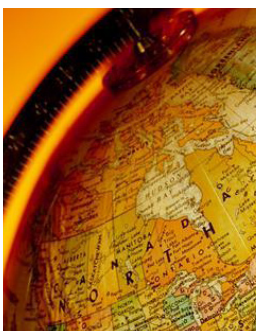
global trends

Eurasia Group Global Trends Quarterly

Executive Summary

First Quarter 2009



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1. Emerging markets' vulnerability and responses to the financial crisis

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Prepared for PricewaterhouseCoopers, LLP

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Background

At the request of PricewaterhouseCoopers, Eurasia Group is monitoring and assessing major trends shaping the global business environment. The focus in the first quarter of 2009 is the global financial crisis and its political, economic, and social implications. More specifically, Eurasia Group addresses the following topics in five white papers: the spread of the financial crisis to emerging markets, growing government involvement in the economy, the potential for social unrest, the prospects for infrastructure investment, and energy-sector volatility. This document summarizes those findings.

EMERGING MARKETS' VULNERABILITY AND RESPONSES TO THE FINANCIAL CRISIS

As the credit crisis unfolded, there was initially some hope that the dynamism of emerging markets would carry them through the turmoil, or that decoupling would somehow insulate them from external shocks. With incredible speed, the financial crisis in the second half of 2008 hit emerging markets as well, radically changing their economic prospects. While the longer-term outlook for emerging markets remains positive, the near-term forecast for these markets looks challenging. Understanding how different countries will fare in the economic turmoil will shape the risks and opportunities investors face.

The good news is that the governments of several emerging economies spent the last decade applying the lessons learned during previous financial crises by shoring up their foreign currency reserves and reducing their foreign debt. In the short term, though, economic fundamentals might not even matter as emerging markets watch their export markets soften, risk aversion rise, and capital flows dry up. Commodity exporters are particularly vulnerable.

Identifying a country's economic vulnerabilities is important, but investors also need to consider each government's effectiveness in responding to the economic turmoil. Governments matter more in times of crisis than in times of prosperity. Certain types of emerging market nations are likely to fare better during the crisis. These include:

- politically stable countries that have consistently reduced their macroeconomic vulnerabilities through market-friendly policies during times of economic plenty (eg, Brazil);
- countries with deep pockets that are able to use government spending to stimulate the economy (eg, China and Saudi Arabia); and
- frontier markets not overly dependent on commodity and agricultural exports (eg, Egypt).

Other emerging market governments will have difficulty pushing through policies that would help mitigate the impact of the financial crisis and the impending slowdown. These include:

- countries where weak governance is coupled with deeply unpopular leadership, or where domestic political clashes are likely to intensify and prevent necessary government measures (eg, Argentina and Thailand);
- countries with upcoming elections that could distract governments from economic crisis management, particularly where there are competitive election environments and/or weak coalitions (eg, India, Indonesia, Turkey, and Ukraine); and
- countries that have relied on the policies of resource nationalism and the fiscal freedom provided by high commodity prices (eg, Russia and Venezuela).

Emerging markets outlook for 2009:
Vulnerability and responses to global financial crisis

Economic vulnerability to the crisis		Ineffective: *Government unable or unwilling to enact effective policies*	Muddling through: *Government undertaking some positive policies to respond*	Appropriate: *Government proactively using policies to respond to crisis*
Severe	*Significant economic hardship or macroeconomic imbalances*	Argentina Pakistan Ukraine Venezuela	Latvia Russia	
Considerable	*Serious economic repercussions*	Nigeria	Brazil India Mexico Romania South Africa South Korea Turkey	China Hungary Poland Saudi Arabia UAE
Moderate	*Economic downturn primarily from global recession*	Philippines Thailand	Egypt Indonesia Kenya Malaysia Vietnam	

Effectiveness of government policy response

Source: Eurasia Group

Business implications

- The economic downturn in emerging markets is causing an increase in protectionism and economic nationalism. Countries including Russia, India, Indonesia, and Brazil have already announced their intentions to raise import tariffs or restrict trade. US legislators have favored "Buy American" clauses. Governments will favor local industry, creating an uneven playing field for foreign competitors and raising the risk of trade tension.

- The steep declines in equity markets around the world provide a potential opportunity for mergers and acquisitions, as many companies are currently undervalued. Wal-Mart's December bid for Chile's Distribucion y Servicio (D&S) grocery store chain is one example. Conversely, companies from emerging markets have a chance to grow when incumbent players stumble. Distress in the US automotive industry could open the door for Chinese or Indian firms to acquire weakened competitors or create a new low-cost competitor in the US.

- Some emerging markets, particularly those that have gone to the IMF for assistance (eg, Hungary and Ukraine), will be under external pressure to make structural, political, financial, and regulatory reforms that could increase their attractiveness in the long term.

GROWING GOVERNMENT INVOLVEMENT IN THE ECONOMY

The paradigm of deregulation, privatization, and free markets that has dominated the global economy since the early 1990s is now facing its greatest challenge. In the developed world, the level of government intervention in the economy is the greatest it has been in 50 years. The US government and many governments of EU member states (eg, France and the UK) now own significant stakes in their largest financial institutions. Flush with cash from export-led sectors, whether manufacturing in China or the energy sector in Russia and Venezuela, a number of states prior to the crisis were taking increasing roles in directing the domestic economy. As the crisis continues, governments of many emerging market countries are increasingly spending to prop up their respective economies and ensure that key enterprises are able to survive and compete.

In the wake of the perceived failure of the US regulatory model, reregulation will be the new buzzword in many parts of the world. Regulation is likely to spread from the financial services industry to other sectors, such as telecommunication, airlines, and energy. Changes to taxes, tariffs, nontariff barriers, and currency policies are also probable as governments more directly manage their domestic economies.

Business implications

- In their haste for action, developed governments are likely to impose regulatory requirements that overreach, are too stringent, and cost too much. The US Congress, for example, does not have a good track record: Sarbanes-Oxley was introduced after the 2001 Enron scandal and is widely considered to impose unfair burdens on companies that are not commensurate with the stated problem. This scenario is now likely to be repeated on a larger scale as governments consider a complete overhaul of financial regulatory institutions, accounting rules, health and safety standards, and climate change legislation.

- For the largest emerging market countries, government intervention in the economy provides an opportunity to increase the country's geopolitical influence. States such as China, Russia, and India have incentives to create large national champions that help domestic growth and their geopolitical interests. The crisis may in some cases dampen this drive, but it could also give some governments, such as China's, more leeway to consolidate strategic industries under its direct control.

- As states assume a larger role in the management of their economies, foreign investors may be forced to deal with counterparties that are owned or controlled by authoritarian states. This may pose a significant level of reputational risk. In 2007, for instance, Fidelity Investments sold its stake in PetroChina because its reputation was being affected by that company's ties to the Sudanese government and the Darfur crisis. In such an environment, it will be essential for foreign investors to conduct proper due diligence when doing business with partners from authoritarian states.

- As governments around the world respond to the crisis, corporate bailout packages are likely to be a major part of their tool kit. In the short term, the recipient companies are likely to make better business partners because their assured existence minimizes supply-chain and counter-party risks. Such benefits, however, must be weighed against the increased political risks associated with government involvement.

THE POTENTIAL FOR SOCIAL UNREST

The economic effects of the financial crisis have not yet been fully felt and the social ramifications, therefore, will likely follow. As unemployment increases and standards of living decrease, governments around the world will face increasingly insecure and angry populations. This could lead to rising crime, labor strikes, increased nationalism, radicalism, and xenophobia. Labor strikes or popular demonstrations could turn violent, as happened during the December 2001 Argentine riots that followed a classic run on the banks. In less stable emerging markets, rioting and looting along ethnic lines is a possibility. In the wake of the 1997 Asian financial crisis, food riots in Indonesia targeted the Chinese business community. Even developed nations, such as the US and EU member states, could see large strikes and demonstrations if unemployment rises significantly. Events in Greece in late 2008 may be a harbinger.

Social impact of the crisis in emerging markets:
Vulnerability and responses to global financial crisis

Political vulnerability		Market-friendliness of the government's response: Low	Medium	High
High	*Government could become unable to manage political fallout*	Pakistan Russia Venezuela	Thailand	Nigeria Ukraine
Medium	*Serious but manageable political repercussions*	Argentina Indonesia	Hungary India Mexico Poland South Africa South Korea	Kenya Philippines
Low	*Government is able to manage political fallout from the crisis*	China Vietnam	Brazil Malaysia Saudi Arabia	
		Government is likely to actively distort markets for political purposes	*Government is likely to increase subsidies and welfare payments but protect market players*	*Government is not likely to significantly intervene in domestic markets*

Market-friendliness of the government's response

Source: Eurasia Group

The crisis will push politics in a more favorable direction for national industries, consumers, and labor. Immigration policies, especially in developed economies, are likely to be revised if the crisis is severe and prolonged. In countries with aging populations, this could mean a less flexible and more expensive workforce. Immigration restrictions and economic deterioration in the EU, the GCC, and the US are slowing the flow of remittances to emerging market nations, such as India, Pakistan, the Philippines, Mexico, and Romania. The economies of these countries depend on remittances, and reductions could lead to greater poverty and political instability. If urban industries in emerging market countries are hurt by the crisis, there is likely to be a reversal of current urbanization patterns and a reduction in the size of urban populations. China, for instance, is worried about the social tension that could arise if a sizable portion of the 20 million unemployed workers in its urban coastal areas moves to rural inland areas during 2009.

One issue facing investors is how to identify those countries that are best positioned to handle social and political unrest, and which countries are likely to use market-friendly approaches in doing so. States such as Russia and Venezuela are poorly positioned to deal with social unrest and are likely to interfere strongly in the economy to stave off political fallout. On the other hand, some states that have historically had trouble handling domestic unrest, such as Nigeria, Ukraine, and the Philippines, may pursue market-friendly approaches—even if only because their governments are relatively weak or have been bailed out by the IMF. China and Vietnam both have the government apparatus to suppress unrest. China has the added advantage of cash resources to devote to mitigating social unrest by, for example, boosting welfare benefits for the unemployed. Most emerging market states, however, fall somewhere in the middle of these extremes. Social unrest is relatively manageable, and states such as India and Mexico will try to reinvigorate the economy without overly disadvantaging foreign investors.

Business implications

- Pro-consumer and pro-labor policies will increase transaction and regulatory compliance costs for businesses. In some cases, governments may decide to impose price controls on specific staples (eg, food and fuel), as Russia has already done for basic foodstuffs.

- Unrest and demonstrations could threaten supply chains and operations.

- A prolonged economic crisis will mean that regional and local identities will become more important, making consumers and governments less friendly toward things perceived as foreign. Meanwhile, governments in both the developed and developing world are likely to favor the purchase of domestically produced goods as part of measures to prop up local economies.

- The ability to be perceived as a valuable and responsible corporate citizen will be more important than ever. Corporations that are perceived as providing essential jobs and services might have some protection from the populist pressure that will result from the deepening financial crisis. Where foreign direct investment is seen as helping the local economy, the result may be better conditions for foreign investors.

PROSPECTS FOR INFRASTRUCTURE INVESTMENT

As global economic growth decelerates, governments will turn to infrastructure investment as part of their fiscal stimulus packages. These infrastructure projects are not only designed to stimulate economies, but also to address critical infrastructure deficiencies. Years of sustained economic growth and rapid urbanization has put a significant strain on infrastructure, creating pollution problems, traffic jams, and power shortages. In the new economic environment, however, some governments are better able to finance these kinds of large projects than others. Countries that are expected to succeed include those with substantial cash reserves and those that can credibly engage in deficit financing.

China, for example, announced a $586 billion fiscal stimulus package in November 2008, which includes substantial investment in railways, roads, energy, ports, rural infrastructure, and affordable housing. China is perhaps best able to finance such a large increase in government spending given its relatively strong fiscal position with a low debt-to-GDP ratio. The governments of the Arab Persian Gulf nations are also planning significant investments, though with the financial crisis and decline of oil prices, several countries have begun to review their plans, including directing their sovereign wealth funds to invest at home rather than abroad, and to seek private sources of financing. A number of other emerging market nations, such as Brazil and India, are unable to finance infrastructure investment on their own, and will instead turn to private infrastructure funds or to private infrastructure companies through public-private partnerships. While infrastructure investment may stall in the short term, as companies struggle to access financing and governments face time lags, infrastructure investment is poised to significantly increase in the medium to long term.

Infrastructure targeted as part of fiscal stimulus plans

Country	Total fiscal package	Targeted infrastructure
China	$586 billion	Railways, roads, power grids, ports, rural infrastructure, affordable housing
EU member states	$264 billion*	Highways, bridges (Italy) Roads (Germany, Spain) Railways, energy (France) Technology infrastructure (UK)
India	$61 billion	Highways, ports
US	Up to $1 trillion**	Water and electricity utilities, roads, railways, bridges, mass-transit, broadband programs

*Agreed expenditure; total actual expenditures will vary depending on individual member state actions.
**Estimate

Source: Eurasia Group

Business implications

- Companies in fields related to infrastructure are expected to benefit; these include engineering and construction firms, suppliers of materials such as cement and steel, and manufacturers of transport equipment.

- Infrastructure finance has grown in recent years, and is poised to become even more important during the economic downturn, as countries and companies turn to private investment funds for financing. For instance, the Abu Dhabi Investment Company (ADIC) and UBS Global Asset Management in November 2008 announced a new Middle East–North Africa infrastructure investment fund of at least $750 million, which followed the February 2008 announcement of another $600 million fund.

- Investment in green infrastructure will accelerate, particularly in the US, where there is a growing consensus that creating “green collar” jobs and investing in green infrastructure will be important components of a fiscal stimulus plan.

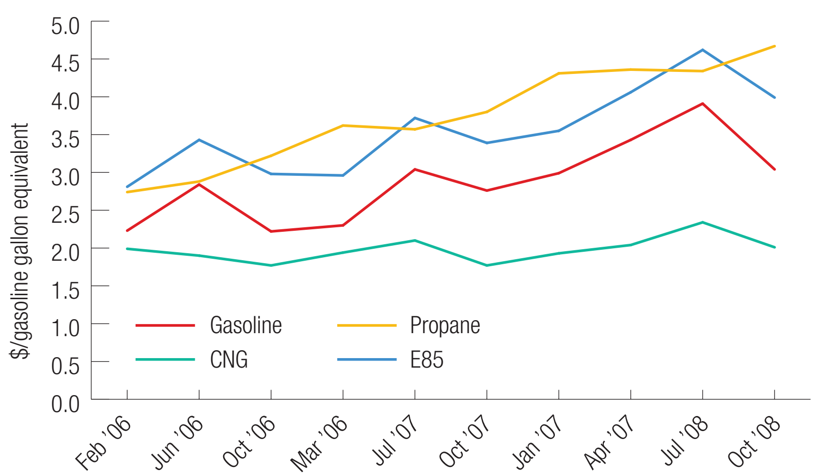
- The awarding of government contracts to private sector firms, which is common throughout the infrastructure sector, always presents a risk of corruption. For example, officials at the Bulgarian national road agency were arrested for demanding bribes to authorize a construction project in 2008. Regulatory, contractual, and legal regimes in emerging markets may not be designed to accommodate long-term investment, which can create risks in the contractual process

- Firms from established economies may find that partnering with infrastructure firms from emerging markets provides entry to new markets, although these firms may also be competitors. Emerging market firms are most competitive in ports and transport, and are relatively less competitive in electric power, water, and sanitation projects.

ENERGY SECTOR VOLATILITY

By January 2009, oil prices had fallen by more than $100 per barrel from highs reached in July 2008. The market focus has now switched from supply insecurity to demand insecurity as higher unemployment rates and lower industrial production reduce demand for petroleum products such as gasoline and diesel. Yet it is clear that issues concerning the security of supply have only receded, rather than disappeared. The threat of geopolitical disruptions in major oil producers like Iraq, Iran, and Nigeria remains a concern. Piracy in the Indian Ocean is a reminder that the global shipping industry remains vulnerable to attacks on the high seas, particularly at strategic chokepoints. Significant geological resources in markets like Mexico and Kuwait remain largely off-limits to industry investment due to resource nationalism. On the industry side, investment in new alternative fuels sources ranging from the Canadian oil sands to biofuels and coal-to-liquids now face challenging economics. Even conventional upstream investment in exploration in frontier markets, or in high-cost deepwater prospects, is being curtailed as industry capital expenditure is cut back.

US alternative fuel price comparison to gasoline



Source: Clean Cities Alternative Fuel Price Report, US Department of Energy, Energy Efficiency and Renewable Energy

The base case is for oil prices to stabilize between $40 and $60, but the forecast is complicated by uncertainties about the depth of the global financial crisis, OPEC policy, and the potential impact of cutbacks in industry spending on new oil and gas developments. Against this background, it can be argued that the industry faces two major uncertainties. The first relates to a lack of knowledge about the length and depth of the global recession, and the extent to which further contraction in global oil and gas demand is likely. Such uncertainty affects the production side of the industry, both the private and state-owned oil companies, and the governments of resource-rich nations. The second major uncertainty relates to the consumer side of the industry, including households, petroleum-dependent sectors, and import-dependent governments. The question for these actors is to what degree they should adjust plans to reduce their oil and gas exposure through costly investment in technologies and policies.

Lower fuel oil and natural gas prices will help the fiscal position of import-dependent governments in emerging markets, creating an important economic tailwind for countries that desperately need one. However, these same governments—most notably the Chinese government—must weigh whether to maintain relatively high retail prices in order to encourage more efficient use of energy in the long term. High-cost producer countries will need to recalibrate the investment framework for oil and gas projects. Governments in Alberta, Brazil, and the UK are already showing signs of scaling back proposed tax and royalty increases. Other governments, such as those in Russia and Kazakhstan, may continue to pursue nationalist policies, even as industry capital expenditure plummets in Russia and the strategic Karachaganak project in the Caspian is postponed. Governments in countries such as Venezuela and Iran, which have mismanaged the recent windfall revenue from oil and have failed to materially reinvest in their energy sector, when compared to other politically important social and economic programs, will also face a potentially painful adjustment.

Business implications

- Uncertainty around the short-term oil price environment makes efforts to hedge market risk more complicated for oil-intensive sectors. Decisions on energy efficiency investment, whether in terms of building technologies, more fuel efficient fleets, or even the location of production, look very different at $45 per barrel than at $145 per barrel.

- While the international oil companies (IOCs) and supermajors face losses in their downstream businesses due to weaker demand for refined products, the downside may be mitigated. These companies could benefit as they employ their significant capital reserves to acquire assets that have been repriced across the industry. Both the IOCs and independents stand to benefit as resource nationalism recedes in high-cost producing nations and the terms of doing business there become more amenable.

- Governments, particularly in more developed economies, must also weigh how to prioritize climate change mitigation efforts against economic recovery plans and the changing dynamics around energy prices.