

Overcoming Ukraine's macroeconomic crisis

12 March 2014

Ricardo Giucci, the head of the German Advisory Group in Ukraine:

Ricardo explained that Ukraine's macroeconomic policy was based on 3 decisions in the years 2010-2013. These were:

- Fixed exchange rate: First, the decision to keep the fixed exchange rate was a wrong one. During after the crisis the neighbouring countries have devalued, while Ukrainian hryvnia stayed the same. This made Ukrainian goods more expensive and the exports dropped. Also, as the monetary policy was following the fixed exchange rate, it caused an extremely tight money supply which brought the interest rates up to 18% [the number is after adjusting for inflation]. The overvalued hryvnia and the tight monetary policy lead to low amounts of exports and investments. Moreover, it has depleted the reserves. Because of these policies the Ukrainian economy's growth was around 0 for the last 2 years, while the average GDP growth of CIS countries was around 2-3% per year. Significant approaching payments make the outlook even more gloomy.
- Heavily subsidized energy prices: In the meanwhile, gas tariffs were heavily subsidized as it was sold to households at 16% of the original price and to local heating companies at 26% of the original price. In total the subsidies amounted to over 6% of the GDP. This has worsened the budget deficit, which started improving from 2009 to 2011, but worsened afterwards. Current account deficit has also worsened to over 10 billion USD from 2010 to 2013.
- Expansive fiscal policy: The fiscal expansion was performed mostly due to political reasons.

There were three alternatives that the Ukrainian government could undertake:

1. Raise debt via bonds;
2. Take on IMF loans conditional on the adjustment of policies;
3. Take money from Russia.

Option 1 was the preferred option as it did not require any adjustment of policies which would result in the loss of popularity among population. Taking a loan from IMF and conducting the reforms would be the only viable long-term solution, but the government was not keen on implementing the reforms. The final option was a credit from Russia, but that would involve political concessions and risks from within Ukraine.

What has happened in fact was that from 2010 to the first half of 2013 the government relied on Eurobonds worth 12.45 billion USD. It was fairly easy to attract money as the interest payments were 5% above market average and the financial investors expected the IMF to bail Ukraine out in case of default due to geopolitical reasons. However, this option became too risky for investors and around November

2013 the Ukrainian government had to resume talks with IMF regarding the loan money. However, they were interrupted by the agreement with Russia that promised 15 billion USD loan and a significant gas price discount. However, already in January the Russian bailout was stopped due to the protests in Ukraine. In February, the new government requested IMF assistance and is ready to accept the conditions, which is now is the only option. However, it must be realized that the current crisis is due to the economic policy within the last 3 years and not the recent protests.

Since February there was no stabilization scheme in place and the adjustments were somewhat disordered. A floating exchange rate was adopted which lead to the devaluation of 20% of Ukrainian hryvnia. The current reserves are only around 15.5 billion USD and the recent events put a very high stress on the banking sector, as almost 10% of deposits were withdrawn from bank accounts since January. The current administrative measures include requirements of 6 day pre-announcements of FX purchases, prohibition of cross-border premature payments and limited case withdrawal. However, these measures do not fix the underlying problem.

Currently Ukraine should cooperate with the IMF and implement further reforms, which include:

- Reduction of administrative controls of bank deposits and return to flexible exchange rate framework;
- Fiscal consolidation;
- Gradual increase in energy prices for domestic consumers;
- Fixing the bank system by saving the systemic banks and failing the minor ones.

However, the future reforms may be hard to implement due to the political instability and conflict in the Crimea. Moreover, Russian sanction against Ukraine are expected and could involve raising the trade tariffs, which could further suppress the growth. Despite that the Georgian experience after 2006 and 2008 prove that reforms can provide a sustainable path for growth. Georgia was growing by 10% following the reforms.

Nadiya Tsok, deputy head of the Ukrainian Mission to the EU:

She has explained the current priorities of the government and its recent achievements:

- Starting in March, the exchange rate was allowed to float which has quickly devalued hryvnia, but the devaluation was not as bad as expected.
- While the gas subsidies must be decreased, it has to be prepared in order to protect the poorest parts of societies.
- The new government has started selling the luxuries that were illegally purchased by the previous government and has implemented cuts in its own budget (e.g. switching to economy class from private jets).

- Ineffective programs that are researched marginally will be closed, since it is uneffective to finance only a fraction of their budget.
- Ukraine is about to receive monetary help from the US, the EU and IMF. For instance, the US provides Ukraine with an unconditional help of 1 billion USD dollars; further assistance is coming.
- Currently the main economic goal of the government is to stabilize the budget.

Open floor

During the discussion several issues were raised and discussed:

- It is necessary to communicate to population that the gas prices will certainly increase and there is no way to avoid it, so that there is wide social acceptance of it.
- Assets of the ex-president should be accounted and processed according to law, which might take a lot of time.
- It was suggested that the Ukrainian oligarchs make a contribution of 1 billion USD each in order to help the budget. However, it is quite unlikely as the oligarchs have assets, not cash and it might take time to liquidate them. Moreover, there is little incentive for them to do so.
- An idea of a wealth tax was raised and while it might be a possible solution, it should be implemented according to law, which might take time.
- Russian banks have given out loans to Ukraine in amount of 26 billion USD. Since there is a war with Russia going on, it was discussed whether Ukraine should default on these debts. However, Ricardo has stressed that it should be processed according to law and daughter branches of Russian banks should be treated as any other Ukrainian bank.
- Georg has pointed out that the head of the national commissions are subject to the political processes and are not independent. The official who proposed to raise gas prices was fired and nobody suggested it after him.
- It was pointed out that the decreases in gas subsidies could lead to political turmoil in the eastern parts of Ukraine. However, Ricardo pointed out that somebody will have to pay the higher prices anyway, but the gas use is very heterogenous across the population and the poorest parts of the society would have to be subsidized.
- The future of the oligarchs in the new system is currently uncertain. Yulia Tymoshenko wanted to re-privatize most of the companies back in 2005 and that has created a lot of uncertainty for the business climate in Ukraine. Also, while the oligarchs from the east of Ukraine need access to Russian markets and could suffer due to the trade war, Russia also needs Ukrainian imports. Ultimately, exports will have to be reoriented.
- Ukraine could also learn from the Troika's programs. Euro is currently too expensive for Greece and Greece is overvalued. However, unlike Greece Ukraine has very flexible labor markets.
- It was also pointed out that Russia is the only state in the world that claims that the new government is illegitimate. The new government was voted in by the majority of the Parliament after the ex-president ran. Also, the new Constitution that reinstates Ukraine as a parliamentary republic is widely supported by the population after the experiences with the ex-president Yanukovich.