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Rating Based on the Country Risk

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Abstract
Participation of a country to obtain the credit, of any kind, making imports and exports by a country or by its financial and trade companies, involves to be taken into account the risks that evolve from this involvement. Through this article I want to present the factors that generate the country risk, the main types of them, methods of analysis, their evaluation by the rating agencies, and, not finally, Romania's rating assessment, compared with some EU countries.
Keywords: Country Risk, Risk Assessment Criteria, Rating Agencies, Romania's Rating

Introduction

The occurrence of the country risk is related to the nationalization of the Suez Canal in 1956. At that time was known as a political risk and focused nationalization of the oil industry in the Middle East and Maghreb.

In the 80s there was talking about the sovereign risk as a result of unable to pay by the Latin American countries.

From the 90s we talk about "emerging crisis". We remember the Mexican crisis in 1994, the Asian crisis in 1997, Russian crisis in 1998 and Argentine crisis in 2000.

In the current work, each country unable to operationally self-sufficient is forced to participate at the labour international division, and in this respect, at the international cooperation on all levels.

The specialized literature shows that the country risk has a direct impact on the cost of the borrowing, because it reflects the probability of default debts by a country (Michael McAleer, 2010).

In the general terms, the country risk definition is: "Country risk is a materialization risk of the losses caused by the situation and evolution of the political and macroeconomic developments from the partner country".

Losses can take the form of missed opportunities, as a result of the contract failure, the real losses materialized in the amounts that cannot be recovered, or, the additional costs involved by the steps taken to determine debtors to meet their obligations.

Factors which influence or generate the country risk are:

- Demographic, structural and educational: the growth rate of birth, age pyramid, share of the urban population in the total population of a country, secondary and higher education level, quality of life (GDP/inhabitant), quality of infrastructure, natural resources;

- Population and trade structure: GDP nominal and GDP real, share of imports and exports in GDP, volume of exports and imports on the geographic region;
- Dynamic private sector: creation rate of the new business, number of privatizations and the methods used, the private sector share in the national economy;
- Macroeconomic policy: monetary policy objectives, price stability, the degree of the central bank independence, inflation rate, changes in the interest rate and exchange rate, budget policy;
- Investment and trade policy: measures to control the imports, customs duties, export subsidies, foreign investment policy, control on the repatriation of the profits, interest and dividends;
- Financial and baking system: analysis of loans by type of institutions and sectors, lending policies, the degree of the central bank intervention, prudential regulations and banking supervision, capital market development and its degree of interconnection with the international markets;
- External debt, debt strategy, debt of the major types of borrowers (private/public), net and gross external debt, debt ratio with LIBOR/EURIBOR variables rates, external debt of the goods and services exports.
- State policy: the degree of consensus on the economic policies, way of succession to power, level of the corruption and bureaucracy, the size of the armed forces, military and economic agreements.
- International position: objectives and strategies of the foreign policy, membership of the international organizations, relations with the IMF and the major industrialized countries: U.S.A, EU and Japan (Anghelache, 2010)

Literature Review

Appealing to review the literature about the country risk, we identify the specialist's works as Pancras J. Nagy (1984), who defined the risk, believing that is a different concept and bigger than the sovereign risk, that is limited at the credit risk of the government.

The literature shows that the country risk has a direct impact on the borrowing cost, because it reflects the probability of non-payment of claims by a country, Michael McAleer (2010).

Ronald L. Solberg made reference in his book "Country - Risk Analysis" at the international credit risk management, and the authors such as Gary A. Dymski and Ronald L. Solberg approached the systemic risk in the international bank lending.

Theoretical Background

For this article I studied the specialized literature and the recent published research and articles on the subject.

In my research I have analyzed the factors that generate the country risk (Dudian, M., 1999), the types of risks that may occur (John Calverley, 1992), the methods of analysis of the country risk (Sorin Lazarescu), the agencies and firms rating (Anghelache Constantin, 2010), the Romania's rating compared to some European Union countries.

Types of risks that may Occur

Taking into account the forms of manifestation of the country risk, such as ability to pay, willingness to pay, payment options, country risk can manifest as:

a. Transfer risk refers to a situation when although a debtor from a country has amounts that he owes and intends or wishes to make payment under obligations that he assumed, he is unable to do this payment because of the limited possibility of the country's government or of the imposed policy by this government.

- In the developed countries this risk is virtually zero, while in the developing countries and the countries in transition to the market economy, the transfer risk is large enough, because the limited position of the national currency to be convertible and the difficult access to obtain the amount in the currency etc. Ability to pay is always associated with transfer risk (John, 1992)

b. Sovereign risk appears when it refers to transactions in which the partner is presented by a State Government or by the companies which have government guarantees. In this situation, the will or ability to pay is a specific manifestation of circumstances, we talk about a country risk and it is called the sovereign risk.

c. Specific risk of the quasi-sovereign borrowers occurs when the amounts in question must be paid by government or public institutions, and the country risk is associated with the sovereign risk.

d. Political risk refers to the fact that the certain developments, political or social, can influence the profit of the foreign investment and cause forgiveness of an international loan. This political risk is actually a manifestation of the political will that leads to the impossibility for payment on the political considerations.

e. General country risk refers to all the socio-political and macroeconomic elements that prevents to a country level, its development prospects. General country risk can be determined by a stronger economic recession, by the political and economic changes, by the social unrest and discrimination of the foreign companies.

f. Systematic risk is determined by the appearance of the systematic development of the crisis, occurring simultaneously in a number of states. Thus, over the time, in the world appeared: the oil crisis, the dollar rate change, the raw materials crisis, etc, which represented the risk to those countries or the companies that were involved in transactions whose performance was held in the areas that were affected by the occurrence of such elements.

Classification of the World States

The country risk analysis should be noted that currently, in the world, based on several criteria, the countries are divided into several groups, as follows:

- developed countries, known as OEED countries (Organization for European Economic Co-operation), which includes the states of the Western Europe, Japan, USA, Canada, Australia and New Zealand;
- Newly industrialized countries, which are located in South East Asia and Latin America. These are countries where the industrial development has progressed, even though other social and economic elements have been left behind;
- Country whose economy is based on the exports of the certain types of limited products or poorly prepared. In this group are the oil producing countries that are members of OPEC (Organization of the Petroleum Exporting Countries) the American countries or some African countries that have limited resources to some goods;
- Underdeveloped countries, whose spectrum covers an extremely wide broad, in these countries are essential elements of analysis which are based on the guerrilla movements; civil wars etc., which prevents the development prospects of these countries.

- The former communist countries, which are grouped into so-called geographical area of Central and Eastern Europe, plus CIS (Community of Independent States). In the group of these countries there are included states, as Romania, which can be grouped in turn, after the possibility and evolution of transition, which they pass until now.

Methods of Country Risk Analysis

a) International Credit Risk Methodology

An important category of methods for predicting of the country risk covers all known techniques called rating or risk dimension. Approach is to provide a note of the examined country so as to enable a classification of the analyzed countries according to their risk. The note may be global or only applied for a part of the risk.

We can mention the International Credit Risk methodology that assigns grades for 100 specific categories ranging from existing political parties per GNP inhabitant. The advantage of the method is simplicity and the low cost: disadvantage lies in the lack of the prospective vision - for example Iran receives an excellent ranking in 1978 several months before the fall of the Shah, Kuwait was considered a country without risk before the Iraqi invasion troops in 1991.

The scoring system can target a particular type of risk, as is the inability to pay. In this case the note concerns only a specific variable, namely the repayment ability of the country. It may appeal to the rating agencies as Moody's and Standard and Poor's which notes that sovereign risk. Also the publications like Euro-money calculated the rating country starting from the financial risks.

Using the Measurement techniques raises some methodological problems for assessing of these risks:

- What is the relevance of the criteria used?
- Who is responsible for the rating?
- What is the subjective part in the credit rating granting?

In addition, almost the techniques aren't adapted in measurement of the emerging country risk. Therefore, we recall for more sophisticated techniques. One of them is "dynamic segmentation". This technique is to identify the ethnic and socio-professional segments the most representative of the country. It is studying how they match or contrast the antagonistic goals.

The purpose of this type of analysis is measuring the political stability of a country. Banks and insurance companies use the expert systems in an attempt to identify the political and economic events likely to cause calamity.

Another used method is based on the probabilities in which there are imagined different scenarios of evolution. In practice there are used a mix of techniques to assessment the country risk.

For the Standard and Poor's rating agency the sovereign risk measurement requires quantification of a set of eight variables:

Table no. 1 The variables considered in the analysis of country risk

Variable	Analysis
1. political risk	• form of the government and the adaptability of the institutions; • degree of the democratic participation; • quality of the power succession process; • the degree of consensus on the economic policy objectives; • degree of integration in the economic and international changes; • The internal security level and the capacity of the national defence.
2. public debt	• Public financial assets; • State indebtedness; • State commitment on pensions.
3. price stability	• inflation; • The average interest rate in the economy; • foreign exchange policy; • The degree independence of the central bank.
4.economic structure of income	• living standards, income and access to the health; • existence or not of a market economy; • Access to the resources and their diversity.
5. flexibility of the external payments balance	• impact of the monetary policy and fiscal on the national accounts; • structure of the current account; • composition of the capital flows.
6. economic growth prospects	• level of savings and investment; • rate and structure of the economic growth.
7. fiscal flexibility	• major budget constraints; • leeway of the fiscal policy; • Pressures on the public expenditure.
8. External debt and the degree of liquidity.	• the level and the structure of the currency of the external debt; • the importance of the banking system; • history of the debt service and any service payment incidents.

Source: Lazarescu Sorin - Financial Rating pdf. p 6, http:// www.biblioteca-digitala.ase.ro

b) Method of risk indicators (Delphi and BERI)

Delphi method consists in:

• a list of the representative criteria for the political, economic and financial situation of the country, such as:

a) *Political criteria:* regime stability, military power, located in a war zone, etc.

b) *Economic criteria:* the structure of the exports and imports, the rate of saving, banking situation;

c) *Financial criteria:* calculate rates, such as: currency reserves/external debt; annuity of repayment of the debt/exports.

- consulting of the experts on the appropriateness of scoring criteria;
- Weighting of each criterion and then determining a note (score), indicating the overall risk of the analyzed country.

In his approach, the method of the risk indicators presents analogous to credit - scoring, but without to use the discriminate analysis, because the difficulties in constructing of a representative sample.

BERI *(Business Environment Risk Index)* is a risk indicator developed in the USA and is a subject to periodic reviews of each country. This indicator is established from fifteen criteria, each is weighted according to the importance. Then, the criteria are scored from 0 to 4 (0 for the high risk and 4 for the low risk), and the combination note-weights gives for each country the final score, the risk indicator.

Countries are classified into categories according to the scores:

- 40 and under: unacceptable risks;
- From 41 to 55: high risk;
- From 56 to 69: moderate risk;
- More than 70: low risk.

Table no. 2 Criteria of analysis for the country risk through the BERI method

Criteria	**Weighting coefficient**	**Number of points (from 0-4)**	**Total (maximum 100)**
Political stability of the debtor's country	3.0		
Attitude of the authorities in terms of foreign investments and repatriation of the profits	1.5		
Trends of nationalization	1.5		
Bureaucratic constraints	1.0		
Compliance of the contracts	1.5		
Quality of legislation and accounting rules	0.5		
Quality of infrastructure (communications and transport)	1.0		
Managerial competence of the debtor	1.0		
The country's growth	2.5		
Inflation	1.5		
Balance of payments	1.5		
The degree of convertibility of the local currency (currencies)	2.5		
Labour costs and productivity	2.0		
Short-term loans available on the local market	2.0		
Possibilities of long-term debt in local currency, mainly in the form of the capital increases	2.0		

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Source: *Lazarescu Sorin - Financial Rating pdf. p 10, http:// www.biblioteca-digitala.ase.ro*

c) Country risk analysis based on the firm value theory

More recent than previous approaches, the theory of the firm value, used as a tool for financial analysis including:

- Estimating the value of the foreign country's economy. In concordance with the theory of value, the economy of a foreign country is estimated by capitalization of the income flows, represented by the surplus of the trade balance;
- Comparing the economy value and the domestic debt. The economy value is the creditors' security. Creditors cannot benefit from a guarantee of 100% of the economy value, so a very useful risk indicator is the level of the external debt.

Rating Agencies

The rating agencies have occurred in 1909 to assess the bond issues of the American rail companies.

In the world there are many such evaluation institutions, but the strongest and whose qualifications matter most are the three American agencies, called "Big Three" (after the model "Big Four" for the consulting firm): Standard & Poor's, Moody's Investor Services and Fitch Ratings.

They are specialized in making ratings on states, establishing the hierarchy depending on which tables are required and imposed some attitudes in relation to each country. For governments, the agencies have a great power when they sell the securities or bonds.

For the governments, the agencies have a great power when they want to sell securities or bonds.

If a country has a good rating, the governments can sell bonds at good prices and it is important that State to keep the same rating, so that interest does not increase.

For example, Moody's has downgraded Ireland on the grounds that it is in the process not being able to get money from the foreign markets, given that investors are less interested in buying bonds from the Irish government. Unable to get money, Ireland could be at risk to be unable to pay.

Methodology used by Moody's is based on defined principles as:

- focus on quality;
- Compatibility with the overview of the subject, given by the opinion of the experts and famous agencies;
- consideration of the long-term analysis;
- level assessment and forecasts about the financial flows;
- understanding of the regional accounting practices (local);
- Examining the adverse scenarios.

Based on these principles, and in accordance with the theory of the bonds assessment, the Moody's agency used for the states compliance, the following long-term risk classes (TL):

Aaa – The bond with the best quality and the lowest investment risk;

Aa – High quality bonds in all respects;

A – Bonds with many favourable investment attributes with high average quality;

Baa – Medium quality bonds;

Ba – Bonds with the speculative elements;

B – Bonds that usually lacking the investment characteristics;

Caa – Bonds with low level;

Ca – Bonds largely speculative;

C – Bonds of the lowest category.

In turn, each of the nine classes can be subdivided by adding the digits 1-3. In the Moody's opinion, classes **Aaa–Baa** have an investment character, and the **Ba–C** has a speculative contained.

In evaluating on the short term (TS), Moody's uses four risk categories, namely:

- Prime 1 (P-1) - high payment capacity;
- Prime 2 (P-2) - strong payment capacity;
- Prime 3 (P-3) - acceptable payment capacity;
- Not Prime (NP) - other issuing quantities.

Rating Firms

Internationally, specialized firms in the country risk assessment were emerged and consolidated. They perform risk analysis, based on all forms of the risk, from the generalized country risk to the political risk.

Such a specialized firm is the Economist Intelligence Unit, which is specialized in providing services on the country risk, such as:

- Country Risk Service;
- Country Reports;
- Country Profiles;
- Country Forecasts;
- Business Operation Reports;
- Economist Intelligence Unit Business News Letters;
- Investing, Licensing and Trading Conditions Abroad;
- Financing Foreign Operations.

There are other specialized firms in the country risk analyzes, such as Dun and Bradstreet company, Frost and Sullivan Political Risk Service, International Business etc., all performing country risk analysis based on a number of criteria and factors that refers both to the mentioned risk, and the complexity of the social, political and economic situation of each country.

Romania's Rating Compared to some EU Countries

Standard and Poor's (S & P) agency has downgraded in January 2012, nine countries in the euro area, in the list being France, Italy, Spain, Austria and Portugal, and confirmed the ratings for seven countries, including among them Germany, the largest economy in the EU, the Netherlands, Belgium and Ireland.

Italy, Spain, Portugal and Cyprus were downgraded by two notches, while ratings for Austria, France, Malta, Slovakia and Slovenia were reduced by one step and the ratings for Germany, Finland, Netherlands, Luxembourg, Belgium, Estonia and Ireland were confirmed.

Agency gave up to the monitoring with negative implications for all ratings of the 16 states.

France, the second largest economy of the euro zone, was downgraded by one step, from “AAA” to “AA +” and lost for the first time the maximum rating possible.

For Italy and Spain, the demotion was by two steps from the “A” to “BBB +” and from “AA-” to “A”. Italy is the third largest economy in the euro area and Spain the fourth.

Austria's rating downs one step from “AAA” to “AA +”.

Portugal was downgraded from “BBB-” to “BB”, Cyprus from “BBB” to “BB +”, Malta from “A” to “A-”, Slovakia from “A +” to “A” and Slovenia from “AA-” to “A+”.

Germany, Netherlands, Finland and Luxembourg have held marks “AAA”, the maximum possible, while Belgium was maintained at “AA”.

Rating of Ireland was held at “BBB +”, and that of Estonia to “AA-”.

The analysts of the Agency consider that the agreement in December 2011 was only partially recognized as the source of the crisis in the euro area, namely that the financial problems as the main cause the excessive spending in the states from the periphery of the monetary union.

Consequently, the Agency believes that a reform process based only on the fiscal austerity is likely to cancel oneself, because the internal demand is in line to the growth consumer fears for the job security and income, thus eroding the tax receipts.

The refinancing costs for some states are likely to remain high and the credit market and economic growth will be recorded new slowing, while the pressure on the financing conditions could persist.

On the other hand, the analysts of the S&P agency believe that the monetary authorities from the euro area have a crucial role in preventing a collapse of the market confidence. European Central Bank (ECB) has successfully eased the conditions for guarantees, allowing an extensive range of the assets in the monetary operations and the monetary policy rate fell to the minimum record of 1%.

The most important, the ECB reduced the pressures for the short-term bank financing.

Investors have anticipated a downgrade of some countries in the euro area and investors on the stocks have already taken into account at least partially, the impact of such decisions. Besides the effect on borrowing costs of states, sovereign ratings have an impact on the qualifications of other issuers in these countries, such as banks.

A reduction in ratings of some countries from the euro area can lead to the downgrading of companies, signalling a higher risk to investors.

In Romania there are presented the large banks groups from the euro area, including Erste, Raiffeisen and Volksbank - in Austria, Société Générale - France, UniCredit - Italy and Millennium - Portugal.

While some countries in the euro area still retains its highest ratings from Fitch and Moody's, the benefit is more as image, because the investors usually take into account the lowest rating of an issuer from the three major rating agencies.

Moody's announced in December 2011 that will analyze the ratings of all countries in the European Union after the European leaders have not taken sufficient action to end the debt crisis, while Fitch analyzes the negative revisions for several countries that do not have the maximum ratings of “AAA”.

S & P assigns the “AAA” rating to the European Union since 1976.

The S & P agency downgraded the United States in August 2011, and, for the first time in the history, the misunderstandings between American politicians have threatened to push the country into inability to pay. The U.S.A rating was lowered one step from “AAA” to “AA +”.

Romania is currently rated “Baa3”, the last from the category recommended to the investors, with the stable outlook.

In the last two years, Romania has met all the conditions of the grant agreement (worth 5 billion Euros) with the IMF, EU and World Bank, even when was needed the politically unpopular measure, but positive for the country rating, such as, reduced the number of the employees and the wages in the public sector, reducing the social benefits and the VAT increase. These measures have lowered the budget deficit from 9% of GDP in 2008 to 4.4% estimated in 2011. Cutting the health costs would be the next step in reducing the future liabilities of the Government, the Moody's agency analysts consider.

Conclusions

In an economy seeking its own identity, the issue of the country risk assessment is a necessity.

The country risk indicator is an indicative indicator that reflects the economic performance and the political stability of a country.

The methods used in the analyzing country risk, such as Credit Risk International Methodology, is based on the analysis of a set of eight variables, Delphi and BERI are based on the analysis of the risk indicators and the country risk analysis start from the theory of value of the firm using as a tool the financial analysis.

The rating agencies are specialized in making ratings on the states, establishing the hierarchy into which are rankings and are required some attitudes in the relation to each country.

The rating companies perform risk analysis, based on all the forms of the risk, from the generalized country risk to the political risk.

Standard and Poor's (S & P) agency has downgraded in January 2012, nine countries in the euro area, in the list being France, Italy, Spain, Austria and Portugal, and confirmed the ratings for seven countries, including among them Germany, the largest economy in the EU, the Netherlands, Belgium and Ireland.

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