Ukraine
Strategy

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IMF Deal and Minsk Two Accords

Keeping hope alive

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Two processes concluded this week that might have a big impact on Ukraine's economic sustainability and the very survival of its statehood: the finalization of the latest round of talks with the IMF and the conclusion of the Minsk-Two ceasefire accords aimed at stopping the military conflict in the easternmost Donbas region. The entire country was looking forward to hear positive results from both negotiations, and the first messages from both looked encouraging on the surface. However, upon closer scrutiny they created more questions than offered answers. This implies ongoing instability through the year's remainder.

What we can generally conclude from these two events:

- Ukraine might get up to USD 40 bln in financial aid from IFIs and Western governments (including USD 17.5 bln from the IMF) during the next four years if the government pursues prescribed reforms, while the exact amount and schedule of loans is not clear now. The good news is that the ability to conduct reforms and gain the loans is entirely up to the government. Therein lies the bad news as well, since the government has demonstrated so far not to be interested in improving governance and cutting costs in many economic spheres. Moreover, the stretched schedule of financial aid (four years) tells little on how much Ukraine will receive in 2015. We estimate the country needs at least USD 14 bln to ensure the stability of the local currency (which has plummeted in value in the last two weeks) for the rest of 2015.

- On the military front, a glimmer of hope has emerged that the war will move from a military confrontation in Donbas to a political dialogue based on the ceasefire agreement. On the other hand, the main driving factor of instability – Vladimir Putin -- continued to evade any official responsibility for the warfare and he took no explicit obligation upon himself to pursue any peace plan. Therefore, we view the Minsk-Two deal as treating the symptoms of the disease, not the real cause.

IMF deal: budget to be "refilled," hryvnia's stability is not secured

On Feb 12, the IMF and Ukrainian authorities reached a staff-level agreement for a USD 17.5 bln loan under the Extended Fund Facility format, which replaces the USD 17 bln standby agreement reached in 2014. They also outlined a USD 40 bln financial aid package for Ukraine. The message is definitely positive but the design of the program remains unclear. Moreover, the Ukrainian government has its work cut out to both facilitate the provision of all the loans and to invest them effectively.

The effect of the IMF deal on hryvnia should be positive, at least for the short-term. The impact will be delayed until the time austerity measures are approved by Rada and donor funding arrives.

Too many questions surround the new support program's timeline

Though the basic figures are now known, it is not clear how the new aid package will be arranged. Specific question arise, such as:

- **How to interpret the timing of a program claimed to be for four years?** It's not clear whether we should include 2014 (when Ukraine received USD 4.5 bln from the IMF).
- **Who will be the contributors to the remaining funds of the announced USD 40 bln?** It looks as though the funding structure is still under discussion.
- **Are current holders of sovereign debt involved in supporting Ukraine?** This is the main question from bondholders right now, and we do not have any answer. What we believe is the restructuring of the 2015 Eurobonds (totally worth just USD 1.2 bln) is unlikely.

Why so little? It might not be enough to stabilize the hryvnia

- We estimate, Ukraine will need at least USD 5 bln in ForEx interventions, **and total dollar funding of at least USD 14 bln this year**, to stop the local currency's weakening against the backdrop of expected substantial hryvnia printing (about UAH 200 bln in 2015).
- **Simple division** of the USD 40 bln aid package by four years provides **USD 10 bln for one year**, which **is not enough to ensure the stability of the Ukrainian currency throughout 2015.** The total size of 2015 aid (which is critical to know) is not clear yet, given that the Ukrainian government has yet to produce its reforms schedule.
- Only in the case of stronger austerity measures (less hryvnia printing) and/or stronger IFIs support can we begin to talk about hryvnia strengthening (closer to UAH 20/USD).
- The USD 17.5 bln in IMF support for Ukraine, stretched over three or four years, is actually quite modest. Averaging USD 4 to 6 bln per year, it's less than what was agreed upon under the old standby program of USD 17 bln for two years. If Ukraine receives USD 4.8 bln in March 2014 (as some insiders claim), further disbursements from the IMF this year may be tiny.

A revised 2015 budget must be approved first

When making their announcement on Feb. 12, IMF officials once more emphasized that fiscal issues are crucial for the IMF. The fact that Mission Chief Nikolay Gueorguiev was not able to offer a date for the new wire means that homework is expected of Ukrainian authorities first. The Cabinet is expected to introduce substantial changes to the 2015 spending plan, which was initially approved with an overly optimistic revenue target with heavy reliance on hryvnia printing, which the IMF clearly frowns upon.

Ukraine expects the budget deficit to increase to 4.6% from 3.7% of GDP, even after the IMF-required spending cuts. The driving force behind revising the 2015 budget is additional outlays on housing subsidies (UAH 12.5 bln), which should grow due to meet IMF requirements to raise heating rates to market levels. In fact, that is all what we know about the budget revisions. At the same time, we know that the Cabinet plans substantial social spending cuts and we anticipate revenue projections will be adjusted to more realistic values.

The IMF funds will arrive not earlier than March

- Ukrainian authorities will need at least one week to pass all the needed budget amendments (if everything goes smoothly).
- As soon as Ukraine does its "homework", the IMF Executive Board will need a week or two to approve the first tranche of the new loan.

Such a timeframe would enable Ukraine to smoothly repay its USD 3.0 bln debt to Russia if called for after Ukraine announces its 2014 GDP number on March 11 (which would give Russia the right to accelerate this loan, as the state debt-to-GDP ratio will officially exceed 60%, as of 2014).

Minsk Two accords: hope for a longer ceasefire this time around

The 16-hour negotiations between the leaders of France, Germany, Ukraine and Russia ended with the adoption of a vague "**declaration**" of the four leaders and a separate **"action plan"** for implementing what is known as the Minsk-Two agreement. The latter document was signed by former Ukrainian President Leonid Kuchma who represented Ukraine, Russian Ambassador to Ukraine Mikhail Zurabov, and two people without any recognized titles: Aleksandr Zakharchenko and Igor Plotnitskiy, the self-declared leaders of the self-proclaimed "Donetsk and Luhansk People's Republics."

The core benefit of these documents for Ukraine is that they set the conditions for a second **ceasefire** attempt starting midnight Feb. 15. All heavy weaponry will be removed far enough to prevent rocket attacks on civilian targets and all hostages are supposed to be released within three weeks. As pointed out by many diplomats, all the struggles and time invested in negotiating was worthwhile if it creates even the slightest chance to end bloodshed and destruction of property.

The core risk is that little will depend on Ukraine in all these actions plans. Meanwhile, Putin succeeded in keeping the Russian government immune from any official responsibility in the conflict and its resolution and thus took no explicit obligations to pursue the action plan (refer to the next page on more details on responsibility taken).

Closure of the entire Ukrainian-Russian border, the core demand of the Ukrainian side and the main factor that can de-escalate the Donbas conflict, is only "promised" to be implemented by the end of 2015 and it's conditional on the successful execution of many items in the action plan (creating a new special status for the Donetsk and Luhansk regions and amending the Constitution to accommodate them), which makes its likelihood extremely low. **Again, the side that has the most influence in resolving these conflicts did not take any obligations upon itself.**

Our view: It was signed to be breached… De-escalation will only be temporary

Unfortunately, the situation won't change much after the Feb. 12 signing, as we can conclude from Ukraine's 2014 deals with Russia (including gas agreements and Minsk-One). Instead, we expect Russia will start blaming Ukraine (et al.) again for violating any item "du jour" in the action plan, using such alleged failures as a pretext to allow the terrorists to further wreak havoc.

Recall, the first Minsk accords were signed on Sept. 5 and Ukraine went to great lengths to adhere to them (including the ceasefire and adopting the necessary legislation to enhance the autonomy of the Donetsk and Luhansk regions). Instead, the Russian-backed terrorists took advantage of the ceasefire to reposition their units and weaponry, attack further and occupy more territory (550 sq. km., to be exact).

Two documents of the Minsk-Two accords

1. The declaration of leaders of France, Germany, Ukraine and Russia

It contains general words about the four leaders' respect for Ukraine's integrity and sovereignty and "firm conviction of no alternative to a peaceful solution". The leaders also endorsed the **action plan** and "will contribute" to influencing the sides of the conflict to facilitate execution of the plan. France and Germany will help to renew the banking system on the territories of the conflict, according to the document.

Russia did not take any obligations with this declaration. Moreover, the document looks very "promising" for Putin who, on paper, gains a new format of dialogue with the West. Three out seven paragraphs of the document refer to "strengthening cooperation" between the EU, Ukraine and Russia.

2. The action plan signed by Ukraine's former president, the Russian ambassador to Ukraine and two men without any title

It's a more detailed document consisting of 13 items aimed to de-escalate the situation in Donbas. At its essence is the launch of a ceasefire on midnight Feb. 15 and the withdrawal of all heavy weapons within 16 days.

The core priority of Ukraine, which consists of the Russian government allowing it to renew control of their common border (through which heavy weapon and mercenaries pour in) ranks as item number 9, which is rather low on the list. Its timing is "by the end of 2015" and it's conditional on constitutional reform (ranked 11) that would provide broad autonomy for the occupied districts of Donbas. In essence, Putin won't let Ukraine control the border unless it amends its constitution to accommodate the Russian government's federalized model for Ukraine. Therefore, we can only be pessimistic about the prospects for peace this year.

Out of 13 items of the action plan (based on our analysis):

- **seven** fall under the responsibility of Ukraine (including constitutional reforms to accommodate Russia, full amnesty for all terrorists, local elections in Donbas)
- **five** are under the responsibility of the Russian-backed terrorists
- **two** are under the responsibility of other sides (OSCE, "contact group")
- **one** is beyond anybody's responsibility (and it's core for Ukraine: securing Ukraine's control over the entire Ukraine-Russia border)
- **two** are under the theoretical responsibility of Russia (who is not mentioned in the document): releasing hostages and removing foreign troops and hardware from Ukraine.

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