Top Risks of 2013

Emerging markets will still have more volatility and instability than the advanced industrial democracies. Some still make good (if not safe) bets for the same reasons they have in the past, but the era of emerging market abundance is finished. In 2013, it’s critical to understand that emerging market downside differs wildly from country to country, and in many of them, in stark contrast to developed markets, that risk is “unbounded.”

It’s 2013. We’ve made it. For those of us watching from the United States, the last few days of 2012 (to say nothing of the first couple of this year) were touch and go. But here we are.

Political risk has entered our vocabulary. Whether staring over the fiscal cliff, battling the eurozone crisis, trying to profit from a rising China, or taking cover from the Middle East, politics has come to dominate market outcomes around the world. Geoeconomics now sits alongside geopolitics in matters of war, peace, and prosperity. Economic statecraft is a key component of global foreign policy. State capitalism is a principal challenge to the free market.

That’s been increasingly true for the last four years because of the way perceptions of political risk have spread across the developed world. Since the financial crisis, what did or didn’t happen in Washington has had an outsized impact on market outcomes. So, too, the reaction of European governments and pan-European political institutions to a crippling, systemic eurozone crisis. We’ve seen a succession of five governments in Japan digging out, first from the recession and then from the largest-scale natural disaster the world has seen in decades.

In responding to the worst economic slowdown since the Great Depression, it’s no surprise that political risk has come to the fore. Dramatic government action was called for, and global markets moved to price in the resulting uncertainty. But looking to 2013, political risk in the developed world is now overstated. Despite the chaos in Congress—which we’ll surely see much more of in the coming year—concerns about the fiscal cliff in the United States have been overplayed. The fragmentation of the eurozone, as well, and the impact of continued zero growth in Japan. The takeaway: The world’s advanced industrialized democracies are much more resilient than feared, and their downside risk is “bounded.” Indeed, in the aftermath of a major crisis, most are even “anti-fragile.”

When I started Eurasia Group in 1998, we focused on emerging markets. My definition of emerging markets served just as well as a business plan: “those countries where politics matters at least as much as economics to market outcomes.” That definition has seemed quaint with the eurozone in crisis and US credit ratings downgraded. But it’s still the case.

Indeed, it’s more important now than ever before. For the past five years, emerging markets have accounted for two-thirds of the world’s growth. By 2020, that number is expected to grow to 75%. The heightened political risk resulting from that change would be a primary challenge even in a geopolitically stable context of US-led globalization. But in a G-Zero world with an absence of global leadership and geopolitics very much “in play,” everyone will face more volatility. That’s going to prove a much bigger problem for emerging markets than the developed world. In 2013, the first true post-financial crisis year, we’ll start to see that more clearly.
1—Emerging markets: Not less risky
For the past four years, we’ve been uncritically thankful for the emerging markets. Set against what seemed like crippled developed countries, emerging market growth kept trade moving, commodities prices afloat, and offered attractive investment opportunities. But in a tougher overall growth environment where the US economy looks like a better bet and the potential for explosive risk in the eurozone goes away, concerns over emerging markets and their future will again receive closer attention.

Emerging markets will have much more volatility and instability than the advanced industrial democracies. Some still make good (if not safe) bets for the same reasons they have in the past—outsized growth potential makes “tail risk” more acceptable, but the era of emerging market abundance is finished. So in 2013, it’s critical to understand that emerging market downside differs wildly from country to country, and in many of them, in marked contrast to developed markets, that risk is “unbounded.” That means we have to stop treating emerging markets (to say nothing of the increasingly suspect BRICs) as an asset class for outsized growth and instead consider which developing country governments have enough political capital to remain on track toward a more advanced stage of development. In that context, it’s worth breaking down emerging markets into three broad categories:

A—Becoming developed. These are governments with the tools to respond effectively to domestic and international challenges and continue to put policies in place that make investment more attractive over time, reducing the chances of sudden crises. Many emerging markets in Latin America are in this basket. In part, that’s a structural advantage: the lack of geopolitical turmoil in the region and the ability of many Latin American governments to pivot in a more fragmented globalization environment. But it’s also a result of the work of three leaders who enter 2013 with significant political capital: post-Lula, Brazil’s Dilma Rousseff; post-Uribe, Colombia’s Juan Manuel Santos; and, the most exciting story, post-Calderon, Mexico’s Enrique Pena Nieto—one of the only leaders in the emerging market space willing and able to advance structural economic reforms.

In the Middle East, despite the domestic struggle over a new constitution and turmoil along its borders, Turkey fits in this category, thanks in part to many years of structural reform as part of an EU membership bid that will never be realized. A few Gulf states, Oman and (especially) the United Arab Emirates, have worked hard to diversify their economies and belong in this group. In Asia, South Korea and the long-lagging Malaysia and Philippines, the latter two now on track to seriously improve broad economic policy (and the Philippines starting to finally tackle pervasive corruption), get the nod. Given a sudden economic shock, none of these markets has the stability or resilience of the United States, Japan, or even the European economies. But they’re getting closer, and all look set to solidly perform in 2013 and beyond.

B—Still emerging—and problematically so. These are countries with upside, but dramatically greater volatility than is generally understood—the result of lower levels of political stability (and/or unwillingness to accept domestic political risk) combined with stronger economic headwinds. A few countries that have looked particularly good in past years make this list. India is an important example, with significant long-term structural advantages but an extremely troubled political reform environment—more on this with risk #9. Indonesia, for several years considered a star among emerging markets, now deserves considerably more caution. There, President Susilo Bambang Yudhoyono’s political capital has been steadily eroding ahead of upcoming elections, and prospects for credible economic reform have stalled.

Many of the larger Middle East economies, Egypt and Iraq in particular, also fit here. Both countries have enormous potential but far more downside, given growing social discontent and political violence and a structurally troubled political environment. Longer term, even much more stable countries such as Saudi Arabia belong in this category. Thailand belongs here thanks to poor existing governance against the backdrop of troubled and uncertain succession. In Peru, Ollanta Humala has been effective in a high-growth environment, yet the risk of a return to serious populism and nationalism as life gets more difficult is larger than most appreciate. South Africa, where leadership has deteriorated steadily at every step from former president Nelson Mandela, is part of this group. In 2013, we are likely to see the rise of economic populism and a decidedly negative trajectory for the country (more on that with risk #10).
Then there’s China, where doubling down on the present development model to safeguard stability makes us more confident about domestic economic growth—but far more worried that foreign companies and investors won’t benefit from it. The investment environment will remain opaque and oriented more toward benefiting domestic players, as China’s relative power balance vis-a-vis international actors becomes more apparent. Uncertainty over China’s short- to medium-term trajectory is an order of magnitude greater than that of any other major global economy.

C—Backsliding. These are essentially “submerging markets,” countries that are both underperforming and generating unacceptable levels of political risk. Absent effective governance and facing significant economic challenges, these markets don’t deserve the benefits they draw from being lumped in the emerging market category—and should be flagged accordingly.

The most notable of these countries is Russia, where opportunities are diminishing on pretty much every front but strategic resource development. President Vladimir Putin’s popularity is starting to wane, but there’s no change in his hold on power nor any willingness to reconsider his statist, highly centralized, and staggeringly corrupt approach to economic development. External relations are becoming more challenging with both Europe and the United States, and capital flight continues apace. It’s not just hard to consider Russia a “BRIC,” it’s hard to justifiably categorize it as a truly emerging market.

Ditto many previously hailed frontier markets, where political risk has destroyed the credibility of governments and created much more downside. Pakistan fits this description, with high-level political assassinations and an increasingly unstable government drawing less international aid and political interest. So, too, Ukraine, with poor governance, no IMF deal, and nowhere else to turn but Russia. Much of North Africa belongs here—Algeria and post-Gaddafi Libya, in particular. And the increasingly marginal players in Latin America—Venezuela, a petrostate that’s teetering along with President Hugo Chavez’s health, and Argentina, with a government unwilling to improve the domestic economic or political environment.

When China becomes the world’s largest economy, we’ll likely stop using the term emerging markets altogether. But until then, it’s worth understanding that we’re no longer talking about a definable asset class. A number of these countries will contribute the bulk of the world’s political risk in 2013.

2—China vs information
Take a serious look at China and the risks come faster than you can process: labor scarcity, pensions, inefficiency of state-owned enterprises, conflicts in the East China and South China seas, clean water availability, clean air, food and commodity scarcity (and prices). Take your pick, there’s more than enough to worry about.

None of these is new. More importantly, none of them is an imminent threat to stability. As the Chinese government has shown—very effectively for more than three decades—it can manage a wide range of risks for longer than we think. Except one. The flow of information.

Cyberspace is the most effective venue for the sudden exposure of personal information—whether forced or accidental. In recent months, we’ve seen more and more examples of this. In the United States, nobody enjoys the privacy they used to. Not New York residents with gun licenses having their addresses published after the Newtown tragedy; not ever-larger numbers of leaders (CIA Director David Petraeus, federal prosecutors in Louisiana, and a host of congressmen) suddenly ousted following scandals that broke online; not Facebook CEO Mark Zuckerberg’s sister Randi when her private family photos got posted publicly.

In the developed world, that’s an annoyance, but the same trend in China has far more serious implications. In a Chinese economy that’s increasingly information driven, a larger, better educated middle class needs access to the internet as part of their work environment...and expects it as part of their daily life. Some of that information is directly undermining the political legitimacy of China’s top leaders.

Maintaining the dominant voice in communications and information flows—and limiting online and offline information channels beyond the state—remains one of the most important political tools that the Chinese communist party holds. The leadership is unaccustomed to seeing its dirty laundry online, and completely unprepared for the public accountability this new trend demands. In particular, the sudden transparency of China’s top military and civilian leaders’ personal and family wealth and how they wield their power poses a
grave danger, one they’re prepared to take extraordinary measures to manage. The widening popular discord in Hong Kong is a good example of where Beijing is headed with its contradictory approaches to information and economics; the chances of a sharper deterioration of public confidence in government will grow sharply in that city in 2013, as Hong Kong becomes a liability rather than an asset for Beijing.

The reaction of the Chinese leadership to this threat is changing. For well over a decade, response 1.0 was the great firewall of China. While that continues to be a part of Beijing’s strategy (with a renewed effort to tackle firewall evasion tactics and the National People’s Congress just last week passing legislation that would force all internet users to register their names—to better allow government tracking), the government has given up on the idea that sensitive information will somehow be kept away from its citizens. With nearly half of China’s population online, and almost 400 million microblogging and social messaging on weibo (China’s Twitter), the Chinese government has lost that battle. Instead, China vs information 2.0 means working to be the loudest voice—and to steer the conversation.

That’s leading to two different policy approaches by the government, both of which have significant downside implications. First, consolidation at the top and, relatedly, more risk-averse behavior. If there’s one thing the government has done during the current leadership transition, it’s been to consolidate the leadership because they’re most concerned with keeping the elite on a single page. It means slow progress on economic reform and bleak expectations for political reform, ensuring instead that the top leaders speak consistently with one voice. The biggest threat perceived by the Chinese government is an unorthodoxy that brings trouble from outside. And so we expect an abundance of policy caution from Beijing in 2013.

Second, there is nationalism. If you can’t beat ‘em, join ‘em. The Chinese leadership can’t control the online discourse, so they need to be the loudest voice online—and channel emotionally charged discussions into areas that are less threatening to Beijing. From the government’s perspective, who should be to blame when the Chinese population gets upset? Others. Familiar domestic “enemies” like Tibetans and Uighurs will see some of the scapegoating, but we’ll also see a substantial increase in hostility toward expatriates. Anti-US sentiment in China and Beijing’s willingness to take on regional battles, especially with Japan, are on the rise.

This threat will likely grow in coming months. If the government feels it’s starting to truly lose the struggle to contain and shape information flows, it will react with more crackdowns, more arrests, and tighter control of the web. That’s negative for the economy and a disaster for China’s international image and “peaceful development” approach to policy—isolating China further from other countries. The most likely near-term impact is a doubling down on existing policy and sharper nationalism in the region and more broadly. China’s rise—a godsend for the markets during the financial crisis—increasingly drives conflict in the post-financial crisis period. That conflict is likely to see a significant spike in 2013.

3—Arab Summer
It was barely more than a year ago that we were talking hopefully about an Arab Spring. Middle East dictators were facing a wave of domestic dissent; international observers wondered whether it could be that the “end of history” from eastern Europe and the former Soviet Union would come to the Middle East. That has morphed not into Arab Winter, where dictators rebound and consolidate power, but a long, hot, Arab Summer—with radicalized movements, sectarian and Islamist, playing a much more important role.

Rising tensions over Iran’s confrontation with Israel and the West are significant enough to merit their own top risk. But beyond Iran, the Middle East is now plagued with various overlapping tensions: sectarianism, especially an increasingly violent confrontation between Sunni and Shia both within and between countries; rising extremism, especially the resurgence of Sunni extremism in the form of jihadist and Al Qaeda-related groups; regional great power tensions, as the traditional Western powers, especially the United States, remain mainly on the sidelines and new actors jostle for influence; and continued political tension and the lack of economic progress in the states that were at the forefront of the Arab Spring.”

At the epicenter of this cauldron lies Syria, where peaceful protests against President Bashar al Assad evolved last year into a
bloody civil war that has since become a proxy war engaging the region’s Shia powers—Iran and Lebanese Hizbullah—on the one side, and Sunni powers—Turkey, Saudi Arabia, and Qatar—on the other.

In the West, the Syrian civil war is often cast as a humanitarian crisis, but in risk terms, the significance of Syria is less in its humanitarian dimension than its geopolitical implications.

Syria has become a magnet for jihadists after Osama bin Laden’s successor, Ayman al Zawahiri, declared jihad against the Assad regime—the first government thus designated that was not a close American ally. Tehran’s decision to double down on its support for Assad upped the regional stakes, especially given the increasing willingness of the regime to use airpower against (largely Sunni) civilian centers. The hope in the West was that the Syrian regime would crumble, split, or seek a negotiated settlement. None of that has happened, and the West is now caught between its unwillingness to get more deeply involved and its lack of an alternative strategy to address the crisis.

In 2013, Syria’s descent into chaos is spreading insecurity into Iraq, Jordan, and Turkey, and threatens to unhinge the greater Levant. Rising Sunni militancy in Syria is spilling over into Iraq’s Sunni triangle, and Syria has again become the entry point for foreign jihadists, challenging both the Shia-dominated government in Baghdad and Iraq’s Sunni political establishment. Less obvious but equally challenging for Iraqi stability and for the overall regional map is the emergence of a de-facto Kurdish mini-zone in northern Syria, whose impact is now felt across Kurdish communities in Turkey, Iraq, and Iran. (Reminder: The Kurds were the only major group not to get their own state after the Ottoman Empire collapsed at the end of World War I.) In Iraq, the Kurdish regional government is becoming more aggressive in promoting its energy development agenda against the wishes of Baghdad, and will seek to take political advantage should Syria’s Sunni-Shia proxy war spread into Iraq. In response to all this, Iraqi Prime Minister Nouri al Maliki is leaning further toward Iran in his constant tight-rope walk between Tehran, the regional Sunni powers, and Washington. This will further antagonize the Saudis and Turks. In a region where Shia-Sunni tension cannot be contained, a unified and stable Iraq becomes less and less likely.

In North Africa, new regimes are having a difficult time consolidating and establishing a new political identity that can accommodate the challenging mix of deepening Islamism, pressing economic demands, and a disturbing lack of strong political leadership. Libya is the most negative face of this dynamic, where Muammar Gaddafi’s most lasting legacy appears to be institutional destruction so deep that restoring even basic security and legitimacy has not proven possible. In its absence, radical elements are providing basic security and fragmented governance in many areas of the country.

In Egypt, the story is more mixed, especially at the political level, where the media continues to label every political challenge a regime crisis. But at some point, President Mohamed Morsi will have to pay much more attention to Egypt’s economy if the Muslim Brotherhood is to consolidate its support. The country’s foreign reserves and currency have plummeted, tourism remains stalled in the face of constant political maneuvering, and negotiations for a much-needed $4.8 billion IMF loan have dragged on because of the constitutional crisis. Ineffective rule could easily swing toward greater populism and governance by the lowest common denominator—it’s very hard to see a win for the moderate secular “revolution” here.

4—Washington politics

2013 should be a year for reform progress and renewed economic dynamism in the United States. Structurally, the US is on the brink of big upside developments—a domestic energy revolution that will reduce domestic production costs and improve the trade balance, the potential for major transpacific and transatlantic trade agreements, a rebounding housing sector, and a business community that is emerging from the financial crisis in strong condition. Moreover, President Barack Obama should be at the height of his political capital after winning reelection in November, and Republicans should have much more freedom to compromise than after the 2010 electoral repudiation of the president and his party, which led to gridlock in the past two years.

But every silver lining has a dark cloud, and dysfunctional American politics will weigh on both the economic recovery and the president’s legislative agenda. We are not predicting a politically induced new recession, let alone a major financial crisis. Yet political uncertainty over corporate taxes and a series of noisy brinkmanship
episodes will generate a modest but real drag on growth.

The fiscal cliff was averted, but the process by which the deal was reached casts a long shadow over hopes that the election might create a more conducive environment for cooperation centered on Obama and House Speaker John Boehner. The model of Vice President Joe Biden and Senate Minority Leader Mitch McConnell reaching a one-minute-to-midnight deal and then steamrolling it through the House of Representatives does not bode well for legislative politics this year. The cliff deal looks like the latest of a series of small, tactical legislative victories for the president—getting hundreds of billions in new revenue with virtually no spending cuts in return—that he has been unable to turn to larger strategic advantage.

Push will come to shove pretty quickly with the conjunction in late February of the debt ceiling limit, the end of the sequestration extension, and the need for a continuing resolution to avoid a government shutdown. Obama has said he will refuse to negotiate over the debt ceiling, while Republicans see this series of decisions as their best chance to extract the entitlement reform and discretionary spending cuts that they failed to win in the fiscal cliff endgame. The politics of the fiscal cliff strengthened Obama’s hand, since Republicans did not want to take the blame for higher taxes for all Americans. The politics of the debt ceiling will not be so favorable for him.

Markets generally discipline political actors who fail to solve problems or push fiscal problems to the brink. But in the United States, bond market pressure for fiscal consolidation and equity market pressure to support growth are now close to irrelevant considerations in the political process. Bond market pressure is absent because the United States remains a relative investment safe haven, and the recent ease with which Obama and Boehner walked away from broader deficit reduction demonstrated the safe haven curse. Therefore, politicians have little reason to agree to take the pain on the deficit reduction side.

Washington is also suffering from the procrastinator’s curse. With all four major brinkmanship events in the past five years ending in agreements (TARP, shutdown, debt limit, fiscal cliff), markets have been “trained” to reserve judgment until the end, minimizing one feedback mechanism that would otherwise force Washington to agree to deals more swiftly.

Media attention has focused like a laser on House Republicans and their responsibility for Washington’s dysfunction, but only the president can shift the politics of fiscal policy. Obama could change the political dynamic in his State of the Union address by presenting a new bipartisan pitch for a big fiscal compromise. But the bar for engaging a restive set of House Republicans has been raised considerably, and we see little indication that Obama will take this opportunity.

5—JIBs—Japan, Israel, Britain

There are three current global trends that matter most: China is rising, the Middle East is exploding, and Europe is muddling through. Set against a G-Zero backdrop, the structural losers of these trends are the JIBs, countries impacted most directly and problematically by changes now underway in the geopolitical order.

These countries find themselves in very similar positions, for three reasons. 1) Their special relationships with the United States no longer carry quite the importance, or centrality, that they used to. 2) They sit just outside the major geopolitical changes underway, and have few available means of playing a constructive role in them. 3) Key domestic constraints in all three countries (political, social, historic, and otherwise) make it particularly difficult for them to respond effectively to the challenges posed by these changes.

Japan faces a much tougher relationship with China, one that’s far more difficult to navigate than other countries in Asia. Unlike other Asian countries, where China’s leaders believe that the power balance (and the presence of Chinese minorities) benefits them sufficiently to allow for an incremental strategy, Japan is too big for that. Further, Japan doesn’t have as much importance for China to be concerned about the potential downside—China no longer needs Japan’s investment dollars because it can get much the same technology from South Korea and Taiwan. Accordingly, China is increasingly prepared to provoke. With the new Japanese election, the potential for Japan to give the Chinese further excuse to lash out is high. Dangerous geopolitical conflict

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is on the horizon in 2013 (also see risk #7.) It’s probably the single most important, and dangerous, geopolitical conflict on the horizon in 2013, and Japan has little capacity to avoid it.

Great Britain is damned if they do and damned if they don’t with the European Union. If they stay in, they will become more marginalized as the Eurogroup plays a larger role; they are increasingly “takers” on a bunch of regulatory issues. If they don’t, they face a Europe that will be increasingly heading in a very different direction in terms of economic and regulatory models. Great Britain’s “best of both worlds” with Europe will become unsustainable—Britain won’t necessarily exit (certainly not this year), but its decision to remain at the margins of the continent and its changes will prove economically problematic.

Israel faces the erosion of moderation and mounting tension between Shia and Sunni extremists, who will compete for influence. The countries they could historically work the most closely with in the region—Egypt and Jordan—are now under tremendous domestic strain and are likely to become at best problematic occasional colleagues, at worst directly antagonistic. Turkey hasn’t the same domestic turmoil, but Prime Minister Recep Tayyip Erdogan sees advantage in being ahead of the crowd and has turned against the Israelis, and the traditional alliance with the United States buys them less than it used to. The good news: They have the security advantages. But that’s increasingly the only good news they’re seeing. Given all the trouble, it’s a critical time for the Israelis to get truly serious on resolving the Palestinian conflict, but with domestic political trends in Israel moving the country in the other direction, that’s implausible.

6—Europe
The risks generated by the European financial crisis were substantially lowered when, in late summer, German Chancellor Angela Merkel rejected the hardline approach of the German Bundesbank leadership and endorsed European Central Bank (ECB) President Mario Draghi’s commitment to buy the bonds of ailing eurozone countries. The Merkel-Draghi axis looks set to endure and puts a strong floor under Europe’s crisis by substantially diminishing the possibility of currency convertibility. But as we’ve been saying for two years now, the eurozone is headed for neither break-up nor resolution, and in 2013, the risks shift from threat of financial crisis to a loss of momentum in creating the institutional and policy frameworks for a redesigned eurozone.

The weak economic outlook and the politics of crisis-fighting will remain sources of uncertainty and risk in 2013. Simultaneously, euro-skepticism is on the rise, and resistance to reforms is increasing given the protracted period of austerity in the absence of prospects for an economic turnaround. Big compromises will be needed to make further progress toward banking union, fiscal union, and an integrated policy framework. The ECB’s floor under the crisis creates a negative incentive, given that in the absence of strong market pressure member states will be tempted to slow the pace of integration that compromise their sovereignty.

Beyond these general issues and the continuing turbulence in Greece, the biggest specific challenges for the eurozone in 2013 are tied up with the Italian and German elections, both of which carry important implications for the eurozone’s trajectory, though for different reasons. In Italy, the primary risk stems from an inconclusive general election result that could challenge the ECB’s bond-buying program (known as the Outright Monetary Transactions program), which remains an untested instrument.

In fact, Italian elections might well yield a fragmented parliament, with anti-austerity populist parties acquiring a large number of seats and the new government struggling to provide political stability. Reaching consensus on unpopular economic reforms will be challenging, raising the risk of market volatility and higher financing costs. In this context, the government could seek a precautionary program from the European Stability Mechanism, the member states’ own firewall instrument. This would allow the ECB to purchase Italian debt in the secondary market provided the government signs up to and meets a number of economic reform commitments. This is where the ECB’s instrument would be challenged: If the government does not meet its reform commitments, three difficult choices would face the ECB: i) the bank would insist on the adoption of additional fiscal measures, further undermining growth; ii) the ECB would continue to buy bonds, even if targets are not met, undermining its own credibility and encouraging moral hazard in Italy and elsewhere; or iii) the ECB would stop purchasing bonds, deepening the crisis in Italy and the wider eurozone at the time when both are most vulnerable.

UNTIL EUROPE FINDS A FORMULA FOR RESTORING ECONOMIC GROWTH MORE BROADLY, THE RISKS AROUND THE EUROZONE CANNOT BE PUT IN THE REAR-VIEW MIRROR
In Germany, the risks around the election do not stem from the outcome per se: It is widely expected that Merkel will prevail and the status quo German strategy of incrementally fighting the crisis will persist. Rather, the risk is that in the run-up to elections, crisis management will be put on hold as the Merkel government delays decisions that could hurt her popularity. Most at risk here are moves that would allow for the direct recapitalization of eurozone banks and the building of an ambitious fiscal and banking union. The pre-election context will also make day-to-day crisis management more difficult. For example, in a scenario where Italy (or another country) does not meet reform commitments, it would be more complicated for Merkel to support continued ECB bond-buying, given the German public insistence that any financing of peripheral countries be contingent on strong conditionality. Having said this, the underlying political support for the eurozone remains strong across government and the public.

The bottom line is that until Europe finds a formula for restoring economic growth more broadly, the risks around the eurozone cannot be put in the rear-view mirror. We’re not quite there in 2013.

7—East Asian geopolitics

Geopolitical risk will continue growing in East Asia in 2013 in a new, and potentially more dangerous, way. For the past decade, the main drivers of regional risk have been North Korea’s nuclear provocations and tensions around the status of Taiwan. These issues were well-defined, and risks were offset by regional commercial integration and shared economic growth. The good news is that North Korea and Taiwan no longer loom as major sources of tension. North Korea has been somewhat less provocative, but at least as importantly, cooperation among other regional actors—along with the United States—on how to manage Pyongyang has actually deepened considerably, lowering the risk of an escalation scenario. And while Taiwan’s long-term status remains uncertain, there is now a stable bargaining environment between Beijing and the ruling Kuomintang in Taipei.

But broader regional relations have become more tense recently as a more nationalistic China has veered sharply away from its “charm offensive” approach to Southeast Asia, while simultaneously becoming more assertive in northeast Asia; and the United States has renewed its strategic and economic commitment to the region, giving oxygen to the hedging strategies of many regional states seeking closer ties with the United States. This in turn has led to another round of “the US is out to keep China down” thinking in Beijing, and growing tensions between the world’s two most important powers. At risk here is the decades-long pattern of East Asia as a zone where positive-sum commerce and economics trumps zero-sum geopolitical tension.

Assertive nationalism from Beijing—most prominent in the form of longstanding expansive maritime claims to a Chinese “core interest”—has engendered a tipping point in how the region is viewing China’s rise, with a deep unease displacing optimism and generating a parallel, if more defensive, nationalism in most of the other states of the region. For the Asia-Pacific region broadly, at the core of China’s appeal has been the belief that China’s economic dynamism creates opportunities for its neighbors, as well. The new conventional wisdom across much of the region is that the era of a cooperative, dynamic, and non-assertive China is over and that the regime they now face will be less dynamic economically and more assertive regionally.

The first serious sign of regional geopolitical tensions moving into the economic/commercial sphere was the government-inspired attacks on Japanese businesses in a number of Chinese cities last fall, as tensions around the Senkaku/Diaoyu islands escalated. Chinese officials told other countries not to worry, that the “anger” would be directed only at Japanese firms and products, which was probably not very reassuring to many.

Given the huge internal challenges they face as they seek to consolidate power, China’s new leaders—President Xi Jinping and Premier Li Keqiang—are unlikely to adopt a less assertive regional stance. It will be virtually impossible for them to yield on territorial or diplomatic disputes early in their tenure. But the dilemma for China is that its inflexibility on such issues—including those currently flaring up in both the South China and East China seas—compels some of its neighbors to take more forceful positions against Beijing and seek closer strategic
engagement with Washington. The Chinese have yet to acknowledge this security dilemma, let alone address it, instead insisting that sharper regional tensions are arising solely from the US pivot.

Consequently, there’s a high likelihood that this dilemma will come into even sharper relief in 2013. If Beijing faces a foreign policy test, Xi will have a strong incentive to demonstrate his foreign policy mettle and avoid being seen as capitulating to outside interests. That dynamic suggests less chance of compromise from Asia’s emerging strategic powerhouse and heightened risk throughout the region.

More nationalist policies are also expected from Japan. The country will become more assertive in its policy postures as a new government led by the Liberal Democratic Party pursues a more nationalist bent. New Prime Minister Shinzo Abe has already pledged to strengthen Japan’s defense capabilities and solidify Japanese control of the Senkaku/Diaoyu islands. Beijing will see such a move as confrontational, and it will herald another period of heightened tension in the Japan-China relationship.

In Southeast Asia, Vietnam and the Philippines are likely to continue to test Beijing over territorial issues, driven by their perception of US backing and their sense that China will not ultimately push toward an actual military confrontation. In the meantime, both countries are deepening their own security ties not just with the United States but with Australia and Japan, as well.

In this context, the lack of effective East Asian regional organizations to mitigate security tensions will become increasingly apparent. While some will want ASEAN to play this role in Southeast Asia, Beijing continues to insist on a bilateral approach to territorial and security issues and has enough influence with Cambodia and Laos to prevent any unified ASEAN stance. And the United States will have to balance the need to reassure its friends and allies with the need to avoid a continued deterioration in relations with Beijing. Don’t expect a new equilibrium on these tough issues this year.

8—Iran

It never fails, we give a speech and we get the question—when is the United States or, failing that, Israel going to bomb Iran? It’s very unlikely, especially in 2013. The more militarist pronouncements of Prime Minister Benjamin Netanyahu and other Israeli leaders are less a signal of Israeli willingness to attack than an exertion of maximum diplomatic and economic pressure on Iran and an effort to get the United States “gradually pregnant” in its willingness to use the military option. But a war-wary America led by a president skeptical of the Israeli prime minister ensures there will be many steps between “taking containment off the table” and actually going to war.

So the risk of military strikes this year triggered by progress in Iran’s nuclear program is less than most observers believe. The Iranian government is not on the verge of a viable “breakout path” based on available data and is unlikely to dash toward a bomb this year. Netanyahu will almost certainly be reelected next month and will continue to highlight the Iranian threat, but will be loath to initiate an attack without evidence of some kind of technical breakthrough or a move by Iran to “sprint to the finish” by expelling International Atomic Energy Agency inspectors.

There is a significant risk; it’s just not the one people are thinking about. We’re likely to see a sharp escalation in the shadow war between Iran and Israel and the United States—a cycle of mutual killings, cyber-attacks, and proxy battles—that has been ongoing for several years. This shadow war has the potential to rattle markets and put upward pressure on oil prices (though in a generally more bearish overall energy environment—see Red Herrings) and could lead Iran, feeling especially vulnerable given the deterioration in Syria that we mentioned in the “Arab Summer,” toward more aggressive action and tit-for-tat escalation. It’s not hard to see how we get from here to there.

The early months of 2013 will likely see a round of intense negotiations between Iran and the West, but unless Iran’s Supreme Leader Ali Khamenei sharply recalculates Iran’s options (unlikely but not impossible—particularly given the timing of the upcoming Iranian presidential elections), these talks will fail and by spring we will again see intensifying sanctions. Those sanctions are already biting—over a million barrels of oil production have been taken off line from sales and tough banking restrictions. Against the backdrop of economic mismanagement and sanctions, Iran’s currency has virtually collapsed.

As new sanctions are put in place, efforts to sabotage the Iranian nuclear program will also escalate. Pressure will intensify on Iran’s leadership to do something in response, both to rally domes-
tic support and to project an image of strength. The combination of continuing Iranian resolve on the nuclear program and internal political and economic weakness will likely lead Iran to escalate its side of the shadow war.

The chance of miscalculation and over-reaction on both sides would then rise. A successful plot similar to the October 2011 plan to assassinate the Saudi ambassador to the United States by bombing a restaurant in Washington would provoke swift and lethal retaliation by the United States. An episode like the 2008 swarming of US naval ships in the Gulf by Iranian Revolutionary Guards’ “fast boats” could equally spark a sharp escalation. So despite our contrarian view that 2013 is not going to be the “year of decision” on the basis of the status of the Iranian nuclear program, the escalating shadow war will keep tensions high and investors on edge.

9—India

India in 2013 will be one of the prime examples of the intrusion of political factors into what had been until recently seen as a long-term economic success story. We have all read articles about how, with the looming long-term structural slowing of China’s economy, India was poised to become the world’s next “growth uber alles” country. Not so fast.

A landslide reelection in 2009 enabled the Congress party coalition to rule without the encumbrance of the communist party, which Congress often blamed for holding back reform. Markets surged, and expectations rose for a new round of fundamental reforms. After all, the architect of Indian reform, Manmohan Singh, was now in full control, and could claim both the confidence of party leader Sonia Gandhi and the commitment of a large group of savvy technocrats ready and willing to push the reformist boundaries. Large-scale reforms—to mining, energy, land acquisition, tax regimes, financing instruments, and more—were to boost economic growth toward a 10% trajectory.

But while India sustained generally substantial growth rates, the tough political choices on reform were continually left for the next parliamentary session, and the breakthrough to higher growth was not achieved. Instead, corruption issues tainted the government, coalition partners proved to be less compliant than expected, and most importantly, the anti-reform elements within Congress showed that they still had considerable political clout and influence with the “ruling family.”

In 2013, the ability of the government to implement robust economic policies will decline even further, perpetuating India’s “stalling or falling” outlook. As general elections draw closer, political opportunism and obstructionism will increase. Any support for reform from the fickle regional parties that hold the balance of power in parliament will likely wane. These parties will distance themselves from the unpopular, corruption-tainted Congress, increase the powers of the state governments they control vis-à-vis New Delhi, and position themselves as kingmakers in the post-election landscape.

Congress’s appetite to push for any reforms will diminish as it goes into full-blown campaigning mode. For its part, the opposition Bharatiya Janata Party will remain obstructionist, especially given that it will be politically consumed by figuring out who should lead the party in the upcoming election battle. These trends will be exacerbated if the election is held early, before the end of 2013. Poor policymaking will extend to fiscal policy, where any meaningful fiscal consolidation in 2013 is unlikely.

Continued profligacy heightens the looming risk of a sovereign ratings downgrade to “junk” status, though the government will seek to accomplish just enough on the reform and fiscal fronts to forestall a downgrade, which heightens India’s fiscal troubles by raising the government’s borrowing costs. It would also precipitate a fall-off in FDI inflows and a likely outflow of foreign portfolio inflows, which in turn would put downward pressure on the rupee.
In the best of circumstances, the political context for economic reform might improve following the elections. But, at this point, the more likely outcome is that India’s policymaking environment becomes even more difficult as the poll is expected to return a more fractious and divided parliament, generating a weak ruling coalition without the political support for a strong reformist push.

10—South Africa
Sub-Saharan Africa, more than any other region, epitomizes the paradox of the shift in economic dynamism to the emerging markets and the significant increase in political risk. In aggregate growth terms, Africa looks to be on a trajectory to continue its recent positive performance. Middle classes are rising, and more countries are headed on higher growth trajectories. But investor beware, in Africa’s two largest and most sophisticated economies—South Africa and Nigeria—the outlook is much less rosy. For Nigeria, the outlook for 2013 is pretty steady, if negative; and it did not make the top risks list. But South Africa, which we included in our 2012 top risks, again makes the grade, as the trends we correctly highlighted last year appear even more ominous for 2013.

The ruling African National Congress’s (ANC’s) recent party conference saw the consolidation of power by President Jacob Zuma and the replacement of party vice president Kgalema Motlanthe with labor-leader-turned-capitalist Cyril Ramaphosa. While appearing to signal a more pro-business tilt, this will almost certainly not be the case. The ranks of reformist and “conciliationists” within the ANC leadership continue to thin, shrinking the party’s “broad church” and deepening its reliance on patronage politics. Perhaps more significant than the Ramaphosa appointment was the fact that former finance minister Trevor Manuel, the ANC’s most internationally respected policymaker, chose not to remain on the party’s 80-member executive committee.

As for Ramaphosa, he is one of the richest and most prominent of those politically connected black South Africans who have taken advantage of black economic empowerment deals and whose success has undermined the credibility of the ANC by highlighting the problems of corruption and inequality.

In fact, the political trends emerging in South Africa are all heading in the same direction—more populism as a strategy by the ANC to maintain its base among the urban and rural poor. The policy initiatives emerging in South Africa are all heading in the same direction—more populism as a strategy by the ANC to maintain its base among the urban and rural poor. While the policy platform that came out of the national conference is quite balanced, it is hard to see real movement on non-populist measures such as loosening the country’s strict labor regulations, modernizing the educational system, and rationalizing state spending, especially at the local level. Rather, the ANC consensus around greater state intervention in strategic industries (mining, mining-related manufacturing) will become policy. Look for higher mining taxes and the speeding up of already significant efforts to exert political influence over the entire sector.

The party will look to shore up support ahead of 2014 elections via social spending, public sector employment, and more aggressive land reform policies. We expect social unrest to deepen in 2013. Coming retrenchments in mining will almost certainly spur another bout of labor unrest following 2012’s violent confrontations between miners and the police, and the mining sector has always been in a leading role in South Africa’s trade union politics. The demise of the once-dominant national union of miners because of its inability to defend miners’ interests will lead the national COSATU federation to become even more assertive, making other sectors more vulnerable to the mining precedent.

Social and political unrest could spread beyond the labor terrain. We expect continuing “service delivery protests” in urban/peri-urban areas. More significant is the risk of political violence as losers in the ANC factional battles ponder next steps and opposition parties and the ANC begin to prepare for national elections in 2014. All this will add spending pressures on the ANC government and sap any reform momentum. South Africa still has many institutional strengths and we are not predicting a fundamental political crisis, but the country is headed along a path that gives little reason for optimism.

Red herrings
1—Geopolitics of energy. The Middle East is exploding. Any time you’ve heard that in the past 30 years, it meant that energy...
prices were going up. Political risk has been more linked with oil prices than any other market area in the world in the post-war era. But most of the Middle East risk in the coming year isn’t about energy producers; it’s about everywhere else. Syria, Jordan, Lebanon, Israel/Palestine. The Iran risk is there, but lower than the markets think. And while Iraq is becoming a much more serious investment risk, for 2013, most of it doesn’t impact oil production.

Add to this the energy revolution coming from the western hemisphere—unprecedented amounts of unconventional gas and oil coming from the United States, as well as exploitation of Canada’s oil sands, and offshore Brazil and Mexico also coming on line. Looking ahead, new fossil fuels are increasingly coming from the developed world and more stable developing countries. That’s a boon for the western hemisphere, and it’s helpful for global consumers writ large.

That’s not great news for poorly governed resource-rich countries like Russia and Venezuela, which really need high energy prices to keep afloat. It also creates a new nearer-term Middle East risk—Saudi Arabia versus an (Iran-influenced) Iraq, both competing for tighter market share in energy and unwilling to produce less and benefit its neighbor. But for the headlines around geopolitical risk spiking energy prices, 2013 isn’t the year to get overly concerned.

2—Global protectionism. Since the financial crisis hit in 2008, we’ve been hearing a constant refrain about the impending rise of protectionism, and the threat it poses to the global economy and globalization. In the annual meetings of the G20, virtually the only issue on which there has remained a strong consensus among the leaders is the looming threat of protectionism and the need to ensure that this risk is not realized.

But maybe the G20 can afford to agree on protectionism because there’s less threat here than meets the eye. Over the past five years, protectionist measures have been rare and relatively small-scale. There has been a lot of talk by the Brazilians about the US Federal Reserve’s series of quantitative easing measures as protectionism, for example, but that gets the story very wrong. Quantitative easing may have put some downward pressure on the dollar (but not much), but the goal was certainly not trade-related.

Looking at 2013, the trend is actually going the other way. In fact, we’re seeing a quickening of competitive trade liberalization efforts, as the European Union—in the face of bleak economic forecasts and efforts by the United States and others to push toward final agreement on a framework for a Trans-Pacific Partnership (TPP)—is generating a strong internal consensus on the need for a new major transatlantic economic cooperation package.

So far, Washington has pushed back on Brussels, not wanting to dilute efforts around the TPP. But if the TPP hits any significant roadblocks this year, Washington policymakers could very well open negotiations with the European Union, creating competitive pressures and enhancing American leverage with both sides. In any event, we could very well see two giant trade deals over the next couple of years that, taken together, provide an alternative pathway forward for trade liberalization in the face of the endless negotiations around the WTO’s stalled Doha round. If so, it would be one of the biggest and most creative examples of what coalitions of the willing can accomplish in the G-Zero world.

3—Radicalism in the developed world. The gap between rich and poor continues to grow, particularly in the United States. Austerity is biting in Europe. And Japan looks toward a third lost decade. Surely class warfare will trigger considerable instability across the developed world?

No. For much the same reason that emerging markets are the top risk this year, it’s the underlying stability of advanced industrial democracies that will come through in 2013. The European periphery has been through three years of crushing austerity—the sorts of measures that aren’t remotely feasible in emerging markets and would shake many of their political institutions to the core. In some cases, with governments effectively appointed by European institutions (Italy, Greece), with record level unemployment, and a recession (in the case of Greece, a depression). And the impact? Demonstrations, expanded support for fringe parties (the UK Independence party, some anti-immigrant parties in a few European states, fringe groups like the Pirate Party in Germany and the Five Star movement in Italy). But nothing that threatens the viability of the governments or governing process.

In the United States, the rich/poor divide is greater than it’s been at any point since the Great Depression. We’ve seen the statistics: The top 1% of American households owns 34.5% of US wealth...
(75% for the top 10% of earners); compared to 1% for the bottom half of American earners. From 1979 to 2007, the top 1% of households doubled their share of pretax income while the share of the bottom 80% fell. But priorities of the United States can be fickle—the debt, healthcare, gun control. Wealth redistribution? Not a priority. And the American population is hardly prepared to revolt over it. The Tea Party movement has elements of nativism but has been largely subsumed by the Republican Party. And the Occupy Wall Street movement? Pretty much out of steam. A return to improved economic growth levels is only going to help, even as the gap between rich and poor continues to widen.

And Japan? Two lost decades, going on three. No growth, but that has less near-term impact on personal well-being, given that Japan’s population is declining. No growth, but population is declining. Elections had low turnout, particularly among the youth. That’s worrisome in terms of engagement. But there’s no movement toward radicalism. Japan has the potential for big demonstrations on the nuclear issue and, worryingly, on China. But that’s about it.

Longer term, if none of these issues is addressed, they’ll surely become more serious. In the European periphery before anyplace else—and so we’ll be hearing more about whether or not there’s a truly a “return to growth” strategy. For the United States and Japan, it’s a matter of more than a decade. For 2013, this isn’t a risk. It’s a herring.

4—European separatism. There are very real separatist pressures building in Catalonia and in Scotland, and national unity remains fragile in Belgium. But there is almost no chance that any of these issues grows into an actual crisis in 2013.

Catalonia will take the first steps toward holding a referendum, but a vote is unlikely until 2014, and a new fiscal deal with Madrid could even contain the push for self-determination. Following regional elections last year, a new center-left coalition was created to push for a referendum in the next two years. However, the coalition is not unified on economics with the center supporting austerity, while the left remains fundamentally opposed.

This tension could have implications for negotiations that will take place over the referendum. Catalan Premier Artur Mas will push aggressively for the referendum to maintain the stability of the coalition. But Spanish Prime Minister Mariano Rajoy might give Mas some economic concessions in separate negotiations over funding regional autonomy in order to divide the Catalan coalition. A better fiscal deal would help Mas save face and could eventually put off a referendum. 2013 will see growing debates around the effects of independence of Scotland from the United Kingdom, which will generate considerable noise. But Scotland’s referendum will not happen until 2014. In terms of the eventual outcome of the vote, polls show that most Scots actually oppose a “yes” vote, fearing tough negotiations over defense and oil revenues, among other issues. Moreover, an independent Scotland could be forced to reapply for EU membership and move toward euro adoption, both of which are highly unpopular.

In Belgium, the rise of the separatist new Flemish alliance (N-VA) will make negotiations on further devolution and finances difficult, but even an eventual collapse of talks won’t lead to the partition of the country. The victory of the N-VA in local elections puts the federal government under pressure. Two of the three Flemish parties present in the six-party federal government—the Liberal Open VLD and the Christian Democrats—need to deliver a credible alternative to the separatists in order to quell public demands for separation. Therefore, the Belgian government will face important challenges to its unity, but the next real challenge for the territorial integrity of the country will be the federal election scheduled in 2014.

?-North Korea. Sometimes...you just can’t know what’s happening. Looking at North Korea this year, that’s really the case. We’ve had a fairly sudden leadership transition in the world’s most totalitarian state, under massive economic pressure, with an untested 28-year-old now running the country. So far, very surprisingly, it’s gone well. Indeed, it’s probably gone better than anyone would have dared presumed—in his first year of power, Kim Jong-un has presided over a regime that’s a bit more transparent, a bit more balanced, and barring a few early purges, a bit more stable.

Even when the North Koreans tested an advanced rocket last month—the sort of thing that would have set off all the alarm warnings in previous years—it was a smaller deal given the way they conducted themselves internationally: with less belliger-
ent propaganda, talking in advance with China and Singapore, making clear what was coming and when. Then, offering a public address for the new year, Kim said his country was seeking economic development and so he hoped to “remove confrontations between the north and south.”

How has the unknown and untested Kim managed to pull that off? Is he sincere? Can he continue? We honestly don’t know. And neither does anybody else. It’s almost impossible to assess whether North Korea is becoming more stable and, if it is, whether that now means the South Koreans, in particular, can start resting a bit more easily. Everything about the North Korean system tells you it’s a perilous bet as a country—but what causes trouble and when? We’d like to say it’s not worth losing sleep over. That’s not quite true. But at the same time, working harder to assess what exactly is going bump in the night doesn’t feel very purposeful. Sorry.