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Ukraine:
Slipping into recession

The plunging global prices of metals hit Ukraine's exports and pushed the economy into recession in the second half of last year – despite the ongoing boom in household consumption. Our forecast of a return to positive growth in 2013 is based on the assumption of a timely and 'controlled' currency devaluation, which would be crucial for the badly needed growth re-balancing. In the longer run, modernization and restructuring could be hampered by the country's increasing political isolation and the largely protectionist stance of the government.

According to preliminary estimates, the recession which had started in the third quarter of 2012 deepened in the fourth quarter (to -2.7% on a yearly basis), resulting in stagnating GDP for the year as a whole. The main reason for the rapid deterioration has been the poor performance of exports, particularly (but not only) of steel – Ukraine's most important export item. Partly, this is due to the weakness of global demand and the existing overcapacities, resulting in steel prices plunging by around 30% last year, but it is also a reflection of the structurally low competitiveness of the Ukrainian steel industry. Because of chronic under-investment in modernization during the 'boom' years, the production technologies are largely outdated and energy-intensive[1] – a massive disadvantage in the environment of high prices of Russian gas and domestically produced coal and electricity.[2] The 'scissors' of high production costs and an overvalued currency (more on that see below), on the one hand, and plunging world prices, on the other, imply that steel mills have been increasingly operating at a loss, cut production volumes, and in some cases shut down altogether. In 2012, metals output fell by 5% and exports by 15% (in US dollar terms), while the slump in increasingly uncompetitive oil refining was even more dramatic. Production and export dynamics in these two branches were progressively worsening towards the end of the year, suggesting that the full impact of the crisis may be yet to be felt. Thus, delayed reforms and the lack of restructuring backfire and pose a drag on economic growth.

1 One quarter of Ukrainian steel is still produced using open hearth furnaces, which e.g. have not been in use in Western Europe since the 1950s.

2 Ukraine's long-standing attempts to re-negotiate the gas contract terms with Russia have proved futile so far (in contrast to many EU countries).

All in all, we estimate that the negative contribution of net exports (of goods and services) to GDP growth in 2012 reached some 8 p.p., and was over-compensated by the positive contribution of domestic demand, particularly private consumption. Judging by the booming retail trade turnover (+14% in real terms), household consumption recorded double-digit growth for the second consecutive year, backed by impressive gains in nominal wages and the lasting price stability (at least according to the official CPI statistics). On the end-year basis, consumer prices fell by 0.2%, first of all thanks to declining food prices, particularly for sugar and vegetables. Anecdotal evidence suggests however that official CPI statistics could be potentially misleading. Apart from the issue whether the high share of food (50%) in the consumer basket underlying CPI calculations is still appropriate, it may come as a surprise why the price-dampening effect of the record-high harvest of 2011 has not died away yet, while the harvest of 2012 was more modest (agricultural production declined by 4.5% last year).

Notwithstanding the faltering economic growth and nearly non-existent inflation, the revenues of the consolidated budget last year picked up by a healthy 12%, largely thanks to increased tax compliance. However, expenditures grew even more strongly (by 18%), driven in particular by the pre-election hikes in social spending. As a result, the budget deficit climbed to 3.6% of GDP (without taking into account subsidies to the loss-making state energy company Naftohaz), although its financing has been increasingly becoming less of a problem. Despite the rating downgrades by Moody’s and S&P in December 2012, the government is having now little trouble to borrow – a reflection of abundant global liquidity, the improved perceptions of the situation in the euro area, and the related rise in the global appetite for risk. Still, given the ‘overheated’ private consumption and the potentially dangerous swings in financial markets’ sentiments, the government would be well-advised to pursue some fiscal austerity. At the same time, the law on the central budget for 2013 envisages only moderate budget consolidation, targeting a 3.2% deficit against the backdrop of tax revenues stagnating in nominal terms.

Despite the impressive 16% rise of deposits, credits to the economy in 2012 were nearly stagnant (+2%): households were deleveraging for the fourth consecutive year, while corporate loans recorded only a modest increase. This implies that increased domestic deposits have been channelled to replace other sources of bank funding – notably foreign loans, as European banks advanced their withdrawal from Ukraine (see Box 2 below), and the banking sector as a whole continued deleveraging vis-à-vis abroad. Lending in foreign currency has been largely prohibited ever since the disastrous experience of the 2009 crisis, while hryvnia lending is effectively constrained by the exorbitant (around 20% p.a.)

interest rates on deposits and correspondingly high interest rates on loans – which themselves reflect expectations of imminent hryvnia devaluation.

Box 2

European banks are leaving Ukraine

The weak credit dynamics in Ukraine is partly explained by the reduced exposure and, in a number of cases, complete withdrawal of European banks from the country. Initially, this trend was primarily driven by factors such as the general risk aversion and the need to comply with tighter (Basel-III) capital ratio requirements by way of reducing the balance sheets. However, it has been boosted recently by Ukraine's worsening economic prospects. Among European banks who either drastically reduced their presence in Ukraine or left altogether in 2012, were Sweden's SEB and Swedbank, Germany's Commerzbank, France's Société Générale, Turkey's FIBA and Austria's Erste Bank, while Austria's Volksbank International (including its Ukrainian subsidiary) was completely taken over by Russia's Sberbank. Also Greece's Alpha Bank and Eurobank as well as Italy's Unicredit (which via Bank Austria owns the 6th biggest Ukrainian bank Ukrsotsbank) are reportedly in the process of negotiating the sale of their Ukrainian assets.

Although the ongoing 'credit crunch' is not helping to revive the economy and inflationary pressures are nearly non-existent, monetary policy has remained rather restrictive. The main reason is that any liquidity sporadically injected by the National Bank in an attempt to boost lending to the real economy has ended up in the foreign exchange market, putting the currency under pressure. In these circumstances, any meaningful relaxation of monetary policy would almost certainly require higher flexibility of the exchange rate, i.e. essentially hryvnia devaluation to a more credible level: by around 10%, according to our estimates. So far, the (near) stability of the exchange rate has been preserved thanks to the combination of persistent forex interventions and administrative measures, such as the 50% surrender requirement for export proceeds and private transfers exceeding UAH 150,000 (some EUR 15,000). Also, the National Bank suggested imposing a 10-15% tax on the sale of foreign cash, effectively curbing household demand for foreign currency (although the corresponding law has not been adopted by the parliament). Still, the success of all these measures may be short-lived and, more importantly, they have done nothing to address the underlying external imbalances and the eroding export competitiveness.

Our relatively optimistic GDP growth forecast for 2013 is based on the assumption of a timely and 'controlled' currency devaluation, which should at least to some extent offset inefficiencies in the exporting sector, improve the trade balance, and thus enable a return to positive GDP growth. Needless to say, the risks lie primarily on the downside, especially if there is no change in the exchange rate policy and if the world steel prices stay at their currently depressed level or decline even further. Another advantage of a more competitive exchange rate is that it would reduce the need for costly foreign exchange interventions, thus 'freeing up' resources for the forthcoming debt repayments to the IMF (USD 5.8 billion due in 2013) without resorting to a new IMF programme, which is being currently negotiated.[3] In any case, the government will probably have little choice but to implement (at least partially) household gas tariff hikes in order to reduce the deficit of the state-owned energy company Naftohaz. This, along with the likely resumed food price pressures, should fuel consumer price inflation, although on annual average it should not exceed 2-3% due to the favourable carryover effect from 2012.

In the medium and long run, Ukraine appears unlikely to replicate the earlier economic success of several Central European countries whose technological modernization and industrial restructuring was largely facilitated by massive inflows of FDI. This is not least because of the protectionist stance of Ukraine's ruling Party of Regions in tandem with domestic 'oligarchs', who are eager to preserve control over the industrial assets. 'Oligarchs' such as Rinat Akhmetov (System Capital Management, Metinvest) and Dmytro Firtash (RosUkrEnergo) have been the main beneficiaries of privatization which gained momentum since President Yanukovych came to power in early 2010. The privatization target for 2013 has been set at UAH 10.9 billion (some EUR 1 billion), with regional electricity and utility companies and coal mines featuring on the privatization list. Still, the inflows of FDI in the coming years should be facilitated inter alia by the newly signed PSA with Shell on the production of shale gas in Eastern Ukraine, with another PSA (with Chevron) involving shale gas production in Western Ukraine reportedly in the pipeline. Though potentially environmentally controversial, these projects should help reduce Ukraine's long-standing dependence on Russian gas starting from 2017.

The parliamentary elections held in October 2012 did not bring about any major change in Ukraine's political landscape, and the incumbent prime minister Mykola Azarov retained his post. However, there has been a considerable re-shuffle both within the government and the National Bank, with persons personally close to President Yanukovych gaining an upper hand. At the same time, the departure from the government of moderately 'pro-European' Petro Poroshenko (economy minister and formerly a close ally of President Yushchenko) and Serhyi Tyhypko (deputy prime minister in charge of social issues and formerly chief negotiator with the IMF), and especially the murder charges brought up

3 The previous IMF programme formally expired at the end of 2012, but was effectively frozen already in 2010, after Ukraine had refused to hike gas tariffs for households.

recently against Ms Tymoshenko[4] suggest that the prospects of the pending Ukraine–EU Association Agreement, including a Deep and Comprehensive Free Trade Agreement, being signed have not become any better. Since the prospects of joining the Russia-led Customs Union appear equally unlikely at this stage, Ukraine will most probably remain 'stuck' in-between and continue its traditional policy of manoeuvring between its two big neighbours in the foreseeable future.

[4] If proven, these accusations – particularly in combination with other (corruption) charges – may potentially result in a life prison term for Ms Tymoshenko.

Table UA

Ukraine: Selected Economic Indicators

	2008	2009	2010	2011	2012 [1)]	2013	2014	2015
							Forecast	
Population, th pers., average	46258	46053	45871	45706	45593	45470	45360	45250
Gross domestic product, UAH bn, nom. [2)]	948.1	913.3	1082.6	1302.1	1400.0	1460	1570	1700
annual change in % (real) [2)]	2.3	-14.8	4.1	5.2	0.2	1.5	3.0	4.0
GDP/capita (EUR at exchange rate)	2700	1800	2200	2600	3000	.	.	.
GDP/capita (EUR at PPP)	5900	5000	5400	5700	5900	.	.	.
Consumption of households, UAH bn, nom. [2)]	582.5	581.7	686.1	865.9	967.0	.	.	.
annual change in % (real) [2)]	13.1	-14.9	7.1	15.7	11.0	3.0	5.0	6.0
Gross fixed capital form., UAH bn, nom. [2)]	250.2	167.6	195.9	241.8	258.0	.	.	.
annual change in % (real) [2)]	-1.2	-50.5	3.9	7.1	3.0	0.0	6.0	6.0
Gross industrial production								
annual change in % (real)	-5.2	-21.9	11.2	7.6	-1.8	3.0	5.0	7.0
Gross agricultural production								
annual change in % (real)	17.1	-1.8	-1.5	17.5	-4.5	.	.	.
Construction output								
annual change in % (real)	-15.8	-48.2	-5.4	11.0	-13.8	.	.	.
Employed persons, LFS, th, average	20972.3	20191.5	20266.0	20324.2	20350.0	20350	20400	20450
annual change in %	0.3	-3.7	0.4	0.3	0.1	0.0	0.2	0.2
Unemployed persons, LFS, th, average	1425.1	1958.8	1785.6	1732.7	1750.0	.	.	.
Unemployment rate, LFS, in %, average	6.4	8.8	8.1	7.9	7.9	7.8	7.7	7.5
Unemployment rate, reg., in %, end of period [3)]	3.0	1.9	2.0	1.8	1.8	.	.	.
Average gross monthly wages, UAH [4)]	1806.3	1905.9	2239.2	2633.0	3025.0	.	.	.
annual change in % (real, gross)	6.8	-9.0	9.7	8.9	14.2	.	.	.
Consumer prices, % p.a.	25.2	15.9	9.4	8.0	0.6	2.5	4.5	4.0
Producer prices in industry, % p.a. [5)]	35.5	6.5	20.9	19.0	3.6	3.0	5.0	5.0
General governm.budget, nat.def., % of GDP								
Revenues	31.4	29.9	29.1	30.6	31.8	.	.	.
Expenditures	32.8	34.0	35.0	32.4	35.4	.	.	.
Deficit (-) / surplus (+) [6)]	-1.5	-4.1	-6.0	-1.8	-3.6	-3.5	-3.0	-2.5
Public debt, nat.def., % of GDP	20.0	34.8	39.9	36.3	36.8	37.5	36.0	35.0
Central bank policy rate, % p.a., end of period [7)]	12.00	10.25	7.75	7.75	7.50	.	.	.
Current account, EUR mn [8)]	-8721	-1242	-2274	-7359	-11209	-8000	-9500	-10500
Current account, % of GDP	-7.1	-1.5	-2.2	-6.3	-8.2	-6.0	-6.7	-6.5
Exports of goods, BOP, EUR mn [8)]	46274	28958	39321	49865	54272	59700	65700	75600
annual growth rate in %	27.2	-37.4	35.8	26.8	8.8	10.0	10.0	15.0
Imports of goods, BOP, EUR mn [8)]	57270	32046	45641	61540	70209	73700	84800	97500
annual growth rate in %	29.9	-44.0	42.4	34.8	14.1	5.0	15.0	15.0
Exports of services, BOP, EUR mn [8)]	12228	9936	12856	13954	15318	16800	18500	20400
annual growth rate in %	18.3	-18.8	29.4	8.5	9.8	10.0	10.0	10.0
Imports of services, BOP, EUR mn [8)]	11039	8248	9538	9576	10545	11600	12800	14100
annual growth rate in %	28.8	-25.3	15.6	0.4	10.1	10.0	10.0	10.0
FDI inflow, EUR mn [8)]	7457	3453	4893	5177	6458	6000	7000	7000
FDI outflow, EUR mn [8)]	690	116	555	138	976	1000	500	300
Gross reserves of NB excl. gold, EUR mn	21847	17825	25096	23593	17186	.	.	.
Gross external debt, EUR mn	72109	72113	88363	97940	104000	.	.	.
Gross external debt, % of GDP	58.6	85.8	86.0	83.4	76.3	.	.	.
Exchange rate UAH/EUR, average	7.708	10.868	10.533	11.092	10.271	11.0	11.0	10.5
Purchasing power parity UAH/EUR [9)]	3.453	3.962	4.407	4.968	5.247	.	.	.

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

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