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RISKS TO WATCH

GLOBAL RISKS

Eurozone debt worries, U.S. mid-term elections, pressure towards populism, U.S.-China tension and the risks of conflict with Iran and North Korea could all hit global markets in the second half .

HERE IS A SUMMARY OF THE KEY POLITICAL RISKS TO WATCH IN H2 2010:

SOVEREIGN DEBT WORRIES, AUSTERITY

Worries about Greek and other troubled Eurozone national creditworthiness **have dominated markets**, pushing last year's concerns about emerging debtors such as Dubai and Ukraine into the shade.

Whether any of the economies of Portugal, Italy, Ireland, Greece and Spain ultimately default will depend on whether they can redress deficits and retain enough investor confidence to be able to refinance debt, or whether the core Eurozone economies of Germany and France **will bail them out if they cannot**.

Pushing **austerity measures** through looks set to challenge several governments, and German voters in particular are reluctant to pay the bill for what they see as profligate southern Europeans. That has left European markets **buffeted by political newsflow more than at any time in recent history**, with worries over both unsustainable borrowing and whether cutting public spending too fast might produce a double-dip recession.

What to watch:

- Can Greece and others push through spending cuts? Civil unrest, strikes and any fears about government stability could all spook markets, not just in Europe, but globally. Do any other countries need support from the "shock and awe" European 750-million-euro support package -- and do markets believe it is enough? Do European cuts produce a double dip recession?
- The failure of any IMF package in emerging Europe might also boost **concerns over the viability of austerity measures**. So far, Romania and Hungary look most vulnerable and risks could rise in Latvia ahead of elections. Does the IMF resume loans to Ukraine, which is also seen receiving greater financial support from Russia?

ELECTIONS AND LOCAL POLITICS

Mid-term Congressional elections in the United States and presidential elections in Brazil are the key remaining votes of the year after a plethora of ballots elsewhere. All 435 seats in the U.S. House of Representatives and about one-third of the 100 seats in the Senate will be up for grabs in the Nov. 2 election, and the anti-incumbent mood among U.S. voters is strong, particularly given high unemployment. How President Barack Obama is seen to have handled the BP oil spill could be key.

Arguably, elections in Britain, Hungary, the Czech Republic, Poland, the Netherlands and Belgium have shown **a general trend towards the right with addressing deficits and cutting public spending being key themes**.

Many investors had been watching Britain's May election closely, hoping for a strong government to address a record deficit and have broadly cheered a new Liberal Democratic-Conservative coalition that has pushed through swift budget cuts.

The October 3 race to replace Brazilian President Luiz Inacio Lula da Silva is expected to move into higher gear in July after the World Cup, with ruling party candidate Dilma Rousseff ahead of opposition challenger Jose Serra. Markets appear largely unconcerned who wins but some investors prefer Serra for his more centrist approach and managerial experience.

Local political disputes in Southeast Asia could imperil recoveries, with Thailand the most vulnerable followed by Indonesia and Malaysia. The elections in the Philippines went better than expected but the government must still redress the deficit.

What to watch:

- Is the Gulf of Mexico oil leak plugged swiftly? How much damage is ultimately done, and how great a price does Obama extract from BP? Expect a shift towards populism by both Democrats and Republicans. If chastened in November, Obama is likely to scale back his legislative ambitions, particularly his stalled attempts to have Congress pass a major climate change bill. What potential Republican challengers emerge for 2012?
- Apart from Latvia and Poland's presidential run-off, Europe has no significant further coming elections. Any signs of potential government weakness, failure or collapse particularly in Greece, Spain and Britain -- all pushing through tough cuts -- would spark wider market alarm. Chancellor Angela Merkel's weakening position after local elections in North Rhine Westphalia went against her are also seen undermining Germany's ability to provide support for the rest of the Eurozone. Are there signs of a recovery of the left that might imply austerity measures might be rolled back in due course?



UNREST, POPULISM AND NATIONALISM

Most experts agree the crisis has produced a [modest rise in demonstrations, strikes and other unrest](#), but much less than many had predicted. Still, investors are watching closely for any events that could affect policy-making and change the investment environment.

Riots in Greece in May, in which three people were killed in a burning bank, hit global markets, fuelling worries that Athens might be unable to push through austerity measures. Unrest in other fringe Eurozone countries, particularly Greece and Portugal, will also be watched closely, but few expect a significant policy impact.

In emerging markets, investors will be watching for any signs of a shift to the left, from strikes during South Africa's World Cup to [further expropriation of Western companies in Venezuela](#). The cost of insuring against expropriation and political unrest damage has broadly risen in the past year.

Particularly in Europe and the United States, politicians have railed against "speculators" and pushed for tough action against banks. This looks to be a key driver of banking share valuations in the second half of the year.

What to watch:

- Do [unions, particularly in Europe](#), follow the example of Ireland, where they avoided outright confrontation for fear of sparking a bond market crash, or take a tougher line following unions in Greece? A European day of action on Sept. 29 will be a key bellwether.
- Is there a trend towards protectionism? The [World Trade Organisation says this is well under control](#), but other economists say protectionism is rising far faster than governments admit, despite G20 pledges to the contrary.

US CHINA RELATIONSHIP

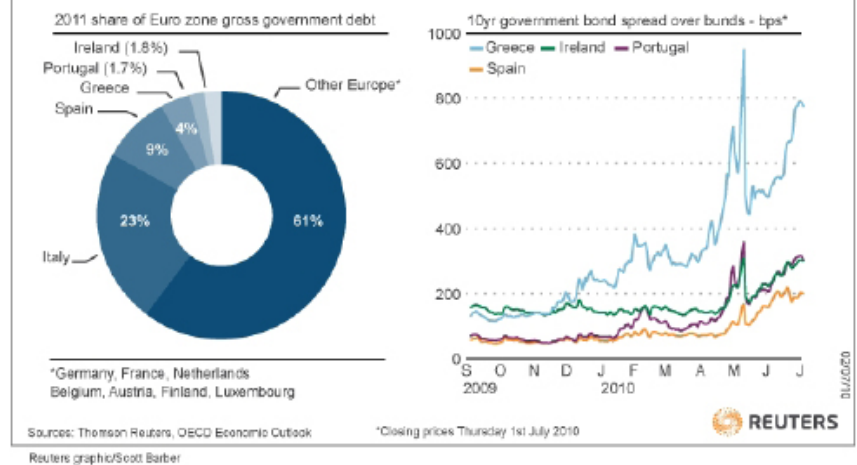
The thorny "G2" relationship between Washington and Beijing is a key preoccupation for markets. While the superpowers have worked to calm tension, there is plenty of potential for problems.

The main bone of contention remains the yuan. After intense international pressure, China [freed the currency in June](#) from its 23-month peg. [Enthusiasm in Washington faded](#) when it became clear appreciation would be gradual and modest. Particularly given high U.S. unemployment, [Obama is under heavy pressure from lawmakers and domestic industry](#) to take a tougher line with China and this will only increase with the mid-term elections. At worst, the relationship could deteriorate into a [protectionist trade war](#).

What to watch:

- Does the U.S. Treasury formally brand Beijing a currency manipulator in a report scheduled for Oct. 15, shortly before the elections? It put off this decision in April, but there are growing calls in the United States for trade sanctions. If Obama feels compelled to take a tough line, relations could swiftly deteriorate.
- Disagreements over how to deal with Iran and North Korea could be another flashpoint.

Euro zone government debt and bond spreads



FRINGE THREATS

Regardless of its effect on the China-U.S. relationship, the threat of conflict particularly between North and South Korea and Israel and Iran could both unsettle global markets in the second half of 2010.

The sinking of a South Korean warship in March with the loss of 46 lives [raised tension on the peninsula](#) to its highest in years, briefly hitting global markets. A measured response from South Korea prevented a serious escalation but worries remain.

Iran responded defiantly to a [fourth round of U.N. sanctions](#) imposed on June 9 after a diplomatic campaign by the United States and its European allies against an alleged nuclear weapons programme.

An [attempted bombing in New York's Times Square](#), as well as militant attacks in Moscow, underlined that [the threat to economies and markets](#) has not gone away.

What to watch:

- Any further [escalation on the Korean peninsula](#) could panic markets, but investors are concerned that an implosion of the North Korean government could leave South Korea with the crushing costs of reunification. Any clues to the health of potentially ailing North Korean leader Kim Jong-il will be closely watched, as will a rare meeting of the North Korean Workers Party in September. That is expected to see the elevation of Kim's younger son Kim Jong-un to a key post ready for the succession, but he is seen lacking his father's clout and other factions may also have an eye on power.
- Does Obama sign more [U.S. sanctions against Iran](#) into law? Does Israel signal it is moving towards launching an attack on Iranian facilities? That could set back Tehran's nuclear programme but risks provoking a wider conflagration that could affect oil supplies.