P1.T4. Valuation & Risk Models

Bionic Turtle FRM Practice Questions

Aswath Damodaran, Country Risk: Determinants, Measures and Implications - The 2015 Edition (July 14, 2015). (Pages 1-45 only)

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Damodaran, Country Risk: Determinants, Measures and Implications

P1.T4.600. Sources of country risk
P1.T4.601. Composite measures of country risk
P1.T4.602. Factors that influence the level of sovereign default risk

P1.T4.600. Sources of country risk

Learning Objectives: Identify sources of country risk. Explain how a country’s position in the economic growth life cycle, political risk, legal risk, and economic structure affect its risk exposure.

600.1. Your colleague Sally has identified the following four countries and included them in a list of countries deemed to offer an excessive degree of country risk with respect to your firm’s portfolio. For each country, she provided a justification. Each of the following is a valid argument for the presence of high country risk EXCEPT which is not strictly speaking a compelling argument, at least according to Damodaran’s sources of country risk? (note: please assume all cited statistics are true)

a) Columbia (in South America) because commodity exports constitute over 80% of merchandise exports
b) Ukraine (in Eastern Europe) because it scores in the bottom quintile (bottom 20%) with respect to the protection of legal, physical and intellectual property rights
c) Myanmar (in Southeast Asia) because it is a young and less developed economy (e.g., lower per capita GNI) although it is growing rapidly (+7.6% in 2014, second highest according to World Bank)
d) Italy (in Western Europe) because its per capita GDP has shrunk in each of the most recent three years (-3.1% in 2012, -2.9% in 2013 and -1.4% in 2014, as reported by the World Bank) despite being a large, mature economy

600.2. Political risk includes governmental stability (versus volatility), level of corruption, physical violence and expropriation risk in a country. Which of the following is TRUE about political risk?

a) a. Singapore is among the most corrupt countries (according to Transparency International)
b) b. Russia is among the most peaceful countries (according to the Global Peace Index)
c) c. The three Scandinavian kingdoms are among the least corrupt countries (according to Transparency International)
d) d. Over the last decade, nationalization risk has been in stark decline globally because businesses prefer to have their overseas profits expropriated for tax reasons
600.3. According to Damodaran, which of the following is **TRUE** about political risk with respect to forms of government?

- a) Democracies create discontinuous risk rather than continuous risk
- b) Dictatorships create continuous risk rather than discontinuous risk
- c) Among the major forms of government, democracies are conclusively more conducive to higher economic growth
- d) In comparing democracies to dictatorships, it is difficult to draw a strong conclusion about which system is more conducive to higher economic growth
Answers:

600.1. D. Declining per capita GDP in not given as a source of county risk; on the other hand, Italy generally scores favorably (or very favorably) with respect to Damodaran's sources of country risk.

In regard to (A), (B) and (C) each is a true statement and valid argument for judging the country to offer HIGH COUNTRY RISK, in the context of Damodaran's sources of country risk:

- **In regard to (A),** according to the United Nations Conference on Trade and Development ([http://unctad.org](http://unctad.org)), in 2014 Columbia's commodity exports as a percentage of merchandise exports were 83%. Says Damodaran, "Economic Structure: Some countries are dependent upon a specific commodity, product or service for their economic success. That dependence can create additional risk for investors and businesses, since a drop in the commodity's price or demand for the product/service can create severe economic pain that spreads well beyond the companies immediately affected. Thus, if a country derives 50% of its economic output from iron ore, a drop in the price of iron ore will cause pain not only for mining companies but also for retailers, restaurants and consumer product companies in the country."

- **In regard to (B),** Ukraine ranks 109th out of 129 in the The International Property Rights Index 2015 ([http://internationalpropertyrightindex.org](http://internationalpropertyrightindex.org)).

- **In regard to (C),** Myanmar is young (it was formerly Burma) and relatively small by most economic measure, yet is among the fastest growing in recent years. This pertains to Damodaran's argument in regard to Life Cycle: "In company valuation, where a company is in its life cycle can affect its exposure to risk. Young, growth companies are more exposed to risk partly because they have limited resources to overcome setbacks and partly because they are far more dependent on the macro environment staying stable to succeed. The same can be said about countries in the life cycle, with countries that are in early growth, with few established business and small markets, being more exposed to risk than larger, more mature countries."

600.2. C. TRUE: The three Scandinavian kingdoms are among the least corrupt countries (according to Transparency International).

For 2015, the top 10 (i.e., least corrupt countries) were the following: Denmark (score of 91), Finland (90), Sweden (89), New Zealand (88), Netherlands (87), Norway (87), Switzerland (86), Singapore (85), Canada (83) and Germany (81).
600.3. D. TRUE: In comparing democracies to dictatorships, it is difficult to draw a strong conclusion about which system is more conducive to higher economic growth

Damodaran on Political Risk: "Political Risk > a. Continuous versus Discontinuous Risk:
Let’s start with the first and perhaps trickiest question on whether democratic countries are less or more risky than their authoritarian counterparts. Investors and companies that value government stability (and fixed policies) sometimes choose the latter, because a strong government can essentially lock in policies for the long term and push through changes that a democracy may never be able to do or do only in steps. The cautionary note that should be added is that while the chaos of democracy does create more continuous risk (policies that change as governments shift), dictatorships create more discontinuous risk. While change may happen infrequently in an authoritarian system, it is also likely to be wrenching and difficult to protect against. It is also worth noting that the nature of authoritarian systems is such that the more stable policies that they offer can be accompanied by other costs (political corruption and ineffective legal systems) that overwhelm the benefits of policy stability.

The tradeoff between the stability (artificial though it might be) of dictatorships and the volatility of democracy makes it difficult to draw a strong conclusion about which system is more conducive to higher economic growth. Przeworski and Limongi (1993) provide a summary of the studies through 1993 on the link between economic growth and democracy and report mixed results. Of the 19 studies that they quote, seven find that dictatorships grow faster, seven conclude that democracies grow at a higher rate and five find no difference. In an interesting twist, Glaeser, La Porta, Lopez-de-Silane and Shleifer (2004) argue that it is not political institutions that create growth but that economic growth that allows countries to become more democratic."

In regard to (A), (B) and (C), each is FALSE.

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