global trends

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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.

The Business Implications of China's Rise in Asia

Key points

China's growing economic and political might will transform the Asian business environment in the coming decade. Driven by Chinese initiatives, trade in Asia will be less restricted. As regional wealth and spending power grows, and as China's export hubs lose their cost advantages, global supply chains will adapt to new centers of demand and shifts in manufacturing bases. Chinese state-backed firms will become more competitive in key sectors across the region. Beijing will continue to actively promote domestic high-tech standards and work to see these standards adopted in neighboring markets. For Western firms seeking to drive high-tech innovation, China's standard-setting push will mean stronger competition for market share in Asia. Meanwhile, China's neighbors will struggle to balance growing economic integration with the Chinese market against the desire to reduce political and economic vulnerabilities. The growing strength of China's state-backed industry will encourage some Asian countries to pursue more aggressive industrial policies and foster national champions, while others will encourage more international investment within their borders. Strategic gamesmanship between China and its regional rivals will drive growth in smaller Asian markets—especially in South Asia—but state-financed investments will make it harder for independent Western firms to compete.

Business implications

- **Supply chains will shift:** Businesses in Asia will see significant shifts in regional supply chains as Chinese demand grows, trade becomes less restricted, and governments compete for new sources of FDI. Firms should consider how to structure their supply chains to best capitalize on the reduced trade barriers that various regional trade deals offer. Meanwhile, more high-tech manufacturing will move to China, and less-developed Asian countries will work to supply the raw materials and basic inputs needed for such production. Countries such as South Korea and Japan—which currently lead in many of the high-tech industries where China is hoping to make gains—will work to diversify their manufacturing bases away from China and into countries such as Indonesia and India to protect their technologies.

- **The gloves come off on standards:** Asia will likely be at the forefront of a global struggle over high-tech standards in the 21st century. Already, Beijing is implementing aggressive standard-setting strategies—utilizing its economies of scale and rapidly developing technological capabilities—to place its domestic firms in leading positions in various regional industries. Western firms will maintain the innovative edge (in most cases), but will have to work harder to stay ahead in the standards game or risk facing a reality in which the best way to profit in Asia is to partner with a Chinese counterpart.

The implications of China's rise in Asia

Positive	• In general, tariffs and other formal trade barriers will fall • Spending power will grow as Asia becomes wealthier • Less-developed economies will move up the manufacturing chain to satisfy Chinese demand • China's neighbors will foster investment and trade with the West to balance against Beijing
Neutral	• Chinese investment in Asia will continue to grow rapidly • Manufacturers will lose cost advantages in China's export hubs • Supply chains will adapt to evolving economic and political dynamics
Negative	• Export-led growth could perpetuate existing imbalances • Beijing will promote Chinese technology and high-tech standards throughout the region • China's neighbors will roll out more support for their own national champions • In some sectors, trade barriers could rise due to national security concerns or to protect domestic industry • Regional competition will limit international investment opportunities, especially in strategic sectors

Renewable Power Faces a New Environment

Key points

Absent a carbon price and a full economic recovery, which would revive private-sector investment in renewable energy, the sector will continue to be vulnerable to sudden changes in policy and a reduction of government support mechanisms. As clean-tech companies look to scale up production and drive down costs through the help of government subsidies, there remains a risk that political support for renewable energy will be exhausted, possibly derailing deployment targets in some countries. Demand-side policies that raise energy costs—such as feed-in tariffs or renewable energy standards—can be a political liability. To build support for renewable energy subsidies, governments have linked demand mandates to a range of preferential policies that promise green collar jobs and economic competitiveness. But legal challenges citing trade law violations are likely to follow. There are technical challenges ahead for the industry as well. For wind and solar, grid upgrades or electricity storage technologies will be necessary if these renewables are to penetrate regional energy portfolios more deeply. Such upgrades will impose additional costs on rate-payers and increase the technical complexity of grid operations. Although government policies in the EU, Japan, the US, and China continue to promote the production and use of renewable energy with no sign of backsliding, the sector remains dependant on political support, which could buckle under the weight of these many challenges.

Business implications

- **Policy volatility is an ongoing risk:** The absence of a strong carbon price leaves promoting renewable energy to a patchwork system of mandates and subsidies. Changes in political leadership or an exhaustion of political will in the face of various industry headwinds could drastically change the investment outlook for renewables in any of the leading national markets. While retroactive changes to renewable energy contracts may or may not prove unique to Spain, the Spanish case underscores the heightened level of political risk in the renewables sector globally.

- **Protectionism is on the rise:** Over the last year, the green jobs debate and focus on winning the clean-tech manufacturing race has become the greatest challenge to long-term renewable energy development. The global recession has left developers greatly dependent on government subsidies when private-sector support has waned, and tensions over green jobs and competitiveness have become a significant political risk. Renewable energy companies are operating in an environment in which subsidies are contingent on domestic manufacturing, either through a manufacturing tax credit or local content requirements. These companies are looking at the upcoming WTO disputes as a bellwether for future restrictions on their business.

Power generation: Added and existing (2009)

Technology	Added (Gigawatts)	Existing (Gigawatts)
Wind	38	159
Small hydropower	2 to 4	60
Biomass	2 to 4	54
Solar photovoltaic (grid connected)	7	21
Geothermal	0.4	11
Concentrated solar power	0.2	0.6
Ocean power	~0	0.3
Hydropower (all sizes)	31	980

Source: REN21, Renewables Global Status Report 2010

Africa's New Opportunities: Energy, Telecommunications, and Financial Services

Key points

Compared with much of the industrialized world, Africa's economies were spared the worst of the global financial crisis and are set to enjoy significant growth and to present attractive business opportunities. Energy, telecommunications, and financial services are among the sectors with the strongest growth potential, although these opportunities are country-specific and do not apply to the continent as a whole. Energy opportunities are primarily driven by the location of natural resources, while opportunities in telecommunications and financial services are driven by population and income growth, both of which fuel domestic demand for these services. Each sector faces a range of political risks, including instability, regulatory uncertainty, and entrenched local interests. These risks vary from country to country and can have considerable impacts on foreign investment opportunities. Local companies are an increasingly important feature of the African business landscape; they can present attractive partnership opportunities for foreign companies as well as pose competitive challenges. Understanding and mitigating these political risks is critical to commercial success in Africa. Sector-by-sector examinations reveal important strategies for businesses attempting to take advantage of growing opportunities on the continent.

Business implications

- **Entry-and-exit political risks are greatest:** Political risks are often most directly in play at the point of market entry and exit. On the entry side, foreign investors may be competing with politically connected local buyers. Or, if the assets the investors are trying to purchase are state-owned, unions and the public may be opposed. Vested interests and union opposition have contributed to the delays of the privatization of NITEL, Nigeria's state-owned telecommunications company. And in Ghana, ExxonMobil's attempted purchase of Kosmos Energy assets was undermined by the preference of the Ghana National Petroleum Corporation for a Chinese buyer, and by political rivalry between the ruling party and the main opposition party.

- **Local relationships matter:** Understanding local players is critical across all three sectors. Some local players may be on the cutting edge of innovation, while others may be undesirable but required by local content laws. Or some local players may be good candidates for acquisition. Identifying local companies' political connections is also critically important. Safaricom's value-added telecommunications services in Kenya have been a major success and are being expanded to other African markets, while some Nigerian banks, whose stock market valuations fell sharply during the financial crisis, are well-positioned within the west African financial market and could make attractive targets for acquisition.

Relative risks to foreign investment in select African countries

	Energy	Telecommunications	Financial services
Higher risk	• Dutch Disease (Ghana, Uganda) • Local content requirements (Nigeria, Ghana, Angola) • Security risk (Nigeria, Sudan)	• Vested interests (Angola)	• Regulatory risk/weak oversight (Ethiopia, Angola) • Significant barriers to foreign investment (Egypt)
Medium risk	• Dutch Disease (Angola, Nigeria, Congo, Equatorial Guinea) • Local content requirements (Republic of Congo, Equatorial Guinea, Uganda) • Tax burden (Nigeria) • Security risk (Uganda)	• Dominant incumbents (South Africa) • Lack of transparency (Kenya, Nigeria) • Regulatory risk (South Africa, Nigeria)	• Regulatory risk (South Africa, Nigeria, Kenya, Egypt) • Dominant local incumbents (South Africa, Nigeria) • Toxic assets (Nigeria)
Lower risk	• Local content requirements (Gabon) • Security risk (Angola, Ghana, Republic of Congo, Equatorial Guinea)	• Regulatory risk (Kenya)	• Full liberalization (Mauritius)

Source: Eurasia Group

Beyond the BRICs: Opportunities in Other Emerging Markets

Key points

The BRICs (Brazil, Russia, India, and China) receive significant attention from multinational corporations due to the size of their economies, but other emerging markets with fast-growing economies and large populations present attractive opportunities as well. In particular, Mexico, Indonesia, Turkey, Poland, South Africa, Vietnam, Egypt, and Thailand offer significant growth prospects for foreign investors. These countries feature growing domestic incomes, relative political stability, and open foreign investment environments. Moreover, a number of them are in the process of implementing reforms that will further improve their business climates, often by reducing the dominance of state-owned enterprises. At the same time, a number of political and regulatory risks, such as security threats, corruption, infrastructure shortages, and populist pressures, will pose ongoing challenges to foreign firms. Each country will present a unique set of opportunities and risks based on its history, political system, government priorities, and regional dynamics. For these reasons, it is important for investors looking beyond the BRICs to track these markets closely.

Business implications

- **The prominence of SOEs is declining:** As economic reforms take off in emerging markets, the role of SOEs is being reduced in favor of greater private-sector participation in a number of areas. While countries such as Mexico have had robust private-sector participation in non-energy industries for some time, significant opportunities for private companies can still be found in areas such as manufacturing and services in Indonesia, consumer products and energy in Egypt, and manufacturing in Thailand. Countries such as Turkey and Egypt are actively soliciting foreign investment.

- **Reform agendas will improve the business climate:** With an eye to spurring economic growth, most emerging markets are attempting to implement reforms to create more market-friendly operating environments. For instance, Mexico will likely pass antimonopoly legislation in 2011 and has implemented incentives to spark its construction and telecommunications sectors. Indonesia is trying to address problems of corruption and excessive red tape, and Poland is in the process of executing fiscal reforms to boost its long-term economic health.

Opportunities and risks in non-BRIC emerging markets

	Risks	Opportunities
Mexico	Politics biased to the status-quo; narcotrafficking violence increasing in the north and west	The government supports the construction sector; the telecommunications sector is liberalizing; health services demand is likely to grow
Indonesia	Public corruption and bureaucratic incompetence continue to frustrate investors	The modest decline in the prevalence of SOEs is creating opportunities for private investment
Turkey	Weak infrastructure, particularly in power and transport, remains a problem	The EU accession process reinforces sound macroeconomic policymaking in Ankara
Poland	The economic recovery is fragile, and budget deficits could worry markets	Investors benefit from low corporate taxes and significant infrastructure development
South Africa	Electricity and transport remain dominated by SOEs, and reliable power supply is an issue	Stable politics and the World Cup provided a boost to the economy and infrastructure
Vietnam	The government is looking to (inefficient) SOEs to drive development in key sectors	The Communist Party is firmly in control, and the reformist faction is strong
Egypt	Labor protests are increasing, and reform is becoming less popular	Six years of a market-friendly government have produced a range of economic reforms
Thailand	Politics will remain volatile, as the Bangkok elite continue to resist Thaksin Shinawatra and his allies	A competent bureaucracy has shielded industry from politics. The manufacturing and consumer goods sectors have been liberalized

Shifting Trade Patterns Mean New Opportunities for Port Infrastructure

Key points

As world trade and economic growth in developing countries boomed over the past decade, global port infrastructure was strained. As a result, governments around the world are now looking to alleviate bottlenecks. In addition, growing demand for commodities from Asia—particularly, China and India—has altered global trade patterns, boosting demand for a new class of mega-ships and therefore bigger ports. The global economic slowdown has had a mixed impact on public support for port investments. While large public works projects are attractive as economic stimulus measures, their hefty price tags have caused some governments to hesitate before disbursing funds. Some OECD countries are stalling on investment because of heightened sensitivity to ballooning budget deficits. Persistent infrastructure bottlenecks will pose challenges for companies that ship products via ports and could drive up global commodities prices if major exporting countries experience shipping delays. At the same time, plans for upgrades to and construction of new ports will create considerable opportunities for shipping and logistics companies.

Business implications

- **Asian commodities demand is creating new shipping routes and infrastructure opportunities in frontier markets:** Rapid growth in emerging Asia, particularly China and India, has created new opportunities for countries that export commodities. In the rush to take advantage of China's and India's voracious appetites for oil, coal, and iron ore, governments and companies have been pouring money into port infrastructure projects to boost export capacity. Sub-Saharan Africa, in particular, has brought new port projects on line. Existing infrastructure there is well below levels that would maximize export revenues. Angolan ports will expand to serve Chinese oil demand, while southern African ports will receive new investments to serve India's rapidly growing coal demand.

- **Economic downturn could slow investment:** The global economic slowdown has led to reduced demand, particularly in a number of OECD markets. Although fiscal stimulus plans could help fund port infrastructure upgrades, government budget cuts, particularly in OECD markets such as the US and the UK, could delay new investments. And given that most governments already disbursed billions of dollars in stimulus funds last year, new funds for infrastructure could be limited.

Global port infrastructure: Drivers and challenges

Country/region	Cargo type	Drivers for port infrastructure	Challenges
Kuwait	Container	Development of Iraqi oil fields	Strained Iraq-Kuwait relations; Kuwaiti parliamentary hold-ups; uncertain Iraqi government competence
UK	Container	Development of offshore wind energy industry	Government budget cuts
US	Container	Panama Canal expansion	Congressional attention to budget deficits could limit federal funding
India	Dry bulk	Surging coal demand tied to power generation build-out	Spotty progress on interstate infrastructure projects to reach inland markets
Southern Africa	Dry bulk	Surging coal demand in Asia, particularly India	Rail bottlenecks; early-stage projects; corruption
Brazil	Dry bulk	Growth in commodities exports; booming trade with China	Inadequate road and rail infrastructure; red tape
Iraq	Liquids	Oil exports	Unstable government; security concerns
Angola	Liquids	Oil exports	Chinese oil-for-infrastructure deals

Source: Eurasia Group