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Russia's support package: Short- and medium term implications

On 17 December 2013 Ukraine signed a number of agreements with Russia which aim at stabilising the financial situation of the country. The monetary value of the financial package amounts to USD 18 bn – a staggering 10% of Ukraine's GDP but also a substantial amount for Russia. It includes loans worth USD 15 bn as well as a preferential price for imported gas, saving Ukraine USD 3 bn in 2014 alone. On top of those two measures the two sides agreed on trade simplifications as well as joint investments.

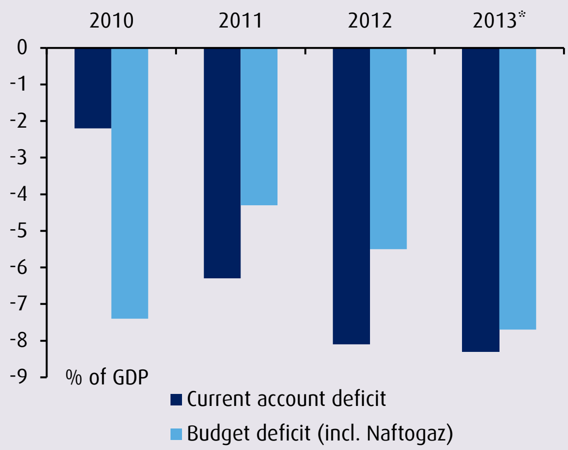
The support package ensures Ukraine can meet its financial obligations, thus avoiding a looming sovereign default and uncontrolled depreciation of the Hryvnia. That said, the Russian support does not offer any solution to Ukraine's more fundamental problems; namely, a much needed reduction of the country's budget and current account deficits. Therefore, the package only addresses the short-term financing needs of Ukraine.

Indeed, following the presidential election in March 2015, not only will Ukraine still face the same massive imbalances but, on top of that, also much increased national debt burden. Therefore, the financial package needs to be judged as problematic in the medium term.

Starting point

The economic situation in Ukraine, which had been strained for some time, has taken a turn for the worse during the second half of 2013. The substantial so-called twin deficits of the country's budget and its current account reached levels, which at this point could not been financed any longer without external help.

Current account and budget deficit



*Source: IMF, *estimated*

This development was mirrored in the National Bank of Ukraine's ever shrinking official reserves, which only provided a mere 2.2 months of import coverage at the end of November. Faced with this rather dramatic situation of a looming default and in turn an uncontrolled depreciation of the Hryvnia, there was no alternative to seeking assistance from an external source. Specifically, this would have meant either one of two possible scenarios: A new IMF programme (including the conditionality attached to it) or a bailout from Russia.

The details of Russia's financial package

The agreement between President Putin and President Yanukovych signed on 17 December 2013 meant that the scenario 'Russian bailout' has materialised. While the package includes various arrangements, the most important points will be highlighted here:

Short-term loan worth USD 15 bn

Russia agrees to buy Ukrainian government bonds to the tune of USD 15 bn with most of the funds provided by Russia Sovereign Wealth Fund. However, it is important to note that the loan will not be extended all at once, but disbursed in several tranches with the precise timing yet to be specified. Nevertheless, market observers expect that the loan will sufficiently satisfy Ukraine's government financing needs until March 2015 – i.e. until the forthcoming presidential election.

A first USD 3 bn tranche of Eurobonds, which are listed at the Irish Stock Exchange, has been issued in December 2013. Especially noticeable is the unusually short two year term – which is also likely to be a feature of the following tranches – and implies that repayment has to start already at the end of 2015.

The gas price discount

Additionally, starting on the 1st of January 2014, the price of gas imported by state-owned Naftogaz from Russia is reduced to 268.5 USD/1000 m^3. This represents a discount of USD 138 or more than 30% off the old import price. The fact that this discount needs to be confirmed by both sides each quarter in order to be renewed represents a powerful lever for the Russian side. There is also very little information on the agreed supply quantities.

Simplifications of bilateral trade

It is understood that the recent problems of Ukrainian exporters to access the Russian are meant to be resolved swiftly by mutual agreement. This is of particular of importance for Ukrainian exporters of steel pipes, rail carriages and chocolate – to name only some – which have been suffering from increased barriers to export their goods to Russia during the second half of last year.

Investments

Finally, there is agreement to promote joint investment projects in various sectors.

The whole package

All in all, the Russian support makes available financial assistance worth USD 18 bn which – at 10% of GDP – is a very significant amount for Ukraine. However, it also represents a substantial sum for Russia, which has to make the funds available in a relatively short amount of time. Nevertheless, with both loans and gas price discounts paid out in tranches, Ukraine is for the foreseeable future fully reliant on Russia's good will.

Short- vs. medium term implications

The deal with Russia is mainly a financial package which, for now, allows Ukraine to finance the twin deficits of its state budget and its current account balance and, in turn, avoid a default and the resulting uncontrolled depreciation of its currency.

These short-term effects have been greeted warmly by financial markets. As a result the interest rates especially of Ukrainian short-term Eurobonds fell from 12% to 7%. Reflecting this, the rating agency Standard & Poor's has changed its outlook from "negative" to "stable".

However, the aid package does by no means resolve any of the fundamental macroeconomic problems of Ukraine. Indeed, while the gas price discount is likely to ease the burden on both, the state budget deficit as well as the current account deficit, by around 1.5% of GDP, they are unlikely to be reduced lastingly. This is particularly true as in the run-up to the presidential election in March 2015 public expenditure is likely to increase again.

The Russian aid package does merely finance the two deficits for some time while offering no attempt to reduce them lastingly and thus doing little to improve the sustainability of the economic situation. This is where it differs from a typical IMF programme which would seek to reduce existing imbalances in the form of excessive budget and current account deficits. The loan which normally accompanies such an IMF programme is only meant to provide breathing space and make sure that the adjustment happens in an orderly manner.

Therefore, our assessment of the medium term implications of the deal with Russia is clearly negative. By mid-2015 – following the elections – Ukraine will not only have to face up to the same old problems of massive imbalances again, but it will also have to deal with a much higher debt burden. Indeed, it is estimated that the Russian package will increase Ukraine public debt from currently 40% of GDP to 50% - which would constitute a very high debt level for a transition economy like Ukraine.

Conclusions

Ukraine has been living beyond its means for some time and an economic adjustment, as demanded by the IMF, was unavoidable. Only by making use of the Russian financial assistance, Ukraine was able to stabilise the situation for the time being while postponing the required adjustment into the future.

Though, on the face of it, this seems to be a good deal, a closer inspection shows that the situation has only been made more problematic. Not only does the country lose valuable time for addressing its fundamental economic problems, it also will have accumulated further debt thus making any eventual adjustment in 2015 more difficult.

Finally, there is no such thing as a free lunch, and many observers assume that the agreement of 17 December is likely to contain concessions from the Ukrainian side. However, as it is not clear yet what they involve, this assessment is by no means conclusive and may have to be reviewed in the near future.

Authors

Robert Kirchner, kirchner@berlin-economics.com
Dr. Ricardo Giucci, giucci@berlin-economics.com

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German Advisory Group
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Contact
German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59, D-10627 Berlin
Tel. +49 30/20 61 34 64 0
Fax +49 30/20 61 34 64 9
info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de