Overview
The Economist Intelligence Unit (EIU), an Economist Group business, produces the Country Risk Service with Country Risk Ratings. These risk levels are designed to quantitatively assess the risk of doing business in a specific country. This assessment is particularly important to commercial bankers, institutional investors, and corporate executives who have or are considering direct foreign investment in a particular country.

EIU’s Country Risk Ratings focus on three risks of particular importance to investors with direct financial exposure: Sovereign, Currency, and Banking sector risks. These risk concepts are explained in greater detail below.

The scores for each of these risk categories are computed from a range of variables that are believed to be important for risk assessment. These include:

- **Current account balance**: the sum of a country’s balance of trade (the difference between a country’s exports and its imports), its net factor incomes (for example, cross-border payments of interest and dividends), and net transfer payments (for example, net foreign aid received or provided)
- **Financing requirements**: the need for financial assistance from international lenders, either quasi-governmental (e.g., the World Bank) or private
- **Foreign reserves**: current holdings of foreign currencies
- **Short-term debt**: the fraction of a country’s total debt obligations that have short-term maturities (less than one year);
- **“Hot money flow”**: inflows of funds that are subject to withdrawal from a country on extremely short notice
- **Banking sector vulnerability**: an assessment of the likelihood of a nation’s banks to default on debt obligations or to become insolvent.

The overall country risk level is derived by taking a simple average of the scores for Sovereign risk, Currency risk, and Banking sector risk. The goal of this risk level is to estimate a country’s probability of default on sovereign debt (i.e., a country’s government debt) during the following 12 months.

Description of Components
The ratings for Sovereign, Currency, and Banking sector risk are determined by a weighted combination of values derived from a universe of 61 possible indicators divided into five different categories: politics, economic policy, economic structure, the economic cycle and liquidity and financing. For example, indicators relating to the government’s commitment to pay, the public debt/GDP ratio, and the fiscal balance in the current year have heavy weights for sovereign risk, whereas the real effective exchange rate, the current account of the balance of payments and the real interest rate have heavy weights for currency risk.

For each risk component, a weighted average of the values for the underlying indicators establishes its total component risk score. A simple average of the three risk component risk scores determines the overall risk rating for a country.

These ratings, along with the overall country risk level, are updated monthly. Here are their descriptions:

- **Sovereign risk** measures the risk of a build-up in arrears of principal and/or interest on foreign- and/or local-currency debt that is the direct obligation of the sovereign or guaranteed by the sovereign.
- **Currency risk** measures the risk of devaluation 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 gauges 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.

Political risk 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. This rating informs the first three.

Economic structure risk 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. This rating informs the first three.

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

Risk rating bands explained
The overall country risk levels are divided into ten bands: AAA, AA, A, BBB, BB, B, CCC, CC, C and D. Characteristics of countries in the different risk level bands are summarized as follows. (See table to right)