

CEPS COMMENTARY



Thinking ahead for Europe

Preventing collapse in Ukraine: The EU should finance the grass roots directly

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The fighting has diminished in intensity, but the financial and economic situation in Ukraine continues to deteriorate. With the currency in free fall and the banking system in a systemic crisis, it is apparent that massive financial support is needed to prevent a collapse. A key question, however, is where should the money go.

Traditional support from the IMF goes to the government and is then used to support banks or to plug holes in the budget. The macro-financial assistance (MFA) of the EU is usually just a supplement to the IMF support to the government. So far, the European Commission has disbursed €1.36 billion to Ukraine under two ongoing MFA programmes for the country. Upon the disbursement of the most recent tranche of the loan, the European Commissioner for Economic and Financial Affairs, Taxation and Customs, Pierre Moscovici, announced: "Europe is delivering on its commitment of solidarity to Ukraine. We are providing essential financial support at a time of extraordinary economic and social challenges for the Ukrainian people. In turn, it is vital for the country to maintain the momentum of reform so as to create the conditions for sustainable prosperity for all Ukrainians."

The billions more that the EU has promised (see Annex) are not likely to be forthcoming any time soon, as the donors conference on Ukraine has been postponed until the new Ukrainian government develops a medium- to long-term strategy to implement structural reforms aimed at improving governance, delivering sustainable economic growth and supporting legal harmonisation with the EU. This risks leading to a long drawn-out process under which much-needed reforms, such as increasing energy prices, are delayed until the overall financial package has been agreed by all parties.

One important issue in this context, however, is whether the Ukrainian government should pay back the foreign financial support that matures in the future. Whereas the EU funds are on loan to Ukraine for a period of 15 years at a low interest rate, almost all experts agree that this condition does not make sense. The financial support from the IMF, the EU and other donors should not be used to finance the exit of foreign investors, especially given that a large share of Ukrainian bonds is held by one hedge fund.

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Instead of paying back the principal, the Ukrainian government should negotiate a rescheduling. This should be possible without generating any financial market instability, given that the case of rescheduling is obvious for a country in war.

However, even if the country can reschedule its debt it will need billions in financial support to plug the gaping hole in the budget, much of which comes from keeping energy and gas prices way below the import price the government has to pay to Gazprom. With energy prices aligned with world market prices, the need for budgetary support would be much reduced.

While the exhortation to 'increase energy prices' may sound easy, it needs to be accompanied by measures on the ground. Two areas are key: i) energy-saving investment and ii) support for the energy poor.

The EU could help on both fronts, and not just by providing funds to be spent on EU experts offering technical assistance. Rather than offering EU funding for technical assistance projects in Ukraine provided in the form of grants, contracts and – worryingly – budget support, what is needed is humanitarian assistance that alleviates the stress on those in need. Given the magnitude of corruption and inefficiency in the country, it would be irresponsible to channel a large amount of funding for this purpose through the government. Arguably, such funding should be disbursed directly to the beneficiaries on the ground, without going through the Ukrainian administration.

Experience in Eastern Europe, where energy prices had to be increased substantially in the 1990s, demonstrated that simple measures – such as better insulation, together with maintenance and repair of the region's many long-neglected central heating systems – yield a quick and substantial payoff in reducing energy intensity. Even a slight improvement in Ukraine's energy efficiency would significantly reduce the country's dependency on Russian gas.

Thus, what is needed is an emergency programme, to be administered directly by a joint EU-Ukrainian task force, under which energy savings projects can be evaluated, approved and paid for on the ground, at the neighbourhood level. One should send many hundreds of small groups (in the interest of speed probably organised by Member States, but acting under an EU umbrella) to the municipalities, armed with euros and ready to disburse the money for thousands of small projects with a minimum of formality but a maximum of transparency (e.g. quick but open tenders, with 'neighborhood committees' allowed to see all the bills). Central and Eastern European member states, especially those whose languages are similar to Russian and Ukrainian, should be able to quickly mobilise the required technical expertise. Rapid disbursement of the funds would also have a strong impact on local economies and on public opinion, even on the minority who still views the EU with suspicion.

Local NGOs and other civil society organisations, which are trusted much more than the administration, should be involved at all stages. The EU knows them and has recently earmarked €10 million to support civil society organisations in the country.

A similar approach should be used to provide direct social-security assistance to the energy-poor. Instead of providing billions to the Ukrainian ministries, the money could be spent much better by handing out cash in euros on the ground. Here again a large number of small groups would be needed to cross-check social-security records and heating bills to verify the case for compensation for higher energy prices and thus avoid abuse and misuse of the programme.

This approach would constitute a sea change in the way the EU supports Ukraine. The overall financial assistance by the EU to the country exceeds €10 billion euro, but direct expenditure on the ground (for humanitarian and recovery support) amounts to less than €100 million, or

about 1% of the total. This is the wrong proportion. Given the widespread government corruption and inefficiency, such programmes will be nothing more than a drop in the ocean. What is needed are programmes that by-pass the authorities.

A delicate question is whether EU support should also be offered in the 'occupied areas'. We would recommend that this should be done only on the condition that the security of EU and member states' personnel can be guaranteed and that they are accompanied by independent OSCE observers. The offer should thus be valid also for the territories of the so-called Luhansk and Donetsk Peoples' Republics. If the self-declared authorities there do not accept these conditions, this would be clear evidence that they are not interested in the well-being of the local population.

In sum, the macroeconomic situation is disastrous and some macro-financial assistance to the government is unavoidable. But this kind of support should be limited to the necessary minimum. Independently of the macro picture, the EU should act on the ground by financing quick small-scale energy savings investments and a direct distribution of EU money to energy-poor pensioners. Directly distributing euros in this way would constitute a much more effective form of support as it would immediately benefit the local economy.

Annex: The standard approach: Throw billions at Kiev

The EU programme of financial and technical cooperation supports Ukraine's ambitious reform agenda. More than 250 projects are currently being carried out across a wide range of sectors, regions and cities in Ukraine. EU assistance focuses in particular on support for democratic development and good governance, regulatory reform and administrative capacity-building, infrastructure development and nuclear safety. EU funding for projects in Ukraine is provided in the form of grants, contracts and – increasingly – budget support.

On 5 March 2014, the European Commission agreed on a financial assistance package of at least €11 billion in loans and grants from the EU budget and EU-based international financial institutions, to:

- help stabilise Ukraine's economic & financial situation
- support transition
- encourage political and economic reforms
- support inclusive development.

Key elements of the package:

- €3 billion from the EU budget in the coming years, €1.6 billion in macro financial assistance loans (MFA) and an assistance package of grants of €1.4 billion
- Up to €8 billion from the European Investment Bank and the European Bank for Reconstruction and Development
- Potential €3.5 billion leveraged through the Neighbourhood Investment Facility
- Setting up of a donor coordination platform
- Provisional application of the Deep and Comprehensive Free Trade Area when Association Agreement is signed and, if need be, by autonomous frontloading of trade measures
- Organisation of a High Level Investment Forum/Task Force
- Modernisation of the Ukraine Gas Transit System and work on reverse flows, notably via Slovakia
- Acceleration of Visa Liberalisation Action Plan within the established framework; Offer of a Mobility Partnership
- Technical assistance on a number of areas from constitutional to judicial reform and preparation of elections

Source: http://eeas.europa.eu/delegations/ukraine/projects/list_of_projects/projects_en.htm