

Magni Client Commentary

Talking Points on International Governance Research and Investing

October 2016

Country Ranking Trends

- Magni completed a review of auditing changes in the European Union. Following the review, eight countries were modestly upgraded for the progress they have made in strengthening their auditing requirements. The impact of the improvements will be to provide even greater comfort that the financial statements of companies listed on the major European exchanges are representative of the actual operations in those companies. Investors consider analyst projections of future earnings as having more value when the underlying financial statements are more accurate.
- As with last month, there is a lot to watch. Thailand, Philippines, Colombia, and Japan have situations where various forces and political considerations are preventing much-needed reforms, though of the four, Colombia probably has the most promising situation.

Death of a King Creates Thai Uncertainties

- King Bhumibol Adulyadej died on October 13th and the military junta declared a year of mourning. Given the country's polarized politics the king had been a unifying figure in the country over his 70-year reign. His death may lead to further delays in holding the general election, which is to transfer power back to civilian control following the latest military coup. Adding to concerns are fears of a contested royal succession following the crown prince requesting time to mourn before taking the throne. The promulgation of a new constitution is another required step before general elections can be held. The country's latest constitution, approved by a national referendum in August, awaits the new king's signature. Higher political tension may also impede structural reforms, which are crucial for boosting Thailand's growth potential.
- The political machinations are likely to stall any potential economic reforms and hence likely to keep Thailand's relatively low Magni Country Score at its current level.

Can the Philippines be Populist and Still have Economic Reform?

- The economic fundamentals in the Philippines are solid, but erratic statements by the new Philippine president Duterte have created uncertainty that is raising concerns. Most recently, his announcement that he would realign his country with China had to be later taken back and clarified by his administration. There are also concerns with the rule of law given the reports of large numbers of extrajudicial killings in his war on crime. It's still early in his term and he has so far retained the support that brought him to power in a country frustrated with conventional politicians. Despite his sometimes-controversial actions, the economic appointees he has brought into his administration have been well respected technocrats. Also, the IMF in their most recent evaluation had a positive outlook for the Philippine economy and for its anticipated economic growth. There is a risk is that the populist rhetoric of Duterte damages investor confidence and disrupts these positive trends, but so far the behind-the-scenes developments have been more reassuring.
- While the Philippines has both reasons for optimism and for pessimism, the observable and verifiable changes to the legal, regulatory, accounting, and economic systems are minimal, hence the country's Magni Country Score is unchanged. If the populist

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sentiments erode the rule of law, the score will decline. Conversely, if the technocrats prove effective in strengthening the business environment, the score will increase.

Will Colombia Finally Unlock Its Potential?

- In a referendum held earlier this month voters narrowly rejected a peace deal negotiated between the government of Colombian President Santos and the Revolutionary Armed Forces of Colombia (FARC). The agreement reached after four years of negotiations would have formally ended the 52-year-old conflict. Critics of the accord complained among other things that it went too easy on the rebels. The government expected that the country would see post-conflict benefits through better security and increased investment. The government is now trying to negotiate a new deal acceptable to both the FARC and the opposition. The risk is that continued political uncertainty could delay the adoption of important economic reforms. In particular, a much-needed tax overhaul which could help revive the economy appears to be delayed. The current loophole-ridden system assures that few Colombian companies and individuals do indeed pay the highest marginal rate of 70%.
- The complexity of the approval process for a peace deal stands in the way of a promising situation. Colombia has one of the better prospects for an improved Magni Country Score.

A Stimulated, but Unreformed Japan Continues to Stagnate

- The Japanese economy continues to struggle. The Bank of Japan has implemented a new round monetary easing measures that includes a commitment to keeping the interest rate on year 10-year government debt at zero. Despite over 3 years of aggressive easing, Japan's central bank has been unable to generate its objective of sustained inflation. Another fiscal stimulus package has been passed in hopes of adding to the effectiveness of monetary policy. However, Japan's continual spending since the 1990s has brought government debt to nearly 250% of annual economic output, the worst ratio in the world, without breaking the protracted period of stagnation. There is also concern that heavy spending could backfire by adding to public concern about Japan's economic future. What has been missing is the so-called third arrow of Abenomics, namely structural reforms such as lightening the regulatory burden and reforming the labor market.
- Making progress on the more difficult steps that will increase the economy's long-run growth potential is critical to overcoming multiple decades of stagnation. Japan has a relatively low Magni Country Score for being such a developed country. The reforms, if implemented, would increase Japan's score and its relative position among the other countries in the developed markets.