

**Jerome Vacher, IMF Resident Representative in Ukraine:
The Fund stands ready to support the economic reforms in Ukraine**

Yuriy Skolotyanyi, Zierkalo Niedieli, December 7, 2013

After as much as five central TV channels broadcasted the statement by Victor Yanukovich claiming the lack of any results in negotiations with the IMF as well as unacceptability of the IMF conditions requiring to rise the utility tariffs for the households, the odds for signing the new financing program with the Fund seemed as illusive as the chances for signing the Association Agreement with the EU.

However, shortly after that, Ukrainian President and then Prime-Minister announced that they would be interested in restoring the effective cooperation with the “creditor of the creditors” as soon as possible, though “under acceptable conditions” and provided “a reasonable compromise is reached”.

Incidentally, in his interview to ZN.UA Geoffrey Pyatt, Ambassador of the US to Ukraine, expressed his confidence in the fact that Ukraine has no alternative except resuming the cooperation with the IMF.

What are the Fund’s views on the chances to bring the positions in negotiations closer with a view to the above? Is the conditionality brought forward by the Fund immutable and what is the motivation behind it?

ZN.UA has requested Jerome Vacher, IMF Resident Representative in Ukraine to provide explanations on these and other issues.

- *Mr. Vacher, are you in a position to confirm the existence of the letter quoted by the Prime Minister? Did it indeed contain the requirements of 40 % increase in gas tariffs, freezing the minimum and average nominal wages at the current level, undertaking substantial cuts in budget expenditures, reducing energy subsidies, phasing in of VAT exemptions for the producers in agricultural and other sectors ?*

The Fund’s views on the policy adjustment needed in Ukraine have been expressed consistently in our discussions with the authorities during this past year, including the Article IV mission's concluding statement published in Kyiv in October. Referring to your question about the letter, the content of the Fund's working discussions with the authorities is not made public by the Fund.

- *Let us then get back to the statements published earlier. The official statement publicized by the IMF on October 31, 2013, says among other things that the “authorities are developing policy proposals to correct external imbalances and revitalize growth”. Can we discuss this in a more detail? Did the IMF staff have an opportunity to review any of such proposals at least on a preliminary basis? What are the key components of these proposals?*

The statement that you are referring to summarized our discussions for the 2013 Article IV consultation, our annual health check on the economic situation and policies in Ukraine, with a team visiting Kyiv October 17-29.

The IMF board is scheduled to discuss in mid December the report that results from this visit.

As mentioned in this press statement, the authorities have been developing policies to correct external imbalances and revitalize growth. To form a comprehensive reform agenda, these should cover:

- 1) exchange rate and financial sector policies;
- 2) fiscal policies;
- 3) energy sector policies, including tariff adjustments accompanied by targeted subsidies for 40% of the households who need it the most;
- 4) reforms to improve the business climate and support growth.

After two missions in early 2013 (February and April), Fund staff and the authorities have been engaged in technical discussions on policies that could form part of a comprehensive Fund-supported program. The Fund stands ready to continue discussions with the Ukrainian authorities on these matters.

- *And yet if we are to discuss specific conditionalities emphasized by the Fund, could you provide more details? In particular, would you please specify how the Fund views the contents of measures to ensure greater exchange rate flexibility? What are the main deficiencies of the current regime for the market regulation? What steps are expected on the side of Ukraine with regards to strengthening the financial sector?*

It has been the IMF's long-standing advice that the Ukrainian economy would be best served by a more flexible exchange rate. This would help mitigate external shocks due to volatile export prices and partner country demand, strengthen reserves and preserve competitiveness. In the medium term, we believe that inflation targeting is the appropriate monetary framework for Ukraine, and preparations for its introduction should be accelerated.

To strengthen the financial sector and prepare it for greater exchange rate flexibility, several steps can be taken. For example, we found that large negative foreign exchange positions have been reduced, but that further progress is needed in this area.

We have also advised the use of independent diagnostic bank audits to ascertain asset quality and the adequacy of loan classification, provisioning and collateral. We have also been working with the National Bank of Ukraine on strengthening its financial stability and supervisory functions. Other policies to strengthen the financial sector over time include progress on overcoming remaining regulatory and tax obstacles to recognizing, restructuring and selling non performing loans, and progress on the implementation of supervision on a consolidated basis.

- *There are a number of issues related to the state budget. How ambitious in the IMF view budgetary consolidation shall be for the next year compared to the current*

- year budget (in terms of quantitative parameters: budget deficit, expenditure constraints, limits on growth of wages and pensions)? What measures are being proposed/considered by the Authorities and which of them are indeed relevant in the view of the IMF staff (including reduction of the existing tax exemptions)? Are the differences in positions being gradually eliminated and what are the key impediments?*
- *Have the operational versions of the 2014 draft budget been proposed to the IMF Staff assessment and what is the status of finding the agreement on its key parameters?*

The draft 2014 budget has not been submitted to Parliament as we speak and we have not seen a working version of the budget. However, we have been able to discuss the authorities' economic outlook and their policy intentions in the fiscal area in the context of our Article IV Consultation mission.

We advised against unaffordable and untimely tax cuts, with any tax cuts postponed until the needed adjustment in current expenditure is well under way and the budget deficit reduced to more sustainable level. We see this more sustainable level at about 2 ½ percent of GDP for next year, followed by further gradual reduction in the medium term. High budget expenditure (nearly 50 percent of GDP) should be reduced by limiting spending on goods and services, keeping the public sector wage bill unchanged, and indexing pensions only with inflation. This should be accompanied by several reforms to strengthen the institutional framework for fiscal policy and limit the accumulation of fiscal risks over the medium term. And of course, the significant quasi fiscal losses in the energy sector have to be addressed in parallel.

- *You have mentioned the issue of quasi fiscal losses in the energy sector. In the mission statement, the issue of tariff increase was extracted from the context of fiscal consolidation and formulated as a separate issue. To what extent the schedule of this increase needs to be intensified? What effects will this produce in terms of reducing the state budget deficit? Has the Fund received such proposals from the government? Could you please specify in a more detail the essence of the proposals and the IMF reactions to these? If Ukraine were able to ensure fiscal consolidation without raising tariffs, would this move be needed at all?*

I can tell you how we see the situation in the energy sector and what is needed in our view. You are correct in saying that this is much broader than just a fiscal issue, and there are many other important reasons to address it decisively. Overall energy subsidies in Ukraine, on and off budget, are assessed at 7 ½ percent of GDP in 2012 with relatively more affluent households being the largest beneficiaries. This is a regressive and inefficient system. The very low retail tariffs (20-30 percent of economic costs and 3-5 times lower than in the neighboring energy-importing countries such as Moldova, the Baltics, and Poland) – the main factor behind the high subsidies – encourage one of the highest energy consumption levels in Europe and lead to large quasi fiscal losses by Naftogaz.

They also generate balance of payments and governance problems, with various arbitrage opportunities between the different rates for energy. Our view is that the current extremely

low gas and heating tariffs for households cannot be maintained any longer. We are aware of the important role of gas and heating in Ukraine. But after all, when you go to the shop to purchase food or clothing, no one allows you to pay only a fraction of the price – why should this be allowed for energy?

Of course, we do not think that full cost recovery can be achieved overnight given that there is quite some way to go. We recommend that the tariffs be increased steadily and decisively in several steps over the next few years toward economic cost recovery.

Such policy is not only indispensable for reducing the large quasi fiscal losses and budget subsidies, but to rein in the current account deficit, secure funds for domestic investment to achieve energy independence – a key medium term objective of the authorities – and alleviate governance problems. But it is very important to note that at the same time we recommend increasing targeted social assistance to the bottom least affluent 40 percent of households by expanding existing means tested programs. 40 percent of the population is significant and more than other countries are doing. This aspect of our recommendations – a compensation of higher tariffs for a substantial share of households - is often overlooked unfortunately. And of course other measures that take much longer time to take effect, such as energy efficiency measures or increases in domestic production, are also needed to reduce costs and ensure the sustainability of the energy sector.

- ***What other reforms and initiatives in your view might be helpful for Ukraine under the current conditions?***

A comprehensive and credible reform agenda is needed to correct imbalances and boost growth. As noted, this includes exchange rate flexibility combined with policies to strengthen the financial sector, ambitious fiscal consolidation, and reduction of the large quasi-fiscal losses in the energy sector.

But this in our view also includes one more important component: comprehensive structural reforms to improve the business climate and growth. Much remains to be done in Ukraine despite recent progress and efforts undertaken by the authorities. We recommend a focus on structural reforms that would address the most binding constraints to growth, which are generally the areas where Ukraine lags well behind other countries in Central and Eastern Europe. This includes revamping the judicial system, simplifying or repealing burdensome government regulations, stepping up anti corruption measures, and enforcing clear and consistent rules in tax administration.

- ***One of the concluding paragraphs of the above-mentioned Mission statement emphasized the “need for the authorities to make significant progress in all of the above policy areas.” Shall we interpret this as strengthening the requirements for Ukraine to obtain the Fund financing and – hence – reducing its chances for it?***

A comprehensive set of policies needs to be put in place to address imbalances in Ukraine’s economy and sustain economic growth. These are the same set of policies that we have recommended for quite some time in the dialogue that we have with Ukrainian authorities.

But of course the more the situation deteriorates the deeper the needed adjustment is likely to be in order to correct imbalances.

So it is always better to be proactive and address the situation rapidly. And given the track record in implementing policies in the previous two arrangements with the IMF - it has also always been clear that strong upfront measures would need to be implemented to ensure that Ukraine's macroeconomic problems are being adequately addressed.

This is also the expectation of many, including investors and the population, which favor a strong commitment and a clear path on economic policies for the months and years ahead.

- *What is the position of the IMF (if any) with regards to the recent decisions by the leading international rating agencies lowering the ratings for Ukraine? Where is the line which separates fairly adequate assessment of the risks and an overly pessimistic view on developments in Ukraine?*

We do not take a position on individual decisions taken by rating agencies. However, the downgrades largely reflect Ukraine's current vulnerabilities and underscore the need for corrective measures to address its macroeconomic imbalances: the large current account and fiscal deficits, the low level of reserves and the sizable quasi fiscal losses in the energy sector.

- *Has the IMF indeed assessed the potential amount of financing – in accordance with the PM's statement – as USD 4 billion?*

Before a specific amount is agreed, an agreement on the policies that would address imbalances and promote growth and would constitute the basis for a program would be needed.

- *Is the Fund considering rescheduling (rolling-over) of the loans extended to Ukraine?*

We lend to support policies that are designed to address imbalances in the economy and promote growth, and not for the purpose of refinancing existing commitments. Ukraine has been servicing its obligations to the Fund and the international community in full and on time.

- *Many observers believed that signing the Association Agreement between the EU and Ukraine would have raised its chances for resuming the program with the Fund. Had these expectations been justified and how the absence of any agreement reached in Vilnius would affect the negotiations between the IMF and Ukrainian authorities?*

We view a signing of the EU association agreement as positive for Ukraine's economy, as it would potentially help exports and increase FDI, and can anchor structural reforms.

We also note that potential gains could be significantly magnified once competitiveness and the business climate are improved along the lines that we recommend.

That said, there is no link between the EU association agreement and potential program negotiations with the Fund. Program discussions are a matter of bilateral relations between the IMF and Ukraine.

- ***How strongly do the positions of the key IMF share-holders – the US and EU member states - affect the decisions of the Executive Board of your organization and could they play a decisive role? Can we consider their current stance as favorable for Ukraine?***

The U.S. and EU play an important role in the world economy and consequently at the Board of the IMF. However, the Executive Board of the IMF represents all its 188 member countries. The IMF has also been implementing a quota and voice reform to better reflect the changing relative weights of the member countries in the global economy, in particular the growing weight of emerging economies. The Executive Board normally makes decisions based on consensus but sometimes formal votes are taken. But for all member countries, the common goal is that the IMF through its policy advice and lending operations contributes to sound macroeconomic policies that correct imbalances and support sustainable economic growth.

- ***Could you please provide any comments regarding the recent statement by Prime Minister Azarov and President Yanukovich claiming that the IMF conditionality and in particular the need to raise household gas tariffs by 40 % is unacceptable for Ukraine? Has such a condition indeed been brought forward by the IMF? What effects might this statement have with regards to the prospects of negotiating a potential new program between the IMF and Ukraine?***

Earlier in this interview, we have discussed what are our policy recommendations on the energy sector that include tariff adjustments accompanied by targeted subsidies for households who need it the most. As we indicated, to address imbalances and support growth there is a need for a comprehensive reform agenda centered on increased exchange rate flexibility accompanied by measures to strengthen the financial sector, ambitious fiscal consolidation, energy sector reform, and deep-reaching structural reforms to improve the business climate and support growth. The Fund stands ready to support the economic reforms in Ukraine and continue discussions with the Ukrainian authorities on these matters.