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# DEPENDENCE OF COUNTRY RISK COMPARED TO THE FOREIGN DEBT LEVEL

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## Abstract

*The article presents some of the fundamental aspects of country risk' dependence compared to foreign debt level. Starting from external debt burden we analyze the usage of foreign loans, foreign debt bearing capacity as well as the availability of data regarding the external debt.*

*Country risk represents the exposure to losses which may occur in a business with a foreign partner, caused by specific events that are, at least partially, controlled by the partner country' government. Macroeconomic analysis of economic and financial component of country risk involves how this risk is influenced by government policy, by the economic role of government, by pricing strategies, investment priorities, financial structures, macroeconomic policy, by the ability to obtain foreign funds, the level of external debt as well as the liquidity and cash flows in that country.*

**Keywords:** external debt level, external debt burden, debt service ratio, capital inflows, economic strategies, external debt cycle, critical level of debt

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**Country risk** is highly dependent on the **external debt level**, namely all the liabilities, that one time, one has to other countries, due to the external current and capital operations, commercial and non-commercial, foreign trade activities, tourism and international services, cooperation, joint ventures, loans on interests, foreign exchange availability etc.

In general, the **external debt burden** is the cost of interest on this debt. The term "**burden**" could mean that government loans are a bad thing, because they pass current financial obligations to future generations. However, the thing that should be noted is that the interest paid on foreign debt is a transfer that is not a net reduction of economic capacity to provide goods and services. One of the fundamental problems of country risk' analysis aims at determining whether or not the debt is sustainable.

At the same time, however, it turned out to be one of the most difficult

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issues. In the mid 70s, the **debt service ratio** was carefully observed and it was shown that levels over 20-25% were too high. But such simple rules became complicated when it was observed that some countries had much difficulty at lower levels.

Zaire suspended interest payments in 1975, although its debt service ratio was only 11.7% in 1974, increasing to 15% in 1975. Later, in the 70s, many countries reached levels above 20-25%, Brazil, for example, reaching a rate of over 60%. In this case, country risk analysts argued that the level is too high, but that could be supported as long as they could get loans.

The period 1979-1981 had certain problems, i.e the difficulties of refinancing many countries were only avoided because loans were refinanced through the market. However, to some extent, a country with a considerable debt is always in the situation that if obtaining new loans is suddenly stopped, the balance of payments deteriorates drastically - if they are to maintain debt service.

In recent years, it is clear that the old rules of thumb are ultimately wrong. Very few countries, with rates of debt service above 20% could avoid debt rescheduling, while big debtors with rates below this level could not avoid this. However, a number of debtors, especially smaller and weaker countries, continued to face difficulties with rates below 20%.

The aim of the analyst, in our opinion, has to be an overview over debt burden, an image that must then be put in relation to the general political and economic situation. At a certain point, the greatest difficulty was to find data. Government sources could not be helpful, because they only publish statistics concerning the medium-term debt of the public sector. In many countries, this represents only about half of the total debt, because it excludes the short-term debt, as well as the debt of the private sector. At the same time, more statistics are produced and published, but some countries still do not publish full data. International sources such as the Bank for International Payments, World Bank, IMF and OECD remain the most useful as a starting point, all these improving significantly in recent years.

The purpose of a loan is, primarily, to allow a higher level of imports than would otherwise be possible (although sometimes it can be designed to increase reserves or literally, to allow a lower level of exports). It is clear the importance, for the reimbursement of loans and economic development, to determine if additional imports thus obtained are used for productive purpose or not. In any case, it is not sufficient that a certain credit to be linked to a specific project. Money can have any destination, so that credits for a project can, simply, ensure for currency other use, less productive. Ultimately, to understand how a country's external borrowing is used, means to understand both the economic and the political process.

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**An influx of capital**, regardless of origin, will have, in practice, one or more of the following effects:

- increase the level of productive investments;
- increase the ability to obtain foreign currency for the country, i.e. increasing exports or reducing imports through appropriate investments;
- incorporation in investments that do not directly influence the increased capacity to obtain currency, for example construction;
- financing speculative activities such as those related to properties and stocks (including stocks of imported goods);
- compensation of private equity exits due to political fear or monetary speculation;
- growth, for the government, of the possibility to avoid major *economic policy* changes, such as: reducing domestic demand, domestic capital market liberalization in order to encourage domestic savings and reduce fiscal deficits;
- support consumer spending for the middle class, which show a greater demand for imported goods;
- creating resources for military spending;
- ensure projects or other business with high profits which, legally or otherwise, are intended for government supporters.

In most countries there is a combination of all these.

**An inefficient use of borrowed funds** is more likely with higher levels of corruption and more inefficient internal capital markets and/or government planners.

Therefore, we return to the importance of a **consistent economic strategy**. It is more probable a proper use of loans if domestic real interest rates are positive and if the exchange rate is competitive. Therefore, the **general direction of economic strategies** is one aspect of responding to the question whether “the burden of debt can be managed?”.

Another aspect is the **material resource base of the economy, including human resources**, which will determine whether economic growth and exchange funds can be achieved. It is vitally important to analyze credits and the wealth of debit country.

Much of the academic literature has been devoted to the analysis of debt’ bearing capacity by developing countries, trying to determine how much a country can borrow. Although, no clear conclusions were drawn, a number of useful ideas were suggested and developed.

**External debt cycle** was analyzed in the context of economic development. Theoretically, the process of development based on foreign

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loans generate resources for debt repayment and, at some point, the country is a **net creditor**. This model can be seen, for example, in USA, that after being a **net debtor** in the second half of the 19<sup>th</sup> century, became a creditor in the 20<sup>th</sup> century. But this is a very long process and, at least historically, during this process, his creditors often recorded losses.

In any case, it highlights the **rationale for substantial lending** to developing countries and highlights the idea that a country should not necessarily expect to continuously reduce debt, but to be able to pay interest.

Some research, although using simple models, suggest that, because debt can be sustained on long term, the growth rate of a country must be higher than the real interest rate on foreign loans. This gives the possibility of intuitive judgments, but it is difficult to integrate in country risk analysis, this thing being possible only by taking a very long term perspective.

There is sufficient evidence that loans of different groups within a country, both from the private sector or from the state, may determine, in the future, a higher cost for the country than for each of these groups. This means that, following a strategy of uncoordinated borrowing and, in particular, the government encouraging foreign borrowing by keeping internal interest rates high, at global level, the country will quickly accumulate excessive debt.

Research carried out could not provide a clear conclusion regarding a critical level of debt to exports or measured against another variable that is considered too high for any country and under which will not have any difficulties. As we previously mentioned, it depends very much on the country's resources, on the economic strategy and the perception of that country's prospects. Recent years experience also highlights the importance of market conditions, i.e global perceptions of credits.

Available data regarding debts have improved substantially over time, a considerable process being recorded since 1982. With successive engagement of countries in the process of rescheduling, virtually all of them have reached a debt greater than anticipated by analysts. Always, it was due to a last-minute euphoria of short-term contract loans or use credit lines, or the accumulation of arrears. Therefore, the errors are only in the sense of excessive caution, the general rule to be followed is **to use the largest debt that can be estimated**.

Because, ultimately, the entire debt has to be repaid by using the foreign currency resources of central bank, the consolidated debt has to be considered. It is true that some transactions liquidate themselves and that some debts can be repaid from foreign currency funds from other deposits, but usually this is only a small part of **total debt**.

For analyzing country risk, in order to obtain a complete picture of a country's debt, the analyst is to request data on:

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- **total debt detailed on creditors**, i.e banks, governments, multilateral organizations, and the IMF;
  - **total debt detailed on debtors**, i.e the government or government guarantees and the private sector;
  - **maturity analysis**: ideally reflect the whole profile, if not, at least detailing on short-term and medium term debts.
  - structure of interest rates, i.e the level of installments and the percentage of the variable ones.

For some countries, the respective data may be available from government sources, but in this case, the analyst must compare them in order to check with those provided by international sources.

### Conclusions

We believe that, there is a direct relationship between the degree of civilization and country risk. In our opinion the higher the degree of civilization of a country, the lower the country risk. In order for Romania to become a low-risk country, and all the countries would want to have economic or financial relations of cooperation, or otherwise, it has to climb the ladder of civilization, to improve its management and image worldwide.

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