



Top RISKS 2015

IAN BREMMER
PRESIDENT

CLIFF KUPCHAN
CHAIRMAN

- 1 THE POLITICS OF EUROPE**
- 2 RUSSIA**
- 3 THE EFFECTS OF CHINA SLOWDOWN**
- 4 WEAPONIZATION OF FINANCE**
- 5 ISIS, BEYOND IRAQ AND SYRIA**
- 6 WEAK INCUMBENTS**
- 7 THE RISE OF STRATEGIC SECTORS**
- 8 SAUDI ARABIA VS IRAN**
- 9 TAIWAN/CHINA**
- 10 TURKEY**
- * RED HERRINGS**

OVERVIEW

GEOPOLITICS IS BACK. AS 2015 BEGINS, POLITICAL CONFLICT AMONG THE WORLD'S GREAT POWERS IS IN PLAY MORE THAN AT ANY TIME SINCE THE END OF THE COLD WAR.

US relations with Russia are fully broken. China is charting its own course. The ties that bind Europe are fraying on multiple fronts. Others—Gulf Arabs, Brazil, India—are hedging their plans and alliances in reaction to increasing geopolitical uncertainty.

Ultimately these realignments will reshape the world order, but for now their impacts, while noteworthy, are more regional than global. China's rise still matters less than the headlines imply. Yes, it's the leading trade partner for more than 100 nations, but China's political, security, and economic influence remains underdeveloped. It will grow quickly, but we're not there yet. Crises in the Middle East have produced a world with more refugees than at any time since the Second World War, though with muted implications elsewhere, especially given the newly limited relationship between Middle East turmoil and energy markets. Russian revisionism is a direct threat to swathes of Europe, much less so farther afield. And most of Europe has far too much keeping them busy at home.

For now, the bigger change is in the United States, and it is both accelerating those realignments among the powers and elevating geopolitical risk around the globe. There's a view that America is withdrawing from the rest of the world, and that withdrawal is giving rise to much more conflict. That's the wrong way to look at it. Instead, it is America's growing unilateralism that is having geopolitical impact. The United States in recent years has more often acted just like any other country: sometimes proactive, sometimes belatedly reactive, and sometimes indifferent—but with much greater impact. This is an evolution from America the global policeman, leading NATO, providing collective security across multiple alliances, and powering a transatlantic relationship that underpins global "rules of the road" while battling enemies of those rules when necessary. That historical consistency (not without its hiccups) has fallen off.

There's a paradox here. The new unilateralism is hardly caused by America's leader stomping around the world. Rather, it's America projecting power through an arsenal of disparate mechanisms that allow it more easily to act alone, and with less direct impact at home. The extensive use of drones to skirt conventional warfare. The employment of state-of-the-art surveillance for US advantage. And an important shift in policy: the use of coercive economic diplomacy to pursue American interests with less regard for allies. To this point, the US and Europe have worked closely together on sanctions and other punitive measures against both Iran and Russia. But we don't expect that unity to hold in 2015 as Europe begins to feel more economically vulnerable and US politicians, those in power and those preparing for 2016 elections, take a tougher approach. All of which creates a backlash that will roil international politics.

2015 will see more geopolitical challenges than 2014. In part, that's because the costs to the United States of risk aversion will remain low, though the impacts will be felt keenly elsewhere. A more robust American recovery surely helps. But so does the reality that the United States is a far cleaner "dirty shirt" geopolitically than it ever was economically. In most cases, this calls for patience, not panic, as cans are kicked further down the road—as we expect with deliberations on climate change, growing tensions in Asia, and probably nuclear negotiations with Iran. But American unilateralism is stoking dangerous trends: Russia is lashing out, the Middle East is fragmenting, Islamic radicalism is expanding, and Europe faces challenges on all of these fronts. I'm very far from a pessimist, but for the first time since starting the firm in 1998, I'm starting to feel a serious undercurrent of geopolitical foreboding.



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THE POLITICS OF EUROPE



Activists' masks representing German Chancellor Angela Merkel and French President Francois Hollande

EUROPE'S ECONOMICS ARE IN SUBSTANTIALLY BETTER SHAPE THAN AT THE HEIGHT OF THE EUROZONE CRISIS. BUT THE POLITICS IS NOW MUCH WORSE. THAT'S TRUE ON THREE LEVELS: BOTTOM-UP, INTRA-EU, AND OUTSIDE-IN.

FRICION AMONG EU STATES IS WORSENING

At the grass roots, it's a surge of public anger across Europe. While there's a level of social instability attached to that, the immediate problem is a range of political movements that are developing momentum. Some are far left; others are far right. All are euroskeptic, and all are challenging establishment parties that have lost political legitimacy. Their rise has been dramatic, shows little sign of slowing, and will become politically meaningful in 2015. In particular, Syriza is likely to win snap elections in Greece and join a governing coalition, and Podemos could actually win in Spain's general elections at the end of the year.

More broadly, this populist surge requires a move by the establishment parties toward more euroskeptic positions to ensure they remain in power. This trend is clear both in Europe's periphery and its core. In France, the rising popularity of the National Front (FN) means the Union for a Popular Movement will have to tack to the right to improve its chances of regaining power in 2017. In the UK, a challenge from the UK Independence Party has moved Prime Minister David Cameron toward a much tougher line on immigration and toward support for an in/out referendum on EU membership in order to win national elections in May. Even in Germany, the rise of the Alternatives for Germany party has limited Chancellor Angela Merkel's ability to support deeper European integration and Eurozone stabilization.

Friction among EU states is worsening. The best case for Europe would be Germany, France, and the UK working together to provide leadership. But that's far less likely in this environment; France can't temper German insistence on austerity over stimulus because France won't meet its deficit targets—and because President Francois Hollande's unpopularity (ratings have dipped as low as 13%, the lowest number for any French president ever!) is only encouraging the FN. The Brits are likely to remain disengaged given their own unresolved questions of EU membership. And new, more populist, peripheral governments

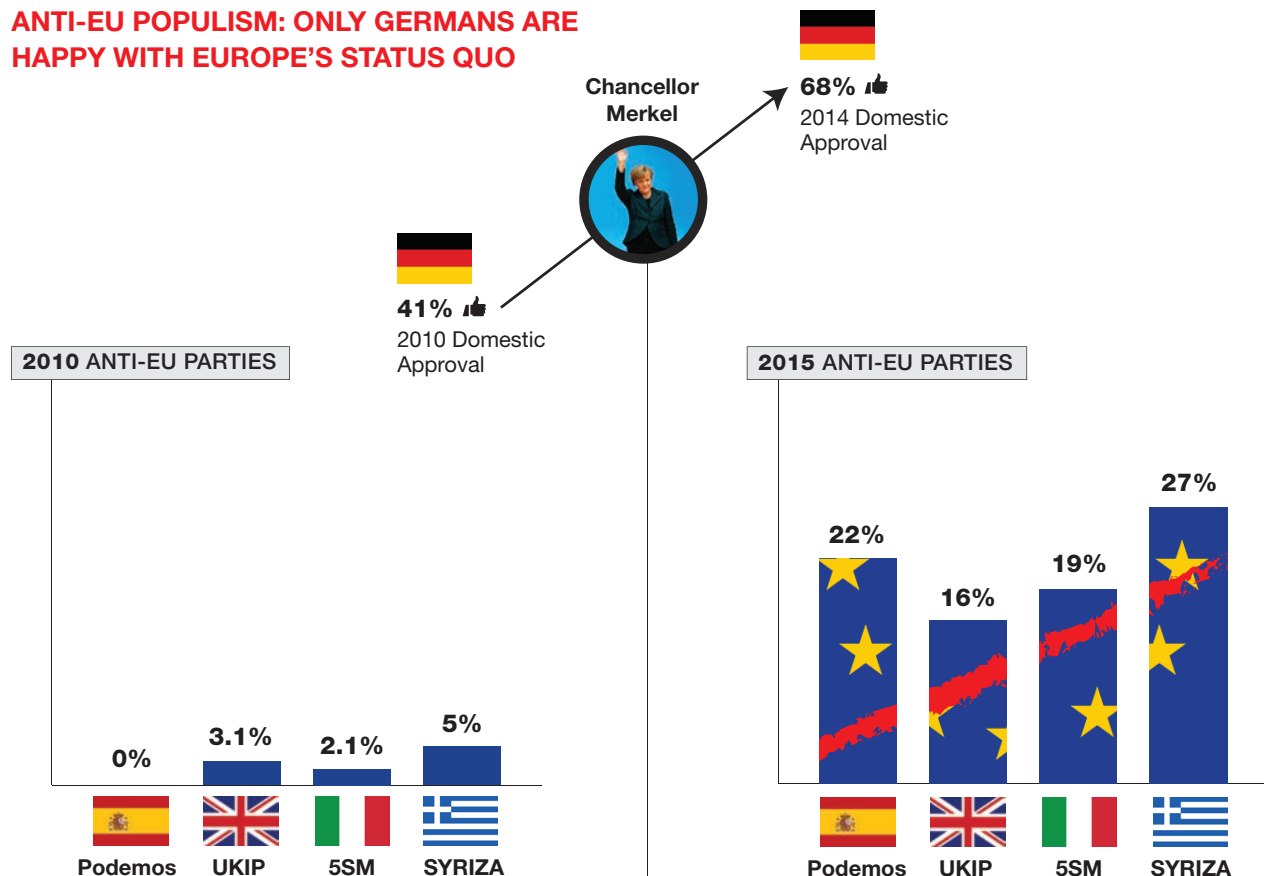
will work to unwind the pension reforms, fiscal balances, and other hard-fought pieces of legislation that the Eurozone crisis made possible. This year, conflicts over fiscal balances between and among Brussels, Berlin, Paris, Rome, and a host of other European capitals will make America's Democrats and Republicans look like one big happy family.

The external political environment is more challenging, as well. The Russia crisis is set to escalate, and worries over potential security incidents between Europe and the Russian military—far higher than at any point between China and its Asian neighbors—leave Europe in no condition to handle the resulting economic consequences. Terrorist threats from Islamist militants are much greater than in any region outside the Middle East, given the number of European citizens fighting in Iraq and Syria, and the size of Muslim communities inside these countries. Perhaps most importantly, the transatlantic relationship is deteriorating. American unilateralism is a challenge for Europe on most every level. Washington has more interest in punishing Moscow and less interest in safeguarding Europe's economic wellbeing. Spying and the use of drones are poisoning European public attitudes toward Washington. The US-Britain relationship is closer on these issues, but relations between Americans and Germans—far more important for Europe's future—are further apart.

European leaders, therefore, must manage domestic dissent, squabbling among governments, and external threats. We'll see bigger headline crises in a geopolitically tumultuous 2015. Europe will bear the cost of most of them. And so, this year, the politics of Europe is our top risk.

DOMESTIC DISSENT, SQUABBLING AMONG GOVERNMENTS, AND EXTERNAL THREATS

ANTI-EU POPULISM: ONLY GERMANS ARE HAPPY WITH EUROPE'S STATUS QUO





RUSSIA



A depiction of Russian President Vladimir Putin

LAST YEAR, WE HIGHLIGHTED RUSSIA AS ONE OF THE TOP RISKS TO GLOBAL SECURITY—THAT WAS BEFORE MOSCOW CARRIED OUT THE MOST BRAZEN REDRAWING OF EUROPEAN BORDERS SINCE WORLD WAR II, AND THEN FELL INTO A SEVERE CURRENCY CRISIS.

PUTIN CAN'T BACK DOWN ON UKRAINE, AND HE WON'T

The conflict with the West over Ukraine has crystallized a newly aggressive and explicitly anti-Western Russian foreign policy. Western sanctions, a sagging oil price, economic stagnation, and the ruble's plunge are weakening Russia economically and financially, though not driving it to the point of crisis. A Kremlin that feels antagonized and isolated but not substantially constrained is a dangerous prospect. An aggressively revisionist yet increasingly weak Russia will be a volatile actor on the global stage in 2015, posing a top risk to Western governments and businesses throughout the year.

Having whipped up nationalist sentiment about perceived Western threats to Russia's security and way of life, President Vladimir Putin can't back down on Ukraine, and he won't. Moscow will continue to arm separatist rebels in the Donbas, with the aim of creating a "frozen conflict." As a result, both violence and existing Western sanctions will persist in 2015, and there's a real risk of Russian escalation and additional sanctions this year.

Europe and the United States will increasingly treat Russia as a pariah state. Putin will both relish and resent that treatment. Acrimony with the West will deepen, and there are several potential areas of risk.

First, there is the strong possibility of a larger Russian-linked cyber-attack on a major Western financial or government institution. Cyber-warfare is an area of (post)modern conflict in which Russia is long on expertise and short on qualms. Even a limited direct attack on a Western institution would provoke a serious escalation in tensions.

Second, Russian saber-rattling along—and above—NATO's borders will intensify. Russia's aim is to test NATO's mettle and response capabilities, rather than to court open conflict or try to carve out separatist enclaves in Europe. Nonetheless, investors and policymakers will still get jittery about Moscow's intentions. And of course, with Russian aircraft buzzing NATO more frequently, the prospects of lethal miscalculation will rise.

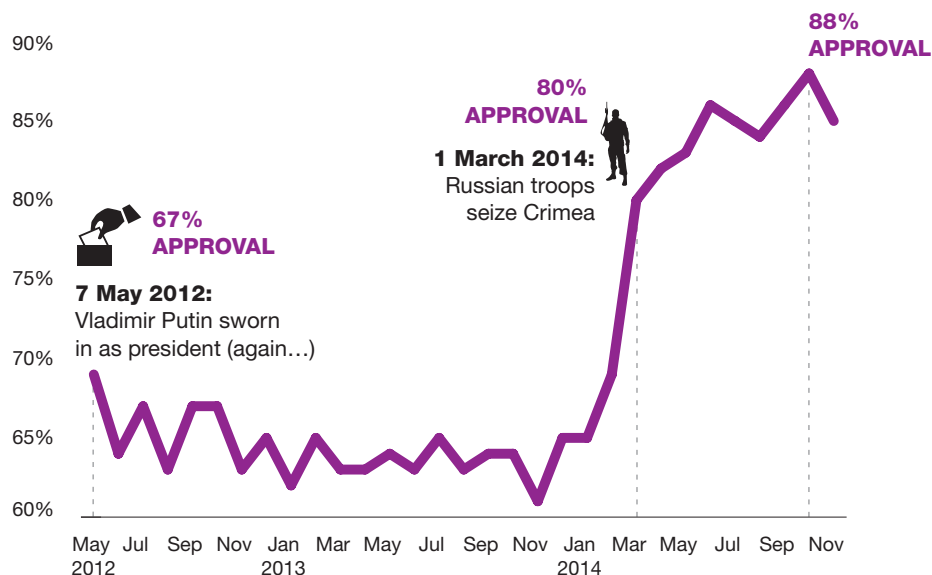
Third, keep an eye on Moldova, which is set to deepen its EU integration in 2015. While this small former Soviet republic carries none of the strategic or cultural significance for Russians that Ukraine does, the Kremlin views the entire former Soviet sphere as its exclusive zone of influence. The pro-Russian "frozen conflict" state of Transnistria, nominally part of Moldova, gives the Kremlin a formidable lever of influence to undermine Moldovan security. For Europe, Moldova is economically irrelevant, but given the precedent set by Ukraine, Brussels will have to respond to any Russian attempts to block Chisinau's westward progress.

Fourth, Russia will deepen its efforts to undo aspects of the US-led global security and financial orders. Moscow will probably withdraw from a major arms control treaty, and if Iran talks fail, Russia could well lead the charge to break the sanctions regime against Tehran. Russia will also accelerate its economic and strategic reorientation toward China, though it will be the much weaker partner in that relationship. We've not quite arrived at a Russia-China axis: Whereas China has misgivings about the current global order, Beijing still prioritizes a good relationship with the United States, while Russia increasingly prioritizes a bad one. Nevertheless, Moscow-Beijing cooperation on security and financial structures that circumvent US-led institutions will significantly deepen, marking the most important geopolitical development in 2015.

In sum, Russia is a power whose geopolitical ambitions are rising precisely at the moment that its economic fortunes are declining. Throw into the mix a headstrong and wildly popular president with a penchant for bold and occasionally reckless shows of defiance on the world stage, and Russia is one of the top risks for 2015.

RUSSIA WILL TARGET THE US-LED SECURITY AND FINANCIAL ORDERS

PUTIN APPROVAL RATINGS



Source: Levada



THE EFFECTS OF CHINA SLOWDOWN



An investor at a brokerage house in Haikou, Hainan

WE'RE QUITE OPTIMISTIC ABOUT CHINA THIS COMING YEAR. PRESIDENT XI JINPING HAS CONSOLIDATED AN EXTRAORDINARY AMOUNT OF POWER SINCE ASCENDING TO THE PRESIDENCY.

CHINA IS CHANGING DIRECTION, AND OTHERS MUST LEARN TO COPE

He has launched policies long overdue to rebalance the economy, pushing ahead on improving air quality, pursuing a series of measures aimed at making state-owned enterprises more efficient, and spearheading a massive anticorruption campaign within the Communist Party. Xi's the big winner geopolitically and geo-economically from the West's face-off with Russia, and his internal economic focus ensures that China's regional policy is more balanced, rather than focused on escalation with Japan, India, or in Southeast Asia.

That said, the biggest political windfall for Xi comes from the dramatic decline in oil prices. His priority efforts to reduce resource and capital intensity growth, implement new energy and environmental policies, limit debt for state-owned enterprises and local governments, and roll back overproduction in heavy manufacturing can all be enacted with less danger of political pushback because of the softening effect of lower energy costs. Xi wants a dramatic economic rebalancing without serious political risk; he's bought himself another 18–24 months of stability. This will result in stable yet slower growth for China, particularly in the commodity-intensive sectors.

So where's the risk? In all those countries with economies that rely on commodity exports to China. Petrostates are used to wild swings in demand and price. But commodity producers that have profited from steadily expanding Chinese demand have been riding a one-way bet for decades. Now China is changing direction. A number of economies must learn to cope with a new reality.

In Brazil, a slowdown in China—the country's largest trade partner—comes as a particularly unwelcome development as President Dilma Rousseff struggles with a stagnant economy. Beginning her second term with substantial political liabilities, Rousseff will now have to cut spending and raise taxes to compensate for the revenue shortfall. As the

commodity slump drags down growth and drives the real's depreciation, Brazil's president will become more unpopular and politically weaker, making it harder for her to deliver on macroeconomic and fiscal reform.

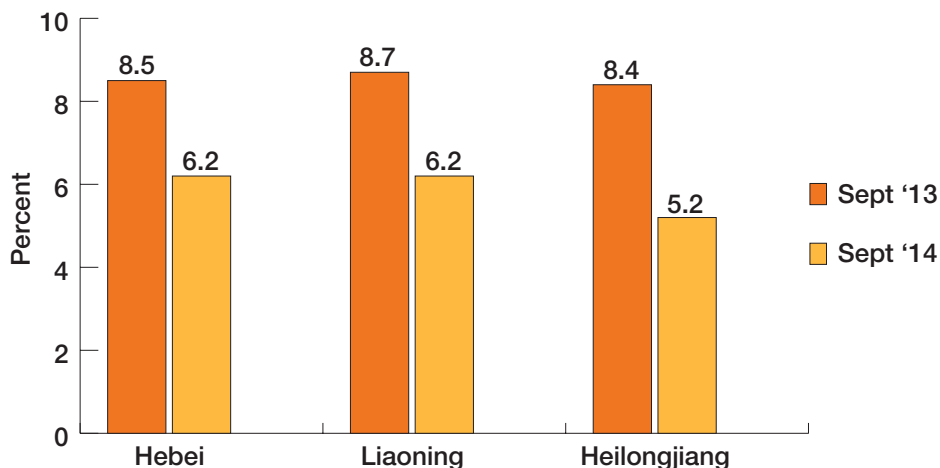
Australia's dependence on Chinese trade and investment, and China's huge appetite for Australian iron ore and coal, leaves the country dangerously exposed. Prime Minister Tony Abbott's government will move to mitigate the impact of slower Chinese growth by boosting infrastructure spending and promoting exports through trade agreements. However, budget targets will be difficult to meet as growth slows, commodity prices remain depressed, and the lack of a majority in the senate limits the government's ability to pass planned spending cuts. The Abbott government's popularity, already tied with Labor at 37%, will likely continue to fall.

Indonesia faces challenges from declining commodity prices as a result of reduced Chinese demand, given that 65% of Indonesian exports are commodity-related. Slower growth will, in turn, limit President Joko Widodo's ability to improve governance and stabilize the economy, which is otherwise one of the more promising reform stories among the emerging markets.

The greatest pressure may well be in politically unstable Thailand. There, a slump in commodity prices driven by weaker demand in China (Thailand's top export destination) will dampen economic growth prospects that, in turn, will undermine the ruling junta's legitimacy, increasing pressure to return the country to democracy. This will weaken the military government's commitment to maintaining control of the budget, as rubber farmers from southern Thailand, the military's traditional allies, lobby to offset their low market prices with new subsidies. Authorities will also be under pressure to help rice farmers in the north, whose subsidies were clawed back following the coup.

COMMODITY PRODUCERS HAVE BEEN RIDING A ONE-WAY CHINA BET FOR DECADES

GDP GROWTH RATE IN CHINA'S MAJOR INDUSTRIAL HUBS



Source: China's National Bureau of Statistics



WEAPONIZATION OF FINANCE



An engraving plate for a US dollar bill

THE UNITED STATES REMAINS THE WORLD'S ONLY SUPERPOWER, BUT WASHINGTON IS NOW USING ITS INFLUENCE IN IMPORTANT NEW WAYS. AFTER WORLD WAR II, AMERICAN DOMINANCE WAS ESTABLISHED BY THE FORGING OF US-LED ALLIANCES SUCH AS NATO AND MULTILATERAL INSTITUTIONS SUCH AS THE IMF AND THE WORLD BANK THAT ENSHRINED US-AUTHORED RULES AND STANDARDS.

**EXPECT MORE FINANCIAL
CARROTS AND STICKS**

For the Obama administration (and indeed, many of its critics), “boots on the ground” is a 20th-century concept. The American public has had enough of wars and occupations. But on core security issues, the United States still wants significant influence over global outcomes. That means less reliance on traditional elements of America’s security advantage—its nuclear weapons arsenals, its carrier groups, or other conventional assets. And more reliance on the dollar, which is now actually more strongly imbalanced in America’s favor than it was before the financial crisis. Access to the US marketplace and US banks, and Washington’s ability and willingness to use them, are becoming more important as instruments of foreign and security policy. There is no better example of this trend than the weaponization of finance—the systematic use of carrots (access to capital markets) and sticks (varied types of sanctions) as tools of coercive diplomacy.

The United States is expanding its ability to track the financial transactions of government leaders of concern, as well as their state and private sector allies, in order to close their access to capital and property. It is pressuring others who engage in business with these individuals to cut them off. Most obvious is the steady escalation of sanctions against Russia and other perceived rogue states. Less obvious are large-scale measures against financial institutions (mostly European banks) that help finance international entities under

US sanction. In the background looms the ultimate threat: that the United States will financially isolate rogue states by severing their access to capital and the infrastructure used to clear payments. Risks of miscalculation and unintended consequences are high, because use of these tools is new and Washington is learning how they work by trial and error.

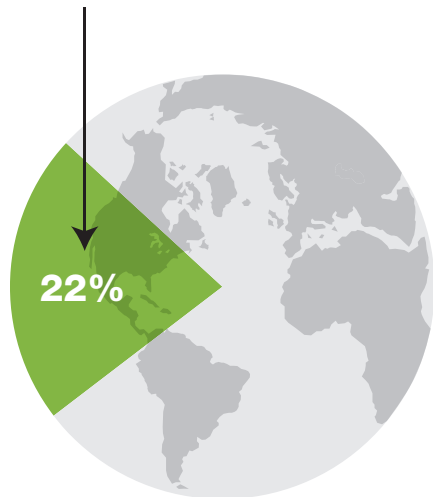
Of critical importance, the weaponization of finance is a tool that can be used with minimal cooperation from other governments. The most important near-term challenge is the damage inflicted on transatlantic relations. Europe will become more frustrated with an American unilateralism that Europe (and European banks) must pay for. Also, the US could well slap new sanctions on Russia and/or Iran, eliciting a backlash in 2015. Over the longer term, though, others will diversify away from reliance on the dollar and US-dominated institutions, particularly in East Asia, where China has the muscle and the motive to create its own institutions, and where there is less dollar-denominated debt to complicate the process. The Asia infrastructure investment bank, the BRICS bank, and the Silk Route Maritime and Overland initiatives are all steps in that direction. These projects, combined with Beijing's determination to broaden and deepen commercial and investment relations across the region, will eventually undermine Washington's ability to use these tools to lean on financially weak states.

And a fat tail concern for 2015, also related to the rise of strategic sectors: Governments targeted by sanctions will increasingly treat companies that comply with them as instruments of American power. This will expose these firms to heightened risks of retaliation—from regulatory harassment to contract discrimination to cyber-attacks. The US financial sector is particularly vulnerable on this count.

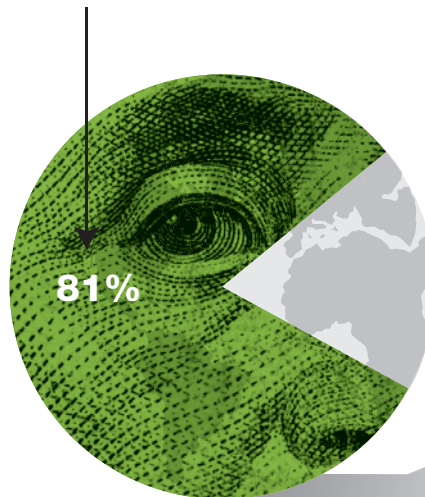
**THOSE TARGETED BY
SANCTIONS WILL TREAT
COMPANIES THAT COMPLY
AS INSTRUMENTS OF
US POWER**

THE ALMIGHTY DOLLAR

U.S. % of the
Global GDP



% of Global Trade Finance
Conducted in \$USD:



Source: Swift via Bloomberg





5 ISIS, BEYOND IRAQ AND SYRIA



Fighters hold an ISIS flag, pulled down after taking control of Saadiya

IN 2015, ISIS FACES SETBACKS IN ITS CORE BASES IN IRAQ AND SYRIA, BUT ITS MILITARY POWER REMAINS SIGNIFICANT, AND ITS IDEOLOGICAL REACH WILL SPREAD THROUGHOUT THE MIDDLE EAST AND NORTH AFRICA

ISIS WILL LASH OUT IN NEW WAYS

It will grow organically by setting up new units in Yemen, Jordan, and Saudi Arabia, and it will inspire many jihadist organizations to join its ranks. Ansar Bayt al Maqdas in Egypt and Islamists in the Libyan city of Derna have already pledged allegiance to ISIS leader Abu Bakr al Baghdadi.

ISIS has emerged as the main representative of militant Islam, both as a direct result of its military successes in Iraq and Syria and the weakening of moderate Islamist parties across the region. Its decision to split from Al Qaeda is a manifestation of the return of jihadist ideology to the Middle East away from former bases in Afghanistan and Pakistan. Moderate Islamist movements, such as the Muslim Brotherhood in Egypt, which embraced both Islamic ideals and the existing political structures, have lost ground. The decades-old competition between these two ideological camps will continue, but for now, radical jihadist Islam is on the rise.

The US-led campaign against ISIS will erode the group's conventional military capabilities. The United States, potent Shia militias, Kurdish peshmerga forces, the Iraqi army, and Sunni tribal forces will contain the Islamic State's power over the next year, though they are unlikely to score a definitive victory or regain control over the rebellious Sunni heartland. This resilience will inspire ultra-conservative Muslims to sympathize with the organization and join its ranks.

This new echelon of jihadist Arab and international leaders will expand its operations beyond Iraq and Syria. ISIS has to show successes in order to continue to attract fresh recruits, and it will likely lash out in new ways. In particular, it will try to punish Sunni states that have joined the US coalition.

In 2015, therefore, the risk to Sunni states will rise. Saudi Arabia's Wahhabism provides ISIS with ample room to recruit in a conservative population, pockets of which would be sympathetic to its objectives. ISIS could attack Western expats in the kingdom, harming the business climate. ISIS could likewise target the United Arab Emirates; violence against Westerners or the local population in the emirates would pierce the image of financial safe haven that underlies these states' prosperity. ISIS will aim to pressure the Hashemite leadership in Jordan to demonstrate that no Muslim alliance with the US can provide security or stability. Violence against Westerners in Jordan would both hurt the tourism industry and undermine the investment climate. In Egypt, Ansar Beit al Maqdis is likely to target Westerners, undermining Egypt's slowly recovering tourism sector. Finally, in Yemen, we expect the control of Shia Houthis over the capital Sanaa and large parts of Yemeni territory to further stoke sectarian tensions. ISIS's sectarian ideology will become more appealing, and some Al Qaeda followers would defect to join the group.

THE RISK TO SUNNI STATES WILL RISE

THE NATURAL LIMITS OF ISIS EXPANSION

ISIS, a Sunni extremist group, will struggle to advance beyond Sunni strongholds

AREAS UNDER ISIS CONTROL*



Source: BBC
*These maps are general illustrations based on Eurasia Group analysis

ETHNO-SECTARIAN MAP*



Source: Eurasia Group, The Gulf/2000 Project



WEAK INCUMBENTS



Brazil's President Dilma Rousseff with Vice President Michel Temer

POLITICAL RISK STEMMING FROM WEAK INCUMBENTS WHO RECENTLY WON REELECTION WILL WEIGH ON KEY MARKETS IN 2015.

With the important exceptions of India and Indonesia, the wave of emerging market elections in 2014 saw incumbents win underwhelming victories. Sluggish growth and mounting popular demands were not enough to displace ruling party candidates in Brazil, Colombia, South Africa, and Turkey, and are unlikely to do so in Nigeria in 2015. But they did reduce incumbent support, producing risk-averse governments with weak mandates to tackle economic reforms or respond to external shocks (including oil market volatility and higher US interest rates) in the year ahead. While the newly elected government in India (and to a lesser extent Indonesia) will benefit from a honeymoon period and political distance from past failures, repeat-term governments will be more constrained.

In Brazil, Rousseff barely won reelection in a highly polarized political environment. Led by new Finance Minister Joaquim Levy, Rousseff's more constructive cabinet will make credible fiscal adjustments to try to ward off another sovereign downgrade and will press for fiscal reforms and an opening of the oil sector. However, Rousseff's mounting political liabilities—including reduced popular and legislative support, the Petrobras corruption scandal, and a more demanding middle class—will limit room for a broader fiscal adjustment or structural economic reforms, leading to a lower growth trajectory and greater social instability.

South Africa's "slow burn" will continue in 2015 behind the weak leadership of President Jacob Zuma and persistent factionalism among the ruling African National Congress's (ANC's) trade union allies, driving tepid responses to external economic challenges while exacerbating the country's domestic problems, including labor instability. At best, macroeconomic policy will counter pressure on the rand and help avoid credit downgrades, and there will be some improvements in local governance. But structural reforms to labor markets or troubled parastatals remain unlikely, undermining implementation of the National Development Plan.

Meanwhile, in Nigeria, President Goodluck Jonathan is likely to secure reelection on 14 February. Yet during his second term, he will face a more aggressive opposition and polarized political environment, making reforms and fiscal policy adjustments more difficult as lower oil revenues limit the government's options.

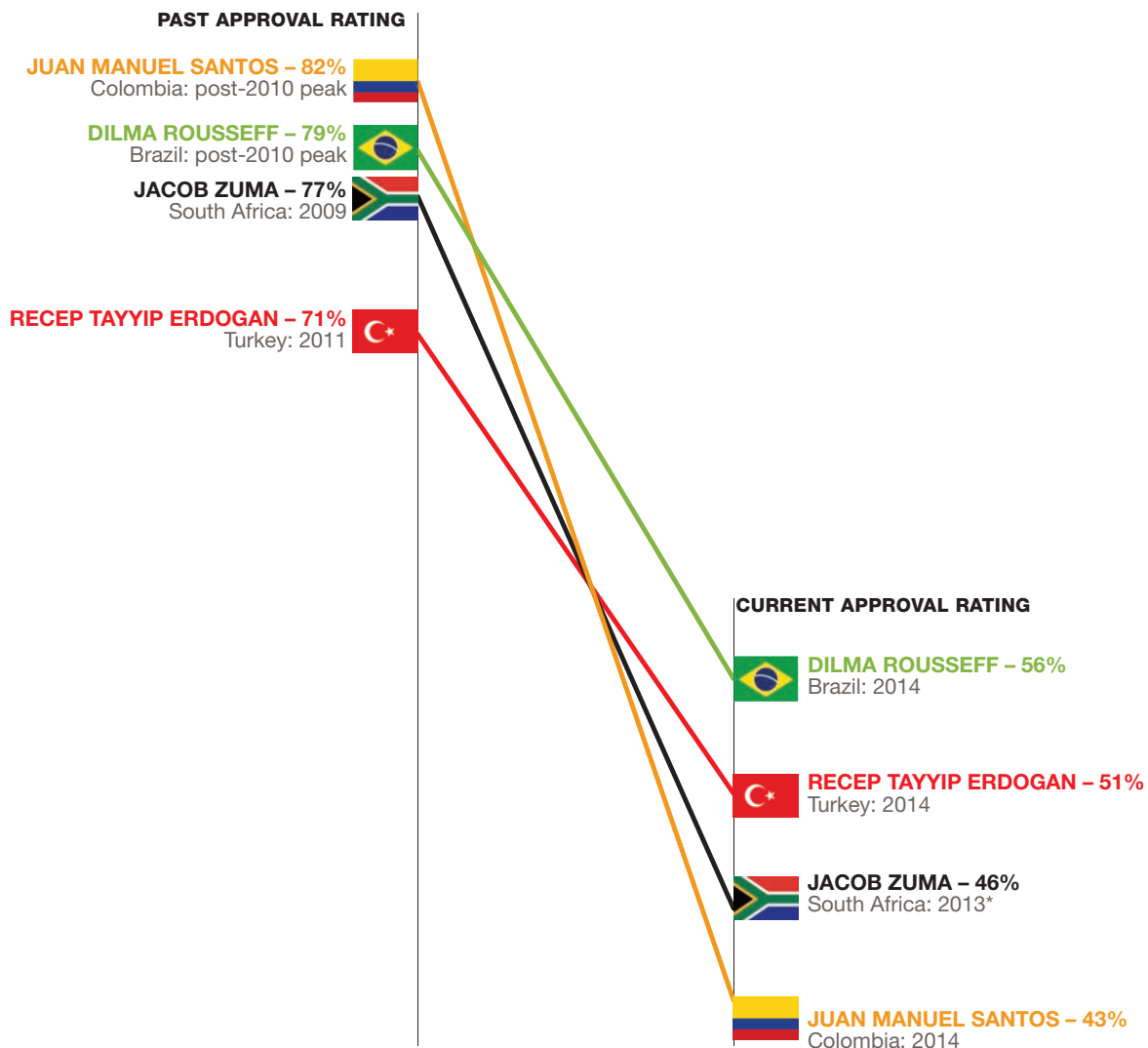
2014 SAW INCUMBENTS WIN UNDERWHELMING VICTORIES

In Turkey, former prime minister Recep Tayyip Erdogan's victory in the August 2014 presidential election will reduce government stability and coherent policymaking in 2015. Erdogan and new Prime Minister Ahmet Davutoglu will cooperate to maximize the ruling Justice and Development Party's (AKP's) performance in April's parliamentary elections. In the process, they will stall the Kurdish peace process, helping the AKP score points with its nationalist base but increasing the risk of violent protests by Kurds. The leaders will also pressure the central bank to cut interest rates, risking higher inflation. After the elections, the two leaders will compete for executive power, undermining the policymaking process, while efforts to remove political opponents from influential government positions will paralyze the civil service.

And Colombia's President Juan Manuel Santos will maintain a friendly stance toward the private sector and probably sign a peace deal with the Revolutionary Armed Forces of Colombia. But his administration will struggle to enact more favorable regulations for the extractives sector owing to social opposition, while lagging oil production and dim prospects for fiscal reform bode ill for financing any peace deal.

The weakness of so many incumbents in important emerging market states will weigh on both global growth and political stability in 2015.

REPEAT-TERM GOVERNMENTS WILL BE CONSTRAINED

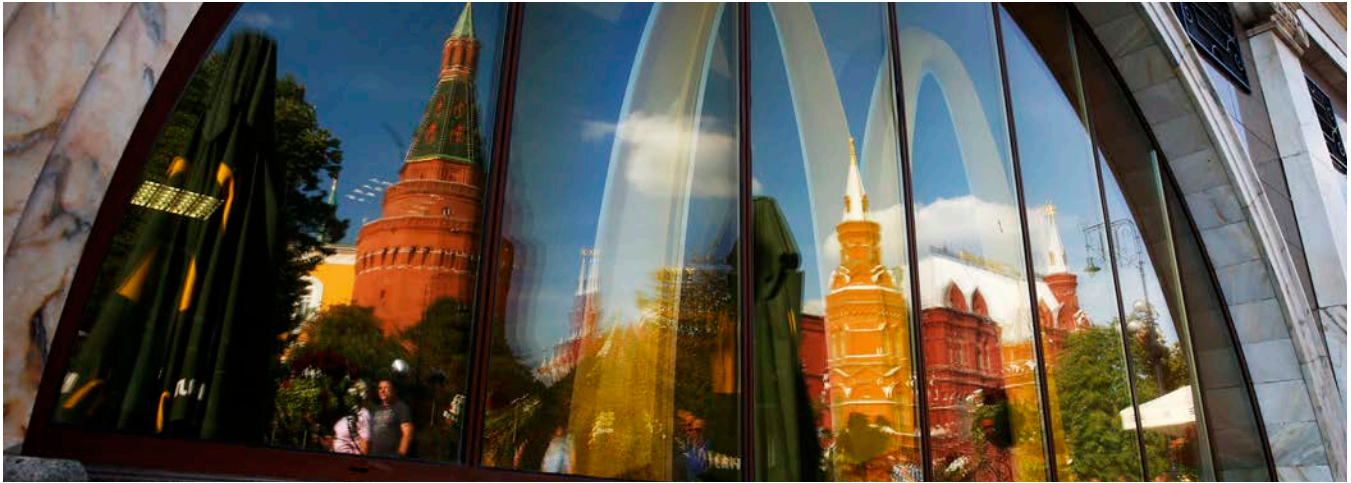


*The most comparable figure available that matches 2009 data

Sources: Ibope, Ipsos, Metropoll



THE RISE OF STRATEGIC SECTORS



The Kremlin as reflected in a window of a McDonald's restaurant

IN 2015, SUCCESS AND FAILURE FOR BUSINESS WILL DEPEND INCREASINGLY ON GOVERNMENTS. FOR DECADES, THE PERCEPTION WAS THAT MULTINATIONAL COMPANIES WERE DEVELOPING GREATER AUTONOMY FROM POLICYMAKERS, BOTH IN THEIR HOME GOVERNMENTS AND IN THE COUNTRIES WHERE THEY OPERATE, ERODING STATE AUTHORITY TO REGULATE THE FLOW OF GOODS AND SERVICES AROUND THE WORLD.

**GOVERNMENT INFLUENCE
IN ECONOMIES IS
EXPANDING**

Instead, government influence is expanding, focused more on political stability than on economic growth. In strategic economic sectors, those the state considers important for political stability and the interests of the political elite, as well as alliances with national and local governments, are critical for success. This is boosting the prospects of companies that operate in harmony with their political goals and punishing those that don't.

We see this trend in emerging markets, where the state already plays a more significant role in the economy. That's the case for different sectors in different countries. For example, in Turkey's media sector, a previously open business environment has turned more strategic as the government has become particularly sensitive about anything that could facilitate state criticism. So too across a sweep of sectors in Russia, where pressure will increasingly be applied to any company perceived to be American. (McDonalds was hit particularly hard in 2014 because it's perceived to be an iconic American, rather than a global, brand.) Many European companies can also expect a hard time in Russia, as the Russian government responds to EU sanctions by favoring Asian and emerging market-based companies. In India, the retail and pharmaceutical sectors will remain politically sensitive, particularly in rural areas where foreign products are less welcome. In the ex-

tractive sectors across Southeast Asia and sub-Saharan Africa, cozy relationships among key players and the state's desire to steer revenue toward social spending will keep many governments involved as critical economic players.

This trend is by far most important in China, where despite efforts to make state-owned companies more competitive and efficient, their interests will still earn plenty of protection. The government wants to attract more capital, but not at the expense of the state capitalist model. Couple that with vigorous cyber-attack capacity and no independent judiciary (and therefore little regard for intellectual property) and we expect a growing number of sectors where it will be more difficult for Western multinationals to compete. That's perhaps most true in sectors critical for innovation in the marketplace, those that traffic in consumer behavior and big data, an area the Chinese government intends to control. The picture in China may improve as the leadership becomes more confident in its ability to enact reforms that open the market, but we aren't close to that tipping point. For 2015, this is a growing challenge.

A second challenge comes from rogue states, who can quickly redefine a sector as strategic, even if only to punish or intimidate a single company. North Korea's ability to launch sophisticated cyber-attacks against Sony has made entertainment companies of all kinds think carefully about any North Korea-related content. (That Sony is a Japanese-headquartered company probably didn't help its cause.) This was the biggest win North Korea has had in years, but it's an even more concerning prospect when applied to wealthier and more technologically advanced rogues. Russia's cyber capabilities against Western multinationals are vastly better developed, and Moscow has a history of using debilitating attacks against the financial institutions of governments it wants to intimidate—Georgia and Estonia have both been in the crosshairs in the past decade. Firms and governments can't count on Kremlin restraint or its fear of retaliation when Putin already believes that American policy is designed to force regime change in his country.

And third is the growth of strategic sectors in the United States. Far from being ideologically interventionist in the private sector, US national security priorities have nonetheless expanded the military industrial complex to include a wide swath of technology, telecommunications, and financial companies. Their cooperation with US security agencies is required to facilitate the tracking of potential threats to the United States—their location, communications, and access to funds. In many cases, companies are prohibited from disclosing their cooperation with the US government. Other governments, both allies and adversaries, have objected. In many countries, American companies suspected of information-sharing and other forms of close cooperation with the US federal government are seen as threats to national security, leaving these firms with higher barriers to market entry and a tougher regulatory environment. Dynamic American companies such as Amazon, Apple, Facebook, Google, and their successors will experience challenges doing business not only in China but in any country in which data, information, and media content are considered politically sensitive.

THIS TREND IS MOST IMPORTANT IN CHINA



SAUDI ARABIA VS IRAN



The front lines near Aleppo, Syria

SAUDI-IRAN TENSIONS WILL SPIKE DURING 2015, WORSENING THE SUNNI-SHIA SECTARIAN RIFT ACROSS THE REGION.

DOMESTIC POLITICS IN BOTH COUNTRIES WILL FUEL CONFLICT BETWEEN THEM

The relationship will be especially volatile this year because: 1) there will be an unprecedented number of theaters of proxy conflict; 2) domestic politics in both countries will enhance conflict; and 3) the evolution of diplomacy on Iran's nuclear program, regardless of the outcome, will provoke more strife between Riyadh and Tehran.

The list of arenas where the two countries either support opposing proxies or hold opposing policies is longer than ever. The newest hotspot is Yemen, where the Houthis—who follow the Zaidi branch of Shia Islam, and whom the Saudis battled in 2009—recently captured most of Sanaa (the capital) and now have great influence over the government. The Saudis accuse Iran of supporting the Houthis with arms and money.

Tehran and Riyadh will have very different approaches toward Iraq's Prime Minister Haidar al Abadi. The Saudis will press for maximum inclusion of Sunnis in Iraq's government. Iran will advocate continued Shia dominance, and increasingly support Shia militias and their fight with the Islamic State. In Syria, the Saudis and Iranians will hold diametrically opposed views on the future of President Bashar al Assad, and the violent standoff between their proxies will continue. In Lebanon and Bahrain, the Saudis and Iranians will back opposite sides in tense and unstable political environments.

The Saudis are formally preparing to combat the Iranian threat on a multilateral basis, pressuring Qatar back into the Gulf Cooperation Council (GCC) fold and obtaining GCC agreement to form a joint naval force and counterterror police unit. Direct conflict between Tehran and Riyadh is unlikely, though the increased intensity of proxy wars will further destabilize the region throughout 2015.

Inside both Iran and Saudi Arabia, domestic political friction will boost tensions. In the kingdom, succession battles are underway. Erratic foreign policy behavior is possible as contending players and groups try to demonstrate their foreign policy mettle. In Iran, much of the elite see lower oil prices as part of a Saudi plot to undermine Iran, and hardliners who support a tougher policy toward the kingdom have gained strength at the expense of President Hassan Rouhani.

Finally, intensified negotiations over Iran's nuclear program will stoke tensions. The talks will probably fail to reach a comprehensive agreement. If Washington imposes harsh new sanctions in response, Tehran will adopt a more aggressive regional policy, including toward the Saudis. If the diplomatic process settles on a "long-term interim agreement," raising expectations for an easing of sanctions on Iran, Saudi Arabia will feel exposed and more aggressively protect its regional turf. Even a partial agreement would heighten Saudi neuralgia about American commitment to its security. If a comprehensive deal is reached, an improbable but possible outcome, the Saudis' worst nightmare would become reality. Saudi leaders believe a deal would lead to a US-Iran rapprochement that will both undermine Saudi security and turn Iran into a rising geopolitical and economic power. In turn, the Saudis would quickly ramp up support for its proxies to cut Iran down to size.

INTENSIFIED NUCLEAR NEGOTIATIONS WILL STOKE TENSIONS



US Secretary of State John Kerry with Saudi Arabia's Foreign Minister Prince Saud al Faisal



TAIWAN/CHINA



Pro-democracy activists fight with pro-China activists

RELATIONS BETWEEN CHINA AND TAIWAN WILL DETERIORATE SHARPLY IN 2015 FOLLOWING THE OPPOSITION DEMOCRATIC PROGRESSIVE PARTY'S (DPP'S) LANDSLIDE VICTORY OVER THE RULING NATIONALIST PARTY IN NOVEMBER'S LOCAL ELECTIONS.

Taiwan's political class will focus overwhelmingly this year on throwing elbows at one another ahead of the 2016 presidential election. President Ma Ying-Jeou is already a lame duck, and we expect no progress toward an agreement with China on any form of trade liberalization.

If China decides that its economic engagement strategy with Taiwan has failed to advance its end goal of reunification, Beijing may well take a more confrontational approach by backtracking on already agreed trade and investment accords and by hardening its rhetoric. The move would provoke public hostility in Taiwan and inject more anti-mainland sentiment into the island's politics.

These developments would spill over into US-China ties. While the Obama administration would try to steer clear of tensions, as it did with Hong Kong in 2014, the Republican-controlled Congress would pressure the administration to harden its position, which would prove challenging for Obama to ignore (to say nothing of by then presidential candidate Hillary Clinton). Any US comment on relations between China and Taiwan would quickly increase resentment and mistrust between Beijing and Washington.

Beijing is well aware that a more confrontational approach will raise the chances that the DPP and its likely presidential candidate Tsai Ying-wen win the 2016 election. But as with Hong Kong, the Xi administration considers Taiwan a core part of domestic policy, not a foreign policy concern, and is less willing to be patient. And Xi might well decide the DPP will win in 2016 whatever China does and that a forceful signal of the mainland's resolve is useful. Taiwan is more vulnerable to such pressures than Japan or the Philippines, given that it is not a direct treaty ally of the United States, even though the US has commitments to ensure Taiwan's self-defense capabilities.

BEIJING MAY TAKE A MORE CONFRONTATIONAL APPROACH

HOSTILITIES WOULD IMPACT US-CHINA TIES



TURKEY



Turkish police raided media outlets close to US-based Muslim cleric Fethullah Gulen

FOR THE SECOND YEAR IN A ROW, TURKEY MAKES OUR LIST. LOWER OIL PRICES HAVE BEEN GOOD NEWS FOR THIS COUNTRY, BUT THAT'S ABOUT ALL THAT'S GOING WELL.

Heavy-handed rule, short-sighted political decisions, and bad foreign policy bets will all conspire against Turkey. At home, Erdogan has used election victories in 2014 to ensure decisive defeat of his political enemies (of which there are many) while remaking the country's political system to tighten his hold on power. Erdogan is unlikely to win the powers he wants, forcing him to rely on soft influence instead—a recipe for more disputes with his prime minister, less policy coherence, and more political unpredictability. A diverse population is becoming a divided one, as is the case in politics, business, the media, police and the military, and the judiciary. It's becoming increasingly dangerous to be caught on the wrong side.

On foreign policy, Erdogan has made nearly every bad bet available. Support for the Muslim Brotherhood in Egypt blew up in his face as the military ousted its government and set up a stable new government now hostile to Erdogan's interests. He backed Hamas before last year's conflict in Gaza left Hamas isolated and the Israeli government strengthened. He aligned with Qatar before the Saudis forced the Qataris back into line within the GCC. He got cozy with Putin just as Russia's government was becoming a pariah and its economy began sliding into recession. He pushed hard for the removal of Syria's Assad, a man whom the United States can no longer afford to fight and who will be around to create trouble for Turkey for many years to come. Turkey's relations with its NATO allies have never been more troubled.

Given the instability in the region, it's not the best time to pick the wrong friends. Refugees are bringing more radicalism into Turkey and adding to the country's economic hardship. Lasting peace with the Kurds, who want political reform and for Erdogan to fight the Islamic State, is becoming less likely. And Turkey's troubles also contribute to the political vacuum in the Middle East, at a time when sectarian fights and proxy wars are growing.

Turkey has too many advantages to become a disaster—a large, urbanized, well-educated, and growing population; a strong business and banking community; a competent bureaucracy. Erdogan has an authoritarian bent, but he's not Putin. Yet Turkey's troubled politics poses problems that aren't going away.

ERDOGAN HAS MADE MANY BAD BETS

TURKEY HAS TOO MANY ADVANTAGES TO BECOME A DISASTER



RED HERRINGS



Members of a nationalist movement raise Japanese flags; and recent gas prices

ASIA NATIONALISM

A lack of global leadership—what we call the G-Zero world—has created considerable geopolitical instability in recent years. But in Asia, leadership at the national level is now having the opposite effect. Four of Asia's key economies benefit from strong, charismatic, and popular leaders (especially in contrast to their predecessors): China's Xi, India's Narendra Modi, Japan's Shinzo Abe, and even Indonesia's Joko. All four are prioritizing sweeping domestic economic reform that's well overdue in their countries and, at least thus far, are enjoying some success. Most importantly, all four are pursuing these policies without their hands being forced by immediate crisis (unlike the American response to the financial crisis or the European response to the Eurozone crisis). This affords them more flexibility when challenges to their policy priorities arise, and greater likelihood of success—or at the least, significant progress before their efforts diminish.

And so despite plenty of domestic support for nationalism in Asia, these four critical actors have good reason to avoid foreign distractions, improve their regional economic ties, and keep security relations in balance. We'll surely see headlines around military confrontation in the South and East China Seas, Indian assertiveness (and Chinese concern) over Arunachal Pradesh, and talk of military buildup across the region. China's assertiveness won't disappear, though it's much more likely to remain focused on smaller states without ties to the West, such as Vietnam. Serious tensions are a longer-term concern. For 2015 at least, there's going to be a pragmatic restraint among Asia's powers, and an immediate move toward cooler heads in the event of any accidental incident.

THE ISLAMIC STATE

As noted, ISIS poses a notable threat to multiple countries in the Middle East, and its influence will continue to expand. But the Islamic state that the group would create will not prove viable in 2015, and it will not be able to expand the territory under its direct control. In Syria and Iraq, ISIS grew by conquering ungoverned territory and capitalizing on antigovernment sentiment among Sunni populations. But even in these countries, ISIS will lose territory as the US-led coalition, Iran, Shia militias, and the Iraqi government gain ground at ISIS's expense. Assad will remain in power in Syria. If ISIS attempts to move into Shia or mixed areas in Iraq, Iranian forces will probably stop them. Iraq's government

EXPECT PRAGMATIC RESTRAINT AMONG ASIA'S POWERS

will remain in place, and oil production will increase. In more stable Sunni states, such as Jordan, Egypt, Saudi Arabia, and the United Arab Emirates, there are effective intelligence, security forces, and militaries to keep ISIS from gaining a foothold. Even in Lebanon, where the population is diverse and the state is weak, ISIS will fail to undermine the established order as sectarian political leaders who dislike each other are still keen to avoid severe internal strife. ISIS will not disappear and its influence will prove long-lasting. That said, it will not replicate the stunning military successes it demonstrated in the summer of 2014 or create a state that can be sustained over time.

PETROSTATES

The sharp slide in global oil prices has led to the expectation that several authoritarian oil-producing states are going to see both their geopolitical weight and perhaps their internal stability shaken very rapidly in 2015. That will not be the case. First, Saudi Arabia and its core Gulf Arab partners will likely restrain output in the first quarter to a degree that maintains a slowing of US production growth but allows for a modest recovery in prices. But even if the oil market “flood” scenario is allowed to play out fully, the massive cash reserves that these producers have amassed will allow them plenty of room for maneuver in the short term. The smaller Gulf Arab producers are in an even stronger position, with lower budget-balancing prices and higher reserves on a per-capita basis. So too, the ability of Russia to maintain both its policy toward Ukraine and its financial reserves, and of the Saudis and their allies to support other authoritarian regimes such as Egypt’s and the non-Islamist side in the Libyan conflict, will not be compromised any time soon. The one exception is Venezuela, where social and political stability is at risk in a low oil price environment and where there is a very real threat of near-term instability and default. In other oil-producing countries without massive cash reserves, most notably Nigeria, Brazil, and Colombia, politics will become more difficult and so will their ability to adjust to a shortfall in revenue from oil production. But in none of these three will internal political or social stability be meaningfully at risk.

MEXICO

It’s been an uphill struggle of late for President Enrique Peña Nieto. He’s had to fight off accusations of financial impropriety involving his wife and his finance minister. Meanwhile, the government hasn’t lived up to commitments to improve the security environment in the ongoing drug war, and popular outrage remains over the murder of 43 college students handed over to drug lords by a local mayor. Economic growth has been anemic. Was the promise of Peña Nieto oversold?

We don’t think so. The only way he succeeds is through economic reform, and he still has both the popularity and the determination to make that happen. On the domestic political front, Peña Nieto’s weakness has mainly benefited the right-of-center National Action Party, not the Party of the Democratic Revolution, and the former generally backs the president’s reform agenda. Furthermore, the reforms pending this year—telecom and energy—are the most significant for the economy. Both will have an outsized impact on productivity and competitiveness, and they will attract large-scale investment from the United States—more important wins for the Mexican president than last year’s election reform and tax reform, which had more symbolic and incremental/long-term gains attached. Combine that with substantial support from the economic rebound in the US, improving cross-border trade, inbound investment, and tourism numbers, and it should be a reasonably positive year for America’s southern neighbor.

REFORMS THIS YEAR ARE THE MOST SIGNIFICANT FOR MEXICO’S ECONOMY