

University of Zurich – Department of Banking and Finance – Masterarbeit

Development of a model correlating bank crises and sovereign debt defaults for CIS countries



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Executive summary

This thesis, based on the book “This Time is Different – Eight Centuries of Financial Folly” (Princeton University press, 2009) by Carmen Reinhart and Kenneth Rogoff and the research paper “From Financial Crash to Debt Crisis” (NBER Working Paper No. 15795, 2010) by the same authors, expands and applies the models and concepts presented to the CIS region, consisting of countries that rose from the ruins of the Soviet Union and having very specific economies.

The first part presents general information about debt and defines the framework used in the whole thesis by introducing Reinhart/Rogoff’s model. It goes through the authors’ four hypotheses concerning debt and banking crises: the presence of private borrowing surges before domestic bank crises, the coincidence in time of banking and sovereign debt crises, the public borrowing acceleration ahead of debt crises, with “hidden debts” appearing during the crisis episode and shifting towards short-term maturities ahead of debt crises. The “this time is different syndrome”, or why so little experience is taken from past errors in the areas of public financial management is also evoked.

The second part describes the history of external debt formation in the region from the independence of the countries up to today and, providing an insight in the main patterns of indebtedness for CIS countries. The economic situation of the countries at the fall of the USSR is explained, and the “zero option”, by which Russia took all Soviet Union’s assets and liabilities, is discussed. From this situation, a timeline is constructed, with first bilateral debt with Russia, and then multilateral borrowings from international financial institutions, and the

setting up of internal borrowing for the most financially advanced CIS countries. The debt ratios used for debt analysis are then detailed and used to describe the situation in the region today, on both external and internal fields. From this assessment, groups with common trends, problems and challenges can be made: CIS-7, Belarus/Ukraine, Kazakhstan and Turkmenistan.

The third part provides two case studies: Moldova, which experienced debt crisis (Paris club restructuring) in 2006, and Kazakhstan, where a debt crisis can happen very soon. In the case of Moldova, the assumptions of Reinhart/Rogoff don't seem to work, and in Kazakhstan, they apply but with some reserves. It may be too early to apply completely the model to the region, due to a very specific debt history and an underdevelopment of the financial sector.

The thesis assesses the default risks of the CIS countries, defining potential defaulters (Kazakhstan and Ukraine) and countries that are less likely to default. It recommends a quick development of a domestic banking sector and an increased monitoring of the multilateral debt taken by the governments.

It also indicates paths for further research in the field of debt analysis in the CIS region.