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Not Everything that Counts Can be Counted:
A Critical Look at Risk Ratings and Governance Indicators

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Accurately evaluating country risk and assessing the quality of governance in emerging market economies has become a priority of international corporations, investment banks and multilateral financial institutions. The rating system of the *Political Risk Services* (PRS) Group, the *International Country Risk Guide* (ICRG), constitutes one of the most influential time-series databases of country risk analysis. This study assesses the accuracy and predictive powers of the ICRG model, evaluating its ability to discern trends and highlight structural vulnerabilities, and thus to warn of impending crises. Three major crises are examined: the Brazilian financial crisis of 1999, the Argentine economic meltdown in December 2001 and the Peruvian political crisis of 2000. The study finds mixed results, which have important implications for research and policy. JEL codes: A10, F35, F47, G24

'Not everything that can be counted counts, and not everything that counts can be counted.'

Albert Einstein, quoted in Kaufmann, 2003:5

Accurately evaluating the exposure to sovereign risk and assessing the quality of governance in emerging market economies and developing countries have become critical tasks for country risk rating agencies, international investment banks and multilateral financial institutions (Christl, 2001). International investors are increasingly relying on country risk data to better gauge business opportunities and foresee major crises in increasingly volatile emerging markets.

The turbulent decade of the 1990s was marked by recurrent crises that rocked the once-promising emerging markets and revealed the weaknesses of new and restored democracies. Uncertainty and vulnerability are inherent features of emerging market economies. From Indonesia to Argentina, from Russia to Brazil, financial crises have often had their origins in the intrinsic weaknesses of the institutions of governance. They have fueled a backlash against the neo-liberal recipes of the Washington consensus' economic policies, especially in Latin America where a decade of reforms has failed to significantly enhance growth and equity (Stallings and Peres, 2000; Santiso, 2004b and 2003).

In developing countries and transitional economies, donor governments and international financial institutions have invested extensive resources in evaluating the quality of government and the soundness of economic policy. They have attempted to identify feasible qualitative and quantitative indicators to assess the quality of governance in order better to target assistance and improve aid effectiveness. Based on recent research on the effectiveness of aid in good policy environments, development assistance is becoming increasingly selective and targeted at poor countries with 'sound policies' and adequate institutions (World Bank, 1998; Santiso, 2002 and 2001a). The World Bank has developed indicators of governance and institutional quality, which inform its concessional lending policies to poor countries in the context of the *International Development Association* (IDA) (World Bank, 2002). More recently in 2002, the United States government launched a new initiative aimed at increasing foreign aid

levels by $5 billion to $15 billion by 2006, the *Millennium Challenge Account*, which selectively targets US bilateral aid to poor countries with sound policies and good governance. Indicators of government performance and governance quality figure prominently in the process of selecting aid recipients (Radelet, 2003 and 2002; Birdsall et al, 2002; Kaufmann and Kraay, 2002).

Country risk ratings and government performance indicators are thus the subject of renewed interest by scholars and policy-makers alike. This study focuses on one of the most prominent and influential providers of indicators of governance quality and sovereign risk, the *International Country Risk Guide* (ICRG) database of the *Political Risk Service* (PRS) Group. The PRS Group is the only risk-rating agency to provide detailed and consistent monthly data over an extended period for a large number of countries. It has provided country risk ratings covering a broad repertoire of countries since 1979. These ratings are used by some 80 percent of the world's largest global companies,[1] as well as aid donors and international financial institutions such as the World Bank. The PRS Group has devised two systems for evaluating the risks faced by business in countries around the globe, one of which is the ICRG. The ICRG system rates political, economic, and financial risks, breaking each down into its key components, as well as compiling composite ratings and forecasts. The ICRG rating system comprises 22 variables in three subcategories of risk.

The study critically assesses the conceptual foundations and predictive powers of the ICRG rating system. While it would be unrealistic to expect the ICRG data to accurately and precisely *predict crises*, one

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1.   As ranked by *Fortune*. Source: PRS Group. www.prsgroup.com

would nevertheless expect country risk time-series data to *reflect trends,* highlight structural vulnerabilities and provide early warning signals. Furthermore, while country risk ratings and governance indicators cannot be expected to give an *absolute value* of the level of risk or the quality of governance, one might reasonably expect from them a *relative measure* of these.

Few studies question the theoretical underpinnings and predictive powers of such datasets. This study aims to contribute to this debate by assessing the accuracy of the ICRG model. Until recently, economic and financial data analyses were the main determinants of financial decisions of firms. Major political events in the last few decades have, nevertheless, highlighted the need for taking political considerations into account when forecasting country risk. However, reducing often disparate and generalized political information to precise and objective indicators, which can be readily used in forecasting models, presents significant challenges. Moreover, the subjective nature of some of the indicators contained in these datasets questions their reliability as a guide to policy.

The ICRG model comprises estimations of economic and financial as well as political risk. The former two categories generally lend themselves to more precise quantitative definitions, while the latter commonly is based on survey data of a limited pool of experts and therefore more dependent on individuals' perceptions. Risks here are understood to entail events or vulnerabilities such as increasing government instability or a sudden eruption of conflict, which may lead to direct or indirect threats to business activities in emerging markets. The study focuses on sovereign risk, that is, the ability of the government and its agencies, as opposed to private entities, to repay a loan.

What can reasonably be expected of these instruments ultimately depends on their intended *purpose.* In order to assess the ICRG model, its purpose must first be established. Often, clients tend to over-estimate the accuracy and reliability of country risk ratings. However, the ICRG risk-rating model should be evaluated based on the model's stated aims and recognized abilities, not on the expectations placed upon them by clients. According to the PRS Group, the ICRG rating system aims to provide an assessment of countries' political stability, their economic strengths and weaknesses as well as their ability to finance their official, commercial and trade debt obligations. As such, the criteria for evaluating the model should be based on its ability to *detect and anticipate underlying vulnerabilities* potentially leading to a crisis, and *specify* the nature of such a crisis, in particular distinguish between the relative importance of financial, economic and political dimensions. Fundamentally, country risk ratings are to be understood as assessments of *exposure to risk*, rather than *predictors of crises.* Expectations on the performance of such ratings systems must be kept realistic and must take into account the unpredictable nature of country dynamics.

This study looks at three instances of crisis in relatively similar emerging markets in Latin America: the exchange rate crisis in Brazil in 1999, the financial collapse and economic meltdown of Argentina in 2001–02, and the political and electoral crisis in Peru in 2000–01. The specific nature of each of these crises signals the presence of specific problems, be they financial, economic or political. The accuracy of the ICRG risk ratings is thus assessed in each individual case based on its ability to discern *ex ante* the main determinants of a crisis, e.g. its underlying nature. Based on disaggregated

data on economic, financial and political risk as well as the composite risk rating, the study assesses the extent to which the ICRG model was able to foresee these crises or detect trends pointing to the structural vulnerabilities, which ultimately produced the crises. This method of evaluation is admittedly rudimentary, yet it allows us to pinpoint structural weaknesses in the predictive power of risk ratings and governance indicators.

These three events were selected because they represent three distinct types of crises, which occurred in three middle-income emerging economies in the same region and over the same period, essentially the late 1990s and early 2000s. The three countries were characterized by significant economic, financial and political volatility and vulnerability in the late 1990s and early 2000s. In the case of Argentina and Brazil, these crises also had significant systemic consequences for the region. Case selection is based on the most similar method of comparative inquiry, as this approach allows us to better capture how well the ICRG is able to detect the *emergence* of a crisis or, at least, its *nature*. Although in all three cases financial, economic and political factors are closely intertwined, the Brazilian crisis was primarily a financial one, while the Argentine crisis was an economic collapse rooted in a dysfunctional political system, and the Peruvian crisis was essentially a political one. Thus, the evaluation approach attempts to neutralize some exogenous variables related to the dissimilar character of country and historical contexts.

The article is structured in four substantive sections. The first section compares and contrasts the purpose and origin of commercial country risk ratings and non-commercial governance indicators, while the second one specifies the ICRG model. The third section examines the three country case studies of Brazil, Argentina and Peru. The fourth section draws tentative conclusions, underscoring the caveats of political risks analysis.

Country Risk Ratings and Governance Indicators

Assessing country risk and gauging the quality of governance in emerging market economies represent tremendous conceptual and policy challenges to both policy-makers and researchers, as well as to financial analysts and aid practitioners. Country risk broadly refers to the likelihood that a sovereign state may be unable or unwilling to fulfill its obligations towards one or more lenders (Krayenbuehl, 1985). Political risk refers to "those political and social developments that can have an impact upon the value or repatriation of foreign investment or on the repayment of cross-border lending. These developments may originate either within the host country, in the international arena, or in the home-country environment" (Simon, 1992:118). A primary function of country risk assessment is thus to anticipate with reasonable early warning the possibility of debt repudiation, default or delays in payment by sovereign borrowers.

The search for adequate indicators of governance performance and institutional quality has attracted considerable interest from a variety of sources. There now exists a wide variety of country risk ratings and indicators of governance performance. A first distinction between risk ratings and governance indicators concerns their *purpose.* Broadly speaking, there have been two main thrusts behind the articulation of such indexes. On the one hand, there is the need by international investment banks to better assess sovereign risk in order to mitigate the exposure to sudden reversals of investment conditions (i.e. measuring *risk* and exposure

to it). Traditionally, risk assessment in this context has been based on economic and financial indicators, but in recent years there has been an increased appreciation of the importance of also taking political indicators into account when assessing the overall risk of any emerging market economy. On the other hand, there is also the need by international financial institutions to assess the quality of governance to better target development assistance through increased selectivity (i.e. assessing *performance*).

Governance indicators
A second, yet related, distinction concerns their *source*. Non-commercial indices, such as Freedom House's indices of civil liberties and political rights or Transparency International's corruption perception index fulfill a different purpose embedded in the ethical values that they aim to promote. These indices are however riddled with measurement and comparability problems, which make them unsuitable for cross-temporal analysis. The widely used Freedom House data, for example, is not designed as a series; its scale changes over time. Similarly, Transparency International's corruption perception index is an un-weighted aggregate of several indices and surveys of corruption. The annual assessments do not include the same samples, which are enlarged as the exercise is repeated.

The Polity IV and Polyarchy datasets, which are often used to evaluate the quality of democracy, are much more accurate and refined measures of governance. Both are based on solid theoretical frameworks and consistent time-series going back to the early 1800's. Largely based on the ground breaking work of Ted Gurr, the Polity dataset evaluates the degree of democratization of a state by codifying four institutional dimensions with the objective of placing political regimes along a democracy – autocracy continuum. The index it generates is a combination of a democracy scale (political participation, competition, openness, and constraints on chief executive) and an autocracy scale (lack of competition, regulations of political participation, lack of competitiveness, and lack of constraints), each composed of four categories. The Polity dataset was originally constructed to test the durability of states (Gurr, 1974; Gurr, Jaggers and Moore, 1990; Jaggers and Gurr, 1995; Marshall and Jaggers, 2002).

Tatu Vanhanen's Polyarchy dataset covers 187 countries over the period 1810 to 1998 (Vanhanen, 2000). Vanhanen's index of democracy offers a measure of the quality of democracy assessing the degree of participation (measured by the percentage of voters as per the voting-age population) and competition (assessed by the relative weight of the ruling party), largely based on Dahl's concept of polyarchy (Dahl, 1971.) Vanhanen originally constructed the Polyarchy dataset to "explain the emergence of democracy" (Vanhanen, 2000:253).

These indices have contributed to shift the debate on "what democracy is ... and is not" (Schmitter and Karl, 1991) to qualitative assessments of the degree of democracy or the level of democratization, thereby conceptualizing democratization as a continuous rather than dichotomous variable. Vanhanen's index of democracy is a continuum while the Polity project adopts a scalar approach. They reflect a growing concern to better capture the nature of political regimes in the gray area between liberal democracies and overt autocracies. Consequently, however, they are also marred by problems of measurement and accuracy, as they are largely based on subjective measurements. (Gates al., 2001).

Risk ratings

On the other hand, the majority of risk ratings produced by private companies such as Fitch Ratings, the Economist Intelligence Unit (EIU), the Business Environment Risk Intelligence (BERI), Institutional Investor, Standard and Poor's Rating Group or Moody's Investors Services essentially serve a commercial purpose aimed at assisting investment banks in their portfolio decisions. Their primary aim is to assess the level of sovereign risk and their clients' exposure to it. Each of the rating providers must amalgamate a range of quantitative and qualitative information into a single index or rating.

For example, the Business Environment Risk Intelligence (BERI) provides two services: the Business Risk Service and the Forelend or Lender Risk Rating. Eighteen BERI analysts analyze various sources of country data and produce initial draft reports, which are submitted to a panel of experts. BERI relies on two permanent panels of some 150 experts worldwide for country ratings and qualitative observations based on the initial reports by the BERI analysts. One of the two panels assesses political conditions and the other provides perspectives on the business-operating environment. Similarly, the Business Risk Service (BRS) monitors 50 countries three times per year and provides assessment of 57 criteria in three separate indices: the Political Risk Index (PRI), the Operation Risk Index (ORI) and the R factor. The PRI relies on the ratings of diplomats and political scientists of six internal causes of political risk, two external causes and two symptoms of political risk. The ORI highlights major

obstacles to business development, and the R factor measures a country's willingness to allow foreign companies to convert and repatriate profits and to import production components and raw materials.

The Economist Intelligence Unit (EIU) provides analysis and forecasts of the political, economic and business environment in over 180 countries. In 1997, the EIU launched two quarterly publications: the Country Risk Service (CRS) and the Country Forecasts (CFs). These publications rely on a network of more than 500 information-gatherers for risk assessments, which are also checked for accuracy and consistency by a panel of regional experts. The CRS covers 100 emerging markets and provides risk ratings for seven categories of country risk: political, economic policy, economic structure, liquidity, currency, sovereign debt and banking sector. The political risk category is divided into two components: political stability, which examines whether the political scene is free of internal or external threats to security; and political effectiveness, which assesses the quality of governance. The CFs cover 60 countries and measure the quality of the business environment. They are designed to reflect the main criteria used by companies to formulate their global business strategies, and cover ten criteria.[2]

In the past few years, international financial institutions such as the World Bank and regional development banks have invested significant resources to assess the determinants of institutional quality, governance performance and economic growth, as well as the causality chains between these

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2. These are: the political environment, the macroeconomic environment, market opportunities, policy towards free enterprise and competition, policy towards foreign investment, foreign trade and exchange controls, taxes, financing, the labor market and infrastructure.

variables (IMF, 2003.) They are attempting to devise credible and reliable measures of governance by aggregating different datasets from different sources in order to reduce measurement discrepancies. The World Bank Institute (WBI) developed a dataset of aggregated governance indicators combining commercial and non-commercial indicators (Kaufmann, Kraay, and Zoido-Lobatón., 1999a and 1999b; Kaufmann and Kraay, 2002b.) This time-series dataset covers 175 countries since 1996. It constructed aggregate indicators of perceptions of governance, organized in six clusters corresponding to six basic dimensions of governance (Kaufmann, 2003; Kaufmann and Kraay 2002a.) The first two clusters are intended to capture the process by which those in authority are selected and replaced, and include indicators of "voice and accountability" and political stability. The next two clusters include indices measuring the government's ability to formulate and implement sound policies, assessing both government effectiveness (which include the quality of the bureaucracy and the credibility of government's commitment to policies) and regulatory quality. The last two clusters summarize the respect of citizens and the state for the institutions that govern their interaction, focusing on the rule of law and the control of corruption.

Indicators of governance performance have considerable influence on foreign aid policies. They are increasingly being used to determine the level of concessional lending and grant aid conceded to developing countries, especially low-income countries. In 1998, the twelfth replenishment of IDA resources introduced a performance-based aid allocation system (IDA 1988, 2001 and 2002). The IDA amended its guidelines to better gauge the quality of economic governance in recipient countries and its Country Policy and Institutional Assessment (CPIA) framework was expanded to take into consideration four indicators of institutional quality: accountable and competent public institutions, transparent economic and social policies and practices, a predictable and stable legal framework, and participation by affected groups and civil society.[3]

More recently, the World Bank and the Organization for Economic Cooperation and Development (OECD) launched an initiative to devise "second-generation governance indicators" with an emphasis on public sector governance and the search for objective and politically acceptable performance indicators (Knack and Kugler, 2002; Knack, Kugler, and Manning, 2000 and 2001.)

Nevertheless, although these sets of indicators originate from different sources and serve different purposes, they share common concerns. Assessing the level of sovereign risk and evaluating the quality of governance are indeed the two sides of the same coin. International financial institutions and private investment banks have increasingly relied on such indicators to evaluate economic and social progress and assess their exposure to country risk. Econometric regression analyses and cross-country studies have confirmed the linkages between good governance and economic performance, as well as between institutional quality and aid effectiveness (Burnside and Dollar, 1997 and 1998; World Bank, 1998;

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3. However, the CPIA is a survey of the Bank staff working in the country assessed, which cast doubts on its reliability and objectivity, as country-based staff tends to have a vested interest in increasing aid allocation to "their" country.

Collier and Dollar, 2001). New tools have been designed to capture specific aspects of governance and institutional quality with particular implications for foreign investment.[4] However, the process of identifying, selecting and specifying risk ratings and governance indicators is plagued with both conceptual challenges and political problems. More fundamentally, while tremendous progress has been achieved in recent years in refining governance indicators, allowing for a wave of cross-country econometric analyses, few indicators are available to assess long-term trends, as there exist few consistent time-series.

Critics have questioned the utility of trying to aggregate a wide range of factors into one single indicator to assess the risk potential in a specific country at a specific time. They have also argued that the statistical methods used in quantitative assessments of risk are based on the assumption that the analysis of past events may be used to forecast the future. This, they argue, is not necessarily true (Goldberg and Haendel, 1987). Such criticism notwithstanding, the ability to make an informed assessment as to the different components and level of risk in any one particular country, based on that country's economic, political, financial and social environment is critical for the multitude of international banks and multinational businesses operating around the world. Moreover, and

although political risk analysis is not foolproof, it can offer a guide for reducing some of the uncertainty in foreign political and social developments that may have an impact on foreign lending and investment (Harms, 2000; Simon, 1992). It is, nevertheless, important to be aware of the choices and assumptions underlying such indicators.

This study looks at the performance of all three ratings indices of the ICRG system as well as the composite rating index. The conceptual analysis, nevertheless, centers on the political risk rating, its most controversial component, in an attempt to discern its contribution as well as any problems associated with its use. Political risk analysis is indeed often based on qualitative indicators, reflecting perceptions or judgments by competent observers captured in survey data. While time-series data is usually lacking for testing causality, pooled data is subject to the problem of scaling across countries. Experts surveyed for qualitative assessments of political risk, moreover, sometimes allow their judgment to be clouded by preconceptions of expected events or by the influence of past events.

The ICRG Model[5]

The PRS risk rating system assigns a numerical value to a predetermined range of risk components, according to a preset

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4.   These include, in particular: the *Stability Index* devised by Lehman Brothers and the Eurasia Group (LEGSI) which assesses political stability and generates monthly country stability ratings for emerging markets; the *Opacity Index* (OI) of PricewaterhouseCoopers and Transparency International which aims to measure the degree of transparency of economic policy management, especially it affects foreign investment (PriceWaterhouseCoopers 2001); and the Global Competitiveness Report prepared jointly by the World Economic Forum and Harvard University, which computes a *Growth and Competitiveness Index* for 75 countries as an aggregation of a technology index, a quality of public institutions index (itself sub-divided into a contracts and law sub-index and a corruption sub-index) and a macro-environment index.

5.   This chapter draws extensively on PRS, 2001.

weighted value. Each scale is designed to give the greatest value to the lowest risk and the lowest value to the highest risk. There are three categories of risk components: political, economic and financial risk. The sum of the risk points assigned to each risk component within each risk category determines the overall risk rating for that category. The composite risk index is then calculated based on the three different risk categories according to a formula, where the political risk rating contributes 50 percent and the economic and financial risk ratings each contribute 25 percent. The data used for this study encompasses three countries, Argentina, Brazil and Peru, and spans from January 1990 to January 2002.

The risk rating categories
The main aim of the *political risk-rating* category is to provide an assessment of the political stability in a specific country at a specific time. The political risk rating is based on points, which are assigned to a number of components and sub-components as listed in Table 1. The maximum number of points is one hundred: the higher the total number of points, the lower the risk, and the lower the number of points, the higher the risk. The ranges of the different risk levels are described in Table 2.

   The first component of the *political risk rating*, government stability, attempts to capture the extent to which the government is able to carry out its policies as well as its ability to stay in office. A measure of socio-economic conditions is included in order to assess the socioeconomic pressures, which could constrain government action or fuel social discontent. The third component, investment profile, assesses factors affecting the risk to investment that are not covered by other political, economic and financial risk components. Data on external and internal

conflicts is included, as conflicts tend to have a disruptive impact on governance. Corruption is included in the model, as it is a threat to investment through its ability to distort the economic and financial environment, and reduce the efficiency of government and business, and as it introduces an inherent instability into the political process. Furthermore, estimates of the influence of the military on politics as well as of religion on politics are introduced, as these two factors might contribute to a reduction in democratic accountability. The law and order indicator assesses the strength and impartiality of the legal system as well as popular observance of the law. The ethnic tensions component is an assessment of the degree of tension within a country, which is attributable to racial, nationality or language divisions. Democratic accountability and bureaucratic quality, finally, are included to assess the responsiveness of government and the institutional strength and quality of the bureaucracy. The maximum value of the aggregate political risk rating is 100.

   The *economic risk rating* aims to provide a means of assessing a country's current economic strengths and weaknesses, and is composed of five standard components, widely used by most risk-rating agencies. These include: per capita Gross Domestic Product (GDP), real GDP growth, annual inflation rate, budget balance as a percentage of GDP, and the current account as a percentage of GDP. The maximum value of economic risk rating is 50. The *financial risk rating* provides a means of assessing a country's ability to finance its official, commercial and trade debt obligations. This category is made up of five components: foreign debt as a percentage of GDP, foreign debt service as a percentage of exports, current account as a percentage of exports, net international reserves in months of

Table 1.
The risk rating categories and their components

Political Risk Rating	Max	Economic Risk Rating	Max	Financial Risk Rating	Max
Government stability	12	GDP per capita (as percentage of average)	5	Foreign debt (as percentage of GDP)	10
Government unity	*4*				
Legislative strength	*4*				
Popular support	*4*				
Socioeconomic conditions	12	Real GDP growth	10	Foreign debt service (as percentage of exports)	10
Unemployment	*4*				
Consumer confidence	*4*				
Poverty	*4*				
Investment profile	12	Annual inflation rate	10	Current account (as percentage of exports)	15
Contract viability/expropr	*4*				
Profits repatriation	*4*				
Payment delays	*4*				
Internal conflict	12	Budget balance (% of GDP)	10	Official reserves (as months of import cover)	5
Civil war	*4*				
Terrorism/pol. violence	*4*				
Civil disorder	*4*				
External conflict	12	Current account (% of GDP)	15	Exchange rate stability	10
War	*4*				
Cross-border conflict	*4*				
Foreign pressures	*4*				
Corruption	6				
Military in politics	6				
Religion in politics	6				
Law and order	6				
Ethnic tensions	6				
Democratic accountability	6				
Bureaucratic quality	4				
Sub-total	**100**	Sub-total	50	Sub-total	50

Source: PRS, 2001.

imports cover, and exchange rate stability. The maximum value of the financial risk rating category is also 50.

Annexes 1 through 3 provide a graphical overview of the country risk profiles of the three countries under review for the period between January 1990 and January 2002. As shown in Table 2, the critical value below which the risk is deemed as high is 60 for the political risk rating, and 30 for both the economic and the financial risk ratings. The risk is viewed as very high at values below 50

Table 2.
Risk rating ranges

	Political risk	*Economic risk*	*Financial risk*
Very high risk	0 – 49.9	0 – 24.9	0 – 24.9
High risk	50 – 59.9	25 – 29.9	25 – 29.9
Moderate risk	60 – 69.9	30 – 34.9	30 – 34.9
Low risk	70 – 79.9	35 – 39.9	35 – 39.9
Very low risk	80 – 100	40 – 50	40 – 50

Source: PRS, 2001.

for the political risk rating and below 25 for the economic and financial risk ratings.

The composite risk rating
The composite political, financial and economic risk rating (CPFER) is calculated using the following formula:

CPFER = 0.5 * (PR + FR + ER)
PR = Total political risk indicators
FR = Total financial risk indicators
ER = Total economic risk indicators

The maximum rating possible is thus 100 and the lowest is 0. Again, the highest overall rating indicates the lowest risk and the lowest rating indicates the highest risk. Overall, the ratings may be assessed according to the categories shown in Table 3. As with the

political risk rating, the critical value below which the composite risk is judged to be high is 60.

Case Studies

The three case studies selected constitute critical moments of crises. The dictionary definition of a crisis is "a critical time of great instability and strain", or a "turning point," and that of risk is "possibility of loss or injury." The predictive powers of the ICRG model and its ability to detect tendencies towards such "critical moments" or "turning points" are assessed in light of three crises. First, the exchange rate crisis in Brazil and subsequent devaluation of the Real in January 1999 is examined, using monthly data for the three disaggregated risk ratings as

Table 3.
Composite risk rating ranges

	Composite risk rating
Very high risk	0 – 49.9
High risk	50 – 59.9
Moderate risk	60 – 69.9
Low risk	70 – 79.9
Very low risk	80 – 100

Source: PRS, 2001.

well as the composite risk rating, in order to determine how well the model identified the type of crisis and anticipated its emergence. Second, the debt default and political crisis in Argentina of December 2001 is examined. The Argentine crisis was an economic collapse rooted in the all-too-rigid economic model of the 1991 "convertibility law." The Argentine dysfunctional political system further compounded the economic and financial problems and eventually also collapsed. Third, the political crisis in Peru leading to and resulting from the flawed elections in April 2000, as President Alberto Fujimori vied for a third term in office but eventually went into exile, is also scrutinized.

Brazil's currency samba

Upon assuming office in 1995, President Fernando Henrique Cardoso set about deregulating the Brazilian economy (Roett, 1999). His successful Real Plan, introduced in 1994, shortly after his appointment as finance minister, managed to cut inflation and boost real incomes. His successes notwithstanding, plans to reform the public sector and the tax and social security systems, necessary for the restoration of fiscal balance and to improve industrial competitiveness, were met with strong opposition in Congress (EIU, 2001a).

The lack of fiscal reform left Brazil vulnerable to the effects of the 1997 East Asian financial crisis and the subsequent Russian crisis in 1998. As interest rates then rose sharply in September 1998 in defense of the exchange rate, the economy went into recession. An agreement with the International Monetary Fund (IMF) in November 1998 helped relieve some of the financial pressure. However, a corruption scandal in November 1998 involving three government figures close to the President increased political tensions and further

weakened the government's ability to carry out its policies. The legislature's rejection of one of the main measures in the IMF-supported fiscal adjustment package again created turbulence in the markets. The final straw was the debt moratorium declared by the state of Minas Gerais in January 1999 (EIU, 2001a). Attempts by the Brazilian Central Bank to fend off pressure on the currency failed, and the real was eventually allowed to float freely from 15 January 1999.

Though rising unemployment and falling real wages weakened the Cardoso government and caused a drop in the President's popularity, fears of steep increases in inflation and a deep economic recession proved baseless. Recent research has also revealed the impact of electoral cycles on financial markets' perception of economic and financial stability, which Juan Martínez and Javier Santiso (2003) aptly describe as a "confidence game." Moreover, some of the remaining measures of the IMF fiscal package were passed during the first half of 1999, and fiscal austerity combined with prudent monetary policy helped to stabilize the economy, and contained inflation. The adoption of the Fiscal Responsibility Law in May 2000 also helped restore confidence in the ability of government to reign in public finances and correct some of the excesses of the decentralized fiscal system. The recession lasted just nine months and recovery in output began during the fourth quarter of 1999 (EIU, 2001a).

As evidenced by Graph 1 below, the composite risk rating for Brazil dropped sharply in late 1998 and indicated high risk in early 1999. It went back up to moderate risk in late 1999, indicating an improvement in the overall risk indicators. It appears, nevertheless, that a warning of high risk surfacing only in early 1999 may not have been a sufficient indicator of the challenges

Graph 1.
Brazil: composite risk rating
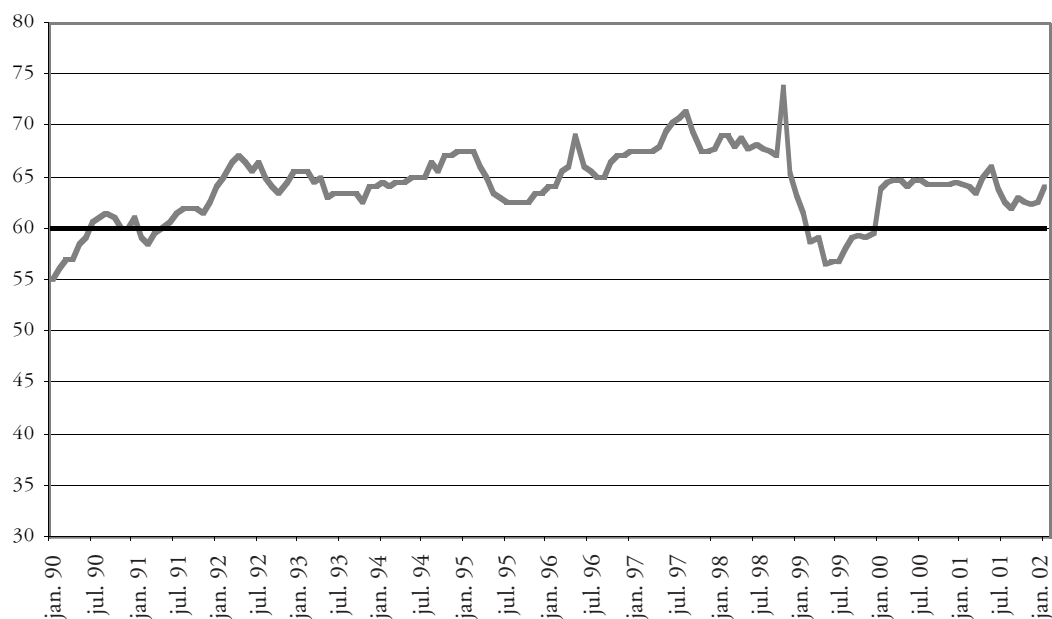
ahead and, more fundamentally, perhaps did not correctly reflect the underlying causes of financial vulnerability. Brazil's composite risk rating went below the 60 point mark (the level below which the risk is deemed as high) only during a brief period of time in 1999, descending from the lowest risk level ever attained by Brazil (almost 75 points) in late 1998. Annex 1 provides a graphical overview of the country risk profile of Brazil.

The Brazilian crisis was primarily a financial one, and the financial rating indeed dropped drastically, falling from a level of very low risk to indicating very high risk within a matter of months between late 1998 and the first half of 1999. The economic risk rating also started dropping sharply towards the end of 1998, displaying high levels of risk towards the first half of 1999. In the case of the economic and financial risk ratings, the bold horizontal line at 30 in the graphs indicates the level below which the risk is

deemed as high. Below 25, the risk is seen as very high, and above 35, the risk is seen as low. Looking at the components of the financial risk rating, several of the indicators would have been expected to indicate potential weakness. For instance, with increasing pressure on the Real, stemming from a perception of it as being overvalued, Brazil's trade balance suffered, and as the government attempted to buttress its fixed exchange rate in the face of increasing pressure, it eventually began losing valuable international reserves. The current account deficit had been growing but then started decreasing, following the devaluation of the Real in January 1999.

The political risk rating dropped somewhat at the onset of the crisis, but remained at the level of moderate risk. Looking at the different components of the political risk rating, government stability dropped somewhat, indicating greater risk, at the

beginning of 1999, but then strengthened toward the beginning of 2000, albeit at a lower level, indicating a structural deterioration of the quality of governance. The indicator on socioeconomic conditions dropped in December 1998 to a high-risk level and remained there until early 2001. One might nevertheless speculate on the relatively high score of Brazil's political risk rating (between 60 and 70 points throughout the 1990s), given the inchoate nature of its political system (Lamounier, 1999). Nevertheless, it appears that the ICRG model gave correct and relatively timely warning of the crisis and reflected the financial nature of the crisis.

Argentina's last tango

The financial crisis is Argentina in 2001–03 is an economic failure as much as a political one, due partly to the weakness of its institutions of governance (Schamis 2002; Pastor and Wise 2002; Santiso 2001b). After a prolonged recession, which had been exacerbated by the devaluation of the Brazilian real in 1999, the Argentine government finally defaulted on its US$132 billion debt at the end of 2001 (Feldstein, 2002; Schamis 2002; Mussa, 2002; Pastor and Wise, 2001). Economic problems had been growing for some time, causing social unrest, and finally led to the fall of the government of President Fernando De la Rúa on 24 December 2001. Soon thereafter, interim President Adolfo Rodríguez Saa declared a moratorium on Argentina's international debt. Rodríguez Saa nevertheless insisted that the Peso would not be devalued. The Peso, which, through the currency board, had been pegged at parity to the dollar for 10 years, was eventually devalued, and subsequently left to float freely. With 70 percent of all private debt denominated in dollars this was indeed a disaster for ordinary Argentines

(Wheatley, 2001). The economic woes of the country, and specifically of ordinary Argentines eventually spilled over and sparked a political crisis in late 2001, early 2002, with executive powers being handed over to three different interim Presidents following the fall of De la Rúa, until finally Senator Eduardo Duhalde was chosen to take office for two years.

Various factors have been blamed for the Argentine crisis, such as the rigid currency board, the deficit spending of Argentine politicians, and the vulnerability of political institutions. According to Hector Schamis (2002), however, these factors must be seen in the context of particularly unfavorable and volatile international conditions and a complicated domestic political process. The political institutions of democratic governance were highly fragile and vulnerable, after a decade of rule by executive decrees during the two consecutive presidencies of Carlos Saúl Menem in the 1990s (Waiseman, 1999; Santiso, 2001b). Moreover, Argentina had been experiencing recession for four years, which had eroded the fiscal base and weakened its ability to service the debt. In the context of the currency board, the government could not intervene with counter-cyclical policies to stimulate the economy and Argentina's debt repayment risk-index eventually became increasingly worse. This led to interest rate hikes and to further debt repayment problems. According to Schamis (2002), the crisis of 2001 had its roots in the early 1990s, when President Menem's political ambitions inhibited the establishment of sound macroeconomic policies and firm institutional foundations. Continued prioritization of political goals, coupled with an unfavorable external environment compounded the fragility of the Argentine economy.

International creditors began raising

Graph 2.
Argentina: composite risk rating
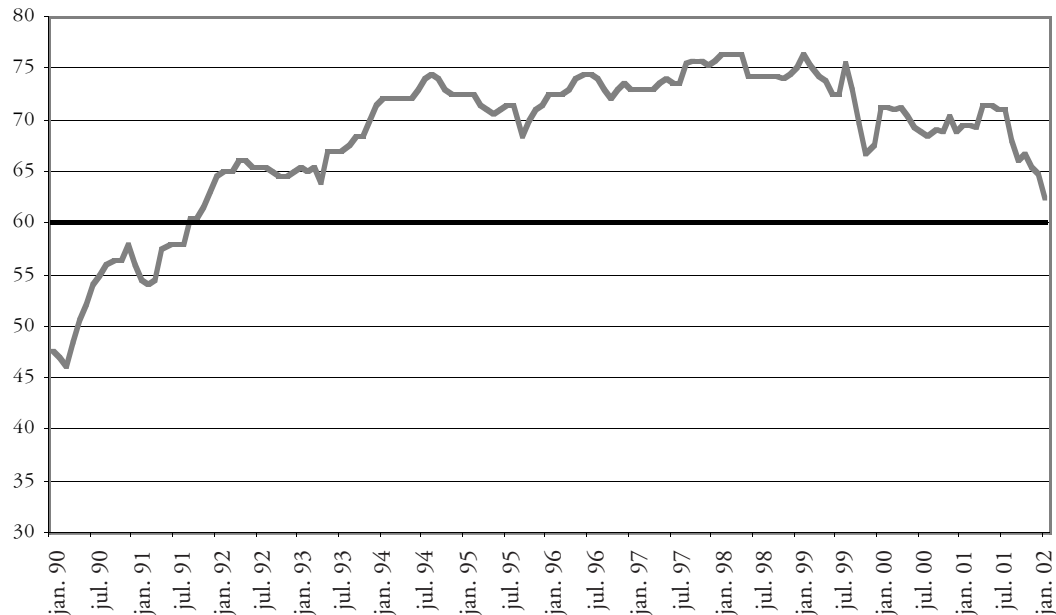
interest rates in the fall of 2000, further aggravating the situation. By the spring of 2001, Argentina was paying as much as 12 percent interest rates on much of its debt, even though by the summer of 2001 its ratio of debt to GDP and to exports was no worse than that of Brazil (Schamis, 2002:85). When the United States declared, in the spring of 2001, that there ought to be no bailout of Argentina, were it to get into more serious trouble, default became all but inevitable.

Looking at Argentina's composite risk rating in Graph 4 below, there appears to be no clear indication of a looming crisis. The composite risk rating started to decline only in mid-1999. In early 2001 the rating index even pointed to a low risk, with the composite rating during the months of January through May ranging from 69.5 (moderate risk) to 71.5 in May (low risk). Again, the bold horizontal line at 60 indicates the level

below which the risk is deemed as high. Below 50, the risk is seen as very high, and above 70, the risk is seen as low. Between January 1994 and mid-1999, Argentina was indeed considered low-risk.

The Argentine crisis was essentially an economic and financial one, but also sprung from latent political vulnerabilities. Annex 2 provides a graphical overview of the country's risk profile. Looking at the economic risk rating, several indicators were worsening in the years leading up to the crisis. Argentina had been in a recession for some time, and irresponsible, politically motivated spending patterns, in particular in the Provinces, had seriously undermined the budget balance. Moreover, a historically weak export sector left little room for an export-led improvement in the economy. In terms of the financial risk rating, Argentina's ability to service its foreign debt was increasingly undermined by the erosion of the fiscal base,

and as pressure on the peso mounted, international reserves continued shrinking.

The ICRG economic risk rating nevertheless stayed well above the high-risk mark and even indicates low-risk from January 2000 through the early half of 2001. It then dropped to moderate risk, but increased slightly (indicating somewhat lower risk) in January 2002. This seems somewhat counter-intuitive, as the components of the economic risk index, per capita GDP, real GDP growth, annual inflation rate, budget balance, and current account as percentage of GPD, should have been able to capture the imminent crisis. GDP per capita dropped from the onset of the crisis and real GDP growth was negative during much of 2001 and 2002. Moreover, the budget balance and current account indicators were also strongly negative. It would therefore seem that this indicator should have detected the problems and should have given some warning.

The financial risk rating appears, nevertheless, to have captured the coming financial woes, as Argentina's ability to service its debt became increasingly weak. Looking at the components of the financial risk rating, foreign debt as a percentage of GDP, foreign debt service as a percentage of exports, current account as a percentage of exports, net foreign reserves, and exchange rate stability, it is clear that virtually all of these indicators worsened. Argentina's financial risk rating, according to the ICRG model, dropped to a high-risk status in January 2000, from a downward trend initiated in late 1997. This high-risk warning remained until October 2001, when the rating increased to moderate risk, but then it dropped to high risk again in January 2002.

The political risk rating gave little sign of trouble ahead. Indeed, its is surprisingly flat from mid-1993 until mid-2001. Even as the government resigned at the end of 2001, and there appeared to be some difficulty even finding presidential candidates willing to stay in the job for any length of time, the political risk rating only indicated moderate risk. Looking at the components and sub-components of the political risk-rating index, there should perhaps have been some stronger indication of trouble. Government stability, with its sub-components government unity, legislative strength and popular support, was certainly questionable at best, while socioeconomic conditions, composed of unemployment, consumer confidence and poverty, were rapidly deteriorating. Corruption, moreover, has long been a significant concern in the Argentine context, an element that is only partially reflected in the ICRG model. The case of Argentina highlights the difficulty of the ICGR model to adequately capture the weaknesses of the institutions of governance in a democratic context. As the model tends to give significant weight to factors non-relevant to democratizing countries such as Argentina (the degree of internal and external conflict, military and religion in politics and ethnic tensions account for 42 percent of the political risk rating), the model thus encounters difficulty in accurately assessing the quality of governance in this type of regime.

Most analysts had expected Argentina's default to be relatively contained, since the country had warned the international community of its deteriorating economy during some time before its actual default. Investors thus had ample opportunity to reduce their risk and exposure. While the risk of crisis was reflected in the financial risk rating, the extent of its economic and political woes, however, does not appear to be correctly reflected in the economic and political risk ratings, leading the composite risk rating to

appear overly optimistic. According to the ICRG model, a poor rating in one of the risk categories may be compensated for by better ratings in the other categories. This certainly appears to have been the case in the ratings for Argentina, as the composite risk rating did not indicate significant risk, despite the high financial risk. There exists indeed a great risk of misinterpretation and mis-calculation of political risk in the ICRG model. As discussed above, disproportionate weight is given to certain indicators, which may not be very relevant in the case of Argentina, nor, indeed, in the other two case studies. Again, the problem of corruption is significant in Argentina, and this is not correctly reflected in the political rating, thus understating the importance of the problem and its consequences. The repercussions of this misjudgment are important, as the political risk rating accounts for half of the composite country risk rating.

Peru's Pisco sour

Fujimori came to power in Peru following the elections of 1990. Peru was then on the verge of economic and social collapse, following years of hyperinflation, and econo-mic mismanagement under the government of President Alan García, coupled with guerilla violence, which seriously damaged the country's infrastructure and undermined investor confidence. Fujimori introduced a radical stabilization program that removed price controls, froze public-sector wages and cut social spending. He managed to bring hyperinflation under control, but also led the country into a deep recession (EIU, 2001b).

Despite being highly successful in the fight against terrorism, Fujimori's in-creasingly authoritarian style of government soon became a liability (McClintock, 1999; Levitsky 1999). In April 1992, as the legislature began opposing his economic policies as well as his strategy against terrorism, he closed down Congress and suspended the judiciary, with the support of the military. Through the enactment of a new constitution in 1993, and by capitalizing on the damaged reputation of the traditional parties, he managed to strengthen centralism and enhance his own powers. Though he was reelected in 1995, he struggled to maintain his previous levels of popularity. Dissatisfaction with the govern-ment's abuses of power and with the many instances of corruption grew, and prompted protests in Lima as well as in the provinces. In December 1999, Fujimori announced that he would seek an unprecedented third term as president, and formed a new electoral coalition, Perú 2000 (EIU, 2001b). Throughout 1999, the administration made serious efforts to discredit anyone who was seen as a major threat to a victory by Fujimori (Conaghan, 2001). The opposition was highly fragmented and could not agree on a single candidate to oppose the incumbent. Nine opposition candidates eventually ran for the presidency, thus seem-ingly ensuring Fujimori's victory. In the final months of the campaign, however, oppo-sition support started to coalesce around one single candidate, Alejandro Toledo of Perú Posible. Toledo ran on a ticket of greater democracy and a continuation of free-market reforms.

President Fujimori won (or rather stole, as it was later confirmed) the first round of the April 2000 presidential election and eventually also managed to gain a con-gressional majority for his Perú 2000. It was, nevertheless, widely suspected that his victory was largely a result of a sophisticated electoral fraud, media manipulation, and intimidation. Toledo, moreover, withdrew his candidacy before the second round of voting, citing insufficient conditions for free

and fair elections (EIU, 2001b). The Organization of American States (OAS), which had been monitoring the electoral process, declared it to be flawed and withdrew its observation mission. Suspicions of wrongdoing by Fujimori and his entourage were confirmed in September 2000, when a videotape surfaced, showing Mr. Fujimori's security advisor and *de facto* head of the intelligence service, Vladimiro Montesinos, handing over US$15,000 in cash to a congressman elected under the Perú Posible banner, who subsequently defected to Perú 2000. The ensuing scandal led Fujimori first to call for new elections, and then to flee to Japan, from where he resigned as President. Congress chose an interim president, Valentín Paniagua, whose main responsibility was to prepare new elections in April 2001.

Peru's 2000 crisis was essentially a political one. The political risk rating included in Annex 3 reflects the low level of stability in government that lingered from the García years and which remained as Fujimori became increasingly authoritarian. From January 1993 onwards, as Fujimori openly resorted to authoritarian methods of government, the political risk rating started to improve, reflecting in particular Fujimori's successful strategy at taming internal conflict and achieve a greater degree of political stability, law and order. Towards the mid- to late 1990s, the political risk status was raised to a level of moderate risk, as opposed to the previous years of high or very high-risk levels, remaining largely flat throughout the late 1990s. The risk level nevertheless hovered around the 60-point mark, pointing to lingering structural vulnerabilities. In early 2000, the risk rating dropped again to a high-risk level, at the onset of the political turmoil surrounding the 2000 elections. Indeed, many of the components of the

political risk rating worsened at this time. The exposure of abuses of power and corruption scandals sent popular support for the regime dwindling and heightened instability. Increasing poverty rates in the run-up to the 2000 elections were also contributing to the lessening support for Fujimori. Furthermore, Fujimori's reliance on the military continued to be an element of concern. The fact that the ICRG model does capture the seeds of the Peruvian political crisis of 2000 also reflects the fact that this crisis was one of the most widely expected, and was foreseen by most analysts, as it developed gradually over the few years preceding it.

The level of political risk nevertheless seemed to have diminished in early 2000, reaching a moderate level in the spring of 2000, then dropping again briefly in late 2001. Following the elections in 2001, and the victory of Toledo's coalition, the political risk rating has been increasing, with only moderate or low risk levels. Any indication of tangible risk reflected in the political risk rating was not, however, reflected in the composite risk rating. As shown in Graph 4 below, the composite risk rating was well above the high-risk mark in 2000 and continued rising throughout the crisis. The economic and financial risk ratings both indicated low risk throughout the events of 2000, thus positively influencing the composite risk rating. Nevertheless, the political risk rating accurately captures the end of the "honeymoon" period immediately following the election of Toledo in mid-2001. Annex 3 showing Peru's country risk profile provides a graphical overview of the political, economic and financial risk ratings for Peru.

The comparison with 1992 is indeed instructive. The political crisis sparked by President Fujimori's *autogolpe* in 1992 was

Graph 3.
Peru: composite risk rating
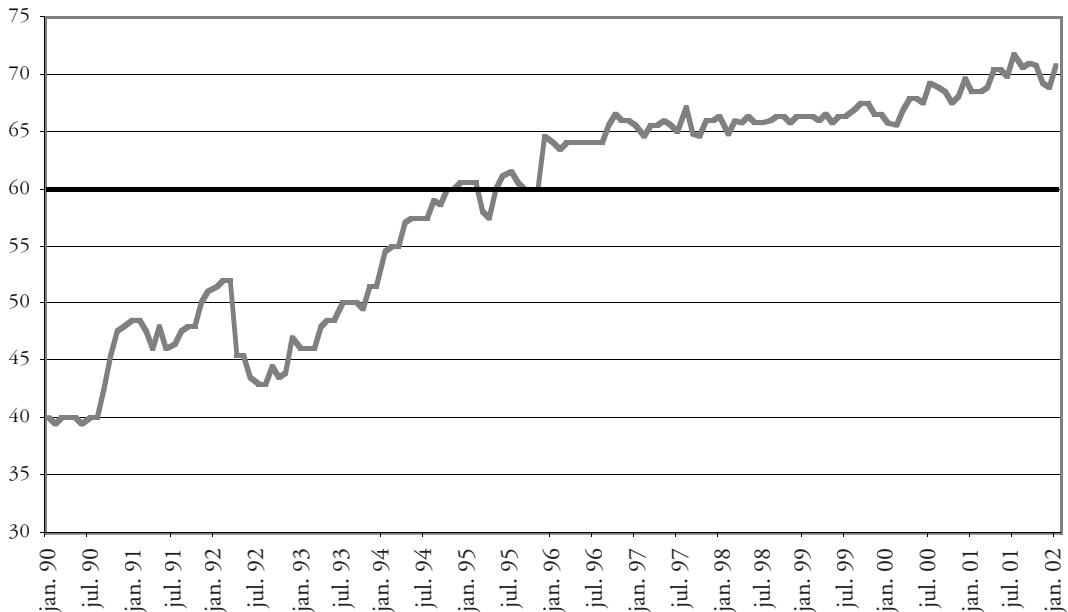
reflected in a sharp drop in the political risk rating of Peru. Political risk was already at a level of very high risk prior to the *autogolpe*, but subsequently dropped ten points to an abysmal level. This heightened level of crisis in 1992 was also reflected in the composite risk rating.

The composite risk rating nevertheless fails accurately to capture the risk level during the political crisis of 2000. Compensated by the economic and financial risk ratings, the ICRG overall risk rating for Peru throughout the crisis remains at a moderate to low level.

The case studies reviewed in this article show mixed results regarding the predictive powers of the ICRG model. The ICRG model did, in some cases, correctly discern the nature of an impending crisis and somehow predict it, but in at least one instance, the warning appeared to have

lagged behind actual events. In some cases, the model failed to accurately capture the warning signals of a crisis. A closer look at some of the sub-components of the ICRG risk ratings does show, moreover, that the political risk rating, which typically is based on survey data and individuals' perceptions, is particularly vulnerable to misinterpretation, as it appears to have reacted to actual events rather than predicted them. This finding thus leads us to question whether the political risk indicator of the ICRG model behaves more as a lagging indicator rather than a leading indicator of crises.

Tentative Conclusions

The conclusions of this study have important implications for policy and research: perceptions matter. Indicators of political risk and governance quality decisively influence the investment decisions of

multilateral corporations and banks. Furthermore, they increasingly guide the aid allocations of bilateral donors and international financial institutions. The study highlights the fragile foundations of political risks analysis and, consequently, the limitation of many cross-country econometric analyses that often assume as a given, the accuracy of the indicators of governance quality they use to infer other things.

The study briefly reviewed three instances of crisis to assess the predictive powers of the ICRG model. The case studies included three different types of crisis: an economic crisis (Brazil in 1999); a crisis which started out as a financial and economic one, but which soon expanded into a political and social one as well (Argentina in 2001-02); and finally a political and electoral crisis (Peru in 2000). The ICRG risk analysis model showed mixed results in highlighting the vulnerabilities leading to these crises. In the case of the Brazilian devaluation, the model did indicate a high level of overall risk, but only once the crisis had actually erupted. The economic risk rating indicated high risk in January 1999, the same month the devaluation was actually carried out. The composite risk index did not drop to a high-risk level until March 1999.

In the case of Argentina, the composite risk rating did not indicate any significant risk of systemic crisis. Despite a sharp drop in real GDP growth at the end of 2001, and despite decreasing levels of per capita GDP as well as an increasingly negative budget balance, the economic risk rating did not reflect the wider dimensions of the impending crisis. Nevertheless, the financial risk rating dropped to a high-risk level in January 2000, well before the onset of the crisis. As Argentina's ability to service its debt became increasingly weakened, the various components of the financial risk-rating

category were able to pick up the signs and pointed to a high risk early on.

The greatest shortcomings of the model originate in the political risk rating. Indeed, the ICRG model failed to capture the institutional roots of economic vulnerability and the political consequences of the economic collapse in Argentina. To the model's credit, it should be noted that few, if any, analysts predicted the dramatic political fallout of the Argentine crisis. Nevertheless, despite dismal performance in most of the indicators making up the political risk rating, the model indicated only a low level of risk until November of 2001, when it dropped to a moderate risk. As for the political crisis in Peru, the model did not indicate any overall risk, as the political risk was compensated for in the model by relatively low economic and financial risk. The political risk indicator, having remained at a level of high or very high risk from before the 1990s until the mid-1990s, dropped to a high level of risk again at the end of 1999. The dip was, nevertheless, quite small and brief.

The study reveals a number of flaws in the ICRG model. First of all, while it is certainly valuable to allow for comparability between countries, it is doubtful whether all components and sub-components of the risk categories are as relevant and of equal importance in all countries at all times. Consequently, it may be desirable to revisit relative rating-weights to better capture the systemic roots of political risk. Although the ICRG allows users of its ratings to alter the relative weights of indicators in order to adapt them to their own needs, the ICRG model and its forecasts are based on the weightings presented in this study, and may thus provide a somewhat skewed reflection of reality.

In the three countries studied, the indicators on internal and external conflict,

Graph 4.
Corruption in Argentina and Brazil
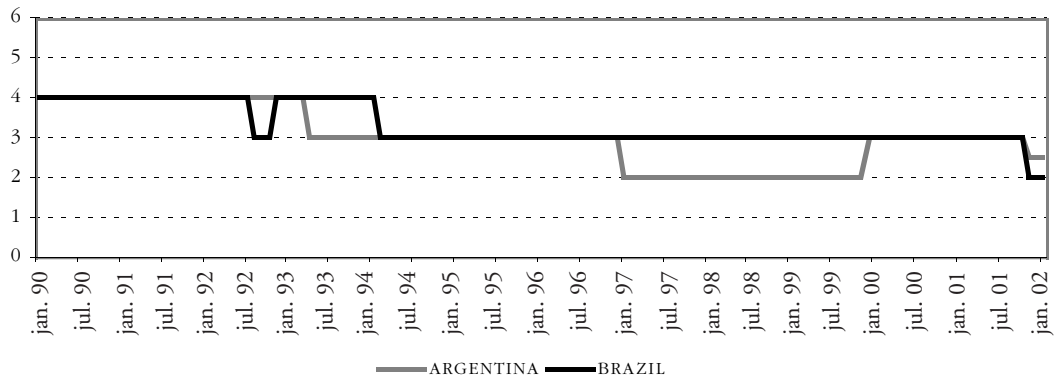
for instance, may not be as relevant for assessing country risk as they might be in other countries. In the absence of any major internal or external conflicts, these three countries would earn a high mark in these two categories, each accounting for 12 percent of the political risk rating. This might cause the political rating score to be unduly high, despite serious problems in other areas, such as corruption or the rule of law, which only account for six percent each.

Second, the ICRG model assigns 50 percent of the aggregate value of country risk to the political risk rating. This choice, which reflects the importance of political economy factors, may or may not be appropriate. It might nevertheless be challenged on the grounds that the political risk rating is the most subjective component of the country risk rating, as its sub-components typically are based on survey data and individuals' perceptions. The political risk rating might even arguably be a lagging indicator, reacting to developments in the economic and/or financial sectors. For example, the indicator of corruption for Argentina and Brazil appears quite generous and overly stable over time. Graph 4 below shows that, out of a

possible six points (six indicating the lowest level of corruption), both countries were awarded four points, indicating only moderate risk, for almost a decade without interruption.

Looking at the specific example of the impeachment of Brazilian President Collor de Melo in September 1992, on the grounds of corruption, it is clear that the model simply reacted to this event and had previously made an incorrect assessment of the level of corruption in Brazil. Though the news of the president's potential involvement in a corruption scandal broke in May of 1992, the model only downgraded Brazil's record on corruption in August, to a level of high risk. Presumably, the level of corruption in Brazil did not simply increase overnight, but rather the model failed correctly to capture the presence of systemic corruption.

Similarly, endemic corruption is a structural weakness of governance in Argentina. The autocratic tendencies of President Menem, and in particular his reliance on executive decrees, undermined the institutions of accountability and judicial checks and balances, especially during his second term in office (1995-99). This trend

is reflected in the downgrading of the ICRG corruption index throughout the 1990s. However, the election of de la Rúa in late 1999 and the alternation in power it entailed did not automatically lead to a reduction of structural corruption, as the upgrading of the ICRG corruption index in late 1999 seems to suggest. True, the fight against corruption figured prominently in the political agenda in 1998-99 in the context in the electoral campaign and, in December 1999, an anti-corruption office was created within the Ministry of Justice. However, the intrinsic weakness of the rule of law and the fragility of the mechanism of control in public finance have deeper roots, as indicated by the controversies surrounding the bankruptcy and "economic subversion" laws between the government and the IMF in early 2002 and the impeachment process of the Supreme Court initiated by the Argentine Congress.

Undoubtedly, further research is required to develop more robust methods to evaluate the accuracy of country risk models and their predictive powers. In particular, a more rigorous assessment of the quality of each component and sub-component of the ICRG model would be required to ascertain the predictive powers of each individual indicator. Yet, this study has shown the difficulty of the ICRG model to accurately capture the nuances of political risk in similar types of regime (in this case consolidating democracies in emerging market economies.) While such political risk models do reflect changes *of* political regime, they experience greater difficulty in capturing changes *within* a political regime.

Indeed, risk models tend to have great difficulty in capturing the quality of governance and the strength of political institutions in consolidating democracies in the gray area between overt dictatorship or conflict countries and liberal democracy. In

particular, they tend to inadequately assess the many realities of the wide spectrum of regime possibilities with a democratic label. While possessing the formal institutions of democracy, many new and restored democracies fail to anchor its behavioral principles and the modes of governance associated with it. Indeed, a wide array of semi-democratic or semi-authoritarian regimes has emerged, with an extensive "gray area" in between. Larry Diamond (1999) has aptly described this gray area as a "twilight zone".

New and restored democracies can adopt many shapes and shades, between the two extremes illiberal and liberal democracies (O'Donnell, 1994; Zakaria, 1999). Increasingly, democracy is used with adjectives to capture the reality of "hybrid regimes" struggling to consolidate (Collier and Levitsky, 1997). There is a pressing need to devise new categories for capturing the many realities and the great variety of hybrid democracies that have emerged since the late 1980s. Ultimately, these considerations question the intellectually elegant assumption of a linear "democratization continuum," from overt authoritarianism to liberal democracy. Some scholars have questioned the usefulness of the democratic transition and consolidation paradigm to describe the dynamics of democratization and guide policy (Carothers, 2002; Diamond, 2002; Levitsky and Way, 2002; Schedler, 2002, 2001 and 1998). While the assumption of "linearity" of the traditional democratic transition paradigm, reflecting a gradual and progressive movement towards democratic consolidation, is difficult to justify (Carothers, 2002; Diamond, 2002), a simple dichotomous distinction between democratic and non-democratic regime is even worse. Such dichotomies tend to be too broad and sweeping. As new and restored democracies struggle to consolidate,

concerns have gradually shifted from the relation between regime type and economic development to the intricate links between regime quality and economic performance, as the focus of reformers gradually shifts from first to second-generation market reforms (Pastor and Wise, 1999; Santiso 2004a and 2001c). This trend reflects growing concerns about the *effectiveness* of political institutions and the *credibility* of economic policymaking (Knack and Keefer, 1995).

While recognizing the utility and necessity of a means of assessing risk to minimize exposure to it, it is also necessary to acknowledge the limitations of country-risk models. Two conclusions can be drawn. First, such models must be recognized for what they are, that is analytical tools to inform judgment. Unrealistic expectations should not be placed on them and statistical analyses relying on them should be approached with caution. Second, further research is required to refine such tools and develop new ones. Major efforts are being deployed in this regard. Yet, the unavailability or unreliability of time series data is a major hindrance to our understanding of the dynamics of political change and governance reform *over time*, a shortcoming that will not be resolved before a generation when more accurate date will be available. In the meantime, the ICRG remains one of the few sources of such data.

Nevertheless, instead of further aggregating variables and constructing new ones, the academic and policy communities ought to examine more carefully how indices are constructed and the nature of their components. Risk ratings are highly sensitive to the specific combination of indicators used to obtain them, and it is thus critical to ask what lies behind the numbers used to make country forecasts. Political risk ratings may indeed be composed of subjective measurements, but they are critical to our understanding of the overall risk profile of a country. It is therefore essential to make explicit the underlying assumptions of such ratings and to consider the implications of their use.

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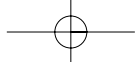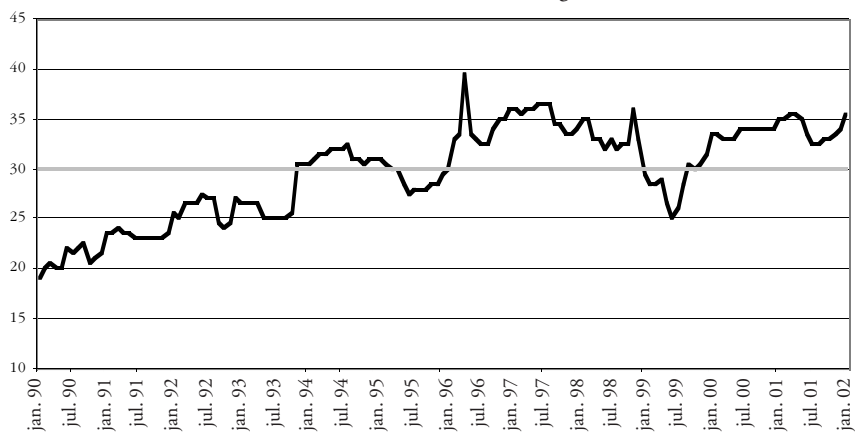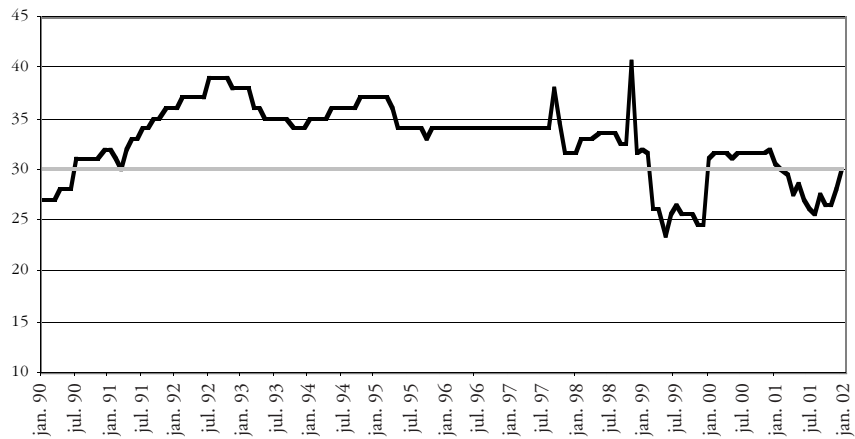
Annex 1: Brazil country risk profile
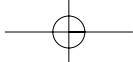
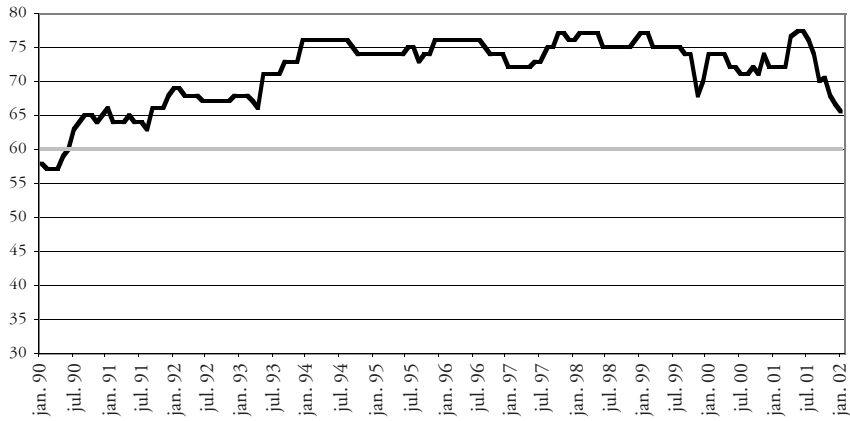Brazil: Political risk rating
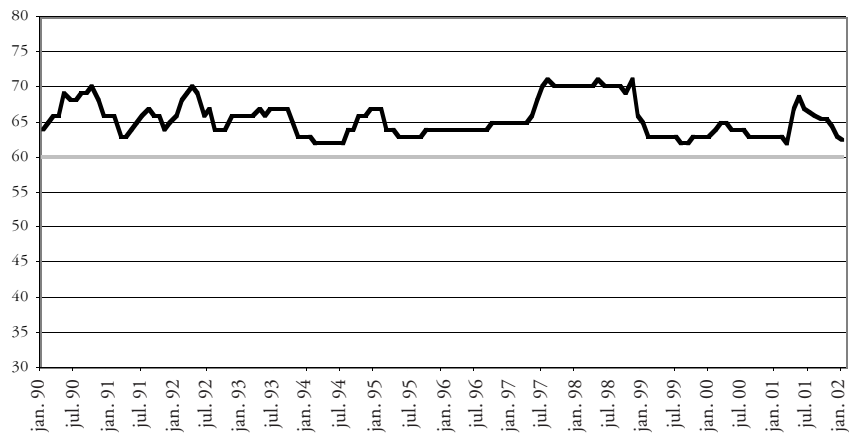
Brazil: Economic risk rating

Brazil: Financial risk rating

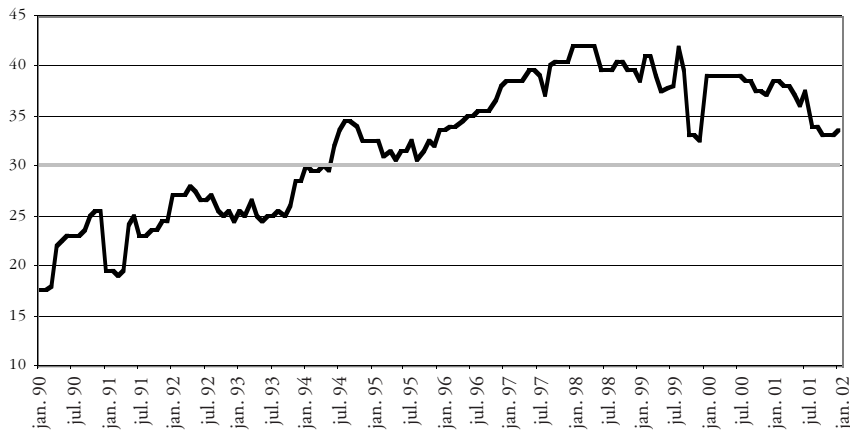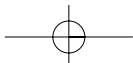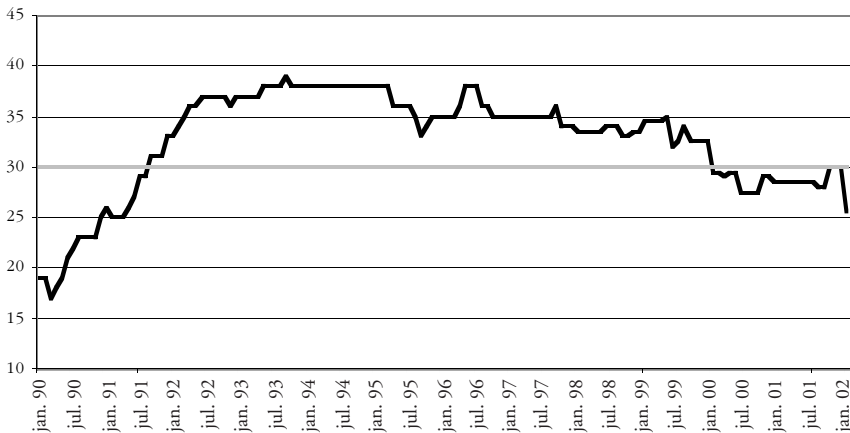## Annex 2: Argentina country risk profile
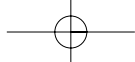
Argentina: Political risk rating

Argentina: Economic risk rating

Argentina: Financial risk rating

Annex 3: Peru country risk profile

Peru: Political risk rating

Peru: Economic risk rating

Peru: Financial risk rating