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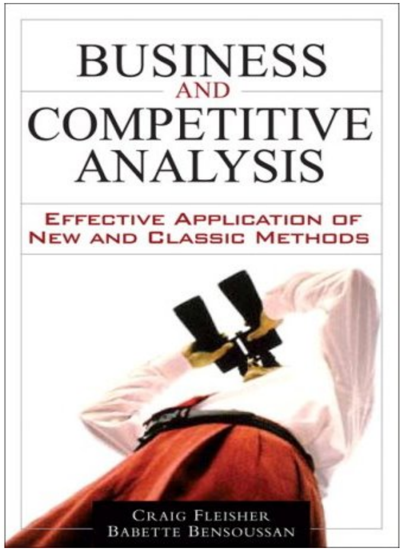

Chapter 19

Country Risk Analysis

Ch19. Country Risk Analysis

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- Strengths & Advantages
- Weaknesses & Limitations
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Ch19. Country Risk Analysis

Short Description

- Country risk assessment (CRA) deals with how a firm addresses the risks involved in making investments in a foreign country.
- Country risk can be segmented into the following six categories:
  - economic risk
  - transfer risk;
  - exchange rate risk
  - location or neighborhood risk
  - sovereign risk
  - political risk

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Background

- CRA became popular in the 1970s.
- Risk assessment forecasting services from agencies such as the IMF, the *Economist*'s Economic Intelligence Unit, and WEFA built from years of testing.
- Indices that rated country risk began to develop, often with data collected from vast and knowledgeable sources.
- Subjectivity inherent because experts disagree on types and gravity of risk.
- Over time have become more quantitative.

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Strategic Rationale

- Global expansion is becoming increasingly attractive for firms.
- Outsourcing, joint venturing, licensing opportunities, access to developing markets, and learning curve effects are all reasons firms go to foreign countries.
- Benefits can be numerous, but some risks include:
  - Foreign entity defaulting on its debt.
  - Renegotiating or rescheduling obligations.
  - The transfer of risk (foreign exchange rates and controls).

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Strengths and Advantages

- CRA is important to enhance the firm's understanding of risks that are associated with foreign investment.
- CRA can help identify remedies to minimize or even eliminate taking on all of the risk.
- Can help a firm chose among potential locations.
- Can help identify other firms which have previously invested in risky countries.
- CRA is part of the cultural awareness.

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Weaknesses and Limitations

- Problems that plague the CRA discipline:
  - Concerns arising from data collection.
  - Lack of objectivity.
  - Looking to past events to predict the future.
  - Lack of specificity.
  - Data may not be available for under-developed nations.
  - Not helpful in understanding benefits.

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Process for Applying Technique

- Can be adapted to a large or small project.
- The following fairly standard methodology:
  1. Create a foreign country market risk assessment team.
  2. Weight how important each of the different risk categories will be to the decision.
  3. The team should select appropriate measures for each of type of risk.
  4. For qualitative indicators, canvas risk experts and give outcomes a score from 1 to 5.
  5. The resulting values can be combined for each risk factor.
  6. Each risk factor's score can then be multiplied by its weight, and aggregated to create a total score.

Process for Applying the Technique

- Assessing country risk ordinarily requires the use of a variety of sophisticated quantitative techniques.
- Can purchase reports from BERI, CRIS, EIU, & many others.
- Acquiring these reports is a helpful but not sufficient step in doing CRA.
- Assessing country risk is ‘art’ and ‘science’.
- Risk factors chosen for model should suit needs of firm.
- Risk factors will fall into following 6 categories.

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Process for Applying the Technique

- Risk: Economic
  - Sources
    - Disadvantageous shifts in policy goals including fiscal and monetary.
    - Disadvantageous shifts in demographics, natural or other resources and industry.
  - Indicators
    - GDP growth rate
    - Tax system stability
    - Government debt levels
    - Financial security

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Process for Applying the Technique

- Risk: Transfer
  - Sources
    - Movement of capital is restricted by agents of government. Can happen at any time and for a variety of reasons
  - Indicators
    - Having trouble attracting foreign currency.
    - Debt service payments/exports ratio.
    - Amount and type of foreign debt/income.
    - Foreign currency reserves/different import categories.
    - Current account status.

Process for Applying the Technique

- Risk: Exchange Rate
  - Sources
    - Unpredictable, unfavorable exchange rate movement or change in type of exchange rate (fixed to floating or vice versa).
  - Indicators
    - Pegged currency ranges.
    - Recent change from floating to fixed rates or vice versa.

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Process for Applying the Technique

- Risk: Location/ Neighbourhood
  - Sources
    - Instability in a neighbor, similar country or region infects the country where you have invested.
  - Indicators
    - Geographic location and proximity to hot or trouble spots.
    - Instability in strategic partner or ally.

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Process for Applying the Technique

- Risk: Sovereign
  - Sources
    - Inherent risk that a government may default on obligations, either by choice or necessity.
  - Indicators
    - Similar to transfer risk indicators.
    - Track record: Has government repaid in the past?

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Process for Applying the Technique

- Risk: Political
  - Sources
    - Risks that result in loss of profit, expropriation, or repudiations due to changes in the political environment.
    - Macro-risk refers to instability caused by civil wars, terrorism, coups, shifts in societal values, powerful unions, religious disagreements, revolutions, national work stoppages, etc.
    - Micro-risk include boycotts, activism, acts of terrorism, and competition from other multinationals.
  - Indicators
    - Qualitative expert opinion

Process for Applying the Technique

- Is there a quantitative and qualitative assessment of the risk?
- Is a formal analysis of country risk conducted at least annually?
- Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any special risks?
- Is the analysis adequately documented and are conclusions effectively communicated?
- Are the resources devoted to the CRA process adequate?
- Have analysts checked with their decision makers to assess their satisfaction with previous country risk analyses?
- As a final check of the process, are the analyst's conclusions concerning a country reasonable?

CASE STUDY: ZYBOLDT METALS (ZMC) EXPANSION INTO EASTERN EUROPE

- ZMC, viewed home canning products as a key part of the firm's product offering (operations in US and Canada.)
- The firm hoped to achieve at least a 50 % growth in its home canning sales within the next three years, and an expansion into Eastern Europe.
- Market research showed that families in this part of the world generally preferred the ZMC canning process and its preservative free taste.
- Want to know if the potential benefits of investing in Hungary and the Ukraines would outweigh the associated risks.

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CASE STUDY

- Step One: What kind of investment is ZMC making?
- Which types of country risk will ZMC be exposed to?

Risk Category	Direct Investment Private Sector*
Economic	High
Transfer	Moderate
Exchange	High
Location	High
Sovereign	Moderate
Political	High

CASE STUDY

- Step Two: Choose weighting for each risk type:

Risk Category	Direct Investment Private Sector*
Economic	2
Transfer	1
Exchange	2.5
Location	2
Sovereign	1.5
Political	2

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CASE STUDY

- **Step 3:** Select indicators
- Grading Guide:
  - A = 0 points,
  - B = 1 points,
  - C = 2 points,
  - D = 3 point,
  - F = 4 points,
  - +/- = add/subtract .25 points.

Case Study

- **Hungary**
  - Basic economic facts:
    - GDP (ppp): USD$149.3 billion (2004)
    - GDP (ppp) per capita: USD$14,900
    - GDP (ppp) real growth rate: 3.9 per cent (2004 est.)
    - Inflation rate: 7 per cent (2004 est.)
    - Debt (external): USD$57 billion
  - ***Economic risk indicators***
  - High debt service ratio (23.5 for 2004), and total debt increasing over the next two years. Hungary maintains large fiscal and external deficits. However, domestic spending is getting stronger and a cut in the VAT will help keep inflation down.
  - **Score = B = (1).**

Case Study

- **Hungary**
  - ***Transfer risk indicators***
    - Current Account Balance was – 8.8 per cent of GDP in 2004, and is projected to remain around 8 per cent in 2005 and 2006.
    - The country's debt-service ratio paid is over 20 per cent, averaging around 22 per cent between 2004 and 2006.
    - Foreign investment has been a key to Hungary's economic success. With about $55.44 billion in foreign direct investment (FDI) since 1989, Hungary has been a leading destination for FDI in this part of Europe.
    - Foreign firms account for over 70 per cent of Hungary's exports, 33 per cent of GDP and about 25 per cent of new jobs.
  - **Score = B = (1).**

Case Study

- **Hungary**
  - ***Exchange rate indicators***
    - In 1995 Hungary's currency, the forint (HUF), became convertible.
    - In 2001, the Government lifted the remaining currency controls, allowing the forint to appreciate by more than 12 per cent in a year.
    - Conflicting fiscal and monetary policy in the summer of 2002 caused confusion in the market.
    - In attempts to reassure the market, the Medgyessy Government repeatedly said the country would join the ERM II as soon as possible, with hopes of adopting the Euro by 2008. This issue remains on hold until the next elections (in mid-2006), which may settle direction and timing.
  - **Score = B- = (1.25).**

Case Study

- **Hungary**
  - ***Location risk indicators***
    - There are no significant location risks in the near future, although the surrounding area has been tumultuous within the last decade.
- **Score = A- = (.25).**
  - ***Sovereign risk indicators***
    - Hungary has not had any problems in this area since becoming a liberalized economy, and shows no obvious signs of sovereign risks in the near to mid-term.
- **Score = A = (0).**

Case Study

- **Hungary**
  - ***Political risk indicators***
    - Election in mid-2006, after several rounds of governments have been unable to hold power for long periods.
    - The current ruling party was trailing badly in the polls at the end of 2005.
    - Both the government and opposition have populist platforms.
  - ***Score = B- = (1.25).***

Case Study

- ***Hungary country risk summary***

Risk Type	Weight		Grade	=	Total
Economic Risk	2	x	1	=	2
Transfer Risk	1	x	1	=	1
Exchange Risk	2.5	x	1.25	=	3.125
Location Risk	2	x	.25	=	.50
Sovereign Risk	1.5	x	0	=	0
Political Risk	2	x	1	=	2
			Total	=	**8.625**

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Case Study

- **Ukraine**
  - ***Basic economic facts:***
    - GDP (ppp): USD$299.1 billion
    - GDP (ppp) per capita: USD$6300
    - GDP (ppp) growth: 12 per cent (2004)
    - Inflation rate: 12 per cent (2004 est.)
    - Debt external: USD$16.4 billion (2004 est.)
  - ***Economic risk indicators***
    - Period of economic decline in the 1990s.
    - Turnaround in early 2000s.
    - Growth was driven by strong domestic demand and growing consumer and investor confidence.
    - Excessive government regulation, corruption and lack of law enforcement.
  - **Score = B = (1).**

Case Study

- **Ukraine**
  - ***Transfer risk indicators***
    - Has been encouraging foreign trade and investment.
    - In reality large local firms have considerable political and legal influence.
    - Ukraine is dominated by powerful local players who have successfully prevented foreign investment.
    - The risk that foreign investors' assets will be de facto expropriated is low, but recent examples exist.
    - Lack of protection for minority shareholders' rights severely restricts portfolio investment activities.
  - **Score = C = (2).**

Case Study

- **Ukraine**
  - ***Exchange rate indicators***
    - Ukraine's currency, the hryvnia, was introduced in September, 1996 and has remained stable until quite recently.
    - There has been increasing volatility in the rate since 2000.
  - Score = C = (2).

Case Study

- **Ukraine**
  - ***Location risk indicators***
    - The region surrounding Ukraine is mostly stable.
    - The only remaining location risk issue is inside the country, as crime is a serious problem in Ukraine, and a higher than European average.
    - Number of racially motivated assaults and incidents of harassment to individuals of African or Asian decent have been reported in recent years.
  - **Score = C = (2).**

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Case Study

- **Ukraine**
  - ***Sovereign risk indicators***
    - Ukraine has a recent history of defaults and therefore may have higher than average levels of sovereign risk.
    - There are still some trends on the horizon to suggest the retention of higher than average levels of risk in this indicator.
  - **Score = D+ = (2.75).**

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Case Study

- **Ukraine**
  - ***Political risk indicators***
    - A new democratic constitution was adopted on 28 June 1996, which mandates a pluralistic political system with protection of basic human rights and liberties.
    - Recent elections have been challenged and there remains some skepticism over the long term stability of the government.
  - **Score = C- (2.25).**

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Case Study

- ***Ukraine country risk summary***

Risk Type	Weight	x	Grade	=	Total
Economic Risk	2	x	1	=	2
Transfer Risk	1	x	2	=	2
Exchange Risk	2.5	x	2	=	5.
Location Risk	2	x	2	=	4
Sovereign Risk	1.5	x	2.75	=	4.125
Political Risk	2	x	2.25	=	4.5
			Total	=	**21.625**

Case Study

- **Recommendation**
  - Based on the calculations performed, it was clear to the analyst that at the end of 2005 Ukraine held a far higher degree of country risks in the short and medium term than Hungary.
  - This raised a number of ‘yellow flags’ that the analyst knew would require further analysis.

Ch19. Country Risk Analysis

- **FAROUT Summary**

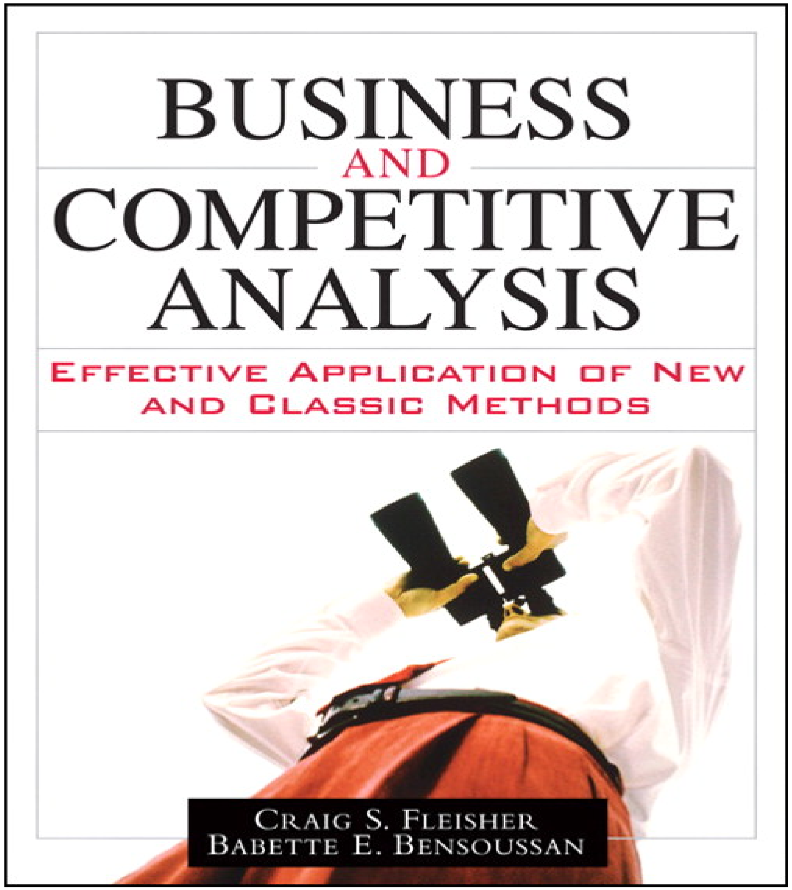
	1	2	3	4	5
F					
A					
R					
O					
U					
T					

Ch19. Country Risk Analysis

Related Tools and Techniques

- Investment Valuation Analysis
- Outsourcing Analysis
- Political Risk Analysis
- Porter's Diamond of National Advantage
- Scenario Analysis
- STEEP/PEST Analysis
- Strategic Relationships Analysis
- SWOT Analysis
- Value Chain Analysis

Ch19. Country Risk Analysis



For More About Country Risk Analysis and 23 Other Useful Analysis Methods, see:

Fleisher, Craig S. and Babette E. Bensoussan

Business and Competitive Analysis: Effective Application of New and Classic Methods

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