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Managing political risk in advanced economies

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Abstract Research in political psychology suggests that people who are angry at political conditions tend towards greater political participation and to disregard economic consequences of their choices. These characteristics can be found in voting outcomes associated with the wave of popular discontent sweeping North America and Europe. If this discontent is indeed related to inequality, as many presume, political risks in advanced economies could escalate significantly in the years ahead. Banks can address these risks by augmenting the political expertise of country risk teams, addressing political risks operationally and responding to rising risk as citizens.

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ANGRY PEOPLE

Gather a group of students. Randomly assign them to write about some past experience that made them either angry or fearful. Immediately afterwards, ask the students to decide between two candidates running in a primary for the Massachusetts State Senate. The students who have just written about fear will browse candidate websites in greater detail, making careful comparisons between candidates' policy platforms and their own preferences. The students who have written on anger, however, will spend relatively little time doing research, and afterwards, there will be no statistical evidence that these students have considered the candidate's policy platform when making their choice.[1]

Such findings have been replicated not only in a number of laboratory experiments, but also in studies of opinion poll results; in particular, a series of polls conducted in the wake of US presidential elections, that ask people not only how they voted but how they are feeling. People with greater self-reported anger regarding political conditions tend towards greater participation. They tend to be more likely to join campaign events, donate to campaigns, speak to friends about politics and to turn out to vote.[2] But when they do vote, they tend to vote, in a manner of speaking, recklessly. Compared to other voters, they will tend to have spent less time seeking out information on the issues,[3] to support riskier policies,[4] be more likely to select policies that seek to punish others,[5] will tend to make decisions based on prejudices and simple heuristics[6] and will tend to have given little consideration to the economic consequences of their decisions.[7]

Today, many people are angry about politics. In a 2015 poll,[8] for instance, some 69 per cent of Americans described themselves as either 'very angry' or 'somewhat angry' about 'the way things are going' in the United States. In a 2016 poll,[9] 71 per cent agreed with the statement that the American economy is 'rigged' to favor the rich and powerful. There is a backlash underway in advanced economies, reflected in the victory of Donald Trump in the US presidential election, the

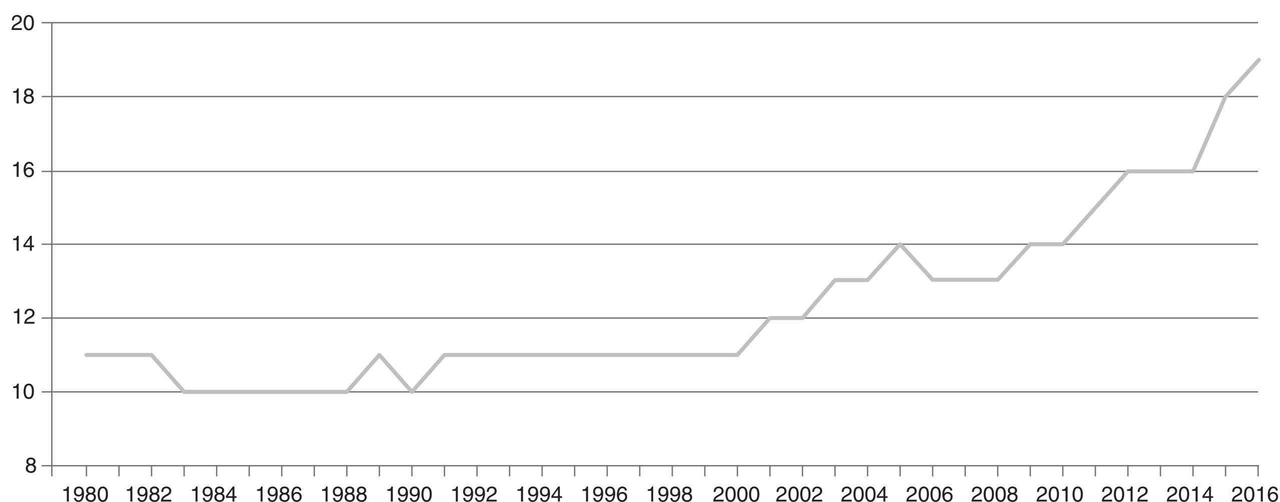

Figure 1: Mean populist party vote share in Europe
Source: Timbro.

rising vote share of populist parties in Europe (see Figure 1),[10] the electoral success of the radical left Syriza in Greece, the recent gains for the radical right in Austria and Eastern Europe, economically destructive referendum results for Britain and Greece.

Although the backlash is complex, mixing elements including a distrust of elites, political polarisation, racial tensions, class tensions, dissatisfaction with the economy and employment conditions, fear of terrorism, fear of immigrants and anti-globalisation sentiment, the research in political psychology quoted above sheds some light on its evolution. When people become angry about politics, they tend towards greater political participation and their political preferences appear to shift. 'Angry' does not necessarily mean 'irrational', but voting choices may be made with less regard to economic consequences as priority is placed on non-economic issues or redistribution and detailed analysis of policies falls by the wayside. With anger-driven shifts in participation, more extreme electoral choices may result as the median voter is shunted aside by his angrier compatriots.[11]

HOW RISKY?

It is a commonly-held view that the underlying causes of these diverse political phenomena are economic in nature. In its October 2016 Global Financial Stability Report, for instance, the IMF[12] writes: 'Growing discontent about anemic income growth and rising inequality has opened the door for more populist, inward-looking policies'. Supporting such sentiments, research suggests that fiscal austerity may have a strong historical correlation with political instability, including riots and demonstrations, in Europe.[13] Another recent paper indicates that following systemic financial crises, the far right vote share rises, on average, by 30 per cent in advanced economies.[14]

Such observations raise the alarming possibility of vicious cycles. Political instability and votes cast in anger may lead to further economic downturns, worse income growth and yet more anger (a cycle observed in Greece until the Greek government elected to, in essence, abandon the policy platform on which it had been elected). In the case of Brexit, it is difficult to imagine that the looming negative economic consequences of the referendum vote will improve the public mood. This darkening mood could lead to further disruptive referenda results, notably in Scotland and Northern Ireland.

Of course, if these phenomena are cyclical in nature, eventually, most countries ought to recover. Some commentators have suggested, however, that the worsening of economic conditions may have structural causes. For instance, productivity growth may have fallen to 'permanently' lower levels; or a dearth of well-paid jobs for low-skilled workers may relate to the advance of technology. Such structural explanations

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for economic conditions are worrying, because they suggest that destabilising economic pressures could continue to escalate (eg as a robotics revolution increasingly impacts jobs in the service sector).

Perhaps even more alarming is the other possibility noted in the IMF's comment: that rising public discontent may be linked to income inequality. Such a connection would be alarming because inequality is unlikely to be addressed without profound political upheaval. Although there are many proposals to address inequality,[15] in the final analysis any policy that is extremely effective in addressing inequality must, almost by definition, impose the largest relative losses on the wealthiest members of society. Such policies are rarely adopted in the absence of intense political pressures. During the 1920s through to the 1940s, high inequality on the European continent was resolved, in many cases, via fascism or war. In the United States during that time, policies that measurably reduced inequality were only adopted in the face of the pressures of wartime financing and the rise of the far-left American demagogue Huey Long. These policies included inheritance taxes at 70 per cent, and 80 per cent taxes at the highest levels of income, a tax regime best described as 'confiscatory'.[16]

It must be noted, however, that it is emphatically not the case that the more severe the conditions of absolute or relative economic deprivation, the more severe the political response.[17] There is no clear causal link between inequality and political instability.[18] The process by which economic issues become politicised is contingent and complex. Hence it is quite possible that the current era of rising instability will come to an end even in the absence of effective measures to address inequality. (Some previous political upheavals in advanced economies, such as the 1968 Paris uprisings, or the 1960s and 1970s 'race riots' in the United States, were followed by a rapid return to stability.[19]) At the same time, this absence of a simple link between economic conditions and instability implies that even upon economic recovery, public discontent may persist.

RISK MANAGEMENT

The 2011 Standard & Poor's (S&P) rating downgrade for the United States was arguably the first recent country risk event attributable to the phenomenon of rising political risk in advanced economies. S&P linked the downgrade in part to attempts by members of the US House of Representatives to use the threat of a US sovereign debt default to achieve policy objectives. Although the downgrade had little impact on bond markets, it was epochal; not since 1860, when S&P was founded, had the US been downgraded. The AAA rating that had survived two world wars had been undone by political polarisation.[20]

A far more impactful country risk event was, of course, the 2012 sovereign default by Greece.[21] It is tempting to see the Greek default as purely economic in nature, reflecting a history of over-borrowing; however, some analysts have argued that the Greek crisis was not triggered solely by the Greek government's October 2009 restatement of its debts – after October 2009, sovereign yields rose but then plateaued. The uncontrolled rise in Greek sovereign yields began in March 2010, after Eurozone authorities issued statements that may have undermined an implicit guarantee for Eurozone member states' debt.[22] That is also a form of political risk.

How can financial institutions respond to the rise of political risk in advanced economies?

Firstly, there is a question of expertise. The assumption that politics will not affect economic outcomes in advanced economies is almost definitional, one of the elements that qualifies a country for advanced economy status.[23] If this assumption no longer holds true, banks may need country risk staff with a background in politics, including European and North American politics. Of late, the political risk component of country risk has increased around the world, following, for instance, instability in Turkey and Russia's standoff with the West over Ukraine. But it is expected that emerging market area specialists will understand politics; it may be increasingly necessary in advanced economies as well, where country risk assessment tends to be dominated by economists and credit analysts.

Second, financial institutions may need to address country risk operationally as well as financially. Companies that as a matter of course assume high levels of political risk, such as oil and gas and mining companies, tend to take a very different approach to country risk management than banks, one that is based on operational management as opposed

to compliance and finance. This stance is necessary because in such environments operational decisions can have large impacts on political risk levels. For example, many US power companies operating in Indonesia invited Suharto regime-associated figures to serve as co-owners of investments. This was a good operational decision but contributed to expropriation risk following regime change. Similarly, decisions by country managers at oil companies in the Niger Delta to provide community services in areas where their pipelines had been disrupted created a payoff cycle in which local communities were incentivised to disrupt operations. To guard against such perils, country risk management staff in extractive industry firms tend to have input into operational decisions. To quote a recent example in banking where such input may have been useful, the decision by Goldman Sachs to hire former European commission president José Manuel Barroso ignited a substantial political backlash.[24] Banks are not simply impacted by political risk in advanced economies; they are also targets of the current backlash and thus need to manage risks accordingly.

Lastly, financial institutions must contemplate rising advanced economy political risks from the perspective of citizens. In a sense, political risk in home countries is unmanageable; Barclays, for instance, cannot address UK country risk via risk limits. That said, there are measures that could reduce advanced economy political risk. For instance, in the US, the elimination of debt ceiling requirements would prevent politicians from wielding default threats and, by that means at least, imperiling the US credit rating. Regulatory recognition that home country sovereign debt is not in fact risk-free[25] would help to hold politicians to account for their actions, by increasing the financial market response to policies that raise sovereign risk levels. Backing of such political and regulatory measures may seem beyond the remit of country risk management. But whether political risk in advanced economies escalates to unmanageable levels, as it did in many European countries in the 1920s and 1930s, is not pre-ordained; whether the current backlash snowballs or melts away will be determined in part by the way governments react, governments we elect and influence. Political risk has come home to advanced economies. Bankers no less than anyone else have a citizen's responsibility to combat it.

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9 See http://fortune.com/2016/06/29/marketplace-edison-survey-rigged/ (accessed 24th October, 2016).

10 I was directed to this graph by an Oxford Economics client note. Note that it is very difficult to define 'populism' and the classifications used in the Timbro study could be debated.

11 The median voter theorem posits that when certain restrictive assumptions are satisfied, democracies will select the policy option preferred by the median voter on a left-right spectrum.

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18 The most successful, although indirect, effort to establish such a link is Alesina, A. and Perotti, R. (1996) 'Income distribution, political instability, and investment', *European Economic Review*, Vol. 40, pp. 1203–1228. By contrast, there is a large literature linking inequality and poor economic outcomes.
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22 Jones, E. (2015) 'Getting the story right: how you should choose between different interpretations of the European crisis (and why you should care)', *Journal of European Integration*, Vol. 37, pp. 817–832.
23 For a discussion of the definition, see https://www.imf.org/external/pubs/ft/weo/faq.htm#q4b (accessed 24th October, 2016).
24 See https://www.theguardian.com/business/2016/sep/15/jean-claude-juncker-jose-manuel-barroso-decision-to-join-goldman-sachs (accessed 25th January, 2017).
25 See Capuano, C. and Ruggerone, L. (2015) 'How much economic capital could European banks save? The case for optimal European sovereign risk allocation', in Wilkin, S. (ed.) 'Country and Political Risk: Practical Insights for Global Finance, Second Edition', Risk Books, London. Capuano and Ruggerone demonstrate that the regulatory fiction of risk-free sovereign debt results in reduced levels of bank lending in Europe. A recent Oxford Economics client note suggests that this policy may increase the risk that the bank-sovereign doom loop will re-emerge following the end of quantitative easing because banks have been incentivised to overload on own-country sovereign debt.