PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 26 (621), 28 February 2014 © PISM

Editors: Marcin Zaborowski (Editor-in-Chief) ● Katarzyna Staniewska (Managing Editor)
Jarosław Ćwiek-Karpowicz ● Artur Gradziuk ● Piotr Kościński
Roderick Parkes ● Marcin Terlikowski

Ukraine: Economic Reforms Can't Wait for Stabilisation

Patryk Toporowski, Sebastian Płóciennik

Ukraine is close to bankruptcy and desperately needs foreign financial assistance to service its obligations. Its finance ministry estimates the state's needs at $35 billion up to next year. But even this additional money will not suffice to stabilise the economy: Ukraine needs profound structural reforms if it is to be transformed into a modern market economy. Poland can play a role in this process, acting as a model of European reform to the east, and as promoter of Ukraine's interests to the west.

Ukraine's GDP has stagnated for two years, and its currency, the hryvnia, has lost around 15% of its value since the beginning of the year, driven by uncertainty and a current account deficit of 7.9%. The national bank's reserves are insufficient to stabilise the exchange rate. Many banks have introduced daily withdrawal limits, individuals are closing their accounts, and some Polish-owned banks, such as PKO BP's Kredobank, have closed branches for the foreseeable future.

The markets perceive Ukraine as a potential insolvency case. Besides being roundly rated as close to trash status, Ukraine's cost of debt grew in the darkest days even to around 15.5% for 10-year bonds, whereas credit default swaps (the cost of default insurance) reached around 11 percentage points—one of the highest in the world. After the political situation in Kyiv was resolved, however temporarily, the cost of bonds improved, but only to 9.26%.

Even if the market did welcome the change in Ukraine's government, moreover, the country still needs to pay $13 billion for bonds debts that will come due between now and 2015, and an additional $19 billion worth of bonds are due in 2016. This is not to mention the bills for natural gas of around $2 billion, owed to Russia. Bearing in mind that Ukraine's GDP is only around $175 billion, the total sum that it must pay in the coming years is enormous. Ukraine's ministry of finance assessed the government's needs at $35 billion till the end of 2015.

Finding the Immediate Aid. Ukraine badly needs money. At the end of 2013, Russia promised to buy Ukrainian bonds to the tune of $15 billion. But in the middle of February, and after buying bonds for $3 billion, it suspended further purchases pending the outcome of the ongoing political crisis. After President Yanukovych's flight, further financing from Russia was hardly possible, and on 23 February the G20 finance ministers gathered in Sydney to agree that the IMF is the most suitable institution to offer aid, with the IMF announcing its readiness to help a democratically-elected government.

In fact, the IMF ring-fenced $15 billion for Ukraine in 2009, of which only $2 billion was spent. Yet, although the $13 billion balance is poised to help in restructuring Ukraine's economy, it depends on domestic economic reforms being introduced. Statements from IMF officials clearly suggest that the aid would flow only with a considerable lag of at least 2–3 months. On top of that, it is not certain whether the IMF's $13 billion is anywhere near sufficient. This means that either an increase in the IMF's proposed funds, or additional funds from other sources, are required to run Ukraine's economy.

The EU's package to Ukraine for 2014 amounted to only €600 million. However, this can be extended to complement the other (IMF) packages. The EU may help Ukraine through increasing macro-financial assistance—the same mechanism that was used to aid Georgia in 2009. A further possibility is for the ECB and other central banks to offer credit to Ukraine to maintain the unrestricted exchange of the hryvnia. Moreover, the EU may consider re-orienting means within Heading 4 of the EU budget, in favour of the Eastern Partnership and the quality of governance in

Ukraine. One other available option is to use means from the European Development Fund, outside the common budget.

These options could be treated together with the IMF's aid package and presented at the conference of donors to Ukraine, which should take place as soon as possible. By bringing together other donors, such as the G20 states, it is possible to offer a single well-designed and integrated aid package with no more than minor inefficiencies and overlaps. A schedule of payments is also crucial. The quality of the administration should be the first priority, before the officials receive the cash marked for the biggest socio-economic projects. And the aid should be divided into several conditional tranches in order to secure positive results.

Structural Reforms. Whilst the provision of funds is the most pressing priority, Ukraine needs deep reforms. Their absence will render any financial aid meaningless. The EU, together with the IMF, as the most important and long-term donor, should define a "road map" which marks specific stages in the integration of Ukraine with the EU over the next decade—from association, through membership of the European Economic Area to the eventual prospect of EU membership. Every stage should be signposted with reforms. This strategy of conditioning worked well in the case of candidates from Central Europe, and should also be helpful in the case of Ukraine, where it would consist of four strategic areas.

First, the Ukrainian economy needs to be open. An association agreement will help to boost trade with the EU and develop mutual ties. Here, it is worth considering some asymmetric advantages for Ukraine, which will minimise the shock and help to smooth adjustment. The liberalisation of trade with the EU should go hand in hand with a more liberal visa regime—here the preparations on both sides are quite advanced. Deeper trade integration with the large EU market will make Ukraine not only more competitive, but also less vulnerable to sanctions from Russia.

The second area is finance. The official exchange rate of the hryvnia is overvalued, resulting in a large current account deficit, controls on capital flows and costly interventions. In the past, the IMF required a flexible exchange-rate regime, but Kyiv refused, concerned about the costs of devaluation. Under current circumstances, a floating regime should be introduced as soon as possible, but to avoid a sudden collapse the IMF should create a stabilisation fund similar to that offered to Poland in 1989. And that is not all. Ukraine must reform its budget, which has fallen into a large deficit in recent years. There is also a lot of uncertainty about the condition of the financial sector as banks are severely exposed to bank runs.

The third area of reform is the efficiency of the state. In the rankings of Transparency International, which measure corruption, Ukraine is 144 on a list of 177 states, sharing a place with the Central African Republic and Nigeria. Kyiv's determination to change this has been limited: in November 2013 it refused to sign the anti-corruption initiative of the European Bank for Reconstruction and Development. In the coming months the priority of the new government should be a zero-tolerance policy against corruption and fraud. This means deep reforms of the judiciary and administration.

The fourth area, which integrates the various weaknesses of Ukraine, is energy policy. Preferential prices offered by the state for households at an 86% discount create a huge burden on the national budget. Moreover, so-called oligarchs have purchased gas as household units but were reselling it or using in industrial production, causing massive losses for the state. Another problem is the dependence on imports from Russia, also controlled by the oligarchs. Thus, the EU and other international partners should help Ukraine to diversify sources of energy and recognise the opportunities connected with shale gas.

Recommendations. These structural reforms, implemented jointly with the provision of financial aid, should start a process of reorientation, shifting power from the oligarchy to small and medium-sized enterprises. This will be a better engine for the economy, and contribute to furthering democracy and independence. Instruments applied by the European Union and its Member States to support this process should gradually go beyond the catalogue above, including the integration of universities from Ukraine into European networks, or the creation of joint infrastructure projects.

Rather than providing (modest) individual aid, Poland should focus on convincing the whole EU of the benefits of structural, long-term programmes in favour of Ukraine. Poland's role might, moreover, be more distinct in the field of consulting and organisational support. Ukraine will soon face many sophisticated challenges, for example how to deal with the social costs of the reforms. Poland has both successes and failures in this area, and together they create a very interesting and useful template for Ukrainian reformers.

If Warsaw pushes other governments to provide financing, it may face criticism of free-riding. It should, therefore, highlight that greater Ukrainian integration comes with costs of its own for Poland. Its agricultural sector will face competition from Ukraine, which enjoys exceptional natural conditions. Poland may also start to lose out in some areas of industry. Foreign companies which once moved production to Poland attracted by low labour costs may consider shifting again to a country with wages three times lower.