Country risk analysis: political and economical factors

SIMONA VALERIA TOMA, MIOARA CHIRIȚĂ, DANIELA ANCUȚA ȘARPE
Department of Economics
University “Dunarea de Jos” of Galati
Domneasca Streets, No. 47, Galati, 80008, ROMANIA
simona.toma@ugal.ro, mioarachirita@gmail.com, d_sarpe2000@yahoo.fr

Abstract - The present paper analyses the relationship between political risks, economic risk by using an alternative definition of country risk. The paper has four principal parts - the first tries to familiarize the reader with the definitions and the fundamentals of the country risk analysis, the second presents the political risk, the third present the most important economical indicators of the country risk and the fourth focuses on the Romanian case.

Key-Words - country risk, political risk, economic risk, indicator’s risk

1 Introduction
In times of uncertainty, the risks associated with engaging in international operations have increased substantially. Moreover, such risks have become more difficult to analyze and predict for decision makers in the international financial community. Country risk reflects the ability and willingness of a country to service its foreign financial obligations. Such risk may be prompted by country-specific and regional economic, financial, political and composite factors. Country risk is of critical 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 decisive for its dominant position in the international financial community and political status [1].

Country risk and globalization are two terms that at first sight may seem incompatible, globalization meaning opening, expansion of international economic relations, while country risk indicator generates limits or adjustments for the external activities. Thereby, the premises for reducing country risk are created as; in general, the increase in the globalization level has led to improved country rating. Country risk is not therefore an obstacle to globalization, however, it may be considered one of the factors which led to polarization, to marginalization of poor countries and hence, low listed in the risk rankings. In general however, development of the statistical data within the real economies states the mutual inter-relationship between the two concepts [2].

Country risk analysis (CRA) attempts to identify imbalances that increase the risk of a shortfall in the expected return of a cross-border investment. This paper describes the general process used to create risk measures and discusses some of the weaknesses of this process.

All business transactions involve some degree of risk. When business transactions occur across international borders, they carry additional risks not present in domestic transactions. These additional risks, called country risks, typically include risks arising from a variety of national differences in economic structures, policies, socio-political institutions, geography, and currencies. Many of the individual events investigated by country risk analysis fall closer to uncertainties than well-defined statistical risks [3].

2 Political Risks
According a financial dictionary the political risk is the risk that a foreign government will significantly alter its policies or other regulations so that it significantly affects one's investment. More broadly, 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. For example, if one exports goods to a foreign nation, and that nation elects a new government that enacts protectionist tariffs, this will negatively impact the export business [4].
Political leaders are responsible for formulating policies, goals, and implementing strategies to maneuver a country through various stages of economic, social, and political development. The quality of political management, or the management process of public politics, plays an important role in the performance of these political leaders. High quality political management grounded in democratic rule of processes and laws is needed to transform and drive an emerging economy towards sustainable growth and development and the success, or failure, of political management can be shaped by the existing socio-economic and cultural environment [5].

There are a multitude of factors that can affect the ability of political leaders to direct and manage economic, social, and political transformation and development in an emerging nation and a potential factor that has yet to be empirically explored in this context is the effect of widespread corruption. In other words illicit trade, organized crime and corruption are chronic risks that are perceived as highly likely to occur and of medium impact. The negative effects of corruption, illicit trade, organized crime and fragility are easy to characterize but extremely difficult to quantify. The opaqueness of this nexus of risks has resulted in too little attention and too few resources devoted to mitigating it, and the significance of this nexus of risks has increased considerably in recent years – in part because of global governance failures, as informal networks engage in legal and regulatory arbitrage [6].

**Political Risk Measures:** Few quantitative measures exist to help assess political risk. Measurement approaches range from various classification methods (type of political structure, range and diversity of ethnic structure, civil or external strife incidents) to surveys or analyses by political experts. Most services tend to use country experts who grade or rank multiple sociopolitical factors and produce a written analysis to accompany their grades or scales. Company analysts may also develop political risk estimates for their business through discussions with local country agents or visits to other companies operating similar businesses in the country. In many risk systems, analysts reduce political risk to some type of index or relative measure.

Unfortunately, little theoretical guidance exists to help quantify political risk, so many “systems” prove difficult to replicate over time as various socio-political events ascend or decline in importance in the view of the individual analyst [3].

The structure of the government and its features like political and administrative organization are also relevant aspects to be approached. The political forces which act in the country, theirs representatives and the main national issues that have been discussed must be focused, once they can give an important vision about what the investors could expected in terms of economic and sector policies and its consequences for the non-residents capital owners. Particularly important is the dominant conception about democracy, military subjects, relationship with the international market, and the inter-political strategy of development [7].

Political leaders in advanced economies are under increasing pressure to seek short-term solutions.

### 3 Economic Risks:

The most representative economic risk factors are: macro economical 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 [8].

Other factors that influence the economic risk are: policy trends, fiscal policy, monetary policy, international assumptions, economic growth and exchange rate.

How does monetary policy affect country risk? This question has become a central issue in the current theoretical debate, due to the fact that monetary policies aimed at fighting inflation have been undermined by fiscal dominance models, in which country risk is the base of monetary instability brought about by interest rate increases, having an adverse effect upon the control of inflation [9].

Economic Risk is the significant change in the economic structure or growth rate that produces
a major change in the expected return of an investment. Risk arises from the potential for detrimental changes in fundamental economic policy goals (fiscal, monetary, international, or wealth distribution or creation) or a significant change in a country's comparative advantage (e.g., resource depletion, industry decline, demographic shift, etc.). Economic risk often overlaps with political risk in some measurement systems since both deals with policy.

*Exchange rates* are the domestic price of a unit of foreign currency. Exchange rates impact international trade, part of a country’s circular flow model of economic output and income. Exchange risk is an unexpected adverse movement in the exchange rate. Exchange risk includes an unexpected change in currency regime such as a change from a fixed to a floating exchange rate. Economic theory guides exchange rate risk analysis over longer periods of time (more than one to two years). Short-term pressures, while influenced by economic fundamentals, tend to be driven by currency trading momentum best assessed by currency traders. In the short run, risk for many currencies can be eliminated at an acceptable cost through various hedging mechanisms and futures arrangements. Currency hedging becomes impractical over the life of the plant or similar direct investment, so exchange risk rises unless natural hedges (alignment of revenues and costs in the same currency) can be developed [3].

*Inflation* is a sustained rise in the average level of prices that causes a decrease in the purchasing power of a country’s currency. By decreasing the purchasing power of money, inflation has what economists call redistributive effects.

*Unemployment* is measured as the percentage of the labor force not currently working. Labor force is defined as people working plus people actively seeking work. “Actively seeking work” usually means people are currently registered with their state employment service.

*Economic Risk Measures*: analysts examine traditional measures of fiscal and monetary policy. For longer term investments, they also examine growth theory factors. For fiscal policy, analysts examine such factors as the size and growth rate of government expenditures (investment vs. spending as a percent of GDP), tax policy (types and rates of taxation, fairness, effectiveness vs. popular avoidance), and the government’s debt situation (government deficit/GDP, total government debt/GDP, debt financing sources). Analysts examine the impact of monetary policy and financial maturity on economic growth (inflation, money supply growth, real and nominal interest rates, and financial sector/GDP). For longer term investments, analysts focus on long run growth factors (growth in productive plant and equipment, private and foreign direct investment/GDP, labor force growth, unemployment, productivity), the degree of openness of economy (exports plus imports/GDP, FDI/total private investment) and institutional factors that might affect wealth creation (property rights, the degree of regulation, extent of any black market) [3].

Beyond those macroeconomic variables which deal with the external sector of the economy, there are some others as relevant such as the interest rate, public debt and its service, level of investments, budget equilibrium (incomes and expenditures), internal savings, consumption, GDP/GNP, inflation rate, money supply, etc. The analysis must be completed with qualitative variables, which consider social aspects as population, rate of birthday, life expectancy, rate of unemployment, level of literacy, etc. Despite its importance, only some of the social statistical variables could be directly used in the models as it happens when analyzing corporations. In fact, as already commented, social-political aspects are essential for all kind of analysis due to they draw the whole environment of the running economy. Further approach on these aspects will be seen in a following session (Contents of Analysis) [7].

4 The country risk: Romania’s case
The purpose is to present the evolution of the country risk of Romania through using the specific statistic indicators with the granted classification by the main rating agencies. The risk exposure is the result of credit activity to a public debtor (in this case, a country), this activity being applied by banks at international level. From this point of view, the analysis of the country risk must offer information on the base of which the banks can establish the upper limits of exposure to a country and can monitor as possible in real time, the exposure to the respective country. The market risk appears as a result of unfavorable changes that may appear in a country’s financial market and that may affect the performance of activities that compose the portfolio
of a bank, which has an exposure in relations with the respective country. In the literature approaching the country risk, the market risk is as inexistent or it is treated with superficiality, although it constitutes a fundamental component of the banking risk, concerning the development of the activities that unfold on these markets. From this perspective the approach of the country risk is insufficient and the developed methodologies must be extended through including this last aspect. But this paper does not purpose to introduce new components in the methodologies of analysis concerning the country risk and the market risk. The administration of a financial activities portfolio usually generates two categories of risks: the risk exposure and the market risk. The purpose is to present the evolution of the country risk of Romania through using the specific statistic indicators with the granted classification by the main rating agencies. The paper has three principal parts - the first tries to familiarize the reader with the definitions and the fundamentals of the country risk analysis, the second presents the statistic indicators and methods used in the assessment of the country risk and the third focuses on the Romanian case [10].

According to Coface, Romania with a 21.4 millions habitants and 158 393 (US$ million) GDP, have a rating country: B (political and economic uncertainties and an occasionally difficult business environment can affect corporate payment behavior. Corporate default probability is appreciable) and a business climate rating: A4 (a somewhat shaky political and economic outlook and a relatively volatile business environment can affect corporate payment behavior. Corporate default probability is still acceptable on average) [11].

<table>
<thead>
<tr>
<th>MAJOR MACRO ECONOMIC INDICATORS</th>
<th>2008a</th>
<th>2009b</th>
<th>2010(e)</th>
<th>2011(f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic growth (%)</td>
<td>7.3</td>
<td>-7.1</td>
<td>-1.9</td>
<td>1.5</td>
</tr>
<tr>
<td>Public sector balance (%GDP)</td>
<td>-5.7</td>
<td>-8.6</td>
<td>-7.3</td>
<td>-4.9</td>
</tr>
<tr>
<td>Current account balance (%GDP)</td>
<td>-11.4</td>
<td>-4.5</td>
<td>-5.1</td>
<td>-5.1</td>
</tr>
<tr>
<td>Foreign debt (%GDP)</td>
<td>51.4</td>
<td>69.2</td>
<td>72.3</td>
<td>70.8</td>
</tr>
</tbody>
</table>

Foreign exchange reserves (in months of imports) 5.3 7.5 8.4 8

e Estimate (f) Forecast

Tabel 1

Strengths:
- Attractive destination for foreign investors thanks to a large domestic market
- Brighter economic outlook as a result of the country’s integration into the European Union
- Well-capitalized banking sector
- Limited public sector debt burden

Weaknesses:
- Extent of private sector debt
- Exposure of companies to exchange rate risk
- Political instability that undermines Romania’s capacity to implement policies prescribed by the IMF
- Lagging pace of reforms in the public-sector
- Current account deficit still high.

RISK ASSESSMENT

A constrained recovery

Romania's GDP continued to contract in 2010 while recoveries were in process in most Central European countries. A recovery is expected to effectively begin in Romania in 2011 but at a very moderate pace, constrained by the scale of the private debt accumulated these past years and which financed an unsustainable current account deficit. Only a mild consumption recovery appears likely with households continuing to focus on debt repayment. Both unemployment and inflation are expected to remain above the levels prevailing in the rest of emerging Europe. Incomes have moreover been growing at a markedly slower pace under the effect of restrictive fiscal policies. Foreign trade will not contribute to the recovery with a sharp rise expected in capital goods imports that will keep the current account deficit at a high level. Investments are, however, expected to rebound sharply amid the overall improvement in the health of Romanian companies; a marked improvement is expected on average in the telecommunications, para-oil, chemicals, and pharmaceutical sectors. Risks will remain high, however, in construction, textiles, metallurgy, and distribution, affected by the repercussions of two years in recession.

Difficult fiscal adjustment

In March 2009, Romania had to seek assistance ($20 billion) from the IMF, European Union, and
other multilateral institutions. The initial trenches of international aid were focused on increasing foreign exchange reserves and maintaining a stable exchange rate. External financing needs will remain high in 2011 due to persistent imbalances in the current account. Romania continues to attract substantial direct investment albeit far below the levels prevailing just before the crisis. Continued multilateral financial support will thus be crucial to financial stability. Although a sharp reduction in the fiscal deficit is expected, the pursuit of economic policy and the objectives dictated by the IMF has lacked consistency and implementation of reforms in the public sector has been lagging. Despite the increase in the VAT rate to 23%, fiscal revenues remain undermined by an informal economy evaluated at 25% of GDP. Better absorption of community funds is also a priority in this context of financial constraints.

**A government with a weak electoral base**

Elections for parliament are scheduled late 2012 and for the presidency in 2014. The current government has depended on support from independent parties, which has proven very volatile. It is uncertain whether the early elections likely to be held in 2011 can resolve the question of governmental stability since they may give rise to another fragmented coalition. In this context, there have been systematic delays on implementation of unpopular reforms, insisted on by the IMF, intended to consolidate public-sector finances and those demanded by the European Commission focused on improving governance [11].

**According to D&B’s latest proprietary cross-border payments performance data, 23.8% of payments arrived 30 or more days over terms in the year to end-Q1 2010. Some 66.3% of payments arrived promptly, while 12.2% of payments were made 60 or more days over terms. The data show that 1.1% of payments were severely delinquent, with delays of 120 days or longer. The proportion of payments made promptly or within 30 days of terms has increased steadily, owing in part to stricter trade terms imposed by shippers and also to firmer implementation of EU payments rules. D&B continues to recommend the use of LCs when trading with counterparties in the country, while SD remains our minimum terms.**

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010f</th>
<th>2011f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth, %</td>
<td>6.3</td>
<td>7.3</td>
<td>-7.1</td>
<td>0.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Inflation, annual ave, %</td>
<td>4.9</td>
<td>7.9</td>
<td>5.6</td>
<td>4.2</td>
<td>4.0</td>
</tr>
<tr>
<td>Govt balance, % GDP</td>
<td>-2.5</td>
<td>-5.4</td>
<td>-8.3</td>
<td>-7.2</td>
<td>-5.1</td>
</tr>
<tr>
<td>Unemployment, %</td>
<td>6.4</td>
<td>5.8</td>
<td>6.9</td>
<td>8.0</td>
<td>7.6</td>
</tr>
<tr>
<td>C/A balance, % GDP</td>
<td>13.5</td>
<td>11.6</td>
<td>-4.4</td>
<td>-5.0</td>
<td>-5</td>
</tr>
</tbody>
</table>

**Tabl 2**

Economic policy will be predicated on the exigencies of meeting the requirements of the USD27bn financial support package agreed in March 2009 with the international financial institutions (IFIs): the IMF, EU, European Investment Bank and the European Bank for Reconstruction and Development. This will require sustained fiscal retrenchment, including deep cuts to public sector wages, pensions, benefits and staffing levels, as well as a comprehensive overhaul of the pensions system. However, the Constitutional Court ruled a 15% cut in pensions illegal on 25 June, forcing the government to announce plans to raise VAT from 19% to 24% in order to qualify for the next tranche of IFI funding. The funds are needed to meet the country’s steep external financing requirement, following years of foreign credit fuelled current account and fiscal deficits. As a result of the fiscal squeeze, D&B expect real GDP to grow by a meager 0.2% in 2010, following a contraction of 7.1% in 2009. We expect activity to pick up modestly in 2011, with the economy growing by around 2.8%, still well below the more than 7.0% per annum averaged in the three years prior to the downturn, limiting new business opportunities in the country.

Meanwhile, the commercial environment will remain challenging, despite Romania having accessed to the EU in 2007. In particular, credit risk has risen as the economic downturn has progressed, with bankruptcies rising. Stricter credit terms imposed by shippers have ensured that cross-border payments performance has not deteriorated, but D&B continues to recommend caution when dealing with new prospects. Positively, the mostly foreign-owned banking sector remains well capitalized, although reluctant to lend, with firms struggling to obtain credit finance [12].
According to the Euromoney Country Risk Score in March 2011, the Romanian current score was:
- Economic (% score, 30% weighting): 49.78
- Political (% score, 30% weighting): 44.79
- Structural (% score, 10% weighting): 45.19
- Credit rating (score out of 10, weighting 10%): 3.96
- Debt indicators (score out of 10, weighting 10%): 6.99
- Access to capital market (score out of 10, weighting 10%): 5.25

5 Conclusions
As could be seen, country risk analysis is not an easy task. The analyst must follow standard procedures to assure coherency in its studies, using reliable and useful sources of data, including rating agencies, official institutions and other several sources. After dealing with the macroeconomic, socio-political and financial aspects, the analysis has to clearly show the strengths and weakness of a country, in order to define a risk level and, consequently, a related price for the asset in risk.

Political risk - internal and external security situation, policy competency and consistency, and other such factors that determine whether a country fosters an enabling business environment;

Macroeconomic risk - the inflation rate, government balance, money supply growth and all such macroeconomic factors that determine whether a country is able to deliver sustainable economic growth to provide further expansion in business opportunities.

As such, addressing the two central risks in this report – economic disparity and global governance failures – could go a long way towards improving both the effectiveness of risk response and overall resilience at the global level. Both risks have strong impact on the three important clusters highlighted by this year’s risk perception survey. While many of the longer-term developments and effects of global risks are difficult to anticipate with a reasonable degree of certainty, investments in these central risks are certain to have positive effects on overall risk resilience. However even with the best analysis, we can never anticipate or prepare for all risks. In an increasingly connected world, there is a plethora of risks that are beyond the planning and assessment capacities of decision-makers and risk experts alike. To be prepared for these future challenges and to continue to seize opportunities in rapidly changing strategic environments, organizations and decision-makers must continue to invest in our ability to adapt and learn, thereby building more resilient systems. We hope that the Forum’s Risk Response Network will make a tangible and valuable contribution towards achieving this goal [5].

Acknowledgement:
The work of TOMA SIMONA was supported by Project SOP HRD – TOP ACADEMIC 76822/2010.

References
[1] “Modelling country spillover effects in country risk ratings” - Suhejla Hoti, Australia, 2005
[9] “Monetary policy and country risk” - Vladimir Telesa; Joaquim Andradeb, Brazil, 2008