



Peter Apps, Political Risk Correspondent.

+44 20 7542 0262 peter.apps@thomsonreuters.com

RISKS TO WATCH

WESTERN EUROPE

Western Europe faces one of its most challenging years in recent memory in 2011, with pushing through painful austerity measures in the face of unrest and likely divisions on handling the euro zone debt crisis. While almost all Western European countries are under some market pressure to rein in deficits, the fringe economies dubbed the PIIGS - Portugal, Italy, Ireland, Greece and Spain - remain most in focus. Almost all European countries have seen an increase in strikes, protests and unrest during the financial crisis and it looks set to get worse in the coming year.

HERE IS A SUMMARY OF THE POLITICAL RISKS TO WATCH IN WESTERN EUROPE:

TROUBLED EURO ZONE FRINGE

For Ireland and Greece - forced to seek a bailout from the IMF and European Union - the key question will be whether the tough associated austerity measures prove politically sustainable.

For the others, the question is whether by cutting spending and controlling banking problems they will be able to persuade markets they can do without a bailout. For Europe's richer central core nations, the debate remains how much support is genuinely available and what strings are attached.

Whether sparked by unrest or other political issues, political wobbles will likely not only push borrowing costs higher but could ripple into wider European or even global markets.

What to watch:

- Whether bond markets and credit ratings agencies keep up the pressure on euro zone fringe states will have much wider social, political and market implications. So far, market pressure has tended to return even to countries that had been seen to have tackled the crisis, such as Ireland. There have already been signs of investors turning on Belgium. Do other countries come into focus?
- Will the political consensus around austerity in the PIIGS begin to break down? Do other euro zone countries and Britain push on with spending cuts or do they move back towards stimulus mode to avoid renewed recession?

FUNDAMENTAL CHALLENGES

EU policymakers are increasingly upfront that the bloc faces fundamental questions over its future that go well beyond short-term problems with Greece, Ireland or elsewhere. European Commission President Jose Manuel Barroso told EU leaders at a meeting in December problems were "systemic", while the IMF has said the EU's current country-by-country crisis response measures were inadequate.

At a two-day summit, leaders agreed a change to the EU treaty to create a permanent financial safety net from 2013, although market concerns remained over whether the bloc



Demonstrators carry cartoons of Ireland's PM Brian Cowen and Finance Minister Brian Lenihan. Reuters/Cathal McNaughton.

had enough immediate funds to aid troubled countries next year.

In the longer run, some analysts say the bloc must either move towards a broader fiscal union or risk fracturing altogether. Some leaders including Italy's Silvio Berlusconi back the idea of common euro zone bonds - something Germany's Angela Merkel vehemently opposes.

What to watch:

- If other countries such as Portugal or Spain need bailing out, is there sufficient money or does the euro zone need to put together another crisis fund? Does pressure grow to make private bondholders take serious "haircuts" through restructuring debt?
- Does pressure grow for euro zone bonds despite German opposition?

SOCIAL UNREST

So far, while demonstrations have won occasional small concessions they have largely failed to impact the wider policy Greece, which saw widespread rioting on several occasions, including demonstrations in May in which three people died in a burning bank, is seen most at risk.

KEY DATES

Early 2011
Irish national election likely to be held.

May 5, 2011
Referendum on Britain's voting system and local government elections.

March 2012
Latest date for Spanish elections.

April 2012
French presidential election.

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REUTERS

Britain saw its worst rioting in two decades in December over proposed student fee rises, with more expected next year as spending cuts begin to bite. However, to date, the coalition government has not changed course.

In contrast, Ireland has seen mass street demonstrations but almost no violence despite some of the toughest cuts in Europe widely seen as a sign that, as in many emerging European economies, society has largely accepted austerity.

France saw major demonstrations against proposed pension reform, and could see more in the run-up to elections in 2012, although the government pushed through its pension changes despite the protests.

Italian rioters fought running battles with police in the streets after Prime Minister Silvio Berlusconi won a no-confidence vote, while Spain declared a "state of alert" to force striking air traffic controllers back to work.

What to watch:

- Do protests come together into a wider European anti-austerity movement or remain fragmented, largely the preserve of individual interest groups? In Britain, do students become a core part of a wider protest cause or disappear politically now the fees vote is passed?
- Signs in any country that social protest has forced the reversal of austerity policy might give heart to demonstrators elsewhere but could concern markets.
- Unions will likely be more focused on ousting the centre-right government such as those in Britain, France or Italy rather than left of centre ones in Greece, Portugal or Spain.

ELECTIONS, GOVERNMENT TENSIONS

Forcing through such painful austerity measures would test even the most resilient government, and many of Europe's are dealing with mounting domestic political problems of their own as well as looming elections that will affect policy-making.

The political temperature in France looks set to rise ahead of its 2012 presidential poll, in which President Nicolas Sarkozy will face a Socialist challenger that could be the current IMF chief Dominique Strauss-Kahn. That, together with the rising risk of unrest, looks likely to deter Sarkozy from further reforms.

Spanish Prime Minister Jose Luis Rodriguez Zapatero could struggle to make it as far as scheduled polls in 2012 if he loses the support of key minority parties such as The Basque Nationalist Party.

Italian Prime Minister Silvio Berlusconi survived the latest no-confidence vote in December, but many analysts believe he will face the electorate next year after losing the support of key allies.

German Chancellor Angela Merkel will be closely watching local elections, keen to avoid losing further power. Portugal's Socialist minority government is seen constrained by its need to keep other parties onside. In contrast, Greece's Socialists seem relatively well ensconced in power despite protests.

Britain's Liberal Democrat-Conservative coalition - its

first in decades - is seen as relatively likely to survive, with junior partner the Lib Dems now so unpopular they have too much to lose to trigger elections.

What to watch:

- Ireland is seen almost inevitably facing a change of government when elections take place early this year. But will the opposition Fine Gael party stick with the current austerity plans?
- Any new signs of coalition strains in Britain or elsewhere might spook markets.

OUTSIDE RISKS

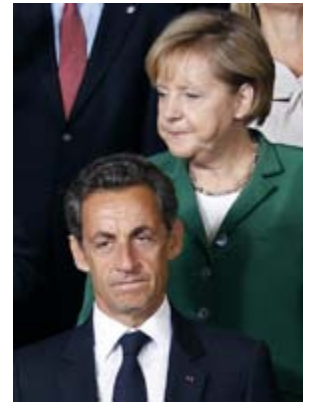
While Europe's own political problems look set to preoccupy many in its markets, European investors also face a host of outside political risks during 2011.

While the risk of a debt crisis in emerging Europe affecting richer European countries looks much lower than it did a year ago, analysts warn rising geopolitical tensions between China and the United States over currency and other issues could hit the wider global economy.

Conflict in the Middle East around Iran's nuclear programme or on the Korean peninsula would likely also have a knock-on effect on European markets, while overseas European firms face mounting competition from rivals from emerging economies.

What to watch:

- Are any military clashes in the Middle East or Korea limited in nature or sustained? Markets might be able to shrug off limited action, but any long-term impact on oil supplies or Asian growth would be much more serious.
- Is Europe dragged into a wider currency stand-off between the United States and emerging economies? So far, European policymakers have kept largely to one side and the euro has tended to be a beneficiary of dollar weakness.



Germany's Chancellor Angela Merkel and France's President Nicolas Sarkozy. Reuters/Francois Lenoir

