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THE HARSH REALITY OF UKRAINE'S FISCAL ARITHMETIC

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Highlights

- Ukraine is struggling with both external aggression and the dramatically poor shape of its economy. The pace of political and institutional change has so far been too slow to prevent the deepening of the fiscal and balance-of-payments crises, while business confidence continues to be undermined.
- Unfortunately, the 2015 International Monetary Fund Extended Fund Facility programme repeats many weaknesses of the 2014 IMF Stand-by Arrangement: slow pace of fiscal adjustment especially in the two key areas of energy prices and pension entitlements, lack of a comprehensive structural and institutional reform vision, and insufficient external financing to close the expected balance-of-payments gap and allow Ukraine to return to debt sustainability in the long term.
- The reform process in Ukraine must be accelerated and better managed. A front-loaded fiscal adjustment is necessary to stabilise public finances and the balance-of-payments, and to bring inflation down. The international community, especially the European Union, should offer sufficient financial aid backed by strong conditionality, technical assistance and support to Ukraine's independence and territorial integrity.

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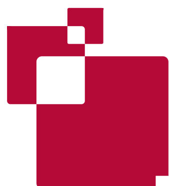

THE HARSH REALITY OF UKRAINE'S FISCAL ARITHMETIC

MAREK DABROWSKI, JUNE 2015

UKRAINE IS STRUGGLING not only with external aggression but also with the dramatically poor condition of its economy and finances. To a certain degree, the economic challenges are the consequence of war. The annexation of Crimea and the conflict in Donbass have resulted in heavy direct and indirect fiscal, economic and social costs in the form of higher military spending, war damages, human suffering, large numbers of displaced people, loss of control over part of a major industrial and exporting region (Donbass), a sharp decline in business confidence and a decline in trust in the national currency and banking system. Trade and other economic sanctions imposed by Russia (even before the open military conflict started in March 2014) have caused additional damage. However, the conflict is not the only reason for Ukraine's poor economic condition.

Ukraine continues to suffer from years of poor economic management and slow reform (see Aslund, 2015, chapter 4; Dabrowski, 2007 and 2014). The fall of former president Viktor Yanukovych's regime in February 2014 could have enabled a return to freedom and democracy and a pro-Western reorientation of Ukraine's foreign and domestic policies. However, the pace of change has been too slow to prevent the deepening of the macroeconomic crisis or to boost business confidence.

To avoid further deterioration of its economic situation and greater political destabilisation, Ukraine's reform process must be accelerated and better managed. It should include a front-loaded fiscal adjustment package that is strong enough to stabilise public finances and the balance-of-payments while reducing inflation. The international community, especially the European Union, should encourage the Ukrainian authorities to move in this direction by providing a sufficient aid package with associated conditions, technical assistance and effective support to the country's independence and territorial integrity.

THE SAD LESSONS OF 2014

In spring 2014, the new Ukrainian government of prime minister Arseniy Yatseniuk faced a dramatic deterioration in the macroeconomic situation marked by a twin fiscal and balance-of-payments crisis. From the very beginning, the policy response looked insufficient. This was the case for both the government's actions and the International Monetary Fund Stand-By Arrangement (SBA) approved on 30 April 2014[1]. Further economic developments in 2014 and early 2015 proved the sceptics correct.

The main issues, as highlighted by Dabrowski (2014), were:

1. Apart from numerous structural and institutional weaknesses, deep macroeconomic (fiscal and balance-of-payments) imbalances posed the main threat to the Ukrainian economy in spring 2014; they required an immediate and bold response.
2. Given the size of macroeconomic imbalances and the high probability of further adverse shocks (which indeed happened), there was no time for gradual adjustment. The insufficient adjustment package brought with it the risk of widening imbalances and a crisis of confidence – unfortunately, this scenario materialised.
3. The two areas that required immediate and major adjustments were natural gas subsidies and oversized public pension entitlements.

On this last point, the 2014 SBA offered only limited adjustment of natural gas tariffs for households, which increased by 56 percent, while heating tariffs increased by 40 percent, both from an extremely low level (less than 20 percent of full cost recovery). Further gradual tariffs increases were planned with the goal of reaching the full cost-recovery level by 2017.

1. http://www.imf.org/external/np/sec/pr/2014/pr14189.htm. Also see IMF (2014), Dabrowski (2014), Mitov and Schneider (2014) and Schadler (2014).

Changes to the pension system, on which Ukraine spent 17.1 percent of GDP in 2013, were limited. They included cancellation of some earlier decisions that would have led to generous pension increases. They did not change one of the lowest retirement ages (mandatory and actual) in Europe. As result, the 2014 SBA envisaged very modest and gradual improvements in the general government fiscal balance over 2014-18: by 2 percentage points of GDP annually, on average. In addition, the deficit of Naftogaz, the state-owned oil and gas company, was to be reduced at the annual rate of 1 percentage point of GDP, being eliminated only in 2018.

Although the current account deficit was expected to decrease from over 9 percent of GDP in 2013 to 4.4 percent of GDP in 2014, it was to remain on the level of about 4 percent of GDP until 2018.

Furthermore, the programme was built on an overly optimistic assumption that GDP would decline in 2014 by 5 percent only, and growth of 2 percent would return in 2015. Another optimistic assumption was made about net inflow of foreign direct investment (FDI) of 2 percent of GDP and above until 2018.

On the structural and institutional fronts, neither the IMF SBA nor government plans were particularly ambitious. They spoke about preparing detailed action plans during 2014, rather than offering concrete reform measures.

FROM WEAK PROGRAMME TO BALANCE-OF-PAYMENTS CRISIS

The dramatic developments in the second half of 2014 painfully exposed the overly optimistic macroeconomic projections of the SBA. Ukraine's GDP declined by 6.9 percent in 2014 instead of the forecast drop of 5.2 percent, as the conflict in Donbass escalated (see Havlik, 2014, for its consequences). The slow pace of reform meant no real improvement in the business climate or business confidence in regions not affected directly by war[2]. On the other hand, the general government cash deficit in 2014 was smaller than projected: 4.6 percent of GDP instead of 5.2 percent of GDP, marking a small improvement in comparison with 2013 when it amounted to 4.8 percent of GDP. Here, paradoxically, the conflict in Donbass provided some sort of relief: the earlier scheduled fiscal transfers to the region were suspended. However, if the government of Ukraine manages to regain control over the conflict areas, it will have to pay arrears to pensioners.

The 2014 fiscal picture looked much worse when one added in the quasi-fiscal deficit of Naftogaz. The consolidated deficit exploded from 6.7 percent of GDP in 2013 to 10.3 percent in 2014 (instead of the forecast 8.5 percent). This clearly confirmed insufficient adjustment of administrative gas tariffs for households and heating utilities in 2014, which increasingly lagged behind the actual import prices (which Naftogaz had to pay to Gazprom and other gas suppliers).

The unfavourable fiscal developments, only partial improvement in the current account (from -9.2 percent of GDP in 2013 to -4.8 percent of GDP in 2014) and intensive capital outflows meant that the external financing envisaged in the 2014 SBA was insufficient to avoid a balance-of-payment crisis. The National Bank of Ukraine's (NBU) foreign exchange reserves started to decrease rapidly in Q4 2014, reaching the critically low level of $4.7 billion in February 2015 (Figure 1 on the next page). As result, the hryvnia rapidly depreciated, despite various capital and current account control measures adopted by the NBU (Figure 2).

While market panics were partly triggered by the new escalation of the Donbass conflict in January and February 2015 (before the signing of the second Minsk ceasefire agreement on 12 February 2015) and by contagion effects from the currency crisis in Russia and other Commonwealth of Independent States countries (Dabrowski, 2015), it was Ukraine's weak macroeconomic fundamentals that played the decisive role.

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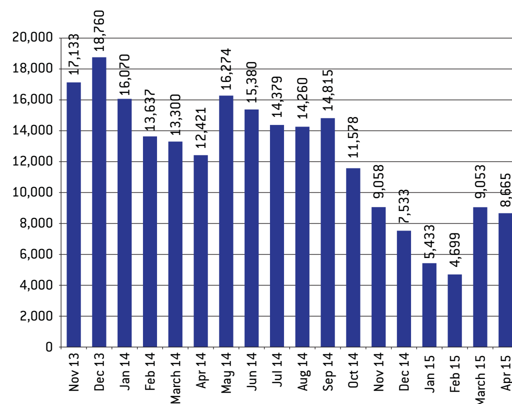
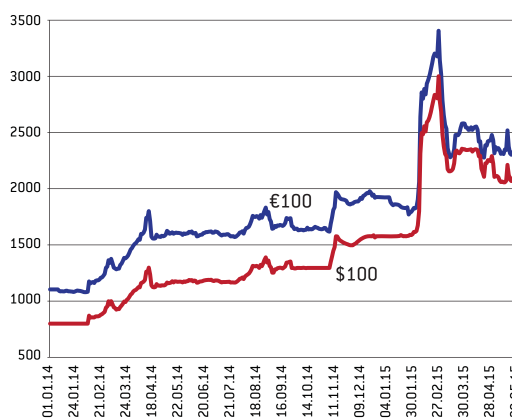
2. Macroeconomic data on 2014 and projections for 2015 are drawn from IMF (2015) unless otherwise indicated.

Figure 1: National Bank of Ukraine foreign exchange reserves, 2013-15, $ millions



Source: National Bank of Ukraine.

Figure 2: Official hryvnia exchange rate 2014-15, UAH/$ and UAH/€



Source: National Bank of Ukraine.

DRAMATIC CONSEQUENCES OF THE COLLAPSE OF THE HRYVNIA

Unlike the 40 percent hryvnia depreciation against the dollar in Q1 2014, which was necessary to correct its earlier over-appreciation and restore Ukraine's external competitiveness, the currency's further dramatic collapse at the end of 2014 and in early 2015 did more harm than good. Even if the hryvnia (UAH) recovered from its lowest point (30 UAH for $1 on 26 February 2015) to about 21 UAH for $1 in the third week of May 2015), it lost almost two thirds of its value compared to the beginning of 2014. As a result, average annual inflation increased from -0.3 percent in 2013 to 12.1 percent in 2014 and is expected to increase further – to 33.5 percent in 2015. According to the IMF's May 2015 projection[3], 12-month inflation will reach 46 percent in December 2015.

3. http://www.imf.org/external/np/sec/pr/2015/pr15243.htm .

This means substantial price rises, which are usually most painful for the lowest-income population groups. Thus, the policy of gradual fiscal and macroeconomic adjustment aimed at reducing social pain actually magnified it. It is not the first such experience in Ukrainian economic history (think about the economically dramatic 1990s).

Furthermore, the deep devaluation of the hryvnia undid the effects of the partial adjustment of gas and heating tariffs in mid-2014. In early 2015, these tariffs were lower relative to the gas import price in hryvnia than a year earlier. The reduction in price of gas imported from Russia, from $385 to $248 per thousand cubic metres in Q2 2015 (Powell *et al*, 2015), provided some relief but was not enough to offset the consequences of the devaluation of the hryvnia. Thus the new dramatic increase in domestic gas tariffs became urgent to reduce the disparity between import and domestic prices and Naftogaz's resulting quasi-fiscal deficit.

Again, we observe a well-known paradox: a policy to providing social cushioning (by postponing the unavoidable price adjustment) has the opposite effect – it increases the cumulative pain and delays potential gains such as reduced fiscal imbalances and the possibility of structural and institutional changes in the gas industry (see below). In other words, slow adjustment during a crisis often results in magnified adjustment needs.

The new wave of devaluation increased the burden of public debt: according to the IMF projection (2015, Table 1, p.47), it was expected to reach 94.5 percent of GDP in 2015, including the publicly guaranteed debt. Devaluation also increased private external debt: the total external debt (both public and private) is projected to increase from 102.4 percent of GDP in 2014 to 158.4 percent of GDP in 2015. This also increases the vulnerability of Ukrainian banks and those non-financial corporations that have borrowed abroad, and will increase the cumulative costs of bank restructuring, which were already high in 2014.

IS HISTORY REPEATING ITSELF? THE NEW RESCUE PROGRAMME AND ITS WEAKNESSES

To arrest market panics and avoid even deeper macroeconomic crisis, the international commu-

nity has rushed a new rescue package for Ukraine. As before, the IMF programme will play a central role. The four-year Extended Fund Facility (EFF) programme of $17.5 billion approved on 11 March 2015 replaces the 2014 SBA[4]. The overall amount of the EFF remains roughly the same as the 2014 SBA, but offers Ukraine longer maturity. The amounts pledged by other multilateral and unilateral donors to supplement the EFF are a bit higher than a year ago.

The approval of the EFF, immediate disbursement of its first tranche of $5 billion (including $2.7 billion of budget support) and decisions of other donors to join the aid package have allowed a partial replenishing of the NBU's foreign exchange reserves, calming the currency market and strengthening the hryvnia (see Figure 2). Up to the end of 2015, the entire IMF disbursement should amount to $10 billion, assuming positive results from the debt-restructuring negotiation and subsequent reviews of programme implementation.

However, the question of whether the new programme is sufficient to arrest entirely the crisis and address its roots in a sustainable way remains open. As with the SBA, two major doubts are: (i) weak conditionality, which allows for the continuation of the strategy of gradual fiscal adjustment and slow structural and institutional reforms; (ii) the insufficient size of financial aid to close fiscal and balance-of-payments gaps, especially in a medium-to-long-term perspective. Needless to say, these two issues are closely related: deeper upfront fiscal adjustment would enable faster reduction of public-sector borrowing requirements and make it easier to close the balance-of-payments gap.

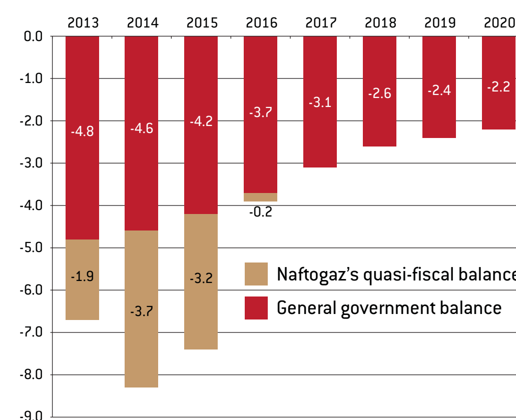
FISCAL GRADUALISM AND GAS TARIFFS

According to the EFF programme (IMF 2015 Table 1, p. 47), in 2015 the general government deficit will amount to 4.2 percent of GDP, a modest decrease from its 2014 level (4.6 percent of GDP). Gradual deficit reduction will continue in the subsequent years (Figure 3) – to 3.7 percent of GDP in 2016, 3.1 percent in 2017, 2.6 percent in 2018, 2.4 percent in 2019 and 2.2 percent of GDP in 2020. Apart from the 'official' general government deficit, one should add the quasi-fiscal deficit of Naftogaz: 3.2 percent of GDP in 2015 (which gives 7.2 percent of GDP total) and 0.2 percent of GDP in 2016. After 2016, Naftogaz's operational deficit should disappear.

Naftogaz's losses will continue in 2015-16 because of the delay in the adjustment of household gas and heating tariffs to the cost-recovery level (this will happen only in 2017). Nevertheless, because of the effects of abrupt hryvnia devaluation in 2014-15 (Figure 2), the tariffs increase on 1 April 2015 had to be steeper than the 2014 increase, by 284 percent and 67 percent, on average, respectively. As before, gas tariffs remain differentiated depending on the volume of gas consumed: 3,600 UAH for 1 cubic metre in the winter period (October-April) if monthly consumption is below 200 cubic metres, and 7,188 UAH/cubic metre for monthly consumption above 200 cubic metres and in the summer period (May-September)[5].

Continuation of the two-tier retail gas tariffs and keeping them below the cost-recovery level have been clearly motivated by social considerations. However, it brings numerous negative consequences. First, it involves substantial fiscal costs: eventually the government must cover Naftogaz's quasi-fiscal deficit. Second, it slows down structural and institutional changes in the gas industry, such as unbundling of Naftogaz, providing third-party access to the gas transmission system, improving corporate governance and fighting corruption, all of which are rightly considered as important structural benchmarks of the

Figure 3: Ukraine: fiscal balance of general government and Naftogaz, % of GDP, 2013-20



Source: IMF (2015), Table 1, p. 47.

4. http://www.imf.org/external/np/sec/pr/2015/pr15107.htm.

5. http://www.nerc.gov.ua/index.php?id=14329.

EFF (see Zachmann, 2015, on the gas sector reform agenda). Even if the new legislation on the gas sector is quickly adopted, its implementation will lag as long as Naftogaz continues its role as a government social agency rather than a profit-oriented commercial entity. Third, the below-full-cost-recovery tariffs will continue to discourage domestic gas production, energy saving measures and development of renewable energy sources. Fourth, they will hinder the reduction of Ukraine's energy dependency on Russia. Ironically, Ukrainian taxpayers and international donors will continue to subsidise overconsumption of Russian gas. The process of bringing retail gas tariffs to the cost-recovery level could be much faster than envisaged by the EFF.

THE PENSIONS PROBLEM

Ukraine's spending on public pensions is one of the highest in the world (17.1 percent of GDP in 2013). This can be explained by very unfavourable demographic trends, low statutory retirement ages (60 for men and 57 for women[6]), even lower actual retirement age (because of numerous early retirement privileges) and a high replacement rate for some privileged pensions.

Unfortunately, the EFF-backed programme does little to address the major shortcomings of the public pension system. New legislation adopted in early 2015 started the process of gradual increasing the retirement age for people who worked in hazardous or difficult work environments and some other categories, in case of massive lay-offs or for health reasons. It also increased the minimum number of required work years for retirement of some groups that receive special pensions (for example, teachers and doctors). Although they move in the right direction, these changes in the effective retirement age will not bring about a quick visible fiscal effect, because of their slow pace and fragmented character.

Other adjustment measures set limits on pension benefits for pensioners who continue in employment (especially for civil servants). The biggest short-term fiscal gain (more than 2 percent of GDP) will come from delaying pension indexation until December 2015 and permanently decreasing the replacement rate (to 60 percent) for some privileged groups of pensioners such as retired civil servants, prosecutors, teachers and academic workers. While reducing pension privileges for certain professional groups goes in the right direction, the indexation delay means indiscriminate real depreciation of all pension benefits against the expected high inflation. Furthermore, it will provide only a temporary respite to the budget, because indexation is only delayed.

Definitively increasing the retirement age and more radical elimination of various group privileges would be a much better solution from both fiscal and social points of view than freezing nominal pensions across the board. A higher retirement age would limit the number of young pensioners, most of whom continue to work in the formal or informal sectors while receiving pensions. Freezing nominal pensions hits, in the first instance, the most vulnerable groups of pensioners – those with low benefits, in advanced age and poor health that do not have other income sources.

ALTERNATIVE ADJUSTMENT STEPS

Being reluctant to make a far-going systemic adjustments to energy subsidies and the pension system, Ukrainian authorities had to look for other ways to increase revenues and cut expenditure as part of the new programme. The adjustment package includes combination of both types of measure. Some, such as elimination of subsidies to the coal industry, reduction of employment in the budgetary sphere and public administration or broadening the property tax base are steps in the right direction. Other proposals look more controversial. In particular, there are plans to reintroduce a progressive scale of personal income tax (as compared to the flat rate in recent years) and a temporary import duty surcharge. The latter would be an additional import barrier (on top of almost three-fold devaluation of hryvnia) for an economy that is strongly dependent on imports, both in the consumption and production sectors. Together with postponing the implementation of the deep and comprehensive free trade agreement (DCFTA)[7] with the EU until 2016, this will slow down the restructuring of the Ukrainian economy and the reorientation of its foreign trade. It also violates at least the spirit of the DCFTA and

6. According to the pension reform adopted in 2011, the retirement age for women increases by six months each year to reach 60 in 2021 (from 55 before the reform). The retirement age for men – civil servants will gradually increase to 62 in 2021.

7. See http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc_150981.pdf.

Autonomous Trade Preferences granted to Ukraine by the EU for the transitory period up to the end of 2015.

THE FINANCING GAP, DEBT RESTRUCTURING AND LONG-TERM DEBT SUSTAINABILITY

Ukraine's relatively slow pace of fiscal and macroeconomic adjustment creates large borrowing requirements. The IMF (2015, p.12) estimates a financing gap of $40 billion in 2015-18, with more than half ($21.4 billion) falling due in 2015. This might again be (like the 2014 SBA) an overly optimistic estimate.

The first source of risk relates to the expected GDP dynamics. In January-April 2015, Ukrainian GDP declined by 17.6 percent compared to January-April 2014 (Ustenko *et al*, 2015). The steepest decline was recorded in construction (-34.2 percent) and industry (-21.5 percent). As result, in the course of the EFF First Review completed in May 2015, the IMF increased the expected GDP contraction in 2015 from -5.5 percent (as assumed in the original version of the EFF) to -9 percent. The 2 percent GDP growth projected for 2016 remains under question. There are other risks, especially of a geopolitical and security character: continuation of the war in Donbass and its possible spread to other territories.

However, even the currently estimated financial gap of $40 billion might not be fully financeable. The IMF, World Bank, European Union and other multilateral and bilateral donors have pledged only $24.7 billion. The remaining $15.3 billion should come from the so-called debt operation, ie the restructuring of public external debt in the form of Eurobonds held by foreign creditors.

At the time of writing, negotiations with bondholders are ongoing and substantial differences remain between both sides (see Gilmore and Wilson, 2015; Moore and Buckley, 2015). To stay in line with the EFF debt and external financing parameters the government of Ukraine requested an agreement that would include three components: (i) maturity extension, (ii) coupon reduction, and (iii) principal reduction. The bondholders are against haircuts and are ready to offer only debt payment rescheduling. Russia which holds $3 billion out of the total $23 billion of Ukraine's Eurobond exposure does not participate in the negotiation process.

Even if the debt agreement is signed soon, it will close Ukraine's access to private markets for years. It might also discourage FDI and other forms of private capital inflows that are so badly needed to restructure and modernise the Ukrainian economy. Furthermore, when one looks at the EFF medium-term fiscal projection, the question arises of how Ukraine will be able to finance the continued fiscal deficit of more than 2 percent of GDP and refinance its public debt exceeding 80 percent of GDP after expiration of the EFF at the end of 2018. It is worth remembering that Ukraine faced problems before (1998-99, 2008-09, 2014) with private market access when it had much lower public debt-to-GDP ratios.

In this context, the approved EFF does not necessarily meet the second and third criteria of exceptional access (medium-term debt sustainability and regaining access to private capital markets by the end of programme life), which would justify the possibility of extending the IMF financing of this size (900 percent of the member country's quota in the Fund) with heavy frontloading.

OTHER WEAKNESSES

The EFF programme only partly addresses the structural and institutional reforms that are so important for the modernisation and consolidation of the Ukrainian state and the return of the Ukrainian economy to a sustainable growth path. This reflects generally slow and sometimes contradictory changes in this area.

Since the collapse of the Yanukovych regime in early 2014, the new authorities have made some progress in areas such as business deregulation (streamlining registration procedures, limiting numbers of permits and inspections), simplification of the tax system (elimination of various distorting taxes of marginal importance), strengthening corporate governance (especially in relation to state-owned enterprises), transparency (broader access to public information), public procurement and amendments to anti-money laundering laws. The

EFF also includes several incremental steps in the structural and institutional spheres as structural benchmarks. These concern, for example, strengthening the legal and financial independence of the NBU, gradually abandoning restrictions on current-account convertibility, establishing the National Anti-Corruption Bureau, Naftogaz restructuring, strengthening payment discipline in the energy sector and changes to the Civil Procedural Code.

Nevertheless, this is still too little (and often too slow) progress to ensure sufficient changes in the Ukrainian economy and governance structures. In several important spheres, the major reform agenda is still lagging far behind. This includes, for example, the reform of the judiciary and law-enforcement agencies, local and regional government, fighting corruption, bank restructuring, comprehensive business deregulation, civil service reform, tax and customs administration and tax collection procedures and privatisation of state-owned enterprises. The reform process also often lacks in comprehensiveness and implementation. Delay in implementation of the DCFTA (see above) also means slower pace of various important regulatory and institutional reforms and delays in building competitive markets.

INTERNAL POLITICS AND THE POLITICAL ECONOMY

This brings us to the question of how determined the new president, parliament and government elected on pro-reform and pro-European platforms in 2014 are about reform. There is no problem of lack of pro-reform political mandate, but there is a question of effective reform leadership. This also involves the question of policy coordination between the president and prime minister (in the context of an unclear demarcation of their responsibilities), between the government and the Rada (parliament), and within the government coalition. Numerous incidents of spontaneous legislative initiatives in parliament, including the example of a law aimed at restructuring foreign-currency-denominated loans at very favourable exchange rate (for debtors), which would ruin the banking system and state budget[8], point to serious problems in this area.

Obviously, the conflict with Russia distracts attention, political energy and resources from the domestic reform agenda. However, it also helps to consolidate and mobilise society around the president and government, and can justify politically unpopular decisions. Time is working against the new Ukrainian authorities. Slow progress on reform will delay economic recovery and will weaken the Ukrainian state. It will make the period of pain and sacrifices longer with no visible gains. This might lead to popular disappointment and a weakening of the pro-reform mandate. It will not help in confronting the external threats.

THE ROLE OF THE INTERNATIONAL COMMUNITY

The international community, including the EU, should encourage and facilitate fast and consistent reform in Ukraine through sufficient and well-tailored assistance, which should address Ukraine's most important needs but also involve ambitious and demanding conditionality and far-going technical assistance. The latter should focus, among other things, on facilitating smooth implementation of the EU-Ukraine Association Agreement (AA) and DCFTA, which is a difficult task for the Ukrainian side given the numerous institutional weaknesses that the country suffers from. If done rapidly and successfully, implementation of the AA/DCFTA can help in institutional and regulatory convergence with the EU's *acquis* in several important areas and sectors, and provide an important external anchor for the domestic reform process (see Gligorov and Landesmann, 2015).

To avoid the build-up of an excessive and unsustainable debt burden, part of the foreign aid package should be in the form of grants instead of loans. This concerns, for example, some infrastructure projects (especially those that can increase transport and transit facilities between Ukraine and the EU) or projects to strengthen

'Time is working against the new Ukrainian authorities. Slow progress on reform will delay recovery and will weaken the state. It will make the period of sacrifice longer with no visible gains. This might lead to popular disappointment and a weakening of the pro-reform mandate.'

8. See eg http://24tv.ua/news/showNews.do?minfin_snova_rassmotrit_zakon_o_valjutnyh_kreditah&objectId=580788&lang=ru.

Ukraine's defence capacities against external aggression.

Looking ahead, Ukraine and two other Eastern Partnership countries (Georgia and Moldova), which already signed AAs/DCFTAs with the EU, would benefit from ambitious roadmaps setting out closer cooperation in various areas, and step-by-step integration with the EU based on well-defined institutional conditionality.

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