

N. O. Potyomkina,

PhD (Economics)

E. S. Voshchyna,

M. M. Breiman,

Donetsk National Technical University

CURRENT APPROACHES TO COUNTRY RISK ANALYSIS

Introduction

Analyzing risks is a natural part of investment decision-making process. Every investor considers different types of risk, but majority of professional investors agree that this process must begin with a country risk analysis. To check, if this approach is correct or not, one can simply look through the current news. This article is written in 2013, and just the year before, in 2012, investors, governments, and citizens of the Eurozone suffered a huge loss resulting from a sovereign default of Greece [1]. The other European country – Cyprus, was one of the Greece creditors. But in the March of 2013 Cyprus itself went into a debt crisis [2].

Cyprus is a relatively small European country, but outcomes of its possible default are significant. This country was known as a tax haven, or an offshore-zone, mostly used by the countries of Eastern Europe – especially by Russia and Ukraine. It is enough to say, that Cyprus is the biggest source of investment flows into Ukraine, which is in fact mostly Ukrainian money, coming back from Cyprus banks performing role of a financial laundry. Cyprus served as a base (officially) for many financial institutions, funds, banks, etc. The latest news is such that Cyprus financial system will receive a bail-out from EU [3]. However, foreign deposits in Cyprus banks are most likely to be taxed. It all results in a huge loss for those, who invested (or stored) their money in Cyprus financial sector.

Current approaches to assessment of country risk

In a modern economy it is a role of global institutions (usually rating agencies) to analyze the country risk. Of course, comprehensive investment analysis usually includes a country risk assessment made “in-house”, however:

a. Even if analysis is made in-house, it usually relies on the competent data and opinion of rating agencies

b. Country risk is considered an important question on the early stages of the investment decisions, when full analysis isn't done yet. In this case, ratings of the country risk are the only source of information.

There are several agencies that could be seen as reliable sources, like Standard & Poor's, Moody's, Fitch, Economist Intelligence Unit, Euromoney, Institutional Investor, Political Risk Services, Business Environmental Risk Intelligence, Control Risks Information Services, international banks in general and others institutions. Some

of them also provide information and analysis of economic sectors, companies and operations, assigning related ratings.

Nowadays, the rating system is wide known and used all over the world. Moody's and Standard & Poor's rating systems use to divide countries in categories as below and the four first levels of each one are considered “investment grades” (better quality of the asset in risk terms). Based on their evaluations, the agencies give their opinion in the form of letter grades, which are published for use by investors (see table 1 below). For the typical investor, risk is judged not by a subjectively formulated probability distribution of possible returns but by the credit rating assigned to the asset by investment agencies. In their ratings, the agencies attempt to rank issues according to the probability of default. Both agencies also have a Credit Watch list that alerts investors when the agency is considering a change in rating for a particular borrower.

Moody's and Standard & Poor's do not have an econometric model for country risk analysis. Standard & Poor's follows the behavior of many macroeconomic variables and other relevant information, and **compares** the outcomes with the peer group of countries.

Moody's believes that credit rating is by nature subjective. Moreover, because long-term credit judgments involve so many factors unique to particular industries, issuers and countries that any attempt to reduce credit rating to a formulaic methodology would be misleading and would lead to serious mistakes. Thus, Moody's, following analytical principles, deals with several relevant risk factors (including quantitative ratios as an objective and factual starting), building scenarios and relying on the **judgment** of a diverse group of credit risk professionals to weight those factors and establish the ratings.

Another popular way of evaluating risk is the system of risk assessment of various countries through the so-called “**BERI index**”, developed by the Swiss company of the same name. This abbreviation stands for “Business Environment Risk Intelligence”. The evaluation system is based on giving each type of risk a certain weight reflecting its importance to the success of a business and the level of risk rating scale from 0 (very high risk) to 4 (lowest risk). For convenience, the sum of coefficients is reduced to 25 points, so that the country, the least risky in all respects, has a chance to get a total

Table 1

Credit ratings by investment agency Moody's [4]

Grade	Meaning of the grade
Aaa	Best quality
Aa	High quality
A	Upper medium grade
Baa	Medium grade
Ba	Possess speculative elements
B	Generally lack characteristics of a desirable investment
Caa	Poor standing; may be in default
Ca	Speculative in a high degree; often in a default
C	Lowest grade; extremely poor prospects

Table 2

Credit ratings by investment agency Standard & Poor's [5]

Grade	Meaning of the grade
AAA	Highest rating: extremely capacity to pay interest/principal.
AA	Very strong capacity to pay
A	Strong capacity to pay
BBB	Adequate capacity to pay
BB	Uncertainties that could lead to inadequate capacity to pay
B	Greater vulnerability to default, but currently has capacity to pay.
CCC	Vulnerable to default
CC	For debt subordinated to that with CCC rating
C	For debt subordinated to that with CCC – rating or bankruptcy petition has been filed
D	In payment default

of 100 points, the most risky and will have the least amount of points approaching zero. Scheme for the construction of the integral index BERI is displayed in the table 3.

BERI index is provided for 140 countries worldwide. Professionals working in each region present their estimates three times a year. Experts of the company through a special computer programs analyze large amounts of statistical information for each country, with which the index is calculated. Next, expert opinions and statistical data compiled by experts of the company and reduced to the overall country index. This allows the company to forecast BERI degree of country risk in the long term of 1 to 5 years. Similarly, the company is building BERI indices to evaluate individual risks. As these

private ratings BERI gives the index of political, financial and operational risk. In the private ratings the same criteria are used, but in smaller numbers and with increasing coefficients.

Comparative rating systems, using similar methodology, are developed by consulting firms Frost & Sullivan (Rating World Political Risk Forecast), Business International and Data Resources Inc. (rating Policon) and many others. Most of them are available online.

Another widely used country risk rating system is provided by the magazine "Euromoney" and is called "Euromoney's Country Risk Index". It is determined by the score of 9 parameters, each of which has a certain weight in the overall rankings. Overall rating describes

the economic opportunity of the country to pay for the borrowing of funds. The maximum final grade for the country is 100.

The structure of the credit rating by “Euromoney” includes following indicators:

- political risk (25% weight in the overall ranking);
- economic outlook (25% weight);
- 3 financial indicators (10% weight in the overall rating for each);
- 4 bank indicators (each of 5% of the weight in the overall rankings.)

The rating is made twice a year, in March and September, and now covers more than 180 countries [6].

1. Political risk. These are the most common categories: the possibility of non-payment for the supply of goods and services, the non-payment of loans, financial liabilities, dividends, and the impossibility of repatriation of invested capital. The lower the risk, the higher the ranking score. In this case, the maximum possible amount of points is 25.

2. Economic perspectives (Economic performance). The index is based on the predictions of the countries in this and next year. The maximum possible amount of points is 25. Economic data for the ranking is compiled from a review of 35 economists from major banks, financial and economic institutions.

3. Indicator of external debt (Debt Indicator). The maximum possible amount of points is 10. Estimates for this parameter are taken on the basis of the World Bank’s “Global Development Finance”.

4. Debt in connection with the default or in connection with the restructuring of debt (Debt in default or rescheduled). The highest score (10 points) is received by those countries which did not have non-payment. Zero is assigned to the country, which has had the failure of all financial obligations or term of payment was moved across the debt. Estimates are based on the source of the World Bank “Global Development Finance”.

5. Credit rating or credit rating of solvency debts (Credit rating). Credit ratings are taken as the average of the ratings by “Moody’s” and „Standart & Poor’s”. Countries without a rating receive a rating of 0, while those with only short-term ratings receive estimates based on the rating of BBB. The highest score for the most creditworthy countries is 10.

6. Access to banking resources (access to bank finance). This is calculated by experts as a percentage of private, long-term, unsecured loans to GDP. In the best variant the maximum number of points reached is 5.

7. Access to short-term financial resources (access to short-time finance).

8. Access to capital markets (access to capital markets). The highest rating is given to those countries that were able to get the resources from the capital markets, the zero mark - if access was completely impossible.

9. Access to forfeiting services (Discount on forfeiting).

Overview of country risk analysis systems given in this article is far from being complete. There exist many other rating systems, evaluated by different agencies, magazines, universities, etc.

Ukrainian performance

All three major international credit rating agencies – Moody’s, Standard & Poors and Fitch assign their sovereign credit ratings to Ukraine. Latest Ukrainian credit rating by Moody’s was assigned on 05.12.2012 and is B3. Moody’s explained downgrade of the rating by “low institutional sustainability, lack of external liquidity and negative forecast for Ukrainian economy in general” [7] Historical evolution of this rating is presented in a following table.

According to the Euromoney Country Risk results for June 2011 [10], Ukraine scores 44.08 out of 100 points which corresponds to the 85-th place in the rating of 186 countries.

Results of the different country risk ratings listed above can be interpreted by the international investor as relatively poor, which is unfavorable for the future of the Ukrainian economy. Main reasons for such a low performance are political risks connected with political instability, various economical risks mainly due to insufficient protection of private capital, insufficient government control of financial sector, imperfection of the law base. Other important problem, affecting country risk of Ukraine in latest years is growing sovereign debt. Rating agencies note lack of financial stability, unwillingness to introduce necessary reforms, structural weaknesses [11].

Conclusion

Analyzing the country risk is an important part of the investment process. Usually such analysis is held on the early stages of the investment process. Latest political and economic events, particularly debt crisis's in Greece and Cyprus underline the importance of such analysis – as many investors already lost their money in one country and are likely to lose in the other one.

Professional analysis of country risk is usually held by specific global institutions with required competence – rating agencies. Three leading companies on these market are Moody’s, Standard & Poors and Fitch. All of them provide ratings in form of letter grades accordingly to their own grading tables. Different methodology is used to form these ratings – one way is to analyze and compare different variables with peer countries, and the other – to collect opinions of experts from the region under review. Besides these rating agencies, there are many other competent organizations providing there all ratings. In this article, in particular, the BERI country risk and the Euromoney country risk indexes are examined. Those are more complex and cover different types of risk. Political and economic risks are separated from each

Table 3

The structure of the integral BERI index

Criterion	Wage
Political stability	3
Treatment of foreign investors and their profits	1.5
Risk of nationalization	1.5
The devaluation of the national currency	1.5
Balance of payments	1.5
Bureaucratic barriers	1
Economic growth	2.5
Convertibility of currency	2.5
Ability to implement and contracts trials	1.5
Labor costs and labor productivity	2
The presence of experts and expertise	0.5
Communication and transport	1
The availability of local managers and partners	1
The possibility of short-term loans	2
The possibility of long-term loans and the availability of equity capital	2
Overall	25

Table 4

The structure of the integral BERI index

Date	Rating
06.02.1998	B2
09.09.1998	B3
05.01.2000	Caa1
24.01.2002	B2
10.11.2003	B1
08.08.2008	B1
12.05.2009	B2
05.12.2012	B3

other, and both expert opinions and measurable indicators are taken into account.

Because ratings of country risk are considered by investors, it is an important question how well does Ukraine perform in these ratings. Ukrainian results are relatively low. In rating agencies ratings Ukraine never reaches “investment grade” zone, which is preferred by investors. In 2011 Euromoney country risk rating it only scores 44 points out of 100, which is not a favorable result. Possible reasons, according to rating agencies, are structural problems, weakness of the important institutions and political instability.

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The structure of the integral BERI index

Date	Rating
13.06.2001	B-
26.03.2002	B
25.06.2003	B+
21.01.2005	BB-
08.06.2005	BB-
12.01.2006	BB-
25.10.2006	BB-
14.05.2008	BB-
25.09.2008	BB-
17.10.2008	B+
13.02.2009	B
12.11.2009	B-
17.03.2010	B-
06.07.2010	B
21.07.2011	B
02.09.2011	B
19.10.2011	B
26.04.2012	B
18.07.2012	B
09.08.2012	B
08.03.2013	B

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Потьомкіна Н. О., Вощина Є. С., Брейман М. М. Сучасні підходи до аналізу ризику країни

В статті розглянуто різні підходи щодо оцінювання ризику країни, рейтинги, що складаються професійними рейтинговими агентствами, шкали, що ними використовуються. Проаналізовано методи, що використовуються для створення рейтингів ризику країни. Розглянуто питання щодо позиції, що займає Україна у світових рейтингах, причинах знаходження на цій позиції.

Ключові слова: ризик країни, інвестор, рейтинг, підхід, експертна оцінка, політичний ризик, криза.

Потемкина Н. А., Вощина Е. С., Брейман М. М. Современные подходы к анализу странового риска

В статье были рассмотрены различные подходы к оценке странового риска, рейтинги, составляемые профессиональными мировыми рейтинговыми агентствами, шкалы, используемые ими. Проанализированы методы, применяемые для составления рейтингов странового риска. Рассмотрен вопрос о позиции, занимаемой Украиной в мировых рейтингах, причинах нахождения на этой позиции.

Ключевые слова: страновой риск, инвестор, рейтинг, подход, экспертная оценка, политический риск, кризис.

Potyomkina N. O., Voshchyna E. S., Breiman M. M. Current Approaches to Country Risk Analysis

This article deals with the topic of country risk analysis. Different approaches to this problem, ratings developed by international rating agencies and their grades were examined. Ukrainian performance in these ratings was examined, as well as reasons of such performance.

Key words: country risk, investor, rating, approach, expert's opinion, political risk, crisis.

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