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# Ukraine’s unenviable financial challenges ahead

By Evan Ostryzhniuk
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New Prime Minister Arseniy Yatseniuk was brutal in his assessment of the state of Ukrainian finances during his parliamentary address on Feb. 27. He stated that ex-President Viktor Yanukovych’s administration siphoned more than $70 billion from the financial system over the last three years. The nation’s treasury has next to nothing left – some $400,000 – and foreign reserves are down to a dangerously low $15 billion.

The interbank rate of the hryvnia, the national currency, reflected the gloom, settling at Hr 11.2 to the dollar by the end of the business day on Feb. 27.

Thus, the nation is on the verge of default and it will have to tighten its belt in order to survive the severe economic challenges ahead. Already numerous high-ranking Western officials have stated that donor countries and organizations are lining up to prevent economic collapse, but the urgency of the crisis combined with Russia’s hostile attitude towards the new government means that the government must immediately address three key problems.

Servicing the national debt is a priority for the new government because without the money Ukraine will be unable to pay back the International Monetary Fund and cover euro- and domestic bond payments in the near term. In 2014 alone Ukraine needs to find an estimated $7 billion to cover foreign debts, on top of the $1.8 billion it still owes Russia’s Gazprom for natural gas.

However, the situation could be worse. Analysts had estimated that the total national debt was $73.1 billion, but Yatseniuk has now revised that figure to $75 billion plus “$37 billion which disappeared to an unknown direction.”

Until ex-president Viktor Yanukovych disappeared on Feb. 21, the government had been relying on a multi-year $15 billion loan negotiated with the Russian government on Dec. 17 of last year. However, Russia only gave $3 billion through a eurobond purchase onDec. 20 and was supposed to purchase $2 billion more on Feb. 17 before the Kremlin suspended the deal on account of the “political instability.”

The possibility of default is complicated by declining trust in Ukrainian debt. On Feb. 21 Standard & Poor’s rating agency lowered Ukraine’s sovereign debt from CCC+ to CCC with a

negative outlook for both the local and foreign currency, which is only two notches above default level.

Yet markets reacted positively to the regime change. The Ukrainian Stock Exchange index started rising already on Feb. 21 and by Feb. 26 was up by 20 percent, while yields on the sovereign bonds that mature in 2023 declined from 11.2 percent to 9.5 percent, suggesting that institutional investors are cautiously optimistic about Ukraine's future.

Still, with empty coffers and an unfriendly Russia, the money has to come from somewhere. An IMF mission is scheduled to visit next week. Ukraine's Finance Ministry indicated that the treasury needs $35 billion over the next two years to stabilize the macroeconomic situation.

Any Western money that is forthcoming though will require stiff austerity measures like the hiking of household gas prices, reducing social welfare programs, ending subsidies as well as perks for former and current government officials and lawmakers.

Meanwhile, European Foreign Affairs Committee head Elmar Brok told 1+1 channel that that the European Union was prepared to give Kyiv €20 billion to implement the measures and prevent a default. This view is supported by the UK, Germany, U.S., and IMF Managing Director Christine Lagarde.

But the money, primarily from the IMF, won't come until April or May said Timothy Ash, head of research for Standard Bank in London. "It will take two weeks or so to figure out how much damage has been done over the past few weeks/months of turmoil," wrote Ash. "Key questions will be how deep the recession will be this year, where will the hryvnia land, how big is the budget deficit, how much hidden debt/arrears are out there, and how big is the hole in bank balance sheets."

Russia might be even harder to convince to restart its promised loans to Ukraine after Yanukovych was deposed whom it backed.

Former advisor to Russian President Vladimir Putin and professor at the Cato Institute, Andrey Illarionov, told the Kyiv Post that Russia "almost certainly" will not renew the loan program and will be "looking for short-term – one to two weeks – ways of influencing the situation" in Ukraine, including possibly militarily occupying Sevastopol. Illarionov does not believe Putin will employ economic pressure, as he did in 2013, because such instruments, like trade embargoes, take too long to be effective.

Russian economic retribution against Ukraine would likely extend to raising prices for the all-important natural gas imports, putting more pressure on Ukraine's dire cash situation. The Dec. 17 agreement lowered the gas price for gas from $410 per 1,000 cubic meters to $268.5, but it also stipulated quarterly price revisions. The last time a popular revolt removed Yanukovych from power in 2004 Russia steadily increased gas prices to $410 by 2009. Ukraine imported 26.8 billion cubic meters of gas from Russia in 2013 for $10.7 billion.

**Budget woes**

The 2014 state budget needs to be revised because the revenue assumptions were unrealistic when the document was passed on Jan. 16. "To correct the situation, the government will need to prepare revised parameters for both the revenue and expenditure sides," said Dmytro Churin of Eavex Capital. "It will be a difficult process, but if we assume an increase in the budget deficit, then finding sources of financing in the current environment is unrealistic. First of all, the budgeted gross domestic product growth of 3 percent should be changed to increase to within one percent."

The previous government was anticipating revenues of Hr 395 billion on a hopeful 3 percent GDP rise. The budget deficit was planned to be Hr 71.6 billion, although analysts believed that the gap could reach Hr 100 billion or more, since the government was unlikely to fill the revenue side of the equation.

Yatseniuk has already announced that government expenditures must be severely curtailed if the budget deficit is to be reduced to realistic levels. "To go through these economic challenges we have no other way but take unpopular decisions regarding subsidies, tariffs, (and) social programs. The government has to take measures in order to reduce the state's expenses. However, we have the opportunity to stabilize the financial system. Ukraine has to start negotiations with the IMF immediately," he said.