IMF Country Report No. 16/320

UKRAINE

EX POST EVALUATION OF EXCEPTIONAL ACCESS UNDER THE 2014 STAND-BY ARRANGEMENT

September 2016

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

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Ex Post Evaluation of Exceptional Access under the 2014 Stand-By Arrangement**, prepared by a staff team of the IMF. It is based on the information available at the time it was completed on September 2, 2016.
- A **Statement by the Executive Director** for Ukraine.

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September 14, 2016

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IMF Executive Board Completes the Second Review Under EFF with Ukraine, Approves US$1 Billion Disbursement, and Discusses Ex-Post Evaluation of 2014–15 SBA

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Ukraine's economic program supported by an arrangement under the Extended Fund Facility (EFF). The completion of this review enables the disbursement of SDR 716.11 million (about US$ 1 billion), which would bring total disbursements under the arrangement to SDR 5,444.21 million (about US$7.62 billion). In completing the review, the Executive Board approved waivers for the nonobservance of performance criteria related to net international reserves, non-accumulation of external payments arrears and non-introduction of new exchange restrictions.

Ukraine's four-year, SDR 12.348 billion arrangement (about US$17.5 billion at the time of approval of the arrangement) was approved on March 11, 2015 (see Press Release No. 15/107) to support the government's economic program, which aims to put the economy on the path to recovery, restore external sustainability, strengthen public finances, maintain financial stability, and support economic growth by advancing structural and governance reforms, while protecting the most vulnerable.

The Executive Board also discussed the ex-post evaluation of the Stand-By Arrangement (SBA) with Ukraine that was approved in April 2014 (see Press Release No. 14/189).

Following the Executive Board's discussion, Ms. Christine Lagarde, Managing Director and Chair, said:

"Ukraine is showing welcome signs of recovery, notwithstanding a difficult external environment and a severe economic crisis. Activity is picking up, inflation has receded quickly, and confidence is improving. Gross international reserves and bank deposits have risen. While the social and economic cost of the crisis has been high, growth is expected to be higher in the period ahead. This progress owes much to the authorities' program implementation, including sound macroeconomic policies, bold steps to bring energy tariffs to cost-recovery levels, and measures to rehabilitate the banking system. Determined policy implementation, however, remains critical to achieve program objectives, given the significant challenges ahead.

"Further progress in fiscal reforms is key to ensure medium-term sustainability. The authorities need to avoid tax policy changes that lead to higher deficits. The focus should be on improving tax and customs administrations. Moreover, parametric pension reform is crucial to reduce the pension fund's large structural deficit, help reduce fiscal deficits and public debt, and create room to bring pensions to sustainable levels over time.

"Monetary policy has been skillfully managed and financial sector reforms have started to yield results. Priority should continue to be given to reducing inflation and rebuilding international reserves, also to make room for the gradual removal of remaining administrative measures. The authorities need to further strengthen the banking system through recapitalization, unwinding of related-party lending, and resolution of impaired assets.

"A sustainable recovery requires completing the structural transformation of the economy, where much remains to be done, including combating corruption and improving governance. Creating a level-playing field and ensuring equal application of the rule of law is essential to raise investment. A decisive start needs to be made with the restructuring and divestiture of state-owned enterprises, and prosecuting high-level corruption cases.

"Ukraine's international partners have contributed to efforts to strengthen the economy with considerable financial and technical support. These remain important for the success of the program. The completion of the restructuring of sovereign debt held by private bondholders was an important step to put debt back on a sustainable path. It is important that the resolution of remaining sovereign arrears proceeds promptly.

"The ex-post evaluation of exceptional access under the 2014–15 Stand-By Arrangement notes that while the program faced substantial risks from the outset and did not achieve many of its goals, it served as an important policy anchor in an uncertain environment."

UKRAINE

EX POST EVALUATION OF EXCEPTIONAL ACCESS UNDER THE 2014 STAND-BY ARRANGEMENT

September 2, 2016

EXECUTIVE SUMMARY

Ukraine requested a 24-month SDR 10.976 billion exceptional access Stand-By Arrangement (SBA) in April 2014 against the backdrop of large internal and external imbalances, considerable domestic political upheaval, and an emerging conflict in the East. Inconsistent macroeconomic policies in the preceding years had led to a potent combination of an overvalued pegged exchange rate, large and growing twin deficits, and a weak banking system by end-2013. Domestic political turmoil and conflict in Crimea and Eastern Ukraine added to these problems, creating an urgent need for financial assistance from the international community. The 2014 SBA (of about $17 billion) was Ukraine's third since 2008.

The program faced substantial geopolitical risks from the outset. Program success hinged on 1) the conflict in the East being short-lived, and 2) program policies being implemented successfully. It was recognized that all parties played a role in preserving stability, and that an escalation of the conflict posed a large risk to the success of the program.

Economic and domestic political risks also loomed large. With the previous two programs having gone off track quickly, and imminent presidential elections, implementation risks were recognized to be high.

The program rightly focused on immediate and medium-term objectives, building on the new authorities' commitment to reforms and the public's demand for a new way of governance. Despite the risks and the difficult backdrop, the new administration stated a strong will to tackle deep-rooted governance and institutional reforms, as they recognized the failure of previous policies. Moreover, popular demand for a break with past policies was seen as increasing the chances for success. The program therefore targeted both short-run macroeconomic stabilization and deep-reaching structural reforms to support sustainable growth over the longer term.

Safeguards to mitigate risks included: in terms of program design and financing, comprehensive and upfront conditionality, wide international support for the program, and financing from other partners. All presidential candidates expressed support for program objectives, and the new administration was seen as providing a window of opportunity for change. Moreover, IMF management sought commitments from the European Union, Russia, and the United States at the time of the First Review to work with all relevant parties to help restore peace quickly.

Important steps were taken under the program. The authorities made good strides early on, including in long-standing difficult areas, such as raising energy tariffs and largely maintaining a flexible exchange rate, albeit with occasional sizeable interventions. Banking sector diagnostics were conducted for the largest banks and a large number of them were resolved in an orderly manner. Naftogaz restructuring also began under the SBA, as did anti-corruption and governance reform. Fiscal consolidation began, although in part also due to low-quality and one-off measures.

However, as the conflict in the East intensified—and combined with uneven policy implementation—it became increasingly clear that program goals could not be attained. Stabilizing macroeconomic conditions and restoring confidence proved elusive, given the intensification of the conflict in the East and the protracted domestic political uncertainty. These shocks and the mixed program implementation led to a loss in confidence and a sharp depreciation of the currency, depleted reserves, large output losses, and a widening energy sector deficit. Debt became unsustainable and financing needs escalated. In late-2014, the authorities started debt restructuring talks with private external creditors to help secure debt sustainability, and in March 2015, the SBA was replaced with an Extended Fund Facility to provide more financing for a longer period and support the authorities' deeper reform plans.

In hindsight, the financing envelope constrained policy space to some extent in meeting program objectives, and an earlier debt operation, for example, could have helped in this regard. The likelihood and severity of the various well-recognized risks, even putting aside the conflict, would have warranted a more conservative baseline outlook, and there could have been greater emphasis on contingency planning in case the conflict did not de-escalate as assumed. The case for concluding that the exceptional access criteria were met was not compelling.

Nevertheless, looking back, the SBA served as an anchor for economic policies in an uncertain economic and political environment. Importantly, the program helped garner international support for Ukraine at a critical time and possibly prevented worse outcomes. Work on the unfinished policy agenda continues.

With the benefit of hindsight, Ukraine's experience offers the following lessons:

- In active conflict situations, having a well-developed and realistic adverse scenario and contingency plans is critical.

- Programs in countries with recurring economic crises should not hold back from pursuing structural reforms, although these need to be carefully prioritized.

- It would be useful to consider developing staff guidance on integrating risks to the outlook into a bottom line assessment regarding the probability of debt sustainability for the second EA criterion, and on assessing a program's prospects of success, the fourth EA criterion.

Authorized for distribution by
The European and Strategy, Policy and Review Departments

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INTRODUCTION

1. **This paper presents an Ex Post Evaluation (EPE) of the 2014 Stand-By Arrangement (SBA) with Ukraine.** The 24 month, SDR 10.976 billion (800 percent of quota) program was approved in April 2014. The first review was concluded in August and the program was canceled on March 11, 2015 with the approval of an Extended Fund Facility (EFF) arrangement. The approved level of access under the SBA was "exceptional" as it involved access above the Fund's normal access limits that were prevailing at that time (200 and 600 percent of quota on an annual and cumulative basis, respectively). Fund policy requires an EPE to be completed for exceptional access programs in the year after they end, to assess "whether justifications presented at the outset of the program were consistent with Fund policies and to review performance under the program" (See Ex Post Evaluation of Exceptional Access Arrangements—Revised Guidance Note).

2. **The paper is organized as follows:** The next section describes the background and context for the 2014 SBA. The subsequent sections give an overview of the program strategy and design, summarize program objectives and outturns in the key policy and reform areas, assess whether the program adhered to Fund policies, and explore questions that arise from the 2014 SBA experience. Lessons from the program and authorities views on the findings conclude the report.

BACKGROUND AND CONTEXT FOR THE 2014 SBA

3. **Ukraine had a long history of engagement with the Fund prior to the 2014 SBA, with some similarities among past programs.** The 2005 Ex Post Assessment (EPA) and the EPEs for subsequent exceptional access programs note that weak policies and political instability had prevented Ukraine from fully transitioning to a market-based system. The associated vulnerabilities had periodically given rise to financing needs, requiring external assistance, including from the Fund. Past program requests have also typically coincided with a change in political leadership. According to the EPA and the EPEs, past programs were relatively successful at stabilizing the macroeconomic situation, but had made less progress on structural reforms due to the lack of ownership and governance issues before going off track (Box 1).

4. **Vulnerabilities had been building up for some time in the lead up to the 2014 SBA.** As discussed in the 2013 Article IV Report (IMF Country Report No. 14/145), progress on reforms had stalled in the aftermath of the 2010 SBA, and inconsistent macroeconomic policies had deepened vulnerabilities in the lead up to 2014. In particular, a potent combination of an effectively pegged overvalued exchange rate, twin deficits reflecting unsustainable energy pricing policies and generous spending, deficit financing through bank balance sheets and monetization, a steady rise in indebtedness, growing contingent liabilities, pressure on international reserves and loss of market access characterized the economy in late 2013.

5. **Ukraine was also undergoing another period of political change.** Then-President Yanukovych's unexpected decision not to sign the EU trade treaty in late November 2013 gave rise

to anti-government protests ("Maidan" movement), culminating in then-Prime Minister Azarov resigning in January and, subsequently, President Yanukovych stepping down on February 22. Presidential elections were expected in May, but it was not clear whether parliamentary elections would be held at that point.

6. **One important difference from earlier programs was a newly-emerging conflict in the East.** Right after President Yanukovych left office, tensions emerged in Crimea and soon spread in the Eastern regions. In addition, a gas price dispute emerged between Gazprom and Naftogaz, threatening not only the fiscal balance but also the gas supply to Ukraine and the rest of Europe.

7. **Discussions on the 2014 SBA took place under difficult economic and political circumstances** (Box 2). By March 2014, Ukraine was in the midst of a full-fledged currency, banking, balance of payments and political crisis: reserves were declining rapidly amidst capital outflows; the effective peg had to be abandoned after which the hryvnia quickly depreciated; and bank and corporate balance sheets came under increasing pressure. The annexation of Crimea by Russia and ongoing tensions in the East weighed on confidence and domestic political uncertainty, complicating the situation. With international markets effectively closed, Ukraine requested financial assistance from the international community and the Fund to meet its financing needs, including for making repayments to the Fund.

8. **A key consideration in program design was how to take account of the newly-emerging conflict in the East.** The ratification of the European Union (EU) Association Agreement in March 2014 provided some indication/signal that the EU might have helped to promote stability and security in the region. In addition, IMF management secured specific assurances from the European Union, Russia, and the United States that they were committed to working with all relevant parties to help restore peace and security as soon as possible, thereby laying the basis for economic stability and recovery. Based on these assurances and the broad support of the international community, the program was predicated on the assumption that tensions in the East would not escalate or spill over to the rest of the economy. This formed the basis for the Executive Board's decision to approve the program. It was nonetheless recognized from the outset that economic, political and, importantly, geopolitical risks, loomed large and could derail the program.

9. **The political environment, despite the uncertainties, was seen as conducive to making a decisive break from the past.** Following the Maidan movement, there was a strong sentiment to address deep-seated governance and institutional problems, and a desire to integrate further into the global economy. All presidential candidates expressed support for program objectives, and notwithstanding uncertainties stemming from upcoming presidential elections, a new administration was seen as providing a window of opportunity for change. These political assurances were another important consideration that featured in the IMF's decision to approve the program.

OVERVIEW OF THE 2014 SBA

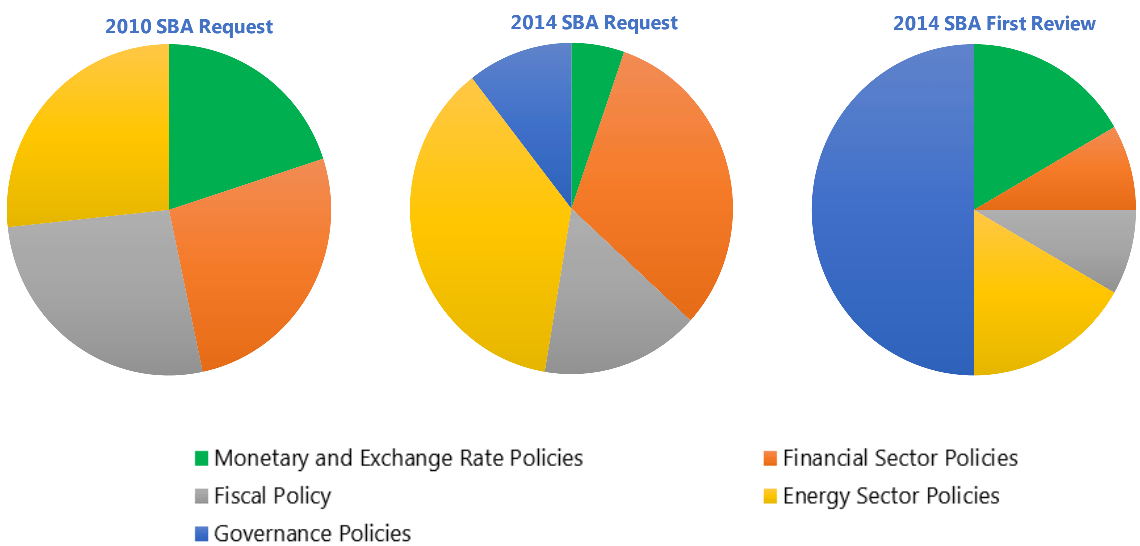
A. Program Strategy

10. The 24-month SBA was approved in April and rightly focused on three main objectives: 1) stabilizing the macroeconomic situation in the short run; 2) implementing deep-reaching reforms to strengthen governance and transparency; and 3) laying the foundation for robust and balanced economic growth over the longer term. Reforms were aimed at achieving and sustaining external sustainability, ensuring financial stability, fixing public finances, rationalizing the energy sector, and improving the business environment.

11. Conditionality was appropriately comprehensive and front-loaded, supporting program objectives while seeking to mitigate implementation risks. Following the recommendation of the EPE for the 2010 SBA, the program had relatively more upfront structural conditionality, including 12 prior actions upon approval, to strengthen the odds of achieving a decisive break from Ukraine's poor track record under past arrangements. The structural conditions covered a broad range of policy areas (Figure 1) and were more comprehensive than in Ukraine's past programs or other recent exceptional access arrangements (Figure 2; Tables 1 and 2).

Figure 1. Structural Conditionality by Topic

Structural conditionality in the 2014 SBA started out by focusing on the more urgent policy areas of energy, fiscal and financial sector policies, then turning to governance reforms in the First Review.

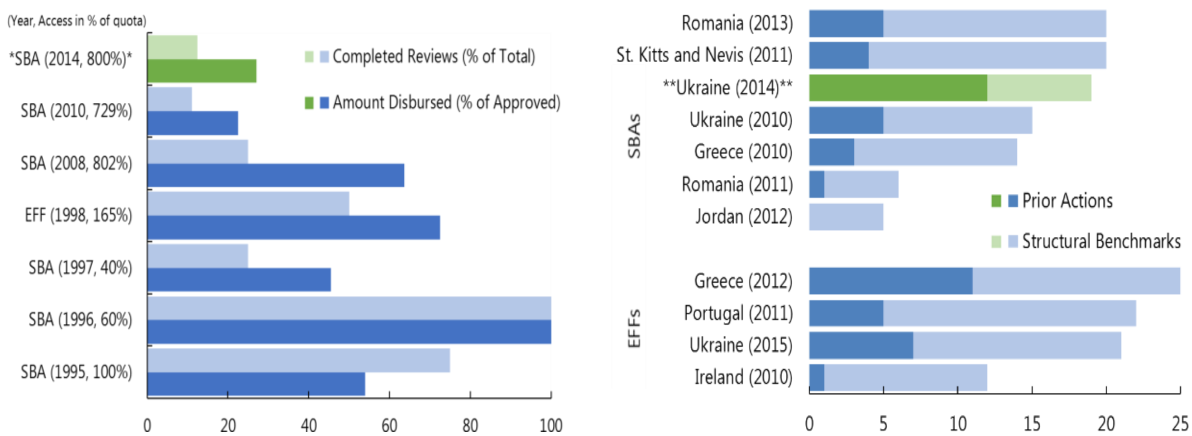


Source: IMF country reports 14/106, 14/146 and 14/263.

Figure 2. Ukraine Program Track Record and Conditionality at 2014 SBA Request 1/

The last two programs before the 2014 SBA had only 2 and 1 reviews completed, respectively.

Prior actions accounted for much of the success under earlier programs, and were also used in the 2014 SBA.



Source: IMF Staff Estimates.
1/ Ukraine had a 12-month precautionary SBA in 2004 under which no reviews were completed or purchases made.

12. As an additional safeguard against implementation risks, the program was initially monitored on a bimonthly basis (Table 3). The idea was to allow for early corrective actions should policies deviate from the programmed targets. In hindsight, the high review frequency may have helped maintain close engagement with the authorities and gather updated data, but did not necessarily help put in place emergency measures sooner.

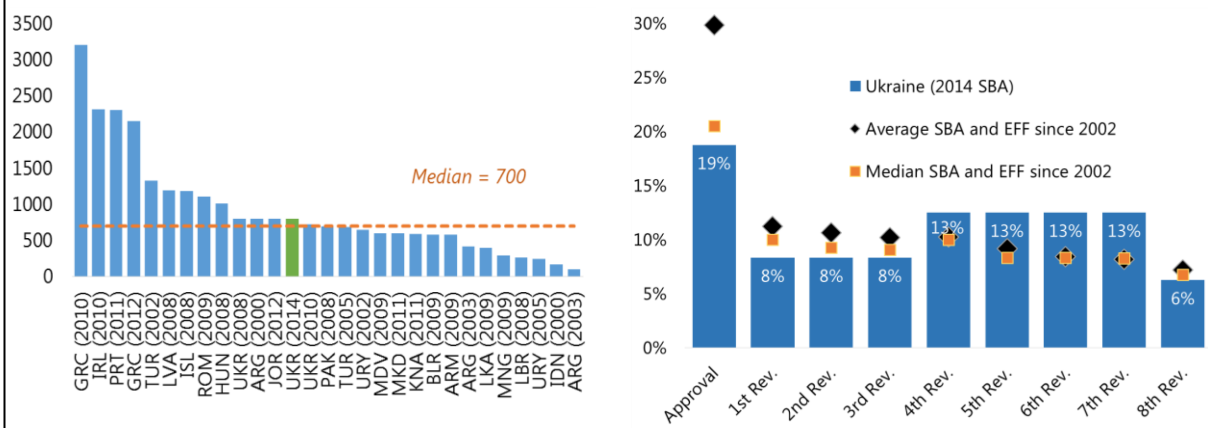
B. Program Financing

13. Approved access of about $17 billion covered over 60 percent of Ukraine's financing needs. Ukraine's gross external financing needs were projected at $27 billion over 2014-16, driven by a substantial current account deficit, large private sector external debt obligations and the need to replenish the very low level of National Bank of Ukraine's (NBU) international reserves (Table 4). Access to Fund financing was slightly above the median in exceptional access arrangements approved since 2000 at that time (Figure 3).[1] Roughly $15 billion was pledged by other official creditors and the projection assumed regained access to market financing in later program years (see later discussion on the third exceptional access criterion).

[1] The $27 billion estimated financing needs does not include the $5.2 billion of scheduled repurchases to the Fund over the program horizon. In net terms, the Fund's share of overall support over the program was 44 percent given these scheduled repurchases.

Figure 3. Ukraine Program – Access and Phasing

Approved Access (percent of quota) | **Phasing of Access by Review** (percent of total access at approval)



Source: IMF Staff Estimates.

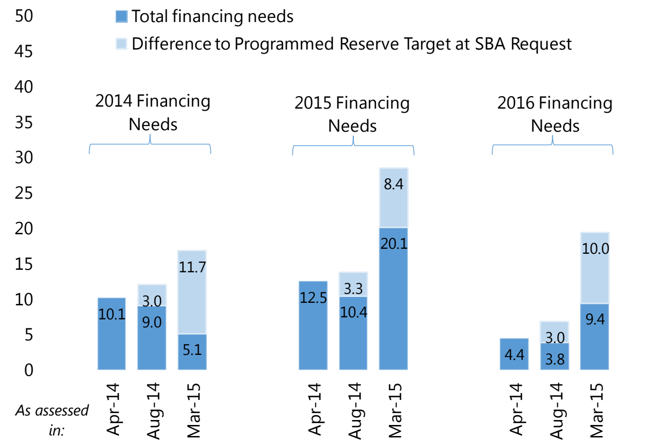
14. Phasing was designed to balance Ukraine's urgent financing needs against the considerable risks to the program (Figure 3). Poor implementation under the previous two SBAs justified limiting Fund's exposure until performance under the program started to establish a better track record. Therefore, access was only moderately frontloaded, with SDR 2 billion (150 percent of quota) made available upon approval, helping to alleviate immediate financing pressures and catalyze international support. Subsequent purchases were more back-loaded. The planned bi-monthly reviews at the beginning of the program would have also increased Fund's exposure incrementally.

15. The program ended up providing more budget financing than envisaged, owing to the rising fiscal needs stemming from Naftogaz losses. At the program request, about $2 billion of the first purchase (roughly a tenth of total agreed access) was allocated for budget support. The First Review reallocated another $1 billion to the budget to cover Naftogaz's increasing deficit, raising the share of budget financing to over 40 percent of the realized purchases under the 2014 SBA.

16. Financing needs ballooned towards the end of the program, ultimately making the program objectives unachievable within its timeframe. As discussed further below, the financing envelope constrained policy space to some extent in meeting program objectives. In the event, many of the risks noted in staff papers materialized during the short-lived program; notably, the conflict intensified over the summer, confidence could not be sustained and the domestic political uncertainty ended up being more protracted (see next section). In the First Review, financing needs were contained by lowering reserve accumulation targets and assuming that the de-escalation of the conflict would allow for higher market access later in the year (Figure 4, Table 2, section on exceptional access criteria). However, by the end of the year, the financial situation became more difficult. Naftogaz payments to clear arrears to Gazprom, continued capital outflows, as well as delays in disbursements from other external parties, contributed to reserves being depleted to critical levels. The Fund recognized at that stage that Ukraine's financing needs would be larger and more protracted than covered under the SBA, requiring deeper structural reforms and a debt restructuring operation to ensure sustainability. To that end, the SBA was replaced with the EFF, which included additional financing and has a longer repayment period. The international community also provided additional financing and the authorities started debt restructuring talks.

Figure 4. Evolution of Financing Needs and Shortfall from Initial Reserve Targets[1/]

(in billions USD)



Source: IMF Staff Estimates.

1/ March 2015 observation for 2014 financing needs reflects the outcome as assessed at the time and partially reflects delays in external financing caused by delays in completing the SBA reviews.

PROGRAM IMPLEMENTATION AND OUTTURN

A. Macroeconomic Framework

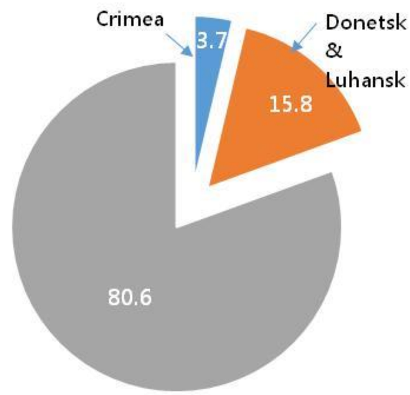
17. The strong V-shaped recovery expected under the program was predicated on program policies being implemented and the conflict in the East being short-lived (Table 5). Growth was expected to decline initially, reflecting a drop in private consumption and investment, coupled with some drag from fiscal consolidation. The exchange rate was expected to stabilize at that point, restoring competitiveness. With successful program implementation, growth was expected to recover strongly and quickly, led by investment and exports. More importantly, reflecting available information at the time of the program approval, the outlook hinged on the Eastern conflict ending soon, not having major spillover effects to confidence, and being contained in Crimea, which accounted for only 4 percent of GDP.

18. Most risks highlighted in the program materialized, and most macroeconomic outcomes deviated fundamentally from projections, particularly in the second half of 2014 (see next section for details):

- Most importantly, the ***conflict in the East*** was more intense and longer-lasting than assumed in the baseline projections. Besides the direct impact on GDP, through a severe drop in industrial production and exports in the affected regions (Figure 5), the escalating conflict deteriorated confidence and demand in the rest of the economy. On the ***domestic political front***, after the presidential elections, parliamentary elections were set for the Fall, and forming a government took several months. The ensuing uncertainty further deteriorated consumer and business confidence.

- Bouts of rapid ***capital outflows*** led to more ***depreciation*** than expected under the baseline. From its end-2013 level, the hryvnia depreciated by 35 percent at the time of the SBA request and by nearly 90 percent by year-end. Constrained by fiscal dominance, including the need to facilitate the financing of gas imports and the DGF, the monetary stance remained looser than should otherwise have been. The outflows and depreciation added to pressures on bank balance sheets, further ***reducing credit*** to the economy.

Figure 5. Share of Eastern Territories in Ukraine's GDP, 2012



Source: IMF Staff Estimates

- The large depreciation also added to the domestic costs of imported ***energy***, further depressing domestic demand and adding to ***Naftogaz's losses***. Moreover, the effective loss of control over Crimea resulted in about 14 percent loss of Naftogaz output.

- The depreciation, and higher energy prices added to ***inflation***, raising it from 16 percent at the time of the program request to 25 percent by end-2014.

- Notwithstanding the sharp import contraction, the ***current account*** recovered less than expected, since exports remained weak owing to the collapse of trade with Russia, Ukraine's largest trading partner.

19. In the end, the recession turned out to be deeper and more protracted than expected (Figure 6). Real GDP contracted by 6.8 percent in 2014, close to the projection at the time of the First Review. However, the sharp V-shaped recovery did not materialize. 2015 growth projected at the time of the EFF First Review was -9 percent, 10-11 percentage points lower than projected under the SBA.

B. Exchange Rate and Monetary Policy

Program Strategy

20. The SBA targeted maintaining a flexible exchange rate, gradually unwinding controls, and moving to an inflation targeting regime. These were long-standing policy objectives, including under the 2010 SBA. In February 2014, facing pressure on the hryvnia and rapidly declining reserves, the long-standing exchange rate peg was abandoned and a flexible exchange rate regime was formalized in NBU regulations. The SBA supported maintaining exchange rate flexibility, but judging the depreciated hryvnia at the start of the program to be in line with fundamentals, cautioned against overshooting, which could adversely affect balance sheets.[2] Under the program, exchange controls in place prior to program approval were to be gradually unwound after July, as conditions allowed. The move to inflation targeting as the new monetary anchor was planned by 2015:Q2.

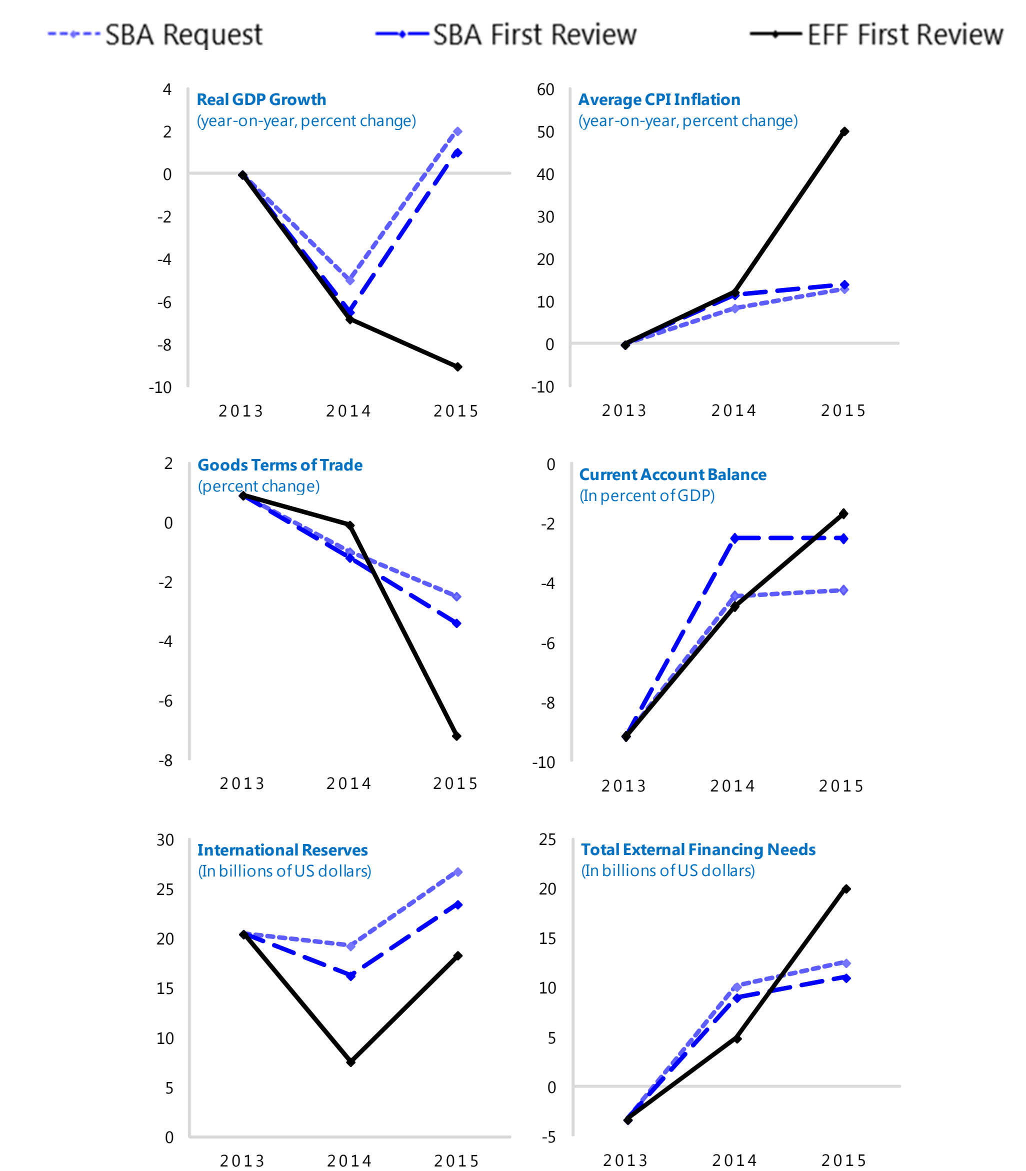
21. Monetary policy was envisaged to be tight, but was hampered by the need to provide adequate domestic financing, which came at the cost of depleting reserves. Until the envisaged move to inflation targeting, the program aimed to keep monetary policy tight through quantitative targets and a positive real interest rate. However, the ceiling on Net Domestic Assets (NDA) allowed for purchasing government bonds for recapitalizing the Deposit Guarantee Fund (DGF) and Naftogaz of UAH68 billion during the program period. This expansion of NDA came in addition to a UAH70 billion increase in Q1 alone from government financing and extending liquidity to banks. The impact on the monetary base for the year was expected to be 21.5 percent (against a 3.5 percent increase in nominal GDP), given the envisaged decline in NBU Net Foreign Assets (NFA) by about 14 percent.

22. In addition, the adjustors to the monetary performance criteria were generous, and injected further liquidity in the system. The program had adjusters not just for lower-than-projected disbursements by other creditors, but also to accommodate NBU liquidity support to the Deposit Guarantee Fund (DGF) and bond purchases to finance recapitalizing the DGF and banks.[3] The program also included an indicative target on the cumulative change of the monetary base that only allowed for an upward adjustment should the NBU have to finance the Deposit Guarantee Fund (DGF) or purchase government bonds to recapitalize banks. The indicative target foresaw no adjustments for a better than expected outcome in reserves accumulation. In short, by design, these adjustors contributed to permanently injecting liquidity and lowering reserves under the program.

[2] Staff cautioned that a further depreciation (to UAH/USD 12.5) would increase capitalization needs in large domestic banks from 1½ to 3½ percent of GDP and, perhaps, as high as 5 percent of GDP if the exchange rate depreciated by 50 percent relative to end-2013.

[3] The existing Board guidance on adjusters for NIR and NDA performance criteria speaks only of allowing for small deviations from program financing assumptions that could be accommodated within the program without affecting the program's main objectives. Since adjusters can defer policy adjustment, it is recommended that programs rely on reviews and waivers from the Board if adjustments are needed.

Figure 6. Ukraine: Key Economic Indicators

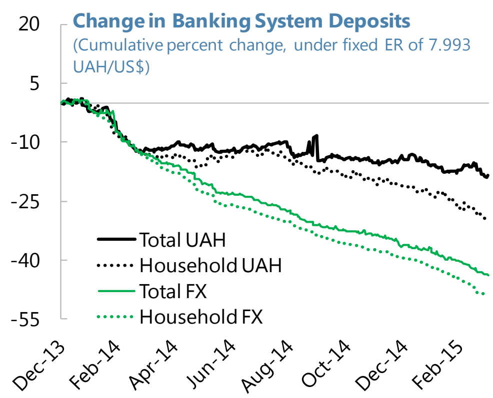


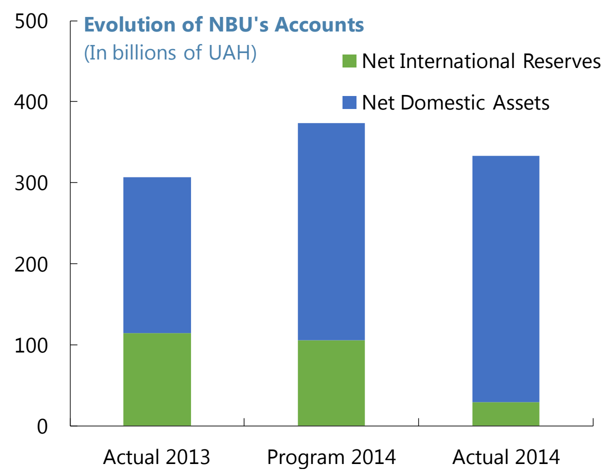
Source: IMF Staff Estimates.

Outturn

23. The monetary stance was looser than envisaged and reserves were severely depleted under the program. With the budget facing significant financing constraints, the NBU was called to become the country's lender of last resort. In the end, the NBU's net claims on the government ended up growing by over 125 percent, 2.5 times more than initially envisaged. This contributed to NDA growing by over 65 percent and NFA declining more than expected. Further pressure on reserves came from the weakening confidence in the currency and the banks: household hryvnia deposits declined by almost 10 percent over 2014, while foreign currency deposits declined even more sharply by US$11.1 billion, accounting for most of the US$15 billion decline in NBU's net foreign assets (NFA) over 2014 (Figure 7). The rest of the NFA decline is largely due to the $3.1 billion Naftogaz payment to Gazprom. The NBU's efforts to tighten monetary conditions by raising interest rates in the second half of 2014 failed to affect market rates or raise bank deposits with the NBU (Figure 8). A tighter monetary stance from the outset, and further tightening when pressures on the hryvnia mounted, could have buttressed demand for domestic currency and also shifted the burden of the adjustment to the government (paying higher interest rate on its domestic debt). Such a stance would have been more consistent with program objectives of building reserves, stabilizing prices and preventing exchange rate overshooting, and could also have improved the effectiveness of exchange controls (also see section on capital controls). That said, such a policy would have also been procyclical, adding to already severe downside pressures on the real economy and would have required financing for the government from other sources.

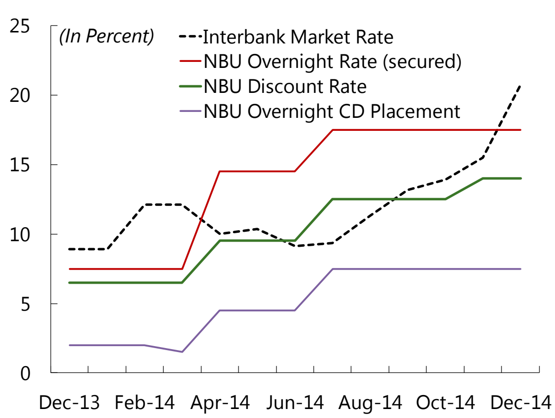
Figure 7. Banking Sector Deposits and Evolution of NBU's Balance Sheet

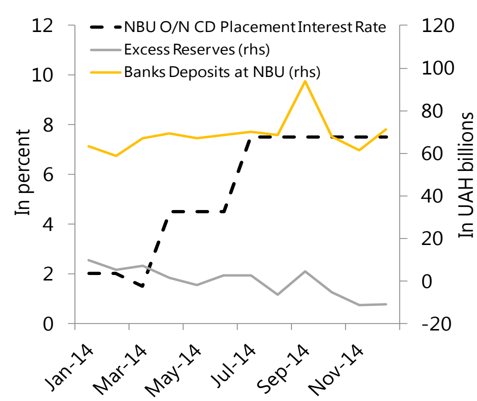




Source: IMF staff estimates.

Figure 8. Interest Rates and Deposits at NBU

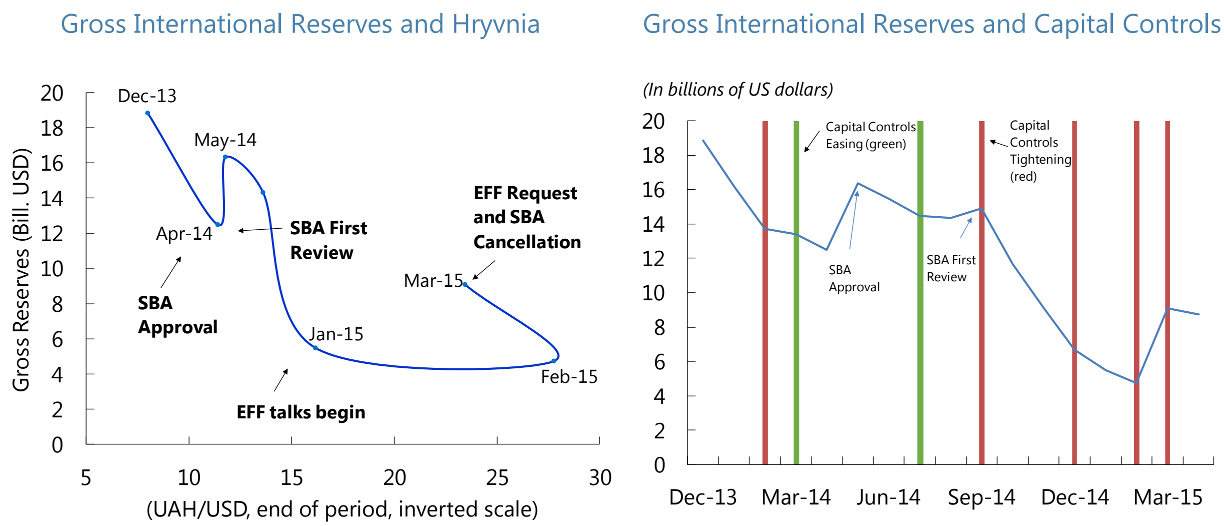




Source: IMF staff estimates.

24. Exchange rate flexibility was maintained, albeit with episodes of large foreign exchange intervention. The NBU allowed the exchange rate to depreciate significantly and to some extent absorb the impact of the geopolitical turmoil and the weaker policy stances. However, the NBU intervened heavily during the third quarter as the conflict in the East intensified and the domestic political uncertainty and elections spurred capital outflows, returning to a flexible stance only later in the year (Figure 9). While an effort was made to tighten capital controls, the volume of capital flight suggests that these controls may have been too weak, not implemented fully, or put in place too late to counter the effects of the geopolitical instability and the loose monetary stance. Overall, the hryvnia depreciated against the U.S. dollar by about 90 percent by the end of 2014, far more than envisaged under the program.

Figure 9. Ukraine: Gross International Reserves, Exchange Rate and Capital Controls



Source: World Economic Outlook, NBU and IMF staff calculations (2015).

25. The plan to move to an inflation targeting regime was overly ambitious. The plan would have been ambitious even in the absence of the conflict, given that a move from exchange rate anchoring to inflation targeting would require, among other things, overhauling NBU operations and internal procedures, building a track record of meeting forecasts, and improving its communication strategy, all of which take some time. Though more technical assistance was provided and the NBU made progress towards the goal, in the end, the preconditions for moving to inflation targeting were not present then. Fiscal dominance continued and the monetary transmission mechanism was still impaired due to the weak banking system.

C. Financial Sector Policies

26. The SBA included actions in five priority areas regarding the financial sector: continue providing liquidity to solvent banks in need; assess bank resilience through an independent asset quality review (AQR) for the top 50 banks; assess bank solvency and make sure that shareholders were the first line of defense to capitalize banks; upgrade the regulatory and supervisory framework to international standards; and improve banks' capacity to resolve NPLs. Though earlier programs had attempted to unveil the ownership of banks, the 2014 SBA did not look into this area.

27. As the NBU's technical capacity strengthened during the SBA, problems in banks' balance sheets came to light. Nonperforming loans (NPLs) rose from 23.5 to 32.0 percent over 2014, brought about by the economic crisis and the geopolitical developments. Over this time, the NBU made progress in improving supervision and upgraded its regulatory framework in critical areas, particularly in connected lending. This allowed the NBU to conduct a second AQR, which identified larger capital needs in some banks than the independent reviews had found.[4] These steps also allowed the NBU, together with the recapitalized DGF, to begin downsizing the banking system in an orderly way; of the 180 banks that Ukraine had at the beginning of 2014, 33 banks had gone into resolution by the end of the year and some 80 more were being closely monitored, a commendable feat that is difficult to undertake in most circumstances.

28. The pace of reforms in other priority areas was much slower. The mechanisms for emergency liquidity assistance to the financial system (ELA) were upgraded. While shareholders have been used as a first line of defense when resolving banks, the government has had to buttress the solvency of some public banks. Creating an official centralized credit registry is pending legislation and the banks' capacity to deal with NPLs remains a challenge. Reforms in many of these areas are covered in the successor program.

D. Fiscal Policy

Program Strategy

29. Fiscal vulnerabilities had been accumulating in Ukraine for years, even if public debt was initially relatively low. From 2011 to 2013, the overall general government balance deteriorated by 2 percent of GDP (1½ percent in structural terms), due in large part to pension and wage increases. In addition, off balance sheet activity had been increasing as the authorities tried to buoy public investment by extending state guarantees (reaching 7 percent of GDP in 2013) and resorted to government IOUs for repayment of overdue VAT refunds and expenditure arrears (over 1 percent of GDP). Quasi-fiscal losses in the energy sector had also been accumulating as a result of low gas tariffs. Therefore, in addition to general government deficit targets, the program also included a target on the combined general government and Naftogaz deficit (next section).

30. The fiscal situation at the outset of the 2014 SBA was therefore challenging. In the absence of program measures, the 2014 general government deficit was expected to reach 8½ percent of GDP on further wage and entitlement spending increases and falling revenues as a

[4] Among the steps taken by NBU under the 2015 EFF were the creation of a special unit in charge of monitoring connected lending, and the granting of legal powers to that office to presume connected lending whenever the documentation and guarantees of a loan are substandard. Banks do have the recourse to complete the documentation or upgrade the guarantees.

result of poor tax compliance and the weak economy. Such a deficit would have required large-scale monetization and further contributed to unfavorable debt dynamics and deteriorating confidence.

31. Against this background, the fiscal objectives were broadly appropriate aiming to maintain priority spending and initiate medium-term fiscal adjustment (Text Table 1). Revenue shortfalls resulting from macroeconomic and political disruptions required a rapid policy response involving a mix of revenue and expenditure measures. Over the medium-term, an expenditure-led consolidation would return public finances to sounder footing. Specifically, the program targeted a structural fiscal adjustment of 2 percent of GDP from 2013 to 2016, with half of the adjustment front-loaded in 2014. The target on the overall balance, however, masked a rising interest bill. Looking instead at the programmed structural primary balance, the fiscal effort in the initial program was over four percent of GDP, including 2 percent in 2014.

Text Table 1. Fiscal Balances at Program Request
(percent of GDP)

	2013	2014	2015	2016
General government balance	-4.8	-5.2	-4.2	-3.1
Structural government balance	-4.6	-3.6	-3.1	-2.6
Structural primary balance	-2.1	-0.2	1.2	2.1
Interest bill	2.5	3.4	4.3	4.7
General government and Naftogaz balance	-6.7	-8.5	-6.1	-4.4

Source: IMF Staff Estimates

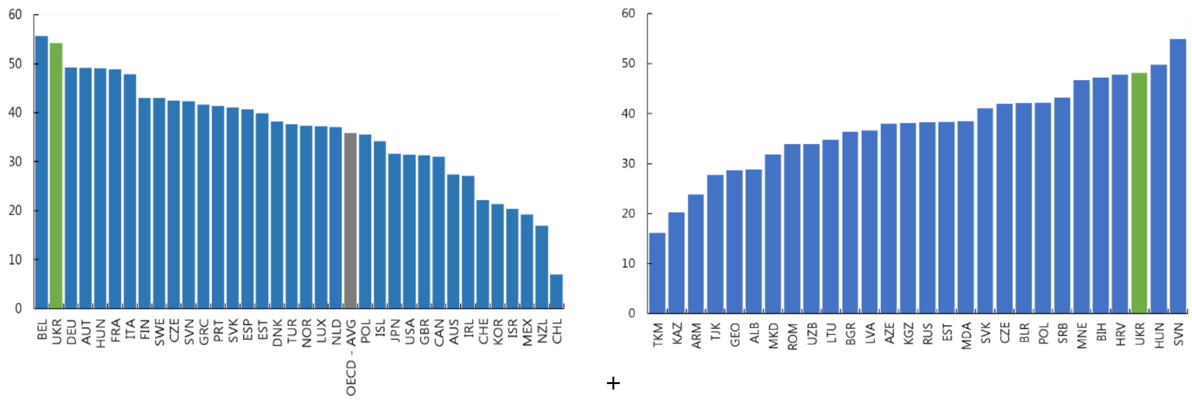
32. With tax rates in Ukraine already high, program measures on the revenue side focused on eliminating VAT exemptions and improving tax administration (Figure 10). The authorities committed to suspend the application of a zero VAT rate to grain and crop exports, introduce a reduced VAT rate on medical products previously exempt, and a higher excise tax rate for diesel fuel, alcohol and tobacco. A reorganization of state tax and customs services to reduce tax fraud, specifically concerning fake exports of fuel and illegal alcohol production, was also expected to yield significant revenues. Importantly, as a prior action, parliament also reversed the planned VAT rate reduction for 2015.

33. With spending relatively high in Ukraine, expenditure efforts rightly constituted the bulk of planned adjustment (Figure 10). Specifically, the upfront ratio of expenditure to revenue measures was about 2:1. The government agreed to cancel already-planned discretionary wage increases, maintain a hiring freeze, and cancel the discretionary increase in pensions and pension-linked benefits. As a prior action, a new public procurement law was adopted to strengthen governance and reduce exemptions from regular competitive procedures, allowing additional savings on government purchases. Other program measures included a rationalization of subsidies to enterprises, social assistance, and, capital expenditures.

Figure 10. Ukraine – Cross-country Comparison of Fiscal Policy

Tax Wedge on Wages in Ukraine and OECD Countries (2013) 1/
(In percent, Average Tax Wedge)

Total Government Expenditure to GDP, 2013
(In percent)



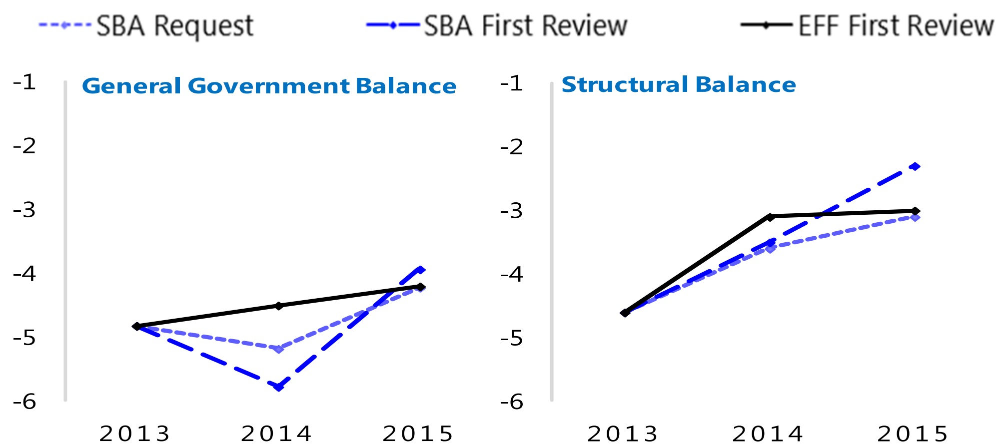
Sources: Word Economic Outlook, 2015.
1/ Family type: Single person at 100% of average earnings, no child.

Outturn

34. **The 2014 budget deficit outturn significantly overperformed program targets, on the back of one-off factors and a less-than-desirable composition** (Figure 11). In light of the weak economy and falling revenues, the fiscal target was loosened at the First Review while maintaining the same structural effort, including through additional measures reflected in a supplementary budget. Eventually, however, revenue losses resulting from the deteriorated security situation in the East and weak economic growth were partially offset by higher-than-expected exchange rate depreciation and inflation. Importantly, expenditures were significantly curtailed, owing to liquidity constraints (VAT arrears, which were subsequently cleared) and stalled budgetary payments to the conflict areas in the East. Moreover, an earlier profit transfer from the NBU supported the budget outcome. As a result, the general budget balance for 2014 was higher than targets by about 0.7 percent of GDP while the structural balance exceeded targets relative to the program request by about ½ percent, implying an adjustment of 1½ percent over 2014.

35. **The significantly smaller deficit outturn was procyclical and suboptimal, but perhaps unavoidable given the severe financing constraints.** With shortfalls in external financing and revenue considerably below targets, including due to the unexpected disruptions of fiscal flows to and from the East, expenditure cuts contributed to the overperformance. At the same time, it was also important to take advantage of political and reform momentum at the outset of the program to improve long-term sustainability. To that end, on the revenue side, it would have been better to discontinue the preferential VAT regime for agriculture as envisaged under the program.

Figure 11. General Government Fiscal Targets and Outcomes
(in percent of GDP)



Source: Staff Estimates.

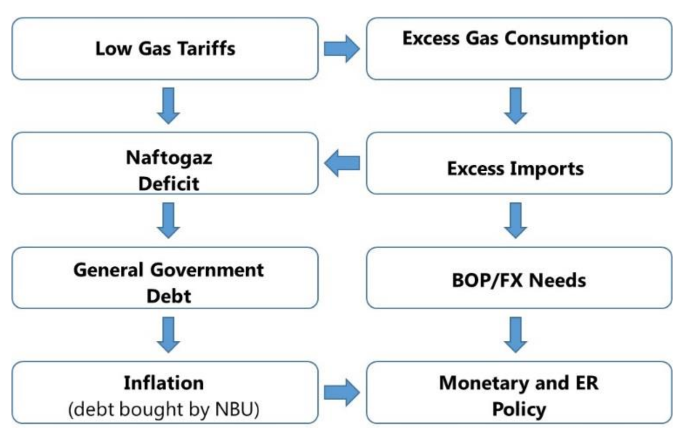
E. Energy Sector Policies

Program Strategy

36. The loss-making and opaque gas sector in Ukraine weighs heavily on public finances, the external sector, and the overall economy. The very low tariffs for residential gas and district heating encourage excessive energy consumption and lead to large fiscal losses, drive gas imports up, discourage investment in domestic production, and breed governance problems (Figure 12).

37. Previous programs attempted, unsuccessfully, to address the issue through a series of tariff increases. The 2010 SBA, for example, included a 50 percent increase in tariffs as a prior action. However, in an environment of rising import prices, the 2010 tariff increases achieved little and the authorities balked at additional increases before the program went off track. By end-2013, tariffs were just 10-20 percent of import parity and significantly lower than in peer countries.

Figure 12. Key Energy Sector Links to Economy



Source: IMF Staff.

38. Consequently, the financial position of Naftogaz entering the 2014 SBA was precarious. With a deficit of 1.9 percent of GDP in 2013, the energy sector was creating large quasi-fiscal losses and adding to public debt. In addition, the low tariffs left the Naftogaz balance vulnerable to exchange rate depreciation that could further increase import costs, as well as a growth slowdown that could impact gas sales and the collection of receivables.

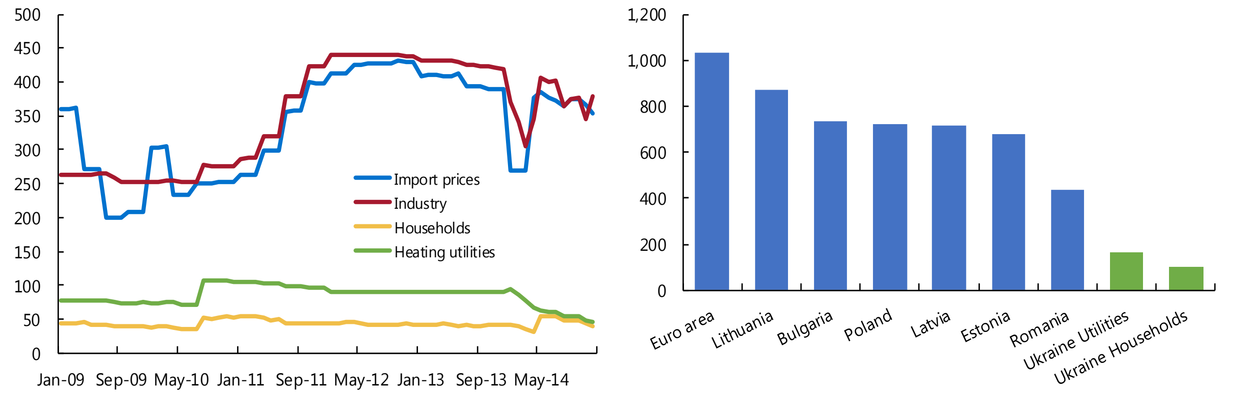
39. The 2014 SBA aimed to gradually eliminate Naftogaz losses by implementing staged tariff increases and improving payment discipline (Figure 13). Specifically, retail gas and heating tariffs were increased by 56 and 40 percent, respectively, in 2014 as a prior action. In addition, a schedule of annual increases of around 20 percent was agreed with the aim to eliminate Naftogaz losses by 2018. To support the tariff increases, the program also addressed the low compliance rates of district heating companies, including by creating special distribution accounts into which all utility payments are made, and from which payments to Naftogaz are automatically drafted.

Outturn

40. A dispute between Naftogaz and Gazprom in early 2014 further weakened program buffers. Specifically, the two companies disagreed on the gas price from the second quarter of 2014 and the amount of unpaid gas deliveries in 2013-14. In order to reduce the risks stemming from the dispute, the First Review provided for the clearance of undisputed arrears from 2013 (US$1.45 billion) and the unpaid gas bills in April–May 2014 (US$1.64 billion) valued at Naftogaz's advocated price as a prior action. Because the sum was larger than envisaged under the original program, the international reserves target was reduced accordingly. It was hoped that this arrangement would contribute to de-escalating tension and reaching a durable price agreement. Ultimately, Gazprom halted gas supply to Ukraine in June, but Ukraine was able to purchase additional gas through reverse flows from EU countries to ensure sufficient gas supply through the heating season.

41. To mitigate the impact on households, the tariff increases were appropriately accompanied by measures to protect the most vulnerable. In particular, the existing housing utilities subsidy program that covers the utility bills above a fixed percent of the enrolled households' income and the category-based privileges program remained in place and a new program to protect vulnerable households not covered by the existing schemes was introduced. Ultimately, the new scheme proved largely redundant, as it overlapped with existing social assistance programs, and these programs were consolidated. Faster tariff increases could have been accompanied by additional social assistance to help maintain popular support for the program; however, this would have required additional fiscal adjustment.

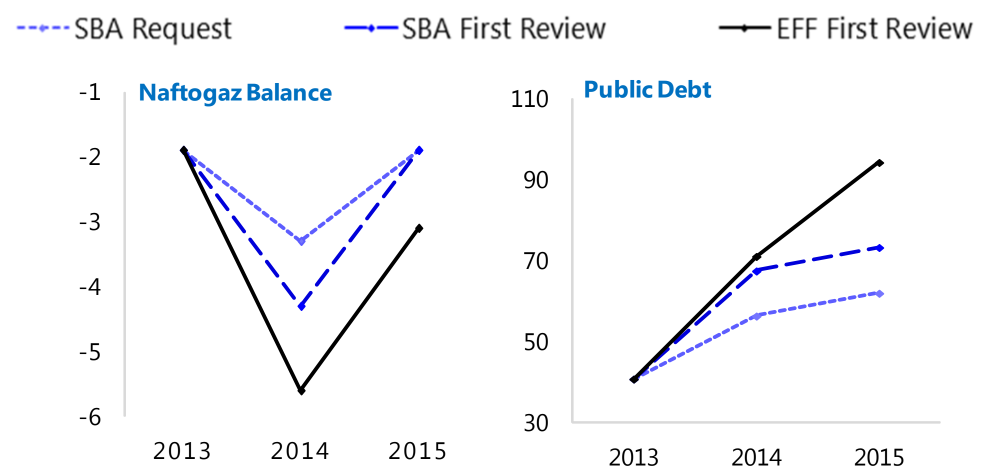
Figure 13. Ukraine: Import Prices and Gas Tariffs (US$/tcm)



Sources: Naftogaz, Eurostat, Ukrainian Authorities and IMF Estimates.
1/ Tariffs net of transit fees, transportation costs and VAT.

42. **In hindsight, the programmed operational balance for Naftogaz in 2014 proved highly optimistic, leading to significant additional financing needs.** Specifically, by the time of the First Review, additional exchange rate depreciation was expected to increase the 2014 gas import bill by 0.7 percent of GDP and external debt repayment by 0.9 percent of GDP. Similarly, revenue projections (gas sales and receivables) were reduced by 2.3 percent of GDP as a result of weak growth and poor payment discipline. With increased transit revenues and other savings expected to provide some offsets, total Naftogaz financing needs in 2014 increased from 4 to 7½ percent of GDP by the time of the First Review. These developments pushed the Naftogaz operational deficit – and consequently the combined general government-Naftogaz deficit – above program targets (missed performance criterion, Table 2, Figure 14).

Figure 14. Naftogaz Balance and Public Debt
(In percent of GDP)



Sources: Naftogaz, Ukrainian Authorities and IMF Estimates.

43. With no prospects for additional external financing and little appetite for additional tariff increases in 2014, additional financing needs were accommodated at the time of the first review. Support was delivered in the form of government recapitalization through t-bills, which is recorded below the line in the budget and therefore contributed to an increase in government debt, further reducing buffers to absorb future shocks.

44. Although Naftogaz finances did not improve as programmed, progress was made on the structural agenda in the energy sector. In particular, the distribution accounts were established, helping to strengthen payment discipline and secure Naftogaz revenues. Audits of Naftogaz finances were also initiated, verifying the accuracy of Naftogaz's reporting of its financial results under the program.

F. Governance and Business Climate Reforms

45. Weak governance, lack of transparency, and a difficult business climate have long impeded Ukraine's ability to maintain higher growth. These constraints have suppressed the productivity potential of the economy, discouraged much-needed investments, and contributed to the significant macroeconomic imbalances in the lead up to the 2014 SBA (as well as earlier programs). Furthermore, the lack of transparency and unfavorable perception of governance problems in the energy sector undermine the legitimacy of higher energy tariffs and impede efforts to reduce the quasi-fiscal deficits.

46. The authorities produced a candid and comprehensive diagnostic study, with contributions from IMF staff, which helped lay a strong foundation for governance and the business climate reforms, including for the successor arrangement. Specifically, the study examined the anti-corruption framework, the design and implementation of key laws and regulations affecting the business climate, and the effectiveness of the judiciary. These areas were supported by new structural conditionality introduced at the first review. Notably, the study—unprecedented in the context of Fund programs—was published by the government, which was interpreted at the time as a signal of strong political buy-in and ownership of its recommendations.

47. Separately, the program also aimed to tackle other long-standing issues. Reforming procurement practices, a long-standing source of corruption, and improving transparency in the state-owned part of the gas sector, including to boost popular support for tariff increases, were part of the authorities' reform agenda for the SBA. The first review also identified a need to amend the NBU Law to address safeguards concerns as well as the anti-money laundering law and the criminal code to support the anti-corruption effort.

48. Reform implementation was uneven after the diagnostic study was completed, raising questions about the influence vested interests still have. Parliament passed legislation to establish an anti-corruption agency to investigate corruption offences and acts of laundering of proceeds among high-level officials. However, changes were made to the legislation that diluted its effectiveness. Progress was also made on an action plan to simplify regulatory frameworks affecting economic activity, although the proposals lacked prioritization and an adequate institutional framework governing its implementation. A new procurement law was passed as a prior action to the program, but later faced repeated, albeit ultimately unsuccessful, efforts by factions of the parliament to re-introduce exemptions from competitive procedures. Amendments to the anti-money laundering law and the criminal code were successfully passed, notwithstanding some initial delays. The program did not address the area of judicial reforms in its limited timeframe, with specific steps planned only in 2015.

CONSISTENCY WITH FUND POLICIES

A. Were the exceptional access (EA) criteria well justified?

- **EA Criterion 1 (EA1) – Exceptional balance of payments pressures**: At the time of the program request Ukraine was experiencing balance of payment pressures from both the current and capital account. By March 2014 official reserves had fallen to critically low levels, covering only two months of imports. While the current account deficit adjusted to some degree over the course of the program, it was to remain elevated and pressures from the capital account continued throughout. The estimated financing needs exceeded normal limits, even after taking into account financial support from the broader international community.[5]

- **EA Criterion 2 (EA2) – Debt sustainability with high probability**: The assessment that debt was sustainable with a high probability rested on the baseline outlook, which assumed no intensification of the conflict and program policies being implemented successfully, which was critical for debt trajectories remaining non-explosive in the DSA shock scenarios. Initially, debt being well below the 70 percent risk threshold was used as an argument, and subsequently, when debt exceeded 70 percent in the projections, the argument hinged on the breach being short-lived. The First Review report recognized explicitly that the debt ratio would remain above the 70 percent risk threshold over the medium term should the conflict intensify. In hindsight, while downside risks to the outlook and those flagged in the DSA tools were well recognized and presented in the program and first review staff reports, the fact that debt proved unsustainable only a few months after the First Review because well-recognized risks materialized calls into question whether these risks were sufficiently taken into account in assessing the probability of debt sustainability (see next section on risks to debt sustainability).

[5] Ukraine’s credit outstanding at the time of approval was SDR 2.58 billion (187.9 percent of quota), leaving up to SDR 2.91 billion that could have been requested without triggering exceptional access procedures over the 24-month period.

- **EA Criterion 3 (EA3) – Prospect of gaining or regaining market access**. Ukraine was expected to regain access to markets in 2015 owing to successful program implementation and support from the international community, and spreads did come down after the SBA approval (Text Table 2, Figure 15). At the time of the First Review, though, despite a worse macro and geopolitical outlook, the market access assumptions were revised up and also brought forward. This proved highly optimistic; spreads increased sharply following the First Review as the conflict escalated and domestic political uncertainty continued, and by year-end, markets were already pricing in a debt operation (Box 3).

Text Table 2. Market Access Assumptions under the 2014 SBA ($bn)

	2014[1/]	2015	2016
Program Request	-	1	3.0
1st Review	2.2	1.5	3.0
Outturn	-	-	NA

[1/] 2014 included a US$1 billion Eurobond guarantee from the U.S., which is not considered market access for program purposes.

Sources: IMF Country Reports 14/106 and 14/263

- **EA Criterion 4 (EA4) – Strong prospects for success**. Despite Ukraine's poor track record of program implementation, the case for EA4 gave the benefit of the doubt to the new authorities, who were seen as committed to reforms, promising a decisive break from the past. In fact, the ongoing geopolitical conflict was considered to play a positive role in galvanizing parliamentary support to undertake reforms that faced resistance from vested interests, including a comprehensive set of prior actions. The case for EA4 was further supported by assurances from the leading presidential candidates, representatives of key political parties and civil society groups. In addition, management had secured assurances from the EU, Russia and the United States on their efforts to help restore peace and security, thereby laying the basis for stability and growth. However, implementation risks were still considerable, and not only because of the protracted and escalating conflict in the East. The re-instatement of the 2004 Constitution gave the parliament, formed under the previous regime, more powers than before. In the event, persistence of vested interests and the fractured political situation contributed to heightened uncertainty, complicated areas of reform implementation and gave rise to legislative initiatives running counter to the program's objectives. Some structural conditions were not met or were significantly delayed (VAT reform in agriculture, law to facilitate NPL resolution, amendments to NBU law), while implementation of regulatory streamlining and anti-corruption measures faced resistance. Notwithstanding smoother program

Figure 15. EMBIG Spreads (2013 – Present)

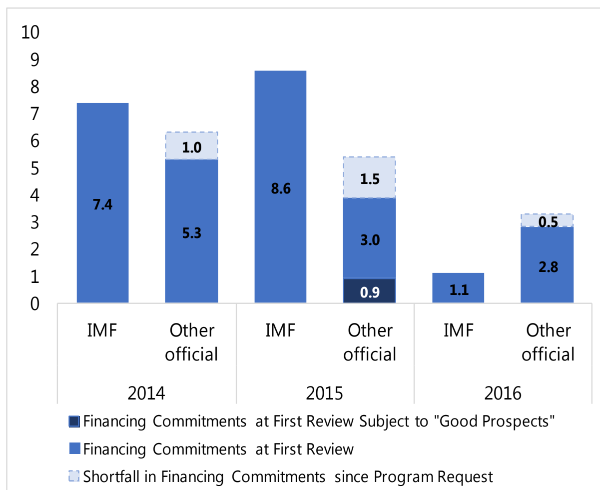
Sources: Bloomberg

policy implementation in other areas, in hindsight, this experience and the uncertain political preconditions cast some doubt on whether the "strong prospects for success" underpinning EA4 were met, especially at the time of the First Review when structural conditionality was set over the election cycle. Ukraine's case also raises the question of how to assess the prospects for program success when a country is in an active and uncertain conflict situation.

B. Were financing assurances and capacity to repay given due regard?

49. Financing assurances weakened as program risks materialized. The program was fully financed ex-ante under the baseline scenario, albeit with limited margins for deviations. However, at the First Review, a $3 billion shortfall in external financing was identified, including about $1.1 billion in the following 12 months, owing to delays in project implementation related to the conflict (Figure 16). The program was nonetheless assessed as adequately financed at that time on grounds of the revised market access assumption for late 2014 (see above section). It is debatable whether, at the First Review, such grounds represented firm financing commitments for the following 12 months, as required under the Fund's financing assurances policy.[6] Financing assurances for the remainder of the program also hinged on securing an additional $0.9 billion of bilateral support from donors and the estimated financing gap under the baseline scenario, while the prospects for covering significantly higher external financing needs in event of a prolonged conflict were not addressed.

Figure 16. Revisions to Financing Envelope, First Review (USD bill.)



Source: IMF Country Report No. 14/106 (Request) and 14/263 (First Review).
1/ Official financing excludes $1 billion Eurobond guarantee from the U.S. in 2014.

50. The potential adverse impact of the exceptional risks on Ukraine's capacity to repay could have been recognized more explicitly. Ukraine's capacity to repay was deemed adequate, with the assessment hinging on the baseline macroeconomic assumptions, as per usual practice, while recognizing "exceptional risks" to the Fund and Fund liquidity.[7] Given these exceptional risks, the analysis could have been usefully expanded to include the impact of the illustrative adverse

[6] At program approval and completion of each review, the Fund's financing assurances policy calls for (i) firm financing commitments to be in place for the next 12 months and (ii) good prospects for adequate financing for the remainder of the program.

[7] *Ukraine – Assessment of the Risks to the Fund and the Fund's Liquidity Position* (April 26, 2014).

scenario presented in the First Review on key repayment capacity indicators and Ukraine's ability to meet its obligations, including to the Fund.

PROGRAM DESIGN AND STRATEGY ISSUES

A. Program Design

Was the length and scope of the program appropriate?

51. **Program length needs to be guided by members' financing needs and should be sufficient to implement needed policies.** According to Fund policies, there should be no residual financing gap beyond the program horizon. The program also needs to allow sufficient time to implement the needed policies. In assessing the extent to which a program should focus on reforms, it is useful to consider whether the macroeconomic imbalances are symptoms of deep-rooted issues. As such, it would be important for programs to include reform elements where relevant, and allow for sufficient time for their implementation, recognizing that reforms can in some cases require advance work, TA, or be politically challenging. In addition, countries like Ukraine that have a poor track record of program performance need time to show commitment and policy action to mobilize external financing.

52. **The approved length and scope appear appropriate in this context.** The time-frame allowed planned policy adjustment to be reasonably paced in closing the financing gap and rebuilding reserve buffers. The SBA was comprehensive on policies, and while some reforms under the program could have been tackled later, such as adopting inflation targeting, the program was able to support the authorities in getting started on needed structural reforms, e.g. related to anti-corruption, the energy and banking sectors, laying the foundations for the broader structural agenda to be supported by the EFF, and helping to address deep-rooted weaknesses that give rise to macroeconomic vulnerabilities.

Was the macroeconomic framework too optimistic?

53. **The likelihood and severity of the various well-recognized risks would have warranted adopting a more balanced baseline scenario, especially by the First Review.** As discussed above, the program was predicated on the conflict being short-lived, with considerable downside risks surrounding the baseline macroeconomic outlook, supported by assurances from the international community that all key parties were committed to help restore peace and security as soon as possible. Against that background, it may not have been possible to predict the full extent of evolution of the conflict at that time, or reflect it in the baseline. At the same time, the staff reports recognized a number of other "very high" risks, including from the weak financial sector and domestic political uncertainty, which could have warranted more conservative assumptions. Moreover, with the conflict starting to escalate by the completion of the First Review, the baseline at that stage could have reflected these latest developments having a deeper impact on the economy, even if the conflict ended soon. In other words, in the EPE team's view, the pressing risks that were

mostly on the downside meant that the baseline was more of a best case scenario that had an increasingly lower likelihood of materializing.

54. A more conservative baseline would have in turn provided more buffers and improved the program's prospects of success. Putting aside the conflict, the baseline facing mostly downside and large risks meant that most deviations from the baseline could exhaust buffers and jeopardize program success, raising additional concerns over prospects for program success (EA4). A more conservative outlook could have allowed for adjusting program objectives without jeopardizing overall program success as risks materialized, though it would have required a larger financing envelope, which was not considered feasible at the time.

55. Instead, the baseline outlook was usefully complemented with an illustrative adverse scenario that helped set expectations in case the conflict intensified (Text Table 3). The adverse scenario presented in the First Review staff report showed that, should the conflict continue at its level of intensity at that time and hurts confidence, maintaining the SBA reserve targets would require an additional $19 billion in external financing through end-2015. The scenario helped communicate that such an event could not be accommodated under the SBA and would trigger fundamental changes to the program strategy.

56. The economic outturn was closer to country experiences with a combination of currency, banking and twin deficit crises (Box 4). Growth and exchange rate projections under the baseline were gauged based on the experience of currency crises in emerging markets (SBA Request, Figure 6). However, the crisis in Ukraine ended up being not just a currency crisis but also a sudden stop, banking and a twin deficit crisis during the 2014 SBA. Studies have found that sudden stops that require a fixed exchange rate regime to be abandoned can result in depreciations of 50-100 percent, depending on the circumstances. When currency crises are combined with banking crises, the economic downturn becomes more severe. Country experiences show that the output contraction in such cases can be 6-9 percent on average per year. Both sets of findings are close to Ukraine's experience.

Were downside risks sufficiently factored into the probability assessment of debt sustainability?

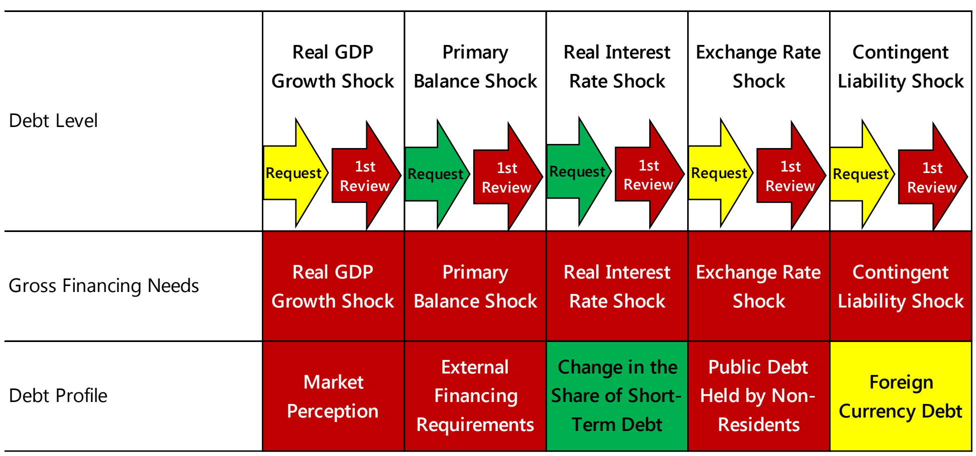
57. While various high risk scenarios and susceptibility to shocks were well-acknowledged, the *probability* analysis of debt sustainability did not sufficiently weigh these in. Notwithstanding the extensive discussion of risks, the reports did not adequately explain how they were accounted for in the probability analysis of debt sustainability. In fact, in the First Review, the DSA heat map, which summarizes risks to debt sustainability under various dimensions under the baseline scenario, looked very similar to those in the Ireland and Portugal programs where exceptional access was justified by invoking systemic exemptions because debt was assessed to be sustainable, but not with high probability (Figure 17). The adverse scenario in the First Review showed that the debt ratio would remain above the 70 percent risk threshold over the medium term if the conflict were to intensify. The reports should have integrated better the risk scenarios and DSA tools to provide a more comprehensive discussion of the impact of risks on the probability analysis of debt sustainability.

Text Table 3. SBA First Review Baseline vs. Adverse Scenario vs. Outturn [1/]

	2014			2015		
	Baseline	Adverse	Outturn [2/]	Baseline	Adverse	Outturn [2/]
Real GDP (percent change)	-6.5	-7.3	-6.8	1.0	-4.2	-9.0
Public finance (in percent of GDP)						
General government balance	-5.8	-7.3	-4.5	-3.9	-8.3	-4.2
Overall balance	-10.1	-11.6	-10.1	-5.8	-10.3	-7.3
Public debt (end of period)	67.6	68.9	71.2	73.4	83.2	94.4
Balance of payments (USD bill):						
Current account balance	-2.5	-0.6	-4.7	-2.5	0.1	-1.7
Gross reserves (end of period)	16.2	8.6	7.5	23.4	4.4	18.3
Total financing needs	9.0	16.6	5.1	11.0	30.0	20.0

Source: IMF Country Report No. 14/263 (SBA First Review) and 15/218 (EFF First Review).
1/ Based on Box 2 of First Review Under Standby Arrangement.
2/ Outturn is based on IMF Country Report No. 15/218 (EFF First Review). The 2014 financing needs outturn is notably lower than projected in large part due to lowered reserve accumulation targets. 2015 reserves include additional financing provided under the EFF.

Figure 17. Evolution of Heat Map from 2014 SBA Request to First Review



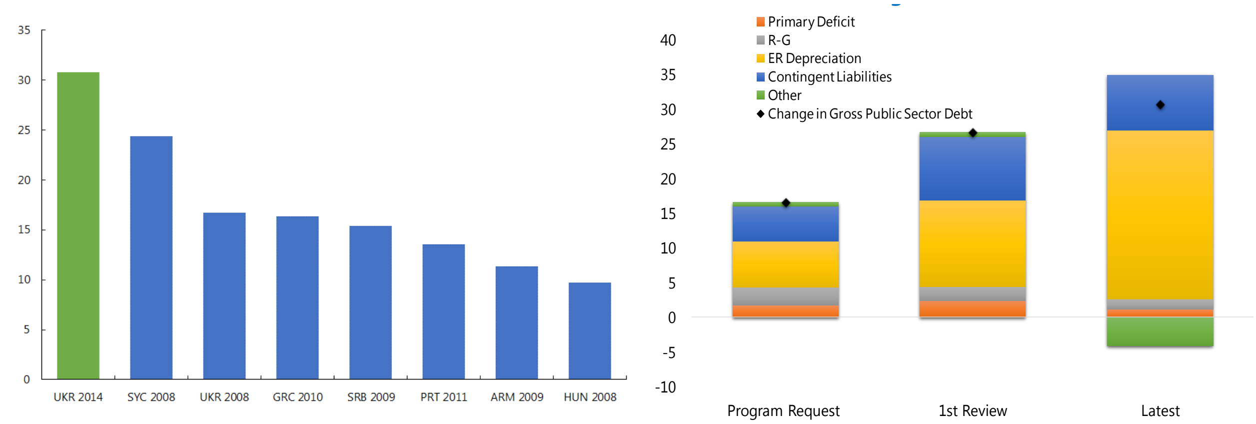
Source: IMF Country Report No. 14/106 (SBA Request) and 14/263 (SBA First Review).

58. In the end, public debt and financing needs overshot program projections by a significant margin. By end-2014, Ukraine's public debt was 15 percentage points higher than projected under the program and the latest estimates for the 2015 debt ratio are 30 percentage points higher than envisaged at that time (Figure 18). This puts the program at the highest debt surprise for crisis programs (among non-restructuring cases) following one year of the program approval. The change is explained mostly by the larger-than-expected hryvnia depreciation, i.e., 90 percent instead of the assumed 25 percent over the year. The depreciation added directly to public debt, as two-thirds was denominated in foreign currency. It also added to contingent liabilities by raising bank recapitalization needs and financing requirements for Naftogaz.

Figure 18. Changes to 2014 Public Debt

Debt Surprise 1-Year After Program Approval (in percentage points)

Contributions to Change in 2014 Public Debt (in percent of GDP)

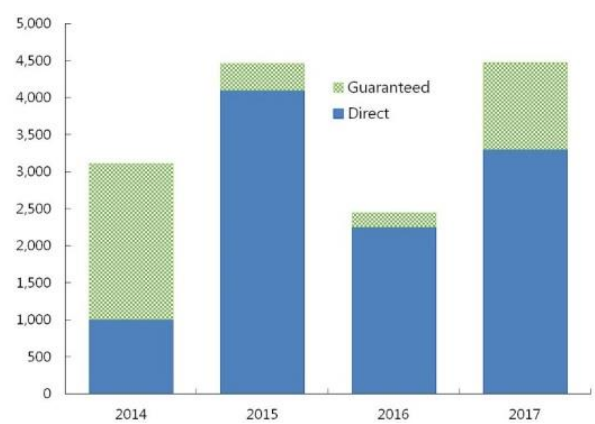


Source: IMF Staff Estimates.

B. Program Strategy

59. As Ukraine's public debt was deemed sustainable with high probability and there were no residual financing gaps, a debt operation was not undertaken at the outset of the program. NBU holding of about 30 percent of public debt was seen as a mitigating factor to rollover risks. And at the time of the First Review, with only US$2 billion maturing in external public and guaranteed debt for the remainder of 2014, the benefits of a debt operation were considered to be rather low against the perceived risks to market confidence.

Figure 19. Amortization of Public Debt Held by External Private Creditors (in US$ million)



Sources: IMF Staff Estimates.

1/ Includes Naftogaz Eurobond.

60. An early debt reprofiling operation would nonetheless have provided useful liquidity relief during the program, at a time of exceptional uncertainties and large financing needs. A reprofiling operation that extended maturities of the privately-held external debt that was maturing over the program period, i.e. about US$3 billion and US$4.4 billion for 2014 and 2015 respectively, would have reduced near-term financing needs (Figure 19). This would have provided additional liquidity buffers and improved debt sustainability, as well as allowed for lower fiscal adjustment and/or lower financing from the Fund, when the country was facing severe economic, financial, political and geopolitical risks, and financing needs were large (Box 3).[8] An early reprofiling would have provided immediate liquidity relief, while also preserving the option of future operations, if needed. In fact, by the time the debt operation was completed in September 2015, public debt had risen by an additional 20 percentage points and had become a solvency issue. The operation therefore ended up being a restructuring that was larger and also covered more debt instruments (state enterprises' non-guaranteed debt).

Could energy prices have been hiked faster?

61. Given the distance from import parity, faster tariff increases, including scheduled future increases linked to the exchange rate, would have been fiscally prudent, but may have been socially difficult. Tariff levels are a politically and socially sensitive issue in Ukraine, and a more aggressive approach could have undermined support for the program. For this reason, the program rightly targeted annual increases toward the end of each heating season, allowing households time to internalize the higher tariffs before the next heating season. A larger upfront increase would have reduced energy-sector vulnerabilities more quickly, but may also have led to higher inflation and lower growth by depressing household disposable income.

62. Going forward, it would be useful to invest more in cultivating public ownership for energy sector reforms in Ukraine. Energy sector reforms have been attempted and failed in earlier programs, being one of the most unpopular policies. However, as the 2013 Article IV Staff Report clearly demonstrates, the tariff structure is regressive, distortionary, and creates arbitrage opportunities. Most benefits accrue to high income households, with lower income households spending a larger share of their income on gas and heating. The resulting fiscal burden from low tariffs is a key source of vulnerability to the Ukrainian economy. Furthermore, social assistance programs provide targeted relief from higher tariffs to make the burden more equitable, bolstering public support for the tariff increases. This all points to the importance of garnering support from the general public for energy sector reforms.

Could banking sector diagnostics have been done sooner and with a greater emphasis on bank ownership?

63. Improving transparency in the banking sector had typically been an area of slow progress, and the program prioritized more urgent issues. The 2010 SBA had focused on the need to have a clear picture about the true ownership of banks but had failed to make the needed

[8] Under the modified EA policy, an assessment at the time of the SBA's approval that Ukraine's debt was sustainable, but with uncertainty as to whether it was sustainable with high probability, could have categorized Ukraine as a "gray case". This could have enabled a re-profiling (i.e., an extension of maturities during the program period), assuming that all other elements of the modified EA policy were also met.

progress. The concern on banking sector ownership was not a priority area for the 2014 SBA from the outset; the program instead focused on the more urgent need to improve resilience of bank balance sheets to depreciation. Had the issue been highlighted earlier, perhaps the initial AQR could have allowed an earlier start in arresting connected lending that has subsequently been identified as the greatest weakness of Ukraine's financial sector. In any event, and as the meager progress of the previous program suggests, the administrative difficulties faced by NBU may have been a great constraint. In these circumstances, the program could have been more sanguine on what could be expected on banking regulation and supervision and on other areas supervised by NBU.

Could capital controls have been brought in sooner and made more stringent?

64. Capital controls need to be considered in the context of the overall policy stance and structure of the economy. The program's initial stance included gradually unwinding exchange restrictions and capital controls, including those that breached Article VIII. It was envisaged that with successful program implementation (and in the absence of shocks), easing controls would be a confidence-building signal, intended to reduce deposit outflows and stem capital flight. The easing was premature as subsequent shocks and further tightening of controls demonstrated. The tightening did not fully bring about the desired effect either. As noted in the Fund's institutional view on capital flow management, controls "appear to be more effective if they accompany sound macroeconomic policies, are well designed and enforced, and are part of a comprehensive policy package."[9] Several of these conditions were missing in 2014, as also discussed in the earlier sections. Specifically, effective controls would have warranted a much tighter monetary stance, implying overcoming fiscal dominance or much higher market interest rates, as well as overcoming administrative challenges to implementing controls so as to tax powerful interest groups that own most banks.

CONCLUSION AND LESSONS FROM THE 2014 SBA

A. Conclusion

65. The 2014 SBA placed a lot of faith in the conflict not escalating and the new government's capacity to deliver policies. Program success hinged on the assurances from the international community to help restore peace and security, and continue supporting Ukraine. The authorities also stated a strong commitment to tackle difficult reforms, though it was not clear whether they had the majority support to sufficiently overcome vested interests.

66. Despite the fragile political equilibrium, meaningful and difficult reform steps were taken under the program. The first stage of energy tariff increases was implemented successfully together with commendable progress in improving Naftogaz governance and finances. A flexible exchange rate was maintained, albeit with occasional sizeable interventions. In the financial sector,

[9] See "The Liberalization and Management of Capital Flows: An Institutional View" (November 4, 2012) and "Managing Capital Outflows—Further Operational Considerations" (December 2015).

tangible steps were taken to identify weaknesses in banks and several were decisively resolved. The authorities' comprehensive diagnostic study on corruption and governance helped lay a strong foundation for reforms.

67. Policy and reform implementation was nonetheless uneven, raising questions about the influence of vested interests at a time when political uncertainty ensued. Fiscal consolidation began, and the outturn was even better than targeted, but in part due to low quality and one-off measures. The 2014 SBA also aimed at a broader set of governance and business environment reforms, which were going to be difficult regardless of the external environment. And indeed, by December 2014, only half of the end-October structural benchmarks had been met, some were delayed, and some faced resistance in implementation. With the macroeconomic situation deteriorating, delays in program implementation on the structural reforms front became less visible, but were evidence of waning ownership and continuing influence of vested interests.

68. In the end, while the SBA was short-lived and did not achieve many of its goals, it served as an anchor for economic policies in a difficult and uncertain economic and political situation. Assurances to restore peace and security ultimately proved insufficient and the conflict lasted longer and had a deeper impact on the economy. The domestic political scene also changed more than expected at the outset, with a new parliament coming into office only by the end of the year. During this time, important policy steps and structural reforms were taken. Moreover, the program helped garner international support for Ukraine at a critical time and possibly prevented worse outcomes. A number of unfinished agenda items, e.g., on energy, banking and governance reforms, are being followed through in the current extended arrangement.

B. Lessons

69. With the benefit of hindsight, Ukraine's experience offers the following lessons for future Fund engagements, including with Ukraine:

- **In active conflict situations, having a well-developed and realistic adverse scenario and contingency plans is critical.** In such active conflict cases, risks to the baseline outlook might be tilted to, or as in Ukraine's case, almost exclusively on the downside. This implies that, in the EPE team's view, the baseline is more of a best case scenario, where any deviation is likely for the worse, by definition, rendering any analysis calibrated on the baseline subject to high risks. Elaborating on downside scenarios before risks materialize can usefully allow for contingency plans to be developed in less politicized environments. A probabilistic baseline, with analyses of key macroeconomic indicators' sensitivity to the main risks (e.g., fan charts for each variable), could be useful to that end.

- **Programs in countries with recurring economic crises should not hold back from pursuing structural reforms, though these need to be carefully prioritized.** As the 2013 Article IV Staff Report (IMF Country Report No. 14/145) noted, Ukraine entered 2014 with a potent mix of vulnerabilities and low buffers that had resulted, in large part, from unsustainable energy, macroeconomic and exchange rate policies, motivated by preserving vested interests. When faced with urgent financing needs, short-term macroeconomic stabilization is certainly critical. But such limited scope programs, as recommended by the 2008 and 2010 EPEs, are not necessarily desirable; any macroeconomic stabilization is not likely to be sustainable if authorities' program objectives do not include tackling the economic structures that give rise to these vulnerabilities. Even in the face of conflicts, the structural agenda should not be sacrificed; rather, it should be prioritized more stringently. Ukraine's 2014 SBA started useful progress on key structural reforms, which set the stage for the EFF to continue with them; this would not have been possible with a short-term program aimed only at stabilizing the economy.

- **It would be useful to develop guidance on integrating risks to the outlook into a bottom line assessment regarding the probability of debt sustainability.** The current DSA framework includes a number of useful stress tests and realism checks, but they remain as standalone pieces and as a result there is considerable room for interpretation in coming up with a bottom line assessment on probability. It would be useful to develop guidance on translating the risk analyses and other relevant factors into the probability of sustainability to inform the exceptional access criteria assessment, while still leaving some room for judgment. Tools that the Fund staff has been developing to help assess the probability that debt is sustainable would be a key contribution to this end.

- **It would be worthwhile to consider developing guidance on assessing a program's prospect for success for EA4.** Track record with earlier programs can be an important indicator, since it reflects deep rooted problems that cannot be addressed easily. At the same time, basing the assessment solely on track record may not give due consideration to new governments with new policy agendas and mandates from the general public. Staff should consider how the forward-looking evaluation of EA4 could more systematically draw on a deeper understanding of the political and social context, including factors such as proximity of elections, the existence and stability of a reformist majority in parliament, fragility of the state (e.g. in conflict or not), the evolution of the political influence of vested interests as well as technical assistance provided to-date.

AUTHORITIES' VIEWS[10]

70. The authorities generally appreciated the Fund's prompt response to the crisis in early 2014. The authorities noted that the approval of the SBA had a positive impact on sentiment and garnered international support at a critical time while providing impetus to important reforms through conditionality.

71. They broadly considered that the program objectives were rightly calibrated, while noting some aspects that could have improved the outturn. Some argued that financing needs

[10] Based on views expressed during the EPE team's staff visit to Kiev in March, by the authorities in office then and earlier, including in the Prime Ministry, the NBU, Ministry of Finance and Ministry of Economy, as well as by counterparts in Naftogaz and the private sector.

were underestimated, reflecting the underestimated effects of the conflict on the economy and the severity of the inherited imbalances. Others indicated that the reform agenda should have been more ambitious and front-loaded, taking advantage of the post-revolution environment of change, to tackle critical reforms on the energy and pension fronts. Overall, the authorities' views varied on whether the program sufficiently addressed Ukraine's deep-rooted structural problems or effectively restored macroeconomic stability at a critical time.

72. While views differed on whether intensification of conflict could have been foreseen, the authorities agreed that the Fund should have reacted more swiftly to the deteriorating situation. The authorities generally concurred that the program strategy should have been changed by the time of the First Review (July-August) when it had become clear that the conflict would last longer and have deeper effects on the economy, including on trade, military spending needs, confidence, and ultimately, financing needs. They noted that the delay in moving to the EFF contributed to reserves dropping to critical levels and the exchange rate depreciating significantly in the interim, weakening the economy further.

73. The authorities noted that not pursuing an earlier debt operation, upon the Fund's recommendation, and the Gazprom payment, placed considerable strain on the economy. The authorities explained that, at the time of the SBA program negotiations, they initiated discussions with private creditors to undertake a debt reprofiling deal, which included $2 billion in additional financing. The operation was not pursued, following the IMF recommendation, but this is now seen as a missed opportunity to regain market access and prevent a liquidity problem from becoming a solvency problem. Furthermore, they noted that the Gazprom payment, a prior action for the First Review, was untimely as reserves were already under sizeable pressure due to capital outflows and domestic political uncertainty. Meanwhile, the promised financing from IFIs for winter gas purchases did not materialize within the initially envisaged timeframe due to unforeseen technical details, resulting in a 9-months delay.

74. On specific program policies, the authorities had the following observations:

- *Monetary and Exchange Rate Policy*: The authorities pointed out that while the program targeted a tight monetary stance, the monetary targets ended up being too loose, allowing the fiscal deficit to be monetized and reserves to fall to uncomfortably low levels. While views differed on whether the move to inflation-targeting in mid-2015 was too ambitious, the authorities agreed that the objective was useful as a basis for abandoning the fixed exchange rate regime. The NBU noted that the transmission mechanism of the interest rate policy was not effective due to the vulnerabilities in the banking sector. On capital controls, the authorities and private sector members criticized the Fund's market approach to the escalating conflict and argued that the comprehensive and tight capital controls introduced in February of 2015 should have been introduced earlier in 2014.

- *Financial Sector Policies*: The authorities were critical of the program's target of providing emergency liquidity assistance to banks which they believed placed considerable strain on an-already depreciating currency and contributed to capital flight and deposit outflows. They were also highly critical of the quality of the AQR conducted by the independent auditors but noted that it provided the groundwork to build the institutional infrastructure within NBU to properly conduct banking sector diagnostics leading to more effective subsequent AQRs and some progress on the related-party lending problem.

- *Fiscal and Energy Sector Policies*: While the authorities agreed with the fiscal tightening objectives of the program, they cautioned against adopting unpopular measures with low yield, such as freezing pensions and minimum wages. On tariffs, the NBU and Naftogaz would have preferred faster tariff increases under the program, but the Ministry preferred the gradual approach of the program to avoid straining the accompanying subsidy scheme.

75. The authorities emphasized the need for contingency planning in a conflict situation and suggested a number of takeaways for future engagements. They recommended that the Fund be "flexible and creative" in reacting to unconventional circumstances such as an escalating conflict. They gave as examples collaborating more with other partners, market analysts and experts in areas where the Fund lacks expertise, and rethinking following a market approach in a conflict situation, and having contingency plans in place. The authorities and private sector members saw a need for the Fund to closely study the political environment, engage different factions, and communicate the benefits of reforms more widely to the general public to strengthen ownership. They also found strict conditionality useful and suggested even or back-loaded programs to maintain reform momentum.

Box 1. Key Findings of Ukraine's Prior Ex Post Evaluations/Assessments

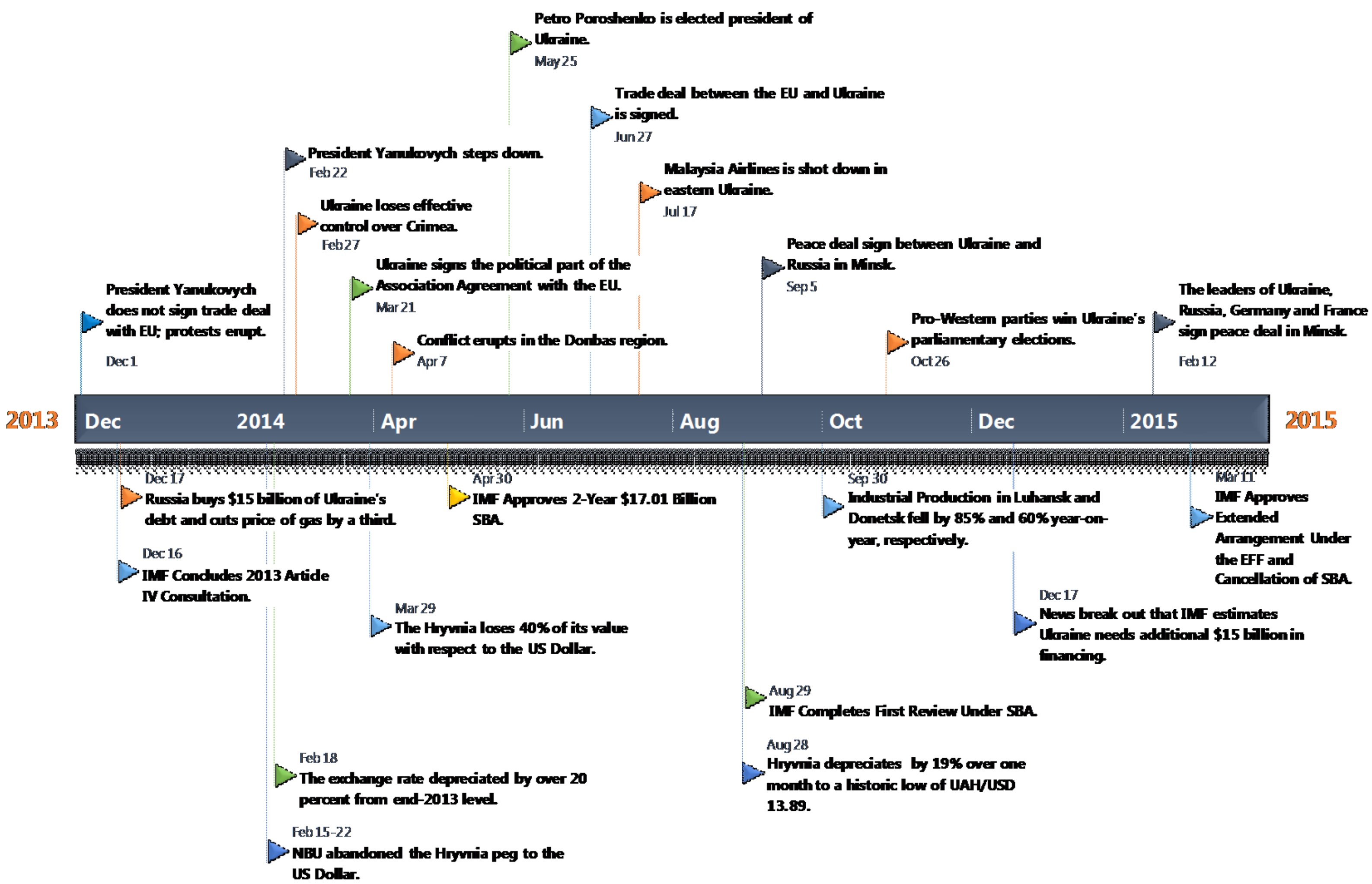
A common thread running through evaluations of prior Fund arrangements with Ukraine is their broad success in achieving short-term stabilization objectives but failure to gain traction in reforms to address key medium-term vulnerabilities. The evaluations reveal a history of incremental but ultimately incomplete progress in key reforms, particularly in areas of exchange rate flexibility, energy and banking sectors and governance, while highlighting long-standing difficulties in addressing weak program ownership and strong vested interests. Stepwise achievements under the programs are often associated with strong upfront conditionality, although this has not always assured success. Given the poor track record, the 2010 and 2008 ex-post evaluations suggested shorter future arrangements with less ambitious medium-term reform agendas. In turn, following a period of successive shorter arrangements, the 2005 ex-post assessment recommended longer Fund engagements to guide more medium-term institutional reforms.

The 2010 SBA Ex-Post Evaluation found the program helped restore market access and made some headway in eliminating preferential energy tariffs, strengthening central bank independence and pension reform, but failed to make progress in the areas of exchange rate flexibility, energy price adjustment as well as bank and NPL resolution. The evaluation largely attributed the program's successes to prior actions, while also suggesting that smaller and shorter arrangements focusing on most critical issues may have better odds of success in cases with poor track record of reform implementation. The evaluation also suggested a mechanism for automatic termination of GRA programs if no review was completed within a short grace period.

The 2008 SBA Ex-Post Evaluation found the program helped prevent a financial meltdown amidst the global crisis by supporting an exchange rate adjustment, cushioning an even sharper demand shock and influencing some policy proposals that may have worsened economic distortions. However, no major shift in policy making occurred under the program and absence of sustained reform drive left large vulnerabilities and distortions in place. On strengthening ownership, the evaluation found that prior actions had facilitated progress in some but not all areas, while less front-loaded access could have helped policy incentives. The evaluation also noted that a shorter program horizon may have better reflected political realities, been more explicit of the program's crisis management-focus and have helped front-load the program design in line with financing. It further highlighted the merit of consolidated monitoring of fiscal and quasi-fiscal accounts and underscored criticality broad donor support and engagement.

The 2005 Ex-Post Assessment of Longer Term Program Engagement found Fund-supported programs successful in redirecting focus of monetary and fiscal policies to macroeconomic stability objectives, but lack of reform-oriented political consensus hindering more sustained reforms toward a market-oriented macroeconomic framework. For future Fund engagements, the assessment underscored the need of strong program ownership and political support and streamlined structural measures focused on critical institutional bottlenecks. The assessment also suggested that addressing Ukraine's medium-term challenges warrants consideration of program horizons longer than one year, with prior actions serving a key role in building a track-record.

Box 2. Timeline of Key Events for 2014 SBA



Box 3. Ukraine's 2015 Debt Operation

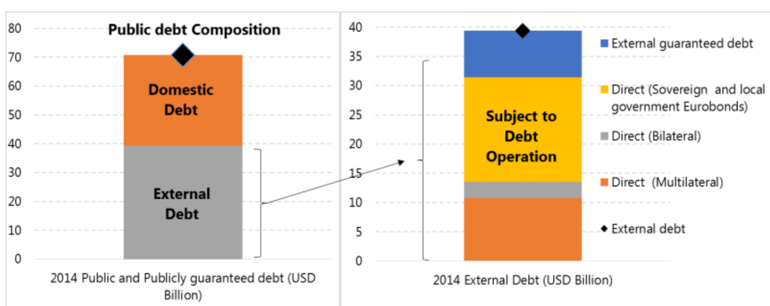
By the end of 2014 it became clear that debt was unsustainable. As downside risks materialized and public debt to GDP surprised by about 30 percentage points as compared to the March 2014 SBA request together with ballooning financing needs, it became clear that the debt path was unsustainable.

The EFF that succeeded the 2014 SBA required undertaking a debt operation that would restore debt sustainability. Restoring sustainability was needed to justify the second exceptional access criterion under the Fund's lending framework. The sovereign debt exchange offer was launched on September 22. Elements of the operation are still under discussion.

Objectives of the debt operation included: (i) generate about US$15 billion in public sector financing during the program period; (ii) bring the public and publicly guaranteed debt/GDP ratio from a projected pre-operation 79.2 percent of GDP to under 71 percent of GDP by 2020; and (iii) keep the budget's gross financing needs at an average of 10 percent of GDP (maximum of 12 percent of GDP annually) in 2019–25. The debt operation also needed to reduce gross financing needs during the EFF program period (2015–18), from an average of 18 percent of GDP to 12 percent.

The debt perimeter, about $18 billion, included foreign-currency denominated debt held by private external creditors (Figure B3.1). This included Eurobonds and commercial loans. Domestically held foreign-currency denominated debt was not included on the basis of potential costs to the banking system, which may have increased recapitalization needs and therefore further incur a fiscal cost.

Figure B3.1. Composition of External Debt under Debt Operation



Source: IMF Country Report No. 14/106 (Request) and 14/263 (First Review)

Ukraine's agreement with private external creditors included the following terms:

(i) 20 percent nominal haircut;
(ii) maturities extended to 2019–27 (versus 2015–23 under existing instruments);
(iii) coupons of 7.75 percent (versus a pre-exchange average of 7.2 percent);
(iv) a value recovery instrument (a GDP growth warrant), providing potential payments to participating bondholders from 2021-40 if nominal GDP is above US$125.4 billion and real GDP growth is above 3 percent (with payments capped at 1 percent of GDP only during 2021–25).

Box 4. Ukraine: Comparable Crisis Episodes

Ukraine was facing a sudden stop, accompanied by a currency, banking and a twin deficit crisis during the course of the 2014 SBA. Inconsistent macroeconomic policies had produced a potent combination of an overvalued pegged exchange rate, large and growing twin deficits, a weak banking system and very low buffers. Domestic political turmoil followed by conflict in Crimea and Eastern Ukraine unanchored expectations and led to rapid capital outflows. With reserves being depleted to dangerous levels, NBU abandoned the de facto currency peg in February 2014. This contributed to further weakness at banks and added to fiscal pressures, while the current account deficit remained large as trade with Russia plummeted after the conflict began. The resulting exchange rate depreciation over 2014 was about 90percent and real GDP contracted by 6.8 percent. Over 2015, the hryvnia broadly stabilized but the economy is estimated to have contracted by another 9 percent.

Literature suggests that a sudden stop that induces a floating regime, as in Ukraine, can result in depreciation of 50-100 percent. Cavallo et. al. (2005) find that collapses of fixed exchange rate regimes typically follow a sudden stop of capital inflows and a sharp short-run overshooting of nominal (and real) exchange rate well above fundamental values.[1] In addition, they find that countries entering a crisis with high levels of foreign debt tend to experience large real exchange rate overshooting, estimating REER total depreciation across 24 crisis episodes in 1990s as 54.5 percent. Rebelo and Vegh (2001) identify 51 crisis episodes in which the fixed exchange rate regime was abandoned and estimate the average change in exchange rate as 98.6 percent.[2] Hagiwara (2005) estimates that the nominal exchange rate depreciation of countries that abandoned a fixed exchange rate system following a sudden stop experienced on average a of 50.4 during a sudden stop, and greater than 50 percent in the first year.[3]

Studies have shown that currency and banking crises combined can result in economic contractions of 6-9 percent on average per year, similar to Ukraine's experience. Kaminsky and Reinhart (1998) find that the economic fundamentals are more severely hit when a currency crisis occurs together with a banking crisis (the currency crisis deepens the banking crisis leading a vicious circle) and resulting in an output loss of 8 percent on average.[4] Hutchinson and Noy (2005) find in a sample of emerging economies from 1975-97 that currency and banking crises contribute over a 2-4 year period to an output contraction of 5-8 percent and 8-10 percent, respectively which suggests a combined output loss for Ukraine of 6.5-9 percent in the first year.[5] Aziz et. al. (2000) find in a sample of 39 banking and currency crises in emerging market economies that cumulative output loss averages 11.7 percent for contractionary crises (71 percent of sample) and 8.3 percent for all crises over an estimated 1.9 years recovery time, which suggests an output loss of 4.4-6.2 percent per year.[6] Bordo (2006) finds that average output loss for sudden stops accompanied by a financial crisis is 6.25 percent based on a sample of emerging markets from 1980-97.[7] Hutchinson et al. (2010) estimate that average cumulative output loss as 9.2 percent in a sample of 83 sudden stop episodes across 66 emerging and developing countries from 1980-2003.[8] In light of the escalating geopolitical crisis, it could be argued that a more conservative GDP estimate would have entailed a sharper than average contraction.

Box 4. Ukraine: Comparable Crisis Episodes (concluded)

[1/] Cavallo, M., Kisselev, K., Perri, F., and Roubini, N. (2005). "Exchange Rate Overshooting and the Costs of Floating." New York University.

[2/] Rebelo, S., and Vegh, C. (2001). "When Is It Optimal to Abandon a Fixed Exchange Rate?" National Bureau of Economic Research.

[3/] Terada-Hagiwara, A. (2005), "Explaining the Real Exchange Rate during Sudden Stops and Tranquil Periods", Discussion Paper No. E-15, Institute for Monetary and Economic Studies, Bank of Japan, Tokyo.

[4/] Kaminsky, G., and Carmen M. R. (1996). "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems," International Finance Discussion Paper No. 544 (Washington: Board of Governors of the Federal Reserve System).

[5/] Hutchinson, M., and Han N. (2005). "How Bad are the Twins? Output Costs of Currency and Banking Crises." Journal of Money, Credit and Banking.

[6/] Aziz, J., Caramazza, F., Salgado, R., 2000. "Currency Crises: In Search of Common Elements." IMF Working Paper No. 00-67.

[7/] Bordo, M. D. (2006). "Sudden Stops, Financial Crises, and Original Sin in Emerging Countries: Déjà vu?" National Bureau of Economic Research.

[8/] Hutchinson, M., Noy, I., Wang, L. (2010). "Fiscal and Monetary Policies and the Cost of Sudden Stops." Journal of International Money and Finance 29 (6), 973–987.

Table 1. Structural Conditionality under the 2014 SBA			
Prior Actions and Structural benchmarks at Program Request: April 30, 2014			
Prior Actions	**Type**	**Status**	**Deadline**
Government will approve a package of revenue and expenditure measures yielding at least UAH 45 billion in and implement them by passing a supplementary budget.	Fiscal	Met	30-Apr
Parliament will pass a reversal of the already introduced VAT rate reduction in 2015 and keep the rate at 20 percent.	Fiscal	Met	30-Apr
Parliament will pass an extension in the recently expired VAT exemption regime for grain exporters until October 1, 2014.	Fiscal	Met	30-Apr
The NBU will adopt a regulation specifying that the official exchange rate is calculated as a weighted average of rates on the same day's interbank transactions.	Monetary	Met	30-Apr
The NBU will instruct the largest 35 banks to launch diagnostic studies on the basis of end-December 2013 data and terms of reference developed by the NBU.	Financial	Met	30-Apr
The NBU will repeal Resolution 109 and announce a specific timetable, agreed with IMF staff, for gradually unwinding banks' net open foreign exchange positions, beginning May 1, 2014 and concluding in 20 months.	Financial	Met	30-Apr
The NBU Council will establish an independent audit committee with a well-defined mandate to provide close oversight of the financial reporting, audit processes and system of internal controls at the NBU.	Financial	Met	30-Apr
We will ensure that: (i) the gas price regulator NERC will adopt and officially publish a decision to raise end-user gas tariffs for households by 56 percent, effective May 1, 2014; (ii) similarly the utility price regulator NURC will adopt decisions to raise the heating tariffs for households by 40 percent on average, effective July 1, 2014.	Energy	Met	30-Apr
We will also publicly announce the decision and schedule for tariff increases through 2017, where the schedule will include the following: (i) in 2015, we will raise end-user gas and heating tariffs by 40 percent on average, effective May 1; and (ii) thereafter we will raise these tariffs by 20 percent on average each year, effective May 1, until losses of Naftogaz are eliminated by 2018.	Energy	Met	30-Apr
To ensure de-politicization of tariff setting, Parliament will pass legislation to vest NURC with the exclusive authority to set heating tariffs in the country.	Energy	Met	30-Apr
To protect vulnerable households not covered by the existing scheme, Government will approve a decision to introduce a new social assistance scheme, as described in ¶23.	Energy	Met	30-Apr

Table 1. Structural Conditionality under the 2014 SBA (continued)			
Prior Actions and Structural benchmarks at Program Request: April 30, 2014			
Parliament will pass a new public procurement law to strengthen governance and checks and balances, including reducing exemptions from regular competitive procedures.	Governance	Met	30-Apr
Structural Benchmarks			
After discussion within government and with the private sector, we will prepare a proposal for the reform of VAT in agriculture with a view to bringing the regime in this sector closer to the general VAT regime.	Fiscal	Met with delay 1/	30-Sep
Complete diagnostic studies and review of business plans for the 15 largest banks, as described in ¶15.	Financial	Met	31-Jul
If existing fit and proper shareholders are unwilling or incapable of recapitalizing in full a weak bank, public funds could be used to bring it back into solvency, according to strict criteria. Government and the NBU will reach agreement with IMF staff on these criteria.	Financial	Met with delay, 4-Jul	31-May
The government should be prepared to manage its financial sector shareholdings in the event that it is called on to use public funds—and to this end, a specialized unit will be set up at the Finance Ministry.	Financial	Met	30-Sep
To provide an accurate picture of Naftogaz finances, Naftogaz will launch a tender by April 3 to conduct audits of Naftogaz operations, led by an external auditor. The auditor will be in place within 60 days of the tender. The results of the audits will be shared with the IMF within 30 days of each period, initially on a monthly basis beginning with data for end-May 2014, and then on a quarterly basis for end-September data forward.	Energy	Met with delay, 8-Jul	30-Jun
To strengthen payment discipline for the heating sector, Parliament will pass legislation that will make distribution accounts fully operational and mandatory for utility payments.	Energy	Met	30-Jun
Complete a comprehensive diagnostic study in close consultation with IMF staff that will cover the anti-corruption framework, the design and implementation of key laws and regulations that may have impact on business climate, the effectiveness of the judiciary, and tax administration, as described in ¶25.	Governance	Met	15-Jul

Table 1. Structural Conditionality under the 2014 SBA (concluded)

Prior Actions and Structural benchmarks at First Review: August 29, 2014

Prior Actions	**Type**	**Status**	**Deadline**
Parliament will pass a supplementary budget, reflecting: (i) the new tax policy and expenditure measures (¶17) and (ii) the funds necessary to recapitalize Naftogaz (¶23).	Fiscal	Met	29-Aug
The NBU will achieve a level of NIR of at least US$7.675 billion by accumulating at least US$200 million through market purchases (¶5).	Monetary	Met	29-Aug
After the completion of Naftogaz's recapitalization procedure, the company will deposit US$3.1 billion in a restricted account with the NBU (¶23).	Energy	Met	29-Aug
The government will take a formal decision to establish by end-August an authorized body accountable to the Cabinet of Ministers to coordinate the effort to simplify regulations (¶24).	Governance	Met	29-Aug
Structural Benchmarks			
The NBU will prepare draft legislative amendments to the NBU Law to strengthen the governance and autonomy framework of the NBU, in line with the recommendations of the safeguards assessment mission.	Monetary	Met with delay, Feb-2015	31-Dec
Parliament will adopt a law to facilitate NPL resolution and help prevent new NPLs, as described in ¶14.	Financial	Not met	30-Sep
Prepare a monthly collection plan for Naftogaz's receivables for September 2014–December 2015, with targets by customer group.	Energy	Met	31-Aug
Submit to Parliament draft law for the establishment of an independent anti-corruption agency with broad investigative powers	Governance	Met	1-Sep
Adopt enabling legislation for the establishment of an independent anti-corruption agency with broad investigative powers.	Governance	Met with delay, 25-Feb 2/	31-Oct
Submit to Parliament amendments to the AML law and the criminal code that will introduce key elements of the FATF standard to support the government's anti-corruption effort.	Governance	Met with delay, 11-Sep	1-Sep
Adopt amendments to the AML law and the criminal code that will introduce key elements of the FATF standard to support the government's anti-corruption effort.	Governance	Met	31-Oct
The government will adopt an action plan to eliminate, streamline, simplify and clarify the legislative and regulatory frameworks governing economic activity.	Governance	Not met	31-Oct

1/ Met on the basis of compensatory measures in revised 2015 budget following rejection by Parliament of a proposal agreed with Staff in December 2014.

2/ Amendments were needed to original legislation approved by Parliament in 2014 to meet compliance with the benchmark.

Table 2. Ukraine: Quantitative Program Targets and Projected Performance 1/

(End of period; millions of Ukrainian hryvnias, unless otherwise indicated)

(End of period; millions of Ukrainian hryvnias, unless otherwise indicated)

	2014										
	March	May			July			September		December	
		PC	Adj. PC		PC	Adj. PC	Est.	IT	PC	IT	PC
I. Quantitative performance criteria											
Ceiling on the cash deficit of the general government (- implies a surplus) 2/	4,732	31,000	25,211	5,193	47,500	36,252	34,000	59,000	64,000	78,000	88,000
Ceiling on the cash deficit of the general government and Naftogaz (- implies a surplus) 2/	4,685	44,700	10,371	14,791	69,200	3,895	48,700	94,800	130,305	128,500	153,349
Floor on cumulative change in net international reserves (in millions of U.S. dollars) 3/ 4/	10,998	-1,273	849.0	849.0	1,096	311	-223	266	-3,780	-687	-3,755
Ceiling on cumulative change in net domestic assets of the NBU 3/ 4/	208,588	36,383	14,523	4,611	21,292	39,379	31,082	29,685	83,638	51,527	104,349
Ceiling on publicly guaranteed debt 2/	0	25,000		0	25,000		0	25,000	25,000	25,000	25,000
II. Continuous performance criterion											
Non-accumulation of new external debt payments arrears by the general government 2/	0	0		0	0		0	0	0	0	0
III. Indicative Targets											
Ceiling on cumulative change in base money 3/	329,061	22,438		13,912	33,303	38,503	28,645	32,593	42,233	44,003	63,211
Ceiling on net accumulation of VAT refund arrears 5/	8,545	0		2,150	0			-2,500	-5,000	-5,000	-10,695
IV. Memorandum Items											
External project financing 2/	317	2,800		414	5,000		1,300	15,500	2,300	31,400	4,700
NBU loans to DGF and operations with Government bonds issued for DGF financing or banks recapitalization 3/	0	0		0	0		5,200	0	5,200	15,000	28,700
Government bonds issued for banks recapitalization and DGF financing 3/	0	0		0	0		0	0	0	15,000	23,500
Stock of budgetary arrears on social payments 2/	0	0		21	0		0	0	0	0	0
Programmed disbursements of international assistance except IMF (millions of U.S. dollars) 3/ 4/	29	1,150		1,898	4,746		2,587	5,786	5,544	6,286	6,826
Percent of it applied to adjustment	...	100		100	100		100	75	100	75	100
Naftogaz purchases of foreign exchange from the NBU for the purposes and in the event of paying gas supply bills and repaying currently disputed arrears to Gazprom as well as the Eurobond issue maturing in September 2014 (millions of US dollars) 3/	813	2,160		786	2,160		786	3,830	5,556	4,830	6,935
NBU purchases of T-bonds Issued by Government for Naftogaz recapitalization 3/	11,100	23,662		10,000	23,662		12,900	41,956	75,100	52,911	104,400
Financing by multilateral institutions and official bilateral creditors disbursed to Naftogaz for investment projects 2/	0	0		0	0		0	0	0	0	0
Net transfers made by Gazprom (advance transit fee) 2/	0	0		0	0		0	0	0	0	0
Estimated arrears to Gazprom for gas imports (millions of U.S. dollars) 6/ 7/	2,238	0		2,449	0		4,469	0	4,469	0	0
Ceiling on bonds issued to pay VAT refund arrears (VAT bonds) 2/	0	16,700		0	16,700		5,800	16,700	16,700	16,700	16,700
Program exchange rate, Hryvnia per U.S. dollar	10.9546	10.9546		10.9546	10.9546		10.9546	10.9546	10.9546	10.9546	10.9546

Sources: Ukrainian authorities; and IMF staff estimates and projections.

1/ Definitions and adjustors are specified in the Technical Memorandum of Understanding (TMU).

2/ Targets and projections are cumulative flows from end-December, 2013. Data for March are flows from end-December, 2013.

3/ Targets and projections are cumulative flows from April 1, 2014. Data for March are stocks as of end-March, 2014.

4/ Calculated using program exchange rates specified in the TMU.

5/ Data for March is a stock as of the end of the month. The flows for May and July are cumulative from end-March 2014. Targets for September and December are cumulative flows from end-May 2014.

6/ Naftogaz is currently disputing the arrears to Gazprom. The estimates of potential liabilities arising from such disputed arrears are provided solely for the purpose of accounting for program financing and risk assessment considerations.

7/ Arrears stock data for end-March, end-May, end-July include arrears for gas imports in 2013 and for imports up to end-March 2014, end-April, and end-June respectively. Arrears for end-September program targets are the sum of unpaid bills from January 2014 (US$3.759 billion).

Table 3. Access and Phasing under the 2014 SBA
($bn)

Date	Amount of purchase: Millions of SDRs	Percent of quota	Conditions
April 30, 2014 1/	2,058.00	150.00	Board approval of arrangement
July 25, 2014	914.67	66.67	First review and end-May 2014 performance criteria
September 25, 2014	914.67	66.67	Second review and end-July 2014 performance criteria
December 15, 2014	914.66	66.67	Third review and end-September 2014 performance criteria
March 15, 2015	1,372.00	100.00	Fourth review and end-December 2014 performance criteria
June 15, 2015	1,372.00	100.00	Fifth review and end-March 2015 performance criteria
September 15, 2015	1,372.00	100.00	Sixth review and end-June 2015 performance criteria
December 15, 2015	1,372.00	100.00	Seventh review and end-September 2015 performance criteria
March 15, 2016	686.00	50.00	Eighth review and end-December 2015 performance criteria
Total	10,976	800.0	

Source: IMF staff estimates.

1/ Of which SDR1,290 for budget support.

Sources: IMF Country Reports 14/106

Table 4. Ukraine: Program Scenario – Gross External Financing Requirements, 2013-15
(Billions of U.S. dollars)

	2013	2014			2015		
		SBA Request	SBA 1st Rev.	EFF 1st Rev.	SBA Request	SBA 1st Rev.	EFF 1st Rev.
Total financing requirements	73.7	63.0	63.3	66.9	58.0	53.4	49.3
Current account deficit	16.3	6.3	3.4	6.2	6.4	3.4	1.5
Portfolio investment	7.5	2.2	2.7	3.5	5.7	5.6	6.3
Private	5.4	1.2	1.7	0.7	1.2	1.2	1.6
Public	2.0	1.0	1.0	2.7	4.5	4.4	4.7
Medium and long-term debt	18.0	17.5	17.9	9.0	11.9	11.9	11.8
Private	17.5	15.4	15.4	8.6	11.3	11.3	11.1
Banks	4.7	5.3	5.3	2.9	5.3	5.3	2.8
Corporates	12.8	10.1	10.1	5.7	6.0	6.0	8.3
Public 1/	0.5	2.1	2.5	0.4	0.6	0.6	0.8
Short-term debt (including deposits)	12.8	12.1	12.1	23.0	11.9	11.8	9.7
Other net capital outflows 2/	-1.9	0.0	2.3	0.4	0.0	0.5	1.2
Trade credit	21.2	24.9	24.9	24.9	22.1	20.2	18.6
Total financing sources	73.0	51.7	49.2	48.9	53.1	49.6	39.8
Capital transfers	-0.1	0.0	0.0	0.0	0.0	0.0	0.2
Direct investment, net	3.3	2.8	0.2	0.4	3.7	1.9	1.4
Portfolio investment	16.1	2.6	4.5	0.7	3.3	3.4	1.9
Private	9.9	1.5	1.3	-0.4	1.8	1.9	-0.1
Public	6.3	1.1	3.2	1.0	1.5	1.5	2.0
Medium and long-term debt	18.8	13.3	13.0	4.8	12.4	12.4	5.9
Private	18.8	13.3	13.0	4.8	12.4	12.4	5.9
Banks	4.3	4.8	5.1	1.7	5.7	5.7	1.4
Corporates	14.5	8.5	7.8	3.2	6.7	6.8	4.5
Public 3/	…	…	…	…	…	…	…
Short-term debt (including deposits)	13.8	10.9	11.3	22.1	12.7	12.4	9.9
Trade credit	21.1	22.1	20.2	20.9	21.0	19.4	20.5
Increase in gross reserves	-4.1	-1.2	-4.2	-12.9	7.5	7.2	10.7
Errors and omissions	-0.1	0.0	0.9	0.1	0.0	0.0	0.2
Total financing needs	-3.3	10.1	9.0	5.1	12.5	11.0	20.0
Official financing	-3.3	10.1	9.0	5.1	12.5	11.0	14.8
IMF	-5.6	3.7	3.7	0.9	7.1	7.1	8.5
Prospective purchases	…	7.4	7.4	4.6	8.6	8.6	9.9
Repurchases	5.6	3.7	3.7	3.7	1.5	1.5	1.4
Official creditors	2.3	6.4	5.3	4.2	5.4	3.9	6.3
World Bank	0.3	1.9	1.7	1.5	1.6	1.3	1.9
EU	0.1	2.2	2.6	2.2	0.6	0.8	1.8
EBRD/EIB/Others	2.0	2.3	1.0	0.5	3.1	1.8	2.7
Memorandum items:							
Gross international reserves	20.4	19.2	16.2	7.5	26.7	23.4	18.3
Percent of short-term debt (remaining maturity)	30.3	33.9	29.5	17.4	53.6	48.3	41.1
Months of next year's imports of goods and services	3.1	2.6	2.5	1.6	3.4	3.4	3.7
Percent of the IMF composite measure (float) 4/	47.3	62.3	54.3	27.1	91.9	83.4	65.4
Loan rollover rate (percent)							
Banks	90.1	85.4	94.1	96.6	107.5	107.5	86.6
Corporates	116.2	89.2	84.4	63.9	108.2	107.9	64.3
Total	107.6	87.7	88.2	85.4	107.9	107.7	77.3

Sources: National Bank of Ukraine; and IMF staff estimates and projections.

1/ Includes repayment of Naftogaz Eurobond in September 2014.

2/ Mainly reflects residents' conversion of hryvnia cash to foreign currency held outside of the banking system.

3/ For the projection period (2014–19), financing from official sources is recorded below the line.

4/ The IMF composite measure is calculated as a weighted sum of short-term debt, other portfolio liabilities, broad money, and exports in percent of GDP, with different weights for "fixed" and "floating" exchange rate regime. Official reserves are recommended to be in the range of 100–150 percent of the appropriate measure. For Ukraine "fixed weights are used until 2013, and "floating" weights are used from 2014 onwards.

Table 5. Ukraine: Program Scenario – Selected Economic and Social Indicators, 2013-15

	2013	2014			2015		
		SBA Request	SBA 1st Rev.	EFF 1st Rev.	SBA Request	SBA 1st Rev.	EFF 1st Rev.
Real economy (percent change, unless otherwise indicated)							
Nominal GDP (billions of Ukrainian hryvnias)	1,455	1,506	1,524	1,567	1,736	1,756	1,981
Real GDP	0.0	-5.0	-6.5	-6.8	2.0	1.0	-9.0
Contributions:							
Domestic demand	0.9	-8.2	-12.4	-13.5	2.0	-0.2	-13.1
Private consumption	5.6	-3.7	-4.5	-7.7	0.8	0.6	-8.2
Public consumption	-0.5	-0.5	-1.6	0.1	-0.3	-0.4	-1.6
Investment	-4.1	-4.0	-6.3	-5.9	1.5	-0.4	-3.3
Net exports	-1.0	3.2	5.9	6.6	0.0	1.2	4.1
GDP deflator	3.1	9.0	12.1	14.8	13.0	14.1	39.0
Output gap (percent of potential GDP)	-1.0	-3.2	-4.2	-2.6	-2.3	-3.7	-5.4
Unemployment rate (ILO definition; percent)	7.2	8.5	10.0	9.3	8.0	9.8	11.5
Consumer prices (period average)	-0.3	8.3	11.4	12.1	12.9	14.0	50.0
Consumer prices (end of period)	0.5	16.2	19.0	24.9	7.4	9.0	45.8
Nominal monthly wages (average)	8.0	4.7	5.1	5.9	14.0	14.9	22.3
Real monthly wages (average)	8.3	-3.3	-5.7	-5.5	1.0	0.8	-18.5
Savings (percent of GDP)	6.5	5.0	5.6	9.4	7.1	5.2	8.2
Private	9.4	8.7	10.1	12.6	9.5	7.2	10.1
Public	-2.8	-3.7	-4.5	-3.2	-2.4	-1.9	-1.9
Investment (percent of GDP)	15.7	9.5	8.2	14.1	11.4	7.8	9.9
Private	13.7	8.0	6.9	12.8	9.5	5.8	7.5
Public	2.0	1.5	1.3	1.3	1.9	2.0	2.4
Public finance (percent of GDP)							
General government balance 1/	-4.8	-5.2	-5.8	-4.5	-4.2	-3.9	-4.2
Overall balance (including Naftogaz operational deficit)	-6.7	-8.5	-10.1	-10.1	-6.1	-5.8	-7.3
Structural general government balance	-4.6	-3.6	-3.5	-3.1	-3.1	-2.3	-3.0
Public debt (end of period) 2/	40.9	56.5	67.6	71.2	62.1	73.4	94.4
Money and credit (end of period, percent change)							
Base money	20.3	21.5	27.7	8.5	14.8	19.7	27.3
Broad money	17.6	11.8	12.0	5.3	17.6	16.4	24.5
At program exchange rate	15.7	2.9	-2.0	-16.8	14.5	14.6	11.8
Credit to nongovernment	11.8	8.7	9.8	12.4	11.7	6.9	15.2
At program exchange rate	10.7	-1.8	-7.6	-15.6	7.5	3.8	-2.9
Velocity	1.6	1.5	1.5	1.6	1.5	1.5	1.7
Interbank overnight rate (annual average, percent) 3/	3.8	10.6	10.2	11.5	…	…	…
Balance of payments (percent of GDP)							
Current account balance	-9.2	-4.4	-2.5	-4.7	-4.3	-2.5	-1.7
Foreign direct investment	1.8	2.0	0.1	0.3	2.5	1.4	1.6
Gross reserves (end of period, billions of U.S. dollars)	20.4	19.2	16.2	7.5	26.7	23.4	18.3
Months of next year's imports of goods and services	3.1	2.6	2.5	1.6	3.4	3.4	3.7
Percent of short-term debt (remaining maturity)	30.3	33.9	29.5	17.4	53.6	48.3	41.1
Percent of the IMF composite measure (float)	47.3	62.3	54.3	27.1	91.9	83.4	65.4
External debt (percent of GDP)	78.6	99.5	102.2	100.4	99.3	106.4	147.7
Goods exports (annual volume change in percent)	-6.7	-2.8	-8.4	-11.1	6.5	4.8	-10.8
Goods imports (annual volume change in percent)	-4.1	-13.8	-21.4	-24.6	2.7	-1.2	-23.1
Goods terms of trade (percent change)	0.9	-1.0	-1.2	-0.1	-2.5	-3.4	-7.2
Exchange rate							
Hryvnia per U.S. dollar (end of period)	8.3	10.5	12.5	15.8	11.5	13.3	23.5
Hryvnia per U.S. dollar (period average)	8.2	10.6	11.3	12.0	11.6	12.9	22.0
Real effective rate (CPI-based, percent change)	-3.7	-18.0	-20.6	-21.0	1.5	-2.2	-10.7
Memorandum items:							
Per capita GDP / Population (2014): US$3,051 / 42.8 million							
Literacy / Poverty rate: 100 percent / 2.9 percent							

Sources: Ukrainian authorities; World Bank, World Development Indicators; and IMF staff estimates.

1/ The general government includes the central and local governments and the social funds.

2/ Government and government-guaranteed debt.

3/ For 2014, average of rates for January–August.

Statement by Oleksandr Petryk, Alternate Executive Director for Ukraine
September 14, 2016

After the sharp recession in 2014 and the first half of 2015, the economy has started to recover. Despite some signs of de-escalation, the geopolitical conflict in the East of Ukraine continues to hold back the pace of the recovery, creating uncertainty for investors and markets. Political tensions in late 2015 led to the appointment of a new government in April 2016. Regardless of this challenging environment, the authorities implemented difficult measures aimed at strengthening the fundamentals of the economy, restoring sustainable growth and financial stability. The authorities strive to achieve price and financial stability under the flexible exchange rate, establish a prudent, strong banking system, sound public finances, fight corruption, and implement comprehensive structural reforms in the public sector and state-owned enterprises.

Despite some delays due to the challenging environment and political uncertainty, all performance criteria and prior actions have been met, except for those on NIR for end-December 2015, the non-accumulation of external debt payment arrears, and the non-imposition of exchange restrictions. However, the progress on the program implementation has been impressive. Economic growth picked up, inflation has been drastically brought down, the banking system recovered, international reserves doubled relative to the beginning of the program, the 2016 fiscal deficit and the current account deficit are thus far in line with the program objectives, following a significant over-performance in 2015, and the debt operation with private bondholders has been completed. The authorities are committed to reach an agreement on the broader sovereign debt restructuring as soon as possible, in good faith and in line with the agreed program objectives.

The authorities remain strongly committed to continue with the program implementation and are determined to fulfill all obligations under the program, in order to achieve the program's long-term goals. The authorities are well aware of the risks and challenges ahead, and of the importance of a comprehensive approach and timely implementation of the reform agenda.

The Ex-Post Evaluation of Exceptional Access Under the 2014 SBA provides a useful assessment of the 2014 SBA. The authorities share the main findings of the report that, although the focus of the program was rightly on the immediate and medium-term objectives and important steps were taken under the program, the intensification of the conflict in the East and the loss of confidence led to unattainable program goals. Although the SBA clearly served as an anchor for the economic reform program in very difficult economic and political times, the replacement with an EFF allowed for more financing for a longer period, to support the authorities' deeper reform plans.

Macroeconomic outlook

The authorities broadly share staff's analysis of the economic outlook. In Q1 2016, for the first time since the Q4 2013, real GDP increased in annual terms and is projected to grow by 1.5 percent in 2016. However, this is somewhat weaker than expected, predominantly due to worse performance in selective service sectors. Industrial production also recovered more slowly than expected (by 1.7 percent in the first seven months of 2016 compared to the same period last year), because of difficulties in the mining and steel industries. Foreign trade is currently the main driver of economic growth, despite the intensification of restrictions in trade with Russia. Domestic investment increased in the first half of 2016 while private consumption remained subdued. Labor market conditions have started to improve with recovering real wages but unemployment remained high at around 10 percent. Inflation slowed to 8.4 percent in August 2016 due to moderate aggregated demand, prudent monetary policy, stabilization of the foreign exchange market and ample supply of food products. The current account balance improved noticeably due to the climbing grain export and higher-than-expected commodity prices. For some time, import remained in line with the program assumptions. In sum, the current account returned to a surplus in Q2 2016 of around US$1.0 bln. and remains in line with the program. International reserves increased to US$14.1 bln. in August 2016, almost double the amount of end of 2014.

Fiscal policy, tax and pension reforms

The government budget performed well in 2015 and 2016, as the authorities controlled spending. Debt interest payments declined following the debt restructuring. Revenues increased. Fiscal targets were met with large margins. The authorities are determined to further reduce the fiscal deficit to ensure debt sustainability, which is critical for financial stability. The parliament approved the 2016 budget in line with the program, supported by a new tax code as agreed with staff as a prior action. Parliament adopted a comprehensive package of tax policy reforms as required under a prior action for this review. A new electronic system of government procurement makes procedures more transparent and efficient, and public investment and services less expensive. Significant progress has been made with improving the tax and customs administration.

Pension reform is the cornerstone of the structural reform agenda, and critical for fiscal sustainability. The population is rapidly aging and the pension fund has a structural deficit that needs to be addressed. The authorities started with the reform agenda by eliminating special pensions to privileged groups. They also extended withholding pension for people that continue to work after reaching the retirement age and reduced the number of people eligible for early retirement (based on their occupation) by at least 40 percent (a prior action). As a new structural benchmark, the authorities will further reform the pension system and social security contribution.

Monetary and exchange rate policy and financial stability

In June 2015, the parliament amended the NBU law, thereby increasing the NBU's institutional and financial independence and allowing for implementation of policies to secure monetary and financial stability, reduce inflation and build up reserves. The flexible exchange rate helps adjusting to domestic and foreign shocks. The NBU intends to continue with foreign exchange auctions to further increase its reserves. The NBU has built up reserves of around US$3 bl. on a net basis since the end of February of 2015. The NBU also agreed on temporary swap/credit lines with the Riksbank and National Bank of Poland equivalent to US$1.5 bln.

The NBU, together with the IMF, developed a road map for further gradual and controlled removal of the administrative restrictions. The optimal strategy, which is a trade-off between the control of foreign currency outflow to ensure financial stability and the negative effects of the administrative restrictions, will be further developed. Strengthened communication with market participants is key to anchor expectations.

A strategy is implemented to adopt best practices of inflation targeting. The NBU board explicitly defined and announced the path of disinflation to reach in the medium term an inflation target of 5 percent associated with price stability. Last year, the NBU has set up a decision-making system based on a regular macroeconomic forecast, switched to a new operational framework with key policy rate as main instrument, and launched regular and systemic communications aimed at anchoring the inflationary expectations. Inflation is now an indicative target of the program. The authorities propose, on the occasion of the next review, the inflation as an indicative target of the program. For the next review, the authorities propose switching to inflation-based conditionality under the EFF program.

The monetary policy transmission mechanism will be gradually improved by narrowing the interest rate corridor and by ensuring that interbank rates remain close to the targeted policy rate. In addition, the NBU keeps the policy interest rate in the positive territory and stands ready to absorb excess liquidity if necessary.

Another key objective of the reform program is the sound and effective functioning of the banking system. The NBU made important progress with the rehabilitation of the banking system. Confidence was restored. The second stage of the diagnostics for the 20 largest banks was completed and recapitalization plans were submitted by the 16 banks which require additional capital. The NBU is currently monitoring the implementation of 14 plans. Capital requirements were increased and non-viable banks have been resolved. New legislation was introduced to limit lending to related parties and ensure transparent ownership of the banks. The Related Parties Monitoring Office (RPMO) has been staffed to monitor outstanding loans to related parties and reports regularly to the NBU Board. To solve the NPL problem, the authorities are working on strengthening the legal framework for private debt restructuring, adopting an out-of-court restructuring arrangement for corporate debt, and sponsoring a voluntary approach for the foreign currency denominated mortgage loans restructuring.

Banking regulation and supervision have significantly improved, in particular by conducting more risk-based supervision and new regulation on credit-risk activities. The NBU has started to work with a Registry of Borrowers which allows monitoring credit risks and related-party loans. Since December 2015, the NBU introduced monthly reports on potential problem banks, based on a revised Early Warning System (EWS). The Ministry of Finance, as the main shareholder of the state banks, made the commitment to run these banks on a commercial basis. The authorities have developed the Principles of State Banking Sector Strategic Reforms which provide a framework for transparency, improvement in management and a sound financial position of these institutions.

Structural reforms and anticorruption program implementation

The authorities made significant progress with reforming the energy sector. In particular, Naftogaz's finances were improved and its cumulative cash deficit reached 0.9 percent of GDP in 2015, which is better than the program target. The authorities remain committed to eliminate Naftogaz's deficit by end-2017. The retail gas tariffs were unified at the full-cost recovery level since May 1, 2016, as were the heating tariffs since July 1, 2016 (a prior action).

The authorities are implementing the anticorruption and judicial reform agenda. The National Anti-Corruption Bureau of Ukraine (NABU) finalized the recruitment process for competent staff and has started to operate. The management of the NABU is implementing the action plan, which was prepared by and agreed upon with foreign specialists, and supported by donors. The authorities have also established a specialized anticorruption prosecution function. The head of the anticorruption prosecutors and two deputies have been appointed in a transparent procedure (a prior action). The parliament adopted a law which requires that high-level officials will report their assets and income in an electronic declaration system. This information will also be publicly available online. Administrative reforms were launched with the traffic police, and many other public services and institutions underwent a clean-up procedure. The Ministry of Finance is implementing a framework for AML reporting and the NBU introduced risk-based off-site and on-site AML supervisory tools. The political influence in the judicial process remains a challenge. To address this problem, the parliament proposed amendments to the Judges' Organization. The preliminary draft was supported by the Venice Commission. These amendments will enhance the judicial independence, introduce standards and procedures for recruitment, and strengthen the management of the judiciary. Public administration reform has reduced the size of state working places. The reform in the civil service will reduce the wage bill and the size of the public administration thereby enabling higher wage levels to attract higher quality staff and reduce corruption.

The authorities continue with the reform of the state-owned enterprises. A privatization schedule for the 10 biggest SOEs was adopted. The government has initiated a review of the existing portfolio of SOEs to identify the non-operating ones for subsequent liquidation.

Final remarks

Despite the external and internal challenges, the Ukrainian authorities remain committed to continue with the difficult but necessary reforms. The new government is determined to reform the economy and lay the foundation for sustainable growth and prosperity of the country. There is broad support and agreement that this is the only way forward. The authorities are grateful for the cooperation with and support from the Fund, other IFIs and the international community.