COUNTRY RISK AND POLITICAL INSTABILITY: A VUCA WORLD APPROACH

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Abstract: *The last three years were characterized by a climate of drastic change due to a cumulus of disturbances and crises, namely the COVID-19 pandemic, inflation, energy crisis, military conflicts, banking fragilities, populism, disinformation, and the idea of deglobalization. These types of events may be interpretated either as antecedents of new and complex categories of risks or as stimulus for certain risks that have long been ignored. One central focus for worldwide policymakers is presently the country risk with all its components (sovereign risk, political risk, market risk, or systemic risk). Furthermore, due to the increase in public and private debt, the risks to which economies are exposed have multiplied. Is this the end of an era or just a temporary disequilibrium? This is one of the key questions among economists, academics, and policy makers around the world. The main purpose of this research is to analyse whether the Russian invasion of Ukraine negatively impacted the country risk of countries situated in the geographical proximity of the conflict area (Romania, Bulgaria, Estonia, Hungary, Czechia, Latvia, Lithuania, Poland, and Slovakia), as well as to determine whether relevant macroeconomic indicators such as debt/GDP, GDP/capita, inflation, or trade openness were deteriorated due to the war. The findings of this research reveal that all the analysed macroeconomic indicators deteriorated as a consequence of the high degree of uncertainty concerning the future economic prospects of these countries, especially inflation and debt/GDP. The results also indicate that the country ratings of the investigated group of countries were severely impacted by the Russian invasion of Ukraine. Although data corresponding for year 2023 show a slight improvement, the existing uncertainty continues to generate a disruptive effect on the markets.*

Keywords: *country risk, political risk, sovereign risk, transfer risk, uncertainty, sovereign debt, ratings.*

JEL Classification: *F34, H63*

1. Introduction

Recent global transformations triggered a redesign in terms of the architecture of the country risk, primarily through an aggressive emergence of the political risk because of the Russian invasion of Ukraine. The country risk, which refers to a particular set of risks corresponding to a specific nation, exposes all those categories of economic agents who have special economic interests in a certain country. Assessing this type of risk proves to be crucial due to an undeniable argument: its ignorance can lead to significant financial losses. Whether it is the case of exporters, importers, investors, or creditors, these different categories of agents must consider this aspect as their primary focus.

For a relatively long period of time, the country risk was perceived as a debated and ambiguous concept, particularly since the available information were discontinuous, even though, from a historical perspective, the country risk is not a new concept. A multitude of definitions and interpretations were developed in reference to the country risk, including the one elaborated by John Calverley. In a much broader sense, the country risk may be interpreted as the multitude of potential losses due to instabilities generated by macroeconomic and/or political events from a certain country. Calverley`s (1990) perspective focuses on the fact that, regardless of the common approach popularized by the literature in the field, associating the country risk only with the banking sector proves to be inadequate, as this risk should not be entirely attributed to bankers. Country risk constitutes a central focus for many categories of individuals, including economists, investors, members of academia, and more. Calverley`s division of the country risk into two main categories, namely the sovereign risk and the transfer risk, brings to the attention a much more complex concept, the generalised country risk. The main outcome of the sovereign risk is based on the impossibility or the lack of intention of a state to fulfil its obligations, whereas the transfer risk implies not gaining access to foreign currency needed for the payment of a foreign creditor. Calverley recalls that the sovereign risk refers to the loans granted by different financial institutions to a foreign government or to a foreign economic agent, but for the second case, the loan is accompanied by a state guarantee.

Currently, the country risk analysis became a sine-qua-non element of the decision-making process developed within different companies or banks. Therefore, the country risk tends to become a decisional instrument, and the formulated conclusions based on its interpretation should offer immediate support to bankers, exporters, or investors (Meunier, 2005). The last three years were marked by a cumulus of severe uncertainties and risks, among which we can mention the sanitary risk (the COVID-19 pandemic), the economic risk, macroeconomic imbalances (inflation), the energy

crisis, and more recently the political risk as a consequence of the war in Ukraine. This mixture of risks has a direct influence on the country risk and on its assessment methods. The present context allows different researchers to debate systematic risks (Qureshi et al., 2022), and a short incursion into the determinants of the country risk seems adequate.
The Russian invasion of Ukraine, which began more than a year ago, raised the awareness of economists and managers around the world. Although political risk was a consistent part of local and isolated strategies in recent years, its effects on companies were perceived as limited. It is the first time in the last 50 years that the political risk resurfaces and concepts such as expropriation or nationalization regain popularity. The main purpose of this article is to draw attention to the importance of political risk as a component of country risk in the context of the Russian invasion of Ukraine. Furthermore, the paper will concentrate on the issue of the sovereign risk (the probability of default of the states) and its contingency on some key parameters (such as trade, commodity prices). To stay in line with the primary objective of this study, three main research questions were issued: *Why did the political risk regain popularity as one of the major risks that EU countries might face? In what way does the Russian invasion of Ukraine influence the country risk of the neighbouring countries? Which is the most suitable set of indicators we can use for the correct assessment of the country risk?*
The reminder of the paper is structured as follows: Section 2 outlines the most relevant studies that were used as supporting pillars for the present research, Section 3 describes the data and their relevance according to the purpose of the current analysis, and Section 4 presents the conclusions and some policy implications.

2. Theoretical background

2.1 The political risk

In recent years, economies around the world have faced a series of disruptions that forced worldwide researchers and policy makers to reconsider their strategies and focus all their efforts on developing response and recovery capabilities. These types of disruptions generated negative effects on the micro and macro environment, ranging from slower growth to distribution and transport interruptions. Many categories of risks were brought into discussion, but little attention was paid to the political risk, especially in the case of countries located in Europe. Political risk was among the interests of academic researchers from the 1970s. What has changed in the last 50 or 60 years was the perspective from which the country risk was analysed.

If the studies developed in the 1960s emphasised the political risk, the new approaches were marked by the following directions:

- The issues of the sovereign debt and the associated crises (the countries located in South America, starting 1970);
- The financial and systemic risk (1980 – 1990);
- The cumulus of crisis at the end of 1990: The Asian financial crisis, the Russian Rubble crisis;
- The economic and financial crisis from 2008, characterized by risk intensification and overlap, country risk analysis proving to be a mandatory requirement for each country, regardless of its level of development, and, even more importantly, the sovereign debt crisis (the case of Greece or PIIGS countries);
- Recent years were marked by a mixture of crises that highlighted once again the importance of the political risk that for a long period of time was considered quasi-absent – after the development of the European Union (a structure that promotes a series of values, including political stability), the political risk was no longer perceived as a threat, neither by the member states nor by its neighbouring countries).

There is an abundance of studies that quest the significance of the political risk, with the main purpose of identifying practical tools that policymakers and economists facing this type of risk might use in the attempt to diminish its negative effects: new relevant indicators and influence factors, but also factors that may generate an impact on the sustainability of the sovereign debt, early warning signals in what concerns over indebtedness. Two main streams of literature emerged, namely the sovereign risk and the sustainability of sovereign debt.
The problem of identifying the precise components that incentivise a country to repay its debts was brought into discussion by several researchers (Rogoff, 2022), who emphasised that the legal approach proves to be more important than the reputational one. Other authors (Dvorkin et al., 2022) illustrated the restructuring mechanism of the sovereign debt, identifying suitable policies for this purpose, as well as techniques of reducing the probability of default, in the context that an increase of sovereign debt is understandable, especially for certain categories of countries (Deceanu&Bodea, 2021).
Further evidence that provide strong support in favour of the crucial role that political risk has for the macroeconomic environment, especially in terms of the investment strategy, was examined by Banerjee and Dutta in 2021. This study concluded that when countries face a high level of political risk, companies tend to

reduce the irreversible capital investments toward these states. Moreover, other studies (Gonchar and Greeve, 2022) find that there is an extremely high volatility of FDI in countries with high political risk. On the other hand, the political risk is highlighted by the Russian invasion of Ukraine (which began more than a year ago), causing severe systemic risk consequences (Qureshi et al., 2022). Another stream of studies elaborated on the subject of political risk, country risk, and probability of default, focused on testing the relationship between external debt and economic growth. For example, Wang, Xue, and Zheng in 2021, using a panel regression for 182 low- and middle-income economies between 1970 and 2018, concluded that an increase in long-term external debt negatively influences the economic growth rates of the analysed countries. Furthermore, the study confirmed that better institutional quality could help countries cope better with the negative effects of high external growth rates and their impact on economic growth. Lof and Malinen (2014) using data gathered for 20 developed countries found no evidence of a strong effect of debt on economic growth and may classify the effect as being in best terms ambiguous.
More recent analyses associate country risk with a series of modern concepts such as populism, public health issues, or green innovation. According to some empirical findings (Hartwell and Devinney, 2021), political risk may be analysed in correspondence to populism as a challenge for the current macroeconomic framework. On the other hand, Yang et al. in 2022 found that there is a strong interconnectedness between political risk and green innovation, the results of the study advocating that a decrease in terms of political risk positively supports green technology improvement. Furthermore, other studies (Peiro-Signes et al., 2022) confirm that the Environmental Performance index is a reliable predictor of the Country Risk Score.

2.1 The political and sovereign risk as main components of the country risk

The dichotomy in what concerns the country risk origins separates the political origins from the economic origins (Hurson et al., 2006). The first category is linked to the sovereignty principle, and even in the present context, characterized by a decrease of its importance, its influence remains powerful. Recently, we observed a return to nationalist and protectionist tendencies in various states. The political risk may be primed either by the internal situation of a certain country or by the interconnections between two or more states. The first situation requires measures that target directly the foreign economic agents (nationalisations, exclusions from

certain fields of economic activity), while the second one implies a series of consequences in respect to the development of international relations (boycotts, etc.).
Within the literature in the field, the global definition of the political risk proves to be quite ambiguous, leading to the development of several classification methods. Since the early 1970s, some researchers have questioned the division of the political risk into the macropolitical and micropolitical risk (Robock, 1973). As the name implies, the first type of risk involves a more general approach, while the second targets only some specific economic agents.
Later, authors such as Channon (1979) developed in their studies several categories of political risk:

- Risks arising from an intervention within the standard regulatory framework, applicable to all economic agents;
- Risks that have origins in the non-discriminatory interventions that give advantages to a specific group of economic agents;
- Risks related to interventions that have a selective profile applicable to specific economic agents.

Other classifications of political risk (Overholt, 1982) multiplied the categories of risk:

- Political risk concerning the assets of an enterprise;
- Organizational political risk that targets the decision-making process;
- Operational political risk with respect to access to imports;
- Political risk of the market, relative to sales and development of the economic agents;
- Statutory risk (e.g., changes of the regulatory framework);
- Contractual political risks;
- Political risk related to property (nationalisation, expropriations).

Earlier surveys of the 1990s revealed the first in-depth analyses of the triggering factors of the country risk, declined in the political context of the foreign state and its economic and financial framework (Marois, 1990).
Four crucial elements – included in the table below – are perceived as the main determinants of the political context, closely connected to the sovereignty principle, as previously mentioned.

Table 1: The political context, as a source of the country risk

1. Geographical sources of the political risk	a) Political risk of a certain state – sovereign decisions (e.g.,: expropriation of the subsidiary of a foreign company, repudiation of foreign debt); b) Political risk identified at the interference of two states (e.g., sanctions applied to economic agents who are nationals of a state in conflict with the host country – the case of the British – Argentine conflict, that generated consequences upon the British companies from Argentina and the blocking of the Argentine accounts in the British banks)
2. Main determinants of the political risk	a) Ideological determinants – nationalism, xenophobia, revolutions; b) Economic determinants (closely related to the political ones; for example, when a state is confronting with severe economic imbalances, it may be tempted to confiscate foreign assets, the main justification being of political nature); c) Sociological determinants – ethnic conflicts, religious conflicts, cultural habits; d) Psychological determinants – for example, the personality of some dictators, which only aggravates a situation considered already difficult.
3. Precursor elements	a) Development of political philosophies hostile to foreign investments: Marxism, nationalism, certain forms of socialism, etc.; b) The emergence of internal conflicts of ethnic, religious, and social nature, translated into various violent incidents; c) Political independence; d) Development of new international or regional alliances; e) The presence of pressure groups hostile to foreign companies.
4. Political risk manifestation	a) Particular events – war, destruction of goods, strikes; b) Punctual decisions – laws, regulations, norms that harm foreign interests; c) General investment climate: hostility, administrative difficulties, etc.

Source : Adaptation from Marois, B., *Le risque pays*, PUF, Paris, 1990.

In the recent case of the Russian invasion of Ukraine, we might highlight the Russian rhetoric close to the previous elements described by Marois – the fear of NATO enlargement, the development of a philosophy hostile to the West, the presence of the so-called threats to the existence of the Russian state. The economic and financial

origins of the country risk have captured the attention of researchers in recent years, mainly due to the fact that they become the main source of risk. In many cases, they are determined by the ineffectiveness of the state to elaborate sound economic policies or by the development of protections measures: inefficient monetary policy, maintaining a high level of budget deficit and public debt, excessive protection of domestic economic agents that may generate inflation, currency shortage, or monetary inconvertibility.

The political, economic, and financial sources of the country risk are multiplied and strengthened by the new international context. This is characterized by a new geopolitical order that is gradually changing: the war in Ukraine continues after one year from its debut, the West-China tensions persist; states such as North Korea are likely to become the centre of new conflict zones, while India and southern Asia are pillars of a new economic edifice. The European construction, although impacted, among other aspects, by economic fragilities and euroscepticism, continues its path, while the US aim to stabilise the economic and social context.

In what concerns the sovereign risk, the prior literature underlined until recently that it is typically low for states that have powerful currencies (Euro, US dollar, British pound), while for developing countries this type of risk may increase. Despite all this, events in Greece, especially after the fall of 2009, but also in the context of public finances during the COVID-19 pandemic, have refuted, at least in part, these assertions. The continuous increase in indebtedness is a certified fact of the recent period, with some exceptions. The austerity measures imposed, and the relocation of the national revenue are more difficult to implement, especially when the effects of the pandemic were so severe.

One element worth mentioning is the fact that developed states are favoured in the process of refinancing their public debts by the particular economic and financial setting, while in the case of developing countries, the ability to pay is a more sensitive issue, closely related to what the international literature titles *willingness to pay*. The problem of solvency is crucial for these countries, while its degradation (due to specific phenomena such as the effects of the crises on the budget balance) gives rise to significant refinancing difficulties. Without a doubt, sovereign risk is currently also influenced by the indebtedness of the private sector, a high level of which increases both the risk of financial collapse of businesses and the fragility of the banking sector.

Globally, the indebtedness rate remains high; although average global public debt has fallen from around 100% of GDP in 2020 to 96% of GDP in 2021, supported by strong real GDP growth, high inflation, and the withdrawal of COVID-19 fiscal

support measures, over indebtedness remains a challenge. Debt reduction is difficult to achieve, at a time when economic activity is affected by major imbalances.

3. Data and discussion

Our analysis relies on a data set collected between 2017 and 2022 or 2023 as for the case of countries ratings. The five-year or six-year span is a sufficient period of time needed to observe the evolution of the country's risk ratings as well as to develop a dataset of the most relevant macroeconomic indicators, including GDP/capita, inflation rate, debt / GDP ratio and trade openness. The country sample includes nine Central and Eastern European countries that are in the geographical proximity of Ukraine and therefore can be negatively affected by the political instability of this country, namely Bulgaria, Czechia, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, and Slovakia. The data used for the current analysis were retrieved from Eurostat, World Bank, and Fitch, S&P, or Moody's global ratings.

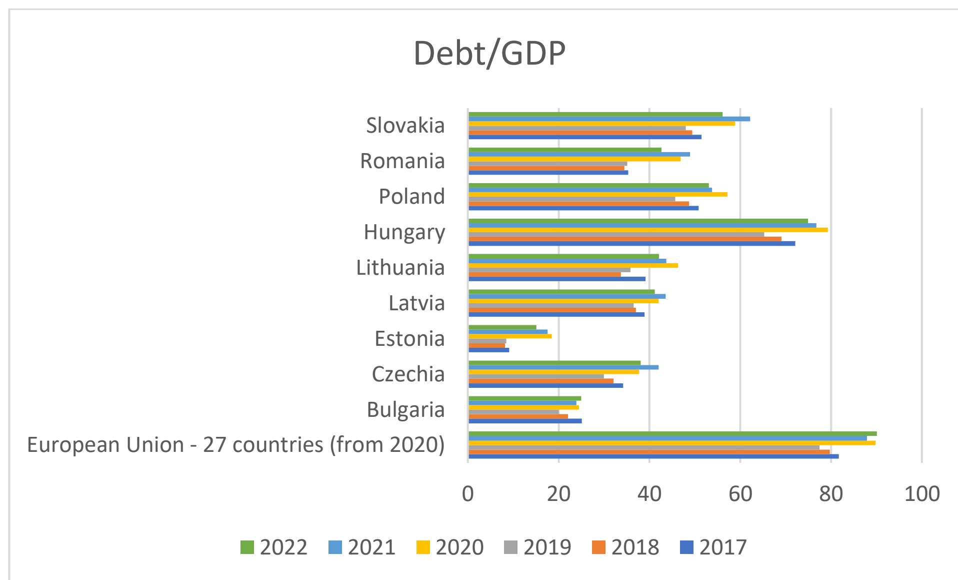

Figure 1: Debt/GDP
Source: Eurostat
(https://ec,europa,eu/eurostat/databrowser/view/GOV_10DD_EDPT1__custom_5600423/default/table?lang=en)

If prior to the pandemic situation a tendency of decline in terms of the sovereign debt was observed (at EU level but not exclusively), in the context of COVID-19 corroborated with the lockdown restrictions, the intervention of states led to an increase of sovereign debt especially between 2020 and 2022, causing a resurface of sovereign debt. This context is characteristic for all the countries included in the

analysis. Furthermore, the breaking point of the Russian invasion of Ukraine worsened even more the overall perception that foreign investors had with respect to the country risk of economies located in the geographical proximity of the war. A more detailed macroeconomic analysis emphasises that for some countries under investigation, such as Romania, the fact that the international loans are obtained at very high interest rates deepens even more the uncertainty concerning the public debt sustainability. Registering high values associated with public debt and deficit is not always a sign of an expanding economy. In this sense, a more complex analysis should be developed regarding the uses of public debt. Sustainable uses could target investments in infrastructure, technological transfer, and not budgetary expenditures such as pensions, public wages, or the payment of previously obtained debts.

Table 2: Trade (% of GDP)

Country/TIME	2017	2018	2019	2020	2021	2022
European Union - 27 countries (from 2020)	90.46	92.13	92.07	85.14	92.83	89.85
Bulgaria	129.68	128.85	124.64	110.28	120.97	121.59
Czechia	150.53	147.95	141.77	133.15	142.50	142.11
Estonia	147.56	145.92	143.75	138.47	156.96	146.04
Latvia	123.81	123.58	120.29	118.83	130.37	123.06
Lithuania	144.87	148.59	149.33	137.20	156.47	146.88
Hungary	165.23	163.26	160.78	155.53	162.79	161.39
Poland	101.28	103.45	102.69	100.32	112.45	103.98
Romania	87.16	86.47	84.50	78.06	87.36	84.69
Slovakia	188.06	189.80	183.48	168.51	187.83	183.49

Source: World Bank (https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS)

The Russian invasion in Ukraine accentuated the logistic deficiencies caused by the COVID-19 pandemic, generating a negative impact on international trade that was severely affected. An explanatory factor for this sharp decrease in terms of trade openness could also be the protectionist measures that the countries imposed with the purpose of protecting domestic producers, on the one hand, and, on the other

hand, minimizing the spillover effects. Considering that an efficient and intense international trade is one of the main factors that are positively related to the sustainability of sovereign debt, it can be concluded that these volatilities in terms of international trade may degrade the configuration of the country risk.

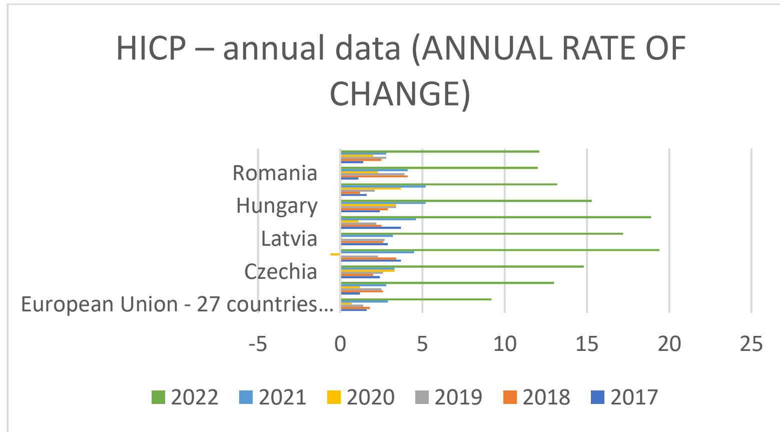

Figure 2: HICP – annual data (ANNUAL RATE OF CHANGE)
Source: Eurostat
(https://ec.europa.eu/eurostat/databrowser/view/PRC_HICP_AIND__custom_5601378/default/table?lang=en)

Inflation is a factor that manifests a negative influence on the country risk. Data included in figure 2 highlight an upward trend for inflation rate between 2017 and 2022 for all the analysed economies, with a maximum level reached in 2022. The highest increase in 2022 was registered for the case of Lithuania, followed by Estonia and Latvia. This increase was driven by a rise in prices for gas, electricity, water, and other fuels.

Table 3: Main GDP aggregates per capita by member state (in Euros)

Country/TIME	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
European Union - 27 countries (from 2020)	29,320	30,290	31,310	30,030	32,440	35,220
Bulgaria	7,420	8,000	8,820	8,890	10,330	12,400
Czechia	18,330	19,850	21,150	20,170	22,270	25,830
Estonia	18,120	19,660	20,960	20,670	23,640	27,170
Latvia	13,900	15,130	16,040	15,940	17,840	20,720
Lithuania	14,950	16,250	17,500	17,810	20,000	23,620
Hungary	12,980	13,920	15,000	14,140	15,840	17,520
Poland	12,120	12,990	13,870	13,720	15,060	17,310
Romania	9,510	10,580	11,560	11,440	12,610	15,040

Slovakia	15,570	16,500	17,320	17,110	18,110	19,590

Source: Eurostat (https://ec.europa.eu/eurostat/databrowser/view/nama_10_pc/default/table?lang=en)

After the sharp decrease registered in 2020, due to the effects of the Coronavirus pandemic (and the lockdown), there is an increase in terms of GDP at the level of the considered states, which attests to a revival of the economic activity; it is worth mentioning, however, that this evolution is accompanied by inflation, and therefore the price increases can "inflate" the data, the values being apparently higher. It is a clear fact that economies are currently not growing significantly, the context of uncertainty corroborated with the lack of predictability being a genuine opponent to the growth of economies and investors' appetite for risk.

Table 4: Country ratings between 2019 and 2023

Country/ TIME	**2019**	**2020**	**2021**	**2022**	**2023**
Bulgaria	Fitch BBB (positive) Moody's Baa2 (positive)	Fitch BBB (stable) S&P, BBB (stable) Moody's Baa1 (stable)	Fitch BBB (positive)	Fitch BBB (positive)	Fitch BBB Moody's Baa1 (stable)
Czechia	Moody's Aa3 (stable)	Moody's Aa3 (stable)	Moody's Aa3 (stable)	Fitch AA- (negative) Moody's Aa3 (negative)	Fitch AA- (negative)
Estonia	Fitch AA- (stable)	S&P, AA- (positive) S&P, AA- (stable)	S&P, AA- (positive)	S&P, AA- (stable) Fitch AA- (negative) S&P, AA- (negative)	S&P, AA- (negative)
Latvia	S&P, A+ (stable)	S&P, A+ (stable) Fitch A- (negative)	Fitch A- (stable)	S&P, A+ (negative)	S&P, A+ (negative) Fitch A- (stable)
Lithuania	Moody's A3 (positive)	Fitch A (stable) S&P, A+ (stable)	Moody's A2 (stable)	Fitch A (stable) S&P, A+ (negative)	S&P, A+ (negative) Moody's A2 (stable)

Hungary	S&P, BBB (stable) Fitch BBB (stable)	S&P, BBB (positive) S&P, BBB (stable) Moody's Baa3 (positive)	Moody's Baa2 (stable)	S&P, BBB (negative)	Fitch BBB (negative) S&P, BBB- (stable)
Poland	S&P, A- (stable)	Fitch A- (stable)	Fitch A- (stable)	S&P, A- (stable)	Fitch A- (stable) S&P, A- (stable)
Romania	S&P, BBB- (negative)	Moody's Baa3 (negative) Fitch BBB- (negative)	Moody's Baa3 (stable) S&P, BBB- (stable)	Fitch BBB- (negative)	Fitch BBB- (stable)
Slovakia	Moody's A2 (stable)	Fitch A (stable) S&P, A+ (negative)	Fitch A (negative) Fitch A (stable) S&P, A+ (stable)	S&P, A+ (negative) Moody's A2 (negative) Fitch A (negative)	Fitch A (negative)

Source: https://tradingeconomics.com/

As data included in Table 4 reveal, the COVID-19 pandemic generated a degradation of the sovereign notes in the context of a high degree of uncertainty accompanied by an increased level of indebtedness. Although a slow post-pandemic recovery can be traced, the recent events such as inflation, the energy crisis, and the war in Ukraine continue to inflate the degradation of the sovereign rating. A slight improvement is observable for year 2023 (also in the case of Romania), but the climate of uncertainty persists.

4. Conclusions and policy implications

For a very long time, the globalization phenomenon, mediated through the flows of goods, services, people, capital, and ideas, was perceived as a necessary criterion for achieving smart and sustainable economic growth. Recent events, however, altered this perception and a new phenomenon received increasing attention from worldwide researchers and policy makers, namely deglobalization.

Due to the constant fragmentation of international trade, foreign direct investments, or global value chains triggered by the pandemic situation or the conflict in Ukraine, the process of deglobalization expanded at unimaginable speed. Under this unstable scenario, the political risk resurfaced, after being considered a marginal risk in the framework of country risk for decades. Political instability tends to perpetuate over time; therefore, if a country registers a high level of political risk at present, it will be more likely to follow this path in the future. Political risk affects a wide range of economic areas, including the banking sector, foreign direct investment flows, international trade, or capital markets.

The present research investigated the impact of the Russia-Ukraine conflict on a set of macroeconomic indicators, including debt/GDP, inflation, trade openness and GDP/ capita from countries located in the geographical proximity of the conflict zone and concluded that all these indicators were negatively impacted. Furthermore, the country ratings given by the most important rating agencies, such as Fitch; S&P, or Moody's, experienced severe degradation. To counteract any further negative shocks, European countries should concentrate all their efforts toward strengthening the pillars of the internal market and protect at all costs the security and freedom of their citizens. For some states, the management of indebtedness will be a challenge, especially from a political and social point of view, as decisions should be made on the proper relocation of the reallocation of national income, a subject considered extremely debatable, because of the effects of recent economic developments.

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