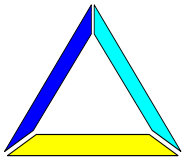
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Should Ukrainian Residents be Allowed to Buy Ukrainian Eurobonds?

Executive summary

In February 2003, the NBU decided to significantly toughen restrictions on transactions by Ukrainian residents involving Ukrainian eurobonds. In practical terms, the new regulation amounts to a prohibition of purchases of eurobonds by residents. In our view, this decision went into the wrong direction. At the present time, restrictions should not be hardened, but considerably relaxed. A relaxation of restrictions would contribute to the profitability and stability of the banking sector, encourage the development of capital markets, facilitate the establishment of private pension funds, improve Ukraine's future current account and decrease the long-term cost of government debt. Furthermore, given the current conditions at the foreign exchange market, a relaxation of restrictions will not jeopardize external and macroeconomic stability, but might in fact even strengthen stability by reducing the risk of revaluation and inflation. Thus, we strongly recommend the NBU to soften restrictions on eurobonds transactions. Also, this relaxation should be conducted as soon as possible to take advantage of the favourable situation.

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1. Introduction

Restrictions on cross-border capital flows and on the foreign exchange market, such as the restrictions faced by Ukrainian residents on eurobonds transactions, involve benefits as well as costs for the economy. The main purpose of restrictions is to ensure external and macroeconomic stability *(benefit*). But by limiting the range of activity of economic agents, restrictions can hamper their efficiency and restrain economic growth (*cost*). The size of costs and benefits of a given restriction in a given country depend on the concrete economic situation of the country. Thus, a certain restriction might be useful at one time, but harmful at another. For this reason, policy makers should regularly assess whether existing restrictions on capital flows and foreign exchange market are still appropriate or not.

In 1998, Ukraine faced a severe external and macroeconomic crisis. Its currency, which was pegged to the US dollar, lost much of its value and the former exchange rate system had to be abandoned. In reaction to this crisis, the authorities introduced several restrictions with the purpose of cutting demand and increasing supply of foreign exchange. These restrictions, in combination with a sensible monetary and exchange rate policy and a prudent fiscal policy, worked well and contributed to the remarkable external and macroeconomic stabilization of the country. But since the introduction of restrictions the economic situation has changed significantly. The former devaluation pressure on the hryvnia has transformed itself into a revaluation pressure. Besides, official foreign exchange reserves stand at record highs. Furthermore, Ukraine has no formal exchange rate system and thus no commitment to intervene at the foreign exchange market to keep the external value of the hryvnia at a certain level or path. This change in the external and macroeconomic situation of the country, point to a considerably reduction in the benefits of restrictions. Thus, some restrictions that were appropriate until now are likely to have become harmful for the economy.

In February 2003, the NBU revised the restrictions on eurobonds transactions by residents and issued a corresponding decree. Officially, the decree was supposed to promote the development of the eurobonds market in Ukraine. But instead of softening these restrictions, as one would expect, the NBU decided to dramatically toughen them. The degree of hardening is so high, that one could even speak of a de facto prohibition for all eurobonds transactions by residents. As a reaction, some commercial banks criticized the new regulation and a debate erupted on the matter. In this paper we present our view on this matter. In part 2 we describe the existing restrictions. In part 3 we study the economic effects of softening of restrictions on macroeconomic and external stability, on the cost of government debt, on the balance of payments, and on the financial sector in Ukraine. In part 4 we conclude and formulate policy recommendations.

2. Current restrictions on eurobonds transactions

Until February 2003, eurobonds transactions of residents were regulated by a decree of the Cabinet of Ministers.[1] Residents were obliged to obtain an individual license from the NBU for each transaction concerning eurobonds. In practice, the whole licensing procedure is said to have being rather troublesome. As a consequence, demand for eurobonds was not particularly high. In 2002, only 3 residents conducted operations with eurobonds.

In February 2003, the NBU introduced a strict new regulation, which for practical purposes forbids the purchase of eurobonds by residents.[2] First, only residents holding the necessary foreign currency are allowed to purchase eurobonds. Second, eurobonds can only be sold for national currency, even if they are sold to non-residents. Thus, buying eurobonds implies switching from a position in foreign currency to one in hryvnia. Third, the paperwork needed to obtain the required individual license from the NBU has been

[1] See Decree of the Cabinet of Ministers № 17, February 19, 1993, "On the System of Foreign Currency Regulation and Control".

[2] See NBU-Decree № 35, January 29, 2003, "On the procedure of issuing individual licenses to residents for transferring foreign currency abroad in order to purchase eurobonds of Ukraine".

increased dramatically. In particular, residents are required to present an agreement (purchase contract) of the purchase of eurobonds and a photocopy of the registration certificate of the non-resident (i.e. the seller of eurobonds). After receiving these documents, the NBU has 30 days for granting the individual license.

As a consequence of the new tough regulation, eurobonds transactions by residents were practically stopped: since February only one commercial bank asked to obtain a license from the NBU. As shown in Box 1, the hardening of restrictions on eurobonds transactions stands in contradiction to the policies pursued by several progressive CIS and eastern European countries.

Box 1. Experience of Central and Eastern European countries in regulating circulation of eurobonds.

Russia. Residents are not required to obtain special permission to buy Russian eurobonds. Currently the largest player is state pension fund; non-state pension funds and investment funds accelerate investment in Russian eurobonds as well. Trade is allowed only at the stock exchange, but at the moment there is an active discussion concerning allowing trade outside stock exchanges as well.

Kazakhstan. Residents are allowed to invest in Kazakh eurobonds. The largest investors into eurobonds are resident pension funds and commercial banks: they hold around 50% of all Kazakh eurobonds. Payments between residents are allowed only in national currency. Trade in eurobonds is conducted only at the stock exchange.

Hungary, Czech Republic, Slovakia*, number of other emerging markets*. There are no restrictions for residents concerning investment in domestic eurobonds.

3. The economic effects of softening current restrictions

The economic effects of softening current restrictions on eurobonds transactions are extensive and rather complex. We decided to concentrate on four effects, which are of special importance for the economy: the effect on macroeconomic and external stability, on the cost of government debt, on the balance of payments and on the financial sector.

3.1 Effect on macroeconomic and external stability

A crucial question to be answered in this study is whether a softening of restrictions would jeopardize external and macroeconomic stability or not. In order to answer this question, we should distinguish between the short and the long run.

In the *short run*, net-purchases of eurobonds by residents from non-residents might be significant. This will lead to an increase in the demand for foreign currency and to a devaluation pressure on the hryvnia. Thus, the question to answer is whether this resulting devaluation pressure could have a destabilizing effect on the economy or not. In our view, the devaluation pressure will definitely not destabilize the economy. Given current conditions at the foreign exchange market, a devaluation pressure might in fact lead in the short-run to more, not to less macroeconomic and external stability. In order to back this view, we should have a look at the current situation at the foreign exchange market and at the policy options of the NBU.

At the current exchange rate of 5.33 UAH/USD, demand for foreign currency falls short of supply, resulting in a revaluation pressure on the hryvnia. The NBU has three options for solving this "revaluation problem". First, it can let the hryvnia revalue (revaluation option). Second, it can purchase foreign currency at the foreign exchange market (intervention option). Third, it can soften restrictions on foreign trade and/or on capital flows (de-regulation option).

A considerable *revaluation* of the hryvnia would worsen the competitive position of Ukrainian enterprises and would have a negative effect on the trade balance.[3] Thus, the revaluation option could jeopardize the external stability of the country. During the last three years or so, the NBU has almost exclusively relied on *interventions* to remove the revaluation pressure on the hryvnia. In our view, this policy has been very wise, given the very low level of official reserves after the 1998 crisis and the limited inflationary effect of interventions during the last two years. But a continuation of this exclusive use of interventions to deal with the revaluation problem is not advisable. First, official reserves stand at record highs and there is no need to keep accumulating reserves in a significant way.[4] Second, net-purchases of foreign exchange imply money creation and pose thus a risk of high inflation and macroeconomic instability. The fact that the link between money creation and inflation has been rather weak in the last two years or so does not imply that such a link will not reappear soon. A softening of restrictions on eurobonds transactions (*de-regulation* option) does not entail major macroeconomic and external risks. Of course, if the additional demand for foreign exchange induced by the softening of restrictions is clearly larger than current excess supply at the foreign exchange market, then a considerable devaluation of the hryvnia and some external instability would emerge. But, as we expect, additional demand for foreign currency will not surpass current excess supply.[5] Thus, a softening of restrictions on eurobonds transactions will in the short run help to solve the revaluation problem of the NBU without jeopardizing stability. In particular, it will avoid a worsening of the trade balance connected with a revaluation of the hryvnia and an increase in inflation associated with interventions.

In the *long run*, the effect of a softening of restrictions on net-demand for foreign exchange would be rather limited. First, residents will not only buy eurobonds from non-residents, but also sell them to non-residents. Second, assuming a continuation of a prudent fiscal policy in Ukraine, the size of outstanding eurobonds will not significantly increase, while foreign trade and hopefully FDI will do. Consequently, a softening of restrictions on eurobonds transactions will neither endanger macroeconomic and external stability in the short, nor in long run.

3.2 Effect on the cost of government debt

For our purposes government securities issued by the Ukrainian state can be divided into two groups: domestic securities and eurobonds.[6] Currently, Ukrainian residents are allowed to buy domestic securities, but not eurobonds. If this restriction were to be relaxed, then eurobonds and domestic securities will become *substitutes* in the eyes of Ukrainian residents. Consequently, in order to assess the impact of a softening of restrictions on the cost of government debt, one should not only look at the effect on eurobonds, but also on the effect on domestic securities.

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[3] As we repeatedly stated in the past (see our policy paper S1 "To devalue or not to devalue: That's *not* the question"), the competitive position of a country depends on the real effective exchange rate, not on the nominal exchange rate to the US dollar. In the last year or so, the real effective exchange rate has not changed much. On the one hand the hryvnia has depreciated against the euro, but on the other hand inflation in Ukraine is considerable higher than in the Euro zone and in the USA. Consequently, a strong revaluation of the hryvnia against the US dollar would imply a real effective appreciation and hurt the trade balance.

[4] As of end of July 2003, official reserves amounted to USD 6.5 bn, which is equivalent to 3.5 months of imports.

[5] According to bankers, domestic demand for eurobonds from within existing foreign currency positions might reached up to USD 100 m, while the corresponding demand from national currency positions should stand at roughly USD 150 m. Thus, following a relaxation of restrictions, net-demand for foreign currency would in the short run increase by around USD 150 m. This amount is rather small when compared with over USD 2.2 bn of net-purchases of foreign currency by the NBU since the start of the year.

[6] As of end of July 2003, the face value of outstanding domestic securities (including POVDPs) amounted to UAH 10.2 bn, while the corresponding figure for eurobonds was UAH 15.9 bn.

A softening of restrictions will have *two* effects on the demand for government securities. Some investors currently holding domestic securities will prefer to hold eurobonds instead of domestic securities. Thus, demand for eurobonds increases and demand for domestic securities decreases (*substitution* effect). But also some potential investors that decided not to buy domestic securities in the past will now start demanding eurobonds. Consequently, total demand for government securities increases (*level* effect). The existence of this level effect on demand is not surprising, if we recall that domestic securities and eurobonds are by no means perfect substitutes. The former are very illiquid[7], denominated in hryvnia and considered by investors to be rather risky. The latter, on the contrary, are very liquid, denominated in foreign currency and regarded by investors as being relatively safe.

The changes in the demand for government securities induce changes in the prices and yields of *outstanding* government securities: the price of eurobonds goes up and their yield down, the price for domestic securities decreases and their yield increases. But this has no influence on the cost of government debt, because interest payments of outstanding securities do not depend on their prices and yields. An effect on the cost of government debt can only take place when new debt is issued. In the short run, the government only plans new issues of domestic securities, not eurobonds. Thus, the cost of domestic securities will increase, while the cost of (the outstanding) eurobonds will not change. Consequently, a relaxation of restrictions on eurobonds transaction will in the *short run* tend to increase the cost of government debt. But in the *medium and long run*, the increase in total demand for government securities should ensure a clear reduction of the cost of government debt.

In our view, the negative short-term effect on the cost of government debt will be widely overcompensated by the positive medium- and long-term effect. Besides, the likely short-term increase in the cost of debt is unlikely to endanger the fiscal stability in the country, given the rather robust current fiscal situation. *Thus, we conclude that a softening of restrictions on eurobonds transactions will have an overall positive effect on the cost of government debt.*

Besides this positive assessment, we should point to a certain fiscal risk related to the softening of restrictions on eurobonds transactions. As we stated before, the softening of restrictions will decrease the cost of eurobonds and increase the cost of domestic securities. As a reaction to this change in yields, the government might be tented to increase borrowing through eurobonds and to decrease borrowing through domestic securities. In our view, this would not be the right approach. Eurobonds are a rather risky form of debt, because of their denomination in foreign currency. An extension of eurobonds borrowing would increase the government exposure to the risk of devaluation and could lead to fiscal instability. Thus, instead of increasing eurobonds borrowing, the government should in our view focus on lowering the cost of domestic borrowing by improving the rather poor reputation of its domestic securities.

3.3 Effect on the balance of payments

The current eurobonds transactions at the secondary market do not affect the Ukrainian balance of payments, because they only involve non-residents. If restrictions were to be relaxed, the following 3 new types of transactions would take place at the secondary market.[8]

Type 1: Residents buy eurobonds from non-residents

Type 2: Residents sell eurobonds to non-residents

[7] The secondary market for domestic government securities is almost non existing.

[8] The effects on the balance of payments of a relaxation of restrictions at the *primary* and the *secondary* market are analogous. For that reason, we chose to present only the effects related to the secondary market.

Type 3: Residents conduct eurobonds transactions with each other

From a balance of payments perspective, type 3 is irrelevant, because it involves only residents.[9] That leaves us with types 1 and 2 for the remaining analysis. Starting from the hypothetical date of relaxation of restrictions, the cumulative purchases of residents from non-residents (type 1) will be higher than the cumulative selling of residents to non-residents (type 2).[10] Consequently, the qualitative effect on the balance of payments of softening restrictions will be the same as the effect of transactions of type 1. For this reason, we only need to discuss the effects of purchases of eurobonds by residents from non-residents.

The purchase of Ukrainian eurobonds by residents from non-residents is equivalent to the (premature) cancellation of portfolio liabilities of the Ukrainian economy vis-à-vis foreign countries. As a result, portfolio liabilities of the Ukrainian economy against the rest of the world decrease. Furthermore, all future interest payments by the Ukrainian government connected with the purchased eurobonds will not be made to non-residents, but to residents. This leads to a future improvement of the position "interest payments" and consequently to an improvement of the current account, to which this position belongs.

In our view, the reduction of the foreign *portfolio* liabilities[11] of the Ukrainian economy and the future improvement in the current account are positive results for Ukraine. Some people might point out that the premature repayment of foreign liabilities represents an outflow of (scarce) capital from Ukraine. In their view, this will result in higher interest rates and lower investment and economic growth. This rather partial view can definitely not be supported by recent Ukrainian economic history. In the period 1995-1998, in which net capital inflows were rather large, the economic development in the country was far from ideal and ended in a severe crisis. In the period 1999-today, a period marked by large surpluses in the current account and thus large net capital outflows, the economic situation improved significantly. Thus, we discard this negative view and conclude that a softening of restrictions will have a clearly positive effect on the Ukrainian balance of payments.

3.4 Effect on the financial sector

Financial institutions in Ukraine have currently a rather limited choice for investment. In particular, no relatively safe, long-term financial instrument exists on the domestic capital market. A softening of restrictions on eurobonds transactions would provide more choice for financial institutions and introduce a quite safe, long-term financial instrument. This would improve the situation of different groups of financial institutions in Ukraine.

Commercial banks would be able to improve their (short-term) liquidity management and their (long-term) portfolio investment. By doing so, banks can improve their efficiency and increase profits, which will contribute to lower interest rates and higher investment. Eurobonds are also interesting for the *Deposit Insurance Fund*. Currently, the fund invests its capital only in national currency, although around 40% of insured deposits are denominated in foreign currency. Consequently, the fund has a significant exposure to the risk of devaluation. This exposure could be eliminated, if the fund decides to hold 40% of its capital in the form of eurobonds.[12] Thus, a softening of restrictions would enable the Deposit Insurance Fund to improve its soundness and contribute to a more stable banking

[9] The balance of payments registers all transactions between residents and non-residents for a period of time.

[10] Strictly speaking, the total value of transactions of type 2 can be higher than type 1 because of changes in the price of eurobonds. But this is not very likely to happen.

[11] We favour a reduction in foreign *portfolio* liabilities (such as eurobonds) because they entail several risks for the country. We would certainly not be in favour of a reduction of other foreign liabilities such as foreign direct investment (FDI) in Ukraine.

[12] For a more detailed discussion and further recommendations concerning the Deposit Insurance Fund see our policy paper S 15 "Deposit Insurance System in Ukraine: Time for Improvement".

sector in Ukraine. The *State Pension Fund* could use eurobonds for the management of its liquidity. But eurobonds will become even more interesting for the private pension funds, which will be created in the framework of Ukraine's recent pension reform. In fact, the third pillar of the new pension system (private pension funds) will hardly be able to develop if no relatively safe, long-term financial instrument exists in Ukraine.

If eurobonds were to be traded in Ukraine, a softening of restrictions would also contribute to the development of the stock exchange. Furthermore, domestic government securities are likely to become safer instruments, because of the new competition from the eurobonds. This will have a positive influence on capital markets development in Ukraine.

We conclude that a relaxation of restrictions will contribute to the profitability of banks, to the stability of the banking sector and to the further development of the stock exchange and capital markets in Ukraine.

6. Conclusions and policy recommendations

After studying the different effects of a relaxation of restrictions on eurobonds transactions we come to two main conclusions. First, a relaxation of restrictions would have an overall positive long-term effect on the Ukrainian economy. The banking sector will become more profitable and more stable. Besides, capital markets will develop, contributing to the establishment of private pension funds as envisaged by the pension reform. Furthermore, the long-term cost of government debt decreases and the future current accounts improve. Second, one could hardly imagine a better time for softening restrictions than today. Because of the current situation at the foreign exchange market, the devaluation pressure connected with a relaxation of restrictions will not endanger macroeconomic and external stability. In fact, it might even strengthen stability by reducing the risk of revaluation and/or inflation. Besides, the short-term negative effect of a relaxation of restrictions on the cost of government debt will not endanger fiscal stability, because of the present rather solid fiscal position.

From these conclusions we are able to derive two main recommendations. First, restrictions on eurobonds transactions should be significantly reduced, even compared with the situation before February 2003. In particular, residents should be permitted to buy foreign currency for purchasing eurobonds from non-residents. Furthermore, they should be allowed to sell eurobonds for foreign currency. Second, restrictions should be softened as soon as possible. By waiting too long, the authorities might miss the perfect time and changing the regulation could become much more difficult.

R.G., I.E., D.S., Lector: F.P.

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