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BACKGROUND PAPER

BP/21-01/09

Growth and Adjustment in IMF-Supported Programs for Europe

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June 30, 2021

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Contents Page

Tables

Figures

Tables

ABBREVIATIONS

AML	Anti-Money Laundering
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BOP	Balance of Payments
CFT	Combating the Financing of Terrorism
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECOFIN	European Economic and Financial Affairs Council
EFF	Extended Fund Facility
EIB	European Investment Bank
EPE	Ex Post Evaluation
ERM	European Exchange Rate Mechanism
EU	European Union
FATF	Financial Action Task Force
FTE	Full-Time Equivalents
GAZPROM	*Gazovaya Promyshlennost* (mostly state-owned multinational energy corporation, Russia)
GMI	Guaranteed Minimum Income
GRA	General Resources Account
IFC	International Finance Corporation
IFI	International Financial Institutions
MOU	Memorandum of Understanding
NAFTOGAZ	*Naftogaz Ukrayiny* (wholly state-owned joint stock oil and gas company, Ukraine)
NPL	Non-Performing Loan
OECD	Organization for Economic Cooperation and Development
PFM	Public Financial Management
PRGT	Poverty Reduction and Growth Trust
REER	Real Effective Exchange Rate
RES	Research Department (IMF)
SBA	Stand-By Arrangement
SC	Structural Condition
SDR	Special Drawing Right
SGP	European Union Stability and Growth Pact
SME	Small and Medium-Sized Enterprises
SOE	State-Owned Enterprise
UFR	Use of Fund Resources
VAT	Value-Added Tax

CHAPTER 1. LATVIA

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EXECUTIVE SUMMARY

The study focuses on Latvia's 2008 Stand-By Arrangement (SBA) and post-program performance. After EU accession in 2004, Latvia experienced a credit-fueled economic boom that collapsed amid the 2008 global financial crisis. The 2008 SBA (SDR 1.52 billion, around €1.7 billion) had multi-partner support: the European Union, neighboring countries, the World Bank, and others provided additional financing of around €7.5 billion and, under the Vienna Initiative, foreign banks agreed not to withdraw funding and capital from their Latvian subsidiaries.

Program design. To address a cyclical deterioration in public finances, front-loaded fiscal measures were identified totaling 8 percent of GDP. To alleviate multiplier effects on activity, social programs were reinforced. Controversially, Latvia's currency peg to the Euro was maintained, and an estimated 30 percent overvaluation was addressed by a strategy of internal devaluation led by public wage cuts. SBA structural conditionality focused on strengthening budget practices and stabilizing the banking sector while parallel EU conditionality on business climate reforms promoted competitiveness and productivity.

Growth outcomes and fiscal adjustment. The 14 percent decline in GDP in 2009 was triple the programmed amount and was followed by further contraction in 2010. The recession was dominated by a pull-back in private spending as credit tightened. Fiscal consolidation, delayed in implementation, likely played a secondary role, despite an eventual doubling of the initially programmed package of fiscal measures. Expanded social programs mitigated the impact of the recession on vulnerable groups.

Financial sector adjustment. Notwithstanding the success of the Vienna Initiative and good progress in implementing financial stability reforms, private credit declined in nominal terms through 2018. Latvia's creditless recovery broadly matched that of regional peers.

Competitiveness and external adjustment. Latvia restored external competitiveness unexpectedly quickly through a surge in labor productivity rather than the envisaged decline in domestic wages and prices. From 2010 onwards, this supported better than programmed export performance, partly offsetting weak domestic demand.

The program achieved its goals. External and fiscal imbalances were relatively quickly resolved. After almost three years' recession, growth resumed at a respectable pace. With restored macro stability, Latvia joined the Eurozone in January 2014.

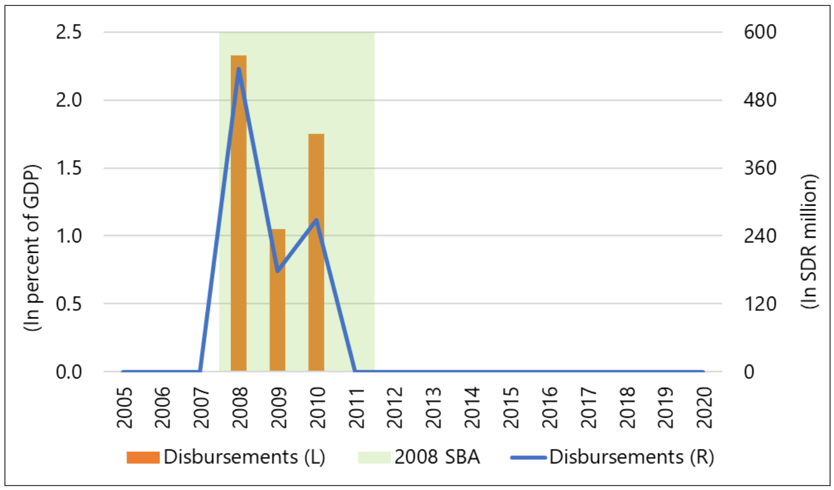
Latvia's bold adjustment retained domestic support despite large declines in activity. This likely reflected lessons about the economic benefits of determined adjustment derived from the country's transition in the 1990s, as well as a clearly communicated national strategy regarding closer EU integration and a large multi-partner program of external support.

Latvia's experience points to a few lessons. During the program, staff and the authorities held divergent views on the case for sustaining the currency peg and on intensifying fiscal adjustment during a severe recession. In the event, the authorities' assessment of the prospects for sustaining bold adjustment proved more accurate than that of staff. With greater attention by staff to prospects for productivity growth, to the political economy of Latvia's modernization and the benefits of program ownership, these program tensions could have been minimized.

I. INTRODUCTION

1. **This study covers the 27-month exceptional access Stand-By Arrangement (SBA) approved in December 2008 during the global financial crisis and its aftermath**. After the arrangement was extended to 36 months (through December 2011) at the time of the second review, Latvia made no further requests for Fund financing (Figure 1).

Figure 1. Latvia—IMF Disbursements



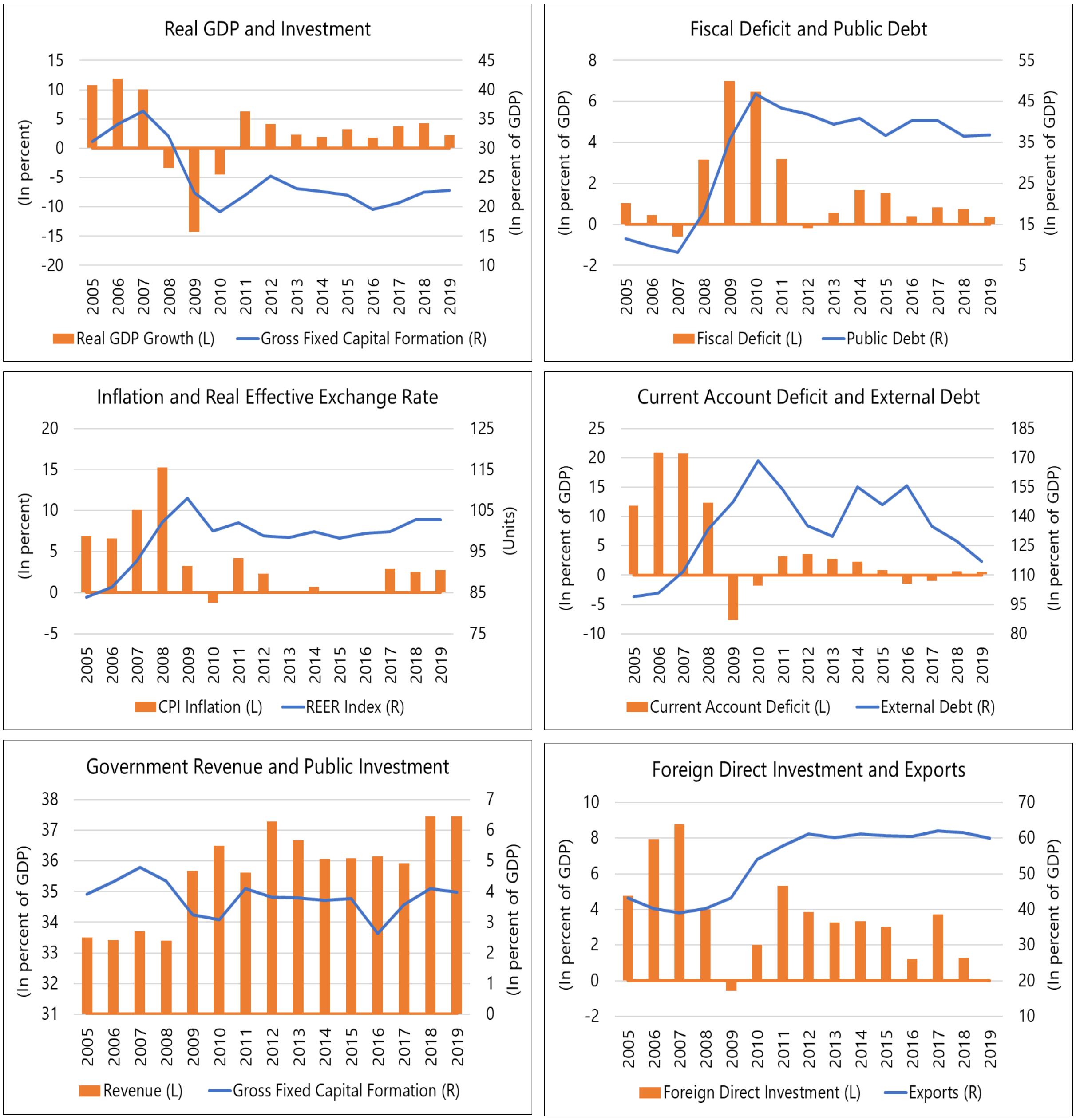
Source: IMF Members' Financial Data.

II. CONTEXT

2. **After gaining independence in 1991, Latvia pursued rapid market-based economic reforms and privatization**. Two-thirds of the economy was in private hands by 1998 and many laws and regulations were adjusted to EU norms ahead of EU accession in 2004. In 1994, Latvia adopted a currency peg to the SDR as a nominal anchor for its small, open economy, switching to a peg to the Euro from 2005 following EU accession. With strengthening growth prospects and low private debt, Latvia was an attractive lending market. Swedish banks rapidly expanded credit after buying numerous small Latvian banks.

3. **Latvia experienced an economic boom, peaking in 2007**. Buoyed by optimism associated with EU accession and sustained by ready credit availability, private demand grew rapidly, complemented by a procyclical fiscal stance. GDP growth rose from a robust 7 percent in 2000–03 to an extraordinary 10 percent during 2005–07 (Figure 2). Latvia became the fastest growing EU member, dubbed a "Baltic Tiger." Low cost mortgages led to a tripling of real estate prices during 2004–06 and construction activity boomed. In 2006–07, a tight labor market boosted real wages by 15–20 percent annually; CPI inflation rose to 14 percent, more than four times the Maastricht reference criterion; and surging imports contributed to current account deficits in excess of 20 percent of GDP. With high price and wage inflation, Latvia's currency peg to the Euro became substantially overvalued, on staff estimates by as much as 30 percent.

Figure 2. Latvia—Selected Economic Indicators



Sources: April 2020 WEO database; INS database; FFA database.

4. **The economy entered recession in 2008**. During 2007, Swedish banks became more cautious about lending in Latvia, reflecting both rising risks and tighter Bank of Latvia lending regulations. Slowing credit triggered a sharp decline in demand, first in the housing sector and then in consumer and investment spending. By early 2008, the economy entered recession. With the eruption of the global financial crisis through 2008, Latvia lost access to international capital, and its largest domestically owned bank, Parex Bank, could no longer fund itself on European wholesale markets. When a run on the bank's foreign currency deposits fueled capital flight,

official liquidity support contributed to depleting almost 20 percent of official reserves in the three months through end-November 2008. The government was forced to take over Parex Bank by end-year amid concerns about the durability of Latvia's currency peg to the Euro.

5. **To address its external and fiscal imbalances, Latvia requested in late 2008 an SBA under exceptional access policy for SDR 1.52 billion** (approximately €1.7 billion or 1200 percent of quota) (Figure 1). The arrangement was coordinated with and supported by additional financing from European Union, neighboring countries, the World Bank, and EBRD, whose combined commitments were projected to fill the bulk of the estimated net financing gap of around €7.5 billion.

III. PROGRAM DESIGN

6. For Latvia, the challenge for program design and policy implementation was to unwind an unsustainable pace of public and private spending without triggering a downward spiral in spending that could be damaging to long-term growth. Key goals were to strengthen public finances while keeping multiplier effects to a minimum; to address the overvalued real exchange rate; and to achieve deleveraging without undermining banking stability. While managing the crisis, the authorities sought to avoid setbacks to the country's goals for closer integration into the European Union, a process viewed as fundamental for national prosperity over the longer term.

Growth Outlook

7. **The program projected a 5 percent decline in GDP in 2009 followed by a further 3 percent decline in 2010**. These projections reflected the sharp fall in credit, second round effects from rising unemployment, and the impact of tighter fiscal policies under the program. Growth was programmed to recover slowly in 2011, firming to 2–2½ percent in 2012–13 (Table 1). In discussing program risks, staff highlighted the challenging policy agenda (maintaining the peg, controlling public spending, recapitalizing banks, boosting competitiveness), but did not foresee the possibility of larger-than-programmed declines in activity and the program did not include contingencies for weaker growth outcomes.

Table 1. Latvia—GDP Growth, 2008–18
(In percent)

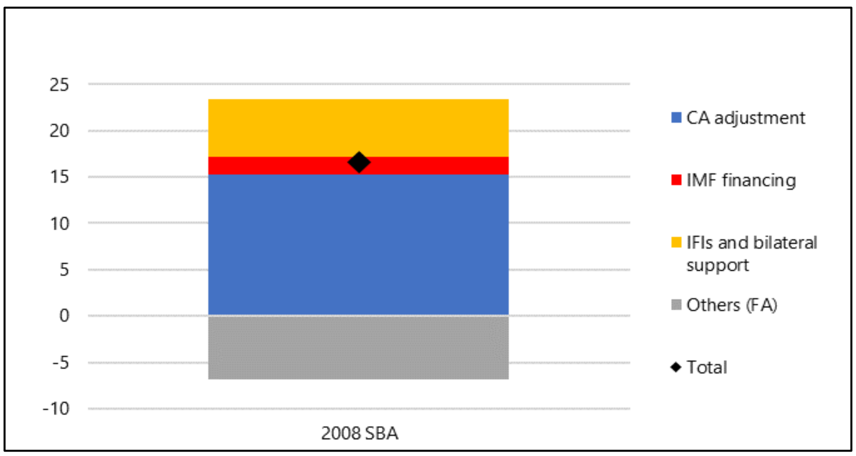
	2008	2009	2010	2011	2012–14	2015–18
Program request (Dec 2008)	-2.0	-5.0	-3.0	1.5	2.3	...
Outcome (current data)	-3.5	-14.4	-3.9	6.4	2.8	3.6
Memorandum items:						
Estonia GDP growth	-5.1	-14.4	2.7	7.4	2.5	3.7
Lithuania GDP growth	2.6	-14.8	1.5	6.0	3.6	3.1

Source: IMF staff report for Latvia SBA request and latest official data.

8. **Much of the projected GDP decline represented an unwinding of the preceding boom**. Based on data through 2007, standard Fund analysis suggested a negative output gap of around 5 percent of GDP (Gruss, 2012), while more recent data suggest the gap was as large as 10 percent of GDP (Blanchard and others, 2013). Accordingly, a significant part of the programmed 10 percentage point decline in GDP over 2008–10 represented an unwinding of unsustainable boom conditions. While GDP projections were broadly in line with independent forecasts at the time, they were arguably a "best-case" scenario for a collapsing bubble.

9. **The programmed decline in domestic demand was anticipated to make a substantial contribution to external adjustment**. With the 2008 decline in imports projected to continue through 2010, the current account deficit was programmed to narrow from 24 percent of GDP in 2007 to 5½ percent of GDP in 2010. Analysis for this evaluation (IEO calculations and Kim and others, 2021) found that, in addressing balance of payments need, Latvia's SBA featured the largest contribution from current account adjustment among a sample of 40 PRGT- and GRA-supported programs (Figure 3).

Figure 3. Latvia—BOP Need Decomposition
(In percent of GDP, annual rate)



Sources: IEO calculations and Kim and others (2021).
Note: See Kim and others (2021) for a detailed explanation of the methodology.

Fiscal Adjustment

10. **Fiscal tightening was central to program design**. With lower GDP undermining revenue collections, the outlook without policy measures was for massive, unfinanceable deficits even before possible bank bailout costs. While this prospect alone called for policy correction, the authorities were also committed to putting the budget back on track to meet the Maastricht criteria for joining the Euro (a fiscal deficit of no more than 3 percent of GDP). The program targeted more than 8 percentage points of GDP of fiscal correction over 2009–10 (Table 2). Reflecting the need to tackle an inflated budget and inefficient social programs, fiscal adjustment depended heavily on expenditure savings, including public wage cuts, a pension freeze and cuts

in education and health spending that accounted for more than 60 percent of the total reduction in expenditure in 2009 (Harrold and others, 2012). Tax revenues were boosted largely through increases in consumption taxes. These measures were underpinned by structural fiscal reforms, which accounted for almost half of the program's structural conditionality (prior actions and benchmarks).[1] Out of 46 structural conditions, 22 were in the fiscal area—specifically, 9 on budget execution and management, 7 on expenditure issues including public sector wages, pensions, and the social safety net, 3 on SOE reforms, and 2 on debt issues. Only one structural condition was set on boosting revenues.[2]

Table 2. Latvia—Programmed Fiscal Adjustment, 2009–10
(In percent of GDP)

				Share of total adjustment	
	2008 Est.	2009 Prog.	2010 Prog.	Latvia 2009–10	Ref. cases[1]
Cumulative fiscal adjustment[2]	…	**7.1**	**8.2**	100	100
Revenue measures	…	2.5	3.4	42	24
Primary expenditure cuts, of which:	…	4.6	4.7	58	76
Wage cuts	…	1.3	1.7	21	9
Other recurrent spending cuts	…	3.3	3.0	36	39
Capital spending cuts	…	0.0	0.1	1	28
Programmed fiscal balance	-3.0	-4.9	-4.9	…	…
Programmed primary balance	-2.4	-3.7	-2.5	…	…
Implied primary balance without measures	-2.4	-10.8	-10.7	…	…

Sources: Staff estimates; Request for Stand-By Arrangement; IMF Country Report No. 09/3.
[1] Sample of 66 fiscal adjustments with no or small reversal in the first three years of the adjustment.
[2] Impact relative to the projected budget outcome without new measures.

11. **Staff discussed the sustainability of the programmed fiscal adjustment, drawing on recent IMF and OECD analysis**.[3] Staff noted that successful consolidations tended to be gradual, spanning a period of time that allowed savings from structural reforms to materialize. From this perspective, Latvia's program was heavily front-loaded, with three-quarters of the adjustment in the first year, versus 40 percent on average for comparable countries during the past two decades. That said, staff noted that payoffs from Latvia's structural fiscal reforms would materialize progressively during 2010–13. Staff noted that countries pursuing expenditure-based consolidations had tended to be more successful, achieving deeper structural reforms and boosting government productivity, while revenue-based adjustments had seen a greater risk of

[1] The 2012 Ex Post Evaluation (EPE) found that structural conditionality was appropriately focused, but that the number of structural conditions was larger than for other post-2008 crisis programs (IMF 2012). Given the strength of program ownership and regular overperformance on quantitative fiscal targets, the EPE saw scope to have reduced the number of structural conditions in the fiscal sector.

[2] The number and classification of structural conditions are based on the MONA data base, which includes only the structural conditions whose implementation status was known. Out of 46 total structural conditions, 20 were on financial sector issues, 3 on non-public sector labor market issues, and 1 on private sector insolvency law.

[3] See Box 3, "Latvia's Fiscal Adjustment in Historical Perspective," in the 2008 Request for an SBA. This box cited IMF (2006, 2007), and OECD (2007) as selected sources.

reversal, notably in advanced economies. While 60 percent of Latvia's programmed adjustment reflected expenditure savings, this was lower than the 76 percent average for other countries undertaking successful consolidations (see Table 2).

12. **Staff expected fiscal adjustment to have a moderate short-term adverse impact on growth, with a positive impact over the medium term**. This assessment drew on studies of large fiscal adjustments in other countries facing exceptionally difficult initial economic conditions (IMF, 2006; 2007).[4] Specific assumptions on fiscal multipliers were not indicated. Staff noted that this qualitative approach to specifying multipliers was standard at the time: a more quantitative approach emerged following Blanchard's 2013 paper on the topic.[5] To help preserve growth, the program prioritized government investments with large short-term multiplier effects that could be funded with EU co-financing. The focus on consumption taxes was viewed by staff as helping to redirect resources towards the tradable sector, and from consumption to production.[6]

13. **In prioritizing budget cuts, efforts were made to support the most vulnerable**. This was an important challenge while seeking to roll back the unsustainable expansion of spending on health, education, and social protection. Staff's advocacy for adequate, targeted social protection was supported by World Bank expertise provided through lending operations to strengthen safety nets.[7] Fund staff's views were not immediately embraced by the Latvian authorities due to concerns about program costs, possible adverse impacts on work incentives, and cultural preferences for family-based rather than government-based safety nets. Seeking to identify areas of agreement, structural conditionality included the development of an emergency social safety net package (first review) and plans for a thorough review of welfare benefits (second review), both supported by World Bank expertise. More specifically, the program provided for an increase in the 2009 social spending budget by 1 percentage point of GDP relative to 2008 levels, complemented by steps to improve the targeting of all social safety nets. This offset, in general, the impact of a pension freeze and a decline in some social benefits indexed to reduced public wages.

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[4] IMF (2007) looked at experience with fiscal consolidations in Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Spain, Sweden, UK, and US. It found that fiscal tightening did not have a pronounced negative impact on economic activity. This reflected, in part, crowding-in of private spending from lower domestic interest rates, strengthened incentives to work following structural reforms, and the impact of declines in global interest rates which often coincided with domestic fiscal consolidation. For Latvia, staff ruled out favorable (negative) short run fiscal multiplier effects of the sort seen in Ireland and Denmark in the 1980s (see Giavazzi and Pagano, 1990) because the scope for supportive monetary policy was constrained by Latvia's currency peg and because shrinking access to credit prevented households from smoothing consumption.

[5] See Blanchard and Leigh (2013).

[6] While staff saw this approach as ameliorating the adverse economic impact on tax increases, consumption taxes were arguably more contractionary than progressive income taxes, because their burden fell on lower-income households with a higher propensity to consume.

[7] The World Bank approved two safety net-related Development Policy Loans in March 2010 and April 2011, each for €100 million. The loans sought to provide emergency safety net support while ensuring that structural reforms established a foundation for medium-term improvements in the social sectors.

Monetary and Exchange Rate Policy

14. **In the authorities' view, maintaining Latvia's currency peg would be central to the adjustment program**. They saw the peg as a conventional choice for a small, open economy like Latvia and noted that it had been effectively maintained since shortly after independence. It had helped anchor inflation (at least prior to the mid-2000s) and had survived shocks from the 1995 banking crisis and 1998 Russia crisis. Most importantly, the peg was seen as a key transitional step toward Latvia's goal of deeper EU integration through Eurozone membership.

15. **In the view of staff, the peg posed potential challenges for adjustment and growth**. With free capital movement between EU members, it eliminated any scope for independent monetary policy to cushion growth during adjustment. More importantly, the overvalued currency would hamper the external adjustment needed to offset the impact of falling private demand and fiscal tightening.

16. **The authorities rejected exchange rate adjustment as necessary for resumed growth**. In their view, depreciation would be counterproductive. With risks of currency overshooting, devaluation could lead to a sharp hike in inflation. More importantly, with recent heavy Euro-denominated borrowing, it would trigger large negative wealth effects for banks, corporates and households. This would exacerbate the recession and further destabilize the domestic banking system. Given these considerations, the question of whether to devalue was barely considered as an issue in Latvia. The topic was rather how Latvia could avoid devaluation.[8] EU counterparts generally sided with Latvia, reflecting their close familiarity with Latvia's circumstances and concerns about the adverse impact that devaluation could have for European banks with Euro-denominated claims on Latvia.

17. **With reservations, staff agreed to support the authorities' intention to maintain the currency peg.[9]** To help restore competitiveness within this framework, the program sought to foster improved competitiveness through internal devaluation. To achieve this, the deflationary impact of falling demand was complemented by a 25 percent cut in central government wages and bonuses in 2009, relative to 2008, with local governments and state-owned enterprises urged to follow suit. Through demonstration effects, this was expected to lead to substantial nominal wage cuts in the private sector. However, given downward price and wage stickiness, staff raised the possibility that, with an overvalued currency peg, Latvia's recession "could be protracted."

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[8] The authorities' position is detailed in Aslund and Dombrovskis (2011). Dombrovskis was minister of finance in 2002–04 and prime minister from March 2009 through November 2013.

[9] Views were mixed within IMF staff. While the peg had support within the country team and was endorsed by Management, it was viewed by many (both within and outside the Fund) as a second-best approach with high risk of failure.

Financial Sector Policies

18. **The Vienna Initiative limited risks to growth from deleveraging**. The Initiative, launched in early 2009, was designed as a cooperative approach to ensure that cross-border banks, which owned the major part of the banking system of most Central and Eastern European countries, did not exacerbate the crisis by withdrawing funding and capital from their subsidiaries. In Latvia's case, arrangements were fairly informal: the main banks involved were Nordic banks, and the Swedish Riksbank was instrumental in ensuring that the parent banks' own adjustment strategies did not put undue pressure on Latvia.

19. **Financial sector stabilization was seen as necessary for resumed growth**. Staff envisaged that recapitalization of Latvian banks and an easing of global deleveraging pressures would provide a foundation for resumed external financing and domestic lending. This, in turn, would help foster a gradual but moderate economic recovery. By the same token, failure to stabilize the financial sector was viewed as a key risk for growth. With foreign banks pledged to maintaining their exposure to Latvia, the priority was to stabilize Parex Bank and address vulnerabilities in other smaller banks dependent on short term external funding. The program also included plans to develop a comprehensive private debt restructuring strategy so that banks' nonperforming loans did not become a durable impediment to their operations.[10] In all, financial sector reforms accounted for about one half of the program's structural conditionality.[11]

Other Structural Reforms

20. For reasons of parsimony, Fund program conditionality did not extend to business climate reforms. Staff recognized that these were important for longer-term growth, noting, for example, that Latvia could do better in promoting investment outside the real estate sector, including by tackling cumbersome business licensing and by attracting flagship investment projects. In practice, discussions on business climate reforms advanced on a parallel track with the EU Commission, with measures to boost competitiveness and productivity included in a Supplemental Memorandum of Understanding with the EU, monitored by the EU Commission.

IV. Program Implementation and Outcomes

GDP Performance

21. **The recession was much deeper than programmed**. GDP fell 14½ percent in 2009, triple the programmed decline (see Tables 1 and 2).[12] Despite a stronger-than-programmed

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[10] Financial reforms were supported by a €200 million World Bank Development Policy Loan.

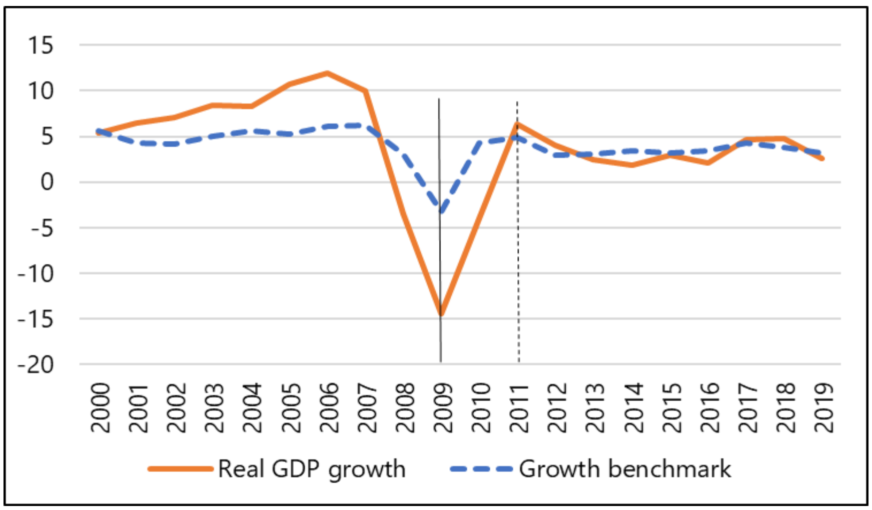
[11] While supporting the focus of this conditionality, the 2012 EPE suggested that the number of benchmarks could have been streamlined to focus on essential actions, dropping others.

[12] The depth of Latvia's recession was similar to its non-program neighbors, Estonia and Lithuania, though its recovery started about a year later. In Latvia, GDP reached its lowest point in 2010Q3 compared to 2009Q3 in Estonia and 2009Q4 in Lithuania.

recovery in 2011, GDP contracted by a cumulative 10 percent between 2007 and 2013 compared to an initially programmed 4 percent. The severity of the recession reflected a larger-than-programmed correction in private consumption and investment—a downside outcome that the 2012 EPE attributed to staff's underestimate of macro-financial linkages.

22. **Regression analysis by the evaluation points to the strongly idiosyncratic aspects of Latvia's growth performance (Kim and others, 2021)**. Panel regression analysis of the external influences on country growth performance over the period 1990–2019 suggests that growth in Latvia was much stronger than the model would have predicted during 2001–07 while the decline in GDP was correspondingly deeper in 2008–2010 (Figure 4). Although conditions in Latvia and other EU crisis cases were dominated by the external influence of the rapid upturn and then collapse of capital flows from EU creditors, these influences go beyond the standard external influences on growth included in the model.[13]

Figure 4. Latvia—Growth vs. Benchmark



Source: IEO estimates.
Note: See Kim and others (2021) for a detailed explanation of the methodology.

23. **Unemployment and poverty rose temporarily**. The unemployment rate rose from 5½ percent in the boom year of 2007 to more than 20 percent in early 2010. It then eased to the 10–11 percent range by 2014, broadly in line with the pre-boom (2002–04) average. The poverty rate (defined as the proportion of persons living below the minimum income level) proved less volatile. It rose to 10 percent during the recession, up from an earlier 8½ percent, before returning to pre-recession levels (or lower) from 2012.

[13] The external factors included in the panel regression were terms of trade, trading partners' growth, US interest rates, regional growth, and a dummy for global financial centers. See Kim and others (2021) for further details.

24. **Growth in the post-program period was generally good, strengthening from 2.8 percent in 2012–14 to 3.6 percent in 2015–18**. This broadly matched outcomes in Latvia's Baltic neighbors (see Table 1). For 2019, growth slowed to the 2 percent range, reflecting the drag from a tightening of anti-money laundering measures in the banking industry as well as diminishing benefits from trading links to Russia, partly offset by continuing favorable prospects for IT and business services.

Fiscal Adjustment and Growth

25. **With demand collapsing, fiscal targets were relaxed alongside corrective measures**. In the first review, the 2009 deficit ceiling was raised from 5 percent to 13 percent of GDP, supported by a new mid-year budget containing significant expenditure cuts and some revenue measures equivalent, in total, to about 3 percent of GDP (Table 3). The 2010 fiscal target was more controversial. Staff expressed concern that a bold reinforcement of the fiscal effort could put additional pressure on output, with significant risks of a downward spiral. Accordingly, staff recommended further fiscal consolidation in 2010 of no more than 6½ percent of GDP, consistent with limiting the 2010 deficit to 12 percent of GDP. By contrast, the authorities saw rapid fiscal adjustment and a V-shaped recession as better than more gradual correction with attendant risks of adjustment fatigue. They also saw it as critical to signal progress toward the 2012 goal for meeting the Maastricht deficit ceiling, which they viewed as critical for confidence in the currency peg and for reducing interest rates. Accordingly, the authorities agreed with ECOFIN recommendations to reduce the deficit to 8½ percent of GDP in 2010—more than 3 percentage points of GDP below the level recommended by Fund staff.

Table 3. Latvia—Fiscal Developments, 2008–18
(In percentage points of GDP)

	2008 Act.	2009 Prog.	2010 Prog.	2011 Prog.	2012–14	2015–18
Cumulative fiscal adjustment						
Program request	...	7.1	8.2	...	...	...
Program outcome measures[1]	...	10.1	16.8	19.0	...	...
Fiscal balance (cash) targets						
Program request (Dec '08)	...	-4.9	-4.9	-2.9	...	...
ECOFIN (Jun '09)		-10.1	-8.7	-6.1	...	...
1st review (Aug '09)	...	-13.0	-12.0	-9.5	-5.2	...
2nd review (Dec '09)	...	-9.3	-8.6	-6.5	-2.4	...
3rd review (July '10)	...	...	-8.1	-5.3	-1.3	...
4th review (May '11)	...	...	...	-4.4	-1.8	-1.7
Outcome	-3.2	-7.0	-6.5	-3.2	-0.7	-0.9

Sources: Staff reports for Latvia SBA request and various program reviews.
[1] Estimated impact of measures. For 2009, 7.1 percent of GDP from 2009 budget (program request) and 3.0 percent of GDP from supplementary 2009 budget and other measures (1st review); for 2010, 2.5 percent of GDP projected additional full-year impact from 2009 supplementary budget (1st review) and 4.2 percent of new measures in 2010 budget (2nd review); for 2011, combined effects of regular and supplementary budgets (4th review).

26. **Differences of view were not fully reconciled in completing the first review**. The EU agreed to disburse its program support based on the ECOFIN fiscal path.[14] About a month later, the Fund agreed to complete its review based on staff's recommended deficit of 12 percent of GDP, noting that public debt would remain sustainable even with this larger deficit. However, staff's analysis showed public debt peaking at around 90 percent of GDP under the Fund-recommended baseline. This projection was viewed as unrealistic by the authorities and criticized by them as suggesting a level of debt well-above the "maximum sustainable debt" established in the literature, hinting at a considerable risk of default.[15]

27. **The authorities proved more successful in cutting spending than staff had anticipated**. Outturn data for 2010 showed revenues overperforming by about ½ percent of GDP while expenditures were 5 percentage points of GDP below staff's program scenario (and 1½ percent of GDP below the "rapid adjustment" scenario proposed by the authorities at the time of the first review). Through 2011–12, revenues continued to slightly overperform staff projections while expenditure consolidation was much more rapid than projected. Thus, public spending was cut from 43 percent of GDP in 2009 to 37 percent in 2012. This compared to an envisaged 2012 range of 39–43 percent of GDP, based on first review's rapid adjustment and program scenarios, respectively. On this basis, the 2010 and 2011 fiscal deficits came in well below programmed levels, establishing the basis for meeting the Maastricht fiscal deficit criterion in 2012 and maintaining low deficits in the post-program period (averaging less than 1 percent of GDP; see Table 3 and Figure 2). With lower than projected fiscal deficits and the absence of initially projected bank restructuring costs,[16] general government debt peaked at 47 percent of GDP in 2010 relative to a Maastricht debt ceiling of 60 percent of GDP.

28. **Fiscal adjustment exacerbated Latvia's recession but appears to have played a distinctly secondary role in relation to private demand**. GDP declined 23 percent between the first quarter of 2008 and third quarter of 2010 (Table 4). The impact of the collapse in credit on private demand was important, with household consumption falling by the equivalent of 12 percent of GDP and investment spending by the equivalent of 20 percent of GDP. (Although the latter figure includes public investment, cuts in this area represented only a small part of fiscal consolidation; see Table 2). The recession also reflected, in its early stages, a decline in external demand. The national accounts suggest that, by comparison, cuts in government spending had a much smaller impact on GDP. These figures underestimate fiscal multipliers by excluding the impact of higher taxes on private spending. Moreover, the constant price national accounts data likely fail to capture the full impact of public wage cuts. That said, fully three-

[14] Countries supporting the financing package shared the EU position on completing the review.

[15] See the Latvian authorities' views reported in the 2012 Ex Post Evaluation. They cited the August 2011 IMF Board paper on "Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis" which summarized the pre-2009 literature as estimating the "maximum sustainable debt level … beyond which a debt distress event is likely or inevitable" to be in the range of 35 to 77 percent of GDP in emerging markets.

[16] The first review projected that bank restructuring costs would add nearly 23 percent of GDP to public borrowing during 2009–11, whereas the actual cost was less than 2 percent of GDP.

quarters of the cumulative downswing in economic activity had happened by the second quarter of 2009, even before the fiscal consolidation package was launched in the summer of that year.[17]

Table 4. Latvia—Contributions to the 2008–10 GDP Downturn
(Percentage points of GDP, relative to the 2008Q1 peak in activity)

		Contributions to GDP change from					
Relative to 2008Q1 GDP peak	Cumulative decline in GDP	Household consumption	Gen. govt. consumption	Fixed capital formation	Exports of goods and services	Imports of goods and services	Statistical residual[1]
2009Q2	-18.0	-11.7	0.2	-15.7	-7.2	20.9	-4.5
2009Q3	-22.1	-12.5	-3.3	-17.8	-5.8	20.3	-2.9
2010Q3	-23.3	-12.2	-3.0	-20.3	0.1	13.2	-2.1

Sources: IEO calculations; official expenditure-based GDP data, seasonally adjusted, chain-linked (2015=100).
[1] GDP and its components do not fully reconcile in the official data.

29. **There is no convincing evidence that aggressive fiscal consolidation was positive for growth through negative multiplier effects on private spending**. Blanchard, Griffiths, and Russ (2013) considered whether confidence effects from fiscal tightening in Latvia helped reduce interest rates, initiating a virtuous circle for growth and fiscal outcomes. They find little evidence for this but suggest that growth prospects may have been boosted by confidence effects from the announced release of EU and IMF financing in June and August 2009, respectively.

Social Programs and Safety Nets

30. **Progress in providing adequate social support for the most vulnerable is not well documented in Fund reports**. However, the World Bank's 2010 Public Expenditure Review (analyzed by Harrold and others, 2012) and other sources suggest that the social impact of adjustment was successfully ameliorated by several programs[18]:

- **Guaranteed minimum income (GMI) programs** provided transfers to households whose incomes fell below a minimum level. After the recession undermined the ability of local municipalities to finance the GMI, the central government covered half of the costs, drawing on World Bank loans. This support was ended in 2012.

[17] Spending cuts were delayed by the fall of the government in February 2009 shortly after approval of the SBA and were implemented after a new government was formed in the summer of 2009.

[18] Harrold and others note that Latvia was relatively unprepared in terms of its social protection system. It did, however, manage to respond quickly by introducing reforms. The effects of the reforms to social benefits took approximately 5–8 months to be felt, but once those reforms were implemented, social benefits expanded significantly. The fiscal program facilitated reforms by allocating an additional 1 percent of GDP of spending on social safety nets.

- A **public works program** was adopted by the government drawing on EU financing. While payments were below the minimum wage, the program was oversubscribed following the sharp rise in unemployment during the recession.

- **Unemployment insurance** eligibility requirements were eased and the duration of benefits extended.

- **Vocational training** was launched with EU financing with a focus on the newly unemployed and those working part-time at risk of losing their jobs.

- **Capital spending financed by EU transfers** increased from 0.6 percent of GDP in 2008 to around 1 percent of GDP in 2009–10 and 1.7 percent in 2011, helping support employment and growth.

31. **Public spending cuts had an unclear impact on the most vulnerable**. Planned pension cuts, which could have adversely impacted low-income households, were invalidated by the Constitutional Court. Thus, fundamental reforms to ensure fiscal affordability remained to be achieved at the end of the program. The education budget was cut by 20 percent in real terms between 2008 and 2009. This was relative to initial over-capacity in the system, but (according to Harrold and others) also reduced spending for some parts of the budget below likely educational needs. Health cuts, like those in the education sector, were front-loaded, mostly taking place in 2009. However, a health safety net was introduced for the first time and some areas of health spending were exempted from across-the-board cuts, including subsidized prescription medication and services for children and mothers.

32. **Migration provided an additional safety net**. Latvia had experienced persistent net migration since independence. The pace surged during 2008–2011, reflecting both better employment prospects abroad and efforts by some households to escape the burden of unsustainable debts at home.[19] Emigration during the crisis reduced Latvia's population by almost 3 percent and shaved 3–6 percentage points off the peak rate of unemployment (Blanchard and others, 2013). While emigration provided citizens with an alternative source of income, it reduced potential output—both by shrinking workforce numbers and through the loss of key skills.

Financial Sector Adjustment

33. **While a sharp credit slowdown was a leading contributor to Latvia's deep recession, the decline was more in relative than absolute terms**. Private credit grew by almost 50 percent annually during 2003–07, boosting borrowing from 32 percent to 93 percent of GDP. Despite slowing, credit actually expanded by a further 12 percent in 2008 as the economy slid into recession. And in 2009–10, the Vienna Initiative was broadly successful in avoiding large-

[19] Banks did not pursue defaulting creditors abroad.

scale funding withdrawals by foreign parent banks, with the decline in private credit limited to a modest 7–8 percent nominal rate. With the sharp fall in output, private credit actually rose in relation to GDP, peaking at 102 percent at end-2009. Declining activity and rapidly falling real estate prices boosted past due loans from close to zero in 2007 to 19 percent of the total by end-2010.

34. **Despite strong ownership of the program's financial reforms, the recovery of credit was slower than expected**. Extensive structural conditionality in the financial sector was almost all implemented, albeit with some delays from the second review onwards. However, while staff projections routinely envisaged a recovery in credit as a support for growth, private credit declined in every year but one between 2009 and 2018, unwinding debt ratios that were likely unsustainable and restoring credit, in relation to GDP, to levels comparable to the 2003–04 period. The 2014 Article IV noted that sharp boom-bust cycles have often been followed by creditless recoveries, especially if the cycle is accompanied by a banking crisis, as in Latvia's case.[20] This may be because corporates were able to meet their financing needs through FDI, leasing, and retained earnings. The main concern has been whether small and medium-sized enterprises had adequate access to financing.

Competitiveness and External Adjustment

35. **Rapid progress was made in restoring competitiveness despite continued adherence to the currency peg.** Manufacturing unit labor costs declined by about 30 percent between 2008 and 2010 (Blanchard and others, 2013), a much faster improvement than anticipated.[21] The manner of adjustment was also unexpected. Private sector wages responded only modestly to public wage cuts, declining just 3 percent in 2010 before rising 4 percent in 2011. Instead, lower unit labor cost was achieved through strong growth of productivity. While the basis for this achievement is not fully understood, the authorities believe that the operational inefficiencies accumulated during the preceding boom years provided the basis for cost savings as the recession hit. With rapid productivity growth, the estimated 27 percent real exchange rate overvaluation prior to the program was reduced to 10 percent by end-2009 and eliminated by the end of the program.[22]

36. **Exports dropped in 2009 but helped stabilize the economy from 2010 onwards**. The decline in export volumes in 2009 broadly matched that for Estonia and Lithuania. From 2010, exports recovered strongly, helping offset the impact on GDP of a continuing decline in domestic demand. By 2012, export volumes were 22 percent higher than in 2008, more than twice the

[20] It is possible that a more buoyant credit market could have supported even faster growth. However, Latvia has matched the recent growth of Estonia and Lithuania (see Table 2), even though credit growth resumed earlier in these countries.

[21] The CPI-based real effective exchange rate was projected to depreciate by less than 10 percent between 2008 and 2010. (The program request did not include unit labor cost projections.)

[22] The sequential REER valuations are from the 2008, 2010, and 2012 Article IV consultation reports.

initially programmed increase and a marked contrast to the 8 percent decline in GDP over the same period.[23] There is less evidence that improved competitiveness led to import substitution. While final demand (domestic demand plus exports) fell 6 percent between 2008 and 2012, import volumes fell just 1 percent.

Structural Reforms and Growth

37. **Latvia's structural reforms under the SBA focused largely on addressing the urgent liquidity crisis and then restoring macro stability and competitiveness under the fixed exchange rate regime.** The concentration of structural conditions in the financial and fiscal sectors (46 percent and 48 percent of total structural conditions, respectively) reflects the urgency and severity of problems at the time. The structural conditions in financial sector aimed at restoring confidence and reducing the vulnerabilities in the banking sector. The structural conditions on fiscal sector reflected authorities' strong dedication to improve fiscal sustainability and included restriction on public wages to facilitate real devaluation. In comparison with other GRA programs over the period of 2008–2019, the number of structural conditions for Latvia (46 in total based on conditions whose implementation status is known) was much larger than other average GRA programs (26.2 conditions). Structural conditionality in Latvia's program was significantly below average in "implementation rate" and somewhat below average in the "depth" of its ambition compared to other GRA programs but higher in terms of "growth/efficiency-orientation" (Figure 5; IEO calculations and Kim and Lee, 2021).[24] In a separate evaluation, the EU credited Latvia with implementing far-reaching structural reforms aimed at enhancing competitiveness and potential growth (European Commission, 2012). However, reflecting political difficulties, the pace of reforms stalled somewhat in 2011, and less progress than expected was made on several conditions relating to state-owned enterprise (SOE) management, strengthening of the competitiveness framework, and setting up a development bank. This is consistent with the finding above that structural conditions under Latvia's SBA was less fully implemented than in comparable GRA programs.[25] Subsequently, Latvia's membership of the OECD in 2016 was preceded by a number of reforms, including to SOE transparency.

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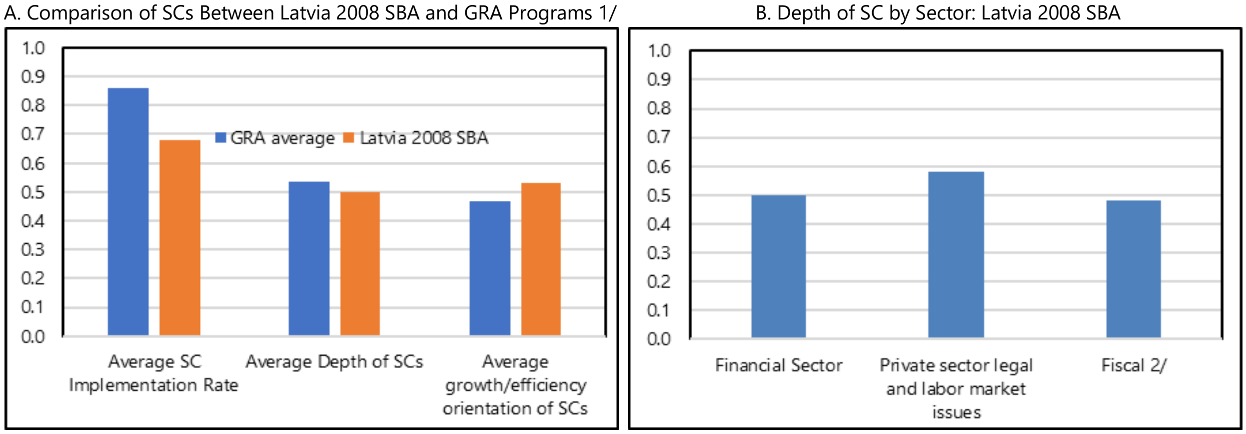
[23] Assuming that higher export volumes were partly offset by higher import volumes (in line with the share of imports in final demand), the expansion in exports between 2008 and 2012 boosted GDP by around 7 percent compared to a scenario of no export growth and by about 4 percent relative to the more moderate path of export growth assumed in the program request.

[24] The SCs under the category of growth/efficiency-orientation included, for example, strategy to strengthen the social safety net, improving the management of SOEs, preparation of labor market policy and reforms in insolvency law.

[25] This refers only to GRA conditionality, not all reforms, including EU/WB reforms.

Figure 5. Latvia—Structural Conditions by Implementation, Depth and Growth/Efficiency Orientation[1]



Sources: IEO calculations and Kim and Lee (2021).

[1] All SCs are assessed in terms of implementation, depth and growth/efficiency orientation, and are assigned numerical values of 0.0–1.0 (1.0 highest). See Kim and Lee (2021) for further details.

[2] Fiscal SCs in Figure 4b include measures related to revenue, expenditure, budget, civil service, pension, social measures, SOE reform and debt issues.

38. **Fund staff's focus on business climate issues picked up in post-program surveillance**. As the recovery advanced in 2012, the authorities agreed with staff on the need for continuing micro-economic reforms to bring down the stubbornly high rate of structural unemployment and enhance trade competitiveness. The Fund's 2012 Article IV consultation detailed the authorities' plans to address bottleneck areas in judicial reform, SOE governance, and higher and vocational education (Bukovska and Moore, 2012). The 2017 consultation addressed issues relating to the measurement and promotion of potential growth, recommending higher public infrastructure investment, active labor market policies, and productivity-promoting institutional reforms (Tudyka, 2017). And the 2018 consultation featured policies to address the headwinds to growth from ageing, outward migration, and declining slack in the labor market (Jewell, Tudyka, both 2018).

V. Authorities and Staff's Perspectives

39. **GDP projections for 2009, while optimistic in retrospect, were regarded as reasonable at the time**. With end-2008 data already pointing to a sharp recession, staff anticipated a GDP decline of 6–8 percent. The authorities viewed this as overly pessimistic, and it was agreed to program a 5 percent decline. Staff recognizes that, with a stronger analysis of the credit cycle, it might have been possible to better anticipate the sharp correction in private spending. However, given unavoidable forecasting uncertainties and political considerations, it may still have been difficult to program a larger recession in 2009.

40. **Discussions in Riga found no regret about the scale and pacing of fiscal adjustment.** The authorities remain of the view that sticking with ambitious fiscal consolidation was the right decision, even in the face of a faster-than-expected decline in GDP in 2009. Regarding the first program review, they saw the Fund's hesitation in endorsing the authorities' ambitious 2010 fiscal target as one example of less-than-full buy-in by the Fund. In their view, staff's alternative scenario in the staff report for the first review showing a less ambitious fiscal adjustment and higher public debt outturn was not supportive of confidence in the program. Moreover, as noted in the authorities' comments to the 2012 EPE, the wide divergence between staff's public debt projection (90 percent of GDP) and the actual outcome (45 percent of GDP; see Figure 2) was hard to fathom. To the extent that Latvian officials expressed reservations about the 2009–10 fiscal adjustment, it related to the focus on spending cuts rather than steps to build a more solid revenue base.

41. **Given that fiscal multipliers in Latvia's program were apparently modest, staff accept that the authorities' preferred fiscal approach was warranted**. The puzzle is why multipliers were not larger. The authorities offered several hypotheses. First, households and companies had already sharply reduced discretionary spending in 2008 after the sudden stop in bank credit (new car sales fell 90 percent). This left little scope for further adjustment in private demand in response to fiscal consolidation launched in the summer of 2009. Latvian observers also noted that while nominal public wages were cut by an average of 24 percent in 2009, this only partly reversed the 45 percent increase during 2007–08. To the extent that employees had not fully adjusted to the latter increase, the impact of public wage cuts on consumer spending may have been modest in comparison to the role played by tighter credit standards and falling real estate prices. A further ameliorating factor may have been the small, open nature of Latvia's economy, contributing to a high pass-through from domestic demand to imports and the capacity to step up exports as the external environment improved in 2010–11.

42. **The authorities also noted that several factors contributed to strong domestic support for bold adjustment.** While the economic crisis had immediate political consequences, leading to the formation of a new government in mid-2009, after this point parliamentary and popular opposition to program adjustment was muted. Latvian observers noted that the government very effectively presented the program as serving Latvia's goal of closer EU integration through Eurozone membership. The link between this goal and specific program measures was also clearly communicated in weekly media appearances by the prime minister. Further, in comparison to other countries, the population had developed a tolerance for tough adjustment based on successful post-independence transition to a market economy.

43. **Fund staff and the authorities concurred that Latvia's financial reform program was well conceived**. Given the slow process of rebuilding financial stability, they did not see scope to have fostered a stronger recovery of growth through a different reform approach. Staff and the authorities agreed that the delayed resumption of credit growth reflected the lingering effects of the crisis, with both banks and borrowers taking a more cautious approach to credit. Staff and

the authorities noted the recent drag on growth from AML issues. In recent years, several Latvian banks serving nonresident investors have prompted AML concerns, with the country's second largest bank closed in 2018 as a result. The authorities noted that tighter AML-related regulation had slowed growth in the financial services sector. Staff noted that an AML/CFT review could usefully have been conducted under the 2008 program but was not considered necessary at the time, because a review had been recently conducted by the FATF body, Moneyval.

44. **The authorities see staff's earlier concerns about the sustainability of the currency peg as a second instance of less-than-full program buy-in**. As noted above, this was a contested aspect of program design. The authorities particularly regret the inclusion in the program document of staff's alternative scenario of a 15 percent upfront devaluation within the ERM currency band, with projections of a slightly deeper recession but a faster recovery. They viewed this as unhelpful for confidence in the program and its currency peg. In the authorities' view, staff and other international economic commentators were mistaken in drawing parallels between Latvia's situation and that of Argentina's currency board. For the authorities, this ignored Latvia's stronger underlying productivity dynamics. Although Latvian wages had risen sharply through 2008, and faster than productivity, they were still low by EU standards. Moreover, Latvia had advantages that would support further strong productivity growth through closer EU integration—advantages that included generally good education, modern transport links, and an inclination toward commerce and manufacturing that had survived the Soviet era. Indeed, partly reflecting these considerations, it was possible for Latvia to boost private sector wages by 70 percent in Euro terms between 2008 and 2019. Staff noted the productivity gains were microeconomic in nature, not well integrated into the Fund's macro analysis, and accordingly difficult to forecast.

45. **The authorities view the Fund's engagement on structural growth issues as having been broadly appropriate**. The limited focus of Fund conditionality on growth/efficiency-promoting structural reforms in the 2009 program was seen as appropriate by both the staff and authorities, given the active role of other partners on the reform agenda and the Fund's programmatic focus on macroeconomic stabilization. Subsequent to the program, the Fund's Article IV analysis has been valued by the authorities as frank and focused on pertinent long-term impediments to growth (skills, education, demographics). In the view of staff, the authorities have been receptive to advice on pro-growth structural reforms and recent growth outcomes have been generally satisfactory. Staff sees scope for higher infrastructure spending but recognizes the government's preference for low taxes and the constraints on spending that this implies.

46. **Technical assistance was viewed as having supported Latvia's structural reform effort**. Fund technical assistance rose nearly six-fold between FY2009 (0.25 FTE) and FY2010 (1.7 FTE). Staff noted that the financial reform program benefitted from substantial TA on private debt restructuring and foreclosure frameworks, while the authorities commended the quality of TA during the crisis which, over a number of years, had substantially strengthened capacity in the Ministry of Finance for public financial management.

VI. ASSESSMENT AND LESSONS

47. **Latvia's challenges, already severe when the program started, only escalated as the program was put into place**. The recession proved much larger than initially programmed, reflecting an initial misreading of macro-financial linkages. This significantly upped the ante for required fiscal adjustment, risking a downward spiral in growth. The collapse in growth underlined, in turn, concerns about prospects for recovery while maintaining an overvalued currency peg. And, had it been known that bank deleveraging would continue for a full decade, few would have envisaged anything more than a failed program and stagnant economy.

48. **Instead, Latvia's adjustment was a success story**. Despite the adverse trinity of massive fiscal adjustment, an overvalued currency, and prolonged deleveraging, Latvia experienced a generally prompt, robust, and sustained economic recovery. External imbalances narrowed quickly; the budget was put on a more stable footing; banking vulnerabilities were addressed; and access was regained to international capital markets. Strong post-program macroeconomic performance was recognized by Eurozone membership from January 2014.

49. **Favorable adjustment-growth outcomes likely reflected several factors:**

- **Latvia's transition experience was a strong asset**. The post-independence transition had demonstrated the economic benefits of determined adjustment, a lesson reflected in readiness to take ambitious, front-loaded adjustment under the 2008 program. Latvia's transition was also a continuing (not just historic) process, marked by expanding commercial ties, improving technology and business management, and rising productivity. These positive dynamics provided the means to regain competitiveness, despite an unchanged exchange rate and lack of downward adjustment in private sector wages.

- **EU integration was a powerful anchor for policy commitment and economic confidence**. Even as jobs were lost and salaries cut, program implementation was viewed as a necessary for Eurozone membership and convergence with wealthier EU states. The promise of closer EU integration may have helped win political support for painful adjustment and acted as an accelerant for confidence and growth once macroeconomic conditions stabilized.

- **Strong communication policies by the government underlined these messages**. The vision of a wealthier future within the EU would not have been as powerful without the effective media strategy noted earlier.

- **Latvia was supported by other partners**. The multi-partner financing package allowed a more gradual fiscal adjustment than would otherwise have been necessary, and the Vienna Initiative helped avoid capital withdrawal that would have destabilized the external accounts and banking system. At the same time, expertise from the EU and World Bank on structural reforms complemented the IMF's focus on macro adjustment.

50. **Latvia's experience suggests a number of lessons**. Narrowly considered, its circumstances were unique, and few countries can hope to match its experience of adjustment and growth. That said, some observations may have broader relevance:

- **Divergent views on adjustment and growth led, at times, to tension between staff and the authorities**. During the program, important differences of view related to the time frame over which adjustment-growth challenges should be considered. In general, the authorities favored a policy approach which, in their view, offered the best prospects for advancing *longer-term* national prosperity, while staff had reservations about the consequences for *near-term* growth. Thus, the authorities' decision to maintain the currency peg and pursue aggressive fiscal consolidation were motivated by longer-term strategic goals for EU integration, while near-term growth was, to some extent, a secondary consideration. Staff's attention to growth issues was understandable and appropriate but in the end country ownership depends on giving due weight to the authorities' judgment on the time frame over which adjustment takes place.

- **Latvia's capacity to boost productivity should have been better appreciated when assessing prospects for competitiveness and growth**. Because potential productivity gains were not adequately considered, staff incorrectly concluded that the program's reliance on internal devaluation posed a risk to growth. These doubts, given prominence in the staff report for the program request, were seen by the authorities as inconsistent with full program buy-in by the Fund. A discussion of productivity prospects should be standard when assessing the outlook for competitiveness in a country like Latvia undergoing a major economic transition. In retrospect, the emphasis given to encouraging cuts in private sector wages was unnecessary: indeed, it may have added to economic uncertainties during the recession, contributing to the slump in consumer confidence and spending. Although public wage cuts made an important contribution to fiscal consolidation and helped realign wage relativities,[26] they would have been better presented as a fiscal measure, rather than as a means for influencing private wage setting.

- **Political economy issues perhaps deserved more attention**. In important instances, staff incorrectly assessed the authorities' ability to deliver economic adjustment—both in achieving rapid fiscal consolidation and managing the consequences of the currency peg. Greater attention to the unique aspects of the Latvian economy and its society may have been warranted.

- **Staff advocacy for strengthened social protection likely helped the adjustment process.** Together with support from the World Bank, important progress was made in strengthening safety nets that were weak at the outset of the program. However, to

[26] General government wages in 2008 were 26 percent higher than in the private sector. By 2010, they were effectively equivalent.

ensure that such safeguards were effective and could be explained to program critics, achievements could usefully have been better tracked in Fund documents. More attention could have been given to tracking and reporting resources allocated or households covered.

- **Equity can be an important goal during adjustment**. Support for Latvia's fiscal adjustment was reinforced, in part, by extending burden-sharing to those who had particularly benefited from the boom years. Thus, the authorities emphasized that ministers and senior civil servants would share in wage cuts and that several well-remunerated public posts would be abolished. Latvia's unequal income distribution may have motivated this focus on equitable adjustment—especially given the inability to advance on the first-best approach of reintroducing a progressive income tax. However, similar equity considerations may also merit consideration in other Fund-supported programs involving difficult adjustment.

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CHAPTER 2. ROMANIA

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EXECUTIVE SUMMARY

This study focuses on Romania's 2009, 2011, and 2013 SBAs and post-program performance. An economic boom linked to EU accession in 2007 collapsed when the 2008 global financial crisis produced a sudden stop in capital inflows. Large external financing gaps were addressed through the 2009 SBA (SDR 11.4 billion, almost €13 billion) with additional support (€7 billion) from the EU, World Bank, and other multilaterals. Under the Vienna Initiative, foreign banks agreed not to withdraw funding. As external accounts strengthened, successor SBAs in 2011 and 2013 were treated as precautionary.

Program design. Romania's procyclical fiscal deficit had to be substantially corrected as growth slumped. To mitigate the impact on poverty, social safety net spending was increased, and pro-growth capital spending prioritized. Within an inflation-targeting framework, growth was supported by monetary easing as inflationary pressures ebbed. Structural reforms, initially focused on fiscal administration and financial stability, expanded in the 2011 and 2013 programs to address growth impediments in the SOE sector.

Fiscal adjustment. Fiscal performance was successfully strengthened, allowing Romania to meet Maastricht goals by 2012. With weaker than expected growth, the bulk of the necessary consolidation spanned four years (twice the expected duration) and required adjustment of 7½ percent of GDP in structural terms (compared to a programmed 5½ percent).

External and financial sector adjustment. The current account deficit narrowed quickly with falling domestic demand. Risks of capital flight were also stemmed by the Vienna Initiative. FDI recovered only slowly, however, and EU balance of payments financing continued to be necessary through 2011. Banks increasingly lost foreign financing from 2013 after the Vienna Initiative expired, one factor contributing to stalled private credit through 2016.

Structural reforms. Romania's long-standing structural and institutional growth impediments were not significantly reduced under the 2009–13 programs. The 2011 program advanced SOE governance and market-orientation (a growth priority), but a stepped-up SOE reform agenda derailed when the 2013 program went off track.

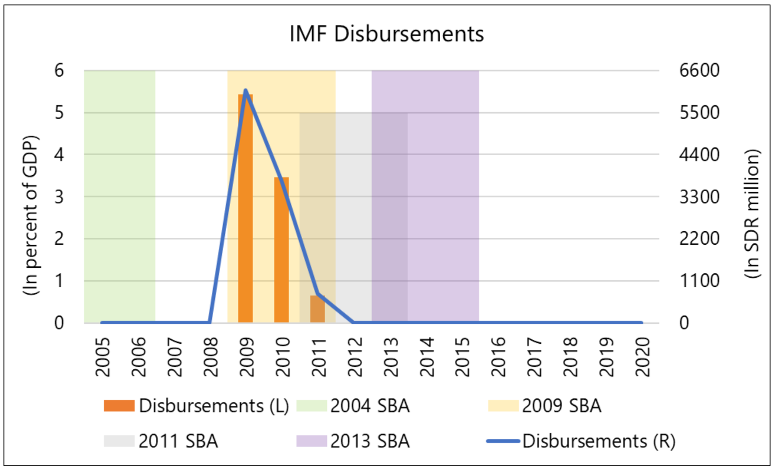
Growth outcomes were weaker than programmed. The 9 percent decline in GDP during 2009–10 was more than twice the programmed amount, and the recovery through 2012 was weaker than envisaged. Romania's large recession partly reflected weak external demand. But the main part reflected its inherited macroeconomic imbalances and the impact of adjustment policies. Possibly the latter effects were exacerbated by the impact on program confidence of a historically mixed program track record, continuing political uncertainties, and delays in implementing some adjustment and reform measures.

The impact of economic adjustment depended critically on program confidence. For this, achieving broad domestic political buy-in to the 2009 program was an important first step. The strong commitment of a broad international partnership for financing the program and supporting reforms was also critical. While programs were generally appropriately ambitious (or quickly recalibrated as needed), more attention could have been given to the challenges of restarting credit growth and achieving greater domestic support for SOE reforms.

I. INTRODUCTION

1. **This case study covers an SDR 11.4 billion 24-month exceptional access SBA approved in May 2009 during the global financial crisis and two successor 24-month SBAs approved in March 2011 and September 2013 (Figure 1)**. The latter were precautionary arrangements with progressively lower levels of access (SDR 3.09 billion and 1.75 billion, respectively). All reviews under the 2009 and 2011 SBAs were completed, but the 2013 SBA went off track after the second review. Subsequently, Romania has not requested Fund financing.

Figure 1. Romania—IMF Disbursements



Source: IMF Members' Financial Data.

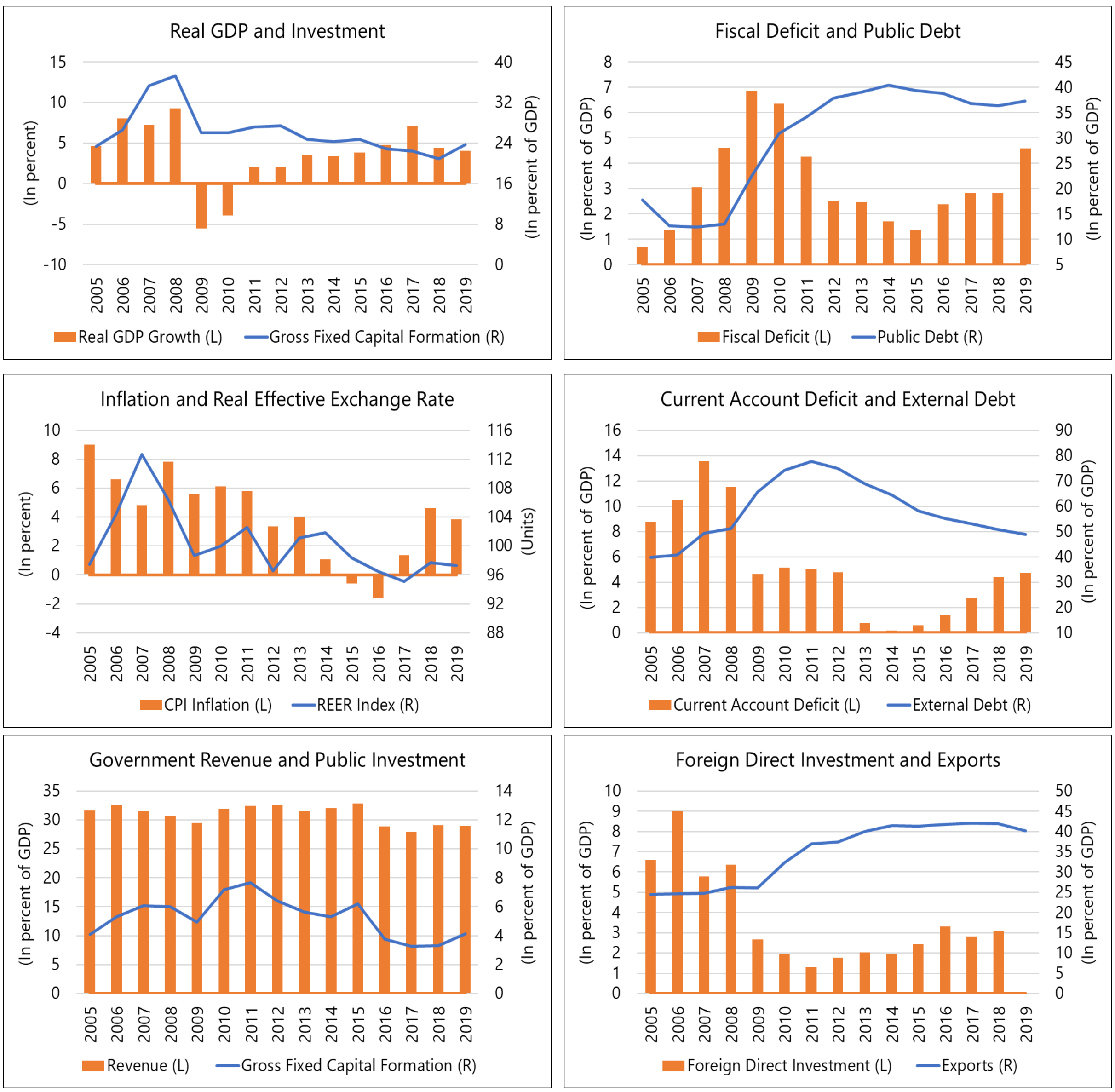
2. **After the 1989 overthrow of the Ceauşescu regime, Romania had some of the worst starting conditions of any transition economy**. Romania was supported by seven Stand-By Arrangements (SBAs) between 1991 and 2006, the first five of which went off track.[1] Nevertheless, program engagement began to deliver meaningful reforms by the late 1990s and macro policies strengthened in the early 2000s. The momentum of structural reforms picked up ahead of EU accession (achieved in January 2007), but quickly slowed thereafter, reflecting political gridlock and reform fatigue. In 2008, staff assessed that the future speed of Romania's real convergence with EU partners would largely depend on tackling looming structural growth bottlenecks including Romania's exceptionally large and inefficient agricultural sector, its inflexible labor markets, an education system insufficiently focused on marketable skills, an underdeveloped public infrastructure, and low energy efficiency. Romania continued to trail best-performing new EU member peers on most structural reform indicators, lagging particularly in the areas of business licensing, ease of employing workers, registering property, public infrastructure, and control of corruption. Moreover, the energy-intensive state enterprise sector was notably resistant to reform.

[1] Arrangements were in place during 1991–92, 1992–93, 1994–97, 1997–98, 1999–2001, 2001–03, and 2004–06. For the first five SBAs, only 54 percent of approved financing was drawn. The 2001–03 arrangement was fully disbursed, and the 2004–06 arrangement was precautionary.

II. CONTEXT

3. **During 2001–08, Romania saw surging growth**. This reflected the impact of earlier reforms as well as prospects for improved market access, institutional reform, and income convergence associated with EU accession (achieved January 2007). Foreign direct investment and capital inflows surged, boosting domestic demand and exports, and fiscal policy was strongly procyclical. GDP growth approached 8 percent during 2004–08 with clear evidence of overheating—rising inflation, real exchange rate appreciation, and a large external current account deficit (Figure 2).

Figure 2. Romania—Selected Economic Indicators



Sources: April 2020 WEO database; INS database; FFA database.

4. **Romania was highly exposed to the global financial crisis and the onset of global deleveraging in 2008**. Banks and nonfinancial corporates had accumulated significant foreign loans, amounting to a combined 30 percent of GDP. In addition, over half of domestic private credit was denominated in foreign currency, much of it contracted by unhedged households or corporates, creating substantial indirect foreign exchange risk exposure for banks. As credit conditions tightened and the currency weakened, falling domestic demand triggered a sharp downturn in economic activity in late 2008, marking one of the sharpest downturns among emerging markets. Export growth turned sharply negative, but imports dropped even more steeply, initiating a rapid correction in the current account deficit through 2009.

5. **Even with the projected current account correction, Romania faced large external financing gaps**. Thus, in April 2009, it requested an SBA under the exceptional access policy for SDR 11.4 billion (1,111 percent of quota, about €12.95 billion). Parallel exceptional financing was arranged with the EU (€5 billion), World Bank (€1 billion), and EBRD, EIB, and IFC (combined incremental lending of roughly €1 billion). Under the Vienna Initiative, foreign partners of Romania's major banks pledged to maintain their exposures to Romania. With a reduced balance of payments need under the 2011 and 2013 SBAs, precautionary Fund financing commitments of around €3.6 and €2.0 billion, respectively, were supported by precautionary commitments from the EU and incremental lending from the World Bank, EBRD, EIB, and IFC (Table 1). Current account adjustment was programmed to address about one-third of the balance of payments need in the 2009 SBA while making only minor contributions under the 2011 and 2013 SBAs (Figure 3; IEO calculations and Kim and others, 2021).

Table 1. Romania—Financing Packages Under 2009, 2011, and 2013 SBAs
(In billions of Euros)

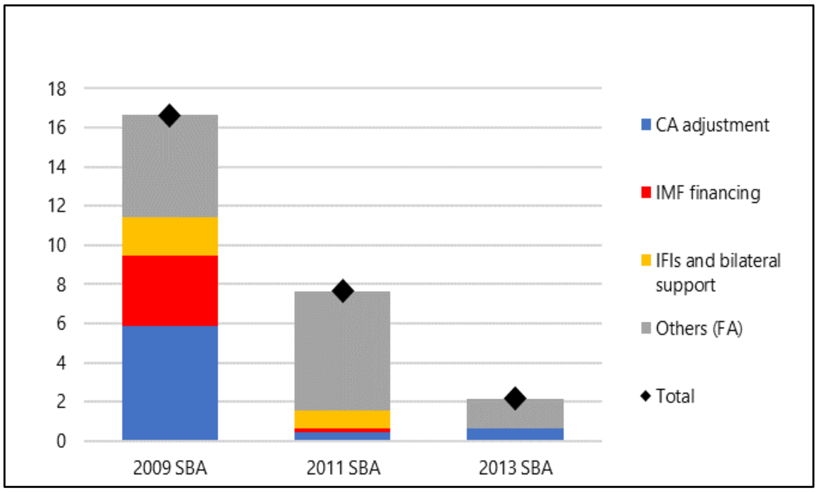
	2009 SBA	2011 SBA	2013 SBA
IMF	12.95	3.6 *	2.0 *
EU	5.0	1.4 *	2.0 *
World Bank	1.0	0.4	1.0
EBRD, EIB, IFC	1.0	1.2	...
Total	19.95	6.6	5.0

Sources: Staff reports for 2009, 2011, 2013 SBA requests. Figures with an asterisk represent precautionary financing commitments.

6. **Given Romania's mixed track record in implementing Fund-supported programs, staff highlighted political risks and sought safeguards where possible**. For the 2009 program, broad political support for adjustment was achieved by endorsement of the program by the president, prime minister, and both parties in the governing coalition. At the same time, staff noted that the October 2009 presidential elections could strain the alliance, and ultimately undermine effective implementation of the program. This proved partly prescient, as political uncertainties did contribute to delays in fiscal measures during 2009 (see below). In documenting the 2011 and 2013 programs, staff continued to identify domestic political tensions as risks to

confidence and program performance, notably for the 2013 program during the run-up to presidential elections in November 2014. Again, this proved prescient, with the 2013 program going off track after the combined first and second reviews in March 2014.

Figure 3. Romania—BOP Need Decomposition
(In percent of GDP, Annual)



Sources: IEO calculations and Kim and others (2021).
Note: See Kim and others (2021) for a detailed explanation of the methodology.

III. PROGRAM DESIGN

7. **Programs targeted multiple objectives that evolved over time.** For Romania, the challenge for program design and policy implementation was to implement fiscal tightening without unduly exacerbating the parallel retrenchment in private spending. Key goals were to minimize fiscal multipliers, provide safety nets for the most vulnerable, and address the impact of deleveraging on banking stability. Following steps to address the financial crisis, attention turned to lingering transition issues, with measures to further strengthen institutions and tackle remaining structural impediments to sustained strong growth.

Growth Projections

8. **Prospects for growth in 2009 were uncertain at the launch of the program**. From late 2008, the slowdown in growth was evident, but few in Romania expected a recession: the February 2009 budget assumed growth of 2½ percent and in the March 2009 program discussions the authorities anticipated slightly positive growth. Fund staff, by contrast, projected a GDP decline of 4 percent in 2009, followed by zero growth in 2010. The authorities accepted these projections but saw them as overly pessimistic. For 2011–13, the program projected a strong growth recovery averaging 6 percent. While the program did not include contingency plans for different growth outcomes, the use of quarterly reviews allowed for early recalibration as needed.

Fiscal Adjustment

9. **Fiscal tightening in 2009–10 was designed to address external financing pressures and strengthen confidence in medium-term fiscal sustainability.** Subsequently, the 2011 SBA sought to further reduce the deficit to within the EU Maastricht limit of 3 percent of GDP by 2012.[2] In both programs, fiscal adjustment was designed to be front-loaded (Table 2).

Table 2. Romania—Programmed Fiscal Adjustment in the 2009, 2011, and 2013 Programs

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Change in structural fiscal balance (Percent pts of GDP, program projections in bold)[1]									
2009 SBA	-2.1	-2.5	**2.9**	**2.1**	**0.5**				
2011 SBA					**2.5**	**0.8**	**-0.4**		
2013 SBA							**0.5**	**0.3**	**-0.3**

Source: Staff estimates in reports for SBA requests.
[1] Year-to-year changes in the structural fiscal balance as measured at the time of program request.

10. **Fiscal adjustment was not explicitly balanced against growth concerns.** Counter-cyclical fiscal policy was not considered an option in the 2009 program because the government did not have financing to cover large deficits (projected at 9 percent of GDP in 2009 without new measures). While acknowledging that the initial effects of measures would be unavoidably painful, there was no explicit consideration of possible multiplier effects from fiscal tightening. By the time of the 2011 program, a growth recovery was underway, and priority was given to cutting the deficit further, also without explicit discussion of possible fiscal multipliers.

11. **Structural fiscal conditionality supported the adjustment process**. It accounted for two-thirds of prior actions and structural benchmarks in the 2009 program (Table 3), including approval of budget measures, tax administration, pension and public compensation reform, fiscal responsibility legislation, public arrears management, and measures to mitigate fiscal risks from SOEs and local governments.[3] In the 2011 and 2013 SBAs, fiscal reforms accounted for one-half of structural conditionality, with continuing attention to public arrears management and tax administration and a new emphasis on public investment management and healthcare reform.

[2] In July 2009, the excessive deficit procedure under the SGP was opened for Romania, based on a government deficit above 3 percent of GDP in 2008. Considering the severe and larger-than-expected downturn, and the efforts made by Romania to reduce public expenditure, the EC proposed extending the deadline for compliance with the 3 percent of GDP limit by one year from 2011 to 2012.

[3] The 2012 EPE concluded that program conditionality in the 2009 SBA appropriately targeted Romania's greatest vulnerabilities.

Table 3. Romania—Structural Conditionality Under the 2009, 2011, and 2013 SBAs
(Number of structural benchmarks and prior actions)

	2009 SBA	2011 SBA	2013 SBA
Fiscal policy	18	19	14
Financial sector	9	1	4
State-owned enterprises	--	20	8
Total	27	40	26

Sources: Fund staff ex post evaluations. Based on the 2009 SBA request and 6 program reviews, 2011 SBA request and 7 program reviews, and 2011 SBA request and 2 program reviews.

12. **Budget composition was designed to cushion the growth impact of fiscal adjustment**. Specifically, resources were allocated for pro-growth capital spending and to protect vulnerable groups:

- All three programs promoted the use of EU co-financing for pro-growth infrastructure spending, including by ringfencing spending from budget cuts.[4]
- With assistance from the World Bank, the 2009 and 2011 programs supported an overhaul of Romania's poorly targeted and wasteful social assistance system costing close to 4 percent of GDP.[5] Reforms sought cost savings while strengthening safety nets and preserving benefits for vulnerable groups.
- Under the 2009 program, the government committed to protecting low-wage employees and the poorest pensioners from cuts to public wages and pensions.
- In the 2011 program, the authorities committed to preserving adequate healthcare services while adopting reforms to better prioritize the healthcare budget.

Monetary and Exchange Rate Policy

13. **Romania's floating exchange rate and inflation targeting regime, together with large balance sheet exposure to foreign currency mismatches, limited the scope for pro-growth monetary stimulus.** Policy interest rates had been increased during 2004–08 to tackle

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[4] Romania was responsible for 15 percent of project costs with the remainder covered by the EU.

[5] In July 2009, the World Bank initiated a €1 billion three-tranche Development Policy Loan (DPL) program. It supported the Government's structural reforms to: (a) improve sectoral public financial management and advance reforms and reforms in health and education); (b) enhance social protection systems (social assistance and pensions) to address the immediate needs of the poor and vulnerable but also to ensure more effective social protection over the longer term; and (c) strengthen the contingency planning and resilience of the financial sector. A successor €1 billion Development Policy Operation (DPO) program approved in June 2012 continued the Bank's engagement in PFM and health sector reforms while launching Bank support for improved accountability of SOEs in the energy sector.

rapid credit growth and inflation exceeding the target range. With weak domestic demand and falling global food and energy prices, inflation was projected to move back into the target range by end-2009. However, staff warned that early monetary easing could weaken the exchange rate, generating severe balance sheet effects on the banking system. The earlier overvaluation of the real effective exchange rate (REER) was effectively corrected through currency depreciation in the year before the 2009 program, a development that helped support growth during the program.

Financial Sector Reforms

14. **The 2009 program was designed to help banks weather the economic downturn**. Additional capital was sought for banks most at risk and the ability of supervisors to deal with banks in weak financial positions was strengthened. To rebuild confidence in the banking system, steps were also taken to bolster the Deposit Guarantee Fund (DGF) by ensuring that payouts could be made quickly and affordably. By the end of the 2009 program, banks appeared to be on a stronger footing and the focus on financial reforms waned in the 2011 program, centering on completing DGF reforms and strengthening banks' financial reporting.[6] The focus on financial reforms re-emerged in the 2013 program as non-performing loans (NPLs) continued to rise. Measures focused on tackling the NPL overhang by incentivizing banks to clean up their balance sheets, creating a market for NPLs, and streamlining bankruptcy procedures. Alternative sources of long-term bank financing were also explored. Financial sector reforms were supported by the EU (under its 2009, 2011, and 2013 BOP assistance programs) and the World Bank (under 2009 and 2011 development policy loans).[7]

Pro-Growth Structural Reforms

15. **Over time, SOE reform became an increasing priority to unlock Romania's growth potential**. In the 2009 program, steps were taken to improve SOE governance, notably because loss-making entities were sapping the budget. Tackling growth and competitiveness issues took on a greater importance in the 2011 program, in part to help Romania weather more difficult external conditions as a result of the broader Eurozone crisis. From this perspective, the poor quality of SOE services in sectors such as energy and transportation were identified as hindering private sector development. The 2013 program adopted a frontloaded agenda of structural "heavy-lifting," with strengthened measures to reduce SOE arrears, enhance SOE governance and transparency, and improve pricing and efficiency in the energy and transportation sectors. Conditionality related to SOE reforms accounted for fully half of the prior actions and structural benchmarks in the 2011 program, declining only moderately in the 2013 program (see Table 3). Energy sector SOE reforms were supported by the World Bank under its June 2012 development

[6] The 2014 EPE noted that the share of financial sector conditionality in the 2011 program was lower than in comparator GRA programs and did not address risks for credit and GDP growth from rising NPLs, unhedged foreign currency borrowing, and possible deleveraging by foreign parent banks.

[7] See footnote 5.

policy operation loan,[8] and by the EU through its support for structural reforms in the energy sector, labor market, and business environment.[9]

16. **Programs highlighted the importance of a wide range of other pro-growth structural reforms, albeit without applying formal conditionality**. The 2009 program urged more spending on public infrastructures and steps to strengthen the business climate through tax simplification, better contract enforcement, more flexible labor markets, vocational training, and comprehensive education reform. The 2011 program recommended a more stable and predictable business environment and encouraged use of the anti-money laundering framework to help detect and deter corruption, where perception indicators significantly lagged the EU average. Program documents also briefly noted the adoption of a new Labor Code in 2011 and efforts to foster youth work opportunities and training. Pro-growth structural reforms were also a topic for the Fund's post-program surveillance.

IV. OUTCOMES

Growth

17. **The recession was deeper and the initial recovery weaker than programmed**. In 2009–10, GDP fell by 9 percent—more than double the programmed figure (Table 4). Similarly, the GDP recovery during 2011–13 averaged 2½ percent, compared to an initially programmed 6 percent. In hindsight, the initially programmed growth path was highly optimistic. Given that the program identified a positive output gap of 5½ percent in 2008, the projected 4 percent GDP decline in 2009 largely represented a correction of an over-heated economy rather than full-blown recession.[10] Similarly, the programmed recovery in 2011–13 exceeded potential growth by a large margin, a gap that increased as potential growth assumptions were progressively reduced—from an initially estimated 3½ percent to around 2 percent in the 2012 Article IV consultation.[11]

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[8] See footnote 5.

[9] EU support for Romania (see Table 1) was conditioned on Memoranda of Understanding of June 2009, December 2011, and November 2013. The structural reform elements of the 2009 MOU focused on strengthening the business environment while the 2011 and 2013 MOUs also covered structural reforms to SOEs in the energy and transport sectors, public private partnerships and SOE privatization, and labor market and pension reforms.

[10] By 2012, the estimated positive output gap in 2008 had been revised up to 10 percent of GDP.

[11] These revisions drew on analysis in the October 2009 World Economic Outlook showing that output does not usually return to its old trend path following a financial crisis (Saborowski, 2012). This is because of durable scars from the crisis: job losses result in lower labor force participation or higher structural unemployment; lasting credit constraints hamper investments; and business failures and skill losses render some productive capacity obsolete.

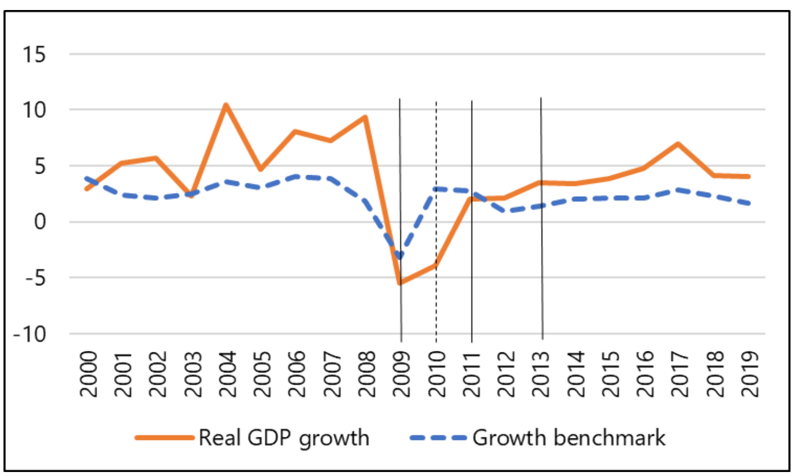
18. **External developments played an important role in triggering Romania's recession, but were secondary in determining its depth and profile**. A panel regression-based growth model suggests that, based on a benchmark estimated from external factors alone,[12] growth would have slowed by around 5 percentage points between 2008 and 2009 (from 1.9 percent to -3.2 percent) whereas the turnaround was actually almost 15 percentage points (from 9.3 percent to -5.5 percent) (see Table 4 and Figure 4). The model also suggests an earlier recovery than observed (starting in 2010 rather than 2011), but then consistently underpredicts observed growth in Romania starting in 2012 when an EU-wide slowdown would have been expected to adversely impact external demand.

Table 4. Romania—Real GDP Growth, 2008–18
(In percent)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
2009 program request	7.1	-4.1	0.0	5.0	7.2	5.4					
2011 program request				1.5	4.4	4.3	4.2	4.1	4.0		
2013 program request						2.0	2.2	2.5	2.9	3.4	3.5
Latest data (2019)	9.3	-5.5	-3.9	2.0	2.1	3.5	3.4	3.9	4.8	7.0	4.1
Contrib. of dom. Demand	8.3	-7.1	-0.7	1.2	0.0	-0.3	3.8	5.3	5.1	7.7	5.8
Memorandum item:											
Panel regression baseline[1]	1.9	-3.2	3.0	2.8	1.0	1.4	2.0	2.1	2.1	2.9	2.3

Source: Staff estimates in reports for program requests, and latest official data.
[1] Projection based on panel regression analysis of the external influences on growth in all countries over the period 1990–2018 (Kim and others, 2021).

Figure 4. Romania—Growth vs. Benchmark



Source: IEO estimates.
Note: See Kim and others (2021) for a detailed explanation of the methodology.

[12] The external growth influences in the panel growth regression were terms of trade, trading partners' growth, US interest rates, regional growth, and a dummy for global financial crisis. See Kim and others (2021) for further details.

19. **In practice, external shocks were amplified by weak domestic policies and their impact on confidence**. Staff analysis during the 2010 Article IV consultation (IMF, 2010) found that unsustainable domestic policies explained a large part of the 2009 output collapse in Romania and other Emerging Europe countries. Many, like Romania, entered the global recession with deep-rooted vulnerabilities, including large current account deficits, loose fiscal policy, and excessive credit growth. These vulnerabilities left them highly exposed to the reversal of market sentiment and the sudden stop of capital flows. Furthermore, the scale of imbalances left little room for counter-cyclical stimulus once the crisis unfolded. In Romania, fiscal adjustment, tighter credit, and policy uncertainty (including arising from delays in developing an ambitious fiscal package) acted as a persistent drag on domestic demand through 2013 (see Table 4). Starting in 2014, domestic demand saw a strong and persistent resurgence and the IEO analysis discussed above suggests that Romania's growth in 2014–18 was more than 3 percent per annum stronger than the benchmark based on external developments. This may have partly reflected the impact of large increases in minimum and public wages, followed by broader procyclical fiscal stimulus from 2016.

Fiscal Adjustment

20. **Fiscal consolidation was achieved more slowly than envisaged**. The initially programmed structural fiscal adjustment in 2009 was nearly 3 percentage points of GDP. However, spending discipline was weak outside the central government, with overruns in local governments and in self-financed entities such as hospitals and universities. At the same time, revenues declined sharply with economic activity. Since achieving the originally programmed deficit would have risked a downward spiral in demand and activity, the first program review increased deficit ceilings in 2009 and 2010 by roughly 3 percentage points of GDP with the 2011 deficit adjusted by half that amount.[13] This accommodated the cyclical deterioration of the economy while preserving a medium-term fiscal consolidation path necessary for program credibility. Although the first review included new fiscal measures for 2009, this was late in the year, and even with a 10-day unpaid furlough of public workers, the 2009 structural fiscal adjustment was eventually estimated to have been only half the initially programmed amount (Table 5).

21. **A more ambitious fiscal adjustment took place in mid-2010**. This comprised a 25 percent cut in public wages, a 15 percent cut in most social transfers including pensions, and a 5-percentage point hike in the VAT rate. The first significant reduction in public sector employment also occurred in 2010. These measures delivered the programmed fiscal adjustment in 2010 as well as the bulk of that envisaged for 2011. With continuing weak growth in 2012, a fourth year of structural fiscal adjustment in the 2 percent of GDP range proved necessary, even with a modest easing of the deficit target (albeit remaining within the 3 percent of GDP ceiling

[13] To close the resulting fiscal financing gap, Fund disbursements were made available to the budget.

agreed with the EU Commission).[14] By 2013, the bulk of Romania's fiscal stabilization effort was complete, and the 2013 program did not seek further substantive external or fiscal adjustment (see Table 2 and Figure 2).

Table 5. Romania—Structural Fiscal Adjustment, 2009–15[1]
(In percent of GDP)

	Date	2009	2010	2011	2012	2013	2014	2015	2016–18
2009 program request	4/09	**2.9**	**2.1**	0.5	…	…	…	…	…
1st Review	9/09	**1.9**	**2.4**	**1.2**	…	…	…	…	…
2011 program request	3/11	**1.5**	**2.1**	**2.5**	0.8	-0.4	0.0	-0.1	…
2013 program request	9/12	**1.5**	**1.7**	**2.1**	**1.3**	0.5	0.3	-0.3	…
Outcomes:									
Structural fiscal balance[2]	…	-8.0	-6.1	-3.4	-1.6	-1.2	0.2	0.0	-2.9
Unadjusted fiscal balance[2]	…	-7.1	-6.3	-4.2	-2.5	-2.5	-1.7	-1.4	-2.7

Sources: Staff estimates in various staff reports.
[1] Year-to-year changes in the structural fiscal balance as measured at the time of program request or review. The bolded figures represent the years of largest structural fiscal adjustment (>1 percent of GDP). While the 2013 program request does not show the structural fiscal adjustment in 2009, it is assumed that estimates are unchanged at 1.5 percent of GDP.
[2] Series compiled from various staff reports.

22. **In calibrating fiscal effort during the 2009 and 2011 programs, staff focused on the structural fiscal balance, which adjusts for the automatic effects of the business cycle**. On this measure, the cumulative fiscal adjustment of 5½ percent of GDP envisaged at the launch of the 2009 program increased to 7½ percent of GDP by mid-2012 (see Table 5). Moreover, whereas adjustment was originally envisaged to be concentrated in 2009 and 2010, sizeable adjustments were eventually needed over a four-year period, with the largest annual adjustment occurring in 2011. The assessed phasing of adjustment is, however, subject to a degree of uncertainty, given the approximate nature of the structural fiscal adjustment calculations (Box 1).

23. **The large mid-2010 fiscal package may have contributed to Romania's delayed and sluggish recovery**. Consumer confidence, which had been broadly stable in 2009 after falling sharply in 2008, saw a further downturn in mid-2010 and retail sales did not see positive year-on-year growth until late 2011.[15] The 2012 Ex Post Evaluation (EPE) suggested that a more gradual fiscal adjustment could have better supported growth. Even with hindsight, however, options for more growth-friendly fiscal adjustment were limited. Some easing of fiscal targets in the first review of the 2009 program was appropriate in the context of the global financial crisis and as the extent of economic weakness in Romania was better appreciated. At the same time, confidence in fiscal management during 2009 was undermined by budget uncertainties ahead of presidential elections, implementation delays in spending measures, spending overruns, and

[14] Staff suggested that a somewhat less ambitious 2012 cash deficit could be considered (still within the EU 3 percent accrual target) to make fiscal policy more supportive of economic growth. Staff and the authorities agreed, however, that tightening financing conditions might limit their ability to sustain a larger budget deficit.

[15] Confidence was also adversely impacted by an episode of severe flooding that boosted food prices.

expenditure arrears. With a more favorable political situation and stronger expenditure management, a somewhat stronger fiscal stance in 2009 could have established confidence in the program more quickly while easing the adjustment burden in 2010. Given that this was not a practical option, there was no real alternative to a strong fiscal package in 2010. Further delays in fiscal consolidation beyond 2010 might have supported growth in the short run but would likely have been counterproductive by weakening confidence in the program and adding to the risks of adjustment fatigue in subsequent years. Moreover, delayed fiscal adjustment would potentially have been inconsistent with the authorities' determination to bring the fiscal deficit under the EDP ceiling of 3 percent of GDP by 2012. All considered, despite some shortcomings in the fiscal adjustment process, it can be regarded as a success, especially given Romania's mixed implementation record in earlier programs.

Box 1. Romania—Structural Fiscal Adjustments

Measures of structural fiscal adjustment are informative. The presentation of Romania's fiscal program in terms of structural adjustment was helpful for gauging the scale and phasing of adjustment, looking past the impact on the fiscal accounts of the cyclical downturn and recovery.

However, estimates can be subject to large revisions. They rely on calculations of potential output, estimates for which are often revised as new GDP data and projections become available. Reflecting downward revisions to GDP growth during Romania's recession and recovery, the structural fiscal adjustment achieved in 2009 was revised down from an early estimate of 1.9 percent of GDP (first program review) to 1.3 percent of GDP when recalculated three years later. In practice, structural fiscal measures can be subject to larger historical revisions than the underlying fiscal accounts. In practice, structural measures are indicative, at best, and cannot be used for precisely calibrating fiscal adjustment. Even if an "optimal" path for structural fiscal adjustment could be determined, achieving this could be difficult, given the likely scale of revisions to the structural fiscal accounts. Even if the programmed fiscal adjustment were achieved in nominal terms, it could prove quite different from that programmed in structural terms, after data revisions.

24. **EU co-financed capital spending picked up only slowly and did little to ameliorate the 2009–10 recession or accelerate Romania's recovery.** Through 2012, absorption rates for EU co-financing remained very low, despite measures in the 2011 program to remove bureaucratic and other obstacles.[16] After further measures to foster uptake in the 2013 program,[17] Romania's absorption rate started to improve, and may have contributed to more robust growth from 2013 onwards. However, absorption rates remained among the lowest in the region and below programmed levels. Multiple factors were identified as hampering the use of EU co-financing: capacity constraints and inefficiencies created by bureaucratic hurdles in both Romania and the EU (2012 EPE); deeply ingrained governance problems associated with the investment budget (2014 EPE); and lengthy procurement processes, gaps in investment budget planning, and political interference (2017 EPE).

[16] In 2012, unused project funds were equivalent to 17 percent of 2009 GDP. To accelerate uptake, the authority of the EU funds unit was enhanced by moving it to the Prime Minister's office, staffing was strengthened, and a review of project readiness was initiated.

[17] For example, investment planning was required to consider potential EU financing.

Social Programs and Safety Nets

25. **Social safety net reforms were too slow to provide early protection for the most vulnerable**. Design and approval of the new social assistance program continued through 2012, and the system was not in place until the recovery was well-advanced.[18] Accordingly, to shelter the vulnerable from the impact of the recession, the 2009 program made a small provision for increased safety net spending under existing schemes, notably by slightly expanding the Guaranteed Minimum Income (GMI) scheme even as other programs were cut.[19] The 2013 program also included budget financing for an increase in the GMI and family allowances to mitigate the impact of gas and energy price liberalization.

26. **Healthcare reforms advanced slowly with an uncertain impact on vulnerable groups**. During the 2011 program, efforts to raise revenues, reduce costs, and better control hospital budgets encountered strong opposition, and a planned comprehensive reform package was withdrawn after public protests. Better progress was made in the 2013 program, including through introduction in 2014 of a basic health package.

27. **Those on minimum wages and pensions were safeguarded during the recession and later saw large income increases**. The program exempted those on minimum pensions from the 15 percent cut announced for July 2010. However, this safeguard was superseded by a constitutional court ruling that the proposed pension cuts were unconstitutional. The program also exempted public employees earning the minimum wage from the announced 25 percent cut in public wages in 2010.[20] Subsequently, the minimum wage was increased by 50 percent between 2011 and 2014, about double the pace of consumer price inflation. During the 2013 program, staff noted that the implied impact on labor costs had not undermined overall competitiveness but could discourage new job creation for low-skilled workers. Following further large increases in the minimum wage between 2015 and 2019, staff intensified warnings about risks to job creation and overall competitiveness (see below).

Monetary Policy and Financial Sector Reforms

28. **Monetary easing provided some relief during the recession**. External confidence was quickly re-established under the program and interest rates and reserve requirements were promptly cut during 2009 and 2010 as inflation concerns related to a depreciating exchange rate eased. This effectively reversed the policy tightening of 2007–08. A further phase of policy easing was instituted in 2013–15 as inflation dropped below the target range. Policy rates then edged higher in 2018–19 as core inflation increased (see Figure 2).

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[18] Fund documents describe various stages of the reforms but do not assess the outcome.

[19] Additional resources for the GMI amounted to 0.05 percent of GDP in 2009 and 0.09 percent of GDP in 2010.

[20] While the constitutional court accepted the overall program of public wage cuts, it ruled these should be for a limited time, with wage cuts later reimbursed.

29. **Romania successfully avoided a banking crisis but still experienced drag from constraints on bank credit**. Under the 2009 program, banking confidence was restored by central bank liquidity provision, commitments by foreign parent banks under the Vienna Initiative to maintain their exposure to Romanian subsidiaries, and a government loan guarantee program.[21] At the same time, the authorities made major reforms to deal with financial sector distress and enhance bank supervision and regulation. Although NPLs rose sharply from 2008 levels (Table 6), risks to the banking system were mitigated by high (98 percent) loan-loss provisioning requirements. However, commitments under the Vienna Initiative expired in 2011 and, in the context of widespread funding pressures in the Euro area periphery, notably Greece, and lower domestic demand, deleveraging by parent banks accelerated starting in late 2012. At the same time, NPLs increased in 2012 driven by weak domestic and external demand, the impact of weak activity on SMEs, and the difficulties in writing off NPLs. Given the need to provision for NPLs, bank profitability turned negative and credit started to decline. Supply-side constraints, in addition to weak demand, were later identified by staff as key factors explaining negative credit growth and the inability of banks to support the economic recovery.

Table 6. Romania—Private Sector Credit Growth
(In percent)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
2009 SBA request	34	16	5	3	…	…	…	…	…	…	…
2011 SBA request				8	9	…	…	…	…	…	…
2013 SBA request						-1	3	…	…	…	…
Outturn	34	1	5	7	1	-3	-3	3	1	6	8
Memorandum items:											
Capital to risk-weighted assets (percent)	14	15	15	15	15	16	18	19	20	20	21
NPLs (percent of gross loans)	3	8	12	14	18	21	21	14	10	6	5
Private credit (percent of GDP)	39	40	40	39	39	34	32	31	29	27	26
Forex private loans (percent of total)	58	60	63	63	62	61	56	49	43	37	34

Source: Official data from selected staff report.

30. **Under the 2013 program, NPLs were reduced considerably and progress was made in reducing the euroization of private credit and the associated risks to the banking system**. NPLs were reduced by the sale of distressed debt and direct write-offs (facilitated by the high levels of provisioning). The euroization of credit was reduced from 2013 onwards by further tightening the regulatory treatment of foreign currency lending (see Table 6). In late 2011, the central bank had established differential loan-to-value ceilings for lending to households in domestic and foreign currency on a hedged and unhedged basis. In early 2013, similar ceilings

[21] Government loan guarantees, which operated between 2009 and 2016, covered part or all of loan principal while capping lending rates in relation to the market cost of funds. The largest guarantee programs covered first mortgages (171,000 loans during 2009–16), private sector projects co-financed by the EU (20 projects during 2010–15) and borrowing by small and medium enterprises (1,600 loans during 2011–15). Default rates on the guarantees were low, limiting the fiscal cost.

were established for loans to businesses. Although mortgage borrowing was exempted from such regulations, the government loan guarantee program provided support for domestic currency but not foreign currency mortgage lending. More generally, disincentives for foreign currency lending were achieved through higher reserve requirements on banks' foreign currency liabilities than on those in domestic currency, though the margin narrowed over time.[22] Despite these measures, credit growth remained stalled through 2016 (see Table 6). In 2017–18, credit growth strengthened somewhat, reflecting a significant decline in banks' NPLs and a strong labor market.

31. **More attention could have been paid to tackling credit market impediments to growth once bank stabilization was achieved**. The EPE of the 2011 program concluded that risks to credit growth from parent banks' deleveraging and relatively high NPLs were not fully reflected in program design (IMF, 2014). Further, the EPE for the 2013 program concluded that more attention could have been paid to strengthening financial intermediation and funding (IMF, 2017). While the 2013 program sought to strengthen access to long-term domestic currency financing through covered bond legislation, the reform was protracted, the associated structural benchmark was reset, and the law passed only after the program had expired. More generally, little attention was focused in the 2013 program on understanding private non-financial sector balance sheet risks and the overall financing of the economy in a creditless recovery. While instances of creditless recovery are not uncommon, this more often follows a banking crisis or a period of excessive borrowing. Romania's case is different, in that although private borrowing had risen prior to the crisis, it remained modest in relation to GDP: indeed, at 26 percent of GDP in 2018, it was among the lowest in the region. While weak credit reflected a range of factors, it is possible that greater attention in the 2011 and 2013 programs to fostering a recovery in credit could have supported an earlier and stronger recovery.

Exchange Rate Policy and External Adjustment

32. **Exchange rate developments were broadly neutral for program growth performance**. With Romania maintaining its commitment to a floating exchange rate, the real effective exchange rate (REER) moved in a narrow range during the three programs, remaining broadly in line with fundamentals through 2017. Exchange rate valuation issues re-emerged in 2018, when staff estimated that the REER had become overvalued by an estimated 10 percent after several years of wage growth in excess of productivity—a trend influenced by large hikes in public wages and the minimum wage as well as double-digit increases in private wages in a tight labor market.

[22] Following monetary tightening during 2004–08, reserve requirements on foreign currency liabilities stood at 40 percent, compared to 18 percent for domestic currency liabilities. After inflationary pressures eased, the foreign currency requirement was reduced to 25 percent (November 2009) and 20 percent (March 2011), while the domestic currency ratio was reduced to 15 percent (November 2009).

33. **External adjustment under the program was relatively rapid but financing needs proved long-lasting**. The current account deficit narrowed more than programmed in 2009, reflecting the unexpectedly sharp decline in activity (Table 7). With financial and capital flows evolving broadly as programmed, this strengthened the overall balance of payments in 2009, resulting in reserve accumulation of €1 billion (compared to no build-up under the program). In 2010–12, the current account continued to overperform, while the recovery in the capital account was more tentative than programmed, resulting in more prolonged than expected financing need. As a result, during the 2011 program Romania tapped the precautionary €1.4 billion financing package provided by the EU (see Table 1). With a moderate recovery in growth and strong exports of services, the current account deficit narrowed to 1-2 percent of GDP during 2013–16, widening to 4½ percent of GDP in 2018 as growth was increasingly driven by domestic demand.

Table 7. Romania—Balance of Payments, 2007–12
(In percent of GDP)

	2007	2008	2009	2010	2011	2012
2009 program projections						
Current account balance	-13.8	-12.4	-7.5	-6.5	-6.2	...
Capital and financial account, of which:	17.3	13.7	-2.3	3.2	7.3	...
Foreign direct investment	5.8	6.6	2.9	3.5	3.5	...
Other capital and financial flows	11.5	7.1	-5.2	-0.3	3.8	...
Overall balance (before financing package)	3.7	0.0	-9.9	-3.4	1.1	...
Outturn						
Current account balance		-11.6	-4.2	-4.4	-4.5	-5.2
Capital and financial account, of which:		12.7	-2.5	1.0	1.5	2.5
Foreign direct investment		6.7	3.0	1.8	1.4	1.3
Other capital and financial flows		6.0	-5.5	-0.8	0.1	1.2
Overall balance (before financing package)		0.0	-7.5	-3.6	-2.7	-0.7

Sources: Staff report for 2009 program request and other staff reports.

Pro-Growth Structural Reforms

34. **Only limited progress was made in reforming Romania's SOE sector**. SOE financial reporting and arrears management was strengthened under the 2009 and 2011 programs and the latter also saw strengthened energy sector regulation and liberalized energy pricing. However, the 2013 program went off track when its ambitious SOE reform program failed to advance. Specifically, little progress was made in restructuring and privatizing energy and transport sector SOEs or in enforcing provisions under the 2011 corporate governance law requiring transparent, non-political selection of SOE board members and executive directors. In practice, political consensus on SOE reform proved elusive: while the 2013 program envisaged a pre-election window of opportunity for reform, this proved inadequate relative to the broadly perceived vested interests in SOEs in providing jobs, fiscal dividends, and remunerative board and management positions.

35. **Some progress was made in implementing other pro-growth reforms, although the links to growth were not well documented**. Several measures were adopted to improve the working of the labor market and reduce Romania's high unemployment rate. Specifically, under the 2011 program, a new Labor Code helped expand the limited use of fixed-term contracts. Under the 2013 program, the authorities started to amend legislation to address high youth unemployment and envisaged early action on an Apprenticeship Law and a law facilitating professional training for higher-education graduates. However, analysis was not provided on the prospective impact of such measures on the business climate or growth.

36. **Romania's structural reform ambitions and implementation seem broadly comparable to other program countries**. Analysis conducted for this evaluation suggests that the growth-orientation of structural reforms in Romania's programs rose from below the average for GRA programs during 2009–10 to above the average during 2011–14 (Table 8; IEO calculations and Kim and Lee, 2021). Except for Romania's 2011 program, structural reforms were deeper than the average for peer programs, and implementation rates were above the average for comparator programs.[23]

Table 8. Romania—Structural Conditions by Depth and Growth Orientation

	Romania programs			GRA comparators		
Aspects of structural conditionality:	2009 SBA	2011 SBA	2013 SBA	25th percentile	Mean	75th percentile
Implementation	0.90	0.81	0.96	0.79	0.86	0.96
Depth	0.71	0.47	0.59	0.48	0.55	0.60
Growth orientation	0.40	0.67	0.54	0.40	0.48	0.54

Sources: IEO calculations and Kim and Lee (2021).

V. AUTHORITIES AND STAFF'S PERSPECTIVES

37. **Officials credited the 2009 SBA with providing critical transparency and credibility in regard to the state of the economy, government policies, and external financial support.** This helped limit the impact of the financial crisis on growth. They accepted that the 2009–10 growth assumptions proved optimistic with the benefit of hindsight but noted that they were realistic at the time; staff concurred on this point. Staff noted that the scale of the financing package developed in support of the 2009 program had been important for confidence, being large enough to cover a range of external risks, including regarding the effectiveness of the Vienna Initiative. The authorities noted that the sluggish 2011–12 recovery provoked a national debate at the time. However, from 2013, growth concerns abated as the recovery accelerated above Romania's long-term average growth of 3.3 percent.

[23] As in the 2018 ROC, the results in Table 8 are based on the MONA database and do not include SCs whose implementation status remains outstanding (e.g., program reviews were not completed because the program went off track). For this reason, the SC scores could be biased upward. For instance, the implementation rate for 2013 SBA is high despite limited progress in SOE reforms (see paragraph 32). See Kim and Lee (2021) for further technical details.

38. **Some officials considered that a larger fiscal adjustment in 2009 might have been preferable.** In their view, this would have eased the burden on the 2010 budget, thereby minimizing adverse multiplier effects during the nascent recovery. Effectively, this would have involved less fiscal accommodation at the time of the first program review, when goals for structural fiscal adjustment in 2009 were eased from nearly 3 percentage points of GDP to closer to 1½ percent of GDP. However, they noted that fiscal policies were not well prepared to deliver large fiscal adjustment in 2009, in part because the scale of the economic downturn and corresponding need for fiscal adjustment had not been recognized at the start of the year, and because 2009 was an election year which made bold fiscal action difficult. Other officials viewed the easing of the fiscal program at the time of the first review as appropriate: maintaining the original fiscal program for 2009 would have risked deepening the already large recession in that year.

39. **The authorities also noted the limited options for postponing part of the fiscal package introduced in 2010.** With a rapidly widening risk premium, fiscal correction was necessary that year for program credibility. While officials accepted that the 2010 fiscal package may have slowed the economic recovery, they cited internal research pointing to a relatively short-lived adverse impact on consumer confidence. At the same time, they believed that the fiscal package may have strengthened confidence, over time, by improving fiscal stability. Overall, given that GDP rose a respectable 2 percent in 2011 after declining 4 percent in 2010, the authorities do not regret the scale and phasing of the 2010 package. Staff noted that, in principle, Fund financing could have been directed more to budget support to accommodate a more gradual fiscal consolidation, as international reserves were over-performing. However, they noted that delaying fiscal adjustment beyond 2010 would have been complicated by the need to reopen the fiscal trajectory agreed with EU counterparts and endorsed by ECOFIN, which could have had adverse effects on confidence in the program.

40. **Officials recognized that efforts to tackle the inflated public wage bill had been only partially successful.** Measures were viewed as necessary, given that the public wage bill was approaching 10 percent of GDP. Moreover, earlier public wage increases were recognized as excessive, so there was little public opposition to the announced 25 percent cut. However, fiscal savings proved temporary given the constitutional court ruling that public wage cuts could be for a limited period only. Subsequently, retroactive payments to make good on foregone wages became a burden on annual budgets. Similarly, officials noted that efforts to cut public pensions were blocked by the constitutional court and the elimination of special pensions for select public employee groups was reversed in several cases under political pressure. Thus, these measures provided, at best, a temporary brake on wage and pension pressures. Some officials also indicated that across-the-board cuts in public spending adversely impacted sensitive social allowances (e.g., maternity and handicap allowances), with consequences for public acceptance of the austerity program.

41. **Several officials would have preferred greater emphasis on strengthening the revenue effort, especially on higher income groups.**[24] In particular, reintroducing a progressive income tax (or adopting a temporary "solidarity tax" on higher incomes) would have distributed the adjustment burden more equitably,[25] particularly as high-income individuals benefited most from the boom years. Relative to consumption taxes, this approach could have resulted in smaller multiplier effects. Officials noted that this approach was precluded by broad political support for the flat tax regime. Accordingly, the regressive increase in the VAT rate was adopted as a fallback option. Officials noted that, when some spending cuts proved ephemeral, efforts were initiated to sustainably broaden the tax base, generally starting with the 2012 budget. Officials also noted that fiscal adjustment did not stop when the Maastricht criterion was met in 2012 but continued through 2013–15.

42. **The authorities and staff viewed efforts to strengthen public sector arrears management as having particularly benefited the business climate and growth.** Payment arrears by SOEs, local governments, and health sector bodies were an important burden on the business community. In the 2009 and 2011 programs, pre-existing arrears were regularized, and disciplinary rules were established to deter new arrears. Improved cash flow left businesses better prepared to weather the crisis and take advantage of the recovery.

43. **The authorities recognized that more effective utilization of EU co-financing could have better supported pro-growth capital spending.** Notwithstanding this, in their view, budgets were generally successful in protecting capital spending from cuts, so that the ratio of capital to recurrent spending improved over the program period. The authorities noted that some measures had been successfully introduced to help tap EU co-financing, based on approaches pioneered in Poland. That said, in the authorities' view, EU counterparts could have been more proactive in tailoring access rules to Romania's conditions and providing technical assistance on how to access available funds.

44. **The authorities noted that measures to strengthen safety nets were still ongoing.** Efforts to better target benefits continue to suffer from a lack a data on the poorest households. The authorities welcomed Fund efforts to protect low-income groups from the worst effects of adjustment. Staff considered, with hindsight, that the Fund's programs with Romania could have benefitted from a structural benchmark or performance criterion on steps to strengthen social protection.

45. **In the financial sector, the authorities strongly commended the Vienna Initiative, while both officials and staff were doubtful about the possibility of additional effective action to support bank credit.** The authorities saw the Vienna Initiative as having been critical

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[24] One cited IMF research findings that fiscal adjustment is more durable when based on revenue mobilization than spending cuts.

[25] Romania adopted in 2005 a flat tax of 16 percent on personal and business incomes, reduced to 10 percent from 2018.

for avoiding a downward spiral in lending and growth. They also noted that Romania's loan guarantee programs had helped underpin confidence in credit markets at a critical time, notably for mortgage finance and real estate construction. Staff also believed that the loan guarantee programs had played a useful role, especially where used to facilitate access to EU counterpart funds. In general, staff and the authorities were positive about Romania's avoidance of banking crisis, progress in tackling NPLs, and the reduced reliance on Euro lending. Even with hindsight, they did not identify missed opportunities for supporting growth through measures to support bank funding and credit extension. The authorities noted that credit growth in the post-program period had been held back, in part, by tighter EU-wide liquidity standards. In their view, IMF staff had played a helpful role in advocating for reasonable post-crisis financial sector standards.

46. **The authorities noted that pro-growth SOE reforms had derailed because of inadequate public and political buy-in.** They emphasized that good progress had been made in strengthening SOE financial reporting and arrears management under the 2009–11 programs. Officials noted that, while staff were appropriately flexible in considering different options for advancing the SOE reform effort in the 2013 program, there was no consensus on how to modernize SOEs. In addition to the challenge posed by vested interests within the SOE sector, there was also a strongly-held belief within parts of government and the public at large that SOEs were national assets that should remain publicly-owned and managed, despite inefficiencies that might arise as a result. Officials noted the complex nature of reforms, which had the potential to produce unwanted results. For example, SOE privatization could reduce financial discipline, since many companies in the private sector are believed to underreport profits to reduce tax obligations. Staff accepted that the 2013 program was overoptimistic about the window for SOE reform. They also struggled with how to build support for effective conditionality in this area. In their view, willingness to advance SOE reforms depended on context: it was most compelling when (a) current arrangements were clearly not working (for example, where SOE governance structures led to unpopular shortfalls in service delivery) or (b) where the government had strong external motivation for reform, such as the earlier program for EU accession. In staff's view, the 2011 and 2013 programs lacked a "hook" of this nature to motivate growth-related reforms. Staff noted that, while the World Bank and EU had the most expertise on SOE issues, they also had been unable to advance SOE governance reforms for similar reasons.

47. **The authorities welcomed staff analysis and advice on how best to promote growth in the post-program period.** In their view, the service and construction sectors have recovered well, while much of the industrial base has been lost compared to the pre-crisis period. Thus, attracting new greenfield investments is a priority, and one area in which Romania has not matched the success of Poland and the Czech Republic. The authorities view the Fund's Article IV engagement on supply-side issues and the appropriate role of industrial policy as of continuing importance. This will be helpful given the need to transition from the demand-led growth experienced in recent years to supply-led growth.

48. **Staff viewed collaboration with other partners as generally successful.** With the World Bank, outcomes tended to vary across sectors. Staff reported good results in incorporating Bank work on SOE corporate governance, energy price liberalization, transport issues, and social safety net reforms into program design. Less success was achieved in aligning with the Bank's health sector reforms, where priorities and costs were difficult to pin down, possibly reflecting indecision within the government. Initial challenges in coordinating program design, discussions, and monitoring with the EU were resolved through changes in team staffing practices and by strengthening pre- and post-mission consultations. Staff noted that the EU successfully complemented Bank expertise in the transport and energy sectors. Staff also noted the value of EBRD inputs in the transport sector.

VI. CONCLUSIONS AND LESSONS

49. **The 2009 and 2011 programs were successful in achieving and consolidating macroeconomic adjustment**. Romania implemented the necessary fiscal and external adjustment, modernized budgetary institutions and practices, and stabilized the banking system. As a result, it was able to graduate from Fund financing after the 2009 SBA. By the 2011 program, a recovery in output was underway, becoming more robust under the 2013 program.

50. **Program success partly reflected the breadth and extent of external support**. Fund resources were complemented by a large multi-partner financing package as well as funding commitments extended by foreign parent banks under the Vienna Initiative. Policy advice and technical assistance provided by the Fund was part of a broader program of technical support extended by the EU, World Bank, and other multilaterals. And Fund conditionality in support of program implementation was complemented by MOUs between Romania, the EU, and World Bank, as well as by the broader disciplining role played by the EU's Stability and Growth Pact.

51. **In terms of program content, a number of measures proved important in ameliorating the impact of adjustment on growth and poverty**. Notable areas of success included the following:

- **Business-friendly budget practices**. Improved public sector arrears management helped strengthen the business climate by improving business cash flow and limiting loan defaults. Over time, steps to broaden the tax base and reduce the burden of public spending also provided relief to the business sector.

- **Safeguards for vulnerable groups**. Programs included measures to safeguard the most vulnerable from cuts in incomes, employment, and public service delivery. World Bank expertise, supported by the EU, was critical for strengthening social safety nets, and Fund staff would not have been able to deliver the same safeguards for macro adjustment without such collaboration. At the same time, greater transparency in Fund documents on safeguard outcomes would have been valuable. The limited documentation by staff may have been in deference to the lead advisory role of other institutions. However, social safeguards can be key to sustaining political support for macroeconomic adjustment and tracking their effectiveness can help identify emerging risks during large, multi-year adjustment programs. Thus, one or more metrics could have usefully been tracked and reported in Fund program reviews (e.g., spending on safety net programs or numbers of households covered).

- **Measures to avoid a financial melt-down**. The Vienna Initiative delayed the withdrawal of funding by foreign parent banks until the recovery was underway, while public loan guarantees helped mitigate credit market risks during the recession, notably in the mortgage market. A banking crisis was avoided, and regulatory measures helped reverse the euroization of private credit, thereby reducing unhedged foreign currency lending risks in the banking system

52. **Even stronger policy implementation could have further reduced the adverse impact of adjustment**. Regression analysis suggests that the scale of the recession and pace of recovery largely reflected domestic imbalances and policies rather than external conditions. Moreover, compared to other program countries, growth was somewhat weaker than would have been anticipated, given Romania's circumstances. Factors that may have exacerbated the recession or held back recovery include the following:

- **Policy uncertainty and program confidence**. Prospects for successful implementation of Romania's 2009, 2011, and 2013 programs were uncertain. Its mixed track record under earlier arrangements raised questions about its ability to sustain difficult adjustment. In this connection, presidential elections in 2009 and 2014 posed particular risks for policy continuity. Staff helped minimize these risks by obtaining broad political endorsement of the 2009 program. However, program confidence was impacted by slippages in fiscal measures in 2009 ahead of the elections. This required a 2010 fiscal package larger than would otherwise have been necessary, undercutting a nascent recovery in consumer confidence. Constitutional court rulings against the proposed 2010 pension cuts and requiring that planned public wage cuts be temporary were a further policy shock that likely impacted program confidence. Not all political risk can be fully mitigated, however, and even with a stronger understanding of the political economy, it is not clear that setbacks to fiscal adjustment could have been anticipated.

- **Weak support for reforms**. Separate from policy uncertainty, policy setbacks can occur when programs adopt goals that are more ambitious than is acceptable to the political establishment or broader population. This appears to have been the case with SOE reforms under the 2013 program. The failure to advance these reforms does not appear to have been an issue of program design or the nature of conditionality (such as the choice between structural performance criteria or benchmarks), but rather due to lack of consensus in Romania on the need for reform.[26] With hindsight, staff were overly optimistic about political interest in and administrative capacity for SOE reforms, staking too much on a perceived narrow window of opportunity for action in the 2013 program. This may have reflected an insufficient grasp of the political economy of SOE reform to judge the likelihood of program success. Arguably, such expertise goes beyond the Fund's mandate and, if staff is to develop a stronger understanding of political economy issues, this should relate to policies promoting macroeconomic stability. On the other hand, a case can be made for including growth-related conditionality in Fund programs where improved living standards depend critically on an improved business climate. Guidance on the appropriate role of the Fund in advancing business climate reforms could help ensure an even-handed approach to program design across the membership and guide staff on the needed breadth of their political economy expertise.

- **Weak institutional capacity**. Greater use of EU co-financing for investment projects could have helped ameliorate the scale of the recession. The shortfall in drawings reflected multiple shortcomings in Romania's institutional apparatus for planning, contracting, and implementing investment projects relative to EU standards. While gradual progress was made in addressing these institutional shortcomings, this was not within the timeframe over which the funds would have been most useful. In cases such as these, alternatives to institutional reform could be considered. In Romania's case, staff could potentially have pressed EU counterparts more to explore the scope for simplifying access to co-financing on a temporary basis to help weather the recession.

- **Failure to anticipate impediments to credit growth**. While the 2009 and 2011 programs addressed risks to banking stability, they gave less attention to restoring financing needed for growth, particularly given the elevated level of NPLs and the potential impact on bank funding of the expiry of the Vienna Initiative. These considerations became increasingly important as credit remained stalled during the 2011 and 2013 programs, resulting in a creditless recovery. Staff's early emphasis on banking stability was unavoidable, given the consequences of banking crises for growth, but over time greater attention should have been paid to a more holistic consideration of how to support the role of the financial sector in supporting growth, especially in a country like Romania where bank lending remains low in relation to the size of the economy.

53. **Post-program engagement by staff has been appropriately supportive of growth**. Within its areas of competence, staff has provided appropriate analysis on policies that would provide a more sustainable footing for growth. This has the potential to support strengthened policy implementation in the period ahead.

[26] While stronger conditionality on SOE reforms could have been adopted at an earlier stage (e.g., through structural performance criteria), this would have risked delaying program reviews, possibly undermining confidence in macro adjustment efforts. And after macro stability was achieved, the leverage afforded by structural conditionality was reduced, whether through performance criteria or benchmarks.

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CHAPTER 3. UKRAINE

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EXECUTIVE SUMMARY

Ukraine has been a frequent user of Fund resources since joining the IMF in 1992. In studying this long-term engagement, Fund staff considered Ukraine to be stuck in an "under-reform trap," owing to vested interests attempting to maintain the status quo. Following a hiatus in program engagement during the early 2000s, the global financial crisis in 2008 unmasked pre-existing domestic vulnerabilities. During the subsequent period to 2019, Ukraine had five IMF-supported programs. Four arrangements had exceptional access. As a result, Ukraine was one of the five IMF members with the highest level of Fund credit at end-2019. In June 2020, Ukraine obtained a new SBA in the context of the COVID-19 pandemic, which is not evaluated in this study.

Vested interests and a fragmented political system continued to adversely affect programs implemented during 2008–19. Geo-political tensions—Russia's annexation of Crimea and conflict in east Ukraine—further complicated economic management. These IMF-supported programs went quickly off track—only 7 out of 41 program reviews were completed—and were replaced by successor arrangements, which typically had front-loaded access.

Three of the five programs (2008, 2014, 2015) took place in the context of a balance of payment crisis and a projected contraction in activity; the activity outturns were even worse. In the two non-crisis cases (2010 and 2018), positive real GDP growth rates were projected, and the outturns exceeded the projections. The crisis programs envisaged tighter macroeconomic policies to restore stability than did the non-crisis programs. Overall, programs were relatively more successful in achieving their targets for external adjustment than for real growth. Indeed, none of the use of Fund resources staff reports explicitly analyzed the growth implications of fiscal, monetary, or exchange rate policies, of the needed correction in domestic national gas prices, or of alternative external financing envelopes.

Looking at ex ante adjustment effort, the estimated annual BOP need (relative to GDP) varied substantially from program to program, ranging from a low of 5 percent to a high of 25 percent. The ex ante fiscal adjustment typically did not take place in full as these programs quickly went off track. In addition, exchange rate depreciation and lower real GDP contributed significantly to lifting the public debt from below 20 percent of GDP in 2008 to unsustainable levels in early 2015, necessitating a debt operation. The 2015 restructuring quickly restored access to foreign financial markets, spurring faster growth and helping to achieve debt sustainability.

Ukraine's IMF-supported programs had wide-ranging structural reform agendas with intense TA support and heavy involvement by international partners. Structural conditions per program with Ukraine along with its compliance rate was above the median in the IEO sample. Progress was made in restoring financial sector stability, addressing distortions in natural gas pricing, and central bank operational independence. However, much less progress was achieved in advancing anti-corruption efforts and improving the business climate; thus, the aspirations for real GDP growth were far from met. The traction of IMF-supported programs could benefit from greater efforts to ensure broad country ownership, more intense coordination with international partners, and less front-loading of Fund access to maintain implementation incentives.

I. INTRODUCTION

1. During the period under review (2007–19), Ukraine had five IMF-supported programs—four with exceptional access—covering nearly all of this period. Four of these programs were supported by Stand-By Arrangements (SBAs) and one by an arrangement under the Extended Fund Facility (EFF). By end 2019, Ukraine was one of the five countries with the largest outstanding amount of Fund credit. Ukraine was initially hit by the global financial crisis, which caused it to seek an SBA in 2008 with exceptional access. This, and subsequent, IMF-supported programs confronted multiple, substantial challenges including a stalled transition to market-oriented economy, vested interests that sought to maintain the status quo, and geo-political tensions owing to Russia's annexation of Crimea and conflict in eastern Ukraine.

II. CONTEXT AND PROGRAM OVERVIEW

2. Ukraine joined the IMF in September 1992 after gaining independence following the dissolution of the U.S.S.R. It first used Fund resources in 1994 under the Systemic Transformation Facility, and then utilized four SBAs and one EFF arrangement during the period 1995–2004. These programs sought to secure macroeconomic stability and tackle institutional and structural economic weaknesses. Program compliance, especially related to structural reforms, was weak. According to the 2005 Ex Post Assessment of Longer-Term Program Engagement (IMF, 2005), Ukraine was stuck in an "under-reform trap," owing to rent-seeking by vested interests and a fractured political system.

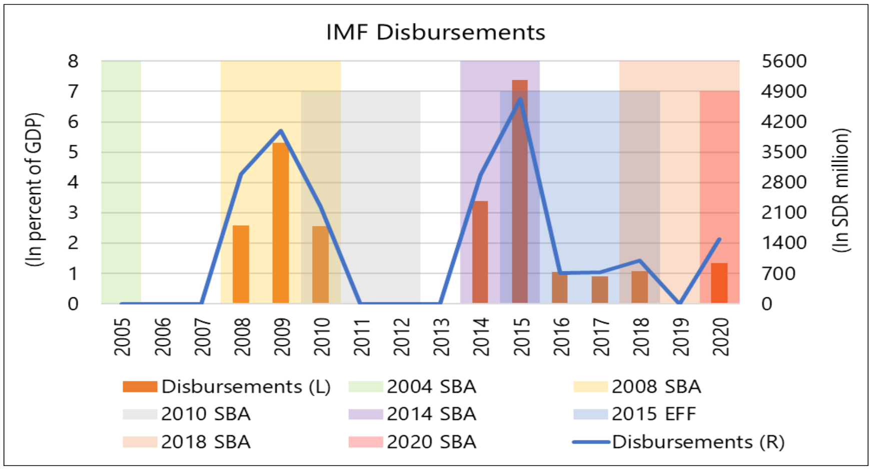
3. During 2007–19, Ukraine requested five IMF-supported programs that covered all but two of these years (Table 1 and Figure 1). New Fund arrangements repeatedly replaced off-track programs whose arrangements were then canceled. Only 7 program reviews were completed out of an envisaged 41 reviews. Nonetheless, reflecting front-loaded access, Ukraine purchased SDR 19.4 billion during 2008–19 or 41 percent of the total committed (SDR 47.1 billion). Fund credit peaked at SDR 9.3 billion in 2011 before declining to SDR 6.9 billion, or 342 percent of quota at end-2019.

Table 1. Ukraine—IMF Arrangements, 2008–19

Years	Duration (In months)	Type	Amount		Initial Purchase SDRs Billions/Percent of Arrangement	Number of Reviews Complete/Planned	Total Purchases (In percent of total)
			SDR Billions	Quota Percent			
2008–10	24	SBA*	11.0	802**	3.0/27.3	2/8	63.6
2010–12	29	SBA	10.0	729**	1.25/12.5	1/9	22.5
2014–15	24	SBA	11.0	800**	2.06/18.8	1/7	27.1
2015–18	48	EFF	12.3	900**	7.09/57.4	3/15	50.0
2018–19	14	SBA	2.8	139	1.0/35.7	0/2	35.7

Source: IMF Staff Reports.
*Use of Emergency Financing Mechanism.
**Use of Exceptional Access Policy.

Figure 1. Ukraine—IMF Disbursements

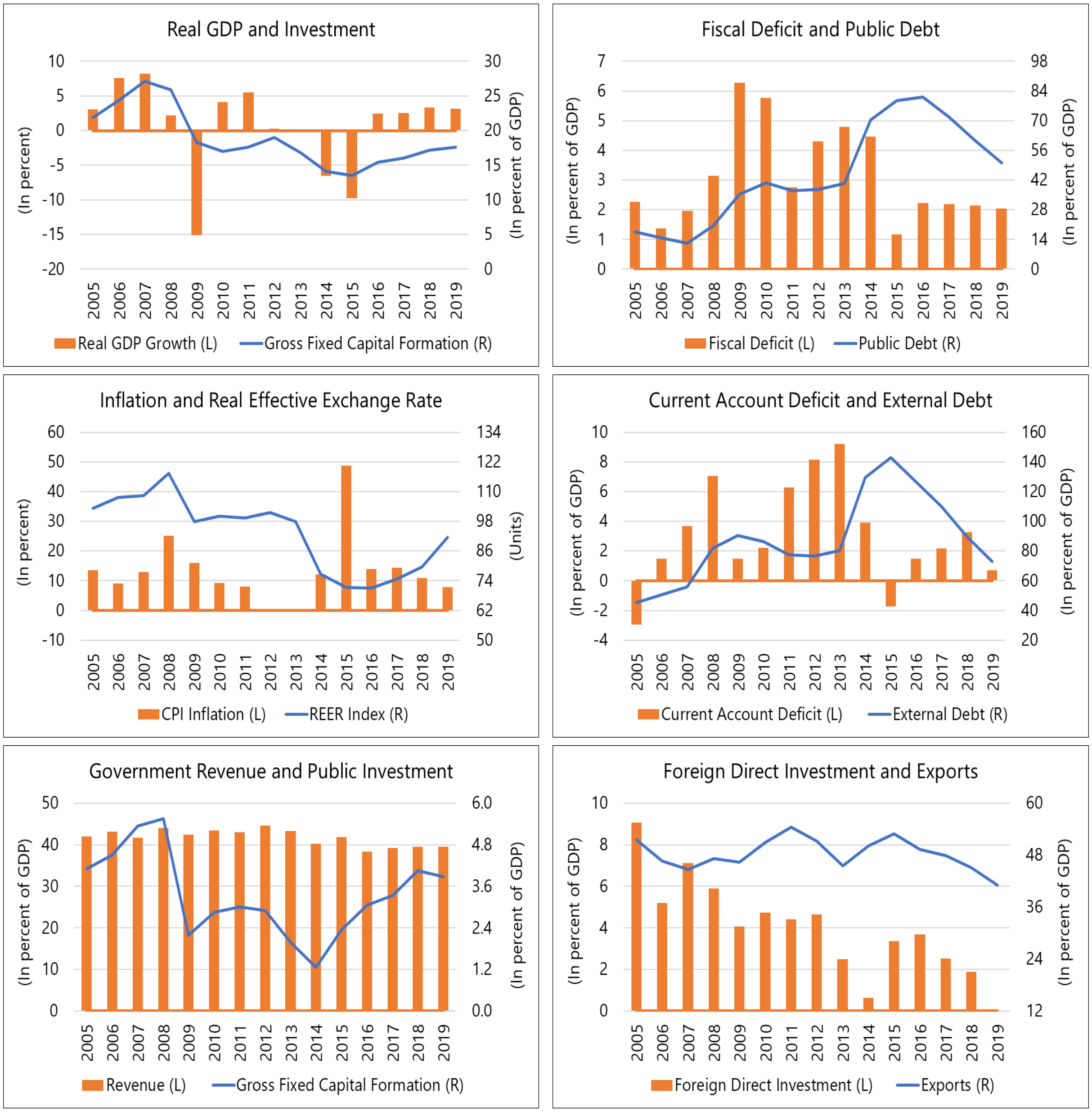


Source: IMF Members' Financial Data.

2. Ukraine's growth performance before the global financial crisis was quite strong, as annual real GDP growth averaged 7.1 percent during 2000–07 (Figure 2). But the global financial crisis unmasked deep, pre-existing domestic vulnerabilities caused by a stalled transition to a market-oriented economy and poor economic governance, and Ukraine quickly faced a dual banking and currency crisis. In November 2008, Ukraine requested a 24–month SBA with exceptional access (802 percent of quota), using the emergency financing mechanism. In mid-2010 after a new government assumed office in March, a second 24–month SBA with exceptional access (729 percent of quota) was requested to help stabilize the economy and restore financial soundness. This program went quickly off-track due to a lack of ownership and weak governance— "a well-worn script of past Ukraine SBAs" (IMF, 2014a).

3. After a recovery during 2010–11, economic growth stalled in 2012–13 owing to inconsistent macroeconomic policies and inattention to structural reforms (IMF, 2013), while the current account deficit rose rapidly to an unsustainable level and international reserves were nearly depleted. In October 2013, Parliament passed legislation necessary for conducting an EU accession agreement, which would preclude Ukraine from participating in a regional customs union, notably with Russia—Ukraine's biggest trading partner. In a surprising move, the government of President Yanukovych suspended preparations for signing the EU agreement, prompting large-scale street protests. In mid-December, Ukraine received assurances of US$15 billion in financial assistance from Russia and a price discount on imported natural gas of about 30 percent. A wave of protests—the "Maidan Revolution"—ensued and led President Yanukovych to flee to Russia. Russia suspended further financial assistance and revoked its gas price discount. Crimea was annexed by Russia and border areas in Eastern Ukraine witnessed fighting led by pro-Russia factions.

Figure 2. Ukraine—Key Economic Trends, 2005–19



Sources: April 2020 WEO database; INS database; FFA database.

4. A new government was quickly formed and requested in April 2014 a 24-month SBA with exceptional access (800 percent of quota). Acknowledging unprecedented risks, this program sought to restore macroeconomic stability, strengthen economic governance, and lay the foundation for robust and balanced growth. However, only one program review was completed, as conflict in the East intensified, overwhelming the authorities' program. Subsequently, the Minsk agreements (2014–15) stabilized the military situation in the East, but without a political resolution.

5. To address Ukraine's protracted BOP needs and deep structural problems, the authorities requested in February 2015 a four-year EFF (900 percent of quota under the exceptional access policy). A sovereign debt operation achieved substantial cash flow relief (nearly US$16 billion) and helped to reduce the debt GDP ratio by about 20 percentage points. The program aimed to restore economic and financial stability through strong adjustment policies and bank recapitalization, and to lift medium-term growth through ambitious structural reforms, including anti-corruption measures. Three reviews were completed over the next 14 months before the program went off track. The program improved macroeconomic conditions but headway on structural reforms, particularly to enhance economic governance, was limited in the face of stiff opposition from vested interests.

6. In early 2018, discussions began on a new SBA that was to provide a policy anchor during the 2019 election cycle and to help unlock financing from World Bank, European Union, and international capital markets. The Board approved a 14-month SBA in December 2018, while cancelling the EFF arrangement. This SBA had limited objectives; specifically, policies aimed at: (i) fiscal consolidation to keep public debt on a steady downward path; (ii) reducing inflation to within the central bank's target range, while maintaining a flexible exchange rate regime; (iii) strengthening the banking system; and (iv) advancing a focused set of structural reforms (e.g., tax administration and governance). No program reviews were completed.

7. A new EFF arrangement had been negotiated to follow this SBA, but eventually, owing to the challenges and uncertainties posed by the COVID-19 pandemic, a new 18-month SBA (139 percent of quota) was approved instead in June 2020 to help Ukraine address the implications of the pandemic. This ongoing SBA is not evaluated here.

8. Since the global financial crisis, Ukraine has witnessed periods of steep contraction in activity followed by gradual recovery (see Figure 2). Consequently, real GDP in 2019 was below its 2007 level, implying a "lost decade" for real growth. Gross fixed capital formation (relative to GDP) during 2007–2019 never returned to the levels prevailing during 2000–07, as gross foreign direct investment (relative to GDP) slipped. Current account deficits experienced three periods of escalations (2005–08, 2009–13, and 2015–19). These developments led to repeated BOP and currency crises and the real exchange rate saw large swings. Not surprisingly, inflation reached local peaks following sharp currency depreciations. Public finances went from a sustainable position prior to the global financial crisis to an unsustainable one in 2014. According to the staff's debt sustainability analysis, the impact on currency depreciations on foreign exchange denominated public debt accounted for about 60 percent of the increase in the public debt ratio during this period, while recapitalization needs of commercial banks accounted for nearly one-fifth. A sovereign debt operation plus greater fiscal discipline associated with an IMF-supported program during 2015–16, helped improve public finances materially.

III. PROGRAM DESIGN, IMPLEMENTATION, AND OUTCOMES

A. 2008 SBA

9. In 2008, Ukraine faced a BOP-crisis triggered by a sharp drop in export volumes and prices, especially for steel, higher import prices for natural gas, and loss of access to international capital markets. These external problems were compounded by an overheated domestic economy. Major strains appeared in the banking system, undermining confidence, including in the currency.

Program Design

10. To facilitate adjustment, the program (i) retained the recently adopted flexible exchange rate policy, (ii) scaled-back incomes policy to be in line with programed inflation, while protecting vulnerable groups, (iii) tightened fiscal policy to achieve demand compression, and (iv) increased energy prices. The staff report stated that the terms-of-trade shock implied a need for much lower real domestic demand and discussions with the authorities revolved around the size of demand compression. In the end, the fiscal deficit in 2009 was programmed to narrow by 1 percentage of GDP—a sizable procyclical policy stance. Neither the staff report nor the policy note analyzed explicitly the growth implications (i.e., fiscal multipliers) of fiscal policy. Spending and revenue measures were programmed to contribute equally to the targeted smaller deficit. Gas tariffs charged by the state-owned utility (NAFTOGAZ, which was responsible for importing, distributing, and transshipping, natural gas) were to be lifted substantially, reducing disposable incomes and curtailing demand. To cushion the impact on vulnerable groups, budgeted social spending was increased and differentiated gas tariffs introduced.

11. A pro-cyclical monetary policy stance was envisaged on top of the procyclical fiscal policy stance. Base money was the near-term nominal anchor until an inflation-targeting regime could be put in place. Real base money was projected to decline in 2009, reversing a comparable expansion in 2008. The cost of disinflationary monetary policy, or the sacrifice ratio,[1] was not specified in the program documents. The flexible exchange rate adopted by the authorities (in March 2009) was retained along with restrictions on capital outflows to support the currency and banking system. These restrictions would be eased as confidence was restored. A bank resolution strategy was formulated to determine bank viability, assess recapitalization needs, and resolve nonviable banks. A downturn was projected based primarily upon Ukraine's experience with a crisis in 2004–05.

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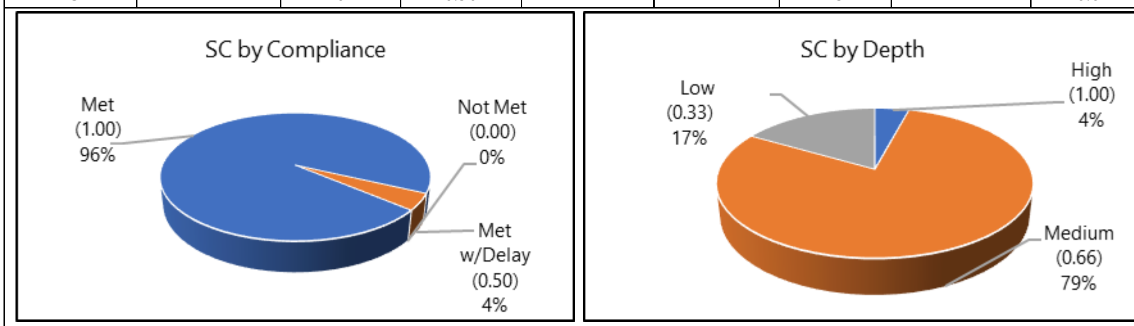
[1] The sacrifice ratio is defined as ratio of the cumulative percentage loss of real GDP to the reduction (percentage change) in inflation achieved. Subsequent empirical analysis at the National Bank of Ukraine estimated a sacrifice ratio of 0.4 (Grui and Vdovychenko, 2019).

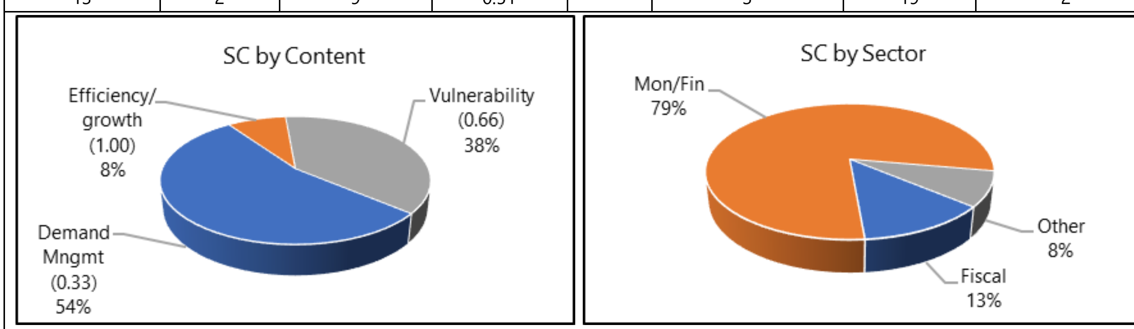
12. Even though the 2008 SBA was focused on crisis management, the staff report observed that the Ukrainian economy operated far below its potential, at less than 30 percent of the estimated global production possibility frontier.[2] Weak market-supporting institutions, lagging liberalization reforms, inadequate infrastructure, shortage of skilled labor, and a difficult business environment were cited by staff as the primary impediments. Nonetheless, structural benchmarks were designed primarily to assist stabilization efforts rather than enhance growth prospects (Figure 3).[3] Nearly, 80 percent of the SCs related to monetary/financial sector, while only 8 percent pertained to growth-oriented reforms (albeit slightly higher than the average GRA-program in the IEO sample). The depth of SCs contained in this SBA scored above the 75th percentile for GRA programs in the IEO sample.

Figure 3. Ukraine—2008 SBA Program

SC by Compliance (Implementation)					SC by Depth			
Met (1.00)	Met w/Delay (0.50)	Not Met (0.00)	Avg Score		High (1.00)	Medium (0.66)	Low (0.33)	Avg Score
23	1	0	0.96		1	19	4	0.62



C by Content (Growth Orientation)					SC by Economic Sector		
Demand Mngmt (0.33)	Efficiency/ Growth (1.00)	Vulnerability (0.66)	Avg Score		Fiscal	Monetary/ Financial	Other
13	2	9	0.51		3	19	2



Sources: IEO calculations and Kim and Lee (2021).
Note: The numbers in bracket refer to the score (scaled between 0 and 1) assigned to the corresponding category. See Kim and Lee (2021) for a detailed explanation of the methodology.

[2] Figure 1 from the staff report (IMF, 2008) utilized empirical estimates derived from WP/06/167 (Ukraine: The Cost of Weak Institutions). Staff's baseline scenario in 2006 envisaged medium-term annual growth rates of about 5 percent from 2005 to 2015, assuming "a mild improvement in Ukraine's institutions."

[3] For details see Kim and Lee (2021) for an analysis of structural conditions in IMF-supported programs during 2008–19.

13. The initial program envisaged a modest output contraction in 2009 followed by a somewhat stronger rebound in 2010, while the current account deficit would narrow in light of the expected global recovery and real exchange rate deprecation. Staff opined that the program's macroeconomic framework established "conservative targets for 2009." The scale of this "slowdown" was calibrated on the Ukraine's experience with an economic contraction in 2004–05 (see Box 3; IMF, 2008). "Considerable downside risks" were cited including from balance-sheet consequences of exchange rate overshooting, a highly uncertain external environment, and a challenging domestic political situation. To mitigate these risks, the program provided for upfront bank recapitalization and sought commitments from the main opposition parties. A further deterioration in the current account deficit was seen as the consequence of a more adverse external environment. Upside risks were also noted, allowing for a better-than-projected current account outturn, faster economic recovery, and a further buildup of international reserves. No explicit policy contingencies or scenario analysis were mentioned in the staff report or Policy Note.

Implementation and Outcomes

14. By the first program review (May 2009), the downturn in activity was clearly much deeper than originally projected for 2009 (-8 percent versus -3 percent), owing to both weaker external and domestic demand. (IEO growth benchmark regressions suggest that adverse external factors contributed 2–3 percentage points to the actual contraction.) As a consequence, external adjustment occurred more rapidly than envisaged, the current account balance for 2009 was projected to move into surplus (+0.5 percent of GDP) compared to the earlier projected deficit (Table 2). Given the deeper economic contraction, the target for the 2009 fiscal target was widened to 4 percent of GDP from balance in the original program. On the other hand, gas and electricity prices were raised to reduce the operating deficit of NAFTOGAZ.

15. At the second program review (July 2009), the 2009 downturn in economic activity was projected to be even still deeper (-14 percent), mainly owing to contracting real domestic demand (-25 percent). The fiscal target was widened again to allow automatic stabilizers to operate fully, while keeping the cyclically adjusted balance unchanged. Owing to fiscal financing constraints, Fund resources were used for budget support to lessen crowding out of the private sector. The stance of monetary policy was kept tight to contain inflationary expectations and exchange rate pressures, while also providing necessary liquidity to the banking system. The program went off track before the close of 2009.

16. Implementation of structural conditionality was generally satisfactory, scoring in the 75th percentile of the IEO sample (see Figure 3). The main accomplishment was the launch (with help from financial experts at the IMF and World Bank) by the authorities of a bank resolution strategy that successfully restored stability and confidence, but the program went off track leaving the bank resolution incomplete. During the program's short span, IMF technical assistance in the financial area amounted to 4½ staff years, accounting for more than 80 percent of IMF technical assistance to Ukraine during this period.

Table 2. Ukraine—Real Growth, Fiscal Deficits, Current Account Deficits, and Gross International Reserves, 2008–19

	Real GDP Growth (In percent)		General Government Deficit (In percent of GDP)		Current Account Deficit (In percent of GDP)		Gross International Reserves (In billions of US dollars)	
	Projected	Actual (WEO)	Projected	Actual	Projected	Actual (WEO)	Projected	Actual
2008 SBA								
(2009 program year)								
Request	-3.0		-0.0		-2.0		30.7	
1st Review	-8.0		-4.0		0.5		29.3	
2nd Review	-14.0	-15.1	-8.8	-9.1	0.6	-1.5	30.0	26.5
2010 SBA								
(2010 program year)								
Request	3.7		-5.5		-1.0		30.3	
1st Review	3.7	4.1	-.5.1	-4.8	-2.8	-2.2	32.4	34.6
2014 SBA								
(2014 program year)								
Request	-5.0		-5.2		-4.4		19.2	
1st Review	-6.5	-6.6	-5.8	-4.5	-2.5	-3.9	16.2	7.5
2015 EFF								
(2015 program year)								
Request	-5.5		-4.2		-1.4		18.3	
1st Review	-9.0	-9.8	-4.2	-6.7	-1.6	-1.7	18.3	13.3
(2016 program year)								
2nd Review	1.5	2.4	-3.7	-2.2	-1.5	-1.6	16.8	15.8
(2017 program year)								
3rd Review	2.0	2.5	-3.0	-2.2	-3.7	-2.2	21.8	18.8
2018 SBA								
(2019 program year)								
Request	2.7	3.2	-2.3	-2.0	-2.9	-0.7	19.5	25.3

Sources: IMF Staff Reports and WEO Database.

B. 2010 SBA

17. The 2010 SBA-supported program (approved in July for 29 months) faced very different macroeconomic challenges than its predecessor. The 2009 output gap was estimated at -8½ percent, while the cyclically adjusted current account balance was assessed to be broadly in line with the current account norm estimated by staff for Ukraine, indicating that from a medium-term perspective, no further external adjustment or real exchange rate depreciation was needed. The new program therefore focused on consolidating the recent stabilization gains and on establishing the conditions for sustained real growth and sound public finances (including NAFTOGAZ) over the medium term.

Program Design

18. Major fiscal adjustment was programmed relying more on revenue measures than expenditure cuts. The combined deficits of the general government and NAFTOGAZ were to shrink by nearly 5¾ percentage points of GDP over two years. Revenue measures (e.g., increases in excise taxes and pension contribution rates) were to account for roughly three quarters of the deficit consolidation by the general government in 2010. The NAFTOGAZ operating balance was programmed to improve by only ½ percent of GDP in 2010, relying on further increases in gas tariffs. An assessment of the demand impact of these actions was not provided in the staff report or policy note. Bank recapitalization was to be completed during the program, while banks under state control would be privatized or resolved. Financing these deficits plus bank recapitalization needs (4½ percent of GDP) was expected to lift public debt to 43 percent of GDP in 2011, but this ratio did not trigger alarms in part because the debt ratio was projected to decline over the medium term.

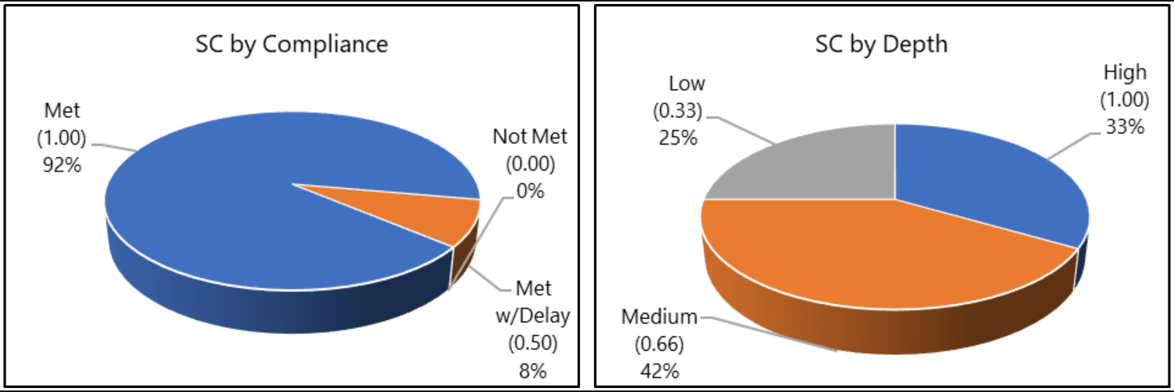
19. As regards inflation, the program sought a very gradual decline of 3 percentage points over two years to 9 percent. The monetary stance was to be less restrictive in 2010. The central bank's institutional framework was to be strengthened to support the future adoption of inflation targeting. Given continuing fiscal financing constraints, the first two Fund purchases were directed at helping finance the 2010 budget deficit to avoid crowding out. With the real exchange rate aligned with fundamentals, the program eased some exchange controls and planned to develop a timetable to eliminate remaining restrictions. A flexible exchange rate policy was to continue with modest intervention to build net reserves (by US$2 billion).

20. In keeping with the program's focus on stabilization, SCs centered on areas in the Fund's core expertise including expenditure and budgetary issues, central bank operations, and exchange rate issues. One third of SCs were in the area of public enterprise pricing and privatization which was intended to foster over the medium-term growth and efficiency (Figure 4). Collectively, these SCs had a growth orientation score slightly below the IEO sample average for GRA-supported programs, while their depth score and implementation scores were both above the 75th percentile for GRA-supported programs in the IEO sample.

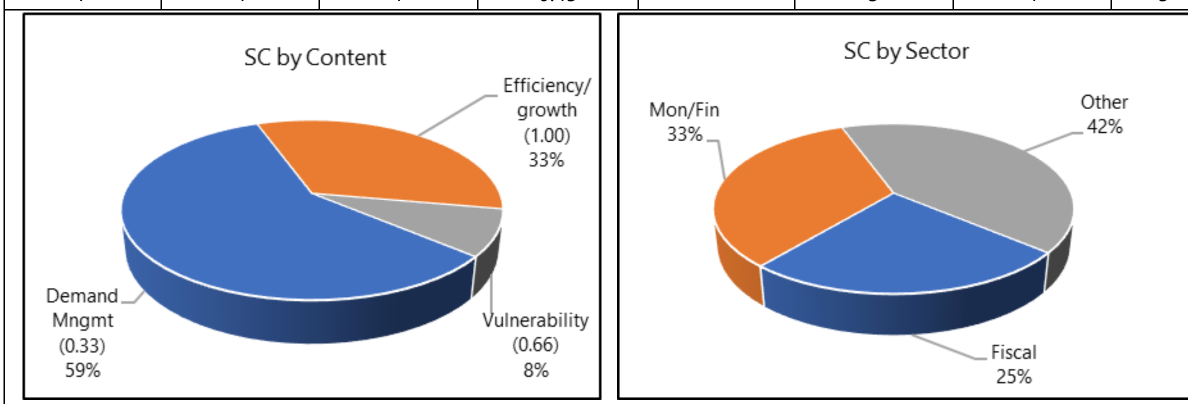
21. The program projected real GDP growth of 3.7 percent in 2010 and 4.3 percent in 2011 Following the collapse in domestic demand in 2009 and notwithstanding significant fiscal drag, domestic demand was projected to rebound, growing by 5 percent in 2010 on the strength of investment for the Euro 2012 football tournament and inventory restocking, Higher private consumption and a more favorable external environment was expected to accelerate growth in 2011 despite continued fiscal drag (as the general government cyclically adjusted deficit was to be lowered by 3 percentage points of GDP).

Figure 4. Ukraine—2010 SBA Program

SC by Compliance (Implementation)					SC by Depth			
Met (1.00)	Met w/Delay (0.50)	Not Met (0.00)	Avg Score		High (1.00)	Medium (0.66)	Low (0.33)	Avg Score
11	1	0	1.00		4	5	3	0.66



SC by Content (Growth Orientation)					SC by Economic Sector		
Demand Mngmt (0.33)	Efficiency/ Growth (1.00)	Vulnerability (0.66)	Avg Score		Fiscal	Monetary/ Financial	Other
7	4	1	0.45		3	4	5



Sources: IEO calculations and Kim and Lee (2021).

Note: The numbers in bracket refer to the score (scaled between 0 and 1) assigned to the corresponding category. See Kim and Lee (2021) for a detailed explanation of the methodology.

22. Risks to the macroeconomic outlook were considered by staff to be broadly balanced. External risks were seen to have diminished but domestic demand could falter in the face of bank deleveraging and doubts about political commitment to reform. An accelerated rebound in Ukraine's major trading partners, a larger-than-expected rise in steel prices, and a return of confidence were seen as factors that could produce a stronger recovery. The outcome of the commercial dispute between NAFTOGAZ and Russia's multinational energy corporation (GAZPROM) was a risk that could go either way. The staff report (and earlier policy note) did not identify specific measures to deal with these various downside risks or provide scenario analysis.

Implementation and Outcomes

23. This SBA stayed on track during 2010; the first program review was completed in late December. But the second program review, which was to focus on 2011 policies, was not completed. The principal obstacles related to raising gas and heating tariffs, tax and spending plans including the target for the fiscal deficit, liberalization of foreign exchange restrictions, and resolution of intervened banks. Nonetheless during the program's short span, the pension system was put on a sounder financial footing, preferential gas pricing was eliminated for certain industries, bank soundness was advanced, and central bank independence strengthened. Macroeconomic policies deteriorated in 2011. The cyclically adjusted fiscal balance improved by ¾ percentage point of GDP, yielding a headline fiscal deficit that was smaller than initially programmed, but gas tariffs were not raised; thus the, NAFTOGAZ deficit was 1½ percent of GDP in 2011 rather than zero. The combined deficit was higher than programmed by ¾ percent of GDP.

24. As regards exchange rate policy, the authorities returned to a de facto exchange rate peg in early 2011. As a consequence, gross international reserves at end 2011 were US$5¾ billion lower than projected (even after adjusting for the absence of further IMF disbursements) and inflation slowed to 4½ percent, or half the rate targeted. The lower inflation was also aided by smaller increases in gas and heating tariffs. With stimulative demand policies, real GDP growth reached nearly 5¼ percent in 2011, or almost 1 percentage point higher than projected by the SBA. Faster real growth was consumption led, leading to a much wider-than-projected current account deficit (5½ percent of GDP versus 3 percent). With a more appreciated real exchange rate, public debt was about 7 percentage points lower than previously projected (at 36 percent of GDP), notwithstanding larger government borrowing.

C. 2014 SBA

25. Over 2012–13, macroeconomic policies became more expansionary, which coupled with the domestic political protests against President Yanukovych (the "Maidan Revolution"), seizure of Crimea by Russia, and armed conflict in eastern Ukraine (see also paragraph 3), generated another BOP crisis in early 2014. Trade relations with Russia—Ukraine's largest trading partner—soured, payment arrears on gas imports from GAZPROM accumulated, and the gas price discount was cancelled by Russia. Foreign capital markets closed to Ukraine, regional and domestic risks produced capital flight/deposit withdrawals, putting the banking system under significant stress. The central bank had to abandon the exchange rate peg in February 2014 and the real exchange depreciated sharply, aligning broadly with fundamentals. Against this background, the new government approached the IMF for financial support. Another SBA with exceptional access was approved in April 2014.

Program Design

26. Staff acknowledged that Ukraine was facing "unprecedented risks," including gas disputes with GAZPROM and tensions in the East, which could require a redesign of the program if they materialized. Nonetheless, staff considered that the authorities' policies deserved "strong support."

27. Under the SBA, the structural (discretionary) fiscal balance was targeted to improve by 1 percentage point of GDP in 2014, implying a procyclical stance given that the economy was projected to contract by -5 percent. Owing to automatic stabilizers, the headline deficit for the general government was to widen by almost ½ percentage point of GDP to 5¼ percent of GDP. The NAFTOGAZ deficit was expected to widen (by ½ percentage point of GDP) as gas tariffs were only gradually adjusted. Full offset of tariff increases for the most vulnerable was to be introduced via a new "lifeline" scheme developed with technical assistance from the World Bank.

28. Base money continued as the monetary policy anchor with inflation-targeting planned for 2015. To achieve the inflation target (16 percent) for 2014, real base money was programed to increase by 4½ percent even though activity was envisaged to contract sharply. This more accommodative stance (compared with the previous SBA) would assure sufficient financial support from the central bank to illiquid banks. In addition, more than half of Fund purchases in 2014 were allocated to budget deficit financing to once again limit crowding out of the private sector. Diagnostic studies of the 35 largest banks were to be launched as a step toward securing financial stability.

29. After contracting in 2014, real GDP was projected to rebound in 2015 (to 2 percent), led by exports and investment. According to staff, this projection was based on experience with emerging market crises over the previous 25 years. Subdued domestic demand and the correction in the real exchange rate was expected to cut the current account deficit by more than half to slightly less than 4½ percent of GDP in 2014 and 2015.

30. A worsening in the situation in the East and poor policy implementation were highlighted as the major program risks in the staff report and related policy note. While these risks were not explicitly examined (for example, in a scenario analysis staff recognized that should the central government lose effective control over the East, the program would need to be redesigned), implementation of prior actions and broad international financial support for the program were cited in the report as key risk mitigation actions.

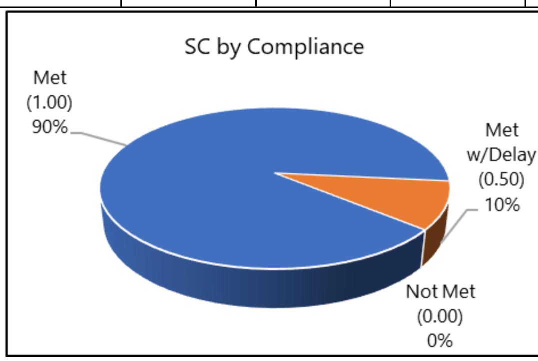
31. The staff report for the program request (IMF, 2014a) noted that "weak governance, transparency, and a very difficult business climate had long hindered Ukraine's ability to achieve greater efficiency, higher growth and trust in government."[4] About three-quarters of the SCs were in areas of IMF core expertise (Figure 5). One structural benchmark outside the IMF core expertise was highly germane—a diagnostic study to develop an anti-corruption framework,

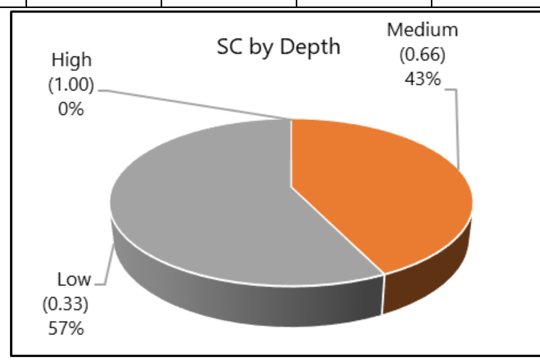
[4] The staff report for the 2012 Article IV consultation with Ukraine (IMF, 2012) updated the analysis in WP/06/167.

including the design and implementation of key laws and regulations that would have impact on the business climate, the effectiveness of the judiciary, and tax administration. With this government study prepared with the assistance of the IMF's Legal Department in hand plus complimentary efforts by the World Bank in the context of a policy development loan, structural measures were developed pertaining to good governance and improved business climate. These reforms were to be supported—both financially and with technical assistance—by the World Bank, EBRD, EC, and the Council of Europe Anti-Corruption Group. This program included a larger share of financial sector SCs related to vulnerability management of the banking sector. The growth orientation of SCs was not different from the previous two SBAs with Ukraine or other GRA-supported programs (see Figure 5). The SC depth was much lower than the previous two SBAs, falling to the sample average for GRA-supported programs.

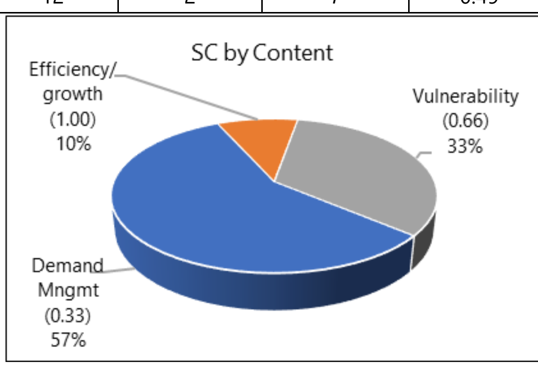
Figure 5. Ukraine—2014 SBA Program

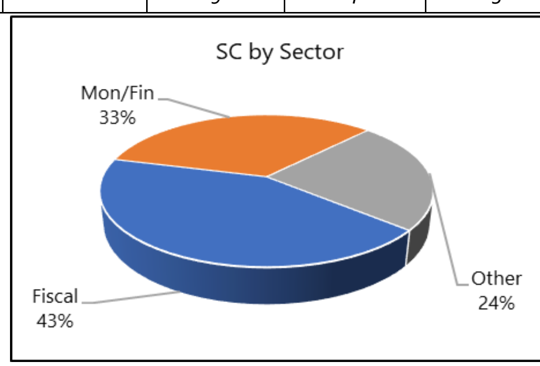
SC by Compliance (Implementation)					SC by Depth			
Met (1.00)	Met w/Delay (0.50)	Not Met (0.00)	Avg Score		High (1.00)	Medium (0.66)	Low (0.33)	Avg Score
19	2	0	0.95		0	9	12	0.47





SC by Content (Growth Orientation)					SC by Economic Sector		
Demand Mngmt (0.33)	Efficiency/ Growth (1.00)	Vulnerability (0.66)	Avg Score		Fiscal	Monetary/ Financial	Other
12	2	7	0.49		9	7	5





Sources: IEO calculations and Kim and Lee (2021).
Note: The numbers in bracket refer to the score (scaled between 0 and 1) assigned to the corresponding category. See Kim and Lee (2021) for a detailed explanation of the methodology.

Implementation and Outcomes

32. By the first program review (August 2014), the previously identified program risks had materialized (see paragraph 30). Armed conflict in the East had intensified and the gas price and arrears dispute between GAZPROM and NAFTOGAZ had worsened. The recession was deeper than originally projected (-6.5 percent vs.-5 percent). At this review, discretionary fiscal policy was left unchanged, but automatic fiscal stabilizers were allowed to operate fully resulting in a wider fiscal deficit. Public debt was viewed as sustainable, even though at 68 percent of GDP in 2014, it was nearing the IMF's high-risk threshold (70 percent). A larger NAFTOGAZ deficit (by 1 percentage point of GDP) was also accommodated. Real base money was programmed to expand at an even faster pace in 2014, notwithstanding inflation rising to 19 percent, at the higher end-2014 inflation target. But the SC compliance rate remained high at 0.95 (see Figure 5). The completed governance study, which was published, emphasized that "state capture" of policy and key economic sectors by oligarchs and other elites was entrenched.[5]

33. As economic and political developments overwhelmed program implementation, no further reviews were completed. Real GDP contracted by 7 percent in 2014 and inflation rose to 25 percent.

D. 2015 EFF Arrangement

34. To address a protracted BOP problem with unsustainable public debt, an EFF-supported program with exceptional access was approved in early 2015. The 4-year program period allowed adjustment efforts to be more spread out and included sustained policies to tackle deep-rooted structural issues.

Program Design

35. After an envisaged real GDP contraction of 5½ percent in 2015, owing to fiscal adjustment, bank deleveraging, and the full year impact of the conflict in the East, a moderate consumption-led recovery was projected in 2016 (2 percent) and 2017 (3½ percent). Growth projections were viewed as "conservative by the standards of past crises, falling near or below the bottom quartile compared to historical episodes of post-crisis recovery." As regards external financing, US$40 billion was mobilized (excluding US$9½ billion in project loans) for the program period. The main sources were the IMF (US$17½ billion), the official sector (US$7½ billion), and a sovereign debt operation to reduce debt service payments (by at least US$15 billion)—see Section IV for details of this debt operation. These resources would finance a buildup of gross international reserves (US$28 billion) and an underlying current account deficit (US$12 billion).

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[5] Staff considered the Fund's engagement with Ukraine on corruption issues to be noteworthy for its openness, depth and consistency (see Box 7 of The Role of the Find in Governance Issues—Review of the Guidance Note, 2017c).

Programmed reserve accumulation was greater than Fund financing in each year. Thus, other external finance covered the projected current account deficits and other net BOP flows.

36. The program contemplated a substantial consolidation effort by the entire public sector. The combined deficits of the general government and NAFTOGAZ were programmed to narrow by 8½ percentage points of GDP during 2015–17; this programmed improvement was heavily front loaded into 2015 (5 percentage points of GDP). The staff report did not discuss the growth implications of this fiscal withdrawal. Expenditure measures (4 percent of GDP) were the primary tool. Even as other expenditures were cut, spending on social assistance was budgeted to increase slightly (by ¼ percentage point of GDP) in 2015.

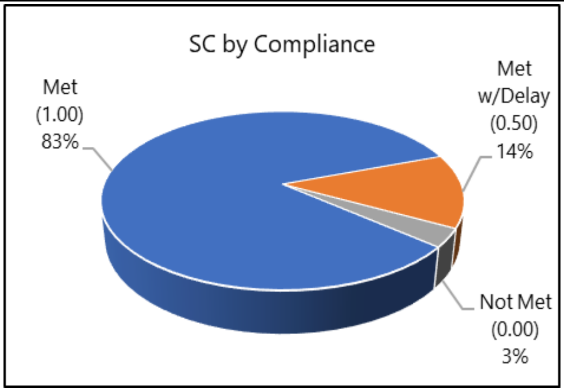
37. With respect to monetary and exchange rate policies, base money remained the policy anchor, while a flexible exchange rate regime was maintained, although comprehensive exchange controls were unexpectedly introduced at the program outset in reaction to what was seen by staff as temporary and excessive pressure on the currency (for details, see Honohan, 2020). The current account deficit was projected to average 1 percent of GDP over the program period, or smaller than the norm estimated by staff, implying an undervalued exchange rate. This would permit inter alia an envisaged gradual removal of exchange controls. Efforts toward adoption of inflation targeting continued. Because currency depreciation and rising NPLs had significantly weakened banking soundness, the bank recapitalization strategy was updated. To support financial sector reforms, the IMF provided almost 4 staff years of technical assistance during the EFF arrangement period, more of such technical assistance than to any other program country in the IEO sample. The revised cost (9½ percent of GDP) was split roughly evenly between the private sector and the budget.

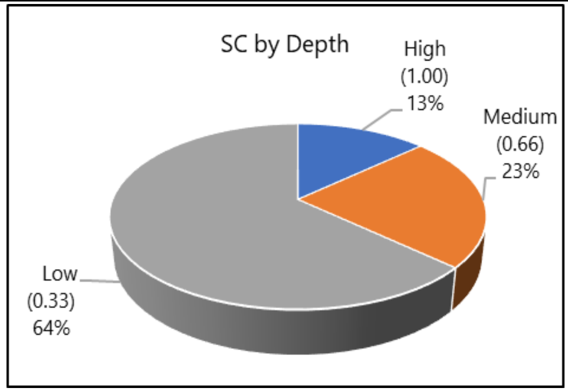
38. Lifting medium-term growth through deep structural (governance) reforms became a key EFF objective. Specifically, "endemic corruption and a stifling regulatory burden, as well as weak investor protection and contract enforcement, has significantly weakened the business climate and deterred investment" (IMF, 2015). Following up on the 2014 governance study, the 2015 EFF developed structural conditionality in close cooperation with other stakeholders (e.g., EC, WB, EBRD, official bilateral creditors, and CSOs/NGOs). Efforts included some 10 measures to strengthen the independence and effectiveness of the judiciary, AML/CFT reforms, asset declarations, and resourcing and oversight of the National Anti-Corruption Bureau for Ukraine (NABU).

39. Unlike the previous SBAs with Ukraine, the EFF-supported program focused on areas outside of the Fund's core expertise, reflecting the major attention given to governance-related reforms (Figure 6). The growth orientation of SCs was much higher than previous SBAs with Ukraine and was also above the 75th quartile in the IEO sample, reflecting a larger share of SCs related to SOE privatization and reforms which were intended to be conducive to growth and efficiency over the medium term. But average SC depth slipped compared with earlier SBAs with Ukraine and below the average for GRA-supported programs.

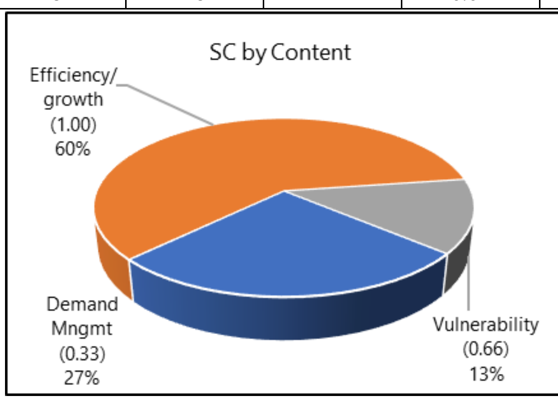
Figure 6. Ukraine—2015 EFF Program

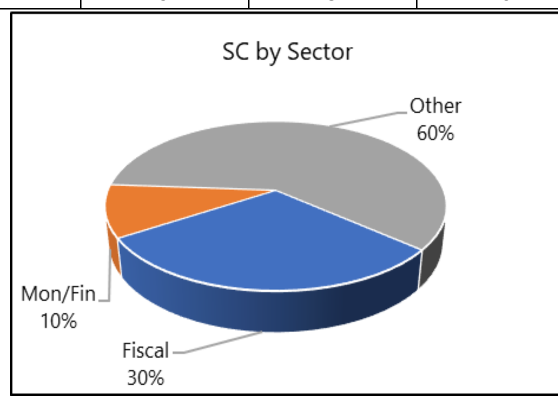
SC by Compliance (Implementation)					SC by Depth			
Met (1.00)	Met w/Delay (0.50)	Not Met (0.00)	Avg Score		High (1.00)	Medium (0.66)	Low (0.33)	Avg Score
25	4	1	0.90		4	7	19	0.50





SC by Content (Growth Orientation)					SC by Economic Sector		
Demand Mngmt (0.33)	Efficiency/ Growth (1.00)	Vulnerabilit y (0.66)	Avg Score		Fiscal	Monetary/ Financial	Other
8	18	4	0.64		9	3	18





Sources: IEO calculations and Kim and Lee (2021).
Note: The numbers in bracket refer to the score (scaled between 0 and 1) assigned to the corresponding category. See Kim and Lee (2021) for a detailed explanation of the methodology.

40. Risks to the programs macroeconomic framework were deemed by staff to be "exceptionally high and predominately on the downside" (IMF, 2015). The main risks identified were resumption of fighting in the East, a disorderly debt operation, and slippages in program implementation, owing to opposition from vested interests. These risks were not quantified in a scenario analysis, even though the associated ex post evaluation (EPE) (IMF, 2020b) suggested that an explicitly quantified downside scenario should be included in all requests for an IMF-supported with exceptional access. Prior actions (7)—notably related to the 2015 budget and increases in gas tariffs—were viewed by staff as providing assurance of the authorities' ability to implement the program, and staff considered the SBs to be "well-calibrated and phased in line

with the authorities' capacity." Other contingencies would be handled by program modifications made during program reviews.

Implementation and Outcomes

41. Only one program review was completed in 2015 (September), owing to heightened tensions in the East. In the event, real GDP contracted by nearly 10 percent in 2015 and inflation rose to 43 percent. Nevertheless, the combined deficits of the general government and NAFTOGAZ contracted by 8 percentage points of GDP with each entity sharing the burden roughly equally. Higher gas tariffs, revenue measures, and public wage bill compression were the principal tools to achieve this deficit contraction. Notwithstanding lower export volumes, the current account deficit (0.3 percent of GDP) was much narrower than programmed owing to import compression associated with the larger demand contraction. One major achievement was the completion of a restructuring of Ukraine's euro-bonds, consistent with the parameters laid out in the program, although a single euro-bond held by Russia remained in dispute (see Section IV). For SCs, compliance continued to be good and above the average for GRA-supported programs.

42. The second EFF-program review was completed in September 2016, or one year after the first review. This delay was prompted by extended negotiations over the 2016 budget, a change in government in April 2016, and postponements in appointing NABU management. By then activity was turning up and real GDP growth was projected at 1½ percent for 2016. With positive demand growth, the current account deficit was expected to increase by about 1 percentage point of GDP, but to only 1½ percent of GDP—well below the estimated current account norm. The combined deficits of the general government and NAFTOGAZ were projected to widen by about 1¾ percentage points of GDP in 2016 to almost 4 percent of GDP. Nominal base money was programmed to expand faster than in 2015 even as inflation was projected to slow sharply to 13 percent.

43. As it turned out, real growth was faster than projected at 2¼ percent in 2016, while end-year inflation was 12½ percent. The combined deficits of the general government and NAFTOGAZ were much lower than programmed at almost 2½ percent of GDP, thanks mainly to better-than-expected revenues owing to the stronger recovery. The NAFTOGAZ operational deficit, which had been 1 percent of GDP in 2015, was eliminated in 2016. The current account deficit, however, rose to 3¾ percent of GDP, owing to much stronger domestic demand.

44. The third program review (April 2017) was also delayed following difficulties in adopting an automatic gas tariff adjustment mechanism, resolving a systemically large, insolvent (and well-connected) private bank, and implementing anti-corruption measures (i.e., asset declaration requirements for high-level officials). The updated program design focused on solidifying the recovery and implementing reforms to permit faster sustainable growth. But renewed tensions with separatists in the East prompted the authorities to suspend trade with non-governmentally controlled areas. Given the risky outlook, the program allowed for fiscal stimulus in 2017 and the cyclically adjusted primary surplus was programmed to decline by 1½ percentage points of GDP.

Higher government wages were the main factor accounting for this surplus decline. The headline deficit of the general government was expected to widen only slightly (¾ percentage point of GDP), owing to automatic stabilizers. NAFTOGAZ's operating finances were in balance (zero) and small tariff adjustments were expected to keep it so.

45. Turning to monetary and exchange rate policies, the central bank adopted an inflation-targeting regime in December 2016, while continuing with a flexible exchange rate policy. The key policy interest rate was to be kept positive in real terms with any easing conditional on inflationary expectations and reserve accumulation. In addition, a conditions-based roadmap for easing foreign exchange controls was developed. To protect financial stability, the authorities also nationalized the largest insolvent private bank and put in place measures to minimize the cost to taxpayers. Overall, real growth was expected to slow temporarily in 2017 to 2 percent, but to accelerate to over 3 percent in 2018. The current account deficit was projected at 3 percent of GDP in 2017—well below the estimated norm—and to narrow in 2018 to 2½ percent.

46. Progress toward addressing corruption issues was limited. In a study for the 2016 Article IV consultation (April 2017) along with the third program review, staff found Ukraine to have high levels of perceived corruption with no improvement over the decade ending in 2016. Using both panel and cross-country regressions, staff (IMF, 2017a) estimated that a one unit improvement in the Corruption Index (CI) from the International Country Risk Guide (ICRG)—or 50 percent—would lift real GDP growth for Ukraine by 0.85–1.35 percentage point after 3 years (IMF, 2017a). No link was identified between the specific structural reforms contained in the EFF-program and changes to the ICRG's corruption index. Staff did observe, however, that implemented reforms had not delivered concrete results and that opinion polls conducted in December 2016 indicated that 89 percent of Ukraine's population considered the authorities' efforts to address corruption to be a failure. This research came too late to influence the EFF's structural conditionality because no further program reviews were completed, in large part because structural reforms, including those to ensure property rights and the rule of law, and to improve the business climate, ground to a halt when confronted with strong opposition from vested interests.

E. 2018 SBA

47. With the EFF arrangement scheduled to expire in March 2019, a new 14-month SBA was approved in December 2018. Building upon the more stable recent macroeconomic performance, the SBA was intended to provide an anchor for economic policies during the 2019 election cycle and to help unlock financing from the EU, World Bank, and international financial markets.

Program Design

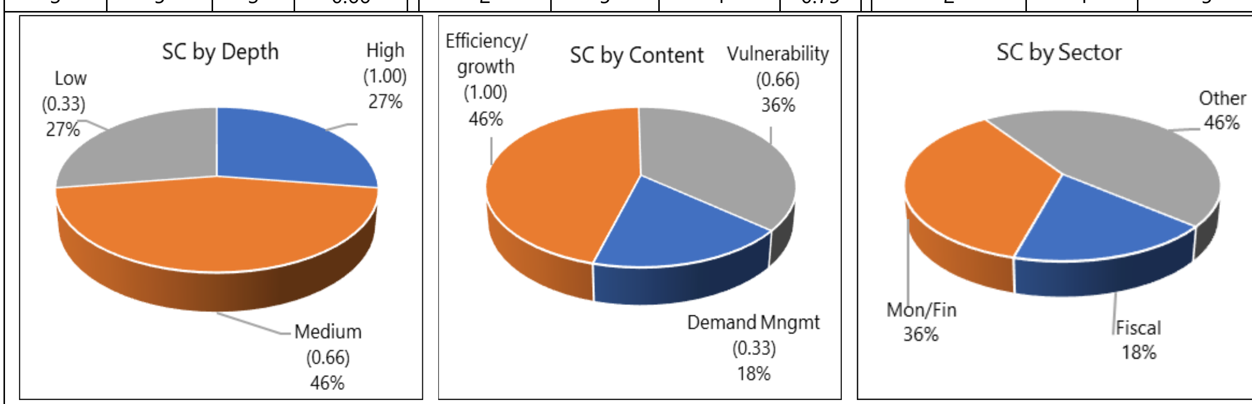
48. Macroeconomic policies supported by the 2018 SBA were geared toward sustaining the recent good economic performance. Real GDP growth was projected to rise to 3¼ percent; inflation to slow to 7 percent; and the current account deficit to widen to 3 percent of GDP,

owing to higher domestic demand. Fiscal policy was programmed to be broadly neutral. The overall general government deficit was projected at 2¼ percent of GDP in 2019 or only slightly smaller than the expected 2018 outturn and was envisaged as keeping the debt-to-GDP ratio on a declining path. This modest deficit narrowing was due to automatic fiscal stabilizers as the recovery gained momentum. Monetary policy was focused on reducing inflation toward the central bank's target (5 percent) and building reserve buffers. Using the inflation-targeting framework, policy interest rates were highly positive in real terms, but they were anticipated to be reduced gradually as inflation eased. Strengthening financial stability continued to be a major policy pillar.

49. In light of the electoral calendar, the program narrowly focused on critical structural reforms, such as strengthening revenue administration, increasing gas and heating tariffs, securing bank soundness, and improving governance and the business climate. Eight SCs were set under the program with slightly over half oriented toward demand management and vulnerability and in the IMF core areas of fiscal, monetary, and financial sectors (Figure 7).

Figure 7. Ukraine—2018 SBA Program

SC by Depth				SC by Content (Growth Orientation)				SC by Economic Sector		
High (1.00)	Medium (0.66)	Low (0.33)	Average Score	Demand Management (0.33)	Efficiency/ Growth (1.00)	Vulnerability (0.66)	Average Score	Fiscal	Monetary/ Financial	Other
3	5	3	0.66	2	5	4	0.75	2	4	5



Sources: IEO calculations and Kim and Lee (2021).
Note: The numbers in bracket refer to the score (scaled between 0 and 1) assigned to the corresponding category. See Kim and Lee (2021) for a detailed explanation of the methodology.

Implementation and Outcomes

50. Fund missions visited in March and May 2019, the latter shortly after the new President (Zelenksyi) was inaugurated. The government could not implement various policies related to anti-corruption measures and banking reforms, because parliament was dissolved, and the government was focused on elections. No program reviews were completed so it is not possible to assess SC compliance. In addition, the authorities and staff agreed that after the elections a

new IMF-supported program would be formulated. Nonetheless, economic performance continued to be relatively good. Real GDP growth, inflation, and the fiscal deficit were all on target or better, while the current account deficit was smaller than envisaged.

F. 2020 SBA

51. In September 2019, discussions on a new EFF-supported program were initiated. A staff-level agreement on a new 3-year EFF was announced in December (IMF, 2019b). But in the event, the global COVID-19 pandemic upended this staff-level agreement before it could be presented to the Board. Instead, an 18-month SBA (179 percent of quota) was approved by the Board in June 2020 (IMF, 2020). This program sought to help the authorities in their efforts to address the impact of the pandemic, while ensuring macroeconomic stability and safeguarding achievements to date. The economic uncertainties surrounding this program were viewed as exceptionally high. A small set of key structural benchmarks (9) were aimed to protect the resources and independence of anti-corruption institutions, safeguard progress made in corporate governance, and enhancing financial stability including by recovering costs from past bank resolutions.

IV. Debt Management and Operations

52. Sovereign debt was not a particular concern for staff in designing the 2008, 2010 and 2014 SBAs with Ukraine as these Fund-supported programs started with levels of public debt that were low (12 percent of GDP in 2007) to moderate (35–40 percent of GDP in 2009 and 2013, respectively). Indeed, for the 2014 SBA request, staff assessed debt sustainability per the exceptional access criteria as met, contending that the program would "reduce public debt levels well below the standard debt sustainability analysis high-risk benchmark of 70 percent," although certain vulnerabilities and risks were acknowledged.

53. With public debt projected to exceed 90 percent of GDP in 2015, owing in large part to real depreciation, the authorities began debt-restructuring talks with private external creditors in early 2015 as they initiated discussions with staff on a new EFF-supported program. Staff judged that a debt operation should aim to reduce the debt-GDP ratio to 72 percent by 2020 and generate debt service relief (US$15 billion) over the program period. These parameters were estimated to lower key debt indicators (e.g., debt/GDP and gross financing requirement/GDP) below their respective high-risk thresholds. According to interviews, the authorities would have preferred a deeper debt reduction operation to yield a higher probability of debt sustainability, but the authorities expressed the view that debt restructuring parameters announced by staff constrained their negotiating options, setting an effective ceiling on debt relief that could be obtained from creditors. As discussed in Section V, program targets could have been reframed within the same financing envelope to provide more resources to fund additional debt relief.

54. By the Board meeting in March 2015 to approve the EFF, the authorities had hired advisors to facilitate consultations with holders of Ukraine's Euro-bonds and were committed to reaching a suitable debt restructuring. An exchange offer was launched in September 2015,[6] that attracted broad private creditor participation and settlement and issuance of new instruments took place in later in 2015 (Erce, 2021). At the second program review (September 2016), staff considered this exchange offer to be broadly consistent with the financing and debt objectives set under the program (IMF, 2016a). In particular, they estimated US$15.7 billion in cash flow relief, while the debt-GDP ratio was expected to reach 73 percent in 2020. Staff anticipated an early return to market access—in about three years.

55. One creditor—Russia, which held a US$3 billion Eurobond—did not participate in this debt restructuring, contending that this bond was an official claim. The Ukrainian authorities defaulted on this Eurobond, resulting in debt payment arrears. The IMF Executive Board recognized this bond as an official claim in December 2015. Also, in December 2015, the Board modified its policy on non-toleration of arrears to official creditors to bring it more in line with the policy on lending into arrears to private creditors. The Fund could now lend to a country with such arrears provided that inter alia the debtor was making "good faith" efforts to reach agreement with the official creditor.

56. Following this policy change, the IMF Board completed the second program review in September 2016 despite the Russian Executive Director disagreeing with the staff's positive assessment of the Ukraine authorities' "good-faith" efforts. In March 2017, the UK High Court issued a summary judgment in favor of Russia, which the Ukraine authorities appealed. At the next program review, the Russian authorities disagreed again with staff's assessment of good-faith efforts. In September 2018, the UK Court of Appeal reversed the High Court's summary judgment, returning the case for full trial. In December 2018, when the Board approved Ukraine's request for a new SBA, staff maintained their positive "good-faith" assessment. Russia's Director voiced disagreement, voting against the SBA request. The legal dispute between Russia and Ukraine remains in the UK courts.

57. Ukraine returned to international capital markets in September 2017, or only two years after completing its debt restructuring and has accessed some US$8 billion by end-2019. Sovereign spreads also dropped sharply (by 1000 basis points) over this period. Public debt fell to 50 percent of GDP at end-2019 and gross financing needs remained well below the high-risk benchmark. Access to international savings at a reasonable cost has allowed greater domestic investment, spurring faster real growth.

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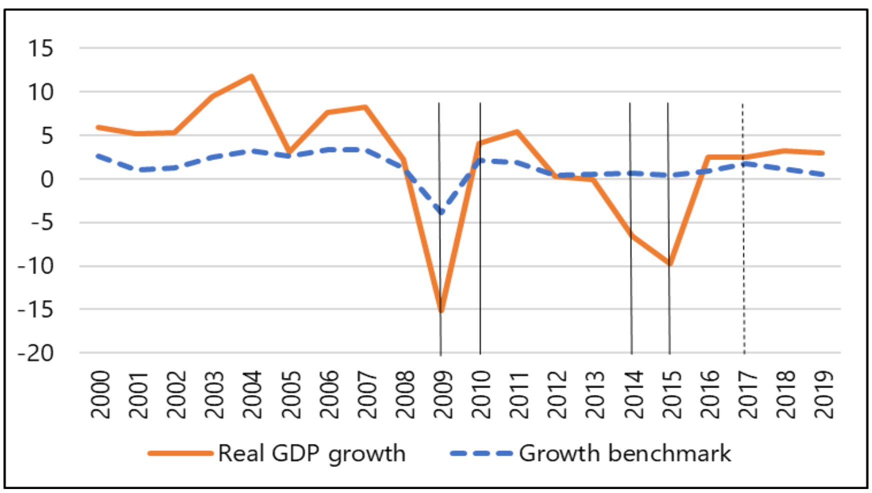
[6] The eligible liabilities for the debt operation included sovereign and sovereign-guaranteed Eurobonds, city of Kyiv Eurobonds, and guaranteed commercial loans), and SOE debt (non-guaranteed Eurobonds and loans) for a total nominal value of US$22.3 billion. Given the variety of eligible liabilities, the precise restructuring terms were different for each instrument/issuer (see IMF, 2016a for details). In general terms, the restructuring terms included a 20 percent nominal haircut, maturities were extended by 4 years to 2019–27; coupons of 7.75 percent (versus a pre-exchange average of 7.2 percent), and a value recovery instrument.

V. Cross-Program Analysis

58. Assessing the growth consequences of adjustment measures has been a consistent challenge through Ukraine's extensive engagement with the Fund. Three of the five program requests (2008, 2014, 2015) took place in the context of a BOP crisis. Real GDP growth was projected to contract sharply but the outturns were worse than projected. In the other two (non-crisis) cases (2010 and 2018), positive real GDP growth rates were projected, and the outturns exceeded the projections. In projecting real growth, staff relied explicitly upon past experience with crises in the Ukraine (2008) and in other countries (2015), along with the usual high-frequency economic indicators, rather than more formal econometric models or multiplier analysis. While the spreadsheet-based approach utilized in Ukraine provided a structured and calibrated methodology, it typically does not include explicit feedback loops from policy settings to real growth as opposed to feedback loops from real growth to variables such as fiscal revenues and expenditures.

59. Actual real GDP growth exceeded IEO estimated growth benchmarks based on external factors in the run-up to the global financial crisis in 2008 (Figure 8).[7] But activity experienced a free fall during 2008–09 followed by a "dead-cat" bounce in 2010–11. Another contraction occurred in 2014–15 followed by a more sustained expansion during 2016–19. These developments in actual growth were statistically significantly different from the IEO growth benchmarks.

Figure 8. Ukraine—Actual Annual Growth and Benchmark Growth



Source: IEO estimates.
Note: See Kim and others (2021) for a detailed explanation of the methodology.

[7] The growth benchmarks were estimated using a large panel regression which explains growth based on external factors alone (Kim and others, 2021).

60. None of the UFR staff reports explicitly analyzed the implications for real growth of fiscal, monetary, or exchange rate policies. In particular, UFR reports typically did not mention the fiscal multipliers for spending or revenue measures utilized in designing these programs.[8] An IMF Working Paper (Fiscal Multiplier in Ukraine, WP/15/71), estimated fiscal multipliers for Ukraine for the first time.[9] One implication of these results was that deficit reduction via revenue measures would have had less adverse impact on growth than equivalently sized spending measures.

61. Program outcomes appear to back up these empirical results on fiscal multipliers, suggesting that programs may have placed too much reliance on spending restraint rather than revenue measures to achieve fiscal objectives.[10] The 2008 SBA, 2014 SBA, and 2015 EFF (first year)—all crisis programs—are notable in that they included fiscal measures to contain, or narrow, the fiscal deficit. In these programs, real GDP was projected to contract, but the outturns were even worse than projected. Consequently, the current account adjustment tended to be larger than programmed—the outturn was a more positive balance (or less negative deficit) that targeted—suggesting that perhaps fiscal consolidation objectives need not have been as ambitious in order to achieve the external adjustment objectives.

62. On the other hand, there were several program years (i.e., 2010, 2016, 2017, 2019) where real GDP growth was projected to be positive and the outturn was faster growth than projected. In these years, discretionary fiscal measures were smaller in magnitude than in the crisis programs and tended to emphasize revenue measures; indeed, in some years, spending was targeted to rise but by less than the rise in revenues. The 2017 annual program under the 2015 EFF is notable in that the cyclically adjusted primary surplus was programmed to narrow—providing fiscal stimulus—primarily through spending measures; real GDP was ½ percentage point higher than projected at 2½ percent. It seems likely that fiscal multipliers were larger during downturns than in upturns.

63. Ukraine was not unique in facing these challenges. In particular, in its Update on Fiscal Adjustment in Fund-supported programs (IEO, 2013), the IEO assessed that the most difficult element in IMF-supported programs—deciding on the magnitude and pace of fiscal adjustment—requires further work. As they observed, this decision necessitates balancing private sector demand considerations against balance of payments constraints, debt sustainability concerns, and the stance of parallel policies. These are challenging tasks but explicitly considering such issues would enhance the quality of IMF-supported programs.

[8] This absence was not usual amongst program staff reports; the 2018 Review of Conditionality (IMF, 2019b) observed that only about 15 percent of such staff reports provided such information.

[9] The authors found that while the immediate (first quarter) spending and revenue multipliers were similarly sized (0.4 and 0.3, respectively), 8 quarter multipliers were larger, but quite different in size (2.9 and 1.0 respectively). While both multipliers were statistically significance initially, revenue multipliers were not statistically significant beyond the first quarter. The impact on growth of capital and current spending were found to be about equal. NBU staff (Vdovychenko, 2018) estimated fiscal multipliers covering a longer period (to 2016) and found similar results except that the spending multiplier was only about half (1.5).

[10] Additional multiplier analysis in the context of Fund-supported can be found in Gupta (2021).

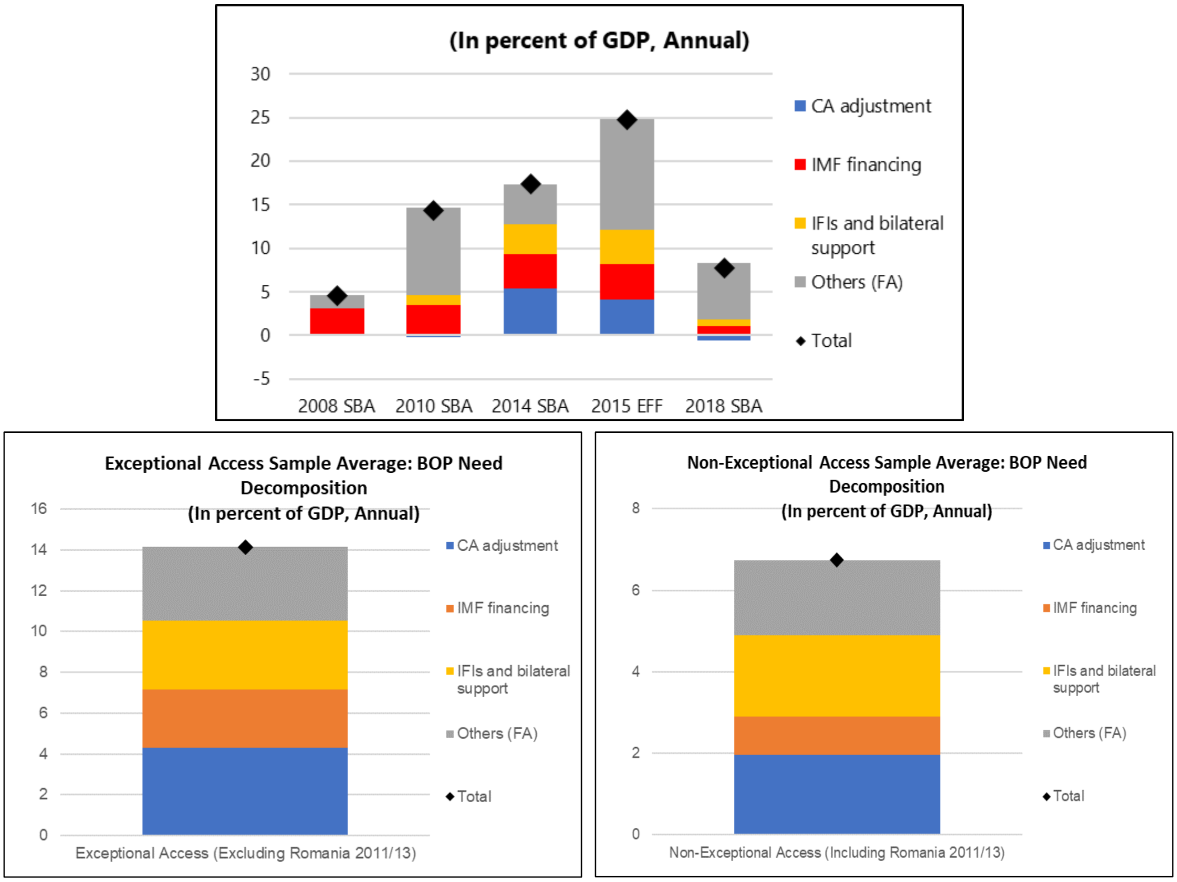
64. Other domestic policies—notably, NAFTOGAZ deficit reduction, and monetary policy—also affected domestic demand. Redressing the quasi-fiscal deficits of NAFTOGAZ via tariff increase was a major element in the efforts to achieve cost recovery and sound fiscal finances in the first three IMF-supported programs. However, UFR staff reports did not analyze the adverse implications on domestic demand of reducing real disposable income of the private sector through gas tariff increases, which essentially passed on to users the higher import prices—effectively an adverse terms of trade shock. In the last two IMF-supported programs, the NAFTOGAZ deficit had already been eliminated so gas price adjustments did not have as large a demand drag as prior programs.

65. Monetary policy was typically geared toward achieving a decline in annual inflation. The monetary transmission channels are changes to the output gap—domestic wage/price pressures—and the exchange rate—import/export prices. This relationship is typically summarized in the sacrifice ratio, but it was not made explicit in program documents. Thus, an impact assessment of tighter monetary policy on deviations in projected and actual real GDP growth is elusive.

66. Turning to the programmed adjustment-financing balance, contributions to reaching calculated balance of payments need were calculated, utilizing the methodology developed for the 2018 ROC, for the five Ukraine programs. Annual BOP needs varied substantially from program to program (Figure 9). For those programs with exceptional access, calculated annual BOP need ranged from a low of 5 percent of GDP (2008 SBA) to 25 percent of GDP (2015 EFF); the average BOP need for programs with exceptional access in the case study sample was 14 percent of GDP.[11] The annual BOP need for the regular-access SBA (2018) with Ukraine was 8 percent of GDP, or somewhat above the sample average for regular access SBAs. The normalized contribution of current account adjustment for Ukraine programs also varied widely across programs, but these adjustment contributions were typically less than the average for GRA-supported programs. This ex ante tilt toward finance over adjustment is consistent with the staff judgment that programmed current account deficits were typically smaller than the prevailing current account norm for Ukraine. However, programmed fiscal adjustment (including NAFTOGAZ) during 2008–14 was not typically implemented as these programs went quickly off track. In addition, real exchange rate depreciation and a lower level of real GDP sharply increased the public debt ratio. Consequently, a debt operation with foreign creditors was necessary in 2015.

[11] The country case study sample consists of 17 countries with 40 programs in total approved and ended between September 2008 and March 2020. Countries included in the sample are Bangladesh, Benin, Cameroon, Egypt, Ghana, Grenada, Honduras, Jamaica, Jordan, Latvia, Malawi, Mongolia, Pakistan, Romania, Senegal, Tunisia, and Ukraine.

Figure 9. Ukraine—BOP Need Decomposition



Sources: IEO calculations and Kim and others (2021).
Note: Sample average is for the sample of programs covered by the 17 country case studies (with 40 programs in total) for the evaluation. See Kim and others (2021) for a detailed explanation of the sample and methodology.

67. The 2015 EFF merits further attention in light of its usually large BOP need (25 percent of GDP) even for a program with exceptional access, while the contribution of current account adjustment was below the average for such programs. The programmed increase in gross international reserves (US$27.7 billion) accounted for 70 percent of the identified financing gap (US$40 billion). This reserve target was equivalent to 113 percent of the IMF's composite reserve metric; although the EPE (IMF, 2020b) observed that this target "incorporated some cushion for significant external debt repayments following the program period," this rationale was not provided in the staff report to request the 2015 EFF (IMF, 2015a). EFF access was equivalent to US$17.5 billion or US$10 billion less than the targeted reserve accumulation. Reducing the targeted reserve accumulation to 100 percent of the IMF metric could have lowered the financing need by US$4.6 billion or could have made additional resources available to finance a "sweetener" to instruments in the restructuring offer that could have improved further debt sustainability.

68. The number of SCs per IMF-supported program with Ukraine was well above the median for IMF-supported programs, reflecting Ukraine's extensive reform agenda. The four IMF-supported programs with Ukraine assessed by the IEO (IEO calculations and Kim and Lee, 2021) had 87 SCs in total. Technical assistance efforts by the Fund totaled 34 FTEs during the program periods, which was substantially greater than for any other program in the sample.[12] Viewed collectively, these SCs had average structural depth and somewhat above average growth-orientation, while compliance was well above the average for GRA-supported programs. Over 70 percent of these SCs were in the IMF's core areas of expertise, providing the underpinnings for the stabilization efforts. This average, however, masks a huge difference between the 2015 EFF and the prior SBAs; the EFF had half of its SCs outside the IMF's core areas, covering SOE reform and governance issues, compared with only one-fifth on average for the three SBAs. Similarly, the EFF had the highest score for growth-orientation among these four programs, but it had the lowest score for structural depth and compliance.

69. Despite the heavy emphasis on structural reforms in Ukraine's programs, measurable progress was very limited. While empirical analysis produced by staff showed a correlation between "weak institutions" and relatively low per-capita output, program documents did not provide an explicit link between structural conditions and improvement in selected reform indices, which were correlated with higher per-capita output. Since the expected growth outcome was not made explicit, it is not possible to assess performance against this program objective. Several other metrics, nonetheless, suggest that the overall impact of the reform agenda was limited. First, according to staff calculations for the WEO, potential output in Ukraine was 6 percent lower in 2019 than it was in 2008. Potential output per worker was roughly unchanged from 2008 to 2019. Second, various reform indices show no consistent improvement. The ICRG's Corruption Index saw no improvement over the period 2007 to 2014. Third, RES's Structural Reform Index for Ukraine also witnessed no improvement over this period. Fourth, Transparency International ranked Ukraine at 126 in 2019, while it stood about 140 in 2008–09 before slipping to a low of 152 in 2011. These indicators do not show any obvious link between SCs in Ukraine's programs and reform progress. In sum, the numerous SCs implemented during the five programs fell far short of the real growth aspirations set out in those program documents.

VI. AUTHORITIES AND STAFF'S PERSPECTIVES

70. Both the 2008 and 2010 SBAs were considered to be appropriately designed by their respective ex post evaluations (EPEs) (IMF, 2012; 2016), but the results were "disappointing" as both programs went quickly off track. On the plus side, the banking system was stabilized, the current account adjusted quickly, and gradual recovery was started. The authorities felt that these programs were for the most part properly designed particularly as regards macroeconomic policies. On the negative side, the structural agenda was only partially implemented, owing to

[12] The 2018 SBA was not included in this technical assistance total because it was ongoing when the evaluation was initiated.

insufficient program ownership. Moreover, the authorities thought there was insufficient recognition of the institutional constraints faced by them. Many prior actions, significant technical assistance, and efforts at cross-party buy-in were only partly successful according to staff. Looking back, officials expressed the view that there should have been greater use of prior actions and more detailed specification of measures to ensure proper policy implementation. They also suggested that the IMF should have paid more attention to areas typically reserved for the World Bank (for example, reforms to improve business climate), given the IMF's "greater leverage" stemming from its larger financial support.

71. Turning to the 2014 SBA (IMF, 2016), staff concluded that it served as an important anchor for economic policies and possibly prevented worse outcomes. But in hindsight, a more conservative baseline outlook was warranted with greater emphasis on contingency planning and an earlier debt operation would have helped to allow more gradual adjustment. The Ukraine authorities shared these views. In particular, the program rightly focused on immediate objectives but the intensification of conflict in the East made these objectives unattainable.

72. An EPE for the 2015 EFF (IMF, 2020b) was discussed by the Board in June 2020 along with a request for a new SBA (IMF, 2020a).[13] The EPE concluded that the EFF-supported program helped restore macroeconomic stability and real growth, but did not fully address Ukraine's underlying BOP vulnerabilities, noting that a successor SBA was needed. Somewhat lower access would have sufficed. In addition, it judged that while considerable progress was achieved in some areas of structural reform, the efforts to improve competitiveness and business climate fell well short, owing to resistance from vested interests. As regards program design,[14] the EPE made five main recommendations: (i) use prior actions judiciously and structural benchmarks parsimoniously; (ii) lay the ground work in advance so countries can take advantage of narrow windows for reform opportunities; (iii) foster genuine reform ownership; (iv) avoid heavy front-loading of access to help sustain reform momentum over the entire program period; and (v) increase timely and well-targeted communications to enhance broad buy-in. The authorities concurred with the findings and conclusions of this EPE.

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[13] According to the EPE Guidance Note, "the policy requires that EPEs be completed within one year of the end of the arrangement. "Completion" in this case should be understood to mean approval by management for circulation to the Board. ….. it would be desirable to complete the EPE prior to discussion on a new arrangement. Similarly, for irretrievably off-track programs, EPEs could be prepared before the formal expiration of the arrangement." As a Policy Note for a new SBA was cleared by management in early September 2018; the one-year EPE clock should reasonably have started then. Both the EPE was only circulated to the Board at end May 2020 or some 21 months later. Consequently, the Board's views did not inform the negotiations on the 2018 or 2020 SBAs. Thus, this shortcoming in the application of EPE policy was not the first such instance (IEO, 2016).

[14] The EPE also made five recommendations related to Fund procedures: (i) require a quantified downside scenario in capacity to repay assessments; (ii) clarify definition of official claims; (iii) develop a rules-based approach to communicating delays in completing program reviews; (iv) develop guidance to assess "reasonably strong prospect for success including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment"; and (v) adopt standardized presentation of depth and implementation record for structural conditionality.

73. Overall, the interviewed authorities did not think real growth was a major consideration in program design. Out of necessity, crisis management (2008, 2010, 2014, 2015) and debt sustainability (2015) were the central focus of these programs. In terms of stabilization, the 2018 SBA was deemed by interviewees as the most successful program during 2007–2019 even if no program review was completed. Indeed, macroeconomic outcomes relative to targets support this judgment. In their view, a number of successful structural reforms were implemented as part of the 2015 EFF (after sustained efforts in the face of earlier setbacks), including the move to inflation-targeting and greater operational independence of the central bank (which was under renewed threat at the time of these interviews), elimination of quasi-fiscal deficits by NAFTOGAZ, restoration of financial stability by inter alia, cleaning up troubled and insolvent financial institutions. However, except for the 2015 EFF, IMF-supported programs were seen as having insufficiently emphasized efforts to build institutional capacity, especially in the finance ministry, improve the business climate, and enhance economic governance, particularly strengthening the rule of law, anti-corruption measures, and judicial reforms. They stressed that reforms in these areas—even if outside the Fund's core expertise—were critical to achieving faster real GDP growth over the medium term.

VII. ASSESSMENT AND LESSONS

74. Policy implementation under the five IMF-supported programs with Ukraine during 2008–2019 was mixed at best. All programs went quickly off track, averaging only one completed review per program. Program ownership tended to fade rapidly once the precipitating financial crisis waned. Overall, these programs were relatively more successful in achieving their targets for external adjustment than for real growth or making sustained headway with the lengthy structural reform agenda. Nonetheless after repeated efforts, notable achievements were made with respect to macroeconomic and financial stability, but much less progress was made in creating a growth-friendly business environment. One lesson is that where program ownership and reform commitments are broadly shared within the country, policy actions need to be frontloaded to take advantage of this "window of opportunity," while IMF financing should be less front-loaded to provide greater incentive to persevere with reform efforts. Moreover, country ownership assessments by staff need to be better grounded and more realistic, especially when exceptional access is considered.

75. Current account improvement was frequently better than programmed because domestic demand growth was slower than projected or contracted more than expected. To assess the relevant tradeoff between external adjustment and short-term real growth, it would be helpful if Policy Notes and staff reports were explicit as to the feedback from proposed policy recommendations to economic activity and the current account balance. Adverse feedback loops may also be stronger in downturns than in upturns. This proposal could be implemented by referencing/footnoting the fiscal (spending/revenue) multipliers, monetary sacrifice ratios, and relevant parameters, say pertaining to the impact of administrated price increases on household consumption.

76. In determining the appropriate current account adjustment, more consideration should be given to the current account norm—the current account balance consistent with medium-term fundamentals and desirable policies. Over the medium term, this norm should be sustainable based on the use of foreign savings on suitable terms. Thus, a benchmark would be provided to determine the appropriate medium-term balance between financing and adjustment. Of course, near-term external financing constraints may require greater near-term external adjustment.

77. Desirable fiscal policy in the medium-term needs, at a minimum, to be consistent with public debt sustainability. Debt sustainability analysis is an important tool but the baseline scenario and shocks—growth and real exchange rate—need to be realistically calibrated. Equally important is the willingness to recognize when debt dynamics are unsustainable and to avoid delays that allow the problem to get worse. Staff modified appropriately the Fund's policy on arrears to official creditors by bring it more in line with the policy on lending into arrears to private creditors. Ukraine's debt operation succeeded in quickly regaining its access to private international capital markets at reasonable cost, helping to spur investment and growth.

78. Structural conditions have been overwhelmingly (70 percent) concentrated in areas of the Fund's core expertise and supported by extensive technical assistance. These measures have helped to underpin largely successful efforts to achieve over time greater economic and financial stability. But outcomes have been less rewarding in areas outside the Fund's core expertise, such as governance and judicial reforms, which were intended, inter alia, to lift potential growth rates, notwithstanding the heightened attention given to governance issues in recent arrangements. While recognizing the challenges to overcoming deep-rooted obstacles to structural reform, greater success in this area may require drawing more intense coordination with other institutions, more precise linkage between specific reforms and expected outcomes, and sustained efforts to build support for reforms among domestic stakeholders.

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