CASE Network E-briefs

No. 10/2010 July 2010

After the Orange Era: Economic Prospects in Ukraine

By Dmytro Boyarchuk, Vladimir Dubrovskiy, Olga Kravets and Kateryna Ruskykh

When Victor Yanukovich won Ukraine's presidential election in February 2010, it marked the official end of the Orange Revolution. Soon after taking office, Yanukovich managed to form a loyal parliamentary coalition in a legally dubious way and, consequently, appointed his ally Mykola Azarov as Prime Minister. Indeed this decision may have made state governance more predictable and even provided for short-term economic stability, but it may have come at the expense of Ukraine's democratic freedom and long-term economic prospects.

Back to an iron fist

In early 2010 Ukraine entered a new phase in its political journey. In an ironic twist, democratic elections that were secured by President Victor Yushchenko brought to power his pro-Russian opponent Victor Yanukovich. Much of Yanukovich's victory was attributed to voter fatigue and frustration with the lack of economic progress, rampant corruption and continuous infighting between Victor Yushchenko and his one-time ally Yulia Tymoshenko. In addition, the global financial crisis took an especially heavy toll on Ukraine's economy. Therefore, despite having been Prime Minister since December 2007, Ukraine's growing economic insecurity became detrimental to Tymoshenko's popularity. As a result she lost the election to Yanukovich, coming in second.

While the majority of voters actually voted against Yanukovich in the first round (receiving approximately 35% of the vote), by the second round run-off Yanukovich outpaced Tymoshenko by just 3.48%, winning with 48.95% of the popular vote. However, he did not, as expected, negotiate a new parliamentary coalition. Instead, he invited a number of MPs from other parties to join his Party of Regions (minority) coalition, including the Communists and Vladimir Litvin's block.

In doing so, Yanukovich managed to appoint his remarkably unpopular but very loyal ally, Mykola Azarov, as Prime Minister. Thus, Ukraine became a de-facto semi-authoritarian presidential republic, whereby the Cabinet reports directly to the President, and the Parliament automatically approves all bills submitted by executive power. Suddenly, state governance became more straightforward and predictable since the constitutional reform of 2004, but this came at the expense of democratic checks and balances. The "order" that Yanukovich was trying to restore was based on personal hierarchical subordination to the leader, as opposed to the rule of law. This can no doubt lead to rising social tensions, some may even result in outright revolt.

Moving towards fragile growth

After more than a year of economic hardship, Ukraine's economy finally started growing by the end of 2009. Both GDP and industrial production grew 4.8% and 10.8% respectively in Q1 of 2010. This pattern of growth is similar to 2000-2003, where external markets stood as the main drivers of growth while domestic demand served as a derivative of exporting sectors' prosperity. Though a revival of Ukraine's real sector was fragile throughout the first months of the year, recently revitalized relations with Russia improve the domestic economic outlook.

For instance, Ukraine recently received a 30% discount on the purchase of Russian natural gas, a key energy input for its core industries. On top of the "thaw" Russia reopened its market to Ukrainian machinery and metal products, making an additional push for steady mid-term growth. In light of these events, and an upsurge in domestic consumption, GDP is expected to grow by 4.1% in 2010 and 5.2% in 2011.

On a downward slide

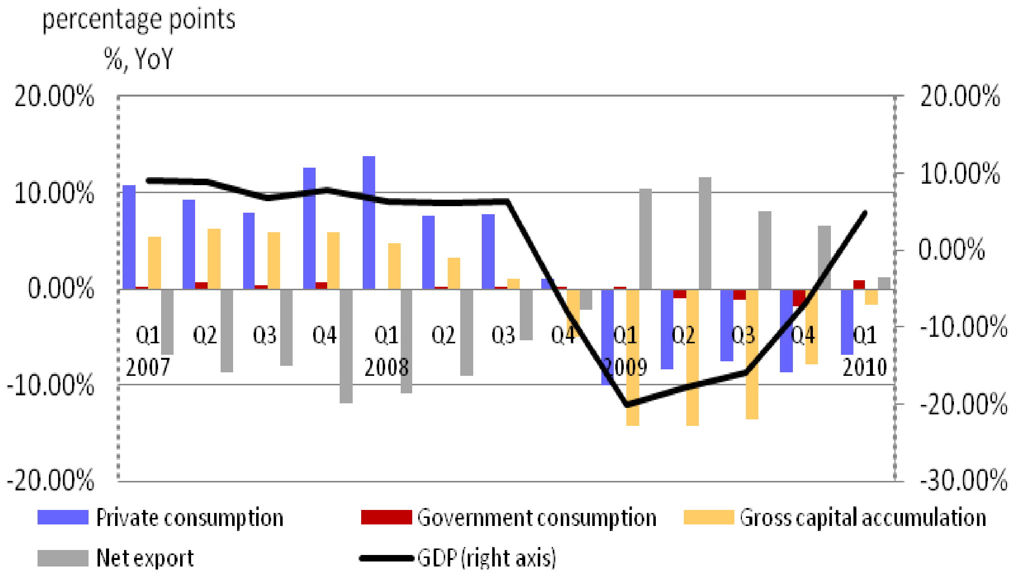
After considerable overheating in 2008, consumer price dynamics began to slow down throughout the recession, though they remained relatively high. A significant increase in the money supply during 2007-2008 was the key reason for the Consumer Price Index (CPI) surge, up to 22.3% year-on-year (YoY). Although the National Bank

CASE E-Brief Editor: Ewa Błaszczynski

of Ukraine began restrictive monetary policy at the start of 2009, inflation remained in double digits (+12.3% YoY). The main constraints behind the CPI's drastic fall were a deep depreciation of the hryvnia, an increase in utility tariffs and worsening inflationary expectations. In the first half of 2010, CPI continued to decrease. New amendments to Ukraine's gas agreements make it possible to avoid new utility tariff increases. In addition, stability on the foreign exchange market also encourages CPI deceleration. All in all, CPI is expected to settle at about 10% YoY by the end of 2010.

While the National Bank was expanding the money supply, hoping to spur economic growth, the annual growth rate of monetary aggregates (M1, M2, etc.) fluctuated above 30% YoY. By 2009, the National Bank's response to the hryvnia's deep depreciation as well as GDP decline was traditional- it cut the money supply. M3 contracted by 5.5% in 2009. Starting in 2010, the Bank loosened its monetary policy and gradually began to pump liquidity back into the economy. By the end of 2010, money supply yearly growth is expected to reach about 13% YoY.

FIGURE 1: DEMAND COMPONENTS' CONTRIBUTION TO GDP GROWTH 2007- 2010



SOURCE: STATE STATISTICS OFFICE OF UKRAINE

Troubled banking sector

Despite an improved economic outlook, Ukraine's banking sector continues to stagnate. Depreciation of the hryvnia, bank runs and rising insolvencies resulted in UAH 27.6 billion in net losses for the sector in 2009. Even by the first quarter of 2010, banks remained loss-making (UAH -4.4 billion). On the up side, small banks seemed to suffer the least- only 15% of all small banks are operating at a loss, while among bigger banks the number is closer to 30%. One of the main differences between the two is that big banks have large credit portfolios and, thus, make more loan loss provisions. Furthermore, the volume of non-performing loans (NPL) in the sector is still increasing. In May 2010, it exceeded 10% of the sector's total loans. Consequently, this will make it increasingly difficult for banks to improve loan performance by year's end.

On the other hand, bank liquidity indicators are improving. Resumed deposits' growth (+15.1 YoY in May) and positive interventions on the foreign exchange market resulted in excess liquidity growth. By the end of June it reached UAH 19.4 billion, while the average value is about UAH 5-6 billion. Nevertheless, credit risk is still high and banks' credit portfolios continue to contract. As an alternative, banks have invested money in state bonds. Since the beginning of 2010 banks increased their bond portfolio by UAH 9.8 billion. Even so, the banking sector is not expected to bounce back quickly.

Public debt stabilizing

In addition to dealing with various global macroeconomic imbalances, the financial crisis weakened Ukraine's internal fiscal standing. By the end of 2009 the Finance Ministry reported about $37 billion (31.6% of GDP) of consolidated revenues-more than 20% below initial estimates. As a consequence, spending was underfinanced by almost $11 billion. Naturally, this made collecting taxes, boosting social liabilities and paying arrears on public obligations quite challenging for Ukraine's newly appointed Cabinet. To make matters worse, internal policy disagreements and political infighting left the country without an approved budget for almost three months.

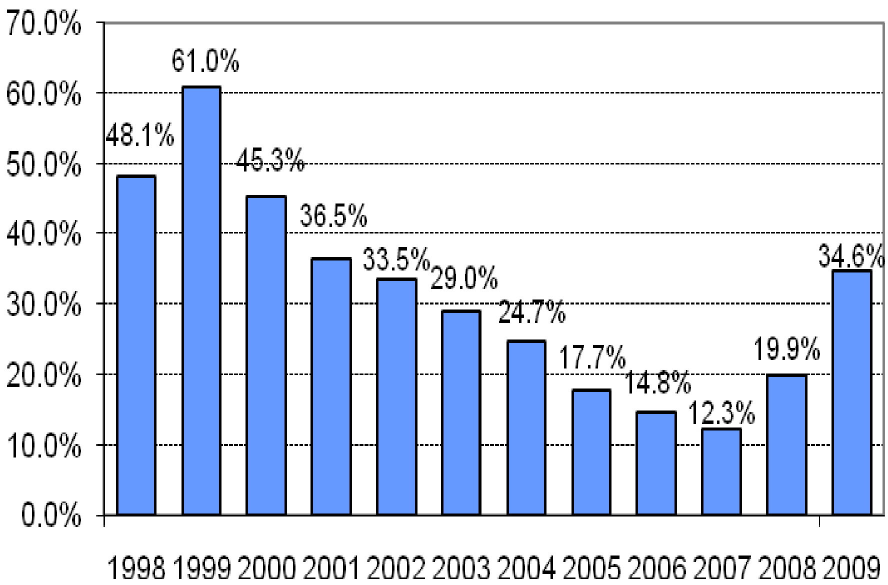
Once the budget was finally approved by April 2010, public finances seemed to stabilize. The new government even managed to push through a parliamentary spending plan for 2010. In contrast to previous years, the 2010 budget was relatively realistic despite approving a 5.8% GDP deficit (revised down to 5.5% on July 8), much of it for social liabilities. As a result of the Kharkiv agreements with Russia, Azarov and his Cabinet were able to provide an additional boost to

CASE E-Brief Editor: Ewa Błaszczynski

public finances by ensuring utility subsidies for the local population and even managed to keep afloat energy monopolist "Naftogaz".

Though challenging, Ukraine's fiscal gap is expected to be successfully covered at the expense of state securities placement. Since the election, doubts over Ukraine's near term political and economic stability have subsided. Some investors are quite positive about the strength of Ukrainian bonds and believe that the combination of high yields and a rebounding economy will encourage businesses to invest in its public debt. That said, public debt keeps on growing. In fact, over the last two years the state debt almost tripled from 12.3% of GDP in 2007 to 34.6% of GDP by the end of 2009. By the end of 2010 the debt is estimated to go up to 35.6% of GDP.

FIGURE 2: PUBLIC DEBT, 1998-2009, % OF GDP



SOURCE: FINANCE MINISTRY OF UKRAINE

Exports improving with key trade partners

With respect to global trade, the slump in demand along with a liquidity crunch deeply depressed Russian and Asian markets, Ukraine's main trading partners. Through 2009 Ukraine's key exports dropped: metal products by 53.6%, chemical products by 50.1% and machinery by 20.9%. In addition, the hryvnia experienced more than a 60% currency depreciation through the autumn of 2008, drawing imports down considerably. As a consequence, the merchandise trade deficit shrank to $4.7 billion (versus -$16.1 billion in 2008), while the current account reached a 1.5% GDP deficit last year-almost five times less than in 2008 (-7.1% GDP). By the end of 2009 foreign trade began improving gradually. By April 2010 exports grew by 28.1% on the back of resumed growth of Russian and Asian markets, while imports still struggled due to depressed domestic demand. Forecasts predict a continued improvement of the trade balance through 2010, however, revived domestic demand along with growing preferences for foreign imports may result in a negative trade balance by 2011.

Conclusion

Ukraine's economic recovery and long-term growth prospects are challenging to say the least. Much will depend on the global recovery as well as investors' risk appetite for emerging markets, including Ukraine. Most will depend on the success and sincerity of the Yanukovich team's economic reforms, specifically on plans to lower the deficit, curb corruption, restore international confidence (among the IMF and other financial institutions), nurture small and medium enterprise (SME) development and improve the foreign investment climate.

Currently, most sectors of Ukraine's economy are showing signs of improvement. Both GDP and industrial production have grown. Recent gas price discounts as well as stabilization in the foreign exchange markets, should limit extreme fluctuations in the hryvnia. Banks' liquidity has significantly improved, enabling the sector to strengthen by the end of 2010. Fiscal accounts are normalizing and exports have risen due to a growth in demand among Ukraine's main trading partners.

The key will be to maintain confidence and economic stability beyond short-term crisis management and a fickle recovery. For this, the Yanukovich government will need to accept a new era in Ukraine's evolution, one where democratic and economic freedoms are closely intertwined.

The e-brief was written by a team of researchers from CASE Ukraine: Dmytro Boyarchuk, Vladimir Dubrovskiy, Olga Kravets and Kateryna Ruskykh.

CASE E-Brief Editor: Ewa Błaszczynski