The year of the pandemic: Covid-19, geopolitics, and the risks ahead for multinationals

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Executive Summary

The twin crises of Covid-19 and a deteriorating US-China relationship have made 2020 one of the most turbulent years in recent memory, raising new risks for firms with a global presence and international supply chains. But while recent geopolitical instability will force businesses to adjust their plans for the future, in most sectors the pandemic will primarily accelerate existing structural risks rather than introduce radically new issues. Eurasia Group has prepared this white paper for Reed Smith to outline top risks in key areas affected by the pandemic and frame how firms should think about Covid-19's impact on longstanding trends.

The pandemic is straining governments worldwide, heightening social and political tensions as unprecedented economic shutdowns raise new challenges for policy-makers and business executives alike. In the United States, Covid-19 and supercharged political polarization raise the risk of the 2020 presidential election being delegitimized in the eyes of voters. Meanwhile, the Trump administration is pursuing an increasingly disruptive escalation with China. Likewise, strained cooperation in Europe will prevent a stronger response to the pandemic, although the crisis has led to the creation of an historic recovery fund and provided a platform for key EU leaders to shore up domestic support that was weakening before Covid-19.

Amid these geopolitical and public health challenges, governments' responses to the pandemic are creating winners and losers in the private sector. Some firms are receiving bailouts and preferential treatment to weather Covid-19's impact, while others face disruption from government action to re-shore supply chains on national security grounds in addition to the steep costs of economic shutdowns. In the energy, entertainment, and transportation industries, a drop in consumer demand and a dearth of government assistance will accelerate simmering risks. Conversely, the healthcare and tech industries stand to benefit to a greater extent from pandemic stimulus but may face challenges related to reshoring initiatives and heightened US-China tensions. Covid-19 will also hasten the transition to a more fully digital economy for financial institutions.

In summary, Covid-19 will force all businesses to recalibrate their business models to the "new normal," although some industries will experience more disruption than others. Government policy will increasingly save or sacrifice firms—while governments themselves confront unprecedented geopolitical and economic instability that will certainly persist beyond 2020.

The pandemic is accelerating structural risks as geopolitical tensions crest

2020 has thus far proven to be one of the most eventful years for geopolitics in recent memory. The Covid-19 pandemic and unexpected escalation of tensions between major powers have forced global firms to adjust their strategy to cope with a more turbulent world. In many sectors, however, the onset of the pandemic has not marked a radical departure from longstanding trends. Rather than an inflection point, for most industries, Eurasia Group views Covid-19 as an accelerant of existing structural risks.

Around the world, the crisis is deepening long-standing governance issues and supercharging already-inflamed political tensions. Similarly, government-imposed economic slowdowns and inflexible public health conditions are making once-distant risks seem more immediate for policy makers and business executives alike.

Eurasia Group has assembled this paper for Reed Smith to outline the central issues that firms should consider when working to understand how 2020's multiple crises will affect their operations over the medium term. Key themes include concerns surrounding the US presidential election, the EU's struggle to maintain unity in Europe, intrusive state action in markets in the name of national security, and a serious deterioration in the US-China relationship. More than ever, businesses will need to navigate a constellation of unique risks and opportunities when planning for the future.

US stability and reliability remain a top concern

As the US approaches the 2020 presidential election, faltering social cohesion and political instability remain top risks. The election presents an unusually high potential for interference and delegitimization because of the probable shift to absentee voting, the risk of disinformation on social media, and opportunities for poor election administration amid a pandemic that may disenfranchise voters in large enough numbers to swing a close vote. Although Eurasia Group predicts that Joe Biden is likely to win the election—and in such a scenario, President Trump would be extremely unlikely to refuse to leave office—acute political polarization, accusations of fraud, and latent social tensions may ignite a political crisis.

President Trump has also made increasingly drastic policy pronouncements on China, while facing accusations of mismanaging the pandemic at home. The Trump administration is increasingly approaching Beijing with "gloves off," imposing escalatory sanctions and executive action against Chinese technology companies with few restraints. Most US allies appear to tacitly support a stronger stance on China, but President Trump is more than willing to take unilateral action that may not be easily undone after 2020. The risk of direct military confrontation is very low. However, fraying relations will persist at least through the year and will cause significant disruption for firms who operate in or are exposed to China.

In Europe, a steady pandemic response obscures simmering problems

Individual European countries took early steps to mitigate Covid-19, but east-west and north-south tensions within the bloc will remain obstacles to effective coordination. Nonetheless, the EU's Recovery Fund—a EUR 750 billion package that allows the European Commission to borrow on behalf of hard-hit member states—represents an important step toward completing the euro area's monetary union. The fund will help to underpin pandemic response with a more robust fiscal architecture. But it will do little to prevent an uneven recovery, the coming financial pressures associated with prolonged recession and a decline in credit quality, and the risk of a damaging second wave of infections.

The pandemic response has also provided a platform for the EU's key leaders, primarily Angela Merkel and Emmanuel Macron, allowing them to shore up domestic support that was wavering prior to Covid-19. It has also plastered over the fragility of some of Europe's weaker coalition governments, such as that of Giuseppe Conte in Italy or Pedro Sanchez in Spain, temporarily shielding them from political volatility. However, pandemic response has also sidelined other political priorities, like the pursuit of an assertive geopolitical stance from the Von der Leyen Commission, or the formulation of a more united position on the creeping illiberalism in Hungary and Poland. Furthermore, Covid-19 has brought the Brexit negotiations between the UK and the EU virtually to a standstill. More likely than not, a barebones agreement facilitating merchandise trade with the EU will be struck in the late months of 2020. However, there remains a significant risk that the UK's transition period following its departure from the EU will expire without the conclusion of a comprehensive free trade agreement.

As Covid-19 outcomes diverge, government policy is creating winners and losers

Active government intervention in strategic sectors is quickly becoming both a significant risk and potential opportunity for firms. Authorities' substantial Covid-19 rescue packages—which so far include USD 2.8 trillion in stimulus in the United States and EUR 2 trillion in the European Union—successfully mitigated a worst-case scenario, although facilitating short-term economic recovery will remain challenging. Authorities worldwide are weighing the need for painful shutdowns and restrictions on business to promote public health against their economic and social costs. Policy choices at the country, state, and local level will be prime determinants of long-term outcomes for individual firms.

Covid-19 will have a significant and lasting impact on the international economy, but firms in some sectors will eventually recover to pre-pandemic highs while others will likely need to permanently adjust their business models to suit the new normal. In energy and the financial sectors, for example, the pandemic is accelerating long-simmering trends. While all businesses should contextualize the pandemic response within a longer-term view of their own industries, outcomes will be markedly different depending on a firm's preexisting financial health, degree of internationalization, and ability to "future proof" their business model.

Likewise, variation in governments' pandemic response plans around the world will result in divergent outcomes on a country-by-country basis. The lack of coordination on public health and economic measures will likely prolong the pandemic itself, as well as the associated economic trauma. Firms should be especially wary of using developed markets to benchmark global progress in addressing Covid-19, as the virus will likely remain a significant issue in emerging economies for years to come—with potential rebound effects on the developed world if mitigation fails in regions with less effective governance.

Eurasia Group has developed three potential scenarios for post-pandemic recovery: a "V-shaped" recovery with a benign policy and public health outcome; a "severe" double-dip recession that creates prolonged economic weakness; and, a halting but upward-sloping "jagged swoosh" trajectory, our base case, which would accompany an intermediate policy coordination and public health scenario. Most economies are likely to follow a jagged swoosh recovery path, with sporadic economic gains and setbacks, but a generally positive growth trend over time. Periods of growth and contraction will not occur simultaneously across industries and countries, with different areas facing unique challenges.

Climate and energy: Current crises highlighting and deepening long-term risks

Pandemic-related economic shutdowns around the world created an unprecedented sudden drop in demand for petroleum products, with the prospect of a protracted pandemic, changing consumer behaviors, and possible green stimulus all weighing on longer term recovery outlooks for the oil and gas sector. Failed and fragile oil-reliant states have been pushed to the brink, while explorers and producers have faced steep consolidation. These factors all contribute to Eurasia Group's view that crude oil demand will struggle for some time to come. This will yield both geopolitical and business risks resulting from increasing instability within and outside of energy-producing countries, a deep market imbalance for energy products, and a growing investment gap required to meet future energy needs.

The simultaneous supply and demand shocks for energy through 2020 have, in some ways, served as a dress rehearsal of sorts for a broader remaking of global energy markets under the constraints of a changing climate if current trends persist. The existential threat of a changing energy mix has at once improved the relative economics of renewable power vis-à-vis fossil fuels while undermining longer term energy security for consumers. The continued pressure of the sustainable finance movement will increasingly strand assets without clear roles in and past the global energy transition, with little regard for the resources, countries, and people that will be stranded along with them.

The risks associated with each of these factors will only be amplified as crisis management turns to stimulus and recovery. Overwhelmingly, governments around the world have committed to rebuilding their economies in a way that emphasizes environmental performance and contributes to climate change mitigation. This has led to renewed optimism in next generation clean energy technologies, irrespective of demonstrated technological readiness or lack thereof.

Although demand will rebound somewhat in the coming years, clean energy policies and environmentally conscious investors will continue to drive change that will exacerbate the risks of stranded assets and investments in a structural way consistent with the disruptions we have seen this year. As with most crises, coronavirus has accelerated current trends in energy and environment, and has done so when both are struggling under the pressures of time and transition.

Entertainment and Media: Traditional entertainment stumbles as online media encounters political risks

Shutdowns to slow the spread of Covid-19 in the US and Europe led to stagnation in traditional media and film production, creating widespread job losses in the sector. At the same time, streaming platforms such as Netflix are enjoying a boom as consumers move away from cable and new players establish a foothold in live television and sports broadcasting. Public health measures forced cinemas, theaters, and music venues to shutter in much of the world, leaving streaming as one of few available entertainment options. When film and television production restarts in earnest, maintaining proper health precautions will be a major expense. Finally, consumers' disposable income is set to fall as a result of crisis-related job losses and pay cuts. Spending on leisure will decrease correspondingly.

Social media is increasingly eclipsing traditional entertainment in market value but is attracting new attention from governments as a potential national security concern. Worldwide politicization of the pandemic is affecting how people acquire and share information, further amplifying the power of social media companies to shape political conversations. Political discord in the United States is also fostering renewed debate about the role of social media in public life and the growing risks of relapsing foreign disinformation campaigns, especially as the US election approaches.

As online media expands, it is developing into as a key point of geopolitical leverage in the deepening US-China decoupling, as well. Recent US executive action against Chinese companies—targeting Bytedance's TikTok and Tencent's WeChat—will likely generate risks to online media companies similar to those faced by internationalized manufacturing firms being forced to re-shore their operations. Eurasia Group expects that further escalation between Beijing and Washington will yield a more fractured, less open global Internet over time.

Life Sciences and Healthcare: Pandemic generates new opportunities and tripwires

The COVID-19 crisis has been a watershed moment for the healthcare industry. While the pandemic has highlighted the crucial role of pharma, medtech, payors and providers in managing public health crises, it has also upended revenue and profitability across the world. The sharp decrease in elective surgeries has been and will continue to be a major challenge for all players across the value chain, demanding a complete rethinking of product and service portfolios, supply-chain management, and resource allocation for all players involved. Decline in regular outpatient visits has affected revenue for private practices and has had a knock-on effect on prescriptions and pharma demand. Providers will continue to experience revenue and profitability pressure, resulting in potential bankruptcies across the sector.

Two trends seem to be emerging from the financial disruption experienced by many healthcare firms. First, pandemic-related economic trauma may generate consolidation through M&A in the provider space through bulk acquisition of small private practices and distressed larger players. Verticalization is also a potential outcome as pharmacy retail chains look to establish a larger foothold in patient care. Second, the rapid rise of telemedicine has emerged both as an opportunity to manage and foster demand and as a challenge, given regulatory uncertainty.

There are also opportunities for healthcare and pharmaceutical companies to participate in the global pandemic response, both immediately and over a longer period. Firms are launching various high-profile initiatives, including vaccine development programs and boosted manufacturing of viral tests, medical tools, and personal protective equipment (PPE). Some of these programs are eligible for government support, as in the United States where federal officials authorized more than USD 9 billion in vaccine contracts to date.

Responding to Covid-19 will also introduce new reputational and operational risks for pharma and medtech. Lucrative "warp speed" vaccine contracts from governments around the world carry the implicit risk of a highly visible failure and loss of public trust, although this is less of a concern in developed markets with stringent medical approval procedures. Any comprehensive vaccine campaign will also force a rethinking of the underlying health system, particularly around drug costs and cost incidence. Distribution schemes viewed as inegalitarian will exacerbate social dysfunction and accelerate political momentum for price caps. More significantly, governments are quickly realizing the national security importance of healthcare and snapping into action to insulate domestic firms from foreign authorities—introducing rules to re-shore supply chains and impose new "home market first" obligations on companies. These measures will disrupt globalized manufacturing and force multinationals to reshape supply chains moving forward, but the economic realities of re-shoring may ultimately temper bold policies to some extent.

Transportation: Trade and aviation suffer during Covid-19, even with government support

The pandemic is causing a profound contraction in global trade flows, which will likely fall by as much as 15% in the third and fourth quarters of 2020, according to a McKinsey study that tracked trade in non-services commodities. Within the overall quarter-over-quarter reduction, trade in certain goods suffered severe cutbacks while others saw only minimal downturn, demonstrating that demand for some products and commodities is more durable than others. Automotive shipping flows decreased by the largest margin, followed by apparel and textiles, and energy. Conversely, agri-food and chemical flows have remained mostly stable throughout the crisis. The decline was also differentiated across regions, with China-US trade plummeting by more than 20% compared to a more modest 13% between Europe and North America. Thus, the impact of weakening trade will be dispersed across sectors and geographic regions.

If authorities launch serious efforts to re-shore manufacturing in certain strategic sectors, trade flows are likely to remain depressed for a longer period. Much uncertainty on country-of-origin rules and designations will likely follow those efforts, especially given existing trade agreements and standards on the one hand, and the integrated and complex nature of supply chains on the other. Volumes from China and India to the United States will be most severely curtailed based on national security considerations in the medical, pharma, and tech industries, but overall US trade in manufactured goods is likely to fall as policymakers act to promote domestic industry. Further escalation between Washington and Beijing might also prompt additional trade restrictions as national security concerns lead to an economic decoupling. These efforts could also drive up costs for producers and reduce productivity as firms scramble to reorganize their supply chains.

Civil aviation is also experiencing a pronounced downturn, owing to an unprecedented lack of demand for travel. The pandemic will continue to force airlines to significantly scale back operations over the short term and ultimately adapt to a post-pandemic normal. Airlines are not likely to see a quick rebound in flight bookings until a reliable vaccine is widely available. Until then, the demand drought will force carriers to downsize in the absence of robust government support. Although some governments initially provided bailout packages for airlines, any further support is less certain and will likely come with stringent conditions. The post-pandemic aviation industry will be highly concentrated, with many smaller firms either being purchased by major ones or disappearing entirely.

Financial Institutions: New innovations in digital money will challenge traditional finance

Financial institutions will be seriously tested in the coming months, as recession will lead to a rise in defaults and a broad decline in credit quality. Major central banks, led by the US Federal Reserve, have taken unprecedented measures to cushion financial institutions and the real economy through aggressive rate cuts, low-cost lending facilities, quantitative easing, and regulatory forbearance to aid the financial sector.

While these measures have prevented the financial sector from freezing up, they have also reduced banks' lending margins, though some better-capitalized institutions may reap gains from trading income generated by market volatility. Equity markets, particularly in the US, remain out of sync with the economic data as central bank liquidity continues to support high valuations. There is a risk of a significant correction, particularly as lenders' results begin to more clearly reflect the scale of distress in the household and corporate sectors.

For retail and commercial banking, in particular, profitability pressure is also compounded by increasing credit default risks on the one hand, and decreasing revenue from lending and transaction fees on the other.

Meanwhile, digital currencies and innovative transaction platforms are mounting a legitimate challenge to traditional financial institutions and transaction platforms, especially in emerging markets. Specifically, technology firms in Western countries and across Asia are expanding into the financial services space with novel payment systems, credit cards, and other products. Authorities will need to adapt regulatory frameworks to govern this convergence of technology and banking, particularly as it relates to data privacy, AI, and cryptocurrency. Often, these new systems are cheaper and more accessible than traditional finance.

Financial sector disaggregation is accelerated by the growing national security role of technology and finance, motivated both by the attractiveness of innovative transaction platforms and the push factor of expanding financial sanctions. A deep rift is emerging between the US and China, which is developing into a trailblazer in digital currencies and person-to-person finance while US firms and regulators remain wary of their potential risks. As geopolitical tensions flare, technology and finance will likely be in the crosshairs and firms in many industries will face heightened compliance risks—in line with Eurasia Group's projection of a "decoupling" between Beijing and Washington.

Firms should interpret the effects of Covid-19 on financial institutions in the context of a generational transition away from the "analogue" economy towards flexible, scalable, and tech-enabled finance. The pandemic is hastening this change in the United States, European Union, and China as public health measures reduce use of hard cash. Nonetheless, less developed economies still depend on traditional finance. Financial and payments sector corporates will encounter an extremely diverse world financial system moving forward.

The legacy of 2020: an even more fragmented global landscape

The year of the pandemic will leave behind an even more disaggregated international environment with more questions than answers, and no clear global leader. As the dust settles, firms and governments alike will need to adjust to new business and geopolitical realities, including a US-China relationship at its nadir and a still fragile EU. Global firms will be presented with unique opportunities to thrive in the new normal, but will also face difficult choices about how to plan for the future.