Evaluation of Risk in in International Lending: A Lender's Perspective

Irving S. Friedman*

Introduction

One of the most important developments occurring during the past decade or so has been the emergence of a new dimension in international banking. I refer to the increasingly significant role of private international banks in the continuing process of economic development around the globe — particularly in those countries often referred to as the "Third World."

I have recently written at some length concerning this evolving role, and its many complex ramifications, in a separate study which has been made available to you. I shall not take the time today to comment on that subject in depth. I should note, however, that it is that development which makes the topic of my paper so important to many involved in the international lending process.

Private bank lending to developing countries has become a major factor in international development finance. This trend has introduced a long line of related questions and issues, e.g., what criteria should guide private banks in their overseas banks? are they adequately informed? what should be the role of the IMF World Bank with respect to private bank lending? would private banks be better guided in their overseas lending activities if they were able to access IMF and/or World Bank reports?

My paper is intended to share with you some thoughts I have regarding country assessments being done by the U.S. banking community; Citicorp's approach to this work; and the potential that exists for improving/refining our own efforts in this area.

In the 20 minutes allotted to me at the Bald Peak Conference, I plan to supplement this paper with some brief remarks regarding the country evaluations which are done by the International Monetary Fund and the World Bank. The underlying theme of my paper and my remarks at Bald Peak is that the country assessments and judgments of the International Monetary Fund and the World Bank Group can be useful to Citicorp and other private banks but cannot substitute for their own. Fund and World Bank assessments are greatly influenced by the purposes which these organizations serve, their institutional characteristics, and operating policies and lending criteria.

*Senior Vice President and Senior Adviser for International Operations, Citicorp.

I am guided in these observations by my previous experience in the IMF and World Bank, where I was responsible for originating, implementing and overseeing country evaluations done in those institutions. When I moved to the World Bank in 1964, I had the practical difficulty of trying to determine the usefulness of IMF country evaluations to World Bank efforts in this area. It was obvious to me that while there was much of practical use for the World Bank in an IMF evaluation, the World Bank — given its different objectives, structure and policies — had to rely on its own unique methodology for assessing countries.

Similarly, my current responsibilities for implementing and overseeing country evaluation work at Citicorp lead me to the view that private banks cannot avoid the responsibility of preparing their own country assessments and reaching their own judgments on countries for which they take full responsibility.

U.S. Private Banks and Country Evaluation

It is to be expected that official institutions such as the IMF and World Bank will arrive at very individual judgments on countries. Their assessments will be greatly influenced by the purposes for which they exist, their institutional characteristics, and their own operating policies and lending criteria. It is not surprising, therefore, that the World Bank and the IMF do not always have the same view on a country. Disagreements are sometimes far-ranging; at other times, more limited to a disparate view on specific components of a government program.

The views of the Fund and the Bank can be useful to private banks, but cannot substitute for their own because private banks differ from the Fund and Bank not only in ownership and sources of funds but also in objectives and, therefore, in management criteria and mechanisms. Private banks aim to make profits and avoid losses. Relative to the IMF and World Bank, private banks have a less stable resource base made up largely of short-term liabilities to the public at large. Some are able to tap the public markets for long-term funds sources. This, however, is the exception rather than the rule. Banks, therefore, place much greater emphasis on the protection of capital, assets, and revenue streams and ability to meet promptly and fully all outstanding liabilities or, in other words, to be adequately liquid.

Does this mean that private banks should evolve a country evaluation methodology in common and distinct from that employed by others?

There has not yet evolved any standard approach to country evaluation among the major private international banks. A recent study conducted by the U.S. Government, [1] copies of which have been distributed to you, reported as follows: that in most banks the country evaluation is undertaken at headquarters by the bank's line personnel, without critical

[1] Export-Import Bank of the U.S., *A Survey of Country Evaluation Systems in Use* (Washington, D.C.: December, 1976).

review by another group in the institution; that analytical approaches vary, with a small number of banks using quantitative techniques, generally together with more qualitative systems; that a number of banks use either a letter or numerical rating to summarize the results of their country evaluation; that a few banks use their results to help analyze the quality of their portfolio; and that none of the respondent banks use the results in fixing interest rates or fees.

The approach which I have evolved at Citibank differs significantly from the pattern just described — though it is consistent in some ways, as will be seen.

It is not surprising to me that private banks should differ in the process of analysis. Each bank has different concerns. One reason for this lies in the nature of the evolution of international banking, particularly since World War II — resulting in part from the continuing process of changes in the world economy and concomitant changes that have occurred in the demand for international banking services. Many banks initiated their international activities in a very limited way, e.g., servicing the overseas needs of domestic multinational customers. Many have still not gone beyond this stage. Other banks, however, eventually began to concentrate on the buildup of a portfolio of high quality international loans. From this base, still others are now maintaining a foreign branch/affiliate network. In addition, a relatively few of the more mature international banks have developed specialty market segments (ranging from geographic specialties to individual customer segments, e.g., government agencies and enterprises, multinationals, insurance companies, correspondent banks, shipowners, aerospace, etc.). Thus, even international banks are very different from each other in fundamental ways.

Some banks are organized along holding company lines; others are not. The former own diverse overseas subsidiaries engaged in merchant banking, real estate, consumer finance, leasing, and other specialized asset acquisition activities.

If I may, I would like to use Citicorp and Citibank as examples because I know them best and, more importantly, our country evaluations are designed to meet their needs. They illustrate well sophisticated international banking activities similar to some other banks.

Citicorp and its subsidiaries and affiliates around the world have approximately 2,000 offices in more than 100 countries. Its principal subsidiary, Citibank, offers general banking services overseas through the International Banking Group, responsible for managing Citibank's activities through branches, representative offices, banking subsidiaries and affiliates in these 100 countries, as well as handling all of Citibank's overseas client base with the exception of multinationals.

Another Citibank Division, the World Corporation Group, operates worldwide and has a physical presence in 47 countries. It serves multinational corporations whether based in the United States or abroad. This group provides credit and financial services to more than 400 multinational corporations.

Citicorp's Merchant Banking Group offers governments, corporations and financial institutions throughout the world fee-based financing and advisory services. Its activities include financial and development consulting, project finance, private-placement advisory services, acquisition and divestiture consulting, venture capital activities, and loan syndications. It also engaged in securities placement, distribution and trading insofar as legally permissible.

Citicorp's Consumer Services Group offers a wide variety of consumer finance services abroad through Citibank's overseas branches and, in addition, through Citicorp's overseas subsidiaries and affiliates in such countries as Australia, Belgium, Brazil, France, Germany, Hong Kong, Italy, the Philippines, Puerto Rico and the United Kingdom. A related group, Citicorp Services Inc., manages the sale and refund of Citibank Travelers Checks by more than 45,000 outlets in more than 160 countries.

Management criteria differ from bank to bank. Some banks are managed essentially from headquarters; others delegate as much responsibility as possible to their field activities. For example, Citicorp's global organization is set up on a decentralized basis. Decentralization reflects the diversity of Citicorp's operations around the world and makes it possible to react quickly and effectively to changing conditions. Corporation headquarters in New York, however, maintains centralized control, establishing general policies with regard to our lending activities in foreign countries and/or setting maximum permissible limits of exposure in each and every country in which we do business. In practice, this means that country evaluations are made in the field with the senior officer in a given foreign country recommending an overall limit for total exposure booked into that country by Citicorp and/or its affiliates. I review the evaluation and the recommendation, and final approval comes from my office. In most cases, however, the senior officer in a given country is allowed to allocate his country limit among individual borrowers.

Operating and lending policies differ as well. Some banks extend credit to overseas entities only when exposure is fully and unconditionally guaranteed by a public or private sector firm located in a country other than the country of the obligor. Others may additionally extend credit to the public sector in a given country or to private firms when resulting exposure is fully and unconditionally guaranteed by the central bank (or some other central government agency) in the borrower's country. Some participate in credit extensions that are only short-term trade-related; others have significant term exposure.

Despite the differences, banks refuse to invest in risk assets in any given country that have attractive income returns but are not in accord with country conditions and outlook. In addition, such banks insure that there is an adequate, independent internal auditing process — both external and internal to the country —designed to insure advanced warning of difficulties and possible losses. A cautious attitude to possible losses means that they are anticipated by way of loan loss provisions and/or offsets against current earnings or reserves.

Each bank's own manner of carrying out its country assessments will be importantly determined by its own objectives, institutional structure, operating and lending policies, as well as by the *stability* of its resources.

Banks and bank holding companies are often perceived by the public more as lenders of funds than as borrowers. Bank deposits, however, can be thought of as a form of borrowing. Traditionally, demand deposits (checking accounts) and personal savings deposits, which as a practical matter are available on demand, have provided a significant portion of bank funds. Loans (only a small portion of which are on a demand basis) and investments are thus partially funded by liabilities payable on demand. Increasingly, banks obtain their funds by borrowings on which they do pay interest. Nonetheless, the maturity periods may be quite different from maturity periods of loans. Such mismatching between asset and liability maturities creates an imbalance, but the managing of this imbalance has been a part of banking ever since silversmiths and goldsmiths started accepting deposits and making loans centuries ago.

Over the past 15 years, the development of fixed maturity liabilities, such as the negotiable certificate of deposit (CD) and the Eurodollar time deposit, has increased banking system stability by lengthening the overall maturity structure of liabilities. Such developments have reduced the imbalances between asset and liability maturities. These fixed maturity instruments further enhance liquidity because, in contrast to demand deposits, the repayment date of these instruments is known in advance. Unanticipated outflows are therefore minimized.

A bank holding company is not a bank and may not accept deposits. Citicorp therefore has had to utilize or develop other funding sources, including commercial paper, intermediate-term notes, long-term debt and floating-rate notes, in order to insure as stable a resource base as possible in support of its worldwide asset acquisition activities.

Private bank concerns are thus potentially much more heterogeneous than those of the World Bank and IMF. Many of their activities are of only marginal concern to the IMF and World Bank Group.

In addition, because they depend upon full and prompt servicing of their loans for their financial profitability and viability, private banks (in contrast to the Fund and the Bank) understandably tend to focus their activities upon the best managed countries and, within these countries, the best managed firms in the most advanced sectors of the economy. Even in many of the developing countries generally classified as the "poorest" because their national income per capita is very low, there are, however, relatively advanced sectors, which I view as "islands of modernity." These may be advanced manufacturing plants or highly modern facilities for producing or processing primary commodities for export.

As these "islands of modernity" attract financing, their growth and the development of other advanced sectors play a vital role in the structural transformation of the developing economy. These "islands of modernity" generate relatively high incomes despite the general low level of the country. As they expand, the per capita income of the entire economy rises. The vast bulk of private lending to developing countries, for example, has been concentrated in "high-income" countries not because of the income level per se, but because these are generally the countries with a larger number of these "islands of modernity." This process will continue, as more and more developing countries continue to modernize more sectors of their economy, increasing their access to private sources of finance.

In short, one cannot generalize on the issue of what approach to country evaluation is best suited for banks. Each bank must define its concerns in relation to its activities both among and between countries. The identification of concerns must begin with the definition of "country risk."

Definition of "Country Risk"

"Country risk," as we define it at Citicorp, comprises the whole spectrum of risk arising from the economic, social and political environments of a given foreign country (including government policies framed in response to trends in these environments) having potential favorable or adverse consequences for the profitability and/or recovery of debt or equity investments made in that country (see Chart I). A few examples of what I mean are: confiscation, nationalization, branching limitations, restrictions on earning remittances, etc. They also include other developments with more indirect impact such as changing market conditions, exchange-rate fluctuations, foreign exchange controls, changes in fiscal and monetary policy, etc., affecting the liquidity of domestic borrowers and hence their ability to service domestic or external debt. As can be seen, I include within this concept of country risk events both within and beyond the control of the governments, and events both domestic and foreign to the borrower's country, as long as they have a potential impact upon our investments, directly or indirectly.

As is apparent from the above, the concept of "country risk" is much broader than that of "credit risk" related to a given borrower's individual creditworthiness; the risks to which I am now referring are all risks which are incurred as a result of our having undertaken certain activities in the foreign country involved, as distinct from considerations relating to the individual borrower.

It should also be clear that "country risk" is a broader concept than "sovereign risk": I include under "country risk" not only those events under the control of the government (or the "sovereign"), but also a wide variety of further potential risks — both domestic and international — over which the borrower's government has no control. It includes risks which affect the customer base of the bank as well as the bank directly. An adverse change in the condition of a major group of borrowers *may be the result of changes in the country environment or government policies*, rather than changes in the sector or the individual firm.

In my view a bank must include all potential risks in performing its country assessment, and not simply confine itself to those which appear most likely or imminent. It is important to try to anticipate the way in which changes in country conditions will occur, and not simply to react to the identification of today's events. It should be obvious to all of us that this is a very demanding professional task.

Not all observers will agree with my definition and views on "country risk." In particular, as I mentioned briefly at the outset, different types of institutions having different goals will define these risks in terms consistent with their own institutional purposes.

The analytical approach taken will also partially reflect the characteristics of the institution, including the diversity of its customer and funding base; its operating and lending policies; and whether or not it has a worldwide network of overseas operations and can tap the expertise of these employees as a source of firsthand information. These sources must be supplemented by a great deal of travel on the part of the senior staff, in order to permit frequent consultation both with the bank's own personnel overseas and with knowledgeable local nationals, such as central bankers and key government officials. Chart 2 identifies these and other basic sources of the information needed for country risk assessment.

My basic approach to the analytical process is to know the individual country, its uniqueness, its vulnerabilities, its longer-term historical development and outlook as well as the most detailed data available on its past and present economic performance. We must know who is really running the country (it is not always the party in power), and whether the government has the political will to carry out responsible economic programs. Basically what we are assessing is the economic management of the country and its consequent conditions and outlook.

This cannot be done simply in quantitative terms, since so many of the key political and social variables are not quantifiable in any useful manner. The major qualitative elements that should be examined in assessing country conditions are shown on Chart 3. Each qualitative aspect has many subdivisions.

In addition to the key qualitative indicators, as the chart shows, there are also many quantitative indicators which must be looked at, including such data as debt service ratios, rates of growth of exports, diversification of exports, variability of export earnings, growth of per capita income, imports in relation to GNP, compressibility of imports, changes in the level of monetary reserves, growth in external debt and debt servicing, and so forth. But no single indicator or ratio can be relied upon to tell us what we wish to know, and some can be very misleading without thorough study of the reasons behind their behavior. Of critical importance is the recognition that few indicators have the same meaning for any one country that they have for another, and there is simply no "labor-saving device" yet invented that can spare us the effort of painstakingly examining each country individually — and repeatedly, or even continuously — since changes of significance can occur rapidly. The process of knowing a country takes years to mature.

Citicorp maintains a centralized data bank on the major economic variables for each country of interest. The variables cover fiscal and monetary policy, inflation and real growth, the balance of payments, external debt, and the central bank balance sheet. Latest data are incorporated as they emerge, and the outlook is adjusted accordingly. Periodically, a world overview is pulled together to insure consistency of the various projections, particularly in respect to the current accounts in the balance of payments and the associated flows of funds.

We have also been exploring econometric methods which might be used to improve our work on country assessments. For example, we have explored the possibility of using discriminant analysis for constructing a composite index of creditworthiness of a less developed country. The results of our experiments thus far indicate that this technique does not give conclusive and unquestionable results but may be useful in identifying those countries which require more careful attention than the others.

There are two aspects of country evaluation which I would like to comment on further. The first is the obvious difficulties of predicting future actions by governments. It is difficult enough to predict behavior of governments assuming certain policy responses to different possible or probable economic trends. We can simulate what the economies response to different policies will be. We can thus have some idea as to what are the implications of one set of policies versus others. Thus, for example, we can test what a change in monetary targets or interest rates might be, or even a change in fiscal deficits financed by monetary expansion. We are, however, dealing with a dynamic interaction between domestic economic and social conditions and government responses at all levels. We are also dealing with international developments and responses of different governments to these developments. In turn, these responses change domestic and international conditions and outlook. We can give intellectual order to this kaleidescope by making simple assumptions but, unlike a cyclotron, we cannot separate out what is moving and place it within a constrained and therefore more controlled environment. Even if the International Monetary Fund had more resources and authority, we cannot even say that national currencies will remain convertible for all current payments. We have given up trying to have stable exchange rates except within limited groups. We have given up assuming market-determined freely floating exchange rates. These are merely a few examples of uncertainty among many. We cannot say, to give another example, at what level of inflation governments will shift their priorities from growth and employment to concern with inflation and vice-versa. We cannot say what are the imitative effects on one country of actions in others, not to speak of the objective effects. We are in a world of unpredictability in the precise scientific sense of the word.

Secondly, we are in a world of paradox. Policy responses to situations which, in turn, affect objective conditions, are not either historically, logically, ideologically, or theoretically determined. It would be convenient if it were so. All these aspects help give guidance, particularly in the short run. In the longer run, we know that economic realities and market forces are powerful influences in shaping events. Repeatedly, however, if we rely on such "logical" responses, we are surprised. We can foresee the range of policy responses which are more likely than others, but the range is very wide and covers many different responses. Zambia, with its high dependence on copper exports, cannot respond to the low price of copper by exporting steel and steel manufactures. Spain cannot take advantage of the high price of oil by exporting oil, or to take a seemingly more plausible response reverting to a nonoil economy.

To take examples closer to our topic of country evaluation for private international bank lending, a creditor or donor country can decide to assist a deficit country with new official loans or grants, or expand resources of international organizations, or stockpile the exports of the country in difficulty, or reschedule or forgive public debt to the country or negotiate an international approach to these countries and see on what courses of actions other governments could agree. Similarly, there is a wide range of possible responses of the deficit country and the impact of the responses on the creditor country. What if the deficit country intensifies import restrictions; changes from a civilian to military rule or vice-versa; or tries to expand domestically to keep up employment or, to the contrary, deflates drastically to adjust more quickly to its balance-of-payments problems, etc.? Potentials for very different responses exist simultaneously. In the real work-a-day world, paradoxes are commonplace. They enhance uncertainty and unpredictability, and thus reduce the value of usual simulation exercises.

Closely related to the problem of the presence of true paradoxes are the existence of false, or apparent, paradoxes which are mainly in the eye or mind of the beholder. What will a developing country in very serious balance-of-payments difficulties do? Default on its external debt? Of course, say and write many! The country is seen as very poor and limited in alternatives and of little importance in international finance. Many are also seen as having short historical records because they are new, or others have records of defaults. But they do not default. Why not? Why the error in judgment by others? Because they simply did not know enough about the political impact of default domestically, or the sense of imperative need countries have to maintain creditworthiness, etc. Yet, these erroneous views, in turn, create changes in objective conditions. A false expectation of default, however false, can itself create severe crises and even actuality of default. The false prophets become true ones — a phenomenon known from ancient times!

We make decisions every day in this uncertain world. Private banks are risk takers. If not, their activities and usefulness would greatly diminish. Their time horizons go beyond their ability to be certain. Yet, they cannot afford damaging surprises. This is why I summarize our actions in country assessment by the aphorism that "the name of the game is anticipation" and that "it is better to be imprecisely right than precisely wrong."

Potential for Improvement in Citicorp's Country Assessment Procedures

Citicorp's approach to country evaluation can be improved in a number of areas. As far as the collection of information is concerned, we receive large masses of data, qualitative and quantitative, on an individual country basis. A large part of the information comes from representatives stationed overseas and is supplemented by data obtained from national and international organizations. The information is evaluated on an individual country basis. We make every effort to insure that our information flow is continuous, reliable, updated, and as precise and detailed as possible. We make every effort to cooperate with others to improve information. For example, last year I was Chairman of a special subcommittee appointed by the Association of Reserve City Bankers which purpose it was to survey the country exposure measurement techniques employed by ARCB member banks. This report has generated considerable interest among the regulatory authorities. It is my impression that its contents were reviewed very carefully by the Federal Reserve and the office of the Comptroller of the Currency. It was used by these regulatory agencies as a starting point to collect information regarding the magnitude of U.S. banks' exposure to foreign countries. Based on such efforts, Citibank and others are able to determine what their share of exposure is in a given country relative to all other U.S. banks.

We need to continue such efforts to improve data upon which to base sound judgments regarding our international activities. In addition, we need to continue work on the creation of a system that would provide us with the most useful worldwide framework within which the performance of individual countries would be assessed. We are making very explicit efforts to integrate economic and political situations into global criteria in order to improve policy-making and/or lending decisions in the real world. It is not enough to know a country in isolation. We must be extremely cognizant of factors exogenous to the country which may impact that country's creditworthiness, e.g., among other variables, growth of world inflation between and among countries, world trade, rise in protectionist sentiments in key countries; changing magnitudes of bilateral assistance; growth rates in industrialized countries; etc. All of these have direct or indirect impacts on any given country's performance.

The integration of individual country information into a much larger framework presents a number of problems. Basic among them is a lack of comparability of quantitative data collected in the 120 countries in which we have exposure. It is even more difficult to compress the multitude of information into a global framework of manageable proportions.

Although we want to integrate the information on individual countries into a global framework, I should emphasize that we do not intend to rank countries by any type of numerical method. I believe that a rigid ranking system would be arbitrary and unrealistic. It would not allow us to take into account the fundamental proposition that we adhere to at Citicorp that exposure in a given country is not homogeneous as to risk.

Our client base is too diversified. Some, like shipowners and airlines, have access to foreign exchange independent of the foreign exchange availability of the country in which they reside. Other customer segments would have uneven access to a country's available reserves in the event shortages were encountered relative to external debt and payments obligations. Specific country risks vary from country to country. Some, as just mentioned, have balance-of-payments vulnerabilities; in others, we are concerned that our equity investments might be confiscated; in still others, we are concerned with specific government measures which adversely impact the cash flow generation capability of private sector clients (and therefore their ability to service foreign and domestic debt), and so on. No simple ranking system can cope with such a diversity of concerns.

Our country reviews and assessments are not only based on historical data but also on projections of country performance. We are now attempting to institute more formal procedures to assess the accuracy of our past judgments and evaluations. If our country evaluations do not anticipate events which have adverse consequences for Citicorp activities in a given country, our system has failed. To the extent that we can anticipate events in a country, we are able to take appropriate defensive action to protect Citicorp concerns. The key is, as noted before, anticipation.

Finally, we must continually refine our understanding of the linkages that exist between a country's projected performance and Citicorp's specific business objectives in that country. It is this link between the country's macroeconomic performance on the one side, and the outlook for specific economic sectors and individual public and private sector enterprises on the other which provides us with the understanding we need in arriving at decisions on countries.

What I have said has obvious implications for Citicorp and other bank managements in the years ahead. Most important is that all of us will be seeking to refine our methods for assessing countries, and our approaches to applying that judgment to the management of our portfolios. No institution can afford to see this work done badly. And increasingly the rewards will go to those who see that it is done well.

There are some clear implications for personnel selection and training — particularly for the larger banks which are heavily engaged abroad and which will need to dedicate increased resources to these problems. They will need increasingly to reflect awareness of the professional nature of country analysis, and to broaden their search both within and outside their institutions in order to find the most qualified persons for this type of work. The same applies to assignment rotation and promotion policies within such banks. It takes time to develop the professional skill to evaluate countries and time to learn any country in depth.

Country-risk assessment must be made on an increasingly sophisticated level so that opportunities both for avoiding loss and for maximizing future business can be anticipated and acted upon effectively. Therein lie attractive rewards for those individual banks which can most accurately evaluate country risk and most effectively act upon that judgment.

Before I conclude, I would like to note that in addition to the work I have been describing, another essential aspect of dealing with country risk and uncertainty is the actuarial principle. Banks are acutely aware of the need to avoid *magnitudes* of risk assets in any one country that are in violation of the actuarial principles of balance and dispersion. The subject of identification of principles to guide diversification and balance are, I believe, worthy of separate treatment and, perhaps, a conference of the kind in which we are now participating.

Conclusions

The response of private banks to these interminable series of uncertainties and difficulties cannot be paralysis of decision-making and action. In appreciating the realities within which they act, there is the foundation for reducing risk to acceptable proportions by the application of the actuarial principle and by country evaluations which employ all sources of information, all known methodologies and analytical tools, all feasible judgments based on experience and sophisticated intuition. It combines the insights which can only be gained on the spot by firsthand continuous and maturing experience with the fruits of careful and systematic scholarship that has extended to the point of being truly scholarly. It is important to distinguish between the opinions of scholars and the fruits of their scholarship. The former are too often unfounded in reality. The latter are nearly always most useful and illuminating. Similarly, judgments based on past experience can be misleading, if not current and not perceived as part of the future.

Our approach to country evaluation is the opposite of oversimplification. It is testing by continuous monitoring and review of past judgments. It is not the elimination of unpredictability or uncertainty. It is the management of unpredictability and uncertainty.

CHART 1
CATALOGUE OF COUNTRY RISKS

FACTORS AFFECTING BANK BOTH *DIRECTLY* AND *INDIRECTLY* VIA CUSTOMER BASE

I. Risks External in Origin to the Country

A. War
B. Hostile or Discriminatory Acts, Short of War
C. Special Vulnerabilities of Bank and/or Customer Base to Other Types of External Events including Effects of Business Cycles, Oil Price Increases, Inflation, Food Shortages

II. Risks Internal in Origin to the Country

A. Revolution
B. Extended Civil Unrest
C. Adverse Economic Conditions and Outlook affecting Bank and/or Customer Base
D. Confiscation
E. Nationalization
F. Indigenization: Ownership and Personnel
G. Exchange Controls and Practices in Respect of
  - Repatriation of Investments
  - Transfer of Earnings
  - Minimum Tenor Limitations on Foreign Currency Borrowings
  - Other Restrictions on Foreign Currency Borrowings
  - Multiple Currency Practices Applied to Capital Flows
  - Servicing of Foreign Currency Loans
  - Exchange Declaration
  - Exchange Surrender
  - Exchange Rationing, etc.
  - Advance Deposit Requests
  - Swaps
  - Hedging
  - Future Exchange Transactions
  - Impact of Bilateral Agreements
H. Trade Controls and Practices, e.g.,
  - Tariffs on Imports
  - Quotas on Imports
  - Other Forms of Import Restrictions
  - Export Taxes/Rebates, etc.

I. Other Government Action, e.g.,
   - Fiscal, e.g., Increases in
     - Direct Taxes
     - Indirect Taxes, etc.
     - Changes in Subsidization Policy
   - Monetary, e.g., Changes in
     - Reserve Requirements
     - Government Credit Policies: Debt/Equity Constraints, etc.
     - Rate Ceilings
     - Open Market Operations
     - Policies Relating to Credit Allocation, etc.
   - Exchange Rates
     - Fixed
     - Floating
     - Multiple Rates
     - Devaluation Policy, etc.
   - International Reserves and Intervention Policies
   - Public Investment
   - Wages
   - Prices
   - Regulatory
   - Change in Policy toward the United States and
   - Changes in Policy toward U.S. and Foreign Multinational Firms

CHART 2
SOURCES OF INFORMATION

I. In Field

A. Information Received from the Network of Branches/Subsidiaries
B. Central Bank
C. Other Government and Municipal Agencies
D. Embassies
E. International Agencies outside the United States, e.g., OECD, BIS, Asian Development Bank, UNDP
F. Business Contacts
G. Other Private, including Professional, Groups
H. Journals and Periodicals
I. Rumor and Gossip

II. At Head Office

A. Experience of Officers
B. International Agencies Located in Head Office Country
C. Central Bank
D. Other Government Agencies

E. Foreign Embassies
F. Business Contacts, e.g., with Other Commercial Banks, Multinational Firms, etc.
G. Professional Groups
H. National and International Journals and Periodicals

CHART 3
MAJOR QUALITATIVE AND QUANTITATIVE ELEMENTS USED TO ASSESS COUNTRY CONDITIONS

I. Qualitative

Impacts on Domestic Economic Performance stemming from:
A. Global Interdependencies
B. Trade Vulnerabilities
C. Proposals and Agreements Taken in International Forums
D. Social Conditions
E. Political Outlook
F. Government Domestic Economic Management
G. Government Balance-of-Payments Management
H. Flow of Funds and Financial Intermediation — Actual and Potential
I. Principal Economic Sectors — Trends and Prospects

II. Quantitative

A. Debt Structure, Profile and Debt Servicing Ratios, e.g.,
- Debt Service Payments
- Interest Payments
- Interest in Relation to Debt Service
- Debt Service in Relation to Gross Capital Inflow
- Debt Service in Relation to GDP and Its Major Components
  - Domestic Savings
  - Consumption
  - Total Investment
  - Public Investment
- Debt Service to Total Exports of Goods and Services
- Debt Service in Relation to Imports
  - Total Imports
  - Consumption Imports
  - Capital Imports Total and Major Components
- Debt Service to Total Government Expenditures
- Debt Service to Total Government Revenues (excluding Borrowings from Central Bank)

Debt Service on Government and Government Guaranteed (Debtor Government) Debt in Relation to Debt Service on Total Debt
External Debt Outstanding in Relation to GDP
Debt Service on Debt to Lenders Guaranteed by Government
Debt Service on Debt to Lenders Not Guaranteed by Government

B. Exports
  Rates of Growth of Exports — Real and Nominal
  Diversification in Products and Markets
  Percentage Shares of Main Categories of Exports
  Variability of Export Earnings During Past Ten Years
  In Relation to GDP

C. External Debt Outstanding in Relation to Exports

D. Exports to Imports

E. Imports
  Rates of Growth of Imports — Real and Nominal
  Diversification in Products and Markets
  Percentage Shares of Main Categories of Imports
  Variability of Import Payments During Past Ten Years
  In Relation to GDP

F. Compressibility of Imports

G. Changes in Level of Reserves

H. International Reserves in Relation to
  External Debt
  External Debt Servicing
  Categories of Imports and Other Payments
  Available Credit with International Agencies, e.g., IMF, World Bank, IDB, etc.

I. Per Capita Income — Growth Rate

J. Fiscal Indicators

K. Monetary Indicators

L. Investment and Savings Ratios
  Total Investment to GDP
  Domestic Savings to Total Investment
  Foreign Capital to Total Investment
  Foreign Debt Capital to Total Investment

M. Service Items and Balance of Payments (excluding Debt Servicing)

N. Capital Flows, Disaggregated as Feasible
  Outflows
  Inflows
  Net Flows

O. Indicators Especially Constructed for Individual Countries, e.g., Capital Flight, Proportion of External Debt to GDP

Note: To the extent possible, under A a distinction should be drawn between debt guaranteed by government and nonguaranteed debt; where significant and feasible, a further disaggregation should be attempted.

Discussion

Rudiger Dornbusch*

Mr. Friedman's paper shows the balance, prudence, and lack of alarm that we would expect from a banker. The paper is not limited to a narrow, technical analysis of country risk but rather goes beyond that to emphasize the broader considerations that govern lending decisions. In my comments I shall first briefly draw out those elements of Mr. Friedman's analysis that strike me as most central and then proceed to some critical remarks and further issues.

Elements of Country Risk Analysis

Country risk analysis, we learn from Mr. Friedman, is a very specialized matter depending on the objectives of the lending institution but also on the sources and the stability of its funding. Practically, this means that lending institutions have to develop their own evaluation techniques that reflect the characteristics of their lending policies. Different methods are appropriate for loans that are externally guaranteed versus those that might be short term, self-liquidating. Or, to give another example, different evaluations are appropriate for loans to the private export sector — islands of modernity as it is in the paper — or to the public sector.

Beyond the need to develop diversified, bank-specific evaluation procedures Mr. Friedman rightly emphasizes the important point that evaluation procedures should be forward looking. They should be anticipating future problems and prospects rather than just recording past episodes and statistics. Country evaluation to a large extent is designed to develop warning signals — an ongoing process of evaluation rather than an episodic or ad hoc analysis that soon becomes irrelevant.

A further point that is sharply emphasized is the recognition that risk is not homogeneous. It makes a large difference, from the point of view of recoverability of a loan, whether the borrower is an export firm with automatic access to foreign exchange or whether it is a local firm that may be solvent in domestic currency but cannot raise the foreign exchange to meet its liabilities.

These considerations lead Mr. Friedman to argue forcefully against a single indicator or ranking index of country risk. The lack of homogeneity

*Associate Professor of Economics, Massachusetts Institute of Technology.

among loans to the same country already makes such indices of questionable use and relevance. Intercountry comparisons become even more doubtful. While a single, composite index is thus rejected, there is nevertheless an emphasis on a structured, technically oriented evaluation procedure that serves as one of the inputs in decisions and ongoing monitoring. The appendix to Mr. Friedman's paper shows the indicators ranging from social and political to the more habitual economic data — the famous ratios. Overriding the importance of these data, however, is a concern to evaluate the "quality of the management" in a particular country. The "management" here includes without question and even primarily the economic decision-makers in the central bank and finance ministries.

The risks perceived in a particular country do not only arise from domestic problems and policies but also from entirely exogeneous events that may, to some extent, be predictable. Much of lending is concentrated on the export sector which is a key element on the domestic macroeconomic scene. In these circumstances it is important to predict export opportunities and prospects by placing country evaluation in the broader context of a world economic evaluation and overview. Such a perspective is required because a particular country's export potential — supply constraints apart — is dominated by income growth abroad. It is also required to achieve consistency in the evaluation of countries that are competitors in the import markets of the large industrialized areas. A world perspective serves as a check on over-optimistic forecasts for each individual country because their sum will have to add to no more than the very predictable imports of developed countries.

Some Issues

Country risk analysis, along the lines suggested by the appendix to Mr. Friedman's paper, strikes me as a quite amateurish exercise. It would appear that a lot of data is brought together, in ratios, products, logs and exponents, but that no coherent or systematic framework for the analysis exists. Those who have worked on macroeconomic problems in developing countries appreciate not only that the data are precariously poor, particularly those that exist, but also that the simplest four or five equation framework does far better than an ambitious all encompassing analysis. Needless to say no small bank has the intellectual or physical resources to do a serious job on a broad scale. In these circumstances banks are much better advised to look for a simple analytical framework — perhaps the standard IMF evaluation blueprint.

These remarks are perhaps a bit strong, but they are elicited by an unqualified listing of quantitative indicators in Mr. Friedman's paper that not only include domestic saving as a component of GNP, but also show a lack of perspective in lumping together essential indicators such as the incompressibility of imports with totally irrelevant matters such as open market operations. More seriously, one cannot help asking how these data affect the decision-making process. If they are not used to develop country-ranking indicators that can be used for quantitative decisions, then lending decisions must perforce take on a more haphazard form. I suspect the procedure is to start from the given portfolio and make marginal changes drawing broadly on the information arising from the evaluation procedure. Thus the procedure leaves the portfolio composition quite sticky. The incremental approach avoids large and sudden shifts in lending patterns but also implies a substantial exposure to surprises.

Individual banks, and certainly the smaller ones, will find it unprofitable if not impossible to perform their own economic and statistical evaluation. They may well produce some information but none to which senior management would attach an overriding information value. The area of country evaluation suggests a strong analogy with the standard lending business of banks. Lending procedures certainly include an evaluation of management and business prospects, but also the use of standard information sources such as Dunn & Bradstreet or other rating services. Given the large scope for economies of scale in information one wonders why there is as yet no country rating service that produces standarized, regular information which could be routinely used in lending decisions.

There is another aspect of economies of scale in information, and that concerns the world economic outlook. Certainly banks would want to consider the overriding impact that world economic interdependence has on an individual country's export prospects and macroeconomic performance. There is, however, very little useful information to which one can turn. The best evaluation of the world economy on a short-term basis is, I believe, produced by the IMF and remains, for reasons difficult to grasp, entirely confidential. It would certainly be an important improvement not only for banks' lending decisions but also for the business sector at large if these "world economic outlook" reports received the publicity that their scope and quality warrant. I would make the same case for the IMF's individual country studies — much as it is handled by the OECD — but I find that case a bit less compelling.

Risk and Return

The most important point in country risk evaluation must, in my judgment, center on the proper conceptual framework for the evaluation of risk and return. A bank in setting an analytical framework for country evaluation will implicitly or explicitly set up criteria that reflect and provide answers to the bank's business objectives. A bank cannot get around the problem of asking for a measure of the return and risk of its loan portfolio, the trade-off between risk and return, and the impact on stockholders of a change in its exposure.

These questions may largely remain implicit and rarely receive a proper formal and quantitative analysis. Nevertheless some interest remains in spelling out the main concerns. Modern finance theory provides a bit of a disappointment here in that it suggests the following. First, what matters to holders of securities is risk and return. Second, the proper measure of risk is the correlation between a firm's earnings and the "market," i.e., some broad index such as S&P, because individual security holders can diversify their portfolios and thus eliminate firm-specific risk. What investors cannot diversify away is the correlation with the market. That is the only risk on which the market will place a price. These two considerations suggest that it does not pay a firm to diversify its sources of earnings in an effort to reduce the variability of its cash flow. The market does not pay for that diversification since stockholders can achieve it by simply diversifying their portfolios. From a strict point of view of finance theory, therefore, we have no reason for diversification considerations in bank lending. The bank should look for maximum expected return, but be unconcerned with the variability of returns on individual prospects or with the correlation between various loans in the bank's portfolio. Country risk analysis in this perspective is mainly a method for evaluating expected return, not risk.

Finance theory notwithstanding, however, banks obviously look for diversification. There is considerable justification for this, not in the least because a bank's diversification has a direct effect on its expected net earnings. A more diversified bank represents a more stable source of funds for borrowing corporations and a more stable place for depositors and holders of CDs. Accepting, then, the desirability of diversification, the issues of the appropriate trade-off between risk and return, and the method of achieving diversification remain.

From a bank's point of view it is important to assess how the various loans are related in their prospects for timely payment of interest and principal. If the loan portfolio is highly concentrated geographically or by customer-type (copper, coffee, REITs), then it must be considered very risky. By contrast if the portfolio is broadly spread across industries and trades as well as regions, then some benefits of diversification are achieved. There remains though the single most important consideration: that most bank loan prospects are affected by the world business cycle. Much as we look at the correlation of individual stocks with the market — the famous betas — we should look at a loan portfolio and ask how it correlates with world economic activity. This is likely to be the dominant source of variability in net earnings simply because the loan-specific risk is diversified away. In this perspective loans to raw material-producing countries appear as high beta positions, as do loans to very trade-dependent countries. By contrast, loans to service industries or relatively closed economies might be low beta positions. Using this perspective, a portfolio that is superficially well-balanced and diversified may well prove to be a high-risk portfolio. It might be most risky simply because it has a lot of loans (spread both geographically and by industry) that share the characteristic of being strongly affected by world aggregate demand.

Conditionality, Bonds and Banks

In concluding my remarks I would like to draw attention to the "debt problem" as a recurring one in the last 200 years. I would also note that the conventional remedy of imposing sounder macroeconomic management, known under IMF stand-by agreements as "conditionality," is not new. The new feature in the current debt problems, arising in the aftermath of the oil shock and the unusually deep and long recession in world economic activity, is the substantial involvement of commercial banks. The problem used to be one of government default on debt that was externally held but broadly spread among foreign bond-holders. The shift to substantial external lending by commercial banks, as opposed to direct lending by bond-holders, is associated with the rise of multinational corporations that thus obtain local finance for their foreign operations. It is also associated quite unavoidably with the large intermediation requirements arising out of the petro-dollar flow to the commercial banking system in the few financial centers.

I have noted that debt problems are not new. Nor are the remedies, as is evidenced by the following quote:

> By 1927 Portugal's financial difficulties had grown so acute as to impel the Government to seek the assistance of the League of Nations in securing a new foreign loan. On the basis of a first-hand investigation in Lisbon, the Financial Committee of the League reported that a loan could be arranged but only if Portugal would agree to a program of monetary, budgetary, and fiscal reform and to the establishment in Lisbon of a foreign agent of the League to receive the revenues assigned for the service of the loan and to supervise the spending of its proceeds. . . .It was under these circumstances that Dr. Salazar became Minister of Finance. . . .Under his able leadership Portugal maintained a healthy financial economy and made economic progress without the aid of any further external loans.[1]

Conditionality has been seriously questioned mainly because of its short-run, budget-cutting orientation. While such policies do not fail to produce short-run improvements in the external balance, they have at the same time had very adverse effects on growth performance, investment, and social structure. One may seriously want to argue that these policies, on net, have actually deteriorated the balance toward large public sectors and promoted less trade-oriented, productive activity. That bias I believe arises in part from the financial aspects of conditionality and lack of attention to longer-term policy orientation. A policy that only creates a recession by cutting public sector activities without providing new, credible and financed alternatives in the traded goods sector is bound to lead to unemployment. In the medium term the public sector will come back to absorb the unemployment and take over illiquid firms, thus setting the stage for the next problem round. Thus conditionality with too short term an orientation is bound to be counterproductive. One must therefore view the current reorientation in conditionality at the IMF toward a longer horizon and structured macroeconomic and sectoral programs as one of the important aspects in international lending and country-risk evaluation.

[1]William H. Wynne, *State Insolvency and Foreign Bondholders*, Vol. III, Yale University Press, 1951, pp. 384-385.