The All-Too-Visible Hand

Political risk and regulatory uncertainty are weighing heavily on the global economic outlook.

January 2017
Releasing a five-year global economic outlook in the current, volatile global environment is perhaps much more brave than it is wise. After all, the world has experienced several wake-up calls, especially in the past 12 months, on the profound weaknesses associated with forecasting even short-term political and economic developments. Beyond that, our ongoing conversations with leaders across the world reinforce the view that operating in the current environment is becoming more complicated, more time-bound, and more difficult altogether.

Precisely because of the totality of the mounting uncertainties we face, the need to carefully analyze the forces shaping the economic outlook is all the more pronounced. In that spirit, we offer here a net assessment of the constellation of elements that will condition the path of the global economy between now and 2021.

The title of this assessment, *The All-Too-Visible Hand*, leaves little doubt about where we fall in this net assessment. We are at the confluence of the end of “the end of history,” the end (or at least the interruption) of many of the economic levers of policy that have defined our capacity to foreordain outcomes, and the end of a quarter-century of turbocharged globalization that has completely redefined the world around us. Adam Smith’s “invisible hand” is disappearing rapidly. If trends persist, soon it could be nowhere to be seen. In its place, we can expect to witness the continued rise of all-too-visible hands—reflected in economic nationalism, the reversal of increases in cross-border factor flows that have contributed to economic growth for decades, and a significantly higher profile of the state in decisions involving commerce.

Of course, political variables have always been an important part of the global economic equation. But we think that on balance, they will be even more important over the next five years. In addition, we think these political and policy uncertainties will generate substantially more downside risk than they have in previous years.

For these reasons, we zoom in on crosscurrents in monetary policy, fiscal policy and rising stocks of debt, the role of regulation, the specter of protectionism, and geopolitical tensions. Each represents an important policy-related wild card, and together they represent significant contingencies on how the future might unfold.

Companies, especially those with global operations, need to devise hedging strategies to account for these looming policy uncertainties. We are well beyond the time when we can take for granted the continuation of the invisible hand.

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Executive Summary

- Global economic growth will strengthen slightly to 3.1 percent in 2017, up from 2.3 percent in 2016, but the medium-term outlook is flat. Average annual global output growth through 2021 will be about 3.0 percent. This delicate recovery will be underpinned by stronger growth in a limited number of developed and emerging markets.

- Four economic elements in particular help explain why projected growth is flat: the growing strength of the US dollar, continuation of the global resource slump cycle, the ongoing hiatus in globalization, and sustained weak productivity gains.

- As important as these and other economic fundamentals are, political, policy, regulatory, and geopolitical risks will largely determine economic outcomes. This creates an even more uncertain global operating environment for businesses, as national politics is becoming more unpredictable in key markets around the world. Five of these political risks in particular represent a substantial drag on the global economic outlook: monetary policy, fiscal policy, regulation of the new economy, protectionism, and geopolitics and domestic political shocks.

- These political variables are manifesting themselves in all five of the world’s largest economies, which in 2016 accounted for 71 percent of total global output (at market exchange rates). For instance, populism and protectionism are weighing on the medium-term outlooks of the United States and the EU member states, while the eurozone and Japan are continuing to pursue unconventional monetary policies to stimulate domestic growth. India and China are grappling with regulatory reform amid a rapidly shifting global environment marked by rising volatility. All five markets are likely to be affected by geopolitical tensions, some of their own making.

- Business leaders—especially those with global operations—need to devise hedging strategies to account for these looming policy uncertainties. With political risk now acting as an all-too-visible hand in shaping economic outcomes, the most important business priorities in the near to medium term will be to build strategic foresight capabilities and become agile enough to respond rapidly and effectively to changing circumstances.
Introduction

The global economy remains sluggish heading into 2017, but the growth outlook is nevertheless somewhat stronger than in recent years. On the positive side, we anticipate a few bright spots in the global economy, such as the US and Indian economies, and the marginal recovery of the Brazilian and Russian economies in 2017. Much of this boost will only be short term, however, so the base case forecast is flat over the next five years, with average annual growth of about 3.0 percent projected through 2021 (see figure 1). This very modest recovery will be uneven. South Asia, Sub-Saharan Africa, and East Asia will see the highest levels of dynamism over the next five years (see figure 2 on page 3). On the negative side, growth in the developed-market regions will continue to be weak, and Latin America will underperform relative to other emerging market regions.

Figure 1

Global economic growth will strengthen marginally this year

A number of economic factors help explain why the recovery is so anemic and uneven. Four are especially important.

First, while the strength of the US economic recovery in 2017 and beyond remains an open question—especially with a new administration about to take office—one clear effect on the global economy in the short to medium term is the significant rise of the US dollar against other major currencies. The US dollar hit a 15-year high against a trade-weighted basket of currencies in late 2016 and is likely to remain strong in 2017. Although this will harm US export competitiveness, in the absence of new American restrictions it will dramatically increase US demand for imports from the rest of the world. And it will improve the relative competitiveness

Notes: GDP is measured at market exchange rates. Developed markets are those that the IMF characterizes as “advanced economies” and emerging markets are those that the IMF characterizes as “emerging market and developing economies.”
Sources: International Monetary Fund, Oxford Economics, Economist Intelligence Unit, A.T. Kearney analysis
The deteriorating environment for continued globalization is the third factor. In 2016 it became increasingly clear that citizens in many developed markets are dissatisfied with their economic

Notes: GDP growth is measured at constant prices. GDP figures are the 2017–2021 simple average of the annual average growth rates of the economies within each region.
Sources: International Monetary Fund World Economic Outlook October 2016; A.T. Kearney analysis
lot in life, and many blamed globalization for their woes. Some political figures, including populists espousing various forms of economic nationalism, fanned the flames. As a result, the hiatus in globalization is continuing. The global economy may be heading toward an “islandization” scenario in which nationalism rises and countries turn inward, implementing protectionist trade measures and fragmenting the global economy. These protectionist and isolationist policies will dampen the growth prospects of some large developed markets over the next few years. However, even as the United States and some European markets turn inward, China, India, many large South American economies, and other emerging markets are seeking new international trade and investment deals.

**Political, policy, and regulatory risk** is the all-too-visible hand that is shaping the global economic outlook.

The fourth element preventing higher levels of global output growth is low productivity growth. The dismal average country-level annual productivity growth since 2008 continued in 2016, at just 0.4 percent. This average is dragged down by developed markets in particular. The Economist Intelligence Unit estimates that in 2016, productivity growth was negative in the United States and less than 1 percent in Japan and most major developed European markets. The longer-range outlook is somewhat stronger, but there are structural changes in the global economy that are weighing on the longer-term trajectory. Chief among these changes is a rapidly aging global population, which is causing the worldwide working-age population to stagnate.

In light of these considerations, sustained economic momentum will remain elusive. And most of the risks are on the downside. Moreover, the nature of those risks is changing, as economic fundamentals are now being overshadowed by a different kind of risk. Consider the current debate over the state of the global economy. Most discussion is dominated by issues such as Brexit, deteriorating infrastructure, China’s reform agenda, the effect of potential corporate tax changes on US business investment, the implications of unconventional monetary policy, and the risks of rising protectionism. What all of these drivers of global economic performance have in common is that they are manifestations of political, policy, and regulatory risk—the new and all-too-visible hand that is shaping the global economic outlook.

**The All-Too-Visible Hand of Political Risk**

Political risk is commonly defined as the risk an investment’s returns could suffer as a result of political changes or instability in a country. Such risks stem from new or divergent economic policies and business regulations, including tariffs on international trade, tax rates, currency convertibility, and environmental and labor standards, as well as from broader government policies such as interest rates and investment in infrastructure and education.

Five major political, policy, and regulatory risks are currently chilling the global economic growth outlook: monetary policy, fiscal policy, regulation of the new economy, protectionism, and geopolitics and domestic political shocks.
Monetary policy

More than eight years after the onset of the global financial crisis, many of the world’s largest central banks have yet to normalize their monetary policies by raising interest rates significantly above zero and reducing the size of their balance sheets to pre-2007 levels. The extended period of time during which interest rates have been held at or near zero is historically unprecedented (see figure 3). So too are the unorthodox expansionary policies in which most of these central banks have engaged, including quantitative easing (QE). These policies, coupled with the reluctance or perceived inability of many governments to maintain an expansionary fiscal policy (discussed below), have put central banks front and center in efforts to stimulate the economy in the wake of the global financial crisis. The Bank of Japan (BOJ) and European Central Bank (ECB) are likely to maintain their expansionary stances. The Bank of England (BOE) and the People’s Bank of China (PBOC) face a delicate balancing act. In the meantime, the US Federal Reserve, as its December 2016 meeting revealed, is shifting toward interest rate tightening. But unwinding these extraordinary policies will be challenging, and central banks currently have very little margin to respond should a new crisis arise. This situation creates risks not only for monetary policy makers, but also for the stability of the overall economy.

Figure 3
Central banks in major economies still have no room to maneuver

Central banks’ target interest rates

(%)
These efforts far outstrip the expansionary policies of other major central banks, and they have reached unprecedented levels. For instance, Bloomberg estimates that the BOJ’s stock purchases will make it the largest shareholder in 55 of the 225 companies in the Nikkei index by the end of 2017. If the Japanese economy continues to stagnate, the BOJ will be forced to continue its extraordinary policies, which will eventually become unsustainable because of their distortional effects on markets and corporate governance.

The ECB is also expected to continue its QE program as inflation in the eurozone remains far below its target of just under 2 percent. In December 2016 the ECB extended its QE program through the end of 2017 due to lower-than-expected inflation and political uncertainty over several key European elections in 2017. However, the euro has weakened dramatically—falling in value from $1.15 in May 2016 to just $1.05 in December—which is likely to push up inflation. And eurozone unemployment fell below 10 percent in October 2016 for the first time since 2011, highlighting the strengthening—albeit slow and uneven—of the European labor market. Along with diverging economic growth rates within the eurozone, these economic indicators mean that the ECB may begin to normalize monetary policy sooner than currently expected.

The BOE is facing a delicate situation in the wake of the Brexit referendum. In the aftermath of the vote, the BOE lowered interest rates and increased its asset purchase program in an attempt to stabilize the economy. But the weaker pound, falling in value from approximately $1.50 in December 2015 to $1.25 a year later, is stoking inflation, which would normally lead to rising interest rates. The BOE may allow higher inflation than usual, though, in order to not stifle growth given a weaker medium-term outlook and the economic uncertainty surrounding Brexit. This unclear interest rate outlook creates challenges for business planning decisions.

The outlook for the PBOC’s monetary policy is also somewhat uncertain. It has held its benchmark interest rate at 4.35 percent for more than a year in order to strengthen economic growth and boost inflation, which remains well below the PBOC’s target of 3 percent. This, along with the government’s efforts to avoid bursting asset bubbles, argues for continued loose monetary policy. But the renminbi has depreciated approximately 6 percent against the US dollar over the past year, hitting an eight-year low in November 2016. At the same time, the country’s foreign exchange reserves have fallen roughly 28 percent since 2014, reaching a five-year low of $3.1 trillion in November 2016. The PBOC has thus far employed capital controls to try to prop up the renminbi and address these international imbalances, but they may raise interest rates in the near to medium term as well.

In contrast, the US Federal Reserve has indicated that it expects to raise rates further in 2017. This is a result of both economic fundamentals— inflations is beginning to rise while unemployment continues to fall—and the proposed substantial fiscal stimulus that is expected to further boost economic growth and inflation. The speed at which the Federal Reserve raises interest rates will depend on the level of fiscal stimulus approved by the new Congress. If large-scale tax reform and infrastructure spending create significant inflationary pressure, the Fed will raise rates faster than if the economy continues on the slow upward trajectory of recent years. However, the recent strengthening of the dollar against other major currencies complicates the calculus for raising interest rates, as that would further strengthen the dollar, hurting US exports, and put downward pressure on inflation.

In the short term, this growing mismatch in interest rates by the world’s major central banks will only exacerbate international exchange rate volatility, affecting the cost of businesses’ cross-border transactions. In addition, central banks’ continued expansionary stance means that they have little to no room to maneuver should another recession hit. And in the medium
to long term, even if central banks are able to wind down the unorthodox policies instituted since the global financial crisis, their ongoing ability to lift real interest rates and stimulate inflation, investment, and growth is in question.

One theory for why central bank actions will continue to face challenges in achieving their objectives is the global savings glut, in which there is a significant excess of savings over investment. This glut puts downward pressure on real interest rates. One factor driving the global savings glut is growing wealth in emerging markets, which is expanding the global supply of savings. But a more fundamental driver is the aging global population: Fertility rates are falling and people are now living much longer, requiring greater savings over a person’s life in order to finance retirement. In addition, more people are now in the middle-age life stage of high savings and low consumption.

With target interest rates hovering near zero in most major economies, **central banks have little room to lower rates further to encourage spending.**

Another theory explaining the ineffectiveness of monetary policy is secular stagnation, with Lawrence Summers being the most prominent and vocal economist on this issue. Summers argues that developed markets have entered a period of secular stagnation, which he describes as “an imbalance resulting from an increasing propensity to save and a decreasing propensity to invest. The result is that excessive saving acts as a drag on demand, reducing growth and inflation, and the imbalance between savings and investment pulls down real interest rates.” Proponents of this theory argue that the propensity for saving is driven by a dearth of investment opportunities due to a variety of factors including declining population growth, stagnant wages, corporate cash hoarding, and slowing technological progress. The secular stagnation theory is thus driven by some of the same factors as the global savings glut, but includes others as well.

Whatever the underlying reason, it is clear that monetary policy has been unable to stimulate healthy inflation and incite more investment thus far, and this problem is only likely to worsen as developed economies continue to age. With target interest rates hovering near zero in most major economies, central banks have little room to lower rates further to encourage spending. Even negative interest rates have been ineffective. And perceptions of likely political and economic volatility over the medium term will only increase people’s desire to save. Monetary policy thus is likely to continue to have limited ability to encourage spending and investment, meaning that the global economy may be facing a prolonged era of lower real interest rates and investment returns.

**Fiscal policy**

Immediately after the financial crisis in 2008, G20 economies coordinated massive fiscal stimulus to stave off a global depression. Although worldwide GDP contracted slightly in

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2009, it has remained in positive territory every year thereafter. While part of this rebound is attributable to the normal business cycle, most economists also credit the coordinated fiscal stimulus—and the associated monetary stimulus—of the world’s leading economies. Although globally significant central banks have maintained expansionary monetary policies in the subsequent years (see above), most governments have moderated their fiscal stimulus measures. The governments of some major economies—notably the United States and key EU members—have even implemented austerity measures due to concerns about persistent budget deficits and rising debt levels. Fiscal policy has thus been more contractionary than expansionary in recent years, placing a drag on overall economic growth.

There are indications that this neutral or contractionary fiscal stance is about to change, however. One reason is that conventional wisdom is coalescing around the idea that many countries have the policy space to increase government spending without crossing a damaging threshold in terms of access to market financing or long-term debt sustainability. The International Monetary Fund (IMF)—and in particular its managing director, Christine Lagarde—has been arguing in recent years that governments should increase investments in areas that provide both a short-term economic growth boost and a long-term improvement in competitiveness and productivity, such as infrastructure, research and development, and education. Other well-respected international economic organizations have recently jumped on this bandwagon. The Organisation for Economic Co-operation and Development (OECD) argued in its November 2016 Global Economic Outlook that all of its members could finance a half-percentage point of GDP increase in fiscal stimulus for an extended period of time, ranging from one year in South Korea to more than six years in Ireland. And the European Commission called on euro member countries to adopt a more “positive fiscal stance” in order to support economic growth.

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Another reason for shifting fiscal policy is domestic politics. After almost a decade of mediocre economic growth—and the resulting lack of job opportunities, slow wage growth, weak consumer and business confidence, and increasing inequality—governments around the world are facing rising pressures from their citizens to do more to boost job growth and economic performance. This is particularly true in developed markets, where citizens have voted for dramatic political changes in recent years. For instance, people voted Justin Trudeau’s Liberals to power in Canada in 2015 after almost a decade of Conservative rule, opted for Brexit in the United Kingdom in June 2016, and picked Donald Trump in the 2016 US presidential election. In all three economies, fiscal policy is changing—or in the case of the United States, seems likely to change—as a result.

Not all governments, though, are in an expansionary mode. There are both upside and downside risks in the years ahead. Governments in some major economies will pursue more expansionary fiscal policy, which will translate into some combination of lower tax rates, greater consumer demand, and near-term investments in infrastructure that will improve logistics and decrease businesses’ operating costs. For instance, the Trudeau government already included more than
$9 billion in infrastructure investment in its 2016 budget and plans to do more to boost economic activity in the coming years. And new UK Chancellor of the Exchequer Philip Hammond’s 2016 Autumn Statement scrapped the government’s previous commitment to balance the budget by 2019, instead outlining a plan to rely on deficit financing to increase infrastructure and public housing spending. Trump has also promised to make infrastructure investment a key economic policy in his new administration. And although Beijing is pursuing structural reforms to shift more economic activity to the private sector, the Chinese government is likely to maintain its expansionary fiscal stance in order to support economic growth.

Other governments will continue with neutral or contractionary fiscal policy in the coming years. Such actions could raise taxes and other business costs while also limiting household demand and economic growth. These contractionary fiscal stances arise from concerns about driving up the cost of government borrowing and generating an unsustainable ratio of debt to GDP. This is particularly true in Europe, where the EU’s Stability and Growth Pact compels members to run only minimal budget deficits, capping them at 3 percent of GDP in the event of a recession or below-potential growth. For instance, Spain’s government plans to cut its budget deficit from 4.6 percent in 2016 to 3.6 percent in 2017 by closing loopholes in corporate taxes and raising taxes on tobacco, alcohol, and sugar-sweetened drinks. And although German Chancellor Angela Merkel announced that her government will increase infrastructure spending in the coming year, it will do so without borrowing any additional funds.

Downside risks on government spending are not limited to Europe, though. Brazil’s government recently passed a constitutional amendment to cap government spending in an attempt to reduce high deficit levels and regain the confidence of international investors. And more broadly, major oil exporters are dealing with weak economic growth at a time of plunging government revenue due to low global commodity prices. The Gulf Cooperation Council (GCC) countries in particular have suffered a dramatic fiscal hit in the past few years—and it looks set to continue for at least another year, perhaps longer. For example, Saudi Arabia’s government expenditure is projected to fall from more than 41 percent of GDP in 2015 to just 33 percent in 2017 and to remain close to that level over the next five years. These fiscal consolidation measures include limiting fuel subsidies, reducing public-sector payrolls, and privatizing state-owned assets, all of which should improve long-term competitiveness but will also drag down near-term growth prospects.

There are opportunities and challenges associated with both expansionary and contractionary fiscal policy. While contractionary fiscal policies may be warranted from a sustainability standpoint, they could also undermine growth prospects in the medium term if they include cuts to competitiveness-enhancing investments such as infrastructure and education. And expansionary fiscal measures are likely to provide business opportunities in the near term and have the potential to boost long-term economic prospects. If, however, they focus only on boosting short-term demand rather than improving long-term competitiveness, they will simply raise government debt levels and lead to greater financing and business operations costs in the future.

**Regulation of the new economy**

The global labor market is in the midst of a dramatic transformation as a result of two forces. The first is rapid technological advances that are automating more types of work and eliminating jobs in the process. The second is the rise of alternative work arrangements, informally referred

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2 The member states of the Gulf Cooperation Council are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
to as the “gig economy,” that are changing long-standing relationships between employees and employers. Governments are behind the curve on crafting policy responses to both of these economic developments. This raises the risk of continued *laissez-faire* disruption and potential social unrest on the one hand, and rising business costs as a result of new government regulations on the other. Governments will need to implement smart policies to simultaneously promote full employment, support economic growth, and stay competitive.

What will the new economy look like? There are two main features: automation and the rise of technology firms. Automation is set to radically reshape the labor market as new technologies increase labor productivity in manufacturing and other industries, reducing the number of workers needed to produce the same output. In the United States, for instance, only two in five manufacturing workers are now engaged directly in production. Automation threatens jobs not only in manufacturing. Many at-risk jobs are in retail and services, as well as back-office functions. British retailers, for instance, predict that nearly one-third of retail jobs in the United Kingdom will disappear by 2025 due to technological advances.

The effect of the new economy on emerging markets will also be profound, with the World Bank estimating that two-thirds of all jobs are susceptible to automation—although with important differences between economies (see figure 4). A big part of this story is that manufacturing no longer generates adequate employment opportunities in emerging markets, as fewer people are needed to produce similar or greater output. This premature deindustrialization, or at least the premature decline in industrial employment, in emerging markets means that these economies are running out of industrialization opportunities sooner and at much lower levels of income compared to the experience of early industrializers. For example, economist Dani

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**Figure 4**

*Automation poses a risk to millions of workers around the globe*

*Employment susceptible to automation (% of total employment)*

![Bar chart showing employment susceptible to automation in various countries, including Ukraine, Nigeria, India, South Africa, Malaysia, Thailand, China, OECD, and Argentina.]

Notes: Estimated share of employment is adjusted for technological feasibility and adoption time lags. OECD is Organisation for Economic Co-operation and Development.
Sources: World Bank World Development Report; A.T. Kearney analysis
Rodrik estimates that the United States reached peak manufacturing employment in the 1950s with GDP per capita of $14,765, but emerging markets such as India and Indonesia reached peak manufacturing employment in the early 2000s with GDP per capita of only $602 and $1,097 respectively.3

Technology firms are also playing an increasingly large role in global economic output. Firms such as Apple, Alphabet, Facebook, and Microsoft are now some of the world’s most valuable companies, yet they have not generated the same level of direct employment as their economy-leading industrial predecessors. So while these technology firms may be improving productivity, providing consumers with valuable services, and generating profits for their shareholders, they are not contributing to broader economic prosperity in the form of massive employment levels. In 1990, for example, carmakers were some of the largest companies in the US economy, and the three largest carmakers in the United States employed 1.2 million people. In contrast, the top three technology firms employed only 137,000 employees in 2014 according to The Economist.

New technologies have, however, enabled the growth of the gig economy—particularly in developed markets—as companies such as Uber, Airbnb, and TaskRabbit have created platforms that allow people to earn income by selling their labor or renting their assets to others on a contract basis. This is fundamentally changing the global labor market, as individuals are more easily able to monetize their skills or assets, but also more vulnerable as many employee or welfare benefits are still tied to positions with a traditional employer. Measuring the true extent of the gig economy is difficult, but alternative work arrangements appear to be on the rise. The UK Office for National Statistics estimates that approximately 4.8 million people are now self-employed (15.1 percent of the total workforce) in the United Kingdom, up from 4 million in 2010. In the United States, a recent study found that 15.8 percent of workers were engaged in alternative work arrangements (including independent contractors, freelancers, temporary workers, and contract workers) in 2015, up from 10.1 percent in 2005.4 The European Commission likewise found that 16.4 percent of the EU labor market is self-employed, and that one in 10 workers are now employed on temporary contracts.

These changes in the global economy have created two main government policy challenges for employment: worker retraining, and fitting the gig economy into existing regulatory frameworks and social welfare benefits. However, policy responses to the new economy have so far been limited and often are occurring only at the subnational level.

Low-skilled workers need to become more technologically savvy in order to stay competitive, and some governments are investing in worker retraining and active labor market policies to mitigate the impact of automation and other technological disruptions of traditional forms of employment. The Chinese government, for instance, has committed 100 billion yuan ($14.5 billion) over the next two years to help retrain coal and steel workers who lose their jobs due to changes in the government’s CO2 targets. And in Ireland, the government-funded Momentum Training Fund provided on-the-job training to more than 12,000 long-term unemployed, particularly in science, technology, engineering, and mathematics (STEM) fields. But many governments are falling behind in helping those displaced by automation and changing employment patterns. The United States spent a mere 0.3 percent of GDP—about $50 billion—on active labor market policies in 2014, the second lowest in the OECD, and the Council on Foreign Relations finds that many US worker retraining programs have not been effective. And despite the EU’s

higher spending on labor market support, the European Parliament found that it has surprisingly few initiatives to retrain current workers for STEM fields.

The rise of alternative work arrangements and sharing platforms necessitates policy responses to manage their economic and social impact. However, national governments have not yet addressed these issues. Many Asian governments, such as those in Hong Kong, Japan, and Singapore, are struggling to regulate sharing companies such as Airbnb, as laws are not keeping up with the times. The UK government has initiated a review to ensure that employment regulations and practices are keeping pace with the gig economy, but no action has yet been taken. As a result, some subnational governments are taking matters into their own hands. Recent court rulings in London and California, for instance, require that Uber treat certain drivers as traditional employees rather than independent contractors for the purposes of overtime pay or benefits. Similarly, cities such as San Francisco and Barcelona have imposed fines or new restrictions on Airbnb in order to keep short-term rentals from driving up overall rental prices and allegedly unfairly competing with hotels.

The effect of the new economy on emerging markets will be profound, with two-thirds of all jobs there susceptible to automation.

Some governments are also considering an out-of-the-box approach that indirectly addresses all of these labor market challenges: the introduction of a universal basic income (UBI). A UBI would provide every citizen with a predetermined amount of money on a regular basis—no matter their wealth or employment status. Pilot UBI programs are under development in Canada, the Netherlands, Kenya, and India. However, implementing a UBI is highly contentious, as illustrated by the Swiss vote against UBI in June 2016, because it requires identifying a funding source, shifting resources from other social welfare programs, and determining the appropriate amount of money each individual would need.

None of these challenges of the new economy have easy answers. As city, regional, and national governments continue to grapple with these issues over the next five years, policies will be volatile and regulatory uncertainty will be high. Different governments will take divergent approaches to worker retraining and regulating both automation and the gig economy, further complicating the business operating environment. While some companies may continue full steam ahead into the new economy, this policy uncertainty is likely to weigh on the global growth outlook in the near to medium term—as will continued labor market disruption, as fewer manufacturing jobs, lower wages, and increased temporary and contract employment are likely to reduce consumer confidence and spending growth.

Protectionism

The global consensus on free trade, long seen as essential to global economic growth, is fraying. This is imposing costs and raising operational and regulatory risks for companies with global footprints. Protectionism has already risen substantially since the global financial crisis, with
World Trade Organization (WTO) members having initiated significantly more nontariff barriers than in previous years (see figure 5). These actions reflect greater public pressure for protectionism. Importantly, the world’s leading economies are at the forefront of this protectionist charge. In June 2016, the WTO reported that the application of new trade restrictions by G20 economies reached its highest level since the WTO began monitoring them in 2009. This increased protectionism is one reason why global trade remains below its precrisis peak and continues to suffer from slow growth—although weaker global economic performance is also a factor. The WTO estimated that trade expanded by a mere 1.7 percent in 2016, the slowest pace since the global financial crisis, and forecasts that trade volumes will grow between just 1.8 and 3.1 percent in 2017.

What is driving this rise in protectionism, particularly in developed markets? After years of increasing global economic integration, politicians are facing significant political pressure to limit imports due to three primary factors: the loss of manufacturing jobs, wage stagnation, and a rise in domestic inequality. China’s accession to the WTO in 2001 and the increasing automation of manufacturing have together eliminated millions of manufacturing jobs in developed markets. In the United States, for instance, the Bureau of Labor Statistics estimates that the number of people employed in manufacturing fell from more than 17 million in 1990 to approximately 12.2 million in 2016, even as real manufacturing output has continued to rise. Partly as a result of the loss of these middle-class jobs, as well as low economic growth over the past eight years, real wages have stagnated for the majority of households in developed markets: Data from the OECD shows that wages in its member economies increased by an annual average of only 0.6 percent between 2000 and 2015. This has also contributed to higher economic

Figure 5

Trade growth is slowing as protectionist measures rise

Trade barriers and export growth
(Number of barriers initiated, % of export growth)

Note: Data for 2016 is forecast as of mid-December.
Sources: WTO, Integrated Trade Intelligence Portal (I-TIP), A.T. Kearney analysis
inequality in many developed markets. According to the OECD, inequality among its members in 2014 rose to its highest level since the mid-1980s.

These economic trends have fueled the rise of populist politics. As discussed in our October 2016 report *Global Trends 2016–2021: Political, Technological, and Demographic Revolutions*, this rising storm of populism is increasing protectionist sentiments and policies in affected countries. Recent populist electoral victories in the United States and Europe signal a new antipathy toward, or reluctance to expand, free trade agreements, and even establishment politicians are taking a harder line on these issues.

As a result, progress on multilateral free trade agreements such as the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (T-TIP) is increasingly unlikely in the near to medium term. In addition, the United States under the Trump administration may impose punitive tariff and nontariff measures to make trade more “fair,” while also seeking to renegotiate long-standing agreements such as the North American Free Trade Agreement (NAFTA). Similarly, many EU members are engaging in protectionist behavior. Although the EU-Canada Comprehensive Economic and Trade Agreement (CETA) was eventually signed, the fact that the Wallonia region in Belgium nearly derailed the entire agreement presages further volatility in EU trade policy. The EU’s protectionist measures may extend beyond goods trade, as it has also proposed tighter capital controls for foreign banks operating within its borders.

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*The inward turn by the US and the EU is significant, and emerging markets now appear to be leading the globalizing charge.*

This inward turn by the United States and the EU is significant because they were the architects of the current liberal international economic system. However, emerging markets now appear to be leading the globalizing charge. For instance, many of the other TPP members are pushing for a renewed TPP without the United States. Moreover, China in particular appears poised to take advantage of the absence of the United States on the global economic scene. At the 2016 Asia-Pacific Economic Cooperation (APEC) summit, China renewed its promotion of the Regional Comprehensive Economic Partnership (RCEP), a proposed free trade agreement between ASEAN states, China, India, Japan, South Korea, and New Zealand. And the African Union has also advanced negotiations on a proposed Continental Free Trade Area, which its supporters argue would double intra-African trade from its 2012 level by 2022. So while the overall political risks around trade policy are tilted to the downside, there are some upside risks in emerging markets in the near to medium term.

**Geopolitics and domestic political shocks**

The global external operating environment is constantly changing, but most observers would agree that the frequency of severe political shocks has increased sharply in recent years.

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5 The member states of ASEAN, the Association of Southeast Asian Nations, are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.
Geopolitical tensions have been rising, leading to territorial disputes, international sanctions, and violent attacks (see figure 6). At the same time, domestic politics is becoming more unpredictable in many countries around the world. Such domestic and international political volatility has raised the cost of doing business and hampered economic growth in many parts of the globe.

One of the most dramatic geopolitical shocks in recent history was Russia’s annexation of Crimea in early 2014. In part because of this action and the ongoing tensions with Russia, Ukraine’s natural gas supplies were interrupted, industrial production fell precipitously, and its economy suffered a bruising recession. In addition, the United States and the EU imposed sanctions on Russia—which retaliated with counter-sanctions—that continue to restrict business and economic ties between these markets. In particular, a variety of potential oil and gas projects are either directly under sanctions or would be affected by sanctions associated with technology transfers.

And the civil war in Syria, which has been going on for six years, has not only imposed untold suffering on the Syrian people, but also wreaked havoc on the domestic economy and fostered instability in neighboring countries. There are also ongoing territorial disputes in the South China Sea and East China Sea that are raising risks for the global shipping industry and for all businesses with supply chain flows through the area. These are significant flows, as $5.3 trillion of trade passes through the South China Sea each year. Another pending territorial dispute is in the Arctic, where the five countries that border the Arctic and other interested parties are staking competing claims on the shipping routes and natural resources in the region. If these or other
The All-Too-Visible Hand

territorial disputes were to erupt into outright conflicts, it would create significant negative shocks for business operations and the global economy.

Rising terrorist attacks have also shocked the global operating environment. While there were fewer than 5,000 terrorist attacks annually on average in 2009–2010, their number rose to almost 16,000 annually in 2014–2015. Heightened violent extremism disrupts business operations and potentially harms economic growth prospects. This is particularly true in markets that suffer from frequent and high-intensity terrorist attacks, such as Pakistan, Iraq, and Nigeria. Terrorism also affects global shipping routes such as the Gulf of Aden and affects global oil prices due to the proximity of many terrorism hot spots to significant oil and gas reserves. In addition, more frequent attacks in Western Europe and the United States could reduce consumer confidence and divert government spending toward security and away from investment-promoting initiatives.

Geopolitics can also surprise on the upside. Colombia’s government recently signed a peace deal with the Revolutionary Armed Forces of Colombia (FARC). The deal will end a bloody conflict that lasted more than 50 years and claimed more than 220,000 lives—and will improve Colombia’s medium-term economic prospects. The Iran nuclear deal in mid-2015 to allow international nuclear inspections in exchange for sanctions relief has reopened a significant energy and consumer market to international investment. Although remaining US sanctions have slowed the initial investment flow, many businesses are eyeing opportunities in the Iranian market. Similarly, the United States and Cuba made a seemingly sudden public announcement in December 2014 that the two countries would restore diplomatic relations. As part of that restoration, the United States eased restrictions on US business activity in Cuba, opening up that market to US investment for the first time in decades.

And it is not just geopolitics that is creating volatility in the business operating environment. Domestic political shocks in several key markets created disruptions in markets and raised questions about the future business regulatory environment and the broader macroeconomic prospects. Two dramatic ousters of G20 heads of government occurred in 2016: Brazilian President Dilma Rousseff was removed from office on corruption-related charges, and South Korean President Park Geun-hye was impeached and had her powers temporarily suspended in early December 2016 pending trial on similar charges. South African President Jacob Zuma has also long been dogged by accusations of corruption. In addition, the attempted coup d’état against the democratically elected government of Turkish President Recep Tayyip Erdoğan in July created a great deal of uncertainty. The failed coup, coupled with the government’s widespread purge of opposition members, has dealt a devastating blow to the Turkish economy—and strained diplomatic and business relations with Europe and the United States.

Finally, in countries around the world voters are increasingly rejecting the status quo in favor of populist political leaders. The UK vote for Brexit and the triumph of Donald Trump in the US elections surprised business leaders around the globe. But other key markets are also experiencing policy volatility as a result of this populist wave, including the Philippines following the May 2016 election of Rodrigo Duterte. This backlash is creating policy and regulatory instability and raises the risk of a potentially hostile environment for globalized business models.

In aggregate, these geopolitical tensions and political shocks are increasing the uncertainty associated with the global operating environment and economic outlook. In fact, in our 2016 Views from the C-Suite survey of global business executives, six of the 10 possible global developments resulted in a nearly dead-even split on the likelihood that they would occur.
Such a sharp division in outlook suggests that many businesses are acting with caution, delaying new investment or planned expansions and carefully monitoring developments. This heightened uncertainty and dampened business confidence will continue to weigh on the global economic outlook in the years ahead.

Key Country Growth Paths

When analyzing the global economic environment, five key markets play a significant role: the United States, the EU, China, Japan, and India. These are the five largest economies in the world as measured at both market exchange rates and purchasing power parity. Together, they account for about two-thirds of global GDP. Understanding the dynamics at work in these markets—particularly those associated with the political, policy, and regulatory risks discussed above—goes a long way in explaining the overall global outlook (see figure 7).

Figure 7
The economic outlook for the world’s five largest economies

Select 2017 economic indicators

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP growth</th>
<th>Inflation</th>
<th>Unemployment</th>
<th>Median age (years)</th>
<th>Government gross debt</th>
<th>GDP per capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>6.1%</td>
<td>2.2%</td>
<td>4.4%</td>
<td>38.7</td>
<td>49.9%</td>
<td>$17,060</td>
</tr>
<tr>
<td>European Union</td>
<td>1.2%</td>
<td>1.5%</td>
<td>8.6%</td>
<td>42.7</td>
<td>91.0%</td>
<td>$43,720</td>
</tr>
<tr>
<td>India</td>
<td>7.3%</td>
<td>5.3%</td>
<td>8.5%</td>
<td>28.1</td>
<td>67.2%</td>
<td>$6,990</td>
</tr>
<tr>
<td>Japan</td>
<td>0.5%</td>
<td>0.4%</td>
<td>2.9%</td>
<td>48.3</td>
<td>253.0%</td>
<td>$39,320</td>
</tr>
<tr>
<td>United States</td>
<td>2.3%</td>
<td>2.1%</td>
<td>4.5%</td>
<td>38.6</td>
<td>108.4%</td>
<td>$59,400</td>
</tr>
</tbody>
</table>

Notes: Median age is 2020 data. GDP per capita is expressed in purchasing power parity.
Sources: Economist Intelligence Unit, International Monetary Fund, UN Population Division; A.T. Kearney analysis

In the United States, a tightening labor market, rising consumer spending, a strengthening housing market, and continued private-sector growth are contributing to a stronger economic outlook. And the incoming Trump administration’s proposed infrastructure investment and reduced corporate taxes are expected to provide additional stimulus to the US economy. With the unemployment rate having fallen to its lowest level since 2007 and consumer sentiment reaching an 11-year high, the Federal Reserve looks set to continue to raise interest rates in the near term. However, a number of downside risks may derail US economic growth over the next five years. First is the rapid strengthening of the dollar, which reached its highest level since...
2001 against major currencies in late 2016. This is likely to lead to a decline in the competitiveness of and demand for US exports, widening the country’s trade deficit and weighing on many export-oriented companies. Another downside risk stems from structural challenges in the labor market, including declining labor force participation rates and falling labor productivity. And in the near term, protectionist policies could undermine recent and expected economic gains. President-elect Trump, for instance, has proposed increasing import tariffs on China and Mexico, which could incite a costly trade war with two of the country’s largest trade partners, reducing economic growth and raising unemployment levels.

Political uncertainty also threatens the EU’s economic outlook. Recent economic data indicates that Europe’s fitful economic recovery may be strengthening. Eurozone unemployment fell below 10 percent in November 2016 for the first time since 2011, as economic sentiment indexes continued to rise. One reason for the stabilizing outlook is that previously weak economies have implemented structural reforms that have contributed to growth. For instance, Spain’s economy expanded at nearly twice the EU average in 2016 and is forecast to grow faster than the other large eurozone economies over the next five years. A weaker euro relative to the dollar is also contributing to the rosier EU growth outlook, as EU exporters should benefit from greater competitiveness. But the ECB’s recent decision to extend its QE program highlights the continued weakness of the eurozone economy. And the nascent recovery rests on fragile political foundations. The Brexit and Italian referendums in 2016 were only the beginning of a series of potentially economically destabilizing elections. In fact, 2017 looks set to be a decisive year for the EU economic outlook, and perhaps the EU itself. Elections in the Netherlands, France, and Germany could bring populists or protectionists to power, threatening the four freedoms upon which EU growth depends. In addition, ongoing Brexit negotiations will infuse uncertainty in business decision making with respect to the UK and EU markets. And even as the Greek economy finally returns to growth, the health of Italy’s banks poses a potentially systemic risk to the eurozone economy. If the EU can weather these political and financial risks in 2017, its medium-term growth outlook will improve.

In Japan, the Abenomics economic agenda has yet to break the country out of its years-long economic stagnation. The economy grew by only 0.6 percent in 2016 and seems unlikely to exceed 0.5 percent annually over the next five years. The BOJ has maintained its expansionary monetary policies in an effort to increase consumer spending and inflation, but Japan continues to suffer from deflation. Since the asset price collapse and the beginning of Japan’s “Lost Decade” in 1992, annual inflation has remained well below the BOJ’s 2 percent target in all but one year, and it was in deflationary territory for most of 2016. Although expectations for inflation have risen somewhat, they remain low due to weak wage growth and consumer spending. Japan’s expansive monetary policy has yet to be matched by an equivalent effort of fiscal stimulus, as high public debt levels (approximately 220 percent of GDP) constrain government spending. The government has also pursued the third arrow of Abenomics, structural reform, only fitfully. While the Abe government has made progress in increasing Japan’s female labor force participation rate—which is now at approximately 66 percent, the highest level in the past 15 years—and improving corporate governance, it has watered down the reforms of its heavily subsidized agricultural sector and has failed to encourage greater corporate investment. And long-term growth prospects are low due to a declining population and highly restrictive immigration policies. However, the 2020 Tokyo Olympic games may provide an opportunity to kick-start growth. If Prime Minister Abe is successful in boosting tourism and increasing infrastructure spending in advance of the games, the country could achieve higher-than-projected GDP growth and truly have something to celebrate.
China’s economy expanded by 6.7 percent in 2016—robust growth compared to other large economies, but the continuation of a steady decline in the country’s GDP growth in recent years. Beijing recognizes the importance of managing this decline in growth in order to maintain stability. As a result, the PBOC has held interest rates low to encourage consumer spending and promote inflation, while the government has implemented a variety of fiscal stimulus measures—including $36 billion in funds to improve transport links between Beijing, Tianjin, and Hebei province. These actions have supported economic growth, particularly in the all-important manufacturing sector, where indexes have recently risen to two-year highs. Although the base case outlook for China’s economy is a continued, managed slowdown in its growth rate, risks to economic stability are rising. Asset bubbles in sectors such as real estate threaten to undercut growth. Beijing also appears to be turning away from some of its reform efforts, for instance with the reimposition of currency controls on the renminbi and gold in late 2016 despite the country’s stated goal to internationalize the currency. China has also yet to tackle its massive government debt obligations, instead continuing to provide cheap capital to state-owned enterprises. International factors such as rising populism and protectionism in many of China’s key developed market trading partners could also weigh on economic growth as a result of reduced demand for exports, but these trends may also provide Chinese companies with more opportunities in fast-growing emerging markets.

While the outlook for China’s economy is a continued, managed slowdown, risks to economic stability are rising.

India remains the world’s fastest-growing major economy and looks set for further expansion over the next five years. India grew by approximately 7.5 percent in 2016, continuing a three-year streak of growth above 7 percent. Some of this strength is due to a favorable external environment (for example, lower prices for commodity imports), with India’s current account deficit falling to a seven-year low of $300 million in the fourth quarter of fiscal year 2015–2016. Indian inflation has also dropped closer to the Reserve Bank of India’s target of 4 percent. Some of India’s economic performance is also due to government actions. Prime Minister Narendra Modi’s government has pushed through reforms to allow greater foreign ownership in the aerospace, defense, and retail industries, and passed a national goods-and-services tax (GST) that will create a common market in the country and is expected to increase economic growth—with HSBC forecasting as much as a 0.8 percent annual increase in GDP growth in the medium term. These and other efforts to liberalize the economy and reduce burdensome taxes and regulations will likely lead to increased investment by both domestic and foreign firms and make Indian industry more competitive. But India still faces a number of challenges that may negatively impact its growth outlook. The unexpected November 2016 demonetization campaign—an effort to swap out all 500 and 1,000 rupee notes to target India’s large stockpiles of black money—has led to a significant decrease in consumer and corporate spending, reducing economic growth at the end of 2016 and likely into the first half of 2017 as well. And while the government will likely increase spending to boost its popularity ahead of state and national elections in 2018 and 2019, the electoral cycle may also slow the adoption of economic reforms. On the whole, however, India looks set to sustain strong levels of economic growth over the next five years.
Conclusion and Business Implications

Our medium-term global economic outlook is more uncertain than in previous years. This uncertainty is hardly surprising when viewed in the context of a global system that is in the midst of profound upheaval, with the United States seemingly retreating from its role in leading a liberal international order, emerging powers on the rise, and domestic political instability in a variety of key markets. After several years of mediocre global economic growth, it is increasingly plausible that a significant negative shock could occur that would launch the global economy into a new tailspin. Alternatively, an upside shock that reignites global growth is not out of the question. The most likely outlook, however, is for continued weak performance.

The primacy of political, policy, and regulatory risks in driving global economic performance is worrying. Business executives value stability, transparency, and predictability in the external environment, as these enable easier decision making. But as we saw in 2016, politics is an unpredictable and messy business. Political risks are thus complicating the environment in which business executives must operate, and likely stifling investment as a result. However, the importance of politics in determining economic outcomes also presents an opportunity. If government leaders strategically assess the factors holding back growth in their economies and implement targeted investments and sound regulations to address these shortcomings, they could dramatically improve their countries’ medium-term growth outlook.

The prospects for such growth- and competitiveness-enhancing government policies seem bleak in many economies, though. As a result of the rising storm of populism, nationalism, and protectionism gripping countries in many regions of the world, political risks are currently tilted to the downside. There is thus a compelling case for business leaders to publicly and privately advocate for government policies and regulations that will foster positive economic and social outcomes in the markets in which they operate—and create a persuasive counter-narrative to increasingly pervasive antiglobalization arguments that appeal to populist sentiments.

Executives cannot simply proceed with business as usual in the current environment, however. They need to closely monitor the political and policy developments in the markets in which they operate for potential changes that would affect their business operations, global footprint, and strategic plans. In particular, three business implications emerge from this analysis:

- **Analyze diverging costs of capital:** The monetary and fiscal policies of key economies on the verge of shifting between contractionary and expansionary stances will bring about changes in the cost of capital in these markets. For instance, rising interest rates in the United States will make it costlier to finance dollar-denominated debt. And as domestic policy stances diverge among the major economies, the costs of capital will also diverge more between markets. In consequence, executives should carefully assess where and how they raise capital in the near term.

- **Assess risks of business model innovation:** Emerging populist and protectionist policies in some of the world’s largest markets may fundamentally alter the cost-benefit assessment of investing in automation and incorporating elements of the gig economy into a company’s business model. Although these business model innovations are reducing the labor bill for some companies and sectors, businesses that take them on may become more heavily regulated and could come under increasing political pressure to create more jobs in their home markets. Executives should include an assessment of these political risks before deciding to pursue these business model innovations.
**Invest in strategic foresight capabilities:** In this uncertain global environment in which political risk is an all-too-visible hand shaping economic outcomes, one of the most important business capabilities will be strategic foresight. With political decisions playing such a large role in economic outcomes, the future of a market's economic performance and business environment is too complex to forecast with any certainty, as it involves multiple dynamic variables driven by political calculations. Strategic foresight enables business leaders to deal with this uncertainty through future-oriented assessments that systematically bound and analyze it, improving strategic decision making and operational agility.

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The authors would like to thank Courtney Rickert McCaffrey and Ari Sillman for their valuable contributions to this report.

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