Finanziato dall'Unione europea
NextGenerationEU

Ministero dell'Università e della Ricerca

Italiadomani
PIANO NAZIONALE DI RIPRESA E RESILIENZA

Università Ca'Foscari Venezia

Finanziato nell'ambito del Piano Nazionale di Ripresa e Resilienza PNRR. Missione 4, Componente 2, Investimento 1.3 Creazione di "Partenariati estesi alle università, ai centri di ricerca, alle aziende per il finanziamento di progetti di ricerca di base"

GRINS FOUNDATION

GRINS – Growing Resilient, INclusive and Sustainable

"9. Economic and financial sustainability of systems and territories"

Codice Identificativo: **PE00000018**

Finanziato nell'ambito del Piano Nazionale di Ripresa e Resilienza PNRR
Missione 4 – Componente 2
Investimento 1.3 – Creazione di "Partenariati estesi alle università, ai centri di ricerca, alle aziende per il finanziamento di progetti di ricerca di base"

SPOKE 4

D4.4.2 – Policy briefs on debt sustainability and financial stability also under compound risk

November 2024

Mitigating the Fiscal Risks of Political Instability

Policy Insights for Sovereign Debt Sustainability

Andrea Consiglio

Executive Summary

Political risk is a critical factor influencing sovereign debt sustainability, particularly in high-debt economies where fiscal margins are constrained. The study *"Are Bad Governments a Threat to Sovereign Defaults? The Effects of Political Risk on Debt Sustainability"* by Ajovalasit, Consiglio, Pagliardi, and Zenios (2024) builds upon the stochastic Debt Sustainability Analysis (DSA) framework developed by Zenios and Consiglio et al. (2021) to include political risk. By extending this model, the authors incorporate International Country Risk Guide (ICRG) ratings into the analysis, allowing for a comprehensive assessment of how governance dynamics shape sovereign debt trajectories.

Two case studies illustrate these dynamics:

1. Italy 2014–2019 Reforms: Governance reforms improved political ratings, narrowing the debt-to-GDP trajectory and reducing realised debt ratios compared to a scenario without reforms.
2. France 2024 Snap Elections: Snap elections caused a sharp drop in political ratings, widening the debt-to-GDP trajectory and increasing borrowing costs, highlighting the destabilising effects of political shocks.

The study suggests incorporating political risk into debt management frameworks can minimise refinancing pressures and stabilise debt trajectories, especially in politically volatile environments.

By implementing governance reforms, preparing for shocks, and optimising debt issuance, governments can mitigate the fiscal impacts of political instability and ensure long-term debt sustainability in an increasingly uncertain global environment.

Context and Importance of the Issue

Political risk significantly affects sovereign debt's sustainability by influencing bond yields and GDP growth. When political risk is high, investor uncertainty increases, leading to higher risk premiums and borrowing costs. This situation also negatively impacts economic performance by reducing private investment, slowing productivity growth, and creating financial instability. As a result, political risk is crucial for assessing sovereign debt sustainability, especially in countries with high debt levels. A decline in governance quality leads to increased borrowing costs, reduced fiscal space, and worsened challenges to debt sustainability. Conversely, strong and stable governance can mitigate these risks by promoting economic stability and relieving refinancing pressures.

The empirical findings from Ajovalasit et al. (2024) reveal a strong link between political risk and both yields and growth. Countries with greater political instability tend to see higher bond yields as investors seek compensation for the increased uncertainty. For instance, a deterioration of the ICRG ratings by ten units leads to a full-sample average annual increase in bond yields by 106 bp, compounding fiscal pressures on high-debt countries. Moreover, the analysis highlights that ten units' deterioration of the political rating leads to an economically large and statistically significant reduction in GDP growth by two percentage points, further straining fiscal space.

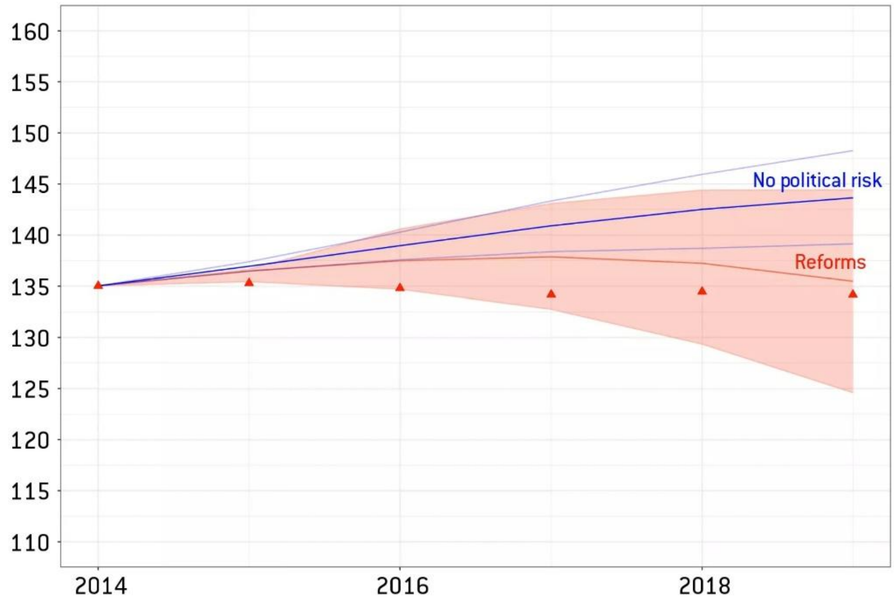
Evidence from the broader literature supports these findings. For instance, Eichler (2014) demonstrates that political risk increases sovereign borrowing costs. Additionally, studies such as those by Bekaert et al. (2014) confirm the adverse effects of political risk on asset pricing and sovereign bond yields, highlighting its impact across both emerging and developed markets.

Ajovalasit et al. (2024) extend this evidence by showing that political risk has a more pronounced effect in high-debt countries, particularly during elevated global interest rates. This amplifies the debt-to-GDP ratio, creating a feedback loop where fiscal vulnerabilities heighten political risk, which, in turn, worsens budgetary outcomes. The empirical analysis also illustrates the asymmetric effects of political risk: while stable governance substantially narrows yield spreads, political shocks create outsized spikes in borrowing costs. These dynamics are particularly evident in Ajovalasit et al.'s case studies on Italy and France, where improvements in political ratings reduced yields and stabilised debt, whereas political shocks significantly widened spreads.

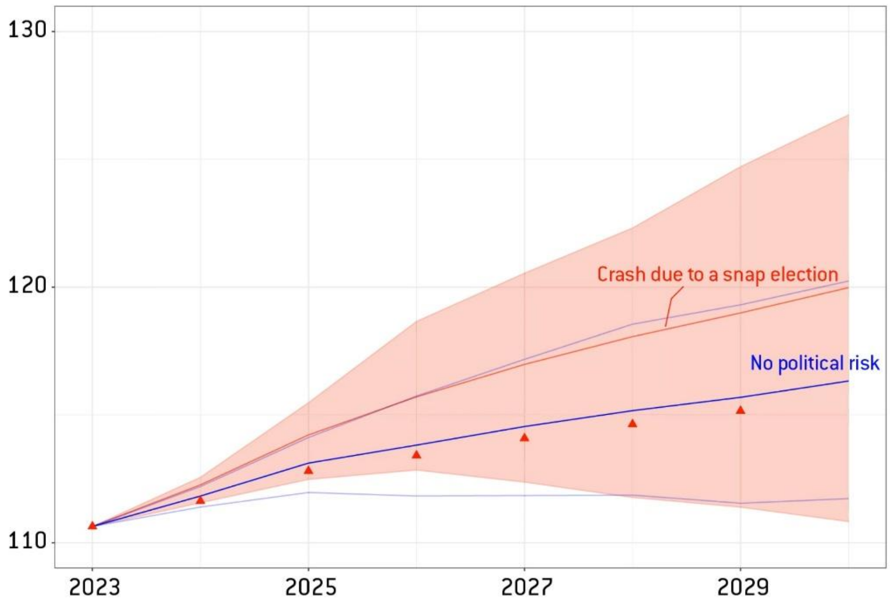
1. **Italy 2014–2019 Reforms:** Italy implemented structural reforms to improve governance and economic stability during this period. Political ratings improved, and this reduced perceived political risk, which led to stabilising debt trajectories. As shown in Figure 1, Panel (a), the coral fan charts with political DSA projections indicate a much narrower debt-to-GDP range compared to the counterfactual scenario, where political ratings remained static. The reforms allowed Italy to achieve lower realised debt ratios than initially anticipated, highlighting the fiscal benefits of governance improvements.

2. **France 2024 Snap Elections:** In contrast, the snap elections in France during the summer of 2024 created a sudden drop in political ratings, increasing perceived risk among investors. Figure 1, Panel (b), illustrates how this shock significantly widened the debt-to-GDP trajectory compared to a counterfactual scenario in which France maintained political stability. The coral fan charts display a higher and more volatile debt range, emphasising the destabilising impact of political shocks on fiscal outcomes. Projections from the 2024 World Economic Outlook reinforce this assessment, showing raised debt ratios due to heightened political uncertainty.

Informed by the Italian and French experiences, policymakers must act firmly to manage political risk and its fiscal implications. Even small improvements in governance quality can yield significant budgetary benefits. Policymakers can stabilise debt trajectories and foster economic resilience by prioritising political stability and incorporating political risk into debt management strategies. This is particularly urgent in a global environment characterised by rising interest rates and increasing geopolitical tensions, exacerbating high-debt economies' vulnerabilities.



(a) *Italian reforms (2014–2019)*



(b) *French snap elections (2024)*

Figure 1. Debt-to-GDP trajectories with and without political DSA for (a) Italian reforms (2014–2019) and (b) French snap elections (2024). Coral fan charts show projections with political risk, while blue lines represent counterfactual scenarios without changes in political ratings. Triangles indicate realised debt ratios for Italy and France's 2024 World Economic Outlook projections.

Policy Options and Analysis

Option 1: Implement Structural Reforms to Mitigate Political Risk

- **Analysis:** Structural reforms to improve governance can enhance political risk ratings. Enhanced political stability and governance quality contribute to lower sovereign spreads and improved debt sustainability.
- **Policy Implications:** Governments should pursue structural reforms that strengthen institutions, reduce corruption, and enhance policy stability. Such reforms can improve political risk ratings, lowering borrowing costs and more sustainable debt levels. However, policymakers must carefully design and implement these reforms to avoid potential social unrest or inequality that could negate the benefits.

Option 2: Integrate Political Risk into Debt Sustainability Frameworks

- **Analysis:** Political risk, encompassing factors like government instability, internal conflicts, and corruption, directly impacts economic growth and sovereign spreads. A 10-point deterioration in a country's International ICRG rating is associated with an average annual increase in sovereign spreads of 106 basis points and a reduction in GDP growth by two percentage points. Despite this, current DSA methodologies often exclude political risk, leading to incomplete assessments.

- Policy Implications: Adopting advanced DSA tools, such as those developed by the GRINS project, allows governments to incorporate political risk assessments into their fiscal planning. This integration facilitates the identification of vulnerabilities arising from political instability, enabling the implementation of preemptive measures to maintain debt sustainability. By utilising these enhanced tools, policymakers can make informed decisions that account for economic and political factors, ensuring a more comprehensive approach to debt management.

Recommendations

1. **Integrate Political Risk into Debt Sustainability Frameworks:**
    - Governments and international institutions should adopt debt sustainability analysis (DSA) frameworks that include political risk metrics, such as those proposed by Ajovalasit et al. (2024).
    - Use reliable data sources like the International Country Risk Guide to track governance-related vulnerabilities that affect debt dynamics.
2. **Implement Structural Reforms to Mitigate Political Risk:**
    - Focus on reducing corruption, improving bureaucratic efficiency, and enhancing the rule of law to improve political stability and lower borrowing costs.
    - Develop mechanisms to ensure consistency in policy implementation across political cycles to build investor confidence.

Implementation Considerations

I. **Institutional Capacity Building:**
    - Governments should invest in training programs and advanced technology to implement sophisticated DSA tools incorporating political risk metrics effectively.
    - Strengthen the capabilities of debt management offices (DMOs) by hiring experts in political risk analysis and fostering collaborations with academic institutions for ongoing research.

II. **Data Reliability:**
   - Contribute to national repositories, like the AMELIA platform, for collecting and analysing governance-related data to complement international metrics and reflect local realities.

III. **Public Awareness and Consensus:**
   - Launch public education campaigns to explain the benefits of structural reforms and highlight the fiscal risks of political instability.

Conclusion

Political risk is critical to sovereign debt sustainability, significantly influencing bond yields, GDP growth, and fiscal health. Ajovalasit et al. (2024) demonstrate that incorporating political risk into debt sustainability analysis frameworks provides a more comprehensive and realistic assessment of a country's fiscal trajectory. Case studies from Italy and France illustrate how governance improvements can stabilise debt dynamics while political shocks exacerbate fiscal vulnerabilities.

To address these challenges, governments must prioritise integrating political risk into DSA, implementing structural reforms to enhance governance, and developing strategic plans to deal with political shocks. These measures mitigate the fiscal impacts of political instability and strengthen long-term economic resilience. By adopting these strategies, policymakers can build a robust foundation for sustainable debt management in an increasingly uncertain global environment.

Acknowledgement

This study was funded by the European Union - *NextGenerationEU*, Mission 4, Component 2, in the framework of the *GRINS -Growing Resilient, INclusive and Sustainable* project (GRINS PE00000018 – CUP B73C22001260006). The views and opinions expressed are solely those of the authors and do not necessarily reflect those of the European Union, nor can the European Union be held responsible for them.

References

1. Ajovalasit, S., Consiglio, A., Pagliardi, G., & Zenios, S. A. (2024). Are Bad Governments a Threat to Sovereign Defaults? The Effects of Political Risk on Debt Sustainability. https://dx.doi.org/10.2139/ssrn.4929114

2. Ajovalasit, S., Consiglio, A., Pagliardi, G., & Zenios, S. A. (2024). Incorporating Political Risk into Analysis of Sovereign Debt Sustainability. https://www.bruegel.org/analysis/incorporating-political-risk-analysis-sovereign-debt-sustainability
3. Bekaert, G., Harvey, C. R., Lundblad, C. T., & Siegel, S. (2014). Political Risk Spreads. Journal of International Business Studies, 45(4), 471–493. https://doi.org/10.1057/jibs.2014.4
4. Eichler, S. (2014). The Political Determinants of Sovereign Bond Yield Spreads. Journal of International Money and Finance, 46, 82–103. https://doi.org/10.1016/j.jimonfin.2014.03.003
5. The PRS Group. (n.d.). International Country Risk Guide (ICRG). https://www.icrgonline.com/
6. Zenios, S. A., Consiglio, A., Athanasopoulou, M., Moshammer, E., Gavilan, A., & Erce, A. (2021). Risk Management for Sustainable Sovereign Debt Financing. Operations Research, 69, 755–773. https://doi.org/10.1287/opre.2020.2047