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Rising political risks cloud outlook for Asian economies

Political risks in Asia have increased, according to Coface's Political Risk Model. Asia currently ranks above the world average in terms of political risk, behind the Middle East and North Africa (MENA), Sub-Saharan Africa and Latin America. Although political risks in Asia have remained broadly stable relative to other parts of the world, some exceptions are notable. These risks could cloud the outlook for some economies going forward. Much of the systemic sources of political risk are related to the continent's dynamic growth and existing social fragilities. It appears that most of the increases in recent years have been due to rising political fragilities, associated with a proliferation of less democratic styles of governance.

In terms of geographic differences¹, South Asia features the highest political risk score, followed by Southeast Asia. East Asia featured the fastest pace of political risk increases since 2007, led by increases in China. Our model also attaches a terrorism "penalty", in countries where there is a high number of conflicts and terrorist attacks. South and Southeast Asia feature high levels of ethnic, religious, and linguistic fractionalisation, resulting in tensions between the different groups. Noteworthy examples of this can be seen in India, Pakistan, Myanmar and the Philippines.

Measuring political risk in the Asia-Pacific region

Political risks are often associated with endogenous sources of fragility, both political and social, which increase the likelihood of risk events taking place, often with ominous costs for citizens and the economy itself. Examples of such events include the Rohingya crisis in Myanmar, where the plight of hundreds of thousands of refugees prompted the European Union and other international observers to impose sanctions in June 2018. Kashmir, where formal borders are yet to be defined, remains a point of contention between India and Pakistan. More recently, protests erupted in the territory over claims that India would cancel Article 35A, which grants special rights to permanent residents of

Jammu and Kashmir. Elsewhere, the Korean peninsula is a looming source of political risk – for example, in early 2018 financial markets reacted to global fears of a war with North Korea, draining billions in liquidity out of Asian economies.

Economic growth and political risk are interconnected. Deteriorating economic conditions are likely to result in higher political risk, and vice versa. For example, a rise in unemployment, inflation or income inequality can exacerbate social discontent. But more importantly, increased political risk can adversely affect economic activity. The impact of political risk on growth primarily involves two transmission channels. First of all, outflows from an economy may lead to falling equity markets and rising bond yields, which worsens financing conditions, making it costlier for agents in

1 - East Asia (China, Japan, Mongolia, South Korea); South Asia (Bangladesh, India, Nepal, Pakistan, Sri Lanka); Southeast Asia (Cambodia, Hong Kong, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam); Oceania (Australia, New Zealand).

the economy (households, companies and the state) to repay their debt and make new investments. Higher debt servicing costs also reduces levels of corporate and household confidence, prompting delays or cancellations in investment and spending decisions. If this situation is prolonged, a third channel may also occur: that of budget policies. In the event of a long-lasting government vacuum, the resulting freeze on public spending causes a negative impact on activity.

Coface calculates political risk scores for 159 countries around the world annually. Our Political Risk Model² takes into account a wide variety of indicators related to political risk. These are grouped into three main categories of political risk: 1) political fragility, 2) social fragility, and 3) security risks (including risks of conflict and terrorism). According to this methodology³, Asia ranks above the world average in terms of political risk (Chart 1). In terms of regional disparities within Asia, political risks were highest in South Asia, followed by Southeast Asia, East Asia and Oceania.

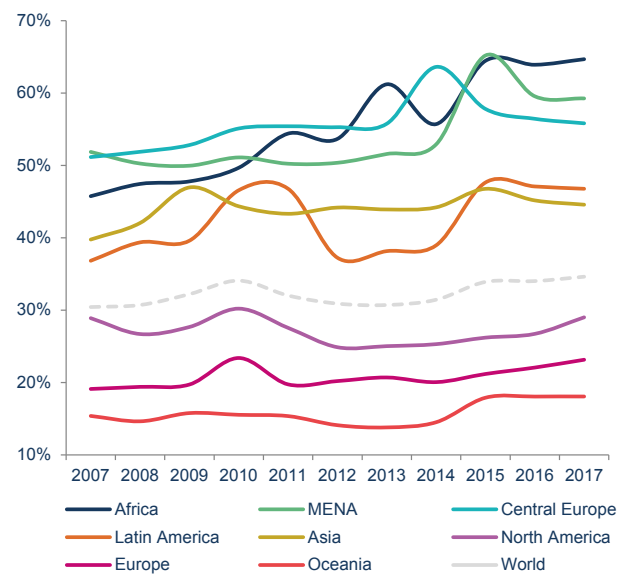
Political fragility drives rise in Asia risks

Despite having lower levels of overall political risk, East Asia featured the fastest increase in Asia since 2007. In addition, political fragility accounted for the bulk of the increase in political risk in Asia. High risk scores are attributed to economies that possess less free regimes, as measured by Freedom House⁴. A large proportion of the economies classified as “not free” or “partially free” by Freedom House are located in Asia. However, most of this can be traced back to China. Coface’s model registered a rise in political risks in China of 7.2 percentage points between 2007 and 2017, reaching 45.8% in 2017⁵ (Chart 2).

20%
Of economies classified as “not free” or “partially free” by Freedom House are in Asia

China’s “economic miracle” has set an important precedent for emerging economies in Asia and beyond to emulate. However, rapid development has come at the cost of greater political fragility. Understanding that stability is crucial for the successful implementation of an ambitious reform agenda, authorities in China have resorted to tightening their oversight on the economy and access to information. China’s anti-corruption campaign, the heightened use of internet surveillance, and travel restrictions on selected minorities and regions all serve this same purpose. More recently, the government introduced a system of “social credit”, which looks into the content that users share on social media. Suppressing social instruments has been an important part of managing social pressures in a Chinese context⁶, something other countries in the region have noticed, as we shall see below.

CHART 1
Political Risk around the world



Source: Coface Political Risk Model

CHART 2
Political Risk scores in Asia (2017)

| ECONOMY | 1 | 2 | 3 | 4 | 5 |
|-------------|-----|-----|-----|-----|------|
| Pakistan | 69% | 65% | 55% | 38% | 100% |
| Thailand | 59% | 67% | 52% | 24% | 75% |
| Philippines | 59% | 57% | 49% | 28% | 86% |
| India | 56% | 44% | 41% | 35% | 96% |
| Myanmar | 54% | 0% | 53% | 28% | 57% |
| Laos | 48% | 88% | 54% | 0% | 18% |
| China | 46% | 62% | 56% | 3% | 34% |
| Malaysia | 45% | 60% | 54% | 3% | 37% |
| Indonesia | 40% | 55% | 44% | 0% | 44% |
| Vietnam | 39% | 64% | 55% | 0% | 0% |
| Cambodia | 33% | 44% | 52% | 0% | 1% |
| Singapore | 29% | 58% | 36% | 0% | 0% |
| Mongolia | 26% | 26% | 45% | 0% | 0% |
| South Korea | 20% | 18% | 36% | 0% | 9% |
| Australia | 19% | 26% | 16% | 0% | 34% |
| Japan | 14% | 8% | 22% | 0% | 19% |

1. Overall score
2. Political fragility
3. Social fragility
4. Conflicts
5. Terrorism

Source: Coface Political Risk model

2 - Daudier, J-L., Nizard, R. & Tozy, S., 2017. Panorama: The rise and rise of political risks, Paris: Coface

3 - In order to take into account the relative importance of the different regions, we used GDP weighted averages

4 - Freedom House. Accessed August 2018. <https://freedomhouse.org/report/freedom-world/freedom-world-2018>

5 - Base effects also play a role. Gross Domestic Product (GDP) reached 82.7 trillion yuan (USD 12.86 trillion) in 2017, accounting for 24.2% of total GDP in Asia, up from 11.6% in 2007. In other words, China contributes a larger share on the GDP-weighted average relative to 2007 levels. This is fair given the relatively larger significance and subsequent impact that developments in China may have for the region and the world.

Social fragilities persist despite rapid economic development

China features the highest social fragility score in East Asia. Pressures include a relatively high level of income inequality, as defined by the GINI coefficient (Chart 3). Corruption perceptions⁷ (Chart 4) and a lack of freedom of expression⁸ (9/100) also remain important factors behind growing social pressures. Additionally, these will not be aided by unfavourable demographic trends (fertility rate 1.56), which will have a marked impact on the country's social security system as well as on the next generation's ability to service burgeoning debt levels (260% of GDP)⁹. Complimentary to the uptick in social pressures, social instruments increased as a result of fast development. Access to higher education (from 20.5% in 2007 to 48.4% in 2017), rising urban populations (from 43.9% in 2007 to 56.8% in 2017) and access to the internet (from 10.5% in 2007 to 50.3% in 2017) all facilitate the expression of social pressures. A centralised approach was adopted in response to these pressures.

But not everything has become more restrictive in China. In 2015, the central government announced plans abolish the "One-Child Policy" to allow couples to have two children. This seeks to tame the weight of social fragilities heightened by China's ageing population. Reducing corporate debt and curbing housing price speculation remain key priorities, despite bullish calls for massive fiscal and monetary stimuli. Measures to reform public healthcare and the pension system have also been launched, though progress on these fronts remains more muffled.

Social fragility scores were also high in South and Southeast Asia. In tune with events in China, economic activity has been good (+7.3% & +4.3% respectively in 2016), but social pressures have been growing as a result. For instance, income inequality remains rampant

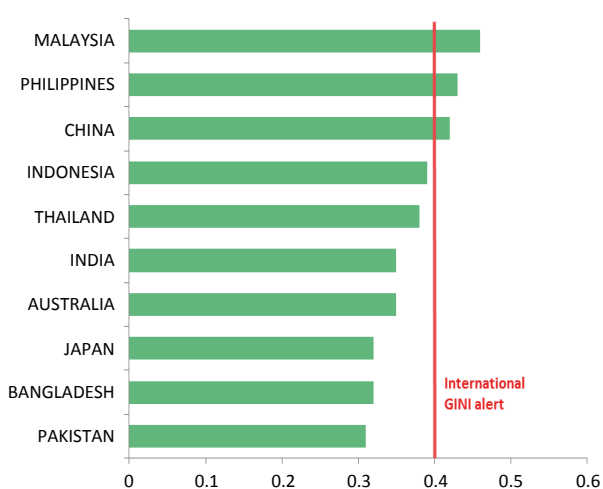
in Malaysia (Gini score of 0.46), Philippines (0.43) and Indonesia (0.39). Poor corruption perception scores and low rankings on the World Bank's "Ease of Doing Business" list are certainly not helping. Moreover, a combination of high inflation and currency depreciation has contributed to the perception of stagnant income levels, adding to social pressures. Given the relatively high income inequality in the region, this is an issue that predominantly affects lower-income households (Chart 5).

Economies in South and Southeast Asia are characterised by large, young, urban classes with rising access to education and information (Chart 6). This means that their populations have access to a growing number of instruments that enable them to express their dissatisfaction with existing pressures, explaining higher overall levels of political risk. A more controlled approach, favoured by China, offers benefits in the short term, which is why governments such as those in Manila and Bangkok have started to favour a more centralised approach. However, being able to respond to growing social pressures may also prove advantageous in the long term – playing an important role in reducing political risk by catalysing change.

A good example of these forces at play is in Malaysia. The results of the May 2018 general election saw former Prime Minister Najib Razak's party lose for the first time since the country gained independence 60 years ago. The population had grown frustrated over corruption allegations surrounding the 1MDB scandal and an unpopular 6% Global Sales Tax introduced by Mr Razak. This tax came during a period of protracted depreciation and high inflation, which eroded incomes and aggravated inequalities. Mahathir Mohamad, the current Prime Minister, vowed to abolish the tax if he was elected.

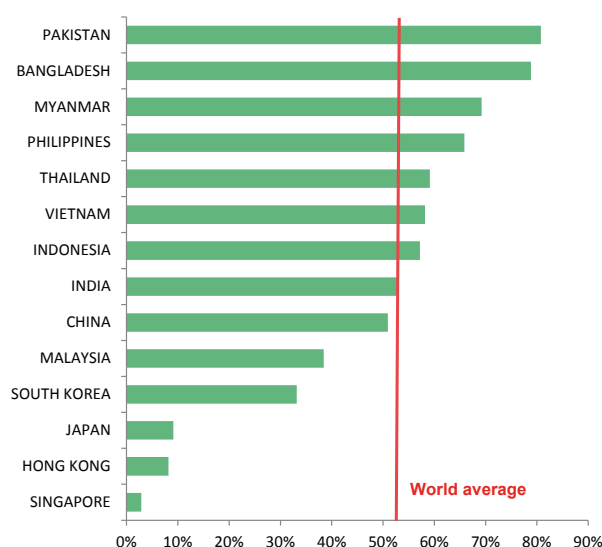
0.45
Malaysia's income inequality amongst the highest in Asia

CHART 3
GINI coefficients in the Asia-Pacific region



Source: National sources and Coface

CHART 4
Corruption perceptions in the Asia-Pacific region



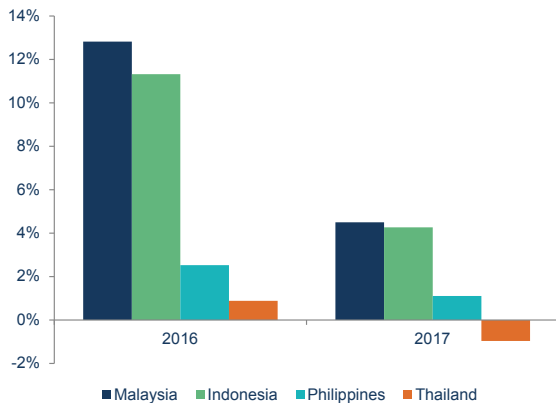
Source: World Bank and Coface

6 - Coface's social fragility scores combine social pressures and social instruments. The logic stems from the idea that social fragility is heightened when a population has the instruments to channel change when it undergoes significant pressures. A good example of this is the Arab spring – the outbreak of protests throughout the Arab world in 2010 was greatly aided by the capacity of protesters to mobilize and communicate thanks to telecommunication and social networks.

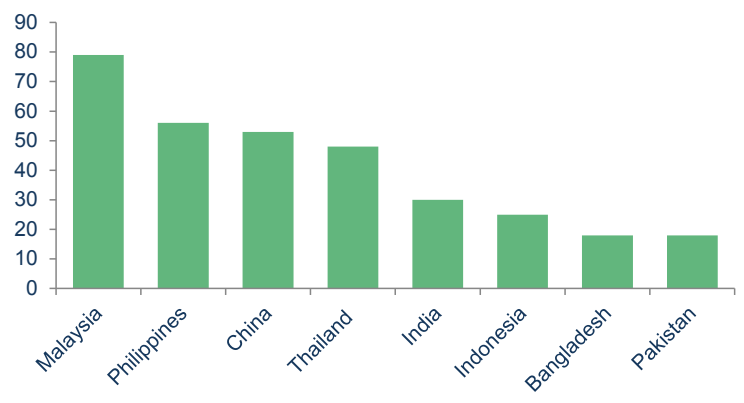
7 - Corruption perception figures by the World Bank, Country Policy and Institutional Assessment (CPIA) database

8 - Voice & Accountability indicators by the World Bank, Worldwide Governance Indicators (WGI)

9 - Debt figures by the Bank of International Settlements (BIS)

CHART 5
Wage growth YOY (adjusted for inflation)

Source: Bloomberg and Coface

CHART 6
Internet access (% population)

Source: World Bank, World Development Indicators

Security risks sour outlook for India, Myanmar, the Philippines and Pakistan

Coface's Political Risk Model applies a terrorism "penalty" in countries where this is a concern. South and Southeast Asia feature high levels of ethnic, religious and linguistic fractionalisation. This can fuel tensions between the different groups in a given region, resulting in increased terrorist acts and inter-communal violence. Despite the number of conflicts decreasing significantly over time in South Asia (from 49 in 2007 to 19 in 2017), the region nonetheless retained the highest score in Asia (82% in 2017). Terrorism in this area was predominantly driven by pervasive state and non-state conflicts between India and Pakistan. Relations between these two economies are complex and largely hostile, due to a number of historic reasons that have their roots in territorial and religious grounds.

The situation differs considerably in Southeast Asia. The terrorism score remains lower than that for South Asia (38% in 2017), but this has deteriorated over time, in line with an increase in the number of conflicts (from 11 in 2007 to 13 in 2017). Existing conflicts were the consequence of resurgence in ethnic violence and insurgency movements.

The Rohingya crisis in Myanmar displaced hundreds of thousands of predominantly Muslim Rohingya people from Myanmar's Rakhine state into neighbouring Bangladesh - Myanmar has 135 ethnic groups but does not recognize the Rohingya as legal citizens. The humanitarian crisis resulted in economic problems for Bangladesh, but it also fuelled inter-communal violence by the Arkan Rohingya Salvation Army (ARSA), allegedly supported by Islamist groups based in Bangladesh and with links to Saudi Arabia.

Terrorism is also an issue in the Philippines, with most incidents linked to insurgency movements (Abu Sayyaf and Moro) in the southern parts of the country (Mindanao, Sulu and Palawan). An outbreak of Islamic jihadism in Marawi, a predominantly Muslim province in Mindanao, led to a high terrorism score for that economy in 2017.

Terrorism in China has its roots in a relatively great degree of religious (0.66) as well as ethnic (0.19) fractionalisation. The country officially recognizes 55 ethnic minority groups alongside the Han majority, including: Hui, Manchu, Tibetan, and Uyghur. The recent uptick in terrorist attacks in China has also contributed to a deterioration of overall political risk. But while the number of attacks is high, the overall score is lower than that of other countries relative to the size of China's vast population. These conflicts were also concentrated in provinces with high levels of ethnic and religious fractionalisation, such as Tibet and Xinjiang.

135

The number of ethnic groups in Myanmar, of which Bamar, Shan, Karin, Rakhine and Mon are the largest

DISCLAIMER

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