Ukraine: Alternative Macroeconomic Scenarios (Update)

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September 10, 2014

Real GDP fell by 3% yoy in the first half of 2014 due to months of political turmoil, sharp Hryvnia devaluation, deteriorated trade relations with Russia and tough fiscal austerity measures. The decline is expected to deepen throughout the rest of 2014 amid weaker exports and consumption prospects and the growing damage from the military conflict in the eastern regions of Ukraine. As a large number of industrial enterprises are concentrated in Donetsk and Lugansk, these oblasts account for about 16% of Ukraine's GDP and almost 30% of total industrial output production. Correspondingly, hostilities in the east exert a significant toll on the overall Ukrainian economy, put additional pressure on public finances, trade and national currency, undermine the speed of economic reforms and delay economic recovery.

Until mid-August 2014, Ukraine was making good progress in stabilizing both its economic and political situation. In particular, on May 25th, Ukraine held early presidential elections, which were won outright by Petro Poroshenko, an experienced politician and successful businessman. Despite restrictions on voting in eastern oblasts, the elections were recognized as free and fair. As promised, President Poroshenko signed the economic part of the Association Agreement with the EU on June 27th, which was considered to be the first step towards eventual EU membership. Snap parliamentary elections were called for October 26th, 2014, as greater support in parliament is necessary for smooth implementation of painful but long-awaited economic, political and social reforms.

Regarding hostilities in the east, during March-April 2014, pro-Russia demonstrations in the eastern oblasts of Ukraine evolved into armed insurgency with the rebels supported militarily by Russia. Nevertheless, the Ukrainian army gradually regained control over the region. By mid-August, the Ukrainian military had captured almost ¾ of the occupied territories, despite Russia's increasing support of rebels and mercenaries with soldiers, weaponry, tanks and artillery. However, at the end of August the conflict escalated again following an 'undeclared' large invasion of Russian troops in Ukraine. This not only allowed the pro-Russian rebels to make a turnaround in the battle but has opened a new frontier in the south of Donetsk oblast. In addition, there was mounting evidence that Russia had been accumulating significant forces not only along the border with the eastern oblasts of Ukraine but also in the annexed Crimea peninsula with an apparent intention of creating a land corridor to Crimea. Amid growing losses and damages for Ukraine and realizing that Russia's army is almost ten times the size of the Ukrainian one, Ukraine agreed to participate in trilateral peace talks with Russia and EU in Minsk, Belarus, on August 26th. Although these negotiations ended with no apparent results, they continued in early September and resulted in a ceasefire agreement signed on September 5th.

Despite the ceasefire agreement, the outlook for Ukraine still remains highly uncertain for the following reasons. First, the deal did not envisage the withdrawal of Russian troops from the territory of Ukraine as Russia continues to deny the presence of its troops in Ukraine. Moreover, further intentions of the Russian leader remain unclear, particularly taking into account that the deal does not envisage any shift in Kyiv foreign policy. Indeed, it was the drastic turnaround in Ukraine's political landscape with the ouster of the former Ukrainian president sympathetic to Moscow and a clear shift in Kyiv foreign policy towards EU that triggered the annexation of Crimea and fighting in eastern oblasts. Furthermore, the armed conflict restored the aspirations of Ukraine for NATO membership, as part of Ukrainian policy. These events irritated Russia and, hence, they still pose additional risks for the effectiveness of the ceasefire. Second, the ceasefire deal did not encompass the issues related to the status of territories under the rebels' control. The agreement states that the region will receive a special status with greater autonomy with no explicit mention of their independence. However, shortly after the agreement was signed, one of the rebels' leaders stated they will continue to seek secession from Ukraine. All these point to the fragility of the ceasefire agreement, which may evolve in accordance to the following three scenarios with Crimea remaining under Russia's control at least over the medium-term forecast horizon.

The optimistic scenario assumes that the armed fighting will subside over the next few weeks. The eastern region will be provided greater autonomy, while the Russian language would be granted the status of regional official language. Moscow will preserve its influence in the region, but thanks to local and parliamentary elections as well as restoration of local state administrations, a delicate balance of powers will be reached. Thanks to donor support and Russia's financial aid, the reconstruction of the Donbas region will gain good momentum. Ukraine will refuse its aspirations for NATO membership while both Russia and Ukraine will refrain from setting new trade restrictions. Broad trade negotiations (possibly trilateral between Ukraine, Russia and the EU) would start at the end of 2014, which would reduce Russia's concerns over the impact of Ukraine's implementation of EU Association Agreement and would result in some relaxation of trade restrictions between Russia and Ukraine in 2015. In this optimistic scenario, Ukraine and Russia will also reach an interim natural gas agreement at the end of 2014 (with natural gas price setting at around $380 per 1000 m3), which would allow resuming Russia's gas supplies to Ukraine during the winter season. In 2015, the countries will negotiate a long-term natural gas contract, agreeing to a compromise price of about $300-350 per 1000 m3. All these factors will strengthen the economic environment in the last quarter of 2014, with 2014 GDP declining by only 5.5%, and will support a good pace of recovery in 2015. However, as investors' confidence will take time to improve, real GDP growth in 2015 will remain relatively moderate at about 3% yoy, while the country will continue to rely in foreign financial assistance to cover its significant external financing requirements.

Under the baseline scenario, the ceasefire deal will not last for long. Fighting will resume in the next few weeks. Russia will continue to supply mercenaries and support rebels with heavy armaments but it will not increase the presence of regular troops in Ukraine. The conflict will not expand beyond the current occupied territories but the gains of Ukrainian military forces will also be rather limited. For that reason, both sides will continue negotiations, which eventually (presumably by the end of 2014) will result in a more durable peace settlement. Granted with greater autonomy, the region will remain heavily pro-Russia and will continue to be a major source of political uncertainty and instability, impeding Kyiv central power authority and weakening the economic unity of the country. For that reason, Ukraine will have to maintain its military forces at a high state of readiness, which would continue pressuring its strained public finances, while the reconstruction of the region will proceed at a moderate pace.

In this baseline scenario, Ukraine's trade relations with Russia will continue deteriorating, with exports to Russia falling by about 40% yoy in 2014 and an additional 20% yoy in 2015. The presence of a problematic region in the east will frustrate the Ukrainian government wishes to join NATO. But the Association Agreement between Ukraine and the EU will be ratified and the implementation plan will be strictly adhered to, which, combined with strong diversification efforts, will support exports to the EU. Trilateral natural gas negotiations will end with no apparent gains for Ukraine in 2014 (there will be no Russian gas supplies during winter), but they will secure continuation of gas transit to EU through the territory of Ukraine in winter in the amounts sufficient for reverse flow exports to Ukraine. A new gas agreement between Ukraine and Russia may be reached in 1H 2015 (or at the beginning of 2015 in case of extremely cold weather). The price for natural gas are likely to stay high (at about $385 per 1000 m3), but it will be documented as either a new price or an official discount in the contract. Despite a gas agreement, Ukraine will continue to reform its energy sector with major efforts directed at increasing energy independence through diversification of energy supplies and facilitation of domestic extraction of fossil fuels, and undertaking energy saving and increasing energy efficiency measures.

According to this baseline scenario, Ukrainian GDP will contract by about 7% yoy in 2014 and by about 2% yoy in 2015. Consumer inflation will surge to 20% yoy in 2014, due to continuing spillover of the Hryvnia depreciation into import prices, higher utility tariffs and large monetization of the fiscal deficit. The prices will advance by another 8% yoy in 2015 amid scheduled tariff increases and continuing embedding of high risk premiums. The fiscal budget deficit will reach 11% of GDP in 2014, driven by larger Naftogaz imbalances, higher expenditures on defense, security, and external debt service, and lower tax revenues associated with the economic downturn and hostilities. With the help of international financing, this large fiscal deficit will be manageable in 2014 and will be reduced to about 6% of GDP in 2015. These large deficits along with sizable foreign financial assistance borrowings will cause public debt (internal and external) to increase to 66% of GDP in 2014 and exceed 70% of GDP next year. Despite this deterioration in Ukraine's fiscal position, smooth implementation of the IMF stabilization program will help restore fiscal soundness over the medium term.

In the baseline scenario, despite weak exports in 2014 and their moderate strengthening in 2015, the deficit in the current account of the balance-of-payments will improve to about 4.5% of GDP and 3% of GDP in 2014 and 2015 respectively. These deficit reductions will be due to major reductions in imports, amid weak domestic demand and lower energy supplies. On the other hand, the capital account of the balance-of-payments will continue to be under stress due to heavy debt service, foreign capital outflows in 2014 and low inflows in 2015. Ukraine's external financing needs would be fully covered by external financing from the IMF, the EU, other IFIs, individual countries (the US, Japan, etc.) and reasonable private debt rollovers, which will help stabilize both NBU international reserves ($16 billion and $18 billion at the end of 2014 and 2015 respectively) and exchange rate at about UAH 15 per USD at year-end 2014 and UAH 20 per USD at year-end 2015.

In this baseline scenario, Ukraine's medium-term prospects are favorable. Having a government committed to reforms and with snap parliamentary elections allowing the formation of strong support for reform efforts, good progress may be expected in the areas of public administration, decentralization, de-regulation, tax system, legal and judiciary, anticorruption, and energy and agricultural sectors. If successfully implemented, the impact of these efforts on business climate and investment environment will be felt already in 2016-2017 with real GDP growth potentially reaching 5% per annum.

In the pessimistic case, the ceasefire deal will be shortly broken and the fighting will erupt with new strength. Russia will increase notably the arming of the rebels and the presence of its troops, though it will continue to officially deny this. Moreover, the conflict will expand also in other regions of Ukraine, particularly in the South, and will extend also into 2015. Ukraine will announce additional mobilization but it will not declare martial law due to the lack of institutional capacities for its introduction as well as the impact on the ability to held elections and receive financial and military help from abroad. Ukraine will terminate both economic and diplomatic relations with Russia. The country will continue to be supported by its western partners (EU and US), including through the assistance of IFIs (IMF and the WB). In this case, Ukraine will experience much deeper economic recession. It will face further balance-of-payments difficulties (due to a collapse of exports to Russia, which accounted for about 28% of total exports of goods and services, further capital outflow and high external debt repayments). It will face more severe fiscal issues (due to the revenue fall and higher military expenditures) and domestic currency pressures. To stabilize the situation, additional external financing of around $25-30 billion will be required. But only a portion of these funds could be secured, leading to sizable monetization of Ukraine's fiscal deficit and further Hryvnia depreciation, with the Hryvnia reaching UAH 20 per USD at the end of 2014 and UAH 25 per USD at year-end 2015. Consumer prices will pick up to about 30% yoy and 40% yoy in 2014 and 2015.

A summary of main macroeconomic indicators of Ukraine for 2014 and 2015 under three scenarios is presented in the table below:

	2014			**2015**		
	Optimistic	Baseline	Pessimistic	Optimistic	Baseline	Pessimistic
Real GDP Growth (% yoy)	-5.5	-7.0	-9.0	3.0	-2.0	-10.0
Private Consumption (real growth, yoy)	-5.0	-7.0	-8.0	3.5	1.7	-9.0
Fixed Private Investments (real growth, yoy)	-20.0	-25.0	-30.0	5.0	1.5	-20.0
Fiscal Balance, incl. Naftogaz (% of GDP)	-10.0	-11.0	-12.5	-5.0	-6.0	-14.0
Consumer Inflation (% yoy, eop)	18.0	20.0	30.0	6.0	8.0	40.0
Exchange Rate (UAH per USD, eop)	12.0	15.0	20.0	12.0	20.0	25.0
Current Account (% of GDP)	-5.0	-4.5	-5.5	-3.5	-3.0	-7.5
International Reserves ($ billion)	18.0	16.0	12.0	22.0	18.0	8.0
Public Debt (% of GDP)	63.5	66.0	70.0	69.0	72.0	90.0
External Debt (% of GDP)	104.0	107.0	115.0	105.0	108.0	150.0