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NEWSLETTER

German Economic Team

UKRAINE

Why an IMF programme is urgently needed

In December 2019, Ukraine reached a staff level agreement with the IMF on a 3-year extended fund facility (EFF). The agreement was supposed to unlock a USD 5.5 bn programme, conditioned on the fulfilment of a set of prior actions. Notwithstanding last year's rather favourable macroeconomic dynamics, the IMF programme was considered as an important tool for anchoring structural reforms and facilitating further support by the EU and the World Bank.

Unfortunately, the fulfilment of the prior actions leading to the programme's ultimate adoption by the IMF's executive board did not make much progress until March, when the corona pandemic and the resulting economic crisis suddenly hit the country. Faced with a large recession and a tripling budget deficit, the pressure for a swift conclusion of a (possibly upgraded) IMF programme has risen dramatically. The two main remaining prior actions were the agricultural land market reform and a law to prevent nationalised banks from being returned to their former owners.

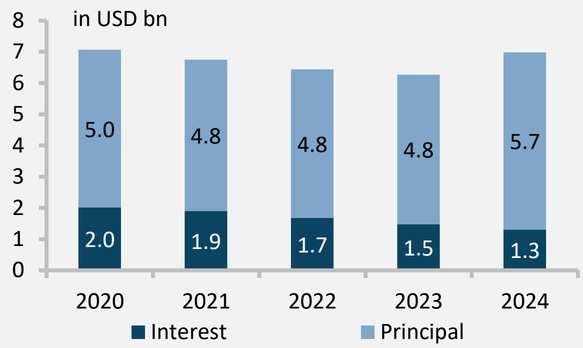
While the law on the land market was finally adopted in the second reading, the final approval of the banking law is still pending. Being passed in first reading, a few deputies attempted to delay the final conclusion by introducing a total of 16,335 amendments for the second reading. However, the parliament has already responded to this challenge by changing its procedures to allow for a quick approval during the next few weeks, which would open the door for an IMF deal.

Background

During the last year, the negotiations of the Ukrainian authorities with the IMF regarding a new programme gained some momentum. In December 2019, a staff-level agreement on a 3-year, USD 5.5 bn programme was announced. Despite rather favourable macroeconomic developments (GDP growth of more than 3% p.a., a strong Hryvnia and a low budget deficit) last year, the programme was seen as an important anchor for structural reforms needed to lift economic growth and to support still high external debt service.

Apart from providing cheap financing, the IMF is also an important anchor for other bilateral and multilateral institutions like the EU (macro-financial assistance), the World Bank and others.

Public external debt service (government and NBU)



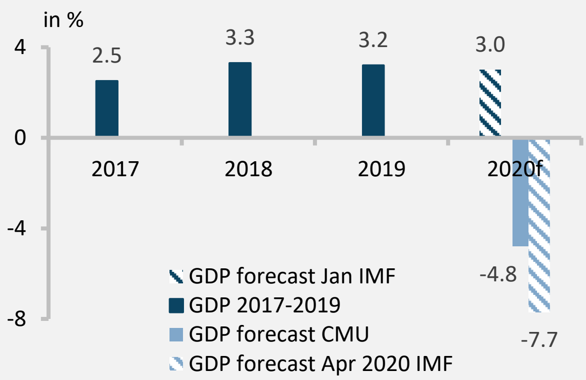
Source: IMF, Ministry of Finance

However, the fulfilment of the necessary prior actions needed for programme approval by the IMF's executive board did not make much progress after the agreement.

External shock: the corona pandemic

In a just a few months, the coronavirus pandemic changed everything: in its recent outlook, the IMF foresees the worst worldwide economic downturn since the great depression of 1929. Ukraine is not immune to that, as can be seen in the dramatically changed outlook for Ukraine in the figure below. But there is high uncertainty surrounding the forecasts as shown by the big difference between the IMF's current forecast (-7.7%) and the government's one (-4.8%).

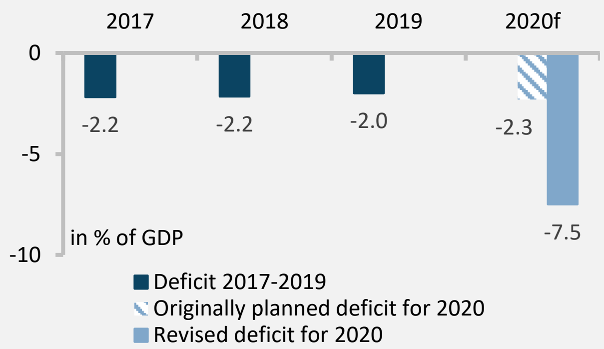
Real GDP growth: Before and after corona



Source: IMF, Cabinet of Ministers (CMU)

The authorities reacted to the pandemic in their economic policy by passing significant budget amendments on the 13 April. Less revenue due to lower GDP and therefore lower tax income is confronted with higher expenditure, in particular on health. The obvious result is a substantial increase in the budget deficit, as the figure below shows. Originally planned at about 2% of GDP as in previous years, the deficit is now set to rise to 7.5% of GDP in 2020, a massive increase.

Budget deficit: before and after corona



Source: IMF, Cabinet of Ministers (CMU)

This sudden jump is now another key motivation for a quick conclusion of an IMF programme: to help with budget financing. Debt issuance on external markets is currently quite expensive (around 9% for 10y Eurobond yields), and local bond markets – despite very positive developments over the recent past – won't be able to absorb such an increase in issuing.

Regarding the adoption of the IMF programme, two prior actions have recently gained prominence: the land market and the banking law.

Land market

There is still no market in agricultural land in Ukraine, despite frequent attempts to bring this in line with international practice. The IMF and the World Bank have repeatedly supported a reform, as the status-quo holds back the sector and the economy. Last year, the reform process gained a new impetus with the adoption of a land market law in first reading. On 30 March, the law was finally adopted, however in a very restrictive form: from 01 July, 2021 onwards, only individuals will be allowed to purchase land of up to 100 ha. Legal persons can acquire up to 10,000 ha from 2024 onwards. The participation of foreigners will be decided in a future referendum. Although the short-term economic impact of this reform will be very low, it is an important step in the right direction.

Banking law

Another conditionality relates to the nationalisation of PrivatBank in late 2016, and current legal attempts by the previous owners to reverse this decision. Therefore, changes to the banking law are required to prevent such a scenario in the future, thereby protecting taxpayers' money (USD 5.5 bn was injected into the bank). A respective law was adopted on 31 March in the first reading. The key question is now about the approval in the second and final reading, as in total 16,335 amendments for the second reading have been registered. The majority of them by just a few deputies, probably with the aim of delaying the adoption for many months, thereby torpedoing the IMF deal. However, the majority of Rada deputies approved changes to the operating procedures to deal with such a massive amount of law amendments – a clear sign of the urgency of the situation.

Conclusion

The speedy renewal of IMF cooperation in light of the massive economic fallout due to the corona crisis is currently economic policy priority number one. Apart from supporting external debt service, increased budget financing needs must be taken into account. The IMF has already signalled that the size of the programme could be increased; some observers expect an amount of USD 8 bn as realistic, with a substantial part of it going to the Ministry of Finance. Now, it is in the hands of the deputies in parliament to create the necessary preconditions as quickly as possible, ideally still in April or early May.

Authors
Robert Kirchner kirchner@berlin-economics.com

Garry Poluschkin poluschkin@berlin-economics.com

Editors
Dr Ricardo Giucci, Robert Kirchner

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German Economic Team

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The German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Georgia and Uzbekistan regarding the design of economic policy reform processes and a sustainable development of the economic framework. It is funded by the Federal Ministry of Economics and Energy (BMWi) and implemented by the consulting firm Berlin Economics.