NORTH-HOLLAND

International Review of Financial Analysis
11 (2002) 1–27

IRFA
INTERNATIONAL REVIEW OF
Financial Analysis

The explanatory power of political risk in emerging markets

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Abstract

There is substantial argument that political risk is an important and increasing influence on international portfolio allocation decisions. The purpose of this paper is to investigate the relation between political risk and stock returns within the context of emerging markets. The issue is examined using a framework that controls for global and local return influences. Consistent with the paper's predictions, the findings reveal that political risk is important in explaining return variation in individual emerging markets, particularly in the Pacific Basin, but not in developed markets. At an aggregate portfolio level, supportive evidence is found of a positive relation between political risk and ex-post returns in emerging markets that is robust to alternative risk measures, and more prevalent during the 1990s. © 2002 Elsevier Science Inc. All rights reserved.

JEL classification: F21; F30; G15

Keywords: Emerging stock markets; Political risk; International asset pricing

1. Introduction

The purpose of this study is to test for an association between political risk and emerging stock market returns. The globalisation and integration of capital markets has opened up new investment opportunities for international investors. As such, political risk

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PII: S1057-5219(01)00067-9

has become an increasingly important concern when making international portfolio allocation decisions. As emerging stock markets tend to be located in developing countries, which are prone to periods of political instability (Diamonte, Liew, & Stevens, 1996), they provide a useful setting for an examination of the relation between political risk and stock market returns.

The concept of political risk is broad and encompasses many facets. However, it might be generally described as the risk that arises from the potential actions of governments and other influential domestic forces, which threaten expected returns on investment. Political risk is an important consideration when making international asset allocation decisions, particularly when the investment set includes emerging markets. Government actions and political events have the potential to substantially alter the value of an investment portfolio. While the concept of political risk is generally accepted as a relevant consideration in investment analysis, there is little available research that examines the relation between stock returns and political risk.

A problem with investigating this topic is that the factors associated with political risk are typically qualitative in nature. However, testing the relation between such factors and stock returns requires a quantitative measure. In this paper, quantitative political risk data, sourced from a risk rating system (Political Risk Services), are employed. While these data have been studied previously (e.g., Diamonte et al., 1996; Erb, Harvey, & Viskanta, 1996), this paper extends the literature through two main contributions.

First, the paper presents a model of return variation that incorporates political risk after taking into account both global and local influences on returns. Given that many factors have been shown to relate to returns, an approach is required that controls for the impact of these factors. Prior work has generally considered the univariate relation between political risk and returns (e.g., Erb et al., 1996), whereas this paper tests whether political risk provides any further information over that already impounded by other influences. Hence, the paper is able to examine the incremental explanatory power of political risk. Second, the impact of political risk is considered at both an individual country level and an aggregated portfolio level. Prior studies have considered either the impact of political risk in a specific market or in the context of an aggregated portfolio. However, from a practitioner's perspective, an examination of political risk is important at both the level of the individual market for market/stock selection decisions, and the aggregated level for asset allocation decisions.

The paper employs monthly data over the period 1985–1997 and a sample of 17 emerging markets. For comparative purposes, a sample of 18 developed markets is also considered. The results show that several emerging markets exhibit a significant relation between political risk and stock returns, particularly those in the Pacific Basin. In contrast, apart from one market, there is no evidence of a significant relation in the developed markets sample. Further, at the aggregated portfolio level, the findings show a significant relation between political risk and returns only in emerging markets. This result is most apparent in the most recent subperiod of the 1990s.

The remainder of the paper is organised as follows. Section 2 considers the nature of political risk in emerging markets. Section 3 discusses the models employed in the paper.