Institute of International Finance

2018
TEN BIG QUESTIONS

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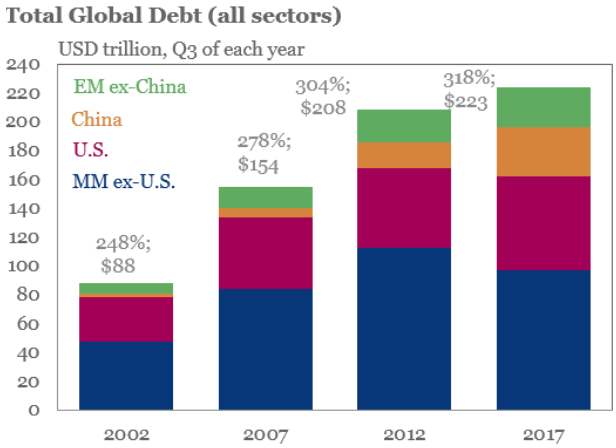
IN A WORLD AWASH IN DEBT, WHAT'S THE IMPACT OF CHINESE DELEVERAGING?

Gene Ma
Chief Economist, China

Emre Tiftik
Deputy Director, Global Capital Markets



Source: Haver, BIS, IIF

With all eyes on rosy growth prospects and soaring stock markets in early 2018, investors are pushing concerns about the massive buildup in global debt into the background. But they shouldn't.

Global debt hit an all-time high of $233 trillion in 2017. That's close to 320% of global GDP, up from 280% in 2007 (see chart). Most of the rise is due to borrowing by mature market sovereigns (to support their economies after the crisis) and by the non-financial corporate sector, where some of the proceeds have funded investment but most have been used for dividends, stock buybacks, mergers, and refinancing.

Why worry? High government debt levels will make it hard for policymakers to get the balance right – not much room for fiscal expansion, or for monetary tightening (as higher rates make it more expensive to service debt). Rising corporate debt has left perhaps 15% of firms worldwide unable to pay for debt service out of current earnings – zombie companies, in effect. With the weakness concentrated in smaller and highly leveraged firms, refinancing risk is especially high for emerging markets, where $1.5 trillion in bonds and syndicated loans comes due this year.

Nowhere are these risks more evident than in China, where total debt to GDP has risen at one of the fastest rates in the world over the past decade, from under 175% of GDP to nearly 300%. Hence Beijing's efforts to curb debt growth – and the impact of deleveraging on growth and financial markets – are key questions for investors in 2018.

Premier Li Keqiang acknowledged the problem in early 2015 and encouraged more equity ownership via IPOs and debt-to-equity swaps. However, the equity boom/bust cycle in 2015-16 dashed hopes of equity-based deleveraging. The deleveraging strategy in 2016 was to shift leverage from the "weaker hand" (corporates) to the "stronger hand" (households). As a result, corporate leverage peaked at just under 167% of GDP in mid-2016, while household debt continued to rise to about 47% of GDP in Q3 2017 – high relative to the EM average.

We expect no meaningful increase in China's debt/GDP in 2018, thanks to still-robust nominal GDP growth and the government's wide-ranging deleveraging efforts. Tighter PBoC policies brought money supply (M2) growth below 9% in October 2017 – the slowest pace on record. New regulations proposed in November signaled determination to curb risks in the shadow banking sector. Opaque, short-term, and expensive local government loans have been swapped into transparent, longer-term, and less expensive bonds. More stringent disclosure and ratings requirements for bond issuers have helped impose some fiscal discipline on local governments. Tighter housing policy should help contain household leverage in 2018.

However, the Chinese financial sector has been skilled at regulatory arbitrage. While traditional shadow banks such as trust companies are being reined in, other schemes are emerging to fill the void. One example is to disguise loans by various investment funds as equities with repurchase clauses. Mushrooming internet finance, such as peer-to-peer (P2P) lending, is not only risky, but hard to capture in traditional financial statistics.

Nonetheless, China's economy is likely to prove resilient to deleveraging, with growth slowing only modestly to 6.5% in 2018. One major reason for the rapid growth of corporate debt was overinvestment in capital-intensive state-owned sectors (see our note on this topic). Debt in those sectors has created very little value in the past decade, implying that GDP lost due to deleveraging should also be limited. Moreover, China's economy is increasingly driven by the nascent service sector and technology companies, which are less adversely affected by deleveraging efforts than the traditional capital-intensive ones.

However, deleveraging still poses risks for China's financial markets and institutions. A slight liquidity squeeze by the PBoC sent money rates to over 20% in mid-2013. Curbs on margin lending set off the equity rout in 2015. Gentle PBoC tightening in late 2016 caused a massive selloff in the highly levered local bond market. We expect Chinese financial firms that rely heavily on wholesale or shadow bank funding to face harder times in 2018. Some wealth management products (WMPs) may finally default. More broadly, China's deleveraging – if it results in slower growth and/or market turbulence – could pose risks for global financial stability.

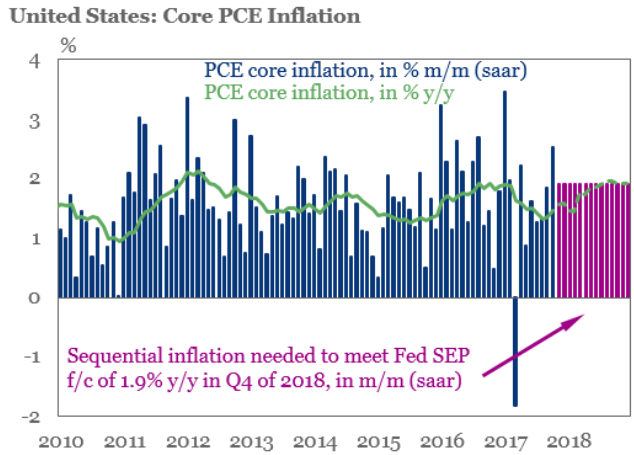
WILL INFLATION FINALLY SPOIL THE PARTY?

Robin Brooks
Managing Director and Chief Economist

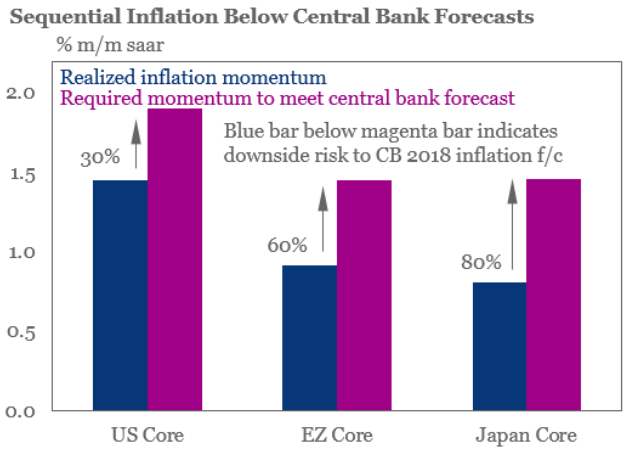
The biggest macroeconomic surprise of 2017 was arguably the decline in U.S. core inflation, despite a steadily tightening labor market. This surprise caused longer-term bond yields to remain anchored at low levels even as the Federal Reserve (Fed) continued down its path of gradual rate hikes, providing a positive environment for more rate-sensitive assets like the S&P 500 and emerging market currencies.

One big question as we start 2018 is whether inflation will rebound this year even as fiscal stimulus shifts the Fed onto a faster rate-hiking trajectory. We are not convinced. We examine the inflation outlook in the U.S., the Eurozone and Japan, and conclude that the outlook should remain benign for the foreseeable future. This conclusion might seem surprising, given that large one-off effects that drove inflation lower in the first half of 2017 drop out of year-over-year calculations this year. But these base effects are widely understood and, if anything, have been superseded by a string of low inflation readings since then, in part due to the "Amazon effect." As a result, we see continued downside risk to the Fed's inflation forecast, with even greater downside risk to European Central Bank (ECB) and Bank of Japan (BoJ) forecasts. The inflation picture should therefore remain benign.

To put things in perspective, we compare the latest inflation forecasts from the G-3 central banks (Fed, ECB, BoJ) to actual inflation and calculate how much month-over-month inflation needs to rise to meet 2018 forecasts. For the Fed, the latest Statement of Economic Projections (SEP) forecasts core PCE inflation – the Fed's preferred measured of inflation – at 1.9% year-over-year in Q4 2018. The top chart shows the sequential path of inflation needed to meet this forecast (magenta bars), which implies month-over-month readings on average 30% higher than over the past year (blue bars). The fact that sequential inflation needs to rise materially illustrates that there is downside risk to the Fed's inflation forecast, i.e. it cautions against expecting too much of a hawkish shift in the Fed's policy rate outlook. The bottom chart repeats this exercise for the ECB and BoJ, where the rise in sequential inflation needed to meet inflation forecasts is much greater. For the ECB, a rise of 60% is needed relative to actual inflation readings over the past year, something that is quite telling given the already very low 2018 ECB forecast for core inflation (HICP) of just 1.1%. For the BoJ, a rise of 80% is needed to bring core inflation up to the forecast of 1.4% for 2018. Across the G-3, risks to the inflation outlook therefore continue to be firmly skewed to the downside, one factor that should help temper any hawkish shifts in policy.



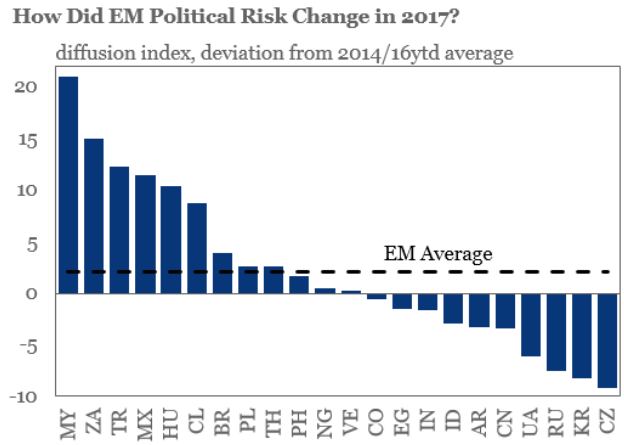
Source: Haver, IIF



Source: Haver, IIF

WILL 2018 BE ANOTHER BANNER YEAR FOR EMERGING MARKETS?

Sonja Gibbs
Senior Director, Global Capital Markets



Source: Bloomberg political risk indices, IIF

Even with stellar 2017 returns in the bag, many investors are looking for further gains in emerging markets this year. Their reasoning is straightforward: global liquidity will remain plentiful even as the Fed moves ahead with gradual tightening, the U.S. dollar will remain soft and volatility low – prolonging the favorable backdrop. Attractive high yields in EM markets should keep emerging market bonds well supported; similarly, a faster pickup in EM growth relative to mature economies should boost portfolio equity, banking and FDI flows. Finally, valuation and positioning both favor emerging markets – particularly EM equities, which trade at a steep discount to mature market equities and are substantially underweighted in global fund investor portfolios.

Corporate earnings could be an upside surprise this year. Encouraged by improving macroeconomic fundamentals, rising commodity prices and a pickup in global trade volumes, analysts have been rapidly revising up EM earnings estimates for 2018. Argentina, Turkey and China – benefiting from a growth turnaround, currency weakness and reforms, respectively – are on the high end of revisions, while Malaysia and South Africa – where domestic political uncertainty has been clouding the outlook – are on the lower end. Average return on equity could hit 12% for the MSCI EM index in 2018 – putting it above that in mature markets for the first time since early 2014.

But the real upside surprise may come from payoff from structural reforms. China is an obvious example: supply side reforms have reduced capacity in industries including steel, aluminum and cement, which should help push 2018 profit margins to their highest level since 2013. Progress on structural reform has also been evident in Argentina (elimination of many trade restrictions); Brazil (liberalization of labor markets); India (tax reform, financial inclusion); Indonesia (reduction in government subsidies, ease of doing business); Mexico (greater openness to foreign investment in telecoms and energy); and Saudi Arabia (framework to improve transparency and accountability in government). Progress on such structural reforms should help improve productivity, boost potential GDP growth, and promote a more hospitable investment climate.

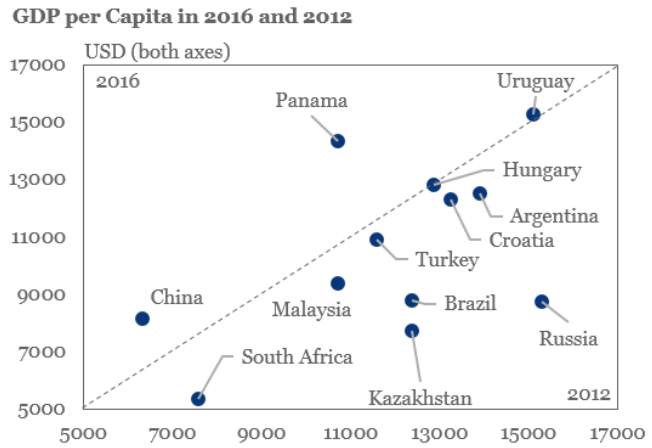
Nonetheless, downside risks should not be understated. A more aggressive path for Fed rates, coupled with planned balance sheet unwind and a stronger USD, could reduce EM portfolio flows by $15-$35 billion in 2018. Such a scenario would also mean trouble for countries with high levels of foreign currency corporate debt – Turkey, for example. More broadly, tax reform could pull investment flows towards the U.S., hurting EM portfolio equity, banking and FDI flows. A U.S.-driven rise in trade tensions could sap EM exports and undermine progress on trade liberalization. Renewed instability or a sharp growth slowdown in China would inevitably weigh on appetite for emerging markets, particularly in EM Asia. Should any of these downside risks materialize, countries with weaker fundamentals and/or elevated political tensions would be hardest hit. Indeed, domestic political risk has risen for many EM countries (see chart); major 2018 elections including in Brazil, India, Indonesia, Mexico, Russia, South Africa, Thailand and Venezuela could impact macroeconomic policy and stall progress on structural reforms.

Given the range of potential risks, perhaps the most notable surprise for EM investors in 2018 may be a wave of funds coming back to active management. Country selection, sector rotation and stock picking should come to the fore this year. Regional rotation may also be a factor, given the relatively higher valuations in EM Asia. Investors will also be taking advantage of greater market depth and diversity – the investible EM local currency bond market (sovereign and corporate) is now some $1.3 trillion, broadly on par with the U.S. high-yield market. EM equity market capitalization has reached a new record high of $5.1 trillion, with information technology stocks now accounting for over 25% of that.

In sum, while EM investors may well be more discriminating in 2018 as the Fed moves ahead with policy tightening, upside surprises are likely to outweigh downside risks.

PUTIN 4.0: REFORM OR STAGNATION?

Ondrej Schneider
Chief Economist, Emerging Europe



Source: Haver, IIF

There is little doubt about the outcome of Russia's March 18th election. President Putin will be re-elected to his fourth term, cementing his legacy as the defining character of modern Russia.

Putin will undoubtedly use his fourth term, which is expected to be his last, to pursue foreign policy ambitions, and in particular to assert Russia's status as a global power. It's less clear, though, how he intends to manage Russia's many economic challenges – whether he will rely on higher oil prices to fuel a modest recovery or whether he intends to pursue genuine reforms.

Putin has largely failed to achieve the ambitious economic targets he set out in his 2012 campaign. Investment share of GDP declined from 23% to 20.5%, instead of rising to 25% as intended. The planned 50% labor productivity increase failed to materialize completely and doctors' wages remain well below the 200% of the regional average target. Indeed, Russia's GDP per capita in dollar terms slipped 30% from its 2012 level and is now lower than Malaysia's, Turkey's, or Costa Rica's, countries that were poorer than Russia in 2012 by 25%-30%. Notably, Kazakhstan closed its gap vis-à-vis Russia by half since 2012 (see chart).

Putin is aware of Russia's predicament and ordered several government departments to develop a reform strategy for his next term. The goal is to lift Russia's long-term growth rate from the current dismal level of 1%-1.5% to 3%-4%. A "reformist" group, led by former Finance Minister Kudrin, proposes slashing military expenditures, strengthening the rule of law, and increasing labor productivity via investing in education, healthcare, and infrastructure. They further propose a pension reform that would alleviate a bleak demographic outlook whereby the number of pensioners per working age would increase from 45% presently, to more than 60% in 2035.

The sensible reformists' plans conflict with powerful and well entrenched interest groups that prefer the status quo.

The interconnected group of state-owned firms, friendly private businesses, and the military industrial complex have benefitted from the recent buildup of the state's role in the economy. The two biggest private banks collapsed in 2017 and were nationalized, leaving the government in control of 65% of the banking sector. State-owned oil producer Rosneft absorbed the fifth largest energy firm, Bashneft, that was supposed to be privatized. Foreign direct investment dwindled after the imposed 2014 financial sanctions on Russia, and no privatization is currently planned.

President Putin, increasingly risk-averse and detached from the domestic agenda, is unlikely to pursue ambitious economic reforms in his fourth term. He is more likely to capitalize on a modest recovery propelled by higher oil prices.

Real GDP likely increased by 1.7% in 2017 and wages grew by 7%. Private consumption has begun to rise after two years of decline with headline inflation at an all-time low of 2.5%. Real GDP growth may accelerate to 2.5% this year and the government will balance its budget two years earlier than planned if oil prices remain close to the current level of $60-$64 per barrel.

Moreover, macroeconomic policies – fiscal and monetary – have already achieved reasonable stabilization. New fiscal rules should help steady the ruble exchange rate and smooth budget revenues. That would contribute to low and more stable inflation and to a balanced budget. New sovereign funds should accumulate $30-$50 billion next year, depending on the oil price, and the current surplus will remain healthy.

Russia's long-term growth, though, will remain constrained at 1%-2% with no or limited structural reforms. With a growth rate this low, Russia would be poorer, in per capita terms, than China or Kazakhstan by the end of Putin's fourth term in 2024, a difficult legacy to turn over to Putin's eventual successor.

WHAT IS THE RISK OF A U.S.-NORTH KOREA MILITARY CONFLICT?

Kristen Silverberg
Managing Director

Since July, the Trump Administration has scrambled internally to catch up with faster-than-expected technological advances by North Korea. The result has been a muddle of confusing signals, ranging from President Trump's threat to unleash "fire and fury," to Secretary Tillerson's more measured attempts to engage the North Koreans diplomatically. Much ink has been spilled over the question whether the President's more combative statements reflect a genuine willingness to consider a preventive military strike or whether he's blustering in an attempt to cow Pyongyang into submission.

In our view, he's doing both. Both the Pentagon and State Department will oppose a preventive strike, and we believe their objections will ultimately prevail. However, the National Security Council (NSC) has not yet ruled the option out, a point senior officials make in both public and private settings.

We would note two critical factors behind the NSC's thinking:

First, the Administration has concluded that a "preemptive" strike – meaning one that would take place only when North Korean use of the weapons is imminent[1]– isn't feasible because the U.S. lacks the ability to detect the movement of missiles on North Korea's Transporter Erector Launchers (TELs), converted Chinese lumber trucks. No matter how many algorithms or eyeballs U.S. intelligence devotes to watching for TEL tire tracks, the missiles are mobile and easy to disguise. Administration officials have, reportedly, further concluded that current U.S. missile defense systems would stop some but not all missiles in a North Korean attack.

Second, and equally importantly, the NSC has reassessed U.S. assumptions about North Korea's objectives. Prior to the Trump Administration, conventional wisdom in Washington was that North Korea was pursuing its nuclear program principally for prestige or regime-preservation purposes. NSC staff, including General McMaster, have rejected that position publicly and privately. In their view, the North Koreans want nuclear weapons for offensive purposes, either to use as blackmail, or even as leverage in a conventional military conflict. In other words, even if the North Koreans can be deterred from actually initiating a nuclear conflict, the U.S. believes that North Korean capabilities would be leveraged to drive the U.S. off the Peninsula.

As General McMaster said in a September 2017 New Yorker interview:

> *The North Koreans have shown, through their words and actions, their intention to blackmail the United States into abandoning our South Korean ally, potentially clearing the path for a second Korean War.*

In the NSC's view, these factors leave them with two bad options: 1) a messy deterrence strategy against an adversary who is attempting to aggressively leverage nuclear weapons or 2) a preventive strike. Officials are reportedly considering a so-called "bloody nose" strike, meaning a limited military attack designed to scare the North Koreans into negotiating.

To avoid bad options, the Trump Administration continues to hope for Chinese intervention that would change the North Korean calculus. Reports that the North Korean Central Committee has been organizing anti-China conferences suggest that the Kim Jung Un regime is prepared to resist additional pressure. Nevertheless, in the short-term the U.S. is likely to ratchet up sanctions on Chinese firms doing business in North Korea.

Ultimately, the greatest risk may not be a U.S. preventive strike, but North Korean action that provokes a U.S. response. For example, North Korea has threatened to demonstrate end-to-end capabilities by detonating a live weapon over the Pacific. The test would require flying a nuclear-armed missile over population centers of U.S. allies and would produce radioactive fallout. It's unclear whether a live atmospheric test would, in the Trump Administration's view, necessitate a U.S. military response and whether any redlines have been clearly articulated to the North Koreans.

Key signs that the U.S. is moving towards war could include mobilization of U.S. armed forces, a call-up of U.S. military reserves, an embargo of North Korean ports by the U.S. Navy, or boarding of North Korean ships. Signs that a U.S. strike is imminent would include evacuation orders for U.S. citizens in South Korea or Japan, a request to Congress for an authorization for the use of force, and crisis consultations at the United Nations. At the end of the day, we believe that the risk of direct military conflict is low, but growing.

1 In Pentagon lingo, a "preemptive" strike is one that takes place only when an attack by the other party is imminent. A "preventive" strike is one designed to take out a potential, longer-term threat.

WILL PRESIDENT TRUMP FOLLOW THROUGH ON HIS TRADE AGENDA?

Scott Farnham, Senior Analyst

Arpitha Bykere, Associate Economist

We believe 2018 will be the "year of trade."

Action on trade issues took a backseat to other priorities in 2017, in part because President Trump's staff persuaded him that moving on trade would undermine his tax reform agenda. With the imminent departure of more trade-friendly White House advisors, such as Gary Cohn (expected) and Jeremy Katz (announced) of the National Economic Council, there will be less of a counterbalance to the trade skeptics within the Administration. In other words, staff bought some time on trade issues so far, but the bill is coming due.

The NAFTA renegotiations remain the elephant in the room as the parties enter the sixth round of talks this month. Key industry groups, including the U.S. Chamber of Commerce and agricultural associations, have expressed support for NAFTA in recent months, making it clear to Congress and the White House that withdrawal from the agreement would not be favorable to business. The result of the negotiations is still uncertain, with U.S. withdrawal from NAFTA a fair possibility. However, a Trump-initiated withdrawal would spark years of litigation and uncertainty in the marketplace as stakeholders challenge the President's authority to completely withdraw from the agreement. In short, it would be a mess.

With changes to NAFTA facing increasing political and legal opposition, it is likely that the President will begin focusing his attention more on China. Imposing sanctions on China via a targeted approach appears to be the path of least resistance compared to pushing for more sweeping changes to trade policies. There are a number of key trade investigations, mostly targeting China, that were delayed last year as the White House looked for help with North Korea and wanted to narrow their focus on the domestic agenda:

- Section 201 on cheap solar panel imports, particularly from China. President Trump has until January 26 to decide whether or not to impose import restrictions and/or tariffs recommended by the International Trade Commission (ITC). The case is controversial within the industry, and could serve as a barometer of Trump's trade appetite going forward.

- Section 232s on national security implications of steel and aluminum imports. The Commerce Department report on steel imports was sent to the White House on January 11, and the aluminum report is expected by January 22. President Trump will have 90 days from receiving the reports to decide on potential action.

- Section 301 on Chinese intellectual property rights violations. The report isn't due until August, but sanctions could come sooner, as domestic industry support appears broadly cohesive.

On South Korea, there are still pending measures against Korean-made washing machines and wire rods that may be imposed, and KORUS FTA renegotiation discussions are still underway. We do not expect President Trump to follow through on his threats to exit KORUS, as the relationship is too important at this time of contention with North Korea. However, continued use, or threat of use, of targeted actions against certain industries in order to chip away at the trade deficit and score political points with Trump's business allies should be expected.

Related to all trade issues is the Administration's rocky relationship with the WTO. The recent meetings in Argentina ended without any major agreements, largely due to lack of U.S. support. On the quieter side, the U.S. has been blocking judge appointments to the WTO's appellate body, slowly strangling the ability for dispute settlement – one of the most important functions of the WTO. These actions, as well as threats by President Trump, have opened the possibility of a U.S. withdrawal from the WTO. While we do not think this is a high probability, it remains an area to watch as President Trump's trade agenda gains momentum.

Meanwhile, notwithstanding a more inward-looking U.S., other countries continue to bolster support for the global trading system, including the largest trading economies (EU and China) and emerging markets that see room to benefit from further trade integration in line with their growing share of the global economy. The EU recently finalized trade deals with Japan and Canada, which still need to be approved/ratified by EU member states against the backdrop of rising nationalism in the bloc. This year, the EU aims to pursue trade negotiations with Australia and New Zealand, conclude trade talks with the Mercosur bloc, and upgrade the existing trade deal with Mexico. Mexico itself is looking to upgrade its trade deal with Brazil and Argentina. This is also in line with Latin American countries looking to diversify their export products and markets. In light of its dimming export-led growth model and U.S. retrenchment from global trade policy, China sees an opportunity to push forward its regional and global interests by negotiating and signing trade deals with several countries in the One Belt region, including smaller economies like Sri Lanka, Pakistan and Maldives, which hope to benefit from China's role in the global supply chain and as a growing high-value producer and final consumer.

Efforts are also underway to deepen regional trade, as seen with China's strong push for the Regional Comprehensive Economic Partnership (RCEP) in Asia, and the Continental Free Trade Agreement set to be approved by the African Union this year. More importantly, the trade deals being approved or upgraded globally are deeper in terms of the share of global population and GDP covered, as well as the provisions included (services, investment, intellectual property, migration of professionals, etc.) – in line with the growing role of services in the global economy and the potential to benefit from information and communication technology (ICT)-enabled services trade. Despite lack of leadership from the U.S. on global trade issues, others are happy to step in.

WILL POPULISTS PREVAIL IN LATIN AMERICA?

Martín Castellano
Deputy Chief Economist, Latin America

Critical presidential elections will take place in several Latin American countries this year (Brazil, Mexico, Colombia, and, potentially, Venezuela). Despite healthy growth in the region – Latin America is poised to grow 2.3% in 2018 – widespread fragmentation, dissatisfaction with traditional political factions, and strong public support for left-leaning candidates have raised doubts about the durability of pro-market reforms in the region. This is particularly true in Brazil and Mexico, which will likely fuel market volatility.

In our view, Brazil's October general election poses less of a risk. While uncertainty over the final presidential candidate nominations persists, the country's two-round voting system favors more prudent proposals, and Brazilian voters have historically had a preference for the status quo. Moderate candidates will be assisted by improvements to the economy driven by current policies as reflected by declining inflation and accelerating activity.

Even if a left-leaning candidate prevails, fragile public finances, a rule-based framework, and the need to sustain investor confidence provide limited scope for increased fiscal stimulus. In fact, politicians are under pressure to deliver on the macro front amid the still unfolding corruption probe and the failure of past populist measures. Moreover, political parties that have recently help build the needed consensus in congress to pass reforms should stay relevant.

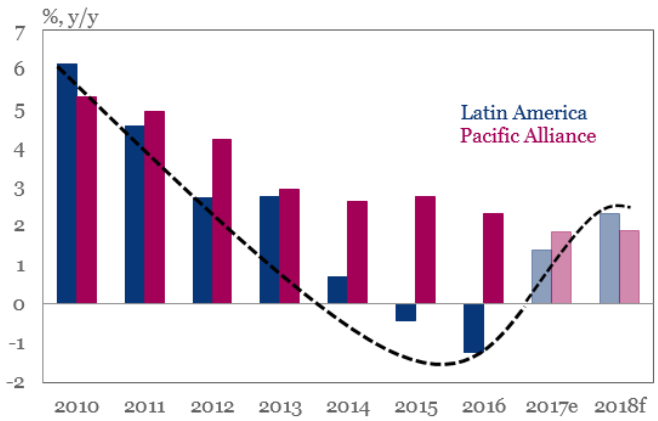
The July presidential election in Mexico poses a greater risk. The prospects of a nationalist-leaning candidate becoming president are high amid a weak economy, heightened tension with the U.S., and the combination of political fragmentation (independent candidates will be able to run for the first time) and a single round of voting. While the scope for introducing a radical policy shift is rather narrow – given limited congressional support and a strong institutional framework – garnering confidence among investors could be a major challenge for the next administration.

Although instability related to the NAFTA renegotiation and the presidential race would weigh on private sector investment, the Mexican economy should continue to grow this year, albeit at a slower pace. The need to contain inflation, which ended last year significantly above the central bank target band, and avoid unwarranted exchange rate volatility would prevent the central bank from providing monetary stimulus, undermining hopes for policy rate cuts.

One major wild card is Venezuela, where presidential elections are intended for 2018Q4. The country remains in a downward spiral amid declining output, accelerating inflation, and debt woes. U.S. sanctions have constrained the regime, further limiting its capacity to sell assets and issue new debt. However, a negotiated solution to the political crisis (which would require the government to pursue economic reforms and reinstate the National Assembly to provide legitimacy) is unlikely to take place in the short-term. With a deeply divided opposition and lack of transparent rules and institutions, the regime's chances of winning the presidential election and remaining in power have increased. The impact of a PDVSA default could prove highly contractionary as the oil company remains the country's main source of foreign exchange.

Moving forward much needed productivity-enhancing reforms in Latin America will require skillful political leadership across the region. Limited public support and longstanding structural weaknesses in many countries (high income inequality, fragile institutions, low productivity, and lagging infrastructure) remain major headwinds to reform efforts.

Latin America: Real GDP Growth



Source: Haver, IIF

IS THERE TIME FOR SAUDIS TO REFORM?

Garbis Iradian
Chief Economist, MENA

Three years after the oil crash, the Saudi economy remains mired in a slowdown, with real GDP projected to contract by 0.7% in 2017 due largely to OPEC-related oil production curbs and anemic non-oil activity following sharp public spending cuts. A stated priority of the government is to diversify the economy away from oil to other sectors, so what matters critically are prospects for the non-oil economy going forward. Prospects in that sector depend foremost on structural reforms, which will feed into activity and productivity growth. We discuss here the outlook on these fronts.

Non-oil growth is expected to pick up gradually beyond the near-term as structural reforms are implemented, including progress in diversification and privatization, which would raise productivity of capital and labor. There has been progress in implementing the Fiscal Balance Program, reining in capital spending, gradually phasing out subsidies, and rolling out revenue raising measures. Some progress has been made reducing the obstacles to private sector growth, including making it easier to start a business. It is hoped that Saudi authorities will still push through deeper economic reforms despite the recent modest recovery in oil prices.

It is still too early to judge the success of the far-reaching structural reforms which have been announced, but a key litmus test will be the privatization program, including the sale of 5% of Aramco expected in 2018. Import substitution policies and local content targets in areas such as defense procurement could stimulate activity, but will take time. To stimulate the private sector, improve productivity, and reduce the fiscal burden of supporting inefficient enterprises, the authorities intend to privatize few state-owned enterprises and work on Public-Private Partnership (PPP) programs.

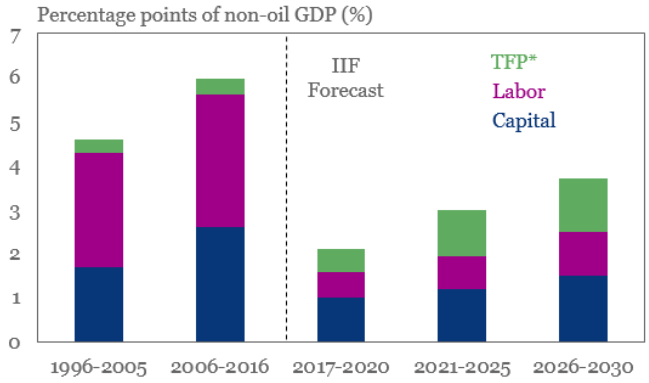
The PPP has considerable scope to increase efficiency and productivity and to release additional public assets that could be used partly to finance spending on infrastructure.

The country's growth model has delivered average non-oil growth of 6% in 2000-14, supported by a sustained surge in public spending. The increase in employment has led to an increase in foreign labor, which account to 90% of the private sector workforce. However, this growth model has also resulted in stagnating productivity (see chart), and progress towards diversification has remained limited. Given the projected weak growth in the coming years, reliance on foreign labor needs to decline to allow new national entrants to the labor force to find employment. But a key challenge is to ensure that Saudi nationals are equipped with the right qualifications and work ethic to make them competitive in the private sector job market.

So far, the public sector has traditionally been the main source of employment for nationals, acting as employer of first and last resort, but it will no longer be able to do so because of the need to restrain the wage bill as a result of fiscal consolidation.

Implementation of "Vision 2030" will help regain competitiveness by implementing deep structural reforms, including steps to build a new, more diverse growth model. This will require shifting national workers from the public sector to the private in a business-friendly environment where the sectors form an effective partnership. With the number of national entrants into the labor force expected to grow rapidly given the demographic structure, and the expected increase in the female participation rate, it will be important to ensure that local education and training improve substantially. If implemented forcefully, such policies could generate the major improvement in productivity performance needed to raise non-oil growth above 3% beyond 2020 (see chart).

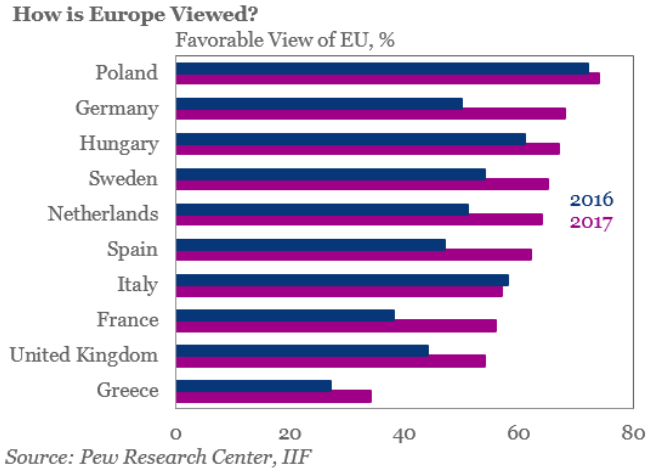
Saudi Arabia: Contribution to Non-oil Growth



**Total factor productivity, a measure of the productivity of labor and capital. Source: IIF*

CAN EUROPE EXIT A LOST DECADE?

Hung Tran
Executive Managing Director



A clear sense of hope has emerged in Europe after years of stagnation, crises, and Brexit. A cyclical recovery has gained traction and the growing populist backlash appears to have been checked after the Dutch and French elections in 2017. However, challenges remain formidable. While some are easier to overcome than others, it's not clear if enough will be done for Europe to exit the "lost decade".

The first challenge is to sustain the economic recovery. Prospects for achieving this goal are reasonable. However, while continued growth is necessary, it is not sufficient. Growth must be made more inclusive to address the implications of inequality in the distribution of income and wealth across the region. Furthermore, national as well as EU reforms need to be adopted to deal with voters' concerns about immigration and terrorism. The indecisive election in Germany – which has led to protracted coalition government negotiations – and the March 4th election in Italy, where populist parties are on the rise, show that populism is still potent. The fundamental goal must be to combat a widespread sense of economic and social insecurity – not just to maintain growth. Against these more difficult objectives, it's less likely that Europe will make sufficient progress.

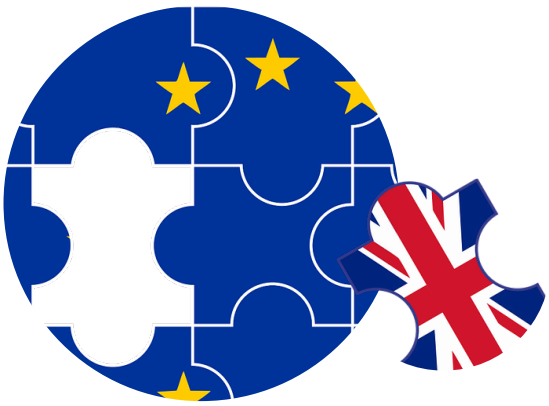
The second challenge is to reach a Brexit agreement, setting a framework for a productive EU-UK relationship – not only in economic and financial matters but also on foreign relations and security policy. For trade issues, it seems likely that a "Canada plus plus" model – which would include areas like financial services, fishery, and aviation which are not in the Canada-EU FTA – will serve as a template for a deal to be implemented after a transition period. Nevertheless, the risk of a hard Brexit without agreement remains high amid a messy and uncertain process of negotiation and ratification.

The third challenge will be to reform the EU to improve its operations and performance so as to regain the trust and support of citizens in member countries. The immediate project is completing the Banking Union as well as the Capital Markets Union. Again, the odds for achieving this are quite reasonable. However, the more important and difficult task is to reform EU institutions and governance to address concerns that the EU has become remote yet intrusive – as well as too bureaucratic and inefficient. These reforms need to be done in a way which involves meaningful consultation with voters. Reliance on inter-governmental negotiations to devolve more power to more centralizing institutions could prove to be counterproductive. But this is the risk that the EU seems to be heading toward.

Fourth, while support for EU membership has risen since the UK's Brexit vote (see chart), growing fault lines within the EU are a particular source of concern and not easy to bridge. These fault lines include deviation by certain members such as Poland and Hungary from the EU liberal democratic values and norms as well as the persistent desire for independence in several regions within member states. This secessionist sentiment has been clearly reflected in the latest election in Catalonia, which has perpetuated political tension in Spain.

Finally, the EU must navigate an increasingly fractious global environment. Close to home, the EU has to deal with a deepening estrangement with Turkey – which still plays an important role in managing Europe's migration crisis – as well as a resurgent Russia and unresolved conflict in Ukraine. More broadly, the EU must cope with the global implications of the Trump Administration's policies, which have severely shaken the post-war political and economic order, threatening trade wars and a disruption to synchronized global economic growth. These external challenges, while difficult to deal with, could lead to more cohesion within the EU – the recently concluded Permanent Structured Cooperation in security and defense issues is a good example.

In short, Europe faces difficult challenges but has a clear window of opportunity to deal with them, helped by the cyclical economic recovery. However, it remains to be seen whether Europe's leaders can rise to the occasion.



WILL THE BITCOIN BUBBLE BURST?

Dennis Ferenzy
Associate Economist, Innovations

Fueled by a frenzied investment mania, Bitcoin's price sky-rocketed in 2017, from under $1,000 at the beginning of the year to an intra-day high of over $20,000 in mid-December. During this period, its market capitalization rose from $15 billion to a high of $326 billion – comparable to that of Bank of America.

The last 30 days, however, have seen a significant pullback in price, with trading concentrating in the $12,000 - $16,000 range. Will this short-term trend continue or will bitcoin return to its 2017 trajectory? Our bet is on a downward trend with wild fluctuations.

The overwhelming majority of economists – and even many cryptocurrency advocates – saw an irrationally exuberant market in 2017: Bitcoin's price soared, news coverage rose, and more and more investors felt compelled to invest in an asset they knew little-to-nothing about. This resulted in Bitcoin becoming, according to some estimates, one the biggest bubbles of all time, surpassing the Mississippi Company and South Sea Company bubbles of the 1700s. When compared to more recent market bubbles, the 2017 ascent of Bitcoin was truly astonishing (see chart on left).

However, this stratospheric rate of growth was unsustainable and is unlikely to return in 2018, especially given Bitcoin's current limitations and challenges. For example, given limits to the number of possible transactions per second, Bitcoin's ability to function as an efficient payment system is constrained. Addressing this scalability issue could lead to disruptive ideological disagreements within the Bitcoin community and additional forks of the network as seen with Bitcoin Cash – raising the risk of market fragmentation. Another major challenge facing Bitcoin is its reliance – in certain hotspots – on mining powered by free or low-cost electricity is coming under pressure. This month China has followed up their ban on exchanges with a crackdown on discounted electricity and tax credits from regional authorities to bitcoin mining companies.

In addition, legal, regulatory, and security barriers may slow Bitcoin's adoption; legislative bodies, regulators, and law enforcement agencies cite tax evasion, money laundering, and financing of illicit activities as serious concerns. Numerous countries, including China, Colombia and Nigeria, have imposed strict restrictions on Bitcoin, and others are likely to follow.

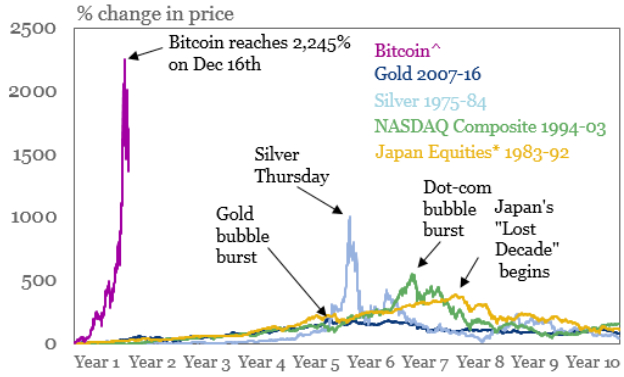
On a related note, the explosion of initial coin offerings (some 50 ICOs are launched weekly and over $4 billion worth of capital was raised via ICOs in 2017), has raised red flags for regulators. Benjamin Lawsky, former Superintendent of the New York State Department of Financial Services, warned last year that if ICOs get out of control, it could result in a severe regulatory backlash against the entire crypto ecosystem. Beijing and Seoul have already banned this form of capital raising, while regulators in Hong Kong, London, Singapore, and Washington, D.C. have warned that ICOs may violate securities laws.

Furthermore, while the newly-launched Bitcoin futures markets add legitimacy, it also allows investors to bet against the cryptocurrency – something that has been difficult and expensive to execute until now. Factors including costly transaction fees, the enormous power needed for mining, the threat of cyber-attacks on Bitcoin exchanges, and high volatility also limit Bitcoin's appeal. Additionally, profit-taking could lead to selling pressure, exacerbated by poor liquidity and panic among inexperienced investors.

That said, a Bitcoin price crash should not spill over to other financial markets or impact the global economy. While Bitcoin's market capitalization has grown significantly, it remains tiny relative to other asset classes (see chart on right). Moreover, with cryptocurrencies traded and held outside the banking sector, the risk of contagion is low. Nevertheless, officials are monitoring Bitcoin closely, warning of a "classic bubble" and urging "extreme caution." France's finance minister has even proposed that Bitcoin regulation be discussed at the 2018 G20 summit in Argentina.

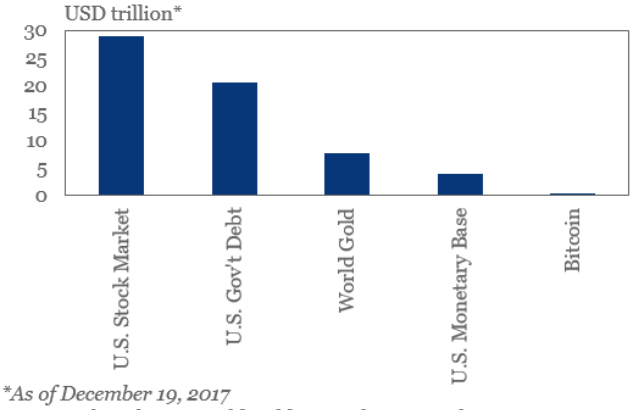
Finally, while we do expect a significant price pullback in 2018, we believe cryptocurrencies are here to stay. Just as internet-based companies flourished after the dot-com bubble, we see a similar trajectory for crypto currencies and companies. Yes, much of the crypto ecosystem could collapse after the peak of the hype (and regulatory oversight increases), but a handful of cryptocurrencies and companies would survive and new ones will be created. Those that can adapt, address operational challenges, and demonstrate valuable use cases should ultimately play an important role in the global economy.

Bitcoin's 2017 Rise vs. Decade-Long Trends in Other Historically Large Market Moves



*^January 16, 2017 to January 16, 2018; *Nikkei 225 Index*
Source: Bloomberg, CoinMarketCap, WSJ, IIF

Market Capitalization Comparisons



**As of December 19, 2017*
Source: Bloomberg, World Gold Council, CoinMarketCap.com, IIF

Questions or comments regarding this publication may be addressed to:

IN A WORLD AWASH IN DEBT, WHAT'S THE IMPACT OF CHINESE DELEVERAGING?

Gene Ma

Chief Economist, China
gma@iif.com

IN A WORLD AWASH IN DEBT, WHAT'S THE IMPACT OF CHINESE DELEVERAGING?

Emre Tiftik

Deputy Director, Global Capital Markets
etiftik@iif.com

WILL INFLATION FINALLY SPOIL THE PARTY?

Robin Brooks

Managing Director and Chief Economist
rbrooks@iif.com

WILL 2018 BE ANOTHER BANNER YEAR FOR EMERGING MARKETS?

Sonja Gibbs

Senior Director, Global Capital Markets
sgibbs@iif.com

PUTIN 4.0: REFORM OR STAGNATION?

Ondrej Schneider

Chief Economist, Emerging Europe
oschneider@iif.com

WHAT IS THE RISK OF A U.S.-NORTH KOREA MILITARY CONFLICT?

Kristen Silverberg

Managing Director
ksilverberg@iif.com

WILL PRESIDENT TRUMP FOLLOW THROUGH ON HIS TRADE AGENDA?

Scott Farnham

Senior Analyst
sfarnham@iif.com

WILL PRESIDENT TRUMP FOLLOW THROUGH ON HIS TRADE AGENDA?

Arpitha Bykere

Associate Economist
abykere@iif.com

WILL POPULISTS PREVAIL IN LATIN AMERICA?

Martín Castellano

Deputy Chief Economist, Latin America
mcastellano@iif.com

IS THERE TIME FOR SAUDIS TO REFORM?

Garbis Iradian

Chief Economist MENA
giradian@iif.com

CAN EUROPE EXIT A LOST DECADE?

Hung Tran

Executive Managing Director
htran@iif.com

WILL THE BITCOIN BUBBLE BURST?

Dennis Ferenzy

Associate Economist, Innovations
dferenzy@iif.com

Designed by Mounika Ramaji.

Washington • London • Brussels • Dubai • Beijing • Singapore • www.iif.com • @IIF