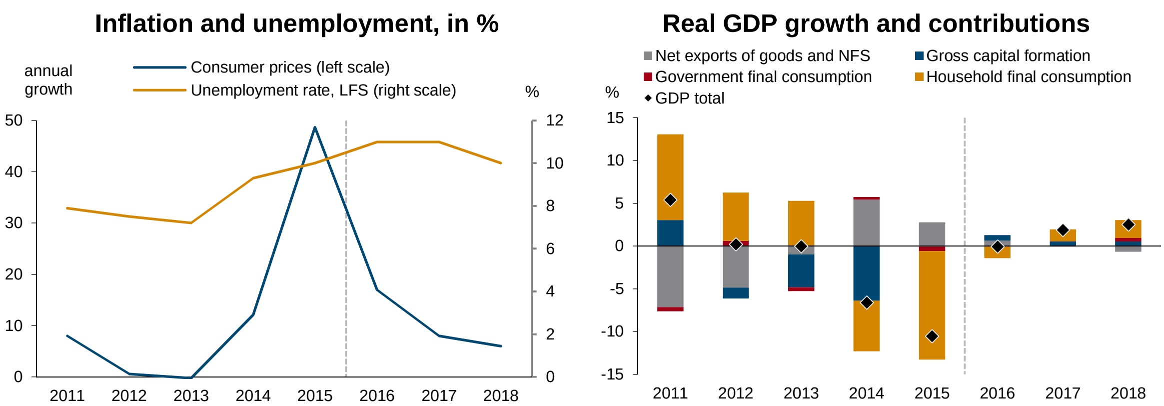

# UKRAINE: A 'deep free trade' EU partner

VASILY ASTROV

**Barring a resumption of large-scale fighting in Donbas, the economic decline has now most probably bottomed out. However, given the depressed domestic demand and the new restrictions on trade with Russia, which will not be offset by the newly established 'deep and comprehensive free trade' area with the EU, we forecast zero growth for the current year, followed by gradual acceleration to around 2% over the period 2017-2018.**

**Figure 57 / Ukraine: main macroeconomic indicators**




Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

On 1 January 2016, Ukraine entered the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU, which is an important part of a broader Association Agreement signed after the Maidan revolution. However, the majority of Ukrainian exports had enjoyed free access to EU markets already since April 2014 (except for some agricultural products which are subject to tariff quotas). Therefore, the entry of the DCFTA into force effectively meant the liberalisation of access to the Ukrainian market for EU exporters (albeit with 3-10 years transitory periods for some products such as cars). On top of that, the DCFTA requires Ukraine to progressively adopt EU standards and regulations (some 60% of the EU's *acquis communautaire*) in a broad range of areas, including technical regulations, sanitary and phytosanitary standards, customs procedures, competition and public procurement rules, intellectual property rights, energy law, etc.[65]

In the short run, the DCFTA will not bring any substantial economic benefit to Ukraine. It is indicative that so far, Ukrainian producers could not take full advantage of the (nearly) free access to EU markets: in 2015, Ukraine's exports to the EU fell by 27% (in US dollar terms), mostly on account of lower commodity prices, while export diversification towards more sophisticated products is hampered by the existing gap in standards and the lack of investments. On the other hand, the influx of European goods to Ukraine is likely to be mitigated by the weakness of the Ukrainian hryvnia, even with no import duties in place. In the medium and long run, compliance with EU standards could boost the competitiveness of Ukrainian products in EU markets. However, their implementation will take a long time, prove rather costly,[66] and will ultimately hinge on substantial inflows of FDI.

At the same time, following the failure of trilateral Ukraine-EU-Russia talks on alleviating the potential repercussions of the Ukraine-EU DCFTA on Russia, Russia retaliated with a number of measures effective from January 2016: it revoked the existing free trade agreement with Ukraine (implying that Ukrainian exports to Russia are now subject to the 'most-favoured-nation' WTO clause),[67] imposed an embargo on Ukrainian food, and restricted the transit of Ukrainian goods to third countries (mostly Central Asia and the Southern Caucasus) across Russian territory.[68] The losses for Ukraine resulting from the Russian food embargo should be rather modest (some USD 300 million, since Ukraine is now exporting only 2% of its agricultural output to Russia, mostly meat), but taking into account the higher Russian import duties on other products, the transit restrictions and other 'non-tariff barriers', the overall losses may reach according to some estimates up to USD 2 billion, or about 2% of GDP. Overall, and despite the recent slump, Russia is still Ukraine's single most important export destination, accounting for some 12% of its goods exports in 2015.

Under these conditions, the expected main engine of Ukraine's economic recovery this year – exports – may not run. In 2015 GDP declined by an estimated 10.5%. In the course of the year, however, the recession slowed down markedly: from -17.2% in the first and -14.6% in the second quarter to -7.2% in the third and -1.2% in the fourth quarter. This reflected above all a lower statistical base (the unfolding of the crisis already by the end of 2014), but also positive growth on a quarterly (seasonally adjusted) basis: 0.5% in the third and an impressive 1.5% in the fourth quarter of 2015.

The economic decline can be only partly blamed on the military conflict in Donbas: from 2015 onwards, statistics exclude territories under the rebels' control, which prior to the conflict used to account for some 8% of Ukraine's GDP. (Still, in the parts of the Donetsk and Luhansk regions which are under Kyiv's control, industrial production dropped by 35% and 66%, respectively, in 2015.) A more important driver of recession has been the dramatic slump in private consumption in the country in general: retail trade

65 The DCFTA is yet to be ratified by all 28 EU Member States. Most importantly, the Netherlands will hold a referendum on this issue on 6 April 2016.

66 The Ukrainian National Academy of Sciences estimated earlier that cumulated costs may add up to some EUR 160 billion over a period of ten years (based on the earlier experience of Visegrad countries and adjusting for the backwardness of the Ukrainian economy).

67 Belarus, Kazakhstan and other members of the CIS FTA have not followed Russia's example and maintain the free trade agreement with Ukraine.

68 Ukraine responded by imposing an import embargo on a number of Russian products, such as food, chemicals and railway equipment.

turnover declined by 21% last year, largely on account of the hryvnia depreciation, which eroded the purchasing power of households. At the same time, the fiscal austerity steps – first of all the nominal freeze of public sector wages and pensions up until September 2015 under conditions of very high inflation, reaching up to 60% on an annual basis – suppressed aggregate demand still further. It is telling that despite the deep recession (and the related operation of automatic stabilisers on the fiscal side), the budget deficit was actually *reduced* by about 3 pp of GDP, to an estimated 1.7% last year. While budget revenues declined only by 4% in real terms, expenditures dropped by 13%, with social protection, health and education all recording over-proportionate declines. On top of that, another 3 pp of GDP were 'saved' via a marked reduction in energy subsidies (which are not part of the government budget), as retail gas tariffs were hiked four times in April 2015.

In line with the IMF demands, the 2016 central budget targets a deficit of 3.7% of GDP and is based on a new tax code. The flat tax on personal incomes has been reinstated and set at 18% (instead of the progressive rate of 15-20% before).[69] The excise taxes on gasoline, tobacco and alcohol have been hiked but the 5-10% import surcharge imposed last year to improve the balance of payments has been now abolished. Most importantly, the single social contribution (payroll tax) paid by employers has been cut from an average rate of 41% to a flat rate of 22%, while the 3.6% single social contribution paid by employees has been abolished altogether. The idea behind is to create incentives to declare wages and thus to 'de-shadow' the economy. However, since other factors behind the widespread tax evasion – above all the reluctance to be exposed to the corrupt and arbitrary state apparatus – are arguably more critical than tax rates *per se*, tax compliance may not increase all that much. Therefore, the likely outcome will be a larger deficit of the Pension Fund and of the government budget as a consequence. On the expenditure side, public sector wages and pensions are to be indexed in two steps by a total of 12.5%, i.e. in line with the expected inflation, while debt service and defence spending are earmarked at 5% of GDP each. The latter is deemed necessary to finance the army, whose size has doubled over the past two years: from 146 to 280 thousand soldiers.

In December 2015, Ukraine defaulted on its USD 3 billion debt to Russia, and the dispute is subject to international arbitration. However, this is no longer an obstacle for the continuation of the USD 17 billion IMF Extended Fund Facility (EFF) programme, after the IMF has changed its rules allowing countries to be in arrears to official creditors. The EFF loan programme in place is one of the reasons why the National Bank has so far been successful in preserving relative exchange rate stability (another reason is extensive capital controls, including a 75% surrender requirement for export proceeds). The arriving IMF funds are virtually the only source of replenishing the foreign exchange reserves, as long as the current account is balanced and the inflows of private capital remain meagre. However, because of the disagreements over the 2016 budget and the slow reform progress, Ukraine has so far received only USD 6.7 billion within the EFF framework (instead of USD 10 billion originally earmarked for 2015), and any further delays – which are now highly likely following the collapse of the government coalition in February 2016 – will put downward pressure on the exchange rate.

Facing the generally depressed domestic demand and the new restrictions in trade with Russia, which are unlikely to be offset by increased exports elsewhere (at least in the short run), the recovery prospects are not very encouraging. We forecast zero growth this year, followed by gradual acceleration to around 2% in 2017-2018. On the other hand, the 'bottom' of economic decline has now probably been

[69] On top of that, personal incomes are subject to a 1.5% 'military tax', initially imposed to finance the 'anti-terrorist operation' in Donbas.

reached – barring a resumption of large-scale fighting in Donbas. The implementation of the political part of the Minsk-II ceasefire agreement, which was signed in February 2015 and was supposed to settle the conflict, has meanwhile been officially postponed until the end of 2016. Still, it is not clear how this can be accomplished, given that the agreement is very vague on political issues and open to contrasting interpretations, particularly when it comes to the sequencing of individual steps (constitutional reform, local elections, amnesty, and the restoration of control over the border with Russia by Ukraine) to be undertaken by the two sides. With no political settlement in place, the conflict is likely to become ‘frozen’ for the years to come.

## Table 26 / Ukraine: selected economic indicators

| | 2011 | 2012 | 2013 | 2014 | 2015 1) | 2016 | 2017 Forecast | 2018 |
|---|---|---|---|---|---|---|---|---|
| Population, th pers., average | 45,706 | 45,593 | 45,490 | 43,001 | 42,845 | 42,770 | 42,720 | 42,670 |
| Gross domestic product, UAH bn, nom. | 1,349 | 1,459 | 1,505 | 1,587 | 1,860 | 2,200 | 2,400 | 2,600 |
| annual change in % (real) | 5.4 | 0.2 | 0.0 | -6.6 | -10.5 | 0.0 | 1.9 | 2.5 |
| GDP/capita (EUR at exchange rate) | 2,700 | 3,100 | 3,100 | 2,300 | 1,800 | 1,800 | 1,900 | 2,000 |
| GDP/capita (EUR at PPP) | 6,500 | 6,600 | 6,600 | 6,600 | 5,500 | . | . | . |
| Consumption of households, UAH bn, nom. | 906 | 1,002 | 1,100 | 1,121 | 1,367 | . | . | . |
| annual change in % (real) | 15.7 | 8.4 | 7.7 | -8.3 | -18.0 | -2.0 | 2.0 | 3.0 |
| Gross fixed capital form., UAH bn, nom. | 248 | 283 | 273 | 224 | 265 | . | . | . |
| annual change in % (real) | 6.5 | 3.3 | -6.5 | -24.0 | -13.0 | 3.0 | 5.0 | 7.0 |
| Gross industrial production | | | | | | | | |
| annual change in % (real) | 8.0 | -0.5 | -4.3 | -10.1 | -13.4 | 1.0 | 2.5 | 3.5 |
| Gross agricultural production | | | | | | | | |
| annual change in % (real) | 19.9 | -4.5 | 13.3 | 2.2 | -4.8 | . | . | . |
| Construction output | | | | | | | | |
| annual change in % (real) | 18.6 | -8.3 | -14.5 | -20.4 | -14.9 | . | . | . |
| Employed persons, LFS, th, average | 20,324 | 20,354 | 20,404 | 18,073 | 16,200 | 16,000 | 16,000 | 16,200 |
| annual change in % | 0.3 | 0.1 | 0.2 | -6.4 | -10.4 | -1.2 | 0.0 | 1.3 |
| Unemployed persons, LFS, th, average | 1,733 | 1,657 | 1,577 | 1,848 | 1,800 | 2,000 | 2,000 | 1,800 |
| Unemployment rate, LFS, in %, average | 7.9 | 7.5 | 7.2 | 9.3 | 10.0 | 11.0 | 11.0 | 10.0 |
| Reg. unemployment rate, in %, end of period 2) | 1.8 | 1.8 | 1.8 | 1.7 | 1.6 | . | . | . |
| Average monthly gross wages, UAH 3) | 2,633 | 3,026 | 3,265 | 3,480 | 4,195 | 4,800 | 5,300 | 5,800 |
| annual change in % (real, gross) | 8.9 | 14.3 | 8.2 | -5.4 | -18.9 | -2.0 | 2.0 | 4.0 |
| annual change in % (real, net) | 8.7 | 14.4 | 8.2 | -6.5 | -20.2 | -2.0 | 2.0 | 4.0 |
| Consumer prices, % p.a. | 8.0 | 0.6 | -0.3 | 12.1 | 48.7 | 17.0 | 8.0 | 6.0 |
| Producer prices in industry, % p.a. 4) | 19.0 | 3.7 | -0.1 | 17.1 | 36.0 | 15.0 | 6.0 | 6.0 |
| General governm.budget, nat.def., % of GDP | | | | | | | | |
| Revenues | 29.5 | 30.5 | 29.4 | 28.7 | 35.1 | 29.0 | 29.0 | 29.0 |
| Expenditures | 31.2 | 34.0 | 33.6 | 33.3 | 36.7 | 32.7 | 32.5 | 32.5 |
| Deficit (-) / surplus (+) 5) | -1.7 | -3.5 | -4.2 | -4.5 | -1.7 | -3.7 | -3.5 | -3.5 |
| Public debt, nat.def., % of GDP | 35.1 | 35.3 | 38.8 | 69.4 | 84.5 | 89.0 | 89.0 | 85.0 |
| Central bank policy rate, % p.a., end of period 6) | 7.75 | 7.50 | 6.50 | 14.00 | 22.00 | 15.0 | 12.0 | 10.0 |
| Current account, EUR mn 7) | -7,351 | -11,153 | -12,441 | -3,476 | -184 | -100 | -100 | -700 |
| Current account, % of GDP 7) | -6.0 | -7.9 | -8.8 | -3.4 | -0.2 | -0.1 | -0.1 | -0.9 |
| Exports of goods, BOP, EUR mn 7) | 44,812 | 50,127 | 44,518 | 38,235 | 31,677 | 31,700 | 32,300 | 33,600 |
| annual change in % | 25.7 | 11.9 | -11.2 | -14.1 | -17.2 | 0.0 | 2.0 | 4.0 |
| Imports of goods, BOP, EUR mn 7) | 57,764 | 67,124 | 61,185 | 43,626 | 34,567 | 33,900 | 34,600 | 36,300 |
| annual change in % | 34.8 | 16.2 | -8.8 | -28.7 | -20.8 | -2.0 | 2.0 | 5.0 |
| Exports of services, BOP, EUR mn 7) | 15,278 | 17,186 | 17,032 | 11,257 | 11,056 | 11,100 | 11,700 | 12,300 |
| annual change in % | 10.6 | 12.5 | -0.9 | -33.9 | -1.8 | 0.0 | 5.0 | 5.0 |
| Imports of services, BOP, EUR mn 7) | 9,613 | 11,351 | 12,141 | 9,350 | 9,213 | 9,200 | 9,700 | 10,200 |
| annual change in % | 0.4 | 18.1 | 7.0 | -23.0 | -1.5 | 0.0 | 5.0 | 5.0 |
| FDI liabilities (inflow), EUR mn 7) | 5,177 | 6,360 | 3,396 | 641 | 2,854 | 3,000 | . | . |
| FDI assets (outflow), EUR mn 7) | 138 | 762 | 324 | 414 | 96 | 300 | . | . |
| Gross reserves of NB excl. gold, EUR mn | 23,593 | 17,186 | 13,592 | 5,429 | 11,320 | . | . | . |
| Gross external debt, EUR mn 7) | 97,940 | 102,120 | 102,852 | 103,557 | 115,000 | 120,000 | 123,000 | 125,000 |
| Gross external debt, % of GDP 7) | 80.5 | 71.9 | 72.5 | 102.6 | 149.8 | 163.6 | 164.0 | 158.7 |
| Average exchange rate UAH/EUR | 11.092 | 10.271 | 10.612 | 15.716 | 24.229 | 30.0 | 32.0 | 33.0 |
| Purchasing power parity UAH/EUR 8) | 4.547 | 4.814 | 5.011 | 5.621 | 7.861 | . | . | . |

1) Preliminary and wiiw estimates. - 2) In % of working age population. - 3) Enterprises with 10 and more employees. - 4) Domestic output prices. From 2013 according to NACE Rev. 2. - 5) Without transfers to Naftohaz and Pension Fund and costs of bank recapitalisation. - 6) Discount rate of NB. - 7) Converted from USD. - 8) wiiw estimates based on the 2011 International Comparison Project benchmark.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.