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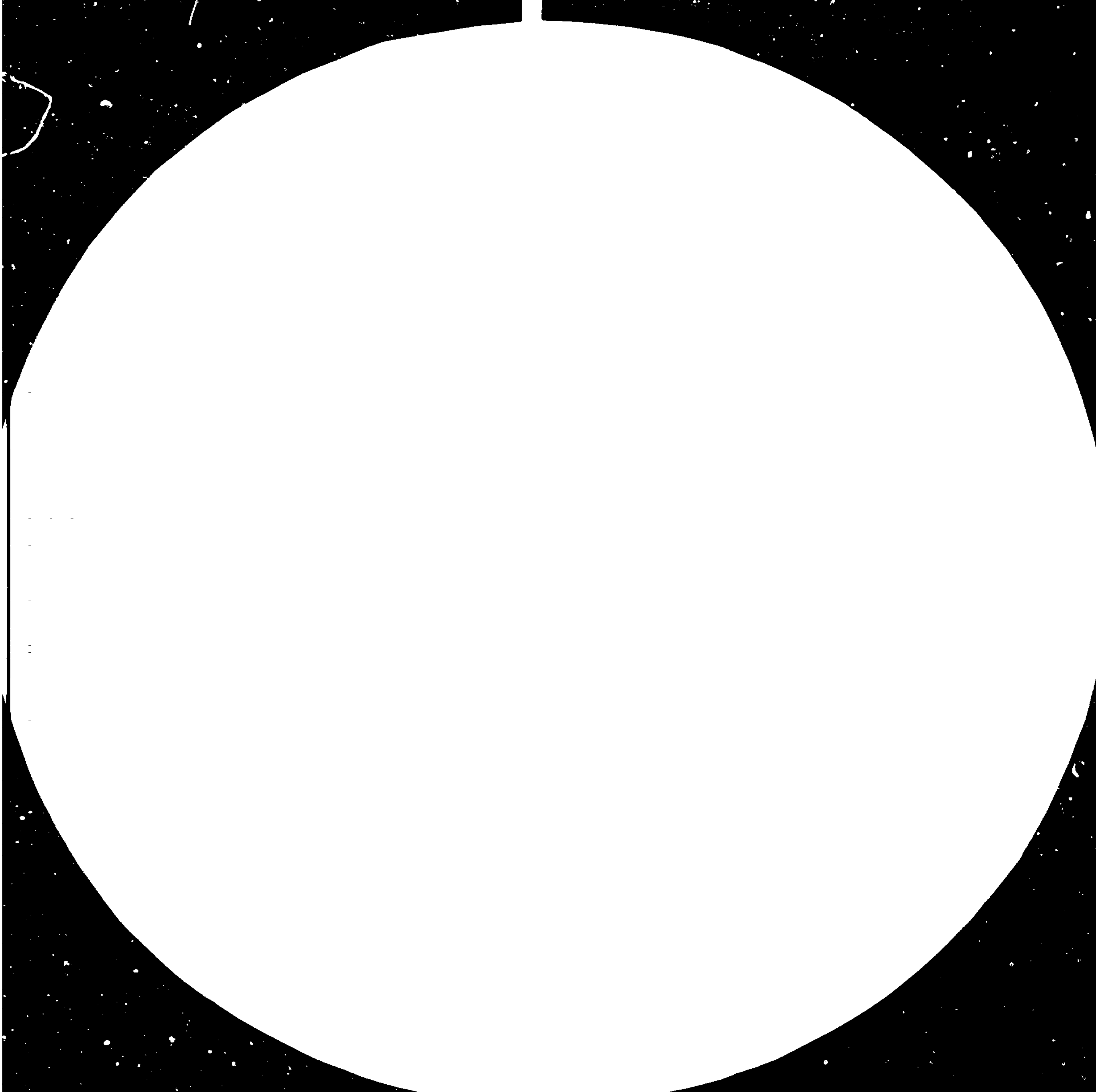

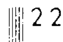
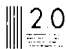

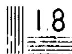

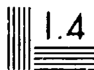

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INFORMATION PAPER

AN ANATOMY OF THE "COUNTRY RISK" CONCEPT IN THE CONTEXT OF EXTERNAL DEBT OF DEVELOPING COUNTRIES*

by

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103326

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1. In conventional banking wisdom, 'country risk' is defined as the risk of loss through default to which banks may be exposed in their international lending due to "events which are at least to some extent, under the control of the government, but definitely not under the control of a private enterprise or individual".1/ Thus, country risk is typically set in the context of a loan arrangement where on the lending side there is the bank (or a syndicate of banks), while on the borrowing side the national government is involved.

2. Since any loan arrangement involves two sides, the above view of 'country risk' is essentially an assessment of lender's risk, associated with the probability of default over which the national government in the borrowing country is supposed to have some control. But from the borrower's side, the default of loan also has further consequences (e.g. sudden drying up of the credit-line) which defines the nature of the borrower's risk from its point of view. Any discussion of the nature of 'country risk' tends to be grossly inadequate, unless both the lender's and the borrower's risk are considered simultaneously.

3. In normal banking practice, lender's risk is usually covered by collaterals against which loan is secured. In a general sense, it is the value of the collateral which determines the creditworthiness of a borrower, although banking conventions widely differ from case to case in determining what is to be treated as collaterals for particular loans. But this idea of a collateral security against which loan is granted becomes considerably hazy in the context of publicly guaranteed external borrowing.2/ For, in effect, it boils down to assessing the creditworthiness of a foreign government by the lending bankers, typically without recourse to tangible collaterals as the basis of objective valuation. This makes the country risk assessment

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1/ Pancras J. Nagy, "Country Risk: how to access, quantify and monitor it", Euromoney Publications, London, 1979. p.13.

2/ The application of country risk, needless to add, is not necessarily restricted to publicly guaranteed borrowing. It also applies to private or corporate borrowing, in so far as the repayment is influenced by governmental economic policies in the borrowing country (e.g. exchange regulation). While this qualification has to be borne in mind, we keep the discussion simpler by focusing on publicly guaranteed borrowing.

a matter of judgement which in turn is based upon two analytically distinct components. First, the ability of the borrowing country to meet debt service obligations. And, secondly, its willingness to meet debt service obligations. The willingness, in turn, is largely determined by the borrowing country's own perception of 'borrowers's risk', i.e. the penalty or unfavourable consequences that are likely to follow in its national economy in case of default of loan.

4. On the first aspect regarding the country's ability to repay, there can usually be some objective basis for evaluation in terms of various systems of indicators that have recently been devised. The claim of objectivity, however, must not be exaggerated in this context, as individual authors concerned with devising indicator systems in answering the question of whether the foreign indebtedness of a country is in danger of reaching critical dimensions, have invariably reached very divergent conclusions.[3/] It is not only that the quantitative watershed values are estimated at very different levels in different studies, but even agreements on the qualitative importance of particular indicators are not generally achieved. Thus, whereas the well-known Peterson indicator system attaches no importance to the debt service ratio, it is not only included in the prognostic functions in some other widely used indicator systems like that of Frank and Cline or of Feder and Just, but it even emerges as one of the two most crucial variables (debt service ratio and the ratio of annual amortization to total debt are the two critical variables) in the discriminant function of the Frank-Cline indicator system. All this emphasises the fact that not only is there no unified system of indicators in analysing the ability of a country to repay external debt, but even qualitative agreements regarding what constitute the crucial indicators have not been achieved. Not surprisingly then, the objective basis of assessing the first aspect of country risk, i.e. the ability of a country to meet its external debt obligations remains extremely poor and shaky, little more than an intuitive feeling by the lender in the final analysis.

3/ See for example, Hans J. Paterson, "Debt crisis of developing countries: a pragmatic approach to an early warning system", Konjunkturpolitik, 23rd year, 1977. C.R. Frank and W.R. Cline: "Measurement of debt servicing capacity: an application of discriminant analysis.", Journal of International Economics, No. 1, 1971. G. Feder and R.E. Just, "A study of debt servicing capacity applying logic analysis", Journal of Development Economics No.4, 1977. See also, P.D. Dhonte, "Describing external debt situations: a roll-over approach", I.M.F. Papers, Vol. 22 No. 1, 1975, for later discussions particularly in paragraphs 8-10 of this paper.

5. But almost all the existing indicator systems would remain grossly inadequate or even misleading in terms of lender's risk assessment, unless they are able to combine the other aspect, i.e. the borrowing country's willingness to repay which essentially entails an assessment of borrower's risk. Thus, what is being suggested here is that, lender's risk cannot be meaningfully defined independent of borrower's risk in the present context. Borrower's risk must be brought into the argument, not only to have a more balanced consideration of country risk, but also because even exclusively from the lending bank's point of view, its lender's risk cannot be approximately assessed without considering the corresponding borrower's risk.

6. In the present context, borrower's risk emanates from the range of problems faced by the government in the borrowing country in case of default of a loan. Since it cannot usually compensate the interest and/or capital loss to the lender by suitable attachment of collateral securities (see paragraph 3 above) in case of default, the consequences of default are usually not restricted to a particular loan arrangement. Instead, default tends to lead to an overall deterioration in the credit-rating of the country concerned, so that borrower's risk lies in the generalized repercussions that follow in future publicly guaranteed loan negotiations. And, it may even get generalized to concessionary flows and private capital flows in future. Thus, the threat which a borrowing country faces in case of default, is typically generalized borrower's risk which cannot be localized to a particular loan arrangement. This will be reflected in diverse ways like higher cost of borrowing in terms of higher interest rates and/or lower maturity and credit-rationing to the country which in extreme cases may even mean drying up of the sources of future credit. Thus, borrower's risk is more difficult to assess because the impact of default is generalized to a wide range of economic problems that follows. But the difficulty in assessing it does by no means imply that an analysis of country risk can afford to ignore its importance.

7. Perhaps the only observation which is broadly valid in this context is that, the greater the dependence of the borrowing country on external sources of credit in running its economic affairs, the greater would be the threat of borrower's risk perceived by it. For, the consequence of default is likely to have stronger repercussions on the economy of the borrowing country, in proportion to the extent of its dependence

on foreign sources of credit. In short, the higher the existing level of dependence of the borrowing country on external creditors, the more willing it would be to meet debt obligations through its own perception of higher borrower's risk.

8. But this results in a paradoxical situation: even from the lending bank's point of view, the willingness to repay by the borrowing country, i.e. the level of borrower's risk, can be increased by first increasing the borrowing country's/government's degree of dependence on external credit. But paradoxically that very method of increasing borrower's risk to ensure greater willingness to repay often runs contrary to the country's ability to repay, as its external dependence increases. The two major components of 'country risk' - the country's ability and willingness to repay may, under these circumstances, move in opposite directions, making any firm assessment of 'country risk' still more problematic.

9. A major consequence of the above line of reasoning is precisely the sort of situation which has come to characterize a significant part of commercial lending to developing countries in recent years. A borrowing country with heavy dependence of external financing perceives a high degree of borrower's risk in case of default and thus faces a sort of borrower's debt-trap. Since it cannot afford to default because of the serious repercussions entailed by its heavy external dependence, it is willing to pay not only an increasing portion of its export earning in the servicing of debt, but is typically willing to take recourse to further borrowing for meeting its debt service obligations. This perpetuates the trap of debt, simply because increasing recourse to borrowing is needed only to keep the existing borrowing arrangements undisturbed. This finds its reflection in lender's risk: the lending banks also have to take increasing recourse to rolling of debt, i.e. lending on an increasing scale, so as to enable the borrower to repay and thus avoid forcing the issue of default in their own interest of maintaining financial stability and confidence. Consequently, the mirror image of a borrower's debt-trap becomes the lender's debt rolling trap. This concretely illustrates our earlier point that lender's risk cannot be meaningfully defined independent of borrower's risk (see paragraph 5). Such a situation is not a mere logical possibility, but seems to have actually arisen in practice in some instances (e.g. Brazil, Poland) in recent years.

10. A central lesson to be drawn for avoiding such two-way debt-trap is to recognize the inadequacies of the present system of country risk calculation which largely ignores the concept of borrower's risk in external debt arrangements. An integration and analysis of the concept of borrower's risk is imperative for both the borrower and lender. It is as much necessary for the lender as for the borrower because, on the one hand the lender does not wish to be exposed to the debt rolling trap which steadily increases the risk of default over time and yet the lender is almost helplessly caught in the trap. On the other hand, the borrowing government or country would not wish to be exposed to the serious possibility of being forced to comprise its economic sovereignty by being helplessly caught in the debt-trap. Only a better appreciation of the interlocking nature of lender's and borrower's risk in country risk assessment can make both the parties in a loan arrangement more fully aware of the implications of external debt. There is a famous wise-crack attributed to Keynes of which it is worth reminding ourselves in the present context: "If I owe you ten pounds, I should be worried; if I owe ten million pounds, you should be worried!".