



Country and Sovereign Risk Analysis

July 4, 2016

Contents

- › Definition of country risk and sovereign risk
- › Assessment of country risk
- › Assessment of sovereign risk
- › Implementation

Country risk: development of a crisis

- Strong increase of private and/or public **debt** drives domestic demand and GDP
- High import demand and a loss of competitiveness due to rising wages (real appreciation of the currency) lead to a **current account deficit**
- Banking sector and/or sovereign accumulate **external debt**
- **Maturity structure** of external debt shortens

Crisis trigger: Sudden shift in risk aversion, terms-of-trade shock, political events

- **Loss of confidence** (capital flight: no market funding available, drop in bond prices, run on bank deposits)
- Strong devaluation, deep recession, strong increase in private sector insolvencies, bank insolvencies, sovereign default, transfer restrictions

Systemic financial crisis

due to a

lack of foreign currency liquidity

Definition of country risk vs. sovereign risk



- › Sovereign risk and country risk measure different risks, but are strongly interrelated
- › Different rating systems due to different nature of risk, but overlapping indicators

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Country risk analysis via rating systems

- Expert system due to lack of data points
- Keep it short and simple: Transparency for analysts and users
- Quantitative indicators:
Consistent evaluation method for all countries (fixed scales)
- Qualitative aspects:
Quantification in relation to other countries (peer group comparison)
- Overruling of model result in special cases not captured by the model

Country risk and time horizon

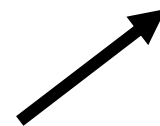
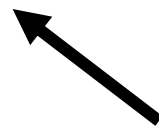
Risk is rising with increasing maturity



short-term:
liquidity
indicators

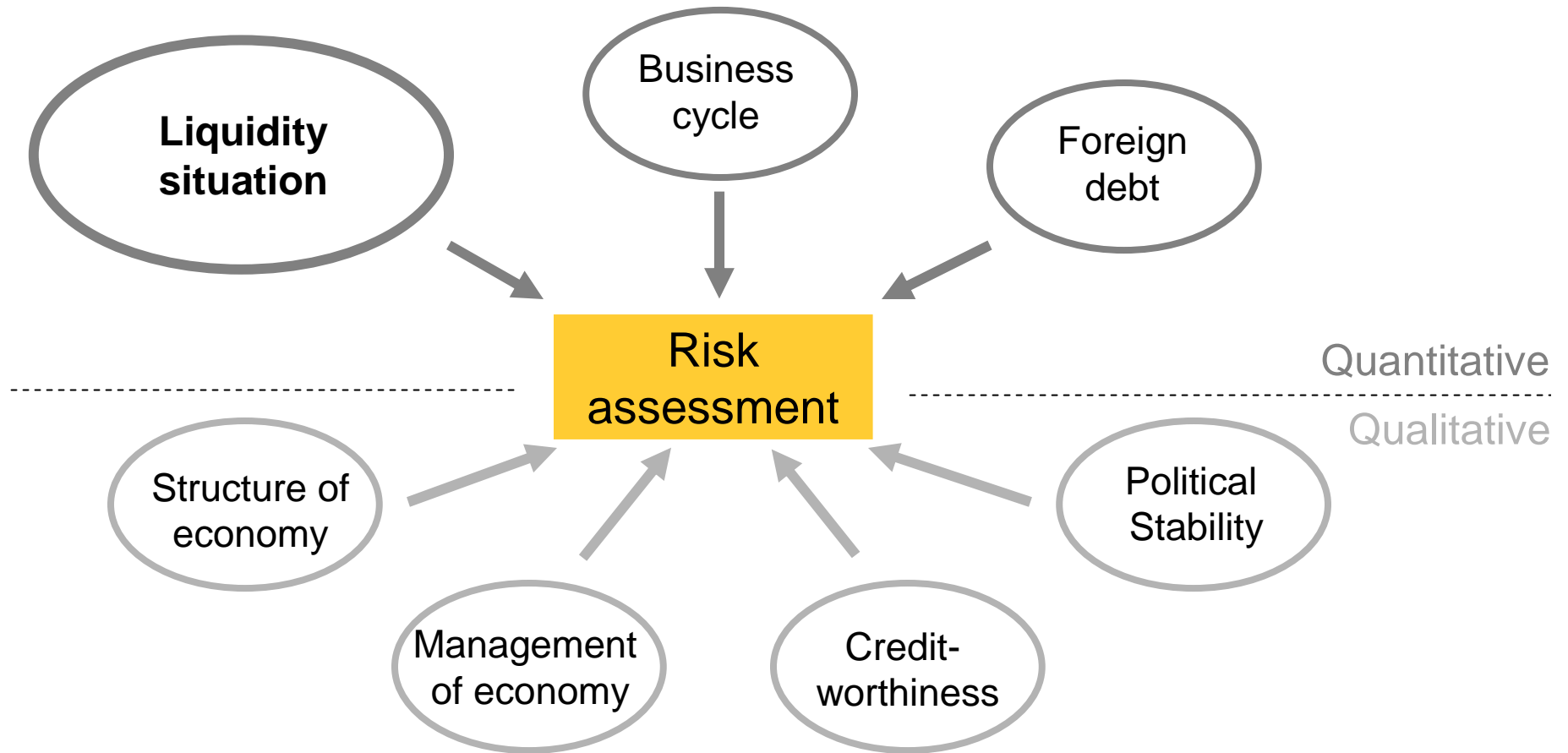
medium-term:
economic
policy

long-term:
structure of
economy



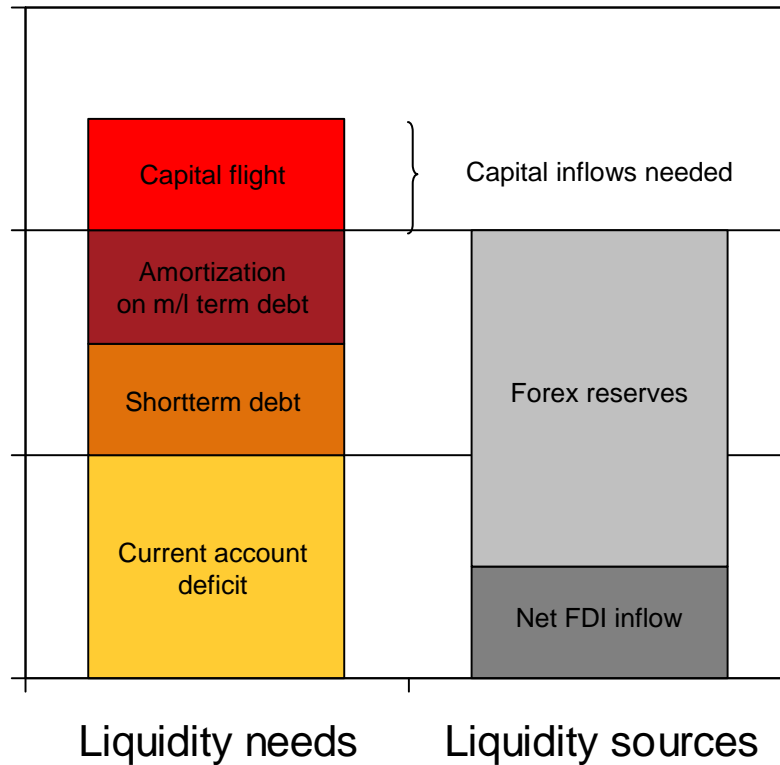
dominant aspects

Time frame: 1 year

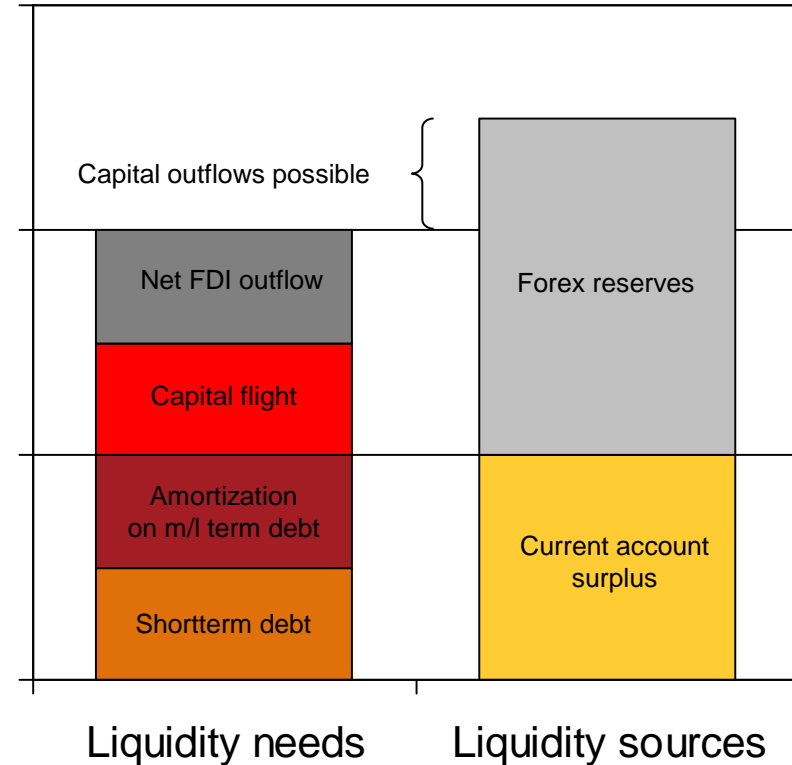


Foreign exchange liquidity situation of high relevance

Example 1: Liquidity deficit



Example 2: Liquidity surplus



Quantitative indicators

Liquidity situation

Foreign exchange reserves
 Short-term external debt
 Amortization on external debt
 Current account balance
 Foreign direct investment
 Capital flight

Business cycle

Real growth per capita (level-adjusted)
 Inflation, budget

Foreign debt

External debt

Qualitative indicators

Structure of economy

Diversification of exports and total economy
 Competition in the domestic market
 Sector risks (e.g. real estate bubbles)
 Stability of the banking sector

Management of economy

Economic Policy, Role of the government in the economy
 Corruption, Protection of Property rights, Investment climate
 External debt and liquidity management

Political Stability

Domestic stability (economic, ethnic or religious conflicts)
 External security (war or threat of war)

Creditworthiness

Rating agencies
 Bond spreads

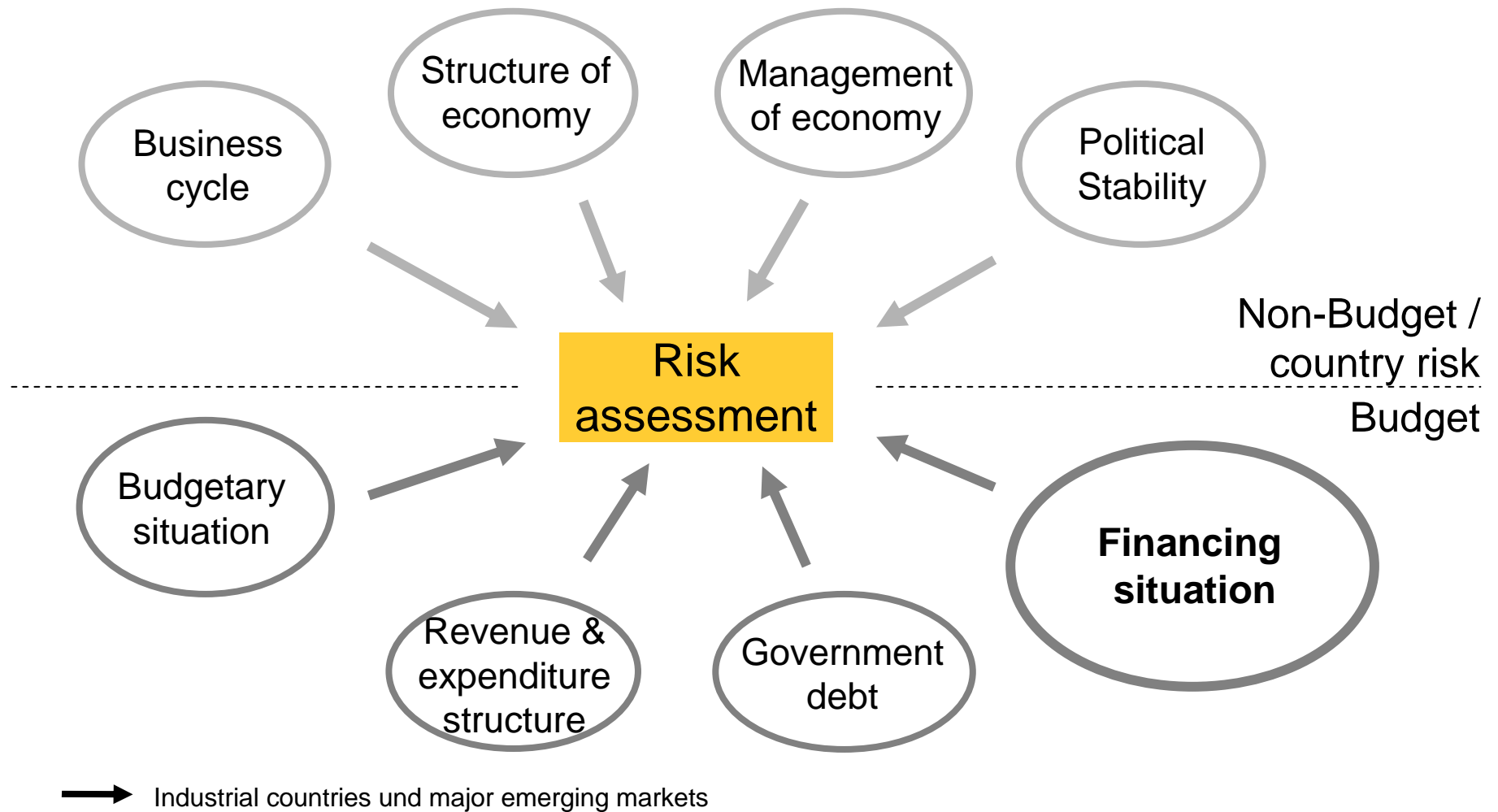
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Characteristics of sovereign risk

- › Counter party risk for sovereign entities
 - › Focus of financial (fiscal) situation of the sovereign
 - › and it's ability to get financing from international capital markets
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- › Willingness to pay a special sovereign risk (political risk)
 - › lack of international insolvency law for sovereigns; ability to change national law

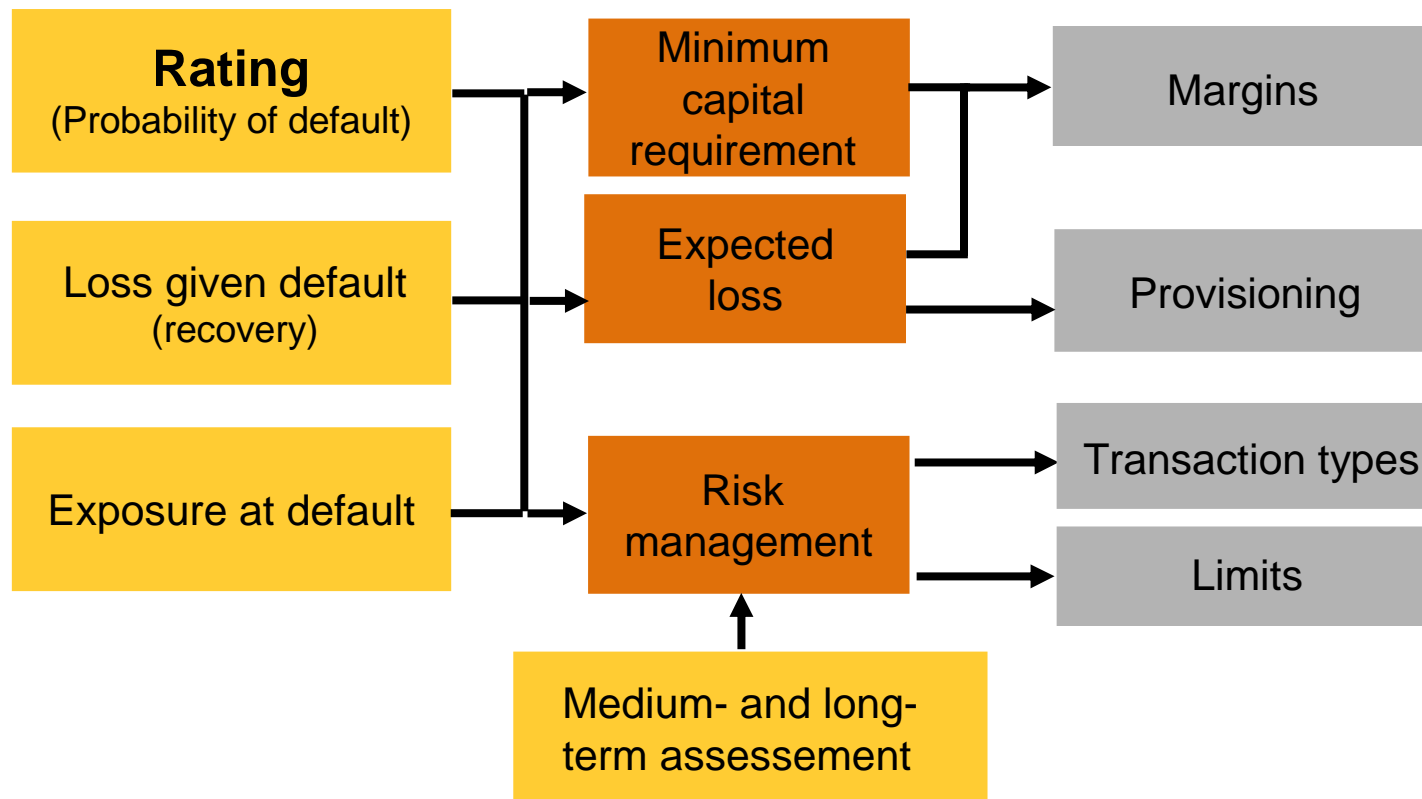
Sovereign risk indicators



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Implementation



Thank you!