

Ukraine's economy: between expected aid from the West and real sanctions from Russia

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The prolonged political crisis in Ukraine has contributed to the deepening of its economic recession, which has already lasted almost two years, thus reducing the possibility of stabilising the socio-political situation. The government's plans for economic stabilisation are based on the expectation of billions in financial aid from the West, although this is dependent on Kyiv undertaking genuine reforms and unpopular economic decisions such as cuts in social spending, and increases in domestic prices for gas, electricity and municipal services. The positive effects of the reforms and the Western financial aid intended for their implementation may be offset by subsequent Russian economic sanctions. The side-effects of these reforms will undoubtedly affect the public mood, and in the long term may have a negative influence on the social perception of the Kyiv government's policies and the evolution of social attitudes towards Russia's policy for Ukraine.

The state of the Ukrainian economy

The growth in GDP in the fourth quarter of 2013 (3.3%), mainly associated with record agricultural production, will probably prove to be a blip in the economic recession which has been ongoing since mid-2012. This is suggested by the persistently poor performance of industrial production (down 4.4% in the first two months of 2014) and falling exports (lower by 12.2% this January year-on-year; during the whole of last year they fell by 8%); the latter has mainly been caused by a drop in orders from Russia, which is still the most important trade partner for Ukraine. According to Kyiv's estimates, Ukraine's GDP will fall by at least 3% in 2014, which will be the worst result in five years (according to some estimates, this year the Ukrainian economy may even see a 7% decrease).

After a period of relatively low prices since 2012, there was significant growth at the end of last year. Although there was deflation of 0.3% throughout 2013, in the first quarter of this year prices have already risen by 1.7%, and the government is assuming an inflation rate of 12% throughout 2014. Given the increases in the prices of excise products and the official rate for gas, which are expected to come in from April, as well as the expected increase in prices of imported products (in connection with the devaluation of the hryvnia by over 30% since the beginning of this year), the government's inflation forecast seems optimistic. The devaluation of the hryvnia resulted in a sharp increase in the debt to GDP ratio, from under 40% at the end of 2013 to 53% at the end of March (according to government estimates).

The crisis translates into pessimistic market expectations. For the first time in two years there has been a decline in the amount of public savings in banks, which in the first quarter of this year were estimated at up to 100 billion hryvnia (over US\$9 billion, at the exchange rate at the end of March), a drop of around 15%. The unpredictable political developments are also affecting the mood of businesses and their investment plans. Ukraine's disconnection from international financial markets has meant that in recent months, the main source for funding expenditures in foreign currencies has been an increased issuance of domestic debt and the use of the central bank's foreign exchange reserves, plus the country's rising debt to Gazprom (in connection with Ukraine's failure to pay its import bills). The Central Bank's foreign exchange reserves have decreased by US\$4.5 billion (about a quarter of the total) since the beginning of the year, and by almost half since the beginning of 2012 (from US\$31.8 billion to US\$15.5 billion at the end of February).

The government's assumptions and the real threats

The government of Arseniy Yatsenyuk inherited a huge hole in the budget from its predecessor. It has thus been forced to pass a budget amendment (on 27 March), and to provide for cuts in spending and revenue of around US\$4.5 billion, including freezing the minimum subsistence level and minimum wage, cutbacks in social programs, etc. A law on the prevention of financial disaster and creating conditions for economic growth has also been passed. As of April, gas prices for domestic municipal (64%) and industrial consumers (30%) have also been raised, and from May prices for the general public will increase (by at least 50%, depending on the volume of consumption).

The government's plans to stabilise the public finances are based on the expectation of billions in financial aid from the West. On 27 March the IMF announced a preliminary agreement on a new loan program for Ukraine of US\$14-18 billion, which requires approval by the IMF's Board of Directors. This is likely to come before the end of April; the Ukrainian government's adoption of the anti-crisis package was the condition for this.

However, it is the relationship with Russia which will be of key importance for Ukraine's further economic and, more broadly, geopolitical perspectives. Moscow is now using economic pressure as one of the main mechanisms to influence Kyiv's policies. After the annexation of Crimea, Moscow unilaterally renounced the so-called Kharkov agreement, one part of which was a discount in the price of gas for Ukraine of US\$100 per 1000 m³ of gas. Earlier, Russia withdrew the discount price it had offered to the previous Ukrainian government in the first quarter of this year. The abolition of both discounts in April brought a sharp rise in the price of Russian gas to Ukraine, from US\$268.50 to US\$485 per 1000 m³ of gas. This price cannot be supported by the Ukrainian economy; Prime Minister Yatsenyuk announced that Ukraine had not agreed to these changes, and is ready to pay the present "balanced market price" for Russian gas.

Moscow is also harassing Kyiv by means of targeted embargoes on selected exports from Ukraine. Although bilateral trade has been declining for two years, the real collapse took place at the beginning of this year; in January, Ukrainian exports to Russia fell by 32.6%. The most serious situation is in the Ukrainian machine-building industry concentrated in the east of the country. Production by Ukrainian plants of rolling stock (mainly oriented towards Russian markets) fell in the first two months by up to 85%, in association with a reduction of

orders from Russia. In early March, representatives of Donetsk city reported that factories there were working at between 5% and 50% of their capacity for that reason.

Conclusions

Ukraine's adoption of the anti-crisis package and budget amendment have practically guaranteed the grant to Kyiv of Western financial assistance (from the IMF, the EU and individual countries), the total value of which could reach US\$27 billion over two years. The commissioning of the IMF loan will allow Ukraine to return to the international financial markets, facilitate the servicing of its foreign debt and, finally, reduce the costs of debt servicing (in 2014-15 Ukraine is expecting large foreign debt payments, estimated at US\$11.6bn and US\$12.2bn respectively, not counting the repayment of foreign loans by the central bank).

The Western financial aid will first of all be used to overcome Ukraine's current economic problems and stabilise the public finances. Whether it will be used effectively in the long term for deep, fundamental reform of the state will depend on the determination and effectiveness of the Ukrainian elite. Dealing with the recession and the problems of the real sector of the economy also depends to a great extent on the development of relations with Russia.

The government's plans to stabilise its rickety public finances, which will involve cutting social spending, significant increases in administrative costs, etc., will affect the deterioration of public sentiment. The effect on the results of the presidential elections planned for May could still be relatively limited, but in the long run, they could affect the evolution of public perception of the present government in Kyiv, the reforms they will implement, and – which is especially important in the case of the east of the country – public attitudes on Russian policy towards Ukraine.