

GOVERNANCE & COUNTRY RISK ANALYSIS
Republic of Solvencia and the International Capital Markets

Eurobond Request to Casino Bank



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Case Study Correction

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SOLVENCIA

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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\$4500 (and \$8000 on a PPP basis). 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.

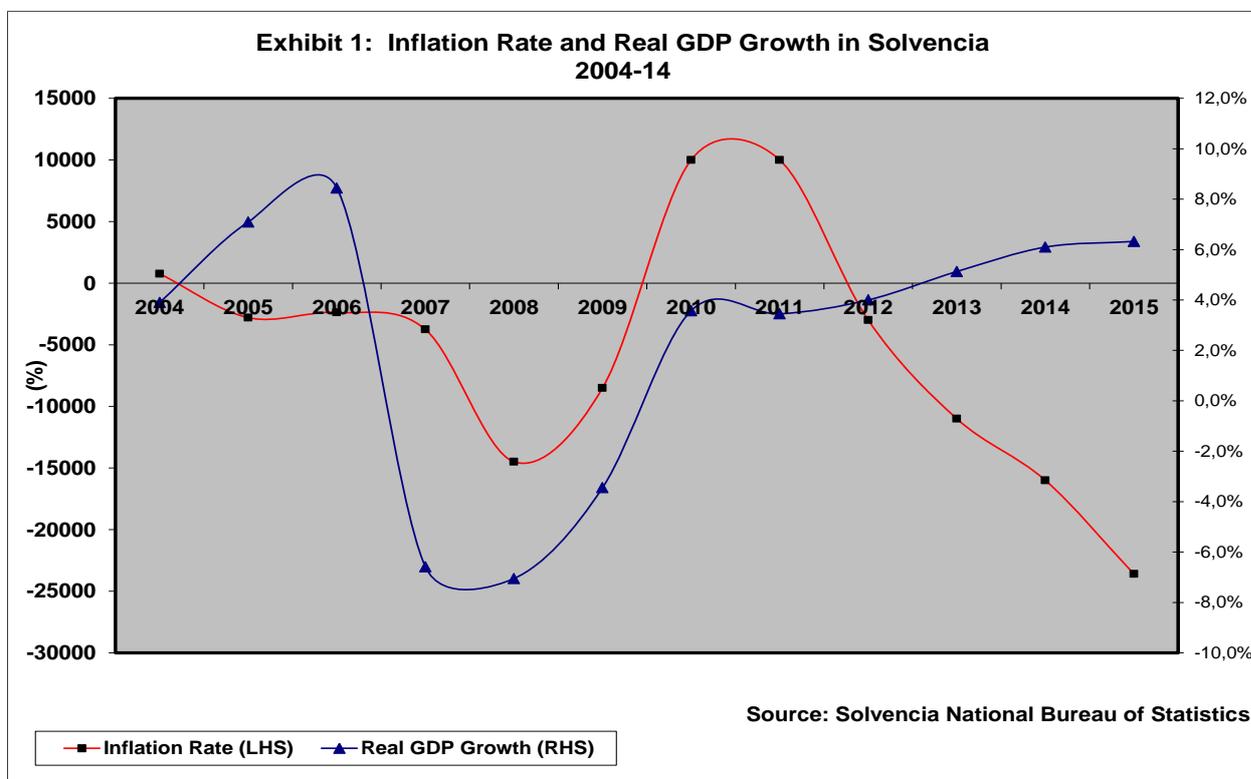
2. The second problem was triggered by poor external debt management. During the period of 1999-2001, the period where Solvencia dragged down into the crisis, Solvencia faced US\$ 3.7 billion of maturing external loans, almost three times higher than the amount due during the period of 1996-1998. This 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.



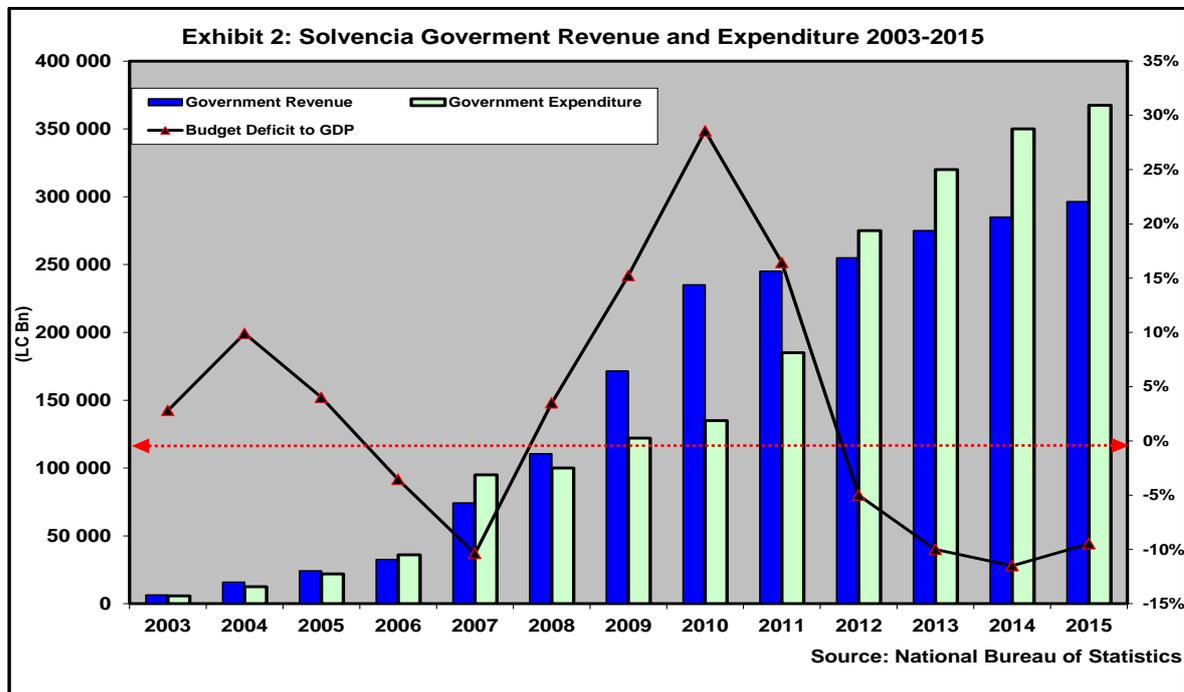
III- The Country's Potential (positive points)

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.

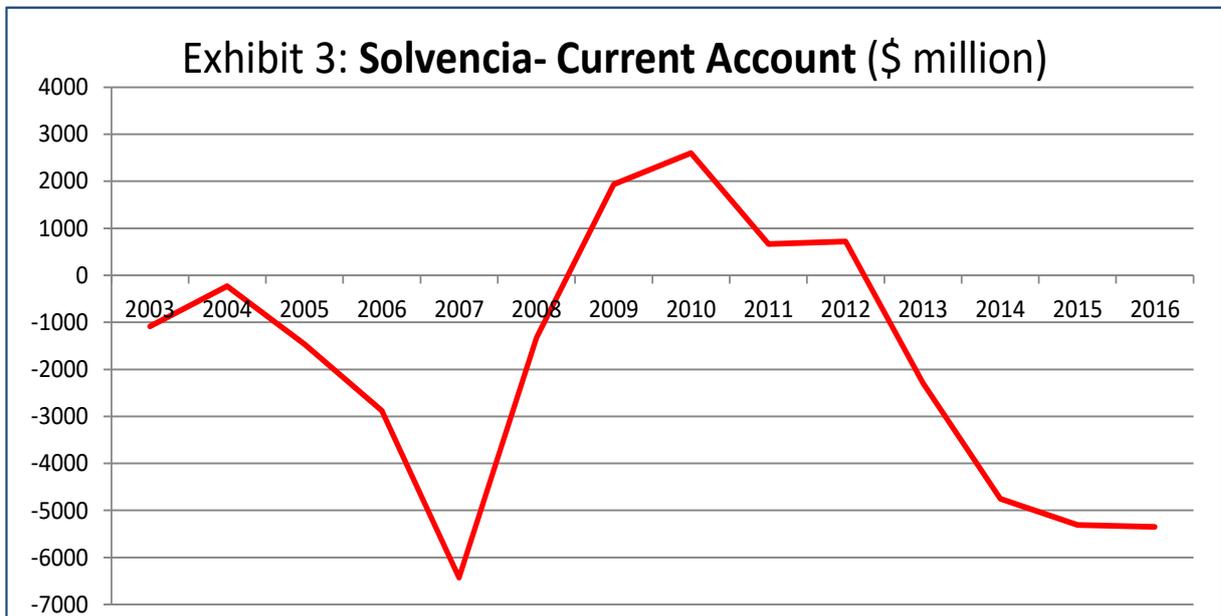
V- Balance of Payment: Facing New Mounting Current Account Deficit

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

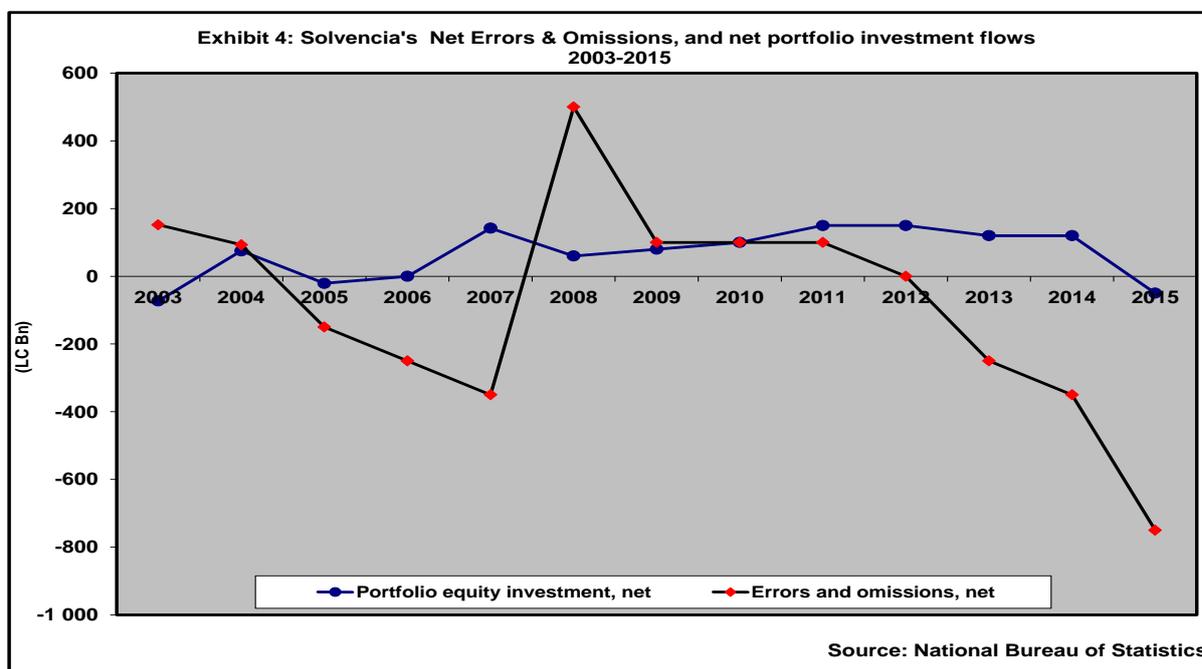
domestic private consumption and government expenditures. Solvencia suffers basically from a demand-led inflation and a cost-driven deficit.

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

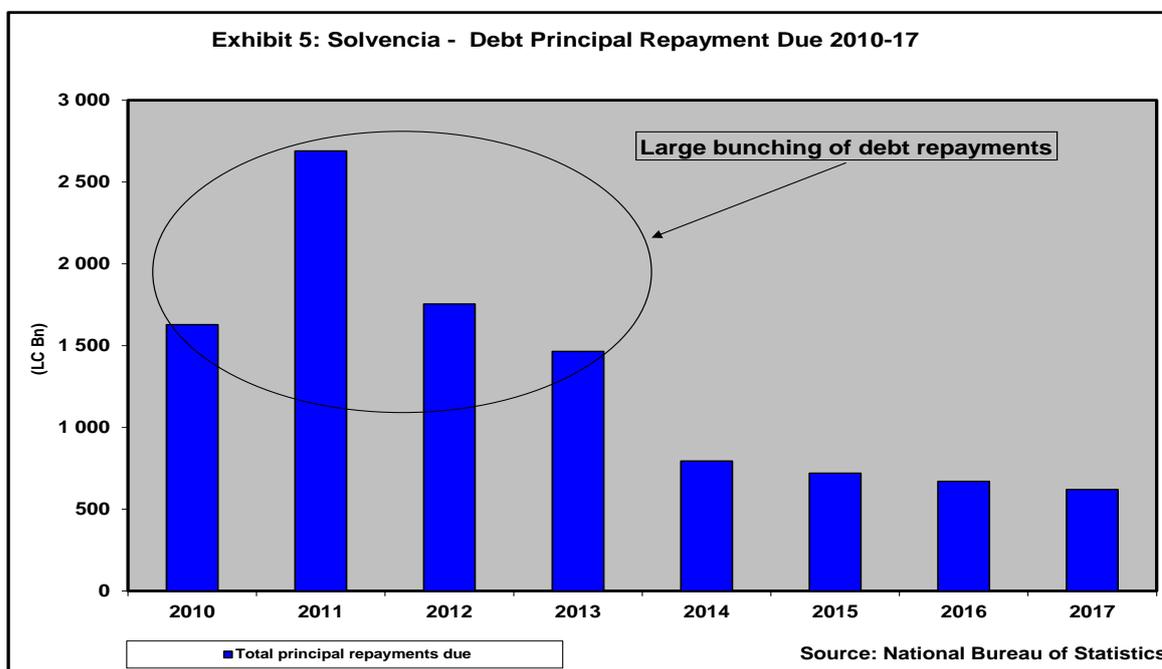
The country's external liquidity situation has deteriorated in the 2004-2008 period due to a combination of factors including the following: shrinking FDI flows, decreasing current account surplus, and a drop in external financing. Rising capital flight compounded the problem. In 2008, the current account 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.



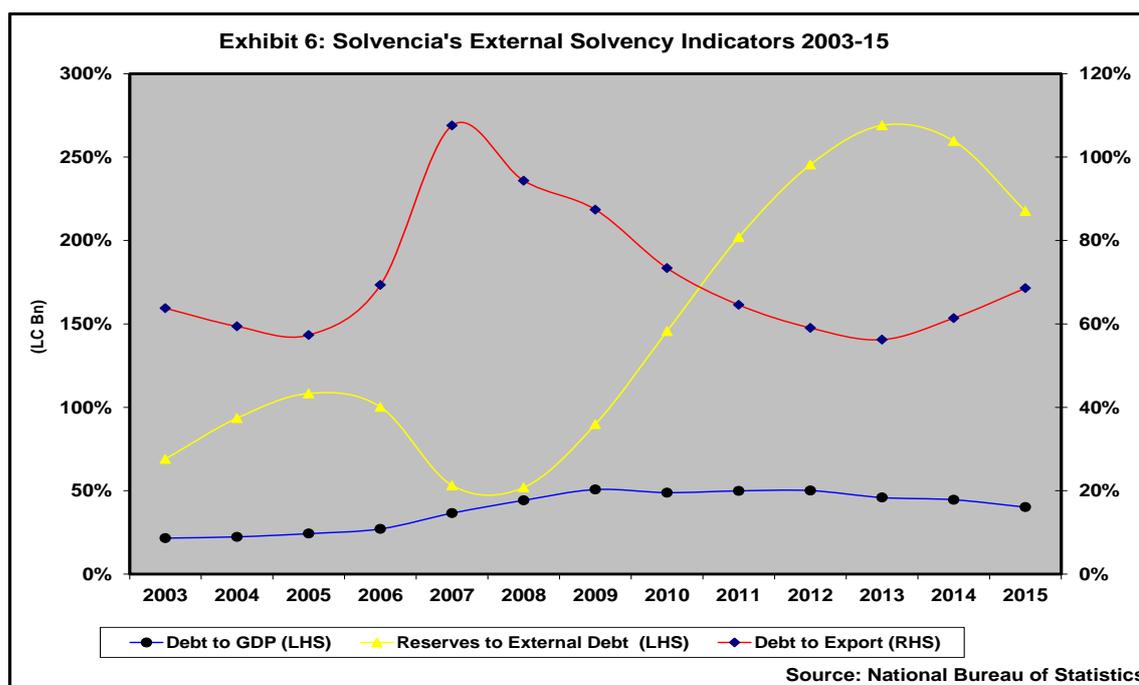
Overall, our main concern stems from Solvencia's protracted disdain for prudent macroeconomic management. There are converging signals that the country is back to the pre-crisis situation of excessive spending, growing deficits, and rising inflation. Despite a high level of international reserves, estimated 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

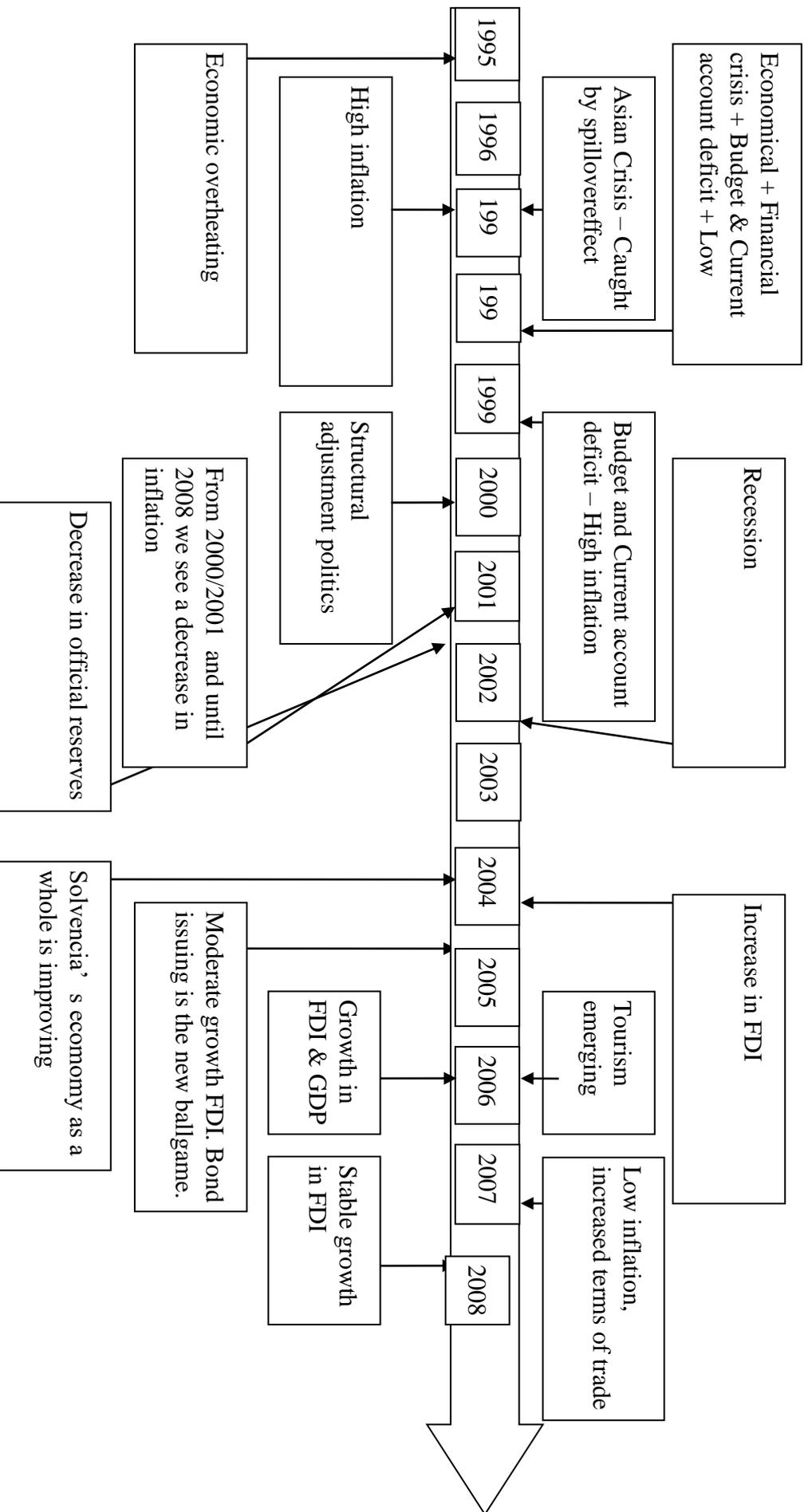
IX- Conclusion and recommendation to Casino Bank's Risk Committee

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

