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Ukraine: Social spending spree

In Ukraine, a less buoyant domestic demand will likely result in a slowdown of economic growth to around 3% in 2012, with risks on the downside. Both fiscal and monetary policies have been relaxed recently, but may not generate sufficient demand in the environment of elevated uncertainties. While currency depreciation pressures have been so far largely counteracted, the high dependence on external funding will continue to remain a source of risk for the financial stability. The country's increased political isolation implies that the association and "deep" free trade agreements with the EU will not be signed at least until the October 2012 parliamentary elections.

Until recently, Ukraine's economy had proven relatively resilient amid the global and European economic woes. However, in the first quarter 2012 economic growth slowed down to a mere 2% year-on-year (after 4.6% in the fourth quarter 2011) and turned slightly negative on the seasonally adjusted quarterly basis. Across sectors, only mining and services recorded solid growth, whereas manufacturing and agriculture were close to stagnant and construction output declined. Above all else, the stagnating manufacturing output reflects a decline in metals, textile and the oil-processing industry – the latter on account of the Lisichansk refinery being shut down.

The slowdown of economic growth has been fully due to the weakening of domestic demand, representing largely a less buoyant private consumption and a marked decline in inventories.¹ The deceleration of household consumption growth from the extraordinarily high pace recorded last year (+15%) may not come as a surprise: even at the current pace, it continues to thrive. In January-May 2012, retail trade turnover soared 15.5% in real terms, facilitated by impressive growth in nominal wages and marked disinflation (see below). Fixed capital investments have also performed strongly (+8% in the first quarter 2012), primarily driven by factors other than the government-sponsored infrastructure projects ahead of the 2012 European football championship, most of which have been

¹ The latter may be attributed to the high statistical base in the first quarter 2011 due to large-scale purchases of gas by Naftohaz in order to compensate RosUkrEnerg following the ruling of the Stockholm Arbitration Court.

largely completed. In fact, most regions hosting championship games have recorded a below-average rise in investments.

In turn, the external sector can be hardly blamed for the recent growth slowdown. In real terms, the dynamics of both exports and imports (of goods and services) in the first quarter 2012 turned negative. However, they declined at a similar pace, so that net exports have been less of a drag on GDP growth than in 2011, when imports surged well ahead of exports. In nominal terms, the export dynamics have been marginally positive (+4.8% in January-May 2012), but exports of metals declined by 7%, reflecting primarily lower global prices. On the other hand, exports of agricultural products and machinery (the latter mostly to Russia) continued to perform well. Growth in nominal imports has been extremely weak, too (+6.4% over the same period), and is likely to remain so in the months to come, as the rising gas prices (mirroring the peak in oil prices in the first quarter 2012) should be at least partly offset by the expected decline in oil prices. In addition, it is still quite possible that Ukraine will succeed in re-negotiating the infamous gas contract with Russia. As a result, further deterioration of the current account deficit beyond 4-5% of GDP can probably be avoided.

Consumer price growth is still being dampened by last year's exceptional harvest. By May 2012, food prices had declined by 4.2% on an annual basis, resulting in consumer price deflation of 0.5% and making a case in favour of softening monetary policy. In March 2012 in a move to revive domestic lending (particularly in the household segment), the National Bank lowered the discount rate from 7.75% to 7.5%. It also eased the reserve requirements on hryvnia deposits, although it simultaneously raised those on foreign currency deposits. The National Bank's purchases of foreign exchange in March and April 2012 in response to the receding depreciation pressure on the hryvnia also contributed to the expansion of the monetary base and, at least in theory, to that of the money supply. However, judging by the stagnant credit dynamics, the effectiveness of those measures has at best been limited. The interest rates for loans demanded by banks have even increased and currently stand on average at 18%. In most cases, they are prohibitively high, especially in an environment marked by lower inflation. Credit expansion is also being constrained by the ongoing deleveraging of the Ukrainian subsidiaries of European banks (which still account for around 25% of the banking sector). The latter are freezing their lending operations or even withdrawing funds so as to be able to comply with stricter capital adequacy requirements.

Confronted by low ratings on the eve of the upcoming parliamentary elections on 28 October 2012, the Yanukovich administration, which had otherwise been known for its

fiscal prudence, has splurged out on social spending. The recently enacted budget amendments envisage for 2012 extra expenditures of UAH 33 billion (an estimated 2.4% of GDP). Of that amount, UAH 18 billion is to be used for social payments such as pensions, children's allowances and disability benefits. Another UAH 6 billion is to be channelled to compensate the depositors of the former Soviet Sberbank, whose savings were effectively gobbled up by hyperinflation in the 1990s.² Before the end of 2012, those eligible are to receive a lump-sum compensation of UAH 1,000 (some EUR 100) and their heirs will receive UAH 500 (EUR 50). Finally, UAH 1 billion has been allocated to the subsidized mortgage programme. Of the 16% interest rate that banks charge for household mortgages, some 13-14 p.p. are to be covered from the state budget. It is hoped that the move will boost mortgage loans (as well as provide a comfortable source of revenue for the banks participating).

These extra expenditures are to be financed largely by improving tax collection. The latter is expected to yield UAH 21 billion, while the bulk of the remaining UAH 12 billion should come in the form of state signature bonuses from production-sharing agreements on offshore hydrocarbon exploration activities. In the first quarter 2012, fiscal performance was indeed encouraging. Despite the slowdown in economic growth, the revenues of consolidated budget went up by 13.5% in real terms. However, the optimistic projection of tax collection for the current year is still based on the official forecasts of 3.9% real GDP growth and 7.9% consumer price inflation, both of which look increasingly unreal. This hints at the budget deficit in 2012 possibly exceeding the current target of 1.8% of GDP (excluding transfers to Naftohaz). Should the government find a way to finance the higher deficit either via extra borrowing or from some other sources (such as higher privatization proceeds), the recent social initiatives should offset the recent slowdown of economic growth. However, if deficit financing proves problematic, compelling the government to cut expenditures elsewhere (most likely on public investments), the economic benefits of the government initiatives may be less apparent.

Given the sluggish GDP growth in the first quarter of 2012, wiiw has lowered its forecast for the year as a whole to 3.2%, with risks on the downside. The authorities will probably avoid taking unpopular measures, such as raising residential energy tariffs or allowing the hryvnia to depreciate - at least not until the parliamentary elections are over. Taking into account the traditional food-price stability over the summer months, inflationary pressures are likely to stay reasonably low in the months to come. However, should the eurozone

² The deposit compensation programme was initially launched by the Tymoshenko government back in 2008, but stalled during the economic crisis.

crisis escalate any further, the repercussions for the financial markets in the emerging economies, including Ukraine, may be severe and potentially jeopardize the viability of the current exchange rate peg of 8 UAH/USD even before the October elections.

EU concerns over what it views as the selective use of Ukraine's judicial system to political ends (first and foremost, but not solely, the 'Tymoshenko case') have resulted in the country's growing political isolation. One manifestation of this has been the boycott of the European football championship in Ukraine by a number of European leaders. After a protracted delay, the Association Agreement with the EU was finally initialled on 30 March 2012. However, the related Deep and Comprehensive Free Trade Agreement was initialled only partly; it is to undergo final verification over the months to come. Meanwhile, further criminal charges have been filed against Ms. Tymoshenko, making it highly unlikely that she will be released or any agreements signed with the EU before the elections in October. Furthermore, recent Ukrainian opinion polls suggest a shift in public sentiment away from EU integration: it is now less popular than e.g. Ukraine's joining a Customs Union with Russia.

Table UA

Ukraine: Selected Economic Indicators

	2008	2009	2010	2011 ¹⁾	2011 1st quarter	2012	2012 Forecast	2013	2014
Population, th pers., average	46258	46053	45871	45706	45751	45611	45600	45500	45400
Gross domestic product, UAH bn, nom.	948.1	913.3	1082.6	1316.6	261.9	297.0	1390	1530	1690
annual change in % (real)	2.3	-14.8	4.1	5.2	5.4	2.0	3.2	4	5
GDP/capita (EUR at exchange rate)	2700	1800	2200	2600	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	6000	5100	5400	5800	.	.	.	.	.
Consumption of households, UAH bn, nom.	582.5	581.7	686.1	857.3	182.2	211.0	.	.	.
annual change in % (real)	13.1	-14.9	7.1	15.0	13.8	9.8	8	6	6
Gross fixed capital form., UAH bn, nom.	250.2	167.6	195.9	247.9	37.7	47.6	.	.	.
annual change in % (real)	-1.2	-50.5	3.9	10.1	2.1	7.6	5	8	8
Gross industrial production									
annual change in % (real)	-5.2	-21.9	11.2	7.3	10.3	0.9	2	4	6
Gross agricultural production									
annual change in % (real)	17.1	-1.8	-1.5	17.5	5.3	0.5	.	.	.
Construction output									
annual change in % (real)	-15.8	-48.2	-5.4	11.1	6.8	-2.7	.	.	.
Employed persons - LFS, th, average	20972.3	20191.5	20266.0	20324.2	20108.2	.	20300	20350	20400
annual change in %	0.3	-3.7	0.4	0.3	0.1	.	0	0.2	0.2
Unemployed persons - LFS, th, average	1425.1	1958.8	1785.6	1732.7	1924.9	.	.	.	.
Unemployment rate - LFS, in %, average	6.4	8.8	8.1	7.9	8.7	.	7.9	7.7	7.5
Unemployment rate, reg., in %, end of period ²⁾	3.0	1.9	2.0	1.8	2.2	1.9	.	.	.
Average gross monthly wages, UAH ³⁾	1806.3	1905.9	2239.2	2633.0	2388.7	2814.7	.	.	.
annual change in % (real, gross)	6.8	-9.0	9.7	8.9	11.3	14.5	.	.	.
Consumer prices, % p.a.	25.2	15.9	9.4	8.0	7.7	2.9	2	6	5
Producer prices in industry, % p.a. ⁴⁾	35.5	6.5	20.9	19.0	20.0	8.5	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	31.4	29.9	29.1	30.3	32.2	33.2	.	.	.
Expenditures	32.8	34.0	35.0	32.1	32.5	33.4	.	.	.
Deficit (-) / surplus (+) ⁵⁾	-1.5	-4.1	-6.0	-1.8	-0.3	-0.2	-3.5	-3	-2.5
Public debt, nat.def., in % of GDP	20.0	34.8	39.1	35.9	34.1	34.5	35	34	33
Central bank policy rate, % p.a., end of period ⁶⁾	12.00	10.25	7.75	7.75	7.75	7.50	.	.	.
Current account, EUR mn ⁷⁾	-8721	-1242	-2274	-6469	-981	-926	-6000	-6500	-7000
Current account in % of GDP	-7.1	-1.5	-2.2	-5.5	-4.1	-3.3	-4.7	-4.9	-4.8
Exports of goods, BOP, EUR mn ⁷⁾	46274	28958	39321	49865	11401	12537	54900	63100	72600
annual growth rate in %	27.2	-37.4	35.8	26.8	51.3	10.0	10	15	15
Imports of goods, BOP, EUR mn ⁷⁾	57270	32046	45641	59782	13660	14641	65800	75700	87100
annual growth rate in %	29.9	-44.0	42.4	31.0	62.1	7.2	10	15	15
Exports of services, BOP, EUR mn ⁷⁾	12228	9936	12856	13954	3028	3138	14700	16200	17500
annual growth rate in %	18.3	-18.8	29.4	8.5	16.7	3.6	5	10	8
Imports of services, BOP, EUR mn ⁷⁾	11039	8248	9538	10444	2291	2372	11000	12500	14500
annual growth rate in %	28.8	-25.3	15.6	9.5	19.0	3.5	5	14	16
FDI inflow, EUR mn ^{7) 8)}	7457	3453	4893	5177	641	1107	5000	6000	7000
FDI outflow, EUR mn ⁷⁾	690	116	555	138	-3	.	.	.	.
Gross reserves of NB excl. gold, EUR mn	21847	17825	25096	23593	24960	22283	.	.	.
Gross external debt, EUR mn	72109	72113	88363	97940	85667	.	.	.	.
Gross external debt in % of GDP	58.6	85.8	86.0	82.5	72.2	.	.	.	.
Exchange rate UAH/EUR, average	7.708	10.868	10.533	11.092	10.849	10.435	11	11.5	11.5
Purchasing power parity UAH/EUR, wiiw ⁹⁾	3.417	3.921	4.361	4.972	.	.	.	.	.

1) Preliminary. - 2) In % of working age population. - 3) Excluding small enterprises. - 4) Domestic output prices. - 5) wiiw projections include transfers to Naftohaz. - 6) Discount rate of NB. - 7) Converted from USD with the average exchange rate. - 8) In first quarter 2012 FDI net. - 9) wiiw estimates based on the 2005 International Comparison Project benchmark.

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