UKRAINE'S PUBLIC DEBT IN THE YEAR 2000

The forthcoming payment obligations for a considerable part of Ukraine's principal and interest payments on its public debt and the question of government's ability to satisfy these payments is likely to become one of the most acute problems in 2000. This account explains the characteristics of the current situation and briefly describes possible alternatives Ukraine has in dealing with its debt obligations.

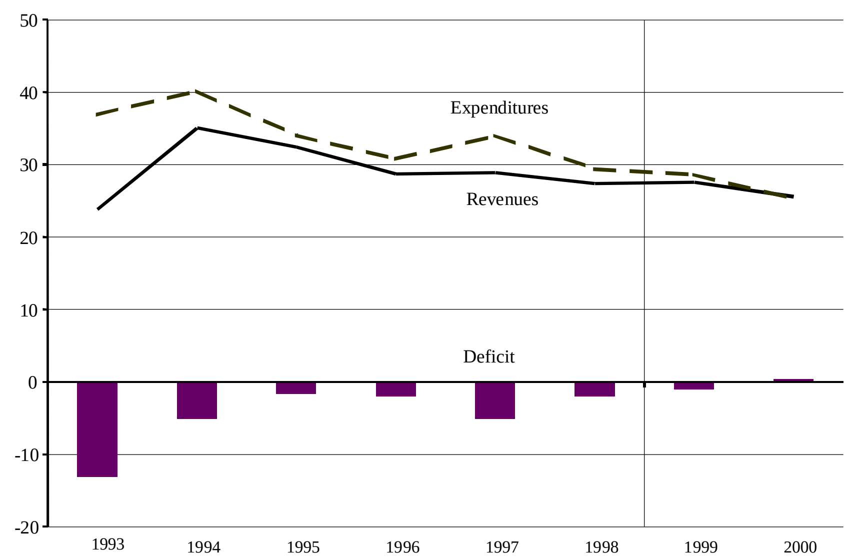
CURRENT DEBT PROFILE

The ability of a state to finance its expenditures with its own revenues is reflected primarily in the balance of the national budget. When a country is short of budget funds, the budget deficit shows the portion of the expenditure flow that is in excess of the overall budget collections (of revenues, transfers etc). In order to cover this shortage of funds and finance the deficit, the government may choose to borrow money from financial markets by issuing some form of public debt. The following sections discuss the policy for financing of the deficit that has been used by Ukrainian government through the recent years.

Background

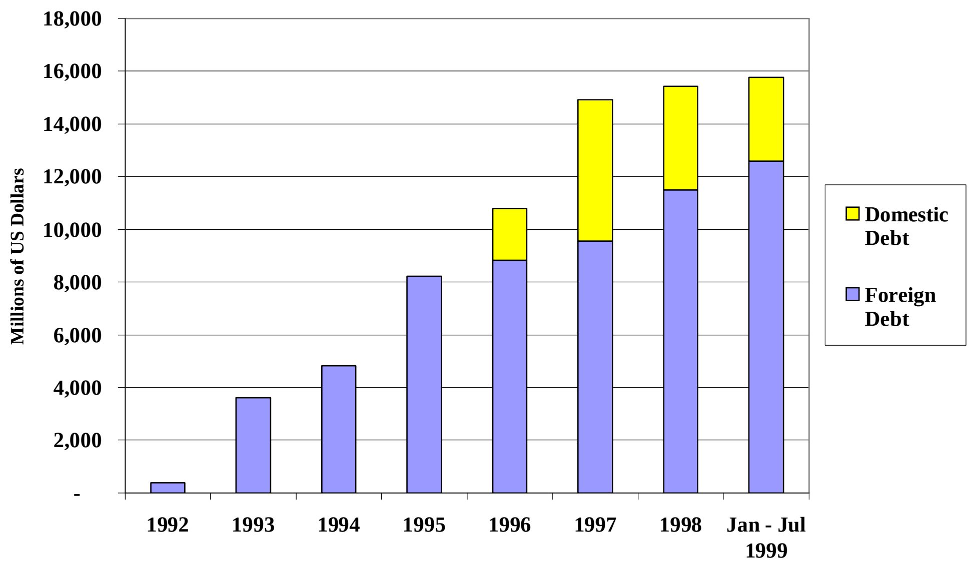
Since the beginning of the 90s, Ukraine's consolidated budget has exhibited large deficits (see Figure 1). In some years budget expenditures exceeded revenues by more than 10 percent of GDP. The resulting deficits were covered by direct credits from the National Bank of Ukraine. The funds necessary for these credits were drawn from continuous monetary emissions carried out by the National Bank and lead to rapid money growth and hyperinflation.

Figure 1. The deficit of Ukraine's National Budget in 1993-2000 as percentage of GDP



In the second half of 1994 the direction of policy changed. An effort was made to achieve a more balanced budget and the deficits significantly decreased. Moreover, NBU participation in financing the budget through direct emissionary crediting was suspended and thereafter budget deficits were financed through external borrowing and internal sales of Treasury bills. The government's debt to the National Bank accumulated by the end of 1995 was equal to UAH 7.748 billion. According to a Cabinet of Minister's decision made in the beginning of 1997, these obligations were canceled (and were not repaid[1]).

Figure 2. The history of Ukraine's National Debt Accumulation



The history of the accumulation of the Ukraine's national debt is shown in Figure 2. From a level of nearly zero at the beginning of the 90s, total public debt has risen to almost $16 billion (including IMF credit to NBU) in 1999.

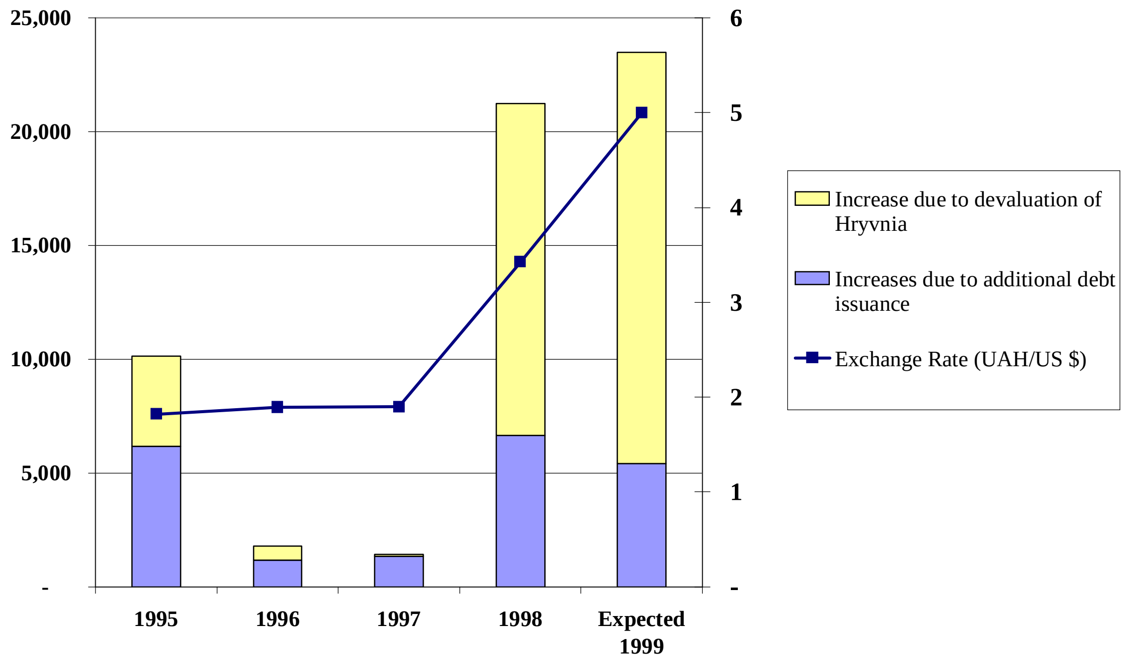
Unlike such budget indicators as revenues, expenditures or deficit and its financing, which are defined by the sizes of financial flows over particular periods, public debt is measured at a single point in time as a stock of liabilities that were accumulated through all previous periods. In other words, the level of the debt is equal to the net sum of all deficits or surpluses incurred by the budget until the present moment. New borrowing increases the level of debt while surpluses may be used to retire debt. Conceptually, the change in the level of the public debt for a given period corresponds to the deficit or surplus incurred during that period[2].

[1] *The Law of Ukraine On the Structure of the Internal Public Debt of Ukraine as of January 1, 1996, and On the Level of Statutory Limitation to the Internal Public Debt of Ukraine for 1996 and 1997* (Dated January 23, 1997)

[2] However, in practice the change in the stock of debt over a particular period does not always equal to the size of the net borrowing flow in that period. For example, the level of the debt can decrease not only due

Interest paid on the debt is considered an expense incurred from the use of financial resources and is accounted as part of the budget expenditures. Redemption of the debt principal made either through a single transaction or through sequential retirement of the portions of the total liability (amortization) merely represents a change in the government's assets and has to be financed accordingly either from the budget surplus or from additional borrowing (refinancing).

Figure 3. Annual increases in the Stock of Foreign Debt and the Rate of Hryvnia Devaluation



Current Composition of Debt Obligations

As Figure 2 shows, Ukraine's public debt as of 1 August 1999 amounted to US $15.6 billion or UAH 67.5 billion (with an exchange rate in August equal to 4.33 UAH/US $). The share of foreign debt in this volume was equal to UAH 53.9 billion or 80 percent. Net of IMF credit to the National Bank of Ukraine this represented UAH 41.9 billion or US $ 9.7 billion. Since the beginning of the year the stock of foreign and domestic debt increased by UAH 14.7 billion, almost 28 percent of the stock at the beginning of the year. Of this increase, around 3 percent were due to the increase of the amount of debt issued by the government while almost 25 percent were due to devaluation of the Hryvnia. Figure 3 shows that the devaluations in the exchange rate have been the primary cause of increases in the stock of Ukraine's foreign debt in 1998 and 1999.

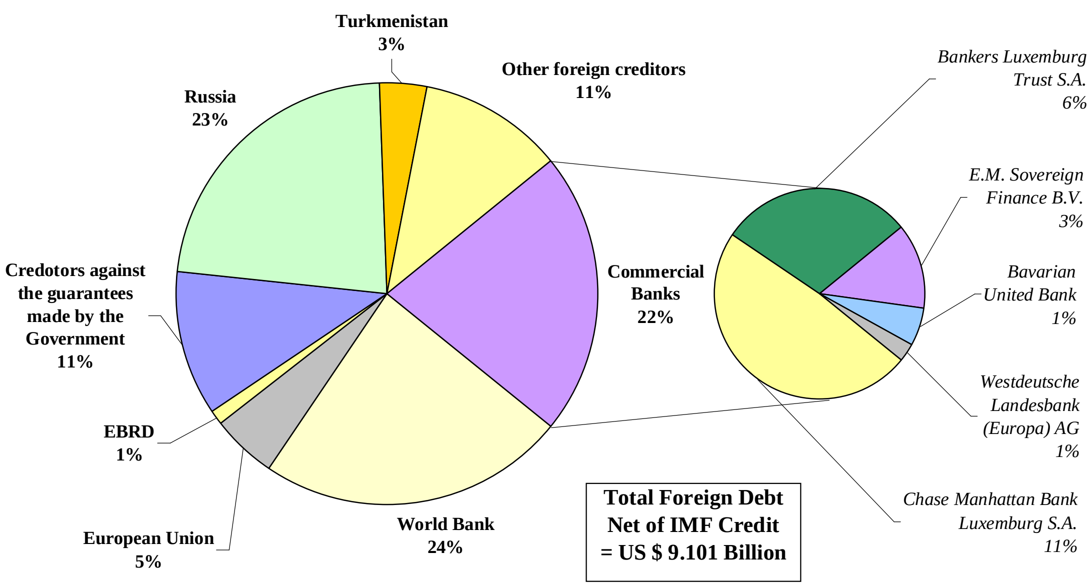
Figure 4 contains data on the foreign debt composition expected by the end of 1999, net of IMF credits. As of the 1st of January, the World Bank will be the biggest creditor of the

to the monetary redemption of the liabilities but also as a result of a change in the terms of payment or cancellation of the debt by the creditor. An increase in the stock of debt could also result from additional government credit guarantees to the private sector if the government has to make good on these guarantees.

Ukrainian government holding 24 percent of the foreign debt. The second largest portion of the debt (23 percent) is held by the government of Russia and 22 percent more are distributed among the foreign commercial banks. Additionally, a significant share of liabilities (11 percent) is due to the payments which the government has to make under its guarantees against foreign commercial loans to the Ukrainian private sector.

Debt liabilities held by Ukraine require the government to pay back part of the principal totalling UAH 16 billion by the end of the next year (under an assumed exchange rate equal to 5 Hr/US dollar). UAH 12.2 billion ($ 2.8 billion) or 76 percent of this amount represents foreign debt liabilities.

Figure 4. Composition of the Stock of Foreign Debt expected by January 2000



Domestic Debt Repayment in the Year 2000

Redemption of the principal for domestically allocated treasury bills in 2000 is forecasted to amount to **UAH 3.896 billion**. According to the 2000 budget proposed by the Cabinet of Ministers, proceeds expected from the new issues of T-bills through the year 2000 also equal to **UAH 3.896 billion** and so can be used precisely to cover maturing domestic debt obligations for that year. In this case the redemption of the debt would be financed by issuing an equal amount of additional debt and thus the forthcoming payments would be *rolled over*[3].

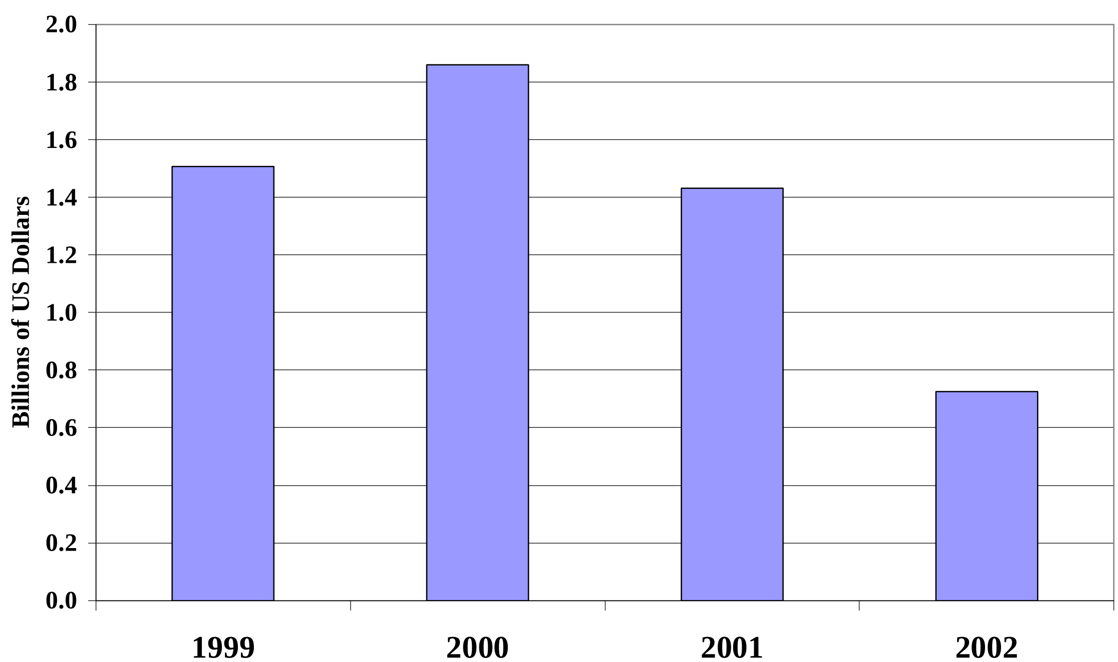
[3] The suggested operation would become the third domestic rollover in the history of Ukraine's internal debt. The mechanism of debt refinancing was first used by the government in 1998 through an internal T-

Foreign Debt Repayment in the Year 2000

According to the schedule of the foreign debt payments, sketched in Figure 6, the major part of the unpaid foreign debt due for redemption in 2000 consists of a principal repayment of a $ 2.068 billion or 75 percent of the total amount due (net of NBU liability to IMF). Unlike servicing of the debt (in form of interest payment), which is normally accounted for as part of the budget expenditures, repayment of the principal can only be financed through additional borrowing or a budgetary surplus. Assuming an exchange rate for the year 2000 equal to 5 UAH/US$, the annual amount of foreign debt principal repayment is equal to UAH 10.339 billion or almost 7 percent of GDP forecasted for the next year.

The amount of foreign debt payments maturing in 2000 is higher compared to 1999 and to the forecasts for the future. Figure shows 5 that already by 2002 foreign debt principal obligations will be more than twice lower than forecasted for the year 2000.

Figure 5. Schedule of Ukraine's Obligations for Foreign Debt Principal Repayment in 1999-2002 (Net of IMF Credit to the NBU)
In Billions of US Dollars



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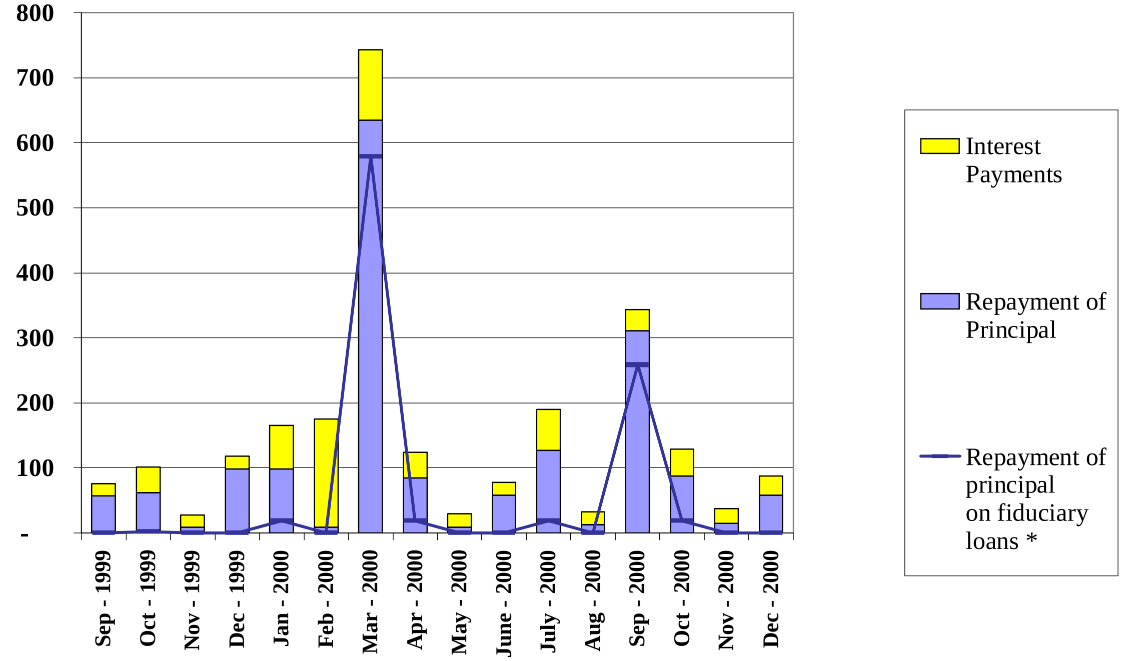
bills swap. Upon the Cabinet of Ministers' decision maturing obligations on loans made in 1997 and 1998 and held by the National Bank of Ukraine were exchanged for the newly issued *conversion Treasury bills*.

Figure 6 demonstrates that 65 percent of the debt principal maturing next year are due to be repaid in two major disbursements: 35 percent in March (Euro 500 million or about $ 490 million) and 30 percent in September (US$ 262 million). (Also see Figure 4).

Figure 6: Monthly Schedule of Future Foreign Debt Related Payments (in millions of US dollars)



* A significant share of Ukraine's foreign obligations was issued on a fiduciary basis, meaning that a number of foreign commercial banks operated as intermediaries by issuing the debt and reselling it ultimate debt holders. According to Figure 4, by the end of the current year this share is expected to reach 22 percent. The largest fiduciary loan (11 percent of the total stock of debt) was received by Ukraine from the Chase Manhattan Bank against the 1999 eurobond issue (to be discussed below). Figure 6 shows that the two major debt repayment peaks scheduled for the year 2000 are mostly due to the obligations on the fiduciary loans principal redemption.

ALTERNATIVE POLICY RESPONSES TO THE CURRENT DEBT SITUATION

For Ukraine to be able to meet its debt obligations, it has two options. The government can run a budgetary surplus and use some of this surplus to retire the debt. Alternatively, if the government has sufficient credibility and lenders are willing to lend it more money, the debt can be rolled over through additional borrowing. If Ukraine fails to meet its original debt obligations, there are two possible scenarios that could unfold. First, the debt might be "restructured", a change in the terms of repayments intended to allow Ukraine to partially meet its obligations. The second scenario is that the government can decide to default on its obligations and thus risk forfeiture of access to the benefits of future international financial cooperation.

Meeting the Debt Obligations

A surplus budget. One of the basic ideas behind the structural reforms launched in Ukraine in 1994 was to finance the deficit through international donor institution borrowing to relieve the macroeconomic situation and to give the economy a financial opportunity to accelerate its structural reformation and increase its economic potential and growth. In theory this process was meant to help increase budget revenue sufficiently to repay the debt accumulated during the transition period.

Budget balancing has remained a challenging task for Ukraine. In the current circumstances an excess of revenues over expenditures could be generated almost exclusively through large cuts in expenditure programs. To repay UAH 10 billion of foreign debt principal scheduled for 2000 would imply expenditure cuts of the same magnitude. An expenditure cut this large represents almost 30 percent of total expenditures. This would clearly effect the government's ability to finance vital health, education and social protection programs. This option is therefore unlikely.

Continued borrowing or "rolling the debt over". Commonly, countries repay debt principal by attracting additional credit flows to repay maturing obligations (to roll the debt over). If potential lenders regard the country creditworthy in a reasonably long term, they may agree to continue financing. However, an unreliable international image of the borrowing government and frustration of the creditors' confidence in the prospects for reforms in the recipient country can cast a chill on their willingness to continue lending or even make it vanish completely.

In the case of Ukraine, because the government has already once restructured part of its external debt, is threatening to renege on its internal debt, and has shown that it can't make the necessary budgetary cuts to generate a surplus, international investors have grown leery of Ukraine. It is very unlikely that Ukraine will be able to raise sufficcient additional foreign capital at reasonably affordable interest rates to merely roll over this debt.

Defaulting on the Debt Obligations

Rescheduling (debt lengthening or "technical default"). If a country can not meet its original obligations, it may attempt to restructure its debt payments rather than to completely default on them. Under an agreement with the creditors, the repayment of the debt principal is rescheduled for a later time when the borrower-country would have to pay it back together with an even higher amount of interest for the period of delay. From the creditor's perspective, motivation for such a strategy could be a hope to receive something tomorrow rather than never, or international concern about possible consequences of the debt crisis and sovereign defaults. Restructuring the debt on conditions unfavorable for the borrower can lead to a net worsening of its financial position. However in a situation of fading alternatives, rescheduling of the debt is one of the final chances a country may have to partially honor sovereign obligations.

Ukraine rescheduled its debts to two foreign creditors in the summer of 1999. In the case of ING Barings, Ukraine incurred a technical default (it declared its inability to pay when the liability came due, but announced its willingness to negotiate to change the payments terms) on \$163 million that it had owed to ING Barings by the 9th of June. Ukraine eventually paid 54 percent of these obligations through a \$32.6 million payment on the 23rd of July and through a \$56.2 million payment on the 2nd of August. The remaining 46 percent was restructured by providing the creditors with 25 percent of the Eurobonds from a new Deutsche Mark Eurobond issue on August 20th (the terms of the issue described below).

In the case of another foreign creditor, EM Sovereign Finance B.V., Ukraine was able to restructure its obligations before they were due, and thus did not officially incur a technical default. In this case, the remaining 75 percent of the August 20th Eurobond issue were provided to these investors in return for the cancellation of liabilities coming due the following September.

However, the conditions on which the agreement on eurobonds was achieved may make it difficult for Ukraine to comply with next years. The additional debt incurred as a result of the restructuring was short term and expensive: interest on the eurobonds was set at the level of 23 percent, which is much higher that the international average; the maturity date for the eurobonds is soon: 26 February 2001.

However, the forthcoming peak of Eurobond repayment in March is expected to be even more difficult to reschedule successfully. In contrast to the ING Barings case, where there was a limited number of bondholders, Eurobonds are distributed among the large number of independent entities. This makes any rescheduling negotiations a much more rigorous task.

Debt Buy-Back. There is a possibility for a country that fails to fully repay the amount of maturing debt to buy this debt back from the creditors on the secondary market and so reduce the size of the sovereign debt obligations. Because of the high risk of default the price of the debt on the secondary markets is likely to be much lower than the face value. In other words, the creditors are likely to be willing to exchange the debt that they own for a payment that is quite small but more certain than the full debt redemption in future. For example, in 1988, the government of Bolivia managed to purchase back its sovereign obligations at a price of 11 cents of each dollar of the debt (11 percent of the face value).

There are different sources from which a debtor country can hope to finance a debt buy-back. In the case of Bolivia the money needed for a purchase were gathered from dollar donations of other countries. If this option is not available, room for financing the buy-back has to be found in the national budget and so is associated with expenditure cuts.

Default. The decision of the government to default on its debt liabilities is associated with inescapable negative consequences. Such negative consequences include seizure of foreign assets of the country, and most importantly – virtual freeze of the possibilities for future international financial cooperation, of which notably painful would be suspension of future borrowing. In comparison to all the available alternatives this option is therefore most inexpedient and hazardous.

CONCLUSION

The size of Ukraine's foreign debt obligations have increased considerably over the past several years both as a result of a change in deficit financing policy that relied more heavily on foreign debt and also due to the recent devaluation of the Hryvnia.

Large foreign debt interest and principal payments for Ukraine are due in 2000 representing about $2 billion. Because it has lost the confidence of international investors, it will be nearly impossible for Ukraine to attempt to refinance these payments solely by rolling them over into future obligations at reasonable interest rates. In order for Ukraine to unilaterally meet its obligations through an attempt to achieve a budgetary surplus, on the other hand, it would have to significantly cut expenditures or raise revenues by about 30 percent. Such expenditure cuts would be extremely painful.

If Ukraine cannot meet its obligations it may attempt to restructure its debt, an option made more difficult because of the large number of creditors involved. However, outright default would almost surely cut off any possible international borrowing in the near future, and would lead to the seizure of Ukrainian assets in foreign countries.