

Country Risk Service Handbook



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Introduction

The Economist Intelligence Unit's Country Risk Service (CRS) publishes comparable and regularly updated country credit risk ratings. The ratings provide a rigorous and independent assessment of the risks facing institutions lending money, financing trade or conducting other types of business that expose them to crossborder credit or financial risk.

Regulation of the Country Risk Service

As of December 31st, 2020, the sovereign ratings of the CRS are regulated in accordance with The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, SI 2019/266 (hereinafter called the UK regulations). Previously, the sovereign ratings were regulated in accordance with Regulation (EC) No 1060/2009 of September 16th 2009 on credit rating agencies, as amended by Regulation (EU) No. 513/2011 of the European Parliament and of the Council of May 11th 2011 and Regulation (EU) No. 462/2013 of the European Parliament and of the Council of May 21st 2013. The registration of The Economist Intelligence Unit as a credit rating agency took effect from June 3rd 2013.

Rating frequency and country coverage

To comply with the UK regulations governing unsolicited sovereign ratings, scheduled ratings are issued three times in a calendar year. The annual schedule for CRS rating reviews is published in advance on eiu.com/regulatoryaffairs. Unscheduled ratings (out-of-cycle ratings) may be issued if warranted in the interest of timeliness.

The CRS covers 131 economies. Of these, 29 economies, including all euro area member states, are classified as developed economies. The remaining 102 countries are classified as emerging economies.

Table 1: Developed economies and euro area member states

Australia	Greece	Norway
Austria	Ireland	Portugal
Belgium	Italy	Slovakia
Canada	Japan	Slovenia
Cyprus	Latvia	Spain
Denmark	Lithuania	Sweden
Estonia	Luxembourg	Switzerland
Finland	Malta	United Kingdom
France	Netherlands	United States
Germany	New Zealand	

Table 2: Emerging economies

Albania	Honduras	Peru
Algeria	Hong Kong	Philippines
Angola	Hungary	Poland
Argentina	Iceland	Qatar
Azerbaijan	India	Romania
Bahrain	Indonesia	Russia
Bangladesh	Iran	Saudi Arabia
Belarus	Iraq	Senegal
Bolivia	Israel	Serbia
Bosnia and Hercegovina	Jamaica	Seychelles
Botswana	Jordan	Sierra Leone
Brazil	Kazakhstan	Singapore
Bulgaria	Kenya	South Africa
Cambodia	Kuwait	South Korea
Cameroon	Lebanon	Sri Lanka
Chile	Libya	Sudan
China	Malawi	Syria
Colombia	Malaysia	Taiwan
Congo (Brazzaville)	Mauritius	Tanzania
Congo (Democratic Republic)	Mexico	Thailand
Costa Rica	Moldova	Trinidad and Tobago
Côte d'Ivoire	Mongolia	Tunisia
Croatia	Morocco	Turkey
Cuba	Mozambique	Turkmenistan
Czech Republic	Myanmar	Uganda
Dominican Republic	Namibia	Ukraine
Ecuador	Nicaragua	United Arab Emirates
Egypt	Nigeria	Uruguay
El Salvador	North Macedonia	Uzbekistan
Equatorial Guinea	Oman	Venezuela
Ethiopia	Pakistan	Vietnam
Gabon	Panama	Yemen
Ghana	Papua New Guinea	Zambia
Guatemala	Paraguay	Zimbabwe

Risk categories and definitions

The CRS publishes scores and ratings for six risk categories (sovereign risk, currency risk, banking sector risk, political risk, economic structure risk and country risk). The scores and ratings for these risk categories are informed by a range of variables divided into five sections: politics/institutions; economic policy; economic structure; the economic cycle; and liquidity and financing.

Sovereign risk	The risk that the sovereign or an entity guaranteed by the sovereign defaults on its debts in the next 12-month period. Sovereign default is defined as a build-up in arrears of principal and/or interest on foreign- and/or local-currency debt owed by a government or a government-guaranteed entity.
Currency risk	The risk of a depreciation against the reference currency (usually the US dollar, occasionally the euro) of 25% or more in nominal terms over the next 12-month period.
Banking sector risk	The risk of a systemic crisis whereby bank(s) holding 10% or more of total bank assets become insolvent and unable to discharge their obligations to depositors and/or creditors. A banking crisis is deemed to occur even if governments restore solvency through large bail-outs and/or nationalisation. A run on banks facing a temporary lack of liquidity rather than underlying solvency problems is not deemed to constitute a crisis, provided that public confidence in the banking system is quickly restored. Banking crises are typically associated with payment difficulties in the corporate or household sectors; bursting of asset price bubbles; and currency and/or maturity mismatches. The rating can therefore serve as a proxy for the risk of a systemic crisis in the private sector.
Political risk	This evaluates a range of political factors relating to political stability and effectiveness that could affect a country's ability and/or commitment to service its debt obligations and/or cause turbulence in the foreign-exchange market. The political risk rating informs the ratings for sovereign, currency and banking sector risk.
Economic structure risk	This is derived from a series of macroeconomic variables of a structural rather than a cyclical nature. Consequently, the rating for economic structure risk will tend to be relatively stable, evolving in line with structural changes in the economy. The economic structure risk rating informs the ratings for sovereign, currency and banking sector risk.
Country risk	This is derived by taking a simple average of the scores for sovereign, currency and banking sector risk.

Sovereign rating band characteristics

Characteristics of countries in the different sovereign rating bands are summarised as follows.

AAA	Capacity and commitment to honour obligations not in question under any foreseeable circumstances.
AA	Capacity and commitment to honour obligations not in question.
A	Capacity and commitment to honour obligations strong.
BBB	Capacity and commitment to honour obligations currently, but somewhat susceptible to changes in economic climate.
BB	Capacity and commitment to honour obligations currently, but susceptible to changes in economic climate.
B	Capacity and commitment to honour obligations currently, but very susceptible to changes in economic climate.
CCC	Questionable capacity and commitment to honour obligations. Patchy payment record.
CC	Somewhat weak capacity and commitment to honour obligations. Patchy payment record. Likely to be in default on some obligations.
C	Weak capacity and commitment to honour obligations. Patchy payment record. Likely to be in default on significant amount of obligations.
D	Very weak capacity and commitment to honour obligations. Poor payment record. Currently in default on significant amount of obligations.

Rating methodology

Ratings are produced by country analysts using the CRS model. The rating horizon is 12 months: the CRS signals the risk of a sovereign default, a major currency devaluation or a banking crisis in the coming year. As such, the model is point-in-time (responsive to changes in political, economic and liquidity conditions) rather than through-the-cycle (responsive to structural shifts only).

The model comprises 61 indicators: 59 individual risk indicators, as well as an additional indicator capturing risks to the analyst's baseline assumptions, and an adjustment factor. The 59 risk indicators are grouped into five risk factors: politics/institutions; economic policy; economic structure; the economic cycle; and financing and liquidity. Each indicator is scored on a 5-point scale of 0 (least risky) to 4 (most risky).

Versions of the rating model

There are three versions of the model: a standard model (used for emerging economies); an industrialised country model, used for developed economies; and a euro area model, which is a variant of the industrialised country model.

The use of different models for emerging and developed economies reflects the fact that emerging economies have traditionally faced constraints on borrowing beyond the short term in their own currencies. They accordingly tend to have relatively high amounts of foreign-currency debt, which leaves their debt dynamics sensitive to capital flows. By contrast, developed countries typically have fluid access to financing in their own currencies, which insulates their debt dynamics from devaluations.

Accordingly, the difference in approach between emerging and developed economies is chiefly found in the financing/liquidity section of the model. In the standard model this section contains a number of indicators relating to external liquidity (for example, the debt-service ratio and foreign-exchange reserves/gross external financing requirement). In the industrialised country and euro area models, these are replaced by liquidity indicators relating to the public sector (for example, the term structure of the public debt market and the public sector's gross financing needs). In addition, the industrialised country model applies more generous risk thresholds to indicators such as the ratio of public debt to GDP and the current-account balance, consistent with observed levels around crisis episodes.

The euro area model has the same quantitative thresholds and weights as the industrialised country model, but some of its qualitative indicators have been modified to account for the special characteristics of a monetary union. For instance, in the euro area model, indicator 46 (relating to whether the country is subject to an IMF programme) is replaced by an indicator concerning the presence of an excessive deficit procedure.

All euro area countries have the same score for currency risk. This is generated by a euro area model that aggregates data from all member states of the single currency (netting out intra-euro area flows in the balance of payments).

Notwithstanding these differences, the three versions of the model have similar characteristics and structure, and the ratings are intended to be broadly comparable across all countries covered by the Country Risk Service.

Indicators in the standard model

The indicators in the standard of the model are listed in table 3.

Table 3: Indicators in the standard model

1. Risk to baseline assumptions	Macroeconomy/cyclical
	33. Real OECD GDP growth
Politics/institutions	34. Credit as % of GDP, growth
2. External conflict	35. Real GDP growth, 48 months
3. Governability/social unrest	36. Real GDP growth, 12 months
4. Electoral cycle	37. Inflation, 48 months
5. Orderly transfers	38. Inflation, direction
6. Event risk	39. Trade-weighted real exchange rate
7. Sovereignty risk	40. Exchange-rate misalignment
8. Institutional effectiveness	41. Exchange-rate volatility
9. Corruption	42. Export receipts growth, 12 months
10. Corruption in the banking sector	43. Current-account balance, 12 months
11. Commitment to pay	44. Asset price bubble
Economic policy	Financing and liquidity
12. Quality of policymaking/policy mix	45. Transfer and convertibility risk
13. Monetary stability	46. IMF programme
14. Use of indirect instruments	47. International financial support
15. Real interest rates	48. Access to financing
16. Fiscal balance/GDP	49. Gross external financing requirement
17. Fiscal policy flexibility	50. Debt-service ratio
18. Transparency of public finances	51. Interest due/exports
19. Domestic debt	52. External short-term debt/fx reserves
20. Unfunded pension & healthcare liabilities	53. % change, fx reserves, actual
21. Exchange-rate regime	54. Net external debt/exports
22. Black-market/dual exchange rate	55. FDI/gross financing requirement
	56. Import cover
Economic structure	57. OECD short-term interest rates
23. Income level	58. Non-performing loans
24. Official data (quality/timeliness)	59. Banks' credit management
25. Current-account balance, 48 months	60. Banks' foreign asset position
26. Volatility of GDP growth	
27. Reliance on a single goods export	61. Adjustment factor (if required)
28. External shock/contagion	
29. Public debt/GDP	
30. Gross external debt/GDP	
31. Default history	
32. Financial regulation & supervision	

Indicators in the industrialised country model

Indicators in the industrialised country model are listed in table 4. The indicators are the same as those in the standard model except for those highlighted in red.

Table 4: Indicators in the industrialised country model

1. Risk to baseline assumptions	Macroeconomy/cyclical
	33. Real OECD GDP growth
Politics/institutions	34. Credit as % of GDP, growth
2. External conflict	35. Real GDP growth, 48 months
3. Governability/social unrest	36. Real GDP growth, 12 months
4. Electoral cycle	37. Inflation, 48 months
5. Orderly transfers	38. Inflation, direction
6. Event risk	39. Trade-weighted real exchange rate
7. Sovereignty risk	40. Exchange-rate misalignment
8. Institutional effectiveness	41. Exchange-rate volatility
9. Corruption	42. Export receipts growth, 12 months
10. Corruption in the banking sector	43. Current-account balance, 12 months
11. Commitment to pay	44. Asset price bubble
Economic policy	Financing and liquidity
12. Quality of policymaking/policy mix	45. Transfer and convertibility risk
13. Monetary stability	46. IMF programme
14. Use of indirect instruments	47. International financial support
15. Real interest rates	48. Access to financing
16. Fiscal balance/GDP	49. Public borrowing requirement
17. Fiscal policy flexibility	50. Public borrowing requirement trend
18. Transparency of public finances	51. Government interest payments/revenue
19. Primary fiscal balance	52. Public debt term structure
20. Unfunded pension & healthcare liabilities	53. Public debt currency structure
21. Exchange-rate regime	54. Public debt market liquidity
22. Black-market/dual exchange rate	55. FDI/current-account balance
	56. Government deposits/interest payments
Economic structure	57. OECD short-term interest rates
23. Income level	58. Non-performing loans
24. Official data (quality/timeliness)	59. Banks' credit management
25. Current-account balance, 48 months	60. Yield curve
26. Volatility of GDP growth	
27. Reliance on a single goods export	61. Adjustment factor (if required)
28. External shock/contagion	
29. Public debt/GDP	
30. Net external asset position	
31. Default history	
32. Financial regulation & supervision	

Indicators in the euro area model

Indicators in the euro area model are listed in table 5. The indicators are the same as those in the industrialised country model except for those highlighted in red.

Table 5: Indicators in the euro area model

1. Risk to baseline assumptions	Macroeconomy/cyclical
	33. Real OECD GDP growth
Politics/institutions	34. Credit as % of GDP, growth
2. External conflict	35. Real GDP growth, 48 months
3. Governability/social unrest	36. Real GDP growth, 12 months
4. Electoral cycle	37. Inflation, 48 months
5. Orderly transfers	38. Inflation, direction
6. Event risk	39. Trade-weighted real exchange rate
7. Sovereignty risk	40. Exchange-rate misalignment
8. Institutional effectiveness	41. Exchange-rate volatility
9. Corruption	42. Export receipts growth, 12 months
10. Corruption in the banking sector	43. Current-account balance, 12 months
11. Commitment to pay	44. Asset price bubble
Economic policy	Financing and liquidity
12. Interest rate convergence	45. Transfer and convertibility risk
13. Inflation convergence	46. Excessive deficit procedure
14. Use of indirect instruments	47. International financial support
15. Real interest rates	48. Access to financing
16. Fiscal balance/GDP	49. Public borrowing requirement
17. Fiscal policy flexibility	50. Public borrowing requirement trend
18. Transparency of public finances	51. Government interest payments/revenue
19. Primary fiscal balance	52. Public debt term structure
20. Unfunded pension & healthcare liabilities	53. Public debt currency structure
21. Exchange-rate regime	54. Public debt market liquidity
22. Black-market/dual exchange rate	55. FDI/current-account balance
	56. Government deposits/interest payments
Economic structure	57. OECD short-term interest rates
23. Income level	58. Non-performing loans
24. Official data (quality/timeliness)	59. Banks' credit management
25. Current-account balance, 48 months	60. Yield curve
26. Volatility of GDP growth	
27. Reliance on a single goods export	61. Adjustment factor (if required)
28. External shock/contagion	
29. Public debt/GDP	
30. Net external asset position	
31. Default history	
32. Financial regulation & supervision	

Qualitative and quantitative indicators

Of the 59 risk indicators, 30 are quantitative and 29 are qualitative. Quantitative indicators are scored on the basis of regularly updated macroeconomic and financial data drawn from a variety of sources, including the IMF, the World Bank, the OECD and national statistical agencies. The indicators are scored by applying thresholds to the data. For example, in the standard version of the model, the score for the indicator relating to the fiscal balance in the latest 12-month period ranges from 0 for countries running surpluses or a balanced budget to 4 for countries where the deficit exceeds 5% of GDP.

The indicators are based on a combination of monthly, quarterly and annual data. In the case of quarterly or monthly data, the most recent available value is used. In the case of annual data, a point-in-time value is estimated using a weighted average of the current year and previous year(s). For instance, if the model is run in the first three months of year T, the external debt stock is estimated using a weighted average of the stock at the end of year T (25%) and the stock at the end of year T-1 (75%) and The Economist Intelligence Unit's estimate of the stock at the end of year T (25%). When the model is rerun in the second quarter, the weights change to year T-1 (50%) and year T (50%).

Qualitative indicators are scored in accordance with the judgement of the country analyst. To score these indicators, the analyst answers a standard set of questions supplemented by written guidance. To ensure consistent assessment across countries, the answers to the qualitative indicators are checked by an experienced analyst covering the same geographic region and periodically subjected to benchmarking reviews.

Risk to baseline assumptions

The model contains an additional indicator, also scored from 0 to 4, which provides scope for the analyst to express a degree of confidence about the macroeconomic and liquidity assumptions underlying the rating. The default score for this indicator is 1 and indicates that the baseline assumptions appear safe. Changing this indicator by 1 point alters the scores of five quantitative indicators by 1 point, provided that they are not already scoring a minimum of 0 or a maximum of 4 (see table 6). For instance, changing the indicator from 1 to 0 (upside risk) upgrades the five indicators by 1 point each. Similarly, changing the indicator from 1 to 2 (moderate downside risk) downgrades the score of the five indicators by 1 point each. In practice, this indicator is rarely used.

Table 6: Indicators affected when the “risk to baseline assumptions” is adjusted

Standard model	Industrialised country and euro area models
16. Fiscal balance/GDP	16. Fiscal balance/GDP
36. Real GDP growth, 12 months	36. Real GDP growth, 12 months
42. Export receipts growth, 12 months	42. Export receipts growth, 12 months
49. Gross external financing requirement	49. Public borrowing requirement
51. Interest due/exports	51. Government interest payments/revenue

Summary risk scores

A weighted sum of the 59 indicators yields a summary risk score from 0 to 100. The weights differ for each risk category. For example, indicators relating to the government's commitment to pay, the public debt/GDP ratio and the fiscal balance have a large weight in the sovereign risk category, whereas indicators relating to the real effective exchange rate and the current-account balance are heavily weighted in the currency risk category.

In the case of political risk and economic structure risk, the scores are a weighted sum of the relevant model indicators. The political risk rating is informed solely by indicators grouped under the politics/institutions risk factor. The economic structure risk rating is informed solely by indicators grouped under the economic structure risk factor.

The country risk score is derived by taking a simple average of the scores for sovereign risk, currency risk and banking sector risk.

Adjustment factor

Once all the indicators have been scored, analysts can apply an adjustment factor to the score of any of the five risk categories if they deem that the model fails to capture a fundamental factor affecting a country's creditworthiness. For example, if a sovereign wealth fund holds assets that are not captured by foreign-exchange reserves data and that could be liquidated to meet debt-service commitments, analysts can use the adjustment factor to make an improvement to the sovereign score. Adjustment factors are intended to be used sparingly.

Mapping scores to ratings

In a final step, the risk scores are divided into ten bands, each of which corresponds to a rating, as shown in table 7.

Table 7: Ratings and corresponding risk scores

Rating	AAA	AA	A	BBB	BB	B	CCC	CC	C	D
Score	0-12	9-22	19-32	29-42	39-52	49-62	59-72	69-82	79-92	89-100

To reduce the risk of frequent rating changes when the risk score is near the edge of a rating band, there is a buffer zone encompassing risk scores ending with the digits 9, 0, 1 and 2. Within this zone, the country analyst has discretion whether to assign the lower or higher letter grade. Analysts are advised to consider the likely trend in the score when assigning ratings.

Model calibration

Given the number of potential factors affecting country risk, and the fact that sovereign, currency and banking crises are rare events, estimating the parameters of any country risk model using purely statistical techniques presents significant challenges. The specification of the CRS model (including the wording and thresholds for each indicator and the indicator weights) is therefore based on a combination of data analysis, relevant research findings and The Economist Intelligence Unit's collective experience and expertise in assessing country credit risk since the early 1980s.

As part of the calibration process, an initial specification of the model was back-tested against past crises over the period January 1997-December 2005. Indicators were tested for significance both on their own and in combination with other indicators. This enabled the model to be refined in an iterative process. Scores for quantitative indicators were generated from historical data. For qualitative indicators, scores from the previous CRS model (in use from January 1997 to March 2006) were used where available. Where the previous model did not have an equivalent indicator, the current score was assumed to have applied in the past (for indicators relating to structural characteristics of the political system or economy) or the indicator was scored on the basis of a quantitative proxy. For example, in the case of indicator 59, relating to the quality of banks' credit management, we took the rate of credit expansion in the previous 24 months and set thresholds that attempted to distinguish between a healthy and a risky rate of credit growth.

Rating performance

The sovereign ratings produced by the CRS are subject to periodic review by an Independent Review Function (IRFn). Findings from recent review exercises are summarised here. They cover the following areas.

Discriminatory power	How the rating methodology performs in terms of its ability to rank countries on their likelihood of default.
Predictive power	The ability of the rating methodology to predict sovereign defaults.
Historical robustness	The stability of the rating distribution over time.

Discriminatory power

The distribution of observed sovereign defaults is shown in table 8 for the period March 2006-June 2022. For consistency with the CRS model specification, sovereign defaults are defined to include arrears on bilateral debt as well as market defaults. The results show that the frequency of default was higher among countries in higher risk score bands (i.e. with poorer ratings). In particular, all market and bilateral defaults occurred in countries with a score of more than 40 (corresponding to a rating of BB or worse).

Predictive power

EIU formally tests the predictive power of its sovereign ratings by using a logistic regression model to estimate the probability of default 12 months ahead for a given rating. For consistency with EIU's sovereign rating methodology, we use EIU's sovereign default database, which includes arrears on bilateral debt as well as market defaults. The results are also shown in Table 8. Data are monthly, and cover the period March 2006-June 2022.

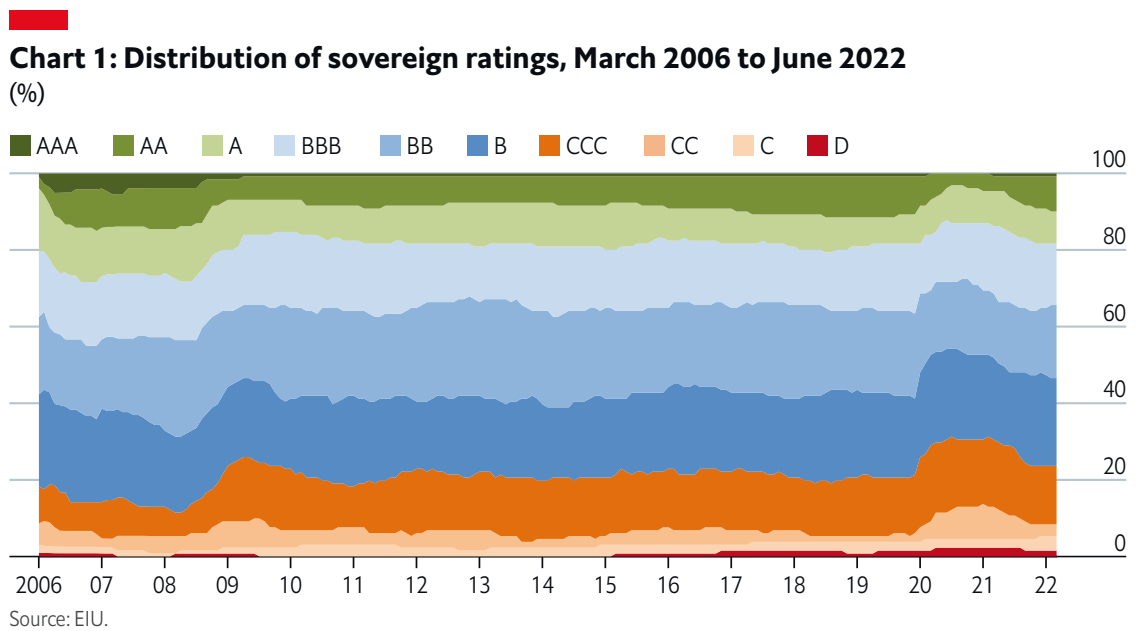
Table 8: Months in default distributed by EIU risk ratings (March 2006 to June 2022)

Risk rating	Number of defaults	Number of rated entities	Long-run default frequency	Estimated PD one year ahead
AAA	0	320	0%	0%
AA	0	2005	0%	0%
A	0	2543	0%	0%
BBB	0	4238	0%	0%
BB	347	5565	6%	9%
B	730	5412	13%	22%
CCC	744	3589	21%	44%
CC	599	1034	58%	69%
C	414	558	74%	87%
D	89	192	46%	95%

Source: EIU

Historical robustness

As shown in chart 1, the distribution of sovereign ratings moves with the macroeconomic and financial cycle. This reflects the fact that CRS is designed to measure point-in-time (12-month-ahead) rather than through-the cycle (medium-term) risks, and thus captures cyclical as well as structural risk factors. In particular, there was a temporary shift to riskier rating bands following the global financial crisis of 2008-2009, and again in 2020-21 as a result of the deterioration in economic and fiscal conditions due to the Covid-19 pandemic. At the same time, chart 1 also reveals a gradual but persistent trend towards greater risk since 2006. Underlying factors include the rise in public and external debt burdens in many advanced and emerging economies, and an increase in political and geopolitical risks over the past decade.



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