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Power and Morality

This year marks the 50th anniversary of Friedrich Hayek's Nobel Prize win. Hayek became famous by attacking the principles of socialism. He argued that the fundamental error of socialism lies in its rationalist goal of social engineering. He complained that socialism neglects the glue of social institutions for society such as personal responsibility, moral values, and the rule of law. The latter, which protects private property and markets, allows us to adapt to problems and crises far exceeding our rational capacities.

Socialism might be gone, but its ghosts are still alive. Our many geopolitical problems and crises today are based on immoral, lawless state dictatorship. During socialism, the West stood united with power and morality. So should it do so today. Not with a fuzzy religious or secular code, but by using power as platform to make moral action possible.

Germany is still a "frontier state" of the West. Its need for military strength can only come from by economic power. To cope with its geopolitical location and lack of natural resources, economic power is a must.

But instead of reinforcing it, our GDP remains below late-2019 levels. Instead of investing in our infrastructure and strengthening our workforce and immaterial knowledge base, we outdo ourselves with social engineering that makes us even more vulnerable: "Bürgergeld", too little political will and law enforcement to undo illegal and culturally disruptive immigration…and on the other hand too little enforcement to integrate and too little attitude to turn the lack of labor into a push to go working. The list is long…our morality has become a very special form of "wokeness".

We need industry leaders that fight for the vision of power and morality. And that is so much more than posting selfies at a demonstration against a dumb right-wing party. We need politicians who are willing to rebuild a powerful Germany in a strong, united Europe. To stand on our own feet and be the most wanted strong partner in transatlantic relationships.

Please enjoy our latest periodical with great pieces of thinking. And embrace especially the vision of Ehud Olmert, who has touchingly outlined his idea of power and morality to finally find a better future.

Enjoy your read

Gerhard Nenning

October 7, 2023— and Beyond

Ehud Olmert
Former Prime Minister Israel

The morning of Saturday, October 7th, 2023 was not supposed to be of any special significance in the life of Israel. It was a Jewish holiday, celebrated in a traditional manner by many observant Jews, and also those more secular who do not observe regularly Jewish tradition. It turned out to be different than any Saturday in the modern history of Israel.

Wherever people woke up early that Saturday it immediately felt something unprecedented happened.

The most striking aspect of the first few hours was a fog of information: the uncertainty and confusion about what was actually happening, and an increasing perception that the core organs of government – police, army, entire ministries – had ceased to function.

On WhatsApp groups across country people asked:

Where is the army? 7:12

Where is the police? 7:33

What happened to our country? 8:04

A sense of impotence and despair from everyone, in every community, from every direction.

Slowly, the horrors of October 7 began to emerge.

Now, months after that accursed day, it feels like the details are better known, the overall picture clarified. But this is only an illusion.

“The evacuation of more than a million and a half civilians from their homes in northern and central Gaza, the destruction of the entire neighborhoods they had left behind seen around the world – has turned Gaza into the focus of global sympathy, prayers, and outrage.”

We are still in the thick of the crisis. While I write these words, dozens of our hostages are still being held in the tunnels of Gaza, many of whom have been reduced to corpses, others clinging to any shred of hope that somehow they may regain their freedom and the fighting is still on.

The massive Israeli retaliation was inevitable. The murderous crimes, the unbound cruelty, the deadly assaults on children, their parents, their grandparents living in the same household, the brutality and inhumanity of the sexual assault of our women, the burning of people still alive, the destruction of human beings in their beds, in living rooms, in so-called safe rooms, without any effort to pretend that this was a conflict between soldiers or armies – all of these triggered an explosion of anger, a desire for revenge that would not, perhaps could not and should not, have been forestalled.

It is with increasing pessimism that Israelis have rightfully begun to ask: Will continuing the war help save the hostages or contribute to their deaths, inflating the spectacle of humanitarian catastrophe that many believe to be taking place in Gaza and thus, in practice, thwart Israel's efforts to achieve a complete military victory?

These questions are already being hotly debated by people inside Israel and by historians and political observers outside – including the Biden Administration. But nowhere is the conflict more heated than with the Israeli street itself. The social and political unity that existed in the hours and days after October 7th has not held.

Political and Social Division

Israel's military campaign by land and air since mid-October, has crushed Gaza, destroying a significant portion of its urban areas as well as a major part of Hamas's fighting force. Israel's prime minister, in the effort to distance himself from the trauma of October 7, continues to boast in endless media appearances locally and globally that Israel will not stop its war until "complete victory" over Hamas.

The moment Hamas invaded in the south on October 7, 2023, Hezbollah's elite forces charged southward in Lebanon, all the way to Israel's northern border. Seventeen years of successful, remarkable deterrence, of quiet and self-restraint, of fear of Israeli reprisal after the conclusion of the second Lebanese war – all unraveled in the wake of the Israeli government's political distractions and military mismanagement of the threat, and a mini-war began in the north as well.

All of the inherent advantages of a regular army, with an advanced and sophisticated air force, with powerful armor and with units armed with precise long-range arms – usually are minimized and in practice negated when the fighting moves from above ground battles to tunnel warfare dozens of meters underground.

Under such circumstances, the remarkable achievements of the IDF – the extent of the destruction of Hamas's infrastructure, the enormous losses among Hamas forces, the destruction of rockets and their launchers, the devastation of their command and control centers – all of these are an impressive source of pride for us, for they saved thousands of Israeli lives.

"We started as David only to become Goliath."

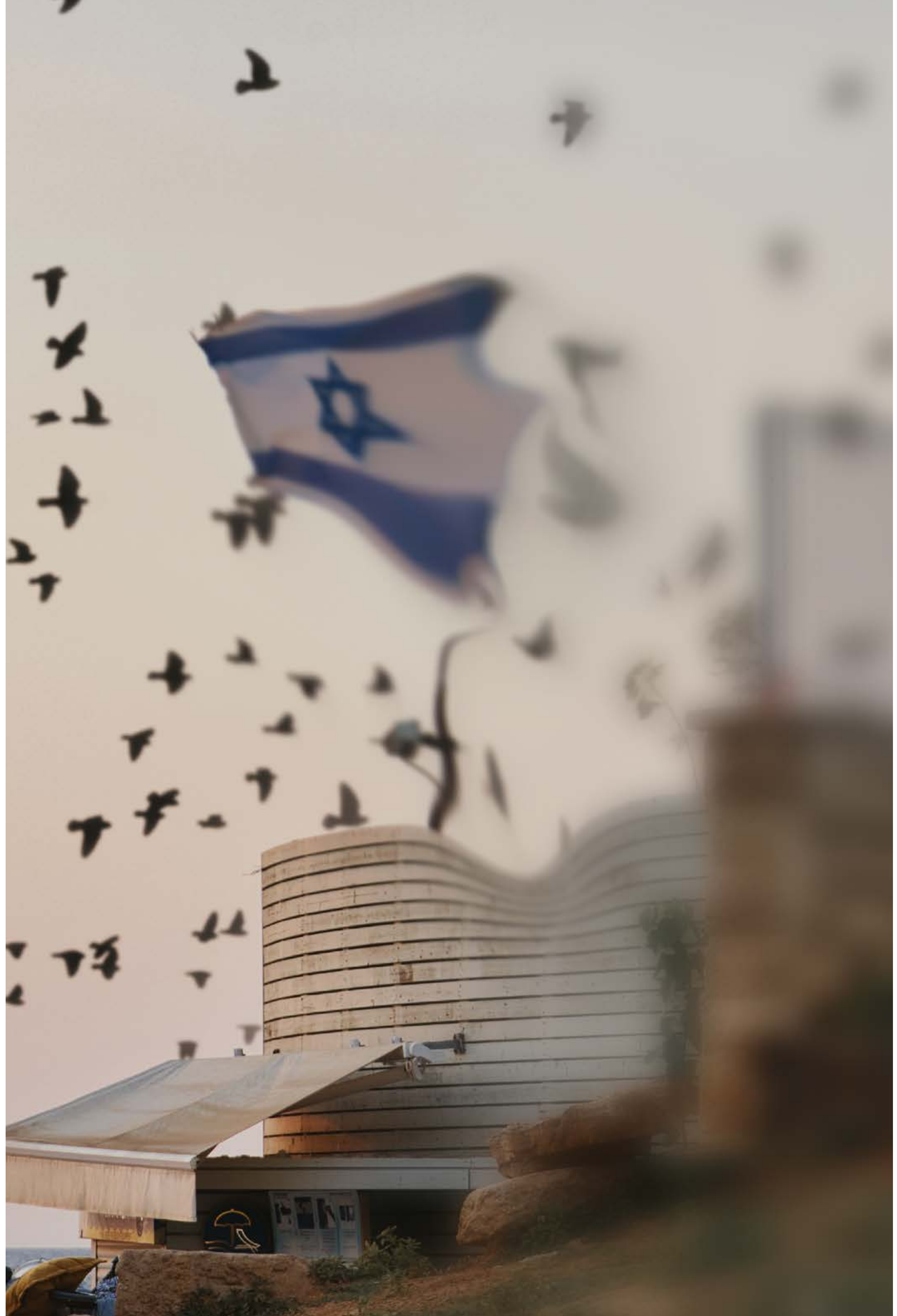
Alongside these achievements, however, we cannot ignore other results of the war, during which almost certainly many thousands of Palestinian elderly and children have themselves lost their lives. Palestinian institutions in Gaza and the West Bank have declared the number of fatalities to be in the tens of thousands. Even if these numbers are exaggerated, we cannot ignore the overwhelmingly and potentially permanent negative impression the images of Israeli destruction in Gaza have made on an increasingly angry world.

International Perception Shift

The enlightened international community, led by the United States, Germany, Canada, Australia, Japan, Great Britain and France and most Western democracies, gave Israel the public moral seal of approval to take action to restore the balance and stability that were broken by the slaughter of October 7. Israel then gave a green light to the IDF, led by the air force, to respond.

Within a few weeks, however, perceptions of what was happening in the south changed completely. From empathy with our pain and support for our response, the international media became a vehicle for the awful images of destruction and death that quickly overshadowed the events of October 7.

The proportion of Israel's military response, the mushroom clouds lurching into the heavens, the tall buildings crumbling in the wake of air strikes and artillery, convoys of hundreds of thousands of Palestinians with their bundles of clothing and children with backpacks streaming from the ruined areas into areas that would be in ruins just hours later – all of this trickled into the consciousness of viewers around the world. Within a short time, the mood of those who had supported Israel changed completely. From a victim, we had been transformed into a cruel perpetrator.



The war against a terror organization is not, and cannot be, a gentle campaign, restrained and devoid of painful events, including mistakes that result in the deaths of innocents. Of course, war against a terror organization, embedded and integrated in crowded urban centers, its fighters hiding in basements of homes, public buildings and hospitals, will necessarily become battlefields with many casualties including innocents.

Many have asked what would someone other than Netanyahu have done? They even ask what I would have done differently. Admittedly thinking about it with the benefit of more than half a year, the initial Israeli reaction was misguided. Instead of starting immediately a military counter-offensive and voicing pledges to annihilate Hamas and its leaders, perhaps what we should have done is to try to make an agreement for the release of all the hostages . There is a lot of time to settle the account with Gaza. Our primary focus, from Day One, should have been to save the hostages and secure their release. By the time we bring back whomever is left, many will be gone.

During his visit to Israel, President Biden said something that flew under most people's radar. It was extremely important, and today it should give us a moment of rethinking and introspection. Biden spoke about the shock that Americans felt after the attacks of September 11, 2001, and the justified rage that nonetheless led to unforced errors. "While you feel that rage, don't be consumed by it. After 9/11, we were enraged in the United States. And while we sought justice and got justice, we all also made mistakes."

We didn't listen to him. We didn't recognize the wisdom in his words. For many months now, we have been driven by our initial rage, driven far away from the achievements of the war, and towards an eventual catastrophe potentially greater than that of October 7.

"Right now, Israel has one principal mission: To bring back all the hostages who remain in Gaza."

What comes next?

With time, more and more national leaders and international bodies began asking us: What comes next? What does the day after look like. Many were prepared to accept the destruction, the thousands of casualties who were not, as far as could be verified, combatants. But as the images of destruction accumulated, as the number of displaced turned into a raging river of hundreds of thousands of refugees – public opinion shifted, taking the political leaders of friendly countries with it.

And every day, pictures of homeless refugees with destruction all around them flood the world. The day is not far off when nations, bowing to increasingly noisy public pressure, will decide to cut off military aid to Israel completely. Canada already announced an immediate halt of military sales. The United Kingdom may follow, with Europe not far behind. Cutting off European or Canadian military sales to Israel would not be a heavy blow; Israel does not depend on European or Canadian arms.

And if that should happen, it could create a momentum that will put pressure on the United States as well.

Right now, Israel has one principal mission: To bring back all the hostages who remain in Gaza.

No deal for the return of hostages will be possible without at least the appearance of Israeli concessions. Concession is not capitulation, but rather fulfilling the state's most basic obligation to its citizens. The Prime Minister's insistence, ignoring the opinions of almost the entire military and defense establishment, as well as Israeli public opinion, seems more like an effort to delay, without any notable military advantage for Israel, the end of the war. Netanyahu is obviously worried that an end to the war will hasten the collapse of the current coalition and bring early elections – and that this is the source of his refusal to reach a deal.

But Israel must bring this war to its end. It must also allow the creation of a body that will manage the Gaza Strip, until the Palestinian Authority is prepared to take over. The PA needs to be upgraded and strengthened. Abbas does not seem willing to take on the responsibility of rebuilding Gaza. In the interim phase, there will have to be an international force comprising European forces along the lines of what weas decided in UN Security Council Resolution 1701 after the Second Lebanon War.

Israel has to embark on a process of introspection and change of course. The first step is to stop the fighting and bring home the hostages. The next is to withdraw completely from Gaza and hand over control to an international force that will preserve the achievements of the war – the destruction of Hamas's military capability – and lay the foundations for the rehabilitation of the Gaza Strip.

In parallel, Israel has to embrace the American proposal, supported by most of the European states, to enter into talks for a comprehensive end to the historic conflict between us and the Palestinian people. This negotiation will be based on the two-state solution. There is no alternative model.

The choice facing Israel today is clear. We can choose the continued occupation of territory, preventing the exercise of the natural rights of the Palestinian people to self-determination, freedom of movement, political and civil rights, and become a pariah state in the eyes of the world. Or we can accept a tough, painful, but in the end inevitable negotiated solution, in partnership with Saudi Arabia and other more moderate Arab nations, based on two nation-states living side by side – not necessarily loving each other but accepting each other.

A brutal wakeup call

October 2023 was a brutal wakeup call, a slap in the face for all those who lived under such illusions. Today, Israel has to change course, to pull together the Israeli public in solidarity and common cause, which were once the source of its power, and to rid itself of the fantasy proponents of constant conflict who prefer to kindle flames of endless hatred between us and hundreds of millions of Muslims, against whom we are but a tiny sliver in a universe where they are the dominant force.

Instead, we can and must become the focal point of a vast regional cooperative unit that will transform a region politically, economically, and culturally and offer everyone, in every community, in every corner of the region, a genuine opportunity for a better future.

Now is the time.

Markets in 2024 – Credit Where it's Due

Davide Serra
CEO & Founder
Algebris

Back in summer 2021, Fed fund rates, the key tool used by the Federal Reserve to set monetary policy, stood at zero. The policy rate in Europe was negative, in an extreme attempt to stimulate an anaemic post-Covid global economy. Yields on government debt were often negative and barely above inflation rates. Global investors faced tough choices – be taxed for the privilege of lending money or take risks in uncertain equity markets.

Fast-forward three years, and the world looks like a very different place. The Ukraine war brought the inflation genie back out of the bottle. Central bankers found out monetary stimulus has a limit. Global interest rates increased sharply, meaning corporates and governments are back facing funding constraints, and investors were reminded fixed income is far from a riskless asset class.

It is tempting to position for a reversion to the 2021 world. After all, inflation rates in the developed world are back to 3% per year. Not quite the 2% targeted by central banks, but much below the 9% reached in summer 2022. In this environment, government bonds may look like a bargain. The 3–4% yield they offer is close to ten years highs, and falling inflation means yields can just fall.

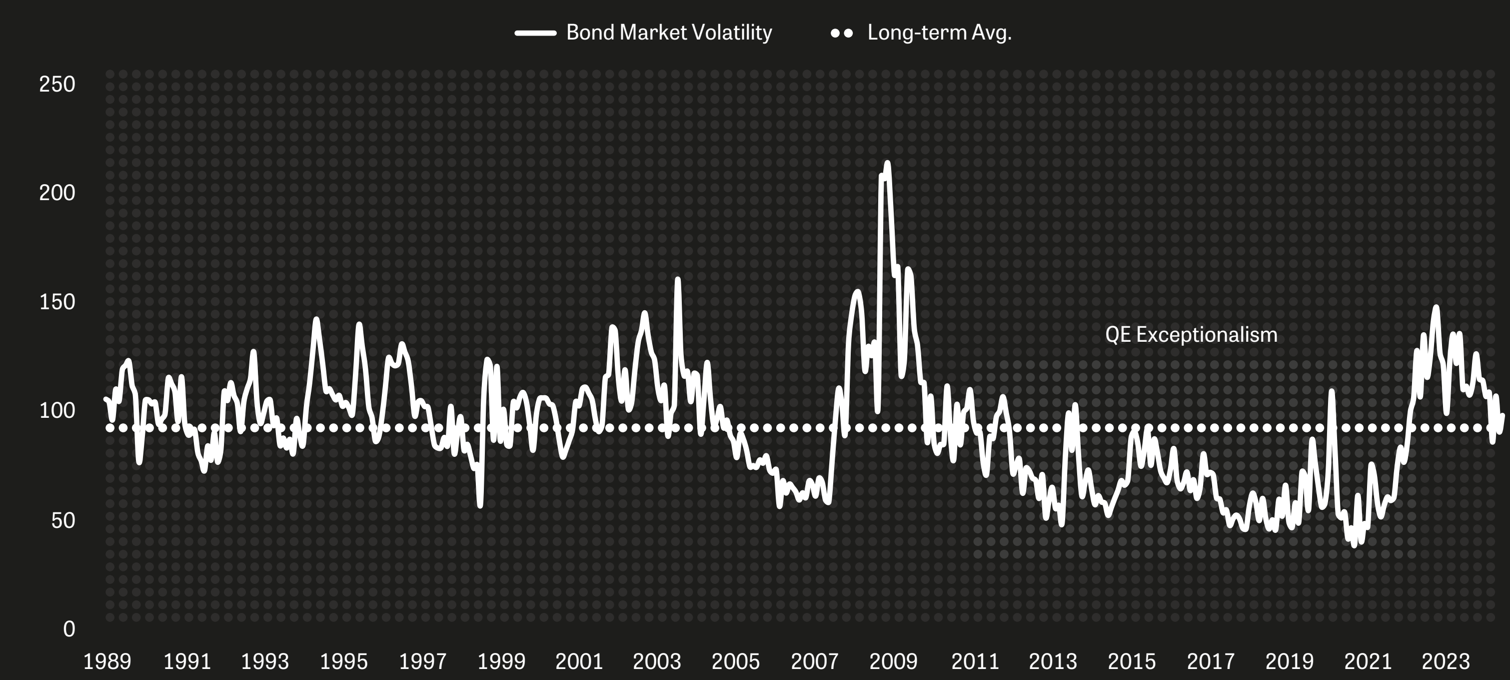
We disagree with this logic, as it exposes investors to quite a few (macro) risks, without appropriate compensation. In our view, 2022 marked a regime shift. Since 2021, inflation expectations have re-set higher, and central banks had to quit large-scale monetary easing. As a result, inflation levels and volatility shifted to permanently higher levels, and fixed income allocations should be re-thought.

Volatile Inflation

First, the inflation fight is yielding some results but is far from over. Core inflation, the key measure of long-term price pressures, has fallen but still runs at 3% in US and Europe. The 2% level sought by central banks will require at least another twelve months of progress, provided no major setbacks. Inflation is also more volatile now. Supercore inflation – a measure that focuses solely on good and services, was running at 8% annualized in the first quarter, to then fall to 4% in the second quarter. Historically, bringing inflation back to target post rapid inflationary episodes takes years, so optimism on future progress must be taken with caution.

Second, central banks will start normalizing rates but won't deliver a deep cutting cycle. Since the big tightening started, growth averaged a respectable 2.2% in the US and 1.5% in Europe. Default rates remained very low, and stress on bank balance sheet have been limited. High interest rates didn't really bite the economy, and while signs of some slowdown have been more frequent recently, there are no recession signs on the horizon. No economic stress and slow inflation progress means no urgency to cut (Chart 1). Some normalization in interest rates has started in Europe, and is about to start in the US, but there are all the reasons for the extent and pace of the cycle to be shallow.

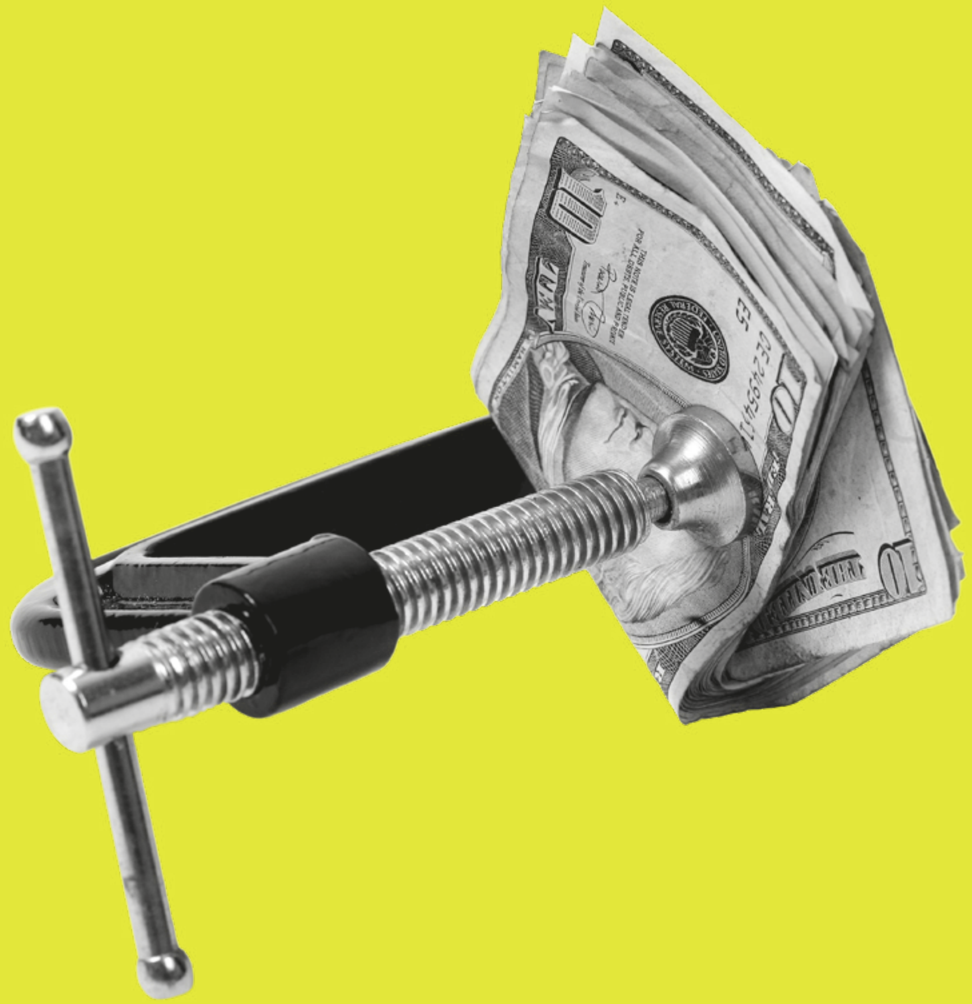
Chart 1 : Insurance and recession cuts look very different



Source: Algebris Investments, Bloomberg Finance L.P. Data as of 19.01.24.
Average of cuts in Fed Funds rate since the first cut during given 1990, 2001, 2007 and 2019 recessionary periods vs in 1995 and 1998

"After all, inflation rates in the developed world are back to 3% per year. Not quite the 2% targeted by central banks, but much below the 9% reached in summer 2022."

"High and volatile inflation, uncertain timing of central banks cuts, and fiscal profligacy all mean fixed income markets will remain hard to navigate."

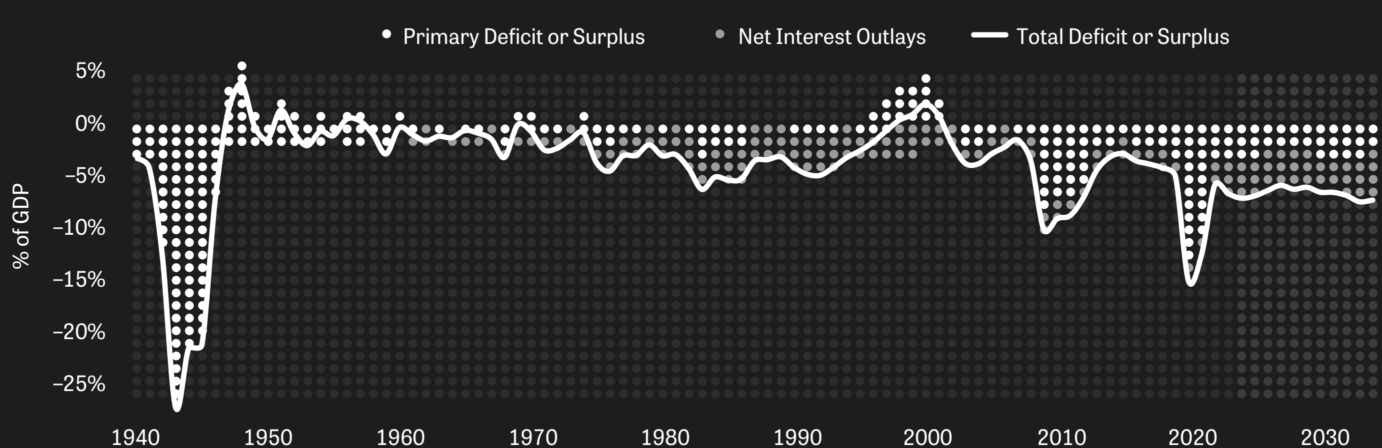


Third, even if central banks decide to cut sharply, yields may suffer due to expansionary fiscal policy. The last three years have seen an explosion in government spending across the developed world. In 2023, the US budget deficit exceeded 7%, despite solid growth of 3% (Chart 2). If Republicans will be in charge of the next administration, the cumulative extra deficit over the next four years is projected at $3tn, 12% of GDP. In Europe, seven countries will go in excessive deficit procedure in 2024. France and Italy are projected to post deficits north of 5% in 2024. Worries about government bond supply are amplified by more lackluster global demand. Since 2022, central banks' bond purchase programs turned into net sales, as monetary authorities' attempt to reduce their balance sheet. Global yield curves remain inverted, meaning the reward to absorb this supply is low for private investors too.

Markets difficult to navigate

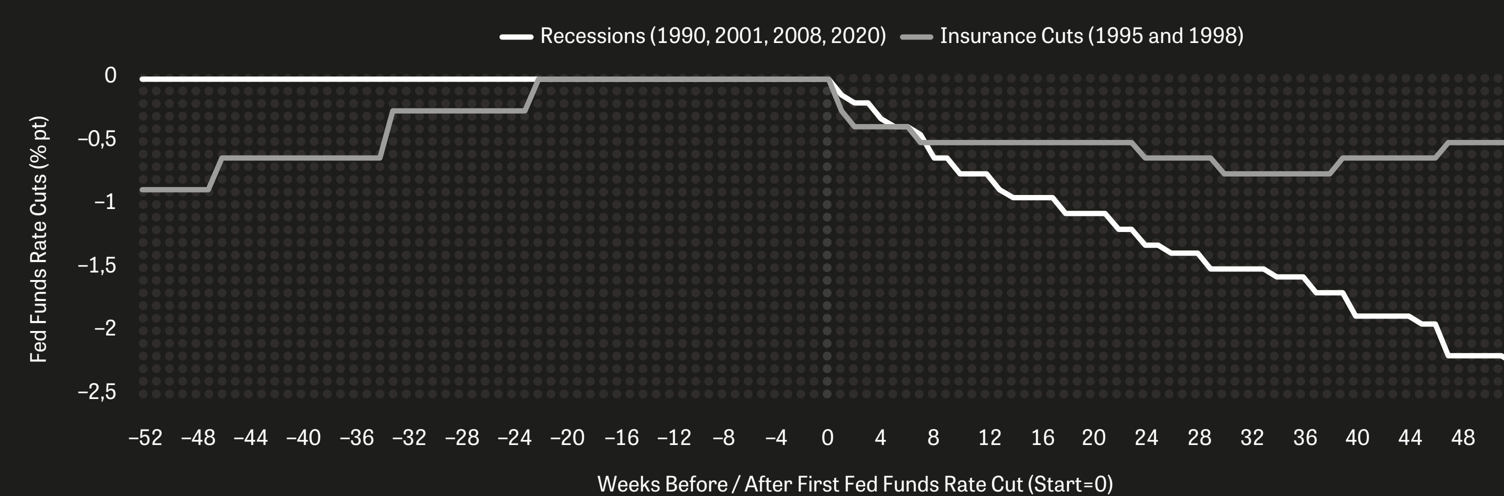
High and volatile inflation, uncertain timing of central banks cuts, and fiscal profligacy all mean fixed income markets will remain hard to navigate. Just in 2024, the volatility of US Treasuries and German bund yields was 0.25% per month, so that all the benefits from one central bank cut can easily be erased in a month. Bond market volatility is back to levels that prevailed before the large monetary expansions of 2010-20 (Chart 3). The implication for investors is that a passive fixed income allocation is unlikely to provide a satisfactory risk-reward, and active management in fixed income markets is paramount.

Chart 2 | US Debt – Higher rates and persistent deficits



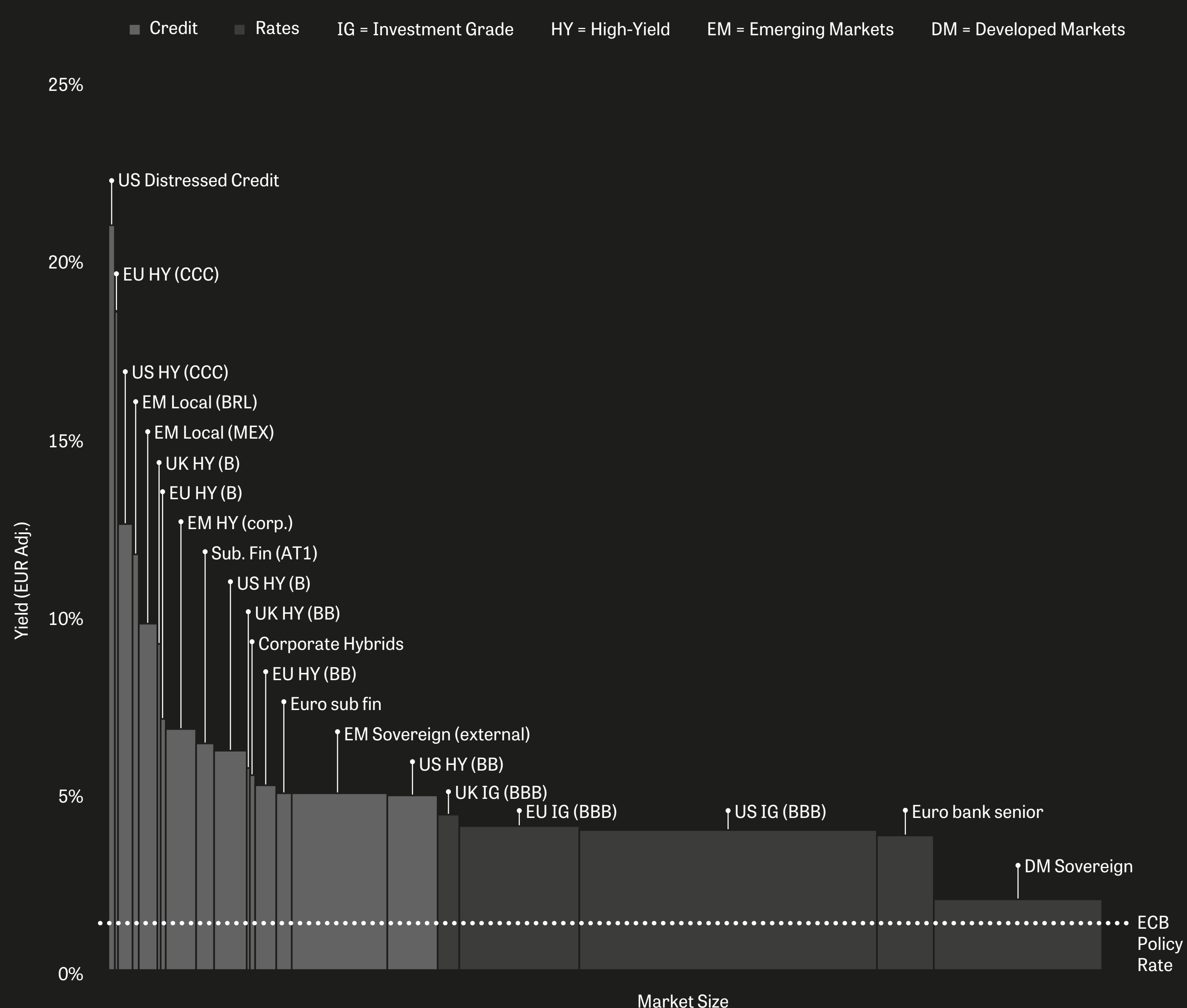
Source: Algebris Investments, Congressional Budget Office. Data as of June 2024. There is no guarantee that projections will materialize

Chart 3 | Macro volatility is here to stay



Source: Algebris Investments, Bloomberg Finance L.P.

Chart 4 | Yield (EUR Adj.) vs Credit Market Size



DM Sovereign bar reduced by 15x. *Rates = Rates-sensitive credit classes (IG credits and DM Sovereign). 10Y yields (local) and total local currency debt outstanding (then EUR adj.) are used for Mexico and Brazil. Bar sizes correspond to amounts outstanding. Ratings shown in Brackets. Source: Algebris Investments, Bloomberg Finance L.P. Data as of 05.07.24.

The good news is – not only governments issue debt. Corporates and financial institutions issue bonds too, and the story here is a little different. The increase in interest rates we have seen over the past two years meant investors challenged the ability of some of these issuers to fund in the market. As interest rates increased sharply and cost of funding increased five-fold, why would anyone lend to private institutions? As a result, spreads on non-government bonds, the difference between the yield on corporate debt and the government equivalent, increased massively. Currently, credit markets are the only segment of fixed income where investors can find Euro yields of 7–9%, vis-à-vis government bond markets, where yields are mostly below ECB cash rates (Chart 4).

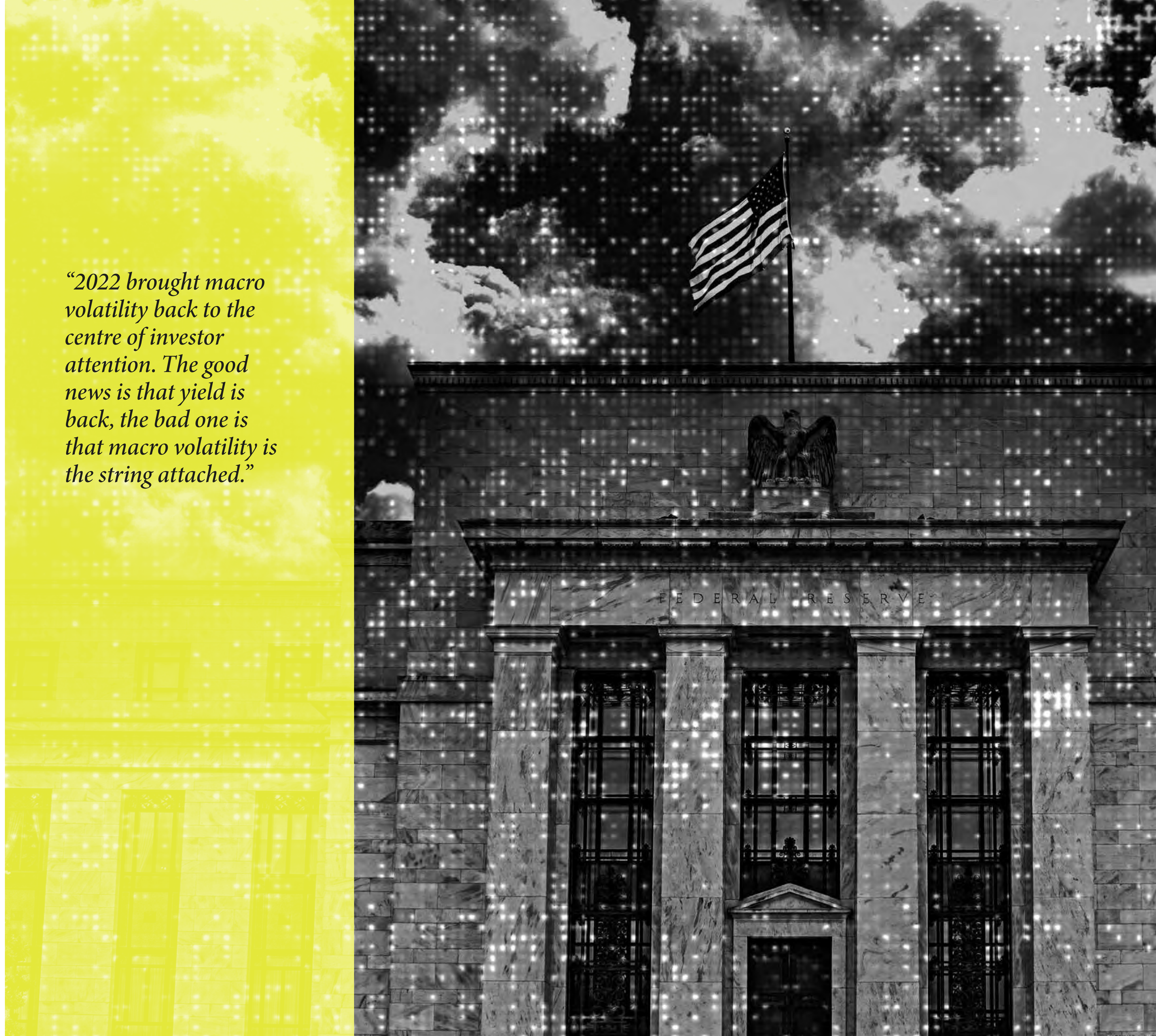
The high interest rates paid on credit is not necessarily justified by fundamentals. Leverage in credit markets remain stable, in line with the past ten years across geographies. For most of investment grade credit, the increase in debt service costs over the past two years is lower than 20%. In high-yield markets, resilient growth meant default rates remain subdued, well below the historical 4% average. For financial institutions the situation is even better, particularly in Europe. Credit fundamentals are as rosy as in the corporate market, and banks actually benefit from higher interest rates. Net interest margins have increased 50% over the past twelve months (as underscored by the +40% appreciation of European bank equities in the same timespan), de facto adding a layer of protection on debt, especially the most junior part.

The value lies in credit

In other words, it is true that fixed income markets are a much more interesting place for investors after the big hikes. But the value lies in credit, rather than rates markets. The former discounts an excessive premium on bonds and offer 7–9% yield at acceptable risks. The latter will continue to suffer from the renewed macroeconomic uncertainty, and the skinny 3% it offers on average does not well compensate for this risk. Of course, credit requires more picking ability, and this makes active management even more important than it has been in the past ten years.

Equity markets look like a trickier place. The rally year-to-date has been strong, and valuations are far from cheap. The S&P 500 trades at 23 times forward earnings, 20% above historical average. That means US corporates must post annual growth north of 6–7% to be able to support the valuation, and even more so if interest rates don't end up as low as the market expects. European equities stand at 14× and are in line with long-term average, although 30% higher than two years ago. We favor sectors and geographies which still offers cheap valuations, such as European assets or financials, but see no rush to add equity risk.

To sum up, 2022 brought macro volatility back to the centre of investor attention. The good news is that yield is back, the bad one is that macro volatility is the string attached. Government bonds are a tricky place to be, as they don't pay enough for the volatility investors have to take on. Credit markets are a less popular but much better alternative in our view. The all-in yield is higher, and the macro risks lower. We believe fixed income exposure should gradually be moved from government bonds to credit. In Equities, valuations are too optimistic, and investors should focus on value.



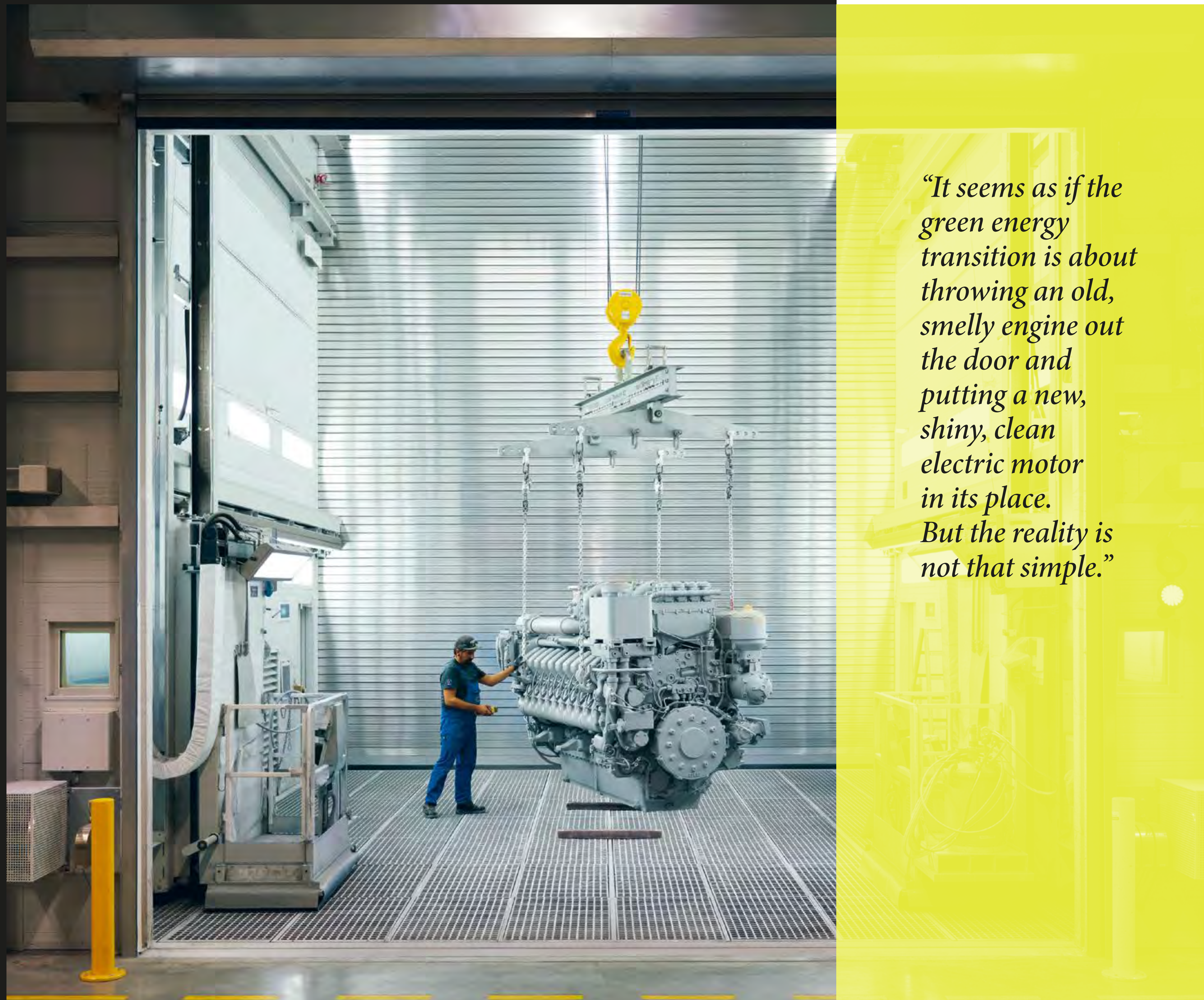
"2022 brought macro volatility back to the centre of investor attention. The good news is that yield is back, the bad one is that macro volatility is the string attached."

UNSUNG HEROES of the Green Energy Transition

Dr. Jörg Stratmann
CEO
Rolls-Royce Power Systems

Why internal combustion engines, of all things, are key allies in the fight against climate change.

The combustion engine is not having an easy time right now. On the one hand, some voices tend to take a somewhat nostalgic view of the combustion engine, seeing it as a lifeline to a supposedly better, simpler past. And I understand that – I also have a weakness for nostalgia which manifests itself in special types of vehicles. But at the same time, the oil-powered transportation sector is one of the main sources of greenhouse gas emissions. The future of passenger transport does not lie in gasoline or diesel engines.



"It seems as if the green energy transition is about throwing an old, smelly engine out the door and putting a new, shiny, clean electric motor in its place. But the reality is not that simple."

On the other hand, show some so-called progressive-minded people a combustion engine, and they'll primarily see the stigma of environmental pollution. "That's all in the past," they'll say demonstratively and relegate the combustion engine to the grubby history books.

Yet because of political wrangling between the two extremes and the emissions scandals in the automotive industry, the internal combustion engine (ICE) has now become the linchpin of climate policy. The EU has resolved what is a de facto ban on ICEs for cars, and Ethiopia has just become the first country to ban imports of fossil-fueled automobiles.

Reality is complex and calls for a nuanced debate

This black-and-white thinking produces a distorted view of things. It seems as if the green energy transition is about throwing an old, smelly engine out the door and putting a new, shiny, clean electric motor in its place. But the reality is not that simple. This fallacy is standing in the way of a clear view of the role the combustion engine actually plays.

In fact – and this may come as a surprise to some – numerous analyses show that the energy transition will only succeed with the aid of ICEs. I'm talking about engines that are particularly large and powerful, the ones used in certain industries such as shipping or in standby power, weighing almost ten times as much as a normal vehicle and where a single engine produces as much power as over 100 VW Golfs. Applications such as patrol boats or large yachts that need their propulsion systems to offer greater range and greater autonomy can simply not be powered purely electrically, they need ICEs.

And talking of which – to clear up a common misconception once and for all – it's not the ICEs that produce harmful emissions, it's the fuel they run on. If we were to leave fossil fuels in the ground and use only fuels derived from renewable raw materials, such as oleiferous vegetation (oil-bearing plants), then the engines essentially give off the CO_2 the plants took out of the atmosphere as they were growing. Or we could use fuel produced by green electricity, for example by using solar or wind power to extract hydrogen from water, which – when combusted – reacts back to water. Or the green hydrogen which serves as the basis for producing green methanol. To put this into figures: using e-fuels or HVO reduces CO_2 emissions by up to 90%, even today.

The challenge, though, is that these fuels are not yet available in the quantities required to replace fossil fuels. We should therefore use them where electrification is not yet an option: for example, in large, energy-intensive applications such as large ships or large, heavy vehicles. In mobile applications, volume and weight are key factors that must be taken into account when it comes to sustainable drive technologies. Where electrification is possible, we should make it happen as quickly as possible – the prime contender being road transport – while reserving alternative combustible fuels for non-electrified applications. And that calls for ICEs.

"When the sun stops shining or the wind dies down, backup power plants fueled by natural gas, biogas, diesel or, in future, hydrogen step in. Electricity is needed more quickly, more frequently and for shorter periods of time: This is where the agility of the combustion engine comes to the fore."

We must therefore view the energy transition as a systemic problem. The Atacama Desert shows how it's done; indeed Chile is the epitome of systemic thinking in the move to renewables. Renewables account for a huge proportion of energy in Chile (55.1% in 2022). Every year, 5,000 terawatt hours of electricity are generated from renewable sources. The country wants to convert 70% of its own energy consumption to renewables by 2030 and be carbon-neutral by 2050.

Sometimes renewable energies need help – and quickly

Even so, in recent years Chile has installed 265 mtu generator sets with a total capacity of 475 megawatts in five power plants to help advance its energy transition. Why does this country, which is currently turning away from fossil fuels, need ICEs? Because renewable energies occasionally need a helping hand. And quickly.

Power generation in the age of renewables is very different – and ironically this is all happening in a system in which ICEs are desperately needed for reliable, steady supplies of electricity. When the sun stops shining or the wind dies down, backup power plants fueled by natural gas, biogas, diesel or, in future, hydrogen step in. Electricity is needed more quickly, more frequently and for shorter periods of time: This is where the agility of the combustion engine comes to the fore.

Systemic thinking helps us understand why the Port of Singapore is using mtu gas engines from Rolls-Royce to meet its commitment under the Maritime R&D Roadmap 2030. The first LNG hybrid tugboat has just been commissioned in May 2024. It uses battery propulsion combined with gas engines for peak performance to meet the demanding requirements of port tug operations and for electric-only maneuvering in port, for example.

Safety net for the age of AI

Rolls-Royce Power Systems is also involved: New mtu hybrid systems featuring components such as batteries, diesel engines and electric motors cleverly combined and controlled intelligently via an mtu automation system are currently being used in the new ferry fleet of Italian shipping operator Liberty Lines. These vessels maneuver quietly and with zero emissions in port via battery-only mode, while the combustion engine delivers the required maximum performance in open waters.

ICEs also form the safety net for our digital revolution, especially as we enter the age of artificial intelligence. Tech giants around the world run engines in emergency situations to ensure their large data centers don't grind to a halt due to a power outage.

By switching to alternative fuels, ICEs can also generate green electricity themselves. It depends very much on what is burned in them. We have now had over 80% of our engine portfolio approved to run on sustainable fuels. This includes, for example, hydrotreated vegetable oil (HVO), a renewable diesel produced from used vegetable oils and other food waste. In simple terms, it is possible to run an engine on old frying fat and avoid up to 90% of carbon dioxide emissions.

German rail operator Deutsche Bahn is already using HVO, as is the mining company Rio Tinto in California in its huge trucks. Our own tests show that HVO burns more cleanly and emits over 40% less soot particulate and up to 8% fewer nitrogen oxides than fossil diesel. There are also fewer deposits inside the engine.

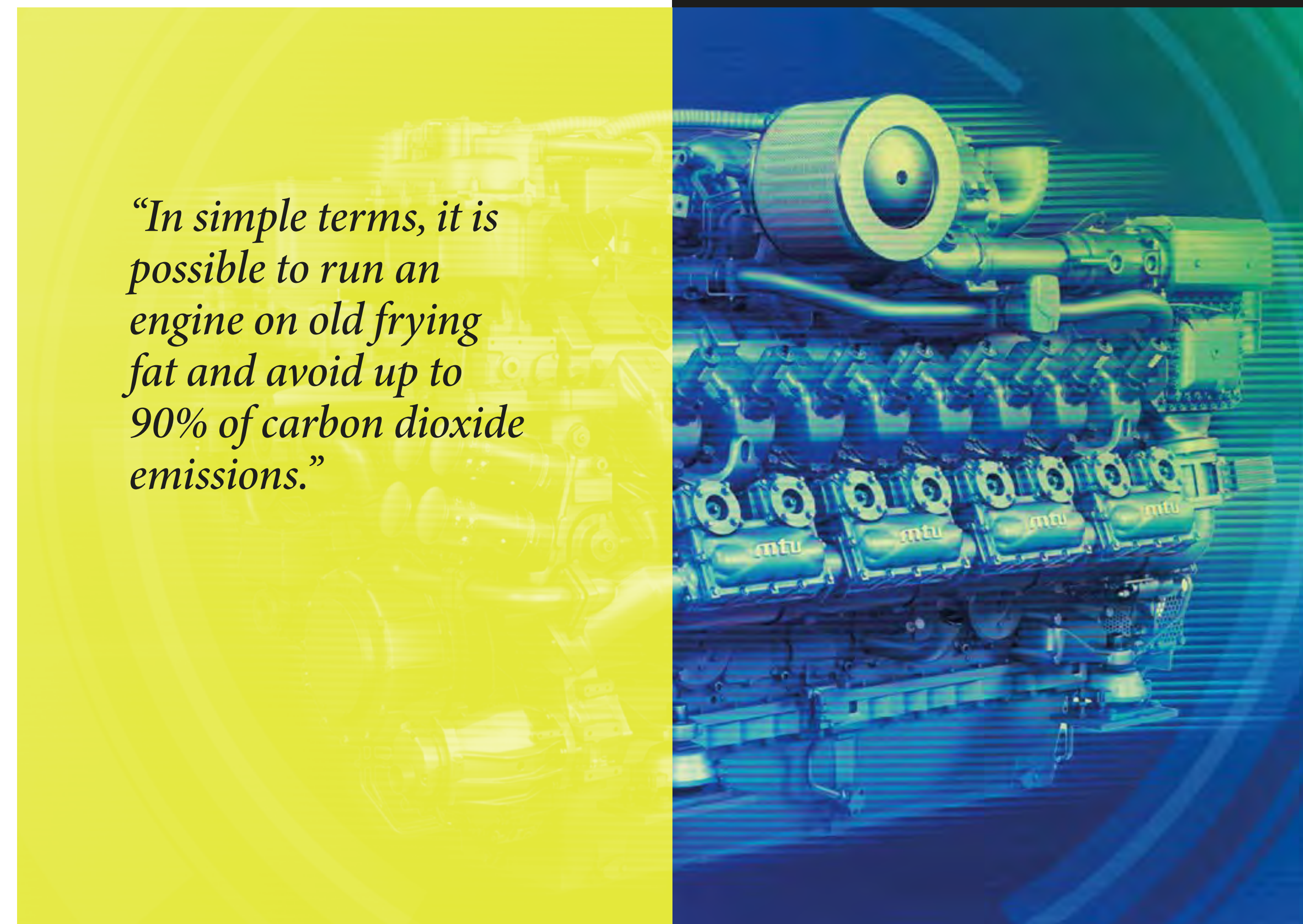
Beyond the simple 'old versus new'

When rethinking technology and its relationship with the environment, we need to go beyond the simplistic dichotomy of 'out with the old, in with the new'. Instead, we should adopt a systemic perspective that recognizes the nuanced role of different technologies as we move to sustainable energy.

ICEs are not about nostalgia; they are an essential part of a greener future. That's why we are even developing a new engine platform – for the first time in 20 years! It will enable us to offer our customers a broader range of services with greater efficiency and less use of resources – thereby forming the basis for further refinement in ICEs powered by alternative fuels. And this step towards making a significant contribution will cost us plenty: we're making a signification commitment to this undertaking.

As a society and as an economy, the modern combustion engine, powered by modern fuels, will give us the freedom, stability and self-confidence to entrust our lives more and more to renewable energies. Because engines are watchful guardians when it comes to reliable energy in hospitals, in data centers, at airports, aboard ships, and in large vehicles.

ICEs are the unsung heroes in the fight against climate change. They are technological innovations that deserve our recognition – regardless of which political camp you belong. They are also driving the successful green energy transition. True to the saying 'All roads lead to Rome', we should also be open to the fact that many paths lead to a greener future, and avoid succumbing to the 'combustion fallacy' by keeping our eyes on the big picture.



> *"In simple terms, it is possible to run an engine on old frying fat and avoid up to 90% of carbon dioxide emissions."*

John Bolton
Ambassador

What Zeitenwende

National security turns on two fundamental questions. Who threatens us, and what do we do about it? Today, the global West (a concept much broader than mere geographic location) is having serious trouble addressing both these basic dilemmas. We are not divided on everything, but we are divided on enough that our adversaries can hardly avoid seeing the divergencies and vigorously exploiting them at will.

The United States is certainly split internally, as this year's presidential race shows. Donald Trump and his congressional supporters question US military support for Ukraine, and even espouse withdrawal from NATO, or fundamentally restructuring alliance commitments. Nonetheless, recent polling shows overwhelming majorities of Americans back NATO (73%–27%) and believe the US should defend NATO allies if they are attacked (74%–26%). However, that same poll also found comparable majorities believe NATO relies too much on US funding and that other NATO allies are not doing enough (74%–26%)[1].

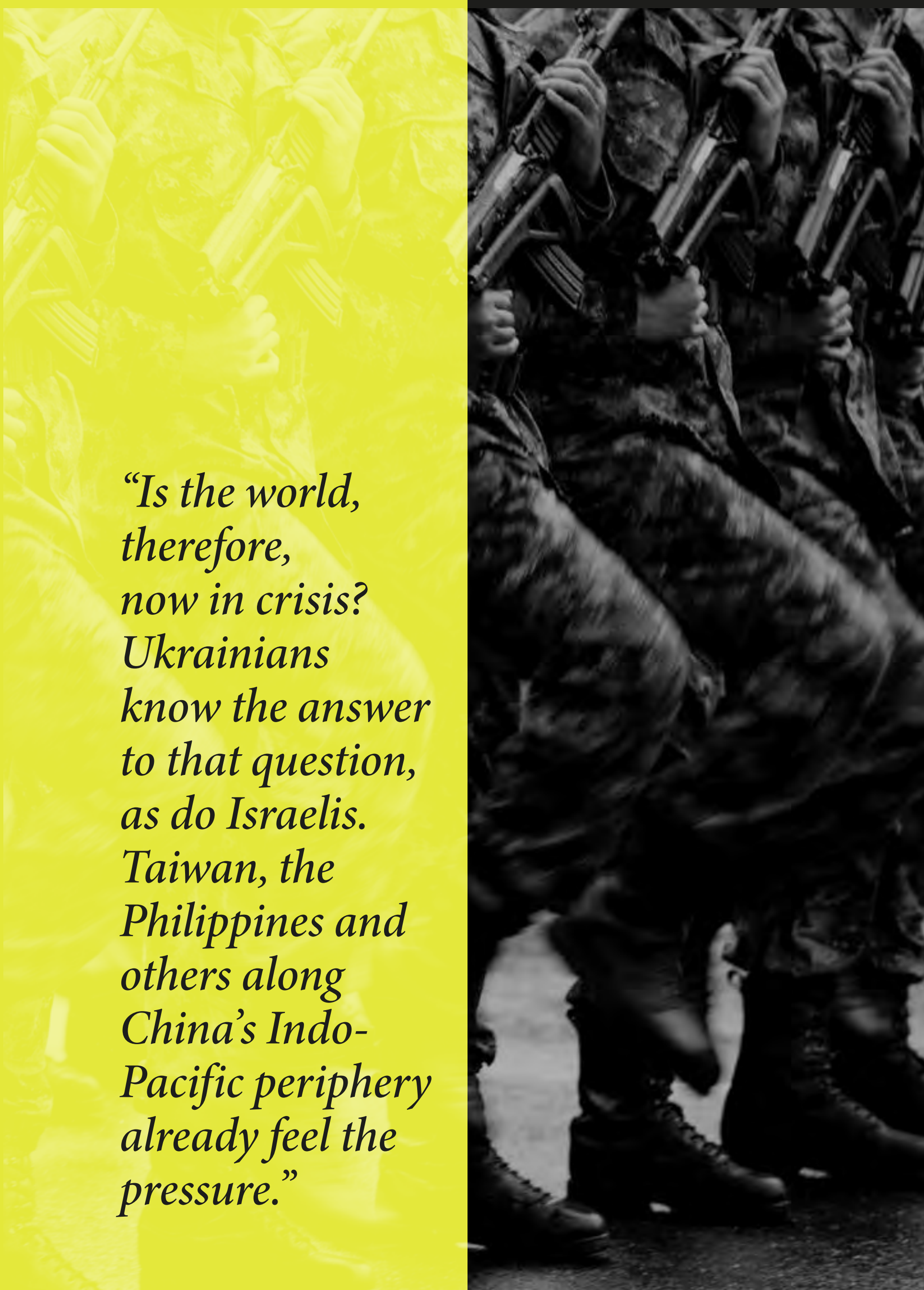
The poll further reflects that support for military aid to Ukraine remains controversial, but respondents nonetheless agreed (66%–34%) that NATO members had a responsibility to support Ukraine against Russia's aggression, and that Ukraine should be formally invited to join NATO (70%–30%). After Congress passed the recent aid bill, many Members experienced no backlash from their constituents[2], meaning the issue wasn't as salient at home as it was for some in Washington. In short, perturbations over Ukraine aid likely have more to do with Trump than they do with underlying American public opinion, at least so far.

Dealing with the greatest adversary

Unfortunately, however, far more troubling over the long-term than America's Trump-induced confusion and division is Europe's apparent inability to see who the greatest adversary is, and its continuing unwillingness to acquire the means necessary to deal with the threat in all its manifestations. The emerging China-Russia axis – what they gleefully call a "partnership without limits" – has two critical attributes. First, this new bloc has a powerful global economic component, something the Sino-Soviet alliance never had during the Cold War. Second, the Beijing-Moscow axis and its satellites have the military wherewithal, including both highly sophisticated weapons systems and enormous manpower, that its Cold War predecessor had only partially, and inadequately. And now, there will be two massive nuclear arsenals facing the West, not just one.

1 https://harvardharrispoll.com/wp-content/uploads/2024/04/HHP_Apr2024_KeyResults.pdf

2 https://www.nytimes.com/2024/04/30/us/politics/republicans-ukraine-aid-vote.html



"Is the world, therefore, now in crisis? Ukrainians know the answer to that question, as do Israelis. Taiwan, the Philippines and others along China's Indo-Pacific periphery already feel the pressure."

Is the world, therefore, now in crisis? Ukrainians know the answer to that question, as do Israelis. Taiwan, the Philippines and others along China's Indo-Pacific periphery already feel the pressure. Take China's economic threat, which includes:

- decade after decade of pirating intellectual property from the West, often focusing on highly sensitive national-security technology, with minimal retaliatory action by the victims;
- weaponizing firms like Huawei and ZTE, which are not "telecommunications companies," but arms of the Chinese state, aiming to seize control of fifth-generation telecoms systems, the better to extract massive quantities of information to transmit directly to Beijing's memory banks;
- deceptive, indeed corrupt, financial practices worldwide, including in Europe and across the West, often called "debt diplomacy," that effectively entrap both private businesses and governments; and
- throughgoing abuse of the World Trade Organization under the guise of being merely a "developing" country.

The United States, reacting to this panoply of offensive economic warfare, has imposed increasingly stiff import and export controls to protect intellectual property and hardware critical to national-security; increased scrutiny, through the Committee on Foreign Investment in the US and in Congress, of the implications of China's activities in America, including purchases of significant amounts of land near military bases and other sensitive facilities; imposed retaliatory tariffs to respond to some of China's worst economic manipulations, urging its fellow industrial democracies to increase their awareness and concern for China's nefarious activities. More is coming whichever major-party candidate wins the Presidency in November.

What about you, EU?

What is the European Union, and Germany in particular, doing? Amazingly, doubling down on its economic dependence on China. Rising concern about increased competition from China, especially in the transportation sector, is justifiably producing near-panic in certain EU circles. Unlike in Washington, however, the initial response is not to defend against Beijing's economic warfare, but to plead for better treatment, including through more pilgrimages disguised as trade missions to the Middle Kingdom.

There is also, however, schizophrenia in EU policy, such as increasing tariffs on Chinese EV's, although to date less than America[3]. Brussels may be trying to buy time for threatened EU industries, or to increase Chinese investment in production in Europe[4]. If so, and if Chinese investment increases, it will mean the EU will be spared from having to make extensive capital expenditures in China so that its intellectual property can be stolen. Instead, Europeans can watch it being pirated without having to leave the comforts of home.

Europe's confused response is reflected in politics as well. Just as Hungary's once-liberal Viktor Orban gravitates toward Moscow, in Germany it is the Alternative für Deutschland ("AfD") that gravitates toward Beijing. AfD leaders complain about the West's "complete paranoia" about China[5]. Should Americans believe that AfD is wrong about the EU but right about China?

On defense issues, Europe, led by Germany, is also still confused, notwithstanding this summer's nostalgic triumphalism at NATO's 75th-anniversary celebrations in Washington. While more NATO members have reached the alliance's 2%-of-GDP targets for defense spending, they cannot pause to congratulate themselves or catch their breath. Threatening circumstances globally and America's abandonment of much of its defense industrial base in post-Cold War euphoria now require significant increases in US defense expenditures. Senator Roger Wicker, likely the Senate Armed Services Committee's next Chairman if Republicans win control of the

3 https://www.wsj.com/business/autos/the-rise-of-chinese-evs-is-dividing-the-west-850b9e1d?mod=hp_lead_pos10

4 https://www.wsj.com/economy/global/europes-response-to-china-shock-2-0-hold-china-closer-38656bd0?mod=hp_major_pos1#cxrecs_s

5 https://www.ft.com/content/712a4abd-66b3-4b83-bba1-012d5cc12f02

Senate, recently made the case for such increases[6]. I believe spending should return to Reagan-era levels (5%–6% of GDP), which would imply corresponding increases for our allies worldwide to at least 3%–4%.

But, say Europeans, or at least Germans, what about der Zeitenwende: doesn't that prove we're serious about defense? The answer from most Americans will be: what Zietenwende?

Zeitenwende spending

German Chancelor Olaf Scholz has already commented on the November US election in ways guaranteed to draw Trump's ire, which will unquestionably produce bad news for NATO if he wins. Scholz said of Biden recently that "this is a man who knows exactly what he is doing." The Chancellor lauded Biden's substantive achievements, adding "I think it is very likely that the current president could win the election"[7]. One of Trump's minions immediately expressed his dissatisfaction with Scholz[8].

What did the Chancellor hope to achieve by praising Biden when he should see clearly that Trump will focus intently on Germany's levels of defense spending going forward. Berlin may temporarily meet NATO's 2% target, because of Zeiten wende spending. But when that one-time surge disappears, the recurrent problem of underspending will immediately resume, initially, by some estimates, as much as 25 billion euros annually[9]. Scholz might as well have put a target on his back, and NATO's. Of course, Scholz's criticism of France's once-and-likely-future presidential candidate Marine Le Pen[10] isn't going to do him any favors with Trump either.

We can collectively do much better than this, but our grace period is not infinite. Let's not waste it.

6 https://www.wicker.senate.gov/2024/5/senator-wicker-unveils-major-defense-investment-plan

7 https://www.politico.com/news/2024/06/15/biden-scholz-g7-00163585

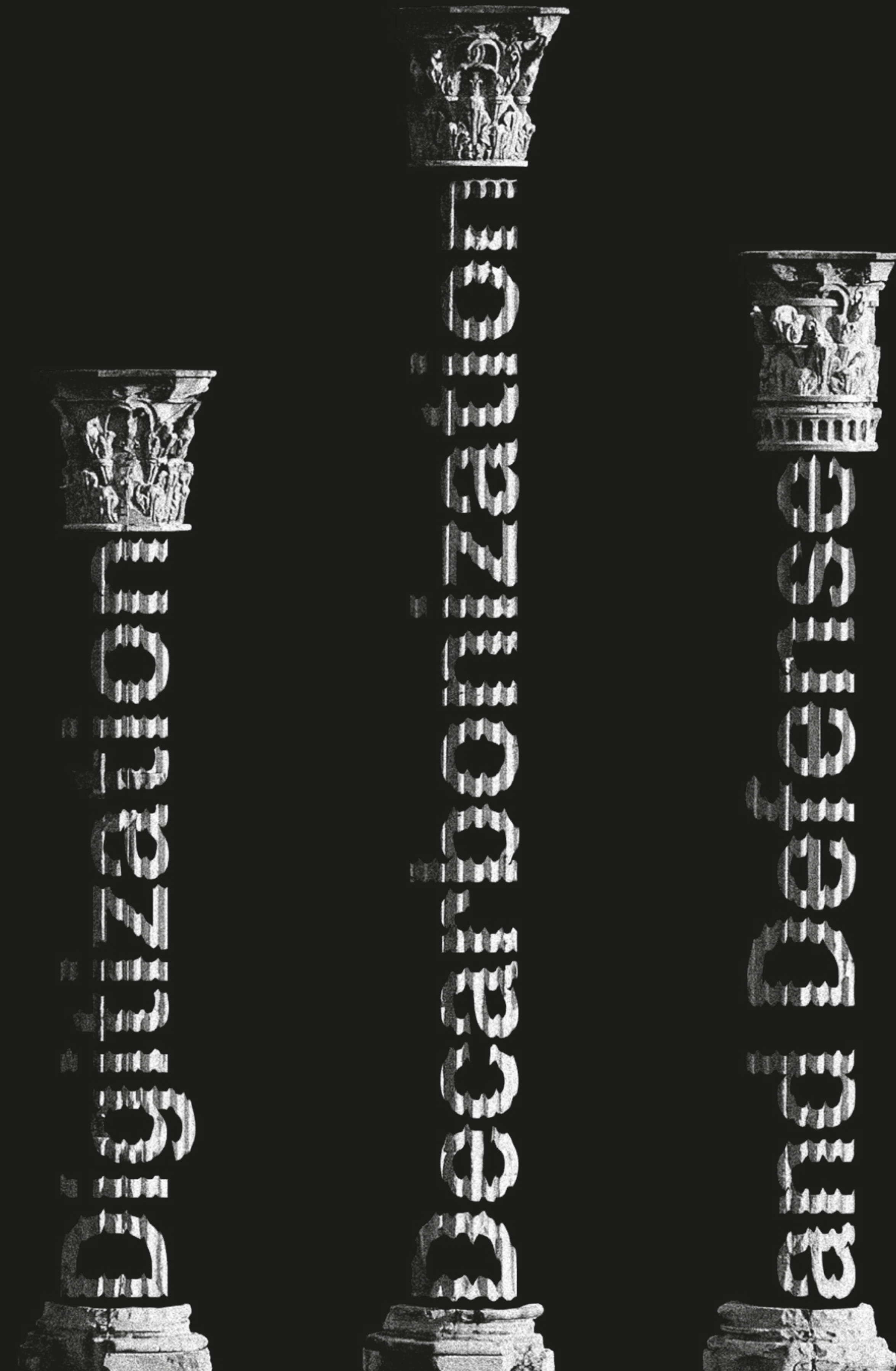
8 https://www.politico.com/news/2024/06/16/trump-ally-colby-blasts-german-chancellor-00163607

9 https://www.ifo.de/en/press-release/2022-04-19/german-armed-forces-need-additional-eur-25-billion-each-year

10 https://www.ft.com/content/0aadcd8a-bbeb-4003-8ed1-a4750a9a1604

> *"But, say Europeans, or at least Germans, what about* der Zeitenwende: *doesn't that prove we're serious about defense? The answer from most Americans will be: what* Zietenwende?"

How Private Capital Can Help with the Three Ds:



Johannes P. Huth
Senior Advisory Partner
KKR

Europe's need for private capital

Europe stands at a critical crossroads. With rapid technological advancements reshaping industries, climate change demanding urgent action, and security challenges evolving in unprecedented ways, we are facing a unique set of pressures that require a robust, coordinated response.

"Private equity firms have the resources and expertise to identify promising technologies and businesses, providing them with the necessary capital and strategic guidance to scale."

The green transition is not just an environmental necessity, but an economic imperative. Trade tensions between the US and China create a complex backdrop for European businesses, adding layers of uncertainty. The outcome of the next US election could further impact transatlantic relations and global stability. Meanwhile, Russia's ongoing war in Ukraine highlights the fragile nature of peace in Europe and the need for a strong, unified defense strategy.

In addressing these multifaceted challenges, private capital emerges as a crucial player. Strategic investments can drive innovation, scale sustainable technologies, and bolster defense capabilities. Private capital can significantly contribute to the three Ds, ensuring that Europe not only navigates, but also thrives in these unprecedented times.

Competitiveness as a central theme for Europe

Competitiveness is and will continue to be a key theme for Europe. For private capital, it means investing in and building companies that can become European or even global champions.

Private equity firms have the resources and expertise to identify promising technologies and businesses, providing them with the necessary capital and strategic guidance to scale. This not only drives economic growth but also contributes to broader societal goals.

Private capital investors are well-positioned to support the EU's goals by investing in promising and transformative sectors and companies. Their ability to source, pool, and efficiently allocate private, long-term capital across European value chains gives them a deep understanding of the industry at large.

The recent geopolitical developments further underscore the importance of private capital in Europe. The European Union's focus on security and competitiveness is likely to be a central theme in the European Commission's agenda. A more geopolitical Europe, one that is resilient and competitive, will require substantial investments in digital infrastructure, green technologies, and defense capabilities. And private capital can play a pivotal role in this transformation.

Especially in an increasingly competitive global landscape for private capital, Europe must get things right in building a productive and sustainable economy. This includes ensuring that private investors see themselves as welcome partners in developing a Single Market and Capital Markets Union, providing efficient access to capital.

Accelerating innovation and efficiency

In the current global economy, digital transformation is not just a competitive advantage; it is a necessity. The rapid advancement of technologies such as artificial intelligence (AI), the Internet of Things (IoT), and 5G connectivity is reshaping industries, creating new business models, and redefining the way societies function. For Europe to remain competitive on the global stage, it must accelerate its digital transformation efforts.

Digital transformation enhances efficiency, reduces costs, and opens up new revenue streams. It enables businesses to innovate rapidly, respond to market changes, and meet customer demands more effectively. Moreover, it is crucial for technological sovereignty, ensuring that Europe can develop and control critical technologies rather than relying on external powers.

Private capital is instrumental in driving digital transformation. It can provide the necessary funding to develop and scale digital technologies and infrastructure. Private capital brings not only financial resources but also strategic expertise and industry connections, enabling businesses to implement cutting-edge solutions and expand their market reach.

For instance, KKR has been actively investing in digital infrastructure and technology companies. Recent investments in firms like Fibercorp and Hyperoptic illustrate a commitment to enhancing digital connectivity and infrastructure. These investments are crucial for building the backbone of a digital economy, ensuring that businesses and consumers have access to high-speed, reliable internet services.

KKR also recently closed the acquisition of the fixed network infrastructure of TIM. As a result, FiberCop has launched an open-access wholesale telecommunications network in Italy, providing end-to-end connectivity services nationwide. The company, formed by incorporating Telecom Italia's fixed line network and owned by a group led by KKR and the Italian Ministry of Economy and Finance, aims to accelerate the transition to fiber-optic infrastructure and support Italy's digital transformation. This strategic partnership between the Italian government and KKR reflects the shared commitment to fast-tracking the digital transition in Italy and represents the significant role private capital can play to support economic and social development.

Another example is KKR's investment in ODF in the Netherlands, a company specializing in data centers and cloud services. Data centers are the backbone of the digital economy, providing the necessary infrastructure for cloud computing, big data analytics, and AI applications. By supporting ODF, KKR is helping to build a robust and scalable digital infrastructure that can meet the growing demands of businesses and consumers.

Overall, Europe's large, developed market and its status as a hub of innovation make it an attractive destination for private capital including from foreign investors. The continent's world-leading R&D, particularly in critical sectors like technology, green energy, and healthcare, alongside its robust infrastructure and skilled workforce, offer vast investment opportunities.

"Private capital brings not only financial resources but also strategic expertise and industry connections, enabling businesses to implement cutting-edge solutions and expand their market reach."

> *"The transition to a low-carbon economy is not only an environmental imperative but also an economic opportunity, creating new jobs, industries, and markets."*

Driving the energy transition

Europe has set ambitious goals for reducing greenhouse gas emissions and achieving climate neutrality by 2050. The European Green Deal outlines a comprehensive strategy to transform the EU into a modern, resource-efficient, and competitive economy, decoupling economic growth from resource use.

Achieving these goals requires substantial investments in clean energy technologies, sustainable practices, and green infrastructure. The transition to a low-carbon economy is not only an environmental imperative but also an economic opportunity, creating new jobs, industries, and markets.

Private capital plays a critical role in financing the energy transition. Public funding alone is not enough to meet the massive investment needs for developing and deploying clean energy technologies. Private capital can bridge this gap by providing the necessary capital and expertise to scale innovative solutions.

Private capital can support a wide range of projects, from renewable power generation and energy efficiency improvements to sustainable agriculture and circular economy initiatives. By investing in these areas, private capital contributes to reducing emissions, conserving resources, and promoting sustainable development.

For instance, KKR's investment in Albioma, a renewable energy company, is one example of recent investments behind the energy transition. Albioma specializes in biomass and solar energy, producing clean electricity from renewable sources. By supporting Albioma, we are helping to reduce dependence on fossil fuels and promote sustainable energy production .

Another notable example is KKR's investment in Encavis, a leading independent power producer focused on renewable energy. Encavis owns and operates solar and wind farms across Europe, contributing to the EU's renewable energy targets. Private capital will further enable Encavis to expand its portfolio, increase capacity, and enhance operational efficiency.

Whilst there has been good progress over recent years, in order to foster a deeper integration of private capital into the overall investment landscape, the European Union must create incentive structures that attract private funding. Policymakers need to ensure the right interplay between public and private funding, realizing that public funding alone cannot meet the needs of the energy transition.

Enhancing security and technological capabilities

Europe faces a complex and evolving security landscape. The conflict in Ukraine has highlighted the importance of a strong and united European defense capability, capable of responding to both traditional and emerging threats.

Strengthening defense capabilities, enhancing technological innovation, and fostering strategic partnerships are essential to continue to ensure security and stability for Europe and beyond.

Defense projects often require substantial investments in research and development, testing, and deployment.

By investing in defense technologies, private capital can help bridge the gap between military needs and technological advancements. This includes areas such as cybersecurity, artificial intelligence or unmanned systems. Such investments not only enhance security but also contribute to economic growth and technological leadership.

Private capital investors, with their long-term perspective, are crucial in building a resilient and prosperous Europe. Their ability to take a long view beyond immediate crises positions them as central pillars in addressing ongoing challenges like climate change and digital transformation, alongside newer security concerns.

The path forward

It is crucial for policymakers to recognize the pivotal role of private capital in meeting Europe's challenges. This will require sustained public policies, coupled with smart deployment of private capital at scale. By working together, the public and private sectors can build a stronger, more competitive, and sustainable Europe.

"The conflict in Ukraine has highlighted the importance of a strong and united European defense capability, capable of responding to both traditional and emerging threats."

"It's not a Job for me, it's a Mission"

Edi Rama (left)
Ghida Fakhry (right)

In June 2024, Prime Minister Edi Rama sat down with renowned journalist Ghida Fakhry to discuss Albania's path to the European Union. With a blend of hope and determination, Rama illuminated Albania's western orientation and the challenges ahead. He passionately emphasized the need for stable political institutions, envisioning Albania's crucial role in a changing Europe. His words painted a picture of a nation ready to embrace its future with resilience and ambition, eager to contribute to the broader European community.

Q

Ghida Fakhry:
Prime Minister Rama, you're a longtime political leader. You're a former basketball player, a painter, a university lecturer, a writer. You're also the only Albanian Prime Minister to have served three consecutive terms in office.

Since 2013, I think it is fair to say that you've been, quite literally, a towering figure over a small nation – in a volatile region with a complex history: centuries of Ottoman rule and decades of communism.

There's been a decisive turn West, under your leadership. Would you agree that Albania today is a country still trying to find its footing, its balance between its ancient civilization and its modern aspirations?

A

Edi Rama:
I don't think it's fair to say that, under my term, Albania turned decisively West because Albanians never had the chance to choose for centuries. But they always wanted West.
A famous poem that has become a bit of an anthem for us says: the sun sets where it rises, meaning West.

The first time we had the chance to choose was when we finally got rid of a very ruthless communist regime, and the slogan of that spontaneous manifestation was: we want Albania as Europe.

For that reason, we are the most pro-European nation among all European nations based on your barometers, believing in Europe and wanting our future to be in the European Union and on the other hand, we are the only place, I think, where Russia has no influence and where nobody has an appetite for it.

G.F.:
You say that you want Albania to be in Europe, in the EU, and that most Albanians feel the same way – but do you believe that the EU feels equally positive about taking Albania in?

E.R.:
Not most Albanians, all Albanians feel the same way. They want Albania to be part of Europe, to be anchored in Europe. And that's why we never had, after the fall of the regime, a communist party, force or movement that would claim the contrary or that would propagate Euro skeptic views.

When it comes to the EU itself, I would say: yes they want it. Compared to before the Russian aggression, we are in a very different dynamic and we are in a different type of relation with the EU in terms of the practicalities and the common efforts to boost the EU integration process.

G.F.:
It has been a slow process.

E.R.:
It has been a very slow process.

G.F.:
There's been quite a few mixed signals. Ursula Von der Leyne came to Albania and said that you were on track; that it was just a matter of time. Do you believe those words – or are they just empty promises?

E.R.:
I believe. She became head of the European Commission, something important changed for us. Before that, there was a commission that started off by saying 'no' to enlargement, and later saying 'we need you' but never taking an extra step to help us get there. So yes I believe, and in that sense, we are all blind believers.

We are in blind love with Europe. Blind love doesn't only have reason but there's also something else that's difficult to explain.

G.F.:
But the question is: is this love mutual? The EU released a recent report looking at the progress made so far by Albania in meeting some of the key criteria for EU membership. It found that Albania needs more stable political institutions and a strong political system to withstand challenges and crises. Also, Albania ranked 91 out of 142 nations on the Rule of Law Index in 2023. The European Commission has said that more needs to be done to tackle high-level corruption.

How confident are you that you'll be able to overcome these hurdles?

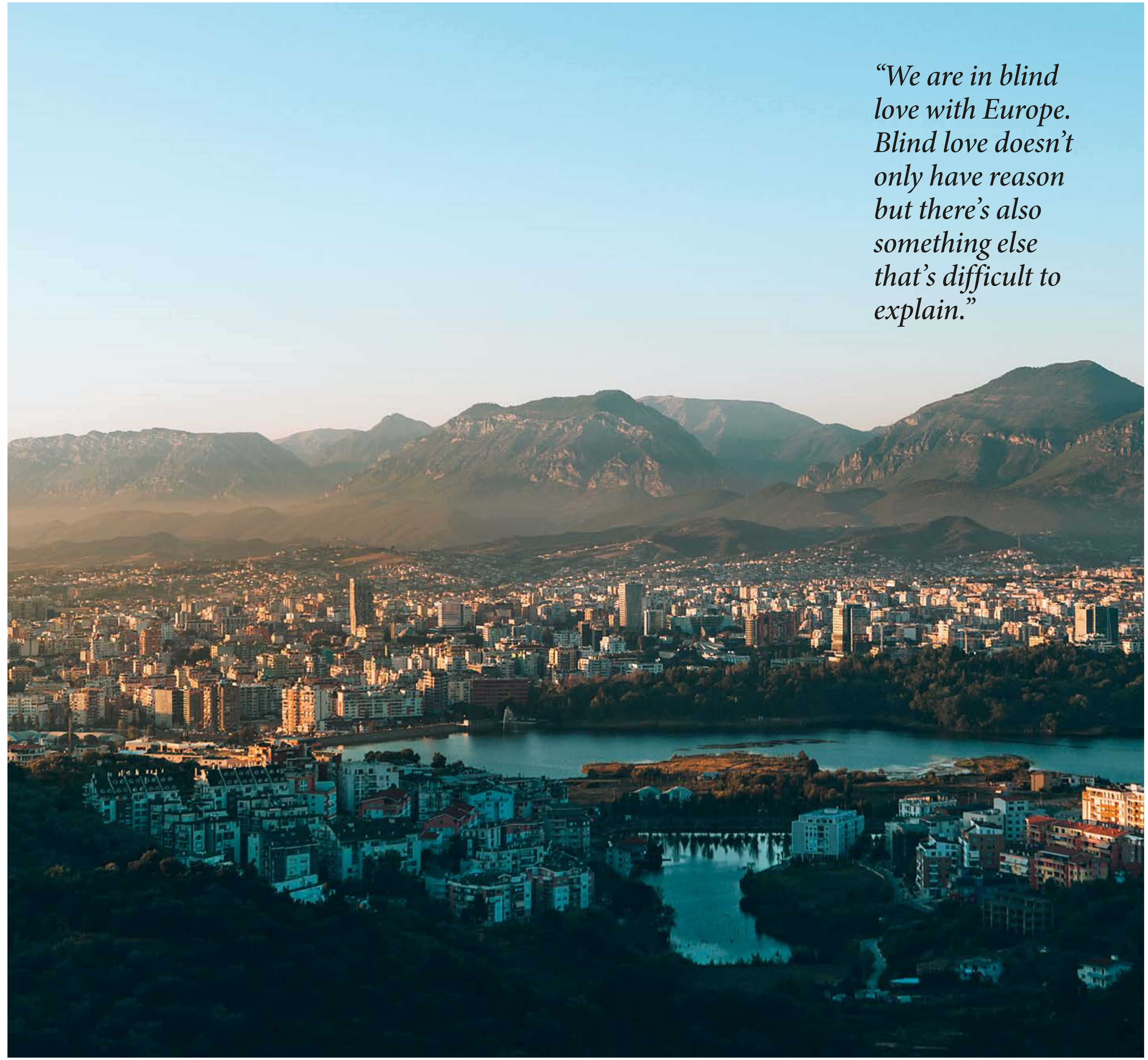
E.R.:
First of all, no, their love for us is not blind. Ours for them is. Secondly, in terms of how we see the EU, I believe they are missing something very important which has been translated into a weakness of the EU itself.

Once a upon a time, when we were all engulfed in this region under the very heavy pressure of nationalism, and when Europe was far from looking as a potential hostage of nationalism, we always believed that this is the place to keep yourself safe for generations from war and nationalism. Now it's very clear that Europe has become hostage of nationalisms .

G.F.:
In what sense?

E.R.:
In the sense that it doesn't really matter if nationalistic movements have taken over everywhere, but everywhere they exist they have the influence of pressure. Look what's happened with the many, many very prestigious socialist parties in Europe, for example, the French Socialist Party; they practically disappeared. Why? Because they fell for it and started playing the game of the Right when it came to migration issues and so on. So this is one side of the story. The other side is: yes they are right, we need to do more for sure. We need to do more there is no doubt.

And that's why I believe the EU is blessed because it is the most amazing source of knowledge about how to build institutions; how to build a functioning democracy. They always ask what the difference is between Albania and others in the region. With that very heavy past...you mentioned the Ottoman Empire; the very long time of disconnection with the West. The key difference between us and countries that are far away like for example Afghanistan or Iraq, is that they don't have the blessings of the European Union and of the possibility to be part of it.



"We are in blind love with Europe. Blind love doesn't only have reason but there's also something else that's difficult to explain."

"There is one more blessing for us, which is new technology. With digitalization, with artificial intelligence, we can make exponential progress to solve issues that would otherwise have taken a long time."

I always say that we should not rush. We have to do our homework. We do not have a tradition of state, a tradition of institutions. We started practically with a very disputable tradition of 50 years of communist dictatorship.

So we need to build many things from scratch and Europe is fundamental to that but it will take some more time. There is one more blessing for us, which is new technology. With digitalization, with artificial intelligence, we can make exponential progress to solve issues that would otherwise have taken a long time.

G.F.:
But how do you do this when there has been a massive brain drain in the region as a whole, Albania in particular. How do you invest in technology when your own youth doesn't seem to have faith in democracy and the economic opportunities?

E.R.:
I would say, first of all, that I don't see this period in history as something unique or something tragic. It's a period in history that we have to go through like others. Number two, we come from a bunker, from a dictatorship where leaving the country was not possible and was considered high treason punishable by death. So I don't see this as a tragic thing.

G.F.:
But if we look at some of the recent statistics, they show that 71% of young Albanians are considering emigration. Over the last four years alone, studies have shown that the youth population in Albania has decreased by 2.5%. More than 1.6 million Albanians live abroad today; that's more than half Albania's population of 2.8 million.

E.R.:
I'm not contradicting that, I am simply saying that this is not tragic. It is very logically explicable because we are free, we live in a free world. People have the right to move, this is normal.

We are in a country that ten years ago barely had 1 million tourists, mostly all of them coming from Kosovo and North Macedonia. Last year we reached 10 million. This year, we may go to 12,13,14 million tourists. It's one of the most secure places in Europe.

G.F.:
But Prime Minister, a lot of the young Albanians leaving are doing so because of rampant corruption and lack of economic opportunities. It must concern you…

E.R.:
I don't buy that, to be very honest. They are leaving for a very simple reason, which is why I left when I was younger and wanted to see the world, to challenge myself. I didn't leave because there was corruption. But yes there is corruption in Albania, there's not the slightest doubt. But there are many young people that are successful, that work in our administration after having passed through competition, fair and honest. You need to have the vision, you need to work and follow your vision, and you have to have patience.

G.F.:
You have shown both vision and patience when it comes to Albania's integration into the European Union. If it were to join the EU, it would become the first Muslim-majority nation to do so.

According to the last census, over 60% of Albanians identify as Muslim, even though most of them are secular.

E.R.:
It doesn't mean anything, we are not Muslims or Christians or Catholics or Orthodox or whatever. We are Europeans first and then all the rest. Why do I say this? Look at how we all live together. I am a Catholic, my wife is Muslim, our two big children from previous joint ventures are Orthodox. We have a little one, I don't know what he'll decide to be. This is Albania so it doesn't mean anything. This is not a problem for us. We are European so I wouldn't make much of it.

G.F.:
But do you think it could be a problem for others? You mentioned earlier that nationalism is on the rise in Europe, extremism as well.

E.R.:
This is what we are, this is our cultural wealth. So it's fantastic to be a European country and having Muslims and Christians. Europe has many challenges, one of them is the cultural war. In my view, it's anti-European.

G.F.:
Let me get to the relationship with the United States. Albania has strong ties with the US. Recently the Secretary of State, Antony Blinken, called Albanians 'most important and strategic of friends'. How mutually beneficial is the relationship?

E.R.:
I would say a lot.

G.F.:
To what extent does this partnership depend on what some would call the threat of Russia wanting to extend its hegemony over the region?

E.R.:
Russia cannot extend its hegemony. Long before Russia became a problem for everyone else, we had no problem with them, but we didn't have any appetite to get closer to them.

G.F.:
Do you feel threatened by Russia today?

E.R.:
No. Albania threatened by Russia? No way. The region is something else. Yes, Russia is a threat because it is a threat, because of its own model of society.

G.F.:
But why should you feel threatened by that?

E.R.:
Because it's a model that doesn't fit with the democratic model of the European Union family.

G.F.:
They're not seeking to be part of the EU family...

E.R.:
It's a clash between two different orders. One is an alliance of democracies for certain values, principles, and way of life. And the other is an alliance of countries with different principles.

G.F.:
I ask you this, in light of the recent decision to re-open a Soviet-era military base 80 km from Tirana, which will serve as a major hub for NATO aircraft. What was the reason behind it if you feel that Russia doesn't pose a threat to Albania?

E.R.:
Vladimir Putin's popularity in Albania is around 1%. In Serbia, its something like 70%. So we don't feel threatened by that temptation because we don't have appetite for it. But when it comes to the military side, Russia is a threat to Europe, yes. I don't see Russia moving into Europe militarily but it is a threat to all we stand for and believe in.

G.F.:
Do you agree with those who see Ukraine as a proxy war between the US and NATO on one hand, and Russia on the other?

E.R.:
I think it's a very simple thing. Ask the Ukrainians and put yourself in their shoes, first. Imagine your country being invaded and then tell me. Would it be a proxy war if the people of Britain would want to resist and their friends and allies would help? I don't think its a proxy war.

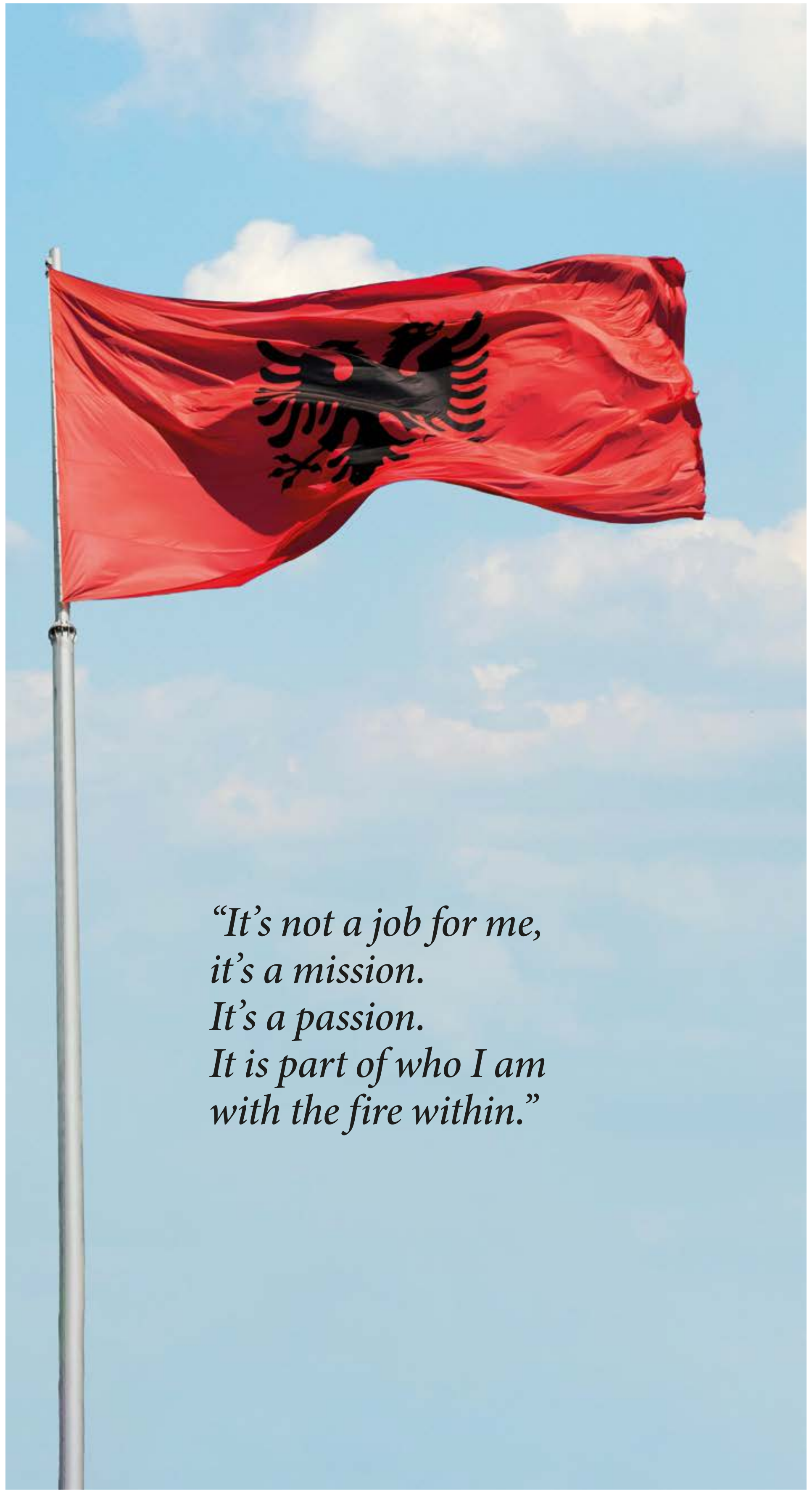
G.F.:
But Britain has never been surrounded by members of the Warsaw Pact the way Russia has been encircled by NATO members.

E.R.:
It's a war of resistance of a sovereign nation that is being aggressed militarily. So it's too easy to put it like that.

G.F.:
Sure, but by enhancing NATO's presence in the region, would you be making the Balkans more or less safe and secure? Would it be more prone to Russia's influence?

E.R.:
What do you mean? Of course more secure. Of course, much more secure.

"(…)we are not Muslims or Christians or Catholics or Orthodox or whatever. We are Europeans first and then all the rest."



"It's not a job for me, it's a mission. It's a passion. It is part of who I am with the fire within."

G.F.:
How is it more secure? You say it's more secure yet you have a raging war in Ukraine that some people pin down to NATO's eastward expansion.

E.R.:
This is a long discussion but nothing can justify a war of aggression, in my view. Then everything else is debatable.

G.F.:
You've been courted by some nations when it comes to immigration and the outsourcing of the immigration problems. You accepted an offer from Italy.

E.R.:
We did not accept an offer, we accepted a request; two different things.

G.F.:
All right, you've accepted a request from Italy to allow two detention centers to be built here in Albania.

E.R.:
Not detention, hospitality centers.

G.F.:
You call them hospitality centers?

E.R.:
It's what they are called in the European Union legislation.

G.F.:
But these will essentially be centers that are used by an EU country – which is a first – to process would-be migrants intercepted at sea. You have said that the problem of immigration should not be externalized, that it should not be transferred to other countries, but isn't that exactly what is going on here?

E.R.:
No. First of all, we are not EU, but we are E – we are Europe. Second, we are not only neighbors divided by sea, but we are very close from thousands of years of history with Italy. Italy has done a lot for us so it's a very special relationship. We have a lot of Albanians living in Italy so it's like home.
What they've asked is to process here migrants so they don't come to Italy's shore and we said yes. It's not like another country – for example Britain – saying we want to transfer…on the other hand, I believe this is not the solution, but it is part of the solution.

We are asked to help and we can help. It's a one-off for Albania but maybe other countries can do it with other countries in the region but still, this is a European thing but it's not the solution.

G.F.:
You say its not the solution yet you've accepted the requests and you've been heavily criticized by human rights organizations.

E.R.:
Friends are there to help when you are in trouble not when you are shining.

G.F.:
But is it worth the price you pay for the heavy criticism in terms of human rights with organizations like Amnesty and Human Rights Watch saying that it will violate migrants' rights and lead to arbitrary detention. Some have gone as far as to say this could lead to a Guantanamo-style detention center.

E.R.:
Listen, when I hear this kind of things, I feel very sorry for the victims of Guantanamo. It's disrespectful towards them, the real victims. So it's a bit too much. Are there concerns? Yes of course.

G.F.:
Finally, what role do you see for Albania regionally and on the global stage? You're a painter, what kind of image would you paint if you look at the future?

E.R.:
I would see Albania as a shining, happy and sometimes chaotic Italy, a little Italy. It will be a little Italy, it will be the best.

G.F.:
And do you see yourself in office, two years from now? There are parliamentary elections in 2025. Despite the challenges, your Socialist Party is still favored to win. Do you see yourself as Prime Minister for a fourth consecutive term?

E.R.:
I like to contemplate the stars but I'm not good in reading them.

G.F.:
Have you had enough or would you like to continue doing this job?

E.R.:
It's not a job for me, it's a mission. It's a passion. It is part of who I am with the fire within. So as far as I still feel the fire it's not an issue of being tired or saying enough, but you never know when the fire is gone.

G.F.:
Prime Minister Edi Rama, thank you very much. I really appreciate you making the time.

What will the End of Petrodollars Bring?

Hung Tran
Nonresident Senior Fellow
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According to media reports in June 2024, Saudi Arabia would not stick to the understanding reportedly reached with the US in June 1974 – following which the Kingdom would sell oil for dollars and recycle so-called petrodollars back to the US Treasury securities markets, in exchange for military protection by the US.

"This trend would gradually reduce the importance of the dollar in international finance and payments – being one dimension of the relative weakening of the dominant leadership position of the US in world affairs."

The beginning and end of that understanding spanning fifty years reflected significant changes in the balance of power among countries in the world, in particular the relationship between the US and Saudi Arabia. While there have been no discernible effects of the announcement on financial markets, that move would join many actions – not the least of which by the BRICS – in reinforcing a dedollarization trend in favor of local currencies in cross-border payments. This trend would gradually reduce the importance of the dollar in international finance and payments – being one dimension of the relative weakening of the dominant leadership position of the US in world affairs.

The 1974 US-Saudi Arabia strategic deal...

In the early 1970's the US was beset with high inflation and current account deficits, largely due to expenditures to prosecute the war in Vietnam – putting pressure on the dollar and threatening a run on the US gold reserves. In what was later referred to as the Nixon shock, in August 1971 the US ended the dollar's convertibility to gold at the fixed price of $35/ounce – the dollar's convertibility had been the lynchpin of the Bretton Woods fixed exchange rare system. The fixed exchange rate arrangement was finally ended when major currencies began to float against each other by March 1973. Then came the great oil shock in October 1973 when the Organization of Petroleum Exporting Countries (OPEC) cut oil production and embargoed oil shipments to the US during the Yom Kippur war, sharply boosting oil prices.

Against the backdrop of great economic and political uncertainty, in June 2074, the US discussed and reportedly got Saudi Arabia to agree to sell its oil for dollars and recycle the petrodollars back to the US Treasury bond markets to help finance US fiscal deficits. Saudi Arabia requested that its commitment to buy US Treasuries be kept confidential for fears of popular backlashes – data on Saudi purchases would not be released by the US until 2016. In return, the US would supply military equipment to Saudi Arabia and protect its national security. The deal satisfied strategic needs of both countries. The US would secure a reliable source of oil supply to meet its need of imported oil as well as of demand for the dollar to keep it stable. In fact the understanding promoted the use of dollars in oil and commodities trading as well as a stable source of demand for US Treasuries, helping to make the dollar the key reserve, financing and transactional currency in the international financial system, helping to strengthen US power and influence. On the other hand, the House of Saud would welcome a strong security partner to safeguard its national security in a troubled neighborhood.

…Fifty years on

Fast forward fifty years and global relationships have changed significantly. The dominant position the US enjoyed in the three decades or so after World War II has weakened noticeably by now. Economically, the share of the US in world GDP has declined from 40% in 1960 to 25% at present. In Purchasing Power Parity (PPP) terms, the US accounts for 13.3% of the global economy, smaller than China at 18.9%. Geopolitically, the US relative position has weakened considerably in the face of growing challenges by China and Russia as well as the widespread desire by other countries in the world to be more autonomous vis-à-vis the US. In particular, the US frequent use of economic and financial sanctions to serve its strategic objectives has prompted many countries to develop alternative cross-border payment arrangements to reduce their reliance on the dollar.

More relevant to Saudi Arabia is the fact that thanks to the shale oil revolution, the US has become the largest oil producer in the world and a net oil exporter. The US still imports oil from Saudi Arabia but at a significantly lower volume of less than 500,000 million barrels per day compared with around 1.5 million barrels per day in the early 2000's. Importantly the US is no longer dependent on Saudi Arabia for its energy requirements. By contrast, China has become the largest buyer of oil from Saudi Arabia – to the tune of 1.58 million of barrels per day in the first four months of 2024, or 20.5% of total Saudi oil export. Geopolitically, China has established close trade-driven relationships with all countries in the Middle East, filling a vacuum created by the US as it has attempted to pivot to Asia. China's role in the region has received a substantial boost when it facilitated the re-establishment of diplomatic relationship between regional arch rivals Saudi Arabia and Iran.

"More relevant to Saudi Arabia is the fact that thanks to the shale oil revolution, the US has become the largest oil producer in the world and a net oil exporter."

“Saudi Arabia’s decision to walk away from the 1974 understanding might turn out to be as significant, at least as a symbol, for international finance as its move to conclude the agreement with the US fifty years ago.”

Given the changes in economic and geopolitical circumstances, one can see it makes sense for Saudi Arabia to diversify the currencies used in selling its oil – as parts of its strategic diversification of relations going beyond the US and Europe to include China and Russia. This diversification has been symbolized by Saudi Arabia confirming its intention to take up the invitation to join the BRICS. Saudi Arabia has also joined the mBridge project bringing together China, Hong Kong, Thailand and the UAE to explore the use of their respective CBDCs for cross-border payments. In fact, Saudi Arabia’s moves seem to mirror those of its ally the UAE which has accepted the RMB for LNG sale to China for the first time in March 2023. In January 2024, the UAE made a payment of 50 million digital Dirham ($13.6 million) to China using the mBridge platform in a successful proof of use.

Dedollarization toward a tokenized payment system

In a broad geopolitical context, Saudi Arabia’s decision is a small but symbolic step as parts of a noticeably growing trend of dedollarization by using local currencies in cross-border payments for trade and investment transactions. The arrangements necessary to use local currencies are entirely within the competency of participating countries without any influences from any major power. These include basically currency swap lines agreed between participating central bank, and the linking of national payment and settlement systems, preferably on a real time gross settlement basis consistent with ISO 20022. At present, using local currencies for cross-border payments entails an efficiency cost as market participants have to use less liquid local FX, money and hedging markets to exchange pairs of local currencies directly without using the dollar as a vehicle currency. However, many countries appear to have accepted the efficiency loss as necessary costs to reduce their reliance on the dollar. Moreover advances in payment technology would greatly reduce these costs going forward.

Specifically the digital payment ecosystem has progressed significantly toward tokenization – the use of tokenized units of exchange such as central bank digital currencies (CBDCs) or stable coins or any items of value. These tokenized units can be exchanged instantaneously and directly between users, both online and offline, without having to be processed through the accounts of intermediaries such as commercial banks. From a technological viewpoint, the tokenized payment system can be designed and constructed to address concerns about privacy and the ability to counter crimes and money laundering. Naturally the current banking model and its maturity transformation will need to be changed. More importantly, the tokenized payment ecosystem would significantly reduce the need for participants to hold reserves to ensure adequate liquidity not only for normal trading but also for stressed financial conditions. As a result, the key pillar of support for the dollar’s dominant position in international finance – the deep and liquid financial markets especially for US Treasury securities making them desirable as reserve assets – would become less relevant.

All these developments would help to gradually democratize the global payment and financial landscape, moving from a dollar based system to one where local currencies can be used for international transactions; with the dollar likely to remain prominent but complemented by several currencies including the RMB, GBP, yen etc commensurate with the international footprint of their economies. In this context, Saudi Arabia to step out of the 1974 understanding and to diversify might turn out to be as significant, at least as a symbol, for international finance as its move to conclude the agreement with the US fifty years ago.

Why do Transformations Fail?

Sarena Lin
Member of The Supervisory Board
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It seems that these days, almost every organization, regardless of size, geography, or industry, is in the midst of some kind of 'transformation'. Faced with various disruptions and uncertainties, companies are looking for trajectory-bending change. And "Transformation", a corporate term that is on the verge of being overused, seems to be a potential savior.

Yet, we have all heard it – as John Kotter famously wrote almost 30 years ago, that 70% of transformations fail, a number that has subsequently endorsed by many other research reports and surveys.

Why do transformations fail? Just like every corporation has its own dynamic, culture, and legacy, transformations succeed or fail also for their unique reasons. I have had the opportunity to lead, be part of, or to observe and study a few transformation efforts over the years, and I believe there are several factors that have outsized influence in the success or failure of a corporate transformation. I believe a leader needs to ask the following questions and answer them well, as they embark on a transformation journey.

I. Do I know where I want to go?

I've spoken to many leaders who declare that they 'need to transform the organization'. They talked about making faster decisions and taking more calculated risks. They debated about inserting 'digital' in the organization. Many then went on to describe the change management offices they have put in place, or the policies they were planning to abolish. However, in my experience, without having a clear picture of what the goal of the transformation is, such efforts are difficult to sustain.

To be clear, a compelling vision goes beyond the financial numbers or the market share. As a leader, are you trying to drive cultural change, bend the growth trajectory, or to build a new digital business? What is the goal you are trying to achieve? A clear vision is a description of the future state so vivid yet so simple that excites stakeholders to come along. It is what galvanizes employees, and hopefully customers and other stakeholders, to rally behind the change. What do you want the employees to feel like working in a transformed organization? How would your customers see and feel the difference?

Equally important, can you articulate a few key milestones that the organization can see and feel, so that the transformation is as tangible as possible?

"Why do transformations fail? Just like every corporation has its own dynamic, culture, and legacy, transformations succeed or fail also for their unique reasons."

II. Am I serious about the change?

The reality is, change is hard. As human beings, we prefer stability over change. We choose familiarity over unknown. To create a real change in how an organization behaves requires strong, persistent, and unwavering tone from the top.

As leaders, we also need to recognize the inherent conflicting demands of transformation. Many transformation efforts take time – changing deep rooted corporate culture requires more than a few fiscal quarters. Yet time is often the luxury most of the corporations don't have. Under pressure to deliver, it is easy for leaders to change the initial vision and direction and lose their own conviction for change along the way. If a leader is not convinced of the change, how does one inspire others to follow?

It is about conviction and commitment, as well as consistent communication of the vision. While change fatigue is real, organizations also have the ability to renew themselves, if their leaders know how to show commitment and empathy, and not forget to celebrate successes along the way.

III. Is my organization culture eating the transformation?

Peter Drucker once said, "Culture eats strategy for breakfast". I'd venture to add, culture eats transformation and change for any meal of the day. While a leader needs to consistently communicate and convince others of the vision, deeply ingrained cultural norms and values are often the most challenging barriers to change.

Beyond processes and policies, every organization has unspoken rules that govern the organization's dynamics and speed. Transformations that fail to address cultural issues – the attitudes, beliefs, and behaviors that govern how an organization 'really' works – are likely to struggle. The questions are, not only how well do leaders know the culture of their own organization, but also how self-aware are the leaders of their own leadership behaviors that shape and influence such cultural norms.

An organization takes on the mindset and behavior of its leaders over time. If the aspiration is to build a culture that supports transformation, then a leader needs to exhibit and internalize the needed behaviors – such as fostering openness, collaboration, and a willingness to experiment and take risks. Only when such behavior and mindset change are visible, will employees start to feel safe to experiment and follow.

IV. Does my organization have the skills and resources to drive transformation?

While a large part of a transformation is about setting the vision and addressing culture challenges, a transformation could be a major organizational undertaking that requires sustained investment in funding, staffing, and skills. Driving change is both an art and a science – the science is required in framing the effort and setting the pace for change, in managing interdependent initiatives in lock step, in identifying and debottlenecking roadblocks early, and in driving performance transparency.

At the same time, transformation is often a full-scale exercise for the entire organization. It not only requires all employees to understand the vision, but also places heavy expectations especially on people leaders to role model and lead the change. Such ability to "lead self" and eventually, to "lead others" is a skill that often needs to be trained, or at least refreshed.

In addition, with the advent of technology and generative AI, technology solutions are often critical enablers for change. Such investments require not only capital commitment, but often also broader organizational change – including workflows, mindset, and skills. Otherwise, such investments will only result in an expansive tool that is underutilized and will not generate the desired transformation the business case initially promised.

Conclusion

As the world continues to evolve with unprecedented uncertainties, transforming organizations to be nimbler and more resilient, yet able to outcompete and outperform their competitions becomes the #1 challenge for many leaders. While driving these transformations can be challenging and complex, understanding the common reasons why transformations fail can help leaders anticipate and address potential pitfalls. Clear vision and strategy, committed leadership, addressing culture and mindset issues, and supporting the effort with adequate skills and resources, are some of the critical factors for success.

Chances are, over time, "transformation" needs to become a skill that every successful organization possesses, where changes become the norm, and transformation becomes part of the daily operating rhythm of a successful company.

"Driving change is both an art and a science."

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