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TOP RISKS 2011

THE RISKS THAT EXERCISE US MOST USUALLY CENTER ON A COUNTRY, AN ISSUE, AN EVENT. WE WORRY OVER POLITICAL CHAOS BEFORE OR AFTER AN ELECTION, A COUP IN A FRAGILE REGIME, OR MILITARY CONFLICT WITH A ROGUE NATION. BUT FOR THE FIRST TIME SINCE WE'VE BEEN WRITING, THE POLITICAL RISK ENVIRONMENT IS MUCH BROADER THIS YEAR. IT'S THE CHANGE IN THE WORLD ORDER ITSELF THAT GIVES US MOST CAUSE FOR CONCERN.

Two years after the financial crisis, there's a strong argument to be made for optimism. The American economy is poised for (at least modest) growth and emerging markets are still churning ahead. By that logic, it's high time for governments, captains of industry, banks, and citizens to get back to business. Time to leave behind record gold prices and put the trillions of dollars sitting on the sidelines back to work.

But that conclusion implies a level of confidence, if not quite comfort, with where the world is headed. Whatever your expected shape of economic recovery—a U-curve, V-curve, L-curve, or something else—we're entering an entirely new world order. That means new ways for states to relate to one another both politically and economically. It means new areas of conflict. 2011 looks to be the year that our understanding of how the world works becomes out of date.

This is scary not because it's incomprehensible but because the scale of change is so great that it becomes difficult to manage. Few of us have experienced a transition of this scope. Following the collapse of the Soviet Union two decades ago, it was fashionable, briefly, to herald

a new world order. The pronouncements were premature. Soviet collapse remade the global security balance, but its economic impact was considerably more modest. The advanced industrialized economies had ruled the global economic system; the end of the Cold War meant a move from the G7 to the “G7 plus one.” Globalization sped up a bit, the West had new countries to invest in (at least for a while), and some of the old ones (Germany) got stronger. “Plus one” didn’t imply a new world order.

That’s not true today. After the financial crisis, the G7 was replaced by the G20. This change brought no challenge to America’s global military supremacy. But the rules of the economic road are a different story and the new geopolitical order is shaped not by a military balance but by an economic one. This new world order marks the end of a decades-long agreement on how the global economy should function. This is world-changing indeed, because the dominant economic trend of the last half century, globalization, now faces a direct challenge from geopolitics.

The rise of this new order will have a profound impact on nearly all of the world’s big-picture, long-term trends. A lack of coordinated governance on key economic issues will become entrenched and give rise to lasting international conflict. States and corporations will become more closely aligned in both developed and developing states. Most significantly, we’ll see a shift in the highest levels of global conflict to the region where globalization and geopolitics collide with greatest force: For the past 20 years, the sharpest geopolitical tensions were to be found in the Middle East; we’ll now see a decisive and long-term shift of those tensions to Asia. All the risks we’re looking at in 2011—conflict from the North Korean succession process, the unwillingness of China to budge under international pressure, the lack of political and economic coordination in Europe, currency controls intensifying global economic misalignment, the geopolitics of cybersecurity—are intensified by this transition to a new world order. The red herrings on our list avoid risk in spite of it.

Surprisingly, and despite all the anxiety these changes have created, there’s no name for this new era. We propose the G-Zero. This is the lens through which we’ll understand global events in the coming years. It’s our top risk for 2011.

1—The G-Zero

In the G-Zero, the world’s major powers set aside aspirations for global leadership—alone, coordinated, or otherwise—and look primarily inward for their policy priorities. Key institutions that provide global governance become arenas not for collaboration but for confrontation. Global economic growth and efficiency is reduced as a result.

It’s a new phenomenon in the post-industrial world. For a brief period following the financial crisis, governance of the global economy looked to be handed over to the G20. It was a decidedly messier group than the G7, with a broader agenda and less room for agreement. Still, at least in principle, members shared an overriding interest

in the stability of the international system. However much the national interests of members may have differed, G20 leaders shared a willingness to work in concert (or at least to talk

the talk) until the world economy stabilized. This was the “rise of the rest” model—a post-American world to be sure, but one where the US continued to play a guiding role.

G20 cooperation proved a short-lived collective reaction to panic: safety in numbers in the face of imminent disaster. The first indication it wouldn’t last came in Copenhagen a year ago, following a climate summit marked by such disunity that the outcome was worse than if no meeting had taken place. Climate proved a sufficiently low-grade priority in the middle of a hard-fought global economic recovery that the frictions were quickly forgotten. That’s less the case with last fall’s IMF meeting in Washington and G20 meeting in Seoul, which ended with warnings of a global currency war and a return to the national economic barriers of the 1930s. During both summits, the economic strategies of the world’s leading economies were set in opposition to one another. In 2011, as the interests of developed and developing states diverge, and as American, European and Japanese lawmakers split over the relative merits of stimulus

GLOBALIZATION NOW
FACES A DIRECT
CHALLENGE FROM
GEOPOLITICS

and austerity, the biggest global plenaries will experience a breakdown of order. This is not simply a lack of coordination and progress; increasingly they will become fora for political posturing at best (the January Obama-Hu Jintao summit, the World Economic Forum), conflict at worst (the Cannes G20, the IMF). During these meetings, markets will hold their breath, hoping they pass without incident. No new global alignment sits over the horizon. Why the G-Zero and not bloc-formation where countries pool their influence? Because the default policy response to a breakdown in global economic governance is every man/nation for himself. As demonstrated even in a politically integrated Europe, without common rules, there's no such thing as collective economic security. In the G-Zero, domestic constituencies will become increasingly effective in pushing populist agendas on trade, currency, and fiscal policy. However much economic dispositions become ideologically statist, in the absence of agreed global norms, economic agendas are overwhelmingly resolved at the national level (whereas security policies, with the partial exception of those of superpowers, are overwhelmingly resolved in coordination with allies). Hence there's no near-term Beijing consensus; no development of the BRICs as an effective bloc; and no effective coordination of the "West."

To be sure, as economic (and related political) conflict grows over time, greater coordination will eventually evolve as a response, first at subregional and then regional levels. And even at the height of the G-Zero not everything on the global stage is up for grabs. There's little capacity to build a nuclear nonproliferation regime in a G-Zero world, but it's not as if the G7 was more effective on that score—financial crisis or no, North Korea and Iran were still going nuclear. And the US had a tough time drumming up support for military campaigns in Iraq and Afghanistan well before the G20 took center stage. But that's little consolation for the coming year. As geopolitics takes on an increasingly geoeconomic hue, all the G20 pledges to avoid the mistakes of the past will not prevent the G-Zero from taking hold and sparking other forms of conflict.

2—A messy eurozone

2011 will be a year of growing uncertainty for Europe. The eurozone will remain intact, but the risk will grow that the crisis will balloon into something unmanageable. The main problem is that the politics of austerity in the periphery is probably not sustainable, undermining the prospects for the "bailouts with tough

conditionality" strategy to contain the crisis. The core eurozone countries, led by Germany, remain committed to the euro and the European integration project, even as they avoid efforts to find systemic solutions to the crisis. In Spain and Portugal, governments are moving to fast-track fiscal consolidation and structural reform

in an effort to preempt market pressures. While markets remain skeptical, the hope in Brussels, Berlin, and Paris is that this is just the beginning of a sustained rebalancing that will help stabilize the eurozone.

In this view, the European economic crisis

is the catalyst needed to restore policy convergence within the eurozone and to enforce peripheral Europe's compliance with the Lisbon agenda of labor and product market reform. Yet the notion that the EU, European Central Bank, and national governments can rapidly remake fiscal patterns of peripheral Europe—let alone their labor markets and regulatory regimes—strains credulity. That's especially true given the weak economic forecast for these countries and their inability to undertake currency devaluations.

Ireland, Greece, Portugal and Spain have all undertaken impressive steps on the fiscal side, but policy sustainability remains an open question. Politicians in each of these governments will have a hard time enforcing cuts to wages and entitlements that erode their nations' standards of living. Structural reforms like privatization and trade union regulation will threaten well-organized groups, which will then mobilize in opposition. The result will not be explicit rejection of these programs, let alone voluntary exodus from the eurozone. Rather, peripheral Europe is likely to take a page from developing countries in how they manage relations with the International Monetary Fund and World Bank—with a lot of fudging and passive opting out of important parts of their plans.

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These dynamics in the periphery will then impact both “core Europe” and broader market perceptions. The political challenges facing reform in the periphery will make it more difficult for defenders of financial bailouts within core countries, and we’re likely to see new political fissures on this issue, especially in Germany. This problem will heighten the sense of broader political conflict on the continent, increase policy coordination risk (especially between Berlin and Paris), and undermine market confidence in the EU’s ability to sort out the crisis.

All of which leads to the real danger here: that the eurozone countries big enough to matter in global finance, Spain and Italy, will find it increasingly difficult to borrow at rates that are financially sustainable. Should this occur, the chances of a truly systemic crisis will grow dramatically.

3—Cybersecurity and geopolitics

For the past decade, increasingly technologically capable hackers and organized crime organizations have elevated cybersecurity as a business risk, but not as a political risk. The centralization of data networks, both in energy distribution (the move to the smart grid) and information technology more broadly (the shift to cloud computing) are now metastasizing the cyber risk, and

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governments are becoming more directly and actively involved in playing both offense and defense in cyberspace. The primary involvement of states in cybersecurity, as both protagonists and principal targets, fundamentally changes the nature of the

risk. The new roles of governments and their antagonists bring geopolitics and cybersecurity together in three different ways.

First, offensive cyber capacity is a new way to project power in a world where direct military strikes are both domestically and

internationally constrained (cyberattacks for power). The almost-certainly state-sponsored Stuxnet attacks on Iran’s industrial infrastructure are a more likely avenue for future offensive efforts versus government antagonists than large-scale conventional warfare as in Iraq and Afghanistan.

Second, the growing and high-stakes conflict between government-supported economic entities and multinational corporations are providing a serious home court advantage for state capitalists (cyberattacks for profit). China is by far the biggest concern here, and combined with Beijing-supported indigenous innovation, this is probably the most important line of conflict between states and corporations globally.

Third, there is the coming backlash from WikiLeaks, with like-minded info-anarchists unleashing attacks on governments and the corporations that support them (cyberattacks for the people, if you will). The almost certain come-uppance of WikiLeaks’ Julian Assange is the beginning, not the end, of coordinated cyberattacks against major government and supporting corporate institutions.

The scale and scope of this retaliation is probably the biggest “known unknown” of 2011. The principal cybersecurity concern of governments has shifted from Al Qaeda and China to radicalized info-anarchists undertaking a debilitating attack against either critical infrastructure, a key government agency or a pillar of the private financial system. This could be a long-term game changer for governments beyond the US, corporations and banks, all of which are vulnerable to sudden, radical transparency.

4—China doesn’t budge (much)

With a sluggish global recovery, especially in the industrialized countries where unemployment remains high, the China growth story will generate more and more resentment abroad. One of the most important implications of the G-Zero is that the pattern of reasonably coordinated global responses to the financial crisis that we saw in 2009, but that broke down by the end of 2010, will not be put back together in 2011. Most significantly, China will talk of participating in global coordination, but it will not follow through.

China’s pattern of export growth that is twice the rate of economic growth, with resulting large current account surpluses, will be the object of intensified international outcry as it is the world’s second-largest exporter in a demand-constrained world economy. In 2010, the gloves started to come off between the US and China. The trend broadens this year with Europe, Japan and much of the emerging

markets and the developing economies also looking to China to adjust its growth model. Further, China's security-driven assertiveness in the Pacific complicates the growing economic reliance of key Asian economies on China, creating greater political and economic tensions in the region. Japan and South Korea, as well as many Southeast Asian states, will be more vocal in publicly expressing their concerns.

Despite mounting political pressure, Beijing is extremely unlikely to provide much policy response. This is not because China rejects the notion of global rebalancing—the 12th five year plan is all about rebalancing the Chinese economy, and the official Chinese media recently printed articles by prominent economists highly critical of China's existing growth model. But Beijing will rebalance at its own deliberate pace, especially given the risks that come with continuing weakness in the global economy, growing inflationary pressures at home and an upcoming leadership transition. China's leaders are especially concerned with sustaining the high rate of job creation that they see as central to domestic stability. These are precisely the conditions under which Beijing is least likely to pursue bold reforms or to respond to the needs of other governments. In the past, China has adjusted the pace of its reform efforts in response to targeted international pressure—for example, by depegging the renminbi from the US dollar immediately before the June 2010 Toronto G20 summit. But very few such steam-releasing events will arise in 2011. President Hu Jintao visits Washington in January, but the North Korea crisis will dominate this meeting, decreasing the likelihood that China will see much value in any major moves on rebalancing.

Nearly ten months will pass before the next G20 in Cannes, a gathering for which French President Nicolas Sarkozy has grand ambitions. During this long hiatus, frustration with and pressure on China will build. So too will the risks of market-moving international reactions to China's incremental, deliberate, consensus-driven approach. At Cannes, more countries than ever could try to confront Beijing on issues from industrial policy to intellectual property to currency valuation. 2010 was characterized by the failure of efforts to confront China on these issues. 2011 will be a year of pent-up frustrations to which China's leaders will have little capacity and few opportunities to adapt.

5—North Korea

In 2011, the North Koreans are likely to take provocative steps against the South despite reasonably strong pressure from China.

In the context of growing US-China mistrust, the potential for the Korean peninsula spinning out of control is real.

North Korea's decision to keep pushing the South Koreans' buttons is almost certainly the result of a faster-than-expected leadership transition in Pyongyang. That's the only variable that could explain the sudden dramatic change in behavior. The belligerence could be coming from external concerns—that Kim Jong Un will be vulnerable to international testing if Pyongyang doesn't first

prove his mettle.

Or it could be internal—if Kim Jong Il doesn't believe he can win agreement within the North Korean leadership for his son's safe accession, especially in the

event that the father dies suddenly. The latter scenario is much more troubling in terms of North Korea's willingness to provoke military conflict on the peninsula. There's no way of knowing which of the two is the more likely.

Beijing isn't prepared to go to the mat against North Korea because the Chinese are deeply unsure about the outcome of the political showdown in Pyongyang. At this point, North Korea is a thorn. But Beijing's view is that it's unwise to take any steps that could upset the North Koreans when a change of regime is in the offing. And change inside North Korea certainly appears to be underway.

Meanwhile, the South Korean political landscape is among the most polarized in Asia, and the hardliners are—at least for the coming year—pulling the strings. President Lee Myung-bak has no desire to provoke war, but he's also politically disposed to take measures that Pyongyang will view as overtly hostile, steps like a reunification tax that plans for an eventual North Korean collapse and military exercises inside what North Korea considers to be contested territory. Further North Korean escalation is likely to provoke a response, particularly if Pyongyang targets peninsular South Korea or US forces. The North directly threatened both in a recent statement. Then there's the alterna-

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tive—that the North Korean transition begins to fail and regime collapse looms imminent. In this case, the US and China find themselves with sharply different priorities in the region’s most serious security challenge—the US military looking to ensure security of the North’s nuclear arsenal; the Chinese military looking to restore order to keep out a flood of refugees. There’s been no military to military discussion, let alone coordination, for scenario planning between US and Chinese top brass—not a recipe for crisis management.

6—Capital controls

The risk is rising that a number of countries, including those that resisted the urge last year, will impose capital controls in 2011. This trend is driven by a combination of the divergence in economic recovery between emerging markets and industrialized countries and the increasingly dim prospects for a coordinated G20 strategy to tackle current account imbalances. The latter is perhaps the most significant immediate manifestation of the G-Zero, with strong

incentives for unilateral responses and where the lack of global governance creates major market uncertainties.

A wall of money, driven by expectations of higher long-term growth rates, is headed into emerging markets and developing economies. This trend is generating upward currency pressure on

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those economies open to capital inflows, hurting domestic firms by making exports more expensive and intensifying import competition.

In response, policymakers in many nations have turned toward currency management, in the form of direct market interventions, to protect local players. Should these upward pressures

continue even in the face of market interventions, governments will begin to look more seriously at capital controls as a way to counter appreciation. This is more likely given the qualified legitimization of capital controls given by both the IMF and the G20 last year. Already, a handful of countries—Brazil, South Korea and Taiwan—have signaled their willingness/intention to move in this direction. Decisions to enact capital controls will be intensely political. Among the key questions shaping individual responses: 1) Are governments confident enough in the perceptions of the investment climate in their country to undertake them? For Brazil, Korea and Taiwan the answer is yes. 2) How strong are the political pressures to contain appreciation, especially in relation to competing interests? Singapore, overriding exporters’ views, decided to accommodate appreciation to strengthen its role as a financial center. 3) Do policymakers believe in active industrial policy and the viability of capital controls? In Malaysia, for instance, the answer is probably yes on both counts. The countries most likely to enact capital controls this year should appreciation pressures continue are Colombia, Malaysia, Peru and Thailand. Conversely, Turkey, Mexico and the Philippines are unlikely to move in this direction. But contagion will also become an important determinant in who undertakes these controls. When government leaders see their trade competitors moving to stem appreciation, or if policymakers perceive controls as effectively stemming appreciation, they’re much more likely to follow suit.

7—United States: gridlock

Strong governance is generally considered good for emerging markets, where new policies are needed to make the trains run on time; at the same time, gridlock is a fine outcome for developed states, allowing markets and businesses to prosper undisturbed. But gridlock can be problematic even in industrialized nations when decisive action is needed, especially in a sluggish economy. That’s the principal political risk facing the US this year. The conventional wisdom is that political risk in the US diminishes in 2011. The 111th Congress (whose rise we highlighted as 2009’s top risk) has finally ended, and Barack Obama will either cleave Clinton-like into the political center or will not be able to overcome congressional gridlock. As a result, only relatively modest policy changes will occur. This is an overly benign view. American gridlock will pose three specific risks for markets in 2011.

First is the risk that there will be no movement on policies that the markets and business leaders want to see. Most important here is housing finance reform. The Obama administration will chart its course in the coming weeks. Democrats and Republicans are not far apart on potential solutions, but the tough issues of winding down Fannie Mae and Freddie Mac and deciding what to do on affordable housing limits prospects for success. Failure to resolve the issue would prolong a key driver of the weak recovery, as would failure to take substantive action on the recommendations of Obama's bipartisan deficit commission.

Second, for the last two years, headline risk was dominated by the fact that the administration made major policy proposals it didn't intend to fight for. In 2011, headline risk will be driven by both parties loudly promoting priorities for which there is no path forward. The Republicans want to substantially revise the Dodd-Frank financial regulation bill, but they don't have the power to do it, even if they threaten to hold up funding for the Securities and Exchange Commission and the commodity futures trading commission. Obama will resuscitate the Dream Act despite the fact that the immigration legislation will not pass the Republican-controlled house.

Third is the risk that a road-blocked White House turns to heavier-handed administrative actions that are hard to predict or influence. Amid gridlock, Obama will often choose to go it alone and use executive branch power to implement his priorities. This will almost certainly be the case on emissions controls, which will generate major congressional backlash, possibly leading to a turn to the judicial system for resolution, only adding to the policy uncertainty.

8—Pakistan

The risk in the subcontinent this year isn't Afghanistan-Pakistan (or Af-Pak, as it's called in Washington). It's Pak-Pak. Pakistan is experiencing a near perfect storm of political, economic and social crises all rising in the absence of an effective central government. There's neither political control nor stability in the federally administered tribal areas or Khyber Pakhtunkhwa (the new name for the Northwest Frontier Province). The government is capable of living with those longstanding threats, but the bigger risk is that instability will spread to Pakistan's most important provinces, Punjab and Sindh. Both have been isolated from the turbulence in Pakistan's tribal areas, but militants there have been increas-

ingly encouraged by Pakistani government weakness and their Afghan counterparts' success across the border.

Further social and ethnic dislocation and conflict in mainland Pakistan would lead the military to weigh the prospect that urban unrest and terrorism are undermining national unity. A 1999-type coup is unlikely, but a failure of security and governance in Punjab and Sindh would encourage the army to intervene politically (if constitutionally) to set

up a technocratic government.

President Asif Ali Zardari will fight any such army effort to remove his cronies and government, risking a debilitating power struggle. Even if a technocratic government is put in place, it will struggle to reverse the effects of three years of weak governance.

In even the best case scenario, Pakistan's governance woes make support for US Afghanistan policy implausible. American gains in Afghanistan on the back of the troop surge are real, though limited, but they are unsustainable without a sea change in Pakistan. That change isn't coming. Longer term, Pak-Pak will revert to Af-Pak. But for 2011, it's Pakistan we should be focused on.

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9—Mexico

2011 promises to be a very challenging year for Mexico. The country isn't headed for state failure, and it's unlikely fighting will spread much beyond the northern and western regions of the country where escalating violence has already created a serious crisis of governability. But Mexican authorities have yet to turn the tide in incapacitating the drug cartels and creating the conditions for a restoration of order. More importantly, in 2011 there will be a rising risk of more dramatic violence, including assassination attempts on government officials or prominent local, US or other foreign business figures—all of which could negatively impact investor confidence in a more material way than in previous years.

Military and federal police forces generated important arrests and deaths of cartel members, as well as significant seizures of drugs, cash and arms in 2010. The cartels are now on the defensive, and government efforts show no signs of letting up. Relations between Mexico and the US on drug and security-related issues have improved dramatically in recent years, and that will continue.

But the government's security operations produce negative results as well. Fragmentation of the leadership of the cartels increases the likelihood of deadly conflict within and among these

organizations. Surviving traffickers try to ward off municipal and state cooperation with federal security efforts, increasing the likelihood of assassination of local officials. And with steady demand for

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narcotics in the US and demand on the rise in Mexico, surviving and new drug trafficking groups will compete to fill any voids in the drug supply chain left by other weakened groups.

More broadly, the political consensus in Mexico in support of the Calderon administration's tough approach to drug violence is weakening. The security issues were a plus for Calderon and his National Action Party (PAN) during his first two years in office, but this is no longer the case. This provides the opposition Institutional Revolutionary Party (PRI), which controls a majority of state and municipal governments, with incentives to push back against the federal government's efforts to consolidate weak, inefficient and compromised municipal police forces.

In the medium to long term, the Mexican government remains equipped to tackle its security woes, but a serious spike in violence this year, especially in high-level assassinations, is likely to erode investor confidence and have negative consequences for the Mexican economy.

10—Emerging markets: not everyone's a winner

The dramatic increase in the flow of capital into emerging markets has lifted all boats. But there are very different risk profiles among emerging markets, and not all are going to perform well this year. The risks facing these countries include both a range of negative economic policies (fiscal imbalances in some, premature austerity in others) as well as more purely political risks (elections, political violence). As these risks play out in 2011, they will contribute to poor investment outcomes, ranging from adverse regulatory changes to asset bubbles to weak stock market performance. The most notable underperformers:

Argentina, where markets appear overly optimistic that policy will improve, either as a result of President Cristina Fernandez de Kirchner losing her re-election bid or a change in policy direction if she wins. But Fernandez de Kirchner is likely to win and policy is unlikely to change, leading to higher inflation and a further continuation of populist policy.

Hungary, where markets have turned more negative recently, but still do not seem to be pricing in the scope of the potential impending crisis as the Fidesz government attacks asset holders across a range of classes. Hungary is almost certainly going to have to turn to the IMF, but Prime Minister Viktor Orban has walked himself into a political corner with his vitriolic anti-IMF rhetoric.

Peru, where investors underestimate the potential for populist candidate Ollanta Humala to make a serious run at the presidency. He's an underdog to be sure, but he has a sporting chance. And even if a more market-friendly candidate wins, we'll see more resource nationalism in post-election policy.

South Africa, where ongoing government accommodation of trade union demands will limit President Jacob Zuma's efforts to enhance the investment climate. This will be reinforced by increased spending, continuing high levels of crime, and the growth of single party rule mentality in the African National Congress.

Sri Lanka, where many have become over-confident that the end of the country's decades-long civil war will usher in a period of political stability. President Mahindra Rajapakse, insecure in his position, is centralizing power while failing to address the country's structural challenges. That's a recipe for resurgent political and ethnic tensions that will dampen growth prospects.

Lastly, Thailand, where investor confidence remains high, but 2011 promises to be full of political tensions, especially given the king's failing health. Allies of former prime minister Thaksin Shinawatra remain popular in much of the country, raising the risks of either a violent, flawed election or a military intervention. There is real potential for serious and sustained unrest between Thailand's incumbent elites and the pro-Thaksin Red Shirt movement, leading investors to reconsider their long-term exposure.

Red herrings

A few pieces didn't quite make it here. Hizbullah in Lebanon has been arming, and 2011 brings a greater chance of war breaking out with Israel. But it's much more likely to be skirmishing; and we don't see significant market implications in any but the most unlikely cases. Terrorism is growing in Yemen and the Horn of Africa, and we'll undoubtedly see more militant attacks in that region as well as a more aggressive American military response. But Saudi Arabia isn't directly threatened, and regional militants' ability to export terror more broadly remains significantly constrained.

Still, there's rather more than we'd like to worry about this year. And so it's good to end on a positive note. There are quite a few—the red herrings.

Iran

Seriously? Seriously. It's not exactly a good news story, given that the Iranians are still going nuclear, and there's very little chance that we're going to see a diplomatic breakthrough. But the sanctions regime is sufficiently serious that Israel will give it time to work. Diplomacy will also take some time to play out. So, there's little need to worry about military strikes. Domestically, leadership tensions are brewing and the reduction of subsidies on key goods will provoke some unrest, but Iran's opposition is in disarray, enabling the well-fed Revolutionary Guard to remain on the sidelines. Iran is a big looming issue, no doubt. It's not a serious risk for 2011.

Turkey

There's a lot of worry about Turkey becoming more Islamist and the prospects for a sharp break with the EU and the US. But an increasingly Islamic Turkey remains on a democratic trajectory, Prime Minister Recep Tayyip Erdogan's Justice and Development Party is serious about improved governance, and a successful Turkey at the end of the day counters Iran (especially in Iraq). In stability terms, Erdogan is likely to win big in upcoming elections, giving him more domestic political flexibility. Expect more geostrategic hedging, but no break with the West.

Sudan

Despite a great deal of (legitimate) hand-wringing, Sudan's not headed back to civil war. We'll surely see considerable tension and some violence around the southern Sudan independence referendum later this month, but both sides have big incentives to compromise. Along with Iraq, Sudan is poised to be an example of how energy resources can sometimes promote stability rather than conflict.

Nigeria

A tense election year will pit northerners against southerners, including inside the ruling Peoples Democratic Party. But we expect incumbent Goodluck Jonathan to win the party primary later this month, setting him up for an electoral win in April and a continuation of the messy, but not fundamentally unstable, politics. A comprehensive peace deal with Niger Delta rebels is not in the offing and sectarian clashes will persist in central states, but Nigeria will continue to prove more resilient than most expect.

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