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Ukraine: the IMF support package and increased defence spending

Sławomir Matuszak

On 21 March 2023 the International Monetary Fund (IMF) announced that it had reached a preliminary agreement with Ukraine on an Extended Fund Facility (EFF) programme, under which the country will receive a total of $15.6 billion in funding, including $4.5 billion by the end of this year. The four-year programme is divided into two phases. In the first, which will last 12-18 months, the main task will be to strengthen the financial stability of the state. The Ukrainian government will be expected to stop the direct purchases of internal bonds by its central bank (which *de facto* means 'printing' the hryvnia), to avoid actions that could reduce tax revenues, and to tighten control over the banking sector. In the second phase, which will start after the war ends, Ukraine will carry out reforms aimed at rebuilding its economy, achieving macroeconomic stability and advancing the country's integration with the EU. A detailed list of all the EFF-related requirements has not yet been published. The agreement must be approved by the IMF Board of Directors, which is expected in the coming weeks.

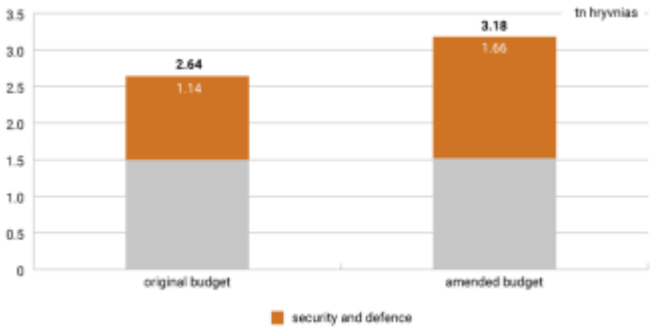
On the same day, the Ukrainian parliament adopted amendments to the budget which will increase spending by 537 billion hryvnias (about $14.5 billion). 518 billion hryvnias will be allocated to defence, including 477 billion hryvnias for the payment of salaries to the army and the security services, while the rest will be used to purchase equipment and weapons. The Ministry of Defence will receive 372 billion hryvnias, the Ministry of Internal Affairs 98 billion, the Security Service of Ukraine 9.3 billion, and military intelligence 4.6 billion. Overall, security- and defence-related outlays are expected to total 1.5 trillion hryvnias (c. $40.5 billion) in 2023, a sum comparable to last year's figure (see chart).

Commentary

- The agreement reached with the IMF is a success for Ukrainian negotiators, since it is unprecedented for the Fund to agree to an EFF programme with a country that is fighting a full-scale war. The IMF's previous programmes required an accurate macroeconomic forecast, which is impossible during an armed conflict (the IMF predicts that Ukraine's GDP this year will change within the range of -3% to +1%). However, the IMF notably insisted that the Ukrainian government had to abandon some of the instruments it had used in the first year of the war, primarily the introduction of new tax breaks (which some of the country's economists had previously criticised as unjustified) and the excessive printing of the hryvnia, which was an important means of plugging the budget deficit in 2022.

- The parliament's decision to increase spending was forced by the overly optimistic assumptions that were made when the budget was adopted last November, according to which the phase of intense hostilities was only supposed to continue for the first six months of this year. The amendments mean that the government (similarly to the IMF programme) expects the war to go on until at least the end of the year. The changes will push the current deficit to 1.7 trillion hryvnias (c. $46 billion), which represents around 60% of budget spending. Ukraine has so far secured €18 billion in macro-financial assistance from the EU and nearly $10 billion from the US for this year. In addition, the Norwegian government has announced $7bn in support over a five-year period, while Japan has pledged $5.5bn through the World Bank, although it is not yet clear whether this will involve direct budget aid. While the IMF funding promised this year will not be enough to cover all of Ukraine's expenses, it will significantly improve the country's situation. Moreover, cooperation with the Fund should make it easier to obtain the missing funds from other donors.

Chart. Ukraine's budget expenditure in 2023



Source: The Ministry of Finance of Ukraine.