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The Scale and Importance of the Financial Assistance to Ukraine

Daniel Szeligowski

Ukraine's new government will face a challenge of continuing the process of macroeconomic stabilisation of the country. Implementing the IMF agreement to receive the next tranche of financial assistance should be a priority. International creditor support is essential in order to continue down the path of economic growth. However, the progress of reform has begun to interfere with the oligarchs' business interest and their resistance will hinder the efforts. This conflict of interests may prevent Ukraine from accessing financial markets and make external debt service more difficult.

Ukraine and the IMF. The International Monetary Fund is Ukraine's most important international creditor. In April 2014, the IMF granted Ukraine a two-year $17.1 billion line of credit. The total needs of the country were estimated to be $27 billion. In March 2015, with the economic situation in Ukraine worsening as a result of the Russian aggression, the IMF replaced the agreement with a new four-year one worth $17.5 billion. The new deal was part of a $40 billion IMF plan to restructure Ukraine's economy between 2015 and 2018. It included $15.3 billion obtained by postponing repayment of debt to external private creditors and $7 billion granted by the EU, World Bank and others, including several countries (e.g., $2 billion in credit guarantees from the U.S.).

The IMF reform programme assumed the implementation of restrictive monetary and fiscal policies and other measures. Ukraine was to limit budgetary expenditures and eliminate the deficit of Naftogaz (the largest state enterprise in the energy sector), and the National Bank of Ukraine was to abandon its policy of maintaining a *de facto* fixed exchange rate and gradually move towards inflation target policy. Ukraine's government undertook to carry out a series of structural reforms, including measures to improve the business climate (such as deregulation and simplifying the tax system), restructure and privatise state-owned enterprises as well as fight corruption. The progress of reform was to be subject to periodic IMF reviews and the release of subsequent tranches of credit depending on the results.

Since the implementation of the IMF-led reforms encountered delays, the disbursement of the tranches was also delayed. As a consequence, Ukraine obtained only $11.4 billion (or two-thirds of the primary allocation) in 2014–2015. In the same period of time, Ukraine's government repaid over $5 billion to the IMF, meaning net Fund support to Ukraine has been slightly over $6bn. The remaining IMF allocation for Ukraine is still over $10 billion and the last tranche released was in August 2015. However, the disbursement of the next tranche was put on hold because of various events, including the political crisis after a failed parliamentary vote of no confidence in Yatsenyuk in February. The appointment of a new government, with Volodymyr Hroysman as PM, should allow Ukraine to resume cooperation with the IMF.

It is also worth noting that signing the agreement with the IMF allowed Ukraine to obtain financial support from other sources, including €2.2 billion in EU macro-financial assistance (another €1.2 billion may be released provided cooperation with the IMF resumes) and $2.25 billion in direct budget support from the World Bank.

Problems with Economic Growth. The delays in implementation of the reform affected the pace of economic growth. According to Ukraine's Finance Ministry, 2016 GDP growth will be only 1%. Restrictive capital-control measures and currency regulations limit production. However, their aim is to stabilise the balance of payments, limit capital outflow and ensure a stable hryvnia exchange rate. Although these measures hinder business, to quit them may be risky due to the low level of foreign reserves, which were $12.7 billion[1] in March 2016, or only $3 billion more than a year ago. However, according to the IMF the figure was supposed to be $18 billion at the end of 2015. As it stands, Ukraine can cover only 3.4 months of imports, while six months is considered a safe level. Moreover, the country's foreign reserves dropped in March for the first time since April 2015, threatening the stability of the national currency as the depletion of reserves may lead to a further fall in the hryvnia in the future. This, in turn, may increase the cost of external debt service.

The decline in export revenues, which in 2015 were a third smaller than in 2013, further delays emergence from the recession. Despite privileged access to the EU market, Ukraine's exports to Member States dropped by 25% in 2015, in part because of the decline in world prices for goods such as metals and grains. Also, many Ukrainian enterprises stopped selling goods to the EU because of increased costs of imported goods necessary for production (such as fertilisers), and were replaced by new exporters that have yet to find customers. This negative trend has continued, with export revenues in the first two months of 2016 21% smaller than in the corresponding period of 2015.

To cross onto the path of fast economic growth will therefore depend on resuming cooperation with international creditors. Provided that the new Hroysman cabinet continues the reforms initiated by Yatsenyuk, in a relatively short period of time Ukraine may obtain the next tranche of IMF credit worth $1.7 billion, €600 million in EU macro-financial assistance and $1 billion with credit guarantees from the U.S. These additional financial resources would allow Ukraine to increase the level of foreign reserves and then to partially liberalise the current strict capital-control measures and currency regulations, which may give impetus to faster economic development.

Oligarchs against the Reform. However, the economic reform has encountered resistance from oligarchs who perceive it to be counter to their business interests and, in turn, have tried to slow or stop it progress by using political instruments and through corruption of members of the parliament. These oligarchs will use the results of the Dutch referendum on the EU-Ukraine Association Agreement to convince the public that bearing the cost of adopting EU norms and standards in an attempt to modernise the country does not make sense. Implementation of the comprehensive structural reform package would lead to depriving the oligarchs of the profit of their monopolies and other advantages, particularly in the energy sector (which according to some estimates as much as 70% of Ukraine's economy may be under control of oligarchs). Continuing the present system which lacks transparent regulations and institutions able to ensure their enforcement, including in the judicial and "anti-corruption" systems, provides them protection from external competition, namely foreign investors.

Privatisation may essentially hit the oligarchs' business activities the hardest, as they control most state-owned enterprises, which are heavily subsidised by the state budget. They will try to exert influence over the privatisation process, for example, trying to block the sale of assets from which they extract these profits (e.g., Ostchem Holding Ltd, controlled by Dmytro Firtash, who blocked the privatisation of the Odesa Port Plant). The government's restrictive economic policy also poses a threat to the oligarchs' interest in access to cheap credit and public procurement, which allows them to obtain additional funds from the country's budget.

Short-Term Perspective. The appointment of a new government will probably not result in quick political and economic reform. The partial macroeconomic stabilisation reduces the determination to implement the reform and cooperate more extensively with the IMF. In such circumstances, it is easier for the oligarchs to fuel public discontent and lend support to populist demands such as increasing public expenditures or withdrawing from raising energy tariffs on individual customers. If those demands are met, it would break the agreement with the IMF and would, in turn, lead to serious difficulties with external debt repayment.

Thus, it is necessary to increase the external pressure on Ukraine's government to implement the reform, namely through conditionality policy. A small improvement in the economic situation cannot constitute a basis for opting out of quantitative criteria specified in the IMF agreement. However, Ukraine's creditors should consider changes to the type of assistance given to the country since simply more credit, although needed, may lead the country into a debt spiral. The EU, in particular, may offer Ukraine additional support in the form of non-repayable grants that could be used for such purposes as implementing the provisions of the EU-Ukraine Association Agreement and adapting Ukrainian enterprises to new or higher technical standards.

[1] Ukraine may use an additional $4 billion to increase its foreign reserve level due to swap agreements with China, Poland and Sweden, which allow for currency transactions at a previously agreed exchange rate, therefore eliminating the danger of a sudden fall in the hryvnia.