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Alleviating Ukraine's (legacy) debt burden during the war

What are the options?

Focus Paper 11:
Alleviating Ukraine’s (legacy) debt burden during the war – what are the options?

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Flag of Ukraine

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1. Introduction

Ukraine has shown considerable success in keeping its economy afloat despite the continuous disruptions due to the external aggression. This is not least due to the support the country has received from its Western allies – politically, militarily and not least financially.[1]

However, insecurity regarding future support, donor fatigue among some important Western supporters and potential external shocks beyond the current level of the war and the defense effort may warrant debt relief negotiations ahead of a more comprehensive solution. The latter can logically only come after the aggression has ended because only then can a sustainable level of external debt be defined with some reliability.
How such a comprehensive solution with the view to recovery and reconstruction post-war could look like will be discussed elsewhere. This paper discusses options for debt treatments while the fighting is still ongoing. We consider options that have been brought forward by stakeholders since February 2022 and assess their potentials, strengths and weaknesses. The starting point for this discussion is the state of the debate at the beginning of 2024:

Quite soon after the Russian attack in February 2022, both official and private creditors had conceded a debt service moratorium to Ukraine on pre-war debt obligations. While in the meantime, the official sector has extended the moratorium until 2027, the debt service suspension by the private bondholders on around US-$ 20bn is set to expire in September 2024. If the hostilities do not end by then, Ukraine will face the choice between either deviating a substantial part of its external support to servicing the legacy pre-war bondholders or to run into an unregulated default. This unpleasant choice can only be avoided if Ukraine either reaches an agreement with bondholders on another moratorium or a restructuring, or if it manages to mobilize additional resources in the form of debt relief towards other creditors.

In this paper we discuss some of the options that have been proposed to accomplish either of the two: alleviating the debt service burden of the legacy claims themselves or gaining additional fiscal space through debt restructuring at large. We take a look at instruments which have been debated in the media and academia, by Ukrainian stakeholders and by third parties, such as creditors and IFIs. We also include historical experiences on the different options.

Of course, there are interlinkages between any measures taken right now with regard to the current debt service burden and elements of the necessary post-war restructuring of the entire stock of external obligations that the country has amassed before and during the war. At this stage, we follow the IMF and the Paris Club in pragmatically assuming that 2027 is a realistic time horizon for the launch of a broader post-war debt restructuring and consequently also for any intermediary operation with regard to securing fiscal sustainability.

[1] For an overview see: European Parliament – EGOV (2024): "Multilateral financial assistance to Ukraine – January 2024", www.europarl.europa.eu/RegData/etudes/IDAN/2023/733763/IPOL_IDA(2023)733763_EN.pdf.

2. Options to deal with the (legacy) debt burden during the war

2.1. Debt buybacks at market rates

Sovereign bonds are being traded among market participants at daily changing rates. The rates – respectively the discounts – reflect the probability that the respective paper will have its coupon payments made on time and the probability that the buy-back will materialize at full face value at the agreed-upon moment in time. In early January 2024, Ukrainian Eurobonds were trading at between 20% and 25%[2], thus indicating a potential for a considerable haircut.

Before the outbreak of the global sovereign debt crisis in the 1980s, market participants have tried to prevent bond issuers from buying back their own paper with discounts on secondary markets, in order to avoid any impression that official sector debt to private creditors could be restructured at all. However, since the Brady plan in the end of the 1980ies, such procedures have been actively used to reduce unsustainable debt stocks in several middle-income countries. While a buy-back with a substantial discount looks very favorable to the issuer at first sight, even those who manage to either directly or indirectly reach out to their own bonds on the secondary market tend to face liquidity constraints. These, in turn, normally have to be overcome by mobilizing additional external resources through either a new loan or issuing a new bond, which, given the present debt distress situation, can translate a liquidity constraint into a serious solvency problem.

These problems have been overcome in the past by mobilizing the necessary resources for the buy-back from official sources at more favorable conditions (see the chapter on a Brady-style solution below).

Where resources have to come from new private financings, an additional problem of seniority will arise which has a potential to impair the more comprehensive solution at the end of the aggression: Will existing lenders, which are not benefitting from the buy-back of a specific bond series, accept sub-ordination to the new liquidity providers? And if they do not: will the new resources not be so expensive as to eat up the alleviation effect from the buy-back?

Two historical experiences may be considered in relation to this option:

- The more recent buy-backs of some Latin American and African countries, which have been linked to the financing of some nature conservation investments:[3] They are being discussed in a separate chapter below, but do not change our general perception of the potential of buy-backs as expressed above.
- The buy-back of a substantial portion of its outstanding Eurobonds by the Ecuadorian government in the end of 2008: The Ecuadorian government of the time had skipped a first coupon payment in December 2008 and then launched a full-blown default on three bonds. The authorities insisted on the illegitimacy of the bonds, pointing to a report published in November by a government-appointed commission. However, it managed to buy back those by staging a "Dutch auction" with an accompanying threat to never redeem any paper that was not tendered under that auction. Ultimately, it managed to buy the outstanding paper back at little more than 30 cents on the dollar. While this operation was undeniably

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[2] Börse Frankfurt (2024), www.boerse-frankfurt.de/bond/xs1577952952-ukraine-republik-7-375-17-34.

[3] In the literature they have been falsely labelled as "debt-for nature swaps", although the debt has not been exchanged for nature investments but bought back with a discount, which then gave way to some limited investment into ecological sustainability.

successful for Ecuador, it can hardly be assumed to be a valid precedent for today's Ukraine: The operation was carried out at a time when Ecuador had reached high levels of oil income, had a historically low debt stock and debt service ratio and in general was able to negotiate from a strong position, i.e. with a view to being able to exist for a long time without any access to international capital markets.[4] Nothing of this is true for Ukraine today.

Buy-backs at reduced secondary market rates could be a useful instrument for individual, small debt relief operations in cases where windfall income allows the Ukrainian authorities such operations. However, these may not be key elements of a broader debt relief strategy. Especially, if Ukraine authorities considered a buy-back at around 20 % at par of the legacy bonds in 2024, Ukraine would have to mobilize an additional US-$ 4-5bn out of its international public sector support only to stage the buy-back. Given present insecurity of US support and the overall financing gap, which the IMF has identified in the December Art. IV Report, this money is clearly not there.

2.2. Official guarantees in exchange for private debt restructuring

To sweeten the private creditors' consent to a payment suspension or even restructuring of the outstanding legacy bonds, it has been proposed to guarantee future payments through official guarantees, thus trading volume for security.[5] Sources from the private sector were cited in media reports as requesting a sort of credit enhancement or official guarantee, for example from G7 partners, for any new deal to be agreed in 2024. Instruments towards this end could indeed be a guarantee by a major official sector player such as the European Union. An alternative could be a subordination of official claims under restructured private claims.[6]

Given the prospect of a full-scale Ukrainian default as a result of the ongoing Russian aggression cannot be ruled out, a guarantee of post-2024 or post-2027 coupons and principal amortizations can indeed be attractive to bondholders and could contribute to temporary suspension as well as reduced coupons and extended maturities after the resumption of payments.

However, would such an operation solve a problem that Ukraine actually has? Ukraine's access to bond markets is nonexistent – due to the ongoing aggression – and will likely remain closed as long as the war lasts, regardless of whether the government stays fully current on its coupon payments or not. The debtor country is therefore in the stronger position, as it has less to lose from an unregulated default than its bondholders. An eventually more constructive behavior by private lenders thanks to an official guarantee therefore needs to be balanced against the risks implied:

- Who would actually provide those guarantees? One would either have to find a bilateral partner prepared to go an extra mile beyond the support already provided, and this to an extent that goes way beyond amounts of present grant or concessional loan support. There are some US-$ 24bn outstanding in Eurobonds, and there is no logical basis to just pick individual series while neglecting the rest. This is why an eventual guarantee would have to be provided for the entirety of that debt stock. None of Ukraine's bilateral creditors has

[4] Things turned worse for Ecuador already shortly thereafter and debt indicators started to rise again very soon – although fueled by other creditors than before, notably China, from whom the country today is extremely dependent.

[5] Strohecker, K. and J. Do Rosario (2023): "Exclusive: Ukraine sounds out bondholders on debt restructuring, new financing - sources", 9 October, 2023, www.reuters.com/markets/europe/ukraine-sounds-out-bondholders-debt-restructuring-new-financing-sources-2023-10-09/.

[6] A similar proposal had been made in the context of Greek crisis by Buchheit and Gulati labelled "structural subordination": Buchheit, L. and M. Gulati (2016): "Targeted Subordination of Official Sector Debt" in: Banking and Finance Law Review.

provided loans to an extent that would even come close to such amounts – not even if all of these loans are combined. The same goes for guarantees. The entirety of all guarantees provided until September 2023 amount to US-$ 6.21bn, most of it from one single provider, the UK.[7]

- In order to align amounts that may eventually be available for any further guarantees, private bondholders would have to accept a considerable haircut. This, however, would pre-empt the post-war "big picture" restructuring at a time when private creditors still look forward to a solution which may be a lot more favorable if they just hold out. Any such solution will therefore lose momentum including from those who would otherwise be the major beneficiaries.
- Ukraine very much depends on the constant inflow of fresh funds from its Western allies. While, here or there, Western governments may find it attractive to enhance repayment securities to private owners of old Ukrainian debt as long as they are citizens or funds/banks of those same countries, there is a high risk that such support to non-Ukrainian privates may come at the expense of future fresh funds to Ukraine itself.

Another option would be to provide official guarantees by having private creditors agree to provide fresh funds in exchange for a debt restructuring. However, where in the past official sectors have undertaken considerable efforts and thrown in resources in order to convince private creditors to keep up their financial engagement in a debtor country in crisis, the results have often been disappointing. The commitments of German banks to stay engaged in Greece after the mobilization of huge amounts of liquidity by European governments in order to keep Greece paying the privates' coupons has been a telling example.[8]

Consequently, there is no reason to consider any such operation for the time being. Moreover, no situation is imaginable where sweetening a private bondholder consent to a temporary payment suspension with official guarantees would be the best possible use of scarce Western support funds to Ukraine. This is, of course, different, once all creditors meet to discuss a comprehensive restructuring of all outstanding debt of Ukraine after the end of the hostilities.

There may be the fear that without a major official sector engagement towards an attractive solution for bondholders or in case of an agreement on a standstill instead of a restructuring, these bondholders might consider selling their claims to aggressive specialized funds, who would then sue Ukraine in Western courts. While such "vulture funds" have indeed caused problems to some countries in the Global South in the past, including Argentina, Peru and Zambia, it is doubtful whether the model would work in the case of Ukraine: Courts in the US, UK or EU – from where Ukraine is receiving huge amounts of public money – would have to rule in favor of the litigating investors. In a case of such an attempt, it is very likely that governments would enhance existing anti-vulture-laws to including Ukraine or quickly create new ones (which is possible, as no global consent is needed for national legislation). Consequently, the discount at which the claims are sold would have to go even way beyond the existing market notation. Bondholders would have to sell their claims for just a few

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[7] Kiel Institute for the World Economy (2024): "Ukraine Support Tracker Release 14", Fig. 9 "Financial Aid", https://www.ifw-kiel.de/topics/war-against-ukraine/ukraine-support-tracker/.

[8] In 2011, German finance minister Wolfgang Schaeuble and highly indebted Greece were promised that German banks would not reduce their exposure to Greece, in exchange for avoiding deep haircuts. Immediately afterwards, their exposure was reduced to around half. See Rehbein, K. (2023): "Ukraine: Options for the end of the debt moratorium in 2024", erlassjahr.de-Blog 12. December 2023, erlassjahr.de/en/news/ukraine-options-for-the-end-of-the-debt-moratorium-in-2024/ and Kaiser, J. (2011): "Griechenland: Notwendige Entschuldung und Optionen für ein angemessenes Verfahren", Fachinformation 30, erlassjahr.de/wordpress/wp-content/uploads/2016/03/Fachinfo-30.pdf.

pennies, which is clearly less attractive than holding out and hoping for a restructuring after the end of the Russian aggression. Furthermore, even if the Ukrainian authorities will organize a debt restructuring instead of another debt standstill, the option of holdouts and lawsuits exists anyway and cannot be preempted entirely. In fact, as holdouts and suing creditors that do not want to participate in good-faith restructurings is a regular phenomenon in debt restructurings, calls for safe harbour and anti-holdout laws by civil society, academia and parliamentarians increased heavily in past years and are being discussed in some legislations.[9]

2.3. Temporary Debt Service Suspension until hostilities end

Debt Service Suspension is one of the best possible options for supporting indebted countries after an external shock. Countries which are particularly vulnerable to the effects of climate change have time and again demanded that option. Lately, specific debt suspension clauses in bond contracts and contracts of multilateral institutions[10] have responded to such calls. However, where such clauses are included, which naturally cover only payment obligations on contracts, they fall far short of the needed overall flow relief after a major external shock.

The logic behind a (automatic) stay of debt service payments after an external shock is that everybody stands to gain from an agreed-upon debt service relief. It allows the disaster-hit debtor crucial first emergency relief and the onset of the necessary reconstruction effort by leaving the money in the country. In a situation where the sovereign is forced to continue payments, also creditors incur a significant risk to face higher losses at an ultimately inevitable debt restructuring at a later moment than they would have if they had agreed to a debt service suspension. The difference between Ukraine's situation and that of e.g. hurricane-prone small island developing states (SIDS) is, of course, that the latter suffer a one-off disaster, after which destruction can be assessed and the need for a debt pause defined with some reliability, while the end of aggression and destruction cannot be realistically projected. The "alternative" use of the budgeted debt service towards emergency relief and reconstruction, however, still is an improvement towards a renewed debt sustainability of Ukraine, although its effects may be superseded by even more destruction caused by the aggressor.

Historically, debt service suspension for indebted sovereigns has been used to provide fiscal space for crisis response and essential development investments respectively in the context of two larger international debt relief initiatives. Both instances, however, show remarkable differences:

- The G20 created the "Debt Service Suspension Initiative to support countries affected by Covid-19" (DSSI)[11]. They allowed for the suspension of payments to official G20 and Paris Club members for most of 2020 and all of 2021. They called upon non-members and private creditors to follow suit. Some non-member official creditors did join with minor concessions, while the private sector did not participate in any way. The suspension provided substantial

[9] Stutz, M. (2023): "The Potential of national Legislation for the Fair Resolution of Global Debt Crises"; erlassjahr.de focus paper No. 9, erlassjahr.de/wordpress/wp-content/uploads/2024/01/Focus_Paper_9_2edition-230130.pdf.

[10] See for example World Bank (2023): "World Bank Extends New Lifeline for Countries Hit by Natural Disasters", 1 December 2023, /www.worldbank.org/en/news/factsheet/2023/12/01/world-bank-extends-new-lifeline-for-countries-hit-by-natural-disasters. There are other multilateral institutions, too, such as the EBRD and EIB, that introduced debt suspension clauses for a specific group of countries vulnerable to climate change into their debt contracts.

[11] World Bank (2022), "Debt Service Suspension Initiative", 10 March 2022, www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative.

fiscal space to some countries with huge debts outstanding to participating governments. However, the suspension was meant to be Net Present Value (NPV) neutral, i.e. after a grace year 2022, debtors are expected to pay the postponed debt service in five equal installments to each of their creditors between 2023 und 2027. It quickly became clear that not all of the 48 countries, which actually have availed themselves of the initiative would be able to shoulder the additional debt service over their regular 2023-2027 debt service. Consequently the "Common Framework for Debt Relief beyond the DSSI" was created. It sets the framework for the inevitable post-moratorium debt restructuring in those DSSI countries which request it. There can be no doubt that a broad and comprehensive restructuring will also be needed by Ukraine at some moment. Unfortunately, the Common Framework has been so ill-designed that until today not a single dollar has been cancelled in favor of any of the presently five countries that have applied for treatment under the framework – which, however, does not impair the merits of the original debt service suspension.

- The Heavily Indebted Poor Countries (HIPC) Initiative of the 1990s and 2000s was quite a complicated process of debt cancellation. It took considerable time from the debtor's qualification in principle through to the "decision point", at which debt relief was actually calculated, until achieving the "completion point", when the debt relief was irrevocably implemented. This process was smoothed with an "interim relief" between the decision and completion points. It meant that current debt service in that phase was reduced to the amounts that had been payable if the completion point had already been reached. That concession to the debtor, however, was revocable in cases where it would have grossly failed to comply with macro-economic as well as poverty reduction conditions set up by the IMF. Given that revoking the interim relief would most likely have led to the debtor running into unregulated arrears, rather than paying up as requested, creditors and IFIs also had a strong incentive not be too stringent in applying the revoking option. While the interim relief arrangements doubtlessly were helpful for the economic recovery of the heavily indebted beneficiaries of the initiative, it also was a face-saving option for IFIs and creditors to tacitly retreat from their original obsession with controlling the economic policies of their debtors through pre-defined and fixed probation periods of 3+3 years.[12]
- US support to the beleaguered Soviet Union played a major role in warding off the German 1941 attack on the Soviet Union and the Allies' ultimate victory in World War II. Much of this support came under the lend-lease scheme (some US-$ 10bn), which de facto turned out to be grants, except for smaller compensations and "reverse land-lease" agreements. However, there were also direct loans outstanding to the tune of US-$ 1.7bn. The US asked for US-$ 1.3bn to be repaid at the end of the hostilities, but was only offered US-$ 170m by the USSR.[13] The remainder was simply not paid until some in-kind-deliveries were finally agreed-upon in 1972 and partly delivered thereafter. For the Soviet Union with its enormous losses in people, productive capacity and infrastructure through the German attack, this "involuntary" and in fact indefinite debt moratorium from its later cold war opponent was certainly necessary and a helpful maneuver to spare its scarce hard currency reserves. For today's Ukraine the most relevant aspect of this historical precedent consists in the fact that the creditor never insisted on any repayments as long as hostilities were ongoing. This, however, was not a de jure, but a de facto arrangement.

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[12] Recall that originally HIPC was intended to be implemented through two three years periods before and after decision point, during which creditors wished to keep full control over the debtors' economic decision via the threat of revoking the agreed debt relief.

[13] See Wikpedia article on Lend-Lease, en.wikipedia.org/wiki/Lend-Lease#:~:text=Similarly%2C%20the%20Soviet%20Union%20repaid,the%20British%20and%20the%20Commonwealth.

On March 24th 2023, the official creditors of Ukraine[14] (excluding only a small number of creditors, such as Russia) extended the 2022 debt service suspension for Ukraine to cover the full period of the existing IMF program, i.e. 2023-2027. In the agreement, the creditors of Ukraine also committed to "an additional debt treatment to restore debt sustainability, once the situation is stabilized or at the latest by the end of the IMF program (2027)." This medium-term arrangement doubtlessly is the best possible debt relief operation that can be undertaken at this stage of the conflict.[15] Its deficit, however, is that it does not even call upon private creditors to follow-suit and provide comparable debt service relief until 2027 – as otherwise is common practice in the Paris Club. Only the envisaged "debt treatment in line with the parameters of the IMF program" is made contingent on an arrangement with the private bondholders, which is at least as favorable. In fact, bondholders already conceded a moratorium in 2022, which, however, only runs until end-August of 2024. Rather than aligning their moratorium with that of official bilateral creditors and the IMF program to 2027, the latest IMF review assumes that bondholders and the Ukrainian authorities will aim at implementing a major restructuring of the "legacy" bonds in 2024.[16]

While in principle a stand-alone operation on the legacy bonds in 2024 could provide Ukraine with far-reaching relief, it also implies high risks for everybody:

- For Ukraine, a less-than sufficient restructuring could lead to a situation where official fresh money is used to service old private claims, which will certainly deal a heavy blow to the badly needed further official support.
- Servicing legacy debt during the war would extract resources that are badly needed for defense and keeping state functions running.
- If comparability of treatment with the official sector is only assessed later (presumably 2027, when the Group of Creditors will likely restructure), it may be difficult to achieve just another restructuring with these same bondholders in case of too little debt relief, especially without any mechanism to enforce comparability of treatment. In the worst case, the official sector would hold back own concessions until comparability of treatment is reached, which could protract the debt restructuring.
- For the private creditors, it may not be the best possible option to negotiate a "final" restructuring while the war is still ongoing. Either the war situation leads to deeper than necessary cuts into their claims, or they achieve a smaller haircut, which could mean that Ukraine cannot sustain the remaining claims due to the ever-rising costs of the ongoing aggression.[17]

The IMF has identified a necessary additional debt service flow relief between 1% and 1.7% of GDP per year between 2024 and 2027.[18] Over the 2024-2027 program period, this accumulates some US-$ 14.8bn. The savings are intended to provide "adequate liquidity buffers in case macro-fiscal or

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[14] Canada, France, Germany, Japan, UK, USA, with a broader number of Western creditors as observers also agreeing to the terms of the payment suspension. Absent among Ukraine's creditors was, of course, Russia, despite its membership in the Paris Club.

[15] erlassjahr.de (2023): "Ukraine: Options for the end of the debt moratorium 2024", 15 December, 2023, erlassjahr.de/en/news/ukraine-options-for-the-end-of-the-debt-moratorium-in-2024.

[16] IMF (2023a): "Ukraine: 2023 Article IV Consultation, Second Review", 11 December 2023, pt. 69, www.imf.org/en/Publications/CR/Issues/2023/12/11/Ukraine-2023-Article-IV-Consultation-Second-Review-Under-the-Extended-Arrangement-Under-the-542297.

[17] The experience in current debt restructurings, that debtor countries face the same coordination issues between different creditors, suggests that concessions by private creditors will rather be smaller than larger.

[18] IMF (2023a), p. 34 and overall financing overview on p. 79.

contingent liability shocks materialize".[19] While the major part of the adaptation effort is being delivered through the ongoing external official disbursements, the debt relief has indeed a substantial role to play.

According to the World Bank *International Debt Statistics*, Ukraine paid around US-$ 247m to bilateral official creditors and US-$ 3.7bn to private external creditors in 2021. Consequently, the flow relief needs to come to the most substantial part through an arrangement with the private sector. To achieve this, an extension of the present moratorium seems to be the best possible ad hoc option ahead of the unavoidable final solution after the end of the hostilities.

2.4. Brady-style conversion of bank debts into bonds

In March 1988, finance ministers Nicholas Brady of the US and Kiichi Miyazawa of Japan developed a plan to deal with the insolvency of a growing number of Latin American (as well as a few Asian and African) countries. After the failure of an earlier attempt of Brady's predecessor in office, James Baker, to keep financing the already unsustainable debt service of some middle-income countries with a rescheduling initiative, the Brady plan for the first time allowed for a reduction in both coupon and principal value of the outstanding debt.

The Brady plan converted outstanding US and international bank loans into "Brady bonds", for which there was a liquid market, and which were guaranteed by zero-coupon bonds, which the debtors bought out of their reserves or with new external financing from the US treasury. Two types of Brady bonds implied different forms of NPV reduction: Par bonds had the same value as the original debt, but carried a smaller coupon. Discount bonds had a lower face value, but the same interest rate.

The program was successful in restoring solvency and market access in most of the 11 participating countries. There was only one country which subsequently also defaulted on its Brady bonds, namely Ecuador. Mexico was the first participating country in the 1980s and managed to fully pay all its obligations under the Brady plan in 2003.

One of the key elements of the Brady plan is certainly not of relevance to Ukraine 2024: The bulk of the outstanding debt is already in the form of bonds. At the same time, there is nothing to win from the conversion of bilateral official loans into tradable bonds. Still, the legacy bonds could be exchanged for bonds with either the lower face value or coupon. This would then rather be a bond-for-bond exchange. However, the market for Ukrainian bonds is largely illiquid as long as the war drags on, except eventually for individual creditors in need of immediate liquidity, who would sell off at this very unfavorable moment in time rather than holding out and waiting for a Ukrainian victory and the restoration of Ukraine's debt sustainability.

Another element of the Brady operation would also be difficult to implement for Ukraine: The country certainly lacks the resources to buy zero coupon bonds in order to guarantee the converted bonds. With the persisting financing gaps[20] and the uncertainty over future liquidity, there is hardly any space for an investment which would sweeten legacy bondholders' readiness to convert their claims.

[19] IMF (2023a): "Ukraine: 2023 Article IV Consultation, Second Review", 11 December 2023, p. 79.

[20] IMF (2023a): "Ukraine: 2023 Article IV Consultation, Second Review".

2.5. Debt Swaps for reconstruction investment

The Ukraine war and reconstruction efforts happen to coincide with a particular strand of the climate financing discussion, namely around the potential of debt swaps for climate protection or for development purposes at large. Debt swaps are already a longstanding instrument of debt restructuring, going back to the earlier stages of the "Debt crisis of the Third World" from the 1980s. The basic concept is that an existing claim by an external creditor is not collected, but left in the debtor country and paid in national rather than hard currency by the debtor government into a mutually agreed development effort.

Particularly with a view to some more recent spectacular operations, however, an important distinction needs to be made between two types of operations:

- A classical debt conversion or swap functions as described above: No money flows out of the country, the claim is entirely or partially transformed into a domestic investment. This can take the form of a direct development project or program with or without any further influence on the part of the creditor. Alternatively, it can establish a counterpart fund, which normally is jointly administered by the creditor, the debtor and sometimes third and fourth parties, such as UN agencies or national civil society organizations.
- Somewhat unfortunately, the term "debt swap" has also become common for another type of operation, which is rather a buy-back than a swap in the narrow sense of the word: The original (private) claim is not being forgiven, but bought back by the debtor with the help of a specific fresh money arrangement, often involving a commercial bank and a development or conservation organization. The buy-back implies a discount, the acceptance of which is sweetened for the original creditor by a part of the savings being invested for a development or nature conservation program – in many cases with a high visibility. This allows the original creditor to appear as a pioneer for developmental or ecological efforts, while still collecting a substantial part of its original claim, often close to its secondary market value.

How relevant can either of the two instruments be for financing the reconstruction of Ukraine?

The original debt for development swaps are regularly confined to claims of bilateral official creditors. Private creditors normally use the type-II instrument and multilateral claims so far have never been converted. This does not mean that by their character a conversion of multilateral claims would be ruled out, but the insistence of multilateral institutions on their "preferred – de facto: exempt – creditor status" have so far blocked any attempts to consider a conversion.

Some traditional Western creditor countries have set up explicit budget lines as well as rules and regulations for their conversion programs. The Swiss program has been outstanding in this regard: On the occasion of the 700th anniversary of the Swiss Federation in 1992, the government set aside a symbolic 700 million Swiss Francs[21] in order to write down debt of countries in the Global South to Switzerland, including in some cases the setting up of counterpart funds in the beneficiary countries. These have often been administered in cooperation with local civil society organizations. The program practically put an end to Switzerland's role as an important creditor to lower and lower middle income countries in the Global South because most recipients have received grants rather than loans ever since.

[21] Ultimately the amounts cancelled did not reach the full amount of SFr 700m.

Another very specific program was the French C2D program, which facilitated the refinancing of the "tail-ends", i.e. the 10% of outstanding claims after a HIPC exit debt restructuring in the Paris Club (90%). France - unlike most other club members - did not automatically top-up the 90% cancellation under "Cologne Terms" to full cancellation, but collected the amount and immediately channeled it back, provided the beneficiary invested the money in Euros or in local currency into agreed-upon development programs. Here again some civil society involvement was made possible. However, the program was criticized for establishing additional conditions for the full cancellation, which others provided without any such demands.

At present, there are three active debt conversion programs still existing:

The German debt conversion facility is an integral part of the country's development cooperation budget. At present, it allows for an annual cancellation of up to € 150m globally. Countries need to be low income or lower middle income countries in order to qualify for conversion under the facility, and the debt situation must breach pre-set thresholds. Only ODA claims can be converted. Ukraine happens to qualify as presently one of only 20 countries worldwide. At least € 22m, but eventually up to € 78m could eventually be converted under the program. The potential purposes for a debt conversion cover practically the full spectrum of German development cooperation, including social, economic and ecological purposes.

Spain presently allows for the conversion of commercial claims as well as those which result from Spanish development cooperation under its *Programa de Conversion de Deuda en Inversiones (PCD)* started in 2006.The basis is law 38/2006. Programs financed under the PCD need to be in line with Spanish development policies and the beneficiary needs to demonstrate its development orientation and good governance. At present, programs in some 20 countries are in their implementation phase. Theoretically, the full amount of € 400m war support by Spain to Ukraine could be converted under the facility; however, this would then be by far the biggest single operation under the programs, and it is not likely that the Spanish authorities would be prepared to use the instrument to such an extent outside the traditional realm of Spanish development cooperation. Given Spain's support to Ukraine's defense effort, however, a smaller operation should meet with interest on the Spanish side.

Italy has started a debt conversion program through its law 209/2000. Like the Spanish program, the Italian one does not have a ceiling. However, it allows only for the conversion of Italian ODA claims. Ukraine only owes Italy from the war support, which cannot be registered as ODA. Moreover, Italy requires beneficiaries to have a Paris Club agreement with a swap clause in place in order to qualify, which Ukraine presently does not have. Additionally, the Italian program requires countries to explicitly refrain from using war as an instrument of conflict resolution.

Beside Switzerland and France, there are a few other countries which have converted official claims into development finance in the past, notably the US (with PL-480 claims) and Canada. Given the exceptional situation in which Ukraine finds itself and the strong support it receives from both partners, a request for a renewed conversion initiative might be launched.

When it comes to debt conversion, Ukraine could, moreover, avail itself of the support of some third parties which have experiences with both implementing debt conversions as well as promoting the dialogue between program countries and their creditors. The Global Fund to Fight Aids, Malaria and Tuberculosis (GFATM) in the area of health investments and the World Food Program (WFP) in the area of food security stand out.

When considering the relevance of such bilateral debt swaps for Ukraine, there is a huge discrepancy between potential amounts - one- or two-digit million amounts - and the need for debt relief - which the IMF in its Art. IV report in December 2023 spotted in the range of 15 billion US-Dollar in the program period. This means that bilateral debt conversions can play a role towards very targeted development finance in the context of the reconstruction or even emergency relief effort. Like everywhere else, they are not an instrument towards debt crisis resolution.

At this point of time, it is likely that a debt treatment by the official bilateral creditors in the Group of Creditors to Ukraine (which includes mainly Paris Club creditors) will be very generous. A precedent could be the Cologne terms, which were used for HIPC debt relief (90 percent cancellation). Most Paris Club creditors automatically topped up the Cologne terms with a further 10 percent cancellation. France did not automatically top up (see above), but used debt swaps instead for the remaining 10 percent. This could be an option in the case of Ukraine: to push for the remaining claims that will not be part of the debt cancellation likely to be agreed in 2027 to be cancelled as part of debt swaps. Furthermore, there are also still official bilateral creditors that may not become part of a Paris Club agreement. It would make sense to explore debt swap options with these more specifically.

More recently, some spectacular operations in Belize, Ecuador and Gabon, among others, took place with private sector claims, touching a far higher amount of the beneficiaries' external debt stocks.

Country	Amount retired	New debt	Net debt stock reduction	Development Investment
Belize	530m	364m	166m	19 x 4m p.a.
Ecuador	1.6bn	656m	1bn	17m p.a.
Gabon	500m	500m	-	125m

This has led some observers to suggest a similar operation for Ukraine.

However, these operations are distinct from the bilateral debt swaps discussed above. In the case of Belize, Ecuador and Gabon, the retired old debt has been replaced by new hard currency external debt, instead of being cancelled for investments in local currency in the country concerned. The newly placed debt was usually guaranteed by a public body, which made it cheaper than the original debt. Only because of this transaction is there any leeway for development/environmental investment. Even if larger parts of the countries' external debt are included in these operations compared to bilateral debt swaps, the net effect needs to be calculated with the new debt, which has financed the buy-back and which may come at market conditions or slightly below due to the official sector guarantee (see table).

Different from the three small countries mentioned above, which had only one or few bond series' outstanding, Ukraine is owing the private sector in the outside world a total of US-$ 20bn. It is hard to imagine that a consent among all the holders – or at least enough to cross consent thresholds – can be reached at a time when the country's economic future is as unclear as under the present Russian aggression.

A third swap option could be a debt-for-equity swap. Under this instrument, which had preceded the emergence of development swaps in the 1980s, existing debt is converted into equity, i.e. the ownership of a Ukrainian asset by the original external creditor. The advantage of a debt-for-equity scheme certainly is the provision of badly needed investment into the productive sector or infrastructure. The downside, on the other hand, is the transfer of ownership to a foreign investor,

which can be unproblematic in sectors which are highly competitive and already have a strong domestic or external productive structure. However, it can be fairly problematic if key infrastructure is privatized and thus handed over to foreign commercial interests – or in the extreme event of investors siding with the Russian cause.

None of these instruments, however, qualifies as a substitute to a comprehensive debt restructuring, which Ukraine will need once the peace is won.

2.6. Subordination of legacy debt under new financings

It has been discussed in other contexts that it needs to be assured that the servicing of the legacy debt would not impair the willingness of new private sector creditors to provide new financings. "Structural subordination" of old under new financings is considered to that end.[22]

The subordination has been applied in the context of debt restructurings mostly through the institutionalization of a cut-off date, e.g. by the Paris Club. The cut-off-date separates old debt, which can be restructured, from new debt, which has been excluded from a restructuring, such as emergency relief during a crisis. This separation is meant to keep the debtor solvent and liquid, while also promoting its ongoing ability to serve restructured old claims. By and large, this tool has been fulfilling its purpose in the context of official restructurings.

Under the official sector's claim to set the parameters for any broader restructuring that will involve not only its own but also private creditors (the "comparability of treatment" policy of the Paris Club), the cut-off date was commonly defined as the first ever round of meetings with the Paris Club. The argument behind this is that after a first restructuring with the Paris Club, debtors might have factored in the proven readiness of Club members to provide restructurings and thus behaved irresponsibly while taking out new loans. This line of argument has always been a highly questionable one – particularly as only long after its establishment, the Club first started to provide debt restructurings in the 1990s. Before then, it only has offered debt reschedulings. However, it still served to define a bottom line regarding which claims would be included and which would not. That helped to encourage new official and private financing where they were badly needed in order to maintain a debtor's solvency and liquidity.

With traditional cut-off dates drifting more and more into the past, the traditional principle of defining them has become obsolete in many cases. Ukraine's existing cut-off date with Paris Club creditors is Dec. 31st 1998 – certainly a pointless date for any restructuring of today. And even if the latest 2015 restructuring with the private sector were considered as a cut-off-date in a rare act of reverse parameter setting between private and official sectors, the entirety of war-related bilateral support debt would be excluded from the operation along with the considerable financing provided from both official and private sources between 2015 and the beginning of Russian aggression in 2022. This would simply make any restructuring pointless. It may, however, well be the case that the Paris Club will define a new cut-off date to separate pre-war from post-war claims.

As long as traditional principles will be applied, a more innovative solution for the necessary protection of new financing therefore needs to be found.

[22] Buchheit, L. and M. Gulati (2016).

It has been proposed to that end to restructure the legacy Eurobonds over an extremely long time frame, so as to make sure that their repayments do not coincide with any new official or private financing which Ukraine needs to attract after the end of the hostilities. This extension of any repayments practically "forever" should than be sweetened for the bondholders by guaranteeing the payments of a reduced or even the currents coupons. This would allow Eurobond holders to keep the paper on their books and receive an income stream.

Based on the World Bank's forecasts in the International Debt Statistics, such a restructuring would take some 11bn US-$ of principal repayments between 2024 and 2027 off the shoulders of the Ukrainian government. The price tag would, however, be the confirmation of around US-$ 4.8bn in coupon payments, which would then eventually have to be guaranteed by some official sector player. As a result, there would be the real danger that these payments would be officialized and added to the already biggest part of Ukraine's outstanding debt.

The expectation of Ukraine and its official supporters outside, would, of course, be that such an "amicable" approach, different from a disorderly Ukrainian default on its Eurobonds, would keep the doors open for renewed private sector engagement in Ukraine.

As we have already seen during our discussion of official sector guarantees above, it remains questionable whether the private sector can thus be instigated to stay engaged: As long as hostilities continue, private investments remain under the threat of a total loss, depending on the outcome of the war. Once peace is won, Ukraine will most likely provide enormous growth perspectives, which make it an interesting investment sphere for private capital anyway and regardless of how it dealt with private legacy bondholders before – at least as along as a renewed external aggression can be ruled out with some probability.

Consequently, a voluntary agreement with Eurobond holders should not be sweetened in any way. Rather the simple moratorium discussed above should be sought.

2.7. Contingency clauses as a standard instrument in bond and eventually other restructurings

The Russian aggression makes every forecast regarding the economic future of Ukraine highly speculative. An element of any war-time debt restructuring could therefore be a standard contingency clause, which makes the effective payments of interest and principal dependent on a set of factors. These can be political in nature, e.g. the end of the war; or they can be economic in nature, e.g. a certain growth rate of the Ukrainian economy with or without the war ongoing.

Such "contingency clauses" have been used in Argentina's earlier restructurings. They can cover a broad range of options for the design of payment obligations, in principle from a full-scale moratorium to market rates. They therefore can be useful for Ukraine in its present highly uncertain situation, too. However, design is of essence, as Ukraine experienced itself after the 2015 debt restructuring and the inclusion of GDP warrants, which became very costly for the country. The downside is that such clauses already define payment obligations for an unforeseeable future and this would risk either being too "generous" to a debtor who recovers faster than anticipated or to establish unambitious criteria, which are unrealistic because destructions exceed any projections which could have been made earlier.

The key question about the instrument therefore is how much sense it makes to seek any "final" arrangements while the war is still ongoing. Should there be any reason to do so – for instance in

order to keep one or several official supporters on board – contingency clauses can be useful in linking capacities to obligations, but only then.

When it comes to private creditors, the currently evolving practice in debt restructurings should also be considered when looking at Ukraine. In all post-COVID-19 debt restructurings that involve different creditor groups (Suriname, Zambia, Sri Lanka, Ghana), contingency instruments are being used to get creditors to agree to a debt restructuring in a context of conflicts between different creditor groups and the lack of mechanisms to enforce necessary debt restructurings. In Suriname, to achieve agreement on a bond restructuring, a value recovery instrument has been introduced that is linked to future oil revenues. In Sri Lanka, macro-linked bonds are discussed to bridge the gap between different understandings of future economic prospects between the IMF and bondholders. In Zambia, there is a contingency on the assessment of debt-carrying capacity. All these instruments cover an upside risk for creditors to reduce debt relief. None of these cover any downside risks, should macroeconomic parameters be worse than expected or a new external shock hit the country. Thus, while creditor interests are protected, the debtor remains unprotected. While the IMF discourages the use of such instruments[23], in the current context of a lack of legal enforcement mechanisms, it becomes more and more standard practice.

3. Other proposals

Other proposals have been made in the recent past, which are not directly related to any debt restructuring or alleviation, but still could have an influence on Ukraine's future debt sustainability. Therefore, they will be briefly mentioned and discussed with regard to their relevance for Ukraine's debt sustainability:

3.1. Donation of SDRs

In 2021, the IMF board has issued new Special Drawing Rights (SDRs) to the tune of SDR 456 bn in order to strengthen global liquidity in response to the global economic disruptions caused by COVID-19. SDRs are an artificial basket currency created by the IMF. SDR 456bn equal about US-$ 650bn. About SDR 275bn went to developing countries and emerging markets including about 2bn to Ukraine; the majority, however, due to the rules of SDR allocation, went to industrialized countries which were less in need.

In 2021, the IMF had called on its rich members to make their SDRs available to poorer members by donating them to the Poverty Reduction and Growth Trust Fund (PRGT). Few members did so. Some considered bilateral arrangements with some of their developing partners, which would have meant that the donor would have received the current interest rate from the recipient. As rates intermediately had been as low as 0.05%, this would indeed have been a favorable option for indebted countries to replace expensive commercial debt with cheap SDRs.

With a comparable aim, it has then been suggested that supporters of Ukraine could also bilaterally donate their "unnecessary" SDRs to Ukraine as long as the Russian aggression is going on. It needs to be considered, however, that since February 2022 the SDR rate has risen from 0.2% to today's 4.1%, thus reducing the potential gains from a donation for Ukraine. While as additional support to

[23] IMF (2023b): "Global Sovereign Debt Roundtable-Cochairs Progress Report", 12 October 2023, https://www.imf.org/en/News/Articles/2023/10/12/pr23348-global-sovereign-debt-roundtable-cochairs-progress-report.

Ukraine's fiscal stance, SDR rechanneling should be considered, it is no suitable instrument towards debt reduction.

3.2. Reduce multilateral borrowing costs by eliminating IMF surcharges

The IMF is one of Ukraine's most important multilateral financiers - both directly as well as indirectly through the signaling effect of its lending. However, IMF loans are not cheap. At present, Ukraine is charged the SDR interest rate of 4.1% plus 100 basis points. Additionally, Ukraine has to pay "surcharges" because its borrowing exceeds 187.5% of its quota. These surcharges can add up to another 300 basis points to the annual interest rate, which means that for a large part of its borrowing, Ukraine does not only pay an exceptionally high (by IMF lending standards) 4%, but up to 8% to the IMF. The intention of the surcharges is to prevent individual borrowers from making extensive use of scarce IMF resources, thus depriving other members, which may be equally in need. Surcharges are therefore demanded for borrowing beyond the quota limit referred to above and also to extending borrowing beyond the agreed timeframes. This policy has been harshly criticized by a broad coalition of debt justice movements and NGOs, particularly for burdening exactly those most in need exactly at the time when then are most in need.[24]

Multilateral creditors including the IMF keep insisting on their "preferred" – de facto: "exempt" – creditor status, which immunizes them from participating in any debt restructuring. While this status is neither enshrined in any of the organizations' articles of agreements or founding documents, it has been widely accepted by almost everybody in the global lending/borrowing business.

In the case of Ukraine (and earlier of a few other countries), IFIs have addressed the dilemma between their role as a lender of last resort on the one hand and contributing to the build-up of an unsustainable debt on the other – by pointing to their willingness to maintain a positive resource flow. In Ukraine's situation, this is welcome, as long as the external support, including the financial support, is essential for keeping up the economy and the country's ability to defend itself against the aggression.

It is no solution, of course, once the war has ended and Ukraine needs a comprehensive restructuring of all its external debt liabilities. Then, the ongoing resource stream, which has helped the country survive the aggression, will turn into a millstone around Ukraine's neck – particularly, if the war will have dragged on for several years and the relative weight of multilateral/IMF claims has grown even further.

It has therefore been proposed to eliminate the surcharges policy altogether.[25] According to the Center for Economic and Policy Research (CEPR), which coordinates the global network on surcharges, the elimination of surcharges would shave off an estimated US-$ 3.8bn of Ukraine's debt service between 2023 and 2033 (or some 39.1% of all charges and interest it has to pay to the IMF). The advantage for Ukraine of this elimination is obvious. However, it would also imply some advantages for the IMF:

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[24] Amsler, F. and M. Galant (2023): "The Growing Burden of IMF Surcharges: An Updated Estimate", Center for Economic and Policy Research, 13 April 2023, cepr.net/report/the-growing-burden-of-imf-surcharges-an-updated-estimate/.

[25] See a joint letter by more than 150 organizations worldwide: Eurodad (2022): "IMF surcharges are Unfair, Counterproductive and a Threat to an Equitable Global Economic Recovery. They should be Eliminated immediately.", debtgwa.net/statements/eliminate-imf-surcharges-immediately?utm_source=emailmarketing&utm_medium=email&utm_campaign=bretton_woods_news_lens_14_april_2022&utm_content=2022-04-14.

- It would reduce the need for fresh financing in order to keep its positive net flow as long as the war drags on.
- It would improve the balance between multilateral, official bilateral and private financing, eventually permitting the restoration of debt sustainability without further cuts into IMF claims later on.

Obviously, the existing surcharges policy would not be altered or eliminated through a "lex Ukraine". But this spectacular case could be an excellent opportunity to finally do what should have long since been done.

4. In terms of a conclusion

Ukraine will need to restructure the entirety of its external debt as soon as the hostilities cease. A lot will depend on the format and prerogatives of such a restructuring process. What can be done while the aggression still continues should not be considered as a substitute or a pre-emption of this "big" solution.

The most natural step to take right now is to minimize current debt service obligations as much as possible in order to maximize the resources available for the ongoing defense effort, emergency relief, reconstruction and the functioning of the Ukrainian state at large. Temporary debt service suspensions are the best instrument to that end. They can even be supportive of the war effort in the sense that Western creditors deliberately forego any payments before a cease-fire, thus signaling to the Kremlin that it must not hope for exhausting Ukraine fiscally.

At this point of time, a broader restructuring of existing debt stocks under the present circumstances is not recommendable. Rather, it makes sense for Ukraine to make use of the existing payment moratoria, seek their extension in line with the IMF debt sustainability calculations at least until 2027 and thus keep the debt to bondholders and other private lenders "dormant" as long as possible. There should be no danger of litigation against Ukraine, even if a moratorium could not be agreed upon with private creditors but would actually be implemented in an "unregulated" way, i.e. if Ukraine would simply not pay up. It would be very difficult for any Western private creditor to sue Ukraine for full payment without the extreme damage to its public image, as a litigation strategy would imply "siding with Putin". Additionally, it could be expected that national anti-vulture legislation would very quickly be implemented by Western governments, who will not want to see their Ukraine support be channeled to private purses. Beyond this aspect, any fear of excluding the country from international capital markets by a continuous payment suspension, seems unfounded, simply because capital market access must be expected to remain limited as long as the hostilities will last.

A victorious Ukraine with the enormous reconstruction needs that the Russian aggression has caused will most likely provide external private investors with enormous profit and growth potentials. For these, a post-war Ukraine could to some degree resemble the situation of post-war Germany and Japan, where "economic miracles" have happened through a combination of investment opportunities, low labor costs, external investments and debt relief. A comprehensive debt restructuring would make sense in such a moment to guarantee attractiveness for new lenders and investors.