FRIDAY GROUP

At the initiative of the King Baudouin Foundation

A report to the King Baudouin Foundation

GETTING OUR WAY IN A FRAGMENTED WORLD

How a more competitive world order challenges our society to get its act together

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April 2013

Summary

Preface – This is the strategy paper written as a part of the programme of the Friday Group. The Friday Group consists of young Belgian talents (25-35 years) that are committed to improving the state of our society. They do so by preparing strategy papers on key challenges and nourishing the debate with new insights and ideas. Each strategy paper goes through a lengthy reflection process. It is first submitted to an extended group meeting that also consists of invited experts and practitioners. Subsequently, it is reviewed and amended by the group members and a selected number of correspondents. The final paper is widely disseminated.

This first paper seeks to make a contribution to the debate about the position of our society in an ever-more competitive global order. It is meant as an exploration. The reader will notice that we propose to look deeper in several important issues. The dire assessment of the current state of world affairs is by no means intended to be a judgment of the long-term prospects of creating a more peaceful and fair global order. It would be grossly inadequate to posit that international cooperation, trade, and communication are to be totally discarded in international affairs. But we do want to caution for a transitional bottleneck that can cause uncertainty and, possibly, deglobalization in the years to come. Deglobalization implies a stagnation of global flows – trade, finance, people – and an increase of nationalism at the expense of international cooperation.

Furthermore, the main message of this report is that we still believe in the vast potential of our society to maintain a good position in the global order. As such, the current economic uncertainty is a wake-up call and should not lead to despair. It is an opportunity also to reflect upon our strength and resilience. The task for our society will be to hedge against new challenges, while remaining committed, for example, to invest in an innovative economy while building a stronger Europe and a safer world. We need to turn the challenges into an opportunity for making our diplomacy more effective and our society more resilient. Retrenchment and a conservative fixation with status quo are no options.

The context - So here we stand, having journeyed happily over the upward trails of the boundless vicennium, staring frightfully and perplexed into the dense haze that covers the path ahead. Since the Cold War drew to an end, the world seemed to be guided by a clear set of principles: cooperation, restraint from aggression, and openness. Some claimed that we had arrived at the end of a long history of harsh power politics; others asserted that we would soon be on a postmodern platform where the narrow national interests made place for more enlightened endeavours. Nothing of that can be taken for granted any longer.

The global order has arrived at a critical watershed with on the one hand the continuation of globalization that brings more prosperity and influence to deprived regions, and on the other hand a scenario in which the shift of the balance of power triggers economic turbulence, political uncertainty, diplomatic strife, and military power plays. In other words: the world could be bound for an episode of deglobalization in which power politics and nationalism will prevail over the previous penchant for cooperation and self-restraint. Nothing of that is inevitable, but neither is it unthinkable any longer. This paper presents three possible directions in which the world order can develop: globalization, fragmentation, and deglobalization. If the world does not manage to agree on a strategy to get through this transitional bottleneck in the coming years, deglobalization becomes the most plausible scenario. **The challenge -** This poses a great challenge to a globalized country like Belgium. If globalization is to deepen, wealth to spread more equally, and international cooperation to be orderly adjusted so as to reflect the new balance of power, we can expect to be among the first in line to benefit and it will largely depend on our own ambition how much we will actually do so. If globalization is to stall and even to regress, however, we will be extremely vulnerable, for we depend to a large degree on international commerce, we rely on a European project that might not withstand the vagaries of nationalism, and we no longer have the institutions, the social consistency, and the strategic culture to address those policies from other countries that compromise our own interests.

The risks of a standstill or reversal of globalization are manifold. In the first place, it will be more difficult to maintain our country's position as a global commercial transit hub or the position of Brussels as an international capital by grace of foreign investors and international organizations. Second, there will be a greater risk of trade diversion, as countries use political tools to attract those economic activities that create jobs and income. Third, there could be a drain of knowhow, as our market alone will not be attractive enough for major industries to keep their vitally important R&D activities in Belgium. Fourth, our society will be facing more brinkmanship from other countries that seek to extract concessions that are not in our interests. Last, greater political contest among European and global powers constrains our diplomatic manoeuvrability.

The recommendations – Let us first restate that this report does not call for protectionism, but a clever strategy that turns the current uncertainty into an opportunity for doing better – both in terms of domestic and external policies. The main way to anticipate threats is not retrenchment and conservatism, but the ambition to make our society, economy, and political system more resilient. The defence of our key interests will be an important task, but increasing the power of our society is even more urgent.

This report calls for a smart diplomacy towards the changing order. This requires a clear definition of important strategic interests and policy tools to be developed in function of those interests, rather than the other way around. It entails solid leadership that is able to identify key interests and to drive coordination across different stakeholders.

We recommend pursuing a **dual diplomacy** that constructively supports the development of multilateral cooperation, but continues to be able to cover the full scope of tasks as long as the European external services is not sufficiently effective.

As regards our economic diplomacy, we are not convinced that its current organization is effective. There are reasons to assume that its poor performance in promoting export, attracting useful investments, and in handling strategic sectors are at least partly the result of fragmentation of capabilities and responsibilities. **We therefore call for an audit of our economic diplomacy.**

At the backdrop of increasing economic competition, a tendency of states to take a more assertive role in economic affairs, and given the risk of deglobalization, it is of utmost importance to reduce our economic vulnerabilities. **First, we need a more effective policy to promote and diversify exports, by backing small and medium large companies, expanding the capacity to address trade barriers**, and to "enhance our country branding capacity".

There is an urgent need to conceive a smart investment policy. We need to choose for quality, not quantity. We call for a new investment promotion strategy that combines the efforts of the federal government, the regions, and important cities.

In addition, **we insist on a stronger policy for strategic economic sectors.** To that end, we call the different governments to establish a standing working group on strategic industries within the Ministry of Foreign Affairs. That working group should consist of experts as well as officials from different administrations that pool their capacity in preparing negotiations with large foreign investors or European institutions.

The global context

The world is exiting its boundless vicennium of globalization, growth, and relative peace.

We are in a major transitional bottleneck. Whereas stability will only be restored if economic imbalances between surplus and deficit countries are restored, adjustment is hampered by a new scramble for industry, demographic pressure, social unrest, and volatile financial markets.

There is no power able and willing to take the lead in this global correction. Their economic vulnerability creates unprecedented mutual dependence and thus a great opportunity for cooperation.

Yet, cooperation is impeding by growing nationalism and distrust. The world is once again becoming fragmented, because of growing protectionism, fear of loosing power, and military rivalry.

While a scenario of more balanced globalization and peace is most desirable, the continuation of the current trends is more likely to lead us to a world of new spheres of influence and towards a new era of great power rivalry.

A BOUNDLESS VICENNIUM

The two decades following the Cold War were marked by new confidence in the future. The world was becoming a better place. Some spoke of the end of a long history of turbulent power politics, others claimed that Europe was to take the lead as a postmodern power and that others would follow. To be sure, the world still witnessed economic setbacks, social unrest, and dreadful bloodshed, but taking abstraction of all events, the broad trend looked positive. A first important trend was **steady economic growth.** The world economy overcame a series of regional recessions and grew by a healthy annual average of 3 percent. International direct investments surged annually by 13 percent, merchandise trade by 10 percent, and trade in services by 9 percent[1].

A second reason for optimism was that **wealth spread geographically.** Between 2000 and 2011, about US$ 4.1 trillion were transferred from developed countries to developing countries through trade and investment[2]. This made industrial capacity and public infrastructure expand faster than anywhere else and accounts to a significant degree for the fact that developing countries grew two times faster than developed countries[3]. The financial inflows in the developing world are also offset by massive investments in stocks and bonds in Western markets by

	Developing Countries	Oil Producers	Developed Countries
Current Account	+ 1,7	+ 2,6	- 4,4
Direct Investment	+ 2,0	+ 0,2	- 2,5
Portfolio Investment	N.a.	N.a.	7,4

***Table 1:** Global capital flows between 2000 and 2010 (approximate accumulated figures in US$ trillion).* Source*: World Development Indicators.* Note*: The current account refers to trade and investment income. For the portfolio investment outflows, i.e. investment in stocks and bonds, we can only guess the exact volume. Especially in developing country there is vast underreporting of outflows because of political reasons and capital flight.*

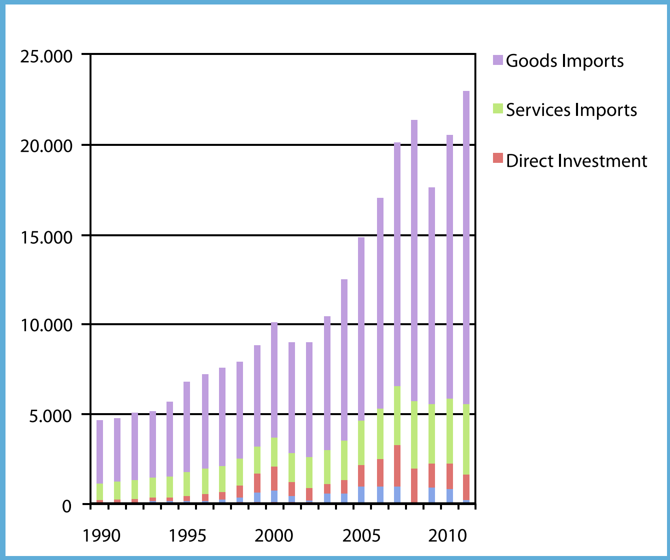


***Chart 1:** Main economic flows between 1990 and 2011 (US$ billion).* Source*: World Development Indicators Database.*

those developing markets and oil producing countries. As much as trade surpluses with the developed world financed 2.4 percent of growth in the developing world, credit from developing countries accounted for 0.8 percent of growth in developed societies.

The spreading of wealth and industrial activity has been giving hopes for **a super cycle of growth and innovation.** Middle-income countries became drivers of productivity with larger and more modern plants churning out ever expanding torrents of goods with fewer workers. Whereas the West and Japan retained a monopoly over advanced products, more countries started to fish in the same pond. China, South-Korea, Brazil, India, to name a few, all made foray in clusters like sophisticated electronics, cars, planes, clean energy, and biotech. Competition got fiercer and caused relentless pressure for efficiency and innovation. As a result, goods became relatively cheaper and markets were expected to provide rapid solutions to new problems that ranged from climate change to health care. Faster productivity gains were reckoned to make wages rise rapidly and less advanced industries to relocate more production activity to cheaper countries. In the same vain, more growth meant more demand for commodities, which benefited many developing countries as well. With the expansion of south-south commerce, mostly centred on China, it was thus anticipated that the gains for the developing countries were to become much greater.

A fourth element has been the apparent improvement in **political stability.** Since the fall of the Berlin Wall, the great powers have largely abstained from new military conflicts or proxy wars, with few notable exceptions including Afghanistan (2001), Iraq (2003) and Libya (2011). The rising powers also refrained from the kind of military aggression that emerging imperial nations displayed in the past. They adhered instead to discourses of peaceful rise and strategic self-restraint. Thus far, none of them sought to confront the superpower position of the United States directly. In addition, we also witnessed a steep decline in intra-state wars. Whereas there were still 160 domestic violent conflicts in 1990; this had dropped to 50 by 2011[4]. The population of refugees and displaced people contracted by 10 million. Compared to 1990, the number of countries without elected executive power of state dropped from 44 to 20[5].

Having said all this, globalization had its dark side as well. As we will see in the next section, it has contributed to major economic imbalances, environmental strains, and social inequality that increasingly lead to political instability. As a result, the world is entering into a critical transitional bottleneck.

A TRANSITIONAL BOTTLENECK

Since about four years, this optimism has faded. The crisis demonstrated that global and regional **imbalances are a recalcitrant cause of economic instability.** The main imbalance is the one between the United States and exporting countries – China, Japan, and several oil producers. Because the dollar remained a safe haven, the United States has been drawing in an average US$ 500 billion per year, mostly by selling bonds. External debt kept the dollar up, which on its turn kept imports up. But production stalled because most external credit has been sunk into an overvalued real estate market, spent on opaque financial products, and is now needed by the government to bail out banks. At the same time, China built up its production capacity too fast by keeping the Yuan low and heavily subsidizing industries. As a result of this overcapacity, investors also inflated the real estate market, drove up stocks to an unsustainable level, and tried to seize whatever opportunity to get their capital out of the country. Thanks to its high growth rates, China got away with it, but the limitations of this growth model are reached. So on both sides you have a failure of government policies – the one stimulating excessive consumption – the other excessive investment. Those government failures are followed market failures that take the shape of bubbles.

Whereas the financial crisis was ignited in the United States, the **Eurocrisis** revealed a similar distortion[6]. Germany has been running a giant surplus thanks to internal devaluation under Chancellor Schroeder, the strength of its industry and the weakness of other members of the Eurozone, which kept the Euro at a low level and gave a price advantage to German exporters. Like China, Germany reinvested a large part of its surpluses in Eurozone countries that ran a deficit, but in sectors that did not generate the incomes needed to repay this credit: real estate and public spending to name the most important ones. In theory, it is possible for Germany to continue to use the price advantage of a relatively weak Euro to provide cheap credit, but this is unlikely to happen due to political resistance and social tensions at home. So, the way out is more production for export in countries like Spain and Greece, more consumption in Germany. But, expectedly, this is not evident either, because austerity measures in deficit countries are no guarantee for a revival in the short term, and because Germany does not want to put its industrial prowess at risk.

The outlook of the world economy increasingly depends on political choices and the ability of elites to implement large and laborious reforms. There are several spoilers that will complicate this political climate even more. First among them is a new **scramble for industry and subsequent protectionism.** The spreading of industrialization is a gradual process, and so is the relocation of production chains. Today, however, all countries are making eyes at manufacturing to generate jobs and income. While China is still in its industrial takeoff, India seeks 100 million new jobs in manufacturing by 2020, Brazil 11 million, South Africa 5 million, Malaysia 3 million,… Europe and the United States, on their turn, try to defend the existent manufacturing jobs. It is worth mentioning that in the last decade, manufacturing created only about 19 million direct jobs. There will be, as indicated before, fierce competition among manufacturing countries. Because of ever shortening product life cycles, factories will rise and fall at an excruciating pace[7]. Yet, the growing penchant for aggressive industrial policy will create greater overcapacity, decrease returns on investment, and trigger speculation elsewhere. And as states throw their lot in with domestic industries, it will be tempting to resort to protectionism when other economies gain ground or global demand slides. Industrial policy and protectionism are two sides of the same coin.

The scramble for manufacturing brings us to another major challenge: demography. Population growth challenges the world to create 600 million jobs over the next decade[8]. Manufacturing will at best generate 10 to 15 million direct jobs, agriculture, as a result of land scarcity and reform, only about 150 to 180 million. The world now needs twice as much growth to create the same number of jobs as ten years ago.

Demographic growth will also affect stability in other ways, not the least because it requires gigantic volumes of raw materials. The positive side is that the world spends more than ever before on the search for solutions: resource-efficient technologies, smarter food production methods, recycling, desalination, alternative materials, etc. The downside remains that technological breakthroughs still come not fast enough to alleviate needs. Conservative estimates show that coal demand is set to increase by 200 percent, gas by 100 percent, and oil by 25 percent between 2012 and 2030[9]. Demand for major ores is also foreseen to double during this period[10]. The consequences are significant. In the last decade, commodity prices have been soaring.

Growing demand for commodities also has a huge impact on the environment. Burning fossil fuels has been the main cause of global warming, which, according to the World Health Organization, causes 150,000 deaths per year. And the worse might still be to come, if world nations do not come to an agreement regarding emissions mitigation and accept to invest significant resources in improving vulnerable societies' resilience to the consequences of climate change.

Demographic growth also imperils food and water security. Yes, agricultural production has increased, but growing demand of new urban middle classes in Asia, ineffective conservation, and inadequate distribution will render the poorest part of the world population exposed to food price hikes, up to 60 percent in the next decade. Besides food, the world faces an enormous challenge to provide access to drinking water.

As the world economy slows down, elites grapple with disconcerting tensions between public expectations and the capacity to fulfil them. The ability of governments to open their borders to commerce and to make sacrifices in the pursuit of international cooperation rested on the expectation that greater gains were in the offing: more profits for entrepreneurs, jobs for the masses, and opportunities to spend for fellow politicians. It was the lure of more prosperity that permitted societies to acquiesce in disgraceful inequality, the profiteering of their leaders, the life in repellent slums as they flocked into bulging cities. Those cities have become the engines of globalization, but they also turned into hotbeds of discontent. Gallup surveys reveal growing social unrest in 40 percent of the countries, mostly in advanced economies, North Africa, South Asia, and East Asia[11]. A broad range of surveys shows that public confidence in the future economic outlook, in the benefits of globalization or free market, and in their government is going down rapidly. In China alone, Chinese sociologists counted over 100,000 mass incidents in 2010.

As governments grapple with social unrest, the world is poised to enter into more financial volatility. In the past decade, financial markets grew spectacularly. In 2011, the value of all financial assets was more than three times bigger than what the world produced that year. This could represent a giant opportunity, but in reality, it does not. Just a minor part is used to strengthen the so-called productive economy. The share of fixed capital formation and spending on innovation remained flat and even decreased if China is counted out[12]. Only about 21 percent of today's global capital is invested in non-financial companies[13]. The largest part of the financial market consists of debt of Western countries, incurred by households, banks, and governments. This leads us back to the government and market failure that we spoke of before. What we witnessed since the crisis is that on the one hand, capital supply dries up. Companies experience more difficulties to invest and banks have to clean up their balance sheets. On the other hand, more money continues to shift to speculation on new failures and subsequent adjustments: speculation on interest rates, speculation on currency devaluation, speculation on credit derivatives, and speculation on gold as the last sanctuary of stability. The volume of these transactions is gigantic. In 2010 the daily trade in interest rate instruments amounted to US$ 2.1 trillion, the trade in foreign exchange instruments to 4.0 trillion[14]. To put matters in perspective: average global trade in goods and services reaches US$ 500 billion a day. The largest mutual funds are bigger than the size of the Dutch economy; the largest hedge fund bigger than Oman. The size of those players and the daily proportions of their speculation will continue to make the world financial market a much more volatile place and render it more difficult for government to assess the ultimate impact of their adjustment policies.

A last reason for optimism during the boundless vicennium has been the multilateral momentum. Indeed, the international organizations that were established by the victors of World War II – such as the United Nations, the International Monetary Fund, and, later on the World Trade Organization – excelled in dissonance and derelict, but new organisations were set up to promote cooperation. A lot was expected from the G-20, which was considered a more democratic set-up to discuss world affairs and address instability. But where new international organisations proliferated the most, was at regional level. Most of them jockeyed initially on expanding regional trade, but also became active in formulating regional rules for matters like security and environment. Regional multilateralism and new diplomatic conduits at the global level: all that seemed to imply that the transformation of the international order would transpire in an orderly manner and through cooperation instead of competition.

NOT SO POWERFUL POWERS IN A POWERLESS SYSTEM

The past decades have triggered a power rebalancing at the global level (the so-called *multipolarization* of international politics) and a greater interdependence between these multiplying poles in every single sector (e.g. trade, finance or security). Relations among global players have evolved – and the definition of a global player itself has changed, extending beyond national entities. Threats and challenges are now global or transnational by nature. Solutions must therefore come from broad concerted efforts.

The main problem of our age holds in the system's inherent difficulty (perhaps its inability) to address effectively the most pressing challenges. On the one hand, the multilateral system which is the natural fallback option for collective action is in a deadlock, partly as a result of the emergence of newcomers that contest the legitimacy of a multilateral architecture inherited from a previously Western-dominated world. Multilateral organisations continue to flourish in numbers across the globe, but it is by no means a sign of renewed multilateral momentum. Major powers have an instrumental or lucrative view on multilateralism, in order to defend their interests and assert their political clout. To universal and rules-based multilateralism, they prefer instead light multilateralism, which offers more flexibility and presents less constrains. The rise of the G20 was a sign of the times in this regard. Its failure to address the causes of the economic crisis, however, underscores the limits of light multilateralism. Multilateralism as we know it is on the brink of decay, precisely when we need it the most.

On the other hand, nation states are too small and too interconnected to deal with most pressing challenges alone. Even the so-called "great powers" with all their resources and capabilities are more vulnerable internally and more constrained externally than often assumed. All the major powers show major economic, social, and political vulnerabilities in one way or another. This has created unprecedented mutual dependence. The protagonists do not only rely on each other in terms of growing trade and capital flows; they depend even more on each other to rebalance their economies so as to maintain stability for the future. Rebalancing is needed between surplus and deficit countries and between overvalued and undervalued currencies. All that has to happen in close coordination, as the smallest increase in interest rates can trigger a destabilizing flash flood of capital and slightest hitch in trade undermine commodity prices or trigger a chain-effect of bankruptcies and defaults.

The United States is plagued by economic exhaustion and military overstretch. With the crisis raging on now for four years, its society shows a growing penchant for retrenchment. Support for free trade and international engagement is on the decline. In spite of massive stimulus, the social climate continued to deteriorate. In 2011, unemployment remained at the highest level since the great depression, the share of people beyond the poverty line hit 15 percent, a record of 400,000 bankruptcies was registered, and 2.7 million homes were foreclosed. Public and political polarization increased dramatically, especially with regard to social safety, environment, the role of government, and labour unions[15]. America has been paying a growing political price for its social polarization. The worse the economy gets, the greater the social stress, the greater partisan differences, and the more difficult it is to address the causes of the economic slump. It is equally paying a price for having lived beyond its means. For decades the US economy has been a safe haven for investors. Not because of its performance, but because of its size, lack of alternative, and occasional diplomatic bullying. Between 1990 and 2011, the US ran an accumulated trade deficit of 7 trillion. This would normally push down the dollar and push up the cost of borrowing, which both did not happen, because the federal reserve printed 7 trillion during that time, while foreign investors bought for about 7 trillion in dollar-denominated assets. This way, about 2 percent of America's GDP was fuelled by external credit, which turned real estate and financial services into the divers of growth[16]. Both of them crashed and now demand the government to save the banks and families whom it encouraged to lend and spend[17]. In the short term, it will continue to turn to foreign investors, but in the middle long term, the only way out of this debt trap, the only way also to avoid social unrest, is to rely on external demand for growth. With still the largest manufacturing sector in the world, cutting-edge export oriented services, and a young labour force, there is no doubt that America should be able to adjust its economy. There is neither much reason to be overly concerned about inflation, because of consumer goods overcapacity, depressed housing prices, and massive increase in domestic energy production. The main challenge is that no other economy in the world wants to take American surpluses. China has recently slowed the appreciation of the Yuan and the Eurozone is much on its guard against a slide of the dollar.

That brings us to **China, the great pretender,** whose growth has been rumbling from the coastal provinces to the hinterland like a steamroller. Each time the world was holding its breath for possible mishaps, growth pushes onwards. If the American economy is plagued by overconsumption, China's ascent is marred by excessive investment. It is normal that an industrializing power sees its infrastructure develop ahead of domestic demand, but in case of China, the gap is getting dangerously wide. In the real estate sector this leads to bubbles, on the stock markets to overvaluation, and in the industrial sector to overcapacity and average profit margins as low as 4 percent. Since 2003, the government has promised to stimulate consumption, which it successfully did, but production capacity still grew much faster. As a result, China has continued to rely on export. Officials insist that China's current account surplus has shrunk, but take oil away and the surplus now amounts 5 percent of its GDP, whereas it was only 3 percent in 2000. The People's Republic relies thus more on export, not less. It does therefore not come to a surprise that the appreciation of its currency is halted whenever export-oriented industries come too much under duress. Furthermore, the slight appreciation of the last few years was largely compensated by enormous volumes of export credit – about US$ 180 billion in 2011 alone. China's growth model is stuck, so much officials came to acknowledge it. Most decision makers also know what needs to be done to rebalance the economy, but point at political caution, ideological divisions, social unrest, and vested interests of large industries as hurdles on the way to reform.

As much as it is considered the land of promise, **India remains an underperforming behemoth.** Its growing population, its entrepreneurial spirit, and its global champions in commercial services all show the potential of the country. A remarkable achievement, India's IT exports reached a value of US$ 56 billion in 2011. But those success stories are rare. Sprawling IT capitals like Chennai and Hyderabad remain islands of prosperity in an ocean of misery. The fact that an average Indian still lives 8 years fewer than an average Chinese or Brazilian is the most blatant indicator of the country's economic deficiency[18]. In the last two decades, India's growth has been jobless. As the cities could not compensate for the decline in rural employment, overall unemployment continued to fluctuate around 8 percent, underemployment around 9 percent[19]. Even though official reports show a decline in poverty, the number of undernourished people increased from about 65 percent to 75 percent in the last two decades[20]. India is unlikely to overcome its development problems. First, it is just not going to create sufficient jobs for the 320 million people that will join its labour force in the next 30 years[21]. Second, a growing trade deficit and growing public debt, will prevent the government from maintaining its spending on poverty alleviation. Third, India will rely much more than most other large countries on inflation-inducing commodity imports. Fourth, Indian politics is bound for further fragmentation due to the success of local and radical parties, so that new governments will continue to struggle to implement reforms. Fifth, persistent poverty, inequality, cultural-religious divisions, and instability in the neighbourhood will make domestic violence to rage on. In the last two decades, about 67,600 Indians were killed in domestic uproar[22]. India's muddling through is destined to hit the curbs.

Then there is **Brazil, the lucky star of America** that just seems to have it all: a thriving democracy with capable leaders, a relatively small population sitting on almost limitless natural resources, and innovative enterprises. After several decades of dictatorship and deprivation, Brazil has at last managed to push inflation down from averages above 700 percent in the nineties to 7 percent in the last ten years, trimmed poverty rates from 40 to 20 percent, reduced income inequality, curbed government debt, and expanded its foreign exchange reserves[23]. By 2007, however, it came again to rely on external credit, credit that fuelled consumption, not productive investment. Brazil has certainly not set itself free from this vicious circle in which high inflation compels the government to elevate interest rates, interest rate increases cause a greater inflow of hot money instead of higher domestic savings, hot money inflows make the Real to surge and discourage investment in exporting manufacturing, and, as a result, also increase both the trade deficit and inflation. The government sought to address this quandary, on the one hand, by limiting public spending on tick, by trying to avoid an appreciation of the Real, by using its growing incomes from resources have its main bank lend cheaply to manufacturers, while still, on the other hand, encouraging foreign investment. This balancing exercise had only limited success. Household debt continued to soar and bubbles grew in the real estate sector. Furthermore, the political efforts rely on raw material exports that now amount to 7 percent of its GDP[24]. The laborious adjustment of the Brazilian economy is going to take time. But as commodities prices are under pressure, Brazil might not have that much time. Meanwhile, its society gets increasingly polarized[25]. Poverty continues to be a breading ground for violence[26]. The ruling Workers Party increasingly responds to this uncertainty by heavy-handedly imposing loyalty on politicians, wheedling popular support to patronage, and preaching protectionism. All that could be temporary, if only commodity prices continued to rise.

THE RETURN OF THE STATE

As chart 2 shows, we do not have the slightest indication of a rebalancing between deficit and surplus economies. Even if we subtract the difference between fuel imports and exports, the gap does not narrow significantly. Chart 3 illustrates that two largest economies have not started to adjust in terms of fixed assets either, which is a precondition for rebalancing. The need for coordination through open markets is increasingly challenged by a tendency towards competition and economic nationalism. The difficult recovery from the economic crisis is triggering a wave of covert competitive devaluations. We counted at least 25 government-engineered devaluations since 2008. Washington, for example, has tried to talk down the dollar. China has slowed the revaluation of the Yuan, Japan intervened by massively selling Yen for dollars, and Seoul tried to halt the appreciation of the Won. Countries erected new trade barriers, which now cover 4 percent of trade among the G-20 members[27]. State support for farming and manufacturing by means of subsidies, cheap loans, or government procurement has been on the rise all over the world[28].

Those measures are, of course, explained as necessities to maintain social stability or to defend fair trade against the alleged protectionism of others. Thus far, we have not entered into full-fledged trade wars. Even though the public turns increasingly against free trade, elites try to defend national interests more by diverting the flows globalization than by cutting them off. Most countries are still run by rather pragmatic elites, but a much more protectionist strand of politicians limits their manoeuvrability, and could replace the pragmatists if people are kept in uncertainty for too long. The economic crisis has sparked a new struggle for wealth. The logic that trade is good for all starts to make place for a more zero-sum notion of the global economic order. Many developing countries already entertained such views before. Today, they are joined by developed states that see their economic privileges shrivel. Of course, the state in developed economies did never entirely disappear. It continued to influence the market via macro-economic policy, interest rates, and issuing government bonds. What changes, is that they now intervene more aggressively and relapse into industrial policy. That renders obsolete the division between capitalism and state capitalism. The state that had been declared dead retakes its central role in economics – the one more effectively than the other. In case of a protracted crisis, this could evolve into a global convergence towards economic nationalism and power politics.

What adds to these tensions is that economic strains are considered to be a part of a much more dramatic evolution: **a shift in the global balance of power**, a shift that is increasingly seen as the rise of China, the demise of the West, and a lot of missed opportunities for all those other developing countries that have not been successful in reducing trade deficits or building competitive industries. China is challenging American unilateralism by working selectively with the other powers, obstructing American influence in international organizations, and using the appeal of its economy. As Sino-American tensions persist, the other regional powers also feel less confident about China's peaceful rise. The fear of China diverting trade and turning economic clout into political influence in their neighbourhoods prompted them to resort to protectionism and aggressive economic diplomacy. The power shift is not yet decisive, but if China will continue to rise, it will inevitably face more resistance. As long as moderate leaders are in charge, those powers will stick to moderate foreign policies and try to avoid violent confrontation. That cannot be taken for granted, though. Social and political uncertainty breeds nationalism and distrust. Perceptions among the main powers have become more negative.

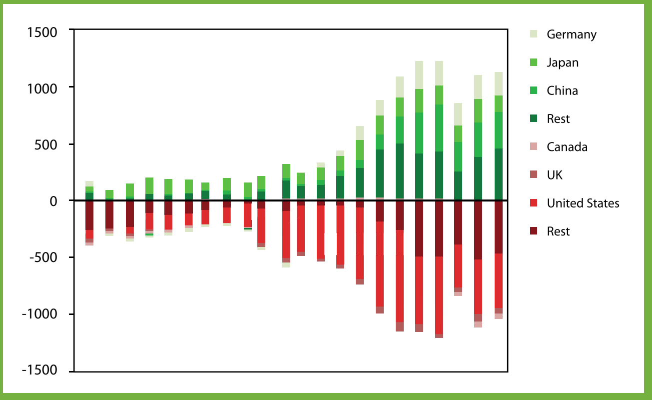


Chart 1. *The current account of selected economies (US$ billion).*

Chart 2. *Fixed asset investment (US$ billion).* Source: *World Bank, World Development Indicators database.*

RISING TENSIONS

There is a new fixation with the balance of power and that leads countries to modernize their military capabilities. As much as Europe considers itself an island of peace; it is surrounded by an ocean of military rivalry. In Asia we witness nothing less than **a new arms race.** China has a manifest destiny to break through America's traditional predominance in the Western Pacific, whereas the latter does everything in its power to retain its advantageous position. The result is a massive naval build up of a scale unseen since the Cold War. The Asian powers too go at great length to balance militarily against China by modernizing their own forces and cooperating closer with each other. Even the most destitute countries like India go all out in bolstering their military force.

Military tensions increase in other regions as well. The Middle East remains the most volatile arena. The nuclear ambitions of the Iranian regime continue to unnerve regional and global powers. The risk is a detonating cocktail of regional conflict and nuclear proliferation. As tensions rise, the vulnerability of the Straits of Hormuz becomes once again particularly salient, as a doorway for a huge chunk of international trade (about 35% of all seaborne traded oil, or almost 20% of oil traded worldwide passes through it).

Sub-Saharan Africa is also a particularly unstable region. Although the economic prospect is more promising than at any point in the past, the security situation is still particularly fragile. And economic competition among great powers for African resources could still lock the black continent into under-development. The whole region encompassing Africa, the Middle East, South Asia and East Asia constitute one big arc of instability, loosely interconnected, made of patent and latent conflicts. Violence could erupt at any time and kindle entire regions. Monitoring and managing this arc of instability remains a major challenge of the coming decades.

We cannot be confident that military tensions will be controlled. The security dilemma is rising in Asia and elsewhere. Territorial tensions could derail regional and global stability under the pressure of untamed nationalism. Geopolitical and geo-economic tensions add up in many regions of the world. The spirit of negotiations and compromise is fading worldwide, and channel of communications to manage rising tensions are often missing.

Meanwhile, **smaller local conflicts in Europe's vicinity will turn into focal points of the new great power politics and challenge Europe's strategic relevance.** The violence in Syria is clearly the most dramatic example. The West, unable and unwilling to intervene, was boldly opposed by the Russia-China-Iran tripartite. Even though there are plenty of strains in the relations among those three and the bloodshed upset many a diplomat in Beijing, distrust of America's strategic intentions made them to turn down any attempt of interference. It remains to be seen how the same dynamics will play out in regard to Iran and North Korea. Also in Africa, there are several conflicts that elicit different responses from the main powers. Strategic distrust will thus impede effective international security cooperation. Moreover, in many cases it encourages smaller states to play one power off against another.

Beyond traditional military threats, new dimensions of security are acquiring growing centrality. This is the case for so-called transnational threats, such as terrorism, nonproliferation or organised crime, which have become much more central to our threat perception than in the past. Human security is a vague concept but it has nonetheless gained prominence in recent years, be it in the context of peacekeeping operations or more recently in the context of debates on Responsibility to Protect (R2P). With the economic crisis, the idea of economic security broadly defined (from job security to securing maritime trade routes) has also returned with new force. Energy security, environmental security, water security are yet other dimensions that suggest that our understanding of security has become more sophisticated, as the threats themselves have evolved, becoming more complex and interconnected. Cyber-security is perhaps one of the most recent additions to the security catalogue. Our societal reliance on ICT is without precedent, for our critical infrastructure, but also for our economy. The cyber-dimension is a source of growth but it has also become a source of vulnerability that can be exploited by criminals and enemies. Overall, (in-)security is back in the centre of international concerns.

THREE PATHWAYS TO THE FUTURE

What are the chances that we can get out of this vicious circle of turbulence? Let us try to extrapolate what we described above into possible pathways to the future global order. These are no precise forecast, but rather some extreme poles within which the world order can be expected to develop.

First of all, none of this gloom is inevitable. As we pointed out, the remedies for restoring economic stability are fairly obvious. International cooperation could put a brake on the new tilt towards nationalism and power politics. So, in theory, nothing has to stand in the way of a **scenario of more balanced globalization and peace.** On the political side, the lack of awareness is no longer an impediment. Overall, political elites understand that action is needed and understand pretty well which measures are required. The problem is, however, that this awareness has not yielded results. Rebalancing within the Eurozone has advanced and the transfer of political sovereignty to economic governance at the European level has been remarkable. But internal devaluations and appreciations – austerity in the deficit countries and more spending in surplus countries – have not progressed enough. In addition, the growing reliance of the Eurozone on external credit keeps the Euro at a too high level and makes adjustment more difficult for weak countries. Rebalancing at the global level has not even started. China and the United States are implementing cosmetic changes rather than the required fundamental reforms. Talks within the framework of the G-20 have gone nowhere. They have not even created common understanding about critical issues like currency manipulation, the development of a new set of rules for trade that also covers services, and the management of capital markets. If anything, those markets promise to become much more volatile and flows of hot money will make it hugely difficult for governments to assess the true bearing of their interventions. Meanwhile, new bubbles are emerging. China might soon turn into the most magnificent of all bubbles if its overinvestment persists and so will commodity bubbles inflate further in all corners of the world. In the West debt fuels new bubbles in health care, education, real estate, and alternative energy.

A second possible future that has attracted growing attention is fragmentation. As Western leadership over the international order fades, **several spheres of influence** will emerge around the main economic powers. China is the most likely candidate to set up its sphere of economic influence. In response to dwindling demand in the West, China diversifies its exports to developing countries where it will trade manufactured goods and services for commodities. For the years to come, Chinese will continue to rely heavily on investment, but by soaking in great volumes of commodities at high prices, it will create demand for its products. Even though this trade will be unbalanced, it will be scattered over a large number of countries, so resistance will be more difficult to organize itself. When Chinese industries get more competitive and the Chinese economy saturated, within 10 years or so, it will start relocating production abroad on a very large scale and see its surpluses lower. It is at that stage, that the Yuan could start to appreciate significantly, become the main currency in exchanges with its partners, and give another boost to Chinese demand. A new middle empire will be born. Europe and the United States, meanwhile, will muddle through. The United States will be able to reduce its global engagement as it banks on plenty of new internal energy reserves and continues to wield influence over North and Central America. Europe, if it survives, will have a similar compact with Northern African countries and Eastern Europe. There are ample of reasons to doubt about this scenario as well. First, there is no reason to expect China to succeed in building its own sphere of influence. Chinese exports of finished goods are moving away from Europe and the United States much slower than domestic problems with the economy arise. Second, juggernauts like Brazil, India, Japan, and Russia do not wish to stomach deficits with China any longer – for economic and security reasons. In other words, the making of new economic blocs, especially the one around China, is also going to work only if some of the international economic imbalances are redressed.

The most ominous pathway is one of acute **deglobalisation and a new era of great power conflict.** This implies that deep recession leads to protectionism and encourages rivalry among the main powers. The result is an atrophy of trade and capital flows and painful adjustment of economic imbalances through a protracted crisis. This process would probably start with a coincidence of protracted stagnation in the West and a crisis of confidence in China. Beijing could try to ward off such crisis by smart stimulus spending on consumption and small enterprises, but this will not be sufficient to absorb the most likely causes of dwindling confidence: the revelation of great losses in exporting industries, a deep drop in real estate prices, a run on the troubled stock markets of Shanghai and Shenzhen, or major social or environmental incidents. The effect of such setbacks will be accelerated because of flawed financial relations between banks and state-owned enterprises, financial problems with local governments, growing national government deficits, and the unwillingness of Chinese citizens to bring their savings to the bank. Such crisis will make China's overinvestment problem imminent, cause major losses, and cause liquidity problems with banks – in spite of their high savings-to-lending requirement. As consumption growth halts, deflation will spread and force Beijing to stimulate exports. Chinese efforts to dump goods abroad at knock-off rates, the collapse of commodity prices as a result of decreasing Chinese demand, and exacerbated financial problems in the West as a consequences of the attempt of institutional investors from the emerging markets to get their money back will cause even greater political tensions. Deflation will become a global phenomenon and drive private investors into gold and, ultimately, US dollars. The result: great distress in China, the end of rebalancing in America, a blow to recovery in Europe as Germany's export-oriented economy will no longer be able to step in, and massive unrest in commodity producers like India, Brazil, and most of the African countries. Like in the early nineties, poor commodity exporters will turn into failing states, breed violence, and cast an even darker shadow over the world economy. In the US, free traders will go mad on Chinese protectionism and hawks will thrive on the patriotic mood to aim at China's military modernization. With Germany overstretched, European progress on economic governance will grind to a halt and eventually reverse. Global trade collapses and removes a crucial brake from the tilt towards conflict between the main powers.

Today we are at a crossroad. If political and economic trends are not reversed, we could slide into a period of deglobalisation, impoverishment, and conflict. No, we should certainly not consider that scenario inevitable. As we indicated, the policy options for rebalancing are quite obvious and so is it clear that the final outcome is a win-win for both the developing countries and the developed markets. That rebalancing entails an economic adjustment between deficit and surplus countries, the restructuring of global institutions, and the search for compromises on key security interests between the major powers – preferably by working towards security regimes. But we do not have the slightest indication that those policy options are going to be pursued fast and convincing enough to stay of the threats that lay ahead. As long as that is the case, a country like Belgium needs to hedge against uncertain times and it is an important duty of our government to reflect more seriously upon the different contingencies.

The challenges for Belgium

Finding 1. As a result of growing international instability and the willingness of the state to intervene more in support of their national interests, our society faces uncertainty at four levels: the global level, the European level, the Benelux, and the national level.

Finding 2. If indeed, we are bound for a period of deglobalization, our society is particularly vulnerable. On the one hand, our economy is highly globalized, but has also become less competitive. On the other hand, our governments often do not perform effectively in defending the economic interests of its people.

Finding 3. Besides economic stress, which is the most urgent challenge, there is a need to evaluate our priorities at the level of security. Some challenges have a direct impact, like competition over the internet, great power politics, and a more polarized society that breeds unrest. But it is also imperative to reflect upon how we can contribute to global security.

OUR SOCIETY FACES FOUR LEVELS OF UNCERTAINTY

The return of **great power politics, if the trend continues, will limit the political manoeuvrability of small countries like ours.** The degree to which small countries are able to defend their interests is determined by five elements: their strategic location and niche capacities, the ambitions of the large countries, the ability to reduce the influence of large countries by building partnerships with as many of those countries as possible, the skill to bargain and to exploit these partnerships, and, eventually, the ability to facilitate multilateral agreements that restrain their influence.

In this regard, we will face four levels of uncertainty. First, there are our **partnerships with the great powers**. Given its strategic location, the presence of many international institutions, and its unique position in the European Union, Belgium has traditionally attracted the interest of the major powers. Whereas the United States has always made its expectations plain, by referring to Belgium's duty as a beneficent of American investment and a NATO ally; China is now more assertive in tying various political and economic demands to enhance cooperation, Russia has drawn more confidence in the bilateral partnership from its influence over the gas sector, and even India seeks to benefit from the growing commercial expectations in our country to extract concessions. All that should not come as a surprise, but as relations between the protagonists remain complicated and conflicting, a clever policy to diversify our relations is needed. While the Transatlantic partnership remains key, it is a task of our diplomacy to craft solid and balanced relations with the other main powers too.

At the **European level**, integration has reached a watershed. There has been a spectacular tendency towards stronger economic governance, but it cannot be taken for granted that the process will also succeed. In the same way, the External Action Service is an unprecedented initiative to build a common foreign policy, but, thus far, the Service has been a great disappointment in developing a common strategy with the member states and positioning itself as a credible interlocutor on the global scene. This might change for the better in the near future, yet, again, we have no certainty that this will be the case. Indeed, we have got too close with the member states to make this project fail and the European Union usually becomes stronger throughout different crises. By and large, **our diplomacy faces the challenge to continue to work constructively towards a stronger European project, while it hedges against the nationalist tendencies of some member states in this difficult transition stage, and develops at least a basic alternative plan for handling an eventual erosion of the European Union.**

The role of the **BENELUX partnership** has been questioned for many decades, especially because European integration has often progressed faster than this tripartite. Still, there are a number of domains in which the BENELUX countries continued to coordinate more intensively than at the European level. This is notably the case with defence, police, and intellectual property. Yet, on several issues listed in the 2009-12 cooperation agenda, progress has stalled, especially between Belgium and the Netherlands. Coordination on European affairs, notably European economic governance and the handling of the Eurozone crisis has been negligible. The combating of narcotics on the border has not been much coordinated either. On transport, the Netherlands continued to show itself obstructive in negotiations over the Scheldt and the Iron Rhine railway corridor. The handling of the financial crisis has been another divisive issue. The main explanations have been a new nationalist and anti-European reflex in Dutch politics and the fact that the Netherlands traditionally assertive economic diplomacy has become more pronounced in symbolically sensitive negotiations. It remains to be seen how much the retreat of Geert Wilders' party from the government coalition changes this. If the BENELUX is to continue to act as a laboratory of cooperation for Europe, more political commitment from its members is urgently required.

The fourth level of uncertainty relates to the institutional (perhaps even existential) future of Belgium. There is no doubt that the current federal model does not function properly. We will not take a stance here on the question whether this is caused by factors such as the flaws in that very model, the growing selfish tendencies of the regions, the increase of conservative forces as a consequence of the lack of a progressive political vision, the growing competition for scarcer resources,…. Important here is that the uncertainty of the future of **Belgium** reduces the confidence of our international partners. Diplomats and investors do often disavow that the institutional limbo makes our country less attractive and effective in asserting its interests in European and international institutions. We also suspect that the effort to brand strong regions under a weak national brand is not working, but further research is due in that respect.

BELGIUM IS ECONOMICALLY VULNERABLE TO GLOBALIZATION SLOWDOWN

In the previous decades, Belgium has been one of the most globalized countries. Consequently, it will also suffer a lot if globalization stalls or retreats. We identify three main challenges: pressure on Belgium's position as a logistics hub, difficulties for exporting companies, and the impact of financial power politics. But there is more. Our society has developed some additional vulnerabilities that will be more pronounced in a global and European reality that becomes more uncertain. On the one hand, it has transformed from a resilient surplus economy into a vulnerable deficit economy. On the other, our government has become less able to promote the national interest abroad.

The future of globalisation is inevitably associated with the future of trade and logistics. Our country functions as a logistics hub for Europe. Obviously, it is not just the sheer number of containers that counts. Much more important is how the logistical sector contributes to employment and domestic growth. In 2011, logistics contributed about 5 percent to our country's added value and employment[29]. The port of Antwerp remains a crucial hub. In terms of transit, Antwerp was outpaced by Rotterdam, but the number of jobs and added value per handled ton remained more than double of Rotterdam's. There are, however, two reasons for concern. On the one hand, Antwerp suffered more from the economic crisis than Rotterdam. Between 2008 and 2012, traffic, added valued, and especially employment dropped. On the other hand, the Netherlands has been much more active in exploring new opportunities to put their ports at the centre of international transport flows. That has been the case with carbon dioxide transport, biomass, LNG, and coal for smart power plants. The economic crisis has also sparked a major strategic reflection upon possible scenarios for global trade flows and their composition. It also triggered the Dutch government to invest much more in economic diplomacy in support of its ports. Other neighbours like France and Germany, and several countries in Southern Europe, now also consider the development of the port industry more as a strategic priority. Belgium and Flanders in particular have struggled to respond in a similar way. Efforts in the direction of port clustering have failed. In other transport sectors, Belgium performed relatively well. Thanks to growing inland shipping, transported volumes decreased much less than in our neighbouring countries. The number of air passengers rebounded much faster than in neighbouring countries. This is an evolution to be watched, as international connectivity is used as a very important argument by cities like Amsterdam, Paris, and Frankfurt to attract high-quality investors. In either scenario – globalization or deglobalization – stiff competition is to be expected for both quantity and quality.

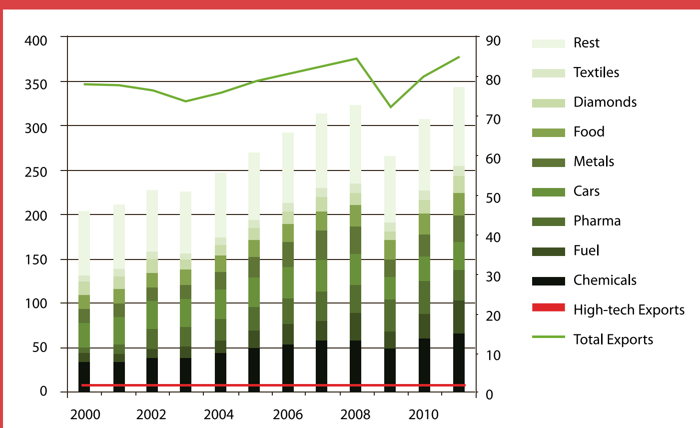


Chart 4. *Composition of commodity exports (left axis, US$ Billion) and share of total and high tech exports of our GDP (right axis, percent). Sources: National Bank and World Development Indicators.*

A regression of globalization instantly affects our country's position as an exporter of **goods.** There are three elements that make our country particularly prone. First, it has become more dependent on export of goods. Whereas export represented 66 percent of our GDP in the nineties, this increased to 78 percent in the last decade, and 84 percent in 2011[30]. Second, Belgium does hardly export anything that is very much in demand – like high-tech or raw materials. Our top products are all goods that even developing countries can produce and also will produce more: pharmaceuticals, petrochemical products, chemicals, plastics, and steel. Those five categories alone contributed 61 percent to the expansion of our exports in the last decade. Third, and related, our exports became more concentrated in these five sectors[31]. Export of cars and machinery, for example, tailed off. Even the touted food sector did not grow very vast in absolute terms and remained flat around 8 percent of our total exports. If exports in the five top categories are to slow, its impact will mostly be felt on the current account. In terms of direct added value and employment they only represent 6 and 3 percent of the national total. About 80 percent of what the pharmaceutical exports, for example, consists of imported components. But still, the difference is good for a share of 30 percent in Belgium's total current account surplus. The impact of any slowdown in exports might thus be felt mostly in the external balance, but that does not make vulnerability less pressing.

Absent a lot of large exporting industries, our economy experienced difficulties to tap into emerging markets outside Europe. Belgium's share in the European Union's total exports to China, India, and Brazil remained flat around 8 percent, thanks to the exports of diamonds and metal scrap. In addition, in comparison to our neighbours, we hardly attracted investments from these emerging markets. Investors from India and China usually do not consider the presence of the European capital a huge asset, in comparison to the concentration of large financial companies and headquarters of important industries is neighbouring cities like London, Amsterdam, Paris, and Frankfurt. Many of them are also unimpressed by the political stability of Belgium. Corporate leaders acknowledge the favourable fiscal climate and the relative ease to register, but they consider it more useful to establish their presence in political capitals that have weight to throw into the scale or financial resources to support their activities.

Races to the bottom in terms of social, ethical, and environmental standards will also particularly challenge our exports. Those downward spirals of norms could undo the incomplete but important progress that has been made in the last decade, threaten Europe's ambition to become a standard setter, and further challenge our country's socio-economic model. The crisis prompted European member states to pursue fiscal competition and social dumping to gain competitiveness[32]. Growing subsidies and state support imperil the internal market. The European Commission faces more opposition in its efforts to set higher environmental standards. It is true that more flexibility and government savings are part of an inevitable adjustment, but those measures will not bear fruit if they are not implemented in a coordinated way within Europe and if their impact is neutralized by aggressive economic statecraft elsewhere, including acts of competitive devaluation, subsidies, etc. The table below, which is based on an interview with sector organizations, gives an overview of how six important Belgian exporting industries were confronted with new challenges in the context of the economic crisis. All sectors report that deteriorating standards have affected their position. The most common complaint related to social and fiscal standards. Free trade and environmental standards were a concern in regard to market outside the European Union.

In absence of international coordination on monetary stability, our country needs to determine how it is to defend itself against **financial hostility from other countries**. The Euro seems to have become the main victim of the efforts of other economies to maintain or expand export-oriented industries. Even as the crisis has made the Euro to depreciate substantially, it remains overvalued by 5 to 15 percent[33]. All major economies, including China and the United States, have bought Euro-denominated as-

	EU					Ex-EU				
	Social	Environmental	Ethical	Fiscal / Financial	Free Trade	Social	Environmental	Ethical	Fiscal / Financial	Free Trade
Automobile	■			■		■	■		■	■
Food	■					■	■		■	■
Pharma	■			■		■	■	■	■	■
Chemical	■	■		■		■	■		■	
Textile	■					■	■			■
Contracting	■					■	■	■		■

Table 2. *Views of Belgian industrial sectors of "deterioration in terms of standards" within the EU and in non-European markets. Source: Telephone interviews with sector organizations and companies, August 2012. Example: "Does your sector suffer from a deterioration in (social, ...) standards in other European countries/non-European countries?"*

sets, mostly government bonds in an attempt to defend their exports to the Eurozone. This equals tacit competitive devaluation, certainly if it coincides with currency pegs or efforts to talk the domestic currency down. The main problem for Belgium is the lack of consensus among the Eurozone members and a lack of an assertive strategy at the level of the European Central bank with regard to the overvaluation of the Euro, which will make it hard to escape from the debt trap. Some still favour a strong Euro for the sake of social stability, others to attract more credit to stabilize the peripheral countries, and it is even maintained that a strong Euro is needed to pay for growing imports of natural gas. Enjoying a strong Euro today, however, means a huge burden tomorrow. Most of the external credit is consumed – or burnt up as imported fossil fuels - and not spent on industries that generate incomes for the next generations. A debate is required in the following: 1) the costs and benefits of a relatively strong Euro, 2) the strategic intentions in monetary policy of key economies like China and the United States, 3) the impact of selling government bonds outside the Eurozone on the Euro's strenght, 4) the impact of currency misalignments within the Eurozone (i.e. Belgium suffering more from an overvalued Euro than, say, Germany or Austria).

There are two important factors that made our country more vulnerable to a standstill or retreat of globalization: one is economic, the other political. **First of all, we have developed from a resilient surplus economy into a vulnerable deficit economy.** Our country used to be a great beneficent from globalisation thanks to moderate trade surpluses, large foreign investment in industries and services, and incomes from investment abroad. The financial crisis made an end to that favourable situation. Since 2008, Belgium has run a trade deficit that amounts to 0,5 percent of its GDP. This has been compensated by larger inflows of foreign portfolio investment and larger inflows of direct investment, notably in the sector of business services (Eur 77 billion), the chemical industry (Eur 27 billion), and the financial sector (Eur 22 billion). A first reason for concern is statistical vagueness: business services are a very opaque sector. We do not know, for instance, how important so-called head offices (NACEBEL 70.1) have become. Eurostat Data show that FDI position in head offices represented 35 percent of total FDI in 2008, but that there was massive disinvestment in 2009 and 2010. Investment in this sector has been encouraged, but their impact on the Belgian economy in terms of employment, income, and sustainability is questionable[34]. A second issue is that foreign investment in almost all other sectors has not increased. Investment in key sector as pharmaceuticals, machinery, automobile, research development, energy, or IT and communication, have been negligible. Third, there is reason to be concerned about our exports. Since 2011, electronics and cars exports shrank. Financial services and machinery exports stagnated. Exports in other vital clusters, like pharmaceuticals, optical instruments, and chemicals slowed down. Only in business services there was a substantial gain in exports, but, again, the true nature of that cluster needs further examination. This poor performance cannot just be explained by the economic crisis, as neighbouring countries did manage to avoid poor results. The main question remains thus whether 2008-2011 was temporary dip, or whether it was a watershed between what used to be growth driven by modest surplus and useful investments, and growth driven by deficits and investments in nebulous and possibly even volatile sectors. Are we shifting from manufacturing to unreliable services, or are we excelling in the bonanzas of tomorrow?

	2002-2007	2008-2011
Trade in Goods and Services	2,8	- 0,5
Direct Investment	1,4	2,9
Income from Employment Abroad	1,3	1,1
Other Investment	0,8	- 5,1
Investment Income	0,3	0,3
Official Reserve Assets	0,2	- 0,1
Portfolio Investment	- 4,5	2,8

Table 3. *Selected balance of payments indicators (share of GDP, accumulated for two periods). Source: National Bank and Eurostat.*

Best Performers	
Oil and Gas	11.127
Business Services	6.215
Pharma. Products	4.329
Diamonds	2.757
Optical Instruments	1.885
Organic Chemicals	1.880
ICT Services	1.368
Transportation	1.352
Misc. Chemicals	1.299
Oils and Perfumes	835

Worst Performers	
Cars	- 3.360
Electric Machinery	- 1.811
Iron and Steel	- 1.463
Zinc	- 1.054
Tapistry	- 566
Glas Products	- 461
Iron	- 449
Timber Products	- 412
Furniture	- 345
Aluminium	- 336

Table 4. *Evolution of exports of the 10 best and worst performing exporting sectors (million Euros, accumulated for 2008-2011).*

Generally, it is considered that Belgium is still one of the bastions of financial strength. Our assets remained larger than our liabilities, and that has allowed our government, for example, to rely to a large degree on the domestic market for recent auctions of government bonds. For two reasons, however, Belgium has become more a playball than a strong player on the financial market. On the one hand, its financial situation is not at all that positive. On the one hand, its financial situation is not at all that positive. Even if Belgian savings hit record levels, these deposits remained small in comparison to debt. Net savings are decreasing, which makes less money available for investment. The traditional surplus of lending over borrowing, one of the key criteria to evaluate the soundness of an economy, is equally decreasing[35]. Belgium holds much less of its own government debt that in the past. In 1990, still 80 percent of public debt was in Belgian hands, in 2000 still 63 percent, in 2011 just 47 percent[36]. It is evident that the less solid the financial balances are, the more vulnerable the country becomes. The second element is that these vulnerabilities are aggravated by a lack of sound financial governance. The main shortcoming, which is an obvious one, is that public debts were insufficiently trimmed at times of growth.

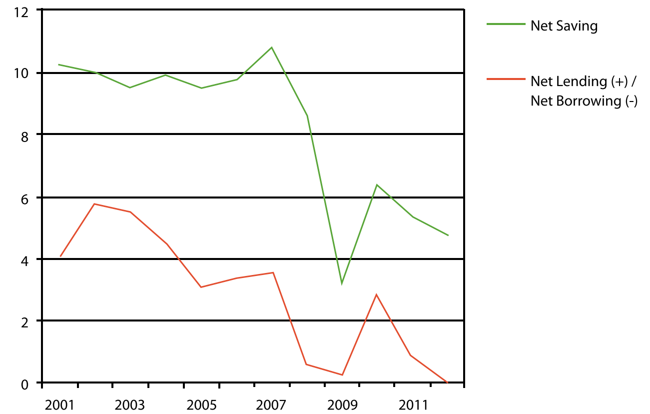


Chart 5. *Two key indicators of our weakened financial strength: net lending/ net borrowing and net saving (Share of GDP). Source: Eurostat.*

Besides more economic fragility, our country is also vulnerable because it seems to lack solid economic statecraft and economic diplomacy. Economic diplomacy is the pursuit of a polity to maximize the incomes from trade in goods, trade in services, and income transfers from expatriates and investors. It also seeks to attract those foreign investments that contribute to a more competitive economy. To be effective, economic diplomacy starts from a sound domestic economic policy that empowers companies and develops those assets that are a comparative advantage in the global market. **Economic diplomacy then becomes the art of combining the pursuit of economic opportunities with measures against foreign challenges to the national economic interest.** Economic opportunities are pursued through image improvement, trade promotion, and the facilitation of investment. Policies that challenge national economic interests are prevented by means of a strategic diversification of economic relations, the conclusion of bilateral agreements, the contribution to multilateral frameworks, and the implementation of defensive measures whenever negotiations fail.

Without a thorough audit of our economic diplomacy, we cannot assert very specific concerns, but there are sufficient indications that our government is not defending the general economic interest in the most effective way. As regards export promotion, we already stressed the fact that we came to rely more and more on just a few sectors. This could imply that efforts to assist small and medium large enterprises in gaining market share abroad have not born fruit. Equally disturbing is the attraction of foreign direct investment, which we have raised before. If we put the data earlier on in this section into perspective, we performed much worse in attracting "good" foreign investment than other small European countries. Between 2008 and 2010, our FDI inflows in manufacturing declined, whereas those of the Netherlands, Austria, and Denmark increased[37]. Compared to those countries, we also attracted less investment in the interesting segments of the services market, like IT and research. Interesting is also that Austria managed to secure foreign investment in the financial sector, whereas Belgium registered a sharp decline. **So, in regard to its main objectives – promoting exports and attracting useful investment – our economic diplomacy has performed badly.** This is unlikely to be due to a lack of resources. In 2012, the three regions, that are supposed to take the lead in economic diplomacy, budgeted 158 million Euros for external economic relations. This was more than the 133 million Euros that the Dutch Government earmarked for similar policy objectives[38]. At the federal level, another 285 million Euros was allocated to economic and trade matters[39]. The financial means are thus certainly available. The question becomes thus rather why our economic diplomacy, despite significant budgets, became so disappointing.

Belgium saw most strategic industries taken over by large foreign investors. As such, that needs not to be a problem, but it makes it even more imperative to pursue a sophisticated economic diplomacy that guards the general interest of our society. There are two sectors where our government has disappointed in doing so. The first is the financial sector. The Belgian banking sector has become much more dominated by foreign banks than it is the case in our neighbouring countries. Whereas domestic banks only represent 40 percent of the Belgian market, they amount to 90 percent in Germany and 95 percent in the Netherlands[40]. Belgium has one of the most globalized banking markets. In the wake of the financial crisis, Paris and the Hague scrambled to limit their costs. Whereas our government claimed victory in negotiations with the Netherlands over Fortis, the latter is well on its way to recover a large part of the 16.8 billion Euros that it paid from carving ABN-Amro from the terminal Fortis structure[41]. Meanwhile the Belgian government had not the slightest influence over decisions of BNP to transfer 30 billion of Belgian savings to strengthen balance sheets in France, and to compensate for deficits in its Italian and Spanish branch by transferring 40 billion in loans to the Belgian branch. Dexia is reported to have transferred for 40 billion in deposits to France as coverage for partially troubled liabilities. When it went bust, the Belgian government did not only pay 2.5 billion above the originally foreseen price, it also covered 60 percent of the rest bank, and France only 35 percent. On top of the financial price tag, experts also indicated that foreign banks, including ING and BNP, tended to be more eager to cut costs, by trimming their staffs, for example, than in their home market. **At times of uncertainty, the return of power politics has been very palpable in the financial sector. Based on the Fortis and Dexia cases, we can only surmise that our government is not well equipped to handle such tides of mercantilism.**

The banking sector is the most dramatic example, but similar problems exist in the energy sector, where one pays 16.6 percent more for electricity and 9.4 percent more for gas than in our four neighbouring countries[42]. It goes beyond the scope of this report to calculate how much a stunted competition policy towards foreign investors in strategic industries has caused a financial drain on our country. Data on this matter is scarce, but one indicator hints at significant loss to our economy: outflows dividends and branch profits to other Eurozone countries (besides Luxemburg, this mostly concerns France and the Netherlands, which both represent 30 percent) have increased dramatically and represent about 3.5 percent of our GDP[43].

Table 5. FDI positions in selected European countries (million Euros). Source: Eurostat and national data for Denmark in 2010.

		2008	2009	2010	Evolution
MANUFACTURING	**Belgium**	**99.169**	**85.362**	**83.826**	**-15.343**
	Denmark	15.221	17.253	18.132	2.911
	Netherlands	171.944	172.781	176.923	4.979
	Austria	11.383	11.694	11.761	378
IT	**Belgium**	**7.054**	**4.578**	**3.242**	**-3.812**
	Denmark	6.609	5.744	6120	-489
	Netherlands	31.203	29.797	28.145	-3.058
	Austria	1.383	1.562	2.293	910
FINANCE	**Belgium**	**170.932**	**112.978**	**106.489**	**-64.443**
	Denmark	54.451	53.837	54.100	-351
	Netherlands	99.056	90.704	77.717	-21.339
	Austria	28.891	47.952	52.322	23.431
R&D	**Belgium**	**212**	**87**	**N.a.**	**N.a.**
	Denmark	440	334	450	10
	Netherlands	20.926	17.444	9.215	-11.711
	Austria	601	838	798	197

BEYOND ECONOMICS: UNVEILING BELGIUM'S VULNERABILITIES

Belgium is highly vulnerable to a regression of globalization. It was just explained that the economic crisis has raised many red flags in the financial and trading sectors of our country. But Belgium is impacted much more profoundly by systemic changes reviewed in the first part of this paper. As geo-economics return to the forefront of international relations, our ability to promote, and defend when necessary, our economic and commercial interests is set to become a crucial dimension of our grand strategy. This would inevitably lead us to rethink our economic diplomacy, our relations with great and emerging economies, as well as our views on the Euro's overvaluation. However, findings from the previous section suggest that this is not yet the case.

The return of geopolitics is concomitant to the rise of geoeconomics. For a small country like ours, this is twice as challenging. As great powers redefine their global posture and as rivalry rises among them, other international players will have to adapt in order to protect their interests. This trend is already well underway and could be further enhanced in an era of globalization slowdown. Let us explicit our argument. As tensions heat up in Asia, for instance, the future of trade flows (particularly dense in that region of the world) could be endangered with grave repercussions in Europe (maritime flows between Europe and Asia are worth about 1 billion Euros per week; EU trade with Asia represents more than a third of extra-European trade). Belgium might be less directly exposed than some of its neighbours (its trade with Asia amounts to 12 percent of its exchanges) but would inevitably pay a high price as well.

As the US is shifting its attention from the Atlantic to the Pacific, following the so-called "pivot" to Asia, Europeans will have to bear more responsibility for their own security, internally and in their vicinity. This is not a small challenge, considering that US support is central to any significant military operation undertaken by Europeans (think, recently, Libya), but also in coping with other types of threats, such as terrorism (counter-terrorism in Europe is done in very close cooperation with the US) or cybersecurity (considering that the US is years ahead of Europe in terms of capabilities, and cooperation take place under US leadership in NATO). **In its security posture, Belgium relies heavily on its strategic partner. A weakening of this partnership would inevitably weaken our security[44].**

The shale gas revolution in the US is yet another major potential geopolitical game-changer, since energy autarcy could possibly (although unlikely at this stage) turn the US attention away from the Middle East, with direct repercussions on energy prices and energy security. Belgium is vulnerable, since it imports a quarter of its crude oil from the region.

Beyond energy security, it is the entire security environment that is undergoing transformation. As the world was becoming more interconnected, countries and companies have become more vulnerable to security concerns they could previously afford to ignore. Various kinds of illegal activities have developed on the dark side of globalization, benefiting from new permissive conditions (new technologies, opening of borders, lowering of traveling and communication costs, etc.). Terrorism, organized crime, cyber-criminality, piracy and other transnational scourges are not new phenomenon, but their potential to proliferate and do harm has increased, while our societies have become less tolerant to these threats. The economic crisis and a scenario of deglobalization will not reverse this trend, but rather modify its dynamics.

Belgium is highly vulnerable through its cyber-connectivity. Although a formidable asset, cyber-connectivity can easily turn into a weakness if appropriate measures are not taken in time. In a scenario of growing economic competition, our country is exposed to espionage and cyber-destabilization by external forces, which can originate from the private and the public spheres. Taking into account the fact that the internet contributes an important share of GDP growth in Belgium (probably around 20 percent), the threat of cyber-attacks and cyber-espionage should not be taken lightly. Statistics indicate that cyber-criminality is rising rapidly in Belgium (while reported internet fraud remains flat)[45] , and cost a lot of money annually (more than 1 billion euros)[46]. Even mundane attacks can have a serious impact. They can directly affect some companies (stealing some revenue or, worse, their secrets), but they can also weaken the e-economy (and the economy more broadly) by damaging the general public trust in the cyberworld. Although some efforts have been done in terms of response and coordination, our country is still lagging behind its neighbouring countries[47].

Terrorism in its modern form is another product of globalization, which presents a challenge to our country. **Although we have not been exposed to any major terrorist attacks in recent years, as opposed to some of our Eu-**

ropean neighbours, Belgium constitutes a prime target as the host of NATO and EU headquarters. But Belgium is not just a target, it is also a breeding ground for terrorist groups. There are multiple known cases of Belgian citizens or residents that have been recruited to train and fight abroad, in Iraq or Afghanistan mainly (Muriel Degauque, the first female suicide-bomber in Iraq, is a famous example). But the biggest danger is to see these experienced fighters return to Belgium and plot a domestic attack. The terrorist threat is particularly difficult to monitor because it is constantly evolving with new technologies, which allow to recruit new members online and even to lead to self-radicalization of individuals – the so-called "lone wolf" threat –, and with the geopolitical context (Afghanistan remains today's main battleground for international terrorism, but it could shift tomorrow to other places, such as Mali or other countries in the Sahel region).

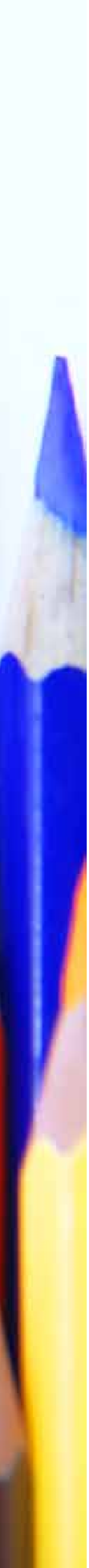
The Benelux is considered to be a hub for organized crime of various kinds and from different origins. Belgium is a big producer of synthetic drugs, with an annual production of about 40 tons. The Chinese community is believed to play an important role in the distribution of these drugs. The production of cannabis is also increasingly spilling over from the Netherlands, while Belgium is an important consumer of cocaine. In addition, our country is the unwilling host for activities of various organized groups, notably from Lithuania and Georgia[48]. Sexual exploitation is significant (90% of prostitution nationally) and generates massive revenues (2 billion euros annually)[49]. The economic crisis is deemed to have increased the appeal of organised crime to vulnerable individuals.

Transnational threats have increased their impact considerably. They are evolving and merging more rapidly than ever before. For instance, terrorist groups finance their activities through criminal activities, notably online, and recruit new members on the internet. Understanding the dynamics of such complex phenomenon is already a challenge in itself. But preparing and responding effectively to such threats is even more problematic, particularly when the means to do so appear insufficient.

In the civilian dimension, the lack of police officers and magistrates to cope with the many challenges is a well-known problem. Although our police force is already bigger than in the Netherlands and Luxembourg in relative terms, unions estimate that some 3000 additional recruits would be necessary. But the problem is not only one of numbers; it is also one of effective organization and coordination between the various governnance levels[50]. In terms of cyber-security, for instance, Belgium is clearly under-staffed but, in addition, the fragmentation and lack of coordination between various agencies considerably limit our ability to protect our economy and infrastructures.

In the military dimension, the situation appears even more problematic. The national military strength has continuously declined from the end of the Cold War to this day, even faster and more extensively than originally planned. The budget has followed a similar trajectory, declining not only in relative terms but also in real terms over the last decades. It represents today a meagre 1% of GDP. Declining military strength means declining ability to defend our interests globally. This precisely at a time when the need to defend them might be the greatest. The role of the military is actually broadening more than narrowing. Key missions include peacekeeping in the European neighbourhood, securing maritime routes or building our cyber-defence capabilities. Relying on our allies and partners for our own security cannot be a strategy. Collective security is a collective effort; free-riding undermines this effort. The pooling of resources at the European level (and at the Benelux level) is a desirable development, but it is only very limited in scope to this day.

In conclusion: For the first time in history, Europe has turned into a peaceful continent and politicians have been able to capitalize on the "dividends of peace" to improve the life of their citizens. Europe has entered the post-modern age and its understanding of security has evolved accordingly. But the world outside the Europe peninsula remains a modern one, and conflict has not disappeared from the global map. Tensions arise in various areas of the world where Belgium has interests. Some concrete illustrations: tensions in the South China Sea threaten the stability of our trade and investment interests in the region, but also the security of our trade routes; geopolitical tensions in the Middle East impact our economy via peaks in oil prices; and instability in North Africa increase our vulnerability vis-à-vis the region in terms of trafficking and uncontrolled migration flows. Obviously, Belgium cannot defend its interests here and abroad on its own. But at the same time, the multilateral organisations (NATO and EU) that have been central to our security and prosperity are at a crossroad, facing an uncertain future**. Time has come for Belgium to think seriously about its interests and how to pursue them strategically.**



Recommendations

A SMART DIPLOMACY TOWARDS THE CHANGING GLOBAL ORDER

Being fixated with domestic politics, **our government is in need of a smarter diplomacy towards the changing global order.** Realism does not mean fatalism, but to consider that the general trend of growing prosperity and deepening international cooperation often shows protracted setbacks of deglobalization, and that even in times of globalization a clever policy is needed to secure its benefits and manage its downside. Realism implies that we improve our position in world affairs with ambition, that we continue to invest in those multilateral institutions that help maintain stability and advance progress, yet, that we not neglect the task of self-confident bilateral diplomacy and a cautious economic diplomacy in periods when international cooperation and commerce are stagnant. Realism requires a clear definition of important national interests and policy tools to be developed in function of those interests, rather than the other way around. Realism entails solid leadership that is able to indentify key interests and to drive coordination across different stakeholders.

The starting point is a new strategic reflection in order to identify its global interests, how to pursue them, and the capabilities needed to do so. Without pre-empting the results of such reflection, it is clear that it should take into account the new global environment and an understanding of its dynamics. We should also examine how to strike a right balance between low politics (trade, education, etc.) and high politics (diplomacy, security, etc.), and spell out how these different realms interact and leverage, positively or negatively. Imperative is to connect the internal and an external dimension, and an understanding of their interaction, as it is as much about Belgium in the world as it is about how the new global environment in impacting Belgium itself.

To stimulate this reflection process, we suggest to the Commission of Foreign Affairs of the federal Parliament to initiate a working group on diplomacy and to organize hearings that should lead to a report with recommendations.

We also propose to the Ministry of Foreign Affairs to exhaust its mandate in promoting discussion with stakeholders how we can develop a more effective foreign policy that pools the strengths and aspirations of different official levels.

A SMART DIPLOMACY

For a small society like ours, the matter is not how much power we have to throw into the international scales, but how smartly we use it. **Smart diplomacy is key**, especially in times of uncertainty. On the one hand, smart diplomacy is multilayered and implies a role for all players: the national government, regions, cities, companies, ngos, artists, etc. It also requires making optimal use of international organizations. On the other hand, it prescribes to build synergy among these players in the most efficient way.

Smart diplomacy is by definition a well-coordinated diplomacy. Currently, our country's role in world affairs is complicated by both domestic institutional uncertainty and international turbulence. This report does not seek to judge on the institutional reform of Belgium, but it does **insist on streamlining among the different government as long as a federal or con-federal model is in place.**

First, it is imperative as the regions gain more influence we do not just bypass diplomacy at the federal level. Instead, we need to rethink it. **The Ministry of Foreign Affairs should evolve from being the overlord of diplomacy into an effective strategic facilitator.** Whenever the state is legally indispensible in foreign relations, the Ministry's role should be strengthened. This also goes for its prestige in matters of protocol and even more so when the scale of the nation helps to gain leverage in strategic matters. An open debate is needed on how the federal diplomacy can evolve into that direction.

Second, and related, we need to invest collectively in our embassies. Instead of just being branch offices of the Federal Ministry of Foreign Affairs, our **embassies should become true international interfaces** in which federal diplomats coordinate, facilitate, and divide the work with their colleagues from the regions. It is true that many European countries do boost large regional offices, independent from the national embassy, but in case of our country this might be a very expensive option to develop in all main capital, not the least in the current economic context. Opening more regional offices would actually appear counter-cyclical when most European countries are actually trying to limit or pool their foreign bureaus. In reality, a case could be made not to pool Belgian regional offices, but to bring them all in a single building to share costs and to increase visibility and the national brand. So, again, we make a case for developing our embassies into a dynamic hub of activity in which all assets of our society are showcased in the most convincing way. Moreover, stakeholders – companies, cities, artists – should be able to make use of it for all sorts of temporary activities. It is therefore recommended that the federal government and the regions embark on a reflection on the future of our embassies.

Third, embassies are about external relations more broadly, not strictly about foreign policy. More coordination is therefore needed between the foreign ministry and all services that have an external competence. This does not mean that the MFA should centralize all external competences, but that it should remain involved and informed due to its competence and, conversely, the foreign ministry should rely on competent authorities when needed. One possible concrete recommendation would be to encourage the temporary detachment of specialized agents (federal or regional) to Belgian embassies whenever a dossier might require it.

In the same vain, we propose a fresh approach for the **diplomatic contact days**. While it will still be useful to have closed-door sessions about sensitive matters, they can become precious opportunities for networking, reflection, and coordination with officials from other departments and government levels. Furthermore, we believe that part of the contact days could be open for debate with experts, business leaders, and parliamentarians.

Coordination starts from a common vision about what diplomacy is ought to stand for, its main priorities, and principles. Given the complicated institutional setting of our international relations, we cannot spend enough attention to the development of a coherent vision to which the public opinion and the main stakeholders can subscribe. We therefore propose a **major consultation on the future of our society's external relations.** Optimally, this process is to unfold over three levels. First, we put forward the idea of an opinion poll that asks a large number of key stakeholders what the priorities of our diplomacy should be. Second, this process could draw from the community of think tanks and university to develop a comprehensive study on our interests and influence in different regions and sectors. Third, we invite the relevant commissions in the parliaments to become more active in evaluating the performance of our diplomacy, to hold more hearings on the matter, and to come up with its more recommendations.

Although a major reflection is due, we also have to make critical thinking of the evolving world order and our diplomacy a permanent feature of our diplomatic agenda setting and policy preparation process. It is therefore advisable to establish a **permanent advisory network** that is piloted by officials from all relevant official bodies and some key experts. The network would assemble stakeholders and experts in topical seminars, the preparation of policy papers, etc. Besides gathering information, this would also be a precious opportunity for building strong networks among those stakeholders.
In order to facilitate contacts, the exchange of ideas, and to advance coordination, we propose to relevant government departments to allow temporary postings of non-officials in its services and permitting some officials to work temporarily in think tanks or companies.

Smart diplomacy is also a holistic diplomacy. To be sure, it continues to focus on high politics and economic interests. More suggestions on this follow below. But smart diplomacy also takes into account that there are many other ways through which our society's interests can be advanced.

A crucial layer of foreign policy concerns country branding. Objective measures of power and competitiveness are one thing; at least as important is how they are perceived. In this regard, our country has not performed well, in spite of being one of the wealthiest places on earth and having enormous potential to continue to thrive. In the country brand index Belgium only comes at the 33th place, which makes it the lowest ranked Western European country[51]. In the Financial Times ranking of top regions in Western Europe, Brussels and Flanders only come at the 7th and 10th place. Brussels and Antwerp only come at the 19th and 23rd place in the ranking of most attractive European cities[52]. As long as the regions work underneath a Belgian flag, they have an interest in remedying this situation. Diplomacy can of course not undo some domestic factors that negatively affect international perceptions, but we nevertheless propose cities, regions, and the federal government to work together on a **common long-term branding strategy** that makes the true potential of our society better appreciate abroad.

A key contribution to this endeavor can come from cultural diplomacy. Our society has a vast richness in cultural heritage, contemporary art, and creative industries. While culture is mostly regional competence, we find it useful to conceive **joint action plan on cultural diplomacy** and to pool resources to broaden cultural exchanges and to use culture in support of advancing our relations with key countries.

The same goes for **academic diplomacy**. Attracting high-potentials to our universities and business schools helps building a strong relationship between our society and the leaders of tomorrow. The other way around, we should support the best researchers and research institutes to hook up to the world's most advanced research programmes and to engineer a knowledge spill—over. The regions are already very active in this regard and we can only recommend them to continue in their efforts.

We also advise our diplomacy to build informal networks of expatriates. There is a large number of Belgians living abroad, often holding interesting positions. Those expatriates can serve as sentinels for our foreign policy but also facilitate new partnerships. Networking with Belgian diasporas remains too much confined to an occasional reception at the embassy. We therefore propose that embassies cooperate with the regional representatives conceive as action plan for **proactive expatriate networking**. In addition, we should also reflect upon how we can use large migrant community as an asset in building stronger commercial and cultural relations with their countries of origin.

In the digital age, **a country does not longer get the full recognition in the real world if it is not visible in the virtual world.** It is a pity that relevant departments too often limit their presence on the web to some rather mediocre websites. We advise our governments to explore how they can set up more attractive and interactive digital platforms to present our society to the rest of the world, to interact with foreigners, and to build communities around them. Conveying a compelling narrative about our society through the internet can make as much difference as grand events. Because the development of such platforms is expensive and contradictory messages need to be avoided, it is recommendable to set up a working group to streamline these efforts.

Smart diplomacy, especially in case of smaller countries, combines a bilateral focus with a relentless effort to advance European integration and develop multilateral organizations. The multilateral system is under stress. Its legitimacy is largely questioned by emerging powers, while it seems unable to cope with most pressing international challenges. The multilateral system is increasingly marginalized or sidelined by smaller, informal, clubs in which Belgium has no weight.

As regards our bilateral relations, both the federal and regional government have invested a great deal of efforts to advance our relations with important countries, especially in the emerging world. We appreciate that also the regional level and some cities reflect upon how to build partnerships with strategic countries. Yet, we have also witnessed that those efforts have become evermore fragmented. Even foreign diplomats complain that our fragmented diplomatic approach can be confusing. Some competition between different official bodies is positive, but we should make sure that different governments do not thwart each other's ambitions. Hence, it is advisable to involve all governments and other stakeholders in the **development of strategy papers for our most important partner countries**. Those papers should aim at a division of labour between various agencies and determine how our resources can be mobilized in the most effective way.

Our diplomacy towards the European Union should be constructive, yet assertive. As long as we are not certain that the EU's external action service and external trade policy will come to graduation and becomes recognized internationally as a respectable interlocutor, we should maintain a track-two approach, while constructively supporting the development of an effective European foreign policy. Our diplomacy should not confine itself to consular matters or commerce, but be able to cover the full scope of tasks.

Still, Belgium must continue to promote deeper European integration: in the age of multipolarity, the margin of manoeuvre for small states like ours is extremely limited. Most European countries are reaching the same conclusion, except for a tiny bunch of reluctant ones. In the current context of crisis, geopolitical reshuffle and return of the state, our country must continue to shield the voice of reason (integration) against the winds of disunion. Belgium must therefore remain at the vanguard of integration in all dimensions, using all opportunities offered by the current Treaty (e.g. Permanent Structured Cooperation).

In the last few years, there has been growing dissatisfaction about the degree of coordination between federal and regional policies towards the European Union. This is understandable, as our own diplomacy is in transition. In principle, we support regions to have a greater say in the European decision making process, but we also must recognize that in many neighbouring member states, regions have recently shifted their efforts from obtaining as much as possible autonomy in the European decision making process towards the full usage of leverage at the national level. In other words, we must guard that the competition for a greater say among our three regions does not undermine our influence. **We therefore ask politicians to stop turning European decision making into a divisive issue.**

Instead, we propose the ministers of external affairs to have a **monthly coordination meeting on European affairs** – in addition to the many meetings that already take place at the departmental level. Those meetings should also identify strategic interests that require joint lobbying and this is particularly urgent as we can only expect more important provisions in economic governance, fiercer competition over European funding, etc.

We also believe that our society has a role to facilitate the formulation of new ideas for a better European future. Some of our academics are already a prominent voice in European debates and we believe that our government can do more to put them into the spot light. Moreover, we have to make a greater effort to turn Brussels into a laboratory of ideas, innovative concepts of urban planning, public transport, integration, culture, etc. For many delegations Brussels is Europe's window to the world, but also their first encounter with Belgium. **By presenting Brussels as one of Europe's leading laboratories of social innovation and creativity, we will strengthen both the prestige of the European Union and our own.**

As a small country, we have a great interest in well function international organizations. In principle, we should continue to work towards a single seat for the European Union in most international bodies. We should also continue to rally support for a major overhaul of the UN system on the basis of innovative proposals, the strengthening of the WTO, and the maintenance of NATO as an organization that defends European security. At the same time, however, we must make sure to maintain influence within informal organizations like the G-20.

DEFENDING OUR ECONOMIC INTERESTS

As regards our economic diplomacy, we are not convinced that its current organization is effective. There are reasons to assume that its poor performance in promoting export, attracting useful investments, and in handling strategic sectors are at least partly the result of fragmentation of capabilities and responsibilities. As we cannot come to a decisive conclusion on this matter in the scope of this report, **we propose an audit of our economic diplomacy**. One of the Friday Group's future reports should be dedicated to this matter. But it is also recommended to the regional parliaments to have hearings and debates organized on this mandate. We call on the Ministry of Foreign Affairs to exhaust its mandate to coordinate economic diplomacy with the regions and key cities.

At the backdrop of increasing economic competition, a tendency of states to take a more assertive role in economic affairs, and given the risk of deglobalization, it is of utmost importance to reduce our economic vulnerabilities. **First, we need a more effective policy to promote and diversify exports.** In absence of many strong companies our government has a key responsibility to help small and middle large enterprises to diversify their exports geographically and sectorally. Furthermore, our government needs to strengthen its capacity to address trade barriers and unfair competition. It has to do so by developing its own capacity to examine important cases of trade distortion and to prepare complaints at the level of the European Commission. Export promotion also means country branding. Belgium used to be a hallmark of quality. We recommend the ministry of foreign affairs to put in place an independent working group of experts that prepares an evaluation of our "branding effectiveness" in comparison to neighbouring countries and cities.

There is an urgent need to conceive a smart investment policy. We need to choose for quality, not quantity. To start with, we need to reduce our reliance on foreign investment in fluid sectors like finance and head offices. The sudden drop in the investment position in those sectors has showed that their contribution to our economy is not sustainable. Second, we need to encourage foreign investment in smart manufacturing, advanced services, and innovation. We call for a new investment promotion strategy that combines the efforts of the federal government, the regions, and important cities. We recommend a strategy paper to be prepared by a mixed working group of officials, corporate associations, and experts by the end of 2013. We also suggest that this reports focuses on both the aspect of economic diplomacy and the state of our investment climate.

In addition, **we insist on a stronger policy for strategic economic sectors** – including the banking sector, energy, and high-tech. This policy should involve a consensus between the different levels of government on what the key interests are, on the way to improve competitiveness, and on how this can be implemented by means of assertive economic diplomacy. To that end, we call the different governments to establish a standing working group on strategic industries within the Ministry of Foreign Affairs. That working group should consist of experts as well as officials from different administrations that pool their capacity in preparing negotiations with large foreign investors or European institutions. It should advise political decision makers and liaise with other relevant entities like the High Council for Finance, Commission for the Regulation of Electricity and Gas, the different regional organizations for science, etc.

Overall, the main challenge to limit our economic vulnerability is to reduce the current account deficit and, as we already mentioned. To reduce the current account deficit essentially means to reduce the trade deficit. We recommend the Friday Group to investigate in one of its future reports how reducing our **reliance on oil and gas imports can curb the trade deficit.** In 2011, our trade deficit in goods amounted to about US$ 13 billion. If we would only be able to cut our oil and gas imports by 25 percent, this deficit would turn into a mild surplus. We also recommend the Friday Group to examine how we can increase export revenues from services, especially in tourism where we ran an average annual deficit of 5 billion Euros.

It is in the interest of our society to let our government play an active role in the debate about **social and environmental standards that apply on European imports.** The example of carbon tariffs on airliners has not been very encouraging, but we need to continue to investigate how more ambitious standards can help European markets to avoid a race to the bottom with other powers. This should not be a matter of protectionism, but a policy-induced encouragement to create a more sustainable level playing field.

Smart diplomacy for comprehensive international security. In the uncertain global order, security remains a priority for our foreign policy. The challenges in this regard are: to keep our own capabilities up to standard, to help setting priorities at the European level, to maintain NATO as defence organization, and to make a modest contribution to the UN Security Council's agenda when we are a temporary member.

In the security realm, the military apparatus has been traditionally responsible for securing borders and defend national interests abroad. Today, the role of the military has evolved to become much broader, including peacekeeping, peace-building, post-conflict reconstruction, etc. Armed forces are evolving, but their importance is not diminishing, contrary to what some could think. Belgium lives in the post-modern age, but most of the world does not, and we lack an appreciable tool to improve our security and that of others.

But the military is no longer the sole security provider. In the face of transnational threats, the military is an insufficient remedy. Deployable civilian capabilities are required. Deployable police officers or judges can be highly useful for multiple tasks. A country like Belgium finds it particularly challenging to deploy civilian forces as we already lack resources at home (e.g. police forces). A personnel deployed is therefore a personnel missing. Some countries, particularly Nordic countries, are able to maintain a permanent roster of standby civilian capabilities that can be deployed. Such system should be an objective for our country. Most threats and challenges we are currently facing require action at home and abroad, comprising a combination of military and civilian force, hard power and soft power. Finding the right balance is a delicate task, which is why it is called "smart power". **Smart diplomacy rests on smart power.**

Belgium should continue to invest in its military capabilities and make a greater part of its defence budget available for military operations. In the last few years, a lot of progress has been made into that direction, but this task is not completed. In 2011, over 75 percent of our defence budget was still spent on personnel. A candid debate is required on the purchase of key capabilities, like new fighter jets and navy ships. In particular on the fighter jets, we should start exploring whether a limited number can be purchased and deployed in an integrated way with other European member states.

Particular attention needs to be paid to non-traditional security threats. In absence of a solid European strategy, our country needs to invest in its capability to counter cyber threats. This requires better coordination between the federal police, state security, and the military intelligence service. Hosting European institutions and NATO headquarters, terrorism remains a permanent threat to Brussels. As such, the security of public spaces and infrastructure remains a foremost concern.

Belgium has been in the vanguard of the development of a European defence policy. In the last year it has campaigned relentlessly for the pooling and sharing of capabilities – with some moderate first success. It has also loyally contributed to most European operations. We should continue to engage for a stronger common defence policy at the European level. **We should promote using permanent structured cooperation, as foreseen in the Lisbon Reform Treaty, as a way to advance defence integration.**

We should follow an **EU-first strategy** when it comes to international defence cooperation. To be sure, NATO should be maintained as a specialized military actor, and as a privileged forum for interaction with our transatlantic partners. NATO is also not incompatible with the aspiration to build a stronger European defence. But still, it is crucial that within the Transatlantic Community Europe becomes able to look after its own security interests.

Belgium should also get its geographical security priorities right. While most of the great power turbulence is centred in Asia, most of our instant concerns are with the European neighbourhood. First, we should insist on a more comprehensive European strategy towards Northern Africa and the Levant. If this region destabilizes further, the security costs for Europe will be immense. We cannot turn our backs to security problems in our backyard. Second, we should energize the debates within Europe about building mature strategic partnerships with Russia and Turkey, two countries that we need to cooperate with in pursuit of a stable neighbourhood. This requires us to restore mutual confidence, but also the ability to present the EU as a credible strategic actor. Third, we need to back member states in the north to defend their interests in the Arctic. While there is no imminent risk of a clash over the Arctic, this is a matter of showing our solidarity and to gain Scandinavian support for a more robust strategy to our southern periphery. Fourth, Europe should work on an independent strategy towards the Middle East. While Iran is retreating further and further from the West, there are still openings to avoid complete isolation, which will probably be the most dangerous scenario. While the United States polarizes, Europe, in coordination with other great powers, is perhaps best positioned to mediate. Fifth, we need to encourage the EU to have a more sophisticated security dimension added to its partnerships with the great powers, which will help fomenting synergies in our neighbourhood and beyond. Last, Europe needs to be able to protect its maritime interests, especially along this corridor of uncertainty that runs from the Levant to the Gulf of Aden.

[1] World Development Indicators Database.

[2] World Development Indicators Database, Data for 70 developing countries, excluding oil producing countries.

[3] Ibid. A net US$ 7.4 trillion inflow is reported for developed countries. This does notmatch with developing and oil producing countries portfolio investment outflows, but that can be explained by a very substantial underreporting of those outflows, capital flight, etc.

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[5] Based on: Cheibub, José Antonio, 2012. Democracy and Dictatorship Dataset: https://netfiles.uiuc.edu/cheibub/www/DD_page.html

[6] Van Overtveldt, Johan 2012. The End of the Euro. London: Ashgate; De Grauwe, Paul. Lessons From the Eurocrisis for East Asian Monetary relations. World Economy, 35, 4, pp. 405-418.

[7] Some interesting data on falling ROIC: Deloitte, 2011. 2010 Shift Index. p. 10. On product life cycles: Capon, Noel, James Hulbert, 2010. Managing marketing in the twenty-first century. New York: Wessex, p. 266

[8] ILO, 2012. Global Employment Trends 2012. Geneva: ILO.

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[10] Rio Tinto, 2012. Economic outlook and commodity prices. London: Rio Tinto.

[11] Quoted in: ILO, 2011. World of Work Report 2011. Geneva: ILO. pp. 11-18.

[12] Source: WDI figures.

[13] About 30 percent in debt securities and 70 percent in equity securities. Source: Yahoo Listings for Industries (http://biz.yahoo.com/p/) , McKinsey Global Institute Global Financial Assets database

[14] BIS, 2011. Triennial Central Bank Survey. Basel: BIS.

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Legal deposit: *D/2893/2013/09*
ISBN-13: *978-90-5130-809-9*
EAN: *9789051308099*
ORDER NUMBER: *3138*

April 2013

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