NEWSLETTER

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The new IMF agreement: all good things come in threes

Ukraine has recently reached an agreement with the IMF on the continuation of the financial cooperation. Although the final decision by the IMF Executive Board is still outstanding, this would be the third programme since 2014. A smooth implementation of the USD 14.9 bn programme over the coming 14 months would be an important anchor for the macro-financial stability of Ukraine in the double election year 2019. Particularly in the context of further financial support by the EU and World Bank, the external public debt service would be made much easier.

Background

In recent years, Ukraine has implemented two co-operation programmes with the International Monetary Fund (IMF). In April 2014, a two-year Stand-By-Arrangement (SBA) was concluded, from which two tranches totalling USD 4.6 bn were disbursed throughout 2014. However, an aggravation of the economic crisis at the end of 2014 made a reformulation of the cooperation agreement necessary. Instead of the SBA, a new four-year programme under the Extended Fund Facility (EFF) was launched in March 2015 with a total volume of USD 17.5 bn.

After two tranches totalling USD 6.5 bn were disbursed in 2015, subsequent programme reviews became much more cumbersome. In 2016 and 2017, for example, only two tranches (USD 1 bn in each year) of the loan was disbursed. As such, Ukraine has not received any fresh funds since April 2017.

Current developments

In recent months, a series of important measures have been taken to revive the cooperation with the IMF. Amongst others, the long-demanded anti-corruption court was legally established in the summer of 2018. As such, a new staff-level SBA with the IMF was agreed upon in October 2018 after an IMF mission to Kyiv. With a duration of 14 months and a total volume of USD 3.9 bn, the programme will cover the 2019 double-election year instead of the EFF, which was originally planned until March 2019.

However, two key preconditions ("prior actions") have been placed in order for the programme to be approved by the IMF leadership. One of the conditions stipulates raising the gas and heat tariffs to a cost-covering level. After cost coverage was achieved for a brief period of time in 2016, rising import prices of gas resulted in another deficit. In October 2018, an important first step was taken: gas prices for the population were increased by 23.5%. Further steps will follow until full cost coverage is achieved. As a consequence, heat tariffs will also rise in response to higher gas prices.

In addition, a sound fiscal policy remains a key objective of the cooperation with the IMF. Since negotiations dragged on into the autumn, the planned budget for 2019 came into focus of the talks. The discussion revolved mainly around the plans of the Ukrainian side to carry out a reform of corporate taxation. According to our estimates, however, this would have resulted in short-term revenue shortfalls and would have - without appropriate offsetting measures - jeopardized the budget deficit target of 2.3% of GDP. As such, it is very positive that - according to all available information - the 2019 budget adopted on 23 November is planned around this deficit target and excludes the mentioned reform.

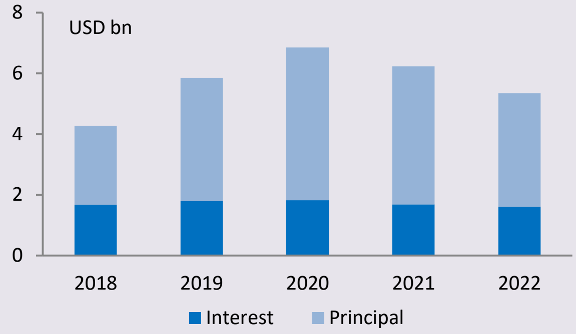
Now that the key preconditions seem to have been met, a positive decision by the IMF's leadership is likely to happen in December; subsequently, the first tranche of the loan can be released to the National Bank of Ukraine to strengthen its foreign-exchange reserves.

Reasons for continuing the cooperation

Why has a new programme that continues the cooperation until the end of 2019 been agreed on? A number of reasons are crucial.

The government and the National Bank are expected to spend more than USD 10 bn on servicing foreign debt in 2018-19. This amount excludes other domestic FX liabilities; nor are the external liabilities of other quasi-sovereign debtors, such as Naftogaz or Ukrainian Railways, included in these figures. In the following years, repayments remain at a high level.

Servicing of external public debt



Source: NBU, own calculations
Note: including NBU; excluding quasi-sovereign institutions

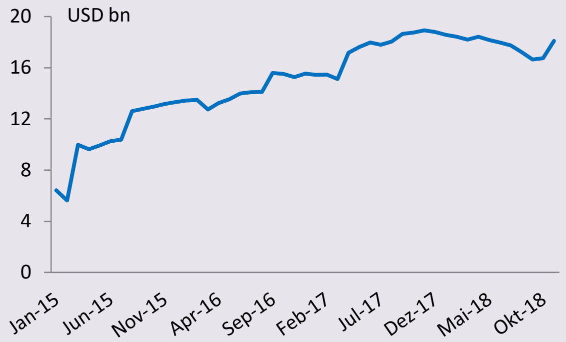
Although Ukraine issued two new Eurobonds (USD 2 bn in total) after the announcement of the IMF staff level agreement, the current upheavals in the financial markets are clearly reflected in a sharp increase of the yields. As such, a recently planned issue by Naftogaz even had to be cancelled.

Yield of Ukrainian Eurobonds (10-year maturity)

Source: CBONDS, own calculations

The new tranches of the IMF loan will help the National Bank to build up its foreign-exchange reserves, which have stagnated since 2017 and are currently stuck at approximately 3 months of import coverage.

Development of foreign-exchange reserves



Source: NBU; November 2018 value from 05.11.2018

Another reason is the financial support of other international donors linked to the IMF agreement. The EU has provided a total of USD 1 bn in Macro-Financial assistance (MFA), which will be disbursed in two tranches and used for government deficit financing. In addition, the World Bank will provide USD 750 m in guarantees that can be used by the government to obtain a syndicated loan.

Conclusion

The continuation of the cooperation with the IMF, which is now underway, and other international donors is very welcome. An implementation of the agreed reforms will provide an important anchor for the continuation of a stability-oriented macro-financial policy. This is very important in the context of the presidential and parliamentary elections next year.

However, one has to ask critically why this insight came so late. The politically undoubtedly very sensitive gas price issue was already a point of contention during the last year; an increase in tariffs at that time could have been made with much less noise. Moreover, the gap between gas import prices and tariffs would not have been so great and as such, a necessary increase of the gas prices might have been lower.

The price to pay for the delayed actions can be clearly seen in the yields on Ukrainian bonds, which increased significantly in the course of 2018. In this sense, the markets have played an important role in the continuation of the IMF cooperation.

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