FOR AGENDA

EBS/08/114
Supplement 2

CONFIDENTIAL

November 3, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Ukraine—Assessment of the Risks to the Fund and the Fund's Liquidity Position**

The attached paper on an assessment of Ukraine's risks to the Fund and the Fund's liquidity position is being issued as a supplement to the paper on Ukraine's request for a Stand-By Arrangement (EBS/08/114, 11/3/08), which is tentatively scheduled for discussion on **Wednesday, November 5, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Ukraine indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Rossi (ext. 35651) and Mr. Arvanitis (ext. 36054) in FIN.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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Department Heads

INTERNATIONAL MONETARY FUND

Ukraine—Assessment of the Risks to the Fund and the Fund's Liquidity Position

Prepared by the Finance and Strategy, Policy, and Review Departments

In consultation with other Departments

Approved by Andrew Tweedie and Adnan Mazarei

November 3, 2008

1. **This note assesses the risks to the Fund arising from the proposed Stand-By Arrangement (SBA) for Ukraine and its effects on the Fund's liquidity, in accordance with the policy on exceptional access.**[1] The authorities are requesting a 24-month SBA with access of SDR 11 billion (802 percent of quota). A front-loading of SDR 3 billion (219 percent of quota) would be made available upon approval of the arrangement; this would be followed by eight quarterly purchases providing access of SDR 6.5 billion (474 percent of quota) in 2009 and SDR 1.5 billion (109 percent of quota) in 2010, with the final purchase in October 2010 (Table 1).

Table 1. Ukraine: Proposed SBA—Access and Phasing

Availability	Date 1/	Purchases		
			Percent of quota	
		SDR mn	Annual	Cumulative
2008	November (approval)	3,000	218.7	218.7
2009	February	1,250	91.1	309.8
	May	2,500	182.2	492.0
	August	750	54.7	546.6
	November	2,000	145.8	692.4
2010	February	375	27.3	719.8
	May	375	27.3	747.1
	August	375	27.3	774.4
	October	375	27.3	801.7
	Total	11,000	801.7	801.7

Source: Finance Department.

1/ Starting in February 2009, purchases will depend on the completion of a review.

[1] See *The Acting Chair's Summing Up of the Review of Access Policy Under the Credit Tranches and the Extended Fund Facility, and Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy* (BUFF/03/28, 3/5/03).

I. Background

2. **Ukraine has had an extensive financial relationship with the Fund since becoming a member in September 1992 (Table 2).** Obligations to the Fund (all GRA) peaked in 1999 at just over SDR 2 billion. Current credit outstanding is SDR 73.14 million. Ukraine's performance under its past programs with the Fund has been mixed. Most recently, the 2004 SBA arrangement, which was treated as precautionary upon approval, quickly went off-track. The 2005 Ex Post Assessment of Longer-term Program Engagement concluded that better program ownership, rooted in stronger political consensus, would be key in improving the chances of success for potential future program-based engagement.[2] Ukraine has repurchased Fund's resources in a timely fashion.

Table 2. Ukraine: IMF Financial Arrangements, Purchases and Repurchases, 1994–2015
(In millions of SDRs)

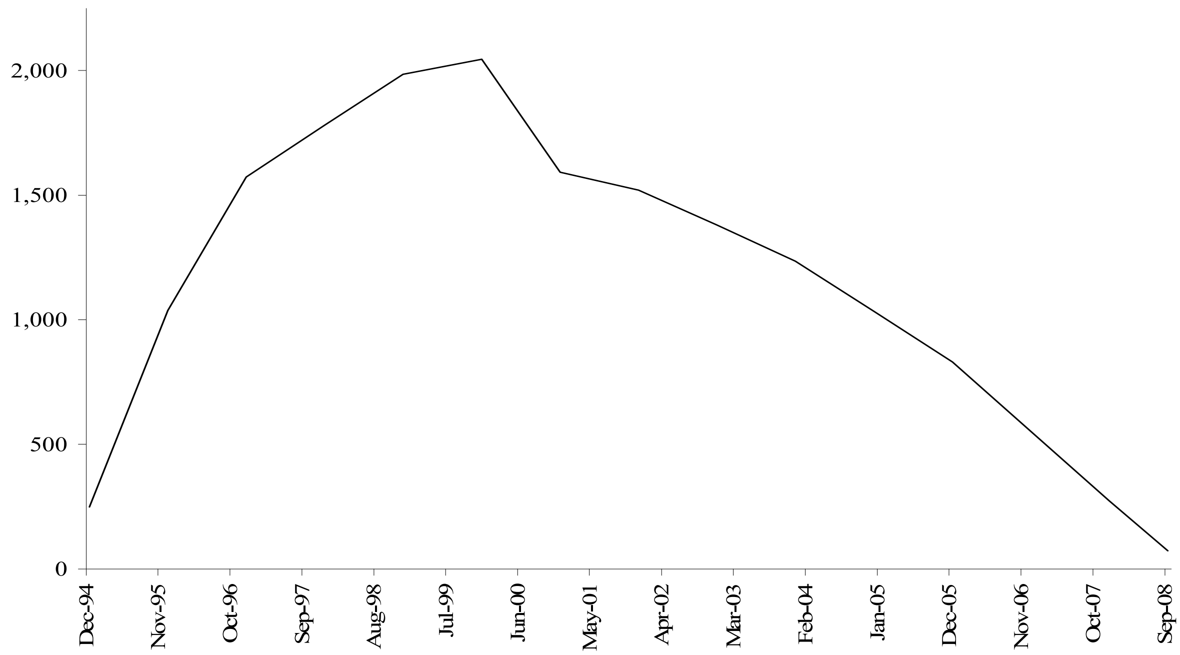
Year	Type of New Arrangement	Date of Arrangement	Date of Expiration or Cancellation	Amount of New Arrangement	Amount Drawn	Purchases	Repurchases	Fund Exposure 1/
1994	STF 2/	26-Oct-1994		498.6	498.6	249.3	0.0	249.3
1995	SBA	7-Apr-1995	6-Apr-1996	997.3	538.7	788.0 3/	0.0	1,037.3
1996	SBA	10-May-1996	23-Feb-1997	598.2	598.2	536.0	0.0	1,573.3
1997	SBA	25-Aug-1997	24-Aug-1998	398.9	181.3	207.3	0.0	1,780.6
1998	EFF	4-Sep-1998	3-Sep-2002	1,920.0	1,193.0	281.8	77.3	1,985.0
1999						466.6	407.0	2,044.6
2000						190.1	643.5	1,591.2
2001						290.8	361.2	1,520.7
2002						0.0	140.7	1,380.0
2003						0.0	144.5	1,235.5
2004	SBA	29-Mar-2004	28-Mar-2005	411.6	0.0	0.0	201.8	1,033.7
2005						0.0	202.8	830.9
2006						0.0	279.0	551.9
2007						0.0	279.0	272.9
2008 4/						0.0	199.8	73.1
2008 5/ 6/	*SBA*	*5-Nov-2008*		*11,000.0*	*11,000.0*	*3,000.0*	*215.6*	*3,057.3*
2009 6/						*6,500.0*	*57.3*	*9,500.0*
2010 6/						*1,500.0*	*0.0*	*11,000.0*
2011 6/						*0.0*	*0.0*	*11,000.0*
2012 6/						*0.0*	*2,687.5*	*8,312.5*
2013 6/						*0.0*	*5,031.3*	*3,281.3*
2014 6/						*0.0*	*2,812.5*	*468.8*
2015 6/						*0.0*	*468.8*	*0.0*

Sources: Finance Department.

1/ As of end December, unless otherwise stated.
2/ The Systemic Transformation Facility (STF) was created in April 1993 and allowed to lapse in April 1995.
3/ Includes a second drawing under the 1994 STF of SDR 249.3 million.
4/ As of end September.
5/ Projected as of end December
6/ Figures under the proposed program in italics.

[2] See *Ukraine—Ex Post Assessment of Longer-Term Program Engagement* (SM/05/379, 10/18/2005).

Figure 1. Ukraine: IMF Credit Outstanding, 1994-2008
(In millions of SDRs)



3. **While public external debt remains low, Ukraine's total external debt has increased in recent years to relatively high levels (Tables 3 and 4)**. By end-2007, Ukraine's public external debt had declined to 11 percent of GDP, well below that of recent exceptional access cases, and lower than that of Iceland and Hungary.[3] However, total external debt reached 58 percent of GDP, over 80 percent of which was owed by the private sector. As a share of GDP, Ukraine's total external debt is higher than the corresponding ratios in three of the five recent exceptional access cases, but lower than that in both Iceland and Hungary.[4] [5]

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[3] See forthcoming staff reports for Iceland and Hungary.

[4] The exceptional access cases used as comparators in this paper are five of the six arrangements approved since the exceptional access procedures were put in place (Argentina, Brazil, Georgia, Turkey, and Uruguay). The 2008 extended arrangement for Liberia also involved exceptional access. However, this arrangement was different from other exceptional access cases since, in this case, exceptional access was granted in the context of Liberia's clearance of arrears to the Fund.

[5] The analysis in this supplement is based on information on Fund arrangements as of end-September 2008. Except where specifically noted, it does not take into account other arrangements that may be put forward for the consideration of the Board in the coming weeks.

Table 3. Ukraine: External Debt, 2005–08

	2005	2006	2007	2008 1/
	(In millions of U.S. dollars)			
Total External Debt	38,843	53,633	81,939	102,128
of which :				
Public	13,526	14,838	15,602	19,485
Private	25,317	38,795	66,337	82,644
	(In percent of total external debt)			
Total External Debt	100.0	100.0	100.0	100.0
of which :				
Public	34.8	27.7	19.0	19.1
Private	65.2	72.3	81.0	80.9
	(In percent of GDP)			
Total External Debt	45.1	49.7	57.8	54.3
of which :				
Public	15.7	13.7	11.0	10.4
Private	29.4	35.9	46.8	43.9

Source: Ukrainian authorities and IMF staff estimates.

1/ Projected to end-2008.

Table 4. Debt Ratios in Recent Exceptional Access Cases 1/

(In percent of GDP)

	Total External Debt	Public External Debt	Debt to IMF
Argentina (2003)	129.0	82.5	12.2
Brazil (2003)	38.6	21.5	5.1
Turkey (2005)	35.0	17.8	3.0
Uruguay (2005)	82.0	60.8	13.8
Georgia (2008) 2/	34.6	21.0	2.8
Ukraine (2008) 3/	*54.3*	*10.4*	*2.5*

Source: Board Documents and IMF staff estimates.

1/ Ratios for the year indicated in parenthesis. Year in parenthesis corresponds to the year of approval of the last IMF arrangement with each country.
2/ Projected for end-2008, including PRGF resources.
3/ Projected for end-2008, assuming first purchase under proposed SBA.

II. THE NEW STAND-BY ARRANGEMENT—RISKS AND IMPACT ON FUND'S FINANCES

A. Risks to the Fund

4. **Access under the proposed arrangement would far exceed that in previous arrangements with Ukraine, and would exceed both the annual and cumulative limits.** If all purchases are made as scheduled, Ukraine's outstanding use of Fund resources would rise from about 5 percent of quota currently to over 200 percent with the first drawing. Access would reach over 800 percent of quota in October 2010—well above Ukraine's historic peak exposure—and remain at this level through January 2012.[6] In terms of quota, this peak exposure would be larger than that in the recent exceptional access cases, except for Turkey (Figure 2).[7]

5. **The proposed SBA will take Ukraine's total outstanding use of Fund resources to 2.5 percent of GDP following the first purchase and 11.5 percent of GDP if fully disbursed (Tables 5 and 6).** Ukraine's outstanding use of Fund resources in terms of GDP would be significantly higher than the ratios for recent exceptional access cases, except for Liberia. Taking into account the first drawing under the program (as well as those under proposed programs for Iceland and Hungary), Ukraine would become the Fund's third largest user of Fund resources.

6. **The Fund's share of Ukraine's external debt and debt service would increase significantly if the SBA were fully drawn** (see Table 6)**.** Ukraine's outstanding use of Fund resources would account for half of Ukraine's projected public external debt by end-2009, and peak slightly above that by the end of the program. Ukraine's projected debt service to the Fund would peak in 2013 at about SDR 5 billion. Given the low public external debt, debt service to the Fund would reach over 70 percent of public external debt service in 2012 and over 80 percent in 2013.[8] In terms of exports of goods and services, external debt service to the Fund would exceed 5 percent in 2012 and 8 percent in 2013.

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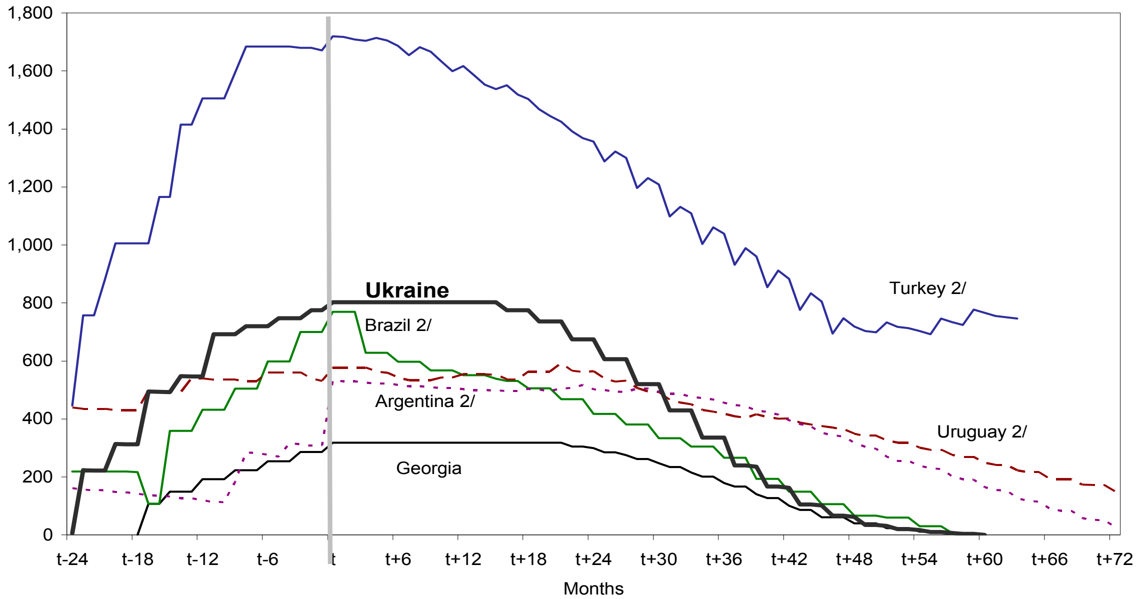
[6] The figures on debt service used in this report correspond to the schedule on an obligations basis, in line with the guidelines stipulated in *Review of Fund Facilities—Proposed Decisions and Implementation Guidelines* (EBS/00/216, 11/3/00). Under the obligations schedule, the first repurchase is scheduled to take place in February 2012, 3¼ years after the first purchase under the arrangement. Under the policy on time-based repurchase expectations, there is an expectation that repurchases of holdings resulting from the purchases in the credit tranches and the EFF, including under exceptional access will adhere to the expectations schedule, and an extension from the expectations to the obligations schedule would require a decision by the Executive Board.

[7] Peak exposure as a share of quota would be smaller than that under the proposed arrangements for Hungary and Iceland, as shown in the second panel of Figure 2.

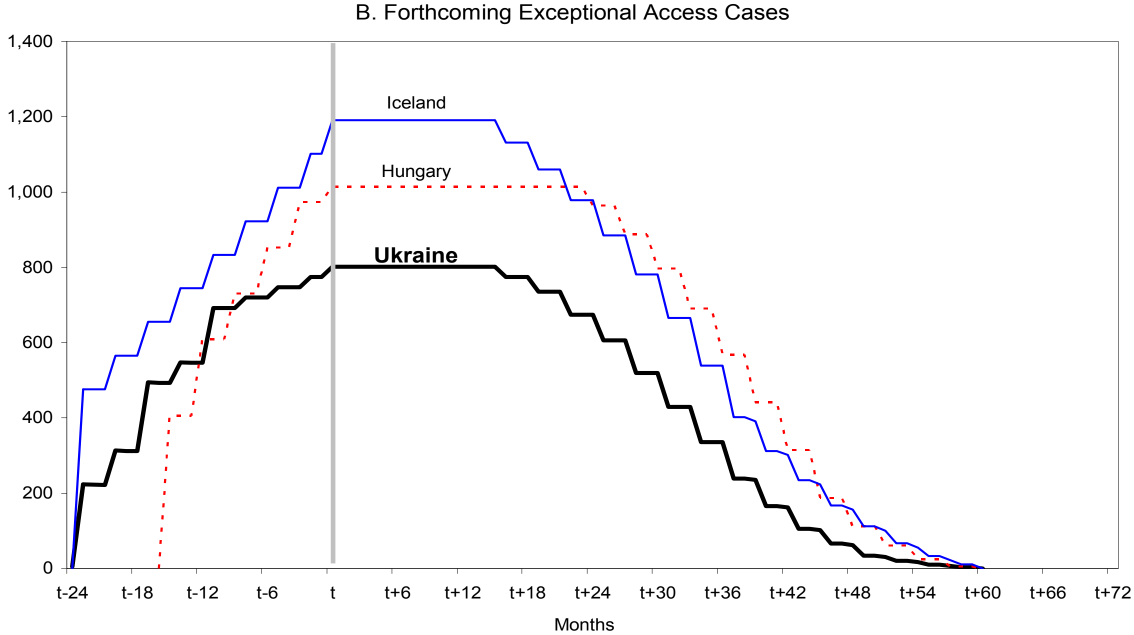
[8] Currency holdings resulting from scheduled purchases under the proposed SBA would be subject to level-based surcharges of 100 basis points over the basic rate of charge (adjusted for burdensharing) on credit outstanding exceeding 200 of quota from the time of approval of the arrangement through January 2014, and surcharges of 200 basis points on credit outstanding exceeding 300 percent of quota from February 2009 to October 2013.

Figure 2. Fund Credit Outstanding in the GRA around Peak Borrowing 1/
(In percent of quota)

A. Recent Exceptional Access Cases



B. Forthcoming Exceptional Access Cases



Source: IFS, Finance Department, and IMF staff estimates.

1/ Peak borrowing is defined as the highest level of credit outstanding for a member, in percent of quota. Month t represents the month of the highest historical credit outstanding (in percent of quota). For Argentina, t is September 2001; for Brazil, September 2003; for Turkey, April 2003; and for Uruguay, August 2004. For Georgia, t would be reached in February 2010. For the countries in Panel B, t would be reached in February 2010 in the case of Hungary, and October 2010 in the cases of Iceland and Ukraine. For comparability, projected repurchases are assumed to be on an obligations basis.
2/ Projected repurchases (on an obligation basis) as of May 2005. Schedules do not show large early repurchases made by Argentina, Brazil, and Uruguay in 2005-06.

Table 5. Fund GRA Exposure

		In Percent of			
				Total GRA Credit	
	SDR Millions	Quota	GDP 3/	As of end-Sep. 2008	After approval of arrangements in panel B 4/
A. Top five borrowers as of end-September 2008					
Turkey 1/	5,898.7	495.1	1.2	77.9	38.4
Dominican Republic 1/	350.2	160.0	1.2	4.6	2.3
Liberia 1/	342.8	265.3	59.4	4.5	2.2
Sudan 1/	220.9	130.2	0.6	2.9	1.4
Georgia 1/	161.7	107.6	2.0	2.1	1.1
B. Forthcoming exceptional access cases					
Iceland 2/	560.0	476.2	5.1	…	3.6
Hungary 2/	4,215.0	405.9	4.2	…	27.5
Ukraine 2/	3,073.1	224.0	2.6	1.0	20.0

Sources: Finance Department and IMF staff estimates.

1/ Fund credit outstanding as of September 30, 2008.

2/ Fund credit outstanding after the first purchases of the proposed SBA. For Ukraine, includes credit outstanding as of end-September 2008.

3/ Staff projections to end-2008.

4/ Numerator is Fund credit outstanding as of end-September 2008 for countries in panel A, and Fund credit outstanding as of end-September 2008 plus the first purchase under the proposed SBA for countries in panel B. Denominator is the sum of total Fund GRA credit outstanding as of end-September 2008 and the first purchases of the three proposed arrangements in panel B.

B. Impact on the Fund's Liquidity Position and Risk Exposure

7. **The proposed arrangement would reduce Fund liquidity by about 9 percent.** Commitments under the proposed arrangement would reduce the one-year forward commitment capacity of SDR 127.6 billion as of end-September by SDR 11 billion (see Table 6).[9]

8. **Fund credit to Ukraine as a share of total current Fund credit from the GRA would increase to 20 percent with the first drawing, taking into account the proposed arrangements for Iceland and Hungary.** The share of the top five borrowers of total outstanding credit would remain virtually unchanged at about 92 percent taking all three potential programs into account (see Table 6).[10]

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[9] The FCC is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of quota-based, nonconcessional resources available for new lending over the next 12 months. See *The Fund's Liquidity Position—Review and Outlook* (EBS/02/177, 10/14/02); (BUFF/02/179, 11/4/02); and (BUFF/02/68, 5/15/02). Following the creation of the Short-term Liquidity Facility (SLF), the calculation of the FCC will exclude repurchases falling due under the SLF—see *A New Facility for Market Access Countries—The Short-Term Liquidity Facility—Proposed Decision (*SM/08/324, Supplement 1, 10/27/08)

[10] Given the expectation for a number of new lending operations beyond that of Ukraine, Hungary, and Iceland, including a number that will involve exceptional access, the concentration of the Fund's lending portfolio is likely to change in coming months.

Table 6. Ukraine—Impact on GRA Finances
(In millions of SDRs, at end of period unless otherwise noted)

	2008	2009	2010	2011	2012	2013	2014
Exposure							
Fund GRA credit outstanding to Ukraine 1/	3,057.3	9,500.0	11,000.0	11,000.0	8,312.5	3,281.3	468.8
Fund GRA credit outstanding to Ukraine (percent of quota) 1/	222.8	692.4	801.8	801.8	605.9	239.2	34.2
Fund GRA credit outstanding to Ukraine (percent of total GRA credit outstanding) 2/	20.0	…	…	…	…	…	…
Fund GRA credit outstanding to five largest debtors (percent of total GRA credit outstanding) 2/	91.9	…	…	…	…	…	…
Liquidity							
One-year Forward Commitment Capacity (FCC) 3/	127,615.8	…	…	…	…	…	…
Ukraine's impact on FCC 4/	(11,000.0)	…	…	…	…	…	…
Prudential measures							
Fund GRA credit outstanding to Ukraine (percent of current precautionary balances) 5/	44.1						
Debt and debt service ratios 6/							
Ukraine's GRA credit outstanding (percent of total public external debt)	24.5	50.3	53.6	51.7	41.9	19.9	…
Ukraine's GRA credit outstanding (percent of GDP)	2.5	10.9	11.5	10.5	7.0	2.4	…
Ukraine's GRA credit outstanding (percent of gross international reserves)	15.2	48.4	49.4	43.1	28.7	10.6	…
Ukraine's GRA debt service to the Fund (percent of exports of goods and services)	0.1	0.7	1.0	1.0	5.2	8.2	…
Ukraine's GRA debt service to the Fund (percent of total public external debt service)	2.1	16.4	22.6	26.7	73.4	81.2	…
Memorandum items							
Fund's precautionary balances 5/	6,938.6						
Fund's residual burden sharing capacity 7/	110.0						
Projected payment of charges to the Fund on GRA credit outstanding	16.2	257.9	500.7	551.8	513.0	306.7	78.7
Projected debt service payments to the Fund on GRA credit outstanding	32.0	315.2	500.7	551.8	3,200.5	5,337.9	2,891.2

Source: Ukrainian authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

1/ Repurchases follow obligations schedule.
2/ Reflects Fund credit outstanding as of September 30, 2008, plus first purchases by Hungary, Iceland, and Ukraine.
3/ As of September 30, 2008. The Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to usable resources plus repurchases one-year forward minus the prudential balance.
4/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward.
5/ As of end-April 2008.
6/ Staff projections for total public external debt, GDP, gross international reserves, and exports of goods and services, as used in the staff report that requests the proposed SBA.
7/ Estimated based on end-September data and taking into account the first purchases of Hungary, Iceland and Ukraine under their proposed programs. Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.

9. **Were Ukraine to accrue arrears on charges under the proposed arrangement, the Fund's burden sharing mechanism could be put under very serious strain.**[11] Charges on the new GRA obligations will be about SDR 250 million over the next year or more than twice the Fund's estimated residual burden-sharing capacity, taking into account the first purchases of the three forthcoming arrangements (see Table 6). However, the impact on the Fund's burden sharing capacity of potential arrears from this arrangement would decline if the Fund's loan portfolio were to expand.

10. **Potential GRA exposure to Ukraine would be substantial in relation to the Fund's current level of precautionary balances.** Outstanding GRA credit to Ukraine would be about 44 percent of the Fund's current level of precautionary balances upon approval (see Table 6).

III. Assessment

11. **There are considerable financial risks associated with the proposed arrangement for Ukraine.** The proposed access, and the substantial and front-loaded financing under the program aim to strengthen confidence in Ukraine's ability to address the effects of plunging commodity prices and the present environment of global deleveraging, bolstering reserves and providing breathing room for implementation of necessary adjustment under the proposed program (EBS/08/114, 11/3/08). However, the arrangement is large in terms of both available Fund resources and the debt service implications for Ukraine. Moreover, there are substantial downside risks to the baseline scenario, including:

- **a worsening of external financial conditions.** A further deepening, or exceptionally long duration, of the ongoing process of deleveraging in financial markets could delay access to international financial markets, affecting particularly the private sector, in the face of its large and increasing financing needs;

- **a possible overshooting of the exchange rate**. A significant exchange rate depreciation would exacerbate pressures on households and banks (with mixed effects on corporates);

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[11] Under the burden-sharing mechanism, the financial consequences for the Fund that stem from the existence of overdue financial obligations are shared between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge, respectively. The mechanism is used to accumulate precautionary balances in the special contingent account (SCA-1) and to compensate the Fund for a loss in income when debtors do not pay charges. The Executive Board has set a floor for remuneration at 85 percent of the SDR interest rate. No corresponding ceiling applies to the rate of charge. The adjustment for the SCA-1 was suspended, effective November 1, 2006, by the Executive Board (Decision No. 13858-(07/1), adopted January 3, 2007).

- **delays in moving forward with financial sector reforms and enactment of a comprehensive bank resolution strategy**. The upfront banking recapitalization provides for a strong start, but implementation of these reforms will require steady and decisive policy actions; and

- **a challenging political situation that could adversely affect program implementation and market confidence.** The Parliamentary passage of anti-crisis legislation and the commitment to the programmed reforms by both the ruling coalition and opposition leaders provide critical support in this regard. Nonetheless, the forthcoming parliamentary election and the presidential election in January 2010 could cloud the already fractious political environment, posing a potentially serious risk to program implementation.

12. **These risks may adversely affect Ukraine's capacity to repay the Fund.** The proposed access is significant in terms of both Fund resources and the debt service burden it generates in a medium-term context of demanding external financing requirements. As such, the authorities' commitment to firm implementation of the program (already demonstrated in the context of substantial prior actions), prompt response to changes in underlying conditions, and continued political support are key to mitigating these risks and safeguarding Fund resources.