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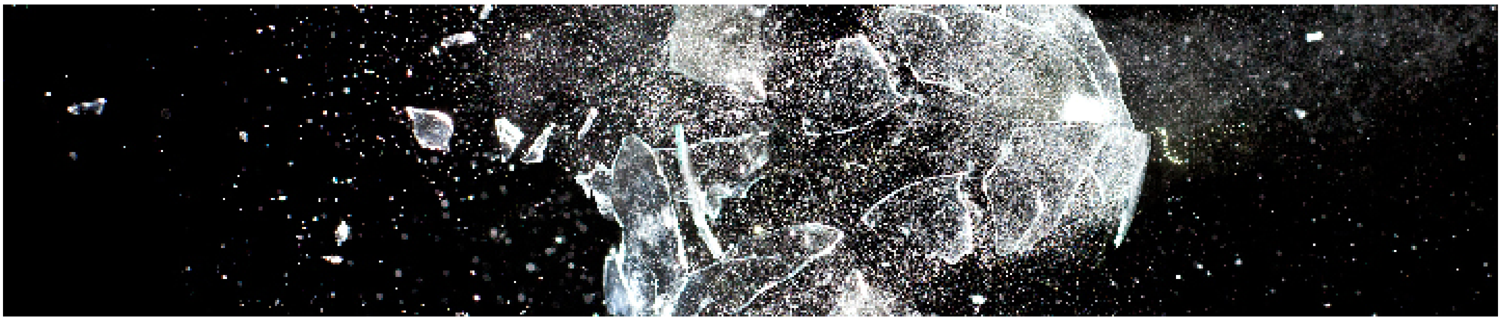
TOMORROW'S CHALLENGES



STRATEGY AND GEOPOLITICS

GAMES COUNTRIES PLAY AND IMPLICATION FOR BUSINESS

By IMD Professor Carlos A. Primo Braga – April 2015

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Mike Tyson once remarked: "Everyone has a plan 'til they get punched in the mouth". This statement underscores the relevance of strategy at different levels. First, it reminds us that "players" in wars, politics, business, and boxing matches typically think *ex ante* about the best strategy to achieve their goals. After all, strategy is "the art of creating power"; that is, a plan of action that helps you accomplish your objectives in the "game" that you are playing. Second, it underscores the importance of thinking through what you will do once the other "players" (opposing armies, political opposition, competitors, or the other boxer in the ring) react to your initial move. In this context, Mike Tyson's statement can be characterized either as an example of a naïve strategy that does not fully consider the next interactions in the "game" or as a shrewd interpretation of the realities of a boxing match.

Business actors have a difficult time in assessing geopolitical risks when defining their strategies. After all, these risks are often classified as the proverbial "black swan". Who expected Russia's annexation of Crimea in 2014? Moreover, as I discussed in a previous article, financial markets tend to heavily discount the relevance of geopolitical conflicts. Hence, "surprises" can be even more disruptive when they become a reality. History provides us with some lessons and "game theory" is helpful in framing strategic responses.

Lessons from history

Geopolitical concerns have become much more present in the minds of CEOs in the last 12 months. The yearly Global Risk exercise conducted by the World Economic Forum, for example, illustrates this, as interstate conflicts were ranked at the very top among key global risks for the world economy in the January 2015 edition of the report.

The obvious question then is: can we derive significant lessons from history? The answer, as usual in billion dollar questions, is "Yo" – a combination of yes and no. For example, if we look at the two world wars, we see different impacts on financial asset classes in the US and Europe. World War I was, in the words of *The Economist* in 1938, "a bolt from the blue" that caught financial markets totally unprepared. World War II, in turn, was preceded by a series of aggressive moves by Nazi Germany that created strong expectations among financial actors that a major armed conflict was very likely.

WWI led to significant losses for European securities and currencies as compared with US financial assets. This lesson, however, had to be interpreted cautiously in predicting the implications of WWII. First, the smart money fled Europe in advance of WWII. Second, not surprisingly, financial assets and currencies in continental Europe were also negatively affected by WWII. British financial assets, however, actually performed better than US assets over the 1939-45 period. In short, different government policies in the two wars significantly influenced financial outcomes and in some circumstances dominated geopolitical shocks.

During the Cold War period (WW III according to some analysts), confrontation between the capitalist and the communist blocks did not move financial markets in a significant manner. The Cuban missile crisis in 1962 barely impacted Wall Street or the price of gold. Maybe this simply reflected the lack of appropriate information about the seriousness of the crisis among investors. More likely, it illustrated the impossibility of proper hedging vis-à-vis the possibility of a nuclear catastrophe.

The apparent resilience of financial markets to geopolitical shocks has continued over time. The only major exception to this was the Israeli-Arab war of 1973 because of its implications for oil prices. In the 21st century, episodes like September 11th and the war on terror have not changed the thrust of the above analysis. Accordingly, one can speculate that financial markets suffer from "disaster myopia" – the thesis that markets tend to excessively discount the danger of a major exogenous shock as time elapses since the last similar shock. According to this view, memories from WWII or even the geopolitically driven oil shocks of the 1970s have already faded. If one adds to this the difficulties in assessing the costs of geopolitical disasters, it is no surprise that markets do not seem to be too concerned with rising geopolitical tensions.

Much ado about nothing?

Does this mean that companies should be oblivious to tensions in Eastern Europe and to the chaotic situation in the Arab world? The obvious answer is no. After all, on top of the humanitarian implications of the crises in question, we cannot simply dismiss the chances of significant macroeconomic externalities. This, in turn, suggests the importance of having clarity on which "game" we are playing.

The Ukraine-Russia conflict is a good example of the complexity of the question. If the Russian actions reflect an expansionist threat to the West, based on a misguided reading of historical ties to Russian minorities in other countries, and the vision of "Novorossiya" as a platform to re-establish the grandeur of the former Soviet Union, then the West should adopt a response based on deterrence. According to this view, only a robust military answer (e.g., providing offensive arms to Ukraine and reaffirming the US nuclear shield as protection to all NATO members) will stop Russia's aggression.

If on the other hand, Russian actions are mainly a tactic to divert attention from domestic political issues by focusing on the external threat posed by NATO expansionism, a different perspective emerges. In this scenario, the aggressive policy is driven by insecurity, and a "muscular" response may trigger reactions that can easily spiral out of control. Accordingly, appeasement structured as a combination of limited economic sanctions and a credible commitment to the neutrality of Ukraine would be better answers to the crisis.

Unfortunately, we don't know which world view drives Putin's perceptions. But it is important to recognize that the optimal response from the West differs dramatically if it is in deterrence or "spiral" mode. We can assign probabilities to each perspective and calculate the boundaries of threats that are both acceptable and effective. In theory, by practicing brinkmanship associated with the gradual escalation of economic sanctions, the West will be better off than by embarking on a full-fledged deterrence approach immediately.

It is important, however, to recognize that this game-theoretical approach is more an art than a science. As George Mikes once said: "many continentals think life is a game; the English think cricket is a game". Currently Putin seems to be playing by different rules and his game is even more complex than cricket. In the current global environment, however, business will ignore geopolitical risk at its own peril.

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