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Ukrainian economy on the verge of recession

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In the third quarter of 2012, Ukraine's economy recorded negative growth (-1.3%) for the first time since its 2009 economic crisis. Q4 GDP is projected to suffer a further decline, bringing Ukraine into formal recession. In addition to the worsening macroeconomic indicators, Ukraine is also facing a series of concomitant economic problems: a growing trade deficit, industrial decline, shrinking foreign exchange reserves, and the weakening of the hryvnia. Poor economic growth is expected to result in lower than projected budget revenues, which in turn could lead to the sequestration of the budget in December. The decline evident across the key economic indicators in the second half of 2012 brings to a close a period of relative economic stability and two years of economic growth, which had been seen as a significant personal achievement of President Viktor Yanukovych and the ruling Party of Regions.

The health of the Ukrainian economy largely depends on the state of the country's export-oriented industries. The current economic forecasts for foreign markets are not very optimistic. It is impossible to determine whether the current economic downturn is likely to be merely temporary or whether it heralds the onset of a prolonged economic crisis. The limited capacity to deal with the growing economic problems may mean that Kiev will need to seek financial support from abroad. This is particularly significant with regard to external debt servicing, since in 2013 Ukraine will need to pay back around 9 billion USD, including over 5.5 billion USD to the International Monetary Fund. In order to overcome the recession and stabilise public finances, the government may be forced to take a series of unpopular measures, including raising the price of natural gas and utilities. These measures have been stipulated by the IMF as a condition of further financial assistance and the disbursement of the 12 billion USD stabilisation loan granted to Ukraine in July 2010. The only alternative for Western loans and economic reforms appears to be financial support from Russia. The price for Moscow's help might however turn out to be very high, and precipitate a turn in Kiev's foreign policy towards a gradual re-integration of former Soviet republics under Moscow-led geopolitical projects.

Fading growth and other signs of a slowing economy

Despite negative GDP figures for the third quarter, the results for the first and second quarters (showing 2% and 3% growth, respectively) might still allow Ukraine to achieve real economic growth for 2012. Since the GDP figures for the fourth quarter are expected to decline further, most independent economists in Ukraine and international financial institutions forecast Ukraine's annual growth to reach between 0.5–1.9%[1]. Whatever the final figures for the fourth quarter,

[1] В. Пасочник, Украинская экономика: поствыборные вердикты, *Зеркало недели. Украина*, 2.11.2012 (http://zn.ua/ECONOMICS/ukrainskaya_ekonomika_postvybornye_verdikty-111522.html); Аналитики не исключают рецессии в Украине уже в этом году, 5.11.2012 (http://korrespondent.net/business/economics/1418958-analitiki-ne-isklyuchayut-recessii-v-ukraine-uzhe-v-etom-godu).

2012 is bound to produce the worst macroeconomic results since 2009, when the deepest economic downturn in the history of independent Ukraine was recorded, with GDP dropping by nearly 15%. (see Appendix 1).

A fall in GDP in the third quarter had been presaged by the negative macroeconomic indicators published earlier in the year. Among the first symptoms of the worsening economic situation was a drop in industrial production in March (-1.1%) – the first such decline since October 2009. In the following two months, production picked up slightly, only to fall back again in June (-1.4%). This trend continued for the next four months (-0.9% in July; -4.7% in August; -7% in September; -4.2% in October). Consequently, overall industrial production for the first three quarters of 2012 fell by 1.2% compared to the same period in 2011. Meanwhile, the value of agricultural production for the corresponding period dipped by 4.4%, and the Ukrainian construction industry suffered a 9.1% slump (see Appendix 2).

Whatever the final macroeconomic figures, 2012 is set to produce the worst results since the 2009 economic crisis (the most serious economic crisis in the history of independent Ukraine).

Poor economic growth has led to lower than projected budget revenues and a rising budget deficit, which by September 2012 had exceeded 24 billion hryvnia (3 billion USD). For September alone, the budget deficit came to 7.4 billion hryvnia. This raises concerns about the possible sequestration of the budget in December. This year, Ukraine's Parliament has already approved a series of increases – in the planned level of the budget deficit, which by the end of the year is expected to reach around 2.5–2.6% of GDP (up from 1.8% in 2011).

The reasons for the current downturn

There are a number of reasons for the poor macroeconomic performance currently evident in Ukraine. First of all, the Ukrainian economy heavily depends on foreign export markets (around 60% of Ukraine's GDP is produced by export-oriented sectors), which have themselves been experiencing a downturn. A fall in global steel prices (see Appendix 3) has contributed to a sharp decline in the value of Ukrainian steel exports in the nine months to September, which has been estimated at 12% or 2 billion USD. Since as much as 70–80% of Ukraine's steel production is earmarked for export, the decline in international sales translated into a 4.5% reduction in the output of the steel industry in the first three quarters of 2012. Weaker results are also apparent in Ukraine's agricultural sector. After last year's record grain harvest of 56.7 million tonnes, this year's harvest is expected to be around 20% lower[2]. A slowdown in the construction industry, which began during the first six months of 2012, significantly accelerated following the end of Euro 2012; however, the majority of construction projects associated with the tournament had been completed before 2012.

Similarly, a decline in the exports of Ukraine's metallurgical industry contributed to a further increase in the country's trade deficit. In the first three quarters of 2012, Ukraine's trade deficit reached 11.5 billion USD and was 2.1 billion USD higher than in the same period in 2011. The main structural problem which has led to the current deficit is Ukraine's dependence on natural gas imports from Russia, and in particular, Kiev's 2009 gas contract with Gazprom. The cost of importing Russian gas in the nine months to September 2012 exceeded 10.4 billion USD. Despite a roughly 30%[3] drop

[2] However, thanks to large grain stocks created last year and rising food prices around the world, the overall value of Ukraine's agricultural exports has increased.

[3] Бойко: імпорт газу в Україну через три роки буде не більше 5–7 млрд. куб. М (http://www.unian.ua/news/536159-boyko-import-gazu-v-ukrajinu-cherez-tri-roki-bude-ne-bilshe-5-7-mlrd-kub-m.html).

in the amount of gas imported to Ukraine, Kiev has already spent more than it did in the corresponding period of 2011 (10.3 billion USD). This is due to the high price of Russian gas imported by Ukraine, which over the past two years has almost doubled. In 2011, Ukraine spent over 14 billion USD on gas imports, which accounted for as much as 17% of the country's total imports for the year (Ukraine's gas bill for 2010 reached 9.4 billion USD, while in 2009 Ukraine spent 8 billion USD on gas). In order to keep prices low, the state heavily subsidises gas for individual consumers and the municipal sector, this policy, however, puts additional pressure on state finances and drives up both national and external debt. The government has in recent years regularly provided additional funding for Ukraine's energy giant Naftogaz by issuing it with state bonds which the company then sells to mostly state-owned banks. The funds are then used to pay Gazprom for its gas. In 2012 alone, in order to cover the deficit in Naftogaz's budget, the state handed over to the company more than 1 billion USD[4]. In addition, this year Naftogaz has secured several loans from both Ukrainian and Russian state-owned banks (incl. a 2 billion USD loan from Gazprombank, obtained in March 2012, which is to be repaid by 2019)[5].

In addition to objective external and domestic factors, Ukraine's economic situation is also adversely affected by the government's economic policy. During 2010, and in early 2011, the cabinet launched a number of significant reforms, but soon after, the reforms ground to a halt. For instance, following the adoption of the 2010 law on the functioning of the gas market and the introduction of the first of a series of planned gas hikes, the policymakers failed to keep up the momentum and take further steps towards a full reform of the Ukrainian gas sector. A new Tax Code, rushed through Parliament in 2010, limited the number of national and local taxes and introduced a gradual reduction in the rate of corporate income tax and VAT; its provisions, however, needed to be subsequently amended on several occasions due to gaps in provisions on the taxation of small and medium-sized enterprises. Following the adoption of the law on land cadastre (in 2011), the planned agricultural and land market reforms also ground to a halt.

Ukraine's recession has been caused by poor economic performance in foreign markets: plummeting steel prices are having a knock-on effect on Ukraine's export-oriented metallurgy industry; the high price of imported gas further deepens Ukraine's trade deficit.

Contrary to the purported liberalization of the economy, Ukraine's economic policy has led to a deterioration in the domestic business climate. One of the main reasons for this was an effective increase in taxation , treated by the Ukrainian government as a remedy for the decline in revenue during the economic downturn. The government, for example, sharply stepped up its collection of corporate income tax prepayments from employers and attempted to delay the return of overpaid VAT to businesses. According to the European Business Association (EBA)[6], in 2011 Ukraine's tax burden rose to the highest level in the country's history (with taxes accounting for 25% of GDP) and continues to grow (expected to reach 26% in 2013)[7].

4 See: «Нафтогаз» отримав 8,5 млрд грн з держбюджету-2012 на покриття дефіциту (http://www.rbc.ua/ukr/top/show/-naftogaz-poluchil-8-5-mlrd-grn-iz-gosbyudzheta-2012-na-pokrytie-19102012180800).

5 «Нафтогаз» залучив у держбанку кредит на 2,5 млрд грн, 24 липня 2012 (http://news.dt.ua/ECONOMICS/naftogaz_zaluchiv_u_derzhbanku_kredit_na_2,5_mlrd_grn-105829.html).

6 The largest organisation of foreign investors in Ukraine, bringing together nearly 900 foreign and domestic companies operating in the country.

7 Ukraine's tax bodies commonly force businesses awaiting the return of overpaid VAT to pay 50–70% of that amount back to the Treasury in the form of corporate income tax prepayments or by purchasing government bonds.

Ukraine's growing dependence on fiscal policy was accompanied by the populist pre-election policy of increasing social spending.

Between 2008 and 2011, Ukraine also witnessed a 70% increase in the level of corruption, measured in terms of business spending on bribes in relationship to their total revenue[8]. In addition, the government's privatisation agenda, which is currently being implemented, has had a negative impact on the investment climate and the possibility of increasing the inflow of foreign direct investment. Contrary to the stated policy of openness to foreign investment, sales of state assets in the electricity and gas sectors (regional gas distribution companies) were biased in favour of Ukraine's 'big business', with close links to President Viktor Yanukovych's political allies[9]. It should also be noted that apart from clearly damaging the investment climate in the country, this approach to privatisation has only resulted in limited profits for the state budget.

Problems with foreign debt servicing and a weak hryvnia

The servicing of Ukraine's foreign debt is proving to be a growing challenge for the government in Kiev. The size of the public debt (direct and guaranteed) still remains at a relatively safe level of about 37% of GDP[10], reaching about 62 billion USD at the end of September 2012. The problem, however, lies in the debt structure and the high proportion of short-term liabilities with maturities within the next year or so. Ukraine had previously experienced problems with servicing its foreign debt earlier in 2012, and dealt with the issue through partial restructuring[11]. In 2012, Kiev also suggested it would like to restructure the IMF loan given to Yulia Tymoshenko's government. Despite problems in negotiating new terms, in mid-November 2012 Ukraine paid off the remainder of this year's repayments, estimated at 3.5 billion USD[12].

The servicing of Ukraine's foreign debt has become a serious challenge. Already this year Ukraine has resorted to restructuring its debt; this will, however, significantly increase next year's repayments.

These repayments, however, coupled with an economic slowdown, drained Ukraine's foreign exchange reserves, which fell from 31.8 billion USD to 26.8 billion USD between January and the end of October (a particularly sharp drop – 8.4% – was recorded in October, coinciding with Ukraine's parliamentary elections)[13]. Foreign exchange reserves have come dangerously close to reaching a critical level, equivalent to just three months of import spending. Meanwhile, in 2013, Ukraine will have to repay its foreign creditors an estimated 9 billion USD[14] (of which over 5.5 billion USD constitute IMF repayments; see Appendix 4).

A significant drop in currency reserves and a growing trade deficit, together with constant expenditure on Russian gas, have sparked fears

[8] According to the EBA, businesses operating in Ukraine are forced to spend up to 10% of their revenue on bribes.

[9] A. Sarna, 'Dmytro Firtash's companies are monopolising the retail gas market in Ukraine', 24/10/2012 (http://www.osw.waw.pl/en/publikacje/eastweek/2012-10-24/dmytro-firtash-s-companies-are-monopolising-retail-gas-market-ukraine) and Запах енерго. Ахметов і Фірташ стають головними покупцями великої власності в Україні, *Korrespondient*, 2/12/2011 (http://kreston-gcg.com/ua/press/publications/energo.html).

[10] In the absence of official data, estimates suggest that by the end of September 2012, Ukraine's public debt had reached around 37–38% of GDP. This was a result of the recent debt growth dynamics and Ukraine's economic growth.

[11] For example, by repaying a short-term loan obtained from Russia's state-owned Vneshtorgbank.

[12] НБУ: Україна повністю розрахувалася з МВФ за поточний рік http://www.unian.ua/news/535899-nbu-ukrajina-povnistyu-rozrahuvalasya-z-mvf-za-potochniy-rik.html

[13] According to the Ukrainian investment bank Dragon Capital, in October, just 20% (about $400 million) of the central bank currency reserves were spent servicing Ukraine's debt (IMF loan), while most was used to bolster the hryvnia's exchange rate.

[14] See, for example: Госдолг Украины: что год грядущий нам готовит… (http://kontrakty.ua/article/55026).

of a potentially significant depreciation of the hryvnia. In mid-November, these factors, combined with the increased demand for foreign currencies traditionally experienced around election time, resulted in a decrease in the market value of Ukraine's national currency from about 8.1 to 8.3 against the US dollar; the lowest since 2009. It is possible, however, that the hryvnia will sink further, trading later in the year at 8.4–8.5 to the US dollar, and even reaching 9 UAH/USD in the future.

Outlook for 2013

Due to the recent parliamentary elections, the Ukrainian government had for some time deliberately delayed a decision to lower this year's projected GDP growth from the unrealistic rate of 3.9% set out in the 2012 budget. A few days before the ballot, the Prime Minister assured the Ukrainian people that the economy was doing well and the situation was stable. It was not until 7 November that Prime Minister Mykola Azarov admitted during a Cabinet meeting that the economic crisis was continuing to deepen,

A recovery of Ukraine's economy is expected to begin in 2013. Such recovery, however, is dependent on the highly unpredictable economic situation in other markets. It is therefore hard to say whether the current recession will be short-lived.

adding that the major cause of the downturn in Ukraine was a current slowdown in global markets, including a fall in the price of steel products and higher prices of imported gas. So far, however, the government has not changed its macroeconomic policies for this year or the next: the draft 2013 budget sets itself a GDP growth target of 4.5%. To meet such an optimistic target, Ukraine would (in addition to other conditions) need the so-called low base effect – i.e. GDP growth in 2012 negative or close to zero. Although experts and financial institutions have so far been predicting some degree of economic recovery for 2013, the divergence of opinion as to next year's growth of Ukrainian GDP is still high (from 0.5% projected by Fitch to 3.8% forecast by Ernst & Young). Since the condition of the Ukrainian economy is highly dependent on the condition of export-oriented sectors – and the outlook for foreign markets remains highly unpredictable[15] – forecasts for next year are subject to a considerable margin of error. Thus, the current economic downturn may be either merely temporary, or it may transition into a prolonged crisis.

Possible future measures and their political effect

To ensure the stabilization of the economic situation, the government may need to resort to controversial and unpopular measures. In the short term, it can 'exchange' some of the foreign debt. This could be done by repaying some of the debt using funds generated through the issue of domestic bonds. The bonds would then be purchased by either state-owned banks or Ukraine's central bank. This option is however limited due to low levels of foreign currency reserves. On November 6, the previous Parliament approved a bill submitted by the National Bank of Ukraine, which gives the NBU powers to order companies operating in the country to sell part of their currency revenues obtained from exports to the state. These measures can be introduced for up to 6 months in order to 'reduce tensions in the foreign exchange market'[16]. The President signed the bill into law on November 15. It is possible that the NBU deliberately

[15] For instance, on 7 November, the European Commission published an 'autumn' macroeconomic forecast for 2012–2014, in which it lowered the expected GDP growth across the 27 EU member states to 0.4% (from 1.3% projected in its 'Spring' forecast); the projected growth for the eurozone has been lowered to just 0.1% (http://europa.eu/rapid/press-release_IP-12-1178_en.htm).

[16] Compulsory sale of foreign currency earnings was scrapped in 2005.

abandoned its attempts to protect the hryvnia after the elections, and by allowing the currency to depreciate the NBU was able to influence the government's decision on the new bill[17].

Allowing for controlled depreciation of the hryvnia, the government has demonstrated to the IMF that it is willing to partially free up the exchange rate by following one of the measures recommended by the IMF to protect the economy against external shocks. This also offers indirect evidence of Kiev's desire to resume its cooperation with the IMF.

No far-reaching reforms should be expected before the 2015 presidential election. Closer links with Russia appear to be the only available alternative to unpopular reforms and Kiev's reliance on the West. A shift towards Russia would however mean Ukraine's inclusion in the re-integration processes across the former Soviet Union.

In order to improve public finances in the coming months, it is likely that the government will intensify the pressure on local businesses, in line with its tried and tested fiscal mechanisms (corporate income tax prepayments, delays in the return of overpaid VAT, etc.).

The government will try to come out of the recession paying the lowest social and political cost possible. The on-going economic slowdown has already undermined one of the pillars on which the Party of Regions and President Yanukovych attempted to construct their public image – the myth of a 'team of professionals' who returned to power in 2010 to 'tidy up' the incompetent rule of the 'orange' government. This myth seemed to work in times of economic prosperity and healthy export markets, which until now tended to coincide with the periods when the current party was in power[18]. This time it appears that the Party of Regions will not be able to cope with the economic problems without outside help, especially with Kiev's limited capacity to service its foreign debt. A marked improvement in Ukraine's relations with the IMF will therefore be key to the country's future. It can be expected that the government in Kiev will have little choice but to raise the price of utilities and gas. More serious and socially unpopular economic reforms, however, are unlikely, particularly in the context of the 2015 presidential election whose campaign is expected to start next year.

At present, Russia offers the only alternative to the unpopular reforms and Ukraine's reliance on the West. The price of Russia's support, however, may be high. Moscow has repeatedly stipulated its conditions, which effectively boil down to the inclusion of Ukraine in the re-integration processes already being implemented across other parts of the former Soviet Union. This, however, could frustrate Ukraine's recent achievements, which until now have allowed Kiev to talk about ensuring a balance in its relations with Russia and the West.

[17] In order to reduce the risk of currency speculation, the NBU is considering the introduction of a 15% tax on foreign currency sales.

[18] Also between 2002–2004 and 2006–2007, when Viktor Yanukovych was in charge of the Ukrainian government.

APPENDIX

1. Ukraine's GDP dynamics between 2000–2012

Source: Ukraine's Office for National Statistics

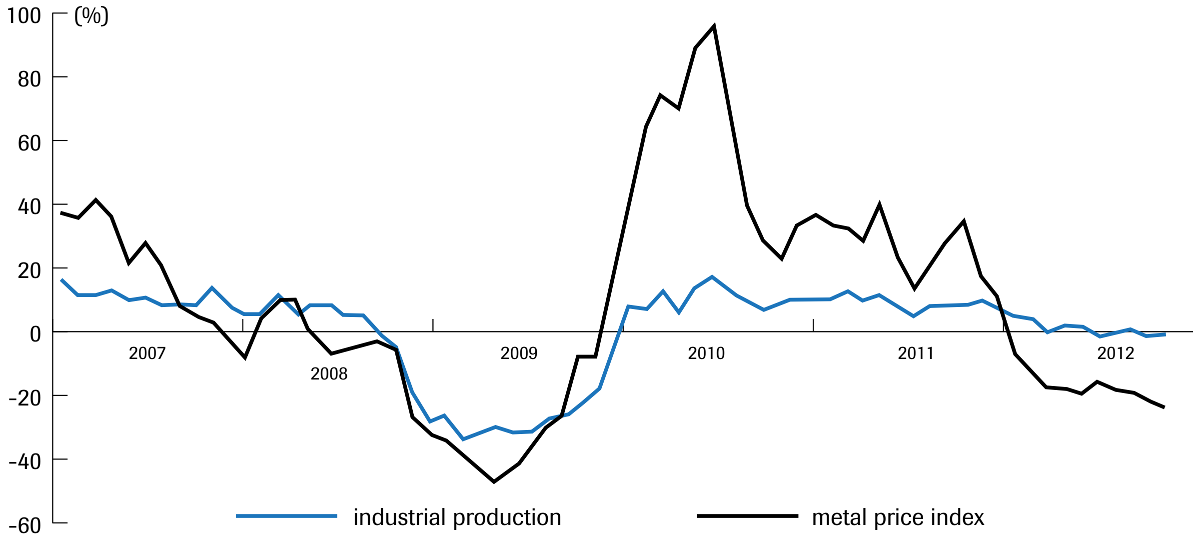
2. Ukraine's basic macroeconomic indicators

	Jan–Sept 2012 compared to Jan–Sept 2011
Gross Domestic Product	below 1.5%*
Industrial Production	-1.2%
Agricultural Production	-4.4%
Construction Industry	-9.1%
Inflation	0.8%
Export of goods *(in billions USD)*	1.8% *(50.8)*
Import of goods *(in billion USD)*	4.7% *(62.3)*
Foreign Trade Balance *(in billion USD) / [Jan–Sept 2011]*	*(-11,5) / [-9,5]*

* *NBU estimates*

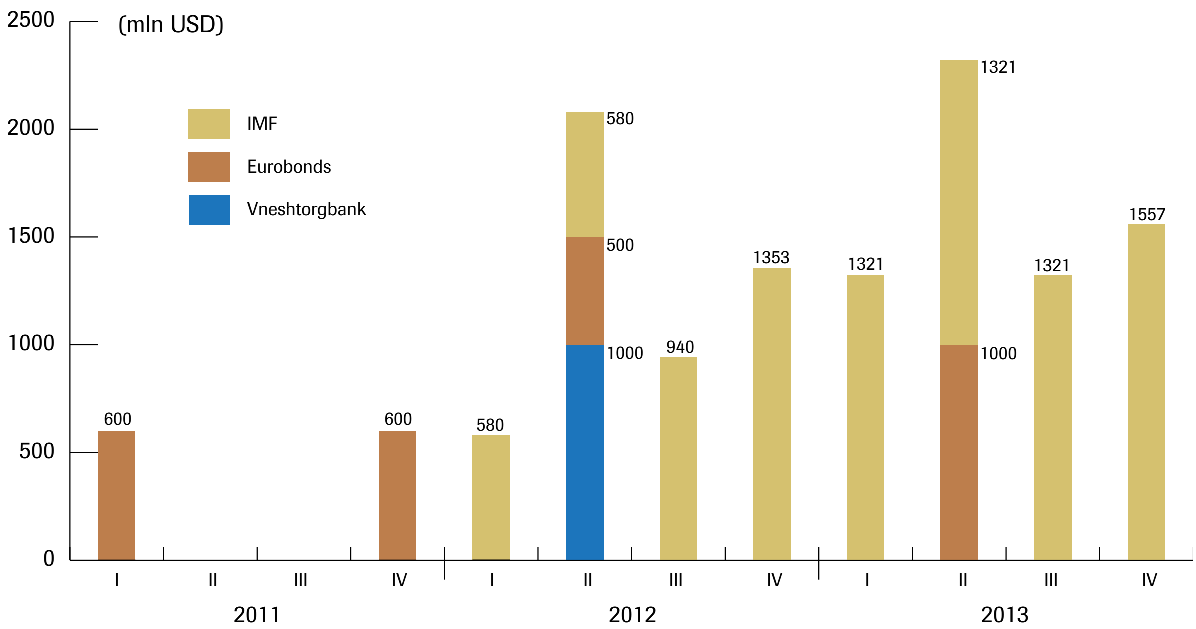
Source: Ukraine's Office for National Statistics

3. Industrial production and global metal prices



Source: Ukraine's Office for National Statistics, IMF (based on: Forbes-Ukraine)

4. Ukraine's foreign debt service obligations to its major lenders (2011–2013)



Source: NBU (based on: Forbes-Ukraine)

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