

Magni Client Commentary

Talking Points on International Governance Research and Investing

July 2016

Country Ranking Trends

- Magni conducted a review of its Economic Standard on Payment Systems. New sources of information are now available which provide a more complete understanding of each country's payment systems, including central securities depositories, settlement systems, and counterparty repositories. This new information provides a deeper understanding of the openness, honesty, and transparency of payment systems.
- When this additional information was used to assess countries, there were some significant changes in country scores. About 1/3 of countries were impacted. In terms of relative ranking, Singapore, Russia, and Hong Kong moved up several places in ranking, while the rest of the impacts were small.

Can Malaysia Use the 1MDB Scandal to Improve?

- The Malaysian investment fund, 1MDB, is now under investigation in the US and at least 9 other countries for offenses related to money laundering and embezzlement. A lack of transparency at 1MDB combined with a complex web of companies and investments funds created an environment that allowed billions of dollars to be siphoned to politically connected actors, including the current prime minister. While the international investigations continue to move forward the results of Malaysia's own internal investigations have been less encouraging. Malaysia has promised to cooperate with any lawful international investigations, but its poor compliance with international money laundering standards gives reason for skepticism.
- Magni frequently views scandals as lagging indicators of underlying corruption. In other words, scandals occur everywhere and the timing of public disclosure of a scandal frequently involves motives other than good governance, such as political advantage for the person or organization encouraging disclosure. However, a government's response to a scandal can provide information about the quality of governance and could cause Magni to upgrade or downgrade a country. Further, transparency is the best inoculation to reduce the frequency and scale of corruption. It is why transparency is one of the primary drivers of high Magni scores across the 12 Economic Standards.

Will Italy Force an End to Kick the Can?

- The upcoming release of Europe's latest round of bank stress tests is causing anxiety as to the depth of underlying weakness that the results will expose. In particular, attention has focused on the Italian banking sector where as much as 18% of bank loans are estimated to be non-performing. An unwillingness to impose losses on small individual investors, who make up a large portion of the Italian bank bond market, has led to reluctance by Italian authorities to take swift action to deal with their bad loan problem. Any injection of public funds into struggling banks risks running afoul of recently enacted, but as yet untested, EU regulations meant to protect taxpayers from paying for bailouts unless bank investors also suffer losses. The ultimate resolution of this episode will also have an impact on an upcoming constitutional referendum called by Matteo Renzi for this coming October. The referendum is meant to streamline government in order to accelerate Renzi's reform agenda, but the results are likely to

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be close and if the referendum fails Renzi has said he will step down. Polls show a new election would bolster Italy's Eurosceptic Five Star party.

- The Eurosceptic forces are growing in the western European nations. Events in Italy appear to be yet another catalyst for unhappiness with the EU. The EU will find it increasingly difficult to “kick the can down the road” as it has on most recent matters and hence they will face the difficult choice of reform or additional Brexit-like referendums among member states.

Will Abe Use his Electoral Win to Reform Japan?

- The Liberal Democratic Party-led ruling coalition won the majority of seats in the recent Upper House elections giving them political momentum to pursue Prime Minister Shinzo Abe's stalled structural reforms. In the near term, the more likely action to be taken will be the passage of what is reported to be the Abe government's largest fiscal stimulus package to date. There is also talk of possible further monetary experiments.
- Longer lasting impact will come from a recommitment to economic reforms along the lines proposed by Abe; instead of short-term stimulus. If such reforms are implemented, Japan's prospects will improve and Magni will upgrade their score.

The Dust Needs to Settle in Turkey

- In the aftermath of Turkey's failed coup attempt, the government of President Erdogan has launched an unprecedented purge of the judiciary and government bureaucracy. Nearly 45,000 government employees have been suspended and close to 10,000 people have been detained. The ostensible reason for the purge is to expel supporters of the U.S.-based imam Fethullah Gulen, who Erdogan's government blames for the coup attempt. However, given the breadth and scale of the government's moves critics see an attempt to cripple opposition and stifle dissent. This fits a recent pattern of his attempting to consolidate and strengthen power in the hands of the presidency. The coup and subsequent crackdown has led to downgrade warnings from all three major credit rating firms and is also causing tension with the European Union.
- So far, the actions do not impact the legal, regulatory, accounting, and economic infrastructures of Turkey and hence Magni has not downgraded Turkey. More time will be required in order to determine whether the coup will have an impact on the country's prospects moving forward.