An IMF loan weakens Ukraine's government?

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Jamila Trindle and Keith Johnson / Foreign PolicyWASHINGTON—The International Monetary Fund's rescue package for Ukraine, worth up to $27 billion, is good news for the nearly bankrupt country and a potentially huge win for the country's fragile, pro-Western central government. But the belt-tightening the IMF requires could be disruptive as Ukraine tries to move forward and prepare for elections in May—and it could wind up threatening the survival of the government it is meant to help save.

The IMF reached a tentative agreement with Kiev's new government last week that includes $14 billion to $18 billion in aid directly from the IMF and the rest of the $27 billion from individual countries that promised to chip in. But it comes with strings: long-needed, but politically difficult, changes to the Ukrainian economy including cutting energy subsidies, cracking down on corruption and strengthening the country's banks.

"If the political will is there and you have the population on board for turning the ship that's probably the best thing that you could hope for at the outset," said Heidi Crebo-Rediker, a senior fellow with the Council on Foreign Relations and a former State Department chief economist.

But will the population be on board? Ukrainians took to the streets of Kiev when former President Viktor Yanukovych rejected a European political and economic deal with similar conditions, in favor of a $15 billion no-strings-disclosed deal from Russia. It's not clear that the reverse will be true—that they will now rejoice at the idea of paying higher taxes and watching their heating bills increase if Kiev removes generous but extremely costly natural gas subsidies.

In addition to raising natural gas prices to market levels, the IMF also wants Ukraine to rein in government spending, be more transparent and close loopholes that make it easy for officials to hand out lucrative government contracts to their cronies. But cutting natural gas subsidies will likely be the most difficult. Right now the government buys gas from Russia at high prices and then sells it to companies and consumers at low prices, a holdover practice from Soviet days that continuously leaves a gaping hole in the national budget.

Ukraine's leaders, left with little alternative, have agreed to the conditions. "We have no choice but to tell Ukraine the truth," Ukrainian Prime Minister Arseniy Yatsenyuk said Thursday in an address to parliament.

Yatsenyuk said he wouldn't allow the country to go bankrupt and introduced a set of what he called "very unpopular, very complex, hard reforms" to parliament that would raise taxes on the wealthy and big business, as well as on the sale of alcohol and tobacco.

The huge increase in heating bills Ukrainians are set to see over the next few years will be far more painful. State-owned Naftogaz said last week that it would raise gas prices by 50 percent starting May 1, the first of many rate hikes promised between now and 2018 as Kiev tries to close the budget gap left by the heavily subsidized natural gas it sells to its citizens.

Those subsidies eat up about 8 percent of gross domestic product (GDP), a whopping percentage for such a poor country.

The huge amounts of money Kiev is spending each year to subsidize gas sales is a similar problem to the one the IMF has identified in a spate of countries in the Middle East and North Africa, where governments routinely underwrite cheap, domestic energy as a way to placate their citizens—but at a tremendous economic cost. In both the Middle East and Ukraine, ending those subsidies could curb profligate energy use and restore a measure of fiscal health, but only at the risk of sparking popular anger which could undermine the governments trying to carry out the reforms in the first place.

The IMF wanted Ukrainian leaders to make some changes right away to prove that they're serious. That's because the IMF has started loan programs for Ukraine before and previous leaders have not followed through on changes they agreed to make.

But some observers think the IMF pressed for too much reform too fast and the changes could divide the fragile country.

"I don't think the IMF should have insisted on an immediate rise in the residential price of natural gas in the first place," said Mikhail Korchemkin, the head of consulting firm East European Gas Analysis. "The situation in Ukraine is very unstable and there was no need to destabilize it more by unpopular decisions of the government."

Chris Weafer of Moscow-based consultancy Macro-Advisory said the gas hikes "will be hugely unpopular and are likely to prove very divisive in the upcoming elections." Weafer said the changes could be particularly problematic in eastern Ukraine, a region already on the radar screens of many world leaders because of mounting evidence of a potential Russian invasion.

"A large number of people there are unhappy with the political changes which they see as being imposed on them by Kiev," Weafer wrote in an email. "The austerity measures will only deepen that discontent."

In a way, the IMF's insistence on painful economic reforms is a consequence of its own high-profile, and much-criticized, role in steering other countries such as Argentina through tough times. When depression hit the Argentine economy in the late 1990s, the IMF continued supporting Argentina with loans, even as fiscal discipline and macroeconomic indicators spiraled downward.

While the IMF took plenty of criticism later on for its role in dealing with Argentina's crisis, most notably from Argentine politicians, the IMF's own conclusions about its performance were starkly different. In an internal review, it concluded that it should have attached more conditions, not fewer, to the financing it provided Buenos Aires.

The requirements in the IMF deal, which still has to be approved by the fund's board, are the same that were attached to the deal discussed last fall with Yanukovych before his ouster. Russia, which sees Kiev's new government as illegitimate, has since withdrawn all financial support and natural gas discounts, which could make Ukraine's economic recovery even more of a long shot.

“It was difficult enough looking at getting Ukraine’s economy back on track without an outside spoiler, so I don’t think anybody’s underestimating just how difficult this will be,” said the economist Crebo-Rediker.

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