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Ukraine:
Association agreement with the EU delayed

In Ukraine, booming private consumption and a bumper harvest contributed to an impressive 5% GDP growth in 2011. The budget situation improved markedly, and currency depreciation pressures were successfully counteracted. However, the recent monetary policy tightening coupled with weak external demand will likely dampen the growth prospects this year, possibly to below 4%, while dependence on external funding will remain a source of risk for financial stability. Following the 'Tymoshenko case', the association and free trade agreement with the EU have been put on hold and are unlikely to be signed before the end of 2012.

The eurozone crisis and the turbulence in international financial markets have so far had only a limited impact on Ukraine's real economy. After soaring by 6.6% in the third quarter (year-on-year), GDP posted still respectable 4.6% growth in the fourth quarter of 2011. This translated into 5.2% growth for 2011 as a whole – slightly above our earlier forecast. Judging by the booming retail trade turnover (by nearly 15% in real terms), private consumption was the main growth pillar last year, backed by both increased disposable incomes and a higher propensity to spend. Also the replenishment of inventories and investments in fixed capital (+21% in the first nine months of 2011) contributed strongly to economic growth, the latter benefiting in particular from the government-sponsored infrastructure projects ahead of the 2012 European football championship. At the same time, public consumption probably declined and real net exports became more negative, as imports grew ahead of exports.

Across sectors, agriculture grew the fastest in 2011, largely thanks to a record-high grain harvest: some 57 million tons, or 44% higher than in 2010. Construction output was boosted by the pick-up in investments, particularly in the second half of 2011. By contrast, industrial production slowed down by the end of the year, partly because of the weakening of global demand for Ukraine's key exports such as metals and chemicals.

Thanks to good economic performance and increased tax compliance, tax revenues rose by 20% in nominal terms in 2011. As a result, the official budget deficit fell to a mere 1.8% of GDP (from 6% of GDP the year before), even if fiscal policy was not overly restrictive.

However, taking into account the losses of the state-owned energy company Naftohaz, the consolidated deficit reached some 3.5% of GDP. At the same time, the government's borrowing needs were mitigated by strong privatization receipts (0.9% of GDP), mostly stemming from the sale of Ukrtelecom to an Austria-based investment fund. Also, in the course of 2011, Ukraine did not receive any tranches within the framework of the IMF stand-by programme, as the government refused to comply with the IMF requirement of raising gas tariffs for households. As a result, by the end of 2011 the stock of public debt fell to 36% of GDP (from 40% at the end of 2010).

Fiscal prudence, strong economic growth and (still) fairly high inflation suggest that the ratio of public debt to GDP will probably decline further in the coming years – barring strong currency devaluation.[1] The government target for 2012 is to further reduce the budget deficit to 2.5% of GDP (including transfers to Naftohaz). The low planned deficit is not least a reflection of the recent borrowing difficulties the government has been facing in the environment of increased risk aversion and elevated devaluation expectations. In September-October 2011, the yields on hryvnia-denominated bonds shot up markedly, prompting the government to issue US dollar-indexed bonds and ultimately US dollar-denominated bonds instead. The borrowing problems may well persist in the months to come given the still unresolved eurozone crisis and its possible spillovers to emerging markets. Therefore, reliance on privatization revenues, which in 2012 are targeted at UAH 10 billion, may become all the more important. On the government's privatization list are notably stakes in regional energy companies.

The turmoil in international financial markets and the devaluation expectations in the last four months of 2011 put the hryvnia under considerable pressure. In response, the National Bank drastically tightened monetary policy and sold USD 6.4 billion out of its reserves. So far, these efforts have proved successful: the depreciation pressures have recently subsided, and the exchange rate has never left the narrow band of 8-8.1 UAH per USD. It is however questionable whether this peg can be credibly sustained, given the marked widening of the current account deficit last year (to 5.6% of GDP, from 2.2% of GDP in 2010) and the potential fragility of external funding in the coming months.

On the one hand, as a result of the recent monetary policy tightening, the stock of outstanding consumer loans fell by nearly 4% in nominal terms in the last four months of 2011, and the overall dynamics of domestic credit was also negative. These developments

[1] The share of public debt denominated in foreign currency stands at around 60%.

came on top of the already weak lending activity last year,[2] partly caused by the ongoing losses of the banking sector (albeit on a much smaller scale than in 2010). Also, foreign-owned banks – which account for some 40% of the sector – kept new lending virtually frozen and even withdrew some of their funds in the last quarter of 2011. Household deleveraging, if it continues, should dampen the growth of private consumption and of import demand this year.

On the other hand, Ukraine's import bill in 2012 may be inflated by the much higher price of imported natural gas (which is tied to the price of oil products with a 6-month lag) – unless the ongoing talks with Russia's Gazprom on revising the contract terms prove successful. In the first quarter of 2012, Ukraine is paying USD 416 per thousand cubic metres of gas (compared to USD 310 in the first quarter of 2011). Should the talks with Gazprom bear no fruit, currency devaluation might be difficult to avoid. However, a one-time devaluation by e.g. 10-15% – provided it is conducted in an orderly manner, ensures the credibility of the new exchange rate and thus prevents a dangerous build-up of expectations of further devaluation – would benefit the economy. It would improve external competitiveness and reduce current account imbalances without proving too costly for the authorities in political terms. Also, thanks to the enacted ban on foreign currency lending, the share of domestic credit denominated in foreign exchange has been declining over the past few years (from 59% in 2008 to 40% in 2011) so that the impact of devaluation on domestic borrowers and financial sector stability should be more modest.

The expected slower growth of both private consumption and investments in 2012 will translate into lower GDP growth which we project at some 4%, with risks on the downside. This pace of growth will probably be insufficient to bring down the unemployment rate, which will stay at around 8%. The poor economic performance in the eurozone should have only a moderate impact on Ukraine, whose foreign trade is geographically relatively well diversified. By contrast, the expected robust growth in Russia will continue benefiting Ukraine's exports of machinery. Although foreign trade developments should be more balanced than last year (we project imports and exports to grow at the same pace in 2012), the current account deficit is unlikely to improve even if the price of imported gas goes down, and will stay at about 6% of GDP. Inflationary pressures will most probably intensify: the low consumer price inflation last year (a mere 4.6% on an end-year basis) was caused by the one-time factor of plunging prices for sugar and vegetables after a bumper harvest, which is unlikely to be repeated. However, the low end-year inflation in 2011 will be

[2] In 2011 as a whole, the stock of consumer loans also declined by 4% (on an end-year basis), while the overall credit to the economy posted a 10% growth in nominal terms.

reflected in a low *average* inflation this year, which we expect not to exceed 5%. For subsequent years, we expect a pick-up of economic growth to some 5%, provided the eurozone crisis is resolved and the prices for Ukraine's exported commodities stay at a reasonably high level.

Following the indictment of the opposition leader and former prime minister Yuliya Tymoshenko (on charges of exceeding her authority in signing the 2009 gas contract with Russia), the signing of an Association Agreement and a related Deep and Comprehensive Free Trade Agreement with the EU was put on hold in December 2011. The reason is EU concerns with political developments in Ukraine exemplified by Ms. Tymoshenko's indictment. The latter is widely seen as an example of selective use of the judicial system for political purposes, raising questions about the adherence of the Ukrainian government to European 'values'. Meanwhile, further criminal cases have been opened against Ms. Tymoshenko, mostly related to her activities as head of Ukraine's Unified Energy Systems in the late 1990s. It is highly unlikely that she will be released prior to the forthcoming parliamentary elections in October 2012. Therefore, the chances that the Association Agreement with the EU will be signed (let alone ratified) until then – or indeed before the end of the year – are slim.

The latter does not necessarily mean that Ukraine will be advancing its integration into the alternative Russian-dominated integration block: the Customs Union and the Common Economic Space of Russia, Belarus and Kazakhstan. Apart from tricky political issues, Ukraine's accession to the Customs Union is complicated by its trade obligations resulting from its WTO membership (even though Russia is now joining the WTO as well). However, the current gas price negotiations with Russia's Gazprom may result in joint ownership of Naftohaz – with or without the involvement of the EU which has recently also shown interest in negotiations. Such a deal could bring Ukraine the benefits of a lower gas price in the short run and better prospects for the modernization of its crippled gas pipeline network in the medium and long run, although the transit revenues will also need to be shared. Besides, it would make the South Stream gas pipeline project almost certainly redundant, while European countries importing Russian gas via Ukraine will likely benefit from the improved security of gas supplies.[3]

The October 2012 parliamentary elections will be held according to the new rules. Half of the MPs will be elected by majority vote (instead of the pure party-list proportional

[3] The relevance of this issue was again demonstrated in January 2012 when the unusually cold weather in Ukraine and in vast parts of Europe resulted in gas supply shortages, with Russia and Ukraine putting the blame on each other as usual.

representation so far); the threshold for a party to get into the parliament will rise to 5% (from 3% before); and parties will not be allowed to form electoral blocks. These changes are aimed at favouring the big parties, notably the currently ruling Party of Regions, and have prompted the opposition forces to consolidate. Thus, the two smaller 'orange' parties (Reform and Order and People's Self-Defence) have announced their merger with Ms. Tymoshenko's Fatherland party, while more generally the 'orange' opposition parties have reportedly agreed to put up a list of joint candidates in majority constituencies. Also the new parliament will most probably be narrowly split between the pro-Russian and 'orange' forces, reflecting the country's profound regional divisions.

Table UA

Ukraine: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011 [1]	2012	2013 Forecast	2014
Population, th pers., average	46788	46509	46258	46053	45871	45700	45600	45500	45400
Gross domestic product, UAH mn, nom.	544153	720731	948056	913345	1082569	1314000	1434900	1612100	1777300
annual change in % (real)	7.3	7.9	2.3	-14.8	4.1	5.2	4	5	5
GDP/capita (EUR at exchange rate)	1800	2200	2700	1800	2200	2600	.	.	.
GDP/capita (EUR at PPP - wiiw)	5200	5800	6000	5100	5400	5800	.	.	.
Consumption of households, UAH mn, nom.	319383	423174	582482	581733	686082	829900	.	.	.
annual change in % (real)	15.9	17.2	13.1	-14.9	7.0	12	6	7	6
Gross fixed capital form., UAH mn, nom.	133874	198348	250158	167644	195927	246400	.	.	.
annual change in % (real)	21.2	23.9	-1.2	-50.5	4.9	9	7	8	8
Gross industrial production									
annual change in % (real)	6.2	7.6	-5.2	-21.9	11.2	7.3	5	6	6
Gross agricultural production									
annual change in % (real)	2.5	-6.5	17.1	-1.8	-1.5	17.5	.	.	.
Construction output									
annual change in % (real)	9.9	15.6	-15.8	-48.2	-5.4	11.1	.	.	.
Employed persons - LFS, th, average	20730.4	20904.7	20972.3	20191.5	20266.0	20290	20300	20350	20400
annual change in %	0.2	0.8	0.3	-3.7	0.4	0.1	0	0.2	0.2
Unemployed persons - LFS, th, average	1515.0	1417.6	1425.1	1958.8	1785.6	1760	.	.	.
Unemployment rate - LFS, in %, average	6.8	6.4	6.4	8.8	8.1	8	7.9	7.7	7.5
Unemployment rate, reg., in %, end of period [2]	2.7	2.3	3.0	1.9	2.0	1.8	.	.	.
Average gross monthly wages, UAH [3]	1041.5	1351.1	1806.3	1905.9	2239.2	2633.0	.	.	.
annual change in % (real, gross)	18.4	15.0	6.8	-9.0	9.7	8.9	.	.	.
Consumer prices, % p.a.	9.1	12.8	25.2	15.9	9.4	8.0	5	7	5
Producer prices in industry, % p.a. [4]	9.6	19.5	35.5	6.5	20.9	19.0	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	31.6	30.5	31.4	29.9	29.1	30.3	.	.	.
Expenditures	32.3	31.6	32.8	34.0	35.0	32.1	.	.	.
Deficit (-) / surplus (+) [5]	-0.7	-1.1	-1.5	-4.1	-6.0	-1.8	-3	-3	-2.5
Public debt, nat.def., in % of GDP	14.8	12.3	20.0	34.8	39.9	36	34	33	32
Central bank policy rate, % p.a., end of period [6]	8.50	8.00	12.00	10.25	7.75	7.75	.	.	.
Current account, EUR mn [7]	-1289	-3849	-8721	-1242	-2274	-6666	-7500	-8000	-8500
Current account in % of GDP	-1.5	-3.7	-7.1	-1.5	-2.2	-5.6	-5.7	-5.7	-5.5
Exports of goods, BOP, EUR mn [7]	31048	36383	46274	28958	39321	49913	54900	63100	72600
annual growth rate in %	10.5	17.2	27.2	-37.4	35.8	26.9	10	15	15
Imports of goods, BOP, EUR mn [7]	35188	44100	57270	32046	45641	59851	65800	75700	87100
annual growth rate in %	21.3	25.3	29.9	-44.0	42.4	31.1	10	15	15
Exports of services, BOP, EUR mn [7]	9000	10337	12228	9936	12856	13839	15500	17100	18500
annual growth rate in %	19.9	14.9	18.3	-18.8	29.4	7.6	12	10	8
Imports of services, BOP, EUR mn [7]	7305	8571	11039	8248	9538	10517	11800	13500	15700
annual growth rate in %	20.7	17.3	28.8	-25.3	15.6	10.3	12	14	16
FDI inflow, EUR mn [7]	4467	7220	7457	3453	4893	5000	6000	7000	8000
FDI outflow, EUR mn [7]	-106	491	690	116	555	248	.	.	.
Gross reserves of NB excl. gold, EUR mn	16587	21635	21847	17825	25096	23593	.	.	.
Gross external debt, EUR mn	41391	54421	72109	72113	88363	95000	.	.	.
Gross external debt in % of GDP	48.2	52.2	58.6	85.8	86.0	80.2	.	.	.
Exchange rate UAH/EUR, average	6.335	6.918	7.708	10.868	10.533	11.092	11	11.5	11.5
Purchasing power parity UAH/EUR, wiiw [8]	2.229	2.663	3.417	3.921	4.366	4.958	.	.	.

1) Preliminary and wiiw estimates. - 2) In % of working age population. - 3) Excluding small enterprises. - 4) Domestic output prices. - 5) wiiw projections include transfers to Naftohaz. - 6) Discount rate of NB. - 7) Converted from USD with the average exchange rate. - 8) wiiw estimates based on the 2005 International Comparison Project benchmark.

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