

# Country Governance Research Commentary

## April 2017

### Country Ranking Trends

After last month's review of shareholder protections some new information became available. In reviewing the information, the Czech Republic, Malaysia, Mexico, Philippines, and Russia all received minor upgrades, while Qatar was further downgraded.

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### European Fears Not Realized, but French Vote Doesn't Settle Much

Prior to the first-round vote in France, the fear in Europe had been that top presidential candidates advancing to the decisive second round would be the euroskeptic candidates from the far-left and far-right. Instead, the political newcomer, Emmanuel Macron from the new En Marche party is running in the second round against the second-place finisher, Jean-Marie Le Pen from the far-right National Front party. Macron campaigned on a platform supportive of Europe and globalization, coupled with calls to overhaul the rules governing the French economy. With support from first round opponents coalescing around Macron he is expected to win handily, but of course recent history suggests caution in predicting election outcomes.

**Implications:** The vote in France was a choice between rapid dissolution of the EU versus continued modest changes and probably slow fraying around the edges. Assuming Macron has the easy time forecast by experts, the "slow fraying" scenario will continue uninterrupted. Magni's overall view of Europe is unchanged. Over the long term, there appears to be significant upside opportunities in the European countries with the best governance, though the opportunities will probably not be realized until the fraying stops and the issues are resolved; either by dissolution of the EU or by a major structural change.

### Perp walk is the new Brazilian Samba

Just as Brazil begins to emerge from its worst recession on record, new headwinds are emerging as the ongoing corruption scandal continues to ensnare more politicians. Specifically, eight of President Temer's ministers have been placed under investigation for alleged participation in a bribery network. Deep interest rate cuts and market-friendly reforms could help maintain and accelerate economic growth. If the landmark pension reform fails to pass through Congress in coming months, growth may falter. This reform is a central part to keeping Brazil's debt under control in the long term. Without changes to pensions, the government will probably not be able to enforce its spending cap and public debt could become unsustainable. With a slew of representatives from the country's three main political parties named, the investigation could have a knock-on effect on next year's presidential elections, including greater chances for political outsiders in upcoming elections.

**Implications:** The ever-expanding corruption scandals reflect well-recognized weaknesses in Brazilian governance. Improving governance requires unpopular reforms. Countries in Central and South America have a track record of choosing populists over reformers with populists hurting instead of helping long-term economic prospects. Magni will be watching to see if Brazil can avoid the populist trap and find either an untarnished existing politician or an outsider who has the political leadership to enact the required reforms.

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### Why is Xi like One of China's Great Gymnasts?

China has removed three of its four top financial-industry regulators over the past year as it tightens the regulation of banks, brokerages and insurers. The latest to go is chairman of the China Insurance Regulatory Commission, who is being investigated for suspected violations of the code of conduct of the Communist Party of China. The exact nature of misconduct has yet to be revealed, but the loosening of controls around risky investments by insurers has been controversial. After encouraging liberalization in hopes of fueling a slowing economy, Beijing is becoming increasingly anxious about possible financial shock. In recent months, financial regulators have issued more than two dozen notices aimed at controlling systemic risk. One key focus is to eliminate regulatory arbitrage between banking, securities and insurance regulators and to contain rising financial risks from years of debt-fueled stimulus. The regulatory push is also seen as an attempt to lessen the chances of a financial flare-up tarnishing the Communist Party's next five-year leadership meeting, which is expected to be held later this year.

**Implications:** China is taking serious steps to improve governance. Magni has upgraded China several times for the improvements, however the cumulative improvement has not been sufficient to improve the country's relative rank among investible countries. With an asset bubble and multiple forces creating headwinds against growth, Xi faces a floor routine tougher than any gymnast's balance beam act. He must continue sometimes-painful reforms, while avoiding a recession, a financial crisis, and/or an uprising by angry citizens. Magni expects the market volatility of recent years to continue, while the longer-term prospects depend on the continued careful balancing of many considerations.

### Is Turkey at a Zenith?

The word zenith comes from an inaccurate reading of an Arabic expression (roughly transliterated as "*samt ar-ra's*"). The expression means "path above the head". This sense of noble high point is apt as Turkey has improved more under Erdogan than Western media tends to report. Yet, the recent vote could well mean that the governance in the country starts going downhill, while the day before the recent election was Turkey's and Erdogan's zenith.

Voters in a national referendum narrowly backed the largest overhaul of Turkey's political system since the founding of the republic nearly a century ago, transforming Turkey's parliamentary government system into a presidential one with strong executive authority. The referendum approved 18 constitutional changes, including abolishing the office of the prime minister and granting sweeping executive powers to the president. International monitors, including from the Organization for Security and Cooperation in Europe, noted irregularities in the voting, which took place under a state of emergency imposed in the wake of last year's failed coup. Turkey's longstanding bid for EU membership was already in doubt and with the latest developments could be essentially halted.

**Implications:** The changes approved in the referendum do not directly change the Magni Country Score for Turkey. The referendum did centralize power and centralized power has generally been inconsistent with good governance. Turkey has improved over the last decade and Magni will be watching to see if the new powers lead to adverse changes material to economic prospects.