TOP RISKS 2017:

The Geopolitical Recession

IAN BREMMER, President
CLIFF KUPCHAN, Chairman

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eurasia group politics first

Overview

IAN BREMMER, President
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It's been six years since we first wrote about the coming G-Zero world—a world with no global leader. The underlying shifts in the geopolitical environment have been clear: a US with less interest in assuming leadership responsibilities; US allies, particularly in Europe, that are weaker and looking to hedge bets on US intentions; and two frenemies, Russia and China, seeking to assert themselves as (limited) alternatives to the US—Russia primarily on the security front in its extended backyard, and China primarily on the economic front regionally, and, increasingly, globally.

These trends have accelerated with the populist revolt against "globalism"—first in the Middle East, then in Europe, and now in the US. Through 2016, you could see the G-Zero picking up speed on multiple fronts: the further deterioration of the transatlantic alliance with Brexit and the "no" vote on the Italy referendum; the end of America's Asia pivot with the collapse of the Trans-Pacific Partnership and the Philippine president announcing a break with the US; the Russian victory in Syria after backing President Bashar al Assad through nearly six years of war.

With the shock election of Donald Trump as president of the US, the G-Zero world is now fully upon us

But with the shock election of Donald Trump as president of the US, the G-Zero world is now fully upon us. The triumph of "America first" as the primary driver of foreign policy in the world's only superpower marks a break with decades of US exceptionalism and belief in the indispensability of US leadership, however flawed and uneven. With it ends a 70-year geopolitical era of Pax Americana, one in which globalization and Americanization were tightly linked, and American hegemony in security, trade, and promotion of values provided guardrails for the global economy.

In 2017 we enter a period of geopolitical recession.

This year marks the most volatile political risk environment in the postwar period, at least as important to global markets as the economic recession of 2008. It needn't develop into a geopolitical depression that triggers major interstate military conflict and/or the breakdown of major central government institutions. But such an outcome is now thinkable, a tail risk from the weakening of international security and economic architecture and deepening mistrust among the world's most powerful governments.

And the recession starts with…

1 Independent America

Trump's "America first" philosophy and his pledge to "make America great again" build on the most core of American values: independence. For Trump, that means independence from America's responsibility to play an indispensable role in world affairs, shaking off the burdens placed on the US by multilateral institutions and a range of allies. If there's not an obvious, near-term benefit for the US, or if it's the provision of a "public good" where others are free riding, it's not something the US should be doing.

This is not isolationism. As leader of the world's most powerful country, Trump rejects the comparative weakness of the presidency, and he wants to more directly project American power in service of US national interests. He's a resolute unilateralist.

Militarily, independent America doesn't signal a reluctance to use force, but a decisive willingness to use it to defend core US interests with less regard for the consequences for others: Trump has promised to "bomb the hell out of ISIS," extend surveillance capabilities, and otherwise leverage US coercive power to punish enemies. Independent America will be more hawkish than Barack Obama's foreign policy.

Economically, independent America translates into industrial policy—if the excesses of free markets allow corporations to capture the state, Trump wants to use the power of the presidency to turn the tables on key economic actors. He has a fundamental mistrust of existing free trade relationships and of globalist multinational corporations that he believes are enriching themselves without regard for the well-being of American workers. Trump will promote patriotism on both fronts—by squeezing bilateral relationships to create better terms for a more powerful America and by using carrots and sticks to convince corporations to invest more (and keep more jobs) in the US.

The shift is greatest on values: independent America renounces exceptionalism, the notion that the US actively promotes democracy, civil rights, and rule of law. Trump's approach toward alliances, and multilateral institutions more broadly, is transactional. Talk of common values can become a smokescreen that allows allies to take advantage of the US. And the US doesn't always live up to those values anyway. Alliances

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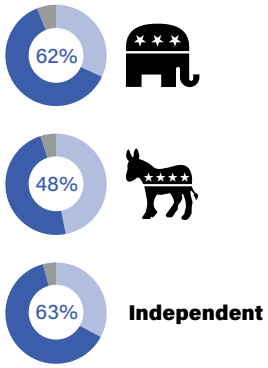
Domestic focus

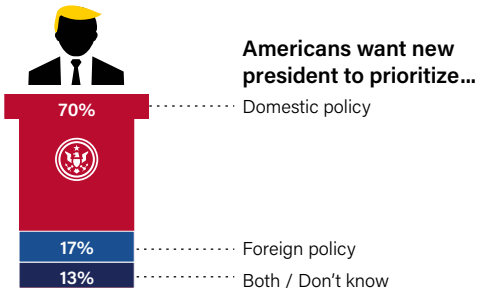
Americans want new president to focus on improving...



Note: Survey was conducted 12–19 April 2016

Source: Pew Research Center

Americans are looking inward



Note: Survey was conducted 12–19 April 2016
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should be more businesslike. They make sense only if there's a near-term "win-win." They should be more flexible in a rapidly changing environment and should not be limited by treaties that don't serve US interests in today's world (NATO, the One China policy, the Paris climate deal, the North American Free Trade Agreement).

There's a logic to these arguments that will make this change of direction "sticky" for much of the US public. A solid majority of Americans has little interest in continuing the country's role as world leader. They feel (correctly, in many cases) that they haven't personally benefited from global trade. A series of recent US military interventions has produced expensive failures, widely denounced in other parts of the world. Meanwhile, the growing geopolitical discord of the G-Zero represents a far greater challenge for other regions than for the US (think refugees and terrorism in the Middle East and Europe; territorial disputes and the arms race in Asia).

All of this creates several areas of political risk.

First and foremost is the near-term chaos that comes from an absent superpower. That's most evident in Europe, where Trump's political tilt toward Russia, his tepid support for NATO, and his alignment with like-minded and antiestablishment movements across the continent (France's National Front, the Netherlands' Freedom Party, and the like) further weaken what had been the most important alliance for protection of the global order. So too for the Middle East, where there's no single regional actor that can come close to providing stability and security, leaving competing state and non-state actors to drive further conflict.

Second is the broader weakening of institutional architecture. Independent America speeds the fragmentation of global trade and capital flows, a global internet, and a coordinated response on climate change. The US has been the primary funder and supporter of the world's core multilateral institutions, like the UN and the World Bank. With independent America, those institutions will come under greater political scrutiny and financial pressure as the Trump administration reexamines their usefulness to US national interests.

Third is the rise of China and the growing potential for direct conflict with the US. President Xi Jinping sees independent America as a core opportunity to advance China's security interests across Asia and its economic interests much more broadly. Xi's recent public speeches calling on China to be the new leader of globalization, his attendance later this month at the World Economic Forum's annual meeting (the first ever for a Chinese president), and his unprecedented support for the incoming UN secretary general highlights an inflection point for the "growing teenager" China, greater than its emergence on the world stage with the Beijing Olympics in 2008.

That rise will lead most US allies in Southeast Asia to shift allegiance toward Beijing, and it will create an expanded Chinese role in international economic governance (though mostly through more opaque, bilateral channels). But China's new opportunity to set rules and the Trump administration's search for "new and better deals" will also make it more likely that China will collide with US national interests. Add Trump's unwillingness to be bound by traditional avenues of diplomacy and the impact that will have on clear communication between the two governments. Xi will feel the need to respond decisively when he perceives key Chinese national interests at stake. We could see confrontation in a number of areas: over a US warming of relations with Taiwan, the growing nuclear threat from North Korea, or through economic tensions on currency, intellectual property, and trade as Trump's efforts at industrial policy are thwarted by the world's leading state capitalist economy (hence risk number two, China overreacts).

A final risk flows from independent America and system breakdown. It's that Russia can act as a rogue and disrupter—and get away with it. The "stiff" US response to Moscow's election-related hacking won't change President Vladimir Putin's behavior. He'll hack away at the French and other upcoming European votes. And the West won't want or be able to muster a serious response—Trump's not interested, and EU leaders are either too weak or tired of sanctions. Similarly, Putin will use his "win" in Syria as a springboard to increase Russian influence in the Middle East—with little pushback. Independent America leaves Putin with a lot of running room.

To quote former president John F. Kennedy: "Domestic policy can only defeat us; foreign policy can kill us."

2 China overreacts

China's scheduled leadership transition this fall will shape its political and economic trajectory for a decade or more. The scale of elite turnover before, during, and after the upcoming 19th Party Congress, combined with the divisive political environment that President Xi has fostered, will make this transition one of the most complex events since the beginning of China's reform era.

Two risks flow from the upcoming power consolidation. First, because Xi will be extremely sensitive to external challenges to his country's interests at a time when all eyes are on his leadership, the Chinese president will be more likely than ever to respond forcefully to foreign policy challenges. Spikes in US-China tensions are the likely outcome. Second, by prioritizing stability over difficult policy choices in the run-up to the party congress, Xi may unwittingly increase the chances of significant policy failures.

> Xi will be extremely sensitive to external challenges to his country's interests at a time when all eyes are on his leadership

The 19th Party Congress comes at a unique moment in China's development. Despite steady growth, the country's large economic imbalances continue to grow, its leadership has slow-walked new market reforms, and economic policy trade-offs are becoming more acute. Politically, fear and frustration among party and business elites are at their highest level since Mao Zedong's time. Xi consolidated power, marginalized opponents, and centralized decision-making so quickly that many in China question whether the tradition of rule by consensus applies anymore. The president's anticorruption campaign has sent shockwaves through a system lubricated for de-

cades by patronage and graft, and leaders in Beijing and the provinces are paralyzed by fear of becoming targets.

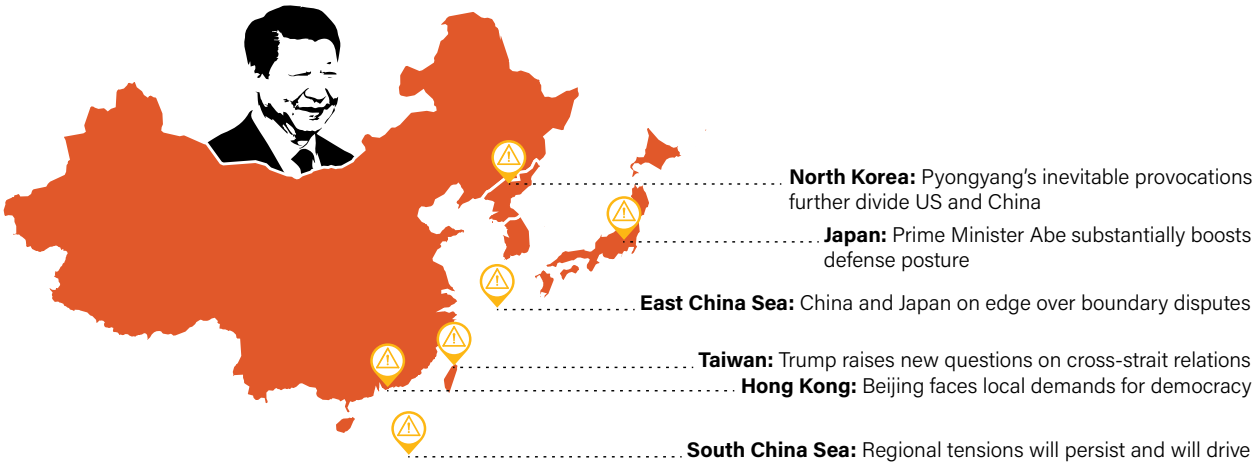
In this context, jockeying for power ahead of the party congress will be cut-throat. Xi is determined to promote his allies, but those who oppose his consolidation of power will view the congress as their last chance to block him. The stage is set for a year of intense internecine political combat.

In his drive to cement power, the president will put a premium on avoiding any event—internal or external—that could make him appear weak. That determination comes with consequences.

First, Xi's sense that he will have to respond resolutely to any foreign challenge to national interests—in a year during which popular and elite perception of his leadership matter more than ever—means foreign policy tensions will escalate. At the least, Xi will view any external challenge as an unwelcome distraction from his focus on domestic political machinations. At worst, he will fear such threats could undermine his standing at home. Consequently, the president is likely to react more forcefully than his potential challengers expect. And unfortunately for global stability, the list of triggers that could rattle the president is long: a newly-empowered Trump and his China policy, Taiwan, Hong Kong, North Korea, as well as the East and South China Seas.

Second, the intense focus on domestic stability means Xi may well overreact or stumble over any sign of economic trouble. This risk could take the form of a re-inflation of asset bubbles to boost domestic growth, or a substantial ramp-up in capital controls—either move would rattle foreign investors and international markets. Whatever form it takes, any misstep by Xi would provoke global economic volatility.

Flashpoints for China that could provoke an overreaction



Source: Eurasia Group

3 A weaker Merkel

This year will bring another wave of political risks in Europe, and some of them will surely materialize. Disputes over Brexit will distract and deepen mistrust between the UK and Europe; French elections could lead to the far-right euroskeptic National Front taking power; the Greek crisis will continue to simmer without resolution; Turkey's slide toward authoritarianism will continue while the country's refugee deal with the EU could easily come apart; and large-scale terrorism remains a far greater risk than anywhere else in the developed world.

Since the Eurozone crisis, Europe has benefited from the stalwart leadership of Chancellor Angela Merkel. Could the Europeans have resolved their financial crises without the Germans forcing a solution? Would the Eurozone even have stayed together? It's hard to imagine.

> Could the Europeans have resolved their financial crises without the Germans forcing a solution?

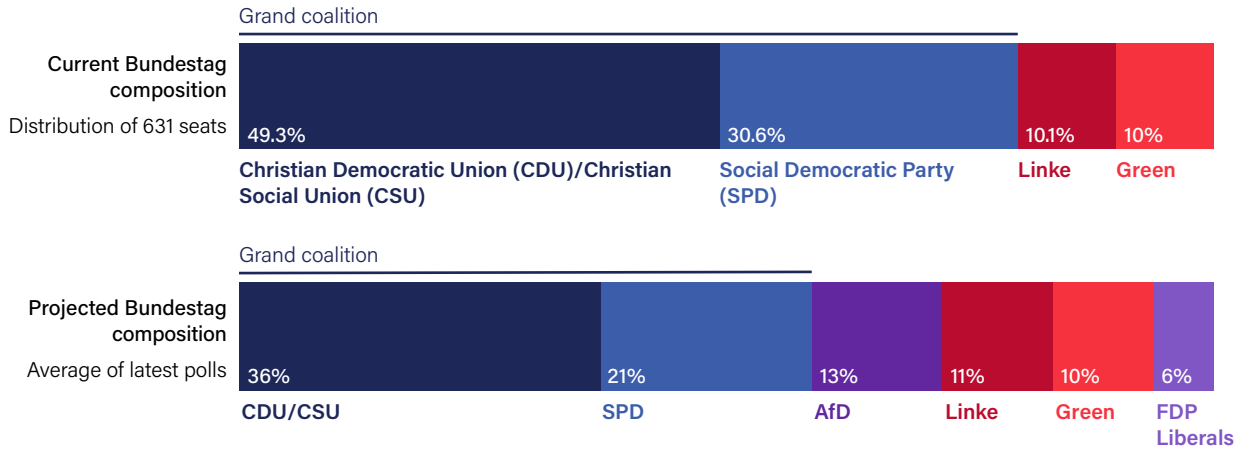
This year, we'll have to. Merkel has faced a series of challenges that continue to undermine her leadership. First, a refugee policy that lacks durable support at home and across Europe, a problem made worse by terrorist attacks and domestic incidents blamed on refugees. A series of corporate crises involving some of Germany's most important companies, such as Volkswagen, Deutsche Bank, and Lufthansa. Finally, the rise of populism has undermined support for her dream of a stronger Europe—both with stunning electoral victories across eastern Europe and in referenda in the UK and Italy and the rise of Germany's Alternative for Deutschland (AfD) party.

Of all the leaders in Europe, Merkel is the safest bet to win reelection this year. There's no strong challenger, and despite the obvious dangers of growing nationalism in the country, populism in Germany doesn't have the same economic implications it does across the continent, since the benefits of EU and Eurozone membership are clear to most Germans. So despite just how wrong the polls have been in recent major electoral contests across the developed world, Merkel will win a fourth consecutive term. But the need to appease domestic critics this year will leave her a diminished figure, impacting the quality of her leadership both at home and in the EU.

Merkel's geopolitical clout is eroding just as quickly. Obama didn't always deliver on his commitments, but the relationship was personally warm and diplomatically well aligned. Not so with Trump, who cares little for the values that are core to Merkel's leadership. When the US-Russia relationship comes back on line, other European states will see an opportunity to rebuild ties with Moscow. Brexit will remove British support for her leadership. The Italians, for a brief moment a stronger pro-EU force, will return to weak governments. In France, if Marine Le Pen is elected president and calls a referendum on EU membership, her government will become Merkel's antagonist. If Francois Fillon wins, Merkel will be dealing with a major ally that tilts toward Putin.

Europe has never needed a strong Merkel more. In 2017, she'll be unavailable for the role.

Polls show declining support for Merkel and her grand coalition



Note: Distribution of seats in the projected scenario was calculated as a proportion of approval ratings
Sources: Forsa (28 December 2016), Ipsos (24 December 2016), Emnid (24 December 2016)

4 No reform

Leadership will also be lacking this year on other issues, as political officials in both developed and emerging economies avoid structural reform, undermining prospects for growth and new opportunities for investors.

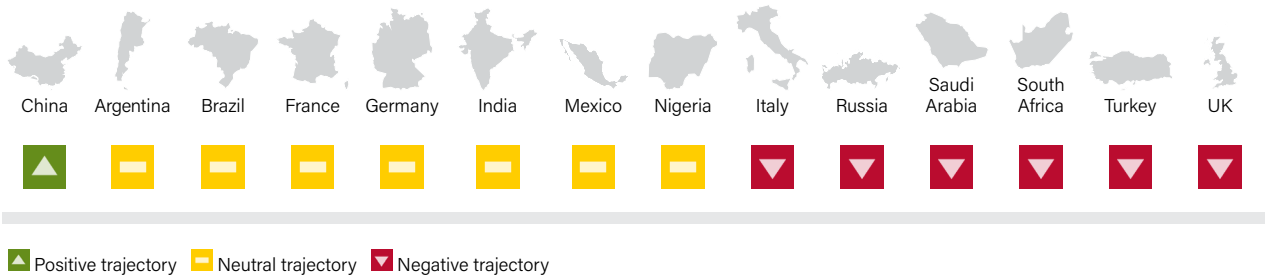
The drivers of this logjam fall into four categories.

First, some national leaders feel as though they've already done their part. In India, Narendra Modi will mainly be resting on his laurels after passing a milestone goods and services tax, implementing monetary and bankruptcy policy reform, and liberalizing FDI in many important sectors. This year, he'll turn his focus to winning state elections. In Mexico, Enrique Pena Nieto will look toward the end of his presidency, having already achieved energy, telecoms, education, and tax reform. He knows he has no mandate to add to this list.

> The reform needle won't move in 2017. Save for a few bright spots, money won't know where to flow

A second group will remain in a holding pattern until after major events on the political calendar. Preparations for China's fall 2017 leadership shuffle will further decelerate an already slow reform process before a new cadre of decision-makers gives it a fresh boost in 2018. Russia will continue to delay its most difficult spending cuts and tax hikes until after the country's March 2018 presidential election. And while France and Germany aren't exactly planning sweeping changes to their economies, even modest progress on labor and other reforms must wait until after their 2017 elections, in spring and fall, respectively. Argentina's Mauricio Macri may once again stick his neck out, but not before his mid-term election moment of truth in October.

Political outlook in world's major economies not supportive of major reform



Note: Eurasia Group's Political Trajectories capture analysts' forward-looking, net assessment of political risk and are intended to capture our bottom-line views on how politics will affect the macro business environment.

Source: Eurasia Group

In a third set of countries, genuine structural reform is not even on the agenda. In Turkey, President Recep Tayyip Erdogan's laser-like focus on consolidating power means easy money and the absence of painful reforms will continue. In South Africa, ANC infighting will eclipse any opportunity for reform. In Italy, a weak government won't have the "oomph" to systematically address banking sector reform and other key problems. In the UK, continued preoccupation with Brexit will prevent Prime Minister Theresa May's government from keeping her promise to "reform capitalism."

This leaves a final group with leaders that will show resolve but fall short of what's necessary. Saudi Arabia's Mohammed bin Salman will keep working on his country's fiscal crunch, but he still won't be able to overcome cultural obstacles that inhibit the kingdom's full economic potential. And Nigeria may see progress on its oil sector reform, anticorruption agenda, and security fronts, but Muhammadu Buhari will continue to falter on key monetary and fiscal issues.

The reform needle won't move in 2017. Save for a few bright spots, money won't know where to flow.

5 Technology and the Middle East

Despite a veneer of effective autocracy, Middle Eastern governments have been weak for decades. Most of the region's borders were created by Europeans and were never fit for purpose. Legitimacy largely came from the outside, and then from energy money. The US and its allies ensured security. Today, all of those things are in short supply.

Technology, a force for economic growth and efficiency, also exacerbates political instability

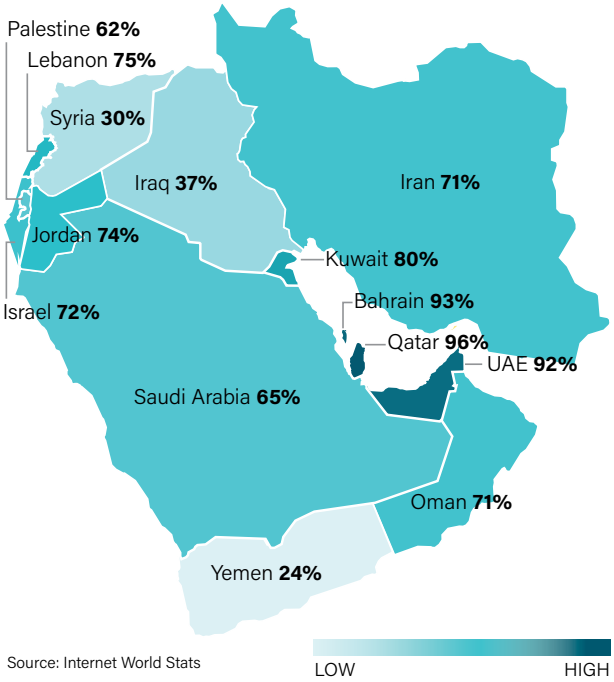
Technology, a force for economic growth and efficiency, also exacerbates political instability. In the Middle East, the latter outcome is proving dominant for several reasons:

Energy. The social contract across much of the Middle East is predicated on lots of cash, generated by the oil and gas sector, to ensure the loyalty of citizens. The model has been subverted by the energy revolution, which has enabled new fracking and enhanced recovery technologies in the US to quickly and substantially weaken OPEC. The trend will intensify, bringing prices down and undermining the legitimacy of many of the region's governments.

Connectivity. Globalization causes backlash in the West. Connectivity causes backlash in the Middle East. The Middle East has forces for social and economic progress, but alienated populations can now communicate their grievances more easily. Terrorists can recruit. And new tools of communication bring together like for like. Shia, Sunni, Kurds, and those who define their identities by tribal allegiance talk within the group, but not with other groups. Each group develops a world view completely distinct from its neighbors. All of this poses a real threat to existing regimes.

Cyber. Iran is one of the biggest users of cyber-weapons, and it is much less constrained than in the past. We're seeing a growing number of attacks on Saudi Arabia, with little effective reaction by the Saudis or their erstwhile allies, the Americans. Regional terrorists are developing new cyber-skills to challenge Middle Eastern systems.

Internet penetration



Source: Internet World Stats

Automation. The other primary asset in the region is its population: In economic theory, young and growing populations should be an advantage, but not when developments in technology are taking opportunities away from a region with critically undereducated youth.

Forced transparency. Wikileaks forced the resignation of the chairwoman of the Democratic National Committee and had an impact on the US election. The Panama Papers forced the resignation of Iceland's prime minister. What happens when forced transparency hits Saudi Arabia, and citizens find out about their leader's collusion with the West (and indeed how princes spend their money/behave in Dubai, London, and the US)? Brittle authoritarian regimes in the Middle East need secrecy to maintain stability. They're not going to get it.

6 Central banks get political

For the first time in decades, central banks face attack not just in emerging markets but in the US, the Eurozone, and the UK. Leaving aside the rationales that led to central bank independence in the first place, politicians have taken to blaming central bankers for political and economic woes of every sort. These attacks represent a risk to global markets in 2017 by threatening to upend central banks' roles as technocratic institutions that provide financial and economic stability.

Theresa May has blamed the Bank of England for low-rate policies that she says have hurt "savers" and increased income inequality. In Germany, Finance Minister Wolfgang Schaeuble has argued that low interest rates have reduced the incentive for peripheral European states to reform their unsustainable economic models. Trump accused the Federal Reserve of supporting Hillary Clinton during the US presidential election campaign. In each of these cases, overt politicization of central banking is breaking longstanding taboos in domestic political cultures.

> In the US, there's risk of an open conflict between the Federal Reserve and the White House

These pressures on central banks will become even more problematic in 2017 as a result of political and economic dilemmas looming in the US and the Eurozone, which together comprise close to 40% of the global economy.

In the US, there's risk of an open conflict between the Federal Reserve and the White House over the country's economic trajectory. President-elect Trump has promised fiscal expansion, which could lead to inflationary pressures and a strong dollar. Should the Fed respond by increasing interest rates faster and further than currently planned, this will create an internal contradiction at

What they are saying

"What they [the Fed] are doing is, I believe, it's a false market. Money is essentially free. She's [Janet Yellen] obviously political and doing what Obama wants her to do."

—Donald Trump, president-elect, 5 September 2016

"Indeed, the ECB's policies are 50% to blame for the surge of the populist, anti-immigration Alternative for Germany party, which grabbed a historic share of the vote at German state elections last month."

—Wolfgang Schaeuble, German finance minister, 8 April 2016

"Because while monetary policy provided the necessary emergency medicine after the financial crash, we have to acknowledge there have been some bad side effects."

—Theresa May, UK prime minister, 5 October 2016

the heart of a key element of the president's policy platform. Higher interest rates would undercut the housing market, while a strong dollar would have a negative impact on US exporters—undermining the president's high-growth promises.

Trump's response would likely be to blame the Fed for undercutting US prosperity, a move that would turn independent technocrats into political scapegoats and put new pressure on future Fed decisions. If the central bank were then to move with greater caution, the president might accuse it of allowing inflation to hurt Americans. Most critically, there's a risk that Trump will seize the opportunity presented to him by Chairwoman Janet Yellen's departure in January 2018 to replace her with a personal ally, a move that would undermine the Fed's reputation for years. It's a no-win situation for the Fed this year—its standing will take a hit no matter what.

In the Eurozone, the risk is that the European Central Bank (ECB) will not have the political support needed to rescue the ailing economies of peripheral states the next time the continent faces a shock. Since President Mario Draghi used his "whatever it takes" speech in 2012 to commit unwavering support to saving the Eurozone, the ECB has consistently come to the aid of Europe's economies in need. But this was never a popular policy with establishment figures, and it has only become more controversial of late, as illustrated by Schaeuble's tough recent comments. The risk now is that Draghi will not feel he has the necessary backing to bolster the Eurozone following a presidential victory for France's Le Pen or a Five Star Movement take-over in Italy, however unlikely these potential shocks might seem today.

7 The White House versus Silicon Valley

Trump has signaled that he is willing to take on US corporations, a move that's mostly about putting political points on the board by announcing better "deals" for the American people. Carrier, a maker of air conditioners, gets a tax break to keep a few hundred jobs in the country. Boeing and Lockheed Martin must sharpen their pencils to win government contracts. Ultimately, these are deals that are made to be signed. Corporate America and big banks are well represented on Trump's cabinet and are ideologically aligned with much of the policy he wants to pass. Trump will surely go after some high-profile organizations that he, for whatever reason, has a personal gripe with, and many of those companies will take a tumble. But that's a problem only for individual firms, not a structural issue.

Technology leaders from California, the major state that voted in largest numbers against Trump in the election, have a bone to pick with the new president

The conflict with Silicon Valley is different. Technology leaders from California, the major state that voted in largest numbers against Trump in the election, have a bone to pick with the new president. Aside from Peter Thiel, the valley's entrepreneurs have fundamentally different world views from the new president. Trump's political agenda leads with national security, while Silicon Valley's core ideology centers on freedom and privacy. Trump wants jobs, while Silicon Valley is driving workplace automation. And while support for science was one of Obama's strengths, it's at best a second-tier priority for the Trump administration, and at worst an inconvenient truth.

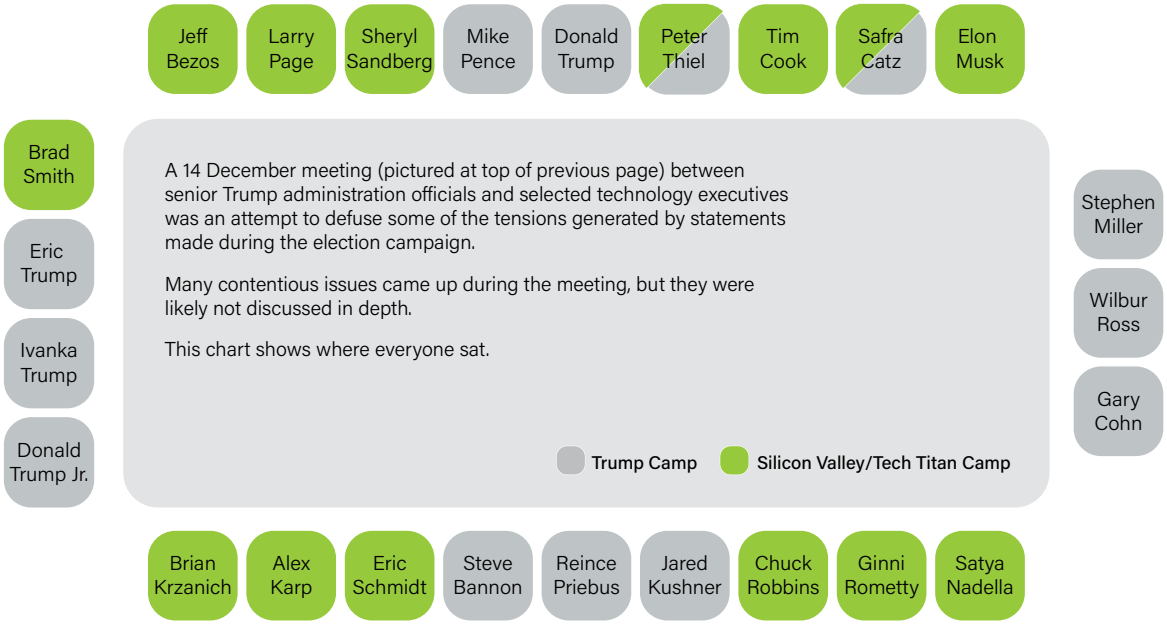
There are a few arenas in which this fight will take place. First is new media. Trump's mastery of social media, big data, and the ability to take advantage of algorithms for news and fake news was critical to his election victory. Silicon Valley chiefs were slow to recognize the problem (and a libertarian streak generally led to a "hands off" approach); but after Trump's election, information and new media firms made limiting the so-called alt-right's influence a top priority. That means trying to limit the spread of fake news and creating programs that cut off bots that act as individuals. Trump's preoccupation with the media makes this a critical area of concern for him. It's a direct threat to his ability to maintain his popularity—and the appeal of his brand—and one he'll feel the need to combat.

The flip side of this conflict is security. Trump sees political influence over intelligence and the broader national security complex as a key component of presidential power, and he would seize the opportunity to expand government control in response to terrorist attacks against the US or US assets abroad. (The terrorist threat is likely to grow, given that Trump's rhetoric creates targets for the Islamic State and other terrorist organizations.) That means we'll see more fights like the one between Apple and the FBI over access to data after the San Bernardino attacks. A constellation of IT firms will face off with the National Security Agency over potential security threats. This will create an early test of the privacy shield on signals intelligence activities (placing limits on bulk surveillance), which is up for review this spring. This is an area where Trump will likely push back, not least because it's a lever he can use to ensure more favorable treatment from new media.

And finally there's the jobs angle. During the campaign, Trump made the return of jobs a messaging priority, but he discussed the problem only in terms of globalization rather than technological change, which is now the far larger issue for US workers. As automation expands, Trump will need to address it. Firms that aren't friendly to him, especially those whose business models center on the use of artificial intelligence and taking labor out of the marketplace, will offer a juicy political target. Example: driving is literally the top one or two sources of employment in all 50 US states. And many of those jobs are set to disappear over the course of the Trump administration. It's hard to imagine Trump not directly going after the firms most easily vilified as responsible for job destruction.

It's not all open warfare. Trump's support for corporate tax reform and more streamlined government regulation will be welcomed by business leaders in Silicon Valley, just as elsewhere. And his anti-immigration policies are likely to hit Mexico, Central America, and the Middle East well before he considers the roll back of H-1B visas that would harm domestic industry. But for the most important driver of the American (and the global) economy, the political headwinds will come as a dramatic change.

The two sides square off



Source: Wall Street Journal

8 Turkey

Last July's failed coup has introduced greater political uncertainty and economic volatility in Turkey, as Erdogan continues to use the ongoing state of emergency to seize control of day-to-day affairs and tighten his hold on the judiciary, bureaucracy, media, and even business sector through waves of arrests and purges. Erdogan is now looking to legitimize his de facto expansion of powers, and with the help of the opposition Nationalist Movement Party (MHP), Turkey is likely to hold a referendum on that question this spring. Unlike other referenda on the continent, the vote should be a win for the increasingly authoritarian president. Erdogan's drive to centralize powers will exacerbate many of the existing pressures on Turkey's domestic governance, economy, and foreign relations.

Voters are close to evenly split on the question of expanding the president's powers, and Erdogan will have to mount an aggressive campaign to win. On the political front, that means the government will continue its witch-hunt against "Gulenists," and tighten its already strict control over government institutions and the media. On the economic front, Erdogan will face pressure to sustain populist, pro-growth measures at a time when tightening external liquidity conditions demand a rethink of economic policy. He'll press the central bank to keep rates low and rely increasingly on fiscal stimulus to offset slowing growth. Erdogan will avoid sorely needed structural reforms of taxes, labor, and pensions.

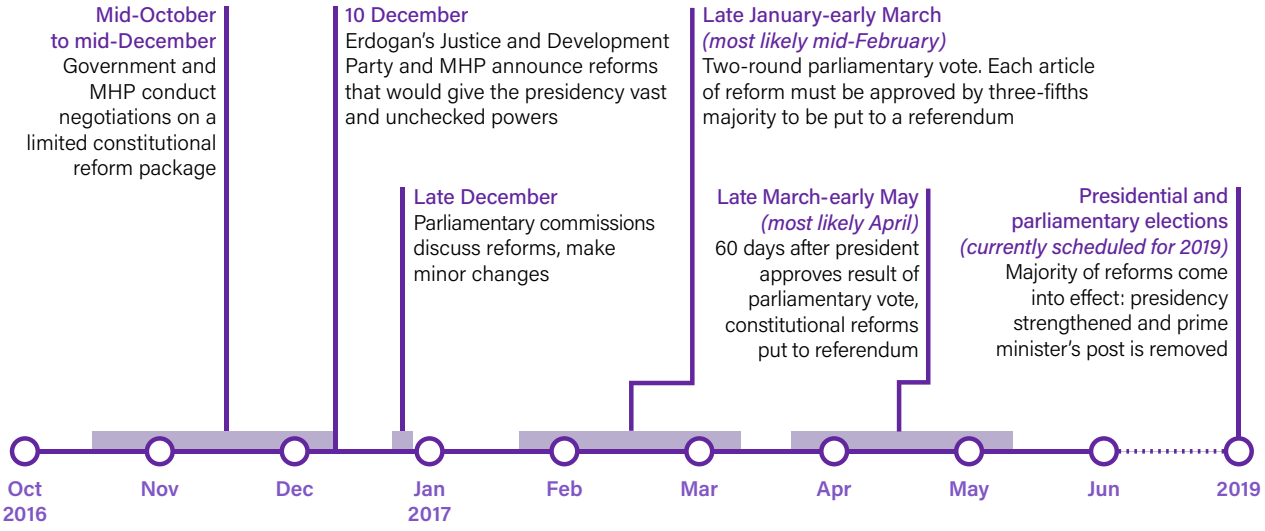
Ever-fewer checks on executive power will leave the private sector vulnerable to political whims

Meanwhile, ever-fewer checks on executive power will leave the private sector vulnerable to political whims, particularly given a politically compromised judiciary.

Erdogan's need to keep the support of nationalist voters will also increase security risks at a time when the military remains weakened by post-coup purges. He'll continue his hard-line stance on the Kurdistan Workers' Party—ruling out a return to viable peace talks—and its affiliates in Iraq and Syria. In both those countries, Erdogan is likely to overreach and alienate allies. And his hard line will stoke terrorism in Turkey. Similarly, while the EU-Turkey refugee deal is more likely than not to hold, Erdogan's repressive policies will keep his relationship with European partners on a ledge.

Finally, Erdogan's referendum victory is unlikely to offer much relief. The nationalist MHP has signed off on a reform package that includes almost every provision Erdogan wants for an unchecked executive presidential system. Yet, though most of these provisions won't go into effect until the next election in 2019, victory will embolden Erdogan to act as a de facto executive president and continue to overstep his formal powers throughout 2017. An empowered, post-referendum Erdogan will double down on his preferred policies, aggravating political, economic, and security risks.

Erdogan's march toward consolidation of power



Source: Eurasia Group

9 North Korea

2017 will be a big year for North Korea. That's not a good thing.

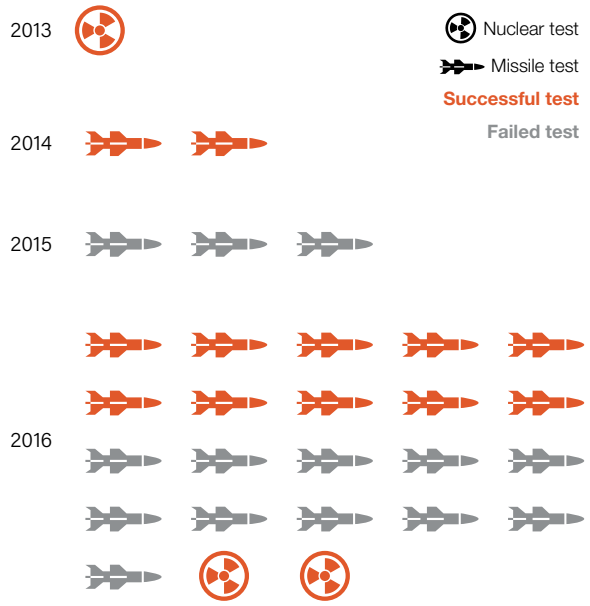
The North Koreans have substantially advanced their nuclear and missile programs and are set to expand them further. The hermit kingdom may have enough fissile material for some 20 nuclear weapons. It's getting closer to mastering warhead miniaturization technology, and thus possessing an intercontinental ballistic missile capability that could strike the West Coast of the US with a nuclear weapon. US policymakers consider this a red line (apparently the North Koreans hitting Alaska isn't particularly worrisome).

US policy continues to focus on complete elimination of the program: rollback, not just containment. In other words, North Korea has to get rid of all of its nukes. (As with "Assad must go" and "Russia must leave Ukraine.") Absent that, the US sanctions will be expanded.

> It's making consistent progress on an intercontinental ballistic missile capability that would allow it to hit the West Coast of the US with a nuclear weapon

There are two main risks. First, the Trump administration ramps up coercive action against North Korea, and this precipitates a crisis in US-China relations. The US pushes China hard to tighten sanctions. China, afraid of North Korean collapse, refuses. Washington goes ahead anyway, including with tough secondary sanctions that hurt Chinese banks at a time when its banking sector is not looking robust. Trump then makes threatening military moves.

North Korea kicks weapons programs into high gear



Source: Eurasia Group

This scenario unfolds in an environment where US-China relations are already deteriorating, over Taiwan and US trade actions. The result is a US-China crisis; Beijing rejects all Trump's actions. Japan is stuck on the US side, creating bigger China-Japan risks as well.

The second risk: South Korean President Park Geun-hye is forced from office and replaced with a center-left government that favors diplomacy with North Korea over coercion. The new South Korean government effectively cancels the terminal high altitude air missile defense system and refuses to work with the US on new sanctions and military options. A tough Trump response generates a crisis in the US-South Korea alliance that sends shockwaves through the rest of Asia at a time when Asian leaders are already questioning Trump's commitment to the region. This reignites Japan-South Korea tensions, especially if the new government in Seoul rejects Park's deal with Prime Minister Shinzo Abe on resolution of historical disputes between the two countries.

For the past decade, North Korea has been a problem but not a significant risk. That changes in 2017.

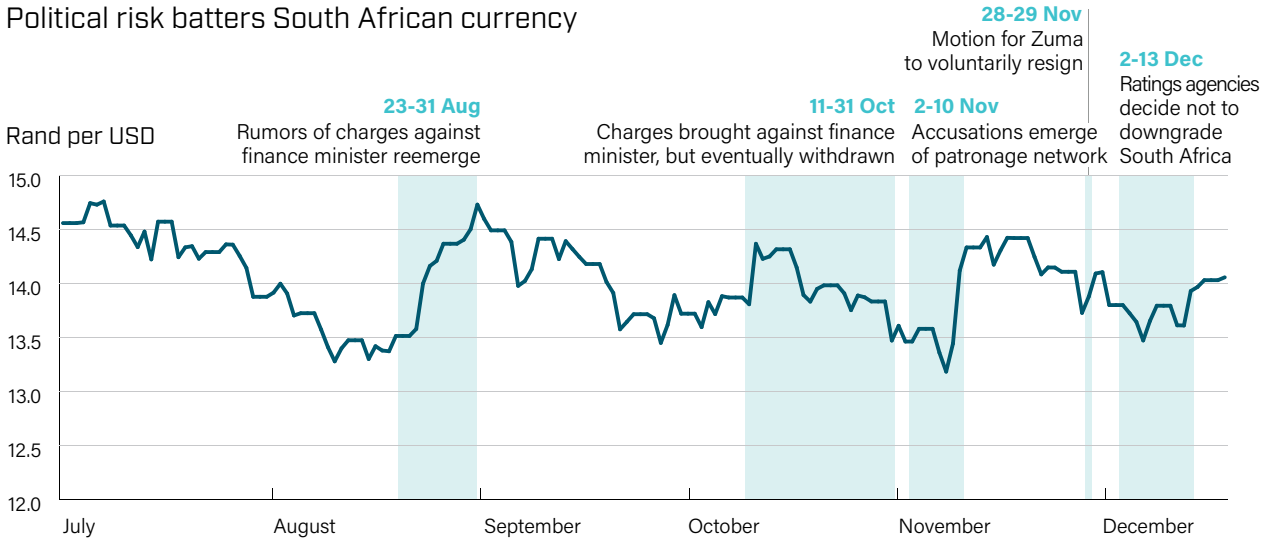
10 South Africa

The political crisis pitting President Jacob Zuma against opponents within and beyond the ruling African National Congress (ANC) will worsen in 2017, putting the South African economy at greater risk and damaging regional stability. Having narrowly averted challenges to his leadership in 2016, Zuma will focus on domestic battles and dig in his heels this year, preventing reformers from taking needed steps to restore the country's economic stability. Internal ANC discord will weigh particularly on state-owned enterprise management. State-utility Eskom holds the largest share of government guarantees, and its balance sheet will loom over the sovereign rating for the medium to long term, particularly with a Zuma ally, Ben Ngubane, serving as chairman.

South Africa's political infighting will undermine the country's traditional role as a force for regional security

Already-intense political infighting within the ANC will intensify in the run-up to the party's internal conference in December 2017 as Zuma and his entourage refuse to surrender privileges and the power that protects them. Having come under unprecedented fire in late 2016, the president will be even less inclined to accept a compromise candidate to take his place when he retires as ANC leader at the end of the year. Instead, Zuma will push for his wife, Nkosazana Clarice Dlamini-Zuma, or David Mabuza, a regional premier and political ally. Jockeying in the months leading up to this shuffle will also prevent reformers, particularly Finance Minister Pravin Gordhan, from implementing policy. Reform of the country's labor market, state-owned enterprises, and energy sector will remain all but out of reach, and it will become ever harder for Pretoria to avoid a credit rating downgrade.

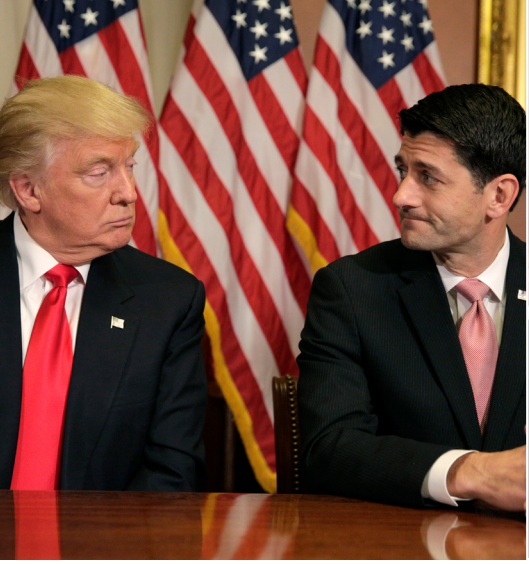
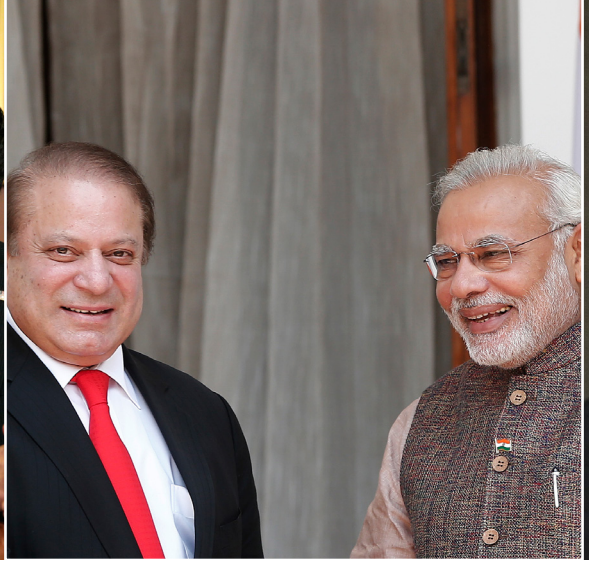
Political risk batters South African currency



Source: Bloomberg, 20 December 2016

South Africa's political infighting will undermine the country's traditional role as a force for regional security. This leadership failure is deepening at exactly the wrong time, because events in coming months will challenge regional stability. As Zimbabwe begins to prepare for its 2018 elections, this year will likely see a surge in opposition protests, which President Robert Mugabe will violently suppress. In 2008, then-South African President Thabo Mbeki helped broker a power-sharing deal when an election in Zimbabwe spun out of control. Today's divided and distracted South Africa is much less able to repeat that role.

In Mozambique, South Africa is a key member of the international mediation team tasked with keeping a lid on the country's growing political and economic troubles. But Pretoria will continue to play a limited role in these efforts while Mozambique's crisis deepens. A tenuous transition deal in the Democratic Republic of Congo, where South Africa has traditionally played a critical mediator role, will face significant risks. Organizing elections this year will be difficult, especially given lackluster support for the deal from Joseph Kabila—whose term expired last December. A breakdown in the process is very possible; any delays will likely be met with further violent protests. It's a bad time for South Africa to remain on the diplomatic sidelines.


Red herrings

US domestic policy

Independent America is the top risk but US domestic policy is a red herring? Yes.

The Trump cabinet is more coherent on domestic issues. It's more aligned with the Republican Party's congressional leadership. On domestic policy, Congress has more power to impose checks on White House preferences, and the wheels of the legislature turn slowly even on a good day. Plus the decentralization of US legislative activity puts a lot of policy power in the hands of governors and mayors.

On domestic policy, Congress has more power to impose checks on White House preferences

At least for 2017, the US domestic outlook is neutral to positive. Reducing some regulation, investing in infrastructure, bringing down corporate tax rates, simplifying the individual tax code—at worst it's slow and incremental, at best it's a near-term plus from a growth perspective. There's plenty of longer-term downside if mishandled: a spiraling deficit if investments don't bring returns, privatization deals that lead to corruption and inefficiency, widening mistrust between haves and have nots if the jobs aren't created. But there's no serious social instability in the country. It's important to remember that in the most important election of their lifetimes, nearly half of eligible Americans didn't bother to vote. The critical political driver for the US at home this year remains political apathy. Given all the heat of political debate that we'll hear this year, it's worth keeping that in mind.

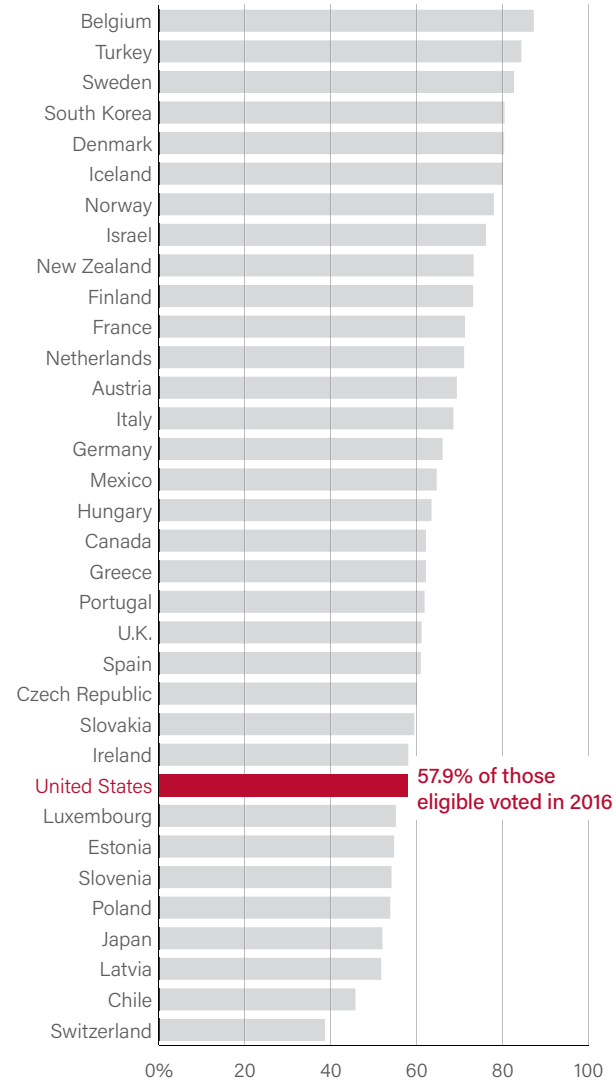
India versus Pakistan

Despite heightened bilateral tensions after a series of cross-border terror attacks, incursions, and exchanges of fire, the prospect of broader military conflict between India and Pakistan remains unlikely in 2017, as both Pakistani Prime Minister Nawaz Sharif and Indian Prime Minister Modi remain focused on domestic issues.

A major confrontation would be particularly costly for Sharif, given that he intends to contest his country's mid-2018 general election primarily on the strength of the economic and infrastructure improvements he has championed. Since he took office in 2013, Sharif has moved cautiously to improve relations with India, and he

Strongest force in US politics is apathy, not anger

Participation rate in last US election was one of lowest among recent votes held around the world



Source: Pew Research Center, 2 August 2016

has had to swallow accusations of weakness for his de-escalatory response to New Delhi's cross-border raids on alleged terrorist camps last year. Given his domestic priorities and the willingness of Pakistan's newly appointed army chief to continue to focus on curbing domestic militancy, terrorist groups connected to the Pakistani establishment are unlikely to feel they have political cover to pursue large-scale attacks that would risk triggering the type of major Indian response Islamabad wants to avoid. If anything, US, Indian, and (most importantly) Chinese pressure to do more to combat terrorism may lead Pakistan's military decision-makers to further constrain militant actions.

In the absence of major aggression by Pakistan-based groups, Modi will rely on his nationalist credibility to tout the deterrent impact of India's 2016 cross-border strikes as part of this year's host of state election campaigns. Modi will also be focused on maintaining momentum behind domestic reform. In fact, were Pakistan to make a major gesture toward Indian concerns about terrorism—such as arresting those accused of orchestrating the 2008 Mumbai attacks—Modi could even push to resume bilateral peace talks.

Brazil

Political and economic conditions surrounding President Michel Temer have deteriorated rapidly of late, leading to increased concerns that he may not finish his term in office. Not only is the economy struggling to recover after a deep, multi-year recession, but ongoing investigations in the Lava Jato probe—recently fueled by plea bargains from executives at construction company Odebrecht—have implicated many of Temer's closest advisors, and even the president himself.

These pressures will make 2017 a difficult year for the president, but they will also create more urgency for legislators to approve important reforms, such as those concerning the country's pension system. Recognizing that the economic conditions and corruption scandals of the past several years have created unprecedented popular anger toward politicians, lawmakers know their only chance of preserving their seats in the 2018 general elections is to move forward on a policy agenda that can generate at least a modest economic recovery. Furthermore, legislators are increasingly aware that failure to approve pension reform would have dramatic consequences for financial markets and confidence in the business sector—deepening the country's crisis.

Fear that Temer's fall might provoke a return to the unhinged political and economic crises that characterized the past few years will be the single most important factor in keeping the president in office and his reform agenda on track in 2017.

It's been 19 years since we started Eurasia Group. How could we have known that "politics first" would not only describe our organization, but the world we live in?

It's a challenging time, and we've tried not to shy away from that in this report. But we also close on a note of hope. So many of the world's challenges remain unaddressed because they lack urgency. Politics hasn't been so relevant to our global marketplace in generations, but that's now a reality that is widely accepted and appreciated. Most of the world's leaders understand that we're living through history right now. It's not a time to just sit back and analyze. It's a time for truth. That surely won't be comfortable. But we're completely committed to it, and to you.

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