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Ukraine:
IMF programme off-track

The economy will continue to recover, benefiting from the newly gained political stability. Relatively good budget performance and favourable financing conditions have reduced the willingness to implement the austerity measures, resulting in a suspension of the IMF stand-by programme. In the short and medium term, we expect a continuation of the current growth path of 4-5% per year, driven largely by domestic demand and accompanied by a moderate widening of current account deficits. The free trade negotiations with the EU have advanced recently; they might come to conclusion by the end of 2011.

Overall, Ukraine's economy is recovering from the global crisis and continues benefiting from the relative political stability following the victory of V. Yanukovych in last year's presidential elections and the formation of a pro-Yanukovych majority in the parliament. According to preliminary data, in the first quarter of 2011 real GDP growth reached a respectable 5.2% year on year and 2.9% against the fourth quarter of 2010 in seasonally adjusted terms. Contrary to the early post-crisis period, economic growth has been driven primarily by domestic demand. The 15.2% increase in retail trade turnover in January-May 2011 (year on year) suggests that private consumption performed strongly, fuelled by rapidly growing real wages. Fixed investments also picked up markedly (by 12% in the first quarter of 2011), and construction finally started recovering, posting a 13.2% increase in output terms in January-May 2011. However, housing construction recorded another decline (by 4.5% in the first quarter of 2011), not least because of still anaemic consumer credit. Exports and imports of goods and services both surged dramatically in January-April 2011 (by 37% and 47% in US dollar terms, respectively), although this very high pace is largely attributed to the low statistical base and will not be sustained for the year as a whole.

At the same time, the recent months have witnessed a setback in implementing a number of 'structural' reforms attached to the USD 15.2 billion IMF stand-by package, resulting in its suspension for the time being.[1] In particular, the hikes in domestic gas tariffs which were

[1] So far, out of the USD 15.2 billion IMF 'package' agreed in summer 2010, Ukraine received only USD 3.4 billion in the course of the second half of last year.

supposed to (ideally) eliminate the need for subsidies to the state-owned energy monopolist Naftohaz have not been fully implemented. While the gas tariffs charged to households and district heating companies were initially raised by 50% in August 2010, further hikes have been postponed. Besides, the higher gas prices charged since August 2010 to district heating companies have been passed on to final consumers only partially, resulting in an accumulation of payment arrears to Naftohaz, whose financial situation has hardly improved. Another IMF conditionality – a large-scale pension reform bill, involving a gradual increase in the retirement age for women (from 55 to 60 years) and men employed in the public sector (from 60 to 62 years) as well as an extension of the required qualification period – has been approved (in the first reading) only in June 2011, i.e. with considerable delay. In our view, the wisdom of the pension reform in its current version is highly questionable, as it will de facto entail painful (and essentially unnecessary) pension cuts to the already poor segments of society and will undermine domestic consumer demand. On the other hand, the hikes in domestic energy prices to cost-recovery levels – though equally unpopular – are indeed badly needed. The recent delays in their implementation provide little incentive for energy-saving behaviour and hardly contribute to improving the energy efficiency – a declared objective of the government.[2]

The setback in implementing unpopular reforms is partly due to the recently sharply plunged approval ratings of the authorities, but also owing to the fact that there is no acute need for IMF funds in the current circumstances: a surplus in the balance of payments, generally rising foreign exchange reserves, and an improving budget situation. The latter is largely thanks to abundant tax revenues: in the first quarter of 2011, the revenues of the general government went up by 17% in real terms year on year, while budget expenditures only by 9%.[3] Besides, budget financing conditions have generally improved. The yields on government (hryvnia-denominated) bonds have plunged to around 8-10%, implying that borrowing costs in real terms are close to, or even below, zero. Also, the government can draw on privatization receipts. The UAH 10 billion privatization target set for 2011 has already been met thanks to the privatization of the fixed line operator Ukrtelecom,[4] with sales of a number of electricity assets being reportedly in the pipeline.

2 The energy efficiency programme for 2010-2015 adopted by the government in March 2010 aims at reducing energy intensity by 20%, environmental emissions by 15%, and heat losses in the housing sector by 50% (compared to 2008).

3 The situation may however change somewhat until the end of the year given that some provisions of the newly adopted Tax Code, such as the lower corporate profit tax (23% instead of 25% before), entered into force as of April 2011.

4 In March 2011, a 93% stake at Ukrtelecom was purchased for EUR 970 million by the Austria-based EPIC (European Privatization and Investment Corporation).

Given strong privatization revenues and provided that IMF lending remains frozen, we expect public debt not to exceed 40% of GDP by the end of 2011 and to decline thereafter thanks to the combination of a relatively restrictive fiscal policy, favourable growth prospects, and persistently high inflation. Despite the delays in gas tariff hikes, consumer price inflation has surged recently (to 11% in May 2011 on a year-on-year basis), fuelled by food and gasoline prices and the 15% hike in electricity tariffs enacted in April 2011. The booming producer prices (around 20% on annual basis) and the likely (at least partial) implementation of the initially announced gas and heating tariff hikes – irrespective of whether cooperation with the IMF will be resumed – suggest that inflationary pressures will most probably remain strong.

Otherwise, economic prospects are relatively favourable. In the short and medium term, we expect a continuation of the current growth path of 4-5% per year, driven largely by domestic demand. Private consumption will be backed mainly by further improvements in real wages, whereas fixed investments will be further helped by the infrastructure projects implemented ahead of the European Football Championship in 2012. The current account deficit will almost certainly widen further, but should be comfortably over-compensated by FDI and other capital inflows. Therefore, the current de facto exchange rate peg of around 8 UAH/USD will most probably be sustained. In the longer run, however, it might become incompatible with the persistently high inflation and the related erosion of external competitiveness.

The negotiations with the EU over a Deep and Comprehensive Free Trade Area (DCFTA), which had been going on since Ukraine joined the WTO in 2008, have reportedly intensified in the recent couple of months. DCFTA would be part of a broader Association Agreement with the EU. According to a number of official statements, the negotiations could be concluded by the end of 2011, although there are still important issues to be settled, including trade in agricultural products, access to markets for aviation services, and the use of geographic product names (champagne, cognac, etc.). In its preliminary version, the DCFTA agreement generally envisages zero duties in bilateral trade, with the exception of the automotive industry (on the Ukrainian side) and agricultural products.

Meanwhile, Russia has recently made attempts to discourage Ukraine from closer integration with the EU and pressured it to join the newly formed trilateral Russia-Belarus-Kazakhstan Customs Union instead. However, Ukraine's accession to the Customs Union appears unlikely and would also be problematic given Ukraine's WTO membership: if Ukraine raises its customs duties for imports from third countries to the level of the Customs Union, these countries – most of which are WTO members – will probably demand compensations. At the same time, preserving close trade links with Russia is essential for Ukraine and would also be compatible with a DCFTA with the EU – particularly if Russia and the EU advance their own integration following Russia's possibly forthcoming accession to the WTO.

Table UA

Ukraine: Selected Economic Indicators

	2007	2008	2009	2010 1)	2010 1st quarter	2011 1st quarter	2011 Forecast	2012 Forecast	2013 Forecast
Population, th pers., average	46509	46258	46053	45871	45934	45751	45700	45600	45500
Gross domestic product, UAH mn, nom.	720731	948056	913345	1094607	219428	.	1258300	1440100	1633100
annual change in % (real)	7.9	2.3	-14.8	4.2	4.8	5.2	4.5	5	5
GDP/capita (EUR at exchange rate)	2200	2700	1800	2300	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5800	6000	5100	5400	.	.	.	.	.
Consumption of households, UAH mn, nom.	423174	582482	581733	685233	149645	.	.	.	.
annual change in % (real)	17.2	13.1	-14.9	7.0	1.2	.	5.5	5.5	6
Gross fixed capital form., UAH mn, nom.	198348	250158	167644	208288	33437	.	.	.	.
annual change in % (real)	23.9	-1.2	-50.2	4.9	-7.5	.	12	10	8
Gross industrial production									
annual change in % (real)	7.6	-5.2	-21.9	11.2	11.2	9.8	7.5	6.5	6
Gross agricultural production									
annual change in % (real)	-6.5	17.1	-1.8	-1.0	5.3	5.3	.	.	.
Construction industry									
annual change in % (real)	15.6	-15.8	-48.2	-5.4	-21.4	6.8	.	.	.
Employed persons - LFS, th, average	20904.7	20972.3	20191.5	20266.0	20088.4	20108.2	20200	20250	20290
annual change in %	0.8	0.3	-3.7	0.4	0.4	0.1	0	0.2	0.2
Unemployed persons - LFS, th, average	1417.6	1425.1	1958.8	1785.6	1983.8	1924.9	.	.	.
Unemployment rate - LFS, in %, average	6.4	6.4	8.8	8.1	9.0	8.7	8	7.8	7.5
Reg. unemployment rate, in %, end of period	2.3	3.0	1.9	2.0	1.8	2.2	.	.	.
Average gross monthly wages, UAH 2)	1351.0	1806.0	1906.0	2239.0	1993.0	2388.7	.	.	.
annual change in % (real, gross)	15.0	6.8	-8.9	7.4	3.3	11.3	.	.	.
Consumer prices, % p.a.	12.8	25.2	15.9	9.4	11.2	7.7	10	9	8
Producer prices in industry, % p.a. 3)	19.5	35.5	6.5	20.9	17.2	20.0	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	30.5	31.4	29.9	29.0	30.6	.	.	.	.
Expenditures	31.6	32.8	34.0	34.9	32.6	.	.	.	.
Deficit (-) / surplus (+) 4)	-1.1	-1.5	-4.1	-6.0	-2.0	.	-4	-3	-3
Public debt, nat.def., in % of GDP	12.3	20.0	34.8	39.8	29.9	35.7	39	38	37
Central bank policy rate, % p.a., end of period 5)	8.0	12.0	10.3	7.8	10.3	7.8	.	.	.
Current account, EUR mn 6)	-3849	-8721	-1242	-2173	41	-581	-3000	-4000	-5000
Current account in % of GDP	-3.7	-7.1	-1.5	-2.1	0.2	.	-2.6	-2.9	-3.1
Exports of goods, BOP, EUR mn 6)	36383	46274	28958	39321	7533	11340	43300	46800	50500
annual growth rate in %	17.2	27.2	-37.4	35.8	16.5	50.5	10	8	8
Imports of goods, BOP, EUR mn 6)	44100	57270	32046	45885	8420	13434	51400	56500	62200
annual growth rate in %	25.3	29.9	-44.0	43.2	17.9	59.5	12	10	10
Exports of services, BOP, EUR mn 6)	10337	12228	9936	12856	2595	3005	14800	16600	18300
annual growth rate in %	14.9	18.3	-18.8	29.4	19.3	15.8	15	12	10
Imports of services, BOP, EUR mn 6)	8571	11039	8248	9193	1861	2050	10100	11300	12900
annual growth rate in %	17.3	28.8	-25.3	11.5	-10.8	10.2	10	12	14
FDI inflow, EUR mn 6)	7220	7457	3453	4893	1107	564 7)	5000	6000	7000
FDI outflow, EUR mn 6)	491	690	116	555	441	.	.	.	.
Gross reserves of NB excl. gold, EUR mn	21634	21847	17824	25096	17934	24959	.	.	.
Gross external debt, EUR mn	54421	72109	72113	88361	76334	85520	.	.	.
Gross external debt in % of GDP	52.2	58.6	85.8	85.0	73.5	74.8	.	.	.
Average exchange rate UAH/EUR	6.918	7.708	10.868	10.533	11.068	10.849	11	10.5	10
Purchasing power parity UAH/EUR, wiiw 8)	2.659	3.412	3.917	4.399	.	.	.	.	.

1) Preliminary. - 2) Excluding small enterprises. - 3) Domestic output prices. - 4) In 2009 budget deficit reached 9.2% of GDP taking into account transfers to Naftohaz and accumulated VAT arrears. - 5) Discount rate of NB. - 6) Converted from USD with the average exchange rate. - 7) FDI net. - 8) wiiw estimates based on the 2005 International Comparison Project benchmark.

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