Chapter 2

Country Risk Ratings

As emerging markets, particularly in Latin America and Asia, have become part of the global investment continuum and become more attractive to international lenders and investors, country risk analysis has concurrently become a critical issue among international financial community. Accordingly, this chapter begins with a discussion of the increasing importance of country risk analysis. Then, the basic criteria by which a country is commonly evaluated by many analysts, are examined. Lastly, the Moody's credit ratings for ASEAN countries are presented in order to develop a broader perspective of the credit performance and the risk of the ASEAN countries.

2.1 Increased awareness of country risk analysis

The need of developing countries for external capitals in financing their development process have increased the role of commercial banks in international lending to developing countries, resulting in an increased accumulation of external debt in those countries. However, the poor economic management, which contributed to rapid inflation, over-valued exchange rate, balance of payments deficits, loss of foreign reserves and even loss of investors' confidence in the countries' creditworthiness, resulted in external debt crisis during the 1980s in many developing countries, particularly in the Latin American region. Apart from the external debt crisis during the early of 1980s, the Mexican financial crisis in the late-1994 which led to the subsequent collapse of the Latin American markets in 1995 and the recent financial crisis in the ASEAN region during the mid-1997 have all caused a great concern among investors and prompted the need for the effective assessment of the relative risk of these emerging markets. Therefore, as these emerging markets are now an important part of the global investment arena, country risk analysis has become an indelible issue among global investors and analysts.

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2.2 Country Risk Ratings Criteria*

Country risk, defined as a probability of default or pricing volatility arising from the economic, social and political environments of a given foreign country, arises when investing in or lending to foreign country. Thus, tools have to be developed and improved to effectively evaluate the relative risk of the foreign countries, especially those of the emerging markets. However, it should be realized that the great number of variables compose sovereign or country risk and there is no exact formula in determining the country ratings is provided in any presses. Nonetheless, these analytical variables are generally interrelated. Therefore, this section briefly examines a group of quantifiable fundamental indicators that are commonly used by many sovereign risk analysts in determining the risk of investing in emerging markets.

(1) **Economic development and price pressures**

As a country with relatively high and rising levels of economic growth can withstand unexpected economic difficulties better than a poor country, the level of economic growth and development is an important indicator of a country's creditworthiness. And the widely used measures of economic growth and development are the growth of gross domestic product and per capita GDP. However, the sources and stability of the growth need to be analyzed carefully in evaluating the country.

Furthermore, as inflation may cause serious economic damage, the rate of inflation and some related indicators such as the rates of money and credit expansion, the impact of fiscal policy on inflation, as well as the budget positions and public debt

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* A list of indicators and issues that needs to be analyzed when making an investment decision on foreign countries or determining the value of emerging markets is shown in Appendix B.

More detail of how countries are rated for their sovereign debt (both in local and foreign currency) can be found in David T. Beers, "Standard & Poor's Sovereign Ratings Criteria", in The Handbook of Fixed Income Securities, 5th edition, eds. Frank J. Fabozzi (London : IRWIN Professional Publishing), pp. 460-472.

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level[*] are also taken into consideration by most analysts in rating the country. For example, Standard & Poor's inflation bencemarks for rating a country's local currency investments are shown in Table 2.1.

Table 2.1: Inflation benchmarks in rating a country.

Local Currency Rating Category	Annual Inflation (%)
BB	25-100
BBB	10-50
A	7-25
AA	4-15
AAA	0-10

Source: "Standard & Poor's Sovereign Ratings Criteria".

(2) **Balance of Payments**

As the balance of payments usually reflects the quality of a country's macroeconomic management, the analysis of a country's balance of payments is essential in assessing the country risk. Balance of payments analysis also enables investors and analysts to predict the likely ability of the country to generate the foreign exchange required to service outstanding external debt. Therefore, the analysis of each element constituting the balance of payments is generally indispensable in determining the country's relative risk.

Merchandise trade is generally the most important determinant of the country's balance of payments.[**] However, analyzing only a country's trade balance is not sufficient, as achieving a trade surplus does not guarantee that the balance of payments is in surplus. Thus, the country's current account transactions and other

[*] The monetization of budget deficits will tend to accelerate the country's inflationary pressures.

[**] It should be noted that developing countries usually experience negative trade balance as they have to depend on imported inputs and raw material used in their development process; however, the trade deficits should not be too high as it may reflect the country's inability to generate earnings to service their obligations.

elements of the capital account also need to be examined. Furthermore, the analysis of the capital account should focus on the structure and adequacy of capital flows used in financing the current account deficits. This is because direct investment inflows provide greater flexibility in the country's balance of payments than other forms of capital inflows, especially the interest-bearing debt inflows.

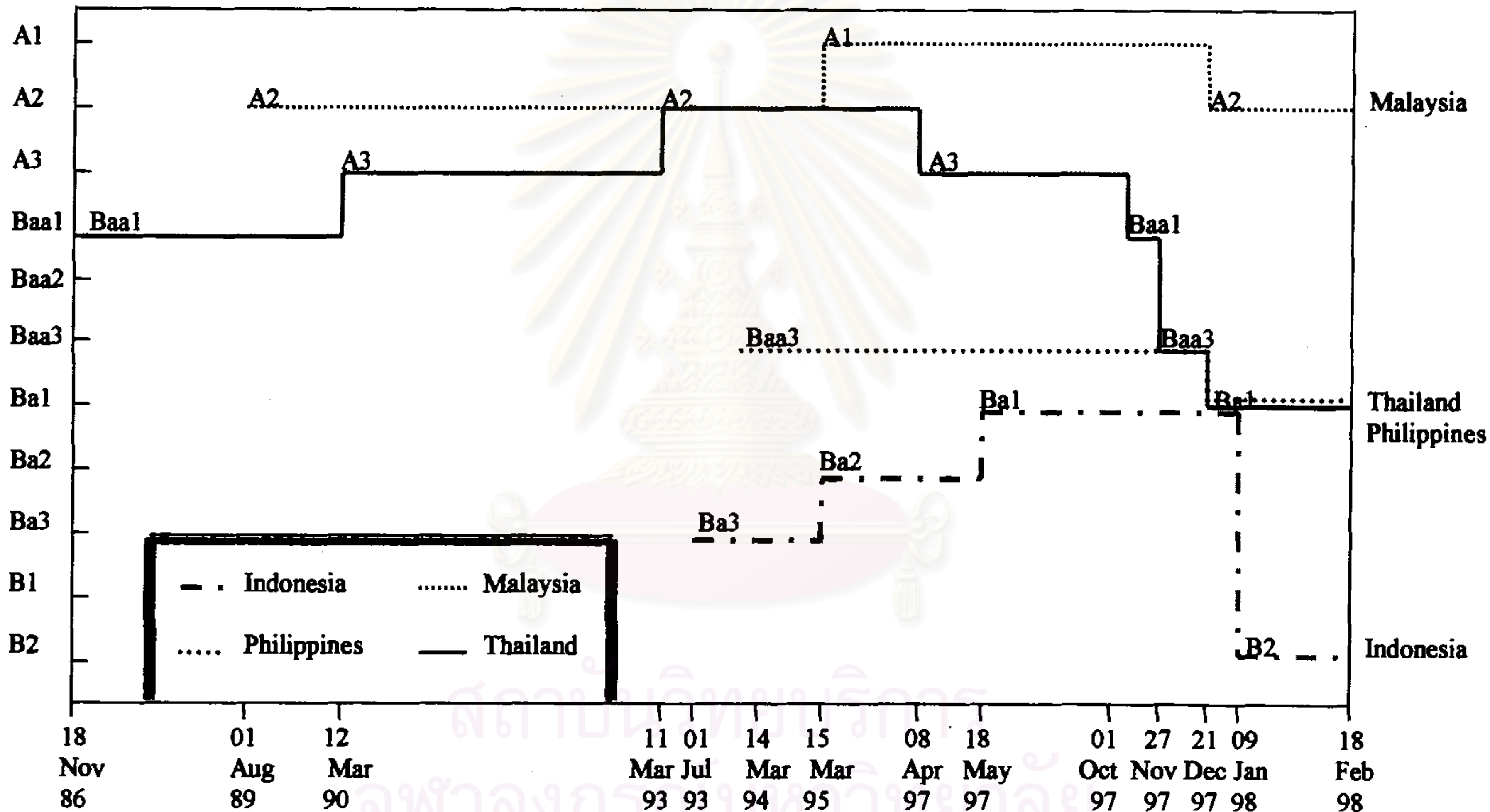
(3) **External financial position**

Along with balance of payments analysis, it is also essential to establish the magnitude and structure of a country's external indebtedness as well as the adequacy of its foreign reserves in servicing outstanding debt. This is because debt statistics indicate a country's external financial position that generally signals the financial crises in many developing countries in face of balance of payments difficulties. In addition, as foreign reserves basically serve as a liquidity cushion of a country, they are also important indicators of a country's creditworthiness.

2.3 Country Risk Ratings for four ASEAN countries

In this section, the historical records of four ASEAN countries' credit ratings as rated by Moody's Investors Service are presented and analyzed in order to develop a broader picture of the actual credit ratings performance of these ASEAN countries during recent years. As can be seen in Exhibit 2.1, the credit ratings of Thailand's long-term foreign currency bonds were higher than those of Malaysia from the first time Thailand was rated in August 1989 until February 1993. Although the credit ratings of Thailand remained stable at A2 over several years during August 1989 to March 1997, the improved credit ratings performance of Malaysia, which due primarily to its relatively good macroeconomic management, boosted it to the same level of credit ratings as Thailand during March 1993 to February 1995. Moreover, Malaysia's strong economic performance eventually resulted in an upgrade of its credit ratings above Thailand's to the A1 level in March 1995. The long-term credit rating for Malaysia remained at A1 for both foreign currency bonds and bank deposits from March 1995 to December 1997. Nonetheless, by the third week of December 1997, the repercussion of the financial crisis in Thailand caused Moody's to downgrade Malaysia's credit ratings on both its short-term and long-term foreign

Exhibit 2.1: Long-Term Credit Ratings for the four ASEAN Countries.



Source: Moddy's Investors Service.

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Table 2.2 (a): Long-Term Sovereign Ratings by Moody's (as of February 18, 1998)

Interpretation	Rating Symbols	Foreign Currency Bonds				Foreign Currency Bank Deposits			
		Indonesia	Malaysia	Philippines	Thailand	Indonesia	Malaysia	Philippines	Thailand
Investment Grade Ratings									
Highest quality	Aaa								
High quality	Aa1								
	Aa2								
	Aa3								
Strong Payment Capacity	A1		15-Mar-95				2-Oct-95		
	A2		11-Mar-93 21-Dec-97		1-Aug-89				2-Oct-95
	A3		12-Mar-90		8-Apr-97				8-Apr-97
Adequate Payment Capacity	Baa1		18-Nov-86		1-Oct-97		21-Dec-97		
	Baa2								
	Baa3	14-Mar-94			27-Nov-97				1-Oct-97
Speculative Grade Ratings									
Likely to fulfill obligations,	Ba1	21-Dec-97		18-May-97	21-Dec-97	2-Oct-95			
(ongoing uncertainty)	Ba2			15-Mar-95				18-May-97	22-Oct-97
	Ba3			1-Jul-93		21-Dec-97		12-Jun-95	
High-Risk Obligations	B1								27-Nov-97
	B2	9-Jan-98							
	B3								
Poor Credit Standing	Caa1					9-Jan-98			

Source: Moody's Investors Service

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Table 2.2 (b): Short-Term Sovereign Ratings by Moody's (as of February 18, 1998)

Interpretation	Rating Symbols	Foreign Currency Bonds				Foreign Currency Bank Deposits			
		Indonesia	Malaysia	Philippines	Thailand	Indonesia	Malaysia	Philippines	Thailand
Superior ability	P-1		2-Oct-95		14-Jun-89		2-Oct-95		2-Oct-95
Strong ability	P-2		21-Dec-97		3-Sep-96		21-Dec-97		3-Sep-96
Acceptable ability	P-3				1-Oct-97				1-Oct-97
Not Prime issuers	NP	21-Dec-97		2-Oct-95	27-Nov-97	2-Sep-95		2-Oct-95	22-Oct-97

Source: Moody's Investors Service

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currency bonds and bank deposits one level from the original level as shown in Table 2.2 (a)-(b).

In the meantime, the economic slowdown of Thailand which began in 1996, coupled with its relatively high current account deficit and external indebtedness continued to undermine investor confidence, resulting in a huge reduction in foreign capital inflows as well as foreign reserves. As a result, Moody's downgraded Thailand's credit ratings for long-term foreign currency bonds and bank deposits from A2 to A3 in April 1997.* Then, the floatation of the baht in June 1997 worsened an already poor economic situation as it further undermined investor confidence, thereby accelerating capital outflows and further eroding the baht's value. As a consequence, domestic interest rates had been increased, resulting in increased liquidity tension. Moreover, the increased political instability further worsened the situation and caused Moody's to announce long-term rating downgrade on Thailand's foreign currency bonds from A3 to Baa1, on foreign currency bank deposits from A3 to Baa3, and a short-term rating downgrade on both bonds and bank deposits from P-2 to P-3 in October 1997. Then, in November 1997, as a result of the increased concern on the country's negative economic outlook (especially in its ability to service short-term debt) Moody's further downgraded Thailand's long-term credit from Baa1 to Baa3 - equals to the long-term credit of Indonesia.**

Furthermore, as Thailand's economic crisis began to undermine investor confidence across the Asia and East Asia, the repercussions of the crisis in Thailand spread over to its neighbouring Asian countries, especially to Indonesia and Malaysia. This ultimately led to the current financial crisis in Asia which further exacerbated the

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* Prior to the downgrade of long-term foreign currency bonds and bank deposits in April 1997, Moody's downgraded Thailand's credit ratings for short-term foreign currency bonds and bank deposits from P-1 to P-2 in September 1996. This was owing mainly to the large amount of non-performing loans of the banking sector and reduced competitiveness of the country in the world market.

** Moody's also lowered Thailand's long-term ratings of foreign currency bank deposits on 22 October 1997 from Baa3 to Ba2, and on 27 November 1997 from Ba2 to B1. These dramatically decline in ratings from investment grade to speculative grade make it more difficult for Thailand to access to foreign capitals.

problem. Thus, as the situation has rapidly become more complicated, greater uncertainty has arisen about the country's ability to recover quickly from its reform measures taken in order to restore investor confidence. As a result, in December 1997, Moody's announced further long-term sovereign rating downgrades: for Thailand and Indonesia from Baa3 to Ba1; and for Malaysia's foreign currency bonds from A1 to A2 and its bank deposits from A1 to Baa1. The short-term credit ratings of Malaysia were also downgraded from P-1 to P-2. Moody's downgrade of long-term ratings of Thailand and Indonesia in this instance had a tremendous impact on both Thailand and Indonesia because their ratings fell from investment grade to speculative grade (i.e. "junk bond" status) which meant that the cost of obtaining foreign capitals would increase significantly, reflecting the apparently soaring risk inherent in investing in Thailand and Indonesia.

By contrast, amidst the sovereign rating downgrades for Thailand, Indonesia and Malaysia, the Philippines' long-term credit rating was upgraded by Moody's from Ba2 to Ba1 in May 1997 and has remained stable at Ba1 to February 18, 1998. Although the long-term credit ratings for the Philippines remain at the speculative grade, its credit rating has improved and has actually been at the same level as Thailand since December 1997. This can be attributed to the Philippines' improved economic performance amidst the ASEAN regional economic slowdown, particularly in 1996.

However, considering the period before 1997, it was found that while the long-term credit ratings improved for Malaysia and Philippines, they remained stable for Indonesia and Thailand. This implies that the economic performance of the ASEAN countries was impressive and relatively stable during the early 1990s. Nonetheless, the regional economic slowdown in ASEAN (excluding the Philippines) beginning in 1996, in lined with the increased overheating tendencies ultimately contributed to economic crisis in Thailand, Indonesia and Malaysia, and resulted in long-term credit ratings downgrade in 1997.

In conclusion, as the external debt crisis in Latin American countries during the early 1980s, the Mexican financial crisis in 1995, and the recent economic turmoil in East Asia have *"all contributed to a profound discomfort still being experienced by*

many investors"[1], these emerging markets must be subject to careful scrutiny. Although there are large number of variables which determine sovereign or country risk, they are generally interrelated and can be grouped into three broad categories: economic structure and price pressures, balance of payments flexibility, and external financial position. Moreover, economic policy management and its influence also need to be analyzed in determining any investments in the emerging markets. Furthermore, analysis of Moody's credit ratings for the ASEAN countries reveals that the long-term credit ratings of Thailand and Indonesia remained stable from the time they were first rated until 1996. However, the deteriorating economic stability which contributed to baht speculation resulted in several rounds of credit rating downgrades for Thailand during 1997. By contrast, the long-term credit ratings for Malaysia and the Philippines were upgraded and remained relatively stable until the emergence of the financial crisis triggered first in Thailand during the mid-1997 which spread over to its neighbouring Indonesia and Malaysia, thereby resulting in long-term credit downgrade by Moody's Investors Service.

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[1] Allen A. Vine, "High-Yield Analysis of Emerging Markets Debt," in The Handbook of Fixed Income Securities, 5th ed., eds. Frank J. Fabozzi (London : IRWIN Professional Publishing, 1997), p. 474.