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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
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"War & Peace" - What Europe is Still About

After several intra-European conflicts between the continental super-powers, two devastating World Wars, both commenced in Europe (WWI with the assassination of Archduke Franz Ferdinand in Sarajevo), the European Union was created to put under the same roof the countries that had fought each other for centuries, slaughtering millions of people in the process. The European Union has made possible 70 years of peace in Europe (recognized by the Peace Nobel Prize of 2012), interrupted by the Soviet invasions of Hungary (1956) and Czechoslovakia (1968) and the American-led war against Serbia in 1998, when Kosovo was trying to become independent in the late 1990s. Twenty years later, we are approaching the moment of a potential breakthrough, with the accession of the Western Balkans in the European Union, beginning with Serbia and Montenegro. In early February, the European Commission is expected to publish a strategic paper, recommending that Serbia and Montenegro could become EU members by 2025, if a number of disputes are resolved in the meanwhile. In particular, Serbia needs to recognise the independence of Kosovo, as a pre-condition for EU accession. That would mean taming the narrative of Kosovo as the cradle of Serbian ethnical and religious beliefs.

Just three weeks before this historical moment, the killing of Oliver Ivanovic, the leader of the Serb minority party in Kosovo, risk jeopardizing the entire process, as the Serb delegation walked away from the talks with the Kosovan delegation in Brussels. This politically-motivated murder could send Serbia back into the arms of the historical ally, Russia, and away from its European future, and could be the trigger of another wave of ethnical and political instability in the region. On the other hand, if the Serbian pro-European leadership keeps its course, it might accelerate the process of EU accession.

The EU was created to reduce the fault-lines that characterise Europe and resolve tensions and conflicts of interests among countries in a peaceful, rather than bellicose way. In our recent publication we discuss how the various countries are positioning themselves in the race to the top positions of European institutions, becoming available from March 2018 until the end of December 2019, with the European parliamentary elections in 2019. The men and women that will take those top positions will determine the future of the European integration process, and whether that can survive for longer or will eventually collapse. For the process of integration to re-start, the Franco-German engine also needs to be re-started, with France now seemingly in the driving seat. The window to reform Europe is narrow, perhaps closing between June and September 2018, with Italian elections in between potentially delaying important decisions.

In a recent paper, a group of European economists has proposed a new solution to address one of the most contentious issues about the future of Europe, i.e. how to make sure that risk sharing does not become risk shifting, and therefore market discipline is maintained. In a recent event held at France Stratégie a number of representatives of continental institutions gathered to discuss the next wave of structural reforms, to make the European project viable also in the future and acceptable to the wider population, in order to prevent or sterilise the ongoing populist backlash. This is Europe as it needs to be – a common place where to discuss and resolve potential conflicts as well as clashes of interests and cultural approaches in a peaceful way. Because the alternative is a return of the scenarios so dramatically depicted by Lev Tolstoy in his epic book "War & Peace".

Our Recent Publications

- *Tensions in the Balkans Are Rising Ahead of Strategic Paper on EU Enlargement, by Arlind Rama, 19 January 2018*
- *The European "Musical Chairs" Game Has Just Begun by Brunello Rosa and Nouriel Roubini, 17 January 2018*

The Week Ahead

Developed Markets: ECB and BoJ policy meetings and US GDP. The ECB will hold its policy meeting and we expect no change in the policy stance, with potentially some additional guidance on the length and size of its QE program, which is currently expected to end in September 2018. The BoJ will announce the size of its monthly purchases, following an unexpected decline in early January that raised concerns of an earlier-than-expected tapering to its asset purchases. In terms of economic data, the preliminary US Q4 GDP will be published (*c:* 2.3%; *p:* 2.1%).

Germany - The SPD party-congress decided on Sunday 21 to start formal talks to form a "grand coalition" government with the conservative CDU/CSU. The risk was that a rejection of the preliminary agreement between Schulz and Merkel by SPD delegates could result in new elections or in a CDU/CSU minority government.

Commodities - On January 21 OPEC met with its partners to review the oil strategy. The unexpected rise in output (+42.4 tb/d in December), driven mainly by Nigeria (+75.7 tb/d), raises fresh concerns about future compliance. By mid-2018, *Russia* could be considering exiting the agreement if oil prices remain at around USD/bbl 70.

The Quarter Ahead

US - The growth outlook remains positive, supported by the 2018 tax-cuts and domestic investment. Some large companies announced plans to repatriate benefits, invest and/or increase wages. The list includes Walmart, Fiat Chrysler and Apple - which announced it would pay a one-off USD 38bn tax payment to repatriate benefits. Expectations of rising inflation —due mostly to the tight labour market— will support further interest rate hikes.

Europe - Economic recovery will last, supported by QE: In the Eurozone, weak inflation—December CPI declined to 1.4% (*c*: 1.4%; *p:* 1.5%)—reduces the probability of an abrupt end to asset purchases. A "*grand coalition*" in Germany will increase the likelihood of deeper reform in the EU. In the UK, Brexit negotiations uncertainty will weigh on growth.

Russia - Interest rates are likely to be cut in the pre-electoral period and economic growth will likely pick up.

GCC - Saudi Arabia and Iran's foreign policy will continue to weigh on political stability in the region, but military conflict is unlikely. Oil prices will likely decline to USD 55-60 b/b in 2018.

China - President Xi will start implementing reforms and growth will likely slow after the recent pick up.

In global financial markets, the probability of a correction in late 2018 is rising, as central banks plan to reduce net QE. The net yearly liquidity injected by the Fed, ECB and BoJ will decline from USD 1,959bn in 2017 to around USD 363bn in 2018. Rising US bill and bond yields (for the first time in a decade 2y UST yields rose above the 12-month trailing dividend yield of the S&P 500) could contribute to generate outflows from stocks later this year, in favor of bonds.

Last Week's Review

US - On January 19, the Senate rejected a bill to extend government funding, prompting a government shutdown. The one-month extension—proposed by Republicans—failed to address Democrats' concerns about undocumented immigrants. Essential services will run until an agreement is reached. The US Treasury can use extraordinary measures to fund most government payments, at least through April. The last shutdown, in 2013, lasted 16 days and put 40% of federal employees (approx. 800k people) on temporary unpaid leave.

Canada - The CB hiked interest rates (for the third time since July 2017) by 25 bps to 1.25% - and hinted at further increases, encouraged by better-than-expected economic data.

Middle East - Turkey initiated a military intervention against Kurdish troops in northern Syria. On January 20, rumours of a possible US intervention in support of Kurdish troops on the Syria-Turkish border led Turkey to initiate a military operation against Kurdish forces in the district of Afrin. As a result, the TRY weakened by 1.6% w-o-w against the USD, to USD/TRY 3.807.

China - GDP growth picked up from 6.7% in 2016 to 6.9% in 2017, the first increase in seven years.

Pablo Gallego Cuervo and Renata Bossini contributed to this Viewsletter. *The picture in the front page comes from this website.*

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Abbreviations, Acronyms and Definitions

bn	*Billion*	*GDP*	*Gross domestic product*
BoE	*Bank of England*	*GOP*	*Grand Old Party (US Republican Party)*
BoJ	*Bank of Japan*	*IMF*	*International Monetary Fund*
Bpd	*Barrels per day*	*IPO*	*Initial public offering*
bps	*Basis points*	*JPY*	*Japanese yen*
c	*Consensus*	*k*	*thousand*
CB	*Central bank*	*m-o-m*	*Month-on-month*
CBK	*Central Bank of Kuwait*	*mn*	*Million*
CBO	*US Congressional Budget Office*	*M5S*	*Five Star Movement*
CBR	*Central Bank of the Russian Federation*	*OECD*	*The Organization for Economic Co-operation and Development*
CBT	*Central Bank of the Republic of Turkey*	*Opec*	*Organization of Petroleum Exporting Countries*
CDU	*Christian Democratic Union of Germany*	*p*	*Previous*
CNY	*Chinese Yuan*	*PM*	*Prime minister*
CPI	*Consumer Price Index*	*PMI*	*Purchasing managers' index*
CSU	*Christian Social Union in Bavaria*	*pps*	*Percentage points*
DFMGI	*Dubai Financial Market General Index*	*QE*	*Quantitative Easing*
DJIA	*Dow Jones Industrial Average Index*	*q-o-q*	*Quarter on quarter*
d-o-d	*Day-on-day*	*SPD*	*Social Democratic Party of Germany*
DXY	*US Dollar Index*	*tb/d*	*Thousand barrels per day*
EC	*European Council*	*tn*	*Trillion*
ECB	*European Central Bank*	*TRY*	*Turkish Lira*
EM	*Emerging Markets*	*UAE*	*United Arab Emirates*
EP	*European Parliament*	*UK*	*United Kingdom*
EUR	*Euro*	*US*	*United States*
EZ	*Eurozone*	*USD*	*United States Dollar*
Fed	*US Federal Reserve*	*USD/bbl.*	*USD per barrel*
FOMC	*US Federal Open Market Committee*	*UST*	*US Treasury bills/bonds*
FRB	*US Federal Reserve Board*	*VAT*	*Value added tax*
FX	*Foreign exchange*	*w-o-w*	*Week-on-week*
GCC	*Gulf Cooperation Council*	*y-o-y*	*Year-on-year*
GBP	*British pound*	*y-t-d*	*Year-to-date*