Ukraine: Current Economic and Business Situation

Dr. Edilberto Segura
Partner and Chief Economist, SigmaBleyzer
President of the Board, The Bleyzer Foundation

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Defense Situation

• Following the Minsk Protocol of September 2014, the fighting in Donbas declined initially, but resumed with new strength in January 2015.
• Diplomatic efforts to restore peace resulted in the Minks-II Agreement (Ukraine, Russia, Germany & France) on Feb. 12, 2015, which envisaged:
  • A new ceasefire starting at midnight on February 15th.
  • Withdrawal of heavy weapons from the front line by Ukrainian forces and rebels.
  • Release of all prisoners and amnesty for those involved in fighting.
  • Withdrawal of foreign troops from Ukraine and disarmament of illegal groups.
  • Restoration of Ukraine’s control over its border with Russia after constitutional reform that would grant more autonomy to the regions and local elections (both to be completed by the end of 2015).
• Despite delays in implementation of the Minsk-II Agreement, there is now progress in de-escalation, with the intensity of fighting receding.
• But the risks of renewed hostilities still remain high. In particular, there have been a number of terrorists acts in other cities, such as Odessa and Khariviv.
• Furthermore, OSCD cannot confirm the total pull back of heavy weapons in many areas controlled by the Separatists.
Ukraine and Separatist Area

- The Separatist area represents 4% of Ukraine, but contributed a large share of its economic output: 14% of exports, 12% of industry, and 9% of GDP.
- The hostilities therefore were the main reasons for the large declines that Ukraine suffered on exports, industry, and GDP:
  - Exports declined by about 22% in two years.
  - As exports represent \( \approx 45\% \) of GDP, GDP dropped by 6.8% in 2014.
  - This led to: devaluation of the Hryvnia (from 8 to 24 UAH/$ in 2014-15), increase in inflation (to 25% as the end of 2014), increase in unemployment rate (to 9% at the end of 2014), and problems in the country’s financial sector (due to deposit withdrawals caused in turn by lack of confidence).
Exports to Russia and Prospects

- About two-thirds of the drop of exports were due to declines in exports to Russia, Belarus & Kazakhstan, which declined from 32% of the total in 2012 to 23% in 2014 and to 13% in early 2015.
- Declines in exports to other countries were due to war damage to productive/infrastructure capacity.
- However, most of the potential export reduction has already taken place: therefore there is little room for further economic decline.
- Thus, future economic recovery will now depend on:
  1. the containment of further hostilities by Russia.
  2. the strength of government reforms agenda to improve the business environment to attract FDIs and increase exports to other countries.
  3. the continuation of international financial support.
Containing Further Hostilities by Russia.

- Russian invasion of Crimea & Donbas was preceded by a well-conceived Russian integrated plan to destabilize these regions, create chaos, and win the support of the local populations through promises of greater well-being, pensions and income; misleading propaganda to create fear, and propaganda to destroy the reputation of Ukrainian authorities.

- These acts of “hybrid war” facilitated Russia’s physical invasion later on.

- Further Russian aggression to Ukraine could be less successful if Ukraine were to have an holistic integrated program to neutralize this hybrid war.

- Such program could have four elements (for which USUBC should help):

  1. Create a Social Stabilization Fund for Kharkiv and Odessa to improve the well-being of local people by financing micro-projects desired by communities (such as school repairs, medical posts, water supply, roads, sewerage, etc.) This will also provide temporary employment and give locals the expectation that Ukraine is doing something for them. Private local and foreign (USUBC) financing for this Fund should be provided.
Dealing with Hybrid War

2. The above fund would provide short term relief to local people. But to improve well-being over the longer term, Ukraine must attract foreign direct investments and find alternative outlets for exports. The USG could help by providing political guarantees for FDIs and by entering into a free trade agreement (FTA) with Ukraine. USUBC firms should help by lobbying with US authorities about these options.

3. Completing the transition to a modern democracy and economy. The government has developed a reform agenda with the IMF (discussed later). But it still lacks the capacity to implement them. Greater support in this area should be provided by international agencies and firms.

4. Responding to Russian propaganda in conventional media. International companies in advertisement and media should help the implementing programs of good journalism and exposing Russian misinformation.

5. Responding to Russian social media attacks. International IT firms should help in devising strategies to counteract these attacks.
The Reform Agenda and International Support

• Following early parliamentary elections in October 2014, a strong pro-European majority was formed in the Parliament.

• Thus, for the first time since independence, Ukraine now has a Parliament, a President, and a Prime Minister who share similar pro-democratic and socio-economic reform-oriented goals, and also who are prepared to collaborate.

• A good catalyst for reforms has been the IMF Program negotiated during January-February 2015: in addition to $17.5 billion of financing, it contains commitments from the government to implement a number of stabilization and structural reforms to improve Ukraine’s business climate.

• The Ukraine-IMF Memorandum of Economic Reforms list the following actions, with agreed upon timetables:
  • Anti-corruption Program to protect business from abuse of power by officials.
  • Improvements in the business legal environment and the judicial/court system to ensure just and unbiased judgments.
  • Further business de-regulation measures to minimize red tape and bribes.
  • Energy sector reform to reduce Naftogaz deficits and encourage energy self-sufficiency.
Reform Agenda (continued)

• Reform of public administration, including decentralization and local government reform, and reform of the tax system.
• Improvements in corporate and public governance that would protect ownership rights.
• Measures to restore the health of the financial sector.

• The government has already disclosed key elements of these reforms: e.g., the number of taxes will be reduced from 22 to 11, the number of agencies having controlling functions will be decreased from 56 to 27, e-gov practices are expected to be introduced in all agencies, etc.
• As financing under the new IMF program will be strongly dependent on the implementation of structural reforms, there are good chances that Ukraine may finally restore macroeconomic stability, reshape its economy, and lay the foundation for strong and sustainable economic growth.
• Thus, Ukraine has a good chance to make a quantum jump in its economic and business environments that will allow it to grow at least by 4-5% pa.
Summary of Reasons for Economic Recovery

If peace is maintained, economic recovery is possible for the following reasons:

- The major cause of economic deterioration (export drop to Russia) has been exhausted, with very limited exports to Russia still remaining.
- For the first time since independence, Ukraine has a pro-reform democratic Parliament, President, and Prime Minister.
- The government has a strong economic reform agenda, supported by the IMF and the international community, and backed up by sufficient funds to cover possible foreign financing gaps.
- The 300% Hryvnia devaluation represented an overshooting and will permit future exchange rate stability, while maintaining Ukraine’s international competitiveness in trade (with low wages) for many years.
- Free trade agreements with the EU, and possibly with Canada, Israel, and other countries should further encourage export and GDP growth.
- Foreign direct investments should be encouraged by low asset prices and large opportunities to exploit local inefficiencies.
Main Macroeconomic Indicators

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<tbody>
<tr>
<td>Real GDP Growth, % yoy</td>
<td>0.2</td>
<td>-6.8</td>
<td>-5.0</td>
<td>2.0</td>
<td>3.5</td>
<td>4.0</td>
<td>5.0</td>
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<td>Fiscal Balance, % GDP</td>
<td>-5.6</td>
<td>-11.7</td>
<td>-7.5</td>
<td>-4.0</td>
<td>-3.1</td>
<td>-2.6</td>
<td>-2.4</td>
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<td>Consumer Inflation, %, eop</td>
<td>-0.2</td>
<td>24.9</td>
<td>30.0</td>
<td>10.0</td>
<td>7.2</td>
<td>5.0</td>
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<td>Exports of Goods, $ bn</td>
<td>62.4</td>
<td>55.6</td>
<td>49.8</td>
<td>53.0</td>
<td>56.7</td>
<td>60.7</td>
<td>65.1</td>
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<td>Current Account, % GDP</td>
<td>-8.1</td>
<td>-4.1</td>
<td>-1.2</td>
<td>-0.5</td>
<td>-0.5</td>
<td>-0.5</td>
<td>-0.5</td>
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<td>UAH/$ Exchange Rate, eop</td>
<td>8.0</td>
<td>15.8</td>
<td>25.0</td>
<td>25.0</td>
<td>25.0</td>
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<tr>
<td>Gross Int. Reserves, $ bn</td>
<td>24.5</td>
<td>7.5</td>
<td>13.0</td>
<td>17.0</td>
<td>22.0</td>
<td>28.0</td>
<td>35.2</td>
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<tr>
<td>Public Debt, % GDP</td>
<td>36.6</td>
<td>73.0</td>
<td>94.0</td>
<td>92.0</td>
<td>89.0</td>
<td>83.0</td>
<td>77.0</td>
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* Includes implicit Pension Fund deficit and Naftogaz imbalances
Source: NBU, SSS of Ukraine, MinFin, IMF, The Bleyzer Foundation
Economic Growth

In 2014, real GDP fell by 6.8% yoy, affected by:
- hostilities in Donbas, disruption of economic ties between the regions and infrastructure damages;
- deteriorated trade relations with Russia;
- sharp Hryvnia depreciation; and
- tough fiscal austerity measures.

The decline took place in all demand components, including exports, investments and private consumption.

But lower imports and high agricultural harvest softened the negative impact of these factors.

In 2015 real GDP is forecast to decline by about 5% yoy with the recovery to start in 2016.
Public Finances

- In 2014, the fiscal budget deficit widened to 11.7% of GDP despite austerity measures.
- The deterioration was due to:
  - larger Naftogaz budget imbalances;
  - higher expenditures on defense, security, and external debt service;
  - lower tax revenues associated with the economic downturn and hostilities.
- High Naftogaz deficits led to the start of energy sector reforms (strengthen payment discipline, restructure the company to cut costs and increase transparency). The reform is expected to gain momentum in 2015.

- Fiscal imbalances led to a rapid increase in public debt-to-GDP ratio (to 94%).
- To contain concerns over public debt sustainability and comply with IMF requirements, the government approved further fiscal consolidation measures.
- The fiscal budget deficit will decline to 7.5% of GDP in 2015 and 4% in 2016.

Source: MinFin, The Bleyzer Foundation
Inflation

- In 2014, inflation reached 25% yoy due to:
  - Higher import prices due to Hryvnia devaluation;
  - The pass-through of rising fuel prices to other goods through transportation costs;
  - Adjustment of utility tariffs;
  - Increase in indirect taxes (excises, import duties, abolition of VAT for some goods);
  - Monetization of public sector fiscal deficit (the NBU purchased 82% of government securities issued in 2014).

- In 2015, consumer prices are forecast to rise by about 30% yoy, affected principally by further Hryvnia depreciation and increases in tariffs and indirect taxes.
- To contain inflationary pressures, the NBU has been taking contractionary measures: the NBU discount rate was raised to 19.5% in February 2015 and to 30% in March.
- Inflation is expected to go down to 10% in 2016,
Banking Sector Weaknesses

- Ukraine’s banking sector is under stress:
  - due to UAH & $ deposit withdrawals;
  - deterioration of asset quality caused by GDP declines and UAH depreciation;
  - high external debt repayments.
- These factors adversely affected the cost and availability of bank credit.
- Despite NBU liquidity support, due to ongoing capital erosion, about 40 banks have been declared insolvent since the beginning of 2014 to date.

- Inadequacies in banking legislation (on mortgages, bankruptcy procedures, loan restructuring, etc.) contributed to banking sector weaknesses.
- To resolve the banking crisis, the Ukrainian authorities plan to improve banking sector legislation, increase transparency in the sector (credit history, bank owners, etc.), and approve a bad asset resolution program.

Select Banking Sector Indicators, % yoy growth

Source: SSS of Ukraine, NBU, The Bleyzer Foundation
Foreign Trade and Current Account Deficit

- As noted, hostilities led to a decline in **Ukrainian exports** from $69 bn in 2012 to $54 bn in 2014, a **fall of $15 bn**, equivalent to a drop of 22%.
- Due to trade restrictions, exports to Russia’s Customs Union decreased by 45%, the equivalent to $10 bn or 2/3 of the overall decrease in Ukrainian exports.
- About 80% of the drop in Ukrainian exports were in 3 categories: Machinery-Transport Equipment (60% of which went to Russia), Metallurgy, and Chemicals.

- Although increasing their share, exports to the EU have reminded at about $17 bn.
- In 2014, due to reduction in imports amid weaker domestic demand, the current account deficit narrowed to 4.1% of GDP (down from 9% of GDP in 2013).
- The CA deficit will decline to 1.2% of GDP in 2015.

Source: State Statistical Service of Ukraine, The Bleyzer Foundation
External Financing

Select BoPs Indicators of Ukraine

- In 2014, Ukraine’s financial account of BoPs had a deficit of 6.3% of GDP, due to:
  - High external debt repayments;
  - Foreign capital outflow amid macroeconomic imbalances and political/military instability;
  - Large domestic FX demand for saving and risk reducing purposes.
- These BoPs deficits, and closed foreign capital markets, led to a depletion of international reserves (to $7.5 bn by the end of 2014, just 1.2 months of imports).
- The BoP will not be an issue in the future.

- Ukraine’s external financing needs are estimated at around $40 bn for 2015-18.
- The government envisages that these needs will be covered by
  (i) the IMF’s EFF of $17.5 bn;
  (ii) other official financing; and
  (iii) the structuring of private foreign debt.
Military hostilities and the imbalances they created, have led to the Hryvnia/$ rate falling by about 300% since January 2014.

Faced with depleted reserves, the NBU tightened administrative restrictions on forex purchases, which stimulated the development of black and grey markets.

To avoid the existence of three exchange rates, on February 5th, 2015, the NBU allowed Hryvnia to free float.

Although this move was needed, the timing may have caused undue uncertainties, since there were still doubts related to the approval of the IMF foreign financial aid package and the military conflict was still escalating.

As a result, the exchange rate overshoot to 30 UAH/$ by the end of February.

By March, it went down to 23 UAH/$ and should remain at 25 UAH/$ in 2015.
Summary

• According to baseline scenario, **GDP will decline** by 5.0% in 2015 due to austerity measures, Hryvnia depreciation and severe economic disruptions caused by hostilities in the East. The recovery should start in 2016.

• Due to low GDP growth and Hryvnia devaluation, **the fiscal deficit** will remain large in 2015. As a result, the public debt-to-GDP ratio will reach 94% of GDP in 2015. But thanks to measures under the IMF program, Ukraine’s public finances will return to sustainable path over the medium-term.

• **Inflation** is likely to accelerate to 30% in 2015 amid further Hryvnia depreciation, aggressive utility tariff adjustments and hikes in indirect taxes.

• Despite weak exports, the CA will improve, thanks to falling imports.

• Ukraine external financing needs in 2015 are forecast to be reduced as a result of sovereign debt restructuring and fully covered by official financing from the IMF, other IFIs, and individual countries.

• On this basis, the exchange rate should stabilize at **25 UAH/$** during 2015.

• With a good start on structural reforms, Ukraine can achieve a quantum leap in its economic development over the medium term.