KFW ECONOMIC RESEARCH

Focus on Economics

No. 53, 6th May 2014

Ukraine: IMF loan cannot prevent economic crisis

Authors:
Stephanie Schoenwald, phone: +49 (0) 69 7431-6446
Dr Tobias Rehbock, phone: +49 (0) 69 7431-2686, research@kfw.de

The IMF (International Monetary Fund) has committed financial support to Ukraine of USD 17 billion, which corresponds to almost 10 % of the country's GDP. More than USD 3 billion will be provided immediately. By 2016, the Ukraine can also count on a further USD 16 billion, the majority (USD 11 billion) being provided by the EU. The programme ensures the solvency of Ukraine in the short term, but the risks to the successful implementation of the programme are extraordinarily high due to previous negligent economic policies and the armed conflicts in the eastern parts of the country. The signed reforms are also very ambitious.

The macro-economic situation is gloomy. Gross domestic product (GDP) fell in five of the last six quarters. The interventions in support of the overvalued hryvnia depleted the currency reserves at the end of March to just 28 % of foreign debt due in the short term. According to IMF estimates, without any counter measures, the 2014 budget deficit (including state owned energy company Naftogaz) would have risen to an unsustainable 12 % of GDP. The current account deficit in the fourth quarter of 2013 reached around 10 % of GDP. Public debt alone remained moderate despite sharp increases totalling 41 % of GDP.

Overdue reforms

The IMF payments are linked with a reform programme[1] that aims to make up for a decade of economic failures within two years. This would also be a huge challenge for Ukraine in times of political stability.

Stop pegging the Hrynia and monetary financing

There is no doubt that the measures with respect to the exchange rate and monetary policy are reasonable. The flexible exchange rate system is to be established on a permanent basis and the Ukrainian central bank is to pursue an inflation target.

After foreign reserves fell to a critical level in February, the central bank allowed the hryvnia to float. Since the end of 2013, the value of the Ukrainian currency against the US dollar has fallen by around 40 %.

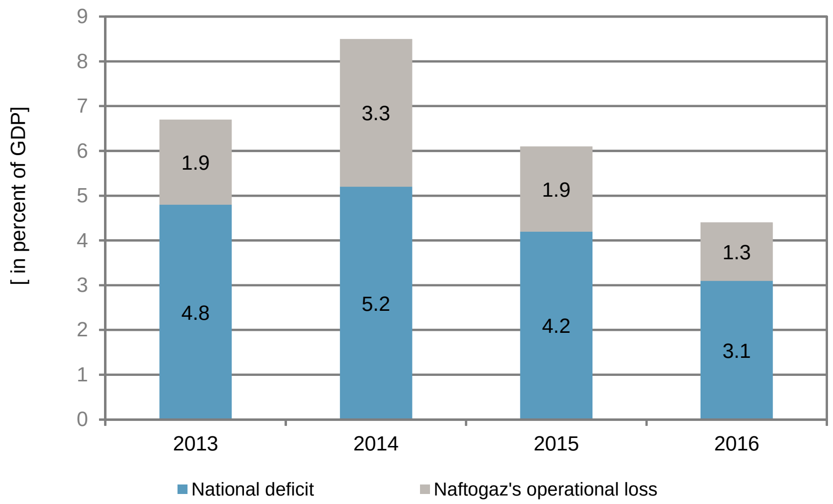
The devaluation has contributed to improve the price competitiveness of the export sector. However, the devaluation has also led to negative balance sheet effects at the same time. Households, companies and banksindebted in foreign currencyare facing difficulties. If the hryvnia does not recover from its current all-time low of almost 12 UAH to 1 USD, the banking sector will need new equity capital. The IMF anticipates that recapitalisation costs will be 5 % of GDP at this exchange rate level.

Floating the exchange rate is a prerequisite if the Ukrainian central bank is to pursue price stability as the its primary goal in the future. Also, the independence of the central bank must be strengthened too. However, as the framework for public sector financing is becoming more challenging, a certain level of resistance can be expected. For a long time, public sector financing was essentially backed by the central bank, which holds 60 % of domestic public debt.

Energy sector reform urgently required

The IMF is also focusing on reforming the energy sector, and rightly so. Among the required measures are the following: an increase in gas and heating prices for private households, enhanced energy efficiency of buildings and production, an improvement in payment discipline and the restructuring of Naftogaz.

Figure 1: Budget consolidation in accordance with the IMF programme (in percent of GDP)



Source: IMF

The programme aimes staggered energy tariff hikes for households between 20 and 56 % per year for gas and heating for the next four years. During an initial phase, gas prices were raised by an average of 40 % on 1st May 2014. These increases are to be welcomed, because energy prices in Ukraine were hugely subsidised (7.5 % of GDP), so that they were the lowest in Europe. which led to wasting energy. However, the IMF is aware of the potential social consequences of the tariff hikes. To alleviate the burden on low-income households, the price increases are to be accompanied by compensatory social measures. As a result, 25 to 30 % of the population will not be worse off.

Naftogaz has experienced drastic losses due to gas prices being far too low. At the same time, significant arrears accrued towards Gazprom, which according to the IMF amount to USD 2.2 billion (1.5 % of GDP). However, Russian media has reported higher amounts totalling more than USD 10 billion.[2] Due to intransparent supply agreements, there is huge uncertainty about the actual commitments.

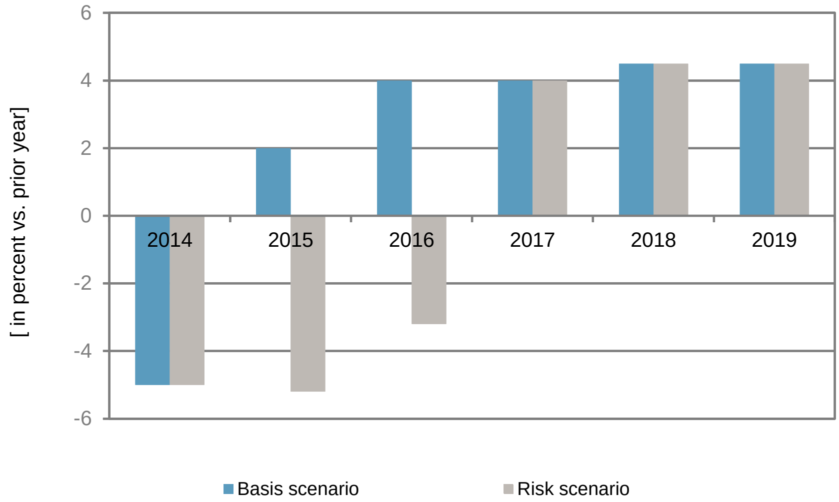
Modest budget consolidation

Ukraine's fiscal position cannot be discussed separately from the financial misery of state-owned Naftogaz. In 2013, the public deficit including Naftogaz losses represented 6.7 % of GDP, whereby 2 percentage points (PPs) were attributable to Naftogaz.

The consolidation rate proposed by the IMF is moderate in comparison. The aim is to reduce the structural budget deficit by 3 PPs until 2016. In comparison, Greece has reduced its structural budget deficit by more than 5 PPs per year since 2009.

The IMF expects the deficitto increase in 2014 due to the unrest and the anticipated deep recession (see figure 1). However, there is a significant risk that these expectations are still overly optimistic. This is indicated by the 8.5 % decline in tax revenue in January and February compared with the previous year.

Figure 2: Real GDP growth, IMF scenarios (in percent, compared with previous year)



Source: IMF

A successful fight against corruption is key

According to the Corruption Perceptions Index published by Transparency International, Ukraine is the most corrupt country in Europe. This, combined with the lack of effective justice and tax administration, is creating a difficult business environment, increasing the investment risk and curbing the potential for growth. Progress is urgently required in this area to ensure the programme's long-term success. This is no easy task; indeed, behavioural changes and the necessary cultural change are both difficult and time-consuming. The IMF is planning to conduct a comprehensive analysis over the next two months with a view to proposing a catalogue of measures.

Considerable risks – higher financing needs are likely

Multiple risks are jeopardising the success of the programme. It is highly probable that Ukraine's financing needs will be higher than anticipated.

Firstly, the underlying growth scenario is very optimistic (see figure 2). After a sharp decline in 2014, the economy is expected to grow again in 2015 and to speed up in 2016. The IMF is assuming that the quality of the institutions will visibly rise as a result of the programme measures, while corruption will subside. Consequently, investments will quickly become growth drivers alongside exports. Scepticism is required in this respect. If they even do succeed, it will be a while before these reforms begin to take effect.

The conflict with Russia is also casting a shadow over prospects for growth. Production-related uncertainty and obstacles caused by the conflict are hugely dampening factors. Add to this the fact that Russia is Ukraine's principle trading partner. Long-term disturbance to the trading relationship would have a significant impact on growth rates.

In the case of a prolonged, deep recession, the debt-to-GDP ratio would rise sharply to around 90 % of GDP by 2016 according to simulations conducted by the IMF.

Secondly, there are additional budget risks. The political conflict may considerably reduce the readiness to pay tax and the ability to collect taxes. Furthermore, the gas price that Gazprom is charging exceeds the IMF's plans by USD 100 per thousand cubic metres. If Gazprom were to prevail, Naftogaz's deficit would increase by 0.5 % of GDP. Add to this the uncertainty surrounding the actual extent of outstanding liabilities to Gazprom.

A weak government doesn't make it easier

We should bear in mind that this IMF programme is the third since 2008. Both of the previous programmes rapidly failed due to the government being insufficiently willing to implement change. The economic reforms that have now been agreed include very difficult measures in a political sense and, correspondingly, would normally spark intense domestic discussions. Implementation of these reforms requires a government with widespread domestic legitimisation, which the current transitional government does not have. There are no real alternatives from an economic perspective. However, as there is widespread international support for Ukraine as a result of the conflict with Russia, Ukraine can probably rely on further financial assistance even if targets are not met. ■

[1] See IMF (2014): Ukraine: Request for a stand-by arrangement – Staff Report

[2] RIA Novosti: Ukraine's Naftogaz Halves Gazprom Gas Imports in 2013 (http://en.ria.ru/world/20140424/189346441/Ukraines-Naftogaz-Halves-Gazprom-Gas-Imports-in-2013.html, downloaded on 5th May 2014)

.