European Politics after COVID-19

How will the EU's new recovery fund reshape the business and political risk environment in Europe?

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Oxford Analytica

Willis Towers Watson

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Section 1: Introduction by Willis Towers Watson

There have been many efforts to find silver linings within the storm clouds of the current pandemic. The temporary reduction in air pollution, caused in part by diminished industrial activity, is often nominated as an example.[1] Other examples include a decrease in unwanted commuting time or an increase in the time some parents are able to spend with their families.

Sometimes, though, one must make one's own silver lining. The European Union has done just that, with a breakthrough deal on a pandemic recovery fund, achieved by the European Council in five challenging days of negotiation from 17 through 21 July 2020.[2] The deal arguably constitutes the highlight of international political cooperation in response to COVID-19 thus far.

The recovery fund deal is more than just a robust economic response to the pandemic. The deal includes significant steps towards both an expanded fiscal union and a common debt instrument for the European Union.[3] These two achievements, if built upon, could help to ensure a sustainable euro that is increasingly adopted as an international reserve currency, thus assuming a cornerstone role in the global financial system with potentially significant benefits for the European economy.[4]

Might a deal with such potentially momentous consequences have other consequences – both expected and unexpected? In this report, through scenario analysis, we attempt to address that very question. The main body of the report develops a plausible but hypothetical scenario that imagines how economies and businesses might respond, assuming the European Council's deal is implemented largely as agreed in July 2020. In this scenario, we envision areas of robust commercial recovery, but also significant challenges for companies unable to adapt to a new post-pandemic policy environment.

There are also, it must be said, ways that the deal could yet fail. Certain elements need to be ratified by the European Parliament or agreed by national parliaments, for instance.[5] During the negotiations, divisions emerged between Eastern and Western European states regarding monitoring of democratic institutions.[6] We consider the downside risks arising from such tensions in "Stress Scenarios" interspersed with the main text. In the week leading up to the negotiations, the European Union considered taking steps to respond to recent developments in Hong Kong.[7] We consider downside risks from these tensions in another Stress Scenario.

Both the central narrative and the Stress Scenarios were developed by the geopolitical consultancy Oxford Analytica, drawing on scholars in their global expert network. Leading experts in European Union politics, European institutions, populism, and political risk contributed to these narratives.

Sometimes one must make one's own silver lining. The European Union has done just that, with a breakthrough deal on a pandemic recovery fund.

For the Stress Scenarios, Willis Towers Watson has modelled the political risk losses that companies could experience using the Value at Political Risk tool (described in the Afterword: About the political risk modelling in this report). We also offer views from two Willis Towers Watson experts who describe how companies can manage the business risks these scenarios present.

The political risk scenarios in this report are intended to be used for corporate strategic planning and risk management stress-testing. As far as possible, the scenarios are not based on specific assumptions about the number of confirmed COVID-19 cases or even the severity of the economic shock that the novel coronavirus may produce. Rather, the scenario is driven by political reactions to COVID-19. In the longer term, such political reactions may transform the world of international commerce as lastingly as the coronavirus itself.

[1] See, for instance, https://www.sciencedirect.com/science/article/pii/S0048969720323378
[2] https://www.consilium.europa.eu/en/policies/eu-recovery-plan/
[3] https://www.euractiv.com/section/economy-jobs/news/recovery-fund-brings-eu-one-step-closer-to-fiscal-union/
[4] https://ec.europa.eu/commission/sites/beta-political/files/factsheet-strengthen-euro-global-role-05122018_en.pdf
[5] https://www.ft.com/content/2b69c9c4-2ea4-4635-9d8a-1b67852c0322
[6] https://www.reuters.com/article/us-eu-summit-easteurope-rule-of-law-anal/ambiguous-conditions-on-eu-deal-set-to-embolden-hungary-and-poland-idUSKCN24M2AL
[7] https://www.reuters.com/article/us-hongkong-security-eu/sweden-joins-france-germany-in-weighing-measures-against-china-over-hong-kong-idUSKCN24E17P

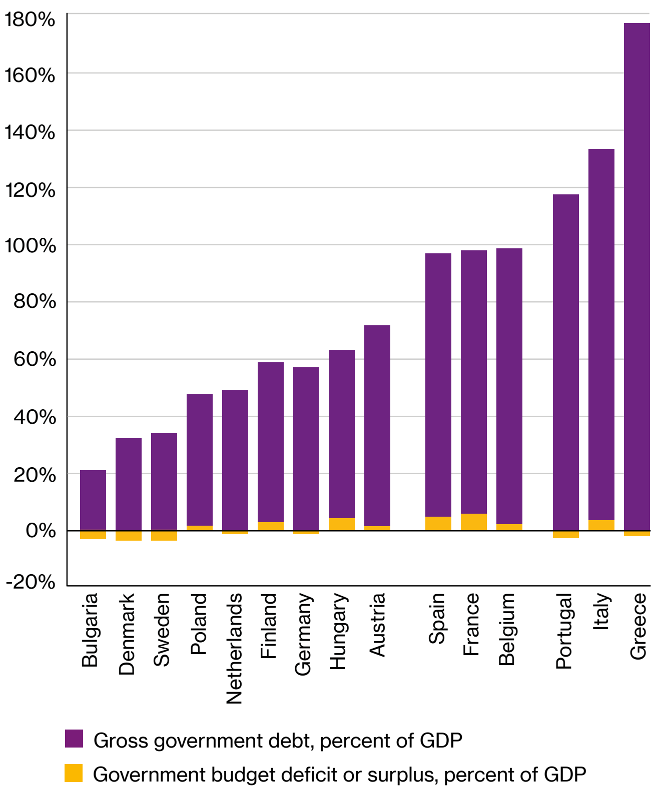
Section 2: A scenario for European politics by Oxford Analytica

Part 1: Scenario background

On 21st July, the European Council agreed a €750bn pandemic recovery fund, alongside a roughly €1tn EU budget agreement. The main objective of the recovery fund is to support national recovery programs, especially for those countries in difficult fiscal positions. (The official title of the recovery fund is "Next Generation EU;" the official title of what we have here referred to as the "EU budget" is the "Multi-annual Financial Framework.")

Why was this historic agreement necessary? In part because the absence of such a program could have restarted the Eurozone debt crisis, or even posed an existential threat to the euro. While some governments in northern Europe have relatively stable financial positions, other governments, such as those in Italy and Spain, were still recovering from the Eurozone debt crisis as the pandemic hit. As a result, those European countries requiring the greatest fiscal stimulus could be least able to provide it.

Figure 1: **A divided continent: debts and deficits at the end of 2019**



Source: Eurostat

The potential risks this situation could create were illustrated around the time of the European Council's first major summit devoted to COVID-19, held on 23 April 2020. Investors appeared to be alarmed by the prospect of limited progress at the summit, together with the announcement of expansive stimulus spending by Italy. Considering Italy's weak fiscal position and the severity of the coronavirus-related economic shock, would Italy's public debt burden be sustainable if European financial support was not forthcoming? Such concerns played a role in sending the spread between Italian and German long-term debt instruments above 250 basis points (or 2.5 percentage points) on the eve of the summit.

Like previous Eurozone debt crises, this April "mini-crisis" was seen off in part by the European Central Bank (ECB), which made aggressive purchases of Italian debt. In addition, Italian Prime Minister Giuseppe Conte announced that Italy would access the line of credit made available through the European Stability Mechanism. The upward spike in spreads reversed itself.

But these actions were not taken without political cost. In Italy, there was a dramatic reaction to Prime Minister Conte's acceptance of support from – and, by implication, the conditions imposed by – the European Stability Mechanism. Matteo Salvini, who is in effect the leader of the Italian opposition, demanded that Conte resign. Voices across the Italian political spectrum protested what they saw as a lack of solidarity on behalf of Northern Europe. Even members of the Five Star Movement, Conte's main base of support, expressed dissatisfaction. It appeared possible that the Italian government could collapse due to internal divisions regarding Conte's decision. Conte began to walk back his position.

Adding to investor concerns, Germany's Constitutional Court ruled on 5 May 2020 that the ECB would have to justify its asset purchase programs within three months – a ruling that arguably raised significant questions about the sometimes contested relationship between EU institutions and those of member states. Between late April and late May, despite ongoing ECB interventions, spreads on Italian debt rose significantly.

With a potential debt crisis brewing, on 18 May 2020, Germany and France made a dramatic proposal that would go some way towards developing a common European Union budget and common debt instrument on a significant scale. This proposal – a reversal of Germany's historical position, and a crucial step towards the European Council's breakthrough deal – constituted an unprecedented show of European unity on the controversial topic of budgetary and debt union. Following this announcement, tensions in debt markets at last began to ease.

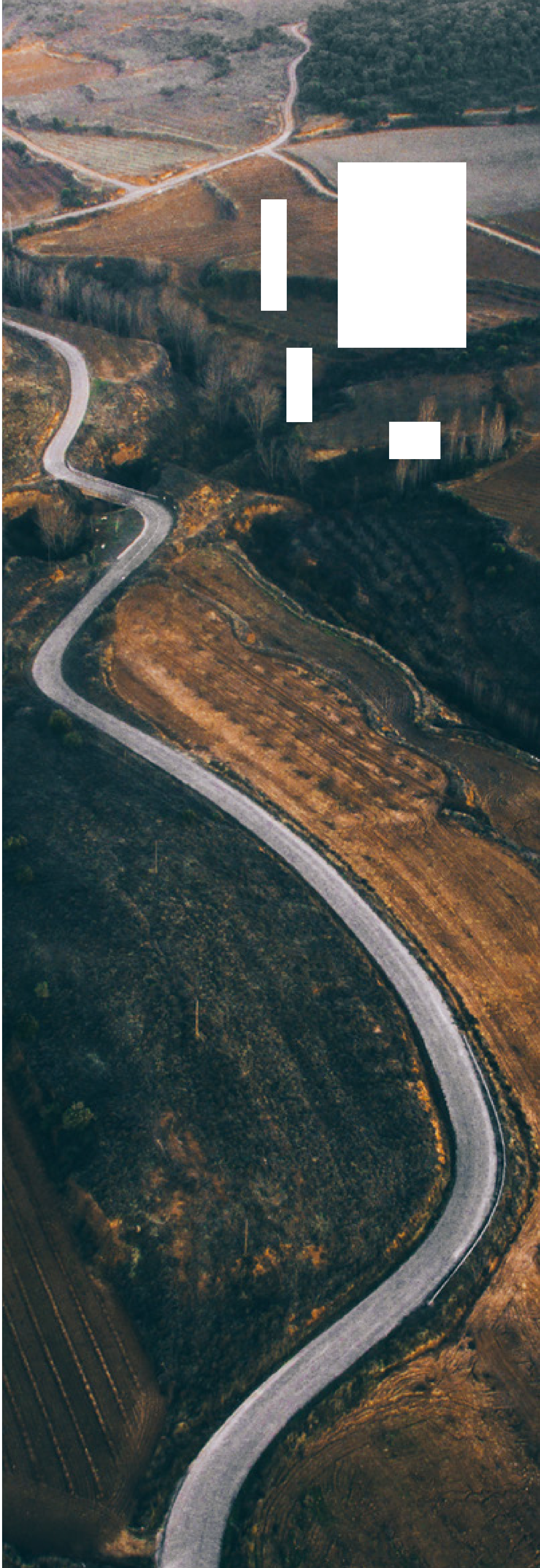
As of this writing, in August 2020, the breakthrough recovery fund deal appears to have further reduced these tensions. Bond spreads between Italy and Germany on 10-year debt fell by roughly 20 basis points almost immediately after the recovery fund deal was announced. The narrowing of bond spreads has been an ongoing source of benefit to the Italian economy and to Italian public finances. The reduction in bond spreads may also help to stabilize Italian politics, by increasing the chances that Italian Prime Minister Giuseppe Conte will be able to side-step the controversial debate about borrowing from the European Stability Mechanism.

Meanwhile, the reduction in bond spreads takes some of the pressure off the ECB. Indeed, ECB purchases of sovereign debt have eased considerably under the positive influence of the recovery fund negotiations. This relaxation of tensions in the markets could make it easier for ECB President Christine Lagarde to rebuild consensus among the members of the ECB's governing board. Over the longer term, the large-scale issuance of a new debt instrument could make it easier for the ECB to rebalance its holdings of national sovereign debt instruments on its balance sheet. Such steps would help insulate the ECB from further tensions with the German Constitutional Court.

There is, or course, much that could still go wrong. Ratification of the European Council's deal may take time. Some countries, particularly the most vulnerable, may find it difficult to meet the standards required to gain access to funds. The deal envisions as-yet-unagreed new European taxes in areas such as carbon emissions, financial transactions and digital commerce. The debate on these issues may be contentious.

In addition, the recovery funds will, in the main, be distributed to member states in 2021 and beyond. In a sense, that is appropriate: concerns about the sustainability of member states' debts are also, mostly, long-term concerns. But if, for instance, business bankruptcies rise rapidly as the autumn wears on, fiscally-constrained countries could face difficult choices in the months before the new European Union relief funds arrive.

It is against this backdrop that our scenario opens in the autumn of 2020.



Stress Scenario by Oxford Analytica - A clash over Europe's Rules

In the autumn of 2020, the government of Poland announces that it will hold a referendum in response to EU criticisms that Polish judicial reforms have been antidemocratic. It will ask the Polish people whether EU law should have supremacy over Poland's national laws. Turnout is high enough that the referendum has legitimacy and it passes. Soon after, the Hungarian government makes it clear that it will not reverse the emergency powers granted by parliament at the start of the pandemic and that it too will seek further public approval for its defence of Hungarian sovereignty against EU rules.

A war of words between Brussels and the two member states ensues. Sanctions are threatened; editorialists suggest that the countries should be suspended from EU institutions or that EU payments to Poland and Hungary should be halted. Right-leaning parties across Europe, beginning with the League in Italy, pick up on the issue. The League calls for mass anti-EU demonstrations. Despite prohibitions on public gatherings still in place, large groups respond in France, Poland, Austria, Greece and Hungary. Far-right demonstrators attack EU buildings and officials. There is a car bomb in Brussels. A nationalist group claims responsibility.

There are rumors that the Italian government will fall, and the opposition League party tops opinion polls as the country's most popular party. The League declares that its official policy will be to support the Poles and Hungarians in achieving more freedom for member states. European businesses begin to question whether the integrity of the single market will survive.

A modest EU recovery from the COVID-19 shock is aborted. Bond markets in Italy, Spain, Greece, and Portugal are hit, as fears of government default make banks weaker, while the possibility that bank bailouts will be needed feeds the risk of government default. Italy suffers a financial crisis.

France and Germany lead negotiations in an emergency EU summit. A "grand bargain" is struck, calming the political situation. Common EU fiscal initiatives are strengthened, as is the bloc's banking union, but not before it becomes clear that the Eurozone will enter a second recession.

Modelling of scenario impacts by Willis Towers Watson

If this scenario were to occur as written, our claims-based model forecasts the losses shown below for EU foreign direct investors. Most of the losses occur in countries that are already vulnerable to external economic shocks and are heavily dependent on EU trade and investment, such as Russia and Turkey. The scenario also envisions extensive social unrest in several Western European countries. More information on the modelling assumptions is provided in the **Afterword: About the political risk modelling in this report.**

Figure 2: **Countries where EU companies suffer political risk losses**

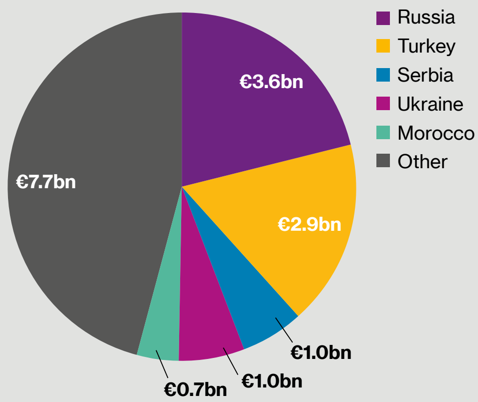
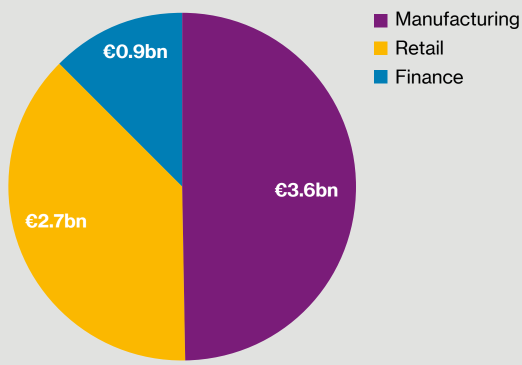


Figure 3: **Industries where insurable political risk losses occur**



Part 2: An uneven recovery

The Euro strengthens and European economies begin to recover

Some Southern European countries face economic headwinds, as tourist sectors contract and banks limit lending

By the autumn of 2020, the fiscal situation for many Southern European countries has become increasingly precarious. Governments across Europe struggle to absorb the fallout from a lost tourist season in those parts of the country that depend primarily on hotel, restaurant, and catering employment. Many firms that survived through the summer months on credit guarantees begin to fold in the autumn. Since the guarantees are held by governments, these bankruptcies impose significant fiscal costs. Moreover, many of these credit guarantees were partially underwritten by banks, so governments are forced to provide bailouts for financial institutions, especially in parts of their countries that suffered most.

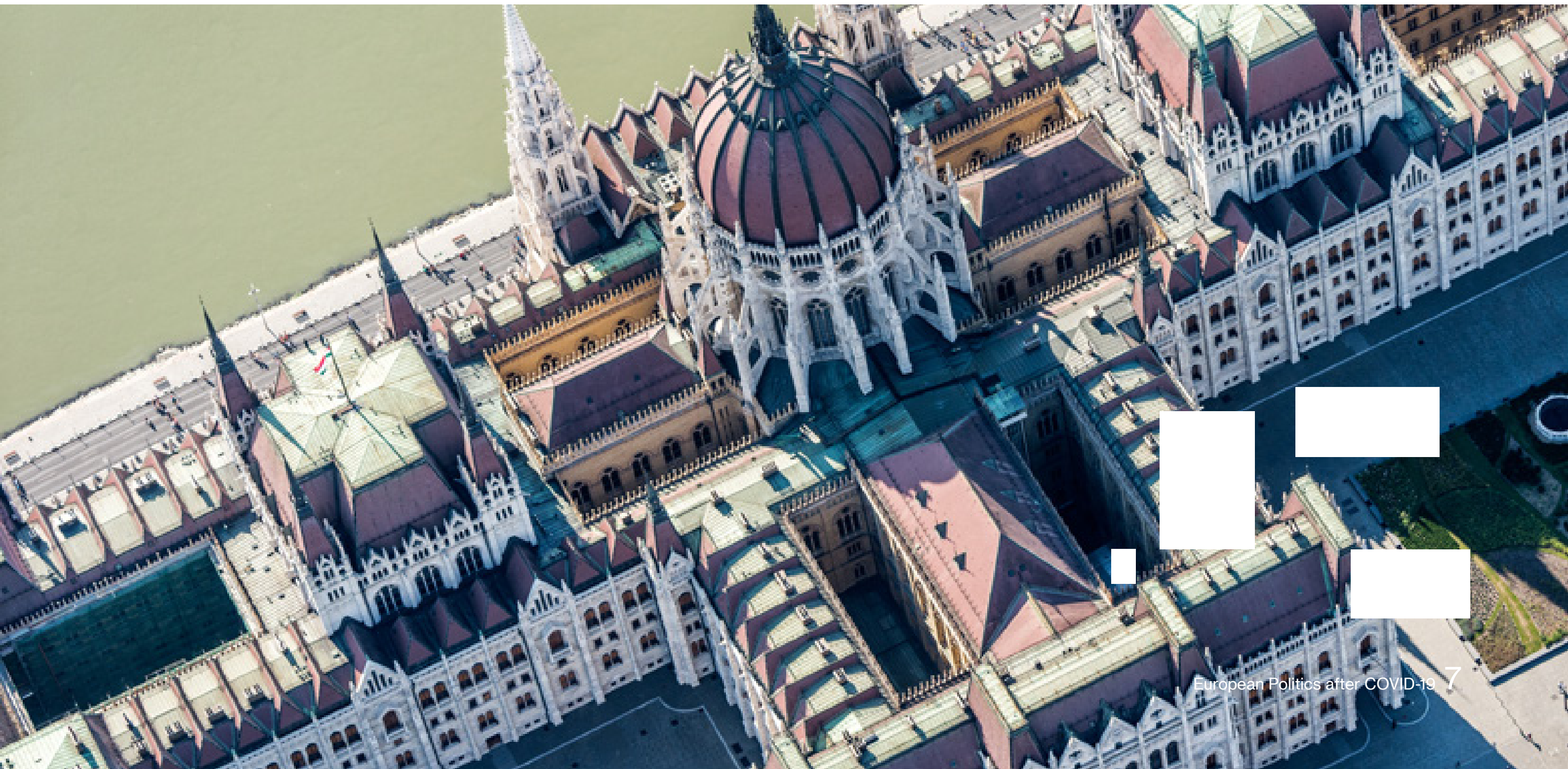
Despite the efforts of European companies to adapt, supply chain disruptions continue to pose a problem. The smaller and medium-sized enterprises that generate the bulk of employment across the euro area struggle with new social distancing requirements. Liquidity problems evolve into solvency problems as the collapse in revenues makes it impossible for many small businesses to keep up with their payment obligations. These bankruptcies sometimes create hard-to-fill holes in broader supply chains. Meanwhile, manufacturing firms struggle to replace critical components that are sourced globally. Agricultural supply chains begin to experience disruptions as producers fail to attract enough seasonal labor to bring in the fresh fruit and vegetable crop. These disruptions center on Spain and Italy, where agricultural firms are most dependent upon migrant workers, but the effects are also felt in Greece and across the Western Balkans.

In the autumn of 2020, Europe faces further waves of infections as the weather cools, but European governments are quick to respond with localized lockdowns, expanded testing, and contact tracing. Over time, European governments and societies become more adept at managing the requirements for social distancing. They also become better at identifying and responding rapidly to new outbreaks. That said, some governments – particularly those with greater fiscal resources to spend on contact tracing and technology solutions – prove to be better than others at minimizing these disruptions.

Meanwhile, the yield spreads between long-term sovereign debt instruments in Italy and Spain relative to Germany remain a potential source of tension. While the European Council's July deal on a European debt instrument helps to ensure the rise in yields never becomes an acute crisis, spreads begin a gradual rise, in part because ECB efforts to rebalance overall holdings toward proportions that more closely resemble the relative size of the national economies imply the purchase of more German debt than either Spanish or Italian debt.

These gradually rising spreads on Italian and Spanish sovereign debt have an impact on the balance sheets of these countries' banks (which tend to hold a great deal of home country sovereign debt as assets and collateral). Both Italy and Spain show relatively poor economic performance as a result of these pressures, the aftermath of the poor tourist season, and the fact that – given their fiscal weakness – they have less capacity in outbreak control. As a result, unemployment increases dramatically, particularly in Spain.

In the autumn of 2020, Europe faces further waves of infections as the weather cools, but European governments are quick to respond. That said, some governments prove to be more effective than others.



Part 3: A new Europe

The political compromises that prevented an economic crisis produce unexpected shifts in the European business environment

Southern European firms face severe competitive disadvantages due to relaxed rules on 'state aids' to companies

Activist industrial policies, COVID-19 disruptions and Brexit push many European companies to relocate supply chains, especially within Europe

While the uneven recovery progresses, the compromises that helped make the European Council's breakthrough July deal possible have begun to reshape the European business environment.

One key area of compromise is on competition policy, and in particular, how the European Commission regulates "state aids" to private corporations (including banks) in the interest of ensuring a level playing field across Europe's internal market.

As early as March 2020, the European Commission had relaxed its restrictions on state aids to make it easier for national governments to provide guarantees for private debts (helping private corporations to remain liquid throughout the initial lockdown phases of the crisis). By May 2020, the European Commission had relaxed its restrictions on the direct injection of state funds into private corporations in the form of public equity.[8] Such actions raised strong objections from Southern European governments which, as a result of weaker fiscal positions, have fewer resources to support their countries' firms, and so could find themselves at a competitive disadvantage. (The German government accounted for the lion's share of the state aid reported by the European Commission in April and May 2020, for example.)[9] Over the summer and autumn of 2020, however, Southern European governments are focused on the immediate need to gain access to funds. The bargains struck on state aids therefore tend to follow Northern European preferences, include further relaxation of competition rules to allow for greater direct investment into firms in a wider range of sectors.

Champions of European industrial policy seized the opportunity. The European Commission headed by Ursula von der Leyen had, even before the COVID-19 crisis, announced plans to promote greater Europe's "strategic autonomy" in the information technology and defense sectors.[10] The lessening of competition restrictions and availability of post-crisis stimulus budgets makes it possible to accelerate and broaden this re-shoring agenda. National government support this initiative with a mixture of credit guarantees and tax incentives, attempting to shift European supply chains away from Asia.

Of course, such activist industrial policies, particularly with regard to reshoring, have in the past produced limited results. The incentives required to induce relocation of production tend to be prohibitively expensive, given very large differences in labor costs and other key business environment factors across nations. Efforts to create entirely new industrial capacity can produce inefficiencies or overwhelm government budgets.

However, in the context of the recovery from COVID-19 these policies prove surprisingly effective, especially in relocating production within Europe. European countries are closer substitutes for each other, so fewer incentives are required to induce companies to move within the region (in contrast to relocating from Asia). In the autumn of 2020, politicians have a unique opportunity to apply large budgets to "job creation" initiatives. In addition, the stakes taken in private firms through "state aid" investments provide governments with a greater voice in corporate decision-making.

These forces are particularly effective in regard to European companies' value chains involving Britain. The British government pushes hard to complete its new economic relationship with the EU by early October in order to ensure there is time for ratification by the December 2020 deadline. After the customary brinksmanship, this effort produces a bare-bones agreement that offers few advantages to manufacturers working across the new customs boundary. The British government hopes to take advantage of its release from European competition regulations to rebuild British manufacturing in the country's midlands and northern regions. The bare-bones deal has the effect of making reshoring more commercially attractive on the European side as well.

The unevenness of economic recovery in Europe further increases the effectiveness of some reshoring initiatives. Regional supply chains in the area that runs from northern France through southern Germany and into Central and Eastern Europe rapidly recover and soon exceed pre-crisis levels of activity. In these areas, political controls on virus outbreaks are most effective and state aids to support private commercial activity are most available. Well-placed companies reap the benefits of relocated production, as do towns and workers living in these regions. A "virtuous cycle" of recovery momentum supplemented by state support emerges in these areas.

[8] https://www.euractiv.com/section/competition/news/germany-gains-most-from-relaxed-eu-state-aid-rules/
[9] https://www.ft.com/content/a68bfd0d-47c7-46ec-ac87-20b8b67ddc32
[10] https://ec.europa.eu/commission/presscorner/detail/en/ip_20_940

Patterns of production in Europe are reshaped, particularly in the pharmaceutical, health care, IT, and defense sectors

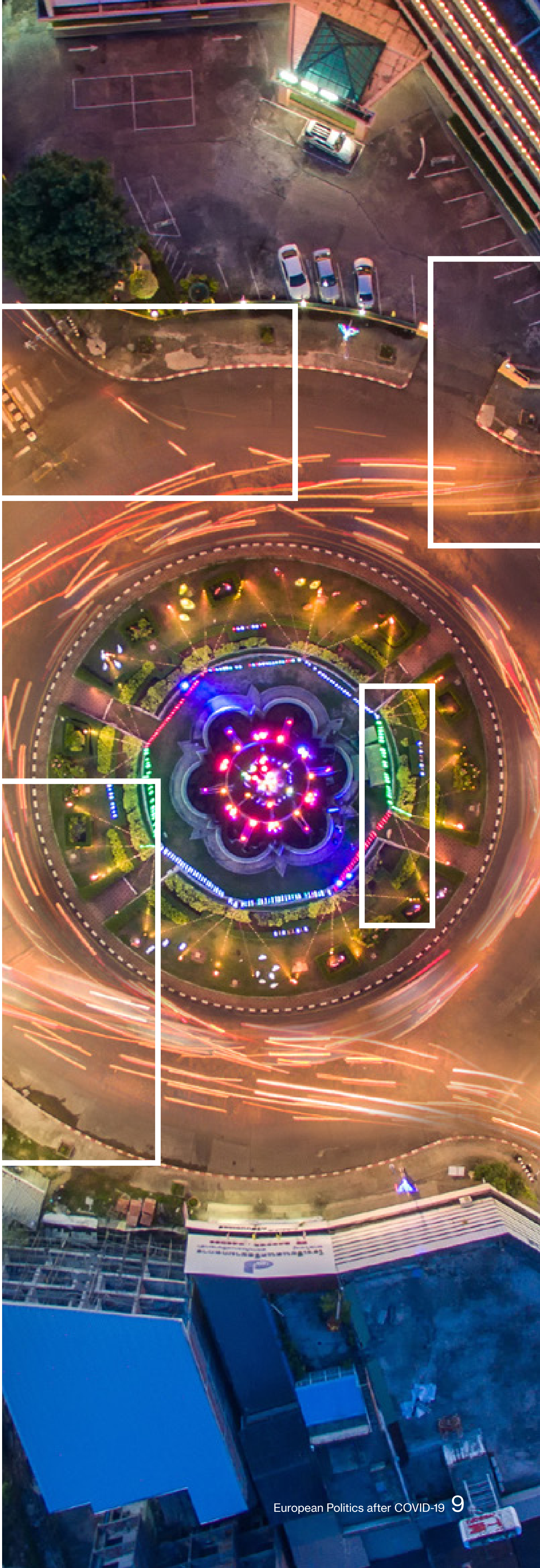
National governments take advantage of the opportunity to build industrial capacity to ensure against shortages of critical components, particularly in the pharmaceutical, health care, information technology, and defense sectors. Fiscally weak governments find that their companies face increasingly severe competitive disadvantages in these sectors. The political focus extends gradually to include automotive and “green economy” industries as well.

As companies find themselves in a business environment in which state policy determines competitive advantage, they increase their spending and capabilities in lobbying for government support. Meanwhile, the voices of business lobbies that advocate open competition in Europe’s single market grow quieter.

Even as Northern Europe recovers, and some regions enjoy an economic boom, the European Commission comes under pressure to maintain the relaxation of its rules on “state aids,” and the new pattern of industrial and regional policy becomes increasingly entrenched. (Partly because some reshored operations prove to be non-viable without ongoing state support.)

This pattern expresses itself differently depending upon the country. France promotes “national champions,” initially seeking new ways to strengthen Airbus Industrie, but extending its industrial policy to support European champions in finance and telecommunications. The German government places a broader emphasis on the medium-sized firms that form the core of its industrial base and on the supply chains that some of the larger firms have created in Central Europe, specifically Poland, the Czech Republic, Slovakia, and Hungary.

For their part, the Central European countries develop a split-frame approach – supporting international supply chains that center on Germany through relatively lax fiscal and regulatory requirements, while exerting increasing political control over firms that focus on the domestic market. Some Central European governments and even individual political leaders gain ownership stakes in domestic companies. This rising control of domestically-oriented firms in Eastern Europe helps to bolster the governments in power by giving them more direct control over economic activity and – crucially – both access to credit and opportunities for employment for political supporters.



How to mitigate the financial impact of political shocks

Laurie Burns,
US Product Leader for Political Risk,
Financial Solutions

One of the first and most dramatic shocks from COVID-19 has been economic, transmitted globally by lockdowns, collapsing commodity markets, and disruptions of major business sectors such as tourism. The economic shock has had obvious consequences, such as undermining the financial performance of many firms and, in some cases, even threatening companies' solvency.

As the adverse examples describe in the Stress Scenarios make clear, however, there are also less obvious risks that must be considered. One of the most important of these risks is exchange transfer risk, also known as "currency inconvertibility."

Countries in financial crisis or running low on foreign reserves may impose currency controls as a tool to manage the economy. Multinational corporations with deposit accounts overseas that need to repatriate intercompany trade payables, loan repayments, dividends or royalties, may find their cash trapped – that is, unable to be converted to "hard currency" or repatriated. Recent examples include Argentina and Egypt [1, 2] and some analysts are currently concerned about Nigeria and Pakistan, among others. [3, 4]

Another risk that may arise is government intervention. Nationalist governments sometimes look towards export and import controls, interference in foreign ownership of local companies, confiscation of assets, or "creeping expropriation" (a series of acts that amount to a de facto taking). If, as the baseline scenario in this report indicates, the level of state intervention in certain industries grows, we may see an in increase in creeping expropriation events.

To a significant degree, the financial impacts of these types of risks can be mitigated using specialist insurance covers. For instance, when investors are blocked from transferring money out or converting money into hard currency such as U.S. dollars due to currency controls, inconvertibility/non-transfer cover can address this risk.

When governments engage in actions that are discriminatory to foreign investors such as export or import bans, sanctions, confiscation, or government takeover, a multinationals' equity value in subsidiaries or joint ventures can be lost in whole or in part. Insurance can offer a solution to underwrite this loss of equity and in some cases, business interruption following it.

In a similar vein, for multinational corporations entering into foreign trade transactions, either economic shocks or discriminatory interventions can obstruct contract fulfilment. Non-payment by a sovereign counterparty or slow payment lasting six months or longer could result. If the contract is with a commercial counterparty, government interference or currency inconvertibility could impede the contract completion. Insurance can again help provide an answer. Companies can look to cover unpaid invoices as well as pre-shipment costs incurred (such as manufacture of component parts).

Finally, multinationals' physical assets could be damaged by politically induced protests – as we have seen in a large number of countries where government responses to the novel coronavirus have been controversial. Political risk insurance assists by providing replacement cost cover for the physical assets damaged as well as ensuing business interruption expense. In a scenario where no physical damage occurs, but a dangerous security situation is present, investors can also look to protect the value of the assets or operations that were forced to be abandoned.

In such a fluid and unprecedented situation, it is too early to make projections on exactly how the insurance market will respond but for now, most insurers have confirmed their commitment and appetite to write political risk insurance, giving risk managers a tool to respond to post-COVID-19 shocks.

Absent such mitigants, the impacts of political risk events on companies can include a need to restate earnings, involve the C-suite and board of directors in media or analyst inquires, and in some cases, a struggle to retain financial viability.

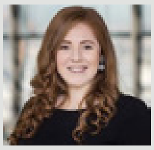
[1] https://www.bbc.com/news/business-49547189

[2] https://www.bloomberg.com/news/articles/2018-11-28/egypt-ends-forex-repatriation-guarantee-in-sign-of-stability

[3] https://qz.com/africa/1817186/coronavirus-oil-price-crash-trigger-dollar-shortage-in-nigeria/

[4] https://www.nasdaq.com/articles/analysis-emerging-market-turmoil-may-bring-fx-controls-back-on-radar-2020-03-25

Taking an integrated approach to geopolitical risks



Lucy Stanbrough,
Research Manager,
Willis Research Network: Emerging Risks

While political events are unpredictable, it seems likely that in the wake of COVID-19 nations will resort to a more protectionist stance, as trends towards greater state control of economies, and nationalist politics, are reinforced by a potential global recession. At the same time, the COVID-19 experience appears likely to bring many opportunities. For example: different and more cost-effective ways of working; a more resilient society; and a possible productivity boom driven by the accelerated integration of technology into business. Not to mention more reliable (if perhaps more expensive) supply chains.

COVID-19 has demonstrated the potential for global disruption in an increasingly globalized and interconnected world and shone a new light on considering the art of the possible. Decisions around strategy, investment, growth and expansion will at the very least need to be reviewed in a harsher and more challenging environment, and boards will need to be ready and able to adjust their companies' strategies appropriately and, in some cases, radically.

The use of adverse scenarios allows businesses to consider whether the right assumptions are being made, the appropriate questions are being asked and whether the key issues are being sufficiently examined. Different functions within businesses need to look at these connected risks/opportunities collectively and manage them using an integrated approach. Such matters are overlooked at one's peril, leading to heightened risk and missed opportunity.

Willis Towers Watson's Geopolitical Risk experts examine risk drivers and their associated risks through six key lenses; Cyber, Climate/Environmental, People, Reputational, Business Resilience and Investment/Return. These interconnected lenses encourage the identification of integrated solutions that can be tailored and address insurable and non-insurable risks seamlessly.

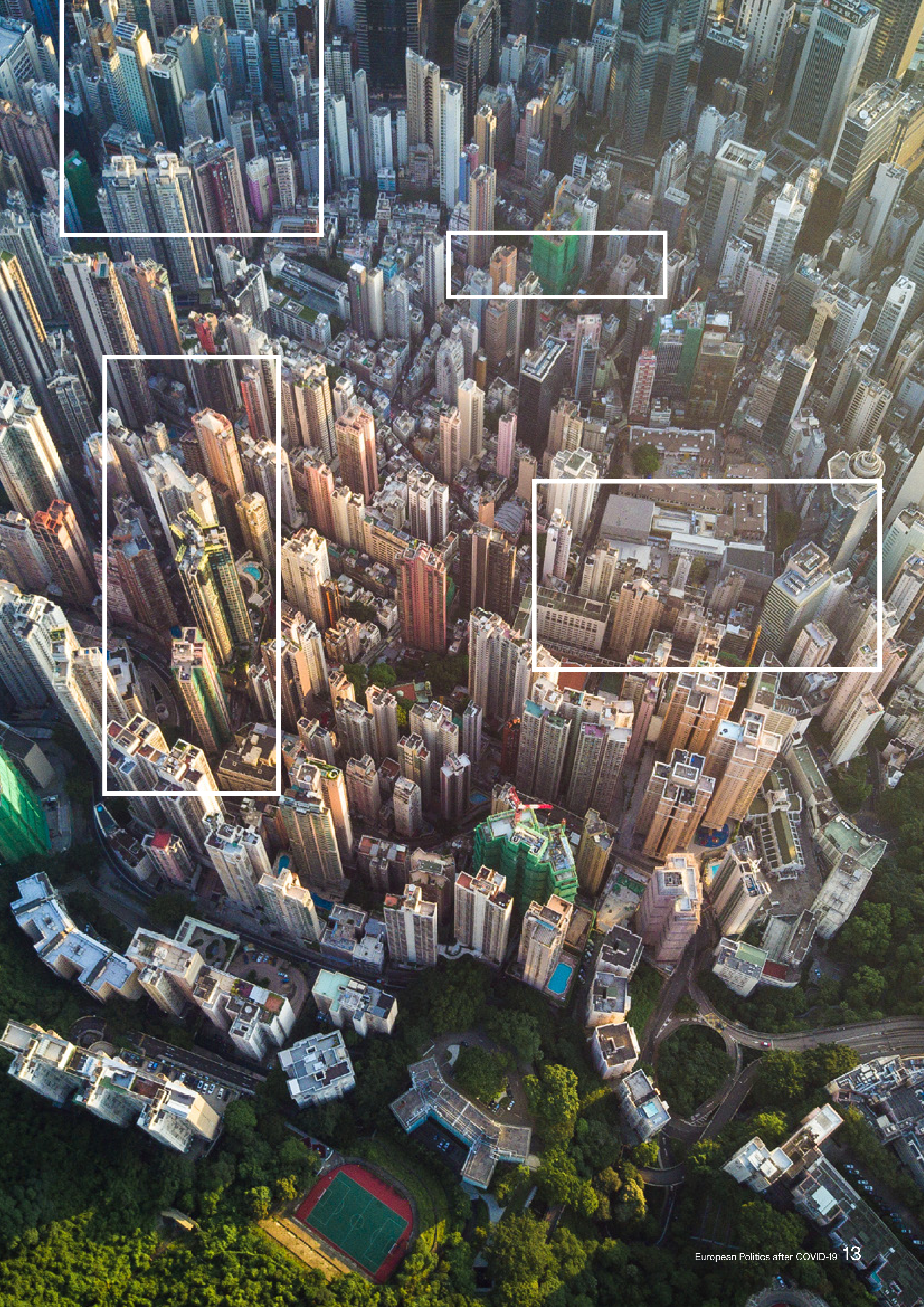
This structured approach provides an effective framework to assess, quantify and mitigate geopolitical risks in an integrated fashion; and might include Red Teaming initiatives to challenge or test the adopted plans and thinking, geopolitical risk workshops, new country risk assessments, tailored scenario development, and risk register stress testing. If the scenarios in this report don't create a problem in your value-chain, what would and is the business resilient enough to meet it? Scenarios can be developed that deliberately challenge adopted strategy, plans and practices.

As COVID-19 continues to unfold, Boards and their risk managers should be proactive and review their risk profiles, risk appetites, and where the relevant tipping points are. Successful organizations will be those that are able to understand, assess and quantify the connected risks, in order to take advantage of opportunities and mitigate or manage the risks of these geopolitical relationships.

To stretch their thinking, businesses will need to:

- **Understand** their new environment through relevant intelligence, assessment and quantification to comprehend the drivers and impacts on their business. Boards must look beyond the most obvious, and work with stakeholders across their business to identify interconnected risks – examining everything from complex supply chains through to human capital policies and reputational damage, to help protect the company and fulfil the duty of care.
- **Identify and assess:** Companies should employ all the tools available to enable them to collate and interpret the information and then deploy subjective (depth of experience, industry insight, research and analysis) and objective (using analytical tools) assessment to inform their organizations' decision making.
- **Prevent and protect:** As the geopolitical landscape changes, so must the way in which risk leaders protect their businesses. A thorough understanding of the interlinked geopolitical risk drivers and their impacts provides a strong foundation for prevention and protection against adverse developments.

Using a range of tools and scenario planning, organizations can gain a holistic view of their risks and drivers, bringing more clarity to complex risk landscapes, and thereby gain competitive advantage. Moreover, organizations can embrace intelligence led capabilities that help to reduce the surprise and shock of regional, national and global events.



Part 4: Political risks

Companies that fail to adapt to the new business environment may find themselves facing political headwinds

Increasing state intervention heightens risks of global trade tensions, clashes between Europe's East and West, and rising populism in economically-weak regions

For those companies that can adapt, many of the trends laid out in the above scenario could serve to leverage the speed of recovery from the COVID-19 shock. For those in challenged sectors or locations, and without the financial resources to make strategic shifts, the new environment may well make recovery even harder to achieve, as these companies find themselves leaning against political headwinds.

This scenario could lead to other political risks as well. After the initial euphoria from the European Council's deal fades, the reality of uneven economic recovery could lead to politicized resentment. (In many cases, the uneven economic recovery is reinforced, rather than being offset, by political action.) Anti-European sentiment in Southern Europe could grow, as opposition parties from poorly-performing regions once again begin to complain about being abandoned by the rest of the EU. Anti-immigrant sentiment could rise, as governments find themselves struggling to provide adequate access to schools and other public services. Both these trends could lead to a recovery in support for populists.

In addition, some Central and Eastern Europe governments (along with some individual political leaders in these regions) may only become stronger as they gain more economic control in an environment of intensifying state intervention in markets. Conflicts that flared during the European Council's negotiations could flare again. The precedent set by the German constitutional court could be used to challenge the supremacy of European law in the area of human rights protection. Some countries may seek to assert new powers to control the media; others may attempt to assert control over the judiciary. Because the support of Central and Eastern European governments is needed in order to move legislation in the European parliament to support recovery, it may be difficult to see off such efforts. (An extreme outcome from such tensions, together with estimates of the potential business losses, in our **Stress Scenario: A clash over Europe's rules**.)

Other areas of political risk arise from the growing importance and effectiveness of industrial policy, as laid out in the above scenario. These policy shifts may not only disadvantage European companies that are unable to adapt; global companies that do business in Europe may also face challenges. Perceived efforts to disadvantage foreign companies can lead to trade disputes, and there are many potential flashpoints for Europe's international trade relations, including over digital taxation, regulation of the technology sector, and carbon tariffs. In addition, European regions that are slow to recover may continue to receive Chinese offers of investment and support, which could create friction between member states and internationally. (An extreme outcome of such trade tensions, along with estimates for potential business losses, is laid out in our **Stress Scenario: A European trade war with China.**)

The growing importance and effectiveness of industrial policy may not only disadvantage European companies that are unable to adapt; global companies that do business in Europe may also face challenges.

Stress Scenario by Oxford Analytica - A European Trade War with China

A bomb blast occurs in Hong Kong, causing devastating damage to a government building. Overnight, Chinese troops are sent in to prevent further terrorist attacks. Days later, videos appear on social media that appear to record incidents of violence involving mainland troops and Hong Kong citizens.

Hawks in the US Congress demand blanket sanctions against China, but the US president is reluctant. Some European officials, hoping to bolster technology “reshoring,” denounce China’ actions in harsh terms, provoking strong responses from Chinese officials. Trade sanctions are proposed but watered down in the face of Eastern European opposition. There is a rash of anti-Chinese public sentiment in Europe, including consumer boycotts. Some EU governments, bowing to public pressure, ban Huawei from bidding for 5G contracts.

China responds by expanding the list of firms designated as “unreliable” to include EU corporations, and in effect forcing some smaller EU companies out of the Chinese market. Some EU businesses operating in China face investigations of “improper market practices” that they see as discriminatory. Key EU businesspeople living in China are also designated as “unreliable” and their visas are withdrawn.

As the trade war intensifies, data indicate another sharp downturn in the Chinese economy. The Chinese currency plummets and capital controls, last imposed in 2015-2016, are reimposed.

China’s leadership announce an ambitious stimulus program for economic recovery, nearly twice the size of the post-pandemic stimulus package. Instead of infrastructure, this new program bolsters China’s push towards technological self-sufficiency: support for technology infrastructure and substitution of technology imports. China’s leadership announces a “moonshot” goal: to achieve technological decoupling from the West within a decade.

In response, the US president announces a “ban” on all US exports of semiconductor products to China. Soon, there is pressure in EU capitols to follow suit.

Modelling of scenario impacts by Willis Towers Watson

If this scenario were to occur as written, our claims-based model forecasts the losses shown below for EU foreign direct investors. Risks in China would rise, as capital controls make it difficult to repatriate earnings and the threat of arbitrary and discriminatory regulatory intervention increases. Other losses occur in countries that are already vulnerable to external economic shocks and are heavily dependent on Chinese commodity demand, such as Angola and Libya. More information on the modelling assumptions is provided in the **Afterword: About the Value at Political Risk Tool.**

Figure 4: **Countries where EU companies suffer political risk losses**

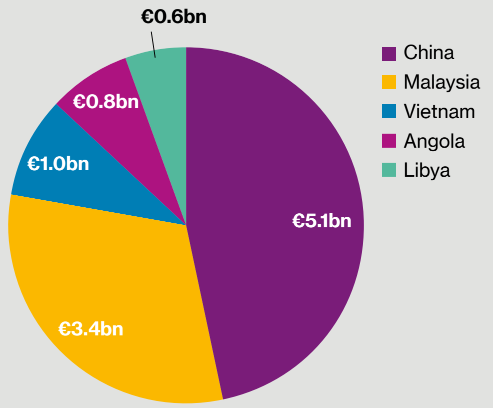
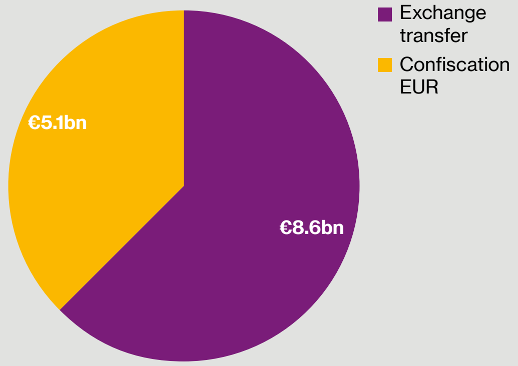


Figure 5: **Political risks that cause loss**



Part 5: Conclusion by Willis Towers Watson and Oxford Analytica

Political events are, of course, unpredictable. European politics will surely not evolve precisely as envisioned in the above scenario. That said, the above narrative is in part driven by the amplification of what Oxford Analytica's experts view as current trends, so companies may do well to take heed and be prepared.

While all countries will react to the economic and public health shocks from the COVID-19 virus in their own ways, certain commonalities are likely. To this end, the above scenario establishes several themes, some of which may also be reflected in other parts of the world:

The most important is the strong re-emergence of an activist industrial policy that builds on public investment in private-sector enterprises and that focuses politically on job creation, regional development, and strategic autonomy. This focus on industrial policy emerges initially with respect to the pharmaceutical, health care, information technology, and defence sectors, but soon spreads to other sectors.

A second theme is the uneven nature of the economic recovery, with more obviously inequitable fiscal capacities at the national level having a greater impact on growth outcomes in an environment where state support is more important. This unevenness reinforces both the move toward a more activist industrial policy and, in Europe, the weakening of certain institutional forms of regional integration, notably surrounding "state aids." Together with the first trend, the result is that supply chains and other economic relationships become more geographically concentrated.

A third theme is the weakening of democratic institutions with greater political fragility in the more liberal democracies of Western and Southern Europe, and a more rapid slide into something more closely approaching democratic authoritarianism in some Central and Eastern European countries. This pattern is reinforced by the weakening of European rule of law and by the strengthening of political control over formerly private-sector activity.

More stress-testing scenarios are available, and can be applied directly to your company, via the Value at Political Risk Tool (for more information on the tool, see the **Afterword: About the political risk modelling in this report**).

We thank Oxford Analytica and its contributors for the development of the scenarios.

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Afterword: About the political risk modelling in this report

The threat posed to businesses by political upheavals or social change, such as expropriation or mass strikes, are difficult risks to manage as the past is often a poor guide to the future. Political risks can emerge rapidly in societies that have enjoyed stable business conditions for years, so that simple trend assessments or data analysis are inadequate in gauging the financial impact of political risk.

Value at Political Risk, a joint initiative by Willis Towers Watson and Oxford Analytica, is a unique analytics tool, which allows global companies to assess in real dollar terms, the financial impact of political risk exposure by industry and country.

The tool gives businesses a competitive edge by:

- Estimating dollar-value losses for political risk events over time.
- Monitoring political risk exposures on an ongoing basis in light of changing world conditions, and
- Assessing the severity of political risk contingencies under alternate investment scenarios.

In this report, we have applied this tool to model the potential political risk losses of European companies under the adverse scenarios described. We have estimated the exposures of European companies using Eurostat statistics on the annual turnover of foreign affiliates of European companies, which are broken down by company and by industry.[1]

The Value at Political Risk tool calibrates ratings of political risk level by country and industry with historical claims data on insurable political risks. To evaluate companies' losses under each scenario, we have adjusted the risk ratings to match the scenario narratives.

Under the "dispute over Europe's rules" scenario we assumed:

- As Europe turns down, countries suffer shocks to their current account deficit proportionate to the share of exports to Europe in economic activity. Risk ratings for sovereign default and exchange transfer risks are re-calculated using these new current account deficit figures.
- Italy, Greece, Spain and Portugal suffer a small increase in currency inconvertibility risk and a significant increase in risks of default by public sector buyers.
- Political violence risks rise due to riots and far-right terror attacks in Austria, Belgium, France, and Germany. The rise is sharper in Italy, Poland, Greece and Hungary.

Under the "European trade war with China" scenario we assumed:

- As China's economy turns down, countries suffer shocks to their current account deficit proportionate to their share of exports to China in economic activity. Risk ratings for sovereign default and exchange transfer risks are re-calculated using these new current account deficit figures.
- Expropriation risks rise for EU companies as discriminatory regulatory interventions force some foreign companies to exit the Chinese market. Companies in the technology sector face higher risks. China imposes severe capital controls, which produce currency inconvertibility losses.

[1] https://ec.europa.eu/eurostat/web/economic-globalisation/globalisation-in-business-statistics/foreign-affiliates-value-added-/-turnover

Each applicable policy of insurance must be reviewed to determine the extent, if any, of coverage for COVID-19. Coverage may vary depending on the jurisdiction and circumstances. For global client programs it is critical to consider all local operations and how policies may or may not include COVID-19 coverage.

The information contained herein is not intended to constitute legal or other professional advice and should not be relied upon in lieu of consultation with your own legal and/or other professional advisors. Some of the information in this publication may be compiled by third party sources we consider to be reliable, however we do not guarantee and are not responsible for the accuracy of such information. We assume no duty in contract, tort, or otherwise in connection with this publication and expressly disclaim, to the fullest extent permitted by law, any liability in connection with this publication. Willis Towers Watson offers insurance-related services through its appropriately licensed entities in each jurisdiction in which it operates.

COVID-19 is a rapidly evolving situation and changes are occurring frequently. The information given in this publication is believed to be accurate at the date of publication shown at the top of this document. This information may have subsequently changed or have been superseded, and should not be relied upon to be accurate or suitable after this date.

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Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

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