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East-West Standoff Complicates any IMF Deal for Ukraine

By The Moscow Times

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LONDON — Ukrainian bond prices are holding up better than expected in the standoff with Russia because investors think the International Monetary Fund might not impose tough conditions in an expected aid program due to Kiev's political importance to the West.

Rather like Pakistan in 2001, which was seen as key in the fight against al-Qaida, some in markets say the IMF, from which Ukraine is seeking financial support, could hand it the money it needs to avoid a default without many of the usual strings.

By normal measures, Ukraine's debt to gross domestic product ratio of about 40 percent is not high enough to arouse concerns, but the combination of its being at the center of a geopolitical tug-of-war and a tumbling currency has seen bets on a default grow.

This year's near 15 percent dive in the hryvna has increased the debt burden and it could quickly spiral if the turmoil causes capital to flee and banks are left with funding holes the state would need to fill.

The uncertainty is rising after Crimea's mainly Russian-speaking population voted overwhelmingly to join Russia on Sunday. Aside from the complexities of a split, it has raised suspicions that other pro-Moscow parts of Ukraine will fall under Russian control.

Rating firms have warned there is a sizable risk of default by Ukraine but markets are hedging their bets, suspecting the Cold War-tinged politics may ultimately determine the outcome.

While bond buyers are demanding more to hold Ukraine's debt and the price of insuring it has risen in recent weeks, there is nothing to suggest a Greece-style scenario where investors lose 70 percent of their money.

"Obviously Ukraine's debt to GDP is high so they need relief. There is no doubt about that, but I think it is not a purely economic issue anymore," said Salman Ahmed, a global fixed-income strategist at the investment arm of private bank Lombard Odier.

"In Greece there was no territorial issue in play. If the West wants Ukraine to align with them rather than Russia they will have to offer a carrot and the carrot could be better terms on the debt."

Through Gritted Teeth

Ahmed likened the situation to the IMF's dealings with Pakistan in late 2001, when Islamabad got approval for a $1.3 billion loan as the West courted it as an ally in the fight against terrorism in the wake of the 9/11 attacks.

Kiev has $3 billion dollars worth of foreign currency bonds due before the end of September and though it still has sufficient reserves, the view among analysts is that running them down too far could spook investors.

The safer alternative is to call on the IMF. Gabriel Sterne at emerging market specialist Exotix, says the Fund's current preference, and the tactic it used in Greece and Cyprus, is rather than just give new Pakistan-style loans, to get bondholders to agree to give struggling countries more time to pay.

Sterne thinks the situation is different to Pakistan because Kiev has more debt on its books than Islamabad did, meaning a restructuring would be more meaningful. But he feels that with so little time to organize one the result may end up the same.

"They may well just stump up the money through gritted teeth," he said.

The IMF declined to comment on its talks with Ukraine but its head, Christine Lagarde, said last week it should finish its fact-finding mission there by Friday.

Kiev has asked for at least $15 billion, but officials at the Fund and places like the European Bank for Reconstruction and Development acknowledge the sum will need to be quite a lot more.

Geopolitical Pawn

Markets appear to be thinking along similar lines to Ahmed and Sterne. They are pricing nowhere near the kind of pain that Greek debt holders suffered.

Ukraine's June eurobond is selling with a discount of 8 percent off of its face value, whereas the longer-term but often more sought-after 2017 and 2020 benchmark, are showing a 14 to 17 percent discount.

"A loss in Ukrainian bonds is not really priced in," said Regis Chatellier, a sovereign strategist at Societe Generale. "The lowest they are trading at is about 82 [versus face value of 100]. If people thought we were going to see a Greek-style restructuring they would be at more like 50."

The other issue complicating the situation is the money Russia recently lent to Ukraine in the form of a bond when its former pro-Moscow president Viktor Yanukovych was in charge.

Kiev has so far received $3 billion of what was meant to be a $15 billion package but Moscow's grab of Crimea has sparked debate on whether Kiev is likely to ever pay the money back.

The bond has a couple of special clauses that have added spice to the debate. Russia can demand instant repayment if Ukraine's debt to GDP hits 60 percent and it also carries 'pari passu,' or equal, status with Ukraine's eurobonds.

That means that if Ukraine does not pay Russia back, unless it also did not pay its eurobonds, Moscow could easily go through the courts to get the money.

But ultimately bond market experts say it is likely to come down to a political decision — whether or not the West and the IMF dangle the easy-money carrot.

"We are seeing East against West, which makes it more difficult for the IMF," said Zsolt Papp, who helps oversee $2.6 billion of emerging-market debt at Union Bancaire Privee in Zurich. "Ukraine is just the pawn here."

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