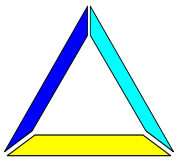
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Changing the Status of Government Debt to the NBU: Policy Options

Executive Summary

The government owes the NBU around UAH 9 bn, which is a sizeable amount for both MinFin and the NBU. The debt originates from 1991-1996, a time in which budget deficits were financed by NBU loans. There are some differences between the NBU and MinFin regarding the exact amount of the debt. Besides, the debt is not homogenous, neither with respect to currency nor to interest and repayment terms. Furthermore, the debt is not securitized and thus non-marketable. In short, it is not the kind of asset you would find in a modern central bank.

In our view, it is time to bury this relic of the old days of monetary and fiscal instability. Concretely, we suggest establishing a high committee with delegates from MinFin and NBU to make recommendations on how to restructure the debt. We think that the restructured debt should be only in hryvnia (currency unification). Also, the debt should be securitized and thus become marketable for the NBU. As to the maturity, we recommend to split it into two parts. One part of the new securities should have a relatively short term maturity of 1-3 years, while the other part's maturity should be 5-10 years. Most important, the securities should pay interests compatible with market conditions.

Besides drawing a clear line with the older days of instability, the securitization of the government debt to the NBU would bring clear advantages for both the NBU and MinFin. As for the NBU, it would create a very important instrument for conducting monetary policy and for fighting inflation. Also, it would improve its balance sheet. For MinFin, it would reduce its foreign debt (i.e. debt denominated in foreign currency) and clarify the status of non-standard government liabilities, thus contributing to a better country credit rating. Besides, this would cost no money to MinFin. The restructuring would on top be beneficial for the financial sector: the new securities could increase the supply and liquidity on the currently illiquid market for government bonds. Also, the securities could be used as collateral in the interbank market and thus contribute to the development of the banking sector.

Outline

1. Introduction
2. Origins and Terms of the Debt
3. Economic Benefits of Securitization
4. Concrete Recommendations
5. Conclusions

1 Introduction

Currently, a considerable amount of domestic government debt in Ukraine is owed to the National Bank of Ukraine (NBU), which holds this stock on its balance sheet in a non-marketable form. Consequently, this debt cannot be traded, i.e. sold (or later re-purchased) in monetary policy operations by the NBU if the situation might require it. According to data provided by the Ministry of Finance, as of 31 December 2006 the total direct government debt stock amounted to UAH 66.1 bn, or 12.3% of GDP, of which UAH 49.5 bn (9.2% of GDP) is owed to external creditors and UAH 16.6 bn (3.1% of GDP) to domestic sources. The biggest part of domestic debt, UAH 8.9 bn (1.7% of GDP) is held with the NBU, whereas the rest, UAH 7.7 bn (1.4% of GDP) is owed in the form of tradable government securities to the private sector.

This situation, where a large amount of government debt is held with the central bank in non-marketable form, is not limited to Ukraine but rather common in other CIS countries, where the (hyper-)inflationary monetary financing of state budgets in the early 90s left central banks across the region with similar non-tradable claims on governments. Over the last years, some consensus has emerged that a solution to this problem might be overall beneficial for the country from an economic point of view. Some countries like Georgia have recently found a solution, while others (incl. Ukraine) are still trying to find an acceptable solution to all government entities involved.

The current status quo in Ukraine, with the majority of domestic debt held at the NBU in the form of non-liquid assets is unsatisfactory for three main reasons. First, the NBU currently lacks marketable domestic assets, which might be used for the conduct of monetary policy (open market operations). World-wide, government securities are very important for the implementation of such indirect monetary policy measures. Second, government securities fulfil also an important role as collateral for lending operations, also among banks and other financial companies. In case this debt would be sold to the market, it could be used as collateral for collateralized loans or for repo transactions, which might further facilitate the development of a liquid interbank money market. Third, judging from the numbers by the Ministry of Finance given in the first section, the domestic government securities market (outstanding stock of only 1.4% of GDP) is very small and illiquid. Since the strictly limited supply serves as a severe impediment for further capital market development[1], a natural step to increase potential supply (and, subsequently liquidity) would be to securitize this debt.

The primary goal of this policy paper is therefore to analyse if a securitization of this government debt could help to overcome the above mentioned shortcomings, and which concrete steps should be taken in order to implement such a strategy of securitization. The term “securitization”, as it is commonly defined and also used in this paper, describes the transformation of non-liquid assets into marketable securities, i.e. into bonds that can be freely traded on secondary markets among market participants. In this respect, it is important to note that the primary focus of this paper is on securitisation, and not on the re-payment of this debt. The NBU, as any other central bank in transition countries, needs to develop effective monetary policy instruments in order to fulfil its policy objectives, and tradable government securities are an important part of it.

The paper is organized as follows: In Part 2, we give a short review of the historical origin, the quantitative importance, and the concrete terms of the government debt which the NBU currently holds. The following Part 3 gives an overview over economic benefits, which might be associated with such a securitization of the debt stock. Part 4 derives then concrete policy recommendations for Ukraine on how the marketability of this debt can be achieved. Finally, Part 5 concludes.

2 Origins and Terms of the Debt

The government debt that is currently held by the NBU can be broadly split into two different categories according to NBU terminology: **internal state debt** and **state securities**. The by far biggest share of this amount consists of internal state debt. The following table gives a quantitative overview:

1 See also Policy Paper V19 “The currency structure of government debt in Ukraine: Why the share of hryvnia bonds should be increased”, February 2007, http://ierpc.org/ierpc/papers/v19_en.pdf.

Table 1
Internal State Debt as of 31 December 2006, UAH m

Internal state debt in national currency	3,568
Internal state debt in foreign currency	5,474
Total internal state debt (before provisions)	9,042
Provisions against total internal state debt	(518)
Total internal state debt (after provisions)	**8,524**

Source: Financial Statements of the NBU 2006

The internal state debt held at NBU is the result of loans in both national and foreign currency granted by the NBU to the government for financing the state budget over the periods 1991-1996 (in UAH) and 1995-1996 (in USD). After the financial crisis of 1998, in the "Law on Restructuring[2]" from April 2000 an attempt was made to provide the legal basis for a restructuring of these loans[3]. The Law states that the foreign currency part of the debt is supposed to be repaid in equal quarterly instalments over 2002-2009, with no interest payments to be made. However, during 2001-2004 the respective Budget Laws suspended this repayment. Only in 2005-2006 an annual amount of UAH 253 m was repaid in accordance with the respective Budget Laws. Regarding the part of internal state debt in national currency, the Law foresees the repayment by equal quarterly instalments over 2010-2035. While the Law includes an annual interest rate payment of 5% on this debt, the period of interest accrual is not clearly stated and therefore no interest income from this source is recorded in the NBU statements of income.

Turning to the second, much smaller position of government debt held at the NBU, this comes in the form of state securities, which are also the result of a restructuring process. As of end-2006, this stock amounted to UAH 411 m. Most of this debt are non-interest paying, held-to-maturity-securities in hryvnia (UAH 395 m), which are to be repaid in 2009-2010. The foreign currency part (UAH 16 m as of 31 December 2006) is denominated in EUR with a coupon of 10% p.a. and has been fully repaid according to the agreed schedule in the beginning of 2007.

To sum up, the quantitative dimension of government debt with the NBU is considerably. Relative to the overall NBU balance sheet, this proportion is 6.4% of total NBU assets and 9.1% of the monetary base. Regarding its structure, as has been demonstrated above, this debt is not a homogenous stock, but rather fragmented according to differing currency, interest and repayment terms. Furthermore, uncertainties regarding the legal basis of some parts of the debt, and delays in interest servicing and repayment complicate its status considerably[4].

3 Economic Benefits of Securitization

As was stated in the introduction, the securitization of non-tradable central bank claims on the government can be beneficial in several ways to the economy. We are focussing in the following chapter on four main advantages of marketable government debt in the possession of the central bank.

a. Monetary policy operations

Open market operations (both outright and, more importantly, in the form of repurchase agreements (repos[5])) are today the main tools for central banks to conduct monetary policy. Along with international best practice, the availability of government securities would permit the NBU to carry out transactions (repos and reverse repos) against these newly created

[2] Law "On Restructuring the Debt of the Cabinet of Ministers of Ukraine to the National Bank of Ukraine".
[3] The terms of a loan of UAH 129 m granted to the government over 1991-1993 in national currency is currently not regulated by legislation. The NBU includes it in its financial statements in the total debt figure before provisions, but raised full provisions against it, whereas the Ministry of Finance doesn't include it in its debt statistics. This explains the slight difference in the figures given by the latter in the introduction and the NBU data (third row of Table 1).
[4] A draft law by the NBU to change parts of the "Law on Restructuring" has not yet been considered by the Verkhovna Rada.
[5] Under a repurchase agreement (repo), the repo buyer (=cash provider) buys securities from the repo seller (=cash receiver), who at the same time agrees to repurchase them at a specified time and price. A reverse repo is the same transaction, seen from the counterparty's viewpoint. The original seller is entitled to the interest payment on the underlying security.

instruments, which can be used to inject or to drain bank reserves. The improvement in monetary policy capabilities therefore serves as the main argument for such a securitization.

At the moment, under the quasi-fixed exchange rate peg, the NBU has to sell its own papers (deposits certificates (CD's) of different maturities) when the monetary impact of foreign currency inflows needs to be limited[6]. Right now, with net USD-buy interventions in the range of approx. USD 200-500 m per month in 2007 and a record level of foreign exchange reserves, the NBU relies on this instrument to control liquidity. The sterilization is handled in a very flexible manner since is reversed relatively quickly due to its short maturities (1-365 days in 2006). An alternative and complementary way to sterilize such sudden inflows would be to use tradable government securities for this purpose. If marketable government securities would be available, the current competition between NBU CD's and outstanding tradable government debt on secondary markets could be moderated, since only securities from one issuer are being used. The current fragmentation with two competing issuers in this segment may well lead to a loss in liquidity in both instruments[7].

b. Effect on the balance sheet of the NBU

A positive side effect of securitization is the fact that as a consequence the balance sheet of the NBU will pretty much resemble the balance sheet of any other modern central bank with tradable government securities on its asset side. The structure of the balance sheet becomes more "healthy", as a considerable proportion of the assets are transformed from an item that was disputed for several years among the contractual parties into standard securities. This further signals to market participants that the NBU has full operational capabilities to conduct monetary policy according to its objectives. Especially in the longer term, where a strategic shift to inflation targeting from the current fixed exchange rate anchor seems likely, the efficient implementation of monetary policy requires the availability of such instruments.

c. Interbank money market development

Moreover, to the extent that with the bonds obtained through securitization the central bank can encourage the development of a private repo market among commercial banks, this could lead the banking system as a whole away from unsecured and towards collateralised transactions in the interbank money market. Currently, the market is still fragmented due to the lack of collateral for such operations. If new securities become available, the improved liquidity redistribution among banks by means of such secured transactions will positively influence domestic banking and financial market development.

d. Bond market development

The increase of marketable government debt with the NBU raises the potential supply in domestic bond markets. As we have argued before[8], the limited supply of hryvnia bonds is a key factor for the lack of liquidity in the market and therefore responsible for relatively high borrowing costs. Consequently, in case the monetary authorities consider it necessary to sell some of the securities on the secondary market, the actual supply rises, without new net borrowing from the government. This could boost liquidity and lower overall borrowing costs for the Ministry of Finance. A more developed domestic government bond market has further repercussions on the transmission of monetary impulses to the economy, as the central bank can extract important information from market yields for their policy purposes.

4 Concrete Recommendations

Judging form the above analysis, we strongly favour a joint approach of the authorities to change the status of non-marketable government debt held with the NBU. Therefore, our **key recommendation** is that a securitization of this debt should be implemented as there are important economic benefits to be expected.

Before turning to more concrete proposals how this could be achieved practically, an important point for the success of such an agreement needs to be stressed. In the process of making this

[6] Of course, CD's are also actively used when other transactions that change the monetary base need to be countered, e.g. changes in the Treasury Account due to domestic transactions.
[7] International evidence for this claim is presented in "Bank for International Settlements Paper No. 30 [2003], pp. 82-98".
[8] Policy Paper V19 "The currency structure of government debt in Ukraine: Why the share of hryvnia bonds should be increased", February 2007, http://ierpc.org/ierpc/papers/v19_en.pdf.

debt tradable in secondary markets where private agents interact, it is of crucial importance that these new instruments carry a yield that is based on market yields of comparable securities. Attaching market-related interest coupons to these securities does not represent a fiscal risk, since both the NBU and the Ministry of Finance are part of the public sector, and the NBU is legally required to deliver the excess of budgeted income over budgeted expenditure to the state budget. Therefore, if the Ministry of Finance would start now to service this debt according to market conditions, it would lose no money, as this is subsequently distributed back in the form of NBU profits.

Coming to the concrete steps how such a securitization strategy should be implemented, we arrive at the following proposals:

Proposal 1: Establishment of a functioning legal framework

A clear, unified and for all parties binding legal framework seems indispensable. In particular, the "Law on Restructuring" needs to be changed in a way that the marketability of government debt at the NBU is ensured. Furthermore, all parties concerned need to observe the law and follow the regulation laid down.

Proposal 2: Setting up a high committee

The bilateral character of transforming loans into marketable securities makes negotiations among government entities inevitable. Progress can only be achieved in a coordinated manner, not against the legitimate interests of any party involved. The first step for making the changes proposed under 1) would be to set up a high committee in which all relevant entities of the public sector are represented. This concerns in detail the NBU and the government, represented by the Ministry of Finance. The task of this group would be to spearhead securitization efforts by working out the legal and technical details of the "New Deal" proposed.

Proposal 3: Technical suggestions

While the exact terms of the newly created securities need to be established by the high committee, some proposals to maximize benefits to all parties involved can be nevertheless made. The first proposal concerns the currency denomination of the new securities. Such a securitization allows the chance for currency unification of this debt, i.e. instruments denominated only in local currency will be created. This will have advantages for the general structure of public debt. Debt denominated in local currency increases, whereas the share in foreign currency goes down. This might affect foreign ratings in the longer term, which is positive with respect to borrowing costs for the Ministry of Finance. Furthermore, the increase in potential supply in domestic currency bonds can be seen positive against the background of developing local markets.

Regarding the maturity of these instruments, several arguments need to be balanced. Currently, there is no liquid long-term segment of the domestic bond market, which would prevent the de facto marketability of such instruments when they need to be sold during the conduct of monetary policy[9]. Therefore, a first step could consist of a certain share of bonds with different maturities (e.g. 1-3 years), which terms should be made similar to existing bonds, thereby creating a more liquid benchmark yield curve in case they are sold in the secondary market. Such an agreement would signal to all market participants a credible commitment to a solution. A second share of the securities could carry longer maturities (e.g. 5-10 years), making their outright sale unlikely (even though they could be used in repos). In the longer-term, if the capital market is more mature, the marketability of these bonds would automatically increase. Furthermore, the high committee proposed would be able to permanently monitor the situation closely, and could make further changes in the terms of the longer-term bonds, if necessary. Such changes could be coordinated with future issues of the Ministry of Finance, if it is able to commit itself to such a fixed borrowing plan, and would further support market development.

As was mentioned in the introduction before, the problem of non-marketable government debt with the central Bank is quite common among CIS countries. This mirrors the fact of widespread (hyper-) inflationary budget financing by central banks in the region, which occurred during the

[9] Alternatively, another strategy is to keep the long-term maturity but attach a floating, frequently adjusted market-based coupon to them. This ensures the possible use in repo-transactions (where prices are fixed up-front), but makes an outright sale less likely due to the long maturity.

first half of the 90s. While some countries like Moldova or Tajikistan haven't been able to solve this problem so far, others have progressed further and finalized a solution. In this regard, the debt securitization experience of Georgia, which occurred last year, is an interesting example.

Box 1
Recent Country Experience in Debt Securitization: The Case of Georgia

In 2006, the total stock of non-marketable government debt at the National Bank of Georgia (NBG) consisted of GEL 833 m. The lack of marketable securities on the NBG's balance sheet constrained severely its ability to conduct monetary policy operations. Especially in its flexible exchange rate framework, the NBG further needed new monetary policy instruments (for both outright and repo operations) to fight still high inflation, which is its primary objective.

Finally, on 20 March 2006, an agreement between the NBG and the government (represented by MinFin) on securitization of this debt was reached. The total stock of GEL 833 m will be gradually converted to marketable securities until the year 2025. To start with, for 2006 GEL 48 m were made tradable as treasury notes with maturities ranging from 1-5 years. A quarterly coupon is paid on these bonds, which is the outcome of a joint assessment by the NBG and MinFin based on market rates (12% in 2006; 10.5% for 2007 and 2008). The remaining part of the debt that has not been securitized so far will pay an interest rate of 5.5% p.a. (modifications to this interest rate are possible by mutual consent by the NBG and MinFin).

Subsequently, on 8 December 2006 the central bank used these now marketable medium-term government bonds for the conduct of its open market operations, in order to sterilize high inflows of foreign exchange. A further objective of the central bank is to develop with the help of these instruments an active and liquid secondary market for domestic government bonds.

Note: The exchange rate on 31.12.2006 was 1.7135 GEL per USD

5 Conclusions

The purpose of this paper was to analyse the status of the non-marketable government debt at the NBU, and propose changes to this status if economic benefits are expected from such a change.

It is widely understood that both authorities involved, the NBU and the Ministry of Finance, have differing policy objectives. The NBU's primary focus is on maintaining the stability of the hryvnia and the soundness of the financial system, while the main focus of the Ministry of Finance is to minimize the funding costs of budget financing. However, the proposed securitization of government can be considered a win-win situation for both parties, as both sides can draw important benefits from such an agreement.

For the NBU, the further improvement of its monetary policy toolkit and the development of the interbank money market, which further facilitates the monetary transmission, are key gains. Especially in the longer term, with a strategic shift to a different policy regime (inflation targeting) likely, the importance of this new instruments will increase. Moreover, the balance sheet of the NBU will look after a securitization more stable and resemble the balance sheet of any other modern central bank. This in itself is a contribution to financial stability.

For the Ministry of Finance, with the status of its debt finally legally clarified, this will also have several positive implications. Creditors will positively react in a positive way to such efforts to create a transparent debt structure, as financial risks have considerably decreased. Furthermore, the proposed changes regarding currency unification might also increase the sovereign rating, as the share of local currency state debt will rise at the expense of foreign currency state debt. In case the liquidity improves in secondary markets as a result of the increase in domestic security supply (without new net borrowings), this may also contribute to lower funding costs.

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