

Monthly Comments – Emerging Markets

MacroFinance Research - October 2018

Key Messages

Country Focus: South Korea: coming into the eye of the EM storm

The appearance of a new Watch List Indication on Economic Activity highlights a vulnerability to a significant shock on the business cycle in the medium-term. The economic model, relying so far on robust external performances, will likely be largely affected by the rise in trade protectionism measures between US and China, the slowdown in China's economy. A fall in economic activity would also translate into strong pressures on the Korean Won and on the banking sector.

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RiskWatch: Annual update of Political & Governance Risk Ratings

The average Political Risk rating across our 100 countries has improved with decreased overall risk level at 53.5, and most of the countries (56) have witnessed an improvement in their Risk rating. Since 2014 countries on the higher end of the Risk rating (around or above 60-d) have steadily improved. Among the best performers, China has the largest improvement, Taiwan continues to register the lowest Risk, while Yemen with its catastrophic civil war has the highest Risk rating. Among the indicators Political Stability has consistently improved as countries with authoritarian governments (Philippines, Turkey, Egypt, and surprisingly Sudan) have seen a reduction in their Political Risk rating. Among regions, Asia has the largest number of countries with reduction in Risk.

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As always, readers are most welcome to come back to us for further details or clarifications.

Completed on October 11, 2018.

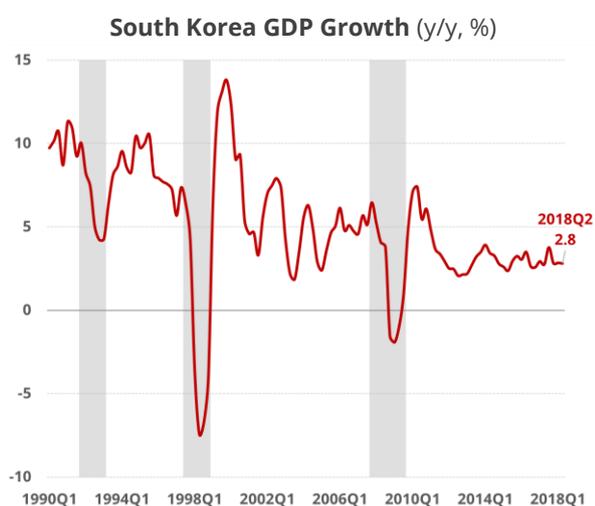
Country Focus – South Korea: coming into the eye of the EM storm

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Early warning signal on economic activity

The appearance of a new Watch List Indication on Economic Activity highlights a vulnerability to a significant shock on the business cycle for the period 2018Q3-2020Q2. In addition, the downturn in our leading indicator of activity (real economic pressure) at an unfavorable level augurs a reduction in the momentum of domestic demand from the beginning of 2019 onwards.

It is worth noting that this current signal of potential major shock would not necessarily translate into a substantial collapse in economic activity (contraction of real GDP and more than 7 points difference in GDP growth year-on-year). Indeed, among earlier episodes of fall in GDP, the Asian and Global Financial Crises (1997-1998, 2008-2009) have led to massive recessions. Yet, from the actual level of GDP growth hovering around its potential, a significant shock on the economic activity could still maintain a poor but positive performance.



Structural economic and financial weaknesses

Export-led economic growth has maintained a robust current account surplus, raised the forex exchange reserves (USD 400bn in Sept. 2018), and kept a low (short- and long-term) external debt. However, in spite of expanding exports, GDP growth has remained stable over the last three quarters (+2.8%

y/y in 2018Q2), which denotes faltering private and public demand (slowdown in consumption and contraction in investment).

The government is trying to support the economic growth with a substantial increase in its budget for next fiscal year, after supplementary expenses of USD 3.5bn already approved in April for this fiscal year. These measures focusing on unemployment (youth, civil servant jobs, etc.) have so far not been effective in tackling the degradation of the labor market conditions. Noticeably, weaknesses in job creation in traditional manufacturing sectors (auto, shipbuilding) are spreading to retail and services, weighing further on consumer confidence.

Meanwhile, the highly excessive *domestic leverage* indicates self-reinforcing mechanisms between cyclical performances and the banking system's overall health, thus a potential large slowdown over the coming quarters shall lead to a rise in delinquencies and pressures on bank assets' quality.

Entering the eye of the trade/currency storm

Several external factors will impact South Korea's economic and financial medium-term outlook:

- Rising trade protectionism measures between the United States and China have suddenly affected the Korean Won with a -5% depreciation against USD in June 2018. Since then, the currency has hovered USD/KRW 1,120 but with a significantly higher volatility.
- Expected substantial economic slowdown in China associated with (controlled) deleveraging in the corporate sector will weigh on Korea's external demand (23% of trade in goods). Given the significant exposure of South Korea to China's value chain, the likely negative impact on external demand could further hit business confidence and investment.
- Downside risks on Japan's economic outlook with potential recession in 2019H2 after the VAT hike application will also negatively affecting South Korea's external performances (exports and currency volatility).

RiskWatch – Annual update of Political & Governance Risk Ratings

The average Political Risk rating across our 100 countries has improved with decreased overall risk level at 53.5, and most of the countries (56) have witnessed an improvement in their Risk rating. Since 2014 countries on the higher end of the Risk rating (around or above 60-d) have steadily improved. Among the best performers, **China** has the largest improvement, **Taiwan** continues to register the lowest Risk, while **Yemen** with its catastrophic civil war has the highest Risk rating. Among the indicators Political Stability has consistently improved as countries with authoritarian governments (**Philippines, Turkey, Egypt, and surprisingly Sudan**) have seen a reduction in their Political Risk rating. Among regions, Asia has the largest number of countries with reduction in Risk.

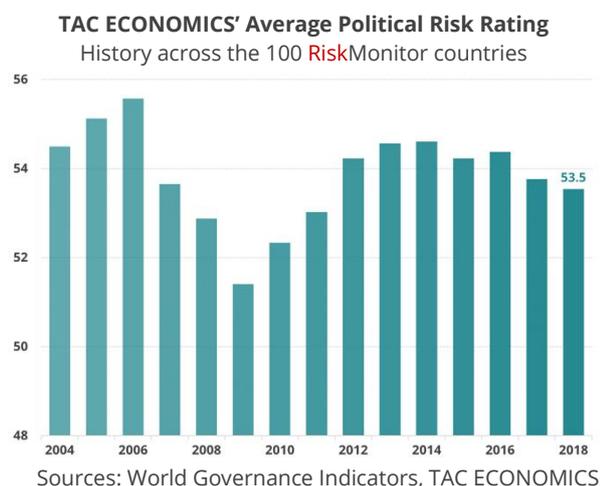
Annual release of World Bank’s Worldwide Governance Indicators

The World Bank has released the annual update of its dataset [Worldwide Governance Indicators](#) on the overall political and governance situation. with an extensive coverage (215 countries), and based on 30+ data/survey sources, allowing TAC ECONOMICS to construct a comprehensive tool for better measuring and understanding Political & Governance Risk in Emerging Markets and Developing Economies (EMDE).

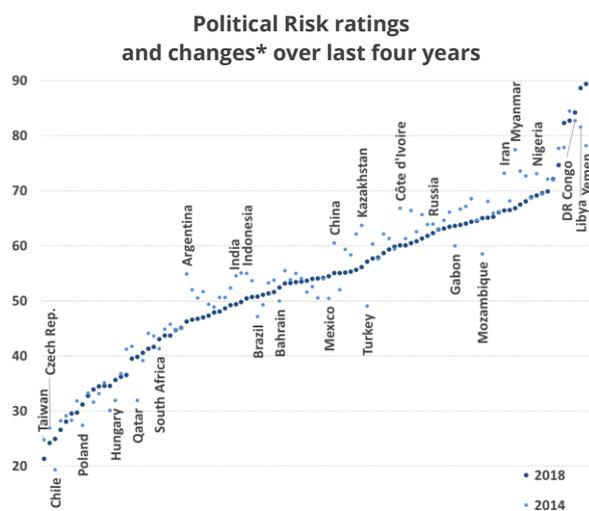
We use World Bank data through six broad measures: two indicators are *stricto sensu* elements of political risk (*Voice & Accountability* and *Political Stability*), two look at the regulatory environment (*Government Effectiveness* and *Regulatory Quality*) and two focus on the legal environment (*Rule of Law* and *Control of Corruption*). Akin to our Economic & Financial Risk ratings, the six indicators of Political Risk for the 100 countries included in RiskMonitor are noted from 0 (best) to 100 (worst) with an overall rating above 60 denoting very high risk.

Marginal improvement in Political Risk ratings

In 2018, the average Political Risk ratings for the 100 RiskMonitor countries has improved to 53.5 (from 54.7 in 2017). A majority (i.e. 56 countries) has registered an improvement in their Political Risk rating, while 44 countries have demonstrated an increase (worsening) of their Risk rating.



This dynamic has seen general improvement since the most recent peak in Political Risk ratings in 2014. Baring few exceptions including the highest risk countries (Yemen, Libya, etc.), EMDE with relatively higher Risk ratings (around or above 60-d in 2014) have demonstrated significant reduction in their Political Risk rating, contributing largely to the overall improvement.



* Countries above the key line have improved their Risk ratings between 2014 and 2018 (e.g. Taiwan); countries below have deteriorated (e.g. Poland).

Sources: World Governance Indicators, TAC ECONOMICS

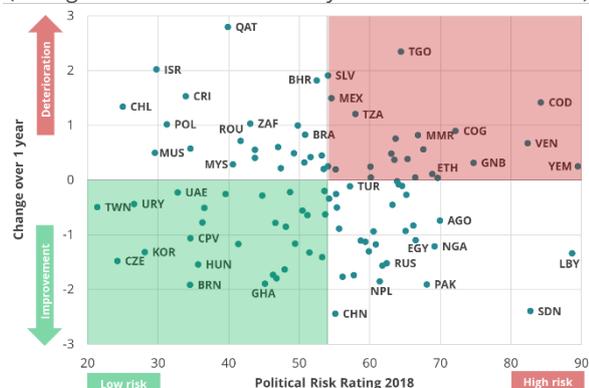
Larger dispersion in Political Risk ratings

The next chart reflects Political Risk rating for each country (horizontal axis) against their annual change in the Risk rating (vertical axis). While 66 out of 100 countries have seen a reduction in their Risk ratings since 2014, 56 have registered an improvement since last year.

Overall, the positive trend in Risk ratings reflects relatively more improvements in low risk countries than deteriorations in high risk countries. Indeed, among the 17 low risk countries (ratings below 40),

11 have registered a favorable decline in their Risk ratings; while, on the opposite, five of the seven countries with severe Political Risk ratings (above 70) have registered a worsening (with only Sudan and Libya improving).

Political Risk ratings and change since last year
(enlarged chart and list of acronyms are at document end)



Sources: World Governance Indicators, TAC ECONOMICS

Outstanding performers and high-risk countries

Taiwan continues to be the best performing country (21.4) for the fifth consecutive year, due to significant improvement in its *Regulatory Quality* and *Control of Corruption*. Thanks to steady improvement over the last four years (massive decline in the *Rule of Law* in 2018), **Czech Republic** (24.2) has overtaken **Chile** (24.9), which despite one of the lowest rating, has gradually deteriorated over the past seven years.

Though **Qatar** still enjoys a low Political Risk rating (below 40, except for its very poor indicator of *Voice & Accountability*), the country has registered the largest deterioration (+2.8 to 39.8) due to sizeable pick up in *Political Stability*, *Regulatory Quality* and *Control of Corruption*, in addition to economic and political blockade led by Saudi Arabia and supported by UAE and Egypt. Furthermore, high Eco. & Fin. Risk ratings (63.9-D) suggests comprehensive contingency plans for investors’ operations with Qatar.

China and **Sudan** have registered the largest improvements in 2018. **China** (-2.4 to 55.1) witnessed drops in all six indicators, notably for *Regulatory Quality*, directly reflecting a series of regulatory reforms by the Chinese government (environment, cyber security, and banking) along with its stringent anti-corruption drive. In contrast, **Sudan**, a perennial high-risk country, saw its first drop in the last four years (-2.4 to 82.7) due to improvement in *Political Stability* and *Governance Effectiveness*; which however denotes the authoritarian nature of the President Omar Hassan Ahmad al-Bashir.

On the other hand, **Yemen** (89.4) has overtaken **Libya** (88.6) as the worst performing country

because of the civil war spiraling into its fourth year, which has led to a large humanitarian crisis and near collapse of governance and institutions. **Libya’s** improvement in its Political Risk rating (-1.3) is deceptive and maybe short lived given the ongoing internal conflict since 2011, with massive political and economic losses. These extremely high risk countries (incl. Sudan) are also affected by Crisis Signals, denoting systemic economic and financial collapses.

TAC ECONOMICS’ Political Risk Rating

Best and Worst performances across 100 countries

	Lowest Risk	Highest Risk	Largest deterioration over 1 year
Voice & Accountability	Uruguay 13.5	Sudan 90.0	Tunisia +3.4
Political Stability	Brunei D. 15.0	Yemen 100.0	Togo +10.7
Government Effectiveness	UAE 17.2	Yemen 88.1	Dominica +5.4
Regulatory Quality	Taiwan 17.6	Libya 97.1	Qatar +5.8
Rule of Law	Taiwan 19.9	Venezuela 98.6	Saudi Arabia +5.7
Control of Corruption	Uruguay 23.3	Yemen 94.3	Israel +7.9
Political Risk Rating	Taiwan 21.4	Yemen 89.4	Qatar +2.8

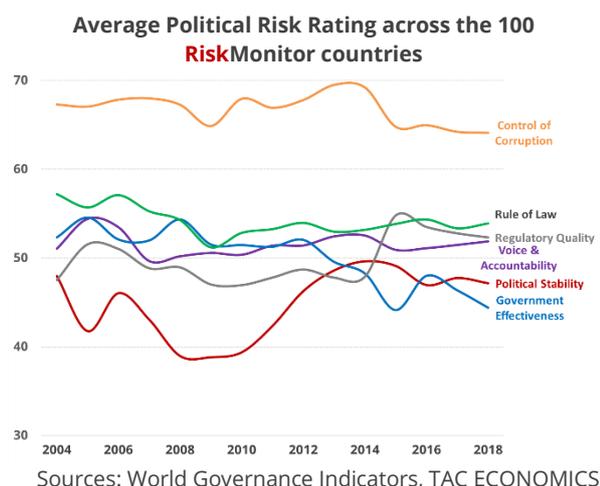
Sources: World Governance Indicators, TAC ECONOMICS

Meanwhile, it is important to notice that **Togo**, **Israel**, **Qatar**, **Saudi Arabia**, **Dominica** and **Tunisia** have registered the largest deteriorations in each of the indicators, portending higher risks of governance and legal environment that must be assessed in detail to maintain and/or expand financial and/or industrial assets in these specific emerging markets.

Unlikely Indicators Reducing the Political Risk

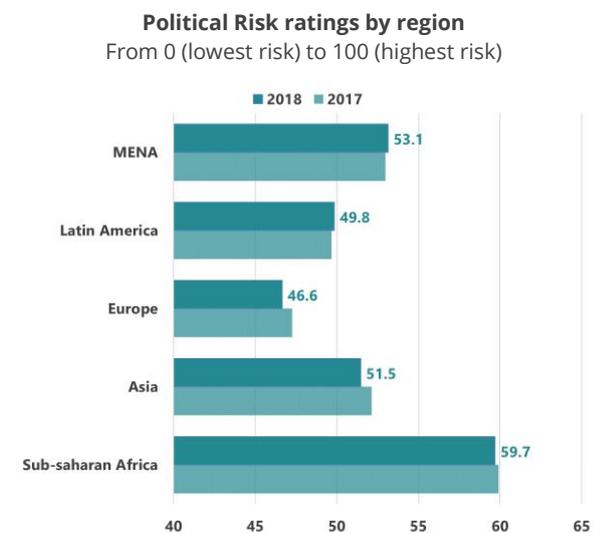
As exhibited in the diagram below, among the six indicators, the two “best” performing indicators have been the *Political Stability* and the *Government Effectiveness*. In fact, although countries with more authoritarian regime have mechanically improved their *Political Stability*, the tandem of apparent liberal economic policies and repressive institutions that creates an illusion of stability, will generally exacerbate social pressure in the long term.

In contrast the “worst” indicator remains the *Control of Corruption* that is incomparably elevated, largely reflecting high level of mismanagement of public funds and blatant disregard for accountability by the governments. Meanwhile, the “intermediate” indicators (*Voice & Accountability*, *Regulatory Quality* and *Rule of Law*) have stopped their previous improvements.



Most regions register an improvement

Three of the five regions – Asia, Europe and Sub-Saharan Africa (SSA) - have recorded an improvement in their Political Risk ratings, while MENA and Latin America’s Political Risk ratings have marginally deteriorated. Noticeably, the range of average Political Risk ratings between the regions (lowest at 46.6 and highest at 59.7) is much larger than the range demonstrated by our Eco. & Fin. Risk rating.



In Asia, 80% of the countries have demonstrated an improvement, with high risk countries (**China**, **Pakistan** and **Nepal**) witnessing the maximum reduction in risk.

Pakistan’s improvements in *Political Stability* and *Government Effectiveness* were measured prior to the major changes the country witnessed (Prime Minister Nawaz Shariff’s removal and conviction; election of anti-incumbent Imran Khan). Meanwhile the worst performers in Asia – **Sri Lanka** (49.7) and **Myanmar** (66.8) - have faced acute political uncertainties. In Sri

Lanka President M. Sirisena’s government facing no confidence motion and faring poorly in the local elections amid charges of nepotism and corruption. Myanmar’s crisis with the Rohingya ethnic minority has received international criticism while also repressing *Voice and Accountability* and reducing *Political Stability* within the country, thereby increasing its Risk rating.

Europe, which has been relatively stable at its lowest levels of Risk ratings, has further seen countries with high Risk ratings like **Russia** (62.3), **Ukraine** (61.7) and **Turkey** (57.2) demonstrate an improvement. For Russia and Turkey (both part of 10-Key EMs) positive change has ironically been in the arena of *Political Stability* under the authoritarian governments of their respective Presidents (Vladimir Putin and Recep Tayyip Erdogan). Meanwhile, thanks to its current stringent reforms, Ukraine has shown improvement in all the six indicators.

In contrast, Sub-Saharan Africa (SSA), the region with the highest average Political Risk rating, has recorded a marginal improvement as almost half of the countries have demonstrated a reduction in Risk ratings. Even though high-risk countries like **Nigeria** (-1.2 to 69.2) witnessed a reduction in Risk ratings thanks to major reforms, the region still has some of the worst performers (**Togo**, **Tanzania** and **DR Congo**). In addition, **South Africa** has seen an increase in its Risk rating as emphasized by the massive corruption scandal and political turmoil under President Zuma (replaced by Mr. C. Ramaphosa in Dec. 2017).

In parallel, within MENA region, even if some countries have improved (**Tunisia**: -1.3 to 51.4; **Egypt**: -1.1 to 66.5), other have registered among the largest deterioration (**Qatar**; **Israel**: +2.0 to 29.7; **Bahrain**: +1.8 to 52.5), especially related to worsening in *Voice & Accountability* and *Regulatory Quality*, a feature defining several authoritarian regimes.

Finally, Latin America’s Political Risk rating has deteriorated this year, led by its biggest economies – **Brazil** (+0.8) and **Mexico** (+1.5). In Brazil, the Risk rating spiked with deepening political crisis amidst serious corruption allegations at the Presidential level; whereas in Mexico the political unrest under then President Peña Nieto is visible through the deterioration of five out of six indicators.

Political Calendar for emerging countries

As a complement to the update of the Political Risk rating, the following table provides an up-to-date calendar of the key political consultations (confirmed or tentative, parliamentary or presidential elections, referendums) expected until the end of 2019.

Political Calendar for the 100 RiskMonitor countries - by date

Country	Date	Election
Gabon	October 27, 2018	Parliamentary (2nd round)
Brazil	October 28, 2018	Presidential (2nd round)
Georgia	October 28, 2018	Presidential
Madagascar	November 7, 2018	Presidential & Parliamentary
Guinea Bissau	November 18, 2018	Parliamentary
Bahrain	November 24, 2018	Parliamentary
Libya	December 10, 2018	Presidential & Parliamentary
Mali	December 16, 2018	Parliamentary (2nd round)
Togo	December 16, 2018	Referendum (Constitutional reforms)
Madagascar	December 19, 2018	Presidential (2nd round)
Togo	December 20, 2018	Parliamentary
Congo, Dem. Rep.	December 23, 2018	Presidential & Parliamentary
Bangladesh	December 27, 2018	Parliamentary
Guinea	January 2019	Parliamentary
Nigeria	February 16, 2019	Presidential & Parliamentary
Senegal	February 24, 2019	Presidential
Thailand	February 24, 2019	Parliamentary
El Salvador	March 10, 2019	Presidential (2nd round)
Ukraine	March 31, 2019	Presidential
Israel	March 2019	Parliamentary
Taiwan	April 6, 2019	Referendum (Independence)
Indonesia	April 17, 2019	Presidential & Parliamentary
Algeria	April 2019	Presidential
Benin	April 2019	Parliamentary
Guinea Bissau	April 2019	Presidential
Macedonia	April 2019	Presidential
Panama	May 5, 2019	Presidential & Parliamentary
Philippines	May 13, 2019	Presidential & Parliamentary
India	April - May 2019	Parliamentary
South Africa	May 2019	Presidential & Parliamentary
Guatemala	June 2019	Presidential & Parliamentary
Mozambique	October 15, 2019	Presidential & Parliamentary
Argentina	October 27, 2019	Presidential & Parliamentary
Uruguay	October 27, 2019	Presidential & Parliamentary
Bolivia	October 2019	Presidential & Parliamentary
Cameroon	October 2019	Parliamentary
Oman	October 2019	Parliamentary
Poland	October 2019	Parliamentary
Tunisia	October 2019	Parliamentary
Ukraine	October 2019	Parliamentary
United Arab Emirates	October 2019	Parliamentary
Romania	November 3, 2019	Presidential
Uruguay	November 30, 2019	Presidential (2nd round)
Tunisia	November 2019	Presidential
Croatia	December 2019	Presidential
Dominica	December 2019	Parliamentary
Mauritius	December 2019	Presidential & Parliamentary

Country	Date	Election
Croatia	2019	Parliamentary
Ghana	2019	Referendum (Death penalty, Presidential powers)
Libya	2019	Constitutional Referendum
Qatar	2019	Parliamentary
Togo	2019	Referendum (Presidential term limits)
Yemen	2019	Presidential & Parliamentary

List of countries and acronyms monitored by size groups

10 Key EM

BRA	Brazil	MEX	Mexico
CHN	China	POL	Poland
IND	India	RUS	Russia
IDN	Indonesia	ZAF	South Africa
KOR	Korea	TUR	Turkey

Next 10

ARG	Argentina	NGA	Nigeria
COL	Colombia	PHL	Philippines
EGY	Egypt	SAU	Saudi Arabia
IRN	Iran	THA	Thailand
MYS	Malaysia	UAE	UAE

30 Mid-Size

DZA	Algeria	MAR	Morocco
AGO	Angola	MMR	Myanmar
BGD	Bangladesh	OMN	Oman
CHL	Chile	PAK	Pakistan
CRI	Costa Rica	PAN	Panama
CZE	Czech Rep.	PER	Peru
DOM	Dominican Rep.	QAT	Qatar
ECU	Ecuador	ROM	Romania
ETH	Ethiopia	LKA	Sri Lanka
GTM	Guatemala	SDN	Sudan
HUN	Hungary	TWN	Taiwan
ISR	Israel	UKR	Ukraine
KAZ	Kazakhstan	URY	Uruguay
KEN	Kenya	VEN	Venezuela
KWT	Kuwait	VNM	Vietnam

50 Smallest

ALB	Albania	GNB	Guinea-Bissau
ARM	Armenia	HND	Honduras
AZE	Azerbaijan	JOR	Jordan
BHR	Bahrain	LAO	Lao P.D.R.
BLR	Belarus	LBY	Libya
BEN	Benin	MKD	Macedonia FYR
BOL	Bolivia	MDG	Madagascar
BIH	Bosnia and Herz.	MLI	Mali
BRN	Brunei	MUS	Mauritius
BGR	Bulgaria	MNG	Mongolia
BFA	Burkina Faso	MNE	Montenegro
KHM	Cambodia	MOZ	Mozambique
CMR	Cameroon	NPL	Nepal
CPV	Cape Verde	NER	Niger
COM	Comoros	PRY	Paraguay
COG	Congo, Rep.	RWA	Rwanda
COD	Congo, Dem. Rep.	SEN	Senegal
CIV	Côte d'Ivoire	SRB	Serbia
HRV	Croatia	SYC	Seychelles
DMA	Dominica	TZA	Tanzania
SLV	El Salvador	TGO	Togo
GAB	Gabon	TUN	Tunisia
GEO	Georgia	UGA	Uganda
GHA	Ghana	YEM	Yemen
GIN	Guinea	ZMB	Zambia

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