Clingendael
Netherlands Institute of International Relations

Policy Brief

MAY 2018

The growing relevance of geopolitics for European business

Frans-Paul van der Putten

Today's international business environment is less predictable, more volatile, and involves more politics than in previous decades. The declining economic weight of the United States and growing doubts about its leadership role in global governance have important implications for European companies. There is a growing likelihood of high-profile incidents in which large enterprises suffer major financial and reputational damage from geopolitical risks – whether through sanctions, state-sponsored cyberattacks or geopolitical shocks. But while managers increasingly regard geopolitics as relevant to their activities, for many companies this insight has not yet resulted in changes to their behaviour.

Transformation of the International Order[1]

A fundamental geopolitical trend is the erosion of the US-led liberal international order.[2] Founded during the Second World War by the United States and the United Kingdom, the liberal international order became the overall global order after the end of the Cold War. It is based on principles such as state sovereignty, abstinence of violent border alterations, no use of military violence unless mandated by the United Nations (UN) Security Council, an open global economy, free access to the global commons, and the promotion of human rights and democracy. A major cause of the liberal international order's diminishing performance is the declining role of the United States as its main sponsor. In the years after 2001, foreign policy under President George W. Bush indicated that the United States was becoming less enthusiastic about issues such as multilateral governance, the role of the Security Council and human rights.[3] The presidency of Donald Trump questions not only multilateral governance, but also the value of an open global economy. These new directions in foreign policy take place against the background of the United States' decreasing economic role. Between 2002 and 2016, the US share of the global economy shrank from 32% to 25%. During the same period,

1 The author is grateful to Rem Korteweg and Ko Colijn for their comments on a draft version of this Clingendael Policy Brief.

2 Hanns W. Maull, 'Resüme', in: Hanns W. Maull, ed., 'Auflösung oder Ablösung? Die internationale Ordnung in Umbruch', Berlin: SWP, Dec. 2017, pp. 115–116.

3 Maull, 'Resüme', p. 129.

China's share increased from 4% to 15%.[4] Yet although China's economic and political power are growing rapidly, China is not filling the leadership gap in the liberal international order that results from US withdrawal.

The Clingendael Strategic Monitor for 2017 highlighted that a new global order is emerging: a 'multi-order', which is a highly diverse system in which international cooperation takes place (or fails to do so) depending on which policy domain is at stake.[5] The state of international cooperation varies per theme and the composition of collaborative partnerships fluctuates over time. Examples of such themes include climate change, trade, counter-terrorism, cyber security and crisis management. Actors may cooperate in one domain while opposing each other in a different field. The emerging global order is no longer centred on a core group of (largely Western) actors that tend to cooperate among each other under the leadership of the United States.

The declining economic weight of the United States and growing doubts about its leadership role in global governance have important implications for European companies.

- ***Greater geopolitical uncertainty.*** While the United States remains a very influential actor, its leadership role in global affairs is declining. This leads to uncertainty in parts of the world where the US has long guarded the regional balance of power. Particularly in the Middle East, Europe and East Asia,[6] the United States' traditional allies are increasingly doubting US security commitments, especially in the long run. They and other states within each region are therefore recalculating and recalibrating their foreign policies, which is changing the regional security orders.

- ***Diminished functionality of global governance.*** The United States – joined by its main partners the European Union (EU) and Japan – has long provided leadership in global governance. It took the initiative to establish core institutions such as the United Nations Security Council, the World Bank, the International Monetary Fund and the World Trade Organisation (WTO). However, today the United States is increasingly just one among several great powers and its ties with the EU are not as close as in the past. The absence of strong leadership increases the risk that multilateral organisations become paralysed on key issues. This has happened, for example, with the WTO (Doha round of trade talks) and the UN Security Council (civil war in Syria).

- ***Politicisation of international economic relations.*** Economic globalisation was previously driven to a large degree by two global powers: first, Britain; and, subsequently, the United States. These countries' governments, enterprises and financial sectors played key roles, but often as distinct actors. Today's American corporations and private financial institutions act primarily on behalf of their shareholders, not of the US government. The rapidly advancing role of Chinese companies and banks in the world economy is different in the sense that they operate within policy frameworks that have been defined by their government. Chinese corporations and financial institutions are either

4 Malcolm Scott and Cedric Sam, 'Here's How Fast China's Economy is Catching Up to the US', *Bloomberg*, 6 Nov. 2017, https://www.bloomberg.com/graphics/2016-us-vs-china-economy/.

5 Kars de Bruijne and Minke Meijnders, 'Multi-Order', report, The Hague: Clingendael, 2017. See also Braz Baracuhy, 'Geopolitical Risks and the International Business Environment: Challenges for transnational corporations and their global supply-chain', *Journal of Political Risk*, 4/6, June 2016.

6 On geopolitical uncertainty in East Asia, see Elena Atanassova-Cornelis and Frans-Paul van der Putten, eds, *Changing Security Dynamics in East Asia: A post-US regional order in the making?* Houndmills: Palgrave Macmillan, 2014.

directly (as state-owned enterprises) or indirectly (as private firms) under the influence of the Chinese state and the Communist Party. By way of its so-called Belt and Road Initiative, the Chinese government is stimulating major Chinese firms to take up key positions in international transport and infrastructure. At the same time, China is aiming to advance from a 'factory economy' to a 'headquarter economy'.[7] The expanding organisational power of China in global economic relations is without precedent and is likely to trigger other states to adopt a more interventionist attitude in their external economic relations as well. The growing role of state actors in the global economy leads to a greater coalescing of economics with politics, as state-controlled companies serve both commercial and political interests.

Relevance for Business

For companies, these developments mean that the international business environment is less predictable, more volatile, and involves more politics. Greater geopolitical uncertainty, for instance about US foreign policy,[8] makes it more difficult to anticipate when and how political and macro-economic factors may change. The ability of global governance institutions to prevent or diminish shocks resulting from such changes is even more limited than when the United States was willing and able to provide leadership on many issues. Moreover, the growing role of state actors, in particular China, in the global economy means that international companies will find it harder to keep a distance from issues that were previously not part of managerial responsibility. One example of an issue that is becoming increasingly sensitive is the transfer of technologies to Chinese or Russian business partners that are regarded as 'strategic' by the home governments of Western companies. Recently, a bipartisan group of US senators introduced the Foreign Investment Risk Review Modernisation Act (FIRRMA), aimed at expanding the mandate of the Committee on Foreign Investment in the US (CFIUS), which screens foreign direct investments to detect and avert potential national security risks. Notably, FIRRMA intends to: 'Update the Committee's definition of "critical technologies" to include emerging technologies that could be essential for maintaining the US technological advantage over countries that pose threats, such as China'.[9] In September 2017, the European Commission proposed an EU-wide mechanism for foreign direct investment (FDI) screening, aimed at preventing investments in European companies that could endanger public order or national security. Concerns in Germany over Chinese takeovers of high-tech firms are one of the factors underlying the European Commission's proposal.

Meanwhile, the process of economic globalisation continues to evolve. Supply chains, which are already highly internationalised, are becoming even more complex, involving an increasing variety of actors, countries and technologies. The limited potential for growth in developed economies pushes international companies towards greater engagement with the developing world. Still, a company does not need to be physically present in countries or regions with a high political risk profile to be vulnerable to geopolitical risks. Unlike many traditional country risks, which are significant primarily in developing countries, geopolitical risks can affect also those businesses whose activities are confined to advanced economies. Not only are these companies often part of global supply chains that are not immune to events in remote regions and that are becoming more politicised, but

7 Baracuhy, 'Geopolitical Risks and the International Business Environment'.

8 'How are Leading Companies Managing Today's Geopolitical Risks?', survey, Willis Towers Watson and Oxford Analytica, Sept. 2017, http://www.oxan.com/media/1955/oa_wtw-political-risk_sep-2017.pdf.

9 'Cornyn, Feinstein, Burr Introduce Bill to Strengthen the CFIUS Review Process, Safeguard National Security', https://www.cornyn.senate.gov/content/news/cornyn-feinstein-burr-introduce-bill-strengthen-cfius-review-process-safeguard-national (accessed 23 Dec. 2017).

political stability in core regions of the global economy such as Europe and East Asia is deteriorating. The European Union has been facing new challenges, such as Brexit and Russian military interventions in Georgia and Ukraine. In East Asia there is growing uncertainty over the future of the Korean peninsula, and over the regional security order. Moreover, the expanding importance of the cyber domain means that the geography of business activities is becoming less relevant as a determinant of geopolitical vulnerabilities.

Geopolitical Risks

Geopolitical developments bring with them both opportunities and risks for companies. It is increasingly important for executives to be aware of these. A failure to act on new opportunities can lead to a strategic disadvantage in relation to competitors who do engage with these opportunities. The risk side is a relatively unfamiliar part of political risk. The more familiar side consists of country-specific political risks,[10] which relate to risks resulting from political factors in a company's home country or in a foreign country (in the latter case these risks are a sub-category of so-called country risks). Geopolitical risk derives from political factors that exceed the national level, which by definition are influenced by geopolitics.

Geopolitical risks for business include:

- ***Boycotts, sanctions, embargoes and other politically motivated trade restrictions.*** The closely related phenomena of boycotts (concerted acts of abstaining from dealing with certain actors as an expression of protest), sanctions (coercive measures adopted by several nations in concert) and embargoes (legal prohibitions on commercial interaction) are not new. For instance, US economic sanctions against countries such as Iran and Cuba have long limited the ability of European companies to engage in activities that relate to such countries. What is new is that European countries are now themselves targeted by sanctions.
  The economic sanctions of the European Union and the United States against Russia, which were initiated in 2014 as a result of the Ukraine crisis, triggered Russian counter-sanctions. Affected companies include exporters of EU agricultural products to Russia and transport companies that incur costs from more thorough border inspections. Moreover, there is an even larger risk relating to China. Unlike with regard to Iran and Cuba, doing business with China can hardly be avoided by major European companies. The current American strategy of prohibiting access by Chinese firms to advanced technology in the United States is likely to expand and force relevant European companies to choose between doing business with the US or with China. A decision in either direction could cause severe damage to these firms. Supply-chain trade accounts for 80% of global trade, and the United States, China, Japan and Germany are the key economies within this trade.[11] This means that severe political tensions between China and the United States (or Germany or Japan) can potentially affect a large number of European firms via the supply chains of which they are a part.[12]

- ***Cyberattacks by state actors.*** Cyberattacks aimed at companies can be either of a criminal nature or politically motivated. Yet states, especially great powers, generally have much larger resources to invest in cyber capabilities than criminals do. This means that states can develop sophisticated cyber weapons that have a very large potential impact. For instance, Stuxnet, a computer malware program that infected many

10 Cecilia Emma Sottilotta, 'Political Risk: Concepts, definitions, challenges', working paper series SOG-WP6/2013, Rome: LUISS School of Government, 2013.

11 Baracuhy, 'Geopolitical Risks and the International Business Environment'.

12 See also: Keith Bradsher, 'Both China and U.S. See a Future with Fewer Ties', *New York Times International Edition*, 18 May 2018.

computers globally, is thought to have been developed by the United States and Israel to sabotage Iran's capability to develop nuclear weapons. Any business is vulnerable to cyberattacks, but the possible damage from a state-sponsored attack is larger than damage from attacks that are unrelated to state actors. Damage to companies may be a non-intended ('collateral') side-effect of an attack against other targets. States may also use their cyber capabilities for industrial espionage, or to enable companies or the nation to engage in industrial espionage against foreign companies. Given the increasing role of the internet, instances of cyberattacks and the related vulnerability of companies are growing as well. Geopolitics and cyberspace are likely to become ever more interconnected, especially as technology transfers are becoming politically more sensitive.

- ***Geopolitical shocks.*** Greater uncertainty over international political conditions increases the risk of geopolitical shocks. Unexpected yet major political events cause sudden changes in the international business environment. The surprise outcome of the 2016 Brexit referendum in the UK has had major effects on EU–UK relations and thus on many businesses. Other examples of highly disruptive events that are possible but very hard to predict include a sudden collapse of US power in a region such as East Asia, the disintegration of the EU, armed conflict between China and the United States, China and Japan, or Russia and NATO, or an expansion of Iran–Saudi proxy wars in the Middle East. Once such shocks occur, companies are forced to adapt, but it is difficult for them to prepare in advance given the limited predictability and huge potential impact.

The Geopolitical Awareness of Business

In late 2017, the *Financial Times* reported that a growing number of business schools are giving geopolitics a prominent position in their curricula.[13] This suggests an increasing interest in geopolitics among enterprises, given that business schools align their educational programmes with the perceived needs of companies. Moreover, a survey among business executives conducted by McKinsey in 2016 indicated that a majority of respondents expect geopolitical, political and macroeconomic instability to affect their companies. Yet the same survey also revealed that very few of the same companies have taken steps to address these issues.[14] So while managers increasingly regard geopolitics as relevant to their activities, for many companies this insight has not yet resulted in changes to their behaviour. Still, it seems likely that growing awareness of geopolitics will stimulate companies to become more responsive in the coming years.

There is a growing likelihood of high-profile incidents in which large enterprises suffer major financial and reputational damage from geopolitical risks – whether through sanctions, state-sponsored cyberattacks or geopolitical shocks. Given the interest of companies in assuring their shareholders that such risks are adequately managed, incidents of this kind would stimulate them to focus more seriously on geopolitical factors. In the past, such incidents may have been regarded as being outside a company's ability to handle. Moreover, investors tend to ignore risks that 'cannot be calculated in probabilistic terms'.[15] However, as geopolitics

13 Janina Conboye, 'Why Geopolitics is Finding a Place on the Business School Map', *Financial Times*, 3 Dec. 2017, https://www.ft.com/content/3aa439a8-cbc1-11e7-8536-d321d0d897a3 (accessed 23 Dec. 2017).

14 McKinsey & Company, 'Geostrategic Risks on the Rise', survey, May 2016, https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/geostrategic-risks-on-the-rise. See also 'How are Leading Companies Managing Today's Geopolitical Risks?', survey, Willis Towers Watson and Oxford Analytica, Sept. 2017, p. 11.

15 Nouriel Roubini, quoted in David H. Anderson, 'Risks Multiply in a Divided World', Zurich Insurance Group, 18 Dec. 2017, https://www.zurich.com/en/knowledge/articles/2017/12/risks-multiply-in-a-divided-world.

are increasingly being regarded as a regular component of the business environment of many middle-sized and large European companies, investors are increasingly demanding business policies that mitigate geopolitical risks.[16] Other stakeholders, such as governments, employees, local communities, media and insurers, are likely to follow. Some of the types of mechanisms that have been developed with regard to corporate social responsibility (CSR) are relevant also for improving companies' capabilities for dealing with geopolitical risks.[17] These include specialised standards for the management and reporting of relevant risks and company-wide raising of awareness of geopolitical risks. As has happened with CSR, companies may increasingly regard geopolitical risk management as a tool to open new markets and opportunities, rather than just as a cost. Yet regardless of whether they are aimed at risk management or creating competitive advantages, European companies need to enlarge their geopolitical awareness in order to operate in a more uncertain, more volatile and more politicised international environment.

16 'How are Leading Companies Managing Today's Geopolitical Risks?', survey, Willis Towers Watson and Oxford Analytica, Sept. 2017, p. 10.

17 See also Sven Behrendt and Parag Khanna, 'Risky Business: Geopolitics and the global corporation', *Strategy+Business*, 32, fall 2003.

About the Clingendael Institute
Clingendael – the Netherlands Institute of International Relations – is a leading think tank and academy on international affairs. Through our analyses, training and public debate we aim to inspire and equip governments, businesses, and civil society in order to contribute to a secure, sustainable and just world.

www.clingendael.org
info@clingendael.org
+31 70 324 53 84

@clingendaelorg
The Clingendael Institute
The Clingendael Institute

About the author

Dr Frans-Paul van der Putten is a senior research fellow at the Clingendael Institute.
Contact: fputten@clingendael.org