WORLD ECONOMIC FORUM

COMMITTED TO IMPROVING THE STATE OF THE WORLD

White Paper

The Age of Economic Coercion: How Geo-politics is Disrupting Supply Chains, Financial Systems, Energy Markets, Trade and the Internet

Global Agenda Council on Geo-economics

January 2016

The World Economic Forum's Network of Global Agenda Councils is the foremost interdisciplinary knowledge network dedicated to promoting innovative thinking on critical global issues, regions and industries, and incubating projects, campaigns and events for the public good. The Network convenes the most relevant and knowledgeable thought leaders from academia, government, business and civil society to challenge conventional thinking, develop new insights and create innovative solutions for key global challenges. In a global environment marked by short-term orientation and siloed thinking, the Network fosters interdisciplinary and long-range thinking on the prevailing challenges on the global agenda.

The Global Agenda Council on Geo-economics was convened from 2014-2016 to advise the World Economic Forum on how economic security is leveraged to project power in the 21st century. The Council aims to enhance a shared understanding of major global transformations, to improve management of risks for governments and business, and to address the economic motivations and instruments increasingly being used for cross-border political and strategic purposes.

This white paper is the result of the Council's collaboration and discussions with experts throughout the GAC Network in 2015. The Council is grateful to *Ulrike Franke, Research Assistant, ECFR, Isabel de Sola, Council Manager at the World Economic Forum, for their contributions to this white paper.*
Global Agenda Council on Geo-economics 2014-2016

Chair, Mark Leonard, Director, European Council on Foreign Relations (ECFR)
Vice-Chair Dmitri Trenin, Director, Carnegie Moscow Center
Sanjaya Baru, Director, Geo-Economics and Strategy, International Institute for Strategic Studies (IISS)
Karan Bhatia, Vice-President, Global Government Affairs and Policy, General Electric Company
Ian Bremmer, President, Eurasia Group
Michael Fullilove, Executive Director, Lowy Institute for International Policy
Nik Gowing, International Broadcaster, King's College London
Sergei Guriev, Visiting Professor of Economics, Fondation Nationale des Sciences Politiques (Sciences Po)
Victor Halberstadt, Professor of Economics, Leiden University
Parag Khanna, Senior Research Fellow, Lee Kuan Yew School, National University of Singapore
Hina Rabbani Khar, Minister of Foreign Affairs of Pakistan (2011-2013)
Felipe Larraín Bascuñán, Professor and Director, Latin American Center for Economic and Social Policy, Pontificia Universidad Catolica de Chile
Paul A. Laudicina, Partner and Chairman Emeritus, A.T. Kearney
Michael Levi, David M. Rubenstein Senior Fellow, Energy and Environment, and Director, Maurice R. Greenberg Center, Geoeconomic Studies, Council on Foreign Relations
Kishore Mahbubani, Dean, Lee Kuan Yew School of Public Policy, National University of Singapore
Takashi Mitachi, Senior Partner and Managing Director; Co-Chairman, Japan, Boston Consulting Group
Linah K. Mohohlo, Governor and Chairman of the Board of the Bank of Botswana
Moisés Naím, Distinguished Fellow, Carnegie Endowment for International Peace
Douglas A. Rediker, Visiting Fellow, Peterson Institute for International Economics
Ghassan Salamé, Dean, The Paris School of International Affairs (PSIA), Institut d'Etudes Politiques
Yulia Tseplyaeva, Director, Center for Macroeconomics Research, Sberbank
Pan Wei, Professor, Center for Chinese and Global Affairs, School of International Studies, Peking University
Wu Xinbo, Executive Dean, Institute of International Studies, Fudan University

Forum Lead: Anja Kaspersen, Senior Director, Geopolitics and International Security

Contents

Introduction: The Connectivity wars
Mark Leonard

A Global survey of economic coercion
Mark Leonard and Ulrike Franke

Trade
Gideon Rose

Financial systems
Douglas Rediker

Supply chains
Parag Khanna and Takashi Mitachi

Energy markets
Michael Levi

ICT
Ian Bremmer

Public empowerment
Nik Gowing

Introduction: The connectivity wars

Mark Leonard, Director, European Council on Foreign Relations (ECFR), United Kingdom

"Once upon a time, two superpowers, the United States and the Soviet Union, held summits to reduce the danger of a nuclear war. Today the summitry is between the US and China, a large part of which is to reduce the dangers of confrontation and conflict in cyberspace."
– Carl Bildt, Prime Minister of Sweden (1991-1994) and Minister of Foreign Affairs of Sweden (2006-2014)

Twenty-five years ago, leaders worried about nuclear Armageddon and mutually assured destruction; today's most common threat is of mutually assured disruption, the disruption of the elements of the global economic system.

If the Cold War organized summits between the superpowers to prevent nuclear Armageddon, today's biggest conflicts between great powers are about the infrastructure of the global economy. The fact that the most contentious topic between President Obama and Xi Jinping – when they met for the first time as heads of state – was about cyber is emblematic of a world in which the great powers are bound together into a single economy and economic might is an interdependent affair. This is also a world where conventional war still risks going nuclear, such that countries are ever mindful of resorting to military means.

As a result, the world's most powerful nations are turning the global economic system into their primary battleground. The internet is just one of the front lines. All of the infrastructure of globalization risks being weaponized: the financial sector, supply chains, the energy sector and the global trading regime. Welcome to the "connectivity wars".

The crisis of interdependence

Economic competition between countries is nothing new. What has changed is the explosion of connections across borders that makes all nations vulnerable to this kind of competition. During the Cold War, the global economy mirrored the global order – only limited links existed across the Iron Curtain, even after China and India started modernizing their economies.

After the collapse of the Soviet Union, a divided world gave way to one of interconnection and interdependence. States largely united in pursuing the benefits of globalization through trade, investment and communications. But, contrary to what many hoped and some believed, this burgeoning of connections between countries has not buried the tensions between them.

With the global financial crisis of 2008, it became increasingly clear that there were winners and losers in the global order – and the prospect of a major shift in power both frightened the established powers and emboldened the rising ones. Power struggles and competition have returned to the fore, and they are increasingly taking on new forms.

The word "geo-economics" was first coined by Edward Luttwak, who claimed in 1990 that, although the competition between great powers had taken on an economic form, its purpose had remained political: "The world is not governed by the logic of commerce but rather the logic of conflict, which is adversarial and zero sum."

Like in a bad marriage, states today are not happy living together but cannot imagine living without each other. They are also wary of the costs of their competition spilling over into all-out war. So they manipulate the very things that bind them together to gain advantage and leverage over each other. And, as countries and companies become more aware of the downsides of interdependence, they begin to explore ways of hedging against it. These attempts to become less vulnerable – by governments and companies alike – may have the effect of further fragmenting the global system.

Although sanctions can take centre stage in conflicts between states alongside military measures – just look at the trade wars between Russia and the West over Ukraine – much of the time, geo-economics is about competition for relative power rather than a placebo for war. In fact, the dividing lines between economic and geopolitical competition are not always clear.

Six battlegrounds

This essay collection sheds some light on these new dynamics. It begins by looking at the different players and their strategies for adapting to this geo-economic reality. First, a survey shows how emerging economies as well as Western powers are turning to geo-economic competition. The next chapters explore six of the most prominent pillars of the global system that will be transformed by this competition.

International trade, and the multilateral regimes that underpin it, has become the most important site for geo-economic competition. It was global trade that allowed the emergence of globalization, with the World Trade Organization mandated to prevent discrimination and provide a level playing field for companies. Today, the goal of universal, simple, multilateral free trade has given way to the reality of multiple overlapping, complex and competitive trade arrangements that are explicitly designed to favour certain countries.

The year 2015 can be seen as the point when the new trade thinking was publicly unveiled: “The US, not China, should write the rules of the global economy,” President Obama declared as he signed the Trans-Pacific Partnership (TTP) with 11 Pacific nations. TTP is only one of several new friendship groups in which like-minded nations are gathering – increasingly with the objective of shielding themselves from the rest of the world.

The United States is also using the global financial system to pursue political aims. Financial sanctions against countries like Russia and Iran and the multimillion dollar fines that US courts have levied against banks that violate US sanctions regimes have changed the behaviour of executives around the world. Even with the rise of emerging powers, the financial market is an area in which the United States still enjoys a relative hegemony. But, with the proliferation of sanctions and the threat to exclude countries from the SWIFT clearance system, many countries are trying to hedge against the dominance of the dollar, as can be seen in developments such as the China International Payment System to Bitcoin.

As technology transforms the nature of the global economy, it too is becoming a central area of competition. Recently, the internet, rather than producing the hoped for “flat world”, seems on a trajectory of fragmentation. Geopolitics and security concerns, aggravated by NSA surveillance scandals, are driving internet fragmentation and calls for “cyber sovereignty”. The US risks losing its hegemonic position in the IT domain as China and other countries make this a strategic priority.

Interestingly, it is the hegemonic play of oil producers on the energy market that has blunted their geo-economic power. In the face of slowing demand, plus attempts to hedge against over-dependence on any one source, and the revolution in unconventional energy, it is now consumer nations that are increasingly able to weaponize energy against the undiversified economies of producer nations. Despite this trend, important oil producing nations in the Middle East seem to have prioritized the preservation of their market share, even in the face of falling oil prices and at hundreds of billions of dollars in cost.

For companies, the most alarming question is how geo-economics will affect global supply chains. Once the poster child of globalization after the Cold War, supply chains are now a favoured battleground for geo-economic disruption. Already threatened economically by disruptive technologies such as 3D printing, they are coming under increasing pressure from geopolitics as well.

The one development that cuts across all elements of the global system is the emergence of a new political environment. The architecture of globalization was built by elites. This political and economic world order is fraying as governments come under more pressure from a more nationalistic public that craves independence and uses technology to put the established parties under ever greater pressure.

The geopolitics of disruption

While conventional military competition looks set to continue, and although few countries will want to shut themselves off from globalization, geo-economic competition will become more prevalent and influential in the global economy and global politics.

A global survey of economic coercion

Mark Leonard, Director, ECFR, Ulrike Esther Franke*, Research Assistance, ECFR

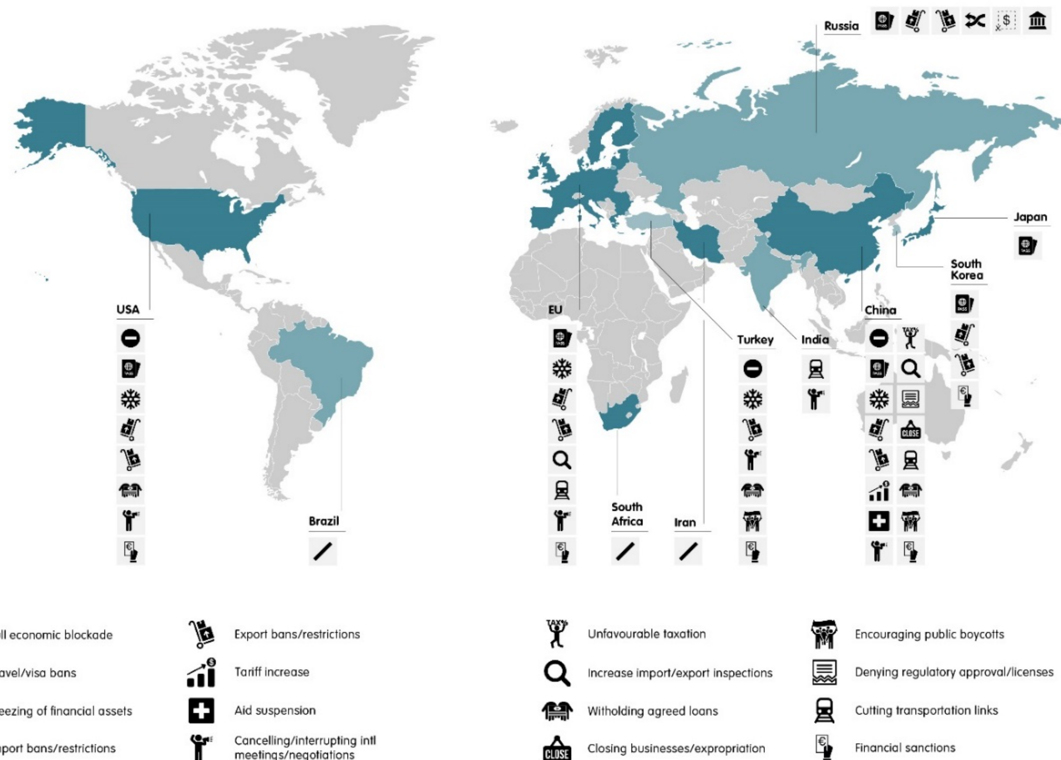
The interconnected, global economic system is at risk of being pulled apart by its key constituents and beneficiaries: It seems paradoxical: all of the players have a common interest in maintaining the system that has generated important benefits for them. But their individual interests of using the system to their advantage, while being as independent from it, as possible trumps the common interest.

States have grown increasingly aware of the webs of interdependence that underpin globalization. Everyone is connected with everyone: trade, finance, supply chains, all span the globe and connect seemingly disparate populations. These links are the reason for the system's success – but they also provide actors with powers over each other, that can be exploited. Economic and financial sanctions are the most obvious of how countries use interdependences and asymmetries to their advantage, but not the only one.

Building on the work of researchers from all over the world, this overview highlights that the use of economic coercion is a global phenomenon. In addition to the usual suspects the US and the EU - we examined how Brazil, China, India, Iran, Japan, Russia, South Africa, South Korea, and Turkey make use of and respond to economic coercion. Some of these countries are emerging powers, some more established players, almost all are members of the G20. Of this group, the majority has , used unilateral sanctions[1] and economic coercive measures over the last two decades. The measures employed range from increased custom controls, economic blockades, and aid suspension to travel bans and the cancellation of international meetings.

MAP 1

[1] All of the eight countries other than Iran support UN sanctions, even though some have voiced criticism against them.



Note on map.[2]

Around the world with economic sanctions

The spotlight has been on economic coercion by Western powers over the past year, creating the impression that economic and financial sanctions are a predominantly Western tool. The press is full of talk about the sanctions against Iran and Russia, and sanctions generally appear to be Western countries' favoured instrument against their opponents. War-weary liberal democracies prefer to rely on their economic might than to fall back on their shrinking military power: the EU had only six sanction regimes in force in 1991, but by 2014 this number had grown to more than 25. In the US, the Treasury's "guerrillas in gray suits"[3] have developed increasingly sophisticated financial sanctions since 9/11.

[2] While every effort has been made to make this overview as accurate as possible, one should note that quantifying economic coercion is not an exact science as what may be counted as an instance of coercion by one may not be by another.

[3] Juan Zarate, Treasury's War, p.xi.

But other countries aren't far behind – even though many of them prefer not to call their actions 'sanctions' and often proceed subtly, increasing import controls rather than officially banning trade, or using health and safety concerns instead of openly forbidding foreign businesses.

Map 1 shows that when a country decides to use economic coercion, it employs a range of actions

The Range of Economic Coercive Measures

- Full economic blockade/ embargo
- Travel/visa bans
- Freezing of financial assets
- Financial sanctions
- Import bans/reductions
- Export bans/reductions (includes Arms embargo)
- Tariff increase/ tariff discrimination
- Unfavourable taxation
- Increase import/ export inspections
- Witholding of previously agreed loans, orders, projects
- Cancelling/interruption of international negotiations/meetings
- Closing of businesses/Expropration
- Encouraging public boycotts
- Denying regulatory approval/ licenses
- Cutting transportation links
- Aid suspension

rather than relying on just one measure. Unsurprisingly, countries play to their strengths – Russia uses its gas exports to put pressure on its neighbours, Turkey leverages its geographic position by cutting Armenia off from trade with the West, and China restricts access to its large consumer market and imposes export sanctions on rare earth minerals. Some states have found particularly creative measures: in 2014, Russia imposed a ban on US adoptions of Russia children, and India more than once banned its cricket team from playing against (and in) Pakistan.

Map 1 does not, however, show that many countries avoid use of economic coercion against certain enemy. Rather, they employ it for particular issues or against a favourite opponent. India's sanctions are almost exclusively directed against Pakistan. China mainly targets states that disagree with its Tibet, Taiwan, or maritime policies, and Turkey employs economic coercion predominantly to punish those who recognise the Armenian mass killings as genocide. Only the EU, the US and Russia have a more global outlook.

But not all emerging countries agree with these policies – or so they say. Brazil, South Africa, and Iran point out that they have made a policy decision not to rely on economic coercion. For Iran and South Africa, this is likely to be motivated by their experiences of being at the receiving end of sanction regimes and thus having first-hand experiences of the at times devastating consequences – Iran has been under international sanctions ever since the fall of the Shah in 1979, while South Africa faced sanctions during the Apartheid regime. Others, such as Brazil - influenced in addition by the experiences in Cuba - question the effectiveness of economic coercion,: "In Brazil we oppose any policy based on sanctions, [...] sanctions, as a rule, end up punishing the population rather than the government", President Dilma Rousseff stated. However, even the countries that officially say they

are not using economic coercion are still playing the game of geo-economic power politics. They may not be the best-positioned to use sanctions but they nevertheless are geo-economic players, using other tools such as strategic alliances.

Hedging

While the exploitation of the system's interdependencies is already problematic, in addition – and in reaction to those exploits – countries are hedging their own vulnerabilities. But by trying to become more self-sufficient and independent, they are decoupling themselves from the global economic system.

The reasons for hedging vary. Many emerging countries have been cautious about their full integration into the global economic system. They have used capital controls and similar measures to keep some control over their economies. Particularly when the US uses its control of the global financial system to enforce sanctions on third parties - as was the case with BNP Paribas and other banks – and when people threaten to exclude Russia from the SWIFT system, this creates fear in other capitals.

Countries that are fearful of becoming targets of Western economic coercion are hedging not only against interdependence as such but specifically against dependence on the West. China, Russia, and Turkey for instance have actively pursued a policy of de-dollarisation or de-euroisation, avoiding the use of dollar and euro, and trying to trade predominantly in their own currencies. China and Russia are also building alternatives to Western-led institutions, such as the Asian Infrastructure Development Bank (AIIB) that is rivalling the Bretton Woods institutions; the Union Pay system, an alternative to Visa or Mastercard; or the BRICS's alternative to the SWIFT international payments system.

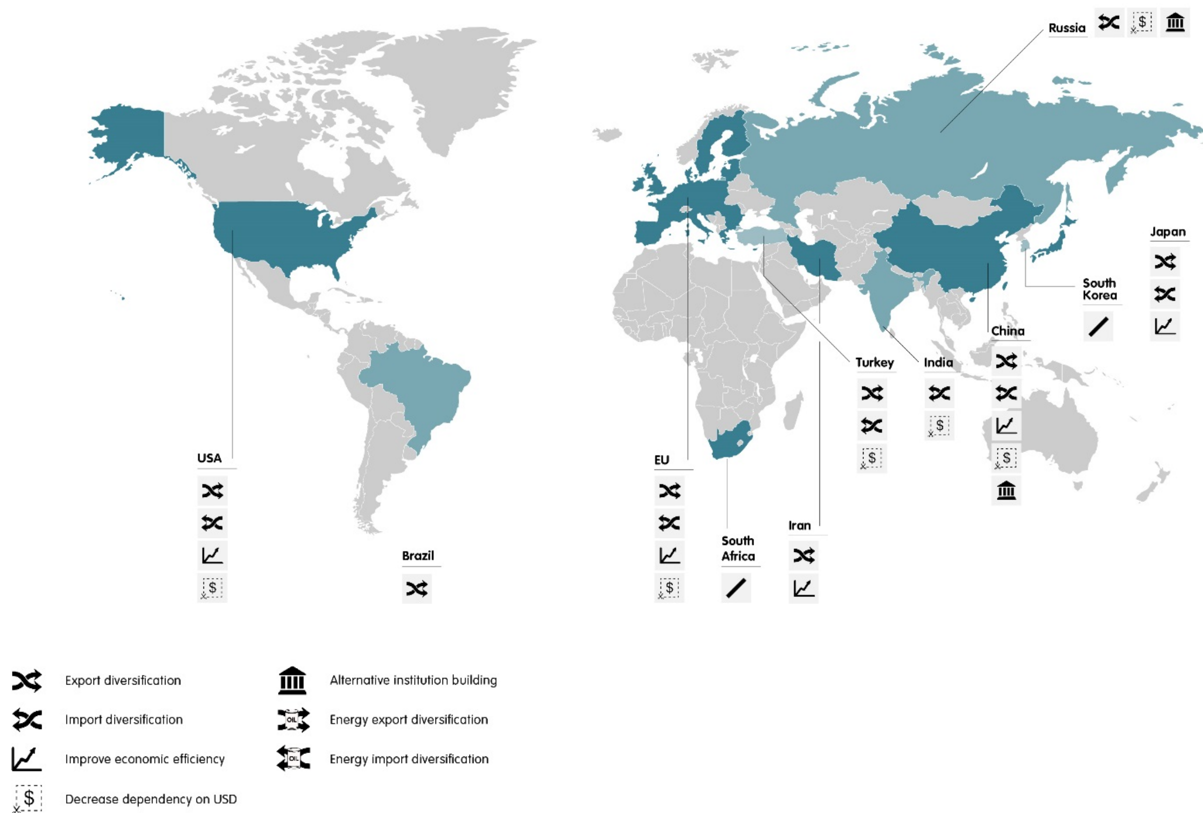
Others states are mainly reacting to the global financial crisis which has heightened fears of close global economic integration. Rattled by the crisis' economic ripple effects, most countries are diversifying their markets and trying to strengthen their national economies in order to limit their economies' vulnerabilities. While this does not necessarily mean an end of globalization, it will mean the building of regional clusters rather than a single market.

Multiple strategies to decrease dependencies and to strengthen a country's positions are being employed. States look for alternative sources of import and new export markets, and group together with like-minded countries in new multilateral institutions that carve out niches of gated globalization. While these strategies appear sound from a national perspective, they may ultimately prove to be more dangerous to the international system than the use of economic coercion ever could be. They

Types of Hedging

- Export diversification
- Export diversification (Energy)
- Import diversification
- Import diversification (Energy)
- Economy diversification / improve economic efficiency
- De-dollarization/ De-euroiszation (i.e. decrease dependency on Dollar & Euro/ avoid Dollar & Euro use)
- Institution Building

undo, step by step, the linkages that allow the global system to function.



Conclusion

The world is entering a new, complex phase of globalisation, which may eventually lead to its demise. Many countries feel duped. They signed up to an international system that was supposed to be governed solely by economic concerns. But now there is a growing realisation that the system can and is being instrumentalised for geopolitical ends. This instrumentalisation is a global phenomenon, even though the Western use of sanctions and economic coercion gets the most attention.

All members of the global economic system need to be aware that taking advantage of the system weakens its foundations. The more economic coercion is employed, the more countries will hedge against it, undoing step by step the links on which the system is based.

We would like to thank the following researchers on whose work this overview is based: Deborah BL Farias (Brazil), Ondrej Wager (China), Stephanie Lee (China), Rishika Chauhan (India), Ali Ghezelbash (Iran), Jamal Ibrahim Haidar (Iran), Kazuto Suzuki (Japan), Dawid Jarosz (Russia), Altay Atli (Turkey), Gustav Venter (South Africa), Yunhee Choi (S South Korea).

Geo-economics, trade and the liberal order

Gideon Rose, Editor, Foreign Affairs, USA

Economics is about maximizing value from transactions involving goods and services. It has its own logic and rules, its own resources and mechanisms, its own contests over relative and absolute gains. Geo-economics introduces another factor – national interests. It is about countries using economic actions to further not simply the maximization of economic value, but also their political and strategic position vis-à-vis other countries.

In the realm of trade, the differences between economic and geo-economic logic would seem fairly clear. An economic approach to trade would seek to maximize the economic returns to the countries in question, giving scant consideration to factors outside the economic realm. A geo-economic approach, in contrast, might seek to achieve economic returns, but would also seek political returns – selecting trading partners and arranging the terms of trading agreements to favour certain constituencies, strengthen allies, weaken adversaries and so forth, even if the introduction of those other factors required deviations from the logic of maximization of total absolute gains.

A powerful state, for example, might shape trading arrangements with weaker states in its orbit so as to exploit the latter for its own gain – or it might shape those arrangements to benefit the weaker powers, so as to strengthen a partner in need or buy loyalty. Or a group of powers might choose to band together in an exclusive trading bloc, benefitting themselves at the expense of other countries deliberately left outside the bloc, even if pure economic logic would dictate the others' inclusion.

Distinguishing between economic and geo-economic logic when it comes to trade is not quite so simple, however, for two reasons. The first is that creating certain kinds of ostensibly open, equitable, apolitical arrangements – the kind that look like they are following purely economic logic – can be a very good strategy for achieving major economic gains for a powerful state. Hence the old adage that "free trade is the imperialism of the strong". Second, geo-economic logic can operate on an indirect as well as a direct level, which is arguably what is happening today with the liberal international order.

Reflecting on the nightmares of the interwar period, when unregulated markets and uncoordinated behaviour led to economic disaster and the rise of aggressive dictatorships, Western policy-makers in the 1940s set out to construct a global system that would prevent such problems from recurring. At the core of the order they constructed are democracies with mixed economies, peacefully cooperating and trading with one another while nestling closely under an American security umbrella.

That core is embedded in a variety of overlapping institutional structures, from the Bretton Woods institutions and the United Nations, to NATO and the European Union, to an endless array of cooperative bilateral, regional and functional groupings. Because the order does not discriminate on grounds of geography, race, religion, or other ascriptive characteristics, any country that wants to join and is prepared to play by the rules is allowed in, making it a potentially universal alliance that is constantly expanding. And because the order has so many aspects and points of entry, countries not ready to sign up for the whole package at once can ease into it over time, starting on the margins and progressing toward the core at their own pace.

This order has been the framework within which a great deal of economic, social and political development has proceeded around the globe, to the lasting benefit of both the United States and the world at large. Its basic outlines were sketched before the post-war break with the Soviet Union, so instead of saying that the Cold War caused or defined the order, it is more accurate to say that the Soviet Union's unwillingness to take part in the order caused the Cold War.

What the superpower confrontation did was ensure that the order was implemented on a partial, rather than universal, basis at first and with substantial internal cohesion thanks to the external threat. It was because the Cold War and the Soviet Union were never the central parts of the story that their passing changed the world less than many expected, merely paving the way for the order's extension into territory that was previously off-limits, which is what has happened over the past two and half decades.

The genius of the order's architects was to recognize that international relations could be a team sport rather than an individual one. The dense network of partnerships they created rested not on charity,

altruism, or self-abnegation but on what Tocqueville called “self-interest rightly understood”. They realized that isolation and autarky led to weakness rather than strength, poverty rather than riches, and vulnerability rather than security. And so they started to coordinate their actions, pool their resources, and forgo the quest for short-term relative gains vis-à-vis one another.

Trade agreements providing for ever greater economic liberalization among ever greater numbers of players have been central to the order’s development – ideally multilateral agreements, but when those were not possible, then at least bilateral or plurilateral ones. Whatever their other differences, US administrations of both parties have passed the baton ever onward in this regard, recognizing that their mission was to reap the benefits of their predecessors’ negotiating efforts while laying the groundwork for new pacts to be concluded by their successors.

This is what is taking place today, with the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). The Obama administration has spent a great deal of effort and political capital both to negotiate these pacts and to get the domestic political authorization to do so effectively. The TPP will be first up, and it is a major trade deal that would not only deepen the liberal order in general, but also bolster and lock in strong relationships with the countries involved, which include many of America’s crucial allies.

From one angle, the TPP looks like it is driven by economics: it would help liberalize economic interactions across a broad swath of the globe; create a stable, neutral set of rules that constrain actors equally; and remain open to participation by other countries over time, whenever they are prepared to meet the criteria for entry. From another angle, however, it looks like it is driven by geo-economics: the pact pointedly does not include China, and is being sold in many quarters with rhetoric suggesting that its chief benefit is to bolster an anti-China containing coalition.

So which is it? In truth, both logics are at work, and different actors may be more persuaded by one than the other. This has in fact been true of the liberal order from the beginning. As Charles Maier wrote about US international economic policies in the late 1940s, it was hard to disentangle idealism and self-interest in their development “because the same policies could serve both aspirations. Washington’s neo-Cobdenite mission did aim at higher world levels of exchange and welfare. Simultaneously, it was intended to benefit American producers who could compete vigorously in any market where the open door and the free convertibility of currencies into dollars facilitated equal access.”

Then as now, the United States acted as a liberal hegemon. Playing such a role necessarily meant playing both for oneself and for the team at large. For as the order’s leading theorist, John Ikenberry, has argued, such a role means that instead of seeing cooperation as an alternative to US leadership, American strategists have come to see “alliances, partnerships, multilateralism, [and] democracy … [were] the tools of US leadership.” In such a context, identifying blatant, short-term geo-economics might be easy, but identifying subtle, long-term geo-economics might be difficult, because it can be disguised as, or even identical to, simple economics.

Economic coercion: Financial sanctions

Douglas Rediker, Visiting Fellow, Peterson Institute for International Economics, USA

The response of the United States and the European Union to Russian actions in Ukraine has allowed these governments to refine the use of financial sanctions as an increasingly available and effective tool to punish and deter violations of fundamental international agreements that underpin the current global world order. Recent experience with Russian sanctions resulted in a virtual roadmap for how to impose economic and financial sanctions consistent with legal regimes in the United States and the EU, as well as through international institutions.

For the US in particular, sitting as it does at the centre of the world's financial system and existing world order, the increasing sophistication and use of such sanctions represents a stark counterpoint to the narrative of broad American decline. In fact, it can be argued that increasingly complex global financial interlinkages and the sophistication with which sanctions can be imposed, represents a significant, and largely unchallenged, addition to the US superpower tool box.

As with military force, financial sanctions represent a tool of hard power that has been used with restraint. Such sanctions have largely been limited to only egregious instances of breaches of international law, in conjunction with wide coalitions and with painstaking respect for the legality of their use. Given hard power alternatives, financial sanctions seek compliance with the existing world order in a manner far less destructive than would be the case were traditional hard power military tools be used instead.

US centrality in the global financial system effectively makes the US the world's only financial superpower. The US stands alone in its ability to use overwhelming force by imposing restrictions on US dollar transactions, US financial institutions, access to the Federal Reserve system and the SWIFT[4] network. But taking such steps would be the financial equivalent of a "nuclear strike" and remains a theoretical, not practical option for the US, especially on a unilateral basis. Short of such theoretical extremes, in practice, cross-border cooperation and incrementalism have been the norm.

In the case of Russia, the US approach was to closely align with Europe to create a multi-step plan to incrementally ratchet up economic and political sanctions, including financial sanctions, in response to specific actions and behaviour. Coordination between the US and EU was seen as crucial, so as to demonstrate a politically unified front, limit opportunity for sanctions evasion and to avoid "backfilling", in which countries profit from other countries' sanctions restrictions.

Sanctions were imposed reluctantly. At first, they were imposed on travel and asset purchases, and only later increased to include financing and investment. Targeted sanctions evolved over time to become sectoral, but remained still short of financial sanctions. It was the downing of MH17 that caused a shift in US-EU sanctions strategy, with greater willingness in both Europe and in the US to support a sharp escalation of financial sanctions as a result.

Even then, US and European officials went to great lengths to limit the scope of sanctions, precisely crafting language to ensure they were targeted to specific individuals, institutions and in response to specific actions. But, while intended to be "scalpel-like", the threat of running afoul of US sanctions legislation and the potentially significant costs for doing so proved to have a more far-reaching impact than was likely anticipated, affecting investment behaviour far beyond specifically sanctioned targets.

Following high profile and financially punitive penalties imposed on several international banks for acting improperly under other instances of US sanctions legislation (best evidenced by the almost $10 billion fine assessed to BNP Paribas in 2014 for multiple breaches of sanctions related legislation), many financial institutions calculated the potential costs of future escalation and erred on the side of caution. Even limited and highly targeted financial sanctions heightened potential risks, and thus chilled a wide range of investments and discouraged the holding or purchasing of Russian financial assets regardless of whether they were actually subject to sanctions.

[4] Society for Worldwide Interbank Financial Telecommunication

While not explicitly threatened, even limited incremental financial sanctions were perceived as increasing the risk of broader US financial system and/or SWIFT-based financial sanctions being imposed in the future; a level of risk most financial actors were not willing to take.

In practice then, even narrowly targeted sanctions resulted in broad risk aversion to Russian financial exposure, causing downward pressure on the currency, credit and deterring counter-party transactions. The Russian experience demonstrated the power of rhetorical "forward guidance" of potential future sanctions escalation. Combined with an uncertainty risk premium, the power of even the initial limited phase of incremental financial sanctions, was demonstrated to have a significant chilling effect on financial actors' willingness to engage in a targeted country.

Assessing the "success" of financial sanctions is both imprecise and subjective, given that they can be seen as seeking both punishment and deterrence. Academic studies have proved inconclusive about their effectiveness in accomplishing strategic foreign policy goals. This makes sense, given that assessing success requires both specific objectives and the ability to correlate the imposition of sanctions with resulting actions and behaviour. Often, foreign policy goals are themselves unclear, politically and rhetorically vague and may vary from country to country.

To date, in spite of efforts to create alternatives to the US dollar and US financial system primacy, there has yet to be created a viable alternative. Along with allies in Europe, there is no effective challenge to US ability to use financial tools to punish, deter and coerce in ways not available to other countries. The willingness of the US to use the centrality of the its financial (and related legal) system as a tool to advance the "liberal rules-based world order", has thus preserved, and could even enhance, US (hard) power dominance.

Russia, Iran and North Korea, have all been catalysts/targets for financial sanctions over the past decade. But US financial and legal reach to address transgressions extends well beyond pure sanctions. For example, alleged financial misdeeds of FIFA were uncovered, exposed and legitimized by the US authorities. Though not financial sanctions *per se*, the primacy of the US financial system and its legal reach brought to heel an institution and individuals in a manner unavailable to any other country. The US alone maintains the willingness and ability to track, expose and impede financial activities to accomplish both broad and/or narrow policy goals.

Still, like other forms of power, the US is limited by its reluctance to overuse/abuse its power and by the limitations of financial power to those countries and actors who participate in the established world order. The current military and security escalation emanating from risks in North Africa portends greater collective focus on actors against whom financial sanctions have limited immediate impact. Non-state actors operating outside the international world order will increasingly find themselves dealing with traditional hard power military response, rather than financial sanctions.

For those countries seeking to participate in global trade and financial systems, the threat of financial sanctions remains a risk that needs to be considered. To mitigate the risk that financial sanctions, in particular those imposed by the United States, could have negative repercussions on them, there are likely to be increasing efforts to create alternatives, "hedges" so to speak against US dominance. The most obvious efforts to do so are initiatives by countries to create alternative financial and payment systems outside the scope of US-EU influence. For example, China Union Pay is seen by some as an alternative to more widely accepted international credit cards like Visa or MasterCard.

Other efforts include the creation of alternatives to the current financial institutions network SWIFT, established by the US and headquartered in Brussels. The threat to impose financial sanctions via the SWIFT network is one of the most effective financial sanctions tools. SWIFT is, at its core, a financial communications network, with payments processed internationally via individual banks with correspondent banking relationships, trusting the SWIFT network to relay payment instructions securely. The ability to replicate SWIFT thus requires not simply the technology, but also the involvement of a critical mass of global financial institutions to make the network effective for the purposes of global banking transactions.

Given the expected continued centrality of, not only the US dollar, but US financial institutions themselves, establishing a parallel network outside the potential reach of US financial sanctions may be technologically possible, but its utility would be limited. Informal money transfer systems, like

Hawala, for example, can provide a means by which transfers can continue largely outside US and international scrutiny, but are not likely to represent a globally attractive alternative to the existing financial system.

One potential risk to the power of the US and Europe to use financial sanctions as a strategic tool is posed by electronic digital currencies, like Bitcoin, where traditional banking relationships and institutions are bypassed. While still relatively early in their technological adoption, these digital currencies operate without the same risk of being subject to financial sanction from the US or any other institution or authority.

As this disruptive technology develops, it poses a potential risk to the status quo in banking, commerce and geo-economic power. Existing adoption, however, is far from a current threat to undermine financial sanctions power. Digital currency usage remains low and to truly undermine utility of financial sanctions, economies would need to have evolved to the point where sanctions would not serve to hinder commerce, investment or trade. Worth noting, but not currently a realistic risk.

As with other forms of hard power, including military power, the US continues to dominate the global financial landscape. The US unwillingness to use financial force is akin to that of its reluctance to use military might. Financial tools are best kept as an unused deterrent and, when used, they are best implemented alongside coalitions of the willing, in particular with allies in Europe. Recent experience of financial sanctions in Russia may not yet be declared a success or failure, but the experience of the US and EU working out the details makes them more likely to be a credible deterrent to outright threats to the rules-based world order upon which US and EU strength is based.

Supply chains as a coercive landscape

Parag Khanna, Managing Partner, Hybrid Reality, Singapore; and Takashi Mitachi, Senior Partner and Managing Director, Co-Chairman, Japan, Boston Consulting Group, Japan

Background

Supply chains have emerged as a crucial battleground for geo-economic competition between states. There are many reasons for the underlying trend towards greater supply chain dispersal – trade and investment liberalization, wage arbitrage, improved infrastructure, expansion of special economic zones (SEZs) and other factors have all contributed to a geographic expansion of supply chains. At the same time, financial and digital connectivity have broadened the scope of supply chains beyond manufacturing into services sectors as well, a trend visible in the growing locations of industries such as BPO (call centres, business analysis, etc.), medical data entry, radiological analysis, legal document searching, and so forth.

As this process unfolds, government and local companies are increasingly colluding to maintain advantages on their home turf while using foreign investment to rise up the value chain. Supply chain coercion is thus not about whether to attract investment, but how to induce and shape it in more beneficial ways.

Outlined below are numerous categories and examples of competitive and coercive activity within the realm of global supply chains:

Location/localization

It is well documented how China has since the 1980s gradually increased requirements for outsourced manufacturing to include more substantial local value-added. This practice has now spread to many other emerging markets.

Recently, Indonesia forced several mining companies to commit to building aluminium smelters in Indonesia, effectively extorting them to sponsor Indonesia's rise up the value chain. (It has also threatened to cancel contracts of companies seeking to include investor-state dispute resolution clauses in investment agreements.) Countries that already have substantial fixed asset investments and are attractive long-term markets such as Brazil and Indonesia are better able to withstand the backlash against such practices.

Another example is India's policies towards the pharmaceutical and defence industries. India now requires drug-makers to conduct their clinical trials in India in order to have preferential market access. In defence, its procurement policy favours countries offering joint ventures in production. All such efforts are embodied in the broader "Make in India" campaign.

Coming back to China, the drive to leverage foreign investment to develop more complex goods continues into the pharmaceutical and automotive sectors. Foreign biotechnology companies are increasingly pressured to share research and conduct clinical trials within the Chinese market, for example, a European car manufacturer was recently compelled to begin automotive engine development in China, a move it had long resisted.

Taxes and trade processes

Legal and regulatory frictions are another means by which supply chains are manipulated for local benefit. This comes in several forms. In terms of attraction, tax incentives are used to attract foreign investment into a given country's special economic zones (SEZs), a practice common in Latin America and Southeast Asia. On the flipside, companies increasingly find themselves subject to onerous tax related investigations and pay-outs as laws shift. Such political risk has afflicted major foreign banks and telecoms operating in India, and energy companies operating in the former Soviet republics of Central Asia.

Materials and chokepoints

China's sudden ban on the export of rare earth minerals to Japan in 2011-2012 served as a major awakening to global markets in general and the electronics industry in particular, on the potential for geopolitical risks to bring about supply shocks in critical materials. Even though China's move spurred a wave of investment in developing more diversified rare earth supplies across the US and Canada,

and though the WTO also ruled against China's policy, China's powerful role in the rare earth minerals market has allowed it to manipulate prices and undercut rivals.

As new technology sectors expand such as renewable energy, minerals, including lithium, are likely to become increasingly sensitive to potential hoarding by state-backed firms or brokers. In the long term, however, the growing diversity of mineral supplies brought about through new discoveries and technological innovation – as well as the growing breadth of supply chains to transfer resources worldwide, despite hoarding attempts – will likely diminish the ability of any one power to control any particular resource supply.

Winners and losers will be distinguished by the degree of diversity of access to mineral supplies. This is certainly true in energy markets, where OPEC has lost its price-setting monopoly due to abundance of new oil and gas discoveries, new supply chain routings, and rapid improvements in renewable and alternative energy technologies and capacity.

IP coercion
Technology transfer requirements are an increasingly active arena of supply chain coercion. With little progress in the TRIPS negotiations and the TPP agreement yet to be implemented, there remains no strong global enforcement for IP standards. In the meantime, Chinese-style practices of requiring more local R&D activity are gathering steam across a range of sectors such as advanced manufacturing and bio-technology.

Strategies and workarounds
With soft barriers to entry and financial protectionism on the rise, many companies have opted to work around the perception of being "foreign" actors by "going local" through joint ventures with local firms. Alliances with national champions reduce the likelihood of government interference, while enhancing positioning in the local market.

Winners and losers
In the long term, the desire to converge towards the highest standard of technology or governance tends to force an adaptation in some areas even as countries seek to control a greater share of supply chains in others. India, for example, is rapidly liberalizing foreign investment in more than one dozen sectors to attract capital and technology, thus creating more opportunities for foreign firms to profit from India's fast-growing market. On the other hand, it has stepped up demands for multinationals to locate more production within its borders as part of its "Make in India" campaign.

Conclusion
The expansion of supply chains into every corner of the world – both in the production and distribution of goods and the reach of financial and digital services – is the embodiment of the flourishing of globalization. At the same time, examining supply chains reveals the increasingly intense competition within globalization to capture the greatest share of value-added and profits.

Though they represent a new chapter in the bumpy playing field of geo-economic competition, unlike trade disputes and rivalries, supply chain disputes will not necessarily end the integrated global trade and financial system – although they will make companies and countries more cautious and aware of the risks of disruption. With the advance of the TPP trade agenda and other inter-regional trade agreements, the continued push for fair competition could be a crucial element in ensuring that the playing field becomes more level over time. Ultimately, free and fair trade is a surest path to minimizing geo-economic coercion through supply chains.

Economic Coercion and the Energy Markets

Michael Levi, David M. Rubenstein Senior Fellow, Energy and Environment; Director, Maurice R. Greenberg Center for Geo-economic Studies, Council on Foreign Relations, USA

Since 1973, when Middle Eastern oil-producing countries cut crude sales to coerce Israel's allies into backing down amid the Yom Kippur war crisis, consuming countries have worried about the oil weapon. The oil weapon, though, is far weaker than most once feared. Policy-makers and businesses should instead focus on a host of other ways in which energy markets can be used for coercive purposes.

The oil weapon is weak because it is usually impossible to target. If one country stops selling oil to another, the buyer can typically turn to international markets to replace the lost supplies. Prices will rise for everyone, not just for the intended target, and the pain of adjusting to the shortfall will be spread across the full global market, diluting its impact. (The exception to this rule is when one country sells another subsidized oil; then, if the seller threatens to charge market prices, the buyer has nowhere to turn. Russia has exercised leverage over former Soviet states this way; Venezuela has similarly enjoyed influence in Latin America and the Caribbean.) The oil weapon's impotence is why it typically is not used.

Oil producers' leverage instead comes from their ability to award investment opportunities to preferred companies. Russia, for example, can choose to reject acquisitions in its large and lucrative oil sector by companies that hail from countries with which it has geopolitical disputes. The United States, recently a destination of choice for oil and gas investment, was reportedly able to dissuade certain Chinese companies from investing in Iran as an informal condition for being able to invest in US shale resources.

For the most part, though, oil exporters are more vulnerable to economic coercion than oil importers are. Part of this is because oil is so important to them: dozens of exporters' depend more on oil markets than even the most oil hungry importers. In 2013, oil accounted for more than 10% of gross domestic product (GDP) in 26 countries; US oil imports, by contrast, were barely 2% of US GDP. Western countries also dominate energy finance and, in particular, technology. This allows them to collectively squeeze oil producers when that suits their geopolitical aims. Russia and Iran have faced coordinated US and European financial and technology sanctions in recent years.

Oil exporters can also be vulnerable to sanctions on their crude oil sales. This stems again from the asymmetry between their dependence on oil exports and consumers' reliance on oil imports. Case in point: between early 2011 and late 2013, sanctions on Iranian oil sales were able to slash Iran's oil exports to a quarter of their prior level, devastating the Iranian economy but only modestly disrupting the global oil market. These sanctions' success was also a result of a reasonably unified geopolitical front from the major oil importers, including China, which left Iran with no way to evade the sanctions. But this also points to limits on sanctioning oil sales: without near-universal cooperation among oil importing countries, most oil exporters will inevitably be able to find full-priced markets for their oil.

Recently, some analysts have claimed that the US oil boom has created new opportunities for this sort of economic coercion. They rightly point out that, absent the recent surge in US oil production, it would have been more difficult to impose oil export sanctions on Iran. But they extrapolate too far. The US boom created headroom to remove Iranian oil through sanctions because it came as a shock. High US oil output, though, no longer surprises. The window for easy US sanctions is unlikely to remain open long.

Natural gas exports offer considerably more coercive potential than oil exports do. That is because it is typically much more difficult to replace a sudden shortfall in natural gas with an alternative source – making a threat to cut off gas supplies potentially fearsome. There is no large and liquid global market for natural gas that parallels the market for oil. Switching from one natural gas supplier to another can takes years, requiring new pipelines and natural gas import facilities costing many of billions of dollars.

This all helps explain why Russia has used natural gas exports for leverage multiple times over the past decade. But, as with oil, consumers can punish gas exporters too: the same inflexibility that leaves importers unable to quickly switch suppliers leaves exporters similarly unable to rapidly shift to

new customers. This can deter use of the gas weapon. Russia, for example, might fear a European shift to alternative fuels, prompting Moscow to exercise restraint in wielding its gas supplies for coercive means.

What about emerging energy technologies? Analysts have raised alarms that, as the world increasingly uses electric cars and renewable energy, countries that control materials such as lithium (critical for batteries) and rare earth elements (essential in wind turbines) will find new sources of leverage. But there is reason for optimism. In particular, unlike with oil and gas, which are needed continuously to generate energy, a disruption to supplies of electric cars or wind turbines would have no immediate impact on consumers. It would, to be sure, hurt companies that produce those products, in turn raising pressure on governments. But the potential for geopolitical coercion appears smaller than with oil and gas.

Policy-makers and business leaders who are worried about the use of energy for coercion would do well to move beyond the leverage of the past – the oil weapon – and worry less about hypothetical sources of future influence. Actual opportunities to use energy-related flows for coercive purposes are plentiful enough.

Economic Coercion and IT companies

Ian Bremmer, President, Eurasia Group, USA

Once considered a globalizing force, information technology today faces some of the world's most punitive geopolitical barriers to entry. Estimates indicate the Snowden leaks could cost the US IT industry up to $180 billion in lost revenue.[5] Even as the fallout from this incident dissipates, the rise of the Internet of People & Things will keep governments concerned with protecting their national data, with a number of intents in mind:

Protecting privacy: Such was the justification behind the European Court of Justice's recent repudiation of the Safe Harbour Decision allowing American technology companies to transfer European citizens' data across the Atlantic.[6] While based on a fair concern, the decision will dramatically hurt prospects for an integrated transatlantic digital market and could harm Transatlantic Trade and Investment Partnership (TTIP) negotiations.

Protecting against foreign threats: China's cybersecurity laws fall mostly under this category. Fearing revelations such as the discovery that the NSA may have been bugging Cisco routers en route to end-users,[7] the Chinese government has grown concerned about overreliance on foreign IT providers.

Protecting against domestic "threats": It cannot have gone unnoticed in the Kremlin that the closest thing Vladimir Putin has to a challenger – a young nationalist named Alexei Navalny – started out as a widely-followed anti-corruption blogger. Iran's attempt at creating a "Halal Internet"[8] following its so-called Green Revolution also fits this pattern.

Supporting domestic economic players: A good example of this dynamic is the European Union's ongoing pursuit of a "Digital Single Market" aimed at removing intra-European digital borders in an attempt to spur a new generation of continental start-ups.[9]

A typology such as the above helps makes sense of an increasingly complex regulatory picture. And yet, a few important subtleties must be kept in mind when trying to put case studies into neatly-defined boxes.

First, local actors sometimes have an interest in blurring the picture by, for example, claiming to act in the name of one cause while furthering another. For instance, Russian lawmakers have presented their country's data localization rules as necessary to defend users' privacy from foreign intelligence services, but the measures will also – and primarily – enhance Kremlin surveillance. Doublespeak is the name of the game.

Conversely, it is important for external observers to remain cautious and objective before attributing ill intents to local decision-makers. For instance, many international observers have expressed concern that Nigeria's stance in fining telecommunications providers for failing to comply with sim-card registration rules may be a case of economic extortion.[10] Yet a close look at the country's challenge in battling technologically-savvy Boko Haram reveals that Nigeria's claim that its rules are justified by national security requisites actually holds some merit.

It is also worth remembering one of the key rules of political analysis: never underestimate the amateurishness of bureaucracies. The US government, for example, is vastly underprepared to coherently deal with the challenges emerging from the rise of the Internet of Things;[11] hence, consider the possibility that messy policy in that area may simply be the result of internal confusion.

Finally, like any threat environment, the nature of what drives economic coercion policies is ever-evolving, and one must stay aware of its vagaries. For instance, after years of focusing on ensuring

---

[5] http://blogs.wsj.com/cio/2013/08/16/nsas-prism-could-cost-it-service-market-180-billion/
[6] http://www.ft.com/intl/cms/s/2/7544e716-6b87-11e5-aca9-d87542bf8673.html#axzz3nivQwwpc
[7] https://www.schneier.com/blog/archives/2015/03/cisco_shipping_.html
[8] http://www.voanews.com/content/irans-next-step-in-building-a-halal-internet/2672948.html
[9] http://www.euractiv.com/sections/infosociety/eu-racing-catch-digital-single-market-plan-314390
[10] http://qz.com/552557/nigeria-says-its-record-5-2-billion-fine-for-mtn-is-about-rule-of-law/
[11] http://www.politico.com/agenda/story/2015/06/internet-of-things-caucus-legislation-regulation-000086

domestic surveillance, there are now early signals that Iran may be toying with controls on foreign market players as a means of preserving its promising but fragile technology industry[12] in a soon-to-be post-sanctions environment.[13]

Regardless of what drives IT nationalism, its result is unequivocal harm to the sector's global business environment. Lost business is the biggest threat: when a local regulation either prevents or complicates the purchase of foreign IT goods and services, it makes it that much less likely outside companies will have a fighting chance at winning new contracts or maintaining old ones.

Second come compliance costs: more stringent regulation means having to hire more lawyers to pore over arcane legislation, particularly as governments often provide little guidance to accompany their diktats. Then there are the costs of actually implementing these new rules: one study put the preliminary costs of Russia's data localization law near a whopping $6 billion.[14]

Of course there is also the fact that a deteriorating geopolitical environment harms upstream research and development (R&D). In a tense international climate, IT companies may be less inclined to hire foreign scientists and engineers. One American ICT company, for example, just a year ago decided to shut its engineering presence in Russia.[15]

Capricious domestic regulation also means fewer opportunities for economies of scale. The Kremlin wanting all smartphones sold in Russia to be able to run on its alternative to the US GPS – a system called GLONASS – is an example[16] of the ways in which companies' profit margins can be cut by having to adapt to national specifics.

A breakdown in international flows can also affect consumers' experiences by, for example, impeding the interoperability of the products they use. The Internet of Things will soon raise the profile of this issue if major IT players continue to compete,[17] rather than collaborate, in building their communication protocols for the ever-longer list of goods connected to the internet.

Indeed, as the IT industry becomes inseparable from the rest of the economy (think of the fact that some of AT&T's greatest growth comes not from new cell phone plans but from connected cars),[18] the economic coercion affecting IT companies will increasingly spill over to all industrial sectors. In an age in which cars are nothing more than "computers we ride in" (Doctorow),[19] no company will be exempt from the coercion aimed at the IT industry.

Is this all a US story, affecting only American IT companies while their European and other foreign competitors get off scot free? Yes and no. It is *primarily* a US story insofar as the Snowden revelations hit the US in ways that haven't affected other major IT producers. It is interesting, for example, that Europeans seeking to escape the perceived vulnerability of relying on American cloud services have opted to replace their US providers with none other than the Chinese company Huawei[20] – long-shunned in the United States for its alleged ties to China's security services.[21]

In IT, as in everything, money talks: foreign consumers may recognize that a Chinese company's security could be just as compromised as an American company's, but at least it is cheaper, goes their thinking. And so Chinese IT companies have been wildly successful in developing countries, not least across sub-Saharan Africa.[22]

But this will change. Having the US as a common enemy is convenient, but sooner or later foreign countries will realize that they can't trust each other either. Snooping is not just a US versus the rest-

---

[12] http://www.al-monitor.com/pulse/originals/2015/11/iran-filtering-policies.html
[13] http://www.ft.com/intl/cms/s/0/52304060-0dc5-11e5-9a65-00144feabdc0.html
[14] http://www.themoscowtimes.com/business/article/data-law-will-cost-russia-6-billion--report/523801.html
[15] http://www.themoscowtimes.com/business/article/google-pulling-engineers-out-of-russia-amid-tightening-control-report-says/513237.html
[16] http://gpsworld.com/glonass-to-be-required-for-phones-sold-in-russia/
[17] http://www.reuters.com/article/2015/05/20/us-huawei-iot-idUSKBN0O514M20150520
[18] https://www.washingtonpost.com/news/the-switch/wp/2015/07/23/atts-strongest-growth-isnt-coming-from-cellphone-service-its-in-cars/
[19] http://boingboing.net/2011/12/27/the-coming-war-on-general-purp.html cited in Marc Goodman, *Future Crimes*
[20] http://techcrunch.com/2015/06/15/deutsche-telekom-ties-up-with-huawei-in-growing-amazongoogle-cloud-rivalry/
[21] http://blogs.wsj.com/digits/2015/07/17/huawei-says-europe-is-like-a-second-home-market/
[22] http://www.oafrica.com/mobile/huawei-going-strong-in-africa/

of-the-world phenomenon. Take, for example, the revelation that a Chinese computer maker had been delivering its products with pre-installed spyware running on them until it was caught in early 2015.[23]

China and Russia may have sealed a neat-sounding "cyber non-aggression pact" last spring, but the reality is that they know they can't trust each other any more than they can the West. When the Chinese government began cracking down on foreign IT providers in the summer of 2014, it was no more lenient with Russian cyber-security providers than with their US competitors.[24]

Likewise, Narendra Modi may have allowed Chinese IT companies to operate in his country as part of his "Make in India" manufacturing strategy, but only under the condition that the Chinese goods produced in this partnership will go through a rigorous vetting process to make sure they're devoid of Beijing's malware.[25]

Does all of this mean IT companies – American or not – are stuck with a global business landscape so rugged that they might as well fall back on their domestic markets? Far from it. What we are witnessing today may be another Darwinian turn in the road that will separate the weak from the rest, but resilient IT companies have a bright future ahead of them, provided they follow a few rules of thumb:

Do not exaggerate the threat, observe the opportunities: In a heated geopolitical environment, knee-jerk reactions against new regulations are normal, but not always advised. Before engaging in an all-out denunciation of new policies, companies should read the fine print and consider potential upsides. Europe's Digital Single Market strategy provides an interesting case study – while most US tech giants took the announcement of this regulatory overhaul as an attack against their presence in the Old World, a few chose to focus on its bright spots. Contrary to most of his peers, for example, Facebook CEO Mark Zuckerberg argued that the unification of 28 regulatory environments into one would help his company operate more seamlessly across European markets.[26] Microsoft, for its part, has welcomed the EU's invitation to rebuild trust in US IT systems by announcing the opening of a "Transparency Center" in which outsiders will be able to review technical details of the company's products.[27]

Play to your strengths: In many instances, the same countries that aim to protect themselves against the dominance of established IT companies are also those that need said-foreign expertise most. Know-how is not something that can be picked off the shelf. For instance, when the Kremlin attempted to create a domestic payment card system of its own, it ended up turning to multiple foreign card companies,[28] to compensate for its repeated technical failures. Similarly, Russia's attempt at a domestic mobile operating system was quickly revealed to be reliant on a Finnish developer.[29]

Take your future into your own hands: The 21st century presents a government-relations paradox for players in the IT industry: more than ever, they are influenced by the foreign policy decisions made by their home governments; yet any attempt at working with policymakers to minimize the excesses of these decisions risks exposing them to accusations of collusion – hence Silicon Valley's profound reluctance to engage with the American government despite the latter's push for greater private sector engagement.[30]

But no one can force IT companies to buy into a narrative pitching IT actors against one another solely on the basis of their national affiliations. In fact, companies willing to look at the IT landscape with an apolitical eye will quickly discover the existence of local allies in their scepticism toward excessive regulation. For example, one of the greatest opponents to Russia's version of the "right to be forgotten" has been a Russian search engine.[31]

---

[23] http://bits.blogs.nytimes.com/2015/02/22/lenovo-and-superfish-penetrate-the-heart-of-a-computers-security/?_r=0
[24] http://www.reuters.com/article/2014/08/03/us-china-software-ban-idUSKBN0G30QH20140803
[25] http://timesofindia.indiatimes.com/india/Centre-to-ensure-Huawei-makes-it-safe-in-India/articleshow/47650936.cms
[26] http://recode.net/2015/05/14/mark-zuckerberg-is-on-board-with-the-eus-digital-single-market-plan/
[27] https://blogs.microsoft.com/eupolicy/2015/06/03/microsoft-transparency-center-opens-in-brussels/
[28] http://tass.ru/en/economy/809589
[29] http://www.theverge.com/2015/5/19/8624901/russia-mobile-os-sailfish-jolla-tizen
[30] http://www.defenseone.com/technology/2015/04/pentagon-sets-silicon-valley-outpost/110845/
[31] http://www.bloomberg.com/news/articles/2015-06-15/yandex-protests-russian-right-to-be-forgotten-internet-bill

Know when to leave: The decision to pull the plug on a market is never a fun one for executives, but sometimes – just sometimes – it is better to leave on time than to overstay one's welcome. And guess what: coming back is always an option, which is what one American IT company did, returning to China after a five-year strategic retreat.[32]

The global business landscape for IT companies will never be as smooth as it once was. But the good news lies at the source of today's tensions: the very reason governments are fighting over who can access their IT turf is that they realize the digitization of the global economy will mean ever-greater market opportunities, which they naturally want to protect. This is, paradoxically, a fantastic opening for foreign IT companies: if they can prove their ability to grow their partners' pie, no doubt they will receive a fair slice of it.

[32] http://www.wsj.com/articles/google-negotiates-a-return-to-china-1441408051

The challenge to leaderships from newly E-empowered communities and the new politics of distraction

Nik Gowing, International Broadcaster, King's College London, United Kingdom

Geo-economics is defined as using economic means to achieve geopolitical ends. But this relationship is rapidly being tested and recalibrated because of the new explosion of digital hyperconnectivity at all levels around the world. Powerful new digital dynamics and communities now challenge fundamentally all the power assumptions about the normative nature and structure of both economies and politics. The result is that current assumptions of geo-economics are being both tested and transformed.

People power

Public impatience, suspicion and discontent with those in governments and corporates who manage economic activity and raise hopes is deepening. Meanwhile, reinforced by e-connectivity, the pressures for accountability are increasing. The greater the official promises and urging for sacrifice to rebalance debt-drained economies and re-stabilize corporates, the greater the public expectation for results in a far shorter time frame and at a greater speed than is probably realistic. This in turn has been fuelled by the scale and increasing ubiquity of that e-connectivity. This is because emotions and perceptions dominate in the public information space as opposed to relying on the dry granular details in hard facts and reason. The result is a growing chasm of confidence and pressure for that accountability supported by a new transparency. This means ever wider challenges to ministers, public servants and C-suite executives from a far wider public space than they naturally assume. The dynamic is readily fuelled by the additional growing public sense of a deficit of legitimacy for both leaders and whatever institutions they represent.

The new dynamics generated in this fast changing e-world are inevitable, inexorable and irreversible. Yet a "flat earth" mentality still routinely pervades the current leadership cohort. By their own admission many in it feel too vulnerable, conformist, risk averse and increasingly uneasy about their capacities to embrace the new non-normative realities for policy which the digitally empowered public expects them to handle with something close to perfection.[33]

The sentiments are especially virulent among the Next Generation of millennials, and generations Y and Z. While the new challenges are largely uncharted or unprecedented, that reality generates little empathy in the public space. By and large, public expectations are for delivery of solutions with near perfection in an ever shorter time frame. This is confirmation of how out of sync leaderships – however defined or calibrated – have become when working out how to address geo-economic realities and the resulting public expectations.

Grounds for concern about this increasing disconnect are highlighted by the kind of hedging policies being developed in China, India and Russia. This is to prepare for the reality of likely growing economic negatives, and the question arising of how those at the top will manage or restrict them.

Three examples at work

The following three examples of these new dynamics cover the spectrum from full democracy (India), to an increasingly authoritarian "democracy" (Russia) to a one-party state (China).

In China, there is evidential concern at the highest political level that the true, destabilizing nature of the national economic slowdown is not gripped or understood in the way it needs to be. The leadership realizes the Communist Party and various ministries have no known model for creating a new policy that will reverse the negatives. They are in uncharted territory with no guaranteed way out. Yet 1.3 billion Chinese have grown up in a system where it is naturally assumed the party will reverse negatives and always somehow manage to do so in order to provide solutions. In a party-controlled society, which is newly connected by up to 2 billion SIM cards, this is potentially a sinister source of tension. And the party from President Xi Jinping downwards realizes that. Disaffected people at all levels readily communicate their disillusionment through the new digital empowerment. Emotions in

[33] See *Thinking the Unthinkable – a New Imperative for Leadership in the Digital Age* by Nik Gowing and Chris Langdon, published online on 13 October 2015. It analyses the candid revelations of executive vulnerability as revealed with highest level C-Suite executives and public servants in interviews lasting up to 90 minutes.

civil society threaten to boil along the lines of the following: What has happened to our jobs and prospects of work? Why has the value of our investments evaporated?

As is evident globally, new ad hoc communities of connectivity readily create a new wave of both democratization and disillusionment. In this way the nature of power is shifting and being redefined in disruptive ways that those at the top are reluctant to concede. In China, the party sees this as a looming threat with incalculable potential consequences for its own credibility and legitimacy. Hence the evidence that what might be called the "policies of distraction" is being prepared. Together they raise the prospect of the highest levels creating the option to play the card of nationalist loyalty in order to distract from failings on the economic front.

This helps explain the tone and message of national strength and Chinese self-confidence sent by the giant military parade in Beijing on 3 September 2015, whose date had been brought forward. Supporting evidence also comes from the building of military-size runways on tiny atolls in the East China Sea, the blunt rhetoric against Japan, and the new official invoking of Confucius as the new national Chinese spirit to aspire to.

In India, a similar frustration has grown steadily against Prime Minister Narendhra Modi's government. There is evidence that he too is preparing to engage in "policies of distraction". He secured a landslide victory in mid-2014 against the incumbent Congress Party by promising to vitalize and unleash India's economic potential. He would remove entrenched bureaucratic resistances and create radical ways to first finance then build the vast scale of infrastructure so desperately needed. His thumping victory was achieved by convincing the business community of what he planned. They believed his campaign promises and bought into them.

But by mid-2015 there were clear signs that disillusion was setting in. It was dramatically fuelled by mass digital empowerment and connectivity that reflected Modi's growing and apparent failings to deliver. While expectations remained high, even the most ardent corporates increasingly expressed disappointment. They began to voice the fear that Modi could not deliver. They felt let down. Then ominously, distractions from this economic disappointment started to happen. First came a clamp down on NGOs, with signs of threats to curb freedom of speech and expression, with prime ministerial expectations of obedience to his words. Then Modi did not openly urge a halt to the anger of Hindu radicals about the eating of beef because of the sacred status their faith gives to cows. The prime minister also refused to condemn Hindu targeting of Muslims. The silence of both him and the BJP actually suggested acquiescence and approval of this public anger.

The Bihar state election in October confirmed the scepticism about Modi's ability to live up to his vote winning election commitments of 18 months earlier. The voters in Bihar decisively rejected Modi's record and promises. Despite his almost daily appearance during the campaign, the vast majority in a state of 100 million did not like the audit of the prime minister's activities or reputation. The fear began to grow that these failings in his geo-economics policies would lead to much worse.

Even eminent Indian figures speculated that to bolster his position and give an impression of being able to deliver decisively on his economic promises of 2014, a nasty "event" (or distraction) would take place (or be provoked). As with the direction of travel under President Xi in China, for Prime Minister Modi this kind of development could conveniently be harnessed to reinforce his nationalist credentials as saviour of modern India. It might even require a national mobilization against an outside "threat" like Pakistan. All of this may seem unthinkable. But increasingly such a scenario is not considered wholly unlikely if a public is disillusioned by what it sees as the failure to deliver on economic promises.

Since 2013, Russia under President Vladimir Putin has engaged increasingly in actions that can be clustered under the strategic umbrella of an aggressive nationalism that has been actively created to distract from geo-economic realities. It is aimed at capturing the hearts of the increasingly e-connected Russian public. They have had no option but to endure ever greater economic negatives, especially because of the impact of the unexpected 60% fall in oil revenues from mid-2014. Generating political optimism in the face of increasingly negative realities was reinforced by what was widely regarded as brilliant command of the public information space prepared and pre-engineered by a combination of the intelligence services and traditional Russian media platforms that had no option

but to be obedient allies for Kremlin demands. As far as is possible in the new digital space, dissent has become suppressed.

This has all gone well beyond Putin's natural political instincts to promote the ambition of a new Great Russia. It has been about finding ways to guarantee the survival and apparent flourishing of the New Russia. This core direction of travel has been highlighted most tragically by the determined Russification of eastern Ukraine in early 2014, followed by what evidence suggests was the opportunistic military seizure of Crimea. Then in late summer 2015 – with Russian fortunes bogged down in international sanctions and a messy ceasefire deal in Ukraine – came new Kremlin opportunism and the very unexpected military intervention in Syria. Throughout and explicitly, the Russian nationalist imperative was highlighted using every form of both information and military power to bolster support of a potentially wavering Russian public that increasingly had no option but to endure geo-economic negatives.

Geo-economics challenged
Such events are happening all over the world in ways that first catch off guard then enfeeble the capacities of both corporate and political leaders. They are either blind to these new realities or indifferent to their impact. They remain slow to understand the profound new vulnerabilities for both centres of power and government, whether democratic, partially free or authoritarian. All are under new pressure to open eyes and be transformed by the impacts of this digital explosion.

The result is that the growing gulf between cultures of the led and their leaders is rapidly forcing new definitions of leadership in 21st century. Most are struggling to understand, let alone catch up. Public campaigns can make it much harder to agree new trade agreements like TTIP, implementing austerity programmes in the Eurozone, or reform Chinese state-owned enterprises. Public pressure can also lead to nationalist outbursts demanding boycotts and sanctions against hostile countries. This new reality is swiftly creating revised fundamentals in what is already a different geo-economic landscape to when this Global Agenda Council was first assembled.

COMMITTED TO IMPROVING THE STATE OF THE WORLD

The World Economic Forum, committed to improving the state of the world, is the International Organization for Public-Private Cooperation.

The Forum engages the foremost political, business and other leaders of society to shape global, regional and industry agendas.

World Economic Forum
91–93 route de la Capite
CH-1223 Cologny/Geneva
Switzerland

Tel.: +41 (0) 22 869 1212
Fax: +41 (0) 22 786 2744

contact@weforum.org
www.weforum.org