



*Nomisma*

# The World in 2018

EDITED BY ANDREA E. GOLDSTEIN & JULIA K. CULVER



INSTANT BOOK 2018

### **Andrea E. Goldstein**

Andrea E. Goldstein is Chief Economist and Secretary of the Scientific Committee of Nomisma. He joined Nomisma in October 2015, after a 23-year career in global governance, at the OECD, the UNESCAP Subregional Office for East and North-East Asia, and the World Bank Group. Andrea has published widely on emerging economies, is a regular *Il Sole 24 Ore* columnist, and an Adjunct Professor at the Catholic University of Milan. He is also Past President of the Bocconi Alumni Association, Paris, and participates in the activities of Aspen Italia.

### **Julia K. Culver**

Julia K. Culver is a Senior Researcher at Nomisma, where she engages in international research and evaluation projects. Prior to moving to Italy, she worked at East-West Center, IDA and CSIS in the United States. Julia follows research and innovation policy, renewable energy and sustainable production and consumption in developing and emerging countries, and EU policy and regulatory reform. She graduated with honors (*Phi Beta Kappa*) from Vassar College, studied at the University of Freiburg and SAIS, and has a Master of Science of Foreign Service from Georgetown University.

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**JULIA K. CULVER**

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**Nomisma Società  
di Studi Economici SpA**  
Strada Maggiore, 44  
40125 Bologna  
tel +39 051 6483111  
fax +39 051 232209  
www.nomisma.it

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**Edited by**  
Andrea E. Goldstein  
Julia K. Culver

**Formatting**  
Patrizia Gozzi

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## THE BROAD PICTURE

## AGRICULTURE IN 2018

The achievements of the Millennium Development Goals (MDGs) in reducing poverty and hunger have been impressive, but uneven. Despite the concerns about the food price spikes registered in the 2007-2012 period, in 2015 we were able to celebrate the fulfilment of the First Millennium Goal, i.e. halving the proportion of undernourished people compared to the 1990 level. This outcome gave momentum to the adoption of the Sustainable Development Goals (SDGs) that are even more ambitious than the MDGs.

We should acknowledge, however, that despite the progress that has been made, large regional discrepancies and pockets of extreme poverty still exist. In addition, the combined effects of conflicts and extreme weather phenomena threaten to reverse the declining trend in the number of people suffering from hunger. According to the Report “The State of Food Security and Nutrition in the World 2017” (FAO, IFAD, WHO, WFP and UNICEF), in 2016 the number of chronically undernourished people in the world was estimated to have increased to 815 million, up from 777 million in 2015 although still down from about 900 million in 2000.

Meanwhile, the landscape of global development policy has radically changed in recent years. In 2015, three crucial events – the Addis Ababa Conference, the UN Sustainable Development Summit in New York and the Paris Agreement on Climate – contributed to the establishment of a totally renewed global Agenda for Sustainable Development.

In this context, achieving ‘no poverty’ and ‘zero hunger’ by 2030,

i.e. the targets of SDGs 1 and 2, appears to be a challenge of unprecedented magnitude, requiring a fundamental change in approach and mind-set.

With regard to the implementation of the revised global development agenda, 2018 could be a turning point. We are concerned about the first signs of a reversal in the trend in the number of chronically undernourished people in the world, but we also have new tools to address this concern.

The 'Goal Approach', which shapes the twenty-first century endeavour to eradicate hunger and poverty, entails two interconnected principles: 'bottom-up multilateralism' and a systemic approach. The first principle means that there are no 'one-size-fits-all' solutions. We should be aware that the pathway to achieving global goals goes mainly through context-specific and 'bottom-up' measures. The EU rural development policy can be considered a landmark in this respect. The second principle means that eradicating poverty and hunger is a multidimensional issue, to be addressed by leveraging many 'pressure points' simultaneously, i.e. acting on agriculture, social policies, health, environment, education and trade.

This said, agriculture continues to play a key role in addressing the challenges of development and should be seen also as an important sector for implementing a strategy for climate change mitigation and adaptation. From an economic perspective, we need to remember that the most forgotten and invisible people, the poorest of the poor, live in rural areas. These are areas where small-holding farmers account for almost all economic activities and businesses, supply and demand, production and consumption. From an environmental and climate perspective, agriculture is a critical sector, dependent on the interaction of only apparently separate domains: water, energy, food, land, ecosystems and their utilization.

Furthermore, the failure to enhance agricultural productivity and sustainability in poor rural areas would also undermine the achievement of other SDGs, most notably those related to gender equality, employment and decent jobs (especially for youth), and sustainable management of natural resources.

Despite the anti-globalization narratives and the still immense

differences in economic and environmental conditions across the globe, farmers in low-income countries and high-income countries – especially small-holders – seem to have more common interests than in the past. The issues they face in their everyday activities are not the same, but there are more areas in which they can better understand each other. Farmers in both developed and developing countries, for instance, experience imbalances in bargaining power in the global supply chains. Also, everywhere in the world agriculture is being pushed to the margins of the economic systems by increasing urbanization and at the same time faces an issue of generational renewal. Finally, climate changes will have an impact on everyone, although with different outcomes.

Given that Official Development Assistance (ODA) in agriculture is declining, while other forms of funding are on the rise, I believe we should focus on establishing more fruitful development-oriented relations between producers across the globe. This could be done through small projects, in which producers share knowledge with other producers in other parts of the world. In some development agencies this is called a 4P (public-private-producers partnership) approach. The time is ripe to fully deploy the potential of ‘producer-to-producer’ collaboration and partnerships.

*Paolo De Castro, Member of the European Parliament.*

# CLIMATE POLICY IN 2018

**M**omentum behind the global shift toward a low-carbon economy continues to build, despite recent hiccoughs. Even as the global economy grew, 2016 marked the third year in a row in which CO<sub>2</sub> emissions remained flat. At the national scale, this trend is supported by a rising number of countries that are increasing GDP while reducing carbon emissions.

National governments have followed a variety of paths to decouple economic growth from GHG emissions. This includes implementing ambitious carbon pricing in 42 countries and over 25 states, provinces or cities; rapidly increasing renewable energy deployment and production, as in India, where the government has set a goal of increasing renewable power generation capacity to 175 gigawatts by 2022; and major commitments by tropical forested countries and consumer goods companies to halt deforestation in supply chains and restore degraded lands.

In June 2017, however, the Trump Administration announced that the United States would withdraw from the Paris Agreement, based on spurious and outdated claims that the cost of acting on climate change would be too great. While no country has followed the US in its decision, in many other countries nationalist political agendas are rising, along with widespread disillusionment over the benefits of globalization and international cooperation. This emerging sentiment could well destabilize many of the gains made in recent years on the climate agenda, amongst others. Despite the political rhetoric, the reality is that record low interest rates, new financing models, and rapid technological developments make this

an opportune moment to deliver inclusive and sustainable economic growth.

And yet, climate action is not taking place at the pace or scale sufficient to avoid the human and economic costs of a changing climate with ever-more severe and frequent extreme weather events. Despite significant investment in renewables over the past decade, 40% of the world's energy still comes from coal, new high-carbon infrastructure is still being planned, and both developed and developing countries continue to struggle to achieve strong and equitable growth.

To truly safeguard our climate, we need to bend the global emissions trajectory downward by 2020. A core pillar of the Paris Agreement is for countries to ramp up their national climate efforts every five years. In Paris, countries took the first step, and in 2020 they must take the next. But this process cannot happen overnight. The process of bending the emissions trajectory begins in December 2018, when Parties to the United Nations Framework Convention on Climate Change (UNFCCC) meet again.

Thus 2018 must be a year in which governments, business, investors and civil society step up and publicly commit to enhancing their climate commitments by 2020, pointing the world towards a safer and more prosperous future. A public commitment in 2018 along these lines would send a strong signal to the markets and others about the inevitable transition to a low carbon economy, and how each can play a part in ensuring that it is a smooth and just transition.

Fortunately, sub-national actors and the business community have already begun to step up. Shortly following Trump's announcement, a coalition of US economic, education, and local government leaders indicated that they will continue to work towards the US' climate commitments under the Paris Agreement, forming the 'We Are Still In' movement. Businesses and investors are also leading the way. The 'We Mean Business' coalition, for example, represents 596 companies with US\$8.1 trillion in revenues and 183 investors managing US\$20 trillion in assets. They have made commitments to taking bold climate action, such as adopting science-

based emissions reduction targets, moving toward 100% renewable energy, or portfolio decarbonization.

Given the urgency of the climate issue, in 2018 it will also be important to capitalize on the growing leadership from investors as they decarbonize their portfolios and increasingly require companies – including oil and gas majors – to disclose how their long-term business strategies align with the Paris Agreement’s goal to keep temperature rise under 2°C. Building on this momentum can help bolster ambitious national climate policies and demonstrate to the world that bold climate action and economic prosperity go hand in hand.

The economic, social and environmental incentives to act are clear. Energy efficiency investments, for instance, could boost global GDP by US\$18 trillion by 2035, according to the IEA, increasing growth by as much as 1.1% per year and creating jobs. Countries that double down on climate action by rapidly shifting to a low-carbon, climate-resilient future are best placed to grow their economies and capitalize on trillion dollar opportunities in clean energy, sustainable infrastructure and modern transportation solutions. To what extent this reality will be reflected in national climate policies and new climate commitments from non-state actors – for example at the Global Climate Action Summit in California in September 2018 – will be something to watch closely in 2018.

*Helen Mountford, Program Director for the New Climate Economy and Director of Economics at the World Resources Institute (WRI).*



# CURRENCIES IN 2018

**W**hat will the world of currencies look like in 2018? The issue of currency manipulation that was raised by the newly sworn-in Trump Administration is likely to return to the headlines, especially if the dollar recovers against the euro. In early 2017 Germany was heavily criticized for sustaining a ‘grossly undervalued’ euro that was seen as part of a plot to ‘exploit’ the US and its EU partners, and, together with China, was thrown into the group of ‘currency manipulators’ – even if, in Donald Trump’s words, China remains “the great champion of currency manipulation”.

A number of key players in the US administration – ranging from Peter Navarro, Trump’s Director of Trade and Industrial Policy, to Donald Trump himself – are convinced that there is a direct link between trade imbalances and ‘currency manipulation’, a reflection of the administration’s nationalist, protectionist and authoritarian view of international economics and governance. As currencies are often the lightning rod for protectionist sentiments, any hint of currency manipulation resonates well with the protectionist rhetoric of the US administration. Expect a continuation of this rhetoric in 2018, even if the dollar remains weak, and more so in case of strengthening of the euro.

Germany’s large current account surplus will also continue to be a topic in the political narrative of the Eurozone and fuel the anti-German and anti-euro rhetoric among Europe’s populist parties. Expect to see this rhetoric to play out in Italy’s electoral campaign, with a significant impact on the euro if the anti-euro Northern

League and its assorted right-wing allies secure a significant share of the votes in the general election in early 2018. This would have a substantial impact on the euro, as for the first time ever markets will contemplate the risk of a collapse of Europe's single currency – unlike in the case of the French presidential election when Marine Le Pen's chances were tempered by the two-round French voting system. A Euroskeptic victory in Italy will shift many investors back to the dollar as the known unknowns of Donald Trump's policy and political stance would be preferable to the unknown unknowns of Italy's Euroskeptic populism.

Safe haven currencies like the Swiss franc will also benefit from a wobbling euro, but not the pound, which Britain's painful Brexit negotiations will continue to keep down in the doldrums. At the time of writing it is difficult to predict if the negotiations for a new trade relationship between the EU and Britain will unfold in a more orderly way than has so far been the case. And in any case, until an agreement is reached, uncertainty will continue to affect business confidence with an impact on the currency. The shift in monetary policy in response to inflation – itself a reflection of the sterling's weakness – above the Bank of England's 2% target is unlikely to substantially drive up the value of the pound. And for a country like the UK, with a significant deficit in its current account – of almost 5% of GDP – a weak currency does not provide much support.

Currencies are not only an expression of national sovereignty, but they also epitomize the limits of such sovereignty in an open economy. Through the Brexit debate, and because of it, the pound will continue to feel the impact of domestic politics on exchange rate dynamics, a stark reminder of the fact that foreign investors have an indirect say in how the country will manage the relationship with the EU and they will adjust their investment preferences accordingly.

By the same token, China's renminbi with its 'managed convertibility' is a reminder that the Chinese currency, despite significant progress since 2010, remains a 'half-baked' international currency. Thus, the dollar continues to be critical in China's trade and financial relations with the rest of the world. Dollars are used to invoice

and settle most of Chinese trade, Chinese overseas direct investments are denominated in dollars and dollars are accumulated in China's foreign exchange reserves, the current value of which is approximately US\$3 trillion. And this dependency is a constant reminder of the limitations of China's financial and monetary system and of the fact that in financial and monetary terms China remains a developing economy, albeit a very large one. Expect more or less the same in 2018, even if the pace of domestic reforms is gradual.

*Paola Subacchi, Senior Research Fellow, Chatham House – The Royal Institute of International Affairs.*

# ENERGY IN 2018

**I**n 2018 world energy demand will reach a new historical peak of 15 billion tonnes of oil equivalent (TOE). This level reflects a 50% rise in demand over 20 years, covered mainly by fossil fuels – oil, natural gas and coal – while renewable energy sources, despite strong year-on-year increases, account for a mere 3% of the total. Strategic games continue to be played with traditional resources and the house of cards is the Middle East with its crude oil, which accounts for 30% of world energy demand.

In 2018, it is likely that the biggest IPO of all times will take place – that of Saudi Aramco, or the Arabian-American Oil Company, a name that recalls the company's origins. Founded in 1944 by the major US oil companies, today it is a kind of state within the state. Muhammad bin Salman (also known by his initials MBS), the 32 year-old member of the Royal family who was nominated as crown prince in June 2017, values it at US\$2,000 billion dollars and wants to make it a symbol and instrument for the latest attempt to modernize his country.

Reinforced by strong US support, as demonstrated by Trump's much celebrated official visit on May 20, 2017, MBS is the new leader of the Middle East. Acting more with the impulse of a teenager and less with the wisdom of an Arab king, his decisions have further contributed to the chaos of the Middle East. His bombardments of Yemen to suppress the revolt of Shia minorities is one of the worst military actions in history. More surprising was the breaking of diplomatic relations with Qatar for alleged links with terrorism and for close relations with Iran, undermining the func-

tioning of the Gulf Cooperation Council, one of the most stable institutions in the region.

Paradoxically, OPEC and oil prices are benefiting from these tensions. The relationship with Iran is now clearer, thanks to the hostile approach taken by President Trump who, unlike Obama, does not want to hear about peace with the historic foe of Saudi Arabia. This has reinforced the fragile truce between Riyadh and Teheran that will allow both countries to focus on implementing the OPEC agreement, which ends in March 2018 but is likely to be extended through the end of the year.

For Russia, encouraged by its diplomatic and military successes in Syria and northern Iraq, it makes sense to strengthen its cooperation with the Saudis and continue capping its production as it has done in 2017. Moscow leads a group of 11 non-OPEC countries that promised to limit their production, and delivered a high level of compliance during 2017.

Since the end of 2016, OPEC's production has remained stable at close to 33 million barrels per day and it will not rise much in 2018, while global demand continues its relentless growth and by the end of the year will reach 100 million barrels per day. Back in 1983, when OPEC first introduced the quota system and the widespread adoption of electric cars appeared imminent, demand averaged 60 million barrels per day, an amount that is 40 million barrels per day lower. No one dared to imagine that there might be such a huge amount of crude oil available around the world over the next three decades, nor that consumption could jump to such a level. All countries participating in the current capping agreement have interests in respecting and extending it. For this reason it is expected that crude oil prices will rise slightly towards US\$65/barrel in 2018, compared to US\$53/barrel in 2017 and US\$43/barrel in 2016, levels that are still less than half of those of the 2010-2014 period. Over the longer term, forecasts are more bullish, taking into account the steady cuts in investments in new production capacity by oil companies outside OPEC.

US oil production, which contributed to the oil price plunge of 2014, is stable at 9.2 million barrels per day and faces difficulties

in rising to a higher level. On the one hand, costs cannot be cut any further and, on the other, the financial system is no longer so eager to lend money to the sector. However, domestic consumption has flattened out because of structural changes in the distribution of wealth, and this frees up supplies for export. Texas is building a massive export capacity to service the international market, and it is likely to regain the role it played in the 1930s prior to the large discoveries in the Middle East.

This is already happening with natural gas. In 2018, the third part of the large Sabine Pass LNG export terminal will be completed, the first of several planned export terminals. From net LNG importer, the US will become an important exporter in 2018 with roughly 15 billion cubic meters to be sold also in Europe. Here the market is dominated by Russian exports that in 2018 will peak at 200 billion cubic meters, a level that is not likely to decrease because their costs are much lower than those of imports from the US terminals.

Europe will need more gas imports, given that it seeks to close its coal plants in coherence with ambitious climate change targets. For the moment, the capacity of gas import facilities is more than sufficient, but new investments are lacking and this paves the way for the next upward trend in oil and gas prices.

*Davide Tabarelli, President of NE Nomisma Energia.*

# INTERNATIONAL INVESTMENT IN 2018

**W**hile international investment flows are expected to grow in 2018 in view of the cyclical upturn in the global economy, the prospects for global investment remain mixed due to changes in policy directions among key countries, along with global power shifts and the slowdown in world trade through connected global value chains (GVCs). These alarming signals add up to what could be deemed a ‘new normal’ for global investment. In short, global economy recovery is under way, but investment growth cannot be taken for granted over the longer term.

During the seven decades after the Second World War, the world economy has been characterized by increasingly integrated flows of goods, services, capital, people and, lately, data and information. This process has been further accelerated as multinational firms have offshored and outsourced their economic activities and relocated them across organizational and geographical boundaries, expanding flows of international investment in both developed and emerging economies. Such integration has been driven partly by the principles of economic liberalization that underlie multilateral and regional agreements, ranging from those of the World Trade Organization to more recent offshoots, such as the Trans-Pacific Partnership (TPP).

While having made significant headway, this globalization-as-we-know-it also raises concerns within and across societies. Workers in advanced economies worry that their jobs are being taken away as manufacturing activities are relocated, whereas suppliers in emerging markets are concerned about being trapped under the glass

ceiling of value creation, unable to take part in higher value-adding activities in technological development or design.

Such anxieties and grievances have given rise to nationalistic and protectionist sentiments, epitomized most glaringly in the United States under President Donald Trump and his controversial 'America First' policy orientation, which considers trade and investment relationships as zero-sum and desirable only when and where the US benefits. Tax and tariff incentives that were once used to promote the global expansion of business and economic activities through trade and investment are being redesigned to shift trade and investment flows in favor of the US and to punish firms whose global operations are perceived as hollowing out America's domestic business activities.

Such a sharp U-turn towards protectionism is also accompanied by President Trump's preference for a bilateral approach to multilateral and regional agreements, resulting in the US' renegotiation of the North American Free Trade Agreement (NAFTA) and its withdrawal from the TPP. A similar preference for less multilateralism is also evident across the Atlantic with the United Kingdom's prospective withdrawal from the European Union.

The changing policy direction of the major economies inevitably leads to the shift in economic power towards China. Ranked as the third largest host economy in the world, with a record investment inflow of US\$139 billion in 2016, China has also become the world's second largest outward investor, with its total outflows reaching US\$183 billion in 2016, surpassing traditional investors like Japan and the Netherlands and trailing only the US, according to the United Nation Conference on Trade and Development.

China's increasing economic might does not come only from its advantageous bilateral positions in trade and investment with others, but also from its role as the new dominant regional economic hub that increasingly links value chain activities in and across Asia. China has now eclipsed Japan as the largest source of intraregional investments in the Asia-Pacific region, with outflows during 2014-2016 of US\$125.7 billion compared to Japan's US\$95.2 billion and investment inflows of US\$78 billion, dwarfing Japan's US\$8.4 bil-



lion inflows almost tenfold, according to data from the United Nations Economic and Social Commission for Asia and the Pacific.

All of these geopolitical and geo-economic shifts in locus of power are taking place amidst mixed signs of global investment recovery. While economic fundamentals support further overall growth, and hence foreign direct investment flows, uncertainties and volatility still lurk behind headline numbers. Take, for example, the divergent signs derived from the figures on overall economic growth and those on global value chain trade and investment prospects.

The world's economy in 2018-2019 is expected to accelerate further, with a growth rate of 2.9% compared to 2.7% in 2017, based on a World Bank forecast. Emerging and developing economies could perform even better, with a 4.5% rise in year-on-year GDP in 2018 compared to 4.1% in 2017, thanks partly to sharp increases in natural resources and commodity prices.

Nonetheless, a closer look at the key mechanism of global value chain integration shows a different picture. In the first report on Global Value Chain Development in 2017 based on the new statistics of value added in trade, several leading global institutions, including the World Bank, the OECD, and the WTO, jointly stated that there has been a marked slowdown in traditional trade and GVC trade since 2011, after the 2008-2009 financial crisis disrupted the rapid expansion of GVC that was witnessed most evidently from 1995 onward. This deceleration may signal the saturation of GVC integration that has been a crucial driver for the global trade and investment flows of the past decades, therefore posing challenges to their future directions and growth.

These uncertainties increase risk levels and paint a different scenario for global investment. Prosperity from global integration was once a goal shared by advanced and emerging economies alike. No more can this be taken for granted as regions and countries are taking a more skeptical stance toward their relationships with the world economy. Investment scenarios from 2018 onward may be characterized more sharply by regional variances and differences. While North America and Europe are pre-occupied with the rising protectionism within their regions, and therefore becoming

more internally focused, other regions that need further integration to fuel their prosperity, most notably Asia, would continue to be staunch supporters of globalization.

Such divergent and contradictory attitudes are likely to become a key feature of global trade and investment in the years to come. How countries and companies trace their paths carefully in order to not squander the mutual benefits of global integration, while at the same time balancing benefits and prosperity within and across regions will be a key feature of this 'new normal'.

*Pavida Pananond, Professor of International Business, Thammasat University.*

# INTERNET LAW IN 2018

**I**n the field of Internet law, in 2018 the main topic will be the legal implications of AI and Big Data applications. According to a recent study by Aspen Institute Italia, the ten most important applications of AI are: natural language processing, speech recognition, Virtual Agent, machine-learning platforms, AI-optimized hardware, decision management support, deep learning platform, biometrics, robotic process automation, and text analytics. Concrete examples of AI applications are smart contracts, self-driving vehicles and facial recognition systems.

AI applications raise at least two kinds of legal questions: one concerning responsibility and the other concerning data processing.

With regard to the first question: who is responsible for the damage caused by a robot or software, which has been empowered to make decisions? Some years ago the obvious answer would have been that the software developer, the producer and the seller would be responsible, either individually or collectively. However, the current scenario is much more complex: the legal response has become better structured due to the pervasiveness of IT technologies in society and the industrial sphere. Today algorithms already exist which are capable of learning independently and making decisions, without the cause-effect relationships necessarily being understood by humans. This inevitably impacts on the fundamental legal bases of responsibility: the responsibility model based on negligent or wilful misconduct is no longer sufficient and new models of responsibility need to be developed.

Then again, who would ever have thought they would find

Asimov's three laws of robotics quoted in a legislative text? And yet they can be found in the *European Parliament Resolution of 16 February 2017* which contains "Recommendations to the Commission on Civil Law Regulations on Robotics". Even though they are only recommendations and therefore considered soft law, the topic under discussion, namely the civil responsibility of robots and AI programmes, would have appeared to be science fiction even just a few years ago.

With regard to the second question: the current applications of AI require enormous amounts of data, namely Big Data, which are now available. One of the main reasons why the use of AI has not been particularly widespread up to now was precisely because of the lack of immense quantities of data on which applications could be built. Today, the necessary volume of data exists and is often provided by the subjects to whom the data refer, for example via social networks.

AI needs Big Data. As the *Economist* recently has pointed out, "The world's most valuable resource is no longer oil, but data". And AI and Big Data require the formulation of new legal models.

Although 2018 is the year in which the GDPR (General Data Protection Regulation) will be applied in Europe, one central issue still remains unresolved, namely that of the dual nature of personal data: they comprise both a personal right and a legal asset. The legal definition of personal data is ambivalent as it refers at the same time to information relating to a natural person and to a legal asset. And it is this legal asset, which has given its name to the society we live in today, that is to say the Information Society.

Thus, the same information, namely personal data, is subject to two different regimes – the first being that of personal rights, the second that of contract law – which are not mutually compatible. Personal data cannot, in fact, be the subject of a contract, as they are part of a fundamental human right. On the other hand, though, it is a fact that personal data are exchanged as content of commercial agreements. From free e-mail services, signing up for social networks, to the use of search engines, the cost of these services is the users' personal information itself. In this sense, there is an in-

trinsic contradiction in the European law. Thus, we need to devise a new legal model that better reflects this reality.

So at present, whenever the processing of Big Data involves data of a personal nature, that is to say referable to a natural person, it is subject to the consent of the data subject, that is to say the subject whose data are being processed. Obviously, this not only limits the circulation of information, but also gives rise to inefficient protection.

There is also a further legal question regarding personal data, namely, to whom do they belong? To the one who collects them or to the subject to whom they refer? Or do they belong to everybody? What is the model for protection of these data? The proprietary form (and in this case, does it mean exclusive property?) or the model based on responsibility? Or could it even be the Open Data sharing model?

And the data owner approach raises yet another question concerning the protection of all those subjects who might potentially use the data. The risk is that new monopolies may be created and that there will be a need for antitrust protection.

In order to solve these problems new legislation by itself is not sufficient, rather we need to develop a new approach. A 'disruptive' approach is also required from a legal perspective. Without forgetting that the law certainly cannot prevent the spread of new technologies, since the function of law is to regulate their developments in order to avoid conflicts. And the playing field in this case is not only European, but global.

*Giusella Finocchiaro, Professor of Private Law and Internet Law, University of Bologna.*

# JOB IN 2018

**T**he world labor market is undergoing a major transformation, which will become more visible in 2018. The proliferation of robots in the production of goods and services is one of the drivers of change. Another, perhaps more profound, change is the fragmentation of production resulting from the diffusion of digital technology in all sectors. Increasingly, economic activity is organized along value chains whereby tasks and jobs can take place in different, though inter-connected, locations. Thus, what matters for an enterprise is no longer its size, but the extent to which it is connected to platforms.

The first and most important result is a diversification in work patterns. In advanced economies, the standard employment relationship – single location, full-time, permanent work — is becoming less and less the norm. More workers will combine their main job with activities performed via the web, through crowd-working arrangements. Also, the incidence of so-called dependent self-employment will further increase. These trends will also be present in the relatively small formal employment sector in developing countries. However, in these countries, the picture is more complex, as some of the pre-existing trends will continue. These include rural-urban migration and declining informal forms of work, such as unpaid family work.

In some cases, new forms of work can help people participate in the labor market, such as parents who want to work from home. But for many others the changes mean greater precariousness.

Secondly, there will be significant job changes both across sec-

tors and within them. Robot-intensive sectors such as banking and manufacturing will suffer many job losses, as machines replace humans. However, even in these sectors, there will be new job opportunities. For instance, there will be fewer white collar employees in bank agencies, but more people employed in financial platforms that offer tailor-made services such as the Fintechs. In some sectors, such as manufacturing, net job losses will occur. However new job opportunities will emerge in sectors that are less directly affected by robots, including anything which involves inter-personal services, such as care work, education and cultural activities.

Indeed, in contrast with the gloomy predictions made by many analysts, there is no generalized scarcity of jobs, at least so far. For the world as a whole, employment increased by around 30 million people in 2017 and the expectation is that at least the same number of net new jobs will be created in 2018. Unemployment will continue to decline to well under 200 million for the world as a whole.

True, artificial intelligence poses a considerable challenge to human work. If machines acquire the learning capacities of human beings, then they could conceivably replace many of the existing jobs. However, the most likely trend, at least in 2018, is for humanoids to complement human work, rather than entirely replacing it.

But even if employment continues to increase, it will become more polarized. Already, the demand for jobs that require skills that cannot be replaced by automated processes will increase. The same goes for unskilled jobs that cannot be routinized (e.g. domestic work). In contrast, the demand for labor which is skilled but routinizable will decline. This may include certain accountancy, simple translation activities or work which requires image recognition.

A third expected trend, also illustrative of the ongoing transformations, is greater perceived job insecurity and wider inequalities. Job insecurity is a logical consequence for many workers of the job changes just described. Inequalities will continue to rise even in countries that face near full employment such as Germany, Japan or coastal China. In 2018, wages will continue to lose ground vis-à-vis profits, one of the key factors behind widening income inequalities.

Given the significance of these trends, countries should engage in a major rethinking of their policies. What worked in the industrial era may be ill-adapted to the digital economy. Social protection, in particular, needs to cover new forms of work and its funding base should rely less on standard employee contributions. Labor regulations should help seize the new job opportunities while preventing widespread precariousness and the risk of an *Uberized* labor market. The disconnect between education and the labor market will continue to grow and unemployment among educated youth will remain high, especially in developing countries. In the absence of decent work opportunities for these young people, migration will continue.

Some countries have started to take action and more will follow. Greater international cooperation would also help. The fight against global tax evasion is especially important as is intensified action to reduce the risk of a race to the bottom in social rights. Otherwise, the emerging job trends, if not properly addressed, will exacerbate inward-looking reactions while nurturing populist movements.

*Raymond Torres, Director for Macroeconomic and International Analysis, FUNCAS.*



# MIGRATION IN 2018

The world economy and society face important challenges in the years ahead: how to curb rising inequality, stabilize and consolidate growth after an uneven recovery following the big recession of 2008-2009; the effects of important countries such as the US and the UK modifying or withdrawing from integration schemes such as NAFTA and the European Union; the increase in migration between countries of the global south; the high prospects for continued armed conflicts in the Middle East and Africa; and the rise of nationalist sentiments and anti-immigration stances in advanced economies and others. In turn, global migration flows present some critical trends:

- A slowdown in migration towards high-per-capita-income nations, the 'global north', in the period 2010-2015.
- A rise in south-south migration – that is to say, migration from a developing country to another developing country – in the same period.
- Disparities in intra-regional migration, with higher levels between Asia and Europe than between Latin America and North America, and the level of intra-African migration remaining in between that of the other two groups.
- More restrictive migration stances in large immigration countries, such as the United States, including the erection of walls along its southern border, mass deportation and the rise of security-led migration criteria.
- The proliferation of money for visa-residence programs ('investment migration programs') in advanced economies as well as in

various islands and special jurisdictions that are oriented toward promoting immigration of the very wealthy.

- The growing number of refugees reaching a historical record of over 65 million by the end of 2016, linked to armed conflicts in Syria, Afghanistan, Southern Sudan and other dispute-ridden nations.

This picture poses important policy challenges and suggests critical issues for future research in the field of international migration. Major trade and integration arrangements are being questioned because of their alleged redistributive effects, delocalization of production and job losses; immigration is being questioned because of perceptions that it can take jobs away from nationals, impose various fiscal burdens and entail unwanted cultural effects. The possibility of an immigration backlash, such as the one observed in the 1920s, should not be ruled out. Furthermore, some affluent nations and the international community are facing the complex issue of absorbing refugees, displaced populations and asylum-seekers.

With the rise of south-south migration in recent years, emerging economies and developing countries are facing new policy issues that they did not face before. On the emigration side, they will have to deal with the social and legal protection of their nationals abroad, particularly poor and working-class migrants facing new entry restrictions and challenges to staying in their host countries. At the same time, authorities in developing nations, particularly of countries that have been experiencing rapid growth and rising per capita incomes in recent decades, are dealing with new inflows of foreigners seeking better-paid jobs than those found at home. Also, the increasing immigration of professionals, entrepreneurs, scientists, international students, and innovators to the global south is a new reality.

From a research perspective, a host of new themes linked to global migration are also emerging and/or continuing in their relevance. We can identify the following key issues that require a new approach:

- Revisiting the role of development gaps and international cycles in driving the size and direction of international migration flows.

In a world in which high-income economies, traditional recipients of international migrants, are affected by internal processes of secular stagnation and impaired job-creation, immigration to the global north is bound to be affected.

- We need to refine our knowledge of the transmission mechanisms between macro and financial crises and international migration and remittances flows in both sending and receiving countries.
- The growing phenomenon of international mobility of the wealthy and oligarchs. The main origin and destination countries and cities of these flows and the pushing and pulling factors governing the mobility of the rich, as well as the connections with off-shore deposits and international transfer of wealth.
- The new pattern of talent mobility that displays a rebalancing between the global north and the global south as origin and destination.
- Further work needs to be done on middle class migration in a field largely dominated, for understandable reasons, by research focused on migration of the poor.

*Andrés Solimano, President, International Center for Globalization and Development, CIGLOB.*

# SHARING ECONOMY IN 2018

**T**he *sharing, collaborative, peer (P2P), access, gig or on-demand* economy has been termed as the absolute social, economic and legal disruption; it has even been qualified (together with AI, Big Data and 3D printing) as the fourth industrial revolution.

The sharing economy is one of the most dynamic economic segments and a core driver of the Digital Single Market pursued by the Juncker Commission. An idea which started off as a communitarian, non-monetized, sharing project has grown into a fully monetized, vibrant and, occasionally, wildly capitalistic marketplace. *Uber*, today's biggest urban transportation company in the world (valued at US\$70 billion), owns no vehicles, and *Airbnb*, the world's largest accommodation provider (valued at US\$30 billion), owns no real estate! In the EU alone in 2015 gross revenue from collaborative platforms was estimated at €28 billion, almost doubling from 2014. Sharing activities are partly in competition with the traditional ones, but to a large extent they generate fresh demand where none existed beforehand; complementarity is testified by the fact that many traditional businesses diversify (through M&As or otherwise) into the sharing universe and vice versa.

The sharing economy is based on a tri-partite relationship, whereby an electronic platform matches consumers' demand for specific services (or goods) with the offer of its affiliated 'prosumers' (producing consumers). Prosumers range from one-off amateurs to fully qualified professionals. They perform their services either electronically, at a distance (Online Labor Markets, such as

designing, coding, and editing), or physically, via direct interaction (Mobile Labor Markets, such as driving, cleaning and baby/dog-sitting). The former category is subject to global (price) competition and broadly unfettered by local regulation, while the latter is more affected by ‘local’ conditions. Hence, *Uber* has been banned in different cities for violating local regulations, while *Taskrabbit* has not, because of the impossibility to localize its workers and their labor rights.

The above occur in a legal vacuum, where platforms claim that established regulations are not fit for them, regulators hesitate to intervene for lack of proper understanding of this new economy and out of fear of stifling innovation, individuals are faced with all sorts of uncertainties (concerning issues ranging from property damage to violations of privacy and labor rights) and courts are trying to decide, as Judge Chhabria put it, in the *Lyft* litigation in California, “whether a multi-faceted product of new technology should be fixed into either the old square or the old round hole of existing legal categories, when neither is a perfect fit”.

Within the above framework, regulators – local, national and supranational – face two broad challenges: on the one hand, they must contain platforms operating on the verge of (or even outside) established legal norms; on the other hand, they should themselves benefit from the platforms’ activities in order to perform their duties towards their electorates.

### *Rules for platforms?*

Traditional legal categories are being disrupted by the sharing economy. Three-party contracts for distinct-but-interdependent services sit uneasily between traditional contract and tort law. The fact that the prosumer is not a professional and therefore enjoys no information asymmetries over the final consumer is a real bomb for the foundations of consumer protection law, which is thus inapplicable. The collection and manipulation of Big Data (both personal and non-personal), the ensuing ‘profiling’ of users and the commercial exploitation thereof make the forthcoming EU General Data Protection Regulation (GDPR), which is supposed to en-

ter into force in 2018, look already outdated. The power hidden in algorithms and the possibilities they offer for market parallelism (eg *Lyft* has been following *Uber* on surge pricing when demand is high) may be calling for a revision of basic competition law principles and instruments. Similarly, market definition and dominance in global, two-sided markets characterized by ongoing innovation, strong externalities and ‘superstar effects’ may need to be revisited. Labor law categories need more flexibility in order to accommodate mini-entrepreneurs who largely depend on a platform for their living.

In these and other areas, regulators need to intervene in order to support the smooth development of this new economy without, however, stifling innovation, and while allowing for as much self-regulation (especially through rating systems) as possible.

### *Partnerships with platforms?*

Local authorities in the UK and elsewhere already replace owned car-fleets with contracts with sharing companies, co-own heavy maintenance machinery and host their traveling officials through lodging available through platforms rather than at hotels. Similarly, hospitals share machinery, information and even doctors. *Airbnb* has been amassing local taxes and reversing them to municipalities, while other municipalities envisage honoring their local transport duties through platforms rather than within the framework of traditional public contracts. A major challenge is that the legal framework for public-platform cooperation is completely absent!

The above difficult issues are certainly not going to be resolved in 2018; on the contrary, they are likely to become more pressing in view i.e. of the forthcoming judgments of the EU and Member State higher jurisdictions, the entry into force of the GDPR and the overall increase of people involved in the sharing economy.

*Vassilis Hatzopoulos, Professor of EU Law and Policies, Panteion University; Visiting Professor at the College of Europe.*

# SMART CITIES IN 2018

Cities around the world are facing tremendous challenges from rapid urbanization and increasing pressure on infrastructure. For the first time in history, over half (54%) of humanity calls an urban area home, and by 2050 that number is projected to increase to 70%. Overcrowding and pollution, together with aging populations, will cause unprecedented challenges in managing transportation, utilities, housing, and services in urban areas. In response, cities have been embarking on ‘Smart City’ initiatives to harness the benefits of emerging digital technologies in order to improve quality of life, efficiency of urban administration and services, economic vitality, and environmental sustainability. Initially, the focus was primarily on technology, but more recently, building innovation ecosystems with citizen and business participation has also become a key aspect of many smart city programs.

Smart city initiatives aim to transform cities into hubs for data-driven innovation. Decisions and solutions made by city administrations are increasingly supported by Big Data and data analytics as applications and sensors embedded in urban infrastructures generate a large amount of data. This has been possible, in part, by the growth of the Internet of Things (IoT). Gartner forecasts that 11.2 billion connected things will be in use worldwide in 2018, up 34% from 2017, and will reach 20.4 billion by 2020. The IoT and the Cloud are transforming entire cities into living labs, where the city itself becomes a platform for real-time open innovation. Some cities have already turned into large-scale experimental test-beds for data-driven innovation in areas such as transport and energy.

The global smart cities market, which accounted for US\$773.2 billion in 2016, is expected to grow to US\$3.7 trillion in 2025, according to Research and Markets. The major driving factors underlying this projected growth include the focus on reducing energy consumption and concerns over proliferation of environmental wastes, with transportation as a growing area of interest. In 2018, a number of telecoms carriers will start to launch the first 5G networks, with broad deployment in 2019. The significantly higher speed, low-latency connectivity and reliability that 5G provides will enable better implementation of IoT for smart city operations and also help self-driving cars interact with other cars and smart roads to improve safety and traffic management.

City governments are assessing the opportunities for improved policy-making and services from the disruptive nature of Artificial Intelligence (AI) and blockchain. AI is helping cities make sense of the vast amounts of data and is able to use those data to build smart city applications in areas such as elderly care and traffic flow management. Blockchain is also expected to have transformational impact on many government applications, including identities, voting, public records, and citizen transactions. Blockchain is not yet ready for large-scale deployment, but promising pilot projects are emerging, especially in record keeping for land or permits.

A growing number of national governments have been incorporating smart city construction as part of national strategies. In the United States, recent federal agency initiatives such as the Global City Teams Challenge, organized by the National Institute of Standards and Technology, and the US Department of Transportation Smart City Challenge on urban transport mobility, have been driving forces behind many smart city projects. In Europe, major smart city initiatives have been driven by dedicated EU funding and are characterized by a focus on open data, citizen participation and sustainability. Governments in emerging economies have been more proactive. In China, the 13th Five-Year Plan (2016 through 2020) put a strategic focus on smart cities for China's new urbanization development, with an expected investment of US\$75 billion during the plan. More than 500 Chinese cities have already proposed tran-



sitioning to smart cities. The Indian government also announced its plan to construct 100 smart cities as the core of India's urban and social development. This will require US\$30 billion in the initial build-out period.

The world in 2018 will see smart city technologies implemented on greater scales and in a wider range of cities. Forward-thinking leaders are already making the policy preparations to ensure that these technologies are integrated in cities for the best possible impact on citizens' lives. Many cities will try to link IoT data into the open data portals for contextual real-time data to be shared and exploited by ecosystem partners. More cities will adopt city platforms based on open standards and open APIs. Many cities will also start to experiment with integrating individual systems into fully integrated municipal macro-systems.

However, challenges remain. These include: ensuring interoperability of technologies within and between systems; guaranteeing accessibility for open data to all stakeholders in a city; overcoming siloed bureaucracy that hinders data sharing and integration; strengthening citizen engagement; removing outdated legacy regulations; and addressing cybersecurity and privacy issues. Success in overcoming these challenges will determine the speed of smart city development as well as the actual benefits enjoyed by the citizens.

*Young-sook Nam, Secretary General of WeGO (World Smart Sustainable Cities Organization).*

# TRADE IN 2018

Support for protectionist trade policies flares up periodically, usually during sustained periods of slow economic and income growth, like the present.

The use of tariffs and other protectionist measures has increased in G20 countries since the global financial crisis and there are clear signs that the trend could accelerate. In his inaugural address, US President Trump stated that “protection will lead to great prosperity and strength” and his campaign promised to turn the tide on globalization. In parts of Europe proponents of protectionism have been empowered. And for the first time, leaders of G20 nations have backed away from a commitment to reject protectionism.

So far it is unclear how countries’ trade policies will change. But, developments to date suggest that maintenance of the status quo is unlikely. Some think change will be at the margin, such as a more forceful pursuit of alleged rule violations within the established international trade system. Others fear transformational changes that risk unraveling the significant reductions in trade barriers achieved over the past 50 years.

Other changes in the global trade environment are also shaping the outlook for international commerce. The number and scope of bilateral and regional trade agreements have expanded rapidly, now covering a vast array of policy areas, including competition policy, intellectual property rights protection, customs regulations, electronic commerce, standards and many more. Meanwhile, progress in broad multilateral negotiations is effectively at a standstill. On a more optimistic note, advances on sectoral

agreements negotiated through the WTO system have gained some momentum.

A second force influencing international trade is the growing importance of global value chains, where services, components and raw materials are traded across countries multiple times, assembled and then dispatched to their final customers. Lower barriers to trade and investment, together with reductions in transport and communication costs and logistical innovations have contributed to an increasingly integrated world economy. While the internationalization and specialization of production according to comparative advantage has been advancing steadily for many years, only recently have new statistics allowed us to measure its importance. Development of these global value (or supply) chains is contributing to increasing trade in services and foreign direct investment.

It is these developments and a desire to understand what they may mean for the broader economy that motivated the Australian Productivity Commission in 2017 to assess the potential impacts of shifts in trade policy towards a more protectionist stance<sup>1</sup>. The analysis draws on stylized scenarios that the Commission has modeled to illustrate the possible effects on Australia and elsewhere of significant international increases in protection, and of different policy responses.

In a scenario where substantial import tariffs are imposed on two of the United States' largest trading partners – Mexico and China – and they reciprocate in kind, economic growth in all three countries would be lower. Mexico would be particularly hard hit, since about 80% of its exports are to the US. Both Mexico and China would redirect some of their exports to other markets at lower prices, benefiting other countries. Overall, world output would only decline by a very small amount.

From the analysis, we could comfort ourselves in the belief that the ultimate effects on economic activity and living standards

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1 The report can be downloaded from: <http://www.pc.gov.au/research/completed/rising-protectionism/rising-protectionism.pdf>.

would be small if the rise in protectionism stopped with the US imposing tariffs on China and Mexico. However in the interim, tariff increases would cause substantial disruption to, and reorganization of, global trade in ways not captured by trade models. The United States is inextricably connected to global supply chains and ironically this may be what deters the pursuit of protectionist trade policy. Meanwhile the uncertainty has a cost.

More seriously, if a scenario akin to the experience of the 1930s were to be repeated – with trade barriers significantly higher around the world – the economic dislocation unleashed would have the capacity to cause a global recession and put the rules-based global trading system that is too easy to take for granted under huge strain. The risk is that it is just as easy to underestimate the consequences of our rules-based multilateral system breaking apart.

Rising protectionist sentiment and actions in some countries may lead some to suggest that a rethink of the international community's commitment to free trade is needed. They would be wrong. Protectionist policies would harm the global economy and risk reversing the community-wide gains that the lowering of barriers to trade have helped to deliver, and would not address the insecurity concerns about jobs and incomes that globalization has come to encapsulate. Yet it would also be a mistake to dismiss the signs of discontent that are testing the social compact that underpins open market policies. Trade policy alone cannot ensure that the potential benefits of liberalization are fully realized or widely distributed. The Productivity Commission's report outlines a three-pronged strategy that would help achieve better outcomes for all and foster public confidence in open markets.

First, countries should continue to work towards freer markets and to make the rules-based trade system function better. Prospective areas for improvement include prioritizing regional agreements that allow, or work directly towards, most favored nation treatment; the greater use of plurilateral sector-specific agreements negotiated in the context of the WTO; and adopting better consultation processes in negotiating trade and investment agreements.

Second, governments should pursue broader policies that

strengthen the economy's resilience and the workforce's adaptability to changes taking place in the global economy, many of which are driven by new technologies. These companion policies can serve to lessen the disruptive impacts of change and create an environment that spreads the benefits of globalization more widely. They include education and training policies that aim to build solid foundation skills and enable participation in further training and reskilling for displaced workers; workforce policies that influence how readily firms can adjust the size and composition of their workforce; and macroeconomic stability.

Third, governments should better engage with the community around the case for free trade, and about policies aimed at managing the costs of adjustment and ensuring that the benefits of liberalization are shared more widely. This would help to build community confidence in trade and foreign investment policies.

Resisting protectionism and continuing to work towards freer markets, while making trade work for all by minimizing adjustment costs and ensuring the benefits are widely shared, is the best path forward. Higher living standards depend on it.

*Jonathan Coppel, Commissioner, Australian Productivity Commission.*

# WORLD ORDER IN 2018

## **F**asten Your Seat Belts, Turbulence Ahead!

Over the last few years, the process of erosion that has affected the international order since the mid-2000s has accelerated dangerously. There can be little doubt that we are no longer in the liberal international order ('LIO 2.0') that governed international relations since the end of the East-West conflict in 1989. In fact, we may well be about to reach, or may have reached already, a tipping point in this erosion when the international order will suffer a 'synchronous failure' as a result of what is happening in many of its parts<sup>2</sup>. Among the most important parts are nation states' political orders, which often appear flawed, fragile and precarious. Yet the ability of states to function in line with the roles they are expected to play within it is critical to any international order.

There were four major factors behind the erosion of international order. First, continuous rapid advances in our scientific understanding and the resulting dynamics of technological innovation produce relentless pressure for change in markets, firms, societies and culture. We usually call this 'globalization'. Second, the gap seems to be widening between the needs and demands for governance at all levels and the ability of politics and institutions

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2 Those are major conclusions of a project on the Future of the International Order undertaken by the German Institute for International and Security Affairs (*Stiftung Wissenschaft und Politik, SWP*) from 2014 to 2017. The results will be published in 2018. See Hanns W. Maull (ed): *The Rise and Decline of the Post-Cold War International Order*, Oxford et al.: Oxford University Press 2018.

to address them. Politics has become the weak link in the social response to globalization, and it seems to be faltering under the strain. Third, the United States, as the principal ordering power, has played a highly ambiguous role in the liberal international order since 1990. In particular, the policies of the first administration of George W. Bush (2000 to 2004) caused a fundamental reversal of the previously broadly positive trends in international order. Those policies, which included the withdrawal from multilateral cooperation in areas such as climate change and arms control and the military interventions in Afghanistan and Iraq, wreaked havoc in many different parts of the international order and simultaneously and dangerously damaged the legitimacy of the US as the global hegemon. Finally, there was no other power that could and would close the gaps left by America's abandonment of constructive leadership. While in the 1990s and 2000s, China was perhaps not yet in a position to do so, but – more importantly – in recent years it has been at least as ambivalent about its role in the international order as the United States. The European Union, which should have been in a position to take up some of the slack, with a few exceptions (such as the nuclear accord with Iran) failed to develop sufficient coherence and cohesion in its external policies to do so.

This perspective does not inspire much hope for a turn for the better in world politics in 2018. Of course, the demise of the LIO 2.0 does not mean that this order has disappeared without a trace. Many remnants of the old liberal international order remain, perhaps most importantly the international trade order governed by the World Trade Organization (WTO). Yet on balance the LIO 2.0 has lost both much of its effectiveness and legitimacy and the power configuration that underpinned it: the geopolitical dominance of the West. Moreover, the present US administration makes that of George W. Bush from 2000 to 2004 appear both very well organized and positively enlightened by comparison, suggesting that the international order will suffer another series of dangerous blows from Washington, further undermining its already shaky foundations. While China rhetorically may have grasped the rudder of the international order that America has vacated, its actual

policies are ambivalent at best. The European Union continues to be preoccupied with its own problems. Russia's contributions to international order have been at least as ambiguous as those of China. Moreover, the confrontation with North Korea over its nuclear program (and increasingly also its cyber-attacks) demonstrates the risks to international stability and prosperity that even small states, and possibly also non-state actors, may pose under today's circumstances of interdependence.

What does it mean when we have a new international order that is no longer liberal and may be experiencing synchronous failure? And what follows from that for international order in 2018? In a nutshell: unpredictability and fluidity. Do not expect anything particular to happen, be it be good or bad – but be prepared to cope with unexpected events and developments that often will start within states. Politics seems to have entered a different aggregate state across its whole spectrum, from the local level to the UN Security Council in New York. It can no longer be described with the previous metaphors of architecture ('two blocks'; 'common house'; 'security architecture'), but requires a new set of metaphors of natural phenomena such as 'torrents' or 'tsunami' that reflect the new fluidity of politics and international order. The fluidity and unpredictability of world politics may be dangerous overall and even destructive at times, but they also hold opportunities for those who are able to move with the flow.

*Hanns W. Maull, Senior Distinguished Fellow, Stiftung Wissenschaft und Politik (SWP); Senior Policy Fellow for China's Global Role, Mercator Institute of China Studies (MERICS); Adjunct Professor of International Relations, Bologna Center, Johns Hopkins University, School of Advanced International Studies (SAIS).*



## EUROPE

## BANKS IN 2018

In 2018 the European banking industry can be expected to face some encouraging developments, as well as several non-trivial challenges. The former include a further – if limited – increase in GDP growth, close to 2% in real terms. While far from exciting, such a scenario would consolidate economic recovery and sustain the demand for new credit, helping European lenders rebuild their income base and improve profitability. In the meantime, rising employment rates and better operating cash flows for non-financial companies should make it less likely that borrowers default on their loan obligations. As quantitative easing is being cautiously phased out, the risk of significant losses on the banks' holdings of treasury bonds will remain moderate, including for lenders based in the Eurozone's peripheral countries. Additionally, low interest rates – while weakening net interest income – will keep down the opportunity cost of holding idle assets, like non-performing exposures and foreclosed real estate, until market prices revert to normal and adequate recoveries can be obtained. Furthermore, non-interest income, such as asset management fees, revenues from IPOs and corporate banking services, can be expected to benefit from orderly financial markets. Finally, as Internet-based transactions continue to replace brick-and-mortar bank branches, cost savings will be used to improve the bottom line and to invest in higher value-added delivery channels.

Against this overall favorable backdrop, a number of challenges will have to be addressed before banks can return to profitability and become attractive again to equity investors.

For one thing, non-performing loans (NPLs) will continue to weigh on the balance sheet, making lenders more vulnerable to unexpected losses and leading supervisors to impose extra capital cushions. While the ratio of NPLs to total loans has been steadily decreasing in the European Union during the last three years (from 6.5% to 4.5%), significant differences remain across countries. Accordingly, some EU jurisdictions may have to deploy ad hoc strategies to ensure that the NPL stock can be reduced within a reasonably short time horizon. State-backed asset management companies may be used to absorb excess NPLs while regulatory innovations are being rolled out to speed up the recovery of bad loans. Competition and bank resolution rules, however, will have to be applied pragmatically for such a tool to prove effective.

European banks will also remain exposed to misconduct risk, due to the mis-selling of financial products to retail and professional customers, the manipulation of financial markets, the violation of rules on taxes, money laundering, terrorism and international trade bans. Based on the European Banking Authority's data, misconduct risk accounts for the vast majority of the operational risks expected by Europe's top banks (€71 billion according to the 2016 EU-wide stress test). While no European lender carries the high costs experienced by large US banks, misconduct costs have been rising sharply for large European banks and may pose a threat to bank stability unless carefully monitored. Unsurprisingly, these costs will remain among the key variables of the new round of stress tests that European supervisors will perform in the first half of 2018.

Finally, bank-related rules are growing too complex and risk becoming a drag on the banking sector. Although European policy makers appear to be increasingly aware of this issue, regulatory overload remains a significant threat, as new regulations are being discussed and may be finalized over the next 12 months. These include new rules on bank capital requirements (the so-called Capital Requirements Directive and Regulation) and bank resolution schemes (the Banking Resolution and Recovery Directive, whose application has increased concerns over consumer protection in

some European countries). Meanwhile, the Basel Committee on Banking Supervision may resume its discussions on the so-called ‘Basel IV’ reform package, aimed at constraining the banks’ ability to use their own risk-management systems to estimate how much capital must be held against future credit losses. While in principle the European Commission should assess costs and benefits of any new regulation before it can be approved into law, such analyses are often carried out in isolation, looking at the effects of individual reforms without assessing how they might interact with pre-existing rules. This may lead to an underestimation of the complexity and of the burden that new regulations may pose to producers and consumers of banking services. By increasing clarity and simplifying the institutional structure that presides over bank supervision, European lawmakers could reduce compliance costs and uncertainty for banks, while remaining tough on bankers if need be.

*Andrea Resti, Associate Professor of Finance, Bocconi University, and Senior Advisor to CRIF Group.*

# FISCAL RULES IN 2018

**C**urrently, the positions on fiscal policy are diverging between Europe and the US. In Washington, extensive discretionary changes in fiscal policies, which were part of Donald Trump's electoral program, are being considered. These changes, however, may not be appropriate for the current state of the American economy, as these measures will increase the public debt as well as inequality with a highly uncertain effect on growth. In Europe, there is slow but steady convergence of national fiscal policies toward the Maastricht and Fiscal Compact parameters. This apparently straightforward contrast between inappropriate discretionary fiscal policy in the US and the return of rule-based fiscal policy in Europe, however, doesn't conceal the weaknesses of the current European framework.

The debate on fiscal rules generally focuses on differing approaches to rules and discretion. Fiscal rules, such as automatic stabilizers or rules on public expenditures, substantially increase predictability and reduce political uncertainty. Compared to policy frameworks where decisions depend on reaching a political consensus, automatic rules also make it possible to react more rapidly to shocks. Finally, rules are a way to resolve the commitment problems of the State and to avoid the vagaries of the political cycle.

In general, criticism of the rule-based approach focuses on two drawbacks. The rules are either too simple or too complex. Simple rules cannot effectively deal with the diversity of unexpected and rare events, such as financial or banking crises, and may thus lead to the adoption of the wrong fiscal policies. Alternatively, when they

are very detailed in order to cope with many possible situations, they are difficult to implement. The real fiscal power then relies on the interpretation of the rules, a process which may appear arcane to outsiders, financial markets and average citizens in primis.

Europe over the past few years provides an unfortunate example of these two problems with fiscal rules. First, the Eurozone is special due to the explicit, rule-based coordination of fiscal policies. These rules are very complex and still evolving. The Maastricht Treaty defined two key thresholds for the government deficit, which should be lower than 3% of GDP, and for the public debt, which should be less than 60% of GDP. As these thresholds could not be applied during the 2008 crisis, a new set of treaties (the Stability and Growth Pact, the Fiscal Compact and the Two- and Six-Pack) now define a more complex set of requirements regarding the structural effort to reduce the public deficit. And yet understanding what the binding requirements are in the current framework still remains quite a challenge.

Second, the EU fiscal framework after the crisis does not pass an economic assessment with flying colors. There is widespread agreement that it has resulted in excessively tight fiscal policies in many countries. This is not to deny that reducing huge public debts is a prerequisite for gaining some fiscal margin of maneuver, but the rhythm of fiscal consolidation was too restrictive after the severest recession in living memory. This has been at the core of the debate over austerity in Europe.

Now the period of austerity is over and growth prospects are recovering. This generates the dangerous illusion that the current framework is not so bad after all. First, the current European economic recovery is due to some favorable (and possibly exceptional) external circumstances such as low exchange rates for the euro and depressed energy prices. Second, after so many stitches to the fiscal patchwork, the current version is now incredibly complex, creating uncertainty and preventing any sense of ownership by European citizens. Third, and most fundamentally, the current rules may well be wrong, in the sense that their application can generate inappropriate policy decisions if a crisis should happen: the recession-

ary bias of the austerity rules is still at work. Fourth, it is not even sure that these rules deal with the main issues, i.e. reducing the high level of public debt in some countries at a constant but reasonable pace.

How to solve this quandary? The current European debate on fiscal policy is moving in two directions.

The first is toward a modification of the rules in order to avoid pro-cyclicality – too tight fiscal policy in crisis time and too loose fiscal policy in good times. Rules focusing on government expenditures, instead of the deficit, could be a good option. Nonetheless, while improving faulty rules is obviously a good idea, developing universal rules is no panacea, as these could be either too complex or too simple.

Second, new institutions such as the European Fiscal Board have been established to assess fiscal spillovers in Europe and the euro area and to contribute to the coordination of fiscal policy. Once such institutions gain enough credibility, they will be useful in orienting the debate (the alternative of relying on cheap talk has proven its limits), but they will still lack the power to authorize deviations from the rules in the case of extreme events.

What is clear is that the European fiscal landscape is becoming too complex, when simplicity and predictability are needed. Political resources ought to be spent on introducing simple rules for normal times and smart, strong, and legitimate institutions for crisis periods, governed by majority rule. The real trade-off is not between rules and discretion, but between rules and institutions. We need institutions with a strong democratic mandate, backed by both the European and national Parliaments.

*Xavier Ragot, President, Observatoire Français de la Conjuncture Economique; Professor of Economics, Sciences-Po.*

# INDUSTRIAL POLICY IN 2018

**E**uropean countries implement very diverse industrial policies, and more convergence is badly needed.

A number of issues have arisen that have led some countries to question the relevance of their traditional policy stance. Even before Brexit and despite its liberal tradition, the UK was looking for instruments and institutions to provide support for its manufacturing sector. Germany was shaken when leading robot-maker Kuka was bought by the Chinese group Midea, without any legal way for the government to object. In France, the final dismantling of the former Alstom group was a controversial topic.

British and American financial analysts' unquestioning promotion of 'pure players' (focused on a single industry) and 'fables' companies (which have no plants and contract out their manufacturing to suppliers) turned out to be toxic. For example, the French firm *Compagnie Générale d'Électricité*, once as powerful as Siemens, General Electric or ABB, was split into several companies, each of them undersized: its telecom division, Alcatel, had to form an alliance with Lucent (itself a spin-off of the American giant AT&T), then was ultimately acquired by Nokia; its energy division was bought by General Electric; and its transport division was acquired by Siemens. These weakened subcritical 'pure players' became prey for the remaining consortia that were able to invest during cyclical downturns that frighten off financial investors.

'Fables' companies were an even more pernicious management fad. Their advocates claimed that manufacturing operations yielding low margins were condemned to relocate to low-wage countries,

and that firms in developed countries should therefore specialize in high value-added tasks. But no company can design products for long without feedback from the production side. The fad put numerous plants out of business, leading distressed inhabitants of impacted areas to reject globalization, vote for Brexit in the United Kingdom and elect Donald Trump in the United States, and foster the growth of populist parties advocating isolationism in France, Austria, Germany and elsewhere.

Yet Europe can reap the benefits of a market that is still larger than either the US or Chinese market if only it eliminates the heterogeneity of its regulations and policies. A common policy, or at least a higher convergence of rules, is needed in areas as varied as greenhouse gas emissions, energy transition, wage taxation, corporate and especially digital transaction taxation, similar to what has been done successfully for most product regulations.

Given that climate change is a top priority, a carbon tax should be introduced. In the absence of a good incentive to reduce emissions, countries continue to implement policies that are sometimes very expensive and inefficient. Denmark and Germany, while making commendable efforts to promote renewable energies, still use highly polluting coal plants to deal with supply intermittency. It goes without saying that a high tax should not undermine European industry in competition with less 'green-concerned' competitors. A carbon tax should therefore apply to imported products, commensurate to the emissions caused by their production. Though somewhat complicated to implement (yet no more than VAT at the time of its introduction in the 1950s), a tax of this kind would comply with WTO rules since it would apply equally to imported and locally made products.

Some convergence is also needed for taxation, especially labor taxation. The current situation sees some countries like France financing their welfare system through high tax on salaries, and others relying on the regular tax system, with all citizens contributing according to their income or consumption spending. This creates significant differences in labor costs between countries. The situation is particularly evident in the case of employees on foreign



postings, when people doing the same work in the same country are subject to very different taxation systems. In the long run, countries like France have to reduce the taxes on salaries to avoid this kind of distortion.

Likewise, the taxation of companies operating in multiple jurisdictions requires a coordinated response by European countries. The European Commission is well aware of this situation. It has condemned some tax practices in Ireland and Luxembourg and is working on a project to tax digital transaction platforms.

Finally, in the past the commissioner in charge of competition policy opposed mergers like the one of Airbus with British Aerospace to avoid creating dominant players in Europe. However, in industries where products manufactured around the world are widely available, this policy prevents the emergence of powerful European players, without benefits for the European consumer, and significantly damages the continent's industrial fabric. European prosperity and the purchasing power of Europeans also depend on an ambitious industrial vision.

Thus an ambitious industrial policy is clearly needed in Europe, as the Continent emerges from a long recession and faces ever-increasing competition from countries that do not shy away from state intervention in support of their industrial champions. New French President Emmanuel Macron has ambitious ideas, but in this as in any other policy domain, a lot hinges on Berlin. There are high hopes that the new German government can kick-start a project to build a stronger and more integrated Europe.

*Thierry Weil, La Fabrique de l'industrie; Professor of Economics, MINES ParisTech; Member, French Academy of Engineering.*

# BREXIT IN 2018

The negotiations on Britain's exit from the European Union (EU) made little progress during the course of 2017. The two sides still have not agreed on the amount of the settlement (though they agreed on the size of the ballpark). Slow progress is a result of four factors. The talks were unprecedented insofar as no Member State has ever tried to leave before. The EU could not start negotiating until the UK formally initiated the procedures for leaving. The elections that were held in the Netherlands, France, Germany and Austria further stymied progress in the discussions. And the scope and variety of disagreements, with structural matters proving to be the most challenging, made matters even more complicated.

To begin with, the negotiations are being held up on all three dimensions – principles, process, and substance. For example, many in Britain do not understand or accept that they should be liable for financial commitments made while the UK was a Member State, just as many in the EU do not believe the UK should be compensated for shared assets. The British also object to the EU's preferred sequencing of the talks, which puts the divorce proceedings before any discussion of the future relationship. Behind these disputes, moreover, lie a host of other disagreements on issues ranging from the amount of any financial settlement, the treatment of EU nationals, the duration of the transition from Member State to third country, and the nature of the new borders – both legal and physical – that will exist once the new relationship is established.

As if that were not enough, the situation is further complicated

by the tight calendar defined by the provisions of Article 50 of the Treaty on European Union, which allows two years for negotiations after a country announces its intentions to leave the EU. The ‘divorce proceedings’, including any financial settlement and provisions for EU nationals, need to be concluded before the Article 50 clock runs out or else all other 27 EU Member States must agree to allow for an extension.

Such talks were not able to begin in earnest after the UK’s 29 March 2017 announcement of its intention to leave due to the French, British, and German elections. They must also allow four to six months for ratification of the agreement and leave time for some kind of transition period prior to the next British elections (which must be held by 2022, according to the Fixed Term Parliaments Act, but could be called much earlier). Most observers agree that two years is the minimum timeframe within which Britain can make the jump from being part of the EU’s internal market and customs union to being an autonomous actor in terms of managing trade with Europe and elsewhere.

The relative balance of power both within and across the UK and the European Union complicates matters even further. British Prime Minister Theresa May lost the May 2017 parliamentary elections and managed to hold onto her majority in Westminster only by dint of the peculiarities of Northern Irish politics – the Sinn Féin MPs refused to take their seats because that would require them to swear loyalty to the Queen of England, and the Democratic Ulster Party is willing to supply the votes necessary to keep May’s Conservative Party in power. Even so, the small size of May’s working majority leaves her hostage to potential back-bench rebellion even as her disastrous performance in the elections leaves her vulnerable to a revolt within her cabinet. This situation is further complicated by sensitive issues regarding freedom of movement between Northern Ireland and the Republic of Ireland.

Because of this political weakness, May finds it difficult to make meaningful and lasting concessions to the EU. For their part, the EU heads of state or government openly speculate as to whether it makes sense to try and support May by offering concessions of

their own – with the potential downside that May might not be able to reciprocate or, worse, that her successor will only take advantage of EU generosity to push for more.

The EU is not in a strong position to make concessions even in the best of circumstances. This weakness on the EU side comes from the complex division of interests among institutions – the European Council, Commission, and Parliament – in addition to the divisions among the Member States. The EU's difficulty in making concessions also stems from the relations that each of the Member State governments has with its own parliaments and constituents.

During the early phase of the talks, this EU weakness came across as consensus: Europe's institutions, like its heads of state and government, have not disagreed openly with one another for fear of politicizing the issues at stake in one or more institutional or national arenas. The appearance of consensus can only be maintained as long as the EU's bargaining position remains unchanged.

This combination of broad disagreement, limited timeframe, and inflexibility on all sides sits on top of the incredible substantive complexity of disentangling two major advanced industrial economies that have worked together on many levels and across a wide range of issues over the past four decades. Ultimately, the negotiations will come to a conclusion and Britain will leave the European Union. The political will is too great for that not to happen. Hence the real question is whether Britain's new relationship with the rest of Europe – and indeed whether the European Union – will function better after this process is completed or whether both sides will be damaged. Given the complex structure of the talks, that remains to be seen.

*Erik Jones, Professor of European Studies and International Political Economy, Johns Hopkins University, School of Advanced International Studies (SAIS); Senior research fellow at Nuffield College, Oxford.*

# GERMANY IN 2018

**G**ermany remains the powerhouse of Europe. The economy is strong and competitive, real wages are growing and employment is increasing. However, the refugee influx is generating upheaval, exposing a political fault line that undermines the impetus to further European integration. The challenge for Germany is to integrate over a million refugees, mainly Muslim and not easily employable, while maintaining its leadership role in Europe. Achieving both will require experimentation with approaches to economic policy-making, now and in the future, that will create more flexibility in the German economic model, draw together those political fault lines, and still support German leadership in European integration.

The *Hartz* reforms of the early 2000s presented a similar labor supply shock and lesson – a textbook case where labor supply rose along a stable labor demand curve, pressing down on wages across the economy. The political solution to unlocking the economic stimulus during *Hartz* was to increase the incentives to work. This included *inter alia* subsidies for low productivity workers and support for persons in need. But the willingness to accept the same approach for the refugees (roughly 2% of the total labor force) is limited, in part for cultural reasons and in part because, like *Hartz*, it threatens the structural stability of the German economic model. As with the *Hartz* reforms, creating a good political resolution of the challenge requires more flexible approaches to policy that are acceptable within the framework of the *Soziale Marktwirtschaft*.

No other G7 country maintains such a high share of manufactur-

ing employment nor achieves such high employment, despite having one of the most restrictive legal frameworks for dismissal protection. Furthermore, the German education system bets on early specialization, bank-based business financing favors already existing firms, and grant-based innovation support subsidizes spending by already successful companies. These features are productivity enhancing in the manufacturing and exporting sectors which are exposed to global competition and face continuous pressures to innovate. But they also constitute barriers to domestic competition and help to create a stable product market structure.

A key aspect of Germany's success is the mutual trust between social partners which favors beneficial, long-term outcomes. Smooth school-to-job transition is achieved by an education system which equips secondary school graduates with practical, employable skills. An important side effect of a stable set of employers is the continuous creation of local jobs and informal community networks that reduce adverse selection and lower the cost of finding skilled labor. Germany's status quo includes strict dismissal protection, which favors long tenures and allows worker-management-owner co-operation with long payback periods. Workers participate in the introduction of new technologies and incremental innovation, which help to maintain international competitiveness, and receive job security in exchange. Long tenures contribute to stable community structures, which facilitate tailor-made local infrastructure and favor stable geographical production structures.

This policy setting is very effective in a structurally stable environment and economy, but also generates resistance to change. It seems to be a fair assumption that the willingness to accept a repetition of the *Hartz* experiences to integrate the refugees is low. Germany faces a challenge, but the old instruments cannot be applied any more. So, what new approach can Germany pursue?

One approach would be to identify areas of the economy where both productivity and employment levels can be increased, such as services where there are major productivity gaps compared to exporting sectors. Enhancing the dynamism of such areas would raise incomes and, importantly, strengthen the overall resilience of

the economy to future shocks. The German economy will have to become more open to change, but stronger productivity growth in domestic sectors would also strengthen its export-oriented model. The current inflow of refugees and migrants provides an opportunity to explore the kinds of product market reforms that would expand employment and entrepreneurship opportunities for the refugees without necessarily putting pressures on wages.

Getting to that point may require renouncing cherished formulas, however. Germany's public finances are sound and policy space exists to finance and enable this transition. But successful adjustment of policy will depend on the ability of policy-makers to define the problems and articulate these to society in ways that are seen to be strengthening the German economy. Indications of progress in this regard are limited. Following the disappointing electoral outcomes for the (once) big parties, the failure to form a new-style governing ('Jamaica') coalition reveals the difficulties with political change management and raises the prospect of opportunism by political parties that were more prepared to compromise when the Chancellor was the dominant political force. The risks are high that failure to find the right economic formula for refugee integration will further undermine the political coherence needed to find a workable solution in the first place. For these reasons, the outcome of the refugee integration challenge is critical to Germany and to Europe.

*Chris Loewald, Head of Policy Development and Research, South African Reserve Bank (SARB), and Andreas Wörgötter, Adjunct Associate Professor, TU Wien, and Visiting research fellow, SARB.*

# FRANCE IN 2018

**E**mmanuel Macron's victory in the French presidential election, followed by his party's success in the legislatives, came as a major surprise for many analysts, including myself!

These victories in part reflected the disillusionment with the parties that had exercised power alternatively over the past fifty years. Among constituencies on the left, many voted for Emmanuel Macron, believing him to provide better protection against the extreme right. For part of the electorate therefore, Macron is president by default, which explains the rapid collapse of his popularity after the election. Macronism, by promising to liberate the economy and to promote equal opportunity in a French-style remake of the 'Third Way' that Blairism embodied twenty years ago, also reflects the consensus of a broad electorate that includes centrists, the neo-liberal right, and the majority of economic elites.

In 2018, the Macron Administration will have a free hand in domestic policy. No national or local elections will take place, with the first being the European parliamentary elections in 2019. Political opposition is weak and fragmented. All that remains of the Socialist Party is its ghost. The radical left and the Communists form two distinct groups in the National Assembly. The extreme right has still not recovered from Marine Le Pen's calamitous performance during the face-to-face debate against Emmanuel Macron between the two rounds of the presidential election.

French conservatives are split into two tendencies: one neoconservative, the other supporting Macron's policies, as does most of the center right. The Administration's economic team – Prime



Minister, Minister of the Economy and Finance, Minister of the Budget – is entirely made up of politicians from the right and is painstakingly resuscitating elements of the historical economic programs of the French center right.

Trade union forces are in disarray as well. The profound changes in social relations, employment protection, unemployment insurance, vocational training, and soon in the retirement system that are being implemented by the government will therefore most likely be carried out without major opposition.

In the European sphere, Emmanuel Macron has already sought to position France as the engine of a new phase of European growth. However, the country is following the strategy of a tightrope walker. On the one hand, France calls for greater collaboration, while on the other it does not hesitate to berate its partners, as was the case with Italy on the matter of the Saint Nazaire shipyards. Similarly, France seeks to profit from Brexit by luring financial employment from the City to Paris. Paris has already gained by the move from London of the headquarters of the European Banking Authority.

In both cases, it behooves France to be credible and to respect its European commitments in terms of government deficit. Structurally, France must spend two GDP percentage points more than the other large continental economies. The baby boom that has been ongoing for nearly twenty years is good news over the long term, but generates much higher spending for education as well as for social protection (maternity/parental leave, health care...). Internal security concerns and the determination to fully assume its military role as a permanent member of the UN Security Council also imply high costs. The resumption of moderate growth in the Eurozone together with the cyclical upturn inherited from the Hollande Administration's budgetary policy offer some margin for maneuver.

Nevertheless, the government's policy will reduce key fiscal receipts substantially in 2018. The most wealthy – 'lead climbers' in the presidential terminology – will benefit from the elimination of the wealth tax and the introduction of a flat tax on income. Salaried workers in the private sector and the self-employed will see their social contributions go down slightly. For the majority of households,

the reduction of local taxes will first occur in autumn 2018.

In order to balance accounts, cost-reduction measures include public sector salary and staff cuts. Retirement benefits will be subject to new taxation. Central government financing of local and regional public spending will be diminished, including the budgets of social housing organizations.

There is considerable divergence in views among experts on the medium-term effects of these important changes that will mark the year 2018. However, over the short term this policy program is likely to further accentuate socio-economic divisions in France – in sharp contradiction with the promise of equal opportunities.

Similarly, the labor market reforms run the risk of intensifying employment insecurity. The young are likely to be the most affected, as they already are by the reduction in housing subsidies and by the critical situation of numerous public universities. The specter of youth mobilization haunts governments in France, though this will not likely occur before the second semester of the new academic year in spring 2019.

The transitory domestic political stability in France would contrast with the situation in its principal European partners (i.e. Germany, Italy and Spain). Thus, 2018 may go down in History as the ‘year of enchantment’ in the current five-year presidential term of office.

*Philippe Askenazy, Professor of Economics at the École Normale Supérieure; senior researcher at CNRS-Centre Maurice Halbwachs.*

# ITALY IN 2018

Italy's political environment in 2018 will inevitably be dominated by the elections to be held in the spring. With a spectacular *tour de force*, a new electoral law has been passed on 25 October 2017, showing that when there is 'political will', Parliament – though afflicted by a perfect bicameralism where both chambers perform the same functions – can be very efficient. In fact, the discussion on the legislative text had begun only on 21 September, such a tight timeframe that implicitly calls for reassessing an issue that was debated throughout 2016: that the Constitution must be revamped in order to make ambitious reforms. The speed of the legislative process on this occasion testifies, in a way, to the vanishing of any call for changes to the Constitution, already rejected in the 4 December 2016 referendum. Indeed the institutional reforms have disappeared from the parties' agendas, and most notably from the Paolo Gentiloni government, which succeeded Matteo Renzi just after the outcome of the referendum.

Thus, what will be on the agenda in 2018? This would depend on the nature of the government that will emerge from the elections. All of the polls on voting intentions over the past few months point to a head-to-head race of the two major parties: the Five Star Movement (M5S), whose candidate for premier is the young Luigi Di Maio (31), and the Democratic Party (PD), still in the hands of Renzi (42), each counting on about 25-28% of the vote. The right-wing parties individually attract lower percentages, but together they can count on around one-third of the electorate: Silvio Berlusconi's Forza Italia (FI) and a revived Lega Nord (LN), led by Matteo

Salvini, are at around 15% each, plus 5% for Fratelli d'Italia (FdI), a right-wing nationalist and identity-based grouping with some 'post-fascist' elements and a veiled tendency for nostalgia. Then there are minor forces at the center and to the left of the PD, but their entry into Parliament is subject to overcoming the newly-introduced 3% threshold: only if the various groups on the left stop arguing with each other and present a single list, then they could send a significant number of candidates to the chambers of Parliament. Lastly, in this final term of the legislature, other formations are emerging, with the risk of further fragmentation. In particular, a pro-Europe list is being prepared, led by Emma Bonino, a historic figure highly praised for her personal and political integrity and 'anthropological' extraneousness to the halls of power (despite a 40-year career in Parliament, government and European institutions).

The division of the electorate into three major components – a left dominated by the PD, an M5S in more or less splendid solitude, a right divided into three parties (FI, Lega and FdI) – will make it impossible to form a homogeneous government. Out of necessity, one of these components or its constituents will have to form a coalition in order to give life to an executive. To date, this solution seems impractical because the supporters of each party consider such alliances to be out of the question. Against this background, two other hypotheses should be considered.

The first is that of a government 'supported' by abstention. In Italy, the Constitution foresees that a government can take office even without the support of the absolute majority of the members of the two chambers: a relative majority is sufficient. This expedient was used several times during the post-war period and therefore would not be breaking with political practices. Indeed, in some cases it introduced important new developments: the Andreotti government of 1976-78, though made up of and supported solely by the Christian Democrats, counted on the 'benign indifference' of the Communist Party, which abstained and in this way legitimated itself to some extent without having to vote in favor of the historical enemy and its government. In the present context, however, without a political majority, it is extremely unlikely that *all parties*, as in the

Andreotti case, will give way to a ‘government of abstentions’. Thus the political direction of the new minority government will depend on who will support it with abstentions and who will vote against it. And this, in turn, will depend on who will be at the helm of this government – a political leader with a clear connotation, or a *super partes* technocrat as occurred in 2011 with the Monti government.

The second scenario after the elections sees the continuation of the Gentiloni government *in prorogatio* as a caretaker, similar to what has happened in recent years in Belgium, Spain, the Netherlands and Germany. This is an emergency solution, but there is evidence that such caretaker governments have not performed particularly poorly, especially in economic terms. A note of caution is warranted: Belgium and Spain have institutional structures that entrust many areas of self-government to their territorial components, while Italy has devolved very few competences to the regions (with the exception of the five governed by special statutes: Sardinia, Sicily, Trentino-Alto Adige, Friuli-Venezia Giulia and Valle d’Aosta).

Indeed, the latter point is going to be an important topic in Italian politics next year. The recent consultative referendum held in Lombardy and Veneto has rekindled the issue of regional autonomy. Although a Catalan scenario can be ruled out, it should be noted that the outcome of the referendum could provide an opportunity to negotiate a redefinition of competencies as requested not only by the Northern regions, governed by the Lega Nord, but even by Emilia-Romagna, the red region *par excellence*, which is calling for more autonomy even without resorting to a referendum.

Lastly, whatever the outcome of the elections, the same problems remain in the agenda: ranging from the weakness of the economic recovery and job creation to rising inequalities, from perceived security risks generated by immigrants (although hard data suggest otherwise), to the demand for efficiency and good governance. All are problems that do not require a ‘stable’ or ‘strong’ government, but a ‘serious’ government – a quality that Italians appreciate most precisely because it is rare among the political class.

*Piero Ignazi, Professor of Comparative Politics, University of Bologna.*

# SPAIN IN 2018

The Spanish economy will end 2017 with growth exceeding 3% for the third consecutive year, outpacing the euro area average. In doing so, GDP will return to peak levels for the first time in nine years.

This impressive recovery has been underpinned by a variety of factors. First of all, the vigorous cyclical upswing primarily reflects the domestic response to the accumulation of pent-up demand during the double-dip recession between 2009 and 2014.

Secondly, Spain has enjoyed a windfall from the European Central Bank's monetary policy. The reduction in interest rates has supported a dismantling of burgeoning household and corporate debts, which were significantly above the euro area average at the start of the crisis. Meanwhile, quantitative easing has been crucial in preventing an explosion in public debt growth. The latter continues to provide a firewall against future episodes of idiosyncratic risk, as was the case during the 2016 caretaker government, and is so far proving to hold up during the political crisis in Catalonia, which has come to a head in the last quarter of 2017.

Thirdly, given the economy's significant energy dependence, the easing of oil prices in recent years has also had a particularly significant impact on the Spanish economy's export competitiveness, making a major contribution to reducing the external trade balance. Spain's net lending position has swung from -10% of GDP in 2007 to +2% since the start of the recovery.

Fourthly, the relaxing of the public administration's fiscal adjustment path also provided an important stimulus to growth in 2015

and 2016. The Bank of Spain estimates that fiscal policy contributed 0.3 and 0.8 percentage points, respectively, to GDP growth in these two years, compared to the 1.0 and 1.7 ppts impetus from ECB monetary policy, and a further 0.3 and 1.1 ppts of momentum from oil price developments.

Fifthly, it is also worth highlighting the spike in demand for tourism in Spain due to geopolitical instability in many of the country's main competitors in the Mediterranean. This has led to record tourism revenues.

Finally, a significant labor cost reduction during the crisis facilitated an exceptional increase in labor productivity, which in turn accounts for most of the competitiveness gains made by the export sector (also supported by exchange rate and oil price developments). The decline in Spanish labor costs from 2009 is unparalleled within Europe, reflected in zero wage growth over 2008-2015 (8% loss in purchasing power) and the loss of approximately 2 million jobs between 2008 and 2017 (at constant GDP).

This contraction in wage remuneration has been the cornerstone of the improvement in corporate competitiveness seen in recent years. And is reflected by the fact that in 2017 household consumption remains some €25 billion below pre-crisis levels, despite GDP returning to similar levels. This gap, together with the €90 billion reduction in real estate investment, has been countered by a larger contribution from exports.

However, while it is true that Spain will present a more balanced growth profile in 2018 than it did in 2008, with exports set to contribute positively to growth (unusual for the Spanish economy during an upswing), it is equally true that the overall deterioration in wage remuneration remains to be addressed. And, though unemployment is still far too high, it is increasingly approaching estimated structural levels. This issue is likely to come to the fore in the political agenda in 2018 as social agents begin to intensify their demands for pay increases.

We see GDP growth as levelling off somewhere between 2.5% and 3% in 2018 – without a more pronounced deterioration in risk factors – but this will be particularly sensitive to developments in

the household savings rate. Private consumption growth has gradually eased over the course of 2017, accompanied by a drop in the household savings rate which has recently nosedived towards record lows. A hypothetical spike in the savings rate for precautionary reasons in the face of some unidentified risk event could lead to a more abrupt slowdown in consumption.

Meanwhile, 2018 should see the public finances finally leave the control of the Excessive Deficit Procedure. This will take place against the backdrop of an absence of parliamentary support, forcing the government to roll over the State budget for the second time since the start of the current legislature. While 2018 is unlikely to see a recovery of public investment – which remains at around half of historic levels – the budget carry-over should not have a significant impact on the economic cycle.

All of the above remains strongly contingent on the outcomes of two historically unprecedented political developments: Brexit and the Catalan conflict. Regarding the former, suffice it to note that the Spanish economy has stronger trade, tourism and FDI links with the United Kingdom than with the euro area on average. Meanwhile, growth in Catalonia, which represents 20% of Spanish GDP, is likely to be weakened by the uncertainty generated following the intensification of tensions with the central government. A decline in both national and international investment and a weakening of tourism revenues look to be all but inevitable. The scope and duration of this conflict will ultimately influence the extent to which Spain can continue outperforming the other euro area economies (as has been the case since 2014), and the stability of the region as a whole.

*Emilio Ontiveros and Daniel Fuentes are, respectively, President and Lead Economist, AFI (Analistas Financieros Internacionales).*



## REST OF THE WEST

## USA IN 2018

Uncertainty has reigned in Washington since the election of Donald Trump, and it is likely to continue to reign in 2018. The uncertainty has several dimensions, all of which feed on each other. Nonetheless, the implications are unlikely to be positive for the United States or for the world.

*Politically*, both major parties are in turmoil. The Trump wing of the Republican Party, which has staked out economic nationalist, populist, and anti-globalization positions, seems to be in the ascendant within the party. Its policies continue to face opposition from more moderate Republicans, especially in the Senate, and from traditionally Republican members of the business community. All of these players can agree on some characteristically Republican policies – tax cuts, more military spending, deregulation – but they quickly divide on other issues, especially on international economic policy. The battle for control of the Republican Party has meant that despite controlling the presidency and both houses of Congress, the party has been ineffective on the legislative front, with most of its policy initiatives coming from executive action.

For their part, the Democrats continue to argue over how best to mount a serious, politically attractive opposition. More mainstream Democrats want the party to make a play for more moderate voters, including those alienated by the Trump Administration. Those in the left, more populist, wing of the party would like it to adopt a policy stance more firmly hostile to aspects of globalization, and more firmly committed to redistributive policies.

Both parties will carry on battles among themselves, even as they

prepare for a hard-fought mid-term election in 2018 – and look toward an even more hard-fought presidential election in 2020.

*Economically*, the country continues to grow at a slow but reasonable pace, with little or no inflation. There are, nonetheless, causes for concern. Productivity growth remains slow, and real wages – along with real household incomes and wealth – are stagnant. This is a problem in itself, and even more so to the extent that it feeds into broad discontent with existing political institutions and politicians.

There are two other sources of economic concern. The first is the great uncertainty about American foreign economic policy. Substantial changes in policy toward international trade and investment could be disruptive to major American industries – with unpredictable consequences.

The second source of concern is the possibility that asset prices may be substantially overvalued. This, in conjunction with growing levels of household debt, could create the preconditions for another round of financial distress. While fears of a bubble are limited, and the financial system is probably better prepared today than it was ten years ago, each new financial crisis presents novel features and potentially difficult challenges to the economic authorities.

These political and economic uncertainties compound the broader uncertainties about the course of American domestic and international economic policy. Many of the Trump Administration's political actions have, so far, been more extreme in rhetoric than in reality. Nonetheless, there seems to be little doubt that the President and many of those around him aim to alter substantially the form and the substance of American foreign policy in both the economic and non-economic realm. Were the stated strategies to be implemented, the United States would follow a mercantilist trade policy to reduce imports and expand exports; would tend to disadvantage foreign investment by American companies; and would restructure both its alliances and its participation in international institutions.

Whether or not the Administration is willing and able to follow these principles to their policy conclusions, they will have – and are already having – a profound effect on the world and America's

place in it. Policy-makers around the world have, quite reasonably, come to see that they can no longer rely on a continuation of traditional American positions in international economic, military, and diplomatic affairs. They have already begun to make preparations for a world in which the United States is conspicuous in its indifference or hostility to many of the traditional structures of the post-war world – structures it largely put in place itself. This suggests that major powers in Europe and Asia will work to build zones of economic, military, and diplomatic security with like-minded countries in their regions. The result could, ironically, be costly to the United States – and, potentially, to the world.

*Jeffry Frieden, Professor of Government, Harvard University.*

# JAPAN IN 2018

**I**n a world badly shaken by populism and authoritarianism, Japan remains a stable liberal democracy. By winning the 2017 general elections, Prime Minister Shinzo Abe gained his fifth consecutive electoral victory over the past five years. While he himself is not too popular, affected by some sleaze issues, his LDP and partner Komei party command two-thirds of the Diet, mainly thanks to the deeply divided opposition. His large majority as well as ample time ahead without a major national election might well allow him to overcome the wariness of the Komei party and push for constitutional reforms in order to change the pacifist Article 9 prohibiting war and an army – a life-long wish for conservatives like Abe.

Three uncertainties that cloud Japan's horizon could, paradoxically, be advantageous for Abe's constitutional reforms. First, the threats coming from North Korea are quite real. In 2017 alone, Pyongyang launched more than a dozen missiles, some of them flying directly over Japanese territory, and conducted its sixth nuclear test. There is little doubt that Kim Jong-un's regime continues to develop its nuclear as well as ballistic missile technologies – 2018 might very well be the year when it becomes capable of launching a nuclear missile with detonable warheads. Particularly worrisome is the prospect that it might acquire a real capability to strike the US, as this might lead to a so-called 'de-coupling' of allies. It means that the US would have less incentive to protect Japan (or South Korea, for that matter) for fear of having San Francisco or Chicago attacked. Japan hitherto had depended on the US nuclear umbrella,

whose perceived unreliability might well persuade Japan to heavily arm itself. This would help Abe to pursue the agenda of giving up Article 9.

The second uncertainty concerns China. The not so civil and peaceful nature of its rise is a medium- to long-term challenge for neighboring countries and beyond. Over the past generation, China increased military expenditures at a rate higher than its economic growth – Chinese defense spending now exceeds the combined military budgets of Russia, France, the UK and Japan. The aggressive pace at which China has built artificial islands and military facilities in the South China Sea may have slowed down after the July 2016 ruling, utterly unfavorable to China, by the Hague's Permanent Court of Arbitration, but nothing has changed in the situation under which international norms are violated. Of particular concern these days is the increase in air force activities. The number of Japan SDF flights scrambled against (potentially) intrusive Chinese aircraft jumped roughly eight times in 2016 as compared to 2010. In summer 2017, Taiwan was on high alert for the Chinese air force drills, involving bombers and fighters, within the zone the former effectively controlled.

The challenge China poses is not just military. With its sheer economic size, China has a peculiar characteristic of depreciating values: human rights as well as social, safety and environmental standards. Inside China, a number of lawyers, journalists and activists are detained for no justifiable reasons. The Taiwanese media is increasingly controlled by Chinese or pro-Chinese capital. Even in a distant region like Europe, the Springer Publisher, at the request of Chinese authorities, has withdrawn some 1,000 articles from its academic journals, on the grounds that they address topics that are considered sensitive by Beijing. Furthermore, there are issues regarding food safety, accuracy of accounting books, and labor standards, with everyone in this interdependent world being affected. In a nutshell, China is a depreciative empire, whose downgrading pressures extend beyond its territorial confines. In the world of 2018 and beyond, this sort of socio-economic challenge needs to be addressed in addition to the military pressures.

Third, the US itself is a source of uncertainty. It is hard enough to deal with all of the above threats, yet President Trump's infamous style of government makes it even more difficult. Abe needs to cope with destabilization originating from Washington DC as well. As a country next to the Korean peninsula, Japan cannot afford to ignore the risk of Trump's erratic behavior. In the end, perhaps, to the extent that former generals deal with the situation, Japan may still rely on the US militarily. More problematic may well be Trump's aggressive pursuit of 'America First', notably in socio-economic domains. In the environmental field, the US itself plays a depreciative role. In trade, the US under Trump demands quick and tangible progress. All of these elements pose a risk for Japan.

Against this backdrop, Abe in 2018 is likely to move to stabilize relations with China by paying a visit, as Xi Jinping, having just consolidated his power, has sent a signal wishing to improve relations with Japan. This, seen from the side of Japan, fits with her own interests: we all know that China holds the key in dealing with the North Korean problem, for which an uncertain Trump presidency cannot be considered wholly dependable.

While still keeping the US at arm's length, Abe will face diverse risks. In 2018, finalizing a TPP-11 (without the US) and reaching an FTA with the EU are likely to be central to the agenda for his government. Also, whatever happens with the territorial issues, Abe will seek better relations with Putin's Russia, especially after the March 2018 presidential elections. However logical it is to maintain good relations with South Korea, in view of the obvious threats from the North, Japanese-Korean relations may turn frosty again, to the extent that the Moon government does not stick to the 2016 inter-governmental agreement on the so-called comfort women. Both may attempt to bypass each other by seeking improved relations with China.

*Ken Endo, Professor of International Politics, Hokkaido University; Chercheur invité, Institut Français des Relations Internationales (IFRI).*

## EMERGING WORLD

## AFRICA IN 2018

Among the forty-nine countries in Africa south of the Sahara, issues of governance, economic development, and security will be prominent in 2018. Political transitions have raised hopes for change in several states. Many economies are slowing after a period of growth, as countries find themselves in the balance between revitalization and stagnation. In the aftermath of large wars, resilient insurgencies and stubborn civil conflicts continue to challenge regional security.

Following the dramatic wave of democratization and political reform in the 1990s, a varied political landscape has developed across Africa, ranging from relatively healthy democratic systems in Ghana and Cape Verde, to troubled electoral democracies in Nigeria and Kenya, to entrenched authoritarianism in Eritrea or Equatorial Guinea. While democratization has gained ground across the region, problems of accountability and performance remain pressing concerns in diverse political systems.

A number of recent political transitions raise possibilities of changing trajectories. In the Gambia, Adama Barrow was inaugurated following a contentious election that surprisingly ousted long-standing dictator Yahya Jammeh, with an exuberant electorate hoping for a democratic future. Angolan elections produced a scripted turnover from incumbent José Eduardo dos Santos to party notable João Lourenço. However, the new president quickly dismissed a number of dos Santos's family members and loyalists from public posts, leading to guarded speculation about political reform in this dominant party state.

More dramatic change occurred in Zimbabwe, where the military intervened to sideline President Robert Mugabe to make way for a civilian turnover. His successor, Emmerson Mnangagwa, a former security chief from the ruling ZANU-PF party, suggested more continuity than change, despite public adulation about the departure of the elderly strongman. Kenya's presidential election was set aside by the Supreme Court, leading to a messy re-run several weeks later. Incumbent President Uhuru Kenyatta prevailed in both polls, but the opposition led by Raila Odinga rejected the legitimacy of the results. Political polarization continues to trouble the new government. In South Africa, criticism of President Jacob Zuma for corruption and 'political capture' of the state financial machinery has fuelled intense contention over the leadership of the ruling African National Congress.

Economic growth accelerated across Africa in the new century, reversing a long period of decline and stagnation. The region's economies grew at an average rate of 5.2% from 2000 through 2014, reflecting the longest period of healthy performance since the era of independence in the late 1950s. Countries as varied as oil-rich Nigeria and Angola, resource-poor Rwanda and Ethiopia, and post-conflict states such as Sierra Leone and Liberia all registered strong performances for more than a decade. Rising commodity prices, investment and trade from China, India and Brazil, improved economic management and reduced debt all contributed to growth.

In the last few years, regional economies have slowed markedly with declines in global commodity prices and lagging Asian growth. Sub-Saharan Africa displayed an aggregate growth of just 1.4% in 2016, although the International Monetary Fund forecasts a modest rebound to about 3.5% in 2018. Under budgetary pressure, a number of countries are taking on more external borrowing, threatening to reverse the gains of debt relief from a decade ago. Mozambique, Ghana, and Nigeria, for instance, have experienced macroeconomic instability arising from deteriorating external balances. Other countries, however, have been able to maintain stability and propel growth – most notably Ethiopia and Rwanda,



which have promoted manufacturing, infrastructure and innovative services.

Improved governance and economic growth have helped to attenuate the devastating conflicts that wracked many countries following the end of the Cold War. In recent years, the number and scale of conflicts have diminished substantially as large wars ended in the Democratic Republic of Congo (DRC), Sudan and Angola, and peace was consolidated in Rwanda, Liberia and Sierra Leone. Nonetheless, several countries, including Somalia, the DRC, Mali and Nigeria, are still threatened by insurgencies, while South Sudan, Burundi and the Central African Republic are gripped by civil strife. Transnational insurgencies such as Boko Haram, Al Qaeda in the Maghreb and Al Shabaab threaten the countries in their sub-regions. Regional cooperation among states will be a critical element in containing militant networks. The civil conflict in South Sudan is currently the largest in the region, claiming tens of thousands of casualties and millions of displaced people. Regional and international efforts will continue to focus on resolution of the war.

Conflict and economic dislocation will continue to drive migration to Europe, with South Sudan, Eritrea, and Nigeria among the leading sources. The recent exposure of abuses involved in human trafficking in Libya and the continued toll of fatalities among migrants attempting passage across the Mediterranean accentuate the urgent need for effective responses to the migrant flows. Unfortunately, the European Union has not been able to craft a strategy to stem outflows from Africa or to reduce the human toll in open waters. Immigration policies across Europe also provide limited opening for legal immigration or asylum.

*Peter M. Lewis, Johns Hopkins University, School of Advanced International Studies (SAIS).*

# ARGENTINA IN 2018

**A**rgentina stands out as a crisis-prone country, notorious for its poor record in macroeconomic management and political instability. Over the past ninety-odd years, Argentina has been trapped in boom and bust economic episodes. These pendular moves along the business cycle are exacerbated by policy choices ranging from loose monetary regimes, overvalued exchange rates, fiscal profligacy, financial repression, and trade restrictions. Redistributive motivations, polarization and institutional instability have historically made Argentine leaders fear for their political survival and heavily discount the long-term impact of their economic policy choices.

While traditional economic and political challenges remain, 2018 could present an opportunity to turn the page. Economic activity is expected to grow at 3.5% and the government is forecasting a single-digit inflation rate within four years, but in the absence of a clear monetary anchor, raising the interest rate could prove insufficient to reach that target. The results on the fiscal side are more promising, as the primary fiscal deficit is expected to drop to 3.2% in 2018. Central Bank reserves have more than doubled under Macri, reaching US\$55 billion in the second quarter of 2017 (equivalent to nine months of imports). A successful tax amnesty on financial holdings – which had risen as a result of capital flight and fear of government overreach in prior years – has expanded the tax base and mobilized idle capital. A sharp drop in sovereign risk has allowed the government to lower the costs of servicing its debt.

Many eyes will be turned on Argentina as G20 chair in 2018 and

the challenges it faces are formidable. While the terms of trade are relatively stable, a stagnant Brazil (Argentina's main trading partner) and growing uncertainty over the evolution of international trade cast shadows over export growth. Savings and investment rates, at 12.8% and 16% of GDP, respectively, remain staggeringly low; labor productivity stagnates; public infrastructure needs upgrading; and the appreciated real exchange rate is affecting the competitiveness of the tradable sector. After years of politicization and abuse of power, distrust over the functioning of political and judicial institutions still looms large.

This is not the first time that economic and institutional reform has taken the central stage in Argentine politics, the most recent effort being by an improbable leader, the Peronist maverick Carlos Menem, in 1989-1999. Yet under Menem spending remained pro-cyclical and was ultimately unsustainable as in previous episodes in Argentine history. The legacy proved unmanageable to Fernando de la Rúa, who succeeded Menem with a reformist message but resigned in 2001, opening the way to the 2002 debt default, severing its link to international finance. Yet strong tailwinds associated with the commodity boom of the early 2000s led to rapid growth during the presidencies of Nestor and Cristina Kirchner. The government reacted to this boom in a pro-cyclical way, increasing public spending through subsidies and other social programs, imposing trade restrictions, and loosening monetary policy. Eventually this policy course proved unsustainable, paving the way in 2015 for the triumph of Macri, supported by *Cambiamos*, an alliance of political parties whose common denominator was their opposition to Kirchner's policies and practices.

On the political front, there are signs that this time could be different. *Cambiamos* has received a solid backing in the mid-term elections held on October 22, 2017. With resounding wins in the most populated districts and important gains in traditionally Peronist strongholds, the centrist coalition is looking at a more promising political environment for advancing its reformist agenda. Its biggest challenge is to put the economy back on a sustainable track while breaking the Peronist dominance in Argentine politics. *Cam-*

*biemos* has made substantial gains in the House of Representatives, but it remains short of a working majority. The opposition camp – controlled by different strands of the Peronist Party – remains dominant in the Senate. The strongest opposition group in the legislature is the United Citizens Front led by former President Cristina Fernandez de Kirchner, who has been indicted for alleged corruption and malfeasance charges and remains toxic to large swaths of the electorate. Other blocs in Congress that are linked to provincial and local leaders distanced themselves from Kirchner.

The visceral divide between pro- and anti-Kirchner camps that has dominated Argentine politics provides Macri with some room for maneuver. A grand bargain between the federal and provincial governments will be necessary in order to pass the fiscal reform announced by the administration after the mid-term elections.

Two local themes will dominate economic debates: the pace and depth of the government's economic reform efforts, and the strategy to fight poverty, which affects one in three Argentinians, and generate jobs. Macri and his allies are betting that higher economic growth, lower inflation, rising financial flows, and falling borrowing costs will set the public sector on a sustainable path. Yet critics from the left argue that the costs of adjustment are inexorably borne by the most vulnerable economic agents, while those from the right would prefer shock therapy. The choices for Macri are not simple, as he is aware that since the 1955 coup, not a single President elected without the backing of the Peronist Party has completed his/her tenure in office. Reining in inflation and cutting spending have traditionally proven to be unpopular – the challenge for *Cambiemos* is to strike a balance that will allow it to break this cycle.

As long as the US Federal Reserve maintains its cautious approach towards raising interest rates, the Argentine government will enjoy some room for maneuver to sustain its preferred path to economic reform. Macri and his allies are persuaded that this gradual approach will give them larger political dividends. The absence of elections in 2018 and the political jockeying among the opposition leaders to distance themselves from Kirchner and her legacy provide a window of opportunity for the gradual path to economic

reform to succeed. This would open the door for fundamental debates on the best policies to promote growth, reduce poverty and improve the living conditions of the Argentinians.

*Pablo M. Pinto, Kenneth Lay Professor of Political Science and Director of the Center for Public Policy, Hobby School of Public Affairs, University of Houston.*

# CHINA IN 2018

**I**n 2017 China accomplished a transformation that its leader, Xi Jinping, has proclaimed as a 'new era'. After one hundred years of humiliation, a half century of national revival and state-building and more than 30 years of opening up to the global market economy, China is now ready to take its place as a Great Power and assume a role as guarantor of global peace and prosperity.

The year began with President Xi Jinping addressing global business leaders at Davos. There he boldly took on the mantle of guaranteeing the open multilateral trading order after the shock of the US election, which brought the protectionist nationalist Donald Trump to the White House. This bid for global leadership has been in preparation ever since Xi Jinping came to power in 2012. Xi began by asserting his own leadership over the Chinese Communist Party apparatus through a far-ranging campaign against corruption that targeted vested interests in the coal and oil industries and within the military and security apparatus. At the same time, he initiated a series of long overdue domestic structural reforms to support a new model of development focusing on consumption, innovation and sustainability. This gave Xi the confidence to commit to hard targets in carbon reduction and take a leading role in concert with then US President Barack Obama to combat climate change in the historic Paris Agreement. In parallel, China launched its own series of global and regional initiatives to promote its place in the world.

Responding to the slowdown in the global economy and global trade that made China's over-reliance on exports unsustainable, and

recognizing its own overcapacity in basic industries like steel and cement, China began to promote its growth model abroad through infrastructure investment. Relying on its huge accumulation of foreign reserves, China initiated and hosted the Asian Infrastructure Investment Bank in 2015, supported and hosted the creation of the BRICS New Development Bank, and promoted the Belt and Road project aimed at building connectivity infrastructure in over sixty countries in Asia, Europe and Africa.

In tandem with this, Xi Jinping has promoted the most thorough restructuring of China's military since the founding of the People's Republic, aimed at making China a world-class maritime power with a global capacity for power projection. China now has its first overseas base in Djibouti, and has systematically restructured the armed forces to promote and enable joint land, sea and air operations with real-time cyber connectivity. These new capabilities target no particular enemy, but are intended to support China's global role. With these series of moves, Xi Jinping has leaped out of Deng Xiaoping's cautious policy of biding time in the shadows to bask in the limelight of global power and influence.

### *The 19<sup>th</sup> Party Congress*

In October 2017 some 2300 delegates of the Communist Party of China met in Beijing to set the course of policy for the next five years and to elect China's leadership. Xi Jinping used this occasion to proclaim a 'new era' and to set the stage for China to become a global power second to none by mid-century. Over the next five years China will confidently become a moderately affluent country and will address the problems of uneven development that Xi has asserted are the 'principal contradiction' facing Chinese society and the Chinese Communist Party. By 2035 China should enter the ranks of high income countries with an economy built on innovation and ecologically sustainable development. This will complete "the Great Rejuvenation of the Chinese Nation" and permanently inter the legacy of 100 years of humiliation.

Xi Jinping solidified his authority through the personnel allocations that resulted from this Congress. He is credited with person-

ally vetting and interviewing candidates up to the level of the 200+ membership of the Party Central Committee. The seven-member Standing Committee of the Politburo of the Party now includes five new members, a majority of whom are solid associates with at least one reformist ally of the Premier. He also promoted a broad slate of loyalists to the wider 25-member Politburo, where some 15 are close associates. The strengthening of the Party Secretariat under the close advisor and former academic Wang Huning, who received an unprecedented elevation to the Standing Committee, means that this body will play a role as a mechanism to ensure the subordination of the State executive to the Party. The organizational shake-up will not be complete until China's legislature, the National People's Congress, ends its new session in March 2018. This will require the selection of a new Vice-President as well as a new slate of Vice-Premiers.

### *The Road Ahead*

The new state leadership will be assigned the difficult task of deleveraging China's ballooning debt. It will also be assigned the task of reforming China's state-owned enterprises. Here is where we will see the contradictory message of the 19<sup>th</sup> Party Congress played out. How can state enterprises be reformed in a way that is consistent with a predominant role for the Party and State alongside a 'decisive' role for the market? How can deleveraging occur while ensuring continued growth as well as the currency liberalization that is required to promote the renminbi (RMB) as a reserve currency? Much of Xi Jinping's agenda depends on maintaining a steady trajectory towards global power and this, in turn, requires both economic stability and growth.

Xi Jinping's increased stature is a double-edged sword. With his enormous political resources, he can attack vested interests and remove roadblocks to effective reform. He can certainly weather the political costs of economic restructuring. However, the strident revalorization of political loyalty, in particular personal political loyalty to Xi Jinping as leader, carries with it enormous risks that political errors will be magnified as no one dares to criticize policies



approved from the top. Furthermore, purges and witch-hunts open the door to careerist sycophants who cover up their own incompetence with attacks on honest but critical officials.

*Jeremy Paltiel, Professor, Department of Political Science, Carleton University.*

# BRAZIL IN 2018

**I**n 2018, the main political event in Brazil will be the general elections that will take place in October. Voters will then choose a new president, two-thirds of the Senate, all members of the Lower Chamber, all state governors, and state assemblies. In sum, most of the executive and legislative branches of government will turn over. Given the great concentration of power within the federal executive, the nation's focus has mostly been on who will be the next president, as well as the daunting challenges she or he will face upon inauguration.

It is unclear who will win the presidency in 2018. Currently, the polls show the leader as being former president Lula da Silva with 35% of the expected vote, followed by Jair Bolsonaro, a congressman who claims to be Brazil's Trump, with 17%, and former senator Marina Silva, in third place, with 13%. Both Lula and Bolsonaro have advocated relatively radical platforms, the first on the left, the second on the right. Experience shows, though, that polls so far ahead of election day are poor predictors of whom voters will eventually choose. This is due to low party loyalty and the fact that most people wait until the last minute to make up their minds.

There are two main possibilities for the election outcome. The most likely scenario, in my view, is that both Lula and Bolsonaro will move further to the extremes, favoring candidates with less radical platforms. If such a middle-of-the-road candidate is able to coordinate parties in the center, she or he may win the election in the first round. Geraldo Alkmin, the governor of Sao Paulo state, is the most likely alternative in that case, even though he currently

commands just 8% of the voters' preference. If this centrist coordination fails, we would default to my second scenario, one of significant political fragmentation. In this case, chance will play a big role in determining who will be the two candidates facing each other in the second round. The chances of Lula or Bolsonaro being elected are much higher in such a case.

The ongoing cyclical economic recovery is one of the factors that favor the first scenario outlined above. The elections will take place with the economy growing at an annualized rate of 4% or more, with low inflation (4%) and record low interest rates (7%). Unemployment will be on the way down, incomes on the rise and consumer credit expanding again. After experiencing the largest recession on record in 2015-2016, and living with unprecedented levels of unemployment, voters should shy away from radical candidates. However, recent elections around the world have shown that overall macroeconomic indicators are poor predictors of voter rationality.

This favorable economic outlook for 2018 will depend to some extent on the sustainability of the current benign external context, in particular, on favorable commodity prices and abundant liquidity, which in turn are conditional on inflation remaining subdued, despite the acceleration in global GDP growth. This combination of low interest rates in developed economies and high growth in China has contributed to raise Brazilian asset values, of the currency and bonds in particular, helping to bring inflation down and lowering long-term interest rates.

Not all news in 2018 will be good, though. The greatest concern is that the elections, by monopolizing the attention of lawmakers, and the economic recovery, by relaxing their sense of urgency, will lead to the abandonment of the reform process, which has seen some progress under the current government. A benign external context will also favor complacency.

Without reforms, the current recovery will not last beyond 2019. Worse, if Brazil does not reform its social security system, the government may eventually find itself unable to finance its deficit, leaving money printing – with its consequent return to high inflation – as the only option.

Businesses and investors know this, and the protracted uncertainty about whether and when reforms will be adopted will curb a significant recovery in investment in 2018, despite the rise in consumption, the decline in interest rates, and the fact that investment has already come down by a quarter in the last four years.

Given this context, one would expect reforms to be the centerpiece of the 2018 electoral debate. In a favorable scenario, in which a reformist candidate were elected, this would give her or him a clear mandate to adopt the necessary reforms, which go beyond changing the social security system to also include tax reform, privatization, trade liberalization and other contentious initiatives.

Is this debate likely to happen? Unfortunately, no. Neither Lula nor Bolsonaro will defend reforms. Lula, in particular, is likely to criticize them, since the reforms are especially unpopular among his core voting group of labor union leaders. Centrist candidates, in turn, are expected to praise the ongoing economic recovery, comparing it to the 2015-2016 recession, which they will blame on the previous Workers' Party (PT) government. And they are unlikely to enlighten voters who believe Brazil is on its way to sustained growth.

Thus, while 2018 should be a feel-good year for Brazilians, it is far from clear whether the country will seize the opportunity to strengthen its weak economic fundamentals. Investors will remain attracted to Brazilian assets, but political uncertainty will keep them on their toes, and volatility should also rise.

*Armando Castelar Pinheiro, Coordinator of Applied Economics at IBRE/FGV and Professor of Economics, Federal University of Rio de Janeiro (UFRJ).*

# INDIA IN 2018

**A**s is often the case with India, 2017 was another year of change and progress combined with regression and tumult. For a polity that is risk averse and adept at making haste slowly, there were some surprisingly bold decisions – with mixed consequences for the country. The year 2018 could see further bold decisions, but with national elections looming in early 2019, the focus is likely to shift to better implementing existing programs, rather than new policy pronouncements.

While the Indian economy grew at over 7% in 2016, key economic indicators – growth, credit, investment, exports – had all started decelerating by mid-2016. In the previous decade Indian corporates had borrowed massively from public sector banks, with many of these loans going sour, leading to the ‘twin balance-sheet’ problem for banks and companies.

Then on November 8, 2016, Prime Minister Modi announced that 500 and 1000 rupee notes (the two biggest denominations, accounting for 86% of the country’s circulating cash) would cease to be legal tender by the end of the year by which time these notes had to be deposited and exchanged for new bills. The demonetization was an unprecedented move and a high stakes gamble to strike a blow against corruption by squeezing those people who held large amounts of unaccounted for cash – so called ‘black money’ – to either bring their cash to the bank and be scrutinized by tax authorities or forfeit the money. But in a country still heavily reliant on cash, the effects were chaotic and India’s large informal sector, where the poor earn their incomes, was particularly badly affected.

A year later the picture is more mixed. The number of applications to file personal income taxes appears to have almost tripled. Faced with the deluge of cash that was returned, banks channeled it into government securities, bringing down their interest rates and allowing the government to borrow at cheaper rates.

Yet despite the evident hardships suffered by ordinary people, a perceptible negative impact on growth (estimated at 1% of GDP), and the goals of rooting out black money still unmet, politically the Prime Minister has done surprisingly well. While elite public opinion has been largely negative, mass public opinion seemed to give the Prime Minister the benefit of the doubt in trying to do the right thing, and the government resoundingly won a critical state-level election, seen as a referendum on its unprecedented action.

The disruption from the demonetization had barely settled before the government passed a new goods and services tax (GST) on August 3, 2017 – one of the most ambitious tax reforms anywhere in the world. It took a decade of negotiations between the federal government and its 29 states and all political parties to create for the first time a genuine common market, economically unifying the country. The tax combines the multitudes of state and local taxes into a system of uniform indirect taxes to be applied to almost all goods and services across the country. The tax will be administered through the GST Council, India's first genuinely federal institution where the center and states are equal stakeholders.

Since the tax is based on value added, it avoids the cascading taxes along the supply chain that have hurt Indian manufacturing competitiveness. And the system of invoice matching on sales and purchases along a supply chain is likely to curb tax evasion and consequently increase tax revenues. There is broad agreement that the GST will prove to be a game changer for the Indian economy in the medium-term, but for small enterprises with weak IT capabilities, moving to the new tax has been especially disruptive.

The government also finally moved strongly to address the 'twin balance sheet' problem in a concerted way, announcing a new US\$32bn recapitalization plan for the banks, raising hopes of a long-term improvement in the funding environment for business.

In parallel, it addressed a singular weakness of Indian capitalism, which lacked an appropriate regulatory apparatus to deal with failed businesses. As per World Bank data, insolvency processes take more than four years in India with about a quarter of the money recovered, compared with an average of 1.7 years and nearly three-fourths recovery for OECD countries.

To address this challenge, India passed a new law to replace the existing ineffective bankruptcy mechanism, giving courts the power to appoint resolution professionals to sell off investments and revive companies financed by loans that became non-performing. But if the mammoth sale of about US\$40 billion of distressed assets (in the first round alone) envisaged for 2018 does take place, it will more than improve the Indian economy. It would also dent the severe crony capitalism that has seriously compromised the political legitimacy of economic liberalization and market reforms.

But while Prime Minister Modi has taken some bold steps on the economy, the same cannot be said in his handling of growing partisanship and polarization in Indian politics. He has been unable – critics allege unwilling – to rein back the more intolerant elements of his own political party. And while there is little doubt that he continues to be the most popular leader in the country, the economic slowdown and the paucity of jobs despite growth have tarnished his image as a competent manager.

Indeed, many of India's governance challenges were in full evidence over the year. The tussle between the judiciary and executive branches continued, and has become worse than ever (at least since the mid-1970s). While India's Supreme Court issued an outstanding judgment upholding the Right to Privacy, it also continued to wade into issues that seemed to be within the prerogative of the Executive Branch, even as it failed to reform itself.

But the intervention of the judiciary has in part been driven by the failures of the Executive and Legislative branches of government. The abysmal air quality of the national capital, which has emerged as the epicenter of hazardous air quality in North India, is symptomatic of these failures. In November 2017, Delhi reeled – once again – under a deadly haze and smog, bringing out in stark

relief not just the poor quality of India's growth but also its continued inability to address what has come to be a major medical hazard. The Lancet Commission on pollution and health reported that more than a quarter of the 9 million premature deaths stemming from air pollution in 2015 around the world were in India. The multiple sources of air pollution – diesel exhaust, natural dust, fires from burning agriculture residues – make this a difficult problem to address, requiring multiple levels of government and sectoral ministries to coordinate and implement policy. And this is precisely where India's institutional weaknesses are most apparent.

On the international front, India continues to struggle between dealing with its security fears of China and a more unpredictable Trump-led United States. A two-month long stand-off between Chinese and Indian troops on the Doklam plateau was accompanied by unprecedented shrill rhetoric from the Chinese official media. While it was eventually resolved after an apparent threat by India to boycott the BRICS summit, it rekindled Indian fears that a rising China is seeking pre-eminence on the continent and is trying to box in India by further expanding its influence in South Asia through the Belt-and-Road initiative.

India's growing proximity to the United States was not directly affected by the vicissitudes of the Trump Administration. The Indian government has managed to keep Trump in good humor. But the apprehension of where the US is headed has led India to redouble its efforts to strengthen its relationship with Japan and to some extent with Australia as well, both of which are as wary of China as they are nonplussed by the actions of an erratic United States. In 2007 Japanese Prime Minister Shinzo Abe had proposed the idea of a 'quad', a quadrilateral partnership between like-minded democracies – Australia, Japan, India and the United States – in the Asia-Pacific region. With China expressing concerns that the grouping was an attempt to 'contain' it, the idea was then shelved. However, in November 2017, officials from the four countries met to resuscitate the idea, under the theme of a 'free and open Indo-Pacific'. Whether this grouping gathers further strength in 2018 will in part depend on China's actions as well as the individual mem-



bers' deep economic relationships with China.

*Devesh Kapur, Director, Center for the Advanced Study of India; Professor of Political Science, Madan Lal Solti Professor for the Study of Contemporary India, University of Pennsylvania.*



In ancient Greek, “nomisma” means the real value of things. It is in this spirit that Nomisma has monitored and analyzed local, national and global economic trends for more than 35 years, gaining strong recognition as one of Italy’s leading economic think tanks and consultancies.

Nomisma’s development has reflected its interdisciplinary vision of the economy, paying particular attention to agribusiness, industry, real estate, territorial development, international cooperation, public services, energy and sports.

More than a half century ago Bob Dylan's "*A hard rain's a-gonna fall*" reflected a dark and turbulent world facing a potential nuclear attack, the rising menace of environmental pollution, a rapidly shifting international order, a growing divisiveness within society and the dawning of new socio-political paradigms and power centers. Does this sound like today? Or is the rain that falls the source of new opportunities? Nomisma has asked prominent experts from around the world to share their views on major trends that will affect the global agenda in 2018. Will the current economic recovery continue and its fruits spread? Or will debt dynamics cause a new crisis? Can Europe successfully manage continuing migration inflows? Will reformist leaders prevail over populism and nationalism? How are geopolitical alignments changing in the Trump era? How will China's new leadership role on the world stage evolve? Can Japan adapt to the challenges from the Korean Peninsula and the opportunities of a Free Trade Agreement with the EU? Will climate change concerns lead to more sustainable agricultural models? And how will smart cities, the sharing economy and internet law change the way we live our lives?

### Contributors

Philippe Askenazy, Armando Castelar Pinheiro, Jonathan Coppel, Paolo De Castro, Ken Endo, Giusella Finocchiaro, Jeffry Frieden, Daniel Fuentes, Vassilis Hatzopoulos, Piero Ignazi, Erik Jones, Devesh Kapur, Peter Lewis, Chris Loewald, Hanns Maull, Helen Mountford, Young-sook Nam, Emilio Ontiveros, Jeremy Paltiel, Pavida Pananond, Pablo Pinto, Xavier Ragot, Andrea Resti, Andres Solimano, Paola Subacchi, Davide Tabarelli, Raymond Torres, Thierry Weil, Andreas Wörgötter

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