



SPECIAL REPORT

Global risks: first half 2015

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The geopolitical risk is back and its relevance for companies goes beyond a mere interest in the international scene. Internationalization is an imperative for any growth-oriented company. But nowadays growing markets are largely to be found in emerging economies where political and legal instability and geopolitical and macroeconomic risks are major factors. The 21st century company with an international expansion commitment is already obliged to be familiar with these risks and evaluate the possible impact on its business.

In the first half of 2015 we find a world in transition and geopolitically unstable. Geopolitical conflicts, with threatening Russia in Ukraine and the Middle East increasingly unstable, have acquired a relevance not seen since the end of the Cold War. The fall in oil prices could give rise to a conciliatory attitude in Russia and Iran's negotiations with the West in the medium term. However, in the short term, it is expected that the increased risk of intra-State armed conflicts, the escalation of cyber-attacks and an increasingly clear use of economic tools for geopolitical purposes, which has been termed "geo-economics", will continue.

In economic terms, the situation remains fragile. The US domestic demand has emerged as the main motor for growth of a stalled global economy, with stagnation in Europe and the emerging economies, especially China, slowing down their growth. The four most populous Asian States (China, India, Indonesia and Japan) are carrying out far-reaching domestic reforms by the hand of four strong political leaders. There seems to be positive impact only on the Indian economy. China is slowing its growth.

This report identifies ten geopolitical and macroeconomic risks at a global level that will determine, to a large extent, in the short and medium term the global geopolitical and economic context. Any internationally oriented company should take them into account when assessing their international investment decisions.

“A greater stress on national sovereignty will gradually hinder the European decision-making”

2. EUROPE: FROM THE NEW MEDIOCRE TO THE POLITICAL INSTABILITY

Despite the fall in oil prices, the depreciation of the euro and the loosening of the public deficits limits for France and Italy, the eurozone GDP remains stalled due to the weakness of the economies of large Member States such as Italy and France and of smaller markets like Austria, the Netherlands or Finland. In the short term, there is a concern for the consolidation of the high youth unemployment and the possibility of falling into a deflationary spiral. During 2015, the Juncker Plan, the Banking Union or the quantitative easing will be implemented. The momentum to complete the European economic governance has been slowed and the focus has moved to political and institutional risks beyond the economic situation.

Political instability may increase: 25 out of the 28 national governments in the European Union are coalition governments. Throughout the year 2015, general elections will take place in some of the weakest countries of the eurozone like Slovenia, Spain and Portugal. A halt to reforms is foreseeable in these countries. Besides, their election results may lead to a greater instability when creating governments without clear majorities. Electorates of these countries seem less and less willing to make sacrifices

which, together with the coming to power of SYRIZA in Greece and the rise of Podemos in Spain or Sinn Féin in Ireland, could give rise to further doubts about the future of the euro in debt markets.

Moreover, the rise of the Europhobic extreme right in more than ten countries of the European Union will gradually become a great source of instability. Prospects of the political parties less in favor of solidarity with Southern Member States are very positive within elections in Estonia (March), Finland (April), United Kingdom (May) and Denmark (September). In Germany, the Christian Social Union in Bavaria (CSU) and the Alliance for Germany (AfD) put pressure on the federal government to reduce its commitment to the single currency. The public opinion and the non-business intellectual elite are increasingly reluctant to give in to the European project and require the pursuit of strictly national interests in a more proactive manner. The Socialist Party (SPD), partner of the Merkel Government, is the greatest counterweight. These pressures will hinder Germany from increasing its public investment by abandoning the zero deficit policy.

The increasing polarization among the electorates and a greater stress on national sovereignty will gradually hinder the European decision-making

“This situation makes it difficult for Russia to consolidate as a power”

process and will slow the momentum of strengthening of the European economic governance. Uncertainty in Europe will continue in light of the doubts about Greece’s future (which will have to receive some kind of help in June while waiting for the final renegotiation of the bailout) and due to geopolitical crises in its surroundings like in the Eastern neighborhood (Russia-Ukraine), the Southern flank (Libya and the Maghreb) and the Middle East (Syria and Iraq).

Finally, there are two additional factors of instability. On the one hand, the increasing uncertainty about the potential UK’s withdrawal from the European Union (the *Brexit*) if the referendum promised by Conservatives has an unexpected result. On the other hand, the increasing weakness of the euro which, although it serves as a boost to growth, it can also be interpreted by markets as an indicator of a secular stagnation of the European economy, especially if the euro’s parity with the dollar is reached with the symbolic significance that a depreciation of around 40% in scarcely a year would cause.

3. AN UNSTABLE RUSSIA THREATENS THE INDEPENDENCE OF ITS NEIGHBORS

The EU’s foreign agenda will remain marked by the Kremlin’s decisions in the short term.

Moscow will have to decide whether to continue with its geopolitical strategy of consolidating its sphere of influence on the *Russkiy Mir* or on the contrary, to try to avoid a prolonged recession focusing on recovering the economy and lifting the Western sanctions. Its economy has been debilitated by the fall in oil prices and the ruble’s devaluation. This situation makes it difficult for Russia to consolidate as a power with the capacity to redefine the world order; although it will keep its “right of veto” intact over its immediate neighborhood. This has been demonstrated by the *frozen conflicts* of Transnistria, Crimea, Abkhazia, South Ossetia and Nagorno-Karabakh.

In the short term, it is not foreseeable that the sanctions regime will change the Kremlin’s attitude on the eastern part of Ukraine. The option of the “finlandization” of Ukraine or the return of Crimea to Ukrainian sovereignty seem to be excluded. The great risks posed by this conflict are to avoid a proxy war with the West, the generalization of “hybrid warfare” including cyber-attacks, the disruption of the energy supply, the emergence of alternative institutions of global governance and the increase in the division within the EU.

The relations between the EU and Russia will be determined by Moscow’s reaction and the suspicion generated by its

“The conflicts between States are changing”

actions in the Baltic countries, Poland or Sweden. Over the last years Russia has gained influence in some Member States of the EU like Czech Republic, Cyprus, Hungary or Greece and countries like Austria, France and Italy which wish to safeguard their economic interests in Russia. This is the case of Spain and Germany as well. For this, it has used different tools such as the supply of civil nuclear technology (Hungary), energy investments and support to the Navy (Cyprus), possible financial support (Greece) or the threat of disruption of the gas supply. From Brussels, concerns have also been raised about the increasing relation of Moscow with European antiestablishment parties like France’s National Front or SYRIZA and ANEL in Greece. The degree of Russian pressure on its neighbors to join the Eurasian Union and whether this project is compatible with the trade agreements of its potential members with the EU will also be particularly relevant. Moreover, sustained growth of the military budgets in the post-Soviet area, including EU’s eastern States, is expected.

The tensions with the EU, especially the sanctions regime and the cancellation of the project South Stream, have made Moscow turn towards China, Turkey and India. In this respect, it must be taken into account that, in the

medium term, the Russian foreign policy will continue to be limited by the diminished growth capacity of its economy due to determinants such as its unfavorable demography, the weakness of the rule of law, the deterioration of the assimilation of immigration and the inability to generate a modern export sector not dependent on natural resources.

4. GREATER RISK OF CONFLICT AND HYBRID WARFARE

Over the last months, the trend experienced during half a century towards the reduction in the number and virulence of armed conflicts has been slowed. Particularly remarkable is the fact that the risk of inter-State conflicts is increasing. An example of this is that in 2014 the figure of 50 million refugees was exceeded for the first time since the Second World War. Territorial tensions in East Asia, instability in the Sahel region, several conflicts in the Middle East and the renewed pressure on the frozen conflicts in the post-Soviet area are signs of this new trend.

The risk of conflict has increased and so has the nature of these ones. As proven by the Ukraine and Islamic State cases, the conflicts between States are changing. The new hybrid wars combine conventional military tools with irregular forces, cyber-attacks, economic measures, propaganda, digital

“Computer-related crimes are around 15-20% of the digital economy”

activism, interposed use of non-state actors or support to local rebellions.

5. CYBERSECURITY IS NO LONGER A MATTER OF THE PAST BUT OF THE PRESENT

The examples of the recent cyber-attacks suffered by JPMorgan Chase, Sony Pictures or large e-commerce companies and retailers like Target, Home Depot and eBay or the big espionage scandals have warned governments, companies and the civil society about the importance of cyber threats.

In a hyperconnected world, the technological progress and the increasing weight of non-State agents make States and the private sector more vulnerable to asymmetrical shocks. Non-State actors –and State ones as well– with an increased access to technologies could cause systemic failures through cyberterrorist attacks. In a context of hybrid warfare, there is a growing concern over cyber-attacks against systemic institutions, especially financial ones. Russia has great capacities in this area so it could use this tool in order to counteract the sanctions regime either directly or through nationalist hackers groups. Moreover, cyber espionage is eroding the confidence between States, especially between the United States and China, both of which are very active in this area.

In many areas, the development of computer networks is already ahead of our capacity to manage them, which might cause major problems and ostensibly increase the vulnerabilities of both States and the private sector. Cyber threats grow in parallel with the implementation of the Internet of Things, the big data, the cloud storage, the collaborative economy, disruptive technologies like drones or 3D printing and the new management of critical infrastructures. Currently, it is estimated that computer-related crimes are around 15-20% of the digital economy and it is expected to grow exponentially in the short term. As a consequence, the insurance market in this area will grow strongly during 2015.

6. MENA: THREE GREAT INTERTWINED CONFLICTS

Middle East and North Africa (MENA) finds itself mired in a spiral of violence and instability after the failure of the Arab Spring. At this time, three major disputes set the agenda of the area: the upsurge in the confrontation between the Sunni and the Shia, the increasing internal fights among the Sunni and the Israeli-Palestinian conflict. In this context it is not unlikely that several countries of the area become failed States. Iraq, Syria, Libya or Lebanon could divide into smaller and weak entities incapable of controlling their territories, what would spread

“The international fear of the Chinese shadow banking has increased”

potential of conflict through the whole area. The threat by the Islamic State (IS) is Syria and Iraq has grown very rapidly. The aspirations of this group are not limited to representing the most radical jihadism but also intends to become a Sunni battering ram against Shiism. Action taken by the international coalition led by the United States are insufficient to dismantle the IS as long as it lacks a credible partner on the ground. The degree of involvement of Turkey, Iran and the Gulf countries in the fight against the IS will be key for the future of the region.

Over the next months, the US and the EU will have to choose where to focus their resources and political capital. In the event of reaching an agreement with Iran, the two other great elements on the agenda (the intra-Sunni confrontation and the Israeli-Palestinian conflict) could be deeply destabilized. Saudi Arabia has already announced that if Iran is allowed with a nuclear program, they will implement one at the same level. Furthermore, Israel would be offended whereas the Shia could gain positions in the case of raising the level of requirements relating to human rights and democratic aspirations towards the closest countries in the area (Egypt and Arab monarchies). Moreover, the independence of the Iraqi Kurdistan would be a game-changer for the Middle East.

Especially important is the management of the impact

of the three million refugees and the almost seven million internally displaced people (IDPs). To these displacements must be added the refugee crisis South Sudan and the Central African Republic are suffering. Over the next months, the risk in Europe could increase due to the migratory pressure. The pressure grows in Southern and Eastern Europe while anti-immigration parties rise and the Italian rescue operation on the high seas Mare Nostrum has been replaced by the limited and undersupplied European operation Triton. Focusing only on the beginning of the year, in only four days in February more than 3800 immigrants were rescued and 330 drowned or died of cold in the Mediterranean.

7. CHINA: ECONOMIC SLOWDOWN AND FEAR OF THE SHADOW BANKING

The much-anticipated slowdown of the Chinese economy is materializing in this year and it is being more pronounced than expected; almost all indicators show a more negative trend than what was predicted by the consensus of analysts. Beijing faces short-term risks such as the overvaluation of the property market, the high local debt and the opacity of the banking system. In particular, the international fear of the Chinese shadow banking has increased. According to McKinsey, these loans outside the balance sheets of formal financial institutions would account for around 30% of the outstanding debt.

“China is one of the greatest winners of the new geopolitical scenario”

Housing prices indicators and the demand of commodities have plunged in the last months, while inflation is at its lowest point in five years. The annual growth of 7.4% last year is the lowest since 1990 and the Chinese government has already announced that its new annual growth target is 7%. The most worrying fact is that in order to achieve this growth a credit expansion of 15-20%, unsustainable in the medium term, was needed. Everything seems to indicate that the slowdown of the Chinese growth will be maintained in the medium term while underpinning the transition from a model based on investment (around 50% of the GDP) and driven by exports towards a more balanced economic pattern giving more importance to domestic consumption and services. Carrying out this transition avoiding any kind of political risk is Xi's main objective. To do this, he will continue with his anti-corruption campaign, a greater sensitivity to environmental claims (especially air and food quality) and the limitation of the indebtedness of the SOEs.

China is one of the greatest winners of the new geopolitical scenario: Russia has moved closer as a consequence of the sanctions of the EU and the US, the territorial tensions with its neighbors in the South China Sea have decreased in the last months, the negotiations of the transatlantic and Pacific free

trade agreements (TTIP and TPP, respectively, in which China is not included) are stalled, and it is one of the great beneficiaries of the fall in oil prices since each dollar of reduction of the oil price represents an annual saving of 2.1 billion. During 2015, the impact of the slowdown of the Chinese growth on its suppliers and the commodities market will be the most relevant aspects. The quest for a less capital and resources intensive growth and, accordingly, a greater rationality in the investment in infrastructure, will cause the global demand of commodities to continue to slow down, which will seriously affect commodities exporters.

8. SLOWDOWN OF THE PROCESS OF CONVERGENCE OF THE EMERGING ECONOMIES AND GREATER DOMESTIC OPPOSITION

During 2015, the growing doubts about the capacity of emerging economies to adapt to the new international context derived from the tapering (reduction in liquidity by the Federal Reserve) and the progressive disappearance of several of its sources of growth could return. On the one hand, the gradual withdrawal of liquidity injections by the US Federal Reserve and the expected increase in interest rates by the Federal Reserve could lead to a progressive return of capital from emerging economies to developed ones. Turkey, Indonesia, India, Brazil and

“Income inequality and social discontent are expected to grow”

South Africa have already taken steps in order to avoid price volatility and defend the value of their currencies. On the other hand, three of the main reasons that have spurred the growth of emerging economies in the last years may be substantially weakened: (1) high commodities prices; (2) low interest rates; (3) external financing.

The combination of both realities could involve a slowdown of the process of convergence of the emerging economies and major geopolitical changes. Emerging economies may be caught in vicious circles in the short and medium term. Strong institutions and the capacity to implement reforms will be crucial. We are talking about Argentina, Mexico, besides the four already mentioned, and those which depend on oil and commodities exports or which have suffered real state or asset bubbles.

In line with this slower growth in emerging economies the social discontent could increase. Color revolutions and Arab springs suggest that a few individuals on the net can influence the global agenda, although the result is much more limited when establishing strong links. New technologies could serve to increase accountability, the fight against corruption or to support democratic demands, although they can also be used to identify dissidents, polarize the debate, increase all kinds of harassment or to facilitate espionage and sabotage.

Over the last years, we have seen major popular protests led by the new middle classes of emerging economies like Brazil, Chile, Hong Kong, Mexico, Thailand, Turkey or Venezuela. Income inequality and social discontent are expected to grow in the light of the lower economic growth prospects. New demands and an increased requirement towards political representatives by the new middle classed could trigger a new cycle of protests. This will test the democratic resilience of a considerable number of nations, will be a factor of instability and could boost the rise of ultranationalist and xenophobic movements.

9. THE GEOPOLITICAL IMPACT OF THE END OF THE COMMODITIES SUPER CYCLE

The year 2014 started with a Brent oil price at around 110 dollars a barrel and ended at 55 dollars a barrel. The main reason for this drop is the mismatch between the supply, which has increased substantially due to unconventional production, and the demand which has been slowed particularly in China. This decrease has not been slowed by a reduction in production due to the ineffectiveness of the OPEC (35% of global production) and Saudi Arabia's refusal, which is its main member. This attitude from Riyadh might be motivated by an intention of gaining international share while seriously damaging the

“The risk of falling into prolonged deflation is high in the eurozone”

economy of its great Iranian rival at a crucial moment in the nuclear negotiations with the United States. This is another demonstration of the increasingly common use of economic tools for geopolitical purposes. Another reason is the reduction of viability and investment in unconventional projects (which are generally unprofitable below 70 dollars). During 2015, the supply and demand will progressively adjust while investment in exploration continues to decrease. This process will be affected by the extreme instability in Libya and Iraq and the geopolitical interests of the large producers.

The sharp fall in oil prices affects mainly those countries that are most dependent on hydrocarbon exports. This way, Algeria, Ecuador, Iran, Iraq, Libya, Nigeria, Russia and Venezuela need prices over 100 dollars a barrel to balance their national budgets. This weakness will affect substantially the foreign policy of these countries, which might change the geopolitical balances in the Middle East, the post-Soviet space and the Caribbean. Moreover, the sovereign funds and the large state-owned enterprises dependent on commodity export will moderate their investor appetite. The great beneficiaries are the EU and China whereas some States could take advantage of the situation to gradually withdraw the harmful subsidies to fuels. This reduction in commodities prices will result in much talk about competition

for access to markets rather than about competition for resources.

10. GEOECONOMICS: STATE CAPITALISM, CURRENCY WARS AND DIVERGENCE IN MONETARY POLICIES

Geopolitical turbulences are leading to an intensifying trend towards a greater state capitalism. Governments are using regulation, standard setting and protection of their strategic sectors (among which cyberspace is included) to favor their national champions. Political pressures are growing in turn upon central banks in order to exceed their mandates and align their measures with interests of their governments.

The fall in commodities prices and the stagnation of some economies are some of the reasons why inflation targets in the United States, the EU, China, Canada or Thailand have not been reached. The risk of falling into prolonged deflation is high in the eurozone if the QE implementation by the ECB is not successful. In the next months, we will be faced with the divergence in the policies of the two great monetary authorities (Fed and ECB) which could result in a significant relocation of capital flows. Since the beginning of the year, around fifteen central banks have cheapened the price of money. Many of them levying negative rates among which three relatively successful economies like Switzerland, Sweden and Denmark are included, damaged by the new monetary policy of

“In the commercial area a clear trend continues towards the regionalization of trade”

the ECB. In Europe, more than 25% of debt issues are listed with a negative yield whether they are Danish deposits or German or Nestlé debt.

Many countries have acted in order to defend their currencies like Canada, India, Indonesia, Turkey, Peru or Singapore. The increasing currency volatility may increment costs for the private sector, slow foreign investment and decrease the growth in world trade. In the long term, currency wars do not benefit any country but the risk of a race to the bottom, in which several countries compete to devalue their currencies, will remain high over the next months.

The use of economic tools for geopolitical purposes by States, which has been termed geoeconomics, has had and will continue to have even more drastic examples throughout 2015. Western economic sanctions to Russia or the recent veto by United Kingdom on the sale of gas pipelines in the North Sea to an investment fund controlled by the Russian magnate Fridman are only two examples.

II. AN INCREASINGLY DIVIDED GLOBALIZATION

The economic crisis has highlighted that the international community is capable of coordinating responses to events of exceptional importance, such as the financial crisis of 2007 or a possible split within the

eurozone, but in ordinary affairs there is a trend towards fragmentation, bilateralism and regionalism. The increasing irrelevance of global institutions that emerged after the Second World War has led to the emergence in the last years of several institutions that try to mitigate these shortages and to give a greater weight to emerging economies in decision-making processes. This trend has been accelerated recently by projects like the Eurasian Economic Union led by Russia or the Silk Road Area Development led by China. In the financial sector, the New Development Bank (NDB) made up by the BRICS and which tries to compete with the World Bank, and the Asian Infrastructure Investment Bank (AIIB) led by China and which intends to replace the Asian Development Bank (ADB) of Japanese influence stand out. These are only some of the steps taken by several emerging markets to promote the de-dollarization of their exchanges. Given the failure of the WTO, in the commercial area a clear trend continues towards the regionalization of trade through free trade agreements (FTAs). In this case, what stands out is the recent Chinese proposal to create the Free Trade Area Asia-Pacific (FTAAP) which would try to replace the Trans-Pacific Strategic Economic Partnership Agreement (TPP) in which China is not included. Despite Beijing's foreign activism, China does not appear as a revisionist power of the world order, whereas Russia

“The EU is a President Obama’s ally”

would indeed try to play this role although its capacities are much more limited. It is unlikely that this alliance will continue over the medium term despite the recent agreements to export Russian gas to China at a value of 400 billion dollars and despite the fact that both central banks have approved a very significant currency swap.

The confrontation between Russia and the West and the political instability could represent a leap in the process towards a real fragmentation of the world order. In the short term, the highest risk in this regard is Russia’s ejection of the global payment system SWIFT. This withdrawal, in the words of the member of the Governing Council of the ECB, Ewald Nowotny, “could undermine the confidence in the system”.

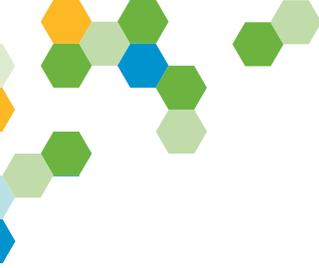
This trend towards governance regionalization will hinder the smaller countries’ capacity to “oscillate”. A greater economic dependency on regional hegemony result in many countries seeing their strategic options and capacity to choose partners limited. A return to the “spheres of influence” as against a globalization based on rules increases the risk of conflict. An example is the current situation in Ukraine and the post-Soviet space in general or in East Asia, where the Chinese neighborhood is increasingly reluctant to Beijing’s policies. In both cases, the weakest countries look at Washington out of the corner

of their eye: they know they have its promise of giving them protection but they doubt whether they will really come to their defense if a security problem arises.

Obama’s lame duck condition gives him a certain freedom to pursue ambitious foreign policy goals. The lifting of sanctions to Cuba and Iran arouses a strong rejection in both legislative chambers, controlled by the Republicans. In both cases, the EU is a President Obama’s ally as when confronting ISIS’s rise and the Russian belligerence. However, the transatlantic relation will likely be less close given the European refusal to get deeply involved in the use of force and the uncooperative nature of the new US foreign policy and security tools such as drones, new technologies or sanctions. The difficulties in the TTIP negotiations show the lack of interest of the United States when prioritizing their European partners as compared with the rest.

12. CONCLUSIONS

The ten risks analyzed have systemic effects and are interrelated and have therefore the potential to trigger a series of reactions of great impact at a global geopolitical and economic level. Strategic investment decisions by companies must be taken on the basis of verified information which establishes scenarios in an appropriate manner. Corporate intelligence



“Corporate intelligence anticipates scenarios and allow us to be the first ones to adapt”

is a growing implementation discipline in organizations in order to meet knowledge needs.

In the last years, States have developed new capacities as regards intelligence services, specifically devoted to the defense of economic, financial and business interests, in short, to the monitoring and follow-up of everything that is likely to generate a national economic interest in terms of defense or expansion. Likewise, large companies' chairmen have developed this competitive advantage through the recruitment of expert consultants in the subject.

The aim is to develop a competitive advantage against the rest of actors in their sector. The best positioned companies prepare in-house and order external intelligence reports that keep them updated about the evolution of risks and opportunities. The return on investments will be better secured as long as there is a better capacity to know the environment than their competitors.

It is usual to analyze specific contexts (the situation of a tender, the processing of a new regulation within the sector, the process of proceedings opened by competition authorities...). But it is also necessary to have a view of systemic risks which set international patterns as the ones described in the report.

An organization without sufficient information will establish a planning which they will have to modify as a reaction to the changes occurred. Corporate intelligence anticipates scenarios and allow us to be the first ones to adapt and to improve our capacity to influence these scenarios.

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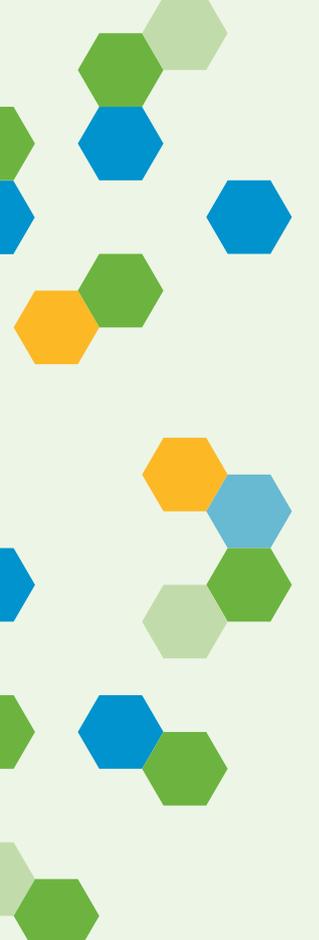
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