



# 2018 Annual Forecast

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# 2018 Annual Forecast

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## Overview

**Reckoning With North Korea:** Though the threat of war on the Korean Peninsula can't be ruled out, the United States will probably try to avoid a costly preventive strike against the North's nuclear weapons program that would plunge the global economy back into recession. Instead, Pyongyang's demonstration of a viable nuclear deterrent next year will spawn a new and more unstable era of containment.

**Hedging All Around:** Deepening collaboration between China and Russia will pose a strategic threat to the United States, spurring Washington to try to check the budding partnership by reinforcing its own allies in the Eurasian borderlands. The fluidity of alignments among great powers will increasingly define the international system as Moscow and Beijing balance against each other, just as many U.S. allies hedge their relationships with Washington.

**Putting Trade Ties to the Test:** The White House will forge ahead with an aggressive trade agenda that targets China, Mexico, South Korea and Japan. While the U.S. trade agreement with South Korea hangs by a thread, congressional and legal checks on U.S. executive power will have a better chance of keeping the North American Free Trade Agreement intact. The United States' increasing unilateralism in trade will expose the weaknesses of the World Trade Organization, but it won't shatter the bloc or trigger a trade war.

**Revisiting Iran:** North Korea's nuclear weapons achievements will fuel a hard-line U.S. policy toward Iran, jeopardizing the Joint Comprehensive Plan of Action. As the United States, Saudi Arabia and Israel close ranks against Iran, proxy battles across the Middle East will intensify. But Iran won't walk away from its nuclear deal with the West. Russia will nevertheless exploit the tension mounting between Washington and Tehran, as well as its advantage on

the Syrian battlefield, to expand its influence in the Middle East at the United States' expense.

**Managing an Oil Exit Strategy:** Major oil producers hope to stay on track to rebalance the global oil market in 2018. As the expiration of their pact to limit production and draw down inventories approaches, compliance will slip among OPEC and non-OPEC participants alike. Even so, Saudi Arabia and Russia may be able to work together to counteract an expected uptick in U.S. shale output.

**The Next Phase of China's Reform:** Chinese President Xi Jinping will take on entrenched local interests as the central government tackles the next phase of its reform agenda: wealth redistribution. A slowing property sector and corporate debt maturities will compound financial pressures on China's northeastern rust belt in 2018, but Beijing has the tools it needs to prevent a systemic debt crisis.

**France Finds Its Voice:** France will find itself on more equal footing with Germany next year as it defends Southern European interests and debates eurozone reform. The possibility of a more Euroskeptic government emerging in Italy will send jitters through financial markets, but the country won't leave the currency zone.

**Populism Persists in Latin America:** Popular frustration with the political establishment will make for a more competitive election season in three of Latin America's biggest economies: Mexico, Brazil and Colombia. Should a populist president take office in Mexico, Congress will block him from enacting any sweeping policy changes. Meanwhile, Brazil and Argentina will have a narrow window in which to implement domestic reforms and push ahead with trade talks in the Common Market of the South before political constraints start piling up against them. □



Getty Images/NASA/Newsmakers

## Global Trends

- The United States will reluctantly adopt a policy of containment toward North Korea when Pyongyang achieves a viable nuclear deterrent, likely in 2018.
- An emerging coalition between China and Russia will increasingly challenge U.S. hegemony, although alliances will remain fluid worldwide.
- Working within and beyond the bounds of the World Trade Organization, the United States will pursue an aggressive trade agenda against China, Mexico, South Korea and Japan.
- As the global oil market recovers, Saudi Arabia will bear the burden of keeping produc-

tion cuts in place as other oil producers renege on their agreed-upon quotas. The Saudis will look to Russia to help forestall an uptick in U.S. shale output.

## Geopolitics Is Back With a Vengeance

Countries across the globe will kick off the new year with a bit of good news. A decade after financial crisis shook the world to its core, growth in the global gross domestic product has finally begun to pick back up. The Organization for Economic Cooperation and Development estimates that the global economy will grow more than 3.5 percent in 2018 — the fastest pace seen in eight years.



But many of the deep structural problems that the financial crisis exposed have endured, signaling a more fragile recovery ahead than the cyclical rebounds of the past. Moreover, a number of geopolitical risks — looming conflict on the Korean Peninsula, threats of a global trade war, stark battle lines drawn in the Middle East, and anxiety over Chinese and Italian debt, to name a few — could cut the economy's comeback short. As U.S. national security adviser H.R. McMaster said recently, "Geopolitics are back, and back with a vengeance after this holiday from history we took in the post-Cold War period."

By themselves, these threats will influence how governments and corporations adapt to a tenser international environment in 2018. However, the worst-case outcome of each risk isn't necessarily the most likely. And because the United States is the only actor with the ability to tip the scales of several scenarios in either direction, any forecast of the year ahead must start with Washington.

By now the world has had a year to observe the presidency of Donald Trump. While there are some aspects of his term that are unique, and therefore more fleeting in their effects, many of Trump's actions stem from deeper forces that will last well beyond his time in office. With regard to the former, a handful of institutional checks on the executive branch made headlines throughout 2017. Congress worked to tie the president's hands in lifting sanctions against Russia. (Lawmakers may likewise try to block Trump from unilaterally withdrawing from the North American Free Trade Agreement in 2018.) The national security establishment has angled to preserve U.S. commitments to NATO while clearly defining the risks attached to instigating war with North Korea or abandoning a nuclear deal with Iran. Figures at the state, corporate and local levels have openly defied Trump's attempts to withdraw from the Paris climate change accord and to reduce state support for alternative and renewable energy sources.

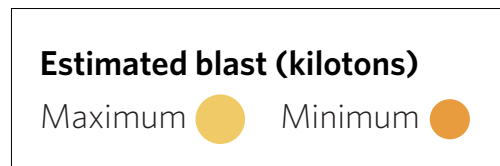
But Trump also doesn't consider himself beholden to the Republican Party or his national security advisers, and he has shown less hesitation than most American presidents to dismiss dissenters or appoint loyalists who adhere to his agenda. Thus, Trump has a wider margin in which to operate than many of his predecessors, which not only will raise the risk of rifts widening within the Republican Party in an election year but will also keep U.S. allies and adversaries on their toes as they try to distinguish between the rhetoric and reality coming from the White House.

## Coping With a Nuclear North Korea

Trump's most consequential decision in 2018 will be how to deal with North Korea's rapidly developing nuclear arsenal. The window for a U.S. preventive strike aimed at devastating Pyongyang's program is closing fast. Though a preventive strike can't be ruled out, its steep price tag — a messy war that shoves the world back into economic recession — will make the United States more likely to resign itself to the uncomfortable reality of North Korea's possession of a viable nuclear deterrent. This acceptance will mark the start of a new and unstable era of nuclear deterrence as the United States and its Asian allies adopt a policy of containment toward the Hermit Kingdom. The gradual degradation of arms-control agreements struck in the 20th century will only further complicate matters as Russia and China try to balance against the United States' expanding missile defense network.

In fact, lately Russia and China have found more reason to cooperate than compete with each other. Both countries are working to insulate themselves from U.S. pressure and reduce Washington's influence in strategic theaters around the globe. To that end, they have hashed out a division of labor of sorts: Where both states share interests, Russia addresses security issues as it deems fit while China takes the lead on economic matters. Moscow and

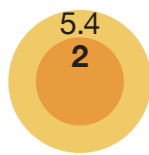
# North Korean Nuclear Tests



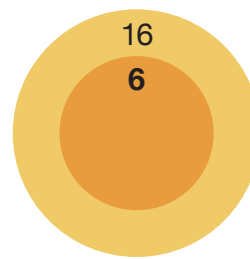
Oct. 9,  
2006



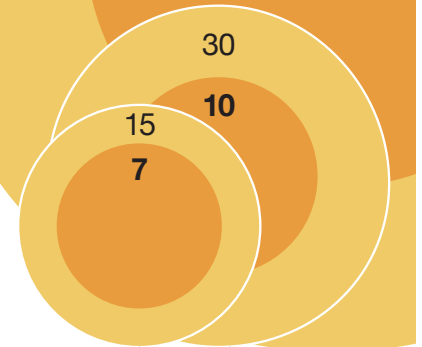
May 25,  
2009



Feb. 12,  
2013

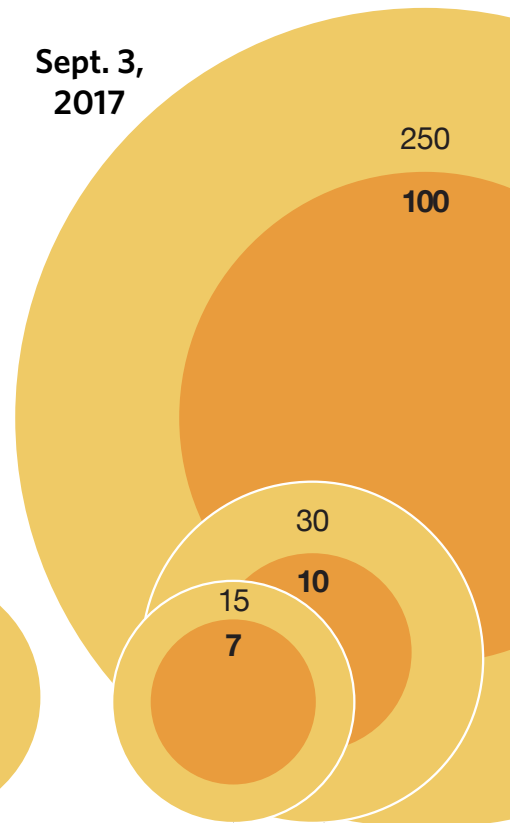


Jan. 6,  
2016



Sept. 9,  
2016

Sept. 3,  
2017



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Beijing also have deepened their cooperation in finance, trade, energy, cybersecurity and defense.

Though this emerging partnership poses a strategic threat to the United States, it will also provide ample opportunity for exploitation as Washington tries to bolster its allies in Russia and China's neighborhood. (Taiwan, in particular, could become a source of contention between Washington and Beijing next year.) Still, today's international environment does not resemble the Cold War, when bolder lines defined alliances and great powers engaged in zero-sum contests. Economic interdependence, mutual distrust and unreliable security guarantees will encourage ostensible allies to hedge against one another for their own protection. Such fluid relationships will come to define the global order in 2018 and beyond.

## An Unrelenting U.S. Trade Agenda

The threat of North Korea will not spare China, South Korea or Japan from the United States' ire in the trade realm. The Trump administration is unique in its willingness to compartmentalize the North Korean crisis and its trade agenda. In keeping with the White House's decision to target countries with which the United States has large trade deficits, China, Mexico, South Korea and Japan will remain in Washington's crosshairs in 2018. (As the Trump administration quickly discovered, Germany is not easy to isolate from the rest of the European Union, which protects it somewhat from the White House's punitive trade measures.)

Should negotiations reach an impasse, the United States is more likely to abandon its trade deal with



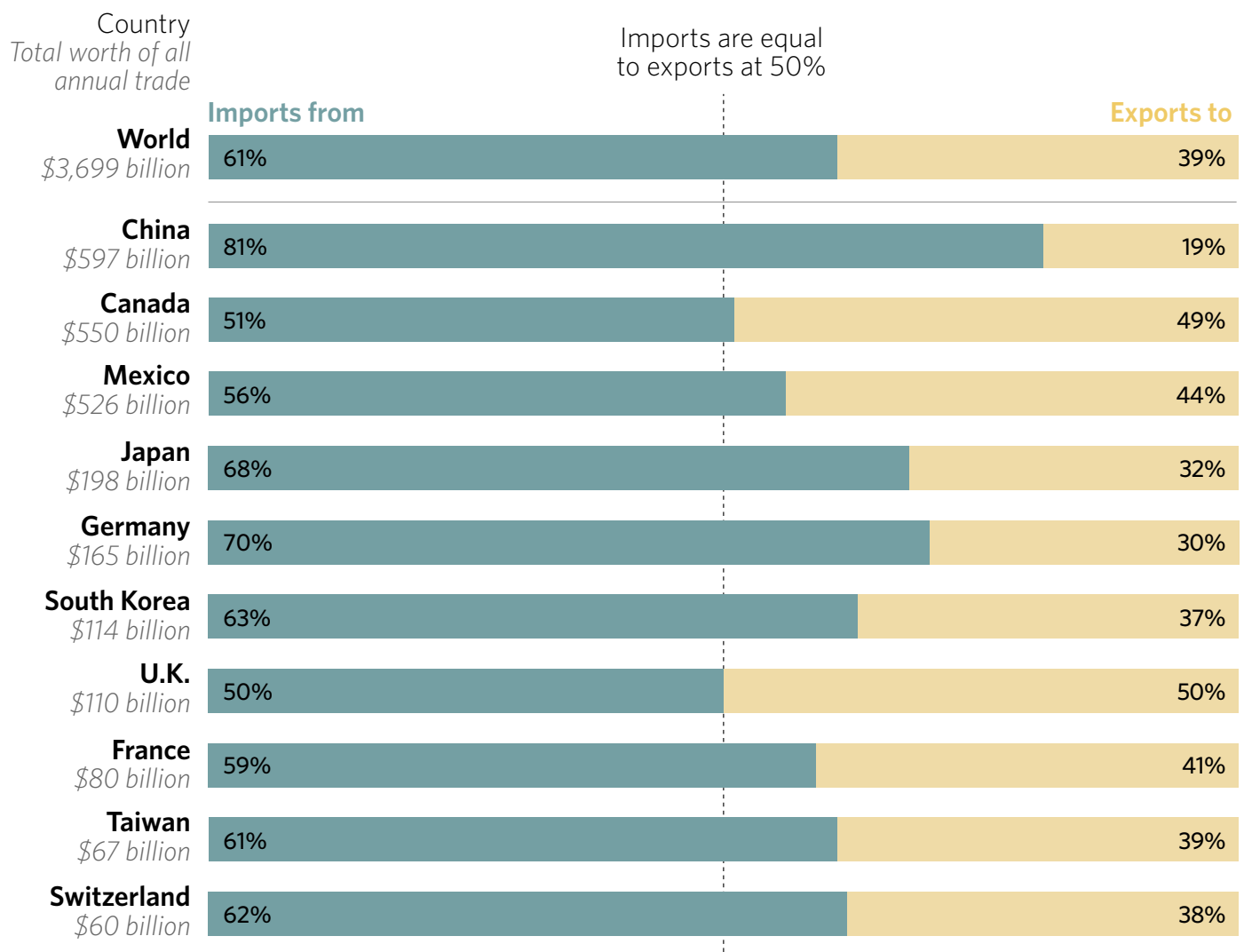
South Korea than other agreements on the table. The ties that bind the U.S. economy to South Korea's are weaker than those linking it to countries like Mexico. And though Trump could choose to pull out of NAFTA next year, the bloc's proponents — including U.S. lawmakers who will weigh the risks of withdrawal as they head into midterm elections — will try to legally block moves by the president to keep the trade pact from falling apart. By and large, the role of the U.S. Congress in regulating foreign commerce and legal disputes will continue to curb executive action in trade in the year ahead.

The separation of national security and trade may be unique to the Trump administration, but protectionism and a willingness to flout the rulings of

the World Trade Organization (WTO) existed in Washington well before Trump arrived at the White House. The United States has long held the opinion that the WTO is ill-equipped to hold China accountable for the free trade violations that its particular brand of state capitalism perpetrates. Although the European Union and Japan share the United States' desire for stricter enforcement of WTO regulations, Washington will not bank on the slim chance that the unwieldy trade body will push reforms through its ponderous, consensus-based bureaucracy.

With China squarely in its sights, Washington will slap Beijing with punitive measures on trade, investment and intellectual property enforcement that it can argue are within or outside of the WTO's

## U.S. Trade Balances: Top 10 Partners, 2016



Source: Trademap

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jurisdiction, depending which designation best suits its needs. The United States already has dusted off two important trade tools at its disposal: A Section 301 investigation of intellectual property theft and forced technology transfers, and a Section 232 investigation into whether imports of Chinese steel hurt U.S. national security and are thus subject to tariffs. (A review of the first case is due in August, and a review of the second case is due in January, at which point the president will have 90 days to act on it.) Washington also will keep lobbying the European Union to withhold market-economy status from China in the WTO — a label Beijing claims the organization promised it in 2016 that would make it more difficult to impose anti-dumping measures against China. Though a verdict for the legal challenge on this matter won't come until 2019, a WTO panel will review the case in 2018.

The Trump administration's trademark bluntness and unilateral pursuit of its trade agenda will continue to raise alarm worldwide, leaving the impression that the White House is intent on dismantling the WTO and razing the global trade order that it has underpinned since the end of World War II. But such concern is likely unwarranted. Though the United States will be more willing to act independently outside the bounds of the WTO, it will not incur the economic risk of withdrawing from the bloc. Instead Washington will rely on it as an enforcement body, even as it compensates for the institution's weaknesses with measures of its own.

Despite the escalation, the White House will stop short of triggering a trade war. While U.S. trade partners will watch its moves with apprehension, they will respond mildly for the most part. Some, like Japan, will try to deflect Washington's advances by highlighting their strategic relationship with and investments into the United States. Others that come into the White House's direct line of fire will challenge its trade attacks at the WTO and in U.S. courts, where litigation could outlast Trump's current term. As for China, some punitive U.S. trade measures will even neatly intersect with Beijing's

domestic reforms and will not pose an existential threat to the Chinese economy.

## A Crude Recovery

Barring a major shock to the global economy, OPEC and non-OPEC oil producers hope to meet their goal of rebalancing the oil market in 2018. As the world's inventories continue to decline in the first half of the year, political divisions in Iraq and capacity constraints in Libya and Nigeria will mitigate the risk of oil producers extending their agreement to limit output into 2019. Signatories will hold a critical meeting to review their progress in June.

The biggest question next year is how well Saudi Arabia and its Gulf allies will see the pact through to its conclusion. They will try to shoulder the bulk of the burden of maintaining production cuts as compliance starts to slip among other members eager to exit the agreement. And as its expiration draws near, U.S. shale production will likely ramp up amid higher oil prices. Determined not to incentivize a strong recovery in U.S. shale output, Saudi Arabia and Russia may continue to collaborate in energy long after the current quotas have ended. For instance, Saudi Arabia can use Russian assistance to diversify its energy sector while working with Moscow to restrict production.

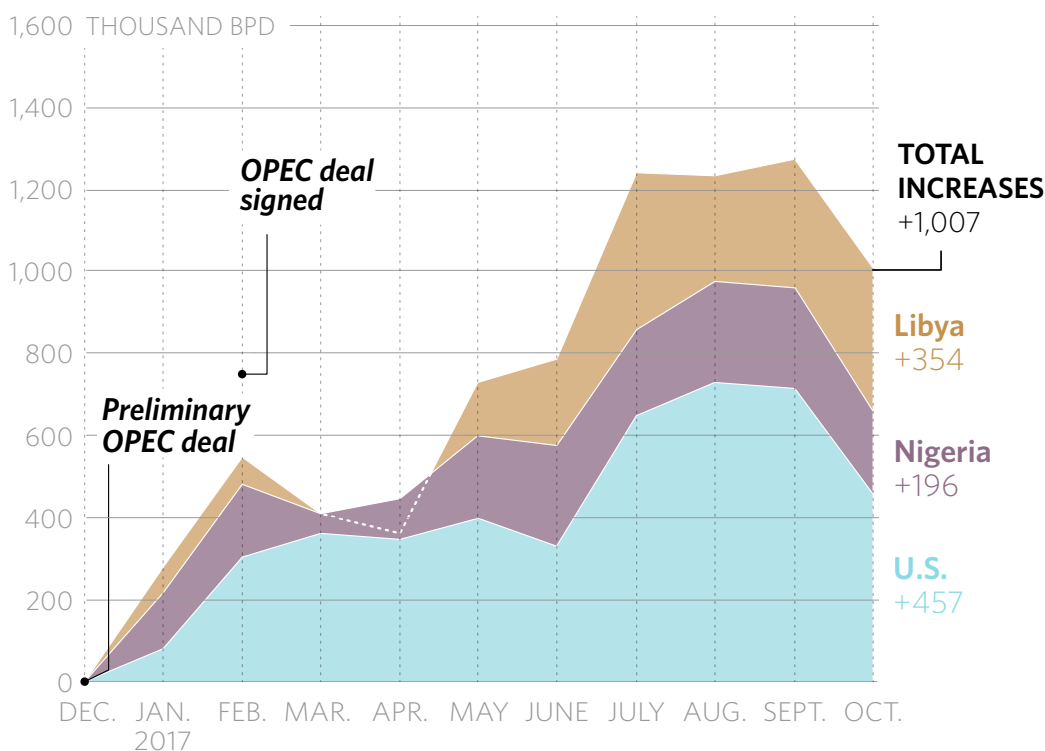
But this cooperation in energy will do little to defuse the competition intensifying in the Middle East. The Trump administration's vow to prevent Iran from following in North Korea's footsteps will bring Tehran and the fate of its nuclear deal with the West back into the spotlight. Saudi Arabia and Israel, keen to roll back Iranian influence while they have the blessing of the White House, will revitalize their campaign to weaken Iran and its allies, including Lebanese militant group Hezbollah.

Backed by Russia, Iran will have the resources to hold its ground as the war among regional proxies builds. But it will take care to avoid alienating



# Oil Production Cuts Offset by Production Increases

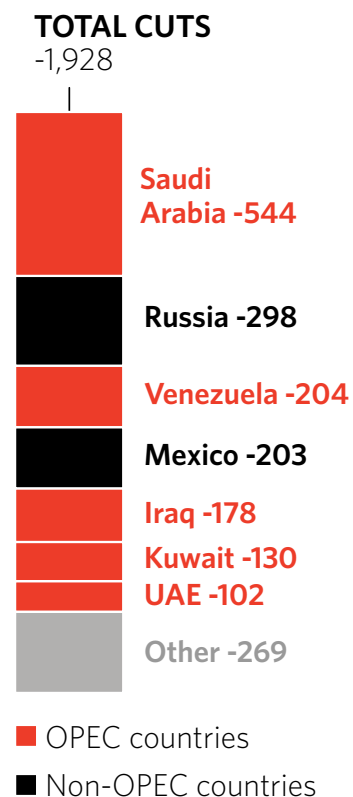
## Increases



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Source: Bloomberg; EIA; OPEC

## Cuts



Europe, which will be necessary in checking any effort by the United States to shred the Joint Comprehensive Plan of Action. The European Union, along with China, Russia and India, won't fully comply with U.S. attempts to reintroduce sanctions against Iran's energy sector. But if the nuclear deal collapses, oil producers may abandon their production cuts early as Saudi Arabia and Russia move quickly to account for the loss of Iranian supplies on the market.

Much of the urgency behind Saudi Arabia's reform agenda and preoccupation with the global oil market's recovery stems from a longer-term challenge that the kingdom and other oil producers face: the expansion of the electric vehicle market. Over the

past year, Europe, China and India spearheaded policy initiatives that aimed to boost the adoption of alternative-energy vehicles. Industry reports, moreover, point to growing demand for such cars in the short and medium term. As demand rises, so, too, will demand for the vehicles' batteries and the lithium they are made of. Though this trend will take decades to unfold, investment in the production of electric cars and related technology will increase next year. Because lithium resources are concentrated among only a handful of countries, including Argentina, Chile and Bolivia, several producers will be well positioned to take advantage of mounting interest in lithium — especially Argentina, since the Common Market of the South, to which the country belongs, will liberalize its trade policies in 2018. □



Thoyod Pisanu/Shutterstock

## Asia-Pacific

- As North Korea races to achieve a viable nuclear deterrent, the United States could choose to launch a military strike against it. But because of the steep costs that such action would carry, Washington is more likely to shift toward a policy of containment.
- China will take advantage of the United States' distraction in North Korea to deepen its conciliatory outreach to its Southeast Asian neighbors.
- Though the United States will intensify its economic offensive against China, the limits of those measures and Beijing's appeals within the World Trade Organization will prevent the outbreak of a trade war.
- At home, President Xi Jinping's steady consolidation of power will give him freer rein to

enact critical reforms. However, he will have to reconcile measures to improve financial stability and pollution control with the need to maintain stable growth.

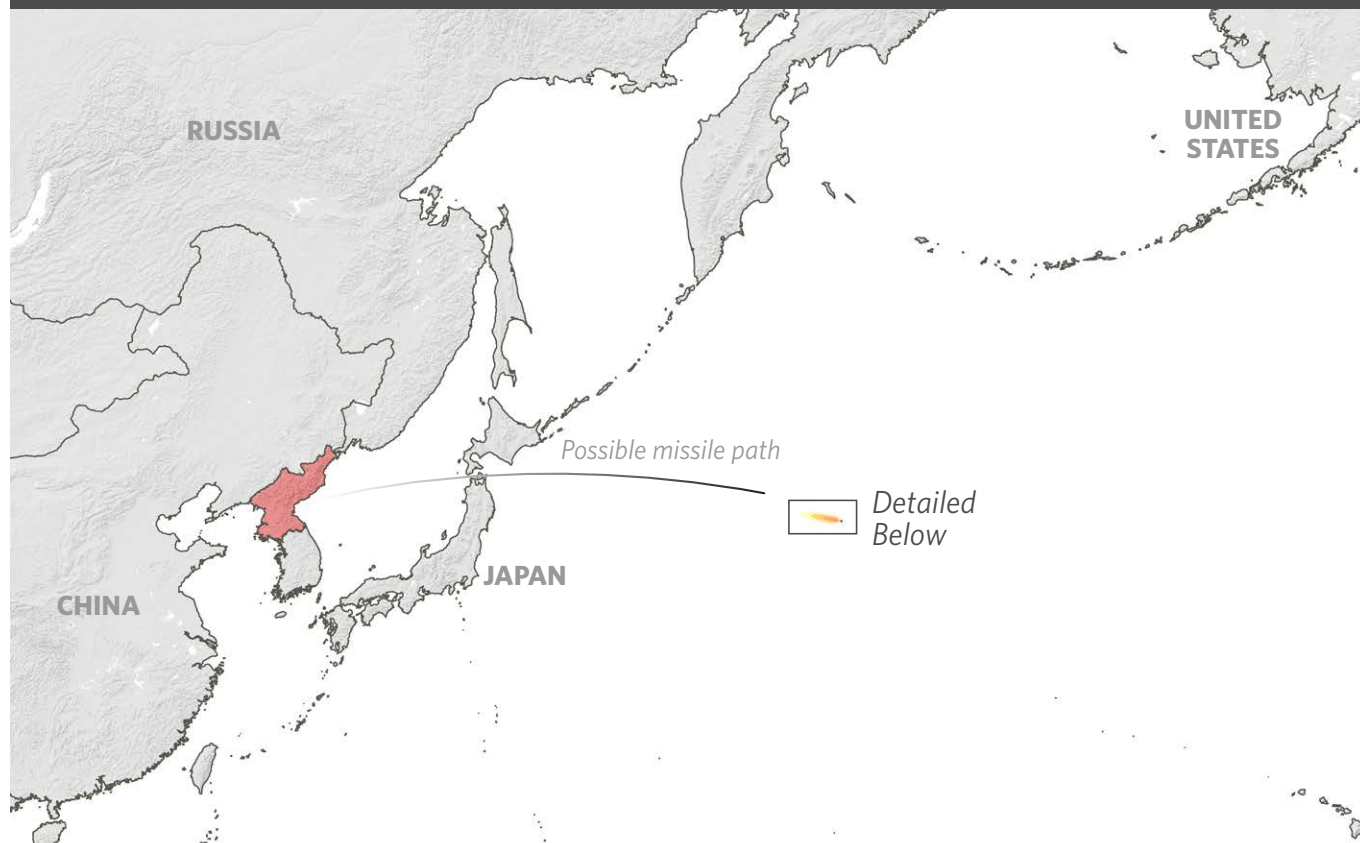
### Coping With a Nuclear North Korea

North Korea became the center of gravity in the Asia-Pacific region in 2017 as it passed the year with 16 missile tests and the underground detonation of a nuclear device. There will be no difference in 2018 as Pyongyang tests its weapons' re-entry and guidance capabilities, launches missile salvos over Japan, considers testing intercontinental ballistic missiles near their maximum range or conducts an atmospheric nuclear test over the Pacific Ocean. Though estimates vary, many experts predict that North Korea will achieve a viable nuclear deterrent in 2018.



## What a North Korean Nuclear Test Over the Pacific Might Look Like

North Korea would likely conduct any atmospheric nuclear test over the Pacific Ocean by launching a nuclear-tipped ballistic missile over Japan. Given the parameters and conditions involved, such a test could entail any number of scenarios. Though neither of the two depicted below are likely imminent, Scenario 1's high-altitude test is the more plausible. A surface test, while having a more localized impact, would do far more damage to anything in the vicinity.



### SCENARIO 1

**A 500-kiloton hydrogen bomb detonated at an altitude of 100 kilometers (62 miles)**

- Fireball radius: 730 meters
- No thermal radiation effects due to high altitude  
(The minimum burst height needed for a yield of 500 kilotons to produce appreciable fallout is 0.66 kilometers)

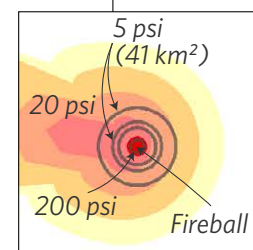
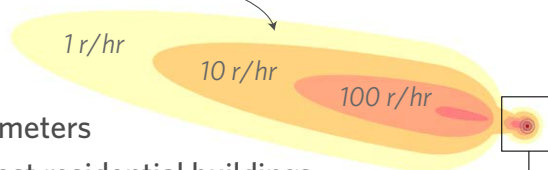
Fireball

### SCENARIO 2

**A 500-kiloton hydrogen bomb detonated at the ocean's surface**

Estimated maximum nuclear fallout contour of 13,362 square kilometers (5,159 square miles), assuming a wind of 14.4 kilometers per hour (9 miles per hour)

- Fireball radius: 950 meters
- Air blast of 5 psi: Most residential buildings collapse; injuries are universal; fatalities are widespread.
- Air blast of 20 psi: Concrete buildings are severely damaged or destroyed; fatalities are near-universal.
- Air blast of 200 psi: Results in pressure approximate to that felt inside a locomotive's steam boiler.



Note: r/hr = roentgen-hour

Within this tight window, the United States will have to decide whether to curb North Korea's nuclear capabilities by force or manage them through a strategy of deterrence. This weighty decision will be at the forefront of global leaders' minds next year, ultimately resting with U.S. President Donald Trump and his advisers.

The first (and less likely) scenario of crippling Pyongyang's nuclear program would require a preventive military strike. Should the United States choose this course, North Korea's response would have devastating consequences, including a massive disruption to regional trade that would heavily damage the electronics, automotive and appliances industries and send shockwaves throughout the global economy. South Korea would bear the brunt of North Korea's retaliation, though Japan may suffer attacks as well. China, meanwhile, would have to decide whether to intervene on the Korean Peninsula to secure a territorial buffer on its doorstep and to stem the outflow of refugees that would likely ensue — raising the specter of confrontation between it and the United States.

If Washington begins leaning toward a military strike, several signs will warn of its coming. First, the United States will pull out all the stops in its campaign to pressure Pyongyang into cooperation, perhaps even leveling harsh sanctions on some of China's core financial institutions and economic entities that do business with North Korea. These measures would come at a time when China is already undertaking a difficult overhaul of its economy, creating economic fallout in and beyond the region.

Second, the United States and its Asian allies would begin moving their military hardware. Washington would order the long-term deployment of two or three carrier battle groups to the waters around the Korean Peninsula; regional intelligence, reconnaissance and surveillance assets would increase; land-based air power, such as stealth fighters, would relocate nearby; submarine deployments would be-

come more frequent; and South Korean troops and reserves would mobilize. Of course, the absence of any or all of these developments wouldn't rule out a preventive strike, since the United States is capable of launching a limited attack on North Korea with its existing presence in the Asia-Pacific. Moreover, an attempt to shoot down a North Korean missile, successful or not, could spark a war.

Barring the unlikely event of a coup in Pyongyang, any measures short of military action won't sway North Korea from its path toward a credible nuclear deterrent. Despite agreeing to a severe U.N. sanctions package against the country in 2017, neither China nor Russia wants the North Korean government to collapse. As a result, they will avoid any action that jeopardizes its stability unless they believe the measures would forestall a strike by the U.S. military. Even if the international community deepens its sanctions regime to an oil embargo or trade ban, North Korea has many tools at its disposal for insulating its leaders and achieving its not-so-distant nuclear goals.

Given the massive costs that a military strike against North Korea would carry, as well as the short time frame in which it must be executed, the United States is more likely to choose its second option: containment and deterrence. The former might entail the economic isolation of the North Korean government, with the intent of limiting the growth of its nuclear arsenal. The latter would involve the gradual buildup of ballistic missile defenses, the permanent monitoring of North Korean activities and the compression of military decision-making channels among the United States and its allies.

Still, a strategy of deterrence carries its own long-term risks, including a heightened threat of miscalculation, similar buildups by Russia and China, and the nuclearization of South Korea and Japan. Furthermore, the fortification of a U.S.-aligned defense infrastructure around North Korea could undermine the missile architecture of Russia and China, bringing their mutual interests further in line,



just as the deployment of the U.S. Terminal High-Altitude Area Defense system to South Korea has.

As tension mounts on the Korean Peninsula, the United States will work to renew the resolve of its most important regional allies. Over the past year, its ties with South Korea and Japan have strengthened. Though Seoul firmly opposes the idea of a preventive military strike against Pyongyang, neither it nor Tokyo would be able to stop Washington from launching one. Even if the United States rejects that route, a pre-emptive strike meant to interrupt an impending North Korean attack would still be on the table.

## China in Transition

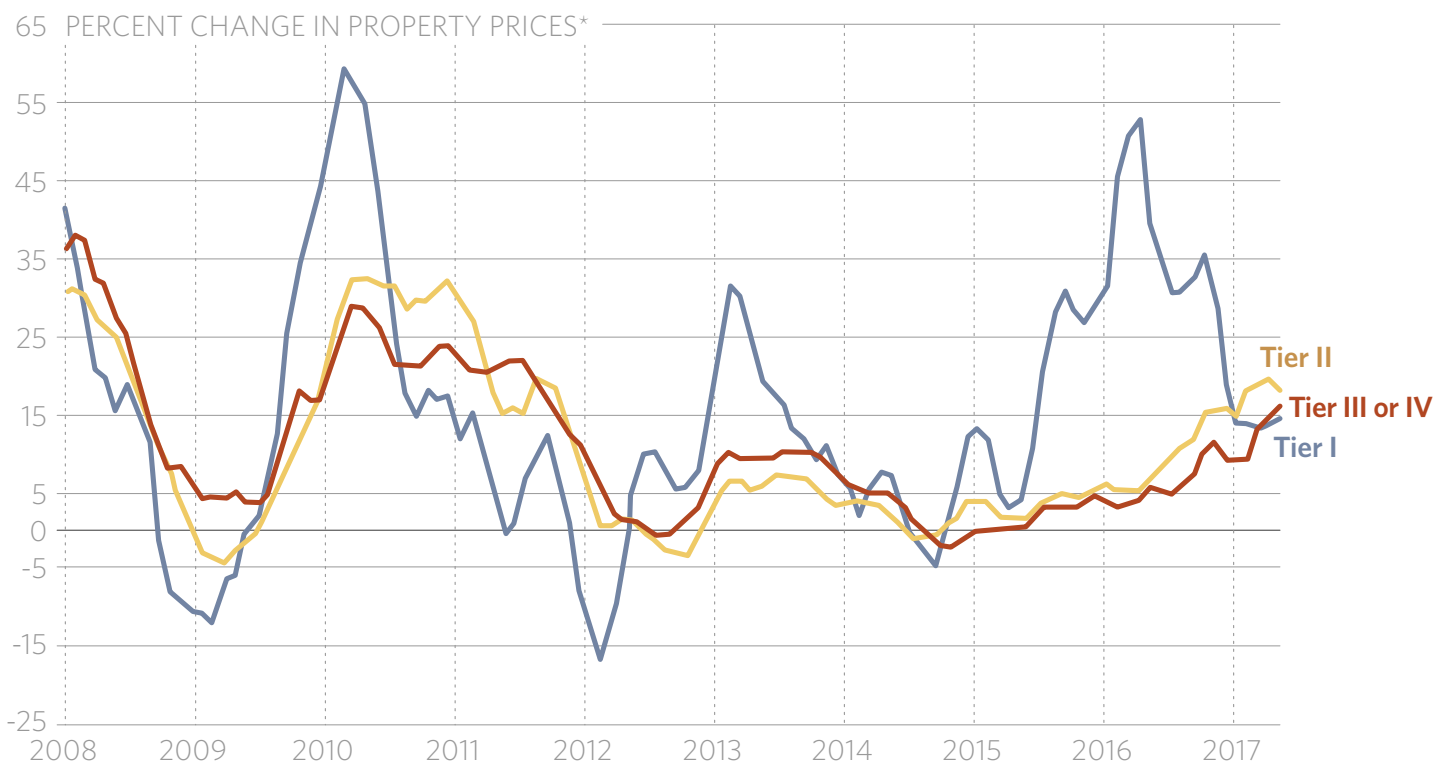
If the unlikely possibility of war on the Korean Peninsula comes to pass, it would have a devastating effect on the political and economic stability

that China has worked for the past three decades to preserve. But beyond the potential crisis brewing next door, China has no shortage of internal challenges to address as it enters a new political and economic era. In many ways, Chinese President Xi Jinping's consolidation of power over the past five years is the result of the country's transformation over the past 30 years as the ruling Communist Party has struggled to weather the profound domestic and international challenges it faces. As Xi starts his second term, maintaining his unrivaled authority will be imperative, particularly as a critical period of China's ongoing restructuring begins.

Xi's newly amassed power will help him marshal the resources and forces he needs to advance his vision for China. This future calls for the substantial redistribution of wealth; greater socio-economic equality; a stronger Party, state and military apparatus; and the projection of power to match the country's rising

## China's Cooling Property Prices

Various targeted policies and regulations have helped bring property prices in China's Tier 1 cities (Beijing, Shanghai, Guangzhou, Shenzhen) down from their 2016 highs.



\*Year-on-year three month moving average

Source: Local Housing Administrative Bureau; NBS; Institute of International Finance

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influence worldwide. Each of these goals is difficult to implement and is made up of many equally daunting objectives that require the ability to push tough reforms through many different interest groups. However, the close coordination of policy within a robust Party and state structure will remove some of the obstacles ahead of Xi, paving the way for the more challenging and politically sensitive reforms as he deems necessary.

Xi's tight grip on power will also create high expectations, though, leaving him little room to guard against policy inefficiencies or failures. Here the Communist Party's ability to keep demonstrating its commitment to identifying and punishing the misdeeds of government officials and institutions is key. The Party will establish an anti-corruption supervisory body, the National Supervision Commission, in March. The new organization will lend additional momentum, enforcement and oversight to the campaign against graft that has underpinned Xi's political agenda and ability to sideline opponents. But it may also fuel concerns about the abuse of power, particularly at the local level. As Beijing feels more

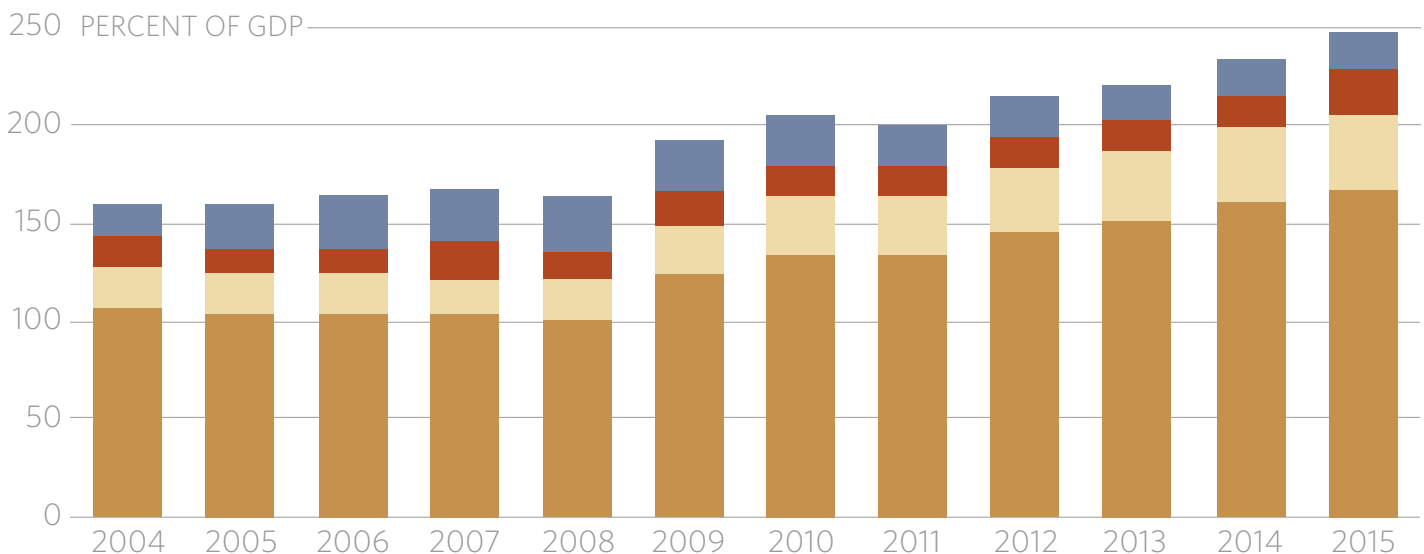
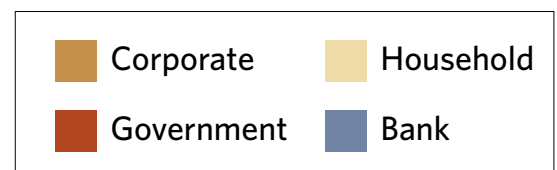
compelled to defend its authority, it will rely on political and ideological conformity, the control of the media or the suppression of dissidents to enforce its official line, risking backlash in the process.

Next year Xi's agenda will center on the challenging socio-economic issues plaguing China. The economy's growth is slowing, compounding the country's substantial regional and social inequality, distorted financial systems and severe environmental degradation. After several years of gradual progress, the Communist Party will look to speed the pace of reform ahead — testing its ability to shore up legitimacy as the economy loses steam. With an eye toward the redistribution of wealth, Xi will accelerate fiscal reforms in 2018, channeling more money to underdeveloped regions and bolstering the financial base of local governments. At the same time, China will keep taking steps to improve social welfare as reforms to land policies and the hukou system of household registration take shape.

Despite its eagerness to push ahead with its plans, Beijing will proceed with some caution to make sure

## The Growing Mountain of Chinese Debt

Increasing corporate debt in China in the past few years has been fueled by a turn toward domestic investment, especially in its construction sector.



Source: Bloomberg

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that the rapid rate of reform doesn't endanger social stability. To that end, fiscal proposals will focus on issues that aren't politically sensitive, such as the implementation of environmental taxes, an uptick in resource taxation and the reduction of taxes for small businesses and individuals. Though China may also take steps toward imposing a property tax, the country's highly leveraged real estate market could delay any attempts to enact the measure nationwide. Nevertheless, the public's expectations of the government's efficacy will ramp up alongside its effort to contain soaring property prices, especially in large cities.

China likewise will keep in place production cuts in heavy industries like coal and steel while trying to deleverage those sectors. At the same time, it will more closely enforce environmental regulations. But it will do so only to the extent that these efforts don't seriously disrupt employment and stability, particularly when it comes to shutting down the country's struggling zombie corporations, or state-owned enterprises operating at a loss. Beijing's attempt to tackle inefficiency in the heavy industries may put upward pressure on the prices of commodities like coal and steel, offsetting slowing investment. If commodity prices rise, the government would have more leeway with the public to hasten its campaign.

Ensuring financial stability will be at the top of Xi's economic agenda. China's mountain of debt will grow steadily higher over the next four years, climbing from 251 percent of the country's GDP today to as much as 320 percent by 2022. However, throughout 2017, Beijing worked to reduce the country's most dangerous debt burdens and pre-empt the risks posed by the rest. It also offered debt-for-equity swaps and private capital to state-owned enterprises, reinforced oversight mechanisms, closed legal loopholes on shadow lending and tightened real estate regulations in major metropolises.

China will feel the benefits of these measures in 2018, but they won't guarantee the country a stable

financial future. The new year will bring new sources of strain as high maturity rates are applied to overlapping corporate and local debts for the next three years. At the same time, the creation of credit and the Chinese real estate market appear likely to stall. Stress in the real estate sector, which will account for half of China's corporate debt maturity in 2018, could in turn carry substantial risks: Not only would a meltdown in the market trigger a series of corporate defaults, but it would also put considerable pressure on the country's financial system.

China has the fiscal and regulatory tools to avoid this scenario, at least on a national scale. However, a localized debt crisis or collapse in the real estate market cannot be ruled out, especially in the vulnerable and heavily indebted areas of the northeastern rust belt, central provinces and heavy industries such as construction, utilities and steel. At best, a contained catastrophe would detract from China's ability to maintain its economic growth and pursue difficult reforms; at worst, it could result in local corporate defaults, bankruptcies and even popular discontent.

## Globalization, Evolved

As China seeks to address its economic problems at home, several factors beyond its borders will help determine its success. Assuming war does not break out on the Korean Peninsula, China will find much-needed buyers for its exports in the steady economies of Europe and the United States. This relief will be particularly well-timed, considering China's investments in fixed assets — a cornerstone of its economy — will continue to slow next year.

On a less positive note, 2018 will bring the real possibility of heightened tension with the United States in trade as the White House more strictly enforces regulations. China will be one of its primary targets, which — along with the protectionism spreading worldwide — could put pressure on the Chinese economy. Over the past year, U.S. trade



measures against China have been largely confined to anti-dumping action; next year they will likely be broader. Even so, both powers will manage their dispute enough to prevent it from escalating into a full-blown trade war.

The United States has erected trade, investment and intellectual property barriers against China for quite some time. However, Trump has wielded these tools more aggressively than many of his predecessors. Combined with his administration's skepticism of multilateral trade mechanisms and determination to reduce the U.S. trade deficit, this approach has encouraged the White House to forgo the use of the World Trade Organization (WTO) to settle trade disputes where possible.

The United States used this year to lay the groundwork for a two-pronged offensive against China. First, it opened an investigation into Chinese intellectual property practices under Section 301 of the Trade Act of 1974. Second, it began to scrutinize national security concerns related to the steel industry under Section 232 of the Trade Expansion Act of 1962. Both of these developments will come to a head in the next 12 to 18 months. On matters covered by the rules of the WTO, the United States will challenge China's intellectual property practices through the organization. More often, however, it will target Beijing's behavior beyond the WTO's bounds. The White House may focus on the sectors it explicitly mentioned in its trade strategy, including heavy industries like steel, automotive and some electronics. Washington will also enter into negotiations with Beijing to persuade it to ease certain trade and investment barriers. Meanwhile, the United States could pursue additional action against Chinese steel and aluminum under the auspices of its national security review. Divisions within the Trump administration might limit the use of this option, though, especially as China keeps slashing production in both industries.

For its part, China will answer by bringing cases to the WTO in hopes of responding with measures

sanctioned by the organization. But to hedge its bets, China will also build out its own intellectual property protections — safeguards it increasingly has use for as its companies pump out higher-value products. In addition, Beijing will use the promise of easing its technological transfer requirements or opening up its financial, services and renewable energy-fueled vehicle markets to dissuade Washington from applying more pressure to the Chinese economy.

Though Xi has vowed to open up China's markets before, foreign investors have been dissatisfied with the lack of progress during his first five-year term in office. The Chinese state's steady consolidation of economic power has only added to their frustration. That said, as Xi and the Party achieve the level of control they seek, they may resume many of their long-delayed reforms. To that end, Beijing will test the waters of market liberalization by creating more room for foreign investment in pilot regions like the Shanghai free trade zone. But China will proceed only insofar as these projects align with its overarching strategy, ensuring that they won't be drastic enough to deter punitive trade measures by the United States.

In fact, under its Made in China 2025 initiative, China has dramatically expanded the role of the state in corporate investments into strategic sectors overseas, such as semiconductors and artificial intelligence, for the past three years. Such moves will keep causing concern in developed markets like the European Union and the United States as the competition heats up in high-end markets and accusations of unfair Chinese practices abound. Consequently, Western countries will keep a closer eye on Chinese investments into their high-tech industries.

China's persistent quest for market-economy status within the WTO — against the wishes of the United States and the European Union — will be another source of friction. To make matters worse, Beijing has opened cases within the organization against both parties; a verdict on China's dispute with the European Union will likely appear by early 2019.

Should the Continental bloc and the United States lose their cases, they probably will remain steadfast in their demands of China. Washington will be particularly reluctant to relent, perhaps forcing Beijing to return to the negotiating table.

Of course, China won't be the only country in the United States' crosshairs. Japan and South Korea have experienced similar pressure from their increasingly protectionist ally as the United States seeks to reduce its trade deficits with them. They, too, have tried to avoid drawing Washington's ire. Tokyo was somewhat successful on this front in 2017, and it will continue to fend off Washington's demands. Seoul, on the other hand, faces the lengthy process of renegotiating its free trade agreement with Washington.

During these talks, the United States will likely push for greater access to South Korea's automobile, electronics and agriculture sectors. At the extreme, Washington may even renounce the pact if it is not satisfied with the results of the talks. Though South Korea has little interest in jeopardizing its relationship with the United States amid the imminent threats emanating from North Korea, any disruption to their trade arrangement will strain the South Korean economy — giving countries like China an opportunity to exploit the rift widening between the two allies.

The premium that Washington has placed on bilateral trade negotiations will only encourage other countries in the Asia-Pacific to seek out multilateral trade platforms that exclude the United States in order to advance their own agendas. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership — a version of the shuttered Trans-Pacific Partnership that the United States does not belong to — still needs to reconcile its members' conflicting opinions and navigate issues surrounding state-owned enterprises, dispute resolution mechanisms and cultural exemptions. But as the deal gradually takes shape, potentially granting Japan a bigger role in setting regional trade

policies, China may feel the need to fast-track its own proposal for an economic bloc: the Regional Comprehensive Economic Partnership.

## The New Silk Road

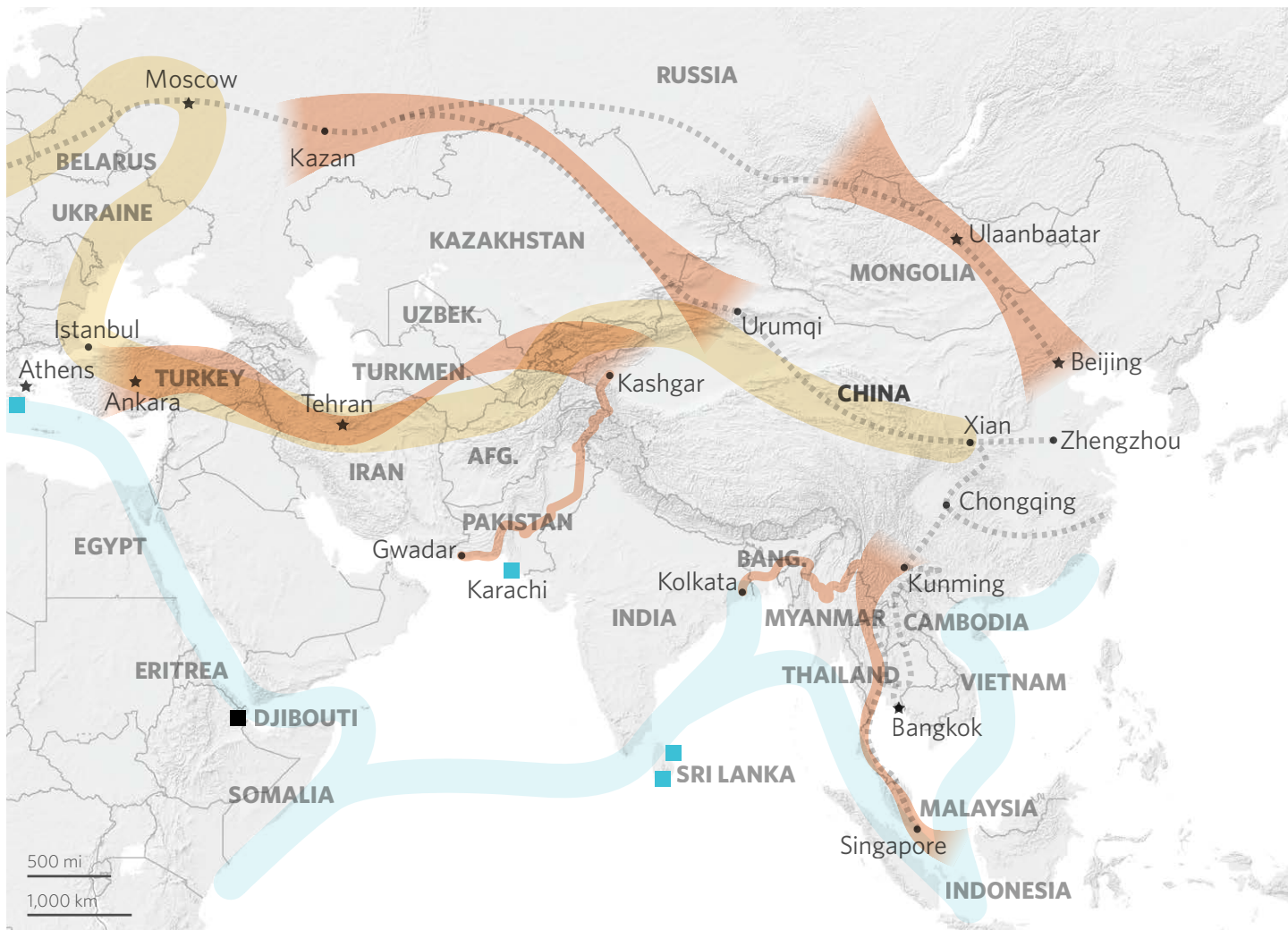
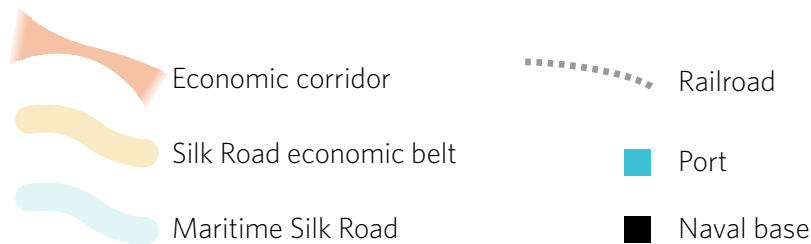
As the United States has tried to scale down its commitments abroad, China has seized the chance to expand its own, in part because its ever-growing interests overseas demand a coherent global strategy. Beijing's sprawling Belt and Road Initiative is one means of extending its influence. Despite China's tendency in 2017 to regulate investments that it believes to be irrational — those in the entertainment, real estate and cultural sectors, to name a few — it will steadily funnel money into the Belt and Road Initiative. The government's strategy of helping Chinese firms climb the value chain will facilitate these financial flows. However, its attempts to ease domestic debt burdens may also undermine corporate finances, potentially cutting off funds to projects whose plans or locations carry added risk.

The Belt and Road Initiative is closely intertwined with China's attempt to increase its global outreach as the international system evolves. In some ways, that evolution may help Beijing achieve its goals. Mounting U.S. pressure has brought Russia's interests into closer alignment with China's — in part because both countries share the desire to insulate themselves from U.S. sanctions. Their burgeoning partnership could increase China's access to Central Asia and the Middle East. In the meantime, as the United States adjusts its strategy in Afghanistan, putting further strain on its relationship with Pakistan, China may have an opportunity to cement politically sensitive projects along the China-Pakistan Economic Corridor as Islamabad turns to Beijing for closer security cooperation.

China's endeavors will not always go smoothly, though. When the Shanghai Cooperation Organization summit convenes in China in June, Beijing will try to expand the bloc's agenda on

# China's Belt and Road Initiative

The massive connectivity initiative, first unveiled in 2013, combines China's long-standing visions for the Maritime Silk Road and Silk Road Economic Belt, targeting 64 countries and 15 Chinese provinces for transportation, energy and trade projects.



Source: Mercator Institute for China Studies

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economic and infrastructure initiatives. But the move will likely encounter resistance from India, which has opposed the Belt and Road Initiative as it has watched China's growing assertiveness in the region with trepidation. In fact, Beijing's ambitions will spur New Delhi to team up with China's regional rivals, including Japan, to advance competing infrastructure projects in Southeast Asia and Africa and to increase security cooperation. At the same time,

political instability, regional groups, local insurgencies, funding problems and suspicions of China's motives will continue to endanger Beijing's connectivity schemes in Central and South Asia.

Closer to home, China will keep relying on a combination of diplomatic pressure and military coercion to curb Taiwan's outreach to other countries, including the United States and its allies. Meanwhile, to

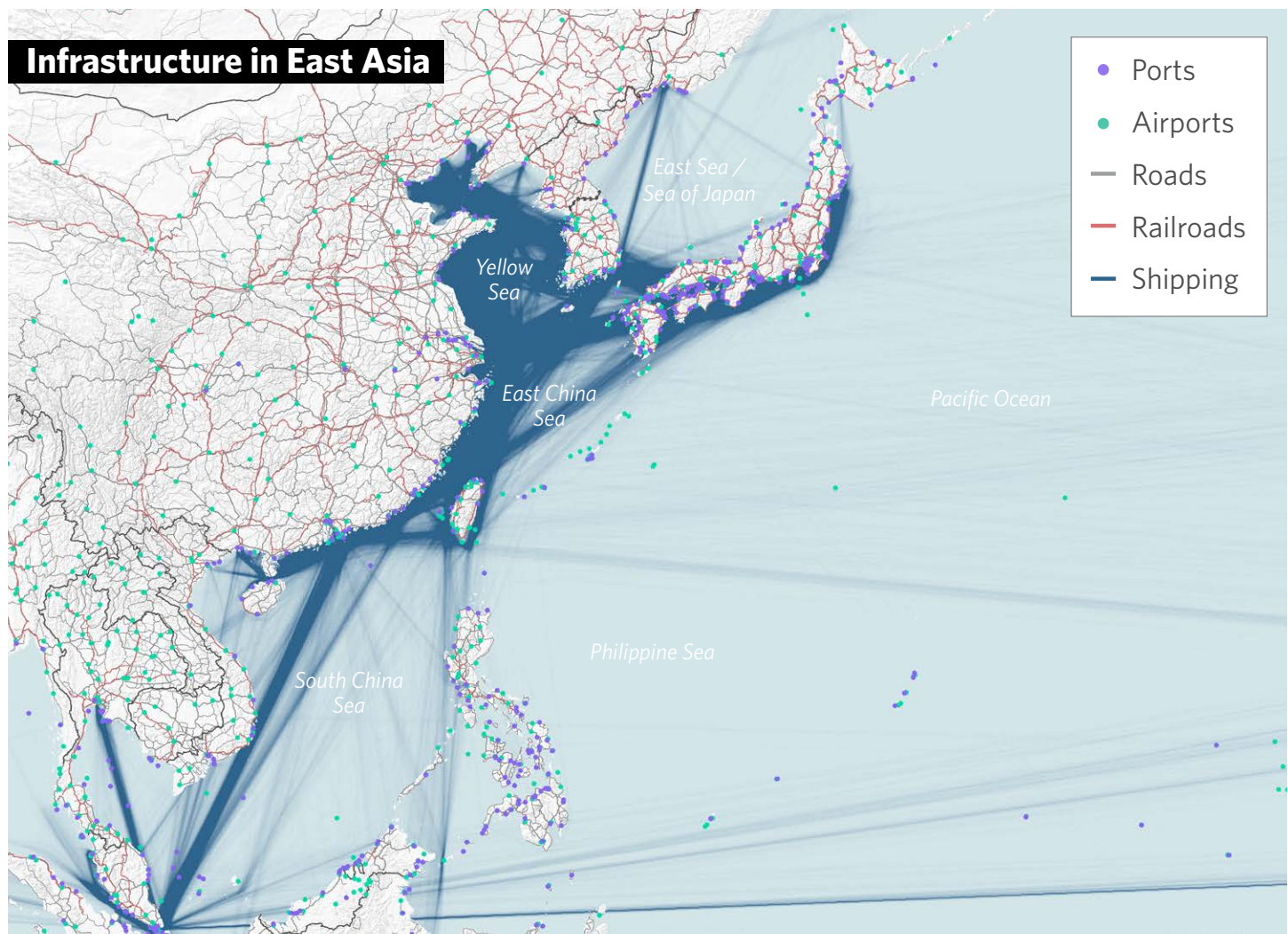


the west, Beijing may have a rare opportunity to pursue a dialogue with Tibet's government in exile as the Dalai Lama ages. The path toward negotiation is all but certain, but talks would enable Beijing to limit New Delhi's ability to leverage the Tibet issue as the Sino-Indian rivalry and border dispute intensify.

## China's Neighbors Strike a Precarious Balance

Though North Korea's recent activities have drawn the United States' attention to the Asia-Pacific, Washington's engagement in the region will diminish in the long run. China's presence, however, will grow. As a result, countries in the region will try to both work with and counter Beijing, a balance that will come to define the Asia-Pacific in the years ahead.

This year, friction between Beijing and Seoul worsened over the deployment of U.S. Terminal High-Altitude Area Defense missile systems to South Korea, eventually triggering the imposition of economic countermeasures by China. Tension likewise marred China's relationship with Japan as the two sparred over the East China Sea throughout 2017. But toward the end of the year, Beijing's ties with its rivals warmed: China and South Korea normalized relations, while Japan hinted that it might participate in China's Belt and Road Initiative. Next year may even bring a trilateral summit for the three neighbors — a gathering that has been suspended since 2015 because of their quarrels. This hardly means their contest for regional dominance will subside. There is, however, room for the North Korean threat, mutual economic interests and the United States' drift away from its current alliances to erode their enmity for one another.



Data: National Geospatial-Intelligence Agency, UCSB NCEAS

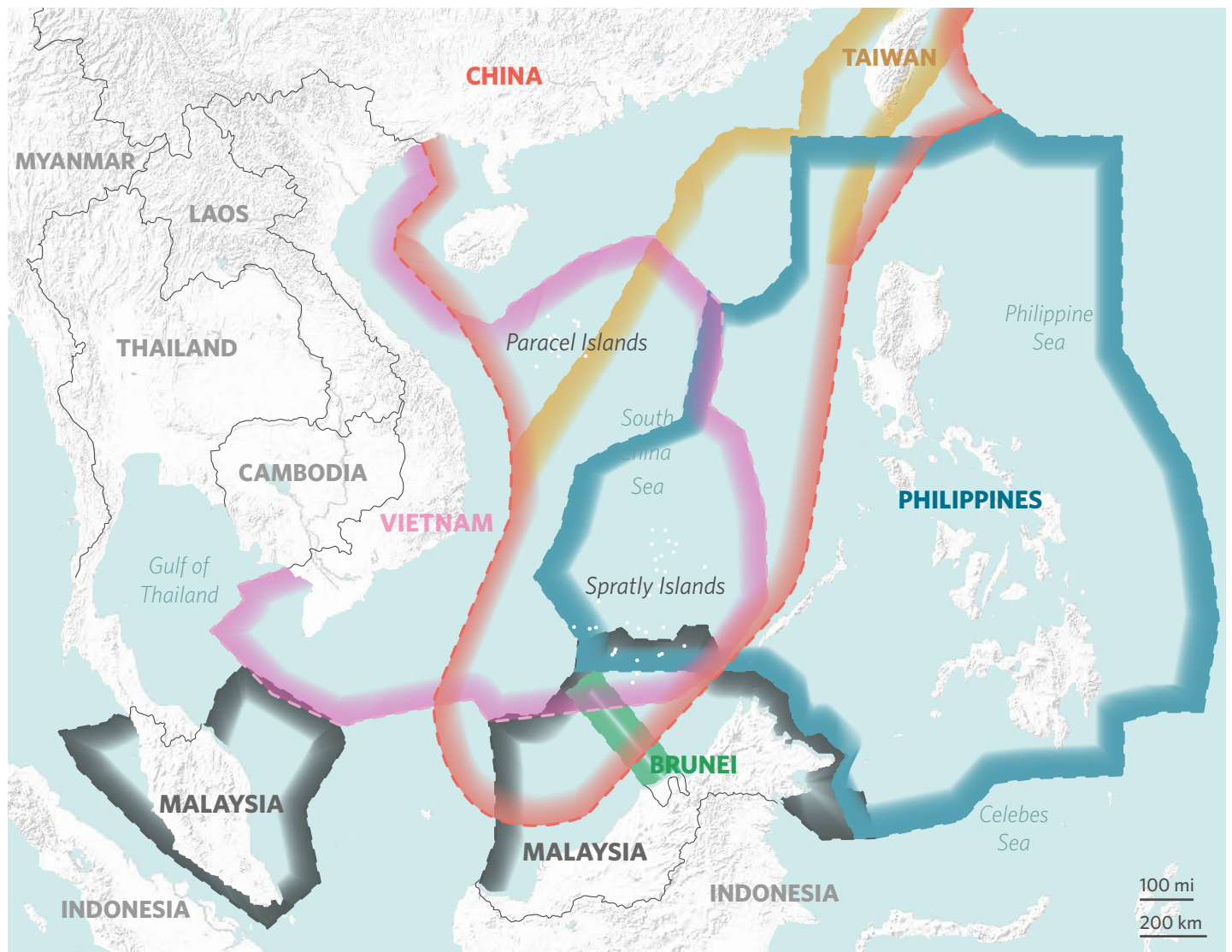
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The easing of tension in Northeast Asia won't preclude the formation of coalitions intended to contain China. Chief among them is the U.S.-led Quadrilateral Security Dialogue, which includes Japan, India and Australia. As new formats evolve, the powers interested in curbing China's reach will try to settle their internal differences as their security cooperation deepens. Australia will serve as a

key swing state because of its strong trade relationship with China and domestic controversy stemming from those ties. By contrast, Japan and India will form a sturdy front against China. By no means does the bloc portend a formal security alliance — or even alignment — among members, but its loose agenda could appeal to countries with a mutual interest in containing Beijing, such as Singapore and

## Territorial Claims in the South China Sea

Six countries lay claim to at least a portion of the resource-rich Spratly Islands. The overlapping maritime claims combined with China's maritime expansionism and the involvement of major naval powers have roiled the waters in the South China Sea for most of the past six years.



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Vietnam. China, for its part, will approach individual countries in an attempt to dilute the coalition coalescing against it.

China will use a similar strategy to take advantage of the United States' distraction with North Korea. Beijing will redouble its efforts to reach out to claimants in the South China Sea, offering compromises that reflect its pre-eminent position in the disputed waterway. This year, China achieved several diplomatic victories with this tactic, including progress on drafting a nonbinding code of conduct in the South China Sea with the Association of Southeast Asian Nations (ASEAN). Beijing will use next year's negotiations over the deal to showcase its success — and to discourage interference by external powers. Though U.S. operations in the contested waters will continue unabated, China will guard against the United States' attempts to encourage countries like Australia, Japan and India to increase their participation and responsibilities in the region.

China also succeeded in preserving its detente with the Philippines as the two countries took strides toward joint energy exploration and coast guard drills. The Philippines, too, aims to protect its sovereignty over its maritime territory. But Manila's conciliatory approach toward China has freed much-needed capacity to deal with urgent issues at home. Though Philippine forces managed to reclaim Marawi City from the Islamic State this year, political and security problems will continue to plague the country in 2018. The administration of President Rodrigo Duterte will turn its attention to revising the constitution, passing legislation to support its peace deals with Moro rebels, securing the restive region of Mindanao and reining in communist militants. With so many concerns to address at home, the Philippines cannot afford to take a tougher stance against China. And though the Philippines' security relationship with the United States will persist, it will not endanger the country's budding cooperation with China.

China's ties with the other major claimant in the South China Sea — Vietnam — are not so friendly.

Over the past year, the two countries canceled military meetings, Beijing pressured Hanoi to halt energy exploration activities in the sea, and a U.S. aircraft carrier visited Vietnam for the first time since the end of the Vietnam War. Though national debt and economic reforms will top Hanoi's agenda in 2018, Vietnam is more stable than the Philippines and will have more space to try to counterbalance China. Just as it did in 2017, Vietnam will try to draw other countries such as Japan, India, Russia and the United States into the South China Sea.

ASEAN will not have the same clarity in its dealings with China. Instead the bloc will face numerous obstacles as it tries to navigate the Chinese-U.S. rivalry in the region, terrorist threats and economic uncertainty. This year, disunity rose within the bloc as some of its members, including the Philippines, struck out on their own to form policies toward China. Such discord will only worsen in 2018 as member states cope with problems at home. For instance, the popularity of the governments in Cambodia, Malaysia, Indonesia and perhaps Thailand will be put to the test in national or local elections next year.

## A Japanese Awakening

As a crisis of nuclear proportions brews on the Korean Peninsula, it will spur Japan ever onward in normalizing its military by bolstering its missile defenses and exercising the enhanced powers outlined in security legislation passed in 2015. The ruling Liberal Democratic Party will also use the popular mandate it received after it swept elections in late 2017 to forge ahead with its agenda for constitutional reform. However, the party likely won't meet the ambitious timetable that Prime Minister Shinzo Abe laid out in mid-2017 as it works to avoid a dip in public opinion. Moreover, Abe's administration will spend next year trying to contain corruption scandals and internal jockeying ahead of a transition in party leadership in late 2018. The commotion could sap legislative resources and undermine the prime minister's popularity. Still, Japan will enter



into the new year with seven consecutive quarters of economic growth under its belt, thanks in large part to rising global demand and Tokyo's stimulus measures. This feat could finance further economic reforms, particularly those that center on wages, income taxes and labor laws.

As the North Korean crisis and a mutual interest in countering the West pull China and Russia closer

together, Japan will seek better ties with both. On some level, Tokyo may work with Beijing on its Belt and Road Initiative. Meanwhile, Japan will move forward with economic cooperation with Russia in the Kuril Islands in pursuit of a peace treaty to officially end their World War II-era hostilities and resolve territorial disputes. All the while, Tokyo will work with Washington to try to pressure Pyongyang to change its behavior. □





Franck Fife/AFP/Getty Images

## Americas

- In 2018, U.S. President Donald Trump's administration will try to implement more of the protectionist trade agenda it unveiled in 2017. Though the possibility remains that the United States could unilaterally withdraw from the North American Free Trade Agreement, the deal's supporters would turn to Congress and the federal courts in that event to prevent NAFTA's demise.
- Dissatisfaction with the political status quo will influence presidential races in Mexico, Brazil and Colombia.
- Brazil and Argentina, South America's two biggest economies, will take advantage of their pro-trade governments' remaining time

in office to forge deeper trade ties with other economic blocs and countries.

- As the United States and its Latin American allies press for free elections in Venezuela under the threat of further sanctions, Venezuelan President Nicolas Maduro's administration will resist any efforts to erode its authority while trying to mitigate the fallout from the country's rapid economic decline.

### Pushing On With Protectionism

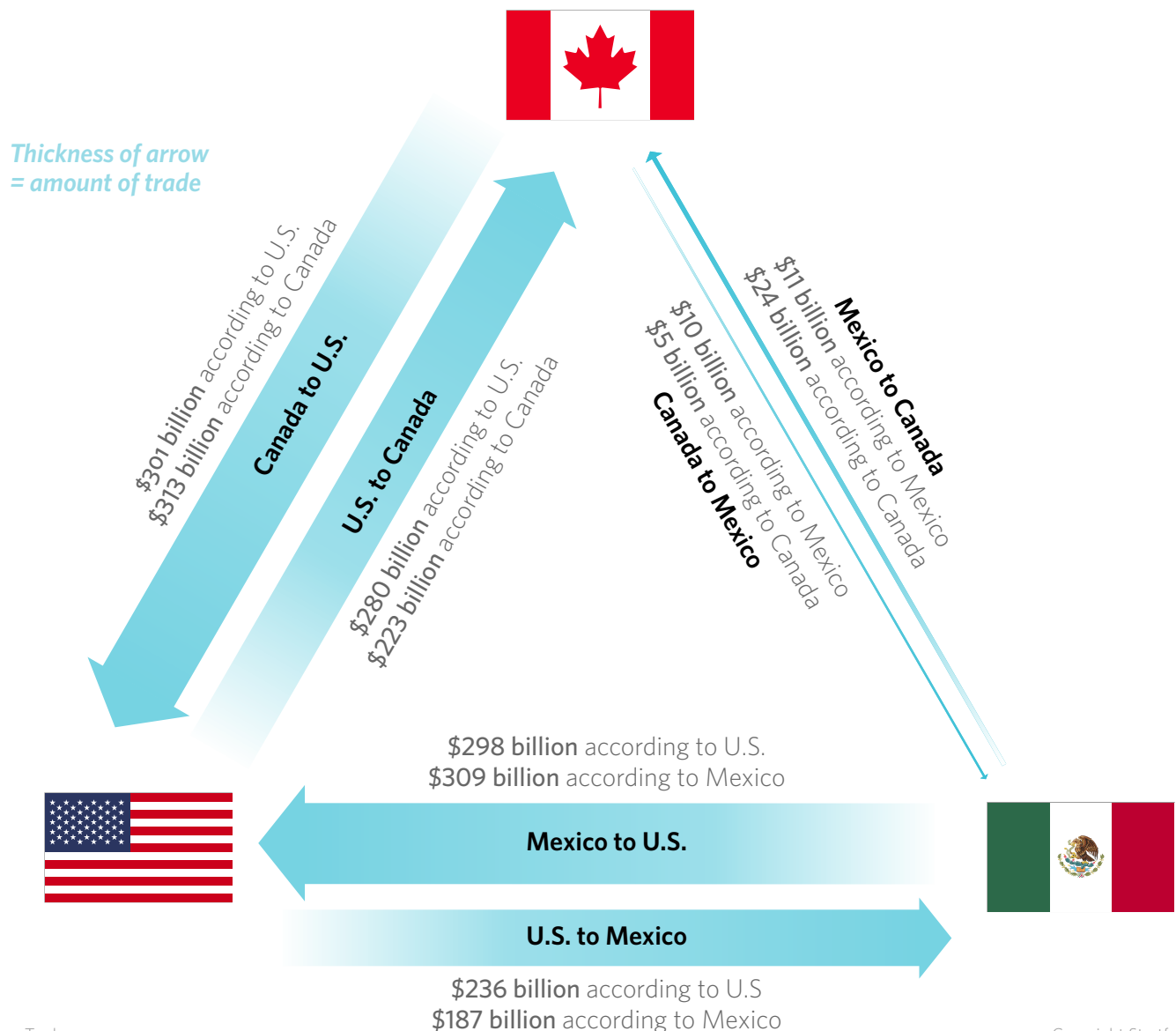
As U.S. President Donald Trump's administration enters its second year, it will continue to contend with the limits of presidential power to shape foreign

trade, security relationships and domestic legislation. Trump wasn't as tethered to the Republican Party's policy desires or as subject to its influence as were many of his competitors for the party nomination. Having emerged as a candidate from outside the party's established political network, he had fewer direct connections to it. This relative freedom has given the president more leeway to entertain (and in some cases, enact) ideologically motivated policy changes that his predecessors found politically untenable, including a more protectionist trade agenda and more stringent immigration restrictions. Nevertheless, Trump doesn't rule in a vacuum,

and many of the factors that will make or break his ability to keep campaign promises are beyond his control. The presidency will go through yet another year trying to align its policy wishes with reality.

Throughout 2018, the Trump administration will try to implement specific aspects of its protectionist trade agenda. Washington, for instance, will proceed with its investigation of alleged Chinese intellectual property theft and forced technology transfers. The inquiry may lead the U.S. government to take retaliatory action against Beijing inside as well as outside the World Trade Organization trade

## Trade Between NAFTA Members



Source: Trademap

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regime. In addition, the White House may make a decision in the coming year about whether it will try to renegotiate the United States-Korea Free Trade Agreement (KORUS), from which Trump has threatened to pull the United States.

KORUS won't be the only trade agreement up for discussion, either. Early in 2018, the administration will decide whether to continue its talks with Mexico and Canada to revise the North American Free Trade Agreement (NAFTA) or to withdraw from the deal. The negotiations reached an impasse this year because Canadian and Mexican officials disapprove of U.S. proposals to raise national content requirements, tighten rules of origin and eliminate investor-state dispute-settlement mechanisms. Though the three sides could still overcome their differences, the odds that they will reach an agreement early in 2018 are looking slim.

Trump will base his NAFTA decision on the advice of his Cabinet and on his own analysis of the potential risks and benefits of pulling out of the deal. Appeals from concerned Republican legislators and private-sector lobbyists could soften the administration's negotiating stance. A withdrawal, after all, would probably cause widespread disruptions in an array of important sectors in the U.S. economy. The risk of an electoral backlash in the states that most depend on NAFTA — and the economic damage that withdrawing from the agreement would wreak — could sway Trump to stay in the talks.

But the president is mercurial enough, and his core political base opposes NAFTA staunchly enough, that he could still decide to unilaterally back the United States out of the deal. In that event, NAFTA's proponents would try to use Congress and the federal court system to halt the withdrawal. The U.S. Congress could try to prevent an attempt to pull out of the deal by pressing, for instance, for a joint resolution to mandate congressional approval of such a move. Legal challenges would also mount against an effort to withdraw from the trade area since leaving NAFTA would cause uncertainty for

so many governments and businesses. The deal's demise could result in the loss of 200,000 jobs, mainly in Southern and Midwestern states — a grim prospect for the Republican Party, which will depend on support in those regions in the midterm congressional elections in late 2018.

The likelihood of a unilateral attempt to pull out of NAFTA will rise, however, the longer the United States, Canada and Mexico negotiate without arriving at a consensus on the deal's future. With the U.S. midterm elections and the Mexican presidential race looming on the horizon, Trump will be eager to wrap up negotiations before the votes. Otherwise, the president may wind up dealing with a new Congress or a different administration in Mexico, either of which could scuttle a revised free trade agreement.

Beyond NAFTA, the approaching midterms could interfere with other parts of the U.S. administration's agenda in 2018. As Congress wraps up major legislative projects such as tax reform and gears up for campaign season, the general unity that prevailed in the Republican Party throughout this year will come under strain. Some Republican lawmakers, especially those whose seats are less secure, will begin distancing themselves from the administration's more politically risky policy proposals, and legislative endeavors that require bipartisan support — such as Trump's infrastructure funding plan — will struggle to gain traction. Similarly, controversial proposals, such as a comprehensive attempt to revise immigration laws, could stall out in Congress.

As Washington pushes on toward protectionism, NAFTA's other members will adjust course. Mexico and Canada alike will try to court new trade partners as NAFTA's future hangs in the balance. Canada, for example, will explore a trade deal with the Common Market of the South (better known by its Spanish acronym, Mercosur) while working to advance talks with Asian countries including India, Japan, China and Singapore. (Regardless of what happens to NAFTA, however, the United States will remain Canada's main trade partner.)

## Votes Against the Status Quo

In Mexico, the Trump administration's quest to renegotiate NAFTA will pave the way for a populist to contest the presidency in 2018. The country's endemic poverty, glaring wealth inequality and systemic corruption have for decades made it a fertile ground for populism. Though populist rhetoric fell out of fashion in recent years because it worried investors, the Mexican political landscape has slowly returned to form. Today, four major political parties are vying for control of the country. Voters have soured on President Enrique Peña Nieto's administration over the past two years after a slew of corruption scandals and the government's perceived complacency in the face of Trump's threats to alter NAFTA. As the ruling Institutional Revolutionary Party lost ground with the Mexican electorate, populist candidate Andres Manuel Lopez Obrador rose as a credible contender for the presidency.

Lopez Obrador, who has been consistently ahead in opinion polls, certainly appears to have a chance to win the July election. But if he were to take office, his administration — like those of his recent predecessors — would lack the power to effect radical policy changes. Lopez Obrador would depend on cooperation from Mexico's highly divided Congress to implement any policy agenda and would have to rely largely on presidential decrees to implement less popular initiatives, such as a review of existing energy contracts. Should he make good on the review, moreover, he would probably alarm investors and jeopardize individual agreements with foreign energy companies, even though his administration couldn't roll back all of Mexico's energy reforms. And regardless of which candidate clinches the presidency, cooperation with the United States on counternarcotics will be as important as ever.

Colombia, meanwhile, is undergoing a similar political shift as a presidential vote hangs on the horizon in 2018. Widespread dissatisfaction over prolonged economic stagnation, revelations of corruption and the government's controversial peace negotiations

with militants have weakened the ruling Social Party of National Unity. Several other political groups have broken their alliances with the ruling party to run their own presidential candidates, paving the way for a tight race. The first round of elections, scheduled for May, promises to be highly competitive; the vote will likely be split among four or five major contenders.

Whichever party prevails in the election, the next Colombian president probably won't derail the previous administration's peace deal with the Revolutionary Armed Forces of Colombia, or FARC. The legislature has already laid the groundwork for the agreement's final approval, which would come under threat in 2018 only if the right-leaning Democratic Center party follows through on a referendum to rescind the legislation underpinning the deal. A new government could, on the other hand, determine whether the government in Bogota continues peace talks with another militant group, the National Liberation Army, or enters a new negotiation to demobilize certain criminal groups.

In Brazil, too, a presidential election next year will showcase the country's discontent with established political elites. Years of recession and sluggish economic growth, which has only recently picked up, and a spate of corruption scandals have crippled some of the strongest political parties, including the Workers' Party, the Brazilian Democratic Movement Party and the Brazilian Social Democracy Party. Their loss has been a boon for outsider politicians such as Jair Bolsonaro, a right-wing lawmaker. Yet the next Brazilian administration is bound to be a weak one whose ability to govern will depend on how well it can appease the various political parties in Congress. The next year may also test the country's political stability. In 2018, a federal court will issue a final ruling on former President Luiz Inacio Lula da Silva's conviction this year on corruption charges. Da Silva is a leading contender for the presidency, and his supporters could take to the streets if the court upholds his conviction and bars him from running for a third term in office in October.

# The Economics of Mercosur

## Mercosur States' GDPs

All figures are in billions USD

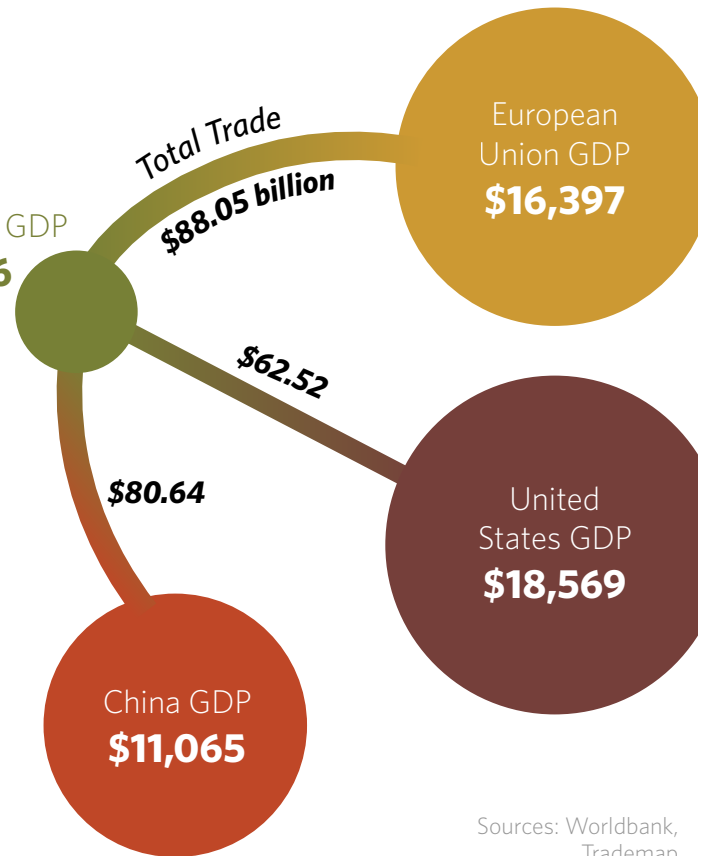
- ① **BRAZIL** \$1,796
- ② **ARGENTINA** \$545
- ③ **URUGUAY** \$52
- ④ **BOLIVIA\*** \$33
- ⑤ **PARAGUAY** \$27



South American nations, particularly those in the Common Market of the South (Mercosur), will keep expanding trade ties with one another and larger global markets. Brazil and Argentina, two of the largest Latin American economies, are pushing for Mercosur to sign more trade deals with other countries and blocs.

\*Bolivia's membership in Mercosur is still subject to approval by the Brazilian legislature.

MERCOSUR GDP  
**\$2,456**  
Billion



Sources: Worldbank, Trademap

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## South America's Economies Come Together

Until then, Brazil's outgoing administration will try to pass measures to reform the pension system and to privatize state assets before its time in office runs out. Argentina, likewise, will push to enact tax reform as well as new labor laws intended to favor investors. Buenos Aires' reforms are far from certain, though, since Argentina's historically populist Peronist parties hold a large enough majority in the Senate to stall them.

Despite the odds against its reforms, Argentina, along with Brazil and the rest of Mercosur's members, will try to maintain its momentum in trade negotiations with partners outside the bloc as they enter 2018. The traditionally protectionist Mercosur has a narrow window of opportunity to expand its

trade horizons before the pro-business administrations in Brazil and Argentina leave office in 2018 and 2019. To that end, the bloc's members will set out to negotiate as many trade agreements as possible over the next year, including deals with the European Union, Mexico, Canada and the European Free Trade Association. The talks won't always yield finished agreements, but the further policymakers get in the negotiations, the more likely that incoming administrations in Mercosur countries will be to move forward with them.

## Venezuela Feels the Squeeze From Washington

Elsewhere in the region, a former Mercosur member — Venezuela — will continue its rapid decline. The country's economic decay will accelerate over

the next year as the government defaults on foreign debt payments, high inflation spirals into hyperinflation and shortages of food and medical supplies worsen. At the same time, oil production, a crucial source of revenue to sustain Venezuela's diminishing food imports, will steadily fall. The economic crisis will persist for years.

Though the Trump administration will have bigger priorities on its agenda in 2018, such as NAFTA negotiations, the United States nonetheless will intervene to try to shift Venezuela away from one-party rule. Washington and its allies in Latin America will pressure the Venezuelan government to hold competitive elections and to recognize the opposition-controlled legislature. Caracas, in turn, will consider negotiating with the U.S. government and the domestic opposition.

But the Venezuelan administration will join the talks only to stave off more sanctions from Washington; it's not interested in holding elections it could lose in 2018, at least not without a U.S. assurance of amnesty for its leaders. The Venezuelan leadership's drive for self-preservation will make any attempt at reconciliation between the government and the opposition difficult. Furthermore, free elections in which the ruling United Socialist Party of Venezuela

could lose power would go against the interests of one of Venezuela's major stakeholders, the Cuban government. And even if other countries, such as Mexico, try to reduce Cuba's energy dependence on Venezuela, the beneficiaries of the political and military patronage networks embedded in Venezuela's state institutions will try to block attempts to institute free elections for fear of jeopardizing their privileges.

As the year unfolds and Venezuela's economy unravels, the risk of political unrest, whether in the form of protests or an attempted coup by members of the security forces, will increase. Renewed dissent alone will not pose an existential threat to the Venezuelan government unless large numbers of police or military units turn against the state. To keep the military on its side, President Nicolas Maduro's administration will allow the armed forces greater control of state oil and gas company Petroleos de Venezuela. A new wave of demonstrations, moreover, would struggle to gain momentum because more and more Venezuelans are opting to leave the country in search of a better life rather than staying and protesting. If factions of the military staged a coup, however, they would jeopardize the current government and may even prevail with enough support. □





Chris Jackson/Getty Images

## Middle East and North Africa

- Iran will lean heavily on Russia and Europe for support as the United States, Saudi Arabia and Israel team up to undercut it.
- Determined to prevent Iran from following in North Korea's nuclear footsteps, the United States will redouble its efforts to counter Iranian influence across the Middle East. Though Washington's actions will jeopardize the Iranian nuclear deal, Tehran won't abandon the accord.
- To the west, the diverging interests of Iran, Turkey, Russia and Syria will impede any meaningful progress in settling the Syrian civil war.
- Saudi Arabia will make notable strides in reforming its economy, but it will struggle to

achieve the same success in altering social behavior and expectations within the kingdom.

### Against Iran, an Unlikely Alliance Rises

The United States will enter the new year intent on reining in Iran. The White House, Congress and the Pentagon share a firm resolve to undermine the formidable network of influence that Iran has built across the Middle East through its connections to an array of political and militant groups. North Korea's likely achievement of a nuclear deterrent in 2018 has only hardened Washington's determination to stop Tehran from heading down the same dangerous path.

The United States isn't the only country eyeing Iran's activities with concern. Saudi Arabia — Iran's regional nemesis — has watched anxiously as the Shiite power's reach has slowly spread through its backyard over the past few years. Emboldened by Washington's renewed campaign against its longtime adversary, Riyadh will seize the chance to challenge Tehran for dominance in the Middle East. Recognizing an opportunity of its own, Israel will lend support to Saudi Arabia and the United States in hopes of cutting down their common enemy. In doing so, Israel will pull its relationship with Saudi Arabia, which has historically existed behind the scenes, out from the shadows.

## Negotiating the Fate of a Nuclear Deal

As tension rises between the United States and Iran, the Joint Comprehensive Plan of Action (JCPOA) will hang by a thread, though it will probably survive the year. The deal was designed to halt Iran's nuclear weapons development program, and by most accounts — including that of the International Atomic Energy Agency — Tehran has complied with its terms. As long as Iran remains in compliance, it will enjoy sanctions relief as well as the ability to receive foreign investment and export oil.

But the White House believes the deal is neither robust enough to contain Iran's nuclear ambitions nor comprehensive enough to stymie Tehran's ballistic missile program, sponsorship of terrorism or support for militant groups, such as Hezbollah in Lebanon and the Houthis in Yemen. U.S. President Donald Trump signaled his intention to confront Iran on the matter when he decertified the JCPOA in October 2017. To Tehran, the move merely confirmed its long-held suspicion that Washington is not a credible negotiator.

That different branches of the U.S. government have different ideas about how to approach the JCPOA will only add to the mixed signals coming from Washington. For its part, Congress will take steps

to slap new sanctions on Iran while taking care not to violate the deal. Trump, on the other hand, has carefully surrounded himself with policy hawks who are more willing to infringe upon the agreement, regardless of whether Iran's activities are related to its nuclear program, to try to force it back to the negotiating table. Their hard-line stance toward Iran will accelerate the deterioration of Washington's relationship with Tehran. And by stripping away the security guarantees implicit in the agreement, the United States will set itself on a collision course with Iran throughout the Middle East.

The White House's willingness to threaten the deal will revive Tehran's old paranoia as it guards against what it believes to be a concerted effort by the United States, Saudi Arabia and Israel to destabilize the Islamic Republic. Iran will not be the first to walk away from the nuclear deal, for fear of its economy falling into disrepair once more amid renewed sanctions. But threats to the JCPOA and harsher economic measures emanating from the United States will stir up hard-liners in Iran who don't value dialogue with the West as much as moderates like Iranian President Hassan Rouhani do. These factions will be able to secure more defense funding and popular support. However, Iranians across the political spectrum will be eager to keep the nuclear deal intact so that the country can continue to export oil and court investment from Europe, China and Russia.

Iran will turn to its allies in Europe and Russia to help protect the agreement's framework. After all, the sanctions that the JCPOA lifted were leveled against European companies, not Iran. As a result, most EU members have defended the deal as a means of allowing their economic transactions with Iran to continue while curbing Tehran's nuclear program. The Continent will thus appeal to the United States to uphold the agreement. Russia will join Europe in its support for the JCPOA, as the closer ties forged by two years of cooperation between it and Iran in the Syrian civil war begin to bear fruit for Tehran off the battlefield.

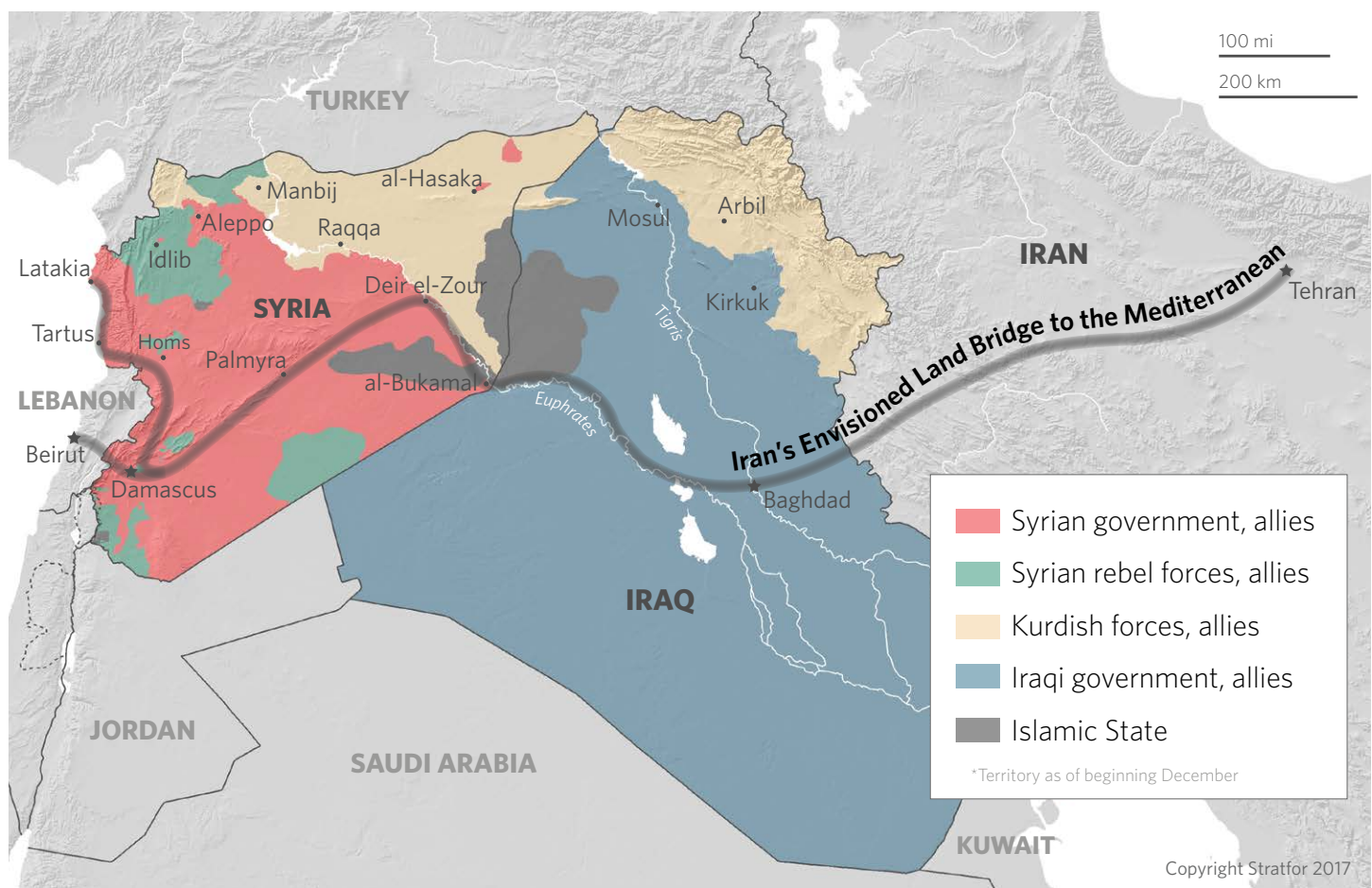
## The Syrian Civil War

As Russia and Iran have gained ground in Syria, Saudi Arabia and the United States have lost it. But though their influence over the country's divided rebel groups has slipped, Washington and Riyadh will look for ways to take advantage of the grueling civil war to undermine Tehran.

Six years of conflict in Syria, coupled with the fight against the Islamic State in Syria and Iraq, have given rise to a slew of Iranian-backed militias scattered across the Levant. Iran is keen to use these groups to clear a land bridge linking it to the Mediterranean Sea for the first time since the Sassanid Empire ruled Persia in the seventh century. But the United States, Saudi Arabia and Israel are determined to quash Tehran's local allies. Hezbollah, a Lebanese militant group that is one of Iran's most powerful non-state partners, will risk becoming a prime target of this crackdown. Though it would be too difficult to isolate and squeeze the group in its homeland,

Hezbollah is more exposed to military action against it in Syria, where it fights alongside the forces of President Bashar al Assad. As long as the war rages on and Hezbollah remains overextended, Israel will have a window in which to strike the group, enjoying the support of the United States and Saudi Arabia as it does.

For the most part, the parties involved in the Syrian civil war have largely achieved their goal of beating back the Islamic State, which lost vast stretches of territory in Syria and Iraq throughout 2017. With their common enemy vanquished, the parties will have to confront the far more complicated and delicate issues the conflict has raised. Though a cease-fire is still unlikely next year, future rounds of peace talks eventually could yield a power-sharing arrangement that reserves a place for al Assad's inner circle and kick-starts the process of drafting a constitution. Yet any deal that Damascus approves would be mostly cosmetic, and any deal that affirms al Assad's authority would be rejected by the rebels.



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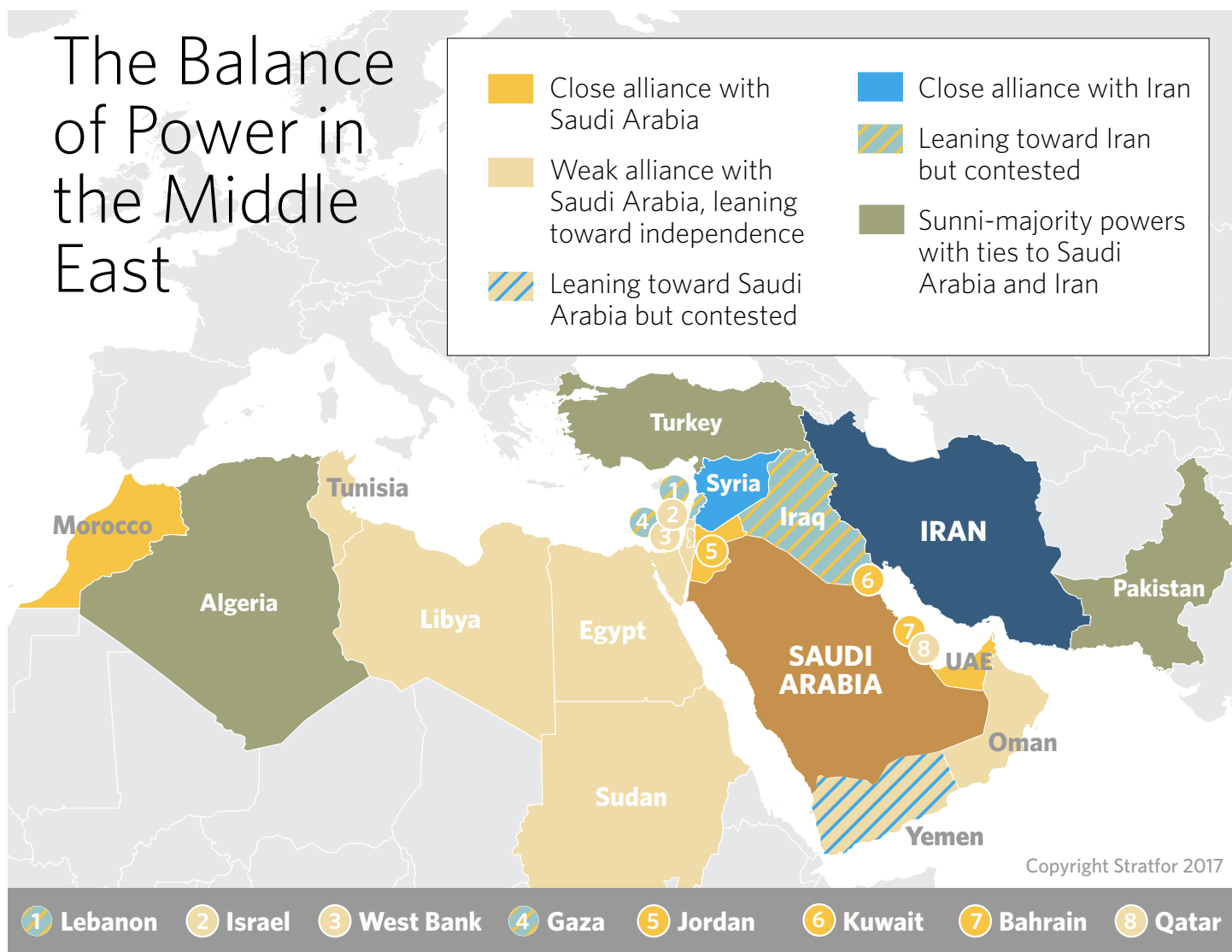
Regardless, Russia is intent on finding a quick exit from the conflict that protects the gains it has made over the past two years. To do so, it will have to rein in the Iranian and Syrian governments, which are more interested in securing a total military victory than in reaching a negotiated resolution. Russia will also have to maintain an open and functional dialogue with Turkey, which has its own ambitions in Syria to attend to. Ankara's primary goal is to prevent the emergence of a Kurdish statelet along its southern border by keeping the region's Kurdish forces divided. Consequently, Russia's negotiations with Turkey in the year ahead will center on the fate of Syria's Kurds, who have demanded their own autonomous region.

Despite the challenges facing it, Russia will play a prominent military and diplomatic role in Syria

in 2018. However, its ability to meddle in Middle Eastern affairs at the United States' expense won't be confined there. Rather, Russia will extend its reach to other corners of the region by strengthening its economic and political ties to the Arab Gulf states, Egypt, Iraq, Libya and Turkey.

## Jostling for the Battlefield Advantage

The tides of the Syrian civil war may have turned in Iran's favor, but Saudi Arabia could have better luck on other battlefields — both physical and political — throughout the region. Hoping to capitalize on renewed U.S. hostility toward Iran, the kingdom will try to counter the growing influence of its long-standing rival among its weaker neighbors, such as Yemen, Iraq and Lebanon.





Complicating Saudi Arabia's efforts, however, will be Riyadh's lackluster attempt to rally its like-minded Sunni allies against the Shiite Iran. On paper, the kingdom's partners are far more powerful than Iran's weak proxies. But in practice they are also less reliable. Saudi Arabia will struggle to amass the support it needs to lead any concrete action against Iran. Because of this failure, at least in part, the kingdom will have trouble eroding Iran's military presence in Syria and Iraq, where Saudi Arabia lacks the asymmetric capabilities in which the Islamic Republic and its allies excel.

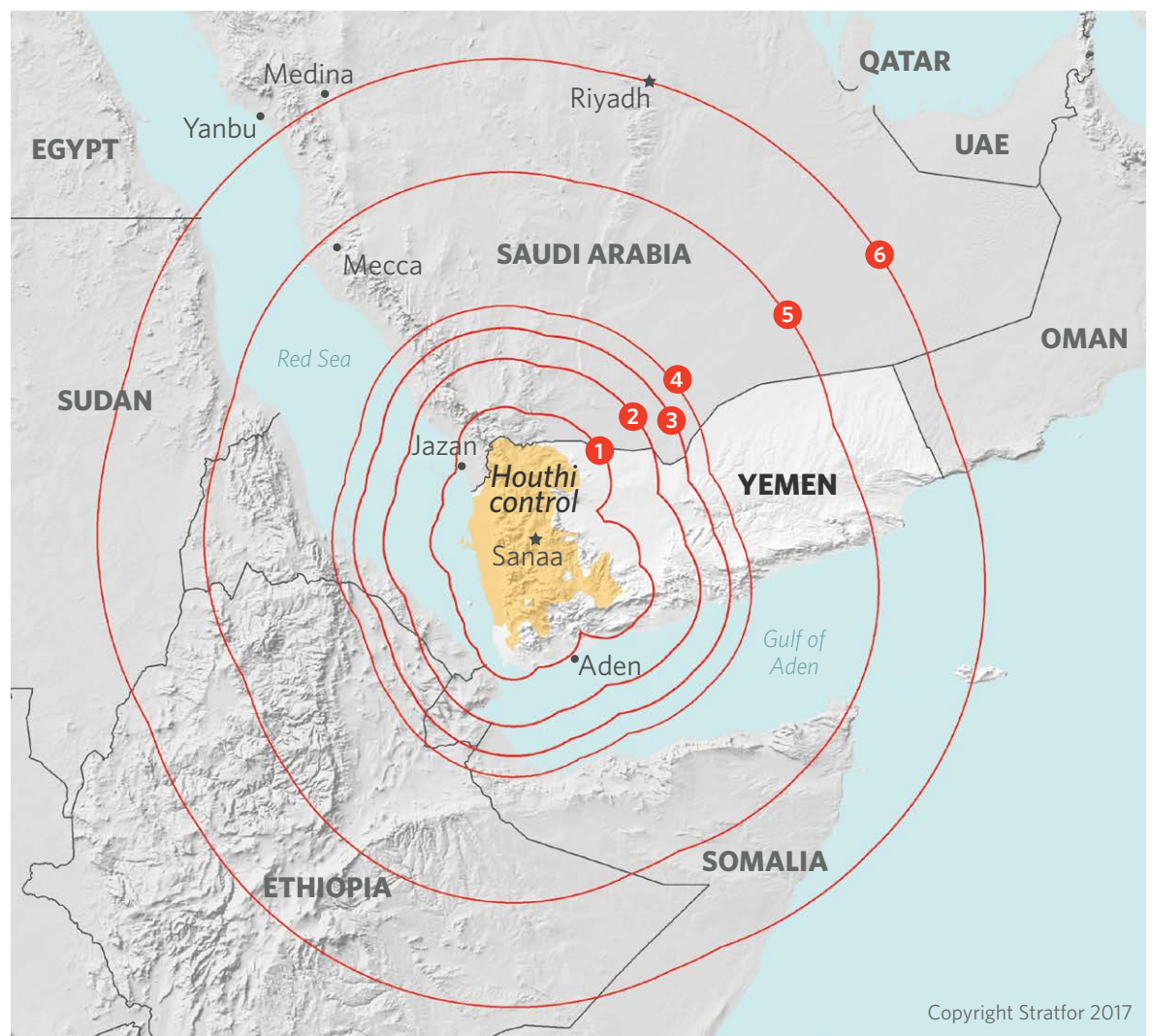
Yemen is one place where Saudi Arabia will be more likely to succeed. The country's civil war took a surprising turn at the end of 2017 when Houthi rebels killed their erstwhile ally, former President Ali Abdullah Saleh. His death drove many of his

followers to defect from the Houthi alliance, perhaps shifting the battle's momentum in favor of the Saudi-led Gulf Cooperation Council (GCC) coalition if they take up arms against the Houthis. Either way, the Houthis will be more desperate than ever to secure aid from Iran in the short term — and the GCC will be more determined than ever to stop them from receiving it.

Yemen will thus become the center of a violent war by proxy between the GCC and Iran as the coalition intensifies its effort to loosen the Houthis' grip on the capital, Sanaa. Now that rifts have opened within the rebel alliance, a political settlement to the conflict will be even more elusive — especially as other Yemeni interests, including southern secessionists, seize the chance to press their own political claims.

## Houthi Missile Arsenal

- 1 SS-21 Scarab  
70 km
- 2 C-802  
180 km
- 3 Qaher-1 and Zelzal-3  
250 km
- 4 Scud-B  
300 km
- 5 Scud-C  
600 km
- 6 Burkan-H2  
850 km



Data: Risk Intelligence, Missile Defense Advocacy Alliance

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## Jockeying for Political Influence

Meanwhile, Saudi Arabia will stir up trouble for Iran on political battlegrounds as it works to undermine Iranian-backed parties and politicians in Iraq and Lebanon. Iraq will hold general elections in May, offering the country a rare moment to assert its independence from the foreign powers involved within its borders. Iraqi Prime Minister Haider al-Abadi will champion an emerging strain of nationalism that advocates the resistance of external influence (including from the United States, Iran and Turkey), while Iraqi Shiite leader Muqtada al-Sadr will embrace the same rhetoric in hopes of channeling it into electoral gains.

After the elections have wrapped up, Iran will use its connections to Iraq's Shiite Popular Mobilization Forces — some of those militias have created political wings that will participate in the race — to shape coalition building in Baghdad. To balance against these groups, the GCC will funnel money and aid to other Sunni and Shiite parties in Iraq. Given the entrenchment of the Shiite Iraqi politicians aligned with Iran, however, the Gulf bloc will have difficulty weakening Tehran's influence.

To the north, in Iraqi Kurdistan, a failed attempt to declare independence toward the end of 2017 made the split between Arbil province (led by the Kurdistan Democratic Party) and Sulaimaniyah province (led by the Patriotic Union of Kurdistan) even more pronounced. Turkey and Iran will settle back into their long-standing roles as the parties' respective economic and political patrons in the year ahead. As the autonomous region's negotiations with the central government progress, Baghdad will use its relationship with Tehran to try to drive the wedge between the Kurdish parties deeper — exacerbating Iran's competition with Turkey in the country in the process. The widening rift among Iraq's Kurds will be clear in the results of the region's general elections in 2018, hindering Arbil's ability to barter with Baghdad over oil revenue and disputed territory.

Meanwhile, Saudi Arabia will try to use Lebanese Prime Minister Saad al-Hariri to influence politics in Beirut in order to undermine Hezbollah's interests. But the militant group is deeply entrenched in Lebanon, and despite the small diplomatic gains that Saudi Arabia will eke out among the country's Sunni and Christian communities next year, Riyadh will not be able to mount an effective assault on the insurgency's standing in the country. Turkey will encounter similar barriers as it leans on its links to Sunni leaders in Lebanon to try to counter Iran's militant partner.

Even so, Turkey will seek out other means of making its own mark on the Middle East. Qatar will be an unlikely ally in this regard: Both countries desire regional prestige and independence from their powerful neighbors, Iran and Saudi Arabia. In the coming year, Turkey will shore up its support for Qatar by deploying troops and military equipment to its territory and ramping up trade. Turkey's growing presence on the Arabian Peninsula will antagonize Saudi Arabia while underscoring the divides permeating the GCC. At the same time, the emerging partnership between Turkey and Qatar will frustrate the Saudi kingdom's attempts to solidify its position as the dominant Sunni power in the Middle East.

## The Saudi Survival Strategy

As Saudi Arabia grapples with its rivals abroad, it will also have to wrestle with tricky reforms at home. Though all GCC states will have to undertake tough reforms in the year ahead, Saudi Arabia's are the biggest and most ambitious. At the heart of the domestic policy changes underway will be Crown Prince Mohammed bin Salman, who will wield his newfound power to advance his sweeping agenda. The young leader will try to make good on his promises of aggressive economic reform, aiming to boost non-oil revenue through taxes and investment profits, stimulate private-sector growth and nationalize the kingdom's labor force.

## Mohammed bin Salman's Expanding Powers

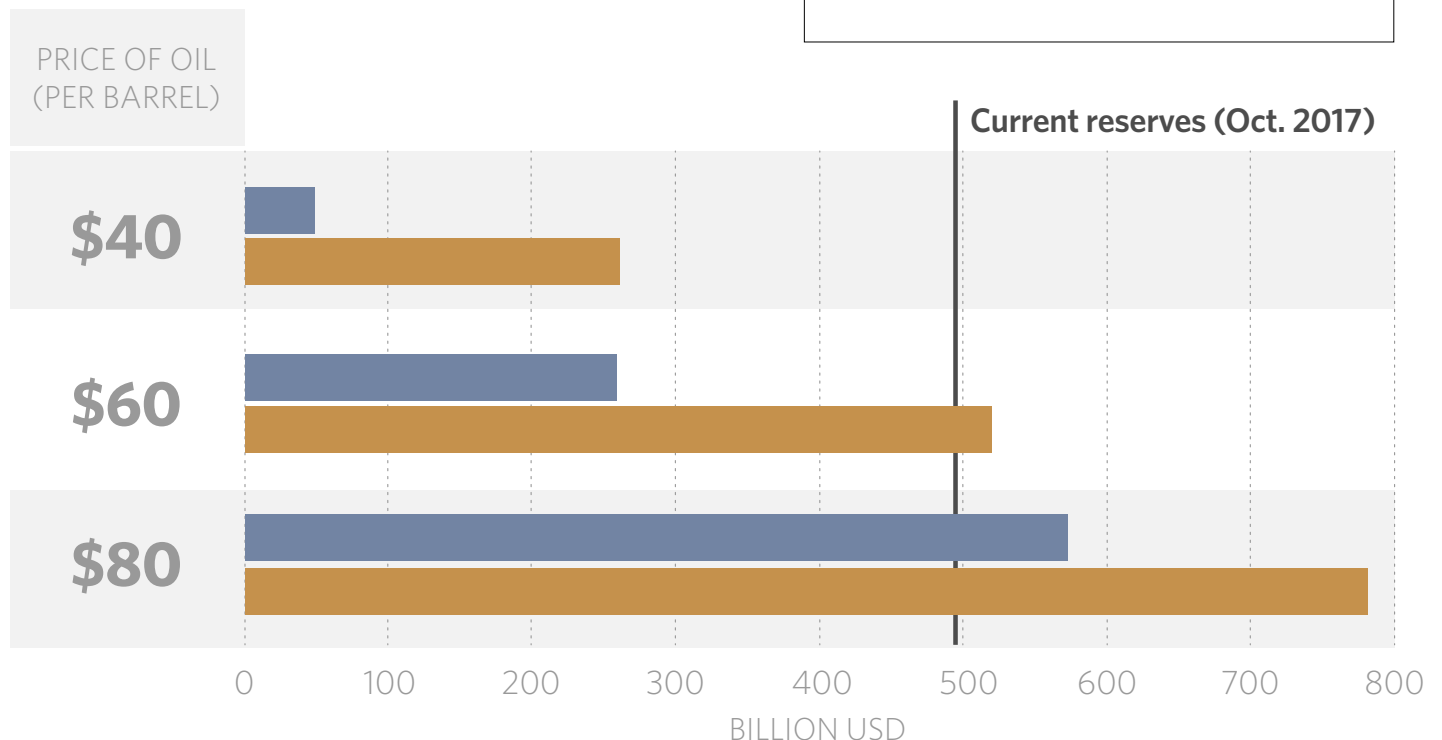
Though Saudi Crown Prince Mohammed bin Salman still faces challenges, he has gained unprecedented control over the top positions in the kingdom's economic, security and political apparatuses.



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## The Importance of Saudi Reforms

The kingdom must increase its non-oil revenue.



Source: JODI database

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Saudi Arabia cannot afford to put off these tough economic reforms any longer, and its citizens will soon see tangible signs of painful, if necessary, change. To balance its budget, Riyadh will have little choice but to enact new taxes and proceed with the planned partial initial public offering of the Saudi Arabian Oil Co., which will provide much-needed capital for the kingdom's future investments. (The IPO is currently set for 2018, but it may be pushed back.) As prices on everyday goods like fuel rise, popular dissatisfaction could rise with them. The government will be responsive to its people's demands, revising some targets if they are deemed too aggressive. Thanks in part to such attentiveness and flexibility, as well as a willingness to boost its capital investment next year, the kingdom will reach several of its goals — including an uptick in non-oil revenue.

Some of Saudi Arabia's economic objectives require bold changes in social behavior that will take time to encourage. Eventually, Salman intends to design a new social contract that adjusts what citizens expect of their government, and vice versa. In the meantime, however, the kingdom will take notable strides toward that contract. Riyadh will likely grant women the right to drive in June 2018, and new entertainment opportunities will crop up throughout the year. The crown prince will preface each step with tentative announcements of the measures ahead to gauge the public's reaction and to fulfill his pledge of maintaining transparency. Though the country's conservative clerics will try to stand in the way of reform by appealing to an older demographic that is wary of the prince's aggressive reforms, young Saudis will increasingly embrace Salman's vision for the kingdom's future.

## North African Nationalism

The Egyptian government will be keeping a close eye on popular opinion next year as well. The country will hold a presidential election in May. The Supreme Council of the Armed Forces will carefully manage the vote, leaving Egyptians with little choice

in their actual selections. But more important will be the headcount at campaign events, social media activity and voter turnout — all of which will reveal some details about voters' opinions of Egypt's economic and security strategies. Any popular frustration with the government in Cairo will be channeled through opposition candidates, such as lawyer Khaled Ali. Subsidy cuts approved by the International Monetary Fund (IMF) and scheduled for 2018 will deal a heavy blow to Egypt's lower- and middle-class citizens, but Cairo will try to mitigate the political fallout at home by handing out cash.

Buoyed by IMF loans, Egypt will exercise greater independence in its relationships abroad. (The more financially solvent the country is, the less reliance it has on foreign backers.) To that end, Cairo will balance its ties with the United States and Russia while holding Saudi Arabia at arm's length. Though Egypt is no friend to Iran, it isn't fond of kowtowing to Saudi Arabia's demands, either. Cairo will likewise find itself distanced from Ankara next year as Turkey lends support to the Palestinian cause — chipping away at Egypt's own credentials as a mediator in the Israeli-Palestinian conflict. Egypt will try to account for Turkey's actions, and to better manage its problems with Sinai militancy, by courting deeper ties with Hamas, the Palestinian group tasked with managing the Gaza Strip. Cairo will also assist in Washington's efforts to negotiate a new peace deal between the Israelis and the Palestinians.

Next door, momentum will build behind an effort to hold elections in Libya. But although the latest U.N.-backed initiative is gaining support, the many factions taking part in peace talks are unlikely to hash out their differences next year. Nevertheless, a shared form of nationalism has arisen among the most powerful groups in Libya's east and west — including Libyan National Army Field Marshal Khalifa Hifter, who is gradually garnering the approval of the international community. A national conference in Tunis intended to catalyze the electoral process will showcase the common ground emerging in Libya in 2018. Even so, few parties will be convinced that the



U.N. talks will meet their demands, ensuring that the strongest among them, such as Hifter, will continue to act in their own interest as negotiations unfold.

## The Jihadist Wars

The Islamic State may have suffered a sound defeat in Iraq and Syria, but the war against the world's extremist groups is far from over. Al Qaeda will attempt to exploit the collapse of the Islamic State's so-called caliphate to polish its own reputation as the leader of the global jihadist movement and to propagate its vision of "the long struggle." The group's recruitment efforts will aim to attract current and potential Islamic State followers in 2018.

Both al Qaeda and the Islamic State will seek out weak states where they can establish new strongholds or expand old positions, focusing on Yemen, Libya and the Sinai Peninsula. The ungoverned spaces of the Sahel, Afghanistan and Somalia may prove tempting for them as well. Meanwhile, al Qaeda will dig into its bases in conflicts throughout the Middle East — including Syria, where a schism between al Qaeda and an offshoot, Hayat Tahrir al-Sham, has jeopardized the organization's cohesion. As the battle for the hearts and minds of potential recruits around the world persists, so will the threat of homegrown militants inspired by the competing extremist ideologies urging them to carry out attacks. □



Yuri Kadobnov/AFP/Getty Images

## Eurasia

- As its standoff with the West intensifies in 2018, Russia will look to expand its influence in the Asia-Pacific region and in the Middle East.
- The United States and Russia will spar over sanctions and arms control agreements as Moscow strives to undermine the unity of NATO and the European Union through hybrid warfare.
- Presidential and regional elections in Russia will serve as a crucial test for the Kremlin, which will have to deal with converging crises at home.
- Though negotiations over the Ukrainian conflict will pick up over the next year, they will fail to produce a resolution to the war in Donbas.

- Economic and security challenges will test governments across Central Asia and encourage Russia and China to collaborate more closely in the region to stave off instability.

### Moscow Looks to the East

As 2018 approaches, Russia — the linchpin of Eurasia — is undergoing a shift in its foreign policy. Years of deteriorating ties with the United States and Europe have led Moscow to recalibrate its priorities and strategy heading into the new year.

As part of this adjustment, Russia will intensify its focus on the Asia-Pacific in 2018. As North Korea

draws closer to demonstrating that it has achieved a credible nuclear deterrent, Russia will continue its behind-the-scenes support for the North Korean government by supplying fuel and maintaining trade ties with the isolated country. It won't have much of an opportunity to act as spoiler or peacemaker in the brewing conflict with Pyongyang, however, since the North Korean administration will forge ahead in its quest for a nuclear deterrent regardless of Moscow's economic and logistical backing. Furthermore, mounting concerns over the rogue administration across the border will compel Russia to temper its support for North Korea. Nevertheless, Russia will work to maintain its influence in the country, which it will try to use as leverage in talks with the United States, as well as with Japan and South Korea. It will also look for opportunities to exploit differences among the members of the U.S. trilateral alliance with Japan and South Korea. And all the while, Moscow will stay in lockstep with Beijing over the North Korean problem, advocating a containment policy and nonmilitary responses.

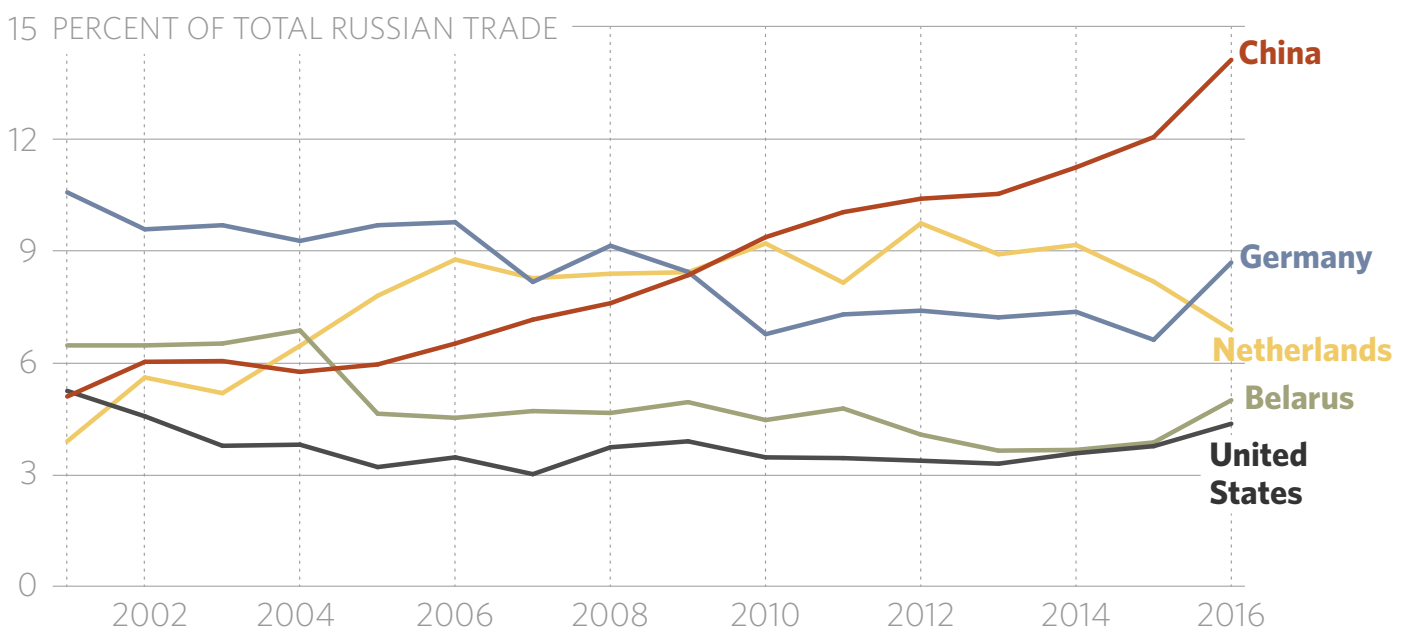
China, in fact, will play an important role in Russia's foreign and domestic strategies in 2018. As Russia's

largest trading partner, China has helped ease the country's economic dependence on the West. Moscow hopes to continue that trend in the coming years by securing Chinese investment across the country in the energy, transportation and agricultural sectors. In addition, Beijing will facilitate Moscow's efforts to bolster its financial systems and cyber capabilities, and the two will strengthen their defense ties through military exercises and cooperation, as well. Their relationship also will extend to joint initiatives elsewhere. In Central Asia, for instance, Russia and China have established a kind of division of labor: China concentrates on economic issues in the region, while Russia focuses on security matters. Redoubling their collaboration will enable both countries to insulate themselves from U.S. pressure and to challenge Washington's strategic position in various theaters around the world.

But the growing partnership between Russia and China can go only so far in the long run. Beijing and Moscow, after all, are natural rivals with overlapping spheres of influence. So though they will keep broadening the frontiers of their cooperation for now, their alliance will eventually have to contend

## Top 5 Russian Trade Partners

Increasing trade with China allows Russia to be less dependent on the West.



Source: Trademap

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## Key Infrastructure Between Russia and China



with diverging views and competing priorities. In the meantime, the burgeoning partnership won't sit well with Japan. Tokyo will offer financial support for strategic projects such as liquefied natural gas facilities to curb Beijing's increasing influence in Russia. Moscow, in turn, will be only too happy to accept.

Beyond the Asia-Pacific, the Middle East will figure prominently in Russia's foreign policy next year. The balance of power is shifting in the region now that coalition forces have all but defeated the Islamic State in Iraq and Syria. Moscow intends to use the clout that its role in the Syrian civil war has earned it to try to influence other foreign powers with stakes in the region to shift the balance in its favor. Russia has four goals for this endeavor: to gain leverage in its negotiations with the West; to contain and counter the threat of Islamic extremism; to turn its

relationships with regional powers to its favor; and to increase its access to energy, arms and agriculture markets in the area. With the entire region in play, Moscow will cultivate partnerships with several countries in the Middle East and North Africa in an effort to undermine the U.S. position there. Russia, for example, will work to restore its military presence in the region by leasing an air base in Egypt and by increasing arms sales to Libya.

Iran will serve an essential role in Russia's activities in the Middle East over the next year. Since the U.S. presidential administration decertified the Joint Comprehensive Plan of Action — the deal halting Iran's nuclear weapons development — the agreement's future has come under greater doubt, and the threat of renewed economic sanctions has loomed larger over Tehran. Moscow will take ad-



vantage of the rising tensions between the United States and Iran to bolster its relationship with Tehran, building on the firm foundation it established through cooperation with Iran in Syria. Much as it does in its growing partnership with China, Russia sees in its ties with Iran an opportunity to counter the United States' strategic position. But their alliance, much like the one between Moscow and Beijing, also has clear limits, considering the conflicting interests of Russia and Iran in the Caucasus and in Central Asia.

Russia will hit similar roadblocks as it works to strengthen its relationships with Turkey and with Saudi Arabia in 2018. As Moscow tries to pursue common interests with Ankara — and to use their deepening ties to widen Turkey's rifts with NATO and with the European Union — the two will butt heads. Turkey, for example, will object to Russia's outreach to the Kurds and to Moscow's overtures to Ankara's rivals in the region. The mounting hostility between the Saudi Arabia and Iran, likewise, will hamper Russia's budding alliance with the kingdom.

## Echoes of the Cold War

Though the Asia-Pacific region and the Middle East will take up more of Russia's attention in the coming year, Moscow's relations with the West will be no less important. Tensions are liable to rise in 2018 between Russia and the United States. Washington has signaled that it may ramp up its pressure on Russia in the coming year through a variety of means, including a heavier sanctions regime and lethal arms sales to Ukraine. At the same time, the United States is building up its ballistic missile defenses in Europe and Asia. The campaign will further strain its bilateral arms treaties with Russia, which will be all the more difficult to renegotiate since Washington has threatened Moscow with punitive measures for allegedly violating the Intermediate-Range Nuclear Forces (INF) Treaty.

Having come to grips with life under existing sanctions, Moscow is determined to avoid incurring more

sanctions from Washington in 2018. With that in mind, Russia will highlight areas in which it would be willing either to work with the United States or to negotiate concessions, such as the peace process in Syria, talks with North Korea or the conflict in Ukraine. Moscow, meanwhile, will prepare for its ties with Washington to further deteriorate by shoring up its relationships in Asia and in the Middle East and by pursuing military buildups in its borderlands, for instance by permanently deploying the Iskander missile system in its exclave of Kaliningrad.

Adding to Russia's sanctions worries, the European Union will vote to maintain its punitive measures on the country throughout the next year. The bloc, however, won't follow suit if the United States slaps new sanctions on Moscow for political interference, despite the fact that 2018 will give Russia ample opportunity to meddle in Europe's affairs. As Italy prepares to hold general elections by May, the Kremlin will use its tried-and-true weapons of hybrid warfare — disinformation, propaganda and cyberattacks — in hopes of bringing a more sympathetic government to power in Rome. An administration led by the Five Star Movement, after all, could perhaps break the unanimous vote required to extend the EU sanctions against Russia in the future. Influencing the elections' outcome won't be easy, as Moscow learned during the recent political races in France and Germany. Even so, Russia will keep up its efforts to sow discord among the bloc's member states and their electorates, even if it doesn't accomplish its goals for the Italian election.

## Russia's Internal Struggle

At home, Moscow will have a host of problems to contend with next year. Russia's worsening economic and financial straits will be one of its biggest challenges. After officially pulling out of recession this year, the country is settling into a prolonged period of stagnation. Banks are failing in near-record numbers, regional governments are defaulting on their debts, more and more businesses are going bankrupt, and a growing number of state firms need

## Russian Economic Woes

Though the Russia economy has pulled out of recession, the country is settling into a prolonged period of stagnation. Moreover, many of the people and entities throughout Russia are still deep in crisis, which will lead to increasing protests and discontent with the Kremlin as the 2018 elections approach.



**13.8%** OF RUSSIANS LIVE BELOW THE POVERTY LINE



**25%** OF RUSSIANS HAVE SEEN WAGE CUTS

AVERAGE MONTHLY WAGE



LESS THAN  
**450**  
USD



**50%** OF WAGES ARE SPENT ON FOOD



**1 in 3** BANKS HAVE CLOSED SINCE 2014

**1998** BANKRUPTCY RATES THIS YEAR ARE AS HIGH AS IN 1998.



**10 of 85\*** REGIONS ARE CURRENTLY ECONOMICALLY STABLE

\* The West only recognizes 83 Russian regions

Sources: Russian Central Bank, Russian Ministry of Finance, World Bank, Centre for Market Research of the ISEHE Higher School of Economics, Vedomosti

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bailing out. These issues will stretch the Kremlin's finances, sap its sovereign wealth funds and force the government to borrow at least \$18 billion more abroad. Finding funding could become even more difficult if the United States imposes sanctions to discourage Western markets from lending to Russia, though Moscow's growing economic ties in Asia and the Middle East will give it some alternative options. Either way, Russia's financial woes are too great for Moscow to shoulder. The Kremlin will have to let some businesses, banks and maybe even a regional government fail as it works to manage the fallout to avoid destabilizing the political system ahead of presidential and regional elections in 2018.

The contests, slated for March and September 2018, respectively, will serve as a test for President Vladimir Putin and his detractors alike. Despite the buzz in Western media, however, Putin has no cred-

ible challenger for his office. His opponents represent an array of ideologies and personalities, and the government will seize on their differences to keep the opposition divided. Still, the ruling United Russia party understands that the swelling tide of protest movements, particularly among young Russians, requires a new strategy. The Kremlin, to that end, will roll out fresh messaging to target the youth vote and try to energize the electorate. And in the likely event that Putin wins another term in office, his administration will use his victory to restore faith in his legitimacy. The various opposition groups, in turn, will hold protests across Russia in the run-up to the vote and may even stage mass demonstrations around Putin's re-election.

Unrest won't be the only political challenge awaiting Putin in his next term. Infighting within the Kremlin will increase next year. While powerful elites such

as Chechen leader Ramzan Kadyrov and oil tycoon Igor Sechin break with Putin to pursue their own agendas, the president will consolidate a coalition of his most loyal advisers to protect him and help him implement his policies. Putin won't fully crack down on the renegades, but he could undertake reshufflings in his administration to limit their power. The result will be an ever-more centralized, authoritarian presidency and a progressively more fragmented political system.

Compared with the presidential election, the regional votes promise to be a tighter race for United Russia. Liberal opposition groups made gains in this year's regional elections. To slow their progress in the 2018 contest, the Kremlin will keep exploiting the divisions between them. Moscow may also crack down to try to curb protests across the country, while allowing some demonstrations to continue as a way to ease the political pressure building in Russia.

## The Fight for Russia's Borderlands

Just beyond Russia's borders, the new year will bring its share of activity and instability. Ukraine, for example, will spend 2018 gearing up for its own presidential and parliamentary elections to follow in 2019 — its first since the snap votes that followed the Euromaidan uprising in 2014. Leading up to the 2019 elections, protests and government shake-ups are likely, and early legislative votes are possible. But the country won't deviate from its Western-oriented foreign policy as it weathers another year of war in the eastern part of its territory. Though the United States and Russia will proceed with negotiations over the conflict in Donbas — and may even make some headway on the issue of U.N. peacekeepers in the region — a broader resolution will remain elusive in 2018. As a result, Ukraine will continue to receive political, economic and security backing from the United States and its Western allies while it strives to further its economic, energy and security integration with Poland and the Baltic States. Russia,

meanwhile, will ramp up its hybrid warfare campaign — including cyberattacks and assassinations — against the country and its supporters.

Southwest of Ukraine, elections could plunge Moldova into political turmoil next year. If the November vote goes in President Igor Dodon's favor — and to the detriment of the coalition that has long ruled the country — Moldova could start rolling back its efforts at integration with the European Union, at odds with the interests of pro-European groups. At the same time, it would probably also begin collaborating more closely with Russia on economic and security issues. Large protests before and after the elections are possible.

Next year will kick off a busy election season in the Caucasus, too. Armenia, Azerbaijan and Georgia will each hold presidential elections in 2018. More than the outcomes of these votes, though, the larger states nearby will influence foreign policy in the region. Azerbaijan and Georgia, for instance, will continue their efforts to forge closer energy, infrastructure and security ties with Turkey, while Armenia strengthens its military partnership with Russia and fortifies its economic links with Iran. Along the way, Tehran and Ankara will be careful not to challenge Moscow's strategic position in the Caucasus. Russia will remain the primary arbiter in the Nagorno-Karabakh conflict between Armenia and Azerbaijan, working to prevent the dispute from escalating while at the same time supplying both sides with arms.

## Instability in Central Asia

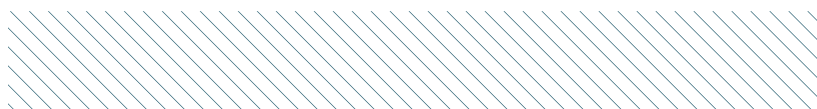
The states of Central Asia, like so many of their fellow former Soviet republics, are in for a year of political transition. In 2018, Kazakhstan will probably follow in the footsteps of Uzbekistan and Kyrgyzstan, which underwent mostly smooth transfers of power this year. Kazakh President Nursultan Nazarbayev will move forward with plans for his succession, having ruled his country since before the

Soviet Union's collapse. Rather than risk destabilizing Kazakhstan by suddenly surrendering his office, Nazarbayev will instead gradually devolve power to Parliament and to key members of the political elite, while overseeing the country's operations from behind the scenes.

But even if the transition goes off without a hitch, Kazakhstan and the other Central Asian states will face numerous threats to their stability in the next year. Low energy prices will compound the socio-economic pressures in the region, giving rise to protests. Uzbekistan will try to alleviate the strain by enacting economic reforms designed to attract foreign investment. It will also make efforts to im-

prove its relations with neighboring Kyrgyzstan and Tajikistan in a bid to help ease border disputes and disagreements over resource allocation.

Dealing with the growing threat of militancy will be a steeper task, given the region's internal security concerns and its proximity to Afghanistan and Syria. Governments across the region will resort to crack-downs and a more centralized power structure to mitigate the risk to their security. In addition, the region's two most influential external powers — Russia and China — will step up their security efforts in Central Asia in 2018. Moscow will focus on expanding its security presence there while Beijing assumes a more active role in counterterrorism efforts. □







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## Europe

- The debate over how best to reform the European Union will take the spotlight in 2018, laying bare the regional rifts that divide the Continent.
- Though France and Germany will be at the heart of this debate, they will prove more willing to cooperate than to confront each other. To that end, Paris will agree to water down or postpone many of its proposals for the bloc.
- General elections in Italy will generate uncertainty about the eurozone's future. Though the country won't leave the currency area in the coming year, its next government will lobby for the authorization to boost public spending.
- The United Kingdom will spend 2018 negotiating the terms of a trade agreement with the

European Union. Though leaders probably will reach an arrangement for the transition period following the Brexit, a trade deal will be tougher to obtain.

- The Continental bloc also will seek out free trade agreements with other countries, a strategy that will become a cornerstone of the bloc's foreign policy.

### Debating a Continent's Future

Talks about the shape of the European Union's structure and governance will take center stage on the Continent this year. Among the items on the bloc's agenda are ways to deepen financial integration, mechanisms to cope with future crises and strategies to increase security and defense

cooperation. But finding a way forward won't be easy. While most EU members agree that political, institutional and economic reforms are needed, they do not agree on what those reforms should look like or how to go about implementing them. Over time, these issues will once again expose the enduring divisions between Europe's north and south and its east and west.

At the center of the debate will be France and Germany. Though the two powerhouses are eager to preserve their alliance, they have different visions for the European Union. The French government, which campaigned on a promise to transform the bloc, has already introduced economic reforms at home. Now that it is on more equal footing with Berlin than it has been in many years, an emboldened Paris will aim to advance its interests at the Continental level. France hopes to create new structures that would allow for greater public spending and financial risk sharing within the bloc — a goal that many countries in Southern Europe, including Italy and Spain, share. These states also advocate the introduction of a common unemployment insurance for EU workers and a common deposit insurance for EU banks.

Germany isn't necessarily opposed to these ideas. It does, however, want to make sure that they are accompanied by more efficient oversight of the fiscal policies and financial sectors of member states. Berlin believes that countries often bend the bloc's fiscal rules and that the institutions tasked with enforcing regulations are too politicized. Several Northern European states, such as Austria and the Netherlands, share this view.

Still, France and Germany will have to wait to hash out a compromise until Berlin settles one of its own pressing political problems: the formation of a new government. The process of trying to build a governing coalition in Germany will consume the first few months of the year. Should the talks fail, early elections will ensue, delaying any European negotiations.

Regardless of when the bartering between Germany and France begins, Berlin will protect its interests, and Paris will not get everything it wants. Instead, many French proposals will be watered down or adapted to meet German demands; others will be postponed. Room for cooperation certainly exists on some issues, such as boosting security and defense cooperation and harmonizing the tax systems of EU members. But other topics — especially those that involve financial transfers from Northern Europe to Southern Europe — will be more controversial.

For the most part, France and Germany will be more interested in cooperation than confrontation. But it is unclear whether their willingness to work together will be enough to keep Europe united.

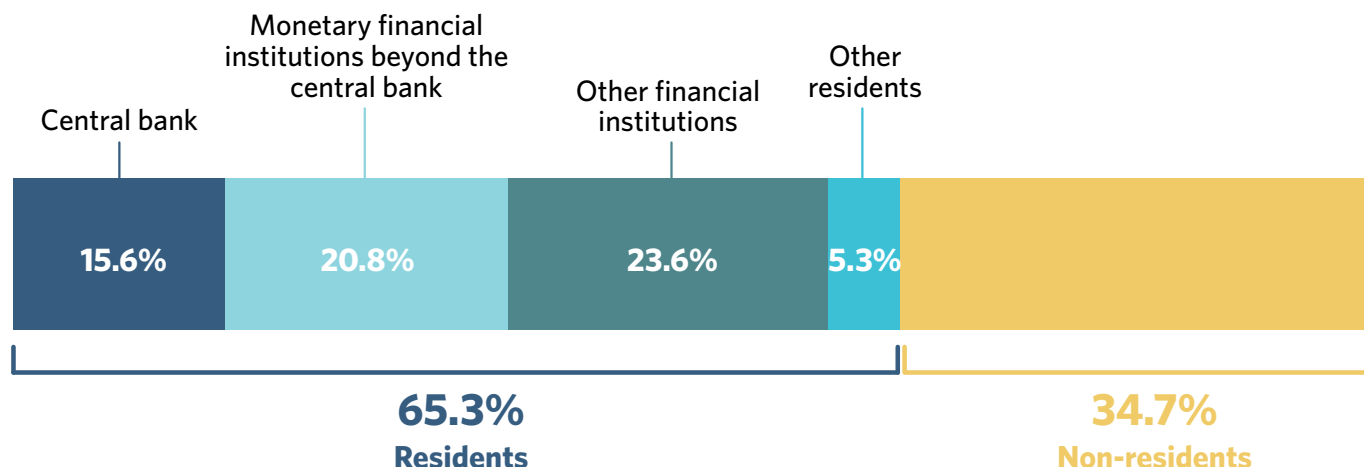
## The Fate of the Eurozone

Italy will be the main source of uncertainty for the eurozone next year. The country will hold general elections by May, and most of its political parties have criticized the EU's deficit targets. Some are also critical of the eurozone. No matter who wins the elections, Rome's next administration will push to increase public spending and redesign the bloc's deficit goals.

The difference between the parties, however, is in their tone. Some, like the anti-establishment Five Star Movement and the right-wing Northern League, will be more willing than others to threaten Brussels with unilateral measures if the European Union does not meet their demands. These threats could include ignoring the bloc's fiscal targets or leaving the eurozone.

Of course, Italy isn't likely to exit the currency area in 2018, but the rise of a Euroskeptic government in the eurozone's third-largest economy could still put the currency bloc at risk. The mere threat of flouting eurozone rules or quitting it outright could cause concern in financial markets, lead to higher borrowing costs for Southern European countries, and raise

## Who Owns Italy's Sovereign Debt?



Source: Bruegel

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questions about the prospects of Italy's fragile banks. On top of these economic risks, a more Euroskeptic Italy would face the prospect of political and institutional isolation within the European Union.

Given the fragmentation within Italian politics, the approaching elections are likely to end in a hung parliament. Yet even if the parties fail to cobble together a coalition government, they could still appoint a prime minister by consensus. EU institutions and financial markets would welcome such a decision because it would temporarily avert a financial crisis. But it would come at a steep cost, creating a government that is constantly on the verge of collapse, weakening Italy's influence in international affairs and undermining Rome's ability to introduce sweeping economic reforms. If, on the other hand, lawmakers are unable to agree on a prime minister, Italy might hold another round of elections by the end of 2018, prolonging the uncertainty obscuring the country's future.

Italy won't be the only eurozone member grappling with tough questions next year, either. Greece's bailout program ends in August, at which point Athens will try to reduce the sway foreign lenders have over

its policymaking. At the same time, however, Greece will ask its creditors to alleviate its debt burden. Athens' financiers will refuse to write down parts of Greece's debt. But they may be more amenable to other measures, such as an extension of debt maturities, lower interest rates and a grace period for debt repayments, particularly if Greece agrees to keep introducing economic and institutional reforms. Athens may indeed be willing to make this commitment if the requested measures are less painful than those attached to its bailout. So although Greece will remain a source of concern for the eurozone in 2018, its membership in the currency area won't be in jeopardy.

Spain will have two problems of its own to deal with next year. The country's minority government will have difficulty pushing through legislation, suggesting that it will make only modest economic and institutional reforms in 2018. Moreover, Catalan secessionism will remain a concern for Madrid as friction persists between the central and regional governments. Though Catalonia won't secede from Spain next year, questions about the region's future will linger.



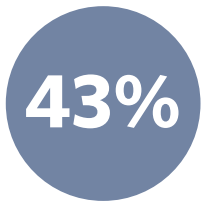
# Brexit and Beyond

Meanwhile, the United Kingdom will spend most of the year figuring out what its relationship with the European Union will look like after it leaves the bloc. Hoping to give companies and households more time to prepare for the Brexit, London and Brussels will negotiate a transitional arrangement as they work to settle a comprehensive trade agreement. Leaders likely will find it easier to approve the transitional agreement in 2018, buying themselves more time to haggle over the trickier aspects of the trade deal, including the movement of services and

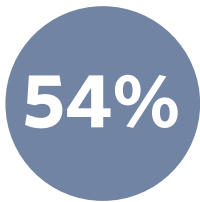
capital. The trade talks could last into 2019, but even if they wrap up sooner, the parties involved can't approve a deal until the United Kingdom has formally exited the European Union in March 2019.

In the United Kingdom, the negotiations will call into question its economic and territorial integrity. Political interests in Northern Ireland, Scotland and Wales will keep a close eye on the talks between London and Brussels, doing what they can to shape the negotiations and voicing their expectations to the British government. London has the ability to resist some of the demands made by Scotland

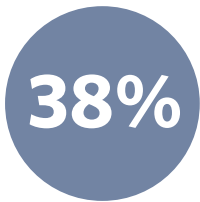
## British Trade



Percentage of British exports going to EU countries in 2016



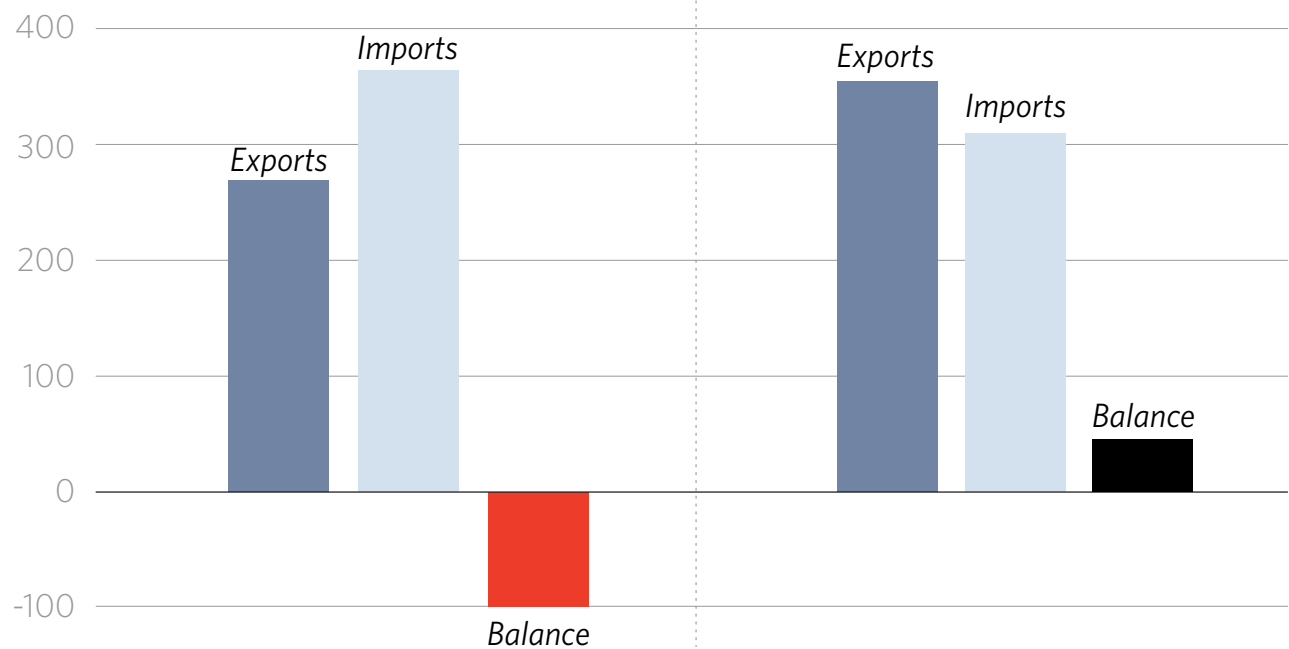
Percentage of British exports going to EU countries in 2006



Percentage of British exports to EU countries that were services in 2016

Trade with EU countries

Trade with non-EU countries



Source: ONS

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and Wales while reaching compromises on others. But the situation in Northern Ireland will be more delicate. There, tension between unionists and nationalists could complicate the already thorny issues the Brexit has raised regarding the region's shared border with the Republic of Ireland. To avoid introducing controls along its border with Ireland, the United Kingdom may have to soften its stance on leaving the EU single market, where goods and people move freely.

All told, 2018 will be a politically charged year for the United Kingdom, and not just because of the Brexit. The British government will encounter constant political challenges, both from the opposition and from within the ruling Conservative Party. Though the country may replace its prime minister, the Conservative Party will try to avoid early elections in which it could make a poor showing.

## A Dilemma for Central and Eastern Europe

As the European Union wrestles with the existential questions before it, countries in Central and Eastern Europe will take different approaches to their own relationships with the bloc. Hungary and Poland, for instance, will fend off Brussels' attempts to interfere with their internal decision-making. Nationalist parties are positioned to perform well in Hungary's general elections in the second quarter of 2018, signaling continuity ahead in Budapest's Euroskeptic domestic and foreign policies. Poland's government likewise will continue to censure the European Union and maintain a tense relationship with Germany. All the while it will preserve its alliance with the United States, which underpins Warsaw's security strategy.

So far this tack has proved popular among Hungarian and Polish voters, but it is risky. Budapest and Warsaw rely on the European Union for money and protection. And although neither Hungary nor Poland is interested in exiting the bloc, their actions could result in their marginalization within

it and the degradation of their influence over Continental affairs.

By contrast, Austria, Slovakia and the Czech Republic will pursue more balanced foreign policies. While they will use Central European cooperation as a means of promoting their agendas and defending their interests, they also will continue to collaborate with Western Europe. The motive behind their strategy is simple: Though these countries are skeptical of further integration into the European Union, they are also closely linked to the German economy. In addition, Austria and Slovakia belong to the eurozone.

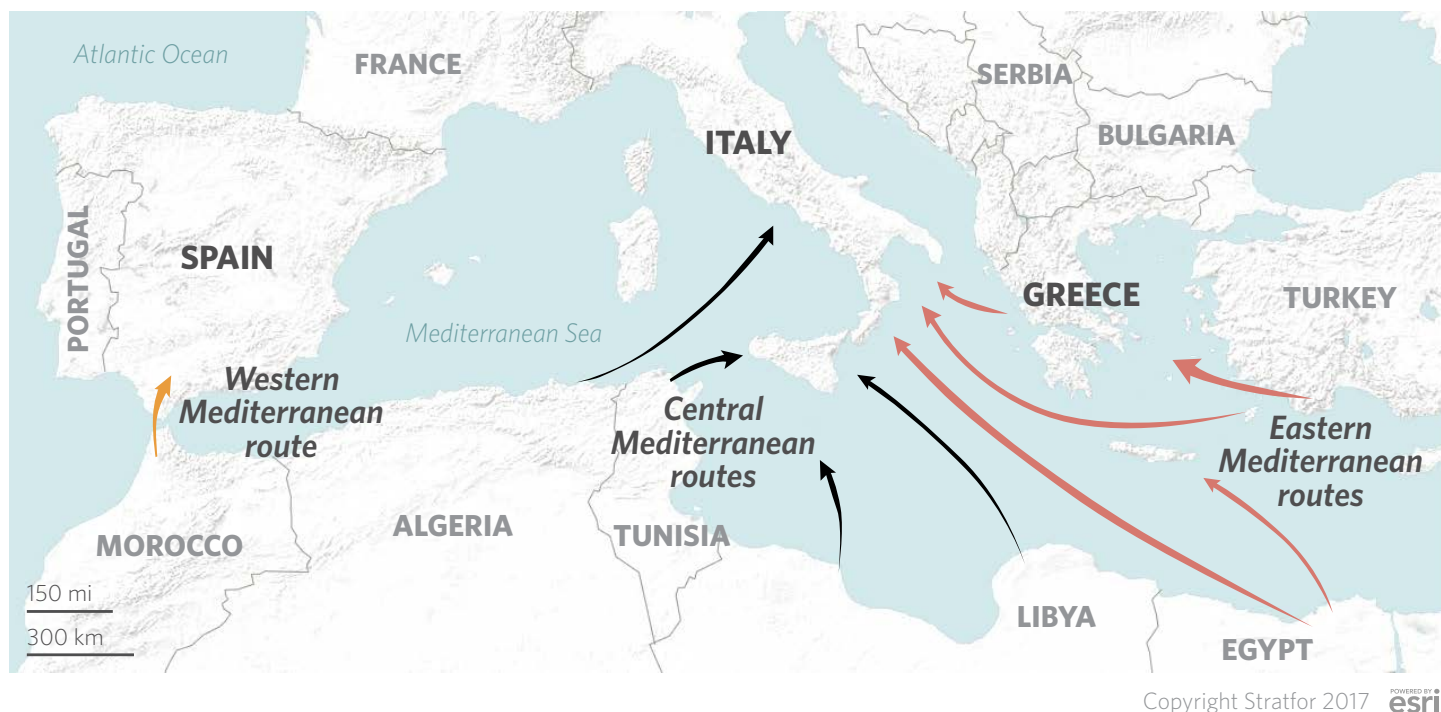
## An EU Foreign Policy Based on Free Trade

Amid a surge of protectionism around the globe that has clouded the future of international trade, the European Union will seek out new free trade agreements. Though the bloc signed a free trade deal with Japan in late 2017, the parties will have to separately negotiate the issue of investment protection in 2018. At the same time, the European Union will try to forge ahead in its talks with Australia, New Zealand, Mexico, India, Indonesia and the Common Market of the South, known as Mercosur. Within these negotiations, issues like agriculture, investment protection and the flow of private data to third-party countries could become sticking points. The process of reaching final deals will be lengthy, likely lasting well beyond next year, but Brussels will stay committed to expanding its collection of trade deals. However, it will also keep looking for ways to better vet non-EU investors that seek to buy companies that are part of sensitive or strategic sectors in member states.

In the meantime, the European Union's relationship with Russia will remain distant. Moscow will try to exploit (and at times, create) friction among the bloc's members with the tools at its disposal, including pipeline politics and propaganda. The European Union, for its part, will continue to argue that it will

## Central and Eastern Mediterranean Migrant Routes

There are multiple paths by which migrants cross the Mediterranean Sea to access Europe. An agreement between the European Union and Turkey struck in March 2016 significantly cut the flow on the eastern routes. The number of migrants taking the central routes has remained steady, if comparatively lower than on the eastern routes at its peak.



lift sanctions against Russia only if Moscow fully complies with the peace deal in Ukraine. Because the sanctions are already a point of contention in Europe, the bloc probably won't expand them, though it may prolong the punitive measures if conditions on the ground in Ukraine do not improve. Brussels will also denounce Moscow's attempts to interfere in European politics while searching for ways to counter Russian propaganda and cyber-attacks. Its success on this front, however, will be only modest.

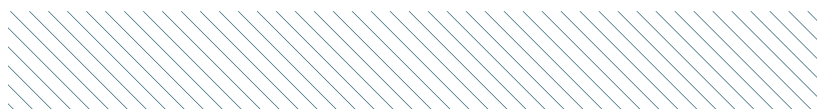
Europe will face a foreign policy challenge to the south as well. Next year, the European Union will study options for addressing immigration from Africa and the Middle East, in part by reforming its migration rules. The most controversial decision the bloc must make is whether to implement a mechanism to more proportionally distribute asylum

seekers across the Continent — a move that, in the end, it is unlikely to make.

Meanwhile, the European Union will work with migrants' countries of origin to try to prevent people from leaving their homes in the first place and to disrupt human-trafficking organizations that funnel migrants into Europe. The number of people crossing into Italy from Libya fell in 2017, but the Continent's migration troubles aren't over. After all, Libya remains politically unstable, and it may not be able to consistently work with Europe to stem the flow of migrants across its borders as its internal turmoil persists. Moreover, migrants have begun using new departure points, such as Tunisia and Algeria, en route to Europe.

Against this backdrop, the European Union will be eager to preserve its migration deal with Turkey in

hopes of blocking floods of people from entering its territory. To that end, Brussels will promise Ankara financial assistance and stronger trade ties, including an update to the existing customs union agreement between them. But if the Turkish government continues to crack down on the media and opposition at home, Europe will increase political and financial pressure against it, adding further strain to their migration agreement. □





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## South Asia

- The slow deterioration of the U.S.-Pakistani relationship over their differences in Afghanistan in 2018 will push Islamabad to develop stronger relationships with Iran and Russia, while Washington solidifies its partnership with New Delhi.
- Negotiations to resolve the war in Afghanistan probably won't materialize next year as Pakistan continues its support for the Taliban — and as the United States sends 6,000 more troops to the conflict.
- Former Pakistani Prime Minister Nawaz Sharif's corruption trial will weaken the country's ruling Pakistan Muslim League-Nawaz party and reinforce the military's political power.

- Focusing on his bid for re-election in 2019, Indian Prime Minister Narendra Modi is likely to refrain from introducing politically sensitive land and labor reforms next year.

### The War in Afghanistan Drives the U.S. and Pakistan Apart

The United States and Pakistan are at a crossroads. The security partnership between the two countries — the most consequential foreign powers involved in the 16-year war in Afghanistan — took a turn for the worse this year. As the Taliban-led insurgency hammered away at the U.S.-backed Afghan military, President Donald Trump cautioned the Pakistani government to stop harboring the militants battling



NATO forces in the longest-running U.S. war. The government in Islamabad, however, has too much at stake to heed Washington's warning. Projecting power into neighboring Afghanistan through the militant groups it supports is part of Pakistan's long-standing geopolitical strategy to try to maintain a sympathetic government in Kabul that will honor the border between their two states and resist India's advances. The politically powerful Pakistani military understands that the issue is a matter of national security. Consequently, Pakistan will continue its support for the Taliban, at the expense of its relationship with the United States.

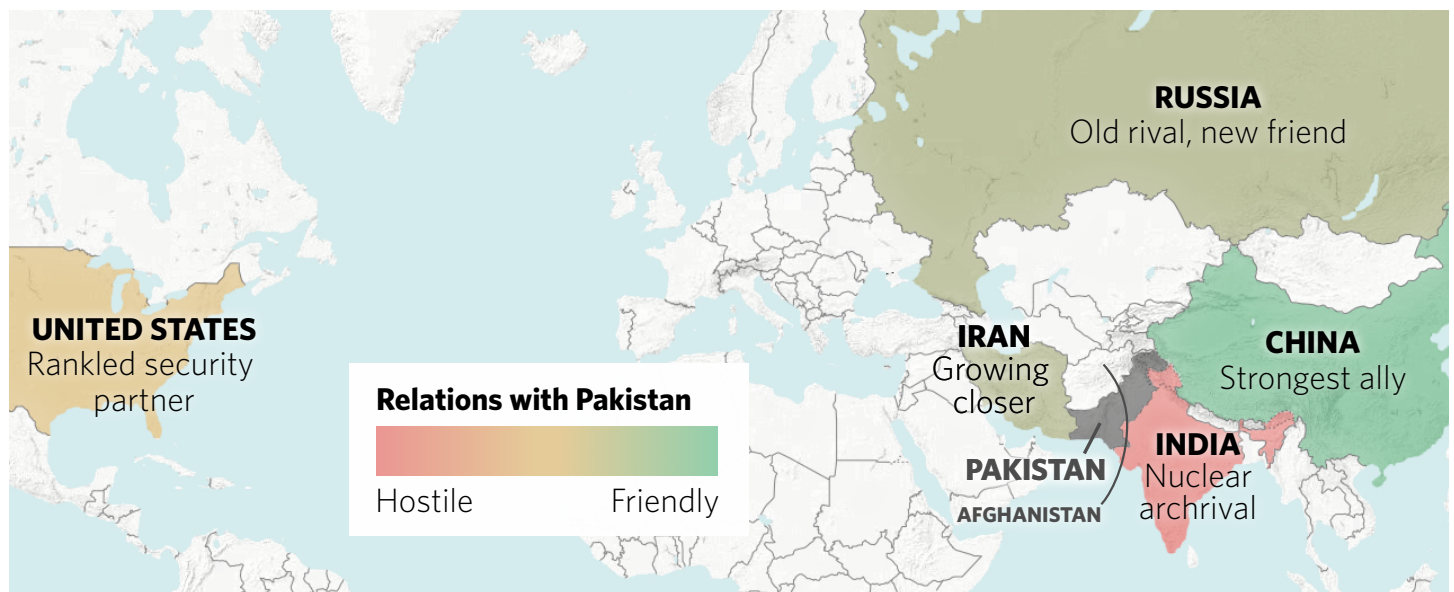
Even so, the countries will maintain their defense cooperation — however begrudgingly — in 2018. Washington probably will avoid taking action that would further strain its relationship with Pakistan, since it can't afford to increase its security burden in Afghanistan when the situation on the Korean Peninsula demands so much of its attention. But even if it defers punitive measures such as revoking

Pakistan's non-NATO major ally status in 2018, the U.S. administration will continue to ramp up pressure on the South Asian country. Washington, for example, could sanction members of the Pakistani government and increase the pace of drone strikes in the Federally Administered Tribal Areas in northwestern Pakistan in an effort to destroy militant havens in the restive region. Already, the Trump administration has announced that it would cut aid to Pakistan by over one-third next year.

Pakistan will respond in kind. As its relationship with Washington cools, Islamabad will enhance its diplomatic and security outreach to Russia and Iran. The two regional powers, after all, share Pakistan's interest in supporting the Taliban as a way to counter NATO's influence, and that of transnational jihadist groups such as the Islamic State, in Afghanistan. Yet these partnerships can go only so far. Islamabad's prominent, if largely symbolic, role in the Saudi-led Islamic Military Counter Terrorism Coalition will limit its ties to Tehran. Similarly, Moscow's rela-

## Pakistan: Friends, Rivals and Others

As Washington's relationship with Islamabad cools, Pakistan will increase its outreach to Russia and Iran while maintaining its strong alliance with China. All of these countries have an interest in facing down transnational extremism under the Islamic State's Khorasan chapter in Afghanistan.



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tionship with India, its largest arms customer, will constrain the budding defense alliance between Russia and Pakistan.

Even without the mounting tension between the United States and Pakistan, though, conclusive peace talks in Afghanistan would be unlikely in 2018. The addition of 6,000 U.S. troops to the war-torn country, mostly in an advisory capacity, means that little will change on the battlefield. At most, the extra manpower will help achieve a more manageable stalemate between the Taliban and the Afghan military as the war drags on for a 17th year.

## Pakistan: A Military With a Country

Pakistan's military, meanwhile, will have more on its agenda in 2018 than the conflict in Afghanistan. Beyond its dominant role in Pakistan's foreign policy, the military also plays a powerful part in domestic affairs. Its plan to nudge militants into the political mainstream through the formation of a new political party, the Milli Muslim League, will get a boost next year in the run-up to national elections. Hafiz Saeed — the accused mastermind of the 2008 Mumbai attacks recently freed from house arrest — has announced that the party will run in 2018 legislative elections. Saeed, who plans to include the issue of Kashmir's secession from India in his campaign, will serve as another point of contention in Pakistan's relationship with the United States and in its rivalry with India. In addition, his rise as a candidate will reflect the resurgence of the religious right in Pakistani politics. The movement will have an unusually strong presence in the 2018 elections thanks to the vulnerability of the ruling Pakistan Muslim League-Nawaz (PML-N).

As election season gets underway, the ruling party will face a leadership crisis. Ousted Prime Minister Nawaz Sharif, currently facing trial on corruption charges, may be sentenced to prison once the proceedings conclude, leaving competing factions of his party to vie to become the PML-N's candidate for

prime minister. The power struggle and its probable outcome also stand to benefit the military. The likely victory of Sharif's brother, Shahbaz Sharif, in the succession battle would be a welcome development for the military, since he favors a more accommodating stance toward it than did his brother, its most vociferous critic. In the meantime, moreover, the strife in the PML-N will weaken Pakistan's most powerful party, giving the military even more clout in Pakistani politics. The boost will enable it to stand firm on its foreign policy, including Islamabad's continued support for the Taliban and enduring rivalry with India. Combined with the stronger Islamist component in Pakistan's politics, the emboldened military will further aggravate ties with Washington and New Delhi alike.

## The India-China Rivalry Intensifies

Pakistan isn't the only foreign policy challenge concerning to India. The strategic rivalry between India and China threatened to give way to a military confrontation this year during a 73-day standoff over Bhutan's disputed Doklam plateau. Though both sides eventually stood down, the underlying problem will follow them into the next year. China's growing influence in South Asia — traditionally New Delhi's sphere of influence — has made India uneasy and has breathed new life into the border disputes between the two. The desire to counter China's growing assertiveness in the Indo-Pacific region will drive India to deepen its security partnership with the United States and Japan, which share the same ambition, in 2018. (Australia may join the effort, too, reviving the quadrilateral dialogue format.) At the same time, Indian Prime Minister Narendra Modi's administration will maintain its economic diplomacy with the members of the Association of Southeast Asian Nations to try to catch up with China on regional trade and investment.

Nevertheless, the competition for international influence between China and India will intensify in 2018. Both countries will move forward, albeit slowly,

with infrastructure projects in Sri Lanka, including the Hambantota and Trincomalee ports, though domestic opposition could hamper the Sri Lankan government's efforts to help keep the ventures on track. Elsewhere in South Asia, however, Beijing seems to have the edge over New Delhi. Nepal, for instance, will continue courting Chinese investment through Beijing's Belt and Road Initiative, now that the Left Alliance has secured a majority in Nepalese parliament. Bangladesh, likewise, will prioritize getting more of the \$24 billion worth of infrastructure projects that China has proposed there underway in 2018, regardless of who wins next year's national elections. In an effort to narrow the gap with Beijing, New Delhi also has offered Bangladesh a \$4.5 billion line of credit for infrastructure development.

Back at home, the Indian prime minister and his ruling Bharatiya Janata Party (BJP) will carry on with implementing the Goods and Service Tax, a sweep-

ing tax reform that passed in 2017. The ambitious measure will likely be Modi's last major reform in 2018 as his administration turns its attention to elections the following year. To shore up his chances of winning a second term in office, Modi will put off politically sensitive land and labor reforms that could challenge his image as a populist candidate. His administration will focus instead on a \$32 billion bank recapitalization program to reinvigorate private investment, along with its efforts to bring the the new tax scheme into effect. Ahead of the national vote in 2019, state elections this year in Karnataka will offer an idea of how well Modi's administration is faring in the face of its failure to create manufacturing jobs on a mass scale. Transforming India into a global manufacturing hub was a pillar of Modi's platform, and his inability so far to deliver on the promise is his greatest shortcoming as his first term in office winds down. □



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## Sub-Saharan Africa

- Southern Africa will undergo a sweeping political transformation next year as South Africa, Zimbabwe, the Democratic Republic of the Congo and Angola try to move away from their long-entrenched leadership.
- Despite his health issues, Nigerian President Muhammadu Buhari could seek a second term in 2019, though he may have trouble holding his party together in an increasingly competitive political environment.
- Stubbornly low energy prices will continue to constrain Nigeria's finances, but as other sources of economic pressure ease, the government may have the means to offer some concessions to militants in the oil-producing Niger Delta region.

- As the incipient Group of Five (G5) Sahel Force struggles to address persistent terrorist threats, the U.S. military will deploy armed drones over Niger as a new way to combat militancy in the vast, ungoverned lands of southern Libya and the Sahel.

### Southern Africa Grapples With Political Change

In 2018, key countries in Southern Africa will undergo leadership transitions — some for the first time in decades. Though the process will play out differently from country to country, each transfer of power is bound to bring change to domestic, regional and international politics.



South African President Jacob Zuma is reckoning with the potential pitfalls of ceding control over his country's ruling African National Congress (ANC) party to a new leader. During the Dec. 16-20 party congress, the ANC selected Zuma's successor, Deputy President Cyril Ramaphosa, who will set the political and economic course of the ANC — and, by extension, of South Africa — for the next several years. Ramaphosa, as the new party head, will also likely assume the presidency in Zuma's wake, either in 2019, when he is constitutionally mandated to hand off the office, or earlier, should he resign before then.

In the run-up to the convention, Ramaphosa and Nkosazana Dlamini-Zuma, the president's former wife, vied to take over the party presidency. Ramaphosa's victory signals a departure in the ANC from Zuma's pro-labor, ethnic Zulu faction, and its populist economic policies and growing reputation for graft and mismanagement. The change bodes well for South Africa's business climate, which has weathered dramatic ups and downs throughout Zuma's tenure. Ramaphosa, for instance, could help patch things up between South Africa's political leadership and the Finance Ministry, whose chief Zuma summarily fired earlier this year during a Cabinet reshuffle. But in the meantime, the deputy president's rise through the party ranks promises to do little for South Africa's structural economic deficiencies, including high unemployment, a rigid labor market and collapsing education standards. The approaching elections in 2019 will compel the ANC to come together as a party and increase welfare in one form or another to shore up its support among South Africa's impoverished black majority, a crucial voting bloc. In addition, Ramaphosa's win could make for a bumpier transition as the next election draws near, should the new party leader decide to push for Zuma's dismissal from the presidency.

Meanwhile, just north of South Africa, Zimbabwe will continue its transition from long-standing President Robert Mugabe in the new year. The process, which got off to a messy start late this year with a military coup, will stabilize over the course of 2018 as the military and political elite rally behind Emmerson

Mnangagwa's leadership. Nevertheless, Mnangagwa has a tough road ahead. The new president will have to strike a careful balance to undertake reforming Zimbabwe's broken political and financial systems while maintaining the patronage networks that underpin his rule. To try to resuscitate his country's moribund economy, Mnangagwa will seek financial and political support from China, Zimbabwe's main foreign investor, and from the West. The funding and recognition that Western financial and political institutions would afford his country probably will be too much for Mnangagwa to pass up, and Beijing won't mind much. The Chinese government, after all, has emphasized the need for stability in Zimbabwe, where increased attention from the West probably wouldn't threaten its core interests.

As Zimbabwe plunges ahead into the next chapter of its history in 2018, the Democratic Republic of the Congo will stay right where this year left it. President Joseph Kabila, who has been in office since his father's assassination in 2001, has struggled to find an acceptable successor to lead his fractious political alliance. At the same time, a weak opposition and the international community's relative indifference have emboldened his administration to push off the transfer of power for the past two years. Kabila's alliance is poised to continue this strategy in 2018, maintaining its strong-arm tactics against the opposition while keeping up the appearance of cooperation.

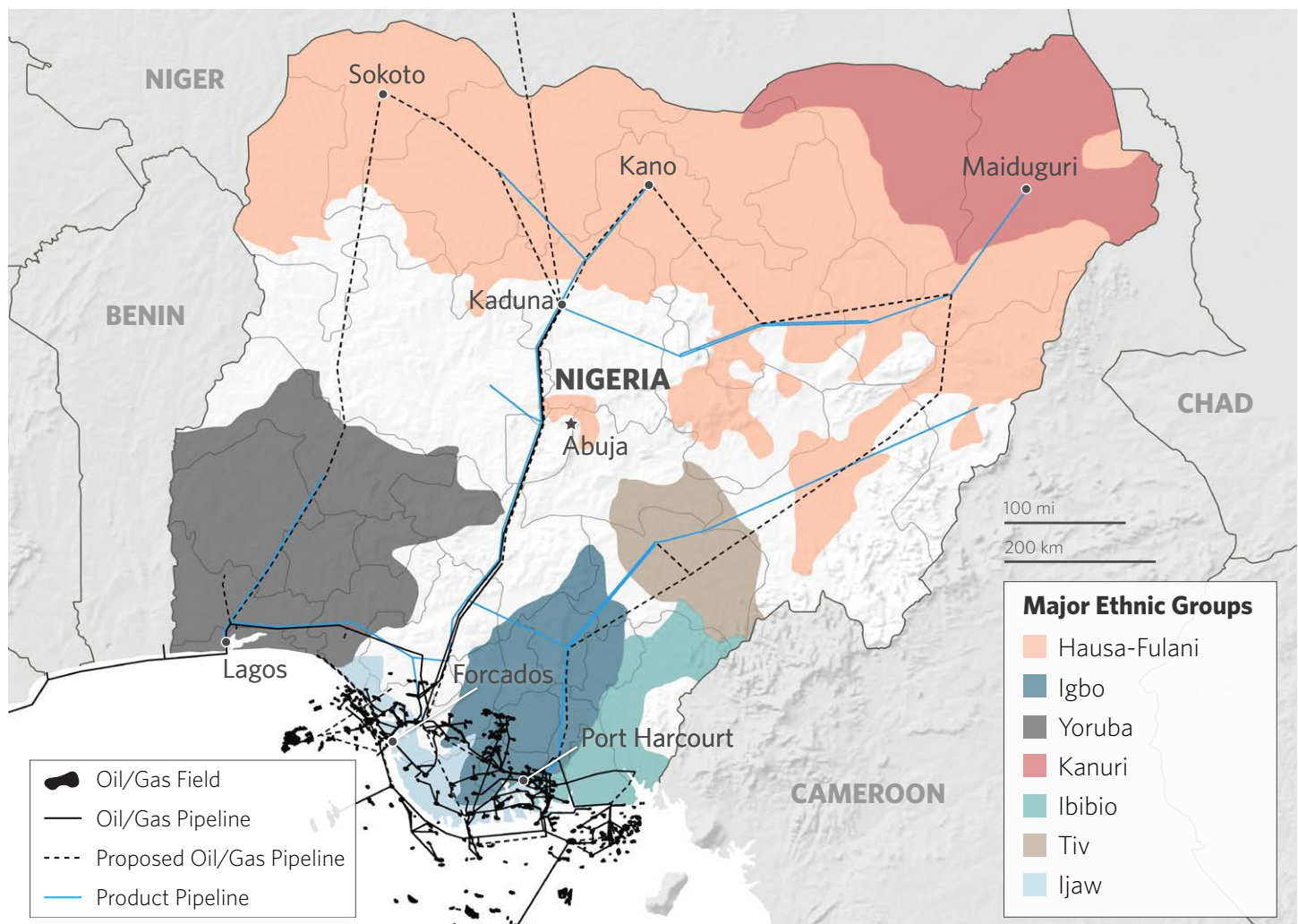
Although the government in Kinshasa has made strides toward improving voter registration throughout the country, it would have to overcome formidable financial and logistical challenges to hold the next general election as planned on Dec. 23, 2018. (The government chose that date only because the United States threatened to mobilize the international community to cut financial support were the vote delayed any longer.) If Kabila doesn't find a suitable successor between now and then, he may resort to desperate measures to protect the fortune his family has acquired during his tenure. Whether he opts to postpone the election further — on the grounds that his administration obviously hasn't prepared to hold a vote — or holds a flawed election

that would doubtless favor his alliance, Kabila could provoke backlash from other countries. But more important international crises elsewhere, coupled with fears of instability in and around the Democratic Republic of the Congo, will stay their hands should Kabila try to delay the election once more.

Compared with the stunted transition in the Democratic Republic of the Congo, Angola's move away from its own long-standing leader, President Jose Eduardo dos Santos, will proceed apace in 2018. Dos Santos' successor, Joao Lourenco, already has begun to chip away at the former ruling family's financial empire since taking office earlier this year. In the coming year, he will continue and expand this campaign, appointing technocrats to key positions in the Angolan government to try to reinforce his authority. Lourenco also will pursue additional probes into the excesses of his predecessor's administration and may push for minor institutional reforms with help from important factions in the ruling Popular Movement for the Liberation of Angola party.

## Nigeria: Obstacles to Prosperity

The new year will be no less consequential for Nigeria as upcoming elections in 2019 start drawing the attention of the country's political elite more and more. Lingering uncertainty over President Muhammadu Buhari's health will cloud his prospects for representing the All Progressives Congress (APC) party in a bid for re-election. Whether the party has another candidate fit to run in Buhari's stead, however, is no more certain. As a result, the APC may struggle to maintain a united front in the coming year, particularly as the People's Democratic Party (PDP) tries to poach more of its members. The rival PDP is liable to have more success with that effort if the APC replaces Buhari with a candidate from southern Nigeria on its 2019 ticket. In that event the PDP, which has selected a northerner to represent it in the election, could force the ruling party to rely on its southern constituents. Northern Nigerians, in turn, could lose their control over the country's lucra-



tive oil industry and resort to backing militant groups to get leverage over the government in Abuja.

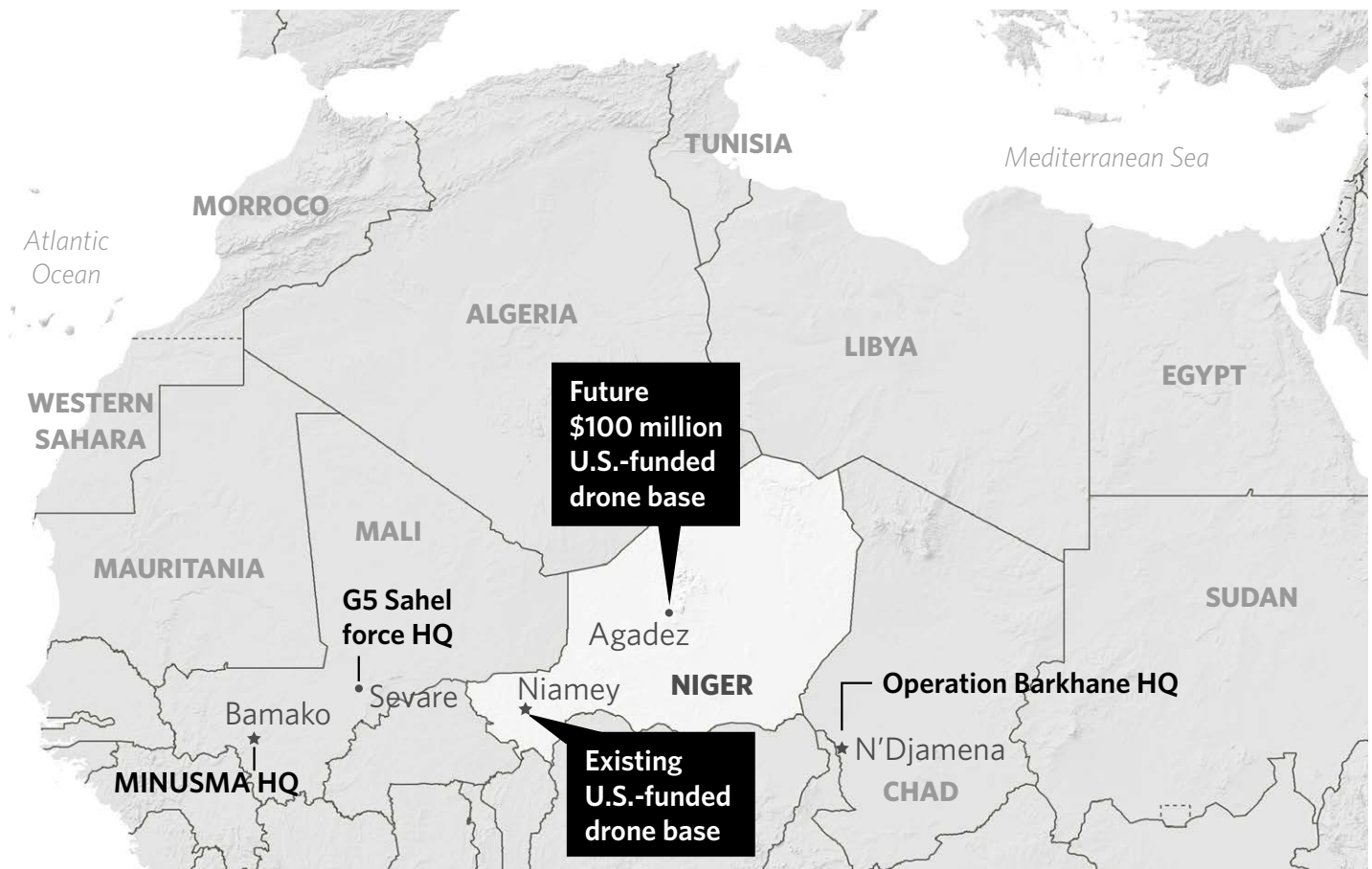
In oil-rich southern Nigeria, on the other hand, the government stands to make headway next year in its struggle against militancy. Falling inflation and austerity measures may give Abuja more resources to devote to calming tensions in the Niger Delta, despite lagging energy prices. So long as northerners are in power, though, the threat of militancy will endure in the region. And the menace of Wilayat al Sudan al Gharbi, better known by its former name, Boko Haram, will permeate northeastern Nigeria throughout 2018. As the Nigerian military and its allies close in on the Islamic State affiliate, splinter groups will continue to stage attacks in the region, even if they struggle to expand their operations.

## Africa in the International Spotlight

Elsewhere on the African continent, countries in the volatile Sahel will face a similar struggle in the year ahead. The newly formed Group of Five (G5) Sahel Force — a joint security endeavor by Burkina Faso, Chad, Mali, Mauritania and Niger — will spend 2018 looking for funding and trying to train 5,000 soldiers to patrol three zones in the desolate region. But their efforts notwithstanding, the security situation in Mali, the epicenter of terrorist activity in the region, will continue unchanged because of setbacks in implementing the 2015 Algiers Accord, which ostensibly ended the conflict in the country's northern reaches. The United States, meanwhile, will turn more of its attention to the Sahel next year as construction wraps up on its \$100 million drone

### The Sahel's International Partners Step Up

In 2018, the United States will likely complete its estimated \$100 million drone base in Agadez, Niger. This, combined with the October decision by Niger's government to allow armed U.S. drones in its territory, will likely result in an uptick in counterterrorism operations against militant groups in the region. Additionally, France will keep up the fight against militant groups and support the new regional G5 Sahel Force.





base in Agadez, Niger, after significant delays. The base, and the Nigerien government's recent decision to allow the U.S. military to arm the unmanned aerial vehicles it uses in the country, will doubtless boost counterterrorism efforts in the region.

In the Horn of Africa, too, the U.S. military will ramp up its campaign against militancy next year. The increased rate of airstrikes and other forms of kinetic action that began this year in Somalia will hold steady as the country's instability continues. In fact, Somalia's security environment may degrade slightly in 2018 when the African Union Mission in Somalia (AMISOM) hands off more of its responsibilities to the Somali army.

Somalia's military, a mostly ragtag force, will probably fail to defend the gains AMISOM has made over the years, giving the country's premier militant group, al Shabaab, more room to operate. The

Somali National Army's losses may well encourage AMISOM to extend the timeline for its drawdown, tentatively scheduled to end in 2020. They could also necessitate more unilateral force additions from the mission's member states, provided international allies such as the United States step up to cover the cost. Yet in spite of the country's persistent security problems — and the growing worries among policy-makers worldwide — the Islamic State branch active in the northern Somalia is unlikely to gain much ground in 2018. Geographic isolation and a lack of capabilities and manpower will limit the group's efforts to expand next year.

To the west, Ethiopia will forge ahead with its flagship project, the Grand Ethiopian Renaissance Dam. Though talks with Sudan and Egypt fell apart over Cairo's fears that the near-completed dam would disrupt the Nile River, the Ethiopian government in Addis Ababa is determined to finish construction





by late 2018. Sudan, moreover, has realized the extra irrigation capacity it stands to gain from the venture, a matter on which it historically has sided with Egypt. And so, Ethiopia will probably achieve its goal, an accomplishment it can point to as it tries to court more Chinese investment for projects to connect its 100 million citizens to the Red Sea.

Outside the Sahel and the Horn of Africa, Brazil will look for opportunities to take advantage of Africa's economic potential. After years spent dealing with political and economic crises at home, the South American country is ready to turn its focus outward in 2018. Its cultural and linguistic ties with the continent, as well as their shared business interests, make Africa a natural choice for Brazil.

Many major Brazilian companies such as Odebrecht and Andrade Gutierrez already have a presence on the continent. Now that they once again have access to credit from state banks — thanks to leniency deals with the Brazilian government over the corruption cases against them — the firms can get back to pursuing investment projects in such places as Angola, Mozambique and Nigeria. In addition, Brazil has plans to increase its military footprint in Africa in 2018. The country is currently in talks with the United Nations to send about 750 troops to the Central African Republic. Though the move will have a negligible effect on the war-torn country, it will give Brazil's soldiers peacekeeping experience while raising the country's profile on the continent and at U.N. headquarters. □



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