

Global Agenda Council on Geopolitical Risk ¹

The New Reality

The international balance of power has shifted, giving emerging market states much more political and economic influence at the world's most important bargaining tables. This rebalancing and the uncertainty it generates will create new risks and opportunities for policymakers, investors and business decision-makers.

The financial crisis speeded the inevitable shift from an international order in which the G7 free market democracies dominated international institutions toward one in which major emerging states have amassed unprecedented geopolitical and economic leverage. The United States remains the only global military power. Given the cost of state-of-the-art military technology—and of building a blue-water navy—Washington will retain this advantage for years to come. Yet, the market turmoil of the past two years has helped ensure that economic resilience, not military might, is now the ultimate guarantor of geopolitical clout.

Fueling uncertainty during this transitional phase in global leadership is the problem that none of the world's leading powers accepts its current trajectory or the burdens that come with it. In fact, for the first time since the end of World War II, no state or bloc of states has the power to drive an international agenda. Americans, accustomed to their country's superpower status, will not welcome a diminished status. Europeans, proud of their union's capacity for collective action to build peace and prosperity, will see their prestige decline as a multiyear bid to save the eurozone undermines confidence in the region's longer-term prospects. Japan remains mired in a period of extended political dysfunction. Major emerging states, particularly China, remain deeply reluctant to assume onerous international burdens at a potentially delicate moment in their countries' development. The result is a vacuum of leadership that will complicate efforts to restore confidence in global economic growth following the most significant market meltdown of the past seven decades.

The speed of this transition should not be exaggerated. It was underway for many years before the onset of financial crisis, and it will take many more years to fully develop. But its impact is already shaping the international business climate, relations among nations, and domestic policy choices in both the developed and developing worlds. The most important near-term implication of this power vacuum is that as states recover from the global slowdown with different tools and at different speeds, the divergence in their interests leads each government to safeguard its domestic political capital with policies that protect local jobs and industries at the expense of outsiders. Both China's unwillingness to allow substantial appreciation of its currency and a policy of quantitative easing in the United States aroused international anger in 2010. Some

¹ The views expressed here emerged from the Council meetings and interactions and do not necessarily reflect the views of the World Economic Forum or those of all the Council Members.

governments have already turned to various forms of capital controls; others will likely follow. New barriers to the free flow of ideas, information, people, money, goods and services will provoke threats of retaliation. Differences of opinion over the proper role of government in an economy will pit developed and developing states against one another as they compete for capital and resources. Multinational corporations face formidable commercial challenges from state-owned companies and privately owned national champions.

In addition, this rebalancing of international power and a growing vacuum of international leadership allows medium-sized powers such as Brazil, Turkey, and South Africa to play a larger role in international diplomacy and conflict resolution. Over time, the experience these governments gain in arbitrating political disputes will enhance global stability. But during this transitional phase and before officials in these countries gain that experience, their initiatives will sometimes undermine rather than enhance international cooperation—particularly as traditional powers resist their efforts.

Challenges

Global rebalancing, a lack of international leadership and aftershocks of the financial crisis create a number of important challenges. Assumptions about security cooperation, economic stability and crisis resolution must be revisited. The decades-long development of multilateral institutions in Europe makes conflict among EU members unthinkable, but other regions do not have this advantage. This is especially worrisome for Asia, given the region's relative importance for the global economy and the number of potential flashpoints there. The long-term erosion of Washington's ability to provide a regional security umbrella in Asia and the Middle East will force historic antagonists to build new standard operating procedures to manage conflict. In Africa, the absence of established conflict resolution mechanisms could allow unresolved border disputes to spark conflict.

Over the longer-term, the willingness of regional powers to mediate disputes will enhance global stability, but it will take time for other governments to accept new countries in these roles and for the powerbrokers themselves to gain experience in conflict resolution. The lack of international consensus will also make it easier for rogue states to sow division among leading powers. Those who believe that military power—and nuclear capabilities in particular—can enhance national prestige and provide the ultimate safeguard for national security will face less coordinated resistance. There will also be bigger holes in international sanctions regimes.

In the meantime, this shift in the balance of global power and lingering effects of recession will fuel the growth of reactionary forms of nationalism in both developed and developing countries. In developed states, particularly in Europe, nationalism flows from deepening anxiety over economic security and expectations of falling standards of living. We believe that threats to the eurozone itself have been exaggerated. But austerity measures, now in place in several European countries, will take time to restore governments to financial health. Over time, as restive publics in vulnerable peripheral countries realize that austerity is a long-term project, frustrations will be expressed in

ever-more-volatile anti-government protests and, in some cases, in an intensification of anti-EU and anti-immigrant sentiment. Management of these frustrations will sap the EU's institutional energy and diminish the European appetite for deeper involvement in the politics of other regions. In the United States, where the so-called real unemployment rate remains well above 16 percent, three consecutive elections have revealed a surge in anti-incumbent anger—providing lawmakers with new incentives to appeal to national pride with punitive legislation aimed at trading partners, particularly China. In developing states, nationalism flows from pride in national accomplishments and suspicions that developed states are conspiring to stunt their growth. The resentments that these perceptions sometimes arouse can, for example, increase Chinese public demand, often expressed via the Internet, for new limits on access of foreign companies to the Chinese marketplace.

In addition, rebalancing itself can provoke tensions. Beijing is well aware that the next stage of China's development will depend on a shift away from current levels of reliance for growth on exports—particularly to consumers in Europe, the United States and Japan—toward much higher levels of domestic consumption. This enormous transfer of wealth from the state and companies toward households is the work of a generation, not of a single five-year plan. But as it erodes confidence in Washington that mutually assured economic destruction aligns US and Chinese economic interests, it will feed mistrust between the two governments.

Chinese policies will provoke sharper criticism from other governments, as well. The Chinese leadership picked high-profile fights of various kinds with Japan, India, South Korea, ASEAN and Australia in 2010. These tensions create an uneasy balance within many governments between hopes for increasingly profitable trade relations with China and fears of Chinese regional dominance. To hedge their bets, many of these governments will work to enhance security ties with Washington in 2011, adding to regional tensions. The Chinese leadership may also find itself increasingly in conflict with emerging powers in other regions over its approach to trade and currency policy. In particular, there is a risk that high-profile gatherings, particularly the G20 summit meeting in Cannes later this year, could provide opportunities for India, Brazil and others to join US and European calls for a more flexible renminbi.

There is also the problem of state capture of energy. China, in particular, has used state-owned oil and gas companies to pay above-market prices to ensure long-term supplies of the energy and other commodities needed to fuel the next stage of the country's development. This practice creates frictions with commercial competitors and other governments by adding upward pressure on the price that all must pay for access to these resources.

More broadly, we are likely to see greater political and trade conflict between the United States and China, and Beijing may continue to be more aggressive in pursuing various commercial and security disputes with its neighbors. But the real threat that the Chinese leadership poses for democratic values and free market capitalism comes from the perceived success of its state capitalist model. As the United States, Europe, and Japan struggle to their feet following the Great Recession, China powers ahead with state-

backed spending and development, encouraging governments, particularly in the developing world, to believe that states can dominate local market activity to ensure strong and steady long-term growth. This is an appealing prospect for some governments in Africa and Latin America, but China's investment strategy extends even into the heart of Europe. In recent weeks, China has invested in key economic sectors in Greece and Italy; signed lucrative commercial agreements in Germany, France, and Britain; and pledged to buy sovereign debt in Spain and Portugal.

In response to China's apparent success, we are likely to see an increase in both the developed and developing worlds in (often subtle forms of) state intervention in market activity. One form particularly worthy of note in 2011 will be an increase in various forms of capital controls. Risk-tolerant investors will continue to look to emerging markets and developing economies for higher long-term growth rates. The continued inflow of enormous volumes of capital will add upward pressure on currencies in these countries, undermining local firms by making their exports more expensive and intensifying import competition. Policymakers in some of them will likely turn to direct market interventions to manage currency values and to protect local jobs and industries. If these market interventions do not stem the threat of currency appreciation, some of these governments will turn to more formal capital controls as a way to counter appreciation. The lack of international leadership will also make it much more difficult to establish a new global financial architecture, to formulate a coherent international response to climate change, or to better coordinate international responses to public health crises.

In addition, the importance of authoritarian states for the global economy will make it more difficult to build international support for protection of human rights, media freedoms, and other democratic values—though demand for these rights within authoritarian states may increase as rising standards of living fuel expectations for other forms of freedom.

Opportunities

The dramatic global power shift now underway will introduce a period of uncertainty and instability before a new equilibrium can take hold. This transition will require a more complex, more management-intensive global order, and established powers will have to downscale expectations – sometimes painfully – of the scope and reach of their influence. But this period of uncertainty and heightened competition also presents opportunities for a range of countries. The governments of medium-sized rising powers like Brazil, Indonesia and Turkey can redefine their roles on the regional and international stages. Iran, Myanmar, North Korea and other “rogue” states will face less coordinated pressure from an international community that cannot agree on how to interact with them. Resource-rich African countries have new choices of political and commercial partners as energy-thirsty states compete for contracts. Finally, we see opportunities as well as challenges for Washington in what is likely to be a period of relative decline.

First, Brazil, Turkey and Indonesia will increasingly offer leadership on the resolution of international conflicts through a combination of four key factors: their growing economic strength; an increased willingness among other states to cede leadership roles to governments that do not have the clout to dominate a region's political dynamics; an ability to avoid labels of east or west, one model of capitalism or the other; and diplomatic dynamism driven by the integration of national economic and political interests.

The second group of states for whom the fragmentation of power, capital and ideas presents an opportunity is that of the "rogues," those states identified with policies that undermine regional or international stability such as Iran, North Korea and Myanmar. A shift in the global balance of power provides these governments with opportunities to form political and commercial partnerships with more influential states, easing international pressure on them for changes that might undermine their domestic authority. These partnerships also offer them access to capital and technology that boosts their development. In the case of Myanmar, the shift will only accelerate a trend by which many of its Asian neighbors and others have prioritized strategic and economic ties over concerns with the regime's human rights record or suspected proliferation activity. In all three cases, a shift in the balance of power away from the United States and European Union toward developing states generally, some of which are not democracies, helps them avoid international isolation.

For resource-rich African countries looking to achieve a trio of strategic aims – to generate growth and prosperity, to retain political control, and to break the cycle of dependency often associated with traditional Western aid programs -- the new era is marked by the pursuit of new economic relationships with the outside world. In particular, Chinese investments across the resource and infrastructure spaces are allowing these African countries to explore a broader range of political and economic models of governance financed by commodities enjoying super-cycle prices. In addition, we believe that the new global balance represents a long-term opportunity for the United States to find a sustainable international leadership role that allows for the eventual sharing of more of the burdens that come with the provision of global public goods. Long burdened by the costs associated with its Cold War and global hegemon roles, the United States is now overstretched, under-resourced and deeply in debt. Americans may eventually look back on this period as the moment when its burdens – political, economic and military – were aligned with its reduced capabilities, allowing it to begin to re-engage the world from a position of renewed vigor. If so, the emerging vacuum of leadership may prove less problematic.

Finally, multinational companies and investors have opportunities, as well. Those who recognize the increased importance of governments in market activity in many countries, particularly in emerging markets where governments practice some form of state capitalism, will have first-mover advantage in many cases. Those who diversify their risk exposure are better placed to survive an inevitable period of volatility in global markets. And those who recognize that not all emerging markets are created equal—that they pose unique risks and opportunities—are best placed to profit.

Wildcards

We must also take into account a number of wildcard scenarios—the unlikely, though not implausible, events that generate shocks with a significant impact on global security and the stability of the global economy. Terrorism, including attacks that involve chemical, biological and even nuclear weapons, remains a constant threat. In addition, the risk of cyberattacks will grow in 2011. The centralization of data networks makes states much more vulnerable to potentially debilitating attacks, and new technologies help governments to project power in a world where direct military strikes are much more costly and dangerous. The almost-certainly state-sponsored Stuxnet attacks on Iran's industrial infrastructure offers a preview of what tomorrow's carefully targeted state-sponsored attack might look like. We can also expect an increase in these forms of attacks directed by state-owned companies against privately owned rivals, including Western multinationals. Finally, the international fight over Wikileaks in 2010 underscores the risk posed by individual hackers and info-anarchists. Following moves in several countries to prevent Wikileaks from further disclosure, hackers sympathetic to Julian Assange targeted governments and the corporations that support them.

The Korean Peninsula

But the most immediate concern is a potential crisis on the Korean peninsula. As Kim Jong-Il's health deteriorates, North Korea will face what may prove a challenging leadership transition. Two deadly North Korean attacks in 2010—the sinking of a South Korean naval vessel and the shelling of a South Korean island—suggest that the DPRK leadership either means to project strength in a time of potential domestic vulnerability or to enhance the standing of Kim's successor with the country's security elite. In either case, there is a risk that North Korea's military will provoke a conflict over which no one is fully in control as hawks in South Korea demand a tough response from their president to any North Korean escalation. Unless North Korea launches a deliberate attack on peninsular South Korea or on US forces in the region, resulting conflict can probably be contained. War serves no one's interests. But there is also the low likelihood, high-impact risk that the internal transfer of power will meet unexpected resistance within the North Korean leadership, creating a dangerous, fluid situation that draws the United States, China and South Korea into a regional security and humanitarian crisis—with long-term economic implications.

Iran's nuclear program

The risk of military conflict over Iran's nuclear program is limited for the next several months. UN, US, and European sanctions have been imposed on Iran, and Israel, the country most likely to strike Iran's nuclear sites, will likely give them time to work. But sanctions are unlikely to undermine the consensus within Iran in favor of the nuclear program, and technical progress in the uranium enrichment process will continue. Over time, tensions will increase again, and the Israeli government may face a choice between airstrikes and a nuclear Iran.

Pakistan

Pakistan's unsteady civilian government faces a perfect storm of emerging challenges. The country faces a constant risk of militant attacks. The ruling Pakistan People's Party, in seemingly constant conflict with the country's media and its supreme court, lacks the political leverage within parliament to restore Pakistan's economic vitality with much-needed fiscal reforms. Social and ethnic unrest has sparked protests and large-scale violence in Pakistan's largest cities. Pakistan's military appears to be increasingly active in the country's politics.

Europe's contagion crisis

We believe that the media, particularly the English-speaking media, underestimates the commitment of European governments to the Euro and exaggerates threats to the eurozone. Yet, there is a reasonable likelihood of substantial debt restructuring in several EU countries, and some EU governments will face risks of sovereign default. In addition, the bid to save the eurozone, and the nationalist tensions it will create between core and peripheral EU countries, will sap much of the continent's energy and limit its appetite for a larger role in international conflict resolution, adding to the vacuum of power in global governance.

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