The South China Sea: Geopolitical Risk Rising but still under Control, yet Insufficient to Trigger Sovereign Rating Adjustment on Related Countries

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On July 12th, the Permanent Court of Arbitration (the "PCA") completed and publicized the ruling on the maritime disputes in the South China Sea, which, as expected, triggered strong opposition from China including Taiwan and aroused heated arguments of the international media. The geopolitics and regional security of this region have therefore raised wider attention. In the view of United Ratings, during the process of precipitating globalization, the existing balance is upset by different forces, so confrontations between nations as well as regional disputes could be intensified by a single event, in particular, during the ongoing secular adjustment circle of the global economy that is going downward. The geopolitical risks there arising should become our focus. However, as to the case of the South China Sea, all the related countries such as China, Philippines, Japan and Vietnam have displayed certain restrained and discreet attitude, in different degrees, for the concern of their own economic and trade interest. Accordingly, although the PCA verdict is increasing the geopolitical risks of the region, it doesn't touch off the sovereign rating adjustment on related countries. The United Ratings will carefully observe and closely track the following development.

1. Regional risks increase but the overall situation is still under control

The sovereign disputes with regard to the South China Sea has a long history, and mainly matters five sound countries, including China and four ASEAN member states, namely, Philippines, Vietnam, Malaysia and Brunei. In 2002, China and the ASEAN member countries signed the *Declaration on the Code of Conduct on the South China Sea*, stressing to resolve the disputes by friendly negotiation and in a peaceful manner, and committing to working out the *Code of Conduct on the South China Sea*, for the purpose of maintaining regional peace and stability. In the year of 2013, the Aquino III Government of Philippines unilaterally submitted the case for compulsory arbitration. Thereafter, some countries outside the region, headed by the United States meddled in the affair in the name of safeguarding the freedom of navigation in the South China Sea, a move heating up the regional situation. After the PCA ruling was released, the existing tensions in the region may be escalated. First, some countries like the US and Vietnam didn't adopt any constructive measure to ease the tensions. Instead, they requested China to respect the arbitration verdict, which further sharpened their antagonism against the stance of China. Second, since this affair involves the sovereignty of China, the Chinese government, while insist on settling the disputes by peaceful negotiation reserves the right to impose an Air Defense Identification Zone of the South China Sea, depending on the degree of the perceived threat. At the same time, the *Freedom of Navigation in the South China Sea Plan* that might be kept implementing by the United States through dispatching military vessels and aircrafts, together with the joint decision of the US and Korea to deploy THAAD missile defense system will undermine the strategic balance of the region. As a result, the geopolitical situation of the Asian-Pacific area could become even more complicated.

Nonetheless, the likelihood of a full-scale military conflict is low. First, in view of the economic and trade relations among the countries surrounding the South China Sea area, each party involved will be sensible enough to avoid any large-scale conflict that could adversely impacts on its own economic growth. Statistics from the China Customs show, by the end of 2015, the bilateral trade between China and ASEAN reached 472 billion USD, making China the largest trade partner of the ASEAN, and ASEAN, the fourth largest export market and second largest import source of China. In 2015, the total bilateral trade between China and Philippines amounted to 35.649 billion USD, indicating an annual growth rate of 2.7% and accounting for 36.4% of the Philippines's total international trade. China is the largest import source country and second largest export market of the Philippines. In the same year, the bilateral trade between China and Vietnam reached 95.82 billion USD, implying an annual growth rate of 14.8%, making China the largest trade partner to Vietnam for the past successive 12 years. Meanwhile, the bilateral direct investment between China and ASEAN reached 150 billion USD, and China's total investment to the ASEAN increased by 60.7%. Against this backdrop, as a direct party of the arbitration, the newly elected Duterte Government, shortly after assuming office, expressly wished to settle the disputes with China through negotiation. In return, the Chinese government also made a positive response to that stance. Since the arbitration verdict was released, the Duterte Government has kept an obviously low profile and repeatedly called on all those concerned to "exercise restraint and sobriety". Such interactions between the two parties could play a direct role in relaxing the tensions, indeed removing a critical fuse that might send the situation out of control. Second, the bilateral relations between China and the US are the most important ones in the world, of which the contents cover a great deal of aspects such as the strategic security, economic and trade ties, and global environment protection. In all these aspects, the two countries share broad and significant common interest. Ultimately, in the process of global economic integration, big powers play games to keep their economic and trade relations in good order, which is in their common interest. Up till now, neither China nor the US is willing to allow their overall relations to be affected by the South China Sea disputes.

2. The risk of regional economic downturn is likely to increase

In the context of economic slowdown in major economies, although concerned countries in this region have succeed in maintaining a relatively favorable developing trend, they are unable to immune from being affected, and therefore witness a trend of sliding downward. In 2015, the GDP growth rate of China was 6.7%, that of the ASEAN as a whole, 4.5%, and that of Philippines and Vietnam, 5.8% and 6.7%, respectively, all higher than the global average growth rate of 3.1%. Nevertheless, impacted by the depressed economies of major countries, the GDP growth rates of these countries started to decline in recent years.

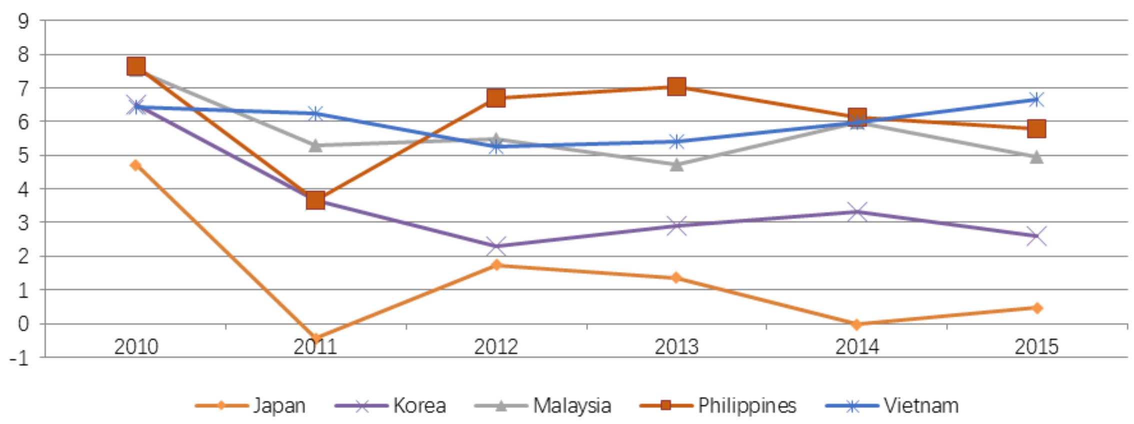

Figure 1 GDP Growth Rates of Main Countries in South China Sea Region in Recent Years (Unit: %)

Source： IMF, United Ratings

Once the regional geopolitical relations become tight due to the PCA verdict, the close trade relations within the area will be affected inevitably. In order to hedge the potential political risks, trade and investment in this region could be negatively impacted.

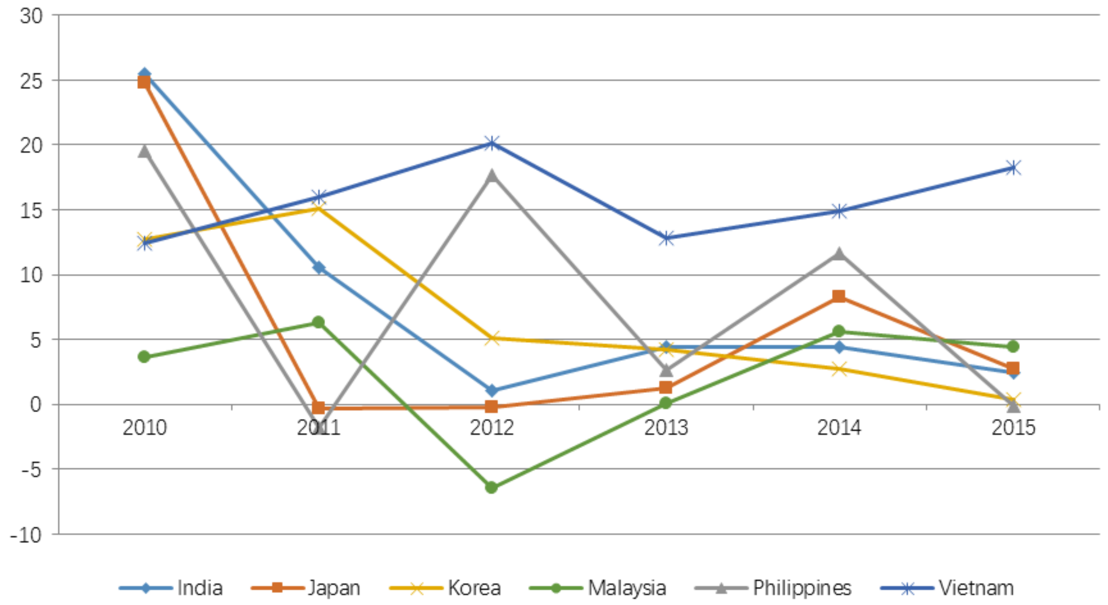

Figure 2 Growth in Goods and Services Export of Major Countries in South China Sea Region in Recent Years (%)

Source： IMF, United Ratings

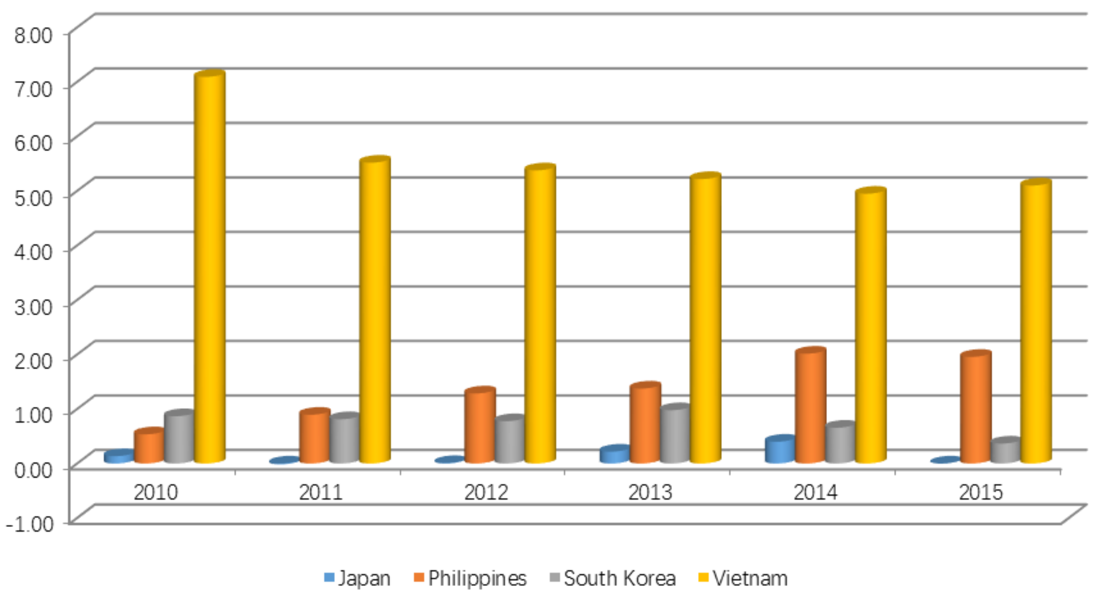

Figure 3 FDI/GDP Ratio of Major Countries in South China Sea Region in Recent Years (%)

Source： EIU, United Ratings

The investing plans aiming at this region by the Chinese investors, particularly those to go to Philippines and Vietnam could be suspended or shelved. Before the situation becomes clear, the investors would prefer to take a wait-and-see attitude, or simply turn to other investment destinations, both of which will greatly undermine investors' confidence. In particular, this could bring about direct negative impacts on the Vietnamese manufacturing sector in its efforts to attract Chinese funds, and the financing of infrastructure development in the Philippines. Obviously, this is unfavorable for both sides to restructure industries through optimizing allocation of resources, thus realizing the complementary advantages. Ultimately, all these negative impacts on international trade and cross-board investment will be transmitted to the macro-economies of all the countries, leading to the decline of reginal economic growth rate and possible increase of reginal economic downturn risks.

3. Possible adverse spillover risk to the global trade and economy

The South China Sea is one of the principal waterways for the international trade. According to the *Financial Times* of Great Britain, each year, about 5.3 trillion USD worth of goods was shipped by the South China Sea, accounting for 32.1% of the total world trade (data of 2015). Not only the economies like China, Japan, Korea and ASEAN depend on the maritime trade route, but also 1.3 trillion USD worth of goods of the US ports was shipped through the region annually. Statistics show, the scale of the reginal economy (including China and 10 ASEAN member countries) accounts for 18.3% of the total world, and furthermore, the added value of the region reaches four tenth of the world, making the area a major diver of global economic growth. If the reginal economic growth substantially decreases due to the tensions caused by the situation of the South China Sea, the rest of the world will lose an important external value-added market, and the economic growth trend will be further depressed. If the security situation of the region goes out of control, the freedom of navigation of commercial vessels will not be ensured, and accordingly disasters could be brought about not only to the nations in this region, but also to the global trade. Even if the tensions of the South China Sea caused by the PCA verdict are limited, it could have some negative impacts on the global trade that is already at stagnation. In this sense, the verdict on the South China Sea disputes has increased the regional risks. Once the situation spirals out of control, new uncertainties would be added to the trudging global economic recovery.

Lastly, in order to observe the future risk trend, attentions should be paid on the following questions: Will the Philippines initiate dialogues and bilateral negotiations with China? Will the United States dispatch warships and military aircrafts to the South China Sea to enforce the freedom of navigation? Will the THAAD missile defense system be deployed as planned?

4. Sovereign Credit Status of the Main Countries in the Region

Highlights of the Sovereign Rating on the Philippines

Date of Rating: July 20, 2016

Long-term Local Currency：BBB_i+	Long-term Foreign Currency：BBB_i+	Outlook: Negative

Rating Rationale

After President Rodrigo Duterte assumed office, due to his tough personal style, nationalistic policy orientation, and lack of solid political build in the parliament, the risks of Philippine political stability and policy continuity are rising. After the verdict of the South China Sea arbitration, the regional geopolitics has become more complicated, bringing significant uncertainty in terms of the external security and economic growth to the Philippines, therefore, the external risks to the country shall bear watching.

Considering the opacity of the new government's policy and worry about the regional security, some of the inbound foreign capital would take a wait-and-see attitude. Besides, external demands will keep shrinking for the global economic sluggishness. As a result, the country's relatively high economic growth rate in previous years is likely to decline. In the medium and long run, problems like the slowing industry upgrading, backward infrastructure, and inefficiency of government will constrain the country's economic growth. The government will broaden the spending scale in social welfare and infrastructure by a large margin, so the tendency of gradual fiscal deficit constriction could reverse, and the government debt burden will turn to rise.

In conclusion, the United Ratings has decided to adjust the outlook of the sovereign rating on the Philippines in foreign and local currencies in the following 1-2 years to Negative.

Key Indicators of the Sovereign Rating on the Philippines Unit: %

	2011	2012	2013	2014	2015	2016f
GDP（billion USD）	224.1	250.1	271.9	284.8	292.0	311.0
GDP per Capita（USD）	2371.9	2604.7	2786.9	2872.5	2900.0	3040.0
GDP Growth Rate（real）	3.7	6.7	7.1	6.1	5.8	6.1
Inflation Rate	4.7	3.2	2.9	4.2	1.4	1.8
Total Credit/GDP	52.0	50.9	51.9	55.8	59.1	60.2
Growth Rate of Domestic Debt	13.8	6.5	11.4	17.8	8.4	11.0
M2 Growth Rate	7.0	9.4	33.5	10.5	9.1	7.0
Fiscal Balance of Governments/GDP	-2.0	-2.3	-1.4	-0.6	-0.9	-0.8
Interests Payment of Governments/GDP	2.9	3.0	2.8	2.5	2.3	2.4
Gross General Government Debt/GDP	51.0	51.5	49.2	45.4	44.8	43.4
Balance of Current Accounts/GDP	2.5	2.8	4.2	3.8	2.9	3.2
Balance of Total Foreign Debt/GDP	29.6	27.9	24.6	27.3	26.3	25.1

Source: Sovereign Rating Database of United Ratings

Note: "f" stands for forecasts.

Highlights of the Sovereign Credit Rating on Vietnam

Date of Rating: July 20, 2016

Long-term Local Currency：BBB_i Long-term Foreign Currency：BBB_i Outlook: Stable

Rating Rationale

In January 2016, the election of the Vietnamese top leadership was accomplished. The domestic policy centering on reform and opening up will continue to be implemented. But enhancement of the Vietnam-US defense relations and promotion of Vietnam-Japan maritime military cooperation make the regional geopolitics more complicated, which is unfavorable for China and Vietnam to consolidate their mutual political trust and resolve the maritime disputes by dialogue.

Supported by the private consumption and investment, the Vietnamese economy is expected to maintain a fairly high growth rate. In the long run, whether its domestic commercial circumstance could improve to accommodate international industry transfer will be key to fulfilling its economic growth potential. Based upon the relative robust economic growth and domestic structural reform measures, in the medium term, the government's fiscal deficit gap is likely to narrow, so the increasing level of government debt burden could be reversed. Impacted by the increasing deficit of the income account, the current account surpluses will continue to shrink, but the demand for external financing won't rise substantially.

In the short run, the situation of the South China Sea remains a main observation point. But the probability of significant deterioration is low. The economy will maintain its current trend of growing, and its fiscal stability will improve slightly. In conclusion, the United Ratings maintains the outlook of the sovereign rating on Vietnam in local and foreign currencies in the following 1-2 years at Stable.

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Key Indicators of the Sovereign Rating on Vietnam Unit：%

	2011	2012	2013	2014	2015	2016f
GDP（billion USD）	134.6	155.6	170.5	185.8	191.4	203.8
GDP per Capita（USD）	1507.2	1722.3	1866.3	2010.0	2050.0	2160.0
GDP Growth Rate（real）	6.2	5.2	5.4	6.0	6.7	6.3
Inflation Rate	18.7	9.1	6.6	4.7	0.9	1.5
Total Credit/GDP	113.1	107.4	108.3	112.4	125.9	130.6
Growth Rate of Domestic Debt	13.9	11.1	13.9	15.5	19.3	18.6
M2 Growth Rate	11.9	24.5	21.4	19.7	14.9	16.9
Fiscal Balance of Governments/GDP	-1.1	-3.4	-5.0	-4.4	-3.8	-3.7
Interests Payment of Governments/GDP	1.1	1.2	1.5	1.7	2.0	2.1
Gross General Government Debt/GDP	49.7	50.0	53.3	52.9	53.5	52.7
Balance of Current Accounts/GDP	0.2	6.1	4.5	5.0	1.0	0.7
Balance of Total Foreign Debt/GDP	39.4	38.0	38.4	38.7	37.6	37.6

Source: Sovereign Rating Database of United Ratings

Note: "f" stands for forecasts.

Highlights of the Sovereign Credit Rating of Japan

Date of Rating: July 11, 2016

Long-term Local Currency：AA_i- Long-term Foreign Currency：AA_i- Outlook: Stable

Rating Rationale

Japan's ruling party alliance won a majority in recent upper house election, but in the short run, the possibility of starting the process of constitution revision is low, and economic growth would be the main concern of Abe's administration. The Macro-economy will continue its slow and instable growth, and the tendency in the long run will depend on the effects of the structural reform. The ease monetary policy will remain unchanged, and the negative interest rate policy will bring pressure to the profitability of the banking sector. The fiscal deficit is tending to decrease, and relatively high government debt ratio is expected to stabilize in the medium run. The balance of current account will remain stable. In summary, the ability of the Japanese central government in term of debt payment will not change significantly.

In the short term, the stability of Japanese politics as well as policy orientation won't have any major changes. Fiscal and monetary policies will be implemented forcefully, but the structural reform is difficult to realize any substantial breakthrough, and the economy will keep growing slowly as it does currently. The fiscal consolidation will continue to progress, and external situation will remain stable. In conclusion, the United Ratings has decided to maintain the outlook of the sovereign rating on Japan in local and foreign currencies in the following 1-2 years at Stable.

Key Indicators of the Sovereign Rating on Japan **Unit：%**

	2011	2012	2013	2014	2015	2016f
GDP（billion USD）	5919.4	5958.8	4913.3	4598.4	4125.6	4709.0
GDP per Capita（USD）	46517.1	46867.6	38692	36266	32593.8	37280
GDP Growth Rate（real）	-0.4	1.7	1.4	-0.1	0.8	0.8
Inflation Rate	-0.3	0.0	0.3	2.7	0.8	0.3
Total Credit/GDP	227.2	232.5	241.7	244.9	253.3	255.1
Growth Rate of Domestic Debt	0.6	3.5	4.7	4.0	2.0	2.1
M2 Growth Rate	2.7	2.5	3.6	3.4	3.7	3.6
Fiscal Balance of Governments/GDP	-9.8	-8.8	-8.5	-7.7	-6.2	-5.0
Interests Payment of Governments/GDP	0.7	0.8	0.9	0.7	0.6	0.5
Gross General Government Debt/GDP	229.8	236.8	242.6	246.4	246.1	247.0
Balance of Current Accounts/GDP	2.2	1.0	0.9	0.8	3.3	3.4

Source: Sovereign Rating Database of United Ratings

Note: The fiscal data are of the financial year that end up on March 31st; "f" stands for forecasts

Highlights of the Sovereign Credit Rating on Korea

Date of Rating: July 20, 2016

Long-term Local Currency：AA_i | Long-term Foreign Currency：AA_i | Outlook: Stable

Rating Rationale

Since the ruling party failed in the parliament election, difficulties in promoting the government policies have become greater, and the uncertainty surrounding the 2017 presidential election goes high, however, it doesn't affect the political stability significantly. Risks in the North-South relations remain high, but are not likely to cause the situation out of control. Nonetheless, the joint decision of Korea and the United States to deploy the THAAD missile defense system, regardless of the opposition of China and Russia, is adding to geopolitical complication. The economy will continue its current gloom status, Current account will turn to deficit, and the government debt rate will remain at a relatively low level. Current account surpluses will decrease, and external situation will maintain stable in general. To sum up, the ability of the Korean central government in term of debt payment will not change significantly.

In the short run, the government is very likely to maintain the current policy. The exact impacts of the THAAD system on security and the economy needs further observation. Economic growth will remain weak, the fiscal stability won't be impacted significantly, and the capability of foreign debt payment is expected to remain stable. In conclusion, the United Ratings has decided to maintain the outlook of the sovereign rating on Korea in local and foreign currencies in the following 1-2 year at Stable.

Key Indicators of the Sovereign Rating on Korea — **Unit：%**

	2011	2012	2013	2014	2015	2016f
GDP（billion USD）	1202.5	1222.8	1305.6	1411.3	1377.9	1355.0
GDP per Capita（USD）	24362.6	24649.4	26192.2	28185.0	27396.9	26840.0
GDP Growth Rate（real）	3.7	2.3	2.9	3.3	2.6	2.6
Inflation Rate	4.0	2.2	1.3	1.3	0.7	1.0
Total Credit/GDP	56.3	57.4	63.6	70.3	89.1	90.0
Growth Rate of Domestic Debt	6.5	4.4	3.6	7.7	7.6	8.0
M2 Growth Rate	5.5	4.8	4.6	8.1	8.2	8.4
Fiscal Balance of Governments/GDP	1.4	1.3	1.0	0.6	0.0	-1.1
Interests Payment of Governments/GDP	-0.5	-0.2	-0.4	-0.1	-0.1	-0.3
Gross General Government Debt/GDP	36.1	38.5	40.5	43.7	44.8	45.6
Balance of Current Accounts/GDP	1.6	4.2	6.2	6.0	7.7	7.2
Balance of Total Foreign Debt/GDP	32.2	32.6	31.0	28.8	27.7	28.3

Source: Sovereign Rating Database of United Ratings

Note: “f” stands for forecasts.