Vasily Astrov

Ukraine:
Ample global liquidity helps maintain fragile status quo

In Ukraine improved access to global capital markets has markedly reduced devaluation pressures and secured financial stability without any need for a new IMF package. However, the economy is expected to come close to stagnation in 2013, although external imbalances are likely to improve somewhat on account of the newly introduced policies relating to protectionism and the energy sector. In the medium term, a return to economic growth hinges on the extent of recovery in the global metals markets and on growth performance improving in neighbouring Russia.

In our previous Forecast Report, we argued that the persistent downward pressure on the hryvnia emanating from high external imbalances and depreciation expectations might ultimately force the National Bank of Ukraine (NBU) to abandon the exchange rate peg to the US dollar and devalue the currency, possibly by up to 10-15%. This scenario has not materialised, at least so far, largely thanks to the ample global liquidity which has facilitated access to external funding even for arguably 'high-risk' borrowers such as Ukraine. The government has had little difficulties in placing Eurobonds whose yields have declined to historic (by Ukraine's standards) lows of around 7% – despite the lack of any progress in negotiations with the IMF over a new loan package. The supply of foreign exchange has been also boosted by the newly implemented administrative measures, notably the 50% surrender requirement on export proceeds and incoming private transfers exceeding UAH 150 thousand,[1] while the demand for forex subsided in line with diminished devaluation expectations. As a result, the NBU has been no longer forced to sell foreign currency to maintain the exchange rate peg. The stability of the exchange rate and the postponement of domestic tariff hikes have also helped to keep inflation at levels close to zero – a remarkable achievement given Ukraine's history of high (and volatile) inflation.

However, the newly gained financial stability has done little to boost the fading GDP growth. In January-March 2013, the economy recorded recession (-1.1%) for the third quarter in a row, although growth turned positive on a quarterly basis (+0.6%). Metals exporters confronted with depressed world prices continue to suffer from the hryvnia

[1] Meanwhile, the surrender requirement has been prolonged until November 2013.

strength, while the recent marked slowdown of growth in Russia – Ukraine's key trading partner – has had a dampening impact on machinery exports. In the first five months of 2013, the exports of metals and machinery dropped by 12.5% and 8.3% in nominal (US dollar) terms, respectively. On top of that, the revenues from pipeline transit, which account for some 40% of Ukraine's services exports, declined markedly due to the reduced shipments of Russian gas to Europe. The noticeable improvement in the trade (and current account) balance in January-May 2013 has been solely thanks to a 12% drop in imports, largely on account of the 30% decline in imported energy. The latter has been partly due to the reduced energy consumption in industry (the output of which fell by 5.2%), but also efforts to substitute expensive Russian gas with supplies from elsewhere and with domestically produced coal.[2] In the short run, imports should also be curbed by the newly enacted protectionist measures such as the 'safeguard' duty on imported cars[3] and the import quota for coal, as well as further advances in gas supply diversification. These policies should lead to a moderate decline in the current account deficit this year (to an estimated 6% of GDP, down from 8.4% in 2012), even if the exchange rate remains intact.

Although the contraction of GDP in the first quarter 2013 was first of all due to a sharp decline in inventories (by some UAH 23 billion, resulting in overall gross capital formation plunging by 27%), private consumption has been losing steam too: it rose by only 4.5%, after a nearly 12% increase last year. The latter should not come as a surprise given that the labour markets are no longer improving, wage growth is slowing down, and a resumption of household borrowing is not in sight. In addition, household incomes have been increasingly saved and used to repay loans rather than consumed. On the contrary, fixed investments have held up surprisingly well, partly benefiting from the increased affordability of credits whose share as a source of investment has climbed from 13% to 25%. However, the decline in construction output has deepened (-16% in January-April 2013), not least due to the high statistical base in the first months of last year on account of large-scale infrastructure projects ahead of the European football championship.

Depressed steel markets, the continued recession in the euro area, growth slowdown in Russia, and subsiding domestic demand will all dampen Ukraine's economic prospects.

---

[2] In January-April 2013, Ukraine's natural gas consumption went down by 7%, the volume of gas imports by 20%, and gas transit by 19% year-on-year. In addition, gas which has been increasingly imported from suppliers outside Russia such as Germany (via Poland and Hungary) is reportedly some 10% cheaper than Russian gas.

[3] The 6.5-13% 'safeguard' duty on imported cars was imposed as of mid-April 2013 for a period of three years. The coal import quota for 2013 has been set at 10.2 million tons, while coke imports have been banned altogether. These measures may be not compatible with Ukraine's WTO membership, so that the country may either have to adopt compensating measures (easing access to the domestic market for other goods) or else face increased protectionism in export markets – such as in Turkey, which has announced a retaliatory 23% duty on the imports of Ukrainian walnuts.

Even assuming that the economy will return to growth in the second half of 2013 (due to the low statistical base and very good grain harvest projections), the outcome for the year as a whole is unlikely to be much better than stagnation. The projected growth acceleration next year (to 2-3%) is conditional on improvement in the global environment, particularly regarding steel markets and an improved growth performance in Russia, and risks lie primarily on the downside. To boost domestic lending, on 10 June 2013 the NBU lowered its discount rate from 7.5% to 7%. However, given the weak transmission mechanism of this policy instrument, its impact on the money supply will probably be modest and counterweighted by other factors such as the high risk perceptions. Equally questionable are the government plans to provide state guarantees for 'priority projects' in order to attract up to UAH 50 billion of bank credit at preferential interest rates: the interest rates offered by the government (9-10% p.a. in hryvnia terms) under the scheme remain largely unattractive for banks.

Continued easy access to global capital markets will further limit the authorities' interest in cooperating with the IMF: since the beginning of 2013, Ukraine has repaid USD 2.8 billion to the IMF (out of USD 5.7 billion due to be repaid this year) without any real need for a new loan package. Still, the potentially dangerous – and abrupt – swings in global financial markets' sentiments remain a serious risk factor and could, in the event of materialising, prompt the authorities to turn to the IMF once again. With or without a new IMF programme, the government might still decide to hike gas tariffs for households in order to reduce the deficit of the state-owned energy company Naftohaz. However, the potential scope of the hike will be increasingly constrained by the approaching presidential elections in early 2015, and securing cheaper gas imports – coupled with reduced gas consumption – will remain the 'first-best' option for the government.

The prospects of signing the Association Agreement between Ukraine and the EU (including a Deep and Comprehensive Free Trade Area) which was initialled last year remain highly uncertain. Theoretically, it could be signed at the forthcoming Eastern Partnership summit in Vilnius in November 2013. However, for this to happen, Ukraine needs to show progress in implementing 'reforms', which essentially boils down to releasing the currently imprisoned opposition leader and former prime minister Yuliya Tymoshenko. Meanwhile, Ukraine has secured 'observer' status in the Russia-led Eurasian Economic Union (which includes also Belarus and Kazakhstan) which will be launched in 2015 on the basis of the current Customs Union/Common Economic Space. Although Ukraine's move should be primarily interpreted as an instrument of pressure on the EU ahead of the Vilnius summit, in the longer run it could facilitate the country's full-fledged membership in the Eurasian Economic Union, representing a continuation of the traditional Ukrainian 'tug of war' between the EU and Russia.

Table UA

Ukraine: Selected Economic Indicators

	2009	2010	2011	2012 [1]	2012	2013	2013	2014	2015
					1st quarter			Forecast	
Population, th pers., average	46053	45871	45706	45593	45611	45533	45470	45360	45250
Gross domestic product, UAH bn, nom. [2]	913.3	1082.6	1302.1	1408.9	293.5	301.6	1420	1520	1640
annual change in % (real) [2]	-14.8	4.1	5.2	0.2	2.2	-1.1	0.5	2.5	3.5
GDP/capita (EUR at exchange rate)	1800	2200	2600	3000	.	.	.	.	.
GDP/capita (EUR at PPP)	5000	5400	5700	5900	.	.	.	.	.
Consumption of households, UAH bn, nom. [2]	581.7	686.1	865.9	986.5	210.5	224.3	.	.	.
annual change in % (real) [2]	-14.9	7.1	15.7	11.7	11.0	4.5	4.0	5.0	6.0
Gross fixed capital form., UAH bn, nom. [2]	167.6	195.9	241.8	265.3	48.1	51.3	.	.	.
annual change in % (real) [2]	-50.5	3.9	7.1	0.9	12.3	4.0	0.0	6.0	6.0
Gross industrial production									
annual change in % (real) [3]	-21.9	11.2	8.0	-0.5	1.8	-5.0	-2.0	4.0	5.0
Gross agricultural production									
annual change in % (real)	-1.8	-1.5	19.9	-4.5	0.5	5.8	.	.	.
Construction output									
annual change in % (real) [3]	-48.2	-5.4	18.6	-8.3	6.2	-13.8	.	.	.
Employed persons, LFS, th, average	20191.5	20266.0	20324.2	20354.3	20040.3	.	20350	20400	20450
annual change in %	-3.7	0.4	0.3	0.1	-0.3	.	0.0	0.2	0.2
Unemployed persons, LFS, th, average	1958.8	1785.6	1732.7	1657.2	1845.0	.	.	.	.
Unemployment rate, LFS, in %, average	8.8	8.1	7.9	7.5	8.4	.	7.8	7.7	7.5
Unemployment rate, reg., in %, end of period [4]	1.9	2.0	1.8	1.8	1.9	2.0	.	.	.
Average gross monthly wages, UAH [5]	1905.9	2239.2	2633.0	3025.0	2814.7	3085.3	.	.	.
annual change in % (real, gross)	-9.0	9.7	8.9	14.2	14.5	10.2	.	.	.
Consumer prices, % p.a.	15.9	9.4	8.0	0.6	2.9	-0.5	0.5	4.5	4.0
Producer prices in industry, % p.a. [6]	6.5	20.9	19.0	3.6	8.5	0.3	3.0	5.0	5.0
General governm.budget, nat.def., % of GDP									
Revenues	29.9	29.1	30.6	31.6	33.6	35.4	.	.	.
Expenditures	34.0	35.0	32.4	35.2	33.8	37.3	.	.	.
Deficit (-) / surplus (+) [7]	-4.1	-6.0	-1.8	-3.6	-0.2	-1.9	-3.5	-3.0	-2.5
Public debt, nat.def., % of GDP	34.8	39.9	36.3	36.6	34.3	37.9	37.5	36.0	35.0
Central bank policy rate, % p.a., end of period [8]	10.25	7.75	7.75	7.50	7.5	7.5	.	.	.
Current account, EUR mn [9]	-1242	-2274	-7359	-11485	-1568	-1326	-8000	-9500	-10500
Current account, % of GDP	-1.5	-2.2	-6.3	-8.4	-5.6	-4.6	-5.9	-6.9	-6.7
Exports of goods, BOP, EUR mn [9]	28958	39321	49865	54316	12515	12130	55900	61500	70700
annual change in %	-37.4	35.8	26.8	8.9	9.8	-3.1	3.0	10.0	15.0
Imports of goods, BOP, EUR mn [9]	32046	45641	61540	70260	15469	14451	68900	79200	91100
annual change in %	-44.0	42.4	34.8	14.2	10.2	-6.6	-2.0	15.0	15.0
Exports of services, BOP, EUR mn [9]	9936	12856	13954	15527	3338	3260	15500	17100	18800
annual change in %	-18.8	29.4	8.5	11.3	10.2	-2.3	0.0	10.0	10.0
Imports of services, BOP, EUR mn [9]	8248	9538	9576	11076	2345	2381	11600	12800	14100
annual change in %	-25.3	15.6	0.4	15.7	11.5	1.5	5.0	10.0	10.0
FDI inflow, EUR mn [9]	3453	4893	5177	6094	1568	933	5000	6000	7000
FDI outflow, EUR mn [9][10]	116	555	138	938	298	.	1000	500	300
Gross reserves of NB excl. gold, EUR mn	17825	25096	23593	17186	22283	17864	.	.	.
Gross external debt, EUR mn	72113	88363	97940	102442	95603	.	.	.	.
Gross external debt, % of GDP	85.8	86.0	83.4	74.7	69.7	.	.	.	.
Exchange rate UAH/EUR, average	10.868	10.533	11.092	10.271	10.459	10.554	10.5	11.0	10.5
Purchasing power parity UAH/EUR [11]	3.962	4.407	4.968	5.239	.	.	.	.	.

1) Preliminary. - 2) According to SNA'93 (real growth rates based on previous year prices). -3) Starting from 2011 according to NACE Rev.2. - 4) In % of working age population. - 5) Excluding small enterprises. - 6) Domestic output prices. In first quarter 2013 according to NACE Rev.2. - 7) Without transfers to Naftohaz. - 8) Discount rate of NB. - 9) Converted from USD with the average exchange rate. - 10) In first quarter 2013 FDI net. - 11) wiiw estimates based on the 2005 International Comparison Project benchmark.

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