Public Debt Restructuring: An overview of the key issues

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1. Introduction

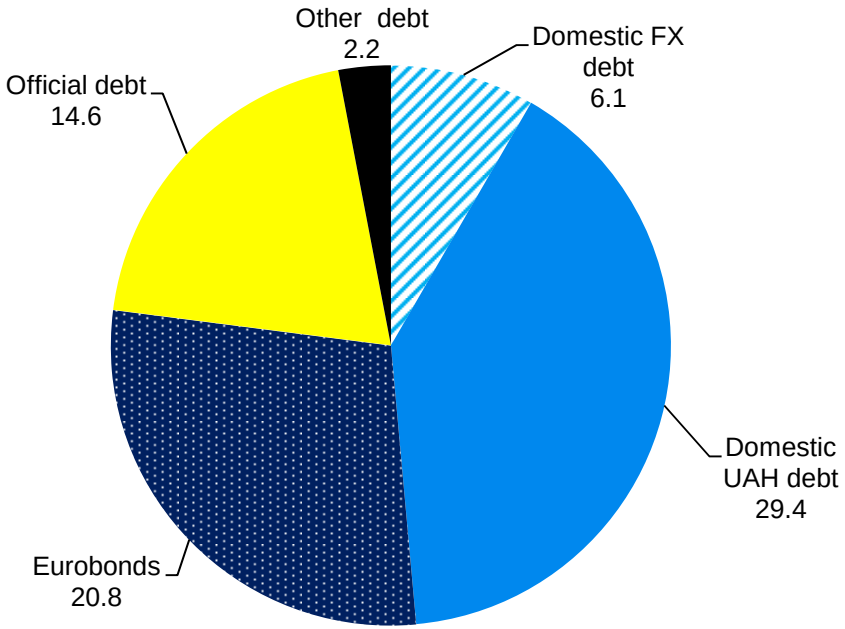
- Ukraine faces immense economic and political challenges
- Significant **twin deficits** in the current and fiscal accounts and **significant FX debt repayments** come at a time when the **access to foreign capital markets** is restricted, and **FX reserves** are at multi-year lows, significantly below any commonly accepted reserve coverage ratio
- In this situation, **external financial support** is clearly needed, and the current negotiations with the IMF is the right approach
- During program discussions, the issue of a possible public debt restructuring via **private sector involvement (PSI)** could become an issue
- A crucial aspect in this respect is the right diagnosis: Does Ukraine suffer from a **liquidity** and/or a **solvency** problem?
  - Difficult to clearly separate both issues; to some extent also intertwined
- This policy briefing attempts to contribute to the current discussion

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2. Public debt structure in Ukraine

Total public sector debt (USD)



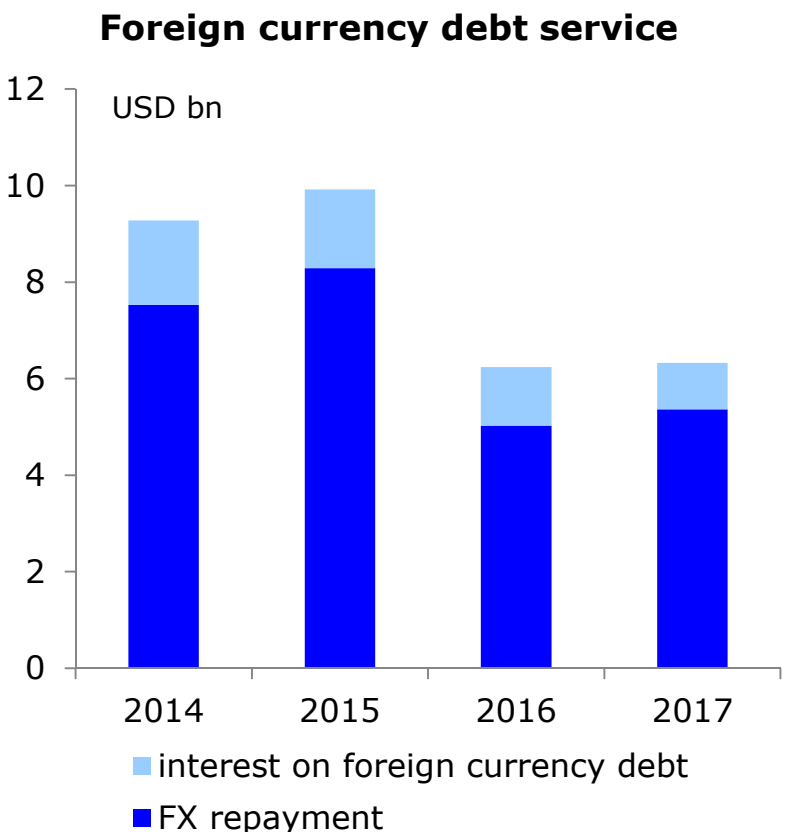
Source: Ministry of Finance

- Total public sector debt (including guaranteed debt): USD 73.1 bn as of 31.12.2013
- 82% direct public debt; 18% guaranteed public debt
- Currency structure: 59.8% in FX, mainly USD
  - Huge risk factor in case of depreciation
- Total public debt amounted to 40.2% of GDP as of end-2013
- Currently, **46% of GDP** (announced by Minister Shlapak on 10.03.2014)
- Rapid increase since 2007 (12% of GDP)

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3. Liquidity Aspects



Source: own calculations based on Ministry of Finance data

Note: Data include City of Kiev Eurobonds

- Public FX debt service schedule reveals peaks in 2014/2015
  - USD 1 bn sovereign Eurobond due in June 2014
  - USD 1.6 bn guaranteed Eurobond of Naftogaz due in September 2014
- In addition: Gas debt in amount of USD 1.8 bn (13 March 2014)
- Private sector debt service is also significant:
  - Q42013-Q32014: USD 21.0 bn repayments (excluding deposits, trade loans and other receivables, Naftogaz is included in public sector debt service)
- Only USD 15.5 bn FX reserves currently available
  - Value is far too low according to all relevant coverage rules (e.g. months of imports, coverage of short-term external debt, etc.)
- No regular foreign market access
- **Liquidity is indeed a concern**

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4. Solvency Aspects

- End-2013 offical public debt/GDP data: 40.2% of GDP
- Currently: 46% of GDP
- A number of risk factors could lead to a further rapid increase in the debt-to-GDP ratio:
  - Further depreciation,
  - Economic recession,
  - Recapitalisation of systemic banks
  - Recognition of previously unrecognized arrears (“hidden debt”)
- **Public debt sustainability analysis** needed to judge if solvency is given
  - See Annex for preliminary analysis

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5. Private sector involvement (PSI)

- Idea: Private investors contribute to the shrinking of the external/public financing needs by changes to the contractual terms of their investments
  - PSI is a broad term, can involve in practice very different procedures (ranging from outright haircuts to extension of maturities)
  - But: Decrease in net present value (NPV) in basically all variants
- PSI has been part of the recent support packages of Greece and Cyprus, and is currently discussed by market players in Ukraine

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What type of debt might be subject to a PSI?

- In Ukraine's case, the discussion would first need to decide which instruments of total public debt would be subject to a possible PSI (see slide 4)
- Legal aspects (e.g. cross-default clauses) need to be taken into account

1. USD 20.8 bn of **public Eurobonds** (11.4% of 2013 GDP)
   - Held by foreign investors
   - Both private (institutional) investors, but also Russia
   - Rather concentrated holdings (e.g. Franklin Templeton held USD 6.4 bn in Feb 2014)
2. USD 6.1 bn of **domestic FX bonds** (3.4% of 2013 GDP)
   - Restructuring apparently triggers default in Eurobonds
   - Concentrated mainly among local banks. A restructuring might automatically increase capital/ recapitalisation needs and thus decrease the benefit for the state in terms of savings
3. **Domestic UAH debt** (16.1% of GDP or equivalent to USD 29.4 bn using 31/12/2013 exchange rate)
   - Less urgent need for restructuring, since in local currency
   - Also significant part of domestic debt held by NBU
4. Restructuring debt to **official lenders** (8% of GDP, USD 14.6 bn) is unlikely
5. Other **guaranteed commercial debt** (1.3% of GDP, USD 2.2 bn)

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a. Benefits

- Budget savings
  - Ukraine can fulfil internal spending priorities (e.g. pensions, defence expenditures)
- Smaller international support package
  - Might help to facilitate approval for a donor support program, as private investors participate in burden sharing
- Reduction of moral hazard
  - Funding of unsustainable economic situation by private investors during 2011-2014 contributed to the problems we face today
  - In addition: Investors received hefty risk premiums for their investments
  - Implicit speculation behind this: Bail-out by West/East due to geopolitical importance of Ukraine
  - PSI might reduce future moral hazard and increase market discipline

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b. Costs

- Negative impact of future capital market access, higher costs of borrowing
  - International experience mixed; good and bad cases
  - Depends on how it is done; also impact on private sector needs to be analysed
  - Reaction of Rating Agencies also important
  - Argument has perhaps less relevance in the future for the sovereign, in case lots of donor funds substitute capital market funding to some extent (e.g. Moldova)
- Relations with Russia
  - Russia might be affected via USD 3 bn “bail-bond” from December 2013; even though it is not clear if it is an ordinary commercial creditor (since also a member of the “Paris Club”)
  - Might lead to further tensions/retaliations apart from capital markets (e.g. financial/trade sanctions)
- Timing
  - PSI involves usually long discussions (e.g. Greece); current situation might not be ideal in this regard
- Unclear impact on possible restructurings in corporate/bank sector
  - Situation might be (ab)used by other Ukrainian debtors from the private sector to restructure their debt
  - Might set a dangerous precedent

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6. Preliminary conclusions

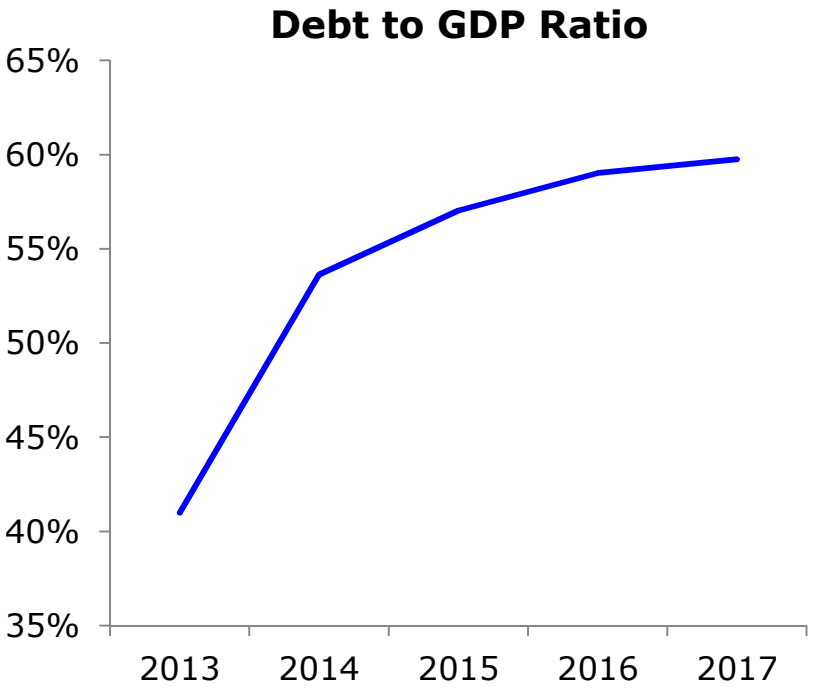
- Ukraine has a liquidity problem, the case for a solvency problem is much less clear cut (at least based on available data)
- Thus, decision for PSI **not straightforward**, but rather controversial; pros and cons are very balanced
- However, many economic and political risks ahead; this adds further to the current uncertainty
- If PSI deemed unnecessary at the current stage, since the country is considered solvent, this implies that one should not exclude its application at a later stage in case adverse shocks threaten the solvency of the sovereign

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Appendix

Some thoughts on Public Debt Sustainability



Source: own estimates

- Starting point: Debt-to-GDP level of 46% (as of February 2014)
- Base case involves:
  - Recession in 2014 (-3.5% real GDP growth)
  - Depreciation of 30% in 2014
  - Consolidated primary fiscal deficit (incl. Naftogaz) gradually improves to 1% of GDP (versus ca. 2% in 2013)
  - As a result, debt will reach 60% of GDP in 2017. For its stabilisation the Government then should ensure primary fiscal deficit at not more than 0.2% of GDP *(under the assumption that real GDP growth is higher than real interest rate)*
- **Under the base case, Ukraine seems to be solvent**
- However, many risk factors, need for more sophisticated scenarios

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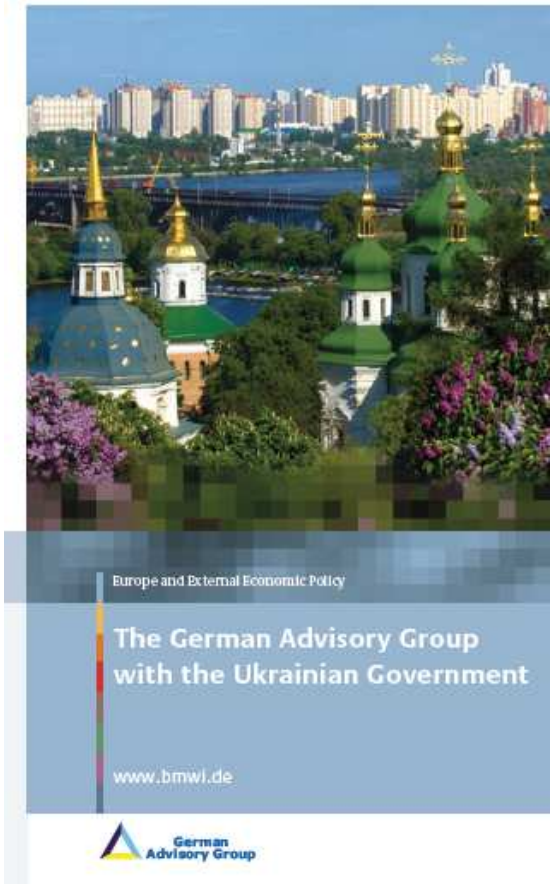
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