

# COUNTRY RISK AND ITS EFFECT ON INTERNATIONAL FINANCE MANAGEMENT

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***Abstract:** The purpose of this study was to show the effect of current country risk on international finance. The findings of this exploratory study shows that country risk considerably affect the operations of international finance but this correlation cannot be stated with sufficient level of confidence. Data and analysis of the study give us a notion that there are effects of country risk on international finance and that effect is negatively correlated that means when the country risk tends to be higher as in turn making the country rating lower, the international finance is negatively affected. In contrary, when the country risk is lower giving a higher country rating, international finance is positively affected. The result shown gives us perception that due to political instability, high interest rate, high inflation rate, and frequently volatile currency exchange rate cause disturbance in the normal operations of the international trade that reduce the country risk rating score and in turn the global international finance gets hampered.*

***Keywords:** Country Risk, International Finance, Country Risk Effect, Risk Analysis, Norway, Venezuela*

## **Introduction:**

Country risk is not a new phenomenon rather it has a long historical background. Many years ago, country risk for international financing has become an issue for investors with the fear of possibility of non-performance. At 1970s, OPEC member countries enjoyed financial soundness and reserved their money in the international banking when the financial institutions were not considering country risk instead they focused on cross border transactions basically in developing countries. In many cases, they made contract for credit agreements without regular attention. In 1980s, many countries like Mexico, Brazil, Poland, Russia, Turkey, Argentina, Asia faced huge losses specifically USA top ten bank invested more than US\$ 50 billion in Latin America due to international banking system for their investors. After that, financial institutions forcefully started considering risk policies, credit procedures, and new methods (Ribeiro, 2001). Calvo et al. (1993), Fernandez-Arias (1996), Taylor and Sarno (1997), Kim (2000) stated that in 1990s, there held an expressive flow of capital in forms of investments in bonds, share, and direct investment which reverted to 1980s and in this context, an essential determinant in international capital flows dynamics called country risk revealed. It has generally two elements, one is domestic risk and the other is external risk where domestic risk is the specific country risk determinants such as economic fundamentals including fiscal and

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balance of payments situation, the stock of international reserves, the real growth rate of the economy and the inflation rate, as well as external risk includes international market factors mostly represented by risk free rate of interest, contagion effects of financial crises and degree of international investor risk aversion (as cited in Teixeira, Klotzle & Ness Jr., 2008). Country risk has been regarded as an important part of investigation for financial institutions, rating agencies, multinational companies, and financial market regulators after the Latin American Debt Crisis of the early 1980s (Iranzo, 2008). There are thousands of websites built for rating country risks for example in China, first rating agency evolved in 1988 where now there are more than 50 dedicated in this field (Iliescu & Dinu, 2011). Mascarenhas (1982), Milliken (1987), Ring, Lenway, and Govekar (1990) stated in their study that a business firm that wants to enter into international financial market should initially segment and select appropriate targets and perform analysis for deciding which markets to enter. In this case, it has to conduct global research to resolve issues such as inaccurate data source, complexity of interactive influences, vague meaning of terms, measurement inaccuracy, environmental forces uncertainty, inability to classify occurring events accurately, and subjectivity to decision-making process (as cited in Levy & Yoon, 1996). In context of imperfect global goods supply, the domestic institutions and autonomy are important for smaller players that would gain services in global competition and maintenance of freedom of action (Ocampo, 1999).

***Objectives of the study:***

The objective of this study is to analyze in depth the current country risk and give an overview for the effect of the country risk on international finance upon which business decision makers can make better decision on financing in international arena. The study seeks to answer the question: Is there any relationship between current country risk and international finance? If so, how much intense the relation is?

***Methodology of the study:***

This is an exploratory study based solely on secondary data. These data are based on the internet, annual reports of different years, different financial websites, journal articles, newspapers, books etc. of different periods. These data were both quantitative and qualitative in nature used to prepare the whole report. This study extends the existing literature analyzing systematic pattern of country risk and its impact on financial market. The findings made based on the existing literature, providing judgment on data comparison in relation to different factors affected by risk of country perceived by different risk rating agency. The result is not absolute but subjective as the researcher used to some extent assumptions.

In this study, the term *country risk* is used to mean “probability that may occur due to adverse situation of the buyer’s country for the inability of the import payment resulting in financial loss. It is the aspect that negatively influences foreign investment which varies country to country”. According to forextraders (2015) the it is the probability that changes in the business environment in another country where people are doing business may adversely impact their operations or payment for imports resulting in a financial loss

(*"What Is Country Risk"*, 2015, October 11). According to Investopedia (2003), "Country risk is a collection of risks associated with investing in a foreign country. These risks include political risk, exchange rate risk, economic risk, sovereign risk and transfer risk, which are the risk of capital being locked up or frozen by government action". The dictionary definition of the term *sovereign risk* is "Probability that the government of a country (or an agency backed by the government) will refuse to comply with the terms of a loan agreement during economically difficult or politically volatile times. Although sovereign nations don't "go broke," they can assert their independence in any manner they choose, and cannot be sued without their assent. Sovereign risk was a significant factor during 1970s after the oil shock when Argentina and Mexico almost defaulted on their loans which had to be rescheduled" (*"What is sovereign risk?"*, n.d.). In case of any financial risk and return model, equity risk premium is considered as the central component and key input in corporate finance and valuation for estimating cost of equity and capital (Damodaran, 2016). The country risk premium (CRP) refers to the additional risk for investing in international market instead domestic one which is normally higher for developing country than developed markets (*"Country Risk Premium (CRP) Definition, Investopedia"*, 2009). According to Damodaran (2015, March), the *equity risk premium* is "the premium that investors demand for the average risk investment, and by extension, the discount that they apply to expected cash flows with average risk. When equity risk premiums rise, investors are charging a higher price for risk and will therefore pay lower prices for the same set of risky expected cash flows".

### *Organization*

The rest of the study is organized as literature review of definitional terms, country risk, international finance, financial crisis, country risk effect; then the current country risk is described, then the subsequent part explains the country risk impact on international finance and finally the conclusion made.

### *Significance*

The concept of country risk and international finance is well recognized. There is no country which is out of international financing although it varies country to country for a number of reasons. These reasons can be assessed by the score of country risk if properly measured. The widely discussed topics country risk and international finance make sense the importance of doing research to see the impact of country risk on international finance for any country.

### **Review of Literature:**

#### *Ins and outs of Country Risk*

The risk is the notion that every entity has to face and there is no entity that does not face the fact of risk at their activity. Due to globalization process, significant risk of multinational corporations for making decision rises and before making decision they tend to anticipate all the potential risks that can occur in host country. Country risk occurs by sovereignty and transfer/convertibility risk. The direct and indirect spread of potential

effects from FDI is wide that affects both domestic country and investors (Petrović & Stanković, 2016). Country rating importance can be assumed by overseeing the number of country risk rating agencies worldwide such as Euromoney, Economist intelligence unit, international country risk guide, Moody's, Standard and poor's, Institutional investor, political risk services etc. These agencies employ different methods of qualitative and quantitative information of economic, financial and political risk measures to associate into a composite risk ratings which is compiled by the international country risk guide which can be regarded as the only agency for providing consistent and detailed monthly data for a large number of countries over an extended period of time (Hoti & McAleer, 2002). There exist a number of discrete methods for assessing country risk including scoring models, analytical hierarchy process, subjective interaction by deliberating experts, statistical designing using regression or factor analysis, and simulation (Levy & Yoon, 1996). Teixeira, Klotzle & Ness Jr. (2008) analyzing in the period 1992 to 2003 said that in addition to the external component, three domestic factors namely public debt/GDP ratio, primary surplus/GDP ratio and international reserves/GDP affect the country risk. These same variables, with exception of the primary surplus, are also related with the specific country risk. Country risk is influenced by the deviations of the domestic economic variables from their long run tendencies in different points of time. However, if we assume that the intensity and direction of those deviations depend on external conditions, the results show that, in the long run, the external scenario has the greatest influence over the country risk. The period includes several breaks that should be considered, such as periods of fixed and floating exchange rate, hyperinflation and stabilization, external shocks, capital market and economic reforms. In the period 1992-2003, country risk of Brazil analyzed by internal economic determinants, intensity of global risk aversion, country risk minus external components (Teixeira, Klotzle & Ness Jr., 2008). Euromoney Country Risk (2013) evaluated investment risk of 186 countries across 15 criteria (or factors) to determine the risks of default on a bond, showing direct investment or to global business relations (70%), by polling more than 400 international economists and other risk experts. Averaging qualitative scores and combining three basic values of ECR (30%) on 100 point scale where, 100 means safest and 0 means riskiest. Factors considered includes three qualitative expert opinions are political risk (30%), economic performance (30%) and structural assessment (10%) and three quantitative values are debt indicators (10%), credit ratings (10%) and access to bank finance/capital markets(10%). The qualitative average scores are political 43%, economic 43% and structural 14%. Credit ratings the higher the average value, the better. They posited that the aggregation of three indicators of Euromoney country risk index, European economic sustainability index and Aggregate value of state index of 27 EU countries offer the possibility of comparing and benchmarking of each country according to the complex valuation of main risk drivers (as cited in Stankeviciene, Sviderskė & Miečinskienė, 2014). Moody's and Standard and Poor's rating agencies explained by a small number of well-defined criteria appeared to weigh similarly. They found the market as gauged by sovereign debt yields the sovereign credit risk rankings by the two agencies. To understand sovereign debt, traditional concept of solvency and liquidity has little help. Creditors cannot seize the borrowers' assets; again borrowers' net worth is not relevant to determine the recovery of loan

amount. Borrower should be able to meet debt-service obligations to borrow. Enforcement is regarded as a problem in international lending. Sovereign ratings are important not only because some of the largest issuers in the international capital markets are national governments, but also because these assessments affect the ratings assigned to borrowers of the same nationality. Determinants of sovereign ratings are per capita income, GDP growth, inflation, fiscal balance, external balance, external debt, economic development, default history. A high per capita income appears to be closely related to high ratings where lower inflation and lower external debt are also consistently related to higher ratings (Cantor & Packer, 1996, October). Canuto, Dos Santos & De Sá Porto, (2004) suggested emerging economies to make efforts to seek improvements in earning higher sovereign ratings. The sovereign debt crisis in Europe has highlighted the role of country risk premia as a link between countries' fiscal and external balances, financial conditions and monetary policy. Inflation targeting (IT) reduces the risk premium, both through adoption of the IT regime, and through the observed track record in stabilizing inflation (Fouejieu A. & Roger, 2013). During period 2000-2005 developing countries have grown 5.3% at an annual rate and IMF reported 8.1% in 2007 and 7.4% in 2008. It was seen that world poverty especially in emerging Asia when 27.9% people were living on earning less than US\$ 1 in 1990 which in 2002 that rate dropped to 21.1% and in 2015 it was 10.2%. In 2000, world enjoyed 58% democratic political system which was 31% in 1950. According to OECD data the world country risk during 1999-2007, upgrades in country risk rating was more than doubled than number of downgrades that was a substantial improvement worldwide (Iranzo, 2008). Country risk cannot be diversified away completely, it can be just eliminated through diversifying equities of multinational companies across many countries that should be come from company's operations making it critical element of valuation. Estimating country risk premium default spread on government bond issued by that country, a premium obtained by scaling up the equity risk premium by the volatility of country equity relative to the US equity market and a melded premium where the default spread on the country bond is adjusted for the higher volatility of the equity market (Damodaran, 2015, July). In the global market along with other sectors, construction firms also have been facing high competition, uncertainty, and risk in domestic country and host country. These risks have effect on its profitability of international contractors. Most important risk factors can be determined for international construction firms are political instability, law and regulation, cultural differences, exchange rate risk, inflation, tax discrimination, language barrier, expropriation, corruption and bribery, societal conflicts, force majeure etc. (Aydogan & Köksal, 2014). The relationship between political activity and international investors has become acute in case of economic and financial crisis. Looking at the political risk may help in developing tools to get more reliable and refined assessment (Sottilotta, 2013). Global risks are interconnected as well it has a systematic impact to manage this risk, it is needed to realize the measure and predict the interdependencies among risks using traditional risk management tools with new concepts generated for uncertain environment. If these risks are not properly identified, their economic, social and political fallouts could be far-reaching. To tighten global resilience, it requires overcoming challenges via international cooperation among government, civil society and business (World Economic Forum, 2014).

*International Finance*

There has been divergence between approaches in financializing countries like US, UK and export-oriented countries like Germany, East Asian countries and this interdependence of the financializing and export-oriented variations of capitalism contributed to the international financial crises for the past four decades. This capitalism imbalance became obstacle to global cooperation in regulating finance. Faced with the “trilemma of economic policies,” the financialized and export-oriented variants of capitalism have chosen different combinations of macroeconomic policies, currency policies, and the regulation of financial flows and financial firms. This divergence has led to conflicting preferences with regard to international cooperation to regulate finance (Kalinowski, 2011). International finance was built upon new architecture during 1990s with recurring bouts of global instability which focused on structural deficiencies of capital market of developing countries and international transactions with these countries. Industrialized countries financial markets fuel the global system and the instability of these markets create threats to the system and these markets grown increasingly fragile as a result of financial innovation and deregulation (Palley, 2000). The financial market is beset by legal uncertainty supported by the regulatory and legal framework where conflicts and inconsistencies emerged in national rules (Financial Markets Law Committee, 2015). Capital flows have surged in volume, in both the developed and the developing world, creating new opportunities for economic benefit and again difficult challenges for policymakers (Obstfeld & Taylor, 2004). It is argued that the recent focus on better understanding of high-frequency financial returns data and decision making at the market microstructure level are promising avenues for understanding the transmission of shocks across markets and countries (Dungey & Tambakis, 2016). Within 20 years after UNU-WIDER founded, there have many changes in international finance and more amount of capital flowing across the world for getting superior investment returns (Addison, 2006). USA is the largest beneficent of FDI in the aspect of globalization which has economic, social, and political interests at stake in developing international policies regarding FDI (Hornbeck & Irace, 2013). The countries in regional and bilateral mutual recognition arrangement such as between Europe and ASEAN are less effective where one seeks to improve regulatory standards in other. Since 1970s, the rapid globalization of finance taken place against background of decentralized legal framework primarily shaped by national regulators (Verdier, 2011). It is suggested that international financial integration will likely remain constrained by country and firm characteristics (Claessens & Schmukler, 2007). The global financial system is gigantic where private-public partnerships finance for projects which consists of different kinds of financial institutions, financial markets of stocks, bonds, commodities and derivatives. In 2012, global financial markets traded US\$ 54 trillion on stocks, US\$ 80 trillion on bonds securities, US\$ 26 trillion on mutual fund industry, US\$ 2 trillion on exchange securities and in 2013, the global financial traded of amount US\$ 70 trillion. The global financial system promotes economic growth by creation of money, promoting trade, facilitating risk management, mobilizing resources, increasing opportunities which are highly interconnected. Global financial market helps raising firms’ capital, promotes global trade though financing outside banking system by building financial architecture (Thakor, 2015).

### *Financial Crisis*

Financial market integration has followed a U-shaped pattern which declined in the mid of twentieth century from the high levels achieved before 1914 to the similar as today. During 1970s and 1980s, there took macro stability restoration. It is broader and deeper than pre-1914. Financial crisis has always part of scene. The effect of these crises was worse in emerging countries. Bordo and Schwartz (1998) said that before 1914, international rescues involved temporary loans between central banks on the basis of sound collateral, on commercial terms. In the twentieth century, until the past two decades, rescues have been made by groups of countries, the IMF and the BIS, to countries facing temporary current account reversals (Bordo, 2000). When financial crisis started at USA and in financial institutions of OECD countries in 2007, it turned into world economic recession when developing and emerging economies especially in the South also affected through trade channels and workers' falling remittances which were to some cases as severe as the developed countries. The effect of the worldwide recession since World war second and first, world GDP reduced by 0.6% in 2009 (Dullien, 2010). Financial crisis of 2008 triggered a sharp global contraction of real activity as well as transformed international economic environment when no country market left unaffected virtually. That crisis highlighted importance of well understanding of international transmission channels and efficient policy responses in the presence of cross-country linkages and dysfunctional financial markets (Bussière, Imbs, Kollmann & Rancièrè, 2013). The tradeoff between global investment risk and return is focused to achieve stakeholders' wealth maximization where in international financial management they spread all over the world (Tiwari, n.d.). To cope with the global financial crisis, countries tried hard but worst was not over when investment banks collapsed, rescue packages drawn up, interest rates cut down, shipping rates declined (Overseas Development Institute, 2008). The US macroeconomic policy and regulatory might bear lion's share of the blame of the crisis but it is a matter of fact that China's high national saving rate and the policy of tightly managing external value by providing cheap goods and financing for those goods (Prasad, 2009).

### *Country Risk, Financial Globalization and Overall Effect*

For the global competition, corporate managers driving in long distant, unfamiliar markets search for ways to minimize uncertainty and formulating their strategies, they rely on country risk which is an objective, fact-finding technique. Currency fluctuations found analyzing 11 measures of 17 countries' risks as the surrogate of the overall country risk and predicting the actual risks, commercial risk measures are very poor again, it is questionable to the usefulness of these measures and why managers choose to use them (Oetzel, Bettis & Zenner, 2001). The capital asset pricing model requires three inputs to compute expected returns including risk free rate, expected risk premium, and beta for an asset where beta is estimated by most practitioners by regression asset returns against index of stock with the slope of regression being the beta of the asset (Damodaran, n.d.). Ilescu & Dinu (2011) found in their study based on statistical data of Romania rating and foreign direct investment (FDI) value from 2000 to 2010 that there exists indirect connection with the statistics that when rating falls, FDI reduced by 1173.76 billion

Euros, a 27.1% FDI average for 11 years. On the other hand, they found FDI influence of 0.05% on Romania rating demonstrating interdependence between the two indicators although with a lower correlation. Their qualitative analysis showed arguments which support reduced rating importance to the credibility of rating agencies that pointed its weak side. Revoltella, Mucci & Mihaljek (2010) found in their study that normally, sovereign credit default swaps (CDS) spreads are useful source of country risk information but during crisis in September 2008 to March 2009, they lead to underpricing or overpricing in case of excessively low or high risk aversion. The authors tested an alternative measure of country risk premium taken to reflect the basic component of country risk based on the long-term relationship between external rating and CDS spreads and said that the adverse market sentiment was the key driver to the high increase in sovereign CDS spreads of countries faced the crisis. During the global financial crises in 1997-1998 for Asia and 2008-2009 for USA, UK, Australia, and Singapore, the researchers did not find any significant impact on returns although both crises increased the stock return volatilities significantly across the four markets. They also found the most crucial market that impacted on the smaller economies volatilities like Australia in USA stock market. A high degree of time-varying co-volatility among these markets indicates that investors would be highly unlikely to benefit from diversifying their financial portfolio by acquiring stocks within these four countries only (Karunanayake, Valadkhani & O'brien). However, only some firms, sectors and countries most often get advantage as for global financial system governments lose policy instruments. There are scopes to form international financial policy cooperation (Schmukler, 2004). There exists a threshold effect of the relationship between financial globalization and economic growth. Financial integration in developing countries can reduce macroeconomic volatility which should be approached cautiously with good institutions and macroeconomic framework (Prasad, 2003). FDI inflow is affected by the political risk although does not by initial level other than financial risks and FDI inflow is negatively associated with delays in payment, contract expropriation and corruption in developing countries where significant improvement leads to increase in FDI inflow (Baek & Qian, n.d.; Hayakawa, Kimura & Lee, 2013). The global financial shocks explained about 20% of movements in the country spread and the aggregate activity in emerging countries where country spread shocks explain about 15% of the business cycles. Interdependence between economic activity and the country spread is a key mechanism through which global financial shocks are transmitted to emerging economies (Akinci, 2013). Financial development strongly negatively affected by political instability with its variation of a primary determinant of differences in financial development around the world (Roe & Siegel, 2011). In time of high volatility, most of the markets move together however, diversification of international stock indices can reduce risk (Agati, 2007). There are plenty of risks beyond planning and assessment capabilities of experts of risk and decision-makers. To seize the opportunities in the highly changing strategic environments by coping with the potential challenges, business concerns must continue investing in their ability and learn to adapt as well as build more resilient systems (Toma, Chiriță & Șarpe, 2011). The variation in country risk of India is highly correlated with changes in FDI flows, interest rates (monetary policy), exchange rates and the unemployment rate. It has also effect of political risk on overall country risk (Basu, Deepthi & Reddy, 2011).



Lower stock returns found in the days around a full moon than around a new moon at the magnitude of difference in return was 3-5% per annum on global portfolios analysis that difference was not due to changes in stock market volatility or trading volumes (Zhu, 2009). Using data from International Country Risk Guide (ICRG), it is found that government stability and absence of internal conflicts beside financial factors and corruption have high influence on FDI inflow and at the same time, higher returns to investments are linked with the improvements of the major two components (Sissani & Belkacem, 2014).

### **Current Country Risk**

*Foreign Direct Investment (FDI) Inflow* means “the value of inward direct investment made by non-resident investors in the reporting economy where FDI net outflows are the value of outward direct investment made by the residents of the reporting economy to external economies” (FDI, n.d.). *World Investment Report 2015* (2015) reported the FDI inflows of 2014 as US\$ 1.23 trillion. According to the *International Country Risk Guide* (2015), country risk for contemporary business world based on 140 countries, global country risk rating for January, 2015 is 68 which were 69 in February, 2014. Again, the maximum rating found 89.8 of Switzerland and minimum 37.5 of Somalia. The other good ranked countries according to country risk rating are Norway- 88.5, Singapore- 86.8, Luxembourg- 85.8, Brunei- 85.0, Canada, Germany, Taiwan- 83.0, United Arab Emirates- 82.8, Qatar- 82.3, New Zealand- 82.0, Korea, Republic, Kuwait, Sweden- 81.5, Hong Kong, Oman- 81.0, Denmark- 80.5; on the other hand, the lowest ratings particularly for Syria- 41.3, Liberia- 49.3, Sudan- 50.0, Guinea- 50.5, Ukraine- 54.0, Zimbabwe- 54.5, Niger- 54.5, Venezuela- 54.8, Mozambique- 55.8, Korea, D.P.R.- 55.8, Congo, Dem. Republic- 56.0, Belarus- 57.3, Uganda- 57.8, Pakistan- 58.3, Togo- 59.0, Egypt- 59.0, Libya- 59.3, Ethiopia- 59.3, Yemen, Republic- 59.5, Mali- 59.5 and more. *Risk Index, PRS Group* (2015, May 18) publishes Political Risk Index (PRI) consolidating the probabilities of three regimes based on forecasting risk of doing business in 100 country reports and converts the number into letter grades scale from A+ (plus) to D- (minus) for three investment areas of Financial transfers (e.g., banking and lending), Exports to the host country market, Foreign direct investment (e.g. retail, manufacturing, mining). 17 risk components from the PRS methodology including turmoil, financial transfer, direct investment, and export markets. The Index provides a basic, convenient way to compare countries directly. According to PRI report, the average global country risk of April, 2015 is 73 that were 73, 72, 72, 72, and 72 in the period 2014, 2013, 2012, 2011 and 2010 respectively. According to April, 2015 Risk rating, the highest rating found 93 for Canada and Hong Kong, Singapore- 92, Norway, Taiwan- 90, United Arab Emirates- 89, Austria, Czech Republic, Australia- 88, Sweden- 87, New Zealand, Finland, Switzerland, United Kingdom- 86, Netherlands, Japan- 85, United States, Chile, Oman, Botswana- 84, where lowest 43 for Zimbabwe; again, 44 for Syria, Libya, for Venezuela- 45, Iraq, Sudan- 50, Russia, Iran- 52, Congo DR- 53, Pakistan, Guinea- 54, Ecuador- 55, Cuba, Ukraine- 56, Egypt- 58, Nigeria- 59 and like. Damodaran (2016, January) conducted an in-depth analysis regarding country risk. For the purpose of estimating equity risk premium, the author used mature market premium

and additional country risk premium of the risk of the country in question. The author estimated the country risk premium by following 5 separate steps including estimation of *Step-1*, mature market risk premium by computing implied equity risk premium for the S&P 500; *Step-2*, default spread of the country in question based on averaging Moody's local currency sovereign rating and CDS country spread; *Step-3*, converting default spread into country risk premium; *Step-4*, total equity risk premium adding mature market premium to country risk premium from step 1 and 3 respectively; and *Step-5*, computing regional average and regional weighted averages using World Bank GDP most recent data. He estimated the long term country risk premium using Moody's country rating and estimating default spread of that rating over treasury bond rate which is the added country risk premium. Again, he added this default spread to the historical risk premium for a mature equity market to estimate the total risk premium. Equity country risk premium is generally greater than country's default spread in short term and the author used the global average of equity to bond market volatility of 1.5 for estimating the equity country risk premium. A table showing the current country risk premium is given below:

**Table-1: Regional Simple Averages**

Row Labels	Average of Adj. Default Spread	Average of Country Risk Premium	Average of Total Risk Premium	Average of Corporate Tax Rate
Africa	4.24%	6.35%	12.35%	28.18%
Asia	2.43%	3.65%	9.65%	22.74%
Australia & New Zealand	1.50%	2.25%	8.25%	28.33%
Caribbean	3.49%	5.23%	11.23%	20.56%
Central and South America	3.66%	5.50%	11.50%	27.04%
Eastern Europe & Russia	2.93%	4.39%	10.39%	16.35%
Middle East	1.61%	2.42%	8.42%	10.77%
North America	0.00%	0.00%	6.00%	26.50%
Western Europe	1.29%	1.93%	7.93%	20.34%
Grand Total	2.74%	4.12%	10.12%	21.55%

**Source:** Damodaran (2016, January)

### Country Risk Impact on International Finance

According to rating agency risk are two kinds. One is calculated risk and other is uncalculated risk. Calculated risk is better than uncalculated risk. Country risk matter is not that much plain to calculate. Calculated risk can diversify. While uncalculated risk is hard to diversify. Consequently, it is crucial to identify the calculated and uncalculated risk. Uncalculated risk increases the risk premium in international finances. Domestic and geopolitical risk is responsible for uncalculated risk. Accounting risk impact the book

value considering calculated risk. For the purpose of showing the effect of country risk in international finance, the researcher chooses two countries in reverse characteristics in case of risk specially using calculated risk where one, Norway found from different rating agencies (on an average) as within the world 5 top ranked countries and the other, Venezuela seen within the bottom 10 countries of the country risk rating ranking. Some of the rating is as follows:

**Table-2: The equity risk premium for Norway**

Country Risk Rating Agency	Norway	
Moody's sovereign rating	Aaa	Local currency
S&P sovereign rating	AAA	Local currency
CDS spread	0.35%	
Excess CDS spread (over US CDS)	0.00%	
Country Default Spread (based on rating)	0.00%	
Country Risk Premium (Rating)	0.00%	
Equity Risk Premium (Rating)	6.25%	
Country Risk Premium (CDS)	0.00%	
Equity Risk Premium (CDS)	6.25%	

*Source:* Damodaran (2016, January)

**Table-3: Country Risk, Ranked By Composite Risk Rating**

Rank in 01/15	Country	Composite Risk Rating 01/15	Composite Risk Rating 02/14	01/15 versus 02/14	Rank in 02/14
2	Norway	88.5	90.8	-2.3	1

*Source:* International Country Risk Guide, 2015

**Table-4: The equity risk premium for Venezuela**

Country Risk Rating Agency	Venezuela	
Moody's sovereign rating	Caa3	Local currency
S&P sovereign rating	CCC	Local currency
Country Default Spread (based on rating)	11.08%	
Country Risk Premium (Rating)	15.44%	
Equity Risk Premium (Rating)	21.69%	

*Source:* Damodaran (2016, January)

**Table-5: Country Risk, Ranked By Composite Risk Rating**

Rank in 01/15	Country	Composite Risk Rating 01/15	Composite Risk Rating 02/14	01/15 versus 02/14	Rank in 02/14
132	Venezuela	54.8	54.3	0.5	132

*Source:* International Country Risk Guide, 2015

The following two tables generated to see the difference between Norway and Venezuela according to financial data:

**Table-6: Norway Country Risk Index vs. Financial Effect (E.g., 2015 data are estimated)**

Subject Descriptor	2010	2011	2012	2013	2014	2015
Political Risk Index (PRI)	87.00	87.00	88.00	89.00	91.00	90.00
% Change	-1.15	0.00	0.01	0.01	0.02	-0.01
Gross domestic product, current prices (US\$ in Billion)	428.53	498.16	509.71	522.35	499.82	397.59
Gross domestic product based on purchasing-power-parity (PPP) share of world total (%)	0.34	0.33	0.33	0.32	0.32	0.31
Total investment (% of GDP)	25.36	25.84	26.53	28.29	28.43	28.21
Gross national savings (% of GDP)	36.27	38.19	38.96	38.32	37.86	35.18
Volume of imports of goods and services (%)	8.31	3.96	3.15	4.33	1.89	1.65
Volume of exports of goods and services (%)	0.66	-0.77	1.44	-2.97	2.71	1.48
General government revenue (US\$ in Billion)	12,221.72	14,079.80	15,063.62	15,359.71	15,390.38	15,259.93
% Change of GDP	55.01	56.20	55.78	54.37	53.73	53.90
General government net lending/borrowing	2,423.67	3,304.85	3,657.37	3,118.00	2,531.52	1,700.98

<b>Subject Descriptor</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
(US\$ in Billion)						
% Change of GDP	10.91	13.19	13.54	11.04	8.84	6.01
Current account balance (US\$ in Billion)	46.77	61.54	63.36	52.38	47.13	27.73
% Change of GDP	10.92	12.35	12.43	10.03	9.43	6.97

**Source:** International Monetary Fund (IMF), World Economic Outlook Database, October 2015

The table shown above specifies the Norway risk rating for 6 years ranging from 2010 to 2015 where the lowest rating was 87 in 2010 and 2011 and highest in 2014. The financial data which is related to and/or influenced by international finance show that when the rating was low, the country's GDP, total investment, volume of export of goods and services, government revenue are relatively low than when the rating was high although in some cases, the scenario is just opposite.

**Table-7: Venezuela Country Risk Index vs. Financial Effect (E.g., 2015 data are estimated)**

<b>Subject Descriptor</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Political Risk Index (PRI)	48.00	48.00	47.00	45.00	42.00	45.00
% Change	4.17	0.00	-2.13	-4.44	-7.14	6.67
Gross domestic product, current prices (US\$ in Billion)	271.96	297.64	298.38	218.43	206.25	131.86
Gross domestic product based on purchasing-power-parity (PPP) share of world total (%)	0.53	0.53	0.55	0.54	0.50	0.43
Total investment (% of GDP)	21.97	23.07	26.60	20.87	19.03	17.85
Gross national savings (% of GDP)	24.95	30.78	29.49	22.35	21.21	17.41
Volume of imports of goods and services (%)	-2.89	15.39	24.40	-9.69	-17.78	-38.61
Volume of exports of goods and services (%)	-12.88	4.67	1.59	-6.17	-4.27	-7.00
General government revenue (US\$ in Billion)	114.76	201.35	209.73	276.39	444.65	446.95
% Change	21.22	27.88	23.53	23.44	28.40	18.11
General government net lending/borrowing (US\$ in Billion)	-56.06	-83.71	-146.92	-170.51	-234.17	-601.33
% Change of GDP	-10.36	-11.59	-16.48	-14.46	-14.96	-24.36
Current account balance (US\$ in Billion)	8.81	24.39	11.02	5.33	10.89	-3.97
% Change of GDP	3.24	8.19	3.69	2.44	5.28	-3.01

**Source:** International Monetary Fund (IMF), World Economic Outlook Database, October 2015

In case of Venezuela, the highest rating found in 2010 and 2011 particularly with the rating of 48 and lowest in 2014, the rating of 42. The above table shows when the rating was higher, the country's GDP in current prices and PPP of world share, total investment, gross savings, net borrowing, and change in GDP were better than when the rating was lowest which is related to country's international finance but the opposite behavior also seen. Among these financial variables, some factors are related with international financing. If we compare the two country's financial data, we can see the effect of country risk on international finance for which there is seen a considerably greater difference and in most of the cases, for these great differences country risk is undoubtedly liable. Thus the researcher advocates on the country risk effect on international financing.

**Table-8: Global Country Risk Rating and its Effect on International Finance**

Global	2015	2014	2013	2012	2011	2010	2009
Country Risk Rating	73.00	73.00	72.00	72.00	72.00	72.00	71.00
% Change	0.00	1.37	0.00	0.00	0.00	1.39	
FDI Inflow (US\$ in trillion)	1.37	1.23	1.47	1.40	1.56	1.33	1.19
% Change	10.22	-19.51	4.76	-11.43	14.74	10.53	-25.21
% Change of World Export Propensity		30.35	30.70	30.64	30.79	28.81	26.63
% Change World Export		1.11	2.93	1.51	15.55	15.75	-25.02
% Change World Import		0.15	1.64	0.87	17.22	17.88	-30.27

**Source:** World Bank (2014), UNCTAD (2015), Risk Index (2015), PRS Group (2015, May)

The aforementioned table shows that in case of global average country risk rating, the highest rating score is 73 found in 2014 and 2015 and lowest 71 in 2009. If we compare the data of 2014 and 2009, we can see that the global FDI inflow of 2014 was US\$ 1.23 trillion when it was 1.19 trillion in 2009 that is a 3.25% increase in the period of better global rating score. Again, in 2014 percentage change of World export propensity, World export and World import are relatively good than 2009 when global average country rating was lower which are generally influenced by international finance.

### **Concluding Remarks and Implications:**

From these data and analysis in the previous section, it gives us a notion that there exist effects of country risk on international finance. And that effect is negatively correlated that means when the country risk tends to be higher as in turn making the country rating lower, the international finance is negatively affected. In contrary, when the country risk is lower giving a higher country rating, international finance is positively affected. After analyzing the data estimation by rating agency and world economic data, this study finds that there exists considerable effect of country risk on international financing but that relationship is not significant to some extent. In case of financing in a specific region where may pose significant risk potentiality, investors as well as financial decision

makers of any country, sector, or business organizations should consider the risk rating prepared by well recognized agency but in general, where there found no significant changes especially in developed countries, they can invest or conduct business undoubtedly. Occasionally, one country's contingent liabilities may lead high risk premium in international finance. Still that country possesses growth potentiality. Cushion like huge foreign exchange reserves for instance can reduce country risk premium in international finance. At the end, this study will help business analyst and researcher finding solution of country risk effect on international finance and give them outline for conducting future research in the similar field with exploratory data analysis.

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