

## THE IMPORTANCE OF THE COUNTRY RISK IN INVESTMENTS MANAGEMENT

Conf.univ.dr. Ion Botescu, Lect.univ.dr. Liliana Nicodim  
Universitatea „Ovidius” Constanța, e-mail: ion\_botescu@hotmail.com

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Abstract: Foreign direct investments represent an activity which on the one hand is characterized by a long period of realization and work of the investment object, and on the other hand it takes place in a foreign country. Because of these reasons the managers have to take into account the country risk in the taking of the decision of investing in foreign countries. A very important help for the managers are the classifications done by the prestigious rating agencies.

**The multinational firms' managers' decision** of investing abroad, must always be based on the evaluation and analysis of the country risk. Banks are other entities that give special attention to the level and evolution of the country risk when financing business outside national borders.

According to Pancros Nagy, country risk may be defined as the exposure to a potential loss – a real active, a business – as an effect of economic, political or social events that are at least partially controlled by the government in the host country and not by the owner of the goods or the firm's manager.

Generally speaking, the country risk is the exposure to financial loss during an international business deal, loss caused by macroeconomic activities and political events in the host country.

The management of the country risk by foreign managers has two stages. The first stage (pre-investment stage) consists of: getting to know the receiving country's investment climate, applying objectives from the investment plan, to the actual conditions found in the host country, insuring the expansion of the investment portfolio, with the help of insurance companies etc. The post-investment stage stands to obtain a higher profit in a small amount of time, in view of repatriating profit and maybe even capital invested, to approach different types of activities in order to shake off the risk and maintain cordial relations with local and even governmental factors etc.

If a foreign investor intends to acquire a functional firm from abroad, then he must be aware that, besides the previously stated risks, there are risks in the particularities of the firm he wishes to acquire.

A study made by Romania's Department of Commerce and Industry and the German Business Club, based on questionnaires filled out by 124 firms with German capital, showed that in the, approximately, 12 years of transition, the Romanian economic environment has been a friendly one. There were discontents about: the legislative instability, the promotion of laws that have contradictory provisions in regard to the same aspects, corruption, the opacity of the privatization process.

Foreign investors have admitted to the fact that in the last 2 to 3 years, the Romanian investment climate has suffered a series of improvements; another plus, legislatively speaking is the accession to the EU, but the justice department is still ruled by negative accomplishments.

When making the decision of investing abroad, the risk class in which the host country is placed plays an important role. At the customers' demand, institutions such as: Institutional Investor, Standard & Poors, Moody's, Coface Intercredit evaluate the country risk based on the economic, social and political indicators. Country studies made by a rating company are used in order to establish the risk classes, positioning each state according to the risk potential of international business deals.

There are two ways of establishing hierarchies. In the first case, all countries subject to analysis occupy a place in an ascendant or a descendant top, depending on the level of the rating that was attributed. The second method implies grouping the countries into risk classes. A risk class is made up of countries whose risks are similar and whose possible damages have comparable dimensions. The more a rating agency wishes to accurately characterize the elements involved when setting the bases of a risk class, the higher the number of used risk classes is.

The foreign investor must take into consideration the fact that there is disparity between the moment in which a disturbing factor makes its entrance in the studied country and the moment when the study is being made.

Practice has shown that in rating tops made by various agencies, a country is regularly included in similar risk classes. This is made possible, partly, by using the same information sources and on the other hand rating agencies try as much as possible to avoid major discrepancies in the evaluation of a country, in order not to damage their prestige.

*Institutional Investor* makes semestrial tops for the 136 analyzed countries.

Their hierarchy is made based on the average of the grades given by a few dozen prestigious financial-banking institutions and by renowned specialists. The average corresponded to each country may vary between 0 and 100 points. According to the average they obtain, countries will be distributed into five classes, which are:

1. *Class A (81-100 points)* corresponds to a minimum level of potential country risk;
2. *Class B (66-80 points)* corresponds to an acceptable level of country risk, with the possibility of minor losses;
3. *Class C (45-65 points)* indicates a critical level of potential country risk. Significant losses are expected; it is best to obtain governmental warranties;
4. *Class D (35-44 points)* contains countries that are characterized by a high level of country risk, with the possibility of having total losses. The foreign investor must be extremely careful and should avoid placements in countries belonging to this category;
5. *Class E (0.34 points)* indicates a maximum level of country risk and it is recommended that business deals with this type of countries are avoided.

The agencies Standard & Poor's and Moody's make country hierarchies after considering the rating for loans given to other countries and for bonds issued by various states. Indicators that express the possibility of paying off the external financial obligations, of the countries in discussion, are also considered.

Standard & Poor's classify countries according to the rating given for investment deals using the notation AAA, AA.....D. Countries noted with AAA are least exposed to risk, the degree of a possible risk externalization gradually growing towards D; this last class even suggests the unavoidable possibility of becoming unfit for payment.

In September 2006 the Standard & Poor's agency granted Romania the rating "BBB-", which means an improvement from a "stable" to a "positive" condition. Romania was thus qualified to enter the class of countries with a low investment risk.

This estimation was mainly due to the positive results recorded in the economic and institutional field, generated by Romania's accession to the EU. The agency's analysts consider that in the next five years the GDP will record an annual average growth of approximately 5%, reaching an income of \$9000 per inhabitant in 2010. The budget deficit will be 2-3% of the GDP. In 2005, Romania's public duty was of 20% of the GDP, with chances of growing up to 25% of the GDP in 2010, which is rejoicing considering that countries in the "BBB" class have an average of 45%. In 2005 Romania's deficit on current account was covered, in proportion of 75%, by the FDI entries and in 2006, according to preliminary data, the percentage will outgrow 90%. Due to the reduction of FDI entries in 2008, 2009 and 2010 the degree of covering Romania's deficit on current account, through the fluxes attracted by FDI, will decrease. The deficit on current account has currently reached 10% of the GDP, having a growth tendency that will lead to the accentuation of the refinancing risks, in case of important capital exits.

Moody's uses a similar notation for obligations and for a state's external debt: Aaa, Aa.....C. The risk grows from Aaa, Aa to C. The notation for a country's titles issued on a short term is P<sub>1</sub>, P<sub>2</sub>, P<sub>3</sub>.

By giving our country the rating "Ba1", Moody's remains the only evaluation agency that placed Romania amongst the states with a low investor risk. The next rating class, to which Romania aspires, is considered by investors to be acceptable. Romania's "Ba1" rating is a consequence of the following factors: tax reduction, the discrepancies between macro-economic policies and the dimensions of the governing coalition.

Coface Intercredit distributed the 153 studies countries to the following risk groups: A<sub>1</sub>, A<sub>2</sub>, A<sub>3</sub>, A<sub>4</sub>, B, C, D.

Class A<sub>1</sub> is also the most appreciated one and corresponds to a safe economic and political environment with little possibility of payment incidents appearing. Country risk deteriorates as we move forward towards the last class, D, which implies a higher probability of deterioration of the economic and political environment with fatal consequences on the payment abilities.

This agency's analysts use the following indicators in order to determine the country risk: vulnerability of development, political and institutional instability, the fragileness of the banking system, the crisis of the foreign currency liquidity, the degree of the external debt, the vulnerability towards foreign capital and the companies' payment department.

### The COFACE evaluation for Romania - 2006

Table no.1

Rating for Romania	2001	2002	2003	2004	2005	2006
Risk Class	C	B	B	B	B+	A <sub>4</sub>

Romania's position in the B class during 2003-2004 implied a stable political environment capable of continually affecting an already poor payment history. Because of the economic growth of 8,4% in 2004 and of the favorable notice regarding the accession in the EU, Romania made a progress in June 2005 and received the "B+" rating. At the end of 2005 our country's "B+" rating improved, turning into an A<sub>4</sub>, which shows a mediocre payment history with a possibility of non-payments situations appearing due to the aggravation of the economic and political environment. We must not forget the floods of 2005 which lead to a

slow economic growth rhythm in Romania, as well as the important dimension within the governing coalition. According to the estimations made by COFACE, the main factor that determined the 2006 economic growth was the increase of the domestic use, which was due to the increase of salaries and the spectacular amplification of the credits for personal use. According to COFACE, the accession to the EU, the political stability and the continuation of reforms can lead to an improvement of rating, for Romania, with the possibility of receiving the A<sub>3</sub> rating in 2007.

According to the table, we can observe that Romania's rating has had a permanent positive evolution, getting closer and closer to the tendencies of eastern and central European countries in 2006. For the first time, since the end of 2005, Romania is part of a more appreciated risk class unlike Bulgaria.

The accentuation of the world economy's globalization in the last decade of the past century has determined the standardization of the legislative framework and of the facilities given to foreign investors from various states. The decision of investing abroad is currently influenced by policies concerning the risks that affect foreign investors and policies adopted by host countries.

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