Country Risk Assessment

A Guide to Global Investment Strategy

Michel Henry Bouchet
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Country Risk Assessment
Wiley Finance Series

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Preface

For a long time, country risk belonged to the category of issues that are difficult to understand because information is fragmented or incomplete. Banks knew neither the size of their loan exposure nor to which countries they had lent. Bankers were mesmerized by international eurocredit syndication. Corporations and investors had neither the information nor the means to assess, much less cover, the risks lurking in the shadows of seemingly profitable cross border transactions. Country risk was considered an opaque, unpleasant fact of life better left in the hands of the IMF and the export credit agencies.

In today's global economy wired to the web, however, all this has changed. Information has become abundant, cheap and almost instantaneous as countries compete in transparency to attract foreign direct investment and portfolio capital. The problem is no longer a lack of timely information. It is rather one of deciding which information is important and then knowing how to process it. Country risk involves complex combinations of macroeconomic policy, structural and institutional weakness, bad governance, and regional contagion wrapped in a paradigm of high levels of trade, capital and information flows.

The aim of this book is to provide the framework for understanding the nature of country risk, its sources and its consequences as well as the tools available for judicious country risk assessment in the context of international business and investment. It does so by combining theoretical analyses with a number of practical observations that stem from the authors' market experience with the modest hope of shedding light on a complex but fascinating issue.
Acknowledgments

A number of our colleagues gave us the benefit of their comments and criticism as we were writing this book. We are deeply grateful to them and to our respective institutions, CERAM Sophia Antipolis, ESC Lille and the University of Middlesex. The project of this book received a decisive impetus at the time of the 2001 Finance Symposium jointly organized by IAFE and the CERAM Global Finance Chair that gathered a number of keynote speakers from the international academic community, the rating agencies, the banking industry, and official financial institutions. Lively and fruitful discussions involved a unique combination of scholars including Nobel Laureate Dr. Myron Scholes and Dr. Benoit Mandelbrot, as well as panelists from official institutions such as the ECB, the World Bank, the NY Fed and the BIS. We also wish to thank Michael Payte (Europe Chairman of the International Association of Financial Engineers) and Michael Howell (Crossborder Capital) for useful inputs, as well as Stefano Gori, Georg Merholz, Christoph Moser, and Madjid Touabi for valuable research assistance. We are also indebted to many colleagues in the markets and the scholarly community; too numerous to name individually in this restricted space but nonetheless the target of our everlasting thanks.
Foreword

By Professor Campbell R. Harvey

When I began working in emerging markets more than 10 years ago, the topic was not fashionable and received little attention, mainly because of the cost associated with obtaining comprehensive information, and due to a lack of quality and timely data. On the contrary, at that time, the hot topics were derivatives, M&As, stock market bubbles, LBOs, and the like. When I jumped into this field, emerging markets were regarded as an exotic risk species – good for portfolio diversification and return enhancement strategies but requiring stamina.

Since then, emerging markets have experienced a huge surge of interest generated by their economic dynamism and marked by bouts of volatility and financial crises. By the early 1990s, developing countries were barely recovering from the 1982 global debt crisis only to be rocked by the Mexican peso crisis of 1994, the East-Asian meltdown of 1997, the Russian default of 1998, the Brazilian crisis of 1999 and the ongoing Argentine catastrophe of the new century. Each crisis was a “surprise” to analysts, each was different from the other and they all differed from crises in the more mature capital markets in the OECD countries. All this seems to have awakened investors, traders and businessmen to the importance of country risk assessment and the specific approaches to tackle it.

This book, then, is a welcome initiative. The authors present the content and the tools of modern country risk assessment, both qualitative and quantitative. The book is comprehensive. It includes the traditional techniques of ratings, special reports, Monte Carlo simulations and discriminant, logit and regression analysis, as well as the more modern techniques of value at risk, non-linear and non-parametric estimation, and the sophisticated, cutting edge models developed in the credit risk literature. The authors analyse the advantages and disadvantages of the qualitative and quantitative techniques they describe and show how country risk assessment can be integrated into the overall decision making process. They recognize that country risk assessment must take into account a wide array of parameters including institutions, sociopolitical structures, demographics, culture, religion, economic infrastructure, and legal and regulatory issues. They also recognize that the powerful tools of modern financial theory and practice cannot be neglected either. Their presentation and illustration of risk exposure includes equity and portfolio investment, direct investment, international credit, and trade. They also show that in the last analysis risk assessment is only as good as the quality of the underlying information.