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*Topic: "Foreign Direct Investment and Country Risk: What kind of
Interaction?"*

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Abstract

The aim of this study is to demonstrate the characteristics of Foreign Direct Investment and Country Risk. Through a theoretical approach, I mention the basic ideas of these two terms and the type of their interaction. In addition I examine the methods, the types and the effects. We are also going to understand how we can overcome country risk, a hazardous situation, in order for the investments to be more efficient and profitable in the host country, as FDI plays an important role in the economic development. In the end, we are going to present an empirical analysis survey in order to understand the relationship between FDI and Country Risk.

Introduction

The role of FDI in developing countries has begun to spread very rapidly, especially after the transition of the countries with command economies into open markets. The changes in global economic, financial and political environment make urgent need to consider new variables that affect FDI and their profitability. The advantages of FDI outweigh the disadvantages, while the opportunities arising, lead to economic growth and prosperity. “FDI’s importance lies in its fundamental difference from other forms of capital investments: the nature and duration of the commitment it involves. FDI is a tool, which enables countries to break with their objective and organizational gaps through the introduction of new techniques, both managerial and technological (Barrell and Holland, 2000)”.¹ So, FDI is more important than a portfolio of investments and also more resistant to economic changes. For all these reasons host countries are looking for FDI inflows and they are interested in developing new ways in order to attract investments.

Furthermore, according to literature, there are several reasons why a Multinational Corporation should or should not invest in a host country. The causes may be either several home countries’ traits or host country’s characteristics. “For instance,

¹“Determinants of foreign direct investment: empirical evidence from EU accession Candidates”, Hubert P. Janicki and Phanindra V. Wunnava, Department of Economics, Middlebury College, Middlebury, VT 05753, USA, Applied Economics, 2004, 36, 505–509

Helpman, Melitz and Yeaple (2004) suggest that a firm's relative productivity plays a major role in the MNEs' investment decision-making process because only more productive firms can earn enough operating profits to recoup the high sunk costs of investing in a foreign country. Yeaple (2009) further extends this insight to propose theoretically that countries with a more favorable investment environment attract a larger number of MNEs".² An attractive environment for FDI is the most significant reason to invest, while there is a limited entry cost and a large market to invest. "All business transactions involve some degree of risk. When business transactions occur across international borders, they carry additional risks not present in domestic transactions. These additional risks, called country risks, typically include risks arising from a variety of national differences in economic structures, policies, socio-political institutions, geography, and currencies."³ Moreover, we have to consider host country's risk in investment decision-making. Country risk is associated with the risk of business as a hostile environment deters investment. It is unlikely that the investor or the home country of FDI is going to invest in a country with weak and risky institutions, with government instability, inefficient bureaucracy, high levels of corruption and insecure property rights; and also economic and financial negative aspects like high inflation and high levels of GDP and GNP. It is true that countries with lower country risk appear to attract more FDI inflows.

In the end, I would like to mention that the purpose of the presented work is to highlight the importance of FDI, to consider the indicators of country risk and how these indicators affect FDI inflows.

² "How does Country Risk Matter for Foreign Direct Investment?", Kazunobu Hayakawa, Fukunari Kimura, Hyun-Hoon Lee.

³ "Country Risk and Foreign Direct Investment", Duncan H. Meldrum.

Foreign Direct Investment

The Definition

Foreign direct investment (FDI) is defined as: “a firm’s ownership, in part or in whole, of an operation in another country” (Deresky, 2003).

“Foreign Direct Investment (FDI) is the process whereby residents of one country (the source country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country)”⁴. The International Monetary Fund’s Balance of Payments manual defines FDI as ‘an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise’. The United Nations 1999 World Investment Report (UNCTAD, 1999) defines FDI as ‘an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of a foreign direct investor (FDI enterprise, affiliate enterprise or foreign affiliate)’.

According to Moosa the common feature of these definitions lies in terms like ‘control’ and ‘controlling interest’, which represent the most important feature that distinguishes FDI from portfolio investment, since a portfolio investor does not seek control or lasting interest. However, there is no agreement on what constitutes a controlling interest, but most commonly a minimum 10 per cent shareholding is regarded as allowing the foreign firm to exert a significant influence over the key policies of the underlying project. Also, another qualification is used to pinpoint FDI, which involves transferring capital from a source country to a host country. For this purpose, investment activities abroad are considered to be FDI when there is control through substantial equity shareholding; and there is a shift of part of the company’s assets, production or sales to the host country.

⁴ “Foreign Direct Investment: Theory, evidence and practice”, Imad A. Moosa, Palgrave, 2002.

Thus, the distinguishing feature of FDI, in comparison with other forms of international investment, is the element of control over management policy and decisions. But, what exactly does 'control' mean in the definition of FDI? The term 'control' implies that some degree of discretionary decision-making by the investor is present in management policies and strategy. For example, this control may occur through the ability of the investor to elect or select one or more members on the board of directors of the foreign company or the foreign subsidiary. It is even possible to distinguish between the control market for shares and the non-control or portfolio share market as an analogy to the distinction between direct investment and portfolio investment. The non-equity forms of FDI include, *inter alia*, subcontracting, management contracts, franchising, licensing and product sharing.

Furthermore, to explain the causes and effects of the FDI we have to come up with the reasons of this interest. According to Moosa, the first reason is the rapid growth in FDI and the change in its pattern, particularly since the 1980's. In the 1990's, FDI accounted for about a quarter of international capital outflows, having grown relative to other forms of international investment since the 1970's. The rapid growth of FDI has resulted from global competition as well as from the tendency to free up financial, goods and factor markets. It has been observed that FDI flows continue to expand even when world trade slows down. For example, when the growth of trade is retarded by trade barriers, FDI may increase as firms attempt to circumvent the barriers. Also, it has been observed that even when portfolio investment dried up in Asian countries as a result of the crisis of the 1990's, FDI flows were not affected significantly. The second reason for interest in FDI is the concern it raises about the causes and consequences of foreign ownership. The views on this issue are so diverse, falling between the extreme of regarding FDI as symbolizing new colonialism or imperialism, and the other extreme of viewing it as something without which the host country cannot survive. Most countries show an ambivalent attitude towards FDI. Inward FDI is said to have negative employment effects, retard home-grown technological progress, and worsen the trade balance. A substantial foreign ownership often gives rise to concern about the loss of sovereignty and

compromise over national security. Outward FDI is sometimes blamed for the export of employment, and for giving foreigners access to domestic technology. The third reason for studying FDI is that it offers the possibility for channeling resources to developing countries. FDI is becoming an important source of funds at a time when access to other means of financing is dwindling, particularly in the aftermath of the international debt crisis that emerged in the early 1980's. "FDI has been the most dependable source of foreign investment for developing countries" (Lipsey, 1999). Moreover, FDI can be important in this sense not only because it entails the movement of financial capital but also because it is normally associated with the provision of the technology as well as managerial, technical and marketing skills. In the end, another significant issue is that FDI is thought to play a potentially vital role in the transformation of the former Communist countries. This is because FDI complements domestic saving and contributes to total investment in the (host) economy. It is also because FDI brings with it advanced technology, management skills and access to export markets.

The Types

FDI can be classified from the perspective of the source country and from the perspective of the host country. "From the perspective of the investor, Caves (1971) distinguishes between horizontal FDI, vertical FDI and conglomerate FDI. Horizontal FDI is undertaken for the purpose of horizontal expansion to produce the same or similar kinds of goods abroad, in the host country, as in the home country. Vertical FDI, on the other hand, is undertaken for the purpose of exploiting raw materials (backward vertical FDI) or to be nearer to the consumers through the acquisition of distribution outlets (forward vertical FDI). From the perspective of the host country, FDI can be classified into a) import-substituting FDI; b) export-increasing FDI; and c) government-initiated FDI. Import-substituting FDI involves the production of goods previously imported by the host country, necessarily implying that imports by the host country and exports by the investing country will decline. Export-increasing FDI, on the other hand, is motivated by the desire to seek new sources of input, such as raw materials and intermediate goods. Finally, government-initiated FDI may be

triggered, for example, when a government offers incentives to foreign investors in an attempt to eliminate a balance of payments deficit”.⁵

The Multinational Corporations

An enterprise is operating in several countries but managed from one (home) country. Generally, any company or group that derives a quarter of its revenue from operations outside of its home country is considered a multinational corporation. There are four categories of multinational corporations: (1) a multinational, decentralized corporation with strong home country presence, (2) a global, centralized corporation that acquires cost advantage through centralized production wherever cheaper resources are available, (3) an international company that builds on the parent corporation's technology or R&D, or (4) a transnational enterprise that combines the previous three approaches. According to UN data, some 35,000 companies have direct investment in foreign countries, and the largest 100 of them control about 40 percent of world trade.

“A corporation that has its facilities and other assets in at least one country other than its home country, such companies have offices and/or factories in different countries and usually have a centralized head office where they co-ordinate global management. Very large multinationals have budgets that exceed those of many small countries. Nearly all major multinationals are American, Japanese or Western European, such as Nike, Coca-Cola, Wal-Mart, AOL, Toshiba, Honda and BMW. Advocates of multinationals say they create jobs and wealth and improve technology in countries that are in need of such development. On the other hand, critics say multinationals can have undue political influence over governments, can exploit developing nations as well as create job losses in their own home countries”.⁶

However, it is difficult to define what constitutes an MNC. There are various names for these firms, like ‘international’, ‘transnational’ or ‘global’ followed by the words

⁵ “Foreign Direct Investment: Theory, evidence and practice”, Imad A. Moosa, Palgrave, 2002.

⁶ Read more: <http://www.investopedia.com/terms/m/multinationalcorporation.asp#ixzz24pfv4TBZ>

‘corporations’, ‘companies’ or ‘enterprises’. There is no a single definition for an MNC. The UN lists twenty-one definitions and the UNCTAD calls them TNC’s.

“The link between FDI and MNC’s is so close that the motivation of FDI may be used to distinguish between the MNC’s and other firms. Lall and Streeten (1977) distinguish among economic, organizational and motivational definitions of FDI. The economic definition places emphasis on size, geographical spread and the extent of foreign involvement of the firm. This definition allows us to distinguish between an MNC and a) a large domestic firm that has little investment abroad; b) a small domestic firm that invests abroad; c) a large firm that invests in one or two foreign countries only; and d) a large portfolio investor that does not seek control over the investment. The organizational definition takes the size and the spread for granted and emphasize factors that make some firms more multinational than others. These factors pertain to organization of these firms, centralization of decision-making, global strategy and the ability to act as one cohesive unit under changing circumstances. Finally, the motivational definition places emphasis on corporate philosophy and motivations. For example, an MNC is characterized by a lack of nationalism and by being concerned with the organization as a whole rather than with any constituent unit, country or operation”.⁷ Also, the World Investment Report (UNCTAD, 1999) defines multinational corporations (which it calls transnational corporations) as ‘incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates’. A parent enterprise or firm is defined as ‘an enterprise that controls assets of other entities in countries other than its home country, usually by owing a certain equity capital stake’. A foreign affiliate is defined as ‘an incorporated or unincorporated enterprise in which an investor, who is resident in another economy, owns a stake that permits a lasting interest in the management of the enterprise’. Foreign affiliates may be subsidiaries, associates or branches.

In conclusion I would like to mention the following facts and figures about multinationals as the UNCTAD (1999) lists:

⁷ “Foreign Direct Investment: Theory, evidence and practice”, Imad A. Moosa, Palgrave, 2002.

1. Multinationals comprise over 500,000 foreign affiliates established by some 60,000 parent firms.
2. The MNC universe comprises large firms mainly from developed countries, but also from developing countries and more recently from the countries in transition.
3. In 1997, the 100 largest non-financial MNCs held US\$1.8 trillion in foreign assets, sold products worth US\$2.1 trillion abroad and employed six million people in their foreign affiliates.
4. In 1997, the top fifty non-financial MNCs based in developing countries held US\$105 billion in foreign assets. Most of these companies belong to Korea, Venezuela, China, Mexico and Brazil.
5. The twenty-five largest MNCs in Central Europe (excluding the Russian Federation) held US\$2.3 billion in foreign assets and had foreign stakes worth US\$3.7 billion.
6. The value of output under the common governance of MNCs amounts to about 25 per cent of global output, one third of which is produced in host countries. In 1998, foreign affiliate sales were about US\$11 trillion.

The Effects

FDI has an impact in host countries as well as in source countries. However, it is not clear what are the gains and the negative aspects of FDI from the perspectives of the two countries. According to Moosa, there is a fundamental disagreement on what constitutes the costs and the benefits of FDI. This disagreement is indicated by the big gap between those holding pro-globalization, free-market views, and those with anti-globalization, anti-market views. Moreover, the division of welfare gains between the host country and the investing country does not only depend on given market prices, but also on the relative strength of the two countries in bargaining over the terms of the agreement governing a particular FDI project.

One way to explain the effect of FDI is to use the conventional multiplier process, but an attempt like this will be made more difficult by the qualitative differences between domestic investment and FDI, which are bound to have different effects

from each other. One reason for the differences in the effects is that FDI is controlled by parties over which there is limited local jurisdiction. MNC's are less dependent on their host countries or countries of origin than local firms, and this makes them difficult to control. The fact that the investor undertaking an FDI project is foreign to the host country creates economic, political and social effects that impinge upon the costs and benefits of FDI.

So the effects of FDI in the host country can be classified into economic, political and social. The economic effects of FDI include the implications for macro and micro economic variables such as the output, the balance of payments and market structure. "The usual convention in analyzing the macro effects of FDI is to treat it as a rise in foreign borrowing. If there is unemployment the capital shortage (as is typically the case in developing countries) such borrowing leads to a rise in output and income in the host country. FDI will, under these conditions, have a beneficial effect on the balance of payments, but an indeterminate effect on the terms of the trade (depending on whether the impact of increased output falls on import substitutes or exports). The micro effects of FDI pertain to structural changes in the economic and industrial organization. For example an important issue is whether FDI is conducive to the creation of a more competitive environment, or conversely to a worsening of the monopolistic and/or oligopolistic elements of the host economy. In general, the micro effects pertain to individual firms and individual industries, particularly those that are closely exposed to, and associated with, FDI"⁸.

The political effects of FDI include the question of national sovereignty, as the sheer size of the investing MNC's may jeopardize national independence. The social issues are concerned mainly with the creation of enclaves and foreign elite in the host country, as well as the cultural effects on the local population.

In the end I would like to add that the advantages and the disadvantages of the effects of FDI are concrete in both countries involved. The benefits for the host country (the recipient or the destination of the investment) are: a) Resource

⁸ "Foreign Direct Investment: Theory, evidence and practice", Imad A. Moosa, Palgrave, 2002.

Transfer: incoming supply of capital, knowledge, technology. b) Employment: new jobs for local labor. c) Competition and Growth: foreign firm competes with local businesses, drives down prices, increases productivity, innovation and economic growth. d) Tax base impact: increased tax revenue from taxable profits of foreign firms and locally employed labor. e) Specialization and Trade: more efficient use of resources produces higher economic growth. Furthermore, the benefits for the firms (the source of the investment) are: a) Access New Markets: market seekers aim to increase revenues and input resource seekers aim to acquire inputs. b) Lower Production Costs: production efficiency Seekers aim to take advantage of market imperfections in factor costs (land, labor, capital). c) Avoid Trade Barriers: FDI production not subject to tariffs and quotas. d) Internalize Proprietary Assets: the value of intangible assets (patents, trade, secrets, process technology, customer lists, goodwill, etc.) is not easy to protect and internalize to protect these assets. e) Alter Risk Profile: diversify operations geographically and economically to produce more stable cash flows and political safety seekers move to avoid politically threatening business environment. On the other hand, we have the costs. The costs for the host country are: a) Competition Impact: foreign firms may drive local firms out of business or may prevent entry of new firms. b) Initial capital inflow followed by outflow of earnings. c) Loss of sovereignty: loss of economic independence with greater portion of economy controlled by foreign firms. d) Risk of specialization: economic shocks to an industry have a greater impact on a less diverse economy. Ending, the costs for the investing country are the Political Risk in firm's home country: outward FDI seen as destroying jobs at home and reducing tax revenue for home country; home country may seek politically popular regulation against industries moving jobs overseas and also the cost of the Political Risk in host country: FDI may destroy local business or send profits back home.

The Final Remarks

“Foreign direct investment (FDI) has gained significant importance over the past decade as the tool for accelerating growth and development, especially of economies in transition. It is widely believed that the advantages that FDI brings to

the standard of living and prospects for economic growth of the host nation largely outweigh its disadvantages. 'FDI's importance lies in its fundamental difference from other forms of capital investment: the nature and duration of the commitment it involves' (Barrell and Holland, 2000).

Its purpose is to establish pan-commercial relations and at the same time exert a noticeable managerial influence over a foreign company. It also serves as an important means by which the central and east European candidate (CEEC) economies in transition awaiting accession into the European Union (EU) can begin to deviate from their communist legacies. Specifically, FDI is a tool, which enables these countries to break with their objective and organizational gaps through the introduction of new techniques, both managerial and technological (Barrel and Holland, 2000). The long-term nature of FDI fosters a high sensitivity to risk perception. Political and macroeconomic stability, as well as transparent legal regulations concerning foreign ownership and profit repatriation, are all important variables to potential investors (Resmini, 2000)".⁹

In the end, taking into consideration the vital role of FDI in the future economic development of the countries we will examine the 'country risk' that a firm should be aware of; and how a firm can overcome this significant and basic problem in order to accomplish its goals.

Country Risk

Country risk comes from investments made by every country and the risks they may entail due to low returns. However it is the only kind of investment risk that depends on geographical factors such as the location of the country in relation to its international borders. From surveys of country risk, the information and data provided are mostly grading scales that are determined by the type of investment. The investments for every country constitute one of the main development factors.

⁹ "Determinants of foreign direct investment: empirical evidence from EU accession Candidates", Hubert P. Janicki and Phanindra V. Wunnava, Department of Economics, Middlebury College, Middlebury, VT 05753, USA, Applied Economics, 2004, 36, 505–509

Because some countries do not have their own the resources and the means to grow by investing, they resort to external borrowing.

The Definition

Country risk is a broad meaning that encompasses both the potentially adverse effects of a country's political environment and its economic and financial environment. Political risk indicates the risk that a government's action will negatively affect a company's cash flows. "Country risk and political risk is an important aspect of international capital budgeting and managing operations in other countries and especially in developing countries".¹⁰

"For some authors, risk is defined as a performance variance, whether it impacts the firm positively or negatively. Robock (1971) explains: 'Yet, as in the case of other types of risk, political risk can result in gains as well as losses.' For this group of researchers country risk refers to the 'probability of occurrence of political events that will change the prospects for profitability of a given investment' (Haendel et al., 1975)".¹¹

The globalization of the world economies, and in particular the internationalization of financial markets in the last decades, have dramatically expanded and diversified investment possibilities, leading to numerous new opportunities, accompanied by new risks. Consequently, there has been growing interest in obtaining reliable estimates of the risk of investing in different countries. These concerns have led to the development of the concept of country risk, and even to the regular publication of country risk ratings by various agencies. Different definitions have been proposed for country risk, i.e. for the risk that a country defaults on its obligations. The existing literature on the topic recognizes both financial/economic and political components of country risk. According to the degree to which some of these components are

¹⁰ "International Financial Management", Geert Bekaert and Robert j. Hodrick, Pearson, Prentice Hall, 2009.

¹¹ "Country Risk Assessment: A Guide to Global Investment Strategy", Michel Henry Bouchet, Ephraim Clark and Bertrand Gros Lambert, John Wiley & Sons Ltd, 2003.

emphasized, country risk is viewed either from the financial/economic perspective only, or from the combined financial/economic and political perspectives. “There are two basic approaches to the interpretation of the reasons for defaulting. The debt-service capacity approach focuses on the deterioration of solvency of a country, which prevents it from fulfilling its commitments. For instance, Bourke and Shanmugam (1990) define country risk as ‘the risk that a country will be unable to service its external debt due to an inability to generate sufficient foreign exchange’. Within this framework, country risk is viewed as a function of various financial and economic country parameters. The cost-benefit approach views a default on commitments or a rescheduling of debt as a deliberate choice of the country, which may prefer this alternative over repayment, in spite of its possible long-term negative effects. Since the deliberate decision to default results from a political process, political country parameters are included in this type of country risk modeling, along with the financial and economic ones. In response to the increased demand for the evaluation of creditworthiness, several agencies such as Moody’s, Standard & Poor, Fitch, The Institutional Investor, Euromoney, Dun & Bradstreet, etc. have developed expertise in estimating country risk. These estimates are presented in the form of ratings, or scores, and are generally viewed as indicative of possible future default. Haque et al. (1996) define country credit risk ratings compiled by commercial sources as an attempt ‘to estimate country-specific risks, particularly the probability that a country will default on its debt-servicing obligations’. Sovereign ratings can be viewed as the probability that a borrowing country will fail to pay back. Country risk ratings impact countries in a number of ways. The primary significance of ratings is due to their influence on the interest rates at which countries can obtain credit on the international financial markets: the higher the ratings (i.e., the lower the risk of default) the lower the interest rate. Following its sovereign rating downgrade, Japan’s borrowing became more expensive as interest rates have increased, reflecting the higher chance of default, which deteriorates even more the situation of the heavily indebted Japanese government and economy. Second, sovereign ratings also influence credit ratings of national banks and companies, and affect their attractiveness to foreign investors. Ferri et al. (2001) call

sovereign ratings the ‘pivot of all other country’s ratings’. Similarly, Erb et al. (1995a) underline that raters have historically shown a reluctance to give a company a higher credit rating than that of the sovereign where the company operates. For example, after Moody’s downgraded Japan in November 1998 (from AAA to AA1), all other AAA Japan issuers have been downgraded (Jüttner and McCarthy, 2000). This led sovereign ratings to be named ‘sovereign credit risk ceilings’. Third, institutional investors are sometimes contractually restricted on the degree of risk they can assume, implying in particular that they cannot invest in debt rated below a prescribed level. Ferri et al. (2001) refine this analysis, pointing out the contrast between the ratings of banks operating in high- and low-income countries, and show that ratings of banks operating in low income countries are significantly affected by variations in sovereign ratings, while the ratings of banks operating in high-income countries do not seem to depend significantly on country ratings. Similarly, Kaminsky and Schmukler (2002) as well as Larrain et al. (1997) note that sovereign ratings are crucial for developing economies, which have a very high sensitivity to rating announcements”¹².

Various approaches of the literature on country risk¹³

Terminologies	Definition of risk	Sources of risk	Nature of the investment	Historical perspective	Methodology
<ul style="list-style-type: none"> ● Political risk ● Country risk ● Sovereign risk ● Cross-border risk 	<ul style="list-style-type: none"> ● Performance variance ● Negative outcome 	<ul style="list-style-type: none"> ● Sovereign interference ● Environmental instability 	<ul style="list-style-type: none"> ● Foreign direct investment ● Banking commercial loans ● Portfolio investment 	<ul style="list-style-type: none"> ● 1960s–1970s ● 1980s ● 1990s–? 	<ul style="list-style-type: none"> ● Qualitative ● Quantitative

The Historical Background

According to Bouchet, Clark and Gros Lambert, the literature on country risk can be analyzed from an historical perspective. Over the last four decades, research in the

¹²“Country Risk Ratings: Statistical and Combinatorial Non-recursive Models”, P.L. Hammera, A. Koganb, M.A. Lejeunec, Rutcor Research Report, March 2004.

¹³ “Country Risk Assessment: A Guide to Global Investment Strategy”, Michel Henry Bouchet, Ephraim Clark and Bertrand Gros Lambert, John Wiley & Sons Ltd, 2003.

field of country risk was mainly driven by a series of crises: 'political crises' in the 1960s and 1970s, 'debt crises' in the 1980s and 'financial crises' in the 1990s. Each type of crisis induced an explosion of papers that tried to explain ex post the causes of the foregoing events. However, very few, if any, adopted a more comprehensive view and tried to extract a general rule from these particular cases.

"The period ranging from the 1960s to the end of the 1970s was dominated by studies on multinational corporations (MNCs) and their exposure to political risk. At that time, many countries had just recovered their sovereignty from colonial powers and, little by little, they started to question the benefits of having extremely powerful foreign firms in their backyard. Over this period, researchers were primarily concerned with the influence of governments on firms doing business abroad. The second stage took place in the 1980s with the advent of the international debt crisis in many developing countries. A large part of the literature was dedicated to creditworthiness assessment. This stream is the same as the one presented above that deals with the matter of external debt servicing. Finally, following the Mexican crisis in 1994 and the Asian meltdown in 1997, a third stage emerged in the 1990s, in order to focus on the financial crises. Currency and banking crises have occurred regularly over the last decades.

A very illustrative example of the historical evolution of country risk can be found in the various changes in the country risk assessment methods of Coface, the French credit export agency, over the last decades (Cleij, 1997, 1998). In the 1980s their analysis was mainly focused on external debt ratios. They then began to include political factors after the Soviet Union's breakup and the Gulf War of 1991. Finally, the Mexican crisis in 1994 led them to consider financial instability as well".¹⁴

Country Risk Types and Measurements

In an attempt to define country risk, the researchers have tended to separate it into the six main categories of risk, with a view to identifying the determinants of country

¹⁴ "Country Risk Assessment: A Guide to Global Investment Strategy", Michel Henry Bouchet, Ephraim Clark and Bertrand Gros Lambert, John Wiley & Sons Ltd, 2003.

risk and the development of models that accurately define country risk and predict future economic situation of a country. Many of these categories have common characteristics, given the inter-relationship of the domestic economy with the political system and with the international community.

- ❖ Economic Risk
- ❖ Transfer Risk
- ❖ Exchange Rate Risk
- ❖ Sovereign Risk
- ❖ Political Risk

Economic Risk: A significant change in the economic structure or growth rate that produces a major change in the expected return of an investment. Risk arises from the potential for detrimental changes in fundamental economic policy goals (fiscal, monetary, international, or wealth distribution or creation) or a significant change in a country's comparative advantage (e.g., resource depletion, industry decline, demographic shift).

Economic Risk Measures: Analysts examine traditional measures of fiscal and monetary policy. For longer term investments, they also examine growth theory factors. For fiscal policy, they examine such factors as the size and detail of government expenditures, tax policy, and the government's debt situation (government deficit/GDP, total government debt/GDP, debt financing sources). Analysts examine the impact of monetary policy and financial maturity on economic growth (inflation, money supply growth, real and nominal interest rates, and financial sector/GDP). For longer term investments, they focus on long-run growth factors (growth in productive plant and equipment, private and foreign direct investment/GDP, labor force growth, unemployment, productivity), the degree of openness of economy (exports plus imports/GDP, FDI/total private investment) and institutional factors that might affect wealth creation (property rights, the degree of regulation, extent of any black market).

Transfer Risk: The risk arising from a decision by a foreign government to restrict capital movements. Restrictions could make it difficult to repatriate profits, dividends, or capital. Since a government can change capital movement rules at any time, transfer risk applies to all types of investments. Usually it is analyzed as a function of a country's ability to earn foreign currency, with the implication that difficulty earning foreign currency increases the probability that some form of capital controls can emerge. Quantifying the risk remains difficult because the decision to restrict capital may be a purely political response to another problem.

Transfer Risk Measures: Typical measures include the ratio of debt service payments to exports or to exports plus net foreign direct investment (debt/interest service ratios), the structure of foreign debt relative to income (various debt/GDP ratios), foreign currency reserves divided by various import categories (import coverage), and measures related to the current account status (external financing gap, current account as a percent of GDP). Trends in these quantitative measures reveal potential imbalances that could lead a country to restrict certain types of capital flows. For example, a growing current account deficit as a percent of GDP implies an ever greater need for foreign exchange to cover that deficit. The risk of a transfer problem increases if no offsetting changes develop in the capital account.

Exchange Rate Risk: Exchange risk includes an unexpected change in currency regime such as a change from a fixed to a floating exchange rate. Short-term pressures, while influenced by economic fundamentals, tend to be driven by currency trading momentum best assessed by currency traders. In the short run, risk for many currencies can be eliminated at an acceptable cost through various hedging mechanisms and futures arrangements. Currency hedging becomes impractical over the life of plant or similar direct investment, so exchange risk rises unless natural hedges (alignment of revenues and costs in the same currency) can be developed.

Exchange Rate Risk Measures: Many of the quantitative measures used to identify transfer risk also identify exchange rate risk since a sharp devaluation of the currency can reduce some of the imbalances that lead to increased transfer risk. A country's exchange rate policy may help isolate exchange risk. Managed floats, where the government attempts to control the currency in a narrow trading range, tend to possess higher risk than fixed or currency board systems. Floating exchange rate systems generally sustain the lowest risk of producing an unexpected adverse exchange movement. The degree of over- or under- valuation of a currency also can help isolate exchange rate risk.

Sovereign Risk: A government becomes unwilling or unable to meet its loan obligations, or reneges on loans it guarantees. Sovereign risk can relate to transfer risk in that a government may run out of foreign exchange due to unfavorable developments in its balance of payments. It also relates to political risk in that a government may decide not to honor its commitments for political reasons. The Country Risk Analysis literature designates sovereign risk a separate category because a private lender faces a unique risk in dealing with a sovereign government. Should the government decide not to meet its obligations, the private lender realistically cannot sue the foreign government without its permission.

Sovereign Risk Measures: Analysts calculate ability to pay using transfer risk measures. Willingness to pay requires an assessment of the history of a

government's repayment performance, an analysis of the potential costs to the borrowing government of debt repudiation, and a study of the potential for debt rescheduling by consortiums of private lenders or international institutions. Sovereign risk may be further complicated by the international setting. In a recent example, IMF guarantees to Brazil in late 1998 were designed to stop the spread of an international financial crisis. Had Brazil's imbalances developed before the Asian and Russian financial crises, Brazil probably would not have received the same level of support and sovereign risk would have been higher.

Political Risk: Risk of a change in political institutions stemming from a change in government control, social fabric, or other non-economic factor. This category covers the potential for internal and external conflicts, expropriation risk and traditional political analysis. Risk assessment requires analysis of many factors, including the relationships of various groups in a country, the decision-making process in the government, and the history of the country. Insurance exists for some political risks, obtainable from a number of government agencies and international organizations.

Political Risk Measures: Few quantitative measures exist to help assess political risk. Measurement approaches range from various classification methods (type of political structure, range and diversity of ethnic structure, civil or external strife incidents) to surveys or analyses by political experts. Most services tend to use country experts who grade or rank multiple sociopolitical factors and produce a written analysis to accompany their grades or scales. Company analysts may also develop political risk estimates for their business through discussions with local country agents or visits to other companies operating similar businesses in the country. In many risk systems, analysts reduce political risk to some type of index or relative measure. Unfortunately, little theoretical guidance exists to help quantify political risk, so many "systems" prove difficult to replicate over time as various socio-political events ascend or decline in importance in the view of the individual analyst.

The factors

Continuing further, we will indicate the factors of the country risk. So, in the context of the creditworthiness of the countries, prevail four main sets of the determinants of the country risk. These are the following: political, economic, social and financial factors. Of these sets arise some data which are sometimes measurable and quantifiable (economic, financial, social) and sometimes qualitative (political, social).

❖ Economic Factors

These factors are relating to quantitative information which was used in macro-econometrics. In this context, belong the following.

Inflation

Gross National Product

Wage Cost Structure

Production of the most important sectors: Agriculture, Industry and Services

Exports of Goods and Services

Imports of Goods and Services

❖ Social Factors

These factors are relating to more quantitative information and refer to the main social and demographic characteristics of the population. These are the following:

Unemployment

Education

Consumption

Urbanism

Average Length of Life

Mortality Index

Malnutrition

Work in the main financial sectors

❖ Financial factors

These factors describe the means by which is served external debt. They present similarities with the economic factors as both use quantitative information. The financial situation of a country is described by the following factors.

Current Account Balance

Gross International Reserves

Gross Domestic Investment

Foreign Debt

Interest

Stock Quotes

❖ Political Factors

The political upheavals are the greatest source of danger for a country and its economy. Well, as it is difficult to predict, their assessment is based on certain basic characteristics of the host country. These characteristics are heavily influenced by economic and social factors in the country. These are concerning quality criteria which can be separated into two subcategories, internal policies and geopolitical factors (externalities). Inside factors are classified as the main features of the political system, the government and other regulatory factors in the country. As such internal factors may include the following:

- Unstable Regime
- Government Instability, Continuous Election
- Feasibility of the Government
- Absolute Control of the Market by the State
- Large Public Sector
- Action of nationalistic and terrorist groups
- Corruption
- The Size of the Country
- The Geological Structure of the Country
- Relations with Neighboring Countries
- Instability in Neighboring States

Country Risk Assessment

The definition, the collection and the spread of international statistics is a collective effort of many people and organizations, public and private. Some of these international agencies and governmental organizations that are very well known are the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), the United Nations (UN) and others. On the other side, and non-governmental organizations and the private sector contribute significantly, both in collecting original data, and in the organization and the publication of their results. Researchers have played an important role in the development of statistical methods and interpretation of statistical indicators to improve quality in supporting and in decision making.

According to The Handbook of Country and Political Risk Analysis, published by Political Risk Services (1998), “the world’s leading commercial publishers of country and political risk analysis” include:

- ❖ Bank of America World Information Services
- ❖ Business Environment Risk Intelligence (BERI) S.A.
- ❖ Control Risks Group (CRG)
- ❖ Economist Intelligence Union (EIU)
- ❖ Euromoney Magazine
- ❖ Institutional Investor Magazine
- ❖ International Country Risk Guide (ICRG)
- ❖ Moody’s Investor Service
- ❖ Political Risk Services
- ❖ S.J. Rundt & Associates
- ❖ Standard & Poor’s Ratings Group

Risk Measures

Measure	Description
<i>Institutional Investor*</i>	Institutional Investor addresses the single issue of creditworthiness in its 100-point index. Every six months, bankers from around the world are asked to rate more than 135 countries on a scale of zero (very high chance of default) to 100 (least chance of default). The responses, from up to 100 banks, are then weighted according to worldwide exposure of the bank and the level of sophistication of the bank's analytical model. The weighted average is the magazine's credit rating.
<i>Euromoney*</i>	<i>Euromoney's</i> country risk rating is based on nine individual variables. These include economic data (25%), political risk (25%), debt indicators (10%), debt in default or rescheduled (10%), credit ratings (10%), access to bank finance (5%), access to short-term finance (5%), and access to capital markets (5%).
International Country Risk Guide (ICRG) and IRIS data set	This data set was assembled from hard copies of the ICRG, a monthly publication of the International Country Risk Guide (ICRG). Each variable's value for a given country and year is a simple average of the two values for the months April and October (for 1995 only April is used; for 1982, the first year, no observations were available before September). The variables include risk of government repudiation of contracts (measured on a 0–10 scale), risk of expropriation (0–10), corruption (0–6), a measure of the rule of law (0–6), and bureaucratic quality (0–6). The IRIS center from the University of Maryland is responsible for assembling this dataset.
Political Risk Services (PRS)*	PRS forecasts risk for investors in a two-stage process. It first identifies future regimes for each country using the Prince method. A probability is assigned to each of the three regimes with the greatest likelihood of assuming power in the 18-month and 5-year time frames. For each regime, PRS' consultants establish the likely levels of political turmoil and of 11 types of intervention that affect the business climate. A consolidated score for all regimes is calculated and converted to a letter grade in three areas of investment: financial transfer, direct investment and export markets.

*Source: The Handbook of Country and Political Risk Analysis (1998). Llewellyn D. Howell (ed.).

According to Moosa, although there is no consensus on how country risk can best be assessed, some guidelines have been developed for this purpose. The first step is to recognize the difference between macro-assessment and micro-assessment of country risk. Macro-assessment refers to the overall risk assessment of a country without consideration of the specific characteristics of the MNC's business. Micro-assessment, on the other hand, refers to the risk assessment of a country as related to the particular characteristics of the business in which the MNC indulges.

Macro-assessment involves a consideration of all the variables that affect country risk except for those that are unique to a particular industry. This type of assessment is convenient, because it remains the same for a given country, regardless of the firm or industry under consideration. This is the assessment underlying the country risk ratings found in financial magazines such as the *Euromoney* and *Institutional Investor*. Thus, macro-assessment of country risk is not ideal for an individual MNC because it excludes relevant information that could lead to an improvement in the accuracy of the assessment. However, macro-assessment could serve as a foundation that can be modified to reflect the particular business in which the MNC is involved. In this case, the macro-assessment may be carried out by an external party, such as *Euromoney* magazine, whereas the micro-assessment is carried out by the MNC.

Macro-assessment involves a consideration of both political and economic indicators of the country under examination. Political factors include, *inter alia*, the relationship between the host government and the MNC's home country's government, the historical stability of the host government, the probability of war, and the probability of changing the rules of the game and so on. The economic factors should include the main macroeconomic indicators, both current and projected, such as economic growth, inflation, the fiscal balance (budget deficit or surplus), interest rates, unemployment, and the extent to which the country relies on export income, the balance of payments and its components and so on.

There is normally some subjectivity in identifying each of the relevant political and economic factors for the macro-assessment of country risk. There is also some subjectivity in determining the weights assigned to each factor. Furthermore, there are some differences in predicting these factors. However, it seems that as far as FDI is concerned, political risk factors are more important than economic ones. "A study by Petry and Sprow (1993) has identified the factors with the greatest potential impact on the profitability of large MNCs. These factors are: unstable currencies,

restrictive practices, tariffs or regulations, foreign government subsidies, shaky government and national debt”¹⁵.

“Micro-assessment of country risk involves the evaluation of micro-political risk and microeconomic risk. Micro-political risk can be best illustrated with the following example. Suppose that a country has received a very good score for macroeconomic risk. The government of that country is, however, sensitive to foreign ownership of mining operations of uranium, but not to other operations, mining or otherwise. If this government is considering some legislation curtailing foreign ownership of uranium mining operations, then there is high (micro) country risk for an MNC considering starting uranium mining operations there. However, other MNCs will not be subject to this kind of risk. Microeconomic risk results from the sensitivity of the MNC’s earnings to changes in the economic environment. Consider, for example, two MNCs operating in the same country: one of them produces electricity, while the other produces luxury clothing. Since the demand for electricity is less cyclical than the demand for luxury clothing, the first MNC’s earnings will be less sensitive to economic growth and the business cycle than the earnings of the second MNC. Hence, a country with a good evaluation in the macro-assessment may end up with a low overall evaluation when the micro-assessment is taken into account, and vice versa”¹⁶.

The Methods

As we have already mention the methods used by the banks and other agencies for country risk analysis can broadly be classified as qualitative or quantitative. However many agencies amalgamate both qualitative and quantitative information into a single index or rating. The data are collected from various sources that include expert panel, survey, staff analysis, and published data sources. The country risk index could be either ordinal or scalar. A survey conducted by the US Export-Import Bank in 1976 categorized various methods of country risk appraisal used mainly by

¹⁵ “Foreign Direct Investment: Theory, evidence and practice”, Imad A. Moosa, Palgrave, 2002.

¹⁶ “Foreign Direct Investment: Theory, evidence and practice”, Imad A. Moosa, Palgrave, 2002.

the banks into one of four types: (1) fully qualitative method, (2) structured qualitative method, (3) checklist method, and (4) other quantitative method.

“The *fully qualitative method* usually involves an in-depth analysis of a country without a fixed format. It usually takes the form of a report that includes a general discussion of a country’s economic, political, and social conditions and prospects. It is more of an ad hoc approach which makes it difficult for users to compare one country with another. One advantage of this method is that it can be adapted to the unique strengths and problems of the country under evaluation.

The *structured qualitative method* uses some standardized format with specifically stipulated scope and focus of analysis. Since it adheres to a uniform format across countries and is augmented by economic statistics it is easier to make comparisons between countries. Still, considerable subjective judgment has to be made by analysts. This method was the most popular among the banks during the late seventies. The political risk index provided by Business Environment Risk Intelligence (BERI) S. A. is an example of country risk rating by structured qualitative method.

The *checklist method* involves scoring the country under consideration with respect to specific variables that can be either quantitative or qualitative. In case of quantitative variables, the scoring requires no personal judgment or even first-hand knowledge of the country being scored. However, in case of qualitative variables, the scoring requires subjective determinations. Each item is scaled from the lowest to the highest score. The sum of scores is then used as a measure of country risk. It is possible to vary the influence that each component variable has on the final score by assigning a weight to each indicator; this is the *weighted checklist approach*¹². The main advantage of this method is that the final summary score it yields is amenable to sophisticated quantitative treatment. Such exercises could provide valuable insight into the checklist’s past accuracy in evaluating country risk. In recent years,

this method has become popular with the banks and other country rating agencies".¹⁷

Several *quantitative methods* are being used for addressing various issues concerning country risk. "For example, these methods can be useful in establishing relationships between political, economic, and financial factors on one hand and some indicator that reflects risk exposure or risky behavior on the other. Since the objective is to classify the countries under consideration into one or the other risk category, these methods are applied to data to identify patterns or/and factors that help assess the risk associated with a particular country. In most cases, the observable indicator of risky behavior or risk exposure takes the form of a discrete (mostly binary) choice variable (e.g. debt rescheduling or not, defaulting or not etc.) or values in a limited range, and the econometric approaches are usually different from simple regression analysis. Sometimes quantitative methods are also used to unveil the importance of various factors in the risk ratings of various agencies. These techniques are further used to evaluate the usefulness of country risk measures published by various banks and agencies in predicting major financial events. A few major approaches used in country risk analysis are discussed below along with their main advantages and shortcomings"¹⁸.

How does Country Risk matter for Foreign Direct Investment?

Due to financial integration and globalization, there has been a rapid growth of international lending and foreign direct investment. Increased flow of capital to the developing countries has increased the risk exposure of the lenders and investors. Thus, country risk analysis has become extremely important for the international creditors and investors.

¹⁷ "Country Risk Analysis: A Survey of the Quantitative Methods", Hiranya K Nath SHSU Economics & Intl. Business Working Paper No. SHSU_ECO_WP08-04, October 2008.

¹⁸ "Country Risk Analysis: A Survey of the Quantitative Methods", Hiranya K Nath SHSU Economics & Intl. Business Working Paper No. SHSU_ECO_WP08-04, October 2008.

All business transactions involve some degree of risk, but international business transactions carry additional political, economic, and financial risks not present in domestic transactions. Country risk relates to the possibility of changes in the business environment, and to the possibility that these changes can adversely affect operating profits as well as the value of assets of foreign investors. The risks arise from country environmental factors such as legal and regulatory changes, government transitions, human rights issues, currency crises, and terrorism, just to mention a few. For multinational companies, these instabilities (political risks) can threaten corporate financial positions, as the costs of doing businesses in an unpredictable, volatile, politically unstable country are usually substantial. Most country-risk measurements are a multidimensional construct that include political, financial, and socio-economic indicators. For many of these constructs, analysts reduce risks to some type of index or relative measure. “To measure risk-based environmental factors that affect FDI (e.g., political, economic and financial risk factors), we use the international country risk rating (ICRG) as in Coplin and O’Leary (1994). Political, economic, and financial factors are of interest to investors, businesses, and individuals. A number of influential studies have employed ICRG data, as country-risk ratings are reported to have a high correlation with actual future equity returns (Harvey et al., 1996; Hall and Jones, 1999)”¹⁹. The essence of focusing on risk-based environmental factors of FDI is that countries with transparent political institutions and governance structure in addition to promoting and improving their economic and financial institutions and structures attract more FDI in particular and investment funds in general.

So, in order to control country risk efficient we have to consider that the institution in every host country should have a country risk management process. According to Monetary Authority of Macao, such process should include effective oversight by the board of directors, adequate policies and procedures and other essential elements. The board of directors of an institution should be responsible for approving and

¹⁹ “Country Risk Factors: An Empirical Study of FDI Determinants in SSA”, Dr. Etienne Musonera, Journal of International Management Studies, February 2008.

periodically reviewing policies governing the institution's international activities to ensure that they are consistent with the institution's strategic plans and goals. The board is also responsible for approving and reviewing country exposure limits and ensuring that management of the institution is adhering to the policies and implementing appropriate measures to identify, monitor and control country risk. Also, the management of an institution is responsible for implementing sound, well-defined policies and procedures for managing country risk. The policies and procedures should set out: (a) the institution's business strategy in cross-border activities, (b) the overall limits and sub-limits for cross-border exposures, including the authority to approve these limits and any exceptions, (c) clear lines of responsibility and accountability for country risk management decisions, (d) the standards and criteria to be used to analyze the risk of particular countries, (e) the authorized activities, investments, and instruments and (f) the desirable and undesirable types of business. Management should also ensure that the policies, standards, and practices are clearly communicated to the affected offices and staff.

Each institution must have a reliable system for capturing and categorizing the volume and nature of cross-border exposures. The reporting system should cover all aspects of the institution's operations. Institutions are expected to have an effective country risk analysis process to assess the risk associated with each country in which they are conducting or planning to conduct business, although the level of resources devote to the process may vary depending on the size and sophistication of an institution's international operations. In assessing the risk of a country, institutions should consider both the quantitative and qualitative factors of that country. For example, the size and structure of the country's external debt, the quality of the policy-making function, social and political stability and the legal and regulatory environment of the country. Institutions may make use of internal and external sources for assessing country risk but they should conduct their own country risk assessment instead of relying entirely on external assessment. During times of instability and impending crisis, institutions should update their analyses more frequently and expand the scope of their country risk analysis as necessary. The

results of country risk analysis should be integrated closely with the process of formulating marketing strategies, approving credits, assigning country risk ratings, setting country exposure limits and provisioning.

Also, institutions should have a system to integrate the results of their country risk analysis into their internal assessment of repayment capability of borrowers. For those institutions that have significant cross-border exposures, they should consider establishing a formal country risk rating system to summarize the conclusions of the country-risk analysis process. The ratings can provide a framework for establishing country exposure limits that reflect the institution's tolerance for risk. They can also be used to determine the appropriate level of provisions for cross-border exposures.

Institutions should have a system for establishing, maintaining and reviewing country exposure limits, which usually reflect a balancing of the following considerations: the institution's overall strategy on international activities; (b) the country's risk rating and the institution's appetite for risk; the perceived business opportunities in the country; and the desire to support the international business needs of domestic borrowers. Country exposure limits should be approved by the board of directors, or a committee thereof, and communicated to all affected departments and staff.

The limits should be reviewed and approved at least annually and more frequently when concerns about a particular country arise. Compliance with country exposure limits should be monitored at least on a monthly basis. In the case of any exception to approved country exposure limits, it should be properly authorized and reported to an appropriate level of management or the board so that it can consider corrective measures.

Institutions should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the institution's level of exposure and the perceived level of risk. The information gathered in this process should be properly maintained in the country risk analysis files. If the institution maintains an in-country office in the foreign country, a report from the

local staff will be a valuable resource for monitoring country conditions. In addition, periodic visits by the regional or country manager to a country or to the borrowers' overseas production lines are also important to monitor country conditions or individual exposures. The communications between senior management and the responsible country managers should be regular and ongoing. There should also be procedures for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country.

FDI and Country Risk: A Research

In order to examine the empirical relationship between Foreign Direct Investment and the host country's risk, we use the appropriate data to test the Hypothesis and to analyze the results that lead us to clarify the peculiar relation and the environment under which occurs.

According to literature and especially to Dr. Etienne Musonera (Journal of International Management Studies, February 2008) study, the following survey is a representative of an Ordinary Least Squares (OLS) regression method.

The Data

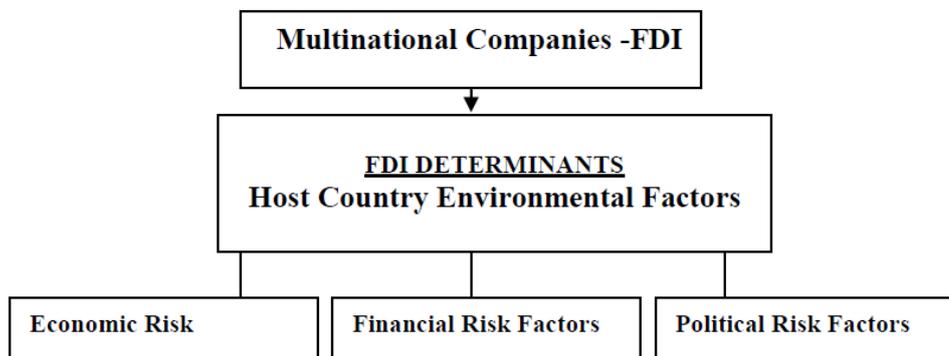
In order to test the factors of FDI inflows that affecting the countries, the study articulates the Country-Risk theoretical model (figure 1). The model states that FDI is determined by country-risk factors such as economic, financial and political risk factors. To validate the model, hypotheses are empirically tested using quantitative data. The data sets are compiled from several sources for the estimation of the model. Data on FDI is obtained from the best source of world development indicators, the World Bank's data bases. Quantitative data on political, economic, and financial risks are obtained from the Political Risk Services (PRS) group database.

The Concept Model and Hypothesis

The theoretical model is consistent with the existing theories of international production, where the demand for inward-bound FDI is said to depend on a variety

of characteristics of the recipient country. The analysis starts from the notion that the location advantage point of view of FDI is influenced by host-country environmental factors. Therefore, the dependent variable represents the host-country demand for FDI while the independent variables are comprised of political, economic, and financial risk components—important constituents of a host-country's environmental terrain.

Figure 1: Schematic Illustration of the Country-Risk Theoretical Model



The key hypothesis of the study is based on the Country Risk Model, presented schematically in Figure 1. This theoretical model posits that FDI inflows into a country (here expressed as FDI amount as a percent of the country's GDP) is a function of three major country-risk factors of the host-country—economic, financial and political (express as risk points per the ICRG's measurement scheme).

The World Bank (2004) define FDI as the net inflows of investment to acquire a lasting management interest in an enterprise operating in an economy other than that of the investor. It is also expressed as the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as reported in the balance of payments. We use FDI as a percent of GDP because it adjusts foreign investment flows for size of the host-country's economy. This normalization is necessary because the size of a country's GDP can influence the amount of FDI it attracts. We group the location-based determinants of FDI into major category forms the literature has dubbed country-risks factors. The dependent variable (FDI) represents

the host country demand for FDI, and we expect a direct relationship between it (FDI inflows as percent GDP) and the location-based FDI determinants (country risk characteristics).

In sum, the hypothesis is that FDI inflows into the countries depend on the degree of economic, financial, and political risks in the host-countries. Alternatively, the hypothesis can be stated as follows: FDI inflow into country I is a function of economic, financial, and political risk points. It can be expressed mathematically as:

$$\text{FDI (I)} = \beta_0 + \beta_1 (\text{ECONOMIC RISK}) + \beta_2 (\text{POLITICAL RISK}) + \beta_3 (\text{FINANCIAL RISK}) + \varepsilon, \quad (1)$$

where, ECONOMIC RISK, FINANCIAL RISK, POLITICAL RISK represent, accordingly, economic, financial and political risk-points; β_0 , β_1 , β_2 , β_3 are regression coefficients, and ε is a random error term. We expect economic, financial, and political risk-points to be positively related to FDI inflows. In fact, all risk-points (per ICRG measurement scheme) are expected to be positively associated with FDI inflows.

The Empirical Estimation

Empirical tests were conducted using both the Pearson Product Correlation and Ordinary Least Squares (OLS) regression methods. Regression analysis on FDI determinants is performed for the countries for several periods. Specifically, the study tests the relationship between the dependent and independent variables, which encompass each country's economic, financial, and political risk measures. Country risk factors were chosen because they interact among themselves in a number of ways, and they largely overlap with other FDI determinants (e.g., social and marketing factors). Furthermore, investors focus on political, economic, and financial institutions as the primary source of actions and policies that determine the success and viability of FDI (Wilhems, 1998). Thus, the objective is to investigate whether country risk factors are indeed important determinants of FDI inflows in tested countries.

The Analysis of Results

The interpretation and discussion of empirical estimates and other tests are discussed in this section. An OLS regression method was used to determine the estimated regression line and to predict the value of the response variable for any value or combination of values of the predictor variables. Goodness-of-fit statistics, such as R-square, adjusted R-square, and standard error of the estimate, were used to determine whether or not the overall model provides information for the prediction of the dependent variable. For the test statistics, we adopt the conventional benchmark that coefficients with p-values less than 0.10 (p-value < 0.10) are statistically significant, and can thus reject the null hypothesis and conclude that the coefficient is significantly different from zero, 0. Two-tailed t-test p-values are reported in the regression tables, indicating each individual independent variable's predictability of the dependent variable.

Regression Results SPSS software was used to perform the OLS regression analysis and to estimate the effects of the hypothesized variable and the control variables on FDI inflows, and especially to check if the changes in FDI can be explained by country risk factors. Recall that high risk points correlate with desirable properties for private investors, and indicate that institutions are transparent and trustworthy. Consequently, FDI inflows depend on the economic, financial, and political risks in the host country. Also recall that the country risk model specifies the following relationship:

$$\text{FDI (I =)} = \beta_0 + \beta_1 (\text{POLITICAL RISK}) + \beta_2 (\text{FINANCIAL RISK}) + \beta_3 (\text{ECONOMIC RISK}) + \varepsilon$$

“The study confirms that the ability to attract FDI inflows depends on the host country's institutions and policies (Wilhelms, 1998; Pigato, 2001). Thus by working on improving environmental factors that influence FDI, such as minimizing country

risks, developing countries can experience more FDI inflows, which in turn would contribute to sustainable economic growth and development”.²⁰

Conclusion

The main purpose of the investors is to take advantage of developing countries by investing needed capital to finance production and economic growth. But unless Country Risk is minimized, investors or the home country will not be willing to invest. After the transformation of the state-owned economies into privately-owned economies and the broadly economic prosperity that occur, the need for investments has become more urgent. For this reason, they have been created new methods and ways to research, to measure, to analyze and to reduce country risk.

It is important to know that whenever changes occurred in the course of investments and economic situation quickly ended up doing better in terms of living standards and overall development. “Recent experiences with opening capital accounts in emerging and developing economies, however, have proved to be a mixed blessing, as it is becoming increasingly clear that not all types of capital imports are equally desirable. Short-term credits and portfolio investments run the risk of sudden reversal if the economic environment or just the perception of investors change, giving rise to financial and economic crises”.²¹

The fact that FDI may cause negative aspects as well, is not a reason enough to consider that FDI is not effective. It would be an extreme to state that the role of the host country’s government is not important. On the contrary, host country’s environment is the most significant indicator while, the changes in political, economic and financial sectors are these factors that affect Country Risk and therefore FDI.

²⁰ “Country Risk Factors: An Empirical Study of FDI Determinants in SSA”, Dr. Etienne Musonera, Journal of International Management Studies, February 2008.

²¹ “Political Risk, Institutions and Foreign Direct Investment”, Matthias Bussea, Carsten Hefekerb, July 2005.

In conclusion, I would say that a country should face its risk's problems in order not to be excluded from investments. It should define the major obstacles and risks to Foreign Direct Investment development. This is the first step which developing countries should exercise in order to attract more inward Foreign Direct Investment.

Further Knowledge

I would like to present two tables showing the today's global situation regarding the ratings and the survey results of Country Risk, according to *Euromoney* measurement method.

Shifting Global Risk Perceptions

	- points difference in ECR scores -		
	2012 (first half)	quarter-on-quarter	year-on-year
Eurozone	-1.8	-0.3	-6.1
European Union	-1.4	-0.2	-5.4
Brics	-1.3	-0.4	-2.8
CEE	-1.2	-0.2	-4.1
Middle East	-0.9	-0.4	-3.6
G10	-0.8	-0.3	-5.0
North America	-0.5	-0.2	-4.7
Africa	-0.4	0.8	-1.8
Latin America	-0.4	-0.2	-1.3
Asia	-0.2	-0.2	-3.6
Caribbean	0.1	-0.1	-0.9
Australasia	0.1	-0.1	-1.0

Note: minus sign indicates increased risk

Source: [Euromoney](#) Country Risk

Euromoney Country Risk Survey Results, June 2012



www.euromoneycountryrisk.com

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