



eurasia group

TOP RISKS 2016

IAN BREMMER, President
CLIFF KUPCHAN, Chairman

- 01 | The hollow alliance
- 02 | Closed Europe
- 03 | The China footprint
- 04 | ISIS and “friends”
- 05 | Saudi Arabia
- 06 | The rise of technologists
- 07 | Unpredictable leaders
- 08 | Brazil
- 09 | Not enough elections
- 10 | Turkey
- * | Red Herrings



OVERVIEW

IAN BREMMER, President
CLIFF KUPCHAN, Chairman

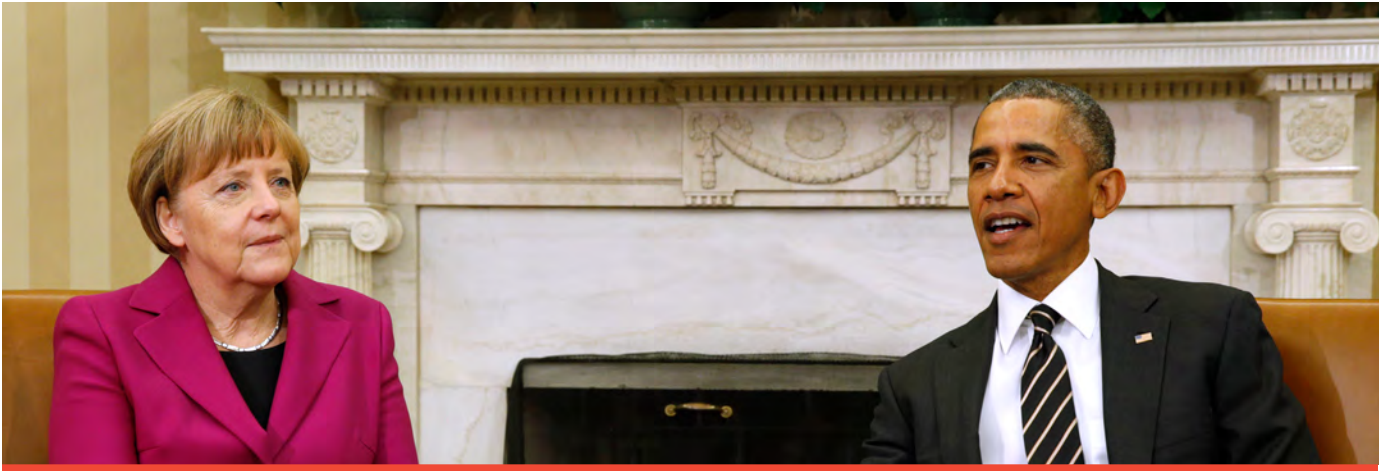
We first wrote about the G-Zero five years ago. It's now fully upon us, and the unwinding of the US-led geopolitical order will accelerate in 2016. There is growing political division in a year with a presidential election in the United States and a foundational political crisis for Europe. Russia, in decline, is led by an increasingly combative—and resurgent—Vladimir Putin. China is becoming far more powerful, but with a foreign policy that reflects primarily economic (though still strategic) national interests.

The results are clear. The Middle East is the most vulnerable to a geopolitical leadership vacuum and is heading toward conflagration. There are six failed states across the broader region (Afghanistan, Iraq, Libya, Mali, Syria, and Yemen) and more refugees than ever recorded. ISIS has become the most powerful terrorist organization in history. Oil economies are under strain. All of this will get worse in 2016.

Europe will feel much of the pain—in economic costs, security vulnerability, and political blowback. The United States, at the twilight of Barack Obama's administration, will mostly stick to its knitting, since the western hemisphere remains insulated from the lion's share of geopolitical instability. In Asia, despite having many of the world's strongest national leaders, helping manage these problems is not a priority.

This all means a dramatically more fragmented world in 2016 with more intra-, inter-, and extra-state conflict than at any point since World War II. And yet drawing the major powers into military battle against one another—World War III—is virtually unthinkable (recent comments from Pope Francis notwithstanding). The world's four largest economies—the United States, China, Japan, and Germany—are all deeply reluctant to accept responsibility for crisis management. Only the Germans are affected directly by this turmoil, and they still have plenty of reasons to duck the fight.

And so, in 2016, conflict intensifies. Last year, investors recognized growing uncertainty but remained more focused on the economic improvements: a US economy in recovery and Europe coming out of recession. That's unlikely to last, as geopolitical risk shakes the global order.



The transatlantic partnership has been the world's most durable and significant alliance, underpinning the global economic order and bolstering peace and stability (such as it is) for nearly seventy years. It was the cornerstone for the international architecture that has mattered most—NATO, the Bretton Woods accord, the United Nations, the World Trade Organization, the IMF, and the World Bank. But it is now weaker, and less relevant, than at any point since the Marshall Plan. In 2016, the transatlantic alliance will be a hollow one.

This new reality has been developing under the radar for some time. Three trends have contributed. First, there's a shift in the geopolitical order in which East versus West has given way to "the rise of the different," with China and other emerging markets creating a much more diverse and complicated set of threats and opportunities for the advanced industrial democracies. Second, there is the emergence of American unilateralism as a policy orientation for both the George W. Bush and Obama administrations, supported by new areas of coercive diplomacy—surveillance and the weaponization of finance—and pushed into the spotlight by the Edward Snowden revelations. Third, there is Europe's strategic weakness, with leaders across the continent fully occupied with a series of economic and political crises.

Foreign policy has arguably become the most important issue in the American election, and yet the transatlantic relationship isn't on the agenda. The United States will turn inward during this highly contentious race, encouraging European leaders to further question US leadership, commitment, and values at a moment when they're focused mainly on their own political futures. That might recede a bit under a more activist, next US president. But the path is set—Europe is divided, vulnerable, and maximally insecure. Governments are going their own way, a trend most obvious in new alignments of Europe's three major powers in new (and opposing) directions.

UNITED KINGDOM—CHINA

It's all about the economy. British leaders worry about the ability to pay for major infrastructure needs when austerity has made budgets ever tighter. The answer? Build a very special relationship with China. The UK led the charge to join the China-led Asian Infrastructure Investment Bank, despite opposition from the United States, to show Beijing that the Brits can be China's most trusted and useful friend. They're opening key investment opportunities to Beijing by showing less regard for concerns about sharing technology, suspending judgement on human

American unilateralism and European weakness have undermined the alliance

rights, and mainly avoiding security questions such as Taiwan, the South China Sea, or even democracy in Hong Kong. The hope is to secure larger and longer-term investment... as well as to become a global hub for internationalization of China's renminbi.

FRANCE-RUSSIA

It's all about security. The French government faces the biggest terrorism threat in Europe and has a more assertive military policy in the Middle East and North Africa than any other European government. The Americans and Brits are dragging their feet on Syria, while the Germans focus more on diplomacy, humanitarian aid, and infrastructure support. The Russians, by contrast, are taking the military lead with little regard for domestic constraints. French President François Hollande perceives Putin to be Europe's best chance of stemming the flow of Syrian migrants headed for the EU's borders. After the most recent attack on Paris, France used a chapter of the Lisbon treaty to call for collective European security—for the first time in history—rather than turning to NATO, which would have made it much harder (if not impossible) to collaborate with Russia. That speaks volumes about France's priorities and the transatlantic alliance.

France's Hollande perceives Putin to be Europe's best chance of stemming flow of Syrian migrants

GERMANY-TURKEY

It's all about politics. German Chancellor Angela Merkel understands that her open-door refugee policy will work only if the rapidly rising tide of refugees doesn't become a flood. That means working with Turkey, which presently hosts more than 2 million refugees from Syria alone. Merkel has made significant overtures to Ankara, promising to support fast-track European Union integration for Turkey as well as offering billions of euros to President Recep Tayyip Erdogan if he takes the lion's share of responsibility for the refugees. There's an ostensible economic rationale—the average refugee costs much less to support in Turkey—but tightening German demographics argue in favor of accepting more, not less, migrants. Turkey's limited alignment with NATO goals in the region is a second concern. Growing domestic and European opposition to Merkel's refugee policy will strengthen the pressure behind her outreach.

These are uncertain bets, to be sure, for Britain, France, and Germany. China doesn't trust the more geopolitically active Britain or find it as economically useful as Germany, and a perception of desperation in its partners usually leads Beijing to push for tougher commercial terms. France will be limited in its ability to secure broader international support for cooperation with Russia, which continues to antagonize both the Americans and many of France's European allies. And Germany's Turkey play is opposed by pretty much everybody. All three of these bets come from weakness and insecurity. European governments are looking to the future and hedging their bets on traditional partnerships.

This year, we'll see these hedges play out in transatlantic divisions over Ukraine, where the Europeans have been less enthusiastic than the Americans about slapping sanctions on Russia. They feel the economic consequences of those sanctions far more acutely than Americans ever will. That consideration will combine with France's security concerns and more pro-Russian inclinations of leaders including Hungary's Viktor Orban and Greece's Alexis Tsipras. This makes the Europeans likely to ease their sanctions on Russia later this year. Washington will not follow suit.

We'll also see a growing gap over Syria. There is a fundamental disagreement between the Europeans and Americans over whether working with Putin in combatting ISIS (and, to a lesser extent, working with him toward a political solution to the Syrian civil war) is an acceptable proposition. They may once have shared the view that President Bashar al Assad must

go, but many European leaders are now more willing than Washington to compromise on the details of that proposition at this late stage in the country's civil war.

In 2016, the transatlantic relationship no longer plays the decisive role in shaping the top priorities for Europeans and Americans alike. The perception of common values and their importance for the global free market are eroding, giving rise to a much more diffuse order of lowest common denominators.

The hollow alliance doesn't make us more pessimistic on climate change; that's a truly global problem and now understood as such. But the Europeans and the Americans will increasingly be going their separate ways. Trading patterns and political allegiances will diverge. The most important risk pertains to the global security system. There's just no more international fireman of any kind; this year will see both a reticent hegemon and a weaker Western coalition. Think the Middle East was troublesome in 2015? This ensures it gets worse.

The United States will turn inward, and Europe will strengthen its ties with other partners





East versus West, old versus new, and core versus periphery. Europe's divisions are nothing new. They've defined Europe's challenges for decades. But in 2016, they will reach a crucial point as an identity crisis emerges between open Europe and closed Europe—and a combination of inequality, refugees, terrorism, and grassroots political pressures pose a fundamental challenge to the principles on which the European Union was founded.

It's not the currency union that's under threat. Greece isn't out of the woods, but it's neither pressing nor threatens contagion. Instead, it's the rise of populism and nationalism, the erosion of rule of law, and the risks to the integrity of the Schengen agreement on open borders.

The risk starts from the top. The biggest advocate of open Europe has been Germany's Merkel. The consistent leader of Europe since the 2008 financial crisis, and the European Union's savior through her stalwart handling of the Greek crisis, she was named Time magazine's person of the year just three weeks ago. But this image was already losing its shine by the fourth quarter of 2015. This year, Merkel's extraordinary welcome to refugees will draw fewer followers inside her own country, and virtually none outside it. This will undermine her political position, and could encourage a domestic challenger over the coming months. It creates a dramatic change in how Europe interacts with itself and with the rest of the world.

That leaves Europe with less ability to respond collectively to any crisis (expected or otherwise). More resentment toward Germany from others in Europe will undermine its political capital. The refugee issue will play out across Europe as the proximate cause. With a growing fear of ISIS and international terrorism more broadly, the Schengen agreement risks being broken in 2016, and as more governments take legal action (as with Slovakia's fight in the European Court of Justice), a divergence of national perspectives will dominate European policy. Closed Europe is first and foremost a Europe that closes itself up to the outside world, and whose countries close themselves up to one another.

There will be a next-stage surge of populism. Trends already apparent in Denmark, Greece, Hungary, Poland, Spain, and Sweden will spread across the continent. In France, it's the National Front with unprecedented levels of support in recent regional elections. Even in Germany, the far-right Alternative for Germany party will continue to gain in the polls, despite being leaderless. In both countries, the populists' growing clout will force establishment parties to amend their political platforms or suffer the consequences.

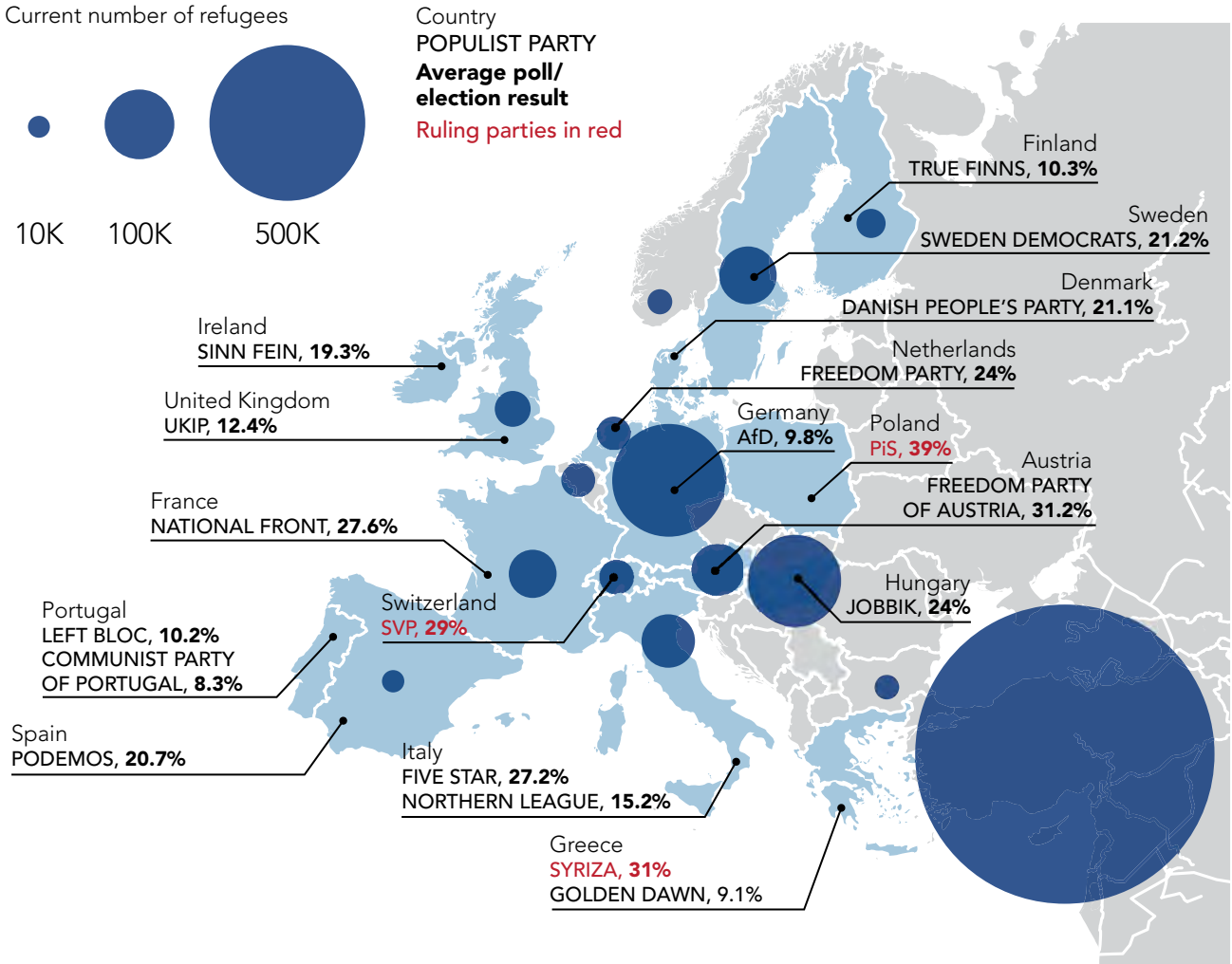
A weaker Merkel will make it more difficult for Europe to address its challenges

Brexit is also a significant risk. British Prime Minister David Cameron is not going to secure major reform from the EU, hurting his ability to make a strong and positive case for keeping the United Kingdom in Europe. Combined with a complicated British industrial and hedge fund relationship with the continent that will see the “Out” campaign better resourced and more effectively led than the “In” campaign, plus a divided conservative party, this will mean an increased likelihood of vote in favor of exit in the upcoming referendum, now expected in June (we see the odds of Brexit at roughly one in three). Concern about the real possibility of exit will lead the headlines for months and roil the markets.

And fat tail risks are growing. In 2015, Europe already experienced its own “9/11” terrorist attacks in France and Turkey. That’s not a coincidence. More dangerous attacks on Europe are likely, further exacerbating political divisions.

“Europe whole and free” is the greatest democratic experiment ever undertaken. It’s about building open societies and enshrining common values into law to avoid war. The economics of Europe will hold together in 2016. Its broader meaning and its social fabric will not.

Populism is surging as refugees bring increased political pressures



Sources: Eurostat, United Nations High Commissioner for Refugees, Eurasia Group



With \$3.5 trillion in reserves, the world's second largest economy, and a willingness to spend internationally, never in modern history has a country at China's modest level of economic and political development produced such an expansive global footprint. And China is putting its large economy and its global economic presence to good use—advancing its interests along the “Silk Road.” Its “One Belt, One Road” strategy seeks to modernize partners’ road, rail, and port infrastructure and is already putting smiles on the faces of leaders in 64 nations. The Asian Infrastructure Investment Bank will begin operations this year as the first international financial institution developed from scratch by Beijing.

Yes, Chinese growth is slowing, and there is urgent need for deeper economic reforms. But this slowdown is not hindering China nearly as quickly as Beijing's impact on the rest of the global economy is expanding. A confident President Xi Jinping has recognized China's overdue need to drop the “small, poor, misunderstood teenager” routine in order to defend its interests. Beijing is moving from free-rider and rule-taker to ever more influential rule-maker.

There is active state support for short-term commercial tactics through state-owned enterprises and privately owned national champions. There will also be longer-term strategic economic plays—like pressing for Chinese standards to compete with “universalist,” US-supported ones. Together, these and other instruments in the Chinese toolkit are creating new sources of geopolitical tension: an unprecedented partnership with Russia, friendships in Europe that raise new and uncomfortable questions in transatlantic relations, and ties with Asian countries whose leaders who face an increasingly difficult balancing process between Washington and Beijing.

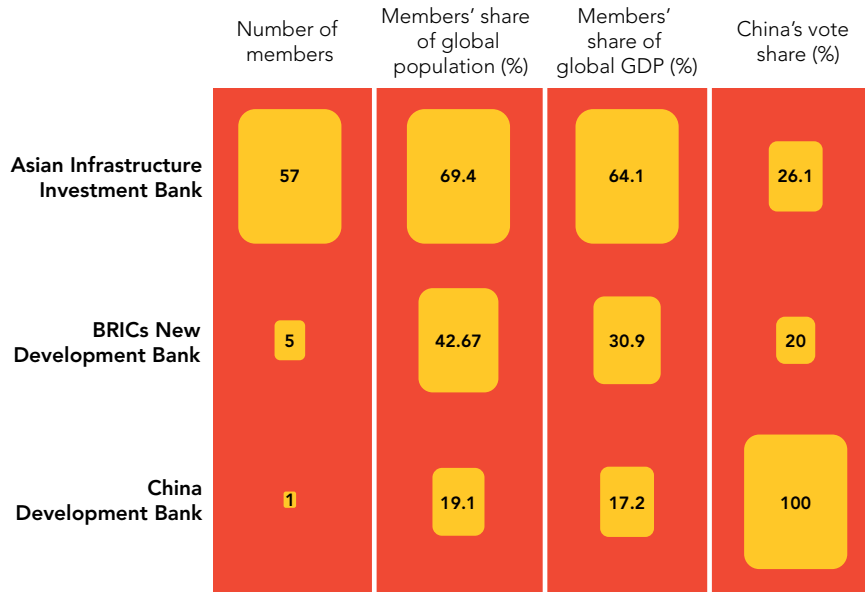
China's global footprint is primarily based on the country's economic prowess. But improving cyber/information technology and military capabilities also play a growing role. The former are nearing parity with those of the United States (though with a different intent than Washington's). The latter are still mostly focused in Asia—on Taiwan and the South China Sea—but are unmistakably expanding.

Here is the risk: Many countries all over the world now recognize that China is both the most important and uncertain player for a wide variety of critical outcomes. This is unnerving those that are more exposed to China than ever before... but aren't ready for this change, don't understand or agree with Chinese priorities, and won't know how to react to this new state of

Beijing is moving from free-rider and rule-taker to ever more influential rule-maker

affairs. Combine this with the reality that a dramatically transforming Chinese domestic environment (four times more corruption investigations in 2015 than in 2011 and financial reforms that will create blowback) and the situation will have an outsized impact on the international marketplace. When China now flexes even the little finger of its economy, global markets will react. In 2016, perceptions of China will be the most important macro driver of change in the global marketplace.

Chinese financial institutions are a key component of Beijing's global economic strategy



China's global footprint will continue to grow

- China has been responsible for approximately **one-third** of global growth for the past seven years.
- Chinese imports and exports account for more than **10%** of global goods trade. **124** countries trade more with China than they do with the United States.
- In 2014, China was responsible for **27%** of global carbon emissions.

Sources: Asian Infrastructure Investment Bank, BRICs New Development Bank, China Development Bank, Financial Times, Global Carbon Project, IMF, Eurasia Group



ISIS is the world’s most powerful terrorist organization. The international responses to its rise are inadequate, misdirected, and at cross purposes. For 2016, this problem will prove unfixable, and ISIS (and other terrorist organizations) will take advantage of that.

The overwhelming majority of the response, and the debate on what more to do, will center on military solutions—bombing, special forces, arming the opposition, and boots on the ground. The United States and Russia will remain largely at odds over support for the Assad regime, and the Saudis and Iranians will remain on opposite sides in terms of local proxies. Every marginal inch of IS stronghold will grow harder to regain. And even while military action will loosen the Islamic State’s grip on territory, international support for ISIS as a terrorist organization will only grow.

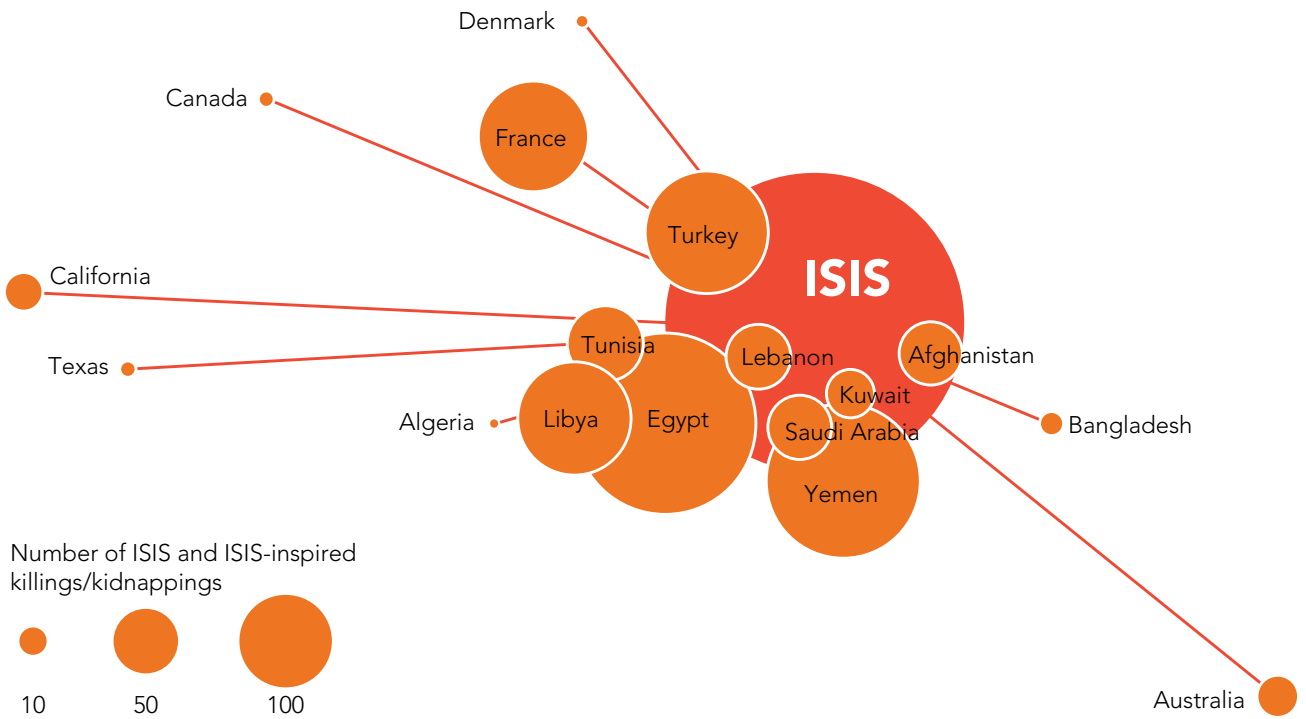
That’s in part because the roots of ISIS now reach well beyond the borders of Iraq and Syria (into Libya, Afghanistan, Yemen, and Mali, as well as Sunni populations across the broader Middle East, Russia, and Europe). Its technological capabilities allow the organization to function effectively in a more decentralized way than Al Qaeda, and the core demand that ISIS is satisfying among disenfranchised young Sunnis can’t be addressed militarily.

For progress, we would need to see change in the economic, social, and cultural opportunities afforded these populations. But 2016 will tip the needle in the other direction. Insecure Sunni governments (and Iraq) will focus more on security, less on liberalization and economic reform. Depressed oil prices will make matters worse. Hostile responses in Europe to a mounting refugee crisis will make clear that displaced Syrian and other populations are increasingly unwelcome either in Europe or in countries along the road. Humanitarian aid will help but remain inadequate to the task, while leadership on accepting additional refugees will fall dramatically short.

And so the threat from ISIS—as well as from Al Qaeda, Boko Haram, and new groups—will increase over the course of 2016. The most vulnerable states will remain those with explicit reasons for ISIS to target them (France, Russia, Turkey, Saudi Arabia, and the United States—particularly US assets in the region), and those with the largest numbers of politically and socially alienated Sunni Muslims (Iraq, Lebanon, Jordan, Turkey, Egypt, and European countries).

The threat from ISIS—as well as Al Qaeda, Boko Haram, and others—will increase

ISIS roots extend beyond Iraq and Syria; the threat of new attacks will continue to grow



Sources: New York Times, Eurasia Group



The Saudi kingdom will face growing and destabilizing discord within the royal family this year, and will be increasingly isolated internationally. This will lead Saudi rulers to act more aggressively in their near-abroad and will further heighten instability in the Middle East.

The threat of intra-royal family strife is on the rise. A scenario of open conflict, unimaginable prior to King Salman's January 2015 ascension, has now become realistic. The core problem is that Salman has moved boldly to empower his 30-year old son, Mohammed bin Salman, almost certainly in preparation to make him heir apparent, fueling frustration among competitors within the royal family. This rivalry is unlikely to lead to near-term Saudi collapse, but the credibility of this scenario—and the general trend of growing instability—in a nation critical to the global economy make it a top risk.

Salman's radical reshaping of power within the family is happening in a Saudi Arabia grappling with \$40 oil, negative demographics, and an undiversified economy. The era of power-sharing among a small number of brothers has been replaced with one in which a shrinking pie is divvied up among hundreds of cousins. The risk is that a group of princes could strike back by attempting to oust bin Salman from his position as deputy crown prince, or by publicly opposing the king. Political instability in a country that produces roughly 10.5% of global oil production would pose significant risk to every market participant.

Meanwhile, Saudi Arabia is more geopolitically isolated than at any other point in the last several decades. The announcement of a Sunni "Islamic military alliance" is mostly window dressing. Members of this diverse group don't have the political will or mutual trust to develop a military arm to confront the Islamic State, and several of them, including Pakistan, apparently didn't know they'd joined when the alliance was first announced. That aside, even the most deafening declaration of political collaboration can't obscure the fact that Saudi Arabia is losing influence over its historic Sunni allies.

Riyadh's Egyptian and Pakistani partners dodged requests to support the kingdom's military intervention in Yemen. Key Gulf Cooperation Council states (and ostensible Saudi allies) are hedging their positions in relation to an ever more influential Iran. OPEC is in shambles. Egypt has backed Moscow's pro-Assad intervention in Syria, directly opposing the kingdom. Turkey hews to a position closer to Riyadh's, but is also an increasingly infuriating competitor for leadership of the Sunni world. The Iran deal and US response to the Arab Spring leave Saudi leaders questioning the depth of America's commitment to their security.

Saudi Arabia is more geopolitically isolated than at any other point in the last several decades

The key source of Saudi anxiety is Iran. Iran's supreme leader, Ayatollah Ali Khamenei, views escalating tensions against the Saudi kingdom as a particularly useful way to whip up political support at home. The threat will intensify because, soon to be free of sanctions, Iran's economy will strengthen, and its government will have more money to spend in support of regional clients. And unlike Saudi Arabia's, Tehran's alliances are consolidating: Iraq is drawing closer, and it is likely Assad will be around a good while longer.

A more isolated Saudi Arabia will double down on protecting its interests, and will be sorely tempted to act upon the saying that offense is the best defense in 2016. Riyadh will continue to support anti-Assad rebels in Syria, and ramp up that aid, despite the opposition's inability to effectively challenge the Syrian president. Even a shooting war with Iran is possible in extremis; the kingdom will push back wherever it views Tehran to be gaining an advantage. More generally, expect an isolated and domestically weaker kingdom to lash out in new ways.

Intra-royal family discord will threaten the stability of the Saudi kingdom





A variety of highly influential non-state actors from the world of technology are entering the realm of politics with unprecedented assertiveness. These politically ambitious technologists are numerous and diverse, with profiles ranging from Silicon Valley corporations to hacker groups and retired tech philanthropists. This trend will create three major risks for 2016 and beyond.

First, because these actors are opaque and lack the traditional constituencies that help us predict the actions of most political actors, they will be difficult to understand and assess and hard to work with or against. The declaration of war on the Islamic State by cyber-collective Anonymous following the 2015 Paris terrorist attacks makes for a revealing case study. In principle a welcome development, the hackers' past excesses left many observers unsure whether to applaud the new initiative or ignore it. In many ways, "non-government relations" will be harder to manage than government relations ever were.

Second, as these technologists grow more politically active, their influence will undermine government policies. The US tech industry has embraced Chinese political leaders at exactly the time when Washington has sought to take a more resolute stance against Beijing's cyber-offenses. This is a clear example of the private sector undermining official state policy. Alibaba Chairman Jack Ma's calls to create an industry-led "WTO 2.0" is another signal of growing private sector ambitions that could raise unsettling questions about the future of an already messy global governance architecture.

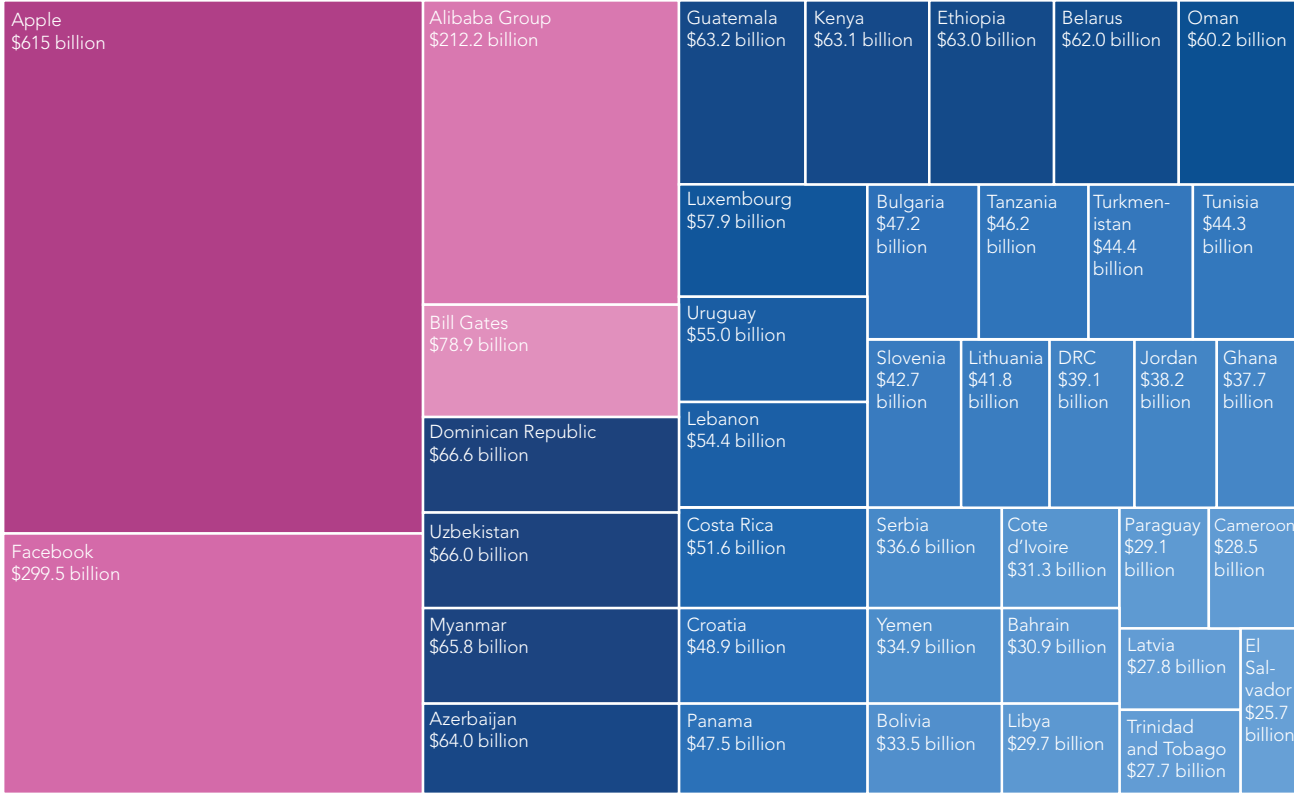
Finally, the political rise of these actors will generate pushback from governments and citizens when they finally realize just how powerful these technologists have become, creating further policy and market volatility. There's little doubt that the European Union's scrutiny of American tech giants has been driven, in part at least, by a tacit mandate from European populations to corner companies so distrusted that they've been assigned their own acronym: GAFA (Google, Apple, Facebook, and Amazon). Meanwhile, from Moscow to Beijing, a rising awareness of the unprecedented reach of figures as "innocuous" as bloggers and e-salesmen has led authorities to view local technology stars with growing suspicion. That's true even for those who are the most celebrated today. (Think back to the rapidly changing dynamic between the Kremlin and Mikhail Khodorkovsky.)

There's much to be celebrated in the increasing power of the most technologically influential. Look to the recent creation of a non-state anti-climate change coalition by former tech CEO Bill

As technologists grow more politically active, their influence will undermine government policies

Gates, illustrating the most promising breakthroughs that could come from the drive by technologists to exert both social and political power. Governments witnessing this evolution will surely play along when they find it advantageous. But more often than not, the political rise of technologists will create conflicts between competing centers of power.

The resources of some technologists surpass those of small countries, giving them significant political power



Pink rectangles represent company market capitalizations and the net worth of individual technologists; blue rectangles represent the GDP values of an assortment of smaller countries

Source: Forbes, MSN Money, IMF World Economic Outlook, Eurasia Group



An unusually wide constellation of leaders known for erratic behavior will make international politics exceptionally volatile this year. Russia’s Putin and Turkey’s Erdogan are leaders of an unruly pack that includes Saudi Arabia’s Deputy Crown Prince bin Salman and—to a lesser but important extent—Ukraine’s Petro Poroshenko.

This crew has a proven tendency to pursue loose-cannon foreign policies. We know Putin loves bolt-from-the-blue moves, such as taking Crimea or swooping into Syria with a chemical weapons deal when Obama faced the unpleasant political consequences of dodging his own red line. Erdogan just shot down a Russian fighter jet. Bin Salman unexpectedly announced a new Islamic alliance against terrorism, veering away from Saudi Arabia’s laser-like focus on Iran. And Poroshenko has at multiple junctures in his crisis with Russia shown a penchant for military options against a much stronger enemy.

Why the unpredictable behavior? Several reasons. Some of these leaders have a need, indeed a craving, to attract attention to themselves. Erdogan and Putin are notoriously big-headed, and young bin Salman has to establish his credentials. Some tend to put personal considerations above national interests: Erdogan wants an executive presidency, bin Salman wants a throne. No matter that both are pursuing these goals at the cost of increasing their countries’ exposure to regional shocks. Finally, these leaders all benefit from a dearth of domestic institutional constraints on their freedom of maneuver.

A number of geopolitical risks will rise from these personalities this year. Expect a high density of black swans flying around—what you don’t know may well hurt you. The situation will be aggravated by the fact that Poroshenko, bin Salman, and Erdogan all feel they have been abandoned by Western leaders whose attention they will only be able to regain through actions too loud to ignore. And they’ll act.

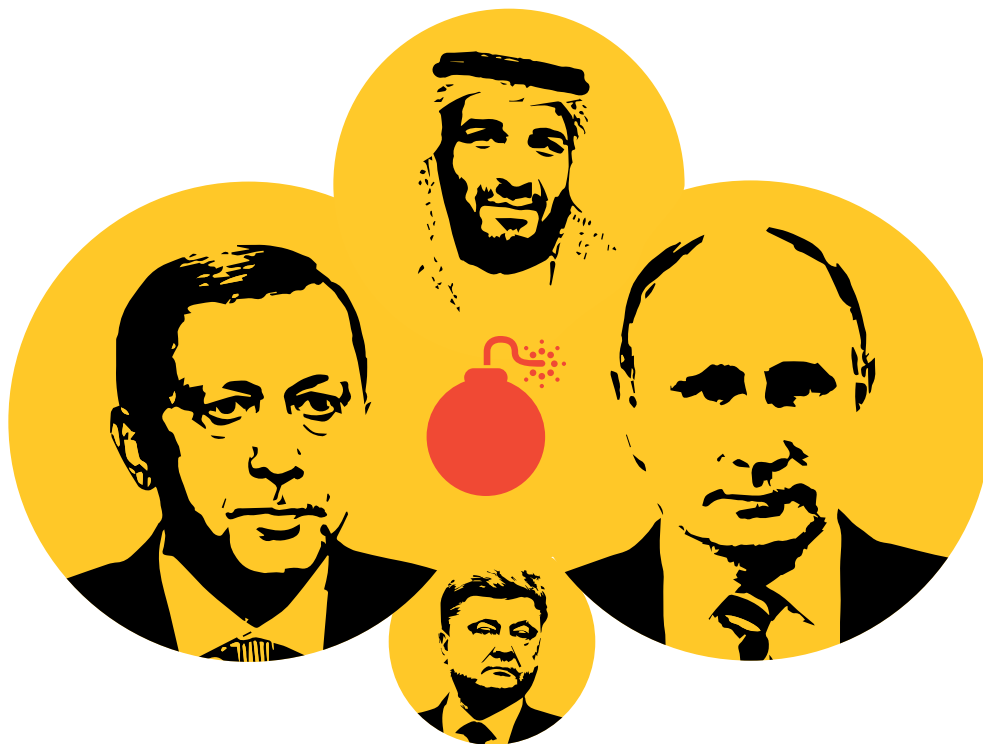
The majority of these leaders play a role in the Syrian conflict, and their interests diverge. Erratic personalities increase risk as the Levant’s tragic conflict enters a crucial passage this year. The blood feud between Saudi Arabia and Iran will also rear its head in one of the array of the region’s proxy conflicts; bet on bin Salman’s need to show “maturity” playing out in an erratic way. All of these leaders have good access to military and paramilitary proxies, giving them an easy way to go erratic while keeping their fingerprints off the result. Putin will not outdo himself by invading a new country, but he will keep pressing where he wants.

Unpredictable leaders have a tendency to pursue loose-cannon foreign policies

Poroshenko is more of a victim than the other principals here, but his risk-taking nature could well spur unexpected troubles. The conflict with Russia will likely freeze over during 2016, the EU will probably ease its sanctions, and Poroshenko could get much of the blame for the failure of the Minsk peace process. There's a risk he'll throw caution to the wind and start shooting, causing Putin to shoot back with a lot more ammunition.

These unpredictable leaders make our list this year because their interventions overlap and conflict. One powerful, erratic leader spells trouble; four spell volatility for the international system, and a lot more turmoil.

A constellation of unpredictable leaders signals greater international volatility





Brazil is in the midst of a deep, multi-year recession, and President Dilma Rousseff is fighting for her political survival as she faces a motion of impeachment in congress.

As much as the Brazilian stock market and currency have suffered in 2015, the country's political and economic crisis is set to worsen over the course of 2016. Contrary to hopes among pundits and many market players, the battle over Rousseff's impeachment early this year is unlikely to end the current political stalemate.

Should the president survive, which still seems likely, her government won't gain the political boost necessary to move on the economic reforms that are critical to tackling the country's growing fiscal deficit. To ensure the support she needs in congress to stave off an impeachment, Rousseff will have to make concessions to her leftist base. Those overtures will weaken her fiscal agenda and explain the decision to replace her orthodox finance minister Joaquim Levy with the less fiscally hawkish Nelson Barbosa. Meanwhile, Vice President Michel Temer has mobilized a large segment of his Brazilian Democratic Movement Party (PMDB) in opposition to Rousseff, a division that will endure long after the impeachment question is settled.

Finally, the president will remain vulnerable to the sprawling "Car Wash" corruption probe into state-owned energy giant Petrobras and associated illicit political financing. This will shed light on new evidence of wrongdoing within her Workers' Party (PT) that could lead to new petitions for her impeachment. Rousseff's fortunes will fall even more quickly if her mentor and former president Luíz Inácio Lula da Silva feels the heat of these investigations and turns against Rousseff's politically contentious reform agenda. If Rousseff continues in office, she'll be a president increasingly captive to the radical elements of her party and hamstrung by an ever more antagonistic congress, leading to policy paralysis.

In the alternative (and less likely) scenario that Rousseff is ousted, an administration led by Temer won't fare much better. To be sure, a new government would benefit from an initial wave of optimism in the private sector. The newly empowered president would call for a national unity government, count on at least tacit support from the right-leaning opposition Social Democratic Party (PSDB), and propose structural economic reforms.

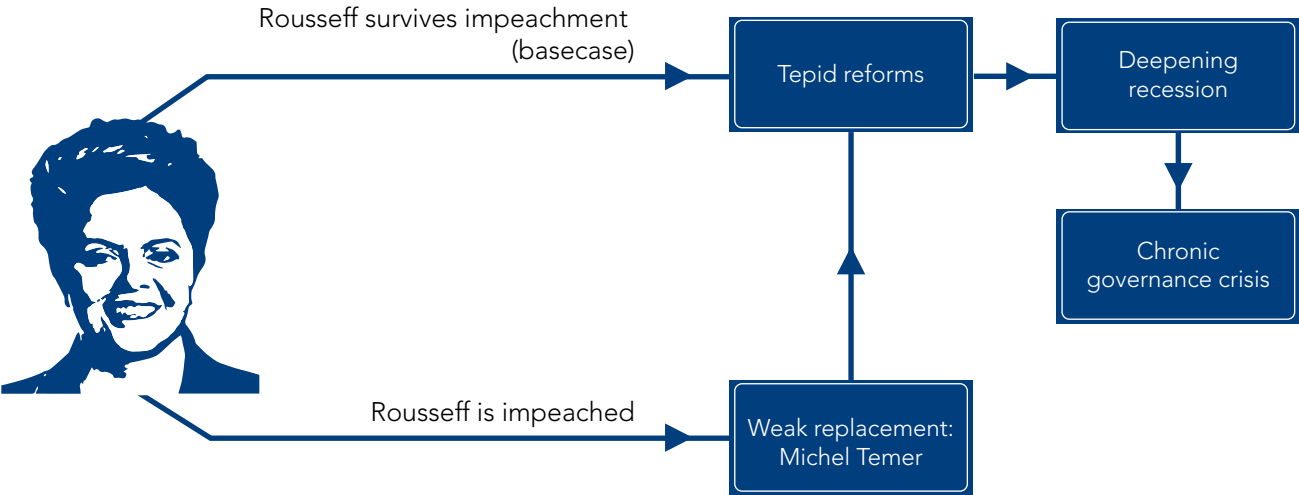
But Temer's liabilities would outweigh the upsides of his taking office. First, scrutiny by Car Wash investigators of the PMDB will grow, implicating members of his new administration and diminishing the incentives for the PSDB to continue lending him their already tepid support.

To ensure the support she needs in congress to stave off an impeachment, Rousseff will have to make concessions to her leftist base

Second, Temer will have to contend with a PT party by then staunchly in the opposition that is both eager to make him pay for Rousseff's downfall and express its discontent with his "neo-liberal" agenda. With unemployment rising to double digits over the course of the year, the new president's political room for maneuver would be sharply limited.

Paradoxically, the cleanest way out of the current political crisis rests in the hands of an apolitical body: the Federal Electoral Tribunal, which will be evaluating a case of fraud in the 2014 presidential election. Should the court find evidence of illicit campaign funding, it can call new elections within 90 days. While unlikely, such an outcome would have the benefit of bringing about a freshly elected president armed with newfound political legitimacy. But we're not betting on it. 2016 will be characterized by deepening crisis in Brazil.

Alternative scenarios will lead to deepening crisis



Source: Eurasia Group



Emerging markets underwent a historic cycle of national elections in 2014–2015, but this year there are relatively few opportunities for voters in these countries to make themselves heard at the ballot box. As slower growth and stagnating living standards stoke popular discontent, governance and stability will suffer. Of the larger emerging market democracies, only the Philippines and Peru will change heads of state in 2016. Russia's legislative elections will have little bearing on an overwhelmingly presidential system. Brazil and South Africa will hold only municipal elections.

Historically, markets have been less volatile in non-election years, but this time will be different. By raising popular expectations, the massive income growth that most emerging markets enjoyed over the past ten years has created conditions for a rude awakening. Economic trajectories won't live up to political promises. More than half of Latin Americans recently surveyed, for example, believe that their standards of living will continue to rise as fast as they have in recent years. Slower growth will make this impossible. At the same time, popular frustrations with corruption, spotty public services, and obsolete infrastructure are all growing, as protests in Brazil, Turkey, Chile, and Russia have shown over the past few years. The conspicuous absence of national-level electoral relief valves raises the risk of instability and dysfunctional governance.

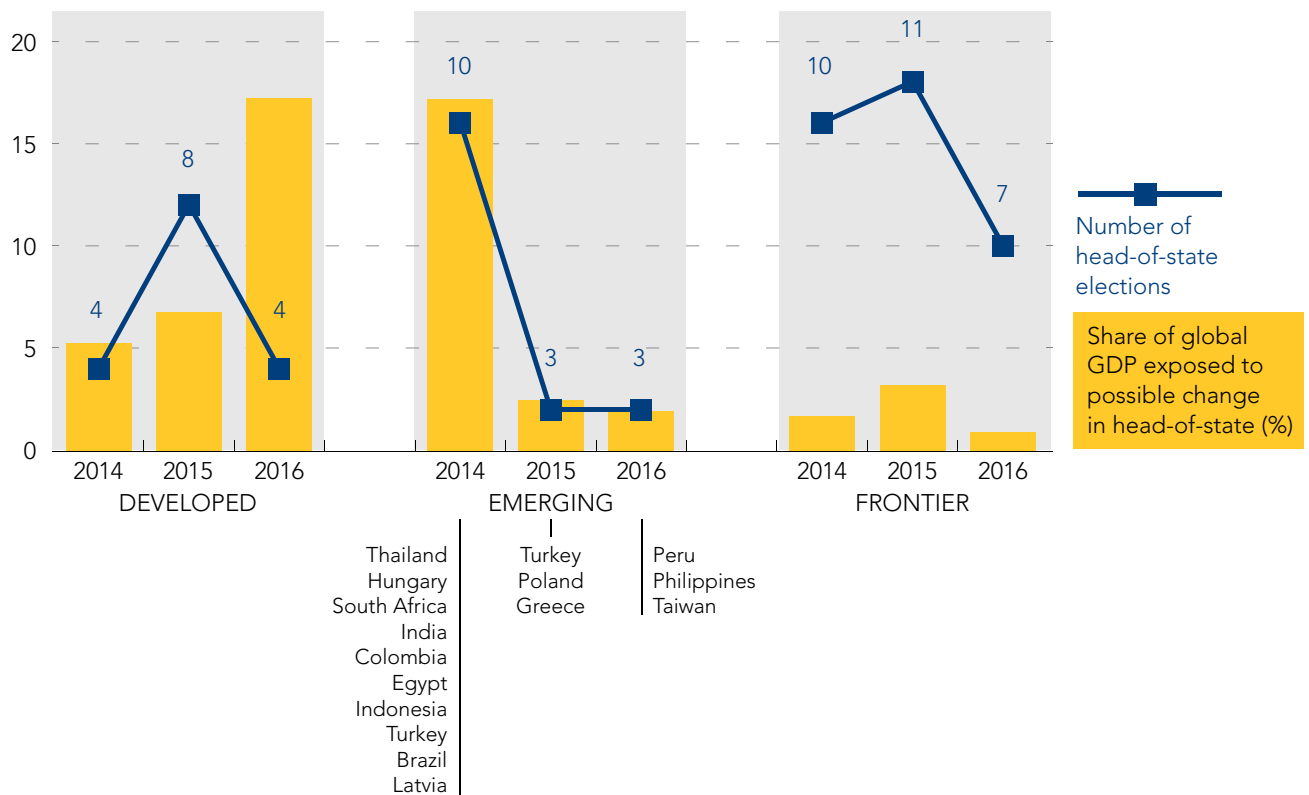
The first risk is the increased likelihood of street protests in Brazil, South Africa, and other emerging markets. Around the world, broader access to social media has made it easier for ordinary people to articulate grievances and act upon them. This isn't just true of emerging market middle classes, whose dramatic expansion over the past decade has fueled growing demands for quality healthcare, education, and infrastructure. It's also become true of historically marginalized groups such as rural communities organizing against natural resource exploitation, ethnic or religious minorities demanding fairer treatment, or the urban poor agitating for basic social support. The risk of protests is high in large emerging markets such as Brazil, where the Car Wash corruption scandal is exacerbating an economic meltdown that is driving up unemployment, or South Africa, where rising frustration with the incompetence and corruption of the African National Congress at the national level could stoke tensions around local elections this summer. Disillusionment with President Joko Widodo in Indonesia could become more pronounced as his reform promises get ever further bogged down, and the risks of a return to instability in Thailand remain real, particularly given the fragile health of the king.

There is an increased likelihood of street protests in Brazil, South Africa, and other emerging markets

The second risk is that disillusioned middle and working class voters will fuel the rise of non-mainstream parties with more reactionary agendas and force established political players to swerve in an effort to avoid political irrelevance. Middle classes are often thought of as forces for greater transparency and better governance. This is often true on their way up, but almost never on their way down. History shows that the fear of losing socio-political status is a fertile ground for reactionary reflexes. While a shortage of elections will limit the opportunity for populist voices to step into formal leadership roles, their agitation will further reduce incumbents' incentives to undertake the politically costly reforms that many emerging markets need. This trend has already begun to play out in the emerging market economies of central and eastern Europe and will likely deepen in 2016.

The soapbox is already competing with the ballot box across many parts of the developed world, leading to political results inconceivable just a few years ago. The danger comes when the same phenomenon takes off in emerging markets, whose weaker institutional resilience exposes them to more treacherous outcomes.

2016 will offer fewer elections for emerging and frontier markets relative to 2014–2015



Source: IMF World Economic Outlook, Eurasia Group



After a decisive victory for his Justice and Development Party (AKP) in late 2015 general elections, Erdogan will now work to replace the country's parliamentary system with a presidential one. Though the president is unlikely to reach his goal within the year, his electioneering in pursuit of this ambition will further worsen an already battered Turkish political, business, and investment climate.

Emboldened by his victory, Erdogan will continue to push the boundaries of Turkey's constitution by centralizing decision-making in his office. That will create strains in the Turkish body politic. It will dash all short-term hopes of an independent—and more moderate—power center led by Prime Minister Ahmet Davutoglu. Looking to enshrine his incremental power grabs, Erdogan will push increasingly loudly for a constitutional amendment. But attempts to secure the support of the 14-plus parliamentarians, which the president needs for a referendum on the issue, will exacerbate divisions within Turkish society, between political parties, and inside the AKP.

Meanwhile, the government's focus on currying favor with voters through economic populism will undermine attempts to address the country's structural economic vulnerabilities. The replacement of reform-oriented heavyweight Ali Babacan with the technically savvy but politically weak Mehmet Simsek as economic coordinator will give the upper hand to the numerous Erdogan loyalists who now populate the cabinet. Political pressures for a loose monetary policy will remain strong and will benefit from the likely replacement of central bank governor Erdem Basci with a more docile figure in April. Despite the announcement of impending structural reforms aimed at reassuring investors, policies focused on stimulating short-term growth through fiscal laxity will dominate the political agenda. The country's general business environment and rule of law will also suffer as Erdogan continues to crack down on domestic opponents in the media, business community, and bureaucracy, while the president's political allies will continue to capture most of the country's economic opportunities and enshrine rent-seeking as a dominant mentality.

The country's foreign policy will be infused with nationalism aimed at catering to Turks' increasingly conservative views in an attempt to bolster the president's referendum agenda. Erdogan's frustration with finding himself on the losing side of the Syrian conflict will lead him to pursue a more erratic course, projecting Turkey as the patron of Sunnis in Syria and Iraq and undermining Ankara's diplomatic ties with Baghdad and Tehran. While Turkish-Russian tensions are unlikely to escalate into open military conflict, the relationship will fail to normalize, and Russian sanctions will

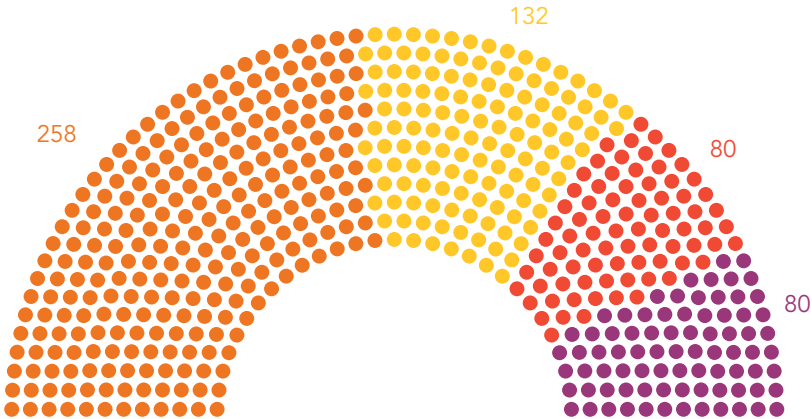
The government's focus on currying favor with voters through economic populism will undermine attempts to address the country's structural economic vulnerabilities

continue to hurt the Turkish economy at the margins. Finally, the promise of improvements in Turkey's relationship with the EU will bolster the president's domestic image as an international leader, but it will not lead to a significantly more constructive policy on the migrant issue.

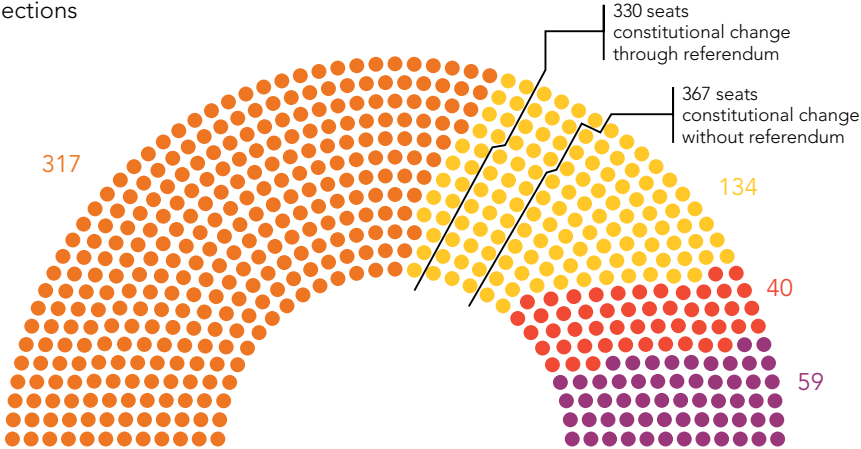
On the security front, there is little prospect of an imminent end to Kurdistan Workers' Party (PKK) violence as Erdogan seeks to gain the political upper hand through military action and the PKK's youth wing brings unprecedented violence to the conflict. At the same time, unrelenting US pressure on Ankara to clamp down on the Islamic State will produce only modest results but make Turkey more vulnerable at home to new attacks by ISIS. Sorry, Turkey.

A restored AKP majority will embolden Erdogan

7 June 2015 elections



1 November 2015 elections

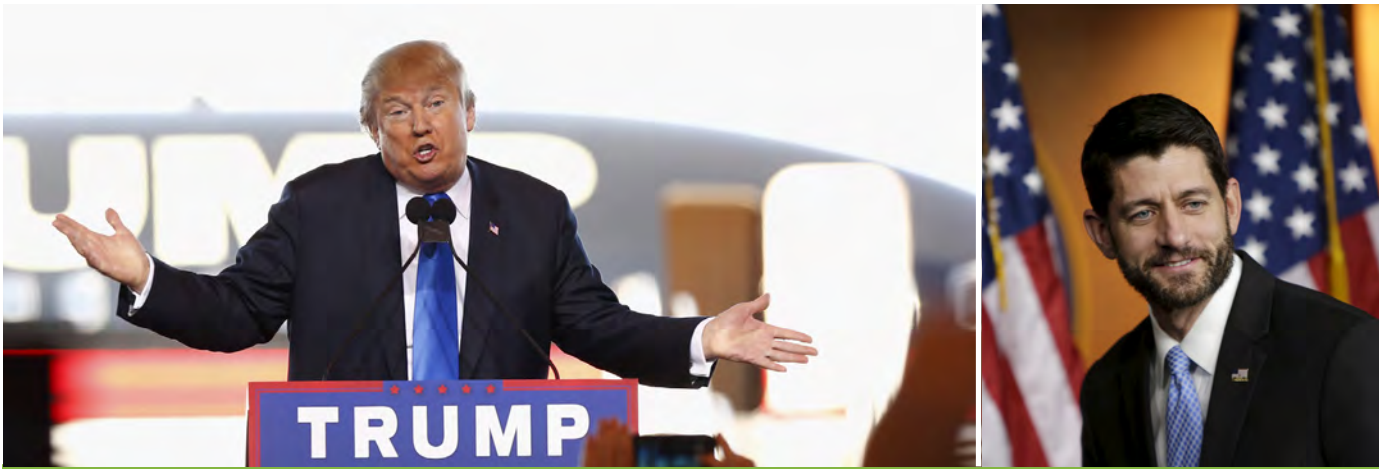


● AKP ● CHP ● MHP ● HDP

Source: Eurasia Group



RED HERRINGS



US ELECTIONS

The US elections have become the world's greatest political spectacle. Two years, two dozen candidates, about as many debates, and some \$10 billion in campaign costs. Populists have hijacked the Republican primary process: Billionaire Donald Trump has now led for nearly six months.

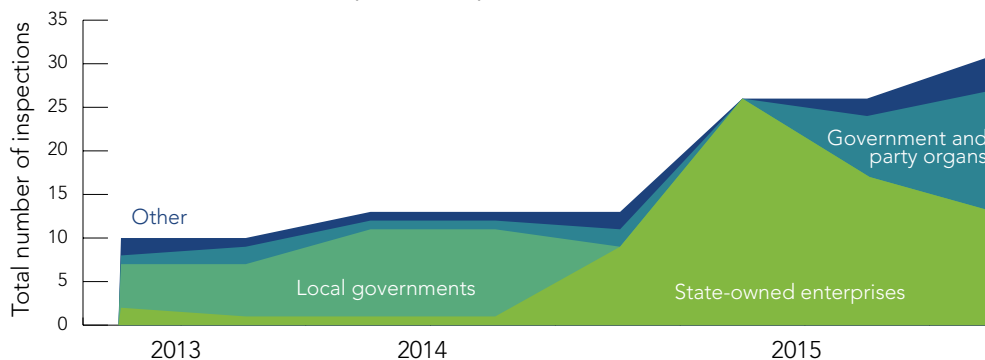
Does it matter? Hardly. We don't think Trump can be the nominee. Even if he is the nominee, he can't beat Hillary Clinton. And even if he did somehow beat Clinton, truly a lottery bet, his willingness and ability to deliver on his over-the-top campaign proposals (closing the borders to Muslims, building a wall at the border, a multitrillion dollar tax restructuring) wouldn't survive Congress or the courts. We're starting to worry about the ten-year horizon for the dollar, but for 2016 top risks, expect huge amounts of noise, plenty of punditry, and nothing substantive to see.

We don't think Trump can be the Republican nominee. Even if he is the nominee, he can't beat Clinton

CHINA: NO HARD LANDING

In 2016, China faces its most serious macroeconomic balancing act to date: allowing the renminbi to depreciate, opening the capital account, deleveraging the banks, and permitting corporate defaults to advance state-owned enterprise reform. That's on top of the complicated internecine politics of the anticorruption campaign and worsening pollution. Balancing these competing priorities creates plenty of opportunities for volatility, which will surely come this year. Still, China's leaders well understand the challenges, as well as the dangers to themselves, of unchecked social instability. If anyone has the political heft and resources to manage economic instability and prevent a genuine hard landing, it's Xi Jinping—even if it means kicking the reform can down the road.

China's central anticorruption inspections



Source: Central Commission for Discipline Inspection, Wall Street Journal, Eurasia Group

There's a very important macro point here. Many observers talk about global recessions arriving at an average of every seven or eight years in the postwar environment. Going forward, given the China footprint, recessions are increasingly likely to come from there (just as the post-2008 rebound was primarily China-driven). But given the country's political ability to stave off unrest, using political control and money in the bank, these cycles are likely to become longer. That's the good news. The bad news: When recessions hit going forward, they're also likely to be larger in magnitude.

ASIA GEOPOLITICS

As China rises, geopolitical risk across Asia will inevitably grow. But not this year. The region's top leaders, Japan's Shinzo Abe (hosting the Group of Seven meeting this year), India's Narendra Modi, and especially China's Xi (hosting the Group of 20), are now focused on stabilizing big power relations in Asia, not stoking tensions. With the entire regional economy slowing, it will be a year of more stimulus at home, less actions abroad. The opposite of Europe, where eroding political capital fosters insecurity, Asia's most worrisome conflicts are buffered by leaders who can focus on their top priorities.

And so despite plenty of tensions in the South China Sea—and continued posturing over Chinese-made artificial islands in that area—there's a limit to how far confrontation can go in 2016. So too China-Japan and South Korea-Japan relations, where none of the feuding governments is prepared to escalate the sort of political, diplomatic, or commercial conflict that might be bad for business. The exceptions are Taiwan and Hong Kong, considered internal issues by Beijing, and bringing little pushback from other powers. Indeed, the politics could be sufficiently strong to bring progress in conflicts historically seen as unyielding, raising the possibility, for example, that a politically unthreatened Putin could offer a deal for cash in Russia's longstanding territorial conflict with Japan. Even more dramatically, the personally unconstrainable Modi could throw his weight behind breaking his country's diplomatic impasse with Pakistan.

