# THE IMF'S UKRAINE BURDEN

Susan Schadler

## Key Points

- Ukraine's adjustment and reform effort was half-hearted at best during its 2014 International Monetary Fund (IMF) program. Although fiscal restraint was effective, the key problems of corruption, huge losses in the state energy company and outflows of domestic capital were allowed to fester.
- In its new and enlarged lending arrangement approved in March, the IMF has been pushed into providing more than half the total amount Ukraine is expected to need in 2015 from official creditors and private sector debt restructuring.
- The immense risks to the success of the policy program, which are rooted in the still-simmering conflict in the east, doubts about the government's ability to take on vested interests and impediments to a negotiated restructuring of private debt — and, therefore, to repayment of the IMF — exceed the IMF's risk-bearing capacity
- Bilateral creditors should be bearing a far greater share of the financial risk in Ukraine.

The IMF has raised red flags on the risks for its financial position from its latest loan to Ukraine. Risks for the IMF may sound arcane — a consideration that is beneath the urgencies of geopolitical strains. After all, taking on risk is a central purpose of the IMF's role as the world's lender into crisis. It is currently popular — whether one is talking about the Fund's role in Greece over the past five years or Ukraine now — to follow even negative assessments of the risk the IMF has taken on with a statement such as, "Of course, the Fund is a political institution and must do what its shareholders wish." But the significant expansion of the Fund's exposure to Ukraine approved by the executive board in March begs a central question about the size of the lending operation and the program of policies it supports: is the IMF equipped to take on the risk of such a large commitment of resources with questionable prospects for success to a country in conflict with questionable prospects for economic success?[1]

The IMF must be part of the Ukraine financing operation for four reasons. First, it alone has the expertise to advise on and craft conditions for macroeconomic adjustment and structural reform. Second, IMF advice to any country is only credible when the institution puts its own money on the table — the need to protect its own resources significantly strengthens the IMF's incentive to at least try to resist political pressures (from borrowers and lenders) to judge economic prospects favourably. Third, Russia, as a member of the IMF, becomes at least nominally a backer of the program (although Russia is rumored to have abstained from the approval of the loan). Fourth, Ukraine has obligations to service past

1 Since its inception, the IMF has avoided lending to countries in active conflict. In all but a couple of cases (where conflict was not a dominant force on the implementation of economic policies), the Fund has ascertained that a country has reached post-conflict status before extending its own resources.

loans from the IMF of $5.5 billion[2] over the next four years; a part of the total four-year commitment of $17 billion effectively rolls over this amount.

These are arguments for IMF involvement, but not for IMF exposure on the scale approved. Given the front-loading in 2015 of the IMF's scheduled disbursements ($10 billion of the $17 billion total), the IMF is to finance half of Ukraine's expected financing need in 2015, after having financed 90 percent in 2014. The IMF's financial structure is not equipped to take on the risks of being the principal financing source of a country in conflict and with an exceptionally poor track record of reform.

The IMF's report (IMF 2015) on its new loan to Ukraine has four standout features: First, performance during the now-terminated Stand-by Arrangement approved in April 2014 turned out to be another in a long line of largely unfulfilled commitments to economic reforms. Second, projections for the economy over the next three years look implausible, barring a major turnaround in the geopolitical and governance situations (in a nutshell, GDP growth is likely to be lower and the external financing need higher than the IMF projects). Third, official support during 2014 has financed a substantial, and relatively easily preventable, deposit flight. Fourth, the IMF has rarely, if ever before, expressed as much concern about its own capacity to take on the financial risks of a lending arrangement.

After a brief summary of the basic plan of the new program with Ukraine, these four interrelated issues will be considered. Taken together, the four issues beg questions about the balance member countries strike in positioning the IMF to maximize its influence in motivating adjustment and reform, protecting the financial integrity of the IMF and using the implicit "political pass" to secure quick, cheap money for geopolitical objectives.

## The New Program

On March 11, 2015, the $17 billion two-year Stand-by Arrangement approved in April 2014 was terminated, and a new $17 billion four-year Extended Arrangement was approved.[3] The (reasonable) case for making this switch is that if Ukraine is to turn its economy around, it will certainly take a policy effort going well beyond early 2016, so a multi-year program of policies and stream of financing is needed. Another practical consideration is that the repayment period of drawings under an Extended Arrangement is 4.5–10 years (compared with 3.25–5 for a Stand-by Arrangement).

As in the Stand-by Arrangement, the policy agenda is driven by three objectives: to rebuild foreign exchange reserves that were ravaged during the 2014 program, as the authorities failed to honour the agreed limit on central bank foreign exchange sales and the commitment to a flexible exchange rate; to reduce the public sector and external financing needs to amounts that have a chance of being available; and to reform an exceptionally corrupt and stifling economic environment, so as to attract investment and improve incentives for production.

The first objective is to be achieved by maintaining high interest rates, but also by a renewed commitment to targets for official reserves, to a flexible exchange rate policy and to capital controls. The second objective is to be achieved on the government side, by a combination of public expenditure restraint, reforms to state enterprises and increases in tax receipts, and — on the external financing side — by reducing the current account deficit and stopping cash outflows. Both should be helped by the 20 percent real depreciation of Ukraine's national currency, the hyrvnia, during 2014. The third involves structural reforms, mainly on governance and the energy sector. These are all sensible — and in fact the only possible — approaches. The question is whether any of this can and will be implemented in a country in serious conflict and with exceptionally deep-seated governance problems that have defied IMF conditionality through nine IMF lending arrangement in the past 20 years. Or is the IMF indulging official creditors (who want IMF money and involvement) with an excessively optimistic view of policies and outcomes?

## The IMF's Optimism

Optimism is endemic in IMF reports on the most difficult lending arrangements, which often involve high geopolitical stakes. The IMF staff, however, is not prone to optimism. Internal debates generally include a fair voice for (many) skeptical staff views, and plausible central projections often result from these internal debates. However, when IMF management reports on these projections to officials of member countries who want the IMF to take a large share of the financing of a crisis country, the pushback starts. At the end of this process, IMF staff must rally around a presentation of the strongest policies borrowing countries will commit to, and of projections that show fully financed fiscal and balance of payments (BoPs) for at least the next year. Generally, the more qualifiers in the report on the risks involved in the policy program and projections, the more the IMF staff had to depart from true central assessments of policies and projections. The Ukraine report is full of such qualifiers.

Where specifically is the excessive optimism in the IMF's presentation of the new arrangement?

2 All figures are in US dollars.

3 Two drawings were made under the 2014 Stand-by Arrangement — $3.2 billion upon approval in April and $1.4 billion after completion of the first review of policies and outcomes in August (IMF 2014a and IMF 2014b).

## Policy Assessment

Ideally, a report following a largely failed program assesses departures from the program and a new program is delayed until the government can demonstrate, through convincing actions, better commitment. The Extended Arrangement has been approved without either of these.

The IMF's recent report is not persuasive on the government's ability and will to put better policies in place. For Ukraine, with its 24-year history of lending arrangements with the IMF and only one having been pursued to completion, credibility is not helped by past performance. Nor does the report offer concrete evidence that much has happened since the hard sell on Ukraine's intentions in the April 2014 Stand-by Arrangement.[4]

- The failure to adhere to the commitment to exchange rate flexibility is the most blatant. The central bank allowed the hryvnia to depreciate episodically but, contravening its commitments, blew through over $8 billion of reserves in the six-month period since the August review of the Stand-by Arrangement.
- The loss of reserves was, in significant part, due to the failure to keep the policy interest rate positive in real terms and to the ineffectiveness of modest capital controls.
- Energy sector prices were reportedly raised, but far from sufficiently, especially in light of the large depreciation of the hryvnia. This appears to be an important source of the large overshoot of the estimated financing requirement of the state-owned gas company Naftogaz in 2014 (and prospectively in 2015) relative to the projections in the April stand-by request and even the first review of the Stand-by Arrangement in August. Whereas earlier reports have quantified in some detail the sources of the overruns of Naftogaz, the current report simply states that the 2014 Naftogaz deficit substantially ran over previous program targets.

| | Projection Date | | |
|---|---|---|---|
| Projection/Estimate of | April 2014 | August 2014 | March 2015 |
| 2014 Naftogaz deficit (hryvnia billion) | 50.4 | 65.3 | 87.3 |
| (percent of GDP) | 3.3 | 4.3 | 5.7 |
| 2015 Naftogaz deficit (hryvnia billion) | 32.7 | 33.0 | 58.0 |
| (percent of GDP) | 1.9 | 1.9 | 3.1 |

*Source:* IMF (2014a; 2014b; 2015).

- Progress appears to have been made in identifying banks with inadequate capital, but action to recapitalize or resolve them has been mostly limited to small banks. Other measures to strengthen bank regulation and supervision appear to have been minimal and now feature in conditionality for the Extended Arrangement.
- On governance reform, the broad message from the report seems to be that background work was started in 2014 and some new laws were introduced, but actual implementation remains to be carried out.
- It appears that the most successful aspect of adjustment and reform occurred in fiscal policy. Although some of the measures contributing to substantial fiscal savings in 2014 are temporary, several are meaningful reforms. The fiscal saving projected (which in part reflects liquidity constraints and the inability to make transfers to areas in conflict) at over three percent of GDP is sizable.

The report describes ambitious plans to push ahead with reforms in all these areas. Public statements by Fund staff and management characterize the government as more reform-oriented than any previous government since transition. The report, however, emphasizes that the heavily technocratic government continues to face formidable vested interests resisting change.

## Macroeconomic Projections

The optimism in the macroeconomic projections, in particular past 2015, has no obvious basis. Projections for the recovery of economic activity stand out. GDP is projected to fall sharply again in 2015 (this is largely preordained by the estimated year-on-year drop in GDP in the fourth quarter of 2014 of over 16 percent, and by the fact that the 2014 outcome was supported by a bumper harvest). In 2016, however, a period of two–four percent GDP growth annually will be ushered in. Supporting this is a pick-up in inflation-adjusted private investment of over 20 percent in 2016, followed by substantial increases thereafter.

A large rebuilding of foreign exchange reserves (from a rumoured $5.2 billion as of end-February to over $18 billion by the end of 2015) is projected. This will require channelling the entire drawing from the IMF (net of repayments on previous loans from the IMF) and most of the expected support from other official sources to reserve accumulation. To reach such an ambitious target, another large current account adjustment in 2015, more effective controls on financial outflows, more aggressive interest rate policy to raise rates proactively and commitment to allowing the exchange rate to adjust to absorb outflow pressures will be needed. The track record in 2014 in all of these areas except current account adjustment was poor. The target also requires that official financing commitments are honoured in a timely fashion and that negotiations with private

4 See Schadler (2014) for a discussion of the IMF's assessment of the Stand-by Arrangement as of August 2014.

creditors for savings of $15 billion on debt service over the next four years conclude successfully within the next few months.

In sum, the projections would require a turnaround during 2015 that would be striking for any economy with a long history of mismanagement and deep vested interests in preventing reform. The conflict in the east, with no obvious resolution in sight, makes it even less convincing that they reflect a balanced consideration of risks.

## What Exactly Is the International Community Financing?

In the kind of chaotic financial conditions Ukraine is experiencing, an important question for the international community is whether its support is financing essential economic needs or deposit outflows as residents abandon domestic banks and the local currency. IMF support for a country that is not taking needed adjustment and reform measures is a waste. IMF support for a country that is not taking needed adjustment and reform measures *and* is allowing large-scale capital flight is unconscionable. So, even if there is cause for skepticism about the adjustment and reform effort to date, concern should be compounded if capital flight on a significant scale is also taking place.

This is never an easy question to answer concretely because numbers do not reveal motives. For example, residents may withdraw foreign currency deposits from banks to pay for imports (especially if trade credit is limited) or to take savings out of the country. In either event, net foreign assets of commercial banks or the central bank fall, in the former case giving rise to a financing item on the external financial account and in the latter a drop in net foreign assets of the central bank. Similarly, a current account deficit may reflect net payments for essential goods and services or over-invoicing of imports and under-invoicing of exports — that is, capital flight through the current account.

Broadly, the limited data presented in the report suggest something on the order of a 60/40 split between the contributions of current account and net portfolio, medium- and long-term obligations on the one hand and capital flight on the other to the overall BoP deficit. The following table summarizes the contours of the BoP estimates.

| **BoP Estimates for 2014** (billions of US dollars) | **Projection Date** | |
|---|---|---|
| | **August 2014** | **March 2015** |
| Current account | –3.4 | –6.1 |
| Official debt (amortization less Eurobond issue) | –0.3 | –2.1 |
| Foreign direct investment | 0.2 | 0.4 |
| Private portfolio | –0.4 | –1.1 |
| Private medium-, long-term loans | –3 | –3.2 |
| Banks | –0.2 | –1.2 |
| Corporations | –2.8 | -2 |
| Trade credit | –0.1 | –4 |
| Short-term loans (excluding trade credit) | –6.2 | –0.2 |
| Currency and deposits | –1 | –1.5 |
| Banks | 2.5 | 1.1 |
| Other sectors | –3.5 | –2.7 |
| Of which foreign exchange deposit outflows | –3.1 | –7.1 |
| Errors and omissions | 0.9 | 0 |
| Overall balance | –13.3 | –17.8 |

*Source:* IMF (2014a; 2014b; 2015).

We start with the reasonable (although far from satisfactory) assumption that the current account deficit, official debt flows, private portfolio and medium- and long-term lending flows, and foreign direct investment are non-capital flight entries. The remainder — composed mainly of short-term private credit, trade credit and deposit flows — can be considered far more likely to comprise a significant element of deposit and capital flight. Using this division as a guide leads to the conclusion that about $5 billion of the overall deficit of $18 billion reflected capital flight.

There are two immediately apparent reasons to see this as a low estimate. First, in the March 2015 estimates, foreign exchange deposit outflow is reported as $7 billion. Second, a comparison of the March 2015 BoP estimates with the projections made in August 2014 sheds some light on what was probably unexpected capital flight. The estimate of the overall deficit increased by about $5.5 billion. Of this, about $2 billion reflected a delay in an expected US-guaranteed Eurobond issue. The remaining $3.5 billion reflects predominantly a substantially larger-than-expected current account deficit. Current account surprises are commonplace, but this is a large change, especially when a significant share of the data for 2014 should have informed the August projections. It seems likely, therefore, that at least some of the upward revision in the current account deficit reflects capital flight disguised in over- and under-invoicing.

These calculations are at best indicative; however, they give weight to the importance of three points:

- In 2014, when the overall BoP deficit substantially exceeded projections made even as late as August, capital flight was a significant contributor.
- In 2015, some $13 billion from official financing and restructuring of privately held external debt will be used to restock reserves to roughly their early 2014 level. In effect, most 2015 financing will simply be financing the losses from the government's failure to meet policy commitments and to stem capital flight in 2014.
- To the extent that BoP support has financed capital flight, the building of capacity necessary to repay official creditors has not taken place.

## Pushing the Limits of the Fund's Capacity to Bear Risk

The Fund has raised red flags about the impact of the loan to Ukraine on its risk profile. The bulk of the report on the Extended Arrangement presents relatively upbeat assessments of policy intentions and macroeconomic projections — albeit qualified by strong statements about downside risks. But an accompanying report, "Assessment of the Risks to the Fund and the Fund's Liquidity Position," has unusually blunt language about the inadequacy of the Fund's precautionary reserves to absorb the risk related to the Extended Arrangement.[5]

The Fund assesses the risk it undertakes in Stand-by and Extended Arrangements through many measures, but three form the backbone of its conclusions. The first is the impact of a proposed loan on the Fund's "forward commitment capacity" (FCC) that is, in effect, the funds available for future support to countries with BoP problems. The Fund currently has a relatively high FCC, and the resources committed to Ukraine have only a small negative effect.

The second measure is the concentration of the IMF's outstanding commitments. As of mid-February 2015, almost 85 percent of outstanding credit (plus the prospective $10 billion disbursement to Ukraine in 2015) was to Greece, Ireland, Portugal and Ukraine. While such regional concentration is high, it does not exceed levels in other periods of regional crises.

It is on the third metric — the capacity for maintaining the value of members' reserve holdings in the Fund in the event of Ukraine failing to repay principle or servicing charges — that the Fund staff has raised red flags. In a statement that stands at the extreme end of the spectrum of concerns in recent years about the financial risks to which the IMF is exposed, the staff report states "were Ukraine to accrue arrears on charges after drawing under the proposed arrangement, the Fund's burden sharing mechanism would be clearly insufficient" (IMF 2015).[6] Moreover, the report points out that after the March disbursement, credit outstanding to Ukraine stands at 57 percent of precautionary balances; if the amount committed were fully disbursed, total Fund credit to Ukraine would amount to over 100 percent of precautionary balances in 2018.

## Conclusion

The risks in the new IMF Extended Arrangement with Ukraine are huge: the track record of Ukraine's adherence to commitments is exceptionally poor; there is little indication that even well-meaning officials can stand up to vested interests opposing reforms; and even relatively straightforward measures to limit capital flight have proven elusive. Financing of the program in 2015 relies heavily on reaching a quick deal with private creditors (including the Russian National Wealth Fund). Towering above all of these risks is the unresolved conflict in the eastern part of the country.

In these circumstances, member countries of the IMF have opted to have the IMF take on at least half of the total financing requirement for 2015 by scheduling $10 billion of disbursements in a single year. This was expedient for official supporters, who themselves were reluctant to provide financing directly or faced political constraints on doing so.

Even apart from the risks that have been placed on the IMF's accounts, this funding strategy raises important questions for 2016 and beyond. One stands out. If, as seems likely, the macroeconomic projections beyond 2015 prove too optimistic, who will pick up the tab at that point? Further net IMF exposure would be beyond reckless. We must hope that some Plan B is receiving cold, hard consideration in the capitals of Ukraine's official supporters.

5 For general information on how the IMF assesses risks to its financial position, see IMF (2014c).

6 The Fund has two principal mechanisms for covering the risk of non-payment of principal or charges (effectively interest), in the Fund's terminology "deferred payment of principal or charges." Precautionary balances are held in an amount of at least 10 percent of the IMF's capacity to lend and are intended to safeguard the Fund's financial position in the event of non-repayment of principle. A burden-sharing mechanism is available to compensate for delayed payment of charges. This involves reducing the remuneration to member countries financing the commitment to Ukraine and increasing the charges on all countries borrowing from the Fund. Because the Special Drawing Right (SDR) interest rate is currently exceptionally low (reflecting low global interest rates) and these margins are set as a premium or discount on the basic SDR interest rate, burden-sharing capacity is also currently very low.

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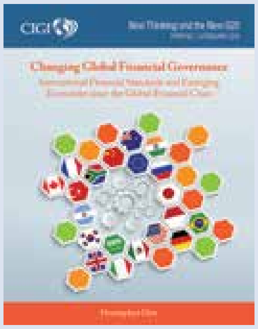

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