



Assessing Economic Country Risk

In June 1980, outstanding U.S. bank loans to non-oil exporting developing countries totaled about \$70 billion. As a result, banks have heightened their efforts to evaluate the special risk (country risk) involved in international lending. Good country risk analysis requires, in effect, a projection of a country's future economy, including non-economic factors.

International lending by western industrialized countries' commercial banks has expanded dramatically in recent years. Net loans outstanding rose almost fivefold from \$172 billion in 1973 to \$810 billion in 1980. A significant portion of this lending (\$195 billion at year-end 1980) is to the non-OPEC developing economies.¹

U.S. banks are very active lenders to developing economies. Over the period December 1977 to June 1980, U.S. bank claims on the non-oil exporting developing countries increased by \$18 billion, to total about \$70 billion; this increase represents a healthy 13.6 percent annual average growth.²

The availability of these funds is of increasing importance to the non-oil exporting developing economies. In fact, external public and publicly guaranteed debt of these developing economies (as reported to the World Bank) made available from private financial institutions increased more than sevenfold from 1973 to 1979, rising to \$124 billion in 1979. As a share of total public external debt, borrowing from private financial institutions increased from 16 percent in 1973 to 36 percent in 1979 (Table 1).

Defining "Country Risk"

The expanded international lending by commercial banks has been accompanied by an increase in the share of interest payments and payment of principal going to private financial institutions (Tables 2 and 3). In turn, banks have increased their analysis of borrowing countries. (The largest U.S. banks may have large staffs engaged in this effort.) The reason why banks analyze countries is that international lending, in contrast to domestic

¹These data are from the Bank of International Settlements (BIS) quarterly reports titled **International Banking Developments** and refer to the dollar value of the gross external assets of banks in the BIS reporting area (the Group of Ten countries and Switzerland, Austria, Denmark, Ireland) and the branches of U.S. banks in the principal offshore centers in the Caribbean and Far East.

²These data refer to U.S. bank claims on foreigners by country of guarantor for 130 U.S. banking organizations with sizable foreign banking operations. Since 1977, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency have been conducting a semiannual activity survey of such banks' foreign lending. Survey results are made available to the public by the Board of Governors of the Federal Reserve System as a Federal Reserve press release, **Country Exposure Lending Survey**.

Table 1
EXTERNAL PUBLIC AND PUBLICLY
GUARANTEED DEBT OUTSTANDING

(\$ billions)

	1973			1979		
	Total	PFI*	Percent PFI	Total	PFI	Percent PFI
97 developing countries	86.7	16.4	18.9	297.6	123.6	41.5
80 non-oil exporting countries	62.9	9.9	15.7	194.0	70.3	36.2
Latin America and Caribbean	27.4	10.1	36.9	111.3	70.8	63.6

*Private Financial Institutions

Source: World Bank, *World Debt Tables*, Volume I.

Table 2
DEBT SERVICE ON EXTERNAL
PUBLIC AND PUBLICLY GUARANTEED

(\$ billions)

	1973			1979		
	Total	PFI*	Percent PFI	Total	PFI	Percent PFI
97 developing countries	10.8	3.1	28.7	48.6	28.8	59.3
80 non-oil exporting countries	7.3	1.8	24.7	26.4	13.2	50.0
Latin America and Caribbean	4.3	1.9	44.2	25.8	18.9	73.3

*Private Financial Institutions

Source: World Bank, *World Debt Tables*, Volume I.

Table 3
INTEREST PAYMENTS ON EXTERNAL PUBLIC
AND PUBLICLY GUARANTEED DEBT

(\$ billions)

	1973			1979		
	Total	PFI*	Percent PFI	Total	PFI	Percent PFI
97 developing countries	3.4	.9	26.5	18.3	10.6	57.9
80 non-oil exporting countries	2.5	.6	24.0	11.1	5.8	52.2
Latin America and Caribbean	1.4	.6	42.9	9.2	6.5	70.6

*Private Financial Institutions

Source: World Bank, *World Debt Tables*, Volume I.

bank lending, entails assuming risk apart from the quality of the commercial or credit risk of the borrower. This additional, unique risk of lending internationally is called "country risk."

Country risk includes economic, political, or social factors which might make borrowers either unwilling or unable to repay their debts to foreign lenders in a timely manner. Nationalization of foreign companies, repudiation of debt by a government, wars, and revolutions are examples of country risk. Other examples would be inability to obtain the needed amount of a foreign currency to service debt or government controls on foreign exchange transactions and capital movements.

Insufficient or controlled access to foreign exchange, often precipitated by a balance of payments goods and services deficit, or by capital flight, is often associated with "economic" rather than "political" or "social" risk; in fact, these different risks are often inter-related.³

The economic element of country risk is of obvious concern to lenders. It is, however, also a concern to the borrowing developing economies which need to maintain a flow of resources from abroad in order to achieve economic development objectives. Increased economic risk spells a slowdown in the net flow of external capital to sustain or increase that growth.

Countries may, of course, borrow for reasons other than to fill a domestic savings-investment gap. They may, for example, borrow in order to finance current consumption. Or, they may borrow to correct a temporary weakness in the balance of trade due to bad weather, an unexpected increase in import prices, or a world recession.

As a general principle, the return on the borrowed funds must exceed the cost. In other words, borrowing should cause national income to grow. In addition, the stream of returns must also generate export revenues (or reduced import spending) which will provide the foreign currency needed to pay back the loan during the life of the loan agreement.⁴

³It is not clear which of these risk categories is most important. On the one hand, the recent growth of literature on political risk suggests increasing concern with the international environment. On the other hand, experience suggests that countries are unlikely to repudiate debt and thus cut themselves off from international credit markets.

⁴There are exceptions to these guidelines. For example, countries may want to smooth out their consumption stream over time (borrow more now in anticipation of future revenues) or they may want to and may be able to roll over debt principal.

Assessing Economic Risk

Assessing economic country risk is not easy. Examining a variety of cost and maturity profiles and the associated returns over time from investment projects requires, in effect, a projection of the future economy. The problem is further compounded because the degree of debt-servicing difficulty is related to the availability of future capital inflows from abroad, which is not solely determined by economic variables.⁵

Country risk assessors typically examine the current and past economic structure, just as a physician compiles a medical history and takes measurements when examining a patient. Country risk analysts look at the background of the country — its quantity and quality of physical and human resources. They look also at its technological base to see how and why the country has come to its current level of development — at how it has been “nurtured.” Economic country risk analysis also entails the assessment of internal factors as well as external developments which affect the domestic economy.

Internal Factors

General indicators of current development include:

- level and rate of economic growth — GDP, real GDP/capita⁶
- social characteristics — education level, infant mortality rate, fertility, literacy, income distribution
- government's economic policies — spending, taxes, deficits; money growth, credit policies, inflation; environmental controls, tariffs, quotas

The basic rationale for examining these internal indicators is that high and growing

levels of economic and social achievement today — in terms of real GDP per capita and education, for example — are correlated with past success in managing resources: the country has the skilled people necessary for future economic growth.

If the economy also is well-endowed with natural resources, a solid technological base, and developed financial markets, the potential for continued expansion is evident. However, in order for this potential to be realized, the government's management policies must be appropriate. The question is whether the government is encouraging efficiency, investment growth, and other desirable goals or whether it is impeding them; its answer has critically important implications for the country's growth prospects.

External Factors

Having examined the internal structure of the economy, the economic risk assessor turns to the external features. Ultimately, he will begin to formulate judgments about the ability of an economy to carry additional debt.

Because of the frequent concern with an economy's ability to generate foreign exchange to repay debt, economic risk analysts have tended to evaluate very carefully a country's external position. They first analyze the balance of payments situation — the trade balance, the current account balance, and capital flows.⁷ They also carefully analyze the country's foreign debt and its relationship to the balance of payments. Finally, country risk analysts examine the level of international reserves and the availability of external credits. Their analysis emphasizes the following:

- exports and imports — absolute level and rate of growth; diversity of exports; ability to reduce imports
- tourism and transportation service receipts, investment income, and transfer credits and debits
- direct foreign investment and short-term capital flows
- external debt — public and private, long and short-term, size, composition and

⁵The availability of capital will also depend on the political and social risk factors (and upon profitability conditions in other countries) which combine with economic risk to encompass “country risk.” The requirements for assessing country risk are naturally even more complex than the assessment of economic risk. As Ingo Walter has written in an unpublished 1980 paper: “Given the nature of the problem, effective country risk assessment requires a true ‘renaissance man’ (or woman), exceedingly intelligent, holder of multiple doctorates from respectable institutions in economics, political science, sociology, psychology and perhaps a few other fields as well, totally objective, with a great deal of common sense. In addition to being exceedingly well-traveled, he or she should be up-to-the-minute on developments in all countries of interest to the bank (and in other countries that might affect them), and be personally acquainted with key policymakers in each of them. Such individuals are not too easy to find.” Paper presented at a conference on “Internationalization of Financial Markets and National Economic Policy,” Graduate School of Business Administration, New York University, April 10-11, 1980.

⁶GDP, or gross domestic product, refers to the sum of the values of goods and services produced within a nation's borders.

⁷The trade balance comprises merchandise import and export transactions while current account comprises transactions in goods, services, and unrequited transfers; the current account thus excludes transactions in financial assets and liabilities. The capital account covers the net acquisition of financial assets, some of which may be used to finance current or other capital account transactions.

growth; debt-service, size, growth, and repayment schedule

- international reserves

The trade balance is examined to see if exports are growing in a healthy fashion and whether the country is dependent upon, say, a principal commodity export or has diversified exports. An important aspect of imports will be the composition and growth of inelastic components like energy and food. Other components of the current account — tourist service receipts, investment dividends and interest, and private and public transfers are examined for their growth, stability, and impact on the current transactions balance.

The analyst examines the capital account as it covers the net acquisition of financial assets. The capital account can serve as an indicator of investor confidence (if foreign direct investment growth is healthy) or concern with government policies (if capital is being pulled out).

Debt and debt-service growth will typically be examined in connection with balance of payments developments along with changes in reserves; the basic rationale of this procedure reflects the fact that one pays for past or current resource use which is in excess of current income out of savings, by borrowing, or from outsider investment.

Ratios and Country Risk Assessment

Country risk analysts have developed a set of summary indicators to predict short run debt-servicing difficulties in advance. Analysts have tended to focus on ratios of variables associated with the external side of the economy — exports, imports, debt, debt service and its amortization and interest components, international reserves, International Monetary Fund credit available, the current account balance (currently or cumulatively), and so on. A list of some of these external indicators and what they attempt to summarize is given in Table 4. The heavy reliance on ratios reflects a carry-over of financial analysis techniques used to assess the creditworthiness of commercial borrowers. Ratios also are usually more informative than variables discussed in absolute size.

When measuring long term debt repayment capacity, on the other hand, analysts tend to look more at other economic variables; in

particular, they focus on the growth of internal variables such as gross domestic fixed investment, the marginal capital-output ratio as a productivity measure, and such other ratios as capital imports to domestic investment, domestic saving to GDP, investment to GDP, government expenditures to GDP, and so on (Table 4).

Ratios, used singly or in combination in a checklist system, have met with limited success. Extreme caution must be used in interpretation, because a given ratio value may be high or low, depending upon such factors as the size, economic structure, and level of development of a country.

The debt-service ratio, for example, is defined as amortization plus interest (generally on public and publicly guaranteed debt for simplification purposes) as a ratio of exports of goods and services. It serves as a measure of a country's burden of debt in terms of foreign exchange earnings and thus reduced import capacity.

Illustrative of difficulties with ratios, however, there are a variety of problems associated with the debt-service ratio which make it inadvisable to rely on it solely as a risk indicator. A country's reported debt-service ratio could rise when debt-management is improving or fall when there is no improvement due to changes in available information. It ignores other forms of foreign liabilities such as profits on foreign investment. In inflationary times, rising nominal export prices and floating, volatile interest rates make interpretation of the ratio difficult. Because of bunching of repayments, fluctuating exports and other factors, the ratio also is often volatile, rising and falling sharply even from year to year. Other ratios have similar idiosyncracies and require similar cautious interpretation.

Conclusion

International bank lending has grown dramatically since the oil-price increases of 1973-1974. The growth of such lending, particularly to the developing economies, has caused country risk to be an issue which lenders, borrowers, and regulators in the U.S. and other western economies take seriously. Analysts of the economic dimension of country risk (in simplified terms, the ability to repay foreign debt), take a holistic approach in evaluating a country's economic strength.

Table 4
Indicators and Ratios Frequently Used in Economic Risk Assessment

INTERNAL

Gross Domestic Product (GDP) — measure of the size of the economy
GDP Composition — indicator of the overall structure of the economy
Population — measure of the potential size of the market
GDP/Population — measure of the level of economic development
Savings/GDP — indicator of growth prospects attributable to domestic savings
Investment/GDP — indicator of current commitment to future economic growth and productivity
Capital/Output — marginal capital-output ratio measures productivity of new investment
Government Spending/GDP — indicator of government involvement in the economy
Public Sector Deficit/GDP — indicator of the financial management capabilities of the public sector
External Public Debt/GDP — indicator of over all exposure to the international economy and long-term debt burden
Money Supply Growth — measure of economic activity and stability of the currency
Consumer Price index and/or Wholesale Price Index — measures of domestic inflation rate
Unemployment Rate — measure of labor slack in the economy

EXTERNAL

Imports and/or Exports/GDP — measure of the openness of an economy
Export Volume — indicator of growth of the external sector of the economy
Exports/Imports — called the "coverage ratio"; indicator of economy's rate of growth
Export Composition — indicator of vulnerability of foreign exchange earnings to price fluctuations
Manufacturing Exports/Total Exports — indicator of diversity and stability of exports
Oil Imports/Main Export — crude measure of the terms of trade of an economy
Current Account Deficit/Exports — short term measure of possible balance of payments difficulties
Total External Debt/Exports — long term indicator of country's liquidity
Interest Payments/Exports — indicator of debt burden; reflects carrying costs of the external debt
Total Service Payments/Exports — measure of external debt burden
Amortization Payments/External Debt — measure of liquidity and (reciprocal) indicator of average maturity of debt
Interest Payments/International Reserves — short-term measure of ability to meet debt servicing requirements
International Reserves/Imports — measure of short-term liquidity
International Monetary Fund (IMF) Credit Usage/IMF Fund Quota — measure of short-term liquidity

Their methodology is not unlike the physician's who assesses the healthiness of his patients by peering into the patient's background and environment in addition to taking various measurements of health. The objective in country economic risk evaluation is to assess the collective impact of a country's

evolving domestic and international economic relationships on the economy's ability to carry a heavier debt burden. Identification of potential debt-servicing problem situations and assessment of economic risk requires a thorough understanding of the internal and external workings of an economy. 

—William J. Kahley