

# Financial mechanisms of ensuring the development of business under high interest rates

Vitaliy Shapran<sup>\* A</sup>; Igor Britchenko<sup>B</sup>

<sup>A</sup> National Bank of Ukraine, Instytutska St, 9, Kyiv, 01601, Ukraine

<sup>B</sup> VUZF University, 1, Gusla str., Sofia, 1618, Bulgaria

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## Abstract

In the given article the problems of choice as for the types and forms of debt and share financing on the developing and “frontier markets” with high interest rates have been considered, the definition of what kind of interest rates can be viewed as high and under which circumstances nominal interest rate and in which ones – the real interest rate is important for business.

Also, the classification of debt and sharing financing is given and the comparative analysis of such financing is made. Some close attention has been paid to the calculation of the real interest rate according to the inflation forecast.

Recommendations concerning attracting of relatively cheap trade financing including international financial and credit organizations, development of operation factoring, financing from captive financial institutions of the exporters of the materials and equipment from the EU and the US have been grounded.

The opportunity of relatively free of charge share financing through the mechanism of placing shares IPO/SPO is emphasized, exemplified by the results of placing shares on stock exchanges and their alternative platforms of issuing banks with businesses in Ukraine in 2005 – 2013.

As a result, the conclusion concerning the necessity of thorough analysis of financial conditions on the developing and frontier markets before gaining such financing has been made. High interest rates within the average indicators even on the basis of prime rates do not necessarily mean absence of attractive conditions of financing.

**Keywords:** high rates, monetary policy, development markets, “frontier” markets, prime rates, credit markets, credit market regulations, factoring, leasing, Initial public offer, IPO.

## Introduction

The markets with the high interest rates often limit economic growth and development of business. The policy of high loan interest rates, as a rule, causes criticism of the economists who are eager to help the national market to grow faster than the rest. Although high interest rates – both nominal as well as real ones not always mean lag in growth. For the developing markets some market of capitals of its own or access to foreign stock exchange is often more important than the extent of the

interest rates.

Also, the opportunity to finance one’s own business can influence the dynamics of prices on the finished products on the main export markets. For the successful development, the right choice of financing is more than important. The entrepreneur should have an overall view of strategy to be chosen in the country with high interest rates as well as know some relevant financing variants before taking any decision.

\* Corresponding author:

<sup>A</sup> Professor, Ph.D. in Economics, Member of the National bank of Ukraine Council, e-mail: shapranv@gmail.com, ORCID: 0000-0002-1540-6834

<sup>B</sup> Dr. of Sciences, Professor Higher School of Insurance and Finance, e-mail: ibritchenko@gmail.com, ORCID: 0000-0002-9196-8740

## Material and methods

### Determining of “High Rates”

When a businessman is aimed to be on the credit market, he should understand what high and low rates are and how these rates combine with the exchange currency risk. Compellation of interest and exchange rate risk is a classic of the developing markets which some generations of businessmen have faced. Interest rates within the reserve foreign currency exchange rates such as American dollar, euro, British pound, Swiss franc and Japanese yen, as a rule, is lower than the rates in the national currencies. However, the benefit from the low interest rates on the loans in foreign exchange currencies can remove the exchange risks.

That is why borrower should stick to the following rule: foreign currency should be up to the foreign currency income (foreign currency revenue). In a more complicated variant, the rule is formulated like this: the portfolio structure of currency exchange credit should be up to the currency exchange structure income (foreign currency revenue). In Ukraine after crisis in 2008 – 2009 the corresponding rules were introduced on the level of monetary regulation. Such rules restrict the banks within EU in their credit activity but at the same time they stop any transformation of the exchange risk into the credit one on the macrolevel.

The second moment which is necessary to be taken into account for the credit borrower: what will be the real credit rate on his/her credit. For the calculation of the real interest rate, it is necessary to understand that if the credit does not involve the whole advance payment of interest rates than the borrower will compare his/her annual costs according to the interest rates with the annual forecast of inflation. In such a comparative analysis there are three methodical problems which are difficult to resolve in practice:

First, inflation forecasts are often too optimistic, especially if those governments or central bank forecasts which can have some political character. In the same way the forecasts of international organizations such as,

e.g., IMF, are often not precise in the countries according to the relevant IMF program. If the borrower has an opportunity, I would recommend learning of preciseness of the inflation forecast from different sources over the last 10 years on the national market and only after that to start calculation of the real interest rate.

Second, the level of the real interest rate will not always have some practical value for the borrower. Thereby, the deeper level of specialization of the borrower, the more possible it is that the real interest rate will not reflect the exact load on his/her circulating assets.

When calculating the interest rate, you deduct the nominal interest rate of inflation and, therefore, you come over to the calculation based on the average quantity which is the inflation rate proper. There is a great opportunity that prices on your finished products and services will not grow in proportion to the inflation in strict terms. Let's say that inflation is 5% of the price of finished products or services may fall up to 2-3%. That is why when using the real interest rate for the analysis, it is necessary to understand, how your income depends on the forecast inflation.

Third, in different countries there are different approaches to choosing the interest rate for the best borrower, the so-called prime rate. As a rule, such an interest rate is defined as the minimum interest rate in the bank, as the low credit risk means that bank will have the least interest rate of writing off of amounts. However, the banks on the developing markets use prime time as advertising approach. For instance, the bank sets the interest rate as 5% per year. But none of the borrowers can get such a rate as he/she does not match the strict requirements concerning the best borrower. Therefore, veracity of such interest rates when compared in different countries can vary, let alone that in practice borrowing from the bank at the fixed interest rate will be difficult.

Let us consider the countries from TOP-20 list

based on the size of nominal interest rates. The three leaders: Brazil, Zimbabwe, and Angola are evidently in the difficult macroeconomic situation. However, it is impossible to overlook the fact that in Angola the real interest rate is in minus (Table. 1).

Table 1. TOP-20 countries with the highest credit interest rates Prime Rate, as of March 2021

| № n/n | Country        | Prime-Rate | Current inflation | Inflation forecast if IMF in 2021 | Real interest rate |
|-------|----------------|------------|-------------------|-----------------------------------|--------------------|
| 1     | 2              | 3          | 4                 | 5                                 | 6                  |
| 1     | Brazil         | 40,07%     | 6,10%             | 2,70%                             | 37,37%             |
| 2     | Zimbabwe       | 32,11%     | 241%              | 3%                                | 29,11%             |
| 3     | Angola         | 18,70%     | 24,85%            | 19,60%                            | -0,90%             |
| 4     | Tanzania       | 13,96%     | 3,20%             | 3,70%                             | 10,26%             |
| 5     | Liberia        | 12,44%     | 10,39%            | 8,00%                             | 4,44%              |
| 6     | Kenia          | 12,00%     | 6%                | 5%                                | 7,00%              |
| 7     | <b>Ukraine</b> | <b>11%</b> | <b>8,50%</b>      | <b>5,80%</b>                      | <b>5,20%</b>       |
| 8     | Bahamas        | 9,69%      | 1,20%             | 2,50%                             | 7,19%              |
| 9     | Egypt          | 9,50%      | 4,50%             | 8%                                | 1,50%              |
| 10    | India          | 8,80%      | 5,52%             | 4%                                | 4,80%              |
| 11    | Jordan         | 8,33%      | 0,40%             | 1,40%                             | 6,93%              |
| 12    | New Zealand    | 8,30%      | 1,40%             | 0,60%                             | 7,70%              |
| 13    | RSA            | 7,00%      | 2,90%             | 4,30%                             | 2,70%              |
| 14    | Filipins       | 6,54%      | 4,50%             | 3,30%                             | 3,24%              |
| 15    | Australia      | 6,51%      | 0,90%             | 1,20%                             | 5,31%              |
| 16    | Russia         | 6,02%      | 5,79%             | 3,30%                             | 2,72%              |
| 17    | Thailand       | 6,00%      | -0,08%            | 0,70%                             | 5,30%              |
| 18    | Bolivia        | 5,83%      | 1,40%             | 3,80%                             | 2,03%              |
| 19    | Chile          | 5,80%      | 2,90%             | 2,90%                             | 2,90%              |
| 20    | Sri-Lanca      | 5,76%      | 4,10%             | 4,80%                             | 0,96%              |

Source: tradingeconomics.com, IMF / World Economic Outlook, October 2020

The high nominal interest rate does not always presuppose high real interest rate. It is evident, for example, when comparing the interest rates in Angola and Liberia. Interesting situation is in Egypt: the nominal interest rate is 9,5%, the real interest rate because of the high inflation is just 1,5%, and the real interest rate was less only in Angola and Sri-Lanca. Nevertheless, the conditions of crediting in Egypt I would not call the best ones as products and services of major part of business in this country were not responsive to the inflation. Probably, the long period of high inflation and low real interest rates on credits could change the structure of industrial markets of some

developing countries but there is no certainty that such changes would be useful for these countries. Therefore, the issue of choice between the nominal and real interest rate is still disputable.

In my opinion, both situations when the nominal and real interest rates are still high, are bad for business. High inflation can be a signal for the banks to raise interest rates and as crediting of business is not restricted only for one year then with the low interest rate, we will get its increased growth due to the banks' reaction to the inflation.

As an indicator of high interest rate, I would single out the situation where the most part of the year there was a nominal or real interest prime rate on the level of not more than 5%. In the economies where the inflation grew more than 10%, I would not analyze the interest rates as the situation next year can change because of high inflation. Such economies require analysis on the basis of the long-term period. On the other hand, one should take into account that if on the industrial markets there are no anormal factors, then maintaining profitability of sales more than 5% will be very difficult, especially under competitive markets circumstances. That is why the best will be those markets where the real interest rate will be kept up on the level of 2-3 % as long as 5 to 10 years. Stability of low interest rate load on the basis of stable and not high profitability from sales which is more that the paid interest rates is an ideal situation where an undertaker needs crediting of his/her business.

#### The effect of being in the group

Thinking over the scheme of financing of one's own business it is necessary to correctly adapt the general statistics on the market. At prime rate of 10% and average rate on the market of 15% you can be in such an industry of business in which it is impossible to get a credit even at 27%. As an example, I can give the official statistics of the National Bank of Ukraine according to the dynamics of average interest rate on the market and rate of the banks for micro-business with the turnover up to 50 000 euro (Graph 1).

On the graph there are some effective interest rates on the credits, but the rates calculated are based on the accrued interest income of the banks, i.e., excluding commission. Historically it has been so that the less the segment in which there was a company, the higher interest rates there were in Ukraine. However, in 2020 the given tendency was broken due to some state programs of support 5-7-9%, which influenced the overall statistics very much. In some cases, the state program decreased the interest rates for micro-companies even below the average interest rate on the market.

It is necessary to understand that this kind of program was the first one in Ukraine and its introduction was impossible to be forecast and its influence on the credit market in the national currency for micro-companies was very difficult. As a result, this segment was in the situation when a part of very small companies could get credits at 5% a year, i.e., the real interest rate on such credits in 2020 was almost zero, but in 2021 along with the connection of inflation it became negative.

If we generalize the situation in Ukraine all over the region than business could be given a piece of advice: before signing some credit agreements it is better to get to know if there are some special programs of financing. Such special conditions of financing are not always supported by the state. In practice I met some subsidiary leasing companies of aviation holdings that sold airplane at 0,5% a year at the market interest rates of 4–5%, and financial companies, refinancing of local banks for automobiles purchases at 0,1% and so on. Some special proposals for business can really change your standard industry conditions to which you are used to. Also, it is worth paying attention to the aim of your financing, if for instance, those are automobiles and equipment, then it can very well be that it is a targeted financing of the seller’s bank that will provide you better conditions which cannot be compared to anything like the country market where you

have your business. Types of financing are so various that they require some special consideration.

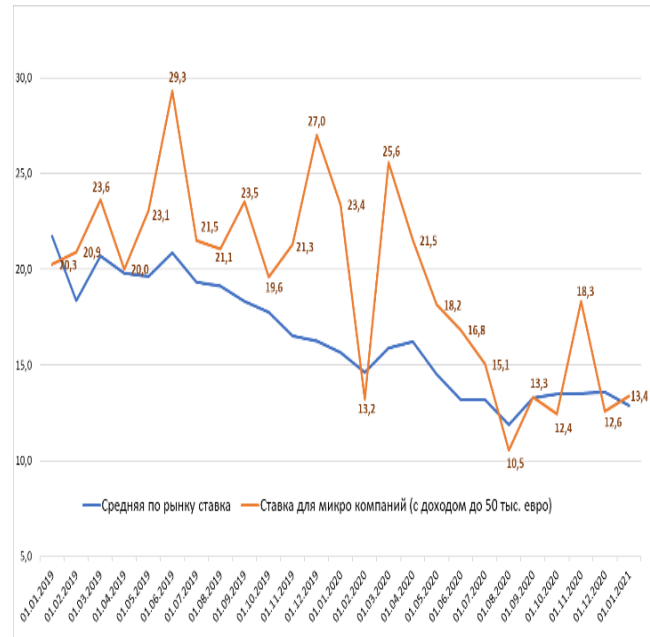


Figure. 1. Dynamics of interest rates on credit in Ukraine in 2019 – 2020.

Source: National Bank of Ukraine

**Choice of debt financing type**

When business chooses how it can make financing, as a rule, on the very first stage it is necessary to clarify whether it will be debt or share financing, i.e., whether the company will borrow or share, i.e., get a partner in business so to speak. Types of financing are shown in enlarged font in Figure 2.

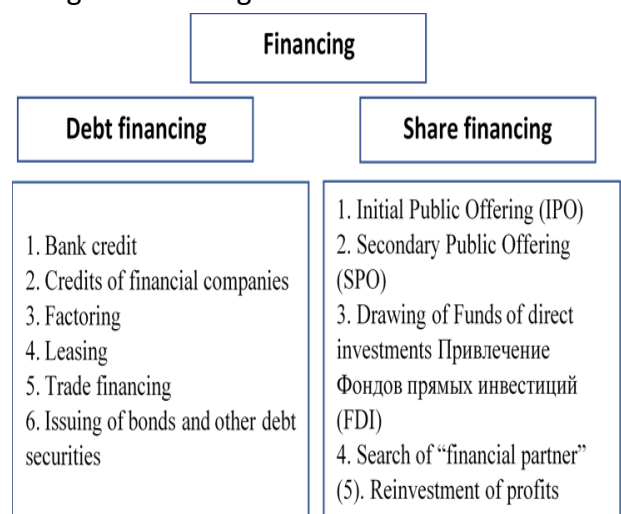


Figure. 2. Types of kinds of financing

When debt financing is chosen, then as a rule, the analysis begins with the credit in the account bank. Credit manager, having looked through the turnover on the account, can suggest the optimum credit product choice and point out possible expenses on the credit. It is necessary to understand that the nominal conditions of a credit will differ from the effective rate which includes all the commission. It is also worth comparing the conditions of different credit products of one and the same bank. For example, crediting on overdraft can be far more profitable than opening of a credit line. If the demands in financing are not permanent and make up to not less than 5–10% of turnover resources of the company then probably it is better not to exceed the overdraft limit.

If the company buys, for example, the auto transport, expands its aviation park, or buys agricultural machinery, then in this case it is better to clarify if the seller could offer such products on credit as they will turn to be more profitable at the leasing or financial companies that globally follow the brands all over the world.

If you are aimed at buying the equipment, machinery, and other main funds or even intangible assets which are necessary in the production process then evidently the most profitable offers will be from those producers that are supported by the banks for purchasing their equipment.

The analysis of bargains in the segment of APC in Ukraine showed that the cost of the resources for the buyers of German or French equipment would be almost the same as for the purchasers of the EU. It is worth taking into account that the trade financing from the EU, Japan, and the USA could have very long-term horizons – about 10-15 years but it will be available only for the Ukrainian exporters, i.e., for the enterprises that have foreign currency income.

Only when all the first 5 variants of cost financing of a price unit have been calculated it is worth paying attention to the issuing of bonds. The bonds on the national markets are good because they, as a rule, allow the issuing bank

offer a higher level of profitability for the depositor giving an opportunity to borrow from those who have deposits in the banks but without the bank services.

Minus of this type of financing are still high transaction expenses: emission of bonds requires registration at the Securities Market Regulator. The company will have to go through the listing on the stock exchange and pay for the maintaining by the custodian and so on.

In every country there will be its own level of profitability of issuing bonds, e.g., in Ukraine public issues will be profitable at the volume of 30-50 mln hrn. In my opinion bonds should be issued for essential filling up of the current assets and expanding of business including the purchase of the main funds but it is necessary to remember the following. It is not worth using the bonds too much as they are the instrument of debt financing. Bonds are the ideal source of financing if a leasing, factoring or any other credit company that is an intermediary between the different participants of the debt financing market. Those companies that work in the sphere of APC or black metallurgy (for example), should not use bonds. It can so happen that trade financing will be more effective than the bonds, and not only because of the economic positions but because of the reputation of the company on the debt financing market.

#### **Share financing: the necessity and dreams**

When all the types of debt financing have been analyzed and there is some understanding that the company cannot cover the credit risks, e.g., the expenses of servicing the debts is too high, then it is worth of thinking about drawing some share capital. The world practice gives several variants: search of “a temporary partner” up to the synthetic financing with the help of special instruments. Temporary partners in business can be your partner in the field – for example, the supplier of raw materials and materials, as a rule, who can be interested in the buyer to continue buying their products.

As a temporary partner in business there can be also a Fund of Direct Investments (FDI). In most situations FDI can be in business for the purpose of selling it afterwards with a profit.

First of all, it should be paid attention to FDI which work within the international financial organisations and made by EBRD and IFC. Often on such markets of Central and Eastern Europe it is possible to see PEF, made by the citizens and government of the USA. Interesting can be offers from PEF that work with the ecological projects. PEF are subsidiary structures of local businessmen, as a rule, that have high requirements of profitability and that is why projects with profitability less than 20% are not taken into account.

Using the stock exchange or IPO is a very important step in the development of company business. It is necessary to prepare for that if the size of drawn resources presupposes sales of more than the third part of the company. However, it is worth considering that under the primary placement, as a rule, the investors usually are not unanimous and it is not obvious that they will vote in similarly at the meeting of shareholders.

In some situations, for the owner of the company the primary (IPO) or secondary (SPO) placement of securities (SPO) can be more attractive than work with FDE where there is a strict norm of profitability, concentration of the securities and sometimes strictness of the corporate management which bring the additional discomfort.

The research of IPO of issuing banks in Ukraine gave an opportunity to make a number of different conclusions.

First, 60–70% of issuing banks took the primary placement as relatively free access to

the capital, i.e., issuing bank at the moment of placing did not think of future quoting of company shares, but it took the means from the investors (here and now).

Second, a number of issuing banks were caught in nonsystematic evasions of paying dividends. During work of the Verkhovna Rada of Ukraine of the 8th Session there was an anomalous situation when the majoritarian owner of the issuing bank was wanted by the Polish Power concerning the lawsuit of one of the nongovernment pension funds and could not be judged as he was the deputy of the Ukrainian Parliament.

Third, less than the third of the issuing banks of IPO were ready for SPO, i.e., they were remembered for some reason by the investors from Poland, Great Britain, and Germany. Practically all the issuing banks were on the alternative platforms due to the very low capitalization, i.e., they were Small Cap Segment. In fact, because of their very small size issuing banks were allowed into the main markets where actively worked some pension funds.

All in all, the issuing banks of Ukraine drew in the period of 2005–2013 about 1,8 bln. dollars of the USA investments, since 2013 IPO/SPO have not been made abroad, and a part of companies could not make it up to 2020 (table 2). In 2021 the first expected IPO on the stock exchange market in Ukraine – IPO of football club Veres.

Table 2. Main results of placement of the shares of the issuing banks with business in Ukraine

| Name of company                               | Year IPO | Platform (stock exchange)       | Capitalization at the placement moment | Approximate capitalisaion on 01.01.2020 |
|-----------------------------------------------|----------|---------------------------------|----------------------------------------|-----------------------------------------|
| Ukrproduct Group (o. Jersey)                  | 2005     | AIM (LSE)                       | £22,05 mln.                            | £1,58 mln.                              |
| XXI Century Investments                       | 2005     | AIM (LSE)                       | £225,0 mln.                            | Торги остановлено в 2013 году           |
| Astarta Holding (Netherlands)                 | 2006     | WSE                             | \$158,17 mln.                          | \$157,95 mln.                           |
| TMM Real Estate Development (Cyprus)          | 2007     | Deutsche Borse (Entry Standard) | €516,12 mln.                           | €1,53 mln.                              |
| Dragon—Ukrainian Properties & Development Plc | 2007     | AIM (LSE)                       | £116 mln.                              | £12,90 mln.                             |

|                                                  |      |                  |               |                                                               |
|--------------------------------------------------|------|------------------|---------------|---------------------------------------------------------------|
| Ferrexpo (Switzerland)                           | 2007 | LSE              | £847,72 mln.  | £1491,57 mln.                                                 |
| Kernel Holding S.A. (Luxemburg)                  | 2007 | WSE              | \$613 mln.    | \$1049,26 mln.                                                |
| Miron bread product, MHP SE GDR (1 GDR =1 share) | 2008 | LSE              | £812,43 mln.  | £948,30 mln.                                                  |
| Avangardco Investments PLC GDR (10 GDR=1 share)  | 2010 | LSE              | \$940 mln.    | \$17,91 mln.                                                  |
| AGROTON PUBLIC LIMITED (Cyprus)                  | 2010 | WSE              | \$207 mln.    | \$19,44 mln.                                                  |
| MILKILAND N.V. (Netherlands)                     | 2010 | WSE              | \$333 mln.    | \$4,14 mln.                                                   |
| Sadovaya Group (Luxemburg)                       | 2010 | WSE              | \$120 mln.    | \$1,34 mln. (trading was stopped 08.2015 and resumed 04.2018) |
| AGROLIGA GROUP PLC (Cyprus)                      | 2011 | NewConnect (WSE) | \$12,34 mln.  | \$1,13 mln.                                                   |
| KSG Agro SA                                      | 2011 | WSE              | \$121,2 mln.  | \$3,55 mln.                                                   |
| INDUSTRIAL MILK COMPANY S.A.                     | 2011 | WSE              | \$123,75 mln. | \$119,9 mln.                                                  |
| WESTA ISIC S.A. (Luxemburg)                      | 2011 | WSE              | \$183,85 mln. | Trading was stopped in February of 2017                       |
| OVOSTAR UNION N.V. (Netherlands)                 | 2011 | WSE              | \$198 mln.    | \$173,16 mln.                                                 |
| Coal Energy S.A. (RPA "Mechanic")                | 2011 | WSE              | \$320 mln.    | \$3,98 mln.                                                   |
| KDM Shipping (Cyprus)                            | 2012 | WSE              | \$67,89 mln.  | \$4,42 mln.                                                   |
| CEREAL PLANET PLC (Cyprus)                       | 2013 | NewConnect (WSE) | \$8,7 mln.    | \$4,44 mln.                                                   |
| Arricano Real Estate PLC (Cyprus)                | 2013 | AIM (LSE)        | £153 mln.     | £42,42 mln.                                                   |

Source: Data from stock exchanges and depository BNYM

Access for private and public placements on the stock exchange of EU and USA is open for any kind of companies of Central and Eastern Europe. The Ukrainian experience, though is sad, but a part of issuing banks continues trading

in London and Warsaw, i.e., under favorable conjuncture these issuing banks can return to the idea of SPO on those platforms where they are already known.

## Results and discussion

### Recommendations for the monetary powers

As it is evident from the example of Ukraine, getting of financing below the average price business should make a lot of analytical efforts. There are the projects of the USA from the USA, EU, and Japan which come to Ukraine with the low rates, there are some state programs, essentially lowering the rates, there are proposals of the big European banks for special programs of crediting for 5-10 years and so on. Nonetheless, if the general surroundings offer a consumer the effective rates on the level of 20-25%, and good proposals are necessary to be

found – it is an idea for the monetary powers to think over what namely is going on the market and what kind of methods should be used to change the situation for better. To solve this problem several recommendations could be given:

1. It is necessary to constantly reconsider the effectiveness of transmission mechanism. Monetary transmission works very badly if the depositors do not have an alternative opportunity of entering the credit market of micro-companies and credits for the population, for example, through the bonds of financial

companies. One of the factors which shows that the channels of transmission are stopped, it raises the level of the bank margin. If the banks gather deposits at 10% per year, and are credited at 20%, and the condition of their credit portfolios is getting better, it is time to think about the reasons of such matters.

2. The powers should put maximum efforts to develop non-banking credit market and not to regulate it too much by the norms and rules of accruing the reserves. For the developing markets it is very important as when there is not a good protection of rights of the creditors, leasing companies can take the leading positions in financing business. The advantages of leasing

even before the bank crediting at a mortgage are obvious: a leasing company remains the owner of the machinery and equipment before their purchase by the leaseholder.

3. The powers should not admit the essential concentration of bank capital and weakening of competition on the bank market as it will break work of transmitting mechanism, and even under the low-key rate of central bank interest rates for business and population in the banks can be very high. The most dangerous concentration of capital in the banks is the concentration of capital in the banks with the biggest number of branches.

## Conclusions

It should be noted that country conditions of drawing financing differ significantly from one another not only globally but also on the regional level of Central and Eastern Europe. Even in those countries where financing remained the major problem, more or less available for business there are main types of financing: bank credit, leasing, factoring, trade financing, issue of bonds, using FDI, IPO/SPO and so on. Nonetheless, there is some specifics:

1. Business should more thoroughly pay attention to different proposals of the market. Cost of financing from the bank; leasing company or trade financing can differ as much as twofold or threefold. If it is a matter of purchasing the main funds or intangible assets then it is worth studying the different variants of debt financing.

2. Even when learning the opportunity of filling up the current means, it is worth looking

through all the variants available in the region. Overdraft with grace-period, special program of country government on credits in the national currency and other innovations can decrease the interest rates.

3. It is worth paying attention to the sensitivity of one's own income towards inflation and look at the real rates of the local banks. It can be so that the credits in the national currency can be cheaper than the foreign one when taking into account the inflation and foreign exchange risk.

4. If the company has outgrown even the issue of bonds, then it is worth to think about of IPO as there are no essential barriers for issuing banks not only from EU but also from Ukraine for placing those in London, Frankfurt, or Warsaw. The given source of financing of business is proven by practice and remains a good working variant.

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