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UKRAINE: STRESS AT THE IMF

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KEY POINTS

- The dire economic situation and security crisis in Ukraine meant the IMF's starting point for engagement — long-standing and severe economic mismanagement and an acute security/energy crisis — was exceptionally difficult, even by IMF standards.
- The IMF faces a situation it is not fully equipped to deal with effectively.
- Not surprisingly, given the constraints that impede its effectiveness in Ukraine's current circumstances, the IMF punted on the program — taking the government's commitment to reform to a significant extent on faith, agreeing to a fiscal and monetary framework that is not adequately funded, yet building into its economic program full repayment of debt to private creditors.

INTRODUCTION

In April 2014, in a departure from its normal aversion to lending to countries in conflict, the International Monetary Fund (IMF) approved a US$17 billion loan to Ukraine to be disbursed over two years. At the time, Ukraine was three weeks away from a presidential election; engaged in combat with an armed separatist movement backed by Russia, its largest trading partner and supplier of energy; and experiencing a significant drain in foreign exchange reserves and bank deposits along with soaring yields on sovereign debt. The country was also reaping the returns of decades of economic mismanagement. Dire from both political and economic perspectives, the situation had the markings of a case where the IMF has the expertise to be usefully engaged, but there were also red flags demarcating circumstances that can hobble the IMF's effectiveness.

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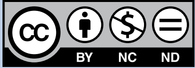

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This policy brief reaches three related conclusions on the Ukraine program and the IMF's role in this far-reaching security-cum-economic crisis:

- The starting point for IMF engagement — long-standing and severe economic mismanagement and an acute security/energy crisis — was exceptionally difficult, even by IMF standards.
- The IMF is not fully equipped to deal effectively with the situation in Ukraine.
- In these circumstances, the IMF punted — taking the government's commitment to reform to a significant extent on faith, agreeing to a fiscal and monetary framework that is not adequately funded, yet building into its economic program full repayment of debt to private creditors.[1]

The policy brief concludes with suggestions for a more transparent approach to support for Ukraine.

THE UKRAINIAN ECONOMIC SPIRAL WAS BOTH SEVERE AND LONG-IN-THE-MAKING

It is widely agreed that the economic situation in Ukraine in early 2014 was dire. Several assessments by the IMF of its support for Ukraine through adjustment programs (eight since 1994) and other non-IMF analyses had pointed out multiple roots of long-standing problems. Broadly, three salient features of Ukraine's recent economic history stand out.

First, Ukraine had a largely rudderless transition following the breakup of the Soviet Union. Unlike its Western neighbours in transition, it did not have the

1 Included in the schedule of amortization of bonds issued to private investors is a US$3 billion bond purchased by Russia's sovereign wealth fund in December 2013. That bond matures in December 2015.

embrace of the European Union, with its framework for institutional reform and macroeconomic stability. Nor was there a homegrown reformist group that gained any traction. In this vacuum, the grip of state control and corruption was never loosened, and basic financial discipline in key parts of the economy was never established. Although high inflation was eventually reduced and growth spurted at times (mainly after discrete devaluations), by 2013 per capita GDP was scarcely above its (admittedly overstated) pre-transition level, and the country remained inhospitable to new industry.

Second, since the mid-1990s, Ukraine had lurched from one economic crisis to the next. It often achieved some degree of stabilization under the pressure of IMF-supported programs, but many critical parts of the economy were never put on a firm footing. The IMF's assessments of its lending arrangements repeatedly raised a few basic problems: a preference for fixing the exchange rate meant that the beneficial effects of two large devaluations (1998-1999 and 2010) gave way to chronic problems with competitiveness and insufficient official reserves; the energy sector, always a focus in reform programs, has been a focal point of corruption, bred deep inefficiency in energy use and ransacked the public finances; pressures on the fiscal accounts from the lax public wage and pension policies and poor revenue administration were recurrent; independence of the central bank was inadequate; and the banking sector, poorly regulated and supervised, has been plagued with weak capitalization, growing non-performing loans and excessive exposure to exchange rate risk, despite periodic reform efforts (IMF 2005; 2011; 2013).

Third, for most of the period since its transition began, Ukraine has had neither a viable constituency for economic reform nor the administrative capacity to execute reforms. Various events (such as fallout from the Russia crisis in 1998 and new governments in 2005 and 2010) have held out promise that the core economic problems would be attacked at their roots. But each time, apparent commitment died — owing at least in part to the enormous difficulty of taking on vested interests that had been allowed to grow since transition. The IMF concluded in the aftermath of the aborted lending arrangements started in 2008 and 2010 that future Fund engagement would need specific strategies to establish commitment before funds were approved. The three main proposals were to: engage through shorter duration programs focused on a small number of issues; rely heavily on substantive prior actions (that is, actual policy changes enacted before disbursement of IMF funds rather than commitments to change policies during the multi-year period of the program); and require that signatories on the program be numerous and as inclusive as possible (IMF 2013).

This history set the stage for political turmoil to trigger a financial crisis. Against the backdrop of Ukraine's inability to access international capital markets, a sequence of plunging foreign exchange reserves, large bank deposit withdrawals and capital flight forced the National Bank of Ukraine (NBU) to allow the exchange rate to depreciate in early 2014. The fiscal position came under pressure from falling economic activity and security-related spending. Public sector debt (which was, fortunately, a relatively modest 41 percent of GDP at end-2013) and total external debt (a more worrisome 79 percent of GDP) started to rise sharply and bank soundness deteriorated (with knock-on implications for government finances). Compounding these adverse economic developments was the transitional uncertainty between the resignation of President Viktor Yanokovich in February and the election of President

Petro Poroshenko in late May,[2] the cessation of Russian energy exports to Ukraine in June and the subsequent plunge into a more direct confrontation with Russia during the summer. In this environment, staunching the latest deterioration in fiscal, banking and monetary accounts was bound to be fraught.

IS THE IMF EQUIPPED TO ENGAGE IN UKRAINE?

The Ukrainian situation is an economic crisis long in the making, beneath a global security quagmire. The economic crisis required a subtle and quick response to buy time to assess whether a reasonable political outcome was possible. The IMF had three distinct features that made it an obvious instrument.

- As long as members were willing to trample on the IMF's standards for lending into crises, a sizable amount of financing could be secured quickly. Financing was critical because Western countries were not able or willing to meet the likely needs, and without adequate financing, some combination of default on external debt, rapidly worsening inflation and severe constraints on security spending would be unavoidable. The view was that any one of these was likely to aggravate the already-severe economic, social and political situation.
- As important as the security and financial crises were, the deep-seated and long-standing mismanagement of the economy was at least as formidable an impediment to social and economic stability. The IMF was uniquely positioned to engage the government in a plan for macroeconomic and structural policies, to set tranched conditionality and to monitor progress in adhering to it. The IMF's role as a third party for holding the government's feet to the fire on structural reform was essential.
- The fact that Russia is a member of the IMF meant that Russia was at least formally invested in the objectives of the program — a token, even if not substantive, benefit of IMF involvement.[3]

Yet the IMF faces three interconnected constraints that impede its effectiveness in Ukraine's current circumstances, especially in light of its large financial commitment (800 percent of Ukraine's quota against a normal access limit of 600 percent of quota for a two-year program).[4]

- The IMF has traditionally avoided engagement with countries in acute conflict. Not only is uncertainty about future economic conditions exceptionally high in such circumstances, but also capacity to implement financial stabilization policies and structural reform is typically weak. In the late 1990s, staff-level consideration of minimum conditions for wartime engagement (capacity to repay the Fund and capacity to implement agreed policies) was undertaken, but abandoned before going to the executive board. In practice, however, the IMF rarely provides financing until acute stages of a conflict have ended. Indeed, much of the discussion

2 In discussions with US Treasury Secretary Jack Lew, IMF Managing Director Christine Lagarde referred to the case for IMF engagement in Ukraine "if a fully established government in Ukraine makes a request" (CNN 2014). This suggests that behind the scenes, and given Ukraine's poor reform track record, the IMF would have preferred to agree on a program after the presidential elections.

3 Records of the IMF executive board discussion and vote on approval of the program are not yet available. Russia could have voted against approval or abstained.

4 Normal access limits are calibrated relative to a country's quota subscription to the IMF. Financing for most IMF-supported programs is below these access limits. For countries in severe crises, the IMF can lend in excess of these limits if the country meets four criteria designed to ensure that the country's plan for addressing its problems is viable. The IMF has granted Ukraine exceptional access.

of the IMF and conflict has centred on how to delineate when a country can be considered post-conflict. Ukraine is almost unique in departing from precedents.

- The IMF's ability to insist that the uncertainties in particularly tense and politically sensitive financial crises are fully reflected in its economic projections (the "program scenario") is questionable. Without a frank reflection of the risks in a quantitative framework, financing for the program is likely to be inadequate and confidence of markets absent.
- The IMF also lacks the capability to recommend debt reprofiling when a program is likely to be underfinanced or prospects for repayment of debt are not high. There is a particularly insidious Catch-22 here: The IMF is adjured against lending in excess of normal access limits unless it can conclude that public debt of the borrowing country is highly likely to be "sustainable" (that is, the country will be able and willing to service its debt fully without unduly depressing economic activity).[5] If the probability of debt sustainability is not high, the IMF should provide exceptional access only if the country also restructures its debt; yet, with no established channel for effecting an extension of maturities or timely restructuring, the IMF is forced into an excessively optimistic portrayal of a country's prospects so as to be able to provide financing without a restructuring.[6]

Not surprisingly, given these considerations, when the strong case for IMF engagement in Ukraine met the serious impediments to the IMF's effectiveness, the IMF punted on the program.

AN IMF-SUPPORTED GAMBLE FOR REDEMPTION

The lending arrangement agreed in April 2014 had two main interrelated objectives:

- structural reform — yet another bid to fix the long-standing weaknesses in governance, fiscal/energy policies and banks that are the sources of Ukraine's economic troubles; and
- establishment of a program scenario that quantified an internally consistent set of outcomes for major macroeconomic and financial variables — this, in principle, would serve as an anchor for fiscal and monetary policies and for expectations of official and private creditors about the one-year ahead outlook for the economy and debt sustainability.

The IMF's first review of the program, completed in August (and the basis for the IMF disbursing the second, US$1.3 billion tranche, of its lending commitment), provides a first glimpse into the government's

5 This is but one of the four criteria for "exceptional access." The others are: that the borrowing country has a large balance-of-payments need; that the country has good prospects for regaining access to private credit markets during the life of the program; and that the policy program provides a reasonable strong prospect of success, based on the country's plan and its capacity to implement it (Schadler 2013).

6 In May 2014, responding to an assessment that the restructuring in Greece had been "too little, too late," IMF staff proposed a mechanism whereby creditors of any country applying for exceptional access, but not fulfilling the requirement that its public debt be sustainable with a high probability, would be asked to grant an extension of maturities. This would provide breathing space to determine whether a restructuring was necessary, while halting diminution in the base for restructuring, if that proved necessary. The IMF's executive board discussed the proposal, but has not decided on implementation.

adherence to the reform program and the plausibility of the program scenario (IMF 2014).

STRUCTURAL REFORM

The IMF continues to assert that the government is fully committed to deep-seated reform. Strictly on the basis of concrete actions, however, it seems to be too early to tell whether an enduring commitment to reform has taken hold. The review showed that early commitments have been met (an increase in energy tariffs, and some background work that is probably necessary for the execution of plans for collecting energy tariffs, reducing energy subsidies, improving bank regulation, recapitalizing banks and reforming governance).

But most actions to date have been preparatory. Political commitment will only be clear when a broader swathe of changes are actually implemented, and the record is not without a few signs of questionable resolve. First, the NBU slipped back into defending the exchange rate (since mid-April, the NBU has, in the staff's words, "re-established its strong preference for a stable exchange rate" [IMF 2014]). This put the 2014 targets for NBU foreign exchange reserves out of reach and, presumably, diminished the improvement in competitiveness. Second, Parliament passed a bill that would have allowed much of the burden of rising mortgages denominated in foreign exchange to be shifted from borrowers to banks' balance sheets. The IMF insisted that this be reversed. Third, in a move that raised questions about commitment to NBU independence, a large "advance transfer" of NBU profits (presumably arising from seignorage buttressed by exchange rate gains on NBU foreign exchange reserve assets) was made in order to meet program targets for the general government deficit.[7] These concrete actions — as opposed to the preparatory steps and promises characterizing most other early parts of the reform agenda — do not bode well for the "unwavering execution" that Fund documents view as indispensible.

THE MACROECONOMIC FRAMEWORK

Developments on the macroeconomic framework front are far less ambiguous: as of end-August, the program had veered significantly away from the program scenario established just four months earlier. This is not surprising given the severity of the situation and optimism of that scenario. However, it means that the gamble for redemption — a program built on the hope that an unidentified piece of good luck would bolster Ukraine's fortunes — looks increasingly desperate

The thrust of the IMF's first review was to acknowledge that GDP growth, inflation, the general government accounts, accounts of the publicly owned oil and gas company (Naftogaz) and bill for bank recapitalization were all worse than expected at the outset of the program (see table). Reflecting the sharp dip in activity, the current account improved more than expected, but net financial inflows were lower, so foreign exchange reserves tanked. Revisions to the macro framework were inescapable. Shortfalls were not, for the most part, because planned policy measures had not been implemented, but rather because hard data for April–June made the over-optimism of the initial economic projections obvious.

The strategy for dealing with the setbacks was to revise the 2014 numbers modestly and then to assume that the bounce back in 2015 (already substantial in the April

7 NBU profit transfers are included in the government accounts as revenue.

PROGRAM PROJECTIONS AND REVISIONS AND "ADVERSE" SCENARIO

	2013	2014			2015		
		April	August	August adverse scenario*	April	August	August adverse scenario
(Percent change)							
GDP growth	0	-5	-6.5	-7.3	2	1	-4.2
GDP deflator	3.1	9	12.1	…	13	14.1	…
(Percent of GDP)							
General government balance	-4.8	-5.2	-5.8	-7.3	-4.2	-3.9	-8.3
Naftogaz balance	-3.3	-3.3	-4.3		-1.9	-1.9	
Public sector financing requirement	9.4	9.4	12.1	13.6	6	6	10.5
Public debt/GDP	40.9	56.5	67.6	68.9	62.1	73.4	83.2
(As indicated)							
Current account balance/GDP	-9.2	-4.4	-2.5	-0.6	-4.3	-2.5	0.1
Official foreign exchange reserves (US$ bn.)	20.4	19.2	16.2	8.6	26.7	23.4	4.4
External debt/GDP	78.6	99.5	102.2	…	99.3	106.4	…

Source: Author.

* The adverse scenario does not provide quantification for the GDP deflator, Naftogaz balance or external debt/GDP for 2014 or 2015.

program) would be, for almost all variables, even larger than that in the initial program. Although external and public debt ratios were raised relative to the April program, the debt sustainability analysis still shows debt stabilizing, just at higher levels. Toward the end of the report, a relatively low-profile statement asserts that the revised program is not fully financed: additional financing for the next year of some US$1 billion beyond the commitments of the Fund and other official creditors is needed, but has not been identified or committed.[8] The report states that the authorities plan to tap the sovereign debt market later in 2014 — a market that has been closed to them since mid-2013, except for a US$1 billion issue earlier in 2014 when the United States provided a guarantee.

A careful reading of the first review suggests a subtle strategy. The report is laden with qualifiers that the program has substantial downside risks and that the program scenario is predicated on the assumption that "fighting in the East will begin to subside in the coming months" (IMF 2014). It does not mention — but it should — that there are growing concerns that the fighting will subside only to give way to a "frozen conflict," which would have enormous economic consequences. The report gives the impression that IMF staff and management find the program scenario as skewed toward optimism as markets do.[9]

8 Full financing for the forthcoming year of a program (what is called, in Fund parlance, "closing the financing gap") has long been a minimal condition for approving both the initial commitment of IMF financing and the funding tranches related to each review. In Greece, for example, one of the Fund's ultimately most effective arguments in 2011-2012 for debt restructuring was that the program could not be submitted to the board until the financing gap had been closed.

9 For examples of market commentary, see Stern (2014) and Talley (2014).

In short, the report begs the question whether, faced with political constraints on openly declaring the program too optimistic, not fully financed and entailing a debt burden that is not sustainable with a high probability, staff and management have deliberately constructed a program that would garner the skepticism of markets and commentators. Is this the IMF's best and only (although certainly not transparent) approach to forcing its major shareholders into a new, more sober approach to Ukraine?

Meanwhile, however, Ukraine appears to be on course to repay a US$1.6 billion Eurobond maturing at the end of September. A further US$3.8 billion (including the US$3 billion bond held by the Russian sovereign wealth fund due in December 2015) is due in 2015. The paradox of the intention to have Ukraine make these large payments despite a large gap between actual financing commitments and the (even understated) financing needs of the program speaks to the severe constraints the IMF faces in dealing effectively with heavily indebted countries in crisis. If there is to be a case tailor-made for the IMF staff's proposal for an extension of maturities as a condition for receiving exceptional access to IMF resources, Ukraine would seem to be it.

WAS THERE A BETTER APPROACH?

This brief documents the difficult circumstances Ukraine posed from an economic perspective for the IMF and its major shareholders. There were no ideal options for addressing them, but it is not clear that the best option was chosen.

Fundamentally, the crisis has both economic and global security aspects. The IMF can (and despite Ukraine's dismal track record for economic reform, probably should) engage to exert maximum pressure for economic stabilization and reform. True, the IMF has on three separate occasions in the past decade drawn lessons from its largely unsuccessful engagement with Ukraine — these were at best partially reflected in the design of the current program. Yet the IMF is uniquely positioned to establish macroeconomic and structural priorities and set conditionality for releasing tranches of a loan. It is the right institution to respond to Ukraine's economic policy emergency and maximize pressure on the government to stick to the agreed reform plan.

But the IMF has been pushed into a role substantially beyond this, in effect picking up the financial burden that official creditors want to avoid, at least in part, for geopolitical reasons. With inadequate funding from other official sources, the Fund has extended exceptional access in conditions that, in a true central scenario, would not be warranted. Moreover, markets have not viewed the program scenario as credible, and the underfinancing of the program has contributed to negative uncertainty. In addition, persisting with a program scenario that envisages full repayment of debt coming due during the next two years is likely to repeat the mistake made in the 2010 lending arrangement for Greece, where restructuring was, in the words of the IMF, "too little, too late."

A better course would have been to proceed with a shorter (one-year) program funded within normal access limits. The program scenario should be crafted as a true central scenario with balanced upside and downside risks (all subject to the high uncertainty of Ukraine's circumstances). This would have required substantially larger financing from other official sources. Also, it would most likely have produced an assessment of future debt levels that would not pass the standard of a high probability of sustainability. Drawing on the IMF's recent consideration of a temporary stay on

debt amortization, Ukraine should have immediately started negotiations with creditors aimed at extending near-term maturities until greater clarity on the outlook could be gained.

This course would not remove either the economic or geopolitical uncertainty of Ukraine's situation. But it would provide maximum incentives for Ukraine to implement the program, raise the credibility of the IMF and Ukraine in the eyes of the market and hasten the resolution of at least the economic crisis.

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Skylar Brooks, Domenico Lombardi and Ezra Suruma

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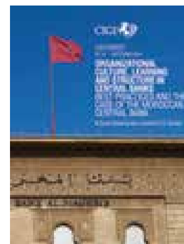

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CIGI was founded in 2001 by Jim Balsillie, then co-CEO of Research In Motion (BlackBerry), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario.

Le CIGI a été fondé en 2001 par Jim Balsillie, qui était alors co-chef de la direction de Research In Motion (BlackBerry). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario.

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