Ukraine: Current Political and Economic Situation

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Political Situation

• Following the ouster of President Yanukovych in February 2014, Ukraine held presidential elections on May 25th and is preparing to have early parliamentary elections in the Fall of 2014.

• The new President, Mr. Poroshenko, a pro-Western experienced politician and successful businessman, pledged to:
  – Bring peace and protect the territorial integrity of the country
  – Implement tough economic restructuring and painful reforms
  – Tackle corruption and overcome years of economic mismanagement.

• On June 27th, Poroshenko signed the economic part of the Association Agreement with the EU. Its ratification is expected in September 2014.

• Settling the conflict in east Ukraine and stabilizing the security situation are currently the highest priority for the Ukrainian authorities.

• Since April 2014, the Ukrainian military and pro-Russian rebels are battling for control of eastern Ukraine, the country’s industrial heartland.

• By mid-August, govt. forces had regained control of ¾ of the territories, but a recent Russian “undeclared” invasion complicated the situation.
Recent Developments

- In the two largest cities of the region – Donetsk and Luhansk insurgents have concentrated significant forces. A new frontier is also developing in the south of Donetsk with an apparent intention to create a land corridor to Crimea.
- Amid mounting losses and growing damages, Ukraine agreed to participate in trilateral peace talks (with Russia and EU) in Minsk, Belarus, which took place on August 26th but ended without results.
- Officially Russia agreed to establish effective control over its border with Ukraine and continues to deny the deployment of troops in Ukraine.
- In practice, it has been increasing supporting rebels and mercenaries with well-armed army equipped with tanks and artillery.
- Ukraine announced a shift in the focus of its military operation to defense against ‘full-scale’ Russia’s invasion.
- On September 2nd, a new ceasefire deal was announced, which, however, may not succeed as Russia demanded Ukraine to negotiate a political truce with the rebels, including recognition of ‘the political organization and statehood’ of the region, which looks unacceptable for Ukraine.
- Heavy fighting is causing damages to the Ukrainian economy, with pressures on public finances, trade, and the local currency.
### Main Macroeconomic Indicators

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<th>2009</th>
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<th>2012</th>
<th>2013</th>
<th>2014f</th>
<th>2015f</th>
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<tbody>
<tr>
<td><strong>Real GDP Growth, % yoy</strong></td>
<td>-14.8</td>
<td>4.1</td>
<td>5.2</td>
<td>0.2</td>
<td>0.0</td>
<td>-7.0</td>
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<tr>
<td><strong>Fiscal Balance, % GDP</strong></td>
<td>-8.5</td>
<td>-6.7</td>
<td>-4.3</td>
<td>-5.6</td>
<td>-6.5</td>
<td>-11.0</td>
<td>-6.0</td>
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<tr>
<td><strong>Consumer Inflation, %, eop</strong></td>
<td>12.3</td>
<td>9.1</td>
<td>4.6</td>
<td>-0.2</td>
<td>0.5</td>
<td>20.0</td>
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<tr>
<td><strong>UAH/$ Exchange Rate, eop</strong></td>
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<td>8.0</td>
<td>13.5</td>
<td>13.5</td>
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<tr>
<td><strong>Current Account, % GDP</strong></td>
<td>-1.4</td>
<td>-2.2</td>
<td>-6.3</td>
<td>-8.1</td>
<td>-9.0</td>
<td>-4.5</td>
<td>-3.0</td>
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<tr>
<td><strong>Gross Int. Reserves, $ bn</strong></td>
<td>26.5</td>
<td>34.5</td>
<td>31.8</td>
<td>24.5</td>
<td>20.4</td>
<td>16.0</td>
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<td><strong>Public Debt, % GDP</strong></td>
<td>34.8</td>
<td>39.9</td>
<td>36.3</td>
<td>36.6</td>
<td>40.5</td>
<td>66.0</td>
<td>72.0</td>
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</tbody>
</table>

* Includes implicit Pension Fund deficit and Naftogaz imbalances

Source: NBU, SSS of Ukraine, MinFin, The Bleyzer Foundation
Economic Growth

• In 1H 2014, real GDP fell by about 3% yoy, affected by:
  • political uncertainties and hostilities;
  • sharp Hryvnia depreciation;
  • worsening trade relations with Russia;
  • tough fiscal austerity measures.

• Weak exports and consumption are the main causes of the downturn.

• However, lower imports and high agricultural harvest are softening the negative impact of these factors.

• The economy is expected to bottom out in 2H 2014 with real GDP down by about 7% yoy for the whole year.

• Moderate recovery could start in 2015.

**Contributions to Real GDP Growth, percentage points**

Source: State Statistical Service of Ukraine, The Bleyzer Foundation
Public Finances

- In 2014, the fiscal budget deficit will widen to 11% of GDP despite austerity measures to rise taxes and cut expenditure.
- The deterioration will be due to:
  - larger Naftogaz budget imbalances.
  - higher expenditures on defense, security, and external debt service;
  - lower tax revenues associated with the economic downturn, hostilities and ineffective tax collection policies;
- High Naftogaz deficits led to the start of energy sector reforms (strengthen payment discipline, and company restructuring to cut costs and increase transparency).

- With strong government commitment to continue fiscal consolidation, the IMF agreed to adjust the programmed public sector deficit.
- Despite some delay, IMF funds are planned to be fully disbursed this year.

Source: MinFin, The Bleyzer Foundation
Naftogaz and the Natural Gas Situation

• The government agreed to raise natural gas tariffs, but Naftogaz deficit will increase to 6% of GDP due to Hryvnia devaluation and higher imported natural gas prices.

• In April 2014, Russia raised gas prices for Ukraine from $268 to $485 per 1000 m3.

• Ukraine rejected the new price and Russia cut gas supplies to Ukraine since mid-June.

• Ukraine and Russia appealed to Stockholm Arbitration Court to resolve the dispute but this will take time.

• To pass through the winter season without Russian gas, Ukraine counts on:
  • Natural gas supplies in reverse order from Europe (Hungary, Poland, Slovakia);
  • Gas consumption savings (up to 30% in industry and municipalities);
  • Energy substitution (by coal, electricity, other fossil fuels).

• Realizing these measures may be insufficient in case of very cold winter, the new round of trilateral negotiations is scheduled for September 2014.
Inflation and Banking Sector Weaknesses

- In 2014, inflation is forecast to accelerate to 20% yoy (it was 12.6% yoy in July 2014) due to:
  - Effect of a 60% Hryvnia devaluation into import prices;
  - Adjustment of utility tariffs, which were virtually frozen over the last five years;
  - Increase in excises and import duties;
  - Monetization of public sector fiscal deficit.
- Ukraine’s banking sector is under stress due to a slowdown in deposit growth and Hryvnia depreciation.

- These adversely affected both the cost and availability of bank credit, as well as the quality of the existing loan portfolio.
- Banking sector weaknesses have been addressing through: (i) NBU’s provision of necessary liquidity, (ii) performing stress-tests for largest banks and developing capitalization plans, (iii) imposing temporary administrative limitations on deposit withdrawals, (iv) removing legal impediments in dealing with collateral.
In 2014, Ukraine experiences severe negative export shocks due to worsened relations with Russia and disruptions in traditional export routes after Crimea’s annexation.

Russia accounted for about 28% of total Ukraine’s exports in 2013.

In 1H 2014, Ukraine’s export of goods and services to Russia fell by 24% yoy and is likely to deteriorate further due to:
- Russia’s imposition of restrictions on imports from Ukraine
- Ukraine’s halt of military and dual-purpose exports to Russia.

Increased EU trade and high agricultural harvest will soften the decline, but overall export performance will be weak in 2014.

Nevertheless, current account deficit will narrow to about 4.5% of GDP in 2014 (down from 9% of GDP in 2013) due to reduction in imports amid weaker domestic demand and lower energy imports.
Despite improvements in the current account, the capital account will be under stress in 2014 due to:

- High external debt repayments (about $8 billion of public obligations and around $60 billion of private sector debt service);
- Foreign capital outflow amid macroeconomic imbalances and political/military instability;
- Large domestic FX demand for saving and risk reducing purposes.

Macroeconomic imbalances and uncertainties have already led to an almost 60% Hryvnia devaluation to about 13 UAH/USD.

Under the baseline scenario, Ukraine’s external financing needs would be fully covered by planned external financing from the IMF, the EU, other IFIs, individual countries (the US, Japan, etc.) and reasonable private debt rollovers.

Under a pessimistic case, Ukraine will require significant additional external financing of about $20 billion.

Assuming both planned and contingency external financing is provided, the exchange rate may remain stable at around UAH 13.5 per USD in 2014-15.
Medium-Term Growth Prospects

• Currently, major efforts of the government are concentrated on stabilizing the military, political and macroeconomic situations.

• However, the Ukrainian authorities understand that macroeconomic stability will not be sustainable without long-awaited structural reforms.

• Main areas of reform include: (i) public administration reform with focus on decentralization and a smaller central apparatus focused on policy; (ii) further business tax system reform; (iii) judicial reform to ensure just and unbiased judgments; (iv) de-regulation of business activities to encourage entrepreneurship; (v) effective anticorruption measures; (vi) banking sector reform with truly independent NBU; and (vii) energy sector reform.

• The government has already disclosed key elements of these reforms: e.g., the number of taxes will be reduced from 22 to 9, the number of agencies having controlling functions will be decreased from 56 to 27, e-government practices are promised to be introduced in all agencies by the end of 2014, etc.

• If reforms are successfully implemented, Ukraine has a good chance to make a quantum jump in its economic and business environments that will allow it growing at least by 5% yoy per annum.
Summary

• According to baseline scenario, GDP will decline by 7.0% in 2014 due to austerity measures and severe economic disruptions caused by Russia’s hostilities. The recovery could start in 2015.

• Due to low GDP growth and Hryvnia devaluation the fiscal deficit will widen in 2014. Public debt-to-GDP ratio, as a result, will exceed 60% of GDP in 2014. 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 20% in 2014, but will moderate to around 8% yoy in 2015.

• Ukraine external financing needs in 2014-15 are forecast to be fully covered by official financing from the IMF, other IFIs, and individual countries.

• On this basis, the exchange rate should stabilize at about UAH 13.5 per USD during 2014-15.

• With good progress on structural reforms, pledged by the new government authorities, Ukraine may achieve a quantum leap in economic development.

• The pessimistic scenario assumes overt armed conflict with Russia and/or extension of the conflict into 2015. In this case, the recovery will be delayed to 2016, while the country may require additional external financing and military aid.