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Political Risk
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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.

CONTENTS

Summary

Under the Spotlight - Currency Depreciations: Questioning Received Ideas

Regional Overview

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SUMMARY

The spread of COVID-19 in the first half of 2020 has affected all emerging markets, although some are showing more economic resilience than others. This is partly down to the varied form and scale of their fiscal and monetary stimulus responses, and the varied quality of their healthcare sector.

The impact on business in E.M. is major: we have seen the re-emergence of obstacles to the free flow of trade, capital and labour, a shift towards relocalisation of supply chains, a rekindling of U.S.-China tensions and a rising risk of debt default across frontier markets, resulting in a rise in sovereign debt repayment risk. The latter is occurring despite the G-20 moratorium on 2020 debt interest. Indeed, credit rating agencies are even threatening to downgrade those countries which accepted the moratorium on the grounds that, if it includes debt owed to private creditors, it will increase overall credit risk.

We have already seen Zambia, Ecuador and Lao PDR take the first steps towards debt restructuring. Our research suggests that Senegal and Mongolia, both of which should see their debt service payments jump in 2021, will be at risk next year. Meanwhile, Nigeria, Angola, Tunisia and Libya are also at risk from the additional shock of a dramatic drop in oil prices.

While we expect a tick-shaped (slower but longer) recovery to prevail in bigger E.M. outside of frontier markets, our central scenario is based on the expectation that the second wave of COVID-19 infections in H2 2020 will create less damage than the first, as governments and healthcare institutions will have experience in managing the pandemic and its effects. Asia should have the fastest recovery given its early start in the pandemic and more efficient institutions in general. Latin America is at the other end of the spectrum, as poor health systems, a large informal sector and an inadequate response to the pandemic delay the recovery.

This quarter, we saw a change in the overall risk rating of one country. Only North Macedonia saw its overall risk score deteriorate to medium-high this quarter amid a medium-high risk of political violence. A significant rise in COVID-19 cases in the summer has resulted in increased protests against the perceived mishandling of the pandemic by the government. While the parliament has just approved a new coalition led by the Social Democrats, this follows a month-long leadership void amid the pandemic.

UNDER THE SPOTLIGHT
CURRENCY DEPRECIATIONS: QUESTIONING RECEIVED IDEAS

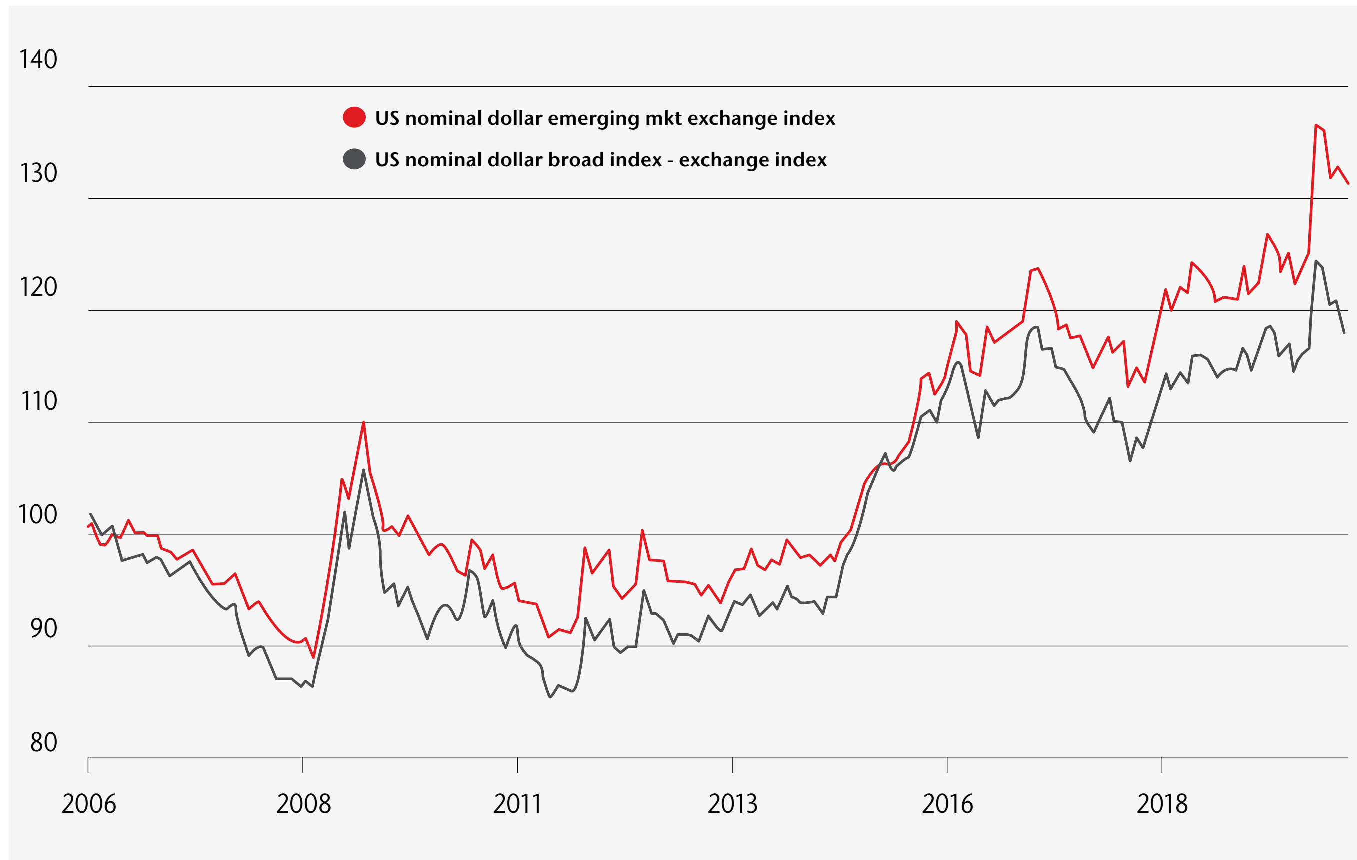
Suffering its biggest trade-weighted drop since January 2018 (Figure 1), the emerging decline in the U.S. dollar reflects both fresh concerns about the U.S. economy's potential recovery path and the political and policy response to the recent rebound in COVID cases, all accentuated by the looming election. Regardless, the drop needs both perspective and context, not least the fact that, before the pandemic, the dollar had appreciated by more than 30% in nominal terms since 2011.

The corollary of this, of course, is that many E.M. currencies weakened sharply in that period, in turn very much begging the question: will these various currency depreciations be able, at least to some degree, to support admittedly fragile economic activity in these respective economies? Similarly, will the dollar's fall of late, especially if it persists and/or deepens, have economic/policy consequences for E.M. countries in particular? However, and building on academic studies a decade old, new research suggests that the short-term gains from any weakening in non-dollar currencies may be limited, at best. Moreover, this may especially be the case for E.M.s.

Indeed, rather than using their own domestic currencies, companies based in these economies are seemingly pricing and/or invoicing both their

respective exports and sources of finance in a few foreign currencies, notably the U.S. dollar. All of which gives rise to what may be the new paradigm for understanding currency swings and economic activity, namely what is now framed both as a dominant currency pricing and financing. The important implication of such increased use of U.S. dollar invoicing is that a global strengthening of the U.S. dollar actually may entail short-term contractionary effects on trade, the opposite conclusion to traditional theory.

Figure 1: The Dollar's 'Fall' in perspective



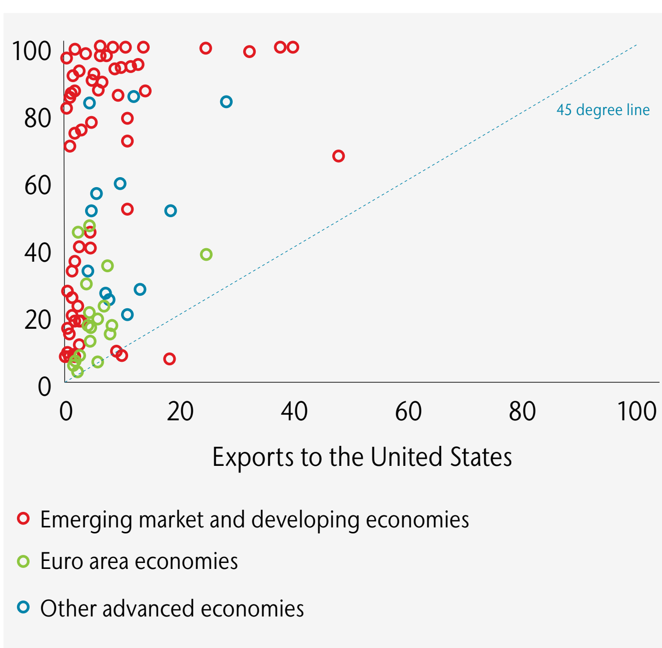
Source: DataStream

CHALLENGING THE F.X. STATUS QUO

The long-standing and traditional view on how swings in exchange rates pass through into the real economy is that companies in any particular economy set their prices in their own home currencies. As a result, whenever the domestic currency weakens, goods (and services) produced in that domestic economy become cheaper for trading partners abroad. In turn, this cheaper pricing means that a weaker domestic currency leads to more demand from abroad, ie providing a boost to exports. As for imports, when a currency depreciates, imports become more expensive in home currency terms, inducing consumers in the domestic economy to import less, possibly substituting the purchase of goods and services abroad in favour of domestically-produced goods.

Thus, in this traditional analysis, a weaker currency can support the domestic economy with net trade boosted in a double-edged sword manner, both by inhibiting imports and promoting exports. Of course, this is very much a simplification of reality, not taking account what the source/cause of the weakening currency may have been originally, as well as ignoring the likelihood that any boost to domestic spending may be entirely offset by damage to spending power caused by any FX-induced rise in inflation, the latter then having potential policy consequences.

Figure 2: Exports Increasingly Invoiced in Dollars, even when the U.S. is not the Importer



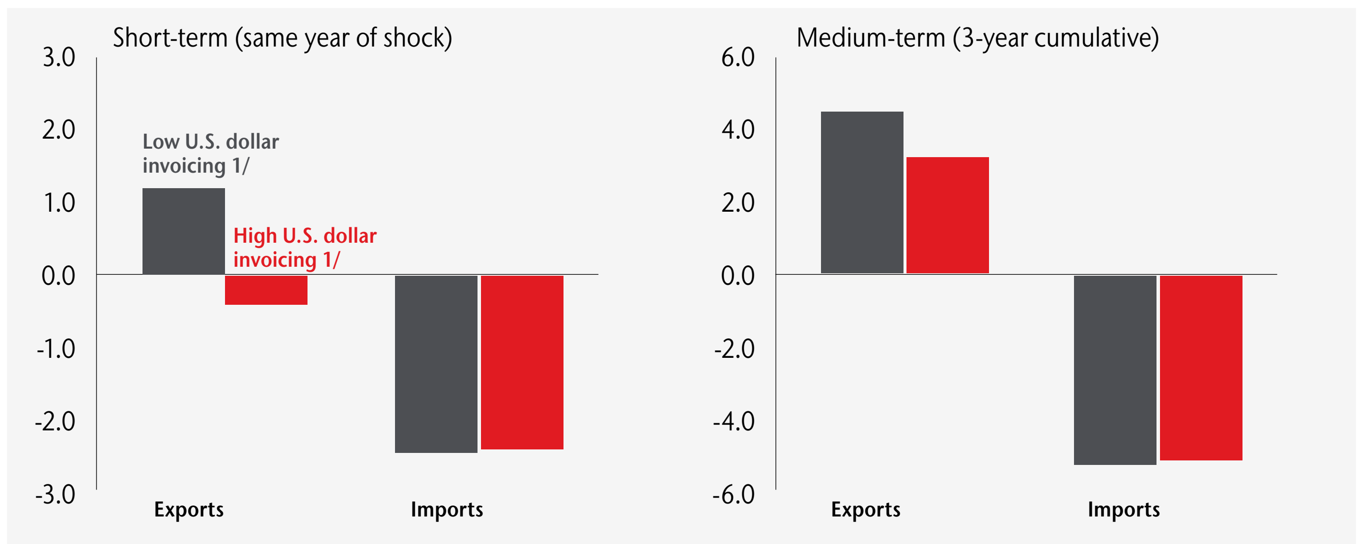
Source: IMF, x-axis is percentage of visible exports to U.S. and y-axis is percentage invoiced in US$

DOMINANT CURRENCY PRICING

However, this traditional view has developed cracks; academic studies and data analysis, dating back over a decade, and fostered in particular by Gita Gopinath, who is now IMF Chief Economist, instead highlight accumulating evidence that a majority of global trade is actually invoiced in a few currencies, most notably the U.S. dollar and to an increasing degree the euro – and not in domestic currencies (Figure 2).

Perhaps the most persuasive evidence is that the share of U.S. dollar trade invoicing across countries far exceeds their share of trade with the U.S., something that is especially true in E.M.s. This is very much supported by recent findings from the European Central Bank. These include: that the U.S. dollar and the euro have been increasingly used for invoicing even as the share of global trade accounted for by the U.S. and the euro area has declined; that the euro is used as a vehicle currency in parts of Africa, and some European countries have seen significant shifts toward euro invoicing; and third, countries invoicing more in U.S. dollars (euros) tend to experience greater U.S. dollar (euro) exchange rate pass-through to their import prices; also, their trade volumes are more sensitive to fluctuations in these exchange rates. It also seems that while the inception of the euro initially reduced the dominance of the U.S. dollar somewhat, other reserve currencies seemingly play much more of a limited role. Dominant currency pricing is common both in goods and in services trade, although it is less prevalent in the latter—especially in some sectors, like tourism.

Figure 3: Dominant Currencies dampen Trade Gains from Depreciation in the Short-Run



Source: IMF, effect of depreciation vis-a-vis all currencies on overall trade volumes

This all supports what is now termed the dominant currency pricing or dominant currency paradigm, which seemingly is common for both goods and in services trade. However, it is less prevalent in the latter—especially in some sectors, like tourism. Key findings include that non-commodities terms-of-trade are uncorrelated with exchange rates and that the dollar exchange rate quantitatively dominates the bilateral exchange rate in price pass-through and trade elasticity regressions. Nonetheless, it is a development that is increasingly relevant for the international trading and monetary system as well as for policymaking.

DOMINANT CURRENCY REPERCUSSIONS

If the prevalence of the U.S. dollar (and euro) in firms' pricing decisions is increasingly sizeable, it will alter how trade flows respond to exchange rates, especially in the short-term. Indeed, and critically, when export prices are set in U.S. dollars or euros, a country's depreciation no longer makes goods and services cheaper for foreign buyers, at least in the short-term, removing one of the veneers of increasing demand that forms part of the traditional view. The reaction of export quantities to the exchange rate is more muted, and so is the short-term boost of depreciation to the domestic economy. Following on from this, the important implication of the increased use of U.S. dollar invoicing is that a global strengthening of the U.S. dollar entails short-term contractionary effects on trade: these may unwind in the medium to longer-term (figure 3), but, as Keynes pointed out, the long-term has certain deficiencies.

This is because the weakening of other countries' currencies vis-à-vis the U.S. dollar leads to higher domestic currency prices of their imports, including from countries other than the U.S., and, thus, lower demand for them. Indeed, the latest Gopinath paper asserts that a 1 ppt U.S. dollar appreciation against all other currencies predicts a 0.6 percent decline within a year in the volume of total trade between countries in the rest of the world.

DOMINANT CURRENCY FINANCIN

Dominant currency financing has further implications. Notably, it seems that the prevalence of the U.S. dollar (and euro) is also an increasing feature of corporate financing in E.M., meaning that exchange rate fluctuations may also pay a part through their impact on firms' balance sheets. For instance, a depreciation that increases the value of a firm's liabilities relative to its revenues weakens its balance sheet and hinders access to new financing, as firms' capacity to repay deteriorates. However, this effect depends on the currency in which revenues are earned, that is, whether revenues are in foreign currency or in local currency.

TURNING THE STATUS QUO ON ITS HEAD

Thus, exporting firms that use the U.S. dollar or euros for both pricing and financing are "naturally hedged" as liabilities and revenues move in tandem when exchange rates fluctuate. This means foreign currency financing is less of a concern when concentrated in exporting firms. However, in the case of predominately importing firms, revenues and liabilities are typically not matched, and exchange rate fluctuations bring about balance sheet effects that constrain financing and import volumes. The clear conclusion is that dominant currency financing tends to amplify the effect of a country's depreciation on its imports. The prevalent use of the U.S. dollar in corporate financing also means that a generalised strengthening of the U.S. dollar can have globally contractionary effects through importing firms' balance sheets.

Thus, the global strengthening of the U.S. dollar seen until recently could actually amplify the short-term global trade and economic activity fall-out from COVID, as both higher domestic prices of traded goods and services and negative balance sheet effects on importing firms lead to lower import demand among countries other than the U.S. In this case, the dollar's fall may be welcome. But as the IMF concludes, exchange rates still have a role to play to contain capital outflow pressures and support the recovery over the medium term. However sustaining the domestic economy in the short term requires a decisive use of other policy levers, such as fiscal and monetary stimuli, including the use of unconventional tools.

The data show that, as one would expect, dollar dominance is the most pronounced in Latin America, with Colombia displaying the strongest extent of dollar dominance. In a recent paper looking at the impact of the 2014-15 Colombian peso depreciation, the Central Bank of Colombia found that, as predicted by the dominant currency pricing paradigm, the depreciation triggered a relatively rapid contractionary response from imports, whereas the response from exports was slower and weaker. It attributed the muted response of exports to exporting firms' reliance on imported imports, and to their pre-existing higher debt, also confirming the role of dollar dominant financing through the balance sheet effects described above.

The Case Of EMEA

EMEA is interesting in that it exhibits dollar dominance in South Africa, Turkey and Russia, but in the CEE-3, the euro has recently seen its share of import invoicing increase. If we first look at the CEE-3, Eurostat data highlight the increasing share of euro invoicing of extra-EU imports in the last five years. Hungary now displays the highest share of euro invoicing at 40% of total extra-EU imports, while the Czech Republic displays the lowest at 27.2%. The share of euro invoicing is slightly higher for manufacturing goods imports than for total imports and much higher for primary goods, in line with the theory.

	USD share	Euro share	Own currency share
Algeria	na	0.49	0
Argentina	0.88	0.08	0
Brazil	0.84	0.11	0.01
Bulgaria	0.43	0.59	0
China	na	na	0.07
Colombia	0.99	0	0.01
India	0.86	0.1	0
Indonesia	0.81	0.04	0.01
Israel	0.73	0.21	0.03
Morocco		0.55	0
Pakistan	0.84	0.07	0
Peru	0.93	na	0
Romania	0.31	0.67	0
Thailand	0.79	0.04	0.04
Turkey	0.59	0.31	0.03
Ukraine	0.75	0.16	0

Source: BIS

Figure 5: Percentage Shares Of Euro Invoicing In CEE-3 Extra-EU Imports

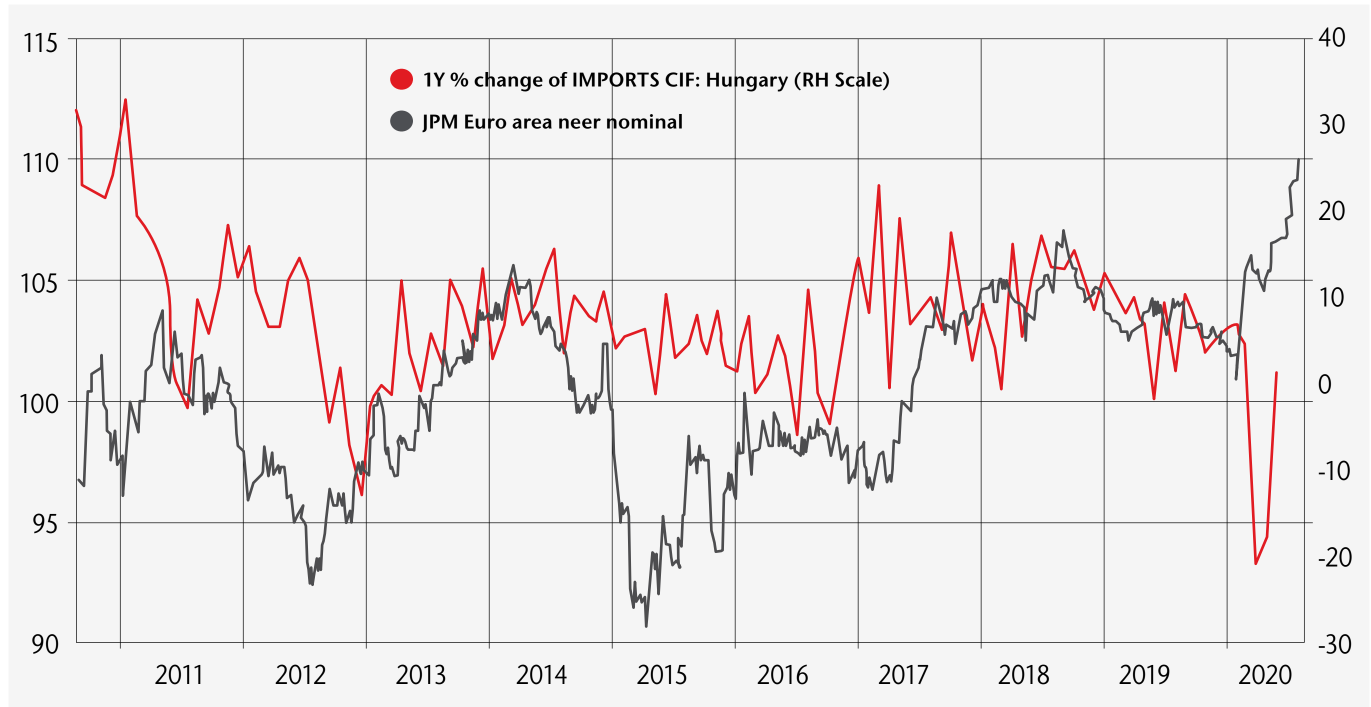
	2010	2012	2014	2016	2017	2018	2019
Czech Republic	23.7	26.5	31.1	32.7		27.2	
Hungary	29.5	22.7	26.5	32.5	38.4	40	
Poland	20.0	18.4	21.6	27.3	28.2	27.1	27.7

Source: Eurostat

The high extent of euro invoicing in Hungary is crucial, when one considers that the level of the EUR/HUF exchange rate has been a critical consideration for the National Bank of Hungary (NBH) historically. It used to be that EUR/HUF 330 was the line-in-the sand for the NBH, at which it would defend the currency through tighter monetary policy rules. Yet the forint has been the worst-performing currency in the CEE-3 this year, and the NBH has done little to correct this. While it decided to offer a new one-week deposit for banks at 0.9%, and widen the interest rate corridor in an implicit tightening in April, this was quickly offset by two cuts in the main policy rate in June and July to 0.6%. It now seems relatively happy with the concept of a weak forint's hypothetical ability to prompt a faster export recovery in the midst of the COVID-19 crisis.

Similarly, at the end of June, the National Bank of Poland even stated that it had a preference for a weak zloty as a facilitator of the recovery, even regretting that the zloty did not weaken in the face of the pandemic and record monetary policy loosening by the NBP. Yet as we noted above, nominal depreciations have a limited impact on trade volumes, especially in the shorter-term, and the trade balance, as real effects are offset by domestic inflation. The relationship between the real effective exchange rate and exports is a stronger one, as is the one predicted by the currency dominance paradigm between the euro trade-weighted nominal exchange rate and import growth (although it is weakened by the fact that so far, the euro accounts for less than 50% of invoicing).

Figure 6: Hungarian y/y Import Growth Vs JP Morgan Euro Nominal Exchange Rate



Source: Datastream, Continuum Economics

If we look at the rest of EMEA, it is harder to find country-specific data on dominant currencies. What clearly emerges, however, is the absence of causation from a weaker local currency to export growth - this has been widely documented for South Africa, for instance. However, we do have data on the extent of dominant currency invoicing in Turkey, which stands out. In Turkey, 60% of imports are invoiced in USD, while only 6% of Turkish imports come from the U.S., providing significant evidence of dominant currency pricing.

Refining the analysis, research from the Central Bank of the Republic of Turkey confirms the theory on the sector-specificity of the dominant currency effects. It points to evidence that the rate of exchange rate pass-through to U.S. dollar and euro-priced goods depends specifically on the type of products traded and their value-added content. For consumption and capital goods, pass-through rates are significant and relatively high when they are priced in U.S. dollars. For intermediate goods, the pass-through to euro-priced goods are higher than those to U.S. dollar-priced goods. Interestingly, sectors displaying a high association with global value chains tend to have a higher exchange rate pass-through for sectors with lower linkages.

Figure 7: Sector Shares In Turkish Imports And Respective USD Share In Sector Invoicing, %

	Share in imports, %	USD share of invoicing, %
Agriculture, hunting and related service activities	3.34	84.51
Food products and beverages	2.14	62.08
Textiles	2.62	70.22
Wearing apparel, dressing and dyeing of fur	1.09	55.57
Basic metals	11.89	79.13
Machinery and equipment	9.16	26.14
Foreign value added content of exports in 1st quantile	8.88	61.76
Foreign value added content of exports in 4th quantile	54.61	47.03

Source: Turkstat, OECD TiVA Database, Continuum Economics

Overall, E.M. evidence suggests that policy should not focus on the exchange rate but on the fundamental determinants of the competitiveness of domestic exporters: productivity enhancement and production costs. Indeed, there are no easy shortcuts to external competitiveness. An E.M. economy has control over these variables, while it has no control over USD or EUR value, especially as their dominance is not about to fade. While the U.S. share of global output and trade has fallen, there is no alternative to the dollar as reserve currency. And as Gopinath stresses, its dominance as reserve currency spills over to dominance as an invoicing and financing currency.

REGIONAL OVERVIEW OF POLITICAL RISKS

Asia

Within Asia, no country has seen any change to their overall risk level. However, COVID-19 continues to take its toll on India with 2.6 million cases, although the rest of South Asia has been relatively preserved by a youthful population resulting in a low death rate. Sri Lanka, which imposed an early and extended lockdown, has fared particularly well within South Asia. However, South Asia has been unable to organise disaster relief following Monsoon floods, due to localised lockdowns. In East Asia, South Korea is dealing with a new wave of the virus, which marks the largest outbreak in six months. The government is sending military doctors into its epicentre in Seoul. In China, the city of Wuhan, where COVID-19 allegedly originated, has not had a case since May, and scenes of a massive pool party in Wuhan which went viral in August, which was held without masks or social distancing, suggest that China has turned the COVID-19 page.

Asia is also the region where the delocalisation of manufacturing supply chains will have the greatest impact. This process will affect China first and foremost and should benefit smaller countries like Vietnam, where some supply chains will be relocated.

Tourism has already been affected by the virus, especially in the Philippines, where tourism accounts for 13% of GDP, and the continued imposition of local lockdowns will continue to weigh heavily. Banking sector vulnerability has diminished overall in the region as a result of ongoing banking sector reforms, except in Lao PDR and Taiwan. Political risks in Asia have remained largely stable this quarter, although the standoff between China and Hong Kong, plus the vulnerability of Taiwan due to the lack of an independent status, imply continued instability.

Asia is the E.M. region with the most optimistic growth outlook for 2020 and 2021, partly as it was the first to deal with COVID-19, but also as China has already posted a V-shaped recovery – we expect 7.6% growth for 2021. The recovery has been supported by the ability of governments to provide stimulus as well as the extent to which governments and central banks were willing to embrace expansionary policy.

China's overall risk score remained stable at medium, but its banking sector vulnerability has declined to medium. The Chinese banking regulator is overseeing a restructuring of the country's banking system and seeks to root out unfit shareholders, as 5% plus dividend yields have convinced mom-and-pop investors to buy bank shares en masse. However, the U.S.-China relationship has greatly deteriorated following COVID-19. Through sanctions, the U.S. government has targeted TikTok, the most popular social media app China has ever produced, and Huawei, which is the world's biggest producer of 5G telecoms equipment and whose subsidiaries became the subject of worldwide curbs in August. Over a year ago, Beijing said it would create an Entity List of those individuals and businesses that pose a threat to China, but it never did, as it could result in a significant delocalisation of Chinese supply chains, which would damage the Chinese economy. We think it is more likely to wait and see whether a Joe Biden presidency reduces U.S.-China tensions.

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 strong rule of law. However, we are likely to see a worsening of Hong Kong's scores on political violence and business environment over the coming quarters. Indeed, in July 2020, Hong Kong Governor Carrie Lam decided

to postpone legislative elections by a year, officially due to COVID-19, although the decision came right after the government disqualified 12 pro-democracy candidates from standing in the elections due to their criticism of the government's recently introduced national security law. The latter makes crimes such as subversion, secession, terrorism and colluding with foreign elements punishable with up to life imprisonment. In response to the law, the U.S. has revoked Hong Kong's special trade status and introduced sanctions to prevent 11 Hong Kong individuals, including Hong Kong leader Carrie Lam, from participating in the U.S. financial system, also penalising U.S. financial institutions and individuals that do business with these individuals.

Sri Lanka's overall risk rating remains medium-high, driven by a political violence score of medium-high. However, sovereign non-payment risk has fallen to medium from medium-high, as the government has been carrying out fiscal reforms, improving public financial management, increasing investment and improving competitiveness. Yet these reforms have been slowed by the effects of COVID-19, as the fiscal deficit is set to reach 10% of GDP in 2020, and the risk of debt restructuring is actually rising. On the upside, COVID-19 fears resulted in the landslide victory in the August legislative elections of the Sri Lanka Podujana party of the strong-handed Rajapatra brothers, who are respectively Prime Minister and President. The election results should increase their ability to pass legislation and particularly economic reforms. But this ability is a double-edge sword, as the election results leave the party just a few seats short of the two-thirds parliamentary supermajority required to amend the constitution, which the brothers hope to do in order to reinstate an all-powerful executive presidential system, implying increased risks to democratic values.

In Mongolia, there was no change in overall risk, which remains medium, however we saw a minor deterioration in the banking sector vulnerability risk up to medium low from low. Indeed, supervisory enforcement has been insufficient to ensure that all banks have sufficient capital. However, we expect consolidation of banks and banking sector reforms to be forthcoming, as it is one of the priorities of the State Monetary Policy for 2020 and the June legislative elections saw the incumbent party retain a strong majority. This is already clear from the merger in late June of two of the country's six domestic systemically important banks, Trade and Development Bank of Mongolia and Ulaanbaatar City Bank. Meanwhile, the main institutional risks remain Mongolia's medium and medium-high political interference and regulatory risks, which have becoming increasingly evident recently from Rio Tinto's Oyu Tolgoy copper venture, where the government has been changing policy goalposts on the costs of supplying electricity to the mine.

In Taiwan, there has not been an overall change in risk, with Taiwan holding on to a medium-low level of overall political risk and risk of political violence. Yet there has been a deterioration in banking sector vulnerability from COVID-19, up to a medium-high level from medium, and Taiwan's banking system leverage should hit a record in 2020 of around 173% of nominal GDP in a pandemic-induced economic slowdown. More importantly, we think that there is a growing prospect of actual conflict in the region. Taiwan President Tsai Ing-wen's re-election as President in January 2020 elections has culminated in the rejection of Xi's hope of 'one country, two systems', yet given Beijing's clampdown on Hong Kong, it puts Taiwan increasingly at risk. Chinese fighter jets have been crossing the Taiwan Strait median line, which is an unofficial dividing line between the two countries. A formal declaration of independence by Taiwan would spark war. Meanwhile, following the cancellation of Hong Kong's special trade status with the U.S., discussions on a potential bilateral trade agreement between the U.S. and Taiwan have begun, although there is a high threshold for an agreement given Taiwan's strict rules on food additive ractopamine prevents it from importing U.S. pork.

Eastern Europe and CIS

Only one country in Eastern Europe and CIS saw its overall risk rating change this quarter; it is North Macedonia. Not only has the economic outlook in the region deteriorated markedly on the back of COVID-19, but it also continues to be affected by a morose outlook for oil, which is the main source of revenue for many countries in the region. Politically, the pandemic has tested democracies and authoritarian regimes alike. Crucially though, the pandemic has provided an ideal excuse for a number of regimes in the region to tighten their autocratic tendencies, threatening democratization and political stability, without even resulting in a more effective containment of the virus, quite the contrary. This intensification of authoritarian rule is highly visible in Russia, where President Vladimir Putin used the opportunity created by COVID-19 fears to launch a Constitutional referendum, which secured him the right to rule until 2036 on the premise that he would protect the population and provide continuity. In Belarus however, the authoritarian government was met with defiance by the local population and the political outcome of the standoff still remains unknown.

With an overall risk level increasing to medium-high, North Macedonia's score is driven by a medium-high risk of political violence. A significant rise in COVID-19 cases in the summer has resulted in increased protests against the perceived mishandling of the pandemic by the government. While the parliament has just approved a new coalition led by the Social Democrats, this follows a months-long leadership void amid the pandemic.

In Ukraine, the politicisation of the economy is increasing economic risk, irrespective of COVID-19. The IMF has vowed to cancel its USD 5 billion loan to Ukraine to deal with the effects of COVID-19 if President Zelensky failed to appoint a new a-political governor of the central bank - the previous one resigned due to political pressure from legislators allied to Igor Kolomoisky, an oligarch who backed Zelensky's presidential bid. Yet Zelensky had also complained about his predecessor's interest rate and exchange rate policies and concerns over central bank independence have increased. A new governor, who does not appear to have his predecessor's reformist credentials, was appointed in mid-July. Shortcomings in the legal system, corruption and inefficient state banks controlled by oligarchs are a thorn on the side of the country's development. Still, IMF financing has both helped to maintain the exchange transfer risk at medium-high and allowed the inability of government to provide stimulus to improve to medium from medium-high.

In Belarus, the risk of political violence is medium-high, mainly driven by political instability and we would expect it to rise. Following the July 2020 Presidential elections, mass protests erupted against incumbent President Alexander Lukashenko, as protesters argued the election results had been falsified and opposition candidate Svetlana Tikhanovskaya had won. Even if the protests are squashed eventually, their scale leaves no doubt as to the democratic awakening of the country and we would be surprised if Lukashenko were to hang on to power in the long-run, even with Russian support. We can expect continued instability until Lukashenko finally loses power.

In Azerbaijan, COVID-19 is exacerbating political violence along ethnic lines. The risk of political violence remains high and is likely to increase further, as the country's conflict with Armenia over the status of the Nagorno-Karabakh region is culminating into Azerbaijan considering war. New tensions began 300 km north of Nagorno-Karabakh in July and prompted tens of thousands of protesters to storm the Azeri Parliament, demanding a return to war. It is unclear whether ultimately, the government will choose this nuclear option, but it is certainly feeding the war rhetoric.

Finally, Russia's risk of political violence is still very high due to the threat of terrorism and increased military activity in the Baltics following Belarus' widespread protests. Political interference and legal & regulatory risks are respectively medium-high and high, with risk of political violence very high, due to corruption and low levels of voice and accountability, as the population feels unrepresented by state-run media organisations. This has been evident with eroding political support for President Putin. The mass social protests underway in Belarus have prompted Russian President Vladimir Putin to tighten the screws on domestic political repression, especially in the context of continued demonstrations in the province of Khabarovsk.

Latin America

In Latin America, no country exhibited an overall change in its risk score this quarter. Overall scores in the region are dragged down by a below average score in legal and regulatory risks and a number of countries have high and very high overall risk scores, namely Venezuela, Haiti, Cuba, and Bolivia. The lull in the widespread protests and social movements in Latin America, which resulted from COVID-19 lockdowns has ended, as we expected, with the virus accentuating social divides. As stimulus spending and government support for COVID-19 end, unrest will only intensify. Already, there have been protests in Argentina against the continued lockdown and plans for judicial reform. In Bolivia, roadblocks emerged

protesting against the postponement of elections, which has happened twice as a result of COVID-19. In Brazil, protests were up by one third in the first three months of the pandemic compared to the previous three months. In Chile, lockdown protests escalated to street demonstrations in defiance of quarantine in mid-July. Panama saw a wave of protests in July, largely by the poor and jobless complaining that income support promised by the government was not reaching them. And in parts of Central America and Mexico, violence among criminal gangs adds another dimension to unrest.

In Colombia, the inability of government to provide stimulus has fallen to medium-low from medium, as the government has shown a strong commitment to fighting COVID-19 with a full arsenal of fiscal tools deployed in a 2% of GDP stimulus. This, and perhaps the low COVID-19 mortality rate, explains why Colombia is one of the few Latin American countries which has escaped large-scale demonstrations this year. Yet this is unlikely to continue. As the daily average of new cases seems to be peaking and the economic crisis begins to bite, we should see protests flaring up. Students at the National Pedagogical University in Bogota, most of whom used to work in the informal economy, have been occupying university facilities since July 27, demanding the cancellation of university fees. Social and political pressures will also rise around pension and healthcare spending. Meanwhile, Colombia faces challenges raising tax revenues over the medium term, especially given an expected loss of oil-related revenues worth over 1% of GDP in 2021 and reduced tax revenues due to the 2019 Economic Growth Law. Finally, elections in May 2022 in Colombia may narrow the window of opportunity for reforms in 2021, so that fiscal and sovereign non-payment issues are likely to arise.

Paraguay's overall risk score remains medium, although legal and regulatory risks are high and political interference risk is medium-high. Exchange transfer risk has increased to medium from medium-low, but we think this will not last. COVID-19 cases have quadrupled since July, despite record low cases before that. The government recently announced an Economic Recovery Plan, which aims to address COVID-related issues but also longer-term structural issues, and we believe that this will diminish economic risks. For the near term, the plan seeks higher public investment, loan guarantees for informal and small enterprises and social transfers to poor households. On the structural front, it proposes civil service reform, a review of the fiscal responsibility law, administrative reform of the state and better public procurement systems, all of which boost the business environment long-term. That said, the government has asked the public works ministry to stop tenders this year due to fiscal issues, which leaves the infrastructure sector on a limb. The fiscal deficit shot up to 6% of GDP this year on the back of COVID-19 and the government is looking to increase bond sales this year to roll over debt.

Peru's overall risk rating remained at medium, but its banking sector vulnerability has fallen to medium-low, as effective financial sector supervision has contributed to preserving financial sector stability. The sector is also relatively safely financed by foreign direct investment. Overall, COVID-19 remains a major constraint on Peru's short-term economic outlook, given Peru has registered the highest death rate from COVID-19 in the world. Peru has obtained a USD 11bn Flexible Credit Line from the IMF to assist it in dealing with the record economic contraction that Peru will experience this year on the back of COVID-19, after administering an early and strict lockdown, which failed to keep the pandemic in check yet resulted in a doubling of unemployment. Still, Peru has abundant treasury assets, which, together with the IMF's credit line, should allow for a strong recovery in 2021-22, which is made more likely by years of sound policy management. Hence we think that any increase in economic risk will be short-lived.

In Suriname, exchange transfer risk has risen to high from medium-high, as Suriname is suffering from insufficient flexibility in its exchange rate, and investors fret on the back of an increasing risk of debt restructuring. Indeed, a 5% real GDP contraction in 2020 could put it on the edge of default. Even before COVID-19, public debt reached 72% of GDP in 2019. On the upside, two discoveries of offshore oil in recent months promise an oil bonanza for the country, assuming exploration proceeds successfully. It is estimated that the Suriname-Guyana basin holds 14 billion barrels of oil and 32 trillion cubic feet of natural gas. We expect the new coalition government headed by Chandrikapersad Santokhi to be supportive of business and continue with planned regulatory improvements, promoting investment and exploration, potentially bidding rounds for the remaining offshore acreage, and maintaining frontier terms for royalties.

Brazil's overall risk score remains medium. Although foreign investor confidence has returned, especially as COVID-19 cases have finally started to drop, interest rates are at a record low and expectations of growth are revived, risks associated with the passage of reforms are rising: administrative reforms will run into constitutional problems and tax reforms will be opposed by individual states. Yet the tax reform would allow President Jair Bolsonaro to extend subsidies to poor families,

which are at USD 100 per month and help the poor forgive Bolsonaro's mishandling of the crisis. Indeed, they have resulted in his record-high 37% approval rating ahead of the 2022 election; hence he is likely to find the means to get tax reform through. The flip side of the continued handouts is rising debt non-payment risk, which is currently at medium-high. In the best-case scenario, the government is projecting a return to fiscal stability in 2023, with debt stabilising over 90%, but the 2022 election already hinders achieving this target. Meanwhile, Brazil's risk of doing business score remains at high, as Bolsonaro's policies have received backlash from the public and foreign investors, especially when it comes to the recent resumption of the Amazon's fires, which have been related to his environmental policies or lack thereof.

Mexico's overall risk level remains at medium, with its lowest risks being legal & regulatory risks and supply chain disruption risk, which are both at medium-low. Its highest risk is exchange transfer at medium-high. While our model still has Mexico's sovereign non-payment risk at medium, we expect Mexico to be downgraded to junk in the next year, which should result in an increase in sovereign non-payment risk to medium-high. President Andres Lopez-Obrador's pledge to implement austerity is partly an attempt to keep the downgrade at bay, hence his minimal stimulus effort to fight COVID-19, but collapsing economic activity is set to boost public debt/GDP to 60% anyway. Meanwhile, the President's resolutely anti-business stance – he focuses on his pet projects instead - continues to put off investors, despite Mexico having the only positive real rates in Latin America. Investment is now at levels last seen in 1995. This policy environment combined with COVID-19 is likely to result in a 10% real GDP contraction in 2020. Here again, there exists the possibility of an increase in the risk of doing business from the current medium level.

The Middle East and North Africa (MENA)

Across the Middle East, no country has suffered any change in overall risk. However, Palestine has seen a reduction in both political interference and exchange transfer risks, while Egypt has seen a reduction in the inability of government to provide stimulus.

Instability and violence across the Middle East are still the main risks to the regional economic outlook. Yemen, Iran, Iraq and Syria are the highest risk countries at a very high risk level. The increasing likelihood of a Joe Biden presidency in the U.S. come November is causing many Middle Eastern leaders to rush to get things done before Biden revives Obama's diplomatic breakthrough with Iran. Crucially, Israeli Prime Minister Benjamin Netanyahu is keen to push ahead with the annexation of 100 Jewish settlements in the West Bank – the U.S. has already recognised the annexation of Arab East Jerusalem and the Golan Heights. In Libya, civil war is intensifying with the possibility of a conflict between Russia and/or Egypt against Turkey. In Iran, there have been explosions at missile, power and petrochemical plants, likely carried out by Israel. This is likely to result in reprisals, like the explosion of the Saudi Aramco facility last year, which followed U.S. sanctions. Meanwhile, the United Arab Emirates' deal with Israel underscores that Palestine's concerns have become low-priority for Arab powers compared to creating alliances against Iran.

Egypt has an overall risk rating of high, while the risk of political violence remains very high. The regime has cracked down on dissent related to its handling of the COVID-19 crisis, with doctors and nurses critical of the regime being recently arrested. Once the pandemic is over, if repression does not diminish, there is scope for increased protests. Meanwhile, the inability of government to provide fiscal stimulus has fallen to medium-high from high, as fiscal stimulus has been limited so far, and we expect Egypt to remain committed to its reform program. Since March, the government has announced fiscal stimulus totalling EGP 180 billion or 2.8% of GDP. Externally, Egypt has threatened a military offensive in Libya if Turkish forces seize the port of Sirte, which is meant as a re-assertion of Egypt's role in the region, implying that Russia and Turkey cannot carve it up without Egypt challenging them.

Palestine has a high level of overall political risk, although the risk of political interference has fallen to medium-high from high. The normalisation of relations between the United Arab Emirates and Israel (without securing concessions that benefit Palestine) has angered Palestine. This is especially so, given that Israeli Prime Minister Benjamin Netanyahu has said he still has plans for West Bank annexation and the agreement only points to its suspension. It highlights that Palestine's concerns have become low-priority for Arab powers compared to creating alliances against Iran. Meanwhile, the economy is heavily constrained due to Israel's control of the borders. This feature has been highly problematic in the context of COVID-19, in that Palestine had to wait for Israel to decide on a lockdown before it could take action. Similarly, the central bank is in no position to provide a significant stimulus to fight COVID-19, and it does not control its own currency – the economy operates on a mix of Israeli shekels, Jordanian dinars, and some dollars and euros. Restrictions on the movement of goods are imposed through permit systems and import/export restrictions. Hence, access to resources is significantly reduced and the recent fall in exchange transfer

risk to medium from medium-high is unlikely to last. Israel collects export taxes on behalf of the Palestinian Authority. However, the Palestinian leadership's severing of official ties with the Jewish state, during the row over annexation, has left Israel with USD 500-650 million in Palestinian taxes, depriving Palestine of nearly two-thirds of its government revenue. The knock-on effect is that tens of thousands of Palestinian employees will receive less than half of their monthly salaries. In this context, COVID-19 has aggravated tensions significantly.

Libya's overall risk score is among the highest in the world. The country's already very high risk of political violence has recently risen due to regular terrorist attacks. It is fast becoming the stage for a proxy war between world powers, since Egypt threatened to deploy troops to counter Turkey, which is sending arms, troops and Syrian militias to back the Tripoli-based Government of National Accord (GNA), while Egypt, Russia and the UAE back General Haftar, whose forces control Sirte and eastern Libya. Foreign backers are pouring weapons into the two forces, openly breaching the U.N. arms embargo and the ceasefire announced on 21 August by the GNA. Haftar has not commented on the ceasefire, but his officials have dismissed it on the grounds that it is a distraction to allow the GNA to reinforce its troops to take the strategic port of Sirte. The odds of a direct conflict between world powers in Libya are high. While the blockade on oil exports has just been lifted, General Haftar has not commented on the possibility of full production resuming at the National Oil Corporation.

Iran's overall risk level is very high, and it is driven by very high legal and regulatory risk. Beyond high political violence risk, the country has a high risk level on political interference, sovereign non-payment, exchange transfer and a high risk of doing business. Exchange transfer risk could even increase further, as the rial is collapsing from COVID-19 panic and the U.S.' punitive measures, and as exporters now risk prosecution if they move foreign exchange revenues abroad. Less than half of foreign exchange revenues were repatriated over the past two years. On the external front, the U.S. is now looking to re-impose U.S. sanctions on Iran. These were waived by the Obama administration in 2015 in the context of its nuclear deal with Iran, which the U.S. withdrew from in 2018. Through the 2015 Iran nuclear accord, Tehran pledged to abide by limits on its nuclear programme in return for sanctions relief. Meanwhile, Iran has agreed to open two sites to the International Atomic Energy Agency, a sign of its willingness to cooperate with the deal.

Sub-Saharan Africa

In Sub-Saharan African, no country has seen a change in its overall risk rating. However, Senegal, Gambia, Equatorial Guinea, CAR, Cameroon and Burkina Faso have all seen a change in their banking sector vulnerability. Burkina, Gambia and Cameroon have seen their banking sector vulnerability increase, CAR's, Senegal's and Equatorial Guinea's has decreased. Most of these changes highlight the banking sector's particular sensitivity to governments' abilities to manage the COVID-19 crisis. In turn, it hinges upon the ability of COVID-19 funding to be translated into lending to the private sector. In other words, in Sub-Saharan Africa, banking sector vulnerability is highly codependent on institutional strength and absence of corruption. In fact, corruption has had a major impact on the siphoning off of COVID-19 emergency funding, with even the most developed economy of the region, i.e. South Africa, dealing with significant misuse of funds. So much for the effectiveness of the IMF's historic USD 4.3 billion emergency loan to South Africa. Kenya and Uganda have suffered a similar fate with deviation of COVID-19 funds.

Africa has the lowest number of COVID-19 cases in E.M., and a low fatality rate due to a young population and higher temperatures. Yet it has not prevented a massive economic hit from the virus. Economic implications are already visible, with foreign investment falling 58% y/y in the first three months of the year.

Burkina Faso has a high overall risk level. COVID-19 has compounded existing challenges posed by the security crisis in the Sahel region, which is centred around Mali but has spread to other countries, including a previously stable Burkina Faso, where thousands have died last year alone. The crisis has resulted in a high number of internal displacements and humanitarian assistance needs. As a result of the crisis, vast swathes of the country are now ungoverned. Hence the IMF has disbursed a USD 115.9 million COVID-19 loan to Burkina Faso. There are chronic shortages of ventilators to deal with COVID-19, with only 11 functioning ones for 19 million citizens. Yet the inability of government to provide stimulus remains at medium, despite French President Emmanuel Macron committing to reallocate EUR 1.2 billion in aid to address the COVID-19 crisis in 19 countries, including Burkina. Banking sector vulnerability has increased to medium from medium-low, as non-performing loans have jumped as a result of the pandemic.

Cameroon presents a medium-high overall risk. It is facing urgent financing needs driven by the twin COVID-19 pandemic and terms of trade shocks. Externally, Cameroon is exposed to demand and supply shocks due to the slowdown in major trading partners China and Europe and falling oil prices. An increase in sovereign debt non-payment risk above the current medium-high is likely; indeed, Moody's has placed Cameroon on negative watch for a downgrade due to the risk of losses to private investors from its decision to accept the G-20 moratorium on debt repayments. While the moratorium should have a positive impact on debt sustainability, a downgrade would offset this impact by increasing the cost of new debt issued on the markets. Banking sector vulnerability has increased to medium from medium-low, as the pandemic has increased non-performing loans.

South Africa remains a medium risk country, well above the regional average, although political violence risk and risk of doing business are both medium-high. The COVID-19 crisis has highlighted high levels of corruption, which have jeopardized the effectiveness of COVID-19 financing. Lack of structural reforms amid ANC internal divisions, the backlash of South Africa's sovereign downgrade to junk in March, just as the COVID-19 crisis was taking off, and the final blow of COVID-19 itself pose upside risks to sovereign non-payment risk, which is still at medium for now. The government's ZAR 500 billion stimulus, which includes ZAR 200 billion in loans to businesses, has intensified this risk, with the government's budget deficit projection for 2020/21 doubling to 15% of GDP. The IMF agreed to a USD 4.3 billion COVID-19 emergency loan to South Africa at the end of July, which is the largest financing it has given to a pandemic-hit country. While it is not tied to specific conditions on paper, we would expect the IMF to pressure South Africa to deliver structural reforms for continued disbursement in practice, and a regular IMF structural adjustment programme cannot be ruled out once the emergency funding runs out.

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