UKRAINE: From illiquidity to insolvency

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In 2015, the ongoing military conflict in the Donbas region, the erosion of incomes on account of galloping inflation and the unrelenting collapse of trade and investment will plunge the economy into deep recession for the second year running. Dismal growth prospects, an ever-weakening currency and massive fiscal deficits on the back of huge expenditures on defence will put the sustainability of public debt in jeopardy. A recovery can hardly be expected before 2017, the all-essential pre-requirement being a lasting peace settlement.

According to preliminary estimates, in the fourth quarter of 2014 Ukraine's GDP contracted by 15.2% (year on year). For the first time, the GDP figure does not cover the eastern areas of Donbas which are controlled by the separatist rebels; including those would certainly show an even deeper recession, since the war has destroyed a large part of the local production and transport capacities. According to official (certainly incomplete) statistics, in 2014 industrial production dropped by more than 30% in Donetsk and more than 40% in Luhansk, accounting for the bulk of the 11% decline in Ukraine as a whole. Coal mining and the metals industry – both heavily concentrated in war-torn areas – were hit particularly hard: by 31% and 15%, respectively, while machine-building, whose main export market is Russia, also reported a strong 21% decline. Apart from the weakening growth dynamics in Russia and the falling rouble, machine-building also suffered from the disruption of existing links in military-related production cooperation because of the export bans imposed by both countries, as well as Russia's import-substitution efforts. All in all, exports to Russia, which used to account for a quarter of Ukraine's exports in previous years, plummeted by a dramatic 35% in US dollar terms in 2014. Exports to the European Union increased by 12% but could not offset the decline in exports to Russia and the rest of the world.

The military conflict in Donbas has obviously had a detrimental effect on the investment climate as well; fixed investments plunged by an estimated 25% last year. Strong capital flight was the main reason behind the free fall of the hryvnia, which lost half of its value against the US dollar. Currency depreciation and energy tariff hikes fuelled consumer price inflation, which climbed to 25% by the end of the year and eroded the purchasing power of households: on average, net wages dropped by 6.5% in real terms. At the same time, credits to households fell by 16% (after adjusting for the valuation effect of forex-denominated loans) amidst strong deposit outflows and the overall gloomy economic prospects. All this weighed heavily on the consumer demand: retail trade turnover – a proxy for private consumption – fell by 8.6% last year. On a positive note, the combined effect of currency depreciation and falling domestic demand contributed to a sharp drop in imports of goods and services by 27% in US dollar terms – much more than that of exports (-20%), resulting in vastly improved trade and current accounts and a strongly positive contribution of real net exports to GDP growth.

The National Bank of Ukraine (NBU) has been trying to limit the scope of the currency depreciation, which is jeopardising both the financial stability and the sustainability of public debt, more than half of which is denominated in foreign currency. However, the choice of instruments at NBU's disposal is very limited: official reserves are already at a critically low level of 1.5 months of imports, interest rate hikes hardly provide an incentive to invest in a war-torn country, while the imposed administrative measures (such as the 75% surrender requirement for export proceeds) have only resulted in the emergence of a vast 'shadow' market for foreign exchange.[1] Therefore, Ukraine continues to be critically dependent on foreign emergency assistance, the bulk of it coming from the IMF.

So far, Ukraine has received USD 4.6 billion as part of the USD 17 billion stand-by financial package agreed with the IMF in spring 2014 (as well as a total of another USD 4.5 billion in other multilateral and bilateral loans and credit guarantees, such as from the World Bank, the EBRD, the EU, the US and Japan). Upon its inception, the IMF programme implicitly assumed that the country's balance-of-payments (and fiscal) problems were those of liquidity rather than solvency: economic recovery and currency stabilisation were expected to enable external debt repayment in the longer run. This assumption – arguably justified at that time – looks now increasingly unrealistic, as economic recovery is not in sight, the hryvnia is likely to depreciate even more, while high defence spending continues to hamper budget consolidation. Rising concerns over public debt sustainability are also pushing the yields on government bonds to double-digit levels (the yields on hryvnia-denominated bonds are of course even higher) – much higher than the GDP growth rate in US dollar terms (which is negative), thus contributing towards the debt to GDP ratio rising still further and sovereign default potentially becoming a 'self-fulfilling prophecy'. The newly announced staff-level agreement (still to be approved by the IMF executive board) over a new four-year USD 17.5 billion worth Extended Fund Facility (EFF) is recognition of the solvency problems the country is facing. The new lending package will replace the previous stand-by arrangement and is only USD 5 billion larger in volume than the funds outstanding in the framework of the previous programme. It does not fully cover Ukraine's extra financing needs which are estimated at some USD 10-15 billion, and thus puts pressure on private creditors (such as Franklin Templeton, the largest single holder of Ukrainian eurobonds) to participate in debt relief and/or restructuring.

Following the latest IMF recommendations, the draft government budget for 2015 targets a deficit of 4.1% of GDP. If attained, this would represent a modest reduction compared to last year (4.8%). However, both figures exclude important quasi-fiscal expenditure items, such as subsidies to the state-owned energy company Naftohaz and the costs of bank recapitalisation. The Naftohaz deficit alone reportedly accounted for some 7% of GDP, as strong depreciation inflated the gas import bill in hryvnia terms, which was only partially offset by the 60% hike in domestic gas tariffs for households enacted in mid-2014. This year, the import gas price for Ukraine should decline thanks to the recent drop in the oil price, to which it is contractually linked. Nevertheless, further tariff hikes for households – reportedly by 280% for gas and 66% for heating – are on the government agenda this year, and are indeed a key requirement of the IMF. The wisdom of front-loaded tariff hikes is however questionable, unless they are accompanied by parallel efforts aimed at promoting energy-saving measures, such as subsidising the installation of heating metres.[2]

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[1] As of 5 February 2015, the exchange rates were finally unified, resulting in another massive depreciation, while the (largely symbolical) NBU discount rate was raised by another 5.5 p.p., to 19.5% p.a. All in all, during the year prior to the time of finalising this report (25 February 2015), the hryvnia lost around three-quarters of its value: from 8 to 32 UAH/USD.

[2] Although the government is planning to allocate 0.7% of GDP in direct heating subsidies to the poor to offset the impact of tariff hikes, this will hardly contribute towards improving energy efficiency.

Quasi-fiscal deficits apart, the 2015 budget is probably unrealistic as it heavily relies on a projected growth of revenues by 26% in nominal terms – roughly in line with inflation, and despite the severe economic recession. The government reckons that tax collection should benefit from the newly enacted comprehensive tax reform: as of January 2015, the tax system has been streamlined and the number of taxes reduced from 22 to 9, while a drastic lowering of social security contributions and a generous tax amnesty are hoped to encourage the 'de-shadowing' of the economy. In addition, government revenues should be boosted by the newly imposed temporary 5-10% surcharge on all imports (excluding energy and pharmaceuticals), although this might be in violation of WTO rules. On the expenditure side, the 2015 budget envisages some austerity measures, such as cuts in the number of public employees in law enforcement agencies and a 'freeze' of the minimum wage until December 2015, implying a further erosion of real incomes by high inflation. However, their austerity impact will be offset by increased military spending. According to the government, the so-called 'anti-terrorist operation' in Donbas costs USD 5-10 million per day. Extrapolated for the whole year, this would sum up to some USD 2-4 billion, or 2-4% of GDP (obviously, the costs can be easily higher if the fighting escalates further). While the effectiveness of the Ukrainian army on the battlefield is far from being impressive, high military spending – mirrored in the statistics by the growth of public consumption – provides at least some growth stimulus in an otherwise strongly recessionary environment.

The snap parliamentary elections in October 2014 initiated by President Poroshenko brought a surprise success for the rival party of Prime Minister Arseniy Yatsenyuk and allowed him to retain his post. With the new-old constitution enhancing the powers of the parliament and the prime minister re-installed once again, the current power structure resembles the earlier fragile Yuschenko-Tymoshenko 'ruling tandem'. The strong election performance of the relatively 'hawkish' party of Mr Yatsenyuk has been a factor behind the recent escalation of the war in Donbas. On the other hand, the arbitrariness of borders controlled by pro-Russian separatists (one-third of Donbas' territory and half of its population) by the time of signing of the first Minsk ceasefire agreement in September 2014 has been probably even more important. Coupled with strong pro-Russian sentiments in some other Donbas territories, which are now under Kyiv's control but were part of the two self-proclaimed 'peoples' republics' back in summer 2014, a military counter-offensive by the rebels appeared to be only a question of time.

Economic prospects remain crucially dependent on a lasting peace settlement of the Donbas conflict, and any recovery can be hardly expected before 2017. Whether the peace settlement will be secured by the so-called Minsk-II ceasefire agreement signed on 12 February 2015 remains to be seen; by the time of finalising this report this was not the case, and separatists were gradually gaining control over new territories. Among other things, the ongoing war deters the inflow of foreign investments which are badly needed to modernise the economy and finance the implementation of the newly signed (but suspended until January 2016) Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU. In addition, high military spending is 'crowding out' other essential payments, such as public sector wages and pensions, and contributes to the progressing impoverishment of large segments of the population. It is also unlikely that Ukraine's exports sector will be able to take advantage of the highly competitive exchange rate, given that part of the production and transportation capacities are physically destroyed, trade with Russia remains severely curtailed, while an increase in manufacturing exports to the EU is conditional on improved competitiveness, including the costly implementation of EU standards envisaged in the DCFTA agreement – both possible only in the medium and longer run. Important exceptions to this may be agriculture and parts of the food processing industry, which are largely located outside the conflict zone and have been able to benefit to some extent from the newly granted market access for their products by the EU.

Table 1 / Ukraine: Selected Economic Indicators

	2010	2011	2012	2013	2014 [1]	2015	2016	2017
							Forecast	
Population, th pers., average	45,871	45,706	45,593	45,490	43,001	42,950	42,920	42,900
Gross domestic product, UAH bn, nom. [2]	1,121	1,349	1,459	1,505	1,511	1,780	1,940	2,090
annual change in % (real) [2]	4.1	5.4	0.2	0.0	-7.0	-5.0	0.0	1.8
GDP/capita (EUR at exchange rate)	2,300	2,700	3,100	3,100	2,200	.	.	.
GDP/capita (EUR at PPP)	5,600	6,500	6,700	6,700	6,400	.	.	.
Consumption of households, UAH bn, nom. [2]	718	906	1,002	1,100	1,135	.	.	.
annual change in % (real) [2]	7.0	15.7	8.4	7.7	-8.0	-4.5	-0.5	2.0
Gross fixed capital form., UAH bn, nom. [2]	202	248	283	273	239	.	.	.
annual change in % (real) [2]	3.4	6.5	3.3	-6.5	-25.0	-10.0	-5.0	5.0
Gross industrial production [3]								
annual change in % (real)	11.2	8.0	-0.5	-4.3	-10.7	-6.0	0.0	3.0
Gross agricultural production								
annual change in % (real)	-1.5	19.9	-4.5	13.7	2.8	.	.	.
Construction output [4]								
annual change in % (real)	-5.4	18.6	-8.3	-14.5	-21.7	.	.	.
Employed persons, LFS, th, average	20,266	20,324	20,354	20,404	18,300	17,800	17,600	17,600
annual change in %	0.4	0.3	0.1	0.2	-5.3	-2.7	-1.1	0.0
Unemployed persons, LFS, th, average	1,786	1,733	1,657	1,577	1,800	2,200	2,400	2,400
Unemployment rate, LFS, in %, average	8.1	7.9	7.5	7.2	9.0	11.0	12.0	12.0
Reg. unemployment rate, in %, end of period [5]	2.0	1.8	1.8	1.8	1.7	.	.	.
Average monthly gross wages, UAH [6]	2,239	2,633	3,026	3,265	3,476	.	.	.
annual change in % (real, gross)	9.7	8.9	14.3	8.2	-5.8	.	.	.
annual change in % (real, net)	10.2	8.7	14.4	8.2	-6.5	.	.	.
Consumer prices, % p.a.	9.4	8.0	0.6	-0.3	12.1	24.0	9.0	6.0
Producer prices in industry, % p.a. [7]	20.9	19.0	3.7	-0.1	17.1	20.0	10.0	5.0
General governm.budget, nat.def., % of GDP								
Revenues	28.1	29.5	30.5	29.4	30.2	.	.	.
Expenditures	33.8	31.2	34.0	33.6	34.9	.	.	.
Deficit (-) / surplus (+) [8]	-5.8	-1.7	-3.5	-4.2	-4.8	-5.5	-5.0	-5.0
Public debt, nat.def., % of GDP	38.6	35.1	35.3	38.8	72.8	115.0	125.0	121.0
Central bank policy rate, % p.a., end of period [9]	7.75	7.75	7.50	6.50	14.00	.	.	.
Current account, EUR mn [10]	-2,272	-7,351	-11,153	-12,441	-3,800	-1,000	-1,000	-1,000
Current account, % of GDP	-2.1	-6.0	-7.9	-8.8	-4.0	-1.9	-1.8	-1.7
Exports of goods, BOP, EUR mn [10]	35,636	44,812	50,127	44,518	42,300	42,300	43,100	44,000
annual change in %	33.9	25.7	11.9	-11.2	-5.0	0.0	2.0	2.0
Imports of goods, BOP, EUR mn [10]	42,866	57,764	67,124	61,185	47,700	44,400	44,400	45,300
annual change in %	40.8	34.8	16.2	-8.8	-22.0	-7.0	0.0	2.0
Exports of services, BOP, EUR mn [10]	13,808	15,278	17,186	17,032	11,070	10,000	10,000	10,500
annual change in %	28.9	10.6	12.5	-0.9	-35.0	-10.0	0.0	5.0
Imports of services, BOP, EUR mn [10]	9,577	9,613	11,351	12,141	9,710	8,700	8,700	9,100
annual change in %	15.6	0.4	18.1	7.0	-20.0	-10.0	0.0	5.0
FDI inflow (liabilities), EUR mn [10]	4,860	5,177	6,360	3,396	300	300	1,000	1,500
FDI outflow (assets), EUR mn [10]	521	138	762	324	300	300	300	500
Gross reserves of NB excl. gold, EUR mn	25,096	23,593	17,186	13,592	5,429	.	.	.
Gross external debt, EUR mn [10]	88,363	97,940	102,120	102,852	104,000	.	.	.
Gross external debt, % of GDP	83.1	80.5	71.9	72.5	108.2	.	.	.
Average exchange rate UAH/EUR	10.533	11.092	10.271	10.612	15.716	33.0	34.0	35.0
Purchasing power parity UAH/EUR [11]	4.328	4.561	4.748	4.923	5.485	.	.	.

Note: From 2014 data and forecasts excluding the occupied territories of Crimea and Sevastopol.
1) Preliminary and wiiw estimates. - 2) According to SNA'08. - 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. - 7) Domestic output prices. From 2013 according to NACE Rev. 2. - 8) Without transfers to Naftohaz and costs of bank recapitalisation. - 9) Discount rate of NB. - 10) Converted from USD and based on BOP 6th edition. - 11) wiiw estimates based on the 2011 International Comparison Project benchmark.
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.