BRUEGEL POLICY CONTRIBUTION

02

THE HARSH REALITY OF UKRAINE'S FISCAL ARITHMETIC

MAREK DABROWSKI, JUNE 2015

Changes to the pension system, on which Ukraine spent 17.1 percent of GDP in 2013, were limited. They included cancellation of some earlier deci-

'The dramatic developments in the second half of 2014 painfully exposed the optimistic macroeconomic projections of the Stand-By Arrangement. Ukraine's GDP declined by 6.9 percent in 2014 instead of the forecast 5.2 percent, as the conflict in Donbass escalated.'

2. Macroeconomic data on 2014 and projections for 2015 are drawn from IMF (2015) unless otherwise indicated.

This means substantial price rises, which are usually most painful for the lowest-income population groups. Thus, the policy of gradual fiscal and macroeconomic adjustment aimed at reducing social pain actually magnified it. It is not the first such experience in Ukrainian economic history (think about the economically dramatic 1990s).

Furthermore, the deep devaluation of the hryvnia undid the effects of the partial adjustment of gas and heating tariffs in mid-2014. In early 2015, these tariffs were lower relative to the gas import price in hryvnia than a year earlier. The reduction in price of gas imported from Russia, from $385 to $248 per thousand cubic metres in Q2 2015 (Powell *et al*, 2015), provided some relief but was not enough to offset the consequences of the devaluation of the hryvnia. Thus the new dramatic increase in domestic gas tariffs became urgent to reduce the disparity between import and domestic prices and Naftogaz's resulting quasi-fiscal deficit.

Again, we observe a well-known paradox: a policy to providing social cushioning (by postponing the unavoidable price adjustment) has the opposite effect – it increases the cumulative pain and delays potential gains such as reduced fiscal imbalances and the possibility of structural and institutional changes in the gas industry (see below). In other words, slow adjustment during a crisis often results in magnified adjustment needs.

The new wave of devaluation increased the burden of public debt: according to the IMF projection (2015, Table 1, p.47), it was expected to reach 94.5 percent of GDP in 2015, including the publicly guaranteed debt. Devaluation also increased private external debt: the total external debt (both public and private) is projected to increase from 102.4 percent of GDP in 2014 to 158.4 percent of GDP in 2015. This also increases the vulnerability of Ukrainian banks and those non-financial corporations that have borrowed abroad, and will increase the cumulative costs of bank restructuring, which were already high in 2014.

3. http://www.imf.org/external/np/sec/pr/2015/pr15243.htm .

privileged groups of pensioners such as retired civil servants, prosecutors, teachers and academic workers. While reducing pension privileges for certain professional groups goes in the right direction, the indexation delay means indiscrimi-

6. According to the pension reform adopted in 2011, the retirement age for women increases by six months each year to reach 60 in 2021 (from 55 before the reform). The retirement age for men – civil servants will gradually increase to 62 in 2021.

7. See http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc_150981.pdf.

$3 billion out of the total $23 billion of Ukraine's Eurobond exposure does not participate in the negotiation process.

Even if the debt agreement is signed soon, it will close Ukraine's access to private markets for years. It might also discourage FDI and other forms of private capital inflows that are so badly needed to restructure and modernise the Ukrainian economy. Furthermore, when one looks at the EFF medium-term fiscal projection, the question arises of how Ukraine will be able to finance the continued fiscal deficit of more than 2 percent of GDP and refinance its public debt exceeding 80 percent of GDP after expiration of the EFF at the end of 2018. It is worth remembering that Ukraine faced problems before (1998-99, 2008-09, 2014) with private market access when it had much lower public debt-to-GDP ratios.

In this context, the approved EFF does not necessarily meet the second and third criteria of exceptional access (medium-term debt sustainability and regaining access to private capital markets by the end of programme life), which would justify the possibility of extending the IMF financing of this size (900 percent of the member country's quota in the Fund) with heavy frontloading.

OTHER WEAKNESSES

The EFF programme only partly addresses the structural and institutional reforms that are so important for the modernisation and consolidation of the Ukrainian state and the return of the Ukrainian economy to a sustainable growth path. This reflects generally slow and sometimes contradictory changes in this area.

Since the collapse of the Yanukovych regime in early 2014, the new authorities have made some progress in areas such as business deregulation

8. See eg http://24tv.ua/news/showNews.do?minfin_snova_rassmotrit_zakon_o_valjutnyh_kreditah&objectId=4-908

Ukraine's defence capacities against external aggression.