UKRAINE: Military spending offsets IMF-imposed austerity

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In Ukraine, the ongoing military conflict in Donbass, curtailed trade relations with Russia and weakening private consumption are pushing the economy ever deeper into recession. Although the collapse in domestic demand combined with currency depreciation has brought about a marked rebalancing towards net exports, the balance-of-payments pressure remains strong owing to the current capital flight. Under the prevailing circumstances, were the GDP to stagnate next year, it could well be seen as a major achievement. That, however, hinges crucially on the prospects for a lasting peace settlement in Donbass, as well as a revival of trade with Russia.

Available statistics and the more abundant 'soft facts' provide evidence of Ukraine's economy in free fall. In the first quarter of 2014, the GDP decline was at 1.1% (year-on-year) still rather modest. However, it accelerated to 4.6% in the second quarter and 5.1% in the third quarter of 2014 (according to a preliminary estimate). For 2014 as a whole, the recession may reach however 8% given the expected deterioration in the fourth quarter. The main reasons behind are the ongoing war in Donbass, severe cuts in exports to Russia, and the IMF-led austerity package taking its toll on domestic demand.

Apart from the direct war-related damage to the local economy (see Box below), another consequence of the conflict in Donbass are the overall high risk perceptions – not only in the areas where direct fighting takes place. In the first half of 2014, fixed capital investment plunged by some 19% (starting from an already low level),[1] and foreign capital has been leaving Ukraine: in January-August 2014, FDI recorded net *outflows* of some USD 600 million. More recently, capital flight has primarily taken the form of foreign currency purchases, as the war in Donbass showed signs of escalation and depreciation expectations picked up accordingly. As a result, the hryvnia, which had already devalued by 50% in the first months of 2014, got under renewed pressure, prompting the National Bank to react. Although Ukraine has now a formal flexible exchange rate regime, further depreciation has been viewed as unwelcome and jeopardising the stability of both the banking system and the public finances.[2] To counter depreciation pressures, the National Bank resorted to a mix of further monetary policy tightening and administrative measures, including a 100% surrender requirement for the incoming foreign exchange (later reduced to 75%) and several steps aimed at curbing the foreign exchange demand, while the scope of market interventions has been constrained by the low level of reserves. The impact of

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[1] As a result, by the second quarter of 2014, the investment ratio plunged to a mere 13.9% of GDP.

[2] More than 30% of domestic loans and more than half of the public debt are denominated in foreign currency, mostly US dollars.

the implemented measures has been, however, short-lived at best: by the end of September 2014, the hryvnia had depreciated by another 15%, to levels around 14 UAH per USD, accompanied by reports about growing currency shortages and the emergence of a 'shadow' market for foreign exchange.

BOX 1 / WAR-RELATED ECONOMIC LOSSES IN THE DONBASS REGION

The Donetsk and Luhansk provinces – commonly referred to as Donbass – are located in the east of Ukraine and have a combined territory of 53 thousand square kilometres and a population of 6.5 million people. Home to coal mining and metallurgy, Donbass has traditionally been Ukraine's industrial heartland, accounting for 16% of GDP and a quarter of the country's exports.

In the first months of the conflict, it was primarily local small and medium-sized businesses which suffered the most. However, as the civil war was gaining momentum, the big industrial enterprises which form the backbone of the Donbass economy, such as those in the metals and chemicals sectors, became increasingly affected as well. In July 2014, statistics reported for the first time huge drops in industrial production: by 28.5% in the Donetsk and 56% in the Luhansk region (year-on-year). In August and September, the drops in industrial production were even bigger: by 59% in Donetsk and 85% in Luhansk, largely accounting for the drops of 21% (in August) and 17% (in September) in Ukraine as a whole (again year-on-year). Apart from shooting, the most important factor behind the halt in production have been damages to infrastructure, notably railway connections and electricity supply. For instance, 70% of coal mines have reportedly ceased operation because of electricity shortages and related flooding, although the lack of crucial inputs such as explosives played a role as well.

Deputy Prime Minister V. Groisman estimated the war-related damage in Donbass at USD 1 billion, with 35 cities and towns (out of 42) and over 11 thousand buildings and infrastructure objects destroyed to various degrees. An arguably more realistic estimate of the size of the damage has been provided by the head of Ukraine's Union of Industrialists and Entrepreneurs A. Kinakh: USD 7-8 billion, or 6% of GDP. The destruction of production capacities means that in the short run, up to 1.8 million people in Donbass may stay unemployed, according to official estimates. In the longer run, however, the problem will likely be the opposite: labour shortages due to the high number of refugees, many of whom may not come back. More than 1 million people have reportedly left Donbass since the outbreak of the military conflict, including 322 thousand to other regions of Ukraine and 875 thousand to Russia.

The exporting sector has been by and large unable to take advantage of the new, much more competitive exchange rate, at least so far. It is indicative that the substantial narrowing of the trade and current account deficits has been solely due to a collapse in imports (by 22% in January-August 2014),[3] while exports declined as well, albeit not as strongly (by 8%). One obvious reason for the export slump are the war-related destructions in Donbass. On top of that, Ukraine has banned the exports of military and dual-use goods to Russia, resulting in a disruption of the extensive value-chain links between the two countries dating back to Soviet times. All in all, exports to Russia – which in previous years was the

[3] The low import figure is partly due to the assumption of a low price of natural gas imported from Russia in April-June 2014: USD 268 per 1,000 cubic metres (cm). In reality, this is disputed by Russia, which calculates with a much higher price (USD 485 per 1,000 cm), resulting in a much higher value of exports to Ukraine recorded in Russian statistics. Because of the price dispute, Ukraine has not been importing any Russian gas since July 2014 pending a new agreement.

destination for around a quarter of Ukraine's exports – fell by 24% in the first seven months of 2014. Exports elsewhere have gone up, largely thanks to agricultural products, but not strongly enough to offset the export decline to Russia. In this situation, the decision to put on hold the implementation of the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU – part of a broader Association Agreement signed earlier this year – and maintain tariffs on imports from the EU at least until the end of 2015 is good news.[4] It will put a brake on the influx of European goods into Ukraine, while Ukrainian exporters will still be able to benefit from zero import duties unilaterally granted by the EU earlier this year. Of course, the suspension of DCFTA implementation – which represents an important reform 'anchor' – means probably also a delay in the badly needed economic reforms and restructuring. However, the latter would only have a positive impact on economic performance if accompanied by inflows of FDI, and FDI will not be coming as long as the conflict in Donbass and its future status remain unresolved, and the perceived risks of investing in Ukraine are high.

The deepening recession and the ongoing currency depreciation are not only aggravating the already severe balance-of-payments problems (the reason Ukraine obtained an IMF 'rescue package' in May 2014), but also increasingly undermine the sustainability of the public debt which has not been a major concern so far. This makes continuous funding from the IMF even more crucial: Ukraine has already received USD 4.5 billion from the IMF as part of a USD 17 billion agreed package, with another USD 2.6 billion potentially coming before the end of the year. Although the IMF conditionalities attached to the loan officially require budget austerity, in practice the latter has been offset by the ballooning military spending, seemingly tolerated by the IMF. In January-July 2014, budget revenues declined by only 3.5% in real terms, helped in part by a spike in inflation and the hikes in excise and property taxes and royalties implemented as part of the austerity package. State revenues are also benefiting from the 1.5% 'war' payroll tax introduced as of 1 August 2014, which is supposed to bring an estimated USD 240 million until the end of the year. According to official budget statistics, expenditures dropped much more than revenues: by 6.3% in real terms in the first seven months of 2014, with the bulk of cuts falling under the category 'national economy'. Public sector wages and pensions have been cut as well, and the minimum wage has been frozen, meaning a strong decline in real terms. By contrast, defence spending was raised sharply, although budget statistics do not give due account of the true costs of the so-called 'anti-terrorist operation' in Donbass. The USD 640 million budgetary allocations to 'defence' in the first seven months of 2014 represent only a fraction of the total campaign costs, which reached according to official estimations USD 4.9 billion, or 4% of GDP.[5] The expansionary macroeconomic impact of defence spending is confirmed by the strongly positive dynamics (+7%) of the 'collective component' of public consumption in the second quarter of 2014 (after a 12% decline in the 'pre-war' first quarter).

Increased military spending has not only 'crowded out' other essential payments, such as public sector wages and pensions, but has proved ultimately misplaced. As predicted earlier by wiiw, the Kyiv authorities have vastly overestimated their ability to resolve the conflict in Donbass by force, and the defeat of pro-government troops in the battle of Ilovaysk in early September paved the way for negotiations over an overhaul of Ukraine's constitutional set-up. A bill initiated by President Poroshenko after the peace initiative agreed in Minsk and hastily approved by the parliament on 16 September 2014

[4] It also means that Russia will probably not revoke its free trade regime with Ukraine; indeed, the decision to delay the implementation of the DCFTA was taken not least under Russia's pressure.

[5] This figure most likely does not include private financing of volunteer regiments which have been fighting on the government side.

granted the insurgent Donbass extensive autonomy in a number of areas and is a welcome step to end the war. However, given the degree of polarisation in the Ukrainian society, this compromise may be not accepted both by the rebels, who see Donbass as independent (or ideally as part of Russia), and by Ukrainian nationalists, who view the autonomy preferences granted to Donbass as a defeat. In addition, many details of the new arrangement remain unclear. Therefore, the current ceasefire continues to be highly fragile.

Given the fragility of the situation in Donbass, the strained trade relations with Russia and the adherence to the IMF-led austerity course, the economic outlook remains rather gloomy. In these circumstances, GDP stagnation next year could already be seen as an achievement. The latter would crucially hinge on a lasting ceasefire and on a revival of trade mending relations with Russia, including most notably the conclusion of a new gas supply contract. These two factors would first of all help Ukraine's exports, while domestic demand is likely to remain depressed for quite some time. In the longer term, a return to economic growth depends not least on the recovery in the euro area and on inflows of FDI, which could finance badly needed domestic reforms and restructuring.

Table 1 / Ukraine: Selected Economic Indicators

	2010	2011	2012	2013 1)	2013 January-June	2014 January-June	2014 Forecast	2015 Forecast	2016 Forecast
Population, th pers., average	45,871	45,706	45,593	45,490	43,162	43,031	43,000	42,950	42,920
Gross domestic product, UAH bn, nom. 2)	1,121	1,349	1,459	1,505	654	688	1,540	1,670	1,780
annual change in % (real) 2)	4.1	5.4	0.2	0.0	-1.1	-2.9	-8.0	-1.1	1.8
GDP/capita (EUR at exchange rate)	2,300	2,700	3,100	3,100	.	.	.	.	.
GDP/capita (EUR at PPP)	5,700	6,600	6,800	7,000	.	.	.	.	.
Consumption of households, UAH bn, nom. 2)	718	906	1,002	1,100	476	521	.	.	.
annual change in % (real) 2)	7.0	15.7	8.4	7.7	7.8	2.1	-4.0	-0.5	2.0
Gross fixed capital form., UAH bn, nom. 2)	202	248	283	273	109	97	.	.	.
annual change in % (real) 2)	3.4	6.5	3.3	-6.5	-5.7	-18.4	-20.0	0.0	4.0
Gross industrial production 3)									
annual change in % (real)	11.2	8.0	-0.5	-4.3	-5.0	-4.7	-11.0	0.0	3.5
Gross agricultural production									
annual change in % (real)	-1.5	19.9	-4.5	13.7	16.8	-3.9	.	.	.
Construction output 4)									
annual change in % (real)	-5.4	18.6	-8.3	-14.5	-17.8	-8.9	.	.	.
Employed persons, LFS, th, average	20,266	20,324	20,354	20,404	19,288	18,486	18,300	18,100	18,100
annual change in %	0.4	0.3	0.1	0.2	.	-4.2	-5.0	-1.0	0.0
Unemployed persons, LFS, th, average	1,786	1,733	1,657	1,577	1,576	1,730	.	.	.
Unemployment rate, LFS, in %, average	8.1	7.9	7.5	7.2	7.6	8.6	9.4	10.0	10.0
Reg. unemployment rate, in %, end of period 5)	2.0	1.8	1.8	1.8	1.7	1.7	.	.	.
Average monthly gross wages, UAH 6)	2,239	2,633	3,026	3,265	3,187	3,366	.	.	.
annual change in % (real, gross)	9.7	8.9	14.3	8.2	9.7	-0.3	.	.	.
annual change in % (real, net)	10.2	8.7	14.4	8.2	9.6	-0.4	.	.	.
Consumer prices, % p.a.	9.4	8.0	0.6	-0.3	-0.5	5.8	11.0	9.7	4.5
Producer prices in industry, % p.a. 7)	20.9	19.0	3.7	-0.1	0.0	7.0	12.0	10.0	5.0
General governm.budget, nat.def., % of GDP									
Revenues	28.1	29.5	30.5	29.4	32.3	32.6	.	.	.
Expenditures	33.8	31.2	34.0	33.6	36.6	35.6	.	.	.
Deficit (-) / surplus (+) 8)	-5.8	-1.7	-3.5	-4.2	-4.3	-3.0	-6.5	-5.5	-5.0
Public debt, nat.def., % of GDP	38.6	35.1	35.3	38.8	36.2	53.4	62.0	66.0	64.0
Central bank policy rate, % p.a., end of period 9)	7.75	7.75	7.50	6.50	7.00	9.50	.	.	.
Current account, EUR mn 10)	-2,272	-7,351	-11,153	-12,441	-4,171	-1,758	-3,800	-3,600	-4,500
Current account, % of GDP	-2.1	-6.0	-7.9	-8.8	-6.7	-3.6	-3.8	-3.2	-3.7
Exports of goods, BOP, EUR mn 10)	35,636	44,812	50,127	44,518	21,960	19,577	41,400	42,600	44,700
annual change in %	33.9	25.7	11.9	-11.2	-9.0	-10.9	-7.0	3.0	5.0
Imports of goods, BOP, EUR mn 10)	42,866	57,764	67,124	61,185	28,290	22,393	52,000	53,000	55,700
annual change in %	40.8	34.8	16.2	-8.8	-11.4	-20.8	-15.0	2.0	5.0
Exports of services, BOP, EUR mn 10)	13,808	15,278	17,186	17,032	7,714	5,698	13,600	13,600	14,300
annual change in %	28.9	10.6	12.5	-0.9	-3.7	-26.1	-20.0	0.0	5.0
Imports of services, BOP, EUR mn 10)	9,577	9,613	11,351	12,141	5,541	4,635	10,300	10,300	10,800
annual change in %	15.6	0.4	18.1	7.0	5.3	-16.3	-15.0	0.0	5.0
FDI inflow (liabilities), EUR mn 10)	4,860	5,177	6,360	3,396	1,315	-395	-500	1,000	1,500
FDI outflow (assets), EUR mn 10)	521	138	762	324	113	308	300	300	300
Gross reserves of NB excl. gold, EUR mn	25,096	23,593	17,186	13,592	16,671	11,308	.	.	.
Gross external debt, EUR mn 10)	88,363	97,940	102,120	102,852	102,832	100,536	.	.	.
Gross external debt, % of GDP	83.1	80.5	71.9	72.5	72.5	101.2	.	.	.
Average exchange rate UAH/EUR	10.533	11.092	10.271	10.612	10.5	14.1	15.5	15.0	14.5
Purchasing power parity UAH/EUR 11)	4.328	4.561	4.750	4.925	.	.	.	.	.

Note: Half-year data (population, GDP and its components, industrial production, LFS) and forecasts excluding the occupied territories of Crimea and Sevastopol.

1) Preliminary. - 2) According to SNA'08. - 3) From 2011 according to NACE Rev. 2 including E (water supply, sewerage, waste management, remediation). - 4) From 2011 according to NACE Rev. 2. - 5) In % of working age population. - 6) Enterprises with 10 and more employees. - 7) Domestic output prices. From 2013 according to NACE Rev. 2. - 8) Without transfers to Naftohaz. - 9) Discount rate of NB. - 10) Converted from USD and based on BOP 6th edition. - 11) wiiw estimates based on the 2011 International Comparison Project benchmark.

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