UKRAINE: Teetering on the brink

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The severe political crisis and the suspension of Russian credits have put the currency under strong downward pressure, prompting the National Bank to switch to a floating exchange rate regime and impose partial capital controls. The near-term economic prospects are hardly encouraging, with a balance-of-payments crisis and a bank run looming on the horizon. A 'rescue package' from the IMF is urgently needed to prevent this scenario. However, the 'austerity' conditionalities, which will likely be attached to such a package, will almost certainly push the economy into recession this year.

According to preliminary estimates, Ukraine's GDP picked up strongly in the fourth quarter 2013: by 3.7% year-on-year and 2.4% against the third quarter (in seasonally adjusted terms). However, this mostly reflected one-off factors such as the growth of agricultural output as the poor weather conditions in September postponed harvesting towards the end of the year. The strong economic performance in the fourth quarter 2013 fully offset the GDP decline in January-September, resulting in stagnation for the year as a whole. Viewed from the expenditure side, investments and net exports recorded marked declines, but private consumption saved the day, as lasting price stability and the gradual revival of consumer credit strengthened the purchasing power of households.

The spectacular 'U-turn' of the government just days before the planned signature of an Association Agreement (including a Deep and Comprehensive Free Trade Agreement) with the EU in November 2013 was largely driven by the economic 'carrots' provided by Russia, although concerns over the potential short-term adjustment costs of a free trade deal with the EU played a role as well. In particular, Russia agreed to a USD 15 billion worth purchase of Ukraine's sovereign eurobonds (of which USD 3 billion have already been transferred) with a preferential yield of 5% p.a. – far below the market rates of 8-9%, and comparable to terms typically offered by the IMF but without the usual IMF 'austerity' conditionalities, such as energy tariff hikes. Besides, Russia offered a 30% discount on the price of natural gas – a marked gain for Ukraine's energy-inefficient and gas-dependent economy after years of fruitless negotiations. This price discount, if sustained, should reduce both the country's import bill (by an estimated USD 3-4 billion per year) and the fiscal expenditures needed to bridge the gap between the high import price and the low level of domestic tariffs for households and district heating utilities.

The Russian credits provided a short-term relief to concerns over the sustainability of Ukraine's fixed exchange rate, which had been mounting in the face of persistently high external imbalances and the prospects of QE3 tapering in the United States, and refinancing costs for the country improved accordingly. However, the government's subsequent miscalculations in dealing with the public protests

which broke out following the EU agreement debacle have in fact reversed these gains and pushed the country into a severe political – and potentially economic – crisis. On the one hand, a one-off attempt at a crackdown and the adoption of restrictive laws effectively antagonised and radicalised the protesters, whose demands shifted towards resignation of President Viktor Yanukovych, early elections and an overhaul of the country's inefficient and deeply corrupt political system in general. On the other hand, the authorities have been unable to suppress the protests even as the latter turned violent and became increasingly dominated by nationalist radicals, mostly from the western provinces. This has exposed once again the inherent weakness of the Ukrainian state and the country's deep East-West divide. The concessions offered by President Yanukovych were 'too little too late' and could not prevent him and his Party of Regions from eventually losing power.[1] While the full economic impact of the recent 'revolution' is yet to be felt, the fragile macro-economic stability has already been shaken. Faced with the prospects of a new (anti-Russian) government, Russia has suspended its credit line, resulting in the transfer of another USD 2 billion being delayed and the scarcity of external sources of finance exerting a downward pressure on the hryvnia. After having spent USD 1.7 billion of reserves on interventions in the course of January 2014, the National Bank has been left with little choice but to allow the hryvnia to depreciate. Formally, the depreciation was allowed through the adoption of a 'managed float' regime which replaced the fixed rate of 8 UAH/USD (with a ±2% fluctuation band) maintained over the past four years. However, as the exchange rate exceeded 9 UAH/USD, the National Bank resorted to partial capital controls in order to avoid a stronger depreciation.[2] In response, the hryvnia strengthened temporarily to levels around 8.5 UAH/USD, but started sliding again thereafter, fuelled in part by the monetary relaxation aimed at easing the tight inter-bank lending market.

By the time of finalising this report (26 February 2014), an economic forecast with any reasonable degree of certainty would be highly speculative even in the short term. The currency has already depreciated by 25% against the US dollar since the exchange rate was abandoned – more than most other emerging economies' currencies. Part of this depreciation is to be seen as a welcome correction of the initial exchange rate over-valuation: many analysts, including wiiw, have consistently argued that the hryvnia has been overvalued already for several years – by up to 20% according to some estimates.[3] Therefore, provided the scope of the depreciation remains moderate, its impact on the real economy should be broadly positive. It should provide breathing space to exporters (who generate the bulk of GDP), create new opportunities for the import-competing industries, and thus benefit the entire economy without excessively eroding the purchasing power of households and their ability to service dollar-denominated loans which, despite the restrictions enacted after the 2008 crisis, still make up some 35% of all credits.

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[1] Instead, the power has been seized by a broad national-liberal coalition, with early presidential elections scheduled for 25 May 2014. Simultaneously, the parliament has reinstated the 2004 constitution which significantly upgrades the powers of the parliament and the prime minister (at the expense of the president), potentially paving the way to future policy stalemates – as they were common during the years of the 'orange' rule in 2005-2010.

[2] These controls included, most notably, a 6-day waiting period for companies wishing to buy foreign exchange, a UAH 50 thousand cap on the monthly amount of forex purchases by individuals, and a ban on buying foreign exchange for certain purposes such as early loan repayment and investing abroad.

[3] Conventional measures of external competitiveness, such as the real exchange rate, may not necessarily provide evidence for that. For instance, according to our calculations, during 2012-2013 the Ukrainian hryvnia even *depreciated* in real terms against the currencies of its major trading partners: the euro area and Russia (by 2.8% and 1.9%, respectively). However, this seemingly favourable real exchange rate dynamics should not be interpreted in a positive way, as it is largely based on the nearly stagnant producer prices which reflect not so much contained cost pressures but rather depressed global prices for some of Ukraine's key export products such as metals and chemicals.

However, it appears more likely that the extent of the depreciation may be much larger, reaching 30-40% or more, which may have adverse consequences for both the domestic demand and the stock of non-performing loans. Also, in the wake of the financial turmoil, the bond yields have jumped markedly (by up to 300 basis points), reflecting growing concerns over the external debt sustainability.[4] These concerns may become self-fulfilling, as rising borrowing costs make debt repayment all the more difficult, potentially creating a downward spiral driving the economy into insolvency. Ukraine's external debt stock is relatively high (75% of GDP), and the scheduled debt service in 2014 alone stands at USD 17.4 billion, corresponding to 10% of the estimated GDP and nearly matching the country's foreign reserves (USD 17.8 billion at the end of January). In addition, as demonstrated by the experience of numerous countries during the 2008 financial crisis, even relatively low debt levels provide no guarantee against insolvency in the case of a 'sudden stop'. Needless to say, a sharp currency devaluation, which can hardly be avoided unless the country promptly secures a new 'rescue package', would make the default scenario all the more likely. Another dangerous consequence of a sharp devaluation could be a panicky run on the banks, paralysing the payment system and pushing the economy almost certainly into recession.[5]

To prevent the looming balance-of-payments crisis, a new 'rescue package' is urgently needed. The recent radical change of the political landscape in Ukraine opens the possibility for a renewed deal with the IMF, which could replace the Russian 'package' and provide the necessary buffer to the country's fragile external liquidity position. However, the tough conditionalities which are likely to be attached to any IMF loan, such as energy tariff hikes for households and other austerity measures, will probably undermine private consumption and GDP growth and may have grave consequences for the fragile social stability, as illustrated by the recent events in Bulgaria and Bosnia and Herzegovina. On top of all that, political risks remain high. A victory of a pro-Western candidate such as Vitaly Klichko or Yuliya Tymoshenko (who has been released from prison) in the forthcoming presidential elections in May 2014 appears almost certain. However, domestic political stability will crucially depend on whether the new Kyiv authorities will be fully recognised in the predominantly Russian-speaking Southeast of the country, including Crimea where ethnic Russians make up the majority of the population. If the new authorities fail to accommodate the interests of the Russian-speaking provinces, this may give rise to separatist pressures and a potentially violent territorial break-up of the country.

In the longer term (2015-2016), a return to better growth prospects crucially depends on the recovery in the euro area and domestic reforms stimulating investments and restructuring. Given the country's location and the deep internal divisions, any future government will have little choice but to continue manoeuvring between the EU and Russia – at least until the relations between the latter two improve substantially, depriving Ukraine of the painful dilemma with respect to the choice of its foreign (economic) policy vector. As long as this is not the case, any major rapprochement with the EU (including association and deeper trade integration) and a marked increase in FDI from the West would be highly unlikely, resulting in further delays in modernisation and restructuring, particularly of the ailing industrial sector. However, FDI inflows may be boosted somewhat by the newly concluded deals on shale gas exploration with Shell and Chevron, which should further reduce the country's reliance on imported Russian gas.

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4 All three major rating agencies (S&P, Moody's and Fitch) have downgraded Ukraine's sovereign rating in response.

5 The currency depreciation so far has already triggered a massive outflow of private deposits from banks.

Table 1 / Ukraine: Selected Economic Indicators

	2009	2010	2011	2012	2013 [1]	2014	2015	2016
							Forecast	
Population, th pers., average	46053	45871	45706	45593	45490	45420	45350	45300
Gross domestic product, UAH bn, nom. [2]	913.3	1082.6	1302.1	1408.9	1444.0	1490	1580	1680
annual change in % (real)	-14.8	4.1	5.2	0.2	0.0	-1.1	0.9	1.8
GDP/capita (EUR at exchange rate)	1800	2200	2600	3000	3000	.	.	.
GDP/capita (EUR at PPP)	4800	5500	6400	6600	6700	.	.	.
Consumption of households, UAH bn, nom. [2]	581.7	686.1	865.9	986.5	1038.0	.	.	.
annual change in % (real) [2]	-14.9	7.1	15.7	11.7	5.5	0.0	1.5	2.0
Gross fixed capital form., UAH bn, nom. [2]	167.6	195.9	241.8	265.3	247.0	.	.	.
annual change in % (real) [2]	-50.5	3.9	7.1	0.9	-7.0	-4.0	2.0	4.0
Gross industrial production								
annual change in % (real) [3]	-21.9	11.2	8.0	-0.5	-4.3	0.0	2.0	3.5
Gross agricultural production								
annual change in % (real)	-1.8	-1.5	19.9	-4.5	13.7	.	.	.
Construction output								
annual change in % (real) [4]	-48.2	-5.4	18.6	-8.3	-14.5	.	.	.
Employed persons, LFS, th, average	20192	20266	20324	20354	20350	20350	20350	20350
annual change in %	-3.7	0.4	0.3	0.1	0.0	0.0	0.0	0.0
Unemployed persons, LFS, th, average	1959	1786	1733	1657	1650	.	.	.
Unemployment rate, LFS, in %, average	8.8	8.1	7.9	7.5	7.5	7.5	7.5	7.5
Reg. unemployment rate, in %, end of period [5]	1.9	2.0	1.8	1.8	1.8	.	.	.
Average monthly gross wages, UAH [6]	1905.9	2239.2	2633.0	3026.0	3265.0	.	.	.
annual change in % (real, gross)	-9.0	9.7	8.9	14.3	8.2	.	.	.
annual change in % (real, net)	-9.2	10.2	8.7	14.4	8.2	.	.	.
Consumer prices, % p.a.	15.9	9.4	8.0	0.6	-0.3	4.0	5.0	4.5
Producer prices in industry, % p.a. [7]	6.5	20.9	19.0	3.7	-0.1	4.0	5.0	5.0
General governm.budget, nat.def., % of GDP								
Revenues	29.9	29.1	30.6	31.6	30.7	.	.	.
Expenditures	34.0	35.0	32.4	35.2	35.1	.	.	.
Deficit (-) / surplus (+) [8]	-4.1	-6.0	-1.8	-3.6	-4.4	-5.0	-4.0	-3.5
Public debt, nat.def., % of GDP	34.8	39.9	36.3	36.7	40.5	46.0	44.0	43.0
Central bank policy rate, % p.a., end of period [9]	10.25	7.75	7.75	7.50	6.50	.	.	.
Current account, EUR mn [10]	-1242	-2274	-7359	-11138	-12157	-8500	-8500	-8100
Current account, % of GDP	-1.5	-2.2	-6.3	-8.1	-8.9	-7.4	-6.7	-6.0
Exports of goods, BOP, EUR mn [10]	28958	39321	49865	54646	48856	51300	54400	58200
annual change in %	-37.4	35.8	26.8	9.6	-10.6	5.0	6.0	7.0
Imports of goods, BOP, EUR mn [10]	32046	45641	61540	69801	63620	62300	65400	68700
annual change in %	-44.0	42.4	34.8	13.4	-8.9	-2.0	5.0	5.0
Exports of services, BOP, EUR mn [10]	9936	12856	13954	15404	15466	16200	17000	17900
annual change in %	-18.8	29.4	8.5	10.4	0.4	5.0	5.0	5.0
Imports of services, BOP, EUR mn [10]	8248	9538	9576	11396	12177	12800	13400	14100
annual change in %	-25.3	15.6	0.4	19.0	6.9	5.0	5.0	5.0
FDI inflow, EUR mn [10]	3453	4893	5177	6094	3000	4000	4500	5000
FDI outflow, EUR mn [10]	116	555	138	938	500	500	300	300
Gross reserves of NB excl. gold, EUR mn	17825	25096	23593	17186	13592	.	.	.
Gross external debt, EUR mn	72113	88363	97940	102454	103000	.	.	.
Gross external debt, % of GDP	85.8	86.0	83.4	74.7	75.7	.	.	.
Average exchange rate UAH/EUR	10.868	10.533	11.092	10.271	10.612	13.0	12.5	12.5
Purchasing power parity UAH/EUR [11]	4.166	4.293	4.470	4.710	4.753	.	.	.

1) Preliminary and wiiw estimates. - 2) According to SNA'93 (FISIM not yet reallocated to industries). - 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 (in 2009 excluding small enterprises). - 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 with the average exchange rate. - 11) wiiw estimates based on the 2011 International Comparison Project benchmark.
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.