P1.T4. Valuation & Risk Models

Bionic Turtle FRM Practice Questions Sample

Aswath Damodaran, Country Risk: Determinants, Measures and Implications

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The components of country risk include political, legal and economic structure.
P1.T4.914. The components of country risk include political, legal and economic structure

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.

914.1. Rebecca works for a socially conscious fund (aka, ESG fund) that employs a scorecard to evaluate international investments. Country risk is a major criteria, and the firm embraces Aswath Damodaran's methodology such that the components of country risk includes life cycle, political risk, legal risk, and economic structure. Political risk, in turn, includes continuous/discontinuous risk, corruption, physical violence, and nationalization/expropriation risk.

Rebecca's fund assigns the greatest weight to physical violence (as a component of political risk) and a key data source is the Global Peace Index (GPI, see visionofhumanity.org). Among the following four countries, according to the 2018 GPI, which is the LEAST peaceful; i.e., has the worst peace score?

   a) United States (USA)
   b) Canada
   c) Australia
   d) Portugal

914.2. Peter works for an ESG fund that evaluates political risk. Among the components of political risk, Peter’s fund assigns the greatest weight to corruption. If corruption is the most important criteria, into which of the following countries is Peter's firm MOST LIKELY to invest; i.e., which is least corrupt?

   a) Libya
   b) Mexico
   c) Venezuela
   d) New Zealand
914.3. Sally works for a fund that has a mandate to allocate a certain portion of its fund to developing (and/or emerging) countries in Asia, Africa or South America. However, the fund is sensitive to country risk, and in particular, the country's economic structure. With respect to economic structure, the fund seeks to avoid countries with a high degree of commodity export dependence. According to this criteria, which of the following countries is preferred; i.e. which is the LEAST dependent on commodity exports?

a) Chile  
b) India  
c) China  
d) Saudi Arabia
Answers:

914.1. A. TRUE: United States (USA) has the worst 2018 GPI score among these countries. Each of the other three are scored as "very high" (dark green) while the US is scored as "medium" (yellow, two broad categories lower) with respect to its state of peace.

Specifically, where a low score is best, Canada's score is 1.372, Australia's score is 1.435, and Portugal's score is 1.318. But the USA's score is 2.3, which is the worst country in the "medium" safety category, directly above Myanmar (score 2.302) which is deemed to have a "low" state of peace. About North America, the report says, "North America retained its second-place regional ranking for the tenth year running, and although the ranking of Canada (6) remained unchanged, and the United States (121) rose one place, their overall scores deteriorated over the year. The United States has declined for two consecutive years and is now at the worst level of any time since 2012. Last year, its score deteriorated on all three main domains [i.e., Safety and Security, Ongoing Conflict, and Militarisation], leading to a decline in its overall score for the second year running. In Safety and Security, an improvement in the impact of terrorism was offset by a deterioration in political instability, the latter a reflection of the increasingly partisan nature of American politics. The improvement in its scores on military expenditure and armed services personnel rate are expected to reverse next year as the most recent Pentagon budget increase feeds through into the data. For a number of years, the United States has scored the maximum (worst) possible score on a number of domains, including incarceration, external conflicts fought, weapons exports, and nuclear and heavy weapons, masking any ongoing deteriorations in these areas.

Last year’s decline masks some notable improvements over time: over the past ten years, there has been a 35 percent improvement in deaths from external conflict as Washington has curtailed operations in Iraq and Afghanistan. Further, last year’s military expenditure was 25 percent below its peak in 2010; and there has been a gradual fall in the homicide rate over the last decade, which is now seven percent below its 2008 levels. Canada suffered a deterioration in its terrorism impact rating after the Quebec City mosque shooting in January, in which six worshippers were killed and 19 injured, and an attack in Edmonton in October when an attacker ran down four pedestrians and stabbed a police officer."
914.2. D. TRUE: New Zealand is consistently in the top ten (top three really)

*Damadoran (2018):* "b. Corruption and Side Costs: Investors and businesses have to make decisions based upon rules or laws, which are then enforced by a bureaucracy. If those who enforce the rules are capricious, inefficient or corrupt in their judgments, there is a cost imposed on all who operate under the system. Transparency International tracks perceptions of corruption across the globe, using surveys of experts living and working in different countries, and ranks countries from most to least corrupt. Based on the scores from these surveys, Transparency International also provides a listing of the ten least and most corrupt countries in the world [in table 1, with higher scores indicating less corruption for 2017. **Ten Least Corrupt:** New Zealand (89), Denmark (88), Finland (85), Norway (85), Switzerland (85), Singapore (84), Sweden (84), Canada (82), Luxembourg (82), Netherlands (82). **Ten Most Corrupt:** Somalia (9), South Sudan (12), Syria (14), Afghanistan (15), Sudan (16), Yemen (16), North Korea (17), Equatorial Guinea (17), Guinea Bissau (17), Libya (17).

In business terms, it can be argued that corruption is an implicit tax on income that does not show up in conventional income statements as such. It reduces the profitability and returns on investments for businesses in that country directly and for investors in these businesses indirectly. Since the corruption tax is implicit, it is also likely to be more uncertain than an explicit tax, especially if there are legal sanctions that can be faced as a consequence, and thus add to total risk. Ng (2006) notes that increased corruption translates into higher borrowing costs for companies and lower stock values."

914.3. C. True: China is easily the least dependent among the four. India is next, but Chile and Saudi Arabia are highly dependent.

In the State of Commodity Dependence Report, export commodity dependence is defined as the ratio (in percentage) of the value of commodity exports to the value of total merchandise exports. A country is said to belong to the group of Commodity Dependent Developing Countries (CDDcs) when this percentage exceeds 60 percent. According to this metric, Chile (86%), India (42%), China (8%) and Saudi Arabia (80%, almost entirely oil)