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# Political Risk in Emerging and Developed Markets

Robin L. Diamonte, John M. Liew, and Ross L. Stevens

*Political risk represents a more important determinant of stock returns in emerging than in developed markets. Using analyst estimates of political risk, we show that average returns in emerging markets experiencing decreased political risk exceed those of emerging markets experiencing increased political risk by approximately 11 percent a quarter. In contrast, the difference is only 2.5 percent a quarter for developed markets. Furthermore, the difference between the impact of political risk in emerging and developed markets is statistically significant. We also document a global convergence in political risk. During the past 10 years, political risk has decreased in emerging markets and increased in developed markets. If this trend continues, the differential impact of political risk on returns in emerging and developed markets may narrow.*

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**D**oes political risk affect stock returns? The often-observed link between dramatic political events and large market moves clearly suggests that it can. Because quantifying political risk is difficult, however, the evidence of its systematic impact on stock returns is largely anecdotal. In this article, we provide direct evidence on this issue by exploiting analyst estimates of political risk.

First, we show that changes in political risk have a larger impact on returns in emerging markets than in developed markets. In emerging markets, political risk changes represent an economically and statistically significant determinant of stock returns. Average returns in emerging markets experiencing political risk upgrades exceed those of emerging markets experiencing increased political risk downgrades by approximately 11 percent a quarter. Changes in political risk are a less important determinant of stock returns in developed markets. There is no statistically significant difference between average returns in developed markets experiencing political risk upgrades and developed markets experiencing political risk downgrades.

Second, we document a global convergence in political risk. During the past 10 years, emerging

markets have become politically safer and developed markets have become riskier. If this trend continues, the differential impact of political risk in emerging versus developed markets may narrow.

## DATA

Several institutions offer country-by-country risk analysis. Most services, however, provide non-quantifiable written reports, which are unsuitable for empirical analysis. Of the few services that offer quantitative analyses, most offer their estimates only on a semiannual or irregular basis. One service, Political Risk Services, publishes the *International Country Risk Guide* (ICRG), which provides an explicit monthly measure of political risk. ICRG's analysts produce risk estimates in more than 130 countries. Their overall country risk ratings consist of economic, financial, and political components. Because we sought to quantify the importance of political risk in stock returns, we used ICRG's political component as our proxy for political risk. Our sample period starts in January 1985 and goes through June 1995.

Analyst ratings of 13 political risk attributes combine to form one overall political risk score for each country. The maximum score assigned to each attribute is set so that each country's overall score falls between zero (highest risk) and 100 (lowest risk). The 13 political risk attributes and

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*Robin L. Diamonte is a senior research manager with GTE Investment Management. John M. Liew and Ross L. Stevens are members of the quantitative research group at Goldman Sachs Asset Management.*

their maximum scores are described in the appendix.

To illustrate the behavior of ICRG's political risk measure, we studied its reaction to a recent dramatic political event: the Persian Gulf War. Iraq invaded Kuwait on August 2, 1990, and Desert Storm pulled out of Kuwait on February 27, 1991. Figure 1 presents the time-series of the political risk measure for Kuwait and Iraq. For both countries, the level of political risk sharply increased just prior to the invasion and remained high for the duration of the war. Following the war, Kuwait's political risk decreased sharply; Iraq's political risk decreased more slowly. In fact, the level of political risk in Iraq has yet to return to its preinvasion level.

Table 1 shows summary statistics of the political risk measure for the 21 developed and 24 emerging markets for which both stock return and political risk data are available. The table presents the average risk, average quarterly risk change, and standard deviation of the quarterly risk change.<sup>1</sup> Within each region, the countries are sorted by their average risk during the sample period, 1985 to mid-1995. Emerging markets have been politically riskier than developed markets. In fact, the riskiest developed market, Hong Kong, has been politically safer than all but five emerging markets. ICRG's political subcomponent data (described in the appendix) indicate that relative to the other developed markets, Hong Kong has suffered from weak political leadership and high external conflict risk. Within the emerging markets, the two riskiest countries, Pakistan and Sri Lanka, help make Asia the riskiest region. Pakistan has been plagued by corruption in government, and Sri Lanka has suffered political terrorism and substantial civil war risk.

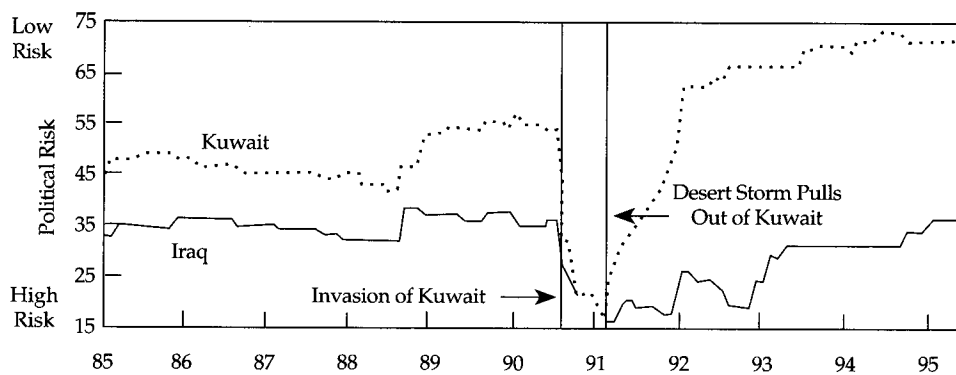
Table 1 also documents a global convergence in political risk during the sample period. Emerging markets have become politically safer, and developed markets have become riskier. The average

change in political risk is negative (riskier) for 19 out of 21 developed markets and positive (safer) for 21 out of 24 emerging markets. Among the emerging markets, Chile has experienced the largest average decrease in political risk, primarily because of its strong political leadership and consistency of free market reforms. Despite Chile's gains, however, the Latin America region has become safer at a slower rate than either the Asian or the European/Mideastern/African regions. The Philippines (Asia) and Zimbabwe (Africa) have been the largest contributors to their respective regions' decreasing political risk. The Philippines has benefited most from strengthening political leadership while Zimbabwe has enjoyed a sharp drop in external conflict risk.

Although Table 1 documents large and volatile political risk changes in emerging markets, this information makes no statement about the ability of these changes to explain stock returns. In addition, the fact that the changes are larger and more volatile in emerging markets than in developed markets does not imply that they represent a more important determinant of stock returns in those markets.

In order to examine the relation between changes in political risk and stock returns, we used monthly total returns (inclusive of dividends) in U.S. dollars on stock indexes from Morgan Stanley Capital International (MSCI) and the International Financial Corporation (IFC). These indexes represent the behavior of stock returns in developed and emerging markets. In most countries, these indexes represent a very large percentage of total market capitalization. To match the time period of our political risk data, the sample period starts in January 1985 for each country except Portugal (2/86), Turkey (1/87), Finland (1/88), Ireland (1/88), New Zealand (1/88), India (2/90), Sri Lanka (10/93), Peru (10/93), Hungary (1/94), and Poland (1/94).

**Figure 1. Political Risk in Kuwait and Iraq, Period Surrounding the Gulf War**



Source: ICRG.

**Table 1. Summary Statistics: Political Risk and Stock Returns, Quarterly, January 1985–June 1995**

Country	Political Risk			Monthly Returns (%)			
	Average	Average Change	Standard Deviation of the Change	Average	Standard Deviation	Minimum	Maximum
<i>Developed</i>							
Hong Kong	67.1	0.17	2.20	2.4	8.4	-43.4	27.5
Spain	71.3	0.07	1.69	1.8	7.5	-20.6	26.7
Italy	73.6	-0.17	1.51	1.6	8.1	-18.6	31.0
Singapore	78.7	-0.15	1.37	1.5	7.4	-41.3	22.3
Ireland	78.8	-0.02	1.74	1.2	6.4	-17.7	18.4
France	79.3	0.00	1.22	1.8	6.7	-18.4	21.0
Belgium	79.5	-0.12	1.54	2.1	6.0	-18.9	26.8
United Kingdom	80.1	-0.17	2.05	1.6	6.2	-21.5	16.0
Australia	80.3	-0.34	1.96	1.5	7.6	-44.5	18.0
United States	81.8	-0.22	1.46	1.3	4.3	-21.2	13.3
Canada	82.5	-0.05	1.18	0.8	4.6	-22.0	14.1
Germany	82.9	-0.05	1.48	1.7	6.8	-17.6	20.2
Japan	84.4	-0.22	1.89	1.5	7.8	-19.4	24.3
New Zealand	84.4	-0.15	1.22	0.8	7.3	-15.8	27.7
Sweden	84.6	-0.20	1.14	1.9	6.9	-21.4	17.2
Norway	84.8	-0.27	1.40	1.5	7.6	-27.8	15.9
Denmark	85.3	-0.20	0.93	1.5	5.9	-11.8	21.3
Netherlands	86.3	-0.15	0.76	1.8	4.5	-17.4	12.2
Austria	86.4	-0.20	1.49	2.1	8.2	-23.3	28.1
Finland	87.5	-0.20	0.95	1.0	7.8	-18.8	24.6
Switzerland	91.5	-0.29	0.93	1.9	5.5	-17.6	16.7
MSCI index	82.4	-0.07	0.60	1.3	4.3	-17.0	11.8
<i>Emerging: Latin America</i>							
Peru	42.7	0.29	2.91	4.0	13.5	-18.6	32.6
Colombia	57.9	-0.02	1.29	3.2	9.0	-17.5	37.3
Chile	59.6	0.73	1.64	3.8	8.1	-19.1	21.8
Argentina	62.8	0.44	1.80	5.4	29.1	-65.0	178.1
Brazil	65.4	0.00	2.09	3.2	20.1	-56.9	57.5
Venezuela	66.1	-0.02	2.71	1.8	13.2	-49.8	48.5
Mexico	67.4	-0.10	2.05	3.2	13.5	-59.3	39.6
Latin index	65.5	0.02	0.66	2.3	10.7	-29.6	37.3
<i>Emerging: Asia</i>							
Pakistan	40.0	0.41	2.42	1.5	7.0	-15.8	35.3
Sri Lanka	40.2	0.37	2.37	0.1	10.9	-16.3	21.6
Philippines	46.3	0.68	2.80	3.6	10.8	-29.3	42.4
India	48.6	0.41	2.99	1.6	9.8	-24.4	35.3
Indonesia	50.3	0.34	1.77	0.3	9.3	-20.9	19.6
Thailand	59.8	0.15	1.74	2.7	9.0	-33.8	33.0
Korea	67.0	0.28	2.37	1.9	8.4	-19.2	26.6
Malaysia	67.2	0.12	1.79	1.9	7.2	-15.6	20.9
Taiwan	76.3	0.00	1.53	2.8	14.7	-35.5	53.3
Asia index	66.2	0.10	1.00	1.9	7.5	-23.4	24.5
<i>Emerging: Europe/Mideast/Africa (EMA)</i>							
Nigeria	47.5	0.27	1.55	1.1	15.7	-70.2	99.5
Jordan	51.7	0.51	3.37	0.8	5.0	-12.8	16.2
Zimbabwe	53.8	0.63	2.26	2.5	9.6	-23.0	45.0
Turkey	55.3	0.05	3.25	3.7	20.9	-31.5	69.3
Poland	60.4	0.63	1.61	-1.2	21.6	-31.7	39.2
Greece	63.5	0.27	1.69	2.3	12.3	-30.8	58.6
Portugal	71.6	0.17	1.88	2.7	12.8	-29.3	70.8
Hungary	73.1	0.02	1.59	-1.0	14.2	-23.3	44.1
EMA index	59.3	0.16	1.20	1.3	8.8	-16.6	33.2
IFC index	65.5	0.12	0.88	1.3	6.7	-25.2	19.4

Notes: The index returns for the emerging market regions are capitalization weighted. The MSCI and IFC index returns are based on their published indexes. The index political risk data are capitalization weighted.

Sources: Developing market returns—MSCI; emerging market returns—IFC; political risk—ICRG.

Table 1 shows the average, standard deviation, minimum, and maximum for each country's monthly return. These data confirm the common knowledge that emerging market returns are more volatile and produce more extreme observations than returns in developed markets. Most emerging stock markets have standard deviations greater than 10 percent a month, at least one monthly loss greater than 20 percent, and at least one monthly gain that exceeds 35 percent. Among the emerging market regions, Latin America has produced the highest standard deviation (10.7 percent), largest monthly loss (-29.6 percent), and largest monthly gain (37.3 percent). The region's impressive volatilities are driven largely by Argentina and Brazil, which even by emerging market standards, stand out as remarkably volatile.

The information in Table 1 hints at a risk-based story for the high positive and volatile returns in many emerging markets. The overall decrease in emerging market political risk may explain the magnitude and sign of average returns, and the large risk changes may explain the high volatility. The overall increase in developed market political risk, however, coupled with the positive average returns in these markets, implies that factors besides changes in political risk explain developed market stock returns. The central question is: Are cross-sectional differences in stock returns driven by changes in political risk?

## CHANGES IN POLITICAL RISK AND EMERGING MARKET RETURNS

We divided our sample of countries into two categories (emerging markets and developed markets) based on their classification by IFC and MSCI. For each category and each calendar quarter, we formed two portfolios. The first portfolio contains the countries that experienced downgrades (increases in political risk), and the second portfolio contains those that experienced upgrades (de-

creases in risk). We then calculated portfolio returns by weighting each country's return by the absolute value of its contemporaneous percentage risk change. Thus, countries experiencing large risk changes receive more weight than those experiencing small risk changes.<sup>2</sup> We repeated this procedure for each quarter to obtain a time series of returns to each portfolio.

For both emerging and developed markets, Table 2 shows the average return, *t*-statistic, and the average political risk change for the following four portfolios:

- Portfolio 1: upgrade
- Portfolio 2: benchmark index
- Portfolio 3: downgrade
- Portfolio 4: upgrade minus downgrade (Portfolio 1 minus Portfolio 3)

The average return on the upgrade portfolio exceeds that of the benchmark and the downgrade portfolio both for developed and for emerging markets. In emerging markets, returns on the upgrade portfolio exceed those of the benchmark by more than 8 percent a quarter and those of the downgrade portfolio by more than 11 percent a quarter. These differences are far less dramatic in developed markets, where returns on the upgrade portfolio exceed those of both the benchmark and the downgrade portfolio by less than 3 percent a quarter.

The upgrade minus downgrade portfolio (Portfolio 4) returns are strongly statistically significant in emerging markets ( $t = 3.90$ ) but are only marginally significant in developed markets ( $t = 1.84$ ). This evidence suggests that changes in political risk clearly help explain the cross-section of country returns in emerging markets but only marginally help explain them in developed markets.

Table 2 also shows that emerging markets produce larger average political risk changes than developed markets. This difference, however, (4.02 emerging versus 3.34 developed) does not fully explain the larger average quarterly return to

**Table 2. Changing Political Risk and Stock Returns, Quarterly, January 1985–June 1995**

Portfolio	Emerging Markets			Developed Markets		
	Average Return (%/quarter)	<i>t</i> -Statistic	Average Change in Risk	Average Return (%/quarter)	<i>t</i> -Statistic	Average Change in Risk
1. Upgrade	12.42	4.54	2.23	6.44	4.64	1.62
2. Benchmark	3.92	1.65	0.30	3.94	3.12	-0.14
3. Downgrade	1.14	0.51	-1.79	3.90	3.24	-1.72
4. Upgrade minus downgrade	11.28	3.90	4.02	2.46	1.84	3.34

*Notes:* The upgrade (downgrade) risk portfolio consists of countries whose political risk decreased (increased) over the period. The average change in risk is the equal-weight average quarterly change in political risk for each country in the portfolio over the full sample period. Within each portfolio, returns are weighted by their percent change in political risk.

*Sources:* Developed market benchmark—MSCI World Index; emerging market benchmark—IFC Index; risk—ICRG.

Portfolio 4 in emerging versus developed markets (11.28 percent versus 2.46 percent). Emerging market returns are also more sensitive than developed market returns to a given change in political risk. In Portfolio 4, the average quarterly return per unit of political risk change in emerging markets (11.28 percent/4.02 = 2.81 percent) exceeds that in developed markets (2.46 percent/3.34 = 0.74 percent). Thus, the magnitude of political risk changes *and* the sensitivity of stock returns to a given change in political risk are both larger in emerging than in developed markets.

Table 3 shows the results of testing the differential impact of changes in political risk between emerging and developed markets for statistical significance. We subtracted the developed market portfolio return from the emerging market portfolio return for each set of portfolios in Table 2. For the set of upgrade portfolios, emerging market average returns exceed those in developed markets by almost 6 percent a quarter ( $t = 2.36$ ). For the set of increasing-risk portfolios, emerging market average returns fall below those in developed markets by almost 3 percent a quarter, although the difference is not statistically significant ( $t = -1.37$ ). The bottom-line result from Table 3 shows that the differential impact of political risk changes between emerging and developed markets is economically and statistically significant. The average return difference between Portfolio 4 for emerging markets and Portfolio 4 for developed markets is almost 9 percent a quarter, with a  $t$ -statistic of 2.72.

Taken together, Tables 2 and 3 support the hypotheses that political risk is an important determinant of stock returns in emerging markets and that political risk affects stock returns more in emerging than in developed markets.

## CONCLUSION

This paper quantifies the importance of political risk in emerging and developed markets. Our two main results are easily summarized.

**Table 3. Comparative Effects of Changing Political Risk on Emerging and Developed Stock Returns, Quarterly, January 1985–June 1995**

Portfolio	Difference in Average Returns (Emerging – Developed, %/quarter)	$t$ -Statistic
1. Upgrade	5.98	2.36
2. Benchmark	-0.02	-0.01
3. Downgrade	-2.84	-1.37
4. Upgrade minus downgrade	8.82	2.72

Note: See Table 2.

- Changes in political risk have a bigger impact on emerging market returns than on developed market returns. The average difference in returns between emerging markets experiencing political risk upgrades and those experiencing political risk downgrades is approximately 11 percent a quarter. In developed markets, the difference is only 2.5 percent.
- During the past 10 years, we have seen a global convergence in political risk. Emerging markets have become politically safer, and developed markets have become politically riskier.

These results suggest several prescriptions. In emerging markets, if one can forecast changes in political risk, one can forecast stock returns. Therefore, emerging market analysts are well advised to devote considerable resources to forecasting political risk changes. In developed markets, political risk is less important. Developed market analysts are better off devoting resources to forecasting other sources of return such as changes in expected future economic conditions. If global political risks continue to converge, however, the large differential impact of political risk changes between emerging and developed markets may fade.<sup>3</sup>

## APPENDIX

The *International Country Risk Guide* model for forecasting financial, economic, and political risk was created in 1980 by the editors of *International Reports*. It provides survey measures of current political, financial, and economic risk. Banks, multinational corporations, importers, and exporters, among others, use the ICRG model to determine the risks of operating in, investing in, or lending to particular countries.

The combined political risk score rates countries on a scale from 1 to 100 and consists of the following 13 components, each assigned a maximum numerical weighting.

- *Economic Expectations versus Reality* (12 percent) measures the perceived gap between popular aspirations for higher standards of living and the ability or willingness of the government to deliver improvements in income and welfare.
- *Economic Planning Failures* (12 percent) measures business support for the current government and the ability of the government to adopt a suitable and successful economic strategy.
- *Political Leadership* (12 percent) assesses the viability of the current government based on the degree of stability of the regime and its leader, the probability of the effective survival of the government, and the continuation of its policies if the current leader dies or is replaced.

- *External Conflict* (10 percent) measures conflict based on the probability of external invasion, border threats, geopolitical disputes, and full-scale war.
- *Corruption in Government* (10 percent) assesses corruption risk by looking at how long a government has been in continuous power, whether a large number of the officials are appointed or elected, and the frequency of bribe demands.
- *Military in Politics* (6 percent) reflects the likelihood of military takeover and the degree of military control over government and governmental policies.
- *Law and Order Tradition* (6 percent) reflects the degree to which citizens of a country are willing to accept the established institutions to make and implement laws, the strength of the court system, and provisions for an orderly succession of power.
- *Racial and Nationality Tensions* (6 percent) measures the degree of tension within a country that is attributable to racial, nationality, or language divisions and the extent that opposing groups are intolerant or unwilling to compromise.
- *Organized Religion in Politics* (6 percent) measures the degree to which religious groups control the government and governmental policies.
- *Political Terrorism* (6 percent) measures the extent to which dissidence is expressed through political terrorism, such as armed attacks, guerrilla activity, or attempted assassinations.
- *Civil War Risks* (6 percent) measures the probability that terrorist opposition to a government or to its policies will turn into a violent internal political conflict.
- *Political Party Development* (6 percent) measures broad-based political participation in the determination of changes in governments and in the formulation of government policies.
- *Quality of Bureaucracy* (6 percent) measures institutional strength, the quality of the bureaucracy, and the expertise to govern without drastic changes and policy interruptions in government services.

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## NOTES

1. We used quarterly, as opposed to monthly, changes for two reasons. First, ICRG's political risk measure changes slowly over time. In many cases, a country may not experience a political risk change during a single month, but during any quarter, virtually all countries experience changes. Second, the substantial first-order autocorrelation observed in monthly stock returns for many emerging markets suggests that nonsynchronous trading contaminates the monthly return data. The use of quarterly return data mitigates this problem.
2. We obtained similar results with equal-weight portfolios.
3. The comments of Cliff Asness, Rick Buckholtz, Kent Clark, Britt Harris, Brian Hurst, Antti Ilmanen, Bob Krail, Burt Porter, Rebecca Runkle, and Ingrid Tierens are gratefully acknowledged. We also thank Laurel Fraser and Taro Harano for research assistance.

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