COMPSS 224B - Assignment 1

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1 Political Risk Use Case

1.1 What is the specific problem you want to solve?

The problem is to assess the political and economic risks associated with **Italy's recent commitment to raise its defense spending to 2% of GDP by 2028**, potentially even higher[1]. This increase in military expenditure occurs against the backdrop of an already massive national debt exceeding €3 trillion[2], raising concerns about **Italy's long-term fiscal sustainability, investor confidence, and compliance with EU fiscal rules**.

1.2 What type of political risk is this?

- **Laws, regulations, and policies:** The reclassification of non-military expenditures (e.g., coastguard, police) as "defense" to meet NATO targets involves politically motivated policy changes and budgetary manipulation.
- **Breaches of contract:** If the Italian government fails to meet debt obligations due to fiscal strain caused by increased defense spending, it could lead to politically motivated credit defaults or renegotiations.
- **Internal conflict (latent):** If fiscal reallocations spark mass protests or labor unrest (especially in sectors facing budget cuts), the situation could evolve into broader internal discontent or social unrest.
- **Governance risk (cross-cutting):** This case also reflects *governance risk* more broadly, as it involves political decisions that challenge fiscal credibility, transparency, and accountability—especially relevant for investor confidence.

1.3 Why is this a political risk now? How did we get here?

The political risk has emerged due to pressure from NATO allies and geopolitical tensions in Europe, prompting Italy to reaffirm its defense commitments. However, instead of increasing military expenditures transparently, the government is attempting to broaden the definition of "defense spending" to include police and coastguard budgets in order to meet NATO targets[1]. **This fiscal maneuvering raises red flags for credit rating agencies and investors already wary of Italy's ballooning debt and chronic budget deficits.** The political calculus—choosing defense alignment over financial conservatism—has become a flashpoint of uncertainty.

[1] https://www.reuters.com
[2] https://www.reuters.com

1.4 Who is the customer or client affected?

- **International investors and credit rating agencies** – as they assess Italy's sovereign creditworthiness.
- **European Union institutions** – especially the European Commission, which monitors member states' adherence to fiscal compacts.
- **Domestic taxpayers and voters** – whose services or subsidies might be affected by reallocation of budget resources.
- **Defense sector analysts and contractors** – monitoring procurement trends and public-private contracts.

1.5 Why does this political risk matter? What are the political or economic impacts?

Italy's move has multiple potential consequences:

- **Increased borrowing costs** due to credit rating downgrades or investor risk aversion.
- **Deterioration of fiscal credibility**, especially if the defense spending goal is met through creative accounting.
- **EU-level tensions** if Italy is perceived to be violating fiscal stability criteria or manipulating budget categories.
- **Public backlash** at home, where austerity has already taken a political toll in past years.

2 Current Approaches and Limits

2.1 What is the conventional political risk methodology to address this issue?

Conventional political risk methodologies typically rely on qualitative expert assessments, scenario analysis, and the use of political and economic indicators such as **credit ratings**, **debt-to-GDP ratios**, and **fiscal transparency indices**. Country risk reports from firms like Eurasia Group or The Economist Intelligence Unit are commonly used by investors to track fiscal developments, political stability, and macroeconomic trends. These approaches often incorporate expert judgment, scenario planning, and historical analogies to predict how political decisions—like increased defense spending—might impact economic outcomes.

In this case, analysts would evaluate Italy's policy decisions using macroeconomic data (e.g., budget deficits, growth projections), political context (e.g., EU relations, NATO pressure), and institutional factors like central bank independence or parliamentary stability. They might also compare Italy to similarly indebted countries that have faced political backlash or market penalties for fiscal expansion.

2.2 What are the limitations to this approach and why?

- **Lagging Indicators:** Political risk indicators (e.g., debt ratios, governance scores) are often updated quarterly or annually, making them poorly suited for capturing sudden or emerging risks like budgetary overreach or market sentiment shifts.

- **Subjectivity and Overconfidence:** As highlighted in the course readings, expert-based forecasts can be highly subjective and prone to overconfidence. They often underweight *tail risks* and struggle to adapt to unprecedented events—such as a Eurozone country inflating defense numbers creatively to meet alliance commitments[3].
- **Structural Blind Spots:** These methods tend to assume institutional resilience in OECD democracies. As a result, they may miss emerging vulnerabilities—such as long-term debt sustainability problems—when packaged under politically sensitive justifications like national defense.

3 How will you try to quantitatively measure the problem?

To quantitatively measure the political and economic risk associated with Italy's defense spending plan, I will focus on **financial market indicators** and **public sentiment proxies** that respond in real time to shifts in perceived fiscal risk.
Key indicators include:

- **Credit Default Swap (CDS) spreads** for Italian sovereign bonds — as a proxy for perceived credit risk and default probability.
- **10-year Italian government bond yields (BTP)** — reflecting long-term investor confidence in Italy's fiscal health.
- **Spread between Italian and German bond yields (BTP-Bund spread)** — a common market measure of Eurozone sovereign risk divergence.
- **Social media sentiment data** and **public opinion polls** on defense spending and fiscal policy — to track societal responses and potential protest risk.

3.1 What dataset will you use to research this? Why is it a good fit?

Table 1: Planned datasets and their relevance, source, and type for political risk analysis

Dataset	Justification and Use	Website	Data Type
Bloomberg	Provides high-frequency financial data such as CDS spreads and government bond yields. Essential for tracking market reactions to fiscal and political announcements in near real-time.	bloomberg	Financial
OECD Data	Complements Eurostat by providing defense spending and long-term economic indicators across developed nations.	oecd	Economic
Twitter API	Enables real-time tracking of public sentiment and keywords related to fiscal policy. Useful for detecting shifts in societal response.	twitter	Social media

[3]https://www.reuters.com

This structured approach ensures coverage of finance, economic, and social indicators using complementary data types for a more holistic analysis of Italy's political risk landscape.

3.2 Before looking at the dataset, pre-register a hypothesis about what you think is driving this political risk problem.

H_0:

1. There is no statistically significant change in CDS spreads or government bond yields within one week of Italy's major defense budget announcements.
2. The BTP-Bund spread does not significantly widen in response to defense spending announcements.
3. Public sentiment and opinion polarization regarding fiscal priorities and defense remain stable before and after the announcement.

H_1:

1. CDS spreads and government bond yields increase significantly within one week of defense budget announcements, indicating heightened perceived credit risk.
2. The BTP-Bund spread widens significantly, signaling greater investor concern toward Italy compared to more stable Eurozone economies.
3. Public sentiment becomes more negative and public opinion becomes more polarized, particularly around concerns about social spending trade-offs and institutional credibility.

These hypotheses are grounded in the expectation that markets and the public will respond not only to the increased spending but also to the perceived manipulation of fiscal categorization under geopolitical pressure[4].

[4]https://www.reuters.com