



# POLITICAL RISK IN EMERGING MARKETS

TURBO CAPITALISM TURNS TO POLITICAL CRISIS

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Oliver Wyman's 2011 report, *The Financial Crisis of 2015: An Avoidable History*, predicted a crisis centered on emerging market economies. As emerging market economies have now begun to slow, we look at what such a crisis might mean for the future of these developing nations. Will they be able to weather the storm and make strides toward becoming "developed economies?" Or will the next crisis unveil weaknesses that send these economies back in time?

Though some developing economies will surely succeed in closing the gap, others will likely stumble. The reason for our pessimism is not the direct economic effects of an upcoming downturn, but rather the political instability that will follow. So it is time for analysts to put the financial ratios to one side for a moment and look at the threats posed by emerging market politics.

## POLITICAL HEAT RISES AS THE ECONOMY COOLS

Many of the largest emerging markets, such as China, Brazil, Russia, and Turkey, have achieved a measure of political stability in recent years. As their economies boomed – creating profits for businesses and opportunities and jobs for citizens – political leaders have enjoyed great popularity.

Although these economies continue to grow, they are slowing from the extraordinary rates of growth observed in recent years. This is in part a natural consequence of success, which drives up labor costs, thus reducing whatever advantages they might have had over developed market producers. The commodities cycle, which until recently fueled growth, has now turned down, leaving many emerging economies greatly exposed as prices fall. Any hope of continued growth in emerging markets is now heavily reliant on interest rates remaining low in developed market economies. The bad news is that 2015 looks likely to be the year when central banks in developed markets finally start to tighten monetary policy.

If those trends play out as expected, the governments of emerging economies will struggle to avoid major currency devaluations and inflation. Moreover, the standard reaction of governments, which is to allow interest rates to rise so as to stem capital flight, risks inducing widespread credit defaults and a deflationary debt crisis.

**25%**  
The percentage decline in productivity that South Africa suffered after strikes in the first quarter of 2014

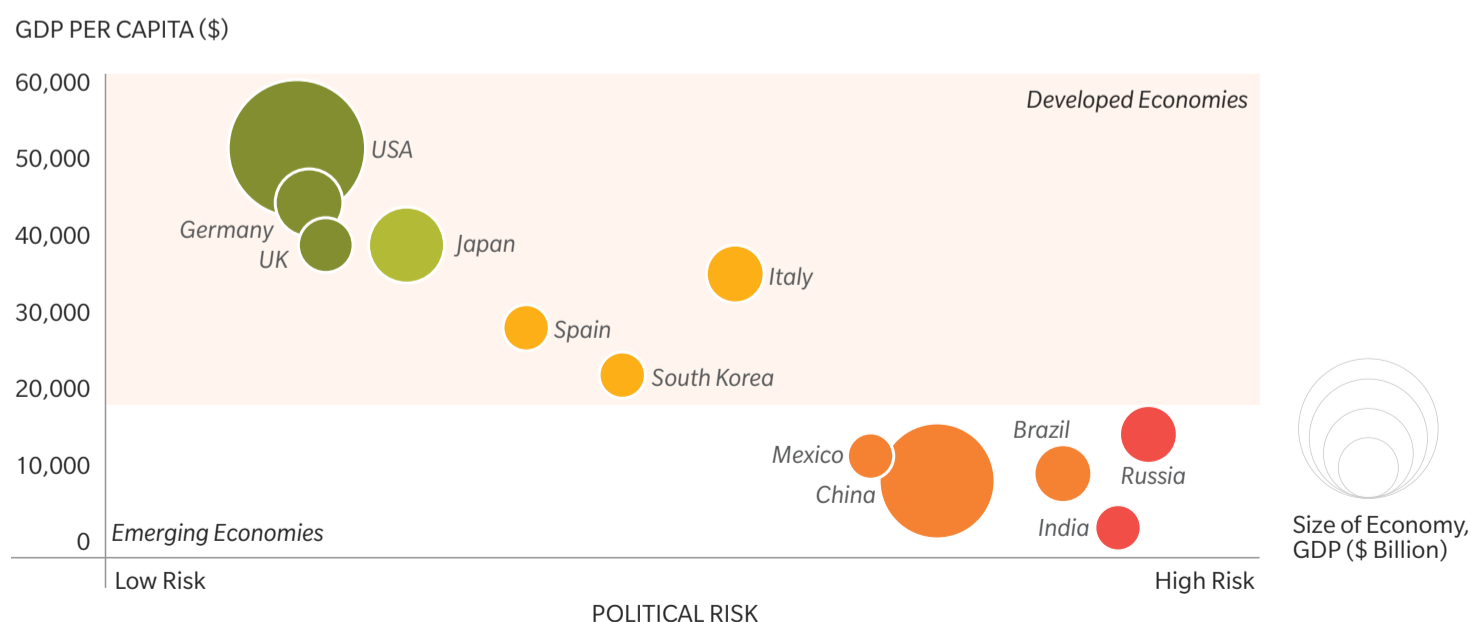
Events may not quite unfold as dramatically as our original crisis prediction from 2011. But even the moderate slowdown in growth now taking place is exposing the high level of political risk in emerging economies. While each developing country has its own unique set of political challenges, there are some common threads that are emerging: waning popularity of political leaders, a rise in nationalist sentiment, and a sense that many were left out of the boom times, now gone.

As Exhibit 1 illustrates, political risk is typically viewed as being higher in those economies with the lowest GDP per capita, reflecting the fact that mass poverty is an important source of political instability. As countries break through into the developed category, their susceptibility to political crisis tends to diminish.

## LESSONS FROM THE FINANCIAL CRISIS IN THE WEST

If the recent financial crisis in the developed world is an indicator, few of the current political leaders of emerging economies will survive a major crisis in their domestic economies. During the recent crisis in the West, there was a sense that not only politicians, but the entire establishment had failed. This loss of faith has created a power vacuum which is being filled in the West with new political forces. We have just witnessed several right-wing nationalist parties sweep to victory in the recent European elections – and, in Greece, a far-left nationalist party.

### EXHIBIT 1: POLITICAL RISK HEAT MAP



Source: Oxford Economics Political Stability Risk Rating, IMF economic data, Oliver Wyman analysis

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Similar patterns now seem to be emerging in the developing world. Voters are losing patience with leaders and accusations of cronyism and corruption are widespread. Political change appears inevitable. The question is how great these changes turn out to be and how drastic their consequences.

## POLITICAL TAIL RISKS

We cannot predict how things will play out in the various emerging markets. But as risk managers, we must remain aware of some of the more unpleasant paths that might lie ahead and prepare our businesses accordingly.

Ethnic tensions and nationalistic sentiments are quick to rise during economic downturns, as people look to blame their problems on external factors. Fingers are pointed not only at foreign countries, but also at elements of the domestic population, with fractures often forming along religious or ethnic lines. Such tensions can lead to the victimization or expulsion of economically important sub-groups, to partitions, to civil war, or even to conflict with neighboring countries.

Troubled governments are also often tempted to confiscate foreign assets and default on debt to foreigners. Such populist policies can come at a heavy price, provoking international trade sanctions and capital markets isolation.

Most emerging economies have young and growing populations. This is generally one of their major advantages over developed economies. However, as unemployment and wage stagnation sets in during a slowdown, it can be a source of instability. Youth unemployment is an important cause of civil uprisings as angry young people take to the streets.

Tensions around employment in emerging economies can be exacerbated by heavy reliance on particular sectors, such as energy or minerals. For example, falling commodities prices are now leading to labor unrest in South Africa's mining sector. Strikes in the first quarter of 2014 led to a 25 percent year-on-year decline in activity, enough to cause the South African economy to contract. This mining sector has also been plagued by a rash of accidents, some of them fatal, which are blamed on aggressive cost-cutting measures. To many observers, the miners' problems symbolize the growing gap between a rich elite and poor workers.

Democratic principles endorsed during the boom period will be put to the test as unpopular leaders try to hold on to power

## NEW DEMOCRACIES

Most emerging economies are new democracies, with fragile legal institutions. Transitions of leadership during an economic crisis are unlikely to be as smooth as they are in Europe and in the United States. Democratic principles endorsed during the boom period will be put to the test as unpopular leaders try to hold on to power. The rise of social media adds an interesting twist to this dynamic. In countries such as China and Russia, which are spread across vast geographical areas, protests historically have been disorganized regional affairs, with anger vented at local politicians. Social media makes it easier to coordinate and mobilize protest across an entire nation, as witnessed in the Middle East.

Many of the political developments can lead to negative feedback on a country's economic situation, and a vicious circle of economic and political problems can quickly ensue. That is why a minor slowdown can quickly escalate into a major economic crisis and why soft landings are rare in emerging-market economies.

We are not predicting widespread impending doom for emerging economies, or even an imminent end to their growth. Risk management is not a matter of predicting the future, but of being aware of the threats posed by potential scenarios. It is fair to say that the early warning indicators are now flashing in some emerging economies, which suggests it's a good time to be alert and take a closer look at your exposure to these markets.

## AFTER THE STORM

On the bright side, some emerging economies will have taken advantage of the recent period of prosperity to push through structural reforms, making investments in education, innovation, and in infrastructure that in turn can lead to sustainable increases in economic output. They have a better chance of emerging from the next crisis in a position to follow in the footsteps of countries such as South Korea and Taiwan that have successfully moved from developing to developed economies. However, even for these ultimately successful economies, the journey is likely to be a bumpy ride.

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