

## COUNTRY RISK ANALYSIS

### Republic of Solvencia and the International Capital Markets



### SOLVENCIA's Eurobond Request

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Book: **"Country risk in an age of Globalization"**: MH Bouchet, C Fishkin, A Goguel. Palgrave-MacMillan 2018

[https://www.amazon.fr/Managing-Country-Risk-Age-Globalization/dp/3319897519/ref=sr\\_1\\_1?s=english-books&ie=UTF8&qid=1536225444&sr=1-1&keywords=country+risk+in+an+age+of+globalization](https://www.amazon.fr/Managing-Country-Risk-Age-Globalization/dp/3319897519/ref=sr_1_1?s=english-books&ie=UTF8&qid=1536225444&sr=1-1&keywords=country+risk+in+an+age+of+globalization)

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**Latest update: Fall 2018**

# SOLVENCIA

&

*Casino*  
BANK



## Country Risk Case Study

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# Republic of Solvencia and Global Capital Markets:

## Eurobond Request to Casino Bank

Fall 2018

### Introduction

It was 9 o'clock yesterday morning, when your secretary passed an important message from Solvencia's Finance Minister, requesting an urgent meeting next week in Monaco. It was not too difficult for you to guess the purpose of the meeting given the country's plan to launch €800 million Eurobond on international capital markets, taking advantage of ultra-low rates of interest currently! Mr. Solvent, the finance minister, wants to get your assessment regarding market conditions for the bond floating, in order to compare your assessment with your competitors' offers in London, Zurich, and New York. The prospects of tighter monetary policy and higher interest rates in the OECD, coupled with market nervousness regarding developing countries' rising debt, however, make the request a formidable challenge!

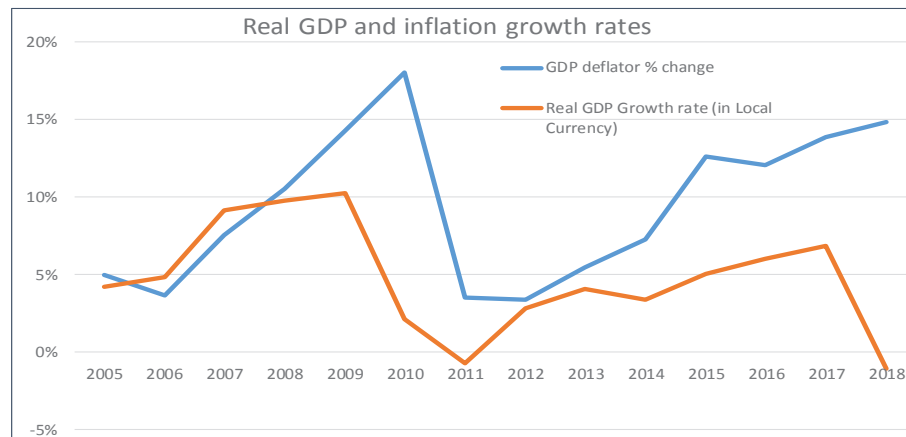
Solvencia's medium-term external borrowing requirements are well known to the international financial community. This request thus does not come as a surprise. You are a young but promising investment banker and you knew that Solvencia was about to approach investment banks in Europe. Your institution, **Casino Bank**, is a reputed player. Competition is fiercer than ever for bond syndication and placement. At stake is a substantial fee (and for you, a substantial bonus!). But rumours regarding Solvencia's liquidity difficulties also come and go in the markets. The country is facing economic overheating, large external financing requirements, and upcoming financial problems, reportedly. Governance is also a thorny issue.

### Republic of Solvencia: Political Background

Solvencia is a country of roughly 9 million people. Its GDP per capita of around US\$8000 (in purchasing power parity) in 2018 corresponds to a middle-income developing country. (Solvencia's GDP per capita thus fits in a group of countries like Belize, el Salvador, Jamaica, and Paraguay, on the base of the UNDP HDI Index method). Solvencia's long struggle for independence ended in the mid-1970s. Gradual political reforms in the 1990s resulted in the establishment of a bicameral legislature in 2012. However, the political climate remains volatile. Political upheaval leads frequently to mass demonstrations followed by harsh repression. Since 2008, however, Solvencia was affected by the spill-over effect of the global financial crisis! In addition, Solvencia's governance improvement was questioned by strong pressure from the IFIs, notably the IMF and the World Bank. Rating agencies stressed that weak governance was a key impediment to sustainable development and to resumption of market access and development aid. Rating agencies are watching and stand ready to change their risk assessment of Solvencia. Moody's country rating currently is "Baa3" while Fitch rating stands at "BBB". Things do not seem to improve at the right pace, nevertheless. You get conflicting signals regarding Solvencia's commitment to structural economic and institutional reforms.

## Solvencia's overall economic conditions and policy outlook

Solvencia faces the challenges typical of developing countries – weak productivity, low competitiveness, and dependence on volatile commodity prices. In 2008-09, Solvencia experienced severe financial turbulences with large budget and current account deficits, following years of economic overheating characterized by high inflation. The spill-over effect of the global financial crisis was an aggravating variable. In addition, a severe drought depressed activity in the key agricultural sector and contributed to a protracted recession along with acute social problems. A sticky exchange rate in the initial period resulted in a sharp decline in external competitiveness, along with booming imports, little export dynamism, and a drop in official reserve assets, particularly in 2008, due to over-valued exchange rate. In 2010-11, Solvencia's government adopted an IMF-sponsored program and it implemented severe adjustment measures culminating with a sharp growth decline. Declining imports shifted the trade balance to a modest surplus, the first time in the decade.



Clearly, Solvencia's government could postpone the economic adjustment for a while; it could not avoid it. The finance minister had to negotiate a structural adjustment program under the auspices of the IMF and the World Bank. The shock therapy was abrupt and it included the usual market-driven stabilization policy measures aimed at reducing domestic demand and restoring competitiveness: currency devaluation, cuts in public expenditures, openness to foreign direct investment, stimulation of private investment, and privatization. The monetary policy framework was strengthened and an inflation targeting system was introduced. A late but substantial real devaluation in 2009-2010 boosted exports and the trade balance benefited from shrinking imports, though at the cost of an anaemic growth rate in 2011-12. One clear positive result has been to keep inflation under control. Overall, as much shock as therapy was provided.

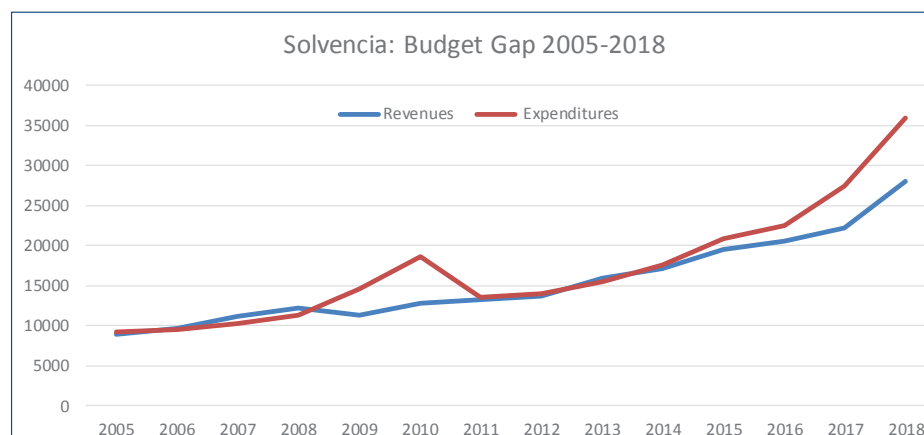
In particular, notable progress was being made in areas such as trade liberalization and privatization. The trade openness ratio reached a level higher than 50% in 2012. The main challenge, clearly, was to further improve the competitiveness and flexibility of the economy. Solvencia's five-year plan (covering the period 2011-2015) was drawn up with these challenges in mind and with a view to articulate a strategy to accelerate the structural transformation of the economy towards one based on more skill-intensive sectors. Priorities included addressing financial sector weaknesses, liberalizing the capital account, improving

the regulatory framework and tackling labour market rigidities. The most notable result was a modest trade surplus in 2011-13 and the emergence of a budget surplus in 2013. But despite progress in raising living standards, unemployment remained stubbornly high. Official data shows that the unemployment rate remains broadly unchanged. However, unofficial estimates suggest that the rate is much higher and unabated. Underemployment is also a problem, particularly for the young population.

Following structural adjustment programs supported by the IMF, the World Bank, and the Paris Club, the currency is now fully convertible for current account transactions, and reforms of the financial sector have been implemented. The devaluation paved the way for the well-known “J-curve”, i.e., growing imports since 2013, due to unfavourable elasticities! On the positive side, exports increased and FDI picked up until 2014. Solvencia reported large foreign exchange inflows from the sale of a mobile telephone license and partial privatization of the state-owned telecommunications company **SolvaPhone**. Growth resumption only emerged gradually after several years of severe decline of real GDP. Favourable rainfall and export diversification led to reasonable growth thanks to good harvest conditions and improving terms of trade. Since 2015, however, Solvencia experienced again rising inflation, showing that stabilization was again off track. Economic growth recovery seems to be driven by large bank loans supported by global accommodative liquidity and low real rate policy of central banking authorities.

### Inflation and Budget Deficit

Inflation in Solvencia looks like a rollercoaster for the past decade (Exhibit 1). After double digit inflation that reached an unsustainable peak in 2008-2010, the government was able to drag down the inflation level to more reasonable levels in 2011-2013. However, rising budget deficit and an accommodative monetary policy stimulated a rising inflation during the 2014-2018 period. Growing inflationary expectations stem from unchecked private and public demand. At the peak of the crisis, in 2009-10, the government budget deficit reached unsustainable levels. Solvencia returned to a similar situation in 2017-2018, illustrating the cost of populist policy measures taken by the government.

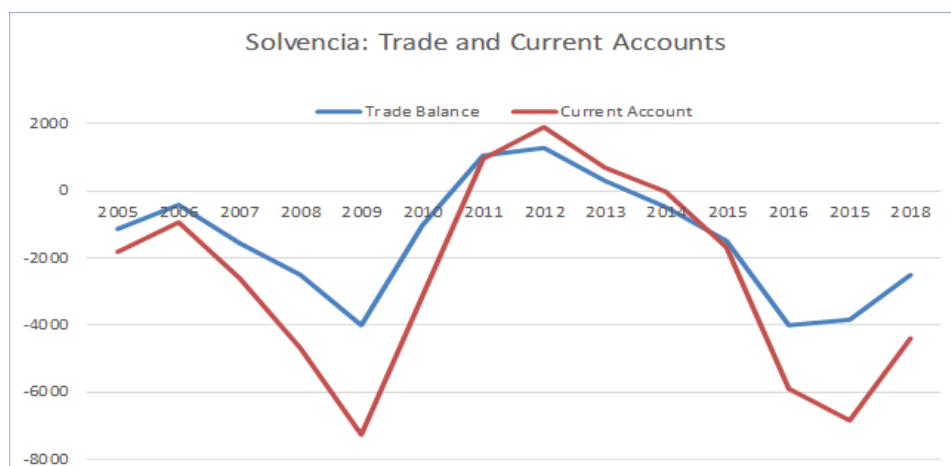


The structural adjustment program increased social and political volatility. Dynamic privatization and severe cuts in government spending produced street demonstrations and

political protests. But the result of economic adjustment could be seen in the 2011-2014 period, when Solvencia managed to stabilize its current account, improving its reserves/external debt ratio, and attracting significant foreign direct investment capital flows. The government also successfully stabilized inflation, while managing a better budget situation.

### Solvencia's Balance of Payment Position

The current account during the period 2007-2010 was driven by the negative pattern of trade balance. Solvencia's trade balance became increasingly negative, mainly due to excessive growth in imports. In addition to the rise in oil prices, imports were boosted by strong demand for capital and related goods reflecting investment expenditure related to the industrial modernization program. In 2011-2013, trade balance generated a short-lived surplus, thanks to significant improvement in external competitiveness. But starting in 2014, trade balance returned to negative territory, as a result of declining export competitiveness. The drop in global oil prices since mid-2014 has been welcome news for Solvencia! Oil is the largest part of the country's imported commodities. The rise in the oil price in the global market, to around \$105/barrel in 2012-13, was an important factor in the worsening trade deficit, though unchecked domestic consumption stems from the accommodative monetary and fiscal policy. The drop in oil prices between mid-2014 and mid-2018 tended to alleviate the pressure.



Balance of services, income and transfers showed a rising surplus starting in 2012-14, backed up by a substantial real depreciation of the exchange rate. No doubt that tourism, a major cash inflow source for Solvencia, benefitted from the large currency depreciation. Meanwhile, continued growth in the level of remittances has kept the transfers surplus steady. This constant inflow from one million expatriates (most of whom live in Europe) has been one of the main factors that has helped shrink the trade deficit in recent years.

The current account balance reached an unprecedented deficit of \$ 7,2 billion in 2009, the equivalent of 14% of GDP, partly as a result of the global financial crisis and also of travel warning issued by the US and EU governments as a response to political instability and social upheaval. A couple of bomb threats in the country's capital city, **Solven City**, did not improve the investment climate. But the main culprit for the rise in the deficit has been a

combination of flat exports and booming imports. Since 2015, a large current account deficit surfaced again.

Debt is still a major financing source for Solvencia's current account deficit. During 2003-2007, commercial banks and capital markets were a primary source of external financing. The bond market was tapped in 2005 and 2006. The financial crisis led to a sharp reduction in international bank lending that was somewhat offset by official creditors, both bilateral and multilateral. The country had to use significant amount of official reserves to finance its external financing requirements. In 2019-20, bond issuing is to be the new ball game in Solven City.

### **The Eurobond Project Request: To float or not to float?**

Solvencia, clearly, is not back on track. There is still a long way to go before domestic and foreign investors recover confidence. Rating agencies are prudent. Corruption and governance remain a genuine problem. Budget deficit is looming again. Long-term challenges include: servicing the external debt in view of the interest rate hike by the US Fed in 2018 and probably 2019; modernizing the industrial sector; preparing the economy for freer trade with the EU and US; and improving education and attracting foreign investment (i.e., non-debt creating flows) to boost living standards and job prospects for Solvencia's youth. Two populist political parties call for debt default or debt restructuring!

Floating a Eurobond issue for Solvencia can be a major coup for your bank, but it can also become a nightmare should you be unable to place the paper in the market. Getting stuck with illiquid bond paper would be costly for your bank's portfolio, and for your so far promising career! Maturity, pricing, coupon and fees are one thing. Capital adequacy ratios, loan-loss provisions and default probability are another. As you have identified several conflicting risk indicators in Solvencia's economic and political situation, the first thing you need to do is to get the "story" of Solvencia right, i.e., you need to do some basic number crunching, particularly liquidity and solvency ratios.

Before calculating the key ratios, however, you need to understand where does the country come from regarding its growth track, what went wrong in the 2003-2018 period, and why. You also need to understand the way the IMF's stabilization program achieved a turnaround in Solvencia's economy and whether this improvement is lasting or fragile. You need to check if the country is not falling back today in the same pitfalls as in 2007-2010. Then you must look at the scope for a resumption of sustainable development over the course of 2019 and beyond. The bond issue is a Yes/No decision though you can add a number of strings & whistles (issue tranches, collateral, currency switching, zero coupon bond, gradual repayment versus bullet payment, fixed/floating rate, conversion features...). Last but not least, you will call Solvencia's finance minister who is waiting in his Monaco junior suite.

**COUNTRY RISK ANALYSIS**  
**Republic of Solvencia and the International Capital**  
**Markets**

**MICHEL HENRY BOUCHET**

FALL 2018

Annex

**Background Information for Solvencia's Eurobond Request to**  
**CASINO BANK**



**For further information:**

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## Annex

### Background Information for Solvencia's Eurobond Request to CASINO BANK

1. What is country risk all about?
2. What is a Eurobond ?
3. What are the key sources of country risk information a risk analyst can rely on ?
4. What are the key conditions that investment banks will/should consider before exploring the launching of a bond issue?
5. What are the key steps of a bond syndication process?
6. What are the underlying elements of a bond spread?
7. What are the main sources of country risk information a risk analyst can/should rely on?
8. What are the main risk parameters of sovereign risk?
9. What is the so-called "J-Curve impact" regarding the short-term balance of payment consequence of a currency devaluation?
10. How can a country manage to finance its current account deficit? In the capital account, what is the difference between non-debt creating flows and other capital flows?
11. What are the key liquidity and solvency ratios that any country risk analyst must consider?
12. What is The Paris Club? Methods and purposes?
13. What is the London Club? What is the IIF's role regarding country risk analysis

**1. What is country risk all about?** (Source: **Country risk in an age of Globalization**, Palgrave-MacMillan, 2018: Bouchet, Fishkin, Goguel)

Risk is a multi-faceted issue. It has to do with uncertainty, i.e., a deficit of information. 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

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.

Country risk includes several parameters:

- Economic risk
- Financial risk
- Foreign exchange risk
- Political risk
- Cultural environment risk
- Legal and contractual risk (repudiation, confiscation, bribes...)
- Regional contamination risk (spill-over effect), and
- Systemic risk (global crisis)

**2. What is a Eurobond?**

First of all, the prefix "Euro" has **nothing to do with the €** currency in the European economic community. A Eurobond is a bond issued and traded outside the country whose currency it is denominated in, and outside a single country's banking regulations. For instance, a Dollar-denominated bond issued on the London market is a Euro-dollar bond. This type of bonds is usually underwritten by a multinational syndicate of investment banks, therefore it can simultaneously be floated in various capital markets.

Eurobonds have a number of salient features.

- They are usually issued in bearer form, with yearly coupon payment.
- This type of bond also doesn't follow country issued domestic bond regulation (NY, London legislations).
- Another feature of Eurobonds, which give advantage to borrower, are less restrictive covenants and call provision features, even for short term bonds.

There are several types of Eurobond instruments. Most commonly issued bonds are in the form of long term bonds as well as medium term notes, commercial papers and floating rate notes (FRN). As a result of this variety type of instruments, the term of Eurobond itself has got a new label, which is "International Securities". The most commonly currency used in Eurobond issuance is US\$, accounted approximately 50% of total current outstanding Eurobonds.

Eurobonds also have secondary market trading, hence market liquidity. Usually, the market makers in Eurobond secondary market are the underwriters who sell the Eurobond in primary market. Since 1969, International Securities Market Association (ISMA) has performed a central role by providing global framework of industry-driven rules and recommendations which regulate and guide trading and settlement in this market.

### **3. What are the main underlying risks of a Eurobond issue:**

Interest rate risk: The major risk faced by investor in bond market is interest rate risk. The change in current interest rate will affect the bond price, hence it will affect value of the investment. The sensitivity of the change in bond prices due to change in interest rate depend on various characteristics of issuance, such as coupon rate and the maturity period. The higher the coupon rate and the shorter maturities of the bond, the less sensitive price change due to change on the interest rate. But, this type of risk is not faced by held to maturity-investor, i.e., an investor who buys the bond and holds it until the last day. The issuer of the bond, especially floating-bonds issuer, also faces significant interest rate risk. Since the change of current interest rate will affect the benchmark rate, and finally will change the coupon rate that the issuer has to pay.

Exchange Rate Risk: currency mismatch: This type of risk is also a major risk faced by issuer and investor of Eurobond. Exchange rate risk refer to change in the exchange rate of issuer's and investor's currency to Eurobond denominated currency, that will affect return of the investor or the issuer's cost of borrowing. For example, imagine that a company in Japan which the revenue mainly generated in Yen, issued a Eurobond denominated in US\$, and one of the investor of the Eurobond is a European investor. Therefore a change in exchange rate between US\$/Yen and €/US\$ will affect the cost of borrowing of the issuer and the rate of return for the investors.

Country Risk: This type of risk is also involved in Eurobond issuance. Country risk refers to any risk that exists with regard to transnational business, which will not exist in domestic transactions. Therefore, based on this definition, sources of country risk could be varying. But basically, any difference in economic structure, political or any other aspects between investor and borrower in a transnational transaction can be a source of country risk. Related with Eurobond issuance, the probability of issuer cannot pay the principal or interest from the Eurobond due to specific problem in country's issuer is a major risk for Eurobond's investor. Therefore, country risk analysis is an important pre-cautionary action before investing in Eurobond.

Default Risk: or often called credit risk is the risk that the issuer of Eurobonds be unable to pay timely coupon and principal payment, in full and on time! The rating agencies such as Moody's, Fitch and Standard and Poor are the major agencies that measure the default risk of issuer.

Liquidity Risk: The risk stemming from the lack of marketability of the Eurobond that cannot be bought or sold quickly enough to prevent or minimize a loss. The primary measure of this type of risk is the bid-ask spread quoted by the market. The wider the spread, the higher the liquidity risk faced by the investors.

"Risk of Risk": The risk faced by investors given the misunderstanding of the risk of the securities that they have invested. The main source of this risk is low understanding of the investors related with the risk-return characteristic of the issued securities, this could happen if the features of Eurobonds becoming more innovative and complex. In addition, unrealistic hypotheses (bell-shaped

curve, thin tails, and Gaussian probability distribution) might add a model risk to a market risk! See Mandelbrot for further analysis of that biased assessment of market finance risk.

#### **4. What are the key conditions investment banks will/should consider before exploring the launching of a bond issue:**

Basically, the investment banks should carefully consider the risks described above before deciding to underwrite the Eurobond issuance. Country risk analysis should be the first priority to evaluate the underlying risk of Eurobond issuance. The country risk analysis involves qualitative as well as quantitative analysis of political, economy and other aspects of the country's issuer's creditworthiness. Qualitative analysis can be applied for political and governance issues of the country's issuer that will impact its ability to fulfill the commitment to pay coupon and principal of the Eurobonds. On the other hand, Quantitative analysis can be applied to macroeconomic, balance of payment and other economic features of the country's issuer. In the case that the Eurobond issuer is a private entity, microeconomic, sectoral as well as industry specific characteristics are also important factors in the Eurobond issuance. Finally, combination of all above-mentioned analysis will give the investment banks a framework and guidance to assess the short and long-term riskiness of Eurobond issuance.

#### **5. How can a bond issue be syndicated:**

Syndication refers to number of banks grouping together to make a loan to one borrower. There are 2 syndication's processes, the traditional one called "*European issue procedure*" which can be described in seven stages:

1. Preliminary negotiations and preparation
2. Legal clauses (pro rata, negative pledge...)
3. Preplacement
4. Fixing the final terms of the issue ( pricing day)
5. Apportioning securities ( offering day)
6. Placing the issue
7. Closing the issue ( closing day)

The second syndication way is called "*Bought deal*": conditions are fixed by the lead manager and proposed to the issuer. This procedure is more rapid than the European procedure and the syndicates much smaller.

#### **6. What are the underlying elements of a spread:**

In the bond market, the spread reflects the additional required rate of return from the investors when shifting their investment from a risk-free or less risky instrument to more risky assets. Therefore, the term of spread reflects the risk premium of the investors. There are several types of spread definition that investors must know in bond market:

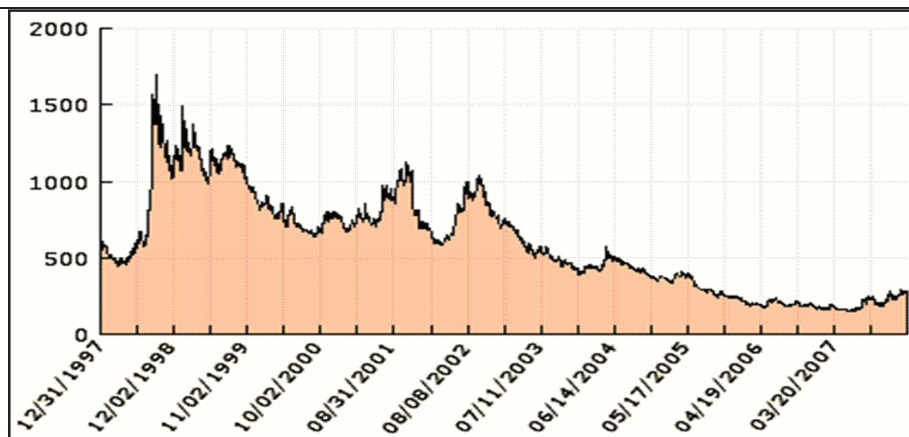
- Quality Spread: spread between different qualities of the credit ratings of the borrower. One can mention the difference between yield on a AAA credit rating company with the A credit rating company in a similar industry with same maturities.

- Maturity Spread: difference between yield of a similar credit rating borrower but with different maturities.
- Intra-market Spread: difference between yield of the bonds from different industries but with similar maturities and credit ratings and trading in same sector of bond market. One example is comparing yield between AAA ratings of a company in manufacturing industries with the company which has same credit rating and maturities but operates in banking industry. Both bonds are traded in same bond market sector, i.e., corporate bond market
- Inter-market Spread: difference between yield on two sectors of bond market, that is, comparing a bond issued by the government's treasury which is being traded in treasury market securities with the bond issued by the corporate with similar maturities.
- Yield Spread: spread within a specific bond market that is attributable to differences between credit ratings (quality spread), maturities (maturity spread), and sectors within markets (intra-market spread).

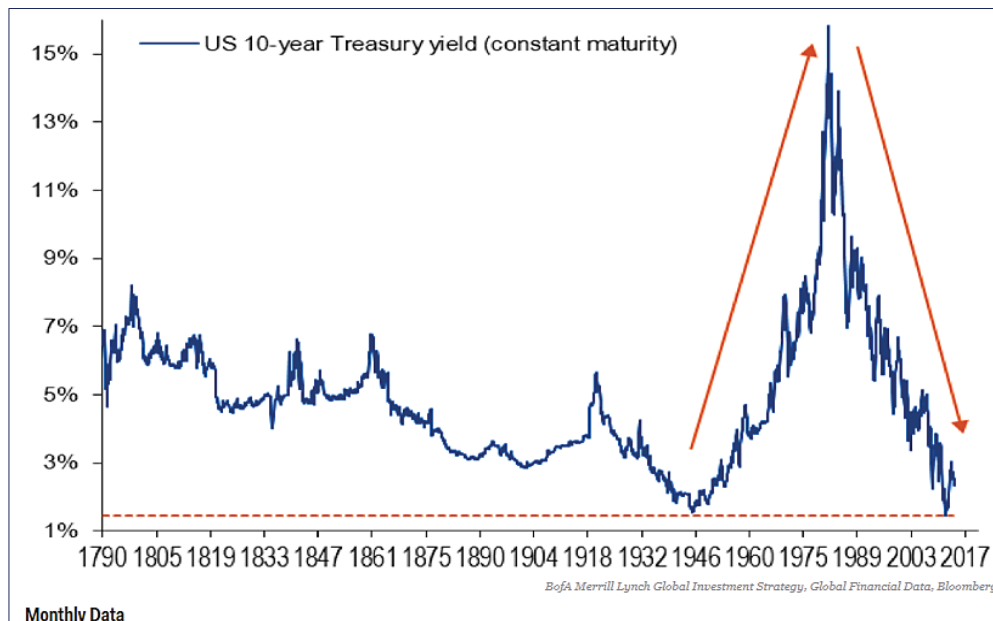
The definition of Eurobond spread which reflects the risk premium can be driven by two factors. First, if the Eurobond issuer is a government, the country risk analysis of the country's issuer is an important factor that determines the risk premium, and therefore the yield of the Eurobond. The yield of a Eurobond issued of a government, will be determined by the benchmark rate and risk premium. The benchmark rate is yield from the bond issued by a super-safe government or a country which holds a AAA credit rating (typically, an OECD country). Regarding current practices, many Eurobonds issued by a government use yield from the US treasuries which have same maturities as benchmark rate, because US treasury securities are still considered risk-free instruments.

Second, if the issuer is a private entity, the component of risk premium will be also determined by the risk analysis of the entity and the industry where it operates. So, total risk premium on the Eurobond issued by the private entity is the risk premium from country risk analysis where the entity operates, coupled with the risk premium from the analysis of entity credit riskiness as well as industry specific analysis where the entity operates.

**Graph 1&2: Emerging Market Bonds (JP Morgan EMBI) Spread over US Treasuries**



Source: CBonds



## 7. What are the key sources of country risk information a risk analyst can rely on:

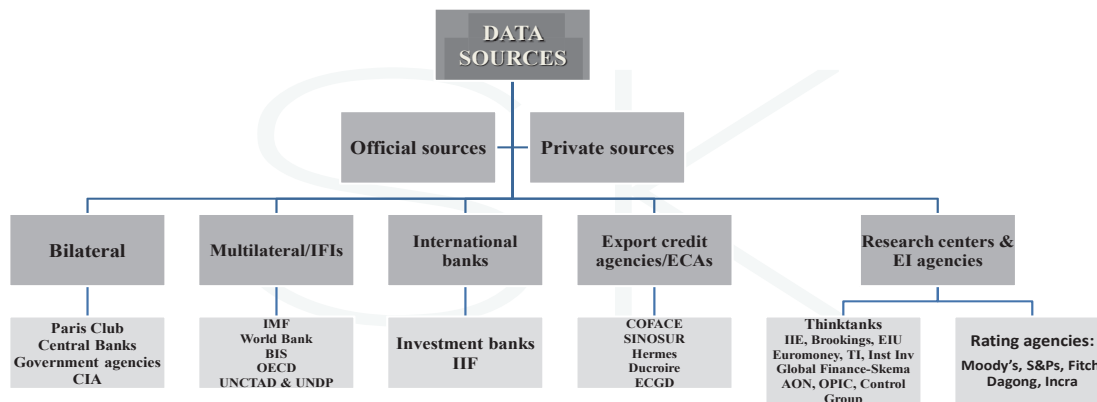
Currently there are many institutions that provide country risk analysis data. Institutions like Standard & Poors, Fitch, Moody's, DAGONG, INCRA, ICRG, Euromoney, Coface and Economist Intelligence Unit issue regular monthly or quarterly country risk analysis.

Developing a reliable country risk analysis is much easier now compared to many years ago, given a wide range of publications and data for assessing country risk. An important source of country risk analysis is balance of payment and macroeconomics data from the country. One can find this data on the national bureau of statistics and central bank of the respected country. But before using this data, you have to analysis whether the government of the country tends to manipulate the data or not. A country with low governance and high corruption tends to manipulate those kinds of data for their own political purpose. In such a case, it is better to use the data from the international financial institutions such as IMF, World Bank, and Bank for International Settlements (BIS). An institution such as IMF, provides comprehensive financial data of a country in the International Financial Statistics monthly database. The IMF has also another database that can be accessed freely, which is World Economic Outlook (WEO) database that is updated periodically. The Bank for International Settlements (BIS) also provides important data such as international bank loans and

deposits, the latter being a proxy for assessing capital flight. Useful trade and FDI data can be obtained from UNCTAD.

**Graph 2: Data Sources Diagram for Country Risk Analysis**

## MAJOR SOURCES OF COUNTRY RISK INTELLIGENCE



Michel H. Bouchet/SKEMA (c) 2017

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Political analysis, including governance and corruption issues, also plays an important factor in country risk analysis. Political analysis includes data on national institutions, governance and corruption, system of government, relationship between executive and legislative, as well as political parties and elections. This type of information can be gathered from independence political observers or institutions. Economist Intelligence Unit (EIU) provides informative sources for this kind of data, through EIU Country Profile. Governance. The level of corruption can be observed through Transparency International, the ICRG database, and the World Bank's governance database.

### 8. What are the risk parameters of a sovereign borrower?

There are several risk parameters that a country risk analyst must assess in measuring riskiness of a sovereign borrower. Macroeconomic indicators such as inflation, interest rate, exchange rate policy, and economic growth as well as independency of the central bank can develop important risk parameters from the macroeconomics side.

Balance of payment data also can be important risk parameters. This includes trade balance, current account deficit, capital account, and international reserve data. Various liquidity and solvency ratios can be developed from balance of payment data to assess country indebtedness and their ability to fulfill their financial commitment.

### 9. What is a J-Curve evolution in a current account balance?

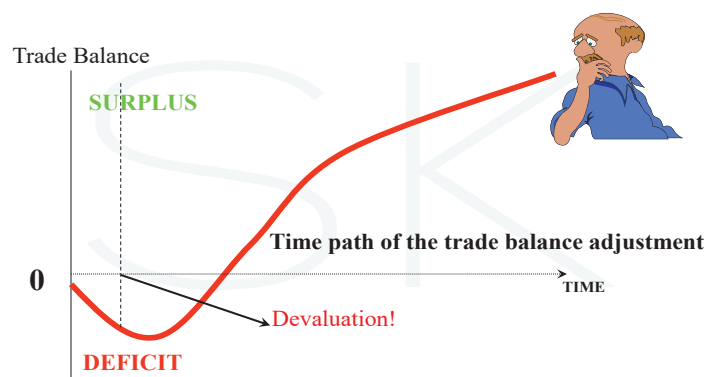
The J-curve illustrates the shape of a country's trade balance following a devaluation. Trade elasticities are key parameters regarding the lag in the shift from a trade deficit to a sustainable surplus. A lower exchange rate initially means cheaper exports and more expensive imports, making the current account worse (a bigger deficit or smaller surplus).. After a while, though, the volume of

exports will start to rise because of their lower price to foreign buyers, and domestic consumers will buy fewer of the costlier imports. Eventually, the trade balance will improve on what it was before the devaluation. If there is a currency appreciation there may be an inverted J-curve.

Following the depreciation/devaluation of the currency, the volume of imports and exports will remain on certain level due in part to pre-existing contracts for imported goods that have to be honored. However, the depreciation in the currency will cause the price of imports to rise and therefore total spending on imports will subsequently increase. This situation, coupled with the inertia of the external demand for exports and the domestic demand for imports, causes the initial worsening of the trade balance. But within around 18 months, a depreciation in the exchange rate can have the desired effect of improving the current account balance. Indeed, demand for exports gradually picks up while domestic consumers will switch their expenditure to domestic products and away from expensive imported goods and services. Equally, many foreign consumers may switch to purchasing cheaper products exported by the country that devaluates its currency, instead of their own domestically produced goods and services. This is represented on the diagram by the movement towards a trade surplus.

**Picture 3: Evolution of Trade Balance – J Curve.**

TIME LAGS, ELASTICITIES AND THE ADJUSTMENT MECHANISM: "J CURVE"



**10. How does a country manage to finance its deficit? With sustainable long-term financing inflows or with volatile short-term finance?**

The best way to financing the current account deficit is using sustainable long-term financing inflows rather than short-term financing. Mainly because long-term financing provides less volatility on balance of payment and therefore provides policy space for the government to perform consistent economic policies.

Long term financing in capital account can be separated into two main part, which are non debt-creating flows and long term debt-creating flows. Non-debt creating flows include portfolio and Foreign Direct Investment (FDI). This type of financing is the best way to finance current account deficit, since there is no obligation to pay interest and principal. It provides budget flexibility to the government to finance the economy. Long-term debt creating flows can be classified into three main sources,

1. Long-term debt from international financial institutions such as IMF, World Bank, regional development banks such as Asian Development Bank, or other multilateral

- creditors. Usually, debt from international financial institutions provides cheaper cost of fund and longer maturities, although with stricter conditionality than private institutions;
2. Long and medium-term loans from official bilateral creditors (i.e., governments of the Paris Club);
  3. Long-term debt from private international institutions such as international commercial banks, mutual fund, and hedge funds. This type on debt could be a loan or Eurobond issued by the country's government.

#### 11. What are the key liquidity and solvency ratios that any country risk analyst must consider:

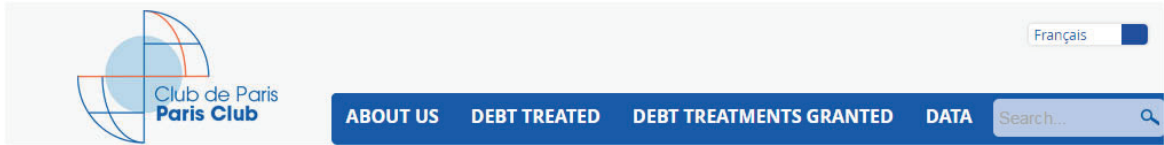
##### ***Liquidity Risk ratios:***

- Debt Service Ratio (Interest+Principal/Exports of goods and services): This ratio provides a good indicator to measure how a country can fulfill its debt obligation based on its ability to provide foreign exchange from export revenues. The higher the ratio, the riskier the country. The threshold usually used in this ratio is 33%
- Interest Ratio (Interest/Export): Provide an indicator to measure current proportion of total interest that a country has to pay in its total export revenues. The higher the ratio (above 25%), the riskier the country.
- Current Account Balance/GDP: Provide an indicator to measure whether the country lives beyond its means or not. The higher the deficit ratio, the riskier the country since it consumes more than its overall income.
- Reserve/Import ratio: This ratio is an important indicator, especially to measure the ability of a country to finance their import based on their current reserve. The lower the ratio, the riskier the country. Usually, if the ratio is below 6 months, it should be a warning indicator for the country risk analyst.
- Import/GDP ratio: Provide an indicator that show how import-dependent is the country's economy. It thus provides a measure of a country's dependency on foreign trade partners.
- Growth rate of exports/Average external interest rate: This ratio provides an important indicator to measure the ability of a country to provide timely interest payments for their external debt with increasing export revenues. It indicates whether the country's export growth rate can match the average interest rate on its external debt. It also measures the effectiveness of the debt-financed investment proceeds. The higher the ratio, the more dynamic the economy.

##### ***Solvency Risk ratios***

- Debt/Export ratio: Is an indicator to measure total stock of debt compared to country's export. A ratio above 150% should be a warning indicator for a country risk analyst.
- Debt/GDP ratio: Is an indicator to measure indebtedness of a country, with comparing total debt of a country to total value of the economy, which represented by GDP. A ratio higher than 100% is a warning sign that a country is highly indebtedness. However much depends on the structure of the country's debt that is, its main creditors, the average maturity, interest rates floating or fixed, and more generally global market access.
- ST Debt/Reserves: Is an indicator to measure the ability of country's foreign reserves to service its short-term liabilities. The higher the ratio, the riskier a country.

**12. What is the Paris Club: <http://www.clubdeparis.org/>**



The Paris Club is a confidential ad-hoc forum of debt negotiations between OECD country creditors and their sovereign debtors. It only deals with official or officially-guaranteed credits (Coface, Hermes, ECGD, and US Eximbank). The first meeting with a debtor country was in 1956 when Argentina agreed to meet its public creditors in Paris. Since then, the Paris Club or ad hoc groups of Paris Club creditors have reached >430 agreements concerning 90 debtor countries. Since 1983, the total amount of debt covered in these agreements has been \$585 billion.

The Paris Club has remained strictly informal: voluntary gathering of creditor countries willing to treat in a co-ordinated way the debt due to them by the developing countries. It can be described as a "non institution". The creditor countries (19 countries including Russia) meet 10 to 11 times a year, for negotiation sessions or to discuss among themselves the situation of the external debt of debtor countries or methodological issues on the debt of developing countries. These meetings are held in Paris. The Chairman is a senior official of the French Treasury. Deputies to the Chairman in the French Treasury serve as co-president and vice-president. The current Chairman is the head of the French Government Treasury.

A debtor country comes to the Paris Club for a negotiation when an appropriate programme is supported by the IMF and shows that the country is not able to meet its debt obligations and thus needs a new payment arrangement with its external creditors.

**13. What is the London Club: <https://www.iif.com/>**



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The London Club is an ad hoc forum for restructuring negotiations formed by private institutions. Each London Club is formed at the initiative of the debtor country and is dissolved when a restructuring agreement is signed. Ad hoc London Club "Advisory Committees" are chaired by a leading financial bank. Recently, Advisory Committees have included representatives from nonbank creditors (fund managers holding sovereign bonds). The first meeting of London Club took place in 1976 in response to Zaire's debt payment problem.

The Institute of International Finance, Inc. (IIF), is the global association of financial institutions. Created in 1983 in response to the international debt crisis, the IIF has evolved to meet the changing needs of the financial community. Members include most of the world's largest commercial banks and investment banks, as well as insurance companies and investment management firms.

Among the Institute's Associate members are MNCs, trading companies, ECAs, and multilateral agencies. The Institute has more than 450 members headquartered in more than 70 countries at

end-2014. It provides members with in-depth country risk analysis of emerging market countries in Asia, Africa and the Middle East, as well as Eastern Europe and Latin America.

## IIF'S ANALYSIS OF CAPITAL FLOWS

### Emerging Market Economies: Capital Flows

\$ billion

	2012	2013	2014	2015
<b>Capital Inflows</b>				
<i>Total Inflows, Net:</i>	<i>1269</i>	<i>1188</i>	<i>1079</i>	<i>1164</i>
<b>Private Inflows, Net</b>	1232	1156	1032	1112
Equity Investment, Net	668	626	657	675
Direct Investment, Net	545	548	540	560
Portfolio Investment, Net	124	78	117	114
Private Creditors, Net	564	530	375	437
Commercial Banks, Net	118	193	124	151
Nonbanks, Net	446	338	251	287
Official Inflows, Net	37	32	47	53
International Financial Institutions	5	-3	19	27
Bilateral Creditors	31	35	28	25
<b>Capital Outflows</b>				
<i>Total Outflows, Net</i>	<i>-1292</i>	<i>-1360</i>	<i>-1348</i>	<i>-1339</i>
Private Outflows, Net	-946	-825	-981	-950
Equity Investment Abroad, Net	-332	-403	-368	-381
Resident Lending/Other, Net	-614	-422	-613	-570
Reserves (- = Increase)	-352	-534	-367	-388
<b>Memo:</b>				
<i>Net Errors and Omissions</i>	<i>-246</i>	<i>-65</i>	<i>0</i>	<i>0</i>
<i>Current Account Balance</i>	<i>276</i>	<i>236</i>	<i>269</i>	<i>174</i>

Source: IIF

MH Bouchet/Skema Global Finance (c)

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OF MBAs  
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INTERNATIONAL FINANCE & COUNTRY RISK ANALYSIS  
Republic of Solvencia and the International Capital Markets

## **Eurobond Request to Casino Bank**



[www.developingfinance.org](http://www.developingfinance.org)

## **Case Study Correction**

**Auteur :** Michel Henry BOUCHET, Global Finance Center  
**Etablissement créateur :** SKEMA Business School



# **SOLVENCIA**

**Eurobond Request to Casino Bank**

## **Case Study Correction**

*Republic of Solvencia and the International Capital Markets:*

*Eurobond Request to Casino Bank*

# Republic of Solvencia: Eurobond Request to Casino Bank

## In The Face of Looming Crisis

- This report is prepared in response to Casino Bank's Board of Directors' request to analyze Republic of Solvencia's current and future country risk situation, in relation to a US\$500 million sovereign bond issuance.
- Based on our analysis, we believe that Solvencia is on the verge of a looming economic crisis with a large trade and current account deficit, mounting external financing requirements, high reliance on short-term floating rate debt, lower debt servicing ability, hence deteriorating creditworthiness. Therefore, rejecting the request to underwrite the Solvencia's Eurobond is the best option for Casino Bank.
- However, we might still underwrite Solvencia's Eurobond issuance, if the Government of Solvencia provides its gold reserves as collateral. This arrangement would create a win-win opportunity for Solvencia and the investor community, while mitigating the risk of intermediation for Casino Bank.

### I- Country Profile and Political Background

Solvencia is a country of roughly 18 million people, with a rising but still low GDP per capita of around US\$1500. It went through a long struggle for independence that ended in 1962. Gradual political reforms in the 1990s resulted in the establishment of a bicameral legislature in 2002. However, the political climate remains rather volatile, social upheaval leads to frequent mass demonstrations, and accusations of corruption and unfair privatization programs, frequently followed by harsh repression.

The opposition movement gained momentum to promote institutional reforms in the aftermath of the severe economic crisis that hit Solvencia in 2007, paving the way for IMF/World Bank intervention. The IFIs imposed the implementation of a structural adjustment program, including stabilizing the public accounts, controlling domestic consumption and encouraging exports, shrinking the balance of payments deficit, as well as promoting political normalization and good governance.

The economic recovery program led to substantial results. Foreign direct investment flows increased. Euromoney and Institutional Investor improved Solvencia's country risk ranking in the mid-2000s. However, recent developments show that Solvencia's weak governance is a real impediment to sustainable development. Rating agencies recently downgraded Solvencia's country ranking.

Overall, our report concludes that there is no significant improvement in Solvencia's commitment to implement deeply rooted institutional reforms and to strengthen its efforts towards fighting corruption and reaching sustainable development.

### II- Background: Economic Crisis in 1999-2009 and Recovery

Solvencia's economic crisis was caused by several internal structural weaknesses and external factors. The main problems include exchange rate overvaluation, growing financing requirements due to a twin budget and external deficit, and excessive debt burden. Deep domestic imbalances led to a severe financial crisis in 2000 that was triggered by the rise in international interest rates and the spillover effect from the Asian Crisis.

In the late 1990s, rigid exchange rate management has led to worsening external competitiveness (combined effect with skyrocketing inflation), and excessive import reliance which created large trade and current account deficits. Overvalued exchange rate created three

problems for Solvencia.

1. First, Solvencia lost its external competitiveness, because the rate of currency depreciation at that time was not enough to match rising domestic prices. Export growth slowed down while imports increased. Dynamic domestic demand led to a mounting trade deficit.

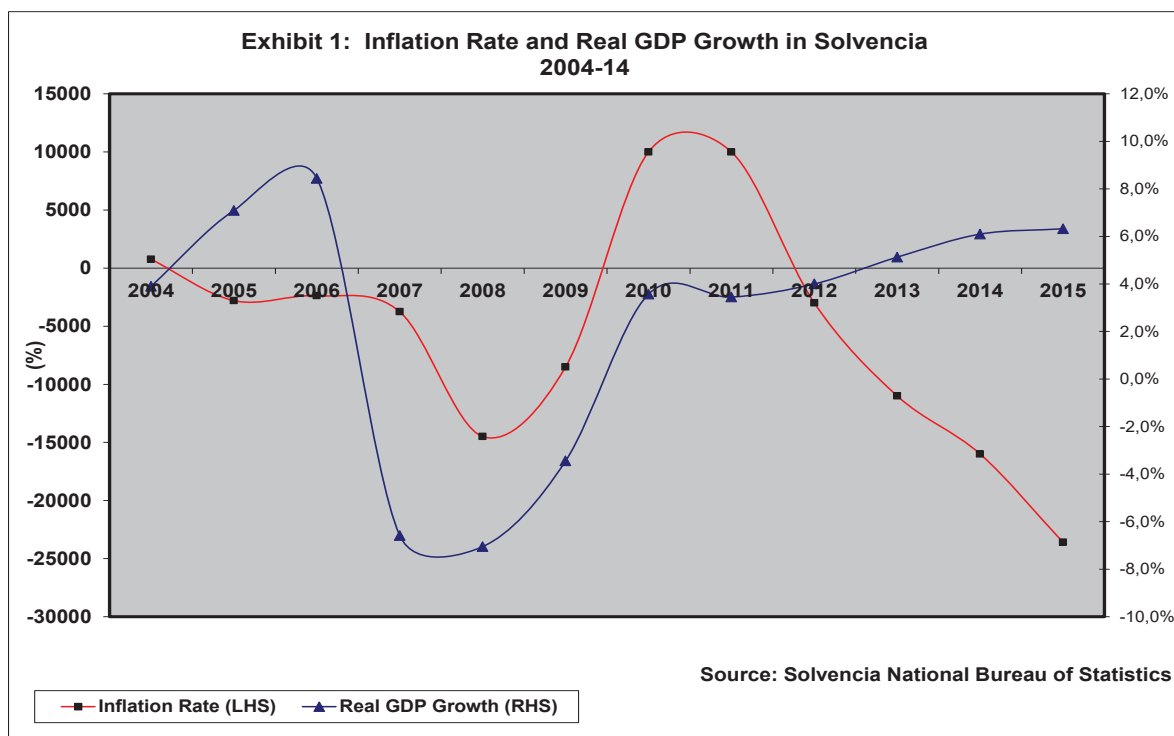
2. The second problem was triggered by poor external debt management. During the period of 1999-2001, the period where Solvencia dragged down into the crisis, Solvencia faced US\$ 3.7 billion of maturing external loans, almost three times higher than the amount due during the period of 1996-1998. This concentration of debt payments and growing current account deficit led to very large financing requirements that could not be matched by new debt and foreign investment. Consequently, official reserves dropped by US\$ 2.9 billion.

3. Besides structural weaknesses, Solvencia was also hit by external factors which include the rise in international interest rates and the spillover effect of the Asian Crisis. The rise in international interest rate has caused increasing interest payments, especially from commercial banks and private creditors due to floating interest rate contracts. Solvencia had to pay US\$ 2.1 billion of interest during 1999-2001, which is more than double the interest payments during 1996-1998. External liquidity deterioration was amplified by the spillover effect from Asian Crisis, leading to capital flight. Cumulative Errors & Omissions in the capital account reached US\$750 million in the three years 1998, 1999 and 2000.

The impact of the crisis itself was very harsh. Real GDP growth (in Local Currency term) dropped by 10% and 13% in 2000 and 2001, respectively. Inflation skyrocketed to 115% at the peak of the crisis in 2000, while the exchange rate depreciation did not keep pace with domestic prices. Current account deficit thus reached an all time high of US\$ 6.3 billion in 2000, which pushed Solvencia to rely on its official reserves for financing the deficit. Consequently, international reserve assets dropped by US\$840 million during the year 2000.

The liquidity crisis led Solvencia to request a Standby Arrangement (SBA) loan from the IMF. The IMF intervention was necessary to strengthen the official reserves and to restore the investors', creditors' and trade partners' confidence in Solvencia. With strong support from the US Treasury and France's Direction du Trésor, the IMF provided urgent cash injection of US\$ 500 million in 2000, and this was followed by another US\$ 250 million emergency loan in the following year. The World Bank itself provided a US\$650 million structural adjustment loan in 2001. The Bank's intention was to enhance the impact of the IMF intervention and to provide a social safety net to mitigate the severity of the stabilization program. However, the loans were not a "free lunch". To be able to withdraw the financing, Solvencia had to implement the IFIs' strict conditionality, i.e., a genuine shock therapy.

Devaluation of currency, liberalization of domestic economy, and privatization of state owned enterprise were the main IMF recipes. Devaluation of currency has helped Solvencia improve the current account position, through the J-Curve pattern, while liberalization and privatization aimed to attract foreign investors in Solvencia. As a result, exports jumped in 2002, imports declined and the trade surplus reached US\$1 billion, the first surplus after six years of deficits! All in all, in 2002, the current account position turned to positive territory, international reserves increased, thus restoring Solvencia's creditworthiness.



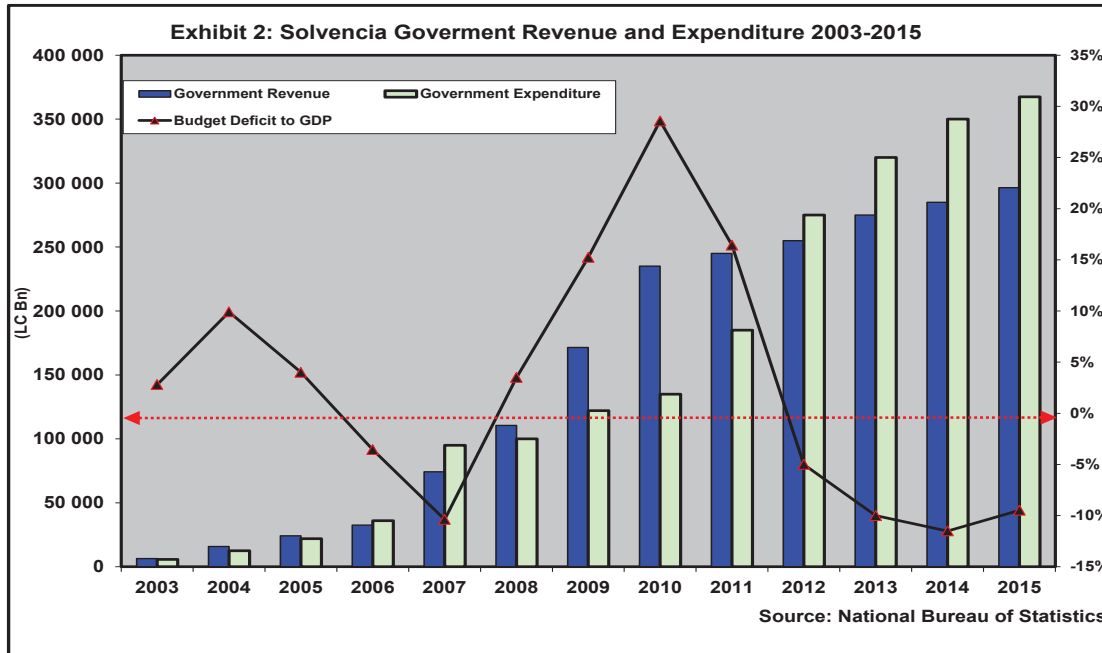
### III- The Country's Potential (positive points)

Solvencia offers some positive elements that could lead to economic and investment opportunities and/or potentials. Amongst are the following:

- **Reforms being undertaken:** After declaring its independence in 1962 the Republic of Solvencia has undertaken a path of gradual reforms and development. This improvement gave birth to more liberal regulations: a bicameral legislature was established in 2002.
  - Under the aegis of the IMF and World Bank, Solvencia carried out normalization of political system and efforts towards improvement of governance starting in 2003.
  - **International Institutions Monitoring:** International community encouraged the Government to undertake structural economic and institutional reforms in order to overcome the obstacles to sustainable development and foreign investment inflows. Governance improvement, however, seems very fragile.
  - **An open economy:** Solvencia's trade openness ratio is rather large. By reducing domestic demand and enhancing competitiveness, the country could boost its export potential and move to sustainable current account surplus. Trade and services sectors can have a positive impact on the country's future economic performance, given their linkages with other economic activities.
  - **Increase in FDI:** As a result of the sale of a mobile telephone license and partial privatization of the state-owned telecommunication company, Solvencia benefited from large amount of FDI after 2000. These non-debt creating capital inflows finance the current account, contribute to economic and employment dynamism, while promoting technology transfers.
  - **Growing agricultural sector:** Agriculture is a very important part of the country's economy. While facing structural and institutional problems with modernizing the industry, favourable climate and good harvesting conditions resulted in the improvement of GDP growth since the crisis.
  - **Dynamic (but not sustainable) economic momentum:** Solvencia's robust economic performance had a positive effect on the public finance sector. The country benefited from the global economic boom and accrued domestic consumption and investment, hence a surge in public revenues.
  - **High potential of human capital:** Solvencia enjoys large skilled human capital as well as young population.

#### IV- The Economy after the Crisis: Losing the Growth Momentum (negative points)

After the economic crisis and the implementation of IMF structural economic policy measures, Solvencia enjoyed moderate but sustainable GDP growth between 5 and 7%, and moderate inflation. Inflation witnessed a decreasing trend, reaching an average level of 10% between 2002 and 2006. Foreign investment activities also started to pick up again, attracting nearly US\$10 billion of new FDI into the country between 2001 and 2005, thanks to the privatization program. Dynamic growth helped increasing government's revenues, leading to a comfortable budget surplus between 2001 and 2004.



However, we believe this favorable economic development was mainly driven by external factors, namely strong growth in the global economy and low interest rate environment during the period of 2002-2006. The soundness of economic fundamentals and the commitment to long-term institutional and structural reforms remain questionable. The latest developments of Solvencia's economy raise concerns. Economic growth in 2008 is expected to be only 3 %, or half of the growth seen in 2007. Moreover, inflation rate also started to pick up again to 22% in 2007 and probably around 30% in 2008, mainly due to soaring oil prices and increasing domestic consumption. On the investment side, high political instability, terrorist attacks and harsh repression to demonstration and political protest have discouraged FDI. In 2006 and 2007, FDI inflows reached barely US\$500 million, and dropped further in 2008.

Moreover, rising government expenditures contributed to a return to budget deficit since 2006, fuelling inflation. After enjoying surplus on the government budget in the period 2001-2004, government budget returned to negative territory. All in all, Solvencia did not benefit from buoyant global economic growth and recent sharp trade dynamism due to deteriorating economic fundamentals.

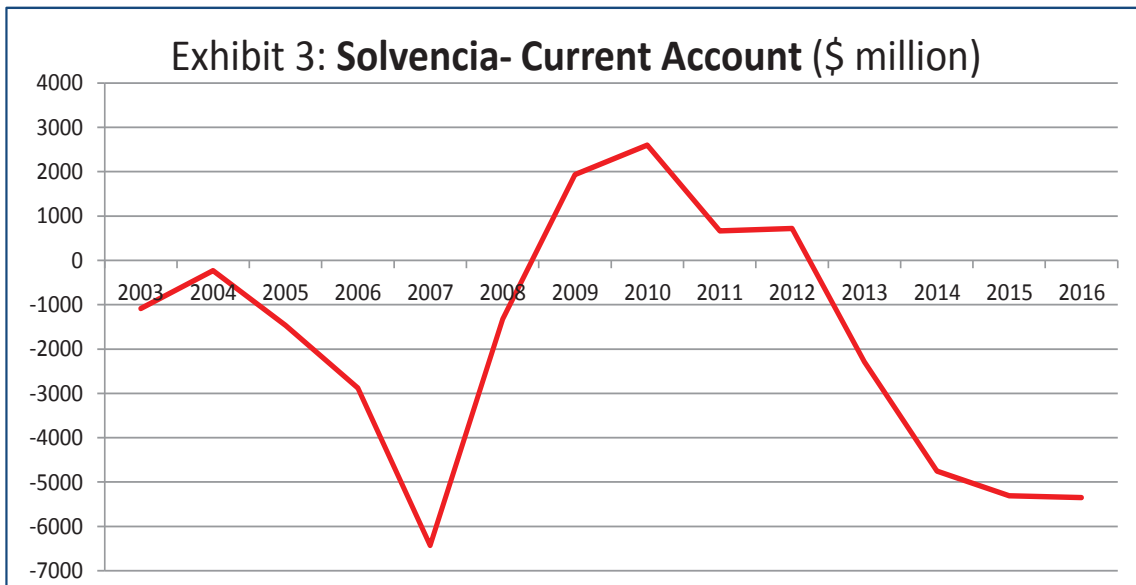
#### V- Balance of Payment: Facing New Mounting Current Account Deficit

From a country risk standpoint, Solvencia's balance of payment exhibits several sources of concern. As we can notice between 1996 and 2000, a larger and larger current account deficit occurred mainly due to eroding external competitiveness, spill-over effect caused by the Asian crisis, and mounting imports due to overvalued exchange rate.

The main reason lying behind the growing trade deficit is not only the surging oil prices (and oil is the biggest part of Solvencia's imported commodity), but also unsustainable

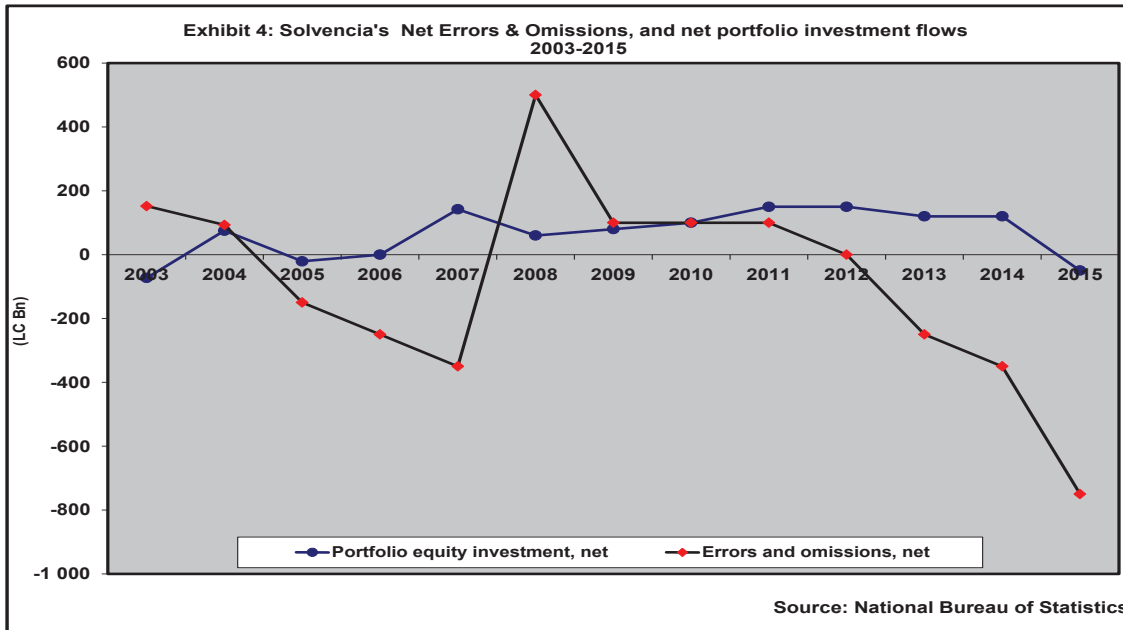
domestic private consumption and government expenditures. Solvencia suffers basically from a demand-led inflation and a cost-driven deficit.

On the revenue side, income from tourism revenues has been witnessing severe problems and have decreased due to travel warnings issued by UK, US, and Japan as a response to the political turmoil, instability, and several bomb threats in the country's capital, Solven City. Private remittances also tend to decrease in 2008, in line with the current threat of global economic recession. This has greatly affected the current account. However, good harvest condition in recent years and diversifying export structure has improved the export position, but still not enough to cover the increase in imports and the drop in tourism revenues. All in all, trade deficit is wider and wider, reaching around \$4,5 billion. We expect the current account deficit to reach US\$5 billion in 2016, as much as in the previous year, equivalent to a record high 10% of GDP!



#### **VI- Twin Deficit Financing: Increase Reliance on External Debt**

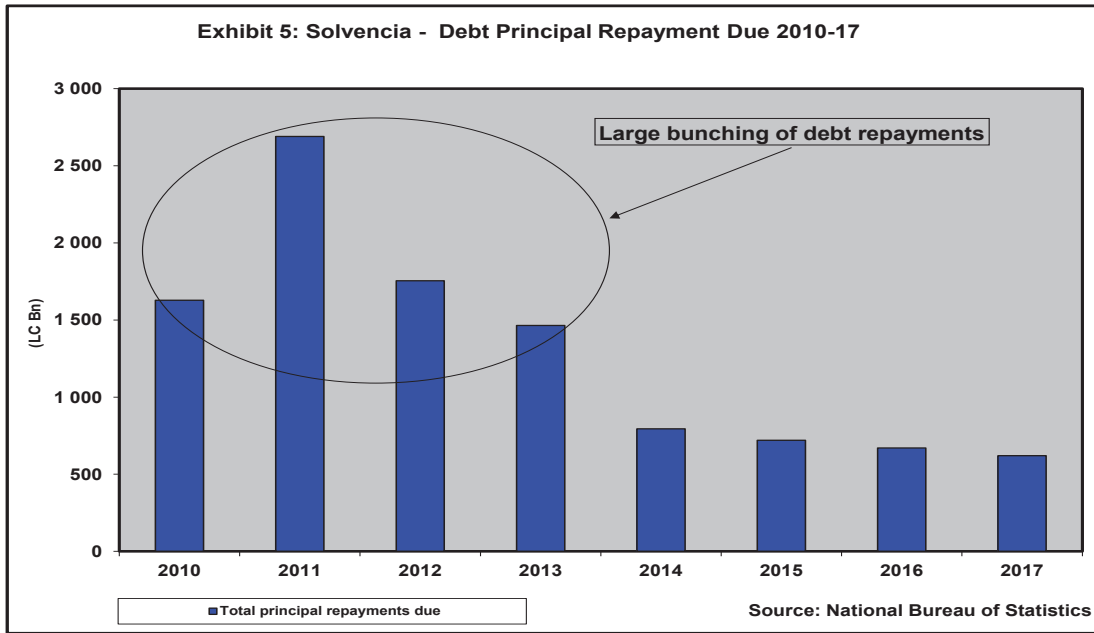
The country's external liquidity situation has deteriorated in the 2004-2008 period due to a combination of factors including the following: shrinking FDI flows, decreasing current account surplus, and a drop in external financing. Rising capital flight compounded the problem. In 2008, the current account deficit exploded, probably reaching -US\$2.7 billion, compared with a surplus of around US\$2 billion per year in the 2002-2003 period. In addition, the NE&Os turned to negative territory, a proxy signal for capital flight. Cumulative capital flight amounted to a record US\$1.35 billion! Accordingly, the country's reserves might drop by US\$2 billion in 2008 alone to cover the mounting external financing requirements.



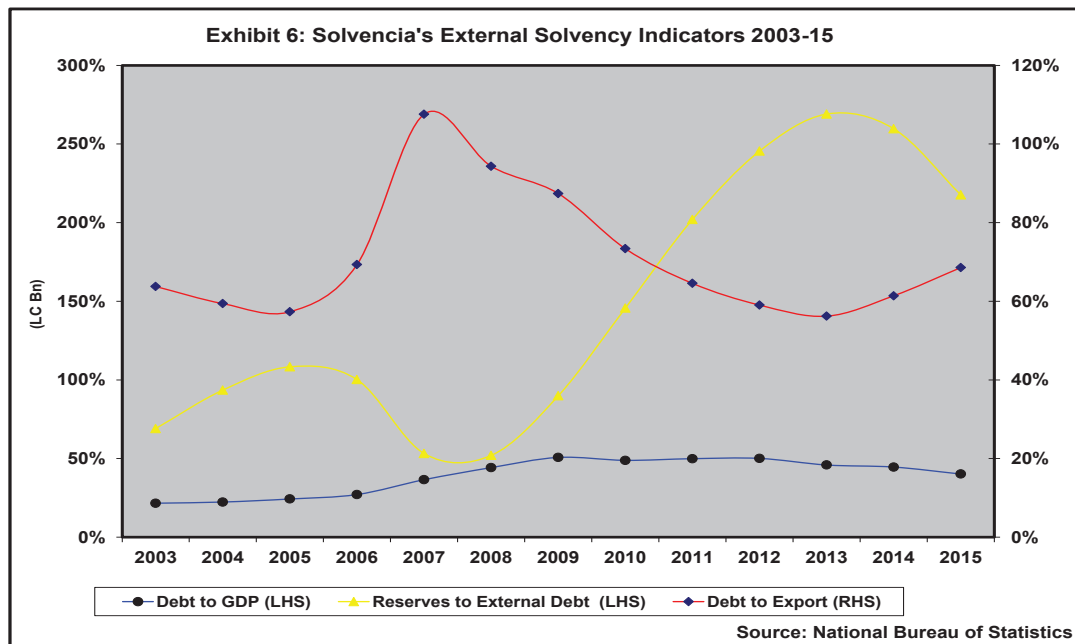
Overall, our main concern stems from Solvencia's protracted disdain for prudent macroeconomic management. There are converging signals that the country is back to the pre-crisis situation of excessive spending, growing deficits, and rising inflation. Despite a high level of international reserves, estimated at still around US\$22.6 billion, current trends point again toward looming liquidity problems.

Solvencia's major sources of external debt are capital markets and foreign creditors including principally International Financial Institutions (IMF and World Bank), official bilateral creditors (i.e. Paris Club) and commercial banks (i.e. London Club). Capital markets (bond issuance) do not represent a large share of the country's external indebtedness.

The main risks of the debt structure of Solvencia, in our opinion, are the growing reliance on commercial bank borrowing, the bunching of principal repayment between 2007 and 2009, and liquidity tensions. The total proportion of commercial banks borrowing in Solvencia's total debt reveals an increasing trend between 1996 and 2008, from 19% to 23% respectively. Since interest rate from commercial banks loans is usually floating, high reliance on this type of financing makes Solvencia's balance of payment very sensitive to future upward changes in interest rates.



The second risk Solvencia faces is high principal loan repayment in the period 2011-13, with almost US\$ 7.5 billion of loan maturing, even higher than total debt service payment due during the 1999-2001 economic crisis. This, in our view, is the major challenge to Solvencia's economy in the future. Debt servicing concentration raises concerns about Solvencia liquidity and its ability (and willingness) to keep servicing its external debt while financing imports. The debt to export ratio will stand at 69% in 2008, compared with 56% in 2006. However, according to our calculations, the reserves to import ratio will remain at a comfortable 13 month level in 2008, well ahead of the safety threshold, which is normally 6 months.



In order to stem a further reserve decline and to restore the international community's confidence in the country's economy, Solvencia has requested a new loan from IMF in 2007, amounting to US\$ 300 million and another US\$ 100 million in 2008. This reveals the fact that the Government of Solvencia has realized it might face liquidity problems in the near future.

On the other hand, solvency is not (yet) a major risk for the country. So far, the liquidity

tension does not translate into solvency risk, as the Debt/GDP ratio is comfortable at 40% in 2008, well below critical levels.

### **VII- Solvencia's upcoming challenges for paving the way to sustainable development, external creditworthiness, and return to market access**

Regarding the need for implementing **market-based economic policy measures**, one can highlight the following challenges Solvencia must tackle over the 2008-2012 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.

### **VIII- Eurobond Project Request: To Float or Not To Float**

Before concluding by providing the recommendation whether we should underwrite or not Solvencia's Eurobond, there is a three-fold question we have to answer: Is Solvencia's economy in the face of new economic problems...? If the answer is positive, how sharp and long will be these problems...? And will the government be committed to take all the necessary measures to move the country back to a track of sustainable development?

We believe that Solvencia is on the verge of new economic crisis, starting as early as 2013. The economic and financial tensions might be triggered by populist policy choices and imprudent financing strategy. We predict Solvencia will face difficulties in servicing its debt, considering that there will be much larger debt service payment during 2008-2011, high current account deficit, and dropping reserves to import ratio. The country would then be vulnerable to exogenous shocks such as soaring oil import prices and rising rates of interest. This might then push Solvencia into payment arrears and to debt rescheduling. The crisis could worsen due to bad governance. All of this situation will dampen Solvencia's economy. We also observe that the IMF and the World Bank will be very cautious not to extend new loans to Solvencia without strong reform conditionality, especially after taking into account its weak governance.

All in all, we stress the need to speed up the pace of **structural and institutional** reforms and to implement the following sustainable development priorities:

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

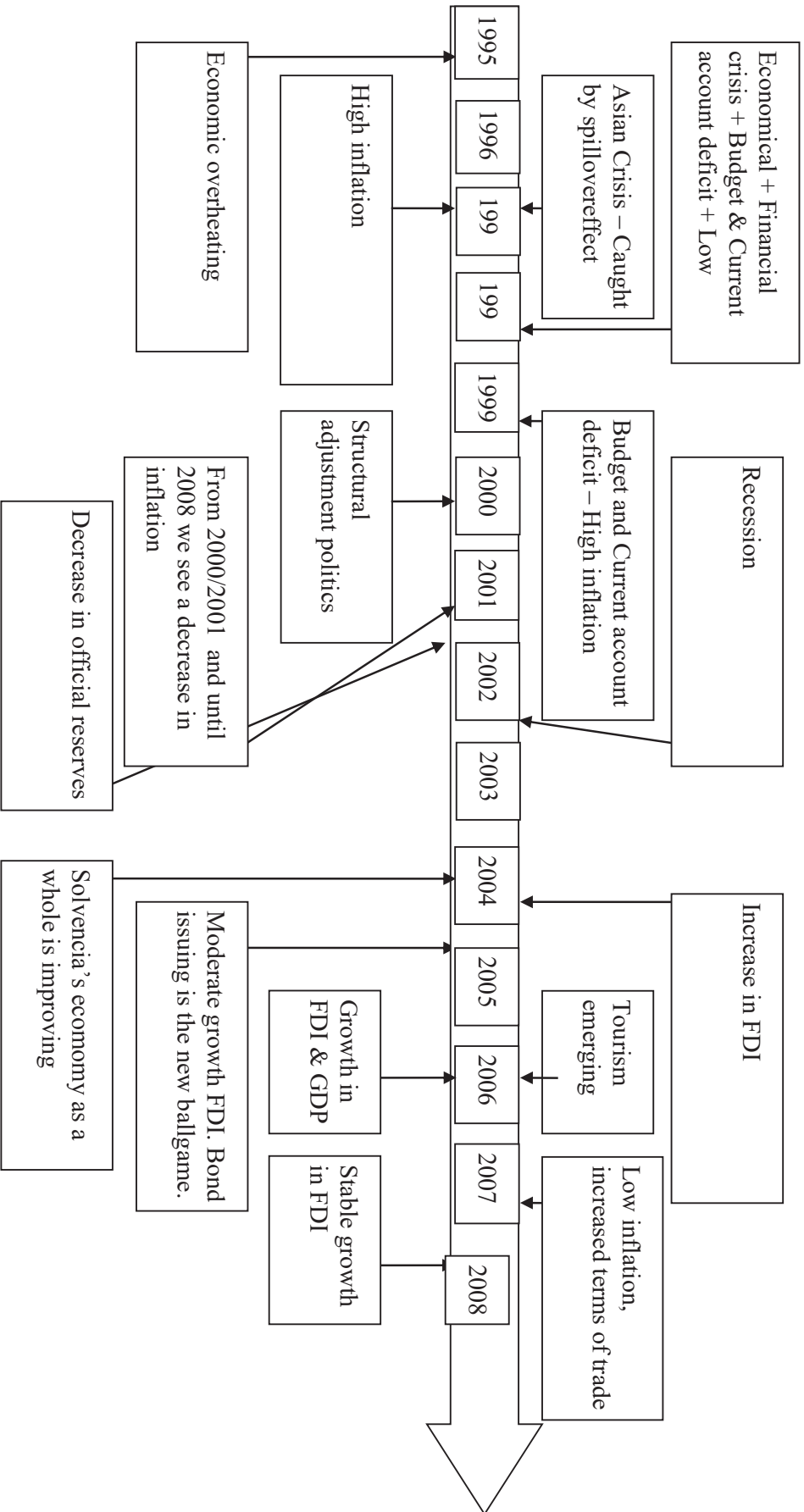
### **IX- Conclusion and recommendation to Casino Bank's Risk Committee**

In conclusion, **we recommend the Board of Directors not to underwrite Solvencia's Eurobond.** We believe that investment banks will be reluctant to underwrite the US\$500 million bond and that bondholders will show little appetite for a straight bond issue despite its attractive yield.

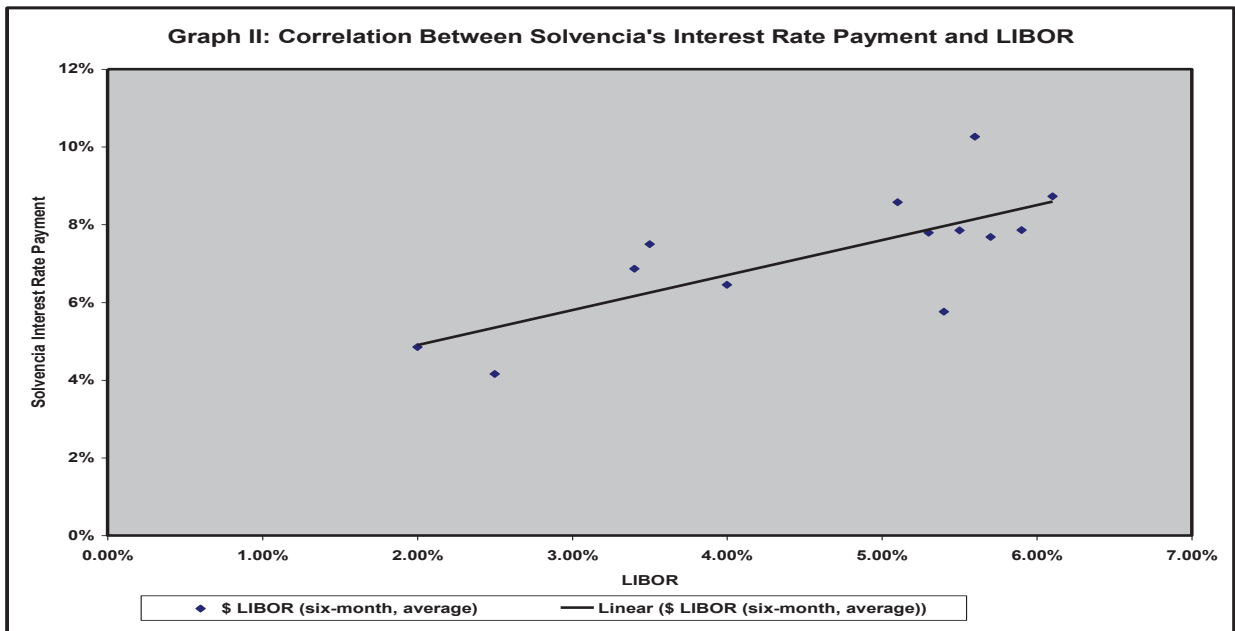
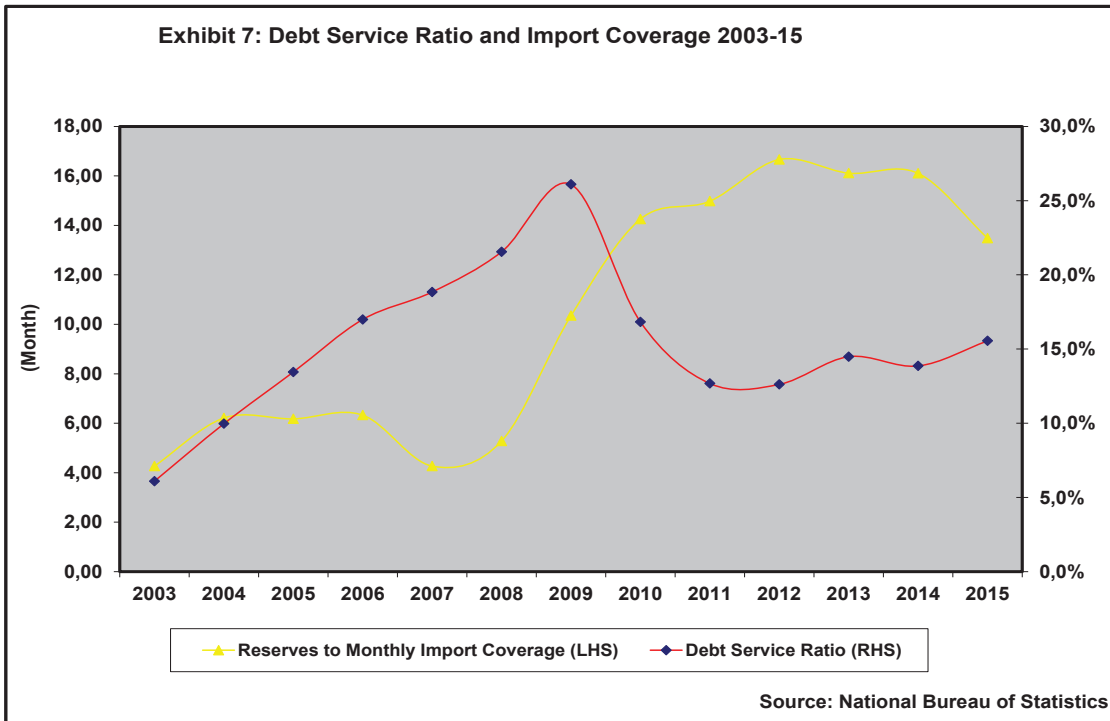
From our standpoint, however, there might still exist an opportunity to support the Eurobond issue while mitigating the risk for Casino Bank. One can request Government of Solvencia to use the country's gold reserves to guarantee the Eurobond. Gold reserves will be held by an independent party, such as the BIS or an escrow account in a reputed financial institution. With this arrangement, we believe, we can sell the Eurobond of Solvencia in the capital markets with promising fees for our bank, and favorable risk/return ratio for international investors.

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 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...

## Appendix: Timeline - Solvencia



## Annexes



INTERNATIONAL FINANCE & COUNTRY RISK ANALYSIS  
Republic of Solvencia and the International Financial Markets

## **Eurobond Request to Casino Bank**



**Michel Henry BOUCHET**  
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**SKEMA Business School**

## Pedagogical Support Note

**Auteur :** Michel Henry BOUCHET, Global Finance  
**Etablissement créateur :** SKEMA Business School

# Pedagogical Support Note for Solvencia Case

The **Solvencia Case Study** combines international finance, capital markets and country risk features that enable the professor to tackle a wide range of issues. The case can be used in a Country Risk Course, an International Finance course, and an International business and strategy course, as well as an Investment Banking course. The case discussion could be presented and dealt with at the end of the first semester, when the professor has addressed such issues as balance of payments, international finance strategy, risk management and capital markets.

## 1. Case Summary

The case study deals with an emerging market country's request for financial advisory services with regard to the launching of a €800 million Eurobond issue on international capital markets. The students must work on the case from the standpoint of an investment banker who has to perform a country risk assessment. The end-product of the case is an in-depth risk analysis report with a clear-cut recommendation to the bank's Risk Committee. The case can combine a written report (group work or personal work) as well as an oral presentation of the analysis' salient points.

## 2. Case material

The case study comprises the following seven elements:

- Pedagogical note
- Case study presentation
- Background information for the students regarding country risk components, eurobond syndication, and other international finance issues.
- Excel spreadsheet with macroeconomic and balance of payment data, including a number of "blanks" to be filled in with liquidity and solvency ratios
- Case correction
- Excel spreadsheet correction
- Case presentation with Power point slides

## 3. Student target audience

The target student audience is mainly Master in International Finance, "Majeure Finance de Marché" in business schools, Country risk analysis as well as International Finance courses in business schools, IEP and University.

## 4. Case Objectives

### 3.1. General Objective

Country risk is a broad concept that comprises an underlying combination of economics, finance, geopolitics, sociology, and history issues. As the global market integration increases the risk of crisis contagion and spill-over, the level of uncertainty and complexity gets larger for the international firm's cross-border strategy. Hence country risk analysis has become today an essential component of strategy decisions regarding export, investment, partnership, mergers, as well as takeovers. The main purpose of this case study is thus to help the students to understand the framework of country risk analysis based on an hypothetical emerging country. However, although the country used in this case does not really exist, all the political, economic and financial background given in this case is typical pattern of a developing country's economic and socio-political challenges.

### 3.2. Specific Objectives

- Helping the students to understand the key parameters of country risk, including political, economic and financial issues of a country's development process.
- Analysing the balance of payment and its large role in country risk analysis.
- Understanding the impact of macroeconomic policies on a country's external financing requirements;
- Identifying the key international finance and economic intelligence sources, both official and private;
- Focusing on the most important liquidity and solvency ratios to gauge a country's debt serving capacity and creditworthiness.
- Writing a succinct and well articulated risk strategy note.

#### 5. Responsibility of the professor:

- Present and explain the case to the class
- Briefly describe the bond issuance process and its main risks;
- Identify the key parameters of country risk (economic, financial, socio-political, regional, and systemic);
- Spell out the main steps in a country risk assessment note;
- Organize the class in various groups to help the students focus on the most important issues (economic, financial, socio-political, balance of payments, external indebtedness issues, as well as liquidity and solvency indicators)

#### 6. Responsibility of the students

- Understand the problems in the case study;
- Identify the critical points of analysis and the step by step country risk assessment;
- One week after the case study being distributed, each group shall submit to the professor an Excel-based quantitative analysis of the case study;
- Two weeks after the case study being distributed, each group shall present its final analysis in a formal oral group presentation. Each group will get 30 mns to address the Casino Bank's "Risk Committee" and provide a clear-cut recommendation regarding Solvencia's Eurobond request.

#### 7. Problem solving objectives:

The Solvencia-Casino Bank case study leads the students throughout the hypothetical case of an emerging country with large external financing requirements. The students must assess the country's country risk situation from the standpoint of an investment banker, focusing on the economic, financial, and socio-political components of sovereign risk.

The professor will spell out the major differences between the role of a commercial bank and that of a merchant or investment bank. The former will lend money and it will mitigate the risk (1) through a Eurobond syndication including a large number of underwriting banks, and (2) it might securitize the loan to sell it on the secondary market as a liquid and tradeable financial instruments. The securitization process will free capital on the bank's balance sheet and will shift the risk to other economic agents, for instance, institutional investors. The latter does not lend any money but acts rather as an intermediary providing fee-based financial advisory services.

The professor will then tackle country risk from the standpoint of uncertainty, i.e., a deficit of information and economic intelligence, hence the need to identify a wide range of country risk information sources, both official and private.

Then the professor will aim at focusing the students' attention on the four main causes of cross-border investment pitfalls, namely, economic, financial, socio-political, and regional spill-over. He/she will emphasize the usefulness of in-depth balance of payments analysis to cast light on liquidity and solvency indicators. Regarding the socio-political analysis that requires qualitative assessment, he/she will illustrate the usefulness and limits of ratings and rankings (Asian crisis, LTCM, Enron, US subprime crisis...).

## 8. Length and case organization

Typically the case runs over two to three weeks

- Week 1: (1 hour) case presentation by the professor, team work organization
- Week 2: Debriefing: each group submits to the professor an Excel-based quantitative analysis of the case study, presenting the key liquidity and solvency ratios; (each group will get 20 mns for a succinct presentation of its calculations)
- Week 3: Debriefing: each group holds an oral presentation of its overall country risk analysis of Solvencia, in a Board Meeting format, using PPT slides, leading to a class wide debate (20 mns each). Alternatively, the professor will split the class in two groups; one group will tackle Solvencia's Eurobond request with a view to turn it down, hence emphasizing the negative points of the country's situation, while the other group of students will emphasize the positive points leading to Casino Bank's support of the country's Eurobond request. The debate will lead to a confrontation of the two stances concerning the bank's strategy with regard to the emerging market country.
- An additional step in the case discussion can be to ask students how to structure a €800 Eurobond issue to facilitate the launching of the bond while mitigating the risk from the bondholders' side. The students might consider various collateralization options, using the gold holdings of the country's central bank, shortening the bond maturity, or including an equity conversion option into the upcoming privatization program of the country.
- The professor will ask each group to submit a written report to the Bank's Risk Committee. The report should be short, well articulated and with a clear-cut conclusion (three pages).
- The professor can then distribute a correction of the case study and to present the salient features of the correction using Power Point slides.

## 9. How can the Solvencia case study fit in an International Finance course and a Country risk assessment training seminar?

The Solvencia case study is useful in that it brings together a wide number of international finance and economic issues pertaining to country risk analysis and management. The overall objective is to lead the students from an in-depth analysis of the country's macroeconomic and financial situation to an investment strategy which can be a **Yes/No decision**, or even a **Yes/But** decision, i.e., using various risk mitigation instruments.

## Succinct bibliography:

### ENGLISH

1. Bouchet, Fishkin, Goguel: *“Managing Country Risk in an Age of Globalization: A Practical Guide to Overcoming Challenges in a Complex World, Palgrave 2018*  
<https://www.palgrave.com/la/book/9783319897516>  
[http://a-online.fr/skema/21-09-2018/life\\_fr.html#article2](http://a-online.fr/skema/21-09-2018/life_fr.html#article2)
2. Bouchet, Michel Henry, Ephraim Clark, and Bertrand Gros Lambert. 2003. *Country Risk Assessment: A Guide to Global Investment Strategy*. John Wiley & Sons: England.
3. Bouchet Michel-Henry: *Country risk in the age of Globalization and Donald Trump*, *World Financial Review*, October 217
4. Bouchet, Michel Henry. 2017. *International Finance Lectures Series*. SKEMA Business School.
5. Fabozzi, Frank J. 2000. *Bond Market Analysis and Strategies: 4<sup>th</sup> Edition*. Prentice Hall: New Jersey.
6. Clark Ephraim, *International Finance*, 2<sup>nd</sup> edition, Thomson, 2002.
7. Madura, Jeff. and Fox, Roland, 2013. *International Financial Management: 5<sup>th</sup> Edition*. International Thomson Publishing: Ohio.
8. BIS *International Banking and Financial Market Developments*, BIS Quarterly Review.

### French, and Spanish:

1. Bouchet et alii : « *Gestion et Finance Internationales*” (Pearson 2004)
2. Bouchet, “*La Globalisation, Introduction à l’Economie du Nouveau Monde*” (Pearson 2005),
3. Bouchet, “*Intelligence Economique et Gestion des risques*” (Pearson 2007, with Alice Guilhon)
4. Bouchet : “*Riesgo-Pais: un enfoque latino-americano*” (ESAN 2007). (with Sarmiento y Lumbreras)

### Websites:

1. <https://developingfinance.org/>
2. [www.iif.com](http://www.iif.com)
3. [www.ny.frb.org/education](http://www.ny.frb.org/education)
4. [www.clubdeparis.org](http://www.clubdeparis.org)
5. [www.imf.org/external](http://www.imf.org/external)
6. [www.economist.com](http://www.economist.com)
7. [www.eiu.com](http://www.eiu.com)
8. [www.worldbank.org](http://www.worldbank.org)
9. [www.bis.org](http://www.bis.org)

## Standard Country Risk Assessment Fact Sheet

### **1. Introduction: Map and graphs**

(History, political system, ethnical features, culture and religion)

### **2. Survey of geographical features, raw material, human and natural resources**

UNCTAD: [www.UNCTAD.org](http://www.UNCTAD.org)

UNDP [www.undp.org](http://www.undp.org)

World Bank [www.worldbank.org](http://www.worldbank.org)

CIA <https://www.cia.gov/library/publications/the-world-factbook/>

### **3. Macro-economic analysis**

Sector analysis, macroeconomic adjustment, trade strengths and weaknesses (partner/product composition),

Inflation, savings/investment ratios

GDP growth, underground economy, public sector expenditures...

IMF/WB/regional development banks: IADB/AfDB:AsDB/EBRD

<http://www.ntu.edu.sg/library/statdata.htm>

### **4. Balance of payments analysis**

Trade balance, current account, reserves, E&O

[www.imf.org](http://www.imf.org)

[www.iif.com](http://www.iif.com)

### **5. Debt Flows & Stock Analysis**

Debt servicing burden, liquidity and solvency indicators

World Bank/OECD/BIS/IMF

[www.bis.org](http://www.bis.org)

Secondary market discounts: Bradynet, EMTA/IFR

### **6. Legal and regulatory framework conducive to private investment**

World Bank Doing Business <http://www.doingbusiness.org/economyrankings/>

Heritage Foundation: index of Economic Freedom <http://www.heritage.org/index/>

### **7. Ratings**

[www.Euromoney.com](http://www.Euromoney.com)

[www.fitchibca.com](http://www.fitchibca.com)

[www.moodys.com](http://www.moodys.com)

[www.standardandpoors.com/ratings](http://www.standardandpoors.com/ratings)

[http://www.cofacerating.fr/portail/chaineeco\\_international/notationpays.asp?metier=ALL&geo=ALL](http://www.cofacerating.fr/portail/chaineeco_international/notationpays.asp?metier=ALL&geo=ALL)

<http://www.weforum.org/en/initiatives/gcp/Global%20Competitiveness%20Report/index.htm>

[http://www.transparency.org/policy\\_research/surveys\\_indices/cpi](http://www.transparency.org/policy_research/surveys_indices/cpi)

<http://hdr.undp.org/en/statistics/>

### **Main Sources of Country Risk Intelligence –I-**

- BERI (Business Environment Risk Index)
- Bradynet Info and data on emerging fixed income markets.
  - Credit Risk International
  - Davos World Economic Forum
  - Dr. Harvey Campbell 's site (Duke University)
    - Dr. Nouriel Roubini's web site (NYU)
  - Economist Intelligence Unit (London) [www.eiu.com](http://www.eiu.com)
  - Euromoney Magazine (Country risk indices).
    - Frost & Sullivan
    - Global Finance Magazine
- Global Risk Assessment, Inc. - Country Risk Services [www.grai.com](http://www.grai.com)
  - Harvard Institute for International Development (Boston)  
IFC Emerging Stock Market Factbook
  - Institute for International Economics (Washington)
- Institute of International Finance Inc. (Washington, D.C.) [www.iif.com](http://www.iif.com)
  - Institutional Investor Magazine
    - ICRG
- International Finance Corporation Data (World Bank: source for emerging markets data)
  - International Finance Review (London): secondary market prices & bond issues
    - Morgan Stanley Capital International Data
  - Oxford Analytica Inc. On-line daily analysis and custom country risk services.
- Political and Economic Risk Consultancy, Ltd.- PERC Gateway to news & country data
  - Political Risk Services (country risk indices).
- Rabid Tiger Project Jeff Deutsch's Political Risk Consulting and Related Research
  - Transparency International (corruption & governance)
    - UNCTAD (trade and FDI data)
  - UNDP (HDI, life expectancy, and GDP per capita PPP)
    - World Bank Governance indicators

### **Useful WEBSITES –II-**

[www.imf.org](http://www.imf.org)

[www.worldbank.org](http://www.worldbank.org)

[www.cia.us](http://www.cia.us)

[www.ifc.org](http://www.ifc.org)

<http://www.iadb.org/>

(Handbook of Economic Statistics. Washington, DC: Central Intelligence Agency):

<https://www.cia.gov/library/publications/the-world-factbook/>

Web sites of central banks (<http://www.zagury.com/cbanks.htm>)

[www.bis.org](http://www.bis.org)

<http://www.ntu.edu.sg/library/statdata.htm>

[www.globalfinance.org](http://www.globalfinance.org)

[www.ny.frb.org/education](http://www.ny.frb.org/education)

[www.clubdeparis.org](http://www.clubdeparis.org)

[www.economist.com](http://www.economist.com)

### **RATINGS –III-**

[www.Euromoney.com](http://www.Euromoney.com)

[www.fitchibca.com](http://www.fitchibca.com)

[www.moodys.com](http://www.moodys.com)

[www.standardandpoors.com/ratings](http://www.standardandpoors.com/ratings)

[http://www.cofacerating.fr/portail/chaineeco\\_international/notationpays.asp?metier=ALL&geo=ALL](http://www.cofacerating.fr/portail/chaineeco_international/notationpays.asp?metier=ALL&geo=ALL)

<http://www.doingbusiness.org/economyrankings/>

<http://www.heritage.org/index/>

<http://www.weforum.org/en/initiatives/gcp/Global%20Competitiveness%20Report/index.htm>

<http://www.imd.ch/research/publications/wcy/index.cfm>

[http://www.transparency.org/policy\\_research/surveys\\_indices/cpi](http://www.transparency.org/policy_research/surveys_indices/cpi)

<http://hdr.undp.org/en/statistics/>



# SK



SKEMA BUSINESS SCHOOL  
**COUNTRY RISK ANALYSIS**  
Republic of Solvencia 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



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 spill-over 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

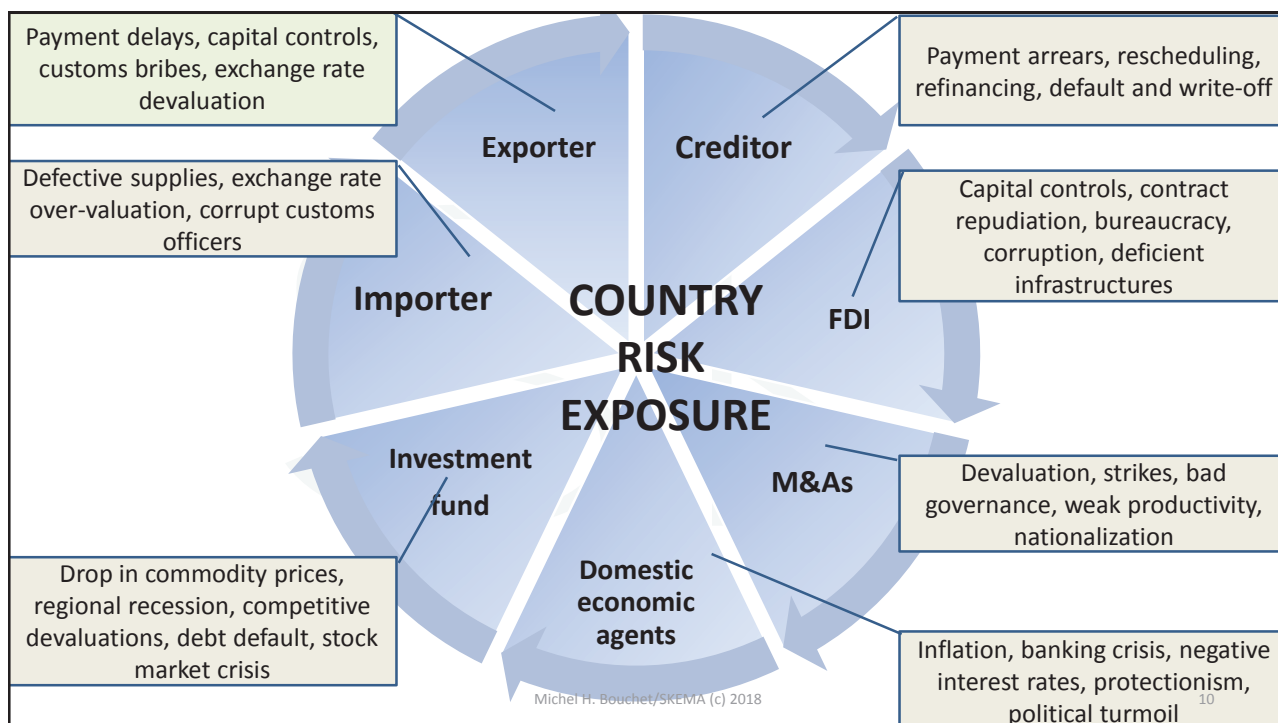
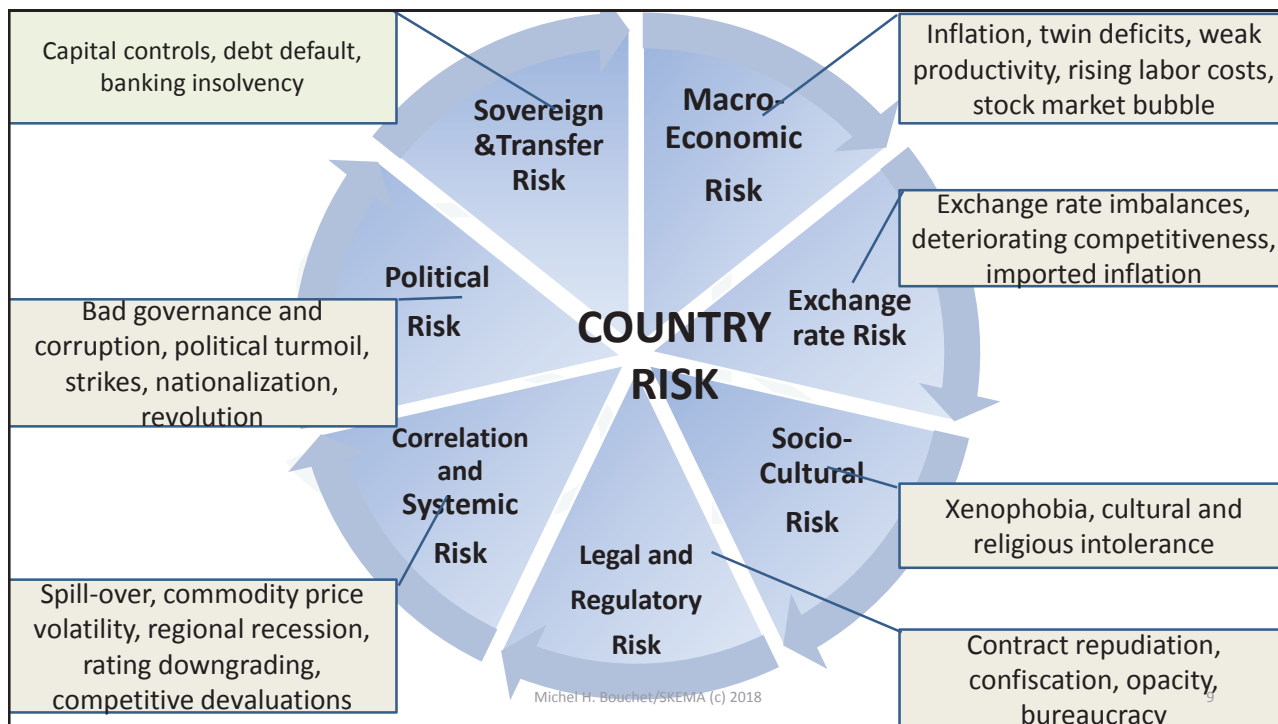
- ▶ *Country risk results from a set of complex and interdependent socio-economic, financial and political factors, that are specific for a particular country, but that can quickly evolve given the country's global integration.*

## 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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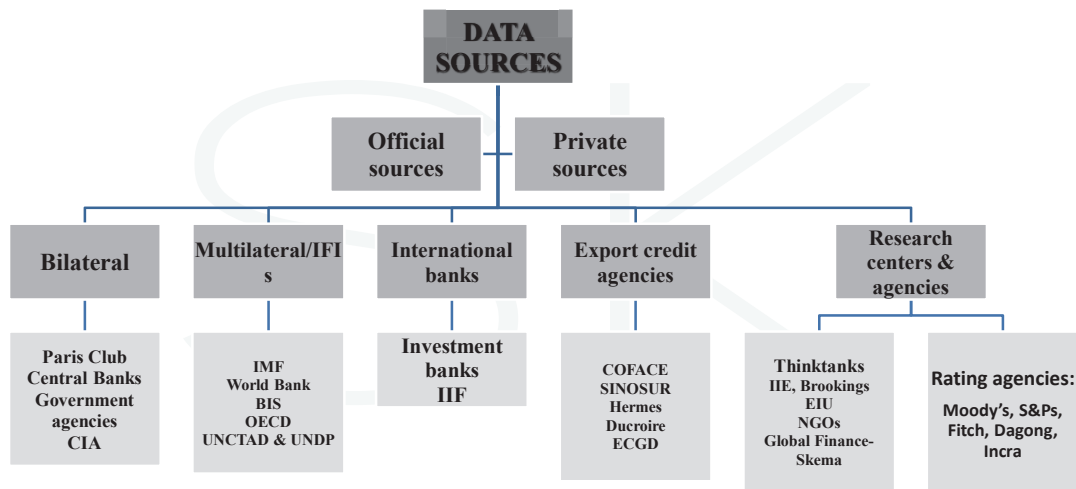
## COUNTRY RISK ASSESSMENT

Reliable and updated information

= Economic intelligence

▶ **Robust risk analysis**

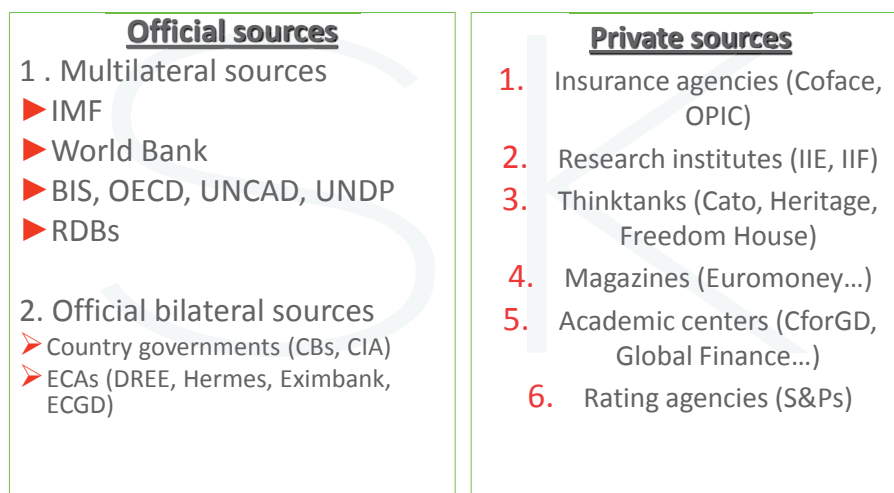
## MAJOR SOURCES OF COUNTRY RISK INTELLIGENCE



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



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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**

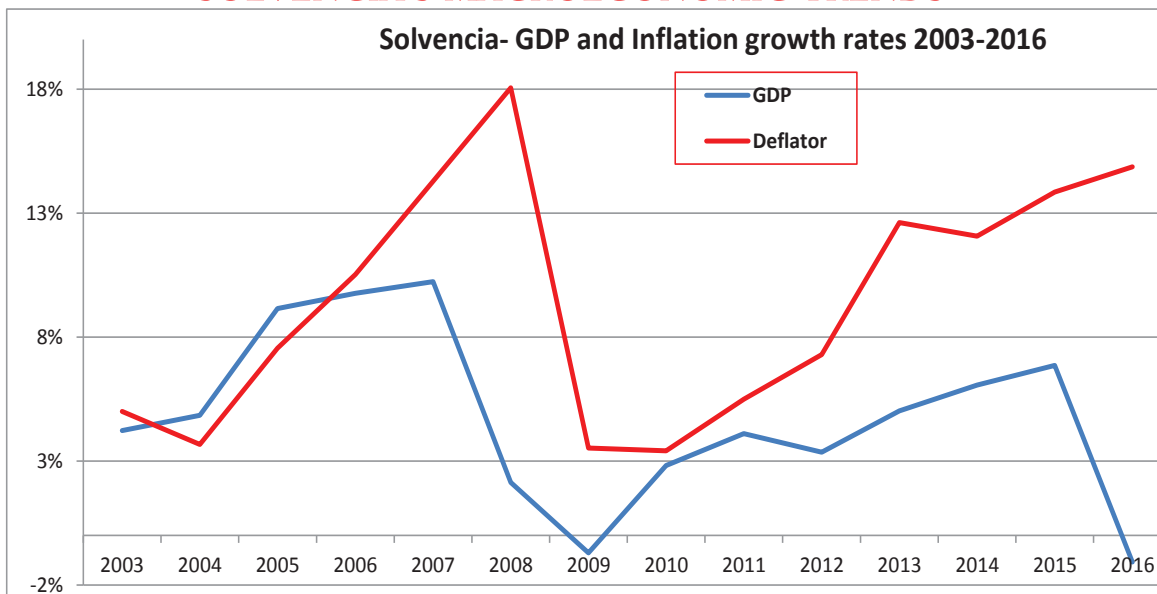
- ▶ Debt/Export ratio
- ▶ Debt/GDP ratio
- ▶ ST Debt/Reserves

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!

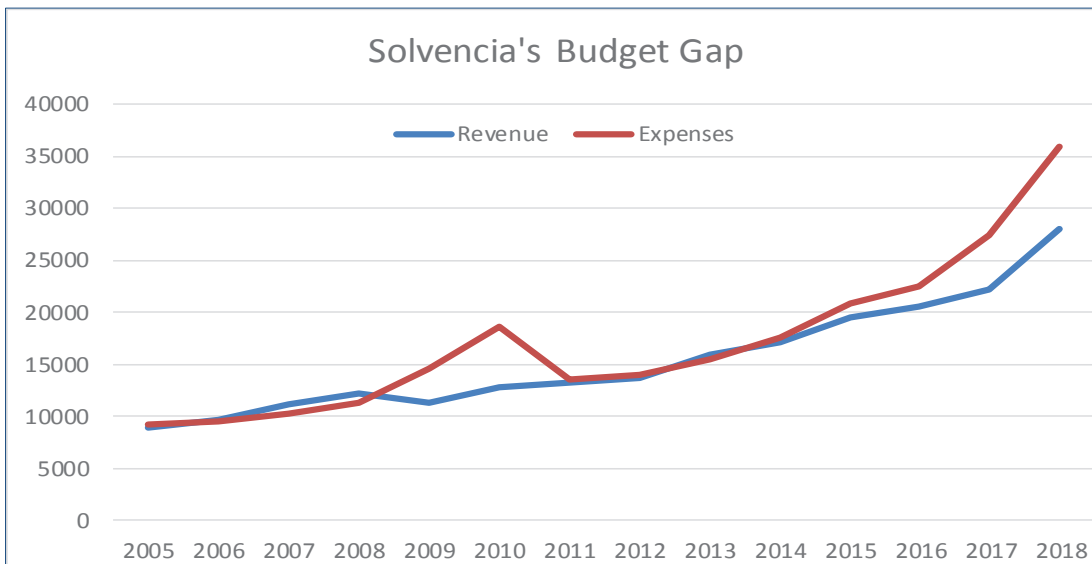
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## SOLVENCIA'S MACROECONOMIC TRENDS



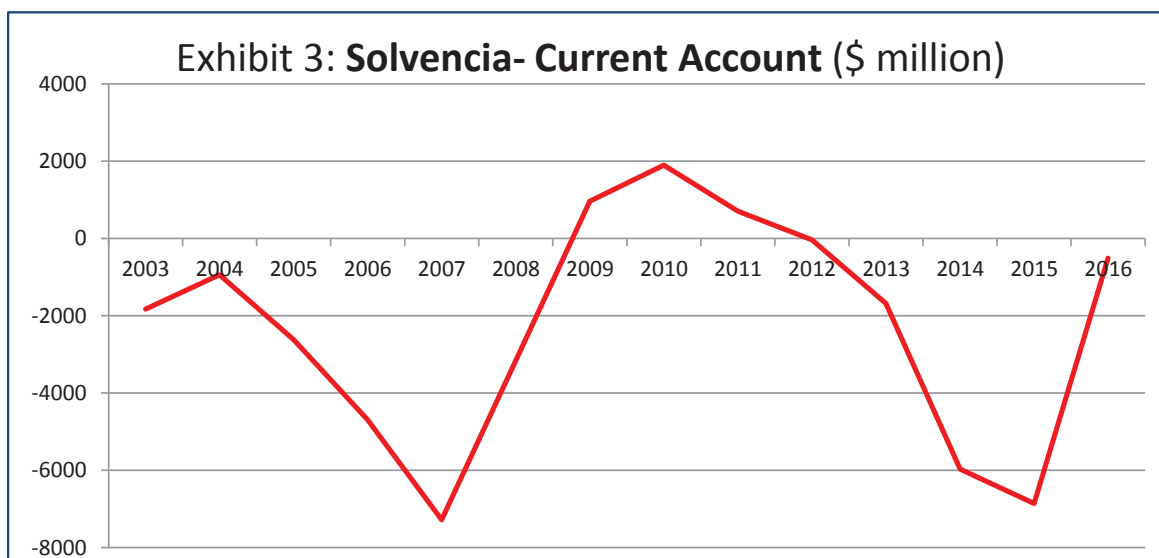
ECONOMIC OVERHEATING AND STOP & GO POLICY



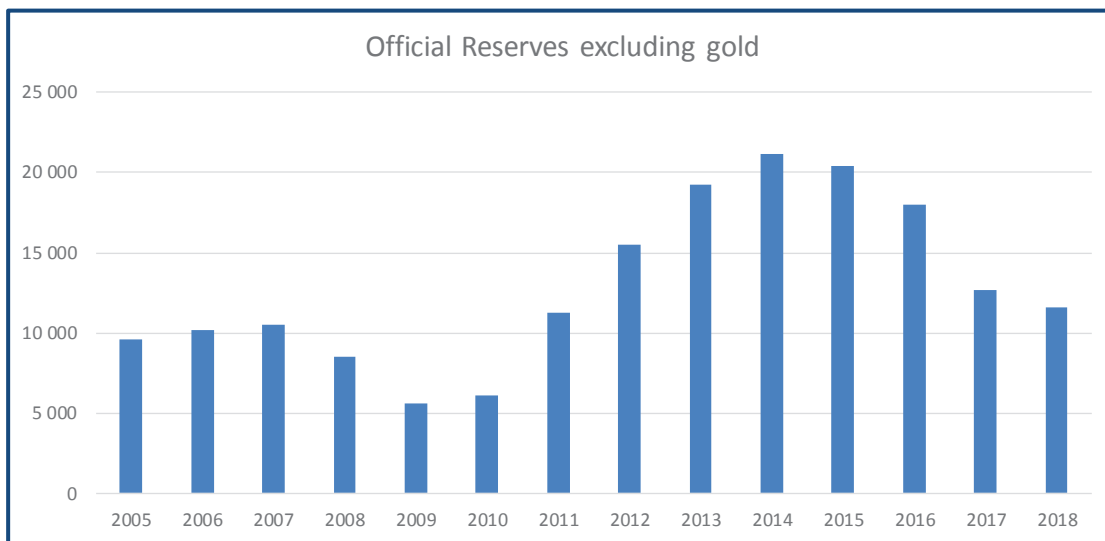
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SOLVENCIA = LIVING BEYOND ITS MEANS



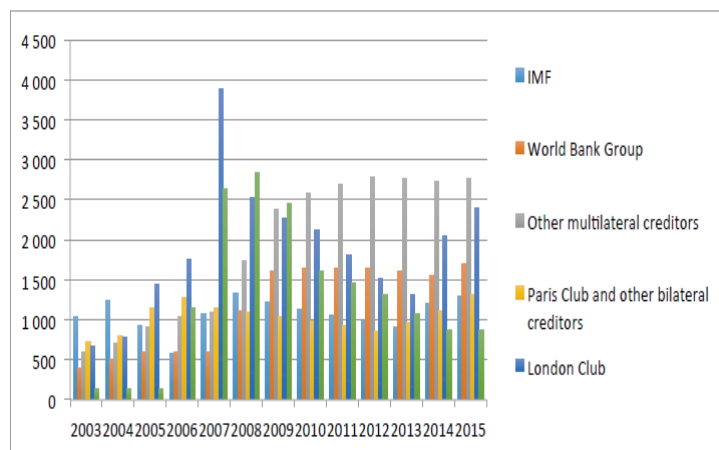
VOLATILITY OF INTERNATIONAL RESERVE ASSETS



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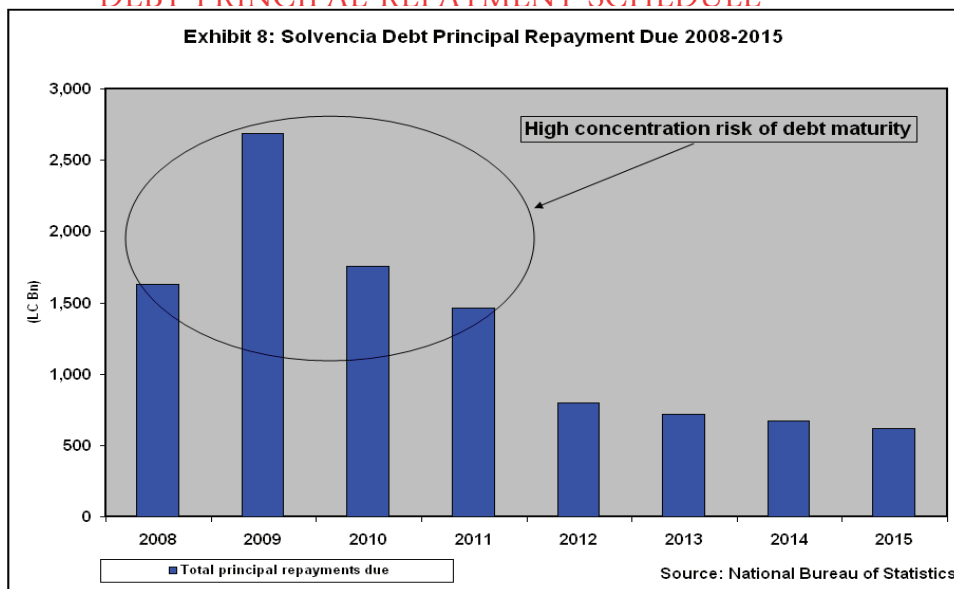
Graph 9. Total external debt devided to creditors 2003-2015, million US \$



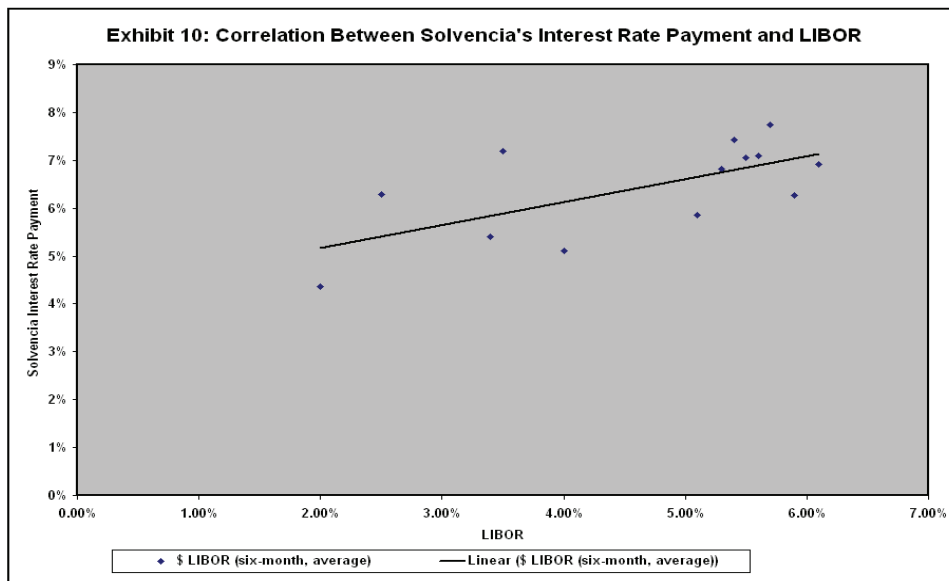
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## DEBT PRINCIPAL REPAYMENT SCHEDULE



## SOLVENCIA'S INTEREST PAYMENT SENSITIVITY TO LIBOR



**KEY MARKET-BASED ECONOMIC POLICY MEASURES TO PRESERVE HEALTHY GROWTH DYNAMISM IN THE 2011-2018 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...





**II. Solvencia risk assessment**

Casino Bank  
Be ahead of your time

Population
<b>7 MILLION</b>
GDP
<b>56,9 BILLION</b>

MOODY'S  
**Baa2**

FITCH  
**BBB-**

MAJOR MACRO ECONOMIC INDICATORS

	2011	2012	2013	2014	2015 (F)
GDP growth (%)	3,45%	4%	5,13%	6,10%	7,36%
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

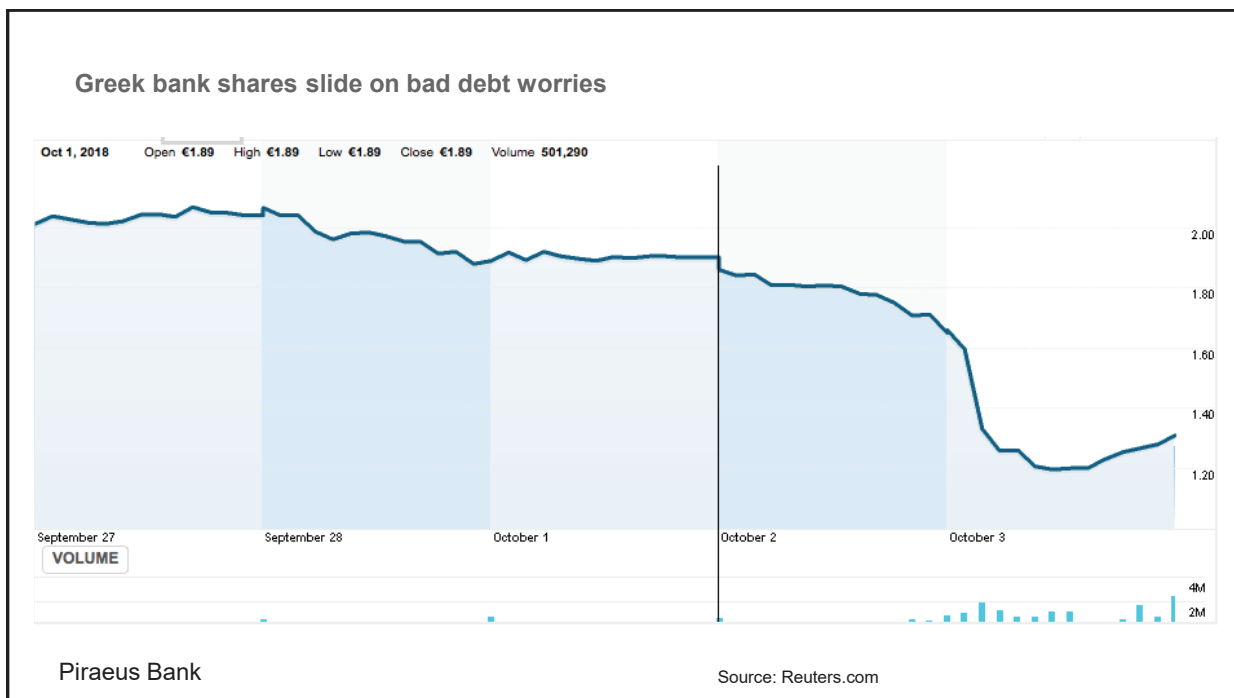
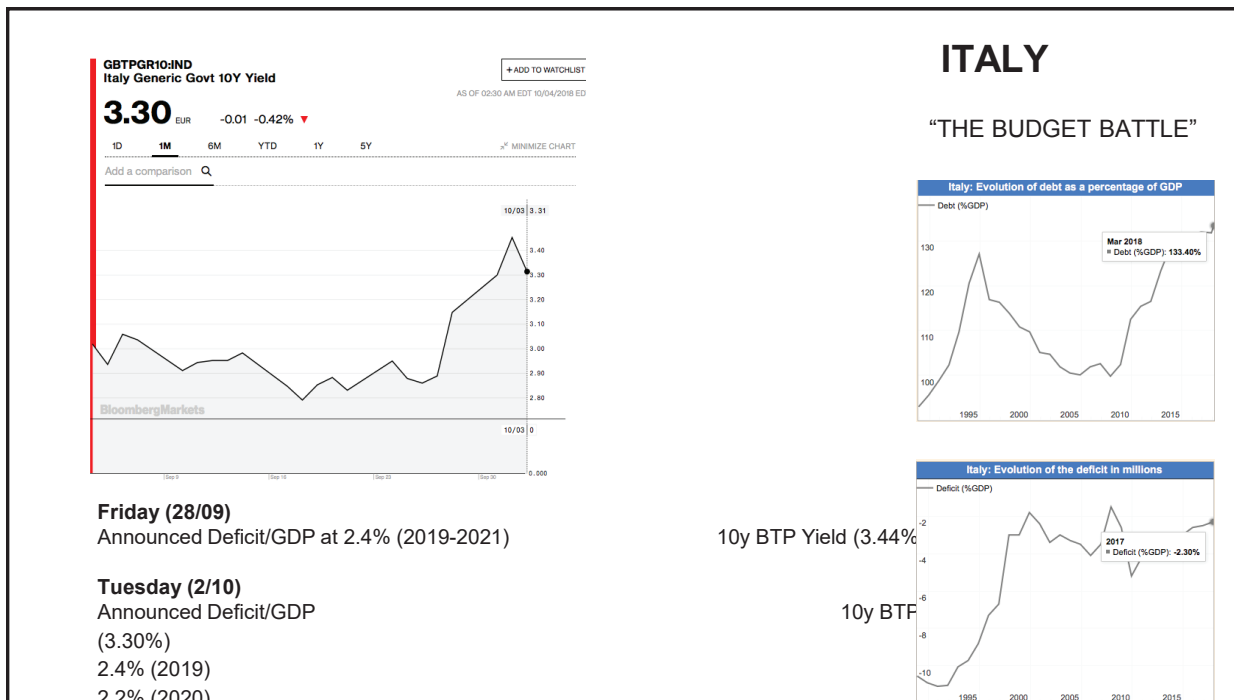
- Growth recovery since 2011
- Terms of trade improvement and privatization measures
- Increase in and diversification of Exports
- Rise in FDI
- Large foreign exchange inflows
- Liquidity ratio and Solvency ratio maintained
- Monetary policy framework

WEAKNESS

- economy overheating: high inflation, large budget and current account deficit
- Still weak productivity
- Dependence on commodity price
- Growing imports (J curve)
- Unemployment high for young people
- Political instability and Governance questioned
- Declining figures for 2015

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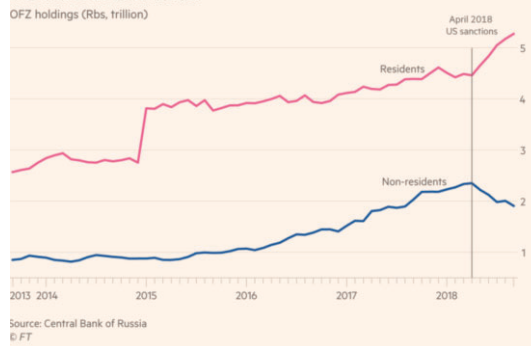


## Can Russia stop using the US dollar?

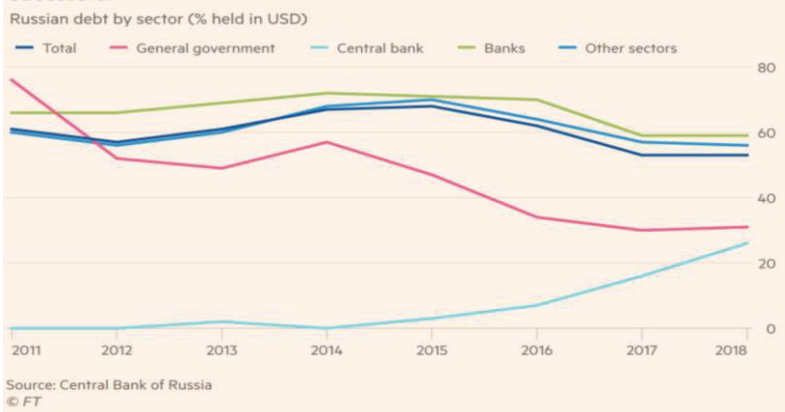
US sanctions have hurt Russia's currency ...

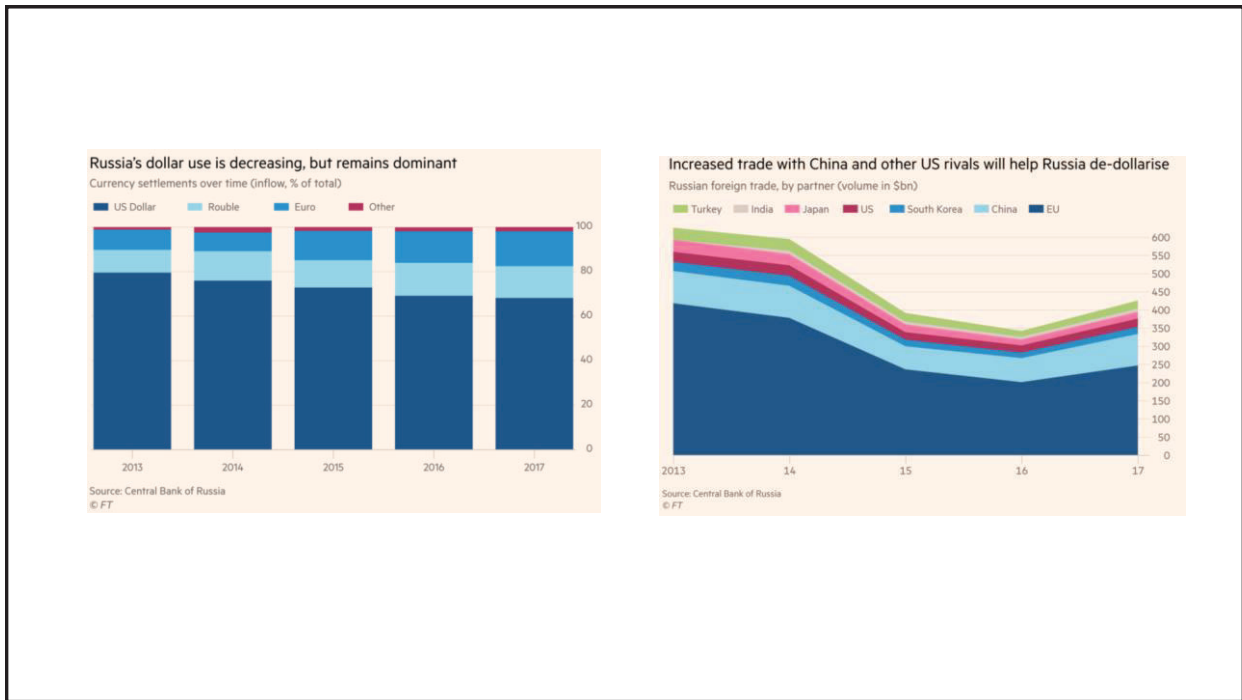


... as well as its bond market



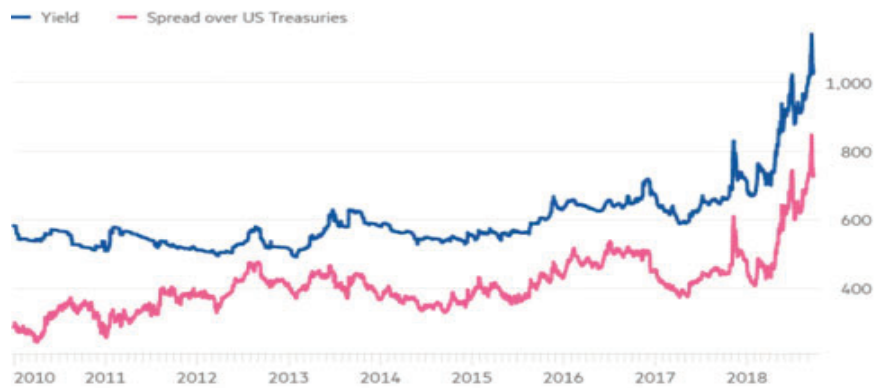
Russia's efforts to reduce dollar-denominated debt have been modestly successful





## Surge in bond yields signals fear of Lebanese default

- Yield on dollar-denominated Lebanese bonds jumped to 10.3% since April
- Spread over US Treasuries jumped to 7.3%



Sources: Thomson Reuters, Capital Economics © FT

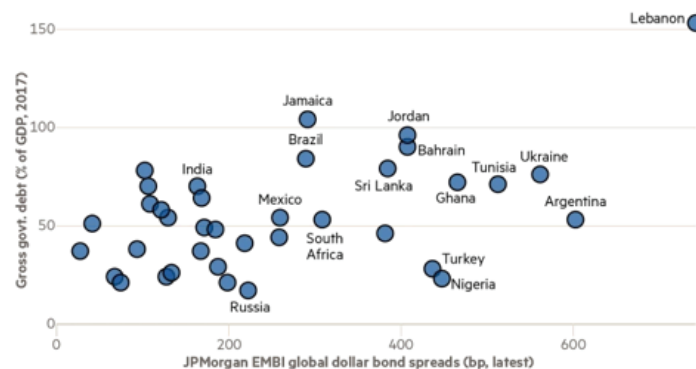
## Surge in bond yields signals fear of Lebanese default

- Debt is equal to 153% of the country's gross domestic product.
- Third-worst figure in the world after Japan and Greece.
- Moody's is predicting that servicing costs of debt will account for 44% of government revenues this year.
- The IMF forecasts Lebanon's current account deficit will come in at around 25.8% of GDP.
- Seven year long war still raging in neighboring Syria, a conflict that has sent an estimated 1m to 1.5m refugees fleeing across the border, a large number in a country with a population of just 4.6M
- Cost of issuing debt goes up which will probably lead to default of the country

## Surge in bond yields signals fear of Lebanese default

### In the red Leb

Bond spreads and sovereign debt levels, emerging and frontier countries



Sources: Bloomberg; Thomson Reuters; Capital Economics  
© FT