UNIT 204 – UPSC - Country Risk Analysis

Country risk is described as the economic, political and business risks that are distinctive to a specific country, and that might result in unforeseen investment losses. Mainly, Country risk refers to the risk of investing or lending in a country, arising from possible modifications in the business environment that may unfavourably affect operating profits or the value of assets in the country. Country risk signifies the potentially adverse impact of a country's environment on the MNC's cash flows. Country risk covers factors to influence the default risk of the country resulting from economic deterioration, political events, currency depreciation and so on.

Country risk mirrors the ability and readiness of a country to service its foreign financial obligations. Such risk may be encouraged by country-specific and regional economic, financial, political and composite factors. Country risk is major concern in the world today, with almost every economic, financial and political crisis or conflict threatening to exceed their initial borders. In the current state of world affairs, the economic and financial wealth and political power of a country are critical for its overriding position in the international financial community and political status (Hoti, 2005).

Historical Review

The practice of country-risk analysis was from earlier time to the origins of cross border lending. Numerous examples of 'sovereign' defaults span a period beginning with the borrowing of the city-states in the eastern Mediterranean in the fourth century BC (Bitterman, 1973). England, France, Spain and Portugal each evaded at least once to various external creditors during the period from the fourteenth through the sixteenth centuries, as did many of the colonies in the Americas in the nineteenth century. Creditors experienced losses due to lack of information on the debtor's financial position or an imprecise assessment of the borrower's ability or willingness to repay. Often the country's incapability to repay stemmed from a combination of country-specific factors, such as fiscal mismanagement, poor harvests or unproductive expenditures relating to war. It can be said that adversative global conditions, including weak growth in important export markets,

deteriorating terms of trade or a speculative lending cycle were major cause of inability to repay. A country's reluctance to repay could be interconnected with these economic events resulting in contractual noncompliance.

Other threats of sovereign willingness to pay are domestic or regional political instability, resulting in either a regime change or weaknesses to appropriate economic policy. During past centuries, the analysis of risks relating to foreign lending was more an art than a science and certainly in some measure continues to be so today. Lending criteria were determined by individual financial houses and merchant bankers as fake country-risk analysts. This practice continued until the late twentieth century when another wave of international lending after the oil shock of the early 1970s prompted the creation of new international-risk departments within banks and multinational corporations.

Compared to the heuristic approach to country-risk analysis used by the early twentieth-century bankers and their predecessors, more analytical methods were developed beginning in the 1970s (Frank and Cline, 1971). The computer uprising resulted in use of quantitative methods, allowing a more sophisticated approach. Despite the increased availability of such quantitative techniques, however, most analysis within commercial banks continued to highlight a more qualitative, albeit analytical, approach. While the analysis of country risk improved during the 1970s and early 1980s, it continued to suffer from some critical problems. Enhancements in methodology were sluggish to be applied in many institutions which lent or invested money in developing countries. Comprehensive data, especially on the external assets and liabilities of debtor countries, was also inadequate.

Major Elements of Country Risk (OECD):

1. General Moratorium
2. Delay in Transfer of Funds
3. Fluctuations in Exchange Rates
4. Measure or Decision to Prevent Payment
5. Force Majeure

Assessing country risks is a crucial task when choosing sites for international business, particularly if investment is to be undertaken. Certain risks can be managed through insurance, hedging and other types of financial planning, but other risks cannot be controlled through such financial mechanisms. Country risk analysis (CRA) tries to identify imbalances that increase the risk of a deficit in the expected return of a cross-border investment. It has been observed that all business transactions involve some degree of risk. When business transactions occur beyond national borders, they carry additional risks not present in domestic transactions. These additional risks termed as country risks, typically include risks arising from a variety of national differences in economic structures, policies, socio-political institutions, geography, and currencies.

Country risk can be used:

- To monitor countries where the MNC is presently doing business.
- As a screening device to avoid conducting business in countries with excessive risk.
- To improve the analysis used in making long-term investment or financing decisions.

The political risk is the risk that a foreign government will significantly change its policies or other regulations so that it considerably affects one's investment. In broad view, it can apply to the risk that a nation will refuse to comply with an agreement to which it is a party, or that political violence will hurt an investment or business. Major political risk factors include, attitude of consumers in the host country, some consumers may be very loyal to homemade products, attitude of host government, the host government may impose special requirements or taxes, restrict fund transfers, subsidize local firms, or fail to enforce copyright laws. The political risk mainly focuses on domestic politics and the international relations. This kind of risk covers the potential for internal and external conflicts, expropriation risk and traditional political analysis. Risk assessment requires analysis of many factors, including the decision-making process in the government, and the history of the country.

The most representative economic risk factors are: macro-economic policy, commercial policy, the degree and mode of state involvement in economy, investment policy, propriety structure, inflation, budget deficit, money supply and the evolution of domestic credit. Other factors that influence the economic risk are: policy trends, fiscal policy, monetary policy, international assumptions, economic growth and exchange rate.

A country's economic development is dependent on several financial factors - interest rates, exchange rates, and inflation. Economic Risk is the noteworthy change in the economic structure or growth rate that produces a major alteration in the expected return of an investment. Risk arises from the potential for harmful changes in fundamental economic policy goals (fiscal, monetary, international, or wealth distribution or creation) or a significant change in a country's comparative advantage.

Types of Country Risk Assessment:
A macro-assessment of country risk is an overall risk assessment of a country without consideration of the MNC's business.
A micro-assessment of country risk is the risk assessment of a country as related to the MNC's type of business.

Techniques of Assessing Country Risk: Country risk, which embodies uncertainty of payback from international business, is perceived and measured linguistically as well as numerically (Terpstra and Yu 1988). There are various techniques of country risk analysis (Madura, 2008)

1. A checklist approach involves rating and weighting all the identified factors, and then consolidating the rates and weights to produce an overall assessment. The weighted checklist seeks to recap all aspects of risk in a single country rating that can be readily integrated into the decision-making process.
2. The Delphi technique involves collecting various independent opinions and then averaging and measuring the dispersion of those opinions.
3. Quantitative analysis.
4. Inspection visit.
5. Combination of techniques.

It has been stated that statistical approach of country risk analysis have been extensively used in past and contributed positively in emphasizing several aspects of country risk analysis. However

these approaches have some limitations in issues such as specification of dependant variable, data requirement and availability.

To summarize, Country risk assessment is mainly about assessing a country's capability to transfer currency for foreign payments. This ability is determined by three main factors: political, economic and financial factors. The country risk assessment involves weighing and estimating these factors in order to reach a conclusion regarding the country's ability to pay.