Focus Paper 08:
Ukraine: War and Debt Crisis

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Ukraine: War and Debt Crisis

by Jürgen Kaiser

Even before the Russian invasion, Ukraine was a critically indebted country, one which could easily slip into debt distress if an external shock occurred. With the Russian attack in February 2022, this shock occurred on the greatest possible scale. The war initiated by Russia is an extreme hit to the Ukrainian economy. The destruction of vital infrastructure, the traumatisation of a large part of the population, the loss of human lives and the loss of livelihood for the survivors will add up to a situation that is completely unsustainable in economic and fiscal terms. The following considerations assume that there will continue to be an independent Ukrainian state after the end of the fighting – which is uncertain at the end of the editorial deadline of this focus paper. The economic potential of an independent Ukrainian state after the end of the war will depend crucially on whether there is a sustainable solution to the problem of external debt.

At this moment (September 2022), this focus paper is intended to accomplish two things: first, Ukraine's current debt situation is analysed. Second, options are presented for a possible debt settlement after the end of fighting and under the condition of a continuing independent Ukrainian state. To this end, the initial situation before the onset of the aggression is first considered to then take a closer look at the differing types of financing received by the Ukrainian state for its self-defence. Finally, there is a discussion on the question of how the foreseeably unsustainable debt can be reduced once the war ends so that the Ukrainian state has a chance of self-determined reconstruction.

The build-up of the current debt situation is divided into three phases because their data come from different sources and, therefore, are not necessarily coherent. The resulting overall picture shows the situation after six months of war, at least in terms of magnitude. In fact, correct debt levels and indicators can only be established in a binding manner in the course of a debt restructuring process during the "verification of claims" that is then necessary.

1 Ukraine's accumulation of debt in three phases before and during the war

1.1 Phase 1: Ukraine's debt situation on 31.12.2020

Debt is not a problem in absolute terms, but only if it is disproportionate to the debtor's economic performance. The main and most common debt indicators therefore reflect different ratios between a country's indebtedness and economic performance. Coherent debt indicators for Ukraine are available for the end of 2020.[1]

[1] The World Bank's *International Debt Statistics* provide coherent data for more than 120 low- and middle-income countries. All of them are based on information provided by the debtor countries themselves, and are therefore not necessarily compatible with information provided by creditors.

In Ukraine, the ratio of external debt to various levels of economic performance was above the limits used to assess the sustainability of debt at that time (cf. Table 1). In the case of the indicator "external debt as a percentage of gross national product," this means that the Ukrainian economy had more external payment obligations than corresponded to its economic abilities. This is also due to the fact that, despite Russia's military aggression in the Donbass and Crimea, the initial development of Ukraine's economy had been surprisingly positive since the near-bankruptcy of the state in 2015 – albeit on credit.[2]

Table 1: Ukraine's debt indicators (as of 31.12.2020)

Indicator	Value of Ukraine	Threshold
External debt as a percentage of gross national product	82.2%	40%
External debt in relation to annual export earnings	214.2%	150%
External debt service in relation to annual export earnings	29.5%	15%
Ratio of public debt to GDP	60.8%	50%
Ratio of public debt to public revenue	151.2%	200%

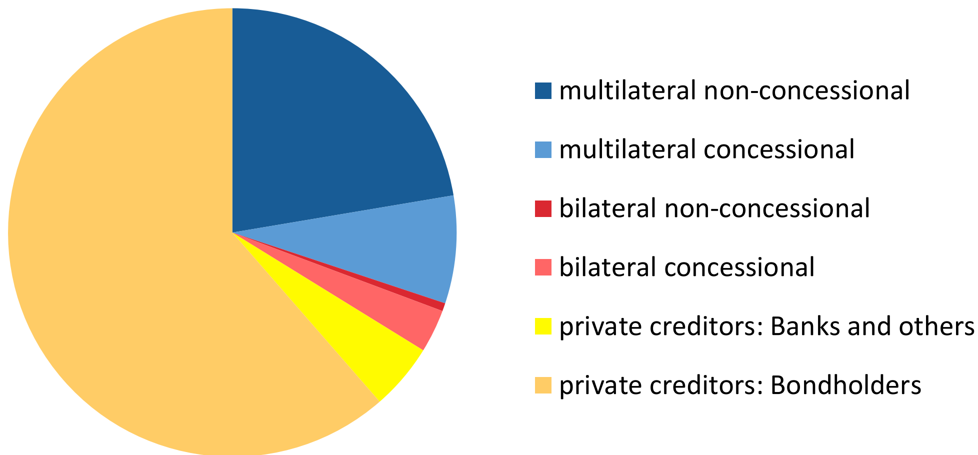
1.1.1 Creditors of Ukraine before the beginning of the war

Of the nearly USD 130 billion of external debt at the end of 2020, USD 24 billion are short-term debt with maturities of less than one year, which cannot be taken into account in a debt restructuring. The greater part of the total foreign debt, which is attributable to private Ukrainian debtors, is initially not considered further here, since at this point the economic capacity of the Ukrainian state is of primary interest, while private debt may become the subject of private insolvency proceedings at home or abroad. The public sector held USD 41.5 billion of long-term debt at the end of 2020. Of this amount, USD 27 billion was owed to private creditors and nearly USD 14 billion to public creditors.

The following graph shows which types of foreign lenders Ukraine was indebted to at the end of 2020.

[2] The limit values used here follow the logic of the annual debt report issued by erlassjahr.de and MISEREOR. For explanations, cf. Debt Report 2022, erlassjahr.de/produkt/schuldenreport-2022.

Figure 1: Creditor profile of Ukraine's public external debt (as of 31.12.2020)



As of 31 December 2020, the Ukrainian state was dependent on the international bond market for three-fifths of its external financing ("Private: Bonds" segment). Only multilateral donors, among which the World Bank features prominently, and which, with almost USD 6 billion, accounts for more than half of all claims from multilateral banks, as well as the International Monetary Fund (IMF) – the largest single creditor with more than USD 12 billion – still play a relevant role outside the bond market as financiers of the Ukrainian state.

Prior to the war, Ukraine barely owed any debt to other governments, whether through trade or development cooperation. However, there are sometimes considerable discrepancies between the information provided by the debtor and that provided by the creditor.[3]

Excursus: Russia as a creditor

Prior to the start of the war, since 2015 Ukraine had been in a dispute with Russia about the repayment of a Eurobond of around USD 3 billion, which Russia had bought in its entirety from the then-President of Ukraine, the pro-Moscow Viktor Yanukovych, shortly before his overthrow in 2013. In 2015, Ukraine negotiated a debt restructuring agreement with investors holding USD 18.5 billion of government bonds. It exchanged the old securities for new, partially indexed bonds, which promised a higher coupon for the eventuality of higher economic growth in Ukraine. Among the creditors at the time were large funds such as *Franklin Templeton* and the Brazilian investment bank *BTG Pactual*. Ukraine insists that the bond held by Russia should be included in the 2015 debt restructuring agreement, whereas Moscow does not view it as a normal bond, but as a loan agreement between states. Nevertheless, Russia also does not wish to negotiate the bond within the so-called Paris Club, where the claims of public bilateral

[3] According to the German Federal Ministry of Finance, for example, Germany is demanding EUR 29 million from development cooperation and EUR 46 million from federal guaranteed trade transactions. Based on Ukrainian data in the World Bank International debt statistics, Germany is owed USD 28 million from development cooperation, but the considerable amount of USD 282 million in trade loans. These incongruencies have their origin in the dual nature of the German *Kreditanstalt für Wiederaufbau*, which provides both federal funds and its own (commercial) loans. These distinctions are not always clearly understood in the finance ministries of recipient countries. Similarly, incorrect postings or time delays may occur if an originally private German claim is compensated on the basis of a Hermes guarantee, and only then does a debt owed to a private German exporter become a claim of the German state.

creditors are rescheduled. Instead, Russia insists on a privileged creditor status as enshrined in the bond contract, which gives priority to the Russian claim over all other public bonds.

As the bond was issued under English law, the case has since been brought before the courts of London. In 2017, the High Court initially ruled in favour of Russia. In November 2018, the Court of Appeal ruled in favour of Ukraine, whereupon Moscow appealed to the Supreme Court. The latter heard the parties in 2019, but has still not made a final decision.

1.1.2 Pre-war debt trend

In 2015 and 2016, Ukraine's debt indicators had risen sharply, apparently as a result of the first Russian act of aggression and the decline in economic output due to the annexation of Ukrainian territories (heavy industry in the Donbas region and tourism in Crimea). Unlike in other countries, the first year of the pandemic in 2020 had not yet had a dramatic impact on the debt situation.

1.2 Phase 2: Borrowings of Ukraine between 01.01.2021 and the start of the war on 24.02.2022[4]

Between 01.01.2021 and the beginning of the war on 24.02.2022, the foreign public debt of Ukraine had already increased noticeably.

Table 2: Development of the foreign debt of the Ukrainian state (in USD millions)

	As of 31.12.2020 according to the World Bank	As of 28.02.2022 according to the Ukrainian Ministry of Finance
Total public external debt	41,5189	56,860
- Bonds	25,553	24,450
- Private banks	1,996	2,870
- Multilateral creditors	12,429	28,040
- Bilateral public creditors	1,541	1,500

Against the background of the growing Russian aggression caused by the advance of troops on the Ukrainian border, there was also a significant shift from private to public, especially multilateral, creditors. The largest contribution to this was a commitment by the IMF under the *Rapid Finance Instrument* of around USD 1.3 billion (1,005.9 million SDRs).

1.3 Phase 3: Post-war debt situation – support for Ukrainian resistance through bilateral and multilateral lending

[4] All information according to Ukrainian Ministry of Finance is available at https://mof.gov.ua/en/borgova-politika

The country is receiving substantial financial and material support from many parts of the world, including prominent states that had previously been creditors of Ukraine. A substantial proportion of this support comes in the form of donations of material, money or services. This type of support is, of course, irrelevant to Ukraine's debt situation. However, a significant part of the support – in particular from multilateral sources – reaches the country in the form of loans, overwhelmingly on concessional terms. On the one hand, they expand the government's scope for maintaining public life in Ukraine, as well as its social and military self-defence. On the other hand, they carry the risk of making post-war Ukraine insolvent.

The comparison of the World Bank figures as of 31.12.2020, which are based on Figure 1, and the figures from the Ukrainian Ministry of Finance as of 31.12.2021 already showed three important trends even before the outbreak of the war, which intensified further in the third phase and will shape the debt situation of post-war Ukraine:

- increase in total debt by 13.5 percent within one year
- slow withdrawal of private bondholders from Ukraine
- significant increase in multilateral financing.

Based on research by *Ukraine Support Tracker* of the Institute for World Economy in Kiel, loan financing from bilateral and multilateral sources amounting to USD 17.1 billion in 2022 can be identified by the end of August.[5] Most of this comes from multilateral sources, namely the IMF, the World Bank Group, the European Bank for Reconstruction and Development, the European Commission and the European Investment Bank. The bilateral lenders are Japan, Poland, Canada, France, the United Kingdom, the United States and Germany. It is noteworthy that, even after the start of hostilities, the IMF's disbursements from the USD 2.2 billion programme that was already running before the war continued.

If these new loans promised until August 2022 are added to the USD 56 billion indicated by the Ukrainian Ministry of Finance, the Ukrainian public external debt will amount to at least USD 73 billion by mid-2022.

If this USD 73 billion amount is compared to the economic output forecast by the World Bank in March, which was reduced by 45 percent compared to 2021, and if private external debt is assumed to have remained unchanged, the ratio of all external debt to economic output is more than 100 percent. [6] The debt to annual export earnings indicator, which is even more important for solvency to foreign creditors and reflects access to hard currency from exports of goods and services, and which was already 60 percentage points above the critical level of 150 percent at the end of 2020, is likely to have developed even more dramatically due to the temporary blockage of Ukrainian wheat exports.

2 Post-war Ukraine debt scenarios and options for effective debt relief

The foreign debt aggregated in the previous chapters represents a snapshot of what is known up to the end of August 2022. Any current calculation of sustainability and need for relief must inevitably be

[5] A. Antezza, A. Frank, P. Frank, L. Franz, E. Rebinskaya, C. Trebesch (2022): "Which Countries help Ukraine and how? Introducing the Ukraine support tracker", IfW Kiel Working Paper 2218.

[6] With a predicted -35 percent, the IMF paints a somewhat less gloomy picture.

based on the assumption that the war will soon be over, without causing further economic destruction. With this hypothetical assumption, the most important parameters of a debt sustainability calculation – absolute debt level, average concessionality[7], repayment profiles and debt level in relation to economic performance, as well as the development of Ukraine's economic performance after the end of the war and financing requirements for reconstruction – are virtually frozen. Beyond this makeshift construct, quantifiable assumptions cannot be made, as with every further day of war (a) debt potentially continues to rise, (b) economic output continues to collapse in 2022 and thereafter, and (c) additional damage caused further increases the need for financing to restore pre-war normality.

Another aspect that is potentially very important, but not foreseeable for the restoration of debt sustainability, is the question of whether the aggressor can somehow be made to pay for the damage that it has caused. It must be borne in mind that the Russian economy will also be severely affected by the war and the sanctions it has triggered. The Ukrainian government recently discussed ways of securing new Ukrainian government bonds through Russian assets frozen in the West.[8]

According to the Statista platform, the estimate of direct damage to civilian infrastructure, including productive facilities and residential development, is just under USD 100 billion as of 18 April 2022[9]. Media reports are already talking of sums in excess of USD 500 billion.[10]

In view of these magnitudes, two predictions can already be made, regardless of when the war ends or its outcome:

a) **Ukraine will not return to a "normal" debtor-creditor relationship with its external lenders after the end of the war.** It is impossible for Ukraine to resume servicing debt in the medium term and then repay payment obligations from the pre-war period, as well as the new loans granted during the war. The holders of Ukrainian government bonds in particular, as well as bilateral and, presumably, multilateral public creditors, will have to adjust to a painful waiver of claims. This also applies if, following a peace agreement acceptable to the West, there is massive support for reconstruction from the European Union and other Western actors. The G7's announcement of a two-year debt moratorium in August 2022, which was soon followed by the private sector, is a recognition of this reality, and thus a step in the right direction.

b) **The instruments currently available to the international community are not sufficient to bring about a special debt restructuring arrangement for Ukraine.** Ukraine did not, and still does not, qualify for existing debt relief programmes, the Heavily Indebted Poor Countries (HIPC)

[7] Concessionality is the discounting of loans compared to a reference loan. The loan can be reduced by lower interest rates, longer maturities or a larger number of years off. Countries with lower incomes tend to have a more concessional debt profile because they receive a larger share of their loans through development finance on preferential terms such as these.

[8] Reuters: "Ukraine considers moves to issue debt receipts backed by Russian assets", 24.05.2022, www.reuters.com/article/ukraine-crisis-debtreceipts-idUKL5N2XG3U4. However, US Treasury Secretary Janet Yellen has rejected such considerations "at this time."

[9] Statista: "Estimated direct losses from damages to civilian infrastructure from the Russian invasion in Ukraine", www.statista.com/statistics/1303344/ukraine-infrastructure-war-damage", as of 18.04.2022.

[10] Handelsblatt: "Das Eine-Billion-Dollar-Projekt: Wie der Wiederaufbau der Ukraine gelingen soll.", 25.5.2022, https://www.handelsblatt.com/politik/international/kriegsschaeden-das-eine-billion-dollar-projekt-wie-der-wiederaufbau-der-ukraine-gelingen-soll-/28376432.html.

initiative, with which the G8 defused the debt crisis of the poorest countries at the turn of the millennium, and the G20 Common Framework, which is intended to help poorer countries overcome the consequences of the coronavirus pandemic. The Evian Approach of the Paris Club[11] could theoretically allow a far-reaching cancellation of the bilateral funds provided by other governments; however, as we have seen above, these are relatively small and an attempt to make a declaration on comparable debt relief by private creditors – as regularly attempted by the Paris Club – could lead to years of legal disputes with non-cooperative private creditors. Above all, this would not affect the seriously increased level of debt owed to multilateral donors.

Innovation in the field of global debt management, as has often been sought internationally – for example with the IMF's proposal for a Sovereign Debt Restructuring Mechanism in 2001[12] or the G77's proposal at the 2014/15 UN General Assembly[13] – and as sought by the German government with the obligation to create a state insolvency procedure in the coalition agreement, is therefore essential in the case of Ukraine.

However, an options menu linking the overcoming of Ukraine's unsustainable debt with the financing of reconstruction could include a number of measures that would not have to be invented, but would revive tried and tested instruments:

- For all bilateral and multilateral public claims provided to post-war Ukraine, a coherent and comprehensive debt restructuring must be negotiated along the lines of the HIPC initiative. An independent debt sustainability analysis would be important, since the traditional authors of such analyses – the IMF and the World Bank – are themselves creditors, in their role as major war lenders. For such a settlement, the negotiating format of a "debt conference", modelled on the London Conference of 1952/53, is conceivable, in which the (West) German pre- and post-war debts were reduced to a sustainable level in a coherent procedure.[14]
- The decree of the impossibility of enforcing private claims against Ukraine in the courts of the most important financial centres (New York and London) for a number of years. This measure had been declared for a shorter period of time in relation to Iraq's oil revenues in 2004 by the Security Council under the Paris Club arrangements. If the Council was unable to take such

[11] In 2004, the Paris Club of Western creditor countries made it possible, for the first time, for middle-income countries such as Ukraine to obtain real debt relief instead of merely extending payment obligations. In addition, unlike previous regulations, the *Evian Terms* allow the highly flexible adjustment of debt relief to the needs of the debtor country. See clubdeparis.org/en/communications/page/evian-approach.

[12] The *Sovereign Debt Restructuring Mechanism* proposed by the IMF in 2001 would have created a globally binding state insolvency procedure on the basis of the Articles of Agreement of the IMF, to which almost all countries in the world belong. However, the IMF had assigned itself the role of arbitrator. In 2003, the project was buried under pressure from the private sector, despite the support of the then German government and some other states.

[13] In 2014, the UN General Assembly decided, on the initiative of the G77, i.e. the group representing developing and emerging countries, to establish a multilateral legal framework for sovereign debt restructuring within one year. However, under pressure from the EU and the other industrialised countries, only non-binding debt restructuring guidelines were adopted in 2015; these have not had any discernible effect since then.

[14] See the London Debt Agreement www.erlassjahr.de/themen/londoner-schulddenabkommen.

actions, executive decrees, as unilaterally enacted by US President Bush at the time, could also serve the same purpose in the important financial centres of New York and London.[15]

- Private creditors should be given the opportunity to convert their claims into investments in reconstruction in Ukraine (known as *debt-to-equity swaps*) at high discounts of at least 90 percent.
- Private creditors willing to submit their claims under *debt for development swaps*[16] in cooperation with international organisations such as the United Nations Development Programme or the United Nations World Food Programme would be eligible for tax deductions.
- The IMF would have to urgently use the war in Ukraine as an opportunity to rethink its policy of surcharges. These burden countries that use IMF resources for longer periods than planned or in excess of the country's quota. In the case of Ukraine, this amounts to 423 million USD in the years 2021-2023 alone.[17]

3 Impact beyond Ukraine

If the international community, the western part of which is currently supporting Ukraine with great resolve, takes up such reform initiatives, this may also result in greater financial stability beyond Ukraine:

Ukraine is not the only victim of war on this planet, even if this may sometimes appear to be the case in the Western perception. The “forgotten wars” in East and Central Africa or Yemen are also affecting countries from which foreign creditors expect huge repayments in relation to their economic performance. In contrast to the 1919 Treaty of Versailles, the London Debt Agreement resulting from the aforementioned London Conference showed us how to deal with the debts of war-torn countries if we want to create leeway for a peaceful new beginning. There is no reason why the lessons learned should be applied in Europe alone.

[15] J. Kaiser und A. Queck: "Odious Debts – Odious Creditors? International Claims on Iraq", FES Dialogue on Globalization, 2004.

[16] In the case of a *debt for development swap*, the creditor waives a claim in hard currency if, in return, the debtor provides the same or a reduced amount in domestic currency for a jointly agreed development project. This may be agreed bilaterally within the framework of development cooperation or through one of the international organisations mentioned above.

[17] There has also been an advance in this direction in the US Congress, see: VOA News: VOA News: "IMF Fees on War-Torn Countries Closer to Elimination", 20.08.2022, www.voanews.com/a/imf-fees-on-war-torn-countries-closer-to-elimination-/6710273.html.