Country Risk

Economic Aspect

Introduction

- Investment in third worlds countries looks very much riskier than at home
  - The increased internationalization of investment in the last decade has raised the exposure of investors to risks associated with events in many different countries
- Concern and analysis of international risks have increased among investors
  - Improvements in collection & dissemination of data on foreign investment
  - Use statistical models to evaluate the safety of loans
- This article → microeconomic framework for analyzing equilibrium in international capital market

The principle

- Every investment (real & financial) is unique
  - Different expected profitability, safety & liquidity
  - Invest in country A has different characteristics than others → the choice of a country affects the business prospects
- Imperfect knowledge of a country's characteristics → create uncertainty
  - It can be reduced by research, although it still remains after gathering & analyzing relevant data
- Analyzing country risk must treat political & cultural factors as given
- Assume that governments of the country have observable & stable attitude toward foreigners, private property, & contracts
  - These are hard for investors to evaluate & are subject to unpredictable changes

Why do classify investments by countries?

1. Useful to identify a group of investments that are likely to have similar characteristics
   - The investments are subject to common sources of uncertainty
   - Sources of uncertainty: climate condition, population growth
2. The existence of nation states → a single country share the same government's jurisdiction
   - Government's policies determine investments' returns
   - Country risk associated with government policies & political events (war & revolution) → **sovereign risk**

Types of risks

Based on the nature/source of risks

1. Exogenous risk
   - Affected by factors beyond the investor's control
   - Ex. Changes in political events (war and revolution)
2. Endogenous risk
   - Derives from the strategic behavior of the government toward investors
   - Ex. The occurrence of economic costs and the loss of benefits due to hostile acts of government towards investors

Variables in country analysis

- Forecasting policies & political developments
  → Social, political, & cultural aspect
- Governments' treatment towards foreigners, private property, & contracts
  → economic aspect

Investments-distinctive variables

- **Direct investment** → implying controlling ownership of a physical investment or business abroad
  - Investors face the possibility that tax system or other legal aspects will change
  - Ex. Host government asks transfer of equity to its own nationals without full compensation (indigenization programs)
- **Indirect or portfolio investment** → in the form of a loan to an agent in the country
  - Re-scheduling, default, outright repudiation
  - If a loan is denominated in the currency of a foreign debtor → risk that exchange controls imposed by host country may prevent the conversion of foreign assets into the investor's own currency

Principle of investments abroad

- A country can attract foreign investment
  - If it can convince potential investors that they will have incentives to allow them earn competitive returns from the country, compared to others
  - The incentives should be strong enough to allow transfers of capital that equates rates of returns across borders
  - The weakness of a country's incentive to secure foreign investors from hostile acts creates distortions and deviations from a situation of perfect capital mobility

Methodology to analyze direct & indirect investment

- A country's government is a sovereign actor
  - Especially if it is unconstrained by constitutional safeguard → it has power to determine legal structure surrounding economic agreements
  - Governments are able to break contracts than are individuals
- Beware of the situation in which the country may prefer: the foreign investment takes place, but the country receives its proceeds, not the investors
  - Recipient's decision to honor contractual obligation is a sign for investment decision → before an investment has been made
  - Rational investors will not invest

Methodology to analyze direct & indirect investment

- Obsolescing bargain → a shift in their relative strength will lead to a subsequent renegotiation
  - This situation often arise, not irrational behaviors
  - Investors build a factory → the protection against expropriation is their monopoly over special knowledge. However, this knowledge one day becomes available to the country → expropriation is possible
  - Investors may anticipate take overs & then, construct smaller plants, employ labor-intensive technologies → recoup cost quickly
  - Both parties anticipate any renegotiations
- One factor protecting direct and indirect investments → the host government's incentive to maintain a reputation as a good place for future investment

Country risk: Default & repudiation

Recent trend in private investing abroad is financial lending & activities of banking syndicates

The most difficult informational problem is whether the borrower is complying with the loan contract

- Banks may roll over loans to avoid public admission of a default

Four reasons why a country may want to borrow in financial markets

1. **Consumption motive occurs** in a country whose income level varies widely. Borrowing allows a country to cut the level of consumption. The country may borrow in poor years, and repaying in good years to keep option the option of borrowing again in the future poor years.
2. If there is a large differential between domestic marginal product of capital, and the world cost of capital (**production or investment motives**)
3. **Adjustment motive** – when a country face sudden & unanticipated reductions in output supply, then borrowing permits a smoother transition
4. Provide liquidity to facilitate international transactions (**transaction motive**)

Public policy & country risk

Countries that unable to prevent repudiation & expropriation:

- They are less private capital
- Capital is cheap in the rest of the world relative to the productivity levels in those countries
- Capital-importing countries are the one who lose most, not the capital owners

In monopoly situation:

- If a host confronts a monopolistic investor, expropriation helps strengthen the host's position
- If foreign lenders do cartelized, the host can apply a respective repudiation

Expropriation

- Investment in extractive industries may be vulnerable to expropriation because it requires much expenditures
- There is very little an investor can do to prevent a host with technical capability from taking over by the government
- Consequently, companies with technical advantage & at discovery stage → more reluctant to prospect widely, preferring to produce less & to protect current operation
- Threat of expropriation may be more intense in the extractive industries than in manufacturing

Several public policies to discourage repudiations & expropriation

1. Information provision

- Providing information is free or not? Cost of providing information is independent of the number of individuals using it, information should be provided freely.
- While, cost of generating information should be publicly borne. International organization that provide information → IMF, World Bank, the UN

There are two types of information

- Information on the dependent variables (debts & foreign direct investments, the characteristics, the incidence of expropriations, repudiations, defaults, other hostile acts.
- Information relevant to decisions on financial & physical investments disseminated by international organization
- Researcher should take care the consistency of data across time

Several public policies to discourage repudiations & expropriation

2. Retaliation

Legislation in the US penalizes countries taking hostile actions against American companies in several ways:

- Prohibitions of bilateral foreign aid
- Exclusion from the generalized system of trade preferences
- The opposition of US representatives to multilateral aid

Other counter attacks

- International institution can also organize embargoes & enforcing cohesion among private investors
- Countries may use political influence with the host's gov't
- An increase in the penalty may lower the country's welfare even though its credit ceiling is raised
- Cutting of foreign aid has been generally ineffective

Several public policies to discourage repudiations & expropriation

3. Insurance

Overseas Private Investment Corporation provides insurance to eligible private investors against various hostile acts

- Maximum 75% of the investment
- Export-Import bank provides similar coverage to American exporters of tangible goods
- This insurance extends to financial obligations for which export constitute security

Other counter attacks

- One difficulty → moral hazard that undermines the usefulness of institutions that provide insurances
- Insurance scheme can complement retaliatory provisions. Ex. By transferring the burden of default from private investors to their governments, these arrangement can strengthen the resolve of these governments to impose sanctions