Country Risk Importance on Investment Decision Making

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ABSTRACT

Given the controversies, especially from the last period, in terms of credibility of the major international rating agencies, this article aims to assess the correlation between country risk ratings and the evolution of FDI flows in the receiving economies. In this regard, we chose to analyze the degree of these influences manifestation in Romania.

The study, based on statistical information on the rating granted to Romania and the value of foreign direct investments during the period between 2000 and 2010, confirms the indirect natural connection of the two indicators. Thus, the results show that, when the rating falls in an immediate lower class, foreign direct investments are reduced by 1173.76 billion Euros, which represents 27.2% of the investments average mean made within the 11 analyzed years. Conversely, we can observe an influence of 0.05% of FDI on Romania's rating.

The data obtained demonstrates the interdependence between the two indicators, however, a low correlation can be observed. The qualitative analysis performed, showed arguments that support the decrease in importance of rating, such as: reducing the credibility of rating agencies as a result of exposing the weak points from the methodologies applied, granting of incorrect ratings, the inability to foresee the financial crisis or increasing the transparency of governments which makes more and more information available to investors. This doesn't mean that the role of country rating is denied. It remains an important decision making criterion in guiding the flows within the global economy space, but it is not sufficient and it is not indispensable.

KEYWORDS: *country risk, foreign direct investments, interdependence*

JEL CLASSIFICATION: *F21, F41*

INTRODUCTION

The risk is the alternative with which most individuals are facing, being widely accepted the idea that it represents a constant in the human activity in general. Under these circumstances it can be said that, the activities with a high degree of safety almost do not exist, the notion of risk becomes complementary to the notion of activity.

Therefore we live in a world of risk and, as Louis de Broglie (French physicist, Nobel laureate in physics 1929) said we must follow the risk because it represents the conditions for all successes.

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In this context, the risk has gained a great significance in all areas of the economic and social life, taking a risk becoming therefore a common practice in the domestic and international business environment. This is because no one would risk knowing that he will lose, but he risks hoping to win (Iliescu, 2007).

With regards to the economic activity, the experts consider that, in order to succeed in business, adapting to the environment has a significant role, which is much easier to accomplish when the risk that can expose the business are known. The forecast of the factors and degree of risk enables the modification of the strategy of action in a timely manner, so that, the profitability of the activity is not affected. This is why learning how to live in this world of risk represents a major challenge for managers, politicians, and individuals in general.

Under these circumstances given the irreversible path that the economic life has joined and the fact that the results of the economic activity have a direct impact on the social and political environment, the analysts, and also the subjects directly involved in the international economic flows, put more emphasis on the concept of country risk.

This is because the expansion of business across borders requires identification, evaluation and a concise analysis of the global risk that the economic agents would face in a concerned national economy.

The information needed to integrate them into the strategy is summarized in the country risk indicator.

Country risk is the one that shows in a general manner the risks of the international businesses, reflecting the overall situation and the cumulative effects of the other associated risks. It is therefore considered a diagnosis of the socio-economic potential of the country that receives international economic flows.

1. GLOBAL ECONOMIC ACTORS AND THEIR POSITION AGAINST COUNTRY RISK

1.1 Theoretical analysis

Therefore, the intensification of international transactions of assets and loans increased the chances of economic agents but also generated increases in risk (Ciocoiu & Neicu, 2007).

Under these circumstances we can say that in an era of globalization the rating has become a necessity. A proof of the importance given to country risk ratings is given by the great number of news that appear in new release on the subject, and thousands of websites dedicated to rating and rating agencies. "I can treat myself by reading medicine papers, but I would better go see a doctor".

Everywhere in the world rating agencies appear to reveal new possibilities for use and cover new holes on the market.

For example, China, the first rating agency emerged in 1988, and currently there are over 50 agencies.

But, some other indices can be as useful, indices whose assessment is also based on a combination of some economic, social and institutional factors.

The applied methodology is different, but still there are common indicators, and the purpose for their computing and publication is the same: to provide synthesized information, necessary to the analysts and participants to the global economic cycle.

The globalization of information, one of the aspects of the phenomenon under full development makes the access to information much easier. The rapidity with which they move gives a positive influence to the global economic agents' activity.

Thus, for approximately fifty years numerous reports are being published, reports that reflect the economic performance and the life standard for a certain number of states that are being analyzed. The media reflects these results, less the calculation method.

It's about globalization index rankings, Global Risk Reports (World Economic Forum - WEF), World Competitiveness Yearbook, published by the Institute for Management Development (IMD), the Heritage Foundation report on economic freedom, the Doing Business report, developed by the World Bank.

In 2001 within the World Economic Forum it has been suggested that an index that will express the competitiveness of different countries should be computed. After identifying the main elements that need to be analyzed, the Global Competitiveness Index has been set as an indicator (GCI) (Ioncică et al., 2008).

This allows the identification and comparative analysis of strengths and weaknesses in the economic field for the countries included in the rankings.

In order to measure the competiveness public information are being used and a survey to which business leaders participate from the 131 countries analyzed (11,000 in 2007) (Laffaye, 2007).

Starting with 1989, the Management Institute from Lausanne (I.M.D) publishes annually the competitiveness index for 55 countries. For computing the index, variables that characterize the following aspects are used: infrastructure, government efficiency, business efficiency, macroeconomic evolution, foreign trade, direct investments, employment and prices development. The data comes from statistical sources for the most part (2/3), but also from local partners (1/3)(Laffaye, 2007).

Heritage Foundation together with Wall Street Journal publishes since 1994 an annual report, "The Index of Economic Freedom" taking into account 50 variables that characterize the ten economic freedoms: Business Freedom, Trade Freedom, Fiscal Freedom, Government Spending, Monetary Freedom, Investment Freedom, Financial Freedom, Property Rights, Labor Freedom (Bouchet, 2008).

If we refer to the accessibility of these assessments and the increasing transparency of the government in providing these information we can say that country risk importance has decreased.

Another aspect that can support this point of view is that of reducing the credibility or rating agencies from the last decade as a result of disclosure of weaknesses within the methodologies applied, but mostly due to granting incorrect rankings.

For example they were unable to foresee the financial-currency crisis on Mexico and Venezuela (1994-1995), of Romania (1998-1999), the Asian acute crisis, especially in Indonesia, Thailand, South Korea (1997-1998), from Russia and Ukraine, Pakistan and Ecuador (1999), not even the temporary cessation of payments and/or rescheduling the external debt in Argentina (2001), Uruguay and Moldova (2002) or Dominican Republic

(2005). Note that, under the Asian crisis, Standard and Poor's has revised South Korea rating (retrogression) no more than six times over a period of three months (December 1997- February 1998) depending on the crisis evolution, which indicates, rather, it's inability to anticipate events (Georgescu, 2006). The most recent example is the failure of rating agencies to anticipate the credit crisis in the USA, crisis that has spread all over the world (the economic globalization implies new opportunities but also increased risks taking into account that all the national economies are involved in various external relations, which makes them part, in a greater or lesser extent, to the effects of the major international events).

The causes can be both prudential, waiting for the strengthening of the change tendency, and bureaucratic as the proposals for revising the ratings must go through mandatory stages, ending with the approval of the internal rating commission within each agency (Mainelli, 2003*).* Moreover these agencies warn that the given ratings represent just opinions, not undertaking any responsibility from their use (Mainelli, 2003). Agencies response to the changes occurred in the economic and/or socio-political field of countries is therefore slow, sometimes appearing just after the manifestation of the crisis.

Therefore, given the reduction from the last period of the rating agencies' credibility, the increase in government transparency that provide more and more information to investors, but also the existing alternatives in terms of synthetic indicators, the usefulness of the country risk indicator on which investors base their decision is put to question.

This doesn't mean that the country risk role is denied. It remains an important decision-making criterion in guiding the flows within the global economy framework, but not sufficient and not essential.

1.2 Empirical analysis

The level of country risk influences the confidence of foreign economic agents within the referred external environment and consequently, their attitude towards the host economies.

Given the complexity and diversity of country risk factors that influence it, in order to avoid confusion, it be taken into account the type of activity that generates the risk. The distinction is made therefore among risk country for foreign direct investment and foreign country risk loans, or country risk associated with portfolio investment.

Moreover the country risk analysis must take into account also the host country vulnerability against the external conjuncture development (import of raw materials dependence, energy from other countries dependence, dependence of international aid, dependence on a range of restricted goods exports), exposure time to risk (short, medium, long), the probability of risk materialization, and also the possibilities to avoid and diminish the risk (for foreign direct investments, the measures can be taken before and after project completion, while for the external loans, they can be taken only before granting the credit).

As the direct foreign investment (in manufacturing or trade) is the most complex form of internationalization, the analysis of the rating importance in the expansion process of the economic-financial activities at an international level will be made from this perspective.

Therefore, this article has as the final objective the evaluation of the correlation between country risk ratings and the evolution of the foreign direct investment flows, in recipient economies. In this regard, we have chosen to analyze the degree of externalization of these influences in Romania.

To highlight the influence of Romania's country rating on foreign direct investments drawn by our country, we've studied the results of a simple regression method, whose equation is:

$$ISD = a*Country\ risk + u \qquad (1)$$

Where: ISD - dependent variable;

Country risk – explanatory variable;

a- coefficient of explanatory variable; shows the influence of country risk changes on FDI;

u- constant term; shows the values of FDI in case the explanatory variable would be zero.

The performed analysis is based on data sets which include values of the indicators included in the model (Table1), registered in Romania for the period 2000-2010.

Table 1. Presentation of data series

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
FDI (billion Euros)	1115	1311	1097	1946	5183	5213	9082	7250	9496	3488	2269
Country risk (class)	B-	B	B+	BB	BB+	BB+	BBB-	BBB-	BBB-	BB+	BB+

Source: Boiciuc (2008); Romanian Agency for Foreign Investment (2011)

Rating classes used are those given to our country, by one of the most respected rating agencies, Standard & Poor's. in order to include in the model the country risk variable it was necessary its transformation into a quantitative variable. The scale used is shown in Table 2.

Table 2. Scaling country risk variable

AAA →1	BBB → 9
AA+ → 2	BBB- →10
AA → 3	BB+ → 11
AA- → 4	BB → 12
A+ → 5	BB - →13
A → 6	B + → 14
A- → 7	B - → 15
BBB+ → 8	B →16

Source: authors

In highlighting the existing influence, we estimated the model's parameters.

The method used for estimating the parameters is Least squares (Results obtained by using an econometric analysis informatics program), method chosen due to the model's validity (Fisher test - Prob(F) value smaller than 0.05) and for meeting the assumptions for error autocorrelation (Durbin-Watson statistics - by comparison between the limits from the Durbin-Watson table and the statistical Durbin-Watson value), and normal distribution of

the residue (Jarque-Bera test - Jarque Bera Probability value of 0.78) and homoscedasticity (White test - probability greater than 0.05).

To test the significance of the slope we applied t-Student test (statistical test applied in order to establish the meaning of the parameters for a regression model). The hypotheses of the test are: H0: a=0 (the slope of the regression line doesn't differ significantly from zero, which is equivalent to saying that, the regression model is not significant) and H1: a≠0 (the slope of regression line differs significantly from 0). The materiality threshold Prob.= 0.004<0.05, therefore we reject the null hypothesis and we do not accept that the regression model is significant from a statistical point of view.

Thus, the equation model resulted:

$$FDI = -1173*Country\ risk + 18292 \qquad (2)$$

We can observe that, in order to shift the country in an immediately lower class, foreign direct investments fall by 1173 billion Euros, which represent 27.2% from the average mean of the investment made during the 11 analyzed years.

Another element that can be drawn out from analyzing the results (using specialized software for econometric EViews analysis) refers to the intensity of the correlation between the 2 variables. Since the regression model has a constant term, and the value for determining R^2 is 0.619, we can say that, 61.9% from the dispersion of the FDI variable data series can be explained through country risk variable.

This demonstrates that for in order to substantiate the investment strategy, the decision-makers are considering also the possibility of materialization of other risk categories: hazard (natural disasters, fires), strategic (risks related to competition, to the intellectual capital of the business), operational (risk related to the current activity of the company - fraud, computer system errors), financial (risks related to the financial flows of the business - currency risk). Determining the risk associated with project cost can be achieved only by accumulating more information (Luban & Hîncu, 2010).

In conclusion, the international economic flows, depending on their type are subject to general business risk (Păun & Păun, 1999). Given the objective of this study, we focus only on foreign direct investment, summarizing the total risk, as follows:

Country risk + Business Risk + Risk project

Therefore, the obtained data support the idea of inverse correlation between the two indicators, correlation that can be observed also using a Scatter chart type (Figure 1).
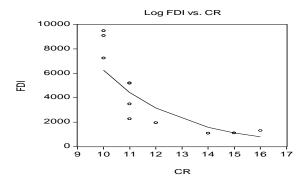
Figure 1. FDI correlation, depending on the CR
Source: adapted from Boiciuc (2008); Romanian Agency for Foreign Investment (2011)

We believe that country risk is still an important element of the decision-making process of foreign investors. Therefore, we made predictions for the FDI evolution over the next five years based on the same model (Table 3).

Basically, we estimated the country risk explanatory variable trend, after which, we have settled based on this result and on the existent correlation, the FDI value for the next five years.

Table 3. FDI projections

Year	2011	2012	2013	2014	2015	2016
Projection FDI (Billion euros)	7962.954	8571.173	9179.393	9787.613	10395.83	11004.05

Source: authors

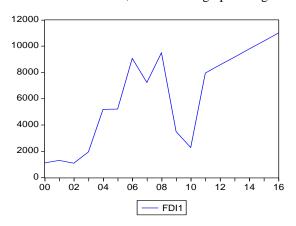To highlight the trend of FDI in Romania, we created a graph in Figure 2.

Figure 2. FDI in Romania
Source: authors

CONCLUSIONS

Economic globalization is based on freedom - freedom to trade with the rest of the world, freedom to invest where the profits are higher, generally speaking the freedom to do business in the country you choose (Dehesa, 2007).

However, to achieve these international flows in profitability and safety conditions, is necessary to identify and manage risks that could arise in the receiving economies. This is because, adopting the decision to extend the economic activity outside the country borders, through investments, lending, trading, must take into account the internal and external factors, whose evaluation is difficult and sometimes inaccurate.

The final conclusion is that the expansion of businesses across the borders requires the identification, evaluation and concise analysis of the global risk that economic agents would face in a given national economy.

This is because knowing a country rating offers the information advantage for those interested to set their businesses outside one country's border and enables the possibility to avoid the classical problem of the lemon, present in all free markets, under asymmetric information conditions (Akerlof, 1970). George Akerlof (1970) argued that individual rationality correlated with asymmetric information, undermines the efficiency of economic activities on free markets. He supports his statement with a very suggestive example on second-hand car market. Because only the sellers know the true value of automobiles, potential buyers assume that all of the cars are of average quality and are willing to pay the best price for this situation. Of course, those with good quality cars are disadvantaged, and the transactions are being blocked.

In this context we can say that, although it shows a number of shortcomings, the usefulness of knowing the rankings of country risk cannot be disputed, for rating agencies may be considered "a vital nerve center of world order"(Sinclair, 2005).

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