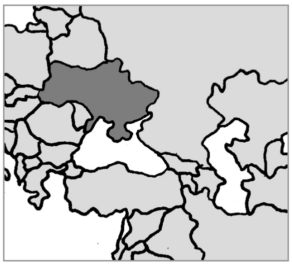

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Ukraine:
in the midst of economic meltdown

After several years of economic boom, Ukraine's economy plunged into recession in October 2008: the combined effect of the global liquidity crunch, the sharp drop in steel prices (by some 70% in the second half of last year) and a resumption of the political crisis. According to preliminary estimates, the country's GDP contracted by 2% (year-on-year) in October and by double-digit rates in both November and December, thus bringing the cumulative growth for 2008 as a whole to just 2.1%. Agriculture performed exceptionally well (+17.5% in gross output terms) on the back of a record grain harvest, whereas construction (-16%) declined throughout most of the year; industry (-3.1%) has been constantly contracting since August. On average, the production of metals (the country's major foreign currency earner) fell by 10.6%, while two other major industries – chemicals and oil processing – reduced their output by 6.2% and 15%, respectively, in response to plummeting world prices.

On the demand side, net exports must have been an even bigger drag on GDP growth (with imports growing ahead of exports), while fixed investments were probably flat. The latter decelerated markedly on a quarterly basis and almost certainly shrank in the final quarter of 2008, as many investment projects (including foreign) were reportedly put on hold. Against this background, private consumption proved the main pillar of economic growth. The retail trade turnover was up by 18.6% in real terms, boosted by the generous wage policy of the Tymoshenko government and the credit boom – at least until the global liquidity crunch spilled over into Ukraine in September 2008. In addition, at the initial stage of the crisis, household spending was fuelled by the shattered trust in banks and expectations of a rise in inflation following the massive hryvnia devaluation (see below). However, as the crisis deepened, the decline in real wages (in December 2008, real wages fell by 3% on a year-on-year basis), blocked access to credit, and – last but not least – rising unemployment ineluctably dampened private consumption as well. At the beginning of 2009, *registered* unemployment (3%) was 0.7 percentage points higher than the year before – back to the level last observed in 2005.[1]

The impact of the liquidity crunch is not surprising given that over the past few years, Ukraine has been borrowing heavily on international capital markets in order to finance its increasingly domestically-driven growth. Throughout, it has relied on access to new credit in order to re-finance its existing debts. Before the financial crisis hit the country in autumn 2008, Ukraine's gross external

1 Registered unemployment is much below the figures provided by labour force surveys (not yet available for the last quarter 2008), given the modest level of unemployment benefits and the low incentives to register as unemployed. However, the *changes* in registered unemployment should be indicative of actual trends.

debt – almost exclusively within the corporate and banking sectors – stood at almost 60% of GDP. In international comparison, this share does not appear particularly high.[2] However, unlike many other countries in Eastern Europe and despite the recent boom in inward FDI, the bulk of the private sector in Ukraine is still largely domestically owned and thus typically lacks privileged access to the funds of parent companies headquartered abroad. Furthermore, the prospects for external borrowing worsened dramatically as global commodity prices plummeted, Ukraine's terms of trade worsened and credit ratings were revised accordingly.

Restricted access to external finance plunged the country's financial markets into turmoil and contributed – along with the shareholder dispute over Prominvestbank – to a run on the banks in October-November 2008.[3] As households started converting part of their hryvnia withdrawals into foreign currency while export revenues were drying up, the exchange rate came under severe pressure as well. Although the National Bank spent USD 4.1 billion of its foreign exchange reserves in October 2008, USD 3.4 billion in November and USD 2.8 billion in December, in an endeavour to bolster the faltering hryvnia, the latter depreciated by some 60% against the US dollar, to some 8 UAH/USD. Ironically, the National Bank spent some of the reserves on sterilizing the hryvnia liquidity which it had injected in order to ease the credit crunch, only to have some of it channelled into the foreign exchange market instead.

Generally, the National Bank's foreign exchange interventions have been constrained by the IMF requirement to keep reserves at a minimum level as a pre-requisite for a 'stand-by' loan (see below). However, in the first weeks of this year, the interbank market exchange rate – though highly volatile – proved fairly stable, even appreciating somewhat. None the less, if sustained over a longer period of time, the new exchange rate will put the holders of foreign-currency-denominated liabilities (half of total outstanding loans in the country) under pressure. In all likelihood, this will lead to a growing number of non-performing loans and a series of private defaults in the months to come.

In an attempt to alleviate the mounting problems, the government received a USD 16.4 billion 'stand-by' loan from the IMF in November 2008, of which USD 4.5 billion has since been transferred. The conditions set by the IMF included a bank re-capitalization programme and a deficit-free central government budget for 2009. However, achieving those two requirements under the current circumstances may prove highly problematic. One reason is the persistent stalemate between Prime Minister Tymoshenko and President Yushchenko and the resultant poor coordination between the government and the National Bank (which is subordinate to the president). As a result, the re-financing of commercial banks by the National Bank – which, according to the 2009 budget law, has to be agreed with the government – virtually stalled in the first few weeks of this year.[4]

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2 Some East European countries, such as Hungary, Bulgaria, Croatia, Latvia or Estonia, have a much higher foreign debt burden (close to, or even exceeding, 100% of GDP).

3 In January 2009, 75% of the insolvent Prominvestbank was acquired by the Russian state-owned Vneshekonombank.

4 One requirement reportedly advocated by Ms Tymoshenko for the banks to be eligible for refinancing is e.g. provision of credit to agricultural producers.

In violation of the IMF conditionality, the 2009 budget also envisages a deficit of 3% of GDP.[5] This is probably justified at a time of a steep economic decline (a balanced budget would undermine consumer demand still further). It is also hardly surprising, as Ms Tymoshenko is seeking to soften the painful social blow of recession and maintain her popularity in view of the upcoming presidential elections. However, given the bleak privatization prospects and blocked access to external funding, the deficit has little chances of being funded from sources other than the National Bank: once again largely in contravention to the IMF requirement. (The National Bank also started purchasing sovereign bonds on several occasions in the final quarter of 2008, as the government was unable to place them in either foreign or domestic capital markets.) These violations imply that further instalments of the IMF loan might prove problematic, potentially raising the country's external financial vulnerability still further.

The combined effect of a recent pronounced devaluation and planned administrative price hikes should be a lower rate of disinflation in 2009 compared to the very high level observed the previous year. In 2008, the consumer price index was up by 22.3% on the end-year basis, largely owing to booming food prices in the first half of the year. The good news, however, is that the devaluation might lend a major boost to net exports. Both in nominal and real terms, we expect exports in 2009 to decline less than imports, which are becoming increasingly unaffordable. At the same time, a marked contraction in domestic demand can be hardly avoided this year. In particular, we expect a decline in private consumption by a few percentage points and a more pronounced contraction of fixed investments, which will almost certainly be double-digit. Against this background, we forecast that the real GDP in 2009 will fall by at least 5%, with risks on the downside. The main challenge facing the country's authorities this year will be to find the right balance between providing enough fiscal stimulus to the economy, on the one hand, and keeping the pace of monetary expansion in check, on the other, in order to avoid a potentially dangerous slide into spiralling hyperinflation-devaluation.

In the medium term, Ukraine's exporters (in the food and machinery sectors, for example) may take advantage of the new competitive exchange rate – though not necessarily in trade with Russia whose currency has also depreciated markedly. They may thus become the locomotive for economic recovery. Helped by growing export revenues, domestic demand will also pick up gradually, albeit not as rapidly as over the past few years, since access to credit will ease only gradually and unemployment will initially not recede from the current level (relatively moderate, given the circumstances), thus making upward wage pressures highly unlikely. In line with these developments, the current account deficit – which we expect to shrink to around 2% of GDP this year – should virtually disappear in the years to come. (Needless to say, this export-led growth scenario hinges on the external environment not being too unfavourable – otherwise the economic recession will continue well into 2010 and possibly thereafter.)

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5 The budget is based on the projections of 0.4% economic growth and 9.5% consumer price inflation. Both assumptions are hardly realistic, but inflation higher than planned should help tax collection and thus at least partially offset the recession-induced revenue shortfalls.

The 'gas war' with Russia in early January 2009 should only have a limited impact on Ukraine's economic performance. The newly signed contract is a welcome step forwards in the hitherto murky energy relations between the two countries. In contrast to earlier agreements, it is a long-term contract linking the gas price charged to Ukraine to the price of oil in line with the 'European formula', with a 20% discount being granted for 2009. Assuming that the oil price stays at its currently depressed level, the *average* gas price paid by Ukraine this year should not exceed USD 240 per thousand cubic metres, representing at the most a 30% price increase compared to the previous year (although in hryvnia terms, the price will probably double). The new contract also eliminates Rosukrenergo as the intermediary in the Russian-Ukrainian gas trade. This represents a victory for Ms Tymoshenko who has pinned her political banner not least to fighting 'shady schemes' – particularly those that benefit her political opponents. Along with the pro-Russian opposition leader Viktor Yanukovych, she is a favourite for the forthcoming presidential elections due in December 2009/January 2010.

Table UA

Ukraine: Selected Economic Indicators

	2003	2004	2005	2006	2007	2008 1)	2009	2010 Forecast	2011
Population, th pers., average	47813	47452	47105	46788	46509	46251	46000	45800	45600
Gross domestic product, UAH mn, nom.	267344	345113	441452	544153	712945	911400	1021700	1161500	1335100
annual change in % (real)	9.6	12.1	2.7	7.3	7.6	2.1	-5	1.5	4.5
GDP/capita (EUR at exchange rate)	900	1100	1500	1800	2200	2600	.	.	.
GDP/capita (EUR at PPP - wiiw)	3900	4500	4700	5200	5800	6100	.	.	.
Consumption of households, UAH mn, nom.	146301	180956	252624	319383	422837	.	.	.	.
annual change in % (real)	11.5	13.5	16.6	15.9	17.1	12	-4.5	2	6
Gross fixed capital form., UAH mn, nom.	55075	77820	96965	133874	195179	.	.	.	.
annual change in % (real)	22.5	20.5	3.9	21.2	24.8	0	-24	2.5	12
Gross industrial production									
annual change in % (real)	15.8	12.5	3.1	6.2	10.2	-3.1	-11	5	7
Gross agricultural production									
annual change in % (real)	-11.0	19.7	0.1	2.5	-6.5	17.5	.	.	.
Construction industry									
annual change in % (real)	26.5	17.2	-6.6	9.9	15.6	-16.0	.	.	.
Employed persons - LFS, th, average	20163.3	20295.7	20680.0	20730.4	20904.7	20800	.	.	.
annual change in %	0.4	0.7	1.9	0.2	0.8	-0.5	.	.	.
Unemployed persons - LFS, th, average	2008.0	1906.7	1600.8	1515.0	1417.6	1500	.	.	.
Unemployment rate - LFS, in %, average	9.1	8.6	7.2	6.8	6.4	6.7	7.5	7.5	7.2
Reg. unemployment rate, in %, end of period	3.6	3.5	3.1	2.7	2.3	3.0	.	.	.
Average gross monthly wages, UAH 2)	462.3	589.6	806.2	1041.4	1351.0	1806.0	.	.	.
annual change in % (real, gross)	16.7	17.0	20.4	18.4	15.0	6.8	.	.	.
Consumer prices, % p.a.	5.2	9.0	13.5	9.1	12.8	25.2	18	12	10
Producer prices in industry, % p.a. 3)	7.6	20.5	16.7	9.6	19.5	35.5	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	28.2	26.5	30.4	31.6	30.8	32.7	.	.	.
Expenditures 4)	28.4	29.7	32.2	32.3	31.9	34.2	.	.	.
Deficit (-) / surplus (+), % GDP	-0.2	-3.2	-1.8	-0.7	-1.1	-1.6	.	.	.
Public debt in % of GDP	29.0	24.7	17.7	14.8	12.4	12.0	.	.	.
Discount rate of NB, % p.a., end of period	7.0	9.0	9.5	8.5	8.0	12.0	.	.	.
Current account, EUR mn 5)	2559	5560	2030	-1289	-4320	-8130	-2200	-500	-500
Current account in % of GDP	5.8	10.6	2.9	-1.5	-4.2	-6.9	-2.2	-0.4	-0.3
Exports of goods, BOP, EUR mn 5)	21013	26906	28093	31048	36383	46000	41400	45500	50100
annual growth rate in %	6.3	28.0	4.4	10.5	17.2	26.4	-10	10	10
Imports of goods, BOP, EUR mn 5)	20555	23895	29004	35188	44100	58000	47000	49800	54800
annual growth rate in %	8.1	16.3	21.4	21.3	25.3	31.5	-19	6	10
Exports of services, BOP, EUR mn 5)	4615	6325	7503	9000	10337	12000	12000	12000	12000
annual growth rate in %	-6.9	37.0	18.6	19.9	14.9	16.1	0	0	0
Imports of services, BOP, EUR mn 5)	3934	5329	6054	7305	8369	10500	10500	10500	10500
annual growth rate in %	5.1	35.5	13.6	20.7	14.6	25.5	0	0	0
FDI inflow, EUR mn 5)	1261	1380	6263	4467	7220	8000	.	.	.
FDI outflow, EUR mn 5)	12	3	221	-106	491	800	.	.	.
Gross reserves of NB excl. gold, EUR mn	5348	6977	16058	16587	21634	21847	.	.	.
Gross external debt, EUR mn	19055	22528	33504	41391	56264	70000	.	.	.
Gross external debt in % of GDP	47.5	47.1	45.3	50.6	58.6	83.4	.	.	.
Average exchange rate UAH/EUR	6.024	6.609	6.389	6.335	6.918	7.708	10	9.5	9
Purchasing power parity UAH/EUR, wiiw 6)	1.451	1.631	1.986	2.229	2.639	3.211	.	.	.

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) Excluding small enterprises. - 3) Domestic output prices. - 4) From 2004 including lending minus repayments. - 5) Converted from USD with the average exchange rate. - 6) wiiw estimates based on the 2005 International Comparison Project benchmark.

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