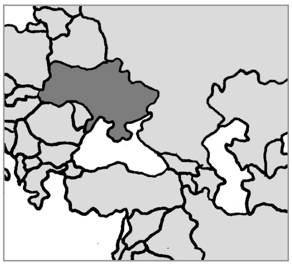

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Ukraine:
Fiscal and other concerns

Ukraine's economy has been hit hard by the falling steel prices and the global credit crunch since September 2008. In 2009, the GDP contracted by an estimated 13.5%, industrial production fell by more than 20%, and construction output by as much as 50%. Across sectors only agriculture – whose output was flat – proved resilient to the crisis, owing to a very high (46 million tons) grain harvest for the second year in a row. Within industry, manufacturing suffered the most (-45% year-on-year in gross output terms), not least due to the collapse in investment demand at home (-44% in the first nine months of 2009) and in Russia, where the bulk of Ukrainian machinery is exported. In contrast, the metals and chemicals industries, which had recorded huge output losses at the early stages of the crisis (late 2008-early 2009), started recovering in the last quarter of 2009 in response to the favourable world market trends. Viewed from the demand side, fixed capital investments plunged the most, reflecting reduced profits, the credit crunch and government budget cuts, which fell primarily on capital expenditures. However, private consumption declined markedly as well (by an estimated 14%) against the background of rising unemployment (to some 9.5% of the labour force), falling real wages (by nearly 9% year-on-year), and the virtual lack of access to household credit. Government consumption fell too, albeit not as strongly, while the dynamics of net exports was strongly positive.

The combined effect of a pronounced devaluation (by 60-70% against the US dollar and the euro) and the deep domestic recession has made imports increasingly unaffordable. The latter plunged faster than exports, and the current account deficit fell dramatically, to EUR 1.4 billion in 2009 (from EUR 8.7 billion the year before). This small deficit was comfortably financed by the (net) inflows of foreign direct investment worth EUR 3.2 billion, representing largely the funding of Ukrainian subsidiaries of foreign banks by parent structures. However, FDI apart, the capital balance proved highly negative: net capital outflows, representing notably external debt repayments by banks and the flight to foreign cash by households, summed up to EUR 11.7 billion. The resulting external financing gap of EUR 9.8 billion was partly covered from the existing foreign exchange reserves and partly from the arriving IMF 'stand-by' funds: in November 2008 Ukraine secured an IMF 'stand-by' stabilization package worth USD 16.4 billion, of which some USD 6 billion (EUR 4.3 billion) were transferred in 2009. As a result, the share of public debt in Ukraine's gross external debt increased (at the expense of private debt), although the overall *level* of indebtedness remained nearly unchanged at above EUR 70 billion.

Initially, the IMF package was aimed at facilitating the repayment of external debts. However, as macroeconomic policy concerns were shifting to the fiscal side, the arriving IMF funds were increasingly used for fiscal purposes.[1] Following the deep economic recession, in 2009 the revenues of the consolidated budget were down by 18.5%, and expenditures by 16.4% in real (CPI-deflated) terms, resulting in a reported deficit of just 2.3% of GDP. However, this figure does not include the costs of banks recapitalization and the quasi-fiscal deficits of the state-owned energy company Naftohaz (also covered from the budget) and of the Pension Fund (in excess of the allocation envisaged in the 2009 budget law). According to the presidential secretariat, taking into account the latter expenditures, the overall budget deficit in 2009 totalled UAH 81.5 billion (8.5% of GDP) – the figure which largely squares with the officially reported public net borrowing needs of UAH 67.1 billion (7% of GDP). The IMF package apart, financing a budget deficit of this size has been a challenge under Ukraine's circumstances, given the still high CDS spreads (currently hovering at around 10%), the blocked access to international capital markets, and the nearly absent privatization revenues (a mere EUR 70 million in 2009) – not to mention political risks. Therefore, the government has resorted to domestic borrowing – typically at high interest rates, reaching up to 30% p.a. in hryvnia terms in October 2009 (although the bulk of newly issued government bonds reportedly ended up in the hands of the National Bank). As a result, public domestic debt in 2009 more than doubled, bringing the total public (including publicly-guaranteed) debt to nearly 32% of GDP, up from 20% the year before. Although this figure appears rather low by international standards, the high yields on government bonds, coupled with uncertainty over the fiscal plans for 2010 and over the prospects of the IMF 'stand-by' programme, give rise to concerns over the sustainability of public finances in the medium term.

After the devaluation-driven spike at the beginning of 2009, consumer price inflation has subsequently been subsiding throughout the year and reached 12.3% by December (corresponding to 15.9% in average annual terms). This trend is hardly surprising against the background of weak domestic demand and would have been even more pronounced, had it not been for the upward adjustments of excise taxes on tobacco and tobacco products, and of some administratively set tariffs such as those for transport. Despite the falling inflation, the monetary policy remained tight, as the National Bank raised its reserve requirements and lowered the discount rate only marginally. Also, repeated foreign exchange interventions to defend the exchange rate and the resulting losses of forex reserves constrained the growth of the monetary base. In 2009, the latter grew by only 1.4% in nominal terms, corresponding to an 11% decline in real (CPI-adjusted) terms. The contraction of broad money balances (M3) was even more pronounced (by 17.1% in real terms), indicating that the lending activity remains virtually frozen. According to the National Bank, the share of non-performing loans surged rapidly in the first months of the crisis (from 3% in September 2008), but subsequently declined marginally (to 9.3% on 1 February 2010), although the IMF estimate puts the figure at as much as 30%.

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1 The IMF programme was suspended, though, by the end of 2009 in response to the government's reluctance to implement one of the conditionalities – the agreed hikes in domestic gas tariffs for households ahead of the presidential elections, and following the 20% increase in the minimum wages and pensions as of November 2009. However, in January 2010 the IMF allowed the government to draw on the National Bank's foreign exchange reserves (originally received from the IMF) in order to provide Naftohaz with enough funds to pay its monthly bill to the Russian Gazprom for the imported natural gas.

Generally, the prospects for the real economy have improved: for 2010 we expect GDP growth of about 3%, with a gradual acceleration in the years to come.[2] This growth will be driven largely by recovering exports (particularly those of metals and chemicals). In the last few months of 2009, the exports dynamics was encouraging, aided by the pick-up of global metals prices and the country's sharply improved competitiveness following the 60% currency depreciation. Also, producer prices in industry picked up markedly (on a monthly basis) – an indicator to be interpreted favourably in Ukrainian circumstances. For 2010, exports are projected to grow faster than imports, resulting in the already modest current account deficit (1.6% of GDP in 2009) shrinking still further. At the same time, the ongoing credit crunch, rising unemployment and falling real wages will continue to depress domestic demand, which is unlikely to start recovering strongly before 2011. The inflationary pressures are likely to subside, although the pace of disinflation will be constrained by the likely hikes in domestic energy tariffs (more on that, see below).

The persistent political instability has played a significant role in the way the global economic crisis has affected Ukraine's economy. The infighting between the (outgoing) president Yushchenko and the (probably also outgoing) prime-minister Tymoshenko has hampered a consolidated policy response, most visibly manifested in the lack of coordination between the government and the National Bank (which is subordinated to the president). The victory of the leader of the pro-Russian opposition Party of Regions, Viktor Yanukovych, in the second round of the presidential elections on 7 February 2010 *per se* does not necessarily put an end to the stalemate, as long as the president and the prime-minister represent different political camps and the frequency of government rotations potentially remains high. Therefore, the key challenge for the new president will be the formation of a loyal government, which would require either a re-shuffling of the current parliament coalition around Ms. Tymoshenko or early parliamentary elections.

In any case, the new government will have to cope with a number of pressing issues, including coming up with a realistic budget for 2010. The latter is also a prerequisite for the resumption of the IMF 'stand-by' programme suspended last year. Meanwhile, the hikes in public expenditures on wages and pensions enacted in November 2009 are unlikely to be revoked. In order to keep the budget deficit in check, the government will almost certainly need to resort to offsetting measures, e.g. an upward revision of domestic gas tariffs for households and communal enterprises – a long-standing demand of the IMF. Another challenge for the new authorities will be to mend relations with Russia, which have suffered dramatically under the presidency of Viktor Yushchenko. The foreign policy course of the new president will be more pragmatic and more Russia-friendly, which implies that the new Ukrainian administration might adopt a less forthcoming stance in negotiations with the EU, e.g. in the current negotiations over a deep free trade agreement. On the other hand, Mr. Yanukovych is reportedly favouring the creation of a Ukraine-EU-Russia gas consortium, which should operate the country's gas pipeline network. The latter should increase Ukraine's reliability for the energy transit from Russia to the EU, although Mr. Yanukovych is also advocating a re-negotiation of the gas supply contract with Russia concluded in January 2009 by the Tymoshenko government. Among other likely economic policy priorities of Mr. Yanukovych – who draws his

[2] According to the National Bank's estimate, in January 2010 real GDP was up by 7.5% in year-on-year terms.

support not least from the export-oriented heavy industry – are currency undervaluation and tax cuts: by 2011, the VAT is planned to be cut from 20% to 17%, and the corporate profit tax from 25% to 19%. The accession to Russia-Belarus-Kazakhstan Customs Union is also under consideration.

In the medium and long run, the country's economic policy challenges include the need for modernization and diversification away from the narrow specialization on metals and chemicals, raising the energy efficiency, and economic integration with its important neighbouring export markets. For that, Ukraine needs to attract substantial amounts of investment and find the appropriate political balance between the EU and Russia. Besides, a broad range of institutional reforms in the areas of privatization, liberalization, competition policy and the rule of law, which have nearly stalled over the years due to the persistent political stalemate and vested interests, need to be advanced – although the latter will be more difficult without the 'carrot' of future EU membership, which is not on the agenda.

Table UA

Ukraine: Selected Economic Indicators

	2004	2005	2006	2007	2008	2009 [1]	2010	2011	2012
								Forecast	
Population, th pers., average	47452	47105	46788	46509	46258	46060	45800	45600	45400
Gross domestic product, UAH mn, nom.	345113	441452	544153	720731	949864	952300	1098600	1262800	1445700
annual change in % (real)	12.1	2.7	7.3	7.9	2.1	-13.5	3	4.5	6
GDP/capita (EUR at exchange rate)	1100	1500	1800	2200	2700	1900	.	.	.
GDP/capita (EUR at PPP - wiiw)	4500	4700	5200	5800	6000	5300	.	.	.
Consumption of households, UAH mn, nom.	180956	252624	319383	423174	576565	574700	.	.	.
annual change in % (real)	13.5	16.6	15.9	17.2	11.8	-14	1.5	4	6
Gross fixed capital form., UAH mn, nom.	77820	96965	133874	198348	258176	185500	.	.	
annual change in % (real)	20.5	3.9	21.2	23.9	1.9	-38	3.0	10	10
Gross industrial production									
annual change in % (real)	12.5	3.1	6.2	10.2	-3.1	-21.9	5	7	8
Gross agricultural production									
annual change in % (real)	19.7	0.1	2.5	-6.5	17.1	0.1	.	.	.
Construction industry									
annual change in % (real)	17.2	-6.6	9.9	15.6	-16.0	-48.2	.	.	.
Employed persons - LFS, th, average	20295.7	20680.0	20730.4	20904.7	20972.3	20100	20200	20300	20400
annual change in %	0.7	1.9	0.2	0.8	0.3	-4.2	0.5	0.5	0.5
Unemployed persons - LFS, th, average	1906.7	1600.8	1515.0	1417.6	1425.1	2000	.	.	
Unemployment rate - LFS, in %, average	8.6	7.2	6.8	6.4	6.4	9.5	9	8.5	8
Reg. unemployment rate, in %, end of period	3.5	3.1	2.7	2.3	3.0	1.9	.	.	.
Average gross monthly wages, UAH [2]	589.6	806.2	1041.4	1351.0	1806.0	1906.0	.	.	.
annual change in % (real, gross)	17.0	20.4	18.4	15.0	6.8	-8.9	.	.	.
Consumer prices, % p.a.	9.0	13.5	9.1	12.8	25.2	15.9	12	10	8
Producer prices in industry, % p.a. [3]	20.5	16.7	9.6	19.5	35.5	6.5	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	26.5	30.4	31.6	30.5	31.4	30.3	.	.	.
Expenditures	29.7	32.2	32.3	31.6	32.8	32.6	.	.	.
Deficit (-) / surplus (+)	-3.2	-1.8	-0.7	-1.1	-1.5	-2.3	-7	-3	-3
Public debt, nat.def., in % of GDP	24.7	17.7	14.8	12.3	19.9	31.7	35	35	35
Discount rate of NB, % p.a., end of period	9.0	9.5	8.5	8.0	12.0	10.3	.	.	.
Current account, EUR mn [4]	5560	2030	-1289	-3849	-8721	-1391	0	-200	-500
Current account in % of GDP	10.6	2.9	-1.5	-3.7	-7.1	-1.6	0	-0.2	-0.3
Exports of goods, BOP, EUR mn [4]	26906	28093	31048	36383	46274	28971	31900	35100	38600
annual growth rate in %	-7.1	4.4	10.5	17.2	27.2	-37.4	10	10	10
Imports of goods, BOP, EUR mn [4]	23895	29004	35188	44100	57270	32791	34800	38300	42100
annual growth rate in %	-27.1	21.4	21.3	25.3	29.9	-42.7	6	10	10
Exports of services, BOP, EUR mn [4]	6325	7503	9000	10337	12228	9867	10900	12000	13200
annual growth rate in %	37.0	18.6	19.9	14.9	18.3	-19.3	10	10	10
Imports of services, BOP, EUR mn [4]	5329	6054	7305	8571	11039	7998	8500	9400	10300
annual growth rate in %	35.5	13.6	20.7	17.3	28.8	-27.5	6	10	10
FDI inflow, EUR mn [4]	1380	6263	4467	7220	7457	4000	4000	.	.
FDI outflow, EUR mn [4]	3	221	-106	491	690	700	.	.	.
Gross reserves of NB excl. gold, EUR mn	6977	16058	16587	21634	21847	17824	.	.	.
Gross external debt, EUR mn	22528	33504	41391	54421	72105	75000	.	.	.
Gross external debt in % of GDP	47.1	45.3	50.6	56.0	82.4	90.2	.	.	.
Average exchange rate UAH/EUR	6.609	6.389	6.335	6.918	7.708	10.868	11	10.5	10
Purchasing power parity UAH/EUR, wiiw [5]	1.631	1.986	2.227	2.656	3.415	3.900	.	.	.

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

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