

# “Specifics of national debt management and its consequences for the Ukrainian economy”

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## Specifics of national debt management and its consequences for the Ukrainian economy

### Abstract

This article is about the specifics of the national debt management in Ukraine. The authors conducted the research of the current state, impact on the national economy and made suggestions of how to increase the effectiveness of national debt management.

**Keywords:** debt, national debt, national debt management.

**JEL Classification:** H60, H63.

### Introduction

In the recent years it has become necessary to form the conditions for stabilization of the financial system of Ukraine in order to achieve acceptable economic growth, carry out the integration of the national economy into the global economic system, and overcome the inflation and dependence of the state and the national economic entities from external financing. These processes may be connected with the effective policies of the national debt management in Ukraine. These problems are especially important due to the increased volume of external debts of the government, banking institutions, and business entities. Moreover, the practice of many countries indicates that inefficiency in terms of the structure of the debt maturities, currencies, interest rates and non-secured obligations were important factors in the launching and expanding of economic crises.

These problems are thoroughly examined in the publications of Ukrainian and foreign scientists, especially in research-papers of such scholars as A. Kirichenko, A. Baranovsky, V. Kucher, T. Vakhnenko, N. Prykazyuk, T. Motashko, S. Yuriy, T. Bondaruk, V. Kudrytskyy, R. Barro, A. Missale, L. Mosley. Many researchers emphasize the general problems of national debt accumulation, indicating a significant effect of target programs of international financial institutions.

In our opinion, there are several issues which require further research, particularly, how efficiently the government manages its debt and whether there is a clear policy in this direction. Certain government actions indicate that there is a lack of long-term debt management program. What's more, the majority of loans, received by various subjects of market relations, are rather a reaction to the current economic situation than pre-weighted decisions.

Within this article we will examine the current state of the national debt of Ukraine, outline reasons of changes in the present stage and formulate several proposals in order to improve the politics of national debt management in Ukraine.

### 1. Review of policy issues

Public debt in general is a complicated mechanism, whose functioning depends on the actions of many subjects of market relations. Therefore, public debt management requires a whole system of methods for its regulation. These methods have their relevance in terms of revealing the problems that exist in this area. That's why, we should, first of all, analyze the overall state of the national debt in Ukraine and then determine how effective the current policy of its management is. Table 1 shows the latest available data on the key indicators of the national debt in Ukraine.

Table 1. Indicators of the national debt in Ukraine, 2003-2008 (million USD)\*

| Indicator                                     | 2003  | 2004  | 2005  | 2006  | 2007  | 2008   |
|---|-------|-------|-------|-------|-------|--------|
| Public administration sector                  | 8929  | 11204 | 12214 | 12894 | 14673 | 14590  |
| National Bank of Ukraine                      | 1919  | 1690  | 1254  | 880   | 462   | 4725   |
| Banks, including                              | 1746  | 2662  | 6112  | 14089 | 30949 | 39424  |
| short-term                                    | 1087  | 1652  | 3084  | 6465  | 11723 | 9330   |
| long-term                                     | 659   | 1010  | 3028  | 7624  | 19226 | 30094  |
| Other sectors, including                      | 10803 | 14532 | 19205 | 24706 | 33026 | 40248  |
| short-term                                    | 7928  | 8783  | 7860  | 8747  | 10297 | 12653  |
| long-term                                     | 2875  | 5749  | 11345 | 15959 | 22729 | 27595  |
| Direct foreign investments: intercompany debt | 414   | 559   | 834   | 1943  | 3079  | 4249   |
| Gross national debt                           | 23811 | 30647 | 39619 | 54512 | 82189 | 103236 |
| % of GDP                                      | 48%   | 47%   | 46%   | 51%   | 59%   | 57%    |
| % of export of goods and services             | 82%   | 74%   | 89%   | 109%  | 128%  | 121%   |
| % of official reserves                        | 29%   | 32%   | 49%   | 41%   | 40%   | 31%    |

\*Source: Ministry of Finance of Ukraine, National Bank of Ukraine.

It should be noted that absolute indexes of all indicators of the national debt in Ukraine have increased. The gross national debt (GDP) has increased by nearly 4.5 times during 2003-2008 that led to a situation when official reserves can cover only 1/3 of the national debt. The average annual growth rate of the national debt was up to 135 %, much higher than the GDP growth so that the ratio of the national debt to GDP was almost 60 % (2007). The same can be said about its ratio to exports of goods and services. If during 2003-2005 the total revenues from export were able to cover the national debt, then, starting from 2006, the national debt exceeded export.

In this case, it is important to note what indicators influence this growth. It should be clarified that most debts are long-term ones. That means that Ukraine got a deferment on loans' payment, when the country entered the crisis. This provides the capability to fulfil obligations, hoping for economic recovery and rise of liquidity of global financial markets, which could be used to refinance debts.

The statistics show that the growth of the national debt in Ukraine resulted from the banking sector. The total debts of banking institutions increased 22.5 times. Short-term debts increased 8.5 times and long-term debts – 45.7 times. The growth rates

occurred in geometric progression, doubling almost every year (except 2008). Mergers and acquisitions in banking, which started in 2005-2006, led to a significant inflow of credit funds from parent institutions. So, in most cases these growth rates were caused by them. In some way it had positive consequences for the Ukrainian economy, because those loans helped to increase the volumes of consumer credits, mortgage credits and loans to buy cars and durable goods. It automatically resulted in the increase of housing construction, growth of imports of respective commodity groups, and the rise of growth rates in related industries.

It should also be noted that direct foreign investments increased dramatically – more than 10 times within 2003-2008. This situation may indicate that foreign investors' trust is growing in domestic companies.

Growth rates of other indicators did not exceed the average: debts of public administration sector increased only 1.6 times, debts of the National Bank of Ukraine – 2.5 times, debts of other sectors – 3.7 times.

These trends led to substantial redistribution in the structure of the national debt in Ukraine (see Table 2).

Table 2. Structure of the national debt in Ukraine, 2003-2008

| Indicator                                     | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|------|------|------|------|------|------|
| Public administration sector                  | 37%  | 37%  | 31%  | 24%  | 18%  | 14%  |
| National Bank of Ukraine                      | 8%   | 6%   | 3%   | 2%   | 1%   | 5%   |
| Banks   | 7%   | 9%   | 15%  | 26%  | 38%  | 38%  |
| Other sectors                                 | 45%  | 47%  | 48%  | 45%  | 40%  | 39%  |
| Direct foreign investments: intercompany debt | 2%   | 2%   | 2%   | 4%   | 4%   | 4%   |
| Gross national debt                           | 100% | 100% | 100% | 100% | 100% | 100% |

In 2003 the majority of the national debt (82 %) was concentrated in the public administration sector and other sectors. But in the following years it became apparent that the growth of the banking sector can be supported only through external sources. Its share was steadily increasing from 7% (2003) to 38% (2007-2008), i.e. the same amount that the public administration sector had at the beginning of the analyzed period. Redistribution was made at its expense. Public administration sector completely lost its weight (only 14% in 2008). On the one hand, it can be considered as a positive feature, because direct government debts are not so big, but on the other hand, the gross national debt becomes less controlled and the influence of the government can no longer be effective.

Despite the fact that other sectors lost their position during that time their share still remains the biggest one – 39% (2008).

Although the indicator of “direct foreign investment” significantly increased, as mentioned above, it does not play an important role in the structure of the national debt (4% in 2008), but, taking into account the financial crisis, it will lose its importance completely.

Concerning the debts of the National Bank of Ukraine (NBU), we should underline that they were falling during this period (up to 2007), but increased significantly in 2008 more than 10 times. That is why its share reached 5% in the gross national debt, although, in comparison with 2003 it lost its weight, when its share was 8%.

It should be mentioned that this situation influenced the economy badly, in general. Primarily, it is due to the necessity to pay off debts. The basic principles of the monetary policy in 2010 stated that “the outflow of funds will continue because of capital transactions and financial transactions, however, in

smaller amounts than it was in 2009. The amount of scheduled payments for direct and guaranteed national debt will be no less than 2.3 billion USD, and for private debts – more than 18 billion USD in 2010” [9].

Obviously, such trends affect the exchange rate of UAH to USD (as the majority of loans were made in that currency). Since 2005 imports exceeded exports and, thus, the main source of US dollars is no longer in operation. The only possibility to provide such payments is to use the official reserves. In the long run, the significant reduction of official reserves will lead to the weakening of UAH because of excessive demand over supply and limited possibilities of the NBU to cover it, taking into account the lack of liquid assets in the NBU. Most likely, it will lead to the reduction in imports due to its lower efficiency because of the falling exchange rate. In this situation we can expect a gradual levelling of the situation in favour of exports, which will provide opportunities to accumulate additional foreign currency reserves. In our opinion, other sources of foreign currency will not be very important because the inflow of direct foreign investments is very unlikely during the global financial crisis. The possibility for banks to attract foreign currency to deposits also seems uncertain, despite the fact that interest rates are quite appealing. However, in our view, it will be easier for banks to fulfil their obligations. But we can't be sure about debts of other entities, whose share in the structure of the national debt is larger than that of banks.

Let's qualify the factors that may have a positive impact on the economy as a result of the growing national debt:

- ◆ acceleration of economic growth;
- ◆ the possibility of large-scale investment and implementation of long-term developing programmes;
- ◆ funds can be raised under much lower rates and for longer terms compared with the possibilities of the domestic financial system;
- ◆ corporate loans tend to have investment direction;
- ◆ implementation of long-term lending programs of physical and legal persons etc.

There are also several negative factors associated with the increase of the national debt:

- ◆ the vulnerability of domestic financial system because of the world financial crisis;
- ◆ volatility of exchange rates, which may affect the ability of national economic entities to meet their obligations;

- ◆ mismatch of debts' currency and assets' currency of the entity;
- ◆ gap between the terms of obtained funds and revenues from investment projects;
- ◆ inability to fulfil obligations in the case of limited access to the sources of foreign currency;
- ◆ low liquidity of global financial markets may reduce the possibility of debt restructuring.

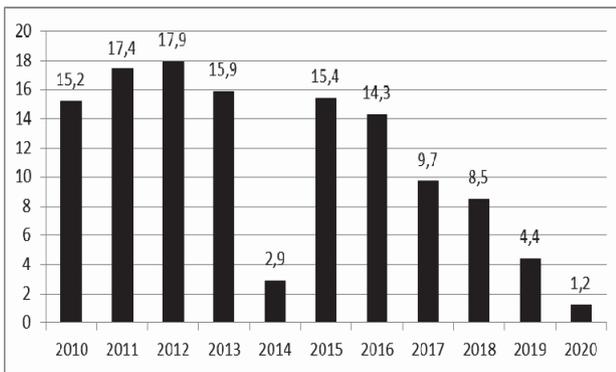
It is necessary to emphasize that there are several problems in the Ukrainian economy, which are caused by the world financial crises, and which could prevent a successful introduction of any government actions in the national debt management:

- ◆ the confidence in the performance of banks has been broken;
- ◆ falling of real GDP per capita;
- ◆ rise of unemployment rate;
- ◆ decline of direct foreign investments;
- ◆ devaluation of the national currency;
- ◆ difficulties on credit markets and need for state intervention;
- ◆ decline of international trade, etc. [14, p. 207].

It is obvious that the pros and cons of the external debt growth are quite significant. Therefore, the government should have specific tools to influence effectively the national debt. Obviously, the practice of recent years has proven that the policies of the national debt management in Ukraine are inefficient, reacting with delay and can not solve the most urgent problems in the financial system. According to many researchers, it should be a system of direct and indirect measures. However, indirect methods are preferable, because “direct control over capital flows encourages economic agents to rent-seeking and isolates the internal capital market” [2, p. 18].

The policy of the national debt management should be adopted on the government level, because critical levels of the national debt could cause a real threat to the national financial security and even limit the national sovereignty. It is believed that if the national debt exceeds 50% of the GDP and the costs of the debt service are more than 30% of exports, than it constitutes a menace to the country [12, p. 8]. Ukraine is close enough to these figures and, taking into account that the country was involved in the assistance program of IMF in 2009, we have to admit that the situation is becoming critical.

For example, according to the Ministry of Finance of Ukraine [8] in the next 10 years the repayment of the public administration sector's debt will have the tendency, shown in Figure 1 (taking into account that principal remains unchanged).



\*Source: The Ministry of Finance of Ukraine.

**Fig. 1. Debt depreciation of the public administration sector in 2010-2020 (billion UAH)\***

## 2. Recommendations

The government should take several steps to minimize budget costs during the crisis, including the following:

1. To abandon attempts to increase the authorized capital of financially weak banks, not excluding the possibility of the bankruptcy of large banks, and to limit financial support to the subsidiaries of transnational banks.
2. To improve liquidity-support mechanisms and procedures of banks.
3. To initiate the process of restructuring the external debts of corporate borrowers.
4. To refrain from financing budget deficit through emission and keep the moderate course of monetary policy.
5. To set up the limit of the budget deficit at a 3%-level of GDP.
6. To strengthen the role of the internal market loans in the financing of budget deficit, to issue government bonds with floating rate, to issue savings bonds and distribute them among individuals.
7. To continue cooperation with international financial institutions and follow the restrained policy of attracting foreign loans from foreign governments [4, pp. 49-51].

In addition to the public sector debt, the share of which is 14% of the gross national debt, there is a

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significant share of obligations of other entities. It is much more difficult to influence them by the government. We would like to underline the positive aspect of these obligations – the majority of them are long-term. However, we can't exclude the possibility that those debt repayments could considerably influence Ukrainian economy in the future. Therefore, the Government and the National Bank of Ukraine together with the major debtors should develop an action plan to restructure their debts, especially those ones, which must be paid to non-residents. The following debt restructuring schemes could be used:

- ◆ respite of payments (prolongation);
- ◆ new loans used for the payment of previous debts;
- ◆ debt cancellation or its redemption;
- ◆ exchange debt for shares in domestic enterprises or the national currency;
- ◆ securitisation of debt [6, p. 251].

In addition, the authorities should carry out a series of steps to:

- ◆ replenish the reserves to a level sufficient to meet the basic needs of residents in foreign currency;
- ◆ improve the financial management of state enterprises and introduce a stricter control of the Ministry of Finance over external loans;
- ◆ strengthen the prudential regulation and establish the exact requirements for bank reserves, especially to the credits in foreign currencies.

## Conclusion

Summarizing the above-said, we should emphasize that national debt in Ukraine needs to be optimized according to the terms, currencies, and interest rates. The government must pay attention not only to obligations of the public sector, but also to the debts of other entities. The effectiveness of the policy of the national debt management will be determined by the gradual reduction of the gross national debt in the long run.

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