

Country Risk Analysis

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Summary and Conclusions

This study aims to give an overview of the state of the art with regard to country risk analysis. What can we conclude from our survey? We think that we can summarize and conclude our studies with the help of four major topics that have been discussed in this volume.

First, country risk has been approached from two theoretical points of view. Payment arrears and defaults can be caused by lack of resources so that countries and governments are unable to pay. Alternatively, redemption and interest payments are viewed as an economic problem. If the costs of repaying the debts exceed the benefits of repayment, default occurs. Then it is the unwillingness to pay that triggers the default. We have discussed both types of theories and have concluded that these are not mutually exclusive: in our view, the factors that cause the inability to pay are the same as the factors that cause the unwillingness to pay. If a number of economic indicators deteriorate in a country, the probability that the country is unable to fulfill its debt-service payments rises as will the benefit of default.

Second, empirical research has focused on a number of issues concerning country risk. First, empirical research has been focusing on the variables that can explain payment arrears and defaults. We conclude that quite a number of economic variables are able to explain payment arrears and defaults, *ex post*. The same variables however, show a bad record in forecasting the timing of payment arrears and defaults. Given a number of methodological problems, however, we conclude that it is quite unrealistic to expect precise forecasting of the timing of payment arrears and defaults. Using empirical indicators to determine appropriate risk premiums in financial contracts may be more feasible but leaves the issue of predicting crises unanswered. Second, a relatively new branch of empirical research investigates the relation between yield spreads and risk-related variables to determine country risk. Because yield spreads also fit in international portfolio models, we conclude that the latter branch offers a challenging new line of research where country risk can be integrated with portfolio analysis.

Third, country risk analysis is a growing business. From our survey of providers of country risk analyses we conclude that there is a large variety in country risk indicators. There are ratings and country reports. In addition, different types of financial assets are used to approach country risk. Finally, we show that subjective judgments are important in the assessment of country risk. A rating is rather an opinion on country risk than an objective measure of country risk. We argue however, that this subjectivity does not imply that the ratings are very volatile or sensitive to specific judgments.

Fourth, country risk and country risk assessment is of growing importance for investors and financial institutions. We have taken the example of the banking industry to sketch how supervisory institutions such as the Bank for International Settlements (BIS) and the Dutch Central Bank define supervision with regard to country risk and to sketch country risk management within the banks. Within this context, Basel II is the standard and according to Basel II banks can use self-developed country risk rating or country risk ratings from one of the providers to determine the risk of loans to foreign countries.

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