

GLOBAL POLITICAL RISK

The New Convergence Between Geopolitical
and Vox Populi Risks, and Why It Matters

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GLOBAL POLITICAL RISK

The New Convergence Between Geopolitical and Vox Populi Risks, and Why It Matters

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2016 has begun, as 2015 ended, amid a significant worsening of the global political climate and along with that, considerable volatility in financial markets. Investors and businesses are increasingly aware of the need to understand the drivers and the implications of a greater level of event risk exacerbated by shifting social patterns.

Tina Fordham, Citi's Global Chief Political Analyst, has already warned that the latest events may mark a turning point in the political landscape as rising geopolitical tensions and shifting socio-political trends converge in an increasingly interconnected world. In this publication, Tina and co-author Jan Techau, Director of European think tank Carnegie Europe, explain how weakened global elites and fast evolving social trends have created an increasingly unstable political environment that threatens to bring unprecedented commercial challenges on a global scale.

There is an increasing likelihood that new transmission mechanisms are evolving that could lead to political risk having an impact on economic forecasting models, changing the way that companies do business and driving a secular, or even structural, increase in risk premia in financial markets.

Until now, financial markets have taken a relatively sanguine view of political events, treating them as regionalized and idiosyncratic. However political risk can quickly and meaningfully alter return expectations across asset markets where transmission mechanisms are established in economic channels.

Political events and social trends are becoming increasingly interconnected; links can easily be made between tensions in the Middle East, terrorist attacks around the world and the migration crisis, between migration and European politics, and between tensions in Europe and politics in the UK. With shifting political sands in the US creating a vacuum in global governance, there is an increasing risk that a negative feedback loop is forming as previously comfortable sectors of society feel increasingly vulnerable and less financially secure.

Hitherto, geopolitical events have largely been addressed through diplomatic channels but, as Tina and Jan point out, diplomacy is ineffective against a rising sentiment of injustice and inequality among increasingly diverse social groupings. The result is an increased incidence, on one side, of non-diplomatic measures such as sanctions, protectionism, aggressive regulation, border disputes and armed conflict, and on the other of anti-establishment sentiment, protests, violent demonstration and terrorist activity. All of these can deliver a direct economic cost that could be changing the business and investment landscape.

There are several channels through which political events could become a driver of financial markets: Sharply higher or lower commodity prices are surely one. Sanctions are another as they will normally have an impact on the economic prospects of an affected country. There may be an offset to this; when exports from a sanctioned country fall, there is likely to be a substitution effect in another producing economy. Overall, however, a combination of more sanctions and increased protectionism is likely to result in lower levels of trade and this, with reduced comparative advantages in production, is likely to weigh on global growth and commerce.

One of the main factors insulating markets from geopolitical risk has been abundant liquidity provision by central banks. As the Fed begins to raise rates, that support will begin to wane. For most of 2015 markets were transfixed by two main drivers; Fed policy and China's economic outlook. 2016 and beyond may prove to be the era in which politics rather than economics comes to the fore. To address this, we have brought together leading experts on geopolitical and socio-economic risks (Tina Fordham and Jan Techau) energy (Ed Morse) and economics (Ebrahim Rahbari) who believe the contours of a new post-Cold War, post-Lehman paradigm are emerging.

If they are right, or even partly right, and these changes are structural, we may be entering a new paradigm, where policy-makers, including Central Banks, have less power to mitigate risks. This suggests a whole host of previously assured assumptions could be in the process of becoming obsolete.

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The world has become a more dangerous place

Will old and new risks converge?

More **referenda/constitutional crises** in systemically-significant countries.



Non-mainstream political parties gaining support, winning over **10%** of overall votes in 11/16 key elections.



Only **6/27** countries with trust in institutions greater than **60%**.



43% of US aggregate income went to middle class households during 2014. Down from **72%** in 1970.



"NEW" Socio-economic risks are on the rise

"OLD" Geopolitical risks are also rising

40 armed conflicts in 27 locations in 2014 - the highest number since 1999.



The Middle East now the most violent region based on **organized violence**



Battle-related deaths currently **highest** in post-Cold War period.



13/40 conflicts are "internationalized". Highest proportion in post-WWII period.



High number of fragile/failing states. 137/178 considered to be 'less stable' to 'high alert'



Source: Citi Research, 2015 Edelman Trust Barometer, Pew Research Center

EUROPEAN UNION



Potential Risks

- Return of the Euro crisis
- Refugee crisis increasing political risk
- North/South + East/West double divide
- Risk of Russian escalation or conflict relapse
- Turkey going further adrift
- Risk of Merkel-exit

THE MIDDLE EAST



Potential Risks

- ISIS expands the caliphate to Libya
- The Saudi-Iran tensions exacerbate proxy conflicts
- Third intifada

Hot spots
where we see
these two risks
most likely to
converge

ENERGY



Potential Risks

- Abandonment of Saudi Arabia as central banker to the global oil market
- Low oil prices hurt petro-states over-reliant on oil revenues

ASIA



Potential Risks

- Great power rivalry looming between the US and China
- Simmering territorial disputes in the South China Sea
- India-Pakistan rapprochement is brittle

Is This the Dawning of a New Era?

The post-Cold War environment, with the consolidation of the Washington Consensus¹ and constellation of pro-globalization trends — from the rise in the number of democracies to the adherence to free trade and other global norms by an increasing number of countries — strengthened hopes that political risk would decline in frequency and significance. After all, leading theorists observed that democracies do not tend to go to war with one another, while new middle classes with enhanced purchasing power and greater economic opportunity would ensure more countries would prioritize growth and stability over the shabby clientelism, power-mongering and sheer unpredictability of the 20th century (the most violent century in human history) through the Cold War era.

The post-global financial crisis saw the return of political risks to advanced economies

Instead, the sense that political risks have actually increased in a more globalized and inter-connected world — in number if not in terms of scale — is hard to escape. Once largely confined to less-transparent emerging market countries, the post-global financial crisis saw the return of political risks to advanced economies as well, from the drama around raising the US debt ceiling and the “fiscal cliff”, to the timing of German regional elections as a key indicator for Eurozone bailout votes. In Citi Research’s Political Analysis unit, we now spend at least as much time monitoring non-mainstream party politics in advanced economies as we do emerging market-based geopolitical risks, for the first time in 20 years.

We see little sign of this trend of political risk cutting across advanced and emerging economies reversing

What’s more, we see little sign of this trend of political risk cutting across advanced and emerging economies reversing. We think it’s unlikely that the moderate global growth that Citi’s economists forecast as their central scenario will dampen these risks. If anything, the data we have analyzed for this report, combined with our combined expertise in comparative political science and international relations and security and defense analysis, underscores how, by many measures, these risks are on the rise and indeed could endanger even the already modest prospects for global growth.

“Old” Geopolitical and “New” socio-economic risks are increasingly converging

In this paper, we identify and outline a new danger, that traditional “Old Geopolitical Risks”, e.g. military conflict, weak and failing states, unconventional weapons risk, etc. and what we call “New Socio-Economic Risks”, which includes Citi Research’s concept of *Vox Populi* risk², the rise of new and non-mainstream parties, populism, sectarianism and tribalism and more protests and referenda, are increasingly converging in an environment where global growth is stagnating while public expectations remain high and government capacity to effect positive change through reforms is low.

A prime example of this phenomenon, which we first referred to as “**Everything that Rises Must Converge**”³, is evident in the extent to which the Syria conflict, now entering its fifth year, had initially not been deemed as being “systemically significant” according to traditional criteria (meaning having the potential to generate either a growth or an oil price shock).

¹ The Washington Consensus refers to a set of economic ideas supported by prominent economics and international organizations, which advocate free trade, floating exchange rates, free markets and macroeconomic stability.

² Citi defines *Vox Populi* risk as shifting and more volatile public opinion that poses ongoing, fast-moving risks to the business and investment environment. Citi classifies *Vox Populi* risk events into four main categories: 1) election risk; 2) “flash mob democracy” mass protest risk; 3) referendum risk; and 4) geopolitical risk. See: <https://www.citivelocity.com/citigps/ReportSeries.action?recordId=26>

³ Citi Research. ‘2016 Global Political Outlook: Everything that Rises Must Converge’. 7 December 2015. See: <https://www.citivelocity.com/t/eppublic/v1Qy>

Yet the displacement of as much as half of Syria's population, on top of a burgeoning population of forcibly displaced people globally (60 million according to UNHCR, the highest number since WWII⁴) has led to a "great migration", as people increasingly globalize themselves. This has in turn led to unprecedented migration from the Mediterranean basin into Europe, resulting in a spike in political risk as a slow growing European economy tries to absorb refugees, subsequently damaging the standing of one of the most popular and powerful leaders in the world — German Chancellor Angela Merkel. In this context, recent events that could further aggravate Saudi-Iranian tensions, may well complicate the efforts to resolve the Syria conflict. A further increase in the flow of refugees to Europe could also have an acute impact upon the UK Brexit debate and German and French elections in 2017 — and therefore the future of the European project. Geopolitical events far away and in areas that seem of only modest economic or financial significance could next arrive at the doorstep of major economies — and financial markets.

There have also been positive changes to longstanding political challenges

While we note in our section on "Silver Linings" numerous examples of positive changes and resolutions to longstanding political challenges, we also observe how many of these were achieved some decades after the initial crises, and typically with little involvement from legislative bodies. Having said that, non-democratic regimes appear to have largely learned from recent conflicts and the events of the "Arab Spring" that political and social change — and all the upheaval it may bring — are best avoided.

Meanwhile, access to social media and the role of technology in accelerating the pace of change, whether to labor markets or to social attitudes, are acting to drive these factors more quickly. As a result, national and international policy-makers tend to be absorbed almost entirely by short-termist, reactive crisis management. Rarely is there patience for time- and political capital-consuming "structural" reform. If undertaken at all, the process and outcome of these reforms often resemble that of crisis management. In sum, policy-makers have few tools in their arsenal and limited political capital to facilitate the domestic reforms that might restore growth or address gaps in human capital formation.

One growing temptation may be to try to shift burdens abroad, by 'scapegoating' foreign actors and powers, using exchange rates and more or less obvious signs of protectionism to protect domestic firms and workers and by shirking responsibilities for policy measures that will have a global and not just local payoff. In general, that means the prospects for international collaboration and coordination in many areas are rather poor (even though recent progress around efforts to fight climate change and nuclear proliferation show that the outlook for international cooperation is not universally bleak). Beyond a handful of specific issues, the maneuvering space for thorough statecraft has almost completely vanished.

International institutions, once the great hope for maintaining the stability of the international system, have also seen an erosion in their capacity to address global challenges, while the international standing of the US has been steadily eroding since the "Sole Superpower" era of the 1990s. Likewise, the classic national institutions designed to legitimize and control executive action, especially parliaments, have often felt sidelined and struggled to keep up with the pace of political developments, the urgency of which has decidedly shifted the power balance in favor of the executive branch. In the long term, such lopsided political practice can create severe legitimacy issues for government as a whole. Where executive action is not properly bound back to the will of the body politic, democracy suffers, and Vox Populi risks are further aggravated.

⁴ United Nations High Commissioner for Refugees (UNHCR): Global Trends – Forced Displacement 2014.

Hopes for a reversion to the pre-global crisis peaceful mean may be misplaced

Yet most political and business leaders and investors today have largely “grown up” in the post-1991 era, often described as the most peaceful and prosperous in human history and characterized by a host of pro-globalization developments and effective US hegemony. With this in mind, hopes for a reversion to the pre-global financial crisis mean, and with it, a return to some semblance of linear progress, may be misplaced.

If all political regimes, save the most repressive and autocratic, are reliant upon delivering economic growth in order to maintain popular legitimacy, the current weak growth outlook suggests we may be in for a bumpy ride. Meanwhile, the wealth effect suggests that momentum in terms of improving living standards and social mobility, not just net income levels, may be necessary to ensure political stability. Finally, just as political risks seem to reach boiling point, the faith of financial markets in the saving grace provided by central banks seems to be waning.

Political and business leaders need to be more attuned to the new shape of global political risk

In our view, political and business leaders will need to be more attuned to the new shape of global political risk, a paradigm shift that means that previous policies will fail to keep pace and uncertainty will remain high, with the potential to interact in unexpected ways. Among the key implications of this more fragile and interconnected risk outlook is that so-called Black Swan events — in this case, geopolitical events producing instability spanning several orders of magnitude — may be both more likely and more difficult for leaders and global financial institutions to resolve.

We hope that this analysis will help deconstruct the global political risk outlook, not just for 2016, a year with comparatively few important elections, but for the next decade and beyond.

Tina Fordham and Jan Techau

About This Report

Pricing geopolitical risks has long been a preoccupation for companies and investors, since the first days of global trade, shipping and insuring. These risks have long been among the most elusive to model — and marked some of the most expensive tail risks in history. They remain so, even in an era of advanced modelling and “Big Data”. Predicting relatively straightforward political events like elections has seemingly become harder, with a string of high-profile failures by polling companies in the past year alone to accurately predict elections outcomes, even in heavily-pollled developed countries. With this in mind, what hope is there for predicting more complex and inter-related geopolitical risks?

We are asked this question on a daily basis, and the answer is — very slim; forecasting remains a numbers game. For geopolitical risk, there is no dataset to run regression analyses with, and the anatomy of every war, revolution, and political crisis is different, even if we know more about the component features and have more case studies to work with.

Political analysis is a combination of both art and science

Political analysis is a combination of both art and science, and one that investors, until recently, have tended to avoid due to the absence of a reliable composite indicator that could be dropped into a model. We choose to take a data-driven approach; for example, we have long tracked the number of conflicts and weak and failing states as well as “soft” risk variables like trust, corruption perceptions, government approval ratings and rates of support for non-mainstream political parties — even though there is rarely any macro market impact from such indicators. Being data-driven, however, has its limits in this relatively new field. Unlike in other asset classes, variables do not move together in predictable ways. The absence of consistent, comparable data across countries makes it impossible to econometrically derive weightings. Political experts themselves have tended to be trained as country or at most, regional experts, rather than thematic or global.

Our approach is to create visual maps of the global political environment highlighting the key geopolitical and socio-economic risks and signposts within it and consider these within the broader macroeconomic and market context. (This in itself is rarely replicated elsewhere.)

We focus on risks with the greatest potential to be either systemically significant or potentially impact markets

We then focus on those with the greatest potential to be either systemically significant or potentially impacting markets, as well as those that we judge as having the potential to influence the business and investment environment over the medium- to long-term, both top-down (changes of government policy, war) and bottom-up (protests and revolutions, public opinion). We also conduct a regular and wide-ranging series of expert interviews, conduct investor focus group discussions to gauge market views on geopolitical developments, and triangulate these views with the mainstream consensus, looking to spot disconnects that could signal surprises and event risks. Our analytical approach is further underpinned by comparative political science and game theory.

We declare the official demise of the assumptions of the post-Cold War era

In this report, we set out a new theory and conceptual framework for global political risk, declaring the official demise of the assumptions of the post-Cold War era in which most managers and investors have grown up, a period characterized by a host of pro-globalization developments that had been the most peaceful and prosperous in history. Arguably this period, which started in 1989 following the fall of the Berlin Wall, ended in 2007 with the fall of Lehman Brothers; but, as any historian knows, it takes years before the features of a new era start to emerge from the dust and remains of the previous one.

Besides setting out this framework and identifying the distinction between “Old Geopolitical Risks” and “New Socio-Economic Risks”, with the help of co-author Jan Techau, Director of the Brussels-based think tank Carnegie Europe and a noted scholar on security and defense issues, we flag the potential for these risks to intersect and converge in ways that bear significant potential to exceed the capacity of policy-makers and institutions to solve. Historically, geopolitical risk has been transmitted via one of two channels: (1) an economic growth shock or (2) an oil price shock. We hypothesize that the more recent confluence of factors that has brought about the current refugee crisis (albeit one that has been many years in the making) is an example of a wholly new channel for political risk, and one with the potential to create as dramatic an event risk as ending or severely dividing the EU, something even the euro crisis didn’t accomplish.

We build on our previous work on *Vox Populi* risk

Additionally, we have incorporated several examples of proprietary political analysis building on our previous work on *Vox Populi* risk, including assessments of Reform Capacity and a diagram mapping the competing and complementary interests in the highly complex Syria conflict. In our mapping exercise of the New Anatomy of Global Political Risks, we distill a broad constellation of global political risks, identifying three key themes: (1) the breakdown of the international security architecture; (2) geopolitical and economic competition; and (3) political and business legitimacy. We then link these themes to examples of related outcomes, such as increased refugee flows, asymmetric warfare such as drones and cyber-attacks stemming from the breakdown in the international security architecture, and the rise in protests and referenda, piecemeal policy approaches and demand for regulation stemming from increased geopolitical and economic competition and declining political and business legitimacy.

Finally, we identify four hotspots, three regional and one asset class-based: (1) Asia pressures intensifying; (2) ongoing Middle East disruptions; (3) the EU at risk; and (4) the new commodities geopolitics. For this latter hotspot we bring in the industry-leading expertise of Ed Morse and Seth Kleinman on Citi’s top-ranked Commodities team. We also feature the insights of Citi’s distinguished Global Economics team with Ebrahim Rahbari.

Our approach can be described as a structured survey approach, underpinned by a wide range of external sources and available data and informed by what we regard as a practical conceptual framework for making sense of what seems to many to be an incomprehensible spaghetti of foreign and domestic policy, competing interests, rogue actors and un-transparent motives. What it not is a list of fanciful “Black Swan” events, a magic formula for re-pricing risk premia, or a list of actionable trade ideas.

Intersecting Risks Mark a Change in Trend

Will the convergence of both “old” geopolitics and “new” socio-economics risks result in a more powerful set of interconnected risks?

Crucial for companies and investors, however, is discerning what developments constitute a signal, and what is mere “noise”

Could 2016 be the year when these risks converge, potentially moving from regional to systemic?

Geopolitical risks are at a post-Cold War high, with the number of violent conflicts proliferating at the same time as confidence in collective security agreements falters. [Vox Populi risk](#)⁵ — the rise of anti-establishment sentiment, non-mainstream political parties, and protests as a source of disruption to the business and investment environment — remains evident, even where growth has returned. Which matters more for markets and the global economy? Or might the convergence of both “old” geopolitics and “new” socio-economics risks result in a more powerful set of interconnected risks than we have yet had to contend with?

Judging by the first few days of the 2016, marked by the abrupt end of diplomatic relations between Saudi Arabia and Iran, North Korea’s alleged test of a hydrogen bomb and an attempted terrorist attack in Paris (scene of two major attacks in 2015), global political risks look set to play a significant role in risk appetite in the year ahead. Crucial for companies and investors, however, is discerning what developments constitute a signal, and what is mere “noise”, i.e. disruptions bringing sound and fury, but signifying little, at least in the harsh calculus of the business and investment environment. Such risk assessments of the macro political environment, though increasingly part of the job of investment professionals, may discount the wider significance of these developments — the extent to which they may represent meaningful reversals to globalization, a source of much of the world’s improvements to prosperity.

In our view, rising “old” geopolitical risks (violence and conflict, military adventurism, disputes over borders & territory) with “new” socio-economic risks (*Vox Populi* risks; uncertain election outcomes, fringe politics, “flash mob” mass protests, declining trust in elites, income inequality concerns) has the potential to converge, creating more destabilizing by-products in the process. In the meantime, governments with limited political capacity increasingly lack the power — or the will — to address these risks with anything other than the piecemeal, “just in time” policies that have characterized the post-financial crisis environment. Could 2016 be the year when these risks converge, potentially moving from regional to systemic?

In the short- to medium-term, there are relatively few systemically-significant elections with the potential to influence global markets in 2016. The most impactful political signposts for 2016 in our view include US presidential elections in November and the UK referendum on EU membership, which could happen as early as June but is expected to take place before year-end.

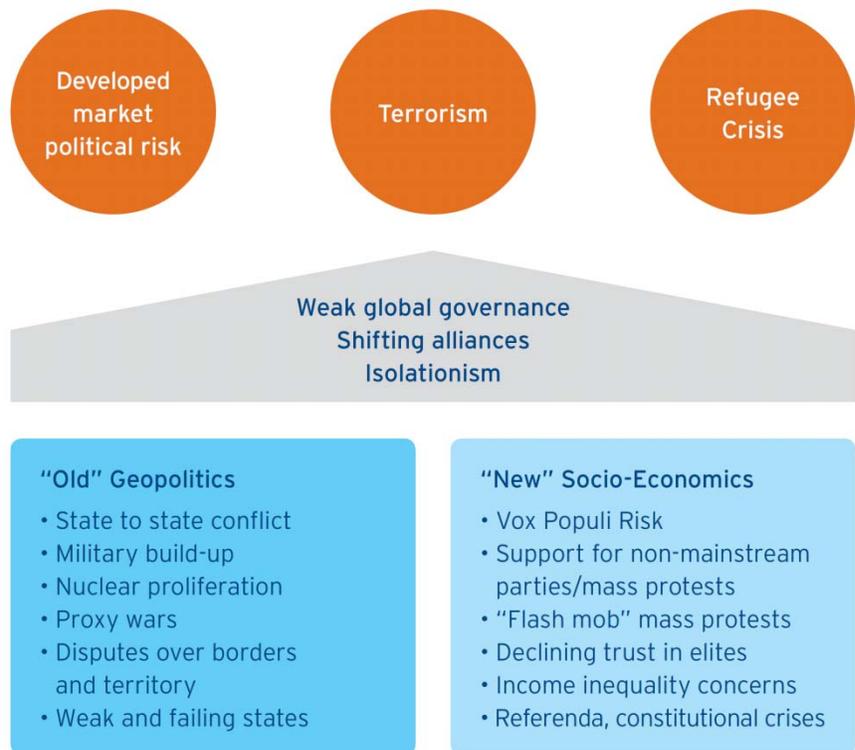
Unscheduled political developments such as government collapses followed by snap elections may also emerge. Recently we highlighted the risk of “Merkel-exit” as a key risk to watch for Europe, given the importance of her leadership to not only Germany but the wider EU project. While the risk of Merkel-exit had receded following a recent vote of confidence by her party, public dissatisfaction with the refugee crisis makes this an ongoing and potentially highly destabilizing risk. Much of the political significance of 2016 will be less about elections but rather how it influences the context for key elections in France and Germany in 2017 and the scheduled political transitions in China and Russia between 2017 and 2018.

⁵ Citi Research. ‘Taking it to the Streets: What the New Vox Populi Means for Politics, the Economy and Markets’. 27 May 2014. See: <https://www.citivelocity.com/citigps/ReportSeries.action?recordId=26>

While we regard state-to-state conflict between great powers as unlikely, high-risk military accidents and close encounters, such as the 2015 [downing of a Russian military jet in Turkey](#)⁶, and revived protest and conflict relapse will test weak governments and alliances and continue to feed into the risks of weak and failing states and refugee flows.

Failure to produce policy options to address middle class anxiety, declining living standards and public trust increases the likelihood that *Vox Populi* risk could move from being episodically disruptive to systemic, undermining globalization in the process. It isn't just about 'the economy, stupid'. Immigration and terrorism risk are now at the top of the list of public concerns in the US and Europe, obliging politicians to utilize scarce political capital and resources to address them.

Figure 1. "Old" Geopolitics vs. "New" Socio-Economics: A New Theory for Understanding Inter-related Risks in the Global System and their Potential to Converge



Source: Citi Research

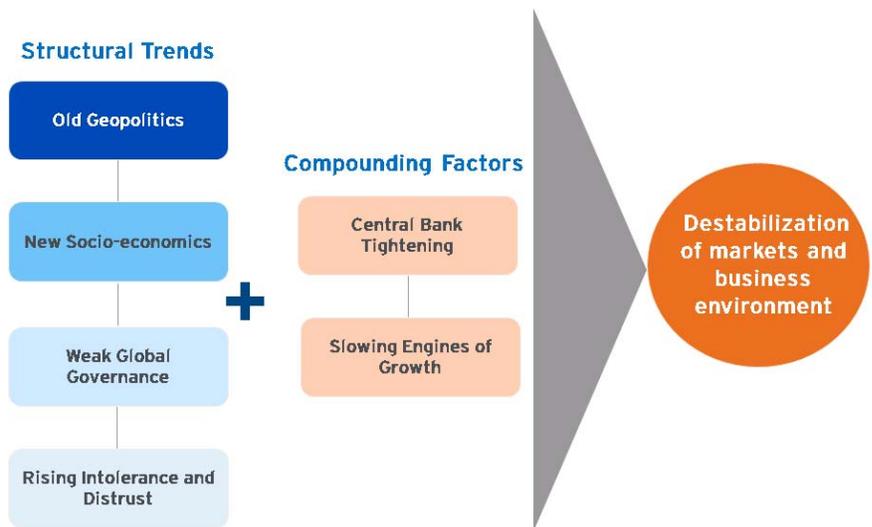
⁶ Citi Research. 'A Turkish-Russian Crisis? Regional and Geopolitical Implications'. 25 November 2015. See: <https://www.citivelocity.com/t/epublic/uy9g>

Figure 2. The Most Fluid Global Political Outlook In Decades, Within an Unusual Macro Context



Source: Citi Research, Uppsala University Conflict Data Program (Organized Violence in the World 2015), FP Failed States Index, European Leadership Network - Dangerous Brinkmanship: Close Military Encounters Between Russia and the West in 2014, Institute for Economics & Peace: Global Terrorism Index 2015, IISS: Armed Conflict Survey 2015, International Crisis Group reports, RAND Corporation

Figure 3. Structural Global Political Trends



Source: Citi Research

The Geopolitical Backdrop

Power Sclerosis Post-Pax Americana

Instability and political crisis around the globe are, for the most part, homemade affairs, originating in the very regions that are afflicted. A whole panoply of reasons, from the troublesome to the severe, are to blame: a lack of political and economic liberties, poor governance, poverty, weak legal systems, corruption, power imbalances and rivalries, ethnic strife, civil war, etc.

But in addition to these local factors, another, more structural reason exists that works as a force multiplier for simmering conflict around the world, most notably in Eastern Europe, Northern Africa, the Middle East and parts of Asia. It is the weakness of the post-Cold War world order, or, to put it more bluntly, the weakness of Pax Americana.

Pax Americana describes a post-World War II global order that relied, to a large extent, on American military, economic and diplomatic power

Pax Americana describes a post-World War II global order that relied, to a large extent, on American military, economic and diplomatic power to guarantee relative political stability and economic development. Pax Americana was institutionally anchored in a global network of multilateral organizations dominated or substantially influenced by the US, such as the United Nations (UN), the North Atlantic Treaty Organization (NATO), the international financial institutions (The World Bank and International Monetary Fund (IMF)), the World Trade Organization (WTO) (formerly the General Agreement on Tariffs and Trade), the Organization for Security and Co-operation in Europe (OSCE), and, indirectly the European Union.

During the Cold War, and for the most part after it ended, the United States served as the direct and indirect guarantor of stability around the globe. Its national interests were globally defined, and by protecting them, it supported and promoted the interests of many other nations interested in regional stability, free markets, open trade routes, and unfettered access to global commodity markets.

The US, through diplomatic activism backed up by unrivaled military power, kept many regional conflicts under control

The United States, through diplomatic activism backed up by unrivaled military power, kept many regional conflicts under control (or pacified them), such as between Pakistan and India, North and South Korea, Israel and its neighbors, and the states of the former Yugoslavia. It did not dominate world affairs in a hegemonic way (which would have been impossible even for the US), but it served as the arbiter of last resort and the world's reserve power. After 1989, most nations buying into the post-Cold-War surge of economic globalization consumed US stability services around the world, even those who openly or clandestinely opposed America's relative dominance.

The US position in global affairs has weakened.

But this fortunate power structure has changed significantly over at least the last decade. The US position in global affairs has weakened. Other powers have gotten stronger. Some military interventions, such as the Iraq war, have eroded both US credibility and resources, an outcome supported by a host of global public opinion data.⁷ Less political capital is available in Washington to underpin America's global role, leading to a "leadership from behind" culture that is considered to be ineffective and widely perceived as US weakness. Inward-looking, isolationist leanings have

⁷ For example, see: Pew Research Center, June 2015, "Global Publics Back U.S. on Fighting ISIS, but Are Critical of Post 9/11 Torture". <http://www.pewglobal.org/files/2015/06/Balance-of-Power-Report-FINAL-June-23-2015.pdf>. The German Marshall Fund of the United States. Transatlantic Trends: Key Findings 2014. http://trends.gmfus.org/files/2012/09/Trends_2014_complete.pdf

As a consequence, the international system is suffering from power sclerosis

gained political traction in America's political mainstream. The threshold of what constitutes US national interest has narrowed markedly in comparison to previous decades.

As a consequence, the international system is suffering from power sclerosis, compounded by absence of a replacement. The "Great Power Sclerosis" describes a situation in which Pax Americana has not been effectively supplanted by another system of global order, but in which its ability to resolve crisis, foster compromise, discipline rogue players, and defuse regional and local conflict is greatly diminished. In a situation of power sclerosis, the institutional framework of Pax Americana is still in place, but the effectiveness of these institutions has either been reduced, is being challenged, or is in doubt. Competing institutions have been established or are in the process of being set up, such as the Asian Infrastructure Investment Bank (AIIB). The overall ability of the system to enforce the formal and informal rules of the established system of global order is critically compromised. Its effects can be observed around the globe, but perhaps most explicitly in and around Europe, the Middle East and Asia.

A reduced US footprint in Europe has led to the silent creation of a security vacuum

In Europe, a reduced US footprint (both in terms of physical presence and amount of political capital available for European affairs) has led to the silent creation of a security vacuum⁸. Europeans are unwilling or unable to fill it through their own increased investments in diplomatic and military capabilities, particularly in a political environment of cuts to social spending due to the austerity measures of the Eurozone crisis, with external powers moving to fill the vacuum:

- Russia is considerably more assertive in Europe's east than it has been since 1990. It has opportunistically expanded its investment in European companies and supports political parties (permissible under EU law) and media outlets in Europe, thereby increasing its influence. The leadership in Moscow understands well the connotations of a reduced US military presence in Europe and weakened trans-Atlantic alliance. Military links are weaker, US influence is smaller, and the maneuvering space of European governments to pursue their own policies — even against US preferences — is considerably larger.
- China strategically invests in Central and Eastern Europe in particular, which has the effect of undermining European cohesion on foreign policy and trade issues. It has built its own parallel multilateral foreign policy track with Central and Eastern European countries, many of which welcome foreign direct investment.⁹
- In November of 2015, [the "1+16" group](#) even codified its own "Guidelines for Cooperation".¹⁰ In the past, it would have been impossible in diplomatic terms for these countries, especially those that are members of the EU and NATO, to pursue their own strategic policies without prior consultation with the US. Today Washington's ability to create cohesive European approaches, and to bring into line those who aspire to go solo, is greatly diminished. The United Kingdom's

⁸ For an in-depth discussion of this issue see: Jan Techau, *The Politics of 2 Percent*, Carnegie Europe, 2 September 2015. <http://carnegieeurope.eu/2015/08/31/politics-of-2-percent-nato-and-security-vacuum-in-europe/fig>

⁹ For Chinese spending patterns in Europe, see: Thilo Hanemann, Miko Tuohari, *Chinese FDI in Europa and Germany*, Mercator Institute for China Studies, Berlin, June 2015. http://rhg.com/wp-content/uploads/2015/06/ChineseFDI_Europe_Full.pdf

¹⁰ The Suzhou Guidelines for Cooperation between China and Central and Eastern European Countries, Ministry of Foreign Affairs of the People's Republic of China, 24 November 2015. http://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1318039.shtml

recent decision to join the China-Led Asian Investment and Infrastructure Bank against Washington's overtly communicated wishes is a case in point, and one that took the US State Department by surprise.¹¹

- Turkey arguably feels less bound by its Western European ties and is pursuing a more independent status as a regional power. The fact that President Erdogan openly criticizes the EU and US, while still a NATO member state and EU accession candidate, and pursues an Islamization agenda for Turkey speaks volumes about Washington's loss of influence in many of the NATO countries whose security it guarantees under Article 5 of the Washington Treaty and US extended deterrence. None of Erdogan's post-Ataturk predecessors would have presumed to challenge Washington so openly. The strategic importance of Turkey — for Europe and the West in particular — cannot be overstated: as a democratic role model in the Muslim world, as a Western ally in Middle Eastern affairs, as a reliable partner on issues such as Russia, migrants, energy, Syria, the Balkans and the Caucasus.

America's reduced presence¹² and influence in Europe is not only leaving space for external players to pursue a long-term divide-and-rule strategy among America's closest allies, it also removes trust from the inner-European political marketplace. When the US became the most important military power in Europe after 1945, old power rivalries amongst European powers — the very essence of European history for 2,000 years — became obsolete. America's presence, its role as arbiter of last resort, and its disciplining power have provided a gigantic backstop for a historically unstable, war-prone continent. On the foundation of this huge political subsidy (coming in the form of military presence, political oversight, and money) European reconstruction, peace and its subsequent economic and political integration became possible. Europeans could work with each other because they did not have to fear each other any longer. With the gradual removal of the US trust subsidy, dormant rivalries, illiberal temptations and the continent's inherent instability could well return.

US influence is also weaker in the Middle East

Pax Americana today also counts for less in the Middle East, most notably in Israel and Egypt, where US influence is weaker than it has been for many decades. Saudi Arabia and the other Gulf states actively promote their own political and religious agendas where formerly such activities were more limited — and arguably conducted in conjunction with US objectives, such as confronting the Soviet occupation in Afghanistan in 1979.

In Asia, a deliberate Chinese access denial strategy is challenging longstanding US policy in the region

In Asia, a deliberate Chinese access denial strategy is challenging longstanding US policy in the region, specifically the South China Sea, and testing US post-World War II security guarantees, particularly with Japan. As a result, feverish alliance-building activity is evident, with many of the medium and small-sized Asian powers seeking to build some sort of counterweight against the increased regional ambitions of China. South Korea and Japan, traditional US allies, grapple with growing domestic anti-American sentiment while, at the same time, seeking to maintain or deepen close security relations with Washington.

¹¹ See: *US attacks UK's 'constant accommodation' with China*, Financial Times, 12 March 2015. <http://www.ft.com/intl/cms/s/0/31c4880a-c8d2-11e4-bc64-00144feab7de.html#axzz3wfaalslh>

¹² For data on the reduced US military footprint in Europe, see: International Institute for Strategic Studies, *The Military Balance 2015*, chapter 4 "Europe," Stockholm 2015.

The much-debated so-called US “pivot” to Asia, which was meant to fundamentally re-adjust American strategic attention towards Asia-Pacific, away from Europe and the Middle East, has never been as substantial on the ground as political rhetoric would suggest. The US is countering expansive Chinese policies, but the increase of American assets in the region has been limited. The pivot has also been partially undermined by renewed tension in Eastern Europe and the worsening of the security situation in the Middle East and North Africa.

No global or regional power has emerged yet to fill the gap

No global or regional power has emerged yet that is willing or capable to responsibly (or, thankfully, irresponsibly) fill the gap that America’s relative decline has created. Europeans are currently too inwardly-focused and too disunited to tap their full potential, both at home, and globally. China, the only other potential step-in, limits itself, for the time being, to a mostly regional role. It is generally interested in global stability as it is one of the biggest beneficiaries of integrated markets, but its political agenda, especially in its immediate neighborhood, does not fully overlap with that of the US or the wider West.

Therefore no trend reversal on the decline of Pax Americana is in sight

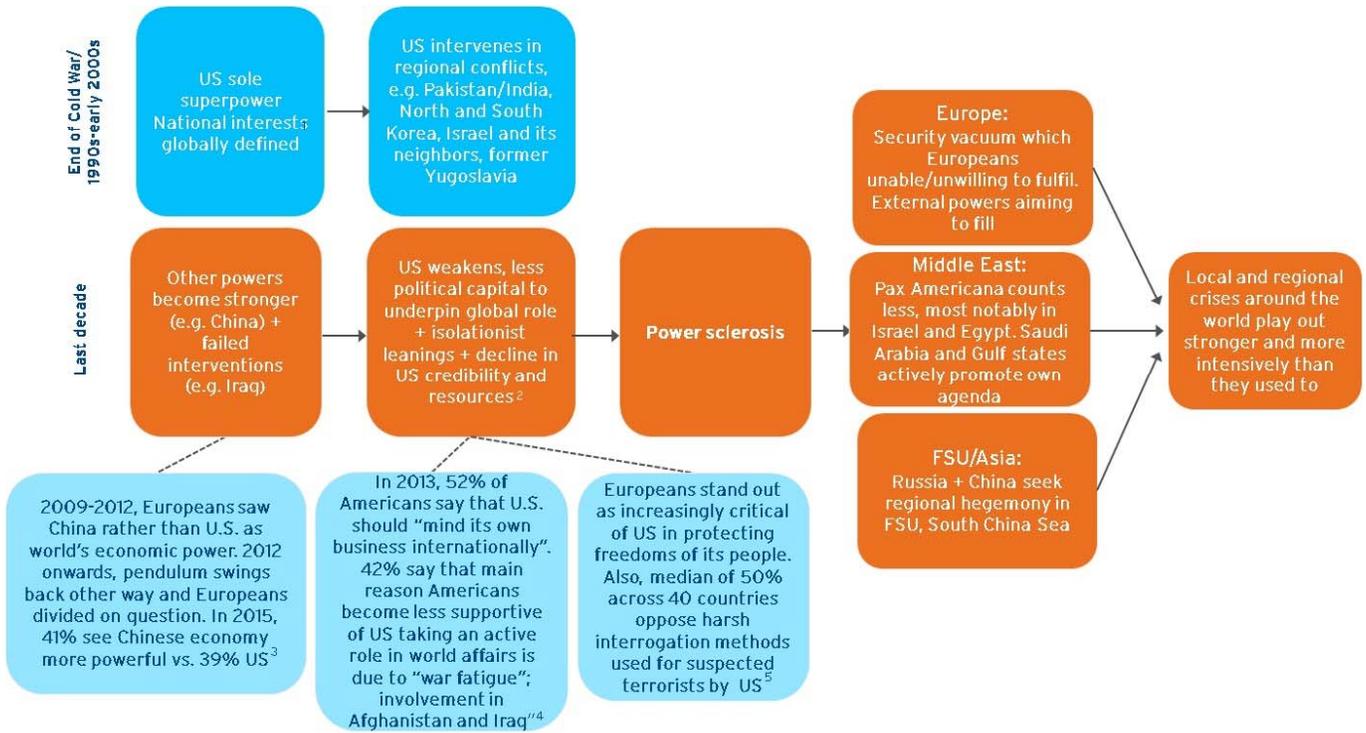
Likewise, no trend reversal on the decline of Pax Americana is anywhere in sight. Washington’s reassurance to its NATO partners after the annexation of Crimea was small-scale and not anywhere near a level that could be seen as relevant compensation of previous troop reductions. And while all candidates in the current primary season promise firmer US leadership and stronger American engagement after the disappointing Obama years, long-term domestic trends point in another direction.¹³ More importantly, leadership is not just a quantitative affair, and does not just rely on coercive muscle, but rests on creativity and smart solutions. But for some time, the quality of the ideas and policy proposals coming out of Washington to address the crunch topics in international affairs have looked to have been better than anybody else’s. A sophisticated, historically informed, and conceptually convincing idea of a system of world order similar to the one US leaders had cultivated after World War II, when Pax Americana was forged, does not seem to exist in Washington these days.

As a result, local and regional crises play out stronger and more intensively

As a net result of all of these trends and developments, local and regional crises around the world play out stronger and more intensively than they used to. Weaker cohesion and diminished disciplining power make escalations of small conflicts more likely and encourage rogue states and opponents of liberal order to assert themselves more self-confidently. Stability in the overall system is weakened and likely to further deteriorate incrementally. The assessment of political risk in and around Europe, and around the world, needs to be made against this backdrop.

¹³ See the results of the most recent poll on “America’s Place in The World”, conducted in 2013 by the Pew Research Center and the Council on Foreign Relations. <https://ropercenter.cornell.edu/CFIDE/cf/action/catalog/abstract.cfm?type=&start=&id=&rchno=USPEW2013-11APW&abstract>

Figure 4. US Policy and Global Attitudes — A Visual Map of How They Have Evolved Over the Past 25 Years



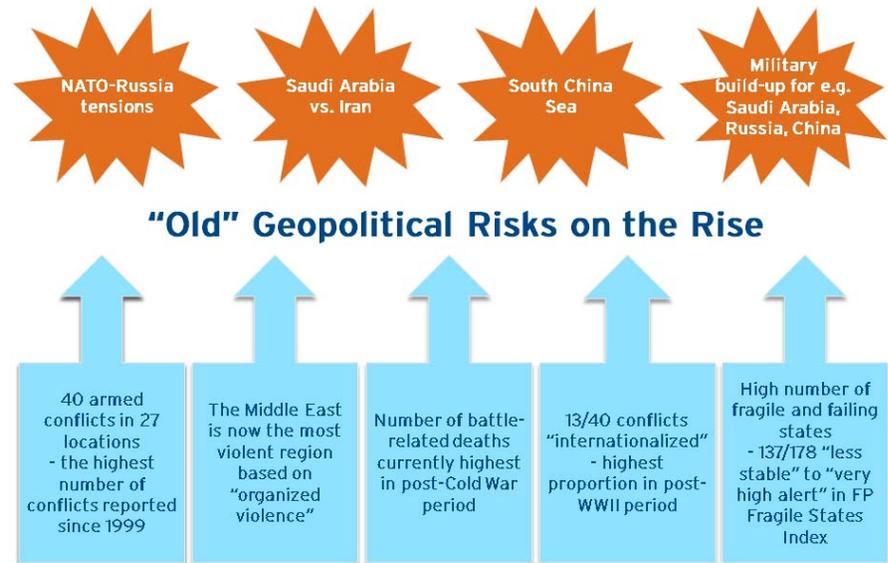
Source: Citi Research; [1] US Department of State. Address by President Bill Clinton to the UN General Assembly. 22 September 1997. Quote: "To seize the opportunities and move against the threats of this new global era, we need...to secure and strengthen the gains of democracy and free markets"; US Department of State. The National Security Strategy of the United States of America. September 2002. Quote: "Today, the United States enjoys a position of unparalleled military strength and great economic and political influence. We seek instead to create a balance of power that favors human freedom... We will extend the peace by encouraging free and open societies on every continent...the United States will...extend the benefits of freedom across the globe. We will actively work to bring the hope of democracy, development, free markets, and free trade to every corner of the world". [2] For data on the reduced US military footprint in Europe, see: International Institute for Strategic Studies, The Military Balance 2015, chapter 4 "Europe," Stockholm 2015. [3] Pew Research Center, June 2015, "Global Publics Back US on Fighting ISIS, but Are Critical of Post 9/11 Torture" [4]Ibid [5]Ibid

Geopolitical Risks on the Rise

We review the incidence of a range of key indicators to assess geopolitical risks

Is the seeming proliferation of geopolitical risks a function of the news cycle, or are these incidents really on the rise? To address this we assess the extent of geopolitical risks by reviewing the incidence of a range of key indicators: violent conflict, military build-up, the number of battle-related deaths, and the number of weak and failed states globally. The answer is clear: by virtually any measure, geopolitical risks have risen, and risen markedly compared to a decade ago.

Figure 5. "Old" Geopolitical Risks on the Rise: How Do We Know?



Source: Citi Research; Uppsala Conflict Data Program, Pettersson, Therése & Peter Wallensteen (2015) Armed Conflicts, 1946-2014. *Journal of Peace Research* 52(4). Note: "Internationalized" internal armed conflict occurs between the government of a state and one or more internal opposition group(s) with intervention from other states (secondary parties) on one or both sides. "Organized violence" measures state-based conflict, conflict between non-state actors and one-sided killings of civilians.

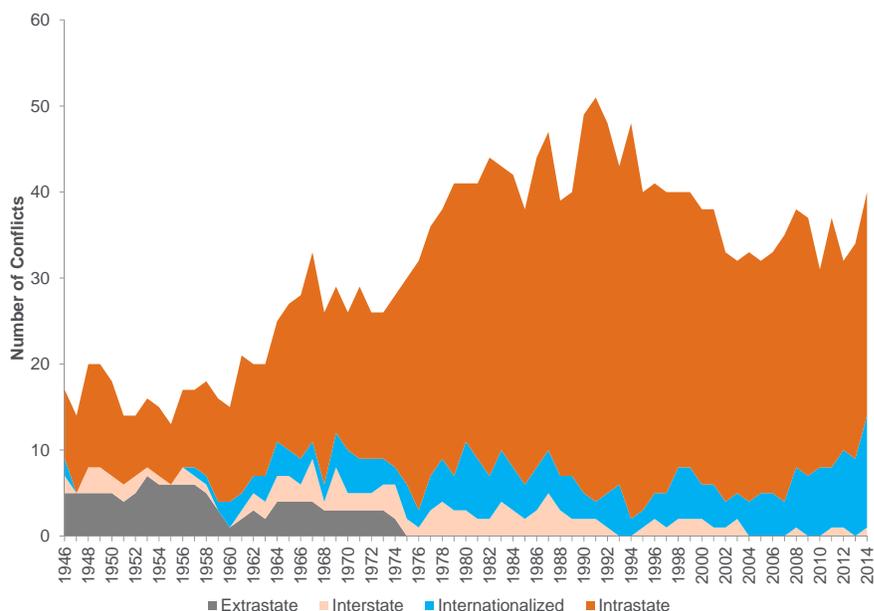
Armed Conflict

The number of armed conflict have risen for three consecutive years

In 2014 the Uppsala Conflict Data Program (UCDP) recorded 40 armed conflicts in 27 locations, rising from 34 conflicts in 2013. This is the third consecutive year in which the number of conflicts recorded has risen and is the highest number of conflicts reported since 1999. Although the number of conflicts is lower than during the immediate post-Cold War period, it points to an upward trend in the number of armed conflicts in the past 10 years.¹⁴

¹⁴ Uppsala University, Department of Peace and Conflict Research: Uppsala Conflict Data Program (UCDP), Armed conflicts 1946-2014, Thérèse Pettersson & Peter Wallensteen. Uppsala measures and tracks three types of conflict): armed conflicts between states, between non-state groups, and civilian massacres

Figure 6. Armed Conflict by Type, 1946-2014



Note: 1. Extrastate armed conflict occurs between a state and a non-state group outside its own territory. These conflicts are by definition territorial, since the government side is fighting to retain control of a territory outside the state system. 2. Interstate armed conflict occurs between two or more states. 3. Internationalized internal armed conflict occurs between the government of a state and one or more internal opposition group(s) with intervention from other states (secondary parties) on one or both sides. 4. Internal armed conflict occurs between the government of a state and one or more internal opposition group(s) without intervention from other states.

Source: Citi Research; Pettersson, Therése & Peter Wallensteen (2015) Armed Conflicts, 1946-2014. Journal of Peace Research 52(4)

Another way of analyzing the trend in armed conflict is tracking the number of fatalities. Due to the escalation of several conflicts and the extreme violence in Syria, the number of battle-related deaths in 2014 was the highest during the post-Cold War period. When looking at deaths from organized violence (including state-based conflict, conflict between non-state actors and one-sided killings of civilians), 2014 saw around 126,000 fatalities. By comparison, the death count in organized violence had not exceeded 100,000 since the 1994 Rwandan genocide.¹⁵

The Middle East has become the world's most violent region

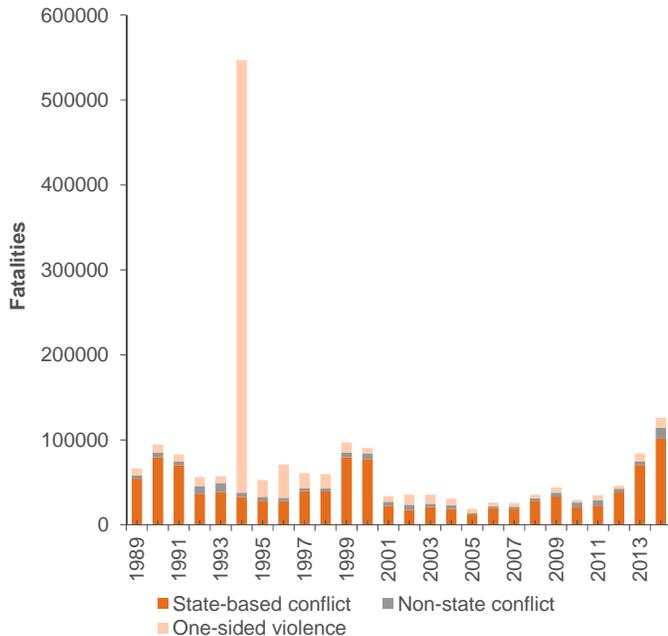
From a regional perspective, the Middle East has become the world's most violent region, according to the level of "organized violence".¹⁶ Despite high levels of violence in concentrated areas such as Northern Nigeria, Africa in recent years has become less violent than it was in the 1990s. However, during the entire post-Cold War period Africa has overall been much more violent than the Middle East. As shown by UCDP, the third region with very high levels of organized violence is Central and South Asia.¹⁷

¹⁵ Uppsala University, Department of Peace and Conflict Research: Uppsala Conflict Data Program (UCDP), Armed conflicts 1946-2014, Thérèse Pettersson & Peter Wallensteen. Uppsala measures and tracks three types of conflict): armed conflicts between states, between non-state groups, and civilian massacres

¹⁶ UCDP measures "organized violence" based on state-based conflict, conflict between non-state actors and one-sided killings of civilians.

¹⁷ Uppsala University, Department of Peace and Conflict Research: Uppsala Conflict Data Program (UCDP), Organized Violence in the World 2015: An Assessment by the Uppsala Conflict Data Program, Erik Melander.

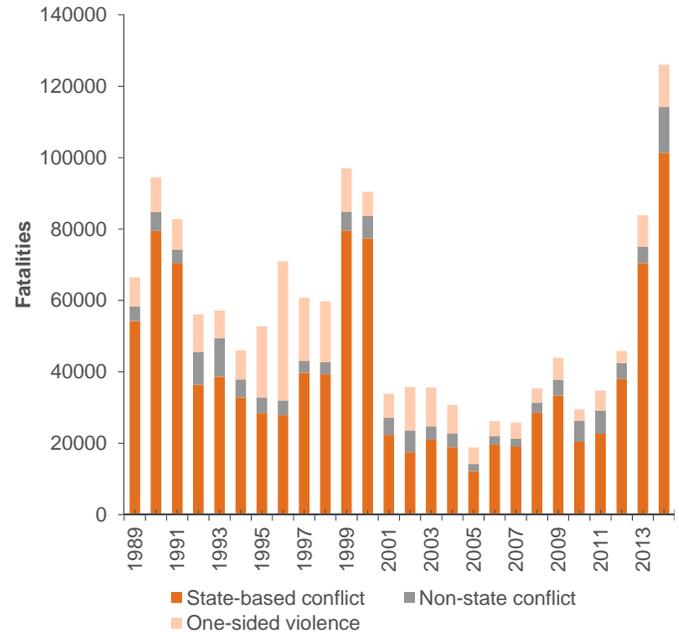
Figure 7. Yearly Fatalities in Organized Violence Including the Rwandan Genocide (1994)



Source: Citi Research, UCDP Battle-Related Deaths Dataset v.5-2015, Uppsala Conflict Data Program, www.ucdp.uu.se, Uppsala University

Note: State-based conflict is armed conflict between two governments (i.e., interstate conflict) or between a government and rebel organization (i.e., intrastate conflict). Non-state conflict refers to armed conflict between two organized actors, neither of which is a state. One-sided violence is when an organized actor (a state or some organized non-state actor) kills unarmed civilians. The graph is based on UCPD "best estimates".

Figure 8. Yearly Fatalities in Organized Violence Excluding the Rwandan Genocide (1994)



Source: Citi Research, UCDP Battle-Related Deaths Dataset v.5-2015, Uppsala Conflict Data Program, www.ucdp.uu.se, Uppsala University

Note: State-based conflict is armed conflict between two governments (i.e., interstate conflict) or between a government and rebel organization (i.e., intrastate conflict). Non-state conflict refers to armed conflict between two organized actors, neither of which is a state. One-sided violence is when an organized actor (a state or some organized non-state actor) kills unarmed civilians. The graph is based on UCPD "best estimates".

As an alternative approach to assessing the impact of conflict, the International Crisis Group provides annual assessments of the "Top Conflicts to Watch", ranked according to humanitarian impact.¹⁸ For 2016, the Crisis Group highlights that the trend toward a greater number of conflicts has continued, reversing the longstanding trend, the fact that these conflicts are causing more civilian deaths and humanitarian consequences than in previous years, and notably, more than 50% involve some type of extremist ideology, a shift from previous wars between nation-states.

A further consequence of the growth of extremist-fueled conflicts is that they are more difficult to resolve, a feature which adds to our concern about the capacity of diplomacy to reduce these new, higher levels of conflict. This is relevant for the Syria case among others; the renewed vigor to resolve the Syria conflict in light of its increased impact outside of its neighborhood is undermined by the fact that some of the most important actors in the conflict, e.g. ISIS and others, are non-state actors who lack a seat at the negotiating table, yet whose buy-in is arguably crucial to end the fighting and paving the way for a post-Assad political settlement and power-sharing arrangement.

¹⁸ International Crisis Group, Jean-Marie Guéhenno. 10 Conflicts to Watch in 2016. 3 January 2016. See also: International Crisis Group, Jean-Marie Guéhenno. 10 Conflicts to Watch in 2015. 2 January 2015.

Figure 9. 10 Conflicts to Watch in 2016 - Large Number of Conflicts in 2016 Involve Extremist Groups

10 Conflicts to Watch in 2016	Key Takeaways
<ol style="list-style-type: none"> 1. Syria and Iraq 2. Turkey-Kurdistan Workers' Party (PKK) 3. Yemen 4. Libya 5. Lake Chad basin - Nigeria 6. South Sudan 7. Burundi 8. Afghanistan 9. South China Sea 10. Colombia 	<p>The list for 2016 has many of the same conflicts identified in 2015: Syria and Iraq, Yemen, Libya, the Lake Chad basin and South Sudan. New conflicts to watch for 2016 are Turkey-Kurdistan Workers' Party (PKK), Burundi, South China Sea and Colombia.</p> <p>Half of the conflicts involve extremist groups.</p>

Source: Citi Research; International Crisis Group, Jean-Marie Guéhenno. 10 Conflicts to Watch in 2016. 3 January 2016.

Proxy Wars

Wars are always bad news for local residents, but have historically typically only generated a broader impact when they spread to other countries and in the worst cases, when they become internationalized and eventually systemic, by increasing oil prices or undermining wider growth prospects. Here too, data suggest that the trend is going in the wrong direction. The UCDP has tracked the number of “internationalized” armed conflicts during 1946-2014. Although there are several dimensions to a proxy war¹⁹, this gives us a good approximation for looking at trends.

Internationalized internal armed conflicts are in an upward trend

Internationalized internal armed conflict is defined as occurring between the government of a state and one or more internal opposition group(s) with intervention from other states (secondary parties) on one or both sides. The data shows that the upward trend in the number of armed conflicts in the past 10 years has been especially pronounced for internationalized armed conflicts. Thirteen of the 40 conflicts (33%) were internationalized, which is the highest recorded proportion in the entire post-World War II period. The US and Russia were two of the main external warring parties in 2014, as they were involved in four and three conflicts, respectively.²⁰

¹⁹ The common features of proxy intervention are as follows: 1. A relationship exists between a principal and a proxy. The principal is a state with sufficient resources and interests to assist a proxy in waging a conflict, the proxy will be a second state, armed opposition movement or para-state, actively engaged in a conflict. Their ideologies, motives and concerns may be different by they share a mutual desire to oppose a common enemy (compatibility of interests). 2. The principal's aim is to influence affairs while avoiding direct participation in, and responsibility for, a conflict. 3. The principal provides the proxy with material aid. 4. The supply of aid requires co-ordination of activities and exchange of information. 5. Proxy interventions are not simply competitions involving one or more outside powers, they also have a basis in a local conflict. 6. Proxy interventions normally result in conflict escalation, increasing the intensity, duration and viciousness of a conflict, and perhaps altering its outcome. Source: Chris Loveman (2002), Assessing the phenomenon of proxy intervention, Conflict, Security & Development, 2:03, 29-48, DOI:10.1080/14678800200590618

²⁰ Uppsala University, Department of Peace and Conflict Research: Uppsala Conflict Data Program (UCDP), Armed conflicts 1946-2014, Thérèse Pettersson & Peter Wallensteen. Uppsala measures and tracks three types of conflict): armed conflicts between states, between non-state groups, and civilian massacres

Syria and Yemen conflicts are the most prominent of numerous proxy wars with most potential to exacerbate systemic risks

The high and growing number of internationalized wars raises the geopolitical risk temperature, as it has been demonstrated that external military support increases the intensity and duration of conflicts. Several theories have been proffered, such as increased fighting power leading to more fatalities and [increased duration of the conflict](#), to having more parties involved making the negotiation process more difficult.²¹

Of the numerous proxy wars, it is perhaps Syria and Yemen conflicts that are most prominent and bear the most potential to exacerbate systemic risks in the region. The two conflicts underscore the wider sectarian divide in the Middle East that appears to be sharpening as Iran emerges from its sanctions regime and Saudi Arabia seeks to preserve its position as the region's pivotal power.

Fragile and Failed States

Perhaps most starkly illustrated in the case of the 9/11 attacks staged from Afghanistan, a country that had not previously been regarded as high on the global risk radar, fragile and failed states over the past 15 years have been established as a key risk factor contributing to heightened geopolitical risk. Various initiatives to track and measure these have been developed in the post-9/11 era. Fragile and failed states bring about a number of problems, with an example being the power vacuum in countries such as Syria and Iraq, increasing the appeal of the so-called Islamic State's "Caliphate" as an alternative to problematic governments.

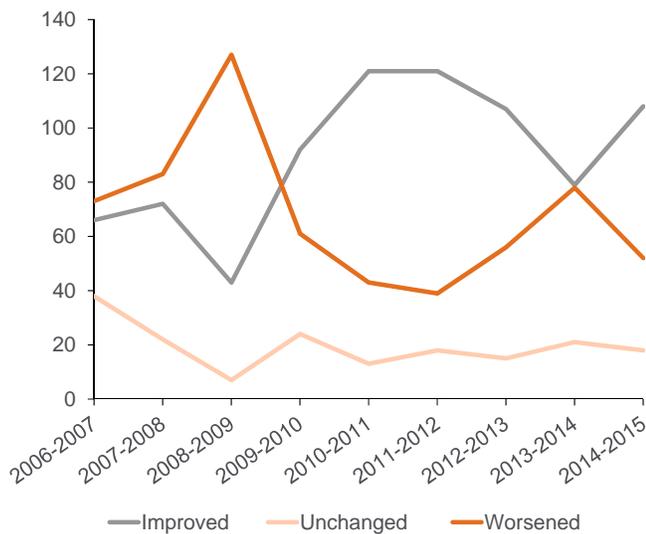
Overall, the Fragile States Index (2015) by the Fund for Peace published by Foreign Policy actually shows that since 2010 more countries have improved their scores (based on levels of stability and the pressures they face) than have experienced a worsened score. However, the index also shows that over 70% of countries currently fall into categories ranging from "low warning" to "very high alert", reflecting the high number of fragile states.²² The "most worsened" country from 2014 to 2015 was Ukraine. Not far behind were Libya and Syria. Furthermore, there has been an increase in the number of countries in the worst two categories ("very high alert" and "high alert") over the past 10 years, increasing from 9 countries in 2006 to 16 countries in 2015.

The number of weak and failed states which are investable may be small, but the potential for a subset of these to be systemically significant, such as Libya and Iraq given their status as major energy producers, or to provide territory for groups such as ISIS and Boko Haram to stage attacks, clearly detracts from not only regional stability, but raises the geopolitical risk temperature. This is evident as terrorism has returned to the top of the list of public concerns for the US for the first time since the immediate post-9/11 period, and suggests that in an election year, foreign policy concerns may play an outsize role compared to the footnote they typically play in presidential campaigns.

²¹ For example, see Loveman (2002), Record (2006), Enterline & Joyce (2008), Cunningham (2010), Pettersson (2011) and Edward N. Luttwak. 'Give War a Chance'. Foreign Affairs. July/August 1999 Issue. <https://www.foreignaffairs.com/articles/1999-07-01/give-war-chance>

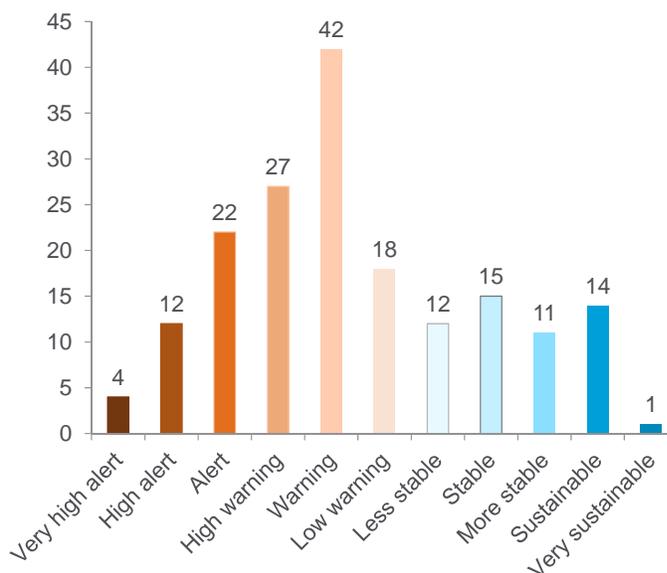
²² The Fund for Peace: Foreign Policy Fragile States Index 2015. This is an annual index ranking 178 countries based on their levels of stability and the pressures they face. List of classifications: very sustainable, sustainable, more stable, stable, less stable, low warning, warning, high warning, alert, high alert, very high alert.

Figure 10. Fragile States Index — The Number of Countries Improving vs. Worsening Score Year-to-Year



Source: Citi Research, The Fund for Peace: Foreign Policy Fragile States Index 2015
 Note: The graph shows the number of countries that either improve or worsen in their total Fragile States Index scores from year to year

Figure 11. Fragile States Index (2015) — Number of Countries in Each Category: More Countries Sliding Into “Fragile” Territory



Source: Citi Research, The Fund for Peace: Foreign Policy Fragile States Index 2015
 Note: 178 countries were assessed for the Foreign Policy Fragile States Index 2015

Military Expenditure: US Still the Biggest, But Regional Powers are Investing More

Global expenditures have declined over the past three years but only marginally

Global military expenditure was \$1.776 trillion in 2014, representing a marginal fall of about 0.4% in real terms compared to 2013. This is the third consecutive year where there was a fall in global military expenditure. However, the falls during the previous two years were marginal and military spending is still only 1.7% below its peak in 2011 and significantly higher than during the end of the Cold War.²³

The pattern in recent years has been a fall in military expenditure in the US and Western Europe, but an increase everywhere else (although spending in Latin America was essentially unchanged). Excluding the US, total military expenditure for the ‘rest of the world’ has increased continuously since 1998 and was up by 3.1% in 2014.

²³ SIPRI, Trends in World Military Expenditure 2014, Sam Perlo-Freeman, Aude Fleurant, Pieter D. Wezeman and Siemon T. Wezeman, April 2015. Note: For military expenditure, dollar figures in 2014 refer to spending at current prices and exchange rates (i.e. converted from national currency to US dollars at the average market or official exchange rate for 2014). Figures for percentage changes between 2 years are given in real terms (i.e. adjusted for inflation). The SIPRI Military Expenditure Database includes figures for each country and region in constant (2011) US dollars, which is the basis for the real-terms calculations. This means that local currency figures have first been adjusted for inflation in each country to express them in 2011 prices, then converted into US dollars at the average market or official exchange rate for 2011. Figures or rates of change in ‘nominal’ terms (US dollars or local currency) indicate figures that are not adjusted for inflation.

US military spending is still the largest in the world but its global share is declining

Military spending in the US is still by far the largest in the world, at nearly three times the level of second-place China (\$610 billion in 2014 and \$216 billion, respectively). Although the US's share of world military expenditure has been declining steadily year over year, its share of world military expenditure remains high at 34% and is at historically high levels and around the same level in real terms as it was during its previous peak in the late 1980s.²⁴

Meanwhile, military spending has been on a downward trend in Western Europe, in part due to austerity policies of recent years required by stretched public finances. However, more recently military spending has risen again in Central Europe and the Baltic states, in part as a reaction to the Ukraine crisis.

China, Russia and Saudi Arabia are increasing military spending substantially

Importantly for geopolitical risk, while the US has seen a fall in military expenditure in real terms China, Russia and Saudi Arabia have continued to make substantial increases. Saudi Arabia's 17% increase in 2014 was the highest yearly increase of any country in the top 15 military spenders in 2014. Furthermore, 20 countries (concentrated in Eastern Europe, the Middle East and Africa), spent more than 4% of their GDP on the military in 2014, compared to 15 in 2013.²⁵ Only three of the 20 countries are functioning democracies, and the majority were involved in armed conflict in 2013-2014 or had a recent history of armed conflict.²⁶

For the world order underpinned by Pax Americana, these trends do not bode well, particularly if US allies continue to under-resource their militaries or indeed if they are less amenable to deploying those assets under the direction of the US. While we believe the US is and will remain the most potent military power in the world for some time to come, its assets will be stretched thinner in a world that requires more balancing and mediating, and in which the challengers of Western liberalism continue to gain in strength. Military expenditure is, of course, only one power indicator among many. But it is perhaps the one most visibly illustrating the changing nature of global order.

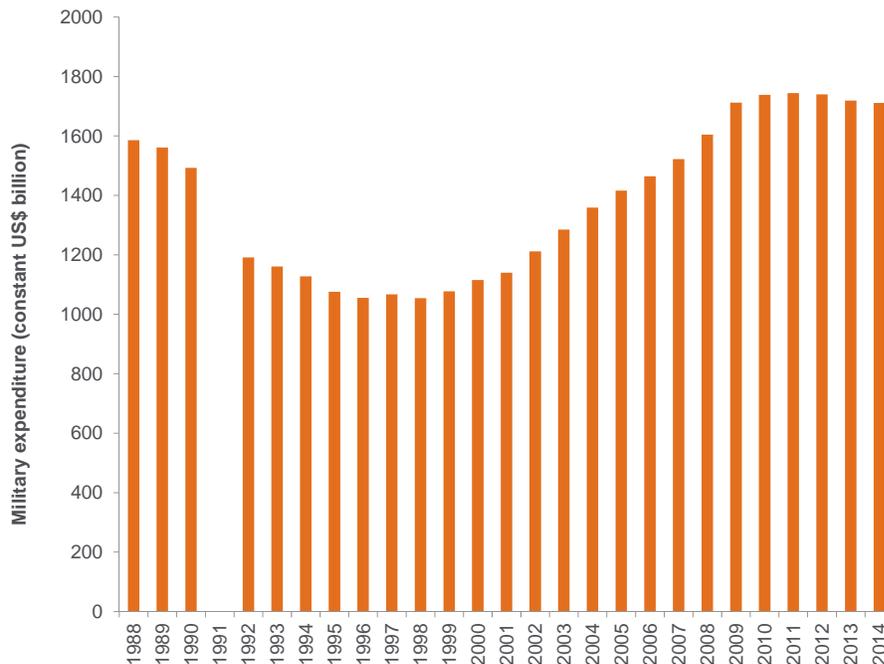
Military expenditure is also a crucial item in a world where geopolitical and socio-economic risks are converging. The West's relative economic weakness after the financial crisis of 2008 has further diminished its military muscle, a muscle that had already been weakened by two decades of cashing in on the peace dividend after the end of the Cold War. Military spending can also galvanize *Vox Populi* risk, as government spending on defense is almost always domestically unpopular. In the domestic debates over government spending, economic and social concerns tend to trump wider geopolitical ones. The case for geopolitical responsibility during times of economic hardship is hard to make. The defense spending patterns of the last 5-8 years demonstrate this.

²⁴ Ibid. See also: IHS Jane's 360 Analysis: Declining US military spending pressures defence contractors. Tate Nurkin, Director of Research, IHS Aerospace, Defence & Security. 19 September 2014

²⁵ List of countries that spent more than 4% of their GDP on the military in 2014: Oman, Saudi Arabia, South Sudan, Chad, Libya, Republic of Congo, Algeria, Israel, Angola, UAE, Azerbaijan, Namibia, Russia, Lebanon, Myanmar, Armenia, Iraq, Bahrain, Yemen, Syria

²⁶ SIPRI, Trends in World Military Expenditure 2014, Sam Perlo-Freeman, Aude Fleurant, Pieter D. Wezeman and Siemon T. Wezeman, April 2015

Figure 12. Military Expenditure By Region (Constant US\$, billion)



Source: Citi Research, Stockholm International Peace Research Institute (SIPRI) Military Expenditure Database
 Note: The totals are based on the data on 172 states in the SIPRI Military Expenditure Database, <<http://www.sipri.org/databases/milex/>>. The absence of data for the Soviet Union in 1991 means that no total can be calculated for that year.

Terrorism on the Rise

Terrorism had its largest YoY increase in 2015 in the past 15 years with 5 countries accounting for 78% of deaths

Levels, frequency and the number of countries affected by terrorism are all on the rise with as much as an 80% year-over-year increase in total number of deaths from terrorism from 2013 to 2014 — the largest yearly increase in the past 15 years. Although five countries accounted for 78% of deaths in 2014 due to terrorism (Syria, Iraq, Nigeria, Afghanistan, Pakistan), according to the Global Terrorism Index by the Institute for Economics & Peace (IEP), a majority of countries did experience a terrorist incident of some kind, a remarkable development.²⁷ Private citizens are also increasingly targeted, with a 172% year-over-year increase in deaths in 2014. The number of countries experiencing more than 500 deaths due to terrorism also increased from five to 11 (2013-2014).²⁸ This clearly represents a concern for

²⁷ Although 60% of the countries covered in the Institute for Economics & Peace: Global Terrorism Index 2015 experienced no terrorist deaths in 2014, 93 countries experienced a terrorist incident of some kind in 2014. IEP defines terrorism as ‘the threatened or actual use of illegal force and violence by a non-state actor to attain a political, economic, religious, or social goal through fear, coercion, or intimidation’. In order to be included as an incident in the GTD the act has to be: ‘an intentional act of violence or threat of violence by a non-state actor’. This means that the incident has to meet three criteria in order for it to be counted as a terrorist act: 1. The incident must be intentional – the result of a conscious calculation on the part of a perpetrator. 2. The incident must entail some level of violence or threat of violence – including property damage, as well as violence against people. 3. The perpetrators of the incidents must be sub-national actors. This database does not include acts of state terrorism.

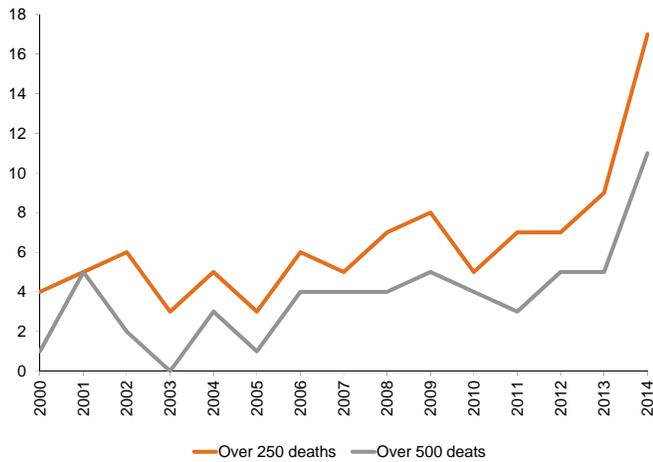
²⁸ Institute for Economics & Peace: Global Terrorism Index 2015. The year-over-year increases are calculate for 2014 compared to 2013 (data for 2015 not yet available).

businesses with overseas operations as well as local economic activity, especially tourism, which can be hit dramatically by terrorist attacks, especially those occurring in resort areas such as Tunisia and Egypt.

Terrorism has risen to the top of US public concern

In the past year, terrorism has risen to the top US public concern. A Gallup survey released in mid-December 2015 showed that 16% of Americans pointed to terrorism as the most important problem facing the US, followed by the country's governance and leadership (13%). However, this is still well below the 46% that called terrorism the country's most important issue in the wake of the 9/11 attacks.²⁹

Figure 13. Number of Countries that Experienced Severe Losses From Terrorism, 2000-2014



Source: Citi Research, Institute for Economics & Peace: Global Terrorism Index 2015

Figure 14. Deaths by Target Type Between 2013 and 2014

Targets	Number of deaths in 2014	Yoy percentage change % (2013-2014)
Private citizens & property	15,380	172%
Other	3,496	82%
Military	2,530	76%
Police	6,124	35%
Business	1,983	24%
Government	2,060	20%
Religious	1,111	-11%

Source: Citi Research, Institute for Economics & Peace: Global Terrorism Index 2015

Anatomy of the New Global Political Risks

We disagree with the sense that global political developments are a series of idiosyncratic random developments happening in isolation. Rather, in our view, after undertaking a wide survey and mapping these risks, key theme are evident:

1. **The breakdown of the international security architecture**, by which we mean the series of military alliances and treaty-based framework for monitoring arms and unconventional weapons which has underpinned the global system;
2. **Geopolitical and economic competition**, which looks at the rising tendency for countries to project power through economic means and reluctance to pool sovereignty to resolve global challenges; and
3. **A noticeable decline in business and political legitimacy**, evident in the trend toward declining trust in elites, rising anti-establishment sentiment and nationalism and populism, all of which are accelerated by growing perceptions of income inequality and shrinking middle classes.

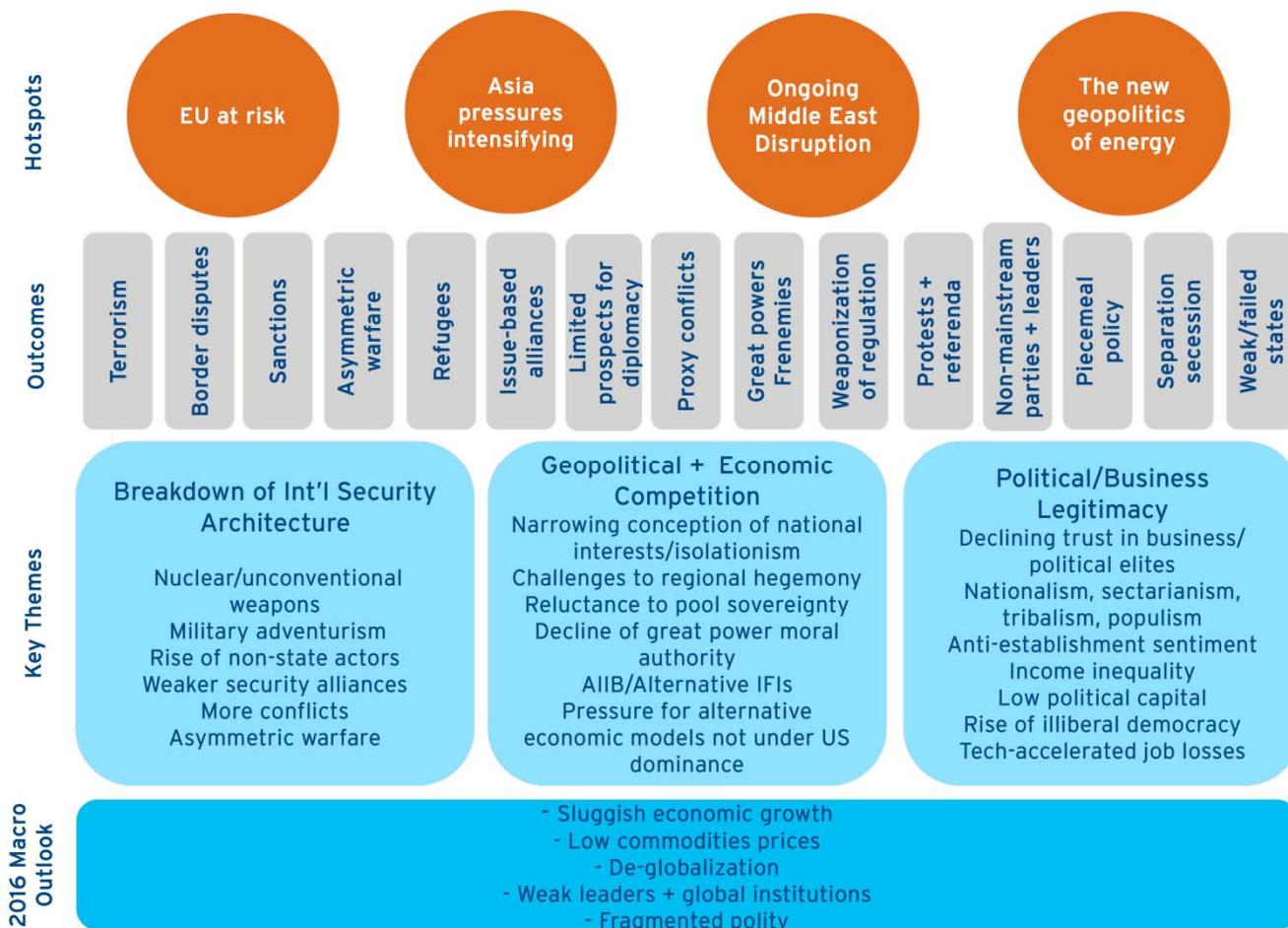
These themes can then be linked to policy and other concrete outcomes, such as increased use of sanctions and asymmetric warfare to project power, greater likelihood of border disputes due to weakening military alliances and the rise of non-state actors and sustained support for non-mainstream political parties, though these manifestations can clearly cut across categories.

²⁹ Gallup. Americans Name Terrorism as No. 1 US Problem. 14 December 2015.

Finally, we distill this constellation of themes and implications into 4 hotspots most likely to be impacted. Three of our hotspots are regional and one, Commodities, is an asset class.

- **Asia**, where pressures are intensifying in terms of China's willingness to challenge the US presence in the region and military alliance with Japan, and the regional power balance is increasingly fluid with the recent signing of the Trans-Pacific Partnership (TPP) as perhaps the most visible signal of the much-vaunted "Asia pivot".
- **The European Union**, where the conflicts of the Middle East and Africa are resulting in unprecedented flows of migrants by post-War standards combined with continued support for non-mainstream political parties at home.
- **The Middle East**, with proxy conflicts and a new power balance emerging at the same time as oil prices fall to at 10-year low.
- In our fourth hotspot, **Commodities**, we judge that lower prices and the scourge of the "resource curse" is altering dynamics, increasing the fragility of a number of regimes and altering the trajectory for geopolitical risk.

Figure 15. Anatomy of the New Global Political Risks: Deconstructing a World in Transition



Source: Citi Research

Vox Populi Risks Continue, and Evolve

What is Vox Populi Risk?

Vox Populi risk includes election risk, flash mob democracy mass protest risk, referendum risk and geopolitical risk

Citi defines *Vox Populi* risk as shifting and more volatile public opinion that poses ongoing, fast-moving risks to the business and investment environment. We classify *Vox Populi* risk events into four main categories: (1) election risk; (2) “flash mob democracy” mass protest risk; (3) referendum risk; and (4) geopolitical risk.³⁰

There have been fewer mass protests in the last couple of years compared to 2011-2012. However, over the past two years we have seen continued constitutional crises, such as in Brazil, highly uncertain election outcomes and referendum risks. Greece and Turkey both held two parliamentary elections in 2015 when the first failed to produce a conclusive result. In 2014-2015, referenda were held in Crimea, Greece, Scotland and Denmark, while separatists took control of Catalonia’s regional government. David Cameron has promised a referendum on the UK’s EU membership by 2017.

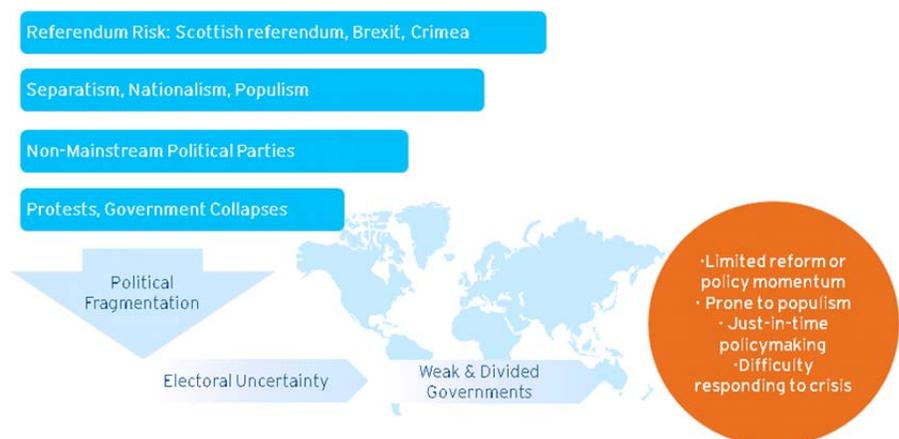
Recent elections have highlighted fragmentation risk...

Elections continue to highlight fragmentation risk, more frequently producing fragile multi-party governments. For example, after the October 2015 election in Portugal, where the center-right coalition won the most votes, the government was ousted by a left-wing bloc after only a few weeks in power; Spanish elections at year end produced a similar result, in both cases highly unusual in post-dictatorship history.

...and non-mainstream parties have continued to grow in strength

Non-mainstream parties have also continued to grow in strength, especially in Europe, but also non-mainstream candidates have seen sustained support in the US presidential race. Anti-establishment sentiment has been high in advanced economies due to a number of reasons such as lack of trust in elites, income inequality concern and middle class anxiety. In the US, this phenomenon is reflected in the strong support for non-mainstream presidential candidates such as Donald Trump and Bernie Sanders. What is different about the last two years is the growing popularity of parties with an anti-immigration platform.

Figure 16. *Vox Populi* Risk is Much in Evidence



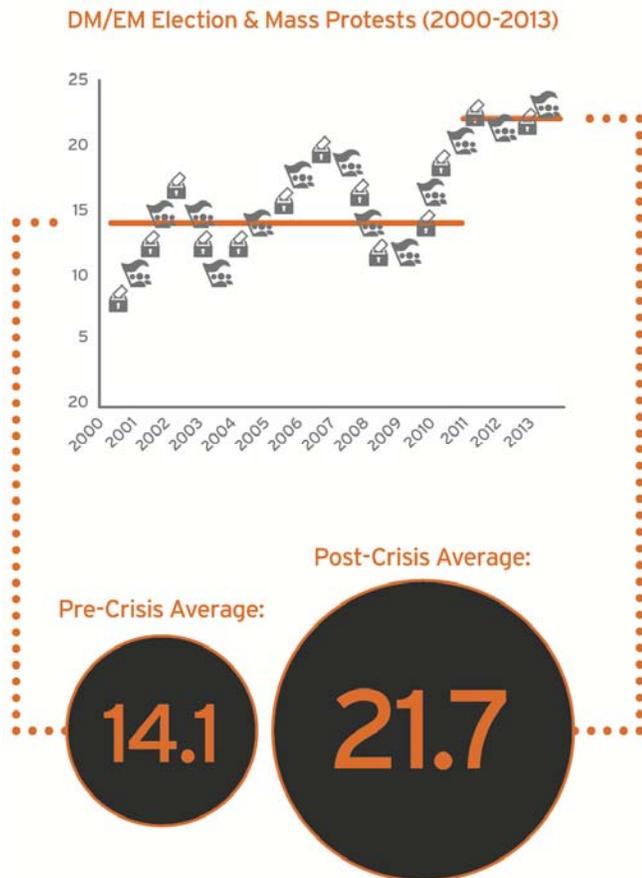
Source: Citi Research

³⁰ Citigroup GPS. Vox Populi, Taking it to the Streets: What the New Vox Populi Risk Means for Politics, the Economy and Markets. See: <https://www.citivelocity.com/citigps/ReportSeries.action?recordId=26>

What do 2015 Elections Tell Us about the State of *Vox Populi* Risk and the 2016 Political Outlook?

We conducted our first empirical assessment of *Vox Populi* risk in 2013, following the dramatic events of the Arab Spring and its aftermath. *Vox Populi* risk is defined as shifting and more volatile public opinion that poses ongoing, fast-moving risks to the business and investment environment. *Vox Populi* risk events into four main categories: (1) election risk; (2) “flash mob democracy” mass protest risk; (3) referendum risk; and (4) geopolitical risk

Figure 17. Yearly Average of Elections and Mass Protests in Major Markets has Jumped 54% in the Post-Crisis Environment



Source: Citi Research

Vox Populi Risks – Taking it to the Streets – Key Takeaways

There has been a dramatic and measurable increase in the number of elections, mass protests and government collapses — a 54% increase versus the previous decade — as well as a proliferation of new and fringe political parties, many of which are anti-establishment.

Political risk is being driven by more middle classes in both emerging and developed market countries. For developed markets, *Vox Populi* risk is being fuelled by perceptions of growing income and wealth inequality and demands for change that often mask a desire to keep the status quo in public resource allocation, favoring the aging and the middle class.

In emerging markets, street demonstrations are giving political expression to new middle classes and placing increased demands on political systems and on the capacity of state institutions to deliver key public goods and services, including health, transportation and education.

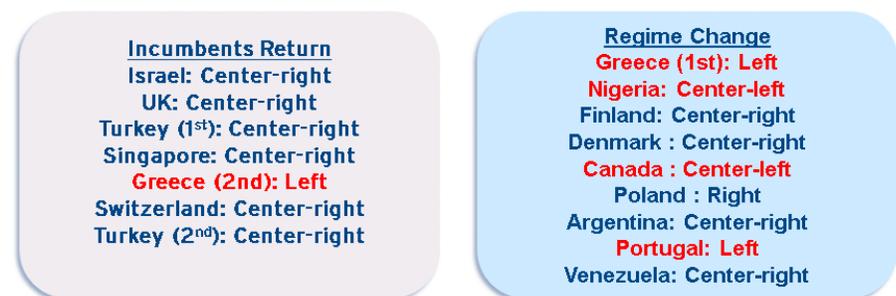
For petro-states, falling petroleum prices are leading to an outcry for improved transparency and governance and a quest in many countries for revenues to be more equitably distributed. A frequent catalyst of *Vox Populi* risk is also the perception of elite corruption. Elite misbehavior has rapidly galvanized public dissatisfaction across income groups and regions, accelerated by social media.

Vox Populi risk has continued to be in evidence

Since then, *Vox Populi* risk continues to be in evidence, though arguably more so at the ballot box than on the streets. 2015 saw approximately 16 geopolitically or systemically significant national elections.³¹ Of these, incumbents were re-elected in seven cases, while nine brought about changes in government. Overall, center-right parties have been the main beneficiaries in 2015's elections, winning in 11 of our 16 country cases; we think this could be the beginnings of a trend that bears watching. The most recent examples are Argentina, where President-elect Mauricio Macri surprise victory sees him overturn 10 years of populist, Peronist rule and Venezuela where the center-right opposition won a majority of seats in the National Assembly overturning nearly two decades of dominance by the Socialists.

Despite modest improvements in economic growth in many cases, support for non-mainstream parties has continued, testing the assumption that economic downturns prompt voters to gravitate away from the mainstream; we see this evolution as part of a longer-term structural trend away from mainstream political parties. In 11 of the key elections we tracked, non-mainstream parties received over 10% of the vote. In five of these 11 cases, non-mainstream parties actually received over 20% of the vote.³²

Figure 18. Recent Election Results



Source: Citi Research

³¹ Elections: Israel, UK, Turkey (June), Singapore, Greece (January), Switzerland, Turkey (November), Greece (September), Nigeria, Finland, Denmark, Portugal, Canada, Poland, Argentina, Venezuela. The outcome of the Spanish election is not included as the government has not yet been formed at the time of writing.

³² 2015 elections where non-mainstream parties received over 10% of the vote: Israel, UK, Turkey (June), Turkey (November), Finland, Portugal, Greece (January), Greece (September), Switzerland, Denmark, Poland. In the latter 5 cases, non-mainstream parties gained over 20% of the vote.

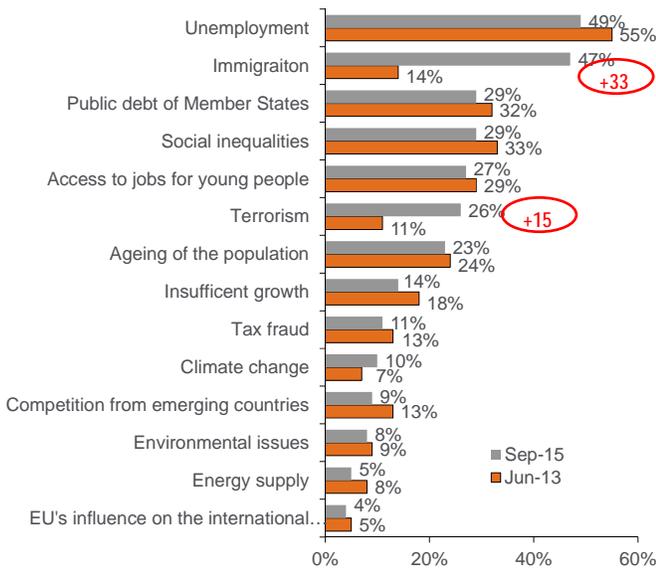
Non-mainstream parties have benefitted from declining public trust in elites, unevenly-distributed benefits of growth, and the perceived irrelevance of mainstream party politics. At this juncture, non-mainstream political parties are rarely outright winning at the polls (Greece's Syriza is a rare exception), but they are contributing to more fragmented governments and influencing the political debate with their often unorthodox policy ideas.

Fear and Loathing

Anti-immigration parties have seen a rise in voting percentage

In 11 of 17 recent European elections, anti-immigration parties have seen a rise in voting percentage. The Finns Party and Golden Dawn in the January Greek election were the only parties with an anti-immigration platform to lose votes in 2015. However, the Finns Party was able to join the government for the first time and Golden Dawn saw an increase in votes in the second Greek election (held in September). It is possible that the decline in votes seen in Norway, the Netherlands, Bulgaria, Italy and Belgium were due to elections being held before 2015 — when the refugee crisis became such a huge concern for European publics. The latest Eurobarometer poll (published in October 2015) shows that concerns about immigration and terrorism, already high in past surveys, had the biggest increases compared to 2013. For 47% of respondents, immigration is the greatest challenge facing the EU and its member states, up from 14% in 2013. Concerns about terrorism were cited by 26% of respondents, up from 11% in 2013.³³

Figure 19. Concerns About Immigration and Terrorism in EU Show the Biggest Increases Compared to 2013



Source: Citi Research, European Parliament Eurobarometer (EB/EP 84.1): The main challenges for the EU, migration, and the economic and social situation, published 14 October 2015
 Note: Question asked: In your opinion, what are the main challenges facing the EU and its Member States in order to face the future? Firstly? And secondly? And thirdly? (MAX. 3 ANSWERS)

Figure 20. Voting Share of Anti-Immigration Parties in European Parliamentary Elections is Growing in Northern & Central Europe

Country	Anti-Immigration Party	% of votes in last election	+/- from previous election	Last Election	Next Election
Poland	Law and Justice (PiS)	37.6%	7.7%	2015	2019
Switzerland	Swiss People's Party	29.4%	2.9%	2015	2019
Denmark	Danish People's Party	21.1%	8.8%	2015	2019
Hungary	Jobbik	20.5%	3.9%	2014	2018
Austria*	Freedom Party	20.5%	3.0%	2013	2018
Finland	Finns Party	17.7%	-1.4%	2015	2019
Latvia	National Alliance	16.6%	2.7%	2014	2018
Norway	Progress Party	16.3%	-6.6%	2013	2017
France**	National Front	13.6%	9.6%	2012	2017
Sweden	Sweden Democrats	12.9%	7.2%	2014	2018
UK	UKIP	12.6%	9.5%	2015	2020
Netherlands***	Party for Freedom	10.1%	-5.4%	2012	2017
Greece	Golden Dawn	7.0%	0.7%	2015	2019
Germany	Alternative for Germany	4.7%	4.7%	2013	2017
Bulgaria	Attack	4.5%	-2.8%	2014	2018
Italy****	Lega Nord	4.1%	-4.2%	2013	2018
Belgium*****	Vlaams Belang/ Flemish Interest	3.7%	-4.1%	2014	2019

Source: Citi Research, various government websites
 *Votes for National Council (one of two houses of the Austrian Parliament)
 **Votes for National Assembly (lower house of French Parliament), first round of voting
 ***Votes for House of Representatives (lower house of Dutch Parliament)
 ****Votes for Chamber of Deputies (one of two houses of the Italian Parliament)
 *****Votes for Chamber of Representatives (lower house of the Belgian Parliament)

³³ European Parliament Eurobarometer (EB/EP 84.1): The main challenges for the EU, migration, and the economic and social situation. 14 October 2015

On the EU periphery, anti-establishment parties more generally (typically anti-austerity) have also continued to perform strongly this year. Syriza is the only non-mainstream party to have won the largest share of the vote in European elections in 2015, but the new Leftist coalition government in Portugal is another potential source of political risk to watch in the year ahead. Led by the Socialist Party (PS) in an alliance with the Left Bloc (BE) and the Communist party (PCP), the coalition's emergence came as a surprise, marking the first Portuguese government to include a far Left party since the emergence of democracy in 1974, even though it remains unclear at this stage how many of the parties' original campaign promises have a chance of being implemented.

Weak Political Leaders Mean Limited Reform Prospects

Weak and divided governments can be a source of concern for companies and investors

For companies and investors, weak and divided governments can be the source of erratic policymaking and a more uncertain operating environment. Cohesive governments with sufficient political capital and legislative energy can be a source of policies which can drive growth, particularly through reforms.

Throughout the late last two decades, the perception of a capacity and willingness to implement market-friendly reforms was a key driver of growth and market optimism for many emerging market (EM) economies, such as Brazil, Russia and China. These new EM markets would also be the source of new middle classes that would demand political stability and form new sources of growth.

With hindsight, the perception of reform momentum in a number of those countries was not always in sync with the realities of reforms on the ground, and the proximate drivers of growth were often built on rising commodity prices and the availability of cheap funding. Now that the commodity and credit super-cycles seem to have come to an abrupt end, structural reforms may be one of few growth options many EMs have. The question is whether they are likely to pursue them.

We use four criteria to assess the reform capacity of G20 countries:

- the approval rating of the country's leader;
- the World Bank Government Effectiveness score ³⁴;
- whether the government is 1) multi-party/divided, 2) "cohesive" (there is a majority), or 3) hybrid/communist/monarchy; and
- whether there is an upcoming election/or has been a recent election.

³⁴ World Bank. The Worldwide Governance Indicators (WGI) project. See: <http://info.worldbank.org/governance/wgi/index.aspx#home>

Capacity for Assessing the Reform Capacity of G20 Countries

Approval Rating of a Country's Leader

The higher the approval rating of the leader, the higher the degree of public consensus and therefore the capacity to implement change. In the Figure 21, we group the countries into four thresholds: approval rating over 65%, 55% to <65%, 45% to <55%, and <45%.

World Bank government effectiveness score

The World Bank's Worldwide Governance Indicators report on six broad dimensions of governance for 215 countries over the period 1996-2014: Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption.

We use the Government Effectiveness scores for our analysis. This captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. In Figure 21, the Government Effectiveness percentile ranks among all countries (ranges from 0 (lowest) to 100 (highest) rank) are displayed. These are the scores for 2014, which is the most recent data available.

Type of Government

It is easier for governments that have fewer checks and balances to push through reforms. (Our focus is on reform capacity, not the will of a government to reform or the quality of reforms.) A majority of governments in democracies and in principle, governments without political competition like monarchies and dictatorships have a higher capacity for reform than multi-party or divided governments.

Recent/Upcoming Election

Governments that are at the end of their term are less able to reform. On the flip side, governments that have recently been elected have greater reform capacity. For example, the new government of Canada (election in October 2015) has greater capacity to push through reforms than the U.S., which has an election in November 2016.

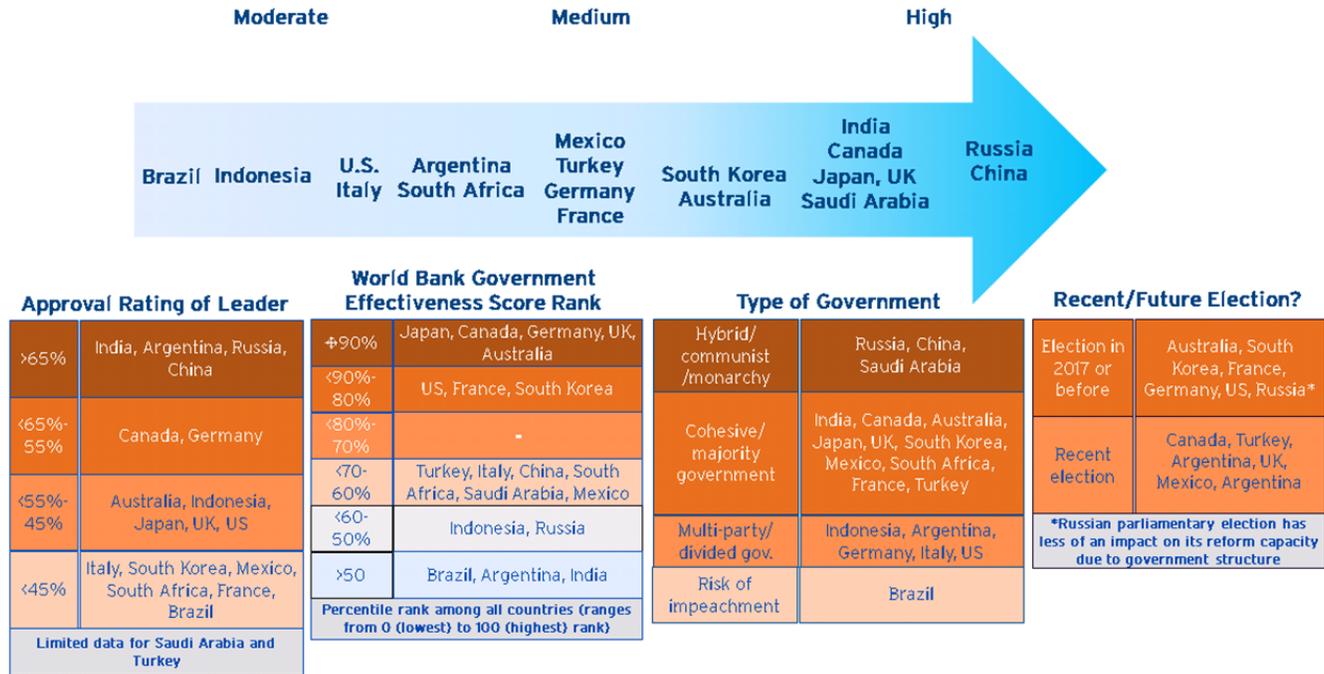
Few elected leaders in G20 countries have approval ratings over 65%

A snapshot of G20 countries highlights how few elected leaders have approval ratings over 65% — leaders in India, Argentina and Russia (with very limited recent data for Turkey, China and Saudi Arabia), and how the majority languish in the bottom two segments, illustrating how limited the prospects for reform in the current political environment may be. Countries with monarchies or hybrid regimes are in principle most able (not necessarily willing) to implement necessary changes due to the absence of political competition.

In democracies, countries with majority governments are better able to push through reforms compared to divided or multiparty governments. Other factors in determining reform capacity include high approval ratings of the leader, "government effectiveness" (we use a score by the World Bank) and whether there is an election coming within the next year or two (upcoming elections decrease the likelihood of a government implementing a reform). Using these variables the graph below shows the reform capacity of governments.

Our analysis shows that only a small subset of the G20 can be counted to have reform capacity. Of these, Russia, China and Saudi Arabia face huge pressure on their economic outlook, while other countries that with higher reform capacity compared to their G20 peers (such as India, Canada, Japan, and the UK) also have weakening economic backdrops constraining reducing prospects for reform.

Figure 21. Reform Capacity of G20 Countries: Reform Capacity in Principle Suggests High in Regimes With Limited Competition, But May Be Complicated By Internal Considerations and Economic Constraints



Source: Citi Research, World Bank: Worldwide Governance Indicators, IFES Election Guide, various polls and government websites
 Note: Risk of impeachment (very low government effectiveness score and approval rating of leader): Brazil: Multi-party government/divided, low approval rating + high government effectiveness (>85%) but election coming up OR fairly low government effectiveness score and low approval rating : US, Italy: Multi-party government, low government effectiveness score, but with high approval rating (>75%) OR cohesive government but with very low approval rating and low government effectiveness score: Argentina, South Africa: Cohesive government, but low approval rating or government effectiveness score OR multi-party government, but high government effectiveness score and moderately high approval rating of leader: Mexico, Turkey, France, Germany : Cohesive government+ high government effectiveness (>85%), but elections in 2017: South Korea: Cohesive government and high approval: India or cohesive government+ high government effectiveness score: Canada, Australia, Japan, UK: Monarchy/hybrid/communist regime: Russia, China, Saudi Arabia

Reform capacity is of course only one side of the coin. The other is the willingness to reform. And what we generally observe is that governments that reform tend to fall into a number of categories: those that tend to do so because they have a strong mandate for reform (think Abe in Japan or Macri now in Argentina); those that are forced to reform by particular immediate (and often external) circumstances (any country under an IMF bailout program); those that see reforms as their only hope of staying in power as circumstances deteriorate but are not quite desperate (Germany Chancellor Schröder in the early 2000s and, to a lesser extent, President Hollande in recent years or Brazilian President Rousseff now) or those that, towards the end of their term, are focused on building a legacy (perhaps US President Obama's motive for supporting the Trans-Pacific Partnership). Put differently, reform willingness and reform capacity may not always go hand in hand. When it comes to the prospects for structural reforms today, we are not particularly optimistic. In Europe, the momentum has clearly died down, and prospects for reform are rare (perhaps in France and Italy) and, even there, limited. In Japan, Abenomics's third arrow remains rather blunt and we have little expectation of an acceleration of reforms in 2016. EMs will be the key area to watch for the prospect of reforms.

Lack of Trust in Business and Political Elites is a Key Driver of *Vox Populi* Risk, and Has Returned to Immediate Post-Crisis Levels

Increased *Vox Populi* risk in electoral democracies worsens governance and reform prospects in most cases — unless there is a broad-based consensus for reform, as was recently highlighted in Argentina. Fragmented governments are unable to push through changes, while unpopular leaders are unwilling to do so. This increases unpredictability and often results in or prolongs economic stagnation.

The continued global decline in trust in elites and institutions is a source of concern. This fuels popular discontent, especially when coupled with stagnant or declining living standards. While electorates have become more demanding with the rise of individualism due to greater choice provided by globalization, the capacity of governments is declining. The lack of trust affects everything from how electorates vote to producing less favorable business environments.

Most “trusting” countries according to 2015 Edelman Trust Barometer: UAE, India, Indonesia, China, Singapore, Netherlands

The 2015 Edelman Trust Barometer shows continued decline in trust in institutions and leaders worldwide. More countries are classified as distrusting than trusting, with the Trust Index being an average of a country’s trust in government, business, media and non-governmental organizations (NGOs).³⁵ With what the Edelman Trust Barometer classifies as “informed publics”,³⁶ only six of 27 countries expressed levels of trust above 60%.

Countries such as Canada and Malaysia that were rated as “trusting” in 2014 fell into the neutral band while South Africa, Hong Kong and South Korea slid from neutral to distrusting status. Among the general public, the trust deficit is even greater, with nearly two-thirds of countries classified as distrusting.

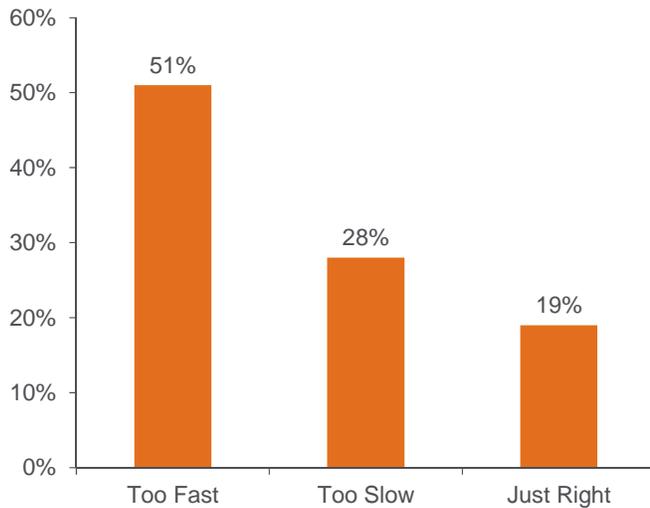
This lack of trust is not limited to the private business sector. Trust in media and NGOs is at its lowest level since the 2008 financial crisis. Government was the only institution to gain trust in 2015. However, governments are still the least trusted institution with “informed publics” in 19 of 27 countries distrusting the government to do what is **right**.

Innovation is also affected by trust and vice versa. The 2015 Edelman Trust Barometer finds that more than half of the global “informed public” believe that the pace of development and change in business today is too fast, that business innovation is driven by greed and money rather than a desire to improve people’s lives and that there is not enough government regulation in a number of industries. They also show that countries with higher trust levels overall also show a greater willingness to trust new business innovations. Lower trust is also strongly correlated with more demand for regulation. Given that the group of people surveyed by Edelman were typically highly educated and affluent, and therefore among the key beneficiaries of globalization, these attitudes point to a wider malaise and concern about the pace of change and dislocation.

³⁵ The Edelman Trust Barometer classifies countries into: Trusters (countries with a score of > 60%), Neutral (50-59%), Distrusters (< 49%). The score is an average of a country’s trust in government, business, media and NGOs. 27 countries in total.

³⁶ All informed publics meet the following criteria: college-educated; household income in the top quartile for their age in their country; read or watch business/news at least several times a week; follow public policy issues in the news at least several times a week.

Figure 22. Stop the World, I Want to Get Off? "The Pace of Change Is..." Figure 23. Drivers of Change in Business Perceived to Be...



Source: Citi Research, The 2015 Edelman Trust Barometer

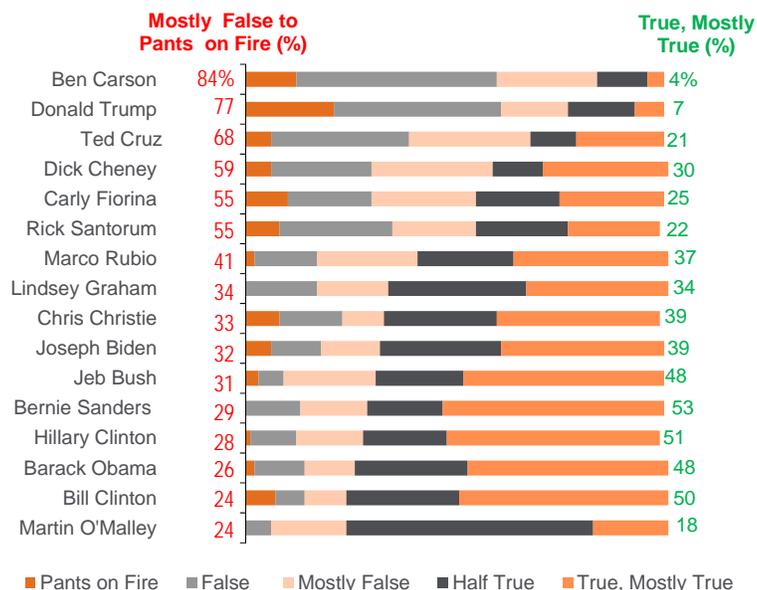


Source: Citi Research, The 2015 Edelman Trust Barometer

You Are Entitled to Your Opinion, But Not Your Own Facts

The innovations that have occurred in social media also have had a negative effect upon public trust. Although there has been a massive rise in the number of people who have access to information within seconds, the information that we often access has varying degrees of accuracy. Social media and websites can offer conflicting versions of the truth. Search engines are now the most trusted media source for general news, with millennials being even more trusting of digital media. While digital media can be a great source of information, there are numerous sites with false information, conspiracy theories and invented statistics. This allows for politicians to make claims that are not factually correct but are circulated by Twitter. Indeed, Politifact confirms that just 7% of Trump's statements are factually correct, while this figure is only 4% for Ben Carson. Politifact shows that 51% of Hillary Clinton's statements and 54% of Bernie Sanders' statements are true.

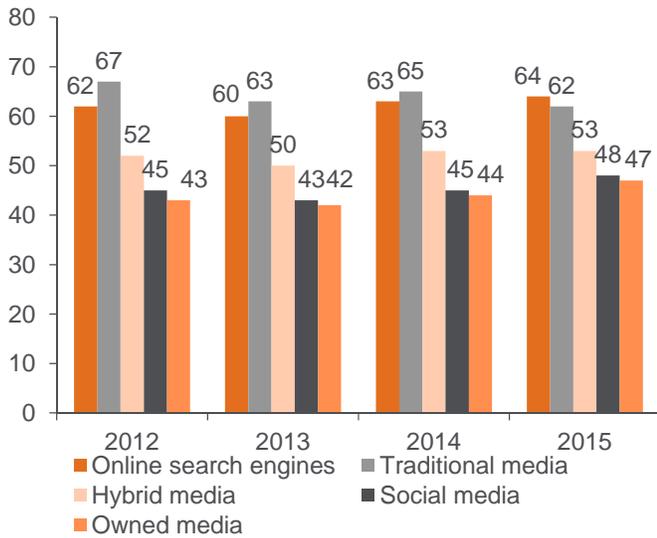
Figure 24. Truth or Dare? Fact Checkers Suggest That Politicians Don't Always Tell the Truth...



Source: PolitiFact: Fact Checking US Politics. Data retrieved 11 January 2015

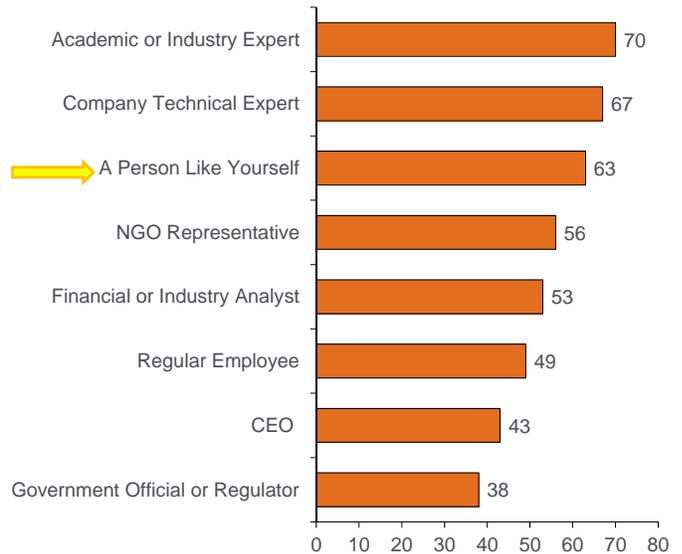
Although many may not believe the claims such politicians make using social media, with low levels of trust people may care less as they don't trust anything that they read. This helps explain why friends, families and inner circles are becoming the most trusted sources. The Edelman Trust Barometer shows that "a person like yourself" is trusted more than a NGO representative, financial or industry analyst, regular employee, CEO or a government official or regulator (the least trusted) when forming an opinion about a company.

Figure 25. Media Sources: Search Engines Now Most Trusted. Millennials Even More Trusting of Digital Media



Source: Citi Research, The 2015 Edelman Trust Barometer
 Note: Trust in source for general news and information, 20-country global data

Figure 26. The Rise of Political Narcissism? “A Person Like Yourself” Is the Third Most Trusted Source of Information



Source: Research, The 2015 Edelman Trust Barometer
 Note: Question: below is a list of people. In general, when forming an opinion of a company, if you heard information about a company from each person, how credible would the information be — extremely credible, very credible, somewhat credible, or not credible at all? Top 2 Box, very/extremely credible. Informed publics, 27-country global total.

Middle Class Squeeze

The rise of living standards for broad swathes of the population in emerging markets may be coming to a halt

Coinciding with this fall in trust has been a perceived squeeze on the middle class in developed markets, while the trend of rising living standards for broad swathes of the population in emerging markets may also be screeching to a halt. *Vox Populi* risk is being fueled by growing perceptions of income inequality and anxiety about globalization, particularly amongst middle classes.

Pew Research shows that after more than four decades of serving as America’s economic majority, the middle class is now matched in number by those in the economic tiers above and below it. According to Pew Research Center, in early 2015, 120.8 million adults were in middle-income households compared with 121.3 million in lower- and upper-income households combined — a demographic shift that could signal a tipping point.³⁷

The aggregate household income has substantially shifted away from middle-income to upper-income households. Forty-three percent of US aggregate income went to middle-income households in 2014, which is substantially lower than the 62% in 1970. Meanwhile, 49% of aggregate income went to upper-income households in 2014 compared to 29% in 1970. This shift has been driven by the growing size of the upper-income tier and more rapid gains in income for upper-income households.

³⁷ Pew Research Center, The American Middle Class Is Losing Ground: No longer the majority and falling behind financially, 9 December 2015. Note: “Middle-income” households are defined as those with an income that is two-thirds to double that of the US median household income, after incomes have been adjusted for household size. Lower-income households have incomes less than two-thirds of the median, and upper-income households have incomes that are more than double the median.

Inequality and declining trust in politicians and establishment institutions are a factor in rising support for non-mainstream parties

Furthermore, this shift has been even more pronounced during the 21st century. In 2014, the median income of middle-income households was 4% less than in 2000. The housing market crisis as well as the recession of 2007-2009 have also caused median wealth (assets minus debts) to fall by 28% from 2001 to 2013 according to Pew Research, even though median wealth since then has probably recovered a bit further.

It's not all bad news for the middle class as the median income, adjusted for household size, has increased 34% since 1970. However, this is still less than the 47% increase in income for upper-income households, though it is greater than the 28% increase among lower-income households. Even though the precise trends vary in other developed economies, the broader picture is similar: gains in income and wealth have been much higher in the top categories of the income and wealth distributions.

The higher concentration of income and wealth at the top and the stagnation of living standards for the middle class (and those below) have already had a major impact on the public and policy debates in many countries, including in the debates ahead of the 2016 US Presidential elections. They are clearly a factor in the rising support for non-mainstream parties, the declining trust in politicians and many establishment institutions.

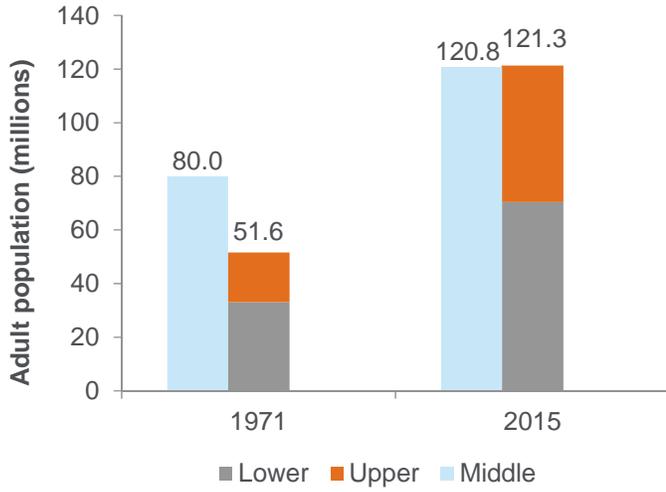
When it comes to actual policies, the impact of these debates we have seen so far is limited and rather varied. In a number of countries, minimum wages (including the UK and the US; in Germany a nationally binding minimum wage has been introduced for the first time) have been raised, even though a number of Eurozone periphery countries under IMF bailout programs also lowered them. In some countries, such as Hungary and perhaps now in Poland, these trends probably provide the political support to impose special taxes on particular industries, notably those with a large share of foreign ownership.

There seems to be a modest shift towards slightly more expansionary fiscal policies in advanced economies (even though the drivers are many; in Europe, the refugee crisis and security issues point to some higher fiscal outlays, mostly unrelated to 'middle class concerns'), but on the whole little evidence of political momentum to arrest or reverse the large increases in inequality. Proposals to that effect are more in circulation than they used to — note the increasing prominence of proposals to introduce unconditional basic incomes from Greece to Finland to the Netherlands) to impose higher taxes on wealth in a wide range of countries and growing voices of restructuring the debt of excessively indebted households and, in some cases, governments (in those cases, to avoid further austerity; see Greece, Portugal and to some extent Spain).

Indeed, while a number of countries have cut taxes (e.g. Spain and the UK) and are slightly boosting infrastructure spending (US and EU), social benefits have often also been tightened, e.g. in the UK as well as many periphery countries in the Eurozone. The wealthy have meanwhile mostly escaped additional tax burdens so far. As for corporates, except in a few stressed Eurozone periphery countries, tax rates are being reduced (usually in a bid to improve cross-country 'competitiveness'), even though in many cases, tax expenditures are being reduced alongside and the tax base is being widened.

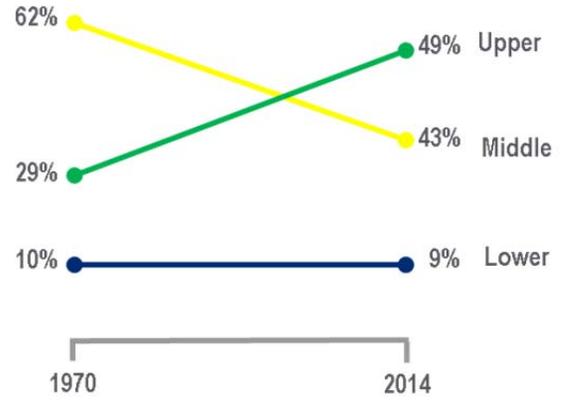
It remains to be seen how this debate will evolve and which policy changes it will result in in coming years. But continuing trends of widening income and wealth inequalities — which could be underscored by rapid technological change favoring the few vs the many as well as ineffective policy responses — bear the risk of further boosting anti-establishment sentiment and could easily, and often abruptly, lead to major policy changes, including taxation.

Figure 27. Middle-Income Americans Are No Longer in the Majority (Adult Population by Income Tier, Millions)



Source: Citi Research; Pew Research Center, The American Middle Class Is Losing Ground: No longer the majority and falling behind financially, 9 December 2015

Figure 28. The Share of Aggregate Income Held By Middle-Income Households in America Has Plunged



Source: Citi Research, Pew Research Center, The American Middle Class Is Losing Ground: No longer the majority and falling behind financially, 9 December 2015

Two Key Political Signposts for 2016: US Elections and the UK EU Referendum

2016 is a year of relatively few systemically significant elections. US elections rarely move markets, but the occupant of the White House still wields considerable power that can impact companies and the investment environment, not to mention foreign policy. Could a change in leadership restore Pax Americana?

Could a New US President Reverse Great Power Sclerosis?

Anti-establishment candidates Donald Trump and Ben Carson continue to dominate polls for the Republican nomination, with sustained popularity for surprise Democratic challenger Bernie Sanders, a self-declared Socialist in a country where the term is typically regarded as a political insult. Candidate after candidate has made campaign blunders that would, under other circumstances, have cost them public support. This time, Americans seem to be rewarding candidates who depart from the usual political script with their support, suggesting a US variation on anti-establishment sentiment, manifested as support for non-mainstream candidates rather than new political parties. But will Americans vote for these candidates in the ballot box, or return to establishment candidates? With just under a year to go, the US political establishment and markets have not been overly concerned, with most treating the race as colorful political theatre, but we suspect that will soon change as the primary process begins.

It is too soon to attempt to forecast who will win the White House in November — polls taken at this stage are typically 6-8 points wide of the mark. But 2016 US elections are shaping up to be highly unusual, where establishment favorites like Jeb Bush have lost momentum and outsiders like Trump and Sanders are defying expectations, creating challenges for forecasters. Hillary Clinton is highly likely to gain the Democratic nomination³⁸, but faces considerable obstacles, not least her high negative ratings: a significant number of Americans already hold a negative opinion of her (51% of US adults according to a Gallup poll released in September).

A recent survey by Pew Research shows that of likely US primary voters, 65% of Republicans want a candidate who offers “new ideas and a different approach” over “experience and a proven record”, up from 36% in March. Voters also want a candidate who shares their views. Majorities of both Republicans (67%) and Democrats (65%) say it is more important to pick a candidate who comes closest to their views on the issues — rather than electability. Just 27% in both parties say it is more important to choose a candidate who has the best chance of winning next November.³⁹ Could this mark the formal emergence of political narcissism?

Majorities of Republicans and Democrats now say it is more important to pick a candidate who comes closest to their views rather than one who is electable. Is this the formal emergence of Political Narcissism?

³⁸ Carnegie Endowment for International Peace, David Rothkopf. The Year the United States Elects Its First Woman President. 31 December 2015.

³⁹ Pew Research Center, survey conducted Sep. 22-27, 2015

Figure 29. Among possible primary voters, % who would be able to support a candidate who wants to...

	Less likely	More likely	Not a factor
Among Republicans/Republican leaners			
End nuclear agreement with Iran	14	69	14
End funding for Planned Parenthood	18	56	23
Send ground troops to fight ISIS	22	53	21
Deport immigrants in U.S. illegally	29	43	24
Compromise with Democrats	27	41	27
Raise taxes on wealthy	34	31	34
Among Democrats/Democrat leaners			
Offer plans similar to Obama admin.	12	61	26
Compromise with Republicans	14	60	23
Cut size of banks	16	48	33
Expand trade agreements	19	45	34
Back nuclear agreement with Iran	27	41	25

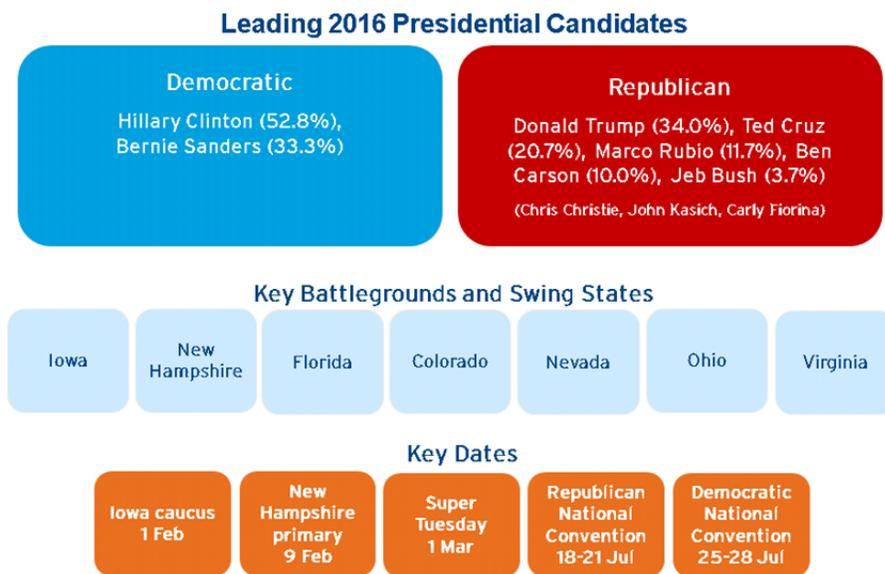
Source: Citi Research, Pew Research Center, Sep. 22-27 2015 based on registered voters

Note: "Democratic" refers to Democratic and Democratic-leaning registered voters. "Republican" for Republican and Republican-leaning registered voters (Pew Research Center)

US election-watchers should be prepared for a long and winding road to the November 8th general election. Party conventions and nominations do not take place until the summer, leaving plenty of opportunity for campaign gaffes, grandstanding, scandals, and debate—or perhaps an independent bid for Donald Trump. Whatever the outcome, there will likely be broad continuity of US foreign policy under either party leadership, a trend which has held for some time. We do not expect, for example, to see a shift to a significantly more interventionist foreign policy approach under the leadership of either a Democrat or a Republican president, though a more hawkish tone could emerge.

For all of the influence that the occupant of the Oval Office may wield in the world, non-Americans are often surprised at what comparatively limited power US presidents have over domestic policymaking within the US system of checks and balances, which grants significant influence to Congress.

Figure 30. US Presidential Election — Key Players and States



Note: "Democratic" refers to Democratic and Democratic-leaning registered voters. "Republican" or Republican and Republican-leaning registered voters (Pew Research Center)
 Source: Citi Research, realclearpolitics.com, January 2015, Potus, Swing States to Watch in the 2014 Election, 18 June 2015.

The new US president coming into office on 20 January 2017 will not be in the position to instigate an immediate turnaround on the trends that have undermined Pax Americana. No new assets will be available to him or her, and the primary focus of presidential action will most likely have to be on domestic affairs. The political capital to spend on major turnarounds in America's foreign policy will likely be limited. But a macro structure such as Pax Americana, born out of a very specific historic constellation after World War II, could not be re-erected in any case. Pax Americana in the 21st century would have to look very different from its earlier iteration, and it would require different policies.

But room for more US leadership, presence and authority does exist. Both in Europe and in Asia, America's absence has been felt. During the US presidential primary campaign, almost all candidates agreed that the US had punched below its weight in the past years, and that more international presence was necessary. A lot could be achieved by changing atmospherics and visibility. The next US president will likely show more of a real interest in regional affairs around the world. It will be crucial to demonstrate to allies and adversaries alike that the US government's full analytical and conceptual power will be dedicated to their issues in a more long-term, sustained way, defying the short-term logic of the news cycle. Also, the diplomatic presence of the US could be made more felt around in key foreign policy markets. This could include appointing career diplomats to key diplomatic posts instead of rewarding donors for their assistance in getting elected. All of this warrants that the new president should travel more and more to crucial hot spots within Pax Americana, among them Eastern Europe and Turkey.

UK Referendum on EU Membership—Could Brexit Happen?

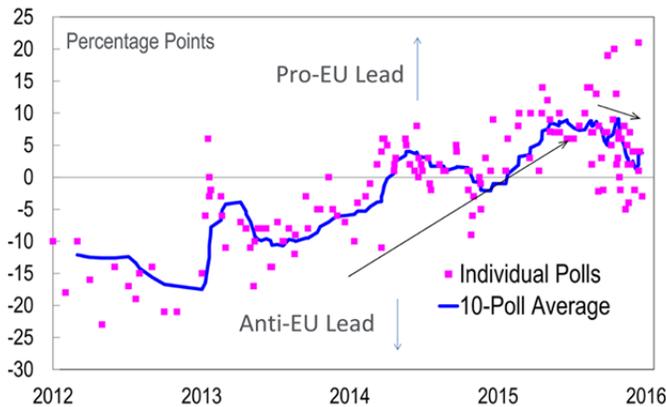
Once a tail risk, risk of Brexit is on the rise

Could the UK vote to leave the European Union? Once no more than a tail risk, in our view Brexit risk — the risk of Britain existing the European Union — is on the rise, with perhaps a 20-30% probability. Most polls continue to show the pro-EU side slightly ahead, with an average margin of 3-4 points in the last 10 polls, but this

is down from a 10-point lead on average last August. There is considerable variation between polls, with those in the fourth quarter of 2015 showing a range between a 21 percentage point lead for “Remain” and a 5-point lead for “Leave”. But the polls are much closer than those in the run-up to the 2014 Scottish referendum. Could Brexit really happen? It is far from impossible — we consider Brexit risk to be one of the top global political risks; if it transpires, would likely prompt a wider unravelling within Europe.

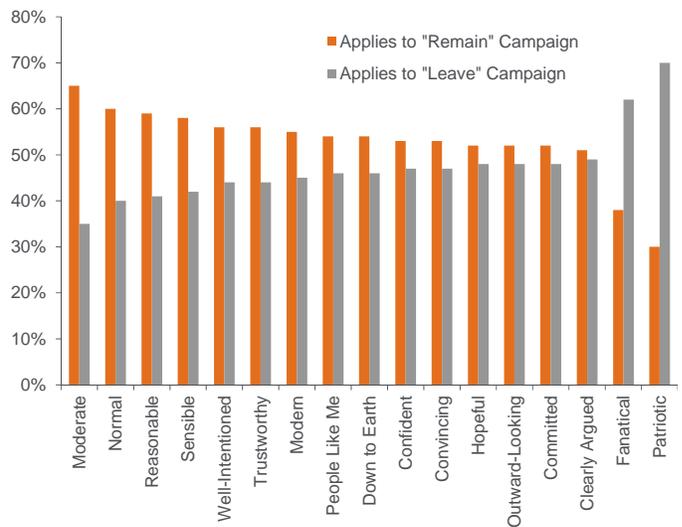
The pro-EU side has considerable underlying advantages, in that on balance the general public views EU membership as less risky than Brexit (especially since Brexit might lead Scotland to leave the UK in order to re-join in the EU). Moreover, the general public regards advocates of EU membership as more reasonable and moderate than the advocates of Brexit. In addition, the pro-EU side is likely to be led by PM Cameron — who has fairly high public approval ratings. By contrast, the anti-EU side is split between “Leave.EU” and “Vote.Leave”, and lacks a high-profile and popular leader (although PM Cameron’s announcement to allow his Cabinet a “Free Vote” may now change this). Most polls suggest that roughly one third of the general public is not strongly pro- or anti-EU, and among these people a natural sense of risk aversion probably will strongly favor the pro-EU side.

Figure 31. UK — Net Balance of Opinion In Favour of Continued EU Membership, 2012-15



Source: Citi Research, Survation, YouGov, Ipsos/MORI, Orb

Figure 32. UK — How Would You Describe Leaders of Pro-EU and Anti-EU Side?, Dec



Source: Citi Research, Ashcroft Polling

However, the anti-EU side also has some strong factors on its side. Those who favor EU exit tend to be more certain to vote than those who favor continued EU membership, and if turnout is low then this would probably help the anti-EU side. For example, a recent Survation poll⁴⁰ (which showed a 2-point lead for EU exit) showed a 10-point lead for EU exit (55% to 45%) among those people (55% of the sample) who say they are “10/10 certain to vote”. In addition, when looking at how survey participants chose up to four words to describe their feelings towards Britain’s membership of the EU in a poll conducted by the University of York (published by Policy Network), almost half chose “uneasy”.⁴¹ Findings suggest that

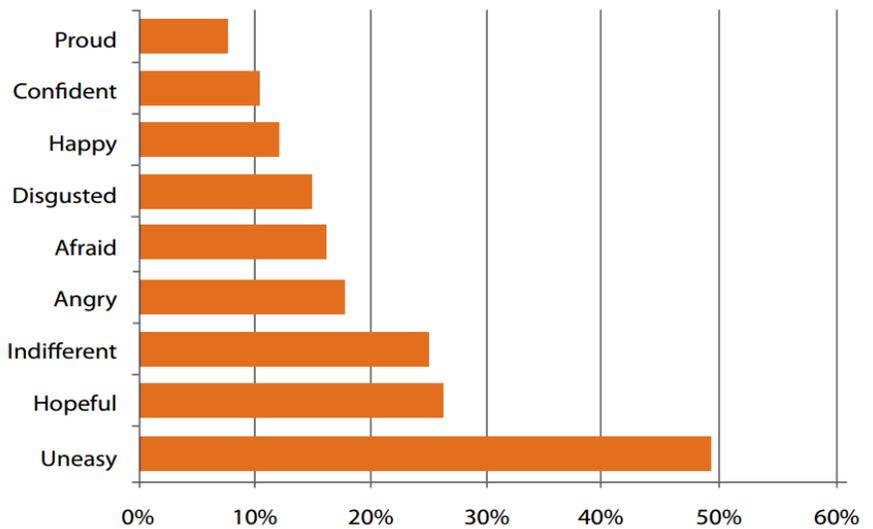
⁴⁰ Fieldwork 30 November to 3 December 2015

⁴¹ Sofia Vasilopoulou. University of York/ Policy Network. Mixed Feelings: Britons’ conflicted attitudes to the EU before the referendum. September 2015. Survey

emotions form a key component of people’s attitudes towards the EU and British membership of it. In addition, the ‘Out’ campaign could well turn out to be better-organized and -funded than the ‘Yes’ campaign.

Moreover, the anti-EU side can tap into wider public hostility to immigration and social change, plus a sense that EU membership and globalization have benefited elites rather than society as a whole. In particular, while inward migration has probably lifted UK economic growth, fully 66% of the general public would like to see immigration reduced.⁴² Across 2015 as a whole, immigration ranked as the top issue of concern among the UK population, with the health service second and the economy third. There is a very close overlap between attitudes to immigration and EU membership.⁴³ Among people who put immigration as the top issue facing the UK, the anti-EU side leads the pro-EU side by 69% to 16%, whereas among people that believe the economy or the health service is the top issue, the pro-EU side are well ahead (by 27 and 32 percentage points respectively). With foreign worker inflows likely to stay high — and the possibility of further large refugee inflows to the EU in 2016 — public concern over immigration may well rise further, potentially helping the anti-EU side.

Figure 33. Which, if any, of the following words describe your feelings about Britain’s membership of the EU



Source: Citi Research, Sofia Vasilopoulou. University of York/ Policy Network. Mixed Feelings: Britons’ conflicted attitudes to the EU before the referendum. September 2015. Survey participants were invited to choose up to four words from a selection, which included four positive words (happy, hopeful, confident, proud), four negative words (angry, disgusted, uneasy, afraid) and one word indicating indifference.

Brexit, with Britain exiting the EU would have implications beyond the future of Britain

A vote to leave the EU would have implications beyond the future of Britain in the EU. Firstly, Brexit would likely lead to the breakup of the UK, as the SNP-led government of Scotland have indicated that they would hold a second referendum on independence. And secondly, Brexit followed by Scottish independence could hasten the unravelling of other nation-states with other separatist movements, such

participants were invited to choose up to four words from a selection, which included four positive words (happy, hopeful, confident, proud), four negative words (angry, disgusted, uneasy, afraid) and one word indicating indifference.

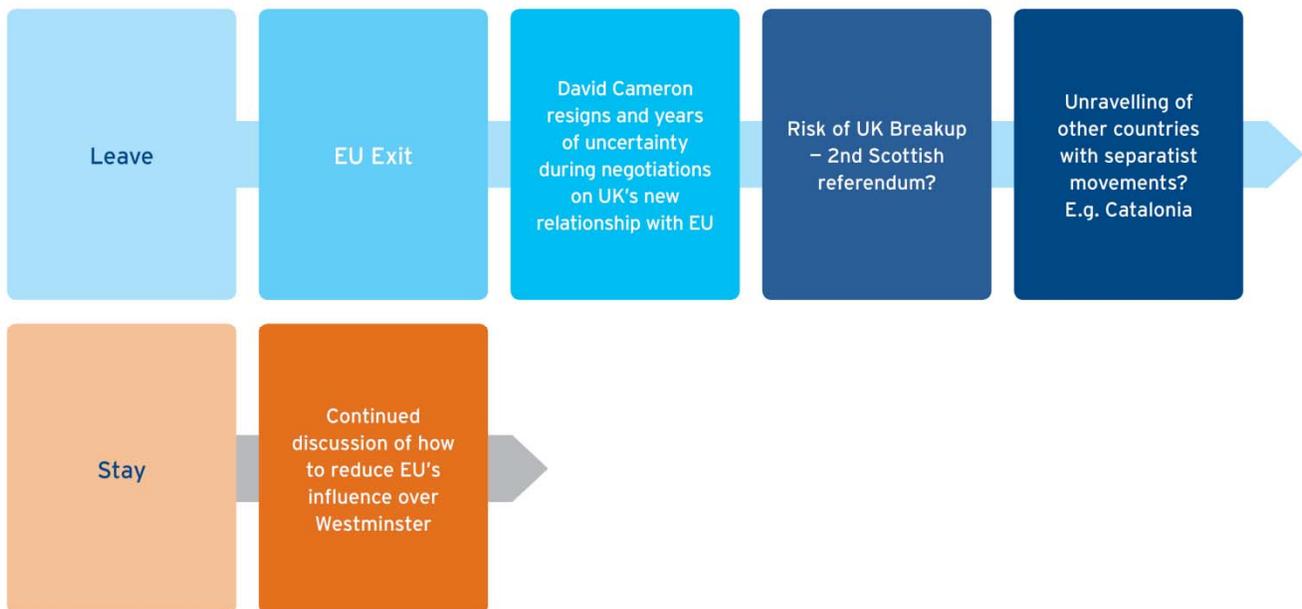
⁴² British Election Study, 2015.

⁴³ See “Britain, the EU and the Referendum: What Drives Euroscepticism?”, Chatham House, December 2015.

Catalonia, pursuing independence with greater vigor. It is also unclear what the effect of the first EU member state to vote to leave would have on the political debate of the remaining members.

There are also security and geopolitical implications to Brexit: to what extent would the UK's global role be diminished by a potential departure from the EU, particularly given its longstanding military role? This aspect of the argument has thus far not featured much in the domestic debate, but will be closely watched by Washington, and is a concern behind the scenes to many of the UK's partners.

Figure 34. The Possible Consequences of Brexit



Source: Citi Research

There are relatively few scheduled political signposts with the potential to influence global markets in 2016

Emotions form a key component of people's attitudes towards the EU. When asked to describe their feelings about Britain's membership of the EU, almost half of respondents reported that they felt uneasy about it. Other negative emotions that the EU provokes are anger (18 percent), fear (16 per cent) and disgust (15 per cent).⁴⁴

There are — perhaps mercifully — relatively few systemically-significant scheduled political signposts with the potential to influence global markets in 2016. The most impactful include US presidential elections in November and the UK referendum on EU membership (due by end-2017 but likely earlier). Taiwanese general elections and South Korean parliamentary elections will also take place, with Taiwan especially closely-watched given the country's relationship to China. Other government collapses and/or snap elections may also emerge of course where governments fall under pressure, with Venezuela and Brazil bearing close watching.

In Brazil, in December of 2015 the Chamber of Deputies President Eduardo Cunha initiated a motion of impeachment against President Dilma Rousseff. [Citi finds that the likelihood of impeachment is around 40-45%](#), but could increase to 60-70% in a couple of months depending on whether the Cunha Speakership issue is resolved, there is popular pressure to convince a significant number of congressmen to change sides, and a political consensus emerges regarding what the day after

⁴⁴ Source: Policy Network, Sofia Vasilopoulou, Mixed Feelings: Britons' conflicted attitudes to the EU before the referendum. Survey conducted 23/04/2015-05/05/2015 by Sofia Vasilopoulou and John Bone, University of York.

should look like.⁴⁵ But the Brazilian case is also an example of how the lack of elections could be a problem: barring an election, it is difficult to see how Brazilian politics could get beyond the vicious cycle of political in-fighting, statist policies and financial market skepticism in the near-term. Fresh elections (and the prospect of a fresh leadership) would not be a panacea but could at least offer hope of path back to recovery.

The political significance of 2016 may be less about election results, but how economic and political conditions will influence the coming constellation of systemically-significant elections in 2017

Instead of the usual focus on election-watching, it may be that the political significance of 2016 will not be about election results this year, but in how economic and political conditions in the year ahead will influence the coming constellation of systemically-significant elections in France and Germany in 2017 — crucial for the future of the EU — and the context for scheduled leadership transitions in China and Russia.

Figure 35. Key Elections/Signposts 2016-2018: Fewer Systemically Significant Elections in the Year Ahead, Still Room for Surprises



Source: Citi Research, IFES, European Commission

⁴⁵ For further details see Citi Research, Local Color: Cunha Kick-starts Impeachment, 2 December 2015

2016 and Beyond: Four Hotspots Where Geopolitics and Vox Populi Risk Are Most Likely to Converge

For 2016 and beyond, in our view there are four hotspots where rising geopolitical and Vox Populi risks are most likely to converge.

1. EU at Risk

The Return of the Euro Crisis

The European financial crisis was the most impactful political and economic crisis in Europe after the end of the Cold War. The current relative calm on this front could be misleading, as neither the political root causes of the crisis, nor the economic weaknesses that triggered it have been addressed decisively.

Debt levels in crisis countries remain high while growth and productivity, on average remain too low. Some structural reforms have been undertaken, especially in Spain, but nowhere have these reforms been adequate, especially not in France.

More importantly, the underlying tension at the heart of the Eurozone crisis has not been resolved: how a currency union can survive without a corresponding fiscal and political union. The most obvious way for this tension is to have comprehensive fiscal and political integration, but neither politicians nor voters in the Eurozone seem to have any appetite to move in that direction anytime soon. In the absence of decisive political integration, alternative mechanisms need to be found to ensure that economic problems in one (or some) countries do not threaten the existence and integrity of the currency union as a whole. Many of these mechanisms are related to fiscal issues and debt and an efficient debt restructuring mechanism for banks and sovereign, an effective common lender of last resort for sovereign and banks and common bank supervision and regulation, could go some way to provide the minimal fiscal underpinning for the Eurozone to survive and perhaps prosper.

There is more hope of progress along those lines, even though that progress was achieved against the backdrop of the life-threatening moments of the Eurozone crisis and it remains to be seen how and when further progress will be achieved, and to what extent the current set-up will be crisis-proof. For now we are skeptical that the current architectures anchors the fiscal and economic sustainability of all its members in the Eurozone. Future economic downturns are therefore undoubtedly to be associated with future fiscal transfers, bail-outs and — in all likelihood — threats to the survival of the currency union in its present form. The Grexit debate is dormant for now and likely to remain so in 2016, in our view (the current government may just about manage to achieve the minimum required to keep the creditors on board, not least as the refugee crisis may have lowered the minimum requirements as Greece's strategic value for the EU has increased; the next government is likely to be in support of the current bailout too). But the underlying issues have not been resolved and the willingness of Eurozone citizens to provide more solidarity to Greece is probably still falling over time.

In the Euro zone crisis lies a perfect example for the convergence of geopolitical and socio-economic risk. The member states of the Europe want to reap the benefits of an integrated currency without paying the political price of such deep economic integration. But having it both ways puts both at risk: political stability in Europe and the economic benefits of the Euro. *Vox Populi* risks have significantly increased because of the Euro crisis. So has the risk of an incomplete currency blowing apart the political integration project that is the EU. European economic recovery in 2016 might be good enough to keep the Euro stable for the time being. But in the medium to long term, the question over political integration in the Eurozone will turn hot again, and it could prove to be as divisive as the Brexit debate.

Refugees — the EU's Biggest Political Risk in 2016

Indeed, the Euro crisis may quite possibly widen into a full-blown EU crisis in 2016.

Nowhere is the convergence of geopolitical and socio-economic risks more visible than in the refugee crisis that hit Europe in 2015. In the short term, refugees have the greater potential to “break Europe” than the Greek crisis or the standoff with Russia over Ukraine. How to come to grips with the massive intake of migrants creates divisions between Eastern and Western EU countries (or, really, between Germany and everybody else), but also, on issues such as relocation and relations with Turkey, between Germany and the rest of the EU.

The refugee crisis marks the first time that Europeans have to pay, both politically and economically, for a massive failure on the foreign policy front. Failed policies in the fields of development aid, trade, border control, and the fight against organized crime all have contributed to the local factors driving the people out of the Levant and Africa. So have ill-conceived military interventions, long-standing support for authoritarian, incompetent, and corrupt regimes, and a widespread lack of interest in the geopolitical importance of the failed Arab Spring, Turkey under Erdogan, and loss of influence of the US in the region. Now that this multiple failure has led to massive fallout, the result is political instability of the EU system and a massive rise in *Vox Populi* risks because of an increase in populism, xenophobia and political fragmentation in European societies (see below).

In 2016, this extremely harmful dynamic will continue play out. The trek of migrants towards Europe has not (structurally) ebbed (refugee arrivals were always likely to slow during the European winter), unified European solutions are unlikely to come about soon, and EU political leaders will continue to be torn between the complex realities of the problem and the increasingly louder demands for quick, simplistic fixes in their home countries. The EU's Schengen agreement, assuring freedom of movement with EU borders, could fall victim to these harmful dynamics, with all political and economic consequences this might have. The further rise of illiberal politics in Europe, and the gain of radical right-wing (and left-wing) parties in elections across Europe is likely.

EU is facing a north/south economic divide as well as an east/west one

The EU's Double Divide

It is natural that the 28 members of the eye don't see eye to eye on all issues. But apart from longstanding differences, two more structural divides have emerged in the EU in recent years that will continue to make unified decision-making on substantial issues difficult in our view. One is the dividing line on general economics between the north and the south. This became visible in the Euro crisis, when the northern countries supported a strategy of fiscal consolidation, reform, and austerity, while the southern parts advocated transfers and deficit spending. France sits right in the middle between the two, torn in two directions. This divide will become important again, and potentially lead to deep divisions, as the root causes of the Euro crisis have not been resolved.

The second dividing line is between east and west. This divide has become obvious in the refugee crisis and, more generally, concerning attitudes towards the basic tenets of the European model of liberal democracy. In Poland, Hungary, and, to a lesser degree, in the Czech Republic, governments are in power that are now openly challenging the codified values-based consensus of the EU. Their socially conservative agendas are increasingly in conflict with Western European ideas of gender equality, minority rights and more recently, media freedom. Their understanding of democratic government, checks and balances and pluralism often is at odds with that of their EU peers. The popular support these governments often enjoy highlights the *Vox Populi* risks that exist in the EU.

Neither divide is capable of breaking the EU as such. But with both economics and identity/values issues being at the core of the debate over the future of the EU, they have the potential to aggravate the already tedious compromise-finding processes.

Instability in Russia

A weak Russia is as concerning to many analysts as a strong Russia

Many analysts argue that the only thing worse than a Russia too strong is a Russia too weak. If true, then there is reason for concern. The Russian political model under president Putin is widely understood to have been based on a social contract that exchanged personal freedom, economic growth and state stability for political rights and civil liberties. The Russian economy was already weak before the slump in oil prices and before sanctions were implemented by the West after the annexation of Crimea in 2014. With the economic outlook now being even more negative, the ability of the ruling elite to sustain the old contract has diminished dramatically. Benefits can't be spread easily any longer, while the people's consent cannot be maintained indefinitely. This poses a direct threat to grip to the continued consolidation of power by the current Russian power elite.

Against this backdrop, the EU and the US will have to take important policy decisions in 2016. The most important one is whether to extend the Western sanctions imposed against Russia after the annexation of Crimea. Sanctions were recently extended by another six months, but another extension in the summer of 2016 could well fail. Momentum is building up among EU member states to ease Russian sanctions regardless of the implementation of the Minsk II agreement on peace in Ukraine, still nominally the key condition for any lifting of sanctions and the decision to extend sanctions needs to be unanimous.

An increasing number of politicians and analysts have voiced the hope that a softer Western approach to Western, ideally with fewer or no sanctions, could bring Russia back into the fold and bring about renewed partnership and improved relations. These hopes feel increasingly hollow. Currently, the chances of turning Russia into a player more aligned with the Western agenda are slim to non-existent in our view. From 2014 on, President Putin has defined the West as Russia's

adversary, even enemy. His stated goal is to establish a counterweight to the “decadent” order of the West. All hopes of making Russia a player roughly in line with liberal Western ideas, an open society, and a constructive approach to multilateral decision-making in organizations such as the Council of Europe, the OSCE, and the WTO — serious projects in the decade following the Soviet collapse — have been shattered. The legitimacy of the leadership around Putin now rests to a large extent on its opposition, even enmity to the West. 31% of Russians saw Russia as a great power in 1999, with this figure rising to 68% by March 2015. Nearly half the population gives Putin credit for restoring the country to its so-called great power status.⁴⁶ The chances of a change of course, or even just of language, are therefore extremely slim and cooperation is likely to be limited to areas that fit Russian objectives in the first place (think limited military cooperation with France to fight the Islamic State).

The risk of Russian escalation of conflict in CEE

In order to give credibility to assertions of a global anti-Russian conspiracy, the Kremlin could be tempted to increase tensions on NATO's eastern flank, thereby increasing the risk of accidental escalation. Similarly, Putin could be tempted to increase tensions in Eastern Ukraine where he has escalation dominance in the standoff between the Russia-supported “rebels” in the Luhansk and Donbass provinces and the Ukrainian government. Should an escalation there, or in the “frozen” conflict over the Moldovan province of Transnistria be deemed useful by the Kremlin, these conflicts could turn hot again, sending considerable shockwaves into an already brittle European security setup. Meanwhile, the trigger for a heating-up of tensions in Ukraine could also come from the Ukrainian side, that fears being left behind or forgotten as Europe becomes more focused stopping the refugee flow from the Middle East and potential terror attacks than containing Russian influence in Ukraine.

Turkey going further adrift

The agenda of Turkish president Erdogan today differs greatly from the economic reform and modernization agenda that he started out with more than a decade ago. After reaping the benefits of his enormously successful economic policies, Erdogan now pursues two primary goals. One is the decisive Islamization of Turkish politics and society, including a decidedly conservative social agenda and a foreign policy informed by religious considerations. The other is the streamlining of Turkish politics into a presidential system. Turkey-EU relations have benefitted from a recent rapprochement over refugee issues. But even though new chapters have been opened in the long-stalled negotiations over Turkish accession to the EU, full membership is still far off for Ankara. Negotiations will still take many years, and creating unanimous consent among the currently 28 EU member states to accept Turkey will be extremely difficult, no matter when the decisions will finally have to be made. Distrust in Ankara prevails, and domestic atmospherics inside the EU will likely make any serious consideration of full membership impossible.

The West needs Turkey's cooperation on many pressing policy issues, specifically for the fight against IS and the easing of migratory pressures on Europe stemming from the Syrian refugee crisis. But relations are already strained and Erdogan's anti-Western rhetoric and his increasingly concerning power aspirations are bound to strain them further.

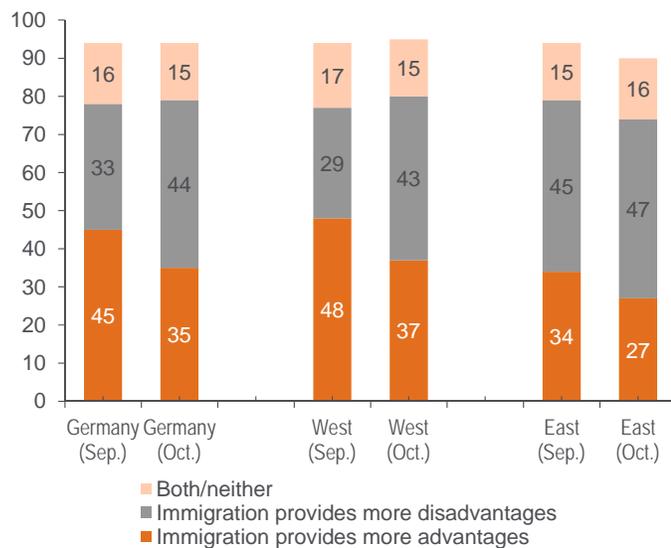
⁴⁶ Andrei Kolesnikov Carnegie Moscow Center, Russian Ideology After Crimea, 22 September 2015/ Levada Center (Russia's position in the international arena) 23 March 2015

The Political Future of Angela Merkel: What Risk of Merkel-exit?

For the first time in a decade in power, Angela Merkel's political future is in question

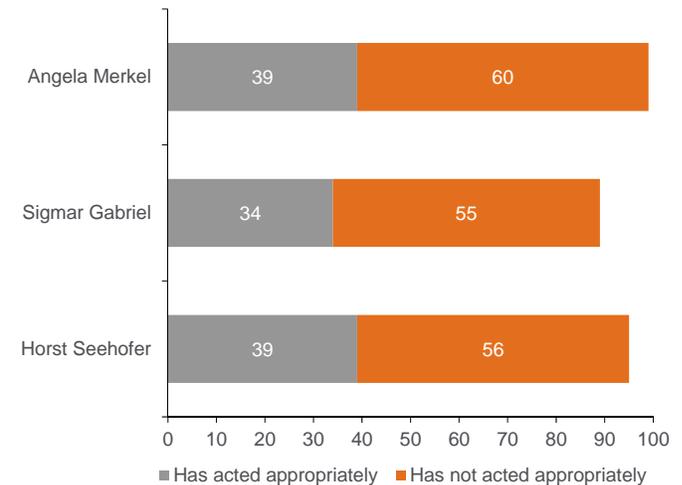
2016 may well turn out to be German Chancellor Angela Merkel's toughest in office. For the first time in a decade in power, her political future is in question. Her approval ratings have fallen since the refugee crisis accelerated, from 67% in August 2015 to 58% in January 2016. Although in our view the Chancellor could very well weather yet another test of her leadership and go on to win a fourth term (the economy is still strong, there is no obvious challenger, and during a party conference in late 2015, she rallied the party behind her), we regard Merkel-exit ahead of German elections (due in 2017) as one of the potentially most destabilizing political risks for the EU, and one with the potential to impact markets. Merkel-exit underscores the political risks of the refugee crisis ahead of crucial French and German elections in 2017.

Figure 36. Does Immigration Provide More Advantages or Disadvantages? September vs. October, East vs. West Germany
Question: What is your opinion on immigration in general? Does immigration provide more advantages or more disadvantages in Germany?



Source: Citi Research, ARD DeutschlandTREND / Inrfatest Dimap

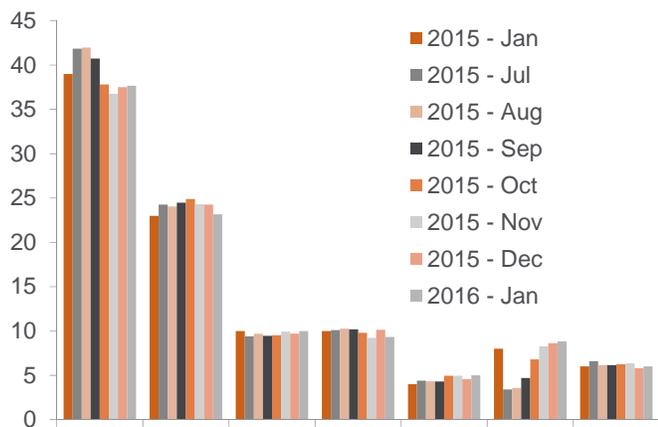
Figure 37. Evaluation of Politicians with Respect to Refugee Policy (November 2015)
Question: Would you say that Chancellor Merkel/SPD-Leader Sigmar Gabriel/CSU-Leader Horst Seehofer has acted appropriately with respect to refugee policy so far?



Source: Citi Research, ARD DeutschlandTREND / Inrfatest Dimap

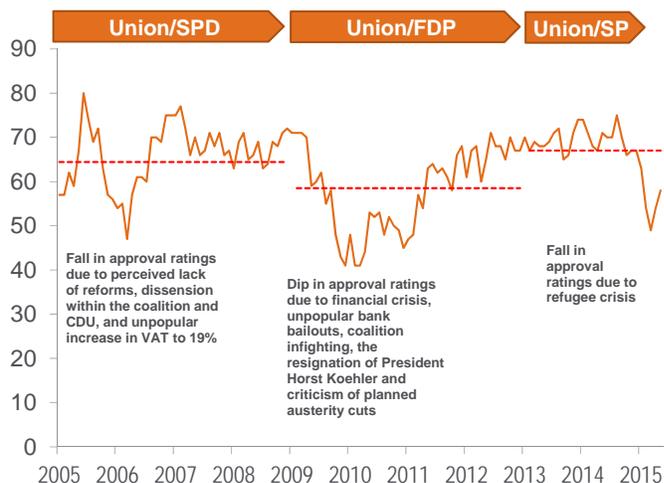
Most worrying for many observers is that Chancellor Merkel's personal popularity has taken a significant hit, dropping 67% in the summer of 2015 to 58% in January 2016. We have to put this into perspective, however: Merkel's approval rating increased by 9 percentage points between November 2015 and January 2016 and is high compared to a number of her G20 peers. Furthermore, during the low in her approval rating which was two months after the refugee decisions, Merkel's rating was still 18 percentage points higher than her predecessor Schröder's rating was in May 2005, two months after his government's decision to reform the labor market. One and a half years later, Schröder was back to 45% and nearly won the election for the SPD. In addition, this is not the first time Merkel's approval rating has fallen. Her average approval rating for the current legislative period is actually still higher than during the two previous periods.

Figure 38. Monthly Poll Average per Party (%), Jul-Nov 2015



Source: Citi Research, Forsa, Insa, ARD-DeutschlandTREND / Infratest Dimap, Emnid, Allensbach

Figure 39. Germany — Chancellor Merkel’s Popularity Rating (%), Dec 2010-Oct 2015



Source: Citi Research, ARD-DeutschlandTREND / Infratest Dimap

Regional elections in Germany in the spring and trends in refugee flows in the H1 2016 and the success in integrating refugees are important signposts for Merkel's political future. Meanwhile, she has fewer friends left in office: her peers in Poland and Portugal were voted out in 2015, the fate of Spanish PM Rajoy is in the balance, following the Spanish election in December, Irish PM Kenny's position may be at risk in the upcoming Irish election. Throw in that disagreements with Italian PM Renzi have grown in recent months (including over the Northstream Pipeline project and EU fiscal rules), that French President Hollande is an unreliable (and at times, unwilling) ally at best, the Greek government is likely to try to exploit any intra-Eurozone divisions, that her erstwhile allies in Eastern Europe are upset with Merkel over her stance in the refugee crisis and that she will be struggling to help keep the UK in the EU, and few will be wishing to see the end of 2016 as much as the German Chancellor.

2. Ongoing Middle East Disruption

ISIS Expands the Caliphate to Libya

One of the most concrete geopolitical risks for Europe in the near future will be the complete or partial takeover of Libya by the militias of the so-called Islamic State. Libya is a failed state in a strategically important location with no consolidated government structures and next to no resilience in the face of IS aggression. While the world's attention was absorbed by the war in Syria, IS systematically increased its presence there in 2015. Their goal is to establish another resources-rich stronghold in the Arab world, thereby creating another stepping-stone towards the erection of a "new Caliphate". Libya hosts large oil fields and two light crude oil terminals owned by US firms in its East, and a gas terminal, owned by Italy's ENI, in the West.

Once a stronghold in Libya has been built, IS would most likely use this to also exploit the political and economic weakness of Tunisia, so far the only modest success story of the Arab Spring. The West will have to dedicate considerable resources to the stabilization of Tunisia over the next few years.

And finally, a consolidated IS presence in Libya would also serve as an ideal base for the organizing and coordination of further terrorist attacks on European soil. The chances of the West of getting involved in a military intervention in Libya over the next year or two is very high.

The Saudi-Iranian Standoff Triggers More Proxy Wars

The ending of the nuclear sanctions on Iran's oil industry look set to mark a new development in the Saudi-Iran standoff, as the oil market becomes yet another proxy war between the two regional powers. Saudi Arabia has been fighting to recover Asian oil market share that was under steady assault by rising Russian and Iraqi flows, with additional incursions coming from Latin America and West African oil producers that had been squeezed out of the US by the shale oil revolution. The unfettered return of Iranian flows will intensify this battle, as Iran must attempt to regain market share that it lost due to sanctions.

Their long-standing enmity makes Iranian-Saudi cooperation exceptionally unlikely, reducing the already slim chance of Saudi Arabia reconsidering its market share strategy and pulling back on production in an attempt to raise oil prices. Instead, the battle for market share is about to enter a new, even more bearish stage. For oil bulls, when it rains it pours: even an escalation in geopolitical tensions is bearish now.

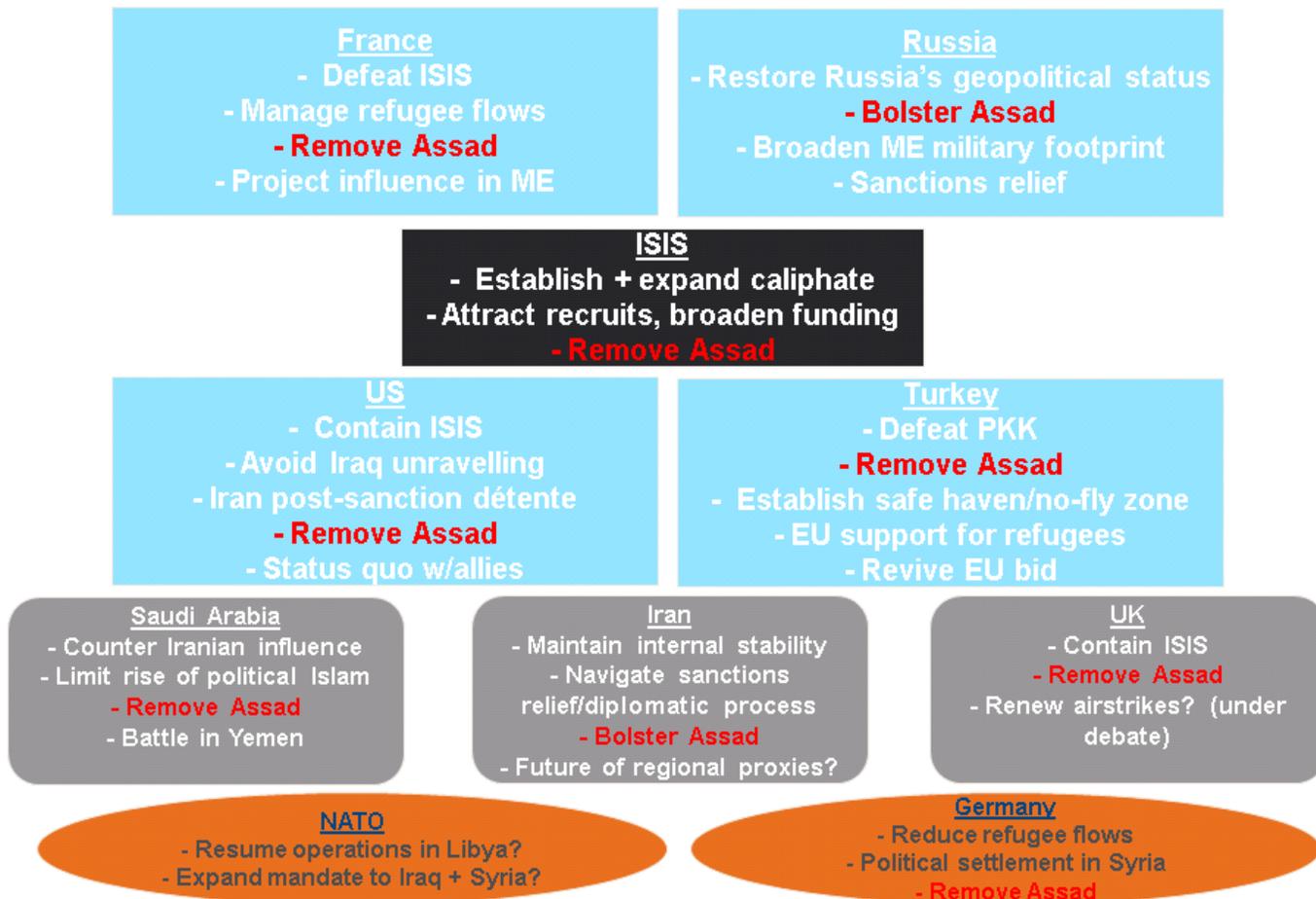
The rivalry between Iran and Saudi-Arabia over the position of regional hegemon has already led to widespread fallout. The Civil War in Yemen is widely seen as a conflict of Saudi and Iranian proxies. In the Syrian civil war, similar powers are at play, with Iranian and Saudi money financing various factions inside the country. Through Hezbollah and Hamas, Iran is a key player in Lebanon and the Palestinian Gaza Strip where violence against Israeli citizens is again on the rise. Saudi Arabia has gained influence in countries in which the political reform processes triggered by the Arab Spring were unsuccessful.

While a direct confrontation between Saudi Arabia and Iran is unlikely, the intensified export of their rivalry into other Middle Eastern countries poses a great danger in an already extremely volatile region rife with religious sectarianism, underdevelopment and growing populations. In 2016, after the escalation over Saudi-Arabia's death penalty and with Iran's return to eminence after the nuclear deal with the United States, Iranian-Saudi rivalry will likely further intensify. This will make a Syrian settlement less likely, as any such agreement would largely depend on some sort of Iranian-Saudi arrangement. Should a peace agreement, including a post-Assad settlement be reached, the West must expect to be drawn further into the Saudi-Iranian rivalry, as it would likely require Western (and Russian) security guarantees for the various parties involved in the conflict.

But as Figure 40 shows, there is significant divergence between key regional and international actors that are involved in the conflict. Coming to an agreement over the future of Syrian president Assad has been a key obstacle, but while international players are keen to strike a deal that delivers a concrete timetable for his departure and new elections, other actors have more important priorities. The outlines for a deal in Syria are relatively clear, but for the various parties at the negotiating table, and those that aren't such as ISIS, the overlap in their priorities is less evident. Absent from the scene are leaders with the legitimacy, political capital and public trust to bridge this gap.

This toxic combination of factors, plus the influence of extremism and sectarianism, makes Syria a highly complex conflict to resolve diplomatically. In the absence of a political settlement, wars end when one side gives up: historical evidence shows this takes longer when conflicts are internationalized as Syria is.

Figure 40. Syrian Conflict:: Key Players Conflicting, Regional and International Interests and Priorities



Source: Citi Research

Third Intifada

The Israeli-Palestinian conflict has been relegated to the sidelines of Middle Eastern affairs due to the dramatic deterioration of the political landscape in the region (Syria, Libya, Yemen, Saudi-Iranian relations). But as the socio-economic situations of Palestinians is getting weaker and the political leadership in Israel is turning more hostile to compromise with the Palestinians, the potential for renewed hot conflict has been building up in recent years. This development culminated in a series of Palestinian knife-attacks on Israeli citizens, followed by retaliatory violence committed by radicalized Israelis. None of the root causes of the Arab-Israeli conflict have been dealt with in the more than 20 years since the Oslo Peace Agreements of 1993. The Palestinian Authority has proven to be incapable of providing economic development and sound administration. Successive Israeli governments have done little to improve relations and Israel continues to provoke both the Palestinians and the international community by means of its highly disputed settlement activities on Palestinian territory. Socio-economic pressure has already

radicalized parts of the younger Palestinian generations, and the continued lack of economic perspective is likely to aggravate this development. If, as has happened in the Gaza strip, external powers such as Iran can gain decisive influence over Palestinian populations and political decision-making, the security situation in and around Israel could worsen much more with violent conflict as a potential result.

3. Asia Pressures Intensifying

It is often observed that there is no such thing as “Asia”, but the vast landmass called by that name is certainly home to many slow-boiling crises with potential geopolitical impact. At this point, the relationship between China and Russia is largely professional, with occasional points of friction we have previously described as a “Frenemies” relationship, but great power rivalry is looming between the US and China. Continued economic woes could lead Beijing to play up diplomatic conflicts with some of its neighbors for domestic gain. One way of doing so is to increase Chinese assertiveness in the simmering territorial disputes in the South China Sea, where a game of military posturing and the creation of facts by China is going on. North Korea’s attempts to use leverage against its neighbors and the international community in order to stabilize a failed state will continue, with the ever-present risk of provocation leading to escalation.

Furthermore, the India-Pakistan rapprochement is brittle, as cross-border violence frequently proves, and it is unpopular in significant parts of the populations on both sides. Hindu-nationalism in India is getting more pronounced, potentially leading to ethnic strife and increased domestic violence in one of the key powers and a key recipient of Western FDI in the region. Political Islam has gained traction in Indonesia, the Philippines, and even Malaysia. With poverty and weak governance being rife in all three countries, new recruiting grounds and safe havens for Islamists could open up.

For Western policy-makers, especially European ones, risks in Asia pose a dilemma. European countries need open markets and accessible trade routes for their own economic well-being. But they depend on a stability that they themselves are unable to guarantee. They rely on regional powers to keep the peace and on US power to mediate and balance an increasingly unbalanceable region. So Europeans and other outsiders watch the growing geopolitical risk in the region with unease. How long will things go well? For 2016, immediate geopolitical risk is not particularly high, but this looks different in the medium to long term.

For Europe and many other non-Asian nations, Asia is full of potential predicaments. Chinese policies at home and abroad are being eyed suspiciously, and yet the economic lure of China is hard to resist. How will the new economic ties with and dependencies on China play out if the US-Chinese relationship goes sour? What if Washington calls upon its allies outside Asia for solidarity in a potential conflict in the region? Any involvement, directly or indirectly, of Europeans in Asian contingencies will be unpopular at home, especially if they involve China. And yet Europeans will have to get used to the idea that at least indirectly, they will end being affected by whatever goes wrong in a region they have very little say in. The convergence of geopolitical and socio-economic risk in Asia will not leave Europeans untouched. Policy-makers should be prepared to make tough calls in the future.

4. The New Geopolitics of Energy — Round One

The battle for market share between Saudi Arabia and Iran obviously coincides with a bitter and multi-faceted enmity and stand-off involving elements of Sunni-Shia antipathies, ideologically incompatible views as to who should govern, as well as rivalry for power and influence in the Gulf area and across the Middle East and shifting alignments with outside powers, most particularly the United States. But it is not hard to forget that issues related to the geopolitics of oil loom large.

The last half-decade has turned the geopolitics of oil upside down and the biggest questions about it related to how long it will last. It might well be a permanent shift in the underlying rules governing the world of oil. It also involves, as does the wider global geopolitical framework, a stunning convergence within petro-states (those countries whose economies, and hence sources of growth and political power, are dominated by oil revenues) of geopolitical and *Vox Populi* risks.

The key change in the oil market that appeared to take place rapidly and dramatically in 2014 was the abandonment by Saudi Arabia of its decades-long policy of being the central banker to the global oil market, a policy itself dependent on its maintenance of spare production capacity in a global environment in which oil demand was expected to grow continually and robustly as a result of a growing global middle class eager to use oil where it had a monopoly in transportation fuels for cars, trucks, planes, trains and ships. Indeed growth in demand in the first decade of this century, particular in China and other emerging markets, provided compelling evidence of ineluctable growth in oil demand for as far into the future as good be seen.

Saudi Arabia's central banker role meant that it could balance markets, either on its own or with the help of other Gulf Cooperation Council (GCC) countries as needed, and with the help of a wider group of producers, either all of OPEC or OPEC plus some critical non-OPEC oil producing countries. By assuring that it was producing less oil and it could mean that markets would seldom function as normal markets, where base load production came from low cost producers like OPEC members and incremental supply would come from marginal, higher cost producers as markets tightened. Instead, by keeping oil off markets the spread between low cost production and market prices could be maximized with more revenue assured than would have been the case had the Kingdom been producing all-out.

Holding spare production brought two other benefits. On the one hand by having an ability to curb prices when markets tightened, it brought the Kingdom influence in the outside world, including the US where it helped assure American protection as a foundation of the country's security, but also in capitals as diverse as Brussels, Paris, London, Beijing, Tokyo and Moscow. It enabled the Kingdom, in short, to play a larger role on the world stage than its GDP would warrant. On the other hand, it also enabled the Kingdom to induce other members of OPEC to curtail production as might be desired when markets got too soft, by threatening to increase production and therefore create the needed discipline across OPEC and to prevent other OPEC countries from free riding on Saudi policy pursued in its own self-interest.

There were three other aspects of the old or traditional geopolitics of oil. First, clearly the tie that bound oil producers together was their common interest in maximizing revenue and maintaining a price floor that would guarantee a minimum level of revenue. Second, the main oil producers, all with low costs of production and long-reserve lives, felt that since oil would rise in value over time it made sense not to produce oil to maximum capacity and not to develop resources today under the assumption that oil in the ground was worth more than oil produced. Indeed there was plenty of evidence abounding that given the seldom-disputed assumption that oil reserves were finite and over time more and more expensive, oil prices would have to rise at least at the general rate of inflation. Third, the oil producers in OPEC, participating in what was justly perceived as a cartel, were in a zero-sum world with oil importing or consuming countries, whose interest in lower or moderate oil prices stood in direct contrast with those of the producers. Importantly that zero-sum world was highly asymmetric. Higher oil prices were far more important to petro-states with GDPs well above 50% based on oil and natural gas production than it was to the others, where energy's share in GDP hovered at 10% or much lower. It was that asymmetry that enabled the petro-states to "get away with" imposing higher prices on gasoline consumers since the policy costs for dealing with higher prices were largely not worth it to them.

All of the underlying bases of this world were turned on their heads in the past half-decade, largely as a result of trends put in place by the high prices of the prior decade. High prices triggered three new trends. First they encouraged new production from what were perceived to be three unconventional sources of oil barely in production before this century began — oil from oil sands, oil and natural gas from deep waters, and oil and natural gas from shale rocks. Second, high prices combined with an increased global political awareness of the environmental impacts of use of hydrocarbons combined to erode what was the expected relationship between GDP growth and oil demand growth. Third, high prices and high revenues and high spending encouraged populations in petro-states as *Vox Populi* spread across the planet, to expect benefits to be spread to them, impacting the perceived legitimacy of government if they failed to deliver.

In a very concrete way Saudi Arabia confronted the consequences of these three trends by the middle of 2014. Noteworthy on the supply side was that OPEC producers were disinclined to invest in incremental production capacity — with the notable exception of Iraq post Saddam Hussein and the possible exception of Venezuela pre-Chavez. So while OPEC capacity remained static for 35 years, high prices led to rapid growth in production in new sources. In the five years from January 1, 2010 through December 31, 2014, nearly all incremental supplies came from non-conventional oil. Brazilian oil (deep water) grew 26%, Canadian output (oil sands) rose 42% and US production sky-rocketed by 88%. And in all three cases the cost of production started to fall rapidly as unprecedented cost deflation set in. By mid-2014 growth in these three new sources of supply outstripped demand growth posing a pricing challenge to Saudi Arabia. The new suppliers were not petro-states but traditional "consuming" countries, a radical change for oil markets.

On the demand side, not only was global GDP becoming more challenging but the expected relationship between GDP growth and oil demand growth also started to diverge. This became acutely apparent in what had become the largest energy market in the world and the largest importer — China — where demand for diesel, the largest single fuel in use in that country, hit a wall. For 20 years, demand for diesel rose step by step with GDP. The last year that happened was 2010 when both rose by 10%. But then diesel demand growth fell to 5% the next year, zero the following years, and has been negative since 2014. In 2013 Saudi Arabia was exporting 7.2-million b/d (m-b/e), 2.8-m b/d was sold to the two largest economies in

the world, the US (1.6-m b/d) and China (1.2-m b/d). By the summer of 2014 sales to these two countries fell to 1.8-m b/d, a drop of more than one-third, inducing the Kingdom to shift its strategy to market share maximization. (By winter 2014, exports to the US fell to close to 800-k b/d). The market share strategy was predicated on the notion that demand growth was going to be slowing down even more as environmental policies saw the rise of both natural gas and electricity as rivals for oil's monopoly role in the transportation fuel market. It was also predicated on new supply coming from both Iraq and Iran as the end of sanctions on the latter country were in sight, and the fear that if the country cut back production in a bear market it would potentially lose market share that could not be easily regained in the foreseeable future.

Finally, recognizing that oil revenues were going to slide, the Kingdom 's public spokes persons started to talk about "belt tightening," which was critically necessary if revenue was being challenged and fiscal break even prices for petroleum would fail to enable it to balance its budget. A critical part of the belt tightening was the fact that if China's demand growth were set aside, the main sources of demand was from the petro-states themselves as demand peaked and started falling in most OECD countries. That combined with weaker markets was a critical problem not just for Saudi Arabia but for all petro-states, including all OPEC countries but critical non-OPEC countries like Russia and Oman as well.

The elements of the new geopolitics of oil that are unfolding are increasingly clear. The unconventional oil revolution has indeed turned the oil market on its head, depriving OPEC of the ability to keep prices significantly higher than production costs. With cost deflation in shale exploitation already at the 30% level with more to go the oil market is testing the price levels at which shale, robust at much lower levels than once perceived, will start to grow again. And with shale rocks so abundant globally it appears as though triple digit oil is highly unlikely to emerge any time soon.

From the perspective of the former central banker of the global oil sector, adding liquidity makes more sense than taking it away, for the very abundance of oil — whether from traditional low cost producers like Saudi Arabia, the GCC, Iran and Iraq, or from the declining cost unconventional producers — has changed the underlying assumption on the value of oil. Oil today is being seen increasingly as more valuable if produced today than if held in the ground. It's a depreciating assets not just because of its abundance at reasonably low prices but because like coal in a world with a growing environmental consensus focusing on a lower carbon footprint, it risks becoming a stranded asset.

A critical result of this is the shift in the underlying zero-sum nature of the geopolitics of oil. Once thought of as defining relations between producers and consumers it looks increasingly like the underlying fixture of relations among producers in search of diminishing market share. With China growing more slowly than once assumed and with peak oil demand potentially in sight there, any one supplier's gain will come at another supplier's expense.

Meanwhile, the burden of adjustment on the supply side has focused on the US as the world's swing producer, one that has production remaining at a fairly robust level even at sub-\$40 prices, at least for now, and with the prospects of adding over 1-m b/d to world's supply whenever prices rebound, probably not much above \$50-55 per barrel.

Similarly the burden of adjustment on the demand side has fallen on the petro-states themselves, given their alarmingly high rates of demand growth over the past decade has started eroding their exportable surpluses at a time with budgetary restraints have made it difficult to continue to subsidize energy. Low oil prices have brought on new geopolitical risks, as governments that have been over-reliant on oil and gas revenues scramble to meet domestic needs. Petro states in particular now face the difficult task of reform lest they become failed states. Can reform work? In principle, but according to our Reform Capacity assessment (see Figure 21) many petro-states might possess some of the characteristic supportive of reform capacity, but thanks to the “resource curse”, few have historically shown much will.

Figure 41. Fiscal Breakeven Oil Prices (\$/bbl)

	2012	2013	2014	2015E
Algeria	125	111	130	111
Bahrain	119	125	123	94
Iran	98	116	102	93
Iraq	103	115	107	71
Kuwait	49	42	57	47
Libya	63	111	206	215
Oman	80	98	108	94
Qatar	63	61	59	59
Saudi Arabia	78	89	111	103
UAE	70	70	74	73
Yemen	237	215	160	164
Russia	106	108	100	85
Venezuela	175	168	161	150

Source: Citi Research

The intriguing question is what the prospects are for state-failure ahead as a number of OPEC countries like Nigeria and Iraq confront fragmentation risk and still other countries more difficult problems of domestic order. Noteworthy is the fact that Venezuela now appears to be unable to meet domestic financial requirements let alone service the international debt coming due this year. For some petro-states in the near term currency depreciation can provide breathing space. For others it would create problems for the public at large, which would see the prices of imported goods rising at a time when many social benefits are being withheld.

The year ahead is thus also likely to see *Vox Populi* issues rising in numerous oil producing countries. This would come at a time when as a result of Saudi Arabia's new policy of market share maximization its spare production capacity has been significantly eroded. Should there be market disruptions lying ahead, prices would rise abruptly. But as that occurred so would production in the new unconventional suppliers.

At a more general level, the dominance of three major producers — Russia, Saudi Arabia and the US — with their combined 38-m b/d of liquids supply looks more critical than OPEC as a whole. Two of the three giant petroleum suppliers are petro-states suffering severe financial pain with an urgent need to both diversify their economies and to attain higher oil prices. For both current foreign currency reserves are eroding fairly rapidly, providing a very tight window in the case of Russia and a looser, longer one in the case of Saudi Arabia, to get to a higher price world and to undertake reforms.

No matter how you look at the geopolitics of oil, it has entered a brave new world and old assumptions about these geopolitical forces don't carry much weight.

Figure 42. Other Issues

- Cost curves and whether there would be a supply gap 2018-2020
- Russia's traditional use of oil as an instrument of policy
- Three giant petroleum producers (US, Russia, Saudi) and what that means for geopolitics
- China and supplier credits and buying reserves in the ground

Source: Citi Research

Wild Cards

Refugee Crisis from Africa

Between 2015 and 2050, the population on the African continent will double in size. Not even the most optimistic economic forecasts for Africa foresee economic growth substantial enough to compensate for an increase of population of that magnitude within a relatively short period of time. As a consequence, migration experts predict within the next decade a massive migratory movement from Africa's sub-Saharan regions will hit Europe. First signs of this development can already be observed. Compared to that kind of trek north, the current refugee crisis, originating largely in Syria, could look like a low-complexity prelude.

The EU has already taken action. In November, at an EU-Africa summit on migration, the EU and many African governments agreed on an action plan designed to address the push and pull factors stimulating migration. But this is only the beginning. The geopolitical risk stemming from African mass migration into Europe could be considerable — from conflict and organized crime alongside the escape routes to increased recruitment for Islamic fundamentalism to political fallout and instability in Europe. But serious Western engagement could also bring economic opportunity for international businesses.

An Islamist breakthrough in Asia

So far, analysis of political Islam has mostly focused on the Middle East and Africa. But Asia has a growing Islamism problem as well, especially in Indonesia, the largest Muslim country by population, and The Philippines. So far, this is not a mass phenomenon, and geopolitically it has yet to turn into a factor of relevance. So it should be counted as a long-term wild card. But, given the stated goal of Islamist revolutionaries to spread their ideology globally, and the great connectivity that has already helped build the so-called Islamic State into what it is today, this possibility should not be discounted.

War between Armenia and Azerbaijan

In what can be described as classic brinkmanship, Azerbaijan has, over the last year, systematically tried to increase tensions in the Armenian-Azeri stand-off over Nagorno-Karabakh. The goal was to put the issue back on the international agenda where it had ceased to be an issue of prominence. Azerbaijan effectively lost the undeclared war between the two countries over this territory in a conflict that lasted for six years and ended in a "frozen" conflict in 1994. Azerbaijan never accepted the de facto session of ethnic Armenians in that region which Armenia supported. The cease-fire that ended the hot conflict is brittle and might not be able to contain an outbreak of new hostilities. Both Armenia and Azerbaijan, independently, entertain close relations with Moscow, and both sides have been recipients of Russian weapons. With the status quo playing against any ambitions of Azerbaijan to regain control over its territory, and encouraged by newly aroused interest in the West for frozen conflicts after Ukraine, leaders in Baku might be tempted to see how far they can go with their agenda.

Unrest in Moldova

Like Ukraine, Moldova is a country with a strategic middle position between the West and Russia. As in Ukraine, the local elites have played a skillful game of non-committal to either one of the two sides while playing both sides to their own advantage. The factors of uncertainty are manifold: will corruption and state capture lead to domestic unrest? Could Moscow be tempted to escalate tensions between Chisinau and the breakaway region of Transnistria, thereby using another “frozen” conflict to stifle political consolidation and reform in a country in Europe’s immediate Eastern Neighborhood? How will the EU adjust its support for democratic and open market reform in a country where elites are interested primarily in maintaining the status quo, not reforming themselves out of business?

Silver Linings

Is it all doom and gloom? Definitely not. 2016 could see cooperation between Turkey and the EU to address the refugee crisis, potentially reviving broader relations, including Turkey's long-stalled EU membership bid, with the first glimmers of progress in this direction beginning to emerge. Increased cooperation between Russia and the West over the Syria crisis is possible in 2016, potentially leading to an improvement in ties that dropped to their worst level in decades.

2015 witnessed a number of diplomatic and trade breakthrough, from the Iran deal to the end of the Cuba embargo, highlighting the power of diplomacy. The US and 11 other nations reached a deal on the Trans-Pacific Partnership after five years of negotiating — potentially tying together 40% of the world's economy and eliminating 18,000 tariffs. Most importantly, the US-China relationship — arguably the most important bi-lateral relationship in the world — is on a solid and professional footing, the “frenemies” element of competition and occasional friction notwithstanding.

Perhaps the most important positive development from the point of view of plausible geopolitical risks that could impact global markets is the diplomatic breakthrough with Iran. While the deal has many critics, its implementation and the end to much of the sanctions regime also means that the risk of a military attack on Iran's nuclear facilities — an operation which would have required an intensive bombing campaign lasting 1-3 months according to a number of estimates — has effectively disappeared. Unless the deal collapses in which case a so-called ‘snapback’ of sanctions — and the risk of conflict — will return.

Figure 43. Is It All Bad News? Silver Linings



Source: Citi Research, Foreign Affairs

EU-Turkish rapprochement

Hot love will not break out between the EU and Turkey any time soon. Too strained is the relationship between Turkey's larger-than-life president Erdogan and leaders in European capitals. But the refugee crisis has brought the two sides closer together than they have been in a decade. For the time being, the advantage is on Turkey's side. The EU needs Erdogan more than vice versa in its frantic hope to

stem the flow of migrants that arrive in Europe via Turkey. But Turkish need to reform and the insight that West is really the only way that Turkey can go if it wants to be a modern, affluent society, could incrementally increase EU leverage over Ankara. The instrument of choice for this is the accession negotiations. The EU should use this instrument better and smarter. Turkey will not be a member any time soon, so no decisions will have to be made by the current set of European leaders. But offering Turkey closer ties with the EU is not only a smart move in terms of realpolitik. It is also the best long-term strategy to counter the temptation of political Islam in this strategically most important country in Europe's south-east.

Tunisia: Test-Case for Arab Modernization

Only one Arab country has come out of the Arab Spring with a positive promise on the future: Tunisia. But the political transition is fragile, economic reforms are stalled, institutional resilience is big, and political Islam an increasing factor in local politics. The EU recognizes the strategic importance of Tunisia as a test case for Arab modernization. But action has been timid despite rhetoric to the contrary. With the new European Neighborhood Policy (ENP) that is a lot more realistic in outlook than it was before, and with the strategic situation in Libya getting dire, Tunisia will likely become the focus of much more generous and determined foreign policy by the EU and its member states.

Is it all doom and gloom? Definitely not. 2016 could see cooperation between Turkey and the EU to address the refugee crisis, potentially reviving broader relations, including Turkey's long-stalled EU membership bid, with the first glimmers of progress in this direction beginning to emerge. Increased cooperation between Russia and the West over the Syria crisis is possible in 2016, potentially leading to an improvement in ties that dropped to their worst level in decades.

2015 has also witnessed a number of diplomatic and trade breakthroughs, from the Iran deal to the end of the Cuba embargo highlighting the power of diplomacy. The US and 11 other nations reached a deal on the Trans-Pacific Partnership after five years of negotiations — potentially tying together 40% of the world's economy and eliminating 18,000 tariffs. Most importantly the US-China relationship — arguably the most important bi-lateral relationship in the world — is on a solid and professional footing, the “frenemies” element of competition and occasional friction notwithstanding.

Reduced political risk following tentative budget deal to finance government through September 2017

The US Congress, previously a source of significant political risk for financial markets with threats over standoffs on raising the debt ceiling, fiscal cliff concerns and more, also seems likely to fade as a catalyst for market risk in the months ahead of November elections.

Conclusion

Although state-to-state conflict between great power is not our base case scenario, we are more worried than at any time in recent memory about the risk of military accidents and close encounters — as evidenced by the November 24 downing of a Russian military jet by Turkey, an incident that has sparked trade sanctions and inflammatory rhetoric. Other risks to watch include the potential for large-scale unconventional terrorist attacks (using chemical, radiological or nuclear weapons).

A number of other concerns persist, such as the militarization of South China Sea and the stability of the opaque and brittle regime in North Korea, while the future of the US role in regional security is being questioned despite the formal US-Japan security guarantee.

Europe will remain exposed to a multiplicity of risks. Its neighborhood is volatile and has a direct impact on security and on domestic politics in EU member states, as the Paris terrorist attacks and the impact of the refugee crisis on political cohesion in Europe have shown. The risk of the common currency failing because of a lack of political underpinning remains high in the medium to long term and the refugee crisis may well have further reduced the political feasibility (and willingness) to provide intra-Eurozone solidarity. Europe's political cohesion has been undermined by socio-economic (the Euro crisis) and geopolitical challenges (Ukraine, Russia, refugees). Brexit could shake it some further. Solidarity among EU members is at all-time low. The EU's dysfunctionality is widely exaggerated, but decision-making on highly contentious issues will remain difficult, underlining the image of a bloc in disarray, and divisions are hardening.

Political risks have thus far been masked by cheap and abundant liquidity from central banks and shale. Meanwhile, declining institutional capacity and trust in elites is helping local grievances gather momentum, suggesting that political fragmentation will continue and regional political risks could yet become systemic. In the interim, the failure of markets to respond exacerbates moral hazard risk for foreign policy, allowing conflagrations to worsen in the absence of global economic or market impact.

The political risks are rising. The world's biggest central bank is — ever so tentatively — trying to reduce its support for the economy and financial markets and it remains to be seen if financial markets will be able to cope with growing political risks without the central bank put. Indeed, the value of the central bank put to guard against political risks and economic drags is increasingly in question, too. A global downturn, which is not our base case but remains a material risk, would further exacerbate political risks. We therefore wonder if the increasing global political risks, concerns about the global economy (notably China) and less-effective central bank 'insurance' could be a rather destabilizing environment for markets.

Over the long-term, failure to devise policies to address middle class anxiety and declining living standards increases the likelihood that *Vox Populi* risk — including mass protests and government collapses — could move from being episodically disruptive to systemic, undermining globalization in the process. And we are deeply concerned that the political capital necessary to stem the refugee crisis and terrorist threat, perhaps best-characterized as the collision between previous foreign policy failures and current governance capacity, exceeds that available to government leaders, who have relied upon central banks to manage the lion's share of global crises over the past several years. 2016 could be a very political year for markets.

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