

Frying pans and Fires...

Country Risk: A 2023 Update

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An Annual Ritual on Country Risk

- For the last decade, I have looked at country risk, in all its dimensions, towards the middle of each year for many reasons.
 - One is *curiosity*, as political and economic crises roll through regions of the world, roiling long-held beliefs about safe and risky countries.
 - The other is *pragmatic*, since it is almost impossible to value a company or business today without a clear sense of how risk exposure varies across the world, since for many companies, either the inputs or output are often in foreign markets.
- Since country risk is multidimensional and dynamic, my annual country risk update runs to more than a hundred pages, but I will try to summarize what the last year has brought in this post.

Drivers of Country Risk

<p>Political Structure</p> <ul style="list-style-type: none"> - The degree of political freedom/democracy affects business risk, but the <u>effects can cut both ways</u> (good and bad). - Democracies expose businesses to <u>more continuous risk</u>, as laws and regulations can change, when elections create government changes. - Authoritarian regimes often offer the promise of predictability, and less risk on a period-to-period basis, but face <u>more discontinuous risk</u>, since regime change is often violent and significantly disruptive. 	<p>Corruption</p> <ul style="list-style-type: none"> - Corruption operates as a <u>hidden tax</u>, reducing profitability and value for private businesses - Businesses operating in corrupt locales face a choice of either accepting corruption as part of the cost of doing business or operating at a disadvantage to competitors who are less scrupulous.
<p>War & Violence</p> <ul style="list-style-type: none"> - Operating a business in a country that is more <u>exposed to violence</u>, from war, terrorism or internal strife, is more difficult than operating that business in a more peaceful environment. - Businesses will face higher costs in operations and/or from trying to insure themselves against violence. 	<p>Legal & Property Rights</p> <ul style="list-style-type: none"> - The value of a private business is dependent on a legal system that <u>respects property rights and enforces those rights</u>. - In a country where there are no or weak property rights or that has a <u>legal system that does not enforce those rights</u>, businesses face more risks and have less value. - <u>Timeliness</u> in enforcing legal rights matters as much as the due process, since rights not enforced in a timely manner provide weak protection.

Country Risk

1. Democracy, in degrees...

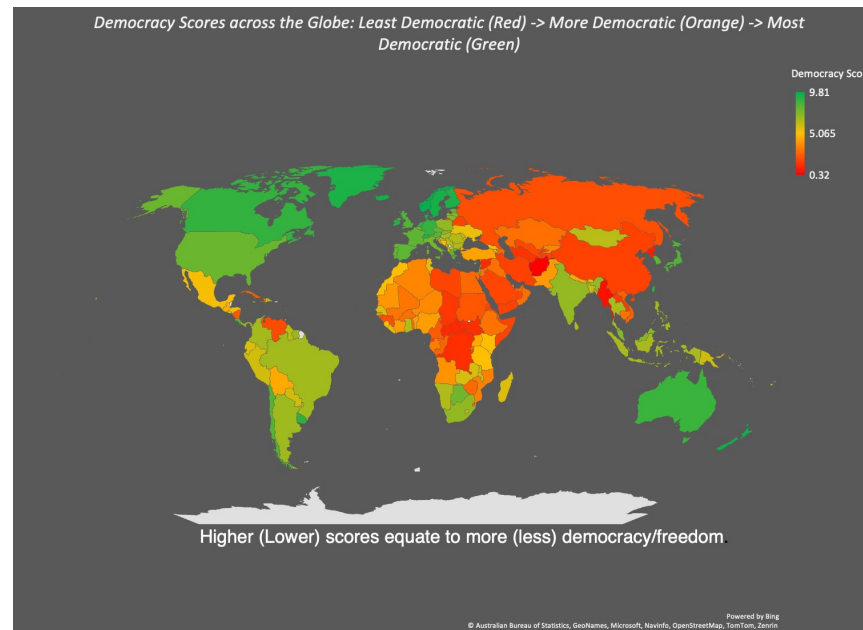
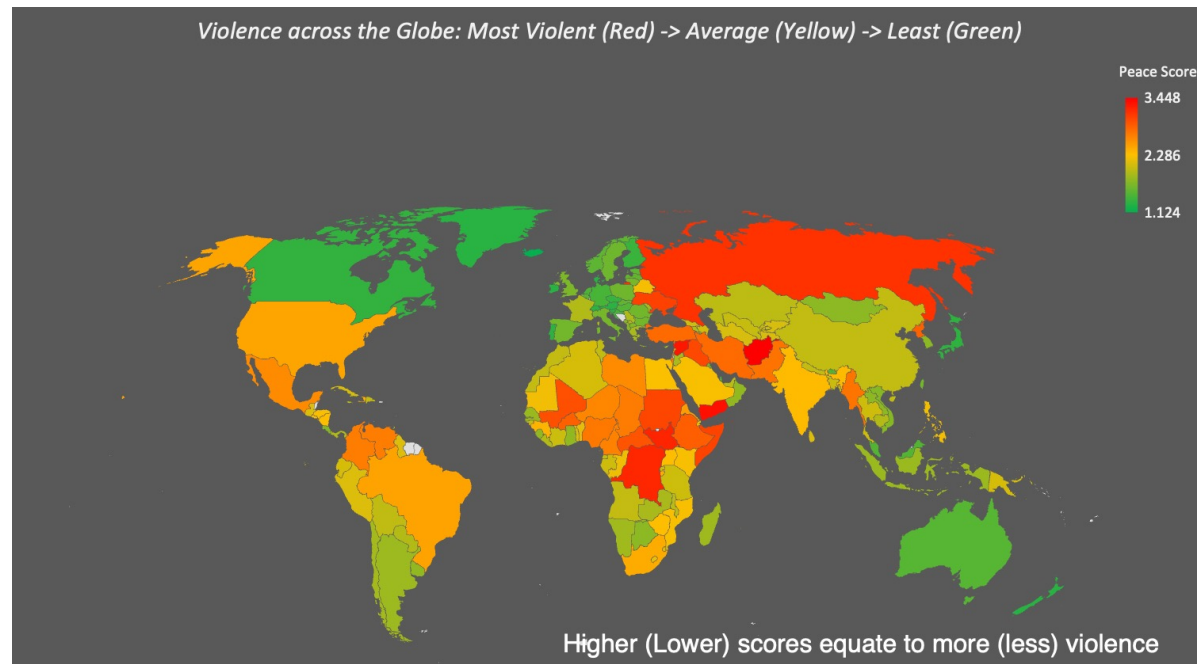


Table 1A: Democracy Index, by Region: 2006 -2022

Region	EIU Democracy Index Score (Higher = More Democratic)				
	2022	2021	2016	2011	2006
Asia & Australasia	5.46	5.46	5.74	5.51	5.44
Eastern Europe	5.39	5.36	5.43	5.50	5.76
Latin America	5.79	5.83	6.33	6.35	6.37
Middle East & North Africa	3.34	3.41	3.56	3.62	3.53
North America	8.37	8.36	8.56	8.59	8.64
Western Europe	8.36	8.22	8.40	8.40	8.60
Sub-Saharan Africa	4.14	4.12	4.37	4.32	4.24
World average	5.29	5.28	5.52	5.49	5.52

2. Violence and its Consequences



Most Peaceful		Least Peaceful	
Country	Score	Country	Score
Iceland	1.124	Afghanistan	3.448
Denmark	1.310	Yemen	3.350
Ireland	1.312	Syria	3.294
New Zealand	1.313	South Sudan	3.221
Austria	1.316	Congo (Dem Rep)	3.214
Singapore	1.332	Russia	3.142
Portugal	1.333	Ukraine	3.043
Slovenia	1.334	Somalia	3.036
Japan	1.336	Sudan	3.023
Switzerland	1.339	Iraq	3.006

3. Corruption, an implicit tax

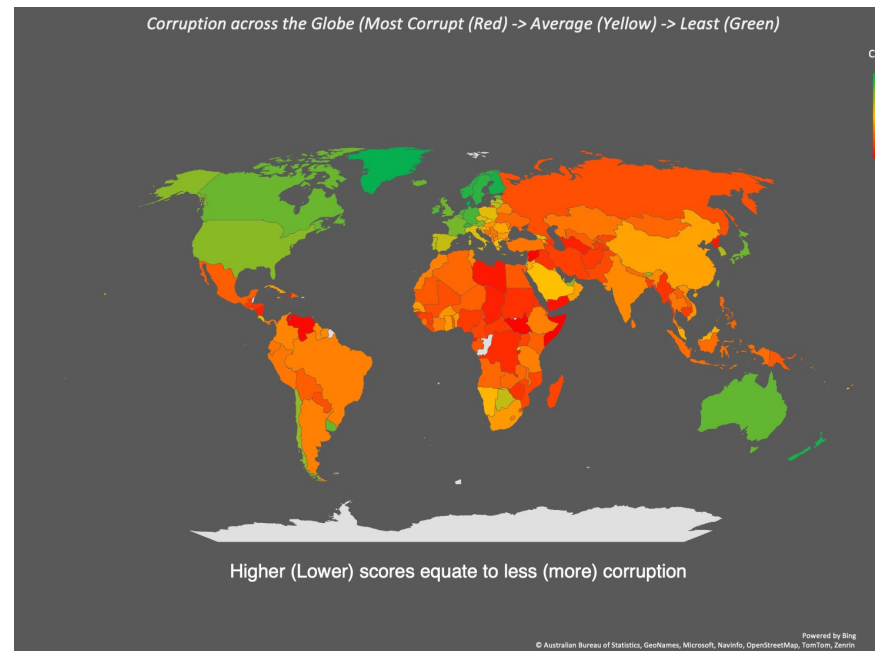


Table 1B: Most and Least Corrupt Countries – 2022

Least Corrupt		Most Corrupt	
Country	Corruption Score	Country	Corruption Score
Denmark	90	Somalia	12
Finland	87	South Sudan	13
New Zealand	87	Syria	13
Norway	84	Venezuela	14
Singapore	83	Yemen	16
Sweden	83	Burundi	17
Switzerland	82	Equatorial Guinea	17
Netherlands	80	Haiti	17
Germany	79	Korea, North	17
Ireland	77	Libya	17

4. Legal Protection or its Absence!

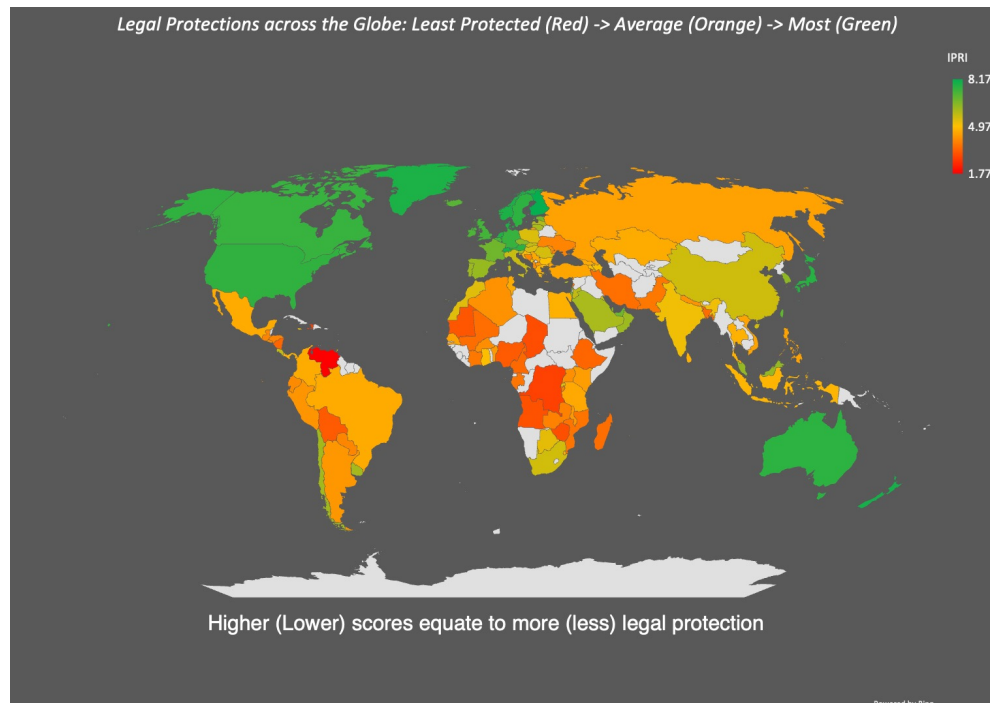


Table 2: Property Right Protection by Region – 2022

Region	IPRI	LP	PPR	IPR
Africa	4.1586	3.8824	4.2890	4.3044
Asia	5.4142	5.2175	5.8313	5.1939
Central America	4.3503	4.0418	4.3809	4.6282
European Union	6.4144	6.6245	6.1400	6.4789
North America	6.5538	6.0333	6.2315	7.3967
Oceania	7.7728	8.3443	7.5844	7.3898
Rest of Europe	5.2692	5.1637	5.3599	5.2839
South America	4.3253	4.1020	4.3227	4.5510

Measuring Country Risk

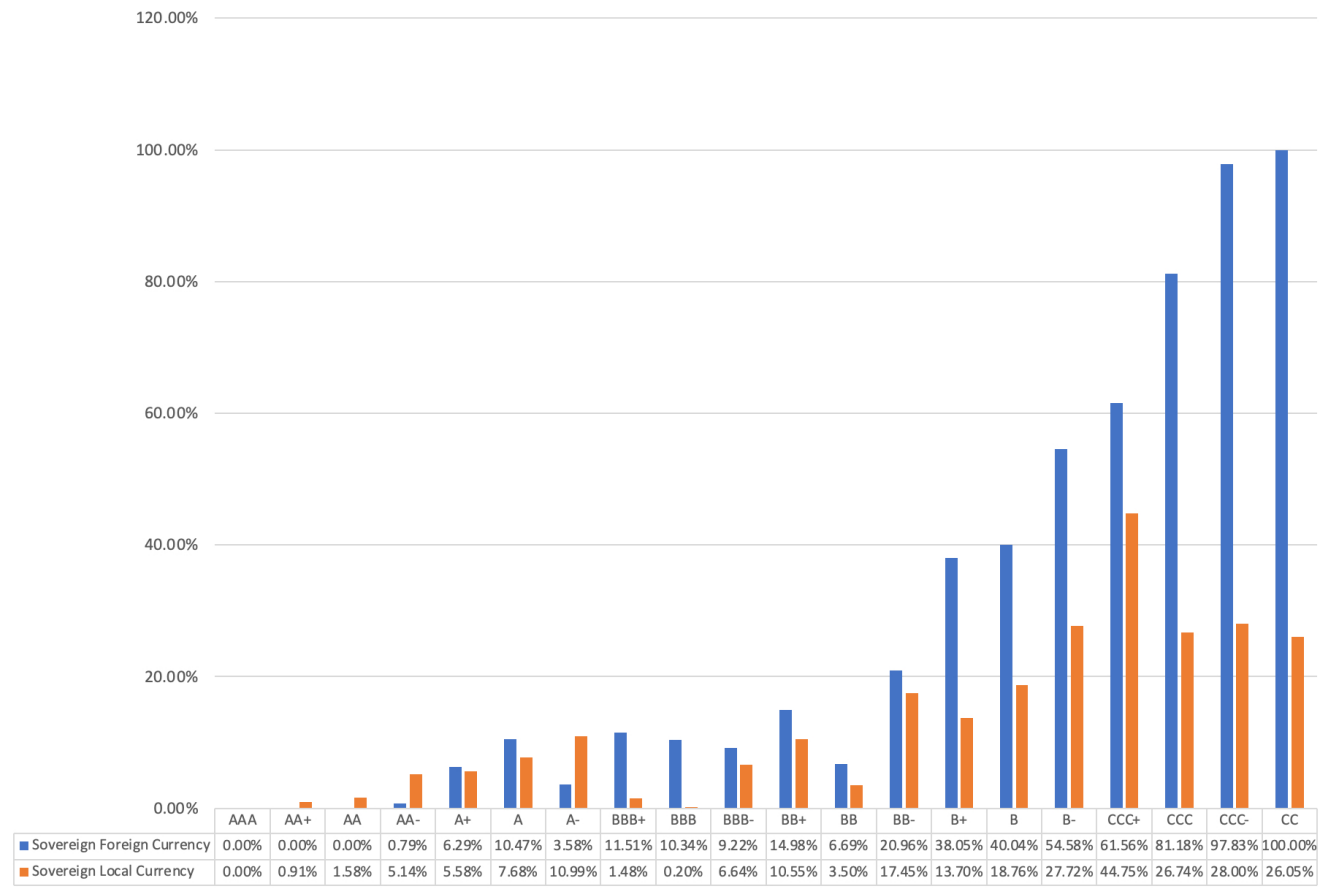
- **Default Risk:** Countries can default on their borrowings, and default risk looks at that likelihood.
 - Sovereign Ratings: Moody's, S&P and Fitch (among others) rate countries on both local and foreign currency debt.
 - Sovereign CDS spreads: This is a market-based estimate of how much it will cost you to buy insurance against sovereign default on an annual basis.
- **Composite Risk Scores:** There are services like PRS, the Economist and the World Bank that measure country risk on many dimensions and with a score.
 - Pluses: Bring in risks that may not be captured in default
 - Minuses: No standardization, Subjective, Difficult to compare across countries
- **Equity/Ownership Risk:** Should be greater than default risk, since equity investors are last in line, behind lenders.

1A. Sovereign Ratings

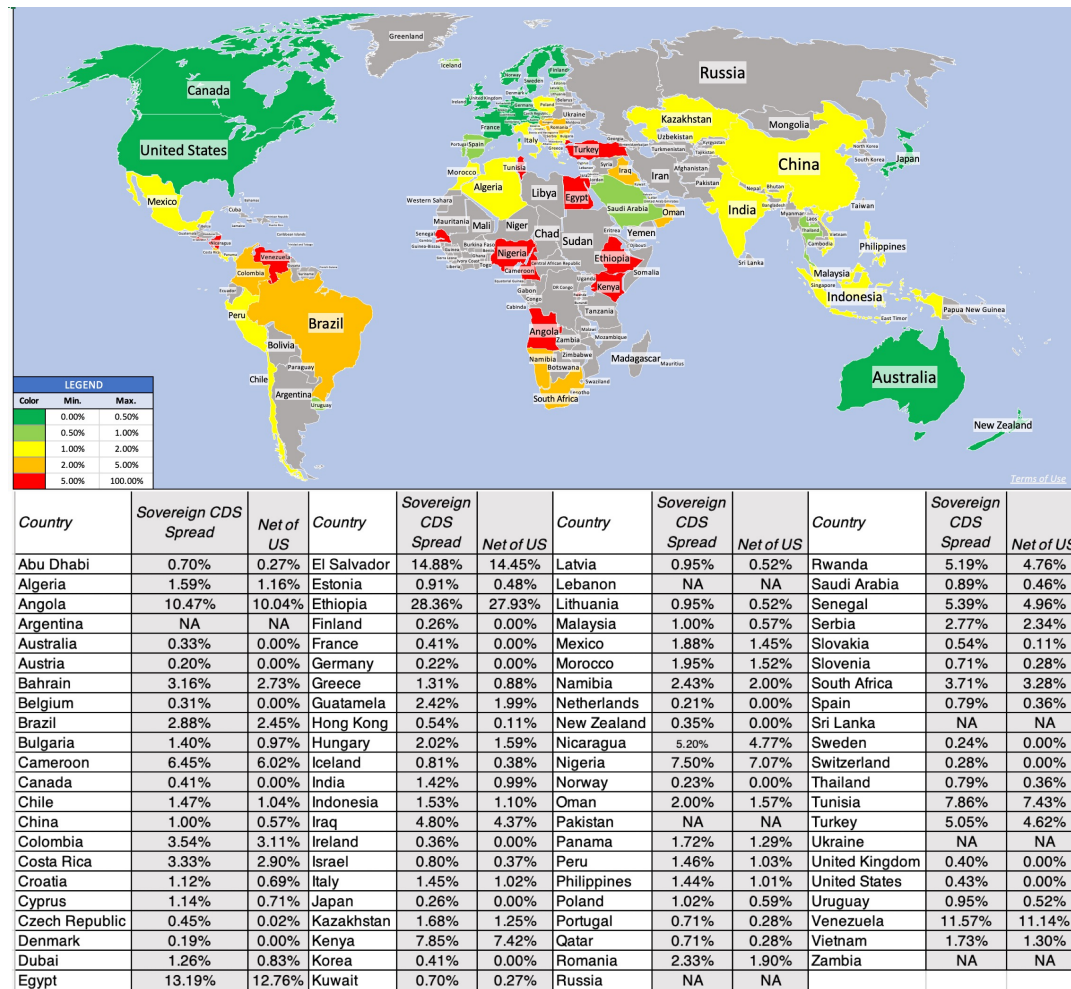
Country	S&P Rating	Moody's rating	Country	S&P Rating	Moody's rating	Country	S&P Rating	Moody's rating	Country	S&P Rating	Moody's rating
Abu Dhabi	AA+	Aa2	Curacao	BBB	Baa2	Laos	NA	Caa3	Rwanda	B+	B2
Albania	B+	B1	Cyprus	BBB	Ba1	Latvia	A+	A3	Saudi Arabia	A	A1
Andorra (Principality of)	BBB+	Baa2	Czech Republic	AA-	Aa3	Lebanon	D	C	Senegal	B+	Ba3
Angola	B-	B3	Denmark	AAA	Aaa	Liechtenstein	AAA	Aaa	Serbia	BB+	Ba2
Argentina	CCC-	Ca	Dominican Republic	BB	Ba3	Lithuania	A+	A2	Sharjah	NA	Ba1
Armenia	B+	Ba3	Ecuador	B-	Caa3	Luxembourg	AAA	Aaa	Singapore	AAA	Aaa
Aruba	BBB	Baa2	Egypt	B	B3	Macao	NA	Aa3	Slovakia	A+	A2
Australia	AAA	Aaa	El Salvador	CCC+	Caa3	Macedonia	BB-	Ba3	Slovenia	AA-	A3
Austria	AA+	Aa1	Estonia	AA-	A1	Malaysia	A-	A3	Solomon Islands	0	Caa1
Azerbaijan	BB+	Ba1	Ethiopia	CCC	Caa2	Maldives	NR	Caa1	South Africa	BB-	Ba2
Bahamas	B+	B1	Fiji	B+	B1	Mali	NR	Caa2	Spain	A	Baa1
Bahrain	B+	B2	Finland	AA+	Aa1	Malta	A-	A2	Sri Lanka	NA	Ca
Bangladesh	BB-	B1	France	AA	Aa2	Mauritius	NR	Baa3	St. Maarten	NA	Ba2
Barbados	B-	Caa1	Gabon	NA	Caa1	Mexico	BBB	Baa2	St. Vincent & the Grenadines	NA	B3
Belarus	NA	C	Georgia	BB	Ba2	Moldova	NR	B3	Suriname	Na	Caa3
Belgium	AA	Aa3	Germany	AAA	Aaa	Mongolia	B	B3	Swaziland	NA	B3
Belize	B-	Caa2	Ghana	NA	Ca	Montenegro	B	B1	Sweden	AAA	Aaa
Benin	B+	B1	Greece	BB+	Ba3	Montserrat	BBB-	Baa3	Switzerland	AAA	Aaa
Bermuda	A+	A2	Guatemala	BB	Ba1	Morocco	BB+	Ba1	Taiwan	AA+	Aa3
Bolivia	B-	Caa1	Guernsey (States of)	AA	Aa2	Mozambique	CCC+	Caa2	Tajikistan	B-	B3
Bosnia and Herzegovina	B	B3	Honduras	BB-	B1	Namibia	NR	B1	Tanzania	NA	B2
Botswana	BBB+	A3	Hong Kong	AA+	Aa3	Netherlands	AAA	Aaa	Thailand	BBB+	Baa1
Brazil	BB-	Ba2	Hungary	BBB-	Baa2	New Zealand	AA+	Aaa	Togo	B	B3
Bulgaria	BBB	Baa1	Iceland	A	A2	Nicaragua	B	B3	Trinidad and Tobago	BBB-	Ba2
Burkina Faso	CCC+	Caa1	India	BBB-	Baa3	Niger	NR	B3	Tunisia	NA	Caa2
Cambodia	NA	B2	Indonesia	BBB	Baa2	Nigeria	B-	Caa1	Turkey	B	B3
Cameroon	B-	B2	Iraq	B-	Caa1	Norway	AAA	Aaa	Turks and Caicos Islands	BBB+	Baa1
Canada	AAA	Aaa	Ireland	AA	Aa3	Oman	BB	Ba2	Uganda	B	B2
Cape Verde	B-	B3	Isle of Man	N/A	Aa3	Pakistan	CCC+	Caa3	Ukraine	CCC	Ca
Cayman Islands	NA	Aa3	Israel	AA-	A1	Panama	BBB	Baa2	United Arab Emirates	AA	Aa2
Chile	A	A2	Italy	BBB	Baa3	Papua New Guinea	B-	B2	United Kingdom	AA	Aa3
China	A+	A1	Jamaica	B+	B2	Paraguay	BB	Ba1	United States	AA+	Aaa
Colombia	BB+	Baa2	Japan	A+	A1	Peru	BBB	Baa1	Uruguay	BBB+	Baa2
Congo (Democratic Republic of)	B-	B3	Jersey (States of)	AA-	Aa3	Philippines	BBB+	Baa2	Uzbekistan	BB-	Ba3
Congo (Republic of)	CCC+	Caa2	Jordan	B+	B1	Poland	A-	A2	Venezuela	NA	C
Cook Islands	B	B2	Kazakhstan	BBB-	Baa2	Portugal	BBB+	Baa2	Vietnam	BB+	Ba2
Costa Rica	B+	B2	Kenya	B	B3	Qatar	AA	Aa3	Zambia	NA	Ca
Côte d'Ivoire	BB-	Ba3	Korea	AA	Aa2	Ras Al Khaimah (Emirate of)	A-	A3			
Croatia	BBB+	Baa2	Kuwait	A+	A1	Romania	BBB-	Baa3			
Cuba	NA	Ca	Kyrgyzstan	NA	B3	Russia	NR	Ca			

A History of Sovereign Default

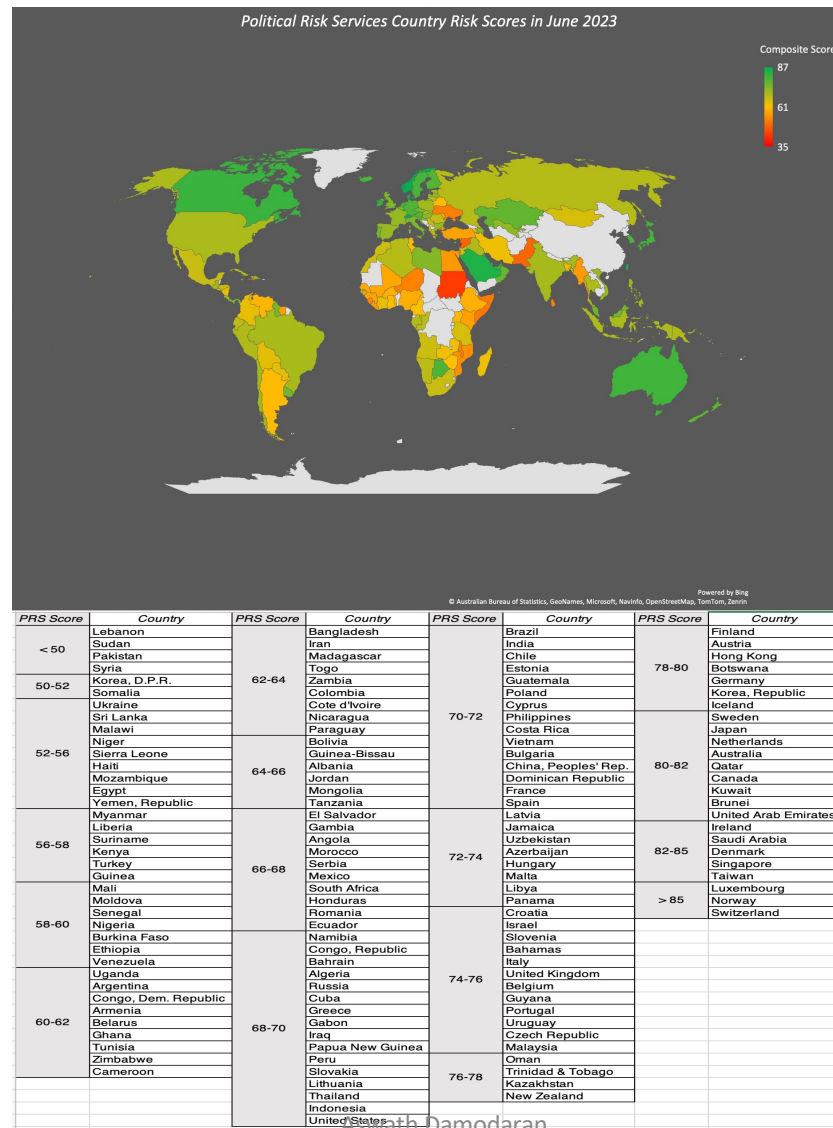
Default Rate in 15-Month Horizon on Sovereign Foreign Currency vs Local Currency Bonds - 1975 to 2022



1B. Sovereign CDS Spreads

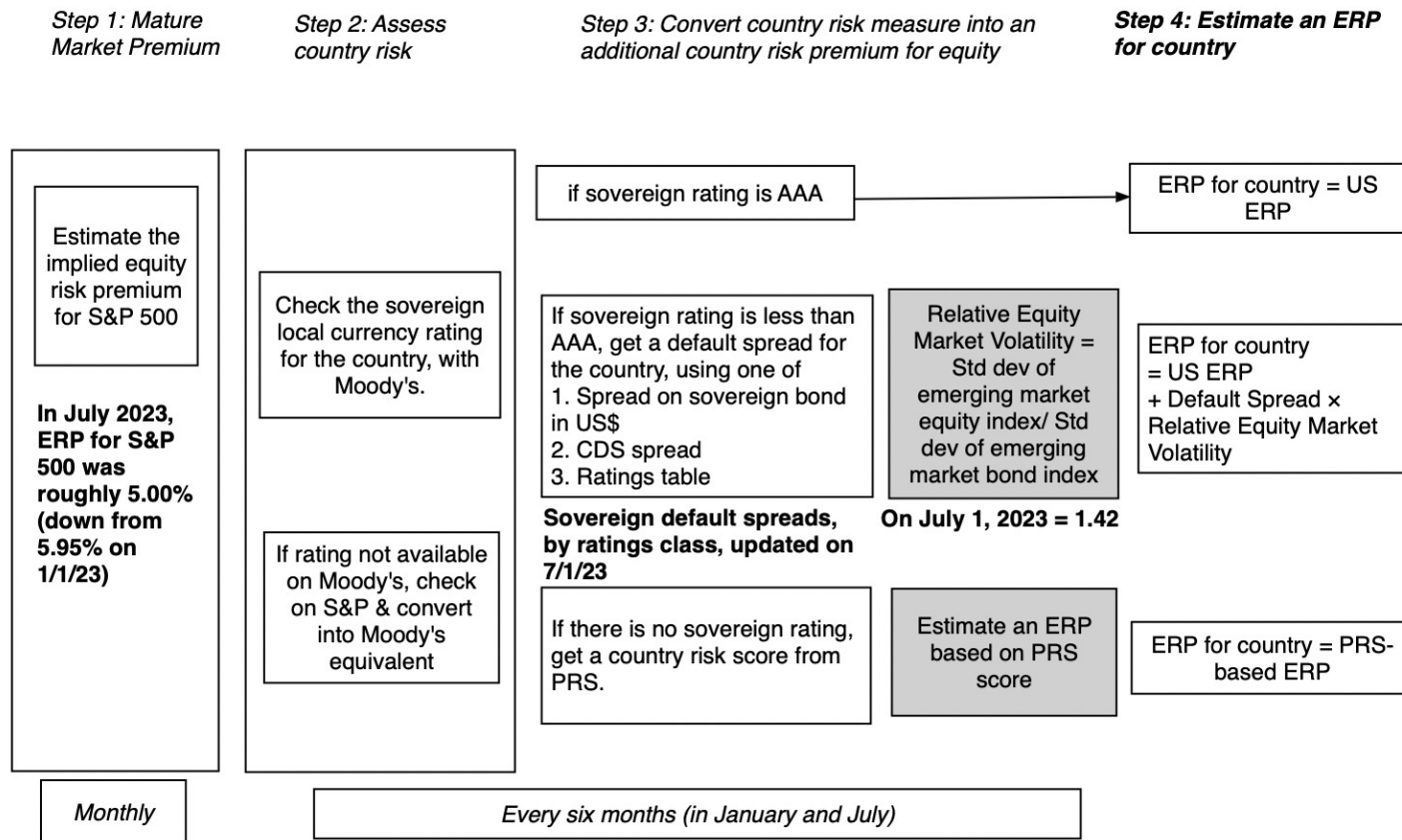


2. Country Risk Scores



3. Equity Risk Premiums: My Approach

ERP Estimation Procedure



Andorra	Baa2	2.89%	7.89%	Italy	Baa3	3.33%	8.33%
Austria	Aa1	0.61%	5.61%	Jersey (States of)	Aa3	0.91%	5.91%
Belgium	Aa3	0.91%	5.91%	Liechtenstein	Aaa	0.00%	5.00%
Cyprus	Ba1	3.80%	8.80%	Luxembourg	Aaa	0.00%	5.00%
Denmark	Aaa	0.00%	5.00%	Malta	A2	1.28%	6.28%
Finland	Aa1	0.61%	5.61%	Netherlands	Aaa	0.00%	5.00%
France	Aa2	0.75%	5.75%	Norway	Aaa	0.00%	5.00%
Germany	Aaa	0.00%	5.00%	Portugal	Baa2	2.89%	7.89%
Greece	Ba3	5.46%	10.46%	Spain	Baa1	2.43%	7.43%
Guernsey (States of)	Aa2	0.75%	5.75%	Sweden	Aaa	0.00%	5.00%
Iceland	A2	1.28%	6.28%	Switzerland	Aaa	0.00%	5.00%
Ireland	Aa3	0.91%	5.91%	Turkey	B3	9.86%	14.86%
Isle of Man	Aa3	0.91%	5.91%	United Kingdom	Aa3	0.91%	5.91%
				W.Europe		1.37%	6.37%

Canada	Aaa	0.00%	5.00%
United States	Aaa	0.00%	5.00%
US & Canada		0.00%	5.00%

Caribbean		14.38%	19.38%
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Argentina	Ca	18.21%	23.21%
Belize	Caa2	13.66%	18.66%
Bolivia	Caa1	11.38%	16.38%
Brazil	Ba2	4.57%	9.57%
Chile	A2	1.28%	6.28%
Colombia	Baa2	2.89%	7.89%
Costa Rica	B2	8.35%	13.35%
Ecuador	Caa3	15.18%	20.18%
El Salvador	Caa3	15.18%	20.18%
Guatemala	Ba1	3.80%	8.80%
Honduras	B1	6.83%	11.83%
Mexico	Baa2	2.89%	7.89%
Nicaragua	B3	9.86%	14.86%
Panama	Baa2	2.89%	7.89%
Paraguay	Ba1	3.80%	8.80%
Peru	Baa1	2.43%	7.43%
Suriname	Caa3	15.18%	20.18%
Uruguay	Baa2	2.89%	7.89%
Venezuela	C	24.82%	29.82%
Latin America		6.03%	11.03%

Angola	B3	9.86%	14.86%
Benin	B1	6.83%	11.83%
Botswana	A3	1.82%	6.82%
Burkina Faso	Caa1	11.38%	16.38%
Cameroon	B2	8.35%	13.35%
Cape Verde	B3	9.86%	14.86%
Congo ((DR)	B3	9.86%	14.86%
Congo (Rep)	Caa2	13.66%	18.66%
Côte d'Ivoire	Ba3	5.46%	10.46%
Egypt	B3	9.86%	14.86%
Ethiopia	Caa2	13.66%	18.66%
Gabon	Caa1	11.38%	16.38%
Ghana	Ca	18.21%	23.21%
Kenya	B3	9.86%	14.86%
Mali	Caa2	13.66%	18.66%
Mauritius	Baa3	3.33%	8.33%
Morocco	Ba1	3.80%	8.80%
Mozambique	Caa2	13.66%	18.66%
Namibia	B1	6.83%	11.83%
Niger	B3	9.86%	14.86%
Nigeria	Caa1	11.38%	16.38%
Rwanda	B2	8.35%	13.35%
Senegal	Ba3	5.46%	10.46%
South Africa	Ba2	4.57%	9.57%
Swaziland	B3	9.86%	14.86%
Tanzania	B2	8.35%	13.35%
Togo	B3	9.86%	14.86%
Tunisia	Caa2	13.66%	18.66%
Uganda	B2	8.35%	13.35%
Zambia	Ca	18.21%	23.21%
Africa		9.26%	14.26%

Albania	B1	6.83%	11.83%
Armenia	Ba3	5.46%	10.46%
Azerbaijan	Ba1	3.80%	8.80%
Belarus	C	24.82%	29.82%
Bosnia and Herzegovina	B3	9.86%	14.86%
Bulgaria	Baa1	2.43%	7.43%
Croatia	Baa2	2.89%	7.89%
Czech Republic	Aa3	0.91%	5.91%
Estonia	A1	1.07%	6.07%
Georgia	Ba2	4.57%	9.57%
Hungary	Baa2	2.89%	7.89%
Kazakhstan	Baa2	2.89%	7.89%
Kyrgyzstan	B3	9.86%	14.86%
Latvia	A3	1.82%	6.82%
Lithuania	A2	1.28%	6.28%
Macedonia	Ba3	5.46%	10.46%
Moldova	B3	9.86%	14.86%
Montenegro	B1	6.83%	11.83%
Poland	A2	1.28%	6.28%
Romania	Baa3	3.33%	8.33%
Russia	Ca	18.21%	23.21%
Serbia	Ba2	4.57%	9.57%
Slovakia	A2	1.28%	6.28%
Slovenia	A3	1.82%	6.82%
Tajikistan	B3	9.86%	14.86%
Ukraine	Ca	18.21%	23.21%
Uzbekistan	Ba3	5.46%	10.46%
E. Europe & Russia		10.35%	15.35%

Abu Dhabi	Aa2	0.75%	5.75%
Bahrain	B2	8.35%	13.35%
Iraq	Caa1	11.38%	16.38%
Israel	A1	1.07%	6.07%
Jordan	B1	6.83%	11.83%
Kuwait	A1	1.07%	6.07%
Lebanon	C	24.82%	29.82%
Oman	Ba2	4.57%	9.57%
Qatar	Aa3	0.91%	5.91%
Ras Al Khaimah (Emirate)	A3	1.82%	6.82%
Saudi Arabia	A1	1.07%	6.07%
Sharjah	Ba1	3.80%	8.80%
United Arab Emirates	Aa2	0.75%	5.75%
Middle East		2.16%	7.16%

Frontier (unrated) Countries			
Algeria	68.75	5.46%	10.46%
Brunei	81.75	0.91%	5.91%
Gambia	66	8.35%	13.35%
Guinea	57.5	13.66%	18.66%
Guinea-Bissau	64.5	8.35%	13.35%
Guyana	75	2.43%	7.43%
Haiti	54.5	18.21%	23.21%
Iran	62.75	9.86%	14.86%
Korea, D.P.R.	51	18.21%	23.21%
Liberia	56.25	15.18%	20.18%
Libya	73.75	2.89%	7.89%
Madagascar	62.75	9.86%	14.86%
Malawi	52.75	18.21%	23.21%
Myanmar	56	15.18%	20.18%
Sierra Leone	53	18.21%	23.21%
Somalia	51.5	18.21%	23.21%
Sudan	43	24.82%	29.82%
Syria	48.75	24.82%	29.82%
Yemen, Republic	55.75	15.18%	20.18%
Zimbabwe	61.25	11.38%	16.38%

Bangladesh	B1	6.83%	11.83%
Cambodia	B2	8.35%	13.35%
China	A1	1.07%	6.07%
Fiji	B1	6.83%	11.83%
Hong Kong	Aa3	0.91%	5.91%
India	Baa3	3.33%	8.33%
Indonesia	Baa2	2.89%	7.89%
Japan	A1	1.07%	6.07%
Korea	Aa2	0.75%	5.75%
Laos	Caa3	15.18%	20.18%
Macao	Aa3	0.91%	5.91%
Malaysia	A3	1.82%	6.82%
Maldives	Caa1	11.38%	16.38%
Mongolia	B3	9.86%	14.86%
Pakistan	Caa3	15.18%	20.18%
Papua New Guinea	B2	8.35%	13.35%
Philippines	Baa2	2.89%	7.89%
Singapore	Aaa	0.00%	5.00%
Solomon Islands	Caa1	11.38%	16.38%
Sri Lanka	Ca	18.21%	23.21%
Taiwan	Aa3	0.91%	5.91%
Thailand	Baa1	2.43%	7.43%
Vietnam	Ba2	4.57%	9.57%
Asia		1.74%	6.74%

Australia	Aaa	0.00%	5.00%
Cook Islands	B2	8.35%	13.35%
New Zealand	Aaa	0.00%	5.00%
Aus & NZ		0.00%	5.00%

Regional numbers are GDP-weighted averages

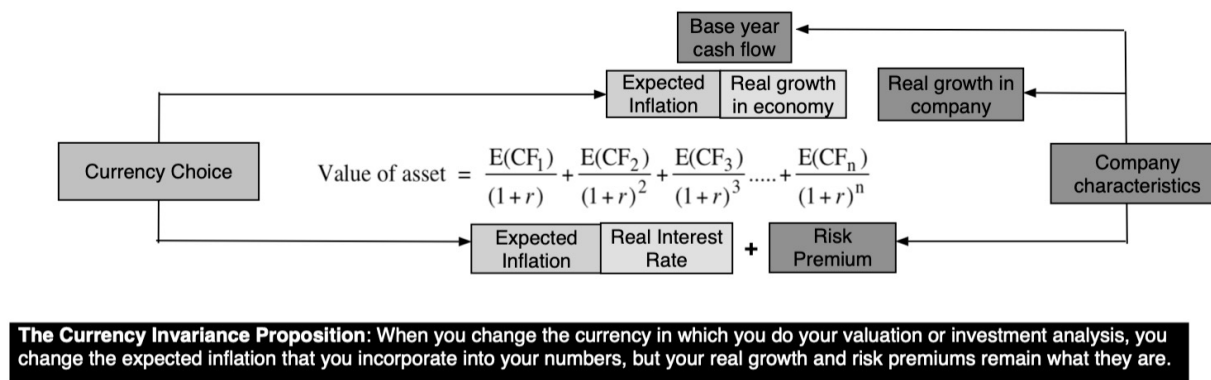
Blue: Moody's Rating
Red: Added Country Risk
Green #: Total ERP

Caveats and Questions

- I am not a country risk researcher, and I try not to let my personal views alter the numbers that emerge from the analysis, since that would open the door to my biases. I will use three countries in the latest update to illustrate my point:
 1. Saudi Arabia: As I noted earlier, using default spreads as my starting point can result in understating the risk premium for countries like Saudi Arabia, which score low on default risk but high on other risks.
 2. Libya: As indicated in the last section, the equity risk premium for Libya, an unrated country, is entirely based upon the country risk score from PRS. That country risk score is surprisingly high (indicating low risk) and it results in an equity risk premium that is low, relative to other countries in the region.
 3. China: In the aftermath of a Beijing crackdown on Chinese tech giants and talk of a trade war between China and the US, the perception seems to be that China has become a riskier place to invest. That may or may not be true, but looking at how Chinese equities are priced, trading still at some of the highest multiples of earnings in the world, investors in equity markets don't seem to share that view (yet).
- With all three of these countries, I have chosen not to change the numbers that resulted from my analysis, lest I be accused of bias, but if you have strong views on these countries or others, nothing is stopping you from replacing my numbers with yours.

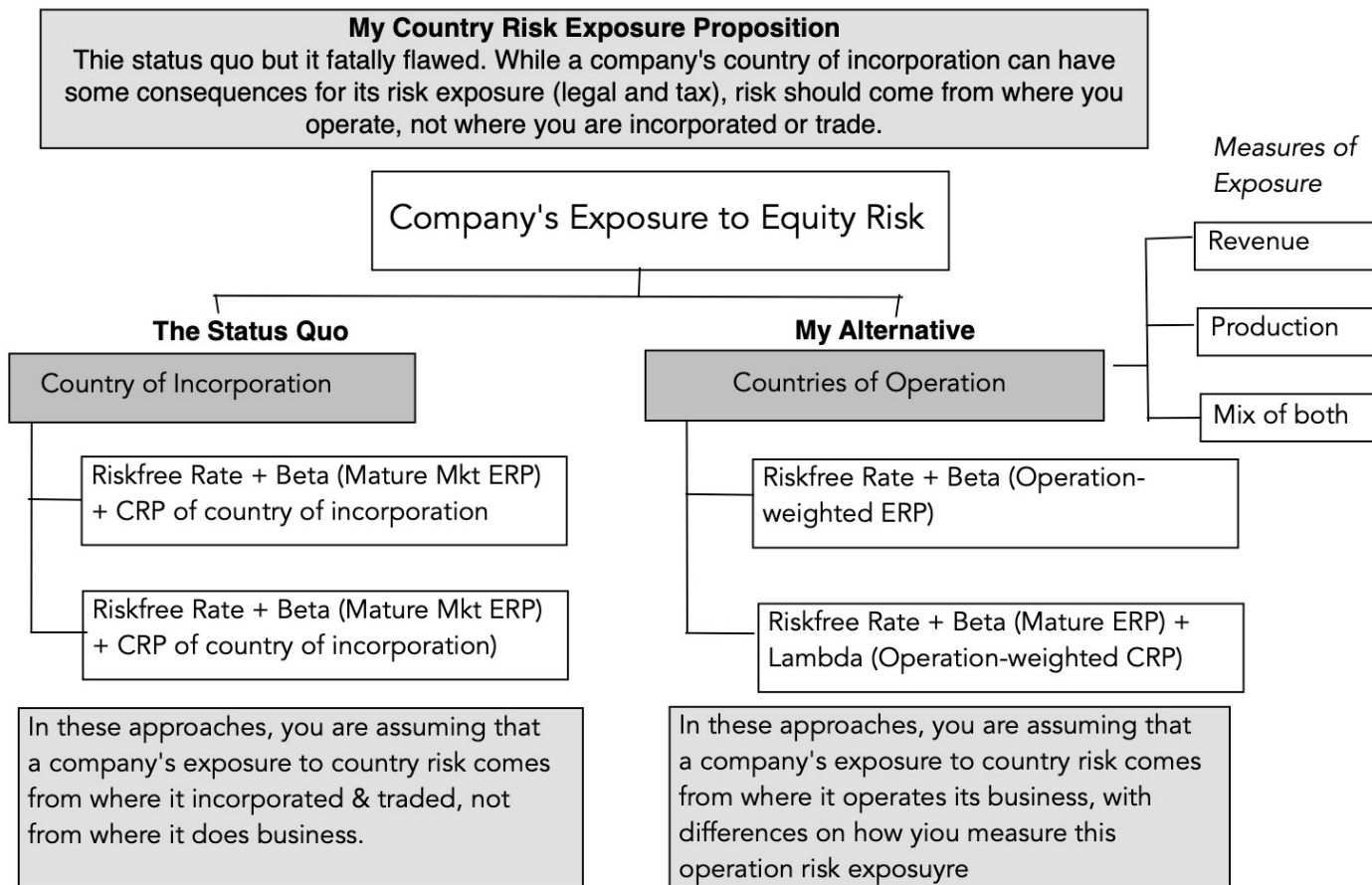
Company Hurdle Rates: The Currency Question

- **Currency Choice:** Each currency brings its own expectations of inflation, with higher inflation currencies leading to higher growth rates for cash flows and higher discount rates.



- **Currency Risk:** While analysts are often tempted to try to adjust discount rates for currency risk, caution is called for:
 - To the extent that currency risk adds to the operating risk of a company, it is, in my view, already embedded in the equity risk premiums that I have computed in the last section.
 - The other reason to tread lightly with currency risk is that for investors with global portfolios, it becomes diversifiable risk, as some companies benefit as a currency strengthens or weakened more than expected and other companies lose for the same reason.

Company Exposure to Country Risk



Conclusion

- Work in progress: I do hope that you get a chance to read the paper or at least review my country risk measures in this post, since there is significant room for improvement.
 - I don't have all the answers, and I probably never will, but progress is incremental.
 - Each year, I hope that I can add a tweak or a component that will move me in the right direction.
- It is not personal: Please don't take any of these numbers personally. If you feel that I have overestimated the risk in your country and given it an equity risk premium that you believe is undeservedly high, it is not because I do not like you or have bad feelings about your country. It is entirely Moody's fault for giving your country too low a rating, and you should take it up with them.