



# SK



SKEMA BUSINESS SCHOOL  
**COUNTRY RISK ANALYSIS**  
 Republic of Solvenia and the International Capital Markets  
 Eurobond Request to Casino Bank

**Michel Henry Bouchet**






## WHAT IS RISK ABOUT?

- ▶ Risk stems from a situation of uncertainty regarding the near or long term, where information about the situation's outcome is insufficient, lacking or simply wrong
- ▶ Information availability is, in itself, a measure of risk (BOP, debt data, transparency...)
- ▶ Information scarcity then requires taking action that might produce negative and costly consequences (investigation time, transaction cost, delays, wrong decisions...)

## THE « DISCOVERY » OF RISK



Pascal 1654



Fermat 1654



1703

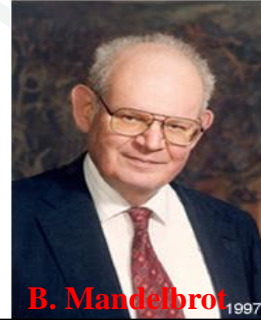
Leibniz



Markowitz 1952



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M. Scholes 1997



B. Mandelbrot 1997

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## RISK & UNCERTAINTY

► **Frank Knight:** 1921 Risk stems from **outcomes that are unknown** but can be tackled with probability distribution....  
Uncertainty stems from a deficit of information, hence randomness of results

► **Harry Markowitz:** 1959: Risk = probability of loss = historical volatility in returns as measured by standard deviation or Beta. But risk diversification and tolerance also matter!

► **J M. Keynes:** (Treatise on Probability 1921): Non-linear nature of risks and danger of expecting the future as simple projection of the past: Role of animal spirits in volatility spillover and herd behavior.

► **Ulrich Beck:** 2010: « Global risk society where current decisions and technological developments trigger long-term global impact » (warming, terrorism, pollution, financial deregulation...)

## TACKLING COUNTRY RISK

### COUNTRY + RISK

- ▶ Country= sovereign debtor, culture, geographical distance, specific values, legal and regulatory constraints, socio-political parameters
- ▶ Risk = uncertainty, lack of perfect information in real time, transfer risk from the private sector, spill-over effect

## COUNTRY RISK

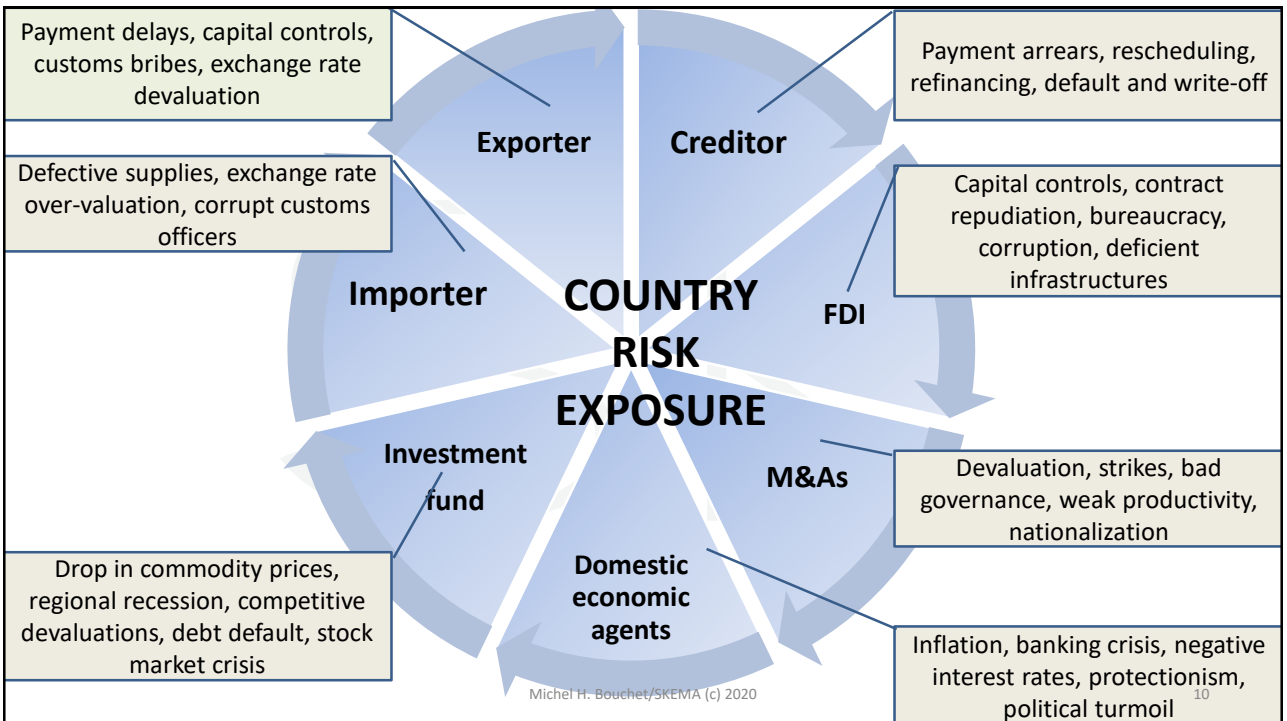
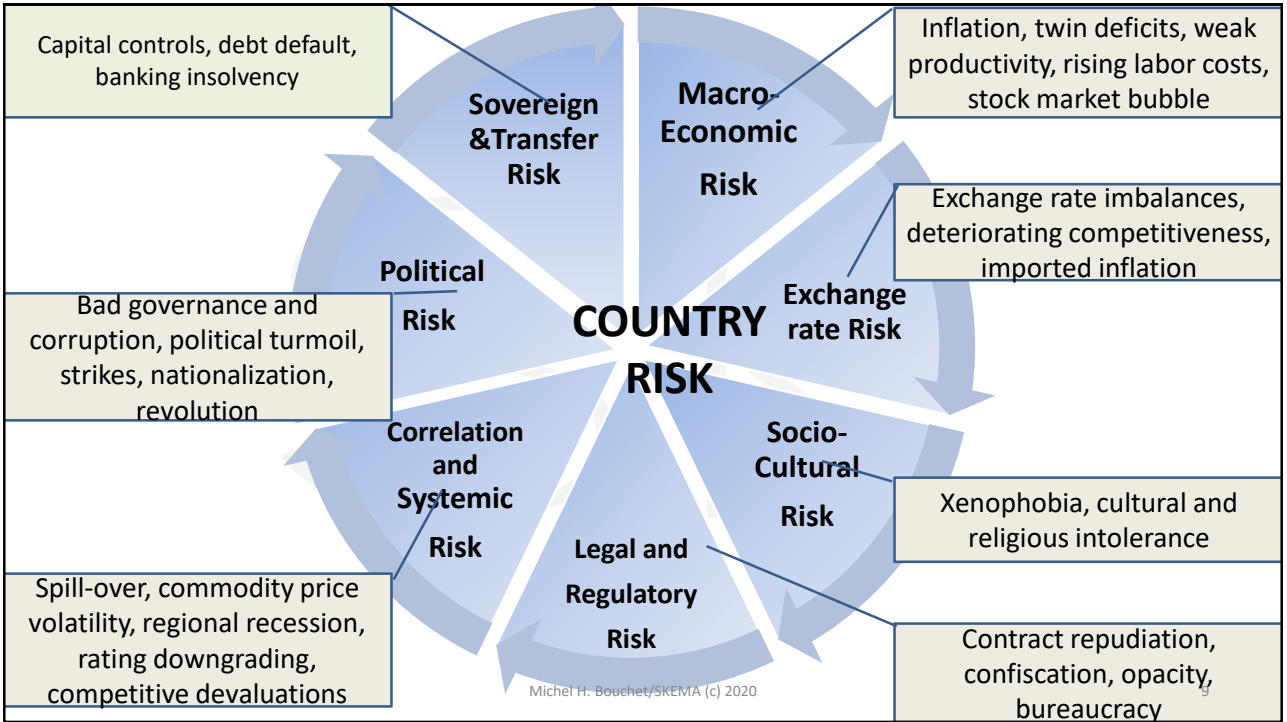
- ▶ *Country risk results from a set of complex and interdependent socio-economic, financial and political factors, that are specific for a particular country, but that can quickly evolve given the country's global integration.*

## WHAT COUNTRY RISK IS **NOT**

- ▶ Country risk is **NOT** a monopoly of foreign creditors, exporters, importers, or investors
- ▶ Domestic residents (households, investors, corporate sector) also face country risk from their own country's socio-economic situation:
  - The country's government can take **arbitrary** decisions that will affect the residents' situation
  - The country can be **contaminated** by negative regional or global forces
  - A deterioration in the risk perception by capital markets and rating agencies will feedback on domestic residents' socio-economic environment and well-being.

## COUNTRY RISK ANALYSIS

- ▶ Country risk analysis involves the assessment of a private or public foreign entity's **ability and willingness** to service its external obligations in full and in time (contractual, debt servicing, import payments, legal commitment...).
- ▶ It incorporates a forward-looking estimate of default probability



## LOOKING TOWARD EARLY WARNING SIGNALS OF UPCOMING FINANCIAL AND SOCIO-POLITICAL CRISIS?

- IMF reports?
- Rating agencies?
- CDS prices?
- Stock market volatility
- Spreads and yields
- Minsky's speculative bubbles and herd-instinct
  - B. Mandelbrot's fractal geometry
  - N. Taleb's Black Swans
- D. Sornette's Dragon-Kings (extreme events)
  - Capital Flight?

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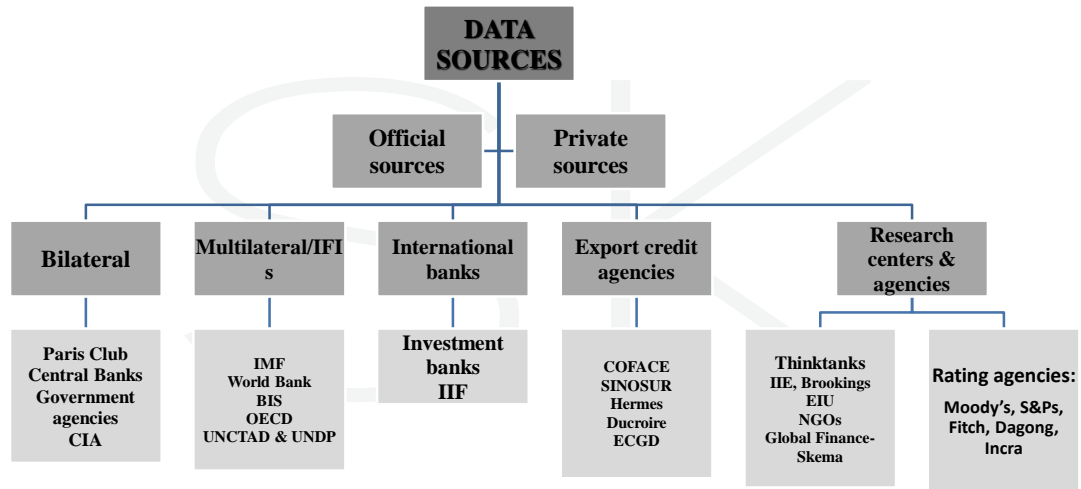
## COUNTRY RISK ASSESSMENT

Reliable and updated information

= Economic intelligence

▶ **Robust risk analysis**

## MAJOR SOURCES OF COUNTRY RISK INTELLIGENCE



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## FINANCIAL, MACROECONOMIC AND SOCIO-POLITICAL INFORMATION AND INTELLIGENCE SOURCES

### Official sources

1. Multilateral sources
  - ▶ IMF
  - ▶ World Bank
  - ▶ BIS, OECD, UNCAD, UNDP
  - ▶ RDBs
2. Official bilateral sources
  - Country governments (CBs, CIA)
  - ECAs (DREE, Hermes, Eximbank, ECGD)

### Private sources

1. Insurance agencies (Coface, OPIC)
2. Research institutes (IIE, IIF)
3. Thinktanks (Cato, Heritage, Freedom House)
4. Magazines (Euromoney...)
5. Academic centers (CforGD, Global Finance...)
6. Rating agencies (S&Ps)

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## HOW DOES COUNTRY RISK MATERIALIZE?

1. **CREDITOR** = Payment arrears, default, rescheduling, write down and/or write off
2. **INVESTOR** = **Capital control** → **Limitations on dividend and capital repatriation**  
**Contractual obligations and legal commitment** : contract repudiation, corruption  
**Public guarantees**: unilateral suspension
3. **TRADE PARTNER** = **Supplies and purchases** (imports of goods & services) → delays, defective merchandise  
**Sales** (exports of goods & services) → payment arrears

## EXTERNAL DEBT ANALYSIS: THE DUAL FACE OF COUNTRY RISK

### ▶ **Liquidity Risk**

- ▶ Debt Service Ratio:  
(P+I/X)
- ▶ Interest Ratio (I/X)
- ▶ Current account/GDP
- ▶ Reserve/Import ratio
- ▶ Import/GDP ratio
- ▶ Growth rate of exports/  
Average external  
interest rate

### ▶ **Solvency Risk**

- ▶ Debt/Export ratio
- ▶ Debt/GDP ratio
- ▶ ST Debt/Reserves

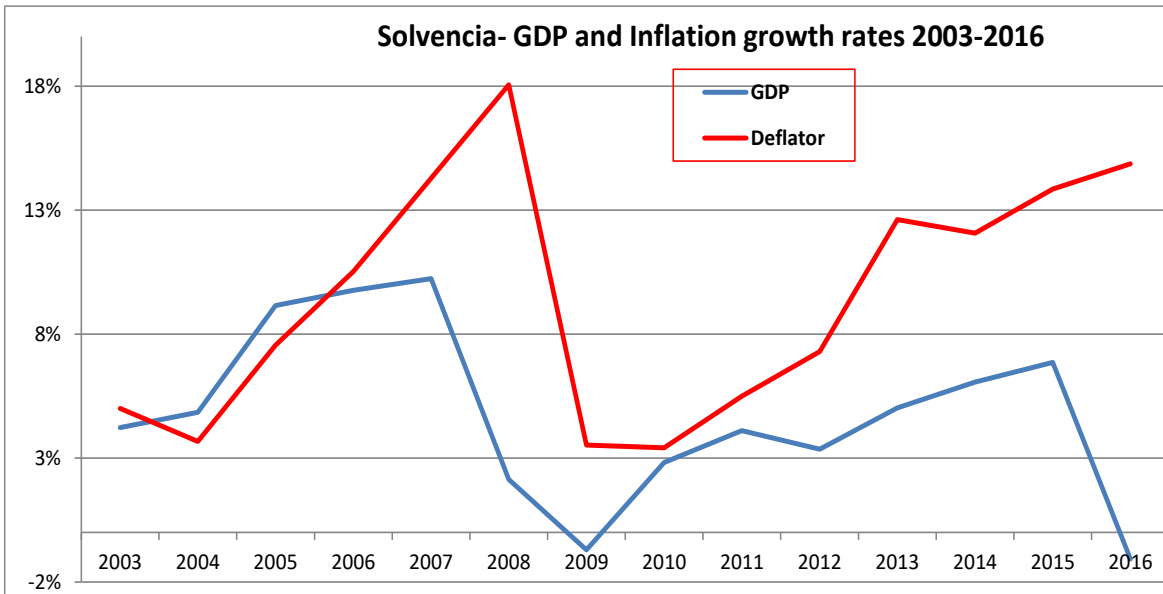
M	Risk Indicators	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
	GDP (in US\$ billion)														
	Real GDP Growth rate (in Local Currency)														
	GDP Growth rate (in US\$)														
	GDP per capita (US\$)														
	GDP per capita /day														
	Rate of currency depreciation														
	Trade Balance (US\$ million)														
	External competitiveness														
	Trade openness ratio (X+M/GDP)														
	Budget Deficit-Surplus /GDP%														
	Current account/GDP %														
N	RATIOS	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
O	Solvency														
	Debt/Exports														
	Debt/GDP														
	Reserves/External Debt														
	Short-term Debt/Total Debt														
P	Liquidity														
	Principal Amortization/Exports %														
	Debt servicing Ratio %														
	Interest/Exports %														
	Reserves/Imports GS in %														
	Reserves/Imports in Months Coverage														
	Average external interest rate in %														
Q	Cash-flow ratio														
	Numerator:														
	+ Official reserves assets including Gold+XG&S														
	+Undisbursed bank credits + Net transfers )														
	Denominator (debt service + MG&S + ST debt)														
	Cash flow ratio														#REF!

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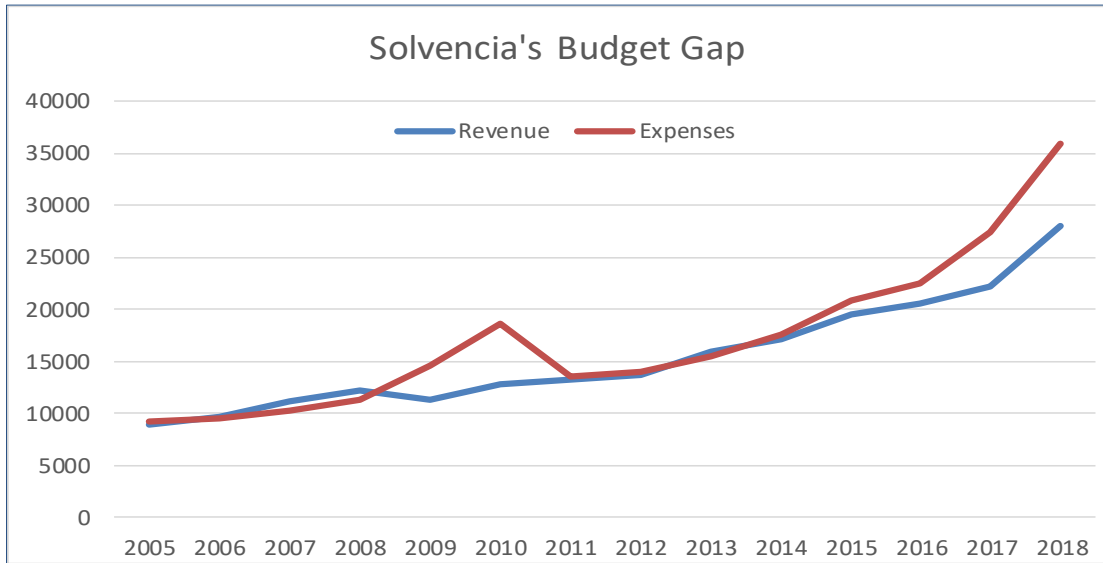
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## SOLVENCIA'S MACROECONOMIC TRENDS

Solvencia- GDP and Inflation growth rates 2003-2016



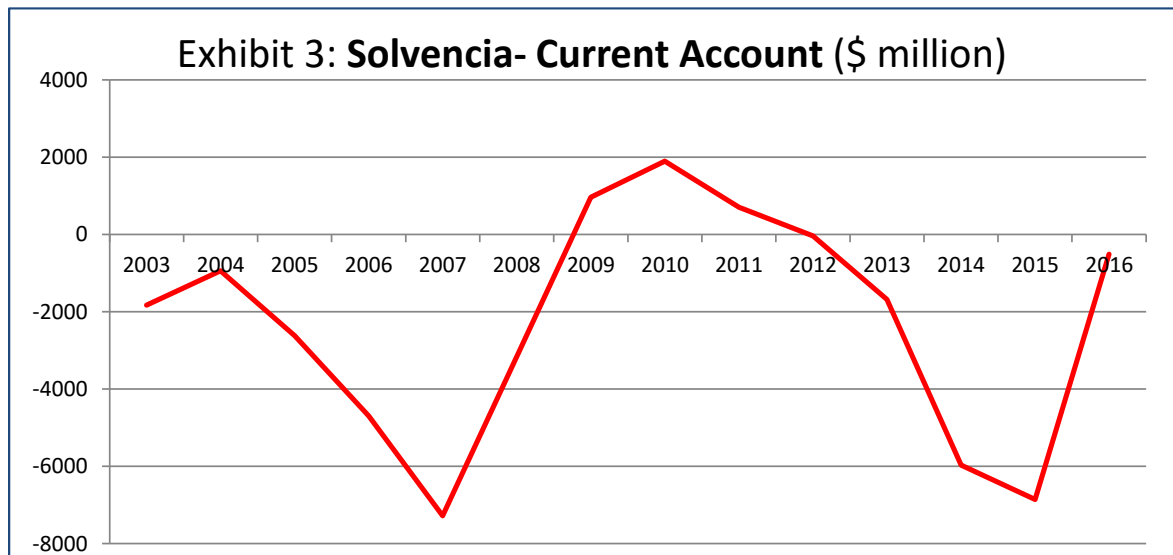
## ECONOMIC OVERHEATING AND STOP & GO POLICY



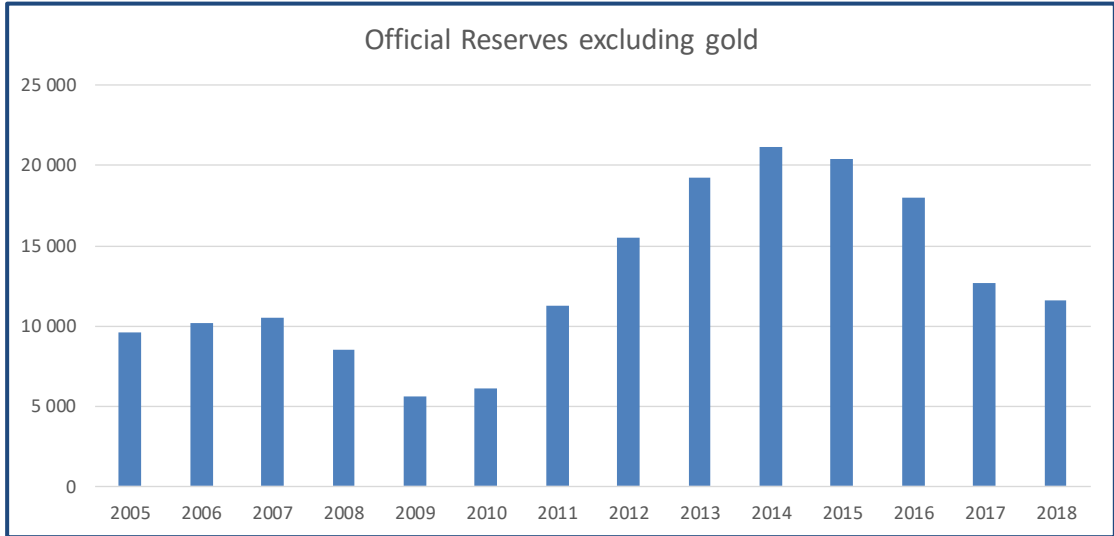
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## SOLVENCIA = LIVING BEYOND ITS MEANS



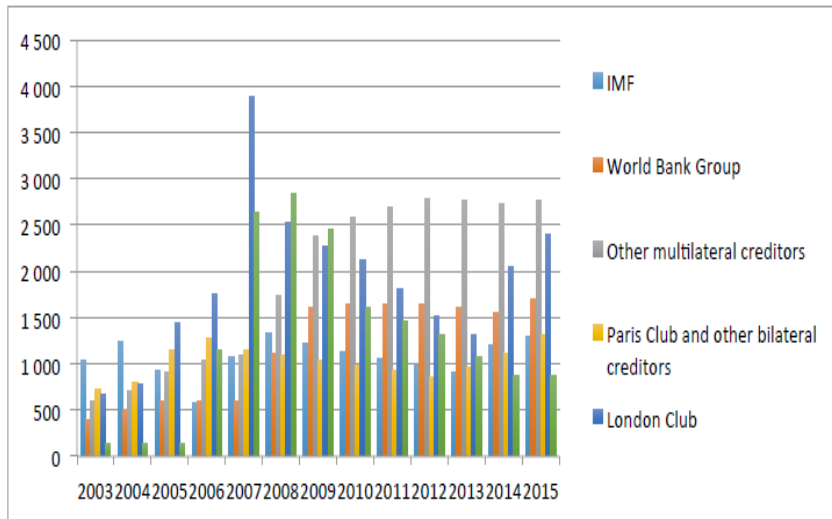
## VOLATILITY OF INTERNATIONAL RESERVE ASSETS



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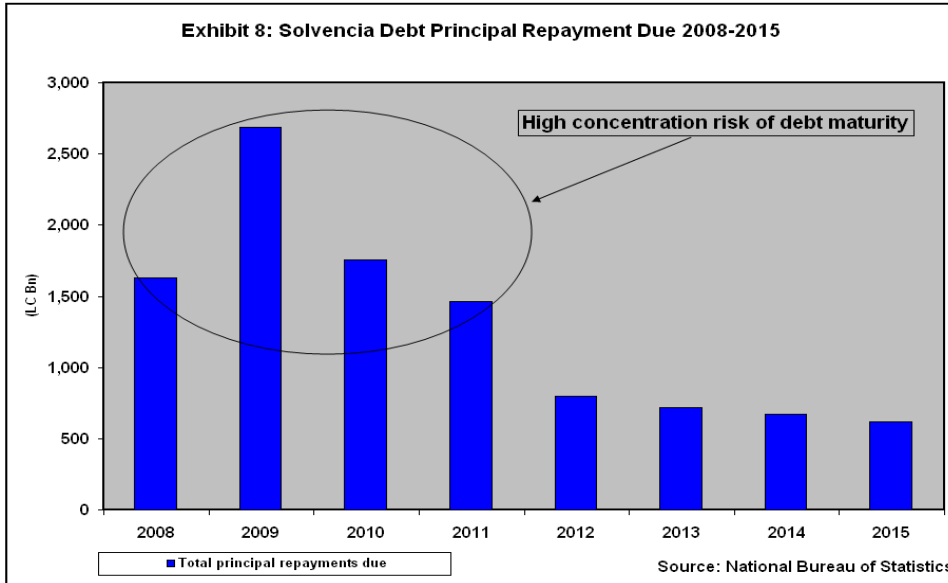
Graph 9. Total external debt devided to creditors 2003-2015, million US \$



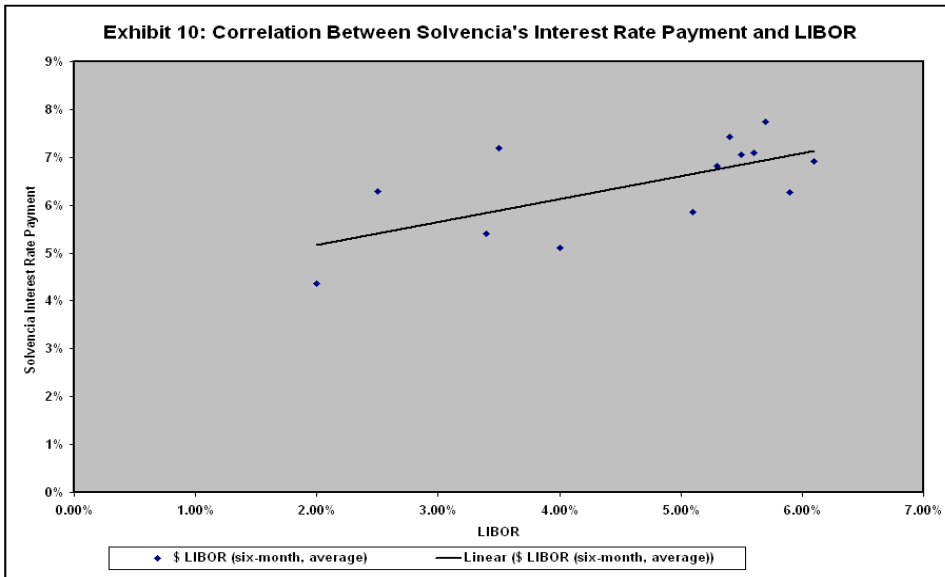
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## DEBT PRINCIPAL REPAYMENT



## SOLVENCIA'S INTEREST PAYMENT SENSITIVITY TO LIBOR



## KEY MARKET-BASED ECONOMIC POLICY MEASURES TO PRESERVE HEALTHY GROWTH DYNAMISM IN THE 2011-2020 PERIOD

1. Adopting market-based economic policies promoting competitiveness and trade openness
2. Cutting inefficient public expenditures and stimulating privatization-driven revenues to balance the budget
3. Focusing on tourism sector, more security and better services
4. Keeping cost-push inflation pressures at bay while maintaining a competitive real effective exchange rate with a floating exchange rate system, aimed at supporting a liberalization of the capital account, attracting further FDI and stimulating productivity growth.
5. Improving the current account balance by encouraging the return of capital flight, and boosting exports of goods and services.

## KEY STRUCTURAL AND INSTITUTIONAL CHALLENGES SOLVENCIA MUST TACKLE TO RESTORE SUSTAINABLE DEVELOPMENT PATH:

1. Addressing financial sector weaknesses, liberalizing the capital account, improving the regulatory framework and tackling labour market rigidities
2. Modernizing the industrial sector
3. Continuing the privatization program given that the state retains a large presence throughout the economy, including in the state-owned banks.
4. Increasing trade openness and diversifying the export base regarding products and markets;
5. Enhancing free trade with the EU and the USA
6. Improving living standards and creating jobs for the young generation
7. Articulating a strategy to accelerate the structural transformation of the economy towards more skill-intensive sectors.
8. Implementing social and institutional reforms while improving governance

## OVERALL CONCLUSION REGARDING SOLVENCIA'S REQUEST FOR LAUNCHING A US\$500 MILLION EUROBOND ISSUE

1. Solvencia's return to market access is premature given lack of market-based economic policy commitment and weak governance
2. Market appetite might be tested with smaller bond (US\$200-350 million) maturing after the bunching of upcoming debt repayments
3. Enhancing features will facilitate the success of the bond issue: equity conversion option, gold collateral, on-going monitoring of the IMF, cross-default clause...



Casino Bank  
Be ahead of your time

## II. Solvencia risk assessment

Population
7 MILLION
GDP
56,9 BILLION

MOODY'S	FITCH
Baa2	BBB-

### MAJOR MACRO ECONOMIC INDICATORS

	2011	2012	2013	2014	2015 (F)
GDP growth (%)	3,45%	4%	5,13%	6,10%	7,30%
Inflation (%)	9,00%	11,45%	17,30%	22,12%	29,43%
Budget balance (% GDP)	9,70%	-2,60%	-8,60%	-11,20%	-12,50%
Current Account Balance (% GDP)	1,40%	1,60%	-4,60%	-9,00%	-9,30%
Public debt (% GDP)	24,30%	23,40%	21,20%	23,00%	23,80%

STRENGTHS	WEAKNESS
<ul style="list-style-type: none"> <li>• Growth recovery since 2011</li> <li>• Terms of trade improvement and privatization measures</li> <li>• Increase in and diversification of Exports</li> <li>• Rise in FDI</li> <li>• Large foreign exchange inflows</li> <li>• Liquidity ratio and Solvency ratio maintained</li> <li>• Monetary policy framework</li> </ul>	<ul style="list-style-type: none"> <li>• economy overheating: high inflation, large budget and current account deficit</li> <li>• Still weak productivity</li> <li>• Dependence on commodity price</li> <li>• Growing imports (J curve)</li> <li>• Unemployment high for young people</li> <li>• Political instability and Governance questioned</li> <li>• Declining figures for 2015</li> </ul>