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Global Power Shift

Winners, losers, and strategies in the new world economic order

http://www.strategy-business.com/article/Global-Power-Shift?gko=d56bb&utm_source=phplist116&utm_medium=email&utm_content=HTML&utm_campaign=Political+Anticipation+-+LEAP+Press+review

by Dennis Chesley, Miles Everson, and John Garvey
4/13/2016

During the mid-2000s, when emerging markets were growing at breakneck speed, the cavernous gap separating industrial and developing economies began to close. This convergence took place against a backdrop of economic liberalization, built on the idea that the financial systems of all nations would dovetail.

That period is now over. Emerging nations are no longer growing as rapidly as they were, particularly in comparison with developed economies; further, the fissures among different systems have become more evident. In PwC's 19th Annual Global CEO Survey, only 35 percent of the corporate leaders who responded said they believe the world is moving toward greater economic union. Instead, 59 percent of these chief executives believe that multiple models will coexist and compete. Consider, for example, how differently government and business investment is conducted in the United States, China, India, Japan, and the European Union. These nations and regions operate with fundamentally different assumptions about the way an economy should be organized. The tension among these assumptions is growing, not diminishing.

In short, a new global economic order is now emerging to replace the one that has existed since the end of World War II. For the foreseeable future, the global economy will be defined by a complex and continuously shifting set of economic relationships. They will be increasingly interconnected, to be sure, but with ever-changing rules for conducting business across borders.

As a business leader, how can you manage this complexity? How can you cross the threshold to the next economic order with confidence and skill? The most effective way is to pay attention to three basic trends: the dispersion of economic power, the continuing evolution of state-directed growth models, and the accelerating disruption felt by business from technological change. These trends may seem self-evident. But none of them is quite what it seems to be at first glance. Further, they will continue to evolve along uncertain paths. None is likely to progress simply as a continuation of what we have seen in the past few years. By looking at these trends closely, you can help your organization take the substantive steps needed to thrive in the new global economic order.

Trend 1: Economic Power Disperses

A fundamental change is taking place. The U.S. dollar is losing its exclusive position as the world's reserve currency. For the next few decades, no single country will be able to dominate the balance of payments as the United States has done for more than 70 years.

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The last time something like this happened was at the end of World War II, and it was catalyzed by the Bretton Woods Conference in 1944. At that session and in its aftermath, the United States brokered international agreements to keep financial affairs running smoothly. It has embraced a global leadership role ever since. The multilateral institutions that emerged then, such as the World Bank, the World Trade Organization, and the International Monetary Fund (IMF), were subject to strong U.S. influence, and they worked fairly well for a long time. That isn't to say the sailing was always smooth. When the U.S. unilaterally abandoned the gold peg in 1971, for example, the "Nixon Shock" set off two years of negotiations before major economies agreed to float their currencies against the dollar. But throughout the postwar period, the U.S. generally sat at the head of the table with other large economies in making key decisions, with the intent of mutual gain among friendly, mostly democratic, liberalized economies.

During the 70 years after Bretton Woods, the economic prominence of the United States was based on four strong pillars. The first two were its burgeoning postwar economy and the trade networks that the U.S. established and dominated. These were also the engines of global growth. The other two pillars were the dollar's status as a global reserve currency and the U.S. influence over multilateral institutions. These provided stability to the global economy and a platform for international cooperation.

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Today, emerging economies are challenging all four pillars. The most notable among the challengers is China, whose global economic influence has emerged rapidly over the past decade. In 2014, China became the largest economy in the world, in terms of purchasing power.

It was then the fastest-growing G20 economy. One indication of China's substantial economic influence is the fact that its recent slowdown has rippled across global markets. This influence has already weakened the first pillar, the strength of the postwar U.S. economy.

China is also now the world's largest exporter. Its rapid move into this role has given it enormous leverage in developing and influencing trade networks, which has weakened the second pillar. Not coincidentally, the effectiveness of multilateral trade agreements is deteriorating; witness the fading momentum of the World Trade Organization. In their place, regional agreements have begun to dominate. The ongoing negotiations over the China-backed Free Trade Area of the Asia-Pacific (FTAAP) and Regional Comprehensive Economic Partnership (RCEP) are pitted against the recently completed Trans-Pacific Partnership (TPP), backed by the United States. These regional deals represent an erosion of the U.S.'s ability to set the rules for the whole world, and of any nation to oversee a global "consensus" that favors its trade agenda alone.

China's progress on establishing the renminbi (RMB) as an international trade-settlement currency, which has undermined the third pillar, has been even more rapid. The RMB's status as an elite global currency was enshrined in November 2015, when the IMF decided to include the RMB in the basket of currencies that make up the IMF's special drawing rights (SDRs). The RMB will have a larger weight in the five-currency SDR basket than the Japanese yen and the British pound sterling. Over time, the RMB's reserve currency status will create an alternative to the dollar, with support from the many nations that see an advantage in having a multipolar global economic order.

As for the fourth pillar, China is pushing hard to expand its presence in existing multilateral institutions and to build new ones of its own. According to the Economist, China's contribution to the United Nations budget doubled between 2010 and 2015, and now represents 5 percent of total U.N. contributions. China is increasingly engaged with U.N. efforts in peacekeeping, climate change mitigation, and poverty reduction.

China also led the creation of the Beijing-based Asian Infrastructure Investment Bank (AIIB), which began operations on January 16, 2016. While cooperating with its counterparts to promote and support sustainable development in the Asia-Pacific region, this bank will operate on a model designed for the new global economic order — "lean, clean, and green," according to its website. A total of 57 nations, which have committed US\$100 billion in capital, are members of the AIIB. Despite the skepticism of the U.S. government, the signatories included four of the United States' G7 partners — Germany, France, Italy, and the United Kingdom. China also joined with Russia, India, Brazil, and South Africa to form the Shanghai-based New Development Bank. Beyond highlighting the institutional underpinning of the new global economic order, these two multilateral development banks will amplify China's influence on global development finance.

How will that financing be deployed? Chinese president Xi Jinping, as quoted by the state-sponsored Xinhua News Agency in February 2015, said that the AIIB will finance China's ambitious "One Belt, One Road" initiative to build overland and maritime infrastructure linking

East Asia, the Middle East, Africa, and Europe. The resulting New Silk Road, as it has been dubbed, will help develop emerging economies, increase trade between China and the rest of the world, and make use of excess capacity in the Chinese domestic economy. It will also support China's political and economic interests around the world.

To be sure, these efforts may be tempered by the recent decrease in the rate of Chinese economic growth. The U.S. economy remains strong, and the legacy of its postwar economic dominance continues to influence the behavior of many globally focused multinational companies and investors. Investors are also waiting for China's capital account to open further before they adopt the RMB. Capital market investors are also cautious about China because they don't yet see its business environment as friendly enough to their interests.

Nonetheless, the creation of a new global economic order is inevitable. Although China will not replace the United States, the U.S. will find it increasingly difficult to regain its position of global economic dominance. Don't forget that other economies are building their power and influence, too. India, the world's third-largest economy by purchasing power, is forecast by the IMF to grow fastest among G20 economies in 2016. It will emerge as an influential economic actor with its own interests.

In this world of dispersed economic power, stability will be more prized than ever. But the nature of that stability will not be dictated by one or two major players. It will depend on the quality of economic relationships among leading nations, even those that have different economic systems. A good example of the new type of relationship is the natural resource investments made recently by a few countries, including China, in frontier nations. These have caused some concern over the potential for exploitation. Yet China's investments in Africa (as scholars Wenjie Chen and Heiwai Tang have pointed out) are more diverse than is widely acknowledged. China is popular in many parts of Africa, and exploitation concerns may be overblown. The ultimate fate of these investments depends on the ability of the outsiders to build mutual trust with the local communities where they invest.

Trend 2: The State-Directed Model Evolves

This current shift in global economic power will be different in one important respect from the last major shift, in 1944. Then, the baton of global economic influence was passed from the U.K. to the U.S., two countries that shared a similar world view. Even so, it had taken 40 years for economic polarity to move across the Atlantic; that shift had begun in the early 20th century.

Today, in contrast, we're seeing a much faster rebalancing among disparate economic and political systems, each with a different level of reliance on markets and state direction. China's state-directed model has delivered significant growth over the past decade, making it clear that the state-directed model will not be superseded by a traditional form of capitalism any time soon.

Some argue that any state-directed economy, be it China or another country, will by definition become stagnant. But stagnation is not inevitable. As with the effective management of a large corporation, success requires the ability to adapt to evolving economic pressures. One example is China's liberalization of state-owned enterprises, which included measures allowing partial privatization. This has lessened state control in sectors categorized as "competitive" (such as

retail and manufacturing) and concentrated state influence in “public interest” sectors (such as energy, rail, shipping, and telecom).

The state-directed approach remains popular, because it is associated with robust growth in emerging economies. Governments in Latin America and Russia, among other areas, have exerted a stronger guiding hand in their national champions in recent years. Major infrastructure projects will further diffuse China’s model of state-driven investment to countries along the New Silk Road. Some governments will manage this process better than others, and the collapse of oil prices will stress state-directed energy exporters. But some are responding by streamlining state-owned enterprises and strengthening the quality of their management; there will be enough of these to sustain the state-directed growth model. Indeed, the more it is stressed, the more it is likely to evolve.

Similarly, there will probably be more forms of welfare-oriented capitalism, as well as hybrid systems, emerging during the next decade, as each country and region addresses the challenges of the turbulent global economy. Although it is possible for these different economic systems to coexist harmoniously, the new multipolar global economic order will add friction to multinational business operations.

The dispersion of economic power, and the resulting incompatibilities, will be most evident in the areas of logistics, telecommunications, software, and infrastructure. With parallel systems in competitive spheres of influence, the movement of supplies, goods, services, capital, and talent from one sphere of influence to another will be less aligned. Businesses can expect periodic disruptions and obstacles, including transaction payment settlement delays and trade tariffs.

One potential example involves the global payment system. The Society for Worldwide Interbank Financial Telecommunication (SWIFT) network, which exchanges global payment information among more than 9,000 financial institutions around the world, is heavily influenced by American and European banks. In 2015, the China-backed Cross-Border Inter-Bank Payments System (CIPS) was announced as an alternative to SWIFT. If it proceeds as planned, CIPS will process cross-border payments denominated in RMB. It will not replace SWIFT, because 45 percent of cross-border transactions are dollar-denominated. Every international bank will still need access to the U.S. banking system. Yet with a well-functioning CIPS on the horizon, some international banks could decide to operate without a U.S. banking license, and the U.S. would be less able to exert its banking rules over non-U.S. banks. This would affect the interoperability of transaction payment systems, making global business harder to conduct.

Nations will have to choose their levels of exposure to and interaction with different spheres of influence. For businesses, however, rationalizing operations and finance among environments with different approaches to market direction and state direction will be more challenging than tax and regulatory compliance. And those alignments will change over time, requiring companies to develop a more adaptive approach to cross-border business.

Trend 3: Technological Disruption Accelerates

Technology has always been a disruptive force. After 1945, governments invested heavily in military and space research. Game-changing technologies such as satellite-based navigation and

the Internet were products of these investments.

Today, a variety of new technologies are emerging, including potentially dramatic breakthroughs in robotics, nanotechnology, and medicine. All of these will affect our societies and businesses. But from the perspective of economic influence, three developments stand out. They are not technologies themselves. They are political and commercial reactions to technology disruption.

The first involves cybersecurity, which is required as Internet hackers continue to gain access to intellectual property, intimidate adversaries, and disrupt public and private affairs. The number of attacks on industrial control systems worldwide rose fourfold from 2013 to 2014, according to a Dell Security report cited by the New York Times in October 2015. This level of malfeasance ensures cybersecurity's presence on every business's agenda. A global defense against cyber-threats may not be feasible, because it would require an unprecedented and ongoing level of international cooperation.

The alternative, however, may lead to draconian measures that constrain business. It has been widely reported that many governments have intervened in their country's cyber-activity, to the point where it affects the use of the Internet. Regardless of the motive, these actions can also limit the potential for economic growth. Accordingly, governments will have to calibrate their actions, much as they have with foreign exchange markets in the past, to balance the intended objectives of intervention with the potential impact on economic growth.

The second technology-related development is the shifting geopolitics of energy. The power of oil-producing nations has been evident at least as far back as the oil crisis of 1973. Now, technologies designed to recover unconventional sources of oil and gas have overturned the balance of supply and demand. The U.S. Energy Information Administration estimates that the U.S. could become a net exporter of energy as early as 2019, on the strength of the fracking revolution. Even if oil prices rebound somewhat, the increasing use of renewables will reduce the geopolitical importance of oil producers.

It should come as no surprise that the two largest oil-consuming nations, the U.S. and China, are also the biggest investors in renewable energy. Another sign of the shift in fortunes is the Breakthrough Energy Coalition announced by Microsoft cofounder Bill Gates and Facebook CEO Mark Zuckerberg in November 2015. This multibillion-dollar research partnership between the public and private sectors is not just a "war on climate change." It is an effort by information technology industry leaders, including Gates; Zuckerberg; Amazon CEO Jeff Bezos; Salesforce.com founder Marc Benioff; Hewlett-Packard CEO Meg Whitman; and venture capitalists John Doerr, Vinod Khosla, and Reid Hoffman, to carve a position of influence over the energy supply for the technology industry.

The third important technology-related trend is the geographic distribution of technological developments, which are no longer limited to developed economies. Technology innovators are more distributed around the world today, and capital seeks them out wherever they live. For example, according to the Global Innovation 1000 study conducted by Strategy&, PwC's strategy consulting business, 94 percent of large publicly held companies conduct research and development outside their home country. Moreover, those with a more global R&D footprint

tend to outperform their less-globalized competitors financially.

Important technologies are emerging where they are needed the most. For mobile payments, that's in Africa, where millions of people have no access to standard banking or landline telecommunications. In the industrialized world, financial institutions are scrambling to study blockchain, a technology for automated verification that enables digital currencies, such as bitcoin. If the right mix of new financial technologies emerges on a global scale, it could dramatically change the structure of the financial-services industry. Indeed, “game changers” in any industry can come from anywhere. This creates unpredictability and makes it even harder to rely on the established sources of geopolitical power and stability.

Prescription for Business

Trends don't exist in isolation. They interact with one another to create patterns of change. Although you can't predict the ways they will combine, you can prepare for the types of uncertainty you know lie ahead. For example, some energy industry observers recognized that fracking would combine with geopolitical tension to disrupt the established oil production system, leading to a long slump in energy prices. They saw that this would reduce the value of investments in clean energy production and upend the economies of oil-rich emerging markets.

Combine this shift in oil price with the dispersion of economic power, and you have a potential global economic crisis, as the Economist suggested in a scenario published in October 2015. But such a crisis could yield significant benefits. With no dominant economy calling the shots, a crisis of this type would give Asian government-owned banks and large U.S.-based commercial banks a stronger awareness of their common interest. They might then seek to establish, with their governments' approval, a global lender of last resort.

With luck, it won't take a global crisis like the one the Economist imagined to spur mutual recognition of common interests in a world of dispersed economic power. But even crises are not necessarily bad. In fact, all this uncertainty can lead to great opportunities for companies that can learn to be appropriately competitive.

The new environment is unfamiliar, even to experienced decision makers. If you are in a position to make major decisions for an enterprise, we believe you should focus on six key areas.

1. Develop a cyber-focused center of excellence. Cyber-attacks are a reality. Like all other major risks, they demand that you closely examine your risk appetite, revisit business processes to minimize their impact, and align your infrastructure and talent to address the technical and business challenges involved. You will need, at a minimum, to be able to respond effectively to attacks and breaches — ideally knowing what you will do before the attack occurs. (See “Safety in the Cloud,” by David Burg and Tom Archer.)

2. Master the RMB. Economic weakness and government intervention in the U.S. and Europe, combined with China's economic growth and liberalization, have broadly legitimized use of the RMB as both a trade and a reserve currency. One source of competitive advantage in the coming years will be access to the RMB. Another will be cost-effective correspondent banking and clearing arrangements, which enable banks to conduct cross-border transactions on each others'

behalf, You will need to stay current on the changing economic landscape and integrate your treasury capabilities — such as capital forecasting, foreign exchange, and liquidity management — with the rest of the business.

3. Recognize government relations as a key competency. As power devolves to regional, national, and local levels, and trade agreements are regionalized, the ability to legitimately influence government stakeholders will often mean the difference between success and failure. This no longer applies solely to regulated industries such as banks and utilities, but to all organizations. Geopolitical risk management, government stakeholder management, and the ability to master public–private partnerships will become requirements for companies that want to prosper on a global basis.

4. Effectively manage in a multipolar world. Organizations will need to assess how their business or policy objectives are affected by the economic and political power shift to a multipolar world, particularly in Asia, where China will increasingly compete for dominance and India is rapidly evolving. They will also need to prepare their logistics capabilities, so that they can move supplies, goods, services, capital, and talent across spheres of influence.

5. Cultivate talent wherever you do business. The local knowledge and language skills of the workforce, particularly the management team, must reflect your business footprint and opportunities around the globe. Although global rotations will still be valuable, differences between markets under various spheres of influence will require more local or regional talent development. In addition, governance models will need to adapt, carefully balancing local decision making with regional and global considerations and requirements.

6. Nurture innovation everywhere. Competitive dynamics in this rapidly evolving world could easily be disrupted by upstart companies whose leaders anticipate trends and get ahead of them. To fight back, every organization will need to establish an innovation culture that spans the globe. The savviest companies will establish innovation centers with a relatively open-ended brief, to keep the company thinking ahead, regularly looking five years into the future. These efforts will extend beyond simple technological disruptors. Companies will work together to develop complex new industrial ecosystems.

As you put all these practices into place, maintain an intense focus on your own distinctive goals — in part to balance the pressures of near-term volatility. Be mindful that it takes time to build institutions — and even longer to build trust in them. Yet those institutions do exist in most countries, the markets learn to embrace them, and they develop staying power. It has happened in every country that has made the transition to a global industrialized economy. Today’s volatility doesn’t change any of that. There may never be a “new normal” of stability, but the institutions of stability will continue to use their influence to promote sustained growth and resilience, the kind that can support business — because they need it. The most farsighted leaders of these institutions are beginning to realize how they can play this role.