Crisis Prevention in Emerging Markets

Moody's perspective

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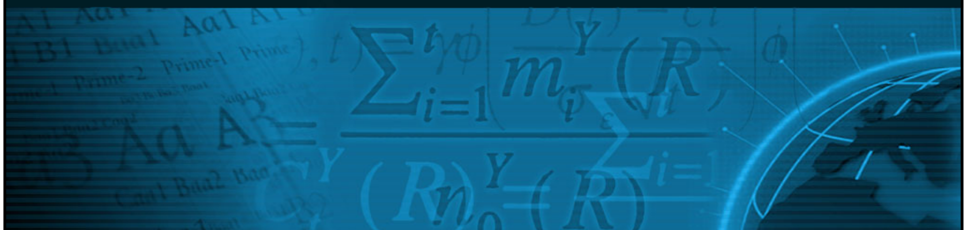

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Introduction

1. What we have learnt in terms of rating policy
2. What we know
3. What we think we know
4. What we do not know

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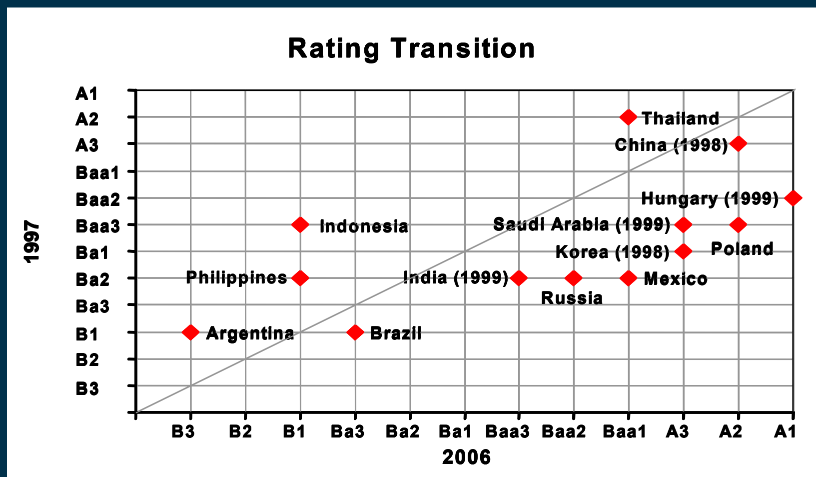
Background: from 1997 to 2006



1. What we have learnt in terms of rating policy?

- **Modesty**
- **Transparency**
- **Focus**

Enhanced focus

- **Definition of sovereign ratings**
- **Probability and severity of default**
- **Key rating factors**
- **Debt payment schematic**

How do we determine government bond ratings?

Shock absorption capacity	Public debt vulnerability
Factor 1: GDP/capita Factor 2: Institutional maturity	Factor 3: Strength of government balance-sheet Factor 4: Susceptibility to risk events

Local currency and foreign currency sovereign bond rating

Debt payment schematic

WHAT HAS TO BE REPAID?	WHAT ARE THE RESOURCES AVAILABLE?
Local currency debt	**Local currency debt**
1. Debt stock 2. Debt flow: financial balance 3. Debt dynamics including FC indexation and maturity structure 4. Contingent Liabilities (banks…) 5. Future liabilities (pensions…)	1. Fiscal resources: static and dynamic analysis of the country's fiscal depth 2. Liquid assets (privatization…) 3. Sellable but illiquid assets
SPILL OVER RISK: balance-sheet effects of currency and maturity mismatches, capital outflows, impact on fiscal revenues of contraction resulting from external crisis…	
Foreign currency debt	**Foreign currency debt**
1. Debt stock (public and private) 2. Debt flow: balance of payment trends (current account, competitiveness…) 3. Debt dynamics: vulnerability of external financing (nature of financing…)	1. Liquid and unencumbered foreign exchange reserves 2. Access to additional external finance at tolerable price

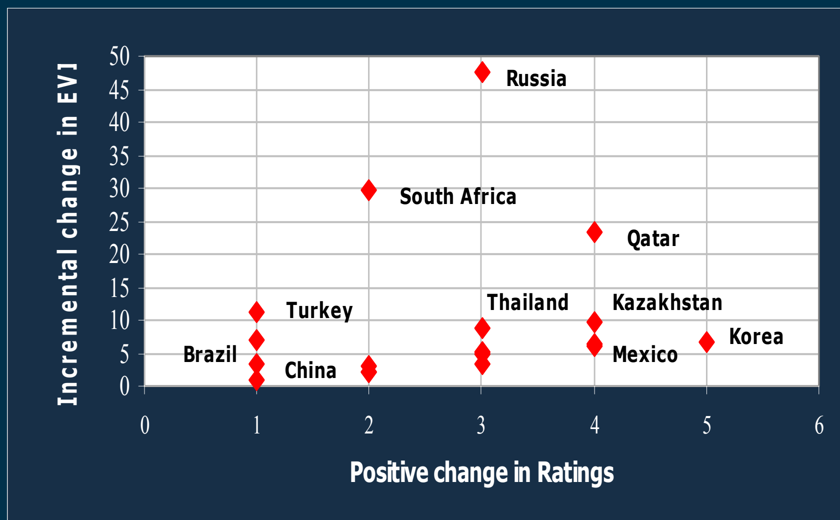
LC

FC

2. What do we know?

- **Liquidity matters (a lot)**
- **Risk management approaches pay off**
- **Economic and trade integration enhances resiliency**

Liquidity matters (a lot)



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Risk management approaches pay off

- The risk management approach to economic policy – analogy with banking
- Scope:
  - Refining macro-financial surveillance tools
  - Defusing crisis triggers and amplifiers
  - Building a sound financial infrastructure
  - Devising new financial (including ALM) strategies
- Limitations

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Economic integration enhance resiliency

- Reduces the probability of crisis
- Reduces the severity of crisis – creating counter-cyclical features
- Examples: the EU anchor, Asia's rebound after the crisis

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3. What do we think we know

- Not all current account imbalances are alike
- Liquidity risk and solvency risk
- Local currency debt is generally less risky than foreign currency debt
- Banking integration provides more stability than financial market integration, but financial market development remains key

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Not all current account imbalances are alike

- A simple analytical approach:
  - The nature/stability of financing is key
  - How vulnerable is the CA deficit? How robust is the financing and how susceptible to an external shock?
  - How sustainable is it? The determinants of the deficit (the S-I gap), the "Lawson doctrine" and the question of competitiveness
  - How severe should an hypothetical crisis be from the point of view of the government's balance sheet?
- Examples: Central and Eastern Europe
- Is that right after all?

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13

Liquidity risk and solvency risk

- Liquidity crisis: price and volume effects
- Mature market economies are not vulnerable to financing discontinuities, but "simply" to price adjustments
- Implications: net debt versus gross debt
- How robust is this observation?

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Local versus foreign currency debt

- The many benefits of raising funds in one's currency
- But in a context of open capital accounts, the superiority of LC debt should not be exaggerated
- Example: Latin America

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Banking integration versus financial integration (1)

- The value of international banking integration in terms of systemic strength
- Example: EU-wide banking integration
- However, this remains largely untested

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Banking integration versus financial integration (2)

Share of bank assets held by foreign banks[1]	1990	2004[2]	in per cent of GDP	in billions of USD
Central and eastern Europe				
Bulgaria	0	80	49	13
Czech Republic	10	96	92	99
Estonia	...	97	89	11
Hungary	10	83	67	68
Poland	3	68	43	105
Emerging Asia				
China	0	2	4	71
Hong Kong	89	72	344	570
India	5	8	6	36
Korea	4	8	10	65
Malaysia	...	18	27	32
Singapore	89	76	148	159
Thailand	5	18	20	32
Latin America				
Argentina	10	48	20	31
Brazil	6	27	18	107
Chile	19	42	37	35
Mexico	2	82	51	342
Peru	4	46	14	11
Venezuela	1	34	9	9

[1] Percentage share of total bank assets. [2] Or latest available year.
Sources: CGFS (2004); ECB; national central banks; BIS calculations. Table 1

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Financial market development is yet critical

- Although it opens the way for potentially sharp reactions to domestic developments and also creates linkages with global finance…
- It instills healthy controversy in asset price valuations
- Example: Gulf countries' stock markets

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18

4. What we still do not know

- Disentangling cyclical and structural factors
- Understanding crises dynamics and the micro-macro nexus
- The understanding of political risk remains elusive

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Disentangling cyclical and structural factors

- What is cyclical?
- What is structural?
- Can cyclical improvements turn into structural one?
- The ordinal and cardinal nature of ratings

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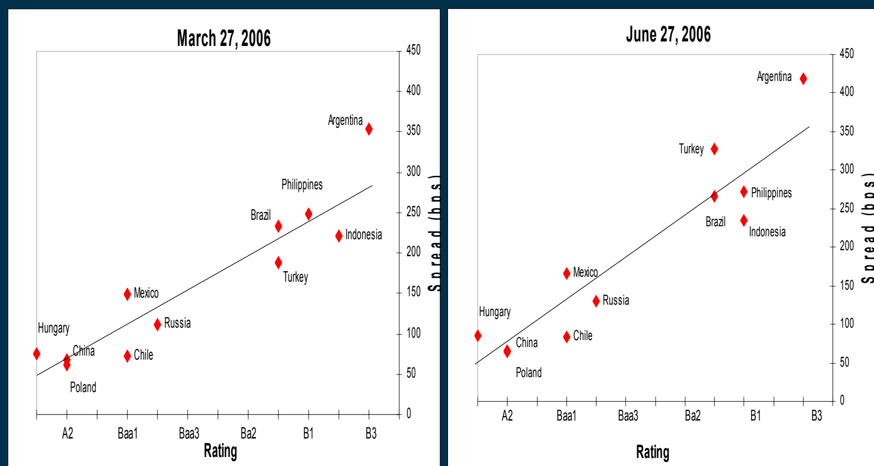
Fundamental versus exogenous factors



Understanding crises dynamics

- The micro-macro nexus:
  - Government's off balance sheet liabilities
  - Ratings' interaction at Moody's
- Contagion remains mysterious

Political risk remains elusive

- Ability to pay versus willingness to pay: are they really distinct?

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23