

US mid-term elections

1 Nov 2018 - Country Risk | Strategic Report

On 6 November 2018, the United States will hold national mid-term elections to select members of the 116th Congress and 36 governors. IHS Markit assesses that there are three election outcome scenarios to consider: (1) Democrats win a majority in the House of Representatives but Republicans maintain control of the Senate, (2) Democrats win a majority in both chambers, and (3) Republicans hold on to their majority in both chambers (see **United States: 23 October 2018: Scenario analysis of US mid-term elections**).



People cheer as President Donald Trump looks at them during a campaign rally at the Hertz Arena to help Republican candidates running in the upcoming elections on 31 October in Estero, Florida, US.

Joe Raedle/Getty Images

- **Under any of the potential election outcome scenarios, the Trump administration will likely continue to rely on executive actions such as issuing executive orders and via promoting new regulations to pursue priorities associated with his America First agenda, particularly on foreign policy, trade, and immigration.** Outside of the 2017 congressional overhaul of the tax code, much of Trump's action as president has relied on using his executive authority outside the control of Congress. In particular, Trump would likely pursue renegotiations of additional trade agreements as well as further trade actions targeting trade imbalances with China and alleged Chinese intellectual property theft and forced technology transfers. The Trump administration has also applied sanctions and the threat of sanctions as a primary foreign policy tool. Additional deregulation efforts, particularly environmental and labour deregulation, are also a fundamental agenda item for the Trump administration.
- **Should Democrats take the House of Representatives and Republicans maintain a majority in the Senate, the likelihood of policy gridlock would almost certainly increase, with Republican efforts to make the 2017 individual tax cuts permanent, eliminate Obamacare, or fund a border wall likely off the table until following the 2020 presidential and congressional elections.** Despite the likely legislative impasse, certain policy areas lend themselves to bipartisanship, and are thus comparatively more likely to advance. One would be efforts to improve US infrastructure, where Trump has proposed a USD1.5-billion 'Legislative Outline for Rebuilding Infrastructure in America'. Additionally, despite the recent lack of progress, a Democratic majority in the House would increase the likelihood of some sort of Deferred Action for Childhood Arrivals (DACA) for border-wall funding legislation to be approved in the next congressional term. Finally, Democrat-led congressional committees would almost certainly expand investigations of the administration, most notably those involving the awarding of government contracts.
- **In the less-likely scenario in which Democrats gain majorities in both congressional chambers, prospects for passage of the Trump administration's legislative goals would essentially cease, while Democrats would look to legislate their 'Better Deal' policy programme.** On the Better Deal agenda, Democrats seek to institute new rules for discouraging drug price gouging, to pass a USD1-trillion infrastructure bill, and to restrict lobbying by former government officials. However, much of this legislation would stall as Democrats would not have the 60 Senate votes necessary to overcome filibusters or would face an almost certain presidential veto. Procedurally, a Democratic Senate would likely slow-walk or reject controversial Trump federal judicial or cabinet selections. Finally, a mid-term

sweep by the Democrats would increase the likelihood that progressive policies represented by Senators Bernie Sanders and Elizabeth Warren, such as USD15 minimum wage and Medicare-for-all, will make it into the party's 2020 presidential platform.

- **Should Republicans maintain their majorities in the House and the Senate, the Trump administration would look to advance items on its domestic policy agenda requiring congressional approval.** Such items would include making the 2017 individual tax cuts permanent or eliminating Obamacare, while on foreign policy the administration would likely be emboldened to pursue more expansive immigration and trade protectionist policies including reconsidering auto tariffs and greatly expanding the current tariff regime against China. Should Republicans maintain their majorities, the likelihood of further congressional investigations into the current administration or Russian interference into the 2016 presidential election would diminish.

Indicators of changing risk environment

Increasing risk

- Mid-term election results in which one party wins the popular vote but is not seated as the party in the majority in one or both houses would increase the likelihood of protests into the thousands of participants across urban centres including Miami, New York, and Washington DC, similar to what was seen following the 2016 presidential election, over issues such as immigration and healthcare.
- Support by Democrats following the elections of the United States–Mexico–Canada Agreement would open the door for further trade protectionism by the Trump administration including additional tariffs on China and reconsideration of auto tariffs directed at Europe.
- A renewed Republican majority in both chambers would be likely to increase calls for a tougher approach on the so-called migrant caravan, including development aid cuts to El Salvador, Guatemala, and Honduras. There would also be an increased risk of cargo delays associated with more thorough customs checks and inspections on traffic traversing the Mexico-US border.

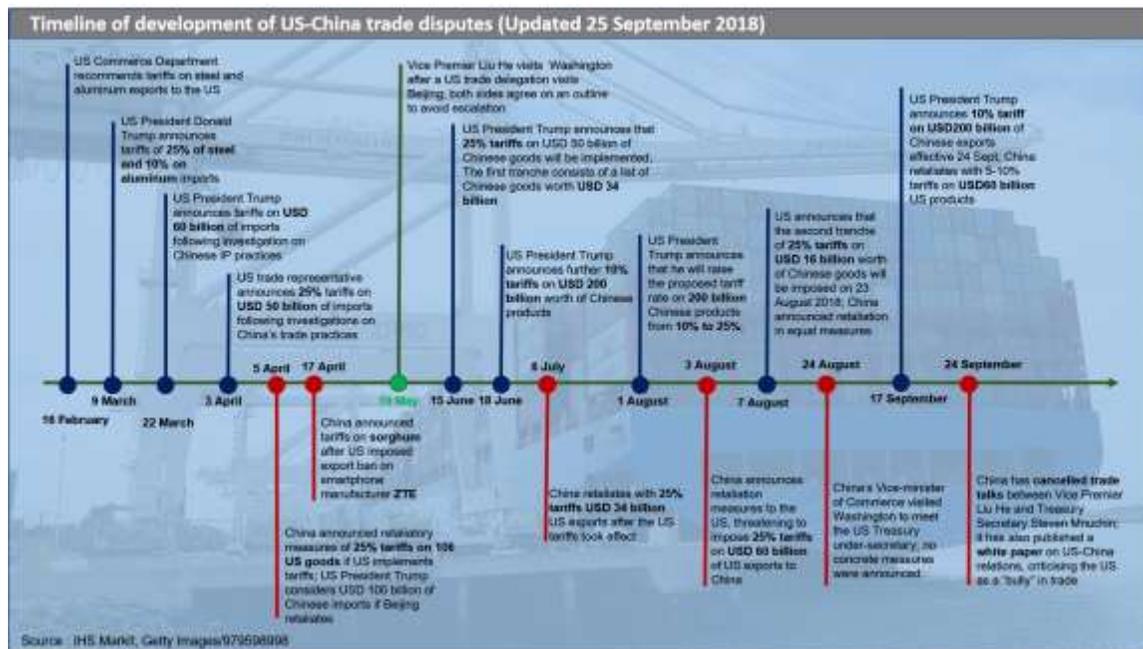
Decreasing risk

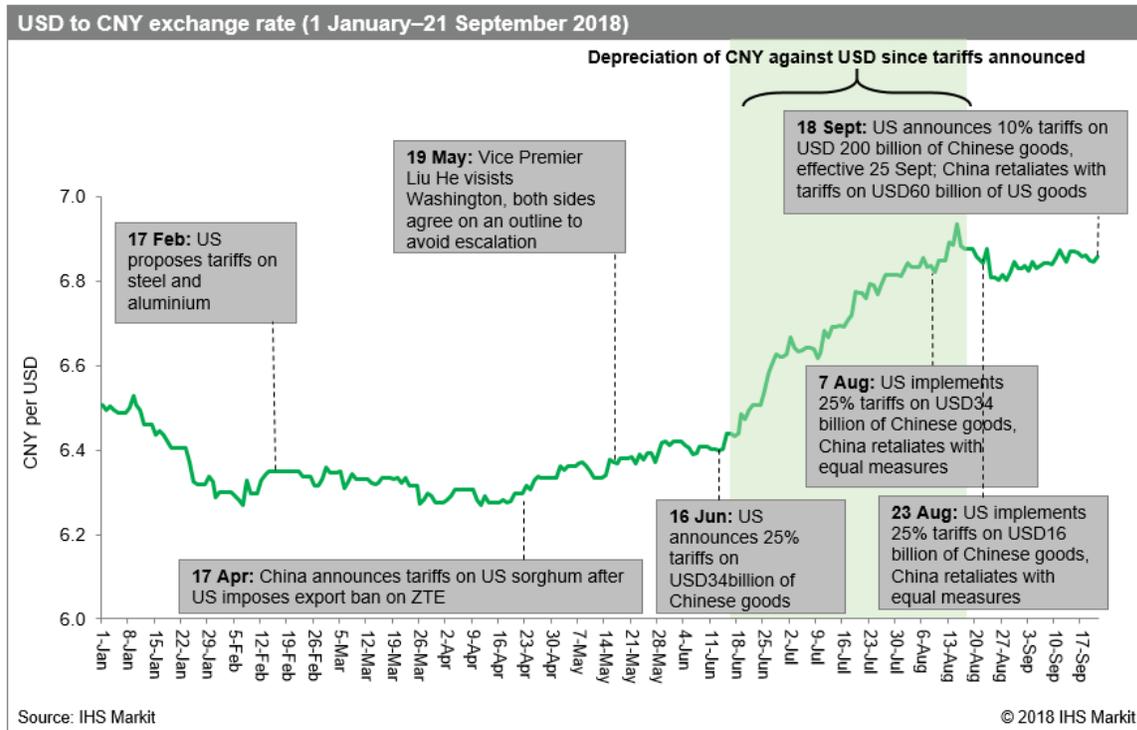
- Should Democratic candidates running on a progressive platform (including on wages and Medicare) not perform well in the mid-term elections, such policies will be unlikely to make it onto the party's 2020 agenda, reducing the likelihood of required tax or regulatory changes.

US-China trade and broader relations

31 Oct 2018 - Country Risk | Strategic Report

International media have reported that China is cutting oil purchases from Iran ahead of US sanctions on 4 November 2018. Additionally, Bank of Kuntun, the main bank carrying out payments with Iran, will suspend businesses with Iran as of 4 November. This report, if true, represents a significant Chinese concession to current US policy of containing Iran ahead of the G20 summit in Buenos Aires, where Chinese President Xi Jinping and US President Donald Trump are expected to meet. Earlier on the 17 October, the US Treasury Department opted not to label China a "currency manipulator" in its semi-annual report to Congress on monetary policies of major trading partners.



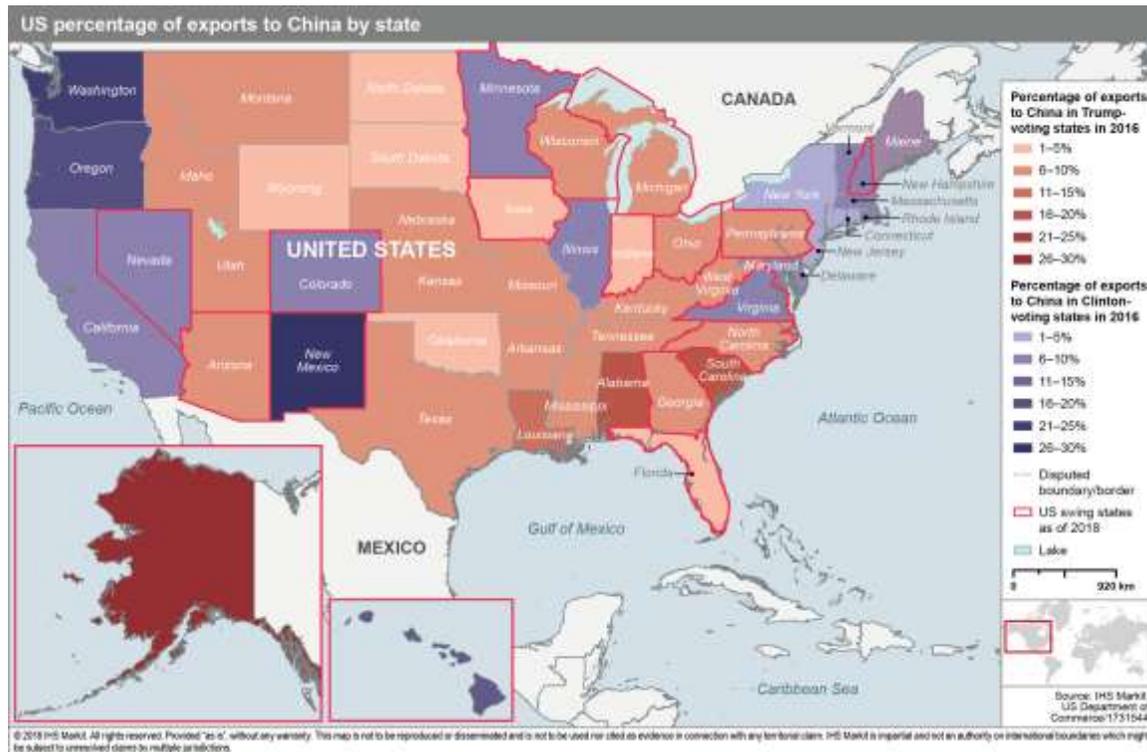


- **The positive development indicates increased likelihood of two sides agreeing to re-initiate negotiations after the G20 Summit.** However, in the short term IHS Markit does not expect a resolution or a new trade agreement with China to be reached. This indicates that existing tariffs will likely remain in place beyond 2019. The US was reported to be prepared to announce tariffs on the remaining USD257-billion worth of Chinese goods should talks fail. China, which has upheld its hard-line stance against US threats since the reversal of de-escalation agreed by both sides in May 2018, has indicated its willingness to engage in a prolonged trade conflict with the US if necessary.
- **The Trump administration appears to have used better trade ties with both the EU and Mexico to concentrate its efforts to increase tariffs on China.** Despite the recent stock market decline, a robust US economy and low unemployment rate have emboldened the Trump administration to continue pressure on China to agree to US demands. Trade hardliners and long-time sceptics of China's influence – such as Director of the Office of Trade and Manufacturing Policy Peter Navarro and US Trade Representative Robert Lighthizer – currently hold significant influence over the direction of US-China negotiations with little substantive opposition from either the Democratic Party or trade advocates from the Republican Party.
- **As situations stand, trade relations will not necessarily improve even if the Democrats obtain a majority following November's midterm elections.** The new US-Mexico-Canada

trade agreement (USMCA) has specific clauses targeted towards Chinese interests. The trade agreement, if confirmed, includes a clause that provides Washington with an effective veto over USMCA members signing free-trade agreements (FTAs) with "non-market economies". This could block China from signing FTAs with Canada and Mexico, and China will probably regard the measure as a US-led economic containment strategy to curb China's economic rise through isolation and realigning global supply chains.

- **China has pursued a mixture of strategies to respond to US trade measures**, including continued lobbying of US companies, trade diversification away from the US, accelerating development of "core technologies" in strategic sectors, and loosening monetary and fiscal policies to support the sectors most severely affected by tariffs.
- **A renminbi freefall or Treasury offloading remains unlikely.** Although the renminbi has experienced a marked devaluation – around 9% since April 2018 – and China's holding of US Treasury Bonds has decreased to USD1.17 trillion (from USD1.18 trillion at the start of 2018), these measures remain unlikely to be used as the main retaliatory tools as such action would be highly disruptive to the Chinese economy. At the local level, regulatory measures such as increased customs inspections and lengthier quarantine periods are being deployed, risking a worsening business environment for US companies that lack strong ties to local governments and regulatory authorities. Nonetheless, nationwide boycotts and disruptions of US business operations are currently unlikely, as China remains eager to continue negotiations and is unlikely to risk further escalations. However, US provocation could increase such risks (see indicators below).
- **In the longer term, China is likely to gradually reduce its economic reliance on the US in trade and investment.** This will include advocating alternative agreements with other trading partners. In a white paper, China specifically highlighted other FTAs such as the China-EU and the China-Japan-Korea FTAs, and its hopes for an early conclusion of the Regional Comprehensive Economic Partnership (RCEP) – a large-scale trade agreement including China and India that if implemented would represent almost 40% of global GDP. Enhancement of connectivity with China's neighbours through the Belt and Road Initiative (BRI) likely will accelerate to ensure long-term access to frontier markets.
- **Beyond trade, indications increasingly suggest a deterioration in long-term Sino-US relations.** There is a growing consensus among China's political elites that the US is restricting China's rise to global prominence, which has been highlighted in China's State Media outlets since tariffs were first implemented. Xi has emphasised the importance of "self-reliance" in all aspects of the economy, and told senior Communist Party leaders that it would be "increasingly

difficult for China to obtain key technologies internationally" during his recent tour of the country's northeastern provinces. This would extend US-China conflicts beyond trade, and would probably lead to a change in China's regional engagement positions and an increasingly confrontational relationship in strategic issues, such as freedom-of-navigation rights in the South China Sea and US-North Korea negotiations.



Indicators of changing risk environment

Increasing risk

- Further resignations of members of Trump's economic policy staff that oppose protectionism would suggest that the president plans to impose further protectionist measures.
- A continued widening of US trade deficit with China, which will potentially surpass USD400 billion in 2018, will motivate the White House to implement further tariffs on Chinese goods.
- US changing its chief negotiator from Steven Mnuchin, which will likely be White House adviser Peter Navarro or US Trade Representative Robert Lighthizer, who both advocate for stronger stance against China.
- The White House publishing further evidence of US companies receiving unfair treatment in China, or US accusation of Chinese cyber-espionage, would indicate a deterioration in broader Sino-US relations.

- Strengthened restrictions on Chinese investments and business activities in the US, either through CFIUS or other policy changes (such as more restrictions on Chinese student or business visas).
- WTO approval of Chinese implementation of trade barriers against USD7 billion-worth of US exports due to US non-compliance over a 2017 WTO ruling in China's favour.
- Continued US provocation through the US navy's freedom of navigation operations (FONOPs) in the South China Sea, increased arms sales to Taiwan, or interference in Xinjiang or Tibet would increase the risk of boycotts or targeted disruptions to US businesses operating in China.

Decreasing risk

- Legislative proposals by congressional Republicans to limit the president's powers to invoke the Section 232 provision would increase the probability of the administration paring back the tariffs' scope.
- US announcement of willingness to continue negotiations without forcing China to agree to any previously mentioned demands.
- Senior Chinese leaders, including Vice-Premier and chief negotiator with the US Liu He or Vice-President Wang Qishan, expressing that China is open to continued discussions;
- Chinese approval of US companies to operate, such as the *People's Daily* signalling that it welcomes Google re-entering China.

Khashoggi fallout: US-Saudi relations

29 Oct 2018 - Country Risk | Strategic Report

Jamal Khashoggi, a Saudi Arabian journalist living in self-imposed exile in the United States, has been unaccounted for since he was last seen entering the Saudi consulate in Istanbul, Turkey, on 2 October. After initially denying any involvement in his 'disappearance' and giving differing explanations for his death, Saudi Foreign Minister Adel al-Jubeir admitted on US television on 21 October that Khashoggi had been murdered in a "grave mistake", and that Saudi intelligence services had attempted an unauthorised cover-up. The disappearance, conflicting allegations, and now confirmation of Khashoggi's murder have provoked bipartisan US criticism of Saudi Arabia,

including individual congressmen placing blame personally on Crown Prince Mohammed bin Salman and some US politicians calling for sanctions.

- **The US administration is likely to prioritise US business interests and the White House's foreign policy goals of expanding the sanctions regime against Iran and promoting its Middle East peace plan, limiting the impact of Khashoggi's killing on US policy towards Saudi Arabia, despite congressional dissent.** US President Donald Trump has taken a cautious tone in dealing with the crisis, suggesting previously that the Saudi government may not be at fault. Trump has since committed the US administration to taking unspecified punitive measures if justified by the evidence and has acknowledged the likelihood that the Crown Prince would have been aware of a covert operation of this sort.



US Secretary of State Mike Pompeo (left) meets with Saudi Arabian Crown Prince Mohammed bin Salman in Riyadh on 16 October to hold talks after the disappearance of Jamal Khashoggi.

Leah Millis/AFP/Getty Images

- **Despite mounting US congressional opposition, the US presidency and administration are likely to retain working relations with Saudi Crown Prince Mohammed bin Salman (MBS).** The US Senate's Foreign Relations Committee on 10 October invoked the Global

Magnitsky Act to force the US administration to impose sanctions on individuals it finds responsible for the 2 October disappearance of Khashoggi. The president has 120 days to decide whether to impose sanctions, having regard to evidence connecting Saudis to the disappearance and killing of Khashoggi. On 23 October, the US Department of State announced that it would revoke the visas of 21 unspecified individuals allegedly involved in Khashoggi's murder, as well as considering the application of Magnitsky Act sanctions. The US is likely to limit financial and diplomatic sanctions to those advisers to MBS who it deems dangerous, and not target royals, even if publicly available, verifiable evidence emerges of a high-level Saudi link to Khashoggi's disappearance or killing. Moreover, with calls from several congressional Democrats and Republicans for sanctions, ranging from visa bans and asset freezes of Saudi officials responsible for the killing, to cancelling more than USD10 billion in weapons sales to the Kingdom, Trump likely does not want to appear non-responsive to the crisis just ahead of US mid-term elections in November.

- **It is highly likely that US weapons, energy, mining, and infrastructure firms will continue to do business with Saudi Arabia as normal.** These are the industries that Saudi Arabia needs to maintain its patronage-based political economy and its stability. The main obstacle will be for US firms that require congressional approval of arms sales, which is less likely to be forthcoming if Saudi officials are found to have approved Khashoggi's consulate killing and evaded Global Magnitsky Act sanction. Even though a number of high-profile technology, media, and financial companies withdrew from Saudi Arabia's international investment forum on 23–25 October, none has yet terminated existing projects or engagements with Saudi Arabia. Russian and Asian firms attended MBS's Future Investment Initiative event, even as Western companies pulled out or downgraded the executive level of their attendees. It is unlikely that the Saudi military could feasibly shift away from reliance on US military equipment without fundamentally weakening its strategic position against Iran in the five-year outlook. Despite Saudi claims to the contrary, firms from countries that take a tough stance against the Kingdom, including public statements directly blaming the crown prince, are likely to be barred from future Saudi contracts, and their personnel and companies in Saudi Arabia would likely face administrative harassment, such as visa delays, freezes on hiring foreigners, and corruption investigations.
- **MBS is unlikely to be removed from his post; accepting responsibility for Khashoggi would weaken him and raise coup risks, but pushing on through the crisis would strengthen his hand.** MBS will probably seek to avoid any admission of guilt or responsibility for the operation. Nevertheless, blaming security officials for an unauthorised killing weakens

MBS, as it tacitly acknowledges that he had incomplete control over the Saudi security forces. Since his appointment as crown prince, MBS has alienated key members of the Saudi ruling and business elites by aggressively consolidating governing power and wealth for himself. This consolidation means that any major policy failures or embarrassments are more likely to be blamed solely on his decision-making. As such, admitting responsibility or appearing to do so would weaken him severely and raise the risk of dissent or a coup. However, King Salman, his father, is unlikely to abandon MBS by allowing his rivals to take revenge on him and giving up the son he has groomed for this post. Consequently, Saudi Arabia is likely to play for time, deflect blame for Khashoggi's disappearance, and work to consolidate MBS's position further, while replacing some key advisers to placate the US.

- **The Turkish government is exploiting its apparent detailed inside knowledge of the case to gain maximum advantage in its relations with the US and Saudi Arabia.** On 23 October, coinciding with the opening of MBS's flagship investment conference, President Recep Tayyip Erdoğan made a statement, previously billed as the "naked truth" about the case. In the event, he said little more than confirm details that had been trickle-fed in Turkish intelligence leaks, and made no specific allegations on responsibility for the killing, but called for further joint investigation. The Istanbul prosecutor's office has submitted an extradition request for the 18 suspects so far identified in connection with the killing, but this is almost certain to be rejected by the Saudis. Erdoğan's avoidance of attributing blame among the Saudi leadership indicates that he does not wish to escalate the issue to the point of irretrievably damaging relations with Saudi Arabia, but instead is likely attempting to maintain a state of confusion to maximise the time available to secure economic support and political concessions from the Saudi government. Erdoğan is also likely taking the opportunity to co-operate with US calls for transparency and to reposition Turkey as an acceptable dominant partner in the region by establishing the inconsistencies in Saudi claims to leadership.

Indicators of changing risk environment

Increasing risk

- Two out of 17 US lobby groups retained by Saudi Arabia have terminated their engagements; further contract terminations would indicate that Saudi influence in the US is falling irrevocably, and increase the likelihood of broader sanctions.
- US Congress presenting a bipartisan sanctions bill, specifically targeting Saudi Arabia, would suggest that the administration is unable to pursue its preferred policies.

- Turkish intelligence officials releasing verifiable evidence of Saudi involvement in Khashoggi's murder would likely force the US administration's hand, raising the likelihood of sanctions targeting senior royals and of a conflict among royals in Saudi Arabia.
- Senior Saudi royals publicly blaming MBS for Khashoggi's disappearance or death, and making evidence of their claim public, would indicate higher coup and government instability risks.

Decreasing risk

- Continued declarations of political support from President Trump and the State Department for the Saudi denial of responsibility would indicate that the Saudis have successfully lobbied for support from the US executive, despite congressional anger.
- Turkish authorities making no evidence of Khashoggi's death available would provide MBS with a layer of deniability of responsibility for any operation.
- A Lebanese cabinet is formed, suggesting Saudi willingness to make compromises to appear as a less disruptive actor.
- Saudi commits funds to the Arab-NATO project, highlighting its willingness to work with the US administration.
- A softening of statements from US lawmakers following the US mid-term elections in November would indicate Congress's preference to maintain the strategic relationship between the US and Saudi Arabia – based on shared interests of military purchases, reliable global oil supply, and confronting Iran in the Gulf.
- Saudi Arabia publicly commits to supporting Trump's Israeli-Palestinian peace plan, which would meet the US administration's requirement of policy concessions from the Saudis.

Saudi crown prince likely to maintain hold on power despite Khashoggi fallout

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Although Saudi Crown Prince Mohammed bin Salman al-Saud (known as MBS) has consolidated his route to succession as king, there are unresolved political and economic conditions, exacerbated by the killing of Saudi journalist Jamal Khashoggi on 2 October 2018, that pose a low-probability/high-impact scenario of his forced removal by his family. This special report

describes these underlying political and economic conditions and the pathway to this outside-risk scenario.

Key findings

- IHS Markit assesses that MBS is likely to retain his dominant position in the Saudi government, especially as the US administration is unlikely to turn against him.
- The crown prince has fundamentally changed Saudi governance by consolidating almost all powers in his own hands, and undermined traditional patronage networks.
- Succession to King Salman, or an attempt by the crown prince to accede to the throne, having orchestrated his father's abdication, would likely create a temporary period of high risk of attempts to oust or assassinate MBS.
- The Khashoggi affair is unlikely to trigger a coup targeting MBS by the royal family; the absence of a clear successor means that such a scenario would carry a severe risk of subsequent instability. The most likely outcome is for MBS to survive the current turmoil and for him to make concessions on Lebanon, Qatar, Yemen, and the Israeli-Palestinian peace process to retain his personal credibility as an interlocutor and to maintain Saudi Arabia's strategic relationships with the United States and Europe.
- The US Congress is increasingly likely to push for dissociation from Saudi Arabia over Yemen and Khashoggi.



Saudi Crown Prince Mohammed bin Salman al-Saud attending the Future Investment Initiative conference in Riyadh on 23 October 2018.

Fayez Nureldine/AFP/Getty Images

Prior to the Khashoggi incident, IHS Markit assessed that MBS had largely consolidated his route to succession as king. Before MBS's appointment as crown prince in 2017, decision-making in Saudi Arabia required the approval of tribal leaders, the clerical establishment, large business interests, and senior royals. This led to a slow decision-making process and prolonged periods of policy paralysis. MBS has side-lined the traditional consensus-based decision-making model with the aim of speeding up both decision-taking and their implementation. MBS has concentrated under his command the authority for governance and economic policy. To date, his attempts at limited social liberalisation, including restricting the powers of the religious police, allowing women to drive, and opening up the Saudi entertainment industry, appear to have been well-received by many Saudis. MBS has pursued a series of economic and social policy changes, intended to diversify the Saudi economy away from hydrocarbons and create more jobs for Saudi citizens. To do this, he is looking to rely on the support of the Saudi youth population as a base for his modernisation programme. Structurally, this means fundamentally altering the existing social contract and welfare system, based on tribal networks of monetary patronage.

There are, however, unresolved political and economic conditions that increase the risks to a future smooth transition of power and a stable political environment. MBS was already increasingly politically exposed as a result of his decision to detain and, in effect, humiliate senior family members and businessmen on unspecified corruption charges, demanding undisclosed out-of-court settlements that began in November 2017.

The following sections explain MBS's economic modernisation efforts, the political changes he oversaw and the Khashoggi affair's effect on Saudi stability, before presenting our main forecasts for political stability and violent risks in the country.

The Khashoggi affair

Saudi journalist Jamal Khashoggi, a *Washington Post* columnist, disappeared on 2 October after entering the consulate of Saudi Arabia in Istanbul, Turkey. Since then, despite initial denials, Saudi Arabia has admitted that a team of 15 men was responsible for his murder. On 25 October, the Saudi state accepted that the killing was premeditated, rather than accidental, blaming senior officials but not MBS. The acknowledgment of a level of official responsibility followed intense

media pressure and Turkish leaks to the media that have not yet been publicly corroborated by evidence. Turkey has continued its pressure campaign, seeking to isolate MBS and weaken him, although its ultimate objective is unclear. On 26 October, Turkish President Recep Tayyip Erdoğan asked Saudi Arabia to reveal the whereabouts of Khashoggi's body. He also asked Saudi Arabia to extradite the suspects to Turkey, which is extremely unlikely to occur. This indicates that Turkey is continuing to push against Saudi Arabia to isolate and weaken MBS and reinforce Turkey's role as the United States' partner in the region. US President Donald Trump has said that he is not satisfied with the Saudi explanation so far, indicating that he believed that MBS would almost certainly have had direct knowledge of the operation to kill Khashoggi. Trump has also said that he wishes to maintain weapons sales to and relations with Saudi Arabia. Trump has said that he will defer judgement of the matter to the US Congress, which has been more critical of MBS.

The US Senate on 10 October invoked the Global Magnitsky Act to ask President Trump to name Saudi officials responsible for Khashoggi's killing in order to bring asset freezes and diplomatic sanctions against them. Senate leaders have also demanded that Saudi Arabia be held to account, with criticism of the Yemen war growing. Twelve Democrat and three Republican congressmen co-sponsored a bill on 16 October that, if passed in both houses of Congress in the face of a likely presidential veto, would force the US secretary of state to certify within 30 days that Saudi Arabia did not order Khashoggi's death as a precondition for all future arms sales and security assistance. It is worth noting that the Justice Against Sponsors of Terrorism Act (JASTA), which permits families of victims of the 9/11 terrorist attacks to sue Saudi Arabia, was passed by the House of Representatives and the Senate with overwhelming majorities in the face of a presidential veto in September 2016. This suggests that Congress will be amenable to putting pressure on Saudi Arabia, even if this is opposed by the US administration as it prioritises confronting Iran, keeping oil prices down, and working towards an Israeli-Palestinian peace agreement. This will be especially the case if CIA director Gina Haspel informs Congress that the Turkish recordings of Khashoggi's killing include a call between the killers and MBS. Haspel briefed the US president on 25 October. A hearing with Congress has not been scheduled but is likely.

The Khashoggi affair led to several governments and financial corporations reducing, or cancelling, their participation in Saudi Arabia's international Future Investment Initiative forum in Riyadh on 23–25 October, sponsored by the crown prince. No companies have, however, cancelled existing investments in or with Saudi Arabia, and most firms that announced that CEOs would not participate in the conference still sent senior executives. Saudi Arabia is highly unlikely

to cancel contracts with firms that reduced their participation; however, firms from countries deemed overly critical of Saudi Arabia would likely face discrimination in the issuance of future contracts. Western governments that are closely tied to developing and supporting the Saudi arms industry are less likely to have any national or private companies face delays with contract tendering, but this will become more likely if officials commit to public criticism of the crown prince. Chinese, Russian, and likely Japanese and Korean firms will probably continue to do business with Saudi Arabia regardless. Moreover, Saudi Arabia is unlikely to sanction or deny contracts to companies whose governments reduced their participation in the Riyadh event, given that these include the US as well as other vital Saudi partners.

Domestically, as yet, there have been no indicators that the Khashoggi affair is putting MBS's position at risk. Rather, King Salman protected his son and helped him blame officials close to MBS, while increasing MBS's responsibilities and extending them to include a review of intelligence services – the likely scapegoats in the Khashoggi affair. Moreover, the family has not yet exploited the issue to move against MBS, despite likely discontent among some senior members of the family, probably due to the clear support for MBS from the US administration.

MBS's foreign policy

Since being appointed minister of defence in 2015, MBS has sought to position Saudi Arabia as an assertive and interventionist check against Iranian expansion in the region. Despite an initial opening up to the Muslim Brotherhood, MBS has changed tack and now works hard against the spread of political Islam. Saudi Arabia saw the Arab Spring and the Muslim Brotherhood as a threat to the Al-Saud's rule. It assessed that it was necessary to enter Yemen, fearing that an ally of Iran, the Houthi movement, was on the verge of seizing control of the country. It had lost Lebanon, and its position in Syria and Iraq depended on jihadist groups that were unacceptable to its Western allies. MBS, therefore, determined that escalation was the only option. However, the decisions made under his supervision have not achieved the desired results, and have often either backfired or ended in embarrassment.

The Saudi intervention in Yemen was intended to prevent the Houthis from consolidating control over the country, with the declared objective of reinstating the internationally recognised government. The intervention has, however, become politically and economically costly, and has failed to defeat the Houthis' insurgency or stop them from firing missiles at Saudi Arabia. Saudi Arabia's diplomatic and trade boycott of Qatar in June 2017 was launched with the hope of US support for regime change in Qatar but has failed to obtain that, and it has become a frozen

dispute. Similarly, the attempt to achieve dominant influence in Lebanon by effectively detaining and coercing the Lebanese prime minister, Saad Hariri, to resign in November 2017 ended in embarrassment, with Hariri returning to Lebanon and withdrawing his resignation. Given the extent to which MBS has concentrated foreign-policy authority in himself and a select group of advisers since 2015, he has no room to shift the blame on to anyone else to appease domestic or foreign audiences.

Moreover, the Saudi response to Canada's foreign ministry tweeting in August 2018 in support of detained human rights campaigners was a display of MBS's willingness to escalate diplomatic feuds for a domestic audience. Withdrawing the Saudi ambassador and exchange students in protest bolstered MBS's nationalist credentials, but also alerted foreign investors that their contracts would be at risk should their governments criticise Saudi Arabia, criticism that is popular with voters.

Family divisions and succession

MBS ordered the detention of five senior royals in November 2017 (see **Saudi Arabia: 6 November 2017: Arrests and removals of top officials strengthen Saudi Crown Prince's succession, indicating shift from consensus-based rule**), and approximately 200 senior business and political officials, most of whom have since been moved to house arrest or released after agreeing to financial settlements. This action failed to trigger a reaction from the interior ministry, which had been led by the former crown prince, Mohammad bin Nayef, and his father, Nayef bin Abdul Aziz, for over 40 years. Similarly, there was no reaction from the Saudi Arabian National Guard (SANG), the kingdom's most effective security force, even though its leader, Prince Mit'ab bin Abdullah, was among the detainees. Mit'ab and his brothers reportedly had their assets expropriated. The SANG is often reported as loyal to Mit'ab personally, as he and his father had led it for over 50 years. That the family, including those who have strong followings in the security services, failed to move against MBS when he targeted them directly is a strong indicator that they will not move against him over the killing of Khashoggi. Moreover, MBS has consolidated his control over the security services, indicating that any move against him would likely be detected during the planning stages, even if it had US support.

Moreover, the sudden death or incapacity of King Salman would be a key trigger of a temporary increased risk, as rival royals would see this as their last chance to prevent MBS's accession to the throne. While there is likely intent for a coup by some senior royals allied with tribal leaders and security leaders, the risk is mitigated by the ability of the state's surveillance capability, MBS's

reported reliance on Egyptian and Emirati forces and mercenaries, and fear of detection. Indicators of a coup that could be detected through open sources would be detectable by the security apparatuses that are loyal to MBS. MBS is almost certainly aware of these risks and is likely making all the efforts he can to prevent them from materialising. Any arrest, trial, and execution of tribal leaders and of clerics would be unprecedented, raising the risk of popular unrest in key cities such as Riyadh, Jeddah, and Dammam targeting the interior ministry and other government buildings, and would allow militant groups to increase recruitment and divide society further. Extended unrest, or the threat of it, would also encourage a coalition of tribal leaders, royals, and officers to seek to replace MBS with a more acceptable figure from the Al-Saud family. The trial and potential execution of clerics would likely trigger terrorist attacks. Most at risk would be the entertainment industry, foreigners, security services, and MBS's advisers.

There have been persistent claims by Saudi opposition social media that MBS intends to have his father abdicate so that he can govern freely. MBS already has all the power he needs to effectively rule the kingdom, and his father's full backing, and has moved against his opponents freely. The main benefit of King Salman abdicating would be to pre-empt any possible attempt to remove MBS upon the death of the king, before his official succession. It is more likely that King Salman would double down and support MBS by abdicating than abandon the son he has groomed as his key assistant and successor.

Economic stability, but full Vision 2030 unlikely



Office buildings at the construction site of the new king Abdullah Financial District on 20 June 2018, part of the Vision 2030 economic diversification projects.

Sean Gallup/Getty Images

MBS's domestic credibility has been bolstered by an improved macro-economic environment in 2018. Since entering recession in 2017, Saudi Arabia's economy has improved and has shown an expected growth of 2.9% in 2018, in large part due to the decision to raise OPEC and non-OPEC production quotas and higher global oil prices. Higher oil prices are likely to reduce some of the immediate economic imperative that was spurring MBS's modernisation programme. IHS Markit assesses that reforms intended to increase the private sector's contribution to gross domestic product (GDP), Saudisation of the workforce, and restructuring of how the Public Investment Fund (PIF), the country's sovereign wealth fund, manages its assets will continue. These reforms are all aims of the National Transformation Plan 2020 and Vision 2030 programme, but the ambitious objectives set are likely to prove difficult to fully achieve.

The November 2017 arrests likely have discouraged Saudi businessmen from bringing wealth held abroad into the country. Moreover, local businesses are likely to be concerned about the subversion of the rule of law indicated by the detention of princes and senior businessmen. It appears most of the November 2017 detainees were released in exchange for payments to the Saudi treasury, with very little by way of due process taking place. This hampers the government's effort to implement Vision 2030. The result will likely be that MBS relies less on consent and more on coercion to maintain his rule.

This will harm efforts to reduce the economy's dependence on oil and its reliance on the public sector for growth and employment. According to IHS Markit economic data, although Saudi Arabia's portfolio investment outflow in 2018 is, at USD12.3 billion, at the highest level since 2014, it is offset by a portfolio investment inflow of USD24.2 billion. IHS Markit forecasted before the Khashoggi affair a net portfolio investment of USD11.9 billion in 2018, which was expected to increase to USD13.6 billion in 2019, an indicator of continued confidence in MBS's reform programme. Such flows of capital, however, are vulnerable to shifts in investor confidence. Foreign direct investment (FDI) into Saudi Arabia increased from USD1.4 billion, or 0.2% of GDP, in 2017 to an expected USD8.8 billion in 2018, equivalent to 1.1% of GDP, and this is far off the stated goal of Vision 2030 to achieve inward FDI equivalent to 5.7% of GDP.

There are indications that MBS is undermining his own programme; following the Khashoggi killing, tens of media and technology companies pulled out of the Future Investment Initiative

conference in October (as noted above). Of the more than a dozen major deals reportedly signed on the first day of the conference, worth an estimated USD50 billion, many were memoranda of understanding (MoUs) with no definite commitment, and the majority were in the hydrocarbon and petrochemicals industry – not the new sectors on which MBS has staked his aim of increasing the percentage of Saudi citizens in work. That said, investments in minerals, hydrocarbons, and infrastructure are sufficient to maintain the current Saudi model, which relies on the state redistributing energy export revenues to the country's citizens.

Outlook and implications

Our baseline forecast remains that MBS is most likely to remain in place and eventually succeed his father. There is a low likelihood of MBS being assassinated, which would carry the risk of bringing chaos to Saudi Arabia as a result of the lack of a clear successor. However, MBS's control over the security services and his father's support indicate that he will remain in place. The only game-changer would be the US administration demanding that the Saudi king and royal family dismiss MBS, which is highly unlikely to occur. In such an outside-risk scenario, MBS would be likely to contest his removal forcibly, leading to fighting between different security apparatuses in Riyadh and at his secure accommodation at that time, likely in Jeddah.

The threat from the family and from the US is a likely incentive for MBS to convince his father to abdicate the throne voluntarily, in the hope that his doing so will allow MBS to consolidate his position under his father's tacit approval, while the latter is still alive. Furthermore, it is likely that MBS will be forced to make some foreign policy concessions to appear less reckless and easier to work with, such as attempting to reconcile with Qatar, reducing the intensity of the aerial bombing campaign in Yemen, and, less likely, encouraging Lebanese parties to make concessions to Hizbullah to facilitate the formation of a cabinet. MBS's preferred option would be to facilitate economic, cultural, and political exchanges with Israel, in order to improve his image and maintain his close ties to the Trump administration.

Following the killing of Khashoggi, and a likely prolonged period of congressional scrutiny of MBS's decision-making, US policy towards Saudi Arabia is likely to become less coherent, varying between pushing Saudi Arabia to award the US contracts in defence, energy, and infrastructure and seeking to punish Saudi Arabia for intervention in the Yemen war and for Khashoggi. Should the US Congress pass legislation targeting Saudi Arabian arms purchases, this would signal a more permanent break in relations that would be destabilising for Saudi Arabia and obviously

detrimental to US business interests. It would also be a trigger for royals and/or military officers who could challenge MBS and attempt to remove him, raising instability risks.

Finally, the unintended weakening of private-sector confidence makes it less likely that the government would fully succeed in its economic objectives, including raising the share of non-oil exports in its non-oil GDP from 16% to 50%. This would occur, as mentioned above, at a time when it has also weakened traditional patronage networks. The Khashoggi affair acts as a further dampener, making it less likely that investment outside of natural resources and infrastructure would come into the country, and therefore making it less likely that the government would succeed in its economic diversification plan, which is the pillar of its jobs creation strategy for the private sector.

Brazil: President-elect's challenges

31 Oct 2018 - Country Risk | Strategic Report

Brazil elected far-right candidate Jair Bolsonaro as president on 28 October; he secured a relatively strong mandate after garnering 55.2% of the vote, against 44.8% for his left-wing rival Fernando Haddad of the Worker's Party (Partido dos Trabalhadores: PT). Representing the Social Liberal Party (Partido Social Liberal: PSL), a party he joined just a few months ago, Bolsonaro, a former Army captain, rode successfully on a campaign focused on combating crime and corruption. He combined this with a socially conservative message and support for an economically liberal agenda, which has been welcome by the markets.

Bolsonaro, who lacks government experience, is now facing the challenge of switching from being the perennial right-wing political campaigner to that of president of the world's fourth-largest democracy. To provide business confidence as well as guarantee credibility with investors, financial markets, and the industrial sector he will need to clarify his stance on crucial issues such as privatisation and pension reform, on which he has been very ambivalent. The president-elect has the scope to guarantee governability, enjoying strong popular support and a favourable background to assemble a working majority in Congress.



Bolsonaro, far-right lawmaker and presidential candidate of the PSL, gestures after casting his vote in the presidential election on 28 October 2018 in Rio de Janeiro, Brazil
Buda Mendes/Getty Images: 1054587968

- **The new Congress will be Brazil's most fragmented in history, with 30 different parties in the Lower House and 21 in the Senate. Nonetheless, several factors work in Bolsonaro's favour.** Firstly, the new Congress is the most conservative in decades, with strong representation of the conservative groups representing security, protestant churches, and agribusiness, known as the BBB caucus (Bullet, Bible, Beef); these sectors are likely to align with Bolsonaro. Secondly, Brazilian centrist parties tend to support the government of the day in exchange for specific posts and budget allocation for the constituencies they represent. Meanwhile, Brazil's industrial and financial sectors are highly supportive of Bolsonaro's announced economically liberal agenda. Federal Deputy Onyx Lorenzoni, who will be Bolsonaro's chief of staff, anticipates counting on the support of approximately 300 deputies. In the 513-member Lower House a simple majority of 257 is needed to pass an ordinary law; however, for constitutional amendments such as the pension reform, support of 308 deputies and 49 senators is needed. If these claims are accurate they would place Bolsonaro's government in a strong position to secure command of the Lower House and potentially the

Senate, although this will be subject to his willingness and flexibility to negotiate with other parties.

- **Bolsonaro has indicated that he supports austerity, but his stance on pension reform is unclear, while his backing of the privatisation of important state-run companies appears unlikely.** Markets have reacted positively to Bolsonaro's presidency, but it reflects more relief that left-wing Haddad failed to get elected than total certainty over Bolsonaro's full commitment to a pro-business agenda. He has been sending mixed signals; he has committed to austerity but failed thus far to come up with a credible plan for the critically important pension reform; he has also ruled out the privatisation of state oil company Petrobras and Brazil's largest utility company Eletrobras. This is contrary to his advisers' initial claim that he supported privatisation across the board. This raises the question of whether Bolsonaro's economic liberalism reflects more the views of his economic adviser Paulo Guedes than his own.
- **Three factions will vie for influence in the Bolsonaro government: liberal-minded politicians and economists, the military, and Congress backbenchers.** The Brazilian press reported several disagreements between these groups during the campaign. Bolsonaro has indicated that the position of agriculture minister will go to a representative of the agribusiness caucus. The minister for trade and industry is likely to be someone with an industrial-sector background. Additionally, some centrist parties will demand important positions in return for guaranteeing Bolsonaro the necessary parliamentary voting support. The military will probably be given control of the Ministry of Infrastructure and even the Ministry of Education. The prevalence or not of these factions will shape policymaking under Bolsonaro; already the pressure from them has forced Bolsonaro to reconsider plans to merge ministries and reduce their number from 29 to 15. He had promised to merge the Ministries of Agriculture and Environment, but relented later after agribusiness leaders warned him that this could bring sanctions on Brazilian food and grain exports. However, on 30 October he announced that the merger would go ahead. He has backtracked on pledges to abandon the Paris Climate Change Treaty due to pressure from the agribusiness caucus. Industrialists also met Bolsonaro recently and lobbied for the Ministry of Trade and Industry to continue to exist – the president-elect had promised to merge it with the Ministry of Finance and Planning, creating a "super Economy" Ministry.

Indicators of changing risk environment

- Bolsonaro fails to reach deals with centre-right parties after refusing to grant them the cabinet posts they demand; this leave his government in minority in Congress.

- Infighting erupts in the budding government coalition over Guedes' plan to push for an ambitious privatisation programme and his call for the adoption of the pension reform promoted by outgoing President Michel Temer.
- Potential government allies fall out with Bolsonaro and his PSL over the presidency of the Lower House.
- Bolsonaro unveils a cabinet made up of highly respected figures from the business sector and academia, which indicates he will provide continuity to the fiscal reforms started under the Temer government, including the pension reform.

Sri Lanka's constitutional crisis

31 Oct 2018 - Country Risk | Strategic Report

On 26 October, Sri Lankan President Maithripala Sirisena dismissed Ranil Wickremesinghe as the country's prime minister after the president's Sri Lanka Freedom Party (SLFP)-led alliance withdrew from the ruling coalition with Wickremesinghe's United National Party (UNP)-led bloc in parliament. Within hours of the announcement, Sirisena appointed former president Mahinda Rajapaksa as Sri Lanka's new prime minister.



Sri Lanka's newly appointed Prime Minister Mahinda Rajapaksa offers prayers in Colombo on 29 October 2018.

Ishara S. Kodikara/AFP/Getty Images

Sirisena justified his decision to remove Wickremesinghe by citing large-scale government corruption by UNP leaders and economic mismanagement. Sirisena also claimed that the UNP had blocked efforts to investigate a plot to assassinate him, and even alluded to accusations that a senior unnamed UNP minister was directly involved in the conspiracy. While Rajapaksa has begun to consolidate his control of the prime minister's office, Wickremesinghe insists that he remains prime minister, with senior UNP ministers describing Sirisena's decision to dismiss the prime minister as unconstitutional.

- **The next parliamentary session is likely to be crucial; both sides will seek to demonstrate a parliamentary majority.** The UNP claims to hold a majority in parliament despite the SLFP-led alliance's withdrawal from government, but Sirisena has delayed any parliamentary sitting until 16 November in a probable attempt to buy time for Rajapaksa to secure broader parliamentary support. According to the Sri Lankan parliament's official website, the UNP-led alliance holds a greater number of seats (106) than the SLFP-led alliance (95) in the 225-member parliament. However, the declining public popularity of Wickremesinghe's economic policy – which has led to high inflation, a deprecating currency, and increasing living costs – will probably encourage non-aligned parties to abstain and fringe UNP members to defect to the SLFP. Crucially, it is highly unlikely that Sirisena would have appointed Rajapaksa without confidence that he could demonstrate a majority in parliament.
- **The constitutional crisis is likely to extend and deepen if SLFP fails to secure a majority in parliament.** Should the SLFP successfully demonstrate a parliamentary majority, the crisis will to a large extent de-escalate. Although the UNP would almost certainly challenge Wickremesinghe's initial dismissal at the Supreme Court, this would not immediately threaten the stability of an SLFP government. Instead, the UNP's legal challenge to Wickremesinghe's dismissal would likely run concurrently while the SLFP governs. However, failure to demonstrate a majority would represent a major defeat for Rajapaksa, Sirisena, and the SLFP more broadly. In this scenario, Sirisena would theoretically be forced into re-appointing Wickremesinghe – a move that the president would probably oppose. In either case, early parliamentary and provincial elections are increasingly likely as this would be perceived a solution to the crisis and would also present Rajapaksa with an opportunity to capitalise on his public popularity to improve the SLFP-led coalition's parliamentary presence.

- **Economic policy-making is likely to stall in the three-month outlook, but a long-term SLFP government would significantly shift away from policies intended to attract foreign investment.** The budget for 2019 was due to be presented in parliament on 5 November, but is now unlikely to be debated until early 2019. According to local media reports, a smaller budget to ensure the day-to-day functioning of government will be presented for the first three months of 2019 instead. More broadly, if the SLFP secures its hold on government – particularly after a decisive parliamentary election – economic policy would increasingly divert away from the UNP's preference for foreign direct investment (particularly from India), privatisation, and macroeconomic stabilisation. During its previous tenures in power, the SLFP instead focused on increasing government subsidies – particularly fuel – and protecting local industries, which would indicate an increase in government expenditure. This in turn would threaten to further increase the budget deficit, which rose to 5.3% in fiscal year 2018 and thus exceeded the government's expectation of 4.8%, according to the central bank. Moreover, it is likely that an SLFP-led government would additionally seek to initiate anti-corruption investigations against UNP leaders while also scrutinising contracts that were agreed under the coalition government.
- **Largely peaceful protests are likely in Colombo ahead of a parliamentary session, but these are unlikely to escalate or spread unless the SLFP cannot demonstrate a parliamentary majority.** Wickremesinghe has to date refused to vacate the prime minister's residence, while other senior UNP cabinet members have continued to report at their respective ministries in Colombo amid protests by pro-SLFP supporters. On 28 October, one protester was shot dead and two others wounded when a UNP minister's personal guard shot at a pro-SLFP crowd at the Ceylon Petroleum Corporation office in Dematagoda in Colombo. However, we do not assess that this is indicative of broader violent unrest, although further protests involving up to hundreds of people are likely ahead of the parliamentary session. These are likely to occur primarily around the parliament building in Kotte, the prime minister's residence in Colombo, and the central administrative district of Colombo. If Rajapaksa cannot demonstrate a parliamentary a majority, the risk of broader nationwide violent unrest will increase, most likely involving fighting between pro-SLFP and pro-UNP activists in the country's south and northwestern areas.

Indicators of changing risk environment

- Further delays to the parliamentary session on 16 November would indicate a lack of confidence from Sirisena that the SLFP can show a majority in parliament, increasing the risk of further political uncertainty and violent protests.

- Comments by the Attorney General Jayantha Jayasuriya suggesting that Sirisena's dismissal of Wickremesinghe was unconstitutional; this would indicate that an SLFP government would be vulnerable to a UNP legal challenge.
- UNP parliamentarians announcing their defection to the SLFP would increase the likelihood of Rajapaksa consolidating control of government.

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