Foreign Policy – 18.03.2014

Jamila Trindle , Keith Johnson

Clean Slate?

Russia's annexation of Crimea could wipe away billions of dollars of Ukrainian debt.

Russia's appropriation of Ukrainian assets as part of its de facto takeover of Crimea could, perversely, provide some relief to the beleaguered Ukrainian economy.

It may be cold comfort when enemy tanks are still on its border, but some observers suggest that Kiev should be able to write off at least $5 billion of its debt to Russia because Moscow has effectively stolen Ukrainian territory and energy resources, as well as military hardware and bases.

"An obvious focal point for the Ukrainian government now that Russia has intervened across its border, and actually seized land/assets is debts owed to Russia," said Tim Ash, head of emerging markets research at Standard Bank Group. "No doubt the lawyers are sharpening their pencils as we speak."

There are already a few ways in which Russian takeover could end up alleviating Ukraine's debt, the most pressing of which is probably the $1.8 billion (and counting) that Kiev owes Gazprom for natural-gas shipments over the last year.

News reports suggest that Russia has already appropriated small Ukrainian energy firms operating in and near the Crimean peninsula. Russian troops in helicopters descended on a natural gas terminal just outside Crimea, the *New York Times* reported Saturday. And Tuesday, Crimean authorities took over a Ukrainian offshore drilling operation, which is expected to be sold to Gazprom, according to the Wall Street Journal. The operation, owned by Kiev's state-owned energy conglomerate, had just spent $800 million on new equipment, which is now lost.

Then there is the rent from the Sevastapol navy base, which under the 1997 and 2010 bilateral accords was worth $98 million a year in cash to Kiev. It is not clear now, with Crimea formally severed from the rest of Ukraine, if Russia would be under any obligation to continue paying for the base.

Another part of the 2010 Kharkiv Accords, which extended the naval base lease to 2042, was to lock-in a long-term discount on Russian gas sold to Ukraine. However, that gas-for-basing deal had already broken down by the time of last year's protests. One of the carrots Moscow had offered Kiev to pry Ukraine away from Europe, in fact, was a 33 percent discount on natural gas -- essentially, what it had already promised to deliver under the terms of the 2010 accord. That discount is revised quarterly and will come to an end this month.

Russia's military aggression is also calling into question the validity of the loan Moscow extended to the now-deposed Ukrainian President Viktor Yanukovych. Late last fall, after Yanukovych turned away from a political and trade agreement with the European Union, Russia offered to lend him $15 billion to aid the struggling Ukrainian economy. Only $3 billion of the loan -- in the form of bonds due in 2015 -- came through before Yanukovych was run out of Kiev.

The question many observers are asking is whether Ukraine should have to pay back that money given Russia's subsequent annexation of Crimea.

Anna Gelpern, a Georgetown law professor, suggested a creative legal maneuver that might allow Britain, a close ally of the new Ukrainian central government, to invalidate those bonds as part of a sanctions package against Russia. Because the bonds are English law contracts, Gelpern said the U.K. could refuse to honor them in British courts, making them effectively void and worthless to private buyers.

"If you close the courts to this debt you make it worthless to the market," Gelpern said. While the plan wouldn't erase the debt, Russia would be effectively left with an unenforceable I.O.U., instead of a tradeable financial contract.

Governments are usually loathe to change the terms of bonds after they've been issued because it can undermine investor confidence, but Gelpern points out it has been done before. After the International Monetary Fund (IMF) spearheaded a global effort to forgive the debt of poor countries like Afghanistan and Rwanda, the U.K. limited private bondholders' ability to sue those countries for repayment in the British courts. After former Iraqi leader Saddam Hussein was ousted in 2003, the United Nations moved to shield the war-torn country's oil and gas proceeds from creditors and then the world's big lender countries agreed to reduce the country's debt, so that its coffers wouldn't be wiped clean by loans taken out by the previous government.

"Of all the sanctions the U.K. could impose, this is really targeted and doesn't hurt too many people," Gelpern said. She first wrote about the idea in a blog post on the Peterson Institute for International Economics website.

It's unclear whether British leaders would embrace the idea. Western officials have been threatening Russia with unspecified "costs" since troops first moved across the border in Crimea more than two weeks ago, but so far they have proceeded cautiously. The United States sanctioned seven Russian officials Monday, but it did nothing to stop, or slow, Russia's de facto takeover of Crimea.

Even if the U.K successfully scratches $4 billion of debt off the ledger, it still wouldn't solve Ukraine's financial problems. The interim Ukrainian government estimated last month that it would need $35 billion over the next two years. The IMF has a team of people on the ground in Kiev now trying to sort out the country's finances and put together a package of loans and reforms that will help the economy recover.

And Russia still holds the ultimate trump card. While lawyers can calculate the price tag for Russia's Crimean adventure, Moscow still has the power to shut off the natural gas supply that Ukraine depends on.