

“Win-win deal”: prospects and risks for Ukraine

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Abstract – In the article the 20% debt haircut agreement was analyzed with possible threats and benefits being showed. It was emphasized that encouraging the bondholders to agree on restructuring terms, Ukraine took a step into uncertainty. First and foremost it promised to pay holders a percentage of its economic growth from 2021. Given the difficulty to make a proper forecast for Ukraine, it's uncertain if the so called “win-win” deal will prove to bring economic stability and prosperity and the resources to pay off debt.

Key words – “win-win” deal, extension on repayments, debt restructuring, investment, forecast, economic growth, IMF, political situation, institutional quality, commodity prices, Global Competitiveness Index.

I. Introduction

In late August Ukraine has reached “win-win” debt deal with creditor group to slash its \$18 billion debt by 20%, which was backed up by 75% of participants. This agreement is an endeavor to stabilise government finances and to avoid further meltdown, caused in many respects by the war on Ukraine’s eastern border. The debt deal should help keep Ukraine’s national currency stable and be able not only to maintain spending on defence in the east, but also to provide financial support for the poor. The restructuring covers 13 series of its sovereign bonds out of 14 involved in the debt procedure, that was approved by the Creditor Committee and the IMF. Now Ukraine plans to substitute these securities by Value Recovery Instruments (VRIs), which are extremely difficult to value. Instead of paying interests for the securities, Ukraine will pay holders a percentage of its economic growth from 2021. For the rest of debt the government got a four-year extension on repayments, the interests on which are going to be slightly higher – 7,75% comparing with 7,2% earlier (they are going to be paid off during 2019-27).

II. Threats for future prospects

Although Ukraine’s finance minister, Natalia Yaresko considers the 20% haircut agreement as advantageous for both sides, there can’t be ignored some warnings. In particular, Jakob Christensen, Exotix credit strategist, has doubts that this deal will help reduce debt to 71% of GDP in 2020, which is one of the crucial targets in the operation. Another economist Gabriel Sterne admits that there is a large likelihood that “they will be back at the negotiating table before too many IMF reviews have passed”. Besides, there exist some uncertainties. First and foremost, VRIs still have to be issued in November. Those 25% of debt holders, who don’t agree with the agreement have the right to institute a claim in the court

(as in the case of Argentina). Secondly, debt restructuring deal means a technical default, that was stated on October, 5th by ISDA – International Swaps and Derivatives Association. From now on IMF remains the Washington-based lender of last resort. As it was neatly stated by Oleksandr Ohrimenko “It has no way to recede. Stepping back means a policy failure as to Ukraine”. Indeed, the Fund failed to make the proper forecasts of GDP growth in Ukraine in past periods. It’s important to note that Ukraine has been remaining a very risky investment place among creditors for a long period now. During the last two years lending rates at the secondary market were very high – 40% and higher, which made it impossible to float the new securities. The only effective instruments to provide the access to financial resources are USA securities.

One good aspect is that this agreement relieved the debt burden for a short time. But the other side of the coin is whether the country will pay more or less comparing with the current value of debt. It all depends on the GDP annual growth rate. Former Minister of Finance of Ukraine Viktor Pynzenyk says that we lose more than win. He emphasizes that the annual growth rate of Ukraine’s economy in the middle 1990s was more than 4%. Given the possibility of such well-being, Ukraine will pay a large share of its GDP. If the rate of growth is 3-4%, then the country will pay 15% of its accretion, if more than 4%, then - 40% of its accretion. A good thing is that the creditors will be interested in Ukrainian prosperity. Consequently, we can hope for investment inflow and growth promotion.

III. Forecasting difficulties of GDP growth

Making a proper forecast for Ukraine’s GDP and what is more important for debt servicing – for exchange rate – looks like a difficult task. First of all as an independent state Ukraine has a very short economic history, which doesn’t allow to build a correct long-run trend of economic growth. That’s why most forecasts are short-run. The one, taken from Eastern European Outlook Economic Research (October 2015) is shown in the table below.

TABLE 1

Economic indices	Years					
	2012	2013	2014	2015(f)	2016(f)	2017(f)
GDP, %	0,4	0,0	-6,5	-12,0	1,0	2,0
Inflation, average, %	0,6	-0,3	12,1	48,0	18,0	10,0
Unemployment, %	7,8	7,4	9,0	9,4	9,1	8,7
Current account, % of BBI	-8,1	-9,2	-4,0	-1,5	-1,3	-1,4
Public sector financial balance, % of GDP	-5,5	-6,6	-7,0	-4,4	-3,0	-2,8
Public sector debt, % of GDP	37,5	40,7	71,2	98,0	96,0	90,0
USD/UAH, end of period	8,05	8,23	15,77	21,00	20,00	18,00

According to Economist Intelligence Unit forecasts for 2015-17 the forecast of main economic indicators is slightly different from that shown above, but the tendencies are positive too. In particular, the GDP growth in 2016 and 2017 is projected to be 1% and 3,2%, inflation – 14,5% and 9,5%, exchange rate – 24,0% and 23,1%, respectively. At the same time IMF is rather optimistic about Ukraine's GDP growth. More precisely, it expects the 2% growth in 2016, 3,5% – in 2017 with 4% annually farther on till 2020.

To make a proper forecast of economic growth the one should estimate many developing tendencies – external environment, political situation, institutional quality, human resources, etc. Nowadays the investment attraction indicator can be bond yields/demand for shares ratio. The investors aren't motivated to finance the production. If the bond yields go down, the investors will turn to underlying assets. At present there are no motives to improve the situation. Still further the bond yield raised rapidly to 47% on October, 14th, being the highest in the world at this moment. The same happened about a year ago, when as a result of investors' distrusts in Ukraine's solvency the rate on the dollar-denominated debt due July 2017 rose 54 basis points to 15,29%.

IV. Prospects of future growth

Internal situation. The slowdown trend of Ukraine's economy can be fixed by the normalization of the situation on its eastern-south border. As it was repeatedly stated the tensions and the cutting off the eastern territories, where the main production potential is located, extremely negatively affect the economy. According to the NBU head, Valeriya Hontaryeva, since the start of operations in Donbas Ukraine has lost 15% of GDP and 20% of currency returns.

Commodity prices. The global economy is expected to grow 2,8 percent in 2015 before strengthening moderately to 3,2 percent in 2016-17. The commodity prices fell drastically due to low demand and supply glut. In particular, the commodities boom, fueled by China's explosive growth in previous years, caused energy and metals companies to ramp up production to levels that today's market just can't support. Steel production, driven by increasing production in China, is expected to continue to exceed demand up to 2017, therefore dampening prices. Lower commodity prices are a reminder for commodity-exporting countries of the urgency to diversify the economies. The similar situation is with coal. Coal prices are expected to decline 17 percent in 2015 to \$50/ton on continued surplus supply. Coal faces difficult market conditions going forward due to slowing import demand in China and increased competition from natural gas due to lower prices.

Meanwhile, according to the Economist Intelligence Unit forecasts the prices for steel and industrial raw materials are expected to recover their upward trends in 2016 and 2017 as well as the price for wheat. Even though given such a favourable prognosis, Ukraine would be unable to benefit fully from higher global prices because of the destruction of industrial plants, mines and infrastructure during the war in the Donbas region.

Institutional quality. The growth of the Ukrainian economy crucially depends on the quality of state institutions and reforming the business environment. The institutional environment is determined by the legal and administrative framework within which individuals, firms, and governments interact to

generate wealth. The efficiency of institutions is important for many reasons. First, its quality has a strong bearing on competitiveness and growth, as it influences investment decisions. Second, it plays a key role in wealth distribution and bearing the costs of development strategies. At the same time, high quality institutions provide healthy competitiveness in the market, prevents excessive bureaucracy, overregulation, corruption, lack of transparency and trustworthiness. In addition, the proper management of public finances is also critical for ensuring trust in the national business environment. According to The Global Competitiveness Index 2013–2014, Ukraine placed 84th among 148 countries.

Conclusion

In the paper the main prospects and threats of 20% debt haircut agreement are shown. This agreement is an attempt to stabilise the government finances, exchange rate and to avoid further meltdown, caused as by the war on Ukraine's eastern border, so by inflation and rapid demand drop. The restructuring covers 13 series of its sovereign bonds which are to be substituted by Value Recovery Instruments (VRIs), according to which Ukraine is going to pay a percentage of its economic growth. Although Ukraine in some way smoothed down the situation, it still has to pay off the debt. Considering that it lacks the bankroll, IMF remains the Washington-based lender of last resort. During the last two years lending rates at the secondary market were very high – 40% and higher, which made it impossible to float the new securities. The amount of money Ukraine it going to pay after 2021 depends on GDP growth rates. On the one hand it's a good thing that debtholders will be interested in Ukraine's prosperity as the higher growth rates will be, the higher will be their returns. On the other hand, it's quite complicated to make a forecast taking into account the uncertainties around tensions on the eastern border, external environment and future political situation. Overall, most existing forecasts are quite optimistic. To make these predictions come true, there should be peace in Ukraine, high quality economic institutions, strong external demand for Ukrainian goods, high transparency and trustworthiness in the country.

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