UKRAINE: Bottoming out

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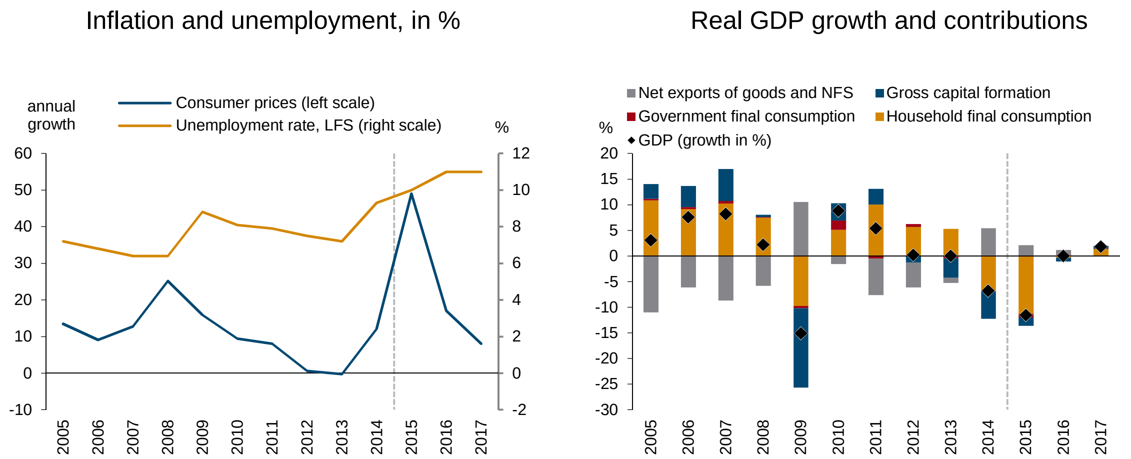
After three quarters of deep recession, the recent months suggest a gradual bottoming out of the economy, albeit at a very low level. Fiscal austerity and high inflation continue to weigh heavily on domestic demand, while exports have so far not been able to take full advantage of the competitive exchange rate. The recent sovereign debt restructuring should provide only a minor relief to the budget and will not prevent the public debt to GDP ratio from rising further.

Figure 62 / Ukraine: Main macroeconomic indicators



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

Ukraine continues to face formidable economic challenges: in the second quarter of 2015, real GDP fell by 14.6% year-on-year after an even bigger contraction in the first quarter (-17.2%). This time, the main drag on economic dynamics was private consumption which plunged by a whopping 28% on account of very high inflation – the legacy of both past currency devaluations and the gas tariff hike implemented as of 1 April. Public consumption exhibited a marked turnaround: after growing by 5% in the first quarter, it dropped by 7% in the second, as increased defence spending was apparently over-compensated by the drastic reduction in energy subsidies. Fixed investments declined as well, but not as strongly as in the first quarter (by 'only' 14%), while the contribution of net exports was once again positive, as imports fell ahead of exports (by 32% and 23% in real terms, respectively).

On a quarterly (seasonally adjusted) basis, however, GDP in the second quarter of 2015 was nearly unchanged (-0.5%), suggesting that the economy has finally started to bottom out. This is also confirmed by the recent monthly dynamics of industrial production: most indicators suggest that the decline has slowed down markedly and in some cases has been even reversed on an annual basis. The latter applies, for instance, to mining and metals production, which in September 2015 recorded 3% year-on-year output growth. One has to keep in mind that these could be the signs of fragile stabilisation at a very low level, which reflects above all the very low statistical base: the bulk of production declines took place in the second half of last year.

Generally, the dynamics of industrial production – though strongly negative (-16.6% in January-September 2015 year-on-year) – has been much more favourable than that of imports (-36% in US dollar terms in January-August, according to National Bank statistics). The domestic industry, particularly consumer goods production, has been able to benefit from the currency devaluation and gain market shares in an overall shrinking domestic market. However, industrial producers have been much more successful in substituting imports than in exporting: exports went down by 35% in January-August.

This can be only partly blamed on the destruction of production and transportation capacities in the war-torn Donbas:[61] the other provinces (except one) recorded strong export declines as well, including the country's industrial 'heartland' outside of Donbas: Dnipropetrovsk and Zaporyzhye (by 25% and 24% in January-July 2015, respectively). The reasons for the observed export slump are manifold and include the declining world commodity prices, e.g. for metals and grain, as well as the severe disruption of trade with Russia, particularly in the military sector.[62] However, it is also clear that industry has been unable to take advantage of the free access to the EU markets unilaterally granted since April 2014, at least so far. In January-August 2015, goods exports to the EU dropped by 36% – more than to some other regions such as Africa and Asia. While Ukrainian products may have now become price-competitive, other factors such as their generally inferior quality and the differences in standards apparently play a bigger role.

In the first eight months of 2015, budget revenues were reportedly 6.5% above the plan, boosted primarily by high inflation, and there is little doubt that the official deficit target of 4.1% of GDP for this year will be met or even over-shot. In addition, the recently agreed debt restructuring deal (see Box below) should provide a minor relief to the budget as well. These developments allowed the government to enact a 13% hike in public wages and pensions already in September 2015 – instead of December, as initially planned (some USD 450 million has been allocated for these purposes). Despite this welcome step, the overall fiscal stance remains highly restrictive: for instance, even after the recent hike, public sector wages and pensions still remain 25% below the level of December 2014 in real terms. We stick to our view that the wisdom of budget consolidation at a time of a severe recession is highly questionable – especially since it is not fiscal problems which are at the root of the current crisis.

[61] Areas under the separatists' control are no longer part of official statistics anyway.

[62] Goods exports to Russia declined by 59% in January-August 2015 in US dollar terms.

BOX 5 / UKRAINE'S DEBT RESTRUCTURING DEAL

On 27 August 2015, Ukraine reached an agreement on the restructuring of its privately held external sovereign debt worth some USD 18 billion. The deal was required by the IMF as one of the conditions for its Extended Fund Facility (EFF) loan package to Ukraine and comes close to meeting the stated IMF target of saving USD 15.3 billion in external debt payments over the period 2015-2018.

The details of the agreed deal are as follows:

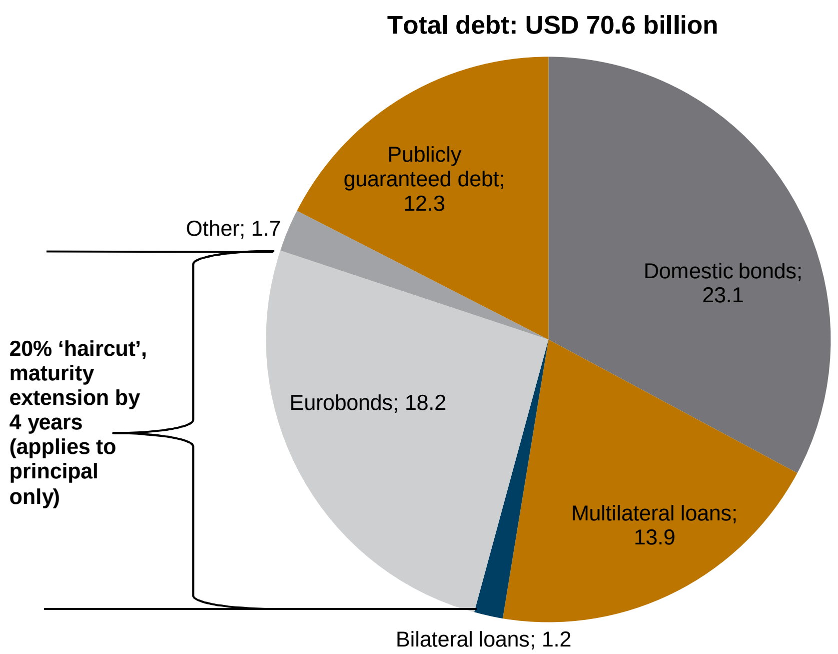
- a 20% debt 'haircut', corresponding to USD 3.6 billion;

- an extension of maturities by four years on the remaining debt, i.e. the redemption of bonds scheduled for 2015-2023 will take place in 2019-2027;

- the above extension applies to principal only; interest will continue to be paid in line with the original schedule and will be hiked to a uniform rate of 7.75% (instead of the weighted average rate of 7.22% previously);

- an issue of the so-called 'value recovery instruments' for the period 2021-2040, the yield on which will be indexed to real GDP growth: zero yield if GDP growth is below 3%, 15% of GDP growth exceeding 3%, and 40% of GDP growth exceeding 4%; these conditions will start to apply after Ukraine's GDP has exceeded USD 125.4 billion[63] (we project that this year GDP will stand at around USD 90 billion).

Figure 63 / Structure of public debt as of 31 August 2015, in USD billion



Source: Ministry of Finance of Ukraine.

[63] http://forbes.net.ua/nation/1402140-parlament-daet-dobro-vr-podderzhala-restrukturizaciyu-gosdolga

Our assessment of the agreed deal is mixed. On the one hand, it is a welcome step towards reducing the burden of debt service on the country's budget, which at 5% of GDP is rather high. However, the agreed 20% 'haircut' applies only to privately held external debt, which accounts for only one quarter of the total: neither domestic nor official external debt are affected – see Figure 63. Thus, USD 3.6 billion written off represents only 5% of total public debt. Because of the agreed higher interest on the remaining debt, the net annual savings to the budget should be only some 0.2% of GDP, according to our calculations. The savings will be even lower if Russia refuses to participate in the deal – as it has done so far, insisting that the USD 3 billion owed by Ukraine to Russia's National Welfare Fund in the form of Eurobonds and due in December 2015 should be treated as official rather than as private debt, which would make it ineligible for restructuring. Overall, given the scale of economic problems Ukraine is facing and the strong support by the IMF behind debt restructuring, it is conceivable that the government could have secured much better terms of the deal.

Finally, it should be borne in mind that the agreed 'haircut' on privately held debt will be more than offset by increased borrowing from official lenders. The latter should reach USD 16.3 billion this year, including USD 10 billion from the IMF and smaller amounts from the World Bank, the EU, EBRD, EIB and foreign governments. As a result, the stock of public debt (including debt of the National Bank) is likely to approach 100% of GDP by the end of 2015 – up from 70% last year.

How long the 'shock therapy' will be pursued remains however an open question, given that the popularity of Prime Minister Arseniy Yatsenyuk – the key figure behind the austerity course – has plunged to a mere 2-3%. He appears to be currently on the losing end both to President Poroshenko (whose protégé Mikhail Saakashvili, formerly president of Georgia and now governor of the important Odessa region, has been publicly at odds with Mr. Yatsenyuk) and Yuliya Tymoshenko, whose party has successfully managed to strike a delicate balance between being a junior partner in the ruling coalition and criticising the government's most unpopular reforms at the same time. Under these conditions, a major reshuffling of the government following the local elections on 25 October 2015 appears increasingly likely.

The prospects for economic recovery continue to be highly uncertain. While, as mentioned above, the recent months have shown certain signs of stabilisation, the dismal economic performance in the first half of 2015 makes us revise our GDP growth forecast for the year as a whole downwards, to -11.5%. With further energy tariff hikes on the government agenda, fiscal austerity will continue to weigh on both private and public consumption also next year (although probably less so than in 2015). In addition, any relaxation of foreign exchange controls – especially if done prematurely – may result in another wave of depreciation and inflation, adding to the erosion of real incomes. The uncertain status of Donbas – even assuming that the conflict is 'frozen' and no escalation of fighting takes place – is likely to dampen overall confidence and the investment climate. So, domestic demand will probably weaken further, although this may be offset by a tepid recovery of exports benefiting from ceasefire in Donbas and the newly competitive exchange rate, and result in overall GDP stagnation in 2016.

The Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU which will take effect in January 2016 involves not only chances but also risks. The latter may materialise if Ukraine fails to attract sufficient foreign direct investment to finance the costly adoption of numerous EU standards as required by the DCFTA agreement. Having already lost the bulk of the Russian market and facing highly uncertain prospects of successful EU integration, Ukraine runs the risk of being stuck 'in-between' for years to come.

Table 27 / Ukraine: Selected economic indicators

	2011	2012	2013	2014 1)	2014 January-June	2015 January-June	2015 Forecast	2016 Forecast	2017 Forecast
Population, th pers., average	45,706	45,593	45,490	43,001	43,031	42,876	42,820	42,770	42,750
Gross domestic product, UAH bn, nom. 2)	1,349	1,459	1,505	1,567	688	817	1,900	2,220	2,440
annual change in % (real)	5.4	0.2	0.0	-6.8	-2.9	-15.8	-11.5	0.0	1.8
GDP/capita (EUR at exchange rate) 2)	2,700	3,100	3,100	2,300	.	.	1,900	1,800	1,700
GDP/capita (EUR at PPP) 2)	6,500	6,700	6,800	6,600	.	.	.	.	.
Consumption of households, UAH bn, nom. 2)	906	1,002	1,100	1,108	521	571	.	.	.
annual change in % (real)	15.7	8.4	7.7	-9.6	2.1	-24.2	-16.0	-0.5	2.0
Gross fixed capital form., UAH bn, nom. 2)	248	283	273	219	97	99	.	.	.
annual change in % (real)	6.5	3.3	-6.5	-23.0	-18.4	-19.6	-18.0	-5.0	5.0
Gross industrial production									
annual change in % (real)	8.0	-0.5	-4.3	-10.1	-4.0	-20.5	-14.0	0.0	3.0
Gross agricultural production									
annual change in % (real)	19.9	-4.5	13.3	2.2	-3.9	-9.3	.	.	.
Construction output									
annual change in % (real)	18.6	-8.3	-14.5	-20.4	-7.8	-28.3	.	.	.
Employed persons, LFS, th, average	20,324	20,354	20,404	18,073	18,486	16,408	16,200	16,000	16,000
annual change in %	0.3	0.1	0.2	-6.4	-4.2	.	.	-1.2	0.0
Unemployed persons, LFS, th, average	1,733	1,657	1,577	1,848	1,730	1,667	1,800	2,000	2,000
Unemployment rate, LFS, in %, average	7.9	7.5	7.2	9.3	8.6	9.2	10.0	11.0	11.0
Reg. unemployment rate, in %, end of period 3)	1.8	1.8	1.8	1.7	1.7	1.7	.	.	.
Average monthly gross wages, UAH 4)	2,633	3,026	3,265	3,480	3,366	3,882	4,300	4,900	5,400
annual change in % (real, gross)	8.9	14.3	8.2	-5.4	-0.4	-22.1	-18.0	-2.0	2.0
annual change in % (real, net)	8.7	14.4	8.2	-6.5	-0.4	-23.9	-18.0	-2.0	2.0
Consumer prices, % p.a.	8.0	0.6	-0.3	12.1	5.8	48.1	49.0	17.0	8.0
Producer prices in industry, % p.a. 5)	19.0	3.7	-0.1	17.1	7.0	42.5	40.0	15.0	6.0
General governm.budget, nat.def., % of GDP									
Revenues	29.5	30.5	29.4	29.1	32.6	36.5	31.0	31.0	31.0
Expenditures	31.2	34.0	33.6	33.7	35.6	35.0	35.0	34.5	34.5
Deficit (-) / surplus (+) 6)	-1.7	-3.5	-4.2	-4.6	-3.0	1.5	-4.0	-3.5	-3.5
Public debt, nat.def., % of GDP	35.1	35.3	38.8	70.2	52.5	75.7	97.0	101.0	101.0
Central bank policy rate, % p.a., end of period 7)	7.75	7.50	6.50	14.00	9.50	30.00	18.0	12.0	10.0
Current account, EUR mn 8)	-7,351	-11,153	-12,441	-3,476	-1,479	-243	-1,100	-600	-600
Current account, % of GDP 8)	-6.0	-7.9	-8.8	-3.5	-3.0	-0.7	-1.4	-0.8	-0.9
Exports of goods, BOP, EUR mn 8)	44,812	50,127	44,518	38,235	19,447	15,421	31,800	32,500	33,100
annual change in %	25.7	11.9	-11.2	-14.1	-11.4	-20.7	-16.8	2.1	1.9
Imports of goods, BOP, EUR mn 8)	57,764	67,124	61,185	43,626	21,912	16,759	33,300	33,300	34,000
annual change in %	34.8	16.2	-8.8	-28.7	-22.5	-23.5	-23.7	0.0	2.0
Exports of services, BOP, EUR mn 8)	15,278	17,186	17,032	11,257	5,648	5,403	10,500	10,500	11,000
annual change in %	10.6	12.5	-0.9	-33.9	-26.8	-4.3	-6.8	0.0	5.0
Imports of services, BOP, EUR mn 8)	9,613	11,351	12,141	9,350	4,641	4,415	8,400	8,400	8,800
annual change in %	0.4	18.1	7.0	-23.0	-16.2	-4.9	-10.0	0.0	5.0
FDI liabilities (inflow), EUR mn 8)	5,177	6,360	3,396	641	-400	1,249	300	.	.
FDI assets (outflow), EUR mn 8)	138	762	324	414	318	79	300	.	.
Gross reserves of NB excl. gold, EUR mn	23,593	17,186	13,592	5,429	11,308	8,353	.	.	.
Gross external debt, EUR mn 8)	97,940	102,120	102,852	103,557	100,742	113,351	113,000	113,500	114,000
Gross external debt, % of GDP 8)	80.5	71.9	72.5	103.9	101.1	149.1	148.7	158.5	163.5
Average exchange rate UAH/EUR	11.092	10.271	10.612	15.716	14.1	23.9	25.0	31.0	35.0
Purchasing power parity UAH/EUR 9)	4.546	4.786	4.895	5.535	.	.	.	.	.

Note: From 2014 data and forecasts excluding the occupied territories of Crimea and Sevastopol and from 2015 (except for population) parts of the anti-terrorist operation zone. Construction and gross industrial production (including E (water supply, sewage, waste management, remediation) refer to NACE Rev. 2).

1) Preliminary. - 2) According to SNA'08. - 3) In % of working age population. - 4) Enterprises with 10 and more employees. - 5) Domestic output prices. From 2013 according to NACE Rev. 2. - 6) Without transfers to Naftohaz and costs of bank recapitalisation. - 7) Discount rate of NB. - 8) Converted from USD and based on BOP 6th edition. - 9) wiiw estimates based on the 2011 International Comparison Project benchmark.

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