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Ukraine—Stand-By Arrangement—Review Under the Emergency Financing Mechanism

In the context of the two-year Stand-By Arrangement for Ukraine under the Emergency Financing Mechanism, this paper on the Stand-By Arrangement—Review Under the Emergency Financing Mechanism for Ukraine was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on December 11, 2008. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Ukraine or the Executive Board of the IMF.

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INTERNATIONAL MONETARY FUND

UKRAINE

Stand-By Arrangement—Review Under the Emergency Financing Mechanism

Prepared by the European Department in consultation with other departments

Approved by Poul Thomsen and Lorenzo Giorgianni

December 11, 2008

Summary. Policies are being implemented broadly in line with program understandings, although risks to the program remain high, given political tensions, the fragile state of the banking system, the sharp contraction of the economy, and the rapid currency depreciation. For a brief period, since approval of the arrangement on November 5, the authorities essentially re-pegged the exchange rate, in contravention with program commitments, causing sizeable reserve losses. When the currency was eventually allowed to float, it weakened quickly on the back of deposit flight. In response, the NBU tightened monetary policy and took other measures to stabilize deposit outflows. The government has taken measures to keep this year's deficit below 1 percent of GDP, as targeted under the program. Preparations for the 2009 budget have started, although the timing of its approval remains uncertain given upcoming elections. The diagnostic phase of the bank recapitalization program has begun, but the resolution of problem banks is proceeding slowly. Policies will be assessed carefully at the time of the first review under the arrangement (late January 2009) to ensure that the program's objectives are still within reach.

Discussions. During December 1–9, 2008 the staff team met with President Yushchenko; Prime Minister Tymoshenko; Minister of Finance Pynzenyk; National Bank of Ukraine Governor Stelmakh; the First Deputy Chief of Staff of the Presidential Administration, Mr. Shlapak; and other senior officials; ambassadors; members of Parliament; as well as representatives of the private banking and business communities. The mission also met senior representatives of the main opposition party.

Staff. The staff team comprised Ms. Pazarbasioglu (head); Messrs. Hofman and Moulin (EUR), Mr. Arslanalp (FAD), Mr. Duenwald (SPR), and Mr. Laeven (RES). The mission was assisted by a concurrent MCM mission led by Mr. Olafsson and Mr. Horvath, resident representative. A safeguards assessment mission by FIN and a LEG/MCM mission on the consistency of the existing exchange controls with Article VIII will finalize their work by December 19, 2008. The mission team cooperated with World Bank staff on structural issues.

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I. Introduction

1. **On November 5, 2008 the Executive Board approved a two-year Stand-By Arrangement (SBA) for Ukraine**, under the Emergency Financing Mechanism (EFM) in the amount of SDR 11 billion ($16.4 billion, 802 percent of Ukraine's quota). A first purchase of SDR 3 billion ($4.5 billion) was made following the Board meeting. The EFM calls for a review of the initial policy response and the reaction of markets to the authorities' policies within one to two months of the approval of the arrangement.

II. Recent Developments and Outlook

2. **Economic developments are broadly in line with the program, although economic activity is contracting faster than expected and the exchange rate remains under pressure** (Figure 1).

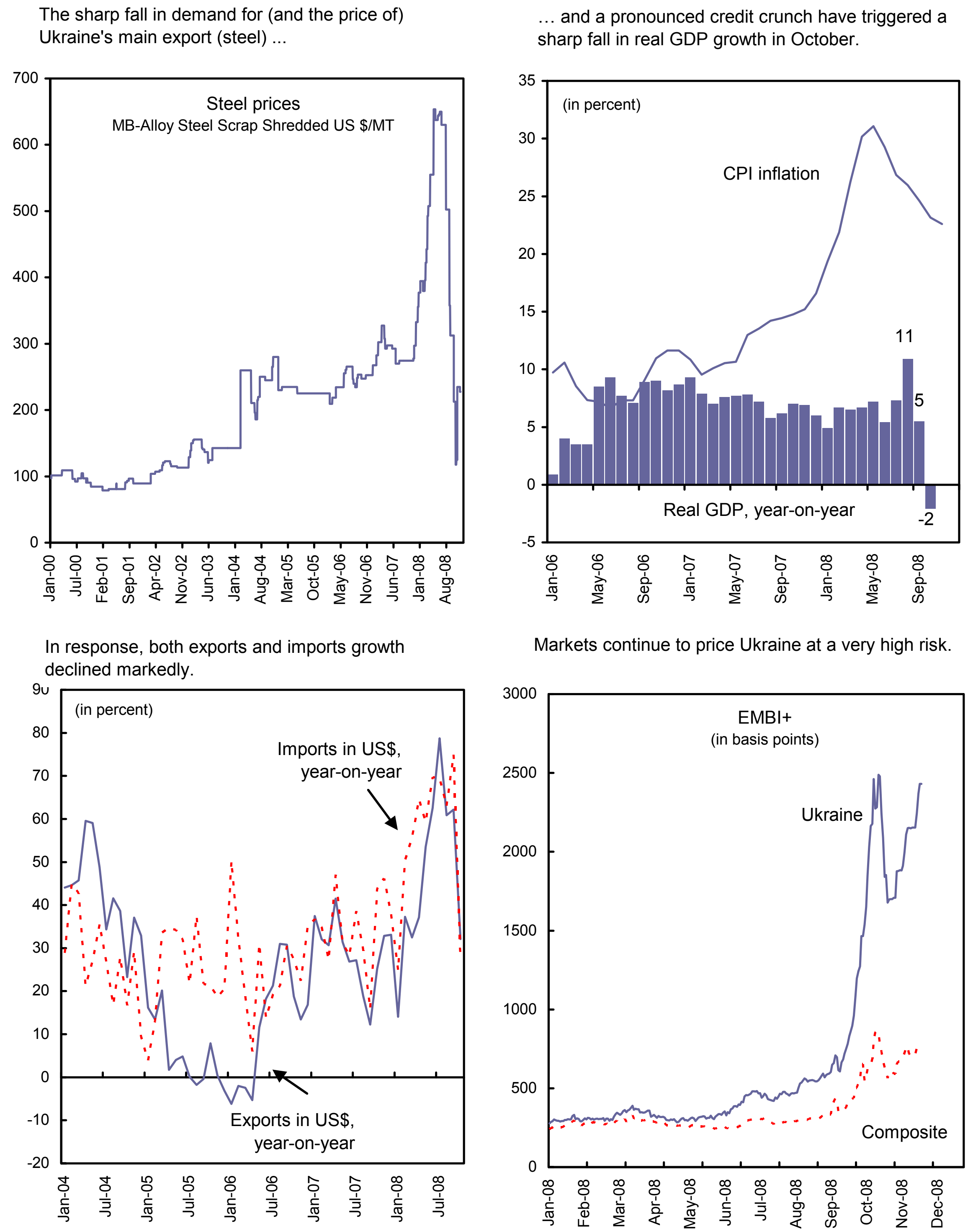
- **Output growth is turning negative on the back of a large terms-of-trade shock and the ongoing credit crunch.** In October, real GDP growth slowed to –2 percent (year-on-year) from above 5 percent in September. The slowdown reflects mainly a collapse of metals output, a deepening recession in the construction sector, and a slowdown in the retail trade sector. In 2008, real GDP growth is likely to be in the 4–5 percent range, instead of 6 percent as assumed in the program, and risks of a deeper-than-expected recession in 2009 have increased.

- **Inflation is likely to stay below program projections in 2008.** Between September and November, CPI inflation eased from 24.6 to 22.3 percent year-on-year despite a cumulative 30 percent nominal depreciation of the hyrvnia in effective terms since end-September. Core inflation and wage growth have also declined slightly.

- **There was a pronounced turnaround in trade developments in October.** Consistent with weakening external and domestic demand and falling commodity prices, both export and import growth fell markedly. The current account deficit continued to widen but preliminary figures for November suggest an inversion of tendency. Going forward, commodity price developments suggest that Ukraine's terms-of-trade may surprise on the upside. Imported energy prices are likely to be lower than expected in 2009 while steel prices have staged a modest rebound recently.

- **Access to capital markets remains difficult.** While there are indications that net FDI and medium- and long-term borrowing are declining relative to year-ago levels, they remained positive in October, and several big companies and subsidiaries of foreign banks were able to roll over their debt through direct borrowing from parent banks and related offshore entities.

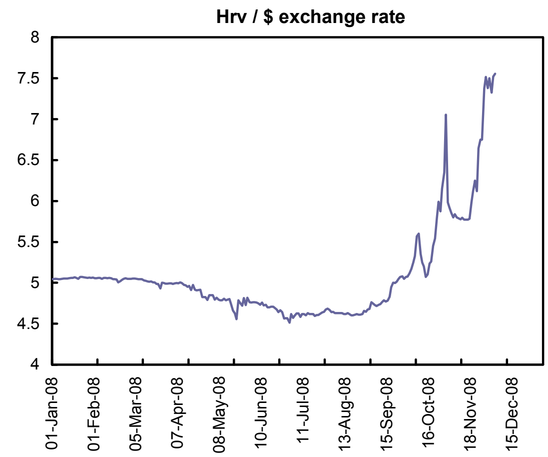
Figure 1. Ukraine - Macroeconomic Developments



Sources: Ukrainian authorities, Fund staff calculations.

- **As a result, financial market indicators continue to weaken**. After a drop in late October, sovereign CDS and bond spreads have risen again and remain at elevated levels. The exchange rate has also weakened considerably (see below). The deterioration in market sentiments since the approval of the program has been largely due to political developments and concerns about private sector defaults because of the difficulties in refinancing foreign liabilities in the current environment.

3. **The hryvnia has depreciated significantly within a short period of time.** Large-scale interventions kept the exchange rate around Hrv 5.8 per dollar up to mid-November, but since then a more flexible exchange rate policy has allowed the hryvnia to adjust to market conditions. At the same time, large injections of hryvnia liquidity by the central bank to meet deposit outflows have leaked into foreign exchange adding pressure on the exchange rate and reserves. Foreign exchange sales by the NBU have amounted to about $3.5 billion since the beginning of November, reducing net international reserves to $29.9 billion (measured at program exchange rates) as of December 5, against an end-December floor of $26.7 billion.



4. **Interbank interest rates have increased sharply.** Against the backdrop of significant stress in the banking system, the interbank market has been illiquid. After peaking at about 50 percent at end-November, interbank overnight rates declined to 25–30 percent range in early December.

5. **The banking system remains vulnerable.** Concerns about the stability of the banking system and exchange rate volatility have led to a loss of 14 percent of local currency deposits between end-September and end-November. Foreign currency deposits have also declined, partly due to falling export revenues in the corporate sector. Since mid-November, the situation has stabilized, as households' foreign currency deposits returned to the banking system attracted by high interest rates. In response to these developments, the NBU has provided about Hrv 40 billion in liquidity since early October, partly through a "financial rehabilitation" facility to banks with shortfalls in regulatory capital. In November, credit growth (taking into account revaluation effects) has come to a halt, with sharp contractions recorded in the mortgage and consumer lending sectors.

6. **The high proportion of foreign currency loans coupled with the terms-of-trade shock, depreciation, and lower GDP growth have triggered an increase in nonperforming loans.** Foreign currency loans to households and some corporates took the brunt of the losses, especially in the metal, energy and construction sectors. Banks are

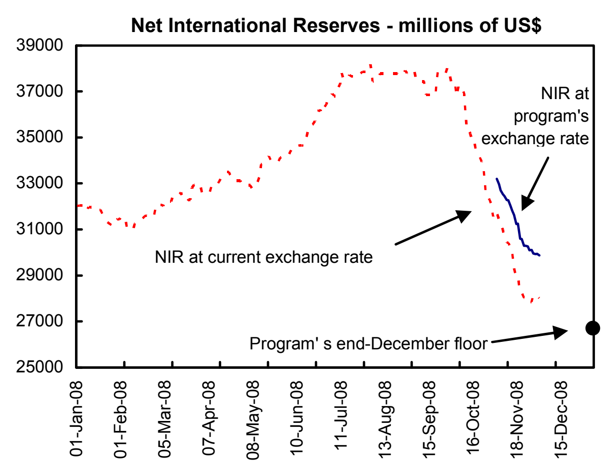
reporting that a 50 percent depreciation of the hryvnia against the dollar would result in an increase of the debt service-to-income ratio from 60 percent to nearly 100 percent for a significant share of borrowers (about 20 percent). The large share of foreign currency deposits in total deposits (about 50 percent for households), and the significant underreporting of income (about one third) should however help cushion the impact of currency depreciation. Banks are rapidly approaching the minimum regulatory capitalization (10 percent) levels. Some have started restructuring syndicated loans with large blue-chip corporates, and foreign currency retail loans.

7. **The deterioration of the economic and financial situation is contributing to an increase in program implementation risks.** After a period of political instability following the dismissal of the speaker of Parliament in early November that brought the parliamentary process to a halt, a new coalition was formed on December 9, 2008. The coalition partners consist of the parties of the President and the Prime Minister and another small party. Although the initial market commentary has been positive, it is too early to judge whether this coalition will bring much-needed political stability. So far, tensions among political figures, fragmented communications, as well as the contraction of the economy and the balance sheet impact of the depreciation of the currency have contributed to public anxiety and to foreign currency substitution. This points to continued program implementation risks.

III. Policy Implementation

A. Monetary and Exchange Rate Policy

8. **After initially re-pegging the currency, the authorities have introduced a flexible exchange rate policy in line with the program**. The NBU has allowed the hryvnia to depreciate since mid-November and, in line with commitments under the program, has introduced regular foreign exchange intervention auctions which increased transparency and improved price discovery. The foreign exchange tax should be abolished in 2009, as agreed under the program, to improve the operation of the foreign exchange market. Given the large reserves losses in October and early November, and the need for potential buffers to meet external payments (such as Naftogaz debt) the mission urged the authorities to keep intervention amounts low. The mission stressed the importance of conveying clear messages to the public, suggesting that the key policy makers publicly reaffirm their commitment to a flexible exchange rate regime.



9. **In view of exchange rate pressures, the authorities tightened monetary policy in early December.** The refinance rate was increased from 16 to 20 percent and the interest rate paid on bank deposits at the central bank was raised from 7 to 10 percent. The provision of refinance credit has been restricted to overnight and two week maturities and collateral requirements were tightened. Bank shares are eliminated from the list of acceptable collateral. The NBU excluded vault cash from the calculation of bank reserves. Staff believes these measures will help reduce incentives for deposit dollarization and recommended that the authorities keep base money under the end-year target (base money amounted to Hrv 174 billion as of December 5 compared to the end-year target of Hrv 190 billion). Looking forward, the authorities need to assess the effects of the recent policy measures, and to consider some further tightening should the pressure on the hryvnia continue.

B. Financial Sector Policy

10. **The diagnostic phase of the bank recapitalization scheme is underway but additional time is needed to finalize a more comprehensive study**. On November 21, the NBU issued a resolution specifying the guidelines for the diagnostic study. The audit firms were selected and have started working in the systemically important banks. They plan to provide audit reports to the NBU by December 15, 2008 allowing observance of the related conditionality[1] (MEFP ¶13). Given the rapid increase in nonperforming loans, a more comprehensive analysis covering a larger portion of banks' credit portfolios will be made available by January 5, 2009. During the diagnostic process, if financial conditions in any bank appear to be deteriorating, the authorities will agree with bank management on a restructuring plan to resolve the underlying difficulties. The NBU should intensify discussions with foreign banks and home supervisors to assess the parent bank funding to Ukrainian subsidiaries, and develop contingency plans.

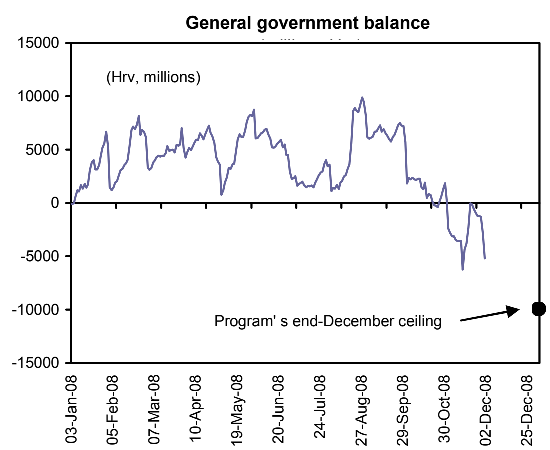
11. **The mission urged the authorities to finalize the resolution of Prominvest Bank.** Prominvest Bank was sold to private investors in November (prior action). However the strategic investors have not been able to inject the required additional capital and the bank was nationalized on December 9, 2008. The authorities will seek potential capital participation by the EBRD and/or other IFIs. A final resolution of this bank (6th largest) with participation from IFIs will increase transparency and should pave the way for a faster resolution of problem banks going forward.

[1] Staff is of the view that if a report satisfying the original coverage requirement is completed by mid-December, the PC would have been observed, and the preparation of the report that would cover an additional share of the banks' loan portfolio would be outside the PC and will be considered as an additional commitment requested by the mission/accepted by the authorities.

C. Fiscal Policy

12. **The end-year target of a general government deficit below 1 percent of GDP is attainable, but there are risks.** The budget was in balance at end-November. In November, the Cabinet adopted a resolution to contain the seasonal end-year spending surge. The resolution strengthens the Treasury's role in controlling expenditures by line ministries and local governments; requires public enterprises to submit their surplus revenues to the budget by end-year; and freezes non-priority spending on goods and services. At the same time, the sharp contraction of output and tax arrears from Naftogaz have started to affect revenue performance. Despite these risks, the authorities were confident about meeting the end-December fiscal performance criterion.

13. **The authorities reiterated their commitment to a balanced budget next year.** They have started technical preparations on the draft 2009 budget. Staff stressed the importance of constructing the budget on conservative growth and revenue assumptions, stressing that the international experience suggest weak tax collection during crisis periods. The mission reviewed the expenditure-saving measures envisaged by the authorities and proposed additional measures to balance the budget (including subsidies to loss-making companies), while advising against a sharp contraction in capital spending and encouraging sufficient appropriations for well-targeted social programs. The adoption of the budget will take place once the parliament resumes its operations, the timing of which remains uncertain. The cabinet adopted a resolution to ensure effective budget execution, based on the expenditure targets of the 2008 budget, in the first three months of 2009. The recommended fiscal stance will be reevaluated at the time of the first review in light of macroeconomic and financing developments.



14. **Financing remains limited to official sources**. Ukraine remains shut out from international capital markets, and domestic borrowing is constrained by limited liquidity in the banking sector. The Cabinet has approved an expanded list of enterprises slated for privatization in 2009, however prospects may be limited given the adverse global financial conditions. The financing possibilities from official sources are likely to be higher than assumed under the program. By end-December, the World Bank is expected to approve a $500 million loan for budget support and negotiations are underway with the World Bank for the financing of two large projects for roads and railways ($500 million of project financing has been approved and another $1.1 billion is under preparation). The EBRD has approved a sizeable EUR 1.1 billion envelope for Ukraine financial sector projects, equity, debt, trade finance and SME finance for 2009.

D. Other Issues

15. **Staff argued against the proposed imposition of import restrictions.** A draft legislative amendment to allow for temporary import surcharges in the event of balance of payments difficulties has been cleared by the relevant parliamentary committee and registered in parliament. Although implementation is not imminent, there are strong industry pressures to introduce these measures. Staff stressed that this would be inconsistent with a continuous performance criterion under the program, and that balance of payments difficulties are best addressed through macroeconomic and exchange rate policies as called for in the program.

16. **The mission urged the authorities to make progress on the resolution of private sector debt denominated in foreign currency**. It discussed with the authorities the implications of different scenarios regarding the risks of extensive private sector default, based on macroeconomic and detailed banks' portfolio data. The mission recommended that the authorities work jointly with the banks to develop a voluntary framework for restructuring household debt.

IV. Staff Appraisal

17. **Policy implementation is in line with the program, except for some initial slippage in exchange rate policy**. The authorities have introduced a flexible exchange rate regime, tightened monetary policy, and have taken measures to contain the 2008 government deficit. Progress has been made on the diagnosis phase of the bank recapitalization program.

18. **The economic outlook has deteriorated.** The large negative terms-of-trade shock and the capital and deposits outflow-driven credit contraction have had a considerable impact on the real sector. Real GDP growth in 2008 is likely to fall short of the program projection and risks of a deeper recession in 2009 have increased.

19. **Continued implementation of the flexible exchange rate regime is necessary.** This will help cushion the economy against any further deterioration of the terms-of-trade, prevent pent-up demand for foreign currency and potentially stimulate capital inflows. The authorities should continue the implementation of regular foreign exchange auctions, with intervention amounts firmly grounded in appropriate reserves targets.

20. **The recent measures to tighten monetary policy should relieve pressures on the hryvnia.** Recent increases in the refinance rate and the tightening of prudential limits on foreign currency lending should improve the relative attractiveness of hryvnia holdings. The restriction of the provision of refinance credit at maturities of less than two weeks and the elimination of bank shares from the list of acceptable collateral are also steps in the right direction. Further tightening of monetary policy, should pressures on the hryvnia continue, is an essential part of the program.

21. **The authorities should adhere closely to the banking policies specified under the program.** The authorities should closely monitor liquidity position of the banks and intensify supervision of those banks that increasingly rely on central bank liquidity support. Prompt action is necessary to resolve banks that may be facing difficulties. Regarding Prominvest bank, it is important that the authorities promptly engage in discussions on potential capital participation by the EBRD and/or other IFIs to restructure the bank in a transparent manner. The authorities should deliver the diagnostic reports for systemic banks on December 15, 2008. The staff welcomes their commitment to provide further analysis of banks' loan portfolios by January 5, 2008.

22. **Prudent fiscal policy in line with program commitments is critical in the face of difficult financing conditions and revenue risks.** For 2008, the authorities should keep the government deficit below 1 percent of GDP. For 2009, they should target a balanced budget in line with the program. It will be critical to base fiscal plans on conservative assumptions. Expenditure targets should be supported by credible expenditure-saving measures, avoid overly large cuts in capital expenditure, and expand well-targeted social programs.

23. **Plans to impose import restrictions should be abandoned**. This would be inconsistent with a continuous performance criterion under the SBA. Exchange rate and macroeconomic policies are better instruments to address balance of payments difficulties than import restrictions.

24. **A strategy for voluntary resolution of corporate and household debt problems is urgently needed.** The working group formed of representatives of banks, NBU and the MoF should rapidly design and implement a voluntary framework for restructuring private sector debts, including proposals to facilitate out-of-court settlements.

25. **The program faces implementation risks that require close coordination among the authorities and with the Fund**. A key element of the program, bank resolution, is nearing the implementation phase, which involves decisions that will affect vested interests and public finances. This requires extraordinary coordination among the authorities, consistent backing by key political leaders, and better communication to markets.

Table 1. Ukraine: Selected Economic and Social Indicators, 2004-09 1/ 2/ 3/

	2004	2005	2006	2007	2008 Proj. 1/	2009 Proj. 1/
Real economy (percent change unless indicated otherwise)						
Nominal GDP (billions of hryvnias)	345	441	544	713	993	1,112
Real GDP	12.1	2.7	7.3	7.6	6.0	-3.0
Contributions:						
Domestic demand	9.1	13.2	13.1	16.1	14.4	-14.3
Net exports	3.0	-10.5	-5.8	-8.5	-8.3	11.3
Unemployment rate (ILO definition; percent)	8.6	7.2	6.8	6.4	6.0	9.5
Consumer prices (period average)	9.0	13.5	9.1	12.8	25.6	21.0
Consumer prices (end of period)	12.3	10.3	11.6	16.6	25.5	17.0
Nominal monthly wages (average)	27.5	36.7	29.2	29.7	37.1	10.5
Real monthly wages (average)	16.9	20.4	18.4	15.0	9.1	-8.7
Public finance (percent of GDP)						
Cash balance excluding banks. recap (both injection and interests)	-4.4	-2.3	-1.4	-2.0	-1.0	0.0
Augmented balance, including effects of banks recap. 3/	-4.4	-2.3	-1.4	-2.0	-2.0	-4.5
Privatization proceeds	3.1	5.0	0.4	0.6	0.2	0.1
Net domestic financing	-0.1	-3.3	-0.4	0.3	1.8	4.4
Net external financing	1.4	0.6	1.3	1.0	0.0	0.0
Public debt 3/	25.5	18.7	15.7	13.0	10.6	17.4
Of which: external debt (foreign currency denominated)	19.2	14.1	12.5	10.2	7.4	10.0
Money and credit (end of period, percent change)						
Base money	34.1	53.9	17.5	46.0	33.0	10.9
Broad money	31.9	54.4	34.5	51.7	37.2	9.4
Credit to nongovernment	30.2	61.8	70.6	74.0	40.9	-9.8
Velocity	2.7	2.3	2.1	1.8	1.8	1.9
Interbank overnight rate (annual average, percent)	6.3	4.2	3.6	2.3	…	…
Balance of payments (percent of GDP)						
Current account balance	10.6	2.9	-1.5	-3.7	-6.2	-2.0
Foreign direct investment	2.6	8.7	5.3	6.5	6.2	6.8
Gross reserves (end of period, billions of U.S. dollars)	9.5	19.4	22.3	32.5	31.4	30.7
In months of next year's imports of goods and services	2.6	4.4	3.7	4.0	5.1	4.5
Debt service (in percent of exports of goods and services)	5.3	4.9	5.1	3.9	2.8	4.2
Goods exports (annual volume change in percent)	18.2	-8.5	2.7	3.2	0.3	0.8
Goods imports (annual volume change in percent)	13.8	13.0	12.5	20.3	16.0	-19.7
Goods exports	51.5	40.7	36.1	35.2	35.3	39.9
Goods imports	45.8	42.0	40.9	42.7	44.8	46.4
Share of metals in merchandise exports (percent)	39.0	40.1	42.2	41.7	44.5	30.3
Net imports of energy (billions of U.S. dollars)	6.0	6.1	8.1	11.5	17.2	16.0
Goods terms of trade (percent change)	9.6	6.2	-0.2	9.0	7.8	-14.5
Goods and services terms of trade (percent change)	7.8	4.9	1.5	7.4	8.9	-10.5
Exchange rate						
Exchange rate regime	*de facto peg*				*managed float*	
Hryvnia per U.S. dollar, end of period	5.3	5.0	5.0	5.0	…	…
Hryvnia per U.S. dollar, period average	5.3	5.1	5.1	5.0	…	…
Real effective rate (CPI, percent change)	-1.4	12.0	4.8	2.6	…	…

Social indicators

Per capita GDP: US$ 3035 (2007); Poverty (percent of population): 8.0 (2006; World Bank estimate);
Life expectancy at birth: 68.3 years (2007); Infant mortality (per 1,000): 11.0 (2007); Gross primary enrollment (percent net): 90.2 (2007)

Sources: Ukrainian authorities; and staff estimates and projections.

1/ Policies assumed here include: (i) increased exchange rate flexibility as from 2008; (ii) convergence of natural gas import prices to Western European levels (adjusted for transit) by 2010; (iii) full pass-through of rising energy import prices in 2009; (iv) public-financed recapitalization of banks for a total amount of Hrv 54 bln (10 bln by end-2008 and 44 bln in the first half of 2009).

2 The public finance aggregates cover the whole of the general government sector, including local authorities and the social funds. Reported fiscal outturns are also adjusted by staff to ensure consistency with international accounting rules.

3/ Government and government-guaranteed debt, and NBU debt. Excludes debts by state-owned enterprises. Debt figures do not include IMF money.