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Expert view

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Ukraine's new IMF programme buys time for reforms

The Executive Board of the International Monetary Fund (IMF) approved on 28 July a new stand-by loan programme for Ukraine. The new programme is intended to last for 2½ years and will allow Ukraine to borrow a total of USD 15.2 billion. USD 1.9 billion is available immediately, with the rest to be released in the normal manner after the IMF's quarterly assessments. The new loan arrangement will also help Ukraine to continue borrowing from the World Bank and the European Union, although the IMF will clearly be the largest lender.

IMF and Ukraine managed to reach agreement on the new programme only after prolonged and difficult negotiations. The previous programme was frozen in November 2009 when the IMF refused to loan any more. Ukraine's budget deficit was much bigger than agreed under the programme, partly because the Ukrainian parliament substantially increased public expenditure in the run-up to the presidential elections. An additional problem was that moves to increase the independence of the central bank had not progressed in the agreed manner. Before it was frozen, Ukraine received USD 10.6 billion in loans from the IMF under the previous programme.

In June 2010, Ukraine borrowed USD 2 billion from the Russian bank VTB (the former Vneshtorgbank) when negotiations with the IMF looked likely to stretch over the summer. Ukraine also attempted to borrow an additional USD 2 billion from the international loan market, but in mid-July decided to postpone its plans to borrow further when it became apparent that investors would demand interest of over 9% on the loan. Since approval of the new IMF loan programme, it appears that Ukraine is also keen to return to the international debt market during the course of the autumn.

Political stability made it easier to agree the loan programme

Prior to the loan being granted, Ukraine had already carried through many of the reforms demanded by the IMF. On 13 July, the government decided on a 50% price rise for natural gas to households and power stations, to come into effect at the beginning of August. The price of gas will rise another 50% in April 2011. This will have considerable implications for the public finances, as the price of gas on the domestic market has been held well below the market price. This subsidy for households and businesses has led to very inefficient use of energy and rapid growth in public expenditure.

Towards the end of April, Ukraine also managed to approve its budget for 2010. The budget deficit for this year is 5.3% of GDP, compared with a public sector deficit for 2009 of 6.2%. The reduction in the deficit is the result of a number of factors. The tax rates on many commodities have been increased and public spending cut. Calculations of the public sector deficit should also include the losses of the national oil and gas company Naftogaz, which, in practice, the government has to cover. This year, Naftogaz is expected to record a loss equal to around 1% of GDP; last year's loss was as much as 2.5%. The losses at Naftogaz are largely due to its having to sell natural gas to Ukrainian consumers at below the market price. On top of that, the company's operations have been rather inefficient. One aspect of the IMF loan programme is in fact a comprehensive overhaul of Naftogaz's operational procedures, where some progress has already been made. In addition to approval of the budget, it is also worth noting that, in July, the Ukrainian parliament very quickly passed a law to significantly increase the independence of the central bank. Until recently, the central bank has had to transfer funds to the central government on a quarterly basis, but a clear rule has now been agreed for the division of the central bank's profits.

The economic policy decisions that have been taken have clearly helped clarify the political situation inside Ukraine since the presidential elections in February. President Viktor Yanukovych, who was elected on the second ballot, also enjoys the support of a majority in the Ukrainian parliament, which has been of the utmost importance in pushing through the reform process.

Table 1. Ukraine's economic performance

	2008	2009	2010f	2011f
GDP growth, %	2.4	-15.2	4.0	3.9
Inflation, %	25.2	15.9	9.9	9.7
Current account, % of GDP	-7.1	-1.5	0.5	-0.6
General government, % of GDP	-1.5	-6.5	-5.5	-4.0
Unemployment rate, %	6.4	8.8	8.4	7.3

Source: Economist Intelligence Unit.

General government deficit down

Although the IMF loan programme will ease the pressures on Ukraine's general government finances, it will not of course be sufficient on its own to guarantee sustainable growth. For example, in foreign trade, the Ukrainian economy remains highly dependent on world market developments for a single export product, steel. The public sector is inefficient, and the country suffers from widespread corruption. It is important to note that almost all the public finance and economic structure reform projects agreed with the IMF were already presented in the economic programme published by President Yanukovych in June. This covers the period 2010–2014 and is intended to considerably boost the efficiency of the country's public sector.

The IMF programme aims for a reduction in the general government deficit to 3.5% of GDP in 2011, and a further reduction to 2.5% of GDP in 2012. As Ukraine's public debt is still relatively low (around 35% of GDP at the end of 2009), this would be sufficient to stabilise the debt ratio.

Structural reforms in many sectors

For the reasons discussed above, the recently approved IMF programme includes numerous reforms to Ukraine's public sector. The tax system is to be simplified by reducing the number of tax types from the present 29 to 17. The relevant legislation is currently going through the Ukrainian parliament. Another change will be a curtailing of the taxation powers of local government. There is also the pension system, which is clearly unsustainable, with pension expenditure (18% of GDP) very high internationally, which means it will probably be necessary to institute reforms such as raising the retirement age.

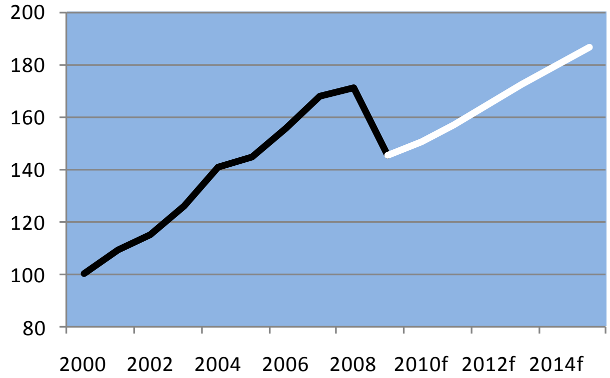
The operational restructuring of Naftogaz and the reform of the entire energy sector are extremely important for the future of the Ukrainian economy as a whole. The gas price subsidy is a drain on public funds. In addition, nobody actually seems to be entirely sure who owns the Swiss-registered company RosUkrEnergo, which transports natural gas from Russia and Turkmenistan to EU countries via Ukraine. It is, of course, important to note that the new political agreement between Ukraine and Russia guarantees Ukraine a discount of around 30% on the price of natural gas, which will at least reduce pressure to use public funds to subsidise the domestic price of gas.

The situation in the banking sector has stabilised, but bank lending has not yet begun to grow. When the crisis hit Ukraine, the government was forced to take control of 5 banks. Other banks also had to be supported in a variety of ways. As part of the IMF loan programme, Ukraine is to begin privatising the state-controlled banks, but this process could take several years. It is worth noting that Ukrainian households did not accumulate as much debt as households in many other countries of Eastern Europe during the rapid economic growth in the second half of the past decade, and this has made it easier for them to adjust in the present situation.

General government financial stabilisation essential to growth

Last year, Ukraine's GDP declined 15.2%, and this year it is forecast to grow around 4%. Continued economic growth will require an increase in investment, but, thus far, growth has been bolstered largely by an increase in net exports. Metal manufacturing has, however, faded in recent months against a background of falling prices on international markets. A recovery in domestic demand is therefore essential to ensure continued growth. Investment will not recover until Ukrainian businesses have a clear view of the near-term outlook and banks are motivated to increase their lending. The reforms now underway will help to address these issues. It should, however, be noted that even if Ukraine's GDP were to indeed grow at 4–5% per annum in the years ahead, it would take until 2013 for GDP to return to the level of 2008. Thus, the impact of the crisis will be visible in the Ukrainian economy for many years to come.

Chart 1. Ukraine's GDP, 2000=100



Source: IMF.

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