

POLITICAL RISK ON THE FINANCIAL MARKET

THE PROBLEM OF ADEQUATE SCIENTIFIC ASSESSMENT OF BUSINESS OPERATIONS - THE NAIVETY OF ECONOMISTS

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Abstract

One of the significant problems of a modern economy and economics is political risk. A destructive influence of politics on the financial market cannot be ignored. It is necessary to indicate some selected specific problems of the financial market connected with politics in the area of: public finance (including EU), monetary policy and capital market. Nowadays, the scale and dynamics of political interference in the economy and finance leads to the problem of rationality in business activities. Moreover, many hidden political factors change the political risk into immeasurable political uncertainty.

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INTRODUCTION

One of the greatest dangers for a modern society, economy and also economics is political risk. Nowadays, an enormous influence of political risk on business is being observed. The scale and dynamics of political interference in the economy allows us to describe this situation as domination of political risk over the economy. Therefore, the rationality of business activities is becoming more questionable.

The political pressure leads a modern economy to the model of almost economic fiction in both scopes: macro and micro.

Unfortunately, the same growing destructive process is also perceived on the financial market.

The aim of this elaboration is to indicate the fundamental problem of modern economics - political risk, especially on the financial market. Moreover, the adequate assessment of political risk is very controversial due to many hidden political factors which change measurable risk into immeasurable

uncertainty. Exactly this negative phenomenon is the main competence problem for many analyses in respect to correct differentiation between risk and uncertainty.

The considerations in the article are focused on enormous changes in the modern economy and finance created by growing political risk. The issue is presented in two aspects: theoretical and empirical, respecting international and also Polish experience. The paper is organized as follows: in the theoretical part the problem of definition or re-definition of economics and political economics is presented, along with the question of political risk and political uncertainty. The theoretical part is also devoted to the issue of public finance and its relation to the financial market. The next empirical parts are dedicated to issues of EU finance, the capital market and the Polish capital market and their relations to politics. Finally, some recommendations and remarks are formulated. Economics or “Political Economics” & “Political Risk” or “Political Uncertainty”?

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The fundamental requirements concerning politics in the scope of the economy is to establish and execute adequate laws. This elementary economic function of politics is not fulfilled properly enough. Instead, the process of growing political interference in the economy is being observed. Only to some extent this process is explicable in respect to important social issues connected with the functioning of the economy. Nowadays, the scale and dynamics of political influence on the economy allows us to describe this situation as domination of political risk over the economy. The political domination over the economy leads to economic pathology. Convincing evidence is provided by both the EU and USA, where the rationality of business activities is becoming more questionable. The sources of financial crisis, its course and anti-crisis initiatives are almost “handbook” cases of the economy dominated by politics. The role of politicians as “great creators” of economic processes is very well known in our part of the world (Central - and Eastern Europe) from the time of socialism.

The destructive influence of politics on the economy is more or less clearly visible. One of the good examples is in the financial market. For instance, changes of financial asset prices due to political events or even political declarations are observed every day. Also prices of non-financial assets are affected. Unfortunately, political domination over the real economy is not so visible in the form of such dynamic changes. The economic results of negative political decisions are perceptible over a longer time period in the form of e.g. high rate of unemployment or low rate of economic growth.

The next problem is a growing social acceptance for political interference in the economy. This kind of political activity is even expected by society, which encourages politicians to act in this way.

Regrettably, also economics is affected as a science about rationality in the economy. In terms of growing political interference in the economy the usefulness of such defined science is limited. Perhaps, the hope for the future of modern economics will be a simple redefinition of this science as a science about quasi-economic justification of political decisions in the economy.

The political determinants of the functioning of global and local financial markets lead to a redefinition of fundamental notions, rules and interactions describing the modern financial market.

The first issue which should be redefined is economics. Taking into account all remarks made above, it is

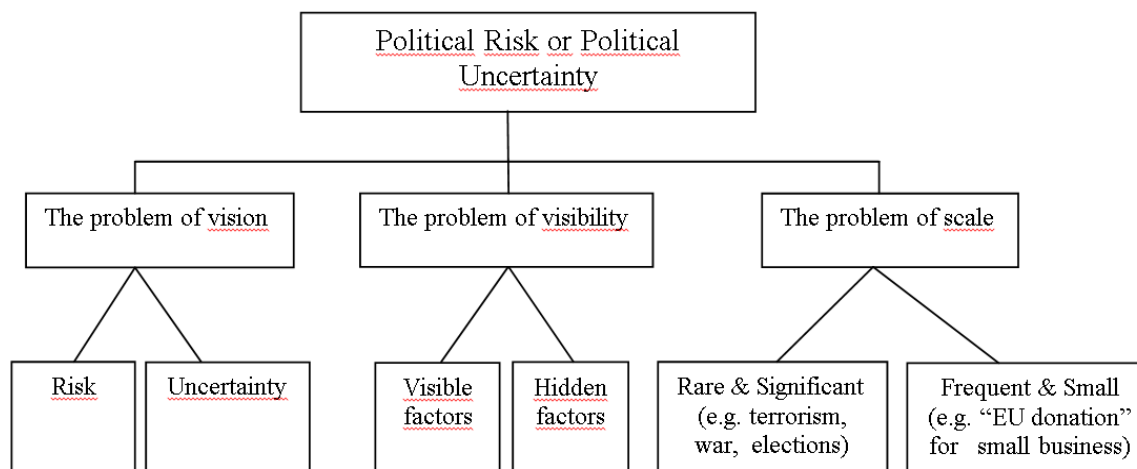
necessary to introduce the term “political economics” and use it to replace the term “economics”. The new term “political economics” (as a draft) means: the domination of political criteria over economic criteria in the economy dominated by political decision-makers (Dziawgo, 2011). All over the world, in the economy the governments replaced market economy laws, and political calculations become much more important than economic calculations leading to growing political risk for every kind of business activity.

It is very important to state that the political risk is much more dangerous than typical economic risk, because it is quite unknown to economists. For adequate assessment of this risk the competences from the area of political science are necessary. However, the fundamental problem concerning political risk is actually the question of correct differentiation between risk and uncertainty (Knight, 1921; Tversky & Fox, 1995; LeRoy & Singell, 1987). This is a question of the vision of the problem (scheme 1). Due to many hidden political factors which change measurable risk into immeasurable uncertainty, the proper term in many cases should be “political uncertainty”. This is exactly the negative phenomenon of term transformation which causes the main problem of quality of many analyses. The term “political risk” is used in this paper only due to its widely common use in financial market practice. Actually, it is not correct but it has become customary to say that and also in politics.

The next question concerning political risk/uncertainty is the question of the visibility and scale of political influence on the economy. Terrorism, war, or even elections are only extreme and very visible examples of political risk or, actually, of political uncertainty. Even the visible examples mentioned above contain a lot of hidden political aspects. Also, very dangerous are examples of invisible political interference in the economy, which happen every day on every level in politics concerning more or less important economic events. They should not be ignored due to their constant destructive influence on the economy.

To sum up the problem of hidden political aspects in the economy, it is useful to indicate some of them, such as: political games, personal ambitions, personal connections, irresponsibility or corruption. Taking into account all of these, one point should be remembered: risk is changing into uncertainty.

Scheme 1: Political risk or political uncertainty



Source: Own elaboration

PUBLIC FINANCE

Public finance crisis is visible evidence of domination of political criteria over economic criteria. The activity of wastefulness and irresponsible public administration supported by many improper and expensive public programmes leads to structural problems of public finance. An unbelievably low level of public finance management has already been a permanent state of pathology for years.

Unfortunately, negative results of the public finance crisis are not the only problem of politics; the entire society and the economy, including the financial market, are also strongly affected. The further functioning of such public finance required restrictive fiscal policy and greater public debt (Dziawgo, 2013). Both are very destructive for the financial market.

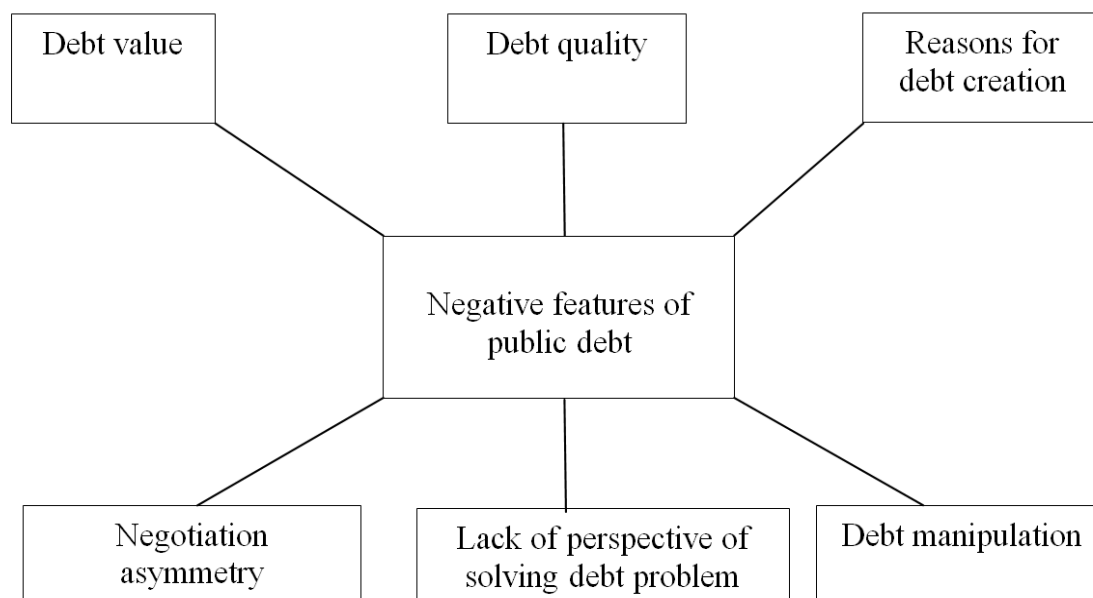
Taking into consideration the problem of public debt, which is probably the most attractive for the media, it is possible to indicate a lot of problematic aspects. For years, getting money for public finance from the financial market using highly rated public bonds, has been a quite convenient way to continue the functioning of an ineffective state apparatus. Actually and paradoxically, the main problem is not the value of public debt. Even more problematic are: the quality of debt, reasons for its creation, negotiation asymmetry, debt manipulation, but first of all – the lack of a serious perspective of a solution to the public debt problem (scheme 2) (Dziawgo, Dziawgo, 2012, p. 59-68). All the above mentioned aspects resulted

mainly from political activity, whose reasons and results are highly uncertain.

The value of public debt is frustrating but actually almost acceptable. Moreover, many economists insist on maintaining the current level of public debt or even on increasing it in order to avoid economic depression. The state expenditures are seen as an important tool of economic growth creation, especially in time of crisis [IMF – Blanchard 2012].

Unfortunately, also the quality of public debt is a matter of wide discussion. However, a low credit rating is really deserved. Of course, the functioning of credit rating agencies is not perfect, but it seems to be independent on politics. Additionally, there is no better system of credit risk assessment (Dziawgo, 2010). The independent system of credit risk assessment of public debt is irritating for politicians, therefore so many anti-credit rating initiatives originating in politics are observed. Economics is also to blame. For sophisticated calculations the rate of return of public bonds was taken into assumptions as “free of risk”. Generations of investors and asset managers grew up being convinced that this attitude to the problem was proper.

Scheme 2: Negative features of public debt



Source: Own elaboration

The next problem concerning public debt are the reasons for its creation. It did not matter if public debt increased due to investment expenditure or consumption expenditure of public administration. The quality of public finance management and effectiveness of public expenditure was also ignored. Subsequent public bond issues quite easily found new investors on the financial market.

The asymmetry of negotiation of both sides of debt transactions is the next problem of public debt created by public bond issues. A concentrated supply of government bonds versus dispersed demand of many investors leads to favorable conditions for the government as a great issuer. Not a single investor is able to force better quality of public finance management. The practical procedure “take it or leave it” by “risk free bonds” was destructive for investors looking for safe investments. Only international institutions acting together are partly able to force better quality of public finance management, but too late and in limited scope (see famous “Trojka” - IMF, ECB, EU in case of Greece).

Public debt manipulation is also a destructive aspect of public finance management. This kind of activity is taken to cover the real value and quality of public debt. There are a lot of possibilities to make numbers unclear, such as: redefinition of public debt, change of

bond issue conditions, use of private-public financial institutions to finance government programmes and many others (Dziawgo, 2013). The so-called “creativity” in public finance makes economic analysis almost useless.

However, the most dangerous aspect of the public finance crisis is a question of a serious perspective to solving the problem. The lack of vision creates the state of uncertainty on the financial market. Unpredictable politics is here exactly the key player.

EU-FINANCE

The European Union is one of the most significant political-economic projects. The Union of Europeans indicates new possibilities of social and economic development in the world. Certainly, politics is an integral part of the EU, but the question is the proportion between politics and the economy. EU public finance and its enormous financial programmes, donations or subsidies of limited effectiveness have been distorting the European economy for years. Taxation as a financial source of financial EU-initiatives also negatively influences the European economy.

A “textbook” case of market economy demolition carried out by the EU is Greece. Not only did the EU tolerate but it even strengthened the low effectiveness

of the Greek economy (Bilski, 2012). A ridiculous system of financial support for Greece by the EU resulted in the European financial crisis. Almost the same is observed in Portugal, Spain and Italy (so-called PIGS Countries). The use of sophisticated economic calculations by these circumstances just to justify or just to understand politically motivated

economic initiatives is only a “paraeconomic” activity in science. After many years of such “healing” of the economy in the south of Europe, public debt as % of GDP in the period of 2008-2012 was much higher. The data presented in table 1 and 2 illustrates precisely the political risk results. The situation is clear – politics has become more influential in the economy.

Table 1: Public debt as % of GDP. PIGS Countries 2008-2012

<i>Specification</i>	<i>Portugal</i>	<i>Italy</i>	<i>Greece</i>	<i>Spain</i>
2008	68,3%	103,0%	107,4%	36,2%
2012*	112,8%	120,1%	161,7%	68,1%

* September 2012

Source: www.economist.com

Table 2: Public expenditure as % of GDP. PIGS Countries 2005-2010

<i>Specification</i>	<i>2005</i>	<i>2008</i>	<i>2009</i>	<i>2010</i>
Greece	44,6%	50,6%	53,8%	50,2%
Spain	38,4%	41,5%	46,3%	45,6%
Portugal	45,6%	44,8%	49,9%	51,4%
Italy	47,9%	48,6%	51,9%	50,4%

Source: stat.gov.pl

The enormous EU budget means enormous political domination over the economy. Politicians become economic policy-makers on international as well as local levels. The measure of political success in the united Europe is the amount of money given by the EU or the amount of money paid to the EU. Each summit of the EU is a place of quite primitive “negotiations” between countries, concerning the participation in the EU budget. The targets and “practical” deficit of the EU budget for the years 2014-2020 is a visible sign of political acceptance for even lower public finance quality.

The activity of the European Central Bank is also connected with politics. Theoretically, any central bank is independent of politics, but the pressure of politics

pushes the bank to undertake non-conventional actions. The purchase of PIGS country bonds (3 programmes - table 3) or refinancing of European commercial banks by LTRO (Long Term Refinancing Operations – 2 programmes), as a European version of QE by FED, are examples of such activities. What is interesting is that in economics such central bank interventions were previously excluded and received condemnation. Nowadays, many economists support the idea of such interventions, indicating alleged advantages. Nobody cares about the long-term value of the Euro currency.

For certain, implementing the political ideology of the EU and ECB leads to greater political risk.

Table 3: Special bond purchase programmes of ECB

<i>Programme</i>	<i>Date of launch</i>
Covered Bond Purchase Programme	2009
Securities Markets Programme	2010
Covered Bond Purchase Programme 2	2011

Source: ECB/2010/5, ECB/2009/16, ECB/2011/17

FINANCIAL MARKET – SELECTED ISSUES

The domination of politics over the economy and the financial market is a fact. Public budgets of the EU and US government oriented at stimulation of the economy make business highly dependent on public support. This is clearly visible on the stock exchange. Public bonds massively issued on a large scale to cover public expenses disturb the balance on the financial market. Even credit rating agencies are strongly affected by politics. The US government attacks on Standard & Poor's credit rating agency in February 2013 seems to be politically motivated. S&P was the only agency which downgraded the credit rating note of the US government in 2011 from triple A to double A+. The legal proceedings by a US court have already started. Other credit rating agencies are not accused (Fitch, Moody's). The EU also attacks credit rating agencies accusing them of unreliability. According to politicians, low credit rating grades caused a critical situation on the financial market (Bielecki, 2012). These are arrogant attempts to turn attention from irresponsible politics.

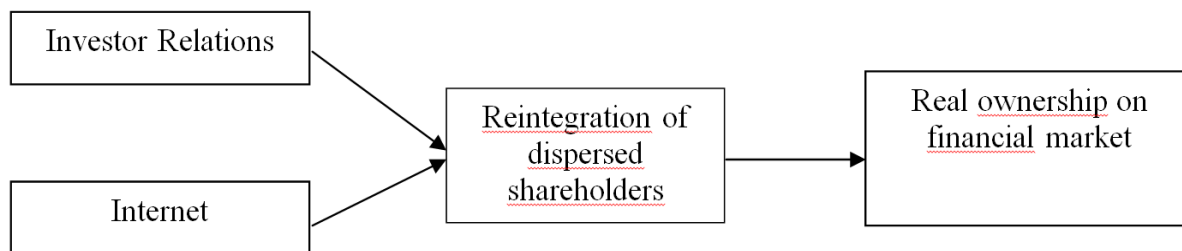
The next negative cases of political interference on the financial market is an attitude of the G20 Group towards off-shore zones and hedge funds. On the financial market there exists "duality of regulation" (Dziawgo, 2008, p. 119-128). One part of the financial market is subject to strict regulation (banking, investment funds, pensions funds). The other part of the financial market is not so strictly

regulated (off-shore, hedge funds, private equity). The financial crisis serves as a pretext for politics to limit independency of off-shores and hedge funds. As a result of G20 actions against the free part of the financial market, more politics is there expected.

The introduction of the Tobin tax on the financial market (FTT) and banking tax are also examples of political interference. The main reason of taxation of these banks is to get more money for the public budget and get public support for politics (Dziawgo, 2013). The same reason is indicated in the case of the huge remuneration in stock quoted companies, especially banks. The EU is already finishing new regulations concerning remuneration in banking.

All the above mentioned examples of political interference in the financial market are only a small and relatively new part of political activities in the scope of the financial market. Politics distort the economic mechanism. Instead of this kind of political action, the support of development of a market economy mechanism is required. For example, better legal regulations of electronic communication and investor relations of public companies would help to create a society of shareholders-owners instead of shareholders interested only in stock exchange speculations (scheme 3) (Dziawgo, D., 2011; Dziawgo & Dziawgo 2012). Long-term capital and the feeling of ownership are needed for financial market stability. Supervision by owners is a better guarantee for stability and effectiveness of the financial market than supervision by politicians.

Scheme 3: Investor Relations and Internet in the process of creation of shareholders-owners society



Source: Own elaboration

POLAND

Political risk means a considerable threat to the Polish economy and financial market. Public expenditures as % of GDP were always high. Also, huge donations from the EU budget strengthened the strong position of politics in the Polish economy. The transfers from the EU budget to Poland for the period 2014-2020 amount to almost 106 billion EUR.

Direct interference of politics in the Polish economy is also part of the problem. Many companies still operate as state-owned and some of them in the monopolist position (PSE – electricity distribution, LOT – airlines, PKP – railways, Gaz-System – gas transmission, Bank Pocztowy - banking and many

others). According to the Polish Ministry of Treasury - 19 leading companies controlled by the Ministry manage more than 700 subordinated companies.

However, the biggest paradox of the Polish market economy versus politics is the presence of the state as the main shareholder of many companies listed on the Polish stock exchange (WSE - Warsaw Stock Exchange). Data presented in table 4 illustrates this situation. The index of Polish “blue chips” on the WIG20 includes as many as 9 so-called “state-owned” companies - almost a half. In other words, this is “politics on the trading floor”. Moreover, even the Warsaw Stock Exchange as a company listed on the stock exchange belongs to the state (51,7%).

Table 4: State as shareholder of companies listed on Warsaw Stock Exchange (February 2013)

Name of company	Sector	Included in WIG20	Share of the state (%)
KGHM	mining	+	31,79
PKN Orlen	fuel	+	27,52
Lotos	fuel	+	53,18
PGNiG	gas	+	72,14
Tauron	energy	+	30,06+ 10,39 KGHM
PGE	energy	+	61,88
PZU	insurance	+	35,18
PKO BP	banking	+	31,39
JSW	mining	+	55,16
PHN	real estate	-	75,00
Enea	energy	-	51,50
PolimexMostostal	construction	-	22,48 (IDA)*
GPW**	capital market	-	51,70

*Industrial Development Agency (state-owned); **WSE - Warsaw Stock Exchange

Source: Gpw.pl

Politics is very active in the economy. The financial market is affected, as well. Recent months have brought new initiatives. One of them was limitation of private pension funds. Next was intervention of the Polish central bank and state-owned bank BGK on the currency market to improve the situation of the public budget. Politicians propose also nationalization of some construction companies to save them from bankruptcy after their deals with the state (Dziawgo, 2013). A private construction company listed on WSE Polimex Mostostal received even additional capital from a state-owned agency (IDA – Industrial Development Agency).

The most destructive example of political interference on the financial market was the totally unexpected (uncertainty) introduction of changes in the mineral tax just to increase public income. The higher tax rate and very short term of its introduction led to a breakdown of share prices on the stock exchange, especially for KGHM shares. The scale of perturbations is presented in picture 1.

The latest idea of political interference in the Polish economy is the idea of even greater state investments. The government established a new state-owned company named “Polish Investments”. The political impact on the economy is growing.

Picture 1: Change of KGHM price share



Source: *Gielda.onet.pl*

CONCLUSION

The growing domination of politics over the economy is very dangerous for modern society, the economy and even economics. For economists it is a crucial scientific challenge. Many hidden political factors change measurable risk into immeasurable uncertainty. The correct understanding and assessment of economic processes require at least awareness of that simple fact. Otherwise, economic calculations are evidence of the naivety of economists.

Expectations for a more responsible and reasonable economy and financial business are connected not only with basic foundations of business rationality, but unfortunately also with serious evidence and doubts concerning the negative political impact on the financial market.

Furthermore, the question of the right proportion between a state and market economy in the post-crisis economy is also the next fundamental problem.

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