Country and Political Risk

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Country Risk

- The risk of investing or lending in a country, arising from possible changes in the business environment that may adversely affect operating profits or the value of assets in the country
- The risk of economic agents (including government) in a particular country will not fulfill their international financial obligations
- The risk that a foreign government will default on its bonds or other financial commitments
- The uncertainty associated with investing in a particular country, and more specifically the degree to which that uncertainty could lead to losses for investors

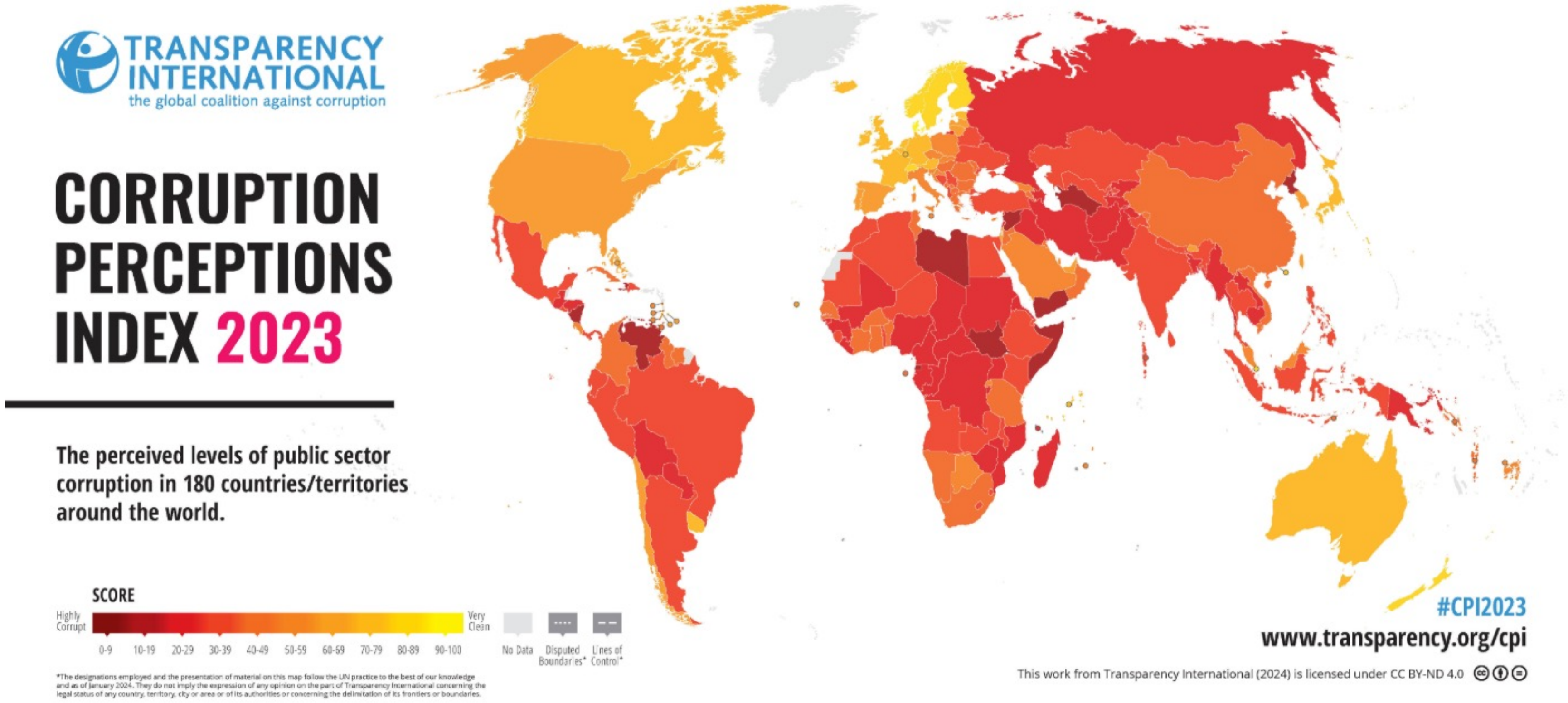
Financial and Economic Risk Factors measurements

- Ratio of a country’s external debt to its GDP
- Ratio of a country’s debt service payments to its exports
- Ratio of a country’s imports to its official international reserves
- A country’s terms of trade (export/import prices)
- A country’s current account deficit

Political Risk Factors

- Expropriation/nationalization – worst-case scenario
- Contract repudiation (revoking) without compensation
- Default on payments, cancelation of licenses
- Taxes and regulation (i.e., hiring/firing, environmental standards, repatriation of funds)
- Exchange controls (e.g., Argentina in 2002)
- Corruption and legal inefficiency, Transparency International Corruption Perceptions Index (for more than 150 countries)
- Ethnic violence, political unrest, and terrorism
- Home-country restriction

Transparency International Corruption Perceptions Index



Source: https://www.transparency.org/en/cpi/2023

Country Risk Analysis

– The PRS Group's ICRG Rating System

Financial and economic risk factors – assessing a country's ability to repay foreign debt; objective inputs

—The political risk components – stability based on government;

- Overall ratings
- 1-49: Very risky
- 50-59.9 High risk
- 60-69.9 Moderate risk
- 70-79.9 Low Risk
- 80-100 Very low Risk

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ICRG Risk Components

ICRG Risk Components

POLITICAL RISK COMPONENTS

Component	Points (max.)
Government stability	12
Socioeconomic conditions	12
Investment profile	12
Internal conflict	12
External conflict	12
Corruption	6
Military in politcs	6
Religious tensions	6
Law and order	6
Ethnic tensions	6
Democratic accountability	6
Bureaucracy quality	4
Maximum total points	**100**

Notes: XGS, exports of goods and services. From *International Country Risk Guide*, published by the PRS Group, Inc. Copyright © 2010. The PRS Group, Inc., www.prsgroup.com.

FINANCIAL RISK COMPONENTS

Component	Points (max.)
Foreign debt as a percentage of GDP	10
Foreign debt service as a percentage of XGS*	10
Current account as a percentage of XGS*	15
Net liquidity as months of import cover	5
Exchange rate stability	10
Maximum total points	**50**

ECONOMIC RISK COMPONENTS

Component	Points (max.)
GDP per head of population	5
Real annual GDP growth	10
Annual inflaction rate	10
Budget balance as a percentage of GDP	10
Current account balance as a percentage of GDP	15
Maximum total points	**50**

*XGS = exports of goods and services.

Source: https://www.prsgroup.com/explore-our-products/icrg/

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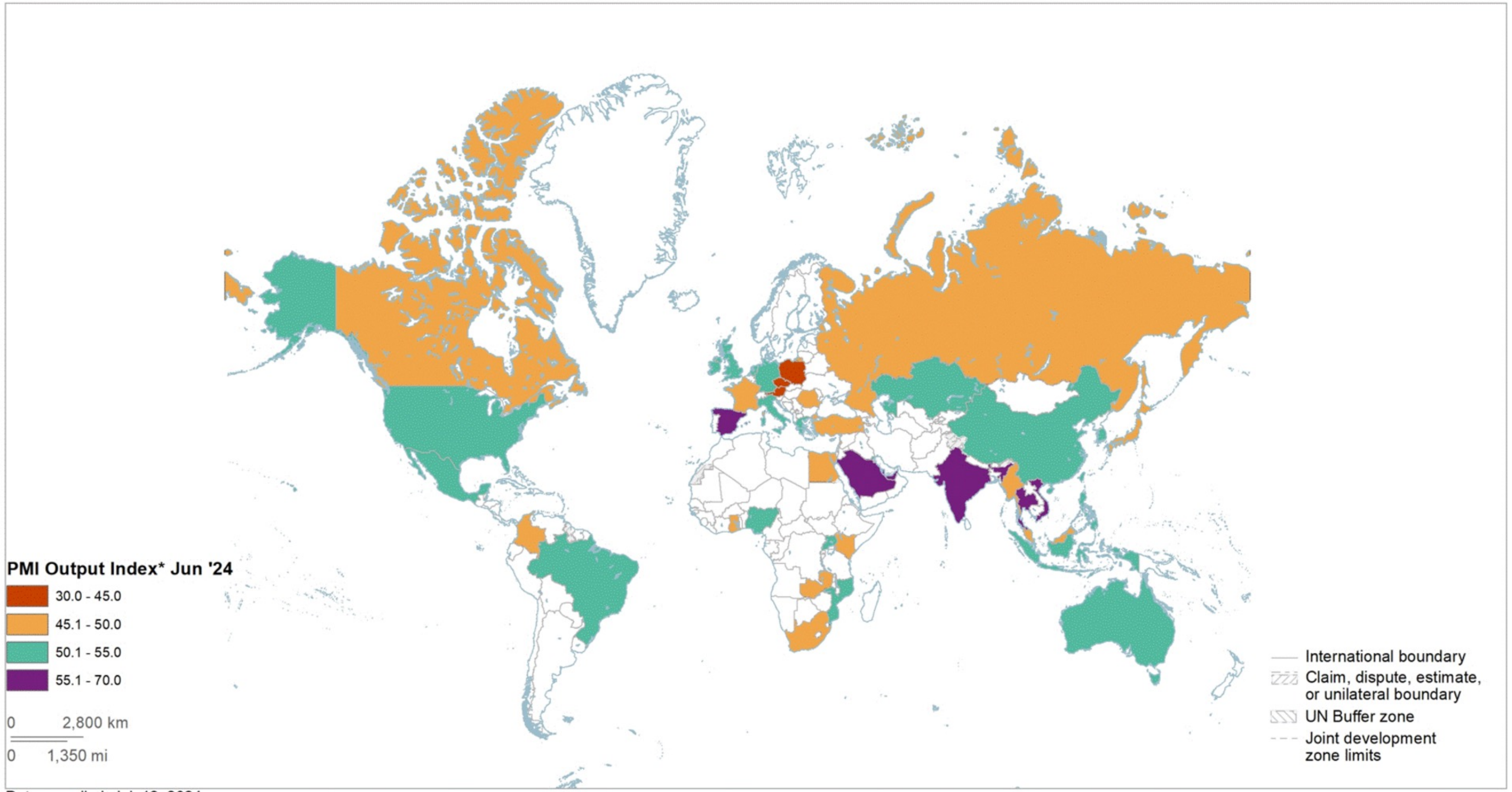
PMI index as Endicator of Economic Activity/Economic Risk

PMI Output Index



Data compiled: Jul. 12, 2024.
Sources: S&P Global Market Intelligence, Judo Bank, au Jibun Bank, HCOB, HSBC, Bank Austria, AIB, Caixin, Nevi / ABN AMRO, Istanbul Chamber of Industry, Standard Bank, Davivienda, Riyad Bank, BLOMINVEST Bank, Qatar Financial Centre, BCR.

Source: https://www.spglobal.com/market-intelligence/en/solutions/products/pmi

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Sovereign risk

– Sovereign risk is the potential that a nation's government will default on its sovereign debt by failing to meet its interest or principal payments

– Sovereign credit ratings

- Moody’s, S&P, Fitch (Source: https://www.moneyland.ch/en/rating-agencies

– Why is sovereign credit risk different?

- Can’t take a country to bankruptcy court
- Still, there are consequences
  - Assets may be seized
  - Country won’t be able to borrow so easily going forward
  - International trade could be impacted
  - Default could make economic crises worse

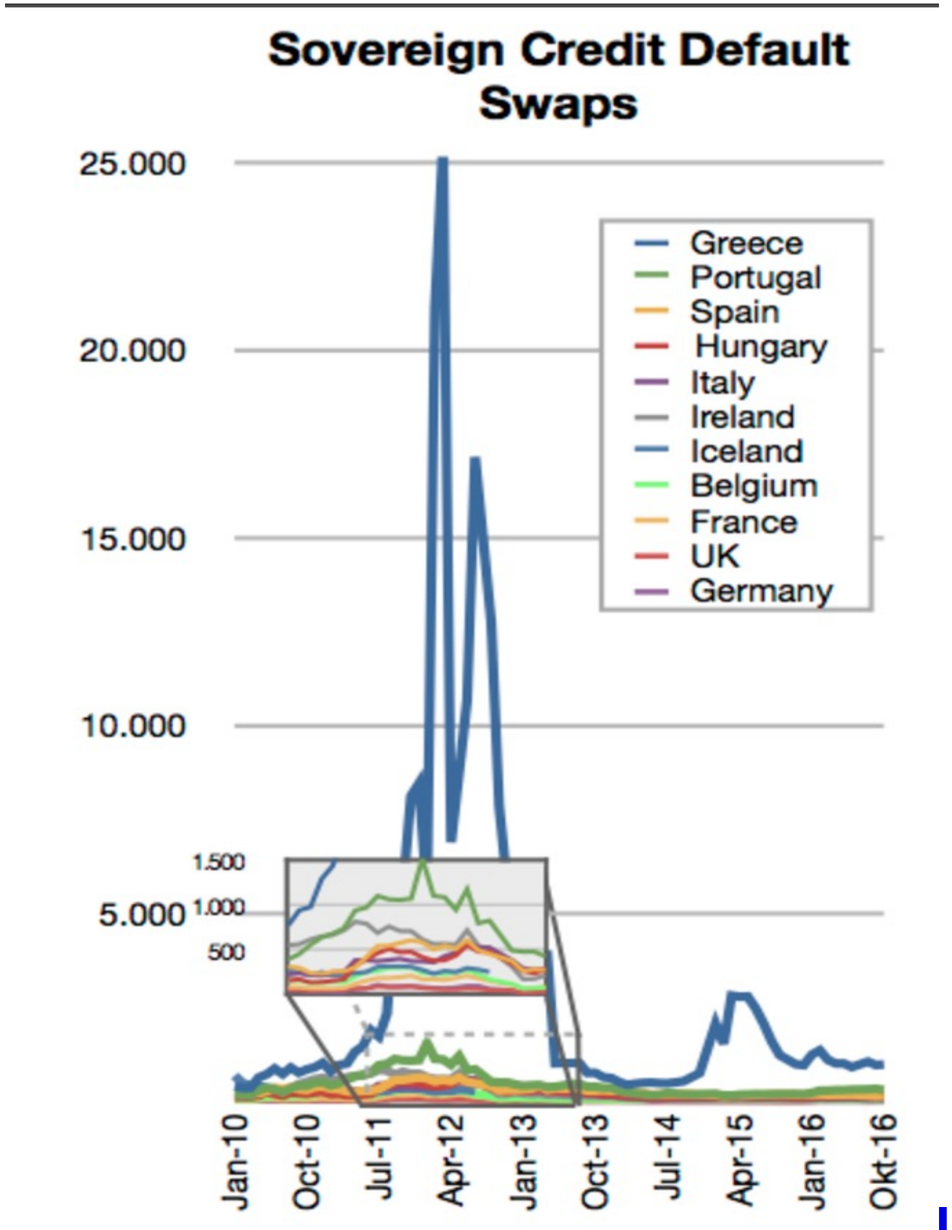
Credit default swap

- Credit Default swap:

A credit default swap is a financial derivative/contract that allows an investor to "swap" their credit risk with another party (also referred to as hedging). For example, if a lender is concerned that a particular borrower will default on a loan, they may decide to use a credit default swap to offset the risk.

Note: reading: [How is a firm's credit risk affected by sovereign](#) risk?

Data Source: https://www.investing.com/rates-bonds/world-cds

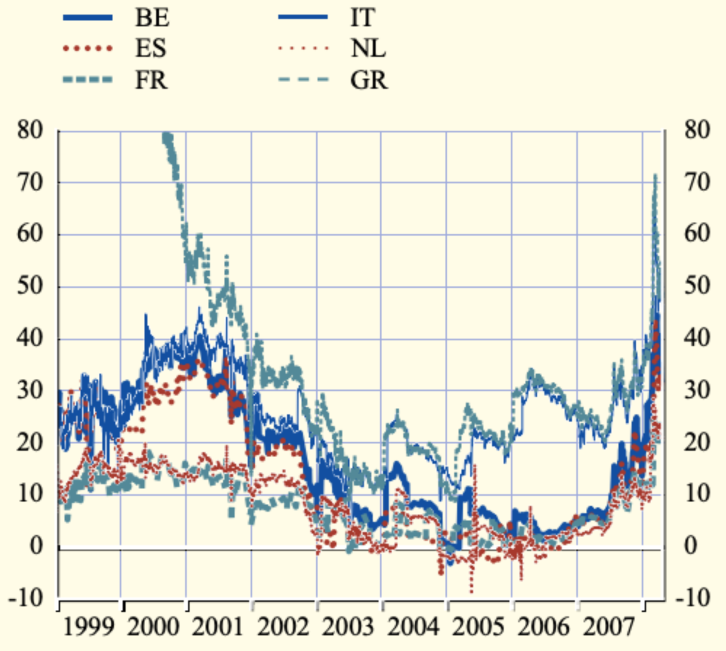


Source: Bloomberg, CNBC

GOV. BOND SPREADS

Chart A Ten-year government bond yield spreads against Germany

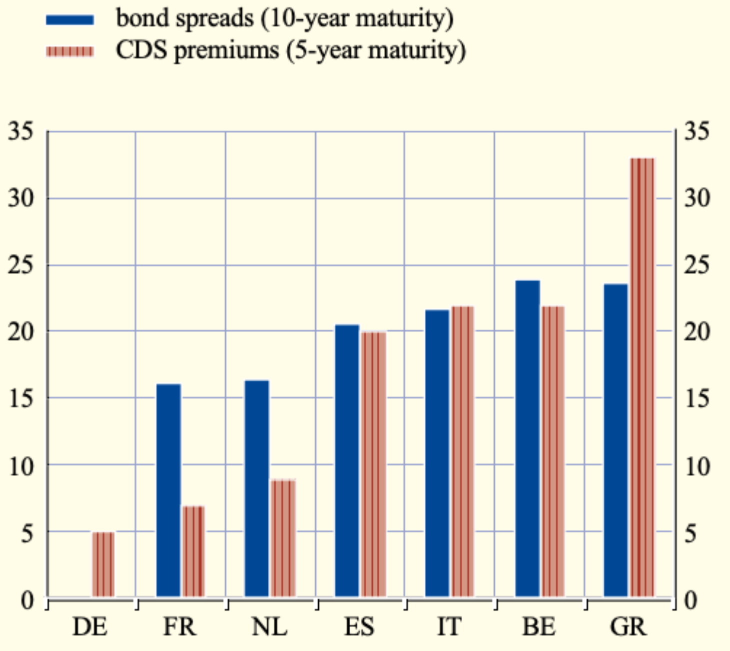
(in basis points)



Source: Bloomberg.
Note: The ten-year spread between Greek and German government bonds was over 300 basis points on 1 January 1999.

Chart B Changes in euro area government bond yield spreads against Germany

(in basis points, July 2007 to April 2008)



Source: Bloomberg.

Bond spreads:

-liquidity
- creditworthiness of the issuers

CDS premium:

- a measure for the default risk of sovereign bonds.

Source: https://www.ecb.europa.eu/pub/pdf/other/mb200805_focus03.en.pdf

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Country and Currency Premiums Around the Mexican Currency Crisis

Exchange Rate		3 Month Interest Rates			Spreads		
		U.S.	Mexico				
Month	Peso/$ Spot	T-bill	Cetes	Tesobonos	Country Risk Premium	Currency Risk Premium	Default Probability
Dec-93	3.1070	3.054	10.370	5.090	2.021	5.569	0.5026
Jan-94	3.1065	2.992	10.890	4.670	1.666	6.148	0.4147
Feb-94	3.1900	3.435	9.340	5.050	1.601	4.237	0.3987
Mar-94	3.3586	3.538	10.120	6.790	3.223	3.274	0.7994
Apr-94	3.2700	3.940	16.450	7.750	3.773	8.535	0.9344
May-94	3.3200	4.260	16.770	7.190	2.899	9.411	0.7196
Jun-94	3.3900	4.240	17.000	7.000	2.731	9.828	0.6781
Jul-94	3.4000	4.354	17.190	7.250	2.865	9.763	0.7111
Aug-94	3.3785	4.655	13.820	7.240	2.555	6.463	0.6348
Sep-94	3.3955	4.768	13.100	6.790	1.998	6.205	0.4971
Oct-94	3.4335	5.121	14.350	6.730	1.589	7.494	0.3956
Nov-94	3.4475	5.423	14.760	7.500	2.049	7.126	0.5097
Dec-94	5.0750	5.682	31.990	10.490	4.741	20.950	1.1710
Jan-95	5.7350	5.902	38.000	24.980	18.800	12.250	4.4890
Feb-95	5.8750	5.870	57.000	16.990	10.960	38.380	2.6670

Notes: The original source is Bloomberg, but the first five columns were taken from Froot (1995). The last three columns represent the authors' own computations. The risk premiums are annualized, but the default probability applies to a 3-month horizon, and is in percent.

Country and Political Risk Analysis

- In order to adjust capital flows (preferred to **adjust in discount rate –** CF discount model) one must compute the political risk probabilities
  - Adjusting the **discount rate** to reflect the additional uncertainty and risks associated with investing in a specific country or under specific political conditions.

1, Start with a Base Discount Rate (Weighted Average Cost of Capital (WACC))

2, Add a Country Risk Premium (CRP), (political instability, economic volatility, currency risk, and the risk of expropriation.)

- **Spread Method**:
  - Use the ***yield spread between the country's government bonds*** (e.g., 10-year sovereign bonds) and a risk-free benchmark like U.S. Treasury bonds. FORMULA: CRP=Country Sovereign Bond Yield−Risk-Free Rate
- 2, **CDS Spread**:
  - Use the country's Credit Default Swap (CDS) spread as a measure of default risk.
- 3, **Equity Risk Premium**:
  - Excess return that investing in local stock market provides over risk-free rate

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Country and Political Risk Analysis

- **Incorporate Political Risk**
- Political risk is harder to quantify but can be added as an adjustment to the CRP based on qualitative or quantitative assessments:

1. **Qualitative Assessment**:

- Assign a risk score based on political stability, regulatory environment, corruption indices, etc. These can be converted into an additional percentage risk premium.

2. **Quantitative Sources**:

- Use indices like the **International Country Risk Guide (ICRG)** or reports from agencies like Moody's or Fitch that assess political stability.
- Source: https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

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Country Risk Premium

$$\begin{array}{c}\text{Country risk}\\\text{premium}\end{array} = \begin{array}{c}\text{Sovereign yield}\\\text{spread}\end{array} \times \frac{\begin{array}{c}\text{Annualized standard deviation}\\\text{of equity index}\end{array}}{\begin{array}{c}\text{Annualized standard deviation of}\\\text{sovereign bond market in terms}\\\text{of the developed market currency}\end{array}}$$

Source: https://analystprep.com/cfa-level-1-exam/corporate-finance/country-risk-premium/

Country Risk premium

- Country A's 10-year government bond yield is 7.5% while the yield on a similar maturity US treasury bond is 3.5%. The annualized standard deviation of Country A's equity index is 30%, and the annualized standard deviation of country A's United States dollar denominated 10-year government bond is 19%. What is country A's country risk premium?

- *Sovereign yield spread* =7.5%–3.5%=4%
- *Therefore, the country risk premium is:*
- 4%(30%/19%)=0.04(0.30/0.19)=0.06316=6.32%

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Calculating a Company's Cost of Equity Using Country Risk Premium

- The equity risk premium for a company in a developing country is 5.5%, and its country risk premium is 3%. If the company's beta is 1.6 and the risk-free rate of interest is 4.4%, use the Capital Asset Pricing Model to compute the company's cost of equity.
- **Solution**
- Total equity risk premium = 5.5% + 3% = 8.5%
- Using CAPM, cost of equity = 4.4% + 1.6 (8.5%) = 18.0%

Managing Political Risk

– What MNCs need to keep in mind when structuring an investment

- Rely on unique supplies or technology (making government takeover more difficult)
- Use local resources (labor, commodity,..)
- Form joint ventures or alliances with local firms to share risks and gain local expertise. Partner with influential local stakeholders, such as governments or prominent businesses, to build goodwill and secure support.
- Bargain with the government
- Hire protection (i.e., bodyguards, or even military companies)

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Managing Political Risk

- Purchase **Political Risk Insurance** from providers like **Multilateral Investment Guarantee Agency (MIGA)**, **Export Credit Agencies (ECAs)**, or private insurers.

These policies cover:

- Expropriation or nationalization of assets.
- Currency inconvertibility or transfer restrictions.
- Political violence (e.g., war, civil unrest).
- Breach of contract by government entities.

– **Hedging Financial Risks**

- **Currency Hedging**: Use derivatives like forward contracts, options, or swaps to protect against currency devaluation.
- **Debt Structuring**: Borrow in the local currency to minimize the impact of currency inconvertibility or devaluation.
- **Revenue Diversification**: Generate revenues in multiple currencies to offset local currency risks.

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Managing Political Risk

- **Continuous Monitoring**: Use tools like political risk indices (e.g., ICRG, EIU Country Risk Service) and reports from agencies like Moody’s or Fitch.
- **Scenario Planning**: Develop contingency plans for worst-case scenarios, such as abrupt regime changes or economic crises
- **Strengthen Local Relationships**
- **Corporate Social Responsibility (CSR)**: Invest in local communities through education, healthcare, or infrastructure projects to build goodwill and reduce hostility.
- **Government Engagement**: Maintain open communication with local and national governments to ensure alignment with policies and regulations.

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Short questions:

What is a common method to calculate country risk premium?

a) Analyzing GDP growth rates

b) Using the spread between a country’s sovereign bond yield and a risk-free bond

c) Monitoring the stock market index performance

d) Calculating inflation differentials

- **Which organization provides political risk insurance to encourage foreign investment in developing countries?**

  a) World Bank

  b) Multilateral Investment Guarantee Agency (MIGA)

  c) International Monetary Fund (IMF)

  d) World Trade Organization (WTO)

What is the purpose of political risk insurance?

a) To protect against stock market losses

b) To hedge currency exchange risks

c) To cover losses from political events like nationalization or war

d) To insure against business operational errors

- **What is the primary difference between political and country risk?**

  a) Political risk focuses on government actions, while country risk includes economic, financial, and social factors.

  b) Political risk applies only to emerging markets, while country risk applies globally.

  c) Political risk measures currency instability, while country risk measures political instability.

  d) Political risk is broader in scope compared to country risk.

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If a company plans to enter a country with high political risk, which of the following actions should it prioritize?

a) Completely avoid investment in that country.

b) Purchase political risk insurance and conduct scenario planning.

c) Only rely on local currency financing.

d) Implement a single-entry strategy without diversification.

What does the term "currency inconvertibility" mean in the context of country risk?

a) The inability to trade local currency for foreign currency.

b) High volatility of exchange rates.

c) Government-imposed currency devaluation.

d) The appreciation of local currency relative to others.