force multinational sourcing and production firms to rely more heavily on smaller and unproven developing market logistics firms, potentially complicating the management of global supply chains.

- **Patterns of capital flow will shift, too.** Greater emerging market trade will bring higher levels of emerging market capital flow. Likewise, the proliferation of trade among countries not dependent on the US dollar will propagate the use of other currencies in the international financial system. China's renminbi will be at the forefront of this change, as Beijing seeks to denominate more trade in its own currency. For global financial services firms, this will mean many new opportunities to engage in needed transactions, such as trade financing and currency hedging, with emerging market companies. This, too, will carry a higher level of risk, given that the credit ratings and financial experience of many emerging market multinational firms are relatively low.

Net inflows of foreign direct investment



Source: UNCTAD

The Politics and Business of Demographic Change

Key points

The world's population growth and urbanization patterns will have important repercussions on economic development patterns, food security, the sustainability of natural resources, and infrastructure. Countries have very different demographic trajectories. Some societies are aging rapidly and their workforces will be constrained as a share of the total population. Other societies are young and growing, which will create ever larger labor forces and consumer markets. Yet both aging and young populations pose challenges. An aging population can burden long-term growth prospects and social welfare systems, while a youthful, expanding population must be fed, housed, educated, and employed in order for its productive potential to be realized. Government policy determines to what degree demographic changes benefit or hurt economic growth and business environments. Business decision-makers need to understand how governments are responding to demographic challenges and whether their policies will mitigate potential social and political upheaval, sustain economic growth, and present opportunities for investment.

Business implications

- **Demographic trends and policy responses will shape consumer markets.** Retail and consumer goods opportunities will depend on each market's demographic structure. Companies can use their knowledge of a country's population to identify and target different consumer groups. Demand for healthcare products and services is likely to grow in countries with aging populations, for example. Convenience—including details such as large-print options for consumer goods and in restaurants—will also be important in such markets. In contrast, countries with a large youth population will have higher demand for food and other basic goods at family-friendly price points.
- **Urbanization creates opportunities for the infrastructure and capital projects sector.** Cities in developed and emerging markets are attracting increasing numbers of migrants; for the first time, more people live in urban than in rural areas. Urbanization creates demand for real estate development, road and rail networks within cities, and improved and expanded sanitation systems. There may also be opportunities for infrastructure between cities such as roads, rail, and telecommunications networks, particularly in big countries such as India and China with multiple urban areas. It is important for business decision-makers to understand the government's priorities, however, and its receptiveness to foreign investment in these sectors.

Policies shape demographic dynamics

Demographic profile	Country	Policy priorities
Young and/or expanding	Nigeria	The government is not addressing regional disparities that could exacerbate the risks of a rapidly expanding youth population.
	India	Varied institutional capacity will entrench state-level differences, risking high population growth in poor areas.
	US	Politicians are divided over how to regulate immigration and meet the challenge of the baby boomer generation, but institutional strength bodes well for a solution.
Aging and/or shrinking	China	Planned investments in education and social insurance will increase productivity and support the aging population.
	Germany	Policies are focused on short-term concerns about aging rather than on long-term population decline.
	South Korea	The government is addressing aging and fertility issues in an ad-hoc and short-term manner.

Source: Eurasia Group

Business Uncertainty Under Directionless International Climate Policy

Key points

Global climate change policy will continue to lack direction, as evidenced by the outcome of the December 2011 UN climate summit in South Africa. The participating countries devised a blueprint for a future global framework, but the strategy is vague and lacks the necessary clarity to guide domestic actions on climate change. Moreover, it will be difficult to craft a global treaty that is satisfactory to both rich and poor countries. In the absence of a guiding international framework, companies will face tough choices about investing in cleaner technologies, and they will have to keep navigating uncoordinated domestic policies of varying stringency. The EU remains committed to its Emissions Trading System (ETS), while the US has pursued federal-level regulations as well as diverse regional cap-and-trade programs. Australia has opted for a temporary carbon tax followed by an ETS. And China, which is coming under increased pressure internationally, will pursue emissions reduction targets and implement pilot emissions trading schemes, but economic growth will continue to trump emissions reduction.

Business implications

- **Policies will be less ambitious and more sensitive to business costs.** Given that most countries will not have robust climate change policies in place for the foreseeable future, those that do will structure their policies to mitigate costs for businesses in order to avoid losing competitiveness. The bleak economic environment will provide additional impetus for provisions such as the free allocation of permits to companies.

- **Policies will be more vulnerable to reversal.** Absent a global architecture, emissions reduction policies will be more vulnerable to shifts in government and to revisions stemming from economic conditions. Following the 2010 elections in the US, Republicans that came into power at the state level withdrew their states from regional cap-and-trade programs. Similarly, if the opposition assumes power in Australia, that country's carbon tax might be scrapped. Such policies' questionable durability will increase uncertainty around business decision-making.

Global climate change policies

UNFCCC	• Kyoto Protocol extended but most developed countries outside EU not participating • Commitment to arrive at a new framework of dubious legal status by 2015 to take effect by 2020
EU	• Still-strong political commitment to the ETS • Carbon price struggling because of poor economic conditions • Revisions to tighten the ETS cap unlikely
US	• EPA regulations on GHG and non-GHG emissions put off or watered down • California proceeds with cap-and-trade as of 2013 • Northeastern states' cap-and-trade deemed ineffective at incentivizing clean energy
Australia	• Carbon tax of AUD 23 to take effect in July 2012 • Transition to emissions trading program in 2015 • Policy uncertainty if opposition takes office
China	• Domestically binding target to reduce carbon intensity per unit of GDP by 17% by 2015 • Pilot ETS programs by 2013, but likely very narrow in scope

Source: Eurasia Group