

AIC CONFERENCE ON COUNTRY RISK  
LONDON, FEBRUARY 9-10, 1998

COUNTRY RISK  
IN EMERGING MARKETS:  
THE DOS AND DON'TS LEARNT  
FROM RECENT HISTORY

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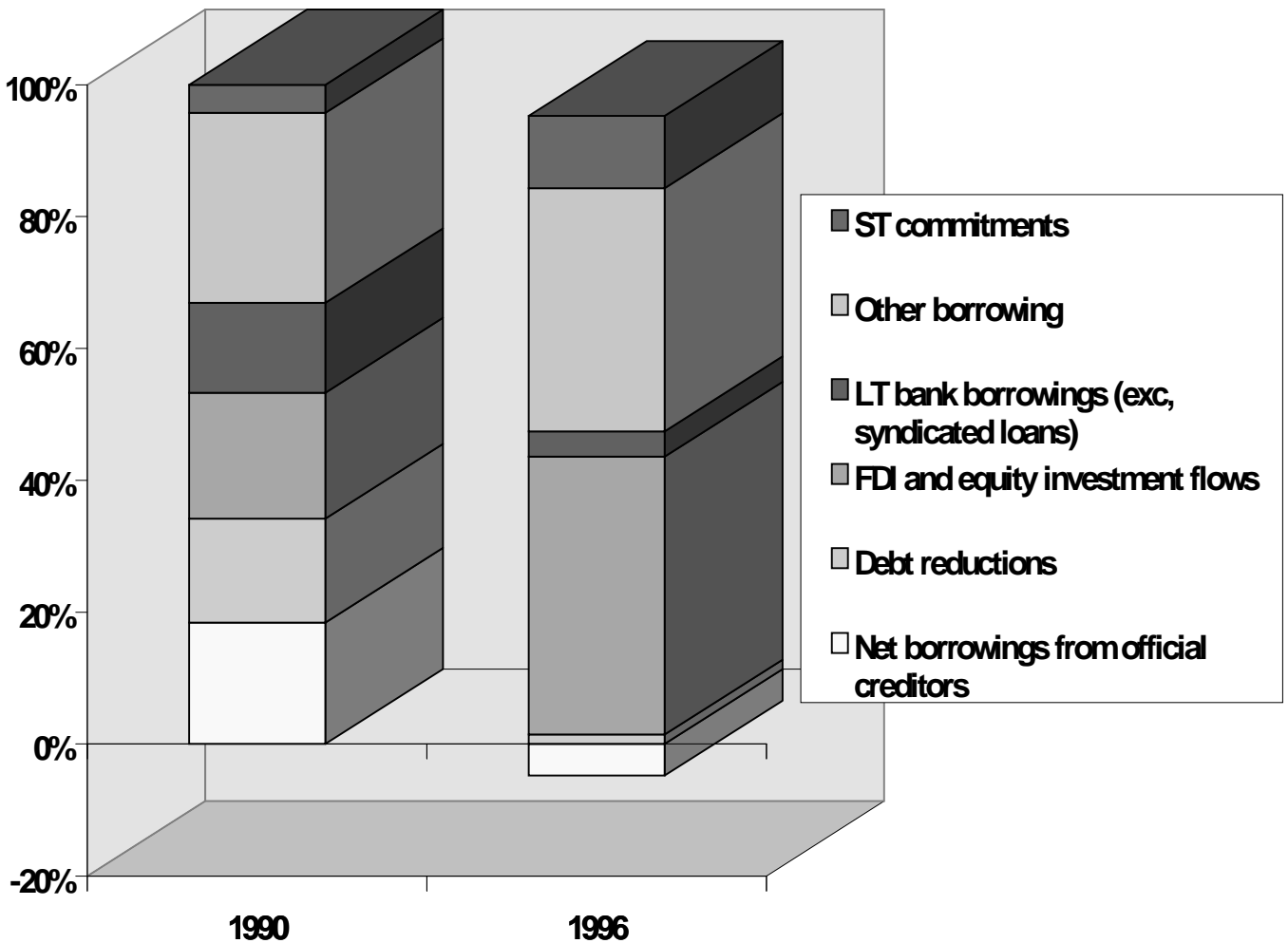
## **THE DOS AND DON'TS LEARNT FROM RECENT HISTORY**

- **THE CHANGING NATURE OF EMERGING  
MARKET CRISES**
- **SUSTAINABILITY OF PERFORMANCE DEPENDS  
ON SPECIFIC COMBINATIONS OF ECONOMIC  
DEVELOPMENTS**
- **THRESHOLDS AND NON- LINEARITY**
- **THE CRUCIAL QUESTION OF TIMING**
- **BEWARE THE HERD INSTINCT**

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THE CHANGING NATURE OF  
EMERGING MARKET CRISES

THE CHANGING STRUCTURE OF  
EMERGING MARKETS FINANCING

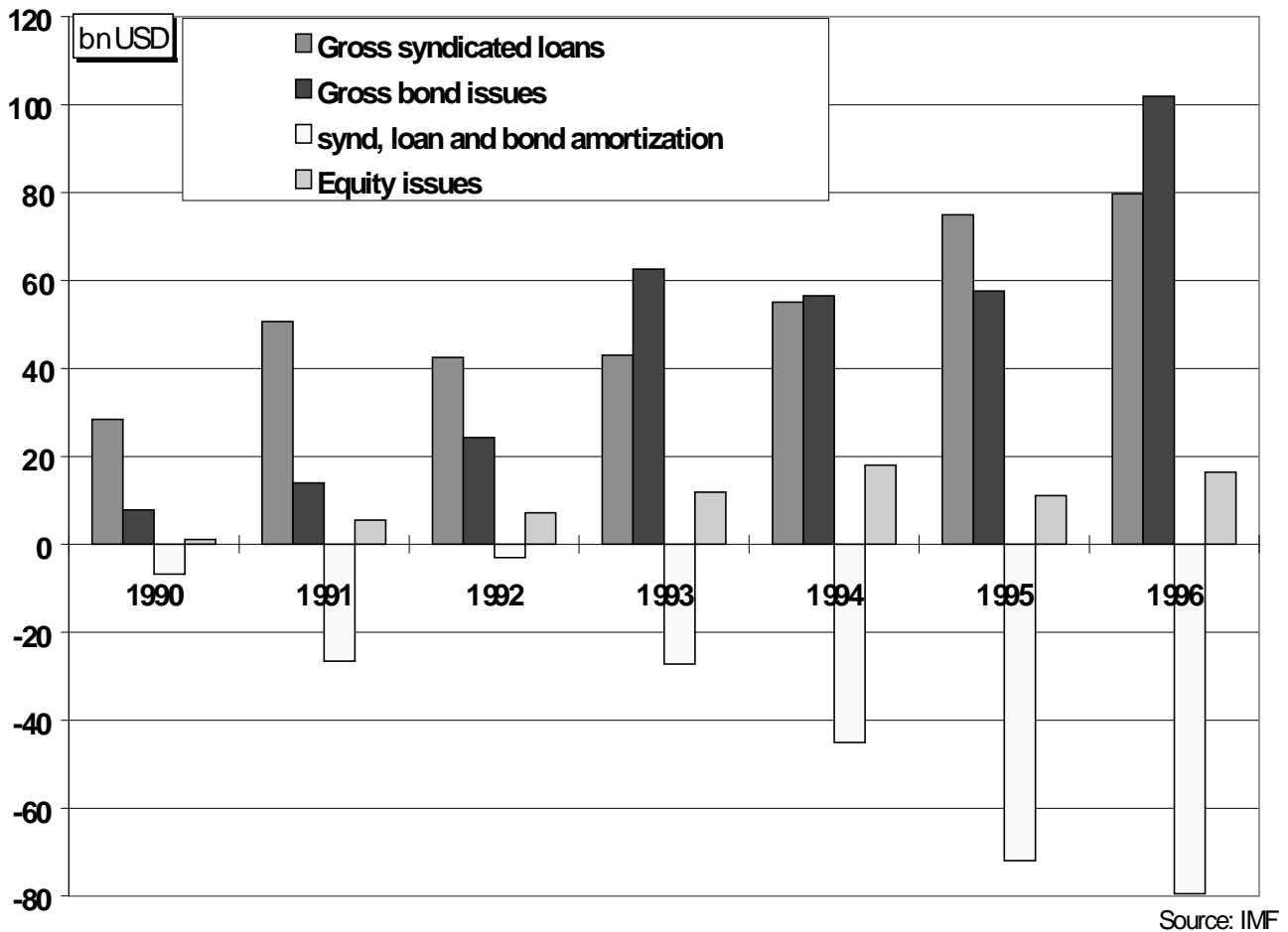


Source: IMF

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THE CHANGING NATURE OF  
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THE CHANGING STRUCTURE OF  
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**THE CHANGING NATURE OF  
EMERGING MARKET CRISES**

- SOVEREIGN RISK
- TRANSFER RISK AND FOREX AVAILABILITY
- MARKET PRICE OF ASSETS (DOMESTIC / INTERNATIONAL BONDS, EQUITIES, EXCHANGE RATE)
- CYCLICAL SHOCK AND COUNTERPARTY RISK
- CONTAGION EFFECTS

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**THE CHANGING NATURE OF  
EMERGING MARKET CRISES**

- INCREASED INTERDEPENDENCE AND COMPLEXIFICATION
- THE EVER CHANGING PROBLEM OF DATA
- THE MISLEADING COMFORT PROVIDED BY FORECASTS

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**SUSTAINABILITY OF PERFORMANCE DEPENDS ON  
SPECIFIC COMBINATIONS OF ECONOMIC  
DEVELOPMENTS**

**A LIMITED NUMBER OF PERTINENT INDICATORS**

- FOREX RESERVES
- REAL EXCHANGE RATE
- DOMESTIC MONEY
- DOMESTIC CREDIT
- GDP GROWTH
- INFLATION
- CURRENT ACCOUNT BALANCE
- TOTAL /PRIVATE / BANK INDEBTEDNESS
- DEBT SERVICE
- INTEREST RATES
- (FISCAL POSITION)
- (STOCK PRICES)

SUSTAINABILITY OF PERFORMANCE DEPENDS ON  
SPECIFIC COMBINATIONS OF ECONOMIC  
DEVELOPMENTS

**THE MEANING OF A GIVEN INDICATOR IS  
*CONDITIONNED* BY THE VALUES OF THE  
OTHER INDICATORS**

- [if *high current account deficit*] [and] [if *weak structure of foreign financing*]
- [then] [deterioration of country risk]
- [amplified] [if *cyclical overheating*]

SUSTAINABILITY OF PERFORMANCE DEPENDS ON  
SPECIFIC COMBINATIONS OF ECONOMIC  
DEVELOPMENTS

- ***Development Balance*** (relationship between macro-economic growth and external financing requirements)
  - ***Financing Balance*** (structure and quality of external financing)
  - ***Short-Term Exchange Rate Balance*** (foreign exchange reserves and the exchange rate)
  - ***Short-Term Cyclical Balance*** (quality of economic policies and position in the business cycle)
  - ***Equity Market Balance*** (valuation and vulnerability of the equity market)
- ... and the next one to be added*
- ***Banking balance*** (overextension of domestic credit and banks' reliance on overseas finance)

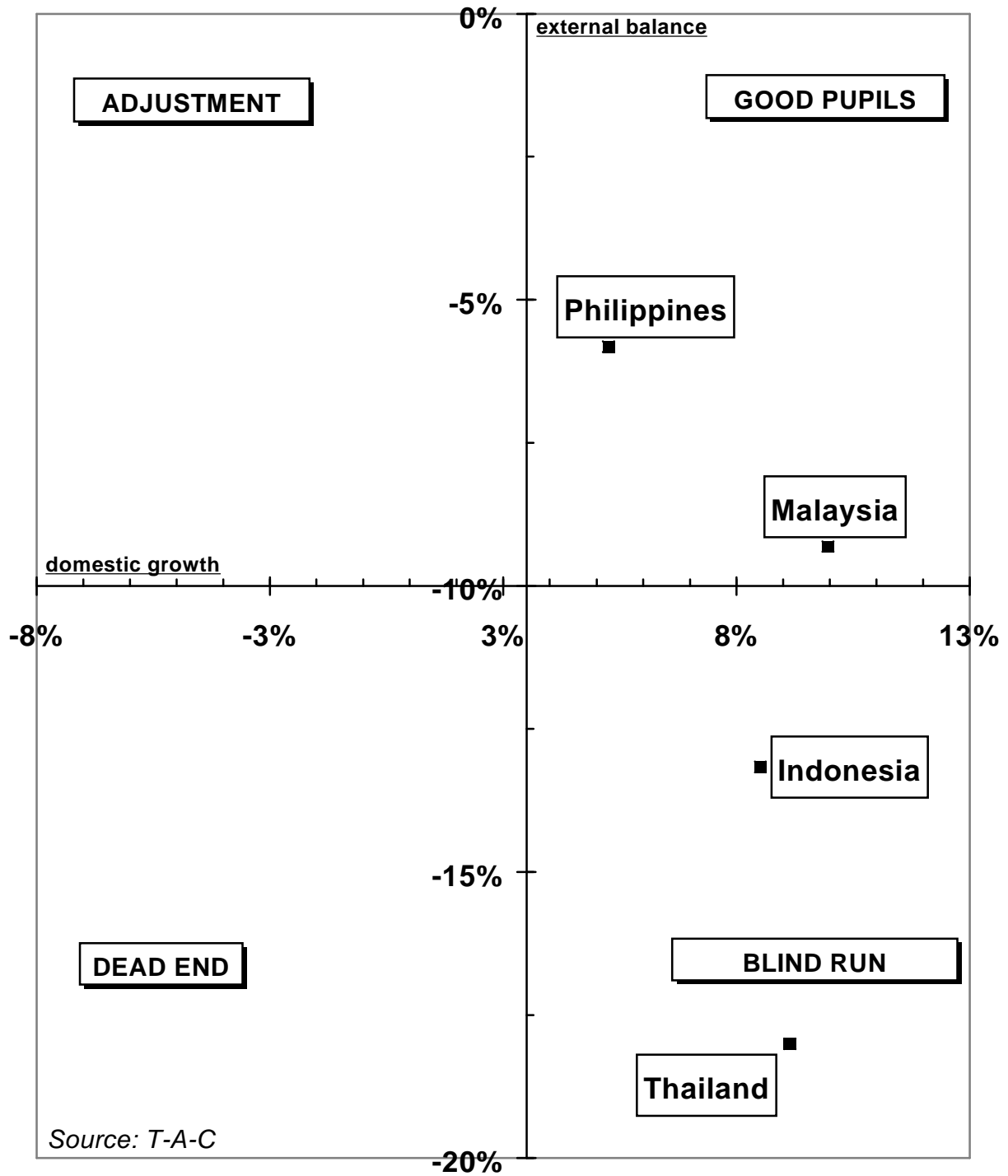
SUSTAINABILITY OF PERFORMANCE DEPENDS ON  
SPECIFIC COMBINATIONS OF ECONOMIC  
DEVELOPMENTS

TWO EXAMPLES OF PERTINENT  
COMBINATIONS OF ECONOMIC  
DEVELOPMENTS

- MEXICO IN 1993-94 : a calamitous performance in both *development* and *financing balances*, with a *speculative exchange rate risk* and a *speculative cyclical adjustment*
- THAILAND IN 1996-97 : a *blind run* in the *development balance*, with a *speculative exchange rate risk*, a *speculative cyclical adjustment* and a growing instability in the *financing balance*

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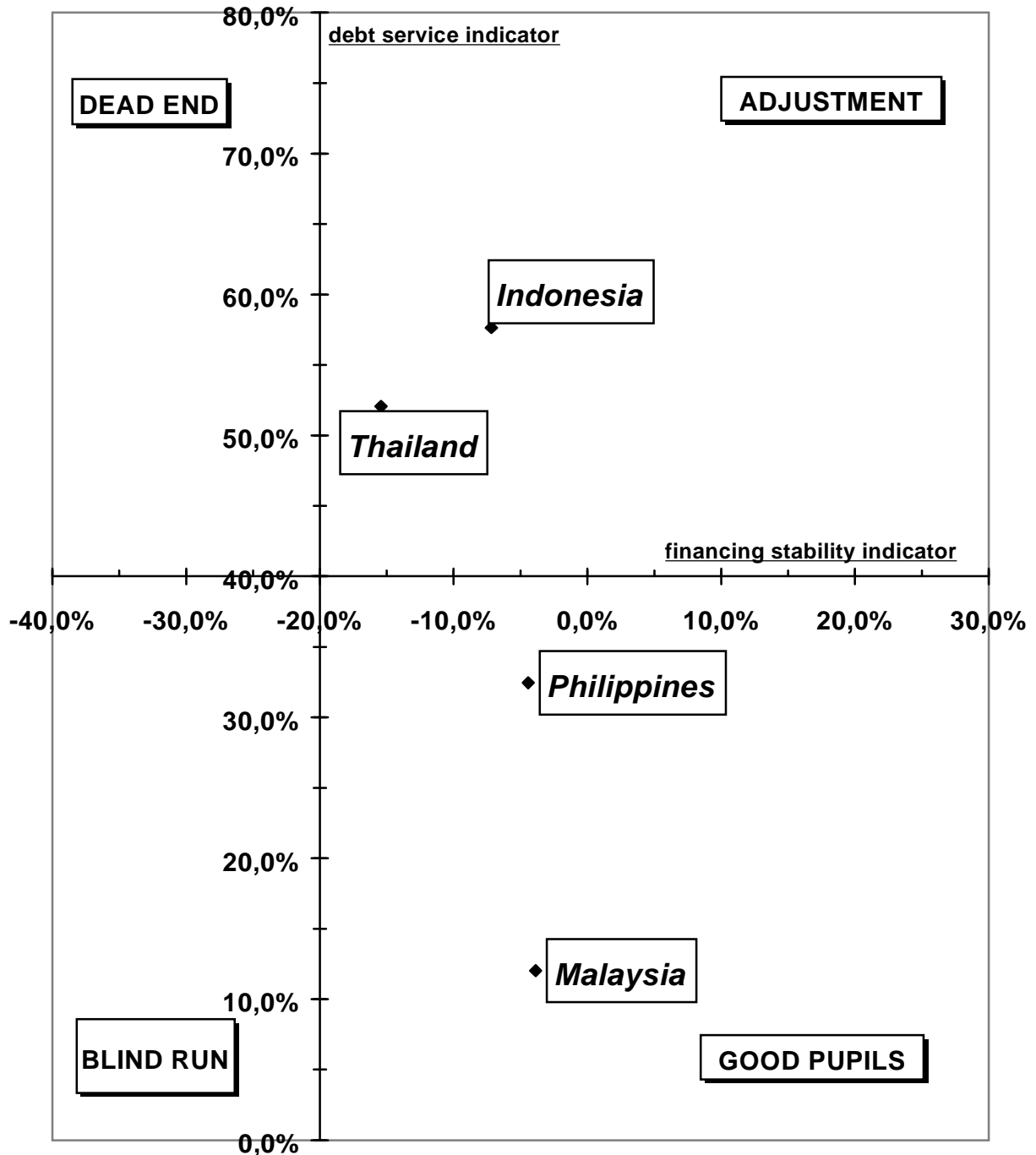
DEVELOPMENT BALANCE  
(official data available at the beginning of March 1997)



Source: T-A-C

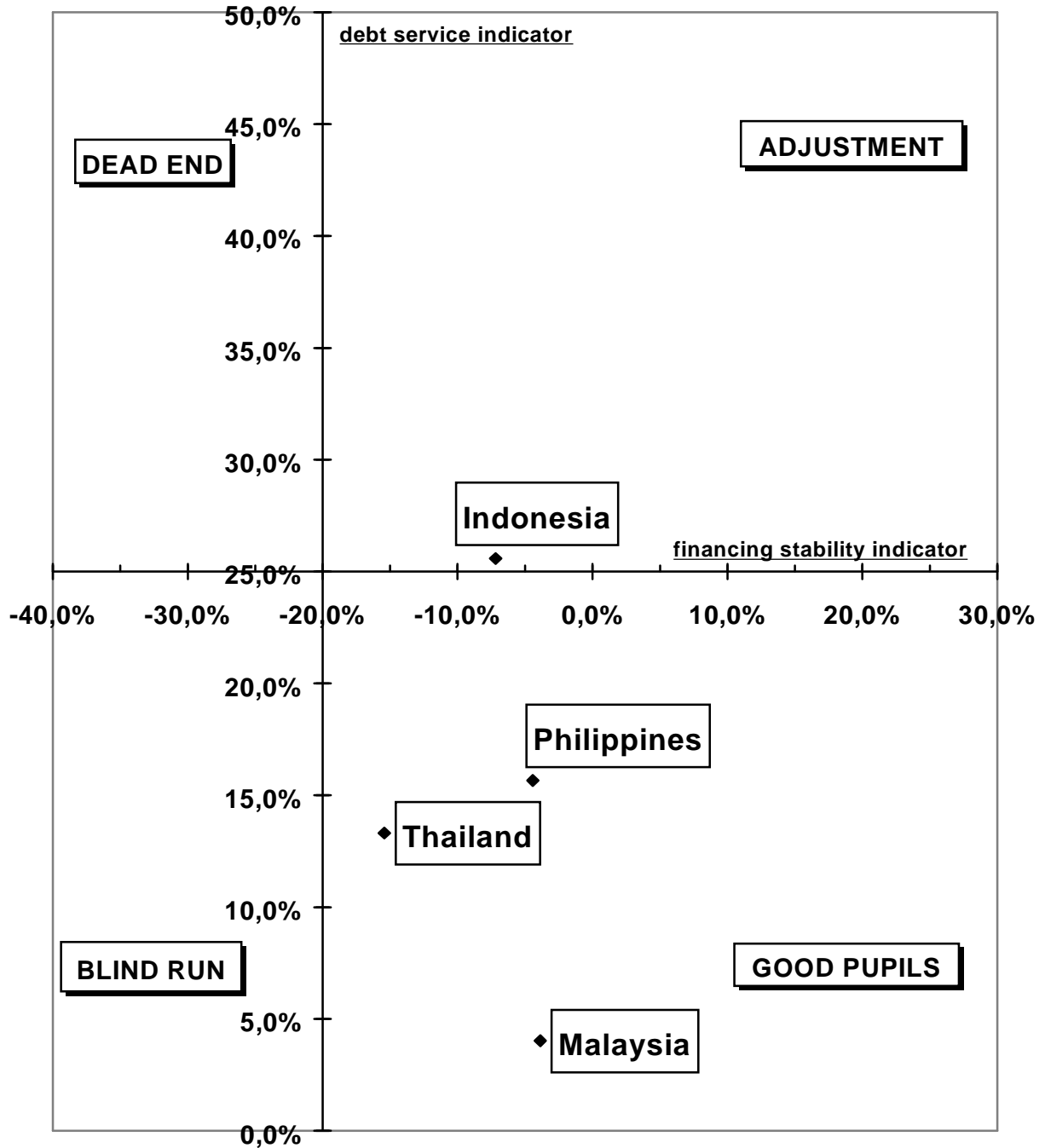
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FINANCING BALANCE / Maximum Potential Service  
(official data available at the beginning of March 1997)



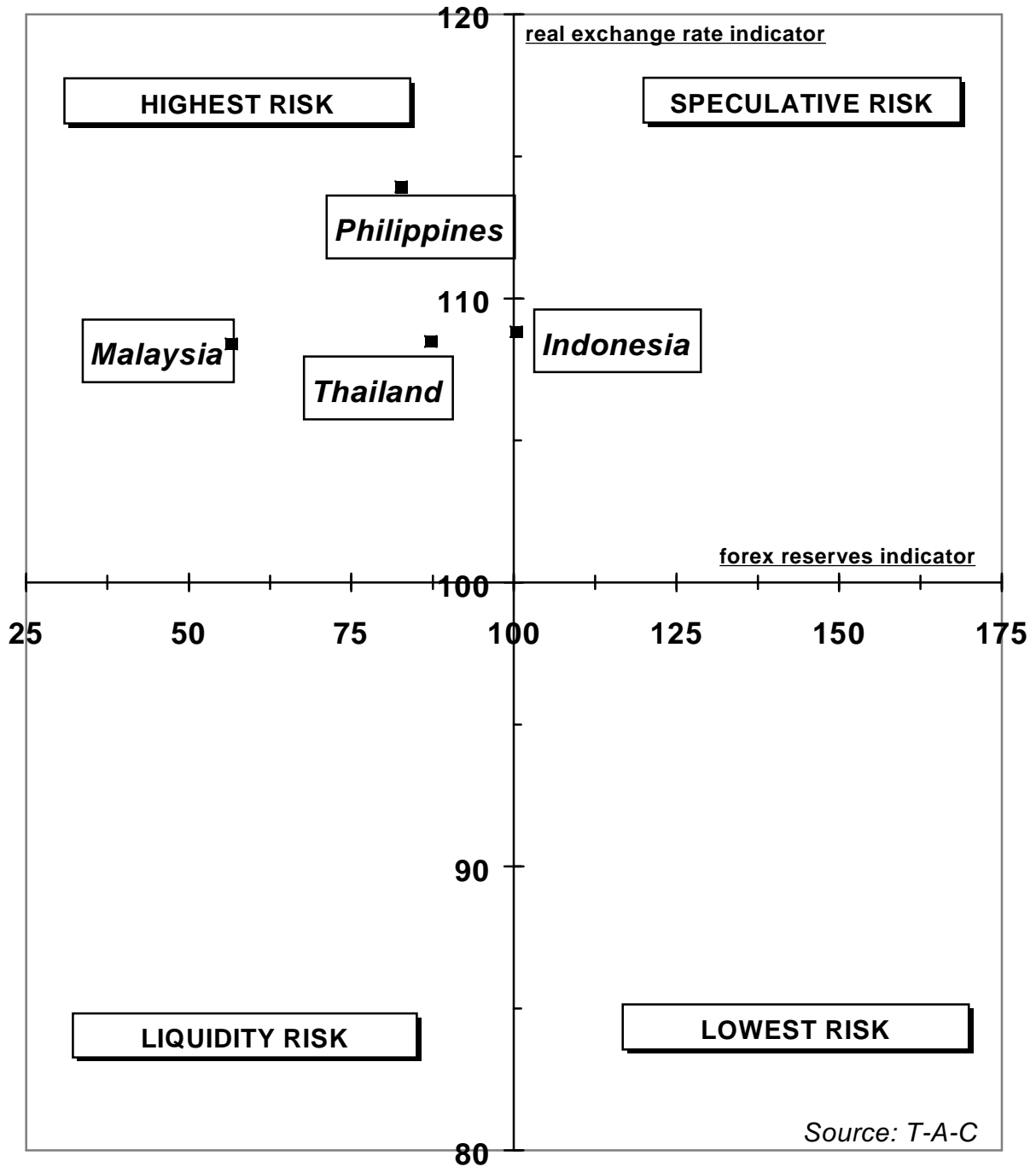
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**FINANCING BALANCE / Standard Debt Service  
(official data available at the beginning of March 1997)**



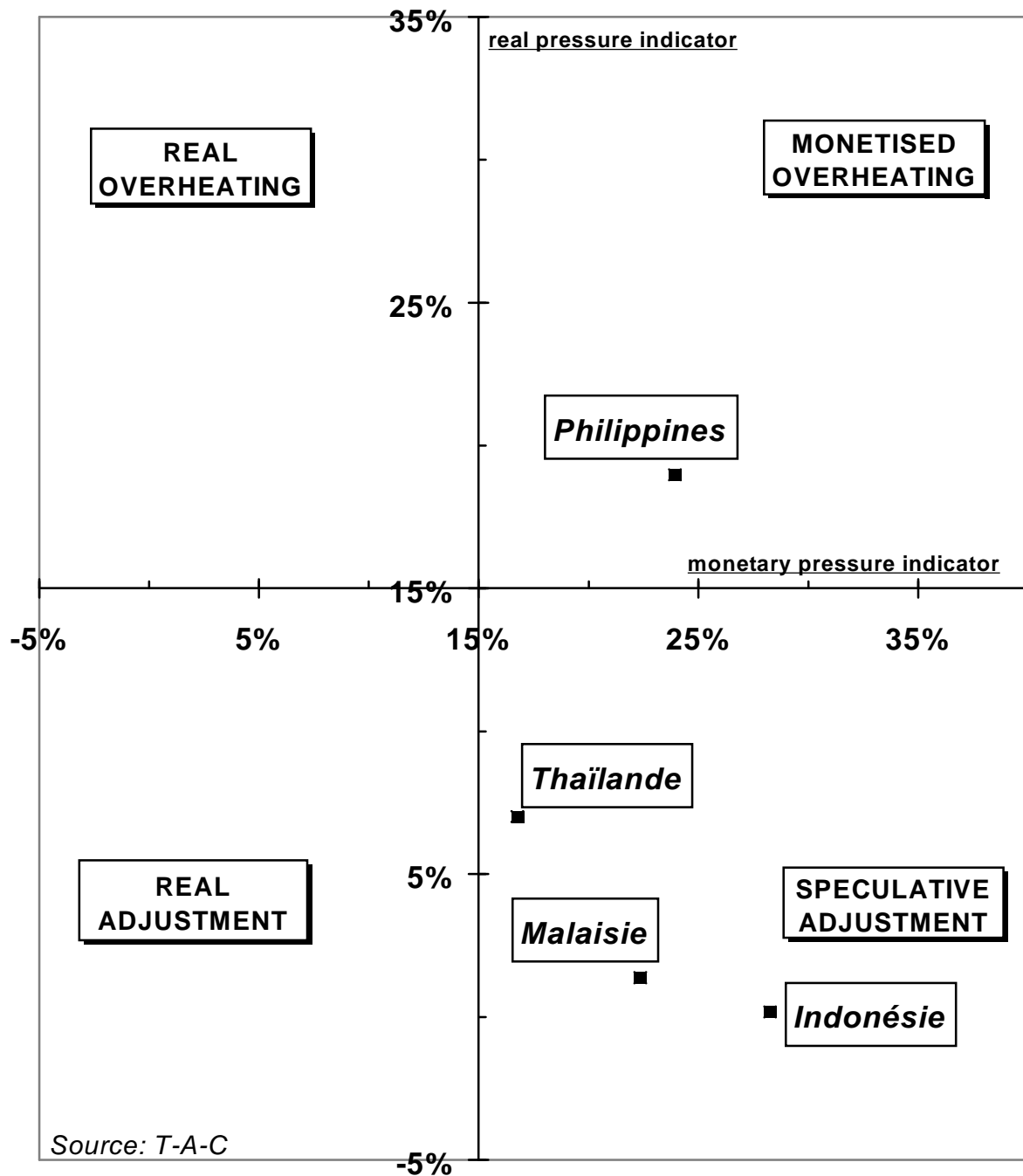
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SHORT TERM EXCHANGE RATE BALANCE  
(official data available at the beginning of March 1997)



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SHORT TERM CYCLICAL BALANCE  
(official data available at the beginning of March 1997)

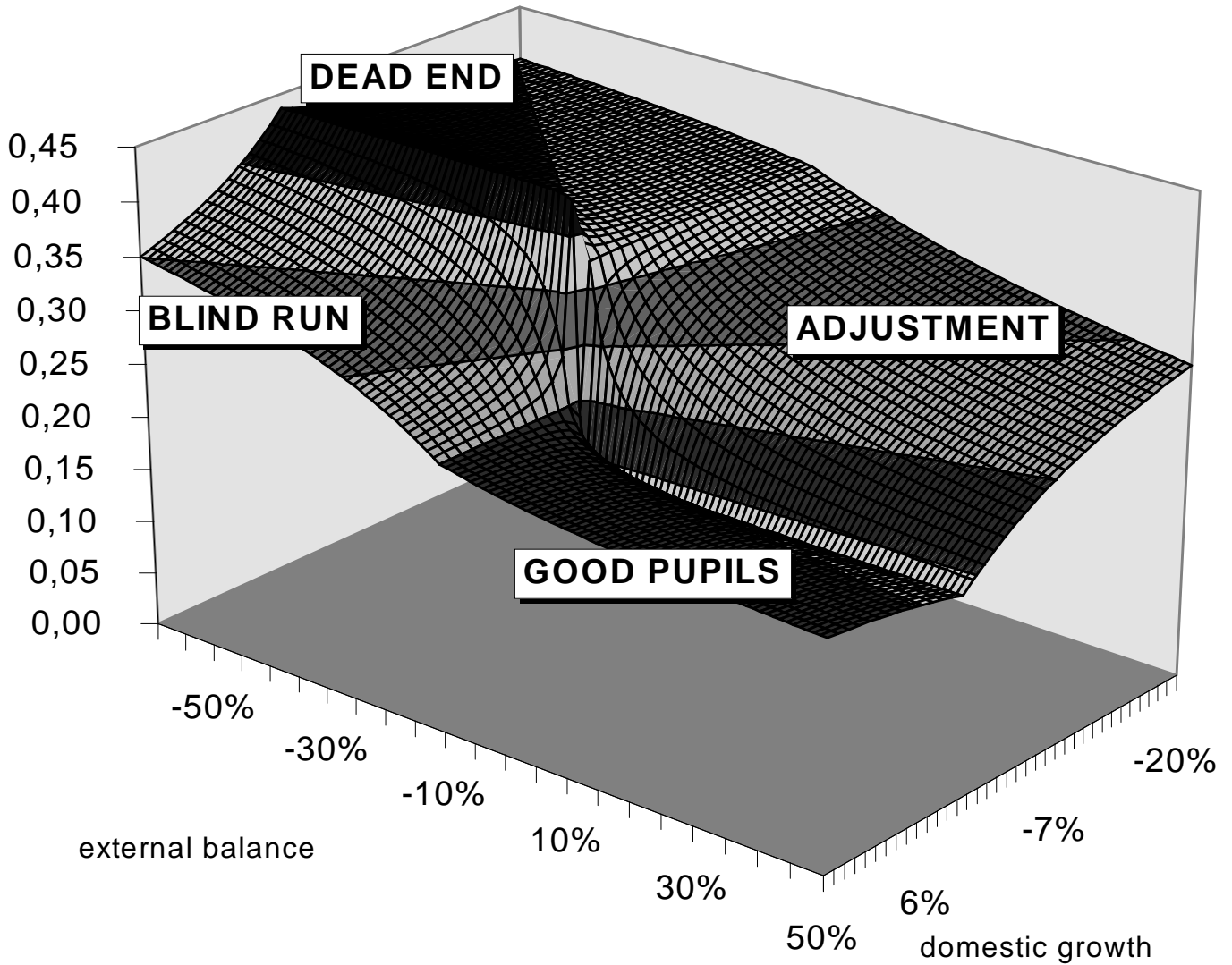


THRESHOLDS AND NON-LINEARITY

- 1- EXACT DEFINITION OF INDICATORS
- 2- SAMPLE OF COUNTRIES WITH AND WITHOUT COUNTRY RISK DIFFICULTIES, 1975-1993
- 3- INTUITIVE SET OF THRESHOLDS BASED ON «COMMON KNOWLEDGE»
- 4- QUANTIFICATION THROUGH NON-LINEAR ALGEBRA
- 5- MEASURING THE SIGNAL / NOISE PERFORMANCE
- 6- THRESHOLDS ADJUSTMENT (●→ 4)
- 7- CHANGE IN DEFINITION OF INDICATORS (●→ 3)

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THRESHOLDS AND NON-LINEARITY  
QUANTIFICATION FUNCTION FOR THE *DEVELOPMENT BALANCE*

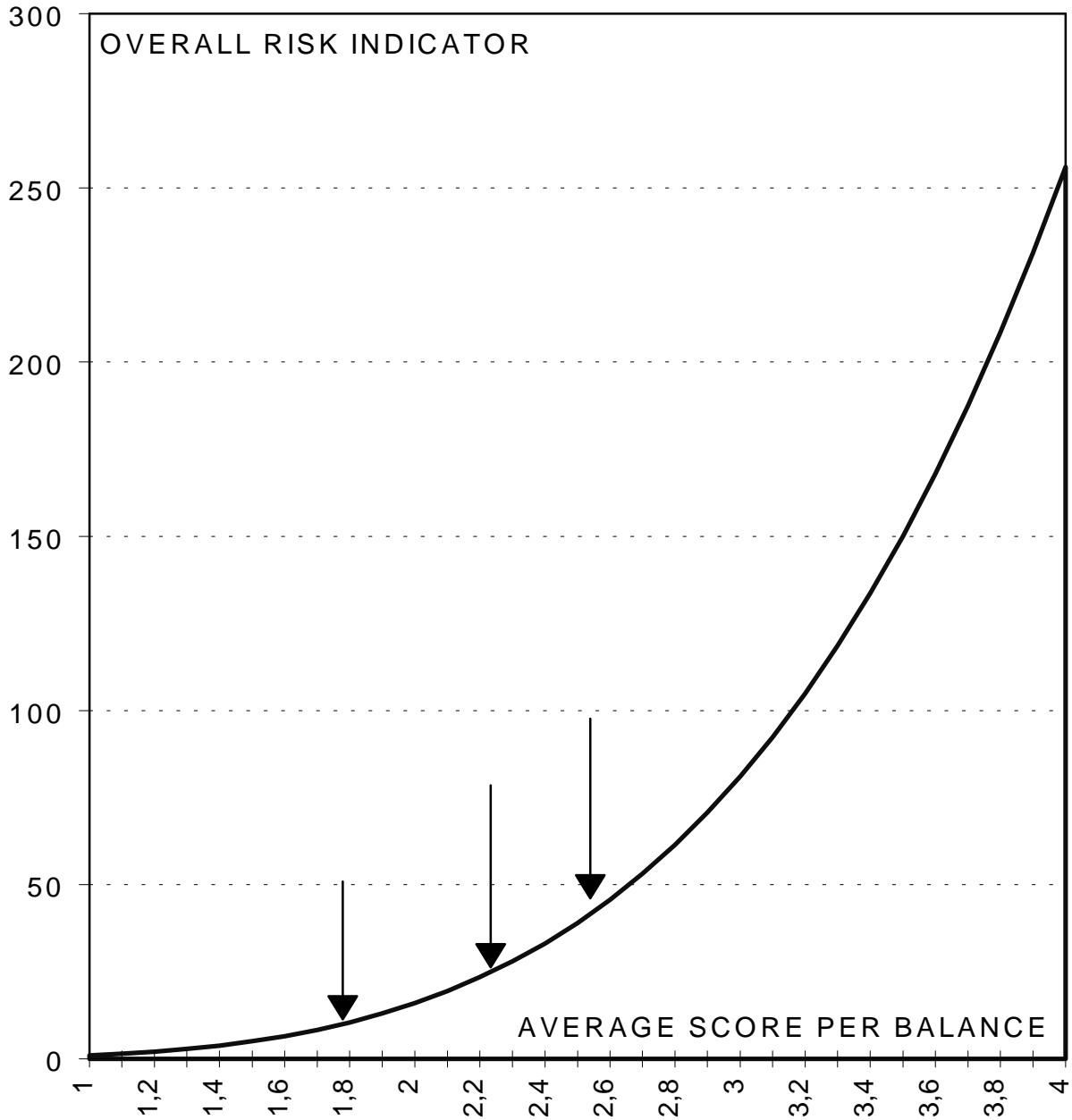


Source : T-A-C

□ 0,15 -0,20	■ 0,20 -0,25	□ 0,25 -0,30	■ 0,30 -0,35
□ 0,35 -0,40	■ 0,40 -0,45		

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**THRESHOLDS AND NON-LINEARITY**



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**THRESHOLDS AND NON-LINEARITY**

**AN ABILITY TO IDENTIFY SPECIFIC SETS OF  
CIRCUMSTANCES EITHER IN THE SHORT TERM OR  
THROUGH A LONGER PERIOD**

**FREQUENCIES (QUARTERLY BASIS DURING 1973-1995) OF 5  
MAJOR "DOUBLE-BALANCE" COMBINATIONS FOR VENEZUELA**

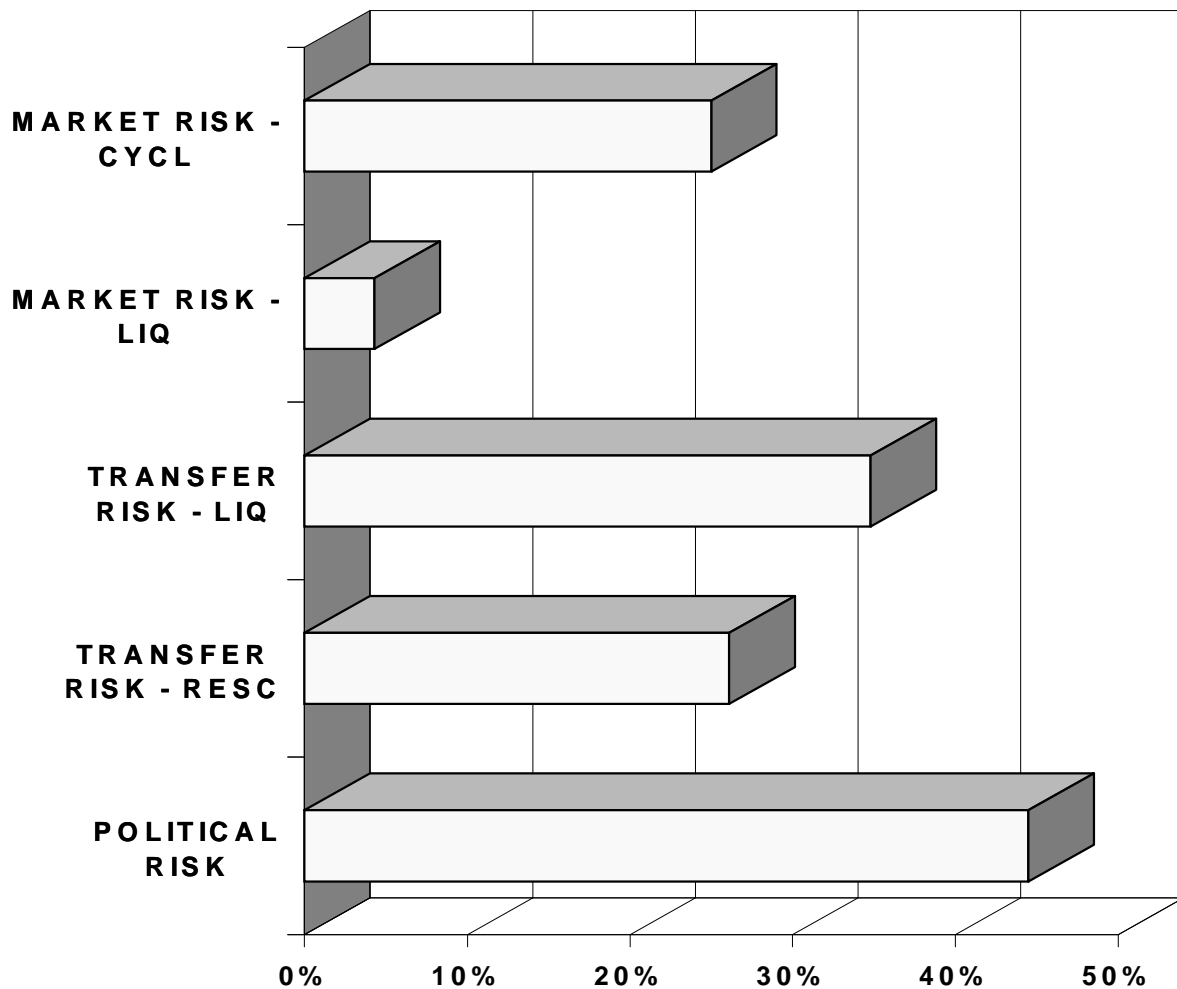
- **POLITICAL RISK (low growth DB / speculative cyclical pos. STCB)**
- **TRANSFER RISK - RESCHEDULING (high debt service FB / low growth or large external imbalances DB)**
- **TRANSFER RISK - TENSIONS ON INT'L LIQUIDITY (high max. potential debt service FB / strong monetary pressure STCB or low forex reserves STEB)**
- **MARKET RISK - TENSIONS ON INT'L LIQUIDITY (financing instability FB / strong monetary pressure STCB)**
- **MARKET RISK - CYCLICAL SHOCK (overvalued exchange rate STEB / large external imbalances DB or strong real economic pressure or speculative adjustment STCB)**

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THRESHOLDS AND NON-LINEARITY

THE EXAMPLE OF VENEZUELA

FREQUENCIES (QUARTERLY BASIS DURING 1973-1995)  
OF 5 MAJOR "DOUBLE-BALANCE" COMBINATIONS



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**THE QUESTION OF TIMING**

- PROBABLY THE MOST DIFFICULT ISSUE
- THE UNCERTAINTY WILL ALWAYS REMAIN HIGH BECAUSE OF THE COMBINATION OF
  - ADEQUACY OF POLICY RESPONSE
  - MARKET PERCEPTIONS
  - CONTAGION EFFECTS AND ASYMETRIC OVERSHOOTING
- PROBLEM OF MORAL HAZARD
- THERE IS A NEED FOR BOTH SHORT-TERM QUANTITATIVE ASSESSMENT AND MORE QUALITATIVE INPUTS

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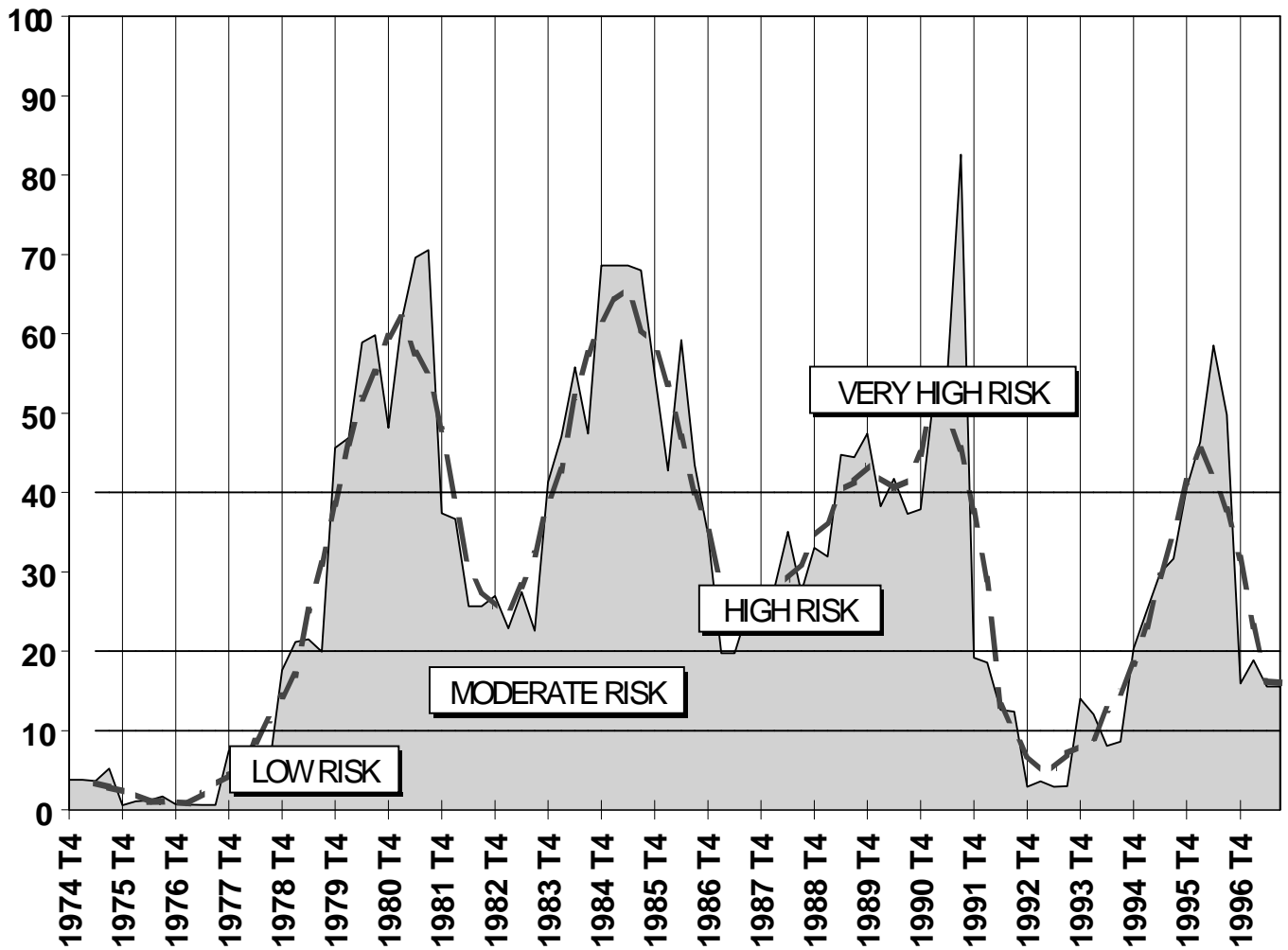
**THE QUESTION OF TIMING**

- **THERE IS NO MAGIC SOLUTION**  
*«Give them a date, give them a rate, but never give both»*
- **COMBINING MEDIUM- AND SHORT-TERM BALANCES**
- **IDENTIFYING LONG- AND SHORT-TERM «PATTERNS»**

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THE QUESTION OF TIMING

CYCLICAL AND TIME PATTERNS OF THE OVERALL  
RISK INDICATOR FOR VENEZUELA



Source: T-A-C

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**BEWARE OF THE HERD INSTINCT**

- **THE CONSENSUS ALWAYS HAS IT WRONG IN TIMES OF CRISES**
- **CATASTROPHIC SCENARIOS ARE VERY DIFFICULT TO AGREE UPON**
- **THE BEST EARLY WARNING : SIGNIFICANT ACCELERATION IN VOLUMES AND DECLINING RETURNS**
- **THE NEED TO CONFRONT MANY DIFFERENT APPROACHES**



T-A-C was created in 1991 with the aim to improve analysis of the links between the macro-economic and financial environment on the one hand, and corporate strategic choices on the other, and to supply information which can be readily integrated in operational decision processes.

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The major research areas on which T-A-C can apply the highest expertise include :

- country risk analysis: non-linear logic analysis, risk rating and optimisation processes, in-depth long-term political, social and economic scenarios ;
  - international financial markets : cyclical developments and asset allocation, evolution of exchange and interest rates;
  - structure of, risks in and performance of the banking and insurance industry : analytical tools for risk assessment, changes in competition and markets, links between macro-economic evolution and the performance of financial institutions.
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During its first seven years of existence, T-A-C has conducted research for more than twenty five corporations or business organisations, either through studies dedicated to answering a specific operational issue or through more general studies aiming at providing background information for decision making. The following list names some of our customers:

Association Française des Banques	Banque de France
Banque Indosuez	Caisse des Dépôts et Consignations
Crédit Agricole	UE-CIC
Compagnie de Suez	Crédit Mutuel
Daiwa Europe	Société Générale
French Ministry of Finance (DREE)	CENCEP (Caisses d'Epargne)
The European Commission	CPR ...

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T-A-C voluntarily keeps a light structure of five economists / analysts but can complement its expertise with the recourse to other specialised consultants or through association with other consulting firms.

T-A-C is headed by **Pr. Thierry APOTEKER**, who graduated from the elite French business school HEC and obtained a Doctorate in monetary economics from the University of Paris. Thierry Apoteker started as a junior economist in a French think tank (B.I.P.E), and then moved to Banque Indosuez, a major international French bank headquartered in Paris and operating in more than 70 countries world-wide. He set up the country risk division before becoming the bank's chief economist and head of the Research Department. He quitted the bank in 1990 to create the consultancy group which bears his name. Until 1997 he taught banking and financial economics at the University of Rennes as an Associate Professor.

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