SIDE – NOTE

Is the parable of Ukraine's "autocracy" good or bad for investors?

(A positive view on the power centralization scenario)

According to common wisdom, democratic countries have a greater capacity to make credible commitments to repay their debts and, as such, they should be perceived as countries with a lower probability of rescheduling or defaulting on debt. This implies that these countries should be charged lower risk premium spreads than authoritarian ones. Thus, additional risk premium becomes more desirable for investors, while Ukraine slips into a power consolidation regime. Furthermore, not only do increased estimations of YTM on sovereign debt lead to upward parallel shift in the corporate yield curve, but they also suggest an undervaluation of Ukrainian equities and undermine M&A activity. Specifically, decreased valuation results under a DCF approach result from aggravated estimations of WACC (due to surges in the cost of debt for Ukrainian companies). We argue that such a claim is not relevant: among emerging economies, democracies could be more likely to reschedule their debts then autocracies, so the former have no advantage.

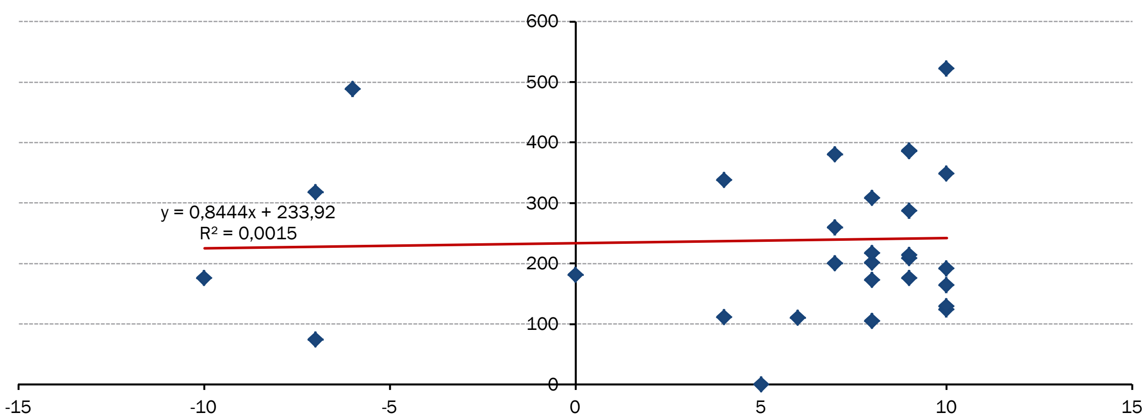
To summarize our political scenario analysis, we assume that of predominant importance for the investment implication is whether the accusations are true that Mr. Yanukovich is turning Ukraine into a "dictatorship" are de facto. Investors should be careful with such "glossary" usage, as academic studies show that the political regime is the cornerstone for the probability of sovereign default. Sovereign defaults typically occur during times of economic trouble, often triggered by large exogenous shocks. However, they are more than simply economic events, since honoring debt obligations by a borrowing government is often a matter of political will. The literature on sovereign debt suggests that defaulting governments have the technical ability to repay debts in most cases; what they often seem to lack is the incentive to do so. Thus, two important hypotheses are worthy of further investigation.

> Hypothesis 1. *In emerging economies, democracies cannot commit to repay their debts with credibility any higher than that of autocracies*

We assume that democracies are more likely to reschedule their debts, while autocracies are more likely to honor their debts than democracies. This is due to the different decision-making mechanisms characterizing democracies and autocracies. Democratic competition and mass mobilization may exacerbate intemperate popular demands for distortionary public policy, such as inflationary public spending. Moreover, in democracies, defaults are forgiven by lenders, because democracies allow replacement of leaders. This is similar to a case study from the corporate governance code: wherein Chapter 11 of US bankruptcy law allows the dismissal of a manager who cannot propose a plan acceptable to stakeholders. For example, in the event of increased probability of Ukraine defaulting on its sovereign default under the democratic scenario, Mr. Yanukovich may simply discharge the current Prime Minister, blaming him should nonpayment occur.

The chart below depicts the dependence of sovereign 5Yr CDS quotes of EM countries on their political regimes. The democratic regime seem to provide no advantages for the country, as long as the determination coefficient is almost zero. We will investigate that correlation more thoroughly when presenting our probit model for yield estimation in upcoming issues.

Sovereign 5Yr CDS vs political regime



Source: Bloomberg, Polity IV, AYA Capital estimations

Note: CDS as of 07/01/2009; polity scale for 2009 (ranges from +10 (strongly democratic) to -10 (strongly autocratic)

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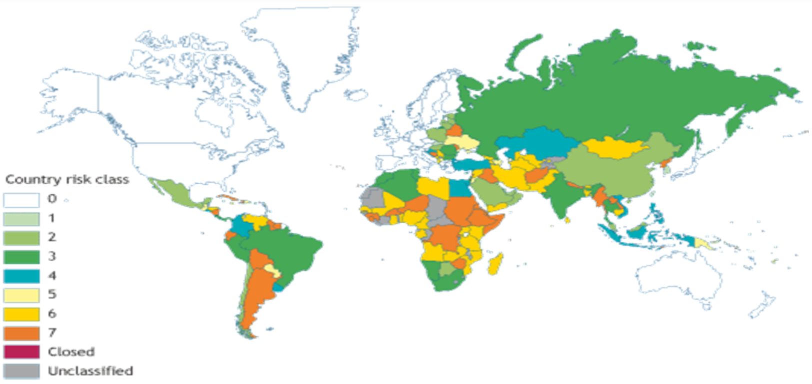
Looking at the map highlighting many of the world's developing nations, we see that the countries with the strongest economies also tend to be the most politically stable. This is true even where political stability is a result of a strong, yet market–oriented, autocratic regime. What is more, autocracies are in vogue among many investors, perceived as being free from the whims of the electorate, inherent in the democratic process. For example, the speed and efficiency with which China has fostered economic progress and, recently, implemented fiscal stimulus, is often attributed to its autocratic mode of governance.

2008 political risks map



Source: EKN 2008 political risks overview (http://www.ekn.se/ar2008/en/allpages.html)

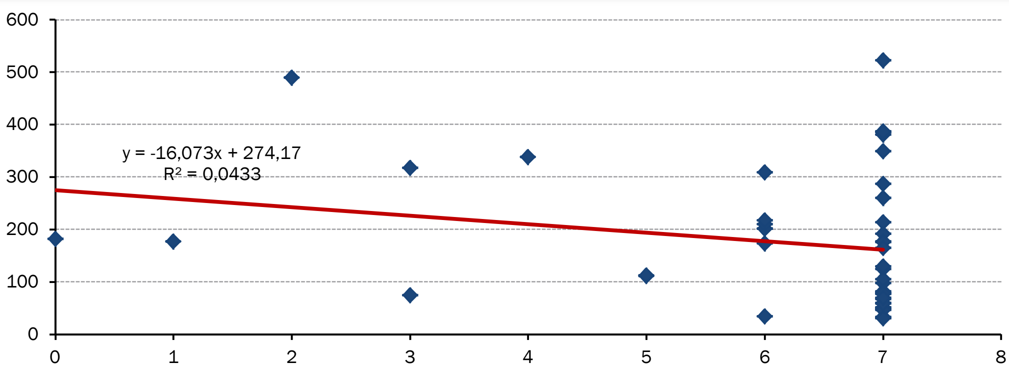
<u>Hypothesis 2.</u> *In emerging economies presidential democracies cannot commit to repay their debts with higher credibility than parliamentary democracies*

Presidential democracies were almost 5 times more likely to default on external debts

Again, academic research provides evidence that presidential democracies were almost 5 times more likely to default on external debt between 1976 and 2000 than parliamentary democracies. Parliamentary democracies are those regimes in which the executive (the prime minister) can be unseated by the legislature via a motion of non-confidence. In contrast, the constitution of presidential countries does not include such a possibility. This distinction is likely to make a prime minister give much greater consideration to the effects of important policy changes on his support base in the legislature than a president would.

As a result, the probability of default in a presidential regime will typically be higher than that seen in parliamentary regimes, where asset holders can sway the legislative chamber. For an illustration of this, assume that a debt default has consequences on the economy which will put downward pressure on asset values. If the owners of assets who would be negatively affected in the event of discontinuance of debt service have higher stakes in a debt policy than those not holding such assets, compensation mechanisms among political actors will tend to reduce the likelihood of debt rescheduling.

Sovereign 5Yr CDS vs significance of political leaders' constraints



Source: Bloomberg, Polity IV, AYA Capital estimations
Note: CDS as of 07/01/2009; Executive Constraints variable over 2009 refers to the extent of institutionalized constraints on the decision-making powers of chief executives, whether individuals or collectivities

The figure above depicts the dependence of sovereign 5Yr CDS on political leaders' constraints. Although the determination coefficient is very low, the slope of the trend line is negative, implying a negative correlation between a parliament's power and the sovereign spread. Moreover, the historical evidence of such persistence exists not only in modern history, but also in pre–WWII debt history.

Pre-WWII Debt History: 1880-1913 and 1919-1938

	Defaulters	Compliers
Presidential	Costa Rica	Switzerland
	Honduras	United States
	Chile	
	Bolivia	
Parliamentary	Greece	Australia
		New Zealand
		Canada
		UK
		France
		Belgium
		Norway
		South Africa
		Spain
		Japan

Source: Warwick Economic Research Papers
Notes: Countries with Polity score > 0 were considered democratic. Default history from Lindert and Morton (1989)

Given Hypotheses 1 and 2, it becomes paramount to acknowledge the direction is which Ukraine is moving. To illustrate, following the Przeworski, Alvarez, Cheibub, and Limongi study[1], regimes are classified as democracies if, during a particular year, they simultaneously satisfy these 4 criteria:

a) the chief executive is elected
b) the legislature is elected
c) more than one party competes in elections
d) incumbent parties have in the past, or will have in the future lost an election and yielded office.

All regimes that fail to satisfy at least one of four criteria are classified as autocracies. Thus, one can doubt whether Ukraine currently falls into the authoritarian classification. However, as long as the possibility of the power centralization scenario exists, we should pay particular attention to further developments. Again, since the type of political regime really exerts an influence on sovereign default probability, foreign investors should be careful with the determinants of political changes and the respective "glossaries". Thus, we should remember there are three types of domestic political changes (ranged by the level of radicalism):

1. **Regime instability** occurs when the institutions of government or the rules of the political game change.
2. **Policy changes** can occur when the preferences of those who control government change; when those who control the institutions of government change; or when the institutions of government are altered, which, in turn, changes the preferences of those who control government.
3. **Government instability** arises when the actors who control the institutions of government change.

Based on recent political developments, we assume that Ukraine will only enter the second stage with an average likelihood to move towards regime change. In summary, the purpose of this note is to highlight that:

1. The AYA Research team will investigate the correlation between political regime and sovereign default probability in our upcoming issues;
2. We will closely monitor further developments in the Ukrainian political arena;
3. We will continually revise the investment implications, as the situation changes.

[1] Przeworski, A., Alvarez, M. E., Cheibub, J. A., & Limongi, F. (2000). Democracy and development: Political institutions and well-being in the world, 1950-1990. Cambridge, UK: Cambridge University Press

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