

## DEFICIT FINANCING AND PUBLIC DEBT IN THE FIRST QUARTER AND APRIL 2000

### BUDGET EXECUTION

#### State budget deficit and financing

A peculiarity of the first several months of 2000 is considerable State budget surpluses, which were far ahead of schedule. As suggested by Table 1, the first quarter showed a surplus of the State budget's general fund, which was higher by UAH 678 million, or 287%, than budgeted. Underfinancing of expenditures (as implied from the interim breakdown for the period) was only 2.5 percent. Hence, the surplus is mainly attributable to the 8 percent overexecution of the revenues side of the general fund.

**Table 1. Balance of the general fund of the State budget between January-April 2000  
(in thousand UAH)**

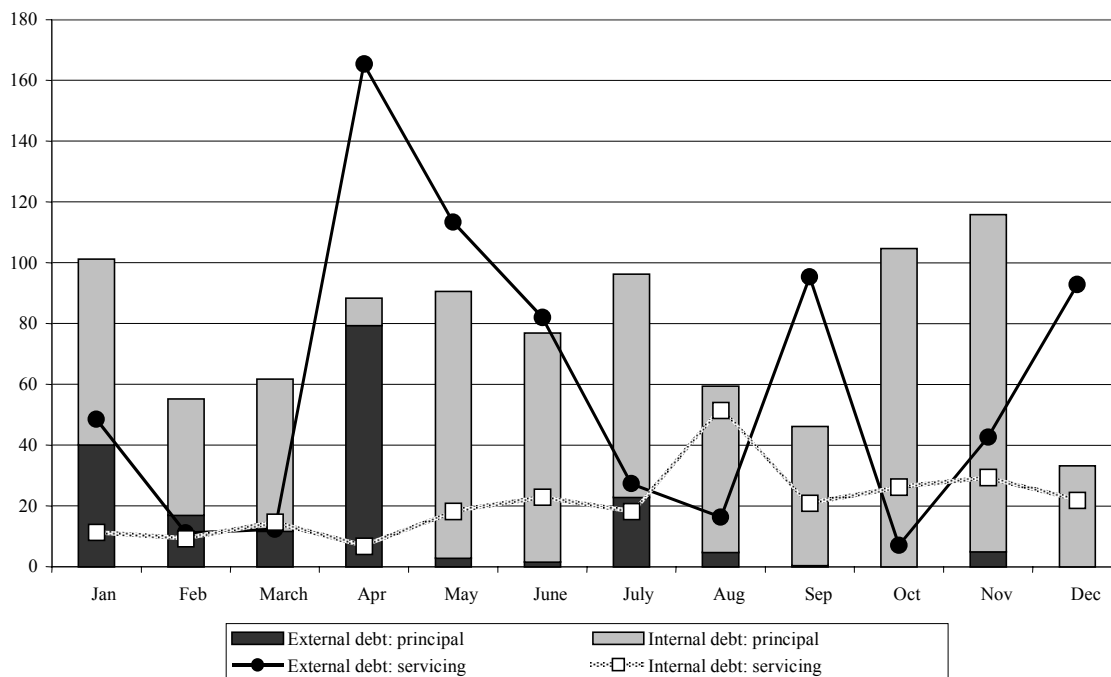
|                      | Percentage of Execution of<br>the Target for the Period |              | Deficit         |                 | Spending on Debt<br>Servicing | Primary Deficit   |
|----------------------|---|--------------|-----------------|-----------------|-------------------------------|-------------------|
|                      | Revenues  | Expenditures | Target          | Actual          |                               |                   |
| January              | 99.2  | 58.0         | 125,001         | -440,947        | 258,557                       | -699,504          |
| February             | 88.8  | 98.7         | -132,050        | -4,930          | 154,707                       | -159,637          |
| March                | 123.0   | 121.8        | -168,109        | -231,767        | 120,154                       | -351,921          |
| <b>Quarter 1</b>     | <b>107.9</b>  | <b>97.5</b>  | <b>-175,159</b> | <b>-677,645</b> | <b>533,418</b>                | <b>-1,211,062</b> |
| April                | 83.3  | 92.3         | 540,939         | 714,097         | 884,498                       | -170,401          |
| <b>January-April</b> | <b>99.8</b>   | <b>95.5</b>  | <b>365,780</b>  | <b>36,452</b>   | <b>1,417,915</b>              | <b>-1,381,463</b> |

At the same time, in April revenues of the State budget assigned to the general fund represented only 83 percent of the target, though expenditures were financed 92 percent. This resulted in the first deficit since the year's beginning. The deficit amounted to UAH 714 million, which is 32 percent higher than the target for this month.

According to the schedule for honoring the liabilities related to the public debt (see Graph 1), April 2000 was the month most overlaid with foreign payments. Due to negotiations aimed at restructuring of the external debt, Ukraine stopped all payments related to redemption and servicing of related external liabilities on January 20, 2000. **All payments accrued during the period between this date and March 15, 2000, were promised to be fully disbursed on April 14, 2000, subject to at least 85 percent participation of foreign creditors in the debt restructuring. This plan was realized.** As suggested by Graph 1, the volume of payments related to accrued liabilities scheduled to April amounted to USD 245 million, including USD 79 million of the principal-related payments.

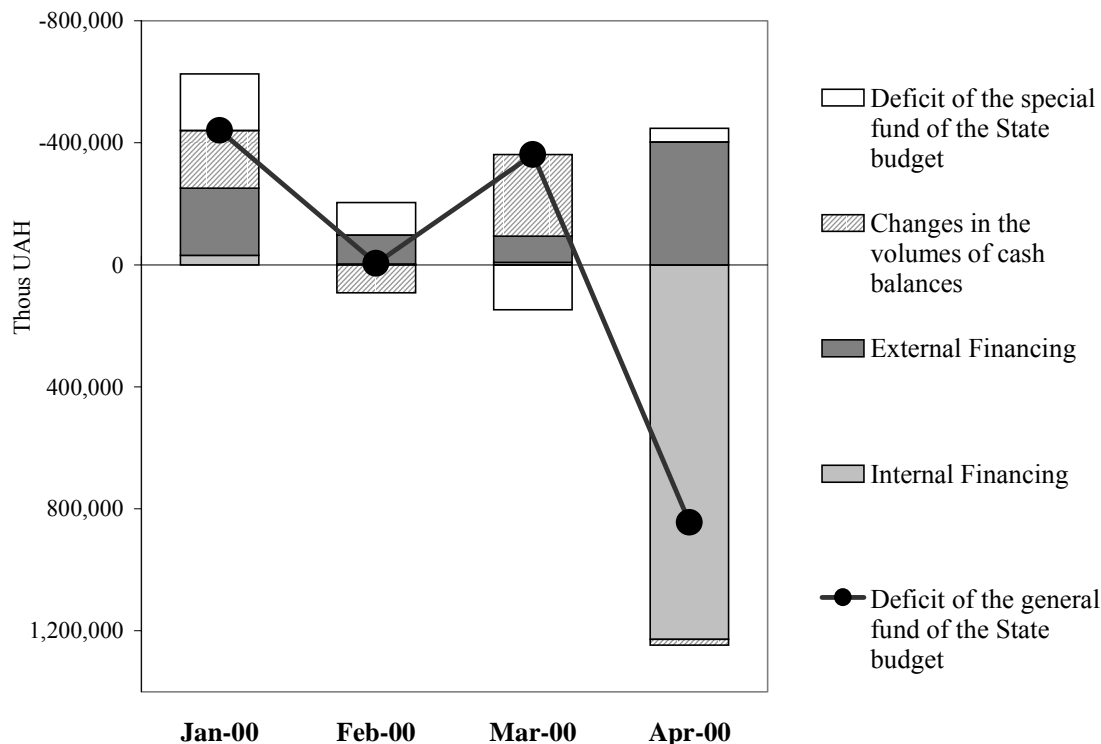
Given the need to finance the considerable budget deficit and payments related to external debt servicing, in mid-April for the first time this year, the government resorted to a weighty internal borrowing which took the shape of a wide-scale T-bill issue (see Graph 2).

**Graph 1. Schedule of repayment of the Government's liabilities in 2000 (in million USD) (with account for changes resulting from the restructuring of the external commercial debt)**



In April, auctions were held which resulted in the placing of T-bills on the primary market with an overall face value of UAH 1,424,308 thousand. The volume of budget receipts from these transactions totaled UAH 1,314,775 thousand, or 92.24% of the overall nominal value of T-bills sold. Taking into consideration the fact that the new T-bills' coupon interest rate was set at a zero percent (Cabinet Resolution of April 10, 2000), the implicit level of interest on the T-bills placed in April was 7.78%. In the context of a critical instability of the Ukrainian T-bill market, this rate should be recognized as amazingly low. For comparison: the target set in 2000 State Budget Law for receipts from T-bills to be placed during the year was UAH 3,896 billion with overall nominal value being UAH 5,171 billion, that is, only 75.34% of the nominal (in this case, the interest on T-bills would be almost 25 percent).

**Graph 2. State budget financing between January-April 2000**



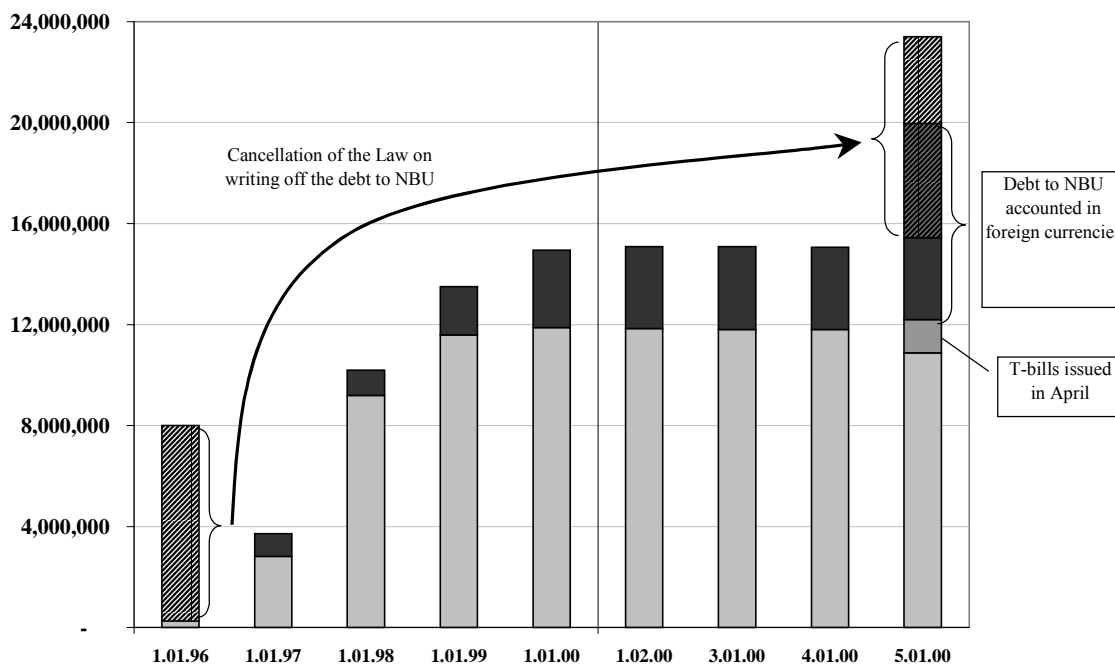
### Internal debt

In the first quarter of 2000, the level of the internal public debt remained almost unchanged. The internal debt increased between January-March by less than UAH 110 million, that is 0.73 percent, from UAH 14,953 million as of the year's beginning to UAH 15,063 million (see Graph 3). The increase in the internal debt occurred despite the fact that the net repayment of internal liabilities amounted to about UAH 42 million. The main reason for that was the recalculation of the Hryvnia equivalent of the government's debt liabilities owed to the NBU and denominated in foreign-currency.

The criterion for division of the government's debt liabilities into internal and external debts is still under discussion. The cornerstone principle applied so far by the Ministry of Finance for classification of the public debt was the currency in which the creditor granted the loan. This approach was embedded in the drafts of major legislative acts which have been passed by the Verkhovna Rada in the first reading and are to be considered in the second reading in the near future, such as the *Law On the Public Debt of Ukraine* and the *Budget Code*. However, the problem of classification of the government's foreign-currency denominated debt liabilities due to the National Bank of Ukraine is still unresolved.

As one can see from Graph 3, in April 2000 the level of internal debt experienced swift changes. As compared to late March, the debt went up UAH 8.3 billion, that is, more than 55 percent. And though it was in April that the first considerable T-bill issue was placed, this was not the main factor for the increased debt. This increase occurred primarily for political and administrative reasons.

**Graph 3. Changes in the internal debt of Ukraine in 1996-1999 and January-April 2000 (in thousand UAH)**



In late April 2000, the Verkhovna Rada passed the Law of Ukraine *On Restructuring the Debt Liabilities of the Cabinet of Ministers of Ukraine due to the National Bank of Ukraine*. This law invalidated another Law of Ukraine passed several years before, according to which all the government's debt due to the NBU resulting from emissary credits of the 1991-1995 and amounting to UAH 7.748 billion as of Jan. 1, 1996, was subject to write-off. The new law restored those debt liabilities which had arisen between 1994-1995 (both the principle and interest accrued between the day of write-off and Jan. 1, 1999). In so doing, some portion of these liabilities was recognized as denominated in US dollars. The amount of the restored debt to the NBU recalculated into Hryvnia of May 2000 totaled UAH 10,552,996 thousand, including UAH 3.439 billion and USD 1.184 billion of the principals, as well as USD 133 million of interest accrued on foreign-currency denominated loans (see Graph 3 and Table 2).

In connection with the restructuring of the debt to the NBU, amendments were introduced into the 2000 State Budget Law setting the ceiling for Ukraine's internal public debt at UAH 29,278,315.3 thousand plus USD 1,317,121.068 thousand (see Table 2).

The level of the debt ceiling is set by the Government in an annual Budget Law as an amount of debt which can not be exceeded during the current year. Prior to year 2000, annual Budget Laws only provided limitation for the internal public debt; however, starting this year both internal and external liabilities were made subject to the limitation. At the same time, up until now, the explanatory notes for the Budget Proposals provided by the Ministry of Finance contained no comments whatsoever on the suggested levels of the debt ceilings.

The amendment to the level of the 2000 internal debt limitation increases the size of the ceiling approximately by the amount of the debt that has been restored by the Law of April 20. Besides, according to the NBU's information on the status of the government's debt receivable, the volume of liabilities which had arisen between 1991-1993 and, therefore, were not subject to restructuring as per the Law of April 20, was UAH 129,233 thousand as of May 1. As Table 2 shows, this amount accounts for the difference between the increase in the limitation on the debt and the volume of this year's increment of the current debt resulting from the law on restructuring. It is obvious therefore that the new number of the debt ceiling implies a possibility of restructuring of the debt to the NBU later in 2000.

**Table 2. Internal debt between 1999-2000 and the debt's limitation  
(in thousand UAH or thousand USD)**

|   | 1.01.1999               | 1.01.2000               | 4.01.2000         | 5.01.2000                |
|---|-------------------------|-------------------------|-------------------|--------------------------|
| <b>Actual debt (thousand UAH)</b>   | <b>13,499,997</b>       | <b>14,953,456</b>       | <b>15,062,971</b> | <b>23,398,360</b>        |
| <b>Limiting amount of debt</b>  | <b>20,260,949</b>       | <b>25,710,517</b>       | <b>25,710,517</b> | <b>36,392,745</b>        |
| <i>including:</i>   |                         |                         |                   |                          |
| debt accounted in UAH   |                         |                         |                   | 29,278,315 (UAH)         |
| debt accounted in USD   |                         |                         |                   | 1,317,121 (\$)           |
| <b><u>Change</u></b>  | <b><u>3,299,880</u></b> | <b><u>5,449,568</u></b> |                   | <b><u>10,682,228</u></b> |
| <b><u>Written-off debt to NBU</u></b>   |                         |                         |                   | <b><u>10,682,228</u></b> |
| Debt restructured in April  |                         |                         |                   | 10,552,996               |
| <i>including:</i>   |                         |                         |                   |                          |
| debt accounted in UAH   |                         |                         |                   | 3,438,566 (UAH)          |
| debt accounted in USD   |                         |                         |                   | 1,317,121 (\$)           |
| Non-restructured debt (1991-93)   |                         |                         |                   | 129,233                  |
| Difference between the limiting amount and the current state                    | 6,760,952               | 10,757,061              | 10,647,546        | 12,994,384               |
| (in percent)  | 50%                     | 72%                     | 71%               | 56%                      |
| Difference between the limiting amount and the state as of the year's beginning |                         |                         | 10,757,061        | 21,439,289               |
| (in percent)  |                         |                         | 72%               | 143%                     |

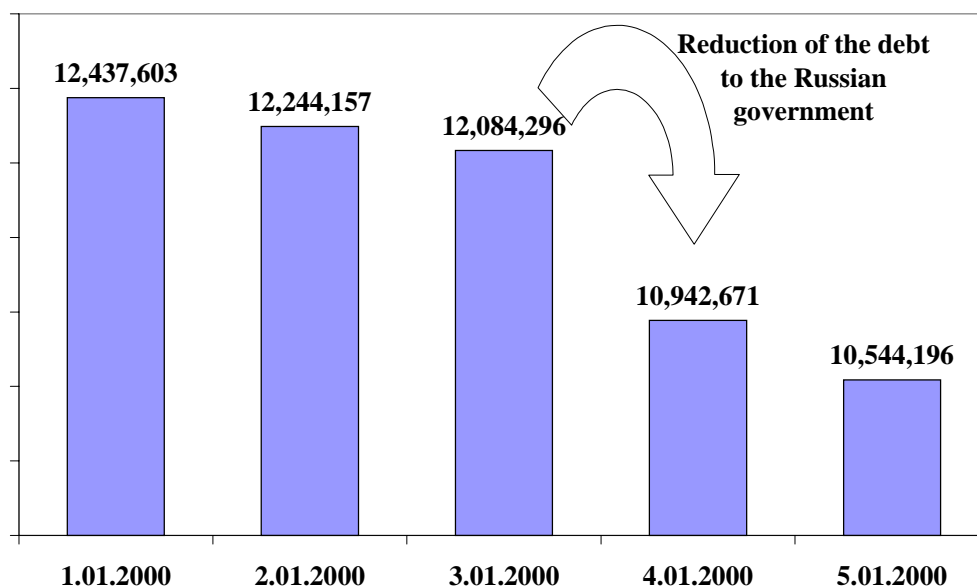
Initially, the ceiling on the internal debt for 2000 was set at UAH 25,710,517.1 thousand, which is UAH 10.8 billion (or 72%) higher than the actual amount of debt as of early 2000 and UAH 5.4 billion higher than the limitation set for 1999 (despite the fact that in the 2000 budget a zero level of net internal borrowing for purposes of budget deficit

financing was envisaged for the year in whole). The amount of debt increase of about UAH 5.4 billion, which was embedded in the debt ceiling as per the 2000 State Budget Law, almost fits the volume of payments related to T-bill repayment in 2000 envisaged in this law (UAH 5,717,346 thousand). As per results of the first four months of 2000, the target for these payments was executed 19.8 percent (out of UAH 914 million of liabilities with a maturity between January-April, only UAH 181 million was financed as of early May). It is anticipated that these overdue liabilities and a portion of liabilities related to future payments will be restructured in the near future.

### External debt

Due to the fact that the surpluses of the first quarter were used to finance the repayment of the principal of external liabilities and clearing of the debt related to power resources supplied by the Russian Federation, the government managed to reduce the external public debt by USD 1,893 million, or about 15 percent, in the first four months of 2000 (see Graph 4). As of late April, the amount of accrued foreign liabilities of Ukraine totaled USD 10,544 million, or about 44.79 percent as a share of 1999's GDP (though at the year's beginning this share was 51.03 percent).

**Graph 4. Ukraine's foreign debt in January-April 2000  
(in thousand USD)**



The settlement of the debt to the Russian government totaling USD 1,099,644 thousand was the main factor of the external debt's reduction. According to the agreement signed by the two governments on March 1, 2000, the major portion of Ukraine's debt to the Russian Federation for consumed power resources and splitting substances (USD

1,099,644 thousand out of the total amount of debt equal to USD 3,074,000 thousand) was cleared against the following debts owed to Ukraine by the Russian government:

| Debt<br>(in thousand USD) | Source of Debt   |
|---------------------------|--|
| 97,750                    | rental payments for the stay of the Russian Black Sea Fleet on the territory of Ukraine in 1998;   |
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| 97,750                    | rental payments for the stay of the Russian Black Sea Fleet on the territory of Ukraine in 2000;   |
| 526,509                   | payment for ships, vessels, and other floatage transferred to Russia;  |
| 21,942                    | interest accrued on the debt of USD 526,509 thousand;  |
| 199,829                   | compensate for the cost of splitting substances extracted from the tactic nuclear weapons shipped removed from Ukrainian territory to Russia in 1991-92; |
| 58,114                    | payment for use by the Russian Black Sea Fleet of land plots and infrastructure on Ukrainian territory .   |
| <b>1,099,644</b>          | <b>TOTAL</b>   |

The parties agreed that, upon the clearing, the Ukrainian government's debt to Russian government would be USD 1,974,356 thousand and outlined the schedule for further repayment of these liabilities which is discussed below.

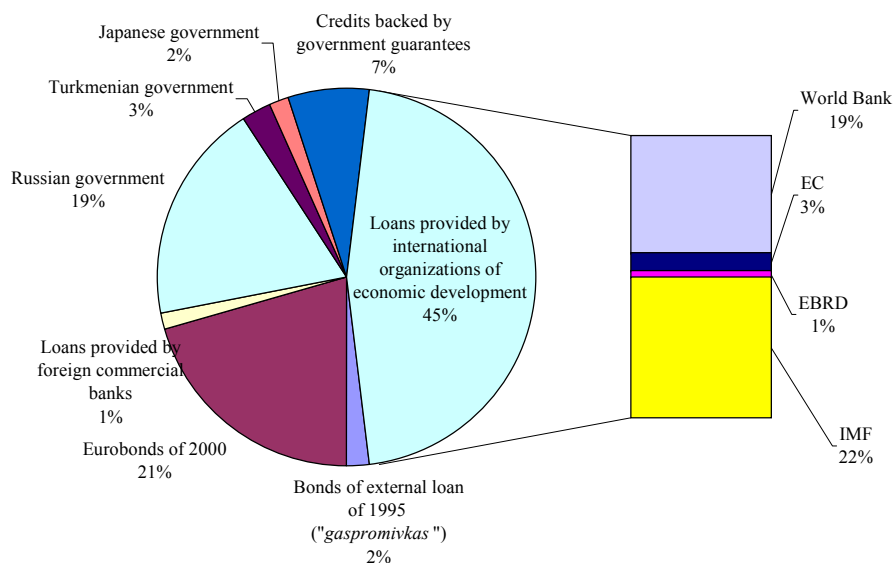
Other payments made by the government to repay the external debt in the first quarter include repayment of the debt to the International Bank for Reconstruction and Development (USD 1,190 thousand), payments related to IMF credits (USD 47,041 thousand in January, USD 103,185 thousand in February, USD 22,567 in March and USD 88,595 thousand in April); repayment and clearing of debts to the Turkmenistan against Ukraine's expenses for training Turkmenian specialists in educational establishments of Ukraine (USD 35,214.3 thousand); final payments related to a credit provided by the Japanese *Nischo Iwai* (USD 6,000); as well as scheduled payments related to the principal of the fiduciary loans and non-restructured T-bills issued in 1995.

New borrowing in 2000 was raised from The World Bank: USD 963 thousand in January, USD 9,964 thousand in February and USD 3,011 thousand in March. Besides, the governments of Germany, France and Spain continued to provide funds as per credit lines in pursuance of guarantee agreements concluded in earlier years.

Graph 5 shows the structure of the external public debt as of late April. As one can see, the largest share of Ukraine's foreign debt (about 45%) is in the form of loans from international organizations of economic development. Among these organizations, the largest creditors of Ukraine are The World Bank and IMF, which account for more than

91 percent of the overall amount of the debt to international organizations of economic development.

**Graph 5. Structure of the external public debt as of May 1, 2000**  
(Total amount of foreign debt, including IMF credits = USD 10,544,196 thousand)



The new Eurobond liabilities resulting from commercial debt restructuring in 2000 ranks second in the total amount of debt. As of early April, the overall volume of these liabilities amounted to USD 2,166,904 thousand, or 21% of the foreign debt. Apart from this, Ukraine's debt to the Russian Federation for power resources consumed continues to be considerable (19% of the total foreign debt). However, as we have mentioned above, a scheme for the repayment of this debt has already been agreed by the two governments. Beginning in 2001, these liabilities will be honored by way of annual clearing of rental payments amounting to USD 97,750 thousand payable by the Russian Federation for the stay of the Russian Black Sea Fleet on Ukraine's territory until the full repayment. If this scheme is to be realized, the debt would be retired in 20 years.



## RESTRUCTURING OF THE UKRAINIAN COMMERCIAL DEBT

### Background information

The fact that the volume of foreign liability payments in 2000 was relatively low is attributable to the restructuring of Ukraine's commercial debts between January-April. As of early 2000, the overall level of the public debt to private creditors amounted to USD 2.7 billion. Out of this amount, about USD 1.5 billion was to be repaid in 2000. As a result of the conversion of debt liabilities, the volume of the foreign debt principal to be repaid in 2000 went down to USD 185 million.

Negotiations with foreign commercial creditors of Ukraine were held by the Ukrainian government in January-April with participation of the investment bank of *ING Barings*, which was chosen to be the lead manager of the restructuring process. Holders of the following debt liabilities of Ukraine were exhorted to participate in the conversion:

- Bonds worth DM 1,537,960 thousand, with the term of maturity in February 2001 and coupon rate of 16% per annum;
- Bonds worth USD 500 million, with the term of maturity in March 2000 and coupon rate of 14.75% per annum;
- Bonds worth USD 73,750 thousand, with the term of maturity in October 2000 and coupon rate of 16.75% per annum;
- Bonds worth USD 258,415 thousand, with the term of maturity in September 2000 and coupon rate of 0% per annum;
- Bonds of external government loan of 1995 ("*gaspromivkas*") worth USD 280 million and USD 750 million, with the term of maturity in 2000-2007 and coupon rate of 8.5% per annum.

It was proposed to change the above-mentioned bonds to new 7-year Eurobonds denominated in US dollars (with an interest rate of 11% per annum) and in Euros (with an interest rate of 10% per annum). The new Eurobonds were issued with quarterly coupons to be paid on June 15, September 15, December 15, and March 15 of every year, and subject to bi-annual amortization payments scheduled as follows: March 15 and September 15 of 2001 - 3%, March 15 and September 15 of 2002 - 5%, March 15 and September 15 of 2003-2006 - 9.333%, and March 15 of 2007 - 9.336%. An average effective lifetime of the new Ukrainian eurobonds is 4.5 years\*. The conversion stipulated

\* The method where the lifetime of a bond is assessed on the basis of the difference between the date of issue and the day of redemption (7 years in case of Ukrainian Eurobonds) is believed to be incorrect since the principal of the debt is repaid in several installments. In order to define the term of redemption of this type of bonds, agents of the financial market typically use average lifetime of a financial instrument, which is assessed as average time of receipt of payments related to the principal weighted by the estimated amount of the principal to be received. Mathematically, this may be formulated as follows:

$$AL = \sum_{t=1}^T \frac{t \times M_t}{12 \times M},$$

where  $AL$  is average lifetime,  $M_t$  is amount of the principal to be paid at the moment  $t$ ,  $M$  is overall amount of the debt, and  $T$  is number of months before payment.

no write-off or reduction of the principal, though for bonds of external loan of 1995 a special scheme of conversion coefficients was developed.

The overall amount of securities successfully converted along the lines of these scheme as of April 14, 2000, was about 99.24% for the fiduciary bonds and 76% for bonds of external loan of 1995 (“*gaspromivkas*”). This rate appeared to be much higher than the 85% level which was set initially as a criterion for success in negotiations.

### **Successful result – illusion or reality?**

When trying to assess the benefits of the restructuring of Ukraine’s commercial debt, one should clearly define the problem, because its degree of solution would provide one of benefit. At numerous presentations of the restructuring plan made by the government jointly with representatives of the *ING Barings*, it was reiterated that current difficulties with servicing Ukraine’s external liabilities by no means suggest a debt crisis. Rather, they reflect a temporary crisis of liquidity. It is obvious that in a situation of temporary lack of liquid funds, a prolongation of the debt allows the debtor to meet the requirements of the credit agreement and have some additional time to improve the strategy of debt management. However, neither agreement with the creditors nor additional time cannot help if such a strategy is lacking and there is a threat that the public debt may become uncontrollable.

The new Ukrainian Eurobonds which entered the world financial market may show the attitude of independent investors to Ukraine’s external debt. Investors’ perceptions with respect to the debtor’s solvency manifests themselves primarily in the rate of return on securities at which the demand for them is sufficient to absorb the supply.

A traditional indicator used to estimate the current level of return for a bond is the so called *yield to maturity*. This index can be obtained by simple calculations for each bond at any point of time on the basis of its current market price and the volume of future returns expected from this security. Yield to maturity is defined as an interest rate, which, being applied to the market price of the bond, would allow the investor to receive the return equal to the present value of all future payments promised on this bond. For example, as of June 15, 2000, the price for a USD 100 Ukrainian Eurobond with a coupon of 11% per annum at the Frankfurt Exchange was equal to USD 63.5 and the price for a bond with a face value of EURO 100 and a 10% coupon was EURO 72.0. It is easy to compute that the rates of discount at which these amounts correspond to the current value of future payments related to such bonds are 26.25% and 20.47%, respectively.

Today, bonds with such a high yield to maturity are reckoned as speculative (unreliable) securities. As one can see from Graph 6, even relative to debt liabilities of other developing economies Ukrainian Eurobonds are perceived by Western markets as a risky investment.

The restructuring of foreign debts was successfully accomplished by the Ukrainian government and allowed Ukraine to honor its sovereign liabilities in a situation of a pre-default panic despite a rather trustless image of Ukrainian securities. This was essential for Ukraine as it gained some time for the government to deal with the problem of debt dependence and an opportunity to strengthen Ukraine's international credit reputation in the future. At the same time, the degree to which this opportunity will be realized depends on the further development of the policy of debt management and the government's economic policy in general.

**Graph 6. Yield to Maturity: International Comparison**  
Source: ING Barings

