The Re-Emergence of Country Risk in Trumpland and in Developed Countries

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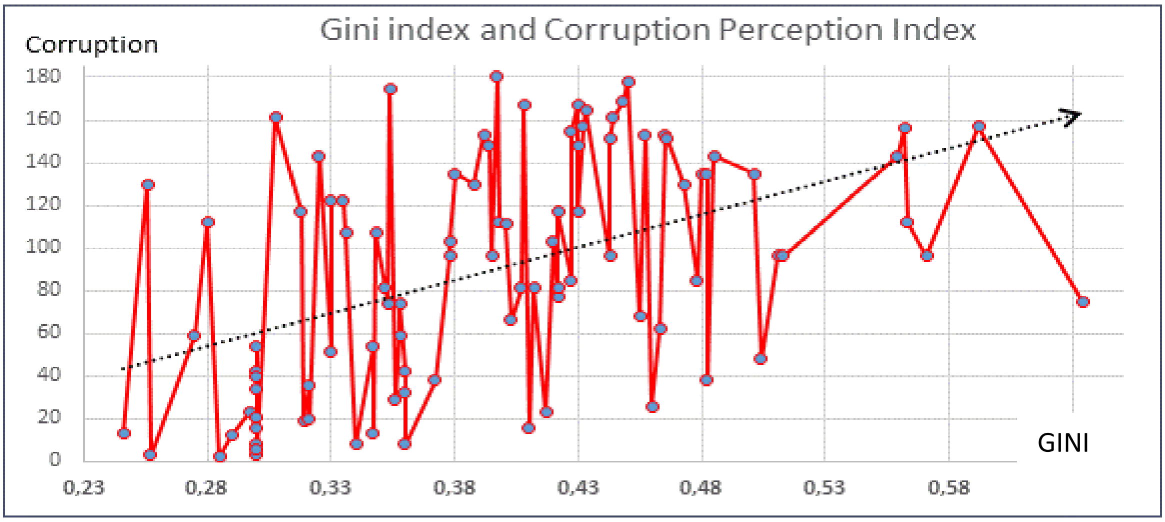
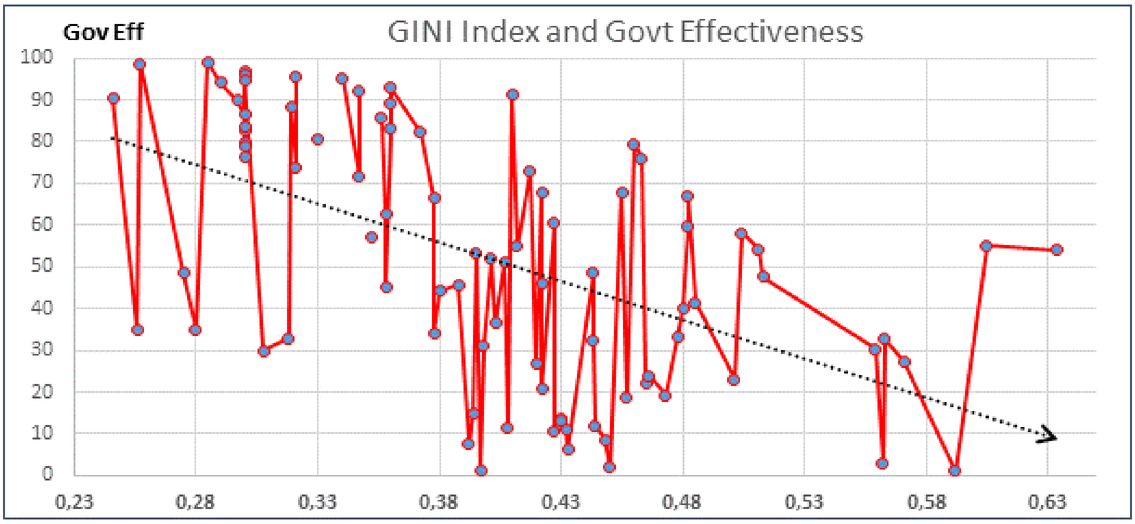
In the age of Globalization of market forces, a crucial question remains the unpredictability of large and abrupt rises in volatility. Where will the fat-tail driven risks come from? Open nuclear warfare, trade protectionism, global stock market crisis, abrupt raw material scarcity and sharp price increases, and a financial market meltdown, stand at the top of the danger list. But the weaker elements of the crisis contamination chain still belong to the so-called emerging market countries, for the majority of risk managers. However, the traditional divide between developed/emerging countries is at best obsolete, and at worst, a source of errors in country risk assessment. This divide adds a conceptual myopia to the complexity of economic, financial, and socio-political risk assessment. One can observe a number of issues that deeply modify country risk assessment today.

1. Since World War II, developing countries with weak socio-political institutions have held the monopoly of political volatility. Country Risk was rooted in the so-called Third World. This is no longer true. Country Risk is not the monopoly of foreign creditors, exporters, importers, or investors. Domestic residents (households, investors, the corporate sector) also face Country Risk from their own country's socio-economic and political situation: a country's government can take arbitrary decisions that will affect the residents' economic and socio-political well-being. For too long the definition of country risk analysis has been restricted to the assessment of a foreign entity's ability and willingness to meet its external obligations in full and on time. This narrow definition concerns exclusively foreign economic agents while excluding domestic residents of a risky country (Venezuela, Turkey, Thailand, but also the USA or Hungary)

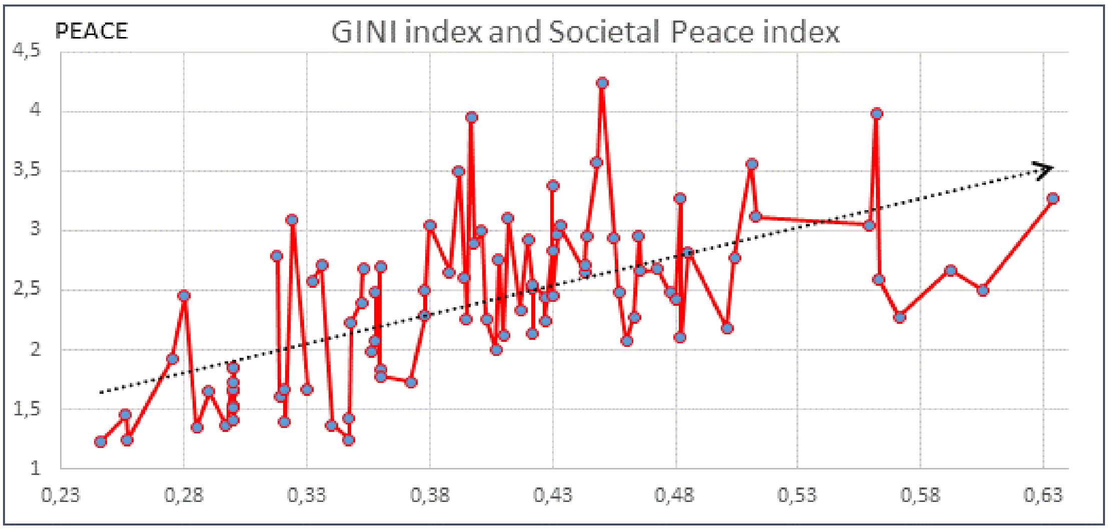
2. The dramatic fat-tail driven risks such as a major political crisis or a global market crash are probably less likely today than deep shocks that come from the gradual erosion of social resilience and adherence to a national community's values and principles. The deep roots of these shocks lie in unsustainable wealth gaps. A new source of Country Risk volatility stems from wealth and income discrepancies that are coupled with missing policies of redistribution, often with opacity and institutional weaknesses, as well as the concentration of political power. In many countries, both developed and developing, the stubbornness of large income inequality is often related to bad governance and high corruption, as illustrated in the following graph for a sample of 100 countries. (Source: Transparency International, US Federal Reserve Bank of St Louis and World Bank)



Corruption, in addition, goes hand in hand with weak governmental effectiveness. Clearly, Nordic countries such as Sweden, Norway, Denmark, and Finland exemplify strong government effectiveness, good governance, and relatively better income distributions. Their public investment ratios stand at, or even higher than 50% of GDP. Their annual growth rate of investment is roughly 5% yearly, an impressive achievement. Consequently private consumption is not the main engine of economic growth and the savings rate of Sweden, Norway and Denmark range between 13 and 17% of GDP, contrary to a modest 5,6% for the EU area. The following graph illustrates the inverse relationship between income inequality and government effectiveness. (Source: Fed Reserve Bank of St Louis and World Bank)



One can also observe a close relationship between large wealth gaps measured by the GINI index and sociopolitical stability measured by the Sydney-based Institute for Economics & Peace. The higher the GINI ratio, the more unequal the income distribution, and the worse the Societal Peace index. (Source: Federal Reserve Bank of St Louis and Institute for Economics & Peace)



3. **A tentative taxonomy of wealth gap sources**. One can observe the situation of four groups of countries regarding wealth gaps. Clearly, economic taxonomy is a one-size-fits-all and there are many notable exceptions, particularly the complex cases of China and India. In **Group 1**, one finds a number of emerging countries that face a fast growing population, insufficient job opportunities, weak production diversification (large dependence on a few primary products), and

economic and political power concentration (e.g.; most African countries with the exception of the Maghreb, Namibia, and Botswana). The majority of these countries are rich though with poor people given that a large share of national wealth is captured by a few people who keep their assets in foreign banking accounts or in offshore real estate investment. Expatriated private savings and capital flight are key features of Group 1 countries[1]. This is why the IFIs' classifications are meaningless while hiding considerable income discrepancies. In the World Bank's list of its 189 member countries, low-income economies are defined as those with a GNI per capita of $1,005 or less, while lower middle-income economies are those with a GNI per capita between $1,006 and $3,955.

Group 2 countries are transitional emerging market countries whose buoyant GDP growth rates owes a lot to their successful integration in globalization. High trade openness ratios, of the order of 100% of GDP or even higher, are the main engines of economic growth, as well as the sources of crisis contamination and economic recession. Latin American and ASEAN countries have experienced cycles of boom and bust since the 1970s due to their economic dependence on foreign trade and capital markets. Wealth gaps are largely the result of the fortune split between the urban elites (managers and capital owners) who monopolize access to the tradeable goods sector and those whose competitive labor costs provide volatile jobs without much scope of rising on the social ladder.

In **Group 3**, one finds developed countries that face structural obstacles to maintain or boost their global competitiveness (their trade market share is shrinking due to weak investment, or lagging R&D efforts…) while their budgetary's margin of maneuver is constrained by drastic regional framework (e.g., EU's Maastricht guidelines), IMF conditionality, or rating agencies' scrutiny (e.g., Eastern and Mediterranean Europe).

Last, there is also a **Group 4** that includes mainly globalized economies, including the US, Canada, Australia, and Mexico, as well as the United Kingdom. In that group, post-WWII fast GDP growth has produced convergence trends with the emergence of growing middle-classes with debt-driven purchasing power increases. Since the 1980s, however, socio-economic catch up and convergence trends reversed and gave rise to rising divergences, with larger income and wealth gaps that have accelerated since the global financial crisis. In Group 4 countries, the overwhelming predominance of finance since the emergence of market globalization in the 1980s resulted in wider wealth and income gaps. In several countries, predominantly in the US, arresting the trend of rising inequality with redistributive tax policy has not been a priority. Donald Trump's sweeping tax bill and deregulation will make things worse. The December 22, 2017 Tax Cuts and Jobs Act whose main result is shrinking the corporate tax rate from 35 percent to 21 percent will widen the gap between capital revenues and wages. In the US today, the median upper-income family holds 75 times the wealth of the median low-income family, compared with 40 times back in 2007. In other words, the top 1% now holds nearly 40% of the nation's wealth, up from 34% in 2007. The bottom 90% holds only 23% of the nation's total wealth, down from 28.5% in 2007. While the arbitrariness of President Trump seems to be unique in its impact upon global uncertainty, it may just be the peak of the iceberg.

Overall, contrary to economics textbooks' pledges, catching up has remained a remote dream, and one observes growing divergences within and between countries. One marked exception is China. One can briefly summarize the main features of each of the four groups in a synthesis table:

[1] Bouchet, Feki, and Kharrat, Capital flight in EMCs. Forthcoming, 2018. And Bouchet, Fishkin and Goguel, "Country Risk in an Age of Globalization", Palgrave-MacMillan 2018.

	Group 1	Group 2	Group 3	Group 4
Economic Status	Developing countries	Transitional emerging countries	Developed countries	Highly developed and globalized countries
Economic Structure	Strong dependence on raw materials	Strong dependence on global trade	Predominance of tertiary sector	Predominance of tertiary sector and finance
Institutional Status	Weak institutions and opacity	Weak institutions and conflict of interest	Democratic parliamentary systems	Democratic parliamentary systems
Governance level	High level of corruption	High level of corruption	Protracted governance weaknesses	Good governance, checks & balances
Income sources	Predominant share of wages	Predominant share of wage & trade revenues	Rising share of capital income/ wages	Rising share of capital income/ wages
Socio-economic divide	Mining and raw materials production	Stock and real estate market bubbles	Low-skills trap and unemployment	Distorted tax policy toward capital owners
Finance/GDP	Low level of financial development	Rising level of financial market depth	Fully globalized financial markets	Fully globalized financial markets
Power concentration	Repressive regimes, autarchy	Crony capitalism with formal parliamentary system	Urban elites and modern aristocracy	Three branches of government
Demography	Fast growing population	Fast growing population	Slow growing population	Slow growing population
Job Market	Little flexibility and lack of training	Competitiva labor costs	Large unemployment level	Deep and flexible with job mobility
Regional scope:	Sub-Saharan Africa	Latin America, ASEAN	EU, Eastern Europe, Maghreb	USA, UK, Canada, Australia, Mexico
Exception examples	Bostwana, Namibia	Uruguay, Buthan	Estonia, Slovenia, Germany	Scandinavia

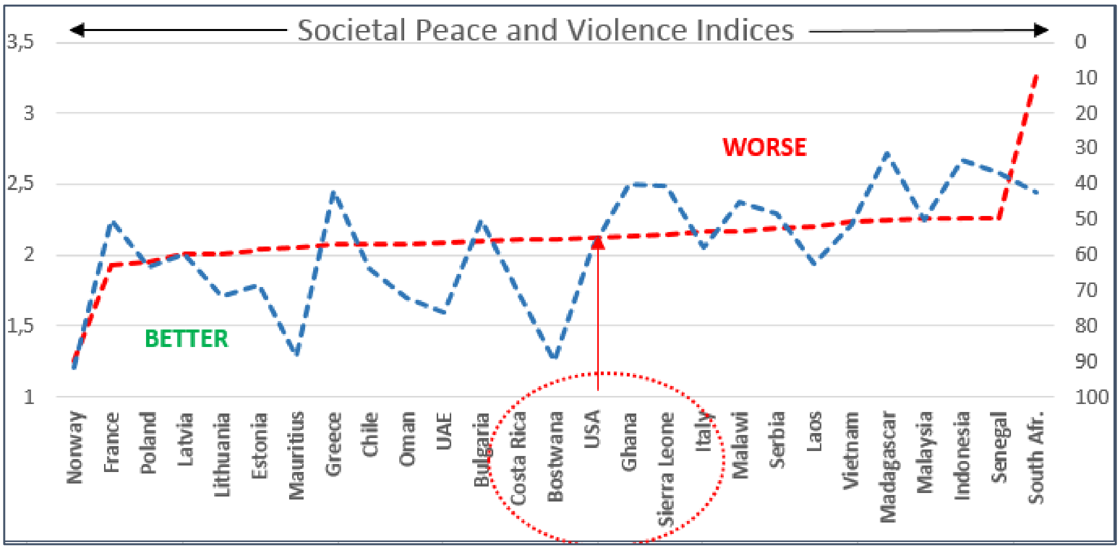
4. **The return of class struggles?** Overall, income inequality in OECD countries is at its highest level since WWII. Though buoyant GDP growth has helped move millions of people toward middle-class status, at least until the mid-1980s, the benefits of growth have not been evenly distributed and income gaps have kept rising. The average income of the richest 10% of the population is about nine times that of the poorest 10% across the OECD, up from seven times 25 years ago. Though income inequality has shrunk a bit in Chile and Mexico, the incomes of the richest are still more than 25 times those of the poorest and the wealth gap constitutes a genuine time bomb. A combination of technological trends, large wage differences, and production offshoring shifts the balance between labor and capital, providing a larger and larger share of income to capital's owners. Worse, the prospects of ongoing socioeconomic progress, that has been the driving force of social stability and adherence to rules since WWII, are eroding. The global financial crisis has made the problem more severe. As the OECD concludes: "Uncertainty and fears of social decline and exclusion have reached the middle classes in many societies."[2] Observing the range of income disparity in the OECD, the US appears the third most unequal country between Chile and Turkey, with a multiplier of 8.3 times between the top 20% vs the bottom 20%, compared with Italy and Portugal where the discrepancy is "only" 6 times.

5. **Why is the reduction of wealth gaps wishful thinking** (short of a nuclear holocaust)? Income and wealth disparities result for a large part from the growing split between labor wages and capital revenues. It is well established that a higher capital share is associated with higher inequality in the personal distribution of income[3]. The labor share in national income dropped from 66% to roughly 60% in the OECD over the period from 1975 to 2010, and one observes more considerable declines in Asia and North Africa. The labor's share in the US national income has declined significantly from a mean of close to 64 percent from the immediate postwar period to the mid-1980s, before displaying a downward trend, averaging around 58 percent recently[4]. The root causes are complex but the phenomenon is probably due to technological innovation and to the globalization of market finance in the mid-1980s that is associated with a decline in the cost of capital that induced firms to shift away from labor and toward capital.

[2] OECD-Inequality and Income. http://www.oecd.org/social/inequality.htm#income
[3] R. Lawrence 2015, T. Piketty 2016
[4] Brookings, Fall 2013.

There are a number of obstacles to any scope of rebalancing between labor and capital, hence of wealth gap reduction, in a foreseeable horizon. Redistributive budgetary policies are constrained in many countries by the threat of rating downgrading, by regional policy frameworks and budgetary guidelines, and by high debt ratios. In itself, a high debt/GDP ratio is not a major impediment for correcting income disparities as long as the debt payments can be refinanced as they come due, and this depends on market rates of interest and country creditworthiness. In the US, interest spending is slated to be the fastest growing part of the budget over the next decade, representing today nearly 7% of all federal outlays after a peak in the mid-1990s. In the UK, debt interest is the fifth biggest item in the budget, after spending on health, benefits and tax credits, pensions, and education. In most OECD countries, the problem has been stifled by central banks' QE policies, creating incestuous financial relations between governments and central banks.

6. **The elusive protection of democracy**. Overall, the current state of income inequality in developed and emerging countries has become too large to be tackled in the short to medium-term. The declining labor share in most OECD and emerging market countries has also political consequences due to the erosion of support for market-oriented economic policies and for market globalization. Centrifugal forces will increase volatility and discontent. Frustration and violence are doomed to rise, making country risk assessment a formidable challenge given that the more developed countries are likely to become the less stable. Risk analysts will have to take into account the obscure side of GDP growth that hides rising and unsustainable inequality. Inclusive growth and trickle down policy will only remain topics for conferences and for academic reports.



Democratic systems have proved to be an elusive defense against income disparities and wealth concentration. The combination of formal democratic institutions and wider wealth gaps can the conditions for sociopolitical destabilization and rising violence generate in mature developed systems. The socio-political polarization that is rising in Trumpland has led former Secretary of State Albright to warn of the growing risk of rampant fascism emboldened by Donald Trump's scorn" for democracy".[5] Fascism can spread out of many more fields that the classical combination of structural unemployment, protracted economic recession, contempt for parliamentary institutions, and military isolationism. Eroding growth prospects and unsustainable wealth gaps can be breeding grounds for fascism even where and when rationale risk analysts do not expect it.

[5] Mary Papenfuss, HuffPost :•April 7, 2018