



konzept

Politics, populism
and power



Cover story

Politics, populism and power

Many investors think of themselves as apolitical, however, recent market turbulence has reinforced just how much politics can affect business and finance. This issue of Konzept offers incisive opinion on some pressing political issues, including the trade war between China and the US, next year's US presidential election, European populism, technology regulation, Brexit, and more. We also examine how the latest developments in artificial intelligence and machine learning are helping investors forecast the market impact of political events.

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Editorial

It is hard to pinpoint many times in living memory when politics has consumed more column inches, investor energy, and even dinner party conversation than it does today.

That is why in this fifteenth edition of *Konzept*, Deutsche Bank's flagship research magazine, we assess some of the most pressing political issues in 2019 and examine their impact on economies, markets, and society.

We start with the big picture, and examine the increasing number of countries using infrastructure projects as geopolitical tools. The US, Russia, China, and Europe are all intertwined in political brinksmanship with new infrastructure for energy, transport, and security purposes. While these projects are often cost ineffective, they operate as chess pieces, sometimes blocking political channels of rival countries, while opening channels elsewhere for future use. Interestingly, the use of infrastructure in this way is not a new phenomenon and a look through history helps us understand the motives and potential outcomes.

Our second feature also looks to history as a useful guide to show how the current tide of populism will change the economic landscape in many countries. Indeed, lessons from various revolutions and uprisings through history show us that populism tends to be rooted in economic despair for workers and eventually inspires fiscal expansion that puts upwards pressure on inflation. Ironically, we argue that labour is on the verge of regaining some of its lost power due to changing demographics and this could amplify the power workers are just beginning to enjoy.

We then take a tour of the most politically interesting countries in the world to see what 2019 has in store. In particular, we interview long-time Washington insider Frank Kelly who gives his candid views on the chance of legislative agreement, deficit spending, the 2020 presidential election, the relationship between President Trump and the Fed, and US trade policy. From the other side of the fence, our Chief China Economist examines China's changing foreign policy in light of the current trade war with the US.

In Europe, we consider what Germany will look like in the post-Merkel era and, separately,

explore the chance of agreement on the continent's most crucial issues against the backdrop of this year's European elections, at which populists are predicted to do well. With the news on Brexit being extremely fluid at present, we speculate on what an outsider might see when they tour a post-Brexit Europe and UK in the future.

Our final two pieces are anchored in technology. The first looks at the whirlwind year technology groups endured in 2018 and explains that political momentum on network neutrality and mergers and acquisitions could reshape technology and media companies just as much as new laws on data privacy.

Our second technology-focussed piece shows how Deutsche Bank's artificial intelligence and machine learning platform, Alpha-dig, can quantify geopolitical risk. For investors, this is a giant leap forward. On average we find that following a significant political event, equities outperform bonds by four percentage points over the following two months. Importantly, this outperformance is not the result of a sudden jump in markets,

nor is it linear. If investors can use AI to better understand the market impact of political events it will move political risk from being one of the most subjective risks in investing to being a quantifiable input that portfolio and risk managers can objectively examine.

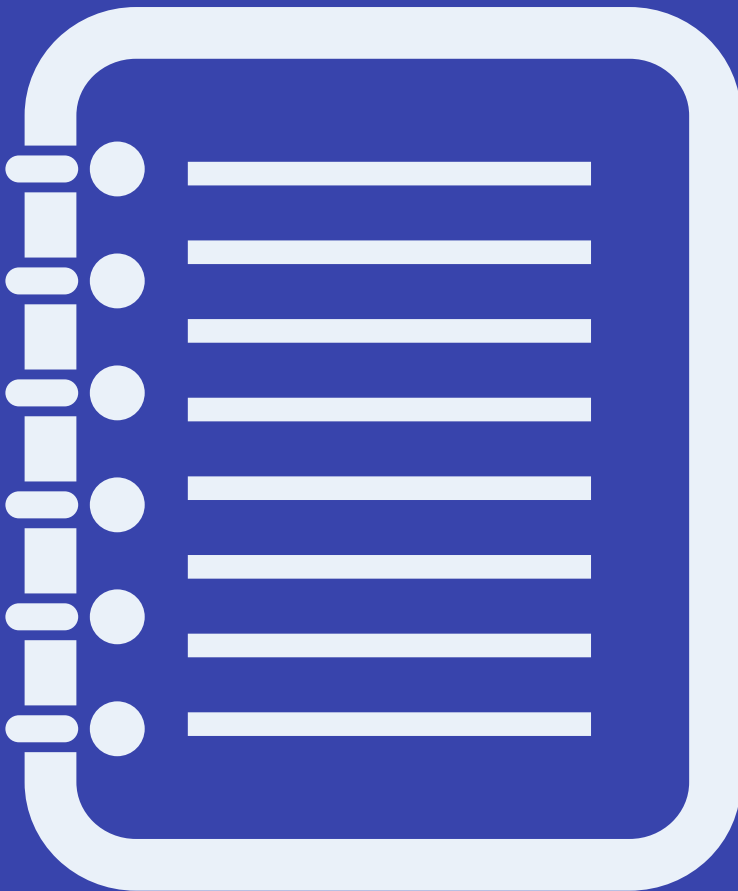
We hope this edition of Konzept gives you some clarity on some of the most pressing, changeable, and curious political issues we face in the world today. When we look back on 2019 in years to come, it will be interesting to see whether we are truly living in a time of exceptional political instability and fracturing or whether the intensity of today's political conversations will crescendo further in the years ahead.

Jim Reid
Global Head of Fundamental Credit Strategy
and Thematic Research

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Summaries



Infrastructure bypasses geopolitical choke points

Peter Garber

Just as many infrastructure projects through history would never have been built if it wasn't for political conflict, infrastructure is again a key tool in geopolitics today. Indeed, with the US increasingly secure in its oil supply, the oversight of the Straits of Hormuz is less necessary. Yet, Middle Eastern oil is still vital for the EU, Japan, and China, and the latter has responded by incorporating oil security into the Belt and Road project. Meanwhile, concerns about relations with Russia, Ukraine, and some Eastern European countries contributed to the Nordstream pipelines which deliberately bypass certain countries. Meanwhile, the annexation of Crimea led to the bridge across the Kerch Straits, a project that has been mulled for a century.

What the history of populism can teach us today

Jim Reid, Henry Allen, Luke Templeman

Far from being unique events, waves of populism and social unrest have often occurred through history. As far back as the French Revolution, such episodes were regularly associated with economic crisis, concerns over national identity, and fundamental dissatisfaction at the governing class. We examine the lessons that previous periods of populism hold for today, including themes of fiscal stimulus and protectionist economic policies. Looking forward, as demographic trends boost workers' bargaining power and populists in government begin to establish a record they have to defend, some of the drivers of unrest should begin to subside.

Q&A on US politics

Peter Hooper with Frank Kelly

With the US facing a period of divided government following the mid-term elections, we interview Washington insider Frank Kelly to assess the implications. Frank gives his candid thoughts on the partial government shutdown and the chances of legislative success over the next two years as the Trump administration faces a Democratic-controlled House of Representatives. He also discusses issues such as a possible infrastructure package and ongoing trade disputes. With the 2020 presidential election in sight, Frank considers how it may affect Washington over the new Congress.

The trade war and China's foreign policies

Zhiwei Zhang

As trade talks between the US and China continue, it is notable that China has begun to invest considerable resources into its relationship with Europe, Japan, and other countries. This is because although a bilateral trade war is painful, it is much less painful than a multilateral one. Indeed, the exposure of China's industrial sector to the US is only five per cent while exports to other countries are five times higher. Against the backdrop of free trade agreements with various countries, the long-term solution appears to be the Belt and Road initiative. However, the question of debt sustainability in the developing countries may cause projects to be reviewed.

Quantifying geopolitical risk

Andy Moniz, Luke Templeman

Artificial intelligence has now grown to the point that it can forecast some market effects of political events. Indeed, Deutsche Bank's Alpha-Dig platform uses machine learning to identify the extent of various political risks and then quantify their intensity. This result is then cross-referenced against markets. On average, in the two months after a key event, equities outperform bonds by four percentage points, however, the return is not linear and understanding this is the key to a profitable investment strategy amidst political uncertainty.

Germany in the post-Merkel era

Barbara Böttcher, Kevin Körner

Germany's post-millennials will struggle to remember a time before Angela Merkel was Chancellor. Following her announcement she will not contest the next election, we examine what Merkel's period in office has meant for Germany and the implications moving forward. Although Merkel has been described as having a consensual approach to politics, many in Germany were unhappy with her decisions during the sovereign debt and migration crises and say these decisions contributed to the fragmentation within German politics that has made it even harder to build coalitions and reach a policy consensus. Given this domestic fragmentation, as well as the changing external environment, the next German chancellor may struggle to achieve the major reforms required over the coming years.

Media, cable, and satellite under the Trump administration

Bryan Kraft

While 2018 turned out to be a humbling year for technology stocks, the biggest political changes that affect the industry may be the ones away from the spotlight. Changes to the rules governing network neutrality and the regulation of pricing have reduced uncertainty for the industry and allowed for new pricing options. Separately, investors expecting more lenient scrutiny of consolidation deals under President Trump have been somewhat disappointed. Any changes to these rules could have serious implications for an industry which is currently grappling with privacy issues.

No end of history – Europe struggling in a changing world

Kevin Körner, Barbara Böttcher

As Europeans reflect on the thirty-year anniversary of the fall of the Berlin Wall, they will go to the ballot box in one of the most fizzing parliamentary elections in memory. Yet, unlike in 1989, when liberal democracy and capitalism were in the ascendant and the EU was confidently expanding, the mood today is very different. Current projections suggest Eurosceptic forces will increase their influence in parliament once again just as the EU has been buffeted by a series of crises that have led some to question its future. With the Trump administration shifting towards an “America First” stance, and China growing in power, Europe has to nail down several issues or risk losing its power on the world stage.

CEEMEA: How the elections of 2019 will shape the region

Kubilay M. Ozturk

Several emerging countries go to the polls this year, including Turkey, South Africa, and Poland. As governments seek to boost their election chances, there is the possibility that some CEEMEA countries will loosen their fiscal stance, while risks have increased that the independence of their central banks could come under pressure. Yet, if populists come to power, or maintain it in some cases, the flip side of illiberal control is that their influence over the judiciary and bureaucracy means they may actually find it easier to implement economic reforms.

A tour through post-Brexit Europe

How will outsiders see Europe after Brexit?

In many cases, the continent will be home to more populist parties emboldened by Brexit. Italy's populist government is openly confronting the EU, factions in German politics is making dialogue difficult, right-wing groups in the Nordics have traction as they have in the Netherlands. Across the continent, Brexit seems to have widened the ideological gap between parties. Oddly, the opposite is true in Britain itself. Rifts within parties themselves are in the spotlight more than the rifts between them. Meanwhile, populist parties lost votes at the last election. Yet, with populism in Europe yet to reach peak levels, Britain's political paralysis may spread to other countries.

Infrastructure bypasses geopolitical choke points

Ever since the advent of steam power, grand infrastructure projects have dramatically reduced the cost of transportation, fostering the internal development of many countries. Yet, many such projects—canals, railroads, highways, ports, pipelines, and airports—included a geopolitical dimension that was an important or even dominating impetus. Without this, many historical projects may never have been built and this still is true of many infrastructure projects under construction today.

Indeed, following the end of the Cold War, the game of geopolitically driven infrastructure construction to neutralise choke points has re-ignited. Some projects reflect competition among great powers for influence in third countries. Offers may be made of cheap financing in places that are poisonous to private sector incentives. Some countries simply follow the old colonial business model of tapping formerly inaccessible resources by finally providing an outlet.

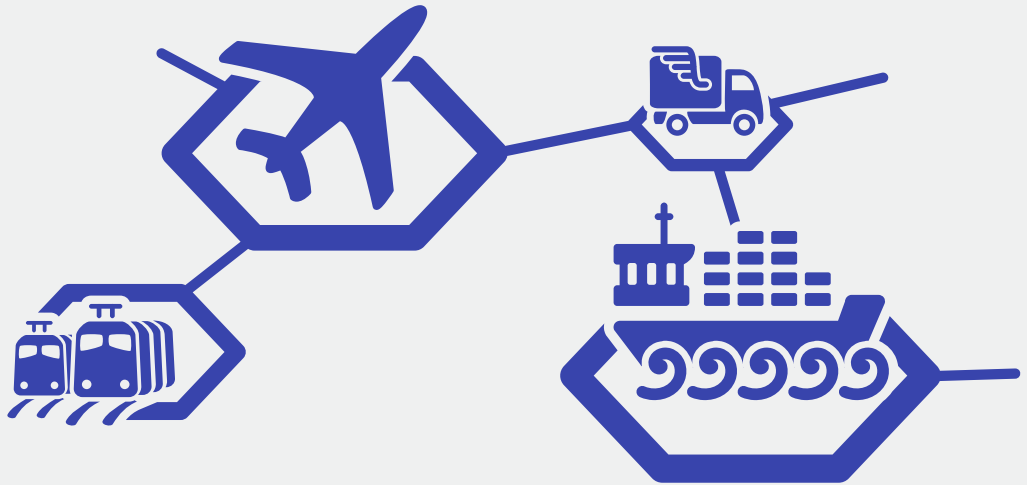
These projects may have little commercial rationale other than to provide an alternative route in case a key choke point is blocked in an economic or even shooting war. In fact, the project itself may deter such a blockage to the main route. That they are built at all and at high cost signals the probability that strategic planners today attach to conflict scenarios, or at least the seriousness of the tail risk. This must force investors to account for the same risks.

The list of these projects in history is long. Take the Suez Canal. Although built by French capital against British opposition, the canal reduced Britain's cost of maintaining naval dominance and empire on a multi-ocean scale. Absorbing the lesson, the US reaped the same benefit with the Panama Canal. Meanwhile, the Trans-Siberian railway secured and populated Russia's Siberian frontiers and projected its power to the Russian Far East. The three US transcontinental railroads secured its Pacific coast to its Atlantic seaboard's power centres and forced the construction of the Canadian-Pacific Railway, likewise to bind British Columbia to the Canadian Confederation. In Europe, the Berlin-Baghdad Railway aimed to secure a port on the Persian Gulf, gain access to oil, and circumvent any potential constriction of the Suez Canal.

Looking forward, geopolitical tensions are currently driving a number of infrastructure projects and we will briefly examine how these link together.

Pipeline interplays with Belt and Road

As the US fracking revolution gathered momentum, American crude oil production peaked at around 9.5m barrels per day in 2014. However, Saudi efforts to boost pumping led to a price war. American drilling contracted and existing wells were temporarily suspended, leading American production to fall to 8.5m barrels. A subsequent rebound in prices has encouraged US crude producers who now pump 11.5m barrels per day. Much has come from the continued development of the Bakken shales in



North Dakota but mostly from the Permian shales in West Texas and New Mexico.

Despite the flood of oil, much of the production capacity already developed has been locked away from the market because of a lack of pipeline capacity. That is where new pipelines in the Permian and Bakken come in. Coming online over the next two years, they will allow the movement to market of an additional 2m barrels per day. In addition, the Keystone/XL pipeline will eventually unlock further oil flow from Alberta. US petroleum and gas supply will then originate entirely in North America and significant net exports will be at hand.

This is a well-recognised geopolitical revolution. With no need for the US to import Middle Eastern or Venezuelan oil, the strategic imperative to defend long sea lanes for petroleum transport will evaporate, at least from a strictly American perspective.

Of course, the laying of these pipelines is a commercially profitable program per se but they carry profound geopolitical impact. It is noteworthy that their construction was internally politically controversial. It was blocked under the Obama administration on environmental grounds and restored under the current administration that was more focused on the business and geopolitical considerations. The spillover implications from this decision are considerable.

Persian Gulf commitments

In the Middle East, the military and geopolitical task of the US for six decades has been to keep the Straits of Hormuz open to the

flow of oil. This mission of positive sea and airspace control is far more difficult than would be a mission merely to interdict traffic through the straits, requiring ever-larger naval, air force, and army deployments and, potentially, war. However, as the US becomes a significant net exporter over the next decade, its strategic burden will shift from requiring the capacity to exert positive sea control to only needing the capacity to exert sea denial through the straits, the Indian Ocean, and the South China Sea.

Watching this shift closely will be Japan and the EU, which are still vitally dependent on Middle Eastern oil. Japan imports more than four-fifths of its crude from the Persian Gulf region. If the US becomes a large exporter, it can insulate Japan and Korea to some degree. Indeed, the US could use exports from the prospective Arctic National Wildlife Refuge production, and its prospective pipeline, although ANWR is rated at only 750,000 barrels per day, far less than Japan's required imports of 4.5m.

Belt/Road in the petroleum dimension

With its economy growing to challenge that of the US, China has increased its dependence on foreign oil. Indeed, China's petroleum production has now fallen below 5m barrels per day while its imports have risen to about 8m. More than half of these imports come from the Middle East. That places China in roughly the same strategic position as was the US after the late 1960s when it was invested militarily in the Gulf region. So now it will be China's burden to secure petroleum transport from the region.

In part, China already does this via infrastructure. Pipeline deals have been made in central Asia, through Pakistan to the Arabian Sea and Iran, and through Myanmar. But it is of particular interest that China secures transportation to the Straits of Hormuz. Indeed, this is one of the essential geopolitical dimensions of the Belt-Road initiative; and it aligns with the construction of potential bases in Myanmar, Sri Lanka, Pakistan, and through to Djibouti.

Venezuela

With waning dependence on foreign oil, it has now become easier for the US to turn the economic screws in Venezuela. This year, the economic cost to the US of embargoing its 750,000 barrels per day of Venezuelan imports will be far less burdensome. More damaging to Venezuela, the door will also be open for the US to block the export of diluents which are vital for the production of Venezuela's produce and export of its heavy crude to other potential markets.

Collaterally, this can also turn into a stepped up economic war against Cuba, which will now likely receive fewer subsidies from Venezuela for supplying President Maduro's Praetorian guard. Existing Russian and Chinese geopolitical loans to Venezuela would then become even more problematic, so they would have to pay up to maintain this thorn on the flank of the US.

Bridge and gas pipelines vs Ukraine

Concerns about Russian politics and infrastructure are not just confined to oil. Indeed, Russia supplies about two-fifths of the EU's gas imports, which it shipped via pipelines through Poland and Ukraine before Nordstream 1 opened in 2011. Built on the Baltic Sea floor, Nordstream 1 was more costly than a land route would have been but it, and the future Nordstream 2, bypass Ukraine and Poland. The Nordstream 2 pipeline itself has been a point of contention between different governments, even within the EU. While Angela Merkel and Vladimir Putin support the pipeline, Donald Trump is opposed, as are the Polish Prime Minister and Ukrainian President.

In total, these pipelines have the capacity to supply a quarter of the EU's consumption. Frequent disputes through 2009 over pricing of gas shipments to Ukraine, and transit fees to the rest of the EU, triggered Russia's cuts in the gas feed into the overland pipelines. Meanwhile, disagreement arose over Ukraine's diverting to itself gas intended for other countries which resulted in shortfalls of deliveries to EU third party countries not involved in the dispute.

There is no need to take a position on whether this was, at the time, simply a hardnosed commercial dispute between bilateral monopolists or a more serious geopolitical dispute, although it certainly emerged as the latter in 2014. The response of Russia and the EU was to open Nordstream 1 in 2011, thereby subtracting an economic weapon from Ukraine and allowing the EU to adopt a neutral position in further disputes. That signalled a cut in ties with Ukraine while the EU has also launched a policy of diversifying its supplies away from Russia.

The Crimean bridge

This policy comes as the situation between Russia and Ukraine regarding Crimea becomes increasingly complex. Since the annexation of the peninsula in 2014, the impact on the region has proved economically costly. Tourism has dried up while Russia has suffered from the imposition of international sanctions and the need to pick up pension costs.

On top of the economic costs, infrastructure security has become a key focus. After the annexation, Ukraine cut off the supply of water, electricity, and transportation across the single land route to the peninsula, forcing Russia to use more costly sea transportation. The completion of the Crimean Bridge across the Kerch Straits last year finally blunted these impacts.

Interestingly, although the bridge had long been proposed, it was not launched until conflict cut the route across the Isthmus of Perekop. The bridge seems also to have provided an easy means, or at least the signal, to block Ukrainian sea transportation via the Sea of Azov and the Straits. It allowed Russia to implement burdensome inspections of Ukrainian sea traffic through the Straits. By some estimates, this has reduced traffic by a quarter through the Ukrainian port of Mariupol, itself under occasional attack during the conflict.

If such blockages intensify, the effect will be to push Ukrainian goods transportation from its threatened south-eastern region onto the roads and railroads to ports such as Odessa in the west. This will increase costs and possibly lead to serious capacity constraints. Thus, at the price of some probably-tolerable new sanctions, Russia has expanded its economic war against Ukraine and may possibly look for further concessions or territory.

Whilst the politics surrounding the infrastructure discussed above is complex, needless to say, little of this type of infrastructure build would have materialised in the first place were our planet a geopolitically sweet world. ●

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What the history of populism can teach us today

“What is the end of our revolution?” wondered Robespierre, one of the populist leaders of the French revolution. It was perhaps a more insightful question than he realised. After a decade of revolution proper, waves of populism surged and retreated as France lurched between dictatorship, monarchy and democracy.

The French revolution is just one of many historical examples of how populist surges shape politics and economies. And while they create great uncertainty, the repeating themes within make it possible to view today’s populist surge through a tighter lens than many realise. These themes include economic hardship, issues of national identity, and an electorate that feels a fundamental dissatisfaction with the incumbent political class and the state of the country.

That these themes are common to most populist episodes should quell some of the trepidation many feel today. Economists and politicians can use learnings from prior episodes to help shape their decisions on issues such as fiscal policy, quantitative easing, protectionism, and immigration. Meanwhile, investors can use history as a navigational aid as the current tide of populism changes the landscape.

Economic crisis

There is an argument to make that the seeds of today’s populism were first sown in the early 1980s. This period marked a key global demographic turning point which coincidentally occurred with China’s re-integration into the global economy for the first time in several centuries. Indeed, in 1980 there were very few workers relative to the overall population and they therefore had pricing power. Nearly four decades on, the ageing baby boomers have

helped reverse this trend, which was supersized by China’s reintegration into the world economy and its own working age demographic overhang.

This abundant global labour supply over the past few decades has led to constant downward pressure on the price of labour. Indeed, workers in many countries have experienced a near three-decade freeze in their real wages, just as increased home and asset ownership, rising wealth and leverage combined to create a kind of money illusion. This may not have been felt acutely before the financial crisis, but it certainly was after it hit. At this point, wealth and leverage disappeared and workers looked more towards their pay packets. They were increasingly frustrated with what they saw and the long-term under-performance of wages was exposed.

Stagnating wages is one thing, but economic crises tend to leave large numbers of people unemployed and when this occurs, it is understandable that the population’s growing frustration can be channelled towards a populist agenda. The figures surrounding the financial crisis speak for themselves. Unemployment in the US peaked at ten per cent while in Europe, things were even more severe. Exacerbated by the sovereign debt crisis, about a quarter of the Spanish and Greek workforce found themselves out of work. Even in countries where the effects were less severe, such as the UK, real wages are barely higher than they were before the crisis.

Adding to discontent at the economic malaise, was the way in which technology and trade were changing the nature of work. This sped the decline of old industries, while legislators struggled to keep up with the rise of the ‘gig economy’ and its implications for labour relations.

It should therefore not be surprising that economic crises have been the overwhelming catalyst for populist revolts through history. Take, for example, the French Revolution. This movement started after a succession of poor harvests that resulted in sharp increases in food prices. On top of this was a fiscal crisis at the state level as a result of France's participation in various wars, as well as general profligacy. Of course, other factors were at play but it was the economic crisis and the hardship it inflicted upon many French citizens that created the conditions for a revolution.

Later, the 1848 revolutions in Europe also followed a period of serious economic hardship. While the revolts are generally seen as 'liberal revolutions', where people rose to demand political reform and democratic rights, it is notable that the period followed the failure of potato crops in the 1840s and the associated severe famine in much of Europe. One study showed that the price of wheat in France and Prussia rose by more than half in the two years to 1847. That price escalation was cataclysmic given the swathes of the population who lived close to subsistence¹. While the tragedy in Ireland was the most visible outcome of the famine, there were also thousands of famine-related deaths in continental Europe. In turn, as people spent more on food, manufacturing began to slump. As a result, unemployment rose and the continent's economic woes spiralled into revolutionary sentiment.

Economic distress has also led to darker outcomes, as seen with the Nazi seizure of power in interwar Germany. The reparations mandated by the Treaty of Versailles after the first world war were layered on top of an already fragile economy. Indeed, by the end of the war, German economic output had shrunk by 30 per cent on a per capita basis. This was followed by a

hyperinflation crisis in the early 1920s where the destruction in the currency's value led to the German government defaulting on its reparation payments. Compounding this, the Great Depression sent unemployment soaring and millions were left destitute. By 1933, per capita output was no greater than it was two decades earlier. The desperation felt by many people was seized upon by populists and channelled into the Nazi rise to power.

Asserting national identity

The second common theme behind populist episodes is the assertion of national identity, and the parallels between the events of today and those in history are striking. Anti-immigration policies are perhaps the most visible example. Indeed, when Donald Trump announced his candidacy for the presidency, his speech made waves for its comments on Mexican immigration. His campaign featured strong rhetoric against



illegal immigration and on bringing down immigration generally. In government, Trump has raised the idea of ending birth-right citizenship and reiterated his desire to build a wall along the Mexican border.

Europe is also dealing with issues of national identity and immigration. Indeed, sovereignty and the free movement of people were key factors behind the Brexit vote, although this was intertwined with economic deprivation and government spending cuts. Similarly, Marine Le Pen in France, the League in Italy, the AfD in Germany, and others have attacked the level of immigration. Some European governments, such as Hungary and Poland, have even refused to accept asylum seekers.

Historically, this is not unusual. In mid-nineteenth century America, there was opposition to the immigration of Roman Catholics from European countries, such as Ireland, because of fears it would change the Protestant culture of the US. Not long after, a backlash against Chinese arrivals led to the Chinese Exclusion Act of 1882. This policy was partly the result of fears that Chinese workers were taking American jobs, a theme starkly prevalent today.

National identity has also raised its head in other forms. In particular, demonstrations in the mid-1800s in countries such as Germany and Hungary were precipitated by a desire for nationhood to be recognised. Looking further back, the French Revolution saw the rise of the mantra of *liberté, égalité, fraternité* and the Tricolore flag emerged.

Dissatisfaction at the political class and the state of the country

The third theme that repeats through history is that populism and social unrest have been driven by dissatisfaction at the governing powers. Populists tend to desire a system that favours citizens rather than the establishment. Brexit and Trump, though distinct in a number of ways, were both rebellions against the political, financial, and media establishments, who were mostly opposed to both.

The desire to throw out the old ways and start afresh was entrenched in French revolutionaries. The Tennis Court Oath of 1789, one of the defining points of the revolution, was framed around the push for constitutional reform that eventually led to the overthrow of the French monarch and the declaration of the Rights of Man and of the Citizen.

Similarly, the 1848 revolutions in Europe shared a desire to progress a liberal democratic

agenda. The French King Louis Philippe abdicated and the second French Republic was established (albeit short-lived after Napoleon III's coup in 1851). Prussia also moved in the direction of a constitutional monarchy, as did Denmark. The Hungarian revolution was suppressed, but eventually led to the Austro-Hungarian Compromise of 1867 that established a dual monarchy for the countries.

In our own time, the revolt in Eastern Europe in 1989 and the recent Arab Spring protests were strongly driven by a spirit of rising against entrenched rulers to "set the country on a better path".

This isn't to say that populism has always led to more liberal or democratic outcomes. In the interwar period, Hitler and Mussolini led fascist regimes, while the Bolshevik revolution in Russia resulted in vast repression as communists gained control. However, despite the result, all these movements arose from deep dissatisfaction towards the ruling class and a desire to shake up the status quo.

Looking forward

It is ironic that just as populism has taken root today, the demographic super-cycle that has depressed wages since 1980 has recently peaked and should slowly reverse, lowering workforce numbers in more economically significant countries. That means, left to its own devices, labour should begin to regain pricing power. This power may be amplified by the fact that many populist policies are already helping lead labour's fightback.

Against the backdrop of improving demographics for workers, we can extrapolate the lessons of populist history to make predictions about how the future may play out. Before we do, it is necessary to determine the direction and brand of populism that societies may face. Taking a step back, it seems strange that right-wing parties dominate today's populist agenda. After all, if populism stems from economic concerns, then one would assume a preference for left-wing parties given their support for greater wealth redistribution to low and middle-income households. Yet right-wing pro-business parties dominate.

The reason is that people frequently view their notion of dignity and respect as more important than their economic situation and are willing to sacrifice the latter, at least in the short term. The political scientist Francis Fukuyama recently argued this stems from the desire for *isothymia*, which can be simplistically translated

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as “a desire to be respected as an equal”. Fukuyama noted that in recent times, significant portions of the population in several developed countries have viewed the established government as giving some groups priority and ignoring others. This feeling of unequal treatment or disrespect opened a void that right-wing populists filled with promises to restore a ‘better’ past and a greater sense of dignity.

However, it would be wrong to completely dismiss the emergence of left-wing populists. Indeed, left-wing parties have been left reeling by the recent swing towards right-wing groups and they will surely react. If they can satiate voter desires on issues of national identity, and also offer their traditional policies of economic redistribution, the pendulum could quickly swing their way as it did in Greece and might do in the UK. In that case, economies can expect higher taxes on the wealthy and corporations, as well as the nationalisation of high-profile organisations and infrastructure.

Another consistent theme of history is that populists enact fiscal expansion. Already in the US and Italy there are signs of this, while the French government has proposed higher spending and tax breaks for bonuses and working overtime in response to recent protests. Markets should therefore prepare for the likely consequences: overheating economies, inflationary pressures, higher debt increasing bond yields, and an eventual slowdown as the economy fails to sustain above-trend growth.

The mechanism for fiscal stimulus has historically been a large-scale military buildup, usually driven by a desire to “restore the dignity” of a nation. Today however, military clout is less important compared to the desire to improve living standards. Hence populists promise more secure jobs, higher disposable incomes and a notion that the country’s identity is intact. As a result, we can expect more economic policies to revolve around income tax cuts, infrastructure spending, and in some cases, universal basic income.

If these policies slow the economy, investors should expect central banks to react differently compared with their actions in the past. This is because much of the recent populist anger has centred on widening inequality, something that was exacerbated by quantitative easing. With populist politicians in several countries already exerting pressure on central banks, it will be difficult in future slowdowns for central bankers not to consider that quantitative easing and other policies that boost asset prices

may be unpopular with the population. However, there is a possibility that central banks could deploy unconventional monetary policy through other methods. These could include creating new money to fund fiscal spending or delivering it directly to the population to encourage spending in the real economy. Although inflationary, this would provide a way to achieve higher spending in the short term.

To bolster the notion of identity and control, we can expect populists to continue to promote protectionism, both of trade and immigration, despite the evidence that free trade and immigration provide significant economic benefits. President Trump’s imposition of tariffs on Chinese imports, and the renegotiation of NAFTA into the USMCA are just two examples of policies other countries seem likely to pursue. The countries that take this route should expect higher consumer prices as tariffs are imposed, and a restriction of consumer choice.

Regarding immigration, the reduction promised by many populists will almost certainly hurt public finances and exacerbate the problem of ageing populations in many western countries. Immigrants tend to be younger workers who pay taxes and consume less state healthcare and pensions. Without immigration, the working population of western countries will bear an increasingly large tax burden to support an ageing population.

To determine where the immigration policies of western nations are heading, we can look to Japan, a country long resistant to immigration. More than a quarter of the Japanese population is now aged over 65 and the total population is shrinking. Although this situation has been known for decades, it is only in recent years that the country is examining proposals to allow more foreign workers.

That bodes ill for Europe. Over the next two decades, Germany, France, and Italy are all forecast to reach the point at which a quarter of their populations will reach 65 years of age. If Japan is only now dealing with the problem, other countries may also kick the can down the road until the problem becomes more serious. However, by that point, the damage of labour shortages will already be forcing either higher taxes or greater government borrowing to maintain existing levels of spending for the elderly with a working population in decline.

The historical lessons of our third theme, the dissatisfaction at the political classes, is more nuanced. That is because prior periods of populism and revolution went hand-in-hand with

the desire for liberal constitutional change. Yet, in most developed countries today, a wide-ranging liberal democracy is well established.

Accordingly, today's populists have generally not opposed the constitutional system in which they seek to govern and, in most cases, have not upended other institutions of government.

Instead, populist political reform has tended to focus on bringing citizens closer to government and this will likely continue. For example, supporters of Brexit want to shift various EU competencies back to the UK. Even pro-EU politicians have echoed this sentiment. For example, French President Emmanuel Macron has proposed the idea of democratic conventions of citizens that would advise on policy.

A consequence of this political shift could well be the greater fragmentation of political systems and nation states. The rise of separatist movements in Scotland, Catalonia, and Quebec show the desire of some regions to chart their own path, while regions within countries have pushed for greater devolution of power from their respective central governments. The consequence is greater policy divergences both within and between allied countries. Barriers to trade will emerge as each set their own laws and regulations.

Similarly, we can expect to see continued attacks on supranational institutions and a renewed emphasis on the importance of the nation state as the appropriate platform for policymaking. This is already happening in the US, Italy, Poland, and Hungary. It is also interesting to consider that the fragmentation of politics in some areas may actually encourage integration in others. For example, in response to some of the polarising voices in Europe, many pro-EU leaders are banding closer together. In particular, the German and French leaders are advocating further integration through various channels.

Fragmentation at a national level could easily trickle down to the corporate level where workers could demand more say in their organisation. Already, Germany operates works councils and in Britain there have been similar calls for workers to be placed on company boards. Given low unemployment in many economically significant countries, and the fact that they are beginning to see their working population peak, workers' bargaining power should improve and support for these arrangements will likely gain momentum.

The current populist tide could rise further in the near future but we expect it to recede over

the medium term as changing demographics helps labour regain some of its pricing power. More immediately, though, it has already become apparent that some of the bold promises made by populist parties cannot be implemented. Furthermore, populism is far from universally popular. Indeed, the recent US midterm election result that saw the Democrats capture the House of Representatives was partly driven by the electorate voicing its displeasure at President Trump.

If and when the current populist tide recedes, it will leave behind a changed political landscape. Fundamental left-right questions about the size and reach of government are complex and ongoing, as are questions of the appropriate level at which sovereign power should rest. Nevertheless, looking at other waves of unrest in the developed world over the last two centuries, we can expect this period to eventually subside and for stability to return, as happened in previous episodes in Europe and the US.

While talk centres on how political parties should react to populist voters, the underlying social and economic problems in many countries remain unaddressed. Fukuyama notes it is far easier to pay lip service to under-privileged groups by funding token projects than it is to enact real change. With that in mind, legislators must enact wholesale programmes that offer marginalised people the skills that provide opportunity. With opportunity comes the gratification of respect and that is the key theme that history tells us prevents populist uprisings. ●

Q&A on US politics

The following is an interview taken by Peter Hooper, Deutsche Bank's global head of economic research, who sat down with the head of Deutsche Bank's Office of Government Affairs in Washington, Francis J (Frank) Kelly.

A long-time Washington insider, Frank began his career as a White House writer for Presidents Ronald Reagan and George HW Bush. He went on to head up public affairs for the Department of Justice and then the Securities and Exchange Commission, after which he established a Washington office for Charles Schwab & Co. He opened the office for Deutsche Bank in 2003. Over the years since, Frank has been a regular participant in many of Deutsche Bank's higher-profile client conferences that touch on the political scene in Washington.

Recent events in Washington have been fascinating and fraught. During its first two years, the current administration has shaken Washington to the core on many fronts. Now, it faces the results of a significant public backlash in the outcome of the midterm elections and a paralysis largely of its own making in the form of a partial government shutdown. While President Trump's Republican party may enjoy an increase in its slim majority in the Senate, the House of Representatives has swung solidly to a Democratic party that has been champing at the bit to take the reins on investigation and review. Many critical issues are up in the air, including regulatory reforms, immigration reform, trade policy, investigations driven by the Special Counsel, and other legislation with

macroeconomic implications, such as infrastructure investment, spending caps, and pharmaceutical prices. If and when the government does get back to more normal functioning, will a split Congress, conflict over a wall, and investigations mean that gridlock prevails in Washington, or will progress be made on issues where many can agree there is need?

1. Frank, as we go to print, the government shutdown is now more than three weeks old. How do you see this ending, and what impacts will it have?

It was extraordinary to watch in early December as President Trump "took on the mantle" of a government shutdown unless he received funding for his US-Mexico border wall. I have never seen anything like it. And it has gone on much, much longer than most observers would have expected – a new record for a shutdown. But it plays strongly to the President's voter base – many of whom think large portions of the US government are wasteful and needless. Still, a majority of Americans do not support the idea of a wall and are blaming President Trump directly for the shutdown.

Now we have a real mess. While it could end at any time, more likely it will drag on well into the current two-week pay period recently begun, and potentially a good while longer. Pressure will build for a resolution as more services are impacted. The increase in waiting times in security lines at airports are only one indication. As your own analysis has suggested Peter, given reduced hours worked, as well as reduced spending by both the 800,000 government workers affected and a potentially even larger number of private workers on

Peter Hooper with Frank Kelly

government contracts not receiving pay checks, the loss in GDP could exceed 0.1 per cent for every two weeks that goes by. Much of this will be made up after the issue is settled and workers are paid retroactively. But there will be longer-term negative effects on issues ranging from the ability of the government to recruit talent to the public's confidence in its ability to provide important services. The Fed and the markets will be flying half blind for a while due to delays in the production of key data.

2. Let me return to the question I was originally going to ask you at the outset:

How has the outcome of the midterm elections affected prospects for the functioning of the government—can we expect gridlock or agreement (and on what)? How do you see working relations between the administration and Capitol Hill and within Congress?

We were offered a sneak preview on live television over the holiday period when the incoming Speaker of the House Nancy Pelosi and Senate Minority Leader Chuck Schumer went to the White House to meet with the President. It was a long, loud and intense debate on funding the border wall that was beamed around the world live. That meeting and the government shutdown that ensued pretty much set the tone for what we can expect to see in policy debates.

Fundamentally, President Trump prides himself on being a deal maker. And he seems to actually enjoy bargaining with opponents. So, with Democrats in control of the House of Representatives for 2019-2020, I would expect intense public debate between the President and Democratic leadership over a host of issues. But I also believe the US shutdown has potentially

poisoned the waters in a significant way between the President and Pelosi and Schumer. So, expect Democrats to be highly cautious going into all deals going forward.

But what overshadows all of this are congressional investigations that are coming into both the Trump Administration and the President's businesses. I suspect the developments here will be quite rough.

3. What is your view of the new leadership on Capitol Hill?

It is, in some respect, back to the future: Nancy Pelosi is again Speaker of the House following her stint from 2007 to 2011. She is the first woman to serve. Steny Hoyer is the House Majority Leader and James Clyburn is the Majority Whip. Both served in the same roles back in the 2007-2011 period. And Pelosi, Hoyer and Clyburn are, respectively, 78, 79, and 78 years of age.

What is different is, while this trio returns to leadership, they are making accommodations to foster younger leadership to step up in the next two to four years. And that younger Democratic leadership is seen as more progressive or left-wing than current leadership. That will definitely have an impact on the House legislative agenda and, I suspect, will be quite market relevant as it will go to tax, environmental, and health policy issues. And they have agreed to term limiting themselves after four years.

In the Senate, it will be exactly as we saw it for the last few years: Mitch McConnell will be Majority Leader and will set the legislative agenda for the next two years. However, in 2020, 28 Republican seats will be up for re-election and potential primary contests, as many as six to

seven in Democratic-leaning states. This will impact the behaviour of those senators and how they vote. The popularity of President Trump will also have an impact on their views and voting decisions. One key moderate Republican senator has already announced his retirement in 2020, meaning he could be less constrained in his voting. With others possibly following, McConnell could face some challenges in controlling his relatively slim three-vote majority in the Senate.

4. What does the legislative calendar look like—key dates, what to look for in coming weeks, months, and year?

We can expect Democrats to be quite energetic about a number of legislative priorities ranging from healthcare reform, to looking at re-writes of the recently passed tax bill, to infrastructure reform.

Also, the President will be giving his State of the Union Address to Congress in late January. This is important because he will be laying out his legislative agenda for 2019. And it will be here that we will be looking for where and how there can be any bipartisan issues – infrastructure, healthcare, tax, etc.

And remember, the debt ceiling issue will quickly re-emerge. But will House Democrats demand some legislative deal in return for a positive vote? We will have to watch for that but there is no way Congress will let the government fall into default, no matter how ugly the politics are by then.

While we think the election season just finished, we are going to go quickly into the 2020 presidential campaigns. This will diminish the energy in Congress in 2020 – meaning, don't expect anything major to be done then. That means Congress is going to have to work hard in 2019 and it's going to be a short, intense calendar to work within.

We also expect House Democrats immediately to launch a number of letters of inquiry (and more than a few subpoenas) flying out of committees to government agencies and departments as they inquire into how and why the Trump Administration made any number of policy decisions.

For example, how and why did the Environmental Protection Agency relax regulations around coal? What was the process

that created the Department of Homeland Security policies around immigration interdiction?

There is nothing unusual here. Opposing political parties in control of either the House or Senate have done this sort of thing since the creation of Congress. Nevertheless, they can be market-moving, significantly impacting whole sectors so investors must watch carefully.

5. Legislation vs investigation, where is the emphasis?

This is the first big challenge to incoming Speaker Pelosi. She has to find a balance here and that will not be easy as political emotions within the Democratic Caucus are sky-high.

For example, there are, reportedly, more than 80 separate requests from senior House Democrats wanting to open specific lines of investigation. If Pelosi allows this – effectively allowing every committee to launch their own line of investigation – the risk becomes that actual legislation is side-lined and the American public looks at Democrats as incapable of actually governing.

That would potentially be impactful to not only the Democrats' chances of holding onto control of the House in 2020 but also winning control of the Senate and White House in 2020.

What to do? I suspect Pelosi will either funnel all the investigative issues into a special committee for investigations or ask one or two committees to manage them. Balance – she will insist on balance.

6. What are the chances of any major legislative initiatives, and what would they be?

I think a number of legislative initiatives have hope. Infrastructure spending is a top priority for both House Democrats and President Trump. The big question here is how to pay for it. Senate Republicans are likely to be hesitant because of the cost – and impact on the already – ballooning federal deficit. However, the Democrats want to revise the recently enacted tax bill. So, a new tax bill could emerge, which could pay for at least a portion of the infrastructure bill. President Trump may have to swallow a tax change/increase if he is going to get an infrastructure package. Barring that, the Democrats would have to go along with more deficit spending.

We can expect Democrats to be quite energetic about a number of legislative priorities ranging from healthcare reform, to looking at re-writes of the recently passed tax bill, to infrastructure reform.

Also, President Trump and House Democrats are aligned on finding a way to cap pharmaceutical pricing. But, again, Senate Republicans will be resistant to doing this and President Trump will have to find a way to convince them to support whatever emerges.

Also, immigration reform will be revisited but a comprehensive solution is unlikely.

7. But doesn't this beg that question: Does anyone in Washington care about deficit spending, the growing size of budget deficits and the ballooning federal debt? Will these concerns have any impact?

I am sure there is someone here who does care. But he or she is an awfully lonely person – among elected officials, no one seems willing to step up, shout it out loud that the deficit is out of control and push to get it under control. By the way, whatever happened to Social Security reform and other entitlement reform? All of this has, for the time being, slipped off the political radar screen.

But this brings us back to your last question and chances of an infrastructure spending package. How to pay for it with the deficit so out of control? I alluded to Democrats pushing for at least modifications to the recently enacted tax bill. Perhaps that could put at least a small dent in the deficit beyond helping to pay for part of an infrastructure package. But beyond this, the only way is cutting government spending in some meaningful way.

8. So let's focus a little more on the prospects for an infrastructure spending package and what it might look like.

You raise some multi-trillion dollar questions. How big? How is it funded? Do Democrats go along with public/private partnerships? Will Senate Republicans go along with more debt spending to pay for it? And what will they spend it on? Potholes and rusting bridges or building highways for electric cars and driverless trucks? New ports for growing oil and gas exports?

Whatever is done and however it is paid for, it will be a multiyear plan – not one giant lump sum. As you have noted in our recent discussions, a package would be a boost to the economy but probably limited to only several tenths of a per

cent to annual growth of economic output over a number of years – even less if it is tax financed. With the economy already operating at beyond full employment, this would only help if the economy is already slowing.

Gary Cohn drafted a proposal before he left the White House, but we think that was only a starting point. There are many possibilities but no definitive plans at this point.

Also, there is the prospect of foreign investment. We know Japan is looking to invest billions in the US. Similar discussions apparently have taken place with Saudi Arabia. Chinese President Xi and President Trump actually discussed Chinese investment in infrastructure when he visited the US in 2017. Congress will debate whether to go along with foreign investment and there are a lot of possibilities.

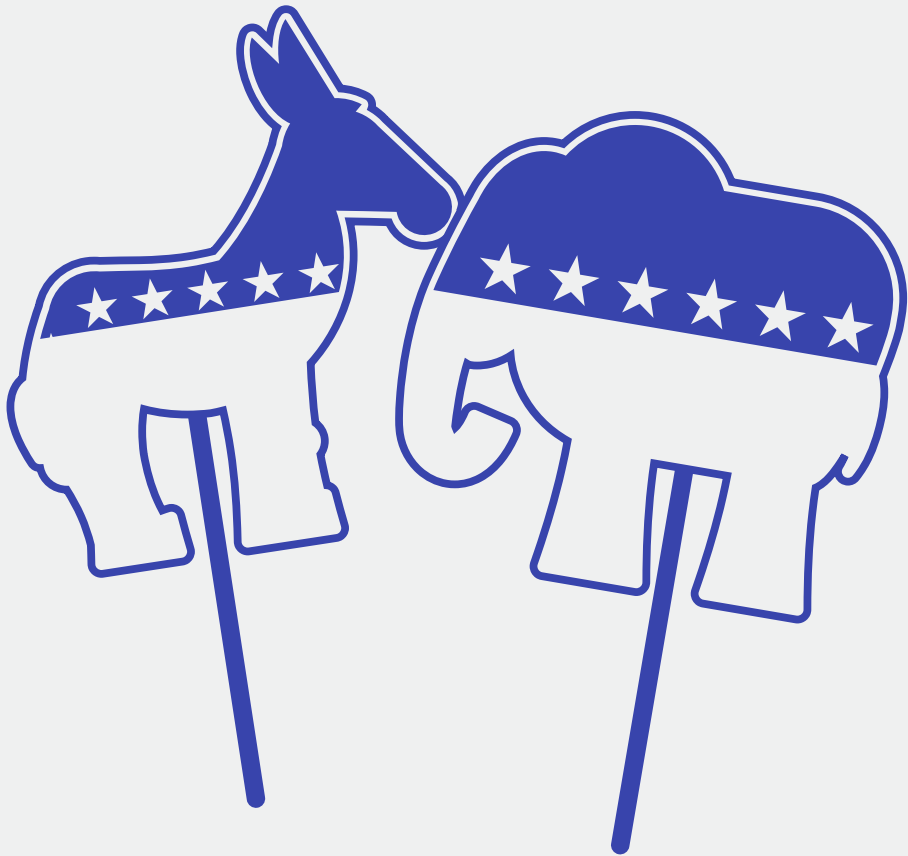
This being Washington, everything is election related and 2020 is going to be a big year for both parties. Economic growth – or shrinkage – will be a key determinant for voters.

9. With 2020 in mind, is there anything else that could add significant fiscal stimulus to the picture in the next couple years?

Aside from a possible infrastructure bill, appropriation bills and a possible tax revision bill along with Obamacare fixes are on the docket. As I mentioned earlier, House Democrats are sure to work up some sort of tax bill – likely to focus on raising corporate tax rates slightly to restore the state and local tax deductions that were taken away in the 2017 tax bill. I would also expect efforts to cut middle-class taxes as well. The challenge will be cutting a deal with the Republican Senate.

10. What about the prescription drug program and pricing? Could this have a significant impact on consumer prices?

Absolutely. With Boomers coming to the age where prescription drug prices really mean something to them, it has become quite a populist issue. President Trump hears it and agrees. And Democrats have long made the same case. President Trump has formulated several plans to force prices lower. In October, he rolled out a plan aimed at lowering Medicare drug prices. He was criticised by fellow Republicans for going too far while Democrats



criticised him for not going far enough. My sense is he wants to go further and with Democrats in control of the House, he now has an unlikely ally to get it done. It will not be easy as Senate Republicans will resist. But he will go at them hard to broker such a deal.

11. [Should we be concerned about the chronic underfunding of government statistical agencies and the quality of US macro data?](#)

I have to say, Peter, this is not a question I am asked very often. Okay – to be honest, never. But it's a good one and important. We take it for granted that the statistical agencies will forever continue to give good, timely data. And aside from economists and academics, no one here in Washington is making the case for better funding. It needs to be raised to a higher level and legislators need to understand that the erosion of statistical analysis will have a massively negative impact on the average American.

However, with the coming census in 2020, I think we will see increased focus – especially from Congress – on the need for better funding, at least for the census. The last thing Congress wants to do is see the census in some way tainted or made less credible. Their very jobs depend on it because the census determines how congressional districts are determined. I do not think they want the federal courts to have to be making those decisions.

12. [What new regulatory initiatives do you see on the horizon?](#)

I do not think we will see any new major regulatory initiatives launched over the next two years. Most of the major regulatory initiatives the Trump administration wants to pursue have been spelled out fairly well over the past 16 months. For example, the Treasury department's multiple reports detailing recommendations to amend Dodd-Frank and create smarter regulatory

regimes for virtually all aspects of financial services. Now, the Federal Reserve, SEC, CFTC, CFPB, and others have to execute.

If you go regulatory agency by regulatory agency, you pretty much see they all have their agendas laid out. But this goes to what I think may be the most interesting aspect of Washington to watch over the next two years. As you know, most regulators are independent agencies, ranging from the Federal Reserve to the Federal Energy Regulatory Commission. No matter what happens – or doesn't happen – in Congress over the next two years, regulators are going to continue to grind forward in pursuit of a smart regulatory review and overhaul.

What we are seeing pretty much across the board amongst the regulators is not a de-regulatory effort but a smart review of existing regulations – can they be updated, eliminating duplicity, and made more efficient? Also, how are the regulators actually working? Are they up-to-date in understanding the industries they oversee? Are they thoughtful and efficient? Look at the Food and Drug Administration. The head of the agency, Scott Gottlieb, has made great strides in modernising the agency and generally gets positive marks from both Democrats and Republicans. Overall, this has to be seen by the market as a positive for the economy – one that is hard to measure but is clearly happening.

13. What can we expect for how US trade policy and conflicts with our major trading partners will play out?

We certainly have seen a seismic shift in trade policy here in the US over the last two years. Trade has been a true passion for President Trump for 30-plus years. He has changed how basic trade policy is made and how it is achieved. I think we should expect more of the same in the next two years.

The markets seemed to miss that fact that President Trump formally notified Congress several months ago that he is pursuing bilateral trade deals with Japan and the UK (as soon as Brexit is finalised). He is quite serious about them. He prefers bilaterals for a variety of reasons. I think the explanation is that this goes to his experience with contracts in the private sector: you always secure a better deal one-on-one than when you negotiate with a group of

vendors. It makes sense.

With regard to China, this is a special situation and truly the clash of two great powers. I am not sure how this is going to end but one thing is clear: The Trump administration is demanding substantial changes in China's basic economic model. In many ways, a complete change to model. That is a huge ask and the question is whether China is willing to do that; if so, what happens next? So far, Beijing is clearly and defiantly resisting making any changes, big or small. Hence, the ongoing stand-off.

Unlike other trade disputes we have witnessed over the last two years, it is important – critical, actually – for markets to understand there are deeper, angrier layers at play here with China. For example, there is a strong bipartisan view that something has to be done with regard to China on intellectual property and technology transfer demands for US firms doing business in China. The level of frustration and anger among legislators, US businesses lobbying in Washington, and key Trump advisors is enormous. US businesses have been coming to Washington for years complaining about intellectual property hacks, how hard it is to enter the Chinese market. The Trump Administration specifically charging China with being responsible for the recent Marriott hacks shows how determined Washington – on both sides of the political aisle – is to putting an end to this.

The fact of the matter is China has few friends in Washington. And the November elections didn't make it any better – perhaps worse. Nancy Pelosi has for decades been highly critical of China for human rights abuses. She also represents San Francisco – a city with countless tech titans furious with Chinese intellectual property theft. Having Pelosi and Trump teaming up against them is not a good scenario for Beijing to face.

Add to this the fundamental geopolitical challenge China is posing globally to the US. The US wants to counter China's Belt & Road Initiative. There are growing tensions between the US Navy and the Chinese Navy over access to the South China Sea.

But it is important to remember President Trump has a clear aversion to upsetting the stock market. Similarly, President Xi does not want to see any major disruption in economic growth in

China. That may be the basis of some sort of deal being made. Or at the very least, to slow the escalation of tensions between the US and China.

14. How do you see relations between the Administration and the Fed playing out? Is it fair to observe that Trump is effectively setting up Powell as the fall guy if the economy turns south?

Let me take the second question first. The answer is yes. The President has, as former President Teddy Roosevelt described, “the bully pulpit” to say whatever he wants, whenever he wants. Fed Chair Jay Powell does not. He, of course, has to be much more careful with what he says. Not a very fair fight but it is what it is. However, we have seen Chairman Powell speaking more publicly lately. And he’s been very clear he would not step down if asked by the President. He has also been receptive to meeting with the President if need be to discuss the President’s concerns – although I doubt that meeting will actually take place. Also, it is pretty clear Chair Powell has the strong support of the rest of the FOMC, and I suspect they would continue to elect Powell to be chairman of the FOMC. I don’t see how an attempt to remove Powell as Chairman of the Fed’s Board of Governors in Washington for “cause” would stand up in either the courts or Congress.

To your first question, the President sees the Fed as easy to hit, particularly as we watch the sizeable fluctuations in the stock market. And President Trump clearly prefers lower interest rates. Keeping that in mind, I suspect we will see more verbal jabs by the President at the Fed. But it will remain verbal – and Congress will increasingly be supportive of Jay Powell if there are too many jabs. Jay Powell is, personally and professionally, a strong and independent thinker. He will do what he thinks is best for the US, not what is politically good. I’m highly confident of that. Powell has also made a real effort to work with members of Congress and that will accrue to his benefit.

15. Who are some of the key players to look for on the Democratic side as the 2020 presidential election heats up?

Do we have a couple of hours to go through the likely list of Democratic candidates? First, I think it’s important to remember President Trump

figuratively “burned the rule book” for who can, and how to, run for president.

Second, this leads me to think we could actually see 20-plus candidates for the Democratic nomination. That is a lot of candidates!

This has led a lot of folks who would never have thought of running strongly leaning toward throwing their hat in the ring. For example, we are likely to see the Mayor of Los Angeles, Eric Garcetti, in the race. When was the last time we saw a mayor run for president? Also, look for billionaire businessmen like Mike Bloomberg and Tom Steyer to consider running.

Other well-thought-of Democrats – former Vice President Joe Biden, Senator Kamala Harris, former Obama Housing Secretary Julian Castro, Senator Elizabeth Warren, Senator Sherrod Brown, Senator Bernie Sanders ...on and on I could go.

But, at the end of the day, the inability to raise sufficient funds for their campaigns will weed out many of these the candidates.

16. What are the polls saying about the next election (for President and Congress), and how reliable are they, especially this far out?

Most of us are still scratching our heads about what happened in 2016 with the polls. But when you go back and carefully look at the polls then, most were within the margin of error. Most but not all. Some were wildly wrong. In 2018 mid-terms, the polls proved to be more accurate.

What was interesting was the divide in polls between those arguing about whether there would be a large ‘wave’ victory for Democrats in the House of Representatives. And, as election night and the following few days suggested, it was not a ‘wave’. But – with so many close elections taking so long to count and re-count – slowly but surely the wave materialised and Democrats ended up winning 40 seats in the House. The polls were ultimately right. ●

The trade war and China's foreign policies

It has been eye-opening to see just how much the ongoing trade war between China and the US has changed China's foreign policy. We continue to believe China will strive to avoid a full blown trade war with the US, strengthen relations with other trading partners, push for new free trade agreements, and reassess the 'belt and road' initiative. Yet, there could be unexpected outcomes to these policies that could lead to meaningful changes in international relations for years to come. Indeed, despite defused tensions between the US and China, American companies doing business in China may face constraints, while European and Japanese companies may receive better market access.

Relations with the US

It is true that there have been episodes of tension between China and the US since the early 1990s when the two countries were the main driving forces for globalisation. However, most of the time the two countries have worked as partners, at least on economic issues. This partnership has become particularly strong after China became a member of the World Trade Organisation in 2001. The figures speak for themselves. Chinese firms sell \$400bn of goods and services to the US while US companies sell almost \$370bn in China¹.

This partnership ended last year and the trade war quickly escalated. A speech by US Vice President Pence in October likely made Chinese policy makers much more worried about long-term bilateral relations and made them realise that trade may not be the most important issue in the minds of the American administration. Some may see the US trade policies as part of a strategy to contain China as a rising superpower. In such a scenario, the bilateral confrontation is set to worsen in the foreseeable future, regardless of the outcome of the trade talks.

In response, China appears to be preparing for economic tension with the US for years to

come. Most urgently, the goal is to avoid further escalation, to the extent possible, and avoid a full blown trade war. To this end, China's policy actions have been refrained. For instance, it has not run its propaganda machine against the US, as it did against Japan several years ago when the two countries were in dispute.

This strategy makes sense. China's economy is under pressure. The leaders clearly recognise the risks in the economy and have moved to contain them through deleveraging. That is to protect against a full blown trade war which would inevitably lead to significant policy easing in China forcing it to leverage up again and jeopardise its growth outlook in the long term.

It is uncertain how long this strategy will be effective and the aftermath of Huawei's CFO being detained in Canada is alarming. The event has moved public sentiment in China and likely made it more difficult for it to reach a trade deal with the US.

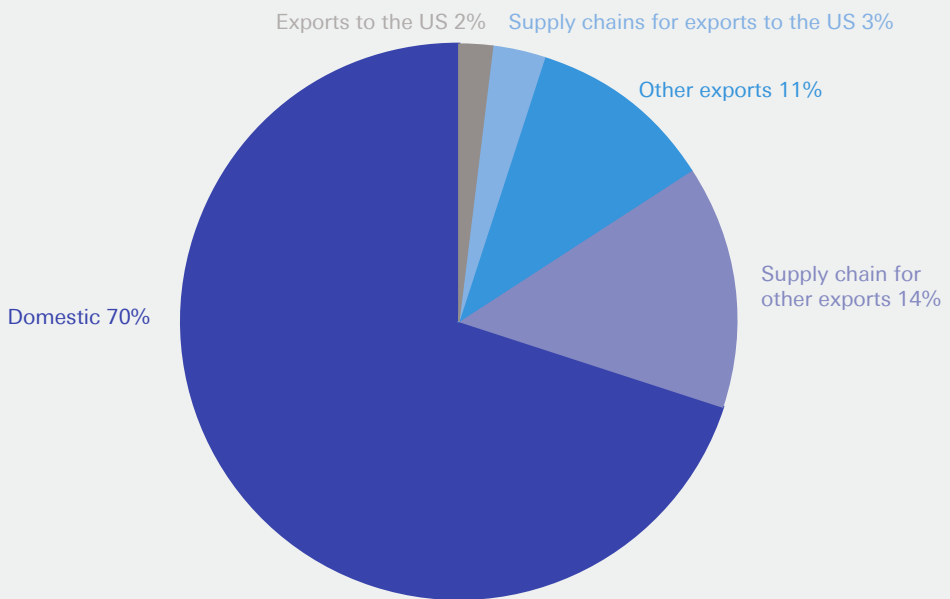
At the same time, the US Department of Commerce is working on export controls over 14 "emerging and foundational technologies". The controls will likely become effective this year and may trigger more investigation against Chinese companies and individuals. The result may be that the focus of bilateral relations moves from a trade war to one over technology.

The Huawei episode aside, China so far managed to keep public sentiment under control and keep trade talks open. China appears likely to make concessions this year to try and reach a deal with the US although bilateral relations may stay intense. Indeed, the shocks could come mostly from the American side as the race in technology will likely become more intense even if a trade deal is reached.

Relations with Europe and Japan

China has spent considerable political resources to enhance relations with Europe after the trade war with the US broke out. Premier Li Keqiang visited Germany in July and signed a long memorandum with Chancellor Merkel. When Vice Premier Liu He cancelled his trip to

Chinese industrial exposure to other countries is much larger than to the US



Source: Deutsche Bank Research, World Input Output Database (2014).

the US last November, he went to Europe instead, attending the Hamburg Summit of China-Europe Forum.

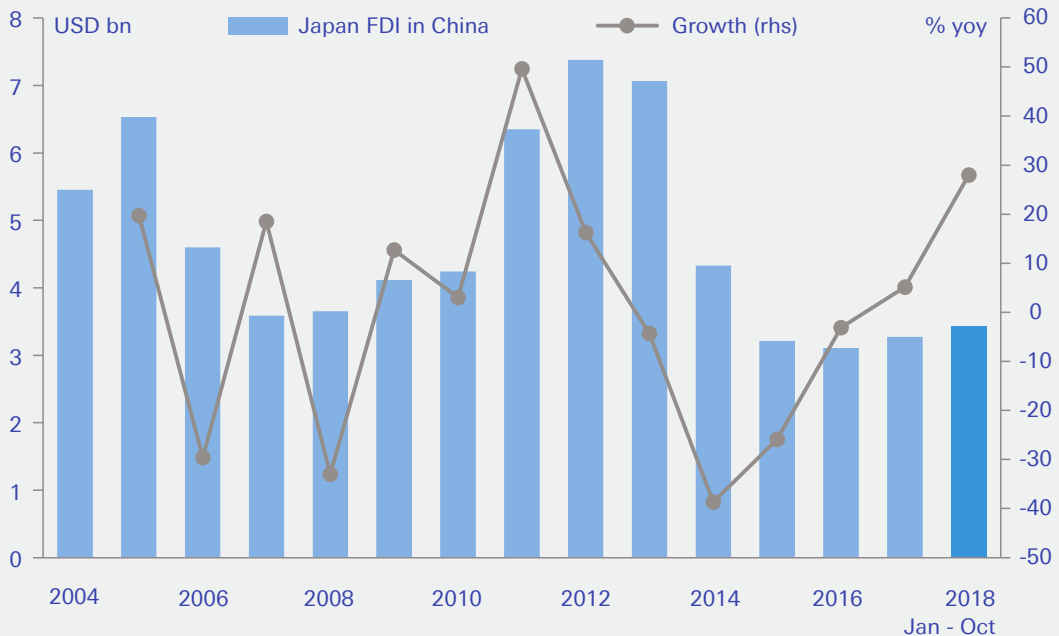
China also made a big change of policy toward Japan. Japanese Prime Minister Abe visited China last October, his first official visit since becoming leader in 2012. After a frosty past, this may be a turning point in bilateral relations.

The strengthening of ties with Europe, Japan, and other trading partners in coming years will likely continue as relations with the US remain intense. From an economic perspective, this is critical. Indeed, China's exports to the US only account for two per cent of its industrial

output. Even counting in all the intermediate goods produced in China for export to the US, the total exposure of China's industrial sector to the US is only five per cent. In contrast, exports to other countries account for a quarter of China's industrial output (including intermediate goods made for exports to other countries). So although a bilateral trade war is painful, it is much less painful than a multilateral one.

For that reason, China is rightfully concerned about the risk of the trade war spreading to other countries. The US government has already moved to push other countries to take sides. For instance, the new North American

Japan's foreign direct investment in China



Source: Deutsche Bank Research, MOFCOM, WIND

free trade agreement, the USMCA, has a clause that requires its members not to sign free trade agreements with "non-market economies".

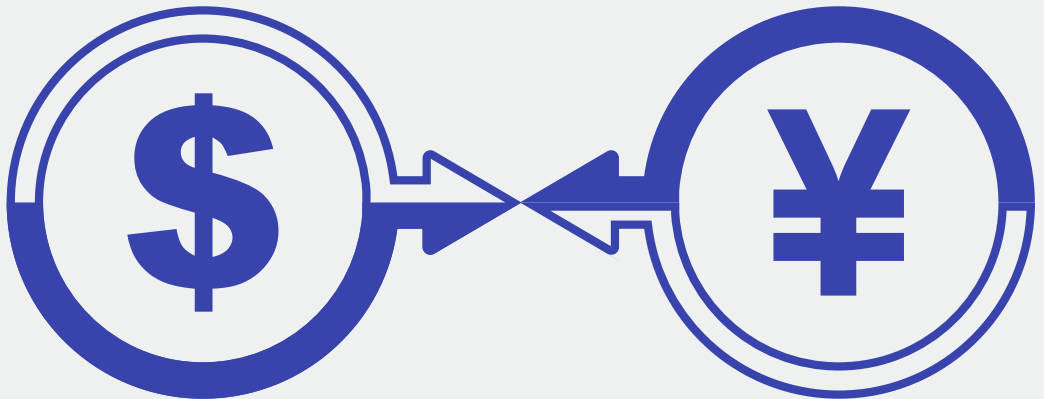
It is worth pointing out that Europe and Japan share some concerns with the US regarding their trade relations with China. All these countries ask for better market access and protection of intellectual properties. Last September, trade representatives from the US, Europe, and Japan issued a joint statement and "reiterated their concern with and confirmed their shared objective to address non-market-oriented policies and practices of third countries".

It is therefore critical for China to prevent Europe and Japan from imposing tariffs on Chinese exports as has the US. In this regard, China made the right move last September by cutting tariffs unilaterally. Moreover, there are

signs that China will provide better market access for foreign firms. Last October, BMW became the first foreign majority shareholder of an auto company in China. More actions are likely this year.

The improvement in diplomatic relations between China and Japan has also helped on the economic front. Japanese firms' foreign direct investment into China rose by over a quarter in the first 10 months of 2018, after falling at an average rate of 17 per cent between 2013 and 2017. Japanese auto makers reportedly benefited after China cut car tariffs from 25 to 15 per cent last May. Indeed, Japan took market share left by American car makers facing higher tariffs.

Europe and Japan can play important roles in the technology space as well, since export controls in the US will likely constrain the ability



of American companies to conduct business in China. There is precedent for this. The US has imposed similar controls on the satellite industry in the past, which made it impossible for American companies to participate in China's satellite launches. Eventually, a European company built satellites without American inputs and became active in China's satellite market.

Promoting new free trade agreements

China has been a keen supporter of new free-trade agreements and the current trade war has only made negotiations here more urgent. The challenge here will be to expedite negotiations of new regional agreements as these have not moved quickly in the past, partly due to the competition between China and

Japan for leadership roles. Today, there is more willingness and incentive to collaborate.

To action this, Japan and China pledged to accelerate free trade talks last year when the two countries held their first high-level economic dialogue in eight years. They also agreed to accelerate negotiations on a free-trade agreement between Japan, China and South Korea and also on the Regional Comprehensive Economic Partnership, a free-trade pact among 16 countries including the ten members of the Association of Southeast Asian Nations, plus Japan, China, South Korea, India, Australia and New Zealand.

While there are significant benefits of such free-trade agreements in the long term, the immediate benefits may not be large enough to offset the trade war with the US. That is

because the effective tariff rates with some regional partners are already low. For instance, China already has a free trade agreement with ASEAN. But securing a free-trade agreement with Korea and Japan would be a significant step to enhance economic ties in the East Asia region. Moreover, the potential for cross border investment and service trade strengthens if agreements are formed.

Reassessing the “belt-and-road” initiative

A more permanent and longer-term solution is the ‘belt-and-road’ initiative, something that China may reassess to address concerns raised by the international community. It is true that this initiative has led to successful cases of infrastructure projects in developing countries, but it has also raised questions about debt sustainability. In some countries, a change of government has led to a

very different assessment of China’s role in the infrastructure projects.

The initiative may need to be reviewed and modified to address these concerns. On the other hand, there is demand for infrastructure in developing countries, hence the initiative will likely continue to be an important part of China’s foreign policy. Interestingly, there is potential for China and Japan to collaborate on the ‘belt-and-road’ following Prime Minister Abe’s visit to China. Railway companies in the two countries may work together in third country markets.

More cooperation with other countries would be an interesting side-effect of the trade war with the US. Indeed, it helps to illustrate just how much China’s foreign policy has changed since it started becoming a world power. As China continues to strive to avoid a full blown trade war with the US, ties with other trading partners will only strengthen. ●

¹ This includes US firms’ exports to China and their sales through local subsidiaries. For instance, iPhones are made and sold in China without going through international trade, hence it is not counted as part of the US exports to China. We include such local sales by subsidiaries in our calculation, for both China and the US.

The strengthening of ties with Europe, Japan, and other trading partners in coming years will likely continue as relations with the US remain intense. From an economic perspective, this is critical. Indeed, China's exports to the US only account for two per cent of its industrial output.

Quantifying geopolitical risk

Most practitioners of geopolitics are seen as being, in some way, the product of Odysseus, the Greek king known for “the study of crafty designs”. That people think craftiness is a key part of political dialogue and events only leads them to conclude that geopolitics can only be examined via subjective analysis. Not so. Indeed, with the help of artificial intelligence, it is now possible to quantify geopolitical risk and predict its effect on equity and bond markets.

The development comes from the application of artificial intelligence to large data sets using Deutsche Bank’s Alpha-Dig platform. This uses machine learning algorithms to infer context from news media, social media, and other natural language articles, and then build a picture of a country’s political risk profile.

The implications for investors are significant. To illustrate, consider how the outcome of the Brexit vote in 2016 affected the UK stockmarket. In the 20 days leading up to the referendum, the FTSE 100 was steady. In the

first few days after the result, it dropped five per cent as investors gripped by fear dumped British stocks. It turns out this was an overreaction, at least in the short term. Indeed, over the next two months, the market climbed 15 per cent.

This result mirrors what the alpha-dig platforms expects, namely, that in the 20 days leading up to a large political event, equities underperform by one per cent relative to bonds. However, in the two months after, they outperform by four per cent. Of course, this is an average and every country is different. In addition, the timing of the market movements is not linear and, as we will explain later, that is where some significant opportunities lie for investors if they can predict how other investors respond to what most people see as a very subjective and dynamic situation.

To construct the gauges of political risk, the Alpha-dig platform first uses algorithms to mine global financial news media. This helps it determine the volume of geopolitical news about

Andy Moniz, Luke Templeman



each country. This can be used as a proxy for how much media attention there is towards certain countries' risks. The process uses Natural Language Processing and machine learning techniques to infer context in a news article and ensure that positive and negative indicators are gleaned from of reporting that may be trying to present on or both sides of a story.

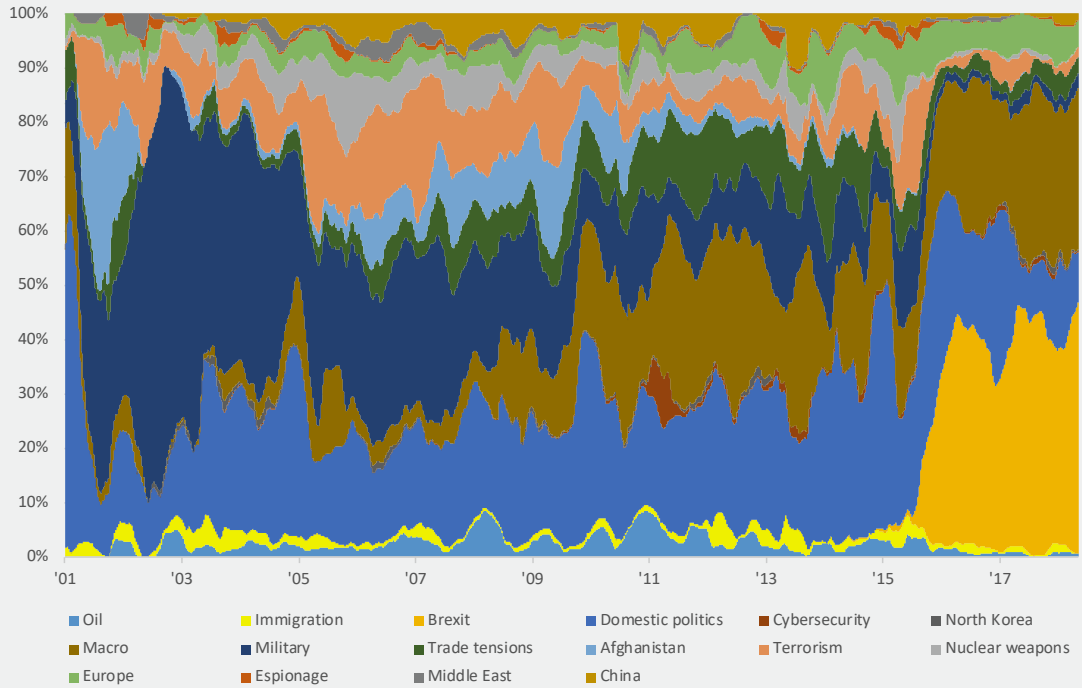
After this, the platform overlays learnings from social media. This may seem strange, but rather than sourcing information that may be unreliable, it uses various social media as a check of how frequently a certain issue is discussed. Of course, this method would be potentially dangerous if applied to, say, equity analysis, but as calculations of political risk naturally involve consideration of how much people are discussing various issues, social media ends up being a very useful data set.

The social media used by the platform is not Twitter or Facebook. These are platforms where conversations often run off on a tangent and there are the obvious concerns about fake news. Rather, Alpha-dig uses Wikipedia. There are two key reasons for this. First, it is relatively

reliable. Indeed, studies have found Wikipedia's articles come close to the level of accuracy as those of other notable encyclopaedias. Indeed, Wikipedia's articles helped IBM's supercomputer, Watson, to beat contestants on the game show Jeopardy. Just as important as reliability, Wikipedia codes its articles in a way that is easy for a machine to read. Many articles also have extra metadata attached.

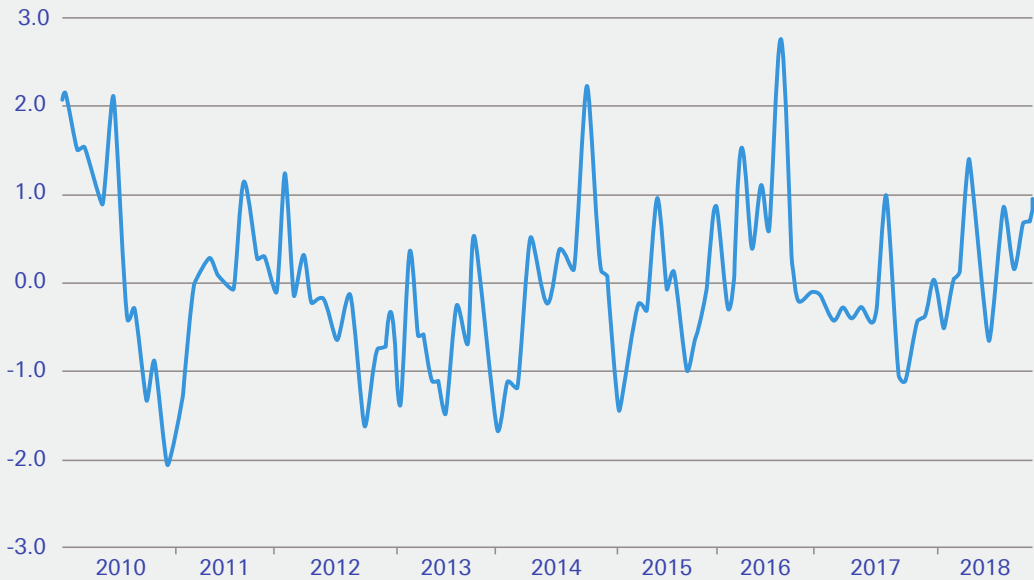
When Alpha-dig is asked to learn about a particular topic, it navigates to the politics main page for each country and then reads through each page where there is a hyperlink and goes two levels deep to build up a knowledge bank of information. The chart on the page opposite shows how this network analysis works for British politics. The central nodes in the network are ordered based upon how connected they are to each other. The more central the node, the more hyperlinks point to that page. That gives the platform a good idea of what Wikipedia writers deem important for that topic. By reading these pages, Alpha-Dig can learn about constitution issues, acts of parliament, as well as about the prime minister and cabinet ministers.

News topics as a proportion of geopolitical news in the UK



Source: Climate Bonds Initiative, International Finance Corporation, Deutsche Bank

How political risk in the UK has changed over time



Source: : DowJones Newswires, Wikipedia, Deutsche Bank.

Of course, if a machine was told to learn about, say, British politics just by reading Wikipedia pages, it would probably come to some unhelpful conclusions. It may, for instance, think that Winston Churchill is an important topic in geopolitics as he is mentioned a lot. Of course, he was, but many decades ago. To adjust for this bias, the platform uses readership data to see what topics are trending. This can be used to understand which topics are currently driving geopolitical events.

Once data from the mainstream financial news is enhanced with learnings from Wikipedia, the platform can create a picture that shows how political issues have become more or less important over time. This picture for issues in British politics is shown on the adjacent page.

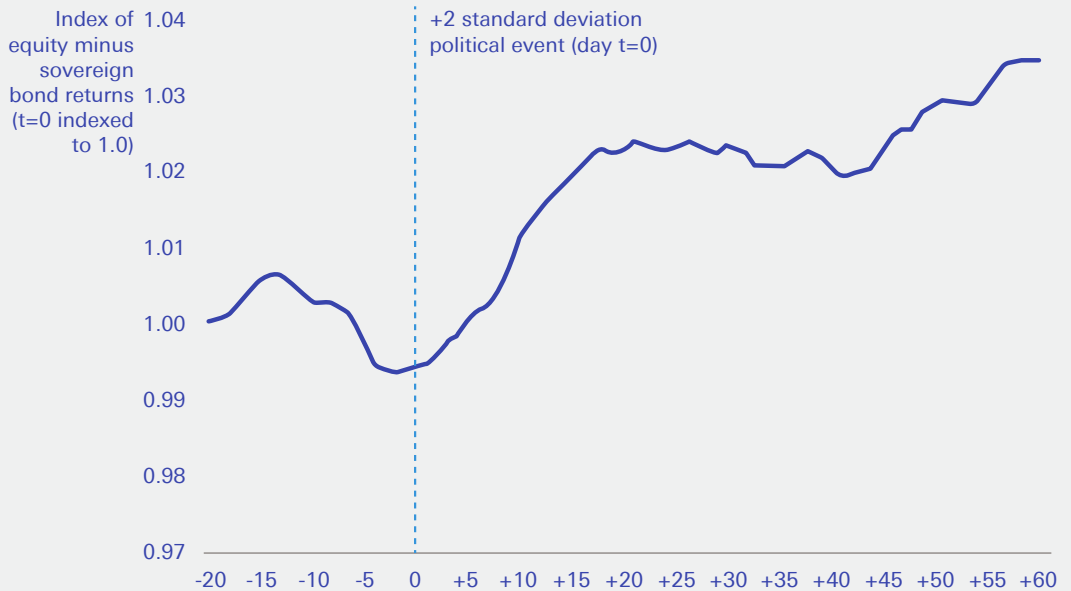
To turn this into investible data, the statisticians then run the numbers. First, they determine the relative importance of a particular topic. In particular, they calculate Z-scores, which look at the average amount of daily geopolitical

news for a topic in the recent past and see what proportion of all geopolitical news is consumed by that topic. In this regard, it is important to differentiate between various types of political risk, such as election risk, terrorism risk, and the long-term and short-term implications.

If a particular political event is receiving attention that is greater than two standard deviations more than normal, it is labelled an 'outlier' event. This essentially means that political risk is at a heightened level relative to its historic norm. The chart on the adjacent page shows how political risk in the UK has changed over time. The 'outlier' events can be seen as: the general elections in 2010 and 2015, the Scottish independence referendum in 2014, and the Brexit vote in 2016.

When we look at these charts for different countries, we can see how they correlate with equity and bond markets. The adjacent chart shows the average effect in the 20 days before an 'outlier' event and the two months afterwards.

Study of equity vs. bond returns around times of heightened political risk



Source: Deutsche Bank

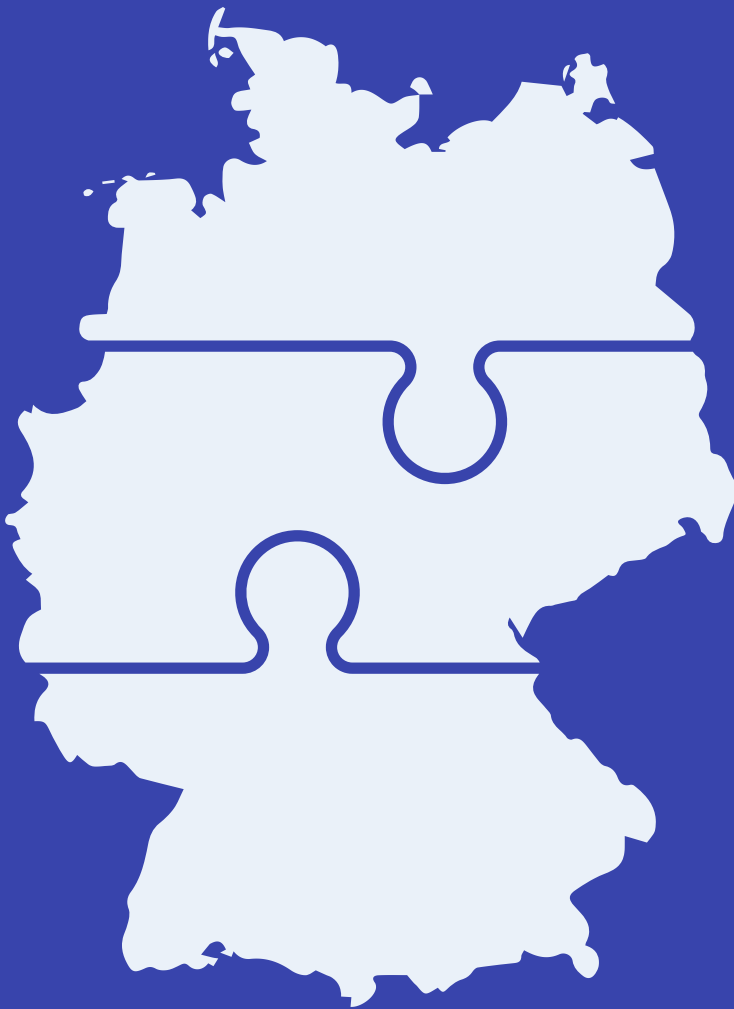
The result of the few weeks before the event may not be surprising. After all, in times of uncertainty, investors tend to abandon equities in favour of bonds. However, the response after the 'outlier' event is curious. Although, the two months after the outlier event gives equity investors a solid return, this does not happen in the efficient manner many expect. In fact, it takes a few days after the event for equity investors to feel confident dipping their toes back into the market. Then, a two week rally ensues, after which investors take a breather for a month before they jump in again and send stocks even higher.

The stockmarket strategy here is obvious. Equity investors should buy stocks in the couple days before a key political event and then hold them through the pause that occurs after the rally in the few weeks afterwards. The second strategy here also revolves around equity volatility with investors able to take advantage of the pauses in equity markets to buy products

that give exposure to volatility that is likely to occur in the future.

It is true that no system can accurately forecast geopolitical implications all the time. Indeed, those who try to emulate Odysseus' craftiness are often surprised by the unexpected effects that can surface. But by using artificial intelligence to analyse and quantify political risk, we can at least create an objective measure that can assist investors in what are notoriously difficult times. ●

Germany in the post-Merkel era



Barbara Böttcher, Kevin Körner

For German post-millennials it must be hard to imagine a time where one had to go to the library or bookstore to read a book, or use a public phone box to keep in touch on the road. For many of them, equally hard to imagine might be a time where Angela Merkel was not the Chancellor of Germany. ➤

If Merkel finishes her fourth term in 2021, with sixteen years in office she will be - together with Helmut Kohl - the longest-serving chancellor in post-war German history. What will her chancellorship be remembered for, and looking forward, can we expect the post-Merkel era to bring about a decisive political shift in economic policy?

Merkel's term has not been one of grand political vision compared with prior chancellors. The legacy of Konrad Adenauer, the first West German chancellor, includes the Franco-German reconciliation after the Second World War and the first steps of European integration. Willy Brandt's Warsaw Genuflection of 1970 helped to ease tensions between East and West during the Cold War. Helmut Kohl is foremost remembered as father of the German reunification in 1990. Meanwhile, under Gerhard Schröder, Merkel's predecessor, Germany took part in NATO combat operations for the first time in Kosovo and Afghanistan, refused to participate in the US-led Iraq war and introduced broad labour market and social reforms.

Nor has Merkel's term been one of grand economic reform. But against manifold headwinds, such as the financial crisis and the largest wave of refugees into Europe since the Second World War, it has been characterised by remarkable economic and political stability in Germany. Whether driven by extraordinary circumstances or her own pragmatic approach to politics, Merkel has safeguarded the status quo rather than proactively seeking to shape the future.

At the same time, her consensus-oriented leadership was essential for manoeuvring the euro area through its first existential crisis, and securing support in her own party for rescue programs for the European periphery. She also negotiated institutional reforms that have been crucial for increasing the European monetary union's resilience against any future upheaval.

Merkel's handling of both the euro and the migration crisis were certainly not shared by all her peers. Indeed, her approach may have contributed to the rise of right-wing, Eurosceptic, and anti-migrant populism. While the populist AfD party is far from representing a majority of German voters, its electoral success has placed pressure on centrist parties and made coalition building much harder. This new, fragmented political landscape is likely to persist and complicate future policy making for the next German leader both within and beyond German borders.

In the post-Merkel era, the new German leader will have the task of defending liberal values whilst adjusting to new political norms at a time when Western liberal democracies and the global rules-based order have come increasingly under attack. This includes maintaining international trade under the World Trade Organisation framework as a major pillar of German prosperity. The same will apply to Germany's role in the NATO defense architecture, particularly as the country has come under pressure from the US to increase its defence spending.

The new chancellor's options for foreign policy outside the EU will depend, to a large extent, on the respective stances of the US and China. It seems unlikely that on security policy, stronger European collaboration could - or even should - replace NATO any time soon, in spite of Merkel's endorsement of the goal of a European army. So while it is maybe too much to talk about a leadership vacuum going forward, it is also clear that a new German chancellor has to grow into this role - as Merkel herself had to. Only over the course of her tenure did Merkel gain the reputation of a reliable and skilled mediator, respected and heard by both political friends and foes.

This has been vividly illustrated in the newly boiled up Ukraine-Russia conflict, where even the American president called to “get Angela involved”. Germany’s international role is not only based on the fact that it is the EU’s largest economy but also because of Merkel’s commitment to bridge diverging interests. Recently, in a statement to the Bundestag, Merkel said that her understanding of German interests always means to also consider the interests of others. The next generation’s leader might be tempted to follow other countries’ example and define German interests more narrowly.

Given Merkel’s weakened standing at home, the remainder of her tenure will likely be consumed with European and international issues. But her room for manoeuvre – whether in meeting French President Macron’s hopes for monetary union reforms or addressing global challenges such as migration and climate change – is limited by the tighter grip of the CDU’s new party whip, the new party leader and, more generally, CDU calls for a conservative renewal. This stance will not change and will thus shape the policy course of any new government in which the CDU/CSU will take part. Even if the CDU/CSU remain the largest political group after the next elections, coalition building might require another two parties. This would make a consistent policy agenda even less likely than during Merkel’s era that comprised different government coalitions.

Just as Germany transitions to a post-Merkel era, the political interests of its European peers are diverging. The Franco-German engine is running rough as French President Macron has faced opposition to his economic reforms. Elsewhere, Britain is leaving the EU, and a group of Northern European countries have formed the “Hanseatic League” in order to defend their collective interests as fiscally prudent, economically liberal, EU net-contributors. With the European enlargement of the early 2000s, the reduction of European politics to a North-South axis is not valid any more. These changed constellations in European politics will determine to what extent consensus-based politics within the EU will be possible in the future, whether during Merkel’s remaining tenure or that of her successor.

Beyond Europe, the next chancellor might be caught in the middle of a US-China clash over trade, as well as geopolitical, economic and innovation leadership. Economic policy has not been among Merkel’s top priorities over the past 12 years which explains the desire of the business wing to push for a change at the helm of the CDU. The German economy’s remarkable performance in the present decade is due to a mixture of external and domestic factors, including former Chancellor Schröder’s social and labour market reforms and the successful restructuring of corporate Germany.

The next chancellor may have to deal with a petering out of these positive effects. Then, the negative impact of missing reforms will become increasingly visible. The shortage of qualified labour has already become a major concern for enterprises, and this is several years ahead of the mass retirement of the baby-boomer generation. Germany is having difficulty implementing sensible, labour-market oriented rules for labour migration from outside the EU, given the ongoing reservations among the CDU/CSU’s conservative camp. In addition, the integration and qualification of the 1.5m refugees that have arrived over the last few years remains a challenging and controversial task. German social policy still too often follows the principle of throwing money at problems instead of launching initiatives to enhance peoples’ earning capacities. There is also much room for improvement in education. Finally, given the lack of private provisioning, Germany’s social security schemes are neither fit for purpose with an aging

society nor prepared for the potential disruptions to the labour market that might arise due to increased automation and use of artificial intelligence.

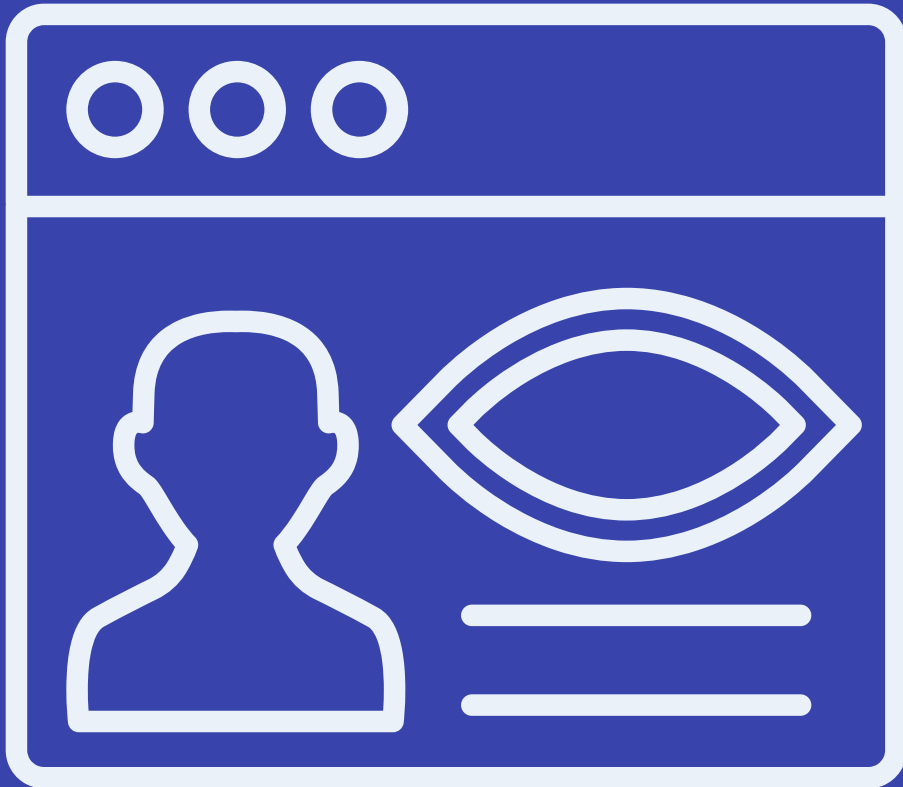
Corporate Germany also needs a reasonable framework to launch a new round of capital investment and restructuring to meet the challenges and opportunities from technological transformation. The German government must support and supplement corporate endeavours through ways, such as digital infrastructure or flexibility in the labour market. Even more important is an enhancement of private firms' financial leeway and incentives for capital investment through comprehensive corporate tax reform. If the next chancellor can achieve this, it would send a strong signal to provide a new impulse to sluggish domestic investment and thereby address a key issue of the current account discussion.

With all these challenges in mind, the prospect for the next chancellor implementing significant policy change appears slim. Surveys show the aging German population is risk averse and oriented towards the status quo. These attitudes are unlikely to change post Merkel and thus there is likely to be little support for reorientation of German politics. Furthermore, the current trend towards political fragmentation seems set to continue and risks becoming worse in the event of another recession or migration crisis.

The next chancellor's biggest challenge, then, may end up being that of coalition building. This may require broad consensus amongst perhaps four political parties and will likely hamper bold policy reforms. Years from now, when the retrospective of Merkel's successor is written, it may transpire that they were constrained by political realities and sentiments that deviated from long-term necessities of the German economy and society. ●

Just as Germany transitions to a post-Merkel era, the political interests of its European peers are diverging. The Franco-German engine is running rough as French President Macron has faced opposition to his economic reforms.

Media, cable and satellite under the Trump administration



For a case study on how an industry can be suddenly humbled, it is hard to ignore the experience of technology firms last year. Just after the Nasdaq hit an all-time high, the online privacy scandal erupted and Facebook chief Mark Zuckerberg was hauled before Congress. ➤

Further revelations of misdemeanours by online advertising companies and the implosion of Cambridge Analytica sent technology stocks on a roller coaster ride for the rest of the year. The episode highlighted just how quickly political visibility amidst a void of regulation can become a lightning rod topic for public anger.

Yet, traditional media and cable companies largely avoided being implicated in the technology scandal. That is despite the lines between the two industries becoming increasingly blurred as video streaming proliferates and business models converge. One reason is that traditional groups have long abided by the more stringent set of rules that govern television advertising.

Harmonising the rules that govern online groups and traditional media firms has been talked about for some years. Indeed, during the early days of the Trump administration, many in the industry called for a synchronisation of rules that applied to television and online advertisers. Unfortunately, the momentum has now slowed as the data privacy scandal has made it more urgent to establish a new framework for this issue.

While data privacy issues consumed the headlines last year, other political machinations are bringing about change that could be just as meaningful to the technology and communications industry.

The first concerns net neutrality, that is, the principle that internet service providers should allow access to the entire internet, without discriminating access for reasons that may include the amount a customer pays or the provider with whom they have a contract. Supporters say that without net neutrality, providers could charge consumers for access to the specific websites they visit, open up a fast lane for those who pay more, or charge content providers, such as Netflix, for quicker access to their subscribers.

Key changes to the network neutrality rules have taken force since President Trump took office. Indeed, the Federal Communications Commission repealed the net neutrality rules put in place under President Obama in 2015 whereby broadband was reclassified from Title One (an information service) to Title Two (a common carrier service). It is true there was political momentum to overturn the repeal and keep the network neutrality rules, and in fact the Senate voted on the issue before the mid-term elections. Yet, although the vote resulted in a 52-47 majority to overturn the repeal, thanks to the votes of three Republican senators, for this to be enacted it will need to be voted on by the House of Representatives and signed by President Trump.

The 2015 reclassification was about more than just network neutrality. It also gave the FCC much broader statutory authority to regulate services; including the regulation of pricing, open access requirements, and service delivery. These Obama-era rules rattled many in the cable industry. Firms had long argued they had never acted to violate the network neutrality rules desired by the FCC and would continue to abide by such standards. They also argued that the Title Two rules introduced a level of uncertainty that discouraged long-term investment in networks and thus harmed consumers. Ajit Pai, now chairman of the FCC, remarked at the time of the 2015 reclassification that, "The commission's decision to adopt President Obama's plan marks a monumental shift toward government control of the Internet."

Certainly, there are some arguments that the Obama-era rules caused a reduction in investment, however, the repeal was broadly consistent with President Trump's broader deregulatory agenda.

For the cable industry itself, the repeal of network neutrality controls reduces the uncertainty around regulatory creep and allows for more pricing options. That said, Congress has not passed new legislation that would establish a new set of permanent rules for broadband so it is possible that a future president, probably a Democrat, could return the industry under the Title Two umbrella, thereby restoring network neutrality.

Already this is being talked about by potential future presidential candidates. Senator Elizabeth Warren, has said, "The repeal of these protections has corporate greed and corruption written all over it." Her argument is that without network neutrality, special interests are favoured over the majority of Americans who are in favour of "a free and open internet." Another possible candidate, Senator Bernie Sanders, has also pointed out that internet access may be determined by income and has called the FCC's vote to end network neutrality, "an egregious attack on our democracy."

Although a future administration could reinstate network neutrality rules, there was little drive to construct legislation prior to the recent mid-term elections. It seemed the Republicans did not want to risk the issue. After all, regardless of political party, it has not been difficult in the past to sell greater regulation of broadband providers to voters. And now the House of Representatives is controlled by the Democrats, the chance of legislation that cements light-touch regulation is greatly diminished. As a result, the rules could bounce back and forth in the future.

One change the media industry expected under President Trump but has not materialised as expected was more lenient scrutiny towards industry consolidation. Particularly, the industry looked forward to regulators allowing deals with broader communications and technology companies. Yet, while some combinations have been approved, such as Discovery-Scripps Networks and Disney-Fox, others have proved more challenging, including Sinclair-Tribune Media and AT&T-Time Warner. In addition, other combinations were abandoned after management deemed there to be too low a probability of regulatory approval. Now, the industry's biggest companies appear reluctant to attempt large-scale mergers and acquisitions.

While it appears unlikely many large deals will be done in the near future, one avenue for acquisitions that may soon be available regards national broadcasters. Indeed, since President Trump assumed office, the FCC has begun to investigate raising the national broadcast ownership cap which currently prevents an entity controlling television stations that reach more than 39 per cent of households. Any increase in the cap will open the door to further industry consolidation. They say this will lead to lower costs, increased leverage in retransmission, and reverse compensation negotiations. With this aim in mind, Chairman Pai did reinstate the discount for Ultra-High Frequency channels which had been eliminated by his predecessor in mid-2016. This means television stations on UHF channels now count less towards the cap than those on Very-High Frequency channels.

Increasing the ownership cap proper is not straightforward. Questions have been raised, admittedly by a minority, about the FCC's authority to raise the cap. That suggests that an act of Congress might be required, although it seems more likely than not that the FCC does, in fact, have the authority. That said, if an act of Congress is required, the probability of it passing has now fallen given the results of the midterm elections.

While the network neutrality and acquisition rules rumble on in the background, the privacy issues around technology firms remains front of mind for many politicians. That leaves technology groups prime candidates for new regulation. Some have called for some platforms to be broken up, something they believe will dilute the market power of individual firms, but that may not have an impact on data privacy concerns. Indeed, nailing down permanent regulation will likely take longer than many expect, particularly as legislators are increasingly aware of the power of technology platforms in elections. And while they continue to debate the issue, it may be that changes to the less-visible rules that govern the industry may end up having a bigger effect than many investors currently think. ●

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No end of history – Europe struggling in a changing world

With European Parliament elections just a few months away, the issues that divide the continent seem set to divide the parliament further. On current projections, the pro-European forces will continue to gain the majority of seats but will diminish in size once again. Eurosceptic and anti-EU forces should increase their influence, making decisions such as the election of the next Commission President and the EU's post-Brexit budget more difficult. This would add to growing disunity in the EU on issues that now range from migration policy, digital taxation to further risk sharing and risk reduction within monetary union.

But it is not just internal bickering that is posing trouble for Europe's politicians. Since the last election in 2014, Europe has faced a number of issues that have forced it to reassess its position in the world, such as growing estrangement with the US under the current administration, widespread refugee flows, increased Chinese influence, and Britain voting to leave the bloc altogether. Against this backdrop, it is worth examining how the internal and external issues will frame the continent during the May elections and for the coming five years.

To better understand the current confluence of issues, it helps to reconstruct how Europe arrived in the state in which it finds itself. Indeed, Europe has come a long way from the great optimism of the early 1990s. As Eastern Europe then turned to capitalism and democracy, it seemed as though the market-based economic model coupled with a liberal democratic political system had triumphed. This sentiment was famously described in Francis Fukuyama's "the End of History and the Last Man", where he mused that liberal democracy may represent "the final form of human government."

For a few years this seemed to be an appropriate description. Liberal democracy extended its reach and more countries became integrated into global trade and institutions. The European Union widened its borders to welcome former members of the Warsaw Pact. Peace and prosperity seemed inevitable. Yet today, various factors have slowed progress. First, the economic rise of China did not lead to a simultaneous democratisation and liberalisation. That China's middle class was strengthened under its existing system suggested that economic success was possible without



adopting Western political values and institutions. The experience in Russia only added weight to this argument. The country experienced democracy and capitalism not as a promised liberation and consumerist paradise but as traumatic chaos and flagrant cronyism. It replied by falling back into nostalgic authoritarianism at the beginning of the 2000s.

The timing of the 2008 financial crisis could not have been worse. As many questioned the implicit rationality of markets and the fairness of capitalism it seemed to vindicate what was being seen by other systems elsewhere in the world. This was particularly the case in the European periphery. In some countries, the single currency became synonymous with economic turmoil rather than a haven of stability. At the same time, Nordic members also saw themselves as victims being presented the bill for the economic and fiscal wrong doings of others.

As scepticism towards the EU festered, the migrant crisis of 2015 only amplified people's fears as geopolitical upheaval in the Middle East triggered a surge of displaced people. Meanwhile, rapid technological progress and the spread of universal connectivity were transforming global communication. Once seen as a force for media freedom and the spread of information, societies began to understand the

downsides of social media and other online platforms and the challenges they posed to democratic discourse. This was not just in the form of fake news, bots, and targeted manipulation, but also as an Orwellian toolbox for government control.

This recent history makes it easier to appreciate how the influence of political groups that follow a nationalist and populist playbook have risen to prominence. In some EU countries, openly Eurosceptic forces now form (part of) the government and some members openly clash with Brussels about issues of law and fiscal rules. Waves of populism, further fueled by social media and other new forms of communication, appear to increasingly discredit the democratic and liberal principles on which the EU is based.

So at a time when Europe finds itself surrounded by internal and external challenges, the Union is divided. That makes this year's European elections as crucial as ever. And assuming populist candidates take more power, as they are expected to do, decision making in parliament on many issues will be increasingly difficult.

The next European parliament and commission will face an increasingly uncertain geopolitical environment that calls for a coordinated European response. Throughout the

Cold War, Western Europe was inseparably linked to the United States. However, American foreign policy has shifted in emphasis away from Europe in recent years. Under the Obama administration, the US underwent a 'pivot to Asia', while more recently, the current administration has threatened the EU with tariffs and linked America's NATO security commitment to the fulfillment of defense spending targets. European leaders have therefore looked to establish several initiatives to strengthen their operational cooperation. To start, both Chancellor Merkel and President Macron have endorsed the vision of a European army. While this might help reduce Europe's reliance on NATO, it is certainly far away from (and is not intended to be) a replacement for NATO as the main anchor of Europe's security architecture. As a result, it will be critical for European politicians to find common ground and then push a united agenda on transatlantic security coordination.

The next serious issue for European politicians to negotiate is how to adjust to the rise of China. For the US, as well as Europe, China's aims for global industry, technology and innovation leadership by mid-century, as outlined in its "Made in China 2025" strategy, has been a wakeup call. Competition for technological dominance is certainly also at the root of ongoing trade tensions between the US and China, which extends to the EU as well. Indeed, Chinese investment flows to the US and Europe in the last few years, often into strategically important sectors, have begun to exceed the flows vice versa. At the same time, many in Europe see Chinese efforts towards investment reciprocity as only half-hearted. Through large-scale infrastructure investments within the EU, or strategies such as China's 16+1 initiatives with Central and Eastern European countries, the influence of China on the continent is growing. With this in mind, the US and Europe have started to become more wary towards foreign, mainly Chinese investment, notably in the technology sector. For example, the US Foreign Investment and National Security Act of 2007 and a recently agreed on European framework for foreign investment screening have both been legislative responses.

The Chinese push to become a technological leader has served to highlight the fact that Europe is struggling to keep pace. While European leaders and institutions have understood this serious issue, the implementation of national and EU-wide strategies to address identified shortcomings

lacks pace and scope while other issues are dominating the here and now.

Europe has lagged in key technologies such as artificial intelligence and their commercial application for some time. Despite Europe's prosperity, educated workforce and technological know-how, the global platform economy is dominated by US and Chinese technology giants. One reason is that the EU's internal market is fragmented because of cultural, language, and regulatory differences, whereas the US and China benefit from a homogeneous internal market.

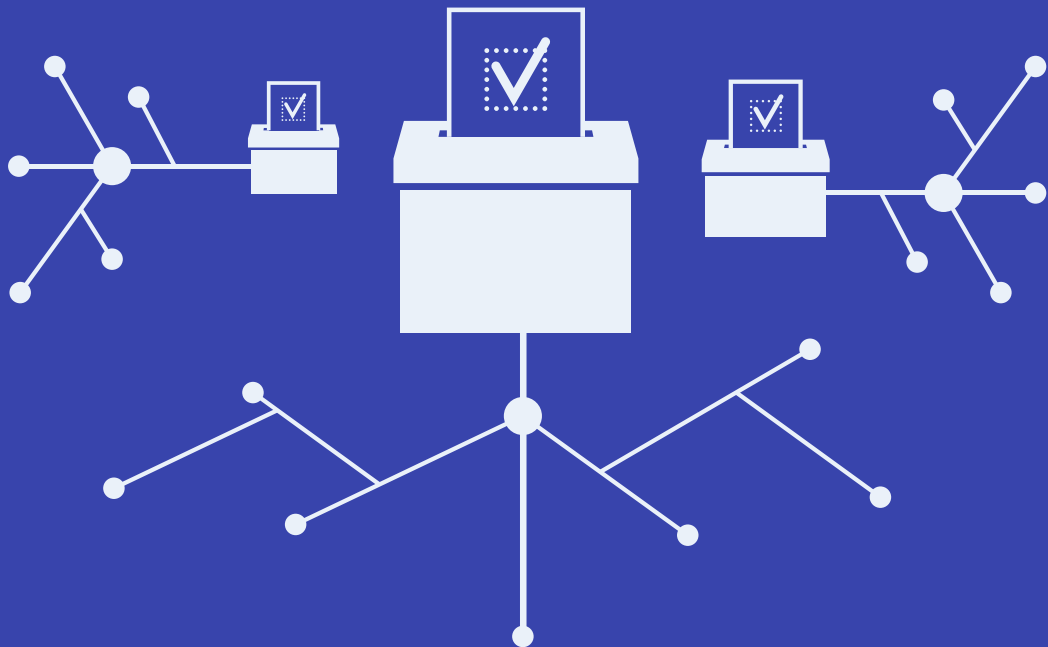
Yet, Europe needs to act urgently if it is to catch up to the US and China as the barriers for latecomers in the winner-take-all markets of the tech industry are only rising. The US 'moat' is its established concentration of companies, talent, world-class universities, and venture capital in Silicon Valley. China's advantage is its government-led approach to sheltering and nurturing its technology industry and that is not compatible with the EU's regulatory framework and free-market policies. In fact, some companies have been scared by the EU's leadership in technology regulation, such as the new GDPR data protection regulations. Although Europe maintains strengths in areas such as industrial robotics and manufacturing, if European leaders continue to allow the US and China to outpace the continent's technology efforts, the remaining competitive advantages might be lost.

As Europeans cast their vote in May, many will find the trade-off between traditional and anti-European parties hard to calculate. They see the cracks in the relationship with the US and wonder if future US governments will be increasingly distracted by their own competition with China. They may also note China's counter-model of state capitalism and strategy of economic opening without democratic reforms risk fuelling further fragmentation within the EU.

To win back a disenfranchised electorate, Europe's traditional parties, and the EU itself, need to convince its citizens that its democratic institutions and beliefs still align with security and prosperity in today's world. This is vital as only through the strength of union can so many disparate countries play a role on the world stage and ensure their interests are not diminished as the influence of other states and regions further increases. Only if Europe's (current and future) political leaders rise to their many challenges can the continent fulfil its vital role in the years ahead. ●

For the US, as well as Europe, China's aims for global industry, technology and innovation leadership by mid-century, as outlined in its "Made in China 2025" strategy, has been a wakeup call.

CEEMEA: How the elections of 2019 will shape the region



Kubilay M. Ozturk

Many people find it strange that the countries of central and eastern Europe, the Middle East, and Africa are frequently grouped together for investment purposes. It is true that sometimes this is done for convenience or because of the availability of data or analysis. In a political context, though, it makes more sense due to some of the commonalities these countries share. ➤

In particular, higher risk premiums on CEEMEA assets are likely as a looser macro policy mix and erratic political headlines both inside and between countries hit the spotlight. And with the financial crisis now receding, central banks can no longer be assumed to prop up the system.

As ten countries in CEEMEA go to the polls this year, their economies will be increasingly dominated by the political cycle, more so than many western countries. In this piece we look at how the outcomes of elections will affect the political and economic environment in key countries including Poland, Turkey, and South Africa. We also look at how tensions with Russia are affecting developed and developing nations.

A theme that permeates CEEMEA countries is that a decade on from the financial crisis, political cycles have made a comeback. One reason is the shrinking pie available in global value-add chains that has coincided with aging populations in developed markets and young cohorts in emerging markets who sense their opportunity. The end result has been a shift in domestic political dynamics in favour of populist and nationalist parties in many countries. A by-product of this has been rising geopolitical tensions and a shift towards an extraction game, particularly in international trade.

The dominance of politics over economics follows more than thirty years of globalisation. Such a shift, both within and across countries, is having repercussions on the economic outlook. Populist parties and governments, which are in the ascendant, tend to have a shorter-term focus, and they could be inclined to follow a looser-than-warranted fiscal stance both before and after the elections. Similarly, given their inherent bias for a pro-growth and pro-employment stance, the operational independence of central banks could come under pressure, particularly in countries where institutional quality is under stress. In turn, this may endanger price and financial stability.

Populist administrations in CEEMEA could also be inclined to tinker with and re-calibrate well-established diplomatic ties, particularly those based on historic economic and financial links. This could be done either to mobilise voters and influence them in a certain direction, or in the interest of short-term economic gains. The result could be the formation of new fault lines between countries or blocs.

Given CEEMEA's geopolitical position, and with more than ten elections scheduled in 2019, the region will likely go through most of these political economy cycles this year.

Take Turkey. Local elections, due to be held in March, will be as important as last year's presidential elections. This is because, historically, whichever party dominates in the two biggest cities, Istanbul and Ankara, establishes its base across almost a quarter of the country's voters which gives it a strong platform to boost its influence. President Erdogan himself first served as Istanbul mayor before becoming prime minister.

Economics, though, has become a key concern in Turkey. The country is currently experiencing rising unemployment and bankruptcy rates, something never endured by the ruling AKP ahead of an election. That makes a looser macro policy stance more likely in the first quarter of 2019, either by extended tax cuts or by monetary easing. This may put downward pressure on the Turkish lira, either due to a lower yield support or markets' rising concerns about a likely reversal in the rebalancing seen in external balances since mid-last year. The stakes here are high. Assuming the AKP retains its popularity across the country, particularly in Istanbul and Ankara, then the government will have four election-free years. That will allow it to re-establish first-generation reforms in the form of restoring price stability and the resiliency of Turkish banks.

Voters in South Africa will also visit the ballot box this year and elect a new National Assembly. While the election is unlikely to immediately pave the way for better economic growth, it may remove a hurdle to some reform in the public sector. If the new government can reduce the cabinet, streamline policy-making and apply a more comprehensive approach to address the precarious financial situation at Eskom, the largest electricity producer in Africa, it could boost markets and eventually improve the overall cost of funding. Certainly, implementation could be bumpy as balance sheet constraints of state-owned enterprises bite, and electricity supply continues to be an issue, but if the new government can push through reforms, they may reduce these key risks to the economy.

In terms of the numbers, the governing African National Congress have held a majority since 1994. Opinion polls give the ANC a comfortable majority, albeit lower than the 62.1 per cent the party received in 2014. The ANC is led by Cyril Ramaphosa, who was elected to a five-year term after beating Jacob Zuma by a narrow margin in late 2017. Ramaphosa will run for a full term in office as the leader of ANC.

Poland will also elect a new parliament in the autumn of 2019. The ruling Law and Justice party (PiS) continues to lead in recent polls against the opposition Civic Platform (PO). However, the local and regional elections last year saw mixed results for the ruling party. While the PiS won more seats in local legislatures than it had held previously and now controls a larger number of the legislatures than before, its overall vote share declined compared with the general election in 2015. Furthermore, it failed to strengthen its position in the main cities. The opposition now appears to have a slightly stronger hold compared with 2015. That leaves Poland set for a more fractured political backdrop in the coming year.

Should an opposition bloc stand firmer than expected in Poland, it may prompt a looser macro stance by PiS in the short term. This would be achievable given that improved tax collection resulted in fiscal over-delivery last year. That said, following continuous confrontations with the EU on issues of the rule of law and legislative changes, the PiS government may take a more reconciliatory stance with Brussels ahead of the ballot in 2019. Potential here has already been signalled in the government's decision last November to pass the amendments to the Supreme Court Act as requested by the rulings of the Court of Justice of the European Union.

Finally, Russia will likely remain a constant subject of US sanctions this year, even though it is ranked as the least vulnerable of the major emerging market economies in Deutsche Bank's emerging market vulnerability monitor. This is courtesy of an improved budget surplus, credible monetary policy, a rising current account surplus, and formidable foreign exchange reserves. While US action on further sanctions and related measures became less of a priority in autumn last year, the new Democratic majority in the House this year could reinvigorate the impetus. That said, Republican control of the Senate and incentives for bipartisan consensus offer a counterweight and mean it does not appear likely to materially alter the current severity of sanctions.

Eventual action against Russia is possible but it could well be event-driven and is unlikely to be implemented immediately in the New Year. Of course, there is an abundance of news flow, however, severe action that targets Russian sovereign debt, state banks, or major energy sector assets, is unlikely without a key trigger event.

One such trigger could regard Ukraine and here rising tensions are a concern. As it stands, recent incidents make some sanctions possible, however, these are likely to be narrow in scope. Given the current outlook,

material escalation in Russia-Ukraine tensions appear unlikely but with the Ukraine presidential election due for March, noise around relations between Ukraine and Russia will likely remain elevated.

It is interesting that when we look at some of this year's key elections across CEEMEA, one of the common threads is the threat of populism. However, the effects of populists do not only flow in one direction. Indeed, a populist government which is more established in office can have a more influential stance on both the judiciary and bureaucracy. If exercised responsibly, such an advantage can make it easier to implement required structural, first or second-generation reforms in the economy.

It is true that since such reforms can cost votes in the near term with benefits arriving only over the medium term, they are hardly the first policy mix for new populist governments. But after a clear second or third mandate, a pragmatist government may embark on a reform agenda. ●

Reforms can cost votes in the short term, so they are hardly the first policy of populist governments.

A tour through post-Brexit Europe



In the not too distant future, a young couple travels from their native country in the South Pacific to Europe to backpack around the continent. They have heard both positive and negative things about populism and the state of post-Brexit Europe but they want to see for themselves just what the EU is like without Britain as a member. >

Our young couple first flies into Rome and travels around Italy to see what the country is like with a populist government. They immediately notice that, contrary to some opinion, many people feel the country is rolling along. Consumer confidence is around its highest point since before the financial crisis although it has fallen back a little lately and people are looking forward to the basic income promised to them. Although ten per cent of the labour force is out of work, more jobs are appearing and the economy is slowly expanding in 2019. Interestingly, the government debt problem is just not something people on the street seem concerned about; it has been around for years. True, many local companies carry large debt burdens but manufacturers are still driving an export-heavy economy.

Our couple catches the train to economically-prosperous Germany and finds a country with politics so fractured the mainstream parties have their lowest share of the vote since the end of the Second World War. The support for Brexit in parts of Britain has emboldened small groups in Germany. Discourse in the Bundestag is increasingly difficult and agreement among the disparate factions is, at times, impossible. Although the large numbers of migrants that arrived in 2015 are integrating themselves into the workforce and society, there is still a large proportion of the population that is concerned about immigration and is propping up right-wing populist parties. With the various groups focussed on domestic politics, the chancellor only has real power when addressing international issues.

Our young couple now travels to the Nordics and Stockholm beckons. Right-wing groups have picked up on one of the key themes of Brexit supporters, immigration, and are pushing their agenda. Indeed, at the last election, 18 per cent of the vote went to the right-wing anti-immigrant Sweden Democrats. It was the party's highest ever return and a five point advance on their tally from the previous election. As a result of this, and the rise of other small parties, the major parties have struggled to form a governing majority, since they have refused to govern with the Sweden Democrats.

From the icy north, our couple meanders to the Netherlands and finds that politics is similarly fractured as Brexit has inspired populist parties to come forward. Indeed, the combined vote of the three main Dutch centre-right and left parties of government is roughly 40 per cent. That is half the level it was in the 1980s. Furthermore, 28 parties contested the last election and 13 won seats. But while politics seems as similarly fractured as elsewhere in Europe, a tour of Amsterdam's financial district finds that big Dutch companies are punching well above their weight. In fact, Brexit has sent business their way and the Netherlands has overtaken the UK as Europe's biggest private equity market by deal value.

A short train trip through the lowlands and our couple arrives in Brussels. Walking around the city, they find that Brexit has both scared and emboldened European politicians. Traditionalists fret about the EU's future and worry about the record number of Eurosceptic politicians that are expected to be elected in the 2019 European elections. The word is that these forces will push back on proposals from the outgoing Chancellor Merkel regarding a European army and closer monetary union. They will push to ensure the EU does not seek 'ever closer union' and instead is open to individual countries deciding their budget and immigration rules. Although the majority of European politicians are still 'pro-Europe', they are increasingly aware of the Eurosceptics' ability to stymie proposed legislation.

On to France where the two parties that dominated for decades are both out of power. Despite that, the non-mainstream president who usurped them is now deeply unpopular. Our couple finds that although unemployment is falling in a similar pattern to that in Italy, the president has declared a state of “economic and social emergency” following the populist protests over fuel tax rises. Consumer confidence is low and to quell any further populist uprising, policy changes have been expedited including a roll back of the fuel tax increase, tax breaks for overtime work, and special incentives for year-end bonuses. Our couple then tries the Parisian cafes and finds pensioners are out in force spending more as their taxes have been lowered.

Keen to understand the root of Brexit, our couple finally catches the train into King's Cross station. In Britain, they are surprised to find that immigration is not at the front of peoples' minds. In fact, only five per cent of Britons cite immigration as the most important issue, well below the 40 per cent who cited it just before the 2016 Brexit referendum. Meanwhile, support for right-wing populists has plummeted. The UK Independence Party commanded 13 per cent of the vote at the 2015 election but in the most recent election, won just two per cent, while the two major parties saw a jump in their combined share of the vote from 67 per cent to 82 per cent.

As with everywhere else our couple has toured, they have found British politics highly fractured. But the rifts *within* the parties themselves seem to be in the spotlight more so than the rifts *between* them. Indeed, government members have pushed back on their own prime minister's Brexit deal, the opposition Labour party has seen a succession of shadow cabinet members quit over disagreements with their leader, and the UK Independence Party, which held Brexit as its *raison d'être*, has become lost in its own scandal.

At first, our couple is confused. Post-Brexit Britain is not the hot-bed of populism they expected. Traditional parties are back in vogue even if they are themselves fractured by Brexit. Our couple wonders whether this is because the British people feel their concerns about immigration and sovereignty have now been addressed by voting themselves out of the EU, or whether they are beginning to realise that many of the promises made by populist parties before the 2016 referendum were overblown. And if the latter, are the supporters of populist parties elsewhere in Europe taking note?

Having completed their European tour, our couple heads back to the South Pacific wondering whether it is good for the UK that a vote for Brexit has tempered populist movements despite the economic cost. They also struggle to see what mainstream parties in Europe need to do to win back support. Without this clarity, they can only surmise that populism in Europe is still to reach peak levels, and unless mainstream politicians quickly find ways of winning back support, some European countries risk falling into the scenario that has paralysed the political process in the UK since the Brexit referendum. ●

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Konzept discusses the thematic issues that affect the world from a financial, social, and environmental point of view. In this edition, we examine how politics and populism is shaping the world. Particularly, we look at the lessons of populist events in history and consider how they will shape our societies in the near term. We also examine how infrastructure projects frequently have a political dimension to them and how people can respond. Together with our other articles, we hope this issue of Konzept will offer some clarity on some of the most urgent, curious, and changeable political issues we face in the world today.

