ISSUES RELATED TO THE COUNTRY RISKS DURING THE ECONOMIC AND FINANCIAL CRISES

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Introduction

The years following the global financial crisis and the pandemic have clearly demonstrated the weakness of collective measures to counter external economic shocks. During the last decades, the global economy has repeatedly faced crises, necessitating the development of new approaches to risk analysis, assessment, and management methods[1]. The sources of crisis phenomena have been financial in nature. However, they have all turned into financial-economic crises with essential negative social impact. In particular, from the early 1970s when the Bretton Woods system collapsed up to the 2020s, financial crises in many countries led to the loss of up to 10-40% of national financial assets. In emerging after 1991 developing markets, which include the CIS countries, the time periods separating one crisis from another are typically 5-10 years, with crises lasting approximately five years (Figure 1). As it can be seen from the figure below, compared to the previous ones, the latest global market crises appear more widespread.

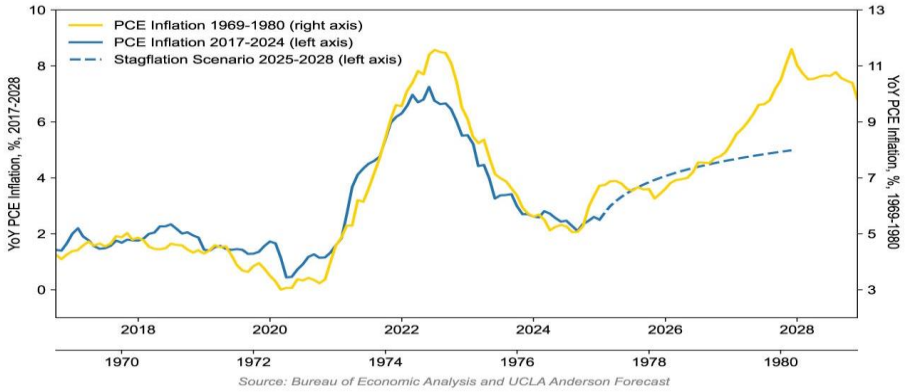

Figure 1. Duration of crises
Sources: Bureau of Economic Analysis and UCLA Anderson Forecast

Methodology

Gathering relevant data from local and international reports to construct statistic lines and other common methods of comparative analysis are widely used in this study. Also, the subjectivity of the assessment is used along with the rating agency assessment methodlogy that is essential in determining the relative weights of various indicators. Despite the inconsistencies discovered during the data accumulation, individual expert opinions are

[1] For the last quarter of the 20th century, the IMF recorded more than 150 currency and 54 debt/banking crises in over 50 countries between 1975 and 1997.

considered in this paper. It appears that the mentioned problem is also present in some international reports leading thus to an insufficient accumulated statistics. In addition, uncertainty of individual risk factors is considered during the country risk assessment. Such method as linking corporate ratings to sovereign ratings is vital since the risks are better scanned at micro and macro levels. "Reputation Model" is of particular attention due to the issue of distorted incentives in rating agencies' relationships with investors (the "reputation model"). Finally, country-specific characteristics are also monitored and will be further used in our future research projects.

Literature review

According to some experts, ratings institutions can artificially maintain a procyclical trend by raising sovereign ratings during favorable financial market conditions and downgrading them during unstable times, thereby deepening the amplitude of the cycle in global financial markets [Ferri, Liu, and Stiglitz, 1999]. Currently, global financial markets are driving the development of the ratings process. To enter the global market, it is necessary to have a rating from the world's leading rating agencies. This is necessary for the following reasons. Firstly, investors are interested in purchasing securities that have a rating. Secondly, institutional investors can often only include securities with a rating of at least investment grade in their portfolios. Furthermore, sovereign ratings are recommended by the Basel Accord for use as a risk measure and are directly incorporated into the regulations of financial institutions. This confirms the high reputation of ratings as an information and analytical product. Assessing a sovereign's creditworthiness is a rather labor-intensive and time-consuming process. Therefore, a rating agency's opinion on a borrower's creditworthiness is new information that can significantly influence market participants' behavior, and sovereign ratings partially relieve investors, who are unable to conduct such a rigorous credit assessment process, from the need to independently assess credit risks. Rating agencies compile country risk ratings as a measure of a country's creditworthiness, which relates to the country's ability and willingness to service its international obligations, and also assess the level of development of the country's economic and political infrastructure. These organizations use publicly available statistical information on macroeconomic indicators and also collect and process confidential information both through communications with the assessed entity and from other sources. However, it should be noted that sovereign ratings have a number of problematic methodological aspects, namely, the subjectivity of the assessments, which depend on both the set of indicators and their weights. European economists Hu, Yen-Ting, Rudiger Kiesel, and William Perraudin believe that ratings do not possess independent predictive power, but rather merely respond to objective changes in a country's economic situation [Yen-Ting et al., 2002]. In the academic literature, there are two competing views on the point at which ratings begin to recognize negative economic trends. According to the first view, rating agencies possess only publicly available information and generally lag behind financial

markets in processing this information about crises [Gropp et al., 2001]. According to another view, rating agencies are, in a sense, professionals in obtaining and processing information, and therefore generate information about default risk that is completely unknown to financial markets (R. Kraussl, 2003). In this case, changes in sovereign credit ratings, by revealing new information about a country's solvency, can lead to shifts in financial markets. This rating impact can be felt both within the financial markets of a given country and also spill over beyond national borders. Furthermore, as R. Kräussl's research has shown, sovereign rating downgrades and negative rating revision forecasts have a stronger impact on economies than positive rating adjustments. Furthermore, the effect of rating upgrades or downgrades is more pronounced in transition markets, where issues of transparency and information asymmetry have not yet been fully resolved.

Analysis

Financial crises come in many stripes, but over the past two decades the common trigger has been debt refinancing problems. High levels of debt and leverage are fine until the point when they can no longer be rolled-over or sustained. Stability and continuity require liquidity. It follows that 'liquidity' must be included in the benchmark that evaluates future financial crisis risk.

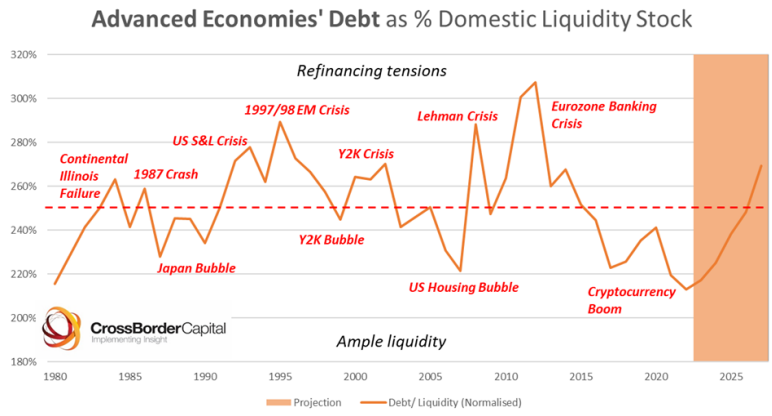

Figure 2. Advanced economies debt compared to domestic liquidity stock [Howell, 2025].

In addition, any financial crisis is a time of social tension, political risks, and a decline in economic growth. Preventing and managing the risks of a financial crisis is a crucial task for the state in its efforts to create conditions for sustainable economic development. Country and sovereign ratings from leading international rating agencies can also help prevent crises. However, experience shows that rating agencies do not always predict crises or prevent their occurrence.

In the current global economic environment, the role of international rating organizations has increased significantly. Rating institutions have a significant impact on a country's economy and the prospects for its financial stability. Economists believe that rating agencies are gradually gaining the role of international companies and will in the future become significant economic actors in their own right, similar to the international economic organizations of the World Bank Group and others[1].

Table 1. Financial crises and their reflection in country ratings

	The Mexican crisis of 1994	Asian crisis of 1997 (Thailand, South Korea)	The Russian crisis of 1998.	The 2008 US subprime mortgage crisis
Pre-crisis	Favorable	Favorable	Improvement of the macroeconomic situation immediately before the crisis.	High leverage
Macro-Situation	Massive outflow of "hot money" under the influence of external conditions	Default of a private company amidst accumulation of unsecured loans	Lack of current liquidity in the government and banking sector.	Overheating of the credit market, particularly subprime mortgages
Trigger	• High dependence on global financial markets	• High dependence on global export, moncy markets • preconditions for bad faith behavior: state guarantees for creditor banks for bad loans	• High dependence on global commodity and financial markets.	• High leverage (government debt/GDP)

Experience shows that international rating agencies have never been known for their ability to anticipate crises. The first major mistakes were made at the dawn of their development, during the Great Depression in the United States, when high-ranking rating agencies failed to foresee the impending collapse. A notable failure of rating agencies in emerging markets was the prediction of the Mexican financial crisis of 1994-1995. Until December 20, 1994, the day the devaluation of the Mexican peso rocked global financial markets, the rating assigned to Mexican sovereign bonds by Standard & Poor's was just one notch below investment grade, with a positive outlook. A similar situation repeated itself during the Asian financial crisis, but on a much larger scale and with greater consequences. Rating agencies also failed to predict subsequent crises. Summarizing the crises of the last half-century, international organizations' ratings and statistics failed to predict the onset of the crises, but instead resulted in a deterioration in ratings and statistics in the post-crisis period. This phenomenon reflects both flaws in rating agency me-

[1] According to Stanford University professor and Nobel laureate Milton Friedman, "Today there are two superpowers in the world: the United States and Moody's." "The US can destroy a country by dropping bombs on it, while Moody's can destroy a country by downgrading its bond ratings. And sometimes it's not at all clear which of them is more powerful."

thodology, their manipulation, and flaws in development systems that failed to predict development threats and led to their collapse.

It becomes obvious that country ratings do not always reflect the actual quality of the economic situation in a country and sometimes contradict the level and dynamics of macroeconomic indicators.

Based on the weak correlation between sovereign ratings and a country's debt burden, it can be concluded that some countries have undervalued ratings. Countries with critical debt situations that have turned to the EEU for assistance have been rated higher than Russia, a country with negligible debt. Russia's debt ratio is low, but corruption is high, the business environment is inefficient, property rights and investor protection are weak, and GDP per capita is low. As a result, the ratings of distressed European countries are higher than those of Russia, despite its insolvency.

There is also the problem of unfairly high ratings due to flaws in the agencies' rating methodology. Due to the rating cap in countries with lower ratings, a company can only receive a high rating if it is a special purpose vehicle (SPV) or a subsidiary of a highly rated foreign company. As a result, small and unstable companies with foreign ownership can receive a high rating, while strong and stable domestic companies cannot. Unlike the gross government debt-to-GDP ratio, sovereign ratings correlate with GDP per capita.

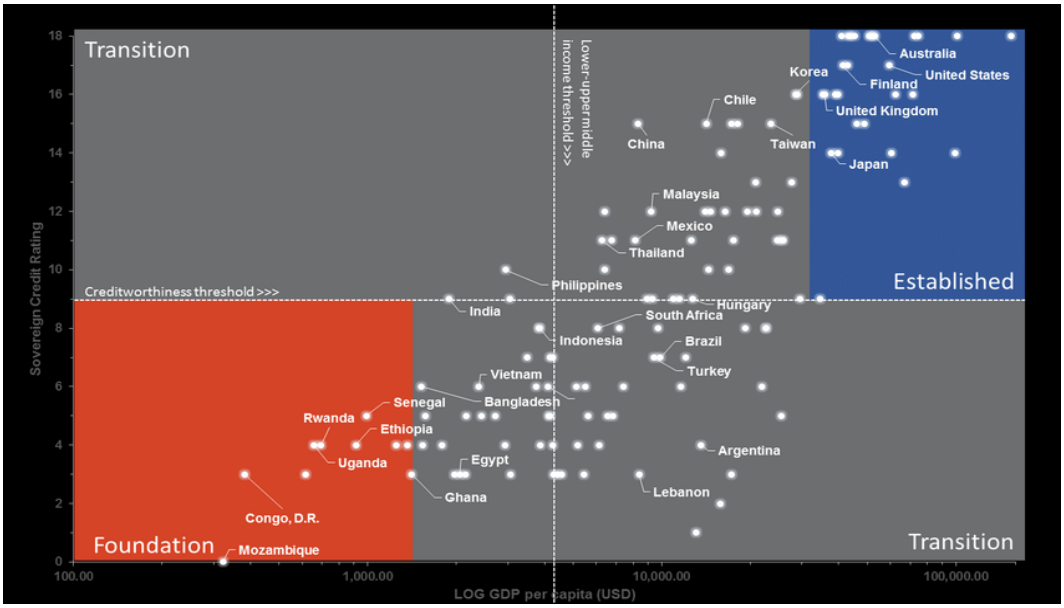

Figure 4. The relationship between average per capita GDP and sovereign credit ratings (as graded by Standard and Poor's) in selected countries.
Source: Floater et al. (2017b).

Many countries have clearly developed good financial management capabilities relative to their levels of economic development, and therefore have greater capacity to raise and steer finance for climate-compatible urban infrastructure. The foundation, transition and established stages are defined by three thresholds: the cut-off between investment grade and`junkand`junk' credit ratings (BBB-); and the lower and upper bounds of the World Bank middle-income band (US$1,025 to US$12,475 per capita). [IPCC Cities and Climate Change Science Conference, Conference Paper, 2018]

It is worthy to mention that the country risks have a certain correlation with government bond yields. Sovereign ratings influence government bond risk premiums. Based on the analysis of leading rating agencies related to the impact of sovereign ratings on government bond risk premiums, countries with high ratings have low government bond risks. Government bonds of countries with speculative-grade ratings are more profitable than those of countries with high investment-grade ratings.

A crisis in any system necessitates its change and the need for new approaches to its resolution. Many international rating agencies modify their methodologies and approaches to assessing country risks after crises, refining them based on the specifics of the development era and the necessary crisis resolution methods.

The crises of the past half-century and their reflection in the ratings analyzed above raise doubts about the effectiveness of credit rating agencies in assessing sovereign credit risk.

Based on an examination of rating agency methodologies, the following main reasons for the inadequacy of both sovereign and corporate ratings by global rating agencies in emerging markets can be identified.

Subjectivity of the assessment. Rating agency assessment methodology is subjective in determining the relative weights of various indicators.

Insufficient accumulated statistics. In practice, it is impossible to verify the accuracy of the relationship between default rates and corresponding sovereign rating levels to determine whether such a relationship is statistically satisfactory. Agencies have extremely limited experience assigning sovereign ratings, both in terms of the length of time over which these ratings have been assigned (for most emerging markets, since the early 1990s) and the small number of ratings assigned.

Rating agencies face a similar problem when assigning corporate ratings in developing countries, where the lack of risk data on local businesses also significantly reduces the reliability of their assessments.

Uncertainty of Individual Risk Factors. A fundamental problem in financial markets is the issue of estimating potential losses associated with the uncertainty of surrounding risk factors. Even if agencies had sovereign default statistics, it would be difficult to estimate

certain sovereign risk factors, such as the level of political stability. Critics of rating agencies argue that the greater the uncertainty of such specific factors, the less likely they are to be included in credit risk analysis. The discrepancy between rating agency reports (which pointed to banking sector risks and short-term debt risks even before the Asian crisis) and ratings largely reflected concerns about the inclusion of uncertainties in rating assessments.

Linking corporate ratings to sovereign ratings. World Bank analysts L. Liu and J. Ferrie note that a close relationship between sovereign ratings and corporate ratings exists in developing countries, but not in developed countries. A downgrade of a sovereign rating in developing countries negatively impacts their corporate ratings.

The correlation is quite significant: around 0.7 for industrial companies in developing countries; however, there is no significant correlation between sovereign rating downgrades and changes in corporate ratings in developed countries. Furthermore, the relationship between corporate ratings and sovereign ratings is quite asymmetric: the average downgrade of corporate ratings follows a downgrade of the sovereign rating, and an upgrade of the sovereign rating does not necessarily lead to an average upgrade of corporate ratings. This is confirmed by both the experience of the Asian crisis and its aftermath.

Clearly, this practice puts companies in emerging markets at a disadvantage whenever a country's sovereign rating is downgraded. This pattern of rating changes raises questions about how global rating agencies distinguish the credit risk of companies in emerging markets from sovereign risk when assigning ratings. An excessively close link between corporate and sovereign ratings prevents investors from adequately distinguishing sovereign risk from the risk of individual companies. Because investors cannot distinguish country risk from corporate risk, they begin to avoid all sectors within a country. This may be one of the reasons for the "herding" behavior of international capital flows in emerging markets during the Asian crisis. This raises the question: why don't global rating agencies give corporate performance indicators the same weight in determining their final rating assessments as they do for entities in developed countries? There are two possible explanations for this: first, it's due to the industry-specific nature of ratings activeties; second, it's the result of distorted interactions between global rating agencies and investors. Both arguments can be cited as reasons for the ineffectiveness of global agencies' ratings in developing countries.

Agencies' desire to minimize costs. Currently, the global rating industry is characterized by low or insignificant competition. Rating agencies are business structures providing services on a commercial basis. Consequently, as a commercial organization, a rating company strives to reduce its unit costs. For rating agencies, this lies in insufficient investment in information collection and analysis (technology, personnel, database creation) in developing and other markets that are new to rating agencies. The costs of crea-

ting such infrastructure are quite high and do not depend on the number of ratings assigned in a given country or region. Consequently, in regions with a small number of ratings assigned, the costs of creating information infrastructure, considered as costs per unit of output (assigned rating), are significantly higher than in regions with a high level of rating coverage. In some regions (probably most developing countries), rating activeties would not even pay for themselves with adequate investment in risk analysis infrastructure. The resulting "underinvestment" in risk analysis infrastructure is the main source of global agencies' ratings ineffectiveness in these countries.

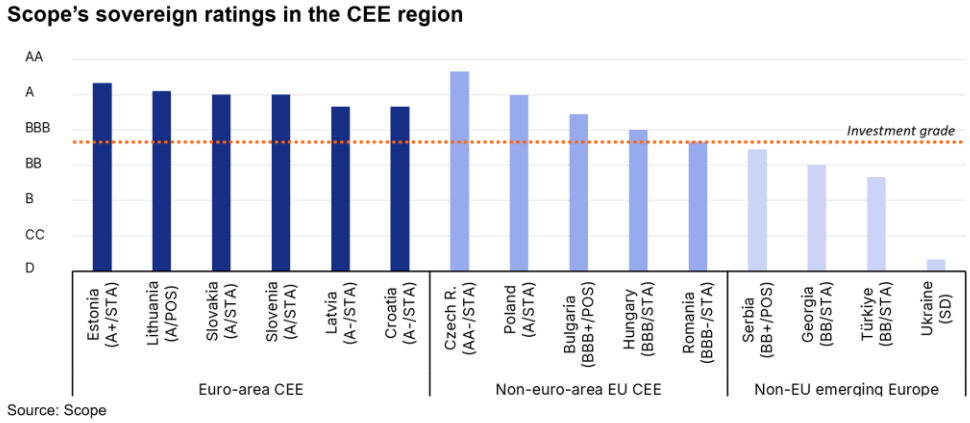

Figure 2. Sovereign ratings in the CEE region [SCOPE, 2025]

"Reputation Model." The issue of distorted incentives in rating agencies' relationships with investors (the "reputation model") deserves special attention. The "reputation model" refers to the following principle: Party A does not always want to tell Party B what it knows or thinks, but rather wants to communicate what it considers best in terms of building the reputation it desires to have in the eyes of Party B.

Let's assume that investors in developed countries are negatively inclined toward companies in emerging markets. If rating agencies were to send a strong positive "signal" by assigning an emerging market company a rating higher than the sovereign, this would be a truly significant signal to investors. However, if a rating agency is concerned with maintaining a conservative reputation, it has insufficient incentive to assign such a rating. In reality, a rating agency cannot be completely confident that an emerging market company will outperform the government in terms of reliability. In any case, there is always the possibility of a negative development, and it is unprofitable for a rating agency to take on the risk of reputational damage.

Conclusions

Thus, although a rating agency often knows that the company it is rating has a higher level of reliability it has an incentive to align the assigned rating with the biases of in-

vestors in developed countries regarding the structures of this market. By aligning its assessments with the prevailing investor opinion, the agency does not shape investors' position on the investment object, but rather promotes their "herd" behavior. Furthermore, the "reputation model" implies a high degree of influence of procyclical factors on the rating assessment. This leads to both the deepening of crises in developing countries, the acceleration of their spread across all emerging markets worldwide, and the undermining of the stability of the global financial system as a whole. In addition, it should also be noted that national characteristics and the specifics of doing business in a particular country are also important factors. Foreign rating agencies do not always understand the specifics of a particular country. To receive an acceptable rating, countries and corporations must base their policies on Western principles and standards. This means that ratings don't always reflect the real situation in a country.

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Issues related to the country risks during the economic and financial crises

Key words: economic crisis, country risks, international rating, investments, financial markets

This article discusses issues related to the country risks during the economic and financial crises. Experience shows that international agency ratings are often a tool for political pressure and manipulation. Typically, the targets of this pressure are non-Western companies, for example: until mid-2011, the ratings of the largest Russian banks (Sber-bank, VTB) were lower than the rating of one of the three problematic Cypriot banks – Bank of Cyprus. After the 1998 Russian default, VTB Bank had a Ca rating from Moody's. However, the bank successfully repaid its debts. Bonds of 25 Japanese companies assigned a Moody's Ba rating or lower in the early 1990s have not experienced a single default for five years, although, according to agency estimates, the probability of default was 20% or more. Finally, there are several examples from the global economy of corporate rating downgrades associated with sove-reign rating downgrades.