

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

Country Risk Mooc : <https://www.udemy.com/course/1426694/manage/curriculum/>

Latest update: Fall 2019

SOLVENCIA

&

Casino
BANK



Country Risk Case Study

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Republic of Solvencia and Global Capital Markets:

Eurobond Request to Casino Bank

Fall 2019

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!

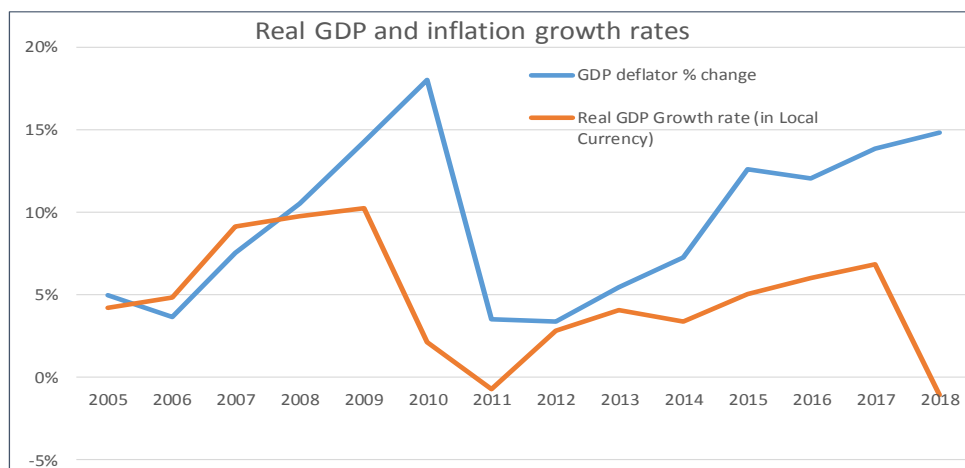
Solvencia's medium-term external borrowing requirements are well known to the international financial community. This request thus does not come as a surprise. You are a young but promising investment banker and you knew that Solvencia was about to approach investment banks in Europe. Your institution, **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.

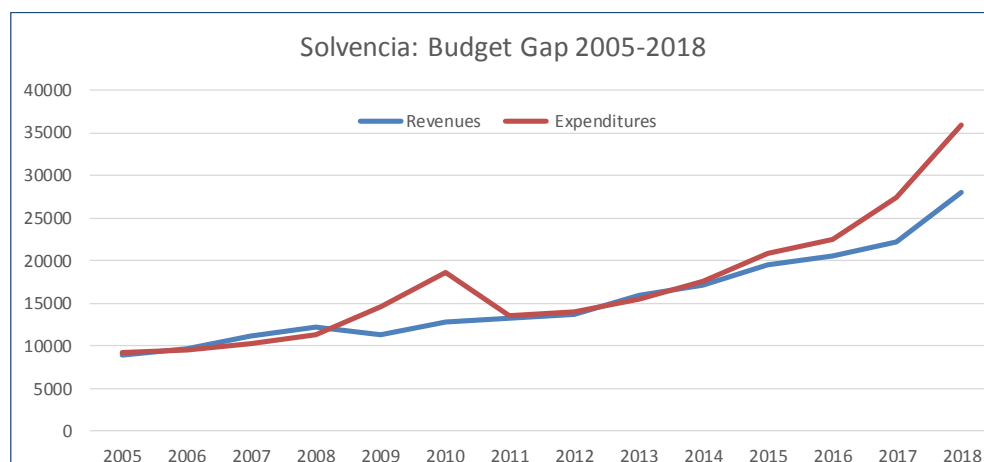
In particular, notable progress was being made in areas such as trade liberalization and privatization. The trade openness ratio reached a level higher than 50% in 2012. The main challenge, clearly, was to further improve the competitiveness and flexibility of the economy. Solvencia's five-year plan (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 skill-intensive sectors. Priorities included addressing financial sector weaknesses, liberalizing the capital account, improving the regulatory

framework, boosting human capital, 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.

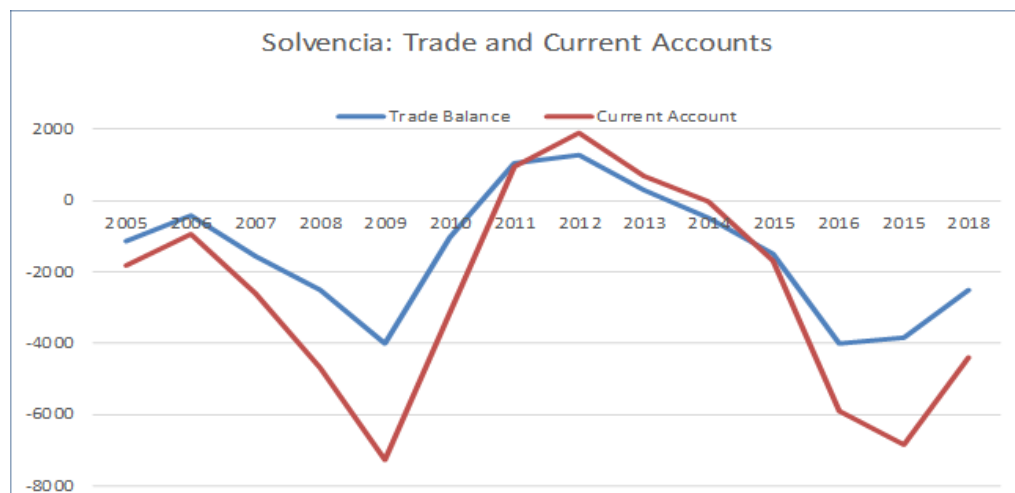


The structural adjustment program increased social and political volatility. Dynamic privatization and severe cuts in government spending produced street demonstrations and

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.