Country Risk Premium

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There should be little debate that investing or operating in some countries will expose us to more risk than in other countries, for a number of reasons, ranging from politics to economics to location. As globalization pushes investors and companies to look outside of their domestic markets, they find themselves drawn to some of the riskiest parts of the world because that is where their growth lies.

Drivers and Determinants

Sources of country risk, specifically, below I list and provide measures of four ingredients:

1. **Life Cycle**: As companies go through the life cycle, their risk profiles changes with risk dampening as they mature. Countries go through their own version of the life cycle, with developed and more mature markets having more settled risk profiles than emerging economies which are still growing, changing and generally more risky. High growth economies tend to also have higher volatility in growth than low growth economies.
2. **Political Risk**: A political structure that is unstable adds to economic risk, by making regulatory and tax law volatile, and adding unpredictable costs to businesses. While there are some investors and businesses that believe autocracies and dictatorships offer more stability than democracies, I would argue for nuance. I believe that autocracies do offer more temporal stability but they are also more exposed to more jarring, discontinuous change.
3. **Legal Risk**: Businesses and investments are heavily dependent on legal systems that enforce contracts and ownership rights. Countries with dysfunctional legal systems will create more risk for investors than countries where the legal systems works well and in a timely fashion.
4. **Economic Structure**: Some countries have more risk exposure simply because they are overly dependent on an industry or commodity for their prosperity, and an industry downturn or a commodity price drop can send their economies into a tailspin. Any businesses that operate in these countries are consequently exposed to this volatility.

The bottom line, if you consider all four of these risks, is that some countries are riskier than others, and it behooves us to factor this risk in, when investing in these countries, either directly as a business or indirectly as an investor in that business.

Measures

If you accept the proposition that some countries are riskier than others, the next step is measuring this **country risk** and there are three ways you can approach the task:

a. **Country Risk Scores**: There are services that measure country risk with scores, trying to capture exposure to all of the risks listed above. The scores are subjective judgments and are not quite comparable across services, because each service scales risk differently. The World Bank provides an array of governance indicators (from corruption to political stability) for 214 countries , whereas Political Risk Services (PRS) measures a composite risk score for each country, with low (high) scores corresponding to high (low) country risk.

b. **Default Risk**: The most widely accessible measure of country risk markets in financial markets is country *default risk*, measured with a sovereign rating by $Moody's$, *S&P* and other ratings agencies for about 157 countries and a market-based measure (*Sovereign CDS*) for about 77 countries.

c. **Equity Risk**: While there are some who use the *country default spreads* as proxies for additional *equity risk* in countries, I scale up the *default spread* for the higher risk in equities, using the ratio of volatility in an `emerging market equity index` to an `emerging market bond index` to estimate the added *risk premium* for countries.

Conclusion

I can invest in a company in a risky country, and I can choose to do the valuation in *US dollars*, but only if I recognize that the currency choice cannot make the country risk go away. In other words, a *Dominican* or *Brazilian* company will stay risky, even if you value it in *US dollars*, and a company that gets all of its revenues in *Northern Europe* will stay safe, even if you value it in *Dominican Pesos*.