New Dimensions of Country Risk in the Context of the Current Crisis:
A Case Study for Romania and Greece

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Abstract:
The attractiveness of a state regarding foreign investors, multinational banks and creditors, is closely related to country risk assessment. Most of the financial and economic rating agencies such as Standard & Poor’s, Fitch, Moody’s, etc., are in a position to analyze, more or less subjectively, more or less reliable, country risk developments. Rating systems that appear as important tools in decision-support are taken, in many cases non-critically, by the decision makers and used as such. The process of globalization has multiplied the country risk acceptance and successive crises with recurrence, often without advance, stressed that the assessment processes has significant shortcomings.

Countries such as Greece and Romania, currently facing similar economic and social problems, are in a delicate situation. Although unlike Greece, Romania has not yet adopted the euro, a number of similarities between the two countries allow a simultaneous analysis. Recently, representatives of Standard and Poor’s announced that the declaration of support came from the European Union to Athens is a conducive factor for Greece, but this remains exposed to considerable risks; in December 2009, the Agency amend Greece in BBB + rating with negative outlook. For Romania, the passage of the attribute “negative” to “stable” is closely related to assessors of reforms agreed with IMF. Currently valued at BB +, Romania is below the recommended level for investment. In this context, the main aim of this article is to find the answer to a series of questions: Are these ratings really fair? What are the relevant variables in the analysis of states like Greece and Romania? What are the problem areas and how they can be treated? What country risk approach is appropriate for these countries?

Keywords: Country risk, the new international environment, rating, evaluation, budget deficit, public debt.
JEL classification: G21; G32; G33; M14; M48

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1. The Concept of a Country Risk

Phenomena occurred in recent years have generated and continues to generate differentiations in diverse concepts. Among them, the economic concept of country risk, considered worldwide as an important decision making process instrument. In an era of economic globalization and financial liberalization, due to the dilution of national state concept and the interdependence of economies the recurrence of different types of crisis expressed and manifested. The current financial crisis entered in its fourth year due to the results of deregulation, the dangerous and irresponsible behavior and the disastrous consequences of the new rules of regulation imposed on different markets.

Obviously, the crisis is a form of manifestation of the risk, as crossing a period of crisis leads to changes in risk analysis itself. The concept of country risk means various types of losses generated by economic relations with private or public foreign partners and caused by particular events influenced by governmental factors. As shown in some studies, the concept of country risk has undergone significant shifts during the last fifty years.

An amount of country risk concepts highlighted in the literature, considering country risk as a set of sovereign actions, political decisions and also an economic or financial risk. In the first category, the concept of country risk through political risk, broadly covering national governments’ actions which are harmful and uncertain to foreign private companies due to changes in the political regime. However, the concept of country risk has a broader conception and shouldn’t focus only in political risk. Moreover, due to financial deregulation or regulation according to some opinions, connections between states and economies have made political risk to join the economic, financial and even systemic risk. Other opinions, have multiplied the approaches of the concept of country risk, together with entities that deal with its analysis. Other studies developed new perspectives of country risk such as:

- The perspective of the economic actor type reached by risk (creditor): banks, investors (financial or industry risk), exporters (commercial risk);
- Type, nature of risk (specific entity receivable, generating the risk) - in this regard, John Calverley (1990) develop a sovereign risk and a non-transfer one;

6 Authors such as Jarvis (2004) stressed that political regime changes are not always harmful and can have beneficial effects.
7 Dr. Emmanuel Martin, Exposure - The causes of the current crisis, Faculté d’Economie Appliquée, Université Paul Cézanne Aix-Marseille 3, Aix-en-Provence, March 2010.
8 The collapse of several debtors because of a serious degradation in the economic situation of a country.
- The type of crisis that leads to the manifestation of risk: evokes the sovereign and the political risk (with their clear differentiation), the economic risk\textsuperscript{10} and the financial risk.

At the same time, according to other approaches country risk is depending on the type of the state or on the nature of the reviewed agents and therefore there is a need for distinction between sovereign and country risk concepts. Generally, sovereign risk’s definitions given by the analysts, coincides with the maximum score of the state (sovereign ceiling), and local agent could not receive higher ratings than the country’s sovereign risk rates. This is not always an appropriate approach as some authors revealed, such as Meunier, N., Sollogoub, T., (2005). During the Russian crisis, Gazprom continued to credit its own debt while the Russian Federation has suspended the payments.

2. The Determinants of Country Risk

Country risk analysis is a strategic tool in supporting decisions and reducing uncertainty. The bet for a country is to anticipate economical changes or incidents that may affect the development of transnational business - macroeconomic, financial or socio-political fragility of a state which are likely to choke financial or commercial operations\textsuperscript{11}. The remarks of such an analysis are addressed to banks, credit institutions, investors and exporters. Investors will be interested in industrial risk sizing, which involves the faulty running manufacture or sale processes and may extend to expropriation / confiscation, or financial risk sizing in terms of changes in the remuneration of securities, while lenders will be concerned with nonpayment risk or late repayment risk. Assuredly, risk assessment interests depends on the state, hence country risk, will be re-analyzed especially in the case of a relationship with an emerging one or some economic agents generating from it.

The aspect that raised further discussion and greater concerns for the methods of country risk analysis, as stated by Meunier, N., Sollogoub, T., (2005)\textsuperscript{12}, evokes two main tracks:

- The use of specific indicators and the establishment of a specific diagnosis;
- The use of empirical methods - the relationship of pre-selected set of variables.

The identification of a reliable and qualitative indicator, in order to anticipate difficulties is a major challenge for the analysts. This approach has gained considerable importance especially after the South American debt crisis in the ‘80s. This crisis brought out the difficulties of paying a debt in foreign currency.

Generally a crisis emerged when a state have a higher average of the emerging market external debt.

\textsuperscript{10} Translated mainly by volatility in GDP and GNP.
- But when can we speak of over indebtedness?
- What causes it?
- What are the main determinants of country risk?

In this context, Meunier, N., Sollogoub, T., (2005) and Thalassinos et al., (2006, 2010a, 2010b) brings out three concepts, also used by most rating agencies, which set their own thresholds for alert:

- Solvency, the total debt versus the rich states;
- Sustainability, the evolution wealth debt to global developments – guidance on the long field;
- Liquidity, the ability of debt repayment at maturity - short-term orientation;

Among other determinants of country risk, also mentioned:

- External debt relative to gross domestic product. It should be noted that it is also important the currency which the debt is expressed. A major part of the debt being expressed in foreign currencies translating in additional risk if the currency is experiencing a depression;
- External debt relative to export volume as it is expressed by the external debt relative to the ability to attract foreign currency. When the value of this indicator exceeds 150%, is an alert corresponding to an over indebtedness; from this perspective, it needs to be emphasized that a favorable development of exports improves prospects for external debt repayment;
- External debt service to GDP and external debt service relative to the volume of exports. These indicators are used frequently by the World Bank to rank states according to the level of indebtedness;
- Currency exchange reserves covering more than three months of imports;
- Total external debt which is dangerous if it exceeds 50% of GDP;
- Inflation rate which is dangerous if it exceeds the threshold of 10.5%;
- Real interest rate;
- Existence of agreements with the International Monetary Fund, essentially positive aspect, generating trust, but can hide the crisis element;
- Political risk and psychological factors;
- Economic structure of incomes;
- Balance of payments flexibility. Balance of payments analysis presents particular importance in tracking the various disturbances in supply / demand, savings / investment, private saving / public saving. Also, it can be achieved the current deficit explanation and determined the status of the international creditor or debtor of the analyzed state.

Among the methods of country risk assessment, an extremely popular one is the construction of ratings. This method has multiple facets, for both securities issuers and creditors. It is a description of the risk in which economic entities exposed signatory of an international agreement. Risk analysis carried out by

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specialized institutions, or in some cases by specific departments of banks or firms. In regard of specialized companies, risk analysis should be provided and disseminated through press releases, publications or through the Internet. In his study “Évaluation du Risque pays par les agences de rating: transparence et convergence des méthodes”, Guessoum, Y., (2004) distinguished different types of institutions carried out country risk assessments:

- Rating agencies - most notable are Moody's, Standard & Poor's and Fitch, their activity will be explained briefly below;
- Insurance companies (e.g. COFACE - Compagnie Française d'Assurance pour le Commerce Extérieur);
- Consultancy offices (North South Exports to France, Business Environment Risk Intelligence);
- Financial publications (Institutional Investor, Euromoney Publications);
- Banks, etc.

Three well known credit rating agencies are the U.S. agencies, Moody's, Standard & Poor's, and the European Fitch IBCA. Their evaluations ranks states in terms of loans and bonds issued. Four major classes of risk are defined, for Standard & Poor's and Moody's, the descending order from the highest level of risk when the country's ability to repay both the debt and interest to the most unfortunate situation of non repayment is as it follows:

S&P: AAA AA A BBB BB B CCC CC C D
Moody’s: Aaa Aa A Baa Ba B Caa Ca C D

In two of the indicators are found the signs "+" and "-". They point perspectives, the possible development of note and are the first priorities for change.

Among the factors used by agencies in conducting evaluations also included the balance of payments and the current account, the level of debt, the deficit level, the structure and the economic growth, the exchange rate and the convertibility of the local currency, the total GDP and the GDP per capita, the labor cost factor and the productivity, the total level of reserves, the interest rates, the inflation rate, the liquidity, the political environment, the international agreements, etc. The share of different criteria and evaluation methodology are unknown to the public. Also it is noted the possibility of classifying factors into two categories: quantitative factors (objective criteria) and qualitative factors (subjective criteria).

Although there are major similarities between agencies, some of the used criteria vary from agency to agency. Standard & Poor's uses 9 clusters of criteria namely political risk, international relations, social environment, economic structure and growth prospects, flexible tax system, flexibility of balance of payments, external debt and liquidity, borrowing costs, price stability, while Moody's, uses 5 clusters namely political dynamic and social interaction, structure and economic performance, tax indicators, external payments and debt, monetary indicators and liquidity. In the contrary, Fitch uses 14 clusters of criteria namely policy and state,
international position, demographic factors, employment, production and trade structure, dynamic private sector, supply / demand balance, balance of payments, macroeconomic policies, FDI policy, banking and finance, foreign currency assets, the external debt and the economic growth. Which one is the most reliable the most objective one is difficult to say.

In addition the foremost problem is the transparency of the scoring process, as most of the institutions do not use the same evaluation process and a number of factors\textsuperscript{14} may cause differences between various evaluations such as the criteria taken into calculation, the methodology used and the type of grades awarded.

3. The Developments in Romania and Greece

Countries such as Greece and Romania are currently facing similar economic and social problems. Unlike Greece, Romania has not yet adopted the euro, however a number of similarities between the two countries allowed a simultaneous analysis. Recently, Standard and Poor's announced that the declaration of support came from the European Union to Greece is a conducive factor for, but remains exposed to considerable risks. In December of 2009, the Agency amend Greece in BBB + (it is explained as good capacity of the state to repay loans received, but the country is facing greater instability which can affect external credibility), with negative outlook. For Romania, the passage of the attribute “negative” to “stable” is closely related to assessors of reforms agreed with IMF. Currently valued at BB+, Romania is below the recommended level for investment.

For Greece, one of the most important problems is the relation of sovereign debt, accompanied by lack of liquidity. Note that a damage from 'A-' to 'BBB +' with negative outlook allows even the formulation of scenarios of a possible engagement to “speculative grades” which is a very bad development for the country in question. Macroeconomic situation is rather difficult and in the fourth quarter of 2009, the Greek economy contracted by 0.8%. Also budgetary and external imbalances, trade union pressures, the government debt approximated at 125% of GDP for 2010. Recently, the government issued bonds on 7 years, which are backed by Eurogroup, with an interest rate of 6%, in order to refinance the debt. Moreover, there are positive signs and the Greek government planned to bring its deficit below 3% of GDP in 2012, compared to 12.7% in 2009.

For Standard & Poor's representatives in Romania's case, foreign creditors could recover between 50 to 70% of the debt, if the country falls into default. Political issues also made their presence felt, and the rating of 'BB +' with negative outlook is not encouraged. However, there are prospects for export growth, enhanced by recent flows of FDI and the IMF agreement and the implementation of reforms negotiated kit could provide stable outlook. Under the 2009s budget deficit

of 7.3% of GDP, the restructuring of public finances is the highest priority, as the adoption of a growth model focused less on consumption.

In order to confirm the assessments of the rating agencies in a more realistic way, the progress of some indicators considered relevant for the study of country risk checked (for the two states) with two diagrams of the evolution are presented below:

✓ GDP and GDP per capita;
✓ External debt;
✓ Total external debt (% GDP) – over indebtedness threshold: 50%;
✓ Exports;
✓ External Debt (% Exports) - over indebtedness threshold: 150%;
✓ Public debt (% revenue rule);
✓ Currency debt (as a percentage of the total);
✓ Budget balance;
✓ Inflation rate - threshold: 10.5%;
✓ Real interest rate.

At the euro area debt for various states as estimated in 2010 is as follows (as a percentage of GDP):

<table>
<thead>
<tr>
<th>State</th>
<th>Debt as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>73.90%</td>
</tr>
<tr>
<td>Belgium</td>
<td>101.20%</td>
</tr>
<tr>
<td>Cyprus</td>
<td>58.60%</td>
</tr>
<tr>
<td>Finland</td>
<td>47.40%</td>
</tr>
<tr>
<td>France</td>
<td>82.50%</td>
</tr>
<tr>
<td>Germany</td>
<td>76.70%</td>
</tr>
<tr>
<td>Greece</td>
<td>124.90%</td>
</tr>
<tr>
<td>Ireland</td>
<td>82.90%</td>
</tr>
<tr>
<td>Italy</td>
<td>116.70%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>16.40%</td>
</tr>
<tr>
<td>Malta</td>
<td>70.90%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>65.60%</td>
</tr>
<tr>
<td>Portugal</td>
<td>84.60%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>39.20%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>42.80%</td>
</tr>
<tr>
<td>Spain</td>
<td>66.30%</td>
</tr>
</tbody>
</table>

Source: Forecast of European Commission in 2010 - Reuters takeover
The evolution of external debt to GDP for Romania is presented in the diagram below:

As it can be noticed the external dept of Romania is on an ascending trend since 2002.

Also we synthesized the data of some of the mentioned indicators above in three different tables as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Romania GPD per capita (euro, current prices)</th>
<th>Greece GPD per capita (euro, current prices)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>10000</td>
<td>15000</td>
</tr>
<tr>
<td>2005</td>
<td>20000</td>
<td>25000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Romania Inflation rate (%)</th>
<th>Greece Inflation rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>5.00%</td>
<td>2.00%</td>
</tr>
<tr>
<td>2005</td>
<td>3.00%</td>
<td>1.00%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Romania Exports (million euros)</th>
<th>Greece Exports (million euros)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>10000</td>
<td>15000</td>
</tr>
<tr>
<td>2005</td>
<td>20000</td>
<td>25000</td>
</tr>
</tbody>
</table>

Source: www.eurostat.com

The size of the external debt as a percentage of GDP for the two countries has grown significantly. In the Greek case, it has exceeded 160% in last year and in this situation governments must find solutions even calling for new privatization.
Also it is believed that the size of the debt is not as alarming as it has been said due to the fact that there are countries with external debt even higher. Also in the case of Greece, the fear of a possible imbalance in the euro area is needed to be added and the main argument constitutes on the economy size.

Furthermore, it is noted that there are major weaknesses in the financial systems of the two countries and also a current worrying account deficit. Moreover, differences in the competitiveness in comparison to other member-states being obvious in the exports / imports balances as the Greek and the Romanian accounts present various problems.

4. Conclusions

Despite readability, speed, a recognized degree of simplicity and some other advantages, the rating is not free of subjective elements and even some opacity. Models are not explained well and scoring systems do not necessarily converge.

For the case of Greece and Romania, although rating agencies reacted very quickly, since the appearance of the first signals of the financial crisis, correcting the rating grades in a negative sense the question that still remains open is how they took into account recent developments. They did not use the same strategy, for example during the Asian crisis in 1997. In that case the lack of well-drawn warnings, such as development budget deficit worrying reach of a threshold of foreign debt, slow capital formation, etc., allowed maintaining high ratings of those economies, which has camouflaged the current starter crisis. In addition, Greece and Romania have proved over the years states of "friendly market", whose good faith to international creditors can not be put in doubt.

Of course, those two countries are facing particular problems such as: low and slow controllable revenue of the state budget, opacity of bank accounting system and inflation. However, that rate of inflation does not necessarily entail escalation of country risk; trade openness of emerging market enhances the inflation and the decrease of it is not synonymous with growth. Essential in country risk analysis, is the total external debt, obtained by totaling public debt and private operators’ debt, one of the key element in calculating risk. For both countries there are two main issues to be analyzed. First the tendency toward long-term debt and second the counterparty borrowing - development. In any case by supervising public debt and private borrowers in an effective way it leads to a considerable control of risk.

Another aspect that is coming out of this article is related to the threat of mimicry and takeover with no critical assessments made by credit rating institutions. Often, economic traders take the informational content of the rating and integrate the results considered as being extremely reliable in operations and decisions on various global markets. Sometimes bad influence assessments may lead to market dislocations affecting negatively the behavior of economic actors.
Finally it is needed to take a detailed look, without reducing the importance of country risk assessment, into the major macroeconomic variables and the prospective of the country in question before the final decision regarding risk. Also, comparing methodologies used and the normalization of processes can facilitate understanding of the grading mechanisms, which can always be improved.

4. References


