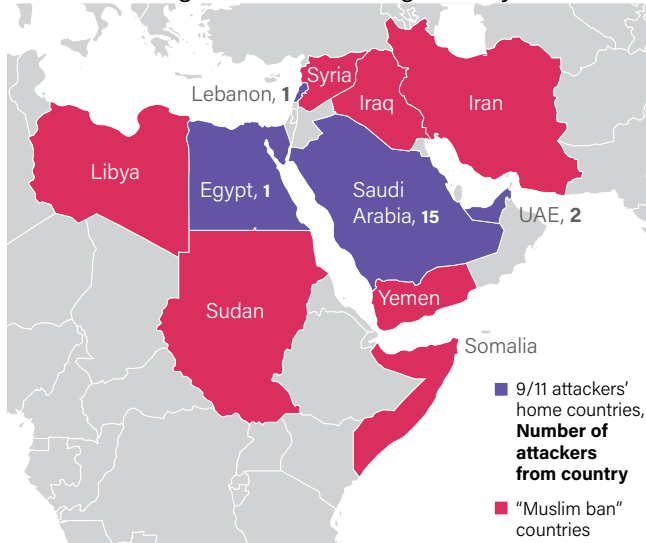




Countries targeted, and not targeted, by travel ban



Provisions of the Turkish presidential referendum



President will have criminal liability

Parliament will lose its right to interpellation

President will get to keep ties to a political party

Presidential and parliamentary polls will occur concurrently, every five years

President will become head of the executive branch and be allowed to issue decrees

Abolishment of prime minister's office and cabinet

President will have wide-reaching authority over the high council of judges and prosecutors

Intensifying trade tensions would be felt beyond China and the US

The bilateral friction is likely to worsen, and the resulting clashes could harm global growth. China's initial approach will be to respond to US actions proportionately, but there are several irritants that could cause more of a spiral. By extension, the Middle Eastern states that have benefited from US-Asia and Asia-Europe trade would be hit by weakening growth. Most affected would be the Middle Eastern oil producers that rely heavily on oil exports for revenue generation to sustain their budgetary needs.

"Muslim ban" will not destabilize US-Middle East relations

The US travel ban on citizens from several Muslim-majority countries will not have a significant short-term impact on US relations and commercial interests in the Middle East. However, over the long term, President Donald Trump's transactional politics, economic nationalism, and broad-based approach to confronting radical Islam will further encourage regional powers to deepen relations with key Asian and European countries.

Sisi will win again in 2018 but face a tougher race

President Abdelfattah el Sisi will defeat any of the three types of candidates he faces in next year's election, though some will create more difficulties for him than others. A regime insider such as former prime minister Ahmad Shafik—who narrowly lost a 2012 presidential bid—would represent the most serious challenge to Sisi because he has name recognition, popularity, and support from within the system. Regardless of whether Shafik decides to run, Sisi is likely to face a tougher contest than he did in 2014, when he earned 97% of the vote.

Erdogan's referendum on a presidential system will probably succeed

President Recep Tayyip Erdogan's presidential system reforms are expected to be put to a referendum on 16 April following their recent approval in parliament. The structural advantages of the "yes" camp are likely to result in approval of the referendum, but it will be a close result. Nonetheless, even a successful referendum is unlikely to lead to more rational policymaking, while a failed referendum carries the risk of early elections.



Intensifying trade tensions would be felt beyond China and the US

Likelihood: 60% Impact: 70%

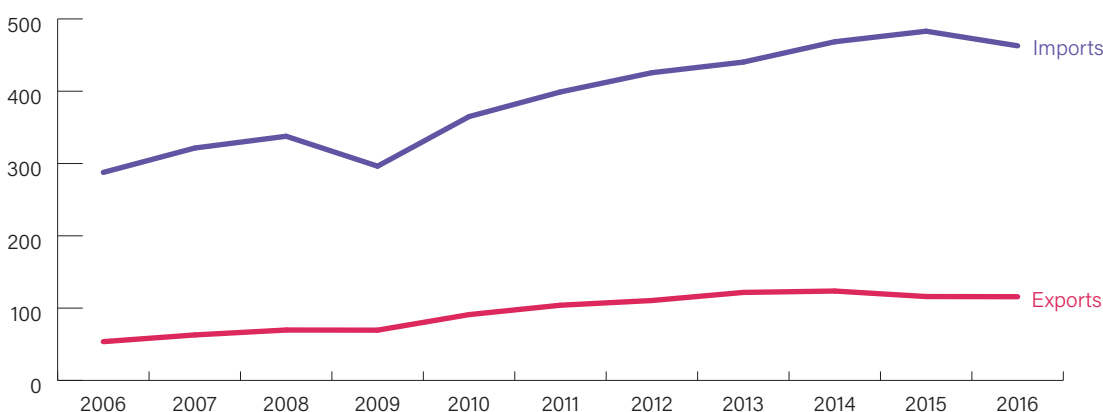
The new US administration is likely to accelerate the pace and broaden the rationale for bringing trade cases and retaliatory measures against China, but it will stop short of broad, across-the-board actions that target the Chinese economy. Instead, the rationale for anti-dumping and countervailing duty (AC/CVD) investigations and section 301 tariffs will be justified on expanded grounds that get at the Chinese government's deep involvement in the economy, from the presence of state-owned enterprises to the use of pervasive direct and indirect subsidies to boost exports and groom national champions. This will build upon the approach taken by former president Barack Obama's administration, which has itself significantly increased the number of China cases brought before the WTO. On the currency front, the Trump team has walked back from his campaign promises to designate China a currency manipulator on day one of the administration, reflecting the weak analytical case, given that the Chinese have been intervening heavily in foreign exchange markets in the past year to prevent the currency from weakening further.

Beijing will draw on a long list of tools to impose costs, shape Trump's behavior, and prompt a negotiated solution. Policymakers have both formal and informal tools at their disposal. The latter group is far more expansive and presents the greatest challenge for US officials. The formal retaliation steps include initiating anti-dumping and anti-subsidy investigations and imposing tariffs against US products, but equally threatening are the informal tools at Beijing's disposal. Such informal retaliatory actions could include judicial and/or regulatory moves that restrict market access or otherwise impede a US firm's business in China. Beijing could simply deny approval for the many licenses needed to export to or operate in China, or approval for an international M&A deal. At the first stage, China would target sectors it believes will resonate politically with the Trump team, including sectors that touch Trump's political base. Beijing's strategy would be to coerce Republican business leaders to lobby the White House to back down from such aggressive actions against China. In the current framework, China's initial goal will be to respond in a proportional manner to incentivize a negotiated solution. However, the scope of each sides' trade actions may expand if bilateral relations deteriorate over handling of the Taiwan and the South China Sea issues.

A heightening of US-China trade tensions will undermine the prevailing global and economic order and negatively affect international trade flows through the Middle East. The region has vastly benefited from Asia-Europe and US-Asia trade flows. Regional ports have played a key role in re-exports and the logistics business. Moreover, the rise of Asian wealth is increasingly important to the long-term investment outlook in the region as Asian investors have become major participants in the process. Most importantly, the Middle Eastern oil-exporting countries rely heavily on oil exports for revenue generation and sustaining their budgetary needs. A more challenging global economic outlook that emerges as result of rising tensions is bound to affect growth and therefore oil demand. In this respect, tensions could somewhat limit the positive impact of the latest OPEC production cut agreement.

US trade in goods with China

USD billions



Source: US Census Bureau



“Muslim ban” will not destabilize US-Middle East relations

Likelihood: 70% Impact: 80%

Trump’s executive order banning travel into the US from seven majority-Muslim countries will unnerve key powers in the region, but it will not lead to a crisis in US-Middle East relations. The countries targeted are unable to mount a diplomatic campaign or produce a coherent strategy to engage the Trump administration over the issue. Other than Iran, all of the countries involved have a weak government in place or are fighting a civil war. Moreover, three powerful states not on the list—Egypt, Saudi Arabia, and the UAE—have either remained silent or expressed support for the ban. The ban targets Iran and its allies, and officials in Riyadh are probably concerned that confronting Trump on the issue would only incite unnecessary tensions. As for Egypt and Turkey, the former will still focus on leveraging Trump to weaken the Muslim Brotherhood, and the latter will avoid friction, hoping that Trump will roll back support for the Kurds in Syria.

Nevertheless, Trump’s rhetoric will legitimize the narrative of jihadist groups and encourage radicalization in small segments of Muslim communities. Traditionally, effective counterterrorism strategies balanced the use of military force with policies that address the causes of radicalization. Current US policy is clearly more focused on force and is less willing to engage in a comprehensive assessment of different factors that contribute to Islamist radicalism.

In the short term, Gulf states will be pleased by Trump as he adopts a hardline posture against Iran, and Defense Secretary James Mattis assures them that US security guarantees still hold. They will be less pleased by US-Russia rapprochement, which will probably enable the Kremlin to cement its expanding role in Middle East security.

Over the medium and long term, the broad contours of Trump’s policies will prove problematic for US relations with the Middle East. The president and his closest aides appear to be translating into policy their view that Islam represents a core threat to US interests. While each administration since the attacks of 11 September 2001 focused on Islamist radicalism, Trump’s is casting a much wider net. Additional US measures that identify Islam as a threat will eventually become a liability for governments in the region, and therefore create challenges for cooperation with Washington.

Further complicating matters is that Trump’s transactional politics will probably prove to be a double-edged sword for the Gulf countries. Leaders in the Gulf are pleased that the new president is not committed to spreading liberal values and pressing them to respect human rights. However, it is not clear whether Trump will demand additional and clear financial or military contributions from the Gulf states. Lastly, there is a risk that the policy process in the White House will discount consultation with Gulf allies; the issue remains important for the Gulf states that felt sidelined by the Obama administration.



Sisi will win again in 2018 but face a tougher race

Likelihood: 90% Impact: 60%

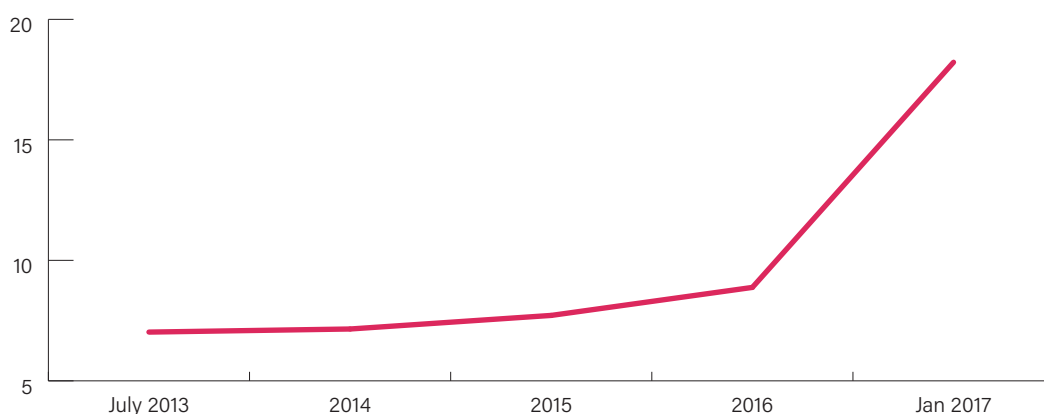
The presidential contest is a year away and Abdelfattah el Sisi will win reelection, but in the context of Egypt implementing painful economic reforms, Sisi is very likely to face a much tougher race than he did when he coasted to victory in 2014 with almost 97% of the vote. Two types of candidates would pose a challenge to him and his regime. The first, and most dangerous, would be an insider with support from within the system. Former president Hosni Mubarak's last prime minister Ahmad Shafik is that candidate. Shafik ran for president against the Muslim Brotherhood's Mohamed Morsy in 2012 and lost by a razor-thin margin. After losing the election, he left to the UAE in order to avoid a series of legal cases. Shafik enjoys good relations with the Emiratis and other Gulf leaders.

Shafik has not indicated that he plans to run, but the legal cases against him have all been settled as of December. Shafik would lose to Sisi. However, it would not be an easy race for the incumbent. Shafik has name recognition, as well as solid backing from within certain quarters of the establishment. He is a former military man with a reputation as a competent manager. Lastly, he has a public constituency. Egypt's non-Islamist middle class would be attracted to Shafik's message because it would not vary ideologically from Sisi's.

If Shafik does not run, Sisi's challenge would probably come from a liberal, left-leaning opposition figure, who would focus on economic grievances caused by IMF-mandated reforms and the repression faced by liberal critics of the regime. This candidate would clearly state his or her opposition to the Brotherhood and run on a plank of supporting the January 2011 and June 2013 uprisings. Yet this candidate would also likely indirectly attract some Islamist support, because while the Islamists may hate the liberals, they hate Sisi more. This candidate would not attract as much public support as someone like Shafik. However, this candidate would pose a challenge because he or she would also probably succeed in spearheading a more sustainable, enduring opposition movement after the election, something that has not existed since 2013. A strong opposition movement that engages in street protests would not threaten the regime but scare the authorities into slowing economic reforms.

It is also possible, though less likely than the above scenarios, that Sisi faces a completely toothless challenger. For such a scenario to unfold, the state would ensure that nobody with any name recognition or credibility be permitted to run. Such a figure would barely register any kind of popular support, but essentially serve as a name on the ballot so Sisi does not run unopposed. This kind of candidate would signal that Sisi's control of the state is tightening, giving him a renewed mandate to implement even more economic reforms.

USD-EGP exchange rates since July 2013 overthrow of Morsi



Source: Exchangerates



Erdogan's referendum on a presidential system will probably succeed

Likelihood: 60% Impact: 60%

After the government's set of constitutional reforms were approved by parliament on 21 January, the government is gearing up its campaign for the upcoming referendum on the presidential system overhaul. Both the ruling Justice and Development Party (AKP) and the opposition Nationalist Movement Party (MHP) will separately campaign for a "yes" vote in the referendum, having backed the reforms in parliament. Together, the two parties will strive to build a broad nationalist front behind Erdogan, using the argument that an empowered presidency is Turkey's best bet to ensure political stability and combat numerous security threats, including the Kurdistan Workers' Party (PKK), the Islamic State, the Gulen movement and various foreign powers. MHP leader Devlet Bahçeli's ability to deliver even a fraction of MHP votes could enable Erdogan to build his broadest coalition of supporters yet (the two parties together won 62% of the vote in the November 2015 elections).

The "yes" camp will enjoy three key structural advantages. First, nationalist rhetoric will polarize society in favor of Erdogan by broadening the appeal of a "yes" campaign focused on combating security threats while dividing the "no" camp. In particular, by identifying the "no" camp with the pro-Kurdish Peoples' Democracy Party (HDP) and by extension the PKK, the government will make it difficult for the Republican Peoples' Party (CHP) to appeal to AKP and MHP voters. Second, the government will be able to use its control of broadcast media to favor the "yes" camp by limiting the scope of debate. Third, the government will use its vast powers under the state of emergency together with the AKP's party machinery to co-opt support and intimidate the "no" camp. Authorities will be able to make use of public finances to fund the "yes" campaign—not least to organize rallies in 40 cities nationwide—and potentially provide handouts.

Nonetheless, there is still a real risk that substantial segments of AKP and MHP voters may not be persuaded to support the referendum. The convergence of slowing growth, lira weakness, rising unemployment and inflation, exposure to terrorist attacks, social unrest, purges, and arrests under the state of emergency—together with foreign policy tensions—could turn into a crisis, undermining confidence in the government.

If approved, most of the provisions of the presidential reforms will only come into effect following presidential and parliamentary elections scheduled for November 2019 and will substantially weaken Turkey's system of checks and balances, democratic institutions, and the rule of law. In the event of a failed referendum, the government will find it even more difficult to normalize economic management, conclude the state of emergency, or deescalate security risks and the fight against the PKK and Gulen, since this could open the door to serious criticism and a strengthening of opposition figures. While a government shuffle would be possible, Erdogan would not be sidelined; instead, he would likely set his sights on the 2019 elections with an eye toward securing a higher parliamentary seat count.



Authorities will maintain exchange rate policy out of need for stability

Likelihood: 75% Impact: 80%

Debates in China over its exchange rate strategy are intensifying now that foreign exchange reserves have dipped below the psychologically important level of \$3 trillion. As reserves decline and capital controls are only partially effective, there are growing calls in policy circles for the government to allow the yuan to float more freely. This would enable the central bank to maintain reserve levels and relax increasingly intrusive capital controls. As this debate unfolds this year, political imperatives will probably lead Beijing to maintain its current approach through autumn. As the 19th Party Congress approaches, the leadership's highest priority is avoiding even the hint of financial instability, which it fears a floating exchange rate would engender.

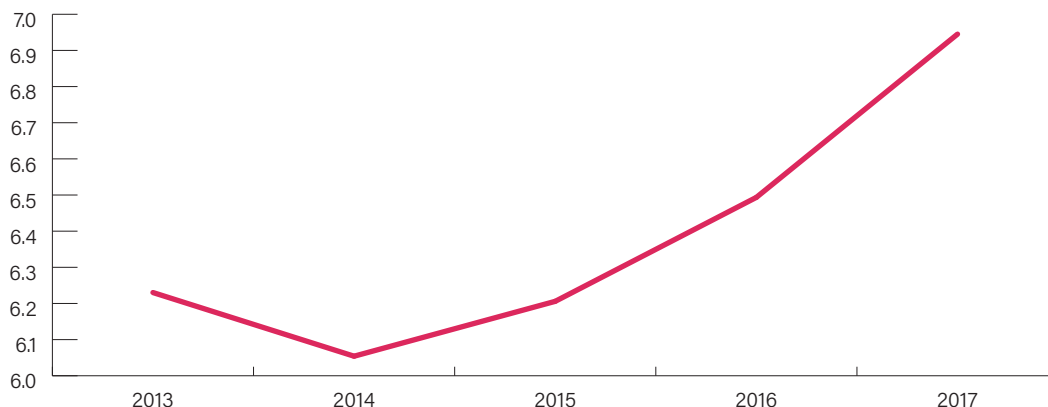
Authorities are probably willing to sustain even peak levels of monthly reserve losses to muddle through the political transition. Many in China view external analysis of reserve adequacy as arbitrary and failing to capture what they see as the country's biggest threat—a loss of confidence in the currency by households; thus, such discussions of reserve adequacy reveal little about China's next steps.

For the senior leadership, the political and economic costs of the current approach pale in comparison to the risks of abandoning it. The government is focused on two inter-related concerns: its political credibility and macroeconomic stability. Since late 2015, President Xi Jinping and Premier Li Keqiang have repeatedly assured markets that the yuan will be “basically stable” and that China will not intentionally devalue the currency for trade gain. Xi reiterated this commitment most recently during his address to the World Economic Forum in Davos.

Overly rapid depreciation of the yuan—against either the dollar or a trade-weighted basket—would not only be a loss of face for Xi, but could also send a signal that the leadership lacks the ability or the will to stand in the way of further currency weakness. Beijing fears that such a dynamic could easily feed on itself. This was the lesson of China's mishandled exchange rate reform in August 2015, which set in motion a vicious cycle of depreciation and outflows that Beijing is still battling.

In such a context, the political barriers to abandoning capital controls and floating the currency are prohibitively high. Consequently, there will be no significant change to exchange rate policy until after the 19th Party Congress. Furthermore, with US-China relations under the Trump administration at an early, sensitive, and potentially volatile stage, it is in Beijing's interest to avoid spurring confrontation with Trump via a large yuan depreciation. While Trump has not labeled China a currency manipulator, he has repeated his suspicion that Beijing is pursuing a weaker currency for trade gain.

USD-CNY rates over past five years



Source: Exchangerates