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## Eurasia Group president outlines top five political risks coming from Washington

NEW YORK, 23 March 2009—The recent outcry over AIG and executive compensation sets the stage for a significant number of political risks emanating from Washington, says Eurasia Group President Ian Bremmer in his weekly note to clients today. “President Obama expanded the likelihood of backlash by taking a strong opening position against the bonuses, increasing the vulnerability of his own Secretary of Treasury Tim Geithner and, more problematically, opening the floodgates for congressional overreaction to popular anger.” Dr. Bremmer calls this “the first significant policy misstep of the Obama administration.”

In January, Eurasia Group identified the US Congress as the top global political risk for 2009—a risk that Dr. Bremmer today says is “considerably more evident after the events of this past week.” In his note, Dr. Bremmer outlines the five US-driven risks and one red herring that threaten to cause further instability in the US and undermine attempts at economic recovery.

- 1) **Toxic asset plan’s failure to attract participation:** The timing of the Obama administration’s unveiling of a new plan for toxic assets—parts of which require taxpayers to assume as much as 97% of the risk—may prove “radioactive” in the current political environment.
- 2) **Ad hoc overregulation:** The struggle between both houses of Congress and the Obama administration to take ownership over executive compensation policy underscores the risks of a delayed and overreaching response to the current crisis, which will be played out on a host of financial regulation decisions in coming weeks.
- 3) **Diminished US global competitiveness:** The implications of restrictions on the financial industry as well the potential to tax corporations to raise necessary revenue will affect the competitiveness of US businesses and the US as a business destination in the long term.
- 4) **Domestic focus resulting in a lack of global coordination:** The US absence from the global stage due to domestic preoccupations will restrain its ability to coordinate globally, and creates a collective action problem as other nations postpone their economic policy responses to see how the US bailout takes shape.
- 5) **Fear of the Fed:** Independent actions by the Fed, which will have far reaching effects on the economy, may draw more oversight and scrutiny from Congress.

**Red Herring—Protectionism:** One serious risk that can be downplayed is a global trade war.

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The full text of Dr. Bremmer's note, including more detail about the above risks and red herring, follows this release. For more information and interview requests, please contact Ms. Alex Lloyd at 646.291.4036 or [media@eurasiagroup.net](mailto:media@eurasiagroup.net).

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[Start of note]

### **The United States: Top five risks and a red herring**

Written by Ian Bremmer, 23 March 2009

Back in January, we listed the US Congress as the top global risk for 2009. That's considerably more evident after the events of this past week. Indeed, I'd be hard pressed to pick a better week to make the point... except perhaps for the week coming.

The combination of the deepest recession of the post-war period, an overwhelmed Obama administration, an extremely unhappy domestic population, and trillions of dollars of bailout and stimulus expense virtually guaranteed that congressional politics would trump economic policy. The tipping point came last week. Specifically on the revelation that, after acquiescing to a \$170 billion bailout of insurance company AIG, Congress's quickly drafted stimulus rider governing executive compensation covered only compensation arrangements after the financial stability plan was unveiled... not those bonuses guaranteed by contract beforehand.

President Obama expanded the likelihood of backlash by taking a strong opening position against the bonuses, increasing the vulnerability of his own Secretary of Treasury Tim Geithner and, more problematically, opening the floodgates for congressional overreaction to popular anger (creating, ironically, the first bipartisan bill to come out of the new house of representatives—undoing the AIG bonuses through the tax code).

This was the first significant policy misstep of the Obama administration (though he's been blamed in many quarters for a too-gradual approach to the financial crisis, that's more a matter of degree)—on previous episodes of congressional populism, like the protectionist impulse, Obama's response has been more balanced, and accordingly he has served as a moderating influence.

Geithner's probably still safe for now (shored by President Obama preemptively saying he "wouldn't accept" a resignation over the weekend). But there's a hornet's nest of political risk now emanating from Washington. Given that, it seems well worth a broader look into the risk environment at both ends of Pennsylvania Avenue. I've listed what we see as the five top risks below (in descending order of importance/likely impact)... and though not exactly balancing them out, I've ended with a red herring.

#### **1) Bank rescue fails to attract participation**

The Obama administration appears set to launch its "toxic assets" program in the midst of a strong congressional (and public) backlash against the financial services industry as a whole; a climate that may not have the room for nuance the administration tried to push this weekend

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when Obama surrogates took to the airwaves trying to draw distinctions between AIG and "good guy" financials that would be subsidized to come to the rescue. The unveiling of further details about the plan should be a net plus-except that parts of the plan call for the American public to take as much as 97% of the risk, an all but radioactive proposal in the present political environment.

Created under massive time pressure and in the absence of critical staff, Treasury Secretary Geithner's broad framework will take months to implement and will still require many details to be finalized. But by pushing forward with the plan on the heels of the AIG bonus flap, the administration is drawing attention to the fact that it's not just American banks receiving major taxpayer subsidies but also a multitude of others (including foreign banks, hedge funds, and other financial institutions). Congress won't be able to stop the administration, but it can potentially attach compensation rules and disclosure requirements to anyone in the process, scaring away participants and causing other unintended consequences... causing the plan to fail.

The related risk from this conflict is that it generates a heavy political focus on how the American taxpayer will be made whole in the event that bailout investments have no upside. That focus might in turn promote ideas such as future fees on the financial industry (which the Obama administration has cautiously mooted). It's easy to see how such a policy stance could unravel—Congress laying down markers that it has no intention of giving the White House any more money, causing public confidence in the administration's handling of the crisis to fall further, dragging with it much of the rest of Obama's agenda. Relations between the legislature and the executive could then deteriorate into veto threats and boisterous grandstanding as Treasury Secretary Geithner (and, by association, the administration) is linked to Wall Street, while members of Congress try to distance themselves from donations received from financials. Progress on the bailout/economic recovery would stumble badly in that instance, and the economic and financial crisis would persist amid inaction.

## 2) Ad hoc overregulation

The broader lesson of the executive compensation fiasco is that Congress and the administration appear willing to revisit the same issue over and over again. With an eye toward the tough battle over executive compensation that had jeopardized initial TARP authorization last October, the new administration released executive compensation guidelines in early February. Senator Chris Dodd (D-CT) then tried to one-up President Obama through a stimulus package rider, only to find that both approaches still left Congress and the administration politically exposed on many bonuses—which existed before but went unnoticed/unremarked upon in a less agitated political environment. Now, with the US media and public squarely focused on the issue, Congress is struggling to take ownership (and avoid culpability), while the Obama administration has announced that it wants executive compensation to be part of its broader financial regulation package to be unveiled before the G20 summit.

The moral of the story: hasty policymaking leads to hasty policy re-making, each time with a broader reach. This scenario is likely to be played out through a number of banking regulation issues in the weeks ahead. The only certainty is Congress will want laws that are sufficiently tough that the current mess "never happens again," which will generate legislation that restricts the latitude of businesses and financials to act in the future environment, creating greater economic inefficiencies accordingly. Which leads us to...

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### 3) Diminished US global competitiveness

Changes in the overleveraged and insufficiently regulated markets of the last decade (what I've elsewhere called fetishized hypercapitalism) are clearly warranted. But even the small amount of legislation passed thus far indicates that likely inefficient and over-zealous regulation will hinder the competitiveness of American businesses and of the United States as a business destination over the long term.

In a sense, TARP recipients are becoming a policy laboratory, where issues that particular members of Congress have long promoted are now being applied to a specific group of people and businesses that have been so publicly discredited that they no longer have an effective domestic lobby. Public restrictions on private compensation are not a new idea in Congress—but they also weren't plausible outside of the current environment. This is similarly the case with recently passed restrictions on the ability of certain banks to hire H-1B visa holders. In short, legislation that couldn't have passed previously can now be made into law, at least when restricted to TARP recipients—important in that this disempowered group still holds the reins on the finances needed to spur economic growth. There is a risk that similar legislation appears in foreign countries (as Germany's Angela Merkel recently commented favorably about the proposed congressional bonus tax legislation), dampening global economic growth... there's also a risk that it doesn't, and the American role in the global financial system is accordingly diminished.

There is also an emerging tension between banks and the corporate world that relies on them for financing. As the cost of the bailout rises, increasingly large deficits will cause the US government to seek new ways to raise revenue. Corporations are increasingly leery that they will bear the cost in the form of higher taxes and higher costs for financial services (such as a proposal to eliminate overseas tax deferral) that increase their cost of doing business relative to foreign competitors. The broader risk is that this drives US-headquartered companies to incorporate overseas, further depriving America of that tax revenue, causing the cycle to repeat itself.

### 4) Domestic focus results in lack of global coordination

The Obama administration has been relatively absent on the global economic stage because of the overwhelming urgency of focusing on domestic aspects of the economic crisis—racing against time to push bailout initiatives and political appointees through an increasingly combative Congress. This insufficient capacity to coordinate globally is creating a collective action problem in the international context—other countries are less likely to determine the extent of their own bailouts until the United States makes clear its own.

There's also a second order risk brewing here—those foreign banks benefitting from US taxpayer funded actions (such as the French and German banks on the receiving end of the US AIG infusion) are more likely to enter congressional crosshairs absent global burden-sharing. I suspect that's one of the next areas of focus after we get through the bonus flap.

### 5) Fear of the Fed

As the US Federal Reserve stands to gain additional authority as the systemic risk regulator, it's

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worth considering the possibility that Congress actually turns against the Fed. House speaker Nancy Pelosi (D-CA) was quoted last week saying that the AIG debacle started when "the chairman of the Fed [announced it] would be making this big infusion of cash into AIG without any prior notification to us. We didn't even know [the Fed] had that kind of money." Last week while Congress waged battle over a couple hundred million in bonuses, the Fed increased its balance sheet by \$1.1 trillion (I can't help but wonder if the third in line to the US presidency now understands that the Fed has as much money as it wants...). More broadly, the actions the Fed has taken independently in recent days will have far reaching effects on the economy... which will also raise the risk of more oversight and scrutiny on that institution.

### **Red herring - Protectionism of mass destruction**

There is one serious risk I think we can downplay—a global trade war. The past months have brought all sorts of fears of growing US protectionism and the spiraling international reaction. And a wide array of localized protectionist measures have been taken around the world—indeed, the world bank has counted about 50 trade restrictive actions and only a dozen liberalizing ones since the G20 countries promised to forestall protectionism last November. To list just a few examples—multiple countries have given low cost or no cost cash to their automakers; the United States has restricted stimulus procurement to a subset of countries under a "Buy American" provision; in response to US cancellation of a Mexican trucking program that country has put over \$2 billion in tariffs in place on trade with the United States.

But thinking about the magnitude rather than the quantity of events uncovers that this is more conventional, rather narrow protectionism than the opening salvos of a trade war. Certainly in the United States, the highest stakes for protectionism are around the automotive sector (after all, the millions of jobs potentially at stake would undo the Obama administration's job preservation goals in one swoop). But there has been no serious suggestion of raising tariffs on foreign autos, and congressional votes and nationwide polls have made clear that there is no public will to keep the industry alive through massive subsidy. If the auto sector—where unionized labor and management could easily point to foreign competition as a cause of its problems—is not enough to merit nuclear protectionism, what is?

Nothing, probably. The biggest silver lining to the economic and financial crisis in the United States is that it has very little to do with globalization. To date, there has been no blaming foreigners; rather, the recession has been a story of domestic greed and poor oversight. Certainly, as Americans feel poorer, the risk of redistribution from the have-lots to the have-littles increases. But it's not a backlash against interconnectedness, trade, or global supply chains.

To be clear, the risk of a global trade war remains if the recession doesn't bottom out. And I certainly see more tit-for-tat protectionism internationally (especially out of Beijing, where economic nationalism is on the rise) as an unintended consequence of US policy. But absent a depression scenario, the near-term likelihood of an all-out trade war is small.

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Looking at the broader US picture, if there's good news here it's that unlike when we wrote about the top risks in January, I think there's now real market focus on the dangers. Last week, we convened a roundtable of some of our corporate risk management and government relations

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clients who said in unison that their attention is now (and for the first time) primarily focused on Washington. Our investment clients are making the same point. [End of note]

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Eurasia Group is the world's leading global political risk research and consulting firm. Since 1998, it has helped clients make informed business decisions in countries where understanding the political landscape is critical. The firm's research analysts are trained social scientists with post-graduate degrees, extensive professional experience, and a diverse range of language capabilities. Headquartered in New York, it also has offices in Washington and London, as well as a network of experts around the world. For more information, please visit [www.eurasiagroup.net](http://www.eurasiagroup.net).

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