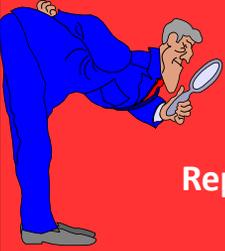




SK

SKEMA BUSINESS SCHOOL
COUNTRY RISK ANALYSIS
 Republic of Solvencia and the International Capital Markets
 Eurobond Request to Casino Bank
 Michel Henry Bouchet






1

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...)

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THE « DISCOVERY » OF RISK



Pascal 1654



Fermat 1654



1703

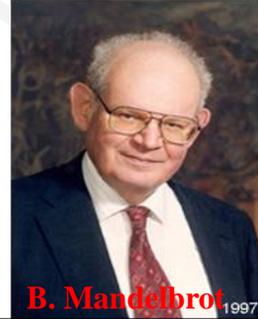
Leibniz



Markowitz 1952



M. Scholtes 1997



B. Mandelbrot 1997

3

RISK & UNCERTAINTY

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

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

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

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

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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

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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 worsen given the country's global integration.**

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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.

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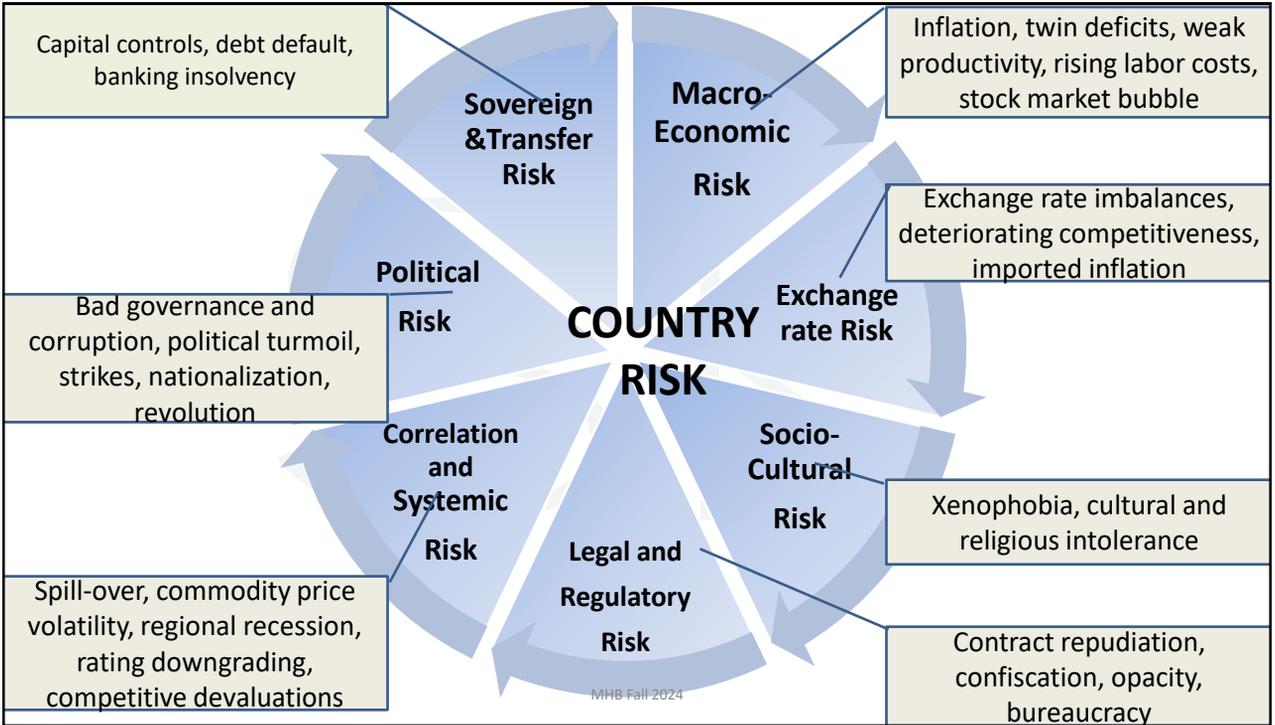
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COUNTRY RISK ANALYSIS

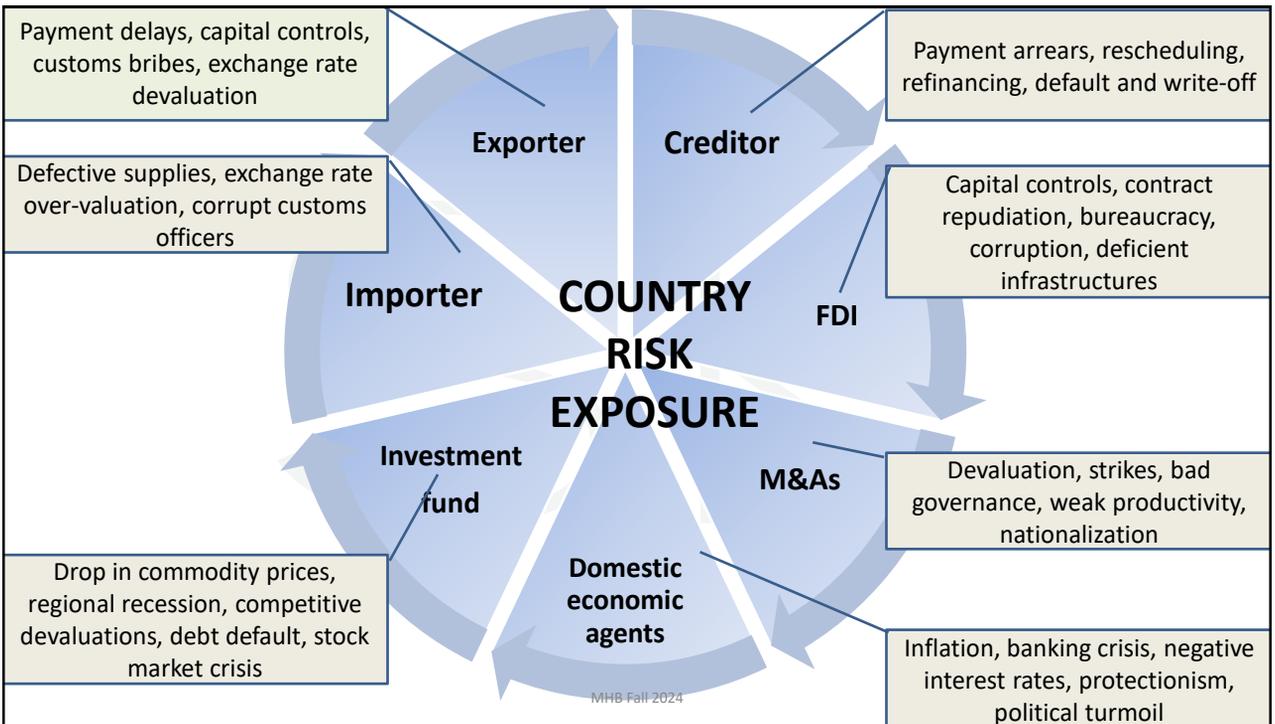
- ▶ Country risk analysis involves the assessment of a private or public foreign entity's **ability and willingness** to service its external obligations in full and in time (contractual, debt servicing, import payments, legal commitment...).
- ▶ It incorporates a forward-looking estimate of default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

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

- IMF and IFIs reports?
- Think tanks and consultancy agencies
 - 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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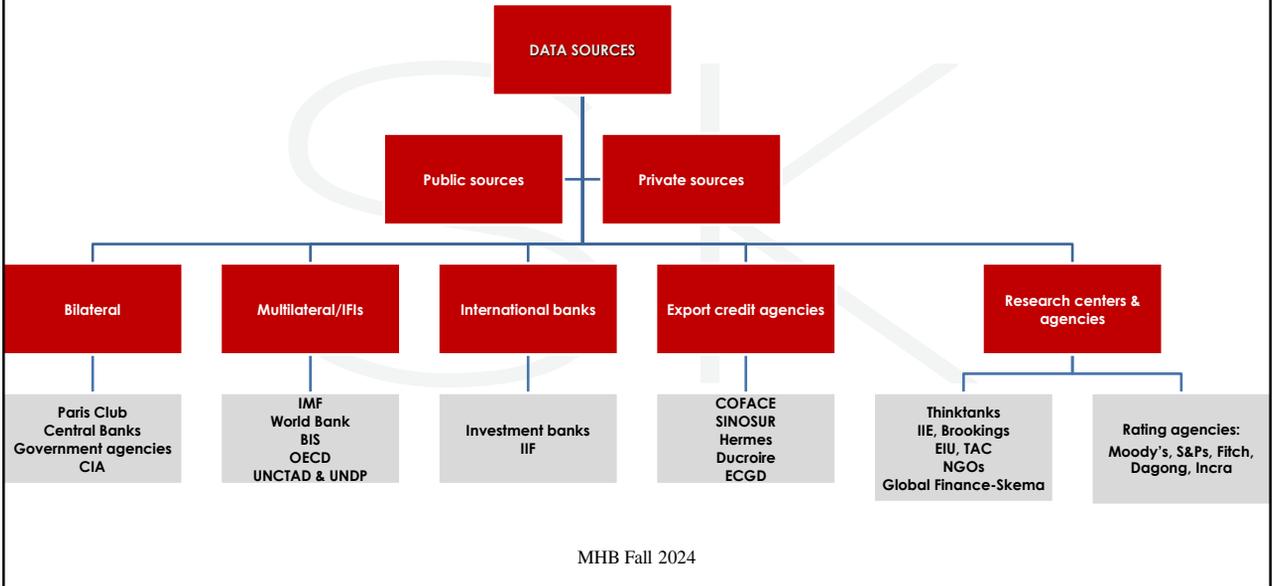
COUNTRY RISK ASSESSMENT

Reliable and updated information
= Economic intelligence
▶ **Robust risk analysis**

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MAJOR SOURCES OF COUNTRY RISK INTELLIGENCE



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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

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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

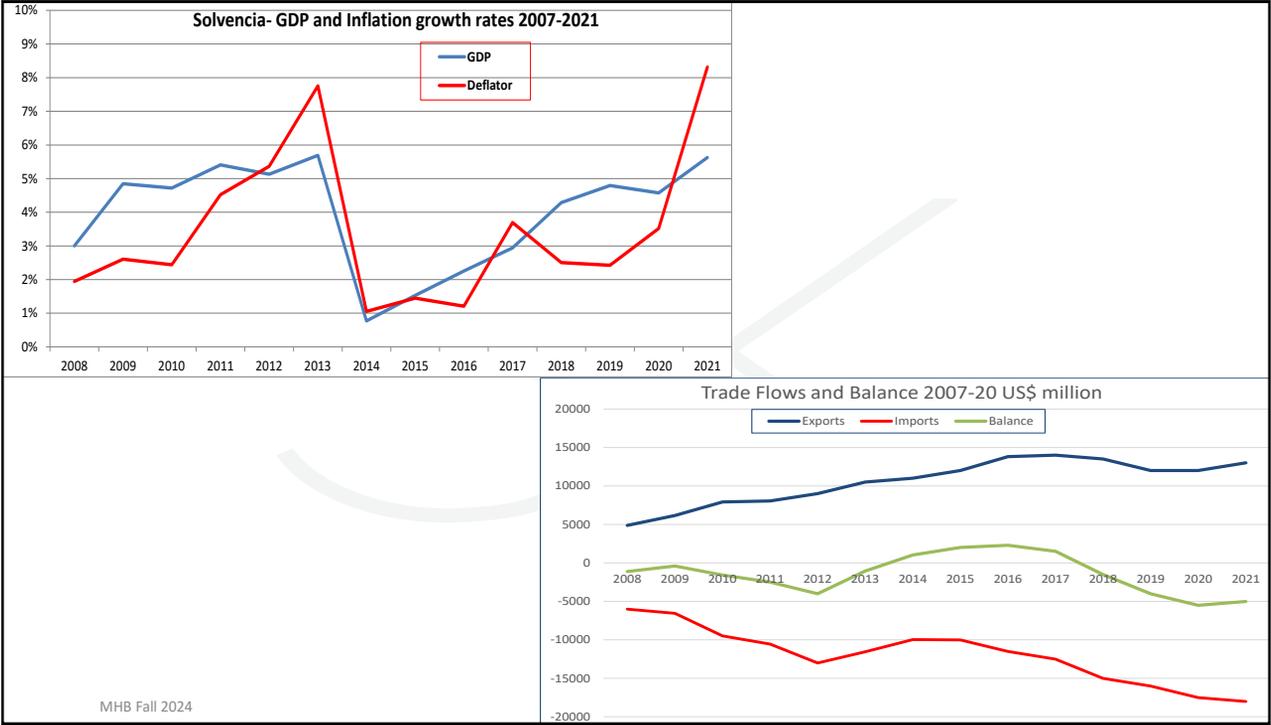
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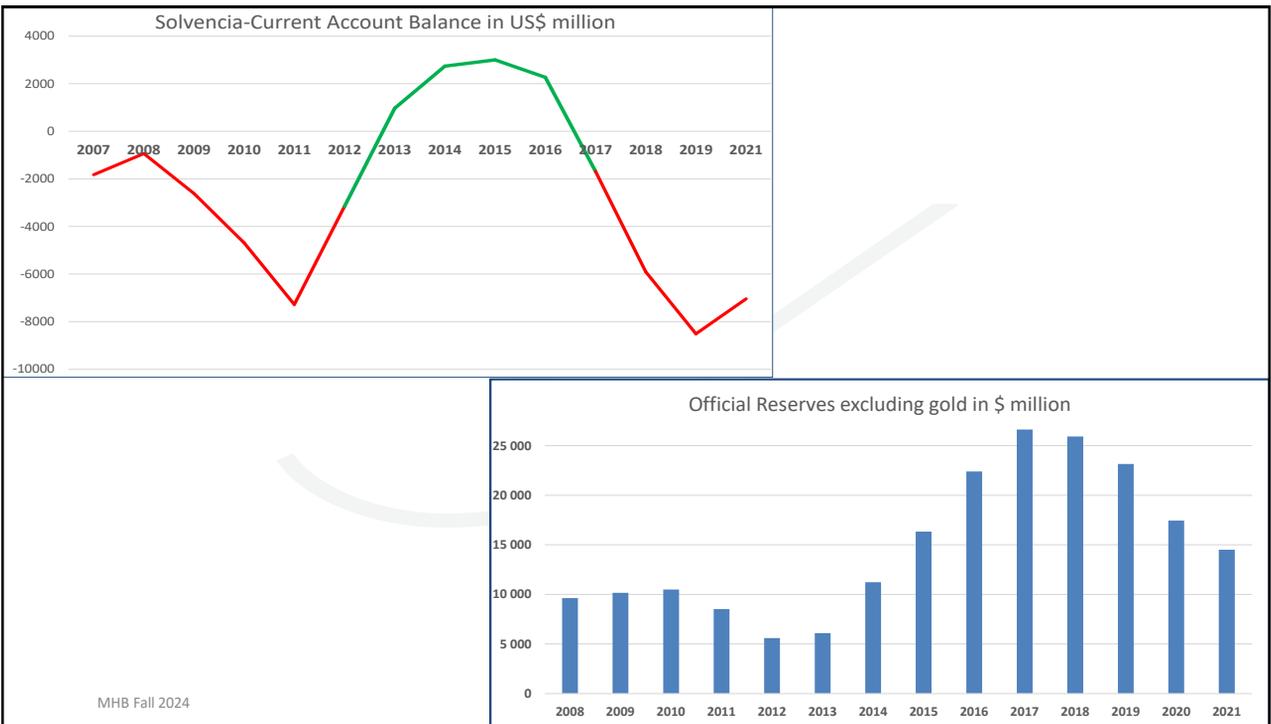
Risk Indicators	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
GDP (in US\$ billion)	5,06	5,17	5,36	5,49	5,59	5,53	4,85	4,03	3,49	3,47	3,58	3,70	3,76	3,76
Real GDP Growth rate (in Local Currency)	4,23%	4,85%	4,72%	5,41%	5,13%	5,69%	0,77%	1,53%	2,26%	2,94%	4,29%	4,79%	4,58%	5,63%
GDP Growth rate (in US\$)	2,25%	4,96%	6,24%	7,07%	7,24%	6,62%	-11,37%	-15,73%	-12,43%	3,04%	5,85%	5,78%	5,45%	8,05%
GDP per capita (US\$)	5 113	5 250	5 468	5 740	6 035	6 308	5 492	4 546	3 911	3 958	4 120	4 285	4 443	4 721
GDP per capita /day	14	14	15	16	17	17	15	12	11	11	11	12	12	13
Rate of currency depreciation	5,26%	2,50%	0,98%	2,90%	3,29%	6,82%	14,89%	22,22%	18,18%	3,59%	0,99%	1,47%	2,66%	5,88%
Trade Balance (US\$ million)	-1 130	-411	-1 577	-2 494	-4 000	-1 050	1 040	2 000	2 300	1 500	-1 500	-4 000	-5 500	-5 000
External competitiveness	0,26%	-5,08%	-6,30%	-7,27%	-7,48%	-7,07%	13,06%	19,23%	14,69%	-3,15%	-5,90%	-5,87%	-5,60%	-8,52%
Trade openness ratio (X+M/GDP)	24,4%	27,2%	35,0%	35,0%	38,6%	36,2%	38,8%	48,4%	63,2%	64,1%	65,6%	61,0%	60,6%	59,3%
Budget Deficit-Surplus /GDP%	-0,5%	-0,4%	1,0%	0,8%	-4,6%	-7,6%	-1,2%	-1,3%	0,5%	-0,4%	1,3%	-1,8%	-8,3%	-5,9%
Current account/GDP %	-3,58%	-1,75%	-4,60%	-7,69%	-11,12%	-4,52%	1,56%	5,25%	6,58%	4,82%	-3,38%	-11,21%	-15,33%	-10,96%
RATIOS														
Solvency														
Debt/Exports	446,7%	364,6%	289,2%	291,5%	300,3%	270,4%	257,5%	229,8%	200,1%	196,4%	197,2%	231,0%	243,0%	227,8%
Debt/GDP	49,8%	48,6%	47,6%	46,4%	47,9%	47,0%	55,2%	64,4%	72,5%	69,3%	64,5%	62,5%	61,9%	59,8%
Reserves/External Debt	37,8%	38,9%	38,7%	30,1%	17,8%	18,6%	33,0%	48,7%	67,7%	81,7%	80,8%	70,4%	50,7%	40,5%
Short-term Debt/Total Debt	0,98%	1,15%	1,31%	1,55%	6,18%	2,87%	2,76%	2,95%	3,14%	3,34%	3,86%	6,35%	9,71%	9,59%
Liquidity														
Principal Amortization/Exports %	30,1%	26,1%	31,9%	47,6%	59,8%	42,7%	31,0%	20,9%	16,0%	14,6%	17,2%	28,4%	32,9%	36,5%
Net Capital Flows	-1354	-255	-867	-1659	-4244	-2718	-1540	-1257	684	-1086	-2082	-2551	-2705	-2493
Debt servicing Ratio %	44,0%	37,3%	48,7%	74,3%	89,4%	62,6%	40,2%	26,5%	21,1%	16,6%	21,2%	38,9%	47,1%	47,0%
Interest/Exports %	14,6%	11,7%	17,9%	29,1%	30,6%	20,3%	10,8%	6,9%	6,0%	2,7%	4,9%	11,6%	15,8%	12,5%
Reserves/Imports GS in %	139,3%	134,6%	96,1%	70,1%	37,4%	45,9%	98,1%	142,1%	169,4%	185,2%	150,4%	125,9%	86,7%	70,1%
Reserves/Imports in Months Coverage	12	11	8	6	3	4	8	12	14	15	13	10	7	6
Average external interest rate in %	5,0%	3,2%	4,6%	8,0%	9,6%	8,6%	5,7%	3,6%	3,0%	2,2%	2,0%	3,7%	5,6%	5,9%

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KEY MARKET-BASED ECONOMIC POLICY MEASURES TO PRESERVE HEALTHY GROWTH DYNAMISM IN THE 2020-2022 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.

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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

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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, recapture clause, extended grace period, gold collateral, on-going monitoring of the IMF, cross-default clause...

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Casino Bank
Be ahead of your time

II. Solvencia risk assessment

Population
7 MILLION
GDP
56,9 BILLION

MOODY'S	FITCH
Baa2	BBB-

MAJOR MACRO ECONOMIC INDICATORS

	2011	2012	2013	2014	2015 (F)
GDP growth (%)	3.45%	4%	5.13%	6.10%	2.30%
Inflation (%)	9.00%	11.45%	17.30%	22.12%	29.43%
Budget balance (% GDP)	9.70%	-2.60%	-8.60%	-11.20%	-12.50%
Current Account Balance (% GDP)	1.40%	1.60%	-4.60%	-9.00%	-9.30%
Public debt (% GDP)	24.30%	23.40%	21.20%	23.00%	23.80%

STRENGTHS	WEAKNESS
<ul style="list-style-type: none"> • 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 	<ul style="list-style-type: none"> • 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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