中国观

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CHINA WATCH

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Prospects for the Global Economy in 2015

Robert Kahn, Steven A. etc.

Introduction>>

Prospects for the global economy are made in terms of four points: Instability in Russia, stagnation in Europe, uncertainty in China and probable breakthroughs in global trade liberalization.

As 2015 dawns, the global economy is navigating choppy seas. Instability in Russia, stagnation in Europe, and uncertainty in China are being offset by a sharp drop in oil prices that the IMF says could boost growth by as much as 0.8 percent above the expected 3.8 percent.

The United States "faces a debt reckoning," writes Guardian finance and economics editor Heidi Moore. U.S.-consumer debt worth $3.2 trillion and the resurgence of subprime lending are both danger signs for an economy that otherwise appears to be on the mend.

Europe, too, could face trouble in 2015 without major structural reform, argues CFR's Robert Kahn. Growth and investment remain low, unemployment is "sky-high," and early elections could once again put Greece "on a collision course with the rest of Europe."

China, which is in the midst of a delicate rebalancing act, will de-emphasize GDP growth in favor of structural, financial, and energy reform, writes the Paulson Institute's Damien Ma.

Finally, CFR's Edward Alden foresees that 2015 could see "breakthroughs in global trade liberalization." U.S.-led trade agreements with both Asia and Europe promise to boost growth, although they face significant obstacles at home and abroad.

Robert Kahn, Steven A. Tananbaum Senior Fellow for International Economics

The European Central Bank (ECB) has wielded a monetary policy bazooka—always on the table, but never fired—that has at times been the only thing standing between Europe and the abyss since the beginning of the financial crisis. ECB President Mario Draghi's 2012 promise to "do whatever it takes" has restored calm and brought down spreads.

Yet growth remains inadequate to address large output gaps and sky-high youth unemployment. The outlook for next year is an uneven recovery with growth averaging just over 1 percent. Low inflation, large amounts of debt, and persistent financial fragmentation provide additional headwinds to growth.

Entering 2015, Europe faces a number of new challenges from both within and abroad. Popular discontent with austerity is growing and fueling rejectionist political movements, and with a number of elections on the calendar—including in Greece, Spain, Portugal, and the UK—there will be ample opportunity for voters to express their displeasure.

In this regard, Greece is once again in the vanguard. The odds are rising that early elections could bring to power the opposition Syriza party, whose platform—a comprehensive debt restructuring, a reversal of structural reforms, and fiscal expansion—would put Greece on a collision course with the rest of Europe. Less commented upon is a European Court of Justice report, expected as early as spring 2014, which could challenge the firefighting capabilities of the ECB to purchase sovereign debt. Such a ruling would risk sidelining the bank at a critical time.

At the same time, the standoff with Russia, combined with soft growth in much of the rest of world, means that external demand cannot be counted on to drive growth which in turn limits the benefits from a weaker euro. A sharp decline in Russian GDP—by at least 5 percent—and reduced investment and trade flows have clearly affected sentiment in the region. Receding hopes for a trade agreement with the United States (the proposed U.S.-EU Transatlantic Trade and Investment Partnership, or TTIP) could further dampen optimism.

To restart growth, Europe needs an all-of-the-above approach, including easier monetary policy, fiscal and structural reforms, and continued efforts to strengthen bank balance sheets. For its part, the ECB looks to be moving slowly toward adopting a program of sovereign bond purchases (like the U.S. Fed's quantitative easing) that would boost its balance sheet by $1 billion in order to stimulate demand.

Finally, countries must implement long-overdue fiscal and structural reforms in the tax and labor realms. Without more assertive action in 2015, Europe will continue to disappoint its citizens—and the crisis could return.

Heidi Moore, U.S. Finance and Economics Editor, The Guardian

Does anyone feel comfortable with the rise in debt over the past few years? It's an overleveraged world, a fact which low interest rates and U.S. economic growth have papered over. But after the 2007–2009 financial crisis, we always look for weaknesses, and 2015 may be the year we have to confront debt again: first by refinancing or negotiating and then, if not, by revisiting the same lack of caution that led to the 2008 crash.

The reckoning will be tough for countries, companies, and consumers.

Economic growth is now slowing in Europe and China, and the receding tide is revealing some structural deficiencies. There are several major risks already emerging: A jolt to the system in the form of falling oil prices at the end of 2014 has exposed weaknesses in sovereign debt, like that of Venezuela, as well as the enormous number of energy companies who have relied heavily on the lowest-rated junk bonds—which make up 22 percent of the market for subprime corporate lending. Standard & Poor's analyst Diane Vazza noted that the large debts held by oil and gas companies mean defaults are likely to increase in the coming year. This spells trouble for the banks lending to those companies, as well as for the rest of the economy, since data from Deutsche Bank show that the energy sector accounts for one-third of all capital expenditures in the S&P 500.

There are other weaknesses lurking as well. Vazza's research, which focuses on potential corporate defaults, found that potential downgrades to corporate bonds far outnumbered potential upgrades in a key sector: finance. Banks are hungry for profits, and Congress has passed a budget that would once again allow banks to use the savings of ordinary Americans to back swaps and derivatives trading. The result will likely be more risk-taking from banks. If they have learned to manage that risk, then we have nothing to worry about. But unfortunately, fallibility is the general rule. The challenge will be making sure that this extra risk does not blow up for the second time in a decade.

Consumers, too, are facing a debt reckoning. Even though U.S. households have been paying down debt—and now actually owe less than they're earning—there is still $3.2 trillion of consumer debt outstanding. And much of that debt is student loans (more than $1.2 trillion), which have a particularly high default rate of 14 percent. At for-profit colleges, the rate is even higher, with one in five student loans in default. Subprime auto loans, too, have followed the same pattern as home mortgages did in

2005 and 2006: Lax borrowing standards have created a great big engine of securitization. The result is that one-third of all auto loans are now subprime. In the past year, securities backed by auto loans came within reach of their 2005 peak value of $108 billion.

In other words, we've seen this movie before—but it doesn't have to have the same ending. Excessive debt remains a challenge, but with care and forethought it can be prevented from shutting down the world economy once more.

Damien Ma, Fellow, The Paulson Institute

As China hops into the Year of the Goat in 2015, it is shaping up to be a year of transitions. Once a high-octane growth machine, China is now shifting into the so-called "new normal" gear of development, in which topline GDP will be deemphasized. In addition, 2015 marks the end of the twelfthFive-Year Plan (FYP) cycle and the beginning of the thirteenth, which ends in 2020—the year by which the country is supposed to have become a "moderately well-off society."

These themes were echoed loudly at December's Central Economic Work Conference, an annual high-level meeting that determines policies for the following year. This year's conference intended to prepare Chinese policymakers and citizens, as well as markets and investors, for the prioritization of structural reform over growth. To reinforce the new paradigm, Beijing is likely to set a growth target of around 7 percent in 2015, down from 2014's 7.5 percent, while emphasizing other indicators such as employment and social welfare.

Similarly, macroeconomic policies will favor economic reforms over stimulating growth. Relatively tight, though flexible, monetary policy and an increasingly liberalized exchange-rate regime could mean more fluidity in the yuan's appreciation and depreciation. In contrast with Tokyo, however, Beijing has little reason to drastically depreciate its currency to support exports. In fact, top leaders are keen to promote imports as well as outbound capital flows. Beijing will preempt a collapse in growth with targeted fiscal policy and restrained liquidity tools rather than extensive stimulus. These policies could support new areas of growth in services and other high-value added industries.

Next year will also be crucial for forging ahead with financial reforms announced at the Third Plenum in 2013. For starters, China is likely to implement an explicit deposit insurance. Deepening integration of Chinese stock markets with global markets will continue as well, a process launched in 2014 with the Shanghai-Hong Kong Stock Connect. And more competition will be introduced into the finance sector, with regulators' December approval of WeBank, a private bank backed by Chinese Internet giant Tencent.

Finally, expect a last-ditch effort to meet China's energy and carbon targets. The emphasis that the top leadership has placed on meaningfully addressing environmental costs should not be taken lightly, and heavy industry and coal producers will face another tough year. Indeed, as policymakers prepare to unveil the next five-year plan, the new economic blueprint will strongly inform China's path toward "peak carbon" by 2030. Supporting an energy transition will be crucial for China's position entering the 2015 climate talks in Paris and beyond.

Edward Alden, Bernard L. Schwartz Senior Fellow, Council on Foreign Relations

The coming year could see the biggest breakthroughs in global trade liberalization in more than two decades. It could also produce some of the most spectacular failures. After years of modest accomplishments and repeated setbacks, 2015 looks to be a turning point for trade.

The United States is currently engaged in two of the most ambitious trade negotiations in history. The Trans-Pacific Partnership (TPP) would free up trade with eleven Asia-Pacific countries, including Japan, while the Transatlantic Trade and Investment Partnership (TTIP) would eliminate most remaining trade and regulatory barriers with the European Union. Despite the complicated nature of the multilateral talks, the United States is pushing hard—the Obama administration wants TPP completed and ratified by Congress by the end of 2015. The U.S.-EU trade deal is on a slower track, but both sides are seeking a deal before the 2016 U.S. presidential elections.

Skeptics will recall, of course, that the TPP agreement was supposed to be signed in 2014, and that TTIP was scheduled to be in the final negotiating phase by now. But trade negotiating is a lot harder than it used to be. The World Trade Organization's Doha round of global talks has been in progress since 2001, but only produced its first agreement, the so-called "Bali package," in 2013. Meanwhile, big developing countries like China, India, and Brazil have matured into global players in their own right, making it harder to reach deals than it was when the United States and Europe called most of the shots. And among the advanced economies, little low-hanging fruit remains—the trade barriers that persist (in agriculture, for example) are the most fiercely defended by powerful domestic interests.

There are signs of promise. Prime Minister Shinzo Abe's resounding victory in Japan's snap election could give him the political capital to make tough concessions in areas such as agriculture and automotives. Elsewhere, the United States and China have agreed to lower tariffs on technology-intensive goods as part of an effort to update the 1996 Information Technology Agreement (ITA).

But obstacles remain, including U.S. domestic politics. The Obama administration will need congressional support in the form of Trade Promotion Authority (TPA), or "fast track" legislation. Republican control of Congress starting in 2015 makes TPA passage more likely, but the effort will continue to face strong opposition from Democrats as well as from some within the GOP. Then there are the civil society concerns: U.S. labor unions are unhappy with the administration for failing to address their priorities, such as currency manipulation, in the TPP, while environmentalist and consumer groups on both sides of the Atlantic fear that TTIP will strengthen corporate rights and weaken health, safety, and environmental standards.

With so many moving parts, both domestically and internationally, the outcomes of the TPP and TTIP negotations are far from certain. But whether in success or failure, trade will be a top foreign policy issue around the world in 2015.

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2014 Was the Year We Witnessed Geoeconomics Trump Geopolitics

Sanjaya Baru

Introduction>>

2014 will be remembered as much for Russia's geopolitical initiative as it would be for the West' s geoeconomic response.

Theorists of international relations and grand strategists around the world declared 'geopolitics redux' when Russia marched into Crimea in the spring of 2014. Russian President Vladimir Putin was castigated, or celebrated, for opening a new era of geopolitical competition on the Eurasian landmass.

However, 2014 will be remembered as much for Russia's geopolitical initiative as it would be for the West's geoeconomic response.

Given the sharp dip in oil prices, the squeeze on Russian big business and economic problems, with a sharply depreciating rouble, the geoeconomic cost of Putin's geopolitical move may yet prove salutary.

Russian Roulette

In the medium term, of course, the Russian economy will recover. It may even benefit from the rouble's depreciation, if Putin's domestic popularity holds in the face of economic difficulty at home. Russia does, after all, still have the trappings of a great power. But in the era of geoeconomics where the oil price or an unsustainable debt build-up can sap national power, Russia will have to find a geoeconomic route out of the geopolitical impasse it has got itself into.

Russia is not the only major power to discover the power of geoeconomics. China entered 2014 imagining that its rising economic clout had already provided it the leverage to make geopolitical moves in Asia. The geopolitical stand-off it initiated with Japan and its other southeastern neighbours in the South China Sea came up against China's own economic interests in the region, nudging Beijing to take one step back after having taken two forward.

Of course, in geoeconomic terms, China is in a different league from Russia. While Russia depends almost entirely on energy to bankroll its power, China has a wider economic base. But China has created economic interdependencies, with its export-oriented industrial strategy, which act as a check on its aggressive political instincts. The 'assertive' China of

2012-13 projected a more benign face to the world in 2014 thanks to its own economic slowdown, on the one hand, and the assertion at home of business interests, on the other hand.

While backing off on its geopolitical assertion, China chose to shift the focus to its geoeconomic clout, supporting new regional and multilateral initiatives in trade and finance and pushing the idea of a maritime silk route. Clearly, China has been cleverer than Russia.

While China's geopolitical clout may have been checked in the near term, her geoeconomic weight remains substantial. Even in South Asia, it is not China's military and maritime power that has altered the Asian balance of power as much as her geoeconomic heft, having emerged the most important trading partner of most Asian economies.

Turn to West Asia. For years, the regional powers have been indulging in geopolitical games. Finally, Saudi Arabia made a geoeconomic move by bringing the price of oil sharply down. A new game is on.

Further west, this century's biggest geoeconomic loser remains Europe. For all their pretension to great power status, 'Old Europe' — to use an Americanism of the Bush era — remains preoccupied with its own relative economic decline. Germany is the only major power of consequence in Europe. But Germany's geoeconomic dependence on Russia for energy, and on China for markets, has exposed its geopolitical limitations.

US Retains Its Magnetism

Where does all this leave the US? Sure, the shale oil business in the US has been hurt by the oil price drop and this would have consequences for the already weakened US financial system. But the dollar has bounced back and employment at home is rising and the US economy is sucking in capital once again. Six years after Lehmann and the trans-Atlantic financial crisis, while Europe remains weakened and troubled, the US has bounced back and demonstrated the capacity to rejuvenate.

While the US has not come out of 2014 as a winner on the geopolitical side, despite its pivot to Asia and reassurances in West Asia, it has retained geoeconomic clout.

Closer home, India's own economic slowdown in 2012-14 has demonstrated how a weaker home economy can limit a nation's external profile and global potential. After all, the globetrotting that Prime Minister Narendra Modi has done in his first seven months in office, it should now be clear to him that India's global profile can only rise along with her domestic economic performance.

Investors at home and overseas still have faith in Modi's ability to revive the 'India Story'. But they are increasingly seen to be keeping their fingers crossed. The India Story is told in simple numbers: following half a century (1900-50) of near-zero economic growth, India's economy grew at 3.5% for 30 years (1950-80), 5.5% for 20 (1980-2000) and 7.5% in the decade 2000-10. Grand strategies about India's rise have been built on this evidence.

India's dramatic slowdown, however, raised all the questions that Modi has been trying to address. Only if he succeeds on the economic front at home would there be takers, once again, for the India Story. This is the era of geoeconomics.

(The writer is Director for Geo-Economics and Strategy, International Institute for Strategic Studies)

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How Can Europe Escape Recession in 2015?

Guntram Wolff

Introduction>>

Two major unexpected developments in 2014 offer the backdrop of Europe' s New Year' s resolution. Policies needed should be implemented to reduce military conflicts in EU neighbouring countries, and to increase growth and jobs.

2014 will be remembered for two major unexpected developments. First, the European Union was caught by surprise by the return of geopolitics. The annexation of Crimea, the military conflict in Ukraine and the increasing tensions between Putin's Russia and western leaders were unexpected. The conflicts in Iraq and Syria and the rise of ISIS extremists found the West equally unprepared. One can speculate if the economic and political weakness of the West in recent years has contributed to the rise of alternative political concepts. But certainly, European Union countries have realised that these conflicts on their doorstep matter. From an economic point of view, these events have arguably had negative effects on confidence and have – together with the sanctions imposed on Russia – contributed to disappointing growth figures. Also of concern are the direct effects on trade and especially on the security of energy supply.

Second, the economic performance of the euro area has fallen on the wrong side of official forecasts. In November last year the European Commission predicted real GDP growth of 1.1 percent for the euro area in 2014, but these numbers have been revised downward to 0.8 percent. Inflation has been subject to similar revisions, and is dangerously low to achieve debt sustainability and price adjustment. Some progress has been made with unemployment but it is slow and numbers continue to disappoint in Italy in particular.

Given this backdrop, it is clear that Europe's New Year's resolution should be to implement policies needed to reduce military conflicts in EU neighbouring countries, and to increase growth and jobs.

For sure, a clear priority for 2015 will be to manage proactively the fallout from a possible continuation of the conflict with Russia. I would certainly emphasise the importance of reducing our collective dependence on gas imports and strengthening our single market for energy. In particular, we should ensure the energy security of all EU member states. The European Commission's work on the so-called Energy Union is central in this respect. Constantly reviewing whether the sanctions against Russia are actually effective is also essential to justify their continuation, despite their negative impact on economic growth in the EU and in Russia.

To grow, Europe needs to invest.

Furthermore, the euro area must amplify its efforts jumpstart growth and create new job opportunities. To grow, Europe needs to invest. The decline in investment in the last seven years has been substantial and the EU is now well below long-term investment trends. A major reason for such weak investment is a lack of trust and confidence. Consequently, one of the most important challenges for policymakers will be to focus on increasing private-sector confidence. Predictability of policy is central. Even more important is regaining trust among European partners.

Such lack of trust is partly caused by different intellectual traditions and, by diverging interpretations around the main causes of the current crisis and contrasting views regarding the appropriate measures needed to tackle it. These differences in analysis between mostly Germany-based and other economists translate into different assessments and undermine mutual trust. This mistrust among European partners is in turn perceived negatively by investors.

We need to acknowledge that the euro area has both significant structural problems and significant demand-side problems

We need to overcome the polarisation of this debate and acknowledge that the euro area has both significant structural problems and significant demand-side problems. Low productivity growth and substantial divergences in competitiveness and unit labour costs in different EU countries call for bold structural reforms. Such reforms should include, for example, better training to help jobseekers find new jobs in different sectors. These reforms will be mostly national but also new initiatives that deepen the single market, for example for digital services, are also fundamental to boosting productivity and creating new investment opportunities.

Initiatives that help kick-start demand in the euro area are equally important. The European Central Bank has been far too slow to react to the deteriorating inflation outlook and needs to be more proactive in 2015. However, monetary policy alone will not be sufficient. As well as improving the framework conditions for private investment, the EU should mobilise public resources for public investment projects. While the investment plan set out by European Commission president Jean-Claude Juncker is an improvement in this respect, the public resources earmarked are clearly insufficient and a top-up will be needed. The EU will also have to become bolder in tackling the banking problems that still weigh on credit and lending in a number of countries. More policy initiatives are required to re-ignite growth in the EU.

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The Fed: QE Done, Lift Off to Come?

Donald Kohn

Introduction>>

The year 2014 was marked by some important transitions for the Federal Reserve in personnel and in policy. The issue facing the monetary policymakers in 2015 will be when to begin to raise policy interest rates.

The year 2014 was marked by some important transitions for the Federal Reserve. In personnel, Ben Bernanke stepped down as Chairman when his term was over at the end of January to take up residence at Brookings, and Janet Yellen, who had been vice chair, succeeded him. In policy, The Federal Open Market Committee (FOMC) successfully ended its securities purchases, completing the tapering off of such purchases that started at the beginning of the year, and capping its securities portfolio at a mere $4.2 trillion at the end of October, up from $480 billion just seven years earlier. And, as the economy gradually came closer to the Fed's interpretation of its Congressionally-mandated dual objectives of maximum employment and stable prices, it adjusted the way it characterized its intentions about holding its policy rate near zero. The issue facing the monetary policymakers in 2015 will be when to begin to raise policy interest rates, which have been close to zero since the fall of 2008 after the market panic that followed the bankruptcy of Lehman Brothers.

The transition from Ben Bernanke to Janet Yellen has been marked by continuity and consensus. Like Chairman Bernanke, Chair Yellen has led the FOMC as a consensus builder. She has reached out to the 12 Reserve Bank presidents as well as her fellow governors on the Federal Reserve Board in advance of FOMC meetings to gather ideas and gauge developing views. In her press conferences, she has been careful to represent the center of gravity on the FOMC, and her speeches on topics central to the determination of monetary policy, such as developments in the labor markets, have been nuanced to reflect an array of possible interpretations of the degree of slack. Yes, there have been dissents from FOMC decisions, but they have been on both sides—desires both to signal earlier tightening and to signal that easier policy will last for longer—and a wide variety of strongly held views is not unexpected or undesirable when the FOMC is operating in such unfamiliar policy territory.

Continued improvement in the economy in 2014 and good progress toward the Fed's goals of an unemployment rate in the 5.2 to 5.5 percent range and inflation (measured by the PCE [Personal Consumption Expenditures] chain price index) at 2 percent meant that the FOMC could end one leg of its unconventional monetary policies, asset purchases—so-called (not by the Fed) quantitative easing, or QE. Ending these purchases didn't mean that the Fed was tightening policy—it continued to hold these securities off the market—but it did mean that it judged that added downward pressure on long-term interest rates was no longer needed to support the economic expansion. The pace of job creation picked up from around 195,000 per month in 2013 to around 240,000 per month so far in 2014; the unemployment rate fell from 6.7 percent at the end of last year to 5.8 percent in November on the usual measure and from 13.1 percent to 11.4 percent on a broader measure which includes discouraged workers and those working part-time for economic reasons. The CPI (Consumer Price Index) measure of inflation fell from 1.5 percent to 1.3 percent in November relative to a year ago on the back of a sharp decline in energy prices; core CPI inflation, taking out food and energy, rose 1.7 percent November over November, about the same as in December 2013, but at least it wasn't moving down as in so many other countries. The PCE targeted by the Fed accelerated slightly through October, the latest data available, to 1.6 over a year ago in the core measure.

What was behind the improvement in labor markets and stable-to-firming underlying inflation pressures? In the fifth year of expansion from its deepest post-war recession, the US finally faced a number of favorable underlying factors. First, households had reduced their debt levels relative to income, were experiencing both rising wealth as equity and house prices increased under the impetus of very low interest rates and higher incomes as employment gains picked up, and as a consequence were in a better position to step up borrowing and spending. Second, lenders, having recovered from the losses of the recession, looked at stronger demand for credit, and trying to find higher yields in the low interest rate environment, increased the supply of credit, loosening the terms and standards they imposed on loans. And third, government on all levels—federal, state, and local—stopped raising taxes and reducing spending, so their actions were no longer a drag on growth. As the amount of slack in labor markets and economy gradually eroded, we began to see scattered early signs that wage and compensation rates might be picking up, supporting expectations of a very gradual upward movement to 2 percent inflation.

All this is expected to continue into 2015, providing a solid base for sustained good growth and a pickup in underlying inflation. In addition, the recent sharp drop in energy prices will add further to the purchasing power of household incomes, supporting greater spending. And if that's all we anticipated, the Fed could exit from the other leg of its unconventional policy—near zero interest rates and the promise to hold them there—readily in 2015 while the economy continued to progress toward the Fed's two goals in labor markets and inflation.

There are however, some clouds on the horizon that justify the question mark in the title of this piece—developments that raise doubt about whether conditions will be right for the Fed to be able to lift its policy rate off of zero this year. And those clouds mostly reflect troubling developments outside the borders of the US. Global growth has slowed in 2014. Both Japan and the euro area experienced quarters of GDP decline; while monetary ease has been stepped up in both jurisdictions, whether it will be enough to restore decent growth is not yet clear. A number of emerging market economies are facing challenges as well: growth in China has slowed more than expected as the Chinese economy makes its transition from export-led to domestic demand-driven growth and from investment to consumption within domestic demand, all the while trying to move its shadow banking system back to the books of banks and further liberalize the financial system; Brazil and some other large emerging market economies (EMEs) are also coping with disappointing economic performance; and of course Russia is feeling the effects of both sanctions and the plunge in oil prices. Lower energy prices will help oil and energy importers, but at the expense of oil exporters.

Responding to both weaker prospects in the rest of the world and to flight to the safety and liquidity of dollar assets as volatility and geopolitical risks have mounted, the dollar has strengthened considerably this year. This will add to the effects of slower growth abroad in holding back our exports and will rechannel a portion of domestic demand in the US toward imports and away from US producers. Geopolitical and as well growth concerns could undermine confidence and reduce the appetite of lenders and investors for taking risks—and we've seen signs of the later popping up in what are already more volatile financial markets.

Although lower energy prices should be only a temporary depressant on US inflation, if low incoming inflation data causes a drop in longer-term inflation expectations, that could threaten the timely return to a 2 percent inflation path. We've seen some signs of a decrease in inflation "compensation" imputed from securities prices, but those prices are subject to a variety of forces and so far, survey measures have held fairly firm. Still, this will be an area that the Fed will watch closely as it assesses whether to raise rates.

To date, these global factors seem to be mostly about downside risks rather than about changing the most likely trajectory of the US economy, but they do point to the possibility that the Fed could find itself making less progress toward its goals than anticipated, delaying the date of lift off.

In its December meeting just concluded, 15 of the 17 folks sitting around the FOMC table thought it probably would be appropriate for the FOMC to raise rates for the first time in 2015. Still, Chair Yellen also emphasized the "data dependency" of FOMC decisions, so we will all have to stay tuned for the answer to the question mark in the title.

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Turbulence in the Oil Market and the Economy

George L. Perry

The sharp decline in world oil prices during the last half of this year has become the defining economic event of 2014. It has been hailed as a timely stimulus to global demand because it adds to the purchasing power of consumers. Lower gas prices have already strengthened the U.S. expansion and supported the still-fragile recoveries in much of Europe, Japan and the emerging economies. These demand side effects are still growing, but they are only the most immediate impacts. Depending on how the tumultuous events in the oil market play out, they will have important effects through many other channels, and not all these will be so desirable.

First some historic perspective. No simple generalization explains the history of oil prices. They have responded sharply to some political and economic changes and have also remained in a fairly narrow range for extended periods. In the first postwar decades, vast new oil supplies from the Middle East kept oil prices low in the face of the great postwar industrial boom. Then in 1973, Saudi Arabia and other oil producing states of the region nationalized their oil industries and formed the OPEC cartel which constrained output enough to quadruple the world oil price to $12 a barrel. In the years since, the ability or willingness of OPEC to stabilize prices has been uneven. Prices soared after the takeover of Iran by the clerics in 1979, and then slid back during the 1980s in the face of new oil discoveries in the North Sea, Mexico and Alaska, and the drive to oil conservation in the advanced economies that slowed demand growth. The next big move came in the 2000s, as surging demand for oil from China and other developing nations drove the price from around $20 at the end of the 1990s to around $120 a barrel in the summer of 2008. Prices crashed during the Great Recession and then promptly started back up as recovery began and China's growth continued.

And then the new era for oil began. The introduction in 2009 of fracking for recovering oil from shale deposits reversed a long decline in North American oil production. Production grew slowly at first, and the renewed global economic expansion brought oil prices back to near $100 a barrel

Introduction>>

The sharp decline in world oil prices during the last half of this year has become the defining economic event of 2014. It has been hailed as a timely stimulus to global economy because it adds to the purchasing power of consumers.

by 2011. Prices then stayed in a narrow range for three years as growing shale production kept global supplies rising in step with global demand. But by mid-2014, what had seemed a sustainable balance was upset as shale production accelerated and Libyan oil output rose sharply from depressed levels. As Saudi Arabia appeared reluctant to reduce output to support the market, the price decline steepened. Are the recent prices around $60 a barrel likely to be the new normal?

In the race between global demand and supply, today's lower prices will both raise consumption and restrain the growth of supply. Both will move up the short run equilibrium price, suggesting a price in the $60s could be sustainable. But uncertainty and turbulence rather than equilibrium may characterize the oil market for some time. As Libya’s experience shows, supplies from the Middle East, including those affected by sanctions on Iran, are hard to predict. How much today's lower prices will affect the growth of supply from North America is uncertain because technology is still evolving. And it is hard to judge what OPEC policy will be going forward. In the past, Saudi Arabia has reduced its production a lot in order to support the world price. But today’s environment is different in important ways. The Middle East is more dangerous than ever and the Saudis’ interests do not include supporting the revenues of countries such as Iran and other potential adversaries. And they may not welcome giving up market share to the U.S. This past week, the Saudi Oil Minister remarked "Why should I cut production"? Taken literally, that sounds like the end of OPEC. Taken strategically, who knows?

As this range of outcomes and responses suggests, there could be pressure for market prices to move above or below present levels. But it seems reasonable to project oil prices settle in a range in the $60s in assessing 2015 economic prospects. The already considerable stimulus to consumer spending will grow further, helping to sustain healthy employment growth. In this environment, I would expect a step towards normalizing interest rates by midyear.

While the economic stimulus from lower oil prices starts immediately, some of the effects through other channels take more time. The creation and expansion of the fracking industry has been an important source of high paying blue collar jobs in the US and has contributed meaningfully to the economic recovery. With today’s much lower prices, the industry’s future plans are being scaled back sharply which will cut into the economy's job growth in 2015. This consolidation will also lead to a rash of bankruptcies among the small firms that have spearheaded the fracking revolution. But those are the risks of a speculative industry. In the aggregate, oil production is not a dominant part of the U.S. economy and the positive stimulus from lower gas prices for consumers will outweigh the negative effects on employment and GDP in 2015.

For countries such as Russia, where oil sales are a major source of budget revenues and foreign exchange reserves, the drop in oil prices creates a huge financial problem. This is already reflected in the drastic decline in the value of the ruble, and the hardship will grow in 2015. With Russia's daily output of over 10 million barrels a day, the price decline since last summer has reduced oil revenues by roughly $500 million a day. Iran and other nations whose economies are dominated by oil, such as Venezuela and Nigeria, are also greatly affected. We can only hope that such drastic financial hardships improve the prospects for successful diplomacy rather than increased belligerence.

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The 'Divergent' World Of 2015

Niall Ferguson

In Veronica Roth 's "Divergent"—a 2011 "young adult" novel set in a dystopian future not a thousand miles removed from "The Hunger Games"—humanity is divided into five factions according to their dominant character traits: Abnegation, Amity, Candor, Dauntless and Erudite. This being a post-apocalyptic Chicago, the last faction turns out to be the bad guys. People who fail the initiation tests are consigned to poverty as "factionless." People with multiple traits are classified as "divergent" and persecuted.

If you were to sort the world's countries into five factions, you would need a slightly modified classification scheme. The U.S., its economic recovery firmly established despite learned talk of secular stagnation, is looking Dauntless. Then there are the Erudite little countries, like Estonia and Singapore, that have the rare distinction of intelligent governance. But the other three factions would need different names.

There are the Abject: from Argentina to Venezuela by way of Russia, corrupt pseudo-democracies reliant on the export of natural resources. There are the Aspirant: from India to Mexico and Peru, countries engaged in a real process of economic reform. And let's not forget the Catatonic: from Japan to the eurozone, economies either immune to monetary stimulus or reluctant to administer it.

In truth, this is a Divergent world, with many countries—like Ms. Roth's adolescent heroine, Tris—displaying more than one trait. Mexico would like to be Erudite but retains many traces of its Abject past. Japan is trying its best to be Aspirant, but Prime Minister Shinzo Abe can't seem to fire his "third arrow" of structural reform. The U.K. would love to be Dauntless, but its economic turnaround lacks the breadth of the U.S. recovery, and political uncertainty around elections in May could prove distinctly daunting.

To understand the world in 2015, it may therefore be preferable to think of four trends that are divergent in the traditional sense. The first, and most obvious, is between the taperers and quantitative-easers in the realm

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In "Divergent," those who are initiated into the Dauntless faction are forced to cross a "fear landscape" that combines all their innermost fears into a single, terrifying simulation. By comparison with most of the past seven years, the fear landscape of 2015 looks remarkably unterrifying. But that is probably a reason for us all—even the Erudite—to be wary.

of monetary policy. While the Federal Reserve and the Bank of England have been signaling their intention to "normalize" policy (i.e., to raise interest rates), the Bank of Japan has already launched an open-ended QE program, with the bank's balance sheet projected to hit 70% of GDP. The European Central Bank, meanwhile, badly needs to reverse two years of balance-sheet contraction.

The second divergence is between exporters and importers of energy in the wake of a steep decline in global oil prices from over $100 a barrel as recently as July to just above $50 at year's end. Assuming that energy prices do not bounce back in 2015, the outlook is as bleak for exporters as it is rosy for importers.

The third divergence is the political one between democracies and autocracies. The majority of democracies are now characterized by multiple parties, very close results and, consequently, relatively weak governments. In autocracies, by contrast, corrupt hierarchies are tightening their grip on power with old and new forms of coercion, ranging from police brutality in Venezuela to Internet trolling in Russia.

Finally, there is a fourth divergence between soft powers and hard powers. President Obama has shown a growing preference for European-style soft (he might say "smart") power. Yet hard power is resilient. Having annexed Crimea to Russia, President Putin still has forces camped out in eastern Ukraine. And all over the Muslim world, myriad Islamist organizations, from Islamic State to the Taliban, are using violence to pursue their atavistic goals. In practice, the Obama administration has had little choice but to keep using hard power, from the airstrikes on Islamic State to the economic sanctions on Russia.

What will be the biggest consequences as these four divergences interact in 2015?

Perhaps the most important question relates to the country hardest to categorize: China. In many ways, China fended off the effects of the American financial crisis by turning a little bit American. After 2009 we saw a proliferation in China of shadow banks, a credit splurge and a real-estate bubble. Now the bust is here, followed by the inevitable financial distress, with colorfully named casualties like China Credit Equals Gold #1 and Henan Swiftly Soaring Investment.

True, there is unlikely to be a Chinese "Lehman moment." Rather than let a big bank go bust, the Chinese would rather arrest, try and shoot the CEO. But deflationary pressures are building in an economy characterized by widespread urban and industrial overcapacity. So a key question for 2015 is how much the People's Bank of China will ease in response. The bank cut rates in November. On Christmas Day it relaxed the restriction on the loan-to-deposit ratio by including interbank deposits from nonbank financial institutions in the denominator without requiring additional reserves on such deposits. More measures like these, and we could see the Shanghai and Shenzhen markets enter bubble territory as small investors flee real-estate for stocks.

The second big question is what the consequences will be of the oil-price slump. At November's OPEC meeting in Vienna, Saudi oil minister Ali al-Naimi said that although falling oil prices would be painful, losing customers to U.S. shale would be worse. Yet it is not clear that American producers will be the biggest victims of the oil-price slump. Thanks to efficiency gains, the break-even price for the median North American shale development is now $57 compared with $70 in summer 2013.

An Arab official gave the game away in Vienna when he reportedly said: "If in the process, you shave 30% off Iran's income, fine. If in the process, you shave 30% off Russia's income, fine." Earlier this month the Iranians held a crisis meeting with the Saudis. "We asked the Saudis to help stop the price of oil slipping further," said an Iranian source quoted in the Times of London. "They replied that Iran should adjust itself to the market and they were happy with the oil price."

Unlike in the 1980s, when the U.S. clearly pressed the Saudis to cut oil prices to squeeze the Soviet Union, today the Saudis (and Emiratis) seem to be the geopolitical playmakers. Their targets are regimes—in particular Iran's, but also Russia's—that have been on the opposing side of the great sectarian war that is raging for control of the post-American Middle East. The essential question is: Can the Saudis hurt the Iranians more than the U.S. has been helping them by easing sanctions in its desperation for a nuclear deal? My bet is that the answer is yes—and that 2015 will see instability in Iran, Russia and Venezuela.

The bad news for authoritarian regimes like Iran's is simultaneously good news for European democracies, nearly all of which are heavily reliant on imported gas and oil. Yet it is far from clear that EU governments will reap much political reward from cheaper energy.

Eight member states have national elections in 2015: Estonia, Finland, Greece, Poland, Portugal, Slovenia, Spain and the U.K. In most cases, incumbents will struggle to secure re-election. We live in an era when close elections tend to be the rule, as more and more countries are multiparty systems and voters seem to prefer governments with wafer-thin majorities. The rise of populist parties, like Ukip in Britain, is making it harder for mainstream parties to muster majorities.

So this new year may well be one of minority governments—in Europe and in Israel and Canada. The exception to the rule will remain the U.S., where the two-party system looks immovably entrenched and the populists, from Ted Cruz to Elizabeth Warren , remain inside their respective political tents.

What, finally, of the geopolitical consequences of a Divergent world? This looks being a bad year for hard power as Russia wilts under the double punch of sanctions and cheap oil. There is also some reason to expect the Islamic State phenomenon to collapse under the weight of its own violence and incompetence. The trouble is that bad guys can also do soft power, as North Korea has apparently proved with the devastating hack of Sony Pictures. Islamic State, too, may have a bigger future as an online propaganda agency for Islamic extremism than as a wannabe caliphate.

Translating all such trend-following into smart investment decisions is never easy. In retrospect, equity investors last year should have shunned Europe and bought South Asia, the countries of the Middle East and North Africa (MENA), and the U.S. (Five markets were up over 20% in dollar terms: the Philippines, Indonesia, Israel, India and Egypt.) In fixed interest, emerging markets and corporates outperformed Treasurys, but a risk-free return of 4.7% on Treasurys was hard to complain about. Commodities were a no-go zone: not only oil but also gas, base metals and cotton. Who predicted all this? No one I know.

So how best to play the four divergences of 2015? The monetary-policy part seems simple: Stay long on the dollar, short the yen and euro. In energy, shun the high break-even exporters and any assets favored by “petro-crats” (yachts, high-end London homes). In politics, it’s hard to see any country that is going to have an Indian- or Indonesian-style positive transition as a result of elections this year. But I would stick with Mexico, despite elections that are bound to give the ruling PRI a bloody nose.

Finally, keep yourself hedged when it comes to energy prices. There is too much potential instability among too many MENA producers to warrant anything but caution.

In "Divergent," those who are initiated into the Dauntless faction are forced to cross a "fear landscape" that combines all their innermost fears into a single, terrifying simulation. By comparison with most of the past seven years, the fear landscape of 2015 looks remarkably unterrifying. But that is probably a reason for us all—even the Erudite—to be wary.

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Foreign Policy Lessons for 2015 and Beyond

Christopher A. Preble

A new year offers a fresh start, an opportunity to reminisce about the year past, and to set goals for the future.

2014 was a busy year. Vladimir Putin hosted the world at Sochi, then reacted to a popular revolt in Ukraine by supporting a counter-revolution and annexing Crimea. Other civil wars raged in Libya and Syria, while Egypt's military quashed any remaining semblance of democracy that had survived from the 2011 protests. The not-destroyed insurgency returned to Iraq with gusto, fueled by American weapons left behind by an Iraqi army unwilling to fight. And the United States continued its habit of conducting numerous tactical operations abroad without any overarching strategy.

The news wasn't all bad: Germany and the world celebrated the 25th anniversary of the fall of the Berlin Wall; President Obama proposed normalizing relations with Cuba; and NATO operations in Afghanistan have (kind of) ended.

The lessons from these episodes suggest some useful resolutions for U.S. policymakers:

Avoid using the U.S. military to fix other nations' politics

You would think that policymakers would know this by now. After all, our track record over the last dozen years is objectively terrible: Iraq is a mess, Libya is a mess, Syria is a mess, and Afghanistan is still, despite many years of effort, a mess. It says a lot that the advocates of U.S. nation building efforts have to go back over six decades, to the successful rebuilding of Germany and Japan, and the Marshall Plan in Europe, to make their case. Though these countries were deeply scarred by war, they retained institutions, and social and political norms, that allowed them to recover, some quite quickly. In other words, they weren't failed states at all. Building healthy states out of weak or failed ones, it turns out, is actually really hard – and rarely worth the effort given that ungoverned spaces aren't as ungoverned as they might seem.

President Obama seemed to understand this. He came into office in 2009

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2014 was a busy year. The news wasn't all bad. The lessons from these episodes suggest some useful resolutions for U.S. policymakers: Avoid using the U.S. military to fix other nations' politics; Stop rooting for the collapse of the Russian economy; Put terrorism in context; Related, stop hyping threats in general; Reform military spending.

generally opposed to using U.S. military personnel for armed nation-building. Unfortunately, he is now ignoring those instincts, largely because of public reaction to the atrocities committed by ISIS in Iraq and Syria. ISIS's barbarism, however, does not invalidate the lessons learned from 13+ years of post-9/11 wars. While the U.S. military retains the ability to assist those on the ground who are fighting back against ISIS and other extremist groups (e.g. al Shabaab in Somalia; Boko Haram in Nigeria), the men and women of the U.S. armed forces should not be sent into harms way when U.S. vital national security are not at stake.

Stop rooting for the collapse of the Russian economy

Western sanctions (along with falling oil prices) are having an effect on Russia. November saw the Russian economy contract for the first time since 2009, a trend that is expected to continue. And the ruble's collapse appears to be accelerating. Those rooting for a full-scale economic catastrophe, however, should be careful what they wish for. An unstable political situation in Russia—a country with still thousands of nuclear weapons—is not in America's (or anyone else's) interests.

The goal of the sanctions should be a negotiated settlement to the Ukrainian crisis that favors western interests. Economic pressure raised the costs of Russia's revanchism in Ukraine and might deter Putin from trying to foment trouble elsewhere along Russia's border. But while we can take some pleasure in Putin's discomfort, the United States still needs Russia's cooperation on a host of important issues, including Iran's nuclear program and the Syrian civil war.

Put terrorism in context

In their 2014 Cato report, "Responsible Counterterrorism Policy," John Mueller and Mark Stewart show that the odds of being killed in a terrorist attack in the United States are 1 in 4 million. Compare that to other fatality rates, like driving in a car (approximately 1 in 8,200) or drowning in a bathtub (1 in 950,000) and you start to realize that while terrorism may be frightening, it's not a large threat. And yet, the United States spends about $100 billion per year seeking to deter, disrupt, or otherwise protect against, terrorism at home. Too much money chasing after too little threat is sure to be spent unwisely.

So, this year, let's put the danger posed to Americans by terrorists in context, and demand accountability for taxpayer funds spent to fight it. Terrorism is a threat, but not a large one, and certainly not one that justifies all of the current policies enacted under the overly broad counterterrorism rubric.

Related, stop hyping threats in general

The world is a dangerous place, but it is not more dangerous than it has ever been, and most measurements of the quality of life and general human progress are trending up, not down.

You may be forgiven for thinking that we live in a uniquely dangerous world, but appearances can be deceiving. As Harvard's Steven Pinker points out, "If you base your beliefs about the state of the world on what you read in the news, your beliefs will be incorrect." After all, we are beset with daily stories of violence, but one's chances of suffering a violent or premature death are very low, and still declining. And our prosperity and broader well-being are protected by a dynamic and resilient international economy, and by the spread of powerful ideas that have reduced poverty and disease.

A better understanding of what actually threatens us will help tame our tendency to overreact. An honest assessment of the threat environment—problems that lurk today and on the horizon—will allow us to redirect some of the money that currently goes to the national security state back to the taxpayers and private entrepreneurs.

Reform military spending

The 2011 bipartisan Budget Control Act (BCA) imposed caps on discretionary spending, and these caps have worked, to a degree: government spending has remained essentially flat since 2009, and spending as a share of GDP, according to figures compiled by Cato's Dan Mitchell, experienced the biggest five-year drop since the end of World War II. Though some would lift the caps on the Pentagon's budget going forward, the United States can maintain the finest military in the world without breaking the bank. The Congressional Budget Office projects that Pentagon spending under the BCA caps will average about $526 per year through 2021 (.pdf, Table 1-4, p. 13), and this figure omits funding for nuclear weapons spending in the Department of Energy; as well as the Departments of Homeland Security and Veterans Affairs, and overseas contingency operations (OCO). When one factors in those additional monies, total spending for national security in 2015 is likely to exceed $800 billion.

But while that much money can buy a lot, it can’t buy everything. Even the richest country in the world must make choices. So far, that hasn’t happened. The cost to implement the Pentagon’s 2014 Quadrennial Defense Review, according to Secretary of Defense Chuck Hagel, is $115 billion above sequestration levels in 2016 alone. The National Defense Panel, tasked with scrutinizing the QDR, calls for even more spending, presuming that the strategic requirements cannot or should not be constrained by fiscal or political reality.

Instead, the spending caps should be maintained, and the U.S. military’s global posture should be adjusted accordingly. Restraint was a wise policy, even when the United States was flush with cash. It is imperative now, when the costs of maintaining global primacy are rising, and the American people’s will to sustain them are declining.

Policymakers should also seek to end the slush fund known as OCO funding. Funding for overseas military operations should be included in the DoD’s base discretionary budget. That was how it was done for most of the nation’s history, and it’s time to return to pre-9/11, pre-Afghanistan, pre-Iraq spending practices.

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The Security Outlook in Asia and the Pacific – Growing Turbulence or a Gathering Storm?

Ron Huisken

Confidence in the capacity of the Asia-Pacific region to preserve a flexible but fundamentally robust security order weakened noticeably over the past year. despite being clearly anticipated and exhaustively studied for some 25 years, themanagement of the Asia Pacific's strategic transformation is headed toward outcomes at the worst-case end of the spectrum.

A security order is a complex tapestry of norms, laws, conventions, deterrents, opportunities, mechanisms for conflict avoidance and resolution, and so on. Many commentators assess that the prevailing order is unravelling and some have even warned of a new Cold War, or argued that 2014 was beginning to look like an ominous echo of 1914. While these contentions have, on the whole, been disputed as analytically unsound and unduly alarmist, the president of the United States has signalled graphically that serious concern is no longer misplaced. Addressing the UN Security Council in September 2014, President Obama spoke of a "pervasive sense of unease" across the globe and of a world "at a crossroads between war and peace; between disorder and integration; between fear and hope."

In our region we have witnessed perceptions taking shape and judgments being made that the strategic aspirations of others could not be reconciled with "our" vital interests. The policy settings that have flowed from these perceptions and judgements have placed the foundations of the prevailing order under severe strain. East Asia today could be characterized as anticipating and trying to prepare for a prolonged phase of contestation. The core axis is between the two mega-states: US and China, although the China-Japan relationship is also critical and has experienced the sharpest deterioration in recent times. Hopes that China's reemergence as an energetic great power would be paralleled by a partly natural, partly orchestrated gravitation toward a new and resilient geopolitical order have faded in favor of a search for new and stronger alignments as states seek to insulate themselves from intensifying geopolitical turbulence.

The more emphatic US pivot to Asia was probably not Barack Obama's

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China's prevailing vision for East Asia cannot be achieved if the US presence in the region retains its current depth and breadth. The United States will not accept being driven away and is resolved to meet the evident preference in Asia to see it continue to play a decisive role. This comment has been drawn from CSCAP's Regional Security Outlook 2015.

in 2011 but George Bush's in 2001. The Bush administration was broadly informed by the neoconservative view that the US should embrace unipolarity, impose it as the core of the international system (because it was better than any balance of power arrangement), and commit to preserving it indefinitely. It reversed the priority order that had guided US policy for decades (from Europe/Middle East/Asia to Asia/Middle East/Europe); conceived of the East Asia Littoral (a vast space extending from South of Japan, through Australia and out into the Bay of Bengal) as a new geographic strategic focus; resolved to gradually reverse the Cold War 60:40 split in favor of the Atlantic over the Pacific for key military assets (SSBN, SSN, CV); and signalled that it would seek far-reaching supportive changes in the nature of its alliance relationships with Japan and the South Korea, especially to minimize the static deployment of US forces in and around these states.

Although 9-11 erased a critical dimension of this pivot - closer political attention to East Asian affairs - much of the rest of it played out behind the scenes of the war on terror. Later, the administration embraced the challenge of a bold reengagement with India delinked from any considerations of preserving a balance with US relations with Pakistan.

Beijing would have seen this US posture as a preemptive signal to China not to consider contesting US primacy, especially as it came on top of US "assertiveness" on Taiwan in 1996, and in 1999 when Washington bypassed Chinese and Russian vetoes in the UN Security Council to bomb Belgrade over ethnic cleansing in Kosovo. Whatever Beijing initially made of this strategic shift in Washington and its possible implications for the "window of strategic opportunity" that figured so prominently in its strategic assessments since the days of Deng Xiaoping, subsequent events transformed the landscape for both capitals.

Beijing witnessed the impact the devastating trilogy of 9-11, regime change in Iraq, and the global financial crisis (GFK) had on US credentials for unipolarity. By the time the GFC struck as the Bush administration was about to leave office in 2008, US standing in the world was lower than it had ever been, especially in those crucial subjective dimensions of respect, admiration, confidence, and trust.

Did China's leadership persuade itself that this was not simply a setback but more of a historic strategic reversal heralding the early end of unipolarity and suggesting that the nature of the future regional and global order was far more open than it had previously imagined? It would hardly be surprising if that was the judgment and the evidence of a markedly more assertive international posture since 2009/10 suggests that this was indeed the case. The Obama administration pointedly stepped away from the neoconservative prescription of perpetuating unipolarity, remained committed to the earliest practicable termination of its large military commitments in Iraq and Afghanistan, and has been steadfast in dealing with crises by leading from within coalitions of the willing rather than resolving to intervene unilaterally and then welcoming coalition partners. These policy strands, although they delivered crucial gains, also inescapably raised questions in many states about what it all said about US capacity and resolve to play its traditional role. The Obama administration's pivot (or rebalance) toward Asia in 2011 was an urgent reminder that the US remained fully committed to protecting and meeting its vital interests, obligations, and responsibilities in Asia, but it did not aspire to project a new grand strategy or endorse the one advanced by the Bush administration. There was not much here to lead strategists in Beijing to fundamentally reconsider their assessment.

It has come more clearly into view that China's prevailing vision for East Asia cannot be achieved if the US presence in the region retains its current depth and breadth. It is equally clear that the United States will not accept being driven away and is resolved to meet the evident preference in Asia to see it continue to play a decisive role.

It would be prudent for the region's political leaders to consciously take steps to ensure key relationships do not settle into an adversarial rut. Instead of simply bracing for an indefinite trial of strength led by the US and China, leaders could press for evolutionary geopolitical change that emerged as a natural consequence of positive strategic developments within the region. This would put the focus back on such things as finding ways to put the Korean Peninsula on a positive trajectory, and on pressing the leaders of China and Japan to commit to following the example set by France and Germany 65 years ago.

Pacific Forum CSIS Honolulu, Hawaii, Jan. 5, 2015

www.pacforum.org

Keeping Safe in the New Year

Lillian Ablon

Introduction>>

2014 was the year the hack went viral and also saw big moves designed to disrupt attackers. Data breaches and cyber security have brought great concern among the media and general public. Resolutions are offered to gain upper hand in 2015 in the safe race.

2014 was the year the hack went viral. Retailers like Staples Inc., Neiman Marcus Inc., Michaels, Home Depot Inc. and eBay Inc. announced breaches, while millions of customers were helpless to stop the flow of credit card information and personal data to cyber attackers. But it wasn't just retail giants: Firms in health care (Community Health Systems), finance (JPMorgan Chase & Co.) and entertainment (Sony Pictures) also fell victim to cyberattacks. In addition to breaches, major software vulnerabilities surfaced. The OpenSSL Heartbleed vulnerability shook confidence in Internet security, while Shellshock exposed a majority of Internet-facing services to attack.

2014 also saw big moves designed to disrupt attackers. A particularly bold one was the U.S. indictment of Chinese hackers accused of infiltrating American companies. There were also internationally coordinated takedowns of black market sites and arrests of high-profile cyber criminals. For example, Operation Onymous resulted in several arrests and disruption of dozens of black market sites, including the latest resurrection of Silk Road, an anonymous marketplace known for its illegal drug trade.

Of course, cybersecurity issues and efforts to combat them aren't a passing trend. They'll only proliferate as the cyber black markets grow, new devices are introduced (e.g., Internet of Things, wearables), tech is used more extensively in new areas (e.g., health information technology, education, self-driving cars), and state and non-state actors continue to use cyber to attack and gain intelligence.

As such, in 2015, expect more attention, but not necessarily more action. Discussions about data breaches and cybersecurity will increase among the media and general public, both of whom have already taken notice of these issues. Some discussions may be counterproductive, but greater awareness of and conversation about cyber threats is a net positive for security.

There will likely also be more focus on dual-use technologies, such as the anonymity network Tor, and their benefits or detriments to privacy and security.

The boom in smart devices will continue as the world becomes more and more connected. In fact, connected devices are expected to outnumber connected people six to one by 2020. As more devices go online, it's safe to expect an accompanying boom of hacks. Some will stem from criminals, some from savvy consumers who want more control over their devices.

Security will remain a cost to companies – not a top priority. Why? Persistent, unanswered questions make it hard for a company to make the right decisions: How much security is enough? How much should be spent? Should security be run internally or outsourced? What tools and people are most effective? Smaller companies and new products are likely to wait until some of these questions have answers or until the threat is real for them – in other words, until it's too late.

Individuals will continue trading security for convenience. For example, they'll favor easy access to data more than security. This preference has ripple effects: Without sufficient demand, companies are that much less likely to make necessary investments in security.

With these trends in mind, it's safe to say that bolstering cyber security will be a 2015 goal for individuals, organizations and governments. So what does that look like?

Multi-factor authentication is a good place to start. This could have possibly prevented the JPMorgan Chase breach. Apple Inc. learned this lesson too late, as well. But after a massive leak of celebrities' nude or otherwise personal photos, it decided to make a change and implement two-factor authentication for iCloud accounts. Developing and enforcing stricter laws on discovering and disclosing breaches could help, too. Currently, there's no consistency for many data breach laws. For example, every U.S. state has its own policies for breach notifications. Consistency could produce faster responses to breach victims, which would reduce fraud and black market trade while boosting accountability for those responsible.

Certain areas likely need special legal attention. Certain health information, for example, is already protected by some of the most robust security laws (e.g., the Health Insurance Portability and Accountability Act). But with the confluence of medical devices and the Internet of Things opening a new can of information security worms, these laws could be strengthened. What, if any, should be government's role in this? What new regulations should be developed, and how should they be enforced?

Of course, laws are only effective if the affected entities realize they've been breached. According to Verizon Communications Inc., unrelated third parties discover an average of 70 to 80 percent of attacks. This suggests that information sharing among companies (and government) could be bolstered in addition to boosting monitoring capabilities and user-awareness training.

Password storage is critical. Sony staff stored plaintext passwords in an Excel file, which unnecessarily exposed the company to attack. As always, individuals should be mindful of online security, maintaining password strength, avoiding dubious links and attachments and refraining from giving away information on online forms.

Stakeholders need to bake security in from the start, making security as much of a priority from the beginning as functionality, productivity and convenience. The recent holiday tech binge is a good illustration of this. Smart devices likely spiked as consumers unwrapped countless Christmas presents and connected them to the Internet of Things. For the vast majority of these devices, security is not baked in. Imagine if an attacker hacked your "smart home" kit and could control your air conditioner, lights and garage door.

It's important to keep investing in security innovation. Companies receiving millions of dollars in venture capital should continue to tackle the hardest cybersecurity problems. This will result in new products like Apple Pay that offer both convenience and security, more tools available for defenders and more collaboration to try to enhance security.

If these resolutions are realized, defenders might not gain the upper hand in 2015, but they'll make strides in better protection, tools and techniques that could help turn the tide in years to come.

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The Future of Cyber Policy in China

Joshua Bleiberg & Darrell M. West

China has ambitious plans to establish itself as a military and economic superpower. In the 21st century, neither of these goals are possible without a thriving innovation economy that relies on advanced Information and Communications Technologies (ICT). If China is to transform itself into an ICT powerhouse, the nation must institute large policy changes. At a recent Brookings event, Greg Austin a Professorial Fellow at the EastWest Institute discussed his new book Cyber Policy in China, which addresses the challenges the country will face in efforts to usher in an ICT revolution.

The State of ICT in China

China has numerous strengths that will aid its efforts to become an ICT superpower. For example, the Chinese firm Lenovo is the world’s largest PC manufacturer. China also has more netizens than any other country in the world. Chinese scientists were the first to successfully teleport quantum information between remote particles. And Chinese engineers are taking a leading role in the development of Internet Protocol Version 6. Many of the world’s fastest super computers are in China. Despite these many achievements, however, China has faced some unexpected ICT challenges. The country fell in the World Economics Forum’s Network Readiness Index from 36th in 2011 to 62nd in 2014, despite recent government efforts focused on improving its worldwide position.

Creating a Generation of Innovators

China made a massive investment into universities throughout the country in 2000, so as to develop greater numbers of Information Technology experts. However, the influx of cash has not had the desired results. Approximately 40 percent of Chinese students who study abroad return to their home, which is below government expectations. In some cases, Austin argues that one reason researchers do not come home because they prefer the "social environment" in other countries.

Four Takeaways about the Future of Chinese Cyber Policy

Introduction>>

China has ambitious plans to establish itself as a military and economic superpower. In the 21st century, neither of these goals are possible without a thriving innovation economy that relies on advanced Information and Communications Technologies (ICT).If China is to transform itself into an ICT powerhouse, the nation must institute large policy changes.

1.China faces many self-imposed barriers that will make it more difficult for the country to become an advanced technology society, including the closed nature of the education system and government censorship of the Internet.

2.Chinese leaders have a deep anxiety about building a highly-functional innovation society. This is partially fueled by the tepid results of ICT policies over the past two decades.

3.China can't shield itself off from the revolutionary and transformative effects of the Internet.

4.The country's leadership continues to place an emphasis on building China into an advanced information society.

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The Sixth Forum On China–Africa Cooperation: New Agenda and New Approach?

Yun Sun

The 6th Forum on China-Africa Cooperation (FOCAC) will be held in South Africa in 2015. This will be the first FOCAC meeting since President Xi Jinping assumed office in 2013. Given China's priorities and agenda in past FOCAC meetings and the heightened importance the Xi administration has attached to Africa, expectations are that China will boost its financing commitment and development priorities in Africa at the 6th FOCAC meeting. The outcome will guide China's Africa policy for the following three years.

THE PRIORITY

China has consistently doubled its financing commitment to Africa during the past three FOCAC meetings—from \$5 billion in 2006 to \$10 billion in 2009 and \$20 billion in 2012. Half of the \$20 billion committed in 2012 had been disbursed by the end of 2013, leading to China increasing the credit line by another \$10 billion in 2014. If this pattern serves as any indicator, China is likely to announce another impressive line of credits available for Africa during the 6th FOCAC meeting.

The key questions are what China and Africa will prioritize the new batch of Chinese financing for and how Africa can work with China to maximize the benefits for the continent. Since its inauguration, the Xi administration has emphasized African infrastructure development. This move originates from the negative publicity and frequent criticism of China's traditional emphasis on natural resources. During his May 2014 visit of Africa, Chinese Premier Li Keqiang enthusiastically promoted major projects such as the "461 framework" on China-Africa economic cooperation1 and the "three networks" (the high-speed rail network, the highway network and the regional aviation network). Many of these plans will materialize or expand during the 6th FOCAC meeting.

Despite the supposedly cooperative nature of FOCAC, China has played a larger role in setting and driving the agenda in the past as the financier of the projects. Africa's priorities in structural reform and capacity building are important,

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China has ambitious plans to establish itself as a military and economic superpower. In the 21st century, neither of these goals are possible without a thriving innovation economy that relies on advanced Information and Communications Technologies (ICT).If China is to transform itself into an ICT powerhouse, the nation must institute large policy changes.

but at times have been regarded as secondary for China under the broader framework of "mutually beneficial" cooperation. Since its inauguration, however, the Xi administration has enhanced its emphasis in the areas in which Africa is most interested. This decision partially reflects China's desire to mitigate the broad criticisms on its "mercantilist" approach toward Africa, Xi's economic charm offensive to boost China's contribution in international development, and rising African demands. The 6th FOCAC meeting, therefore, will possibly witness an elevated devotion on Beijing's part towards those areas, including agricultural development, industrialization, training, job creation and technology transfer through investment in manufacturing industries. In addition, necessitated by China's rising investment in Africa and the local security risks associated with them, peace and stability are likely to be key areas for discussion at the 6th FOCAC meeting.

WHY IS IT IMPORTANT?

As Africa's largest trading partner and a major investor, China's actions have major implications for the development of the continent. Thus, Africa needs to accurately anticipate and assess the Chinese agenda, weighing the pros and cons, in order to approach FOCAC with strategies and priorities that will align with that agenda but also meet African needs. For example, agricultural transformation has been a main priority for Africans in order to enhance productivity, food security and inclusive development. In addition, industrial investments are greatly needed to achieve structural transformation and diversify Africa's production and export base. Given the importance of these issues, African countries should negotiate with China for direct investment in these areas.

China's response most likely will be that its investment in infrastructure will lay the necessary foundation for both Africa's agricultural transformation and industrial development. However, the key question here is whether such infrastructure deals will bog African countries back down to reliance on natural resources transactions and undermine the momentum for structural reform. The Chinese model of infrastructure development in Africa features resources-backed loans and tied aid to create business opportunities for Chinese importers and contractors. While it may contribute to the infrastructure needed for economic development, this emphasis does not address Africa's most urgent needs in agricultural transformation, economic structural reform or human resources capacity building.

Despite the hope that Beijing will contribute more to areas such as agricultural and industrial development, observers of China-Africa relations are concerned that the majority of the new financing committed by China in 2014 or those to be announced in 2015 at the 6th FOCAC meeting will follow the traditional trajectory.

In fact, according to China's former special envoy for African affairs, China has no intention of breaking away from this old pattern. Commenting on the $10 billion China offered in 2014, the special envoy pointed out that "this funding will be paid back by African countries with commodities or the franchise [of the infrastructure projects]" (Shang 2014). Meanwhile, although Beijing has imposed more stringent requirements on Chinese companies in order to improve the companies' records on governance, transparency and accountability when investing in Africa, few Chinese expect them to completely abandon their sub-optimal operation model in the near future. Some Chinese experts have pointed out that private Chinese investors make up about 80 percent of all Chinese entities investing in Africa and, due to their own deficiencies, are less adaptive to the African context (Liu 2013). If African governments deem these approaches undesirable, they need to work and negotiate for a change of rules and practices.

In particular, African regional organizations such as the African Union (AU) should play the important role in pushing China as well as African countries to sign international agreements on transparency especially in the natural resource extraction industry, including the Extractive Industry Transparency Initiative.

China's recent and rising interests in African security affairs could bring more resources and assistance to the table in terms of stabilization and conflict resolution in Africa. China has adjusted its principle of non-interference in other countries' internal affairs in cases such as South Sudan, and has enhanced its military assistance to and security cooperation with African countries and regional organizations. For example, China is scheduled to send an infantry battalion —the largest combat troop contribution China has made to a U.N. peacekeeping mission—to South Sudan in the beginning of 2015. While

China's contribution to African security issues could be positive, Africa needs to understand and prepare for the potential geopolitical implications— most likely, a heightened sense of competition between China and Western powers if China's political influence and security presence in Africa are to expand.

WHAT SHOULD BE DONE IN 2015

During past FOCAC summits, China has largely set the agenda for the meetings. To level the playing field African leaders need to carefully strategize and actively voice their demands for China's contribution according to their own needs. They should coordinate their goals and strategies to leverage collective bargaining and binding power vis-à-vis China through regional and sub-regional organizations. The African Union has played a key role harmonizing the positions and development agendas among African countries: Now is the perfect opportunity for the AU to spearhead discussions with China on how African agendas are incorporated in China's planned activities in the continent.

As noted above, it remains to be seen whether China will abandon its traditional financing model backed by African resources despite its new emphasis on African demands. African leaders therefore must aim for a more informed understanding of the short-term and long-term consequences of Chinese financing projects. As most African countries prioritize structural transformation as the central and most critical theme in their economic policies, they have to develop a nuanced assessment of how China's infrastructure financing will contribute or undermine this theme and actively manage the results.

China has stated a willingness to enhance and improve its input in African capacity building, such as human resources development, technical assistance and technological transfers. The commitment indeed presents an opportunity for African countries to wisely strategize and demand China deliver the investments they need most, including on manufacturing industries and job creation. Africa should not stop with China's piecemeal approach and demonstration projects crafted for public relations purposes. For example, the corporate social responsibility programs operated by Chinese companies are "passive" rather than "active." They are motivated by "executive directives" by Chinese government agencies and "neglect the public relations campaign" (Wang 2014). Instead, Africans should design their own capacity building project guidelines aimed at structural transformation in a comprehensive manner.

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Xi Jinping's Reform Express Gathers Steam

Arthur R. Kroeber

After the enthusiasm which greeted the launch of Chinese President Xi Jinping's landmark reform blueprint at the Third Plenum of the 18th Central Committee in November 2013, the mood among observers of China's economy has gradually soured. A common view is that progress on economic reforms has been slow, bogged down not only by the opposition of vested interests but also by the government's own distraction with its endless anti-corruption campaign, and by its anxiousness to support short-term growth through easy monetary policy.

This popular take misses the mark in three respects. First, the top priority of Xi's reform is not about economics; it is to remake China's system of governance. Successful reform of government and administration, along with more specific market reforms, will, in turn, enable more sustainable economic growth. Second, China's leaders clearly reject the view that to be serious about structural economic reform, they must accept a sharp cyclical slowdown. Instead, they believe that maintaining relatively rapid growth in the short term will give them more breathing room to push through their complex economic agenda. Finally, a tally of economic reform measures this year shows that progress has in fact been impressively brisk.

Governance, Not Economics, Tops the Agenda

Understanding the primacy of governance reform is essential to grasping the role of the anti-corruption campaign, which has resulted in the investigation or disciplining of over 70,000 officials at all levels of government in virtually every province, and has now spread to senior levels of the People's Liberation Army. This campaign is often portrayed as a cynical effort by Xi Jinping to consolidate power, eliminate his enemies and curtail the influence of retired senior leaders, notably former Presidents Jiang Zemin and Hu Jintao. These motives no doubt play a large role, but the campaign is too far-reaching, and has gone on for too long, for them to be a full explanation.

It is now apparent that the campaign's central goal is to sharply reduce

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Clearly these are just initial steps and much work needs to be done to broaden these reforms in ways that will have material impact on China's $8 trillion economy. But it is hard to think of another major world leader whose government has accomplished so much in such a short period of time. Xi Jinping can certainly be criticized on many issues, but failure to deliver on his reform agenda is not one of them.

the system's tolerance of corruption, which has been quite high since the beginning of economic reforms in the late 1970s. This, in turn, suggests a desire to renegotiate the basic bargain between the central and local governments that has held throughout the reform period. In essence, that bargain tasked local officials with maximizing economic growth, in exchange for which they were tacitly permitted to skim off part of the financial gains from that growth. Central authorities only cracked down when the graft reached grotesque proportions (as with smuggling scandals in Xiamen and other coastal cities in south China in the late 1990s), or when political and policy interests converged in an exemplary prosecution (as in the purge of Shanghai party Secretary Chen Liangyu in 2005, which both removed a Politburo rival to Hu Jintao and sent a message to cities to rein in property speculation).

This bargain proved effective in stimulating sustained rapid growth while China was still a low-income country. But the nation's economy has now matured and with a per capita national income of $6,560, China now qualifies as an upper-middle income country, by the World Bank's definition. To sustain high growth at this income level, China needs better governance, a more reliable legal system and considerably less corruption. Thus, the anti-graft campaign is not incidental to or a distraction from the main reform agenda—it is an essential part of the foundation of a more successful economic and political system.

Similarly, the legal system reform outlined at the Fourth Plenum in October, while disappointing many Western observers because it sanctified the Communist Party's position above the laws that apply to everyone else, is in fact a significant step towards a more consistent, predictable, rules-based system. As Cheng Li has pointed out, the very act of devoting a Plenum to legal issues has made possible a discussion about how to create rule of law in China (see "Fourth Plenum Has Opened Discourse on Constitutionalism, Governance"). And the specific reforms that legal scholars believe are likely—creation of circuit courts to limit the influence of parochial interests, more consistent publication of court decisions, prohibition on Party interference in most cases and the creation of limited avenues for public-interest litigation against polluting industries—have the potential to make Chinese governance fairer, more transparent and more responsive to citizens' concerns. As with the anti-corruption drive, a key theme is to readjust the balance of power in favor of the central government at the expense of the localities.

A final element in the governance reform agenda is the important but often-overlooked fiscal program adopted by the Politburo on June 30. By 2016, China will complete its first major overhaul of the nation's taxation and government spending system in two decades. Key items include the elimination of land-based local government financing and its replacement by provincial bond issues; restructuring of taxes to reduce local governments' revenue shortfalls and encourage them to promote consumer services, rather than heavy industry; and stronger resource and environmental taxes to arrest environmental degradation and promote more efficient energy use. Once more, much of the focus is on redefining the core role of local governments: their main mission will shift from promotion of economic growth to effective provision of public services.

Cyclical Economic Management Supports the Reform Agenda

Once we understand the primary role of governance, the sequencing of reform measures becomes more evident, and the relative tardiness of more narrowly economic reforms becomes more understandable. But skeptics have another concern: that the government is losing sight of its long-term structural reform goals in a desperate effort to keep short-term gross domestic product (GDP) growth above seven percent. The premise of this worry is that unless the authorities are willing squeeze out inefficiencies and curb the rapid rise in debt—measures which inevitably require a sharp slowdown in growth—then the structural reforms have little chance of success. In short, the economic model cannot change unless the old, bad habits are punished by clear failure.

Two pieces of recent evidence support this view. First, early in 2014, Beijing relaxed monetary policy and started removing long-standing administrative restrictions on house purchases, in order to prop up a property market that seemed on the brink of collapse. These measures reversed the tight monetary policy of the second half of 2013, which succeeded in bringing credit growth down from 23 percent in April to around 16 percent by the end of the year. Second, the new, looser policy meant that the country's aggregate debt-to-GDP ratio continued to rise in 2014. After rising from 145 percent of GDP in 2008 to 220 percent in 2013, this ratio continued to climb in 2014 and now exceeds 230 percent of GDP. In absolute terms, this figure is not alarming—most developed countries, including the United States, have significantly higher ratios. But the rapid increase in leverage in a short time is usually a harbinger of financial problems.

It is a mistake, however, to assume that the continued increase in leverage shows that Beijing is incurably addicted to its old debt-fueled growth model, or that the authorities have decided to prioritize growth over reform. First of all, the credit stimulus used to support the property market this year was extremely modest: the year-on-year growth rate of credit ticked up only about one percentage point for a few months, and quickly dropped again once stimulus was withdrawn. The removal of administrative restrictions on house purchases arguably played a larger role in the property stabilization than did easy credit.

More important, Beijing's approach to deleveraging is a deliberate policy choice driven by the conviction that growth and reform are partners, rather than antagonists. A relevant comparison is the debate between U.S. and European policymakers after 2008 about the appropriate response to the global financial crisis, which left the rich economies stuck with low growth and big debts. Washington argued that policy must focus on sustaining growth (through ultra-easy monetary policy and large fiscal deficits), and that fiscal consolidation should take a back seat. European officials, especially in Germany, argued that fiscal consolidation and debt reduction had to be a top priority, even if it harmed growth. Beijing obviously favors an American-style approach to deleveraging and structural adjustment. Given the superior performance of the U.S. economy (relative to Europe) since the global crisis, this is a defensible choice.

Economic Reforms are Proceeding Smartly

The last point is that, in fact, China's rollout of specific reform measures over the past year has been impressive. In addition to the fiscal reform package, whose significance has been severely underrated by the market-obsessed international financial media, achievements of 2014 include:

• Abolition of registered capital requirements for new firms, which caused growth in new-company registrations to surge to over 20 percent, the highest rate in a decade.

• Switching the resource tax on coal from a volume to a value basis, a long-delayed measure which should discourage excessive investment and promote energy efficiency.

• Publication of a plan to deregulate all pharmaceutical prices beginning in 2015.

• Publication by virtually all provinces of plans for "mixed-ownership" reform of state enterprises.

• A significant opening of the capital account via the Shanghai-Hong Kong Connect program which permits investors in those two financial hubs to put money directly in each others' stock markets.

• The publication of draft rules on deposit insurance, paving the way for implementation next year, followed by full liberalization of deposit interest rates.

Clearly these are just initial steps and much work needs to be done to broaden these reforms in ways that will have material impact on China's $8 trillion economy. But it is hard to think of another major world leader whose government has accomplished so much in such a short period of time. Japanese Prime Minister Shinzo Abe, for instance, came to office two years ago promising "three arrows" of monetary easing, expansive fiscal policy and deep structural reform. So far he has delivered only one—monetary easing, which has driven the yen down and the stock market up—but structural reform is missing in action and fiscal policy was disastrously captured by Ministry of Finance hawks, whose consumption-tax increase drove the country into a needless recession. The U.S. government is gridlocked and is still fighting over a health care reform law passed five years ago. Six years after the global crisis, Italy has just begun to put in place long-overdue reforms to its labor market, and France, under its last two presidents, has done nothing at all to address its structural economic malaise. Xi Jinping can certainly be criticized on many issues, but failure to deliver on his reform agenda is not one of them.

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