UKRAINE AND THE IMF

FPP COURSE – OPEN LECTURE

Jerome Vacher
IMF RESIDENT REPRENSENTATIVE IN UKRAINE

October 3, 2014
1. Background: how did we get here?
2. An IMF supported reform program
3. Challenges and risks: going forward
A largely inadequate policy mix:

- Large fiscal and quasi fiscal deficit
  - Absent any adjustment and based on budget adopted in Jan. 2014 combined deficit $>12\%$ of GDP
- Fixed exchange rate
- Large current account deficit
- Low level of reserves
Growth well below potential since a tepid recovery from the 2008-2009 crisis

- Pervasive corruption
- Poor business environment
- Lack of FDI
- Productivity lags

Lack of commitment on significant economic reforms
Exchange rate policy lacked credibility.
Level of reserves was inadequate.
Gradual depletion of reserves reflected imbalances.
The hryvnia started to float at the end of January.

Exchange Rates (U.S. dollar per national currency, Jan., 2008 = 100)
• New authorities in place and cooperating quickly
• Challenging situation (imbalances quickly unwinding, security situation deteriorating)
• Previous experiences with programs with Ukraine calling for a strong reform package
IMF’s previous lending to Ukraine

Table 2. Ukraine: IMF Financial Arrangements and Fund Exposure, 1994–2021
(In millions of SDR)

<table>
<thead>
<tr>
<th>Year</th>
<th>Type of New Arrangement</th>
<th>Date of Arrangement</th>
<th>Date of Expiration or Cancellation</th>
<th>Amount of New Arrangement</th>
<th>Amount Drawn</th>
<th>Number of reviews Envisaged</th>
<th>Completed</th>
<th>Fund Exposure 1/</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>STF</td>
<td>26-Oct-1994</td>
<td>3-Sep-2002</td>
<td>408.8</td>
<td>408.8</td>
<td>0</td>
<td>n/a</td>
<td>249.3</td>
</tr>
<tr>
<td>1995</td>
<td>SBA</td>
<td>7-Apr-1995</td>
<td>6-Apr-1996</td>
<td>997.3</td>
<td>538.7</td>
<td>4</td>
<td>3</td>
<td>1,037.3</td>
</tr>
<tr>
<td>1996</td>
<td>SBA</td>
<td>10-May-1996</td>
<td>23-Feb-1997</td>
<td>998.2</td>
<td>598.2</td>
<td>3</td>
<td>3</td>
<td>1,573.3</td>
</tr>
<tr>
<td>1997</td>
<td>SBA</td>
<td>25-Aug-1997</td>
<td>24-Aug-1998</td>
<td>306.9</td>
<td>102.2</td>
<td>4</td>
<td>1</td>
<td>1,700.0</td>
</tr>
<tr>
<td>1998</td>
<td>EFF</td>
<td>4-Sep-1998</td>
<td>3-Sep-2002</td>
<td>1,020.0</td>
<td>1,193.0</td>
<td>12</td>
<td>6</td>
<td>1,980.0</td>
</tr>
<tr>
<td>1999</td>
<td>2,044.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>1,591.2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>1,520.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>1,380.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>1,255.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>SBA</td>
<td>29-Mar-2004</td>
<td>28-Mar-2005</td>
<td>411.6</td>
<td>0.0</td>
<td>1</td>
<td>0</td>
<td>1,033.7</td>
</tr>
<tr>
<td>2005</td>
<td>830.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>551.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>272.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>SBA</td>
<td>27-Jul-2008</td>
<td>27-Dec-2009</td>
<td>11,000.0</td>
<td>7,000.0</td>
<td>8</td>
<td>2</td>
<td>3,057.3</td>
</tr>
<tr>
<td>2009</td>
<td>7,000.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>SBA</td>
<td>April 30, 2014</td>
<td>March 15, 2016</td>
<td>10,976.0</td>
<td>8</td>
<td>4</td>
<td></td>
<td>5,770.8</td>
</tr>
<tr>
<td>2015</td>
<td>10,290.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>10,976.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>10,232.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>6,602.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2019</td>
<td>2,143.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2020</td>
<td>85.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2021</td>
<td>0.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Finance Department.
1/ As of end December, unless otherwise stated.
2/ The Systemic Transformation Facility (STF) was created in April 1993 and allowed to lapse in April 1995.
3/ Completed with delays or waivers.
4/ Figures including transactions under the proposed program are in italics. Fund exposure is derived assuming purchases are made as per the schedule in Table 1 and Ukraine remains current on all its scheduled repurchases.
Commitment to reforms had been weak.
Commitment through program design

- Stand By Arrangement over 2 years
- Exceptional Access
- 8 reviews (the first two on a bi monthly basis) and 9 tranches
- 12 prior actions for program approval
- Board approval on April 30
- First tranche: 3.2 bn USD
1. Exceptional BoP pressures
2. High probability that public debt is sustainable in the medium term
3. Prospects of gaining or regaining market access
4. Strong prospect of success of policy program (adjustment plans, institutional and political capacity)
Exceptional access in perspective

Approved Exceptional Access Cases since September 2008 2/

Source: IFS, Finance Department, and IMF staff estimates.

1/ Peak borrowing ‘t’ is defined as the highest level of credit outstanding for a member. Repurchases are assumed to be on an obligations basis.

2/ Based on post-2008 reform quota. Median credit outstanding at peak is 801 percent of quota; average is 1053 percent of quota.
Exceptional access in perspective

A. Total Access of Recent Exceptional Access Arrangements 1/
(In billions of SDRs)

Exceptional access in perspective
5 key areas

1. Exchange rate and monetary policies
2. Financial sector stabilization and reform
3. Fiscal adjustment
4. Energy sector reform
5. Structural reforms
1. Maintain a flexible exchange rate to restore competitiveness and foster accumulation of reserves
2. Focus monetary policy on domestic price stability
3. Prepare to move to inflation targeting
1. Maintain confidence in the financial system
   – Diagnostic and stress tests for the largest banks
   – Ensure that banks strengthen their balance sheets, notably through recapitalization

2. Strengthen the infrastructure for financial regulation and supervision, including bank resolution
Pace of fiscal adjustment calibrated to restore confidence in public finances without being overly contractionary

- Expenditure restraint
  - Suspension of unaffordable wage and pension increases
  - Public employment reduction through attrition
  - Savings on government purchases
Fiscal adjustment

- Enhanced revenues and collections
  - Elimination of fraudulent tax evasion schemes
  - Higher excises
  - Closing of VAT loopholes
1. Increased gas and heating tariffs over time
2. Accompanied by enhanced social assistance measures to mitigate the impact on the poorest (shift of subsidies directly to households that need it)
3. Improvements in governance and transparency and reduction in operational costs at Naftogaz
Gas and heating tariff adjustments are highly needed.
Structural reforms

1. Stronger emphasis on anti corruption
2. Procurement law and improvements in tax administration
3. Improvements in the business environment (deregulation)
4. Diagnostic study with the government on anti corruption, business environment and the judicial system
Challenges and risks

• Deeper challenges materialized in the spring:
  – Crimea
  – Growing conflict in the East

• Multi faceted impact:
  ➢ Real economy
  ➢ Fiscal
  ➢ Financial sector
  ➢ Balance of payments
Activity and commodity prices remain depressed

Political and economic instability have affected retail trade and construction; agriculture has begun to contract as well.

However, steel production rebounded in 2014, despite lower prices and weak demand in Russia.
Domestic demand and confidence are deteriorating.
Drop in deposits has been more pronounced.

The political turmoil triggered steady outflow of household deposits in the first half of 2014... with the heaviest outflows observed in the regions most affected by the conflict.

Household Deposits in Selected Regions
(Percent change from end-2013)
Inflation has increased

After an initial strong pick-up, headline inflation has begun to decelerate.

Broad-based price increases pushed inflation up in March-June 2014...

Contributions to Annual CPI Inflation
- Services
- Other goods
- Processed food
- Fresh food
NBU has adjusted its policy rates.
NBU provided liquidity support to banks

In early 2014, NBU provided massive liquidity support to banks experiencing deposit outflows.
NBU’s role as dominant holder of domestic debt expanded.
Public debt is increasing at a quicker pace...

External debt is projected to exceed 100 percent of GDP in 2014...

...while the public debt will exceed 70 percent of GDP in 2015, in part because of devaluation effects.
...though remains sustainable over the medium term
1. Policy response to shocks in 3 main areas:
   – Fiscal
   – Fx and monetary policies
   – Energy

2. Combined with intensified efforts on:
   – Financial sector strengthening
   – Business environment and anti corruption
Policy response (1st Review)

• Fiscal policy response:
  – Larger budget deficit target in 2014
  – Fiscal package (August)
  – Stronger structural fiscal adjustment over 2014-2016
  – More conservative stance toward potential fiscal costs:
    • Financial sector
    • Naftogaz
• Fx and monetary policy response:
  – Program path for the NBU’s international reserves revised downwards
  – NBU limiting the decline in reserves through market purchases

• Naftogaz:
  – Stepped up collection of receivables
  – Set aside of funds for arrears resolution
Ongoing developments

- Ongoing current account adjustment
- Episodes of exchange rate volatility and lack of confidence in the banking system
- Security developments continuing to drive market volatility and access
Current account is adjusting

Current Account Balance

- Current account
- Goods
- Services
- Income and transfers

2011 2012 2013 2014
Fx market continues to be affected by volatility

- Fx cash market: selling
- Interbank: selling
- NBU Official

Oct 1
Foreign exchange deposits are still declining.

Monthly Change in Foreign Exchange Deposits
(in billion of US Dollar)

- Jan-14
- Feb-14
- Mar-14
- Apr-14
- May-14
- Jun-14
- Jul-14
- Aug-14
- Sep-14

Households
Corporates
Domestic currency deposits have held up better

Monthly Change in Hryvnia Deposits
(in billion UAH)

- Increasing trend for both households and corporates in Sep-14
- Significant decline in Feb-14 for both categories
- Steady decrease from Jan-14 to Apr-14 for corporates
- Minor fluctuation for households from Jan-14 to May-14
With high volatility, market access remains difficult.
With high volatility, market access remains difficult.
Risks are largely on the downside

1. Extension or worsening in geopolitical tensions
   – Tensions in the East
   – Relations with Russia
   – Gas dispute
2. Financial sector risks
3. Program ownership, domestic politics and other risks
4. Financing
Next steps

• Continuous assessment of policies and advice
• Political timeline (Parliamentary elections)
• Some critical discussions expected in Parliament e.g.:
  – Anti corruption
  – 2015 budget (not yet submitted)
• Combined reviews by the end of the year
Conclusions

• A critical and challenging reform program for Ukraine
• Commitment, program ownership and maintaining the reform momentum will continue to be key
• Support of reforms by the international community also fundamental
• Crisis should be used as a unique opportunity to reform
More information at
The IMF Resident Representative Office in Ukraine Website


Thank you!