

## Country risk and political risk under investigation – recent trends, prospects, and implications

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### Abstract

*For many years, economic growth has been one of the main objectives of economies around the world. Recently, the central focus has diverted from the quantitative to the qualitative approach. Mainstream research acknowledged that institutional quality along with country risk is among the most significant factors that contribute to the achievement of high economic development rates. Country risk is associated with the probability that investors or companies from a certain country will face greater instability or losses and includes financial, economic, and political risks. Lower political risk ranks first in the category of main drivers that enable countries to attract more foreign direct investments and allow markets to operate efficiently. This article examined the recent evolutions in terms of the concept and main antecedents of the political risks, considering the current negative disruptions that economies were forced to experience, covering aspects related to health, wars, and economic downturns. The analysis identified that a high political risk negatively impacts demographics, environment, and the health system. The ability of countries to bounce back and develop a strong resilient economy toward adverse shocks depends on the institutional quality and the effectiveness of policymakers, who are responsible for elaborating efficient economic policies.*

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### 1. Introduction

Global risks should be studied under the comparative incidence of temporal 'apostrophes', as change defines everything around us. There is no socio-economic entity to be excluded from taking risks, as all (from the company to the state) exhibit vulnerabilities. That is precisely why the holistic approach to risk is the only one that can change its status as an observer in the international arena, to that of an assumed, proactive operator. International forums such as the World Economic

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Forum, highlight some specific categories of risks that are currently threatening economies around the world: economic, environmental, geopolitical, societal, and technological (World Economic Forum, 2023). According to the World Economic Forum, the main risks societies will face in the next two years include the cost-of-living crisis and the extreme weather events.

If the last decades have cast in a shadow the political risk (strongly analyzed by researchers in the '1960s-'70s of the last century – the period of decolonization), in recent years it has returned to the forefront, in a general climate of uncertainty (starting with the COVID - 19 pandemic, and continuing with the Russian invasion of Ukraine, but also the Israel/Hamas conflict (Gaza) or China/US tensions (Taiwan)). Political risk, especially within the European context, was perceived as almost non-existent; now, after years of war near the EU's border, political risk has become a major point of interest on the EU agenda. These economic complexities led to inquiries into the effects of these shocks and the appropriate policy measures needed to alleviate their negative consequences.

This article seeks to offer a more comprehensive approach into the problem of country risk, and more precisely, political risk, starting with a short review of the literature on the concept of political risk and continuing with a detailed analysis of the recent evolutions in what concerns the factors associated with the country and political risk. Based on a profound introspection into the literature in the field, the present article identifies a strong relationship between demographic factors, environmental policies, and health factors and country or political risk. Therefore, policymakers should take into consideration these factors when developing the national and international strategies design to ensure sustainable economic development.

## **2. Political risk as a core pillar of the country risk: literature review**

Political risk is correlated with a nation's reputation and the moral hazard a state takes. It considers the probability that (geo)political decisions, namely, existing regulations in the field, will have a negative impact on the performance of companies, markets, and/or states. More precisely, political risk is part of the constraints and other major unpredictable changes in the (inter)national political framework, which may impact the business environment. These political reforms, which are more or less predictable, often change the "*rules of the game*", to the disadvantage of most national entities / economies. It is now common to explore in what way the 21st century globalization transformed the outlook of countries, governments, and businesses (Brown, Cavusgil, Lord, 2012). As a consequence of this, several categories of risk can be distinguished. The geopolitical risk derives mainly from conflagrations (military conflicts), terrorism, changes in the framework

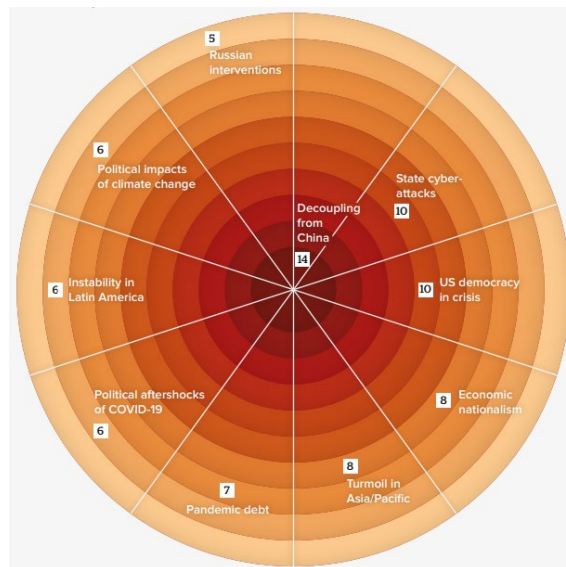
of state power / political forces, but also from imposing certain economic sanctions for noncomplying with certain regulations. The internal/external political risk arises mainly from attacks of separatism, nationalism, ethnic violence, tensions, and then massive protests (ended by social movements or revolutions), regime changes or coups d'état, pandemic crises. This is applicable not only for the case of emerging markets - which one would expect to be severely impacted by shocks (armed conflicts, food crisis, poverty) - but also when developed economies are faced with these adverse shocks. Undoubtedly, the spread of risk matters. The socio-economic repercussions of political tensions, insecurity, and unstable political environment affect, directly or indirectly, the economic growth rates, therefore, the standard of living (Asteriou & Price, 2001:383-399; Aisen & Veiga, 2010:1-28; Tabassam et al., 2016:325-334; Murad & Alshyab, 2019:366-380; Kirikkaleli, 2020:1-10; Simmons, 2023:707-781). Political risk influences the foreign direct investment flows, a country's competitiveness, and overall (geo)political stability. In the end, it can even lead to the withdrawal of capital from countries with a high degree of this risk. Therefore, we operate with two major categories in the field:

- **Systemic risk** affects the entire economic system and is caused by major factors (crises, wars). More precisely, from this perspective it cannot be concluded that there are countries immune to political risk. However, we identify countries with high political risk and others with moderate/low political risk. Without any doubt, the second mentioned category "outclasses", in terms of risk, the consolidated economies of Western Europe, the USA or Japan, capable of withstanding "tectonic movements" of political nature, without distorting the political and socioeconomic structures of the international environment. Globalization does not ease the challenges posed by political risk, but corrodes it in tandem with political instability, high levels of corruption, climate change or international terrorism.
- **The non-systemic (organizational) risk** is controllable to a significant extent because it is counted at the level of the primary economic entity. That is why corporate responsibility plays a decisive role (Walmart, 2022), although - as an example: "as the chances of a more economically left candidate go up, the markets could get rattled"; "just the perception of a less big business-friendly administration could do damage to (...) share price" (Niel, 2020).

The Political Risk Index evaluates world economies, based on the so-called "risk temperature", which denotes the current situation of the countries on the political risk map, but also the future trends. Unfortunately, the current international geopolitical framework facilitates the rapid transition of a country from a moderate / relatively low risk category to a higher risk category. The 2022 Political Risk Survey Report provides eloquent illustrations in this regard. As the data show, compared

to the similar document elaborated in 2020, the ratio between respondents concerned and those not concerned about the conflicts in the area has multiplied from 2:1 to 20:1 (WTW, 2022:4). These massive disruptions were driven not only by the repercussions of the global pandemic, but also by the changes in the geopolitical landscape (see Figure 1).

**Figure 1. Top risks 2022 (number of mentions)**



*Source:* WTW, 2022 *Political Risk Survey Report. How are Leading Companies Managing Today's Political Risks?*, Oxford Analytica, March 31, 2022, p. 17, <https://www.wtwco.com/en-ie/insights/2022/03/2022-political-risk-survey-report>

More precisely (WTW, 2022), from the 15 categories of panel type observations, recorded in 2022, the vast majority of the answers provided (14, as seen in Figure 1) were concerned not so much about the Russian invasion of Ukraine, but by the objective considered number one threat: the imperative of "decoupling" the world economy from the influence of the Chinese giant ("decoupling from China") and - obviously - the presumed costs of this process. The second most mentioned threat was concerning two main trajectories: countering major cyber-attacks ("State cyber-attacks") and the crisis of American democracy ("US democracy in crisis"). The other situations that raised concerns included: the unfruitful manner in which the so-called economic nationalism is practiced ("Economic nationalism"), the turmoil in the Asia-Pacific area ("Turmoil in Asia/Pacific"), the multidimensional consequences of the pandemic crisis ("Pandemic debt", "Political aftershocks of COVID-19"), instability in Latin America ("Instability in Latin America"), climate change ("Political impacts of climate change") or ("Russian interventions").

From a correlated but not similar perspective, the Eurasia Group shows that the current fears of the world map are headed toward the following challenges (Eurasia Group, 2023): "Rogue Russia; Maximum Xi; Weapons of mass disruption; Inflation shockwaves; Iran in a corner; Energy crunch; Arrested global development; Divided States of America; Tik Tok boom; Water stress". At this time, the world is experiencing a high degree of volatility caused by poverty and social disequilibrium.

### **3. Recent trends related to the political risk and the country risk**

There are a wide range of factors correlating to the country and political risk, among which one can mention demographic factors or environmental policies. When evaluating the role that labour and human capital play in terms of sustainable economic development, it is crucial to bring into discussion the importance distinction between the size of the population and the structure of the population. According to Bodnar and Nerlich (2022), the European Union, and especially the member states of the euro area, are facing severe demographic transformations. As data from Eurostat confirm, the population in the euro area will decline starting in 2035, while increased life expectancy and reduced birth rates will determine a negative impact in terms of growth potential of the countries as well as pessimistic fiscal prospects. These transformations will also impact the way in which the institutions of the countries will manage different categories of risks such as, economic or political risks. Many studies recognised the significant relationship between demographics and political risk, especially the channel through which demographics may affect debt sustainability over a longer period of time. Macroeconomic instability is expected to increase across EU member states, while a trend of divergence and increased heterogeneity is likely to characterize the economies of the European Union.

Other studies (Boitan, Marchewka-Bartkowiak, 2022) analyzed the impact of climate change on government debt, demonstrating that climate-vulnerable states pay a higher risk premium in terms of sovereign debt. Moreover, Wang et al. (2022) based on a data set of 32 members of the OECD concluded that a low political risk is positively associated with the consumption of renewable resources.

Another triggering factor, especially with regard to sovereign risk, is health risk; for example, the recent pandemic quickly led to sovereign over-indebtedness in many countries (Singh, Gomez-Puig, Sosvilla-Rivero, 2021). Sovereign debt management, already difficult, has become even more delicate in the context of the health crisis. Moreover, the current need for investment in defence systems puts additional pressure on public debt, in turn changing the architecture of country risk. On the other hand, some researchers highlight the overwhelming importance of indicators on health (main indicators on the health system, indicators on various diseases and

indicators on substance abuse) and demographics (population, population over 65, births/deaths, population growth, population density, urbanization) on country risk (Brown, Cavusgil, Lord, 2012), some making correlations between population ageing and sovereign default risk (pension and healthcare costs increase with individuals' age) (Damodaran, 2020).

Also, increasing importance is given to the link between sovereign risk and global financial risk, an increase in the latter causing sovereign bond spreads to widen (Gilchrist, Wei, Yue, Zakrajsek, 2022).

#### 4. Concluding remarks

In recent years, economies around the world have been forced to prove the efficiency of their resilience and risk strategies, while they were exposed to several shocks that generated profound negative economic consequences (Sace, 2023): a) the pandemic crisis; b) the Russian invasion of Ukraine; c) high inflation rates. In the light of these severe crises, a climate of uncertainty and vulnerability forestalls the global macroeconomic framework. In order to surpass these economic imbalances and re-establish a climate of confidence and predictability, policy makers had to elaborate complex recovery plans that in the majority of cases caused an increase of the public debt and of the government spendings. This article analysed the main categories of risks that countries face nowadays from a conceptual perspective but also taking into account recent trends. In line with previous research, this study highlighted that demographic factors, environmental policies, and health factors are among the most important factors in relation to the country and political risk. Reducing country and political risk proves to be crucial in the attempt of countries to counteract the negative shocks.

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