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From eurozone turmoil and Greek debts to US economic problems, the Arab spring and disaffection shown by the Occupy Wall Street protests, the world has had a tough time - and this year could be even worse

Confronting an age of austerity

Gideon Rachman analyses the hopes and concerns that beset world leaders as they gather in Davos

What better time to hold the World Economic Forum than in the middle of the biggest global economic crisis since 1945? And yet the delegates who make the trek up to Davos this year are more likely to be disorientated than energised by the state of the world economy.

The global economic crisis has raised fundamental questions about the stability of the world economy, about the role of high finance and about the balance of power between the West and the emerging powers. Added to this mix is the new sense of political instability caused by the Arab spring and the outbreak of popular protest from Occupy Wall Street to the streets of Moscow.

The fear of another big financial crisis, plunging the world into a deep recession or worse, still hovers over world leaders. There could be any number of triggers over the coming months: a disorderly Greek default on its debt; a failed Italian bond auction; the collapse of a leading bank. European governments still feel as if they are dancing on the edge of a precipice. Further afield, the leaders of all the world's big powers are well aware that their economies would be severely affected by a crisis within the EU.

But even if Europe manages to avoid an economic disaster, there is a grim realisation that years of austerity lie ahead with all the social and political consequences that will entail. A big question for Europe is whether, under such circumstances, the political centre will hold – or whether new radical forces come to power. The performance of Marine Le Pen and the National Front in this year's French presidential election (the first round will be held in April) will be a key indicator of the strength of populist nationalism in Europe.

In a presidential election year, the US will also be having a vivid argument about living standards and the "American dream". If the election comes down to a contest between Barack Obama and Mitt Romney, the angry populism expressed by the Tea Party and by Occupy Wall Street will not be represented on the ballot.

But the arguments made by these movements will still influence the debate. President Obama, who won as a candidate of hope in 2008, will have to decide whether to stigmatise Mr Romney as a cruel capitalist and a representative of "the 1 per cent". Mr Romney will use the crisis in Europe to bolster his campaign – arguing that the president wants to impose a failed European social model on the US and that he embraces American decline.

Lurking behind this debate will be the question of whether Europe's problems are just one part of a generalised crisis of the West that also implicates the US.

Those who take this view will argue that both the US and the EU cannot control public finances and are burdened by unaffordable promises to their citizens and by cut-throat economic competition from rising powers.

However, if the US economy recovers strongly over the course of the next year, it will be easier to make the argument for US exceptionalism. In that case, expect to hear a lot about the unique flexibility and resilience of American capitalism

The economic and political malaise of Europe and the US have fed the sense that western democracy is going through a crisis. However, the Arab spring pushed sentiment in the other direction. The demand for political freedom across the Middle East – and the way in which this movement has caused palpitations in Beijing and Moscow – makes it possible to believe that the world might be on the brink of a new wave of democratisation.

That said, the year begins with much of the early euphoria that surrounded the Arab spring beginning to dissipate. The advance of Islamist political parties from Morocco to Kuwait –

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Survival tops list of priorities for currency union

Europe

Tony Barber says this year will need political willpower

Barring a foreign policy crisis involving a state such as Iran, Turkey or Ukraine, Europe's biggest challenge in 2012 will be little different from that of 2011: how to protect itself against catastrophic financial turbulence. From this perspective, Europe will count 2012 a successful year if it meets four objectives.

First and foremost, the 17-nation eurozone must survive intact and make progress towards closer political and fiscal integration. Second, no significant European financial institution must collapse and some stability must return to government bond markets.

Third, the sharp economic downturn visible in the closing months of 2011 must end by midyear, permitting renewed growth and job creation. Last, the European Union must reverse what is looking like a steady slide into irrelevance and internal decomposition.

None of these goals is beyond reach. It would be misguided, however, to think there is a straightforward solution to the European sovereign debt and banking sector crises. Europe's financial weaknesses will preoccupy governments and markets for many years to come.

Europe lives in an age of modest long-term economic growth rates, ageing populations, social tensions related to mass immigration, overextended welfare systems and precarious public finances. These will take decades to solve, if in fact they are soluble at all.

The preservation of the eurozone's unity will mean, in the first instance, extending sufficient financial support to Greece to stave off a disorderly default. Europe's political leaders fear that to abandon Greece would set off a market panic that might engulf Cyprus, Ireland, Portugal and other countries, ultimately destroying the cherished project of European monetary union.

Many policymakers see as counter-productive Europe's previous insistence that Greece should receive loans at punitive interest rates and concentrate on drastic budget cuts to the exclusion of economic growth. This trapped Greece in a vicious circle of austerity, joblessness, falling tax revenues, rising debt and austerity.

But Greece and its fellow eurozone strugglers must pay a price for the generosity of Germany, Europe's traditional paymaster, and other rich countries. Germany's political and financial establishment is almost certainly ready to bear a disproportionately heavy burden for saving the eurozone but only if other countries accept a strong, legally watertight mechanism to maintain fiscal discipline.

> Resolving the financial crisis is key to improving perceptions of Europe

Here, some doubts persist. Thanks to a UK veto in December, eurozone governments cannot use the EU's basic treaty as the basis for applying stricter fiscal rules. Instead they must make do, for the foreseeable future, with the less desirable option of an intergovernmental agreement among themselves. Such an accord will lack the legally binding enforcement mechanisms available under EU treaty law. This method of propping up the euro may leave markets unconvinced.

The outlook would be brighter if Germany and its allies were to agree at a EU summit in March to increase the rescue funds set up in 2010 for vulnerable eurozone governments. At present these are capped at €500bn. EU leaders must also keep their promise to bring forward the launch of the European Stability Mechanism, the permanent rescue fund, by one year to mid-2012.

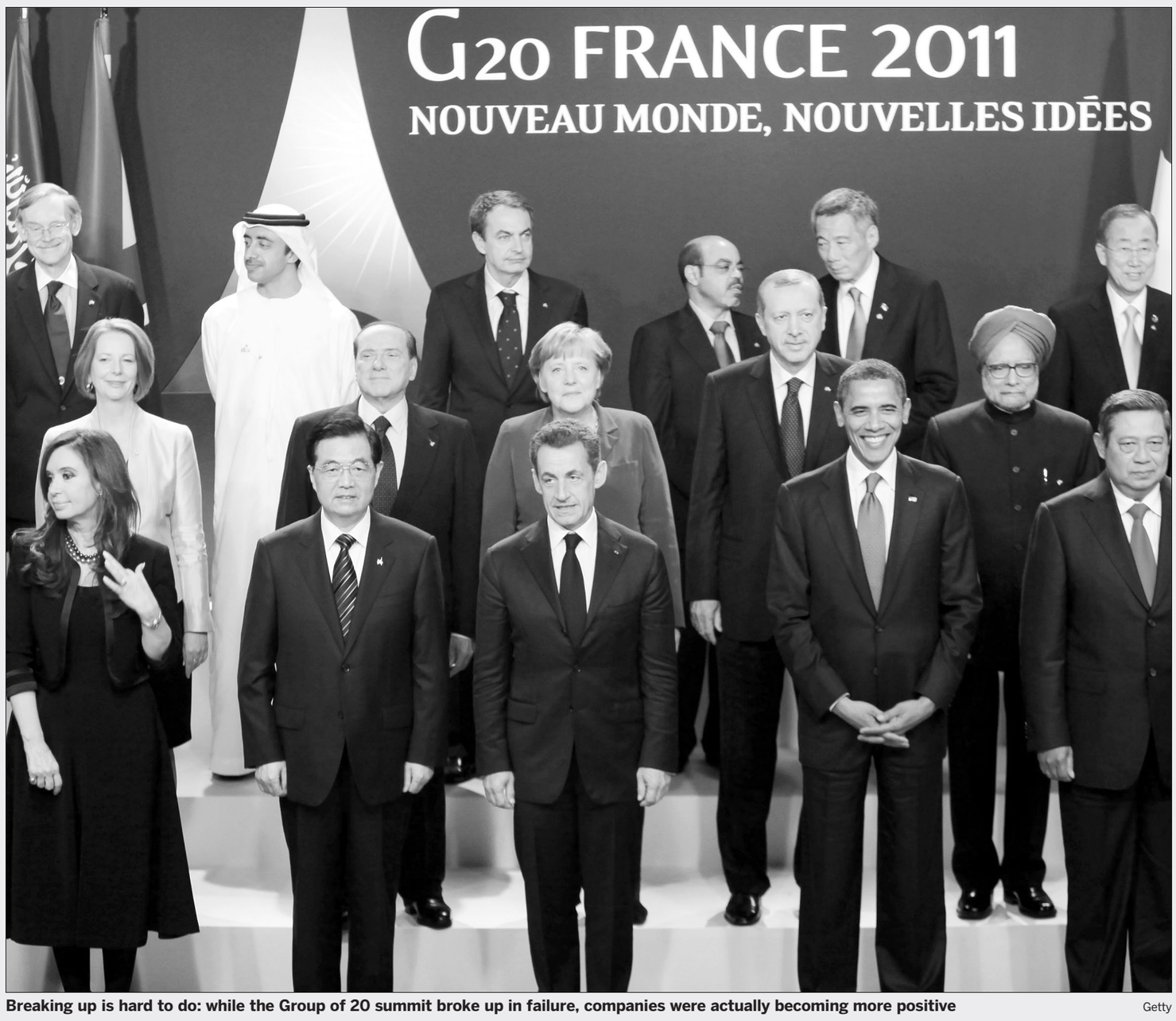
The ESM agreement requires approval from all eurozone member states, including some whose governments lack solid parliamentary majorities. It would be a bad sign if quarrels over the dilution of national sovereignty necessary to make the ESM effective were to delay the fund's launch.

Sovereignty versus European integration is a theme in France's presidential election. Both Nicolas Sarkozy, the centre-right incumbent, and François Hollande, his Socialist challenger, appear to regard inter-governmental co-operation as the most suitable platform for eurozone economic governance. German policymakers would prefer closer European integration. Franco-German tensions over this issue show no sign of diminishing.

Many European banks are so fragile that it would be unwise to rule out a deposit run or a funding crisis such as that which in October struck Dexia, the Franco-Belgian lender. The European Central Bank, by offering unlimited three-year funds for banks, has indicated it will do all it can to maintain calm and liquidity in the financial system.

The ECB is, however, unlikely to expand its government bond purchases in a US-style "quantitative easing" initiative. Between May 2010 and early January, the ECB bought €213bn of sovereign debt from "peripheral" eurozone countries. But this scarcely stabilised the bond markets. EU treaty law bans the ECB from acting as a lender of last resort but it is just conceivable the euro crisis will enter such a dangerous phase that the central bank will take the QE plunge.

Resolving the financial crisis is the key to improving perceptions of Europe across the world. Non-European powers contend Europe possesses adequate resources to overcome its difficulties. It just needs to apply political willpower: 2012 will show whether Europe is capable of that.



Breaking up is hard to do: while the Group of 20 summit broke up in failure, companies were actually becoming more positive Getty

Looking for reasons to be cheerful? The list is longer than you might think

After a second half of 2011 characterised by economic disappointments and geopolitical paralysis, it is no surprise that predictions for 2012 have become much gloomier. Such was the slowdown in the world economy that the latest economic forecasts see much weaker growth in all advanced economies in 2012 and a contraction in the eurozone.

The political front looks little better. Even as the need for international co-ordination has grown, the spirit of global co-operation has waned, having been replaced by conflicting domestic concerns. The downgrading of France and other countries' sovereign debt from its AAA rating, along with continued wrangles over private sector debt forgiveness of Greece, highlights some of the political perils ahead.

Yet such has been the change in mood towards the negative, it might have gone too far. As with 2010, this year might surprise everyone with benign, or even positive, economic developments. Forecasts, after all, are not persistently Pollyanna-ish and make as many mistakes with pervasive pessimism.

At the start of what seems like a difficult year, an important question therefore is what could work well for the global economy in 2012. The list is longer than you might think.

While the eurozone appeared to be staring into the abyss late in 2011 and international meetings such as the Group of 20 summit broke up in failure, companies were actually becoming more positive. Measured by the global purchasing managers' indices, services companies reported the strongest business conditions for nine months in December, while manufacturers said activity rates were at a five-month high. Improvements in each of these indicators was spread around the world, with particular strength in the US. At least for now, momentum has returned to the global economy.

A moderation in energy prices has been fuelling the recovery in advanced, mostly oil-importing economies. Not yet falling, the lack of a price rise has halted the relentless squeeze on corporate and household incomes and will enable a little more spending and investment. If weather-related food supply issues moderate, income gains will also spread further to poorer countries, improving purchasing power greatly.

Even though 2011 was a year that demonstrated – with the eurozone crisis and US budgetary standoff – that politics can imperil prosperity, there is a chance leaders have learnt some lessons. China has long stated it wants a rebalancing of demand from exports to consumption. Its administration might seek to put some action behind the words. Record levels of employment in Germany might finally encourage greater domestic spending and investment. Enough voices in the eurozone have diagnosed the problem that politicians might start working on solutions rather than displacement activities such as a financial transactions tax.

And non-financial companies, the entities with by far the strongest balance sheets, could see a brighter future and seek fresh investment opportunities rather than aiming to hoard cash.

There were sufficient examples in 2011 of investors eager to back real solutions with hard cash, enabling small, positive steps that could create a virtuous circle in financial markets, reducing liquidity strains for European governments and banks. For that to continue, investors need to show money can be made by betting on good rather than bad outcomes. The huge bounce in global equity markets in late November on the back of central banks' globally co-ordinated, but tiny, cut in interest rates on dollar loans to Europe's banks demonstrated the hunger for a positive equilibrium in financial markets.

All of these positive surprises might happen this year. But the most important word in that sentence is "might". We do not know. And 2012 might be another 2008 – far worse than anyone imagined. By looking at the upside risks, the prize that is available can be seen.

It is one worth fighting for.

Chris Giles

The paradox of 2012 - a defensive, short-term America

The US

Gillian Tett finds a nation looking at itself with unease

If you want to get a sense of the challenges gripping the US this year, one place to look is company balance sheets.

In some respects, this would seem to offer a cause for celebration. During the past year, many of its largest companies have reported strong profits and are collectively sitting on an estimated $2,000bn of cash. Little wonder the credit default swaps market ranks more than five dozen US companies a better credit risk than the US government: its corporate giants are not just some of the strongest in the world but better managed than their country.

And yet, glance again at that $2,000bn – and there is a catch: the reason for that mountain of cash is that many companies have been reluctant to invest in the past year. Sometimes that is down to a tax gambit. Because the US currently penalises companies when they repatriate offshore cash, many treasurers are waiting, hoping the law will change before they move their funds. Many chief executives also prefer to invest outside the US today, since they see more opportunities there, due to, say, cheaper labour costs.

But on top of that there is an emotional issue: fear. Recent surveys suggest US companies are very uneasy about the economic, political and business outlook for America – and thus nervous about any long-term projects. The paradox of 2012, in other words, is that a nation built on a future-orientated, proactive mentality – and that still has some formidable strengths – has become strikingly short-term and defensive in its nature, in some important ways.

That reflects a wider sense of malaise. In many ways, the US starts 2012 with some powerful advantages, compared with other Western nations. Three years after the collapse of Lehman Brothers, its financial system is now on a broadly stable footing. Although recent economic data has been mixed, the economic is expected to produce 2 per cent growth this year. And a study this month by McKinsey concludes that: "The United States has seen the most rapid deleveraging among the major economics so far, and may be as little as two years from returning to more sustainable levels of private sector debt."

Yet unemployment continues to be uncomfortably high by postwar standards, hovering around 8.5 per cent. While that is lower than it was last year, it is much higher than during the postwar period – and, strikingly, several percentage points higher than countries such as Germany. The housing market remains weighed down by the fact that around a quarter of US homes are in default or underwater on their mortgages. And, perhaps most damagingly, Congress failed to agree last year on any plan to cut the US debt, which is expected to exceed 90 per cent of gross domestic product soon – a level that tends to presage serious economic challenges, according to economists such as Kenneth Rogoff and Carmen Reinhart.

> A large part of the electorate is completely disenchanted with politics

That, in turn, reflects a bigger political malaise. In some European countries, the past couple of years of economic pain have prompted governments to become more – not less – pragmatic, if not centrist; British politics today, for example, is currently based on a coalition government, and notably free from ideological extremes.

The US, by contrast, has seen growing political polarisation in the past two years among actively engaged voters and politicians that has left a large part of the electorate completely disenchanted with politics. A survey by Edelman suggests that fewer than half of all Americans trust the government, while fewer still care for politicians. It has also created a paralysis in Washington.

And while that gridlock can partly be blamed on the structure of the political system – most notably, the fact that the Founding Fathers inserted numerous checks and balances to restrain power – it also reflects a far more fundamental challenge: America's leaders currently seem ill-equipped to make decisions about where to allocate pain. After all, a country founded on the idea of permanent growth and no resource constraint has not had to worry before about how to divide up the pie; instead, there has been a widespread belief that the economic pie will always keep growing. Many American politicians still insist this is possible, due to a combination of population growth, innovation and the entrepreneurial spirit that has served the country so well before. But the longer that growth remains weak, while debt levels are high, the more pressing the question will become.

Little wonder, then, that with a crucial election looming, words such as "class warfare" and "inequality" are increasingly entering the political rhetoric: the 2012 election campaign is forcing Americans to address some crucial issues about how they see the relationship between the market and state – and their own identity.

But until those are resolved, it will be hard for the country – and its companies – to truly rediscover its mojo; or, more important, use that $2,000bn pile of spare cash to spark the growth that America and the rest of the world now so desperately needs.

Confronting an age of austerity

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and, in particular, their very strong showing in the Egyptian elections – has underlined the point that democracy and liberal values may not advance hand-in-hand across the Middle East. Religious minorities and women clearly have reason to be anxious.

Meanwhile, the outside world will be worrying about whether the Arab Spring increases conflict in the region. The fact that Turkey, run by the mildly Islamist AKP party, has clashed with Israel, raises the fear that several hitherto moderate Arab states may adopt a more confrontational foreign policy – which is likely to be met by Israeli obduracy in return. In the immediate future, there are several potential sources of regional instability. Syria is now in the grip of a low-level civil war. If that remains unresolved for much longer, then international intervention – once regarded as all but unthinkable – will become much more likely.

A crisis in Syria could be pre-empted by a conflict between the West and Iran. The face-off over the Iranian nuclear programme has been going on for many years now and has always involved a good deal of bluff and bluster on all sides. But a genuine crisis does seem to be moving closer, with western anxiety about Iranian progress on the nuclear front being matched by Iranian anxiety about the tightening economic squeeze on the country and the threat of an oil embargo.

There are now also suggestions that the "Arab spring" is going global.

The demonstrations in Moscow at the end of 2011 raise the prospect that a long period of political quiescence by the Russian middle class is finally coming to a close.

A crucial political test will come with the presidential election in March. Will Vladimir Putin face a real challenge? Could he even lose? And, if Mr Putin cruises to his expected victory, amid allegations of media manipulations and ballot rigging, will the Russian middle class take to the streets and demonstrate again?

Since the financial crisis of 2008, the large Chinese delegation in Davos has presented a smooth and confident exterior. With the US financial system in crisis and US democracy apparently dysfunctional, the "Chinese model" has attracted a lot of interest and respect.

This year begins, however, with a new mood of scepticism about China in the air.

The Chinese government reacted extremely nervously to the Arab spring, censoring the internet more harshly and even briefly banning the sale of Jasmine, the symbol of the Tunisian revolution.

Popular protests about everything from factory conditions to corruption and train crashes have become a feature of Chinese life.

The stability of the Chinese economy is also now a leading concern – with worries about inflation, labour unrest and a housing bubble.

Among China-watchers, there is a growing sense that 2012 – which is meant to feature a smooth transition from one leadership team at the top of the Communist party to another – may instead be a year that raises big questions about the stability of the Chinese system.

India, the other great emerging Asian power, also enters 2012 in a less confident mood. Popular protests against corruption have become a feature of political life in India, while economic reforms appear to have stalled.

Beneath all these political and economic issues lies a bigger question.

In the aftermath of the cold war, "Davos man" helped to define "the new world order". But a world built around globalisation no longer seems quite so new, or quite so orderly. Can the World Economic Forum adapt to this situation? Or has Davos man had his day?

Banks face a perfect storm that is getting worse

Finance

Patrick Jenkins explains why the new reality means permanently smaller profit

The City of London: banks around the globe struggle to adapt to regulation that threatens to shrink profit permanently and a bleak economic outlook that will make the short term doubly difficult Bloomberg

It is hard to imagine a more perfect storm. Four years after the worst financial crisis the world has seen – at least for 80 years, if not ever – banks around the globe are struggling to adapt to two new realities: regulatory reforms that threaten to shrink profit permanently; and a bleak outlook for the economy that will make the short term doubly difficult.

The latest financial performance figures from the industry's biggest names speak volumes. Take Citigroup. Here is a bank that dominated the competition until 2007. Though its financial position has been stabilised after the existential jitters that characterised 2008 and 2009, the group's net income slumped 11 per cent in the fourth quarter of 2011, after its investment bank fell into the red. Like so many big banks, Citi's ambitions – and market value – are now a shadow of what they were in the bank's heyday.

Proponents of reform argue that this kind of shift is long overdue and that investment banks, in particular, have been milking the system for years, circulating risky investments, without a proper understanding of what they were doing and without the appropriate capital reserves to underpin them.

The big question now is: where does the banking industry go from here?

One trend spanning the industry – at least among western institutions – is shrinkage, particularly in investment banking.

Regulatory reform at a global level, under the new Basel III rule book, will make large chunks of investment banking more expensive to operate because it demands bigger capital buffers be held to back it. Trading businesses are particularly hard hit, for example. In addition, in the US, part of the Dodd Frank legislative reform process to overhaul bank regulation bans banks from proprietary trading – the practice of betting their own money on trades, as opposed to conducting business on behalf of clients.

The second driving force of trading business contraction comes from the drying up of that client flow, as nervousness has heightened in many financial markets around the world.

In many countries, the same market jitters have reduced equity issuance and advisory business on dealmaking to a trickle, too, while in banks' core lending operations – both to companies and individuals – nervousness about the economic outlook is constraining the market.

In Europe these underlying trends are being compounded by another regulatory initiative. The European Banking Authority (EBA), which oversees bank regulation across the continent, has told banks they must raise a combined €115bn to boost core capital ratios to 9 per cent. Only one bank – Italy's UniCredit – has tried to raise its share of the funds (close to €8bn) in an ultimately fraught rights issue. Many others are seeking to shrink their way into compliance, sparking concerns that a credit crunch will hold back any hopes of an economic recovery later in 2012.

The EBA's move was an attempt to restore investors' confidence in the health of European banks amid continuing fears about the extent of fallout from sovereign debt fears. A collapse of Greece or another eurozone country risks bringing down banks across the region.

Some policymakers, such as Mark Carney, the new head of the Financial Stability Board – which oversees global regulatory reform – believe the answer is to embrace the world of "shadow banks", the loose collection of non-bank financial groups.

"The dark horse is large corporates themselves," says Simon Gleeson, partner at lawyer Clifford Chance. "Many of them are flush with cash and they know better than anyone the credit risk of small corporates that are their suppliers." The trend will potentially turn a swath of corporate treasurers from borrowers – their traditional role – into lenders.

> 'The dark horse is large corporates. Many are flush with cash and know better than anyone the credit risk of small corporates that are their suppliers'

Credit crunch fears have also been fed by the dislocation of markets compounded by the eurozone crisis and the inability of some banks to finance their lending books.

At the end of last year, the European Central Bank sought to bridge the gap by launching an unprecedented three-year financing scheme, through which banks raised €489bn – nearly twice as much as many estimated – a process set to be repeated in February and one that will be closely watched as a sign of how much artificial support banks expect to need this year.

Europe's lenders face an estimated €700bn wall of debt falling due for refinancing this year, with most of that coming in the first quarter of 2012.

The next round of regulations – particularly in Europe but potentially globally, too – will focus on how big banks should be "resolved" in case of failure. But some experts worry that the advent of a resolution regime could endanger any vestiges of a funding market for banks. "There is an argument that says Basel III has already killed the market for issuing bank equity," says Mr Gleeson. "Now the resolution regime, if it isn't properly implemented, could close the senior debt market."

With all those difficulties to contend with, it is hardly surprising that many banks' profits are falling fast. That is prompting yet another round of cost-cutting – for some the third attempt to "right-size" since the disruption of the initial 2007-8 crisis. More than 60,000 jobs were unveiled at a clutch of banks in 2011, led by HSBC. But analysts expect tens of thousands more to go this year.

Banks in some parts of the world – notably Japan, China, Australia and Canada – are using the disruption in Europe and the US to profit from rivals' woes.

They are buying up assets at knockdown prices, hiring staff and expanding into new markets.

But optimism remains a fringe view and few are looking forward to 2012.

Al-Qaeda threat is smaller but jihadism remains

Terror

James Blitz examines the fears that keep security officials awake

More than a decade after the 9/11 attacks on America, few western governments would argue that the threat from international terrorism has been completely eradicated.

But over the past 12 months, jihadists have suffered such a stream of setbacks that US and European policymakers are today feeling a good deal more confident about the outlook for domestic security.

The setbacks for jihadists over the past year have been seen on numerous fronts. In May of 2011, Osama Bin Laden, the founder of al-Qaeda, was killed by a US Navy Seal operation in Pakistan. A few months later, Anwar al-Awlaki, the US-born cleric who was deemed by western governments to be the next big target after bin Laden, was killed in Yemen. In the meantime, the core al-Qaeda group in the tribal areas of Pakistan and Afghanistan is being increasingly decimated by US drone attacks and is now down to a handful of figures on the run.

Still, western intelligence agencies are far from complacent. It is hard to imagine that al-Qaeda could today pull off a complex, spectacular attack on the scale of the one that the US experienced on 9/11. But the terrorist threat that the US and Europe faces is still tangible – and is certain to dominate the minds of UK authorities this year as they prepare for the summer Olympic Games in London.

"al-Qaeda, as a formed structure, is certainly being destroyed by US action," says a western government official. "However, what is also clear is the underpinnings of jihad have not gone away. We face a threat that is more disaggregated and geographically divided than it was, and there are developments that suggest that new challenges may emerge in the years ahead."

As they cast their eyes over those challenges, senior figures in intelligence agencies would probably pick out three new fears. First, the Arab Spring has reduced the political and security grip that was once enjoyed by a number of autocratic regimes over their own people. The US, Britain and France have backed popular uprisings in Egypt, Libya, Tunisia and Syria. But the emergence of mildly Islamist governments in these countries may give jihadists more liberty to move and work against western security interests.

A second fear is the future of Afghanistan. The US-led Nato mission in the country continues to ensure that the Taliban insurgency is broadly checked. But the US and its allies will be out of the country in less than three years from now, ending what will by then have been a 13 year occupation. This is forcing counter-terrorism experts to start exploring what kind of international threat the Taliban might pose after 2014 when it will will have more room for manoeuvre. As one western official puts it: "In Afghanistan, we are currently in a counter-insurgency campaign but we will soon be back to a counter-terrorism situation."

> 'Al-Qaeda, as a formed structure, is certainly being destroyed by US action'

The third broad concern is the shift of jihadist movements away from south Asia to new centres closer to the west. In Somalia, there are dozens of foreign fighters working alongside the al-Shabbab islamist extremist movement. Today they are fighting Somalia's beleaguered government but they may yet turn their attention to the UK and Europe. In Nigeria, terrorist attacks conducted by Boko Haram, a jihadist group, are of growing concern in western capitals, amid fears that this group might try to internationalise their efforts to gain publicity.

None of this, meanwhile, should distract attention from the threat posed by jihadists inside Pakistan and also by the terrorist group Lashkar-e-Taiba. Another big attack by LeT on India, one akin to the devastating Mumbai attacks of 2008, could seriously destabilise India-Pakistan relations and have an impact on inter-ethnic relations in the UK.

All of this gives western intelligence experts food for thought. But they do not see the terrorist challenge simply in terms of changing geography. They also stress that one of the biggest challenges remains the role played by the internet, which allows jihadists to propagate messages that can encourage local people in the US, Britain and Europe to carry out attacks.

The activities of Anwar al-Awlaki in Yemen have shown in the past how a talented, radical preacher can encourage a range of ordinary people in the US and Britain to engage in jihad. Despite the killing of Awlaki, there are fears that such preaching by others will be the model for future terrorist outrages where vulnerable individuals are encouraged to carry out deeds by themselves.

"We face a lower threat than was the case a few years ago when the core of al-Qaeda was launching complex and spectacular plots," says one intelligence official.

"But that does not mean the danger has gone away. The big worry today is of the disaffected and lone figure who has been radicalised over the internet but of whom there has been little trace of any criminal activity."

Anwar al-Awlaki: target after bin Laden, killed in Yemen AFP

Tumultuous Arab states take centre stage

Middle East

Roula Khalaf finds the region at the top of agendas far beyond its own borders

Over the past 12 months, Arab youth movements have shocked the world with their passion for democracy and yearning for dignity. They broke the wall of fear that trapped their parents' generation for decades, and forced a rupture with the past.

But as revolutions rolled from Tunisia to Egypt, to Libya, Yemen and Bahrain, before moving on to Syria, the swift collapse of regimes early in the year gave way to more bloody struggles, to outside interventions and fears of civil strife.

Across the region but perhaps more so in Egypt, the Arab world's largest nation, youth also discovered that toppling a leader with lightning speed leaves the liberation unfinished, with the ruling military council stuck in the same mentality as the ousted regime and quickly developing a taste for power.

For western governments that had hoped for a new Arab order influenced by like-minded liberals, the rise of Islamist movements added to anxiety over a political transformation in a strategic part of the world. Allies on whose support they long relied are being replaced by Islamist parties deeply sceptical about western policies and more sensitive to public opinion.

Here again, Egypt, one of two Arab states at peace with Israel, is at the centre of western concerns, as nearly half the seats in its first democratically elected parliament fell to the Muslim Brotherhood. Adding to western worries and liberal alarm has been the unexpected empowerment of the Salafi movement, ultraconservative Islamists whose social and foreign policy is more hardline than the mainstream Muslim Brotherhood.

Western attention this year will continue to focus on Egypt's fraught transition, as the country heads towards presidential elections and newly elected politicians negotiate over a constitution. In theory, the military council that has been ruling Egypt since February's ousting of Hosni Mubarak should hand over power to an elected president. In practice, the council seeks guarantees that would shield the military from scrutiny and provide it with an oversight role, demands that set the stage for a struggle with elected institutions.

Change in the Arab world has taken less revolutionary forms too. In Morocco, a new constitution has devolved more power to an elected government. The move by King Mohamed VI is still miles away from a constitutional monarchy but it is an experiment that other monarchies will be watching closely. The first parliamentary elections under the new constitution produced a government that is for the first time led by an Islamist party, though one that supports the monarchy.

But not all the Arab world has recognised the power of the new forces at play. In the oil-rich Gulf, monarchies that have been shielded from mass protests have sought to appease populations with generous financial handouts. In Bahrain, where a Shia uprising was crushed with Saudi and other Gulf troops, there are increasing signs of unrest. Steps towards reconciliation have been dismissed by the opposition as lacking credibility and a genuine national dialogue has yet to be started.

In an assessment of the events of the past year, Amnesty International noted: "The protest movements across the region, led in many cases by young people and with women playing central roles, have proved astonishingly resilient in the face of sometimes staggering repression. They have shown they will not be fooled by reforms that make little difference to the way they are treated by the police and security forces. They want concrete changes to the way they are governed and for those responsible for past crimes to be held to account."

Nowhere is this in greater evidence than Syria, where the revolt is in its 11th month but the regime of Bashar al-Assad remains in denial, pursuing violent repression. Both in the region, and outside, officials see no early resolution to the crisis, with neither protest movement nor regime strong enough to prevail. Slow progress in opposition attempts at unity and growing militarisation of the uprising as defecting soldiers clash with government troops threatens a slide into civil strife.

> The Syrian uprising is becoming a factor in the escalating tensions between Iran and the west

Many Syrian activists are now calling for a Libya-style intervention, insisting that the creation of a safe haven near the Turkish border would allow the Free Syria Army, the group of defectors, to organise, and promote defections within the regime. But there is as yet no international consensus over Syria, as Russia continues to back the regime and block its condemnation at the UN Security Council. The differences with Libya run deeper. Intervention in Syria might not be contained within the country's borders, possibly provoking greater Iranian support for the regime.

Pressure on the regime from Arab states, particularly in the Gulf, has intensified in recent months, amid belated recognition that Mr Assad has lost legitimacy and his regime's removal would bring the added benefit of weakening Tehran's regional ambitions. But the attempt to isolate the regime through the Arab League has floundered as killings continue.

The Syrian uprising is becoming a factor in the escalating tensions between Iran and the west, in a convergence of the longstanding regional struggles in the Middle East and the domestic political upheaval.

For much of 2011, Iran's nuclear dispute was overshadowed by the Arab spring. As western governments fretted about the turmoil in Arab states, Iran was pushing ahead with its nuclear projects. In recent weeks, however, as the US and Europe have pushed for new, and more devastating, sanctions designed to hit Iran's oil sales, Tehran has threatened to close the strait of Hormuz, a threat the US says is unacceptable. Many analysts have been warning that failure to de-escalate could drive the US and Iran towards a military confrontation neither is looking for.

A more self-confident continent faces the world

Latin America

But **John Paul Rathbone** says there are likely to be political pitfalls

One telling sign of Latin America's growing self-confidence is the relish with which Mexico, this year's G20 president, rounded on the inability of eurozone economic policymakers to get their act together.

Several factors in 2012 will test this new, regional self-assertiveness. First is the economy. The recent Latin American fiesta of easy credit and rising commodity prices is over. This year, growth will slow to 4 per cent – far from the 6 per cent rate racked up in 2010.

A main reason for the slowdown is the eurozone. Brazil and Chile have already cut interest rates. Credit expansion is starting to slow elsewhere too, although the region's banks remain in good shape.

An even more serious economic challenge – although not one currently expected – would be an abrupt Chinese slowdown. The subsequent collapse in commodity prices might support Mexico, whose economic fortunes are more tied to recovery in the US. But it would hit South America's commodity exporters hard.

In Brazil, President Dilma Rousseff already faces a tough balancing act between slowing growth and rising inflation. Even as the 65-year old technocrat struggles to deepen unpopular structural reforms, a commodity price crash could see investors dump the real, Brazil's currency.

The subsequent depreciation would force up import prices, leaving Ms Rousseff with an invidious choice: sacrifice growth, currently forecast around 3 per cent, or allow higher inflation, already bumping against the top of the government's 6.5 per cent target.

In Argentina, the world's largest soya exporter, that choice has apparently been made. President Cristina Fernández, re-elected by a landslide in October, has said she will continue to prioritise growth, even though inflation is running around 20 per cent. However, a dwindling trade surplus has already forced a series of import restrictions: such measures will halve growth from last year's breakneck 8 per cent rate.

Chile, Colombia and Peru, three of the region's most orthodox-run economies, will meanwhile grow at 5 per cent or more, buoyed up by high mining investment and strong domestic demand.

Politically, the region will have a similarly bumpy ride. Last year, several administrations returned to government. This year, by contrast, will see political change and, in some cases, possible rupture.

In the Dominican Republic, a rare Caribbean success story, May's presidential election will see a close fight between Hipolito Mejia, a social democrat who mishandled a banking crisis when president in 2000-04, and Danilo Medina, candidate of the ruling centre-right party.

In Mexico, July's presidential election will probably see the Institutional Revolutionary party return to power after a 12-year absence. Although the PRI was once a byword for cronyism and corruption, voters have tired of the ruling centre-right National Action party's record on the economy and, especially, security: more than 47,000 people have died since President Felipe Calderón launched his offensive on organised crime in 2006.

> Venezuela's presidential contest could mark the end of Hugo Chávez's 13-year rule

Still, few expect big policy changes from the centrist PRI's telegenic candidate, Enrique Peña Nieto.

Chilean municipal elections in October will reveal the extent of public dissatisfaction over the country's inequality (among Latin America's highest) and ossified two-party system. Dissatisfaction exploded in 2010 during a series of student riots about school fees: while notable in themselves, they also expressed a broader and growing middle class disquiet in the region about education and social mobility.

But the biggest political event of the year is Venezuela's presidential contest in October, which could mark the end of Hugo Chávez's 13-year rule. Key will be whether Mr Chávez has recovered sufficiently from cancer to campaign with his usual gusto (Mr Chávez says he is cured.) Also crucial is whether the opposition rallies around a single candidate.

Nowhere will the result be more closely watched than in Cuba, which depends on Venezuela for subsidised oil. A defeat of Mr Chávez would force President Raúl Castro to speed up economic liberalisation and, possibly, see new leaders emerge from within the Communist party.

Although Mr Chávez has considerable forces to deploy, from financial largesse to near-control of the airwaves, polls suggest he could lose. Few expect the firebrand socialist leader to go quietly if he does.

That would be an early diplomatic challenge for the region's new political groupings, most particularly the Union of South American States, which is committed to democratic process. An early airing of concerns could come at April's sixth Summit of the Americas in Colombia, one of the few regional forums the US can still attend.

Another flourish of international diplomacy comes in Brazil in June. Rio + 20 is supposed to celebrate a landmark UN conference on sustainable development. But how serious world leaders remain about environmental issues while facing a grim economic slowdown is another matter.

In charge: Chinese president Hu Jintao talks to Xi Jinping, anointed to take over at the end of the year as president Getty

Increasing wealth may lead inevitably to democracy

China

Jamil Anderlini explains why this could be a crucial year for the nation

In late October or early November, at almost exactly the same time as Americans go to the polls to elect or re-elect their president, 1.34bn Chinese citizens will find out who has been selected to rule over them for the next decade.

This will be the first time in 20 years a US presidential election and a Chinese Communist party leadership transition have coincided and the first time that the country's top Communist has not been chosen by either Mao Zedong or Deng Xiaoping.

Given the responsibility involved in ruling over almost a fifth of humanity, the process for choosing China's leaders appears remarkably haphazard.

In mid-January, rumours began circulating among Beijing's political chattering classes that Bo Xilai, the high-profile boss of Chongqing municipality, would soon be named as the head of Beijing city.

That may sound like a promotion but would actually represent bitter defeat for Mr Bo, the "princeling" son of a revolutionary general who most observers have predicted will be named to the all-powerful nine-member standing committee of the Politburo.

There have even been whispers that Xi Jinping and Li Keqiang, the two anointed to take over at the end of the year as president and premier respectively, have not yet fully secured their positions.

This extreme uncertainty underlines the fact that, despite having ruled over the world's most populous nation for more than 60 years, the Communist party has not yet managed to entrench a robust succession mechanism.

Although it is mostly hidden from view, this means the main contenders for top spots in the ruling hierarchy are already locked in ferocious power struggles.

"Contests over policy or among political rivals in the party take place almost entirely behind closed doors, and are never revealed to the public," says Patrick Chovanec, a professor at Tsinghua University in Beijing. "We can only guess, from public hints and private conversations, where the faultlines might be; to the outside world, the party presents a solid, disciplined, utterly homogenous front."

As China's top leaders fight backroom battles and focus on besting their rivals in the scramble for power, their ability to push through meaningful reforms or come up with coherent policy initiatives is already being hampered.

In early January, the party held its financial work conference – a meeting of top officials held every five years that has in the past paved the way for major overhauls in the country's financial system.

The meeting's record of past achievements includes recapitalisation of the banking system and the creation of the country's sovereign wealth fund.

But this time the gathering appeared not to have produced any big new initiatives and most analysts expressed disappointment over a lack of "big-bang measures."

The growing sense of policy paralysis as a result of the leadership transition is worrying those in China who argue that bold economic and political reforms are more necessary now than ever.

With its biggest export markets in Europe and the US confronted by continuing crises and signs at home of a looming real estate crash, China's economy is expected to slow further in 2012.

> 'To the outside world, the party presents a solid, disciplined, utterly homogenous front'

Demographic shifts and rising living standards mean that the seemingly endless supply of cheap and pliant labour that has built China's economic success is starting to run out, shaking the very foundation of the country's growth model.

The prospect of sharply slowing growth comes just as China enters the income group that makes it most susceptible to demands for democracy from its increasingly informed and demanding populace.

China's per capita GDP reached around $7,600 in purchasing power terms in 2010, putting it at an income level at which most countries have seen a transition from autocracy to democracy.

"The experience of others that have grown as strongly as China, suggests that democracy is very likely within the decade," says Charles Robertson, an analyst at Renaissance Capital who published a recent report on the linkages between income levels and political transition. "To put it in per-capita income terms, once we have fed ourselves, housed ourselves and are thinking about buying a car, we begin to demand political rights."

Spurred on by the explosive growth of social media, an increasing number of people in China are demanding more of their leaders and protests among workers and ordinary people have been mushrooming across the country.

This has led analysts to speculate that one or more of the duelling candidates for promotion this year may see personal advantage in advocating substantive political reforms as a way of appealing to the more liberal-minded members of the elite.

That does not appear to have happened yet and, on the contrary, the party and state apparatus has actually been tightening its control over society and ramping up persecution of dissidents and anybody calling for better governance.

But just like in the US, the secret Chinese leadership contest is still only in its primary season and there are many months to go before the candidates and the nation will know for sure who will be the ultimate victors.

Politics and uncertainty return to Moscow

Russia

Charles Clover says a Putin presidency is likely to be different from last time

For 12 years, the Kremlin's machine of "managed democracy" functioned flawlessly. The cantankerous lower house of parliament became an obedient rubber stamp for Kremlin backed decrees; feisty independent television channels became compliant, state run and boring: courts did as they were told.

Politics, as such, ceased to exist, except as a giant theatre play staged by the Kremlin's office of domestic political operations.

But unnoticed from inside the Kremlin's spires, discontent was building. And in December, it exploded on to the streets. The proximate cause was rigged December 4 parliamentary elections but the real "detonator" of the crisis, according to sociologists was Russia's middle class, which for the first time has begun to demand rights in addition to rising standards of living.

In two short months, Russia's political scene has been transformed.

Vladimir Putin's days in power, which seemed limited only by his lifespan when, in September, he breezily announced his return to the presidency in 2012 to a cheering crowd of United Russia party delegates, now seem numbered. Politics and unpredictability have returned to Russian public life.

However, the protest movement is unlikely to find its feet fast enough to challenge Mr Putin in March presidential elections, in which he plans to return for a third term as president.

The Russian opposition will only be able to put forward a presidential candidate popular enough to challenge Mr Putin's rule "in one and half or even two years at earliest", Alexei Kudrin, Russian former finance minister, wrote in his blog on January 6.

Mr Kudrin and most other experts consider Mr Putin's win on March 4 a sure thing – but the dynamic of his falling popularity means he will be a very different president than he was in his first two terms from 2000-2008.

The most important question is how Mr Putin and his circle now cope with the slow erosion of his political influence. "He will be a much weaker figure, that is for sure," says a senior diplomat in Moscow.

Most likely, experts say, is that Mr Putin will muddle through. Weakened and without the same mandate of broad popularity with which he ruled from 2000 to 2008 (and de facto to 2012), he will be forced into more populist measures, and unable to implement reforms, such as privatisation and pension reform, which economists say are needed.

Some even believe Mr Putin's next term as president could end in crisis. His approval rating, which has been falling steadily over the past year, may hit difficult territory after an election bump, much as his mentor and predecessor Boris Yeltsin's did in 1996, setting up the famous "operation successor" in which Yeltsin handed over power to his anointed heir Mr Putin before his term ended.

On air: managed democracy functioned flawlessly and feisty independent television channels became compliant, state run and boring but discontent was building Getty

If he wishes to choose his own successor, so it goes, Mr Putin may follow the same strategy. "Putin may not even last the whole term," says one high level Russian banker in Moscow.

It is also possible that Mr Putin, known for his pugilistic style and uncompromising personality, will crack down on the growing protest mood. Andrei Illarionov, a former economic adviser to Mr Putin, believes he is readying security forces for a "GKChP-2" as he calls it – using the acronym for the 1991 coup by hardline generals aimed at forestalling the collapse of the USSR.

> Putin's vision of the future also contains hints of an authoritarian turn

The ruling elite under Mr Putin was always characterised by an uneasy and often fraught coalition of liberals and so called "siloviki" or ex-spies and security men. The latter are epitomised by Igor Sechin, who runs Russia's vast energy complex, and Sergei Ivanov, chief of staff to President Dmitry Medvedev, while liberals are led by former finance minister Alexei Kudrin and Mr Medvedev.

Now, however, with Mr Kudrin out of the government, Mr Medvedev a political corpse following his decision to voluntarily fall on his sword and accept Mr Putin's return to the presidency, and liberals increasingly alienated from the regime and attracted to protests, it is not clear whether Mr Putin will seek to move in their direction in order to co-opt liberals, or retrench and rely on the siloviki.

Already there are signs he is making overtures to the security forces – starting in January the government raised salaries of policemen and soldiers, and pledged a 19,000bn rouble, 10-year spending spree on armaments, which would make it one of the biggest military spenders in the world as a share of gross domestic product.

Mr Putin's vision of the future also contains hints of an authoritarian turn. In October, he wrote a majesterial article on Russia's future part of a "Eurasian Union" of post Soviet states, starting out with Kazakhstan and Belarus.

He insists the formation, scheduled to come into existence as early as 2013, is solely trade based and modelled on the European Union.

However the parallels with the USSR are clear.

"The Eurasian Union reflects the mindset of Putin's team. He's not really thinking about resetting relations with the US. It is a quasi Soviet alliance of authoritarian states," says Lilia Shevtsova, a political expert at the Carnegie Moscow Center, the thinktank.

Chastened administration goes for liberalisation

India

James Lamont sees the country facing uncertain reforms

Within days of the start of this year, India introduced two big reforms.

One was to open the equity markets more to foreign investment. The second was to allow foreign single-brand retailers, such as Sweden's Ikea and the UK's Marks and Spencer, to own their Indian stores outright.

New Delhi also signalled that the world's fastest growing large economy after China would grow less fast than expected.

Manmohan Singh, the prime minister, beat his finance ministry and the central bank to the admission that growth this fiscal year would be 7 per cent. Forecasts had steadily fallen in past months. But, until Mr Singh lowered expectations further, the official outlook was a healthy 7.5 per cent.

"Our country is going through difficult times," Mr Singh acknowledged.

Like most of the world, India needs to put a dismal year behind it. Local commentators have coined 2011 an "Annus Horribilis" where adversarial politics got the better of a floundering Congress-led government and progress.

In spite of predictions of 30 years of uninterrupted growth as India slips the shackles of a socialist past, investors took fright.

"The policy paralysis of last year cannot continue," says Karan Thapar, a prominent broadcaster.

"A lot depends on the performance of the government and the message that it sends out. A government that knows what it wants and is determined to get it can give a sense of purpose and direction."

His comments chime with those of Joseph Stiglitz, the former World Bank chief economist, who says India needs a better "road map" of economic reform to sustain fast growth.

Anna Hazare: brought thousands on to the street AP

Last year, the Congress party-led government was mired in high profile corruption scandals. The most notable was in the fast-growing telecoms sector, where the state auditor claimed a staggering $39bn of potential revenue for the treasury had been lost in a mobile telephone auction.

Mr Singh's administration was then assailed by a popular anti-corruption movement, led by a 74-year old social activist, Anna Hazare. His movement brought thousands of middle class Indians out on the streets.

In the meantime, economic management suffered. The government struggled to get persistent rising prices under control. Inflation stayed firmly near double digits. The fiscal position weakened.

The government also spectacularly failed to get its coalition partners behind reforms such as broader retail liberalisation to push forward structural reforms and anti-corruption legislation. A divided parliament left much pending legislation, from mining to insurance, stalled.

The disarray was reflected in the markets. The Sensex, the benchmark index on the Bombay Stock Exchange, fell 24 per cent over the year, making it one of the world's worst performers. Likewise, the rupee fell 17 per cent against the dollar over the year, forcing the Reserve Bank of India to intervene and raising anxieties about imported inflation.

Top business leaders, among them Deepak Parekh, the chairman of HDFC Bank and Sunil Bharti Mittal, chairman of Bharti Airtel, spoke up about how the government's inertia was hurting the economy just as much as the high borrowing costs inflicted on them. One of the biggest complaints was lack of decision-making.

According to economist Nouriel Roubini, India is better placed than the other Brics. After all, its youthful demographics and entrepreneurial zeal is unchanged. Nonetheless, it underperformed its peers markedly and was hurt by exiting foreign capital from portfolio investment, and ebbing confidence among local businesspeople.

> 'The policy paralysis of last year cannot continue'
>
> **Karan Thapar, broadcaster**

Much of the decline was of its own making, as the country failed to make good on its almost unique resilience coming out of the global financial crisis of 2008.

The early initiatives this year are encouraging signals from a chastened administration.

"These changes are well-timed, and highlight India's exciting investment opportunity," says David Cornell, managing director of Mumbai-based Ocean Dial Advisors India.

Some see the liberalisation as token at a time of weak markets. But Mr Cornell says opening up the equity markets to foreigners is the kind of move that can encourage a greater fund flow and help strengthen the rupee.

Senior policymakers, such as Montek Singh Ahluwalia, deputy chairman of the Planning Commission, say the pessimism is overdone when India's domestically riven growth is compared to gloomier prospects in other markets.

The second half of 2012 holds brighter prospects and should encourage greater confidence that India is not headed back to the so-called "Hindu rate" of growth of 3.5 per cent from heights of 9 per cent.

By midyear, elections, which have main parties already in full campaign mode, in five states will be decided.

The biggest of these is in Uttar Pradesh, India's most populous state and historically a state that can determine who rules at the centre. The poll pits Rahul Gandhi, the 41-year old scion of the Nehru-Gandhi dynasty, against Kumari Mayawati, the champion of the state's lower castes.

Second, the interest rate cycle is expected to turn bringing cuts in borrowing costs from April.

A political reset combined with cheaper lending and lower inflation holds the promise of greater delivery.

Tax, subsidy and other financial market reforms need to be accelerated by Mr Singh alongside bold efforts to broaden the delivery of education, food and healthcare to India's 1.2bn.

The latter, if not the former, are championed by his political partner, Sonia Gandhi, the Congress party president.

If they are not, expect drift in the world's largest democracy until parliamentary elections in 2014.

United Kingdom's year of sport, royalty and disunity

The UK

George Parker explains why the country needs some cheering up

David Cameron has never been one of nature's pessimists. The UK prime minister who once declared "let sunshine win the day", welcomed in 2012 with an appeal to Britain to look on the bright side and to celebrate a year dominated by Queen Elizabeth's Diamond Jubilee and the London Olympics.

Britons need some cheering up. Mr Cameron had hoped the government's austerity programme would have wiped out one of the world's biggest deficits before the next election planned for 2015; now he admits the pain will last well into the next parliament.

In his New Year's message, Mr Cameron invoked the nation to grasp the summer of bunting and sport as "an extraordinary incentive to look outward, look onwards and to look our best: to feel pride in who we are and what – even in these trying times – we can achieve".

Whistling to keep his spirits up, perhaps. But as Mr Cameron approaches the halfway term of the five-year parliament, he has some reason for optimism, in spite of the fact that Britain teeters on the edge of a second recession and the public finances remain in a chronic state.

For a start, the coalition of Conservatives and Liberal Democrats he leads remains stable and united on its central purpose of trying to put the country's finances back on a sound footing. In this matter alone, Britain's first postwar coalition has surprised many.

Ken Clarke, the former Conservative chancellor of the exchequer and now justice secretary, predicted before the 2010 election that if Britain failed to give his party a clear majority, the markets would take fright and the International Monetary Fund would be called in. In fact, the opposite has happened.

Mr Cameron claims the spending cuts and tax rises announced by the government have earned Britain the confidence of the markets and long-term interest rates comparable with those of Germany. The prime minister has so far taken the nation with him.

Polling shows that a majority of people believe the cuts are necessary and that about 65 per cent believe the last Labour government of Gordon Brown is to blame, compared with about 50 per cent for the present government.

Some polls at the end of 2011 put Mr Cameron's Conservatives ahead of the Labour opposition. Indeed the failure of the rookie Labour leader Ed Miliband to win the economic debate or to convince voters that he is an alternative prime minister has reinforced the coalition's stability.

That is not to say the coalition is not under strain. Nick Clegg, the pro-European Liberal Democrat leader and deputy prime minister, was furious when Mr Cameron telephoned in the middle of the night from Brussels to explain that Britain had just been isolated 26-1 over a new EU treaty.

That move delighted many of Mr Cameron's Eurosceptic rightwing MPs, who had previously been the most disgruntled element on the coalition benches in the House of Commons. But it heightened pressure on Mr Clegg to show what he is getting out of the government.

'Let sunshine win the day' – David Cameron, who hoped austerity would wipe out the deficit before the next election

Mr Clegg insists the prize for the Lib Dems – out of power since the 1930s – is to show it is a serious party of government. In the meantime he wants to prove this year that the centre-left party is playing a decisive role in shaping policy.

The Lib Dems hope to show that they are economically competent but fair: the party has promoted policies to rein in excess in the banking sector, increased spending on poor schoolchildren and taking poor people out of tax.

The party continues to be punished in the polls but has no obvious escape route. A new law has enshrined a fixed five-year parliamentary term; Mr Clegg could pull the plug on the coalition early but knows the voters are hardly likely to reward him for doing so, in the middle of an economic crisis.

Both coalition parties are anxious to dispel the idea that they have no agenda for the country beyond fixing the deficit, hence Mr Cameron's focus in recent weeks on education reform and investment in infrastructure, including a planned high-speed rail line linking London with the under-performing regions in the north of England.

Some of the most intriguing political action could take place away from Westminster. Boris Johnson, the idiosyncratic Conservative mayor of London, hopes to win re-election in May, earning a prominent role in the London Olympics and a platform to launch his campaign eventually to succeed Mr Cameron as Tory leader.

Meanwhile in Scotland, Alex Salmond, the nationalist first minister, will continue to use his dominance of the scene north of the border to pursue his goal of full independence for the Scots and the break-up of the United Kingdom; a referendum is promised within the next few years.

Mr Cameron does not normally suffer broken nights. But the idea of being the Conservative and Unionist prime minister who lost the Union might be enough to keep him awake.

In deep water: vast container ships offer cheap transport but companies are pondering the risks of relying on suppliers thousands of miles away Getty

Tsunami, floods and storms move logistics up the agenda

Supply chain

Robert Wright says distance means low cost but also brings problems

When a tsunami triggered by a vast earthquake crashed over sea walls on Japan's east coast on March 11 last year, some tiny ripples from the vast tragedy made themselves felt as far away as England's West Midlands.

Disruption to Japanese electronics makers because of the tsunami led to shortages of key electronics components at British car factories, including Jaguar Land Rover's Castle Bromwich plant in Birmingham.

There was yet further evidence of the vulnerability of global supply chains in November, when floods in Thailand inundated areas that account for 45 per cent of the world capacity to manufacture computer hard disc drives. In between, destructive storms in the US's Tennessee Valley in April caused severe disruption to some US domestic supply chains.

The spate of disasters has raised serious questions about how far retailers and manufacturers will be able to pursue the outsourcing to Asia that has transformed the world economy over the past decade. Increasing numbers, according to executives who organise large companies' logistics, are pondering the risks inherent in relying on a single supplier thousands of miles from their core operations.

Those worries have heightened the concerns about supply chain issues that many companies have felt ever since many found themselves holding too much stock following the 2008 economic crisis. Inflexible supply chains kept delivering goods after the downturn hit in volumes that proved impossible to sell profitably.

The question is how quickly the new concerns will produce an anticipated shift of some manufacturing activity away from Asia towards Turkey, Mexico or other low-cost countries that will allow manufacturers and retailers to shorten their supply chains.

Mark Parsons, a senior executive in the UK and Ireland supply chain business of DHL, the logistics operator, says supply chain risk – which senior executives never used to raise as a concern – is now a regular topic of conversation with top-level managers. The only question is how quickly that concern converts itself into real changes in sourcing patterns.

"It will take a little bit of time for the buyers to reflect what may be currently a board level issue," Mr Parson says.

Steven Gold, an experienced supply chain officer who now works for Alvarez & Marsal, the consultancy, says that individual decisions will come down to the characteristics of demand for particular products.

Mr Gold, based in the US, says clothes makers and electronics companies – both of whose products are subject to sudden, fashion-driven demand swings – are those most likely to move production to Mexico, from where lead times are far shorter than from Asia.

"The consumer is moving very, very quickly," Mr Gold says. "The need to respond very quickly is becoming imperative."

> 'The entire supply business – whether it is components or cables and semiconductors – is in Asia'

Bruno Sidler, chief operating officer for Ceva Logistics, the Netherlands-based logistics company, says the push towards shorter supply chains fits in with the trend since the late 2008 downturn for companies to try to cut down the amount of stock they hold. For the many companies still undertaking most of their manufacturing in Asia, that has meant trying to apply over the long distances of seaborne or airborne supply chains the "just-in-time" techniques originally designed to ensure factories sited near each other held only minimal stock.

"I believe that we have an ongoing evolution from production based on a forecast to on-demand production," Mr Sidler says. "People are trying very, very hard to keep as little inventory as possible."

The challenge, however, is to find the optimum balance for each set of products between the strengths and weaknesses of the different approaches.

Companies' desire to hold minimal stock, for example, can present severe challenges for the shipping lines and air freight operators that move the goods. The "slightest movement" in consumer demand has an immediate effect on demand in supply chains when stock levels are so low, Mr Sidler says.

"That has an immediate effect on carriers," he says. "The airlines and shipping lines, because they have assets that they need to fill, they're really suffering from this volatility."

Nearshoring also potentially increases the costs of transporting goods, even though they are travelling a shorter distance. The vast container ships that bring most goods from Asia to Europe and the US offer very cheap transport even in normal times – and severe overcapacity at present has sent prices to move containers on some routes down to negligible levels.

"The cost of moving stuff from the Far East is still going to be relatively cheap in the greater scheme of things," Mr Parsons says.

Mr Sidler also points out that the shift towards Asian manufacturing is unlikely to be swiftly reversed.

"If you take certain types of technology, the outsourcing has been done to an extent that today the entire supply business, whether it's components or cables and semiconductors, is all in Asia," he says. "It's not something where you can say tomorrow: 'I want to do it in eastern Europe'."

Mr Gold agrees, pointing out that changes of strategy on supply chain issues are expensive.

"You don't do these on a turn of a dime," he says.

Yet there has also been a change of mood. After a decade when the overriding consideration was to reduce costs by outsourcing to Asia, there has been a decisive change in the factors companies take into account.

"This is the year of supply chains," Mr Gold says. "There are going to be a lot of companies trying to rethink and review these questions. Companies are starting to adopt these ideas."

Game goes beyond the boundary of business dreams

Cricket

Roger Blitz finds the sport popular but off-balance

When India completed a 5-0 one-day series whitewash against England at Calcutta in October, the World Cup champions did so in front of a crowd barely half the capacity of the 63,000-seater Eden Gardens arena, one of cricket's most revered venues.

Something is wrong if cricket-mad India cannot rouse itself for the denouement in the humiliation of England, the number one-rated Test-playing country. That was an observation from a lecture last month by Rahul Dravid, India's former captain and, at 39 years of age, its elder statesman.

Five days after that Calcutta victory, a crowd of 95,000 attended India's first Formula One race, Mr Dravid pointed out. "Whatever the reasons are – maybe it is too much cricket or too little by way of comfort for spectators – the fan has sent us a message and we must listen," he said.

Every team sport is in a battle for new participants and spectators, new markets and sponsors. More than many team sports, cricket has over the years experimented widely to make its game more watchable – coloured clothing, white balls, television technology, on-field microphones.

Even the sacred sporting principle that "the umpire's decision is final", which derives from cricket, has been compromised with a system enabling players to challenge umpires' decisions. And yet the fans still stay away.

Despite the misgivings of Mr Dravid and other players, the current thinking of cricket's authorities is to counter this decline by offering the consumer more and more cricket in one form or another.

This engages the authorities in something of a balancing act involving its fan base – between the (older) purists who revere traditional Test cricket, played between countries over as much as five days, and the (younger) crowd excited by the thrill-seeking, biff-bash format of Twenty20 cricket, lasting no more than three hours.

With some notable exceptions, a Test series is uneconomical. It may be "the gold standard", in Mr Dravid's description, and contain memorable encounters but because of its timespan it is invariably played out in front of sparse crowds.

Twenty20 cricket packs them in but its proliferation makes these matches instantly forgettable. In between is a third format, the 50-over version, lasting a day, followed by both young and old but adored by neither.

In 2012, the International Cricket Council (ICC), cricket's governing body, will spend much debate analysing the right balance of these three formats. "The greatest challenge and the greatest responsibility we have is ensuring we have balance," says Haroon Lorgat, ICC chief executive.

But to compete for consumers, cricket must also confront questions about the game's integrity. Criminal prosecutions against cricketers for spot-fixing – accepting money to influence the outcome of minor moments in a game – have led to jail terms for three Pakistani international cricketers in one case, while an English county player awaits sentencing in another.

The game's authorities are running hard to counter worries about corruption by setting up investigative units and rolling out player education programmes. "Corruption is the biggest threat," says David Collier, chief executive of the England and Wales Cricket Board.

> 'Whatever the reasons are . . . the fan has sent us a message and we must listen'

But around much of the cricketing world, finances are threadbare, such as in Sri Lanka, the West Indies, Bangladesh and New Zealand. Anti-corruption officers point to the low wages of cricketers as the reason a handful are tempted into misdeed.

In another sport, say football, a wealthy governing body such as Uefa or Fifa would distribute its income to poorer nations. But power in cricket is invested in the individual member countries, none more so than in India.

While the ICC can distribute revenues from its own tournaments, such as the world cup, to help such countries, the ICC cannot force richer cricketing countries such as India, England and Australia to do the same with their own income.

The Board of Control for Cricket in India has been enriched by the huge revenues drawn to the Indian Premier League. The IPL, worth in the order of $4bn, has made millionaires of players, and its teams are auctioned for hundreds of millions of dollars. The board in 2010-11 declared revenues of Rs20,000 crore ($4bn).

"We respect the independence of each member and the fact that they are responsible for their own affairs," says Mr Lorgat. "We can only support in terms of what they have mandated us to do."

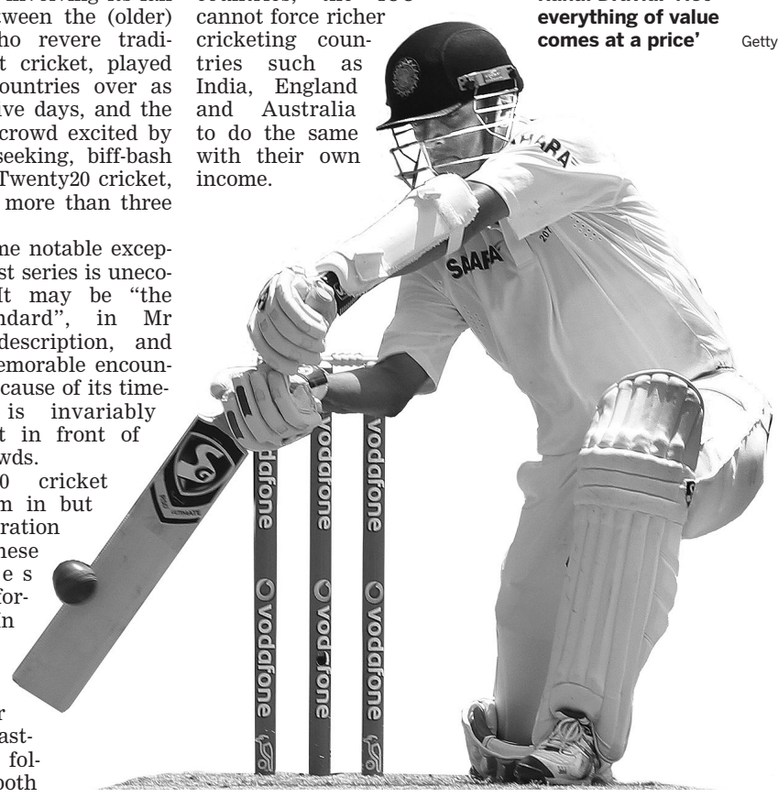
England's success at Test level is reaping dividends. The ECB has grown participation in the game and secured a 10-year sponsorship deal with Investec and some counties are reporting record surpluses. Mr Collier says he is optimistic about negotiations for new broadcasting deals.

But the economic climate is challenging. "We certainly envisage a consolidation period in these next two years," Mr Collier says.

Some people believe cricket's long-term health depends on a shift in the balance of cricket power. A review of how the ICC is governed, by Lord Woolf, a British former lord chief justice, will report by the end of this month. Its findings will include how cricketing governance impacts on the finances of its member countries.

The finances of the game are also impacting on the performance of India's test team on the field, according to some of its former players. Beaten 4-0 in England last year, losing 3-0 in Australia, some ex-players believe the IPL and its riches are the cause of the test team's rapid demise.

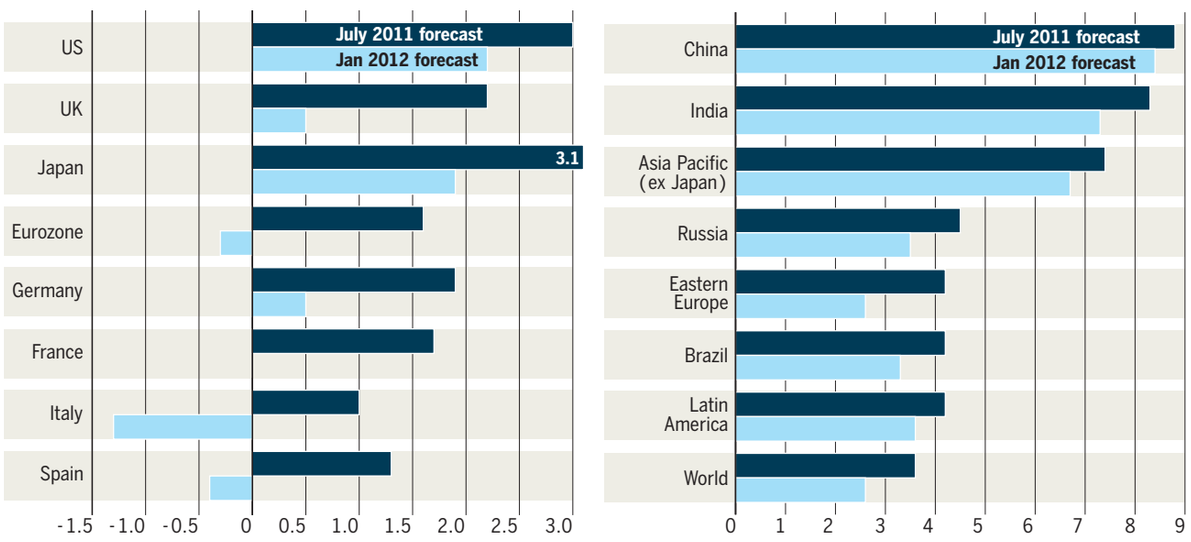
In his lecture, Mr Dravid pleaded with the game's authorities to get the balance of cricket right. "We will often get told that Test matches don't make financial sense, but no one ever fell in love with Test cricket because they wanted to be a businessman," he said. "Not everything of value comes at a price."



Rahul Dravid: 'Not everything of value comes at a price' Getty

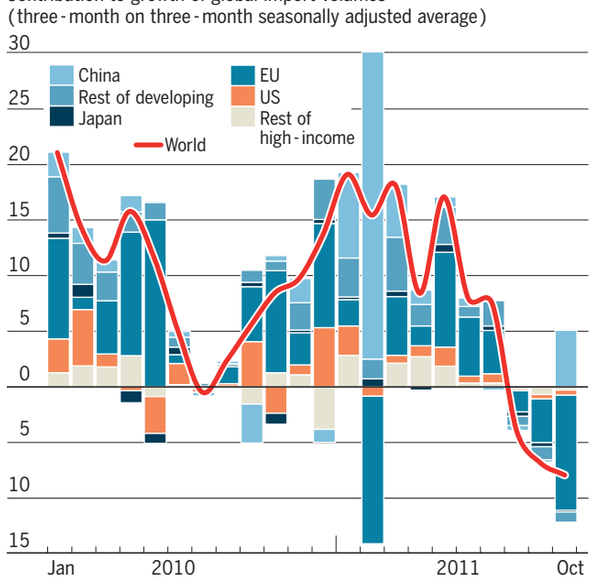
Vulnerability means the risks are on the downside

Consensus forecasts for real GDP growth in 2012 (annual % change)

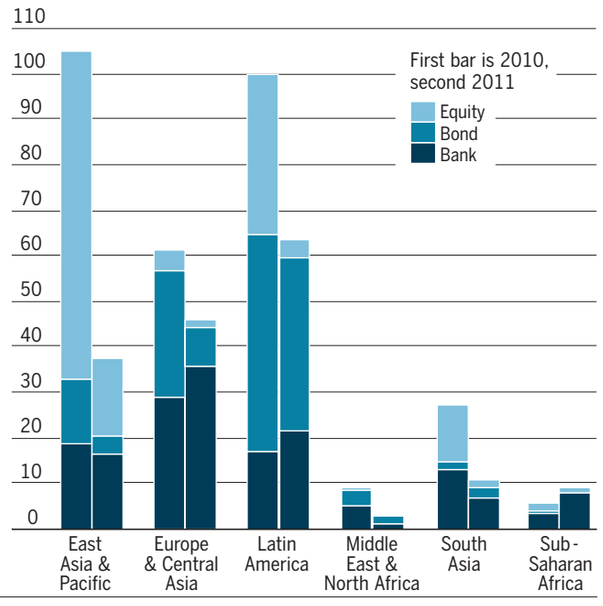


Sources: Consensus Economics; The World Bank

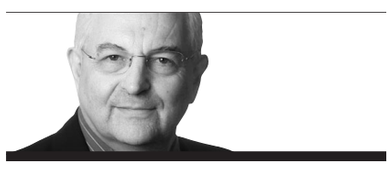
Contribution to growth of global import volumes (three-month on three-month seasonally adjusted average)



Gross capital flows, July to December ($bn)



Yet another year of living dangerously



Martin Wolf

What can we see in the world economy in 2012? Risks galore, is the answer.

The debt crisis of the high-income countries is already four and a half years old. Yet it shows no sign of abating, particularly in the eurozone. While emerging and developing countries are in reasonably robust condition, they would be vulnerable to an intensification of the crisis, which could hit them via several channels: trade, finance and remittances. Many countries – both high-income and developing – are in a weaker condition than they were in 2008 and would, accordingly, find it harder to respond effectively.

The January 2012 consensus of forecasts for this year is lower than it was in January 2011 for all the world's significant economies, including even fast-growing China and India (see chart). The cuts for eurozone countries are dramatic: eurozone growth is now forecast at -0.3 per cent this year, against 1.6 per cent a year earlier; German growth is forecast at 0.5 per cent, down from 1.8 per cent; French growth is forecast at zero, down from 1.7 per cent; and Italian growth is forecast at -1.3 per cent, down from 1.1 per cent.

Anybody who imagines fiscal outcomes will improve against such a grim background is living in a fantasy world. Improvements in structural deficits will be largely – if not entirely – offset by deterioration in the cyclical balances.

Among high-income countries, the bad news is not restricted to Europe. But it is much worst there. US growth in 2012 is now forecast at 2.2 per cent, a small improvement on the October consensus of 1.9 per cent, but still well below last January's 3.3 per cent. Japan's forecast has fallen least, from 2 per cent to 1.9 per cent, though that is largely because of the recovery from the impact of the tsunami.

The US and Japan have their own vulnerabilities, both economic and political. Huge US structural fiscal deficits and the extreme partisanship in Washington are causes for concern. But the eurozone is the epicentre of current fragility, because of the inability of its members to halt and reverse the dire interaction between financial and fiscal turmoil in a rapidly growing number of vulnerable countries.

What makes this stage of the long-running debt crises even more difficult to manage is that sovereign creditworthiness has deteriorated substantially. The more vulnerable sovereigns – including those of Italy and Spain – could not easily rescue their banks, should they need to do so. Even in countries whose sovereign borrowing costs remain low, such as the US, UK and Germany, it is not clear that governments would be willing – or be permitted by domestic politics – to intervene as aggressively, in support of their financial systems, as in 2008.

These vulnerabilities bring substantial downside risks. As the World Bank's latest Global Economic Prospects argues: "While contained for the moment, the risk of a much broader freezing up of capital markets and a global crisis similar in magnitude to the Lehman crisis remains. In particular, the willingness of financial markets to finance the deficits and maturing debt of high-income countries cannot be assured. Should more countries find themselves denied such financing, a much wider financial crisis that could engulf private banks and other financial institutions on both sides of the Atlantic cannot be ruled out."

In sum, the world is certain to live for years with the consequences of the private and public debt accumulations in the high-income countries in the years up to 2007, which were themselves in part the result of the huge global macroeconomic imbalances of that era. But the economic, financial and political defects of the eurozone have hugely exacerbated the fragility. The members of the eurozone are unable either to dissolve their union or eliminate its structural frailties.

What does this actual and potential turmoil in high-income countries mean for the world economy as a whole? In response the Institute for International Finance argues in its most recent Capital Markets Monitor that "the key question for 2012 is whether the resilient parts of the global economic and financial system – the emerging market economies and the non-financial corporate sectors – are robust enough to cushion the potential impact of high credit risk in the mature economies".

In its latest Global Economic Prospects, the World Bank forecasts a slowdown in world trade, with the volume of growth forecast at 4.7 per cent down from 6.6 per cent last year. It forecasts a decline in net private capital flows to developing countries, from $1,055.5bn in 2010 and an estimate of $954.4bn in 2011 to $807bn this year. It has also downgraded the forecast for economic growth in developing countries to 5.4 per cent, from 6.2 per cent forecast in June 2011,

On the face of it, none of this looks too serious. Overall, that judgment is probably right. But we can identify at least two important qualifications to such comforting optimism.

First, averages conceal as much as they reveal. Even such a deterioration in external conditions would pose a substantial problem for many developing countries. Many countries have large current account deficits. Many also have substantially worse fiscal positions than in 2008. All such countries are vulnerable to even modest interruptions in the flow of global finance and the buoyancy of receipts from exports and remittances. Some of these vulnerable countries are important: Turkey, with a forecast current account deficit of around 10 per cent of gross domestic product this year, is a good example.

Second, the shocks in high-income countries might be far bigger than those in the baseline scenarios. At worst, these shocks could be as big as they were in 2008. A collapse in commodity prices, to take an example, would devastate the finances of many emerging and developing countries. Yet there is likely to be a far smaller capacity to combat such shocks in both the high-income and the emerging and developing countries than at that time.

In sum, as the World Bank argues, "developing countries need to prepare for the worst". Unfortunately, that is precisely what the non-financial corporate sector and solvent households of the high-income countries have now been doing for some years. The result has been private sector austerity in these countries and so what might best be described as a "contained depression". But containing that depression has depended on support from huge fiscal deficits and highly expansionary monetary policies. This is going to remain true in 2012.

If governments cannot – or will not – persist with providing such support, a true depression remains possible. Everybody would then be affected, including the most vigorous emerging economies. These remain difficult times: 2012 will not be the end of them.

Culture will remain at the heart of work - and play

Arts

Peter Aspden explains why rich and poor alike take pleasure in beauty

It is a sign of the times that the premier cultural event of 2012 is linked to another field of human endeavour entirely: sport. Culture was a key element of the bid to bring the Olympic Games to London this summer. And the 12-week arts festival planned to accompany the Games is a suitably imposing affair.

With contributions from a host of famous names – Damien Hirst, David Hockney, Yoko Ono, Stella McCartney, Simon Rattle and more – the climax of the Cultural Olympiad aims to prove once and for all that London, not New York, not Paris, really is the arts capital of the world.

It also shows the way in which the arts have become embedded in popular culture in a way that would have been unimaginable just a couple of decades ago. The festival is only partly about star names. There is also a host of initiatives designed to encourage mass participation in the event.

On the day of the opening ceremony, for instance, the contemporary artist Martin Creed, who won the Turner Prize by switching the lights on and off in a gallery at Tate Britain, is asking for the entire population to ring any kind of bell "as quickly and loudly as possible" for three minutes in the morning.

It is a quirky and democratic affair: but just a few hours later, in the Olympic Stadium, we will get the other side of the cultural coin, namely an opening ceremony that has already had its budget controversially doubled so that it manages to provide a suitably glamorous – some would say pompous – image of Britain to send around the world.

Nothing could act as a better reminder that culture is a marketing tool, as well as an organic process that grows from the ground upwards.

The highlight of the London 2012 festival features Britain's greatest cultural ambassador. "Somehow, Shakespeare always seems to have something to say to us" is the quotation vividly sprayed all over the promotional material for the World Shakespeare Festival. It comes from Nelson Mandela.

The festival is an extraordinary coming together of companies from all over the world, each presenting their frequently idiosyncratic interpretations of the playwright's works. Baghdad's Iraqi Theatre Company is bringing its version of Romeo and Juliet to Stratford, set amid sectarian tensions between Sunnis and Shias. There will not be a more resonant work in the festival.

If the eyes of the world will be temporarily diverted towards Britain for a few weeks in the summer, they will spend most of their time focusing further eastward. China will continue to provide surprises as it goes on with its quest to create a contemporary cultural scene that manages to slip under the radar of a nervous government.

The treatment of China's foremost contemporary artist Ai Weiwei, who was arrested, and later released, on charges of tax evasion, attracted world headlines last year, and led to predictions that artists would have to tone down their work. Yet there is every sign that a new generation of mavericks is uncowed by the affair.

> 'Somehow, Shakespeare always seems to have something to say to us'
> **Nelson Mandela**

Look out for the spiky work of Zhao Zhao. His giant sculpture of last year, depicting himself as a soldier, fallen from his plinth and broken into pieces, caused something of a stir when it was displayed at Chambers Fine Art, not least when visitors noticed that the serial number of his "uniform" happened to be the date of Ai Weiwei's original arrest.

China matters to the west, and it is in that spirit that "UK Now" has been devised. A festival designed to show off the best of British creative talent to the Chinese, the event is the "payback" for 2008's "China Now", and is funded by UK companies such as HSBC, Brunswick, Burberry, British Airways and Diageo.

Highlights include the Victoria and Albert Museum's "British Design 1948-2012", and a significant exhibition of Chinese and European ceramics. The festival was launched by the Prime Minister during his 2010 Beijing visit, reflecting its perceived importance as a conduit between the two nations' political classes.

As far as the rest of the world is concerned, the arts are inevitably suffering their fair share of cuts as a result of the world economic downturn. Even the most spectacular cultural initiative of the moment, Abu Dhabi's plans to turn Saadiyat Island into a museum hub to boost tourism, is suffering delays.

It is ironic that spending on culture is under pressure worldwide, just at the time that culture is proving itself to be a vital part of business marketing, economic regeneration, diplomacy and image-building.

In the meantime the art market continues to defy predictions of gloom, to the extent that Frieze, the highly successful London art fair that has become a fixture of the cultural calendar, is expanding its activities.

Its first and long-anticipated New York fair takes place in May, while its Old Masters edition aims to attract the more traditional collector in its first outing in London in October.

Whether it is the super-rich collector or the bell-ringing populace at large, people seem to love art more than ever.

David Hockney: part of the Cultural Olympiad Reuters