

## Ukraine's cooperation with the IMF – unfulfilled hopes for deeper reforms

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The Party of Regions took power in early 2010, after Ukraine had been plunged deep in economic crisis. Over the next year, with the external markets recovering, the country's economic situation started to improve gradually. Ukraine's economic stabilisation was also strengthened by its resumed cooperation with the International Monetary Fund, which provided for a loan worth \$15.1 billion. The issuing of successive tranches of the loan was made dependent on the implementation of a comprehensive reform programme. The cooperation went quite smoothly at first; however, as the economic situation in Ukraine improved, the reformist zeal of the Ukrainian government started to fade, and obstacles began piling up. As a result, Ukraine was refused the third tranche, scheduled for this March, and for the moment the credit line remains frozen. Even though the IMF has numerous reservations about the Ukrainian government's economic policy, the fundamental condition for resuming cooperation is reform of the pension system, which the parliament should adopt.

The difficulties with fulfilling the obligations made to the IMF reflect the wider problem with implementing reforms in Ukraine, as the Party of Regions promised after taking power. Changes which do not affect the interests of influential lobbies are quite easy to carry out. Often, however, these changes are not conducive to the economy's liberalisation; moreover, the influential lobbies are successful in blocking reforms that could harm their businesses. Another impediment to the changes is that some reforms are likely to bring about painful social consequences, and that can affect public support for the ruling group.

Even though theoretically possible, it does not seem likely that Ukraine's cooperation with the IMF will be terminated. But even if this cooperation is continued, deeper reforms in Ukraine are likely to be postponed until after the parliamentary elections in autumn 2012.

## Out of the crisis, and on to cooperation with the IMF

In 2008-2009, Ukraine was worst hit of all the CIS states by the economic crisis, the main reason being the slump in demand for Ukrainian exports on global markets. The populist pre-election policy adopted by the then Prime Minister Yulia Tymoshenko, who disregarded the agreements with the IMF, made things even worse. As a result, the country's GDP dropped by 15.1% in 2009, and in November that year the IMF suspended its cooperation with Ukraine.

In early 2010, following the presidential elections and its final assumption of power, the Party of Regions had to face numerous economic challenges, the most urgent being the need to improve the state of public finances. The necessary condition was to resume cooperation with the IMF, which ensured access to loans with a relatively low interest rate, and helped to improve the country's image on the financial markets. The appointment of the government in March 2010 was in itself a sign of political stabilisation, and led to the first increase of Ukraine's credit rating since the beginning of the crisis<sup>1</sup>.

One of the first decisions taken by Mykola Azarov's government was to resume talks with the IMF. In July 2010, the parties reached an agreement concerning a new 29-month \$15.1 billion stand-by funding programme. The memorandum of cooperation stated that successive tranches of about \$1.5 billion each would be released every quarter, depend-

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on Ukraine's progress in meeting the obligations indicated in the memorandum. The first tranches were to be spent on direct support to the Ukrainian budget, and the following ones on increasing the National Bank of Ukraine's foreign reserves. The priorities set by both parties in the memorandum included the consolidation of public finances (by reducing the budget

deficit to 3.5% of GDP in 2011 and to 2.5% of GDP in 2012); adopting the pension reform; reforming the gas and fuel sector (by imposing market prices on gas and restructuring Naftogaz); strengthening the banking sector and increasing the independence of the National Bank of Ukraine; and making monetary policy more flexible.

The commitments included in the memorandum on cooperation with the IMF, and the employment of the conditionality principle in releasing funds (a principle which PM Tymoshenko had defied) stirred hope for deeper economic reforms. They also corresponded with President Viktor Yanukovich's own declarations. The government could have implemented painful social changes quickly, justifying itself with the IMF's demands, and shifting the blame for the disastrous economic situation onto its predecessors. However, the task proved much harder to carry out.

## Reforms in practice

At first, the Ukrainian government began implementing the necessary changes vigorously. Ukraine received the first tranche of the IMF loan, once the law that was supposed to reduce the budget deficit in 2010 to 5.5% was passed and a 50-percent raise in gas prices for the population was introduced. In September 2010, Ukraine succeeded in finding purchasers for \$2 billion worth of its Eurobonds at favourable interest rates. This was the first successful issuance of treasury bonds since 2008.

In December the Ukrainian parliament passed a budget for 2011 that was compliant with the commitments included in the cooperation memorandum with the IMF (among other

<sup>1</sup> Standard & Poor's upgraded Ukraine's foreign currency sovereign rating from CCC+/C to B-/C, and its local currency rating from B-/C to B/B. The rating outlook was also changed to positive.

things, the budget deficit was reduced to 3%). In response to this, and the government's promise to adopt the pension reform the same month, the IMF Board of Directors decided to release another tranche of the loan. However, by the end of 2010 the pace of the reforms had slowed down considerably.

#### *Monetary policy – no problem*

The National Bank of Ukraine (NBU) is one institution which has met its commitments relatively well. The **Bank has been acting according to the arrangements concerning monetary policy**, such as the increase of currency reserves and maintaining a stable exchange rate for the hryvnia (UAH). In May, the currency reserves exceeded \$39 billion, reaching

their highest level in Ukraine's history. The exchange rate of the hryvnia has also been stable for the last 12 months. In May 2011, the National Bank of Ukraine, following the arrangements with the IMF, adopted a series of regulations which liberalised the financial market. The NBU has once again allowed the banks to carry out swap operations on both the Ukrainian and international foreign exchange markets. The banks were allowed to sell and

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buy currencies on the interbank market during a single session (hitherto they could either buy or sell them); restrictions on the sale of currencies to individuals have been lifted<sup>2</sup>.

The changes implemented have ensured greater liquidity in the foreign exchange market. Their implementation was relatively easy, as these changes did not affect the interests of any important oligarchic lobby.

#### *Socially painful reforms*

At the same time, more and more points of contention arose between the IMF and the Ukrainian government. The greatest problem is currently the implementation of the **pension reform**, whose main provision is to raise the retirement age for women from 55 to 60 years, and to extend the minimum length of service from 5 to 15 years. In Ukraine, spending on pensions accounts for 18% of the GDP, which is one of the highest rates in the world. Despite the promises made to the IMF, the government has repeatedly postponed adoption of the appropriate laws. Initially, the reform was to be adopted by the end of 2010, then in mid-March 2011, but President Yanukovich stated that the project was not ready to be read in parliament, as the public consultations had not been carried out in a proper manner. The project was then returned to the government for revision, and it is not clear whether it will be voted by the parliament during the current session<sup>3</sup>.

The Ukrainian government is aware of the necessity to implement the pension reform. The current retirement age for women is irrational, as their average life expectancy is 74 years (in comparison, average male life expectancy is 62 years). The main impediment to this reform is the Party of Regions' fear of further decline in its popularity. Parliamentary elections are scheduled for autumn 2012, and polls show that the last year has brought a rapid decline in the support for the ruling party – from 39.1% in April 2010 to 15.7% in April 2011<sup>4</sup>. Another important reason is the fear that this reform may stir social unrest in Ukraine.

No less problematic is the **gas sector reform**. Ukraine has pledged to keep the deficit of the state-owned Naftogaz concern below 8.5 billion hryvnia (\$1.07 billion) in 2011, and as of next year Naftogaz is to manage without budget subsidies. One way to achieve this was

<sup>2</sup> By doing so, Ukraine has returned to pre-crisis solutions (in 2009 Yulia Tymoshenko attempted to tackle the crisis by introducing restrictions on the foreign exchange market).

<sup>3</sup> The Supreme Council (the Ukrainian parliament) works in two sessions: the spring session (from February to early July), and the autumn session (From September to January).

<sup>4</sup> The survey of support for political parties was conducted by the Razumkov Centre.

to raise gas prices for individual customers up to the market level (they are currently much lower than for industrial customers, who pay the full market price). This difference in prices has badly affected Naftogaz's financial condition, and has impeded the implementation of an energy-efficient policy. After the first 50% price rise was introduced, the IMF agreed to fulfil Kyiv's request and adopted a more moderate stance. Instead of another 50% rise, it was reduced and divided into two stages – a 20% raise in April and another of 10%

**Contrary to the agreement with the IMF, the Ukrainian government has not introduced the second increase of gas prices for the general public. The impeding factor is yet again anxiety about social unrest.**

in July. The IMF's condition was that the budget deficit must remain at the previous level, and that the government should find additional means for it. Despite this agreement, the government has not raised the gas prices as yet. The factor that has yet again postponed the raise is the falling public support for the Party of Regions.

#### *Influential lobbies are blocking the changes*

The gas price raise is by no means the only problem with the gas sector. A number of cases from recent months have shown that the specific interests of individual business groups mean more than agreements with the IMF which should provide for a gradual improvement of Naftogaz's finances. This may make it much more difficult to keep the budget deficit below 3.5% in 2011 (subsidies to Naftogaz are included in this deficit). If this policy is continued, it is unlikely that subsidies for Naftogaz in 2012 will be abolished.

The most glaring example of decisions that caused losses to the state-owned Naftogaz was the decisions taken by the government which favoured the Rosukrenergo company (RUE). Dmytro Firtash, the co-owner of RUE, represents an influential lobby which includes members of government (such as the energy minister Yuri Boyko) and close associates of Viktor

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Yanukovich (such as the head of the presidential administration Serhiy Lovochkin). One of the cases when the government favoured the lobbies at the expense of state companies was the ruling of the Arbitration Tribunal in Stockholm in June 2010 which ordered Naftogaz to transfer 12.1 billion m<sup>3</sup> of gas back to RUE. The Ukrainian government has not taken any steps to seek a less harsh ruling against

Naftogaz<sup>5</sup>. Moreover, in an agreement between RUE and Naftogaz concerning the return of gas, the chosen version of the agreement clearly favoured RUE, while the state-owned company suffered a loss amounting to \$900 million. Another similar example was Naftogaz's January decision to withdraw its claims against UkrGazEnergo (a subsidiary of RUE) for a gas transit fee amounting to 1 billion hryvnia.

In April, Naftogaz was deprived of its monopoly status in gas imports for domestic recipients<sup>6</sup>. Earlier, UkrGazEnergo received a licence to sell 4.8 billion m<sup>3</sup> of gas on Ukrainian territory. This decision will generate multimillion losses for Naftogaz, as UkrGazEnergo is likely to take over part of Ukraine's industrial customers.

#### *Problems with liberalisation*

In the memorandum signed with the IMF, Ukraine pledged to **liberalise the agricultural market**. Agricultural production and processing are one of the most important (and most

<sup>5</sup> It should be admitted that the takeover of gas by the Tymoshenko government in 2009 was in fact illegal, although the current government could have sought a more lenient ruling from the court.

<sup>6</sup> Naftogaz was not formally a monopolist: since 2008, Gazpromzbyt (a subsidiary of Gazprom) has had the right to sell up to 25% of the imported gas assigned for industrial recipients.

promising) sectors of the Ukrainian economy. Unlike other sectors, it is not dominated by any of the large oligarchic groups. Within recent months, the government has taken a number of steps to strengthen the role of the state in the agricultural sector, and has announced further similar decisions. As of February, contacts with foreign recipients have to be registered on the state agricultural stock. The government is planning to set up a state insurance company which will operate on the agricultural market. Even though similar measures are used in other countries, strengthening the state's role runs counter to the IMF recommendations.

Moreover, the state has interfered with the market to favour individual companies. In October 2010 the government introduced export quotas for grain, officially to prevent excessive price rises on the domestic market following a poor harvest. It soon turned out, however, that most of the orders made did not go to the major agricultural companies active on the market, but to a previously unknown company called Khib Investbud. Initially this company was presented as a state-owned enterprise; it later turned out that the state holds a minority stake in the company (49%), while the remaining shares are owned by stakeholders from Cyprus and Russia. In fact, there are reasons to believe that Khib Investbud is controlled by businessmen associated with President Yanukovich.

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Despite the pressure from the IMF, the validity term of the export quotas was extended several times, which helped Khib Investbud to strengthen its position on the agricultural market. It was only in May when the Ukrainian parliament decided that as of 1 July, these quotas will be replaced by export duties on grain, which should ensure fairer conditions of export. Another example of 'liberalisation', and another bone of contention in talks with the IMF, is the confusion caused around

the creation of a **central securities depository**. Even though the Ukrainian government has formally complied with the IMF requirements, it has done so in such a way as to sustain the control of the state (and associated oligarchs) over the institution that is being created.

At the moment, there are three depositories in Ukraine. The first is the All-Ukrainian Securities Depository (a private company, although not owned by any of the oligarchic groups), which controls over 80% of the market. The second is the National Depository of Ukraine (86% of whose shares are owned by the state) and the third is the depository at the National Bank of Ukraine, which operates with securities of state enterprises. One of the International Monetary Fund's requirements was that a single institution be established to take charge of registering securities. The IMF's representatives assumed that the single depository would be established on the basis of the All-Ukrainian Securities Depository, the company which is most popular with the customers. However, in February the government decided to set up the central depository on the basis of the National Depository of Ukraine and the depository at the National Bank of Ukraine. This decision has sparked opposition from the IMF, which had favoured a depository that would be owned largely by private capital. The government in Kyiv resisted this pressure; in April, the deputy head of the presidential administration, Iryna Akimova, announced that the central depository would be set up by the end of June. The main shareholder will be the state, and most likely significant influence over the depository will be exerted by Rinat Akhmetov, Ukraine's richest businessman.

## Suspension of the loan

The third tranche of the IMF loan was to be spent on increasing the foreign exchange reserves of the National Bank of Ukraine, and was initially planned to be released in March 2011. However, the IMF expert mission which visited Ukraine in February did not recommend releasing the funds in its report. Even though talks have continued, Ukraine has not so far received these funds. PM Mykola Azarov has even declared that Ukraine can manage without the IMF's money, although he admitted that this would affect the country badly. According to the IMF's representative in Kyiv, Max Alier, in order to receive another tranche of the loan, Ukraine must adopt the pension reform, raise gas prices and guarantee that Naftogaz's deficit will not exceed the agreed level.

## Prospects for cooperation...

Despite the problems observed and the suspension of loans, Ukraine is unlikely to stop its cooperation with the IMF. The Ukrainian government owes its current assertiveness to the improvement in the economic situation. But even though the first months of 2011 brought positive changes to the Ukrainian economy (GDP rose by over 5% in the first quarter), it has still failed to achieve the pre-crisis level, and it is far from certain that this growth will be sustained. The GDP is heavily dependent on exports (principally of metallurgical products), and those in turn depend on the condition of foreign markets. The recent developments in Middle Eastern countries (who are important recipients of Ukrainian products) have caused a

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significant slowdown of industrial production growth, especially in the metallurgical and machine sectors. This slowdown was one of the reasons why Standard & Poor's agency lowered its forecast for Ukraine's GDP growth to 3.8%.

In theory, Ukraine could give up the IMF loan completely, and obtain the necessary amount of funds by issuing treasury bonds and borrowing money abroad, for

example from Russia. However, these alternatives would have a much higher interest rate, and are therefore more expensive (the IMF loans are the cheapest option available). Moreover, maintaining cooperation with the IMF is a requirement for obtaining loans from the World Bank and getting macro-financial assistance from the EU. In this situation, the most likely scenario is that Ukraine and the IMF will reach a compromise, for example by adopting a pension reform in a somewhat milder version than previously agreed, and by implementing other reforms to a lesser extent than the IMF had initially demanded.

Further developments will depend on the prospects for Ukraine's economic growth. It cannot be ruled out that if the dynamic GDP and industrial production growth is sustained, the government may choose to postpone the reforms and prolong the talks with the IMF until the parliamentary elections scheduled for autumn 2012.

## ... and reforms

It remains an open question as to how deep the Ukrainian government's conviction to implement the promised economic reforms really is. Even though the current government is the most reform-oriented cabinet since at least 2006, its reformist zeal is fading from month to month as the parliamentary elections approach. Advocates of deeper reforms –



such as the deputy head of presidential administration Iryna Akimova and the deputy PM Serhiy Tihipko – are losing their influence.

At the moment, the main impediment to the reforms is the ruling group's fear of further decline in public support and possible social unrest. In recent months, protests against the economic difficulties have brought together more participants (small businessmen, teachers, industrial workers and others) than those previously organised by political parties. Polls also show that the level of discontent and readiness to participate in protests is growing among the Ukrainian public. On the other hand, the Ukrainian ruling class seems pretty unanimous in their belief that socially painful reforms (such as raising the retirement age or municipal utility charges) simply must be implemented. It can be expected that the government will take firmer steps in those spheres after the 2012 parliamentary elections.

However, the oligarchs' ties with the current government will be definitely a much greater obstacle to overcome: these ties have postponed or even precluded the reforms in some

**The oligarchs' ties with the current government will be a much greater obstacle to overcome: these ties have postponed or even prevented reforms in some crucial sectors. Nonetheless, those reforms that do not raise excessive controversy can be expected to continue.**

crucial sectors. In the case of the gas sector reform, the imposition of market prices on gas for individual recipients and a further liberalisation of the market are merely a question of time – provided that the reform is implemented in a manner that benefits the gas lobby. Changes that would harm the interests of this lobby – such as an improvement in Naftogaz's financial condition – seem unlikely as long

as the current elite holds power. Nonetheless, those reforms that do not raise excessive controversy (such as the banking sector reform) can be expected to continue..



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