Five Forces Driving the World's Political Risk Supercycle

DJ Peterson, PhD, President, Longview Global Advisors
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The global political environment has been characterized as unprecedented, volatile, and dangerous—epitomized by an upsurge in populism and authoritarianism. This brief connects the dots and shows how this megatrend is rooted in five major, interconnected political forces: 1) slow growth, 2) inequalities in income and opportunities, 3) perceptions that governing institutions are unresponsive, 4) political entrepreneurs or insurgents, and 5) a hyperconnected social media environment. These forces are driving an enduring, global political risk supercycle that cannot be ignored. The brief suggests three ways business leaders can respond to the threat.

Businesses need supportive and stable political and legal institutions to prosper, yet the global geopolitical landscape has become increasingly unstable as many seemingly implausible events have come to pass. Executives and investors express surprise and concern about headline political events in the US and Europe, but striking developments are also afoot in emerging markets such as Brazil, Hong Kong, South Africa, Mexico, and Turkey. All told, the global economy is fragile, political institutions are being disrupted, globalization is being challenged, and authoritarian approaches to governance are gaining popularity.

What's fueling this instability? And is turmoil the new global normal or cyclical trend that will ebb? As part of Longview Global Advisors' mission to make sense of a complex world, we explain five intersecting political issues shaping the global political environment. We then offer recommendations to help businesses and investors navigate and mitigate these social and political challenges as well as find new opportunities among them.

1. Slow growth is fueling political volatility

Global growth has been muted and uneven since the global financial crisis, and people are becoming frustrated with the establishment.

In its June 2016 economic outlook, the OECD stated that the global economy was "stuck in a low-growth trap." In the three years since then, global growth has continued to underperform its potential. In October 2019, the IMF warned, that the world was experiencing a "synchronized slowdown," growth was historically weak, and the outlook was fragile. To turn growth around, the IMF, the World Bank, and the OECD have been calling on governments to eschew protectionist measures and undertake bold structural reforms and assertive stimulus measures, such as investing in people and infrastructure. But thanks to high debt ratios and continuing calls for austerity from fiscal conservatives, big spending increases are not politically feasible in the US or Europe. And emerging markets dependent on commodities exports have been forced to tighten belts in response to lower prices.

Brazil provides one notable example of this shift. Over the past 15 years, a favorable export environment, government largesse, and significant capital inflows created economic growth and moved millions of poor people into the ranks of the middle class. But since the onset of a historic recession in early 2015, the federal government has been running a large deficit. Spending cuts, combined with rising unemployment and inflation, have resulted in stagnating incomes and risk throwing people back into poverty.

Economic hardship often leads to political volatility, but a lack of global policy consensus on how to promote sustainable growth is complicating the political picture. For example, the economic thrust of the post–World War II era—whether in the USSR, India, Latin America, or the US—favored government programs and market interventions. This movement fell out of fashion with the economic malaise and debt crises of the 1970s and 1980s and finally terminated with the collapse of Soviet communism. The movement that replaced it is still dominant. Market liberalism began in the 1980s and is epitomized by "getting governments out of business," promoting fiscal austerity, and freeing up the movement of goods, labor, and capital—in part to capture the benefits of globalization.

But because of chronic slow growth since the financial crisis, political support for market liberalism has waned. While policymakers are struggling to reignite growth, people are becoming increasingly frustrated with the establishment, and this dynamic is catalyzing political uncertainty and volatility.

2. Inequality is driving political polarization and calls for more extreme measures

Popular disaffection with slow growth has been amplified by inequality in incomes and opportunities. Unlike in the past, middle classes feel exceptionally exposed today.

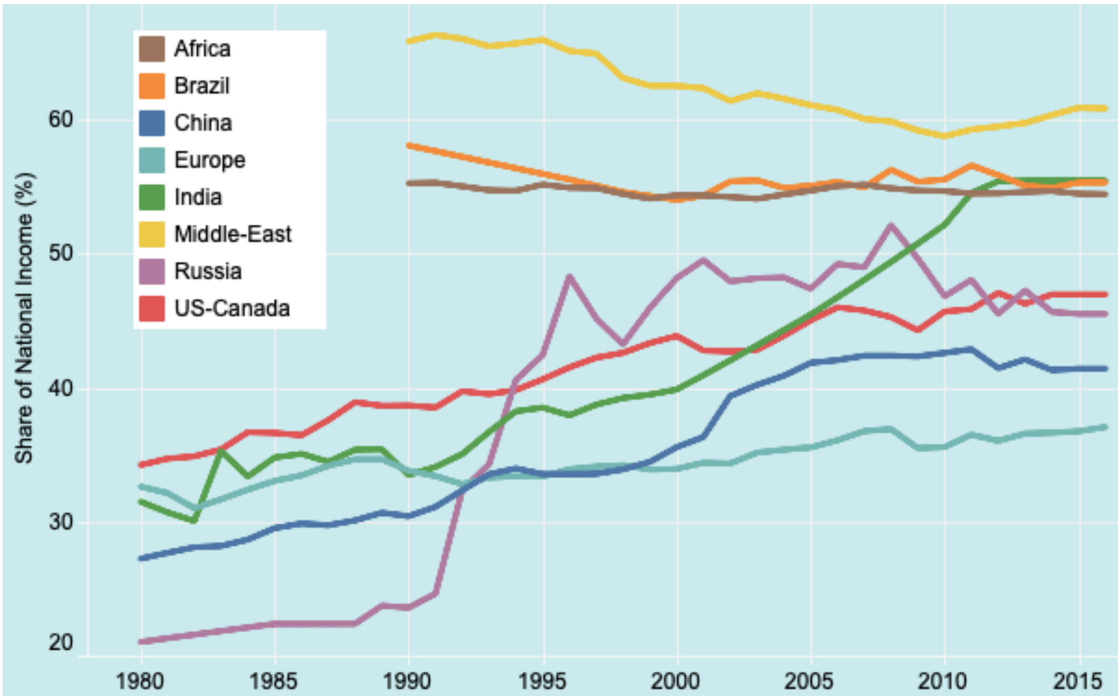
Market liberalism's trickle-down economic benefits have not lived up to their name. In many countries, inequality has surged since the 1980s, especially in emerging markets such as India, Russia, and China after they undertook liberal reforms (Chart 1). Central banks' recent quantitative easing policies, in response to slow growth, have greatly lifted only a few boats. Oxfam International has estimated that in 2017, the wealth of the world's 42 richest people—all of whom could fit on a bus—was equal to the wealth of the 3.5 billion people comprising the bottom half of the global income distribution. This richest people headcount was down from 380 in 2009.

Whereas post–World War II governments in the West played the role of economic and social equalizer, proximity to political power has come to be perceived as conferring huge economic advantages, creating the belief that the system is not fair. This belief has been endemic to many emerging markets. For example, China's princelings and Russia's oligarchs are well known; economic resentment catalyzed the Arab Spring in numerous countries in 2011; and deep-seated frustrations with the high cost of living, a lack of economic opportunity, and elite corruption elites has helped catalyze public protests in Hong Kong, Chile, Lebanon, and Iraq in 2019. The perception of a lack of opportunity and fairness has become very pronounced in advanced economies, including among Yellow Vest protestors and supporters of Brexit, Bernie Sanders, Elizabeth Warren, and Donald Trump.

Economic openness is a casualty of the perception that the benefits of free markets and trade accrue disproportionately and leave losers to fend for themselves—because such perceptions are often based on feelings rather than facts. Open societies may be more at risk of economic and political polarization, as animosity toward politically connected elites in authoritarian ▶

regimes such as China and Russia is kept in check by repression and diverted by nationalist appeals. Middle-ground policy pragmatism—a hallmark of stable democracies—is losing credibility against economic resentment, as evidenced by the push for Brexit, pushback against globalized markets, and rising anti-immigrant and extremist sentiments.

Chart 1. Income share of the top 10 percent, 1980–2016



Source: World Inequality Report 2018, available at wwwinequality.org, November 2019.

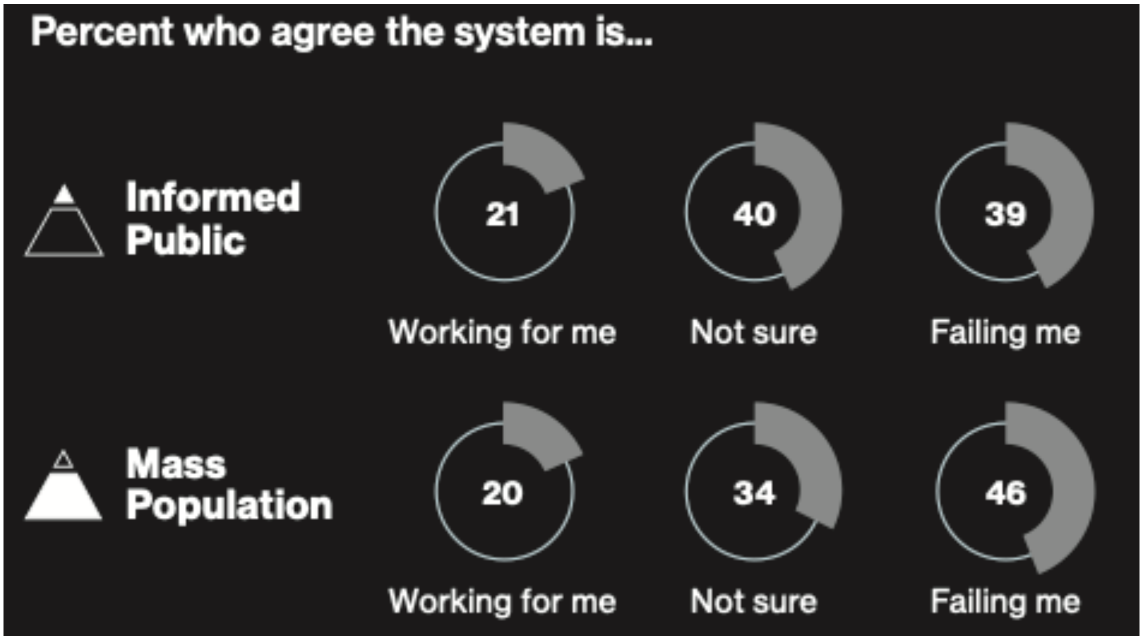
3. Governments can't keep up with the pace of change

Business leaders know that success depends on agility and the ability to accommodate change—the alternative is disruption—but political leaders are struggling to keep pace.

Most of the world's governing institutions, both national and supranational, were developed in the 20 years following World War II. Fifty years later, these institutions are showing signs of advanced age and diminished dynamism: They are encumbered by regulations, procedural rules, political scrutiny, and webs of entrenched interests. Massive debt has also limited policy latitude in many countries, while political polarization has fomented policy gridlock.

Historically, politicians in democracies have risen and fallen based on their ability to deliver broad-based prosperity and security. But the issues currently facing many political leaders feel more existential. For example, policymakers across the EU must contend with chronic slow growth, aging populations, a faulty banking system, technological transformation, terrorism, and refugee management. These types of challenges are undermining the public's confidence not only in their political leaders but also in governing institutions and economic systems. According to public surveys conducted by Edelman in late 2018 in 28 major advanced economies and emerging markets (Chart 2), only one in five people believed that the system worked for them. Moreover, there was a significant gap in sentiment between elites and masses. ▶

Chart 2. Public confidence among elites and the mass population, 2018



Source: Edelman Trust Barometer, 2019 available at https://www.edelman.com.

4. Political entrepreneurs are exploiting the governance gap

The idea that establishment elites are incapable of solving important problems has created a volatile atmosphere in which disaffected voters are willing to take risks, throw wrenches into the political works, and support revolutionary and authoritarian insurgencies.

Just as private sector entrepreneurs exploit gaps in the market and find new ways to satisfy market needs, political entrepreneurs do the same in the public sphere by taking advantage of volatility, peddling new solutions (often from both the left and the right), and breaking rules. Dramatic, anger-driven insurgencies of political entrepreneurs make compelling narratives for disaffected citizens—such as the stances of the Philippines' President Rodrigo Duterte, Hungary's Prime Minister Viktor Orbán, Brazilian President Jair Bolsonaro, and France's presidential candidate Marine Le Pen, and most visibly, Donald Trump. These populist and authoritarian figures are pursuing revolutionary disruption just as leftist revolutionaries did in the past.

But these entrepreneurs are only half the story. In the current global environment, calls from establishment figures for pragmatism and staying the course (Vote Remain!) sound tired, if not suspect. In Germany, for example, the right-wing euroskeptic party Alternative für Deutschland has been able to siphon support from Chancellor Angela Merkel's ruling coalition thanks to her refugee policy. Al Qaeda and ISIS similarly capitalized on anti-establishment messages in failing states in the Middle East and Africa. ▶

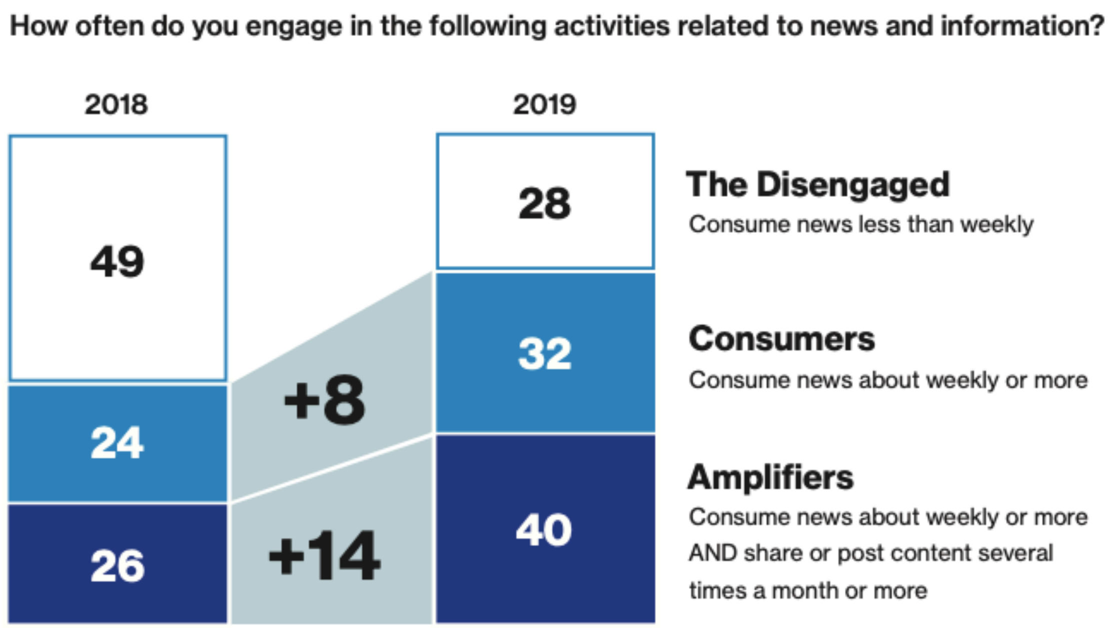
5. Hyperconnectivity unites, divides, and overwhelms

The contemporary social media environment has turbo-charged political engagement and volatility.

The techno-optimist vision holds that Internet access empowers individuals, enhances transparency and learning, and brings people together. The reality is not that rosy. Beijing has proven quite adept at controlling China's information environment, and Russia has become more authoritarian and anti-Western under President Vladimir Putin, even as its citizens have gained unprecedented access to global information flows. And national, ethnic, and religious divides seem to be deeper than ever. Brexit has revealed that the kingdom is far from united.

Thanks to both societal angst and social media, citizens around the world have become much more engaged with news and opinion (Chart 3). In this hothouse and freewheeling content environment, political entrepreneurs can peddle their ideas without having to work through establishment media or institutions. Being provocative is essential to gaining visibility in the crowded media landscape, and this imperative promotes extreme points of view and places pressure on policymakers to react—even though governments in representative democracies are designed to be deliberative and consensual.

Chart 3. Consumption of news and information, 2018–2019



Source: Edelman Trust Barometer, 2019 available at https://www.edelman.com.

Just as the pace and quality of information flows may overwhelm individuals, so too are governing institutions affected. In more open societies, higher levels of transparency and social media activity are driving the public discussions on inequality and corrupt elites—including scandals related to Petrobras in Brazil, 1MDB in Malaysia, and Iranian interests in Iraq. But social media's imperative to be provocative also amplifies misinformation and polarization and distracts from complex policy debates. For instance, few would say that policymaking in the US has improved over the past couple of decades thanks to greater information flows. ▶

How to strengthen business and investment strategy

Business leaders and investors can no longer take political stability for granted, but they can mitigate the challenges outlined above by testing assumptions about the future and developing flexible operating and investment strategies that take the new political context into account.

1. Integrate political drivers into business intelligence and strategy. The political forces outlined here are unlikely to ease, which suggests a number of scenarios may develop. Expect political uncertainty and volatility to persist and probably also prolong slow growth and low interest rates (see box). The US election, for instance, is unlikely to immediately or fundamentally change the country's political climate, so more disaffection, polarization, and gridlock could result. Uncertainty about the future of Europe will increase as Brexit negotiations ensue and national votes in Italy, France, and Germany detract from the European agenda. In Brazil and Malaysia, corruption revelations and collateral damage could continue to unfold. And in China, President Xi Jinping is likely to promote nationalism to further consolidate Communist Party control even as growth slows, a stance that could further disadvantage foreign investors.

2. Look for pockets of opportunity. Volatility creates opportunities as well as risks, and since emerging markets—let alone the BRICs—can no longer be considered an asset class, watch for good governance and sound policies to differentiate between countries poised for relatively stronger economic performance and those that will continue to face serious challenges. For example, attention to inequality in Chile and Iraq could lead to improved governance. Economic stresses are forcing a more ambitious search for practical solutions in South Africa. Look for improved and more agile governance in Columbia, Kenya, and southeastern Europe. City and provincial governments are also stepping up to solve problems and promote growth, so a city- or region-based approach to market development is especially salient in large and diverse nations such as Nigeria, India, and Indonesia, where variation in governance is particularly high. In addition, middle-class segments continue to expand in some markets despite slower growth and rising inequality.

The implications for interest rates

Interest rate observers typically focus on inflation, employment, and growth, but they should also be thinking about politics. Politicians' inability to reignite growth and their economically questionable populist measures have forced central bankers to take extraordinary measures. So instead of pushing up borrowing costs to address risk, central bankers are driving down rates in response to risks such as Brexit, Japan's policy ineffectiveness, and questions about American trade policy.

3. Engage in the social and political environment. Whereas emerging-market companies are used to navigating political risk, Western business leaders and investors need to follow suit and not take political stability for granted. They can no longer blame the political system. Proactive companies and investors are addressing social and political challenges rather than just defending against risks, such as by making money by doing good. There is also a business case for more inclusive growth: Higher levels of income inequality are correlated with slower growth. Public-private cooperation to train workers for the jobs of the future—as seen in Germany and Japan—can create ladders of opportunity and ease the war for talent. On the other hand, a failure to address inequality and other societal ills risks lower productivity, more regulation, and the closing of markets and societies. ■