

The World 2015

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Little room for optimism as global anxiety grows

World leaders face problems that stretch from Europe right across the globe, says *Gideon Rachman*

The World Economic Forum in Davos is a kind of annual stocktaking for international political, business and financial leaders. This year's forum is convening after 12 months in which Russia has fallen out of the international system and the US has plunged back into war in the Middle East.

This year's Davos will also focus on problems closer to its Swiss home. When WEF delegates met last year, the general mood was one of cautious optimism about Europe. Delegates are reconvening in 2015 at a time of growing anxiety about a possible resurgence of the euro crisis. The fact that Greece will be holding crucial elections on January 25, just as the forum comes to a close, ensures that events in Greece and their implications for the euro

will be a hot topic in the Davos corridors.

That discussion will illustrate the close connections between the future of the European economy and the re-emergence of political radicalism in Europe. Tensions between Europe's Muslim population and wider society will also influence the discussions at Davos – following the recent terrorist attacks in Paris, the anti-Islamisation demonstrations in Germany and the rise of anti-immigration parties in countries such as Sweden, Denmark and the UK. The average Davos delegate is rich, politically mainstream and in favour of immigration, so the rise of the political extremes across Europe will be a major source of concern.

The other parts of the world that are certain to attract anxious attention are Russia and the Middle East. For the past decade and more, the Russians have



sent a big delegation to Davos – including appearances by President Vladimir Putin and prime minister (and former president) Dmitry Medvedev. The high Russian profile at the forum was a visible sign of the country's integration into the global economy and international "polite society". So the size of the Russian delegation, what Russian spokesmen say and how they are received will all be watched intently at this year's event. The WEF is precisely the kind of venue where informal conversations can take place to gauge whether there is scope for a rapprochement between Russia and the west. There certainly seems to be some desire for that in western Europe, with President François Hollande of France, who will attend the

The WEF is precisely the kind of venue where informal conversations can take place

forum, pressing publicly for an easing of western sanctions on Russia.

It will be hard to find many optimists about the Middle East. The usual Davos formula for improving this region is "peace talks, plus trade and investment". Events have spiralled well beyond that stage with civil wars raging in Syria, Iraq and Libya. Last year's forum revealed open discord between the Saudis and the Americans about what action to take over Syria. So it will be interesting to see whether the US decision to take military action against the jihadis has helped to heal the breach – or actually widened it. The reception of Benjamin Netanyahu, the prime minister of Israel, will be watched carefully. Over the past year, hopes for new peace talks with the Palestinians have collapsed and Israel has waged a bloody

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The World 2015

Chronic economic and political ills defy easy cure

COLUMN

Martin Wolf



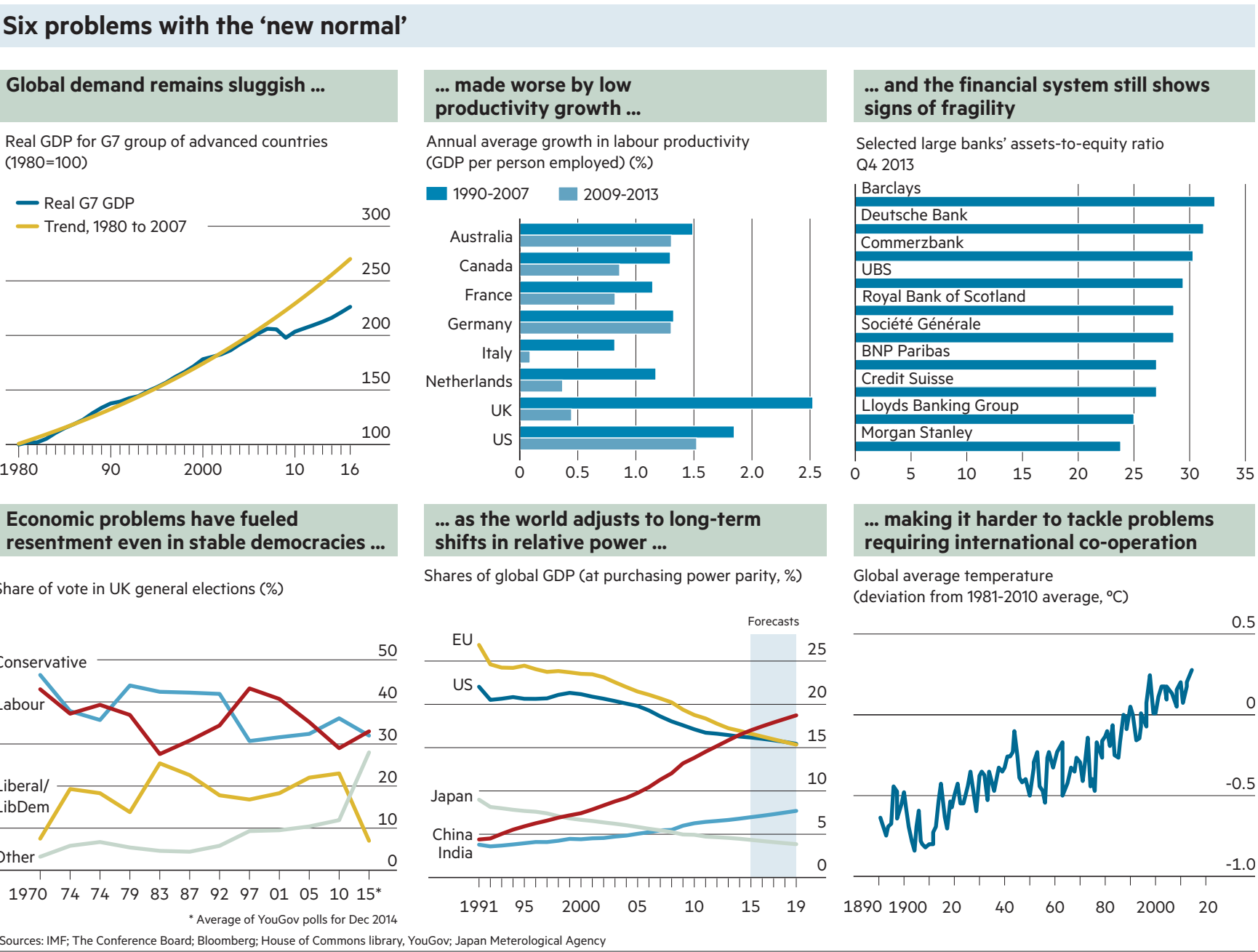
What sort of world are we now living in? The right answer is one characterised by chronic economic and political ailments. Here then are six enduring conditions of the “new normal”.

First, *deficient demand*. The idea behind “secular stagnation” is that, without rapid asset-price inflation or exceptionally aggressive monetary policy, it has proved impossible to generate enough demand to absorb potential global supply.

Chronic demand deficiency is a global condition. It was in operation well before the 2007-2009 global financial crisis. It is in operation today. If anything, it is even getting worse. Overall, debt overhangs in crisis-hit economies remain very high. Meanwhile, the emerging economies, including notably China, have seen their own freedom of policy manoeuvre diminish as public or private debts (or often both) have soared. The only plausible offset is the fall in oil prices, which shifts income from savers to spenders. It should give relief, but only temporarily.

While demand is strengthening in the US and UK, as one might hope after years of aggressive monetary policies, the eurozone remains in a dangerously depressed condition. Meanwhile, Japan has still to escape its deflation trap.

Second, *stagnant productivity*. Since the latter part of the last century, underlying growth of labour productivity in the high-income economies has fallen from close to 2 per cent a year to well below 1 per cent. Low growth of productivity tends to inhibit both investment and consumption, as expected future incomes are depressed, so exacerbating the deficient demand. It also makes the bite of rising inequality more severe.



Happily, however, emerging economies can still catch up on the productivity levels of the rich.

Third, *fragile finance*. The global financial system is in some respects even more fragile than it was before the crisis. The western world’s banking system is even more concentrated than before. The leverage — ratio of assets to equity — of many large global banks is about 25 to 1, which is bound to make them vulnerable. Incentives to move

financial activity outside the highly regulated core of the global financial system are, nonetheless, strong. One source of worry has been the financing of emerging market corporations via dollar-denominated bonds.

Moreover, the lack of transparency of balance sheets remains daunting. In a complex global financial system, the ability of participants to understand balance sheets is limited. This tends to generate cycles of overwhelming

risk-aversion followed by panic-induced aversion. The low real returns on safe assets tend to exacerbate the intensity of the aversion and so the extent of the aversion.

Fourth, *unstable politics*. Deteriorating economic performance and rising inequality are generating substantial political stresses. Hitherto stable western democracies are displaying both sharp divergences of domestic opinion and hostility towards domestic

Stagnant productivity makes the bite of rising inequality more severe

political and business elites. A common element is hostility to both foreigners and supranational political projects.

The UK, for example, once an exceptionally stable democratic polity, is one no longer (*see chart*). Such tensions are particularly threatening to the eurozone.

The current turn of the economic wheel will also stress politically fragile emerging countries, as commodity prices decline, bad debts emerge and the days of cheap capital inflows end. Some areas of the world are characterised by weak or non-existent states. Sometimes, states have never really functioned. Sometimes, brittle despotisms have collapsed, as in Syria. Either way, the absence of order invites interventions and spreads chaos.

Fifth, *tense geopolitics*. Ours is an era of rapid changes in relative economic power, with the rise of China, above all, and the relative decline of Europe and the US. China is assertive; Russia is irredentist; the west is cautious. In this world, the possibility of serious miscalculation is a permanent reality. A year ago, the talk was of friction between China and Japan. Now it is of Russia and the west. Nobody can be sure what will come next

Sixth, *challenge overload*. These stressed political systems confront large domestic and international challenges. Among those challenges are the supply of global public goods, which includes preserving the open world economy, peace and the global commons. It is always hard for a large number of states to co-operate closely. But some of these challenges are particularly tough. Managing climate change is the hardest. Yet 2014 was the hottest year on record.

These conditions are chronic, not critical. They cannot be cured quickly or easily. They can, however, be managed. They should not prevent continued economic growth, particularly in emerging economies. But this process of convergence is operating in the context of stressed economies and fragile politics. Indeed, convergence is, in important respects, exacerbating stress. We cannot afford to ignore all these difficulties. On the contrary, we must work much harder to reduce them.

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European politics emerges as one of the top global risk factors

Eurozone

The European Commission has scaled down forecasts for growth against a background of deflation fears, writes *Peter Spiegel*

The last time the global economic elite met in Davos, 2015 was seen as the year Europe would finally emerge from the shadows of the four-year eurozone debt crisis.

The European Commission was in the process up upgrading its 2015 growth forecasts, European Central Bank chief Mario Draghi was dismissing fears of eurozone deflation and Davos organisers assembled a high-profile panel asking: “Is Europe Back?”

“I think the eurozone, overall, is no longer at the centre of all the concerns of the world economy,” Wolfgang Schäuble, the powerful German finance minister, told a keynote Davos panel on the global economic outlook.

What a difference a year makes. Not only is the eurozone back on the front burner as one of the global economy’s most significant risk factors, but also political turmoil is back with a vengeance. Anti-euro populist parties made striking gains in May’s European Parliament elections in France and Spain, as well as in German regional elections. In Greece, the far-left, anti-austerity Syriza party is leading in polls ahead of Sunday’s national elections.

“Europe’s economics are in substantially better shape than at the height of the eurozone crisis but the politics is now much worse,” wrote the Eurasia Group risk consultancy earlier month after naming “the politics of Europe” as its top risk factor to the global economy in 2015.

The European Commission believes the eurozone will grow only 1.1 per cent this year, down from the 1.8 per cent Brussels forecast shortly after Davos last year, and that unemployment will fall to 11.3 per cent, below the 11.9 per cent it reached at the peak of the crisis, but well above historic norms.

More troubling to many economists is the prospect of Japan-style deflation gripping Europe’s common currency. Both the commission and the ECB have been forced to slash inflation expectations for this year. Brussels now believes



Drachma vs euro: Syriza, Greece's anti-austerity party, leads in the polls — Getty

it will be just 1.1 per cent in 2015, while Frankfurt is projecting 1 per cent. Both forecasts were made before the recent swoon in oil prices.

The combination of political instability and falling prices have raised the prospect that jittery consumers and corporate boardrooms will further scale back spending and investment plans — causing growth to slow even further.

“We see the beginnings of a new phase in the lingering eurozone crisis, where the worst may be behind us, but where certain issues remain ahead,” wrote Standard & Poor’s in a recent report on the eurozone.

‘But that crisis still leaves a nasty legacy . . . we risk leaving a scar on society’

The response from Brussels has been a stimulus plan that aims to use €21bn in EU guarantees to raise €315bn in private capital over the next three years that will be invested in public infrastructure projects. Although the plan has been broadly welcomed, similar schemes have failed to spur economic growth in the past.

“Member states are gradually turning the page of the crisis,” Jean-Claude Juncker, the newly elected commission president, said in his first major address of 2015. “But that crisis still leaves a nasty legacy: high unemployment, high debt, tight access to finance. We risk leaving a scar on society.”

With the prospect of political instability looming in Greece, the eurozone is also bracing for what could become a major Franco-German spat over the future of the bloc’s economic policy making.

In March, Brussels — with Berlin’s backing — is poised to fine Paris for failing to live up to the EU’s tough German-inspired deficit rules, something the French government has warned could further hit growth prospects and inflame anti-EU sentiment in France. Paris has instead called on Germany, which has stubbornly clung to a pledge to balance its budget, to use its fiscal space to spend more.

With such turmoil looming among eurozone governments, focus has again turned to the ECB, which is weighing plans to spur eurozone investment by buying sovereign bonds of eurozone governments. But that plan has come under criticism within Germany, where such schemes are politically radioactive, limiting Frankfurt’s options.

“The stability of the euro and the futures of the participating countries will continue to be vulnerable to the short-term exigencies of German domestic politics,” wrote Simon Tilford, deputy director of the Centre for European Reform. “This is a recipe for stagnation, deflation and political populism in France and Italy. It may culminate in a breakdown in relations between Germany and these countries and could even lead to eurozone break-up.”

In other words, Europe appears once again poised to become the global economy’s problem child.

The World 2015

Falling rouble piles the pressure on Putin

Russia Economic crisis mode raises urgency for Moscow to reach a political solution on Ukraine and secure easing of EU sanctions, writes *Kathrin Hille*

Less than six months ago Vladimir Putin seemed invincible. Russia's president had triggered a clamour of outrage across Europe by annexing Crimea from Ukraine. None of the sanctions imposed by western governments in response looked likely to make him change course. At home, his popularity ratings rose to an all-time record of 88 per cent.

These months of triumph seem long ago. The collapse of the rouble late last year following the steep drop in oil prices has pushed Russia into crisis mode.

The government expects the economy, which grew by 0.8 per cent last year, to contract by at least 4 per cent in 2015. Moscow has already committed more than Rb5590bn (\$9.7bn) to prop up banks and large companies in the wake of the rouble rout and more dark

clouds are gathering on the horizon. The rating agency Standard & Poor's is considering downgrading Russia's sovereign rating to junk status.

"As long as oil continues sliding, the rouble will, too," says a senior executive at one of Russia's oligarch-owned conglomerates. "They can try to defend it by threatening speculators but they can't win." The central bank's predicament was "like sitting in a lighthouse with guys in the woods with bazookas all around".

Like many other observers, the senior executive blames Moscow's policy makers for making matters worse by floating the rouble in November but being unwilling to spend large chunks of foreign exchange reserves to defend it. He is also of critical of Moscow's efforts to clean up the banking sector while a currency crisis was developing.

"This is a stress test — for our econ-

omy and for a lot of people, including the number one in the country," says Igor Vayn, chief executive of Renaissance Capital, an investment bank.

Suddenly, financial analysts are discussing the possibility of another financial meltdown and the opposition, long cowed and marginalised, has started discussing scenarios for Mr Putin's political demise.

Alexei Navalny, the lawyer and anti-corruption blogger who led street protests against Mr Putin's rule three years ago, has certainly felt emboldened — so much so that on January 5 he cut off the electronic tag that monitored his movements while under house arrest. The next day, he went out and then blogged about the steep rise in prices.

Mr Navalny aims to convince the Russian public, long supportive of Mr Putin, that the good times are over. Indeed, inflation, which hit 11.4 per cent at the



Slim pickings: there is less on the shelves after Moscow banned some imports in response to sanctions — Getty/Sasha Mordovets

end of last year, is forecast to surge. Some observers expect this to trigger a wave of bankruptcies. "In February or March, people will start losing their jobs," says the Russian executive.

Mr Putin shows little sign of changing tack but there are indications that Moscow might seek to tilt towards compromise in the international arena. For weeks the Kremlin has been in talks aimed at finding a political resolution of the Ukraine crisis.

The opaque nature of Mr Putin's rule and his record of surprise geopolitical moves are fuelling speculation on how

the Russian leader will react now that he is dealing with an economic slump.

"There is the western idea of a Russian leader plotting, but Putin is much more ad hoc than that," says Jonathan Eyal, international director at the Royal United Services Institute, a think-tank. "He wants to crack open the territorial status quo in Europe and the long-term objective is to create a sphere of influence for Russia, but he is an opportunist, and Crimea was an opportunity he grabbed."

The latest opportunity the Kremlin appeared to see was the gun attack on

the French satirical magazine Charlie Hebdo in early January. Within hours, Mr Putin sent his condolences and the Russian foreign ministry stressed the need for Russia and the west to stand together in combating terrorism.

The opening Moscow is zeroing in on now is the EU's need to decide on the extension of the sanctions it imposed on Russia last year. "If some of those unreasonable sanctions can be lifted, that would be the beginning of an improvement in relations between Europe and us," says a senior Russian foreign policy official.

Little room for optimism as global anxiety grows

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war in Gaza, so Mr Netanyahu's reception may be fairly chilly.

While Europe, Russia and the Middle East will — in different ways and to different degrees — evoke expressions of concern, the discussions about the US, Asia and the wider global economic outlook are likely to be nuanced in tone.

Over the past six years, the forum's consensus attitude to US President Barack Obama has mirrored international opinion — with initial euphoria giving way to disappointment. But the Obama administration is likely to go into this year's Davos with its reputation in better shape than for some years. Economic growth, which is always treated as a rough-and-ready gauge of success, is now fairly strong in the US. Mr Obama is beginning to show signs of the boldness on the international stage that he once seemed to promise. The normalisation of US relations with Cuba will be greeted with interest and excitement at the WEF, particularly since it promises to offer new opportunities for trade and investment. Many delegates will be wondering whether the US breakthrough with Cuba is a harbinger of a deal between Iran and the US during the final two years of the Obama administration.

There will be considerable curiosity about China under President Xi Jinping. Almost all the major multinationals and banks that show up at Davos have vast business interests in China but their attitudes to President Xi have yet to harden into a consensus. Some believe that Mr Xi is a free-market reformer — in the Davos mould — who is intent on eradicating corruption, liberalising markets and building a more co-operative relationship with the US. Others fear that the Chinese economy is losing momentum and that President Xi's drive for stronger central control carries too strong a whiff of Maoist ideology.

The year 2014 was one that began with rising concern about tensions between China and Japan but which ended with a sense that China was looking for some sort of rapprochement with its immediate neighbours and with the US. However, the stability of "greater China" is now on the agenda following the demonstrations in Hong Kong and gains for pro-independence parties in Taiwan.



The future direction of India will attract huge interest. The election of Narendra Modi as India's prime minister in May has excited hopes for far-reaching economic reforms in India, as well as fears of civil conflict. Davos will provide a venue for a public assessment by international big business of whether the Modi administration is meeting the hopes and expectations of economic reformers. Mr Modi himself, however, is unlikely to attend Davos. He is preparing for a state visit from President Obama, who is due to attend Republic Day celebrations in India on January 26.

As ever, the outlook for the global economy will shape all discussions in Davos. Once again the mood is ambiguous, reflecting neither the soaring optimism of pre-crisis 2007 or the deep anxiety of post-crisis 2009.

The big new factor that will be on everybody's mind is the collapse in the global oil price — a phenomenon that neatly ties together all of the chief WEF preoccupations: economics, geopolitics, technology and the environment. For once, it is hard to forecast what the consensus view will be on energy and oil prices. That will make the discussion all the more interesting.

The overarching subject in Davos, however, will be the stability of an international system that allows multinational businesses, international banks and global oil companies to operate across the world.

The global economic framework currently looks more stable than for some years. But the international political environment, from Greece to Russia to the Middle East, looks increasingly threatening.

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The World 2015

Beijing boosts its foreign policy and the war on graft

China Two years after taking the reins, Xi Jinping is beginning to show his true mettle, says *David Pilling*

It was in November 2012 that Xi Jinping stepped on to the stage for the first time as leader of China’s Communist party with the words “sorry to have kept you waiting”. More than two years later, we are better placed to understand precisely what we were waiting for. Though Chinese policies remain opaque, the broad outline of Mr Xi’s presidency has come into focus. In three areas of domestic, foreign and economic policy we can more easily grasp where China is heading.

Domestic policy is the easiest to analyse. Mr Xi has launched the most aggressive anti-corruption drive ever seen in Communist China. What started out as a seemingly routine assault on graft has become Mr Xi’s all-out war on “tigers and flies”. At the level of the flies, state apparatchiks live in terror of a knock on the door. Lavish banquets have stopped, or become ultra discreet. Gift-giving is less generous. Sales of expensive cognac and watches are down. So are Macau gaming revenues.

The tigers – or at least some of them – have been yet more exposed. In

December, after months of speculation, Zhou Yongkang, the former head of China’s fearsome state security services, became the most senior Communist party cadre ever to face formal corruption charges.

There are, of course, still questions about whether this is a genuine crack-down or an attempt to consolidate power by eliminating Mr Xi’s enemies. “It’s both,” says Minxin Pei, professor of government at Claremont McKenna College in California. “Mr Xi is deeply offended by what he considers the parasites of the regime,” he says. He adds that the public’s perception of corruption among officials is sapping the Communist party’s legitimacy.

Second is foreign policy. Mr Xi has taken a stronger grip on steering international relations than his predecessor. He takes personal charge, for example, of relations with Japan over the disputed Senkaku Islands, known as Diaoyu by Beijing. On the whole, China has been more assertive with its neighbours, although there have been signs in recent months of a more calibrated, even softer

Diplomacy: Xi Jinping on a recent visit to Brazil
AFP/Nelson Almeida

approach. Still, under Mr Xi, Beijing has declared – to name just two such events – an air defence identification zone over the East China Sea and rattled Vietnam’s cage by drilling for oil in waters claimed by Hanoi.

There has been much more subtle diplomacy, too. Mr Xi has travelled extensively around the region and in Africa and Latin America. China has made several initiatives that together pose the beginnings of a challenge to the US-dominated Bretton Woods institutions that have prevailed since the second world war. Beijing has launched a Brics bank together with Brazil, Russia, India and South Africa. It has established a \$50bn infrastructure fund that looks like a direct challenge to the Asian Development Bank, which has been jointly run by Washington and Tokyo since its inception in 1966. As if that were not enough, China is promoting a \$40bn Silk Road Fund charged with establishing an “economic belt” across central Asia to Europe.

Economic policy is the trickiest to interpret. Things here are changing,

‘The president is deeply offended by what he considers the parasites of the regime’



Obama eyes his legacy and goes on the offensive

US

Republicans are on the back foot as the president, buoyed by the economy, pushes through popular initiatives, writes *Megan Murphy*

For any second-term US president, there comes a point when the administration’s priorities shift away from the gruelling politics of day-to-day governing toward shoring up a legacy.

For Barack Obama, that has meant adopting a new strategy: going it alone to accomplish his policy goals, without waiting to win the approval of a recalcitrant Congress.

Instead of reeling from the drubbing his Democratic party took in November’s midterm elections, Mr Obama has chosen to go on the offensive, taking bold, often unexpected actions on a range of key issues.

He has overhauled immigration rules to shield as many as 5m unauthorised immigrants from deportation, signed a landmark climate change deal with China and restored relations with Cuba after more than five decades of hostility.

Buoyed by a stronger economy, he has criss-crossed the country as part of his annual State of the Union address to outline fresh initiatives to boost middle-class families.

These range from promising two free years of community college for students to making it easier for first-time buyers to gain a foothold on the housing market.

Republicans may have expected to start the year on the front foot, now that their party holds majorities in both the Senate and the House of Representatives.

They have instead been forced on to the defensive, as they debate how to deal with a president who has simply taken them out of the process.

Mr Obama’s resurgence has been made possible in part by an economic recovery that continues to gather steam.

While the International Monetary Fund has been busy slashing growth forecasts for the eurozone, Japan and key emerging market economies such as Russia and Brazil, the US has stood out as one of the few countries where the economy is doing considerably better than expected.

Growth in the US is expected to hit 3.1 per cent this year, according to a forecast from the International Monetary Fund – well ahead of the 2.2 per cent recorded in the previous two years, and well above the average IMF forecast for other advanced economies of just 2.3 per cent for 2015.

Polls set to provide national identity test

UK

Vote in May seems likely to reflect uncertainty over position in Europe and the world, writes *George Parker*

The UK is going through an identity crisis. In 2014, it looked briefly as if the country would cease to exist. Now voters in a general election in May 2015 are being invited to consider what place the country should have in Europe and the world.

Uncertainty pervades British politics. Tribal loyalties between left and right have broken down with the vacuum filled by smaller parties trading on the politics of identity. Only the foolhardy would confidently predict the outcome of the election on May 7.

David Cameron, Britain’s prime minister, survived his first big political trial last September when Scotland voted 55-45 per cent to remain part of the UK. But the Scottish National party remains a powerful force.

Mr Cameron’s response has been to pass more powers to Scotland and, at the same time, plan to give more powers

to English MPs over English laws at Westminster.

Having survived that challenge, Mr Cameron goes to the polls in 2015 offering voters the prospect of a referendum that will decide Britain’s position in the world: a straight in/out choice on whether the UK should remain part of the EU.

“I don’t think the right answer is for Britain to leave the EU,” Mr Cameron declared on January 7 at a Downing Street press conference alongside a stony-faced Angela Merkel. The German chancellor might have been asking herself why, then, Mr Cameron was asking the British people the question.

Mr Cameron fought hard to resist holding such a referendum. He pleaded with his party to “stop banging on about Europe”, but in the end he bowed to pressure from his own eurosceptic MPs and the advancing UK Independence party to finally settle the issue.

If Mr Cameron wins on May 7 he could spend the best part of two years trying to negotiate a better deal for Britain in the EU. A referendum is promised before the end of 2017.

Ed Miliband, the Labour opposition leader, would scrap the referendum plan, saying that Mr Cameron is

“flirting” with a Brexit (British exit) and sending out a signal to business and international partners that Britain is turning its back on the world and harming investment.

“This is an important issue for Britain’s place in the world,” says Pat McFadden, Labour’s Europe spokesman. “There’s a battle between people who are fearful of global change and want Britain to disengage and those who want Britain to be outward looking and shape the future.”

The rise of Ukip has been widely interpreted as a sign that Britain may be about to side with the first group in Mr McFadden’s argument: retreating behind the white cliffs of Dover, spurning globalisation and closing its doors to the migrant workers who have been drawn to the UK’s reviving economy and booming labour market.

Things may not be that simple. While Ukip is an anti-EU party, its leader, Nigel Farage, recognises that British voters are not obsessed about Europe. Far from it: polls say the UK’s election will be decided on the economy, the state of the National Health Service and immigration.

Mr Farage, therefore, has changed his tack to focus on immigration, blaming

the EU’s free movement rules for the influx of Poles, Romanians and others.

While Britons are relatively uninterested in EU matters compared with other more pressing matters of daily life, polls suggest that if Mr Cameron delivers on his referendum the country may well decide to stay in.

A poll by Ipsos Mori in October 2014 showed support for British EU membership at a 23-year high, with 56 per cent of Britons wanting to stay in the EU, compared with 36 per cent who would choose to leave.

“A Conservative victory would clearly increase the probability of a costly exit but, with opinion polling suggesting a majority in favour of EU membership, we would still consider ‘Brexit’ unlikely,” Goldman Sachs said in a briefing note earlier this month.

Goldman predicts that the Ukip phenomenon will fade and that the Conservatives will emerge narrowly with the most seats in the House of Commons on May 7, though not with enough to give Mr Cameron a majority. A repeat coalition deal with his current Liberal Democrat partners might then come into view.

But Mr Miliband’s Labour party is currently ahead in the polls – a Labour



David Cameron: facing eurosceptics

coalition with the pro-European Liberal Democrats is another possibility. So too is a Labour deal with the Scottish National party, which is threatening to sweep aside many of Mr Miliband’s candidates north of the border.

Some kind of coalition, pact or minority government seems the most likely outcome. This would still be something of a novelty in a country more accustomed to single-party rule. But in a UK that is questioning its very identity, political flux is starting to look like the norm.

3.1% The IMF’s newest forecast for US growth this year	5.6% Department of Labor data for US unemployment
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Figures released last week by the Department of Labor show that the US added more jobs in 2014 than it has in any year since 1999. The unemployment rate has fallen to 5.6 per cent, its lowest level in six and a half years.

Other factors also look set to favour the US this year. The dive in oil prices will ultimately stimulate consumer spending and be a boon for economic growth, officials at the Federal Reserve believe.

Still, the US economy is not without its weaknesses. Inflation at well below the Fed’s 2 per cent target is one concern. Tepid wage growth is another, with a broad swath of America’s middle class yet to feel the recovery in their pay cheques.

The key debate on the US economy now is how Fed officials will weigh these good factors against the bad in deciding when to raise interest rates, and how fast.

But the split recovery is also fuelling a separate, if equally critical, political debate: how to appeal to those voters who have been left behind.

Like other developed economies, the US is grappling with rising inequality. The median wealth of the nation’s most affluent families was 70 times the wealth of lower-income families in 2013 – the widest gap recorded in three decades, according to a recent report from the Pew Research Center.

The measure of President Obama’s success this year may well be a matter of making middle-class Americans feel more optimistic about their own economic prospects, as well as his political ones.

“The fundamental challenge,” says David Madland, managing director of economic policy at the Center for American Progress, a think-tank, is to “make the economy benefit everyone, not just the wealthy few”.

Struggling Rousseff needs convincing vision of future

Brazil

Economists speak of an urgent need to restore confidence in government policies, says *Joe Leahy*

When the president of Brazil went to Davos last year, she was under pressure to justify her government’s intervention in the economy and the country’s slide from Latin tiger to South American sloth.

This time, while she will not be personally attending the World Economic Forum, Dilma Rousseff will be dispatching her new finance minister, fiscal hawk Joaquim Levy, to sell her attempt to remodel herself as a reformer who will return Brazil to sustainable growth.

Her new message will be put to a forum that seemed unconvinced by her arguments last year, when she promised

Brazil would grow again even as the country was slipping into a technical recession thanks partly to a lack of investor confidence.

Mr Levy, a respected Chicago-trained economist who joined Ms Rousseff’s government this year, told journalists this week that he would tell investors in Davos that Brazil “knows how to make the necessary changes in the conduct of macro and microeconomic policy”.

Ms Rousseff, who won October’s presidential election by a narrow margin, hardly needs any reminders of the lack of confidence. Investment as a percentage of gross domestic product has declined, the economy is expected to grow less than 1 per cent this year and the trade balance has turned negative for the first time in 14 years.

While her government has blamed the global financial crisis and the end of the commodities supercycle for the slowdown, other economies in the region, aside from the market pariahs of



Dilma Rousseff: won by a slim margin

Argentina and Venezuela, are still growing.

Instead, economists attribute Brazil’s woes partly to her government’s statist approach during her first four-year term. The government sought to control prices in energy, petrol and transport, as well as interest rates and other areas while relying too heavily on state-run

banks and tax breaks to prop up a fading consumption boom and an inefficient industrial base.

The government mismanaged state-run company Petrobras, forcing it to offer a fuel subsidy at the expense of minority shareholders. This was made worse by revelations of a corruption scandal at the company.

“Brazil has got to go back to the basics,” says Alberto Ramos, economist at Goldman Sachs.

This is exactly what finance minister Mr Levy has promised. This year, he is targeting a return to a primary budget surplus – the money left over before interest payments on government debt – of 1 per cent, moving up to 2 per cent next year. Economists regard 2.5 per cent as the level required to stabilise Brazil’s gross public debt.

“The new economic team and Levy will buy her some time,” says João Augusto de Castro Neves of political risk consultancy Eurasia Group. Mr Levy’s

influence could have some positive spillover effect on other sectors, he adds. But the government still needs to develop a fresh vision for Brazil. Earlier presidents stabilised the economy and boosted the size of the middle class by expanding credit and consumption. Now the challenge is to deliver better public services to this middle class while finding a new growth model.

“Brazil’s political system, the way it is framed, requires someone there with a lot of political ability to govern,” says Mr Castro Neves. For this reason, it will be important for Ms Rousseff to ensure Mr Levy arrives in Davos armed with a broader vision of Brazil’s future and a road map on how to get there.

So far at least, he seems to be on the right track, telling journalists he would seek to reassure investors in Davos that the government is prioritising the private sector. “Brazil is a market economy in which private initiative is what drives things,” he says.

The World 2015

Renewed flames of Sunni-Shia conflict threaten to engulf region

Middle East An end to the carnage may depend on an international deal with Iran, says *David Gardner*

When the radical totalitarians of the Islamic State of Iraq and the Levant, known as Isis, burst out of eastern Syria into north and central Iraq last summer, they announced not just a new caliphate. They had also “broken” Sykes-Picot, the secret Anglo-French pact of 1916 to carve up the Ottoman Empire’s Arab provinces and throw disparate religious and ethnic groups into European-style nation-states.

The political physiognomy of the Middle East has rarely looked more menacing and – as this month’s jihadi killing spree in Paris chillingly illustrated – able to export its violence to the world.

But Iraq and Syria had already started coming apart before Isis gained ground. *De facto* partition of Iraq, a state shattered by the Anglo-American invasion of 2003, was well under way. Syria, where the regime of Bashar al-Assad has been massacring its own people since the uprising against his tyranny in 2011, was fragmenting along sectarian lines. This came about with the Assads wielding a sectarian knife to bolster their ultimately self-fulfilling narrative that what they faced from the beginning was jihadi terrorism.

What had been a Sunni-Shia subplot in this drama – going back to the schism in seventh century Islam – burst on to centre stage after the invasion of Iraq. That catapulted the Shia minority within Islam (a majority in Iraq) into

power in an Arab heartland country for the first time in centuries. The balance of power was tilted towards the Islamic Republic of Iran, which is also Shia, Persian and with ambitions as a regional hegemon.

This fanned the embers of the long Sunni-Shia stand-off into millenarian flame. Iraq dissolved into a sectarian bloodbath. Syria, similar in its ethno-sectarian make-up, has been taken the same way: grafting the Sunni-Shia schism and the Saudi-Iranian contest for regional power on to what started as another Arab struggle against despotism.

Any chance of an end to the carnage in Syria and Iraq, and a return to a level of stability, may depend on an international deal on Iran’s nuclear ambitions, unlocking US rapprochement with Iran. That would have to lead to a cessation of the proxy war across the Middle East between Shia Iran and Sunni Saudi Arabia. These rivals for regional hegemony would have to conclude that their sectarian tactics had rebounded – not least in the eruption of Isis, a deadly threat to them both.

The US-led coalition against Isis, backed by the Saudis and other Sunni Gulf states but also in tacit alignment if not overt alliance with Iran, may constrain the jihadis. But putting Iraq and Syria back together, as well as other imploding mosaic states from Libya to Yemen, will be enormously difficult. There is a slim chance – if ways can be found to transmute fragmentation into



Regional conflict: Iraqi security forces training to fight Isis — Reuters/Azad Lashkari

an institutionalised devolution of power within a set of new national compacts – to preserve unitary but not uniform states.

The ultra-centralism of Arab autocracy that provided an illusion of stability in the past is part of the problem, not the solution, which requires a much more inclusive narrative, with guarantees for all minorities.

Unfortunately, western alarm at the chaos caused by the chain of Arab upheavals of the last four years, and pre-occupation with counterterror measures, is reviving the seductive old model of regional strongmen. Thus, the Egypt of Abdel Fattah al-Sisi, who followed his 2013 army coup against an elected Islamist government with a ferocious crackdown, is almost back inside the western tent.

Yet President Sisi’s criminalisation not only of Islamists but liberals and leftists is almost certainly exacerbating

extremism. Similarly, the Wahhabi religious absolutism of Saudi Arabia, the West’s main Gulf ally, is doctrinally similar to ideas espoused by Isis. Such closed systems are recruiting sergeants for jihadism. Tunisia, the only so-called Arab Spring country to blossom, recognises this: restoring some *ancien régime* personnel but through democratic methods.

A further spur to extremism was last year’s collapse of negotiations between Israel and the Palestinians. Just before Yitzhak Rabin was murdered 20 years ago by a Jewish extremist, an Amman summit unveiled a plan for an economic confederation between Israel, Jordan and an independent Palestine. Now, Jordan and Israel are drifting apart, and Israeli colonisation of the occupied territories has put a viable Palestinian state beyond reach, saddling future generations in that cramped and combustible space with permanent conflict.

Narendra Modi has no room for complacency

India

Competition, mechanisation and a demographic time-bomb could all hinder prospects, says *Victor Mallet*

There were some stern words of caution in India for Narendra Modi’s new government last month.

“India does not have time on its side,” Tharman Shanmugaratnam, the Singapore finance minister and chair of the International Monetary Fund’s policy steering committee told the Indian finance ministry’s Delhi Economics Conclave. While India was the economy with the largest unrealised potential in the world, he said, it faced huge obstacles. “There’s a race against countries, there’s a race against machines and there’s a race against demography.”

These must have been sobering words for Arun Jaitley, the finance minister, and other cabinet members. They have spearheaded a vigorous programme of administrative and economic reforms since the Bharatiya Janata party won an overwhelming general election victory last May. An estimated 1m net new jobs will be needed each month to keep pace with the projected growth of new entrants to the workforce.

Mr Modi has energised a bureaucracy that had sunk into sclerosis and deep corruption under 10 years of Congress rule, and the government has launched initiatives to boost investment in infrastructure and manufacturing in the world’s third-largest economy.

India has increased foreign direct investment limits from 26 per cent to 49 per cent in the defence and insurance sectors, and now allows 100 per cent foreign stakes in railway infrastructure and most big construction projects. It is selling stakes in state companies, including banks and natural resources groups, albeit without conceding majority control to the private sector.

The government has also tentatively opened the door for eventual private investment in coal mining, simplified legislation for land acquisition, abol-

ished the planning commission and launched a long-awaited plan to consolidate a burdensome system of state taxes into a nationwide general sales tax.

Mr Modi has been extraordinarily lucky with oil. India, one of the world’s biggest importers, is an unambiguous beneficiary of the collapse of world oil prices. This has permitted a painless abandonment of diesel subsidies, protected the current account, curbed persistent domestic inflation and allowed fuel excise increases that will help the government meet its budget deficit target of 4.1 per cent of gross domestic product for the financial year ending in March 2015.

Economists agree that the stage has been set for a gradual economic recovery from the low point of the final two years of the previous Congress government, when GDP growth fell below 5 per cent. Nomura, the Japanese bank, for example, predicts real GDP will expand 5.5 per cent in fiscal 2014-15.



If Mr Modi accelerates restructuring and reform, there is no reason why India should not overtake China within a few years to become the world’s fastest-growing large economy.

After more than six months of reformist rhetoric and bold announcements, the challenge now is implementation. “What we’ve yet to see is private investment picking up,” Arvind Subramanian, the chief economic adviser, admitted when he presented the finance ministry’s latest economic analysis.

Mr Subramanian has tried to inject a note of caution and realism into policy makers plotting India’s resurgence as a global economic player.

He suggested a re-evaluation of medium-term fiscal strategy to allow a surge of public investment in infrastructure given the weakness of the recovery and paucity of private investment. “There’s growing ground for hope, but narrowing room for complacency,” he said.

Fall in commodity prices curbs the bullishness of recent years

Africa

Ebola, extremism and elections compound growth problems faced by many in the sub-Saharan region, writes *William Wallis*

Sub-Saharan Africa’s progress towards greater economic self reliance and political stability has been underpinned at most times over the past decade by favourable external conditions.

With world prices softening for the raw materials many African economies rely on for export earnings, the cost of debt rising on international markets and western donor funding coming under strain, the surpluses of the last decade can no longer be assured.

“It has been easy to be bullish about Africa with commodity prices going up,” says Charlie Robertson, chief economist at Renaissance Capital, the Russian investment bank that has championed African growth. “[Falling commodity prices are] now the biggest challenge to the Africa-rising thesis,” he says.

There is still a wall of money eager to exploit commercial opportunities in Africa’s underdeveloped markets – exemplified by the record private equity fund of \$1.1bn raised by Helios Investment Partners, the London-based fund specialising in African investments, earlier this month. But in a more constrained global environment African governments may have to work harder to sustain the momentum; 2015 looks set to be a testing year.

On the continent’s western flank, Guinea, Liberia and Sierra Leone are still struggling to contain the worst ever outbreak of the Ebola virus, with more than 8,000 dead since early 2014 and billions wiped off the value of their economies. Health officials are predicting that it could be another year before the epidemic is fully contained.

Another epidemic, of Islamist extremism, is weighing on the largest economies in the east and west, with security forces in both Nigeria and Kenya struggling to contain a terrorist onslaught. Meanwhile a heavily charged election timetable, with polls due in more than 10 countries, ensures a turbulent year of politics ahead. The more so, because there will be less money to paper over cracks.



Ebola: affected countries are still struggling to contain the virus — AFP/Getty Images

Many economists and investment analysts point out that the continental renaissance of the last decade was not just about commodities. It was about smart policy choices, improved macro-economic management, sounder balance sheets, in the wake of western backed debt relief, and a boom in consumer spending. Nevertheless the rising tide that floated all boats was causing soaring demand for raw materials, sustained by the growth of China.

In the next chapter, says the Zambian economist and writer Dambisa Moyo, poorer performing countries will be

‘For transformation you need a coherent and proactive policy agenda’

more exposed, while those that improve the competitive environment for investment are more likely to prosper.

There are some obvious winners and losers already. Zambia has been exposed by the falling price of copper on which it depends for the vast majority of its foreign currency earnings. The downturn in mining has been compounded by a government decision – taken during the boom – to bring in legislation due to take effect this month to raise the gross royalty on mines from 6 per cent to 20 per cent. Barrick Gold has announced the suspension of activity at its Lumwana copper mine as a result.

The collapsing price of oil is a more mixed blessing. The continent’s largest

economy, Nigeria, faces a tumultuous period with tense elections due in February, at a time when state revenues, more than 70 per cent of which come from oil, have halved. The development of recent oil finds in east African countries will also be delayed.

However, for the continent’s net oil importers, lower energy costs, and smaller import bills could prove a valuable boon, says Steve Kayizzi-Mugerwa, the African Development Bank’s chief economist. Mr Kayizzi-Mugerwa believes that rapid urbanisation and the emergence of a new class of consumers in many African cities will sustain the growth story, while large-scale infrastructure investment such as the \$10bn Chinese-backed railway from Mombasa inland into Kenya will continue to open up the region.

But Renaissance Capital’s Mr Robertson says for African economies to gain access to the capital needed to spark industrialisation, they will have to offset effects of falling commodity revenues.

In addition, although sub-Saharan African economies have grown fast over the past decade, most have failed to come close to creating enough jobs for young people entering the market. To do that, says David Ndeye, a Kenyan economist, governments will have to become far more strategic about how they use scarce resources, encourage the development of skills and make their economies competitive. He says: “For transformation you need a coherent and proactive policy agenda. That you don’t have. Most of us are free wheeling.”

#1 IN ALL-ELECTRIC VEHICLE SALES

Two white electric cars, a Renault Zoe and a Nissan Leaf, are shown side-by-side.

The Renault Nissan logo, featuring the Renault diamond and Nissan oval.

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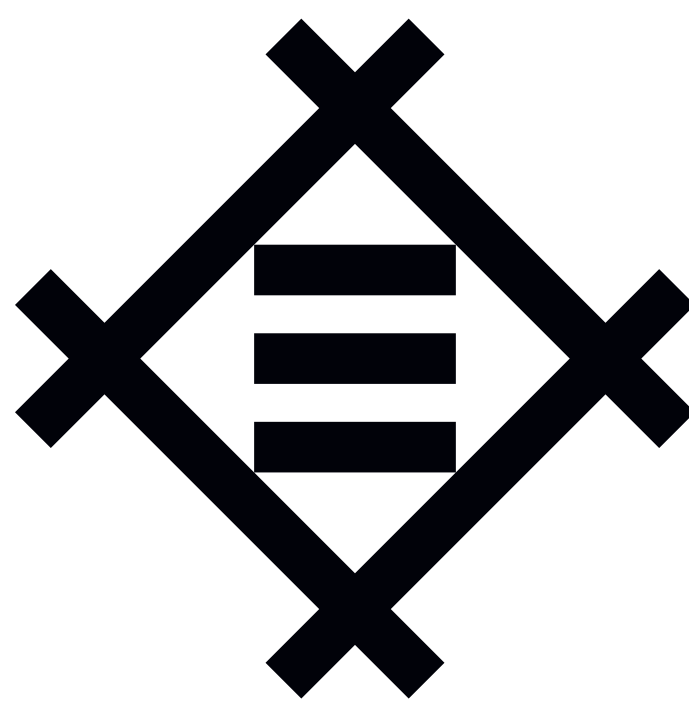
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