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Political risk on financial markets in developed and developing economies

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Abstract

Aim/purpose – We want to draw academics and market practitioners attention to threats form political risk's area that affect national financial markets in both developed and developing economies.

Design/methodology/approach – We analyzed the wide concept of political risk on the basis of international literature as well as national statistical data and international comparative indicants for selected developed and developing economies around the world.

Findings – Growing significance of political risk was signaled, although both types of economies are exposed to different aspects of the threat. We confirmed that developing states are threatened by bigger number of political bothers, whereas advanced countries are susceptible to some forms of violence.

Research implications/limitations – Imply that economies with better economic stance have lower level of political risk, although, their highly developed and integrated financial markets are responsible for the transfer of analyzed risk. Unfortunately, the scarcity of reliable time series about political risk hampered a deeper empirical analysis.

Originality/value/contribution – Presentation of political threats to financial market stability.

Keywords: threat, stability, international finance.
JEL Classification: F30, F34, F65, G15.

1. Introduction

Modern global economy is highly complicated, integrated, and unpredictable. It is featured by series of economic and non-economic perils, which are

often avoided or depreciated. Unquestioned example to be mentioned here is political risk (PR) because its concept seems to be narrowed down to micro and macro governance in less developed economies. Nonetheless, along with the emergence of global ground of PR[1], it poses a hazard to developed states.

Taking risk transfer in global finance into account, financial markets are direly careless with geopolitical risk [IMF 2014]. We may find few research papers concerning political sphere and finance, mostly in context of developing countries [Lensink, Hermes & Muride 2000; Le & Zak 2006]. Arguably, the scarcity of detailed analysis in terms of financial markets may to some extent expound the incomprehension and disinterest of the subject in developed states. We addressed this issue in order to bridge this gap in the contemporary literature. We tried to present the threats from two main aspects of political risk, that are essential to finance in developed as well as developing economies.

To do so, we organized text as follows. In the first part, we demonstrated two-dimensional, theoretical concept of PR with division into three grounds. Next, we made a selective review of empirical studies and showed how political sphere affects variability on financial markets, especially in advanced economies. In the second part we concentrated on analyzing international statistical data (indicants) in order to present the links between economic stance and political risk and finance. Finally, we made some conclusions.

2. Theoretical background

2.1. Political risk perception

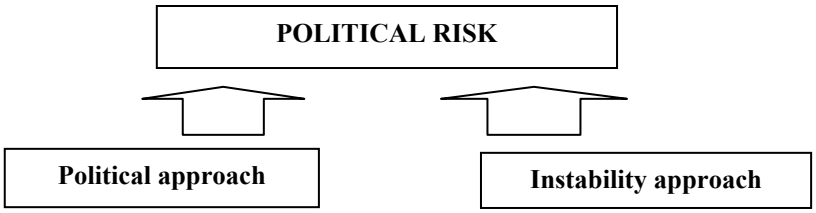
PR comprises of non-economic two-dimensional drivers. According to A. Loikas [2003], PR combines political approach and instability approach. Finally, the sum of different actors' activity from both approaches generates the level of that risk (Figure 1).

Policy approach refers to PR that results from decisions of state authorities made on various levels. This approach is characterized by gradual transformation of institutional framework − changes in the rules of the game. Risk appears as a result of uncertainty between political and economic actors on the platform of formal and informal institutional drivers. The research problem is located in the relationship between economic agents and political authority in the environment where both

[1] In the last decade of XX century OECD countries invested substantially in information and communications technology (ICT). It supported GDP growth through the increase in productivity [Miles & Scott 2005]. Both technological progress as well as financial liberalization contributed greatly to establish the new ground of perils within PR – global ground.

actors have individual and non-compensated roles. The final decisions and actions are usually well-calculated by authorities and they are known by only some pressure groups before they come into life. However, these shifts create uncertainty among wide scale of market's participants (investors, entrepreneurs).

Figure 1. Aggregated political risk



Source: Based on Loikas [2003].

Instability approach involves *internal violence* (*threats to national security from domestic environment*: civil turmoil and internal armed conflicts) as well as external violence, whose origins come from abroad e.g. terrorism, war or cyber threat. Unanticipated events put politicians under immense pressure, make their decisions ill-considered and their behavior reckless. Consequently, uncertainty in national economy is growing.

PR is broadly defined as a political decisions' influence on economy, which can be stabilizing or destabilizing for the free market [Titman, Kewon & Martin 2011]. It hardly comes under economic analysis as it covers wide range of poorly measurable variables, which can be sought on the three planes: micro-economic, macroeconomic, and global (Table 1).

Table 1. Political risk – grounds and factors

POLITICAL RISK			
GROUNDS	Microeconomic	Macroeconomic	Global
FACTORS	Project	Institutional lacks	Anti-globalization, Environmental concerns
	Firm	Social condition	Poverty
	Industry	Economic policy	Cyberattack
			Terrorism and war
	Origin country	Government action	Supranational governance
		National security	International crisis

Source: Based on Titman, Kewon & Martin [2011]; Alon & Herbert [2009].

PR in micro ground affects certain projects realized by overseas companies that function in significance areas (energy, natural resources, etc.) for the host economy[2]. However, PR does not influence industries and companies in the

[2] Micro PR cannot be restricted to the host economy since government from country of origin may also adversely affect company.

same way. Therefore, sometimes political difficulties may create exceptional trade or investing opportunities [Kozłowska 2015]. The typical adverse micro-economic behavior of government presents concept of decreasing bargaining power[3], which rather takes place in less-developed economies. Macro PR overlaps micro ground because they mostly share the same sources, however, that ground depicts country investment's profile clearly, catching the political as well as instability approaches together. Those above-mentioned grounds and factors are thoroughly presented in the literature[4], thus, to take the analysis a step further, it is worth dividing drivers on the basis of their origin from purely political approach and instability approach (Table 2).

Table 2. Political risk drivers in two dimensions

Political decisions/actions	Political instability
1. Government interference with selected projects, firms or industries 2. Economic policy (interest rate, exchange rate, inflation) 3. Institutional lacks 4. Social movements 5. Income inequality/poverty 6. Government actions 7. Supranational governance 8. International crisis	1. Internal violence 2. External violence (international terrorism) 3. Cyber threat 4. Armed conflicts

Source: Based on existing literature.

Apart from bracketing, some factors of a given approach, threats from one area may billow into growth of uncertainty in the other sphere. Income inequality among citizens or anti-globalization forces may be awaken by national or supranational governance, yet, social dissatisfaction and the feeling of exclusion can be a case for violence. Opposite mechanism is visible through indirect effects in case of international (new era) terrorism. That threat comes from instability area, although, it affects political sphere since politicians are obliged to take some necessary steps to prevent it or to minimalize its consequences. They are responding to threat under pressure therefore they generate uncertainty in economy.

[3] The agreements between host government and foreign company is based on bargaining power of two actors [Vernon 1971]. Host country regulates market-entry whereas foreign investors control the production factors such as capital, management and technology. This shows the dynamic interaction between multinational corporation and host government, which finally contributes to the renegotiation of bilateral agreement because of decreasing bargaining power of investor.

[4] See: Alon & Herbert [2009]; Titman, Kewon & Martin [2011]; Waszkiewicz [2015].

Factors from PR's area may influence both real economy and financial markets stability (Table 3).

Table 3. Drivers influencing economy and finance

Economy	Financial markets
Governance in particular trade Social movements Income inequality	Cyber threat
Institutional shortages	
National macroeconomic governance: Interest rate, exchange rate, inflation	
Internal, external violence (new era terrorism), armed conflicts	
International governance	
International crisis	

Source: Based on existing literature.

Real economy may be hurt through expropriations and confiscations since they decrease its competitiveness. Social movements' aims also influence national economy because of imposed restrictions resulting from environmental protection. In context of drivers common to both dimensions, we may mention system shortages such as weak institution and law. When it comes to exchange rate policy in the country conducting own monetary policy, there is a real danger of political pressure on the value of national currency, especially in case of a state with export-oriented policy.

According to the theoretical view, financial markets may discount various politics-related events through the directions of international capital flows. These abnormal signals affect prices, yields and returns of financial instruments on the global scale. For this reason, financial market stability is the fundamental priority in the modern world owing to the fact that excessive volatility encourages financial speculation and hampers long-term investments. If we realize that capital flows affect exchange rate more than international trade [Kotte 2010], we can see how much the country position on financial markets may be complicated through short-term capital flows. Nonetheless, the question is – whether finance instability in advanced economies may be provoked by political sphere today.

2.2. Financial variability due to political risk – short insight into empirical tests

Studies on PR in context of stock markets date back to the middle of 1990s., albeit R. Roll [1988] stated that 60% of shifting prices is still not uncovered. H. Kim and J. Mei [1994], testing impact of China's on Hong Kong's

economy, argued that the majority of unexplained factors is related to political decisions' results. R. Diamote, Liew and Stevens [1996] proved that PR is one of the most important drivers responsible for stocks prices unsteadiness in developing and developed countries, however, political uncertainty plays a bigger role in developing economies. Those results were also confirmed by G. de Santis & S. Imrohoroglu [1997], who claimed that developing markets have propensity to bigger price fluctuations than advanced economies what could be expounded by PR. The influence of political information on exchange rate and volatility on stocks markets was presented by H. Kim and J. Mei [2001]. M. Baker and J. Wurgler [2006] stated that the stock index was rallied before the presidential election in the USA as well as in the aftermath of war in the Persian Gulf (1990) and the World Trade Center (WTC) attack in 2001. What is more, M. Beaulieu, Cosset and Essaddam[2005] noticed that PR effects mostly developed countries. Political business cycle has a vital impact on stock markets volatility. It was positively verified by example of the US economy [Gärtner & Wellershoff 1999]. Especially pending democrats' governance stock returns are higher because of the lower instability of political environment. On the other hand, above-mentioned course of dependency was not confirmed in German economy [Döpke & Pierdzioch 2013].

Analyzed risk was also scrutinized in regard to public obligations, essentially government bonds which set the benchmark for other national, financial instruments. On the whole, studies over bonds markets focus on looking for new and unexpected information and events from political sphere in order to take them in price (yield) of instruments. According to those studies, both investors and other market participants (e.g. rating agencies) strain to determine the solvency of selected national economy. The poor credit rating is an inconvenience to economies needing foreign capital to relive domestic financial market in process of balancing budgetary bill as well as financing real sector. Worsening the credit rating may cause overseas capital to escape from host economy and complicate the access to external funding as an effect of rising costs – higher risk premium paying by issuer [Kaminsky & Schmuckler 2001]. Therefore institution such as rating agencies also impact economic and political stance. J. Beirne & J. Gieck [2012] found evidence of contagion from global bonds to regional stock markets in Central, Eastern Europe, the Middle East and Africa. The recent study of IMF [2014] projecting that geopolitical risk correlated with Ukraine's situation may cause the threat for global financial stability through surge of risk aversion and its spills, what disrupts the trade and finance in the region.

Further field, heavily dependent on PR is a banking sector. The relationship between financial intermediaries and world of politics is complex. Financial institutions may be subject to political pressure twofold. Firstly, because of rela-

tion among election cycle and banks' proclivity to loan's creating. Politicians may pressure on banking sector at the time of election year since budgetary expansion before voting may help them to be reelected [Micco & Panizza 2006]. Secondly, politics (direct) impact is associated with government regulation process and permanent control over various segments of financial markets.

E. Papaioannou [2005] proved that banks prefer to own assets investments in countries, where corruption is strictly limited, legal system functions well, what is more and domestic banking sector is not controlled by the state. Furthermore, when banking system is dominated by state banks, it diminishes overseas banks' interest owing to the political aims dominate over profit maximization [La Porta, Lopez de Silanes & Shleifer 2002]. According to E. Papaioannou [2005], every second percent of banking sector under state's control reduces the scale of overseas banks' inflows by 1,6%. Many countries were infected by problems created in advanced economies due to the fact that banking sector is also able to transfer shocks through the shifts in financial liabilities [Curetti 2013].

In context of instability, L. Wells [1998] demonstrated that unexpected political events affect more financial operations than buying (selling) fixed assets. Then, M. Nishat [2000] argued that political and economic turbulences in host country prompt flux in stock markets and lead to capital outflow. J. Mei & L. Guo [2004], testing 22 developing economies, formulated braver suggestion, namely, that the political instability is a crucial factor which drives to financial crisis. Aside from the fact that international financial market responds quickly and simultaneously, it must be noticed that the scale of this reaction varies among countries [Nikkinen et al. 2008]. The terror attacks bring both direct costs, nagging in short run (e.g. destruction of buildings or information system), as well as indirect effects, which affect the economy in medium run through undercutting the consumers and investors' confidence in host economy [Bruck & Wickstrom, 2004]. Moreover, terrorist attacks are not dangerous only to financial market (stock exchange) in country of occurrence, but also for others. M. Hon, Strauss and Yong [2004] stated that terror attack may bring supranational consequences against the global connections of national financial markets. This scenario can be materialized by contagion effect, which is usually stronger between the USA and Europe than between Asia and Latin America.

What is notably important, the single terror attack has a special range of reaction on financial markets in various countries. The WTC attack in 2001 affected the whole world whereas the act of terror form Madrid in 2004 had rather local consequences [EBC 2004]. Additionally, adverse effects of WTC attack were finished firstly on American financial market [Chen & Siems 2004]. On the other hand, the attacks in Madrid and London (2005) triggered untypical stocks

returns that persisted longer in case of Spain [Kollias, Papadamou & Stagiannis 2011]. That may suggest the salience of country's economic potential in overcoming those turbulences.

Both events from political and instability area[5] make for the sudden change in international capital flows. Unstable capital generates price and yields variations as well as credit crunch. Finally, fluctuations are transferred from directly hurt economy to home markets due to financial ties. The role of economy, that experiences adverse political event, in the region or worldwide is crucial for swift risk spreading over national borders (effect of contagion). Therefore the negative impulse (event) may complicate economic conditions in the economy that is unharmed directly. Finally, PR transportation aids negative wealth effect among companies and households owing to assets prices variations. For this reason firms reduce their investments and increase debt whereas households may reduce savings in order to maintain their consumption spending.

3. Research methods

This part of our study focused on comparative analysis of developed and developing economies to prove that the discrepancies in economic stance are relevant to distant position in context of political risk. We applied statistical data from documents: IMF (2016), McKinsey Global Institute (2015) as well as from Internet databases: US Bureau of Economic Analysis, World Development Indicators. We also utilized following indicants: Global Peace Index from Reports [2011, 2014, 2016] of Institute for Economic and Peace, Worldwide Governance Indicators [2016] about the components of political risk from Internet database of World Bank and Global PRS Risk Index from the website of PRS Group.

4. Research findings

4.1. Economic stance and PR

International organizations divide all national economies into some groups. The classification is usually based on their economic status. Taking only advanced and developing countries into consideration we are cognizant of several fundamental differences between them. Again, discrepancies (Table 4) affect national investment climate in both groups of economies. In developing countries, the stability and profitability of foreign investments are more difficult to

[5] G. Waszkiewicz [2016] elaborated on financial dimension of national security threats.

guarantee due to concerns from political and instability area. Moreover, potentially lucrative business opportunities that accompany rapid economic growth may support corruption. Although investing in developing economies is popular and beneficial, investors know those chances come with risks [Campisini 2016]. Potential politics-related impediments in developing states origin from micro and macro ground e.g. rampant corruption, expropriation and nationalization, legal and regulatory insecurity, political violence, weak state institutions and abrupt political changes. That is why, foreign firms must pay for mitigating that risk through purchasing PR insurance. This kind or risk is deeply grounded and country specific, not easy to transfer. Of course, developing countries are not free of instability threat. Beside terrorism, there is real danger of revolution, military in politics as well as armed conflicts at regional level.

Table 4. Differences between developing and developed economies

	Developed	Developing
National Wealth	High	Moderate
Finance	Developed, Integrated	Less developed
Standard of living	Good	Moderate
Character of economy	Postindustrial (service)	Industrial
Distribution of income	Equal	Unequal
Factors of production	Effectively used	Ineffectively used
Perspective of Growth	Technological progress	Capital accumulation
Infernal violence	Low	Moderate

Source: Based on existing literature.

On the other hand, advanced economies are also susceptible to drivers of PR, that mostly come from global ground. The only domestic source is national governance, which prevailed free market rules after the last crisis what may be linked to control over different sectors of national economy or revive the economic growth. The rest of drivers may induce indirect effects such as supranational governance which may be harmful to real economy (unemployment in Greece, Spain after 2008) and finance (additional tax, credit limits). Supranational governance should not be connected only with political authorities (e.g. European Commission or European Parliament), but also with international institutions that establish expectations towards countries needing financial support (tough budgetary expectations towards Greece). Instability area pertains to the events that may be directed to selected economy such as cyber-attack or terrorist attack. On the other hand, the engagement of main developed countries in some conflicts as well as unsolved scraps near to European terrain or inside the Europe may erode economic stability. It is also worth mentioning military actions not

only in Ukrainian's terrains, but also in the Middle East, close to Europe: Turkish problem with Kurds and recently Syrian zone where unofficially several Great Powers have own interests, frictions in Asia (North and South Korea) let alone tensions between the USA and China or long-lasting strife between regional Great Powers (UK[6] and Argentina).

Especially new era terrorism and rich countries' engagement in armed conflicts influence mostly the perception of instability area in advanced economies. Global Peace Index (GPI) clearly depicts weakening position of Western States. Scores from GPI have risen over the last six years whereas the same indicants have been stable in the majority of developing economies (Table 5).

Table 5. Global Peace Index[7] for selected countries: 2011-2016

Year / Country	2011	2013	2016
USA	2.06	2.14	2.15
Germany	1.42	1.42	1.49
France	1.70	1.80	1.83
UK	1.63	1.80	1.83
Norway	1.36	1.37	1.50
China	2.05	2.20	2.29
Malaysia	1.47	1.66	1.65
India	2.57	2.57	2.57
South Africa	2.35	2.36	2.32

Source: Based on Global Peace Index [2011; 2014; 2016].

Comparative statistical analysis conducted among developing and developed economies contributes to understanding of their distant position in terms of PR. That is why, the scale of PR associates with both streams of economies is also a distinguished feature. On the grounds of five developed economies (Canada, UK, USA, Japan, France) and five developing (Brazil, Argentina, Indonesia, Thailand, Turkey)[8], we created the average value of indicant from each considered area: Political Stability and Absence of Violence (PSaAV), Rule of Law (RoL), Regulatory Quality (RQ), Control of Corruption (CoC), Voice and Accountability (VaA) as well as Government Effectiveness (GE). The scores[9] from given areas are presented by Figure 2.

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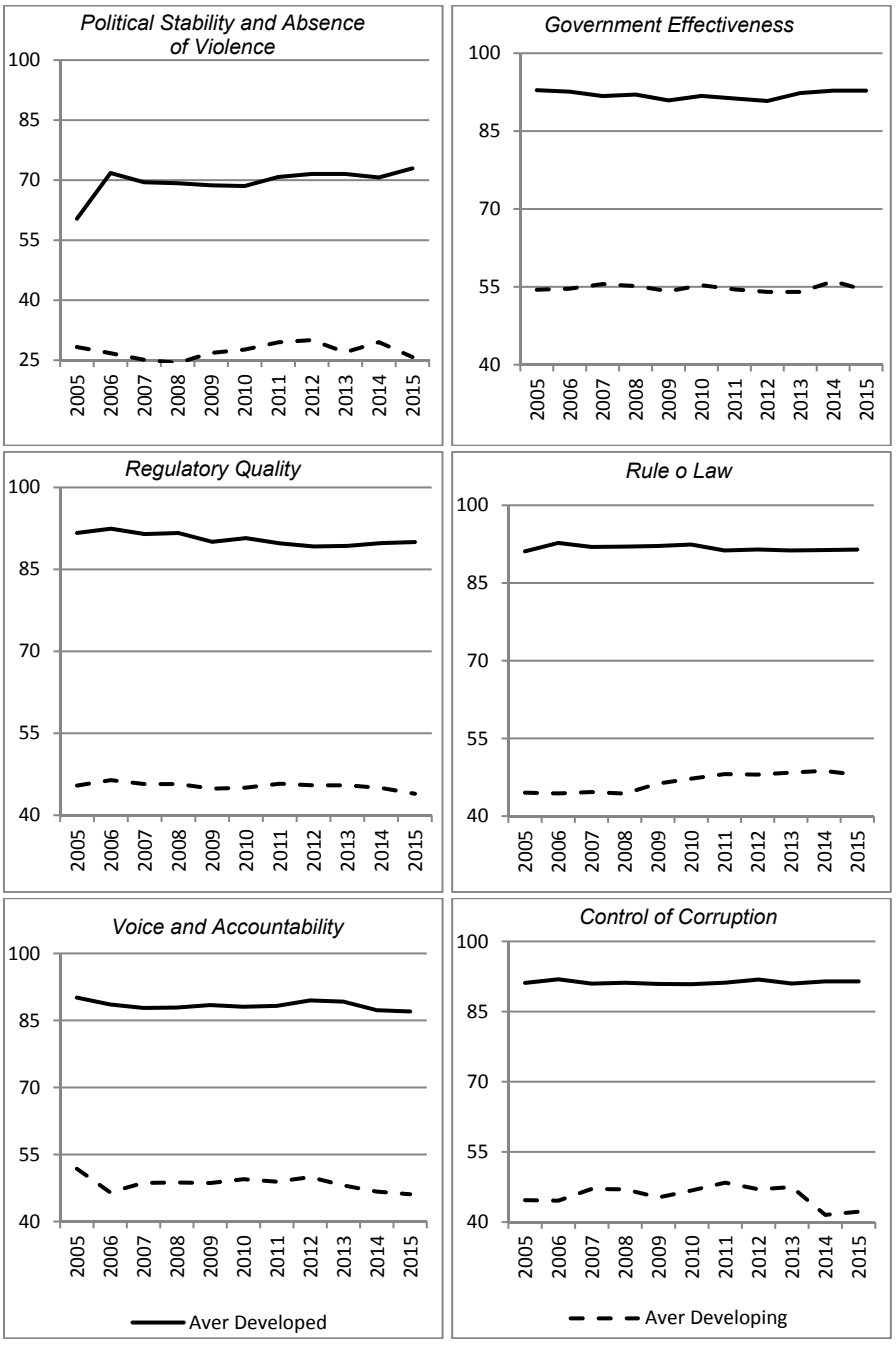
6 United Kingdom.

7 The lower value, the more peaceful situation in given economy.

8 We selected economies on the basis of three criteria for 2015: population (35-350 mn); GDP *per capita* (developing: 11 000-21 000 USD; developed: more than 35 000 USD); Life expectancy (developing: 69-76 years; developed: more than 79 years), after CIA [2015]; World Bank Statistics.

9 The scale's range is form 0 (high risk) to 100 (low risk). The same scales and economies were utilized on the Figure 2 and 3.

Figure 2. Components of PR for advanced and developing economies (2005-2015)

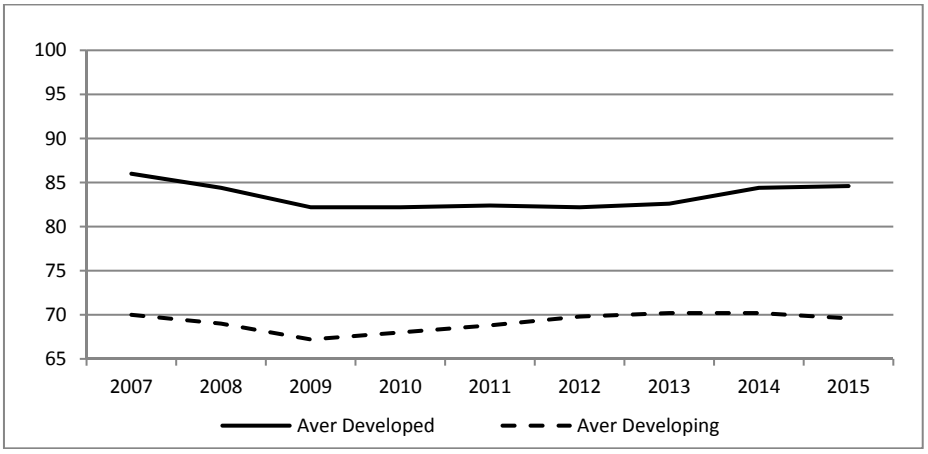


Source: Based on Worldwide Governance Indicators [2016].

The division of national economies into developing and developed facilitate presentation of PR grounds that particular economies are more prone to experience. We can easily observe that average (Aver) for developing economies is usually lower around 40 points towards advanced[10]. Figure 2 depicts how much must be done to level the discrepancies in PR area between those two groups of states. Moreover, it could be an explanation for Lucas paradox[11].

Received results are confirmed by the next international indicant (Global PRS Risk Index) which measures political investment's climate in national economies (Figure 3). Thus, strictly economic approach to political risk gives developed states lower advantage over developing countries than measuring six general aspects (Figure 2). Nonetheless, the marked difference between two groups of states still exists.

Figure 3. Global PRS Risk Index[12] for advanced and emerging economies (2007-2015)



Note: We applied the same group of economies as in Figure 2.

Source: Based on PRS Group [2016].

Developing economies are threatened by roots of PR from micro and macro governance as well as from instability area (terrorism, civil and armed conflicts). Their resistance to global ground's threats will last as long as their financial markets become fully opened and integrated with global finance.

[10] The only exemption displays PSAV where difference is even bigger.

[11] Classical economy claims that capital should flow from rich to poor countries. Nonetheless, that connection does not exist [Lucas 1990].

[12] PRS Group commercial provider of *International Country Risk Guide* which is broadly applied proxy that comprise of three marks measuring political (Global PRS Risk Index), economic and financial risk.

In context of developed economies we noticed conclusions as follows. Firstly, apart from PSaAV (Figure 2), developed states relish indicants over 85 points. That relatively low mark of Political Stability and Absence of Violence among developed economies is in line with the theory and intuition. It proves that violence is tangible threat in developed economies because of new terrorism, armed conflicts and cyber-attacks. Therefore, the instability approach contributes greatly to the scale of PR in developed countries.

To sum up, PR presents real threat to developed as well as developing economies. Nevertheless, we observed the better economic stance, the lower level of PR.

4.2. Competition for international capital: Premium for developed countries with low political risk

The need for capital in national economies is common in both developing and developed countries. Developing economies seek capital to nullify economic discrepancies towards advanced economies (catch them up). The key issue is financing. FDI fuels the convergence between emerging markets and advanced economies through capital accumulation, technology and effective utilization of production factors [Miles & Scott 2005].

Developing economies suffer from the scarcity of internal capital, thus, they fight for foreign funds. Just in terms of international capital flows, growing stability of selected national economy is fundamental. Developing states have to make progress in many fields simultaneously (discrepancies presented in the Figure 2) to encourage foreign investors to plant a business there as well as send their portfolio investments to developing markets, although yields are higher. On the other hand, some economies may change their economic policy and collect money form financial markets instead national resources draining towards unsatisfactory oil prices. Saudi Arabia implemented such policy recently and issued 16,7 bn public bonds [“Financial Times” 2016].

With regard to developed economies, there is also a demand for foreign financing because of debts in public and private sector (Tables 6, 7). Distant positions between developing and advanced economies in terms of public indebtedness (Table 6) may pose a tremendous danger to the whole world. Advanced economies are heavily indebted and are desperately searching for foreign portfolio investment (Table 8). The capital is flowing from developing countries that have financial overhang, e.g. China funds American debt.

Political decisions drive to surge the value of international debt on financial markets, what often forces politicians to change the national debt's limits. Finally, political uncertainty arises in developed countries. Secondly, overseas capital financing debt in advanced countries has a short-term and speculative character. That suggests the threat to exchange rate of national currency since demand and supply are not driven by trade-related transaction but by cross-currency financial flows [Kotte 2010]. What is more, *casino capital* is highly susceptible to various adverse signals running from host economy and its sharp and massive drain may lead to financial or currency crisis. Finally, global indebtedness enables rating agencies to manipulate the assessment of country's credibility (e.g. effect of inflation quotations and rating shopping), what compels countries to shift their policy due to necessity to cover higher bond spread. Moreover, international financial institutions (IMF) impose severe budgetary restriction to public expenditure what generates social unrest and unemployment.

Table 6. Gross public debt and foreign financing in developing and developed economies (% GDP; 2008-2018)

Data \ Years		2008	2010	2012	2014	Projection		Non-resident[13] (% of total debt)
						2016	**2018**	
Developed countries	Austria	68.5	82.3	81.6	84,2	85,5	82.2	82.4
	Belgium	924	99.6	104.1	106,7	106.8	105.5	65.1
	Canada	67.8	81.1	84.8	86,2	92.3	88.3	22.4
	France	67.9	81.5	89.4	95,6	98.2	98.5	64.8
	Germany	65.0	81.0	79.7	74,9	68.2	63.4	62.0
	UK	51.7	76.6	85.3	88,2	89.1	86.4	30.0
	Italy	102.4	115.4	123.3	132,5	133.0	129.4	40.0
	Japan	191.8	215.8	238.0	249,1	249.3	251.8	9.3
	USA	72.8	94.7	102.5	105,0	107.5	106.8	32.5
Developing countries	Argentina	39.3	39.1	37.6	45,1	60.7	59.5	21.7
	Brazil	61.9	63.0	62.3	63,3	76.3	83.6	13.9
	China	31.6	35.1	36.9	41,1	46.8	51.2	…
	India	74.5	67.5	67.7	66,4	66.5	64.3	6.3
	Indonesia	30.3	24.5	23.0	24,7	27.6	29.3	55.1
	Malaysia	39.9	51.9	54.6	55,6	55.8	53.6	24.9
	Saudi Arabia	12.1	8.4	3.6	1,6	17.2	33.3	…
	Hungary	71.6	800.6	78.3	76,2	74.8	73.5	58.0

Source: IMF [2016].

[13] Holding of Gross Government Debt in 2015.

The country's credibility depends on the economic stance that allows to repay national debts as well as to level political risk which determines whether the state will be willing to pay own debts. For this reason, high national wellbeing and low political risk go together as it was presented above (Figures 2, 3).

The financial account position in developed states shows how complicated their present position is. The trends in foreign direct investments and portfolio investment in the majority of economies proved that their aggregated net flows (FDI, PI) are below zero. However, economies with net portfolio flowing below zero are forced to trade more. Export-oriented policy need undervalued national currency, what makes pressure on currency devaluation. That kind of manipulation may be more popular with less developed states with weak institution such as Central Bank. Nonetheless, such behavior in macro scale is counterproductive in terms of diminishing PR and hampers building financial credibility.

Table 7. Debt in selected economies (% GDP)

Countries \ Sector		Real Economy				Financial Sector
		Government	Corporate	Household	SUM	
Developed (Q22014)	Japan	234	101	65	400	117
	Ireland	115	189	85	390	291
	Portugal	148	127	83	358	81
	Belgium	135	136	56	327	75
	Sweden	42	165	82	290	125
	France	104	121	56	280	93
	UK	92	74	86	252	183
	USA	89	67	77	233	36
	Canada	70	60	92	221	25
Developing (2013)	Hungary	83	114	29	225	51
	Malaysia	55	91	76	222	42
	China	55	125	38	217	25
	Thailand	46	65	76	187	64
	Israel	67	73	38	178	12
	Chile	15	86	36	136	40
	Poland	57	42	35	134	20

Source: McKinsey Global Institute [2015].

Data from Table 8 proved that there was a two-way integration in terms of portfolio investment in the recent period. Regardless of national wealth, many countries hold substantial assets abroad, at the same time they have huge liabilities to foreign investors. This leveraged patter implies that the moderate shifts in assets prices can lead to large fluctuations in the country's net foreign assets through valuation effect [Tille 2013]. Additionally, this situation caused that many developed economies (e.g. USA, UK) moved from being a net creditor to being a net debtor towards the rest of world in the 21th century.

Table 8. Net portfolio investment and net foreign direct investment in selected Developed Economies: 2007-2015 (bn USD)

National flows \ Year		2007	2009	2011	2013	2015
France	NPI	168.5	−326.9	−334.9	−79.8	59.2
	NFDI	48.5	70.2	20.2	−13.9	−1.6
Germany	NPI	−215.3	119.2	−51.4	212.8	220.3
	NFDI	89.8	42.9	10.3	28.0	62.6
Italy	NPI	−25.6	−47.5	16.6	−18.4	98.5
	NFDI	52.1	17.8	17.4	7.4	1.0
UK	NPI	−216.9	−43.3	11.8	−87.5	−405.0
	NFDI	160.9	−62.9	53.8	−82.2	−114.5
USA	NPI	−775.8	18.5	−226.6	−30.7	−96.9
	NFDI	102.9	159.9	182.9	117.6	−30.7

Note: NPI – net portfolio investment; NFDI – net foreign direct investment.

Source: World Development Indicators [2016].

On a final note, the fundamental division between developing and developed economies results from their distant credibility and the difficulties with an access to capital within the global finance. Financial markets in advanced economies relish high credibility, however, that notion is challenged since they accumulate formidable debt, complicating their economic perspective (unclear vision of how to limit indebtedness). The situation may be really dangerous when additional credit does not finance economic growth but current consumption and speculation. Even though integrated financial markets facilitate capital flows and mitigate overall risk, they simultaneously support international fluctuations into financial flows, prices and yields because of risk transfer from political sphere to finance. Therefore the blessing may become a curse in terms of political risk transfer within integrated finance.

5. Findings discussion

Theory implies that financial markets discount various politics-related events. What is more, they can transfer those abnormal signals on the global scale due to integrated finance. On this account, financial market stability is the fundamental priority in the modern world owing to the fact that excessive volatility encourages financial speculation and hampers long-term investments. Furthermore, sudden changes in international capital flows provoke fluctuations into stock prices, bonds yields and may lead to credit crunch as well.

High and unstable level of PR certainly debilitates the competitive position of national economy on international financial markets. Thus, PR seems to introduce an emerging problem towards political and economic turbulences at the beginning of 21th century and it is worth analyzing drivers of political risk and their responsibility for adverse financial episodes.

Developing economies suffer from relatively higher PR because they are exposed to greater amount of politics-related threats from micro and macro sphere. They mostly suffer from institutional shortages and harmful micro- and macro-governance as well as terrorism, regional unrests, and local armed conflicts. Therefore inflow of foreign direct investment and portfolio investments as well as foreign banks proclivity to provide credit is more unstable than in case of developed countries. Political uncertainty created there is slowly transferred among countries, however, not only to developing states in the region, but also among developed countries through losses of their national firms abroad.

Advanced economies have integrated financial markets, higher credibility, and easy access to international capital, however, they are also dependent on the variation into trends of capital flows. Such abnormal events may induce fluctuations into prices and yields of financial instruments. On the other hand, micro and macro ground play scant role in the Western countries, however, they are susceptible to threats from global ground such as new era terrorism, engagement in various conflicts around the world as well as supranational and national governance. What is more, PR is transferred mainly in global finance therefore that risk is widespread fast, especially among economies with opened and developed financial market.

On the grounds of sovereign debt markets we can see that country's credibility depends on the economic stance (capability of repaying debts) as well as level of political risk which determines whether the state will be willing to liquidate own debts. That is why, strong economic condition and low political risk are central to state's position as a debtor on international financial market.

6. Conclusions

Political risk is a wide and complicated research subject. Our study tries to clarify its origins and consequences from financial markets' perspective. This approach bridged the gap in existing literature because the majority of researchers predominantly treat political risk as an obstacle to inflow of foreign direct investments.

The main contribution of this text is the concise presentation of threats from political and instability point of view, which further influence volatility on financial markets in developed and developing economies.

Our conclusions have implications for investors and national governments as well. Firstly, both kinds of considered states are exposed to political risk, however, the way of potential impact varies greatly between them. Developing countries should be concentrated on micro and macro governance so that investors around the world could treat them stable and predictable. Developed economies relish relatively low political risk, however, this threat may create variability on financial markets due to terrorism, participation in armed conflicts and cyber-attack.

Secondly, highly integrated financial markets favor substantial international capital flows and risk mitigation, however, they mostly contribute to fluctuations into financial flows due to contagion of threats from political and instability area within finance.

Finally, along with improving the politics-related spheres (e.g. institutions, laws, corruption) and national financial market integration with global finance, developing economies will also become more susceptible to the same threats from PR sphere as developed economies.

Because of the scarcity of reliable time series about political risk, we were not able to verify links between political threats and financial variability on the basis of quantitative analysis. Nonetheless, there still exists a space for exploring this line of study in the future.

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