Ukraine and The IMF: An Uneasy Cooperation

Fyodor I. Kushnirsky[1]

ARTICLE INFO

Available Online July 2014

Key words:
Conditionality;
Economic Growth;
Gas and Heating Tariffs;
IMF;
Ukraine.

ABSTRACT

The paper discusses the role of current political developments in Ukraine, the history of Ukraine-IMF cooperation, the estimation of the effect of IMF financing on Ukraine's economic growth, and the role of the IMF conditionality in controversial issues of increasing flexibility of the national currency, raising gas and heating tariffs, and implementing broad-based economic and governance reforms. Based on results of the estimation of a modified production function, the hypothesis of a positive effect of IMF credit on Ukraine's economic growth has been rejected. The analysis of specific requirements attached to a 2014 standby loan, all of which were accepted by the new government of Ukraine, shows that they will drastically reduce standards of living. Moreover, the government will have to perform magic by reducing the state budget deficit, on the one hand, and significantly boosting subsidies to the needy to compensatefor the rising cost of municipal services, on the other hand. The ups and downs in Ukraine-IMF cooperation demonstrate that the Fund's means of enforcement of conditionality contracts are quite limited.

Introduction

In beginning this research, I did not pay much attention to the political component of Ukraine's socio-economic model. Yet it has become clear that the developments, unleashed by political unrest erupting in November 2013,are too important to be ignored, as they may affect the country's social and economic fabric for years to come.Formally, the unrest was triggered by ex-president Yanukovich's breaking a promise to sign an agreement of association with the European Union, but, in a broader sense, Ukraine once more has been entangled in a tug of war between western powers and Russia.

Battles for influence over Ukraine, occupying a crossroad position between competingmilitary powers, were going on ever since the founding of Kievan Rus' in the 9th century. A culmination was reached toward the end of the medieval period, especially under reign of a leader of Ukraine's Cossacks Bohdan Khmelnytsky. Tired of conflicts with the Polish-Lithuanian Commonwealth, Ottoman Empire, Crimean Tatars, as well asaninternal struggle, Khmelnytsky was seeking a protectorate from Russia, which stayed away from hostilities and lawlessness in Ukraine. Eventually, in 1654 Russia agreed to a military and political alliance with Ukraine that led to the latter's gradual incorporation into the Russian Empire.

A brief period of independence happened in Ukraine in 1917-1920 following the February 1917 Revolution in Russia. Several independent states and regions were declared by rival leaders, with the main one, Ukrainian National Republic. With a rapid succession of leaders replacing one another, coup d'états, uprisings, and alliances with neighboring countries, the larger central and eastern territories of Ukraine ended up as a part of the Soviet Union formed in 1922, andwestern Ukraine became a territory controlled by Poland.

In December 1991 the Soviet Union was officially dissolved, while Ukraine declareditsindependence several months earlier, after an unsuccessful attempt by conservative forces to restore the Communist party control of the country. Leonid M. Kravchuk, Ukraine's first elected president, failed to introduce any reform to move away from Soviet central planning. Reforms gradually started under the second president, Leonid Kuchma, whenprices were liberalized and many small and medium-size enterprises privatized. However, the implementation of reformswas slow and inconsistent, and a positive effect on the country's economy

[1] Professor, Department of Economics, Temple University, United States, 1301 Cecil B. Moore Ave., Philadelphia, PA 19122, Tel. 215-204-5021; Fax 215-204-8173, E-mail: fikush@temple.edu.

happened only toward the end of the century. Reforms continued under the presidents Viktor Yushchenko and Viktor Yanukovich, with varying success.

Once more in recent history, Ukraine has been ensnared in a struggle for influence between European powers and Russia when in November 2013 then-president Yanukovich provoked massive demonstrations in the country's capital, Kyiv, by breaking a promise to sign political and free-trade agreements with the European Union.On the wave of political unrest that turned into an open military confrontation and forced the president to flee the country, several clans, mostly from Dnepropetrovsk, Donetsk, and Lviv, succeeded in gaining controlof the country's government.The first twoclans happened to be in command of metal and energy industries. The Lviv clan, not being powerful economically, became influential in Ukraine's politics, too. It consists of several right leaning nationalistic parties and paramilitary formationsthatconsider themselves on a mission to enforce a strict and exclusive definition of the 'true' Ukrainian identity.

A major reason for unrest in eastern Ukraine, which began after the ousting of president Yanukovich, is seeminglysimple: It was about the status of the Russian language. However, given that fighting over the status of Russian was going on ever since the country became independent, the case is more complicated. After attempts by proponents to make Russian the second official language failed, it was given the status of a regional language allowed to be used in areas of a high concentration of the Russian population. Yet, immediately followingthe president's fleeing Ukraine, a nationalistic group in charge of cultural affairs was able to push the shocked *Verkhovna Rada* (state parliament) to strip Russian of its official status. Although the decision so far has not become law, the damage was done. An instant unrest in several regions quickly turned into a civil war in Donbas, the eastern part of the country.

Why Donbas? It is the most industrially developed part of the country, with huge coal deposits, robust mining, ferrous metallurgy, and chemical industries, environmental degradation, and massive unemployment. The Soviet industrialization drive began in Donbas in the 1930s, with massive infusion of labor from all over the country to build and operate mines that delivered energy resources to existing factories and construction projects, and heat and electricity to the population. The expansion of production in Donbas further accelerated after WWII. If under Stalin's regime workers were mobilized or coerced otherwise to move to Donbas, along with echelons of penal labor, from the 1950s they were attracted through organized recruitment by being offered cash incentives and dwelling for families, mostly in multi-family communal apartments. The workers were overwhelmingly Russian by ethnicity.

Regardless of ethnicity, Donbas is a Russian-speaking region. Clearly, the language is not only about people's communication: If Ukrainian is declared the only official or as they say 'state' (*derzhavnyi*) language (as two parliamentary parties demand to stipulate in the draft of a new constitution), this will affect schools, natural and social sciences, literature, press, television, radio, business documentation, entertainment, and medical facilities. Thousands of state and local government employees will have to be reeducated and filtered through mandatory language testing. Along with Donbas, other eastern and southern regions will be affected as well.

Besides the linguistic issue, there is an economic angle to the divide between the east and the west in Ukraine. Since the industrialized east was incorporated in the Soviet economic structure much more than the agricultural west, living standards were respectively skewed in favor of the former. But, with the collapse of the USSR and the demise of its military-industrial complex, many industrial enterprises in the east were shut down, unemployment surged, and poverty hit formerly thriving families. No wonder there is nostalgia in the east for the 'good' old Soviet system, opposition to market reforms, and strong suspicion of Kyiv government bureaucracy. But, regardless of where their sympathies lie, industrial workers are indeed vulnerable to the ongoing process of severing economic ties with Russia. They are well aware of the fact that Ukraine's mines and otherindustrial enterprises can sell their goods to Russia, but cannot compete with higher-quality European goods.

This paper discusses the short history of Ukraine-IMF cooperation, the results of the estimation of the effect of IMF financing on Ukraine's economic growth, and the role of conditionality in the context of the current IMF lending to Ukraine, in particular addressing the currency flexibility, increasing gas and heating tariffs, and broader issues of economic and social reforms. Accordingly, the methodology combines econometric estimation with intuitive analyses of developmental facts and economic statistics. The case-specific

approach helps draw conclusions on the merits of the IMF programs and the extent of its promotion of reform efforts.

History of Ukraine-IMF Cooperation

Publications on Ukraine began appearing in the western press after some period of its transition to a market economy (e.g., Banaian, 1999 and Aslund, 2009). Analysts also paid attention to the country's nascent cooperation with the IMF and the specifics of the Fund's programs there (Stone, 2002 and Van Zon, 2002).
The demise of the Soviet Union opened new opportunities for the IMF. The Sovietologists, from western academic circles, were the first ones to respond to Gobachev's *glasnost'* and *perestroika*. Needless to say, they were excited but warned against the dismantling of the existing Soviet social and economic system. Instead, they called for the country to move in the direction of market socialism, where the economy would be both government-controlled and able to respond to market signals. However, young Soviet reformers were determined to embrace the concept of private property and free market as a way of creating incentives for production and filling empty shelves of state stores. The advice on the workings of free-market mechanisms was coming from the IMF and World Bank staff and numerous business communities. The lack of a precedent led to naive thinking that, once the opposition from conservative forces was crashed, it would become possible to create market-oriented institutions similar to those already utilized in developed countries. In the process, the old command economy would be dismantled and a new competitive model with market-determined prices and incentives installed. This picture may oversimplify the reality, but who at the time could envision a turbulent transition of a lifespan of a generation?[2]

Seizing the opportunity, western leaders rushed to make the end of the Cold War irreversible. Thus, in the 1990s the U.S. congress hastily appropriated billions of dollars for Russian military conversion and transition to a market economy. To concentrate on and coordinate the effort, the international community called upon the IMF and the World Bank to play an active role in the economic and social transformation of the former USSR countries. Yet it was hard for these organizations to follow the dramatic developments, to say nothing about leading them. Take just one game-changing complication: The socio-economic functions of governments in the Soviet republics were limited to obeying and implementing commands from the central administration in Moscow and, especially, the Communist Party hierarchy. From my experience, planners in most republics were not even able to draw a reliable block of the national economic plan, and central planners usually did the job for them. Understandably, when the Union broke apart and the party apparatus and central bureaucracy became irrelevant, the newly independent states inherited nothing but a vacuum in place of the former decision-making mechanisms. With an exception of the Baltic states, the process of creating bureaucratic operational systems had to go back to square one, with Slavic, Central Asian, and Caucasian countries notably moving in divergent directions.

Against the backdrop of all this uncertainty and chaos, the views of observers, either crediting the IMF with guiding transition of the former Soviet Union countries or accusing the Fund of wrongdoings, e.g., of having 'lost Russia'(Stiglitz, 2002), are merely hypothetical. The reality is probably less spectacular as the Fund policies did not have any tangible impact at all; successes if any were chiefly educational. To give credit to the IMF staff, they frankly admit that their role was marginal in influencing what happened in Russia (Gilman, 2002; Odling-Smee, 2004).[3]

There are many reasons why the IMF involvement in Ukraine's affairs has been more complicated and long lasting than in Russia's and, consequently, more controversial. Ukraine acquired the IMF membership in September 1992. In October 1994 the IMF provided the first loan to Ukraine under a System Transformation Facility (STF), after a newly elected president Kuchma announced an economic reform program. The IMF lending to Ukraine in this early period was simply an enthusiastic response to the government's declarations while in actuality attempts at reform did not occur until several years later. Ukraine's smooth cooperation with the IMF ended soon, however; by the new millennium the Fund became more critical of the country's performance. Ironically, this happened when some success in macroeconomic stabilization was achieved and economic growth restored.

---

[2] A living proof is a 500 Days Program created by about a dozen of reform-minded Soviet economists in 1990.
[3] Incidentally, in 2005 Russia paid off the remaining debt to the IMF and never borrowed again (http://en.rian.ru, Feb. 1, 2005).

From the outset, Ukrainian press and academic publications were extremely negative of the IMF involvement in the country's affairs. In the late-1990s the Ukrainian National Academy of Sciences held a special meeting where academician Pakhomov alleged that the IMF pushed for a 'Latin-American transformation of the post-Soviet countries, with a narrow domestic market, an export-oriented economy, the absence of the middle class, and many other dangerous characteristics' (Rozhen, 2002). Although most Ukrainian economists do not support such a conspiracy theory, a popular belief is that the IMF and the World Bank protect only the interests of the U.S. and its allies, a hardly original viewpoint.[4]

A seemingly easy flow of IMF money in 1994-1998 must have instilled false expectations on the part of Ukrainian officials and the public. They thought that cooperation or at least ostensibly following the IMF advice would further secure the inflow of much needed foreign currency. An awakening happened in 2000 when Ukraine started repaying more to the IMF than borrowing from it (Koshovyi, 2000). Altogether, Ukraine has obtained seven IMF loans, funded fully or partially, and debt accumulated quickly. Thus, while in 2013 the country needed $9 billion for repayment of foreign debt, about two-thirds of the amount was owed to the IMF (KyivPost, March 27, 2013). And this is even considering the fact thatthere was an interruption in IMF financing after 2002.[5]Prior to resumption offull-scale cooperation in 2014, the two intermittent loans, in 2008 and 2010, were realized only partially as the Fund concluded that the respective program performance fell short of expectations.

At the beginning, the 2008 negotiations with the IMF looked promising: A two-year, $16.4 billion loan was approved to help Ukraine restore the country's financial and economic stability and to counter a sharp decline in its exports, caused by a falling global demand for metals and other commodities. Before the 2008 financial crisis, Ukraine enjoyed high world demand for its steel, constituting 40% of country's exports and earning revenues of $17 billion a year. As a result, Ukrainians experienced an unprecedented rise in income which in turn led to current account deficits, an annual inflation rate of 25%, and a highly overheated economy (http://www.imf.org, November 10, 2008). When credit rating agencies downgraded the country's debt, its access to international capital markets practically disappeared. The government requested the IMF support and, in exchange, agreed on a complex reform package stipulating a switch from a pegged to a flexible exchange rate, recapitalization of the banking system, and significant restrictions on fiscal, monetary and wage policies. After three tranches totalling $ 10.6 billion were received, the next tranche of $ 3.8 billion scheduled for November 2009 was terminated as a new IMF mission failed to make a positive statement about the completion of its review (http://news.sevrugin.com). A major reason was that the Ukrainian authorities slowed down cuts in thebudget deficit in the wake of the 2010 presidential election.

The fate of another, $15.4 billion IMF program, approved in July 2010 for 29 months to expire in December 2012, was even less fortunate: Only the first review was completed, with two tranches totalling $3.5 billion allocated. The second review was put on hold in March 2011 when an IMF mission found insufficient progress in the implementation of a half dozen conditions attached to the negotiated program. The most serious objection was caused by Ukraine authorities' refusal to raise gas and heating tariffs in 2011 as promised (http://www.imf.org, November 2012).

It is not surprising that the Ukrainian public is largely critical of conditions presented by the IMF. In early rounds of negotiations, the number of conditions was claimed to be as high as 100 to 120 (Skarshevskii, 2001).[6] Some of them might either be too detailed or dubious, while others went beyond the creditor's competence. For example, to obtain a recurrent tranche, Ukraine was requested to auction 500 million cubic meters of natural gas. Skarshevskii (2001) asks why exactly such an amount and what is the relevance, in any case, of a one-time natural-gas auction to the Fund's concerns. He also gives some other examples of micromanagement. For instance, the IMF insisted on government's initiating a bankruptcy procedure for five out of 50 enterprises that accumulated large tax arrears. What about the rest of them? Then, an odd

[4]Destructive nature of IMF policies in Ukraine is mentioned in the Western press, too. For example, Chossudovsky (2004) refers to a 'major IMF sponsored bankruptcy program directed against Ukrainian industry, which essentially consisted in closing down part of the country's manufacturing base.'
[5]I analyze in detail the new phase of the relationship between the IMF and Ukraine since 2014 when the government accepted all the conditions presented by the IMF.
[6]Griffiths and Todoulos (2014) give an average number of conditions for different countries by IMF facility: For example, 35.5 conditions for the Extended Fund Facility and 21.5 conditions for the Extended Credit Facility.

stumbling block in the 2001 negotiations happened when the IMF insisted on the elimination of an export tax on sunflower seeds.

In examining conditions specified for Ukraine by the IMF, one would notice that they transfer from one program to another in the same or slightly modified form. A major reason for redundancy is the failure of the country's authorities to fulfil their commitments in the first place. A demand for lowering Ukraine's inflation in 1995-1997 is a typical example: In 1995, the demand was to reduce monthly inflation rates to about 1% by the end of the year; in 1996, to reduce monthly inflation rates to about 1-2% by the end of the year; in 1997, to reduce annual inflation from 40% in 1996 to 15% by the end of the year (IMF documentation). That is, each year the IMF condition is formulated anew in the direction of easing or tightening, to reflect the new reality, in the hope that some conversion will happen down the road. Ukraine's experience provides ample evidence that the IMF can do little when a borrowinggovernment backtracks on unpopular reforms. For example, a major IMF condition for a 1998 standby loan was an administrative reform, accompanied by a reduction in the number of ministries and state committees, and a subsequent retrenchment of a significant number of civil servants (Van Zon, 2002). The Ukrainians had accepted the condition, but in a later interview the prime minister boasted that no layoffs took place and there were only minor administrative adjustments. In another skilful tactical move, when the IMF once more emphasized administrative and banking reforms, the government approved them, but abandoned other reform provisions agreed upon earlier. It is common to blame the IMF for not checking on implementation of reform provisions, yet the IMF has sufficient representation in the member countries, and these staffers do plenty of checking, negotiating, and persuading.

The Effect of IMF Financing on Ukraine's Economic Growth

In an attempt to assess the relevance of IMF loans to Ukraine's economic growth, I estimated a modified production function for Ukraine. Along with conventional variables of capital (K) and labor (L), the function incorporates two additional explanatory variables: the institutional index of transition (R) and the IMF credit (F). The role of the R is to counter a slack in the production function existing because of the excessive stock of labor and capital inherited from the planned economy. The rationale for adding the Fvariableis that the IMF credit could directly target economic growth, or it might affect it indirectly by releasing some government funds to be used for productive purposes. The production function is in the form

$$Y = A K^{\alpha} L^{\beta} R^{\varphi} F^{\lambda},$$

where Y, K, and L is real GDP, gross capital formation, and employment, respectively, R is the institutional index of transition, $F$is IMF credit, and A is a constant.

The period under consideration is crucial for Ukraine, from the first loan disbursement in 1994 until 2002 when the country already enjoyed several years of economic growth. As indicated, after that period IMF financing for Ukraine resumed only in 2008. Given the shortness of the period, I employ quarterly data, with the total of 36 observations.[7] Since quarterly GDP statistics in constant national currency, hryvnia, did not exist, they were estimated based on annual values and related growth rates. The real gross capital formation (GCF) in millions of hryvnia was used as a proxy for capital stock in constant prices.[8] To calculate quarterly GCF in constant 1998 prices, I converted the gross capital formation in current prices to constant prices based on the Producer Price Index published by the National Bank of Ukraine (NBU). Employment in thousands was estimated based on Economic Activity and Employment (ILO Methodology) data. The institutional index of transition was constructed as a combination of eight transition indicators reported by the European Bank for Reconstruction and Development (EBRD) and the private-sector share of GDP (Kushnirsky, 2001).[9]

Similar to the other indicators, the IMF credit is in a quarterly form. Disbursements were often made at the end of a period and used in the next period, or some loans could be provided once a year, but were subject to a longer-term use. I spread each loan equally over a time period for which it was provided. In 1998

[7] The data were compiled and partially calculated by NataliyaMuravytska and the author.

[8] The GCF may not be an accurate measure of capital since it is a flow, not a stock. However, an advantage is that it is an actual input, not idle capital on the books of some enterprises.

[9] The eight transition indicators are: large-scale privatization, small-scale privatization, governance and enterprise restructuring, price liberalization, trade and foreign exchange, competition policy, banking reform and interest rate liberalization, and securities markets and non-bank financial institutions.

Ukraine started repaying the principal on standby and STF loans, while the interest payments began in 1996. This required an adjustment in the net amounts of loans. The common measure used is the 'net disbursement of loans and grants'(http://www1.oecd.org/std/DNM/index.htm) which is the difference between loan amounts received and repaid.

The results of estimation of production function in logarithmic form are in Table 1. The coefficients of capital and labor are positive as expected and significant at least at the 5% level. The *R* coefficient is significant at the 11% level, but negative implying that the progress measured in transition points and economic growth in Ukraine were heading in the opposite direction. As was frequently suggested, a certain threshold of transformation had to be achieved for market reform to yield a positive effect on economic growth, or that a positive impact of the transition index was outweighed by a negative role of Ukraine's initial conditions.

Table 1 shows that the coefficient of the IMF credit is positive but highly insignificant meaning that the hypothesis of its effect on Ukraine's economic growth should be rejected. The failure of accepting the hypothesis could be explained with the consideration of the repayment factor: The positive effect might have taken place in early disbursements, but, when the inflows turned into outflows, the effect reversed direction. The two developments thus resulted in a *status quo*. This estimation exercise indicates that, while Ukraine keeps seeking and receiving IMF financing, the latter has been used to cover recurring expenditures, not the modernization of production or institutions, and that Ukrainian analysts are likely correct in asserting that the loans have contributed chiefly to rising external debt.

Table 1. Estimation of the Production Function for Ukraine

	Dependent Variable
	LOGGDP
C	-2.6476 (-0.5308)
LOGK	0.2252 (7.2654)
LOGL	1.1645 (2.3543)
LOGIIT	-0.1542 (-1.6678)
LOGIMF	0.0001 (0.0501)
R^2 Adjusted R^2 F-statistic Probability (F-statistic) Durbin-Watson statistic	0.760 0.7159 17.126 0.000 2.107

Notes: Number of observations equals 36; t statistics in parentheses.

To perform a cointegration test for the production function, I considered three series, *Y*, *K*, and *L*, endogenous, and *R* and *F* exogenous. The impact of *R*, the institutional index of transition, was temporary in nature since, as it reached a certain ceiling and stabilized, its long-run effect on production dissipated. Apparently, the IMF lending is also a phenomenon belonging in the short run. From the augmented Diskey-Fuller test, the hypothesis of a unit root cannot be rejected for *Y,L,* and *K* even at the 10% level. The group is thus *I(1)*, with a maximum of two common trends. Table 2 gives the results of the cointegration test. The assumption is that all three series have means and linear trends, with the cointegrating equation having an intercept (the default model). The hypothesis of no cointegration is rejected at the 5% significance level. The hypotheses of at most one or two cointegrating relationships are not rejected at the 5% level. The normalized cointegrating equation with a unit coefficient on *Y*, $Y - 4.23K - 0.32L - 8352$, identifies a cointegrating (long-run equilibrium) relationship within the three series.

Table 2. Cointegration Test for the Production Function

Sample: 1994:4 2002:4
Included observations: 30
Test assumption: Linear deterministic trend in the data
Series: Y K L
Lags interval: 1 to 2

Eigenvalue	Likelihood Ratio	5% Critical Value	1% Critical Value	Hypothesized No. of CE(s)
0.5384	36.1836	29.68	35.65	None **
0.2870	12.9909	15.41	20.04	At most 1
0.0904	2.8432	3.76	6.65	At most 2

*(**) denotes rejection of the hypothesis at 5% (1%) significance level
L.R. test indicates 1 cointegrating equation at 5% significance level

Unnormalized Cointegrating Coefficients:

Y	K	L
-0.00029	0.00124	9.26E-05
3.89E-05	-0.00021	-0.000156
-0.00018	0.00033	4.84E-05

Normalized Cointegrating Coefficients: 1 Cointegrating Equation

Y	K	L	C
1.0000	-4.2349	-0.3154	-8351.9660
	(0.2583)	(0.0827)	
Log likelihood	-705.6743		

Normalized Cointegrating Coefficients: 2 Cointegrating Equations

Y	K	L	C
1.0000	0.0000	13.8655	-327107.50
		(42.5160)	
0.0000	1.0000	3.3485	-75268.09
		(10.0217)	
Log likelihood	-700.6004		

Gas and Heating Tariffs

As indicated, in July 2010 the IMF approved a 29-month $15.4 billion standby program for Ukraine. Among conditions for releasing successive tranches, the IMF demanded a 50% increase in gas and heating tariffs for households and businesses. Ukraine was able to receive only two tranches totalling $3.5 billion, as the program was frozen in 2011 because of the Yanukovich government's objection to the indicated condition. The new government, installed in 2014 on the wave of political unrest, met all IMF conditions for a two-year $17.1 billion stand-by loan it requested, including that for the gas tariffs. The new gas tariffs will affect all services to the population, including education and health care, and other budget organizations.

In considering gas and heating tariffs for Ukraine, the IMF uses basic economics that applies to all subsidies: The removal of subsidies would free prices, provide incentives for the producer to increase supply and, by the same token, relieve strains on the state budget. Keeping prices low by subsidizing producers benefits all consumers, including the rich. That is why economists prefer shifting subsidies to the poor consumers through the government safety net, whereas the consumers who can afford higher tariffs should pay the full price. However, as is well known, a textbook approach does not necessarily work in every case because the devil is in the details. A simple analysis shows that it is unrealistic to expect that, by raising gas tariffs, Ukraine's government would be able to subsidize all those in need. When the IMF staffers are talking about establishing a safety net to counter a harmful effect of higher tariffs, they mean helping people who are

officially under the poverty line in Ukraine. In actuality, they are only the 'poorest poor' since a sizable fraction of the country's 'middle class' is poor, too, and will apply for subsidies.

Ukraine has had over 19 million apartments housing 80% of the population (Remiga, 2011). Although most apartments are privatized, there are no owners of the buildings' common space. To address the issue, owner associations are being formed, but the process is at the initial stage, as is the installation of energy and water meters. Using available statistics, it is possible to understand how a significant strain on the state budget would arise from the hike in the tariff rates. Thus, 23% of the country's households with all adults employed and 37% with only one employed fall below the poverty line *de facto*, if not officially (http://www.kyivpost.com, November 15, 2011). Poverty is even higher among families with children: 26% of families with one child, 39% with two children, and 70% with three and more children are living in poverty. The share of Ukraine's economically inactive population plus the unemployed was over 43% in 2012. Another characteristic of Ukraine's low living standards is a high 51% of disposable income spent on food in 2011 (*Ukrstat*). So far, most people eligible for subsidies have been pensioners who do not receive help from relatives (*Segodnya*, April 8, 2014). It is thus reasonable to expect that many more households would be in need of subsidy.

In objecting to raising gas tariffs, the former government was perhaps less concerned about millions applying for subsidies than about people taking the matter in their own hands. Based on informal surveys, a third of the respondents were going to stop paying utility bills if gas prices steeply rose. This is not an empty threat given that many Ukrainian households already do not pay their bills. Arrears to housing service providers for gas, heat, and water stood at 8.7 billion hryvnias, or $1.1 billion in 2011 (Remiga, 2011). Energy constitutes more than half of these costs, and the money translates into an average two monthly bills. The new tariff hike might lead to a rise in the number and the duration of non-payments, especially considering that non-paying households so far have not been disconnected.

There are other reasons,too, why the act of increasing gas tariffs by itself will hardly lead to a more balanced state budget. Right now subsidies are paid at three levels: to state monopoly *Naftogaz*, to industrial enterprises, and to the general population, that is, they would rise three times for a one-time increase in tariffs (*Segodnya*, April 8, 2014). Thus, on the one hand, raising the tariffs reduces the budget deficit, but,on the other hand, itincreases the subsidies and thus the budget deficit.Which effect will prevail is anyone's guess, but Ukrainian experts are not optimistic. Ideally, the gas tariff tool should be used for the balancing of the state budget after all subsidies are eliminated at least technically, with the latter recalculated at the last stage. But such a project would be extremely difficult and is probably out of question for the current Ukrainian government.

What Is in Store for Ukraine

As indicated, the IMF approved a $17.1 billion two-year standby loan for Ukraine, with an immediate disbursement of $3.19 billion in June 2014. The attached conditionality (or 'main policy recommendations' in IMF terminology) accepted by the current Ukraine's government is specified as follows:
(a) Allow the exchange rate to adjust to its equilibrium level and increase its flexibility.
(b) Strengthen the financial system's resilience to shocks, by developing comprehensive contingency plans to cover potential capital and liquidity shortfalls under various scenarios.
(c) Curtail the fiscal deficit through a reform-based current expenditure consolidation and the cancelation of unaffordable tax cuts.
(d) Reduce the quasi-fiscal losses in the energy sector by increasing the very low household gas and heating tariffs, while protecting the most vulnerable households.
(e) Launch broad structural and governance reforms to improve the business climate and boost sustainable growth (IMF, 2013).

Most of the forenamed conditions do not sound specific. Whereas some of them are measurable, others are too broad, but all call forchanges to be implemented in Ukraine. Theoretically, they look like a mix of basic economicsalong with debatable and even controversial issues.

Take, for example, the requirement of adjusting the exchange rate to the equilibrium level andincreasing its flexibility. Ukraine has a manageable pegged exchange rate when its hryvnia fluctuates within a narrow

corridor versus the US dollar. To peg the exchange rate or simply fix it at some level, the country must have sufficiently large reserves of foreign currency. Ukraine does not. The objections to the current system are thus reasonable: Market forces of demand and supply guarantee an automatic correction in the flexible exchange rate which will float freely without central bank intervention. On the other hand, the flexible exchange rate may fluctuate widely with the market and, at times, become unpredictable. In Ukraine's reality, if population and businesses do not have reliable information for the value of the money for a long enough period, e.g., at least a year, the trend will be for unloading the national currency, hoarding foreign currency reserves, and lowering standards of living (http://for-ua.com, April 2, 2014). Still, there is a hope since the IMF does not require a full flexible regime for the Ukrainian hryvnia, but just to 'increase its flexibility.' The latter allows for a wide interpretation, but will Ukraine'sauthorities be able to exercise due diligence and pursue a reasonable strategy?

Condition (b) sounds tangled, but it is about the banking system. Ukrainian banks have always worried about the country's economic outlook and access to sufficient liquidity, and the worries rose recently with political and economic instability. That is why there is an excessive competition for clients by means of offering too high deposit rates. For example, deposit rates of 16-18% were not unusual for July 2014 (http://ukraine.deposits.org, July 2014). Consequently, mortgage rates exceed 20%. Therefore, the IMF intent to lower bank vulnerability is quite appropriate. To this end, it prescribes a set of measures for the banks,such as to deal in government exchange-rate indexed securities, toremove tax, administrative, and legal obstacles, and the like. But it isunclear how these hypothetical recommendations will improve bank access to liquidity and reduce the amount of their bad loans in the near future.

The euphemism 'current expenditure consolidation' in condition (c) stands for politically incorrect 'government spending cuts.' If a country lives beyond its means, reducing government spending is of course a reasonable idea, and the main purpose for austerity measures is to cut waste and restore economic growth. Yet, given Ukraine's living standards, it is doubtful that cutting subsidies to a large part of the population, barely surviving at a subsistence level, would be conducive to growth. One should also notforget that recent attempts by the European Union to use a similar blitzkrieg approach to solving the 2007-2008 financial crisis turned out to be at best questionable.

In addition to 'expenditure consolidation', the Fund calls for the cancellation of 'unaffordable' tax cuts, e.g., by phasing out existing value-added tax exemptions in agriculture and passing a five-year plan of raising excise taxes. However, what is missing here is a study showing that agricultural producers, contributing significantly to Ukraine's exports, could survive such phasing out.

In condition (d), requiring the reduction in losses in the energy sector, we come across the familiar call for increasing household gas and heating tariffs. The requirement, which was a stumbling block in all previous negotiations with the IMF, is already in the process of being implemented by the new government. According to interimpremier Yatsenyuk, the total tariff increase will be 120% from 2014 to 2017, rising in annual instalments of 40% in each of the first two years and 20% in each of the last two years (Ukrainian News Agency, March 30, 2014). Mr. Yatsenyuk indicates that almost one third of Ukrainians will be eligible for subsidies, of about UAH 40 or $3.4 per month.On the other hand, he concedes that the expenditure will be toostrenuous for the state budget.

How will the average family be affected? It depends on where people live andon thesize of the dwelling. From May 1, 2014 the rise in the gas tariffs is 50% for an area under 100 square meters, and 62% if it is up to 300 square meters. Drinking water has become 84% more expensive, and sewage 93% (http://for-ua.com, July 6 2014). The full-scale shock on the part of the population will probably materialize in October when the heating season begins; right now people's minds are focused on the civil war in Donbas and the casualties it is causing.

Condition (e), about structural and governance reforms to improve business climate and promote growth, is the least specific. Recommended are improvements in business climate, strengthening the judicial system, simplifying or repealing burdensome government regulation, and stepping up anticorruption measures. All the recommended changes are impressive and have already produced a voluminous body of literature. But each is a multi-decade, if not a multi-generational, project and is hardly measurable or relevant to a two-year IMF program for Ukraine. Besides, even a worthwhile improvement by itself may not necessarily have a direct link tothe goalsthe IMF staff has in mind. Consider, for example, corruption. There were several regular surveys on corruption in Ukraine, from 2004 through 2011.While a negative attitude toward

corruption prevailed, some people, especially young, viewed corruption as a very useful tool. Consequently, the number of those who used corruption if it expedited solving their personal problems remained unchanged at 42% for the entire period (Corruption in Ukraine, 2011). After all, people are rational, are not they?

Overall, Ukraine's society is hardly ready to accept harsh structural reforms prescribed by the IMF, even though theymay eventually boost labor productivity and restore economic growth. But 'eventually' is not good enough for the public which has become accustomed to so many broken promises. In the meantime, people have to endure the loss of purchasing power by the currency (over 40% just in the first half of 2014) and ballooning costs of gas, water, electricity, and all municipal services. In addition, next in store for them are the consequences of breaking a free trade agreement with Russia and eight other members of the Commonwealth of Independent States (*SNG*). No one could predict the full extent of Russian response to Ukraine's association with the European Union, yet a likely scenario is the erection of protective tariffs and quotas. The resulting decline in Ukraine's exports of steel, fertilizers, machines, equipment, and grain will further push domestic production down and increase unemployment. The IMF forecast Ukraine's 2014 GDP to fall by 5%; the initial government projection stood at 3%, but was later changed to a fall of 7% by a mid-year correction (http://for-ua.com, July 11, 2014).

Conclusion

From the history of the IMF attempts to enforce conditionality contracts with Ukraine's government we can learn that the Fund means of enforcement are quite limited. Since loan disbursement is not a one-time event, at some point the funding might be suspended which, as illustrated, happened several times for Ukraine. But,otherwise, if there is no critical shortage of funds, the measure is temporary since the dependence is mutual: The borrowing country needs the money, and the IMF has to disburse the latter to secure additional financing by the donor countries. While some observers call for a stricter accountability on the part of the IMF, it is hard to imagine what the IMF could do other than requiring filling out some additional formsdetailing spending of the funds.The only option the Fund has when the borrowing government fails to fulfil its commitment is to start a new round of negotiations; its position in this redundant process reminds what is called a zugzwang in a chess game.[10]

In my opinion, both the criticism and, to a lesser extent, the praise of the IMF conditionality policy might be exaggerated. Even if countries following its recommendations experience falling economic growth, rising poverty, and social unrest, at best they would have done the same without the Fund involvement. Besides, as illustrated by Ukraine's experience, in many instances a country's government yields to the IMF demand for austerity measures just in order to secure a desired loan but later almost certainly backtracks on its commitments. In the same manner, the success stories could hardly be attributed to the IMF pressure, but rather to the recipient governments' determination to improve economic and social conditions. Again, as illustrated for Ukraine, when the IMF requirements coincide with what the authorities were going to do anyway, e.g., fighting inflation even on their own terms, the synchronization of intentions softens potential disagreements. Otherwise, the idea that, by a stick or carrot, it is possible to persuade the borrowing countries that the program they have to agree upon is in their own best interests has an element of wishful thinking.

The mandate of the IMF, charged with making short-term loans in order to assist countries with payment deficits and currency convertibility problems, was transparent and thus effective. However, the Fund gradually reached an unsustainable level of activity as its functions were broadened to become a command and control center for supervising structural reforms in developing and transition economies. It is difficult to comprehend why the international community would delegate to a single organization a doomed task of simultaneously setting and monitoring reforms in dozens of member countries, and then blame it for an imminent failure. The well-intentioned international activism pursued by both sides of the political spectrum, right and left, has never worked. Instead of recognizing this fact, the international community keeps shuffling the limited set of goals. Changes that come from within the IMF only lead to adding more functions and even greater oversight.

[10] It is a position when any move by a player is disadvantageous.

In the debate on the right role for the IMF, a central question is: Should conditionality be attached to loans made to member countries? Loans to eligible poor countries should openly be classified as grants, similar to the current Heavily Indebted Poor Countries Initiative, and the accepting governments may be asked to introduce some reforms that would benefit their countries. But loans are not gifts, and they should not be heavily subsidized;as basic economics says, a major concern of the lender is the borrower's ability to repay the loan. When the IMF reform projects are separated from lending, the member countries will benefit much from advising by the Fund, which over the years attracted the best cadre from many parts of the world. In such a case,governments will be more willing to get involved and learn in the process rather than spend time on activities undermining the hated conditionality.

Acknowledgement

I would like to thank Erwin Blackstone, the editor, and the anonymous referees for helpful comments and suggestions.

References

Aslund,A. (2009). *How Ukraine Became a Market Economy and Democracy*. Peterson Institute for International Economics.

Banaian, K. (1999).*The Ukrainian Economy since Independence*. Cheltenham, UK: Edward Elgar.

Chossudovsky, M. (2004). IMF Sponsored "Democracy" in Ukraine. Global Research, November.

Gilman, M. (2002).*Russia's Challenges in the 1990s*. Retrieved from the website: http:// www.washprofile. org.

Griffiths, J. and Todoulos, K. (2014). Conditionally yours. *An Analysis of the policy conditions attached to IMF loans*. European network on debt and development, April.

IMF (2013). Ukraine: 2013 *Article IV Consultation and First Post-Program Monitoring-Staff Report*. Washington, DC: December 2.

Koshovyi, D. (2000). One can borrow not only from the IMF.*Galyts'ky Kontrakty*, 36.

Kushnirsky, F. (2001). A Modification of the Production Function for Transition Economies Reflecting the Role of Institutional Factors.*Comparative Economic Studies, 43*, 1.

Odling-Smee, J. (2004). The IMF and Russia in the 1990s. Retrieved from the website: http://www.imf.org.

Remiga (2011). UN Development Program Ukraine.Kyiv: Ukraine.

Rozhen, A. (2002). The IMF Yoke? *The Ukrainian 3*.

Sharov, O. (2002). *Ukraina ta IMF: U poshukakh vtrachenogo chasu*.Visnyk NBU, September.

Skarshevskii, V. (2001). Taking Care of Ourselves.*Biznes, February 5*.

Stiglitz, J. (2002). *Globalization and Its Discontents*. New York: Norton.

Stone, R. (2002).*Lending Credibility.The International Monetary Fund and the Post-Communist Transition*. Princeton:Princeton University Press.

Van Zon, H. (2002).*IMF policy towards Ukraine. Paper presented at the BASEES Conference*, UK: Cambridge, 6-8 April.

Transition Reports 1994, 1995, 1996, 1997, 1999. London: European Bank for Reconstruction and Development.