Political Risk Quarterly Update

SEPTEMBER 2019

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

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SUMMARY

The **US/China** trade war, deteriorating trade relationships globally, the continued surge in populism, and geopolitical tensions have led to an increased level of political risk across the global economy. Souring political tensions and high levels of policy uncertainty make businesses more vulnerable and weigh heavily on the wider business environment. The rise in trade protectionism, disregard for international trade agreements, and consequently, the implementation of tariffs have already resulted in slowing global trade growth and cross-border investment flows. Looking ahead, this may result in countries across the world starting to look inwards and favour local production to reduce their vulnerability to increasingly unstable global supply chains. It is, therefore, crucial to identify and quantify these rising political risks to help clients find and understand risks and opportunities impacting their businesses and supply chains.

This quarter, we saw a change in the overall risk rating for Iran.
Iran's overall risk rating deteriorated to very high this quarter on the back of the US' decision to cancel the waivers on importers of Iranian oil, which has resulted in a collapse of the Iranian currency and the wider economy. Iranian President Hassan Rouhani recently announced that if the US does not withdraw sanctions, there would be no political resolution. In addition, the US is currently putting together a coalition in the region to protect the vital shipping lanes that pass through it. The Strait of Hormuz is critically important for global oil supply chains, as 20% of all crude oil sold on world markets passes through this strait.

Although we have seen no change in **Hong Kong's** overall risk rating yet, this is set to change. Hong Kong still exhibits a low level of overall political risk, due to very low institutional risks and a strong business environment underpinned by limited government interference and a strict rule of law. However, in response to the Hong Kong government's proposal to introduce an extradition law (which has now been cancelled), Hong Kong has been shaken by a slew of mass protests since June. The demonstrators have become increasingly violent, with the situation at an impasse.

US/CHINA TRADE WAR: CATCHING (SOME) ECONOMIES OFF GUARD

The US/China trade war has caught economies off guard and is increasing cyclical and structural risks across developed (DM), emerging (EM), and frontier markets (FM). That said, not all countries are in the same boat, as the degree of dependence on both the US and China's economies varies, as well as structural readiness to react to a broader slowdown.

Global economic conditions are cooling, and risks are increasingly tilted to the downside as escalating protectionist actions are starting to bite. The US/China trade war and subsequent rising global uncertainty are denting business sentiment and manufacturing purchasing managers' indices (PMI) across the board. This has resulted in global trade volume growth falling to 0.5% y/y in Q1, from 2.0% y/y in the previous quarter.

Ripple effects created by the trade war are spreading across the globe and affecting countries differently, with some not directly weakened amidst sluggish auto sales globally and slower smartphone sales in anticipation of the 5G rollout.

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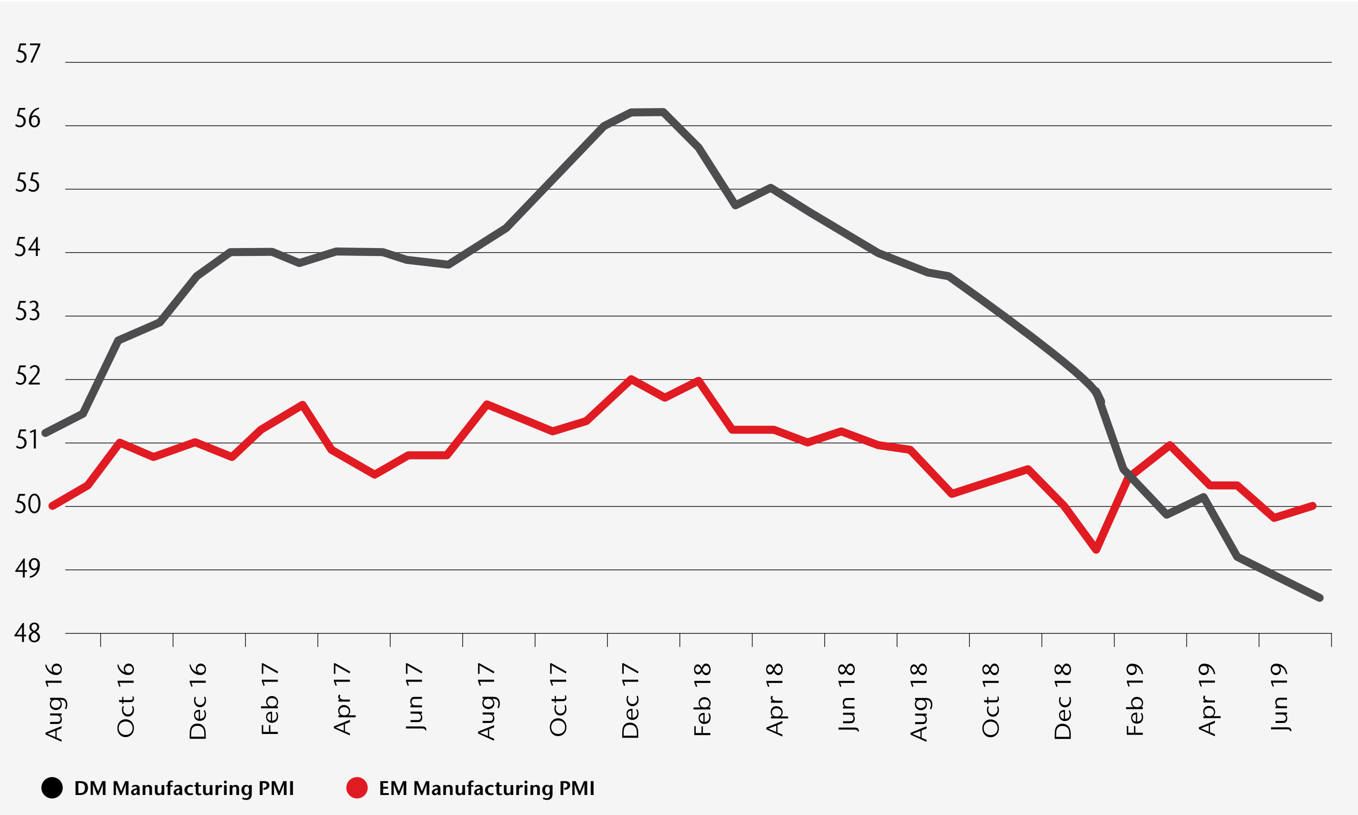
Trade-heavy economies under threat

Below we identify a group of 20 markets (DM, EM and FM) to get a clearer understanding of the global impact of escalating protectionist forces. We use Continuum Economics' Country Insight Model to assess how our select economies are being affected by the increasing number of trade barriers and slowing trade growth and which countries are more vulnerable to a potential escalation in the trade war by making use of Country Insight composite indicators.

For EMs and FMs, the stakes in the trade war are high, as these economies rely heavily on global trade for growth, by predominantly exporting commodities, low-end manufacturing goods and intermediate inputs to global manufacturing supply chains. Indeed, an escalation in the trade war and a potential partial reversal of global supply chains leave EMs and FMs in danger of investor risk averseness and a slump in investment. The trade spat also raises fundamental questions for DM economic growth

Figure 1: PMI's in downtrend since start of trade war



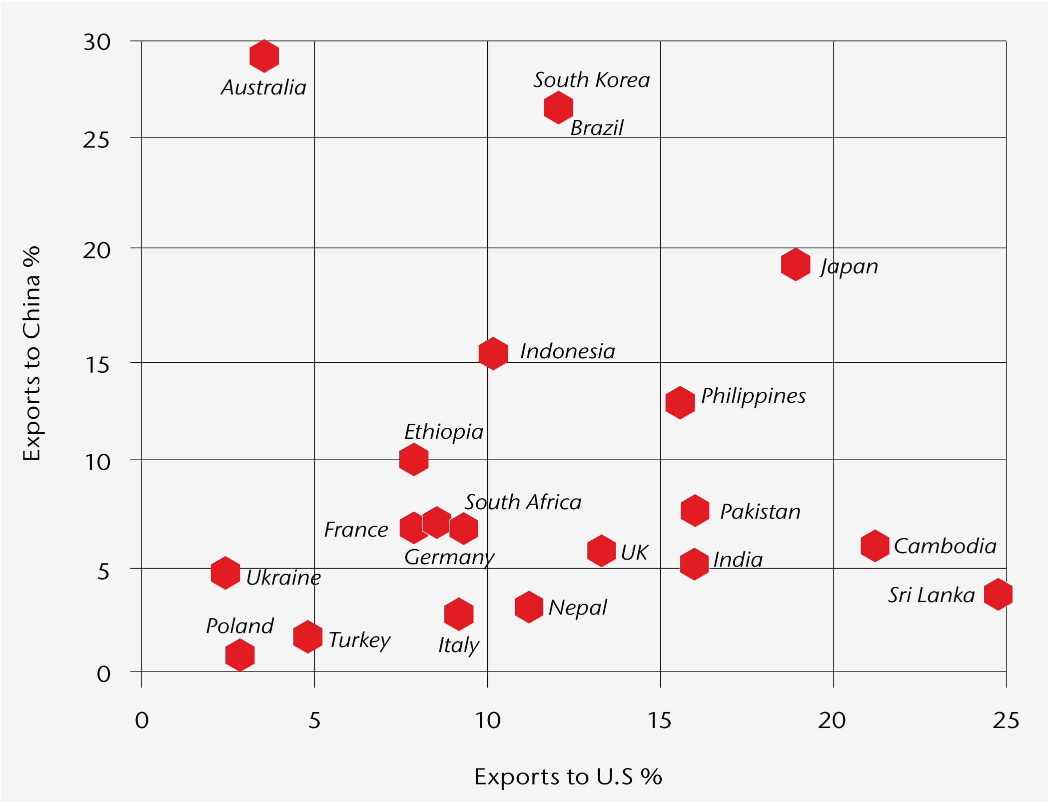
Source: IHS Markit, Macrobond. Note: 50 demarks expansion from contraction.

models, as they are far from immune to it. The Eurozone's (EZ) reliance on the external sector for economic growth has risen sharply over the past few years (with extra EZ goods exports rising by 4 ppts to 20.7% of GDP over the past decade). The bloc's heavyweight, Germany, has already lost its shine over the past few quarters largely in light of a more subdued trade environment, with the Ifo Business Climate Index plunging to a six-year low in mid-2019. A similar trend is observed in South Korea and Japan, which is linked to China's economy through Asian supply chains, resulting in tumbling export volume growth rates over the past few months. In any case, the degree of dependence on the US and Chinese markets for trade and growth matters for all three groups of economies.

Figure 2, in combination with Country Insight's "Exposure to China slowdown" and "Non-Energy exposure to US growth" sub-indicators, allows us to understand which economies are most vulnerable to weaker demand in the US and China (either due to trade barriers or economic weakness).

Among our developed markets, Australia, Japan, and Germany are most exposed to a softening Chinese economy, while Japan and the UK are vulnerable to a slowing US economy. Australia is feeling the effects of softer Chinese demand for its raw materials, Japan depends on the US and China for nearly 40% of its exports, and Germany has an extremely high dependence on the external sector for growth, explaining the scores.

Figure 2: Export exposure to the US and China



Source: UN Trade Data, Continuum Economics

We can determine that among our EM group, South Korea, Brazil and South Africa are the most exposed to weaker demand in China. This should not come as a surprise: all these economies are either commodity exporters or are in close proximity to China. Aside from Mexico, South Korea and the Philippines would be the first of our EMs to suffer from US barriers to trade or a weakening US economy.

FM poorly prepared to slowdown

While the above measures provide us with a solid understanding of direct exposures to the US/China trade spat, we also assess our 20 economies based on resilience as measured by the Country Insight composite indicators. Here we look at banking sector vulnerability; government stimulus ability; FX conversion risk, and vulnerability to capital outflows, which help us to see which economies are most and least vulnerable from a structural perspective if the trade war escalates further.

The results suggest that the group of FMs are the least prepared for external shocks in light of government inability to provide stimulus as well as their vulnerabilities to capital outflows. Among our larger EMs, South Africa and Turkey score poorly in all four indicators, given their structural weaknesses. On the flip side, despite South Korea's high exposure to both the US and China, the country is in relatively strong shape to offset deteriorating economic conditions. From our DMs, France and Australia score particularly poorly in the categories: vulnerabilities to capital outflows and trade vulnerabilities, respectively, not boding well for their overall preparedness. Although Germany's economy is in a weak cyclical position, its high scores suggest it has sufficient means to partially compensate for external protectionist forces.

Asian supply chains

The impact of the US/China trade war is felt most keenly in Asia on the back of supply chain disruptions. That said, there are also some potential benefits of trade and investment diversion to parts of the region. Currently, Asian economies such as Vietnam, Taiwan, India and Indonesia appear to be benefitting from this diversion. Although the uptick in foreign investment in manufacturing in these countries is not new amid cheaper labour costs and relatively business-friendly policies, US tariffs have accelerated this trend in recent months.

In the first seven months of this year, total FDI inflows into Vietnam rose by over 6.0% y/y to USD 10.5 billion, while Chinese FDI to Vietnam increased to USD 2.5bn, equal to a 134% jump. Chinese FDI into Indonesia surged by over 70% y/y to USD 1.2 billion in Q119. Large upticks in FDI from China across parts of Asia reveal the sense of urgency among manufacturers in China looking to avoid US tariffs.

However, competing with China's economies of scale and large manufacturing clusters may prove to be difficult for the smaller economies across Asia. Large parts of Asia remain reliant on China for raw materials and intermediate parts. Also, the smaller Asian economies may not have adequate capacity and infrastructure to meet the demands of foreign investors looking to replace China. Supply chains and supporting facilities across the region are much weaker, while workforces are broadly less competitive, which may push up the cost of business for foreign investors. Economies of scale keep these cheap in China, which suggests that trade diversions can increase costs of production and fuel inflationary pressures. Furthermore, the production facilities in China typically meet a wide range of environmental and labour standards of the US and Europe, which will take time to establish in other parts of Asia.

US policy uncertainty

The medium-to-long-term impact of the US/China trade conflict remains somewhat difficult to assess due to the high degree of uncertainty surrounding it. Trade tariffs and tit-for-tat measures by other countries will likely result in additional economic output losses due to distorted price signals and a reduction in product specializations which have maximized global productivity in the past. The lack of clarity and policy direction coming out of the US will keep uncertainty levels among all economies high, which, in turn, dampens confidence and business activity, potentially putting global supply chains and business investment at risk.

ESG: A VALID CRITERION FOR EM INVESTMENT?

Incorporating environmental, social, and governance (ESG) factors as selection criteria for investments is seen as a defining trend in modern finance. Central banks are championing ESG from a regulatory standpoint, and there is also demand for ESG among investors. However, applying ESG criteria to EM investments creates a variety of issues.

As most EM companies' ESG scores tend to be low, focusing on ESG risks tends to side-line EM companies, many of which are crucial to boosting the initial stages of industrial development. This predicament highlights a trade-off between ESG and growth.
Meanwhile, evidence suggests an underperformance of ESG equity indices versus mainstream EM indices. Still, there is value in looking at EMs through the ESG lens as an additional source of information, which can make the difference in choosing at the margins between two investments, especially in relation to governance.

The contradictions between ESG and EMs

Whether EMs and ESG are compatible depends on how you see the process of economic development and which perspective you take: that of the EM or that of the investor. If you start from the premise that EMs are typically less well-governed, more corrupt and increasingly polluted, EMs will not do well in an ESG-driven allocation of capital, which is more likely to flow to Scandinavia, for example. It is worth noting that the Scandinavians were able to focus on ESG goals once they had already become industrialized, not while they were emerging, explaining why ESG scores and GDP per capita are clearly correlated. If the process of economic development requires that EMs build gas-guzzlers before they can build Teslas, then ESG and EMs are hardly compatible, especially for the least developed countries.

However, if early development does not require giving growth a headstart through the stimulation of industries to build infrastructure and capacity, and if it is possible for EMs to leapfrog straight to environmentally-friendly technologies, then EMs are compatible with ESG. When there is no functioning electricity grid, why not use pay-as-you-go solar-generated power? We believe that while technological leapfrogging is helpful, the greatest gains in productivity are made through indoor plumbing, roads and steam power. Bypassing them means bypassing the greatest sources of growth. Hence, there is a twofold problem: 1) an EM choosing to focus on ESG may not achieve strong growth; and 2) if investors are guided by an ESG framework, they will divert capital from EMs and reward already-developed markets, instead of financing the process of development.

The ESG trend is also indirectly affecting EM access to capital flows, because credit rating agencies are increasingly incorporating ESG factors into their sovereign credit analyses. Indeed, while there are a number of countries with good credit ratings despite having a low ESG ranking, there is evidence of a correlation between ESG and CDS spreads.

For investors with an ESG interest, one criterion could be to seek the investments that will have the greatest impact, and, based on this standard, EMs and ESG are compatible. Even if EMs have lower ESG scores than DMs, the best choice is to allocate capital to EMs, as they will register the highest rate of improvement in ESG scores and need to do so the most. After all, while China may not be representative of EMs, it issued a third of the world's green bonds in 2017, with demand from international investors far outpacing supply.

Finally, there is the question of performance. As it happens, the MSCI Emerging Markets ESG Index has underperformed the flagship MSCI Emerging Markets Index on a total return US dollar basis since 2013. However, there are more drivers than just performance when it comes to ESG. For instance, the fact that investors find it difficult to translate EM ESG into performance will matter less and less, if one considers that wealthy millennials are far less driven by narrow definitions of economic returns than their parents. Rather, the US Trust found that 75% of wealthy millennials "consider the social and environmental impact of the companies they invest in to be an important part of investment decision-making." Two-thirds "view their investment decisions as a way to express their social, political, or environmental values." The other pro-ESG investment force is regulation. In that perspective, ESG investment is an insurance ahead of legislation that might slice the financial world in two, contrasting subsidies and regulatory requirements for assets that help the environment with cascading taxes or penalties for those who harm it. This development is not a long way off.

For EM investors, in particular, the case for ESG can be based on the fact that lack of governance and protection of shareholder interests are often the main explanations for EM equity underperformance. Given that governance is the driver of ESG integration in EMs, avoiding the worst companies in terms of ESG factors will move the investor closer to DM standards. In this perspective, ESG acts as a shortcut to quality investment, based on good corporate governance, a management team that takes a long-term view and doesn't go deep into debt. If you don't take that kind of approach to EMs, you risk holding companies that are vulnerable. A good example is Brazilian miner Vale do Rio Doce, whose dam collapsed earlier this year, killing more than 200 people and resulting in a drop in company value, after it became clear that the company knew the dam was a problem long before the accident.

Case studies in EM ESG: Russia and South Africa

Russia and South Africa stand out among EMEA countries when it comes to ESG. A CFA study on ESG integration in EMEA found that analysts are more likely to "often" or "always" adjust their valuation models for equities/fixed income based on ESG data in Russia than in many other markets covered by the study. The survey suggests that Russian companies that are interested in foreign capital are already communicating their ESG practices according to European requirements to foreign investors. Yet, for ESG to really take off in the country, Russia would need to be excluded from US sanctions; otherwise there would be no integration with global sustainability practitioners, which drives the ESG agenda forward.

While client demand for ESG is the driving force behind the development of the sector in Russia, regulation is becoming increasingly important, and risk management is one of the largest drivers of ESG integration. The Central Bank of Russia has introduced the idea of developing sustainable finance mechanisms in its roadmap of strategic development of the Russian financial market, with an emphasis on green bonds. The first step to regulate ESG matters was the Concept for Public Non-Financial Reporting

Development adopted by the Russian government. As part of the Concept implementation, a draft law, "On Public Non-Financial Reporting," is being developed to establish the requirements for drawing up public non-financial reporting with respect to a significant number of Russian companies. However, a crucial issue is to involve institutional investors in ESG, so the Bank of Russia is considering the possibility of developing a national Stewardship Code for institutional investors.

South Africa has built up a culture of responsible investment practices since the publication of the first King Code in 1992. This was followed by South African Principles for Responsible Investment signatory subscriptions in 2006, the publication of South Africa's Regulation 28, which made responsible investment practices key to retirement fund investing since 2011, and the launch of the Code for Responsible Investment in South Africa in 2011. The CFA survey found that South African investors consider social factors more impactful than in many of the markets that the survey visited, but governance risks are still the main risk investors look to. Risk management is still the main driver of ESG integration.

The case of South Africa illustrates the relevance of ESG, in that a social and governance analysis of sovereign issuers would have given an early warning of the high likelihood of a downgrade to junk for South Africa, which has now become the market's central scenario. The difficulties encountered by top-level management of South Africa's state-owned enterprises and the incessant conflict with the unions would also be captured by ESG factors.

REGIONAL OVERVIEW OF POLITICAL RISKS

Asia

Political risks in Asia have remained largely stable, with no country experiencing a deterioration in the overall rating. However, several countries are in the spotlight this quarter, with ongoing protests in Hong Kong and US tariffs hurting the Chinese economy. Furthermore, localised terrorism and human rights violations in some countries remain a threat to security and may mean higher insurance costs for businesses.

While overall growth prospects in the region are still positive, Asia is increasingly facing strong headwinds from souring relations between the US and China, and decelerating global trade growth. Asia is among the most vulnerable regions to slowing global trade in light of the high degree of trade openness and/or the region's proximity to China. The larger the trade-to-GDP ratio, the more vulnerable open economies are to the global trade downturn. As a result, economic growth has been decelerating sharply in trade-intensive South Korea and Malaysia, but larger, more domestic-focused economies such as Indonesia have also not been spared as domestic consumption is unable to pick up the slack from the malign trade and investment environment.

Although Hong Kong's risk rating has not yet changed, we expect it to do so over the coming quarters. In response to the Hong Kong government's proposal to introduce an extradition law, Hong Kong has been shaken by a slew of protests since June. The protests have become increasingly violent, with the situation at an impasse. Things have the potential to take a turn for the worse given China's readiness to intervene by sending in its army, after labelling the protestors' behaviour 'close to terrorism'. However, we believe that China is unlikely to be too heavyhanded in managing the crisis and will leave it to the Hong Kong government to handle for now.

The ongoing protests in Hong Kong are likely to place downside pressure on retail sales, transportation, investments and tourism, while severely disrupting Hong Kong's infrastructure. Prior to the protests, retail sales had already fallen by 1.8% y/y in the first five months of 2019, much lower than the 13.7% y/y expansion seen during the same period in 2018. The outlook remains unclear, with no signs of when the unrest will be resolved, despite Hong Kong Chief Executive Carrie Lam formally withdrawing the extradition bill in early September.

Vietnam's overall risk rating stayed the same this quarter, but the inability of government to provide stimulus slightly improved to medium low. Broadly, Vietnam has reaped the benefits from the US/China trade war so far in 2019, as the export-oriented manufacturing sector received major tailwinds from production shifts out of China to avoid US tariffs. As a result, and going against the regional trend, the Vietnamese economy remained resilient to the global trade slowdown, with industrial sector growth accelerating in 2019. The EU and Vietnam also signed a trade agreement on June 30, eliminating 99% of tariffs on goods, which should further enhance Vietnam's position as a trading and investment hub in Southeast Asia. However, Vietnam is not immune to the escalating trade tensions and higher financial volatility resulting in broadly weaker global economic conditions. In addition, there is a risk that Vietnam's ballooning trade surplus with the US could result in US President Donald Trump resorting to punitive measures, and slapping tariffs on imports from Vietnam, ending the country's relatively fortunate position in the US/China trade spat.

In Lao PDR, the inability of government to provide stimulus and the exchange transfer risks have risen to medium high and high, respectively. Overall the country maintains its medium high risk rating, which is comparable to Vietnam and the Philippines. The economy remains robust, with growth largely driven by the construction and retail sectors. Government fiscal consolidation efforts and improvements to the business environment should also help to maintain a stable macroeconomic environment going forward.

Mongolia's overall risk rating remained unchanged at medium, although scores in exchange transfer and ability of government to provide stimulus deteriorated to medium high and high, respectively. Economic growth has been slowing in 2019 amid a weakening Chinese economy, which is Mongolia's largest trading and investment partner, but the wider economy remains relatively robust. On the political front, the main mobilizer remains the distribution of mineral resource deposits, as in many Central Asian economies. In particular, the government seems unable to distribute the country's abundant resource wealth better among the relatively small population, which has led to mounting voter frustration and demonstrations.

Although Sri Lanka's overall risk rating remained unchanged at medium high this quarter, the country continues to suffer from the aftermath of the terrorist attacks of Easter 2019. The country's political violence rating remains elevated at medium high this quarter, while the risk of sovereign non-payment deteriorated to medium high. At the same time, the inability of government to provide stimulus worsened to high. In any case, to jump-start the economy and reduce fiscal pressures, the government needs to adopt a policy to lure back tourists. The government already reduced airline charges to support the struggling tourism industry, but international arrivals are still down 71% y/y in June. If the government manages to control the security situation over the coming quarters and win back the confidence of the international community, the tourism sector should recover again.

Eastern Europe and CIS

Eastern Europe and CIS remained largely stable, with no country experiencing a change in its overall risk score this quarter. Overall, the economic outlook is positive in the region although many countries in Eastern Europe and CIS continue to face fragile political situations. Changes in individual risk icons are relatively limited this quarter. Montenegro's exchange transfer risk improved from medium-high to medium, while Serbia's banking sector vulnerability score improved to low. On the flip side, Armenia's banking sector score worsened to medium, from medium-low previously, while Azerbaijan, Kazakhstan, and Belarus' banking scores broadly improved. At the same time, in Belarus the inability of government to provide stimulus rating deteriorated to medium high this quarter. Uzbekistan saw the biggest upgrades across the region this quarter, with its exchange transfer risk improving to medium high (from high) and its inability of government to launch stimulus to medium low (from medium).

Similar to the first quarter of 2019, Uzbekistan stands out again this quarter in terms of number of improved scores in the Eastern Europe and CIS region. Uzbekistan sold USD 1 billion of Eurobonds in February, marking its first appearance on international debt markets since declaring independence from the Soviet Union. Uzbekistan's government continued overhauling the economy and introducing a number of pro-market reforms over the past few quarters. Uzbek President Shavkat Mirziyoyev is attempting to open the country

economically by following Kazakhstan's growth model, which has been reasonably successful over the past decades and outperformed its regional peers. The Uzbek government's Development Strategy entails raising the role of markets and the private sector in the economy as well as strengthening social inclusion. The government has already been relatively successful with its initial reforms including liberalising the currency, lifting trade and regulatory barriers, overhauling visa and registration requirements for foreign citizens visiting Uzbekistan, as well as reducing the state's footprint on the economy. Uzbekistan's growth potential is underpinned by its relatively large (and young) population, significant reserves of natural resources (gas and gold), and its strategic location between China and Europe (making it a key location in China's Belt and Road Initiative). Furthermore, assets across the following sectors will be covered under the government's privatisation plan: banking, insurance, cement, aviation, food and beverage, edible oil and fat, oil and gas.

Kazakhstan has an unchanged medium-high level of overall country risk, although the country enjoys an overall risk rating slightly above the regional average. This quarter there has been a slight improvement in the country's banking sector score, which now stands at low. Overall economic risks in Kazakhstan are modest on account of a relatively open business environment. On the political front, Kassym-Jomart Tokayev, who took office as the president of Kazakhstan in June, succeeding long-standing President Nursultan Nazarbayev, who had ruled the country for 30 years, faced widespread demonstrations amid alleged election irregularities. This raises the question of potentially higher domestic political risks going forward if the country's relatively young population demands a transition towards fair elections and a western style liberal democracy. However, it is widely assumed that the Tokayev administration will be broadly positive for the country's business environment by keeping taxes low and welcoming foreign investors. We note that Tokayev's emphasis on the policy continuity and stability of his predecessor has been broadly welcomed by investors.

The South Caucasus region, which includes Armenia and Azerbaijan, retained medium high levels of overall risk this quarter. Armenia's risk score worsened on the back of a slight deterioration in its banking sector rating to medium this quarter. Azerbaijan's banking sector score improved to low this quarter. The thorn on the sides of both countries remains the on-going territorial conflict over Nagorno-Karabakh, resulting in relatively high levels of political violence. The conflict over the disputed enclave adds uncertainty to the political and economic climates, as both countries are still technically in a state of war with one another. Armenian leader Nikol Pashinyan, who became prime minister in 2018 following a bloodless revolution, and ousting long-standing president turned prime minister Serzh Sargsyan from power, does not seem to favour a compromise with Azerbaijan to end the conflict at this point. This suggests that the status quo over Nagorno-Karabakh will continue for the foreseeable future. On a brighter note, Armenia's sovereign credit rating was upgraded by Moody's to Ba3 from Ba1 in August on the back of strengthening government finances and a continued diversification of the country's economic growth drivers. Furthermore, energy-dependent Azerbaijan remains in talks with the EU to conclude a new trade and political agreement, which would align the country closer with Europe although Azerbaijan does not seek full EU membership.

Belarus' overall risk rating remained at high levels this quarter. On the one hand, the country's banking sector score improved to medium low, but on the other hand its score on government ability to provide stimulus worsened to medium high. Belarus' economy continues to suffer from domestic structural rigidities and poor growth prospects in its export-oriented manufacturing and agricultural sectors. The continued slow GDP growth trajectory in Russia, Belarus' largest trading partner, weighs on the country's overall economy. High public debt levels limit the government's capability to support the economy through fiscal easing, while the scope for monetary policy is limited by the high dollarization rate of the banking sector. For Belarus, the main challenge going forward will be to diversify the economy away from its high reliance on Russian import demand and its vulnerability to commodity price fluctuations.

Serbia's overall risk rating remained unchanged at medium, putting it among the best-rated countries in the region. This quarter its banking sector score improved to low, from medium-low previously. The Balkan economy grew at its fastest pace in a decade in 2018, outperforming most regional peers. However, Serbia is highly dependent on EU demand and infrastructure investments for growth, making the country vulnerable to a global economic downturn and a sluggish Eurozone economy. Furthermore, while Serbia still enjoys a free trade agreement with both the EU and Russia, Belgrade's plans to deepen its trade and investment relations with Russia have triggered a backlash from the EU. The EU absorbs over 63% of Serbian exports, while Russia accounts for just 10% of Serbian trade. Serbia's rapprochement with Russia puts Belgrade's on-going ambition to join the EU at risk, which in turn would raise the country's risk profile. The EU accession process has been an anchor for relative stability and has supported Serbia's attempt to improve its institutions over the past few years.

Latin America

There is no change in the overall risk level of Latin American countries this quarter. The bulk of the changes across Latin America can be found in the banking sector vulnerability and inability of government to provide stimulus indicators. Economic growth prospects across Latin America remain somewhat weak. The region continues to suffer from weaker growth in China and subdued demand for commodities. Other risks have intensified such as US-related trade

uncertainty on the back of the US trade war policy against China, while domestic political risks also remain elevated. Political violence continues to affect countries like Honduras, Nicaragua, Venezuela, Guatemala, El Salvador and Colombia. The resulting exodus of their populations presents challenges for developed countries like Chile and even more so for poorer neighbouring countries.

A major threat for the Central American countries comes from US President Donald Trump's decision to withhold aid to El Salvador, Guatemala and Honduras, after the US vowed to close its southern border with Mexico, in light of relatively unchecked immigration flows coming through Mexico. Three months after President Trump's initial warning, the state department recently confirmed that the administration had informed Congress it would stop the aid. The migrant issue becomes an ever-growing risk to growth and already precarious fiscal conditions across Central America.

Argentina is once again facing an economic crisis, which has led to the government imposing capital controls to prevent the depletion of foreign currency reserves and stabilise the exchange rate (and with it the wider economy). Although Argentina's overall risk remains medium-high, it is set to rise significantly over the coming month in light of the deepening financial crisis. Argentina's political-turned-confidence crisis triggered US dollar outflows and a broader financial market sell-off, resulting in a spike in inflation. The Argentine peso weakened by over one-fifth in August, while the central bank spent over USD 12 billion in the same month (depleting FX reserves by around 20%) attempting to defend the currency. The sell-off was triggered after President Mauricio Macri suffered a defeat to his nationalist Peronist opponents in a primary vote in August. As a result, it is now very likely that Alberto Fernandez (candidate of the nationalist Peronist coalition) and his running mate, former Argentine President Christina Kirchner, will win the presidential election held on October 27. A potential Fernandez-Kirchner government represents a threat to Macri's pro-market reforms, austerity policies, as well as to Argentina's broader macro stability, given Kirchner's track record. During Kirchner's previous term, she presided over four recessions and many devaluations, causing FX reserves to fall by 50%. Previously, investors had welcomed Macri's austerity policies, although his government had been forced to increase the minimum wage and provide bonus payments for public-sector employees amidst widespread backlash. In any case, Argentina's renewed economic crisis increases the country's sovereign non-payment risk (which currently stands at medium-high) and the inability of government to provide fiscal support, which already stands at high.

Bolivia's overall risk score did not change this quarter and remained at high levels. The country's banking sector risk level deteriorated to medium, from medium low previously. Bolivia's economic development continues to suffer from interventionist policies, which is manifested by the very high risk score in the political interference score. Furthermore, elevated public spending and a wide current account deficit will continue to weigh on Bolivia's fiscal balance.

Colombia's risk rating remained at medium this quarter, putting the country among the most stable among the larger South American economies. That said, the inability of government to launch a stimulus slightly deteriorated to medium, while the domestic political situation broadly worsened. The economy has been experiencing relatively solid growth compared to South American peers over the past few years. The country's market size, large natural resource reserves (coffee, emeralds, oil and coal), and recent relative political stability have made Colombia a regional outperformer. Politically, President Iván Duque's grip on power is fading as he lacks a majority in Congress. His low approval ratings and a deteriorating security situation across rural areas have added to Duque's problems. In addition, the Colombian peace deal agreed in 2016 seems to be under threat, which doesn't bode well for the political stability of the country going forward.

Honduras' overall risk rating stayed the same at medium high, although its transfer risk rating improved to medium this quarter. The country's political landscape was strained by accusations of fraud against Preside Juan Orlando Hernandez, although on-going UN talks with the opposition have helped governability and political stability of the country.

Venezuela scores very-high on nearly every risk icon, putting it among the riskiest countries in the world. The country continues to endure a hard economic crisis marked by hyperinflation, mass emigration, corruption, and widespread violence. The high unemployment rate and food/medical shortages add to continued political instability as a significant deterrent to the recovery in the years to come. The population's exodus has now surpassed the 4 million threshold, around 10% of the population. Furthermore, the

IMF estimates that the cumulative decline in the economy reached 65% from 2013-18, and forecasts the economy to shrink by another 35% in 2019. Venezuela's energy sector, which accounts for over a quarter of GDP and 95% of exports, has become a drag on wider economy. Although the country has the largest oil reserves globally, crude oil production plunged from 1.2 million barrels per day to just 830,000 in 2019. We note that Venezuela can produce up to 4 million barrels per day. The IMF announced that if it were asked by the legitimate authorities of Venezuela to come in and provide financial support, it would do so. Similar pledges have come from regional peers. Venezuela's transition to stability and democracy will be slow over the years to come, unless a US military intervention occurs, which is not likely.

Brazil does not display any change in risk icons this quarter, with the overall rating remaining steady at medium (above the Latin American average). All eyes are currently on President Jair Bolsonaro's ability to implement his economic reform programme, which should improve Brazil's business environment. The impact of structural deficiencies in Brazil's infrastructure and capital has stunted growth over the past few quarters, feeding into business pessimism and a weak labour market. On a brighter note, Brazil's lower house of the National Congress has approved the much-awaited pension reform in August, which is widely regarded as an important step to boost Brazil's fiscal position and restore growth. The legislature has been working on the pension reform (in one way or another) over the past two decades. By raising the retirement age, the government hopes to save around USD 230 billion over the coming decade, freeing up fiscal space for crucial infrastructure expenditure. However, we note that Brazil's senate still has to approve the reform. Without the reform, pension spending would increase to 17% of GDP over the coming decades, crippling Brazil's economy, according to Rodrigo Maia, the speaker of the lower house. Foreign investors have also been eagerly awaiting the reform to pass, as it is widely seen as a first test for the legislature to initiate broader economic reforms, including deregulations, privatisations, and overhauling the tax system over the coming years.

The Middle East and North Africa

Across the Middle East, only Iran has experienced a change in its overall risk rating. That said, seven of the 14 countries across the region now either have a high or very high risk rating. The UAE and Qatar exhibit the strongest rating at medium low, followed by Kuwait, Oman, and Saudi Arabia, which exhibit a medium risk level. In Northern Africa, Libya and Morocco managed to improve their banking sector vulnerability scores to medium, from medium low previously. However, the majority of the region still exhibits high or very high overall risk, with Morocco and Tunisia as the exceptions.

Overall, the MENA region contains among the highest-risk countries in the world, such as Libya, Iraq, Syria, and Yemen. Instability and violence are still the main risks to the regional economic outlook. War is continuing in Syria and Yemen, which has also taken a toll on countries like Jordan, Lebanon and Iraq. Yemen is the riskiest country in the region, with an overall risk rating of very high. US President Donald Trump's support for Yemen's Saudi-led coalition, which has been conducting airstrikes on Houthi rebels, caused him to veto a Senate bill asking to end US involvement in Yemen's civil war. On the external front, growing trade tensions are likely to trigger significant fiscal and financing pressures for many countries, clouding economic recovery.

Iran's overall risk rating deteriorated to very high this quarter on the back of the US' decision to cancel the waivers on importers of Iranian oil, which has resulted in a collapse of the Iranian currency and the wider economy. Iranian President Hassan Rouhani recently announced that if the US does not withdraw its sanctions, there would be no political resolution. Furthermore, the US Navy is working on putting together a coalition in the region to protect the vital shipping lanes that pass through it. The Strait of Hormuz is critically important for global oil supply chains, as 20% of all crude oil sold on world markets passes through this strait. On a brighter note, France has proposed (dependent on US approval) offering Iran around USD 15 billion in credit lines through the end of 2019 if Tehran starts to fully comply with the 2015 nuclear deal

(JCPOA) again, which could help to diffuse the tense relations between the US and Iran. Previously the US unilaterally abandoned the Iran nuclear deal and re-imposed sanctions on the country, which has led to Iran breaching some of the limits on nuclear material. In any case, renewed US sanctions will exacerbate structural economic weaknesses in Iran, which could lead to social unrest and an increasingly assertive Iran foreign policy. Additionally, institutional risk remains high as widespread corruption, and weak rule of law contribute to high legal and regulatory risks.

Jordan remains a medium high risk country, although it has seen its risks of political interference and ability of government to provide stimulus deteriorate to high this quarter. The large Syrian refugee population in Jordan is continuing to put pressure on public finances, as the conflict remains far from resolved. It seems that the country will remain dependent on foreign support, while the fiscal deficit will continue to be very high.

Lebanon's overall rating stayed unchanged, but its exchange transfer risk slightly improved from high to medium high this quarter. Its overall high risk rating is largely due to high risk scores in political interference, sovereign non-payment risk, and legal and regulatory risks. The Lebanese economy remains in recession, with GDP contracting for a second year running in 2019. Prime Minister Saad Hariri declared an economic emergency and aims to accelerate structural reforms to ensure the stability of the Lebanese pound (the unit is currently pegged to the US dollar).

Palestine has an overall risk rating of high. While the risk of political interference worsened to high, risks coming from the banking sector improved to medium low.

In Qatar, risks of exchange transfer, banking sector vulnerability, and the ability of government to provide stimulus have risen this quarter, while the overall risk rating has remained at medium-low. The Saudi Arabian embargo against Qatar has had less of an impact than expected. At the beginning of the boycott, the supply chain and shipment routes suffered, but Qatar has adapted well. The country is unlikely to change course and reform its foreign policy, which is centered on maintaining positive relations with Iran. It withdrew from the Organization of Petroleum Exporting Countries to strengthen its top spot as the world's largest liquefied natural gas player, ramping up production. Indeed, the gas industry accounts for around two-thirds of GDP and nearly 80% of export earnings. Despite relatively low energy prices globally, Qatar fared better than most of its neighbours on the back of a relatively successful economic diversification agenda (namely large infrastructure and construction projects ahead of the FIFA Football World Cup in 2022).

Sub-Saharan Africa

No Sub-Saharan African countries saw their overall risk ratings change this quarter. However, out of the 49 countries covered in Sub-Saharan Africa, 26 states either have a high or very high risk rating, making this region extremely risky. The

sources of risk vary throughout the region, but debt burdens are an increasing risk in countries like Angola, Burundi, Guinea Bissau, Liberia, Mozambique, Niger, and South Africa. And with China contributing around a sixth of all lending to Sub-Saharan Africa, it is no wonder the concept of China's debt-trap diplomacy is reverberating across the continent.

Extremism has continued to rise, with IS, Al Qaeda and Boko Haram exploiting state failures to gain relevance: they provide public services like water, sanitation, education, that the state does not. Over the course of 2019, terror attacks in Mali, Burkina Faso, and Niger have killed nearly 5,000 people, which is a significant increase on the year before.

Angola is Sub-Saharan Africa's third-largest economy (behind Nigeria and South Africa), but also one of the most unequal ones globally. In Angola, exchange transfer risk has increased to medium high from medium, as volatile oil prices mean that foreign currency shortages remain prevalent, while fuel shortages remain severe. The ability of government to launch a stimulus risk increased to medium high this quarter, showcasing the country's precarious fiscal position. Angola is the world's eighth-largest exporter of oil, but reserves have been dwindling. The leadership of new President Lourenco, who is on an anti-corruption drive, is encouraging multinationals to step up investment, drawn by his economic reforms and the opening of wide swathes of oil and gas acreage. Angola has launched a new oil licensing strategy to 2025 and announced a bidding round for 10 oil and gas blocks in the first of several auctions it plans in its six-year strategy.

Botswana remains a bright spot, exhibiting a medium low risk rating, with its exchange transfer and ability of government to launch stimulus risks improving to low. The diamond-rich country announced plans to further diversify its economy and reduce its dependence on mining with low taxes, no exchange controls, and no restrictions on foreign ownership. Botswana is among the richest countries in Sub-Saharan Africa, boasting a GDP per capita of USD 18,650 (above South Africa's USD 13,870), and effective institutions built up over the past decades. Furthermore, we note that President Mokgweetsi Masisi's party, the Botswana Democratic Party (BDP), which has been in power since 1966, has seen its support eroding gradually. In 2014, the BDP lost the popular vote for the first time. This may result in somewhat higher political risk and less policy continuity going forward.

Burundi's risk score remained among the highest globally this quarter, with its sovereign non-payment risk deteriorating to high. Making matters worse, a recent UN report said that there is a widespread climate of fear and intimidation against anyone in the country who does not show support for the ruling government. This comes ahead of the 2020 elections, as the government is expanding its control over non-governmental organizations and other political parties. Furthermore, the World Health Organisation stated that Burundi is suffering from a malaria outbreak at epidemic levels, with half of the population infected and killing 1,800 people in 2019 so far alone. The government has yet to declare an emergency.

Mozambique's ability of government to provide stimulus worsened to very high this quarter. Overall, the country is high risk, scoring high or very high in all categories except in the banking sector. Currently, Mozambique is finalising a deal with international bondholders to move past a scandal involving state-owned companies. This restructuring may help the country regain access to the IMF, after lending from the fund ceased in 2016. Mozambique's economy suffered over the past year, as the government has been unable to support the population with emergency aid following the devastating floods earlier in 2019. On a brighter note, Mozambique's opposition and government signed a peace agreement, which should remove a major obstacle to developing offshore natural gas fields. Gas production is set to begin in 2024, with the US oil company Anadarko launching a USD 25 billion project to develop a liquefied natural gas facility.

Namibia has a medium risk rating, which is well above the regional average. However, this quarter, both the exchange transfer and ability of government to launch stimulus risk scores worsened to medium high. Elections are due to be held by the end of 2019, but the ruling SWAPO party is set to retain its majority. Economic conditions remain vulnerable, with weather shocks and climate-related risks on the rise. The IMF estimates that GDP grew by a meagre 1.1% in 2018 following a contraction of 0.8% in 2017. Rebounding mining production and improving conditions for the agricultural sector should help the economy to recover going forward.

South Africa's overall risk rating remained at medium, although the banking sector vulnerability score slightly improved to medium low this quarter. The country marginally avoided a recession, with GDP growth rebounding to 3.1% y/y in Q219. Previously, South Africa was struggling with power outages, hitting the large mining sector hard and resulting in widespread violence. For President Cyril Ramaphosa this comes as a sign of relief, as his party has shown little progress in stopping the infighting, corruption, and pushing through any meaningful reforms. The economy is set to expand by 0.7% in 2019 and accelerate slightly to 1.2% in 2020, which will be insufficient to reduce the country's chronically high unemployment rate of over 29%. At the same time, the government is struggling with state-owned Eskom (a monopolist in power generation), which recorded its biggest annual loss of USD 1.5 billion in the 2018-19 financial year. The government approved a USD 4 billion bailout for Eskom over the coming two years following a USD 1.55 billion cash injection in early 2019. However, this has resulted in Fitch Ratings cutting South Africa's outlook from stable to negative, while maintaining its junk BB+ rating, as the bailout will likely raise the government's budget deficit to over 6.0% of GDP next year. We note that Eskom holds additionally mainly sovereign-guaranteed debts of over USD 30 billion on its books. Given a deteriorating sovereign debt outlook, which suggests increasing sovereign non-payment risks in the future, and sluggish growth, we expect Moody's to downgrade South Africa to junk in H1 2020.

On the upside, higher global commodity and metals prices will help stabilise a number of economic indicators across the region, ranging from fiscal and current account positions to foreign exchange reserves and exchange rates. Oil exporters, such as Angola and Nigeria in particular, will benefit from the changing environment.

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