

CIFE Master in Global Governance & Policy Affairs
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Governance and Country risk Analysis

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Republic of Solvencia©'s Eurobond Request



*Governance and Global Capital Markets
in a post-pandemic world with geopolitical volatility
"To float or not to float?"*



**Governance &
Development**

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Book: "Country risk in an age of Globalization": MH Bouchet, C Fishkin, A Goguel. Palgrave-MacMillan 2019

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

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A DEFI Country Risk Case Study

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Republic of Solvencia and Global Capital Markets:



Eurobond Request to Casino Bank and “Governance & Development”

Introduction

CIFE and SKEMA graduation ceremonies were hardly one year ago, and time flies! It was 9 o'clock yesterday morning, when your secretary gave you an important message from Solvencia's Finance Minister, requesting an urgent meeting next week in Monaco. Solvencia's medium-term financing challenges are known to the international financial community. 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 still low rates of interest! But higher rates are looming in an environment of uncertain global growth, geopolitical tensions, and rising commodity prices. Mr. Solvent, the finance minister, wants to get your assessment regarding market conditions for the bond floating, in order to compare your appraisal with competitors' offers in London, Zurich, and New York. The global pandemic crisis and current geopolitical turmoil, clearly, make the request a formidable challenge due to a host of threats, including risk aversion and market nervousness regarding developing countries' mounting debt. Needless to say, the Trump presidency adds a dose of uncertainty.

You are a young but promising development strategy adviser who just enhanced his/her academic and professional credentials thanks to CIFE's Master in Global Governance. Your NGO, **Governance & Development**, works in partnership with **Casino Bank**, a reputed financial player. Competition is fiercer than ever for bond syndication and placement. At stake is a substantial fee (and for you, a substantial promotion!). However, rumours regarding Solvencia's liquidity difficulties come and go in the markets. The country is facing economic overheating, large external financing requirements, and upcoming socio-political problems, reportedly. Most importantly, weak governance and deep-seated corruption are a thorny issue!

Republic of Solvencia: Political Background

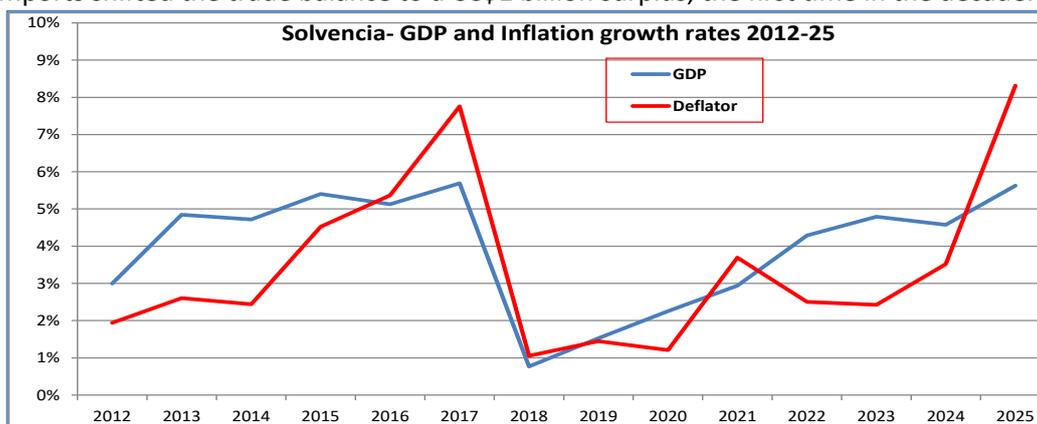
Solvencia is a country of roughly 13 million people. Its 2024 nominal GDP per capita of around US\$5500 and US\$8000 in PPP corresponds to a middle-income developing country. (Solvencia's GDP per capita thus fits in a group of countries like Guyana, Suriname, Moldova, Mongolia, Guatemala, El Salvador, Jamaica, Jordan, and Philippines, 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 late 1990s resulted in the establishment of a bicameral legislature in 2015. However, the socio-political climate remains volatile. Political upheaval leads frequently to mass demonstrations followed by harsh repression. Since 2008, 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 is “Baa3” while Fitch rating stands at “BBB” at end-2024. Things do not seem to improve at the right pace. You get conflicting signals regarding Solvencia's commitment to structural economic and institutional reforms as well as more robust governance and better transparency!

Solvencia's overall economic conditions and policy outlook

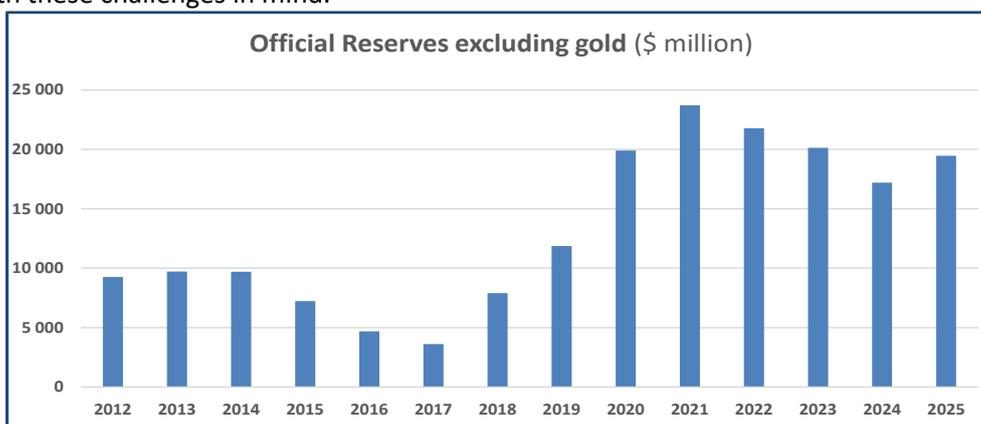
Solvencia faces the challenges typical of developing countries – weak productivity, low competitiveness, and dependence on volatile commodity prices. In 2015-17, Solvencia experienced severe financial turbulences with large budget and current account deficits, following years of economic overheating 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 2016-17, due to over-valued exchange rate. In June of 2018, Solvencia’s government adopted an IMF-sponsored program and it implemented severe adjustment measures with a sharp growth decline. Shrinking imports shifted the trade balance to a US\$1 billion 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 new 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 2018-19 boosted export revenues. The trade balance benefited from shrinking imports, though at the cost of an anaemic growth rate. One positive result has been to keep inflation under control. Overall, as much shock as therapy was provided. The central bank’s official reserve assets picked up during the 2020-2022 period. Notable progress was being made in areas such as trade liberalization and privatization. The trade openness ratio reached a level close to 50% over the 2020-24 period. The main challenge, clearly, has been to further improve competitiveness and flexibility of the economy. Solvencia’s five-year ESTARY (Economic Stabilization and Recovery Plan) covering the period 2024-2028, was drawn up with these challenges in mind.



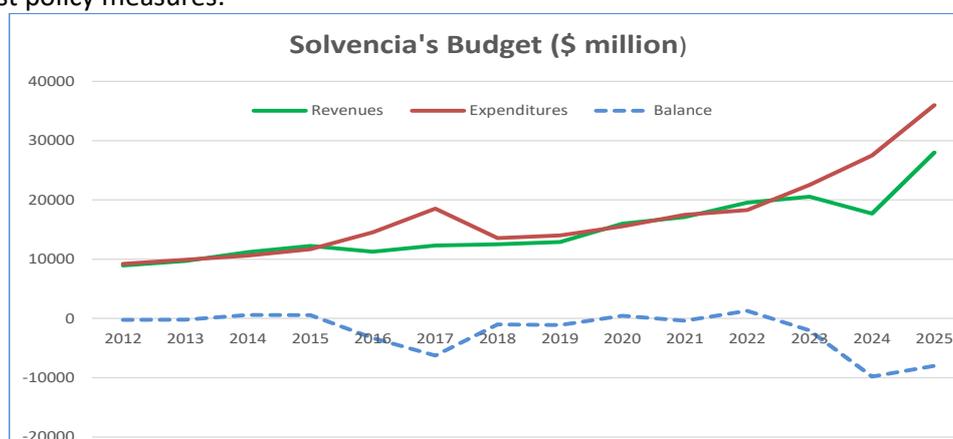
A new strategy aims to accelerating the structural transformation of the economy towards one based on skill-intensive sectors. Priorities include addressing financial sector weaknesses, liberalizing the capital account, improving the regulatory framework, boosting human capital, and tackling labour market rigidities. The most notable result of cooling down the economic growth was a trade surplus in 2018-21 and the emergence of a budget surplus in 2022. But despite progress in raising living standards, unemployment stays stubbornly high. Official data show 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 IFIs and the Paris Club, the currency is now 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 in 2016 and again in 2023, due to unfavourable elasticities! On the positive side, exports increased and FDI picked up until 2023. 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 emerged gradually after several years of severe decline of real GDP. Favourable rainfall and export diversification with good prospects for copper and uranium production led to reasonable growth thanks to good harvest conditions and improving terms of trade. Since 2021 until 2024, however, Solvencia experienced again rising inflation, showing that stabilization is again off track. Economic growth recovery has been driven by large bank loans supported by global accommodative liquidity and low real rate policy of OECD’s central banks.

Inflation and Budget Deficit

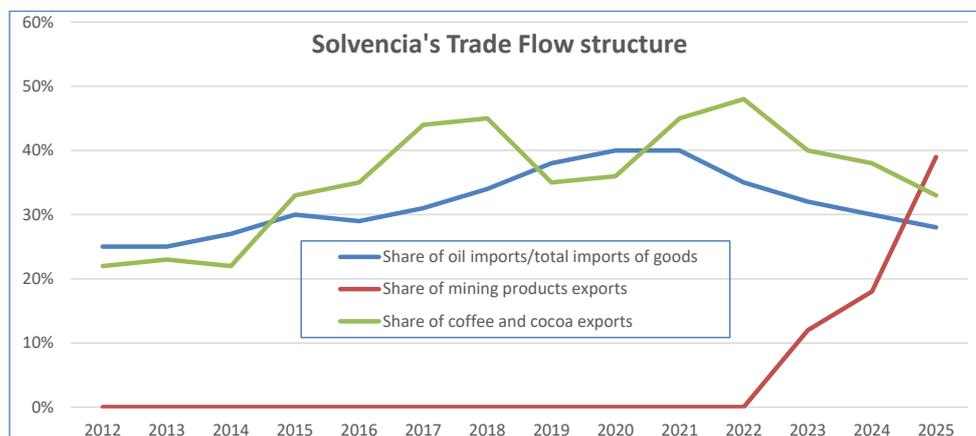
Inflation in Solvencia looks like a rollercoaster for the past decade. Confronted with rising prices that reached an unsustainable peak in 2021-24, the government was unable to drag down inflation to levels that are more reasonable. Growing budget deficit and an accommodative monetary policy keep stimulating stubborn inflation. Inflationary expectations stem from unchecked private and public demand, illustrating the cost of populist policy measures.



The structural adjustment program increased social and political volatility. Weak governance has fuelled mounting social frustration, demonstrations, and a perverse cycle of repression and turmoil. Corruption has remained widespread! Dynamic privatization and severe cuts in government spending produced street demonstrations and political protests. The impact of economic adjustment appears in the 2018-2021 period, however, when Solvencia managed to stabilize its current account, improving its reserves/external debt ratio, and attracting significant foreign direct investment capital flows. But the population's patience is reaching its limits, and violence is on the increase, fuelled by extremist parties and perhaps outside intervention.

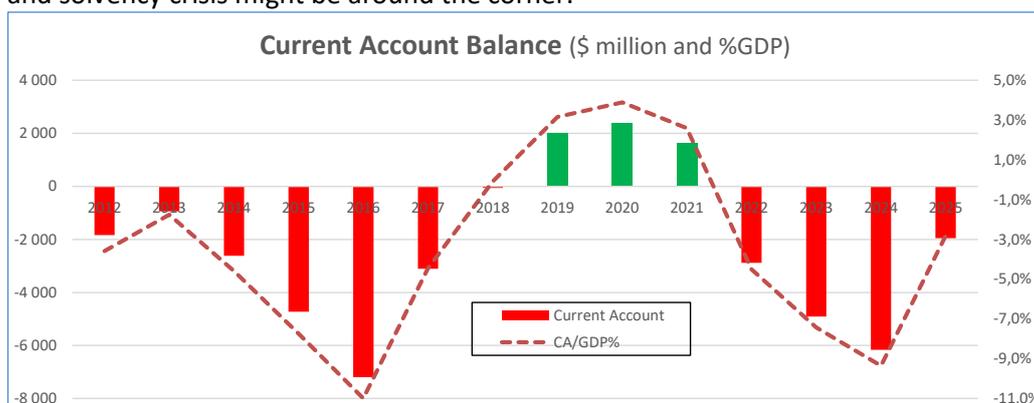
Solvencia's Balance of Payment Position

The current account worsening during the period 2014-2017 was driven by the negative pattern of trade balance. Solvencia's net trade 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 goods reflecting investment expenditure related to the industrial modernization program. In 2018-2021, trade generated a short-lived surplus, thanks to significant improvement in external competitiveness. But starting in 2022, the trade balance returned to negative territory, as a result of declining export competitiveness, though 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 \$82 in 2018 and \$92 in mid-2022, were important factors in the worsening trade deficit, together with unchecked domestic consumption.

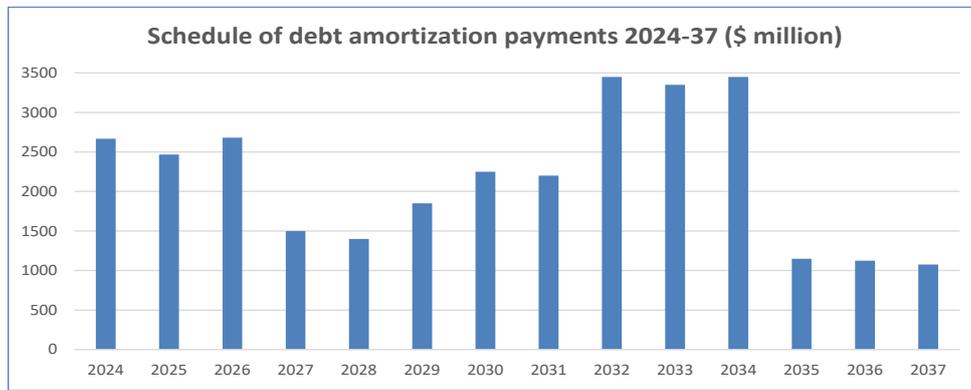


Balance of services, income and transfers showed a rising surplus starting in 2014-16, backed up by a substantial real depreciation of the exchange rate. No doubt that tourism revenues, a major cash inflow source for Solvencia, benefitted from the currency depreciation. But the pandemic crisis in 2020-21, with little scope for a major national vaccination campaign, created headwinds. 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 deficit in recent years.

The current account balance reached an unprecedented deficit of \$5 billion in 2023, the equivalent of 7,4% of GDP and it might reach a crisis level over 9% in 2024, unless drastic correction measures get adopted. The worsening situation stems from soaring imports and higher interest payments, coupled with a travel warning issued by the US and EU governments as a response to political instability and social upheaval. Demonstrators have disrupted activity in Solven City and transport networks. The large current account deficit will increase the sovereign's already large financing needs amid challenging funding conditions. Liquidity crisis is looming, and solvency crisis might be around the corner.



Debt is still a major financing source for Solvencia's current account deficit. During 2010-15, capital markets were a primary source of external financing. The bond market was tapped twice in 2014-15. During the 2010 decade, 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 2025, bond issuing is to be the new ball game in Solven City's Finance Ministry. But a so-called "debt wall" over 2024-26 and again in 2032-24 requires prudent negotiation of external financing conditions! Though the Debt/GDP remains around 50%, the debt composition worsens, with rising short-term liabilities and mounting repayments.



The Eurobond Request: To float or not to float?

Solvencia, clearly, is not back on track. The pandemic crisis has affected the country's health system and put pressure on the budget! Large deficit is looming again. 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. Long-term challenges include: (1) servicing the external debt in view of the interest rate hike by the US Fed probably in 2025, even though US President Donald Trump wants to keep the dollar attractive without higher interest rates! (2) modernizing the industrial sector; (3) preparing the economy for freer trade with the EU; and (4) 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 and debt restructuring! Solvencia might be tempted to approach the BRICs for smooth financing.

Floating a Eurobond issue for Solvencia can be a major coup for your institution, 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 the 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., to do some basic number crunching, particularly liquidity and solvency ratios.

Before calculating the key ratios, however, you need to understand where the country comes from regarding its growth track, what went wrong again in the 2018-2021 period, and why. You also need to assess the way the IMF's stabilization program in 2024 would achieve a turnaround in Solvencia's economy and whether the gradual improvement is lasting or fragile. You need to check if the country is not falling back today in the same pitfalls as in 2014-17. Then you must look at the scope for a resumption of sustainable development over the course of 2025 and beyond considering the global uncertainty that the Covid19 crisis and geopolitical turmoil in eastern Europe and in the Middle East have generated!

Overall, the bond issue is a **Yes/No decision** though you might add a number of strings & whistles (issue tranches, collateral, currency switching, zero coupon bond, gradual repayment versus bullet payment, fixed/floating rate, conversion features, GDP recapture clause, governance-linked conditions...). Finally, you will call Solvencia's finance minister who is waiting in his Monaco suite. You and your colleague from Casino Bank will give him a short though comprehensive memo with your recommendations to ensure that Solvencia's financing will stimulate socio-economic development prospects.

The key questions are among the following:

1. What are the underlying **growth engines** of Solvencia? Domestic demand? Private investment? Budget deficit? Buoyant exports? External financing? Is **trade openness** growing or shrinking?
2. Does Solvencia maintain a **competitive exchange rate** to offset its price differential with trading partners?
3. Is the **twin deficit** (budget and current account) sustainable given the inflationary tensions and the bunching of upcoming debt payments? Can the large current account deficit be financed with long-term inflows?
4. Do export earnings keep pace with the interest payments to stabilise **liquidity ratios**?
5. What about **solvency indicators** at the end of the period under review? Can they be kept under control and how?
6. Does the benign increase in the debt ratios hide a **debt structure deterioration** or not?
7. What about the **composition** of the financing of the **current account deficit**? Stable or volatile external flows?
8. Under what conditions could rapidly **rising mining export revenues** coupled with import growth checking generate current account surplus?
9. Is there a comforting trend of **non-debt creating flows**, i.e. FDI? What about ratings and rankings?
10. Do **official reserve assets** provide enough cushion to meet debt and incompressible import payments?
11. Can the bond issue provide enough **financing stimulus** to place Solvencia on a sustainable growth trajectory?