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## External public debt in the financial system: the practice of national and foreign formation

### Abstract

*Introduction.* Under the condition of realization of Ukraine's ambitions, it is essential to conduct a comparative analysis of the peculiarities of the formation of external public debt of our state as well as the new EU member states and East European countries which keep to the European Neighbourhood Policy. According to the results of such an analysis, we have detected the problems related to the formation of external public debt, identified a link between external public debt and the elements of the financial system, improved the mechanisms of its regulation system. Financial problems of the studied countries have different origin, yet those countries have very similar challenges such as violation of economic sustainability, structural imbalances, deterioration of the debt burden indexes. A study of the formation of external public debt as well as its structure and a clear understanding of its role in the existing financial systems of the mentioned countries should become the basis of a comprehensive approach to the improvement in the effectiveness of the latter as well as to the implementation of the public debt regulation mechanism.

*Results.* A general trend towards deterioration of the conditions in the debt market both within the European Union and the countries which aspire to join the EU maintained due to the ineffective measures taken in regulating the financial system and unbalanced macroeconomic policies proves that the issues related to the formation of external public debt in the specified countries are characterized by the use of public loan as a tool to increase government expenditure without collecting extra public revenues by the government, which may lead to further deterioration in public finance. According to the selected features, we have detected the role of external public debt relevant to the Ukrainian financial system with regard to the impact of the external public debt on the state budget, the lack of the operations aimed at formation and repayment of external government borrowings, the loss of opportunities to determine the peculiarities of formation of external public debt in the Ukrainian financial system to harmonize structure balance of payments, manage the exchange rate and reduce debt burden in public finances.

*Conclusion.* The specific features of external public debt formation in the group of studied countries have been described; the factors that cause its dynamics have been selected. The close influence of tools of public expenditures and income management on the external public debt formation and means of monetary policy have been justified. Practical recommendations on improvement of the regulatory mechanism of Ukraine's public debt through the implementation of new current tasks of debt policy which foresee the definition of significant weight of external foreign debt in the total structure of public debt and the acceptable limit of the expenses in the structure of market and the institutional mechanism of public debt regulation as well as regulatory additions related to the debt policy in coordination with the state monetary and fiscal policy have been provided.

**Keywords:** External Debt; Financial System; Public Debt Regulation; Debt Policy; Government Credit

**JEL Classification:** H60; H63; H81; H 87

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### Зовнішній державний борг у фінансовій системі: практика вітчизняної та зарубіжної формації

**Анотація.** У статті досліджено місце зовнішнього державного боргу у фінансовій системі України, проаналізовано його стан та структуру у нових країнах-членах Європейського Союзу та східноєвропейських країнах, стосовно яких проводиться політика добросусідства з боку Європейського Союзу. Виявлено, що в сучасних умовах розбалансування державних фінансів та з урахуванням наслідків недосконалої системи регулювання державним боргом посилюється вплив останнього на стан та структуру фінансової системи досліджуваних країн. Запропоновано напрями удосконалення державної боргової політики України в контексті узгодженості з державною бюджетною та валютною політикою.

**Ключові слова:** зовнішній державний борг; фінансова система; механізм регулювання державного боргу; боргова політика; державний кредит.

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### Внешний государственный долг в финансовой системе: практика отечественной и зарубежной формации

**Аннотация.** В статье исследовано место внешнего государственного долга в финансовой системе Украины, проанализированы его состояние и структура в новых странах-членах Европейского Союза и восточноевропейских странах, по отношению к которым проводится политика добрососедства со стороны Европейского Союза. Выявлено, что в современных условиях разбалансирования государственных финансов с учетом негативных последствий несовершенной системы регулирования государственного долга усиливается влияние последнего на состояние и структуру финансовой системы исследуемых стран. Предложены направления совершенствования государственной долговой политики Украины в контексте согласованности с государственной бюджетной и валютной политикой.

**Ключевые слова:** внешний государственный долг; финансовая система; механизм регулирования государственного долга; долговая политика; государственный кредит.

### 1. Introduction

External public debt is a complex economic category that possesses peculiar features, characteristics and system elements, which gives us an opportunity to apply regulatory mea-

asures aimed at affecting the structure of public financial system by using them for modeling different financial obligations relevant to the elements of financial system changing according to the requirements set by the economic conditions and the state

economic policy. Nowadays, the formation of external public debt that is considered by us to be its determined structure and a stage of relations and connections, which corresponds to the particular development stage of the financial system, is in a shake-out phase in every country of the world. Taking into consideration the EU integration vector chosen by Ukraine, it is necessary to conduct a study relevant to the role of external public debt in the financial system, evaluation of its state and structure, the comparison of national experience and the functioning practice in the new EU member states and East European countries which keep to the European Neighbourhood Policy.

## 2. Brief Literature Review

The following foreign scientists have dedicated their works to the studies of public debt from the perspectives of state complication and its structure deterioration under the conditions of financial crisis: K. Rogoff (2008; 2010), M. Carmen (2008, 2010), V. Reinhart (2008, 2010). A study of external public debt of the developing countries was conducted by A. Guscina (2006) and O. Jeanne (2006). The theoretical basis and the problems of default incurrence as to the public debt obligations were presented by U. Panizza (2009), F. Sturzenegger (2009), J. Zettelmeyer (2009). The scientific works of the foreign scientist U. Panizza (2008) are dedicated to the analysis of the internal and external public debt of the developed countries. Among domestic scientists, an important contribution into the investigation of the state and structure of the national public debt as well as a foreign practice of its formation and regulation was made by T. Boholib, T. Vakhnenko, V. Koziuk, O. Melnyk. In particular, in the article «The World Financial Crisis and External Debt of Ukraine» O. Melnyk analyzed the state of the external public debt of Ukraine and determined the drivers of the world financial economic crisis, which had influenced its structure [1]. The problems of the steadiness of the financial system in the context of crisis phenomena from the perspective of the budget system as a key element of the latter was the subject of T. Boholib's research [2]. Taking into consideration a high level of considerations related to the functioning of the Ukrainian and foreign countries' public debt, we should stress the insufficiency of researches relevant to the formation of the national public debt obligations in the post-crisis period, the analysis of its features, the study of foreign practice for comparison purposes to elaborate an effective regulatory mechanism under the conditions of implementation of reforms related to the European integration.

**3. Purpose of the article** is to determine the place of external public debt in the modern financial system of Ukraine and elaborate its regulation system on the basis of the domestic and foreign practices of its formation.

## 4. Results

Today, the issues related to the state and structure of external public debt are being studied not only for the reason of its absolute value accumulation and degradation of the debt burden indexes. Under the modern conditions of financial imbalances of the European countries and further reforming of the financial system by means of decentralization, a deeper impact of the external public debt on the elements of the financial system remains a burning issue because of the additional strain on the state budget caused by the structural imperfection due to taking on large-scale external loans as well as the inconsistency and inefficiency of external loans usage.

Taking into consideration the EU integration processes in Ukraine and the need to adjust the domestic financial system, it is important not only to assess the state of public finances, but also to conduct a comparative analysis of the state of particular branches in the new EU member states as well as of the reasons and indexes of foreign debt changes of the East European countries which keep to the European Neighbourhood Policy.

It should be noticed, that in the period of the world financial economic crisis the public debt as an integral part of the financial system played a key role with regard to the macroeconomic regulatory mechanism of the EU countries. Today, the budget

systems of the founding members of the EU (Germany, Great Britain, France) and the financial aid recipients (Spain, Greece, Portugal, Italy) are characterized by an absolute increase in external public debts caused by the need for financing of the national economies, which have suffered from the world economic crisis and debt burden relative indexes due to a decline of GDP growth, a reduction of export volumes as well as a reduction of the average per-capita income.

Figure 1 shows the dynamics of the debt burden principle index in the new EU member states in the period of 2010-2014.

The analysis of the trends mentioned above and the data reflecting the ratio of the national debt to the GDP in the new EU member states, shown in Figure 1, gives us an opportunity to conclude the following:

1. Among all the countries under analysis, Hungary, Croatia, and Slovenia have the highest index of debt burden relative to their financial systems. It should be stated that the worst indexes of the pace of development and debt loans are inherent to Slovenia, which is a result of a higher debt levels in the bank sector, the absence of reforms in 2010-2012, the weakness in the financial regulation system, macroeconomic imbalances, which have appeared during the post-crisis period due to falling investments in the financial sector, the increased unemployment, a reduction of the external demand for products.

2. During the specified period, a positive trend related to the reduction of public debt is observed in Hungary alone, which was achieved through taking effective economic measures, namely by imposing a tax on banks and transnational companies to reduce the public budget deficit and to support the middle class.

Figure 2 shows the dynamics of change in the index of debt burden index – the ratio of the gross external debt to exports in East European states which keep to the European Neighbourhood Policy.

The carried out analysis of the abovementioned index which characterizes the paying capacity of the states under analysis allows us to make the following conclusions:

1) Azerbaijan has the best position due to the criterion of potential capacity of payment of the external debt; the situation is deteriorating in Ukraine and Belarus.

2) A possibility of non-fulfilment of commitments in case of increase of the debt in comparison to the income from exports is observed in Armenia.

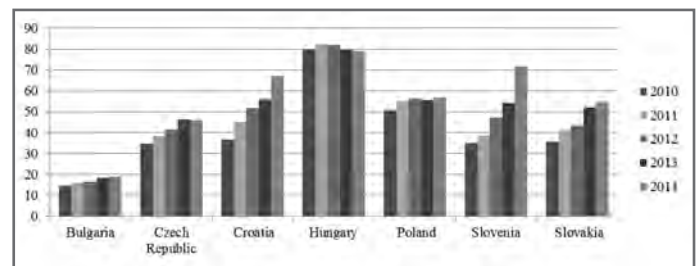


Fig. 1: The indicator of debt burden – the ratio of government debt to GDP, in the new EU member countries, %

Source: Compiled by the author according to the International Monetary Fund

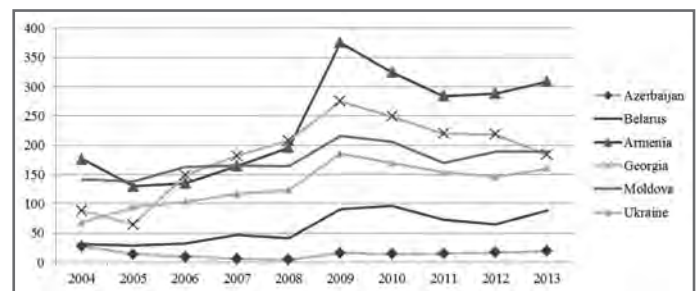


Fig. 2: The indicator of debt burden – the ratio of gross foreign debt to exports to Eastern European countries, %

Source: Compiled by the author according to the International Monetary Fund

Therefore, the analysis of the external debt market of the new EU member states and East European countries which keep to the European Neighbourhood Policy lets us determine the general trend of deterioration in the debt market both in the EU and in countries aimed at joining the EU. It proves that the state of external debt formation is characterized by the use of public loans as an instrument related to the growth of public spending applying no additional methods for state income raising by governments. The functioning of the financial system based on tax and credit backgrounds creates a risk of deterioration of the state of public finances in the future.

Since the beginning of the development of Ukraine as an independent state, external loans have been the main tool for attracting additional funding to finance the public budget deficit, to replenish the currency reserves of the National Bank of Ukraine and to redress the balance of payments. In this case, there is a constant aggravation of the problem related to the full servicing and repayment of debts, especially in the period of internal and external economic crises in connection with the ineffective policy of getting the funds and their irrational use. The place of the external public debt in the domestic financial system is determined by us via its element – the public loan, application of which may mean the mobilization of financial resources to fund the public budget deficit or to affect inflation processes. Today the place of the external state debt in the financial system of Ukraine becomes apparent through the distributive function of the public loan, in accordance to which the state as a borrower under the active use of external loans provides itself with the additional resources for funding state expenditures.

Under the modern conditions of political and economic instability, the inadequacy of public funds, imbalances in public finances of Ukraine, the public loan has negative characteristics, the main of which are:

- predominance of medium-term and short-term loans;
- large scale earning power ratio of state stock, caused by the crisis of world financial markets and the Ukrainian loan rating downgrade;
- weak differentiability of creditors;
- inefficiency in utilization of loans;
- peaks of payments to the principle vendors in 2015 (the IMF, Russia);
- targeted large-scale external public loans in the first half-year of 2015 (the IMF, international financial organizations, the G7 states).

In the course of the scientific investigation by means of general theoretical and specific methods of scientific cognition, both historical and logical ones, a summary of the domestic debt practice of raising external loans and a period of the of external public debt formation has been performed; the peculiar features and characteristics of the changes in the place and the role of the external public debt in the financial system of Ukraine have been determined. The results are shown in Table 1.

The theoretical investigation of the place and the role of the external public debt in the financial system of Ukraine demonstrates the existence of the direct influence of the state foreign loans on the size of money capital in centralized funds, unfavourable impacts on the fiscal position as a link of the financial system and the absence of practical application of methods of formation and payment of external public loans as an instrument in the financial policy. Among the lost opportunities to use the peculiarities of external state debt formation in the financial system of Ukraine there is attraction of external state loans in order to harmonize the structure of balance of payments, exchange rate administration, introduction of debt instruments with a floating rate indexed to the level of inflation.

Among the negative after-effects accelerating the influence of the increasing external debt of the state economy there are social problems in the society, decrease of the economic activity, government expenditures reduction and essential shrinkage of forex reserves.

Tab. 1: Features of the formation of external public debt in the financial system of Ukraine

Period	Interconnection with Links of Financial System	Impact Assessment
Period of 1991-2000: stage of the external public debt formation	- usage of foreign loans for «critical import» and state budget financing; - usage of state budget burden through accumulation of late outgoing payments, for long-term debt and import of energy sources as well as high yield from the obligation of external public loan.	- a chaotic loan process; - absence of agreement with budget policy (lack of marginal indexes for external state debt amount).
Period of 2001-2007: stage of structural transformation and alteration of elements of the external state debt management	- increase of state loans in obligations; - cut down of state budget burden on the account of credits contraction, given on the security of the government; diminution of external state loans; - complicated usage of foreign loans as an instrument fluctuating the dynamics of total amount change of the external debt.	- transition from post-crisis speeding-up to steady development; - cut down of state deficit increase risk on the account of the policy, implying the extension of terms for external loans and diminution of their services; - complicated budget planning due to absence of regulatory acts concerning the procedure of state debt reconstruction; - absence of agreement with budget policy (lack of marginal critical indexes of the external state debt amount).
Period of 2008-2014: stage of debt management elements usage	- increased burden on the public debt on the account of factual considerable service payments; - irrational structure of foreign loans; - budget deficit financing; - share reduction of external state debt with floating rate.	- fiscal destabilization in Ukraine; - increased dependence of national economy upon creditors; - fixing of after-effects, brought in by failure to execute fund raising; - simplification of budget charges planning.

Source: Own research

Modern market condition of the external public debt of Ukraine is considered to be unsatisfactory at the moment. It is confirmed by the rates given in Table 2.

Debt load rates estimation not only allows to analyze the paying capacity of the state, but also to distinguish features, which will be applied in order to give characteristics of the financial system of Ukraine in future and have an effect on its structural elements:

1) A high level of national economy dependence on inward investment influence will be typical within a long-run period. The problems connected with the failure to perform future obligations appear if the debt increases swiftly in comparison with export receipts.

2) There are such factors as worsening of financial standing, budget instability as the main element of the financial system of Ukraine existing within the short-term outlook because of the increase of specific weight of public debt service expenditures.

3) Vague adaptability of the financial system due to the factual sensibility of obligations repayment concerning debt service to the unexpected export receipts shrinkage.

4) A need in a short-term correction and agreement of financial, foreign trade and exchange rate policies.

**5. Conclusions**

According to the results of the study, set forth in this paper, concerning the specific features of the formation of the external public debt in the financial systems of Ukraine and other European countries mentioned in the study, the conclusions are as follows:

1. At the present stage, changes in the formation of external public debt in the financial system of the studied countries occur under the influence of the similar external factors in crisis and post-crisis periods, which are reflected in the deterioration of public finances state due to the growth of public budget deficit caused by excessive increase in the size of government expenditures, falling budget incomes at all levels, decrease of the growth rate of gross domestic product, increase of the external debt. The experience of the new members of the European Union proves the necessity of introducing not only cost saving measures in the sphere of budget expenditures, but the importance of finding ways to increase the revenue base of the centralized fund, in particular, by supporting and promoting the middle class development.

2. Dynamics of the formation of external public debt can be explained by the following factors:

Tab. 2: The main indicators characterizing the state of external debt of Ukraine, %

Indicator	2009	2010	2011	2012	2013	2014
<i>Responsibility</i>						
The ratio of the government external debt to exports	184,0	177,7	151,8	144,7	160,1	-
The ratio of the service government external debt to exports	39,7	39,2	32,7	31,5	-	-
The ratio of the payment on public debt to the expenditure state budget	16,6	13,9	20,6	23,3	27,6	35,5
<i>Liquidity</i>						
The ratio of short-term debt to non-paid total external debt	19,0	21,8	24,2	25,7	-	-
<i>Indicators by the government sector</i>						
The share of public debt service in the expenditures of state budget	3,8	5,1	7,0	6,2	7,9	10,5

Source: Compiled by the author according to the Ministry of Finance of Ukraine and the State Statistics Committee of Ukraine

- political and economic crises, inefficient structure of national economy, inconsistent reforms in the financial system and increase of the external public debt relevant to Ukraine;
- on the part of the EU, there is a generation of risks related to the external public debt which are caused by increased expenditures on its payment and service concerning the new members of the European Union and Eastern European countries which keep to the European Neighbourhood policy.

3. Low adaptability of external public debt in the East European countries which keep to the European Neighbourhood policy (including Ukraine) caused by the use of the public loan as a tool of increasing state expenditures; the use by the government of additional methods of mobilization of state incomes and minimization of a risk of further deterioration of public finances of the group of countries under the investigation should be achieved due to the functioning of the financial systems of the studied countries, primarily on the tax but not the credit basis.

4. The stake of the public debt in the national financial system manifests itself in its usage as a source of financing of the state budget deficit which makes stabilization of the pace, which is impossible under the conditions of constant growth of the public debt. It also takes place in relation to a close interdependence of debt formation and instruments for regulation of state expenditures and income as well as the means of monetary policy.

5. In view of the ways towards the improvement of the national debt policy drafted in accordance to the detected flaws in the formation of external public debt of the financial system of Ukraine and studied soft spots of the European practice, it is important to define its orientation towards finding the solution to the present issues introducing the following tasks:

1) to determine specific gravity of the external debt in the general structure of the state debt and the allowable limit of expenditures of services in the structure of state expenditures;

2) to connect the market with the institutional mechanisms for public debt regulation;

3) to enlarge the system of restrictions, set by national legislation the following ones:

- to restrict short-term loans by establishing critical value for the amount of short-term loans relevant to state budget revenues;
- to restrict usage of borrowings refinancing the public debt when the time of repayment has already come. It should be pointed out that the funds are raised with the purpose of further investment and may be used for refinancing only in case of an advanced payment or debt redemption of public debt on a better basis;

4) to combine the collective aims of the debt policy and the major principles and aims of the budget policy. At the present stage a one-sided trend of the debt policy which enhances to balance the budget may be traced. The budget policy has to be agreed with the budget not only at the stage of execution of the budget (while attracting resources for costs financing), but also at the stage of financial planning and budgetary management (while defining the allowable amount of expenses to be financed). Interconnection of the debt and budget policies has to be established at the stage of projection of financial flows. Coordination of debt policy and budgeting processes has to

involve the issue of debt obligations including the seasonal factor of budget replenishment;

5) to agree the debt and exchange rate policies keeping in mind an increased risk relevant to forecasting the amount of future external debt due to the instable exchange rate caused by introduction of a new exchange rate regime. Liberalization of the exchange rate policy increased the requirements towards predictions in foreign trade and financial operations affecting the fluctuation of the exchange rate. Public debt regulation needs a transition to a multi-component currency structure of the public debt. Its alteration will allow us to conduct a more effective policy aimed at limitation of costs, spent on servicing the loans.

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