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Political risks threaten the 2017 country ESG landscape

After a fairly tumultuous 2016, current political uncertainties will likely make 2017 equally unpredictable. So, at this stage, it would be highly speculative to attempt to predict what a "hard" Brexit as pursued by Theresa May would imply, or to anticipate what the Trump victory ultimately portends following his first controversial executive orders that appear to confirm the fears associated with his election. In Europe, crucial elections lie ahead in the Netherlands, France, Germany and possibly Italy, which will provide key tests for populist movements but also impact the future of the EU. Added to this are various other geopolitical risks, above all in China, which is preparing for a major leadership transition under President Xi Jinping. All these factors could potentially have far-reaching consequences for economic policies, the macro-financial environment, political stability and, last but not least, country sustainability developments around the globe.

Advanced economies become the main source of risk

Regardless of how things develop in Europe and the US, it is now clear that developed countries have replaced emerging markets as the main source of political risk. According to the IMF's recently published World Economic Outlook update, political risk in advanced economies is one of the biggest threats to global growth. Indeed, political trends over the past few years indicate that the era of relative stability and predictability in major advanced economies is over.

The rise of populism and nationalism found its expression in the rapid dissemination of anti-establishment, anti-globalization and anti-immigration sentiment, crystallizing into "shocks" such as Brexit and Trump's victory. Increasing populist pressures have already begun to influence policy agendas in many Western countries and will likely continue to redirect economic policy towards reinforcing domestic labor markets, protectionism, and tightening immigration rules – precisely the political platform that led to the election of the new US President Trump (see Figure 1).

Figure 1: Strength of populist tendencies in 20 large economies

	Fiscal	Immigration	Trade	Governance	"Strong" leader in power
Eurozone countries					
Netherlands	Moderate	Strong	Moderate	EU	No
France	Limited	Strong	Strong	EU	No
Italy	Moderate	Strong	Moderate	EU/domestic	No
Spain	Moderate	Limited	Moderate	Limited (Podemos)	No
Germany	Limited	Strong	Moderate	Limited	No
Other advanced countries					
USA	Strong	Strong	Strong	Anti-Washington	Yes
South Korea	Moderate	Limited	Limited	Corruption	No
UK	Moderate	Strong	Moderate	Anti-EU	No
Japan	Limited	Moderate	Limited	Limited	No
Canada	Moderate	Limited	Limited	Limited	No
Australia	Limited	Moderate	Moderate	Limited	No
Switzerland	Limited	Moderate	Limited	Migration referenda	No
Emerging economies					
Mexico	Moderate	Limited	Moderate	Corruption/security	No
Brazil	Strong	Limited	Moderate	Corruption	No
Saudi Arabia	Moderate	Limited	Limited	Limited	No
Russia	Moderate	Limited	Moderate	Limited	Yes
Turkey	Limited	Moderate	Limited	Authoritarianism	Yes
Indonesia	Limited	Limited	Limited	Limited	No
India	Limited	Limited	Moderate	some	Partly
China	Limited	Limited	Moderate	Limited	Partly

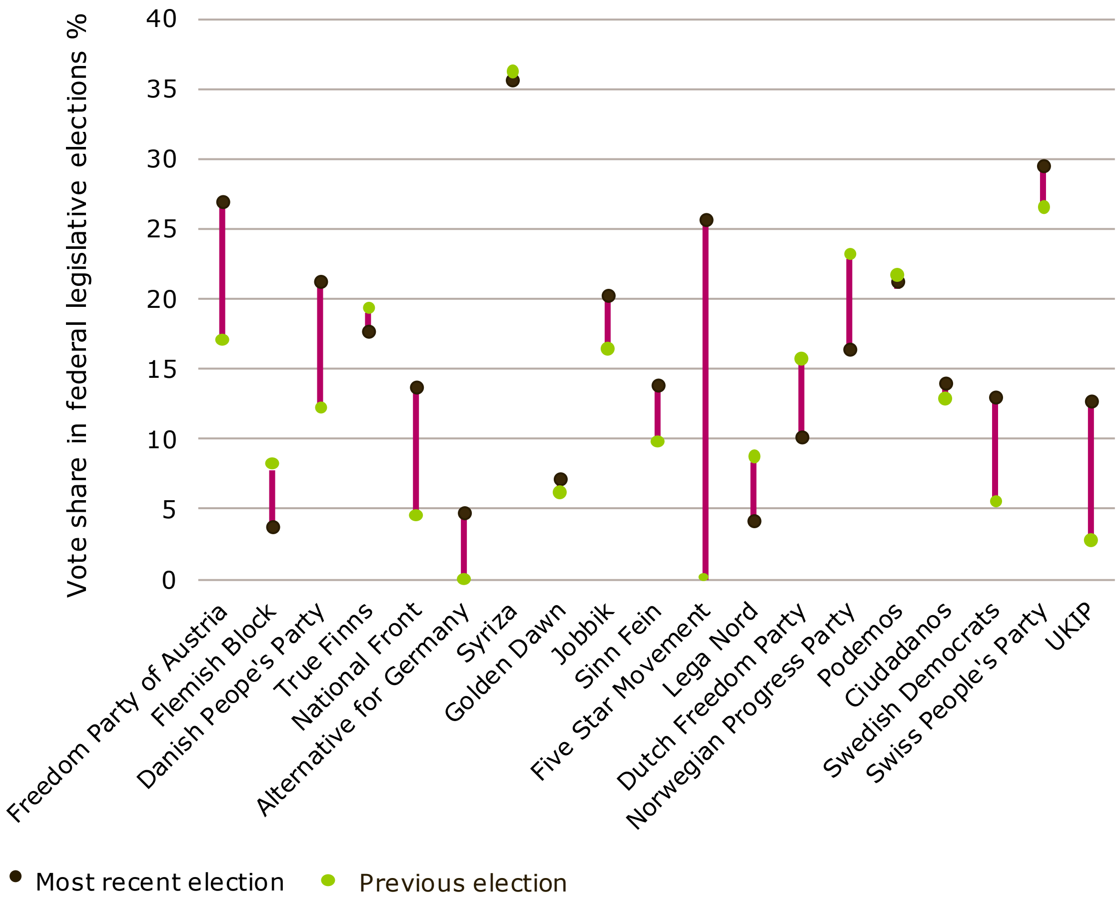
Countries ranked by likelihood of populist party/leader

Shading indicates strength of populist focus: Strong | Moderate | Limited

Source: Business Insider UK, Oxford Economics, RobecoSAM

In the US, the wave of populism has hijacked the Republican Party, while in Europe it has thrown many of the traditional mainstream political parties into crisis, rapidly galvanizing support for new extremist parties both on the left as well as on the right (see Figure 2).

Figure 2: Europe's non-traditional parties enjoy tailwinds



Source: parties-and-elections.eu, RobecoSAM

Looking ahead to the upcoming elections in the Netherlands, France, Germany and possibly Italy, the greatest threat currently appears to be in France. The latest polls as of mid-February show that Marine Le Pen of the anti-immigration and anti-Europe National Front is continuing to extend her lead, but is still expected to lose in the second round against either former economy minister Emmanuel Macron or former prime minister François Fillon. More recently, however, Fillon's election chances have diminished after was hit by a 'fake jobs' scandal involving his wife and children. In Italy, where the latest anti-establishment blow was dealt in early-December when voters clearly rejected plans to reform the country's constitution, early elections pose a risk given the growing popularity of the anti-establishment and euro-skeptic Five Star Movement led by Beppe Grillo, which is now in a neck-and-neck race with the center-left PD (Democratic Party). In the Netherlands, Geert Wilders' Party for Freedom is currently leading the polls, but a fragmented political system should prevent his party from winning a parliamentary majority. And last but not least, the Alternative for Germany is set to achieve a notable success, even though it is not expected to score a decisive victory. All told and regardless of what polls currently predict, another nasty surprise in the form of a populist political takeover in one of Europe's major economies cannot be completely ruled out given the most recent events and the unexpected twists associated with electoral campaigns, as exemplified by François Fillon's "Penelopegate."

But emerging markets also have troubles of their own

The spread of political uncertainty and instability has not been limited to advanced economies though, and has also affected emerging markets across the globe. Some of these countries, above all Turkey and the Philippines, have also not been immune to populist and nationalist tendencies. In Mexico, Trump's anti-Mexican stance and President Peña Nieto's sliding approval ratings have increased left-wing Andrés Manuel López Obrador's chances of taking power in 2018. And in Brazil, continued popular discontent following the impeachment of Dilma Rousseff and the Temer government's persistently low approval ratings could lead the country to once again elect a populist (Workers' Party, known as PT) government in 2018 if the economy does not recover rapidly and strongly enough, which would reverse a recent trend away from populism in Latin America (see Figure 1).

In China, a scheduled and delicate leadership transition could prompt President Xi Jinping to respond forcefully to foreign policy challenges, potentially escalating US-China tensions. A possible retrenchment by the US in Asia might also encourage China to further reinforce its claim to primacy in the region and become even more aggressive in asserting its territorial claims, which could spark a conflict in the region. Similarly, worries are mounting in Eastern Europe over the new US administration's perceived lack of commitment to the existing security alliance in the region, especially in view of Russia's increasingly heavy handed foreign policy stance.

Moreover, a variety of other geopolitical risks will further weigh on global prospects in various ways, including North Korea's recurrent saber rattling, the potential cancellation of the Iran nuclear deal, or the resurgence of tensions between India and Pakistan. In parts of Africa and the Near & Middle East, civil wars and internal conflicts will continue to damage prospects in those regions, nurturing radical Islamic ideology and laying the ground for further acts of terror around the world. At the same time, such developments are fueling the flow of refugees and migrants, with serious repercussions for neighboring countries and Europe. In the longer run, the entire region is unlikely to emerge from the temporary consolidation of authoritarian regimes in those countries that continue to ignore the demands of the majority of their population. Ultimately, only a decisive move towards a more inclusive governance structure will ensure a return to political stability, which is the basis for economic development. For this reason, various governance features are an important building block of our country sustainability assessment.

What does this mean for country sustainability?

As already indicated, political developments will also certainly impact country sustainability profiles around the globe. The Trump election – apart from reflecting a populist backlash against globalization – could easily shift the delicate geopolitical balance if he actively pursues his "America first" vision and withdraws from the global stage to some degree. Not only would this raise (geo-)political risk and further jeopardize stability, but it would also directly affect country sustainability profiles, as political risk and stability are important assessment criteria in our country ESG framework. We have already seen the deterioration of political risk and stability scores in a number of countries over the past two years, hurting their overall sustainability performance. But political developments can also have an indirect impact on a country's sustainability profile by influencing various other ESG factors beyond political risk.

Income inequality and pent up resentment over having missed out on economic growth have been touted as key factors contributing to the outcome of US election and the UK Brexit referendum. Indeed, in both countries income inequality, as measured by the GINI coefficient, has increased since 2010, according to OECD figures published in November 2016. Both countries are at the upper end of the corresponding OECD ranking, whereas other major OECD economies such as Canada, France or Germany display much more equal income distributions, which may help them counter the populist threat. The OECD report[1] also shows that the economic recovery since 2010 has not delivered inclusive growth and that income inequality remains at record high levels in many countries. Persistently high or rising income inequality increases the risk of societal polarization, spreading public discontent, increasing social unrest and boosting populism. This is also illustrated by the developments in southern European peripheral countries such as Greece and Italy in recent years. Both recorded a rise in income inequality, while at the same time experiencing greater social unrest and a rise in political risk. But rising inequality is not the only explanation for this phenomenon. The decline of traditional mainstream parties is also the result of a widespread and increasing sentiment among voters that their broader concerns are no longer being taken seriously enough by the established party spectrum, driving them to search for alternatives. This highlights the importance of incorporating such factors – which often do not receive sufficient attention in mainstream economics – into any comprehensive country assessment. Policymakers should place greater emphasis on better distribution of income and wealth in order to prevent further spread of such unpleasant trends as those observed last year.

Another potentially dangerous fallout from the rise in populism is the gradual erosion of a country's institutions, which is another important factor shaping a country's sustainability performance. A telling example of this are the recent developments in Turkey, where President Erdogan continues to use the state of emergency to tighten his hold on academia,

[1]OECD Inequality Update 2016: "Income inequality remains high in the face of weak recovery;" November 2016

bureaucracy, business sector, judiciary, media, military and police, continuously undermining the country's institutional framework. In January, the Turkish parliament approved a bill to create executive presidency while eliminating the role of the prime minister. The change, subject to a constitutional referendum on April 16, would dramatically expand the president's powers and allow Erdogan to stay in office until 2029. Over the past few years, Turkey has been a prime example of how continuously undermining a country's institutions results in greater political instability and the gradual erosion of the overall ESG profile, as has already been outlined in more detail in previous reports.[2] And given that – over time – such a deterioration in a country's sustainability profile will have negative implications for a country's economic development and overall creditworthiness, it came as no surprise that Turkey was stripped of its sovereign investment grade rating by all three major rating agencies within the last six months, with Fitch being the last one to announce this move on January 30, 2017.

However, Turkey is no exception, as populist leaders generally seek to dismantle existing checks on their power, a development we have also seen in more advanced economies and EU member countries like Hungary and Poland. All three countries have seen a fall in their "political rights" and/or "civil liberties" ratings, "institutions" and "political risk" scores in recent years. Given that these are all important features of our country sustainability assessment, it comes as no surprise that the overall country ESG score for these countries has also declined over the past couple of years. True, the more mature Western democracies can still rely on a functioning system of "checks and balances" based on an established rule of law and strong institutions, which is also reflected in their much higher and stable scores for the respective indicators. However, even their institutions are coming under attack with rising populism. Just look at how central banks are increasingly subject to political pressures, undermining their standing as independent technocratic institutions, or how the new US President Trump has publicly attacked the media, antagonized members of the judiciary, and cast doubt on the legitimacy of the electoral process. While this is not yet properly reflected in current data, it is likely to have a negative impact on various governance aspects sooner or later. As a result, indicators such as rule of law, regulatory quality, accountability, government effectiveness or institutions could deteriorate and thus also impair the country's overall sustainability performance over time.

Last but not least, such political developments will also leave their mark on the environmental dimension of country sustainability. Although Europe's populist parties do not have a uniform position on environmental strategies, increasing pressure from populists or growing popular dissatisfaction with public matters in general could nevertheless lead governments' policy agendas to prioritize other issues over environmental programs. In the US, President Trump announced plans to promote the development of domestic fossil fuel energy, weaken various air and water pollution regulations, and to pull out of the Paris climate deal, signaling a clear break from the previous administration on energy and environmental policy. Hence, current political developments could also adversely affect environmental policies, leading to a deterioration of some of the environmental input factors of our country ESG tool, particularly the Environmental Performance Index and energy-related indicators. Such a policy shift by the US could severely impair global efforts to combat climate change, even though other major countries vow to stick to their climate pledges, at least for now. But it is nevertheless an indication that country sustainability prospects are being harmed by developments in the environmental dimension. And as environmental perils such as those resulting from climate change will remain one of the world's key concerns going forward, they could further add to political and social instability if not addressed properly, further illustrating the interlinkages between the various individual indicators and the three ESG dimensions.

[2] See: RobecoSAM: "Country Sustainability Ranking Update," November 2016 & "Country ESG trends in Turkey: a country going astray," December 2016, http://www.robecosam.com/en/sustainability-insights/about-sustainability/country-sustainability-ranking/country-esg-trends-in-turkey-a-country-going-astray.jsp

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