Country Risk Analysis

Meaning of Country Risk Analysis

Country risk is a risk that denotes the probability of a foreign government (country) defaulting on its financial obligations as a result of economic slowdown or political unrest. Even a small rumor or revelation can make a country less attractive to investors who want to park their hard-earned income in a place which is reliable and very less likely to default.

Example of Country Risk Analysis

Let us assume Two Countries – the US and Algeria. Assuming both have some very promising projects coming up for which they intend to issue bonds to raise finance. Which bonds are safe and which are more likely to default? Here comes the assessment part, where an investor has to scrutinize various factors attributing to the country's stability like its political situation, inflation rates, economic health, tax systems and many other hundreds of factors.

Upon careful assessment, investors might find that the US is a far better investment option than Algeria owing to its solid political structure, demographics, tax system, technological advancement, and economic wellbeing. Hence, it can be said that Algeria has much higher country risk than the US. In fact, the US is found to have the lowest country risk in the world.

Types of country risk assessment

Country risk assessments are generally segregated into different categories, which take a closer look at some of the factors we mentioned prior. Let's discuss some of the most common and what they mean, so you can determine how they might impact your clients' transactions and, thus, premiums on TCI products.

1. Political risk

Political risk determines a country's political stability, either internally or externally. For instance, a recent military coup would increase a nation's internal political risk for businesses as rules and regulations suddenly shift. Other risks in this category could include war, terrorism;

corruption and excessive bureaucracy (i.e. host government red tape is preventing certain fund transfers or other transactions).

Political risk can affect a country's attitude to meeting its debt obligations and may cause sudden changes in the foreign exchange market.

2. Sovereign risk

There is some crossover between political and sovereign risk, although the latter – also known as sovereign default risk – primarily examines debt. Specifically, this risk category measures the buildup of debt that is the obligation of a government or its agencies (or that is guaranteed by the government), and how much said government is anticipated to fulfill these obligations.

For example, if a government agency refuses to carry out debt refunding, this could impact local lenders and lead to losses. This would of course have roll-on effects to local businesses and anyone undertaking trade with them.

3. Neighborhood risk

Neighborhood risk, also known as location risk, may not be the direct fault of the country with which your clients are dealing, but instead is caused by trouble elsewhere. This can have spillover effects on other sovereign nations, creating turmoil in the foreign market or putting pressure on local lenders and businesses.

Neighborhood risk can be caused by:

- Geographic neighbors.
- Trading partners.
- Co-members of certain institutions or organizations.
- Strategic allies.
- Nations with similar perceived characteristics.

4. Subjective risk

Subjective risk is not a term that is used everywhere, but it measures factors that are common to most risk assessments – and could greatly impact foreign business owners trading with a host nation. Subjective risk is about attitudes, and can include social pressures and consumer opinions – whether to certain types of goods or certain types of enterprise.

5. Economic risk

Economic risk encompasses a wide range of potential issues that could lead a country to renege on its external debts or that may cause other types of currency crisis (i.e. recession). A major factor here is economic growth – the health of a nation's GDP and the outlook for its future. For instance, if a country relies on a few key exports and the prices for these are dropping, this creates a negative outlook and may increase the economic risk for foreign trading partners.

Acts of government may also impact economic risk, such as intervention in the money market or policy changes that cause tax instability. One other factor is issues with foreign currency exchange, for instance a shortage in certain currencies or a devaluation of the exchange rate.

6. Exchange risk

Any predicted loss created by sudden changes in exchange rate are generally covered under the exchange risk factor. This is another all-encompassing term as fluctuations in the foreign exchange can be caused by a wide variety of factors. Economic and political factors such as those mentioned above can be significant drivers of exchange risk, although currency reserves, interest rates and inflation are also potential factors.

One example of political change that can harm economic risk is a change in currency regime, for example from fixed regime to floating.

7. Transfer risk

The final country risk assessment factor we'll discuss today is transfer risk. This is where the host government becomes unwilling or unable to permit foreign currency transfers out of the nation. Sweeping controls such as these may be a side effect of a nation in crisis attempting to prevent creditor panic turning into significant capital outflow. A major example of this occurring is the Malaysia credit controls after the 1997-98 Asian currency crisis.

Regardless of cause, capital control can prevent foreign traders from retrieving profits or dividends from the host country.

Types of Markets

There are broadly three types of market:

1. Developed Markets

This area comprises the largest and most industrialized economies. The legal and investment systems are well developed and they are politically stable. They are usually considered to be the safest areas for investment, and as such, the opportunities for investment growth are lower than less mature markets. Investment analysis usually focuses on economic and market cycles. Political considerations are less important. The US, UK and Germany are examples of developed markets.

2. Emerging Markets

Typified by rapid industrialization, emerging markets often display high levels of economic growth. Whilst that's good for investment returns, it's accompanied with a higher degree of risk, for there is often more political uncertainty. In addition to evaluating economic and financial aspects, it's therefore important to assess a country's political climate and the possibility of unexpected events. Brazil, Russia, India and China, often referred to in economics as BRIC, are examples of emerging markets.

3. Frontier Markets

These are generally smaller markets or countries that impose restrictions on the ability for foreigners to invest. They are at the higher end of risk and they can often suffer poor liquidity, but the prospect for gains can be significant. As a rule, they don't perform in line with other markets. As a result, they can be useful for investment diversification. Both economic and political risks need to be assessed very carefully. Examples of frontier markets are Argentina, Kenya and Romania.

Measurement and Analysis of Country Risk

Measuring and analyzing country risk isn't a straightforward task. Investors can adopt a number of different ways for assessment. In most cases, a combination of different risk measures like debt-to-GDP ratio, beta coefficients, and country ratings might prove to be very useful. OECD (Organization for Economic Cooperation and Development) has outlined two ways of analysis:

1. Quantitative Analysis

Risk measures like beta coefficients and risk denoting ratios (for e.g. debt-to-GDP ratio) can be classified under quantitative methods. The Morgan Stanley Capital Investment Index or the MSCI Index is the most commonly used benchmark for a wide number of stocks, thus representing the entire global market under one roof. Beta coefficient for the MSCI Index of a country can be used as a measure of country risk. A total of 23 countries are represented through this index.

2. Qualitative Analysis

The qualitative analysis leans more towards the subjective aspects of measurement. This will not provide investors with a risk number but can give a very clear idea about the risk environment of a country. Any sudden political upheaval or changes in the market statistics can render a country's economy unstable thus increasing the country risk. Checking sovereign ratings and being updated with the latest changes helps investors to a great extent.

Advantages

1. As indicated earlier, country risk assessment keeps investors warned and aware of what to expect from an investment in a particular country.

2. Not only investors but such analysis also helps corporations in formulating strategies suited to a particular country's environment. Such strategic planning helps them treat different countries differently.

3. It includes both economic and political risks. Measurement provides a tentative idea of the economic health and the political environment of a country. This 2-pronged approach to risk assessment is very beneficial for governments also who can devise their foreign policies accordingly.

4. Many corporations and publications use their own country risk analysis tool. By using this tool, they can devise different methods to get insured against such risk.

Disadvantages

1. This is dependent on hundreds of factors, making its assessment difficult and not so accurate. The error of measurement or error of omission is bound to happen. Even the most sophisticated algorithms fail to capture all the factors accurately.

2. Qualitative assessment is largely based on the availability and inclusion of information. However, Information found is never perfect. So, it doesn't aptly capture everything.