KPMG

Top Risks 2021: The Bottom Line for Business

How Eurasia Group's predicted Top Risks for 2021 could affect your business - and what you can do about it.

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January 2021

KPMG International

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2021 will overwhelmingly be about economic responses to Covid-19's lingering symptoms and scar tissue (debt burdens and misaligned politics), even as vaccines roll out and the healthcare emergency fades. **As economic issues come to the fore, there is no global leadership on political models, trade standards, and international architecture to follow - Eurasia Group's Top Risks 2021.**

Top Risks 2021 is Eurasia Group's annual forecast of the political risks (with the most potential to impact the global business environment) that are likely to play out over the course of the year. It can be an overwhelming read at the best of times, let alone in a year in which Eurasia Group predict that "*the geopolitical recession—and the factors driving our G-Zero world*[1]*—will intensify.*"

Heightened geopolitical volatility tends to mean heighted uncertainty for business leaders, which in turn can lead to decision paralysis. To help get a handle on your potential exposure to Eurasia Group's predicted geopolitical developments, here are KPMG's **top three 'bottom lines' for business**:

#1 'G-E-T' with the program

Eurasia Group's Top Risks for this year are notably dominated by structural trends, rather than country and event-level risks. The list reflects the three biggest, longer-term shifts that will influence the business landscape over the next decade – and importantly, predicts that the impact of these will be felt in 2021. These are:

1. A changing **geopolitical** landscape, as suggested by *Risk #1 46* ('US leadership')* and *#4 US-China tensions*, as well as *#2 Long Covid;*

2. The prominence of **environmental, social and governance (ESG)** issues, with *Climate: net zero meets G-Zero* ('Climate competition') coming in at *#3* and related policies referenced throughout; and

3. The primacy of **technology** and physical capital, with challenges associated with the rise in AI, the Internet of Things and other emerging technologies showcased in *#5 Global data reckoning* ('Global data fragmentation') and *#6 Cyber tipping point.*

Eurasia Group's inclusion of all three trends is a reminder that all are interconnected and will be influenced by politics and policy – and as such, should not be considered in isolation.To help identify these network effects, we drew on KPMG professionals' and Eurasia Group's expertise to conduct a **Dynamic Risk Assessment (DRA)** of the Top 10 Risks.

On a traditional 2D map[2], the first four risks (unsurprisingly) rank the highest in terms of Eurasia Group's predicted impact and likelihood. But which risks did the 4D analysis[3] show as the most important to watch – or not - and why?

Despite coming in at ***#4, US-China tensions*** is the most pertinent risk. Although of slightly lower likelihood and impact in a 2D view, it exhibits three key features that dial up its importance in a 4D view:

— It is highly interconnected, forming part of all three near-term scenarios ('Risk Clusters') expected to be encountered.

— It is 'contagious'. It is the most vulnerable to the direct or indirect effect of other risks, and is second only to *#1 US leadership* in terms of its own influence across the network; these two issues remain the main determinant of global affairs.

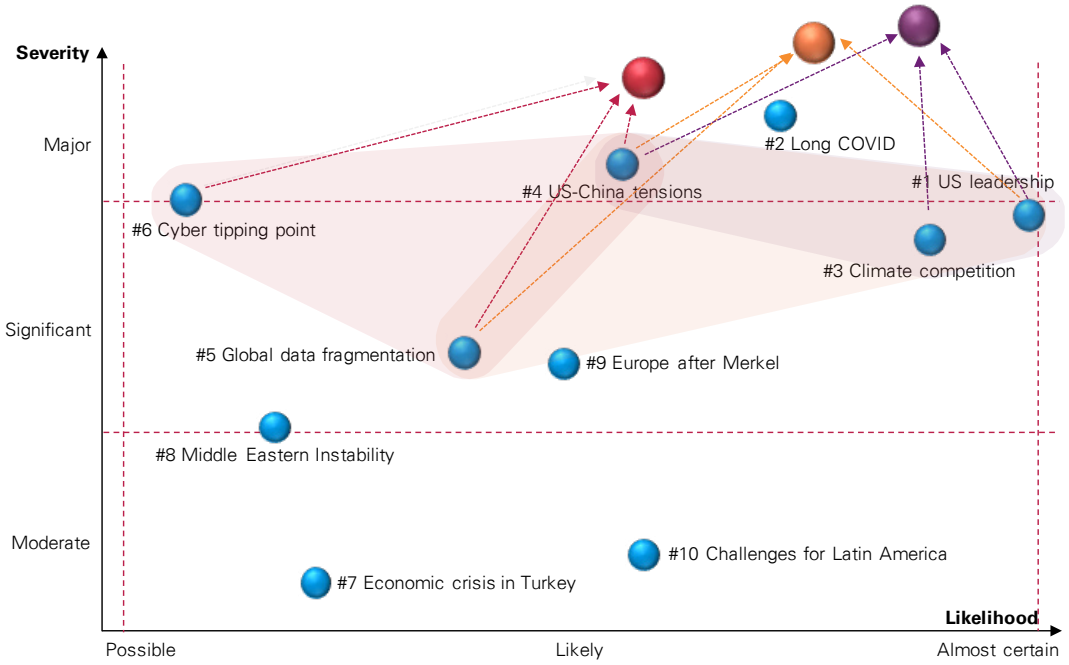
#1 US leadership, *#5 Global data fragmentation* and *#3 Climate competition* are similarly important due to their influence and connectivity within the network. Why does all that matter? The changing geopolitical landscape (*#4 US-China tensions*) could trigger, or be triggered in term by other structural trends like ESG (RC1) or technology (RC2 and RC3), leading to a domino effect of issues with a more severe collective impact.

Unsurprisingly, the analysis identified *#2 Long Covid* as the third-most influential risk in the network. Why not higher? Perhaps because we have found the appropriate mitigation (i.e. vaccination) to that risk and the end is (hopefully) in sight.

The DRA analysis suggests that *#8 Middle East: low oil takes a toll ('Middle Eastern instability')* and *#10 Latin America disappoints ('Challenges for Latin America')* are 'tendrils' (individually benign with limited connectivity and contagion effects). Barring applicable business interests, these are unlikely to be the main focal points for geopolitical risk management purposes.

[1] G-Zero refers to a geopolitical recession / depression, where there is no clear global leader.
[2] A 2D risk map assesses impact (Y-axis) and likelihood (X-axis).
[3] Four-dimensional analysis includes an assessment of contagion effects (interconnectivity) and velocity (time to impact).

Dynamic Risk Assessment



There are three potential scenarios (risk clusters, or RCs) in the short-term, all of which would have an impact more severe than any individual risk:

RC1: *#1 US leadership, #4 US-China tensions, #3 Climate competition.*

RC2: *#5 Global data fragmentation, #1 US leadership, #4US-China tensions.*

RC3: *#6 Cyber tipping point, #5 Global data fragmentation, #4 US-China tensions.*

What can you do?

Strategic risk management: get comfortable with being uncomfortable. If you take away one thing from this report, it should be that geopolitical risk is on the rise, not least due to interconnectivity – and in that sense, you can no longer try to avoid it. Current levels of political, social and economic volatility and uncertainty will continue in most of the markets that you care about in 2021, and even wholly domestic businesses risk getting caught up.

For effective decision-making and growth under these conditions, you need appropriate governance frameworks in place. How are macro non-financial risks dealt with as part of your ERM process?

At the very least, 'geopolitics' should no longer be a single line item on your risk register. (Sub-) Risk identification and prioritisation will provide a clearer view on causes, escalation factors, and consequences, as well as prevention, mitigation and recovery controls. The Top Risks list is a start, but the end product should include a broader and deeper view of macro, sector and country-specific risks, with impacts tailored to your business.

Given the criticality of *#4 US-China tensions and #1 US leadership,* a predictive socio-political understanding of the US will be essential for your growth strategy - regardless of your geographical footprint. By including these risks in your strategic risk management processes, others can be indirectly mitigated as a result and provide a point of competitive advantage.

Stress-testing and scenario planning: connecting the unconnected. If you are already au fait with DRA, use a panel of experts with the broadest perspectives to design possible extreme scenarios. How do these scenarios affect your business from financial, non-financial and strategic perspectives? Test and fine-tune policies and procedures - the process is more important than the outcome.

Given current levels of COVID-19-driven uncertainty, you can also build in-depth political and economic scenarios for key markets to identify impact on the network and your business; this will be particularly important for those with heavy exposure to 'COVID-19 canaries' (major economies with weak fundamentals that rely heavily on international capital identified in *#2 Long Covid)* or a polarized electoral calendar (*#8 Middle Eastern instability, #9 Europe after Merkel, #10 Challenges for Latin America).*

Update them quarterly or as needed, and use 'Red Teams' (i.e. individuals separate from the process) to constructively challenge input.

#2 Policy will be more predictable than public sentiment

Politics has appeared less predictable in recent years due to events and decisions that were no longer clearly linked to 'Western' economic logic – from Brexit to COVID-19 lockdowns. The 'process' of political decision-making has also been challenged, with fast-hitting changes announced over the likes of social media and little clarity provided over day-to-day implementation.

In good news, 2021 will arguably map a **more predictable domestic regulatory horizon in most markets**. Social economics will drive insular politics thanks to three underlying internal drivers shaping public policy: debt, populism and polarization. By understanding the social drivers, political motivations and constraints, regulation (or lack thereof) can be more accurately anticipated.

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> Given rising poverty, growing inequality, and high unemployment, weak incumbents will be unwilling to make politically costly decisions, such as cutting spending on social services; indeed, elections will incentivize politicians, especially those in the legislative branches, to push policies that further strain their countries' balance sheets.
> *- #10 Latin America disappoints*

In less welcoming news, these three trends pose a material risk themselves (as summed up in *#2 Long Covid*). They also have the potential to inflame public sentiment through a perceived lack of coordination by government across a range of key issues (*#2 Long Covid*, *#3 Climate competition*, *#5 Global data fragmentation*, and *#6 Cyber tipping point* to name a few). And when governments are considered inactive at best and ineffective at worst, there is a **greater chance of corporate 'liability' (i.e. reputational risk) from citizen activism**.

COVID-19 debt

Eurasia Group predicts that 2021 will *"expose the underlying vulnerabilities of many markets."* Whilst interest rates are low, the debt burden is affordable, but the inflection point from 'support the economy' to 'pay back the debt' could occur in some major markets this year. It can be expected that there will be little public or government appetite for increased costs of living or changes in consumption, making taxes on foreign companies (i.e. digital services taxes or carbon border adjustment mechanisms) particularly palatable – although coordination and agreement on these at the global level is another matter entirely.

Polarization

An underlying feature in many of the risks, from *#1 US leadership* (noting that the Democrats have since won effective control of a 50:50 Senate) to *#10 Latin America disappoints*. In generalised terms, turning politics to policy is harder in a more institutionally polarized environment (such as divided and minority governments). As Eurasia Group writes, this may make it harder to *"enable the compromises necessary to resolve fundamental problems,"* but sclerotic policy also tends to be more predictable. A good understanding of the limits of executive power (i.e. what is the realm of the possible) and the range of issues garnering bipartisan support (i.e. what is the realm of the likely) will help with the assessment of specific risks of potential regulation.

Populism

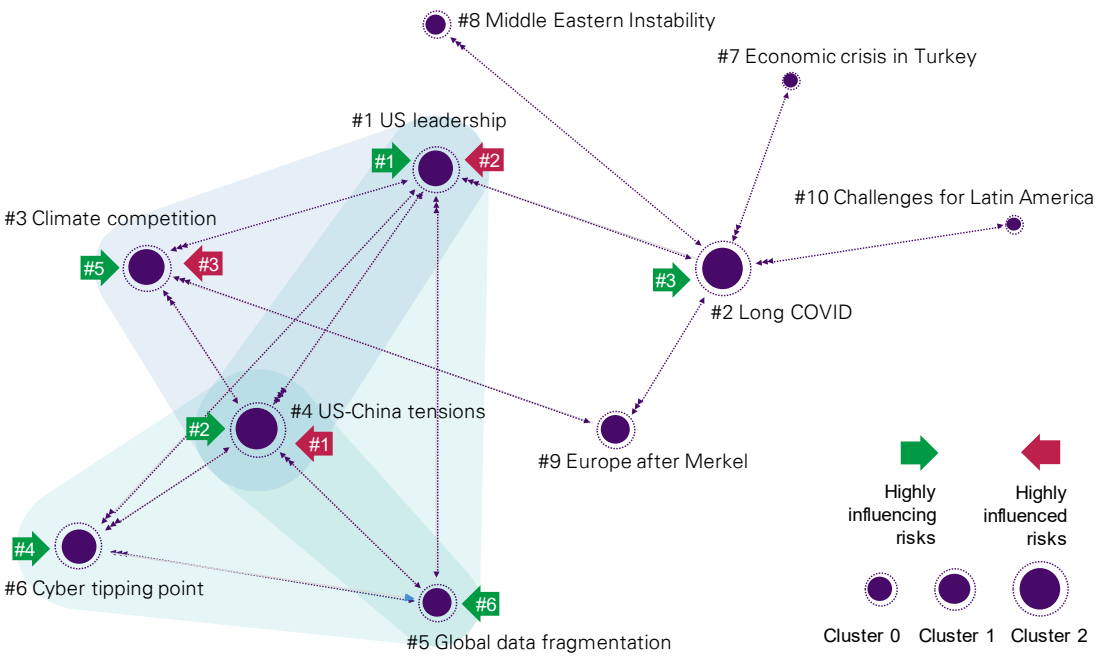
A public that already feels like that system is not meeting their needs is unlikely to be pacified by further inaction by a polarized government. Beware of thematic trends manifesting in event-level risks, like the elections referenced in *#8 Middle Eastern Instability*, *#9 Europe after Merkel* and *#10 Challenges in Latin America*.

But it can also directly lead to business and reputational risk;. What will be the next issue to gain public and company airtime, because of the (perceived) lack of effective governance?

Instability and anti-incumbent anger will grow around the world, leading to more protests and new opportunities for populist candidates. - *#2 Long Covid*

Businesses risk big losses if they focus only on net zero and not on G-Zero. - *#3 Climate competition*

Connections and Impact



There are three intervention points that, if sensibly managed, should have the highest pay-offs for the global outlook: *#1 US leadership*; *#2 Long COVID*; and *#6 Cyber tipping point*.

Yet despite their relevance, some of these risks are not governed by established or sufficiently influential governance bodies (for example, *#6 Cyber tipping point* or *#5 Global data fragmentation*).

What can you do?

Monitoring: create a radar with real-time and predictive insights. Better inform risk-taking by harnessing the power of big data and machine learning to monitor public sentiment, political shifts and policy updates. You want to be able to anticipate the direction of travel and speed of change of the identified (sub-)risks to your business, as well as identify trends that may not otherwise be visible to management.

Social license to operate: 'compliance' becomes central to strategy. Although it may not come in the form of government fines, non-compliance with the ethical expectations of society can be just as costly. Brand perceptions will change very quickly and, thanks to increased levels of inequality and divergences in public sentiment, in unexpected ways.

For example, 'ESG-friendly' businesses may be highly valued by talent and consumers in developed economies, but there may be backlash where an ESG-driven change is seen to come at a cost to the lower socioeconomic consumer under current economic conditions. Or, when more companies set net zero targets without a clear idea of how to achieve them, the 'mere' purchase of carbon offsets may no longer be seen as sufficient to meet public and investor expectations of 'genuine' circular economy and decarbonization solutions (for example, switching to (clean) electricity to generate heat, using hydrogen power, and the capture and storage or utilization of carbon emissions).

Ensure your strategy, risk and compliance processes incorporate these changing values - not just to survive, but to create a social compact that resonates with consumer bases and investors to drive growth.

#3 Competition creates winners (and losers)

This is not the year that we discover the panacea to globalization. As outlined in a number of risks (*#2 Long Covid; #3 Climate competition; #4 US-China tensions; #5 Global data fragmentation; #6 Cyber tipping point* as a start), despite overtures of multilateral discussions and some liberalization in bilateral relations, the global stage will be dominated by competition, not cooperation, across three key areas: **climate change, technology, and related trade and investment.**

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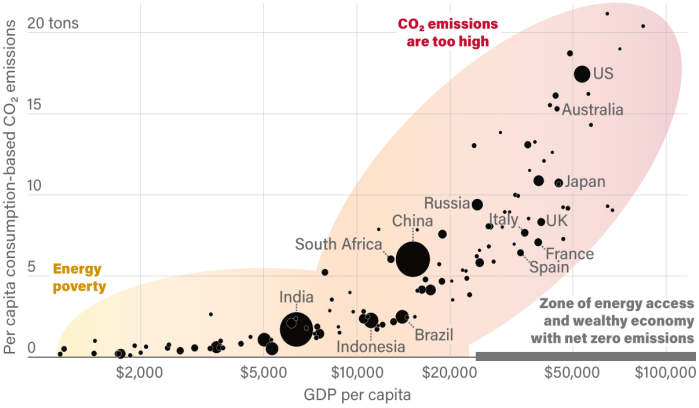
> The US will make climate and the energy transition a matter of industrial and national security policy. - *#3 Climate competition*

Eurasia Group Top Risk *#3 Climate competition*

For people and politics, net zero presents challenging trade-offs

Consumption-based carbon dioxide (CO_2) emissions per capita vs GDP per capita, 2017



Source: Our World in Data, Max Roser

As outlined in more detail in our latest report Geopolitical Face-Offs, we can continue to expect new and revamped policies and actions that look to achieve national 'sovereignty' in critical subsectors within and related to these fields by supporting by supporting domestic industry, protecting against foreign interference, and even targeting foreign companies.

Now, protectionism is not all bad for all companies. Nearly a quarter of the world's largest firms are state-controlled, and state aid for critical sectors and 'Made in X' companies is not new. To capitalise on this geopolitically-fuelled opportunity, you first need to understand your exposure to, or reliance on, these 'strategic' subsectors. This is also essential to minimise fall-out. Increased state intervention could impact any number of factors (see below) that materially change the attractiveness and operational reality of a given market.

One of the realities of a G-Zero world is that global economic power and decision-making is moving towards the likes of India and China - these are not markets that can simply be ignored, even if barriers could go up. Seeking growth in this environment means you will need to get comfortable with operating under different political and economic models, which pose a different set of risks.


Market access


FDI / M&A policy


Tax policy & scrutiny


Industrial policy, protectionism & tariffs


Data & privacy protections


Sanctions


IP protection


Immigration & labour policies


Export controls

What can you do?

M&A / technology / data strategies: price it in. The politics of climate change, technology and other 'strategic sectors' will matter even more to your financial (investments and capital), business (markets and growth strategy) and operating (technology, data and supply chain) models in 2021.

An understanding of geopolitics is critical for core financial assumptions for markets and entities alike; for example, politics impacts the likelihood and valuation of debt fragility (*#7 (Out in the) cold Turkey*), physical and transition risks posed by climate change (*#3 Climate competition*), and the availability and flow of sensitive data (*#5 Global data fragmentation*).

Yet it is surprising how often geopolitical risk is reduced to a simple qualitative comment on the side of a valuation or financial model, or technology / data / location strategy, despite having fundamental implications for business models and operations. For example, supply chains will likely continue to face disruption as competition leads to proactive, tech-focused industrial policy; the trend is already evident in semiconductors, with an industry leader planning to open a new manufacturing facility in the US by 2025 and a new packaging plant in Japan (*#4 US-China tensions*). Business leaders may also need to make tough decisions on whether to move domiciles, establish new ones, or take other necessary steps to protect the flows of data that they need to run a global business (*#5 Global data fragmentation*).

At the very least, make sure you can answer three questions: how will political uncertainty impact core financial assumptions? What political risks might jeopardize ability to realise future revenue and income? And what underlying political assumptions are necessary for your business plan's success?.

(Geopolitical) Due diligence: know your audience. Not exactly new advice, but for companies venturing beyond their comfort zone, any market entry (or exit) strategy will require an on-the-ground understanding of the political, economic, regulatory, environmental, societal, and security environment.

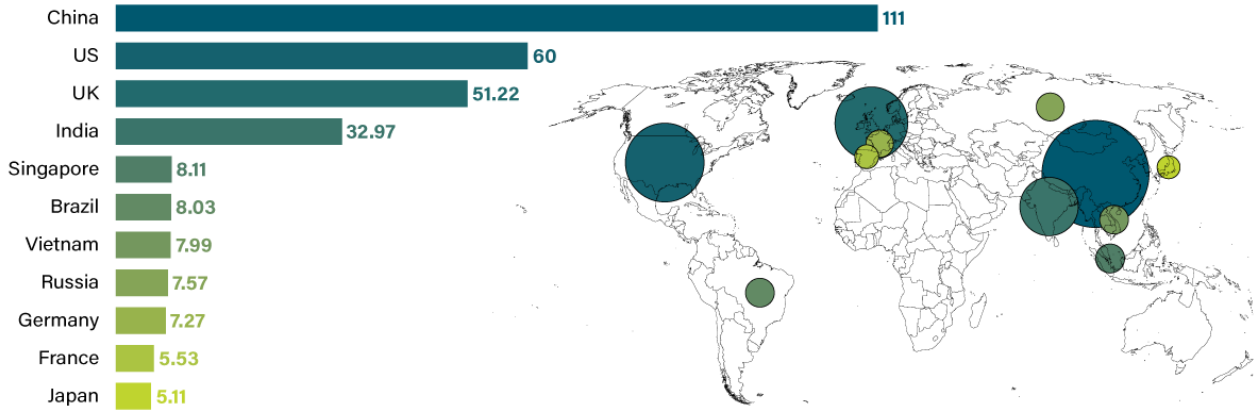
For example, a media company picking its next market for expansion or monitoring its current footprint should consider the following (non-exhaustive) geopolitical factors alongside traditional strategic and operational risks:

- **Political landscape:** Economic Protectionism; Technology Competition; Data Protectionism; Regime Change; Cyber Warfare; Climate Change.
- **Regulatory trends:** FDI / M&A Restrictions; Export Controls; Industry Incentives; IP Protection; Censorship / Content Moderation.
- **Social dynamics:** Ethnic / Religious / Sectarian Division; Social Media Perception.

Eurasia Group Top Risk *#5 Global data fragmentation*

Countries with the most cross-border data

million Mbps, 2019



Source: Nikkei Inc.

If that's 2021, check out our latest report Geopolitical Face-Offs for a view on how these trends play out in the longer-term: how the acceleration of societal polarization will make us question the way we think about productivity, economics, and what we mean by a 'company'.

About the KPMG and Eurasia Group Alliance

KPMG International has formed an alliance with Eurasia Group, one of the world's leading global political risk research and consulting firms, to develop solutions that help businesses deal with geopolitical challenges. Through our alliance, KPMG professionals can bring the political insights of Eurasia Group's analysts across 100+ countries and territories together with KPMG firms nuts and bolts understanding of your business covering from the macro to the most granular of analysis. KPMG professionals can help business:

Anticipate what is coming by drawing on non-traditional data with the aim of pinpointing 'around the corner'trends.

Plan for the longer-term through in-depth politicaland economic scenarios to help with investment frameworks, financial models and strategic planning.

Decide where to go by advising on the prioritization of your next big market via a high-level assessment of overall potential and fitness for investment based on your strategic priorities.

Decide how to get there through market entry strategy, including issues like localization, partnerships and local stakeholder management.

Understand the big picture so that regulatory, locational, reputational, political and financial risks are included not only at the operational level, but can also be integrated into the strategic decision you make.

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