

Ukraine's Economy Since Independence and Current Situation

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Economic Performance since 1991

- Since independence in 1991, the Ukrainian economy has passed through nine phases:
 1. The 1991-1998 “preservation” or status-quo phase with high fiscal budget deficits and little reforms
 2. The 1998 financial crises triggered by Russian debt default
 3. The 1999-2003 recovery with limited reforms, based on exports encouraged by a large 1999 currency devaluation.
 4. The 2004 Orange Revolution that encouraged large increases in foreign private debt.
 5. The 2004-2008 recovery with limited reforms based on foreign debt.
 6. The 2009 crises associated with the US sub-prime crises
 7. The 2010-2014 Yanukovich period with high corruption
 8. The Pro-EU Maidan revolution of 2014
 9. The current 2014-16 period of war with separatists supported by Russia.

Economic Performance in the 1990's

After independence from the Soviet Union in August 1991, Ukraine had a large potential to grow fast:

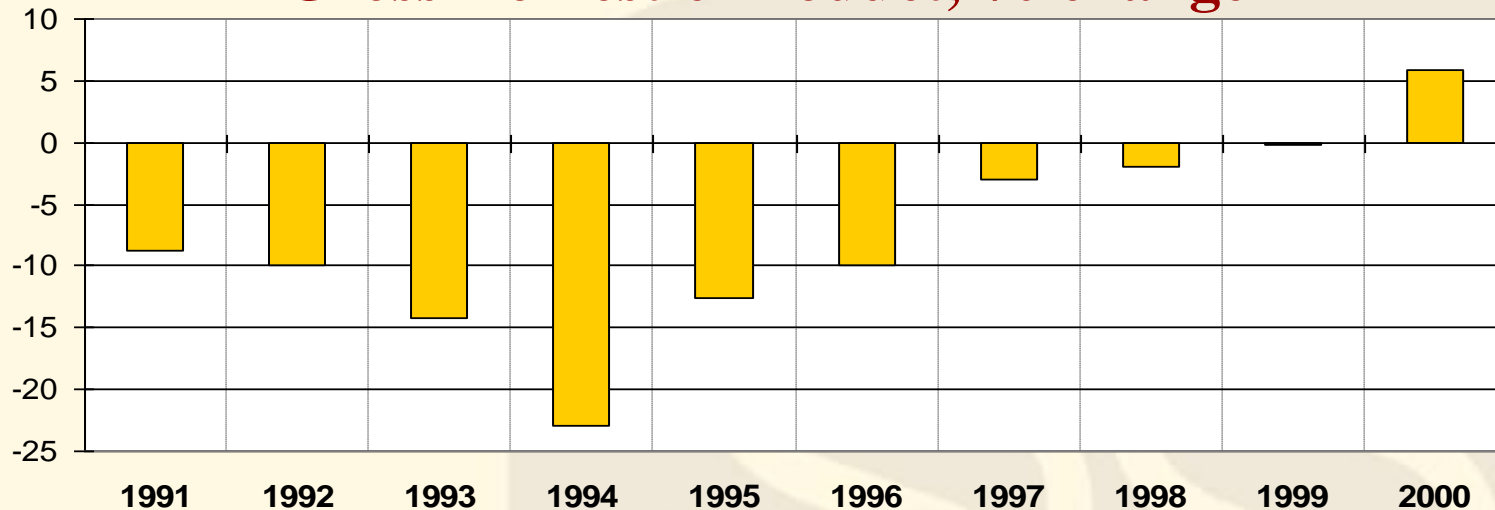
- It was the second largest European country in land mass and the 4th largest in population (51 million people).
- Had well educated and skilled labor force.
- Had extensive and rich agricultural soil: used to be the grain-basket of the former Soviet Union.
- Had good industrial activities.
- Had good mineral resources (iron ore, coal).
- Had a reasonably developed infrastructure.

What happened after Independence?

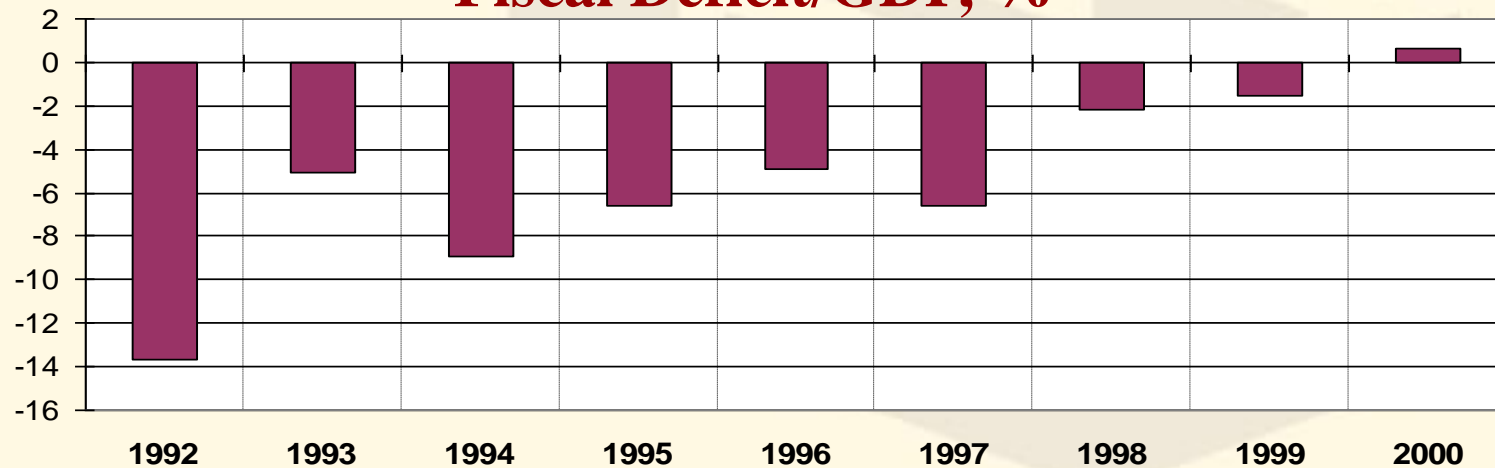
- Despite favorable initial conditions, Ukraine *had a difficult transition* -- with a long recession lasting several years.
- This was because:
 1. Its economy was open and dependent on other FSU Republics -- but Independence cut these production & trade relations.
 2. It had a large percentage of military industries (25% of enterprises produced military goods) -- which found themselves without markets.
 3. Due to negligible energy cost, many industrial processes were very energy intensive (Ukraine used 6 times more energy/GDP than in EU) -- they became inefficient when energy cost increased 10 times.
 4. Lack of serious and deep economic reforms.
- Although corporate restructuring was needed, the government instead followed a “**preservation**” strategy, giving huge subsidies to enterprises that produced **large government deficits** (of up to 25% of GDP in 1992) and which led to high inflation rates (of up to 10,160% pa in 1993).

Economic Performance Indicators, 1991-2000

Gross Domestic Product, % change

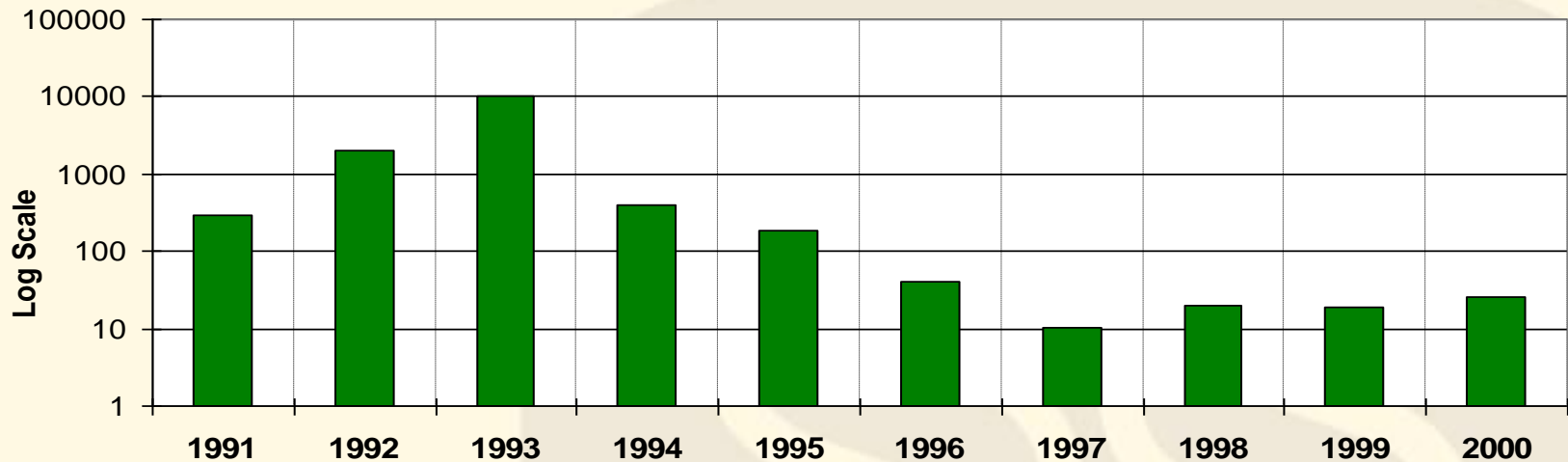


Fiscal Deficit/GDP, %

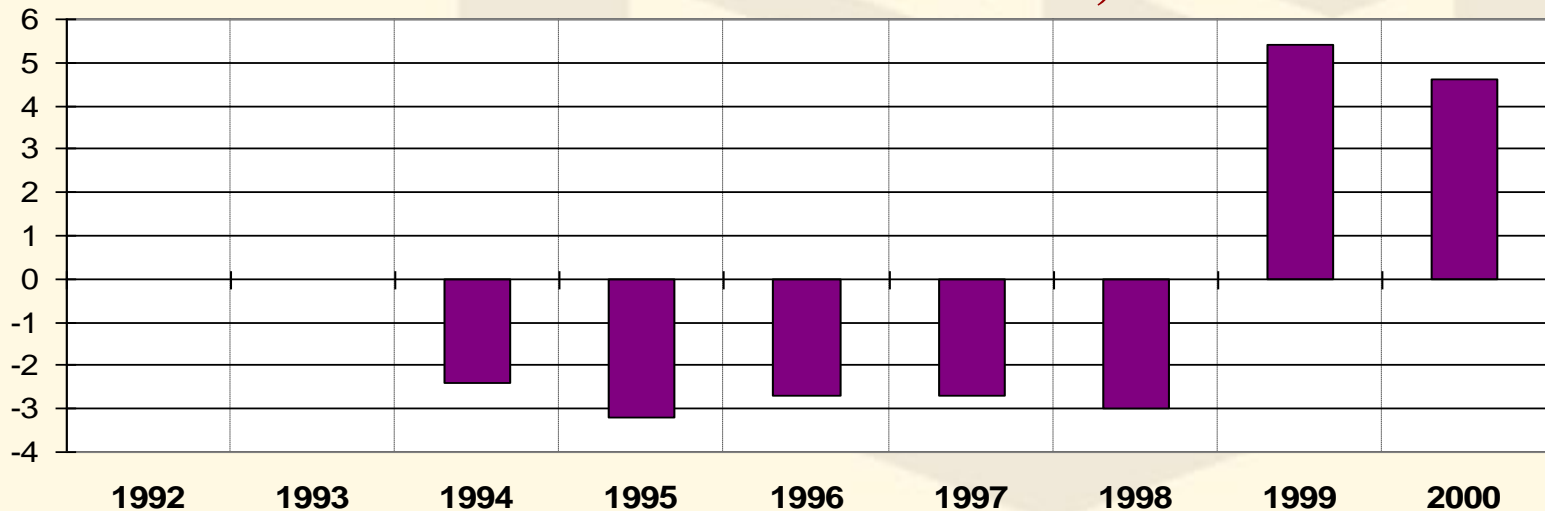


Economic Performance Indicators, 1991-2000

Annual Inflation Rate



Current Account Balances of B/P, % of GDP



In 1995, President Kuchma was elected based on a reform agenda & progress was made in several areas:

- Prices and international trade were liberalized.
 - Taxes were lowered and many subsidies eliminated.
 - The small & mass privatization programs advanced.
 - The NBU was strengthened with sound monetary policy.
 - A new currency (Hryvnia) was introduced in 1996.
 - Ukraine accepted the IMF Obligations under Article VIII.
 - Inflation was reduced to 10% in 1997.
 - The exchange rate was maintained stable at 1.9 UAH/US\$
 - The NBU's international reserves increased.
- These measures led to international financial support led by the IMF.
 - **But reforms to improve the investment climate were stalled in 1996-97** as government efforts shifted to political and constitutional reforms.
 - More critically, the fiscal deficits remained high at **6% of GDP and was financed by short-term foreign debts from European banks.**

Foreign Capital was concerned with the risks.



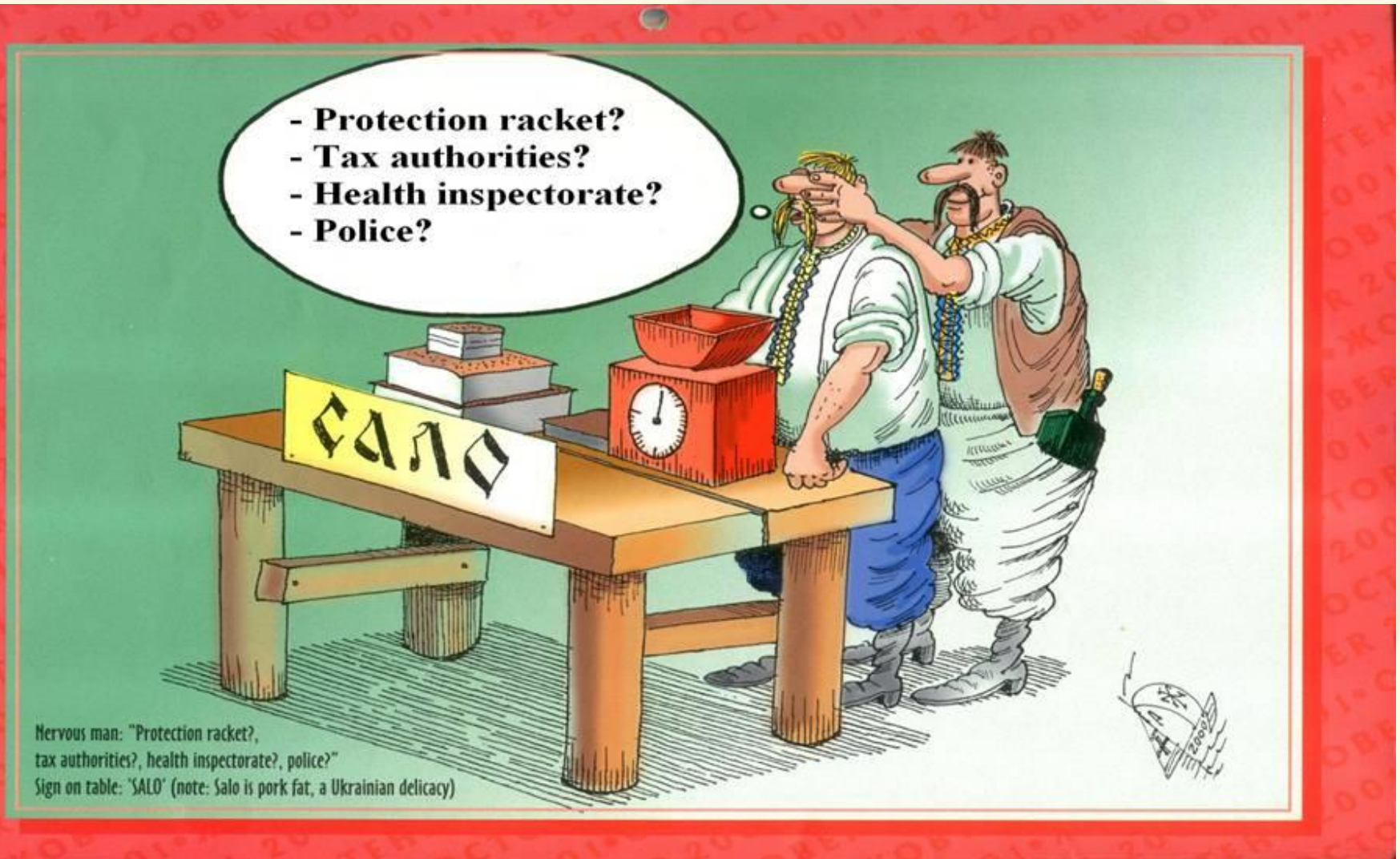
Ukraine looked like a dark tunnel:
Sign: "Ukrainian Business"



Even many local firms were worried with the environment



Fear of Government abuses was widespread.



Excessive inspections/regulations were taxing



The 1998 Financial Crises triggered by Russian Default

- With a weak economy, the debt default by Russia in August 1998, triggered a hard financial crisis in Ukraine:
 - Foreign banks were not willing to roll-over Ukraine's short term foreign debt which had increased rapidly in 1996-98.
 - Capital outflows accelerated.
 - International reserves fell sharply from US\$2.5 billion in April 1998 to US\$800 million by December 1998.
 - The exchange rate depreciated by 80% from 1.9 UAH/US\$ in December 1997 to 3.4 UAH/US\$ by the end of 1998 and to 5.2 UAH/US\$ in 1999.
 - In two months, the local stock market index collapsed by 55% from 40 in August 1998 to 18 in October 1998.

The post 1998 Crisis recovery period – 1999-2003

- But Ukraine recovered very well from the 1998 crisis:
 - **The fiscal deficit was brought under control** and remained below 1% of GDP from 1999 to 2003 (the major lesson from the crisis).
 - **Lower fiscal deficits led to surpluses in the current account.**
 - It negotiated successfully with banks the restructuring of its debts.
 - Monetary policy stabilized the exchange rate at UAH 5.2 per US\$.
 - Key economic reforms were implemented, including adoption of legislation for WTO accession, improved intellectual property rights, liberalization of many business activities, payment of wage and pension arrears, elimination of barter trade, enactment of Laws on Banks, better legislation on money laundering, etc.
- The major Hryvnia devaluation of 1998, the improved fiscal situation, and new economic reforms supported exports and GDP growth.

Ukraine- Economic Performance in 2000-2003

- Between 2000 and 2003, Ukraine showed overall excellent performance, with the highest GDP growth in the region.

	2000	2001	2002	2003
Real GDP Growth	9.2%	9.2%	5.2%	9.6%
Fiscal Balance (% GDP)	-0.3%	-0.3%	0.7%	-0.2%
Consumer Inflation (eop)	6.1%	6.1%	-0.6%	8.2%
Exchange Rate (Hr/\$, eop)	5.30	5.30	5.33	5.33
Current Account (\$bn)	1.4	1.4	3.2	2.9
<i>(as % of GDP)</i>	3.7%	3.7%	7.5%	5.8%
International Reserves (\$bn)	3.1	3.1	4.4	6.9
Foreign Public Debt (% GDP)	26.3%	26.3%	24.1%	21.3%

Source: State Statistics Committee of Ukraine, National Bank of Ukraine, Ministry of Finance of Ukraine, The Bleyzer Foundation

15

Contributors to Good Economic Performance

Economic performance in 2000-2003 was supported by key measures:

- Reasonable macroeconomic stability **with low fiscal deficits**
- Competitive exchange rate that accelerated exports, with exports becoming the main source of GDP growth.
- Simplified business regulations, particularly for starting a business
- Adoption of legislation for WTO accession, including improved intellectual property and minority shareholders rights; better regulated the foreign banking; liberalized trade)
- Initiation of the reform of the tax system (eliminated tax exemptions; reduced the personal and corporate income taxes).
- Approval of banking and money laundering legislation
- Re-activation of the privatization process

The 2004 Orange Revolution





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WHERE OPPORTUNITIES EMERGE





W H E R E O P P O R T U N I T I E S E M E R G E

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The Presidential Elections of 2004

- In initial 2004 Presidential election was won by a pro-Russian candidate, Mr. Viktor Yanukovich.
- But due to fraud suspicion, over 1 million Ukrainian citizens protested in the streets in what became known as the "Orange Revolution".
- The Supreme Court declared the elections invalid due to "irregularities" and ruled for a re-run of the elections in January 2005.
- These elections were won by Mr. Yushchenko, a pro-Western candidate who became the third President of Ukraine in January 2005.
- Before the elections, in December 2004, the Parliament approved a compromise package of laws calling for changes to the Constitution.
- These reforms turned Ukraine into a parliamentary-presidential republic, reducing presidential power and giving more authority to the Parliament and the Prime Minister.
- These reforms, however, provided for overlapping responsibilities between the President and the PM that are at the core of political difficulties.

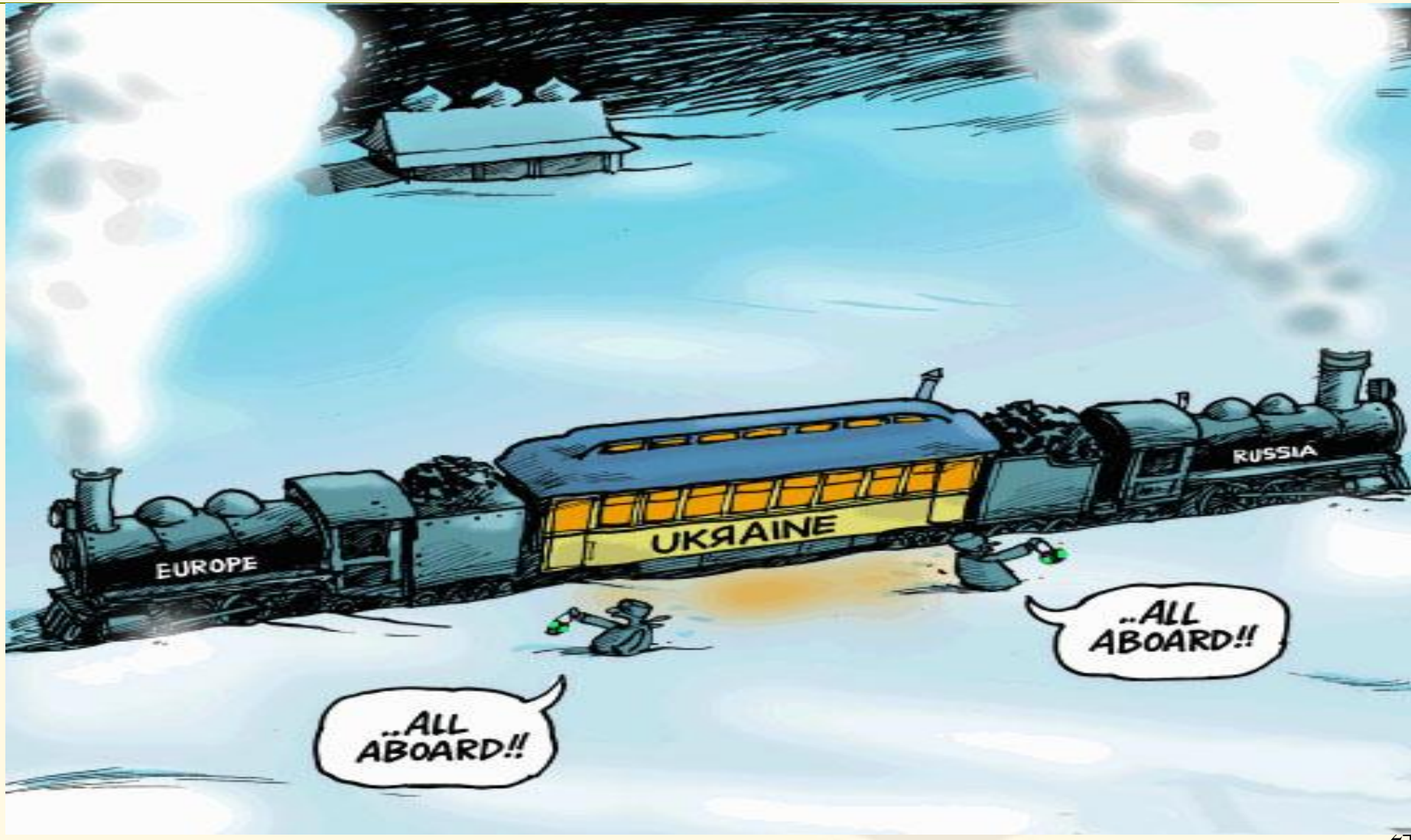
The Orange Revolution

- Nevertheless, the “Orange Revolution” has had a profound impact on the civil, political and governmental structures of Ukraine.
- It transformed the country politically, with more competition among political parties, more transparency, a more open dialogue about political disagreements, more checks-and-balances and more accountability than ever before in the country.
- Ukraine was the only post-Soviet county (in addition to the Baltic states) where civil and political freedoms were developing.
- As a compromise, Mr. Yanukovitch became the PM followed by Ms. Tymoshenko in December 2007.
- But unfortunately, the authorities did not deliver any reform program and the country missed the opportunity to take off .
- GDP growth was based on large private foreign borrowings.

Surveys showed that most Ukrainians favored greater economic ties with the EU.....



...but were undecided on the type of ties with the West



Ukraine- Economic Performance during 2004-2008

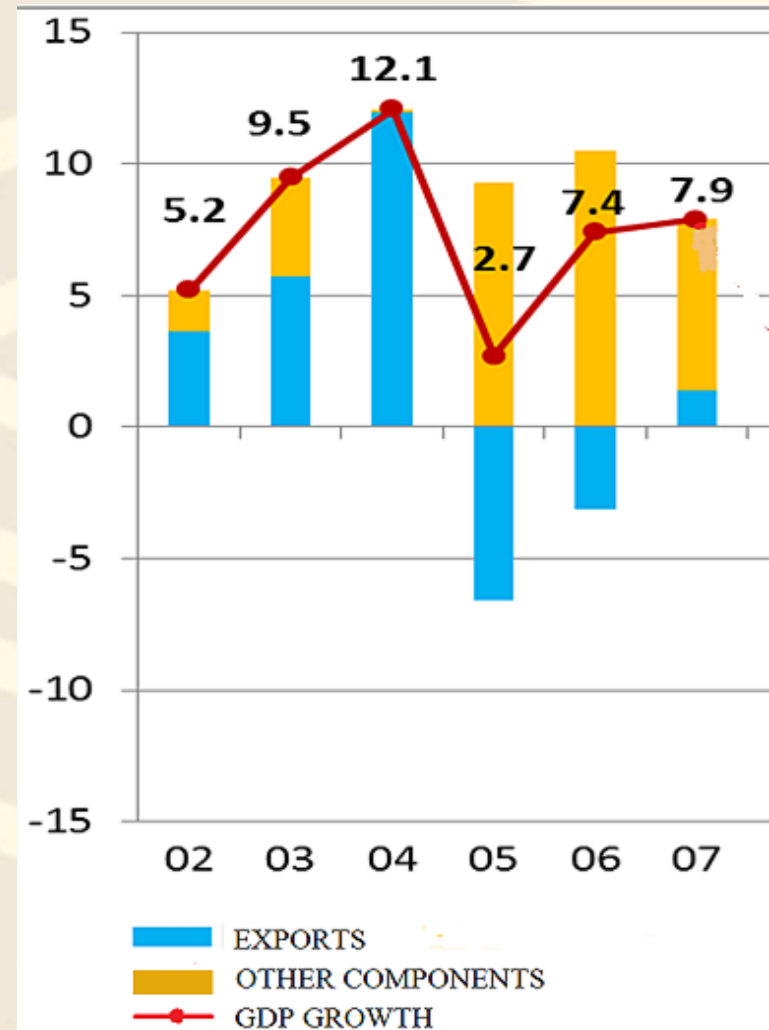
- Between 2004 and Sept 2008, Ukraine continued its good performance.
- But GDP growth was based on consumption and investments financed principally by large foreign debt that led to money supply increases, high inflation, and high current account deficits.**

	2004	2005	2006	2007	Sep 2008
Real GDP Growth	12.1%	2.7%	7.3%	7.6%	6.3%
Fiscal Balance (% GDP)	-3.2%	-1.8%	-0.7%	-1.1%	-1.7%
Consumer Inflation (eop)	12.3%	10.3%	11.6%	16.6%	24.6%
Exchange Rate (Hr/\$, eop)	5.31	5.05	5.05	5.05	4.85
Current Account (\$bn)	6.8	2.5	-1.6	-5.9	-13.0
<i>(as % of GDP)</i>	10.6%	2.9%	-1.5%	-4.2%	-6.4%
International Reserves (\$bn)	9.5	19.4	22.3	32.5	37.5
Foreign Public Debt (% GDP)	18.7%	13.4%	11.9%	9.8%	6.5%

Source: State Statistics Committee of Ukraine, National Bank of Ukraine, Ministry of Finance of Ukraine, The Bleyzer Foundation

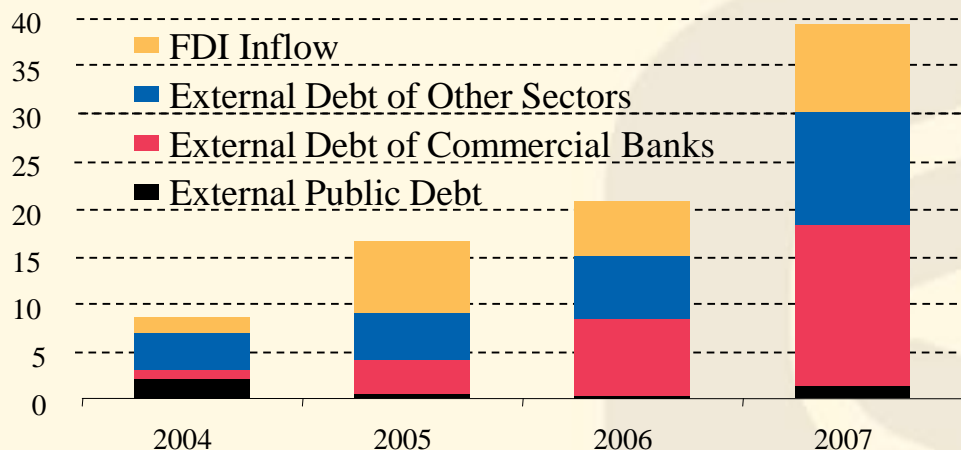
Growth Drivers During 2002 - 2007

- Exports were the main sources of growth in 2002 to 2004, driven by a competitive exchange rate and high growth in the EU and EMs.
- But in 2005-2007, the main sources of GDP growth were domestic consumption and investments
- Domestic consumption and investments were stimulated by money supply increases from a large inflow of foreign capital that brought **external foreign debt** (principally private) from \$20 bn in 2002 to \$90 bn in 2007.

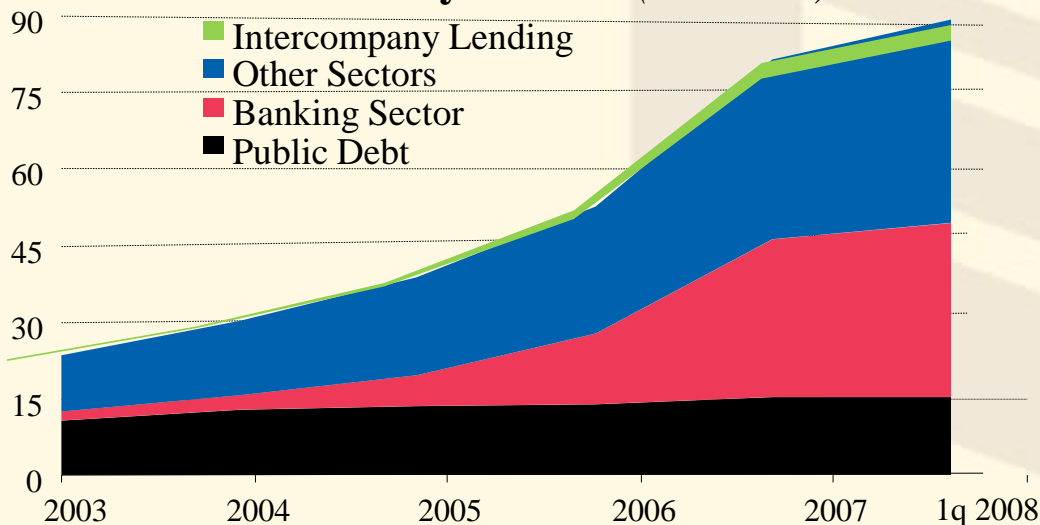


Sources of Foreign Capital Inflows

Foreign Capital Inflow (\$ billion)



External Debt by Sectors (\$ billion)



- The side charts show the composition of foreign capital inflows.
- Over the last two years, foreign direct investments contributed 25% of capital inflows.
- The major capital inflows came from increases in commercial bank borrowings (45% of the total) and other borrowings (particularly corporate long-term debt).

In 2008, the Sub-Prime Crisis hit Ukraine hard, due to high dependence on foreign debt and exports

- Export of goods: **- 40% yoy** (2009)
- Real GDP: **-14.8% yoy** (2009)
- Industrial production: **-22% yoy** (2009)
- PFTS stock price index: **-74%** (2008)
- UAH/\$ Exchange Rate: **65% Depreciation** (2009)
- Unemployment (ILO): **9.4%** (4Q 2009)
- Real households' income: **-8.5% yoy** (2009)
- Broad fiscal balance: **-11% of GDP** (2009)

The Crisis Affected Ukraine Harder than other EMs

Country	GDP, % yoy 2009	Local Currency Depreciation vs. US Dollar (mid-2008 to end-2009)
Ukraine	-14.8	65%
Latvia	-17.5	9%
Lithuania	-14.4	9%
Estonia	-14.5	9%
Russia	-8.0	29%
Mexico	-6.9	27%
Romania	-7.1	27%
Hungary	-6.7	26%
Taiwan	-3.5	6%

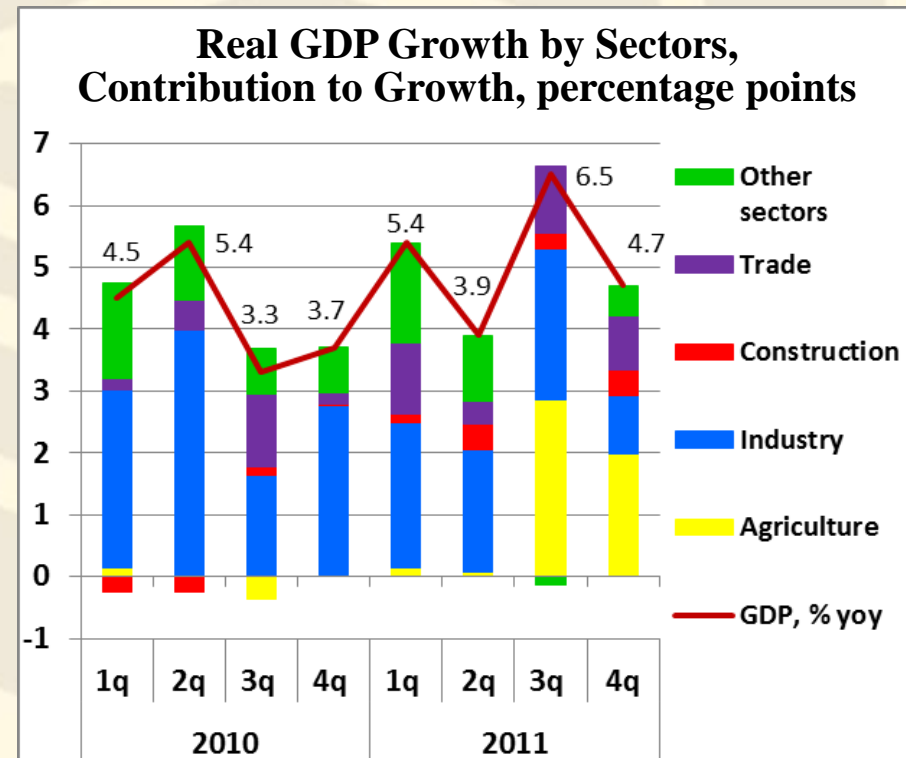
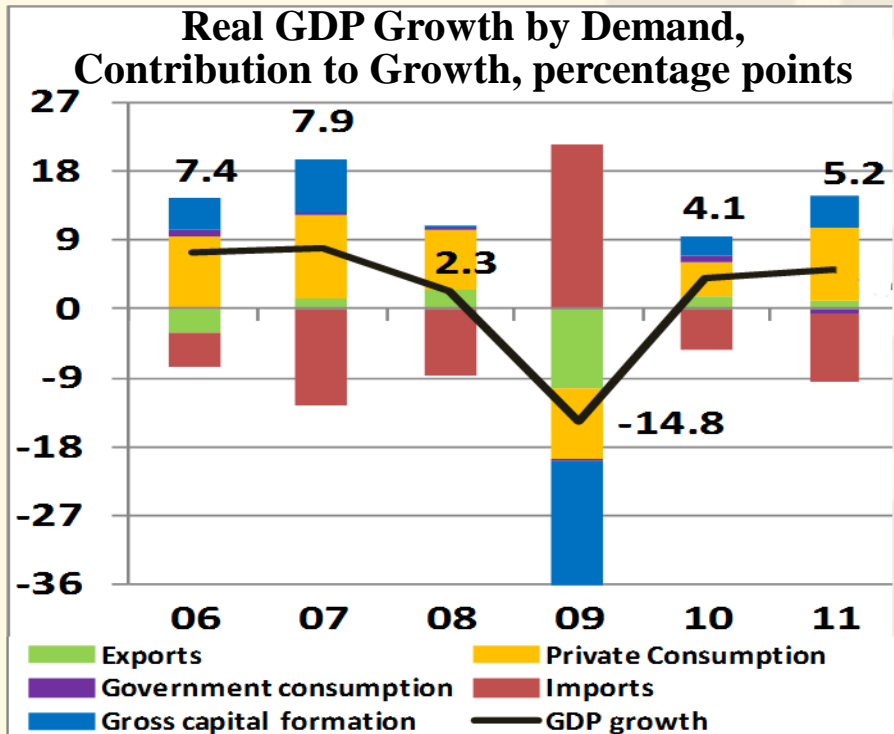
* The Bleyzer Foundation for Ukraine and Romania, The Economist for others countries
Sources: The Economist, Central banks of the respective countries, The Bleyzer Foundation

Ukraine Handled the 2008 Crisis Relatively Well

- Ukraine secured loans from the IMF and World Bank at the end of 2008.
- Private firms & banks were able to restructure short-term foreign debt.
- A program for troubled banks was implemented. The main aspect of this program was the recapitalization of troubled banks with public funds.
- The NBU supported banks liquidity through its refinancing operations; eleven banks were taken under NBU temporary administration with one of them successfully sold to new shareholders; the Central Bank monitoring was placed in several other banks. All in all, four banks were recapitalized.
- At the beginning of November 2008, the guarantee on deposits of individuals was increased three times to UAH 150,000 (about \$20,000).
- The authorities agreed to gradual fiscal consolidation and implemented structural reforms to revive growth.
- The Hryvnia depreciated by 65% in 2008-9, restoring competitiveness.

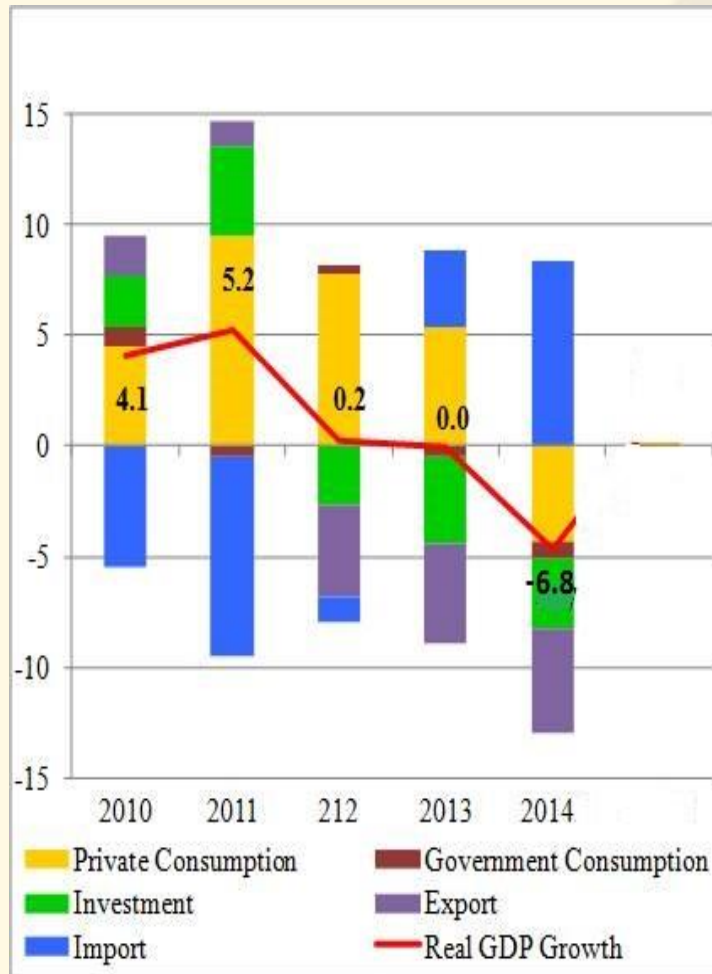
The Economic Recovered Quickly in 2010 and 2011

- Under the new President Yanukovych, in 2010 and 2011, GDP grew rapidly at 4.1% and 5.2% pa, respectively, better than most European countries.
- Real GDP growth was driven by private **consumption** and public **investments**.
- **Agriculture**, with a record high harvest, played a significant role in supporting GDP growth in 2010 and 2011, and also in reducing inflation.



But GDP Growth stalled in 2012, 2013 and 2014

Real GDP Growth by Demand, Contribution to Growth, ppts



- In 2012 and 2013, economic growth slowed down to 0.2% yoy and 0% yoy.
- GDP growth was depressed by weaker **exports and steel prices** (due to a poor economic environment in Europe) and low domestic **investment** activity.
- Ukraine, however, in 2012-13, avoided a decline in GDP due to increases in **domestic consumption**, stimulated by growth in real wages.
- In 2014, GDP decline by 6.8%, principally due to a dramatic change in Ukraine's political landscape, caused by the invasion of Russian troops in Crimea and Eastern Ukraine.

2014: A Dramatic Change in Political Landscape

- Yanukovych's decision of November 2013 to postpone signing of the Free Trade & Association Agreement with the EU - and increase cooperation with Russia -- sparked massive protests in Kiev and West Ukraine.
- Starting as pro-European demonstrations, the protesters later demanded an overhaul of a seriously corrupt and authoritarian political system.
- These protests resulted in the ouster of Yanukovych in February 2014, the return of the 2004 Constitution (under which the President shares power with the Parliament and Prime Minister), and early presidential elections.
- The President's ouster led to unrest in East and South Ukraine, with Russia invading and annexing Crimea, an annexation not recognized internationally and invading Eastern Ukraine (Donetsks and Lugansk), the industrial center of the country.
- Protests in Eastern Ukraine quickly evolved into armed insurgency supported by Russia.

New President: Presidential Elections

- Early presidential elections in May 25, 2014 were won by Petro Poroshenko, a successful businessman and politician, who received 54.7% of the vote.
- Pro-Europe candidates received close to 90% of the votes. Despite scarce voting in eastern oblasts, the elections were recognized as free and fair.
- Mr. Poroshenko started military actions in Eastern Ukraine to restore order.
- But little military progress was made and in September 2014, a ceasefire was agreed with the involvement of Germany, France, Belarus and Russia.
- This agreement was ineffective and in February 2015, diplomatic efforts to restore peace resulted in the Minks-II Agreement (Germany, France, Ukraine and Russia) which envisaged:
 - A new ceasefire starting on February 15th.
 - Withdrawal of heavy weapons from the front line by Ukrainian forces and rebels.
 - Release of all prisoners and amnesty for those involved in fighting.

Defense/Military Situation

- Withdrawal of foreign troops from Ukraine and disarmament of illegal groups.
- Restoration of Ukraine's control over its border with Russia after constitutional reform that would grant autonomy to the regions (to be completed by end 2015).
- Despite some delays in implementation of the Agreement, there has been progress in de-escalation, with the intensity of fighting receding, except for some sporadic actions along the ceasefire line.
- Thanks to EU/US sanctions, a stronger Ukrainian army, clear resistance from local populations, and the possibility of US military assistance, it appears that Russia may have abandoned its plans to invade the rest of Ukraine and create a "Novorossiia" state covering eastern and southern Ukraine.
- If so, the separatist area would remain "frozen". This would provide the opportunity for the rest of the country to restart investments and growth.

Ukraine and Separatist Area



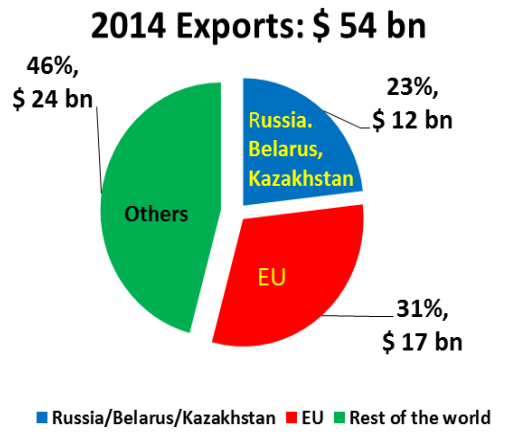
- The Separatist area represents 4% of Ukraine, but contributed a large share of its economic output: 14% of exports, 12% of industry, and 9% of GDP.
- The hostilities therefore were the main reasons for the large declines that Ukraine suffered on exports, industry, and GDP :

- Exports declined by about 22% in two years.
- As exports represent about 45% of GDP, **GDP dropped** by 6.8% in 2014.
- This led to: **devaluation** of the Hryvnia (from 8 to 25 UAH/\$ in 2014-15), increase in **inflation** (to 43% as the end of 2015), increase in **unemployment** rate (to 10% at the end of 2015), **higher fiscal budget deficits** (to 11.7% of GDP in 2014) , and problems in the country's **financial sector** (due to deposit withdrawals caused in turn by lack of confidence).

Economic Impact on Ukraine's Population

- Although the statistics show a sharp deterioration on economic conditions, the impact on living standards of the population has been less severe:
 - ❖ First, Ukraine's informal economy has expanded substantially since the beginning of 2014, providing unreported income to the population. A recent study by the Ministry of Economy shows that the informal economy may have increased from about 35% of GDP in 2013 to about 42% of GDP in 2014. This increase was induced by the military conflict, weaknesses in the banking sector, and currency inflation and depreciation.
 - ❖ Second, the population has been using its substantial foreign exchange savings to maintain current consumption, as demonstrated by the fact that foreign exchange sales by the population have exceeded purchases for several months in a row, and foreign currency deposits in April 2015 declined by 35.4 % yoy.
 - ❖ Third, the significant transfers of funds from abroad, principally to relatives in Ukraine, have helped ameliorate the effects of GDP declines on living standards. In fact, according to NBU statistics, net current transfers in January-April 2015 reached USD 629 million, compared to USD 1,541 million in 2014.

Exports to Russia and Prospects



- About two-thirds of the drop of exports were due to declines in exports to Russia, Belarus & Kazakhstan, which declined from 32% of the total in 2012 to 23% in 2014 and to 10% in early 2015.
- Other declines in exports were due to war damage.
- **However, most of the potential export reduction has already taken place: therefore there is little room for further economic decline.**
- Thus, the only way now is up. But the speed of economic recovery will depend on two interdependent factors :
 1. the strength of government reforms agenda to improve the business environment to attract FDIs and increase exports to other countries.
 2. the continuation of international financial support.

Summary of Reasons for Economic Recovery

If peace is maintained, economic recovery is possible for the following reasons:

- The major cause of economic deterioration (export drop to Russia) has been exhausted, with very limited exports to Russia still remaining.
- For the first time since independence, Ukraine has a pro-reform democratic Parliament, President, and Prime Minister.
- A strong civil society has emerged which will push for changes.
- The government has a strong economic reform agenda, supported by the IMF and the international community, and backed up by sufficient funds to cover possible foreign financing gaps.
- The 300% Hryvnia devaluation represented an overshooting and will permit future exchange rate stability, while maintaining Ukraine's international competitiveness in trade (with low wages) for many years.
- Free trade agreements with the EU, and possibly with Canada, Israel, and other countries should further encourage export and GDP growth.
- Foreign direct investments should be encouraged by low asset prices and large opportunities to exploit local inefficiencies.

Main Macroeconomic Indicators

	2013	2014	2015	2016f	2017f	2018f	2019f
Real GDP Growth, % yoy	0	-6.8	-10.5	2.0	3.5	5.0	6.0
Fiscal Balance, % GDP	-6.5	-11.7	-3.5	-4.0	-3.1	-2.6	-2.0
Consumer Inflation, %, eop	0.5	24.9	43.3	18.0	10.0	8.0	6.0
Exports of Goods, \$ bn	59.1	50.6	38.7	40.8	44.9	48.4	51.1
Current Account, % GDP	-9.1	-3.6	-0.5	-0.5	-3.0	-2.5	-2.0
UAH/\$ Exchange Rate, eop	8.1	15.8	25.0	25.0	25.0	25.0	25.0
Gross Int. Reserves, \$ bn	20.4	7.5	13.3	17.0	22.0	28.0	35.2
Public Foreign Debt, % GDP	31.7	34.9	47.0	55.0	60.0	60.0	55.0

* Includes implicit Pension Fund deficit and Naftogaz imbalances

Source: NBU, SSS of Ukraine, MinFin, IMF, The Bleyzer Foundation