

# Political Risk Quarterly Update

MARCH 2019

Complementing the annual Political Risk Map, Aon's political risk newsletter is developed in partnership with Continuum Economics (formerly Roubini Global Economics), providing insight into political risk in non-EU and -OECD countries.

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## SUMMARY

Globally, risk of supply chain disruption remains a meaningful concern even for the strongest countries, which tend to be reliant on imports. Climate change and extreme weather conditions have exacerbated the risks of supply chain disruption in certain regions.

Recently, small islands have been badly affected by climate hazards.

Looking ahead, these countries will continue to face natural disaster related challenges that will affect their economies in the short and medium term. This highlights the importance of assessing the ability to recover from shocks and the need for investors to hedge risks.

This quarter, four countries have experienced improvements in their country risk ratings: Azerbaijan, Croatia, Macau and Mongolia.

**Azerbaijan's** overall risk rating improved to medium-high from high as we see lower risk of supply chain disruption. The country has been showing steady economic growth in recent years, on the back of strong macroeconomic measures. Higher oil prices have also helped strengthen the fiscal position. Azerbaijan saw its supply chain disruption risk easing to medium from high.

In **Croatia**, the overall risk rating improved to medium-low, and is the lowest of the region. Economic risks are medium-low thanks to the

resilience of the economy and the banking sector. Additionally, a budget surplus, low interest rates and strong economic growth have all contributed to a significant reduction of public debt. Meanwhile, the risk of political violence remains medium-low.

In **Macau**, the overall risk rating decreased to low from medium-low as exchange transfer risk eased. The level of domestic political risk is low for the region. Scores for regulatory quality are consistently high, with Macau significantly above the average for East Asia.

**Mongolia's** overall political risk has eased to medium from medium-high, on the back of lower exchange transfer risk. The country faces few domestic risks due to a stable governmental structure and absence of violence. However, Mongolia faces risk from its proximity to Russia and China. The main institutional risks are the medium and medium-high political interference and regulatory risks, respectively. Poor control of corruption and a low quality of governance are both concerns for investors.

While we saw no overall risk rating worsening in countries this quarter, conflict and violence have persisted in countries already classified as high-risk, such as Venezuela, Yemen, Honduras and some African countries. This will continue to undermine their business environments.

## REGIONAL OVERVIEW OF POLITICAL RISKS

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### Asia

Risks in Asia have remained largely stable, with only Mongolia and Macau experiencing an improvement in their overall rating as exchange transfer risk has eased. On the whole, the sources of risk are varied throughout the region.

Political risk in the region continue to develop ahead of a busy election season, which will limit the implementation of reforms in the near term.

India, Indonesia, the Philippines and Thailand, among others, will hold polls this year. Even if the current ruling parties stay in power, countries in the region are likely to delay policy action to guarantee votes as populist ideas gain ground, exacerbating risks which may mean higher insurance costs for businesses.

While overall growth prospects are still positive

for the region, global and domestic headwinds could potentially increase the overall risk of several economies. Escalation of trade tensions, tightening financial conditions and China's economic slowdown are increasing concerns. This is true in particular for open economies such as Thailand, South Korea and Taiwan, as well as for China itself. If commodity prices rise faster than expected, oil importers such as India and the Philippines are also at risk, due to their relatively weak current account balances.

In Thailand, the overall risk rating is medium-high. The upcoming election will return the country to civilian rule nearly five years after a coup d'état overthrew the previously-elected government. The risk of political violence remains high. The risk of political gridlock and potential social unrest after the delayed elections is significant. This could reduce Thailand's ability to return to stronger economic growth and regional leadership.

India and Indonesia are medium risk countries. Legal and regulatory risk has eased over the past year. Going forward, we do not expect significant changes in government policies. However, a weaker political environment will bring some slowdown of reform momentum which could potentially exacerbate the economic risks. In India, mounting tensions with Pakistan could hurt the business environment.

In South and Southeast Asia, we see high levels of security and political violence risk due to ethnic and religious frictions, which have resulted in tensions between various groups in many countries such as Pakistan, India, Myanmar and Philippines. Moreover, tensions between India and Pakistan have escalated after the suicide bombing against an Indian military force in Kashmir.

Human rights are also at risk in certain countries in the region. Political violence remains an issue in Myanmar and

Afghanistan. Increased violence in Afghanistan, resulting from a Taliban insurgency could contribute to further unrest in the country. Meanwhile, in Myanmar, the delay on implementing economic reforms as well as dealing with the Rohingya issue is likely to weigh on the economy in the coming years. Moreover, it could threaten to return Myanmar to a state of semi-isolation in the international community, particularly in relation to the US and Europe

Concerns around China's stability persist, as leverage risks are increasing. However, we expect domestic fundamentals to remain resilient in the near-term. The uncertainty from trade tensions and fears of an economic slowdown have prompted Chinese authorities to loosen both fiscal and monetary policy.

### **Eastern Europe and CIS**

The region has seen two countries improving their overall political risk rating this year, Azerbaijan and Croatia. Overall, conditions look favourable for the region but many countries in the Eastern Europe and CIS region continue to face fragile political situations. International tensions are increasing and are becoming a big concern in the region. The escalation of tensions between Russia and the Ukraine, while concerning, is unlikely to lead to full-on conflict.

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Belarus has a high level of overall political risk. Economic risks



have decreased as GDP growth is the strongest in the CIS. Last year we saw lower risks of sovereign non-payment and exchange transfer risk. Institutional risks are relatively high due to large amounts of political interference in the economy. Legal & regulatory risk remains high due to extremely poor regulatory quality and low levels of accountability. The lack of structural reforms is also likely to remain an issue.

In Macedonia, the risk of political violence remains medium-high. Although ethnic and political tensions are less pronounced than they once were, clashes between security forces and various ethnic groups are still a regular occurrence, particularly in border areas.

In Moldova, political risks are persisting amid increasing domestic tensions. The risk of political violence is very high. Legal and regulatory risk is also very high as corruption is widespread. The results of the parliamentary elections are likely to weigh on these risks, as the outcome could determine the country's relations with the West and Russia.

The Russian economy continues to recover somewhat. Although economic sanctions have tightened, Russia experiences relatively low and stable inflation and increased oil production. The overall risk score for Russia remains medium-high—the risk of political violence is still very high due to new and continued sanctions and the threat of terrorism in the region. The country still needs to improve the institutional infrastructure, reform the labour market and increase investment in innovation and infrastructure. The risk of supply chain disruption increased to high from medium-high.

Ukraine's economy remains affected by internal and external conditions. Ongoing geopolitical concerns and the upcoming elections must be monitored as the risk of political violence remains high. Ukraine's political agenda will be dominated by two elections this year. A change of president may open the opportunity for new peace talks, but tensions over Ukraine are unlikely to subside, regardless of the result.



## Latin America

After a busy electoral year, risks in the region remain stable as no countries in the region saw a change in their political risk rating this year. However, domestic and external headwinds for the region remain.

Societal discontent, new governments, new elections and the possible delay of public and private investment are growing risks in a number of countries, with the exception of Chile. Furthermore, weak growth and political constraints have put fiscal targets in peril. Deteriorating fiscal positions remain particularly concerning, given the political difficulty of imposing austerity amid already-weak growth.

On the external side, rising interest rates, China slowdown, US-related trade uncertainty and global demand for commodities are the greatest risks to Latin American countries. Regarding commodities exporters, the recovery in commodity prices and the fall in imports have helped narrow high current account deficits, and external imbalances are now less of a concern.

Growing humanitarian crises in several countries like Venezuela, Honduras and Nicaragua pose a significant challenge for the region. The situation in these countries has resulted in large groups of people fleeing to neighbouring countries, increasing social tensions and political violence between immigrants and local communities in the hosting countries.

In Nicaragua, unrest is ongoing, impacting foreign direct investment, tourism and domestic activity. The political risk increased from medium-high to high due to higher political instability, lower government effectiveness and weaker rule of law. If the Nicaraguan government falls under popular pressure and collapses, it could motivate unrest in other parts of the region. This is especially true for other Central American countries such as Honduras and Guatemala, which suffer from similar political instability driven by opposition challenges.

Conflict and violence have persisted in Venezuela, where the current regime is weakening but will likely persist due to the support from the military and from China and Russia. As Venezuela continues to veer into collapse, there has been a clear surge in the outflow of migrants from the country. This increase creates significant challenges not only for Colombia—their main destination—but also other South American and Caribbean countries, which have recovered rather weakly from the 2008 crisis in terms of their labour markets and levels of investment. Brazil, Argentina and Peru look especially vulnerable to these migration inflows due to a lack of fiscal room and weak political environments. Poor Caribbean countries are also likely to suffer, as their services and economies can get overburdened very quickly. Moreover, the already very high economic risk coupled with the drain of quality human capital in Venezuela will make it very difficult to reduce the overall political risk in the near future.

Markets lost confidence in Argentina given disappointment in its recovery, political scandals and political uncertainty in upcoming elections. The country's risk rating remains



medium-high. Increasing social discomfort increases the odds of social unrest and the return of an anti-market president in the October elections. Even if the government was able to secure the funding for this year through IMF loans, markets have become more reluctant to finance the country, which has exacerbated Argentina's relatively high economic risk.

Although Brazil's overall political risk remains unchanged, further risks are emerging after Bolsonaro's victory. The new government has raised market expectations sky high, with promises to fix the fiscal deficit, reduce the size of the government and unleash the private sector energy with lower taxes, less regulation and less corruption, which will help to reduce its overall political risk. However, the government does not have majority in congress and will likely have difficulties in passing the needed reforms to reduce its high economic risks. There is room for positive surprises, but they will be marginal, as there is limited room for real improvement in fiscal accounts.

### **Middle East and North Africa**

The Middle East and North Africa region has experienced no change in its overall risk rating. Strong external demand has reduced fiscal deficits and boosted economic growth in the region, but multiple headwinds, such as tighter financial conditions and mounting geopolitical tensions threaten, the region's outlook in 2019.

The region contains some of the highest-risk countries in the world, such as Iraq, Syria, Yemen and Libya, where political instability and violence are the main risks to the regional economic outlook. Syria and Yemen are engulfed in war, which has also taken a toll on countries like Jordan, Lebanon and Iraq. Yemen, Iraq and Syria remain the riskiest countries in the region, with an overall risk rating of very high. Political unrest remains elevated with protests spreading across the region.

Oil producing countries in the Middle East could benefit from higher crude prices in 2019, but regional uncertainties weigh on growth. On the external front, a sharp tightening of global conditions and growing trade tensions could potentially trigger significant fiscal and financing pressures for many countries, clouding economic recovery.

Although Iraq's overall political risk remains unchanged at very high, higher oil prices and security improvements are supporting economic activity and could potentially reduce economic risk. However, the large fiscal deficit and the drawn-out process of government formation are still dragging growth.

Iran continues to have high levels of overall risk due to a high risk of political violence driven by mounting tensions within the region, as well as with the new US sanctions likely slowing Iran's growth. Inflation in Iran continues to climb due to overspill from US sanctions. Additionally, institutional risk remains high as widespread corruption and weak rule of law contribute to high legal & regulatory risk.

Despite Egypt's overall score remaining unchanged at high, the risk of sovereign non-payment and exchange transfer have eased slightly and we are seeing some improvements in its fundamentals. Egypt is expected to be the region's top performer in 2019 as progress has been achieved regarding structural reforms. Also, the government's effort is yielding some results by helping reduce exchange transfer risk and lessening Egypt's high debt burden and fiscal deficit.

Saudi Arabia's overall risk rating remains medium. The economy had a strong 2018 where we saw the risk of exchange transfer easing. However, key economic reforms appear to have stalled, which threatens long-term economic growth. True diversification for the economy remains a challenge, with the ARAMCO IPO delayed and oil prices not high enough to finance a large-scale spending plan.

### **Sub-Saharan Africa**

2018 was a year of strong political activity in Africa, and a year of political power transition. This year, more than 20 African countries in the region will hold elections, including Nigeria and South Africa—the two biggest economies in the region. However, the quality and independence of these elections continue to vary widely. Elections, unrest and political changes in a continent where presidents have held on to power for decades may bring positive change or fuel more instability.

Gambia and Ghana are the only two Sub-Saharan African countries that improved their overall risk ratings this year.

Gambia's overall risk rating improved to medium-high from high due to lower economic risks and less risk of political interference. Signs in Gambia are hopeful as the strengthened macroeconomic backdrop will continue to provide room for President Adama Barrow to maintain broad political support and push through reforms to state institutions. Political risk remains high and the country faces several key challenges, including a limited availability of foreign exchange reserves, weak agricultural output and a slowdown in tourism.

Improvement in Ghana's overall political risk rating from medium-high to medium was driven by lower risk of political interference and a lower risk of sovereign non-payment. Ghana remains one of the countries in Sub-Saharan Africa with the lowest overall political risk, maintaining a relatively peaceful environment and stable democracy. Improving rule of law also contributed to the lower risk. There have been improvements in the nation's fiscal and current account deficits, which have eased the risk of sovereign non-payment.

Ethiopia, one of the region's brightest spots, is undergoing some of the most interesting political developments in the region. After taking power last year, Prime Minister Abiy Ahmed introduced a multi-party democracy. This is especially notable in a country that was under the rule of the Ethiopian People's Revolutionary Democratic Front for almost 25 years and where political repression to suppress ethnic tensions was widespread. This year, the country saw an improvement in exchange transfer risk.

South Africa's overall risk rating remains medium. While the country currently enjoys relative political stability, economic

activity will remain sluggish due to weak fundamentals. The outcome of the May 8 election will be key in determining how the South African government tackles the country's structural problems and will set the tone for the reform momentum. This year also saw a small reduction in supply chain disruption risk, from medium to medium-low.

Despite recovering oil prices, Nigeria's oil industry has faced production and export hurdles amid an atmosphere of political instability. The risk of instability in the Niger Delta and the presence of the extremist group Boko Haram have made the risk of political violence very high. The country saw an election marred by violence and elections-related violence will likely persist.

Zimbabwe remains a political and economic basket case, where labour unrest has been fuelled by a scarcity of food, medicines and foreign exchange. Political tensions are on the rise, with the government and opposition still in a dispute over last year's election. This year, we saw the risk of political intervention and economic risks rise.

The sources of risk remained varied throughout the region, but debt burdens are a risk factor risk in countries like Mozambique, Angola, Congo, Zambia, Djibouti and South Africa, amid rising interest rates. The relationship between China and some African nations is seen as one of the main problems. Large infrastructure projects, financed by China, are burdening the host countries with high debt levels, which will be hard to repay. Around 20% of African government external debt is owed to China, making China the largest single creditor nation for African countries.

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## About Continuum Economics

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