EQUITIES

Political Risk in Emerging and Developed Markets

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The often-observed link between dramatic political events and large market moves suggests that political risk can affect stock returns. Quantifying that risk is difficult, however, because 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 markets experiencing increased political risk downgrades by approximately 11% a quarter. There is no statistically significant difference between average returns in developed markets experiencing political risk upgrades and those 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.

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.

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