The Long View: Political Issues to Watch in 2018

DJ Peterson, PhD (dj@longviewglobal.com)
December 20, 2017

Overview

The business backstory for 2017 is that geopolitics did not seem to matter—at least not the way they have in recent years. Major political tremors have rattled the US, Europe, the Middle East, and Northeast Asia; the geopolitical balance of power between China and the US is shifting; fake news has become a buzzword in many countries; and political polarization and fragmentation seem to be on the rise globally. Despite of all of this, the world's economic outlook is the rosiest in years and global markets are flying high. Loose monetary policies and record borrowing have helped paper over political risks.

Eight key issues for 2018

1. Globalization: Made in China
2. Global risk: Made in America
3. Brexit: Mind the gap
4. Europe: Pulling together
5. Saudi Arabia: Wait and see
6. North Korea: Nuclear winter redux?
7. Russia: More relevant, more peripheral
8. Latin America: Perennial underperformer?

While the economic outlook is better, the global political risk supercycle will persist into 2018. The US, UK, Saudi Arabia, North Korea, Brazil, Mexico, and Venezuela will be notable hotspots. More global governance challenges such as inequality, populism and extremism, truth in media, cybersecurity, free trade, and climate change persist as well. Over the past year, a number of business leader forums focused on geopolitics with little resolution on how governments and the private sector can or should address them. **In a robust growth environment, a challenge for business leaders in 2018 is to reassert corporate leadership on global and societal issues as they navigate the seas of political unease.**

Accordingly, this outlook focuses on eight key country-level issues that investors and business leaders will need to pay attention to in 2018 in dealing with politicians and policymakers, stakeholders in society, and local business partners and competitors.

Globalization: Made in China

Consumers worldwide have become accustomed to seeing "Made in China" labels on everything they buy. This ubiquity was achieved largely by China becoming the world's order taker, but the government is undertaking several changes to turn the country into an order maker.

First, Beijing is investing in sunrise technologies such as the internet of things, artificial intelligence, robotics, aerospace, and new energy vehicles. Its Made in China 2025 blueprint aims to promote domestic innovation and brands, setting out to have Chinese firms control 80% of the domestic market in these priority technology areas within eight years. This coordinated and well-funded drive pushes the limits of trade rules and presents a competitive threat to multinationals. For example, the rapid expansion of solar power generation around the world over the past decade is due in large part to China's development incentives, easy access to capital, and innovation in manufacturing that have led to the country's overcapacity and falling prices for panel making. Western manufacturers that pioneered solar technologies are getting crushed. ▶

Second, China is exporting its prodigious engineering and construction capability across Asia and into Africa and Europe with its Belt and Road Initiative and the Asia Infrastructure Development Bank, with the intent of knitting its part of the world together and doing so on its terms. As such, Belt and Road should not be seen as market driven, but as an intensely political and geopolitical venture that has significant implications for multinational infrastructure and logistics firms, as well as changing the governance expectations of large infrastructure projects. China's reach into global commercial real estate is also expanding: Its outbound investment in massive real estate ventures is transforming the urban cores of Western cities such as Los Angeles, Vancouver, Brooklyn, and Sydney.

Finally, Beijing is repositioning itself as a superpower. President Xi Jinping no longer downplays the country's global influence by asserting that China is a developing nation. At Davos in January 2017 and during the Communist Party congress in October, Xi presented China as a nation with strong, unified leadership and a well-defined plan for the future that will drive global growth and integration as well as play a more active role in multilateral institutions.

While economists worry about a domestic debt overhang and other imbalances accumulating in the economy, Xi has shown that while he talks about economic reforms, he would rather extend top-down control and growth to fuel his superpower agenda. Expect China's economy to continue outperforming expectations in 2018.

Growth Forecast	2017	2018
World	**3.6**	**3.7**
Advanced Economies	**2.2**	**2.0**
—France	1.6	1.8
—Germany	2.0	1.8
—South Korea	3.0	3.0
—Spain	3.1	2.5
—United Kingdom	1.7	1.5
—United States	2.2	2.3
Emerging Markets	**4.6**	**4.9**
—Argentina	2.5	2.5
—Brazil	0.7	1.5
—China	6.8	6.5
—Mexico	2.1	1.9
—Russia	1.8	1.6
—Saudi Arabia	0.1	1.1
—Venezuela	-12.0	-6.0

Source: IMF, October 2017

Global risk: Made in America

Like this year, 2018 will be another long, tense year politically for the US. It will be dominated by election politics, which will deepen ideological rifts and generate more negative headlines for Republicans, Democrats, and the administration of President Donald Trump. In this environment, the survival of each party in the year ahead will likely stem not from one party's strengths, but from the other side's weaknesses. There is likely to be major political volatility and shifts, but there will be no change in tone or leadership.

A desire to get something done on tax policy forged a unity of purpose among Republicans in late 2017. That said, it is not clear what other legislative victory they can achieve. Infrastructure is on the agenda, but deep divisions between Trump nationalists, fiscal conservatives, and moderates will be accentuated as midterm elections approach. Yet Republicans can rely on favorable electoral fundamentals for House and Senate races and run on a platform of booming markets and continued growth. On the heals of the tax bill, the Conference Board, for instance, upgraded its 2018 growth forecast for the US to 2.8%.

Democrats are united in opposition to Trump and the Republican agenda, but little else. Establishment moderates and grassroots activists are deeply divided over whether to embrace the litmus test of single payer healthcare and whether to call for impeaching the president. ▶

Anti-Trump protests that marked the beginning of 2017 have lost their novelty and energy, and while the Democrats have notched notable victories in Virginia and Alabama, it is not clear that the Democrats will find an overwhelming new narrative against Republicans nationwide and find their way out of the political wilderness next fall.

And then there is the president and the special prosecutor's investigation, #HimToo, vacancies and churn in senior government ranks, media exposés, and more. Judging by past performance, none of this will knock Trump off his game. While his approval ratings are low, Trump has completely dominated the political landscape, which for his diehard supporters (about one-third of voters) counts as authentic leadership, if not entertainment.

In 2018, US business elites will have to balance the economic benefits of the tax bill with more political dysfunction and volatility at home and abroad. They increasingly are expected to explain their country to the world and take stands on policies and principles, but the red-hot political climate has created risks for being outspoken too. The midterm election will force the issue.

Brexit: Mind the gap

The Conservatives' June 2017 electoral debacle broke confidence in the May government's Brexit strategy and gave way to fears of a chaotic crash-out, somewhat reminiscent of Y2K doomsday predictions. London's recent capitulations on immigration and the divorce bill have bolstered business confidence going into 2018, suggesting that businesses and investors will not face a cliff edge and worst-case contingency plans will not need to be activated.

Brexit Day is March 29, 2019. London's priority in 2018 will be to minimize disruption and downside for both sides—a tall order. The tight deadline severely limits how much and how quickly the UK can diverge from its current relationship with the EU and its other trading partners. Many issues will be deferred by hasty stop-gap measures that preserve much of the *status quo ante* for 3-5 years while permanent arrangements can be negotiated. For example, setting up systems on both sides of the Channel to clear thousands of customs declarations per year will require hiring, training, and positioning thousands of inspectors—tasks officials have admitted will take several years to implement. In any event, the May government's stumbles so far suggest that the coming year will continue to be punctuated by dire warnings from businesses and investors of gaps and impending trouble.

> The EU-27 countries have been notably united, consistent, and firm in Brexit negotiations. An issue of major concern to them is how a new border regime between Ireland and the UK is defined. This has critical implications for the UK's broader trade deal with the EU and it could trip up negotiations in 2018 and threaten the Tories' tenuous leadership deal with Northern Ireland's Democratic Unionist Party.

According to a recent RAND Corporation assessment, every post-EU relationship option for the UK—Canadian, Swiss, Norwegian, Turkish, or WTO—promises to depress Britain's long-term economic outlook. But economic dislocation is not the only challenge Britain faces. There is a diversion risk as well: Policymakers will be preoccupied with the transition for at least five more years, crowding out other important issues such as healthcare, housing, education, inequality, and innovation. The bigger picture is that although the British have asserted that they are not European, their political leaders have no clear vision for what they want their country to be in the future. Should the public become disenchanted with it all, the Tories will face an existential crisis and the business community may also have to contend with a hard-left Labour government on top of a costly Brexit in a few years' time. ▶

Looking out ten years, London may feel different but will operate largely the same way it has. Financial services will play a less prominent role in the economy, creating more room for the tech, entertainment, media, and creative industries to thrive. The UK's trading and entrepreneurial cultures will not go away, market institutions and the rule of law will remain intact, and London is likely to remain a top global real estate market.

Europe: Pulling together

Europe in 2017 was marked by the specter of nationalism and fragmentation, but growth across the EU accelerated. While the far right progressed in Germany and Austria and had a strong showing in France, voters and politicians largely chose the path of pragmatic leadership. Going into 2018, policymakers want to get past Brexit as soon as possible so they can focus on their own grand projects to remake the continent. Rather than expecting the EU to fall apart in 2018, expect it to pull together, which will support investor and business optimism.

Angst voiced during the last few weeks over Chancellor Angela Merkel's difficulties in forming a government has been overblown. Pragmatism and responsibility, not grandstanding and polarization, underpin Germany's political culture. The process will take a few more months to finalize, but the country is likely to be led by another grand coalition of Merkel's center-right Christian Democratic Union/Christian Social Union parties and the center-left Social Democrats. A key difference is that Merkel will be looking to cement her political legacy and the new government is likely to support closer Franco-German cooperation to address European challenges. Tighter eurozone integration will be on the 2018 agenda.

> Compared with the past year, the election calendar in Europe in 2018 is relatively light. Nevertheless, elections for the European Parliament loom in 2019 and the clouds of nationalism and fragmentation will reemerge. The coming year will shaped by political jockeying and preparation.

In contrast to the political division and inward preoccupation exhibited by the US and UK, France offers a model of democratic political renewal. The May 2017 election of President Emmanuel Macron broke the old two-party hierarchy and ushered in a new generation of politicians, and the public and powerful unions largely have gone along with Macron's efforts to make the economy more competitive. While foreign investors associate France with rigid labor laws and high taxation, the innovation and start-up scenes are flourishing. Promoting innovation and entrepreneurship are national policy priorities: At a tech summit in June, Macron said, "I want France to be a start-up nation." And, finally, Paris is seeking to use Brexit as an opportunity to challenge London as a center for entrepreneurship, creativity, and business, if not financial services.

Catalonia is a globalization success story, but its impetuous push for independence in 2017, combined with Madrid's heavy-handed response, revived fears of a fragmenting Europe. The December 21 elections will return independence-minded parties to the regional parliament on promises to defend Catalan interests. But unionists will also be fired up, and independence activists will have to be more modulated and nuanced in their approach. A key issue to watch in 2018 is how Madrid responds: A clumsy hand will energize the resistance.

Saudi Arabia: Wait and see

Saudi Arabia has embarked a far-reaching economic, political, and cultural transformation instigated by Crown Prince Mohammed bin Salman (MBS). Weak oil prices are the immediate driver of change, but prices have been down before. What's different this time is that market experts are talking about the prospect of peaking oil demand, budget commitments are structurally higher than oil revenue expectations, and Iran has eclipsed Saudi Arabia as a regional geopolitical power. ▶

The stunning announcement in October 2017 of a new anti-corruption committee and the arrest of dozens of prominent elites highlights the fast-paced, wide-ranging, high-stakes nature of MBS's plans. The crown prince is taking a tool from the kits of Xi and Vladimir Putin: Fighting alleged corruption is his new hammer to realign economic interests and consolidate political control. While graft is a problem, MBS is likely reordering it according to the interests of his clique. (His purchase in December of a da Vinci for $450 million, which he is gifting to the UAE, and a recent purchase of a personal yacht for a similar price make one question arguments that he is seeking to more effectively allocate the kingdom's resources.) In any event, the message MBS is sending is that he can choose who he wants to prosecute, with no royal or business elite being untouchable. This will generate significant political risks for foreign banks and business partners in the year ahead, especially as billions of dollars of wealth is forfeited, repatriated, and reallocated.

MBS also is leading his charge on behalf of a younger generation that is impatient with the status quo. He has put princes from his branch of the family and those loyal to him into new cabinet positions, bucked conservative cultural norms and the clerical establishment that has held policy sway in the kingdom since the 1970s. The issue to watch in 2018 is whether this relatively young and untested leader can outrun the forces he is challenging in Saudi Arabia's tight-knit familial system that is built around seniority, negotiation, and payoffs. Longer term, these moves are raising expectations among young, restive Saudis, and their frustrations will escalate if economic opportunities do not improve.

A paradox of Saudi Arabia in 2018 is that Mohammad bin Salman is using the power of the state to fundamentally reorder economics. While he is seeking to improve competitiveness and attract investors, his methods are neither transparent nor follow the rule of law. The economic opportunities and risks are tremendous.

This is especially pertinent given that MBS's track record is not good. His country has been on the losing side of the civil war in Syria, he has pursued a destructive and losing war in Yemen that has also exposed Riyadh to missile attacks, and he instigated the Qatar blockade that has exacerbated intra-Sunni tensions and pushed Qatar closer to Iran. Finally, not two weeks after MBS hosted "Davos in the Desert"—a splashy confab at the Riyadh Ritz-Carlton to lure foreign investors—he confounded them by turning the hotel into a prison for Saudi elites. Not surprisingly, regional investors are taking a wait-and-see stance and looking to park their money elsewhere for the medium term. The government's preparations for selling a small stake in Aramco are proceeding, but it appears more likely that the deal will be executed as a private or local placement that falls short of the transparency expectations of global markets.

North Korea: Nuclear winter redux?

There is a dominant line of thinking in political science and economics that political leaders are essentially predictable and rational. A corollary is that nations that gain nuclear weapons capability become more geopolitically risk averse because nukes are not good tools for coercion: Their use invites massive retaliation and annihilation. (The US used nuclear weapons when it had a monopoly on the technology in World War II.) Accordingly, Kim Jung Eun, rather than being crazy, rationally views a nuclear capability and the capacity to deliver nuclear weapons to US territory as the ultimate guarantor against external threats—something his country has faced since its founding. But Kim regards the US as posing a significant threat and is taking actions—nuclear tests, missile tests, cyber attacks—that risk provoking the US.

A nuclear conflict involving North Korea has been treated as a very low risk, albeit a potentially high-impact black-swan event. Whether one believes the relevant actors are rational, the ▶

notable differences in the stand-off in 2018 are that the chance of miscalculation is higher given Pyongyang's accelerated testing program and Washington's bellicose signals, such as the administration raising the specter of a preemptive attack and Trump's assertion "we will take care of it" after North Korea launched a more advanced missile in November 2017. The US's demand that the North denuclearize is a nonstarter for Pyongyang (and its erstwhile allies in Beijing and Moscow), while Washington's signals are confusing—with the secretary of state offering to negotiate while the While House bats down such offers. As in financial markets, rational decision-makers do miss and misinterpret signals and stumble into trouble.

A nuclear conflict in 2018 is still highly unlikely, but its probability has increased. Black swans are hard to predict and harder to plan for, and nobody wants to think about nuclear war and the potential for millions of human casualties. But being surprised by one is worse. Global markets are flying high, but conflict in Korea would ground them in a hurry.

Russia: More relevant geopolitically, more peripheral economically

Putin is coyly presenting himself as the reluctant tsar (last played by Nicholas II), but his victory in the March 18 presidential election is preordained. However, elections are a weak knee in Russia's body politic: The issue to watch in 2018 is how elegantly Putin's team can pull off the win while achieving respectable turnout and without sparking a popular backlash. Otherwise, a political clampdown could ensue, harming economic sentiment and further distancing Russia from the West.

In any event, Russia is recovering from its two-year recession, and the IMF expects the economy to grow 1.8% in 2018 because of the firming of global oil prices and recovering domestic consumer demand. Interest from foreign investors and businesses is also up, but unlike China, Russia remains a price taker and its economic outlook remains heavily dependent on oil revenues. Putin has no plans to invigorate the economy, and other than selling natural resources to China, its business leaders and people are inward-looking and isolated from the global economy.

> The outlook for emerging markets in 2018 is very uneven, and it will be important to examine country-specific risks, such as governance. Questions to ask about emerging markets in 2018:
>
> - Is the current situation cyclical or structural?
> - Are debt loads sustainable? Will rising interest rates spark a crisis?
> - Are policymakers united or divided?

As Western headlines continue to focus on revelations of Russia's fake news propaganda, Western election meddling, geopolitical power plays, and incriminations from the Mueller investigation, Putin's stature will be burnished at home. But Russia's long-term economic outlook is uninspiring. The perception of Russia's strategic threat (combined with US legislation adopted in August 2017) lock in sanctions for the foreseeable future, and this dramatically narrows the scope for constructive relations—something that all interested businesses and investors should take into account.

Latin America: Perennial underperformer?

Political developments in Latin America have largely been eclipsed by events around the world. Of note, the IMF expects the region to continue underperforming the global economy with a modest increase from 1.2% growth in 2017 to 1.9% in 2018. Latin America has experienced a tide against leftist-populist politics on the continent over the past couple of years—in Brazil, Argentina, Chile, and Venezuela. In 2018, presidential elections will be held in Mexico, Brazil, and Colombia, and the overarching issue for businesses and investors will be the prospect for populists and the left to regain ground. ▶

The most pressing policy challenges for Brazil in 2018 are spurring growth while enacting pension reform, including raising the retirement age, which is a profoundly unpopular move. President Michel Temer, the centrist reformer who has led the country since summer 2016 and is hobbled by corruption charges, will be stepping aside in October, but the race to be his successor does not look very promising. The two most popular candidates for the presidency are the leftist former President Luiz Inácio Lula da Silva, who is in jail on corruption charges and is likely to be ineligible to run, and the authoritarian-populist Jair Bolsonaro. The Car Wash anti-corruption investigation continues to snare high-level politicians of every stripe, and many observers assume and hope this will lead to better governance. The fall election will be an important signpost to watch.

Argentina's pragmatic and business-friendly president, Mauricio Macri, is pushing to reform the economy after more than a decade of leftist, populist mismanagement. Although Macri's party got a boost in the October 2017 mid-term elections, some of the reforms may experience pushback, include cuts to popular subsidies. Policy priorities for 2018 are tax reform aimed at boosting investment and pension reform to ease budget pressures.

Venezuela's turmoil has been widely reported on. Given the contentious political situation and economic contraction—by one-quarter in the last two years, according to IMF estimates, with a further 6% contraction in 2018—it's not clear whether President Nicolas Maduro can survive another year. Should there be regime change, a transition government will have the herculean task of stabilizing and reforming an impoverished, polarized, and armed country while placating bondholders abroad.

NAFTA negotiations are not going well, and a US exit announcement in early 2018 is most likely. While Washington is insisting on several "poison pill" changes, including minimum US-origin content requirements and the elimination of trilateral dispute resolution panels, Canada and Mexico have made it clear they will walk away if the US maintains its hard line. The headline issues in the Mexican election in July are all domestic: crime, corruption, and slow growth. A US withdrawal would also inject NAFTA into election politics, providing sustenance to the most populist and nationalist of the three main candidates, Andrés Manuel López Obrador. His victory would represent a historic shift to the left in Mexican politics. The broader US-Mexican relationship would then be under pressure from both sides of the border, hurting not only trade and investment but also cooperation across a host of issues such as investor protection, drugs, and migration. ■