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Top Risks 2023: The Bottom Line for Business

How Eurasia Group's Top Risks for 2023 could affect your business – and what you can do about it

KPMG International

KPMG Insights

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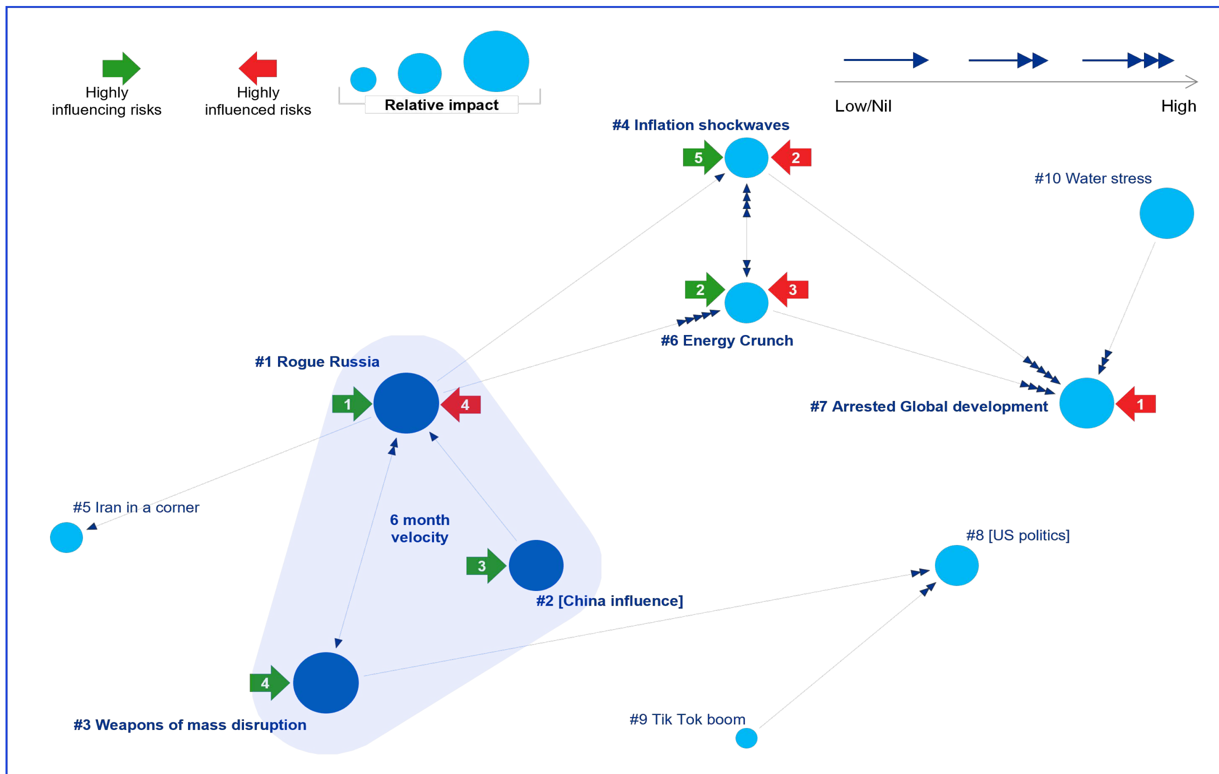
Top Risks 2023* is Eurasia Group's annual forecast of the political risks likely to play out in 2023. It is a reminder that we are truly in an era of volatility, where a new crisis is always around the corner, threatening business everywhere. Our most recent CEO Outlook shows that geopolitical uncertainties will likely continue to impact business strategies, with 81 percent of CEOs adjusting or planning to adjust their risk management procedures. This year, Eurasia Group similarly warns that "we remain in the depths of a geopolitical recession, with the risks this year the most dangerous we've encountered in the last 25 years."

Dynamic risk assessment

The forecast is a reminder that geopolitical risks tend to be highly interconnected and contagious. As such, they should not be considered in isolation. The following analysis intends to look beyond the traditional severity and likelihood metrics and investigate the velocity (how quickly the effects of a risk impact will be felt) and contagion (how likely it is that a risk will trigger other risks, should it occur). DRA helps us represent Eurasia Group's Top Risks as a network, with each risk node influencing and/or being influenced by other risks in the broader network.

Not surprisingly, *#1 Rogue Russia* is a highly central risk. That is not to say it is the most severe risk, in fact *#3 Weapons of Mass Disruption* was deemed most catastrophic if fully triggered.

Instead, the DRA shows that an unpredictable Russia constitutes the most influential risk in the network, more inter-connected directly and indirectly and likely to trigger several other risks with a rapid as well as catastrophic combined effect.



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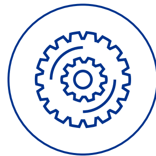
From a whole-of-network perspective, a few features stand out which provide insight as to where corporate risk management approaches can be most effective:

Russia's willingness to weaponize its energy and other resources has had a significant inflationary impact on the global economy. As prices rise and central banks maintain tight monetary policy to counteract the trend, energy uncertainty will be a drag on economies, some still in recovery post-Covid.



We also see a scenario or 'cluster' within the network in #1 Rogue Russia, #2 [China influence], and #3 Weapons of Mass Disruption. These risks are bi-directionally inter-connected and presage another potentially high-risk, rapid (six-month velocity), and catastrophic scenario. This highlights the combined risk severity of the Russian government's ongoing war in Ukraine and possible escalation with the North Atlantic Treaty Organization (NATO), China's influence on the global economy (especially as it reopens its doors after shifting its Zero-COVID strategy), and the disruptive nature of new technologies like generative Artificial Intelligence (AI).

In terms of business focus, addressing the most 'contagious' risks, or most influential, can help isolate the potential impact of other risks further down the contagion scale. Some of these risks can be actively managed. For example, ensuring energy supply resilience and a sound location strategy can help mitigate the second most influential risk, #6 Energy crunch, which can in turn help tackle inflation and stagnant growth. With other risks – businesses have less agency. #1 Rogue Russia requires a more reactive approach focused on regular geopolitical monitoring and analysis of its downstream impact on more manageable risks.

Heightened geopolitical volatility can mean uncertainty for business leaders, which in turn can lead to unproductive decision paralysis. To help understand and mitigate any potential exposure to Eurasia Group's predicted geopolitical trends, here are KPMG's **top three 'bottom lines' for business**, borne out of Eurasia Group's Top Risks

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01

Globalization is changing, national security is shaping it

Globalization is changing, national security is shaping it

Eurasia Group's Top Risks show that we have entered a new world. Today's fraught geopolitical environment is characterized by a departure from the international rules-based order of the post-Cold War era. Globalization has evolved into a fragmented world with less economic cooperation and heightened competition.

Where highly integrated and complex supply chains were once celebrated as a hallmark of free trade and economic efficiency, they can now be perceived as a vulnerability in need of reshaping amidst rising geopolitical competition. In the name of building resilience, we see a rise in unilateral national industrial policies that favor domestic suppliers in attempts to onshore or "friendshore" procurement in critical industries, such as tech (semiconductors), energy, pharmaceuticals, defense, among others. All of this amplifies the inflationary pressures we are experiencing today, which will likely persist into 2023 (Top Risks 2023 #4 Inflation Shockwaves).

Free and unfettered globalization is now being reshaped by national security priorities. The new paradigm for the global economy is defined by:

High levels of interdependence between societies and markets achieved through 30 years of economic integration, causing both enormous economic growth and vulnerabilities.

Heightened **geopolitical competition** and polarization amongst countries, driving a G-Zero world, characterized by a vacuum in global governance.

The **primary area where geopolitical competition resides is in the economic sphere,** centered on the race for technological supremacy.

Companies are important players in this geopolitical arena.

From a corporate perspective, the world has seemed flat for a considerable time. It may be tempting to assume a continuation of this trajectory, but we should remember the history of the last 30 years. The fall of the Soviet Union allowed for the integration of the Russian industrial machine into the global system of trade, providing cheap energy and commodities. A decade later, China entered the World Trade Organization (WTO), giving the world a competitive labor force and manufacturing capability.

Despite this path towards integration, many counter trends were simmering in the background, including the rise of middle powers challenging the status quo. These trends developed and became exacerbated by recent events like the war in Ukraine and the impacts of Covid. As a result, new supply chains are now being created while old ones are being diverted. The transition to a new model will be costly and last years, at least until new industrial plants in burgeoning industries come online and new economies of scale are generated.

To steer their companies in this new environment, leaders need to reexamine outdated business models. Most C-suite executives today have only known a post-Cold War economy characterized by trade liberalization and economic integration.

Many of the challenges confronting global businesses, such as trade barriers, fragmented regulatory regimes, access to key technologies as well as supply chains disruptions, are all driven by this new model of globalization. **Understanding how national security is shaping the new model and assessing the impact of politics on business objectives is now necessary to help seize opportunities and avoid risks.**

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Trends driving the future of globalization

As a starting point, business leaders should identify and monitor the key drivers that are shaping the new global economic paradigm. At the high-level, these are:

End of the peace dividend and ripple effects of the war in Ukraine

The war in Ukraine is among the most important geopolitical events of the last 30 years. It marks the end of the European peace dividend, and its ripple effects will likely last for decades. Eurasia Group warns that "the potential for mutually assured destruction because of accidents and miscalculation will be higher in 2023 than at any time since the Cuban missile crisis in 1962. And unlike the height of the Cold War, Putin has no way to climb down or return to a pre-war status quo" (Top Risks 2023 #1 Rogue Russia). On a macro level, Russia's relations with the United States (US) and Europe are severely damaged and are unlikely to return to normality for a very long time. NATO and its allies are exorcising Russia out of the global trading system and shutting off major investment channels, effectively delinking the world's 11th largest economy and a critical exporter of commodities like food and energy from industrialized democracies. The crisis is exacerbating already high energy prices, inflation, and supply chains disruptions. It has caused the largest refugee surge into Organization for Economic Cooperation and Development (OECD) countries since World War II. The risk of cyberattacks is growing, as is the risk of asymmetric attacks against NATO allies. Global military expenditure has surpassed $2 trillion per year for the first time in 2021 and continues to rise. Most alarming, a food crisis is looming for some of the world's most vulnerable nations. Inequality is growing and for the first time in 20 years poverty is on the rise. The World Bank is sounding the alarm on low global growth prospects and even the risk of stagflation (See Bottom Line #2).

As the war continues into 2023, with no signs of a resolution in sight, Western allies plan to maintain sanctions and export controls on Russia and remain broadly aligned in staunch support of Ukraine. Businesses will be forced to manage ongoing and complex additional restrictions, highlighting the critical need for due diligence and compliance structures. This will likely increase operating costs and hamper efficiency. **Sanctions, ongoing high commodity prices and reputational damage are therefore among the main challenges facing companies operating in foreign jurisdictions in 2023.** A tail risk to watch, driven by the developments in Russia and Ukraine, is Iran (Top Risks 2023 #5 Iran in a Corner). Eurasia Group warns that domestic repression, nuclear advances, and involvement in Ukraine will combine to increase the risk of confrontation with Iran this year, either through a direct conflict in the region - Israel's new government policy will be an important watchpoint - or through proxy wars and terrorist activities. Despite limited market attention, North Korea – another rogue state – could also increase tensions through renewed missile testing in 2023.

West vs Rest strategic competition

Beyond its considerable humanitarian and economic toll, the war in Ukraine has also increased divisions between the industrialized democracies of the West and the middle powers of many emerging markets, often referred to as the global South. Russia has weaponized its energy, raw materials, and food exports in order to disrupt European unity and elicit anti-Western sentiment in these developing countries, many of whom declined to participate in US-led sanctions against Russia. These middle and emerging countries are becoming increasingly important actors in global politics and are calling for reforms of the current international order, which they often perceive as serving primarily Western interests. Amid ongoing strategic competition in a multi-polar world and the war in Ukraine, Western industrialized democracies are closer than at any point in recent history. But many countries outside that affiliation see it in their best interest to maintain neutrality.

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Alternative economic cooperation frameworks such as the BRICS (initially a group of emerging economies: Brazil, Russia, India, China, and South Africa) and the Shanghai Cooperation Organization (a political, economic, and security bloc of Eurasian states) are gathering steam with new players looking to engage, for example: Turkey, Iran, oil-rich Gulf states, as well as states in Asia and Africa. These same players are also exploring alternatives to the dominance of the American dollar in global commerce.

The risk for business is that we may end 2023 in a deeper competition between the "West and the Rest" that can further depress global economic growth, especially if decoupling extends beyond a few critical sectors. Despite efforts by both China and the US to reduce their interdependence, the two economies are deeply intertwined and, absent a major political miscalculation on either side, may remain so for the foreseeable future. Eurasia Group discounts the risk of a near-term military conflict as it would likely guarantee mutually assured economic destruction (Top Risks 2023 *Red Herrings) at a time when both countries have domestic issues to tackle. In this context, a possible positive "grey swan" event for 2023 could be a partial relaxation of tension between the West and China. This may not immediately bring unalloyed trust into a fraught relationship, but it could be a pivot to a revival of effective global governance based on pragmatism.

Demographic challenges in key economic hubs

For the first time since 1950, the world's population is set to decline over the next few decades. This creates another challenge to the globalization model — and its prosperity — as it relies on a growing population to continuously invest and drive growth. As the baby boomers retire this decade, many populations may not have sufficient Gen X and millennials to replace them without triggering labor shortages. Globally, more than 1 billion people will be aged over 65 in 2030 with 210 million aged over 80, about double the numbers in 2010. Ageing populations in key manufacturing hubs (China, Germany, Italy, Japan, etc.) will likely add to inflation and limit available investment capital.

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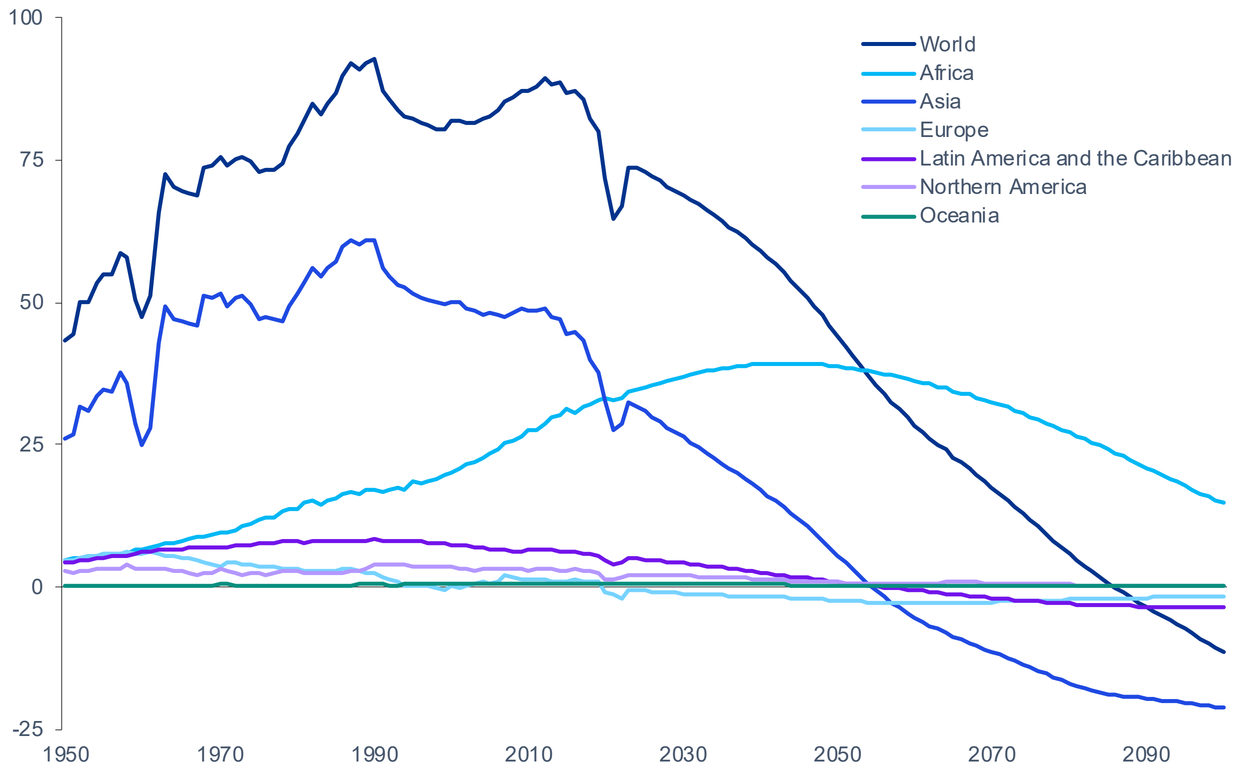
On the other hand, India is expected to provide more than one-sixth of the growth in global working population (age15-64) between now and 2050. By April 2023, the United Nations (UN) expects India to surpass China as the most populous country on Earth. Looking ahead, the bulk of global population growth in 2050 and beyond will be concentrated in Africa, with rapid growth constituting both an opportunity and a threat to its development objectives. If new production centers are successfully established, it could exponentially increase growth and development in the region. Alternatively, mass migration to ageing countries may heighten the risk of political and social unrest. In sum, **demographic trends will likely become a key element of business success, both in terms of talent resourcing and location strategy for future investments and market expansion.**



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Industrial policies informed by national security goals increase protectionism

Several countries are using industrial policies and subsidies to accelerate the shift of supply chains away from geopolitical rivals, as well as harsh investment screening and export controls to keep critical resources out of hostile hands. The result is a ramping up of trade and investment barriers. The UN reports a sharp increase in subsidies among G7 countries, from 0.6 percent of GDP in 2016, on average, to 2 percent in 2020. More than 100 countries (over 90 percent of world GDP) have implemented industrial policies to influence the market. For example:

- The European Union (EU) is implementing a generous COVID recovery package, with more than $850 billion in spending, including business subsidies.
- China looks to pursue self-sufficiency in energy, food, and technology as part of its dual circulation strategy.
- In the US, subsidies in the Inflation Reduction Act (IRA) amount to $465 billion for green energy, electric cars, and semiconductor industries, with much of it conditional upon domestic manufacturing.
- $371 billion have been earmarked for the semiconductor industry over the next decade in the seven most generous jurisdictions, including the US, China, the EU, India, Japan, South Korea, and Taiwan.
- India is providing up to $26 billion of production-linked incentives over five years for domestic firms in 14 priority sectors.
- Since 2020, Indonesia has banned the export of nickel to encourage battery manufacturing at home.
- Australia and Canada are dishing out billions of dollars to boost mining and processing of critical ores.
- The EU's proposal for a Directive on corporate sustainability due diligence is likely to go before the European Parliament and the European Council this year. It would apply to firms with 500 employees or more and annual sales of €150 million and it would demand to scrutinize human rights, environmental and labor standards across the entirety of their supply chains and ensure their business (and suppliers) is compatible with European standards.

This points to another risk for business in 2023 being the proliferation of unilateral policies across major economies, resulting in a tit-for-tat escalation that could upend the international system of trade and investment at a time when multilateral trade institutions are particularly vulnerable. In such a zero-sum scenario, there will be winners and losers based on control of critical resources.

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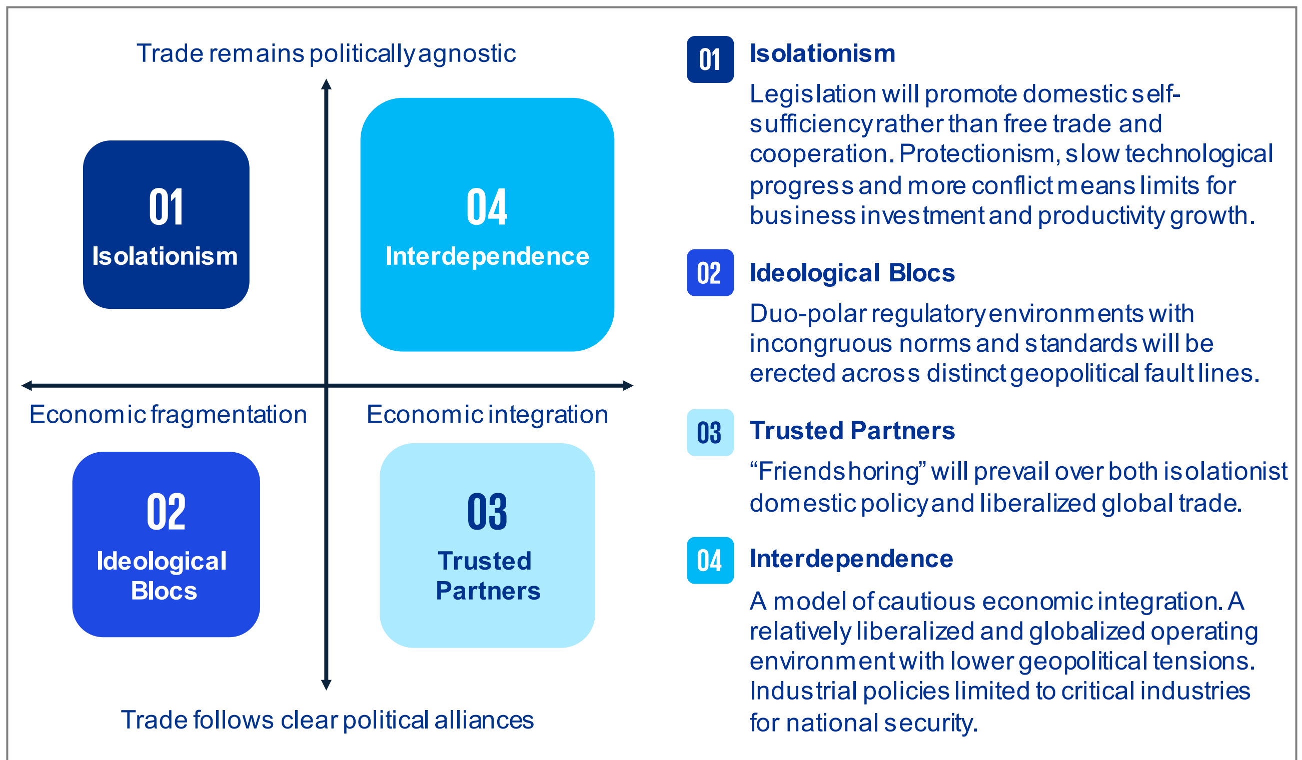
Mapping future globalization scenarios

Having considered the geopolitical drivers of the economic environment, businesses should map and stress-test possible future scenarios for globalization as they apply to their sector, operations, and strategy. Four likely scenarios are:



The picture painted in Top Risks 2023 hints at a movement from a model of interdependence towards either a "trusted partners" or an "ideological blocs" scenario, with the signposts highlighted above influencing the future direction of travel.

What can you do?

Make supply chains resilient and seamless

In 2023, geopolitics and shifting globalization will likely make supply chain management a key concern at the board level. Our Global Operations Center warns that nations may be skeptical about cross-border trade cooperation; cyber criminals will ramp up activity; there will be key material access turmoil; manufacturing footprints will change shape; retail and distribution supply chains may morph rapidly; supply chain technology investments will likely accelerate; and on the Environment Social Governance (ESG) front, scope 3 emissions will likely be scrutinized – notably, by investors and regulators in addition to the environmentally conscious consumer.

- **Capability:** A mature supply chain planning capability remaining one step ahead and ready to tackle supply chain risks and opportunities
- **Agility:** Making sure your supply chain is responsive and agile to manage the unexpected, and to deal with these threats and disruptions appropriately, efficiently, and profitably
- **End-to-end forward-looking visibility:** Having 'control tower' visibility on key real-time indicators; being able to maneuver your supply chain beyond your own business borders; and building real-time collaboration with your ecosystem of supply chain partners will likely be critical – all done using digital capabilities. The ultimate goal is to enhance collaboration across the supply chain eco-system. KPMG has developed an approach in KPMG Origins that helps global trading partners codify trust while enabling more streamlined interactions across organizations and borders

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Streamline trade compliance in a fragmenting world

Many global trade functions struggle to keep up with the increasingly complex operational tasks required to keep international supply chains flowing. As national security, regulations, and industrial policies increase the burden of compliance, companies may find value in outsourcing the high-touch transactional work that characterizes modern trade operations. Accessing free trade agreements, monitoring import declarations, resolving export sanction hits, and having a knowledgeable representative when cooperating with government entities.

Appoint a Chief Geopolitical Officer (CGO)

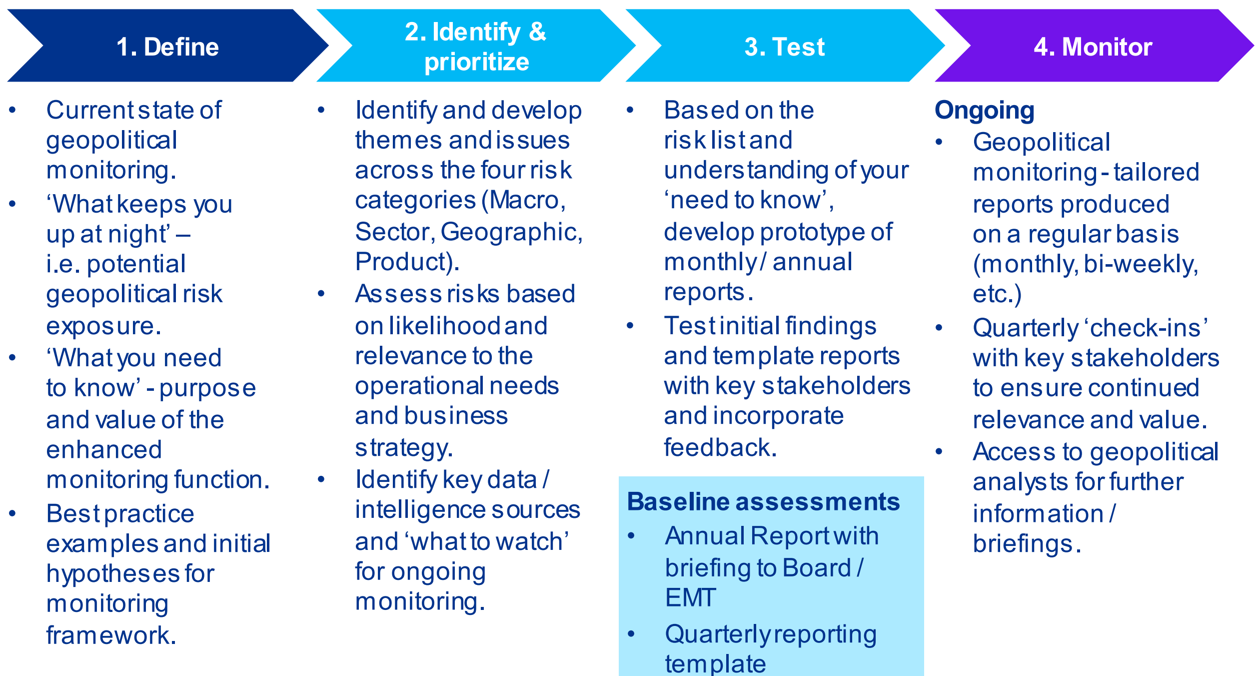
A CGO is a member of the senior leadership team with single-point accountability for managing the impact of politics on the company's business interests. They work closely with functional experts (corporate affairs, risk management, sustainability teams) and other executive portfolios to maintain a whole-of-company view.

Conduct a geopolitical stress test

Getting a handle on current levels of activity and exposure to geopolitical developments is an important building block, especially if this hasn't been a subject of active thought for the C-suite and the board. One way to do this is to conduct a geopolitical stress test on the strategy and planned initiatives. A CEO could take their company's 3-year business plan and model future scenarios (individually or collectively) to get an idea of their exposure and resilience.

Implement a geopolitical risk assessment, forecasting and monitoring solution

For companies that truly want to feel they have a handle on geopolitical risk, they should go beyond relying on mass media for information and invest in specialized geopolitical forecasting and monitoring capabilities that focus on the politics that really matter to the organization. There are tools (including DRA) available to help companies navigate this landscape with support from specialized teams of political analysts focused on covering politics in real-time and the expertise to translate those into business implications.



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02

Productivity, efficiency, and ESG: A strategy for troubled economic times

Productivity, efficiency, and ESG: A strategy for troubled economic times

Both Eurasia Group's report and the DRA (page 1) show a self-evident yet critical bottom line: the current "polycrisis" and the ensuing geopolitical recession are deteriorating economic conditions, mainly through historically high inflation and unravelling years of global advancements. The IMF highlights that the cost-of-living crisis, tightening financial conditions in most regions, the Russian government's invasion of Ukraine, and the lingering COVID-19 pandemic all weigh heavily on the global economic outlook. Global growth is projected to fall from an estimated 3.4 percent in 2022 to 2.9 percent in 2023, then rise to 3.1 percent in 2024. The forecast for 2023 is 0.2 percentage point higher than predicted in the October 2022 World Economic Outlook (WEO) but below the historical (2000–19) average of 3.8 percent. From a business lens, our CEO Outlook shows that 86 percent of leaders believe we are entering a recession over the next 12 months. As a silver lining, the data on resilience hints at some cautious optimism. 76 percent of CEOs interviewed said they have planned for a recession, and 20 percent are boosting measures to adapt to geopolitical issues as a key strategy in the next 3 years. In short, despite challenging times ahead, 71 percent of CEOs have a renewed sense of global economic confidence over the next 3 years. In order to capitalize on this optimism, four interlinked issues should dominate conversations at the board level: **stagflation, energy and food crisis, cost of living crisis and inequality, and the future of ESG**. All will be impacted by geopolitics, particularly by "*China's economic rebound post-zero covid and Europe's painful transition to living without Russian energy" (Top Risks #4 Inflation Shockwaves).* Monitoring and managing these macro-trends will likely be key to building business resilience in 2023 and beyond.

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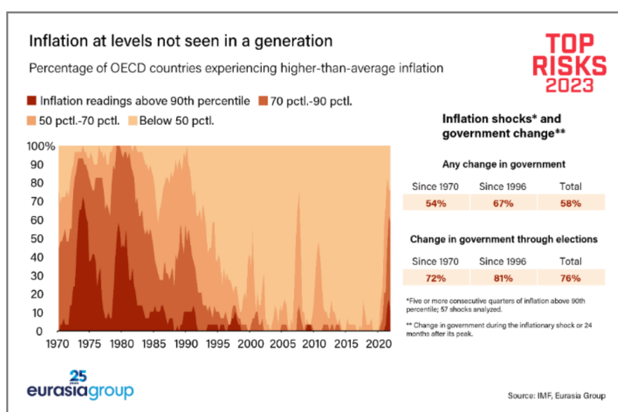
Stagflation

In 2023, persistent inflation and dampening demand could trigger the stagflation trap. An ugly situation not faced since the 1970s. The signpost to watch will be the central banks' balancing act between tightening monetary policy to keep inflation at bay, while avoiding a permanent depression of global demand and investment growth. This may be very tricky, especially if the supply side causes of inflation persist – i.e., supply chain disruptions, demographic challenges, impact of the war in Ukraine on critical commodities. As such, business leaders may face two types of profit margin erosion:



01 **High input and operational costs such as energy, raw material, and labor.** Stubborn inflation can act as a tax on everything business does, including future investment. Companies with sophisticated supply chains might have to spend more on beefing up inventory just to avoid supply shortages and maintain a certain level of output.

02 **Weakening demand.** This will vary between markets and sectors depending on a) the intensity of the economic shock on consumer confidence; b) the essential nature of a particular industry; c) the effectiveness of fiscal policy intervention; and d) governments' ability to boost public expenditure. Even if governments in Europe are spending heavily to soften the energy shock, demand may still weaken as households lose purchasing power amid structural challenges. In America, stubbornly high interest rates could also start taking a toll on the global economy.

Businesses have a few mitigation options:

Reduce costs through efficiency and productivity gains.

Harnessing new technologies can help (see Bottom Line #3), as can supply chain restructuring to circumvent shortages and soaring input costs. For example, companies in Europe that are struggling with high energy costs (i.e., chemicals and heavy industries) – especially those in countries traditionally over-reliant on Russian gas – are already shifting manufacturing to less impacted locations.

Pass cost increases on to consumers

Companies with high pricing power and strong brand recognition may be well placed. Either because they sell essential goods with inelastic demand or because consumers trust and buy into their brand narrative. Another reason why a genuine ESG strategy will be essential in 2023. Yet leaders should be wary of a tipping point in price hikes, beyond which customers will shift to cheaper substitutes.

Adjust wages

Leaders will likely face mounting pressure to increase wages to offset the cost-of living crisis at a time when market conditions are getting tougher and lay-offs might become necessary. Finding the right balance between talent retention, fair compensation and driving efficiency gains will be a major challenge this year.

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Energy and food crisis

Energy and food remain the main drivers of inflation. The Russian government's war in Ukraine and the risk of further instability from Moscow in 2023 will continue to cause disruptions and, in turn, broader economic woes. **Absent a durable solution to the conflict, the reshaping of global food and energy supply chains will be an important signpost for business leaders to gauge the intensity and duration of the looming economic crisis.** Geography will matter too. Countries and territories able to ensure energy and food self-sufficiency can thrive. Those who manage to secure reliable external supplies can survive. And the rest will likely struggle.

Eurasia Group expects the energy crisis to deepen in the second half of 2023, particularly in Europe. Their forecast shows Russian energy flows to Europe dwindling even further under the combined effect of sanctions, oil boycotts, and shipping restrictions. Russia may retaliate by cutting remaining gas supplies and rerouting to Asia, who is likely to increase demand (led by a rebounding Chinese economy). Winter could drain Europe's gas stocks and expensive liquefied natural gas (LNG) imports may not be enough to absorb the shock. New LNG regasification terminals will likely open in Europe, but they may compete with growing demand in Asia, potentially keeping oil and gas prices high.

As many nations look for energy stability, they are temporarily shelving decarbonization goals, thus exposing the essential role fossil fuels still play in powering the global economy. Even before the war in Ukraine, fossil fuels constituted 80 percent of total energy supply with renewables accounting only for 3 percent (graphic below)[1]. Tensions between the developed and the developing world caused by the scramble for energy might also weaken climate policy. Requests from emerging markets for financial support and damage compensation from climate adaptation and extreme weather events may fall on deaf ears as developed countries focus on domestic energy needs to the detriment of international cooperation.

Against this background, the world may necessitate a much steeper decarbonization curve in the medium to long term to attain net zero by 2050. Absent technological breakthroughs, demand reduction, energy efficiency programs or a radical change to our growth-based economic model, this is likely to cause significant shocks.

"The respite in energy markets will be temporary — the eye of the hurricane before a renewed energy crunch adds to pressure on consumers, puts fiscal strain on governments, and deepens divides between developed and developing nations and the United States and Gulf countries."

Renewables, and especially solar power, will likely see growing demand in 2023. The same is true for hydroelectricity and nuclear, even as water shortages will hamper their full potential. France is poised to open new next-generation nuclear power stations; China plans to launch an experimental fast-reactor and South Korea and Germany will likely drop plans to close existing plants. Hydrogen continues to attract attention, even if commercial scale use is still a few years' away.

The energy transition will be complicated by geopolitical factors. Pursuing a clean energy revolution in the age of strategic competition among nations, will mean dealing with more complex and critical supply chains. Countries may scramble for huge quantities of rare earths, copper, cobalt, chromium, lithium, nickel, graphite, silicon, zinc, and more.

[1]IEA 2022; World total energy supply by source, https://www.iea.org/reports/key-world-energy-statistics-2021/supply, License: CC BY 4.0

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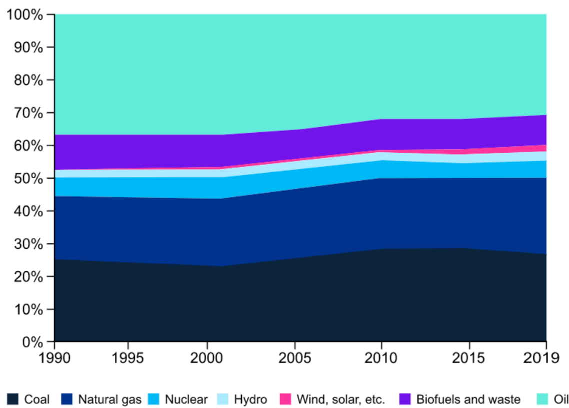
IEA Database: Total energy supply (TES) by source, World 1990-2019



And the necessary quantities for a green transition will only be available if we combine supplies from a wide array of disparate suppliers, including those less strategically or politically aligned. Without serious efforts in energy efficiency, circular economy, and overall energy demand optimization, the task may be herculean.

Energy, climate change and the ongoing war in Ukraine will also affect critical food supplies in 2023 and beyond. The UN expects an additional 50 million people will face severe hunger, and 19 million more people to face chronic undernourishment in 2023. Domestic food inflation in more than 60 countries is reportedly 15 percent higher year on year, and about 60 percent of low-income countries find themselves in, or at high risk of, debt distress.

Agricultural output will be affected by a lack of fertilizers given Russian supply shocks, high energy prices, and the effect of massive droughts in 2022. Critical grain exports from Ukraine are particularly vulnerable as Russia might reinstate blockades to pursue military goals. Net food importers will be exposed as governments will be encouraged to impose food export restrictions. For example, Indonesia announced export restrictions on palm oil to boost its domestic use for biofuel. As they account for 50 percent of global production, the measure is likely to shoot up prices of what is traditionally the cheapest edible oil in the region for importers such as Malaysia, India, Vietnam, and Pakistan. More protests like those seen in Sri Lanka last year might erupt. The hope is that supply chains and consumer preferences can shift fast enough. Switching from sunflower oil to other vegetable oils or from wheat to millet, for example, could help in building resilience.

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Cost of living crisis and inequality

The perfect storm described above of tight financial conditions, persistent inflation, global energy and food crunch will hit households' budget hard and, if things deteriorate, they will escalate a cost-of living crisis which is already the number one risk in this year's World Economic Forum (WEF) Global Risks Report.

Eurasia Group depicts a potentially catastrophic scenario *(Top Risks #4 Inflation Shockwaves, and #7 Arrested Global Development):*

- A reduction in investment risk appetite that will drive capital out of emerging markets and into the US.
- A possible financial crisis that will be mismanaged because of lack of global policy coordination.
- Debt defaults in several countries, which would further weaken global growth, fueling already mounting inequality and, in turn, social unrest and disruptive politics.
- A contracting global middle class and a reverse in development progress with tens of millions of people on the verge of disaster without a safety net.

The ongoing cost-of-living crisis will spur demands from populations to national governments and business leaders to address socioeconomic challenges. Business leaders will have to solve mounting compensation issues, with the risk of strikes and reputational problems increasing. Protests are already sprouting up (see graph below). For businesses, protests in liberal democracies are an accepted form of political speech and an important social safety valve.

In more autocratic jurisdictions, protests can be more problematic and escalate into broader political disruption and repression. This would increase volatility and disruption in the business operating environment, especially as economic conditions continue to disappoint.

If a recession does occur, a softening labor market will also make talent acquisition and retention difficult, just as our biggest working generation, the baby boomers, retires. Real wages are falling in many countries - Brazil, Italy, the Netherlands, Spain, the UK, and the US to name a few. Companies should prioritize equity and transparency in their approach to compensation; in cases of binding budget constraints, offering additional flexibility or benefits and a greater degree of responsiveness may help to maximize cohesion.

Conversely, a rosier scenario could eventuate in countries where labor remains strong, the post-pandemic spending spree continues – especially in sectors like travel and (revenge) tourism – and governments are able to help households with energy bills and other spiraling expenses. **The cost-of-living situation would improve even further in the event of contained or even falling energy prices, particularly in Europe. Another reason why energy policy and the successful implementation of energy transition plans will be a key watchpoint in 2023.**

The global inflation shock will be the principal driver of global recession, add to financial stress, and stoke social discontent and political instability everywhere"

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The future of ESG

The global instability we are experiencing is likely to lead to continued crises, requiring high-level and sophisticated corporate responses. A coherent and comprehensive ESG strategy will be key, even as the future of ESG standards and reporting suffer from growing global fragmentation. How the global order resettles after the conflict in Ukraine could bring about an even more unstable world, with increasing divides between major economies. In that world, new disruptions that interrupt business operations in a similar way are even more likely – and potentially more damaging. Part of the lift for ESG strategists and boards will be to closely track geopolitical shifts and identify new crises as we see the end of the European "peace dividend."

There will be fundamental differences between global companies with more public ESG duties and local companies with more limited ESG expectations. Even today, the pressures weighing on high-profile global operations are not felt equally by smaller businesses, particularly those operating in markets without high ESG accountability. Also, the perceptions and demands of ESG in different regions vary. Encouraging global corporates to accept this differentiated responsibility will be a central determinant for the future of ESG. The ensuing social issues and humanitarian responses, coupled with additional emerging concerns including biodiversity loss, and human rights abuses, create an overlapping and very complicated tinderbox. **One of the major shifts likely for business leaders will be to expand its perspective beyond the Western lens in terms of anticipating where ESG problems will arise.**

In addition, as ESG standards mature, there may be more uncomfortable conversations about regional and cultural expectations for each ESG category – particularly the "S". For local companies only operating in one region or cultural zone, this will be a more limited risk. **For global companies, however, navigating this field will require careful (and conscious) trade-offs. The nuances of this outlook make it even more necessary that functions like corporate affairs, risk management and sustainability teams be included in high-level business decisions. The shifting goalposts for ESG are making it even more difficult for companies to gauge what their reporting requirements will be. The more that disclosure requirements differ between jurisdictions such as the EU and the US, the more expensive and time-consuming they will become.**

What can you do?

Get on top of the ESG game

Organizations may lack the experience, capabilities and skills needed to manage geopolitical risk exposures and anticipate the ESG challenges these can create. Agile governance is key to addressing risks which are not easily quantifiable, increasingly non-linear and with wide-ranging first and second order business impacts. Who in the organization should have the leadership and oversight capabilities and responsibilities in this area? What analytical capabilities do businesses need to anticipate geopolitical risks and their impacts, including on ESG deliberations, and how should these be deployed internally for maximum effect? Answering these questions will be critical towards developing an effective ESG approach. In addition, a coherent ESG strategy should include:

- **ESG landscape:** identify ESG trends and drivers that could impact your business, and how your business compares with direct peers and best in class ESG companies. This helps in deciding where to focus efforts.
- **ESG maturity and ambition assessment:** benchmark ESG maturity against industry frameworks and good market practice.
- **Materiality assessments:** identify ESG risks and opportunities that are material to your business. Options include depth of internal engagement and incorporating external stakeholder views, such as customers, suppliers, lenders, and shareholders to build social license.
- **Develop ESG strategy and strategic options:** focus on long-term value and competitive advantage, outlining strategic options and platforms that could enable access key opportunities and mitigate priority risks.
- **Circular economy practices:** evaluate circular economy targets and ambitions against operating models and performance metrics. Eliminate waste and reduce costs throughout the product lifecycle and across your supply chain.
- **Compelling ESG story communication:** manage stakeholders' expectation and enhance brand perception among customers, employees, lenders, and shareholders.

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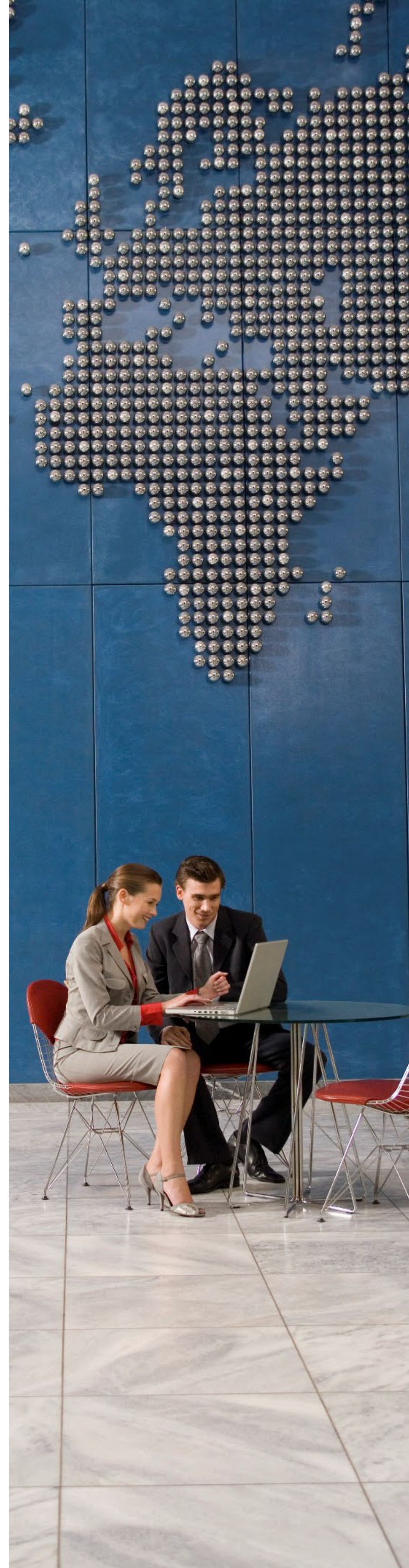
Source and retain talent

There are several steps that firms can take to mitigate the risk of disruption, minimize reputational risk, and retain talent:

- First, firms should ensure that employees and company assets will be **secure in the event of instability.**
- Corporates should draw on the lessons learned in 2020-21 to keep supply chains flexible and resilient in the event of strike-related disruption.
- In wage negotiations, **equity and transparency** are more important than ever. Given the growing set of social expectations that consumers place on executives, management should communicate thoughtfully, openly, and proactively with staff to avert reputational consequences. This is especially true for global brands and multinationals, which may have to navigate different wage-setting conditions across countries.
- When budget constraints are binding, **flexibility and responsiveness may go a long way toward retaining talent.** If firms cannot fully satisfy workers' wage demands, offering other benefits, such as more flexible working times or additional leave, can communicate commitment to staff. Building company culture and providing more intensive feedback and training—particularly for early-career employees and new-joiners— can also help to improve cohesion.

Strategic deals to unlock value amidst high inflation and rising capital cost

- Current market conditions, technological disruption and geopolitically driven economic headwinds make executing deals and value creation more important but also more complex than ever before. What's more, this disruption impacts buyers and sellers in different ways, making the process less clear.
- Against this backdrop, dealmakers should proactively design new investment strategies to focus on value creation and productivity to secure sustainable long-term returns. This could include investing in new verticals to address market change or those that have been turbo-charged by the impact of the pandemic or other geopolitical trends, such as semiconductors, drones, education technology, cyber security, in-home care, medical devices, domestic tourism, green technologies, radiology, and hybrid work-related businesses, to name a few.
- With a broader range of opportunities but also risks at stake, new imperatives to grow and a competitive deal environment, it's important to both sides of every transaction to leverage big data and advanced analytics. This helps reduce risk, empowers teams to develop more informed strategies and builds competitive advantage.
- When contextualized by the right sector, market and geographical insight, advanced analytics may also provide deal practitioners with the right intelligence at the right time -- despite limited information from sellers or bidders. Early in the deal process, the right data and analytics tools can help with the workflow and analysis, which includes framing ideas, investment hypotheses and anticipating likely bidders' thinking.
- A political risk due diligence exercise could also complement traditional commercial due diligence efforts. At a minimum, dealmakers should be able to answer three questions: how will political uncertainty impact core financial assumptions? What political risks might jeopardize ability to realize future revenue and income? And what underlying political assumptions are necessary for a business plan's success?



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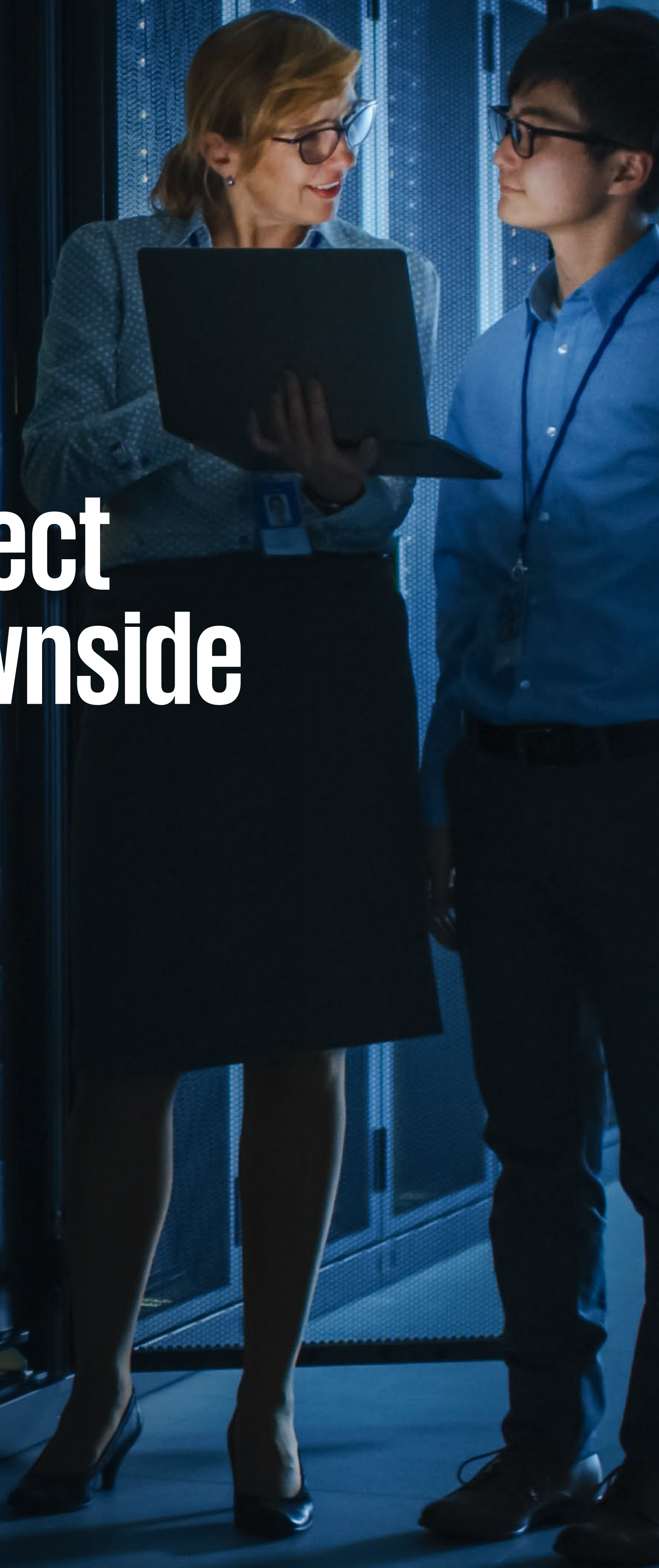
03

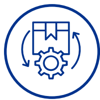
Tech is key: Harness the upside, protect from the downside



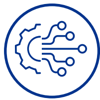
Tech is key: Harness the upside, protect from the downside

Throughout history, the main sources of permanent productivity gains have been achieved via technological breakthroughs. Today we find ourselves on the cusp of an advanced robotics and AI revolution that may very well provide a much-needed boost to the global economy and usher in a Fourth Industrial Revolution. In an ideal world, this technology would be a panacea for developing approaches to global goals of creating a cleaner, safer, and more inclusive world. However, countries and territories are locked in geopolitical competition, with the actors that previously facilitated globalization now accelerating its contraction by prioritizing strategic resilience and national security aims (*see Bottom Line 1*). This competition is felt acutely in the advanced technology sector.

The proliferation of technology policy frameworks that bring like-minded governments closer but, at the same time, deepen the geopolitical chasm between industrialized democracies in the allied West and the "rest":



The US-led **Chip 4 alliance**—a "democratic semiconductor supply chain"— has engaged Japan, South Korea, and Taiwan in building shared semiconductor manufacturing links across the region, based on trade and national security grounds.



The **US-EU Trade and Technology Council (TTC)** plans to cooperate on the development and deployment of new technologies based on shared democratic values, including respect for human rights, that encourage compatible standards and regulations, across the two members. The pact explicitly mentions in its mandate, the importance of "building a shared understanding of China's economic and industrial directives and other non-market policies and practices."

Western and Chinese tech firms are competing in Africa and other emerging markets for technological influence.

As a result, companies are feeling the push to shelter operations from geopolitical competition. Many are voluntarily decoupling from foreign suppliers to pre-empt further restrictions down the road. Firms should take a long-term view on anticipating some of these upcoming regulatory actions and determine whether a strategic shift in operational footprint or data storage practices are preferable to the headaches associated with navigating a geopolitical storm. As tit-for-tat regulations on advanced technology and data sharing between countries accelerate, it will be necessary for companies to stay abreast of regulatory developments in their sector and regions.

Whereas last year's Top Risks report sounded the alarm on rising tech giants and their inherent disincentives to serving the public good, this year's challenge will be for global businesses to implement advanced tech responsibly and harness its potential without falling prey to its sabotaging pitfalls.

The Proliferation of AI can have profound implications beyond politics, too. Companies in every sector contend with new reputational risks when key executives or accounts are impersonated with malicious intent, triggering public relations scandals and even stock selloffs"

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Harnessing

With capital costs increasing and emerging markets offering more uncertain growth prospects (see above), it may be tempting for businesses to retreat into excessive caution. Forward looking tech investment can be hard to swallow given the costs, time-resource commitment, and the non-tangible nature of its ROI calculus. But this approach risks overlooking a once-in-a-generation opportunity to be at the frontier of channeling major tech advancements into significant productivity gains. Tech has already proved a game-changer in many sectors, for example:

Healthcare

The Internet of Medical Things (IoMT) is a collection of medical devices and applications communicating with healthcare information technology systems via online computer networks. Healthcare providers can leverage IoMT to be used for screening, diagnosis, and treatment through referral and follow-up pathways, sparking a digital transformation for patients and providers.

Industrial manufacturing

Large-scale manufacturers have increased productive efficiency and quality performance by leveraging big data and advanced visual inspection technology to upgrade manufacturing processes.

Sustainability

In attempts to achieve corporate sustainability goals and reduce emissions, multinationals can deploy machine learning optimization through digital representation of energy management systems to realize their ambitions. Clean technology can be essential to lower the cost of low emission energy and help solve the sustainability versus reliability/ supply abundance conundrum.

Indeed, private sector initiatives addressing climate change through innovative tech may prove the most effective avenue to actuating change at a time when international, multi-lateral dialogue has stalled.

To potentially benefit from these advancements, managers and executives should embrace change and welcome tech innovation across all business functions, understanding that value added by digital transformation goes beyond traditional cost benefit analysis and includes what the risks of inaction may bring in the market. Corporate decision-makers should understand the process for how AI is developed and deployed. What are the most critical AI systems and processes the company has deployed? To what extent is bias—conscious or unconscious—built into the strategy, development, algorithms, deployment, and outcomes of AI-enabled processes?

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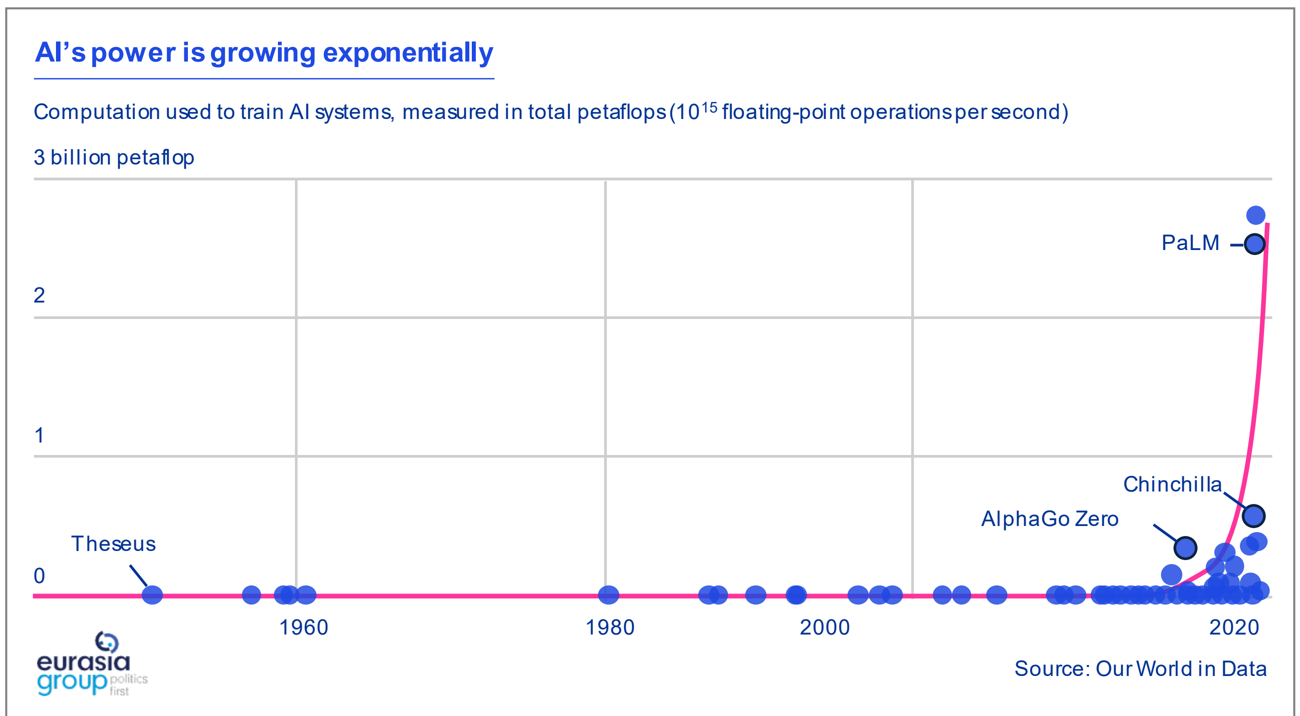
Protecting

On the flip side, harnessing new technology means also shielding its potentially negative impacts to business. Cybersecurity threats are dynamic, and its related impacts continue to intensify. The acceleration of AI and digital strategies, the increasing sophistication of hacking and ransomware attacks, and the lack of definition for lines of responsibility—among users, companies, vendors, and government agencies—have elevated cybersecurity's place on board and committee agendas. Boards have made strides in monitoring enterprise-wide cybersecurity effectiveness. From a budget standpoint, organizations in the US and Europe have considerably upped their cybersecurity spend in the last few years. Other efforts include company and business-line-specific dashboard reporting to highlight and prioritize critical risks, vulnerabilities, and threats; war-gaming breach and response scenarios; and discussions with management on the findings of ongoing third-party risk assessments of the company's cybersecurity program. Despite these efforts, the growing sophistication of cyberattacks and the complexity of cyber risk management point to the continued challenges ahead.

An important step business leaders should take in maintaining cyber resilience is ramping up data management capabilities and reshaping where cyber risks fit – once a standalone responsibility – under the larger umbrella of data governance.

Managing the tension between how the company may use customer data in a legally permissible way and customer expectations as to how their data will be used will also be focal point as reputation and trust risks abound in this area. Failing to preserve digital trust can have detrimental repercussions, financially, reputationally, legally and more.

Further complicating things, is the ability to co-opt advanced technology for nefarious use with equal effectiveness and ease by powerful autocratic regimes and rogue individual actors alike. Nation-states are no longer alone at the wheel of disruption these days. We have already seen the impact of misinformation campaigns flooding political discourse with manipulative content indistinguishable from legitimate sources. Generative AI and machine learning can equip less sophisticated operations and motivated individuals with huge disruptive power. From a business perspective, the diffusion of tech might make it difficult to identify sabotage attempts with significant consequences. Eurasia Group warns that "citizen activists, trolls, and anyone in-between will be able to cause corporate crises by generating large enough volumes of high-quality tweets, product reviews, online comments, and letters to executives to simulate mass movements in public opinion."



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What can you do?

Invest in a cybersecurity strategy

Enhance cybersecurity risk quantification.

According to the most recent Cyber Trust Insights survey, only 58 percent of companies describe their approach to quantifying cyber risks as 'robust' and that their cyber risk scenarios are adequately tailored to meet business needs. To address this, careful modelling and quantification work can help decision-makers understand the organization's true level of cyber risk exposure. This can help management understand which controls contribute most to reducing certain cyber exposures — and, therefore, helps ensure they are focusing their resources in the areas of greatest return. KPMG's Cyber Security Services practices bring a broad-ranging, business-operations perspective to cyber services. KPMG firms can help you maintain your information protection agenda as your business and technology programs evolve by providing greater visibility and understanding of changing risks

Embrace "secure by design" principles

In the digital age, security, trust, and resilience are inseparable. Businesses cannot achieve one without the others. That's why "secure by design" is a critical element of many successful digital transformations. At its heart, "secure by design" is about embedding security through every aspect of technology development, from architecture to design to implementation. This approach helps enhance the overall security of systems, products, and services while also reducing overall costs, as companies do not need to layer on new technology later that was not contemplated up-front. It also ensures security is not approached as a one-and-done capability. Only by making security part of the core organizational DNA can enterprises stay ahead of ever evolving cyberattacks.

Address the human factor in cyber security

Although advances in artificial intelligence, quantum computing, and other emerging technology areas are enabling the next generation of cyber security products, no technology offers complete cyber protection. In our globally connected world, people are the starting point of the vast majority of breaches. Massive digitization of customer channels and working models has created even more potential vulnerabilities through employees, partners, and customers. The good news is that enterprises can take simple steps to enhance cyber defenses without massive investments in broader suites of technology-based security solutions. This includes ramping up identification, access, and authentication capabilities and training of employees on their key role in creating a safe, secure digital environment

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Invest in public-private security partnerships

Traditional cyber defenses may capably defend against lone hacker attacks. However, a different profile of cyberattacker is growing in influence. Today, sophisticated organizations and rogue individuals both pose an increasing risk to businesses of all kinds. Public-private collaboration will be crucial to defending against emerging threats. According to the KPMG 2022 cyber report, Mission: Trust. How to unlock the true value of the CISO, almost half of respondents (44 percent) maintain that cyber security collaborations between technology providers, employees, customers, suppliers, and partners help anticipate attacks.

Transition to digital transformation

Become a connected enterprise to meet and exceed customer expectations

Customer centricity starts from within. After all, customer interactions often require contributions from several departments. A lack of alignment between functions and systems can hinder the ability to deliver smooth customer experiences.

Use cloud as a tool to reach ESG ambitions

As ESG climbs the corporate agenda, we can expect it to play a more influential role in digital strategy. A future next step for businesses that have already embraced cloud as a foundation is to use the technology to improve visibility into ESG metrics and goals. According to the 2022 KPMG Digital to the Core survey report, almost 27 percent of respondents say that advancing their ESG commitments/priorities is a key driver of their digital transformation investments. Look to cloud technologies to help quantify and track progress around ESG responsibilities such as reducing carbon footprint and improving sustainability. More than one in five respondents already consider ESG-related improvements a top three benefit of cloud in their enterprise.

Give the workforce a boost with intelligent automation

The next rising star in the technology function could be a bot. By using automation to shoulder the burden of repetitive tasks, existing staff can be upskilled to deliver other knowledge-based skills that are in high demand but short supply.

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About the KPMG and Eurasia Group Alliance

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

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

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

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

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

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

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