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EX POST EVALUATION OF EXCEPTIONAL ACCESS UNDER THE 2010 STAND-BY ARRANGEMENT

The following documents have been released and are included in this package:

- The Ex Post Evaluation of Exceptional Access Under the 2010 Stand-by Arrangement with Ukraine, prepared by a staff team of the IMF. It is based on the information available at the time it was completed on November 27, 2013.
- A press release summarizing the views of the Executive Board, as expressed during its December 16, 2013 discussion of the 2013 Ukraine Article IV Consultation, First Post-Program Monitoring, and Ex Post Evaluation of Exceptional Access.

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UKRAINE

November 27, 2013

EX POST EVALUATION OF EXCEPTIONAL ACCESS UNDER THE 2010 STAND-BY ARRANGEMENT

Authorized for distribution by **the European Department and the Strategy, Policy and Review Department**

Prepared by an interdepartmental staff team consisting of A. Abiad (head, RES), N. Arnold (FAD), A. Culiuc (SPR), L. Kaltani (EUR), P. Lohmus (MCM), and J. Manning (EUR), with assistance from A. Kini-Kaboré (RES) and D. Noren (EUR).

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INTRODUCTION

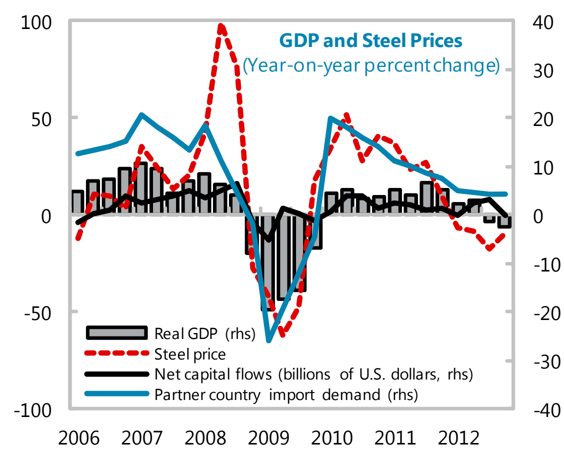
1. Following the global financial crisis, Ukraine began a tenuous recovery still facing significant financing and adjustment needs. Ukraine's economy was one of the hardest-hit during the 2008–09 global downturn, as declining confidence in the currency and banks led to a run on deposits, and the ensuing 15 percent contraction in GDP strained public finances. Policy adjustments supported by a 2008 IMF Stand-By Arrangement succeeded in stabilizing the economy, and by mid-2009 an incipient recovery was underway. But a severely dysfunctional government and weak policy implementation in the run-up to elections in early 2010 led to widening fiscal and energy sector deficits, the banking system remained hobbled by weak balance sheets, and the foundations for sustained growth were still missing.

2. A new government took office in early 2010 and reached agreement on a new 29-month Stand-By Arrangement (SDR10 billion, 729 percent of quota). The key objectives of the 2010 program were to consolidate public and energy sector finances, restore banking system soundness, and develop a more robust monetary policy framework focused on domestic price stability, with greater exchange rate flexibility.

3. This report assesses the effectiveness of Ukraine's 2010 SBA, which the IMF's Executive Board requires for arrangements entailing exceptional access.[1] It addresses the following two questions: Were the macroeconomic strategy, program design, and financing appropriate and consistent with Fund policy? And did outcomes under the program meet program objectives? The report begins by providing the background and context for the 2010 program. It then discusses the overall program design and financing (including evaluation of exceptional access criteria), as well as policy implementation and performance under the program, before concluding with some lessons.

BACKGROUND AND CONTEXT FOR THE 2010 SBA

4. Ukraine was pummeled by the global financial crisis, but policies supported by a 2008 Fund program helped set the stage for a recovery. The collapse in the price of steel (which accounts for 40 percent of Ukraine's exports and 15 percent of its GDP), the cratering of global demand, and a sudden



Sources: Ukrstat; Bloomberg; and IMF staff calculations.

[1] See "Ex Post Evaluations of Exceptional Access Arrangements—Revised Guidance Note", February 2010, available at: http://www.imf.org/external/np/pp/eng/2010/022510.pdf.

stop in capital flows triggered a balance of payments crisis in Ukraine, eroding confidence in both the currency and the banking system and leading to a deposit run. A fiscal crisis soon followed due to the contracting economy, the realization of contingent liabilities, and the drying up of market access. A 2008 Fund program aimed to stabilize the banking system and facilitate adjustment of the economy, and led to a gradual recovery by mid-2009 (Box 1).[2]

Box 1. Findings of the Ex-Post Evaluation of Ukraine's 2008 SBA

The ex-post evaluation of Ukraine's 2008 SBA found that the core short-term objectives were largely met, but little progress was made toward meeting medium-term objectives—which then became the focus of the 2010 program. Under the 2008 program, a much-needed exchange rate adjustment facilitated a turnaround in the current account and reserve position, the banking system was stabilized, and a gradual economic recovery took hold. But efforts to tackle underlying structural and institutional weaknesses stalled as the program went off track after just two of the envisaged eight reviews were completed. The banking system remained vulnerable, the exchange rate regime soon returned to the pre-crisis practice of de facto pegging, the energy sector remained largely unreformed with quasi-fiscal deficits widening, and fiscal, legal and governance reforms fell short of objectives. These outstanding issues became the focus of the 2010 Stand-By Arrangement.

The ex-post evaluation's key lesson was the importance of ownership and governance, but it found no clear-cut answers on how to achieve this in Ukraine. It concluded that "little ownership and overall weak policy implementation prevented better outcomes and tackling fundamental structural and institutional weaknesses, leaving Ukraine with core medium-term vulnerabilities." It noted that efforts to strengthen ownership—by having multiple signatories of the program, many prior actions, and close IMF involvement—were only partially successful in the 2008 program. The report also concluded that less front-loading of the program could have provided a stronger incentive to follow through on policy commitments, but would have had to be balanced against the need to secure confidence and adequate financing.

5. Sharp political divisions, weak institutional capacity, and election-related spending pressures led to a fiscal blow-out and the program going off track in late 2009. As political commitment to program-supported policies vanished ahead of the January 2010 elections, the combined general government deficit (including transfers to Naftogaz, the state-owned energy holding company) reached 8.7 percent of GDP in 2009, reflecting increased spending heading into the elections as well as revenue shortfalls. Fiscal prospects worsened further in late 2009, when the government backtracked on announced gas price increases, enacted a social standards law that

[2] See "Ukraine: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-by Arrangement," IMF Country Report No. 11/325, November 2011, available at http://www.imf.org/external/pubs/ft/scr/2011/cr11325.pdf.

would increase expenditures by over 4 percent of GDP, granted public wage "top-ups" costing another 0.8 percent of GDP, and postponed planned fiscal structural reforms.

6. The balance of payments also remained vulnerable, and reserve coverage was low. Although the current account deficit narrowed sharply to 1.5 percent of GDP in 2009 following the depreciation and collapse in domestic demand, external vulnerabilities persisted. Ukraine continued to face high rollover risks in an environment of restricted market access. External debt had risen sharply in 2009 due to real exchange rate depreciation and recession, and external financing needs were high—an estimated $30.6 billion (22.5 percent of GDP) in 2010. Reserve cover at the time of program approval was low, at 70 percent of short term debt, leaving the country exposed to potential confidence reversals and financial strains in other parts of Europe, especially in the context of the de facto peg the authorities had reestablished.

7. A new government took office in early 2010, offering the prospect of change, and quickly negotiated a new Fund program. The previous government had been extremely dysfunctional, with the president and prime minister undercutting each other's policies. A new, more cohesive government took office in March 2010, offering the hope of greater political stability. Moreover, the new government quickly elucidated a five-year reform plan, broadly consistent with many of the Fund's policy recommendations and with the recommendations of an international independent experts' commission.[3] In July 2010 the new government requested the cancellation of the 2008 Stand-By Arrangement—which was already seriously off-track and set to expire in November 2010—and requested and received a new 29-month Stand-By Arrangement for SDR10 billion ($15 billion, 729 percent of quota). Although extending the 2008 program was considered as an option, both the authorities and Fund staff had a preference for a new arrangement, which would foster ownership, allow for a fresh start, and lock in policy adjustment over a longer period.

PROGRAM DESIGN, FINANCING, AND EXCEPTIONAL ACCESS CRITERIA

A. Program Objectives and Design

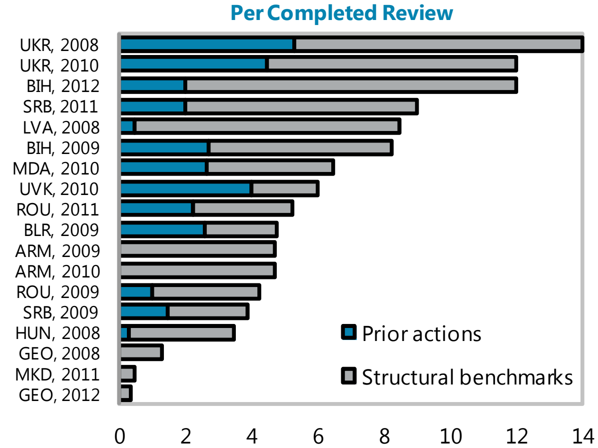
8. The 2010 program's primary objectives were to restore market confidence by putting the public finances on a sustainable path, increasing the country's resilience to shocks, and

[3] On February 26, 2010, a day after assuming office, President Yanukovych established the Committee on Economic Reforms. The reform program developed by the committee, "Prosperous Society, Competitive Economy, Effective Government" (http://www.usubc.org/site/files/Ukraine_Program_of_Economic_Reforms_2010-2014.pdf), was released in June 2010 and drew on recommendations from McKinsey & Company and the Independent International Experts Commission led by economists Anders Åslund and Oleksandr Paskhaver (http://www.iie.com/publications/papers/aslund0210.pdf).

bolstering the financial sector. The SBA aimed to restore confidence in fiscal sustainability by reducing the general government deficit through a combination of revenue and spending measures, a reduction in Naftogaz's deficits through energy tariff increases (gas and heating), and structural fiscal reforms. To increase the country's resilience to shocks, the program envisaged an increased focus on domestic price stability (with an eventual move towards inflation targeting) and greater exchange rate flexibility, which could serve as a first line of defense against external shocks. Key structural reforms of the 2008 SBA remained relevant and were incorporated into the new program, including reforming and modernizing the energy sector and restoring and safeguarding banks' soundness through recapitalization and strengthened supervision.

9. The program appropriately relied on prior actions to claim early successes. Under the previous seven arrangements, Ukraine completed less than half of the envisaged program reviews. Given this spotty program performance, and recognizing that early successes were critical for advancing the reform agenda, the program aimed to strike a balance between giving the authorities the benefit of the doubt in terms of policy commitments and learning from past experience. The program therefore relied heavily on prior actions, which mitigated the risk that policy commitments would not translate into action. Five prior actions at program approval focused on fiscal consolidation, energy tariffs, and central bank independence; four prior actions followed during the first review, which was the last review completed.[4]

Number of Structural Conditions Per Completed Review



Source: IMF staff estimates.

10. Program conditionality was more extensive than in comparator programs, for well-founded reasons. The program included six quantitative performance criteria and two indicative targets. The program request included eight structural benchmarks to be completed by end-2010, while the first review envisaged six other benchmarks for the first half of 2011. While this exceeds the number of conditions in other programs approved in the aftermath of the global financial crisis, extensive conditionality was an appropriate choice for Ukraine, which faced more severe issues across a larger number of structural areas than Eastern European peers.[5] Most importantly, extensive

[4] One of them was a structural benchmark reset as prior action.

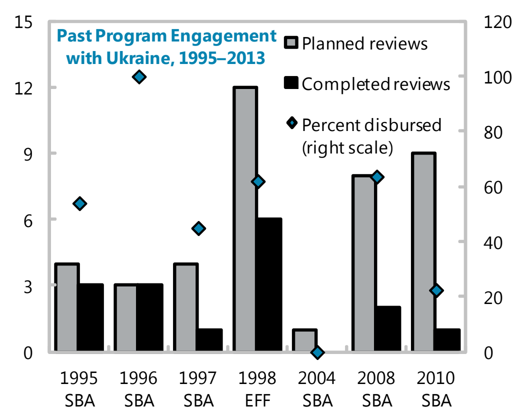
[5] The program also erred on the detailed side in defining quantitative targets and structural benchmarks. Such detail was warranted, as exemplified by a seemingly unambiguous prior action at the time of the 2010 program request to "increase heating tariffs." The prior action was met in the legal sense, but not in substance, as the regulator announced the tariff increase but communal utility companies continued charging old tariffs when the heating season started. Another prior action at the time of the first review was necessary to ensure the pass-through of gas tariff increases to end users.

conditionality was warranted because of elevated implementation risks, a fact acknowledged from the program's inception (Box 2). Structural conditionality was in line with the program's objectives, and had a stronger focus on public enterprise reform and pricing than in other CEE programs (figure below), reflecting the importance of the energy sector for macroeconomic stability. Overall, conditionality was critical, well-articulated, and in the areas of the Fund's competency.

Structural Conditionality by Topic in Ukraine and Other CEE Programs, 2008–13

Source: IMF staff estimates.

11. The program's duration was appropriate given the extensive and ambitious reform agenda, but in hindsight a shorter program might have been preferable.[6] The 29-month SBA was long enough to cover the implementation of the envisaged reforms, including the multi-step energy tariff increases, pension reforms, and a gradual transition to inflation targeting. However, the substantial duration of the arrangement had its shortcomings. Based solely on Ukraine's past track record, the likelihood of completing all nine reviews was slim. While the new government deserved the benefit of the doubt, a shorter arrangement could have limited the Fund's initial financial commitment and avoided the possibility of a program being off-track for a prolonged period. An alternative approach to achieve the same goals would be the early termination of a defunct program, but such a mechanism was not available in 2010 nor is it part of the GRA toolkit at present. As it happened, the 29-month program



Source: IMF staff estimates.

[6] In addition to sufficiently tackling short-term stabilization needs to resolve the country's underlying BOP problems, a shorter program could have covered the initial elements of the structural reform agenda, positioning these structural policies as part of a longer-term reform strategy.

Box 2. How Did the Program Deal with Risks?

Implementation risk. As highlighted in both the 2005 ex-post assessment of program engagement in Ukraine and the 2011 ex-post evaluation of the 2008 SBA,[1] critical reforms had often been obstructed by lack of policy commitment and program ownership. However, the 2010 program was formulated under a much more favorable political environment than its immediate predecessor: the executive benefited from a parliamentary majority and a cohesive economic team, and did not face elections for another four years. Despite these promising factors, the program request stressed that consistent implementation and strong political backing at the highest level were critical for the success of the ambitious program agenda. Extensive reliance on prior actions was the program's main tool for addressing implementation risk. The very limited frontloading of Fund financing also created additional incentives for completing subsequent reviews.

Macroeconomic risks. The sharp global recovery in mid-2010 was generally favorable to emerging markets, but uncertainty remained high especially with the emerging turmoil in EU periphery countries. Prospects related to the gas sector (potential renegotiation of gas import prices, and fallout from an international court ruling against Naftogaz) created an additional layer of uncertainty for Ukraine. The program's key policies (transitioning to a flexible exchange rate, strengthening the financial sector, and improving public finances) represented an appropriate response to the more volatile external environment. The program also envisaged that reforms in the gas sector would help the country diversify its economy and make it less energy dependent, thus reducing balance of payments risks.

Risk for Fund resources. The Assessment of the Risks to the Fund undertaken as part of the program request evaluated the risks to the Fund as "considerable," with access under the program making Ukraine one of the two largest debtors to the Fund at the time. The proposed access was also deemed significant in terms of its debt service burden on Ukraine. Minimal front-loading was the primary means for addressing these concerns. The program also expected to attract slightly higher financial commitments from other IFIs and official lenders (the European Commission, the World Bank, and EBRD in particular) compared to the previous program. This helped keep the Fund's contribution below the level originally requested publicly by the authorities (around $20 billion).

[1] See "Ukraine: Ex Post Assessment of Longer-Term Program Engagement," November 2005 (http://www.imf.org/external/pubs/ft/scr/2005/cr05415.pdf) and "Ukraine: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-by Arrangement," November 2011 (http://www.imf.org/external/pubs/ft/scr/2011/cr11325.pdf).

veered off track after just the first review, and over the next two years numerous attempts were made to get the program back on track. The authorities consistently announced that "negotiations with the Fund are continuing," while the Fund remained relatively quiet about the deteriorating state of program negotiations and lacked a mechanism for terminating the arrangement. As a result, market perceptions of Ukraine were probably more favorable than they otherwise would have been, and the authorities used this opportunity to tap capital markets. Importantly, the protracted attempts to get the program back on track delayed Article IV consultations, and an Article IV staff report went to the Board only in June 2012 and was issued in November 2012, almost two years after the December 2010 SBA First Review and four years after the previous Article IV staff report.

B. Financing

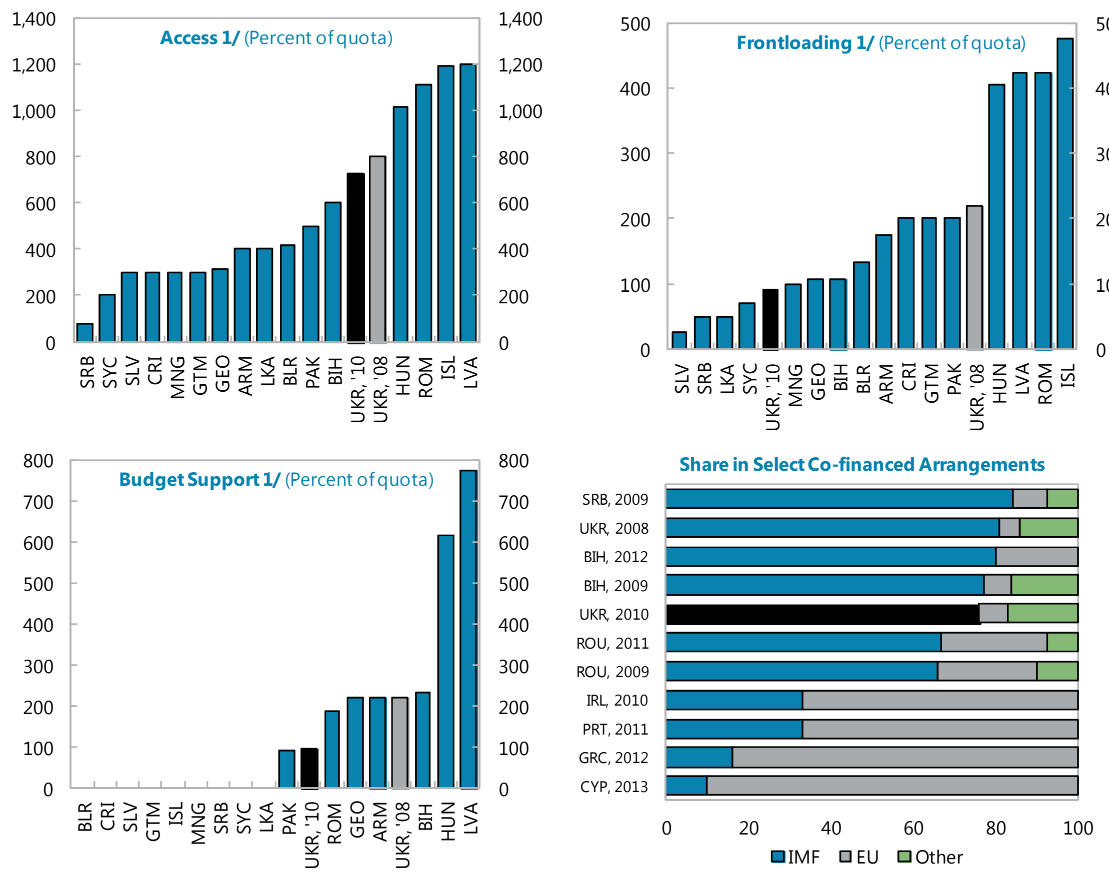
12. The SBA entailed high access to address considerable financing needs, and phasing was only marginally frontloaded. The financing package was set at 729 percent of quota (SDR10 billion, around $15 billion), and had a first disbursement of 91.1 percent of quota, with subsequent disbursements of about 73 percent of quota and about 55 percent of quota for the last disbursement. The rationale for the exceptional access was the reduced availability of international financing, low rollover rates of private external debt, and the need to strengthen reserves. Given that the overall fiscal adjustment was too large to be executed in one step, 50 percent of the first two disbursements was earmarked for budget support. The program also envisaged co-financing from other official donors (primarily the European Commission, the World Bank, and the EBRD), on par with other programs since mid-2009. However, given the stronger emphasis on public enterprise and pension reforms than in other CEE programs, higher financial participation by IFIs specializing in structural reforms could have helped signal their confidence in the likelihood of success of the structural reforms agenda.

Access and Phasing Under the Stand-By Arrangement

Date	Amount of purchase: Millions of SDRs	Amount of purchase: Percent of quota	Conditions
July 28, 2010	1,250	91.1	Board approval of arrangement
November 30, 2010	1,000	72.9	First review and end-September 2010 performance criteria
March 15, 2011	1,000	72.9	Second review and end-December 2010 performance criteria
June 15, 2011	1,000	72.9	Third review and end-March 2011 performance criteria
September 15, 2011	1,000	72.9	Fourth review and end-June 2011 performance criteria
December 15, 2011	1,000	72.9	Fifth review and end-September 2011 performance criteria
March 15, 2012	1,000	72.9	Sixth review and end-December 2011 performance criteria
June 15, 2012	1,000	72.9	Seventh review and end-March 2012 performance criteria
September 15, 2012	1,000	72.9	Eighth review and end-June 2012 performance criteria
December 15, 2012	750	54.7	Ninth review and end-September 2012 performance criteria
Total	10,000	728.9	

Source: IMF staff estimates.

Financing Indicators: Ukraine in 2010 vs. Ukraine in 2008 and Other Comparator Programs



Source: IMF staff estimates.
1/ Sample includes non-concessional loans signed between Sep., 2008 and Oct., 2009.

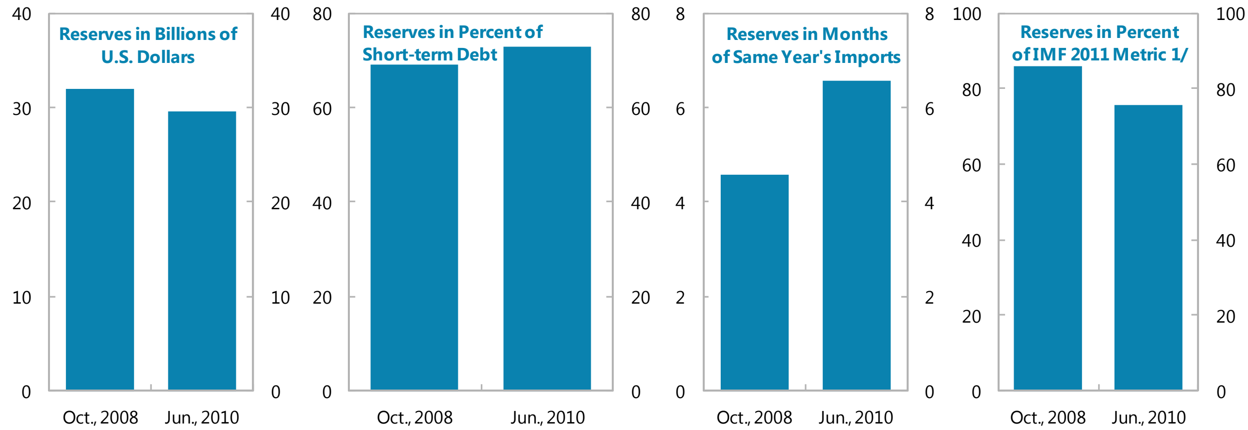
13. While exceptional access was unavoidable, financing was probably excessively high, especially when compared with the size and prevailing conditions of the 2008 SBA. As Ukraine had not started repaying the 510 percent of quota that it had purchased under the previous arrangement, any program above 90 percent of quota would have been above the normal access limits. As mentioned above, the program's rationale for the access level hinged on considerable external financing needs, which were estimated at the time at $31 billion on average for 2010–12. In this context, the $5 billion per year (on average) that the program was providing appear appropriate. However, differences compared to the 2008 SBA arrangement (11 billion SDR, or around $17 billion) suggest that the 2010 program may have been overfinanced. While the two arrangements were comparable in size, the economic situations were different:

- In November 2008, market access was nonexistent, whereas by mid-2010 it was merely limited.

- Ukraine experienced large portfolio outflows in the second half of 2008, but these had turned back into inflows by Q4 2009.

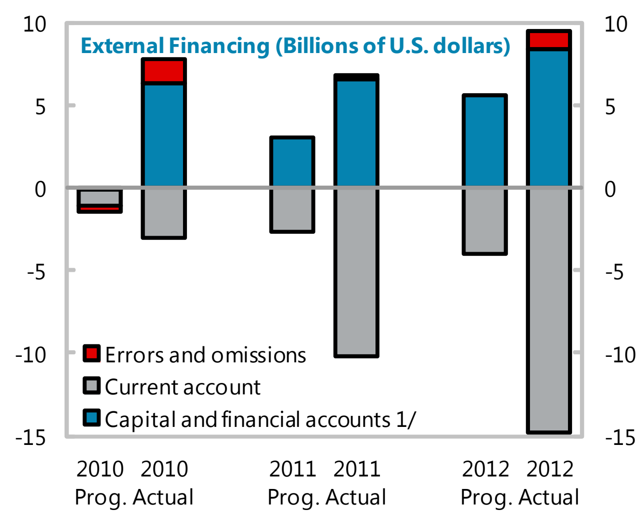
- In 2008, Ukraine faced an additional current account crisis triggered by plummeting terms of trade (steel prices in particular). By mid-2010 the price of steel increased by about 30 percent from the mid-2009 trough, and the current account deficit was much smaller due to import compression and gains in competitiveness from the depreciation of the hryvnia.

Reserve Adequacy Indicators Ahead of 2008 and 2010 Programs



Source: IMF staff estimates.
1/ Metric already under development but not yet finalized at time of 2010 program request.

These differences in the external environment are also reflected in the evolution of reserves. In 2008, reserves were dropping for three consecutive months ahead of program approval, while in 2010 they were growing in the four months ahead of program approval. The levels of reserves prior to program approval were also comparable across both programs (see figure). In short, while macroeconomic and especially external conditions were far from perfect in early 2010, they appeared considerably better than at the time of the approval of the 2008 program.[7] Also, as shown in the figure and detailed in Table 3, net flows in the financial and capital accounts in 2010-12 were considerably higher than projected under the program.[8] To conclude, it appears that Fund financing in the 2010 SBA was on the high side given Ukraine's needs and outlook. It should be noted



Sources: IMF Country Report No. 10/262; and Ukraine: Staff Report for the 2013 Article IV Consultation and First Post-Program Monitoring.
1/ Net of official financing.

[7] The drop in reserve adequacy as measured by the IMF 2011 metric was primarily due to a rise in the stock of portfolio liabilities.

[8] Overall financing in 2010 was better than projected, but the current account deficit ballooned in 2011–12, in part due to the real appreciation of the hryvnia and widening fiscal deficits.

that at the outset of the program, the IMF mission envisaged a smaller package, of around $12 billion.

C. Exceptional Access Criteria

14. The program was approved in line with the Board decisions on modified exceptional access criteria.[9]

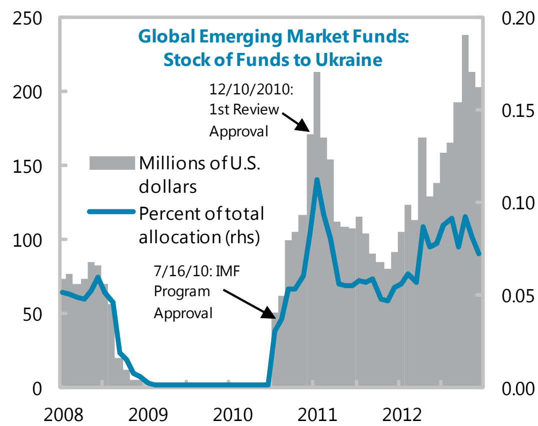
- **Criterion 1**: The *member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account resulting in a need for Fund financing that cannot be met within the normal limits*. While Ukraine was not experiencing exceptional balance of payments pressures in 2010, the potential for such pressures was definitely present. External financing needs were large, international reserves continued to be low, and the outlook had large downside risks.

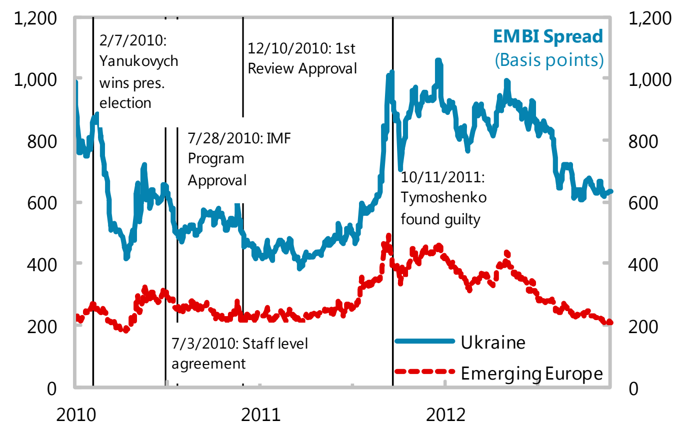
- **Criterion 2:** *A rigorous and systemic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term*. While public debt rose rapidly in the aftermath of the global financial crisis, it rose from a low level, and was projected to peak at just above 40 percent of GDP. Stress tests indicated that Ukraine's medium-term public debt sustainability was sensitive to growth assumptions. The macro framework underpinning the program was sufficiently conservative so that even though the deficit outturns in 2011 and 2012 were larger than programmed, the public debt outturn in those years was better than projected, on the back of stronger than anticipated growth and real appreciation in those years (Figure 2).[10]

- **Criterion 3:** *The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding*. The mere fact that the country was negotiating a program with the IMF triggered market interest, and a $2 billion Eurobond placement occurred just two months after the SBA approval. Spreads came down both at the approval of the program and after the first review.

[9] See "GRA Lending Toolkit and Conditionality: Reform Proposals" (http://www.imf.org/external/np/pp/eng/2009/031309a.pdf) and "GRA Lending Toolkit and Conditionality—Reform Proposals—Supplement 1, Revised Proposed Decisions" (http://www.imf.org/external/np/pp/eng/2009/031909.pdf).

[10] When the program moved irretrievably off-track, however, fiscal and quasi-fiscal deficits widened further. Combined with weak growth and higher borrowing costs, these deficits are projected to raise Ukraine's public debt to levels likely to generate financing difficulties (see next section).





Sources: EPFR; Bloomberg; and IMF staff estimates.

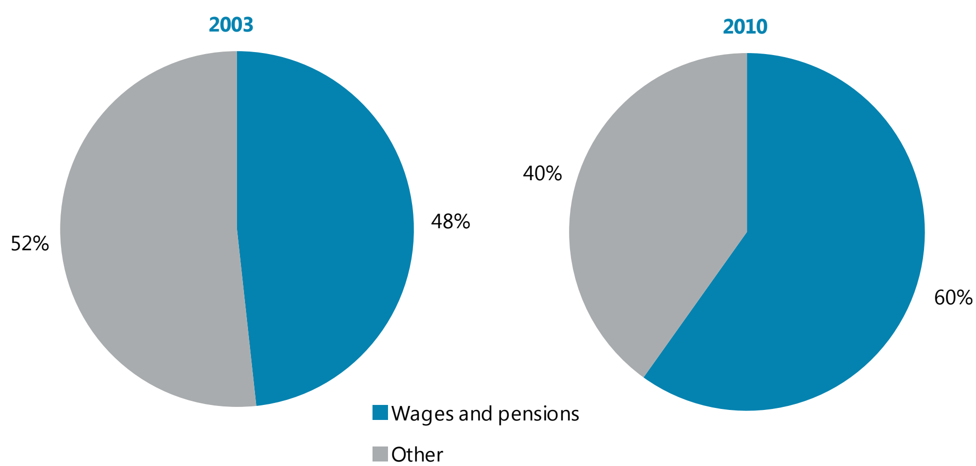
- **Criterion 4**: *The policy program provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.* At the time of program approval, prospects for success seemed reasonably strong. The 2010 program request rightly acknowledged Ukraine's mixed track record of program implementation. But prospects for success were buttressed by the fact that the new government was more cohesive, by the program being backed at the highest political levels, by the government quickly elucidating a reform strategy in early 2010, and by the large number of prior actions undertaken by the government despite limited frontloading of financing. In hindsight, the government's institutional capacity to deliver core reforms under the program seemed sufficient, but the political costs implicit in some reforms (gas tariff increases, exchange rate flexibility) and the likely opposition from vested interest groups (especially in the case of energy sector reform) proved to be an insurmountable obstacle to political will and capacity to deliver, especially since global economic and market conditions had improved and there was less pressure on the authorities to deliver the requisite policies.

15. Exceptional access procedures were followed. The Board was involved early in the lead up to the program request, with an informal briefing taking place on April 16, 2010. A report assessing the risks to the Fund and the Fund's liquidity position was provided to the board. The staff report and related documents (the Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding) were published.

FISCAL POLICY

16. During 2000–07, Ukraine experienced a period of rapid growth and an apparent improvement in its public finances, which masked growing structural fiscal vulnerabilities.[11] Over this period, fiscal revenue rose from 33 percent of GDP to nearly 42 percent and general government gross debt fell from 47 percent of GDP to 12 percent, driven primarily by growth and negative real interest rates. This decline in debt as a share of GDP occurred even as government spending also rose substantially, by 7.3 percent of GDP over 2001–07. The spending increase was primarily driven by higher spending on public wages and pensions (which accounted for more than 100 percent of the increase in total expenditures over this period), exacerbating budget rigidities and weakening the structural fiscal position. This rise in current spending also limited the scope for boosting public investment, and fueled consumption (and current account deficit) growth.

Wages and Pensions as a Share of Total Spending in 2003 and 2010



Sources: Ukrainian authorities; IMF staff estimates.

17. When the crisis hit in 2008, public finances rapidly deteriorated and the government faced difficulties financing itself.[12] From 2007 to 2009, the general government cash deficit ballooned from 1.9 to 6.3 percent of GDP. This actually understates the size of the deficit, since the government also accumulated a large stock of VAT refund arrears in 2009. A broader measure of the deficit that includes the deficit of Naftogaz (2.4 percent of GDP) and bank recapitalization costs (2.6 percent of GDP) was even higher, at 11.3 percent of GDP in 2009. As a result, the gross public debt-to-GDP ratio almost tripled between 2007 and 2009, rising from 12.3 percent to 34.6 percent

[11] Ukraine's real GDP growth rate averaged 7.5 percent a year over 2000–07.

[12] This was one of the primary reasons for the 2008 Stand-by Arrangement (SBA), which was frontloaded and included a substantial budget support component.

of GDP. Additionally, during the run up to the January 2010 elections, a costly new "Social Standards Law" that raised public wages and pensions was passed. This added to budget rigidities and complicated future fiscal adjustment efforts.

A. Fiscal Policy Objectives and Key Reform Measures under the 2010 Program

18. In light of the marked deterioration in the public finances in 2008–09, the primary fiscal objective of the 2010 SBA was to return public finances to a sustainable path. Besides more standard expenditure cuts and public administration and tax reforms, there were two reforms that were at the heart of the program's strategy to achieve its fiscal objectives.

- *Energy sector reforms:* Given the continuing fiscal cost of supporting Naftogaz—due to losses generated by setting gas and heating tariffs well below the cost-recovery price—a key element of the fiscal stabilization strategy was to increase end-user energy tariffs to eliminate Naftogaz's deficit by 2011 (see next section). The first tariff increases were a prior action for the SBA request. Recognizing the quasi-fiscal nature of Naftogaz activities, a ceiling on the combined general government and Naftogaz deficit was also included as one of the program's quantitative performance criteria.

- *Pension reforms*: The other plank of the program's fiscal policy approach was that it sought to reduce spending by cutting current expenditures, particularly the public wage bill and pension costs. The most critical structural reform proposed was the reform of the pension system. By 2009, the pension system had become unsustainable, with pension contributions almost 7 percent of GDP less than pension expenditures (worth 18 percent of GDP in 2009).

19. The planned fiscal adjustment under the program was ambitious but feasible, and the phasing of the adjustment aimed to avoid disrupting the economy's return to growth.[13] The general government deficit target for 2010 was set at 5.5 percent of GDP, a 0.8 percent of GDP reduction relative to 2009. The combined general government and Naftogaz deficit was set at 6.5 percent of GDP, down from 8.7 percent of GDP in 2009. Much of the decline in this deficit target was meant to come from the 1.4 percent of GDP reduction in Naftogaz's deficit following agreed-upon tariff increases and other energy sector reforms. A faster pace of adjustment was set for 2011, with a planned 2 percent of GDP decline in the general government deficit to 3.5 percent of GDP and the complete elimination of Naftogaz's deficit. In 2012, this was to be followed by an additional 1 percent of GDP improvement in the general government deficit.

[13] At the time of the SBA request, with an output gap estimated at -7.5 percent in 2010, the cyclically-adjusted primary balance was projected to improve from -0.5 percent of GDP in 2010 to 1.0 percent in 2011, and to 1.2 percent in 2012.

20. Other debt creating flows were excluded from the program deficit targets, but these continued to add to public debt in 2010. Specifically, to repay VAT refund arrears accumulated by the previous government in 2009 (1.5 percent of GDP), the program allowed the authorities to issue bonds, in lieu of paying cash, to VAT refund claimants. Any VAT refund arrears after 2009 would have had to be paid in cash, with a ceiling on VAT refund arrears set as an indicative target. Additional costs from supporting the financial sector, financed by bank recapitalization bonds worth 1.8 percent of GDP, were expected in 2010. At the time of the SBA request in 2010, the combined general government and Naftogaz deficit plus other debt creating flows was projected to be 9.9 percent of GDP.

21. The program sought to protect social assistance spending for the poor and public investment to avoid stymieing the nascent recovery. In particular, the program aimed to bolster social assistance for the poorest households, which were most vulnerable to the impact of the planned energy tariff increases. Public investment had already suffered substantial cuts in 2009, falling from more than 5 percent of GDP to just over 2 percent of GDP. In part, the planned fiscal adjustment under the program sought to create budgetary room for greater capital expenditures. However, a ceiling on publicly guaranteed debt, mainly related to infrastructure projects, was also added as a quantitative performance criterion to limit the accumulation of opaque contingent liabilities and their use as a means of effectively evading the program's deficit ceilings.

B. Implementation of Fiscal Policies under the Program

22. The fiscal elements of the program were appropriately designed, but weak ownership by the authorities resulted in limited improvements in the state of public finances. After program approval in July 2010, the government quickly regained access to financial markets and issued a $2 billion Eurobond. While renewed access to markets was anticipated at the time of the SBA request and was encouraging in some respects, it also may have weakened the government's incentives to respect agreed upon fiscal targets and push through politically difficult reforms. By early 2011, following the completion of the first review, spending overruns and delays in implementing structural reforms were beginning to raise doubts about the authorities' commitment to the program's fiscal objectives.

23. Slippages in the implementation of measures to reduce the general government and Naftogaz deficits emerged early in the program. Repeated attempts were made in 2011 to conclude the second review under the SBA. The mission in February 2011 found that the authorities had substantially exceeded the ceilings on both the general government deficit and the combined deficit (by 0.9 percent of GDP) in 2010, mainly due to Naftogaz's deficit exceeding its target by 0.7 percent of GDP. This overrun came despite better than expected economic growth in 2010. On the government's part, the missed deficit target was mainly the result of spending overruns towards the end of the year. For Naftogaz, the failure to fully implement important deficit reduction measures was to blame (see next section).

24. Critical reforms were delayed or faced resistance, including pension reforms, the establishment of an automatic VAT refund process, and raising energy tariffs. The authorities renegotiated the pace of tariff increases during the initial second review mission, but even after doing so, they failed to raise tariffs as agreed. The approval of pension reforms, initially set to be completed by end-2010, was delayed well into 2011. An automatic VAT refund system was also delayed, but was eventually established.

25. The delays in VAT refund system reforms, and actions that hindered staff's ability to verify the elimination of VAT refund arrears, were indicative of the lack of program ownership. Staff held firm in their view that program conditionality needed to be respected and, after some delay, the authorities established an automatic VAT refund system. However, discretionary approval of VAT refunds provided opportunities for rent seeking and, as a result, the automatic VAT refund system's efficacy was undermined by half-hearted implementation. This also contributed to the failure to eliminate VAT refund arrears as programmed. After the first review, the authorities provided incomplete or inconsistent data, making it difficult for Fund staff to properly assess the stock of VAT refund arrears and whether or not the indicative target for eliminating VAT refund arrears had been achieved.

26. The failure to enact reforms and to cut Naftogaz's deficit meant that the general government deficit had to be squeezed further to meet the combined deficit target for 2011. During February 2011 discussions for the second review, the authorities agreed to reduce the general government deficit target in 2011 in order to accommodate a higher deficit for Naftogaz (projected to be 0.7 percent of GDP at the time) and still meet the combined deficit target (3.5 percent of GDP). This was despite the fact that the adjustment needed to meet the original general government deficit target for 2011 was already ambitious. The revised general government deficit target (2.8 percent of GDP) implied an adjustment of 3 percent of GDP relative to the 2010 outturn (5.8 percent of GDP), which would have required strong measures to achieve. However, the measures proposed by the authorities were often not well-specified or the savings projections were overly optimistic in Fund staff's view, which hindered the completion of the second review. Moreover (and contrary to Fund staff's advice), in the first half of 2011 the government adopted a supplementary budget that increased spending by an additional 0.9 percent of GDP. The Fund team correctly concluded that the government's claim that the modest revenue overperformance in the first half of 2011 would cover this additional spending was not credible, especially given the lack of transparency on VAT refund arrears.

27. In late 2011, attempting to bring the program back on track, Fund staff proposed to relax the combined deficit targets for 2011 and 2012 in return for immediate energy tariff hikes. By October 2011, the deficit projection for Naftogaz had been revised up to 1.5 percent of GDP (relative to 0 percent projected at program approval, and 0.7 percent of GDP projected in February 2011). Staff viewed the need to put Naftogaz's finances on a more sustainable footing as critical. As an incentive to raise energy tariffs, staff proposed relaxing the combined deficit target by 0.8 percent of GDP to accommodate the projected increase in the 2011 Naftogaz deficit, rather than demand spending cuts to further reduce the general government deficit to meet the original combined deficit target (3.5 percent of GDP). For 2012, staff also proposed a looser combined target (3.1 percent of GDP) to accommodate some of Naftogaz's deficit continuing into 2012. However, a tighter general government deficit target (to 1.8 percent of GDP) was proposed for 2012, which would maintain the 1 percent of GDP improvement in the general government deficit from 2011 to 2012 that was originally envisioned in the program.

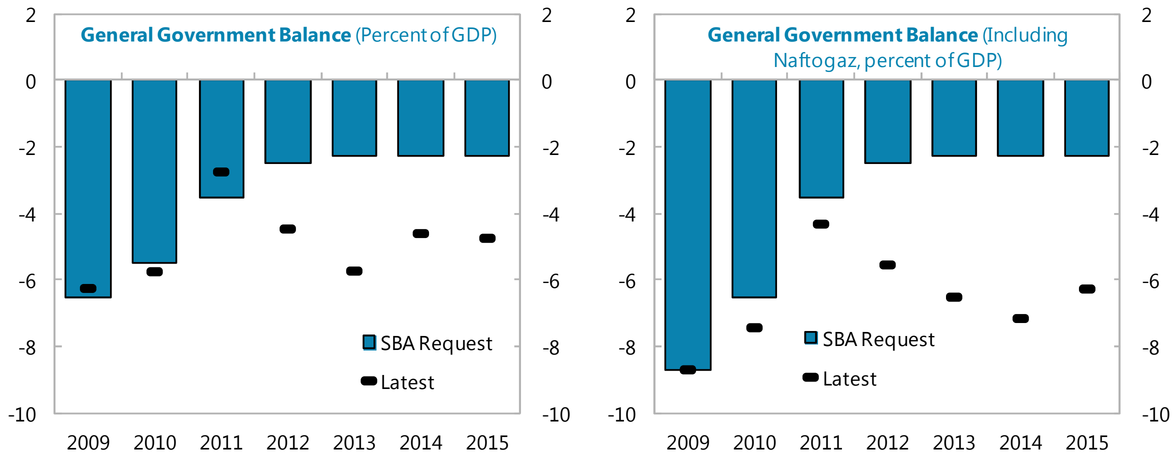
28. The authorities' resistance to raising energy tariffs and to implementing necessary fiscal adjustment measures prevented the completion of the second review. Efforts to find a compromise solution on energy tariff increases were unsuccessful (see next section). The authorities were also unwilling to take the necessary fiscal adjustment measures to meet the proposed deficit targets for 2012. In particular, the October 2011 mission considered the government's growth and revenue forecasts for 2012 to be overly optimistic and estimated that further spending reductions worth 0.9 percent of GDP would be needed to meet the general government deficit target of 1.8 percent of GDP.

29. After failing to complete the second review in 2011, the parliamentary elections in 2012 made it unlikely the authorities would implement the measures needed to get the program back on track. Beyond the refusal to increase energy tariffs, there was little appetite for further spending cuts, especially measures to cut (or limit the growth of) the public wage bill and pensions in an election year. The general government deficit outturn in 2012 was 4.5 percent of GDP, 2 percentage points higher than originally programmed (and 2.7 percentage points higher than the revised deficit target proposal discussed in 2011).

30. Unsurprisingly, the program's main fiscal objective—putting the public finances on a more sustainable footing—was not realized. As noted in the discussion of the second exceptional access criterion, in 2011–12 the public debt-to-GDP ratio was lower than projected at the time of the 2010 SBA request. But fiscal discipline dissipated as the program veered further off-track, and the latest macroeconomic and fiscal forecasts for Ukraine are worrisome. Naftogaz's deficits have not been eliminated as hoped, but have widened. And instead of gradually shrinking, general government deficits are expected to deteriorate further. At the time of the 2010 SBA request the gross general government debt ratio was expected to be 34 percent GDP in 2015. Instead of debt declining over the medium term, the latest forecasts are for public debt to rise to nearly 53 percent of GDP by 2015 (Figure 2)—driven by lower growth, higher general government and Naftogaz deficits, and higher borrowing costs.[14]

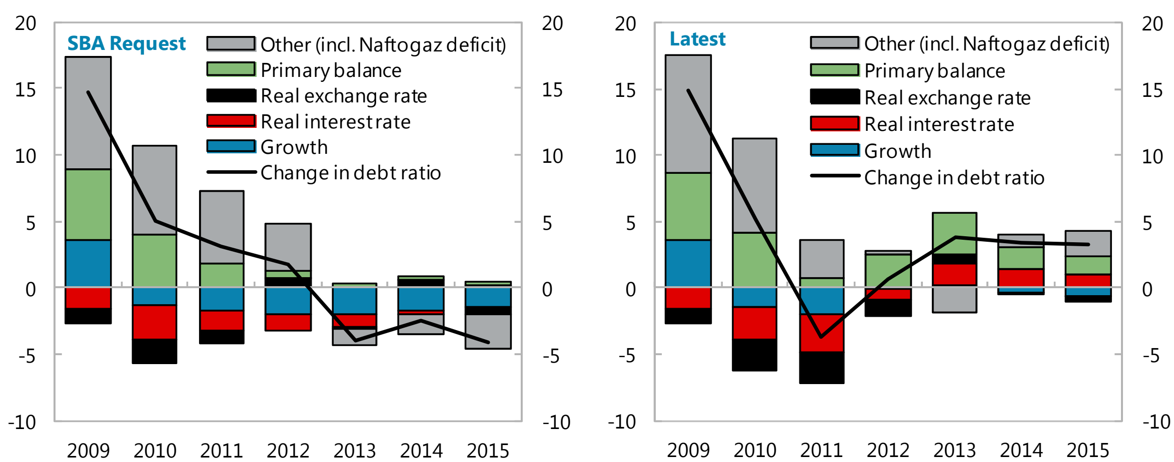
[14] While non-implementation of reforms likely contributed to the lower growth outturn in 2012–13, the external environment also turned out to be less supportive than projected at program approval; global growth in both 2012 and 2013 was more than a percentage point below what was forecast in the April 2010 WEO.

Programmed vs. Actual General Government and Combined Deficits



Sources: IMF staff estimates.

Programmed vs. Actual Decomposition of Change in Public Debt-to-GDP Ratio

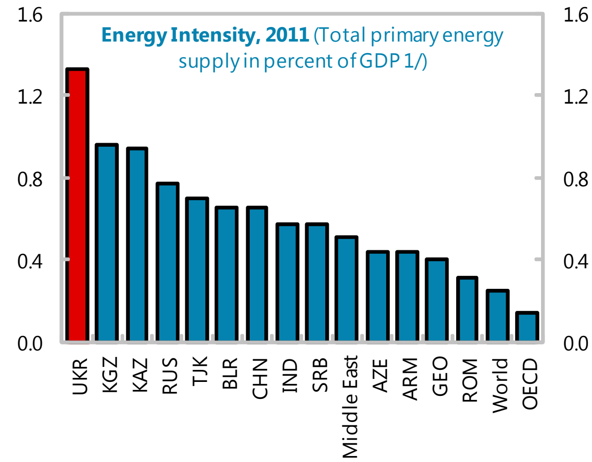


Sources: IMF staff estimates.

31. **However, the program was successful in other respects, with the 2011 approval of the pension reforms representing a major achievement.** While the medium-term savings from the enacted pension reforms may be less than initially hoped for, the fact that pension reform was passed at all is significant. Political resistance to pension reforms has prevented such reforms in the past and it has been a perennial issue in the Fund's discussions and programs with Ukraine over the last two decades (see, for example, the 2005 ex-post assessment). Even during the debate in Parliament over the pension reforms in 2011, amendments to the reforms were proposed that would have completely undermined the savings generated by the reform plan. However, most of these were excluded from the reform bill that was passed, as staff held firm in their view that the pension reform measures (and related savings) agreed upon with the authorities should be reflected in the legislation. The authorities deserve credit for pushing through such a politically contentious reform with most of the elements envisioned in the program left intact.

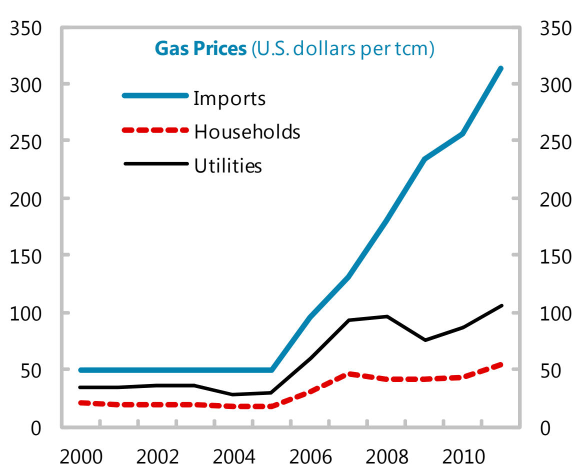
ENERGY SECTOR POLICIES

32. Ukraine is one of the least energy-efficient countries in Europe. Ukraine's energy intensity, defined as the ratio of total primary energy supply to GDP, is twice as large as that of Russia and ten times higher than the OECD average. Even after controlling for the fact that Ukraine produces energy-intensive products, this feature still remains and is driven to a great extent by energy overconsumption. Overconsumption is in turn a byproduct of very low domestic energy tariffs which have not kept up with rising import prices, especially since 2006 when Russia announced that it would phase out subsidies to Ukraine. This not only has squeezed the profitability of Naftogaz, implying insufficient investment as well as very large quasi-fiscal costs for the government, but has also made the gas and heating sector extremely nontransparent and vulnerable to vested interests.

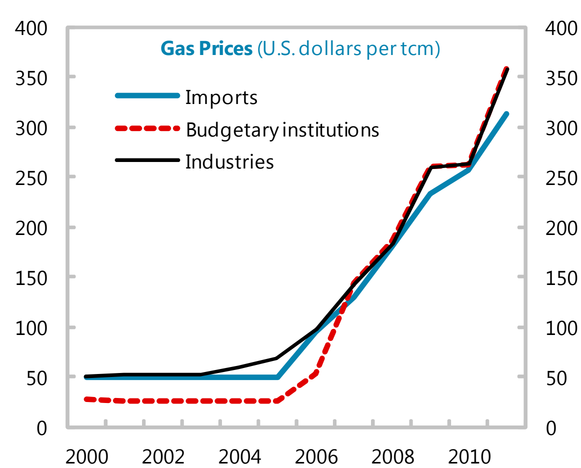


Source: International Energy Agency (2012), "Energy Balances of Non-OECD Countries."
1/ Total primary energy supply measured in tonnes of oil equivalent and GDP measured in 2005 constant U.S. dollars.

33. Domestic gas and heating tariffs for households have not kept up with rising gas import prices. Since domestic prices for industrial users and budgetary institutions have been adjusted to import parity, the differential tariffs have created arbitrage opportunities for domestic gas sales (namely the possibility of siphoning of inexpensive gas for households and heating utilities to commercial sales) while also undermining the transparency of the energy sector and making it vulnerable to corruption. Gas prices for households in Ukraine remain among the lowest in Europe while heating tariffs, which for a long time were set by communal councils, pay little regard to economic costs.



Sources: Naftogaz; and IMF staff estimates.



Sources: Naftogaz; and IMF staff estimates.

34. The 2008 SBA had aimed to foster financial stability for Naftogaz, as well as greater transparency, but the results were disappointing. Despite the authorities' commitment to gradually unwind energy subsidies for heat and gas, so as to bring energy tariffs closer to cost, gas tariffs were only increased once at the start of the 2008 program. Some modest steps were made to initiate a restructuring process for Naftogaz, and the program monitored the combined balance of the general government and Naftogaz recognizing the quasi-fiscal nature of Naftogaz activities. In addition, the program had made a push for greater transparency through the expectation of regular and independent assessments of Naftogaz's cash flow by a reputable international auditor, though with mixed results. Despite these efforts, the gas sector's continuing losses weighed on the public finances throughout the 2008 SBA.

A. Energy Sector Policy Design and Implementation under the 2010 Program

35. Energy-sector reforms were taken up again in the 2010 SBA in order to complete the agenda initiated under the previous program. As noted above, the 2010 SBA presented an opportunity for a fresh start with a new, more cohesive government. As an initial positive signal, the President's reform program explicitly recognized the challenges posed by the current gas and heating pricing policies. Energy reform became one of the main pillars of the 2010 SBA, with four key objectives: (i) to gradually bring domestic gas prices for households and utilities to import price parity; (ii) to strengthen social safety nets to mitigate the impact of energy tariff increases on the most vulnerable; (iii) to strengthen payment discipline; and (iv) to liberalize the gas sector and unbundle Naftogaz. The program aimed at the elimination of Naftogaz's deficit by 2011.

36. Domestic energy tariff increases were appropriately sequenced in the design of the program, and preferential treatment for certain industries was to be eliminated. One success under the program was that preferential tariffs for sugar, fertilizer, and metallurgy industries were eliminated. In addition, the government committed to maintaining gas tariffs for all industrial users at import parity. Gas prices for households, at less than one-sixth of import prices, were increased by 50 percent as a prior action for program approval. An additional 50 percent increase was planned for April 2011, with semi-annual increases thereafter until import parity was reached for all categories of consumers, after which an automatic adjustment mechanism would be put in place to depoliticize price setting for public utilities. Increases in heating utility gas prices of 50 percent were also a prior action for the approval of the program. Although the price increases were announced, they were not implemented, and an additional prior action for the first review required that the energy regulator issue instructions to communal utility companies to raise end-user heating tariffs to reflect the August 2010 increase.

37. The program adequately addressed the social implications of energy tariff increases. A supplementary budget approved at the outset of the program allowed for additional outlays to limit the impact on the most vulnerable. The program supported existing social assistance programs that protected the most vulnerable, covering any utility costs in excess of 20 percent of household income for working families (15 percent for pensioners). In addition, staff supported the authorities' efforts to strengthen existing social assistance programs.

38. Some small energy sector reforms were completed successfully. The authorities aimed to address the low compliance rates of district heating companies through the implementation of several reforms: (i) adopting legislation that transferred the authority for setting heating tariffs for communal utilities to a new independent regulator; (ii) creating a distribution account into which all utility payments would be made, and from which payments to Naftogaz would be automatically drafted; and (iii) passing legislation to revoke the law banning penalties for overdue utility bills to the population. The authorities made progress on all these fronts, but these were meant to be complementary to the energy tariff increases, and thus did not materially improve Naftogaz's finances. The program also aimed to support the liberalization of the gas sector and the unbundling of Naftogaz through a structural benchmark on undertaking measures to strengthen the transparency and governance of the gas sector, in accordance with the principles of the Brussels declaration, and this structural benchmark was met at the time of the first review.[15]

39. The authorities balked at a possible second round of tariff increases at the time of the second review, which was a key contributor to the program going off-track. Political support for tariff increases waned as the government's popularity fell in 2011. Fund staff tried to be flexible in the face of this resistance, raising Naftogaz's deficit target for 2011 and accommodating the authorities' request for a more gradual approach to tariff increases. But this was still not sufficient to bring the program back on track, as the authorities decided against implementing even this more gradual schedule of increases. Fund staff remained appropriately firm in the view that tariff increases were necessary to reduce Naftogaz's heavy burden on state finances, reduce energy overconsumption, and provide resources for needed energy infrastructure spending.

40. In hindsight, it appears that the government did not have sufficient ownership of energy sector policies under the program, which should be taken into account in future programs. The authorities appear to have halfheartedly signed on to program commitments in the energy sector, as evidenced by completion only in spirit of the program's initial prior action, and by their backtracking on subsequent tariff increases. The failure to raise energy prices has proved to be a stumbling block for the last two SBAs and the little progress made was achieved exclusively via prior actions. Lack of ownership in this area—relfecting strong vested interests and rent-seeking opportunities that can only be dismantled through energy tariff adjustments—are likely to remain a significant challenge in designing future Fund programs.

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[15] The Brussels Declaration of 2009 opened the way towards reform of the Ukrainian gas sector, and enabled the financing of a modernization program for Ukraine's gas pipelines by international financial institutions. It was signed by Ukraine's Prime Minister, EU commissioners, the EBRD, and the World Bank. See http://eeas.europa.eu/energy/events/eu_ukraine_2009/joint_declaration_en.pdf.

FINANCIAL SECTOR POLICIES

41. The 2008 SBA was relatively successful in stabilizing the banking system, and financial sector conditions were slowly improving in 2010. The 2008 program had achieved one of its key objectives—preventing severe financial disruption and restoring financial sector stability, albeit a fragile one. Funding constraints started to ease as deposits slowly returned to precrisis levels. Some banks remained on a lifeline as the authorities still kept in place crisis-era extraordinary liquidity support measures (amounting to almost 10 percent of GDP).

42. However, the banking system was still vulnerable and the restructuring process was incomplete. The improving liquidity and pro forma high capital ratios were masking a steady deterioration of asset quality, and increasing provisions were eroding capital. The completion of bank recapitalization, agreed under the 2008 SBA, continued to be postponed and high non-performing loan (NPL) levels acted as a drag on new lending, even as funding constraints were gradually easing. Banks' balance sheets continued to be undermined by foreign exchange regulations.[16] Weaknesses in the legal, tax, and judicial systems prevented more aggressive resolution of bad loans, and oversight and transparency of the banking system was weak.

A. Financial Sector Policy Design under the 2010 Program

43. Against this background, the 2010 SBA aimed at further strengthening the banking sector. The program focused on several priority areas: (i) completing recapitalization or resolution of problem banks; (ii) restructuring state-intervened and state-owned banks; (iii) strengthening the oversight and transparency of the banking system and enacting key financial sector legislation; and (iv) creating a framework that properly recognized and facilitated the resolution of impaired loans. In this context, a large number of unfinished policy actions were carried over into the 2010 program conditionality from the previous SBA.

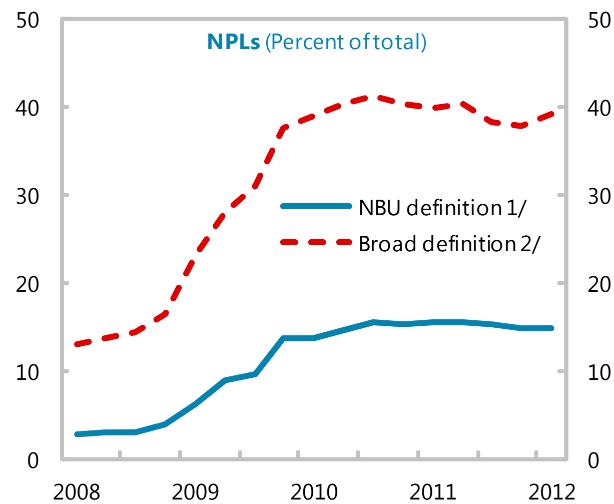
44. A cornerstone of the program was the restoration of banking system soundness. Among the key unfinished tasks from the earlier SBA was the finalization of the bank recapitalization exercise based on the findings of the extended audits for all the banks, undertaken in early 2010. These audits revealed that 61 banks (holding 59 percent of assets in the banking system) needed about UAH40 billion of additional capital (about 4 percent of GDP). Of this, about one-third was expected to be provided by the government to cover the capital needs of banks under state control. Private shareholders were required to complete the injection of the required capital no later than end-2010 to avoid state intervention and, if necessary, resolution.

[16] In early 2009, the NBU revised banks' FX net open position calculations by removing loan loss provisions against FX loans from the statutory calculation (Resolution 109). This forced banks to sell FX to comply with the new resolution, which in turn eased pressure on the exchange rate, but also pushed most banks into a short position in economic terms (up to about $8 billion for the banking system as a whole)..

45. The three banks which were recapitalized by the state during the crisis were expected to be privatized or resolved. To determine the capital shortfall, the banks' potential and other modalities of resolution, and to maximize the recovery value for the state for two of the intervened banks, the authorities agreed to hire external advisers in consultation with the World Bank. The weakest bank of the three, Rodovid, was slated to become a bad bank and to absorb all the bad loans of the intervened banks. For the other two state-owned banks, due diligence studies—focusing on financial, legal and operational risks, adequacy of risk management and internal controls—were completed based on the terms of reference agreed with the Fund.

46. The resolution on Nadra bank, kept under temporary administration by the NBU from February 2009 to August 2011, was particularly important given its large size. The political sensitivities involved in the resolution led to lengthy negotiations around the modalities and cost of resolution. The program insisted on a viable business plan which would restore the bank to profitability, and on any potential "fit and proper" investor having the ability to inject the necessary capital upfront. The external audit of Nadra Bank, based the terms of reference agreed with the World Bank and IMF experts after lengthy negotiations, was completed by October 2010 showing a capital shortfall of about UAH8.8 billion. The temporary administration of Nadra was lifted in August 2011 and the state did not participate in the recapitalization of the bank.

47. To help revive stagnant lending, the high level of NPLs in the banking system also needed to be addressed. The program focused on developing a comprehensive strategy for resolving mounting NPLs, improving the legal framework in dealing with and collecting NPLs, as well as addressing tax obstacles for recognizing, restructuring, and selling NPLs. In the same context, the authorities committed to improve the insolvency framework, including the corporate insolvency law and other related legislation. Some of the administrative measures introduced to protect the FX reserves had to be removed as they endangered banking sector stability (see section on monetary and exchange rate policy below). These efforts were expected to be complemented by steps to strengthen judicial decisions and collateral enforcement. The process got off to a good start with a working group established under a mandate from the presidential administration to revise the appropriate legislation and regulations to facilitate NPL resolution.



Sources: National Bank of Ukraine; and IMF staff calculations.
1/ Includes NPLs that are classified as doubtful and loss.
2/ Includes NPLs that are classified as substandard, doubtful, and loss.

B. Implementation of Financial Sector Policies under the 2010 Program

48. **Despite a promising start, bank restructuring remained incomplete**. The recapitalization of private banks was completed by end-2010 as planned. In addition, eighteen banks were in the process of being liquidated and four banks were under temporary administration. The due diligence studies for the two state banks were completed as planned, but the processes for the state-intervened banks were drawn out and the banks remained under temporary administration throughout the program. The ultimate privatization of Nadra bank was marred with disputes on the modalities for due diligence and ultimate privatization.

49. **Authorities pushed for reliance on public funds to kick-start lending rather than removing the bottlenecks for credit resumption, thus undermining program objectives.** Ideas were floated to establish a publicly financed bad bank, a new land bank, or directed credit programs. Draft legislation was submitted to parliament for creating a bad bank financed by the central bank, which contradicted the commitments taken under the program.

50. **The quality of financial sector oversight and transparency of the banking sector had been a priority of the IFIs for a long time, and some progress was made.** The cornerstones of this program were the enactment of banking legislation governing ultimate controllers of the banks and a move towards consolidated supervision. Legislation on ultimate controllers (requiring full and regular public disclosure of ultimate controllers of banks) and on consolidated supervision was approved, and amendments to the central bank law to strengthen its independence were also passed. However, these legislative changes had little impact as implementation and enforcement remained weak and did not reach the intended goals, as manifested by subsequent discussions between the authorities and the Fund.

51. **There was also some progress on improving the framework for the resolution of impaired loans, but many issues remained unaddressed.** The new corporate insolvency law did not facilitate out-of-court restructuring, and the tax treatment of NPLs continued to hinder loan workouts. The legislation regulating the "Creditors and Receivers of Financial Services" lacked sufficiently strong provisions on security of collateral, bankruptcy, and enforcement of judicial decisions. By the same token, a number of adopted measures to reinforce oversight and enhance transparency were incomplete or ineffective, so that the implementation of the adopted legislation later had to be reviewed, including the law on ultimate controllers. The fact that a number of bank owners and major shareholders were part of the process could have made it difficult to pass balanced legislation, as already highlighted in the ex-post evaluation for the 2008 SBA.

52. **Overall, on the implementation of financial sector policies under the program the record was mixed.** While the authorities managed to carry out some of the measures to strengthen the banking sector, particularly through recapitalization, they failed to take advantage of the improved economic environment to introduce more broad-ranging reforms in the banking sector and to restore full public confidence in banks. In particular, the reforms in other areas—the corporate insolvency law, foreign exchange regulations, resolution of intervened banks, and the framework for addressing NPLs—were delayed or incomplete. A significant amount of Fund

technical assistance from MCM and other departments was provided to the central bank in the context of the 2010 program, and the World Bank and IFC involvement in the banking sector was also noticeable, albeit with mixed results.[17] The slow space of reforms was also reflected by the continuing decline in the share of foreign banks through deleveraging, exiting certain market segments (e.g., the retail market), or withdrawing from Ukraine entirely. Their businesses were partly taken over by local players, reducing transparency further.

53. As a result, the system continued to be characterized by regulatory forbearance and weak enforcement of existing laws and regulations. Weak and occasionally discriminatory regulatory enforcement concealed the true condition of some parts of the banking system, complicating assessments of the sector. There was occasionally strong resistance to some proposals from the authorities, who went public arguing that the IMF was recommending remedies for bank restructuring which had been used elsewhere but could not be implemented in Ukraine.[18] This indicated, in part, a lack of ownership of the agreed financial sector reform plans.

MONETARY AND EXCHANGE RATE POLICY

A. Monetary and Exchange Rate Policy Design and Implementation under the 2010 Program

54. The 2010 SBA aimed to increase the economy's resilience by focusing monetary policy on domestic price stability and allowing greater exchange rate flexibility under a more independent central bank. The program had three interrelated reform measures to achieve this: (i) moving towards more flexible exchange rate regime and to a more open and transparent foreign exchange framework; (ii) strengthening the independence and accountability of the National Bank of Ukraine (NBU); and (iii) exiting bank support measures introduced during the 2008–09 crisis, including phasing out a number of liquidity support and exchange rate control mechanisms, replacing the former with standard liquidity windows to solvent banks and backed by appropriate collateral policy.

55. As a positive first step, the NBU Law was amended as a prior action for program approval, strengthening the independence of the central bank and broadening its mandate to include price stability and to move away from a de facto exchange rate peg. The other major achievement was the amendment to Resolution 47 which eliminated the possibility of direct NBU lending to the private sector, and tightened the conditions for providing emergency liquidity assistance to banks that were solvent and financially viable but which faced short-term liquidity pressures.

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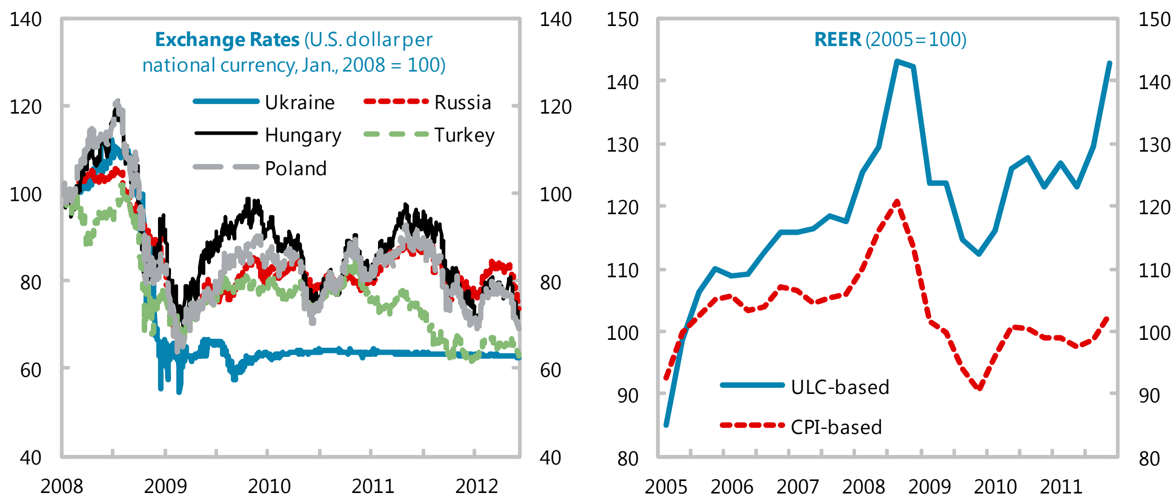
[17] The IMF TA ranged from high effectiveness in the area of accounting to low in the area of monetary policy and operations.

[18] See http://news.kievukraine.info/2011/03/while-imf-takes-pause-ukraine-considers.html.

56. After a sharp depreciation and a short-lived period of flexibility using multiple-price FX auctions, the NBU kept the hryvnia broadly stable against the U.S. dollar since August 2009. The July 2010 SBA staff report noted that greater exchange rate flexibility was desirable to discourage dollarization and excessive risk-taking by unhedged borrowers, to provide a buffer against frequent external shocks, and to help focus monetary policy more squarely on meeting its price stability objective. It also noted that the current real effective exchange rate appeared to be broadly in line with fundamentals,[19] and financial sector stability was slowly returning.



Sources: Bloomberg; State Statistics Committee of Ukraine; OECD; Haver; IMF, *International Financial Statistics*; and IMF staff estimates and calculations.

57. Against this background, Fund staff considered it to be an opportune time to reinitiate changes to the monetary and exchange rate policy framework. The authorities' commitment to low inflation had been compromised over time by the pursuit of multiple objectives. The hope was that with the changes in the NBU Law, the central bank would use the relative lack of exchange rate pressure on the hryvnia to start exiting from the restrictions introduced in the foreign exchange market in previous years, partially in response to the crisis. Also, with the recovery of the financial system, the transmission mechanism was expected to become more robust and responsive to NBU monetary policy operations.

58. Under the 2010 SBA, the authorities conducted a full assessment of all regulatory impediments in the FX market and provided a timetable to remove unnecessary restrictions. For example, the foreign exchange transactions tax was removed and rules on inward investment were eased, and a pilot was implemented whereby the banks were exempted from Resolution 109

[19] All three exchange rate assessment methodologies suggested that the exchange rate was within 2 percentage points of equilibrium, well within the margin of error of these methodologies.

under the condition of buying government FX-linked paper (which was not the best practice to handle FX net open positions). Nevertheless, the operation of the foreign exchange market remained constrained by regulatory measures. The various restrictions decreased the depth of the foreign exchange market and inhibited its functioning in the price formation of the hryvnia exchange rate.

59. The strong attachment to a de facto peg has been a long-standing feature of Ukrainian policy, often implemented by a host of regulatory and administrative measures that made a move to greater flexibility more difficult. The Fund has consistently argued for many years that a more flexible exchange rate would better serve commodity-exporting Ukraine in the face of external shocks. But, through varied economic circumstances, the authorities have maintained a highly managed exchange rate for most of the past two decades, introducing restrictions and regulatory constraints on the FX market to protect the exchange rate and reserves. While these may occasionally have played a role in slowing down outflows and protecting the balance of payments during periods of stress, they introduced significant distortions, were not transparent, and allowed for excessive discretion. Moreover, they were difficult to reverse.[20]

60. Despite the official shift in the NBU mandate, the monetary policy framework did not change throughout the program and the exchange rate remained the main target. There was only limited progress in removing inefficiencies and distortions from the foreign exchange market,[21] and monetary policy continued to support a de facto peg, including through prudential and administrative measures. This resulted in large swings in liquidity and interest rates. The authorities missed an opportunity to move to a flexible exchange rate from a position of strength.

61. The NBU's reluctance to fully exit the accommodative stance it assumed during the crisis further hampered the move to a more conventional monetary policy regime. The authorities were concerned about the impact of higher interest rates on the banking system and on the availability of credit to the economy, and kept the stabilization loans extended to the banks during the crisis in place, albeit under stricter conditions. At the same time, there was a reluctance to tackle the mounting NPL problem, particularly the legal framework hampering the resolution of NPLs, which could have helped in easing credit constraints (see previous section).

62. The program could have benefited from a greater focus on money market developments. The money markets were fragmented and underdeveloped. This impaired the NBU's ability to effectively control bank liquidity and sufficiently influence short-term money market interest rates, which were meant to serve as a replacement for the exchange rate anchor.

[20] In particular, a sudden unwinding of Resolution 109 could have put pressure on hryvnia liquidity and the exchange rate, particularly when combined with ongoing external deleveraging of banks (the banks would move from hryvnia to FX to reduce their open FX positions).

[21] In addition to Resolution 109, other measures included raising reserve requirements on FX deposits, lowering banks' net open long FX limits, and requiring FX buyers to present identification.

Compounding the problem, the amendments to the NBU Law did not induce the NBU to alter their monetary policy framework as expected, suggesting that the weak rule of law also hindered the achievement of the program's monetary policy reforms.

CONCLUSIONS AND LESSONS FOR FUTURE FUND ENGAGEMENT

63. The 2010 SBA laid itself an ambitious task. While the 2008 SBA's primary objective was short-term stabilization in the face of the global crisis, the 2010 program's primary goals were to address longer-term issues such as ensuring the sustainability of fiscal and quasi-fiscal finances, improving the economy's resilience through changes to the monetary policy and exchange rate frameworks, and placing the financial sector on a sounder footing.

64. For the most part, the 2010 program was appropriately designed given the ambitious agenda it had set out to accomplish. The macroeconomic strategy and program design correctly addressed the most important vulnerabilities—Ukraine's large fiscal and quasi-fiscal deficits, its lack of resilience to external shocks, and lingering weaknesses in the financial sector. In terms of phasing, the program was for all practical purposes evenly loaded (with only slight frontloading), which increased incentives to complete additional reviews. While the program's long duration was appropriate given its focus on medium-term issues, hindsight would suggest that a shorter program would have been preferable given the country's past program performance. The size of the program could also have been smaller (indeed, the original access proposed by Fund staff was lower), as financing needs were less dire and the external environment more favorable than during the 2008 SBA. Finally, strong reliance on prior actions was appropriate and consistent with recommendations of previous ex-post assessments and evaluations for Ukraine, and these prior actions were responsible for delivering some of the program's successes.

65. Despite going off-track relatively quickly, there were some notable achievements under the 2010 program. These include the (slightly delayed) passage of pension reform in August 2011, the elimination of preferential treatment for certain industries in gas pricing, the catalytic effect the program had in very quickly restoring market access, and the passage of the NBU Law strengthening the central bank's independence.

66. But by and large, the overall results of the 2010 SBA were disappointing and hewed to the well-worn script of past Ukraine SBAs, with the program going off-track due to lack of ownership and weak governance. Like most previous Fund programs in Ukraine, the 2010 program went off-track before completion. This report's assessment is also broadly consistent with those of the 2005 ex-post assessment and the 2011 ex-post evaluation of the 2008 SBA—that in large part this was due to the authorities failing to have sufficient ownership of the program, with strong vested interests opposing the program's policies. The same issues that derailed past programs also hindered the completion of the 2010 SBA, including the difficulty of sufficiently adjusting energy prices and increasing exchange rate flexibility.

67. The energy sector—with its lack of transparency and lucrative opportunities for arbitrage and rent-seeking—is likely to remain a formidable challenge for future Fund programs in Ukraine. Contrasting the progress in implementing pension reforms on the one hand and energy sector reforms on the other provides circumstantial evidence for the nefarious effect of vested interests in the energy sector. The adverse social impact was the primary reason invoked by the authorities in resisting both reforms. Though the program design explicitly addressed these concerns in the case of energy tariffs (by factoring in additional spending on targeted transfers to cushion the price impact on the socially vulnerable), in the end it was the pension reform that saw the light of day. One interpretation of these events is that the success of the pension reform reflects more dispersed opposition to the reform and a lack of powerful vested interest groups. It is not clear how the program design could have neutralized opposition to energy sector reform, especially given that prospects for program success was appropriately evaluated as reasonably strong (due to a more cohesive government, the program being backed at highest level, the government elucidating a clear reform agenda, and the large number of prior actions undertaken despite very modest frontloading).

68. This report draws a few lessons that will hopefully be useful in designing future Fund programs in countries where the record of completing Fund programs is poor and ownership is in question:

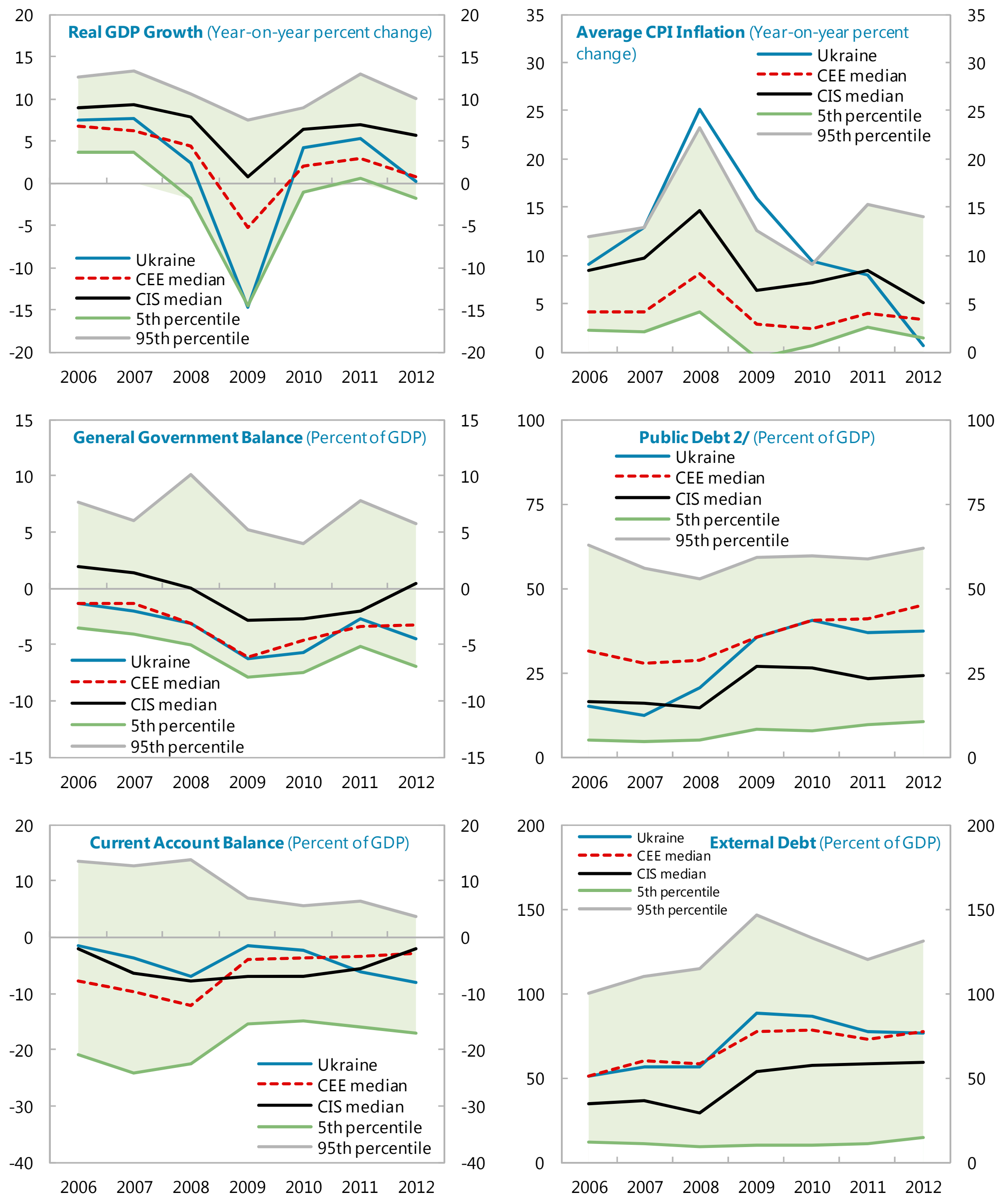
- **Shorter programs may often be more appropriate**. Long-duration programs are useful when trying to address a host of medium-term problems, but this may prove too ambitious in countries with a track record like that of Ukraine. A shorter program focused on the most critical issues could offer both the Fund and the authorities better odds of success, as well as the opportunity to reassess objectives and financing needs earlier. It also helps avoid protracted periods of attempting to restart a program, as was the case in the 2010 SBA. In recognizing medium-term challenges and objectives, the program could be positioned as part of a longer-term reform strategy.

- **A mechanism to terminate defunct arrangements could be useful in designing future Fund programs, especially when program ownership is an issue.** Such a mechanism has already been enacted for PRGT programs as part of the 2012–13 Review of Facilities for Low-Income Countries—the arrangement terminates automatically if no program review has been completed over a period of 18 months.[22] An analogous mechanism for GRA programs (possibly with a shorter grace period) could help free up Fund resources early and limit unproductive attempts to restart a program.

[22] See Review of Low-Income Countries—Proposals for Implementation—Amendments to PRGT Instrument (Decision No. 15352; April 8, 2013) and Review of Facilities for Low-Income Countries—Proposals for Implementation (March 18, 2013; and Supplement 2; March 19, 2013).

- **Prior actions continue to be a powerful tool for making incremental progress, especially on difficult issues**. In the case Ukraine's 2010 SBA prior actions were responsible for the majority of the successes the program could claim. Ukraine's example shows that while the Fund has moved toward streamlining conditionality, the use of relatively more prior actions continues to prove useful in cases of where the track record is weak, or where policy commitments have failed to translate into action.

Figure 1. Ukraine: Performance Among Peers, 2006–12 1/

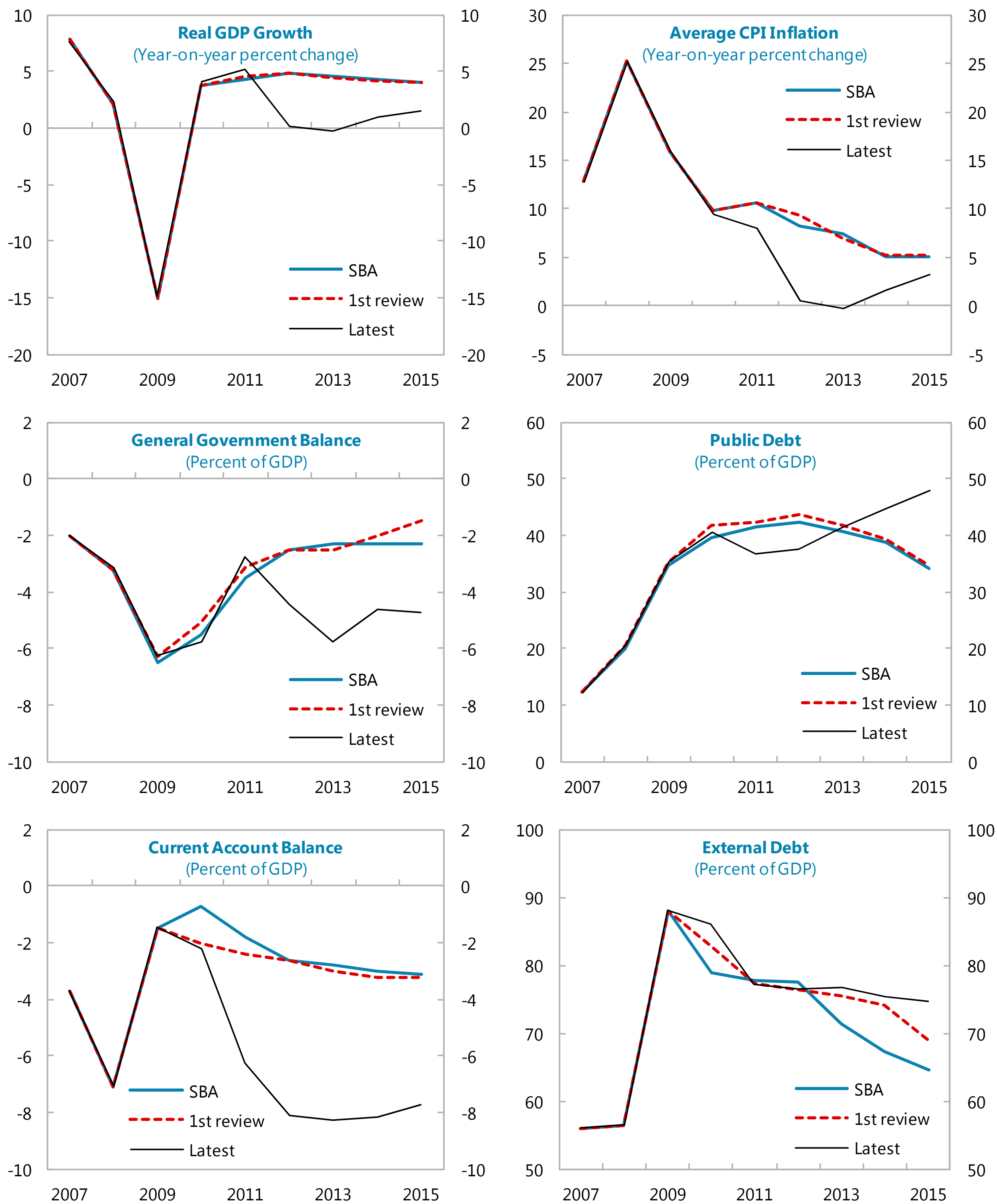


Sources: IMF, *World Economic Outlook;* and IMF staff calculations.

1/ CEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Rep., Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovak Rep., and Turkey. CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Rep., Moldova, Mongolia, Russia, Tajikistan, Turkmenistan, and Uzbekistan. The 5th and 95th percentiles include the entire CEE and CIS samples excluding Ukraine.

2/ CIS, 5th, and 95th percentiles exclude Mongolia.

Figure 2. Ukraine: Program Projections, 2007–15



Source: IMF staff estimates and projections.

Table 1. Ukraine: Selected Economic and Social Indicators, 2008–12

	2008	2009	2010		2011		2012	
			Prog.	Actual	Prog.	Actual	Prog.	Actual
Real economy (percent change, unless otherwise indicated)								
Nominal GDP (billions of Ukrainian hryvnias)	948	913	1,083	1,083	1,235	1,302	1,405	1,409
Real GDP	2.3	-14.8	3.7	4.1	4.3	5.2	4.8	0.2
Contributions:								
Domestic demand	8.3	-25.8	4.9	7.7	5.9	12.6	6.5	5.5
Consumption	7.9	-9.7	1.4	5.4	2.9	9.4	4.4	8.2
Investment	0.5	-16.0	3.4	2.3	3.0	3.2	2.1	-2.7
Net exports	-6.0	11.0	-1.1	-3.6	-1.6	-7.4	-1.7	-5.3
Unemployment rate (ILO definition; percent)	6.4	8.8	8.8	8.1	7.9	7.9	7.4	7.5
Consumer prices (period average)	25.2	15.9	9.9	9.4	10.7	8.0	8.3	0.6
Consumer prices (end of period)	22.3	12.3	12.0	9.1	9.7	4.6	9.2	-0.2
Nominal monthly wages (average)	33.7	5.5	16.0	17.7	14.1	17.5	10.8	14.9
Real monthly wages (average)	6.8	-8.9	5.5	7.6	2.0	8.8	2.3	14.2
Public finance (percent of GDP)								
General government balance 1/	-3.2	-6.3	-5.5	-5.8	-3.5	-2.8	-2.5	-4.5
Net domestic financing	2.8	1.6	2.9	1.1	1.7	2.4	1.8	4.3
Of which: privatization proceeds	0.3	0.2	0.9	0.2	0.4	1.8	0.2	0.9
Net external financing	0.4	4.7	2.7	4.6	1.4	1.2	0.5	0.9
Overall balance (including Naftogaz operational deficit)	-3.2	-8.7	-6.5	-7.4	-3.5	-4.3	-2.5	-5.5
Public debt (end of period) 2/	20.5	35.4	39.5	40.5	41.5	36.8	42.2	37.4
Money and credit (end of period, percent change)								
Base money	-77.4	4.4	14.4	15.8	13.5	6.3	12.5	6.4
Broad money	30.2	-5.5	14.7	22.7	15.1	14.7	14.1	12.8
Credit to nongovernment	71.9	-2.2	4.0	1.1	14.2	9.5	11.9	2.2
Velocity	1.8	1.9	1.9	1.8	1.9	1.9	1.9	1.8
Interbank overnight rate (annual average, percent) 3/	12.5	11.5	1.3	2.0	...	5.8	...	10.8
Balance of payments (percent of GDP)								
Current account balance	-7.1	-1.5	-0.7	-2.2	-1.8	-6.3	-2.6	-8.1
Foreign direct investment	5.5	4.0	3.4	4.2	3.6	4.3	3.9	3.8
Gross reserves (end of period, billions of U.S. dollars)	31.5	26.5	30.3	34.6	38.5	31.8	43.4	24.5
Months of next year's imports of goods and services	6.7	4.3	4.8	4.2	5.5	3.7	5.6	3.0
Percent of short-term debt (remaining maturity)	67.8	67.4	74.8	73.3	89.7	55.4	96.2	40.0
External debt (percent of GDP)	56.4	88.2	79.0	86.0	77.8	77.2	77.6	76.6
Goods exports (annual volume change in percent)	2.3	-24.2	9.0	9.3	8.5	7.1	8.6	2.0
Goods imports (annual volume change in percent)	13.5	-41.6	10.7	15.0	10.8	22.6	10.0	2.2
Goods terms of trade (percent change)	8.7	-13.8	1.9	0.3	-0.4	7.6	0.5	-3.2
Exchange rate								
Hryvnia per U.S. dollar (end of period)	7.7	8.0	...	8.0	...	8.0	...	8.0
Hryvnia per U.S. dollar (period average)	5.3	7.8	...	7.9	...	8.0	...	8.0
Real effective rate (CPI-based, percent change)	10.3	-17.6	...	2.6	...	0.4	...	2.3

Sources: Ukrainian authorities; and IMF staff estimates.

1/ The general government includes the central and local governments and the social funds.
2/ Government and government-guaranteed debt (includes debt to IMF).
3/ For 2013, average of rates for the first nine months.

Table 2. Ukraine: Prior Actions and Structural Benchmarks for the 2010 SBA

Measure	Target Date
Prior Actions for Program Approval	
1. Enact a supplementary budget with fiscal measures of UAH 16 billion, consistent with a general government deficit of 5.5 percent of GDP in 2010 and the commitments included in the MEFP, paragraph 10.	
2. Increase gas tariffs for all households and utility companies by 50 percent (MEFP, paragraph 12).	
3. Enact amendments to the NBU law in line with IMF recommendations (MEFP, paragraph 16).	
4. Amend Resolution 47 in line with IMF recommendations (MEFP, paragraph 17).	
5. Adopt legislation transferring the authority for setting heating tariffs for communal utilities to a new independent regulator (MEFP, paragraph 12).	
Prior Actions for Approval of the First Review	
1. Submit to Parliament a 2011 budget consistent with a general government deficit of 3.1 percent of GDP and the commitments included in the MEFP, paragraph 6.	
2. Submit to Parliament legislation on pension reforms consistent with commitments in the MEFP, paragraph 11.	
3. Pass legislation to revoke the Law "On Temporary Ban to Levy Penalties on Ukraine's Citizens for Overdue Payments of Utility Bills" (MEFP, paragraph 14).	
4. NERC will issue (by December 16, 2010) instructions to communal utility companies to raise end-user heating tariffs (effective January 1, 2011) to reflect the August increases (MEFP, paragraph 15).	
Structural Benchmarks	
1. Pass legislation to revoke the Law "On Temporary Ban to Levy Penalties on Ukraine's Citizens for Overdue Payments of Utility Bills".	End-September 2010
2. Agree with Fund staff on a schedule for phasing out existing restrictions on the foreign exchange market.	End-October 2010
3. Complete the audit for Nadra Bank before any decision on its resolution.	End-October 2010
4. Parliamentary approval of legislation on pension reforms consistent with commitments in the MEFP, paragraph 11.	End-December 2010
5. All banks should meet capital requirements and capital deficient banks should increase their capital in line with the approved plans (MEFP, paragraph 20).	End-December 2010
6. Complete due diligence of state-owned banks in line with paragraph 23 of the MEFP.	End-December 2010
7. Initiate the implementation of the reform and restructuring strategy for Naftogaz in accordance with the principles of the Brussels declaration.	End-December 2010
8. Amend the law "On surcharges for the purposes of mandatory state pension insurance" to permanently eliminate the surcharge on non-cash purchases and sales of foreign currency (MEFP, paragraph 19).	End-December 2010
9. Set up a more systematic, timely, and transparent VAT refund process (MEFP, paragraph 13).	End-January 2011
10. Formulate a comprehensive public administration reform plan aiming to improve the cost efficiency of public service delivery (MEFP, paragraph 12).	End-March 2011
11. Approve an increase in gas tariffs for all households and utility companies by 50 percent, effective April 15 (MEFP, paragraph 15).	End-March 2011
12. Adopt amendments to the Law of Ukraine "On restoring the solvency of the debtor or announcing him/her bankrupt" and related regulations to speed up the insolvency process, make it more transparent, and facilitate out-of-court restructuring (MEFP, paragraph 24).	End-June 2011
13. Implement a schedule to phase out Resolution 109 with a gradual reduction of banks' foreign exchange positions in line with the MEFP, paragraph 19.	End-June 2011
14. Establish a framework to develop the forward exchange market, including by allowing transactions between banks in line with the MEFP, paragraph 19.	End-June 2011
15. Submit to Parliament a 2012 budget consistent with a general government deficit of 2.5 percent of GDP.	End-September 2011

Table 3. External Financing Requirements and Available Financing, 2009–12

(Billions of U.S. dollars)

	2009		2010		2011		2012	
	Proj. 1/	Actual	Proj. 1/	Actual	Proj. 1/	Actual	Proj. 1/	Actual
Total financing requirements	44.7	57.4	30.6	48.8	31.3	71.1	32.0	85.3
Current account deficit	1.8	1.7	1.0	3.0	2.7	10.2	4.0	14.8
Medium and long-term debt	18.5	16.9	15.4	14.6	15.5	16.2	14.8	19.0
Private	16.4	16.4	12.6	14.2	14.5	15.7	14.0	16.5
Public	2.1	0.5	2.8	0.5	1.1	0.5	0.8	2.5
Short-term debt (including deposits)	13.2	13.4	9.6	9.7	8.6	12.2	8.6	14.2
Other net capital outflows 2/	11.2	11.4	4.6	6.2	4.5	12.0	4.5	10.6
Total financing sources	30.6	43.3	29.5	52.2	31.6	67.4	33.6	79.0
Capital transfers	0.6	0.6	0.0	0.2	0.0	0.1	0.0	0.0
Direct investment, net	4.7	4.7	4.6	5.8	5.4	7.0	6.2	6.6
Portfolio investment, net	0.0	-1.6	1.9	4.3	1.6	1.6	1.6	5.7
Medium and long-term debt	14.0	13.6	12.5	16.3	15.5	15.9	16.3	20.5
Private	13.3	12.9	10.5	14.4	15.0	15.7	15.3	19.8
Public 3/	0.7	0.7	2.0	1.9	0.5	0.3	1.0	0.7
Short-term debt (including deposits)	9.4	9.7	9.4	12.1	8.6	16.5	9.0	18.7
Trade credit, net	2.0	2.4	1.2	-1.8	0.5	5.8	0.5	0.7
Increase in gross reserves	-5.5	-5.7	3.6	8.5	8.2	-3.1	5.0	-7.2
Errors and omissions	0.4	0.2	-0.3	1.4	0.0	0.2	0.0	1.0
Total financing needs	8.2	8.2	4.9	3.8	7.9	0.3	3.4	-1.9
Official financing	8.2	8.2	4.9	3.8	7.9	0.3	3.4	-1.9
o/w IMF	8.2	8.2	3.3	3.4	6.0	0.0	2.3	-3.4
Memorandum items:								
Gross international reserves	26.5	26.5	30.3	34.6	38.5	31.8	43.4	24.5
Stock of existing IMF credit (billions of SDRs)	7,000	7,000	9,250	9,250	13,250	9,250	14,766	7,016

Sources: IMF Country Report No. 10/262; and Ukraine: Staff Report for the 2013 Article IV Consultation and First Post-Program Monitoring.

1/ Projections as time of program approval.
2/ Mainly reflects withdrawal of residents' foreign currency cash holdings from the banking system.
3/ For program period (2010–12), financing from official sources is recorded below the line.

Annex I. Summary of the Authorities' Views on the 2010 Program

During the meetings with IMF staff in November 18–20, 2013, the authorities expressed the view that the 2010 program was properly designed. They felt that the program correctly identified Ukraine's most pressing problems at the time, and that the policies to address these issues were broadly appropriate. The program's goals were not exhaustive, focusing only on the most critical macroeconomic priorities. Authorities noted that some important reforms, such as judicial reform, could have benefited from being covered by the conditionality of the 2010 program, but they understood that these areas fell under the World Bank's remit, and that increased conditionality would have made completing the program even more difficult.

Authorities highlighted a number of achievements during the period covered by the 2010 program. The primary achievements in the fiscal area were the passage of pension reform; a new tax code; the streamlining of subsidies in anticipation of raising energy tariffs; and a pilot project to assess household incomes. In the areas of financial sector and monetary policy, achievements included the passage of legislation identifying ultimate owners of banks; the transition to consolidated reporting; the establishment of the NBU's financial stability unit; legislation on creditors' rights; legislation strengthening the NBU's independence; and the elimination of surcharges on foreign exchange transactions.

Authorities acknowledged that the primary reason that the program was not completed was the failure to implement the second round of energy tariffs in 2011. They noted that in hindsight, energy sector reform should have been made the focus of their policy efforts, as imbalances in the sector are an important contributor to the country's macroeconomic problems via its effect on fiscal and external deficits. They noted several reasons for the failure to raise tariffs in 2011, including a fall in the government's popularity and the hope that the price of gas imports from Russia could be lowered, which did not materialize. Authorities remain cognizant of the need to raise energy tariffs, but emphasized two important considerations: first, there must be a recognition that these are very difficult to do prior to elections; and second, that higher tariffs need to be accompanied by parallel efforts to modernize the energy sector and improve energy efficiency.

The authorities agreed that greater ER flexibility is required, but emphasized that there are conditions that still prevent this from happening. Depositors remain sensitive to exchange rate expectations, and banks' portfolios remain vulnerable. There is also a need to reduce dollarization further, and this will be helped by the policy that foreign exchange loans can no longer be granted to those without foreign exchange income. Authorities noted that more time was needed to obtain the proper conditions for a move to greater exchange rate flexibility.

The authorities agreed with the general findings and conclusions of the ex-post evaluation, including the possibility of engagement via shorter and smaller programs. They noted that shorter programs could be more feasible to complete given the high frequency of elections in Ukraine. But they stressed that short programs should not be "shock" programs—the pace of reforms should not be compressed into a shorter period, but rather the pace of adjustment should remain the same as under a longer program.

Lastly, the authorities agreed that adequate ownership was an important issue in the 2010 program, and will continue to be an important issue. To strengthen ownership, authorities felt it was important that the IMF and authorities agree not only on objectives and conditionality, but also on what is achievable and feasible—that is, there needs to be a clear recognition of the institutional constraints the government faces. They reiterated that the government's objective is not just to get financing, but to make sure that the appropriate policies actually get implemented. They also stressed the need for public dialogue to persuade and educate, as this will also help strengthen ownership.

INTERNATIONAL MONETARY FUND

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation, First Post-Program Monitoring, and Ex Post Evaluation of Exceptional Access with Ukraine

On December 16, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the 2013 Article IV consultation and the first Post Program Monitoring Review, as well as the Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement with Ukraine.[1]

The Ukrainian economy has been in recession since mid-2012, and the outlook remains challenging. In January–September 2013 GDP contracted by 1¼ percent y-o-y, reflecting lower demand for Ukrainian exports and falling investments. Consumer prices stayed flat, held down by decreasing food prices and tight monetary policy. Weak external demand and impaired competitiveness kept the trailing 12-month current account deficit elevated at about 8 percent of GDP by end-September despite a significant reduction in natural gas imports. The high current account deficit amid less favorable international market environment pressured international reserves, which fell below the equivalent of 2½ months of imports by end-October 2013. Under currently planned policies, modest growth should return in 2014, driven by improvements in external demand, strong grain exports, and continuing consumption expansion. However, this outlook is subject to significant risks, emanating from the inconsistent policy mix and heightened political and economic uncertainty in recent weeks.

The fiscal stance loosened in 2012–13, contributing to the buildup of vulnerabilities. Large pension and wage increases, generous energy subsidies, and soccer cup spending led to a widening of the combined deficit of the general government and the state-owned company Naftogaz to 5½ percent of GDP in 2012. In 2013, the combined government-Naftogaz deficit is projected to expand to 7¾ percent of GDP.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

An inefficient and opaque energy sector continues to weigh heavily on public finances and the economy. Overall energy subsidies in Ukraine reached about 7½ percent of GDP in 2012. The very low tariffs for residential gas and district heating cover only a fraction of economic costs and encourage one of the highest energy consumption levels in Europe. As a result, Naftogaz's losses in 2013:H1 more than doubled and the company is late on payments for imported gas.

Tight monetary policy in 2012–13 focused on defending exchange rate stability while accommodating the expanding fiscal deficit. In part reflecting deficit monetization, base money increased by nearly 15 percent in the year to September 2013. To ensure steady supply of foreign exchange to the market, the authorities tightened foreign exchange regulations and controls, which increased transactions costs in the economy.

The banking system appears stable at present, but vulnerabilities persist. A high average capital adequacy ratio of 18 percent provides some cushion against risks stemming from an elevated non-performing loan ratio of 14 percent. High interest rates offered by banks induced a more than 30 percent increase in hryvnia deposits in the year to November, while credit to the economy expanded only modestly, constraining economic activity.

Ukraine remains current on all its payments to the Fund, and the authorities have reaffirmed their commitment to repay all outstanding Fund credit. On the obligation basis, outstanding Fund credit to Ukraine would decline below 200 percent of quota by February 2014 and below 100 percent of quota by September 2014.

In accordance with IMF procedures for arrangements entailing exceptional access, the Executive Board discussed an ex-post evaluation (EPE) of Ukraine's experience under the Stand-By Arrangement (SBA) approved in July 2010. The EPE finds that the SBA-supported program was appropriately designed to address Ukraine's most important vulnerabilities, and delivered some notable achievements, including the passage of pension reform in 2011. However, the program quickly went off-track as the authorities stopped implementing the agreed policies, reflecting insufficient ownership. The same issues that had derailed previous programs in Ukraine hindered the completion of the 2010 SBA, particularly the reluctance to sufficiently adjust energy prices and increase exchange rate flexibility.

The EPE draws several lessons for future IMF engagement with Ukraine and other countries from the experience of the 2010 program. First, exceptional access and long-duration arrangements may be too ambitious in countries with low program policy ownership; arrangements with lower access focused on critical areas may have better prospects of success. Second, a mechanism to terminate off-track arrangements could be useful in designing future IMF programs, especially when program ownership is an issue. Finally, prior actions continue to be a powerful tool for implementing program policies, as they were responsible for the majority of the achievements under the 2010 SBA.

Executive Board Assessment[2]

Executive Directors noted that, despite the Ukrainian authorities' efforts to maintain macroeconomic stability amid worsening economic conditions, the current macroeconomic policy mix has generated large external and fiscal imbalances and has contributed to deepening the recession. Directors recommended the authorities implement a package of comprehensive policy adjustments in several areas, including curtailing the fiscal and external current account deficits, phasing out energy subsidies, strengthening the banking sector, and improving the external competitiveness of the economy.

Directors concurred that the overvalued exchange rate has contributed to a widening external current deficit, loss of competitiveness, and steady depletion of international reserves. At the same time, a tight monetary policy, focused on defending exchange rate stability and based on the extensive use of administrative controls, has stifled growth. Against this background, Directors advised the authorities to allow greater exchange rate flexibility and to accelerate the transition to an inflation targeting framework.

Directors welcomed the reported positive developments in the banking sector. Banks' exposure to foreign exchange risk has declined and bank capitalization and provisioning have risen, providing a cushion against risks stemming from high non-performing loans. Directors warned, however, that maintaining financial stability leaves no room for complacency and recommended the authorities enforce consolidated supervision and high reporting standards, proceed with independent audits of vulnerable banks, and develop contingency plans to support banks in case of need.

Directors stressed the importance of fiscal consolidation for the overall adjustment effort. High budget expenditure should be reduced by rationalizing public procurement, restraining the growth in public sector wages and employment, and limiting pension indexation to inflation. In addition, authorities should refrain from unaffordable tax cuts. Directors agreed that these measures would reduce the fiscal deficit to a sustainable level over the medium term while creating space for essential public investment.

Directors underscored the need for a comprehensive energy sector reform. They stressed that upfront, meaningful, and broad-based tariff increases are essential for reducing large quasi-fiscal losses, attracting new investments, and improving governance. Energy tariff increases should be accompanied by measures to protect the most vulnerable households. Directors welcomed the authorities' plans to continue with energy-saving reforms, increase domestic gas production, and

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

diversify energy imports, but stressed that these measures cannot substitute for the indispensable tariff adjustments.

Directors noted the uneven progress in improving the business climate. They welcomed the streamlined procedures for starting a business, registering property, and dealing with construction permits. Directors stressed that much more needs to be done to enhance institutional capacity, strengthen the judicial system, improve law enforcement and tax administration, and eradicate corruption.

In discussing the ex post evaluation report on the 2010 SBA, Directors noted some important achievements, including the 2011 pension reform, but regretted the authorities' insufficient ownership, which undermined the program. Directors agreed that, in view of Ukraine's track record, arrangements with lower access and strong prior actions would be most appropriate. While most Directors concurred that arrangements of shorter duration would also be preferable, some others underscored that the structural nature of many of Ukraine's economic problems calls for maintaining a sufficiently long time horizon.

Ukraine: Selected Economic Indicators, 2010–14

	2010	2011	2012	2013	2014
				Projections	
Real economy (percent change, unless otherwise indicated)					
Nominal GDP (billions of Ukrainian hryvnias)	1,083	1,302	1,409	1,432	1,503
Real GDP	4.1	5.2	0.2	-0.3	1.0
GDP deflator	13.8	14.3	8.0	2.0	4.0
Unemployment rate (ILO definition; percent)	8.1	7.9	7.5	8.0	8.0
Consumer prices (period average)	9.4	8.0	0.6	-0.3	1.6
Core inflation (period average) 1/	8.6	7.7	3.3	0.2	1.4
Nominal monthly wages (average)	17.7	17.5	14.9	9.0	5.6
Real monthly wages (average)	7.6	8.8	14.2	9.3	3.9
Public finance (percent of GDP)					
General government balance 2/	-5.8	-2.8	-4.5	-5.7	-4.6
Overall balance (including Naftogaz operational deficit)	-7.4	-4.3	-5.5	-7.7	-6.6
Structural general government balance	-3.7	-3.0	-4.5	-4.1	-4.1
Public debt (end of period) 3/	40.5	36.8	37.4	41.3	44.7
Money and credit (end of period, percent change)					
Base money	15.8	6.3	6.4	14.7	12.9
Broad money	22.7	14.7	12.8	16.8	14.1
Credit to nongovernment	1.1	9.5	2.2	7.8	8.2
Interbank overnight rate (annual average, percent) 4/	2.0	5.8	10.8	3.3	…
Balance of payments (percent of GDP)					
Current account balance	-2.2	-6.3	-8.1	-8.3	-8.2
Foreign direct investment	4.2	4.3	3.8	2.4	2.4
Gross reserves (end of period, billions of U.S. dollars)	34.6	31.8	24.5	18.5	11.2
Months of next year's imports of goods and services	4.2	3.7	3.0	2.2	1.3
Percent of short-term debt (remaining maturity)	73.3	55.4	40.0	32.3	18.8
External debt (percent of GDP)	86.0	77.2	76.6	76.7	75.3
Goods exports (annual volume change in percent)	9.3	7.1	2.0	-7.4	3.9
Goods imports (annual volume change in percent)	15.0	22.6	2.2	-5.5	2.6
Goods terms of trade (percent change)	0.3	7.6	-3.2	2.2	0.2
Exchange rate					
Hryvnia per U.S. dollar (end of period)	8.0	8.0	8.0	…	…

Sources: Ukrainian Authorities; and IMF staff estimates.

1/ Excludes unprocessed food, fuel, and administrative services.

2/ The general government includes the central and local governments and the social funds. In 2013, the general government deficit includes recognized arrears (1.3 percent of GDP).

3/ Government and government-guaranteed debt (includes debt to IMF).

4/ For 2013, average of rates for the first ten months.