Current Economic Situation

Sept 2013

In the short-term, Ukraine faces three main macroeconomic challenges:

1. **Economic downturn and weak recovery.** Due to Ukraine's high dependence on exports (50% of GDP), weak external demand and downward correction of world commodity prices weighed on economic growth since the second half of 2012. Coupled with tight monetary policy, which dampened credit growth and private investments, these weaknesses caused economic activity to decline by 1.2% yoy in 1H 2013. For the whole year, however, the growth is projected at 0-0.5% yoy thanks to a record high agricultural harvest (projected at around 60 million tons) and solid increase in private consumption.
2. **Strained public finances.** Slower than projected nominal GDP growth and government reluctance to reduce energy subsidies to population and heating companies (through an increase in natural gas tariffs) are the principal reasons for persistently high public sector deficit (including implicit Pension Fund deficit and Naftogaz imbalances). Although Ukraine managed to reduce its fiscal imbalances from around 8.5% of GDP in 2009 to 5.6% of GDP in 2012, its fiscal deficit stays above 3% of GDP, a level considered sustainable over the medium-term. In 2013, due to a delay in fiscal adjustment measures, public sector deficit is forecast to exceed 5% of GDP. On the upside, Ukraine's public debt (at around 37% of GDP) compares quite favorably with a number of developed countries and emerging markets. However, relatively short maturity of government debt obligations amid volatile foreign capital markets adds to fiscal as well as Balance-of-Payments pressures.
3. **High external financing needs.** Weak exports and high energy imports led to a sharp widening of current account deficit in 2012. The government has been taking measures to reduce imports, in particular by cutting the volume of energy imports, while record harvest will support exports. However, intensified trade tensions with Russia, the largest trade partner, which accounts for about ¼ of total merchandise exports, and robust domestic consumption will allow only a relatively moderate improvement in current account balance to about -7.5% of GDP in 2013. In addition, Ukraine has significant short-term external debt obligations. The Ukrainian authorities have to repay $1.6 billion and about $3.6 billion to IMF only in 4Q 2013 and 2014 respectively. Coupled with current account, external private debt repayments and population demand for foreign currency, these payments pressure Hryvnia exchange rate. As the latter is maintained virtually fixed to US Dollar, these pressures led to a reduction in NBU international reserves to $21.6 billion as of end-September, which is less than 3 months of imports.

Outlook

Despite these short-term challenges, the medium term outlook for Ukraine is favorable. Over the medium-term, Ukraine should be able to grow by 4%-5% per annum. The following developments are forecast to support Ukraine's economic performance over the period:

1. **The recovery of global economy** should support Ukraine's exports. The global economy has already showed signs of recovery. Though still subdued in 4Q 1013 and 2014, the recovery is forecast to strengthen over the medium-term, benefiting export-dependent countries.

2. **A Free Trade Agreement with the EU**. There is a rather high chance that FTA and cooperation agreement with the EU will be initialed in November 2013. In the short-term, the elimination of tariffs and other quantitative restrictions would have only modest economic benefits for Ukraine. Moreover, it may worsen Ukraine's foreign trade performance due to likely imposition of trade restrictions by Russia, which highly opposes the agreement. Over the longer-term, however, the agreement will become an anchor for institutional development and economic reforms in Ukraine, which will bring improvement in the business climate. In addition, being in the supply chain for the large European market, Ukraine would attract large foreign direct investments. This should support both exports and investment activity in the country.
3. **Steady gains in agriculture.** Ukraine has the highest potential to increase grain production and exports over the next ten years, according to OECD-FAO projections for 2021. Indeed, thanks to recent increased domestic and foreign investments in the sector, the average grain output production over 2008-13 was almost 50% higher than the average output over the preceding six years. In 2013, Ukraine may collect up to 60 million tons of grains. This will be the third year of record high harvest over the last six years. Correspondingly, grain exports may also hit a record this year. Despite these improvements, Ukraine has only started to unlock its grain production and export potential.
4. **Reduction of dependency on energy imports**. The growth of imports may be contained by government efforts to reduce the volume of energy imports, diversify energy supplies and stimulate domestic extraction of energy resources. Ukraine entered into agreements with several multinational oil companies (Exxon Mobil, Shell) to develop shale gas deposits. This will not only reduce the country's dependency on energy imports, but will support the extractive industry and will bring higher FDI.
5. **A new agreement with the IMF.** Ukraine has been in talks on a new $14.3 billion loan agreement with the IMF since early 2013. Although the progress in the negotiations was modest so far due to Ukrainian government reluctance to raise natural gas to population, the cooperation may be resumed at the end of 2013/the beginning of 2014. The Ukrainian authorities hope that their efforts to reduce energy dependency will allow them to avoid a painful increase in natural gas tariffs. Moreover, in his recent interview to Bloomberg, the president of Ukraine hinted than Ukraine may request the IMF to replace this requirement with another condition. He did not elaborate on the details, but eventually a compromise may be found. With the IMF program in place, Ukraine's external liquidity and fiscal challenges will be reduced, bringing Ukraine onto a more sustainable path of growth.

   At the same time, even in the absence of the IMF financing, Ukraine may progress in reducing its fiscal and external debt challenges, though this process will be more prolonged and costly. High fiscal deficits may be addressed with strong political will. External liquidity may be provided by entering into bilateral agreements (e.g., Russia, China, etc.), which, however, may bear not only economic but also political costs for the country. In any case, the country is unlikely to default on its obligations.
6. **Low inflation and a moderate Hryvnia depreciation.** Steady gain in agriculture, virtually stable utility tariffs and tight monetary policy allowed reducing substantially inflationary pressures. In 2012, consumer prices fell 0.2% yoy and are forecast to increase by 1-2% yoy at the end of 2013. Although inflation is likely to accelerate in the coming years, it is likely to stay in single digits. In addition, as inflation remained lower than in Ukraine's main trading partners, purchasing power parity estimates are now favorable for Ukraine, indicating reduced exchange rate pressures from the side of economic fundamentals. At the same time, high external debt repayments and population demand for foreign currency are pressuring Hryvnia exchange rate in the short term. With the IMF financing, Ukraine will successfully address its challenges. But as a more flexible exchange rate is among key IMF requirements, a moderate depreciation may be anticipated in the medium-term. Low price growth and a moderate depreciation will support consumers' purchasing power, and private consumption will remain one of the main drivers of economic growth in the medium term.