THE SWEDISH TRADE & INVEST COUNCIL

IF CRISIS HITS

THE IMPACT OF INTERNATIONAL CONFLICT ON SWEDISH BUSINESSES

Business Sweden

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INTRODUCTION

OPTIMISTIC BUT PREPARED

Business Sweden is experiencing a rapidly increasing demand for analysis of geopolitical scenarios and the consequences they would have for Swedish companies and their business operations. The reason for this is the widely felt uncertainty about where the world is heading – and the feeling that positive global development is threatened by the change in the US political landscape, a disunited Europe and the advance of China and Russia.

Further darkening the outlook is a potential dismantling of the multilateral trading system in favour of hard-nosed economic nationalism, and accelerating climate change. Some encouraging signals are coming from Europe, but the overall view is that the global political state has changed for the worse amid an increased risk of regional conflicts, some of which would have serious international repercussions.

Business Sweden has contracted the Swedish Defence Research Agency (FOI) to outline three geopolitical scenarios, each describing a possible political or military sequence of events stemming from a national or regional conflict. Each scenario plays out in the spring of 2018. The scenarios are separate and written as if they were intelligence or newspaper reports authored in June 2018.

Business Sweden's analysis is conducted in three steps. First, we describe each scenario and its respective geopolitical context, identifying the crisis trigger and detailing the sequence of events. Second, we analyse the economic impact of each scenario on the affected region and its spread to other areas. To simplify the translation of events into macroeconomic effects, we assume that the economic impact is immediate.

Third, we take stock of the possible consequences for Swedish companies under each scenario. The analysis uses available statistics on the regional distribution of Swedish companies' exports and foreign sales. To better understand the latitude that Swedish businesses have in managing their operations in an international conflict, Business Sweden bases its conclusions on interviews with senior managers with global sales experience.

I am an optimist, a trait I share with many Swedish executives. I remain hopeful about the future. But even an optimist would wish to be prepared if crisis hits. In that context, I hope that you find this report both interesting and intriguing.

Lena Sellgren
Chief Economist

LENA SELLGREN
Chief Economist,
Business Sweden

EXECUTIVE SUMMARY

In this report, Business Sweden outlines three possible geopolitical scenarios and analyses their economic impact and consequences for Swedish companies.

The scenarios all play out in 2018. To simplify the analysis, Business Sweden has assumed that their economic impact will be felt directly. The effect on regional and global GDP growth is therefore presented in a forecast for 2018.

GREY ZONE CONFLICT ON SWEDEN'S DOORSTEP

This scenario is based on Russia's ambition to regain its traditional superpower role and expand its influence around the Baltic Sea and neighbouring region. The backdrop is the European Union's political inability to respond to Moscow's challenge and America's dwindling interest in Nato and in defending Europe against Russian encroachment.

When Russian military exercises in Belarus transmute into an outright invasion, the occupying forces encounter no armed resistance. But the invasion and ensuing annexation create deep friction between Europe and Russia and trigger a military build-up in the Baltic Sea region.

The global economic impact of this scenario is limited. The international community has low expectations of Russia in the light of its past conduct in Georgia and Ukraine. The conflict hits Russia hardest, mainly due to falling oil prices and weakened rouble. But Europe is not spared: economic growth drops by 1 percentage point, compared with the baseline scenario.

This scenario has serious negative consequences for Swedish companies operating in Russia and parts of Central and Eastern Europe, where a drastic fall in demand forces them to scale back their business activities.

COLD WAR AND FRAGMENTATION IN THE MIDDLE EAST

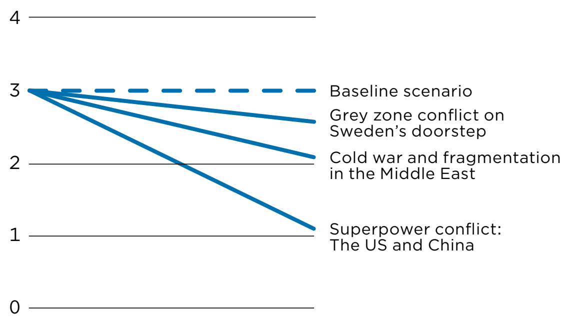
This scenario builds on a revival of the Middle East's thousand years of conflict via a confrontation between the Sunni and Shia interpretations of Islam. Jihadists from the Islamic State's collapsing regime in parts of Syria and Iraq launch terror attacks in North Africa and the Mediterranean, exacerbating regional instability and sparking an exodus of refugees to Europe.

Tension increases between the scenario's main rivals – Sunni-led Saudi Arabia and Iran, the leading Shia state – as both strive for political, economic and religious dominance in the region. Iran's influence is increasing amid the ongoing civil wars in Syria and Yemen and closer ties between Tehran and Iraq's Shia government. The 2016 international accord on Iran's nuclear programme has enabled the country to resume oil exports and start rebuilding its economy. Meanwhile, the Trump administration's more adversarial stance on Iran provides some succour for Saudi Arabia.

The crisis trigger is regime change in Bahrain, a Sunni island-state in the Persian Gulf with 1 million inhabitants and a Shiite majority. The coup spooks Saudi Arabia and other neighbouring Sunni states, reflecting fears of a new Arab spring and demands for democratic reforms and civil rights. The unrest in Bahrain abates, but tensions spread through Saudi Arabia's support for Kurdish independence in Iraq, which evokes a strong reaction from Turkey.

As with the first scenario, economic impact is limited to the conflict area: the Middle East and North Africa. Deteriorating security and a collapse in demand force Swedish companies to reduce their operations in the region.

WORLD GDP GROWTH 2018, %



SUPERPOWER CONFLICT: THE US AND CHINA

This scenario is set against the backdrop of an emerging multipolar world in which regional powers with growing ambitions and influence are challenging US economic and military hegemony. The US and China have long competed for power in Asia-Pacific through economic and military presence. When the Trump administration renounces its leadership of the prevailing world order by asserting a narrow definition of national interest, it paves the way for China to play a more expansive regional and global role. Nervousness increases among America's Asian allies, which find themselves having to manage relations with China minus open support from Washington.

In June 2018 the US imposes punitive tariffs on Chinese goods after repeated complaints about the economic harm China causes the US through currency manipulation. The US also shows displeasure with its allies' closer relationships with China. The ramming of a Philippine destroyer by a Chinese military vessel in the South China Sea near the disputed Spratly islands stirs strong emotions in Japan, which fears a similar chain of events around the Diaoyu/Senkaku islands (which are administered by Japan but claimed by China). The US and China both strengthen their local naval presence. Just as it appears that the US will blockade the Spratly islands, a move certain to be viewed in China as an act of war, the US suffers a massive cyber attack that disables key military and civilian installations.

The economic impact of this scenario is substantial and global. Consumers and businesses worldwide recoil at the prospect of a US-China armed conflict. Oil prices plummet 50 percent to $27 a barrel. The US tariffs on Chinese goods ignite a trade war. Both countries see a slump in economic growth as the downturn spreads to other regions. European growth hits zero. Raging economic nationalism in the US and China hits Swedish businesses amid a sharp drop in global demand and a glut of Chinese goods in the European market.

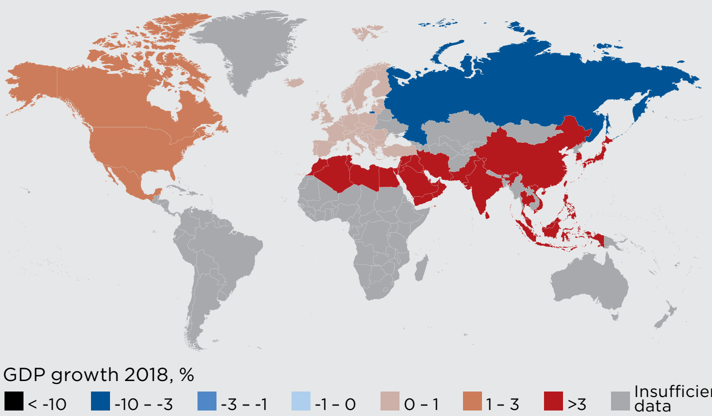
GDP GROWTH 2018, %

REGION	BASELINE SCENARIO	SCENARIO 1 Grey zone conflict on Sweden's doorstep	SCENARIO 2 Cold war and fragmentation in the Middle East	SCENARIO 3 Superpower conflict: The US and China
WORLD	**3.0**	**2.6**	**2.1**	**1.1**
Sweden	2.2	1.7	2.4	0.1
Europe	1.7	0.7	1.9	-0.1
Middle East	3.7	3.2	-23.5	1.8
Africa	2.6	2.5	-3.2	1.9
Asia	4.4	4.2	4.2	2.1
North America	2.6	2.4	2.2	0.8
South America	2.3	2.1	2.0	0.8

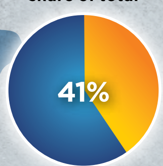
Scenario 1

Grey zone conflict on Sweden's doorstep

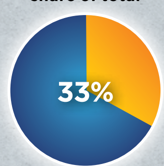
ECONOMIC IMPACT



Swedish goods exports
Neighbouring markets, share of total



Swedish companies' foreign sales
Neighbouring markets, share of total



1. **Russian military exercises in Belarus**
2. **Disunity in Europe**
3. **Demonstrations in Minsk**
4. **Russian troops in Belarus**
5. **Military build-up in the Baltic Sea area**

The European Union (EU) is a political and economic union between 28 European states. It traces its origins to the former European Coal and Steel Community, a treaty that came into force in 1952 with the primary objective of avoiding future wars between European nations.

Cooperation between the signatories developed over time and led to the formation of the European Economic Community (EEC) in 1967. The EU was founded by the Maastricht Treaty of November 1993. Sweden has been a member of the EU since 1995.

The North Atlantic Treaty Organization (Nato), also known as the North Atlantic Alliance, is a military alliance between the United States and mainly West European countries. Nato was founded in 1949 and is headquartered in Brussels.

Nato has 29 member states, including the US, Canada, Germany, France, the UK, Italy, Spain and Turkey. Thirteen East European countries have joined the alliance since the fall of the Berlin Wall in 1989.

Twenty-two of the EU's 28 member states also belong to Nato

Belarus was a Soviet Union republic that gained independence after the Soviet collapse in 1991.

The country is geographically half the size of Sweden with a similar population of 10 million people. The capital Minsk is the largest city, with 2 million inhabitants.

Belarus had a GDP of $60 billion in 2016 (Sweden: $560 billion).

The Belarusian economy is dominated by state-owned enterprises and has close ties with Russia, including dependence on Russian oil and gas supplies.

Scenario 1

GREY ZONE CONFLICT ON SWEDEN'S DOOR-STEP

SEQUENCE OF EVENTS: STOCKHOLM, 1 JUNE 2018

Attempts by Russia during the last decade to reclaim and reassert its traditional superpower role have created friction with the mechanisms of multilateral cooperation that have formed the bedrock of peace in Europe since the end of the Cold War. Russia's ambitions can be partly explained by a need for an external threat to consolidate the government's hold on power. The war on Georgia, the annexation of the Crimean peninsula and the proxy war in Ukraine all stem from this perceived necessity.

Rhetoric about spheres of interest is one of many devices Russia uses to undermine the European Union and Nato. In autumn 2017, Russian military exercises underlined the country's ability to carry out rapid large-scale operations. Unsurprisingly, this attracted attention in foreign capitals, with extensive media coverage of a massive military airdrop at various training fields in Belarus. Russia's claim that its armed personnel had reached the 1 million mark was widely reported in the West, though experts regarded the figure as an exaggeration.

As winter set in, the West responded by trying in vain to match the size of the Russian military force on display. Nato exercises held in Eastern Europe to reassure newer members of the alliance's military clout were well organized but overshadowed by ongoing bickering in Brussels. When the negotiations on Britain's departure from the European Union collapsed in January, the UK government accused the EU of failing to heed Europe's collective economic and security needs. The European Commission replied that the UK's commitments within the Nato framework could not compensate for its departure from the EU.

In February, the UK announced it would no longer pay for defence capability in Eastern Europe and would withdraw from its commitments to Nato's new elite force, which it had led as late as 2017. France also weighed in, declaring that the fight against terrorism took priority over providing military backing to countries that did too little to defend themselves. The Anglo-French stance threw open the rift within Nato on national defence spending levels.

In a speech in early March that endorsed the UK view, US President Trump reiterated his claim that the US accounts for three quarters of the alliance's budget. Nato's European members replied that each member's contributions to the Nato budget were in proportion to economic size. Diplomats expected this infighting to embolden Russia, but were nevertheless shocked by the events that unfolded in Belarus in the weeks to come.

RUSSIAN TERRITORIAL EXPANSION

A prolonged economic slump in Belarus worsened during the winter of 2017/18 as high inflation ate further into the savings and wages of large sections of the population. In January 2018 the government began collecting new taxes and levies that had already attracted widespread criticism when first announced. A breakdown in the country's social contract, whereby the president enjoyed broad political support in return for maintaining a generous welfare state, brought demonstrators onto the streets of Minsk in early March. The protests were no larger than anti-austerity demonstrations a year earlier, but they precipitated a chain of events whose precise nature remains unclear. What is known is that Russia had been seeking new negotiations on natural gas deliveries to Belarus. Some sources suggest that Moscow had threatened to increase the price of gas or interrupt oil deliveries, on which Belarusian industry depended. Others believe the tipping point reflected Belarus President Alexander Lukashenko's recent willingness to contemplate leaving the Russian-led Eurasian Economic Union. Certainly, President Putin would have seen any move by Belarus to leave the union as an extension of Western influence in Russia's sphere of interest.

As March progressed, the demonstrations in Minsk started to ebb. However, Russian media sought to fan the flames by dubbing the protests a so-called colour revolution orchestrated by Western interests and claiming the legitimate Belarus government was under siege. (Media coverage favoured the incumbent Russian president, who won the presidential elections in March comfortably in the first round of voting. His current mandate stretches from May this year to 2024.)

Towards the end of March, political and social tensions in Belarus began to rise again. President Lukashenko sought to demonstrate control by ordering a wave of nationwide arrests.

Citing the risk of unrest spreading from Belarus to Russia, Moscow ordered tighter border controls and imposed curbs on travel and trade between the two countries. At the end of March, Belarus was hit by repeated interruptions to gas deliveries, which Moscow blamed on sabotage inside Belarus. Just prior to Easter, Minsk and other major Belarusian cities experienced severe power failures. Kremlin officials briefed the international media that the Belarusian president had asked for assistance to maintain law and order, and Easter saw Russian forces entering Belarus territory without encountering armed resistance. Since April, Russian troops have been stationed at strategic checkpoints around the country. Lukashenko remains as head of state.

MILITARY BUILD-UP AND FAKE NEWS

The European Union quickly accused Russia of meddling in Belarus' internal affairs. Moscow rejected the criticism, insisting the situation in Belarus differed from Ukraine and that Russia was simply assisting a neighbouring country and indirectly supporting peace and security in Europe.

Despite dismay in many European capitals, the EU was unable to agree on extended sanctions against Russia. Some member states such as Italy pointed out that Lukashenko had requested Russian help and that Russian gas deliveries to EU countries remained unaffected. Meanwhile, Poland, Latvia and Lithuania – which from May experienced a major influx of refugees from Belarus – asked the EU for help.

The EU and Nato both demanded answers on the size and duration of Russia's military presence in Belarus. Unverified intelligence reports suggested Russia had stationed units armed with tactical nuclear weapons in Belarus. The Polish government asserted that Russian interference was less about Belarus than about the Kremlin's determination to gain a strategic advantage in Eastern Europe. Moscow rejected this claim, pointing to its own exposure in its encircled enclave Kaliningrad.

In May, Russia informed several North European countries that it needed to increase marine patrols to provide added protection for its oil and gas pipelines. (Russian naval forces are responsible for the security of the Baltic Sea North Stream gas pipeline.) Independent experts predicted this would negatively affect seaborne trade flows in the Baltic Sea.

From May onwards, news agencies in Russia and Eastern Europe began reporting that Nato was putting pressure on Finland and Sweden to apply to join the alliance. Nato insisted it had not tried to influence any country in this direction, while Russian media claimed to have revealed a desire in several large member states to force Finland and Sweden to join. The Kremlin demanded that the alliance immediately refrain from arm-twisting to win new members and discontinue its "extensive military build-up". Nato officials retorted that its measures in Europe were in response to prevailing security conditions and stressed there were no restraints on cooperating with countries like Sweden, whose technological expertise might prove valuable in future potential military conflicts.

As summer approached, the governments of the Baltic states voiced concern at perceived Russian interference in their internal affairs, including cyber attacks on their national electricity grids as well as the grid linking Sweden and Lithuania. Cyber attacks were also directed at businesses. Moscow denied all involvement. Meanwhile, the military build-up on Sweden's doorstep continued and it became evident that the military presence around the Baltic Sea had reached the point of disturbing and sometimes disrupting civilian air and sea transport.

ECONOMIC IMPACT IN THE REGION AND GLOBALLY

This putative scenario relates to Sweden's near-abroad – which, loosely defined, comprises Norway, Denmark, Finland, the Baltic states, Poland and northern Germany. The western rim of the scenario's key player, Russia, is part of the region. Belarus, located closer to Central Europe, is on the periphery. Whether or not we define Sweden's vicinity country by country or as a geographical area around the Baltic Sea, it is an economically heterogeneous and diversified region. Thanks to rapid economic growth in recent decades, Poland and the Baltic states have reduced the wealth gap to the Nordic countries and Germany. Russia has failed to break the dominance of oil in its economy, which is characterized by political interference, oligarchical family empires and endemic corruption. The fall in the oil price and the imposition on Russia of international economic sanctions have worsened the state of an already weakened economy.

This grey-zone conflict on Sweden's doorstep – including a tacit Russian annexation of Belarus – will impact the economy in the form of falling global confidence among consumers and businesses. The drop in the confidence indicator is set to 10 percent of the drop recorded during the financial crisis of 2008-2009 – the largest decrease in global economic confidence registered in modern times.

The adverse effects on the world economy will therefore remain muted. The global community's expectations of Russian geopolitical behaviour are already very low and few countries will react strongly to a Russian intervention in Belarus, a former Soviet republic where Russia retains military bases and personnel. The Belarus economy is small and the country's businesses have an insignificant international presence.

Russia's power play will still lead to global anxiety and falling stock markets worldwide. Consumers will trim their purchasing and the business community will postpone some major investments. The oil price will fall to $45 per barrel. In Europe, household consumption will shrink, with larger downturns confined to the most exposed Central and East European economies. The exodus of refugees from Belarus will be limited but nevertheless cause friction in Poland and the Baltic states. A broad European military build-up, including a spike in spending on cyber security has already started, but will have no immediate economic impact.

In Russia, business investment will fall by 30 percent, mainly due to a total investment freeze by foreign-owned companies. International businesses will retain a footprint in Russia but will heavily reduce operations and mothball some assembly lines. The rouble will drop sharply, driving up the price of imports. A rapid increase in inflation will undermine household purchasing power and the Central Bank of Russia will announce a sharp hike in interest rates, further dampening economic activity. State oil revenues will shrink, making it increasingly difficult for the Kremlin to compensate hard-hit consumers with lower taxes. Public investment in the oil industry will be eased back, causing oil production to fall by 10 percent. A shortage of spare parts will worsen and international transport links will be disrupted.

All this will tip the Russian economy into rapid recession and cut European growth by more than half.

CONSEQUENCES FOR SWEDISH COMPANIES

Swedish firms in the defence and cyber security industries will see increased demand for their products in Europe. Other than that, it is mainly in Russia and certain Central and East European countries where this scenario will have consequences for Swedish companies. The economic impact of the conflict on other regions will remain limited. Several large Swedish companies have production units in Russia and are big investors in the country. Russia to some extent also serves as a platform for exports to Central Asia. Small and medium-sized companies with up to 250 employees account for a full 20 percent of Swedish business revenues in the Russian market.

In this scenario, Swedish companies will postpone all investments in Russia indefinitely. Operations will continue, but at a lower level. Companies will seek cost reductions by shrinking their geographical presence in Russia, scaling back support functions and dismantling business units outside their core business. Some foreign personnel will be sent home and replaced by local hires. Margins will be squeezed as companies fail to offset exchange rate losses with higher prices. Each company's financial robustness and expectations of an eventual market turnaround will determine its future presence in Russia.

Scenario 2

Cold war and fragmentation in the Middle East

War and war-like situations in the region

Libya: The civil war in 2011 was followed by a second civil war in 2014, between the ruling regime and a rival faction. Large parts of Libyan territory currently lack a functioning government.

Syria: A brutal civil war since 2010 between the regime and opposition forces has devastated the country. Both sides receive military support from abroad. The United Nations and others have brought forward a number of peace initiatives, so far without success.

Yemen: A civil war between the ruling Sunni regime and rebel Shiite forces has been ongoing since 2014. Saudi Arabia supports the regime; Iran supports the rebels.

Iraq: The US and its allies' invasion of Iraq in 2003 to topple Saddam Hussein developed into a lengthy occupation. Following the withdrawal of most US troops in 2011, the country has been mired in infighting, terrorist attacks and sectarian violence.

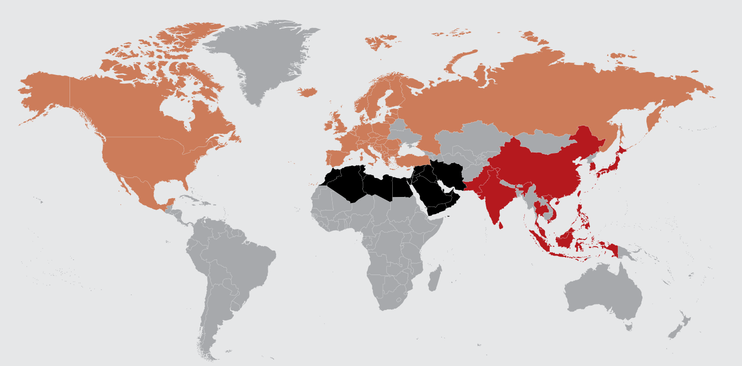
1. **Terror wave in North Africa**
2. **Increased tension between Saudi Arabia and Iran**
3. **Regime change in Bahrain**
4. **Saudi support for Kurdish independence in Iraq**
5. **Turkish retaliation against Saudi Arabia**

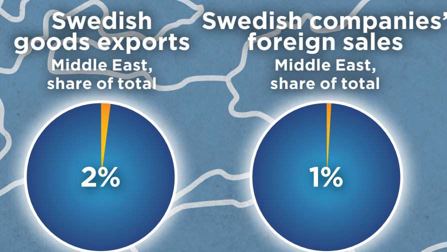
Relations between Saudi Arabia and Iran are characterized by political, economic and religious rivalry in a race for regional influence. The conflict between Sunni and Shia interpretations of Islam underpins the two nations' competing ambitions.

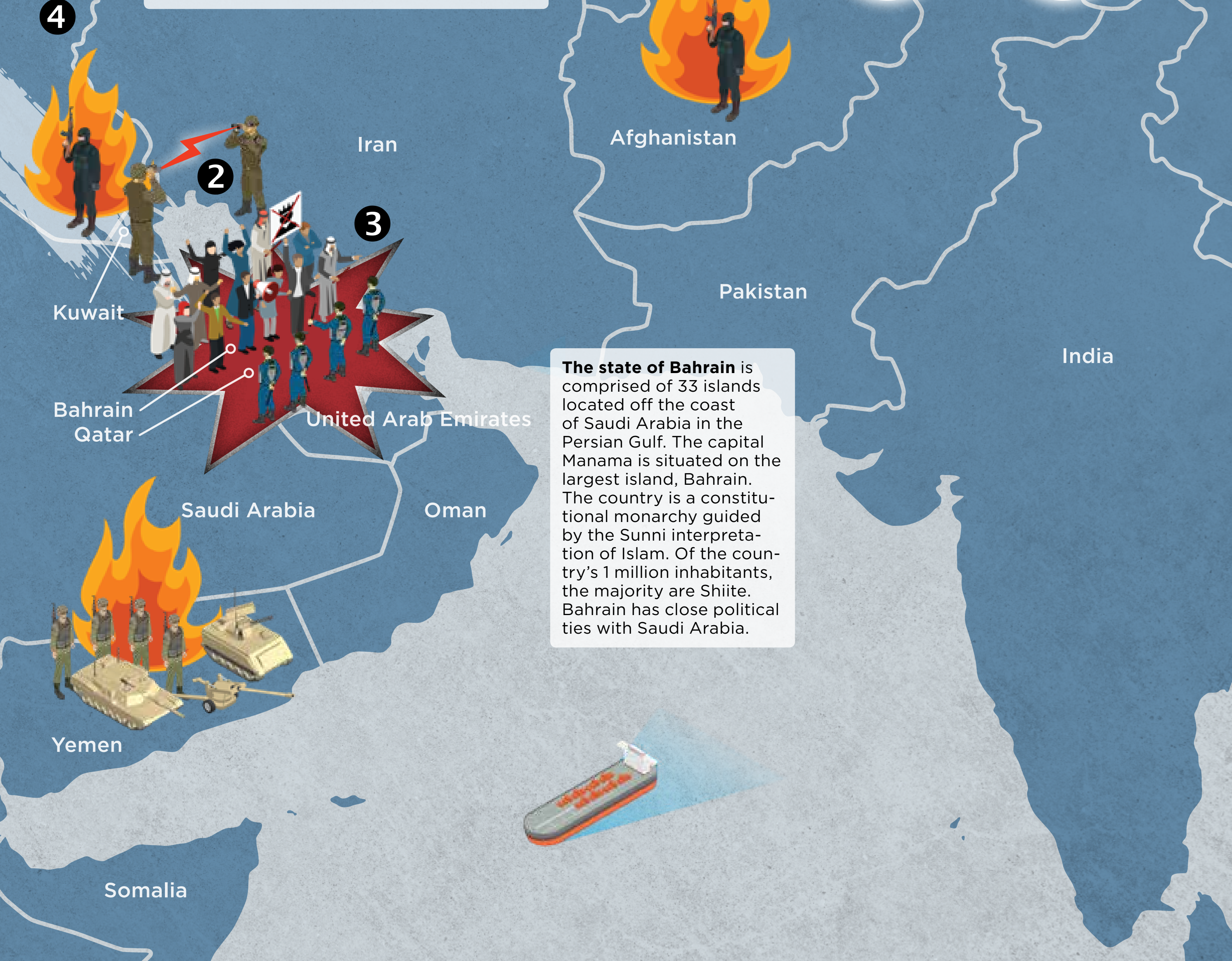
The Kingdom of Saudi Arabia was founded in 1932 from two territories on the Arab peninsula. The country is an absolute monarchy dominated by Wahhabism, a Sunni doctrine and religious movement. The country has 30 million inhabitants, of which a third are foreign citizens. The capital is Riyadh. Saudi Arabia is one of the world's largest oil producers.

The Islamic Republic of Iran was founded after the revolution of 1979, which brought down the monarchy and ruling king (the Shah). The country is governed by religious principles with Shia Islam as the state religion. Iran (formerly Persia) has a long of history as a regional power in Central Asia. After many years of isolation, Iran welcomed a lifting of international economic sanctions against it in January 2016 following an agreement to dismantle its nuclear energy programme. Iran has 80 million inhabitants and its capital is Tehran. The lifting of sanctions saw Iran quickly resume its position as an important oil producer.

ECONOMIC IMPACT







The state of Bahrain is comprised of 33 islands located off the coast of Saudi Arabia in the Persian Gulf. The capital Manama is situated on the largest island, Bahrain. The country is a constitutional monarchy guided by the Sunni interpretation of Islam. Of the country's 1 million inhabitants, the majority are Shiite. Bahrain has close political ties with Saudi Arabia.

Scenario 2

COLD WAR AND FRAGMENTATION IN THE MIDDLE EAST

SEQUENCE OF EVENTS: BRUSSELS, 1 JUNE 2018

The level of conflict in Syria has abated, but dramatic changes are afoot elsewhere in the Middle East and North Africa. Jihadists are returning home in the wake of Islamic State's (IS) failure to establish a caliphate in the Tigris and Euphrates region, their presence a source of substantial political and social stress across North Africa. Countries in the region are alert to the jihadists' presence but lack the resources to address it. Tunisia suffered a number of terrorist attacks during the winter and in southern Libya terrorist networks are gaining a foothold. Libya's position is exacerbated by competition between rival governments claiming the right to rule the country.

Experts warn that IS followers will revert to terrorism and piracy in the Mediterranean from bases in North Africa if they are not contained (though the terrorist atrocity on a cruise ship in January has yet to be followed by other attacks). Several countries, including Russia, have offered to assist North African nations in surveying and patrolling their coasts.

International observers believe a second Arab spring would destabilize the region and give terrorist organizations more freedom to operate. Refugee flows from and through the region to Europe continue and may yet grow. Since the turn of the year, however, a different challenge has overshadowed the refugee and terrorism problems in North Africa: the onset of a new Arab spring in the Persian Gulf.

INCREASING TENSIONS BETWEEN SAUDI ARABIA AND IRAN

Late in 2017 Iran accused Saudi Arabia of pushing the new US administration to question the international agreement on Iran's nuclear programme, the Joint Comprehensive Plan of Action (JCPOA). Iran's regional political influence is certainly growing, but the country is primarily focused on economic development and exploiting the increased trade that the agreement facilitates. The prospect of higher economic growth also impacts on Iran's domestic politics. Conservative factions may allow a reform-minded president take power but will not accept reforms even if they have public backing. The struggle between conservatives and reformists in Iran will therefore continue.

Irrespective of the veracity of Iran's accusations that Saudi Arabia is influencing US policy on Iran, it is a fact that the two regional powers are locked in a local cold war. One unintentional consequence of the US-led intervention in Iraq was the formation of a new government with close ties to Iran. Until spring 2018, Saudi Arabia held most of the cards thanks to its economic and military strength and regional influence through multilateral organizations like the Gulf Cooperation Council (GCC) and Opec. Saudi Arabia's good relations with Egypt had also helped to establish a basic, if fragile, regional status quo.

The winter brought warnings from international observers that Saudi Arabia was vulnerable to the same fundamentals seen in North Africa and which had created conditions for the first Arab spring: a young population, high unemployment, and prevalent social media use. Saudi Arabia had shown signs of war fatigue from its prolonged military campaign in Yemen and previous military air engagements in Syria. And its relatively strong underlying economy had been undermined by its determination to cut oil prices to reduce Iran's oil export revenues – a strategy that backfired by damaging Saudi Arabia's ability to uphold its generous welfare system. But as events turned out, the uprising and calls for a new Arab spring did not start in Saudi Arabia but in the small neighbouring, island-state kingdom of Bahrain.

CRISIS HITS BAHRAIN

Conditions in the Persian Gulf following Bahrain's abdication crisis in February this year gave cause for concern in Saudi Arabia. Riyadh blamed Iranian meddling for undermining Bahrain's Sunni monarchy, forcing the king – a Saudi ally – to abdicate and go into exile. The composition of the constitutional council set up in Bahrain after the abdication mirrored that of the national population, of which the majority is Shiite. This raised fears in Riyadh that the country would become an ally of Iran, the leading Shiite state. Saudi Arabia's worst-case

scenario is encirclement by enemies if Bahrain, Yemen and Iraq are all pulled into Iran's orbit. In March, just after the onset of the Bahrain crisis, the Saudis intensified their military campaign in Yemen in an attempt to gain full control of the war-torn country and end Iran's growing influence over its southern neighbour.

Bahrain had been close to being engulfed by the first Arab spring. In 2018, many had expected a Saudi intervention as steadfast as in 2011, when Bahrain's king was nearly toppled. Then, Saudi Arabia led the Gulf states' campaign to stop the Arab spring spreading from North Africa to the Persian Gulf. US sources have confirmed that Saudi Arabia again was prepared to intervene and reinstall the monarch. However, Qatar and the United Arab Emirates (UAE) appear to have concluded that they were too exhausted by the campaign in Yemen and other engagements in the Middle East to lend assistance to Saudi military action in Bahrain. At the same time, Saudi military forces were distracted by their ongoing campaign in Yemen.

Before Saudi Arabia could issue a go-ahead for military intervention in Bahrain, the regime was overtaken by widespread protests held in Riyadh in April. Inspired by Bahraini civil society, thousands of Saudis demonstrated against the government's preparations for an isolated Saudi intervention in Bahrain without support from the other GCC countries. The protesters also demanded domestic reforms. But the likely trigger for the still-unfolding power struggle in Riyadh was the extent of Saudi Shiite participation in the demonstrations.

Both Kuwait and the UAE have seen sporadic civilian protests without experiencing widespread unrest. Relatively high living standards in these countries make popular uprisings less likely. In Saudi Arabia, government promises of greater labour market opportunities and more generous handouts served to dampen the protests during the spring. But these pledges were expensive, and international observers expect fresh discontent to surface eventually in Saudi Arabia. Some experts argue that the Saudi government has proceeded gently for fear that unrest night otherwise spread to Mecca and undermine the legitimacy of the ruling dynasty and its role as guardian of the nation's holy sites.

POWER PLAY BY TURKEY AND EGYPT

In May, Saudi Arabia declared its support for the Kurdish autonomy initiative in Iraq that was launched in April. Riyadh's underlying purpose is to undermine Iran's influence in the region, but also to divert the world's attention from the events unfolding in the Gulf states. The announcement by the leadership of Iraqi Kurdistan that it would prepare to organize an independence referendum in 2019 was widely regarded as a gambit orchestrated with Saudi backing.

It is still unclear if the referendum can be pulled off. A declaration of independence would be a setback for the Iraqi government, which has close relations with Iran. And yet, support for a sovereign Kurdistan is a double-edged sword for Saudi Arabia.

Though Turkey's position is less hostile than Iraq's, Ankara could easily regard an independent Iraqi Kurdistan as a threat. Failing alternative options, however, Turkey might accept an independent Iraqi Kurdistan provided the new nation agrees to sells its oil to Turkey. Relations between Saudi Arabia and Turkey are already under strain because of the countries' divergent views on the Muslim Brotherhood.

Saudi Arabia is close to Egypt, whose regime has defeated the Brotherhood. The Egyptian leadership seems uncomfortable with how gently Saudi Arabia has proceeded against protesters, both in its domestic affairs and in Bahrain. Like other countries in the region, Egypt frets that a new Arab spring elsewhere in the region might spread to North Africa.

Intelligence reports in late spring alluded to covert threats from Turkey to obstruct Saudi Arabia's regional influence. Turkish tactics included demands for a higher oil price – a measure that would favour Iran. Turkey also seems to have approached Israel as a means to balance Saudi support for the Kurds and warned Europe against aligning with Saudi Arabia in its support for the Kurdish independence movement, implying such a step would impede refugee cooperation in the region. Turkey's leverage in this arena reflects its strategic location between Europe, one of the world's largest energy consumers, and a large swathe of global oil and gas reserves.

Saudi Arabia is not isolated, but it risks becoming more dependent on the US than its leadership had foreseen. The US position is equally tricky: it must strike a balance between Saudi Arabia and its neighbours like Qatar and Bahrain, which host American military bases. Washington shares Riyadh's desire to prevent the spread of Iranian influence on the Arabian peninsula. The US has historically been the guarantor of the flow of oil from the Persian Gulf to the world market. At present, America's own demand for oil from the Gulf is limited, but it has several strategic interests to monitor in the Middle East. One involves preventing other geopolitical adversaries like China or Russia from gaining a decisive influence in the region. In this context, the shelving by Bahrain's constitutional council in April of plans to finance and open a new naval base for the UK came as a setback to US and Western interests. It is unclear what security alternatives the UK will pursue in the Gulf.

The fear now is that increased tension between Saudi Arabia and Iran may negatively affect oil shipments from the Persian Gulf, even though Iran has a strong motive to step up its oil exports. The war in Yemen also threatens regional trade flows. The conflict has reached the stage where fighting could spill over into the Aden Gulf, potentially impeding shipping traffic to the Suez Canal. There is also an increased risk of terrorist attacks against maritime transport through the Bosphorus strait.

ECONOMIC IMPACT IN THE REGION AND GLOBALLY

For years the mainstream international view of the Middle East has been of an inherently unstable region with a number of more or less permanent trouble spots. Doing business there is seen as carrying a certain level of risk. However, the region's potential to shake the global economy when old and new flashpoints flare has decreased in tune with shrinking global dependence on oil and the diminishing influence of Opec. Middle Eastern countries are in general small and economically insignificant. Among the exceptions are Saudi Arabia, the leading Gulf state and large oil producer, the UAE, which has evolved into an interesting logistics and financial centre and major tourist destination, and Egypt, which is North Africa's largest economy. Iran has huge economic potential, but long-standing international sanctions have seriously stunted its industry and infrastructure.

While decades of conflict have lowered expectations and served to limit the global economic reach of a new crisis in the Middle East, the scenario outlined here – which includes an alarming and escalating fragmentation of the region – would be serious enough to hit global business and consumer confidence.

The scenario envisages an increased risk of terrorism and disruption to oil deliveries and, at worst, an international armed conflict due to increased tensions between Saudi Arabia and Iran, triggering a flood of refugees to Europe. It also assumes a drop in business and consumer confidence to 20 percent of the global financial crisis peak level, and that world stock markets go into reverse as the public mood darkens.

Lower global demand depresses the oil price, though disruption to production and deliveries from the region reduces supply and stabilizes the price of crude at $45 per barrel.

Outside the Middle East, the impact on GDP is limited. Some European countries are forced to increase public expenditure to manage the refugee influx and a lower oil price comes at a cost to Russia. However, growth in North America and Asia falls by only a few decimal points.

In the Middle East and North Africa, the crisis has large-scale economic consequences. The wars in Syria and Yemen and the war-like situation in Libya and Iraq create a flood of refugees, posing a threat to neighbouring economies. The deteriorating security situation and loss of tourist revenues drag the whole region into a downward spiral. Regional trade will decelerate and business investment will cease. Foreign-owned companies will scale back their operations to a minimum or leave. Private consumption will fall dramatically and become dependent on barter trade, smuggling and black markets. Even the wealthier oil-producing countries will lack the resources to stabilize their economies through increased public expenditure. GDP will fall by a full 25 percent across the region, with war-torn nations hit hardest.

IMPACT ON SWEDISH COMPANIES

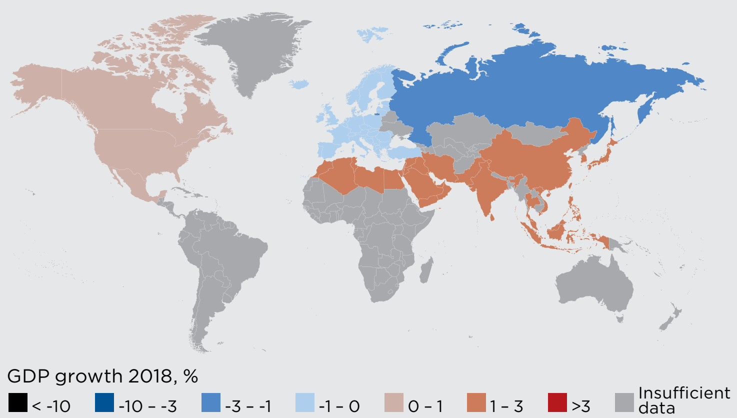
Swedish companies in the region are often represented by sales offices only, and they work through local partners and distributors to reduce business risk. Despite the fact that Swedish companies have been present in the region for a long time, their regional economic footprint is relatively light.

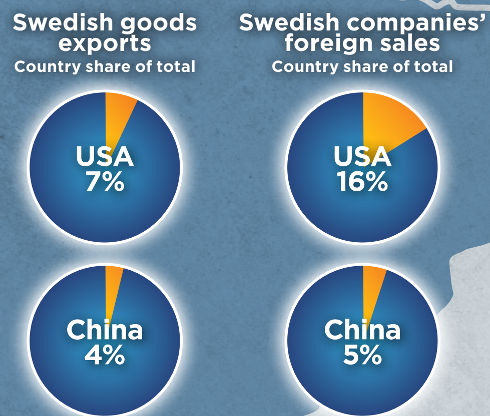
This scenario envisages Swedish companies scaling back their activities as the conflict escalates. Foreign personnel are sent home and replaced by local hires as security deteriorates. Management of regional business operations transfers to European subsidiaries or Swedish head offices. Large companies trim operations to a minimum and wait for hostilities to end, simultaneously working hard to maintain good relations with their distributors, partners and customers. The conflict has serious financial repercussions for medium-sized businesses. For small enterprises, which account for 7 percent of Swedish sales in the Middle East, the squeeze is too hard to bear and they quit the region.

Scenario 3

Superpower conflict: The US and China

ECONOMIC IMPACT





The trade in goods between the US and China totalled $600 billion in 2016. The US is China's most important export market and China is the US's third most important export market after Canada and Mexico.

The US imports $460 billion of goods from China, corresponding to 21 percent of total US imports. US goods exports to China stand at $115 billion, accounting for 8 percent of total US exports.

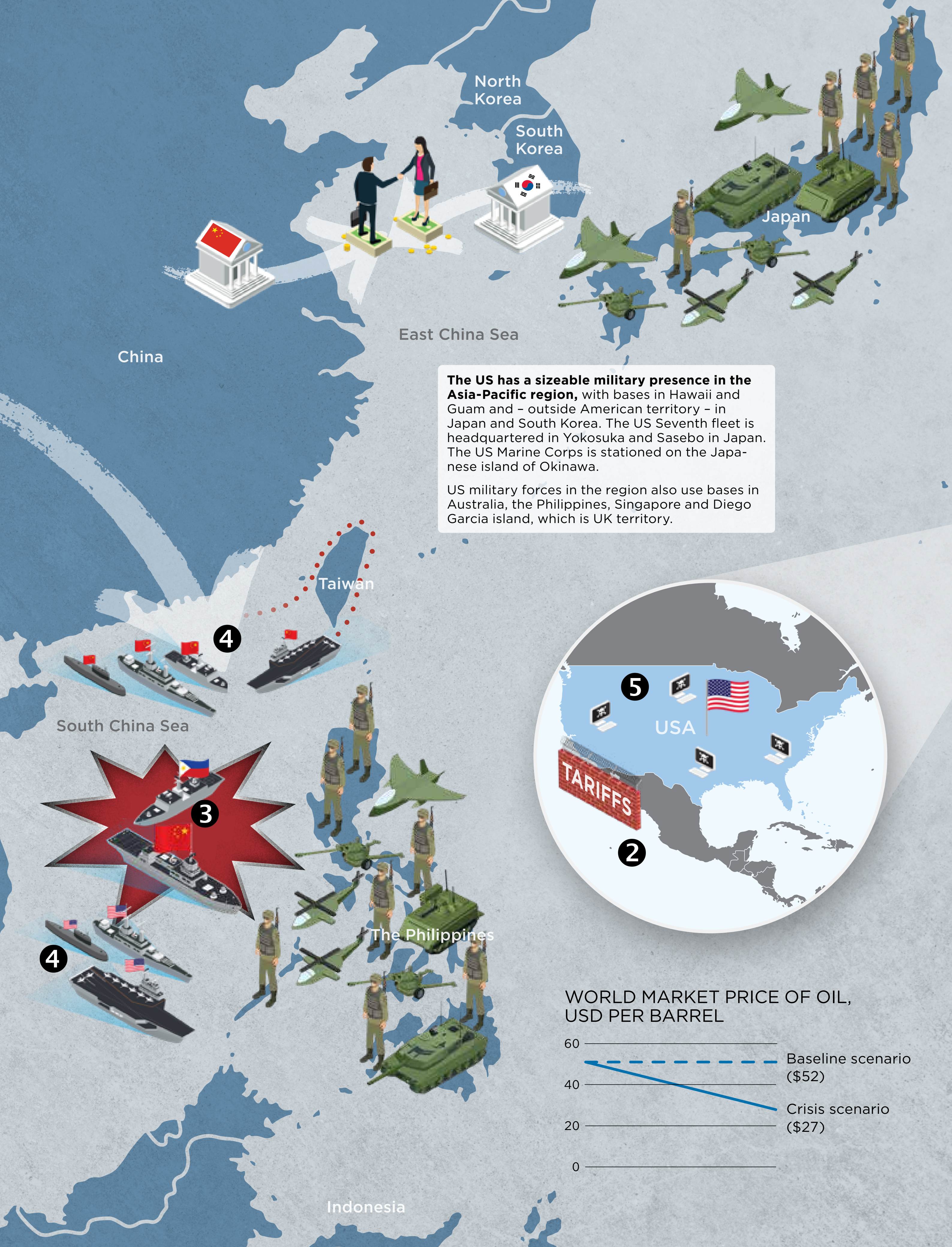
Eighteen percent of China's goods exports are to the US. American goods account for 10 percent of China's total imports.

US companies are large investors in China. Chinese corporations have invested in the US but to a limited extent. The US authorities have blocked several deals on national security grounds.

India

Sri Lanka

1. **China steps up its influence in the region**
2. **The US introduces punitive tariffs on Chinese goods**
3. **Incident near the Spratly islands**
4. **Naval build-up in the South China Sea**
5. **Cyber attacks against the US**



The US has a sizeable military presence in the Asia-Pacific region, with bases in Hawaii and Guam and – outside American territory – in Japan and South Korea. The US Seventh fleet is headquartered in Yokosuka and Sasebo in Japan. The US Marine Corps is stationed on the Japanese island of Okinawa.

US military forces in the region also use bases in Australia, the Philippines, Singapore and Diego Garcia island, which is UK territory.

WORLD MARKET PRICE OF OIL, USD PER BARREL

Scenario 3

SUPERPOWER CONFLICT: THE US AND CHINA

SEQUENCE OF EVENTS: WASHINGTON, 1 JUNE 2018

Prior to the 2016 American presidential election, Washington remained highly committed to the US-led world order established after World War II and built around multilateral organizations like Nato, the World Bank and the International Monetary Fund (IMF). US decision-makers knew that America's "soft power" was closely tied to these institutions, the country's ability to lead and its financial and economic clout. But the new administration has a narrow interpretation of the US national interest.

Both the US and China are currently guided by strong nationalistic impulses that will increase the risk of confrontation as they struggle for influence in Asia. Shortly after President Xi Jinping accepted the post as general secretary of the Communist party in 2012, he launched the concept of "the Chinese dream", one of his most successful leadership initiatives. The personality cult around him reinforces China's ever more authoritarian direction of travel.

China will defend its interests in the Asia-Pacific region with political, economic and military action. Among other initiatives, China has set up the new regional Asian Infrastructure Investment Bank (AIIB) to compete with organizations like the IMF, which is under strong US influence. China wants more say in other multilateral forums too, and has succeeded in improving relations with and moving closer to Russia. These efforts have the ultimate purpose of obtaining military and economic parity with the US. They are considered necessary to fulfil China's aspiration to again be the "Middle Kingdom" of the world, or at least the dominant force in Asia-Pacific. And China is in a hurry: its leadership wants to double national GDP between 2010 and 2020 in time for the Communist party's 2021 centenary. US influence in Asia is an obstacle to China's geopolitical ambitions.

China's desire to stand out as a free trade advocate was exemplified at the Communist party congress in November 2017. President Xi again disassociated himself from the protectionist chatter that China assigns to the US, though international observers point out that substantial political and economic reforms are needed before the Chinese market can be compared to Western markets in openness terms.

THE TRADE WAR BEGINS

In January this year President Trump finally made good on his election promise to stigmatize China as a currency manipulator. Frustrated over a lack of progress in bilateral negotiations the previous year, the US administration claimed China was "screwing its best customer". (Opinions differ among economists on whether China gains export advantages from keeping its currency artificially weak.) The real purpose behind the verbal attack was probably a desire to deflect public attention from the disappointing US growth rate and to energize the Republican party before the mid-term elections to Congress. The results of these elections will be an important test of support for the Trump presidency and the administration's ability to implement more of its political programme.

Since Trump's inauguration, China has successfully wooed several of America's allies. Numerous alliance systems around the world have over the decades given the US an advantage vis-à-vis China, which lacks formalized pacts. In Asia, the US counts Japan, South Korea, the Philippines and Thailand among its allies. It also has a security arrangement with Taiwan. But unlike Nato, these bilateral alliances do not take the form of collective defence. Observers note that some of America's regional allies have often felt that the US has failed to meet their rightful expectations. During the winter, China and South Korea re-established constructive relations when the new government in Seoul eased Beijing's concerns regarding South Korea's defence cooperation with the US.

The US reacted strongly when China and South Korea during Xi's visit to Seoul in February announced plans for closer economic cooperation through an extended bilateral trade agreement and other initiatives. Trump highlighted the deal as a classic example of how allies exploit the US by letting it pay for their security while pursuing unfavourable trade policies. The US secretary of defence quickly reassured South Korea and other regional allies that America would not withdraw any forces from the region. Rumours suggested that the US secretary of state had to persuade Trump to refrain from again questioning the so-called "One China" policy and implying Taiwan separateness from China. In 2016, the then presidential candidate

Trump had done just that, prompting China to show its displeasure by dispatching its only naval carrier to sail close to Taiwanese waters.

THE CONFLICT ESCALATES

It came as a shock when Trump at the start of the Republican's election campaign in Florida in March announced that the US would from July 1 impose a 45 percent tariff on all imports from China. Though the measure ran contrary to World Trade Organization (WTO) rules and threatened to start a trade war, the Trump administration insisted the WTO had become an instrument for China to hold America hostage and gain advantage at its expense. The same week, the US secretary of state revisited his idea of blockading artificial islands in the South China Sea that China has constructed and equipped with airfields.

Since May, senior officials in the Trump administration have been defending the US trade measures against criticism that they run counter to the letter and spirit of international trade agreements and that the US is undermining the world order. The White House view is that a US-led world order is not a priority national interest and the US is a merely a country like any other. (Some observers regard the president's zero-sum perspective on international negotiations as akin to the worldview of other regional powers.)

Against this backdrop of increasing regional tension, other nations were emboldened to promote their national security interests with little concern for regional impact. This tactic undermined regional stability, which depends on collaboration. Meanwhile, Chinese offence at Trump's blandishments prompted Beijing to attempt to save face by manufacturing a confrontation with the Philippines. Seeing the country as the US's least important ally in the region, China calculated that there would be limited risk of triggering an international crisis by locking horns with Manila.

Thus, a fortnight ago a Philippine destroyer started what was to prove its last trip – a patrol tour of the South China Sea. Seven days later a Chinese naval ship rammed the Philippine vessel after the two found themselves on collision course near the Spratly islands. Following the incident, the Philippines stressed the need for US military presence in the region, claiming America's reputation as a trustworthy ally was at stake.

The following day, Trump administration officials sought to calm tensions by downplaying the event. China, however, responded by sending more naval ships to the area to "defend Chinese workers on the islands". This sucked Japan into the crisis as China's territorial claims on the Diaoyu/Senkaku islands in the East China Sea have fuelled Japanese fears that it would be China's next target after the Philippines. As intensive diplomatic talks between Tokyo and Manila continue, the Pentagon has announced that the US will send an aircraft carrier fleet to the South China Sea to "secure the free flow of people and goods in the Asia-Pacific region". It is doubtful whether this will stabilize matters. Sources in Beijing claim the country's leadership has contemplated branding the increased US naval presence as an attempt by the Trump administration to enforce the blockade proposed by the US secretary of state when he was appointed. Beijing may interpret such a measure as an act of war.

By what looks like more than idle coincidence, last night the US suffered a massive cyber attack on military and civilian targets. A virus infected US air force systems, causing a power failure at Fort Meade in Maryland, home to the US cyber command. State Department sources say proof is being sought that the attack was orchestrated by China. China denies all involvement, noting drily that the US has plenty of other enemies capable of mounting such a strike.

Yesterday Beijing proposed that ASEAN, the regional economic organization for South East Asia, should host negotiations next week in which China, the US and other parties "address the enmity in the region and between the superpowers". The offer is being seen as an attempt by China to take the high ground as a more responsible partner than the US and gain goodwill internationally.

REGIONAL AND GLOBAL ECONOMIC IMPACT

The immediate effect of an open conflict between the two superpowers is mainly psychological: consumers and businesses fear the tensions may escalate and spiral out of control. Looming in the background is the fear of an armed confrontation, in a worst-case scenario with nuclear weapons, which would have the potential to devastate large parts of the globe.

At the time of writing, the conflict remains limited and under a degree of control. It has, nevertheless, already caused a dramatic jump in global economic uncertainty. Our scenario sets the loss of global consumer and business confidence to two-thirds of the drop recorded at the height of the 2008 financial crisis. World stock markets have fallen and banks and other financial institutions can be expected to reduce lending, limit their international exposure and prioritize their most important customers. Households worldwide are nervous about the future. Consumption will fall and savings will increase, dampening global economic growth.

The oil price will halve to $27 per barrel and the US will ban exports of American oil. Canada will be obliged to sell all its oil that is not used for domestic consumption to the US, at world market prices.

In the US, the punitive tariffs of 45 percent on Chinese imports will cause rapid price hikes in consumer electronics, clothing and shoes and white goods, which will mainly hit lower-income households. Demand for Chinese goods will fall, while imports of equivalent products from other countries experience an upswing.

Fraud related to country-of-origin customs declarations will increase, as will the use of transit countries for Chinese goods. Entering imported goods at US customs will become more time-consuming and subject to confusion and discretionary practices. US, European and Japanese companies with manufacturing in China – which account for half of China's goods exports – will suffer a heavy sales drop in the US market due to the tariffs. The US will tighten its control of high-tech exports to China and give the government Committee on Foreign Investment in the United States (CFIUS) a broader mandate to block Chinese acquisitions of US companies and other investment in the US.

China's response to the imposed American tariffs will be nuanced. Aside from filing complaints about the US breaking WTO rules, China will block imports of American farm products such as soybeans, citing public health and safety concerns. A nationwide consumer boycott of US goods and firms will be organized, leading to steep falls in sales of American consumer electronics and other consumer goods such as cars. Many US companies will be hit with heavy fines for contract violations when scaling back operations in their Chinese subsidiaries, which employ 1.6 million people in China. By contrast, Beijing will compensate Chinese suppliers forced to reduce production and lay off personnel as a result of the trade war. China will cancel all orders for US-made civilian airplanes and invite the European aviation industry for talks. The country will undertake a massive sell-off of US bonds, though to little effect as the Federal Reserve will counter the sale with a new bond-buying programme.

China's goods exports will fall by 10 percent, while US goods exports will drop by 5 percent. Economic growth will be hit in both countries, but especially in China. The direct and indirect economic effects on the rest of the world will be substantial. In most of Europe and Asia, economic activity will fall drastically. Europe will find itself at zero growth. The world economy will stagnate with a growth rate of 1 percent.

IMPACT ON SWEDISH COMPANIES

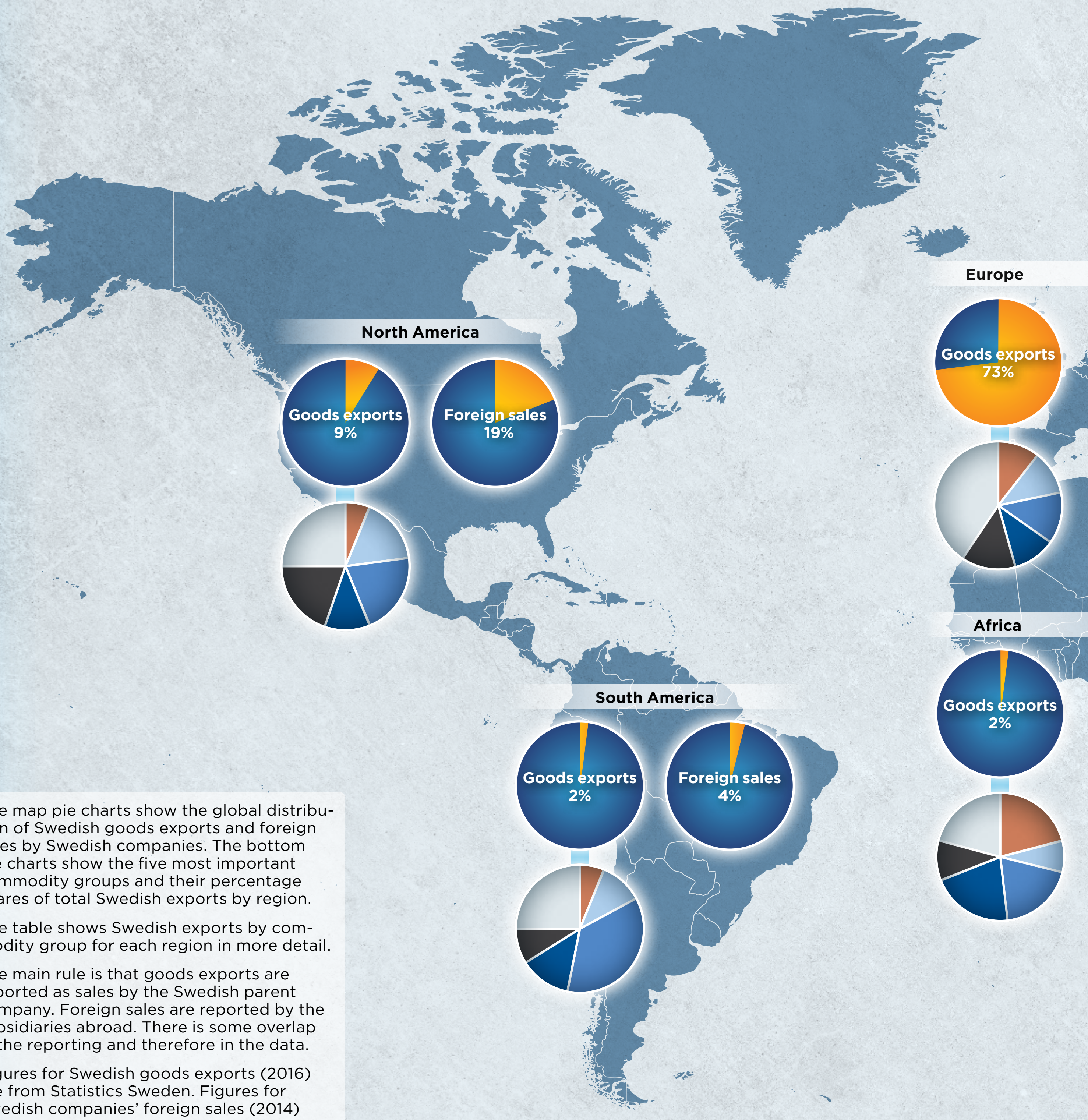
Almost all Swedish large companies are present in some form in the US and Chinese markets. They operate across a wide spectrum of sectors, including research and development, manufacturing, sales, service and support, and employ Swedish as well as local suppliers.

The US is one of the most important markets for Swedish exports and foreign sales. Business Sweden's data shows that Swedish companies have revenues of some SEK 250 billion in China and employ 180,000 people there.

The slump in the Chinese economy that will result from this scenario will have serious consequences for Swedish businesses. The business climate in China will harden even more as a rise in economic nationalism puts a restraint on commercial ties. In the US, Swedish companies will be discriminated against at an unprecedented level. Companies will have to manage a large fall in global demand at the same time as Chinese goods earmarked for the US flood into Europe. Many companies will postpone investments, limit their international exposure and move resources to markets best placed to withstand the ensuing global recession.

250
SEK BILLION
Swedish company sales in China

Swedish companies in the world market



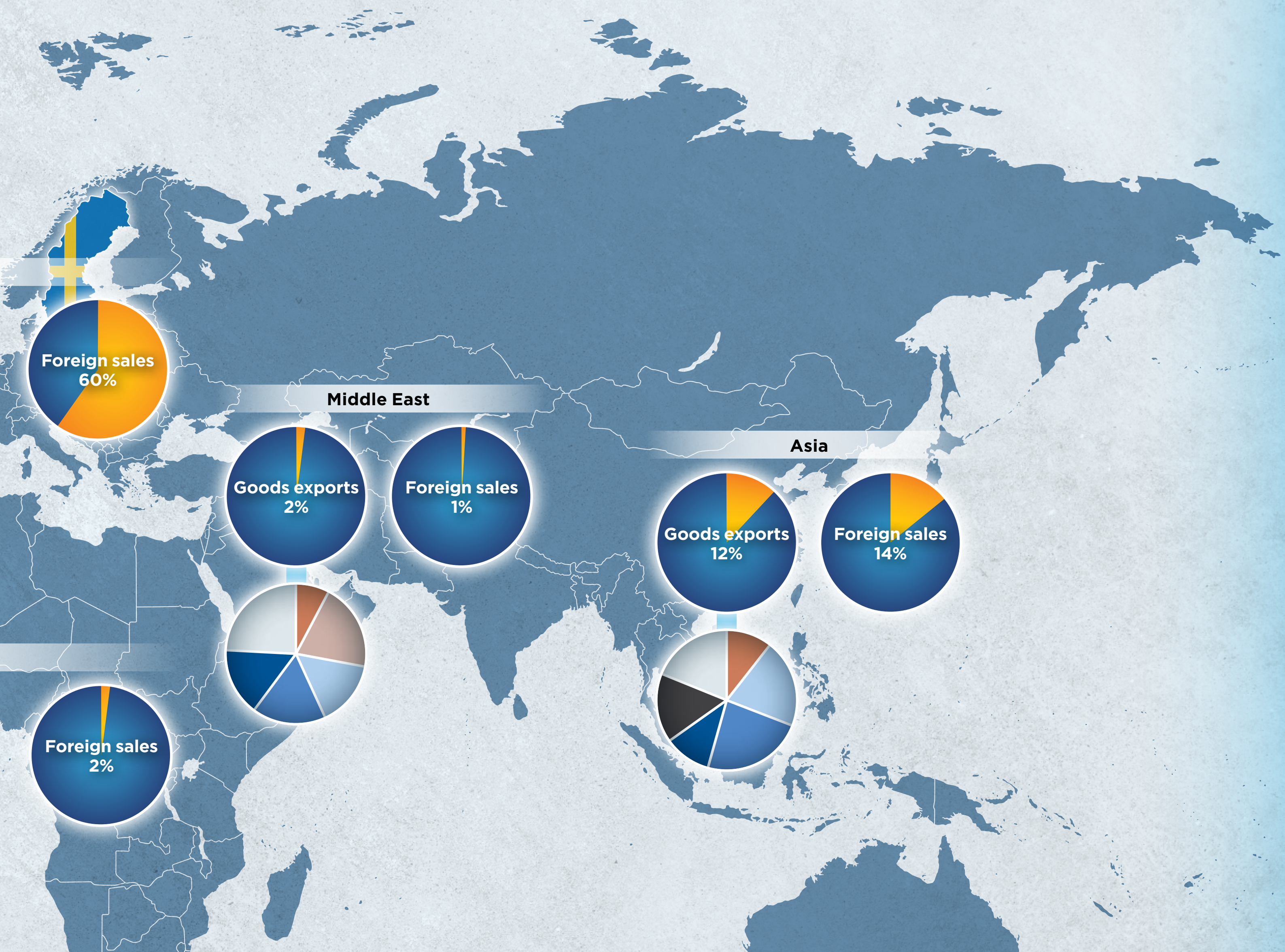
The map pie charts show the global distribution of Swedish goods exports and foreign sales by Swedish companies. The bottom pie charts show the five most important commodity groups and their percentage shares of total Swedish exports by region.

The table shows Swedish exports by commodity group for each region in more detail.

The main rule is that goods exports are reported as sales by the Swedish parent company. Foreign sales are reported by the subsidiaries abroad. There is some overlap in the reporting and therefore in the data.

Figures for Swedish goods exports (2016) are from Statistics Sweden. Figures for Swedish companies' foreign sales (2014) are from Statistics Sweden and the Swedish Agency for Growth Policy Analysis. Foreign-owned companies in Sweden – of which companies like ABB, AstraZeneca, Volvo Cars and others have important operations in Sweden – are not included in the foreign sales figures.

Business Sweden has processed the data.



SWEDISH GOODS EXPORTS 2016,
DISTRIBUTION BY REGION IN PERCENT

	EUROPE	MIDDLE EAST	AFRICA	ASIA	NORTH AMERICA	SOUTH AMERICA
Pulp and paper	11%	11%	21%	11%	3%	6%
Metals	8%	17%	4%	7%	6%	5%
Chemicals and pharmaceuticals	11%	15%	8%	20%	17%	11%
Machinery	13%	16%	19%	23%	21%	36%
Electronics, power and telecom	11%	17%	21%	11%	11%	13%
Automotive	13%	8%	10%	16%	20%	9%
Food	9%	4%	4%	2%	4%	3%
Refined oil	8%	2%	5%	0%	2%	3%
Wood products	2%	0%	0%	0%	1%	0%
Clothing and footwear	2%	0%	0%	0%	1%	0%
Instruments	2%	3%	1%	4%	6%	2%
Other manufactured goods	4%	1%	3%	2%	3%	4%
Other goods	6%	6%	4%	4%	5%	8%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

How Swedish businesses manage in times of crisis

EXPERIENCE FROM INTERNATIONAL CONFLICTS

Company executives that Business Sweden interviewed for this report emphasized that Swedish multinationals possess extensive experience of operating in difficult markets and in managing conflicts and crises in their external environment. Swedish corporate culture is generally process-oriented and equipped with the requisite expertise to operate in countries with poor safety and security standards.

Large Swedish corporations normally act swiftly when the business climate in a foreign market starts to deteriorate. Their global organization will give an early warning to headquarters if a conflict or crisis looms. As individuals, Swedish executives are often internationally experienced and have the ability and readiness to address a crisis, particularly when the market in question is high-revenue and of top concern to management.

For any company, it is important to retain individuals with experience of managing international conflicts and crises, especially in times of transition to younger top management. Ways to achieve this include maintaining a mixed age profile at management and boardroom levels and appointing people with previous experience of crisis management to key positions in the global organization.

Swedish small and medium-sized enterprises typically have a much lesser capacity to manage business operations in a conflict or crisis in their foreign markets. They lack the necessary personnel, resources and market presence to receive and analyze early warnings of a looming conflict. But SMEs can remain informed by staying in close contact with other operators in the market, such as Swedish embassies and chambers of commerce. They can also hire consultants specialized in advising on difficult markets.

PREPARATIONS AND RESPONSIVENESS

Business Sweden's interviewees see every international conflict and crisis as unique, depending on where and how it emerges. Swedish companies must handle events case by case. It is important to have a contingency plan that sets out the conditions in which the company should act and how. An effective plan will enhance the ability to make good and timely decisions. The interviewees also stressed that there is no one-size-fits-all manual that will work in all conflicts and crises. An element of improvisation and day-to-day judgment is always required in respect of how a crisis unfolds and what the company's response should be.

ACTING IN A CONFLICT

Swedish multinationals normally take the long view when a conflict or crisis hits a foreign market as it is expensive both to withdraw from a market and also to re-enter it. Companies usually endeavour to keep their operations going, even if they have to scale back to a low level. While waiting for the market to normalize, corporations will work hard to maintain good relations with partners, distributors, customers and suppliers.

If a company's business depends on public contracts it will maintain contact with local authorities, banks and all legitimate interests in the market. In difficult market conditions, foreign companies have a tacit understanding to refrain from acting aggressively and will typically abstain from cutting prices or trying to win market share.

The interviewees stressed that the most important thing a company should do in a foreign conflict or crisis is provide factual and correct information to shareholders, employees and other stakeholders. Staff safety is the top priority. In a deteriorating security environment, companies may have to act quickly to bring foreign personnel home and ensure the safety of local employees as best they can.

The interviews also highlighted Swedish trade unions as a valuable asset to companies in foreign crisis and conflict management. Company management and union representatives often work well together to find ways for the company to navigate a situation. Panic can cause irreparable damage to a company's reputation and business and should be avoided at all costs.

Sources:
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Swedish Agency of Growth Policy Analysis
Swedish Defence Research Agency (FOI)

Geopolitical scenarios: Business Sweden and FOI
Economic impact: Business Sweden forecasts using the Global Economic Model in collaboration with Oxford Economics (London)
Impact on Swedish businesses and their scope for action in an international conflict: Interviews by Business Sweden

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