DAVID M. CURRIE

Country Analysis

Understanding Economic and Political Performance

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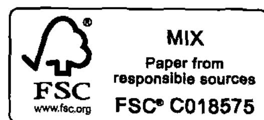

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Foreword

Why I Wrote this Book

After teaching finance and international economics for several years, I noticed two things. First, many students who had been trained in economics were well-versed in theory. They generally understood how a country was supposed to perform, at least under the idealizing assumptions of economic theory. However, if these same students were asked to analyze a country's performance, they were not as successful. They were not always able to apply the theory to actual circumstances.

The second observation was that executives, the readers of country reports from publications such as *The Economist* or *Financial Times*, frequently did not understand the reasoning behind the analysis. They would encounter terms such as GDP growth, inflation, and Current Account deficit, but either did not know what the term meant or didn't understand why the term was important. They saw the effects of all these variables on their business operations but didn't always understand the principles that caused what they observed.

There apparently was a disconnection between academic training in economic theory and the practice of evaluating the performance of a country. This book is an attempt to make that connection. It shows how to apply economic principles to evaluate the performance of a country. It thus extends the traditional economic curriculum into the realm of reality. At the same time, the book explains the principles underlying the analysis so that users of country analysis understand why the principles are important.

You won't find much theory in this book. There are plenty of economics texts that explain theory at various levels: to novice undergraduates, to advanced graduates, and to the general public. This isn't to imply that economic theory is unimportant. Just as you'll do better in finance if you have more exposure to accounting, you'll do better at applying economic principles if you're trained in the theory behind the principles. Who knows, perhaps reading this book will spur you to study economics if you haven't already, or bring back pleasant memories of your study of economics.

Two hundred years ago, economics was known as political economy because it was recognized that economic decisions were made in a political context. This book follows the same path. In fact, the book opens with politics not only because it is recognized as the major factor in country analysis, but also because governments adopt the economic policies that are the subjects of the remaining chapters. If you don't include government in risk analysis, you're omitting the major agent in macroeconomics.

Who Should Read this Book?

This book is oriented toward executives making investment decisions. In today's world, it is possible to invest beyond the borders of one country. But if that's the case, how do you decide where to direct your investment? What makes some countries more attractive and others less attractive? The investing decision is a tradeoff of risk relative to return, but how do you evaluate risk? This book is a step in that direction; it is about one of the major risks of investing globally: country risk.

A principle of investing is to diversify risk, which is the financial way of saying not to put all your eggs into one basket. Risk can be diversified in many ways, such as buying a variety of stocks rather than only one or buying bonds as well as stocks. In the modern world, diversifying increasingly means investing in other countries, something that has become possible only within the past few years. But investing globally creates other risks that aren't always apparent to investors accustomed to investing only in one country. This book is my attempt to identify and help you understand many of these risks.

In this book, you'll find four approaches that are not typical of most economic or investment books:

1. *Country Analysis* focuses on the analysis of economic and political information rather than on the derivation of theoretical principles. Most economics texts are filled with theory, so this is a departure from the norm.
2. *Country Analysis* has a global perspective throughout. Many people who study economic principles don't realize that the principles apply to other countries, not only in the United States or the United Kingdom or Japan. Because this book is intended for a US audience and I teach in a US business school, many of the background explanations relate to the US. However, the examples that illustrate the principles are drawn from around the world.
3. *Country Analysis* includes political and cultural aspects of economic decisions. Because governments create the environment in which investment decisions are made, investors should understand politics as well as economics. And because governments are part of the culture of a country, it is equally important to understand culture.
4. *Country Analysis* provides a frame of reference – the Washington Consensus – that allows us to determine whether a country's performance is good or bad. Economists traditionally don't like to make value judgments, but we won't shy away from the task. After all, it's your money, so you'd better have an idea about what is a good or a bad risk.

There have been other books titled Country Analysis. This one differs from almost all of them in at least two aspects. Some country analysis books are attempts by practitioners to write down some of the principles they used when making decisions about investing. In most cases, these attempts do not do a thorough job of explaining why the principles were used. It's one thing to say that a country with a government budget deficit equal to 15 percent of GDP is a risky investment, but it is more helpful to explain why a budget deficit is important when analyzing risk and what creates the deficit.

The other type of book about country analysis frequently relies on mathematics. Many of the principles of economics and finance can be expressed through mathematics. Although doing so is efficient, it limits the audience because many of us do not think in

mathematical terms. This book uses mathematics in a few places where necessary, but it doesn't use mathematics as a shortcut to explain principles.

Attributions

Numerous people have helped improve the final product. At the Crummer Graduate School of Business, Dean Craig McAllaster provided financial support as well as encouragement. Special thanks go to Prof. Serge Matulich and Prof. Frank Dasse for suggesting ideas for several topics and reviewing chapters. I am grateful to colleagues at Jurai Dobrila University of Pula, Croatia, for their discussions about many of the topics. Prof. Denisa Krbec let me share her office, leading to innumerable opportunities for discussion. Finally, the Fulbright Program encouraged me to enhance relationships with colleagues from other countries, which I have done enthusiastically.

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Contents

List of Figures and Tables *ix*
Foreword *xi*

Chapter 1 Global Investing **1**
Types of Investing 2
Country Analysis 5
Principles of Investing 6
Our Approach 12
Further Reading 13

Chapter 2 Economic Indicators **15**
Learning Objectives 15
Gross Domestic Product 15
Inflation 19
Per Capita Figures 23
Income Distribution 24
US Dollar Equivalents 25
Is Gross Domestic Product the Best Measure of a Nation's Health? 28
Unemployment 28
Interest Rates 30
Conclusion 32
Further Reading 32

Chapter 3 A Frame of Reference: The Washington Consensus **35**
Learning Objectives 36
A Brief Historical Background 36
The Washington Consensus 38
More Detail about the Criteria 40
The Principles in Action 52
Criticisms of the Washington Consensus 55
How we use the Criteria 57
The Consensus and the World Financial Crisis 58
Conclusion 59
Further Reading 59

Chapter 4 Evaluating Governance and Culture **61**
Learning Objectives 61
What do Governments do? 61
Why Institutions Matter 63

	Summary of Governance	75
	Why Culture Matters	75
	Summary of Culture	79
	Conclusion	79
	Further Reading	82
Chapter 5	**Evaluating Fiscal Policy**	**83**
	Learning Objectives	83
	Budget of the United States Government	83
	National Debt	93
	Economics of the Budget	95
	Budget Process in the United States	97
	Measuring Government Risk	100
	Conclusion	110
	Further Reading	111
Chapter 6	**Evaluating Monetary Policy**	**113**
	Learning Objectives	113
	What is Money?	113
	A Brief History of Banking	116
	The United States Central Bank	119
	What does a Central Bank do?	120
	How do the Policy Tools Work?	122
	What Happens at the Fed?	127
	Confidence	129
	How does the Central Bank Relate to the Treasury?	131
	Measuring Central Bank Risk	133
	Conclusion	134
	Further Reading	135
Chapter 7	**Evaluating International Transactions: The Balance of Payments**	**137**
	Learning Objectives	137
	The Importance of Reserves	138
	Accounts in the Balance of Payments	139
	Accounting Enters the Picture	141
	Balance of Payments as Flows	148
	Economic Implications of the Balance of Payment Figures	148
	Measuring Balance of Payment Risk	150
	Managing the Balance of Payments	153
	Confidence, Again	157
	Conclusion	158
	Further Reading	158
Chapter 8	**Currencies**	**159**
	Learning Objectives	159
	What is an Exchange Rate?	159

	Purchasing a French Government Security	162
	Appreciation and Depreciation	163
	Why do Exchange Rates Change?	166
	Exporters and Importers	176
	Predicting Exchange Rates	180
	Conclusion	182
	Further Reading	182
Chapter 9	**Managing Currency Risk**	**183**
	Learning Objectives	183
	The French Security Investment	183
	Hedging Currency Risk	184
	Is Hedging Always Necessary?	196
	What Happens to Risk?	196
	Derivatives	197
	The 2008 Financial Crisis	199
	Conclusion	202
	Further Reading	203
Summary of Risk Measures		**205**
Index		*207*

List of Figures and Tables

Figures

2.1 Treasury yield curve, 1/7/10 31
4.1 World Governance Indicators for United States, 2003 and 2008 65

Tables

2.1 United States gross domestic product, 2006 and 2007 (billions of dollars) 18
2.2 Rates of inflation for selected countries, 2006 20
2.3 US nominal and real GDP, 2006 and 2007 23
2.4 Rates of inflation and economic growth for selected countries, 2006 23
2.5 GDP per capita, domestic currency in constant prices, 2000 and 2006 24
2.6 Indicators of income distribution 25
2.7 GDP per capita in USD using exchange rates and PPP, 2006 27
2.8 World's largest economies in USD ranked by exchange rates and PPP, 2007 27
2.9 Top ten and bottom ten countries in Human Development Index, 2007 28
2.10 Standardized unemployment rates, March 2008 29
2.11 Results of US establishment and household surveys, March and April 2008 29
3.1 Summary of sovereign ratings criteria 55
4.1 Corruption Perceptions Index, 2009 67
4.2 Global Competitiveness Index, 2009 70
4.3 Index of Economic Freedom, 2009 72
4.4 Freedom in the World, 2009 73
4.5 Ease of Doing Business, 2009 74
4.6 Hofstede's cultural dimensions 77
4.7 GLOBE cultural dimensions: Society practices 80
5.1 US Federal receipts and outlays by major category, 2000–2002 84
5.2 General government revenues and spending, 2000 86
5.3 US tax rate schedule, 2006 88
5.4 Spending purposes as percent of GDP, 2003 90
5.5 US Federal debt at end of fiscal year 94
5.6 Who owns the US debt? 95
5.7 2009 Fiscal stimulus as percent of GDP for selected countries 99
5.8 US GDP components, 2000 to 2002 101
5.9 Government outlays as percent of GDP for selected countries, 1995 to 2005 102
5.10 US budget receipts and outlays, 1995 to 2005 103

5.11 General government surplus or deficit as percent of GDP, 1995 to 2005 104
5.12 US Federal debt as percent of GDP, 1995 to 2005 105
5.13 General government gross debt in percent of GDP 106
5.14 External debt ratios for selected countries 110
6.1 Yearly change in consumer price index, selected countries 133
6.2 Comparison of growth rates of money supply to real GDP 134
7.1 International trade in selected countries, 1980 and 2000 138
7.2 Illustration of Current, Financial and Reserve Accounts 140
7.3 Balance of Payments, United States, 1999 and 2000 143
7.4 US international investment position, end-of-year 2000 148
7.5 Current account surplus (deficit) as percent of GDP for selected countries, 2002–2006 150
7.6 External debt and debt service ratios for selected countries, 2007 153
8.1 Exchange rates for the US dollar against selected currencies 161
8.2 Return to US investor on a three-month French BTF 165
8.3 Prime rates in selected countries 172
8.4 Spot and forward rates of US dollar against other currencies 172
8.5 Currency risk facing a US importer 177
8.6 Currency risk facing a US exporter 178
9.1 Spot rates for US dollar 184
9.2 Return to US investor on a three-month French BTF 185
9.3 Forward rates for the dollar 187
9.4 Return to US investor using forward hedge 188
9.5 Currency futures 191
9.6 Return to US investor using futures hedge 191
9.7 Currency futures options 193
9.8 Return to US investor using futures options hedge 194
9.9 Citigroup derivatives position, 12/31/2008 198

CHAPTER 1 Global Investing

When you have a spare moment to think about globalization, what comes to mind? Do you think of the flood of imports from China, explaining why you see "Made in China" on everything from clothing to toys to housewares? Do you think of outsourcing jobs to Mexico or India, where labor rates are lower than in the US? Or do you think of the money you save as a consumer by purchasing less-expensive imports, or the fact that your company can survive a little longer by lowering labor costs?

These are all aspects of globalization, both the good and the bad. But there is another aspect of globalization that many people overlook: the ability to invest in almost any country around the world. Globalization is breaking down many of the barriers that previously prevented investing, or at least limited it to a few major companies with a global reach. Now even common folks like you and me can invest in another country, sometimes directly, sometimes through a financial intermediary that specializes in the process.

Look at firms catering to average traders, such as eTrade® or Charles Schwab® to see how they make it possible to invest globally. If you prefer to rely on others to do the research and trading, you can still invest globally through mutual funds such as Franklin Templeton Investments® or exchange-traded funds such as Wisdom Tree®, just to pick two whose ads have appeared in periodicals recently. At any of these locations, you will find the ability to either purchase assets (shares, bonds, real estate) in another country directly or invest in a fund that will do it for you. Globalization has made it easier to invest abroad. In fact, many investment advisors encourage investing abroad, as you will read in Box 1.1. Even after the global financial crisis of 2008, financial advisors suggested keeping a portion of an investor's portfolio in international assets.

The ability to invest abroad doesn't mean you know what you're doing. Ability doesn't equal knowledge. Just because the day is approaching when you can invest anywhere around the world, it doesn't mean that you know where the right places are to invest. There are myriad issues to consider. Which countries have a climate favorable for foreign investors? Which countries create growing, thriving markets that will enable firms within the country to prosper? Which countries experience economic fundamentals that enhance or at least don't diminish the return on your investment? Which countries have stable political regimes and policies that help ensure the safety of your investment? Which countries allow you to take your money out when you liquidate your position?

Notice that all the questions focus on a country's environment for investing. Financial advisers and books about investing usually have plenty of advice about which are the right firms or industries in which to invest. But in a global investing environment, understanding countries and their governments are equally important. Governments create the climate that attracts or repels investment from abroad. This book is about the interplay between economic and political forces and how they determine the climate for investing in a country. It is part of a process called *country analysis*: the process used by potential investors to analyze the political, economic, and cultural environment of a country.

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Box 1.1 Invest globally

For years, investment advisers and securities managers have encouraged United States investors to look beyond United States borders. In the mid-2000s, when markets were booming domestically and abroad, fund managers recommended investing 10 to 20 percent of a portfolio overseas.

One argument was that overseas securities markets were performing better than United States markets. For example, one index of stocks in developed countries provided a 23.3 percent annual return to United States investors for the five years from 2002 to 2007. A similar index for developing countries returned 46.5 percent. During the same period, an index for the United States market returned 12.8 percent annually.

Another argument was that the United States dollar was depreciating steadily against many foreign currencies. Although it sounds counter-intuitive, a weakening dollar actually increases returns to United States investors. When you cash out your foreign investment, that currency is worth more United States dollars, so you get not only the market return but an additional return due to that currency's appreciation. Dollar depreciation is one reason why returns on the overseas indexes were so high during the five years.

Even after the financial crisis of 2007 and the recession of 2008 led to declining markets worldwide, market pros continued to recommend foreign securities as part of an investing portfolio. One bond analyst recommends 10 to 40 percent of a portfolio in overseas bonds, which is consistent with the pre-recession weights. Regardless of economic conditions, investing outside the home country is a reality.

Sources: Ian McDonald, "Forget Xenophobia: Go abroad for gains", *Wall Street Journal*, Mar 6, 2006, p. R1; Karen Hube, "Going global: How do you get there from here?", *Wall Street Journal*, Sep 8, 2008, p. R1; Jennifer Levitz, "Why foreign bonds make sense for income-oriented investors", *Wall Street Journal*, Dec 8, 2009, p. C9.

Types of Investing

Of course, this idea of investing globally is not new. Big corporations have been doing it for years and continue to do so. In fact, the principles of country analysis were developed decades ago by oil companies and commercial banks as part of their global expansions.

You're familiar with one type of investing because it frequently makes the news: investing done by large corporations. When Belgium's InBev purchased Annheuser-Busch, the US's largest brewery in 2008, it seemed like an American institution was passing. When China National Offshore Oil Company, a firm partially owned by the Chinese Government, wanted to purchase Unocal, one of the US's largest oil companies in 2005, it set off such a brouhaha that the US Government nixed the sale. The same reaction didn't occur seven years earlier when BP, a British-Dutch oil company, purchased Amoco, another of the US's largest oil companies; that sale was allowed. It's obvious that governments play a role in investing, even in the US.

A variation on this type of investing occurs when a foreign enterprise builds a new facility in a host country. In 2009, Toyota Motor built its eighth North American manufacturing facility, this one near Tupelo, Mississippi. A decade earlier, Mercedes built a manufacturing plant in Alabama. BMW built a plant in South Carolina a few years before that. Of course, US auto manufacturers such as General Motors and Ford have made similar investments in other countries. Now foreign manufacturers are returning the favor.

Economists have a term for these two investments: direct investment. *Direct investment* occurs when a foreign organization builds a facility in a host country or buys controlling interest in a host company. This is the style of investment that has been occurring for a century or more. Some countries welcome direct investment, while other countries discourage it.

Another kind of investing, *portfolio investment*, occurs when foreign investors purchase securities such as stocks or bonds. Portfolio investment is a more recent phenomenon that has blossomed in the past two or three decades. In the old days, many countries had what were termed closed capital markets: governments of those countries adopted policies that either limited investment to locals or discouraged foreign investment by limiting inflows or outflows of cash. Or else the countries were not sufficiently developed that they had stock or bond markets. In the past few decades, more countries have developed capital markets and even more countries have relaxed limitations on inflows and outflows of capital, so portfolio investing has increased globally.

At the same time, there were few mechanisms through which investors in one country could purchase securities in other countries. Virtually all of the investment was by large financial institutions rather than by individual investors. But over time, financial institutions developed mutual funds and exchange-traded funds that made it possible for smaller investors to invest abroad. It's also possible to bypass domestic financial intermediaries and go directly to an intermediary in another country to invest. We can invest directly in some other countries by opening an account at a brokerage firm in that country.

All of these changes – creation of capital markets, removal of restrictions on investing, and enabling small investors to invest in other countries – have created a global market for securities, as you will read in Box 1.2.

The upshot of all this is that smaller investors like you and me are gaining the ability to invest globally, either directly or through financial institutions. And the investments are not simply in securities such as stocks and bonds. We can purchase currencies, real estate, corporate stocks and bonds, government bonds, and even exotic investments such as derivatives.

Thomas Friedman calls this trend the "democratization of finance." Power is moving toward the individual and away from large institutions. A financial cold anywhere in the world (but particularly in the US) causes sniffles throughout the world. If you doubt that, look at the effect of the US mortgage meltdown in 2007, the subsequent financial crisis in 2008, and the global recession in 2009. As you read Box 1.3, look for evidence that investing has become easier for individuals and that the variety of investments has expanded.

Box 1.2 Global investing involves risk

Although investing globally makes sense, it is not without risks, and the risks are of a different type from investing domestically. *Business Week* began an article with this sentence: "Seek profit from strong economies in emerging markets, where demographics and government policies are driving impressive growth." That sounds simple enough, but how do you identify a strong economy? What demographics drive growth? What government policies promote economic growth and make your investment safer or riskier? Those issues are the topic of this book.

As developed countries become more closely integrated, their markets tend to move together. To increase returns, investors begin to move to less developed countries – known as frontier markets – where markets present both the potential for higher returns but also increased risk.

Here are some of the risks that we will discuss in this book:

- Credit risk: lending to a foreign government exposes you to risk that it won't pay you back. How do you determine when a government is a good or bad credit risk, or when it has policies that protect your investment? We'll cover these in Chapters 4, 5, and 7.
- Inflation: high inflation in the foreign country potentially reduces your return because it devalues that currency. How do you tell whether a central bank is credible? We cover this in Chapter 6.
- Currency exposure: the return you earn from investing abroad magnifies when the foreign currency appreciates. What indicators help you forecast whether a currency will appreciate or depreciate, and how do you protect against the currency moving the wrong way? We cover these in Chapters 7, 8, and 9.

Other risks tend to focus more on markets than on the environment for investing, so we don't go into detail about these risks:

- Volatility: markets in frontier countries are generally more volatile than are markets in developed countries. The investment's value goes up or down quickly, and sometimes the changes are drastic.
- Liquidity: frontier markets aren't as liquid as in developed countries, so it's not as easy to bail out if you need to exit quickly.
- Correlation: returns in frontier markets are not as closely correlated to returns in developed markets, so there is greater advantage in diversification.

Sources: Ben Steverman, "The action stays offshore", *Business Week*, Dec 28, 2009, p. 60; Ben Levisohn, Tara Kalwarski, "Cashing in on foreign debt", *Business Week*, Jun 29, 2009, p. 56; Jeff D. Opdyke, "The Street's rush into far frontiers offers big game and bigger risks", *Wall Street Journal*, Jun 16, 2008, p. C1.

Box 1.3 Investing possibilities are endless

If you want to invest overseas, there is no end of ways to do it. Thanks to globalization, you can buy securities directly in many countries. If securities aren't your bag, you can purchase real estate in a foreign country. To do this kind of investing, you need to have a certain amount of expertise, so this book helps.

If you don't know anything about the bond market in Moscow, Russia or the stock market in Zagreb, Croatia and choose not to make the decisions yourself, you can invest in Wall Street funds that achieve the same purpose. Mutual funds and exchange-traded funds offer portfolios oriented toward overseas bonds, overseas stocks, securities from developed countries or from developing countries, or combinations of any of the above. If you don't know anything about real estate abroad, find a Real Estate Investment Trust that does.

Of course, executives in multinational corporations regularly make decisions about expanding into foreign countries. Their access to information is different from what you have, but the process they follow and the factors they consider are similar to the factors discussed in this book. They also contend with the same risks that we discuss. For example, Wal-Mart spent more than $5 billion in 2009 as part of its international diversification strategy. It operates more than 3,700 stores in 14 countries, and it faces the same risks that were covered in Box 1.2. You have more in common with Wal-Mart than you think.

Sources: Jane J. Kim, Aaron Lucchetti, "Jumpy investors gain reasons to look ahead", *Wall Street Journal*, Mar 27, 2007, p. D1; Eleanor Laise, "Why venturing abroad still makes sense for fund investors", *Wall Street Journal*, Feb 2, 2009, p. R1; Jeff D. Opdyke, "Real-estate investors head overseas", *Wall Street Journal*, Jun 21, 2007, p. D1; Miguel Bustillo, "After early errors, Wal-Mart thinks locally to act globally", *Wall Street Journal*, Aug 14, 2009, p. A1.

Country Analysis

When large institutions did the investing, they developed contacts to help them collect economic and political information about the target country and processes for analyzing information once it was collected. Collecting timely, reliable information has always been a formidable task. Big institutions had the resources necessary to obtain information about economic growth, inflation, incomes, trade flows, government policies, and underlying social currents. Once they had the information, institutions had the staff to analyze the risk of investing in the target country. Even so, analyzing risks of investing was "more an art than a science," according to Ronald Solberg. There was no standardized methodology for evaluating risk.

The world changed with the development of the Internet. Information became available at low cost to anyone with the wherewithal to find it. Governments, who collect and disseminate the information, learned that it was to their advantage to provide information in a timely manner. Suddenly, you and I can find a country's rate of economic growth or inflation, or get wind of changes in government policy by typing a few keys as part of an Internet search.

One thing that individuals didn't have was a process for analyzing the information once we had it. Most of us don't possess the expertise to interpret detailed economic information, and we don't have a framework to tell us what differentiates good performance from poor performance. That's where another link in the chain helps.

During the 1980s, at about the same time the Internet was developing, an analyst at a Washington think tank summarized the criteria that institutions such as the International Monetary Fund (IMF), the World Bank, the US Treasury, and several other major lenders used to help them identify good credit risks. John Williamson called these criteria the Washington Consensus. Among the criteria were: whether the government or the free market determined what went on in a nation's economy, the extent of government control over interest rates, capital flows and exchange rates, the level of corruption in the government, and whether the government adopts sound economic policies.

Over the next decades, investors around the world adopted elements of the Washington Consensus – knowingly or unknowingly – because it provided a framework to use in evaluating the economic and political performance of a country. Maybe everyone didn't agree on all of the elements of the Washington Consensus, but investors used many if not most of the criteria because they made sound economic and financial sense.

So we have almost the perfect storm that affords everyone the ability to collect and analyze information to help them invest anywhere around the globe. Governments produce information on a more-timely basis, the Internet allows us to collect the information at relatively low cost, and the Washington Consensus provides a framework through which we can analyze the information we obtain. The stage is set for global investing to flower.

The trick is to know what the information means. Statistics become meaningful only when there are guidelines to help us interpret what they mean. The Washington Consensus provides the standard by which to evaluate the statistics, but even then we must understand how the statistics influence the decision to invest. This book will help us understand the information so that we can discriminate between country environments that promote investment success and those that impede success.

Both direct and portfolio investors use the criteria of the Washington Consensus when making the decision to invest. Some of the criteria may carry more weight for one type of investment than for the other, but all of the criteria are important. Thus, this book matters for investors in real assets such as buildings and factories as well as for investors in financial assets such as stocks and bonds.

Principles of Investing

Finance theory incorporates several principles that help guide the investment decision. We will discuss several principles, emphasizing the ones that relate to country analysis. For a more comprehensive introduction to investment principles, you may wish to refer to a finance textbook or tradebook.

RETURN ON INVESTMENT

What is a return on an investment? Suppose you have an opportunity to purchase a security for $100. You anticipate that in one year the security will be worth $110. If you

make that investment, you will receive a $10 profit on an investment of $100, so you get a return of $10/$100 = 10 percent. The *return on investment* consists of the increase or decrease in value compared to the original investment; the return on investment usually is expressed in percentage terms.

Notice that the return could consist of a decrease in value. Reality may not turn out according to what you anticipate. If the security instead is worth $90 in one year, your return on investment will be $-10/$100 = -10 percent. You lost money on that investment, so your return was negative.

Obviously, it matters what kind of security you invest in. If the security is a corporate stock, there is a real possibility that the value in one year may be different from what you anticipate. Stocks don't have any guarantees about what the future price will be, so they entail more risk. Stocks are called equities because you own a share of the equity of the corporation. You gain or lose according to the market's perception of the value of your share in the profits or losses of the corporation.

Or the security may have been one-year debt obligation issued by the same corporation. Debts are different from equities because you don't own a share in the profits or losses of the corporation. Instead, you get an assurance that the corporation promises to repay you $110 in one year. Now you're breathing easier because you have a promise that you will receive a 10 percent return on your investment.

Unfortunately, the promise is only as strong as the organization that issues the promise. Corporations occasionally experience financial difficulty and are unable to repay the debts they have incurred, as investors learn during a recession. Even governments sometimes have difficulty repaying debts, so a government that shows an ability to repay its debts is safer than a government that is in danger of not repaying its debts. Discriminating between the two is where analysis comes in.

RISK VS. RETURN

The most basic principle is that investors measure at least two dimensions: the return they expect to earn from the investment and the risk associated with the investment. Comparing investments based solely on their expected returns gives a misleading view of the spectrum of investments because it ignores risk.

Think of investing in securities in the US. Securities include bonds issued by the US Treasury, bonds issued by the governments of 50 states and thousands of political subdivisions such as cities, counties, airport authorities, and other municipal agencies, bonds issued by corporations, and common and preferred stocks issued by corporations, just to name the obvious types of securities.

Now think for a moment about the risk of each of those securities: Is there a market where the securities are traded, so you can buy and sell the securities whenever you wish? Is there a chance that the issuer of the security will not be able to pay interest or principal on bonds or dividends on stocks? Is the issuer in a growing or a dying industry or market? Has the issuer borrowed too much in the past so that it might not be able to repay new borrowing? It should be obvious that securities differ in each of these, and perhaps other, aspects of risk. Ignoring the risks would mark you as a naïve investor indeed!

The basic principle is that, if the risk between two investments is the same, an investor will choose the one with the higher return. The principle applies in the other direction,

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