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ESADEgeo POSITION PAPER 41

JUNE 2018

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May 2018

1. Introduction

Political and geopolitical risks are no longer a tail risk for business. Many recent shocks to markets – from Brexit to the increasing risk of a China-US trade war – are political in nature. It is no coincidence that these upheavals are increasingly frequent: they are the ripple effects of major shifts in the world's political and geopolitical paradigms. A number of factors have converged to bring to an end the era of relative global stability that characterized the Western world after World War II and to open a new period of political, geopolitical and economic flux. Paramount among them is the fragmentation of the international world order brought about by the retrenchment of the US, which commenced under President Obama and is intensifying under President Trump, as well as the rise of new global powers, most noticeably China but also, in different ways, states such as Russia or Turkey. This has coincided with a moment where the process of economic globalization is coming face to face with some of the less positive consequences of its inner logic, particularly its deflationary impact on wages among large segments of the workforce in developed economies, helped along by the impact of technology on employment. In fact, what makes this era particularly problematic is that it is the first time in recent history that a global economic dislocation and a global geopolitical rearrangement have coincided. The collapse of the USSR in the early 1990s was made less destabilizing by a steady international economic context, while previous economic shocks such as the 1973 crisis took place in a context of relative geopolitical stability.

The convergence of these mutually reinforcing economic and geopolitical dislocations provides fertile ground for continuing shocks to markets. The question is what impact they will have on corporations and investors, but the answer is not evident. On the one hand, there is evidence that business executives are quickly waking up to the salience and potential negative impact of these shocks. According to a 2017 McKinsey Global Institute survey, eighty-four per cent of executives (the largest share in the survey's history) believe geopolitical instability will have an

important or very important impact on global business, up from 61 per cent previously. However, less than one-third said an understanding of these factors is extremely or very well integrated into overall company strategy, and, more tellingly still, only 13 per cent say their companies have taken active steps to address risks deriving from either geopolitical or domestic political instability.

On the other hand, the current increase in political instability has not, at least for the time being, hurt markets or corporate earnings. Political and geopolitical uncertainty have increased by most measures, yet corporate profits and stock markets in both developed and developing markets have continued their upward trajectory. Although one could argue that the potential negative consequences of these events are yet to materialise, markets should have discounted them and this should have been reflected in valuations.

When trying to explain why this has not been the case, the most sanguine analysts argue that 'we have seen it all before', that these shocks always entail opportunities, and that markets have proved their resilience. They point to the fact that the doomsday scenarios that many – including respected economists such as Paul Krugman – painted should Brexit or a Trump presidency materialize, did not come to bear. There is however an alternative scenario: that markets are not pricing the impact of these risks correctly. That is the argument this paper will make. In order to do so it will first identify some of today's most significant risks and then suggest reasons why markets may not be pricing them appropriately.

2. The times they are a changin'

The current period will likely be seen, in hindsight, as a turning point in contemporary history. Whether this point represents the end of the US hegemony, the true beginning of the 21st century or any other characterization, what is clear is that we are experiencing, in real time, the transition from one world order to another. This shift had been incubating since the global economic crisis of 2008, 9/11, or even the collapse of the USSR. At a political and geopolitical level, this new reality is characterized by set of drivers, a few of which stand out.

2.1. *Apolarity* and the return to great power rivalry

The era of relative geopolitical stability that has characterized the post-war order has come to an end as a result of both US retrenchment and the growing ascendancy – in ambition as well as willingness to project power to match it – of China and Russia. Rivalry among great powers is, in all likelihood, returning. As Graham Allison has recently shown,[1] periods in which an

[1] Allison, G. 2017. *Destined for War: Can America and China Escape Thucydides's Trap?* London: Scribe UK.

established power has been challenged by a rising power have historically led to significant instability and conflict. With the nuclear deterrent still very much in place, it is difficult to conceive of the large powers entering into a direct conflict today. Nevertheless, and as has been traditionally the case throughout history, the danger is one of a conflict by proxy, where miscalculation may lead to the great powers coming face to face. Recent conflicts in Syria or Ukraine are clear examples of how the present vacuum of power is fostering geopolitical instability that can pit powers against each other.

China, of course, poses the most significant threat to the US' hegemony, and it is in the South China Sea that the most important geopolitical tensions between the world's largest powers can arise, as well as in Taiwan and North Korea. Beijing aims to expand its sphere of influence not just in the South China Sea but throughout the Pacific and even beyond, and to that effect, it has been developing a vast network of trade and maritime infrastructures. Although these infrastructures are officially only intended for commercial and civilian uses, such as protecting Chinese supply routes against a perceived US threat, they will undoubtedly be used to project military and geopolitical power. There is ample debate about how the China-US relation will evolve, but China's growing power projection is likely to lead to increasing clashes of interests with the US. This will cast doubt on the future of the relatively constructive relation that the countries have maintained over the last three decades, in which they acted more like two competitive multinational corporations than two competitive states in a realist world.

While China has benefited from the current international economic and political order and still has a vested interest in the stability of international system (which ensures that it does not have to assume the costs and responsibilities that come with being a great power), historical experience shows that economic expansion invariably leads to a projection of political power – if only to protect economic interests. To put it more succinctly, China's capitalist success will lead to economic interests beyond its borders and to military intervention whenever necessary to defend these interests. In sum, China is likely to become expansionary as its geopolitical ascendancy, its desire to create a sphere of influence and its need to project economic interests combine.

There are of course other problematic geopolitical theatres across the globe. The Middle East is once again witnessing an escalation that could provide a stage for proxy confrontation among the great powers. The Israeli-Palestinian conflict is of course a permanent hotspot, but a potentially more dangerous theatre is opening up due to the decisively anti-Iranian posture adopted by the US in conjunction with Saudi Arabia and Israel. This posture has been on most dramatic display in the US' withdrawal from the Iranian nuclear deal, which was undertaken in clear confrontation with European signatories, Russia and China. And in Europe, a resurgent Russia is perceived as a real threat throughout Eastern and Central Europe, as well as the

Baltics and even Scandinavia. The fact that the US has decided to re-establish its second fleet – which was disbanded in 2011 – to patrol the Western Atlantic is a clear sign that the US' and its NATO allies concur. Finally, the establishment of PESCO – Permanent Structured Cooperation under the EU's security and defence policy – in 2017 is another sign of the increasing unease in European capitals about the continent's security prospects.

2.2. Globalization plateaus and protectionism is on the rise

This geopolitical fragmentation has important consequences for economic globalization. As Findlay and O'Rourke have explored in their magisterial *Power and Plenty: Trade, War and the World Economy in the Second Millennium*,[2] it is no coincidence that the three great periods of economic globalization of the last millennium – the Mongol Empire, *Pax Britannica* and *Pax Americana* – have coincided with the presence of a hegemon. These hegemons guaranteed the safety of trade routes and provided an anchoring point to establish international orders that included global trading norms and standards capable of reducing transaction costs and enabling international economic integration. This will of course not come as a surprise to students of International Relations, who have long been familiar with Hegemonic Stability Theory and its quite reasonable hypothesis that the presence of a hegemon is a prerequisite for stability in the international order. It follows that the geopolitical fragmentation we are witnessing today will have an economic corollary. This is already apparent in the Trump administration's withdrawal from Trans-Pacific Partnership and its increasing adoption of tariffs. In sum, one of the key obstacles to globalization is not economic but geopolitical in nature: geopolitical fragmentation and the absence of a hegemon.

Yet this is not the only factor. A second reason driving the erosion of globalisation is the social and political impact of its economic repercussions. As markets have opened around the globe, developed economies have experienced a supply shock, in receiving a massive inflow of savings and labour output from emerging economies. This has decreased the bargaining power of labour in developed economies, leading to wage deflationary tendencies. In turn, these tendencies – along with their negative impact on consumption – make inflation, even at modest levels, increasingly difficult to attain. In other words, global aggregate supply has, inevitably, grown much faster than global aggregate demand, leading to a deflationary context that is politically unacceptable to large segments of the population in advanced economies. Coupled with the employment effects of technology, and with an ideological climate that has made it difficult to increase redistribution to compensate those who have lost out in the

[2] Findaly, R. and O´Rourke, K. 2009. *Power and Plenty: Trade, War and the World Economy in the Second Millennium.* Princeton: Princeton University Press

equation, globalisation is now seen as detrimental by a significant part of the social and electoral majority.

These deflationary tendencies have therefore become a major threat to globalization itself, via at least two channels: first, the accumulation of debt, which becomes harder to repay in a non-inflationary context, and second, the socially and politically discontented part of the population that has seen its wages stagnate. As Richard Koo and others have argued, the first channel can lead to a deflationary trap through debt-recessions, where monetary stimuli have little effect given that both corporations and consumers devote any excess liquidity to paying down ever-increasing debts in real terms rather than to increasing their consumption. With respect to the second channel, the work of the late Tony Atkinson, as well as Branko Milanovic and Thomas Piketty has provided ample evidence that inequality, in both wealth and income, is a reality. In sum, globalization's inner logic may be leading to its plateauing. A persistent low-wage growth environment is unacceptable to the majority of the electorate, which has seen wages stagnate as the value of debt increases. For this group, the low prices brought about by globalization no longer make up for its downsides.

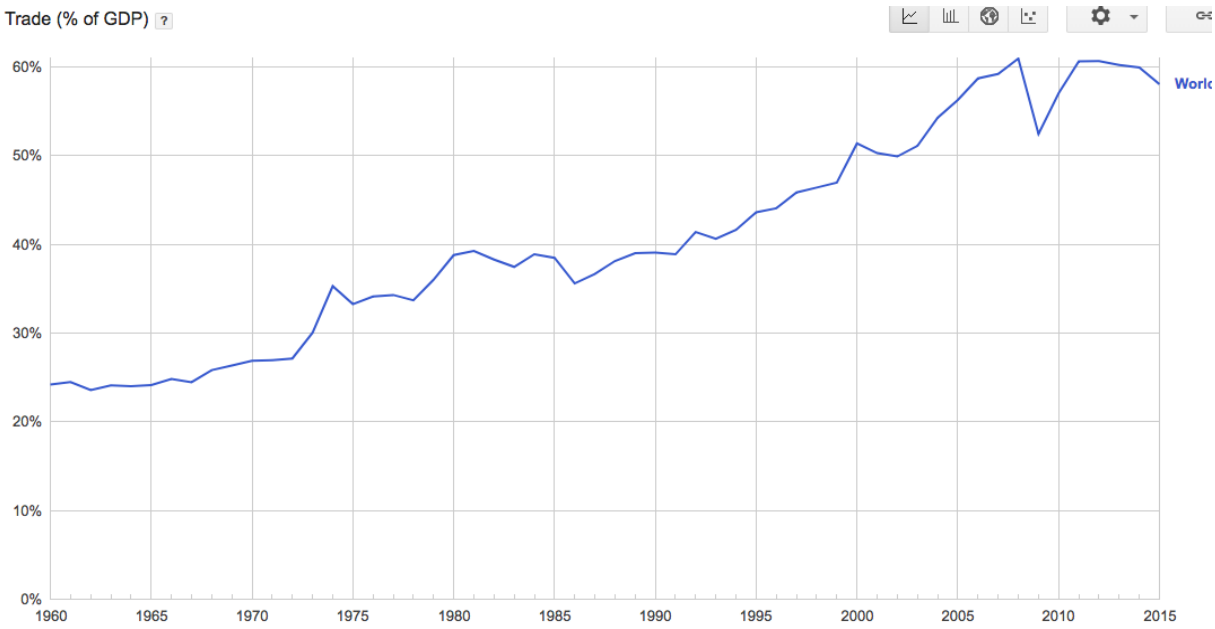
This plateauing of globalization is reinforced by the advent of new technologies that are eroding the cost advantage of offshoring. Robotization, 3-D printing and other technologies are reducing the need for human labour in many manufacturing processes and thereby diminishing the cost savings brought about by cheaper labour in developing economies (these savings of course have to be offset against the costs of internationalization, including freight and other transaction costs, as well as economic and political risks in foreign markets). These technologies thus create a compelling logic to bring manufacturing back to developed markets (even if the jobs won't be coming back), which is leading to an increase in onshoring in developed markets, as Finbarr Livesey has recently shown in his *From Global to Local: the Making of Things and the End of Globalisation*.[3]

Nevertheless, this trend should not be exaggerated. The world is stabilizing its level of international economic integration rather than dramatically reducing it. Yet the factors described above have indeed led to a stagnation, if not decline, of the ever-increasing international flows of goods and capital that characterized the post-war era. During the global economic crisis that started in 2009, international trade collapsed – and while it has since recovered to pre-crisis levels, in real terms, it has remained stagnant as percentage of GDP. This stands in stark contrast with the fact that trade growth almost constantly outpaced GDP growth from the mid-1880s until 2007, with the exception of the years between the World Wars. The increase in international trade as a percentage of global GDP was particularly noticeable

[3] Livesey, F. 2017. *From Global to Local. The Making of Things and the End of Globalisation.* London: Profile Books.

in the decades up to the crisis, doubling from 30 per cent to 60 per cent between the early 1970s and 2007 (see Figure 1).

Figure 1. Trade stalls: World trade as % of world GDP



Source: World Bank, 2018.

Financial globalisation has also stalled, at least in developed economies. Since 2007, the global stock of external assets and liabilities has remained relatively constant, in contrast to an increase of almost 190 percentage points between 2000 and 2007. It si significant that even the Bank of International Settlements, the *international bank of banks* and a steadfast advocate of financial globalisation, has acknowledged this trend.[4]

But the most dramatic materialisation of this backlash against globalization is the rise of protectionism, which of course reinforces the trend. Protectionism can directly affect the trade arena, as Trump's rhetoric and early actions have revealed, leading to 'beggar-thy-neighbour' policies in the form of tariffs, non-tariff barriers, competitive currency devaluations and even outright 'currency wars'.

Finally, the backlash against globalization is not only being reflected in economic protectionist tendencies, but also, in many developed countries, in hostility towards immigration. The Brexit vote, the election of US President Trump and the rise of the extreme right in various European nations are all clear demonstrations of this trend. While anti-immigration attitudes have an important cultural and political component, as we will see later, they also lead to major economic consequences: immigration is positively correlated with innovation and growth, and

[4] Bank of International Settlements. 2017. *87th Annual Report*. Basel: BIS.

its absence may be particularly problematic given the aging populations of most Western economies.

It is difficult to predict with certainty how these trends will play out, economically speaking, but a world of regional trading blocks is increasingly looking like the most likely heir to globalization. These trading blocks would also represent blocks of geopolitical rivals. Advanced economies would group assemble in two major free trade areas, one in the North Atlantic and another in Asia, while China and Russia would build a Eurasian trading bloc that would counteract American domination, making prescient MacKinder's maxim about the importance of Eurasia.

Comparing today's trends with the 1920s collapse of the previous era of economic globalization is illuminating. Princeton historian Harold James identifies resentment against the three key elements of mobility that are also salient today – capital flows, trade and international migration – as the main reason for the collapse. He claims that there are significant parallels with today's reality: highly integrated systems are inherently vulnerable to collapse, and world financial markets are vulnerable and unstable. Interestingly, in a manner that is reminiscent of the problematic role played by European Economic and Monetary Union (EMU) institutions, James points out that the institutions that were set up to handle economic integration were actually the transmission channels through which many of the tensions developed. While James does not foresee another Great Depression today, his work provides a cautionary tale where the institutions that were meant to save the world from the consequences of globalization – the WTO and IMF, translated to our own time – ended up destroying both prosperity and peace. He finds evidence today of the two most common explanations for the economic collapse of the past: rising volumes and volatility of capital flows triggered unsustainable booms and busts, and widespread fear of globalization provoked a social and political backlash. What is missing up until now, compared to the events in early 20th century, is an ideology and political movement(s) driving this societal reaction, a role fascism played in the past. But political movements can develop quite quickly, and the populist parties that are mushrooming in many developed countries today may constitute their embryo.

2.3. The retreat of openness and the challenge to the liberal democratic order

A number of factors are fuelling an increasing and pervasive discontent with the current liberal democratic socio-economic system that is preeminent in Western societies. First, as seen above, the negative consequences of economic globalization have led to a significant increase in economic inequality in both developed and developing countries. In his now famous 'elephant graph', Branko Milanovic illustrated that while globalization has been extremely positive for most in developing economies and the top earners in developed economies, it has been correlated with stagnant or even decreasing incomes for working and middle classes in

developed economies. Technological disruption, of course, has also contributed to job destruction and wage stagnation. A recent OECD report estimates that 46 per cent of the current jobs in developed economies have an over 50 per cent chance of disappearing because of technology.[5] Whether driven by globalization or technology, what is clear is that economic insecurity is fuelling populism.

Yet there is more to the ascendancy of populism than economic inequality. Authors such as Norris and Inglehart[6] have cast doubt on this economic interpretation and have pointed to cultural backlash or a 'retro reaction' to the progressive value change of the 1960s and 1970s as the main factor driving the rise in populism, providing empirical data from value surveys in the US and Europe to substantiate their claim. Their work further strengthens arguments made by others, such as US sociologist Robert Putnam, who claims that economic inequality is a symptom rather than a cause of the current malaise. Putnam sees economic inequality is a consequence of reactions against progressive values, solidarity and the strong role of the state that started in the late 1960s. It was these reactions that opened the window to the ideologies of Thatcher and Reagan, which in turn enabled the economic policies that have led to inequality. In what could be considered a vicious loop, growing inequality is now further reinforcing opposition to 'open societies' and progressive values, while strengthening support for protectionism and anti-immigration attitudes.

This loop is creating important political repercussions: an 'order-openness divide' is now emerging as the key political cleavage, as opposed to the left-right economic dimension that still informs most analyses. The salience of the former cleavage was noticed as early as the mid-1970s by various analysts, most noticeably Daniel Bell, but it has become more pronounced as the aging West's ethnic transformation has accelerated. According to this line of analysis, people are divided between those who dislike difference – signifying a disordered identity and environment – and those who embrace it. The former react against both ethnic and moral diversity. They therefore see the transformation of their societies into more diverse entities as threatening, and wish to protect themselves from it. Voting patterns in the Brexit referendum offer illustrative evidence of this trend: 71 per cent of those most in favour of the death penalty indicated that they would vote to leave the EU. Among those most *opposed* to capital punishment, in contrast, this percentage falls to 20 per cent. Similar trends surface when examining the correlation of Brexit vote intentions with opinions on other issues related

[5] OECD. 2018. *Automation, skills use and training. OECD Social, Employment and Migration Working Papers*. DOI: http://dx.doi.org/10.1787/1815199X

[6] Inglehart, R. and Norris, P. 2016. *Trump, Brexit, and the Rise of Populism: Economic Have-Nots and Cultural Backlash*. Faculty Research Working Paper Series, RWP16-026. Cambridge, MA: Harvard Kennedy School.

to order and discipline. In sum, it may very well be that it is values, even more so than economic inequality, that are driving the recent populist surge.

The combination of economic inequality and the backlash against openness – including immigration – is a toxic political cocktail that has led to the rise of what has been termed 'populism'. Yet, this is a contentious term. First, because it is used to refer to extremely varied political movements – from 'Trumpism' to Corbyn's Labour, from Orban's conservative anti-migratory Fidesz to Greece's left-wing anti-austerity Syriza, rendering it almost without meaning. To some, populism it is certainly a dangerous political movement. Jans-Werner Müller[7] has argued that at its core, populism represents a rejection of pluralism. In this interpretation, populists claim that they, and they alone, represent the people and that these people they represent are the source of legitimacy – to the exclusion of all others. This opens the door, in Mueller's view, to a dangerous claim to exclusive moral representation of the people. This claim, in turn, can lead to authoritarian states that exclude the interests of those not considered part of the proper 'people'.

Yet this purely negative, almost tautological, definition of populism (it is a 'negative' movement because it is defined in 'negative' terms), which has been embraced by the political mainstream, does not fit well with the significant electoral support that populist parties are receiving. A not insignificant part of the electorate considers the claims underlying the support for 'populist' parties (such as criticism of increased economic inequality, and critiques of the potential negative effects of immigration on local wages and social and political cohesion) to be legitimate. In fact, a growing number of respected analysts are arguing in favour of what they term 'good populism', both at a political level[8] – as a healthy, pluralist, challenge to the elites' abusive practices – and at an economic level – with economic and social policies that would resemble a much needed New Deal.[9]

In any case, the growing political and institutional presence of populist parties and their anti-globalization rhetoric will undoubtedly affect economic openness. While centre-right and centre-left parties still advocate free trade and globalization, political pressure to moderate those views is already apparent. The danger is not so much that populist parties may actually reach power (they already have in Greece and may do so in Italy), but that that they may push centrist parties into more nationalist and mercantilist positions as these centrist parties try to stop the flow of voters haemorrhaging to the far right or left populist options. In Austria, Hungary

[7] Mueller, JW. 2016. *What is Populism*? University of Pennsylvania Press
[8] See for example: Howe, R. 2018. *Populism and its Enemies*. Draft. NYU Law School; and McCormick, J.P, 2011. *Machiavellian Democracy*, Cambridge and New York: Cambridge University Press.
[9] Rodrik, D. 2018. What Does a True Populism Look Like? It Looks Like the New Deal. *New York Times*, February 21, 2018.

and other European nations, this shift in centrist politics is already a reality. In Germany, the extreme right has gained parliamentary representation for the first time. And in France, the campaigns of Francois Fillon, the main centre-right candidate, and extreme-right Marie Le Pen – even if ultimately unsuccessful – showed the electoral appeal of heavily nationalist and socially conservative discourse and the weakened political support for free trade and an internationalist agenda, including further European integration. The way the Conservative party in the UK framed Brexit is yet another sign of this tendency. Just as in migration issues, centrist parties are likely to adopt policies that limit other facets of globalisation, such as freedom of trade or capital flows. In sum, while the origins of what has been termed as populism may be diverse, its normative valuation debated and its typology varied, all of populism's forms seem to share one factor: a call for a renewed centrality of the state, politically and economically speaking.

2.4. The return of the state and the 'geopolitization' of everything

A number of factors are converging to lead to what one might call the 'return of the state', even if what is meant by 'the state' is markedly different across countries. A first factor, naturally, the loss of faith, brought about by the Great Recession of 2007, in the 'Anglo-Saxon' model of capitalism and the pre-eminence it postulates of markets over states. The fantasy that markets were capable of auto-regulating was seen for the self-interested mirage it was and the crisis opened the door to a new era of regulation, especially in financial services. Second, with the centrality of central banks in the response to the crisis coming to an end, governments will no longer able to unload on central bankers the responsibility for difficult economic policy decisions. Now that the limits of monetary policy in an age of deflationary tendencies have become apparent, fiscal policy (which is of course much more exposed to political pressures), will take the driving seat, returning governments to the limelight. Third, as discussed above, protectionism looms large, a fact that would restore a leading role to states and their decisions on tariffs, currency manipulation and limits to the movement of people, among others. Economic nationalism may today be the ascending paradigm, and it is certainly the paradigm that President Trump publicly defends for the US. Finally, in developed economies, this renewed centrality of the state may reflect a shift in the political economy paradigm, driven by populist policies to abandon austerity and the more limited state role that the so-called neoliberal age has pushed for the last four decades (although this was only true to a certain degree – as a percentage of GDP, public expenditure has been increasing consistently in most western European states, and it has now over 50 per cent in many of them). In the emerging economies, meanwhile, five of which will be among the top ten world economies by 2030, state capitalism represents the norm rather than the exception. 77 of the 98 Chinese companies in the 2015 Fortune 500 list were state-owned enterprises.

The new salience of state capitalism is likely to herald a strengthening of what Edward Luttwak termed ‘geoeconomics’: the waging of conflict through economic means. Whether via tariffs or financial sanctions, the use of these mechanisms is likely to be far more frequent now that the border between markets and states is blurring and that the need to keep up appearances of respect for ‘free markets’ is diminishing. When commercial and strategic goals intertwine, the repercussions for businesses are important. Companies are more likely to be affected not just by protectionist measures but also by other means used by their home or host states for security purposes, some of which may not be driven fully by economic or commercial logic. Firms are also more likely to be pressured or used as pawns in the security field, with their governments pressing them to act as intelligence gathering tools, for example, as those governments work to buttress their economic intelligence capabilities.

The use of economic means to wage conflict is illustrative of a wider phenomenon that Nader Mousavizadeh has called the ‘weaponisation of everything’. According to this trend, almost any factor of production or exchange – from technology to finance to trade – can be used as a tool of conflict. Technology is a particularly relevant example. While discussions on technology’s impact have up until now focused mainly on its impact on innovation and, more recently, on robotization’s possible negative impact on employment and the social consequences thereof, 2017 is likely to be dominated by discussions on the geopolitics of technology. First and foremost among these impacts is cybersecurity, of course. After the US presidential election episode, cybersecurity has unquestionably become a sovereign state issue – but unlike in other realms of inter-state conflict, in cybersecurity there is an added danger, in the lack of even a minimal set of rules or global governance regime to manage it. Yet the geopolitics of technology is not limited to cybersecurity alone. There are other issues, such as the implications of the ownership of robotization technology, which is concentrated in just a handful of countries (US, Japan, China, Germany, UK, and, to a lesser degree, Israel), and the diffusion of power brought about by communication technology and social networks, which make it increasingly difficult for governments to suppress information. This could become a significant source of instability for autocratic states from Saudi Arabia to China, which have traditionally relied on information control to maintain law and order, but which may in the future face social discontent as a result of worsening economic conditions. Such discontent could be develop further if the impact of automation on employment begins to be felt in developing economies: a report by UNCTAD estimates that automation could lead to the destruction of up to two-thirds of existing jobs.

The trends identified above are of course not exhaustive. Other issues are important as well. We are in the midst of a great demographic transition: the world’s population is growing older, more urban, and is moving more. This has important economic implications. The German work

force is shrinking faster than the Japanese, which does not bode well for Europe's growth prospects. As explained above, ageing and its effects on predominant values in society, including decreased openness to diversity, is intimately connected to hardening attitudes towards immigration, another key issue of our time. The integration of immigrants is sometimes made more difficult by cultural and religious differences, pointing to yet another important trend in this new century: the ascendancy of religion and its perversion by some. This trend is leading to the danger, or for some, the interest in making Huntington's 'clash of civilisations' a self-fulfilling prophecy. In this scenario, radical Islamic terrorists provide inestimable help. The terrorist threat is in turn connected with two other major trends: the rise of non-state actors and a possible revival of nuclear proliferation, which is possibly the greatest threat to mankind. The only other issue that could compete for such an accolade would be climate change, which also has significant economic implications given the heavy and increasingly unsustainable investments in the world's fossil fuel-based economy. The combination of all these trends is heralding a new age of uncertainty, with important implications for markets and corporations.

3. The geopolitical dissonance of markets

3.1. A new world of political and geopolitical risk for business

The trends described above can translate into a number of important risks to business. The first is, clearly, that military conflict could arise as geopolitical instability increases. Recent wars in Syria, Ukraine and Yemen are clear examples of this. Analysis by Cytora Ltd., a Cambridge-based research firm specialising in geopolitical risk, identifies more than 100 potential scenarios for two nation-states to spark off a military conflict in the next decade. Yet markets can be affected without the geopolitical instability leading to actual conflicts. The mere perception of a threat of geopolitical risk has been shown to have negative economic and financial implications. Research by New York Federal Reserve Board of Governors economists Dario Caldara and Matteo Iacovellio[10] has shown that the threat of geopolitical risk events leads to a decline in real economic activity and to lower stock market returns, as well as movements in capital flows away from emerging economies and towards advanced economies. Furthermore, as previously discussed, the rise of geoeconomics and the *weaponisati*on of trade, finance and other economic and market instruments is yet another risk that this new geopolitical age is creating. Corporations are increasingly likely to find themselves in the crossfire of such actions, and they may suffer serious collateral damage. Some recent examples of this include by the sanctions against Russia after the Ukraine conflict – and

[10] Caldara, D. And Iacoviello, M. 2018. *Measuring Geopolitical Risk. International Finance Discussion Papers 1222*. Board of Governors of the Federal Reserve System

Russia's retaliation, and the US and China's increasing use of economic tools to exercise political pressure on their adversaries. Two areas where this is already clearly playing out are cybersecurity and trade protectionism.

In sum, geopolitics can have both direct and indirect consequences on markets and corporations. Political and geopolitical events lead to disruptions that markets find difficult to assess and often cause assets to be mispriced. The difficulty is of course to identify the gap between the market price and the political risk-adjusted price. To do so, it is important to detect the correlations and transmission belts that are arbitraging the difference between price and value, and to understand how political and geopolitical factors may lead to such mispricing. The channels of impact can be financial or economic and will affect asset classes to varying degrees. Researchers have established many well-known mechanisms through which political risk can impact business. Some of the most relevant ones are: expropriation, capital controls, currency devaluations, price controls, taxation/fiscal policy, non-payments and regulatory changes in heavily regulated sectors (energy, infrastructures…). Meanwhile, conflicts can damage production facilities and/or public/private infrastructure, close trade routes, disrupt (increasingly global) supply chains, energy supply and supply of other raw materials. Mere volatility can seriously affect currencies, lead to capital flight, cause stock market instability, and lead to an increase in commodity prices.

In sum, political and geopolitical risks can generate uncertainty and add costs to companies operating not just in conflict regions but also at home. Investors must consider whether potential investment returns justify expected risks. Furthermore, geopolitical instability can weaken economic growth and asset returns and thus have important indirect effects on investment portfolios. These investments, for instance, can be particularly vulnerable to actions by non-state actors, especially terrorist groups, as we have seen recently in France or Turkey. Finally, the channels of contagion are not the only variable: the time frame is also critical. Markets are usually concerned with short-term effects, while corporations must also study the implications in the mid-term. Brexit is a good example. In the immediate aftermath of the vote, expectations for additional monetary easing led to a rally in both bonds *and* risky assets, but Brexit's mid-term effects may be less positive.

However, assessing the impact of political and geopolitical risks is not straightforward, and most firms, while paying lip service to the relevance of these issues, actually do very little to properly incorporate geopolitical dislocations and associated political risks into their management and investment decisions and valuations. Why are markets not reacting more worryingly to this new era of geopolitical instability? There are three possible explanations.

3.2. The geopolitical dissonance of markets

The first reason why the actions and decisions of executives and investors may not be reflecting today's geopolitical shifts is a belief that these events may not be that relevant or that, if they are, they may be a source of opportunity rather than risk. After all, for the last three decades, most geopolitical events – the collapse of the USSR, democratization in Latin America, the opening of China, etc. – have been positive for free markets, and many investors still believe this will be the case. Historically speaking, it is also true that geopolitical events have had little impact on equities in the short term, and even less in the long term. For instance, many had predicted vast negative effects when the UK public voted for Brexit and when Trump was elected, but these have not materialized. Instead, in the short term, markets have reacted positively.

A second reason may be the fact that executives and investors often consider attempting to assess the impact of events on markets a futile exercise. Geopolitical disruptions seem arbitrary and unpredictable to most financial analysts, who therefore consider incorporating these disruptions into their quantitative models a hopeless task. Most quantitative methodologies, whether based on polling, econometric methods or big-data models, have failed repeatedly to predict the most important events, including of course Brexit and Trump's election. This is no coincidence. Despite the progress that has been made in forecasting by analysts like Philip Tecklock – who has shown that forecasts by well-trained analysts working as a team tend to be more accurate than those of individual experts, the reality is that linear models (that work by making adjustments to baseline scenarios) cannot effectively predict events which constitute a change in this linearity. It is difficult to quantify political risk, because human and social organizations often experience paradigm shifts which are characterized precisely by non-linearity.

In this context, it is important to understand that what we are facing today is not just an increase in risk, but also in uncertainty, a crucial distinction that economists Frank Knight and John Maynard Keynes introduced in the first half of the 20th century. While risk can be defined as measurable uncertainty, uncertainty is not subject to quantification or the laws of statistics, since probability must be derived from a significant sample of independent and homogeneous events – which are absent in contexts of uncertainty. Or, to put it differently, a change of paradigm, which is what uncertainty implies, is not subject to linear analysis. Investors are used to working from baseline cases and attaching probabilities of deviation in one direction or another, based on predictable events. But with uncertainty, this methodology does not work. Furthermore, the current uncertainty is driven by political and geopolitical factors, which are

determined by hard-to-measure human and social interactions. Quantitative models cannot easily incorporate the subjective judgements that form the essence of politics.

While the two arguments above may explain why markets have not been significantly affected by the current increase in political and geopolitical risk, there is an alternative interpretation: executives and investors may be mispricing the potential negative implications of these events. After all, the fallibility of investors in assessing the impact of these issues is a reasonable assumption. Market price consensuses reflect the average opinion of market participants. Most of these participants are financial experts with limited political and geopolitical expertise or experience, which makes the accuracy of their analysis and conclusions in this field rather limited. As such, it is a reasonable assumption to make that asset prices, in so far as they reflect this fallible analysis, may not be capturing the potential negative impact of geopolitical events.

Furthermore, investors may be subject to a certain 'cognitive dissonance' – the discomfort of and resistance against taking actions that go against one's beliefs or value preferences – when it comes to incorporating their assessments of geopolitical risks into management and investment decisions. In a recent article, Acharia, Blackwell and Sen[11] modelled how cognitive dissonance shapes political attitudes, in the sense that actions may shape preferences rather than the other way around. A similar model could also be applied to our subject matter to try to shed light on why investors are displaying a 'preference' for a sanguine attitude towards the market risks created by the current political and geopolitical upheaval. As explained above, recent history has shown most investors that geopolitical disruptions do not significantly affect markets, and that they have in fact often created investment opportunities. As such, investors' current management and investment decisions may reflect this sanguine attitude towards geopolitical risk – which, in turn, leads to a preference for viewing geopolitics as a non-risk for business and markets. A self-fulfilling prophecy is thus created, where geopolitical shocks are positively valuated, or their potential negative impacts are minimized, at the least.

Yet this approach can, obviously, distort markets and condition prices. In fact, political economists have explored in depth how ideas can shape markets. The work of MacKenzie[12] and others on the financial sector suggests that development of a financial idea such as the Black-Scholes valuation model and its deployment by market agents to an increasing number of asset classes ended up altering pricing patterns in a way that made reality fit the stylized model. A similar dynamic took place with the pricing of collateralized debt obligations (CDOs)

[11] Acharia, A., Blackwell, M and Sen. M. 2018. Explaining Preferences from Behavior: A Cognitive Dissonance Approach. *The Journal of Politics*, 80 (2). Published online March 1, 2018. http://dx.doi.org/10.1086/694541
[12] MacKenzie, D. 2006. *An Engine Not a Camera: How Financial Models Shape Markets*. Cambridge: Cambridge University Press.

through the use of rating methodologies designed for other purposes. In sum, investors' mental frameworks can, and do, distort prices. But at some point the gap between valuation and fundamentals, between wishes and reality, becomes unsustainable. And as Martin Feldstein once quipped, if something is unsustainable, it cannot be sustained.

In sum, a certain degree of cognitive dissonance may be blinding executives and investors to the risks that a change in the geopolitical paradigm may entail. While isolated geopolitical events may be of limited impact, what we are witnessing is a more profound paradigmatic shift that may generate novel and underestimated risks. Should this be the case, making an effort to understand the potential consequences of geopolitical dislocations for markets would be essential, and the difficulty of doing so ought not to be a reason not for at least trying.

4. Conclusion

The changing political and geopolitical paradigm described in this paper certainly brings opportunities to executives and investors, but it also generates major risks that can hardly be ignored. It is important to understand that these risks are not just ethereal 'macro' issues with little direct impact on business operations and results but rather threats that can directly affect businesses' bottom lines and valuations, as the sterling's devaluation following the Brexit vote attests. Yet today there seems to be a pervasive complacency among executives and investors regarding the potential negative impact of these risks. This complacency may be justified – but there is also a chance that it is in fact the result of a certain 'geopolitical dissonance of markets'.

President Franklin Delano Roosevelt famously said that we had 'nothing to fear but fear itself'. One wonders whether today it would be more appropriate to say that if there is something to fear it is the apparent absence of fear. While it is true that we do not face the sense of existential risk that the Cold War brought about, it is also true that that fear focused minds and in some ways provided the best insurance policy. Today, on the contrary, there is a serious risk of underestimating threats. This paradigmatic shift will make prediction of political and geopolitical outcomes particularly hard. Nevertheless, this difficulty should not keep firms from trying to incorporate political analysis into their investment decisions. In fact, being aware of the importance of political and geopolitical risks should arguably not drive a doubtful aspiration to make consistently accurate predictions – rather, this awareness should instil a culture of political awareness in corporations, allowing them to build capabilities to resiliently manage political and geopolitical shocks.

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