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Political Risk and National Debt Markets in Advanced Economies

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Abstract: The importance of the sovereign bonds within the investment alternatives all over the world, encourages to broaden examination of political instability in context of debt markets. Problem of political risk is mainly scrutinized with reference to developing and emerging economies on microeconomic level, however, it is worth separating that issue from political threat for debt markets. Moreover academics face problem with finding universal indicant to measure political factors responsible for national solvency on debt markets. Considerations were based on literature's review, results of empirical studies as well as accessible statistical data. In effect, political risk as a potential hazard for debt markets in advanced economies was underlined. There was also suggested that persistent, adverse tendencies in political risk may negatively influence country's solvency on debt markets.

Key words: political risk, debt market, instability, index, threat

Introduction

The matter of political risk was originated in economic science in 1960s as an effect of raising financial flows from the USA to Europe and creating Eurodollars markets. At the beginning concerns for capacity to settle the debts were growing and political risk was linked only to transforming and developing countries [Green 1974]. In the late 1980s the notion about limiting financial flows among countries was deliberately consolidated against unfinished public debt's problems and high political risk in many national economies [Lucas, 1990]. Since then, uncertainty of political conditions was considered only towards developing countries and it was mainly discounted concerning companies which invested in unpredictable regions of the world. Then appeared a flowering of studies presenting the correlation between political unsteadiness and foreign direct investments [Sigh, 1995] and the impact of political risk on capital markets' volatility, especially in developing economies. Such a state of studies was held for over two decades in turn with omnipresent belief that political instability had been indispensably replaced with economic risk. Nevertheless, the appearance of

new threats in XXI century compel to ponder over the nature of political risk, not only in context of developing and low-income, but also in regard to advanced economies. The recent study of IMF [2014] projected that geopolitical risk correlated with Ukraine's situation may cause the threat for global financial stability through surge of risk aversion and its spills over, what disrupts the trade and finance in the region. Not only does that region, but also advanced European economies may be endangered by that threat[1]. On the other hand, despite mounting uncertainty of political environment, financial markets are careless with geopolitical risk [Khan, 2014].

1 Political risk – general characteristic

Political risk is broadly defined as a political decisions' influence on economy, which can be stabilizing or destabilizing free market [Titman et al., 2011]. It is peril less amenable economic analysis than economic or financial risk because its interpretation covers wide range of poorly measurable variables [Pilbeam, 2006], which can be searched on three planes: microeconomic (firm – specific), macroeconomic (country – specific) and global –Table1.

1 Political risk returns to Eurozone debt crisis, http://www.ft.com (10.08.2012), Italy now more risky than Namibia as political risk premium jumps, http://www.euromoney.com (10.08.2015), EMU Periphery Watch: Spain Bonds Slip As Political Risk Grows, www.marketnews.com (10.08.2015).

POLITICAL RISK			
GROUNDS	**Microeconomic**	**Macroeconomic**	**Global**
SOURCES OF RISK ON EACH GROUND	Firm	Economical	Terrorism and war
	Project	Social	Poverty
	Industry	Government action	International crisis
	Host country		Environmental concerns
			Cyberattack
			Anti - globalization

Table 1
Political risk – grounds and sources
Source: Own elaboration on the basis of: Eiteman et al., [2010] and Alon, Herbert [2009].

Political risk in microeconomic view refers to firms activity in selected trades in the overseas markets. Ch. Hill [2013] determines political risk as a possibility that political moves provoke drastic changes in economic surrounding and it negatively impacts returns or other goals of business activity. Political uncertainty in micro ground affects particular industries, firms, projects realization by overseas companies in the host economy (and domestic firms too). Nevertheless, micro political risk cannot be perceived strictly in context of host economy owning to firm nationality and its connections with country of origin. Accordingly, micro risk is not included in macro plane totally (Table 1) since micro uncertainty also refers to firms origin economy whereas macro is linked only to the host country.

Overseas companies are exposed to two kinds of dangers. Firstly risk of adverse exchange rate's shifts if they use different currency in transactions outside and in home country, where its assets are valued. This sort of uncertainty pertains to governmental interfering with exchange rate relations between two currencies (i.e. purposely appreciation or depreciation of own currency). Secondly, governance risk springs from remote priorities of government and foreign company in following fields: harmful influence on host country's development, threat of national sovereignty's infringement, overseas domination in key industries, impact on country's balance of payment, control over export market and excessive exploration of natural resources [Eitman et al., 2010]. To defense own interests host countries take actions which rise governance risk. That may be: expropriation of equipment, expropriation with minimal compensation that is below market value, blocked funds, non-convertibility foreign money into

parent's currency, substantial shifts in taxes, numerous controls in foreign firms and new requirement for overseas investors [Eitman et al., 2010][2]. In fact, foreign companies functioning in strategic businesses for host country e.g. natural resources, banking, finance and insurances are highly exposed to political instability.

Political risk in macroeconomic aspect accounts for aggregated country risk, next to financial and economic risk [Erb et al., 1996]. Instability in macro ground overlaps micro ground because they mostly share the same sources. First of all, governmental actions complicating firms' existence in particular trade, hamper competitiveness (ownership structure, nepotism and corruption, protectionism, secure intellectual property), and can contribute to negative assessment of total country risk. Moreover, each country is prone to social anxiety, disorders and other disturbances which generally result from bad governance (high and prolonged inflation, raising debts, falling living standards of citizens). This can easily billow into demonstration, religious tensions and even violent conflicts. Subsequently, moves to appreciation of political instability. Therefore political risk is strictly connected with mixture of inner social and economic (financial) conditions.

Political instability in global ground gained momentum after 2000 with technology development and its application in financial market (cyberattack) as well as with progressive globalization and appearing of the new social movements focused on global an environmental problems. However, the basic sources of threats coming from global plane remains unchangeable - war and poverty (inequality) [Eitman et al., 2010]. Additionally, growing role of terrorism must be articulated because it posed highly unpredictable danger, especially in the aftermath of numerous terror attacks, since 2001.

To conclude, so far political risk was mainly considered towards developing countries on firm specific level, but present global situation encourages to take up that issue in regard to financial sector in rich countries where ties are stronger and risk can be transferred quickly and easily.

2 Commercial insurers consider following actions: confiscation, expropriation or assetsnationalization, export/import embargoes or cancellation of export/import licenses, physical damage to assets from political violence, termination of or default on contracts, non-payment or moratorium due to exchange transfer and currency inconvertibility, non-delivery of goods, calling of on-demand bid or contract bonds and guarantees for political reasons, forced abandonment, non-payment by government owned entities of trade related debt to financial institutions. Source: www.aon.com (28.08.2015)

2 Political risk on sovereign debt markets

Aggregated risk on debt markets consists of some fundamental groups of risk such as: market risk (interest rate, currency, inflation), credit risk, liquidity risk and global aversion to risk. Nevertheless, changes in government policy as well as above presented unexpected politics-related actions can lead to uncertainty and instability of economic surroundings that bond investors experience even if they are outside because of cash flows from issuer to investors.

The political risk constitutes a small subgroup of uncertainty, rarely scrutinized because of limited number of quantitative data as well as of confidence that political instability was replaced with economic risk some decades ago. Nevertheless, macroeconomic factors inform only whether government will be capable of repaying the debts while political factors explain additionally government's un/willingness to do it. [Easton, Gersovitz, 1981]. For these reason investors should take into consideration not only country's ability, but also country's willingness to service its debt. The core point of political risk analysis is to look for non-economical and non-financial determinants which could force debtor to turn away from settling his debts. By the way, the rising role played by these factors discourage investors from investing in politically unstable economy.

The state of national debt market may be assessed by seeing gross amount of public debt (short- and long-term, domestic or foreign) and by caparisoning to other countries the costs of issuing debt (credit rating, bonds yield, bond spread premium). According to that view, political risk can impact debt market bidirectionally.

Firstly, it weakens the national economy fundaments, through the quality of conducting fiscal policy (large expenses, prolonged budgetary deficit) which provokes increasing taxes, limiting incomes of individuals as well as future efforts to repay public debt – that course of action can simply leads to unpredictable social events.

Secondly, through financial channels where financial and individual investors as well as other institutions evaluate credibility of national debtors. The role of effective financial markets is to contain all feasible information into price of financial instruments. Therefore political risk is a result of perceiving the national economy by creditors and investors, for those global hazards are crucial factors, what was suggested early by D. Jodice [1985].

In case of poor remarks (from rating agency), government must offer higher yields and lower price of public bonds to meet investors' requirements. That is why worsening the credit rating may complicate the access to external funding as an effect of rising costs – higher risk premium payed by public and private issuers [Cantor, Packer, 1996; Kaminsky, Schmuckler, 2002].

A huge threat to debt markets stems from the fact that growth of global instability, provoked by political actions, can be spilled over national boarders through financial channels. However, the role of economy, where undesired act happens, in the region or in the world is crucial for the swift spreading risk over other countries. Besides, sudden negative political event can generate high political risk and it may have an impact on financial and economic components of aggregated country risk. This risk can be easily transferred (through banking system and other business and financial ties) to the next countries, where it might complicate political and economic situation.

On the whole, both investors and other market participants (e.g. rating agencies) should try to determine the future solvency (credibility) of selected national economy on the basis of all accessible data, not only from financial and economic spheres, but also from others, such as unexpected information and events from political area in order to contain them into price (yield) of debt instruments. Therefore new approach to analysis of national debtors' solvency should fortify well-known economic and financial threats with political risk.

3 Measuring political risk

There is a great problem with measuring political risk and majority of researchers face that. Some of them strain to create own proxies, others try to abstract value of political risk from boarder indicators. The first approach is typical for G. Beraert et. al [2014], who proposed own indicant - political risk spread on the basis of bond spread. What is more, he even stated that, on average, one third of sovereign spreads reflects political risk. Whereas J. Duyvesteyn et. al [2015] presented second option and converted political risk rating from Political Risk Service (PRS) into risk points. Basing on PRS data and subjective analysis, he created the scale of that risk.

In fact, there are some international institutions, which offer own reliable data which presents the scale of political risk[3] or allows to abstract political risk from others. The great example of data on that threat, especially for economic purposes, can be International Country Risk Guide from PRS. That indicator presents aggregated country risk and includes financial risk rating, economic risk rating and political risk rating at once. Political Risk Rating (PRR) constitutes weighted average of the risk rating of the following components: government stability, socioeconomic conditions, investment profile, internal conflict, external

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3 Economist Intelligence Unit, Heritage Foundation Index of Economic Freedom, Global Insight Business conditions and Risk Indicators.

conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and bureaucracy quality.

Data from PRS group was employed to identify the level of political risk in selected advanced economies in that paper. On the grounds of six different fields: voice and accountability; political stability and absence of violence; government effectiveness; regulatory quality; rule of law and control of corruption[4] , the aggregated final index (average of six fields) was constructed – PR_{index}. What is interesting, PRS publishes own Global PRS Risk Index which also present the same direction of changes as proposed measure on the basis of PRS data, however PR_{index} may be more sensitive to shifts in macroeconomic and political background. For example, Greece in years 2011-2013 had still rank 68 (according to PRS Index[5]), however the economic and political situation changed a lot.

The scale of political risk is inversely proportional to the proposed measure– Table2. In other words, political risk in 2002 was lower in France (0,772) than in Greece (0,713).

4 Each field is evaluated from 0 to 1. The highest value of indicant, the lower risk described to the economy (higher quality of institutions and governance). These scores are comparable over time and across countries since individual measures are based on similar methodologies.

5 https://www.prsgroup.com/category/risk-index (30.08.2015)

	Finland	France	Greece	Spain	Germany	Portugal	Italy	Hungary	Poland
2002	0,987	0,772	0,713	0,838	0,872	0,840	0,723	0,833	0,760
2003	0,985	0,762	0,712	0,822	0,870	0,837	0,697	0,833	0,743
2004	0,985	0,782	0,740	0,820	0,877	0,817	0,720	0,782	0,747
2005	0,985	0,797	0,735	0,815	0,910	0,847	0,733	0,772	0,780
2006	0,985	0,793	0,733	0,823	0,908	0,845	0,733	0,767	0,763
2007	0,987	0,842	0,732	0,817	0,912	0,842	0,733	0,757	0,772
2008	0,982	0,827	0,722	0,805	0,903	0,837	0,738	0,753	0,785
2009	0,983	0,832	0,720	0,797	0,903	0,828	0,735	0,737	0,787
2010	0,982	0,812	0,670	0,770	0,885	0,792	0,717	0,723	0,782
2011	0,950	0,758	0,678	0,730	0,868	0,752	0,665	0,703	0,762
2012	0,940	0,752	0,648	0,722	0,890	0,725	0,667	0,69.7	0,752
2013	0,937	0,728	0,660	0,748	0,892	0,727	0,663	0,703	0,750

Table 2

Political risk prescribed selected countries [PRindex]; 2002-2013

Source: Own *calculation* on the basis of PRS data.

On the basis of Table 2, it can be also observed that the most politically secure country in 2013, among selected, was Finland, but the most unsecure was Greece, however there are also two economies from outside the Eurozone. In terms of PR stability, it can be stated that the greatest deviations of coefficient were noticed in Hungary (0,046) and Greece (0,032), while other economies feature rather low deviations, the lowest in Germany and Poland (0,016).

Financial markets employed rather economic and financial indicants to assess the instability before 2008, therefore debt markets of Eurozone's members showed lower risk than it really was. Before the last crisis transpired, the euro area was a territory of high economic security and stability, that's why member states received credit on easy terms because investors did not anticipate the adverse course of events (Table 3). There economic and financial risks were believed to be under control, but political risk was totally ignored.

On the grounds of Table 3 it can be noticed that some economies bear lower costs of debt service than PR_{index} suggested. For example countries such as Hungary or Poland payed more for their debts (Table 3) than Greece until even 2009, then Portugal up to 2010, though these countries were on the edge of bankruptcy.

That way of risk evaluation performed by international investors (Table 3) and institutions (Table 4) was especially interesting in case of Poland, where economy was robust, but country got capital more expensively than Italy and Spain up till 2012.

	Finland	**France**	**Greece**	**Spain**	**Germany**	**Portugal**	**Italy**	**Hungary**	**Poland**
2006	3,78	3,80	4,07	3,78	3,76	3,91	4,05	7,12	5,23
2007	4,29	4,30	4,50	4,31	4,22	4,42	4,49	6,74	5,48
2008	4,29	4,23	4,80	4,37	3,98	4,52	4,68	8,24	6,07
2009	3,74	3,65	5,17	3,98	3,22	4,21	4,31	9,12	6,12
2010	3,01	3,12	9,09	4,25	2,74	5,40	4,04	7,28	5,78
2011	3,01	3,32	15,75	5,44	2,61	10,24	5,42	7,64	5,96
2012	1,89	2,54	22,50	5,85	1,50	10,55	5,49	7,89	5,00
2013	1,86	2,20	10,05	4,56	1,57	6,29	4,32	5,92	4,03

Table 3

10 Y sovereign bond yields [%]; 2006-2013

Source: Eurostatdatabse.

	Grecee	Spain	Poland	Portugal	Hungary	Italy
2006						
Moody's	A1	Aaa	A2	Aa2	A1	Aa2
S&P	A	AAA	BBB+	AA-	BBB+	AA-
Fitch	A	AAA	BBB+	AA	BBB+	AA
2008						
Moody's	A1	Aaa	A2	Aa2	A2	Aa2
S&P	A	AAA	A-	AA-	BBB+	A+
Fitch	A	AAA	A-	AA	BBB+	AA-
2009						
Moody's	A1	Aaa	A2	Aa2	Baa1	Aa2
S&P	A-	AA+	A-	A+	BBB-	A+
Fitch	A	AAA	A-	AA	BBB	AA-
2010						
Moody's	Ba1	Aaa	A2	A1	Baa1	Aa2
S&P	BB+	AA	A-	A-	BBB-	A+
Fitch	BBB-	AA+	A-	AA-	BBB	AA-
2012						
Moody's	C	Baa3	A2	Ba3	Ba1	Baa2
S&P	CCC	BBB+	A-	BB	BB+	BBB+
Fitch	CCC	BBB	A-	BB+	BB+	A-
2013						
Moody's	C	Baa3	A2	Ba3	Ba1	Baa2
S&P	B-	BBB-	A-	BB	BB	BBB+
Fitch	B-	BBB	A-	BB+	BB+	A-

Table 4

Credit ratings for selected national debtors; 2006-2013

Source: Reuters data, International Finance Statistics.

Looking on the data in Table 4, it can be stated that until the last crisis, the credit ratings were stable. Only in case of Hungary (one institution) and Italy (two institutions) ratings were changed in 2008. The drastic shifts in assessment of public debtors started in 2009 because of worsening public financed stance as well as constructive criticism over rating agencies policy. Since then credit ratings were regularly downgraded for Greece, Spain and Portugal. These facts allow to suspect that credit ratings akin to bonds yields presented low sensitivity to macroeconomic situation of public borrowers, especially before 2009.

On the other hand, Poland set exception because within all analyzed years national credit rating was not downgraded, however, Poland, beside Hungary and Greece, used to pay the most for own debt service until 2010. It is worth noticing that, apart from rigidity of credit ratings and bonds yields up till 2009-2010 towards Greece, Portugal and Italy, the level of political risk (measured by PR_{index}) informed about higher security (solvency) in Poland in comparison to mentioned economies since 2005 – Table 2.

Taking into consideration some countries without common currency (Hungary, Poland) and euro members (Greece, Portugal, Italy, Spain), it can easily draw conclusion that financial markets might have valued political risk with a higher care than economic and financial risk. Both credit agencies as well as international investors underestimated the threat of insolvency in some developed economies since coefficients from bond markets (bond yield, credit ratings) did not alert investors. Even though, the scale of political risk was assessed precisely (PR_{index}), that kind of uncertainty played minor role in evaluation of future countries' solvency.

4 Conclusion: Political risk– potential threat for debt markets

In XXI century, political risk may be viewed as potential threat for advanced economies because of military operations' transfers from the vicinity of Europe (Near East) into its terrain (Ukraine, Turkey) and acts of terror in resilient economies (e.g. Great Britain, France). According to neoliberal thesis about the night watchmen, who provides citizens with the public order and national security in uncertain times, the role of governments' activity may grow. Finally, the domination of political and institutional decisions over economic choice will provoke higher exposition to political risk.

For that reason evaluation of risk incorporated in sovereign bonds could be supplemented by political risk analysis since modern investors should take into consideration not only country's ability, but also country's willingness to service its debt. The example of advanced economies from European Union proves that

persistent and adverse tendencies in political risk may negatively influence country's solvency in the future apart from economic and financial conditions.

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