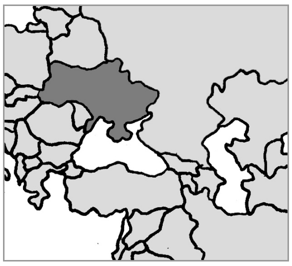

Vasily Astrov

Ukraine:
back to external equilibrium

Ukraine's economy has been hit hard by the falling world steel prices and the international credit crunch since September 2008. However, the latest data offer a mixed picture of the current situation. On the one hand, the developments in real GDP (-20.3% in the first quarter 2009 year-on-year), industrial production (-31.9% in January-May 2009), retail trade turnover (-15.3%), construction (-55.8%), fixed capital investments (-39.5% in the first quarter) and foreign trade (according to the customs statistics, in January-April 2009, merchandise exports and imports fell by 41.1% and 50.1% respectively, in US dollar terms) provide evidence of a near-collapse of the economy. The decline in industrial output has been broad-based, with machine-building falling by 53.6% in January-May, metals by 43.7% and chemicals by 35.8%, although the predominantly domestically-oriented food industry has performed much better (-7.3%). Also, unemployment has risen: in the first quarter 2009, the unemployment rate (according to LFS) stood at 9.5% – some 2 percentage points higher than in the first quarter 2008. Still, the surge in unemployment appears to be relatively small compared to what the dramatic contraction in output might suggest, which is partly due to the substantial wage flexibility (in January-May 2009, real wages fell by 10.4% year-on-year)[1] but also to the reluctance to undertake large-scale layoffs in big industrial enterprises, such as steel mills, forming the backbone of the local economy.

On the other hand, the combined effect of a pronounced devaluation (by about 50% against the US dollar since October 2008) and a deep domestic recession has made imports increasingly unaffordable[2] and thus has nearly restored the external equilibrium. According to preliminary estimates, in January-April 2009 the current account deficit stood at a mere USD 594 million (down from USD 5.6 billion in January-April 2008). The radical improvement in the current account and the National Bank's policy of targeted auctions (the sale of foreign exchange for special purposes such as foreign debt repayment, payment for import contracts, and the servicing of foreign-currency loans by private individuals) have brought about a turnaround to the depreciation expectations, reducing the incentives of households to withdraw bank deposits and convert them into foreign currency. In April-May 2009, the volume of private deposits rose by UAH 2.5 billion (after declining by some UAH 20 billion in the first three months of the year), and in May 2009 the National Bank abolished the

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1 Of course, the falling wages reduce domestic consumer demand and thus aggravate the recession.

2 Imports have also been dampened by the Russian natural gas supply cuts in January 2009 in the wake of the Russian-Ukrainian gas price dispute, by Ukraine's strategy over the following months to minimize gas imports in anticipation of declining prices (in line with the new formula linking the gas price to that of oil), and by a temporary 13% extra import duty imposed at the end of 2008 (for a number of goods such as cars and refrigerators, the duty is still in place).

moratorium on premature deposits withdrawal. At the same time, the hryvnia strengthened somewhat in May 2009, stabilizing at around 7.6 UAH per USD.

Concerns over the prospects of a sovereign default have subsided, too, resulting in plummeting credit-default-swaps spreads (from exorbitant levels in excess of 50% to below 20%) and allowing the government to resume borrowing, at least in domestic capital markets. Also, after the initial devaluation-driven spike, consumer price inflation has calmed down (in the first five months of 2009, consumer prices rose by 7.4%), permitting the National Bank to marginally cut its discount rate to 11% p.a. in June. Last but not least, consumer confidence has been improving (although it remains to be seen to what extent this will actually translate into higher consumption propensity, particularly given the ongoing credit crunch in the retail segment – more on that, see below).

Given limited own fiscal resources and the blocked access to international capital markets, Ukraine – unlike e.g. advanced OECD countries or Russia – is hardly in a position to implement a fiscal stimulus programme to mitigate the impact of the crisis on the real economy. Until recently, its concerns have been largely on the external front, making it seek an IMF stand-by loan worth USD 16.4 billion (of which USD 4.5 billion were transferred in November 2008). Indeed, even with the sharply improved trade and current accounts, the overall balance of payments has been deeply in the red due to substantial net capital outflows (USD 5.7 billion in January-April 2009), resulting initially from household demand for foreign cash and more recently from a hike in external debt repayments. The fact that originally the IMF package was aimed exclusively at solving the balance of payments problems – rather than at easing the impact of the crisis on the real economy – was exemplified by the IMF conditionality of a deficit-free budget for 2009 (ultimately ignored by the Ukrainian government).

However, more recently, the marked improvement of the external position and the seemingly mounting problems on the fiscal side[3] have brought about an important shift in the IMF priorities. Thus, USD 1.5 billion of the USD 2.8 billion worth second IMF tranche released in May 2009 is to be used for covering the 2009 central budget deficit targeted at 4% of GDP. In reality, the deficit will probably turn out to be higher – even despite the fiscal consolidation measures approved in order to meet the IMF requirements.[4] So far, the government strategy in the fiscal area has been to focus on social expenditures – not least due to prime-minister Ms Tymoshenko running for presidency. Budget cuts fall mostly on investment programmes and partly explain the above-mentioned collapse in investment activity.

3 Although the Ministry of Finance reports on the favourable fiscal situation (e.g., in January-April 2009, the central budget revenue target was over-fulfilled by 3.9%), this appears to be due to a number of accounting tricks and continuous downward revisions of revenue targets. In any case, in the first quarter of 2009, revenues of the consolidated budget were down 11.5% year-on-year. It was particularly import duties which have recorded a strong decline in line with the plummeting imports, while excise taxes collection has actually gone up.

4 These measures, summing up to nearly 1% of GDP, included *inter alia* raising the revenues of the Pension Fund and adopting a financial plan for the state-owned energy monopoly Naftogaz.

The 4% budget deficit target does not take into account the costs of the bank recapitalization programme (UAH 44 billion envisaged for 2009), which is also a key IMF requirement. The government has drafted a list of five big domestically-owned banks in need of recapitalization and has already taken decision on acquiring the majority stakes in three of them (Rodovid Bank, Ukrgazbank and Bank Kyiv) for a total of UAH 9.6 billion, to be financed by the National Bank.[5] At the same time, the foreign-owned banks (accounting for some 40% of the sector's assets) started receiving parent funding for the purpose of recapitalization. Despite that, credit activity remains virtually frozen: between January and April 2009, the volume of total credits declined by 2.6%, and of those denominated in foreign currency by 7.9%. Besides, there is evidence of a declining loan quality, which is hardly surprising against the background of the severe output slump and the pronounced currency devaluation given that more than half of all loans are denominated in foreign exchange (58.2% at the end of March 2009). According to the IMF methodology (taking into account sub-standard loans), the share of non-performing loans stood at 24% at the end of March 2009, up from 17.7% at the beginning of the year. In the retail lending segment, insolvencies and debt restructurings have already been widely reported, while large-scale defaults in the corporate sector are still likely to come.

Despite the 20% fall in real GDP in the first quarter 2009, we expect the GDP decline for the year as a whole to be somewhat smaller, albeit still double-digit. This is not least due to the fairly good grain harvest expectations and the very low statistical base in the fourth quarter of last year.[6] The good harvest should also help further disinflation (to around 16% on an annual average) and boost the current account which may well turn positive throughout the rest of this year (for 2009 as a whole, we expect the current account to be broadly balanced). In the medium term, the country's exporters (in the food and machinery sectors, for example) could take advantage of the new competitive exchange rate and thus become a locomotive for the modest economic recovery projected for next year. Any recovery in steel prices (as well as the prices of other commodities) would also be crucial for both the medium- and the long-term prospects. Helped by the growing export revenues, domestic demand may also pick up gradually, albeit not as rapidly as over the past few years, since access to credit will ease only gradually and unemployment will initially hardly recede, making upward wage pressures rather unlikely. (This export-led growth scenario hinges on the external environment not being too unfavourable – otherwise the economic recession will continue well into 2010 and possibly thereafter.)

Protracted efforts to create a coalition between the party of the current prime-minister Yuliya Tymoshenko (BYuT) and the pro-Russian opposition Party of Regions (led by Viktor Yanukovych) – which would have involved major constitutional amendments turning Ukraine into a parliamentary republic – have failed, opening the door to the next presidential elections probably taking place in January 2010. With the popular rating of incumbent president Yushchenko in the one-digit range, the two favourites to win the elections are currently Mr Yanukovych, followed by Ms Tymoshenko. Either

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5 Two other banks – Nadra and Ukrprombank – should follow suit once they reach agreements on the restructuring of their foreign debt.

6 In the fourth quarter of 2008, real GDP contracted by 8% year-on-year.

way, the country's foreign policy orientation following the elections should become more multi-vectoral, although this may not necessarily have direct implications for the economy (the lower probability of further 'gas wars' with Russia being an important exception). In any case, more than half a year left until the elections is a long time span, particularly by Ukrainian standards.

Table UA

Ukraine: Selected Economic Indicators

	2005	2006	2007	2008 1)	2008 1st quarter	2009 1st quarter	2009 Forecast	2010 Forecast	2011 Forecast
Population, th pers., average	47105	46788	46509	46258	46330	46112	46000	45800	45600
Gross domestic product, UAH mn, nom.	441452	544153	720731	949864	187717	.	980600	1114700	1281300
annual change in % (real)	2.7	7.3	7.9	2.1	6.3	-20.3	-11.0	1.5	4.5
GDP/capita (EUR at exchange rate)	1500	1800	2200	2700	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	4700	5200	5900	6400	.	.	.	.	.
Consumption of households, UAH mn, nom.	252624	319383	423174	576565	125825	.	.	.	.
annual change in % (real)	16.6	15.9	17.2	11.8	22.5	-11.6	-12.5	2	6
Gross fixed capital form., UAH mn, nom.	96965	133874	198348	258176	49604	.	.	.	.
annual change in % (real)	3.9	21.2	23.9	1.9	19.4	-48.7	-30	2.5	12
Gross industrial production									
annual change in % (real)	3.1	6.2	10.2	-3.1	7.8	-31.9	-18	3	7
Gross agricultural production									
annual change in % (real)	0.1	2.5	-6.5	17.5	0.2	1.7	.	.	.
Construction industry									
annual change in % (real)	-6.6	9.9	15.6	-16.0	1.7	-56.7	.	.	.
Employed persons - LFS, th, average	20680.0	20730.4	20904.7	20972.3	20715.2	20005.1	.	.	.
annual change in %	1.9	0.2	0.8	0.3	0.9	-3.4	.	.	.
Unemployed persons - LFS, th, average	1600.8	1515.0	1417.6	1425.1	1578.2	2096.9	.	.	.
Unemployment rate - LFS, in %, average	7.2	6.8	6.4	6.4	7.4	9.5	8.5	8	7.5
Reg. unemployment rate, in %, end of period	3.1	2.7	2.3	3.0	2.3	3.1	.	.	.
Average gross monthly wages, UAH 2)	806.2	1041.4	1351.0	1806.0	1619.0	1736.0	.	.	.
annual change in % (real, gross)	20.4	18.4	15.0	6.8	13.3	-12.3	.	.	.
Consumer prices, % p.a.	13.5	9.1	12.8	25.2	22.5	20.4	16	12	10
Producer prices in industry, % p.a. 3)	16.7	9.6	19.5	35.5	26.9	17.3	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	30.4	31.6	30.5	31.3	32.5	.	.	.	.
Expenditures 4)	32.2	32.3	31.6	32.8	29.5	.	.	.	.
Deficit (-) / surplus (+), % GDP	-1.8	-0.7	-1.1	-1.5	3.0	.	.	.	.
Public debt in % of GDP	17.7	14.8	12.5	19.9	9.4	19.1	.	.	.
Discount rate of NB, % p.a., end of period	9.5	8.5	8.0	12.0	10.0	12.0	.	.	.
Current account, EUR mn 5)	2030	-1289	-4320	-8838	-2472	-627	-800	500	1000
Current account in % of GDP	2.9	-1.5	-4.1	-7.2	-10.0	.	-0.8	0.4	0.7
Exports of goods, BOP, EUR mn 5)	28093	31048	36383	46274	9327	6494	35000	38500	42400
annual growth rate in %	4.4	10.5	17.2	27.2	12.7	-30.4	-24	10	10
Imports of goods, BOP, EUR mn 5)	29004	35188	44100	57846	12447	7367	39000	41300	45400
annual growth rate in %	21.4	21.3	25.3	31.2	29.6	-40.8	-33	6	10
Exports of services, BOP, EUR mn 5)	7503	9000	10337	12228	2384	2163	11600	11600	11600
annual growth rate in %	18.6	19.9	14.9	18.3	23.9	-9.3	-5	0	0
Imports of services, BOP, EUR mn 5)	6054	7305	8369	10579	2237	1959	9500	9500	9500
annual growth rate in %	13.6	20.7	14.6	26.4	21.2	-12.4	-10	0	0
FDI inflow, EUR mn 5)	6263	4467	7220	7457	1734	732	.	.	.
FDI outflow, EUR mn 5)	221	-106	491	690	111	12.2	.	.	.
Gross reserves of NB excl. gold, EUR mn	16058	16587	21634	21847	20535	18647	.	.	.
Gross external debt, EUR mn	33504	41391	54421	74287	55585	75160	.	.	.
Gross external debt in % of GDP	45.3	50.6	56.0	84.9	63.5	76.6	.	.	.
Average exchange rate UAH/USD	5.125	5.050	5.050	5.267	5.050	7.700	6.2	6.2	.
Average exchange rate UAH/EUR	6.389	6.335	6.918	7.708	7.559	10.065	10	9.5	9
Purchasing power parity UAH/EUR, wiiw 6)	1.986	2.229	2.639	3.211	.	.	.	.	.

1) Preliminary. - 2) Excluding small enterprises. - 3) Based on domestic output prices. - 4) Including lending minus repayments. - 5) Converted from USD with the average exchange rate. - 6) wiiw estimates based on the 2005 International Comparison Project benchmark.

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