

# UKRAINE'S RESILIENCE TO CRISES: PUBLIC DEBT



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The Centre for Economic Strategy is an independent research agency on public policy issues. The mission of the CES is to support reforms in Ukraine in order to achieve sustainable economic growth. The Centre contributes to the development of Ukraine's economic growth strategy, performs an independent analysis of the most important aspects of national policy, and works on strengthening public support for reforms. It was established in May 2015

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- Free and fair competition
- Reducing the role of the state due to improving its effectiveness
- Information transparency and freedom of speech
- The rule of law and the protection of private property
- Healthy and stable public finances
- Knowledge-based economy.

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# 1. DEFICIT AND DEBT AS A METRIC OF FISCAL SUSTAINABILITY

*Public debt is assessed to be sustainable, although risks remain very high—especially in case of further unexpected shocks to the exchange rate and/or GDP, as in the adverse scenario, which could render debt unsustainable.*

Public and External Debt Sustainability Analysis,  
1<sup>st</sup> review under the stand-by arrangement,  
IMF Country Report

It is now possible to stipulate that the fiscal and banking policies in 2016-2019 gave Ukraine a strong safety margin. As the Ministry of Finance faced the COVID-19 crisis and a 4% drop in GDP in 2020, it was forced to increase the budget deficit by 2.7 times compared to 2019, or up to 5% of GDP. Government guarantees issued to Ukravtodor and other state-owned companies in 2020, as well as c, "pulled" another 1.1 % of GDP. Thanks to the accumulated cushion of strength, public finances did not drop into the abyss.

In general, the situation in public finances, despite the two years of crisis, looks rather promising: the debt burden has been contained and the deficit has been reduced. This is to be encouraged. But the attitude of parliamentarians to budget allocation, the high share of foreign currency debt and the large nominal funding requirements for short-term debts and deficits, as well as the troubled segment of state-owned companies, are a cause for concern. If fiscal risks materialise, public finances could collapse.

This note presents the analysis of the Centre for Economic Strategy and the views of the panelists who participating in the forum "Ukraine's Resilience to Crises: A Look into the Near Future"<sup>1</sup>, organised by the Centre for Economic Strategy on 8 December 2021.

## 1.1. BUDGET DEFICIT: IS THERE ANY REASON TO BE CONCERNED?

The budget deficit in 2019 was only 2% of GDP, considering all fiscal and non-fiscal expenditure. Increasing it to 5% was not a big concern. If one imagines that the 2019 deficit would have been at 5-10%, as it was in 2010-2013 (given the off-budget burden), it would not be painless to raise it.

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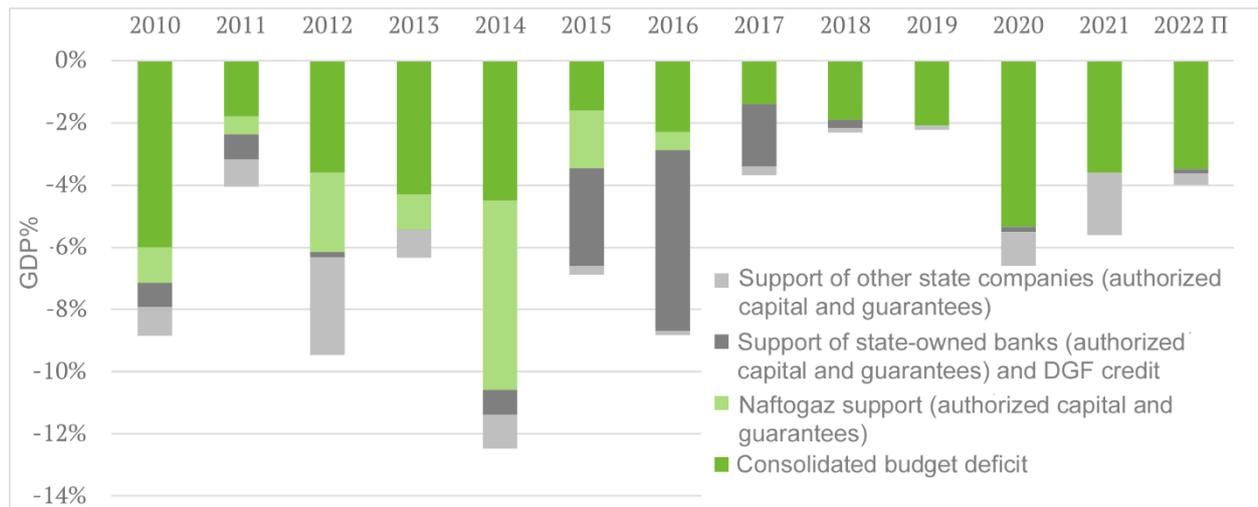
*We are getting used to the budget deficit figures of hundreds of billions of hryvnias. This is an extraordinary challenge. The budget balance problem is a problem for the entire government, and a problem for the country's financial stability.*

*Victor Pynzenyk, former Vice Prime Minister and Finance Minister of Ukraine, member of the Supervisory Board of JSC "Mahistralni Gazoprovody Ukrainy"*

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<sup>1</sup> <https://ces.org.ua/ukraines-resilience-to-crises/>

Figure 1. Public finance deficit by components



Source: State Treasury, Cabinet of Ministers, Ministry of Finance, Verkhovna Rada, State Statistics Service, CES calculations

If the MPs and the government do not hastily spend several dozens of billions of hryvnias in the final days of 2021, the budget deficit of 2021 may turn out to be far less than the planned 5.6% of GDP thanks to the deflator growth (and consequently the nominal GDP) at a higher pace than it was projected in the budget planning. Currently the NBU's projected GDP of 5,190 billion UAH and the planned budgeted deficit of 247 billion UAH already indicate a deficit-to-GDP ratio of 4.8%. Market analysts forecast an even lower figure. If the extra-planned revenues were not spent immediately, it would reduce the interest costs and the debt burden in the following years.

But traditionally MPs, when they witness extra-planned budget revenues, prefer to spend them quicker. For Ukraine, a country with costly borrowing, such decisions are a shot in its own foot. This year alone MPs have added 64 billion UAH to the revenues and expenditures when amending the budget, which is about a quarter of the planned limit. They prefer to spend this money, but not to reduce borrowing.

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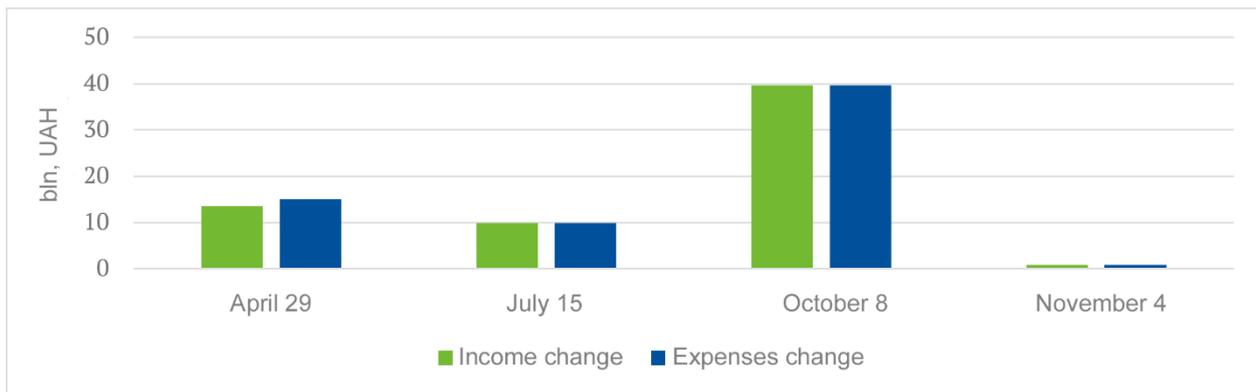
*Revising the budget should be an extraordinary circumstance. This year there was every chance of reaching a different deficit figure. But according to the latest revisions a revenue increase is already planned.*

*Victor Pynzenyk, former Vice Prime Minister and Finance Minister of Ukraine, member of the Supervisory Board of JSC "Mahistralni Gazoprovody Ukrainy":*

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Every year in November and December, public budget managers receive millions from the treasury, which must be disbursed before the end of the budget year, otherwise they will be wasted. The quality of such "spending" is questionable. At the same time, the Ministry of Finance actively manages to cover the borrowing plan on the open market by increasing debts.

Figure 2. Changes in income and expenditure as amended in the Budget Act 2021



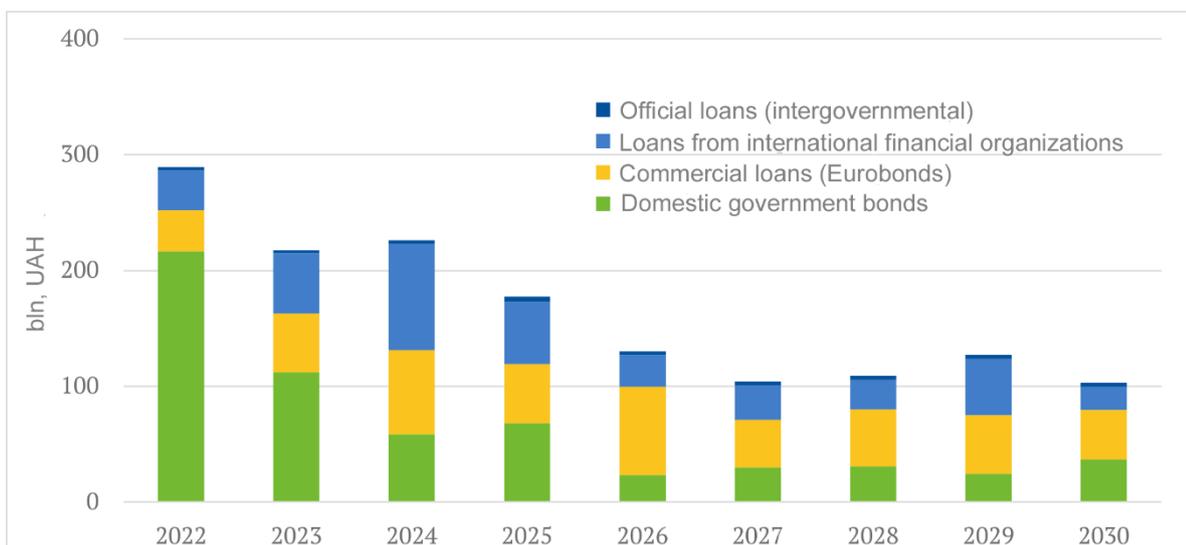
Source: Verkhovna Rada of Ukraine website

The public budget deficit is expected to fall to 3.5% of GDP in 2022. The government is returning to a prudent fiscal policy after the crisis years. The primary balance (the public budget balance before interest payments on debts) will almost return to the surplus range as it was before COVID-19 crisis. There is finally fiscal consolidation, albeit not to the fullest extent.

## 1.2. DEBT REPAYMENT: WHEN WILL THE BURDEN REACH ITS PEAK?

Ukraine does not have to extinguish substantial amounts of debt - external debt repayments will peak in 2025, while domestic repayments are usually successfully refinanced by Ukraine. The next two years of external debt repayments are moderate.

Figure 3. Debt repayment schedule



Source: Ministry of Finance of Ukraine, projected public debt payments for 2021-2046 under existing agreements as of 01/09/2021

The risk is that half of the medium-term external debt is corporate debt. Now this debt costs 1-2% per annum, but if we are to turn to commercial loans or Eurobonds to refinance this debt (5-7% per annum), the servicing costs could increase significantly with an additional USD 300-500 million for debt servicing.

The IMF sees several types of external shocks and is testing the capacity of countries to withstand them. The red flags regarding the potential damage to public finances by external shocks are now as follows:

Table 1. Ukraine Public DSA—Risk Assessment

Debt burden 70% of GDP (The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant)	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Financing needs of 15% of GDP (The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant)	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Debt profile (the cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white)	Market Perception (benchmark – 200 and 600 basis points for bond spreads)	External Financing Requirement (benchmark – 5 and 15 percent of GDP)	Change in the Share of Short-Term Debt (benchmark – 0,5-1%)	Public Debt Held by Non-Residents (benchmark – 15-45%)	Foreign Currency Debt (benchmark – 20-60%)

Source: IMF Country Report No. 21/250, Annex II. Figure 1. Ukraine Public Debt Sustainability Analysis – Risk Assessment

Thus, the IMF sees no risks in the debt burden per se, but problems may arise from the need for financing - even in the baseline scenario they exceed the safe benchmark. In general, the quantitative debt-to-GDP ratio is not a concern for analysts either.

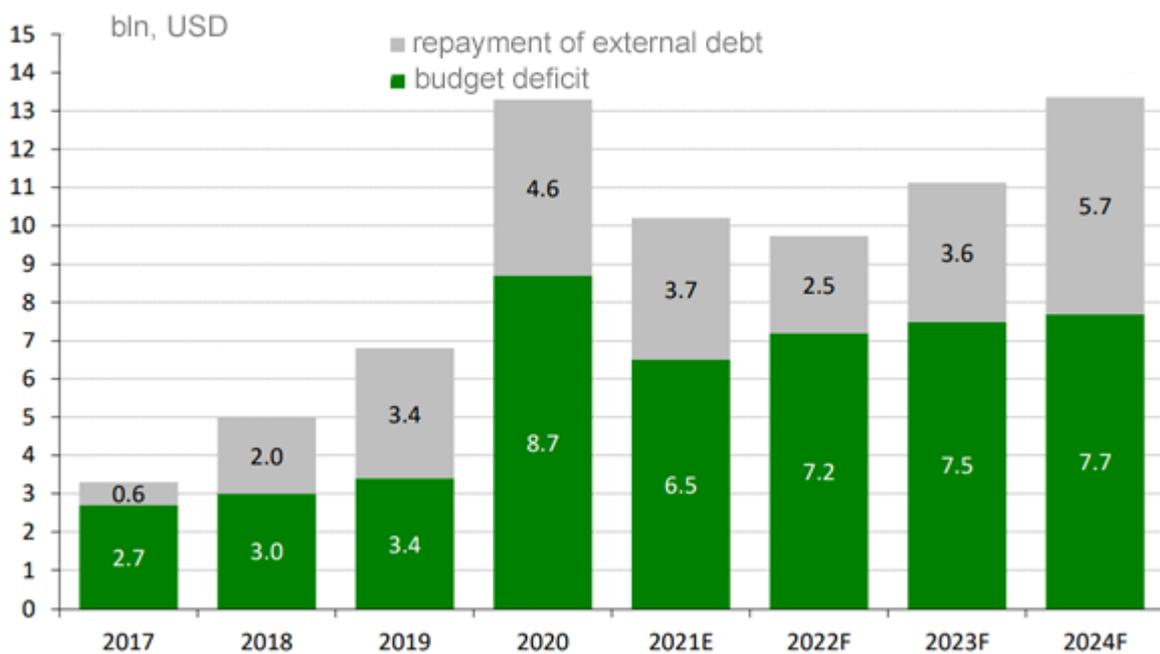
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*Ukraine's public and guaranteed debt to GDP ratio will be 50% for 2021 and 2022. This is a moderate level, even by the standards of countries with higher credit ratings than Ukraine. The financing needs, however, remain a challenge. The total forecasted budget deficit and external debt repayment in 2022 will be USD 9.7 billion - a much larger financing need than, for example, in 2017-2019 (USD 3.3-\$6.8 billion).*

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Olena Bilan, Chief Economist at Dragon Capital.

Figure 4. Large financing needs as a constraint to fiscal sustainability



Source: Dragon Capital calculations for CES forum “Ukraine’s Resilience to Crises: A Look into the Near Future”

The second issue is the high share of debt denominated in foreign currency. Both IMF experts and Ukrainian analysts agree on this. Hence, it raises currency and refinancing risks.

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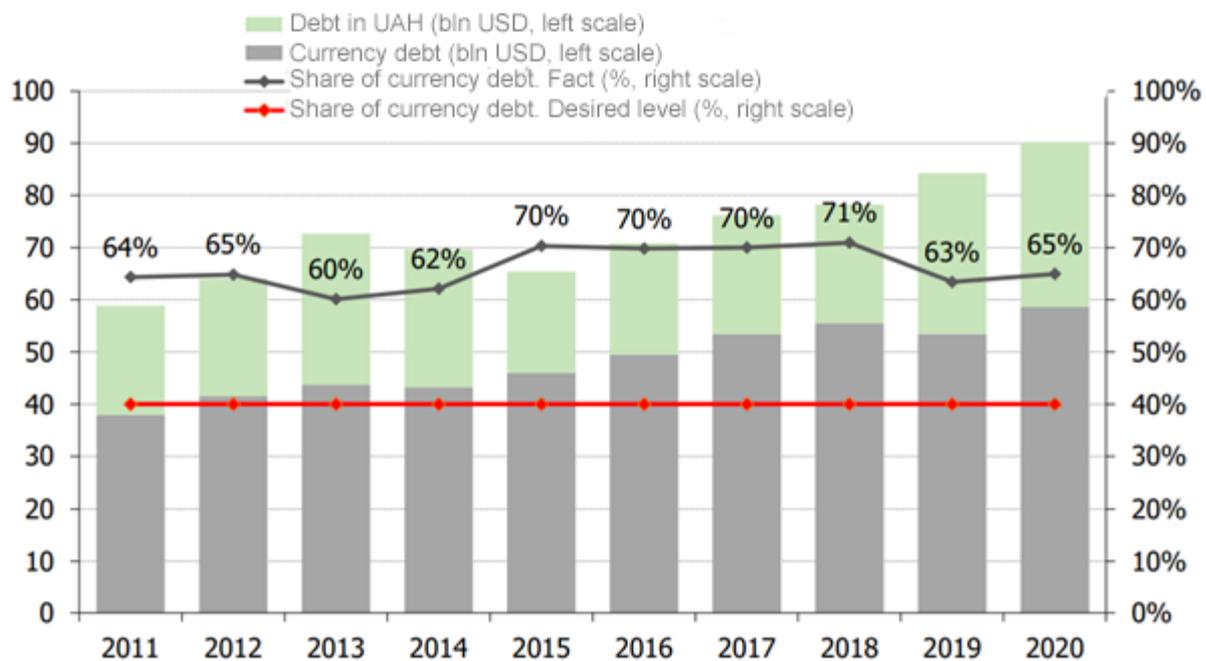
*The share of foreign currency debt was 65% in 2020 and the desired level for fiscal sustainability is 40%. At this level Ukraine would have received, all other things being equal, a one-notch credit rating upgrade.*

*Olena Bilan, Chief Economist at Dragon Capital.*

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Not only public debt is at risk because of its currency structure - so are the debts of state-owned companies. At the beginning of 2021, five enterprises had 100% of their liabilities in foreign currency: SE SFGCU, NEC Ukrenergo, SE Zorya-Mashproekt, SE Yuzhmash and SE MA Boryspil. In other state-owned companies, the share ranges from 71.8% to 92.8% (see the chart in the same briefing series 'Ukraine's Resilience to Crisis: State-Owned Enterprises').

Figure 5. Currency structure of public debt as a risk to fiscal sustainability



Source: Dragon Capital calculations for CES forum "Ukraine's Resilience to Crises: A Look into the Near Future"

### 1.3. ARE DEBT SERVICE PAYMENTS AFFORDABLE FOR UKRAINE?

The high debt-servicing cost is one of the central problems of public finance. While the debt-to-GDP ratio is moderate, market interest rates for Ukraine reflect high risks and are among the highest in the world. In 2021, interest payments represented 13%<sup>2</sup> of state budget revenues. But if the payments are measured by total general government revenues (including local budgets and the pension fund), interest payments reach 7.3%<sup>3</sup>. This is even lower than the median for countries with comparable credit ratings.

<sup>2</sup> Planned figures, subject to change, for October 2021

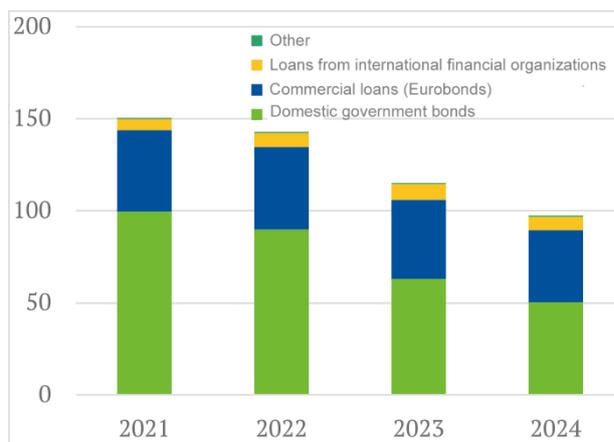
<sup>3</sup> Dragon Capital calculations

Figure 6. Interest payments, % of state budget revenues



Source: State Treasury Service of Ukraine, State Statistics Service, CES calculations

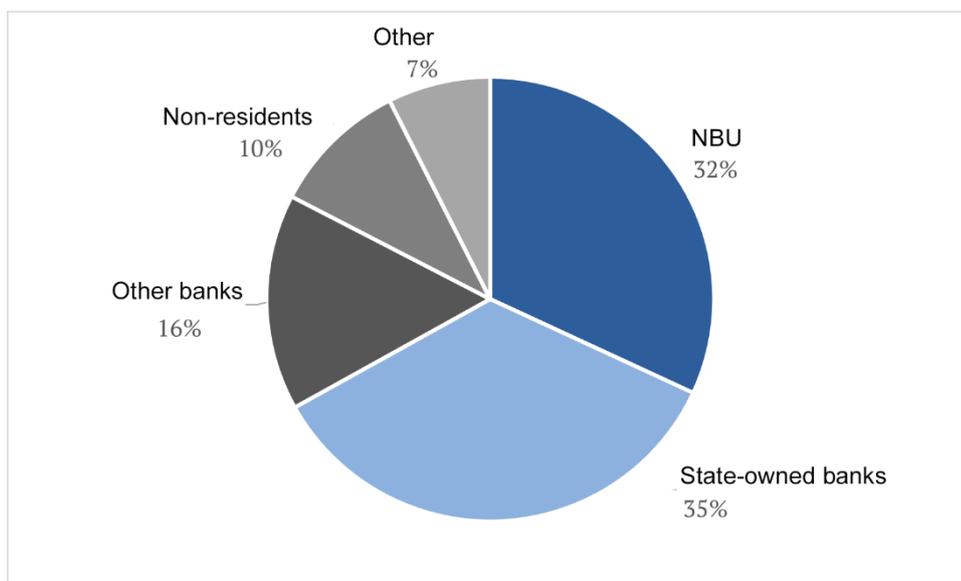
Figure 7. Estimated debt service payments, under current agreements, UAH bn



Source: Ministry of Finance of Ukraine

But, only more than half of these payments go to private investors. The rest continue to circulate in public finance: treasury payments go to the NBU and state banks. The point is that they are the biggest holders of domestic government bonds, Ukraine's most expensive domestic debt. The NBU owns about 36% of all hryvnia-denominated government bonds issued, while state banks own another 35%. This totals 71% of government bonds in circulation.

Figure 8. Structure of government bondholders as of 1 October 2021



Source: NBU

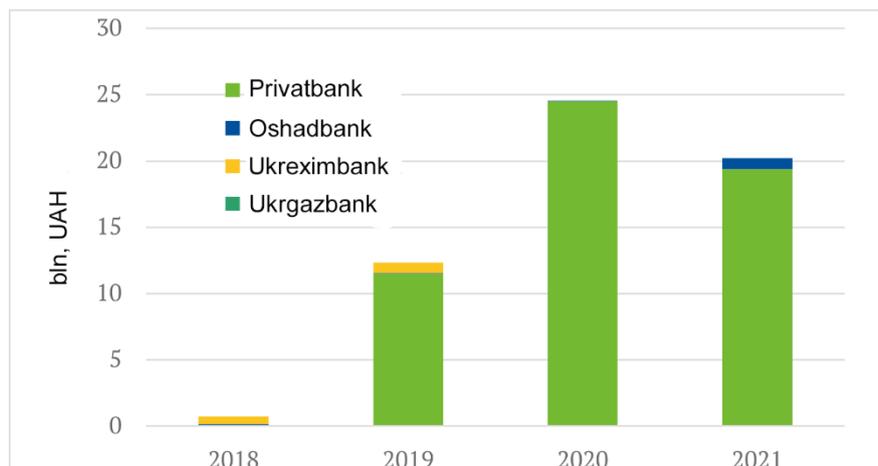
Accordingly, the government will transfer about UAH 60 billion of the UAH 90 billion interest payments on government bonds expected for 2022 into its "other pocket", according to a very simplified calculation<sup>4</sup>. This is about 40% of the cost of servicing both internal and external debts.

<sup>4</sup> Does not take into account the different interest rates of different series of government bonds in the portfolios of different owners. The calculation is simplified by assuming that the ratio of interest payments will be the same as the ratio of government bonds in ownership.

Meanwhile, the National Bank of Ukraine returns to the budget a fraction of the interest payments received each year as NBU profits, which are transferred to the budget according to the law "On the National Bank". In 2019, the NBU received UAH 32.5bn of interest income from the government and transferred UAH 64bn to the budget. In 2020, the NBU received UAH 28bn in interest payments and transferred UAH 43bn to the budget.

The situation with state-owned banks, although similar, is somewhat worse. Four state banks received UAH 27bn in interest payments for government bonds in 2020,<sup>5</sup> Privatbank transferred UAH 19bn in dividends to the budget for 2020. The other state-owned banks did not transfer such volumes to the state, and Ukreximbank had to be additionally funded.

Figure 9. Dividends from state-owned banks



Source: Case Ukraine, "State-owned banks: a suitcase without a handle"

This mitigates the situation in terms of fiscal risks but does not help to reduce the tax burden - the funds collected from taxpayers are still used for public redistribution.

## 1.4. STATE-OWNED ENTERPRISES: IS THERE A THREAT TO FISCAL SUSTAINABILITY?

So far, guarantees and quasi-fiscal expenditures to support state banks and state-owned enterprises are the most threatening elements for fiscal sustainability right now.

This is pointed out by the Ministry of Finance in its fiscal risk report and by the IMF in a memorandum.

<sup>5</sup> Source - Annual consolidated IFRS financial statements of Privatbank, Sberbank, Ukreximbank and Ukgazbank.

Figure 10: Matrix for assessing fiscal risks by source in 2022

Potential fiscal impact	High (> 0.5% of GDP)			Public sector activity
	Medium (0.1-0.5% of GDP)		Macroeconomic environment  Public and guaranteed debt management	Financial sector  Failure to meet the privatisation revenue plan  Pension sector
	Low (<0.1% of GDP)	Public-private partnerships  Emergencies		
		Low (<33%)	Medium (33-66%)	High (>66%)
		Probability of fiscal risk occurring		

Source: Ministry of Finance of Ukraine

Aggregate taxpayer expenditures to support state-owned banks over the past 12 years have exceeded UAH 370bn (\$21bn at the historical exchange rate).<sup>6</sup> Six of the top 10 state-owned enterprises in 2020 were unprofitable (cumulative loss of UAH 84bn). Collectively, the top 10 state-owned enterprises in 2020 had financial debts of UAH 191bn - long-term and short-term loans and bonds issued.

Table 2. Selected Financial Statements of Top 10 State-Owned Enterprises, UAH bln

	Total income from sales	Total aggregate (loss)/profit
<b>Naftogaz</b>	193,0	-33,2
<b>Ukrzaliznytsia</b>	75,3	-12,4
<b>Ukrenergo</b>	58,2	-27,5
<b>Energoatom</b>	45,6	-4,8
<b>Centrenergo</b>	20,6	0,1
<b>Ukrhydroenergo</b>	13,2	4,1
<b>Ukrposhta</b>	9,2	0,2

<sup>6</sup> State banks: a suitcase with no handle, Case Ukraine.  
<https://case-ukraine.com/ua/publications/derzhbankyl>

Ukrainian Sea Ports Authority	7,4	2,6
State Food and Grain Corporation	7,1	-5,9
Roads of Ukraine	5,4	-0,1

Source: Financial statements of companies for the previous year 31 December 2020

For two years in a row, there has been no budget cap on the provision of state guarantees. This means that the government outside parliamentary control can provide debt guarantees, and it takes advantage of this. This, in effect, increases the 'off-budget', quasi-fiscal deficit, because the government is obliged to repay these debts if the state-guaranteed company cannot repay them.

The IMF Memorandum also draws attention to this risk, recommending that extra-budgetary expenditure, such as capital increases for state-owned companies or issuance of government guarantees, should be closely monitored. In the case of Ukraine, both should be added to the analysis of the wide range of public finances - in 2021 such extra-budgetary expenditures already amounted to 1.5% of GDP - the guaranteed debts of GarPoc, Ukravtodor, Ukrrenergo and Ukrzaliznytsia, as well as the charter capital increases of Ukrfinzhytlo and the Export-Credit Agency. Previously, considering the additional funding of Naftogaz and state-owned banks, such spending reached 8% of GDP (2014) and significantly worsened public finances. Now, unless the government changes its policy of low tariffs in the energy sector, the difference with market prices will need to be compensated from the budget and the debt risks will increase.<sup>7</sup>

## 2. HOW DOES THE STATE RESPOND TO CHALLENGES?

The Ukrainian government has implemented several measures to strengthen public finances: by introducing medium-term planning, reducing the planned budget deficit to 3.5% of GDP and, in a memorandum with the IMF, committing to conditions that meet the principles of fiscal sustainability, including reducing Quasi-fiscal risks. Further cooperation with the IMF allows other IFIs and official lenders to raise funds at low interest rates and refinance short-term debt on favourable terms.

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*The Ministry of Finance, just like analysts, sees a problem with the debt structure - a high share of foreign currency borrowings. To reduce it, it is working on the domestic debt market development, attracting investors and expanding their range and adjusting the range of instruments accordingly. The Ministry of Finance focuses on domestic government bonds in local currency, which reduces both currency and refinancing risks. In the medium term, the MoF will probably abandon domestic government bonds in currency. But for the purposes of meeting large funding needs, the capacity of the local market is limited.*

*Polina Yarova, director of the Debt Policy Department at Ministry of Finance of Ukraine.*

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<sup>7</sup> See the brief in the same series, "Ukraine's Resilience to Crises: Energy Resilience".

On December 9th, 2021, the government approved a medium-term public debt management strategy for 2021-2024.<sup>8</sup> It defines four main objectives for public debt management, which are fully in line with the goal of increasing fiscal sustainability:

1. Increasing the share of state debt in state currency.
2. Extending the average maturity and ensuring an even repayment schedule of public debt.
3. Attracting long-term concessional financing.
4. Continued development of strong investor relations and further improvement of the state debt management policy.

The Budgetary Declaration for 2022-2024<sup>9</sup> envisages a gradual reduction of the budget deficit from 3.5% of GDP in 2022 to 2.7% of GDP in 2024. So, the new policy of the Ministry of Finance is fully in line with the objectives of fiscal sustainability. It is important that MPs and the government share these aspirations.

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*Unfortunately, the Ministry of Finance is essentially the only strong 'island' of fiscal culture. It is important that other authorities get used to this. The problem of balancing the budget is a problem of the country's financial sustainability. It should be seen not only by the Ministry of Finance, but by all authorities - the Parliament, the Government, and the President.*

*Victor Pynzenyk, former Vice Prime Minister and Finance Minister of Ukraine, member of the Supervisory Board of JSC "Mahistralni Gazoprovody Ukrainy".*

*The Ministry of Finance cannot cope on its own in complying with fiscal rules and best budget practices, when the rest of the authorities see the budget only from one perspective - as a source of funds to finance their needs.*

*Oleksandra Betliy, a leading researcher at the Institute for Economic Research and Policy Consulting.*

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<sup>8</sup> Medium-term Public Debt Management Strategy 2021–2024, Ministry of Finance

<sup>9</sup> Budgetary declaration for 2022–2024, Ministry of Finance

### 3. RECOMMENDATIONS

In addition to the measures already listed in the budget declaration and the public debt management strategy, the government and the parliament could be advised to focus on the following activities to increase fiscal sustainability and reduce debt risks:

- Reduce state involvement in the banking sector. State banks have received a large amount of government bonds with additional funding. In addition to the capital contribution, the state pays the banks billions of hryvnia in additional interest payments each year.

State banks can require additional capital if macroeconomic conditions deteriorate. With weak rule of law, they can easily become a tool in a political game or "instructive lending".<sup>10</sup> This would entail new losses of taxpayers' money. The state's share in the banking sector (47% at the end of October) needs to be reduced by mass privatisation.

- Conduct a corporate governance audit of companies with state-guaranteed debt and ensure that for the next few years financial plans are developed and adopted that allow for repayment or refinancing of debts without the need for budgetary resources or new state guarantees.

The government needs to moderate the appetite of state companies, and the parliament should ensure that such initiatives will not be supported.

- Study the methodology of credit ratings assigned by the major credit rating agencies and aspire to improve Ukraine's credit rating.
- Reintroduce fiscal caps in the Budget Law - in particular, the Budget Code's provisions for the budget deficit limit (up to 3% of GDP and within the limits specified in the Budget Declaration) and the limit for the government guarantees (3% of planned revenues of the general government budget fund).

Consideration should also be given to introducing an additional rule in the budget regulations on the management of budget revenue revisions during the year to prevent the immediate "eating away" of excess revenues.

- Examine international debt relief initiatives for a green and just recovery, and actively promote the issue in the platforms of the IMF, G20 and others.
- Reduce the share of foreign currency debt by meeting billions of dollars in financing needs, it is necessary to involve hryvnia. To do so, the local market should be developed, and the potential circle of investors should be expanded.

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*Non-residents are now a very volatile source of demand for Ukrainian currency-denominated government bonds, and Ukrainian banks already have oversaturated government debt portfolios. A further increase in the share of government bonds in bank assets will force banks to crowd out lending to the private sector. A separate dialogue on how to increase the demand for government bonds and part of hryvnia debt is worthwhile.*

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<sup>10</sup> For more, see Banking fragility rooted in justice failures, Centre for Economic Strategy.  
<https://ces.org.ua/banking-fragility/>

*Olena Bilan, Chief Economist at Dragon Capital.*

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- It is important to avoid issues that might alarm investors and rating agencies and create a negative news backdrop.

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*Negative examples from the recent past include careless comments on the sovereign default, non-payment of funds to green energy investors after the issue of relevant green Eurobonds, the president's public confrontation with Rinat Akhmetov and claims of a coup d'état, failure to fulfil the IMF promises on anti-corruption bodies, etc.*

*Yaroslav Zheleznyak, MP, First Deputy Head of the Parliamentary Committee on Finance, Tax and Customs Policy.*

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- The role of the Ministry of Finance among other authorities and its institutional capacity should be strengthened.

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*The role of the Ministry of Finance, as opposed to line ministries that are in charge of their own fields, is to see the big picture in terms of financing the needs of all authorities. The Ministry must be heard in the Government, the Parliament and the President's Office when it comes to budgeting and public debt management. The Fiscal Risk Report of the Ministry of Finance should be read by all members of the Parliament and the Government.*

*Oleksandra Betliy, a leading researcher at the Institute for Economic Research and Policy Consulting.*

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