

GWU – IBI – MINERVA PROGRAM

COUNTRY RISK ANALYSIS

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COUNTRY RISK ANALYSIS

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I - INTRODUCTION

Creating the present country risk work emerged from the necessity of finding conclusive answers on about accepting or not some credit risks, specially those ones represented by the possibility of restriction of payment, imposed by a country.

Furthermore, it is important to observe that the capacity of payment of a debtor may be deeply threatened if some macroeconomic instabilities affect its commercial environment, constraining its activity as a whole.

Nowadays, such issues are getting more relevant around the world, for the so called globalization has led the countries towards economic disclosures, essential for keeping them competitive.

So, an increasing number of companies are taking advantage of the external trade, which represents huge business opportunities as much as the possibility of buying products and, mainly, the development of new profitable and promising markets. The financial institutions, while financing the commercial flow among nations, are trying and taking advantages of such opportunities as well.

On the other hand, out of the commercial extent, new business opportunities are realized to those ones who are interested on investing extra

values abroad through direct investments or through the stock and security markets (public and private).

By the way, since the eighties, the financial markets are getting extremely more sophisticated with the introduction of several new products. Moreover, commodity and stock exchanges markets are now linked through real time connections, what makes the information faster and more efficient.

So, all of them, investors, banks, and companies are trying to improve their asset returns, taking advantage of the amazing international liquidity opportunities, brought by the process of globalization.

However, to some countries, such opportunities do not only mean increasing of the investment return. They also represent additional risks from the volatility intensification of returns of each implemented business decision. The concerning risks get stronger due to the country's capital flows velocity.

Under this highly sophisticated context, where the decisions are set in an effective global market, the country macroeconomic instabilities get amazing proportions as could be noticed during the crisis of Mexico, Russia, Brazil, Asia and, more recently, Turkey and Argentina.

So, the international trade evolution and the investment and financial programs development as well – due to the business set up, velocity and

breadth – demand periodical improvement of risk methodology and analysis, specially the country risk ones, which are approached in this paper.

II - HISTORY OF THE THEME

Since long ago, cross-border business risk has been an issue that has worried those ones who have transactions or assets to receive from foreign customers (residents in different countries). The possibility of a non-performance has been presented during this whole period.

In the seventies, the world economy was facing a relevant liquidity, plenty of dollars, most of them derived from the recycling of money earned by nations that were members of OPEC. Their strong reserves were deposited in the international banking system.

At that time, the financial institutions were not well prepared to deal with country risk but, looking for business, they quickly enhanced their exposure in foreign markets, especially in developing ones, which traditionally require capital. In several cases, the loans seemed to be contracted without regular attention to credit procedures of both the borrower and the country.

Since the eighties, some important problems involving the payback of those credits have started affecting countries such as Poland, Mexico and Brazil, whose defaults had caused heavy losses for the international banks and, consequently, for its investors and shareholders. For instance, at that time, over US\$ 50 billion were invested in Latin America by the US top ten banks and their provisions against losses had to be raised significantly to reflect and support new conditions in their statements. So, the financial institutions were forced to adopt maximum exposure risk policies, new analytical methods and strong credit procedures, all of those supported by reliable data.

A - THE SOURCES OF DATA

In terms of information to provide analysis correction, the one who is in charge (usually an economist working as an analyst at the credit department or even directly subordinated to the board of directors (scenarist) of financial institutions or rating agencies) should have access to a diverse and different source of data, including those provided by the public offices of the country which has been studied. That is why the complete transparency is essential, particularly nowadays when demand for disclosure is so strong.

Therefore, the federal government, plus specialized international institutions such as IMF, WORLD BANK, IIF, IDB, etc, is important search of data to the analyst. For instance, below there is a list of some local sources used by Merrill Lynch in its web site guide for Brazil:

Newspapers: Folha de São Paulo, Gazeta Mercantil e O Estado

News official agency: Radiobras

Official data and reports: Brazil Financial Wire, Central Bank, Finance Ministry, Institute of Geography and Statistics and BNDES.

B - RATING AGENCIES

Besides the institutions above commented, there are several agencies that could be seen as reliable sources like Standard & Poor's, Moody's, Economist Intelligence Unit, Euromoney, Institutional Investor, Political Risk Services, Business Environmental Risk Intelligence, Control Risks Information Services, international banks in general and others institutions.

Some of them also provide information and analysis of economic sectors, companies and operations assigning its related ratings. Such ratings,

while an evaluation about the quality of the assets or the transactions, according to their objective and terms also affect their pricing.

Nowadays, the rating system is wide known and used all over the world. Moody's and Standard & Poor's rating systems use to divide countries in categories as below and the four first levels of each one are considered "investment grades" (better quality of the asset in risk terms). Based on their evaluations of a bond issue, the agencies give their opinion in the form of a letter grades, which are published for use by investors.

For the typical investor, risk is judged not by a subjectively formulated probability distribution of possible returns but by the credit rating assigned to the bond by investment agencies. In their ratings, the agencies attempt to rank issues according to the probability of default.

Both agencies have a Credit Watch list that alerts investors when the agency is considering a change in rating for a particular borrower.

CREDIT RATINGS BY INVESTMENT AGENCIES

MOODY'S (*)

Aaa	Best quality
Aa	High quality
A	Upper medium grade

Baa	Medium grade
Ba	Possess speculative elements
B	Generally lack characteristics of a desirable investment
Caa	Poor standing: may be in default
Ca	Speculative in a high degree; often in a default
C	Lowest grade; extremely poor prospects

(*) Moody's uses notches (1,2 and 3) to better contrast risks among each rating

STANDARD & POOR'S (*)

AAA	Highest rating: extremely capacity to pay interest/principal.
AA	Very strong capacity to pay
A	Strong capacity to pay
BBB	Adequate capacity to pay
BB	Uncertainties that could lead to inadequate capacity to pay
B	Greater vulnerability to default, but currently has capacity to pay.
CCC	Vulnerable to default
CC	For debt subordinated to that with CCC rating
C	For debt subordinated to that with CCC- rating, or bankruptcy petition has been filed.
D	In payment default

(*) S&P uses notches (+,-) to better contrast risks among ratings

Nonetheless, controversial questions involving its consequences, like reorientations about the capital flow around the world, turn it somewhat arguable. During a crisis period, the time it takes to define a straight position, as in the case of Asia and Turkey, is also questionable.

Despite relevant opinions against the ratings, they remain useful and necessary, although it is important to have a deeper evaluation of their methods and procedures. At least, it is forceful recognizing that rating agencies have been providing a periodical and organized skill of data, which remains as a powerful tool to deal with a cross-border analysis.

For instance, the chart below presents the evolution of Brazilian ratings provided by Standard & Poor`s and Moody`s.

SOVEREIGN RATING HISTORY

Moody`s			Standard & Poor`s		
11/86	Assign	Ba1	12/94	Assign	B
12/87	Downgrade	B1	07/95	Upgrade	B+
03/89	Downgrade	B2	04/97	Upgrade	BB-
11/94	Upgrade	B1	01/99	Downgrade (*)	B+
09/98	Downgrade	B2	01/01	Upgrade (**)	BB-stable
10/00	Upgrade (**)	B1/stable			

(*) Devaluation of the national currency; (**) Improvement in economic fundamentals.

III – METHODS OF ANALYSIS

A- METODOLOGIES

Country specific risk refers to the volatility of returns on international business transactions considering several facts associated with a particular country. The concept evolved in 1960s and 1970s in response to the banking sector's efforts to define and measure its loss exposure in cross-border lending. The idea of transfer risk (that a government might impose restrictions upon payments abroad) has changed to the concept of sovereign risk, which is broader than transfer risk once it includes the idea that, even if the government is willing to honor its external obligations, it might not be able to do so if the overall economy cannot generate the necessary level of foreign currency.

Therefore, the analytical tools have been improved on to drive the challenges brought by the globalization and new financial products. Emphasis shifted to diversification and hedging techniques and some statistic sophisticated models have been developed in order to objectify as much as possible the analysis, breaking it down into major components as economic, financial, currency and political risks. Except by the political risk, all of the others are market-based and measurable, corresponding to the spread out

concepts in modern economic and financial theory. Certainly, all of the components have to be thought not only by itself but, specially, by the outcome of their interaction.

Although somewhat subjective and frequently not easy to predict, the political risk approach is really relevant, due to most of the government decisions affects directly the economic agents, its expectations, behavior and the landscape where transactions are made.

As already commented, there is a huge difficult to define an accurate measure to predict cross border risks. Even in the case of financial investments, the high levels of market volatility make measures based on contemporaneous market indicators highly unstable. Moreover, the limited history of bond market prices in emerging markets makes it impossible to ascertain any long-term trends in risk.

Despite this difficult, **GOLDMAN SACHS** has designed a model to help strategic investment decisions for securities in emerging markets. The model is used to recreate discount rate history for 23 emerging markets over the last 25 years and produces a database of long-term and contemporaneous discount rate for any country, any time, with or without a local bond or stock market. It is a complement to its estimates of contemporaneous discount rates. The model highlights the importance of global monetary conditions, global

risk aversion and commodity prices in determining emerging market discount rates, complementing domestic cash flow, balance sheet and wealth indicators to enhance its formulation's explanatory power.

With the model, Goldman Sachs tries to bridge the gap between the assessments of near-term market risk typically emphasized by portfolio managers and longer-term risk trends more often looked at by direct investors in plant and equipment.

Although comprehensively not allowing perfect disclosure for outsiders, the model defines the sovereign risk adjusted discount rate (R) as the sum of the risk-free rate (yield of a long-term US Treasury bond) plus an adjusted equity risk premium for a given emerging stock market. The drivers of risk premium could be attributable to global, country, and company-specific factors.

Global Indicators $>$ **Spread + Volatility** $<$ Domestic Macroeconomic Indicators

Company \wedge Indicators

The risk global and domestic drivers selected by Goldman Sachs are measured by using some proxies, as below:

GLOBAL DRIVERS

- **Degree of risk aversion in developed markets** → the difference between yields of relatively low-quality BB rated corporate credits and high-quality AAA bonds or US Treasures.
- **Global monetary conditions** → level of US interest rates.
- **Commodity prices** → global supply and demand conditions.

DOMESTIC DRIVERS

- **Balance sheet and Wealth** → level of internal and external debts, exports, GDP and GDP per capita.
- **Income statement** → GDP growth, fiscal gap (tax revenues minus expenditures plus domestic debt amortization), and the external gap (current account balance plus debt amortization).
- **Stability of cash flows** → level of inflation or exchange rate volatility.
- **Debt service history** → “dummy” variable for countries that have defaulted on their debt service obligations in the past.

Running the whole model, a sophisticated equation, it could explain how much a change in a variable will affect the country risk in terms of basis

points over the benchmarking bond. In average terms, the model found emerging stock markets correlations of 56% for discount rates and 48% for sovereign spreads. Moreover, the correlations between sovereign bonds and stock markets tend to be lower in relatively closed markets dominated by domestic investors, and vice-versa.

The last step, is a simulation using different combined scenarios, trying to predict the future behavior of the used variables and, consequently, of the asset. Goldman Sachs believes that an accurate measure would be expected to provide a strong correlation between discount rates and the stock markets in each country. In fact, according to Goldman Sachs, for Latin America (more opened stock markets) the correlation achieves 70 and 59% respectively. This level of correlation is quiet high and should be following during next years in order to confirm its assertiveness.

As could be seen, even when dealing with a market based investment, as equity and bonds, with several available numbers (rates, yields and volatilities) and powerful statistical tools, the analyst has to use so many proxies to run a model and, after, he has to make some assumptions about the proxied variables. However, the models are relevant because they permit objectify the steps of the analysis, comparing each prediction with the future

behavior of the asset, also opening a room over which the analyst can go deeper.

MERRILL LYNCH in its portfolio strategy for emerging markets (equities, bonds and commodities) uses to divide the portfolio according to its index weighting for each country (table 1). After, considering the ongoing behaviors of the global economy and the countries, the strategists define a recommended portfolio by adjusting the weight of each country (market weight, under or overweight) and the respective duration (short, neutral or long). Within the countries, similar approach is adopted for each asset (table 2).

Thus, building the portfolio, Merrill Lynch does not have an econometric model to estimate the intrinsic risk of the countries despite following the behavior of many macroeconomic variables and other information to define the weight of the countries in its portfolio. (see annex 1)

MOODY'S and **STANDARD & POOR'S** also do not have a econometric model for country risk analysis. Standard & Poor's follows the behavior of many macroeconomic variables and other relevant information, and compares the outcomes with the peer group of countries.

Moody's, believes that credit rating is by nature subjective. Moreover, because long-term credit judgments involve so many factors unique to

particular industries, issuers and countries that any attempt to reduce credit rating to a formulaic methodology would be misleading and would lead to serious mistakes. Thus, Moody's, following analytical principles, deals with several relevant risk factors (including quantitative ratios as a objective and factual starting), building scenarios and relying on the judgment of a diverse group of credit risk professionals to weight those factors and establish the ratings.

B – THE BASIC DATA (Quantitative and qualitative variables)

These are ones of the most important subjects on analyzing a country. The models already commented and its components (economic, financial and currency risk) usually are based on these variables. The previous definition on what variables the analysis must be focus on has to respect the particularities of each country and the needs of the model been used. However, standard variables as described below should be approached to keep the analysis consistent and comparable with other similar works about other countries.

Thus, the first step is to be sure that the historical macroeconomics series of official data are reliable, consistent and comparable. Doing so, the analyst should pay attention to expressive changes that could have occurred

during the historical period, in order to evaluate its reasons, meanings and impacts, including the answers given by the economic agents, international market and the government to them.

There are some standard economic variables that often could be found in most of the diverse approach adopted by financial institutions and rating agencies. Those variables, which have been largely used along the years, are, somehow, straight connected with the country's real ability to repay its commitments. In fact, even statistic models (discriminating analysis) were made using such variables in order to predict country's default probability.

EXTERNAL SECTOR - The balance of payments (summary account of economic transactions among a country and the others nations of the world, during a period) as a whole and its evolution through the years means a strong source of data. Some of its contents as exports, imports, debt services, directly investments, loans in general, repayments of loans, external debt, and flow of foreign reserves (multilateral funds), are almost ever present in any analytical approach.

The exchange rate (currency risk) is, for sure, another essential variable to be considered due to it balances the transactions (equalizes the

prices of goods, services and capital) between residents and non-residents. The analysis has to consider the historical behavior of the exchange rate and, most important, the policy which has provided its support (fix, float, mix, etc exchange rate regime) making clear whether the country is following a rational economics approach or it is using the exchange rate as a tool to sustain a forced macroeconomic equilibrium.

INTERNAL SECTOR (Public and Private) - Beyond those macroeconomic variables which deal with the external sector of the economy, there are some others as relevant such as the interest rate, public debt and its service, level of investments, budgeted equilibrium (incomes and expenditures), internal savings, consumption, GDP/GNP, inflation rate, money supply, etc.

The analysis must be completed with qualitative variables, which consider social aspects as population, rate of birthday, life expectancy, rate of unemployment, level of literacy, etc. Despite its importance, only some of the social statistical variables could be directly used in the models as it happens when analyzing corporations.

In fact, as already commented, social-political aspects are essential for all kind of analysis due to they draw the whole environment of the running

economy. Further approach on these aspects will be seen in a following session (Contents of Analysis).

IV – PURPOSE OF THE ANALYSIS AND ITS TERM

Before starting an analysis is essential a definition about why it is been done. Once many contents of each country risk analysis usually deal with common variables, there are always specific aspects, which must be emphasized according to different uses. Otherwise, it will not be useful and, worst, could lead to some issues that will not clearly explain what kind of risks the investor could be submitted to.

First of all, it is important to reckon what kind of investment has been thought, like loans, trade, direct investment, bonds, shares or whatever. This definition will address to another important issue, which is the term of the investment (short or long).

DIRECT INVESTMENT

For instance, if a company looks for a place to install its new industrial plant, besides a normal business plan (market, suppliers, labor forces, location, energy, etc) the analysis must contain an approach upon the legal environment

as national regulations about profit transfers, special reduced tax for foreign investments and minimum term of them, political forces and its viewpoints about international capital, exchange rate regime, other macroeconomic aspects and so on.

FINANCIAL INVESTMENT

In case of investment in the capital market, beyond some specific financial assessments (historical prices of company's shares, its returns, standard deviations, forecasts about the behavior of the market and the own company), the analysis has to emphasize the financial equilibrium of the country, specially in the short run, like its cash flow in terms of current account balance and reserves, besides the exchange rate and the perspectives of changes on the legal environment as well.

All those aspects are so important because, even under sound opportunities and well-counterbalanced markets, there are always risks to be handled and any kind of investments must have previous well-defined way out.

TRADE

In terms of foreign risk analysis, the trade is the less risky sort of investments due to commerce is the last economic sector that could have its

financial commitments blocked out by low liquidity or political restrictions. Countries tend to prevent defaults in trade because it is largely essential in supplying its needs. Nevertheless, it is necessary a kind of credit risk analysis not only about the customer but also about the country. By the way, this sort of risk (changes in the taxation regime for consumer goods and capital goods) is now being faced by Brazilian companies, which maintain business with partners from Argentina.

V – CONTENTS OF ANALYSIS

B – COUNTRY HISTORY

According to the purpose of an analysis its approach can be focus differently, but it is always convenient some kind of historical brief, in order to identify aspects that could interfere in the country's future behavior reducing the ability or willingness to payback any external commitment. In this way, some chronological highlights over the main historical data could provide a good comprehension about key factors which draw the profile and behavior of the society, the private sector, the government, the legal

environment, the economical, political and diplomatically relationships to neighbor nations and the world as a whole.

The structure of the government and its features like political and administrative organization are also relevant aspects to be approached. The political forces which act in the country, their representatives and the main national issues that have been discussed must be focused, once they can give an important vision about what the investors could expect in terms of economic and sector policies and its consequences for the non-residents capital owners. Particularly important is the dominant conception about democracy, military subjects, relationship with the international market and the geo-political strategy of development.

Social aspects and their key-indicators like IDH, population growth rate, infant mortality rate, analphabetism rate, unemployment ratio, life expectancy, composition of the population (age, sex, labor force) have to be broadly considered. In the same way, geographic positioning and its related strengths and weaknesses are essential aspects whose derived options have been drawing the country along the years. For instance, if the country does not have a seacoast it could be an important restriction for international trade of goods because it does not have its own harbor and will depend on the quality of the relations made along the years with its neighbor countries.

B – COUNTRY RISK AS A CORPORATE RISK

Country risk studies are analogous to business risk analysis in the sense of both are related to the future capacity of enhancing wealth from the available resources, in terms of capital, technology, natural resources and labor forces. This simplification is obviously to explain that those kind of analysis takes into account the long accumulated knowledge period from the business approach for companies, including financial theory.

1. DEPENDENCY LEVEL

Thus, when somebody starts a study about a country it is necessary to identify the environment where it has been working. In other words, it means that the next step after the brief history is a clear definition about the state of the art of how the country is positioned in the world in terms of its wide relationships, economic block in which it belongs to (or not), importance of international trade for the nation's figures and so on. All these aspects are relevant to identify the dependency level of the country, which is essential to estimate the freedom grades that it has to run its economy. In this sense the

further a country presents a diversified economy in terms of production (industries, agriculture and services), the further it could present sovereignty in its world relationships. In the same path, the more an economy has a strong international trade in both directions, the better it could deal with its international partners. It is sure that financial dependency to meet the needs of a country also is a strong and permanent concern for the analyst. In this case, the volume and maturity of debts (internal and external) and, the available sources of financing also help to measure the freedom grades of the country.

Both relations can be extracted from some economic variables. In case of how much is the output spread away throughout the economy, the analyst could break the GDP's economic sector, assessment its composition in terms of values and percentages of participation of each one and the level of regional or sector concentration. It is similar to corporate approach when analyzing the income structure.

The same approach could be made in case of the international trade. For that, the analyst must break up each part of the trade balance (imports and exports) in sectors, goods, countries and economic blocks, identifying its composition and level of concentration (percent and value). Complementary, in the search of defining the rest of the world relevance for the country's economy, it would be convenient getting the ratio between the trade balance

and the GDP (sum of imports and exports over the GDP). To be consistent along the time, all those data and ratios must keep the same collect method and have to be selected within a period of five years, at least.

Financial issues also have to be clarified, as how and how much is been supported by domestic or external savings.

At this moment, the conclusions could be registered to point out the aspects that remain relevant for the comprehension about dependency level of the country and its freedom levels.

The conclusions about the approach upon the **DEPENDENCY LEVEL** and the **LEVEL OF CONCENTRATION IN PRODUCING AND TRADING GOODS AND SERVICES** are key factors to understand the economy's trend and will draw the **restriction frontiers** of the Nation. In other words, those conclusions will compose the chart of the nation's **STRENGTHS AND WEAKNESSES**.

We can figure out, for example, a country that is so much dependent on few raw material exports to its GDP. What could it happen if, in case of a sudden and significant decrease of international prices of such goods, or worst, if its costumers develop new products dismissing that raw material? What economic choices could the country have in a situation where its main outcome starts to fall down? How would it deal with a decline in its wealth?

What would be the strongly affected sectors in the country? How could the country repay international commitments?

The international market is full of threat for its players and sudden happenings are frequent and have to be dealt by the economic agents. They are part of the game. Nevertheless, the analysis must provide good information to the risk takers and, like corporations, countries could not be so dependent of few goods, few financiers or even few partners because its ratings, for sure, will not be sound.

C - EXTERNAL ENVIRONMENT

Since ancient time, external trade has been an important factor to the development of societies. Nonetheless, nowadays, globalization has brought international business to the center of the discussions and so forth the external environment had become vital for all countries, including the ones where the external sector has not been so strong yet.

Thus, a whole vision on what is taking place around the world (the economic trends, the behavior of financial markets (flows and rates), the forecasts for conflicts among nations, the improvement of the economic blocks, the level of openness of the world economy, financial crisis and

international liquidity) is a framework over which the analysis is supposed to have a start.

Nowadays, for instance, we wonder about the behavior of US economy (soft or hard landing)? What will happen to oil prices and its supply? How long will it take to Japan to recover its ability to consume? Other subjects are also relevant as: Would European Community speed up its pace towards a stable growing and is euro recovering its related value against dollar? Or what about the forecasts to the agribusiness and the prices of the related commodities?

By the way, in jan/2001, Merrill Lynch has designed 3 scenarios for US economy and Oil Prices:

	US GDP	FED CUTS	RISK APPETITES	OIL PRICES
Soft landing	> 3%	moderate	strong	Risk for upside
Rough landing	2-3%	- 150 bps	fair to positive	US\$ 25
Hard landing	< 1%	aggressive	weak	Risk for downside

According to Merrill Lynch, for Brazil, under these scenarios, the six-month spread changes in bases points could vary from -75 (soft landing) up to + 150 (hard landing). Again, it is important to register that the changes in the spreads tend to have a strong impact in emerging countries economies and,

moreover, the scenarios are dealing only with external variables that could not be driven by the emerging countries.

So forth, the analyst must select those issues that are more close related to the country which he is dealing with, seeking to figure out about the impact of the most probable scenario of them to apply over the country's economic variables. The external landscape, its trends, the dependency level and the ratio between external trade and GDP will provide useful information to connect the external sector to the domestic one in order to identify opportunities and threatens.

For example, if a country is highly dependent on exporting agro commodities to nations that have been keeping strong protect barriers for its markets, affecting its ability to sell its production and, at the same time, some imports that are relevant for the country had their prices risen up, probably the country's trade balance would not be in equilibrium. So, it could be necessary to increase the interest rate to attract capital inflows. Moreover, some import restriction could be established in order to compensate the payment balance equilibrium as a whole.

Then, the new exchange rate brings with itself a change in the related prices of the whole domestic economy that could cause an impact in terms of internal prices (inflation) and other macroeconomic aggregates as outcome,

growth rate, interest rate, savings, consumption and so on. The dimension of the impact will be also defined by the stage of international liquidity, the bigger it is, the softer and cheaper is the adjustment process.

It is evident that much more complex examples could be designed to demonstrate the links between the external and internal sectors, but what is really important is the specific case that demands a deep analysis among the key aspects which could better explain the concerning risks. Therefore, some ratios could help the analyst.

D - RATIOS FOR ECONOMIC RISK EVALUATION

Cross-border economic risk analysis involves an assessment about the ongoing and prospective macroeconomic ratios among some variables. They could be separated into two groups (domestic and external). Its figures must be presented in historic series (at least five years) to provide information about its evolution, which could be real values, percentages or relations. In case of domestic economy, the main and most used ratios/variables are:

1. DOMESTIC SIDE

GROSS DOMESTIC PRODUCT (GDP): As already seen, its real value should be broken up by sector (agriculture, manufacturing, construction, services), by principal goods and services and by private and public sector.

GDP GROWTH RATE: Its annual rate could be also broken up in the same way, to point out the sectors/products that have been having a particular behavior (different of the average) for better understanding the economy's trend. For instance, to identify which sectors are more dynamic and which ones have slowed down their performance.

GDP PER CAPITA: Its evolution, in real terms, is an economical measure of the country's productivity. Many rating systems use this ratio in its analysis because, in the long run, it helps explaining how efficient is the country's growth rate. Combined with the GINI INDEX the ratio provides a good vision about the trends to improve the social-economic level of development of the nation.

GINI INDEX: It measures the income distribution among different groups in society or, in other words, how equitably economic growth spreads its benefits among the population. Combined with the evolution of GDP PER CAPITA could bring a vision about how strength, and attractive the internal market is becoming. The more distributed is the flow of wealth, the bigger are the business opportunities and lesser the risks (probability of volatility in the internal environment).

UNEMPLOYMENT RATE: It is an applicable measure which deals, among several aspects, with the labor factor (sufficiency) and could explain the strength and performance of the whole economy, the freedom social grades for adjustments in it, the size, conditions and opportunities presented by the internal market and the political environment. Combined with some geo-economical data such as population and its growth rate, the analysis could reveal strategic issues that the economic policy will have to approach.

INTERNAL SAVINGS/GDP: This ratio and its evolution work with the propensity of saving of the whole economy. For a better understanding, if necessary, GROSS DOMESTIC SAVINGS could be broken by economic agents (householders, firms and government).

INVESTMENT/GDP: In the long run, this percentage offers a vision about how strong and bigger could be the economy in the future because it gives a potential rate of capital improvement, named the **GROSS FIXED CAPITAL FORMATION**. Once more, its important to break this information up in sectors to apprehend what is the direction the economy is going to grow and, consequently, what kind of business opportunities are ahead. Moreover, the values and percentages should be compared with the **SAVING** figures in order to identify whether they are having a compatible behavior or not. If not, the gap between investments and savings will have to be offset by external capital.

GROSS DOMESTIC FIXED INVESTMENT/VARIATION OF GDP:

This ratio is interesting to evaluating the quality of the previous (since around five years before) investment decisions in terms of its productivity in growing the GDP. The better the decision in a specific period, the bigger the economic return emerged some years later.

GROSS DOMESTIC SAVINGS/GROSS DOMESTIC FIXED

INVESTMENT: An important ratio that explains the domestic savings is

enough to support the investment made at the economy. The difference between investment and savings (**THE RESOURCE GAP**) should be provided by external funds (savings from the rest of the world) and it is equal to the outcome of the **CAPITAL BALANCE** in the Balance of Payments. This ratio, combined to **NET CAPITAL IMPORTS/GROSS DOMESTIC FIXED INVESTMENT**, indicates how dependent the economy is on foreign resources. **THE RESOURCE GAP** by itself could not be interpreted as a negative factor. Then the analysis must investigate if the investment that it sustains is productive (quality of investment decisions) and/or if the **GAP** is not so much derived from a increase in the **CURRENT CONSUMPTION** which will not become a engine to amplify the strength of the economy in the future (investment).

FISCAL POLICY

Until now the approach has been restricted by the macroeconomic variables that deals with the amount/sort/quality of the product provided by the economy, in a certain period of time, and how it has been supported. But, the fiscal side is also so much important, because it helps to understand, in a broadly way, the role of the government, its budget equilibrium, its relevance

in the entire economy and whether or not the public sector has been well managed in terms of economic rationality. Therefore, some ratios are useful:

BUDGET DEFICIT/GDP: Its size and evolution represents how far the DISSAVINGS are contributing to increase the RESOURCE GAP. If it has a chronicle behavior, even though the expenditures were well managed and justified, a solution must be found to balance the outcome and not distort the economic fundamentals. Sometimes the budget presents a surplus and also an adequate answer is required to balance again the figures, as it is happening now in the US where people is discussing the convenience of a tax cut. In case of budget deficits it is pertinent knowing what are the main causes that justify the deficit, as current expenditures (PRIMARY DEFICIT) or the debt's services. Moreover, the deficit as a whole could has its origins not only at the federal level but also at state or even municipal levels.

INTERNAL DEBT/GDP: This ratio and its evolution, mixed with the **BUDGET DEFICIT/GDP** ratio analysis, offers a vision about how much the public sector is using the country's savings. Moreover, if the ratio and its behavior are relevant, the analysis must go over where the debt is/was been applied (current expenditures or investment) and as far as the public finances

are related to past decisions, its amount, its specific destination (social security and other social programs, etc) and its maturity structure. Researching the FISCAL POLICY, the analysis would find out whether or not some measures are being taken to solve the disequilibria and could point out if debt-servicing obligations will not exceed debt-servicing capacity in terms of cash flow. The size of the INTERNAL DEBT is a key issue always focused by everyone in charge of country risk analysis. If it is a huge ratio, investors will be certainly concerned.

MONETARY POLICY

The monetary policy is an essential issue once it deals with the price stability that is an important target which policy makers are always concerned about. An economy which presents low inflation and less volatility in its relative prices of goods and services, provides enormous facilities to decision makers in terms of their predictions to expected returns of investments and a less risky social, economical and political environment. Beyond others benefits, it also contributes for a better equilibrium between internal and external sectors because the exchange rate would be less affected by domestic price changes. At the same time, the stable landscape produces a much more

attractive business opportunities on the viewpoint of international investors and, consequently, a stronger possibility for capital inflows.

All those aspects request an analytical approach over price indicators such as:

INFLATION RATE: its significance has already been commented, but it worth analyzing its framework by breaking up the different components like prices to consumers and firms, looking after why they are, eventually, changing.

PERCENTAGE INCREASE IN THE MONEY SUPPLY: It offers a vision over how policy makers are dealing with the variations on the stock of currency that could be taken into account when analyzing the government budget to identify whether or not the public sector is pressuring the supply of currency in order to support current deficits. Obviously the percentage must be compared with the **INFLATION RATE**.

REAL INTEREST RATE: A powerful measure about the confidence of economic agents, which deals with theirs expectations about the future of the economy. The price of the currency has an inverse correlation with the

investment and commonly when it rises, usually, the whole economy shows a downturn on its performance. The real evolution of the rate should be measured after extracting the effects of the inflation during the period. On the other hand and according to the needs, the future behavior of the inflation could be projected to measure the future real return of an asset.

2. EXTERNAL SIDE

GROWTH RATE OF EXPORTS: It is an index that measures the evolution of the amount exported by a country. If necessary, the analysis could be completed with VAREX.

VAREX = VARIANCE OF EXPORTS: This index provides information about the behavior of the exports. It is a key issue to analyze the performance of the exports breaking it up to identify the causes of a variation. The causes could represent different types of risk like volatility in prices and or in quantities of goods/services trade abroad. Moreover, changes in exports sometimes could address to a new composition in the list of exported goods like a higher or lower aggregate value products.

GROWTH RATE OF IMPORTS: This index measures the evolution of the amount imported by a country. If necessary, the analysis must be completed as it was suggested above for exports.

STRATEGIC IMPORTS/IMPORTS: It shows the dependency of the country on intermediate goods that are necessary to maintain current levels of output, or investment goods necessary to maintain a future output. In general this kind of goods are associated with raw materials like oil, energy, chemicals, etc. For instance, annex 2 provides some information about the impacts of US\$ 1.00 increase in oil prices for emerging markets.

EXPORT/IMPORT: It is a ratio that matches the unit value of imports which one unit of exports can buy. Named as **TERMS OF TRADE**, its behavior could explain changes in the TRADE BALANCE that could affect the performance of the external side of the economy. Recently, many developing countries that are strongly dependent on their agricultural lists of goods had the terms of trade severely affected by a decrease in the price of the goods. Moreover, most of those countries had suffered, at the same time, from a boost

in the international price of oil which has contributed to worsening their terms of trade.

TRADE BALANCE: The synthesis of exports and imports is one of the most relevant sources of data for the analyst. According to the relevance of the trade balance for the whole economy and its variations, it could indicate how much a deeper approach over trade variables is required. The structural factors that usually change the outcome of trade balance are, for instance, the activity levels of the country and world economies, the exchange rate and the terms of trade. To estimate the importance of the international trade for the country and its economic openness level, the analyst could add the amount of imports and exports to compare the outcome with the GDP. Many rating system also use the ratio NET EXPORTS/GDP to better understand the importance of the international trade for the country, especially as source of foreign currency.

CURRENT ACCOUNT BALANCE/GDP: This medium-term ratio has been identified as one of the most important tools to predict crisis. The deficits or surpluses in the current account are directly associated with the ability to pay external liabilities and, also, with the level of international reserves. In case of

Asian crisis, some of the involved countries have faced current account deficits.

INTERNATIONAL RESERVES: The amount of the reserves represents the stock of foreign strong currency that a country has to compensate deficits in the balance of payments. Usually, in the analysis, the amount of reserves constituted by gold is not taken into account because it does not have the same liquidity of others assets. The amount of international reserves and its volatility is always a key variable in country risk analysis indicating how powerful is the economy to deal with imbalances in the external sector. Sometimes, market agents loose their confidence in the country and a speculative attack against national currency may occur. At this moment the amount of international reserves is vital for the policy makers to deal with the effects of such attack.

INTERNATIONAL RESERVES (minus gold)/MONTHLY IMPORTS:

This liquidity ratio measures a country`s ability to maintain import levels with disposal current cash. It represents the number of month of imports that could be supported by strong foreign currency. Its outcome and the percentage of STRATEGIC IMPORTS must be together analyzed.

EXTERNAL DEBT: This amount and its variations have to be evaluated in order to identify its composition and maturity (key aspects that will integrate the future capital inflows requirements). It is also important knowing the distribution of the debt between public and private sectors, checking it against the equilibrium of the public finances. This way, even in the case of a long-term debt, it could indicate future solvency problems. Again, most of the rating systems consider the size of the external debt as a key variable.

EXTERNAL DEBT/GDP: Sort of financial leverage ratio that shows the whole external debt importance to one year flow of production. The lower the ratio, the better the economy's external financial position. Meanwhile, to get a broad comprehension about the country's solvency, it is important to remember that the ability to pay should be derived from how wealthier the economy has become with external savings and, also, how much foreign inflows it has been able to generate in a given period of time.

SHORT TERM DEBT/RESERVES (minus gold): This liquidity ratio shows how much the reserves are committed by amortizations in the short run. The debt's maturity is essential to identify whether or not a country could

have problems to repay its liabilities. For example, previously Asian crisis, some regional countries had such a high short-term external debt (maturity of one year or less, almost hot money) that their economies were driven to a serious liquidity crisis because the investors start not to reinvest their money into the nations. In fact, the countries began suffering a large speculative attack against its currencies.

EXTERNAL DEBT SERVICES/EXPORTS: The developing markets find in exports their main source of funds to generate strong foreign currency in order to support amortizations from the external debts. The exports must be large enough to pay interest and principal on the outstanding foreign debt. If they are not, the foreign currency will not be available to meet payments, the higher the ratio the bigger the default probability. This financial ratio brings a practical application of the country's ability to pay resembling a cash flow coverage ratio. In fact, it is not exactly a complete cash flow analysis because there are other variables like **IMPORTS** and the outcomes from the **CAPITAL BALANCE** that, also, might have to be taken into account when dealing with country's cash flow. Some authors support a ratio at about 10%, but anything over 30% is something to be concerned about. In fact, these percentages have only to be considered as comparative numbers and they must be analyzed

among other variables because of the particular macroeconomic profile of each country at a given moment, its financial structure and the ability to generate enough foreign currency to match its international commitments. Another common related ratio is EXTERNAL DEBT SERVICES/TRADE BALANCE.

CAPITAL INFLOWS (predictions): This is a difficult information to be found, because it deals with expectations that could not be well estimated. However it is strongly relevant to figure out the future's balance of payments profile and how its equilibrium will be achieved. The forecasts of capital inflows should contribute to drive the actions of both risk takers and policy makers.

EXCHANGE CURRENCY RATE: The most ubiquitous and best-known type of country risk. The "right" price of the currency in market terms (supply and demand for the currency) is essential for reaching out the economic stability and the growth of any country. Whatever exchange rate regime adopted by a country – fixed, flexible or any derivation of both -, long-term success depends on a commitment to sound economic fundamentals supported by the authorities.

The exchange rate interacts with most of the economic variables shifting, also, the behavior and decisions of the economic agents. It plays an important role in terms of income distribution, level and composition of the output, price levels and trade terms. In this way, even the outcome of a slight change in the rate could mean the difference of returns between one and other alternative choices of investments. Moreover, the exchange rate, if well defined, contributes to a profitable allocation of resources in the whole economy, besides preventing artificial losses or gains of competitiveness and their impacts in the trade balance.

Nowadays, due to the worldwide high volatility of capital flows and its requests for immediate macroeconomic adjustments, many countries have been adopting a flexible exchange rate regime in order to better set the price of their currencies, lightning external imbalances.

Thus, in country risk analysis the exchange rate assumes a central position and must be closely followed to identify any unusual behavior. This is why the analyst has to be aware that, sometimes, the governments promote artificial rates stirring up dolorous but necessary adjustment. Those tricks over the market value of the currency will certainly distort its price and many of the country`s macroeconomic figures, disqualifying his own conclusions.

E - DOMESTIC FINANCIAL SYSTEM

After the international crisis the banking sector has adopted many actions to avoid losses. Basel Committee, also, has defined some strong procedures to be followed by the financial houses and Central Banks have been trying to better supervise their jurisdictions. Despite those actions, recently Asia and Turkey crisis have shown that the surveillance is not yet enough to keeping the soundness of some domestic system.

Actually, the international banks had developed so many tools to better deal with international crisis. However, not all countries have modern and well-established managing risk procedures. The performance of some banks has demonstrated that some important customers could not afford the impact of currency depreciation and the guarantees were not sufficient to support the loans.

When domestic banks do not have a sound risk management policies and strong adequate provisions to their credits, the country risk as a whole happens to be worst and the nation has enormous difficulties to resist at a speculative attack.

Therefore, as far as possible, the analysis must investigate the health of the domestic financial system, by assessing information provided by the

Central Banks and, further, from the principal banks of the country. But, it is not such a reliable research once the disclosure is never complete and, more, the quality and composition of the assets and liabilities remain always difficult to draw. By the way, accessing Central Bank policies and supervising procedures could also help to evaluate the health of the financial system. The straight and independent are the controls, the soundness might be the financial system.

F - CONJUNCTURAL ASPECTS

After an extensive country's overview, by approaching the key aspects that define the profile of the nation, like its international relationships, levels of dependency and concentration, the macroeconomic performance connected with its strengths and weakness, and the social-political figures, the analysis should be completed in order to try and figure out what can happen in the country's future.

In this way, identifying the strategic vision of the leaders and their main plans could set the directions over which the country would go through and how the weakness would be overcome. For that, the analysis must consider the

issues that are being discussed by the government, politicians and other forces of the society as well the challenges they have to deal with.

At this moment, a strong effort has to be made by the analyst to draw the most probable scenarios that would remain and their impacts over the economic environment and the reverberations at the business market. These scenarios could contain some predictions about the future behavior of the macroeconomic variables in order to forecasting using the balance of payments as a kind of cash flow.

For sure, drawing the projected “cash flow” is not such an easy exercise, but it is important to capture the economic trends and, moreover, the perspective of any imbalance in the current account (deficits) which could amplify the financial risk of a foreign exchange shortage. In other terms it could reasonably signal a higher risk score and, consequently, a stronger volatility in the expected returns. To sum up, risk of payments reprograms or even defaults.

G - THE WORLD`S VIEW POINT (How the nation is seen)

Nowadays, economic agent`s expectations are probably the strongest drivers for capital flows. Those expectations are oriented by how could

investors leverage their profits assuming less risk. Especially in the case of investments in the capital market, where the speed of flows is so faster, there are always different alternatives for investors. So, if they feel that a country could be suffering any kind of financial problem, they would leave the country immediately. Sometimes, when the economy is strongly dependent on those capitals and does not have sound economic fundamentals, it could precipitate a severe financial crisis.

That is why it is really essential in terms of country risk analysis a clear comprehension on how about the nation is seen by the market. For sure, a good vision will not avoid completely any kind of contagious movements, but it could make it softer. Thus, the analyst must be aware about market's vision and the best way to do it is a periodical and systematic follow up, keeping in touch with the changes in the market's mood and identifying the influences brought by this vision of the world.

By the way, as in case of corporate risk, country's data disclosure is vital for keeping the confidence of the investors.

Therefore, the analyst has to deal with a sort of externalities in his work like the ones discussed above. However, the sensibility of the market and changes in expectations, sometimes not rational, is only part of the problem.

H - ABILITY TO PAYBACK and WILLINGNESS TO PAY BACK

In fact, more relevant is the real **ABILITY TO PAYBACK** a financial aspect which is supported by sound economic fundamentals, macroeconomic equilibrium, and available foreign exchange currency to afford the debt service, the level of imports and capital transfers (royalties, etc). Forecasts of balance of payments can provide good information in this direction.

The other essential aspect that the analyst has to deal with is just the **WILLINGNESS TO PAYBACK**, a political restriction that lately is not so common. In fact, this kind of restriction has happened during severe reductions on international liquidity in the capital markets and/or when imbalances in the current account occur, causing the necessity of adjustments which the government does not want to support. There are, also, some other restrictions associated with conflicts and political issues, but usually, for almost all the countries, these events happen simultaneously to a foreign exchange currency crisis.

I - STRENGTH AND WEAKNESS CHART

Before defining the country's grade risk, it is convenient drawing all relevant aspects that were provided by the analysis. In order to clarify some of

them, the chart below could be used as an idea to combine each strength and weakness with the related possible prospects. Just to give an example, the chart contains some variables that were built from combined experiences about an imaginary country. It is a simulation of relationships among several variables (quantitative and qualitative) to show how they are interdependent and how complex is any analysis.

STRENGTHS FACTORS	POSSIBLE REPERCUSSIONS
- High government approval rate	Political stability
- Increase in IDH performance	Lesser social demands
- Population profile allows economic equilibrium	Enough supply of labor force
- Relevant internal market	Opportunity for private profits
- Well-defined social-economic plans	Support for private economic decisions
- Budget equilibrium on the short run	No more pressures over interest rates
- Available environmental resources	No constrains in terms of raw materials
- Diversified economic structure	Low exposure to sectors instability
- Strong and well managed private sector	Entrepreneur culture
- Modern and well-regulated banking system	Less risk in a volatile situation
- Sustainable GDP growth rate	Reduction of unemployment rate
- Rise in the growth fixed capital formation	Positive forecasts for future growth
- Efficacious monetary policy	Less volatility of returns for investors
- Sustainable decrease on interest rates	Better conditions for investments
- History of no external conflicts	Stability in external relationships

- Long-term maturity public internal debt
- Floating exchange rate
- Import profile concentrated in capital goods
- High level of reserves/Imports

- Budget compatible debt services
- Flexibility for market adjustments
- Positive forecasts for future growth
- Room to deal with liquidity constraints

WEAKNESS FACTORS

- Income concentration
- Low levels of literacy/skill labor forces
- External environment presenting instabilities
- Economic block integration remain slow
- Slowdown in developed countries
- Increase in the strategic raw material's prices
- Decrease in commodities export prices
- Expressive ratio Internal Debt/GDP
- Strong resource gap
- Forecasts for trade balance deficit
- Worsening in the terms of trade
- Investors concerns on the financial markets
- Raise in international interest rates
- Improve in the ratio CA deficit/GDP
- Worsening in the ratio External Debt/GDP
- Reductions on capital inflows
- Restrictions to sustain GDP's growth

POSSIBLE REPERCUSSIONS

- Social pressures.
- Productivity restrictions
- Diverse contagious risks. Rise in spreads
- Limited trade improvement
- Limited market for exports
- Rise in foreign currency expenditures
- Risk of trade balance deficit
- Sterilization of private savings
- External flows dependency
- Improvement in capital flows needs
- Pressure over current account balance
- Liquidity's lack to developing nations
- Increase in the external debt
- Improvement in capital flows needs
- Risk of downgrade in country grades
- Risk of currency devaluation
- Risk of government's income reduction

In a direct way, the chart seeks to emphasize the risks pointed out during the analysis and it must be evaluated in connection with the observed macroeconomic performance provided by the ratios above commented. Once more, it is important to enforce that those ratios must be analyzed within a wide historical and interdependent approach, to ensure its consistency.

VI - RISK LEVEL AND EXPOSURE LIMITS

Defining the risk level is a very difficult task. First of all, as already commented, it has remained clear the existence of several restrictions to build econometric models to deal with country risk analysis as a whole. The most common models are more likely to be used for capital market investment, where the prices of the assets and their related volatilities give a floor to follow the behavior of securities.

Nevertheless, managing credit risk demands a score to discriminate different sorts of risk among nations. In this case, after getting the outcomes from the macroeconomic and social ratios, it is possible to make a grade to block those countries that in general present similar behavior. Peer analysis could be built to better split the countries according to the observed

performance and an automatic rating system could be applied over the “similar” countries, discriminating the “bads” and the “goods”.

However, the subjective approach remains essential to confirm or not the attributed scores. Thus, the analyst, qualifying the analysis with the whole content of his research (including other analysis offered by rating agencies), provides an essential contribution to define the final risk level.

Depending on the uses of the analysis, an **EXPOSURE LIMIT** could also be defined. Its value or percentage is derived from a strategic definition (credit policy) provided by who is in charge of this issue. Sometimes supported by advisors of investment banks or even the board of directors of several kinds of institutions. The important is that it has to be coherent with the attributed country ratings when defining each exposure limit. Also, the exposure limits are established respecting the current risk propensity of the risk takers.

VII - PRICING SYSTEM

The pricing system represents the logical relationship between the interest rate and the established countries ratings. The risk premium varies from country to country according to the ratings. The worse the attributed

rating for a country, the higher is the risk premium. However, usually the market anticipates changes in the country's rating by rising or decreasing the interest rates or even redefining the weight of the nation in the investors portfolios.

VIII – FOLLOW UP

Any country risk analysis must be updated periodically. Probably, the follow up is almost so important as the analysis. Through the follow up the analyst can identify relevant social-political changes and, moreover, volatilities on the behavior of the macroeconomic variables and ratios. Keeping in touch with these changes is not so difficult after a well-defined source of data and a good comprehension of the country provided by the first analysis.

In fact, nowadays, the computers can help a lot following up the country's performance by calculating automatically all the ratios, its evolutions and standard deviations. Moreover, they can also provide comparisons among the figures of different countries, peer analysis and so on.

Therefore, following the news, chatting with partners and other well informed people and having some automatic updates about the monthly

numbers behavior (those that are available), the analyst could identify if it is necessary a review of the country risk. By the way, it is essential to point out that one of the most important sources of information is that one which deals directly with customers, specially the traders.

IX – CONCLUSIONS

As could be seen, country risk analysis is not an easy task. It demands a holistic vision, specialized skills and persistent approach. The analyst must follows standard procedures to assure coherency in its studies, using reliable and useful sources of data, including rating agencies, official institutions and other several sources.

After dealing with the macroeconomic, socio-political and financial aspects, the analysis has to clearly show the strengths and weakness of a country, in order to define a risk level and, consequently, a related price for the asset in risk.

Managing the risk of a portfolio demands a systematic follow up concerning to external and internal environment, governmental policies, outlook provided by rating agencies, and so on. However, there are some tools that could also be suggested in this study as:

- a) SENSIBILITY CHART OF STRENGTHS AND WEAKNESS
pointing out the key aspects that threaten the country;
- b) CHAIN OF VALUE involving the main countries that maintain trade relationships with the nation, broken by sectors and products, besides a series of each historical relevant price;
- c) TABLE OF MACROECONOMIC VARIABLES in a computer system that provides alert signals when the behavior of any ratio presents a relevant change.
- d) TABLE OF FINANCIAL MARKETS PERFORMANCE
following up the behavior of bonds and stocks already issued and to be issued as well.

Those tools help the analyst to identify whether is necessary another deeper approach.

During this work many research material has been consulted and, moreover, several information about Brazil has come from different sources. Although the scope of this work is just a method to analyze and follow up country risk for credit procedures, there are some aspects that remain relevant to better understand Brazil`s ratings and the country`s effort to improve them.

First of all, it is forceful recognize that globalization is a huge trend which drives the economies to a much more intensive type of international trade. In this environment, EXPECTATION is a key word, which foreign economic agents are dealing with day after day, looking for countries where they can maximize their returns without taking additional relevant risks. Thus, CONFIDENCE plays a central role in terms of inflows of capital for countries strongly dependent of external savings, like Brazil. The higher the confidence the better the risk perception and, consequently, the country`s rating.

In case of Brazil, achieving a range of rating like INVESTMENT GRADE (BBB- or Baa3) is essential to ensure stable flows of capital and lower interest rates for loans and bonds issued by the government or by the private sector. On the other hand, when Basel Committee defines the new requirements of capital for banks according to the country risk rating, the investment grade will be a powerful tool to sustain lower levels of interest rate for the whole economy.

According to the research, in macroeconomic terms, the most relevant international concerns about Brazil are associated with the size of internal and external debts related to GDP and its consequences. Accumulated during years, they pressure Brazil`s financial conditions by demanding a big share of

capital inflows to meet debt services, restricting investment expenditures and, consequently, the freedom grades to growth.

Despite the narrow financial range to drive the economy and its vulnerability to deal with external shocks (international liquidity, price of strategic commodities, international interest rates, and so on), many different institutions are sustaining that Brazil is doing very well even during some political affairs. For instance, considering the consolidation of the democratic regime, almost all of those institutions are pointing out the following:

- 1) The inflation rate is extremely low in historical terms and the monetary policy is been well conducted by the Central Bank
- 2) The public sector is getting stabilized (large primary surpluses and tight fiscal policy)
- 3) The internal real interest rate is decreasing in annual terms
- 4) The economy is much more open than it used to be
- 5) The economy is growing and the unemployment rate is decreasing
- 6) The level of disclosure rose (transparency)
- 7) The exchange rate regime is fully flexible and market based
- 8) The average maturity and duration of the federal public internal debt is getting longer

- 9) Foreign Direct Investment are likely to continue to finance a large share of the current account deficit
- 10) The foreign reserves are quiet satisfactory
- 11) The Central Bank has strong procedures to keep sound the domestic financial system, and so on.

Thus, to reach the investment grade from the current level (Standard & Poor`s: **BB-** and Moody`s: **B1**), besides keeping the directions that have been supporting all those significant improvements, the economy has to generate foreign exchange in a larger amount and maintain a sustainable growth rate in order to reduce the financials constrains (internal and external). In this way, an independent Central Bank to keep the financial system well-supervised and, mainly, to defend the purchase power of the currency must occur.

Therefore, the environment must be stable and the productivity of labor and capital must be stimulated by reductions in production costs (including a deep tax reform that must provide simplification and better management conditions).

Moreover, the country has to have a better strategy to promote its exports more quickly. Some of the measures to build this way have been

implemented since some years ago, but its effects could not be plenty felt yet.

However, there are some other essential measures, whose strong effects will happen only in the medium term, that urge to be strengthened to provide a quality jump for the nation and to reduce inequality consistently (key strategic challenge). Among them, huger investments in basic education, sanitation and infrastructure are essential, besides improvements in the public management skills.

It is really possible and, for sure, it will be done.

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