THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

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The Impact of the Suspension of the Association Agreement with the EU on the Economy of Ukraine

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On November 21st, 2013, just a week ahead of Vilnius Eastern Partnership Summit, the Ukrainian government decided to postpone almost six-year long preparations to sign an Association Agreement with the EU. Although the agreement is not canceled and the Ukrainian government confirmed its adherence towards the European integration, it is likely to take about two-three years for Ukraine to get another chance to sign the agreement as 2014 would see EU parliament elections followed by Ukraine's presidential elections due in late-March 2015.

The Government justified the decision by the difficult current economic situation of Ukraine. Affected by weak global demand for products such as steel, which impact was aggravated by intensified trade restrictions from Russia and rigid domestic macroeconomic policies, the Ukrainian economy contracted 1.3% yoy over the first nine months of 2013. The vital for economic growth industrial sector reported a 5.2% yoy reduction in production output. A decline in exports resulted in large current account deficit (forecast at around $15 billion in 2013, or 8.2% of GDP) despite government efforts to cut energy imports. In addition, Ukraine is facing high external debt financing requirements. Only public and publicly guaranteed principal payments stood at $9 billion in 2013. Although external public debt burden is forecast to moderate in the coming two years, it will still remain large at around $8 billion and $6 billion in 2014 and 2015 respectively. Ukraine's private sector external debt requirements are looming high at around $50 billion per year. However, as trade credit and related-party borrowings represent substantial portion of these debt obligations, the private sector enjoys high rollover ratios.

Outstanding External Public and Publicly Guaranteed Debt in 2013-2015 (principal only), $ billion

	2013	2014	2015
IMF	5.6	3.7	1.5
Foreign currency domestic bonds	1.9	0.8	1.6
Eurobonds	1.0	1.0	1.3
Other (IBRD, bilateral agreements)	0.5	0.4	0.4
Quasi-government (Naftogaz, state banks, local authorities)		1.9	1.0
Total	**9.0**	**7.8**	**5.9**

Source: IMF, MinFin, The Bleyzer Foundation

As foreign investors turned increasingly risk averse amid nearing FED QE taper and existing vulnerabilities of the Ukrainian economy, since June 2013 Ukraine found it increasingly challenging to secure sufficient foreign currency liquidity. As a result, NBU gross international reserves fell to $20.6 billion as of end-October 2013, the lowest level since 2006. Being below three months of imports, this level of international reserves further undermined foreign investors' confidence in Ukraine's ability to weather adverse external shocks, which was reflected in a series of sovereign credit rating downgrades over the last two months.

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Facing restricted access to foreign capital markets since June 2013, the Ukrainian authorities, however, remained reluctant to resume co-operation with the IMF as two principal Fund's requirements (to raise natural gas tariffs to population and freeze public sector wages) are politically sensitive to implement in the run up to 2015 presidential elections. For this reason, cooperation with the IMF is unlikely to be resumed until after the elections. In this respect, the postponement of the AA and the loss of the EU assistance in the negotiations with the Fund will have a marginal impact on Ukraine's relations with the organization. At the same time, by making several principal decisions at the beginning of November, the government may relatively quickly restore IMF financing in case of emergency. Thus, it was agreed to raise natural gas tariffs by 60% for select households.[1] The government will develop a program to stabilize public finances, including a delay in profit tax rate cut, a revision of tax privileges for business and social benefits for population, a reduction of expenditures on public administration, etc. Finally, the band of Hryvnia exchange rate fluctuations will be widened up to UAH 8.5 per US Dollar. We believe, however, that such emergency may arise only under pessimistic scenario.

The Government believes that, given a very fragile economic situation, the signing and implementation of the FTA/AA with the EU, although bearing strong medium and long term gains for the Ukrainian economy, might have worsened the situation further in the short-term given Russia's likely reactions. In fact, the impact of halting the FTA/AA agreement on the Ukrainian economy (excluding reputational and public costs) will depend on what kind of and the size of the support Russia provides to Ukraine.

Under **the optimistic scenario**, Russia opens up its borders to Ukraine's exports, reduces natural gas import prices and proposes solid financial support in the form of bilateral or Russian state-run bank loans to Ukraine. According to mass media, Russia is ready to open a $15 billion credit line for Ukraine. In addition, Russia may involve Ukraine into its ambitious modernization program of the army and navy, expenditures on which are expected to amount more than $650 billion for ten years. All this would substantially reduce Ukraine's current account deficit, spur exports and economic growth, as well as would allow keeping natural gas tariffs to population unchanged, simultaneously narrowing Ukraine's fiscal deficit. A notable improvement in the Balance of Payments would allow keeping Hryvnia exchange rate stable over 2014-15 and replenishing international reserves to healthy levels.

Under **the base line scenario**, Ukraine will improve its relations with Russia with the latter rewarding substantial short-term financial support to Ukraine. However, Russia will stay cautious with fully opening its borders for Ukraine's exports and revising downwards natural gas prices for Ukraine. As a result, Ukraine will enjoy some narrowing of its current account deficit, while the provided financial aid would be sufficiently large to allow Ukraine balancing its foreign financing needs. International reserves would stabilize at a low level, while Hryvnia may be allowed to fluctuate up to UAH 8.5 per USD through 2014-the first half of 2015. The Ukrainian economy would grow by 2-3% yoy in 2014 and 2015, underpinned by loose domestic fiscal and monetary policies in the run-up to presidential elections and the reviving global economy.

Under **the pessimistic scenario**, Russia, encouraged by the success of its trade pressure strategy to 'persuade' Ukraine to suspend the FTA/AA with the EU, continues its work to incorporate Ukraine into its own economic bloc with Belarus and Kazakhstan. As Ukraine is likely to continue resisting this integration, Russia's financial relief may turn to be rather modest, while foreign trade relations between the countries may see little improvement. As a result, facing substantial foreign financing needs and

[1] For those, who consumer more than 3.5 thousand m3 of natural gas per year.

experiencing difficulties in accessing foreign capital markets, Ukraine may face a currency crisis, which will force the country to apply for emergency IMF financing.

The outcomes of these three scenarios are compared with the most likely economic impact on the Ukrainian economy if the agreement with the EU had been signed.

Apart from strengthening Ukraine's democracy, the rule of law and the quality of life in general, signing and implementation of the Association Agreement, which included a deep and comprehensive free trade agreement, was expected to be beneficial to the economy of Ukraine over the medium to long term. Being in the supply chain for the second largest consumer market in the world (measured by household final consumption expenditures in US Dollar terms for 2011)[2], the AA would stimulate foreign direct investment and domestic investment to modernize its production facilities, improve the quality standards of goods and services. These would eventually increase competitiveness of Ukrainian products and stimulate exports. In addition, with the improvement in quality, domestically produced goods were expected to effectively compete for domestic consumer too, reducing the country's sensitivity to adverse swings in external demand. Being also an anchor for economic transformations, the implementation of the Agreement would facilitate improvements in business environment, which would help attracting foreign capital to the country.

However, the agreement would have had substantial short-term economic costs as elimination of trade barriers with the EU may have stimulated imports of better quality and relatively cheaper goods to Ukraine, exacerbating Ukraine's strained external liquidity position. In addition, there was high likelihood that Russia, Kazakhstan and Belarus would have imposed strict trade barriers for Ukraine worried that their markets will be flooded with European, Turkish and other goods through Ukrainian territory (so called re-exports) or lower quality Ukrainian goods, which would face tighter competition from EU products. Moreover, Russia had aspirations to inline Ukraine to join Customs Union. As a preemptive measure and a warning signal for Ukraine not to sign the AA, Russia were steadily constraining Ukraine's exports. In August 2013, almost all Ukraine's exports to Russia were blocked for about a week. According to State Statistical Service of Ukraine, exports to Customs Union fell by about $5 billion over January-September 2013 compared with the same period in 2011. Although other factors (such as economic slowdown, measures to protect Russia's car manufacturers following WTO accession, etc.) contributed, the decline should be principally attributed to cooling trade relations between Russia and Ukraine, after the AA was taking inertia.

Russia alone accounts for about 25% of Ukraine's exports. Sensitivity analysis shows that full-scale trade restrictions, if imposed by Russia and other members of Customs Union, may have cost Ukraine from $6 billion to $9 billion. Moreover, the supply of Ukrainian goods to Customs Union is dominated by high value added products, such as nuclear reactors, locomotives and spaceship equipment, etc. In contrast, raw materials and relatively low-value added goods dominate in Ukraine's exports to the EU. Correspondingly, ceteris paribus, the short-term negative impact on Ukraine's real GDP growth and employment from trade restrictions with Russia would have been higher than a positive effect of a similar increase in the value of exports to Europe if such compensatory measures were proposed by the EU. In the absence of such compensatory measures, Ukraine's current account deficit would have increased, employment and real GDP would have declined, weighing on tax and budget revenues.

[2] Source: World Bank Database. Despite the recent economic crisis, the European Union citizens remain among the wealthiest in the world in terms of GDP per capita.

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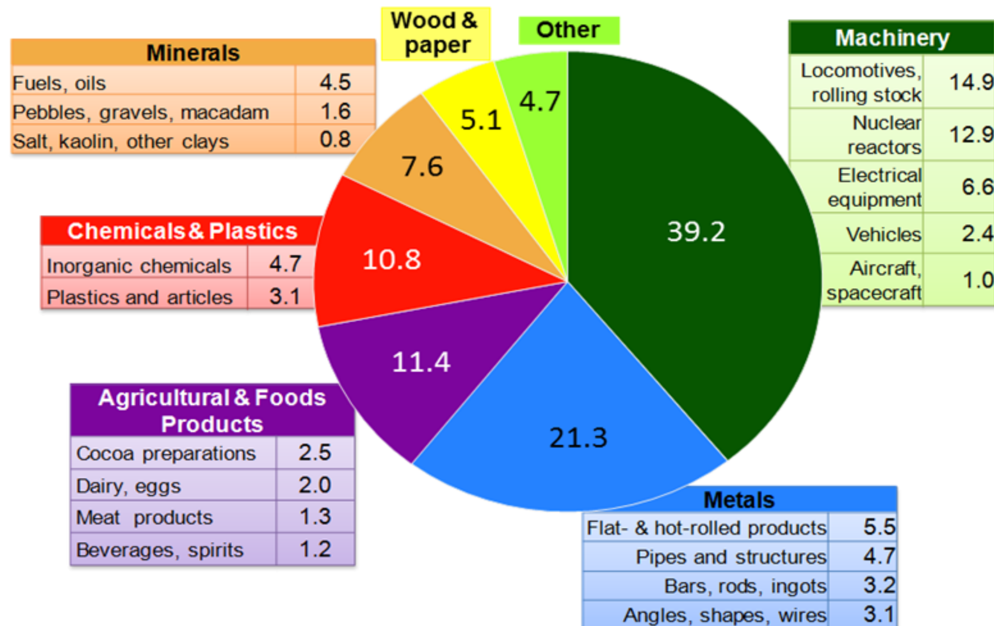
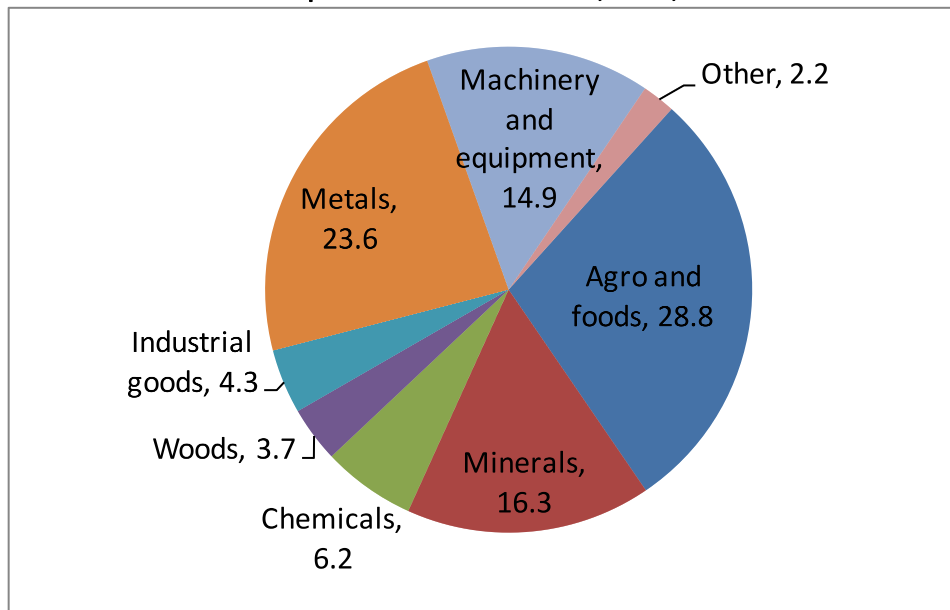
Structure of Ukraine's Exports of Goods to Russia, 2012, % of total



Source: UN Comtrade database, Ukraine's State Statistics Service

Structure of Ukraine's Exports of Goods to EU-27, 2012, % of total



Source: NBU

In particular, with exports accounting to around 50% of GDP and exports to Russia accounting for 25% of total exports, Russia's trade barriers in response to Ukraine's signing of the FTA/AA with the EU would have resulted in a 35-50% yoy decline in exports to this country, which, ceteris paribus, would transform into a 4.5-6 percentage point decrease in real GDP. Moreover, experiencing higher imports from the EU, its current account gap would have widened to around $20 billion in 2014. Even if Ukraine secured IMF

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financing with likely annual disbursement of $7.5-10 billion in 2014, received financial support from the EU and other international financial institutions and accessed foreign capital markets for sovereign borrowings in 2014, it still would have lacked about $5-8 billion of external liquidity. As a result, Ukraine's international reserves could have fallen to a critical $14 billion with Hryvnia depreciating to at least UAH 9.0 per USD. A continuing economic recession amid higher inflation, depreciation of national currency and budget expenditure squeeze would have inflated political costs for the ruling coalition and would have meant little chances for the president to be re-elected in 2015.

Ukraine's Short-Term Foreign Financing Needs and Sources of Financing and Forecast of Select Macroeconomic Indicators for 2014

$ billion	FTA/AA with EU, severe trade barriers with CU	No FTA/AA with EU		
		Optimistic case	Base line case	Pessimistic case
OUTFLOWS				
Current account deficit	-20.0	-8.0	-12.0	-17.0
Public and quasi-public debt	-7.8	-7.8	-7.8	-7.8
Private debt	-51.0	-51.0	-51.0	-51.0
Population purchases of the foreign currencies	-2.5	-1.0	-1.5	-2.5
Total outflows	**-81.3**	**-67.8**	**-72.3**	**-78.3**
INFLOWS				
FDI	8.0	7.0	5.5	4.0
Public debt roll-over				
IMF	8.0	0.0	0.0	3.0
Other IFIs (incl. EU, WB, etc.)	2.0	0.0	0.0	0.0
Sovereign borrowings	2.0	3.0	2.0	1.0
Bilateral financing from Russia	0.0	8.0	10.0	6.0
Private sector roll-over ratio, %	*103.0*	*112.0*	*106.0*	*100.0*
Private sector roll-over	52.5	57.1	54.1	51.0
Total inflows	**72.5**	**75.1**	**71.6**	**65.0**
External financing needs	**-8.7**	**7.3**	**-0.7**	**-13.3**
Real GDP growth, % yoy	**-4.0**	**4.0**	**2.5**	**0.5-1**
Inflation, % yoy, end of period	**8.0**	**3-4**	**7.0**	**8.0**
Fiscal balance, % of GDP	**-4.0**	**-4.0**	**-6.0**	**-6.0**
International reserves, $ billion	**15.0**	**25.0**	**20.0**	**13.0**
Hryvnia exchange rate, UAH per USD, end of period	**9.0**	**8-8.2**	**8.3-8.5**	**10-11**
Yanukovych's chances to win	**Low**	**High**	**Moderate**	**Very low**

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Medium-Term Prospects

Over the medium term, the short-term impetus for growth of the Ukrainian economy, provided by closer relations with Russia, without joining the Customs Union, would start decaying as Russia cannot provide the markets and technology that would allow Ukraine to diversify its economy. The delay in the FTA/AA will also reduce pressures to implement economic and social reforms. Ukraine will continue to depend on metals and agriculture for exports and growth. Given benign external environment, this will allow the country to maintain a rate of GDP growth of 2% to 3% pa in the medium term.

At the same time, a gradual reduction of external public debt burden and likely solid consolidation measures after the presidential elections will help sustain Ukraine's fiscal deficit at around 3% of GDP. A revival of the global economy and continuing efforts of the Ukrainian authorities to diversify energy imports should gradually bring current account deficit to a more sustainable level of around 4-5% of GDP. After 2015 presidential elections Ukraine may return to the signing and implementation of the FTA/AA with the EU. A more favorable external environment for traditional Ukraine's exports should help Ukraine to weather the likely short-term cost of the implementation of the agreement. On the other, hand, the postponement of the FTA/AA signing may encourage Russia to put economic and political pressures to Ukraine to join its Customs Union with Kazakhstan and Belarus and there is a relatively significant risk that Ukraine may dropped out the FTA/AA with the EU and eventually join the Customs Union.