Magni Client Commentary

Talking Points on International Governance Research and Investing

September 2016

Country Ranking Trends

- September was less quiet than the prior month, though this increased activity did not result in many changes to Magni Country Scores. Populism continues to be a potent force and it is a source of much activity. Populist governments tend to focus on “ends justify the means” efforts instead of structural reforms. Even in well run countries, proposed economic reforms can get “watered down” in the legislative process. Once approved, the implementation can take time. Magni Country Scores recognize public statements of intention, though the highest scores occur following successful implementation.
- Simply said, there is a lot to watch, but much less to report. This commentary’s articles on Brazil and Russia highlight some of what Magni is watching. Magni completed a review of key aspects of Russia's financial system. As a result of the review, Market Integrity was downgraded. While recent reforms move Russia in a good direction, the scores in Financial Regulation and Banking Supervision were not changed. Magni requires more complete and effective implementation of reforms, before upgrading these scores (see article further down).

When Will Brazil Address the Causes of Corruption?

- Michael Temer, who is now Brazil's President following his predecessor’s impeachment, is attempting to push controversial austerity measures through congress to help bolster Brazil’s troubled economy. One such measure is a proposed constitutional amendment to limit growth in public spending for up to 20 years. Centrist parties have pledged their support for this plan, raising the prospect for quick approval. Complicating his reform agenda is a recent Supreme Court decision allowing prosecutors to open a probe into corruption allegations that Temer had solicited campaign donations from an illicit source. Mr. Temer likely won't be targeted by the probe while he remains in office, thanks to special legal protections afforded to sitting Brazilian presidents. However, the ongoing scandal risks eroding his already limited political capital.
- Austerity programs do not directly impact Magni Country Scores. Actually undertaking structural reforms that would make corruption more difficult and that would provide better transparency so corruption can be more easily discovered is a different matter. Such reforms would improve Brazil’s relatively low score.

Immediate Small Downgrade for Russia with Potential Future Upgrades

- Magni reviewed several aspects of Russia's financial system stability, including banking supervision, securities regulation, and money laundering. The availability and accuracy of beneficial ownership information is deficient and Magni downgraded Russia in the area of Market Integrity. In the areas of banking supervision and securities regulation the Central Bank of Russia (CBR) recently assumed the responsibilities of unified regulator facilitating greater oversight of the financial system. Major reforms have been introduced that increase CBR’s duties and powers in many respects, although implementation has not yet been well tested. In addition, adherence to international standards is hampered by complex and inconsistent legislation with many overlapping provisions. The regulatory approach is also highly rules based, which presents challenges to an effective risk based supervisory regime. Until Russia makes greater progress on these good, but nascent reforms, Russia's ratings for Financial Regulation and Banking Supervision are unchanged.

Back to the Future on Banking Supervision

- The Basel Committee on Banking Supervision will soon finish the post-crisis capital framework known as Basel III. The new framework will shift from risk-based capital rules and back toward simpler capital ratios. Banks are concerned proposed changes could greatly increase capital requirements. However, the Group of Central Bank Governors and Heads of Supervision, which oversees the Basel Committee, has sought to give assurances that the proposed rule changes would not significantly increase overall capital requirements. The European Union has said they may opt out of the new global rules if the changes are seen as disadvantaging their domestic banking industry. Any country refusing to adopt the new framework could undermine the goal of a global approach to preventing financial crises.
- The risk-based capital rules from previous Basel frameworks systemically under recognized the risks in Residential Mortgage Backed Securities (RMBS) and in sovereign debt. The artificially low risk assessment on RMBS instruments helped increase the severity of the financial crisis. The artificially low risk assessment on sovereign debt in countries such as Greece helped hide the severity of the southern European debt problem. While theoretically sound, risk-based capital rules are subject to gerrymandering and the potential problems arising from this gerrymandering far outweigh the theoretical advantages. Simpler capital ratios reduce the opportunity for gerrymandering and are hence less likely to generate systemically under recognized risk assessments. Once the Basel framework is approved, Magni will be watching for countries that do not adopt it.

Populist Backlash Against Globalization Hurting Growth

- Further evidence of the adverse impacts from the populist backlash against globalization continue to emerge. A recent OECD report warned that the backlash was having a negative impact on the world's growth potential. Growth expectations for the year have been lowered slightly to 2.9 percent. This rate of growth would make 2016 the weakest year for global growth since the financial crisis of 2008-2009.
- A low-growth trap may be taking root, as poor growth expectations further depress trade, investment, productivity and wages. The OECD said newly imposed protectionist measures should be reversed, while existing tariff and non-tariff barriers to trade should be reduced and regulations harmonized. It also said impediments to cross-border investment by businesses should be removed.