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## Politicians share responsibility for the risk of their state defaulting

**Investors assume higher risks of default when a country is politically unstable or governed by a party at the left or right end of the political spectrum. However, according to findings obtained by Stefan Eichler from the Halle Institute for Economic Research (IWH), the more democratic the country is and the more it is integrated into the global economy, the lower is the impact that such political factors have.**

It is not rare for sovereign defaults to have political causes. This is because it is ultimately the national government that decides on whether a debt is repaid. For instance, in 2015, the Greek government openly threatened to default if a portion of their assistance package was not paid out to them. Whether a government is actually willing to pay its debts therefore plays a critical role in the risk of sovereign default. Stefan Eichler from the Halle Institute for Economic Research investigated whether and the extent to which bond investors also consider political factors to be important regarding the risk of sovereign default. On the basis of risk premiums for the sovereign bonds of 27 emerging and developing countries between 1999 and 2009, he examined the influence of various political factors on the risk of default perceived by investors.

Studies on sovereign default risk typically present economic and financial factors as being decisive. The few studies that have tackled the political dimension analysed the risk of default using the assessments of credit rating agencies. "Sovereign credit ratings can be considered to be somewhat of a black box in many respects since they lack transparency," explains Eichler. He therefore studied the perception of investors by looking at the effective interest rates of sovereign bonds.

"First of all, the political ideology of the government plays a key role for investors. Countries with a left-wing or right-wing government suffer from significantly higher risks of sovereign default than countries with centrist governments. On average, left-wing governments pay a 2.6% higher interest rate than centrist governments, while for right-wing governments the risk premium is 3.9%. This is because investors anticipate that ideologically motivated payment defaults are more likely with both left and right-wing governments," Eichler continues.

Political stability is also reflected in interest rates. The more stable a country is, the lower are the effective interest rates it has to pay for credit. A two points higher index for political stability reduces the risk premium by 6.6%. "This corresponds

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with the difference between stable Chile and crisis-stricken Venezuela, for example," Eichler explains. "For investors, political stability increases the certainty that a state will feel obliged to honour the public debt accumulated by previous governments." Conversely, in politically unstable countries, investors find it difficult to assess the intentions and competencies of the new government.

However, the effects of ideology and political stability on the risk of sovereign default are partly determined by other factors, namely the level of democracy, and integration within international markets. Political stability plays a less significant role in democratic states. "In democratic states the governments across all political camps generally agree that fiscal obligations have to be met", Eichler adds.

Moreover, if a country is barely involved in international trade, the risk of default is likewise much more dependent on election cycles, political ideology and stability. "In the eyes of investors, foreign trade increases the political will to honour payment obligations. This is because they assume that countries more closely integrated within the global economy also suffer more if their international financing is restricted. We should bear this in mind when debating the pros and cons of globalisation. A globalised state enjoys greater trust and also appears much more resilient to the outside world," concludes Eichler.

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