

## Where we're headed

The global economy is estimated to grow at over 3% this year and next. Not robust, not a disaster. The geopolitics are more problematic; with more volatility today than at any time since the Cuban missile crisis. But even there, the crisis isn't global: the Middle East is riven with inter- and intra-state conflict in a context of state failure; and in the absence of strong leadership or coordinated policy responses, European stability is being severely undermined by the direct spillover of next-door tensions. That's not the case elsewhere, where the western hemisphere in particular, but also Eurasia and Asia, have been broadly insulated from such conflicts.

Climate change (specifically, extreme climate conditions; not yet global warming or rising seas) is starting to exacerbate instability in areas already stressed by poor economic growth and, in many cases, geopolitical tension: Nigeria, Syria, and Yemen in particular. Less stable areas of Sub-saharan Africa will be most sharply impacted in coming years: ecologically-vulnerable bits of north, east, and west Africa.

Meanwhile, technology drives economic growth but also leads to greater instability. It politically empowers disenfranchised individuals and groups while exacerbating the inequality they suffer. This is coupled with the world's biggest geopolitical trend: the rise of emerging markets, and China in particular. Resulting in the fact that the countries that are gaining the most economic and influence on the global stage also have the most brittle political institutions and the most vulnerable middle classes. They're accordingly in danger of becoming the most destabilized by technological change.

That's creating a **growing sense of un-sustainability**. An unprecedented amount of wealth being generated while political obstacles, a lack of leadership, and technological change create ever-greater economic imbalances. Public trust in leading institutions (government, media, and corporations) erodes, expanding social instability and populism. That present course (just like the g-zero, geopolitically) can't continue for long. We see three possible outcomes:

- 1) **condominium**. Under pressure, governments (and corporations) reshape the social contract to alleviate inequality despite market forces to the contrary. Globalization continues in its present form (though supply chains become much more local — that's an economic driver, not a political one).
- 2) **top-down**. Globalization slows/stops for a global underclass with states and corporations successfully creating real and virtual borders to separate unproductive/unhappy citizens from their brethren.
- 3) **bottom-up**. Globalization slows/stops for the wealthy, as social instability expands and cyberattacks/forced transparency and other asymmetric responses prevent captured institutions from effectively functioning.

The good news is that, like climate change over the past decade, this past year we've witnessed a sea change in decision-makers' approach to these challenges, especially in the private sector — coming to terms with the fact that the rapidity of technological change coupled with geopolitical instability is a near-term threat to the global economy (and, accordingly, to their business). The bad news is, unlike climate change, there's much less time available to prepare a response. And most governments have a long list of higher, short term priorities. At least for now.

We expect we'll be writing much more about this in coming months. As an aside, it's the reason we're launching a geo-technology practice. More on that soon...

## **Brazil**

Brazil has a new president, at least for now, with vice president Michel Temer taking over from Dilma Rousseff after she lost two successive impeachment votes in both houses of congress. Finally a better story for Brazil? Sort of.

First, the country's not done with the impeachment proceedings themselves. Next is a trial, which will take about 2-3 months to run. An extraordinary backdrop for the Olympic games (to say nothing of the fact that we're seeing more calls from epidemiology experts for Brazil to cancel the games because of the danger of exposing 1m visitors to a highly contagious Zika virus). We'll see protests, as Dilma and former president Lula maintain they've done nothing wrong and the impeachment is a political witch-hunt. The world will be focused on Brazil at the worst possible time; not much help for the government there.

The impeachment itself should go relatively smoothly. A 2/3rds vote in the senate is required to uphold the impeachment vote after the trial — and the numbers are there. So until presidential elections in 2018, Temer will now be in charge.

The ease of that vote speaks to the strength of the "anyone but Dilma" drumbeat that's been steadily growing over the course of the lava jato scandal. That will give Temer a significant majority in congress to begin his presidency. And accordingly a real window for a "honeymoon" of sorts on economic reform, especially given Brazil's deep recession, fiscal crisis, and mostly-absent legislative agenda as the investigations and arrests around the Rousseff government intensified in recent months.

How much that translates into decisive policy enactment is another matter. Legislators want help from the government to secure reelection — especially in an environment in which they won't be able to raise significant funds from major government linked-companies that are now under maximum scrutiny. But the fiscal reforms required in Brazil are politically unpopular: Brazil's taxation levels are already comparatively high; that means Temer's real option is constitutional reform to cut pensions, and reduce earmarked spending in healthcare and education. But all of that's exactly the sort of middle class concerns that led to the massive Brazil demonstrations of a couple of years ago.

So Temer's economic success is likely to be limited. Expect more progress on microeconomic reforms to attract private investment in areas like oil and gas, telecom, logistics infrastructure; as well as state owned enterprise governance. That will be seen as a positive by the foreign investment community and should prove a boost to public-private partnerships in infrastructure. But broader structural reforms will be the subject of compromise, in an attempt to keep costs for the population down in the short term. Meanwhile, the lava jato case is hardly over... and will create a distraction for legislators caught up in it already, as well as for new cabinet members, many of whom could still face indictment.

And the window for these reforms is relatively short: the next presidential elections are up in 2018. While Temer has said he won't be a candidate, the nearing political season will bring routine campaign concerns back to the fore for Brazilian legislators. In short, Temer won't be able to fully deliver on the reforms Brazil needs. But he will at least make some progress on fiscal reforms that matter, and quicker progress on reforms that can attract more private investments. All in all a bridge government to lay the groundwork for

a deeper round of reforms for the next government. For the first time in a couple of years in Brazil... it could be worse.

## **Saudi Arabia**

We recently had some interesting meetings with a few Saudi CEOs and a high-ranking member of the royal family. The sense of urgency to change the direction of policymaking in the kingdom is clear. The public mandate is diversification away from oil; privately it's about the strengthening the economy overall, gaining the upper hand in a regional geopolitical confrontation with Iran, and ensuring the succession of deputy crown prince Mohammed bin Salman to the throne. The first alone would be challenging. All three together is a tall order indeed.

One key point where these factors align is in pushing for greater market share in the oil market. We heard in each of our meetings that the Saudis intend to increase production in the coming months — some claim dramatically (another million barrels this summer, even more before long). With the intention of 1) squeezing the Iranians as they bring more oil to the market; 2) hoping for the highest possible return for their Aramco IPO on the basis of proof of greater production capacity; and 3) showing decisive leadership from the deputy crown prince to facilitate a faster transition towards his rule. apparently that's also why the minister of oil was abruptly pushed out last week — he didn't agree on the strategy. Traditionally the oil ministry has backed away from that kind of production level because it could cause damage to the oil fields. In other words, urgency is also leading to a focus on the short term at the expense of economic sustainability.

Hard to know just how much of this to buy given the hyperbole around some of bin Salman's 2020/2030 vision statements (and the likelihood for pushback among other high ranking officials — consensus is still expected for key economic decisions in Riyadh). We'd expect at least some movement in this direction — a few hundred thousand barrels in coming months... while giving themselves the option for much more presuming a demand expansion next year (the high number of drilling rigs in Saudi Arabia certainly suggests they're getting ready for this). Not what you want to see out of the kingdom.

The challenge against Iran will mean an expanded effort to work with Asian economies; investing in refineries in growth markets across the region (something the Iranians can't do, given both their resource limitations and the remaining sanctions environment). We should also see a charm offensive in Beijing — it was particularly interesting to see the Saudi minister of state for foreign affairs last week offering his praise for China's "adherence to peaceful means" in the south china sea dispute. China itself is reluctant to take sides between Iran and Saudi Arabia. But the Saudis don't see much point in adhering to US policy preferences at this point.

Geopolitically, this will also mean an intensification of Saudi-supported sectarian conflict against Shia forces in the region. In Syria, Lebanon, and most directly Iraq (where the kingdom sees the present Iran-supported government as one of the most significant long term threats to its own stability). The noted exception is Yemen, where bin Salman had personally expanded a military conflict that has been both expensive and unsuccessful. There, Iranian support is more indirect than in other conflicts, and there's now a strong Saudi effort to bring some form of negotiated settlement.

## Russia, China

As globalization and technology play together to destabilize the legitimacy of entrenched institutions, among the most concerned are large authoritarian governments. and they're starting to react accordingly. In the past months, we've seen a significant escalation of anti-foreign NGO legislation from both china and Russia, which will dramatically expand state power against non-state actors (and their funding) which they see as potentially destabilizing.

One more interesting (and surely related) china point worth mentioning: the Chinese government now floating a proposal that would give it a 1% stake in – and a seat on the board of – for major internet companies like Baidu. President Xi Jinping is personally making all aspects of internet "sovereignty" a top priority for the Chinese government; he surely recognizes the immediacy of the growing security threat. If you think Facebook's algorithms are powerful and opaque, wait until you see what comes out of Beijing.

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Two separate moves away from austerity in, wait for it... **Germany. For the first time since the cold war, Germany has decided to expand its military** — with nearly 15,000 additional troops and 5,000 civilian posts. There's a growing concern about security across the continent and a recognition that Berlin needs to do more in the region. Russia, of course, is a part of the threat.

In parallel, it's also worth noting that Chancellor Angela Merkel is now promising to boost pensions for working class Germans in order to boost her support in the face of a growing threat from the populist “alternative for Germany” party. As in Europe's other major economies, there's no chance an extremist party can take over government in Germany, but such parties' expansion will lead to growing populism from establishment figures themselves.

And a final data point of interest... we hear from the White House that the **United States is moving towards lifting its arms embargo on Vietnam**, part of gearing up for what will be Obama's first visit to the country later this month. Both sides are interested in getting closer, as a reaction to China upping its military presence in the region (and also to bring the ranks together after the landslide victory of a wild-card Rodrigo Duterte in the Philippines). Vietnamese defense officials haven't talked about a big defense confab recently hosted by the government with all the principal us defense contractors in attendance. Apparently president Obama personally gave his support to the enterprise. China won't like it one bit. But we'll stay within the confines of guarded tit-for-tat unilateralism in the region; we don't see any sudden crisis emerging here.