International Journal of Economics and Finance; Vol. 16, No. 10; 2024
ISSN 1916-971X E-ISSN 1916-9728
Published by Canadian Center of Science and Education

The Effect of Political Risk on Financial Stability in MENA Region

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Received: August 26, 2024 Accepted: September 28, 2024 Online Published: September 30, 2024

doi:10.5539/ijef.v16n10p82 URL: https://doi.org/10.5539/ijef.v16n10p82

Abstract

This study investigates the impact of political risk, represented by political index for each country, on the financial stability in Middle East and North Africa (MENA) region, which is divided into three groups according to the level of income during 2009-2021. Financial stability is measured by a Z-score and an aggregate banking stability index. This has been applied on 9 countries using panel data analysis. The findings reveal that political risk has a significant negative effect on financial stability partially, most notably on the Z-score side. Macroeconomic factors, including broad money, domestic credit to private sector by banks, GDP growth, income, and market capitalization of listed domestic companies, are also identified as determinants of financial stability. The study contributes to the literature by providing empirical evidence on the impact of political risk on financial stability in MENA region over 13 years. Practical implications for regulators, policymakers and investors are discussed, highlighting the need for a better understanding of political, economic and health risks and their effect on stock performance.

Keywords: Aggregate Banking Stability Index, financial stability, MENA region, political risk, Z-score

1. Introduction

After the incremental global economic recovery from severe financial and political crises, inflationary press had already been accumulating, significantly influencing economic activities and the financial industry. Stakeholders are concerned about political events and wars that may have important repercussions on market sectors, particularly on the financial sector worldwide. According to (World Bank Group, 2024), both developed and developing economies are predicted to grow at a slower pace over 2024-26 than in the decade preceding the epidemic due to effects negative shocks sequency.

In this regard, the MENA region is homeland to natural-resources dependent economies broadly, but at the same time, this region includes still political and societal splits. According to respondents to the Executive Opinion Survey in this region, “Terrorist attacks” ranked as the third-leading risk in it. Therefore, the effect of technological and geopolitical disturbances may be more evident in this region than elsewhere in the world (Marsh & McLennan Companies and Zurich Insurance Group, 2019). Where the wars and political risk are more significant in emerging economies, that these events lead to stock market falls and devastation of resources widely (Wisniewski, 2016).

Political risk is formed by political instability and uncertainty, influencing future economic fields situations and playing a critical role in decision-making processes. One of these fields is the banking sector (Şanlısoy et al., 2017). Some scholars argue that there is a significant impact of crises and wars on financial markets (Berkman et al., 2011, Izzeldin et al., 2023) and banking industry (Şanlısoy et al., 2017; Al-Shboul et al., 2020; Diab et al., 2023). In broad terms, though political events and wars generally have a significant effect on the financial industry, significant gaps remain in academic research in this field.

The previous research focus on political risks has predominantly centered on financial markets and corporate performance, neglecting the long-term dynamics of the banking sector. This study’s motivation stems from the fact that existing literature has largely overlooked income disparities and depends on only one measure of financial stability, limiting our understanding of these important relationship. By adopting diverse methodologies, this study aims to address these gaps and explore the impact of political risk and economic factors on financial stability across MENA countries with varying income groups.

This study aims to make new contributions to the literature on the relationship between political risks and the

financial sector. Previous literature has primarily focused on financial markets and companies, with less attention paid to the long-term impact of this risk on the banking sector in the MENA region. By addressing this gap, the study seeks to validate this relation, thereby expanding the academic understanding in this area. Further, this study depends on two measures to assess financial stability, Z-score and an aggregate banking stability index and explores the determiners of financial stability in countries, thus presenting insights into the financial dynamics of this region.

The current study investigates the effect of political risk on financial stability to fulfill an existing research gap regarding: (a) applying to 9 MENA countries which is divided into three groups according to the level of income over 13 years and (b) measuring financial stability with different metrics. This study determines the significant variables that may influence financial stability, it considers both the market characteristics and macroeconomic variables. This study attempts to answer the following questions: (a) Does political risk affect financial stability in MENA Region? and (b) Do macroeconomics factors and market characteristics affect financial stability in MENA Region?

The findings indicate a significant negative effect of political risk on financial stability partially, most notably on the Z-score side. These results indicate the political risk decreases bank stability partially. The outcomes also reveal that macroeconomic factors play an important role and are important determinants of financial stability. Remarkably, the findings provide strategic insights for regulators, policymakers, and investors to assess the role of political instability in the banking industry and examine the extent of investment potential in the relevant countries. This study may be expanded by conducting more studies to explore the impact of political instability on financial markets worldwide.

The rest of the current study is organized as follows: Section 2 presents the problem statement, while section 3 reviews the literature and discusses the hypotheses. Section 4 shows the data and methodology. Section 5 presents the empirical results and robustness tests while Section 6 concludes and makes recommendations for further research.

2. The Problem Statement

The adverse effects of restrictions on doing business, changes in the business environment, disruption of banking operations through government involvement and improper legal, institutional, and policy frameworks are referred to as political risk Janbaz et al. (2022). Under this importance, this field has attracted the interest of some researchers and policymakers to explore this issue, i.e. explore the relation between political events and financial sector. Intriguingly, some empirical studies attempt to investigate the effect of political instability, wars, and crises on the financial markets in countries (Berkman et al., 2011; Wisniewski, 2016; Izzeldin et al., 2023), while other studies focus on assessing the relationship between the political uncertainty and banking industry (Şanlısoy et al., 2017; Al-Shboul et al., 2020; Diab et al., 2023) financial and economic risk (Kirikkaleli & Onyibor, 2020; Kirikkaleli, 2020).

As previously mentioned, the growing concern about political risk in financial systems has led to investigate the impact of political instability on financial soundness, rather than wars and financial crises like most of the literature. The current study contributes to literature by providing evidence from the MENA region, that is less attention paid to the long-term impact of this risk on the banking sector in the literature. The following graphs present the evolution of political instability and financial soundness in the MENA region during 2017-2021, as shown in Figure 1 & 2:

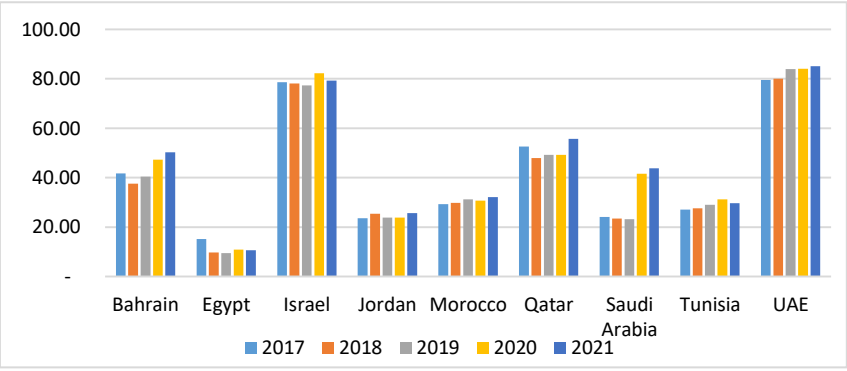

Figure 1. Political risk for selected countries

Source: Prepared by Researcher.

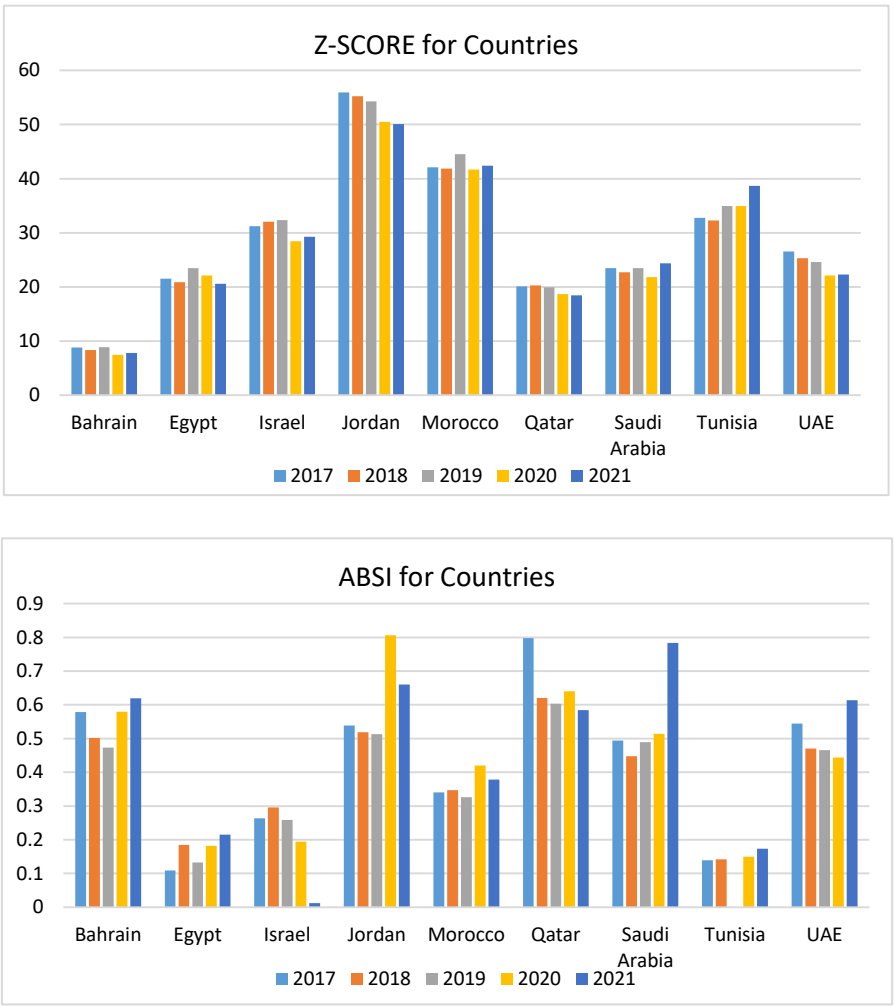

Figure 2. Financial stability for selected countries

Source: Prepared by Researcher.

This suggests that an increase in the political instability level may lead to a decrease in financial stability in the MENA region due to changes in the business environment and disruption of banking operations by government involvement and improper legal and policy frameworks.

This study attempts to fill a gap in the literature by discussing the effect of political risk, represented by political index for each country, on the financial stability in the MENA region, which is divided into three groups according to the level of income during 2009-2021. This study depends on two measures to assess financial stability, rather than one measure like most of the literature. Further, this study explores the determinants of financial stability in this region. In short, the current study attempts to answer the following questions:

- Does political risk affect financial stability in the MENA region?

- Do macroeconomics factors and market characteristics affect financial stability in the MENA region?

Overall, this sample of this study includes 117 observations in 9 countries and considers two groups of control variables, which included macroeconomic variables and market characteristics.

3. Related Literature and Research Hypotheses

This section aims to review some of the relevant literature that has been conducted in the two fields: a) Effect of Political instability and Wars on Financial sector; and b) Macroeconomic Factors and Financial Stability.

3.1 Effect of Political Instability and Wars on Financial Sector

Some studies seek to explore the effect of political events, wars, and crises on the financial markets in countries (Berkman et al., 2011 and Izzeldin et al., 2023). While other studies focus on assessing this relationship in one

country (Hudson & Urquhart, 2015; Ma et al., 2024). Berkman et al. (2011) reveal that the international crises have a significant effect on market volatility by examining 447 international political crises during 1918 to 2006. Izzeldin et al. (2023) examine the world financial market reactives in three events, namely the Russian-Ukrainian war, the Covid-19 epidemic, and the global financial crisis and find the Russia-Ukraine war has led to a significant volatility in these markets. This study reveals that an immediate reactive of global stock markets to the Russia-Ukraine war, which indicates that the inroad was explained by investors as real news. While their response lagged to the two another events.

While Hudson and Urquhart (2015) reveal that World War Two events had adverse impact on stock returns in Britain significantly. Ma et al. (2024) assures the significant positively impact of corporate political risk on the stock price crash probability of listed companies in China during the period of 2011 to 2020. In examining the relation between the political risk and banking industry, this field has attracted the interest of some academics to examine this issue (Şanlısoy et al., 2017; Al-Shboul et al., 2020; Diab et al., 2023). Whereas other studies assure the importance of examining the relationship among political instability, financial risks and economic risk (Kirikkaleli & Onyibor, 2020; Kirikkaleli, 2020). And some of this research is briefly discussed as follows.

Şanlısoy et al. (2017) assures the significant negative effect of the political instability on the banks' profitability, most notably on public banks using quarterly data and a sample of 41 banks in Turkey during 2002 to 2015. Al-Shboul et al. (2020) reveal that there is a positive relation between political risk and banks' risk and political risk has a less of a harmful impact on Islamic compared to conventional banks using a sample of 256 banks in the MENA region during 2008 to 2017.

Further, Diab et al. (2023) investigate the impact of political instability and corporate governance on bank stability of 954 observations from 14 countries in the MENA region during 2010-2018. Diab et al. (2023) reveal that there is a positive relation between political stability and bank stability during this period. Kirikkaleli and Onyibor (2020) reveal that there is a negative relation between political instability and economic stability in Southern European countries using quarterly data and different techniques such as Panel co-integration tests during 2000-2015. Also, this study finds that there is a long-term relationship among these three types of risks in these countries and the improvement of the financial environment is closely linked to reduced economic risks. Kirikkaleli (2020) confirms that there are changes in financial risk caused by significant changes in political instability in the long run using quarterly data and the wavelet approach in Venezuela during 1985 to 2018 and reveals the significant vulnerabilities in these three types of risks, namely economic, political, and financial risks at various time periods.

Previous literature has primarily focused on financial markets and companies, with less attention paid to the long-term impact of this risk on the banking sector and the income levels across countries. Further, this study depends on two measures to assess financial stability and explores the determiners of financial stability in countries, illustrating strong research importance to explore the effect of political risk on banks' stability in the MENA region.

According to the previous work and problem statement discussed above, the current study objectives to test the following hypothesis: H1: Financial stability is significantly driven by political risk in the MENA region. The criteria for hypothesis testing can be presented as follows:

HO1: There is no significant effect of political risk on financial stability.

HA1: There is a significant effect of political risk on financial stability.

3.2 Macroeconomic Factors and Financial Stability

Regarding the relation between macroeconomic factors and the financial soundness, most of the studies have indicated that there is positive or negative or no significant relationship with macroeconomic (Gizycki, 2001; Jokipii & Monnin, 2013; Karim et al., 2016; Semenova & Vitkova, 2019; Mabkhot & Al-Wesabi, 2022; RIFA'I, 2023; and Kumar et al., 2024). Jokipii and Monnin (2013) reveals that there is a positive relation between banking stability and real output growth for 521 banks in 18 OECD countries during 1980-2008 and find that there is no clear relation between financial stability and inflation using quarterly data.

Karim et al. (2016) finds there is a long run relation between both the commercial banks or overall banking stability and macroeconomic variables. But there is no evidence of long run link between the Islamic bank's stability and macroeconomics variables in Indonesia during 1999-2013. Semenova and Vitkova (2019) reveal that there is a weak positive and negative relation between most of the macroeconomic indicators and the financial ratios for the build sector in the Czech Republic and Spain during 2007 to 2015.

In this context, Mabkhot and Al-Wesabi (2022) find that there is a negative link between the inflation rate, global

financial crisis, oil price changes, and banks' stability during 2005-2020 in GCC countries. But the Islamic bank is less adversely affected by a financial crisis, oil price changes, inflation rate and political risk. RIFA'I (2023) investigates the effect of macroeconomic activities on the banking risk in Indonesia and finds that a decline in production and trade capability may lead to an increase in the non-performing loans, the loan to deposit ratio and return on assets fall during 2011 to 2018. Kumar et al. (2024) reveals that the industrial production is positively associated with financial stability, while inflation is adversely associated with industrial production using monthly data during November 2004 to July 2017 in Pakistan.

Notably, the current study explores the effect of macroeconomic and market characteristics on financial stability. Therefore, this study proposed the following hypothesis: H2: Financial stability is significantly driven by macroeconomic factors and market characteristics in MENA region. The criteria for hypothesis testing can be presented as follows:

HO2: There is no significant impact of these factors on financial stability.

HA2: There is a significant impact of these factors on financial stability.

There is a paucity of studies that may be able to provide evidence of political risk, represented by political index for each country and their impact on the financial stability in the MENA region over 13 years. This study depends on a Z-score and an aggregate banking stability index as proxies of financial stability. Further this study seeks to determine the important variables that may influence banking stability, it considers both the market characteristics and macroeconomic variables.

4. Data and Methodology

4.1 Data Sources

The sample includes 117 observations in 9 MENA countries according to data availability during 2009-2021. The counties represent (Bahrain, Egypt, Jordan, Israel, Morocco, Qatar, Saudi Arabia, Tunisia, and UAE). To explore the effect of political risk on financial stability over the study period, this study employs panel regression analysis.

4.2 Variable's Description

Following the literature, this study measures bank stability by Z-score (Karim et al., 2016; and Al-Shboul et al., 2020), and ABSI (Tarin, 2013; and Nayn, and Siddiqui, 2020). This study depends on political index for each country to measure the political risk. This study determined six factors based on prior literature as control variables.

Table 1. Description of variables utilized in this study

Variables	Sign	Source
Aggregate Banking Stability Index	ABSI	International Monetary Fund (IMF)
Z-score	Z-score	
Political Risk	PR	Bloomberg
Broad money (% of GDP)	BM	
Domestic credit to private sector by banks (% of GDP)	DCPB	
gross domestic product (GDP) growth (annual %)	GDP_G	World Bank
Inflation (annual %)	INF	
Income	Inc	
Market capitalization of listed domestic companies (% of GDP)	MC	

Source: Prepared by Researcher.

4.3 Research Models

An overview of the methodology used will be presented in this section. The models were estimated using EViews software. The current study uses ordinary least squares regression analysis and two panel data models (fixed and random effects models) to assess the impact of political instability on financial stability. According to literature review, financial stability can be predicted through several factors, as follows:

$$(\mathrm{Z}-\widehat{\mathrm{SCORE}})_{\iota t}=\alpha_0+\beta_1 PR_{it}+\beta_2 BM_{it}+\beta_3 DCPB_{it}++\beta_4 GDP\_G_{it}+\beta_5 INF_{it}+\beta_6 Inc_{it}++\beta_7 MC_{it}+e_{it} \quad (1)$$

$$(\widehat{\mathrm{ABSI}})_{\iota t}=\alpha_0+\beta_1 PR_{it}+\beta_2 BM_{it}+\beta_3 DCPB_{it}++\beta_4 GDP\_G_{it}+\beta_5 INF_{it}+\beta_6 Inc_{it}++\beta_7 MC_{it}+e_{it} \quad (2)$$

Where i indicates' countries, t performs years, and e_{it} is the error term, α is the intercept: β_j is the estimated regression coefficient of defined variables; j = 1, 2 ,3…7; assumed it pursues a normal distribution. This study defines independent variables as PR.

5. Empirical Results and Discussion

Section 5 shows a descriptive statistics summary of all variables, the correlation matrix, hypotheses testing, and robustness tests. The outcomes of the descriptive statistics summary of variables between 2009 and 2021 are shown in table 2. While Table 3 presents the correlation matrix. Using panel analysis according to fixed effect model, findings reveal that study hypotheses could be accepted.

5.1 Descriptive Statistics

Table 2. Descriptive statistics of major variables

Variable	N	Mean	Median	Minimum	Maximum	Std. Dev.	Skewness	Kurtosis	Jarque-Bera
Z-SCORE	117	28.69463	25.85413	7.201674	62.56835	13.46992	0.715728	3.216106	10.21687
ABSI	117	0.441797	0.473218	0.000000	0.821213	0.172859	-0.268550	2.715330	1.801379
PR	117	45.59933	42.41000	9.520000	85.12000	22.86458	0.338018	1.784109	9.435155
BM	117	85.69959	82.90379	49.16938	135.8447	20.12483	0.500172	2.392963	6.674770
DCPB	117	61.59510	64.71591	24.02463	138.4197	18.21115	0.390671	5.695644	38.40033
GDP_G	117	3.143235	3.064192	-8.621135	19.59233	3.835086	0.803576	8.488641	159.4521
INF	117	2.939803	2.087669	-4.863278	29.50661	4.125558	2.804392	16.91386	1097.137
Inc	117	2.247863	3.000000	1.000000	3.000000	0.899291	-0.506402	1.437836	16.89737
MC	117	65.53073	59.43506	10.02372	345.3531	55.08121	3.578520	17.78485	1315.349

Source: Outputs of data processing using Eviews 12.

Table 2 presents descriptive statistics for the variables used in the analysis. As shown, the mean of dependent variables, namely Z-SCORE and ABSI are 28.69463 and 0.441797 respectively. Furthermore, the median Z-SCORE and ABSI are 25.85413 and 0.473218 respectively. The standard deviation of Z-SCORE and ABSI are 13.46992 and 0.172859, respectively. Notably, the mean and median of PR are 45.59933 and 42.41000, respectively, with a minimum value of 9.520000 and a maximum of 85.12000, indicating that there is variation a political risk index in MENA region. While Inc ranges from 1.000000 to 3.000000, signifying three levels in income across countries.

Table 3. Correlation matrix

Variable	PR	Inc	BM	DCPB	GDP_G	INF	MC	Z-SCORE	ABSI
PR	1.000000								
Inc	0.743952***	1.000000							
BM	-0.282604***	-0.355381***	1.000000						
DCPB	0.317060***	0.345765 ***	0.449545***	1.000000					
GDP_G	0.115433	0.006038	-0.173453*	-0.315866***	1.000000				
INF	-0.436080***	-0.461463***	-0.149207	-0.560053***	0.028246	1.000000			
MC	0.129333	0.284996***	-0.006212	0.163162*	-0.102714	-0.264345***	1.000000		
Z-SCORE	-0.268422***	-0.443363***	0.606325***	0.158026*	0.016948	-0.103810	-0.004705	1.000000	
ABSI	0.235569**	0.591405 ***	-0.082953	0.312377***	-0.074470	-0.351748***	0.264262***	-0.202395**	1.000000

Source: Outputs of data processing using Eviews 12. Notes: *p < 0.10; **p < 0.05; ***p < 0.01.

Table 3 displays the correlation analysis results of all independent variables. There is a significant and positive association between PR and ABSI at a 0.05 level of significance. The correlation coefficient of Inc, DCPB, and MC is positively correlated and significant with ABSI. These results indicate a negative association between INF and ABSI at a 0.01 level of significance. Additionally, the correlation coefficient of BM and DCPB are positively correlated with Z-SCORE. But the correlation coefficients of the Z-score show a significant and negative association between the PR and Inc, suggesting that the higher the political risk, the lower the financial stability, most notably on the Z-score side. The correlation matrix does not display a high association between the explanatory variables, where the correlation coefficients are less than 0.8. This study also found variance inflation factors are lower than 10, indicating that there was no multicollinearity problem.

5.2 Political Risk and Financial Stability Empirical Results

To test the effect of political risk on financial stability in the MENA region during 2009 to 2021. This study uses panel analysis according to fixed effect model after conducting several tests (Lagrange Multiplier and Hausman Tests), as shown in table 4.

Table 4. Political risk and financial stability

Variables	Model 1 Z-score	Model 2 ABSI
	41.72507	-0.083496
Constant	**(**3.046690**) *****	**(**0.159124**)**
	-0.088166	0.004201
PR	**(**0.027774**) *****	**(**0.001451**) *****
	0.050639	-0.003074
BM	**(**0.023900**) ****	**(**0.001248**) ****
	-0.131297	0.003295
DCPB	**(**0.022923**) *****	**(**0.001197**) *****
	0.095049	-0.005019
GDP_G	**(**0.056859**) ***	**(**0.002970**) ***
	0.050815	-0.003506
INF	**(**0.069265**)**	**(**0.003618**)**
	-2.815829	0.186895
Inc	**(**0.906440**) *****	**(**0.047342**) *****
	0.009443	0.00000215
MC	**(**0.003873**) ****	**(**0.000202**)**
R-squared	0.982609	0.711938
Adjusted R-squared	0.980026	0.669156
S.E. of regression	1.903697	0.099427
F-statistic	380.4359	16.64123
Prob (F-statistic)	0.000000	0.000000

Note. Each cell contains the estimated parameters, with Std. Error between brackets, where * denotes p-value of 10%, ** indicates 5% and *** denotes 1%.

The outcomes show the coefficient of PR is negative and significant ($P < 0.01$) with Z-score, indicating that the higher the political risk, the lower the financial stability, most notably on the Z-score side. But the coefficient of PR is positive and significant with ABSI, suggesting that the effect isn't noticeable on ABSI. The findings support the view that political instability decreases financial stability partially in developing countries and are consistent partially with the results of Al-Shboul et al. (2020). Therefore, these results support the first hypothesis partially, indicating political risk led to decrease in the Z-score in MENA region.

Additionally, BM, GDP_G, and INF are positive and significant with a Z-score but are negatively significant with ABSI. While DCPB and Inc are positive and significant with ABSI but are negative and significant with Z-score. But the effect of INF isn't noticeable on financial stability. The results support the second hypothesis, indicating that financial stability is driven by macroeconomic factors and market characteristics.

5.3 Robustness Check

To ensure validate the reliability of the research outcomes, this study conducted a robustness check by Panel Generalized Method of Moments (GMM) by Error Components Generalized Least Squares (EGLS) and cross-section weights methods. Panel EGLS is advantageous for controlling omitted variables in panel regression. The findings align with my prior outcomes, as shown in table 5.

Table 5. Political risk and financial stability

Variables	Model 1 Z-score	Model 2 ABSI
	42.83541	-0.234982
Constant	**(**3.050915**) *****	**(**0.141792**)**
	-0.073547	0.004940
PR	**(**0.011130**) *****	**(**0.001202**) *****
	0.011079	-0.003386
BM	**(**0.016844**)**	**(**0.001094**) *****
	-0.092636	0.004423
DCPB	**(**0.018493**) *****	**(**0.001425**) *****
	0.093666	-0.000677
GDP_G	**(**0.037708**) ****	**(**0.002372**)**
	0.000488	-0.003747
INF	**(**0.045482**)**	**(**0.003260**)**
	-3.122199	0.212906
Inc	**(**1.189152**) ****	**(**0.046442**) *****
	0.010557	0.0000581
MC	**(**0.002897**) *****	**(**0.000162**)**
R-squared	0.992137	0.755172
Adjusted R-squared	0.990969	0.718812
S.E. of regression	1.816588	0.097242

Note. *, ** and *** denote statistical significance at the 10%, 5% and 1% levels, respectively.

Table 5 indicate that PR has a negative effect on Z-score. Further, the findings support that PR has a significant positive impact on ABSI, suggesting that the effect is not noticeable on ABSI. The findings show that DCPB and Inc have a significant negative impact on Z-score but BM, GDP_G, and INF have a significant negative impact on ABSI. The outcomes of this study align with the findings of the prior work. The findings support the hypotheses in this study partially.

6. Conclusion and Recommendation

This study explores the effect of political risk, represented by political index for each country, on the financial stability for 9 countries in the MENA region, which is divided into three groups according to the level of income during 2009-2021. Financial stability is measured by a Z-score, and an aggregate banking stability index. The findings find that political risk has a significant adverse impact on financial stability partially, most notably on the Z-score side. The outcomes are consistent with the results of Al-Shboul et al. (2020) and support the financial fragility hypothesis partially. Remarkably, the findings have practicable suggestions for regulators, policymakers and investors to assess the role of political instability on financial stability and examine the extent of investment potential in the MENA region. However, the study has constraints, including the potential for unobserved heterogeneity across countries and banks, as well as the data collection from 2009 to 2021, even though this is due to the availability of data. Future work could explore the impact of political and health risks on stock performance. Furthermore, extending the data collecting stage to investigate the impact of the other factors on the financial soundness and incorporating alternative measures of bank stability could provide further insights.

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