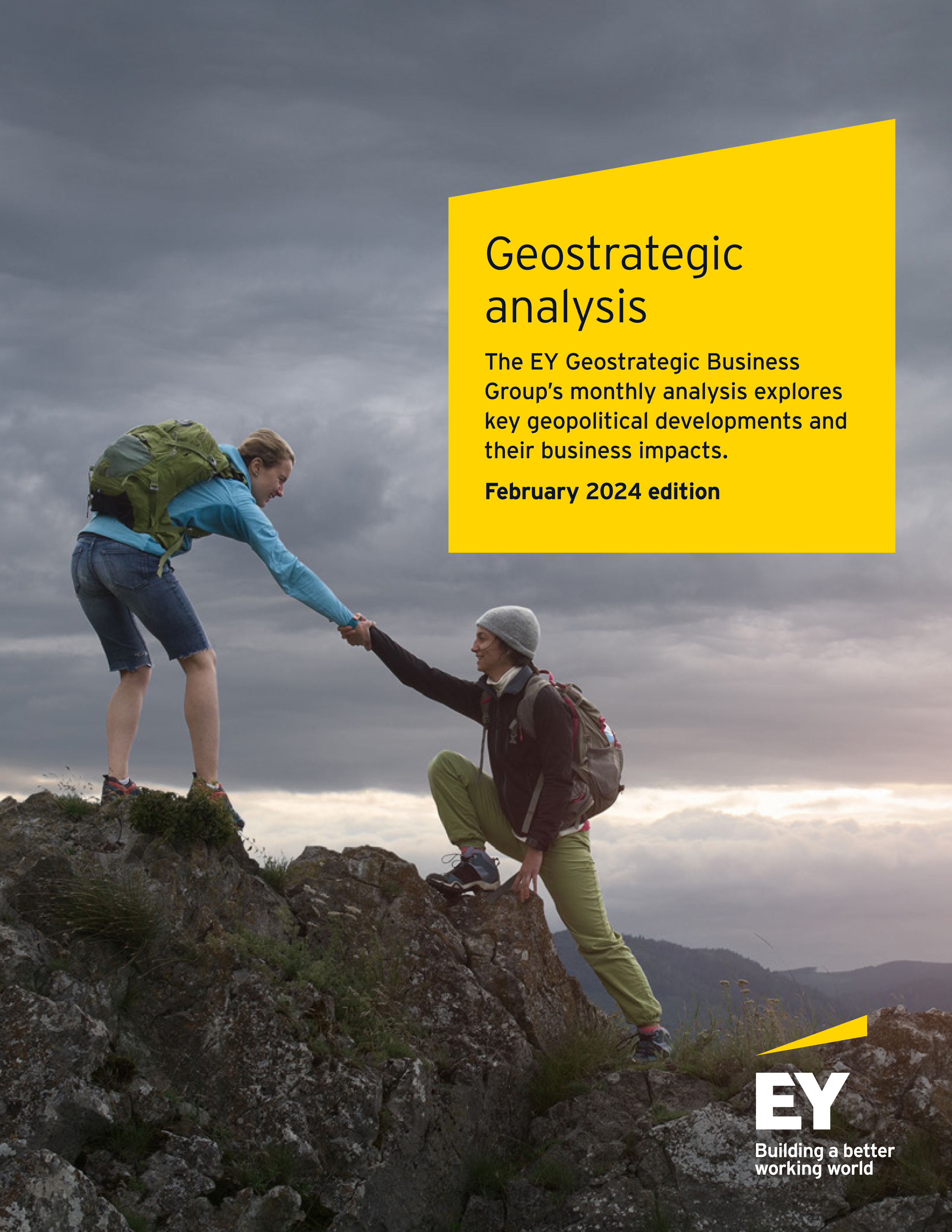


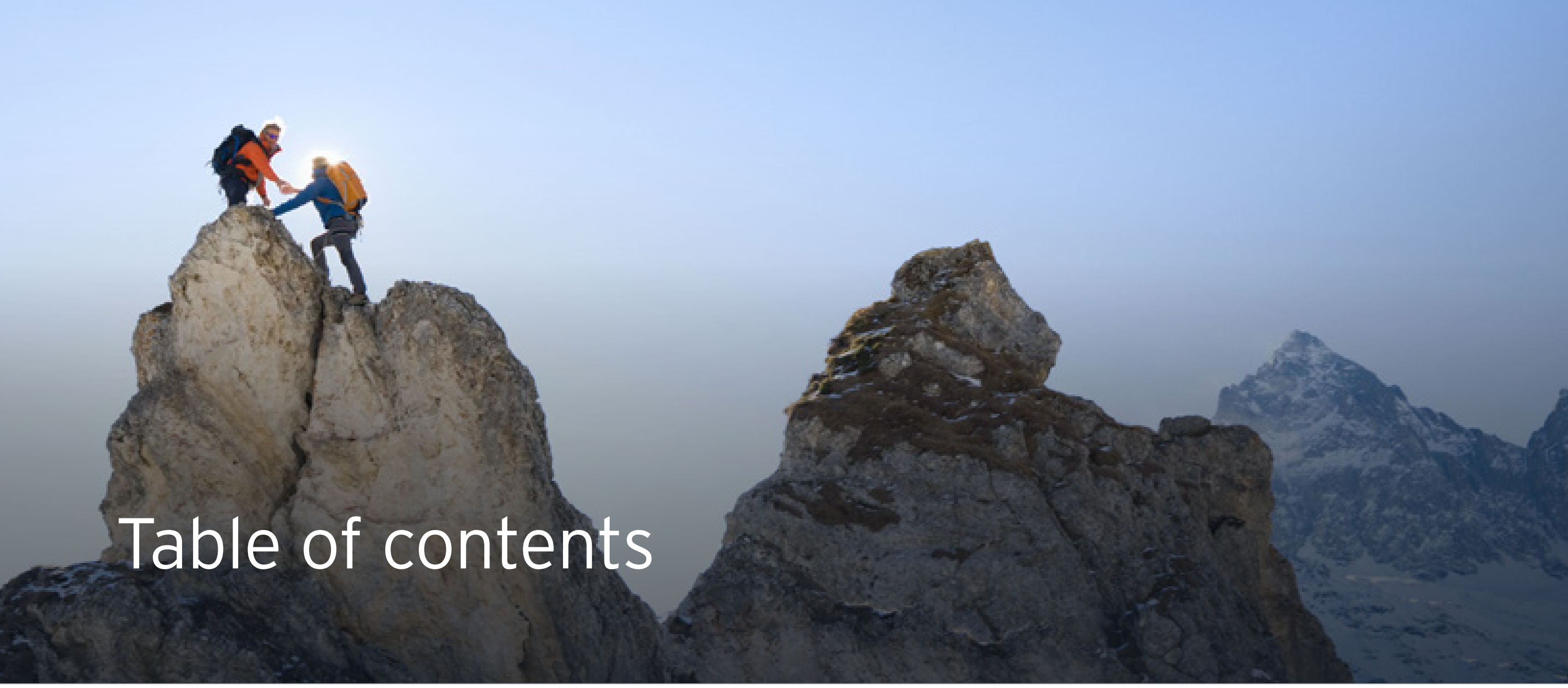
Geostrategic analysis

The EY Geostrategic Business Group's monthly analysis explores key geopolitical developments and their business impacts.

February 2024 edition

EY

Building a better working world



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EY Geostrategic Business Group (GBG)

Translating geopolitical insights into business strategy

Read more.

1 Top development

Red Sea instability will continue to challenge global trade

What happened

Since November, the Yemen-based Houthi rebel group has conducted at least 30 attacks against ships transiting the Red Sea to or from the Suez Canal. Since late December, a US-led coalition of 20 countries has been providing protection for commercial ships transiting the Red Sea and Gulf of Aden.[1]

In January, land-locked Ethiopia signed an agreement with Somaliland, a breakaway region of Somalia, to gain access to the port of Berbera and some coastline along the Gulf of Aden.[2] In exchange, Ethiopia became the first country to recognize Somaliland as an independent state, which has sparked controversy in the region.

The Sudanese military and the Rapid Support Forces (RSF) paramilitary group have been fighting a civil conflict for more than nine months, further heightening instability near the Red Sea.

What's next

The risk of geopolitical disruption to ocean-based commercial transportation in and near the Red Sea (and other busy maritime chokepoints) is likely to persist in the near and medium term, as discussed in the EY 2024 Geostrategic Outlook.

The US-led coalition will continue to provide security to ships transiting the region and to conduct strikes against Houthi targets, especially if a cargo vessel or warship suffers heavy damage and fatalities. This could lead to escalation by Houthi militants or other Iran-backed groups against US or UK targets elsewhere in the region.

Recent US and UK airstrikes against Houthi targets are unlikely to significantly deter further attacks on shipping though they will likely limit Houthi capabilities. The Houthis claim their attacks relate to the conflict in Gaza, so are unlikely to cease hostilities while it is ongoing.

Somalia will continue to push against Ethiopia's port deal with Somaliland, as the African Union and other external parties are likely to continue to call for a peaceful resolution. Any conflict would likely further destabilize maritime routes in the area.

Sudan's civil conflict is spreading eastward, signaling potential further instability close to the Red Sea.[3] An RSF victory is seen as increasingly likely, though, so a resolution of the conflict may be possible in the coming months. RSF leader General Dagalo's recent meetings with leaders from Uganda, Ethiopia, Djibouti, Kenya, South Africa and Rwanda may indicate a shift in perceptions regarding the legitimacy of a potential future RSF-led government, at least within the region.

Business impact

Major sectors affected include energy, advanced manufacturing and mobility and consumer products and retail.

The Suez Canal typically handles about 30% of global container shipments and about 12% of global trade. Since the attacks began, most major container lines have suspended traffic through the Red Sea.[4] Relatedly, shipping war risk premiums for the Red Sea have increased substantially. Shipping companies and insurance companies will see higher rates for their services, but face heightened operational risks.

Importing companies — primarily in Europe, as exports from East Asia to Europe account for a significant share of Suez Canal container traffic — will likely face delivery delays and higher costs. Executives should prepare for inflation to persist and should consider diversifying their supply chains, including potentially through the use of air freight and alternate maritime or land routes.

Suez Canal fees account for at least 1.5% of Egyptian GDP and are a significant source of government revenue. Trade volumes through the canal have dropped by 40% as ships divert around southern Africa. If this continues, Egypt's economy may suffer and companies with exposure to Egypt may face lower levels of demand.

The Red Sea conflict highlights the intensifying risk to maritime trade and other aspects of the ocean economy. Heightened risks in other regions — such as the Persian Gulf, Black Sea, and East Asia — will require continuing operational flexibility by companies dependent on complex global supply chains. Executives should develop contingency plans to mitigate logistics risks and increase supply chain resilience, including through consideration of more regionally based approaches.

For more information, contact Angelika S Goliger, Ben-Ari Boukai, Jay Young, Hulisani C Muloiwa and Courtney Rickert McCaffrey.

Additional reading: 2024 Geostrategic Outlook

[1] How Houthi Attacks in the Red Sea Threaten Global Shipping | Council on Foreign Relations (cfr.org) https://www.cfr.org/in-brief/how-houthi-attacks-red-sea-threaten-global-shipping
[2] New Deals Open Old Wounds in the Horn of Africa | Council on Foreign Relations (cfr.org) https://www.cfr.org/blog/new-deals-open-old-wounds-horn-africa
[3] Sudan's Calamitous Civil War: A Chance to Draw Back from the Abyss | Crisis Group https://www.crisisgroup.org/africa/horn-africa/sudan/sudans-calamitous-civil-war-ch ance-draw-back-abyss
[4] The Houthis are borrowing from the Iranian playbook in the Red Sea (ft.com) https://www.ft.com/content/4c1714f1-bd58-4d9b-bef7-9be694953ca9

Sector in focus: Energy and resources

EU energy diversification to secure supply and stabilize prices, but weighs on competitiveness

What happened

Since the beginning of the war in Ukraine, EU governments have successfully reduced reliance on Russian energy imports by doubling liquefied natural gas (LNG) imports and reducing gas demand by 20% from 2021 due to more clean power generation, energy efficiency measures and an industrial slowdown.[5]

In December 2023, EU leaders reached a tentative agreement to reform the EU electricity market. The reform would introduce Contract-for-Difference (CfD) mechanisms, allowing governments to use profits of energy producers above a certain level to co-finance clean energy investments.

What's next

Despite the risks of further disruptions to oil trade in the Red Sea and sabotage of critical energy infrastructure,[6] European countries are expected to avoid major interruptions to their energy supply this winter and conclude the season with gas storage at 50%-55% of capacity.[7]

The EU's energy supply will continue to increasingly rely on imported LNG—mainly from Norway and the US, which alone is expected to increase production capacity to an amount equal to about 10% of the EU's total LNG imports.

In the long term, as the share of renewables in the EU power system increases (a target of 70% by 2030), power prices are expected to be more stable, as a result of both reduced exposure to fossil fuel volatility and reform of the electricity market and pricing mechanism.

Business impact

While European gas prices are expected to be stable and low throughout this winter, electricity prices are likely to remain elevated in the medium term, which could negatively affect the international competitiveness of energy-intensive industries in Europe.

As the EU continues to de-risk its energy supply chains away from Russia, energy companies may benefit from public investments to expand renewables and nuclear production. CfD financing, for instance, would secure a minimum return on investments for companies and prevents excessive electricity costs for consumers in the event of another crisis.

At the same time, as European gas prices will increasingly be exposed to global LNG markets, businesses should identify and monitor political risks that could disrupt LNG trade routes and production, such as Red Sea instability and potential shifts in the US's LNG export policy.

For more information, contact Famke Krumbmüller and Andy Brogan.

Additional reading: How bold action can accelerate the world's multiple energy transitions

[5] European natural gas demand tracker (bruegel.org) https://www.bruegel.org/dataset/european-natural-gas-demand-tracker
[6] Nord Stream blast 'blew away 50 metres of pipe' (bbc.com) https://www.bbc.com/news/world-europe-63297085
[7] European gas prices cool as traders shrug off cold snap (ft.com)

3

Other issues we are watching

Taiwan’s post-election stability, Brazil tax reform, Argentina’s reform hurdles

Taiwan’s post-election environment likely to be stable

Taiwan was among the first jurisdictions to hold elections in the 2024 global elections supercycle. The ruling Democratic Progressive Party (DPP) won a third consecutive presidential term — albeit with a smaller vote share of only 40% — but lost its majority in parliament. The opposition Kuomintang (KMT) won the largest share of parliamentary seats and will likely seek to align with the other opposition party, the Taiwan People's Party (TPP), on a variety of domestic and foreign policy issues.

Business impact: Beijing’s reaction was muted, claiming the DPP and its more pro-sovereignty stance “cannot represent the mainstream public opinion on the island”.[8] A split government in Taipei means that cross-strait relations are likely to remain consistent with the recent past, as neither the president nor parliament will be able to shift policy significantly without the other’s support. While there may be intermittent business disruptions due to military exercises in the strait — particularly around president-elect William Lai’s inauguration on 20 May — such disruptions are likely to be minimal and the business environment will be stable.

For more information, contact Courtney Rickert McCaffrey and Yi Y Xie.

Brazil’s tax reform could provide an economic boost

The Brazilian congress passed a constitutional amendment in December that reforms the country’s tax system. The amendment replaces the country’s five separate consumption taxes with a dual value-added tax (VAT) system.[9] The new VAT will be assessed at the federal and state levels and be phased in over seven years starting in 2026. The implementation of the reform will require additional legislation, which could limit some of the tax credits and special regimes that are included in the constitutional amendment.

Business impact: The new dual-tax system will be a significant overhaul of Brazil’s highly complex tax system, with government officials claiming it could add almost 2.4% to Brazil’s GDP growth over the next eight years. The reform seeks to avoid an increase in the overall tax burden, leading to a likely reduction in the cost and effort of tax compliance. However, there is uncertainty about the VAT rate that will be set. Some initial analysis suggests the new system could be especially favorable to companies with longer supply chains and larger capital intensity, notably manufacturing. Increasing the competitiveness of Brazil’s manufacturing base could also create growth and investment opportunities in other sectors.

For more information, contact Jay Young and Waine Peron.

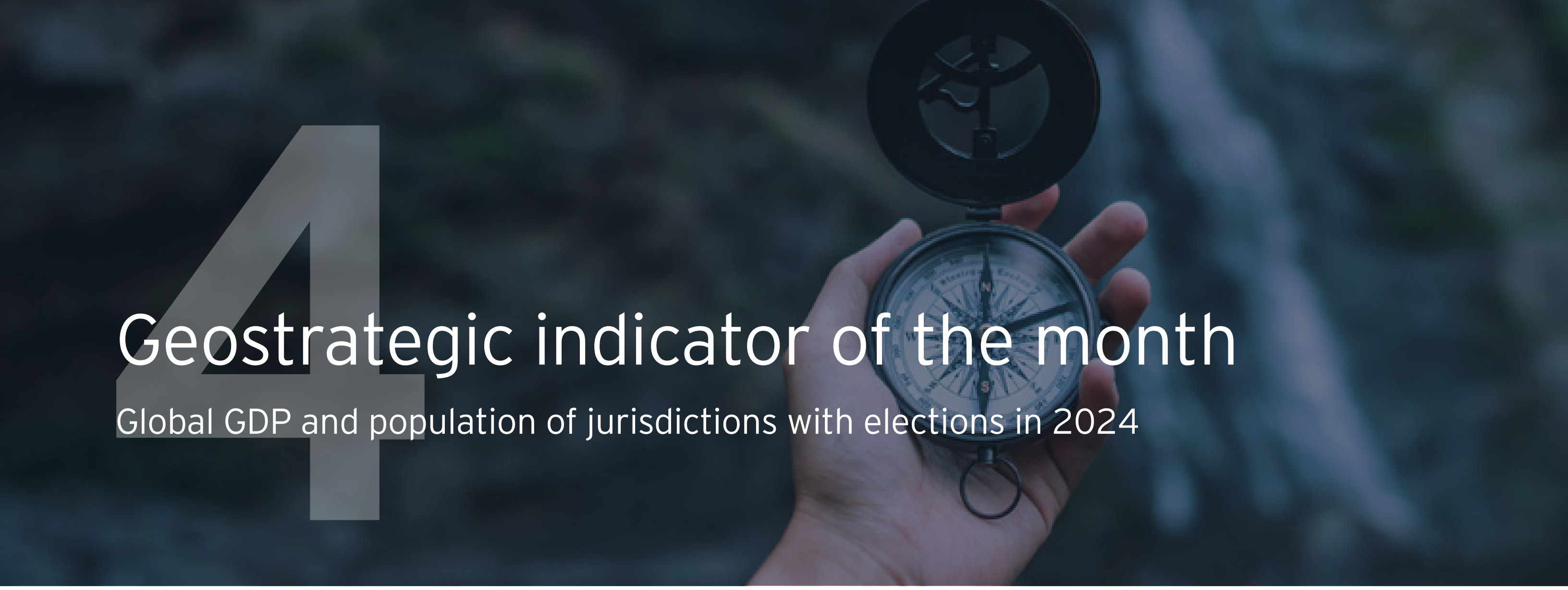
Argentina’s reform agenda faces economic and political hurdles.

Argentina’s new president, Javier Milei, has embarked on sweeping reform efforts. The administration’s initial proposed “omnibus legislation” contains more than 600 measures that would introduce electoral reforms, expand presidential powers during a transition period and deregulate the economy, including privatizing state-owned industries, removing fuel subsidies and raising export taxes.[10] However, the outlook for passage of the legislation is uncertain given the governing coalition’s lack of a majority in congress. Milei also issued a wide-ranging presidential decree that includes measures to reduce regulations and reform public administration.

Business impact: The government has secured an agreement with the IMF to meet repayment obligations through April.[11] However, attempts to stabilize the economy will be challenged by congressional and judicial scrutiny, as well as the population’s ability and willingness to weather austerity measures and continued high inflation, estimated to reach over 200% in 2023.[12] The potential for labor strikes and broader political and societal tensions will remain elevated in the near term, which could create business operations disruptions. If the reforms are implemented, privatization may create new opportunities for infrastructure and construction firms. Regulatory reforms would also reduce costs and create opportunities for companies across sectors, notably including energy and resources.

For more information, contact Adam Barbina.

[8] Mainland spokesperson comments on Taiwan election results-Xinhua (news.cn) https://english.news.cn/20240113/a669c1402683472ca4e420ca94fcd8df/c.html
[9] Brazil passes long-awaited tax reform (ft.com) https://www.ft.com/content/b707b4a7-9871-4c30-8232-470691e0dedc
[10] Argentina’s Javier Milei presents wide-ranging reform legislation to Congress (ft.com) https://www.ft.com/content/4f10131f-7f5b-4888-8402-b11db3095964
[11] IMF Staff and the Argentine Authorities Reach Staff-Level Agreement on Seventh Review under the Extended Fund Facility Arrangement https://www.imf.org/en/News/Articles/2024/01/10/pr2405-argentina-pr2405-imf-staff-authorities-reach-sla-seventh-review-under-eff-arrangement
[12] Consumer price index | Ministry of the Economy of Argentina (indec.gob.ar) https://www.indec.gob.ar/uploads/informesdeprensa/ipc_01_24DBD5D8158C.pdf



Geostrategic indicator of the month

Global GDP and population of jurisdictions with elections in 2024

The indicator

In 2024, a wave of elections is set to occur in geopolitically significant markets around the world, representing 54% of the global population and nearly 60% of global GDP. These elections will be held amid already heightened mistrust in governments.[13] Such dynamics, combined with nationalist and populist trends and polarizing issues, increase the risk of social unrest surrounding elections. Key upcoming elections include those in India, Indonesia, South Africa, Mexico, the UK and the US, as well as the European Parliament elections in June.

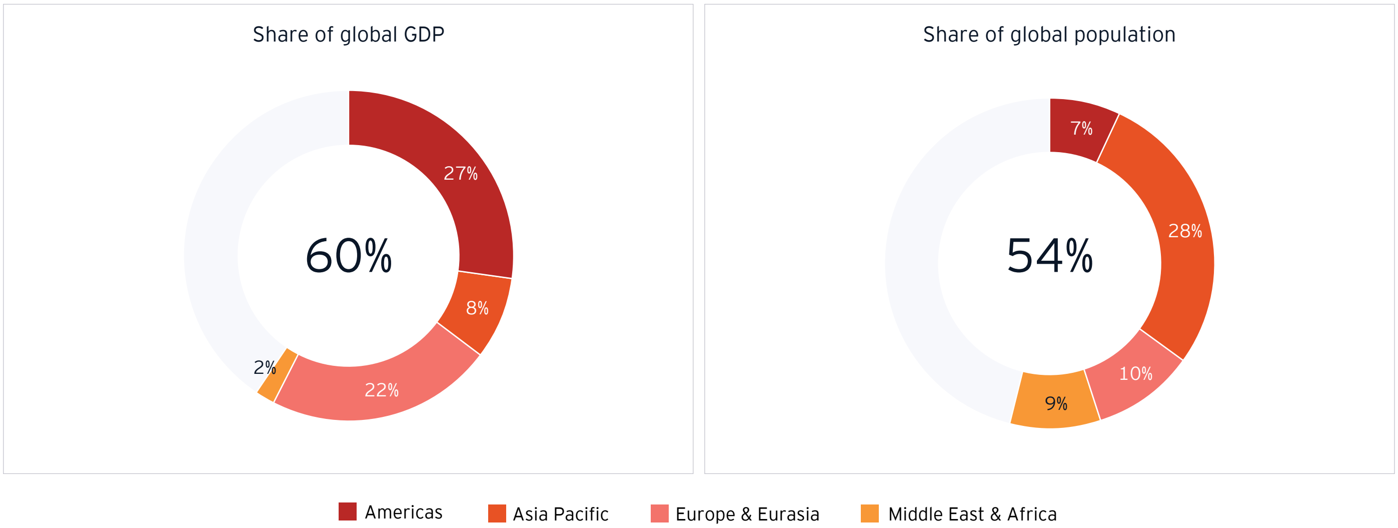
Business impact

The combined effect of this global elections supercycle will be an unprecedented level of electoral, regulatory and policy uncertainty, with long-term impacts for industrial strategies, climate policies and ongoing military conflicts. Heightened voter concerns about inflation and economic growth mean many new governments are likely to have economic policy at the top of their agendas. Successfully navigating these challenges requires scenario analysis, which is the identification of multiple plausible outcomes and the assessment of business implications. Companies should monitor election outcomes and how they affect stakeholder interests, and be prepared to evaluate corporate strategy as the post-election landscape becomes clearer.

Additional reading: 2024 Geostrategic Outlook

Jurisdictions with elections in 2024 account for more than half of global GDP and population

Shares of global GDP and population of jurisdictions with elections in 2024, by region



Source: World Bank, International Foundation for Electoral Systems.
Note: These figures include jurisdictions for which elections are planned for 2024 but no date has yet been set.

13. 2023 Edelman Trust Barometer Global Report (edelman.com) https://www.edelman.com/sites/g/files/aatuss191/files/2023-03/2023%20Edelman%20Trust%20Barometer%20Global%20Report%20FINAL.pdf

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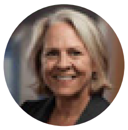

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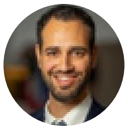

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