



Budget Report: 1st Quarter 2015

The 1st quarter of 2015 was marked by an unexpected improvement of the fiscal situation. In particular, the consolidated budget revenues increased by 25.0% to UAH 140.3 billion (as compared to UAH 112.2 billion last year). The main factors stimulating the budget revenues increase was the currency devaluation, new and increased taxes, as well as proceeds from 3G license fee.

In January through March 2015, the consolidated budget expenditures were reduced in several areas: economic activity, salaries in budget-funded institutions, and social expenditures. The total saving on these items as compared to 2014 is about UAH 10 billion. However, the government had to spend much more on debts, funding of military action, and utility services. As a result, the consolidated budget expenditures in 1Q2015 were UAH 126.0 billion, which is 12.9% more than last year (UAH 111.6 billion). The high rate of revenues growth, exceeding the respective growth of expenditures, allowed significant consolidated budget surplus of UAH 14.0 billion (3.9% of GDP), whereas the budget deficit anticipated by the plan for the entire year is 4.1% GDP.

A distinctive feature of the 2015 budget was the new inter-budget relations. The changes to the budget code introduced in late 2014 resulted in a significant increase of the local budget revenue (+15.8%, to UAH 27.8 billion). However, the local budgets are so far either uncertain about the sustainability of such results, or are unable to set their priorities: over one half of the consolidated budget surplus was accumulated because of the local budgets' delays with expenditures.

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TRENDS: Ministry of Finance is Searching for Outside Funding

In January 2015, the majority of amendments to the tax code and budget law adopted around the New Year's Eve entered into force (they are described in detail in our reports: 2015 Budget: the "Empty" Version and Budget Report: 4th Quarter 2014). In February, additional changes were made in the state budget, which turned out not as large as expected. Given the deteriorating currency problems, the Ministry of Finance held many important international negotiations. Most importantly, agreement on the new funding program was reached with the IMF. At the same time, meetings were held with other international organizations and governments which agreed to support Ukraine along with the IMF. An important task for Ukraine was to hold separate negotiations with creditors on restructuring of commercial debts. However, the negotiations with creditors turned out rather difficult.

Revenue increases by 25.0%

In 1Q2015, the consolidated budget revenue grew 25.0% as compared to 1Q2014, and in January through April 2015 by 30.5%. This is a significant positive development, considering that throughout the entire 2014 the consolidated budget increased only 4.5% as compared to 2013. As a result, in 1Q2015, the government managed to fulfill the consolidated budget with a significant surplus of UAH 14.2 billion, and in January through April the surplus increased to UAH 18.5 billion. This removed the need for monetary financing. The highest growth was observed in March (+48.7%), largely due to devaluation of hryvnia in February to UAH 30.0 for 1 US\$. The appreciation of UAH over the following months, in turn, resulted in slower growth of revenue. As a reminder, the consolidated budget revenue increase planned for 2015 is 26.6%.

IMF replaces Standby with Extended Fund Facility

During the Davos Global Economic Forum (January 21), the government submitted a request to the IMF to replace the current Standby program with the Extended Fund Facility. Under the Standby program approved late last April, Ukraine received only US\$ 4.6 billion out of US\$ 17.0 billion approved for two years. Both programs, Standby and the Extended Fund Facility, are intended for medium income countries (the funds are borrowed on market terms) and for countries with inefficient state governance (the IMF makes its own requirements to the reforms). The only difference between the programs is the repayment time. Standby may last up to 3 years (repayment due in 3¼–5 years), the Extended Fund Facility may last up to 5 years (repayment due in 4½–10 years).

On March 11, the IMF approved the new program, granting a loan of US\$ 17.5 billion for four years (the Standby was cancelled). According to the plan, over one half of the funds (US\$ 10.0 billion) was to be given Ukraine in 2015. The first installment of US\$ 4.87 billion was received by Ukraine on March 12. Three installments US\$ 1.67 billion each are planned for June, September, and December 2015. It is planned to distribute the remainder of funds (US\$ 7.5 billion) evenly in

Major Budget Event in 4Q 2014

January	21-24 – Global Economic Forum (Davos, Switzerland), government submits a request to the IMF for a new program
February	16 – Government submits proposed amendments to 2015 state budget to the Verkhovna Rada
March	2 – Verkhovna Rada adopts the amendments to the 2015 state budget 11– IMF approves the Extended Fund Facility of US\$ 17.5 billion for Ukraine 12– The first installment of US\$ 5.0 billion is received by Ukraine 13– Consultations on debt restructuring are commenced

Source: CASE Ukraine

12 installments over 2016–2018 (about US\$ 0.6 billion each quarter).

International financial institutions and governments of several countries combine their financial efforts to assist Ukraine

Extended Fund Facility of US\$ 17.5 billion is only one of the components of the international assistance package to Ukraine, amounting to US\$ 40.0 billion for four years. In fact, the commencement of the Mechanism unlocked Ukraine's cooperation with international organizations and other governments suspended in late 2014. According to the IMF's estimates, over 2015–2018 Ukraine will receive about US\$ 7.2 billion from the World Bank, EU, USA, Germany, Canada, Switzerland, Norway, and others (US\$ 6.3 billion of which in 2015). The IMF believes that Ukraine may save US\$ 15.3 billion over four years (of which US\$ 5.2 billion in 2015) on foreign payments on debts through restructuring.

International assistance package to Ukraine

	2015	2016	2017	2018	Разом
Total	21.5	6.8	6.9	4.8	40
<i>of which:</i>					
IMF	10	2.5	2.5	2.5	17.5
Other international organizations	1.8	0	0	0	1.8
EU	1.8	0.7	0	0	2.5
USA	2	0	0	0	2
Other governments	0.7	0.2	0	0	0.9
Debt operations	5.2	3.4	4.4	2.3	15.3

Source: IMF

Debt restructuring

As required by the IMF, on March 13 Ukraine started the consults on restructuring of its commercial foreign debts in order to relieve the debt burden. Generally, the IMF anticipates that “debt operations” will save Ukraine US\$ 15.3 billion over the next four years. Negotiations with creditors were extremely difficult and prolonged. The stumbling point is the partial write-off of the debt, which Ukraine insists on and the creditors object to. In order to increase the pressure on the creditors, on May 19 the Verkhovna Rada even allowed the government to temporarily suspend payments on all or some debts¹.

Amendments to the 2015 state budget

The 2015 state budget was approved on December 28, 2014, on condition that the government proposes amendments thereto by February 15, 2015. Amendments to the 2015 state budget were also one of the conditions for approval of the Extended Fund Facility. The draft of the respective amendments was submitted by the Government on February 16, and approved by the Verkhovna Rada² on March 2.

As a result, the state budget revenue was increased by UAH 26.4 billion (+5.5%) to UAH 502.3 billion, and the expenditures by UAH 39.0 billion (+7.4%) to UAH 566.9 billion. According to the amendments, the 2015 state budget deficit increased to UAH 75.8 billion (4.1% of the GDP) as compared to UAH 63.7 billion (3.7% of the GDP) envisaged in the previous budget version. The maximum amount of debt as of the year's end was increased from UAH 1,176.1 billion to UAH 1,394.0 billion (by 18.5%). The revenue was increased due to anticipation of more rapid inflation. Due to this and to the additional costs of the subsidies for the public and aid to displaced persons, the expenditures increased as well (all changes are covered in detail in our comment on the 2015 budget amendments).

¹ Law of May 19, 2015 No. 436-VIII, Law of May 19, 2015, No. 437-VIII

² Law of March 02, 2015 No. 217-VIII

Government carries forward several important reforms

According to the IMF Memorandum and the main 2016 policy areas, most budget areas are to be reformed in 2016. This concerns:

- Executive government agencies: optimization of maintenance costs.
- Social benefits: reform of the public transport benefits system and switching to targeted cash benefits;
- Education: optimization of the number of facilities, increased class sizes and teacher loads.
- Healthcare: creation of unified medical space and optimization of the number of healthcare facilities. At the moment, introduction of mandatory medical insurance is being negotiated at a high level.
- Pensions: limitation of preferential pensions. Several laws limiting the amount of preferential pensions have been adopted since the beginning of the year. The parliament is considering a draft law on introduction of the second accumulation tier of pension insurance.
- Coal sector: reforms and privatization.
- Science: wage grid optimization, state order changes, appraisal.

At the moment, it can be said that the government has intensified its activity in the aforementioned areas. The largest progress may perhaps only be observed as regards limitation of pensions. However, the changes that have occurred so far can hardly be considered reforms. Most of them are still at the stages of development and discussion.

REVENUE: revenue increased 25.0%

In 1Q2015, the consolidated budget received UAH 140.3 billion, which is 25.0% (UAH +28.1 billion) more than in 1Q2014. In particular, the tax revenue increased by 34.9%, and non-tax revenue was reduced by 4.6%. The major factors promoting increased revenue were the inflation provoked by devaluation of hryvnia, as well as the recent amendments of the tax code. In 1Q2015, the local budgets were performed according to the new rules. And even though the share of local budgets in the revenue (excluding transfers) reduced from 21.4% in 1Q2014 to 19.8% in 1Q2015, the local revenue growth rates significantly increased.

PIT revenue increased due to new taxes

In 1Q2015, the personal income tax (PIT) revenue amounted to UAH 20.5 billion, increasing by 26.7% as compared to 1Q2014. Excluding the new taxes (pension tax, military tax, and interest income tax), the increase amounted to a mere 2.4%. A part of the new taxes made up 19.2% of the total PIT revenue in 1Q2015. The revenue on new taxes increased as compared to the prior periods due to several amendments to the Tax Code³, including the taxation of the part of the pension exceeding three minimum wages (UAH 3,654), prolonged military tax period and expansion of the tax base, as well as the increased interest income tax rate.

³ Law of December 28, 2014 No. 71-VIII

Consolidated Budget Revenues, UAH billions

	1Q 2014	1Q 2015	Change, %
REVENUE	112.2	140.3	25.0
Tax	83.5	112.6	34.9
PIT	16.2	20.5	26.7
EPT	15.6	16.6	6.5
VAT	27.7	43.0	55.4
<i>of which</i>			
<i>VAT</i>			
<i>(collection)</i>	36.6	55.0	50.4
<i>domestic</i>	19.0	25.1	32.1
<i>import</i>	17.4	29.9	71.9
VAT (refund)	-8.9	-12.0	34.7
Excises	7.9	13.7	73.1
<i>of which</i>			
<i>domestic</i>	5.4	7.7	41.7
<i>import</i>	2.5	4.9	94.6
<i>retail</i>	0.0	1.2	
Import duty	2.4	6.3	158.9
Non-tax	28.0	26.8	-4.6
NBU	15.8	5.5	-65.5

Source: State Treasury Service

EPT revenue grows for the first time over a long time

In the 1st quarter, the enterprise profits tax revenue amounted to UAH 16.6 billion, increasing by 6.5% as compared to 1Q 2014 due to the increased revenue in March. The EPT revenue in January was UAH 2.2 billion, 40.0% lower year-to-year, and in February it was UAH 2.6 billion, 21.0% less as compared to February 2014. However, in March 2015 the EPT revenue rapidly increased (+29.5%) to UAH 10.1 billion as compared to UAH 7.8 billion in March 2014.

The revenue changes were primarily determined by the tax schedule. In particular, advance payments in January and February 2015 are made in the amount of 1/12 of the EPT accrued for 2013, and in March 2015 through May 2015 in the amount of 1/12 of the EPT accrued in 2014.⁴ Additionally, the annual tax return for the year 2014 was required to be filed by March 2, 2015, and the respective taxes were to be paid within 10 days. The overpaid taxes are carried over to offset future obligations.

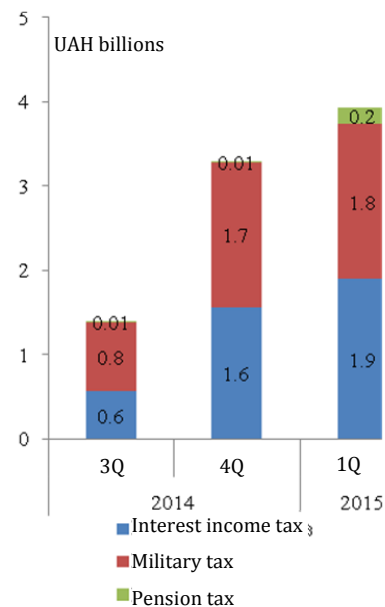
Moreover, it is obvious that inflation pushes higher the profits of profit-making companies. As a measure of this effect, according to the State Statistics Service, the profit of profit-making companies in January through September 2014 was UAH 215.5 billion, which is 65.4% higher than profit declared in the corresponding period of 2013 (UAH 130.3 billion). Considering this trend, the annual EPT revenue plan was increased in March⁵. Besides, it may be expected that numerous changes in the tax law will have a positive impact on tax revenues in the future: the consolidated income tax was cancelled, and it was prohibited not to make advance payments in case of losses in the 1st quarter. Based on the quarter's results, the "Tax Compromise"⁶ *per se* made a barely noticeable effect on the budget revenue (UAH +261.5 million as of the beginning of April), but by the end of May it increased to UAH 793.9 million. And although this amount remains less than it had been anticipated by the fiscal services (UAH 1–3 billion), in the nearest future the number of inspections and additional accruals may be increased based on its results.

Indirect tax revenue increased due to inflation

The inflation resulted in a significant increase in the amount of indirect tax revenue in 1Q2015 as compared to 1Q2014, especially as regards taxes on imported goods and services. For instance, the domestic VAT revenue in 1Q2015 increased 32.1% year-to-year, whereas the import-related VAT revenue leaped up by 71.9%. The excise tax shows a similar situation: the excise tax revenue on the domestic products increased by 41.7%, and by 94.6% on the imported goods. The import duty revenues shot up to 158.9%. In view of this trend, the VAT and import duty plan was increased in March⁷.

An important role in increasing the indirect tax revenues was also played

New Types of PIT Revenue, UAH billions



Source: State Treasury Service

⁴ <http://sfs.gov.ua/baneryi/podatkovy-zmini-2015/podatok-na-pributok/63503.html>

⁵ Law of March 02, 2015 No. 217-VIII

⁶ till April 16, 2015, the company had the right to pay only 5% of the amount of tax (VAT, income tax) outstanding/understated for any tax periods till April 1, 2014, adjusted for the period of limitations (1095 days)

⁷ Law of March 02, 2015 No. 217-VIII

by the numerous legislative changes. The excise tax on retail sales of excise goods⁸ is in effect since January 2015, and a temporary import duty since February⁹. Over the first three months of 2015, they produced an additional UAH 1.2 billion and 2.7 billion of local budget and state budget revenue, respectively.

January through June 2015 also became the transition period for the electronic VAT administration system, with tax invoices registered with the Unified Registry, but without limitation by amount¹⁰. The system makes everything clearly visible for the tax officials. However, it creates additional technical problems for both taxpayers (due to the large amounts of information, the system sometimes did not make it possible to register the tax invoices) and to fiscal service officers (there was a several-fold increase in the workload: the number of tax invoices with amount exceeding UAH 10,000 increased by a factor of 4.3). The largest fiscal effect from this innovation is anticipated in the 2nd half 2015, when the businesses start depositing 1/20 of their turnover on special VAT accounts.¹¹

Government increases VAT refunds

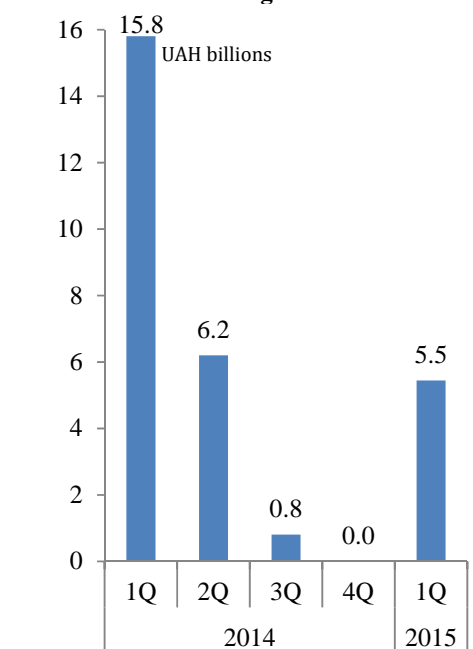
The government promised to simplify VAT refunds and took an obligation not to accumulate VAT refund arrears. As a preventative measure, the list of criteria under the simplified procedure was significantly reduced in the end of 2014. The salary size, number of employees, level of income tax paid, absence of declared losses, and size of discrepancy between the tax credit and tax liability were removed from the list of criteria. However, a new requirement regarding non-current assets in relation to the refund amount was added to the Tax Code. And indeed, the amount of VAT refunds in 1Q2015 increased 34.7% year-to-year to UAH 12.0 billion.

However, it appears that the main factor causing increased volumes of VAT refunds was devaluating national currency (the customs value of exports in UAH increased). Therefore, whereas the US\$ value of exports in 1Q2015 decreased by one-third year-to-year, the average exchange rate of UAH in January through March 2015 was 2.4 times higher. The problem has not been resolved, on the contrary, it has become worse: companies complain of selective approach by the fiscal service, and informal sources in the fiscal service admit that the new criteria and application thereof are subjective. The Head of the State Fiscal Service has admitted that despite the increasing refund amounts, his service is overwhelmed by its responsibilities and is hoping for a new issue of VAT sovereign bonds by the end of 2015.

NBU reduces the budget support

In February 2015, NBU transferred to the budget UAH 5.5 billion (nothing in January and March), which is almost three times less than in

Funds Transferred by the National Bank of Ukraine to the State Budget



Source: State Treasury Service

⁸ Law of December 28, 2014 No. 71-VIII

⁹ Law of December 28, 2014 No. 73-VIII

¹⁰ *ibid*

¹¹ The VAT amounts in invoices have to be covered either by available tax credit (amount of VAT to be refunded by the state), or by a "reserve" amount of own funds on the VAT account.

1Q2014. Together with the limitation of quasi-fiscal expenditures, this helped the appreciation of hryvnia. As a reminder, in 1Q2014 the government was in a hurry to receive funds from the NBU before commencing cooperation with the IMF, which frowns upon such practice. Under the IMF pressure, the annual plan for NBU funds transfer was somewhat reduced¹².

Was the fiscal decentralization a success?

Based on the results of 1Q2015, the government claims that the decentralization reform was successful and already resulted in the local budgets receiving UAH 5.5 billion additional income. As it is already known, the adoption of the 2015 budget was accompanied by amendments to the Budget Code, according to which the local budgets received new income sources: enterprise profits tax, retail excise tax, property tax, etc. However, so far we remain of skeptical opinion regarding the results achieved. In particular, UAH 5.5 billion in additional income announced by the government is made up by additional revenue of the local budgets' general fund. Most of this amount had belonged to the local budgets before, but was included in the special fund (i. e. was assigned to specific expenditures). Should one consider the "net" increase, however, the local budgets' revenues, excluding transfers, increased by UAH 3.6 billion, or 15.6%. Most of this increase is made up by the budget facilities' own revenues (1Q2015: UAH 5.6 billion, which is 160% higher than in 1Q2014). Along with additional revenue, additional responsibilities was also transferred to the local level. So far the issue of comparability of the amounts of revenue and responsibilities transferred remains open. Considering the consumer price index (136.3) and producer price index (142.4), the actual revenue of local budgets decreased. Additionally, the average increase in the revenue of local budgets had an asymmetrical effect in the field. For instance, this concerns the retail excise, which was concentrated in the border regions and in Kyiv. The distribution of enterprise profits tax and mineral resources management fee is uneven.

Forecast: the optimism should be cautious

From the revenue standpoint, 1Q2015 was indeed successful as compared to the prior periods. However, it is unclear how stable this success will be. Since the middle of March, hryvnia has been appreciating, and the currency market has been stable. Moreover, the inflation, which was the main source of growth, in addition to increasing the revenue harms the economic activity. Thus the performance of the revenue part of the budget in 2015 remains an open question (the planned consolidated budget income is 26.6%). Most likely, the 2nd half of 2015 will be dominated by administrative means of budget revenue collection.

Growth of Local Budgets' Revenues in 1Q2015



Source: State Treasury Service, Ministry of Finance, CASE Ukraine

¹² Law of March 02, 2015 No. 217-VIII

EXPENDITURES: the saving was absorbed by war and debts

In 1Q2015, the consolidated budget expenditures were UAH 126.0 billion, which is 12.9% more than in 1Q2014 (UAH 2014 billion). However, over the 1st quarter, just a little more than 1/5 of the expenditures planned for the year were fulfilled. The slow expenditures early in the year are traditional. As compared to 1Q2014, the debt and defense expenditures increased more than twice. The law enforcement, environment, and healthcare expenditures also significantly increased. The consolidated budget expenditures on all other functions decreased.

The reduction of budget wage bill somewhat slowed down

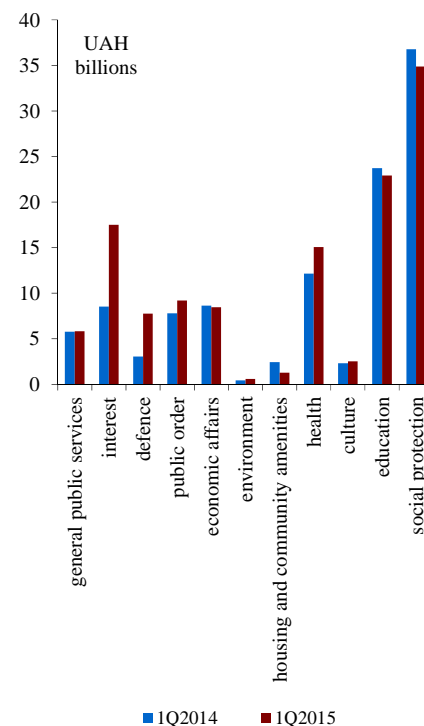
The consolidated budget expenditures for compensation of employees in 1Q2015 amounted to UAH 20.5 billion, or 16.3% of the consolidated budget resource. The salary growth in the budget sector was lower than the economy's average. While the average wage in the economy increased 11.6% year-to-year, in state governance, defense, and social insurance it increased by 2%, and in education and healthcare sectors by 5%. In aggregate, the budget wage bill (except for the military servicemen's remuneration) in 1Q2015 continued to decrease. As compared to late 2014, the reduction rates slowed down from 12.4% to 10.7% year-to-year, however, early in the year the government managed to repay the debt on salaries in the budget sectors.

Social expenditures decreased

In January through March 2015, the consolidated budget expenditures on social support amounted to UAH 34.0 billion, and were 5.3% less than in the same period 2014. However, this is affected by the comparison base, as treasury report for 1Q2014 included the social expenditures to the population of the Autonomous Republic of Crimea. Together with the reduction of scholarships and other social payments, one of the major causes of reduction in the social expenditures is the reduction in the Pension Fund transfers.

In 1Q2015, the state budget spent UAH 4.0 billion on the funding of the Pension Fund, deficit, which is UAH 1.4 billion less than last year. however, despite the lack of indexation of pensions to salaries and refusal to increase minimum pensions, there has not been a significant reduction in the Pension Fund expenditures. In 1Q2015, the pension expenditures amounted to UAH 62.8 billion, which is 1.4% less in 1Q2014. Clearly, one of the causes explaining the slow decrease in expenditures is the reduction of debt on outstanding pensions: today, out of 1.2 million of pensioners of Luhansk and Donetsk Oblasts, over one half receive their pensions regularly. Although the number of such pensioners is increasing, the government assures that the Pension Fund budget has allocations for all outstanding pension payments. At the same time, despite the politicians' pompous claims about the importance of reducing special pension, the transfers from the state budget for the payment of such pensions have barely changed (UAH 15.4 billion, same as last year). In

Consolidated Budget Expenditures by Functions



Source: State Treasury Service

fact, the saving from limiting special pensions is not as high: the proportion of pensioners receiving high pension is about 3.3%, and the share of respective expenditures is around 10%. Moreover, most changes apply to the pensions which are yet to be assigned.

The role of the state in the real sector decreased

In the 1st quarter the fiscal expenditures for economic affairs reduced to UAH 8.5 billion and were 1.9% lower than in January through March 2014. The structure of respective expenditures changed significantly. In particular, in 2015, the government finally made a fundamental reassessment of its role in the economy, almost ceasing subsidies in the coal sector and reducing the agriculture support costs by a factor of two. At the same time, the road maintenance expenditures increased. However, as it turns out, the majority of improvements in the road sector remained in the past: almost 80% of the 1Q2015 expenditures on the road sector was actually spent on repayment of Ukravtodor's (state road service) debts.

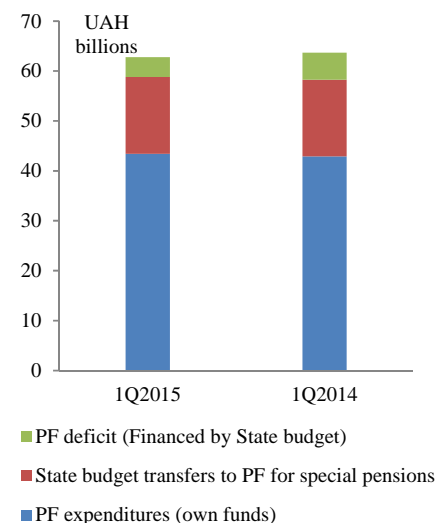
The saved funds were spent on war and debts

Due to the funding of the military action, the defense costs in 1Q2015 increased 2.5 times year-to-year, and amounted to UAH 7.8 billion. However, these expenditures decreased almost by a factor of 1.5 as compared to late 2014. The military expenditures in 1Q2015 made up 6.2% of the consolidated budget, which is an unusual burden on the budget of the country which would spend 2-3% of the consolidated budget on defense for decades. However, even such significant military expenditures will suffice for active military action. This is why it is anticipated that defense expenditures will grow more by the end of the year. In particular, the Ministry of Finance received a request from 10 agencies responsible for defense and law enforcement in Ukraine to increase the funding by over UAH 17 billion in the aggregate, in particular due to increased number of military staff of the Ukrainian Armed Forces (+40% of the annual defense budget). Moreover, in 1Q2015, the military budget was underutilized, with the military services disbursing 88% of the expenditures planned for the quarter, or less than 1/5 of that planned for the year, which means faster military expenditures by the year's end.

Government makes capital expenditures

The distinctive feature of 2015 was the presence of capital expenditures. As compared to 1Q2014, they increased by a factor of 4.3. However, such increase is largely connected to absence of such expenditures in early 2014, when the government suspended public procurements until new legislation was passed. In aggregate, the capital expenditures of the consolidated budget in 1Q2015 were not as high and amounted to UAH 6.7 billion, or 5.2% of the consolidated budget expenditures. Obviously, the need to maintain highly depreciated infrastructure and possible restoration of the eastern regions' infrastructure will require developing alternative funding (public-private partnership) and releasing fiscal resources for social investments.

Expenditures of the Pension Fund of Ukraine



Source: Pension Fund, State Treasury Service

Forecast: the expenditures will increase

Manual control and non-systematic reduction of expenditures do not produce the required impressive result. In the future, the potential of such reduction is limited and requires qualitative reforms.

It may be anticipated that over the next few months the budget expenditures will increase. This is especially important in relation to local budgets, which have accumulated a half of the consolidated budget surplus.

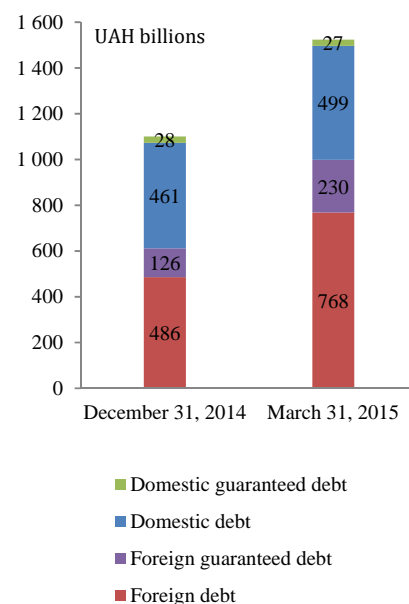
DEFICIT AND DEBT: budget fulfilled with a surplus

The excess of the revenue growth rate over the expenditures growth rate made it possible to fulfill the consolidated budget in 1Q2015 with a significant surplus. The consolidated budget surplus was UAH 14.0 billion, or 3.9% of the GDP¹³, UAH 4.2 billion of which is the state budget surplus and UAH 9.8 billion was the local budgets' surplus. As a reminder, the budget amendments in March increased the planned 2015 state budget deficit from UAH 63.7 billion (3.7% of the GDP) to UAH 75.8 billion (4.1% of the GDP). The amount of debt as of the end of 2015 amounted to UAH 1,524.3 billion, or about 94.4% of the GDP, which is an equivalent of US\$ 65.0 billion. The state borrowed UAH 91.0 billion (UAH 33.7 billion of which were domestic borrowings and UAH 57.4 billion were foreign), and repaid UAH 34.3 billion (UAH 29.6 on domestic obligations and UAH 4.7 billion on foreign ones).

IMF approved the Extended Fund Facility for Ukraine

The history of borrowings in 1Q2015 developed rapidly. In late January, Ukraine addressed the IMF, requesting it to provide the Extended Fund Facility¹⁴ instead of the last year's program. On March 2, the amendments to the state budget required to receive the loan were made, and on March 11 the IMF approved a US\$ 17.5 billion four-year program. From this amount, it is planned to provide Ukraine with US\$ 10.0 billion during the first year. On March 12, the first installment of US\$ 4.87 billion was received, of which US\$ 2.2 billion were spent on replenishment of the foreign exchange reserves, and US\$ 2.8 billion on the government needs. On May 12, the IMF started the first EFF revision. The next installments, US\$ 1.67 billion each, are expected in June, September, and December. The approval of the program also opened the doors to the funds of other international organizations and governments for Ukraine. On April 21, Ukraine received EUR 250 million from the EU (third installment of the 1st Macro-Financial Assistance Program, which complements the IMF assistance).

Ukraine's Debt in 1Q2015 in the National Currency



Source: Ministry of Finance

¹³ GDP of 1Q2015 (NBU assessment)

¹⁴ Has a longer duration and repayment period than the previous program

The government started borrowing less from the National Bank

As a result of offering domestic bonds, it became possible to gain UAH 10.0 billion in January and US\$ 0.3 billion in January for the state budget since the beginning of 2015 (in February through April, the Ministry of Finance did not actively engage resources from the domestic market due to high price of resources and no urgent need for funding during that period).

Besides, in early 2015, the Ministry of Finance issued domestic bonds to increase the authorized capital of Naftogaz of Ukraine by a total amount of UAH 26.1 billion (UAH 17.2 billion in February and 8.9 billion in April). Thus the government has already reached the limits for purchase of sovereign bonds by the NBU for recapitalization of Naftogaz of Ukraine prescribed under the new IMF cooperation program. In April, the NBU purchased state bonds to a total par value of UAH 7 billion (UAH 34.4 billion since the beginning of the year). During that time, the bonds were not issued either for the needs of the banks or for the needs of the Deposit Guarantee Fund.

The government started negotiations on debt restructuring

As of the end of March 2015, the debt amounted to UAH 1,524.3 billion, or about 94.4% of the GDP¹⁵, 34.5% of which is the domestic debt and 65.5% is foreign debt. The amount of debt was, among other factors, influenced by the devaluation of hryvnia (from UAH 15.8 to US\$ 1 as of the end of December 2014 to UAH 23.4 as of the end of March 2015). In US dollars, the debt as of the end of 2015 amounted to US\$ 65.0 billion.

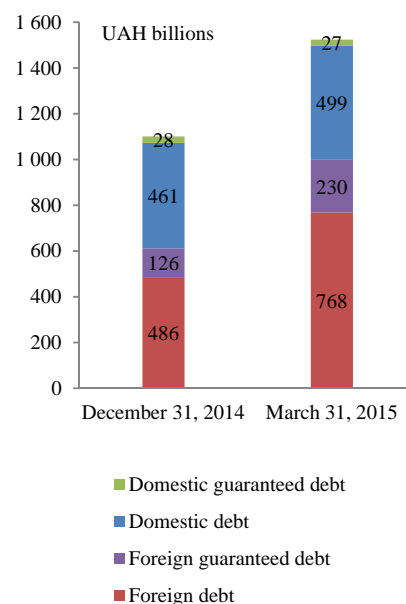
Despite the fact that Ukraine continues paying on its foreign obligations timely and in full amount (in terms of payments, the 1st quarter was the least critical period of 2015), the debt service and repayment are a huge burden on the country. This is why the IMF requires Ukraine to negotiate restructuring with its creditors. The negotiations continue, and are rather difficult. In order to force the creditors to make concessions, in May the Cabinet of Ministers requested the Parliament to give it a right to temporarily suspend payments on all or some debts⁽¹⁶⁾.

Forecast: deficit will come after the surplus

So far there are no grounds to believe that the budget surplus will remain. On the one hand, the income growth rates may slow down due to appreciation of hryvnia. On the other hand, the expenditures in further periods will increase. Additionally, shortfall of privatization proceeds, increase of security and defense expenditures, and political risks connected to indexing of social standards and guarantees pose significant risks for the budget.

The debt will continue to grow. In addition to the IMF credits, in 2Q 2015 Ukraine will start receiving funds from other international organizations and governments, including the World Bank, EU, USA, etc. The difficult

Ukraine's Debt in 1Q2015 in the Foreign Currency



Source: Ministry of Finance

¹⁵ GDP in 2Q2014 through 1Q2015

¹⁶ Law 436-VIII of May 19, 2015

course of negotiations on debt restructuring casts doubts at least on the possibility of successful completion of such negotiations in June. At the same time, it is also unlikely to result in termination of IMF funding (it can be expected that the IMF will make alternative requirements).

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