Chapter 5

Measuring Country Risk: A Topic of Renewed Interest

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ABSTRACT

The concept of “country risk” has once again come under the spotlight. Globalization, the shock-waves of the subprime crisis, manifested in sovereign and private debt crises, and the fear to a “contagion” of risk between market participants are, among others, the reasons that make topical this form of risk. The aim of this chapter is to offer an overview of the factors that influence country risk, and an analysis of the methods most commonly used to measure it, with a discussion of their pros and cons. The conclusion is that none of those methods have offered satisfactory results. In this regard, the authors propose a change in the way to analyze country risk. Rather than attempting to predict debt crises, it is necessary to identify the sources of risk, and accept uncertainty as a feature of the current environment.

INTRODUCTION

The concept of “country risk” has again become topical. There are a number of reasons why this form of risk has once again come under the spotlight of in-depth analysis. The first and most obvious factor is the process of globalisation, which has intensified in recent decades, creating a new, complex and interconnected economic, political and social setting. Another reason for this renewed interest can be found in the recent sovereign and private debt crises in a number of European countries (both EU and non-EU member states), including some within the Euro zone, such as Greece, Ireland, Portugal and Spain. At the same time, the shockwaves of the subprime crisis have reached countries on other continents. Finally, there is growing interest in the complex network of direct and indirect interconnections between the public sector, business, households and financial and non-financial institutions, especially with regard to a possible “contagion” of risk between different agents and participants (sovereign risk – when the debtor or guarantor of the debt is the state and for sovereign reasons may refuse payment of the debt –, business risk and banking risk).

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This interest is cyclical and recurring: between 2002 and 2007, widespread growth in global economies and an almost complete absence of any external financial crises meant that scarcely any consideration was given to country risk. This was in contrast with the immediately preceding period (1994-2002), which saw major external financial crises in a number of emerging economies, among them Mexico, Asian countries, Russia, Brazil, Argentina and Turkey.

The first indications of the importance of country risk date from the 1970s, with the triggering of the oil crisis and the collapse of the fixed exchange rate system. In the 1980s, foreign debt crises in numerous developing countries helped reinforce an awareness of the scope of this type of risk, subsequently confirmed with the crises of the 1990s referred to above.

The importance acquired by the concept over the years, and the progress of events in that time, have resulted in the development of different—and sometimes significantly diverse—ideas of what country risk is. The main cause of the confusion and lack of consensus among experts is the inherent complexity of this type of risk, including as it does different components with multiple factors impacting on it. As a result, different attempts to accurately measure country risk have led to the emergence of a wide variety of approaches and methods, though to date none has managed to achieve entirely satisfactory results.

Against this backdrop, the aim of this paper is to review the literature on country risk, in order to offer a synthesised overview that may be of use for a better understanding and measurement of the concept. The remainder of the paper is structured as follows: first the concept of country risk and the most important types of risk it encompasses are explored; the factors that most significantly influence this type of risk are then set out; an analysis is then made of the methods most commonly used to evaluate and measure country risk, with a discussion of their pros and cons; and finally, a summary and conclusions are offered, together with a list of references.

**CONCEPT AND TYPES OF COUNTRY RISK**

As discussed above, it was not until the 1970s that the concept of credit risk and its variant in the international area, country risk, began to be seen as being particularly significant. This period coincided with the outbreak of the oil crisis and the collapse of the fixed exchange rate system.

Following pioneering contributions by Harberger (1976) and Krayenbuehl (1985), and the work of the Group of Ten in 1982, country risk began to be understood as being

*the possibility that a sovereign borrower might not be able or willing to meet its payment obligations for a variety of reasons different to those that commonly arise in all types of loan. Such risks might range from the consequences of official decisions, social and political changes in the debtor countries; the consequences of unforeseen circumstances or events, such as natural disasters or external shocks linked to global phenomena (Linde, 2002, pp. 2-3)*.

In the following years a number of attempts were made to establish more clearly the exact meaning of country risk. It was defined as the risk of non-repayment of bank financing of a public or private organisation with a public guarantee from a given country, arising out of causes relating to that country and not to the individual debtor’s circumstances. The concept was later extended to encompass international bond issues and portfolio investments, and even any economic or financial dealings with a given country (García & Vicéns, 2007; Harland, Brenchley, & Walker, 2003; Jensen & Young, 2008).