

## Current Economic Situation in Ukraine and Prospects

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Ukrainian GDP has been declining for five consecutive quarters since mid-2012 and only in the last quarter of 2013 real GDP growth recovered thanks to a record high agricultural harvest. According to the State Statistics Committee, real GDP increased by 3.7% yoy in 4Q 2013, which compensated for a 1.3% yoy decline in the previous nine months of 2013. As a result, Ukraine reported zero economic growth for the whole 2013 year. Although Ukraine avoided a decline in GDP in both 2012 and 2013, real GDP has been virtually flat over the last two years. This situation reflected (i) weak exports caused both by poor economic performance in Ukrainian trading partners and Russia's artificial export limitations; and (ii) weaknesses of domestic economic policy pursued by the former government, which led to low private investments.

Hard economic data for the first month of 2014 were also disappointing. Economic activity in January was negatively affected by the ongoing political unrest and related uncertainties. This poor performance occurred despite a recovery of world steel prices and an almost 35% reduction in imported natural gas prices (in accordance to a deal between Russia and Ukraine concluded in mid-December 2013 which cut natural gas prices for Ukraine from about \$410 in 2013 to \$268.5 per 1000 m<sup>3</sup> since the beginning of 2014). The deal with Russia, the largest single country trade partner of Ukraine, was also expected to benefit Ukraine's industrial sector as it contained a number of sector agreements; but due to political turmoil in Ukraine as well as economic slowdown in Russia, the implementation of these agreements never started. Moreover, during January, Russia tightened again custom controls on imports from Ukraine. That meant that all vehicles traveling from Ukraine to Russia had to be unloaded and inspected, which delayed custom clearance for 10-15 working days. As a result, industrial production in Ukraine was down by 5% yoy in January 2014, mainly on account of a 23% yoy drop in machine-building and a 10% yoy reduction in metallurgy, products for which Russia is the main market. Although the service sector reported increases in output in January, to a notable extent this improvement may be attributed to a low base for comparison. Only agriculture and retail sales kept reporting solid gains, advancing by 6% yoy and 8.8% yoy respectively.

Ukraine's fiscal budget position in 2013 deteriorated due to weak economic activity, generous expenditures on wages and pensions, and energy subsidies. The fiscal budget deficit (including Naftogaz and Pension Fund) widened from 5.6% of GDP in 2012 to an estimated 7% of GDP in 2013. These significant fiscal deficits add to financing concerns as it generates large increases in public debt and wide current account gaps. The current Ukrainian public debt of about 40% of GDP is not excessive by international standards; but large fiscal deficits may expand this debt rapidly. Moreover, short-term external public debt liabilities due in 2014 are high, standing at about \$8 billion. The rollover of this public debt is problematic due to the current political crisis, economic downturn and unfavorable developments in global financial markets for emerging markets. Indeed, these concerns have led to currency depreciation pressures, with the Ukrainian Hryvnia reaching UAH 10.4 per USD at

the interbank market as of the end of February 26<sup>th</sup>, a depreciation of about 20% since the beginning of the year. This devaluation will make it harder for the government to service and repay its foreign currency debt.

Moreover, Naftogaz debt to Gazprom for natural gas consumed in 2013 of around \$2 billion and \$3 billion of sovereign Eurobonds purchased by Russia at the end of 2013 may be demanded by Russia to be paid in 2014. In this case, Ukraine's external public and quasi-public debt repayments may be as high as \$13 billion in 2014.

In addition to its external debt payments, Ukraine needs to finance large current account deficits in its balance-of-payments. According to NBU data, the current account gap reached \$16 billion in 2013, or 8.8% of GDP. An imported gas price discount would have had a favorable impact on Ukraine's external position in 2014. However, as current Ukrainian top officials have announced that Ukraine will restore the Association Agreement with the EU, Russia is likely to increase the price of gas for Ukraine since the gas price deal reduction was subject to quarterly revisions. Furthermore, Russia is resuming pressure on Ukraine through trade restrictions. In addition to tightening custom clearance procedures, Russia has been considering imposition of restrictions on agricultural and food products import from Ukraine on health grounds. These negative factors from Russia may be more than offset by favorable economic recoveries in Ukraine's main trading partners, as now anticipated, by lower consumer goods imports and better exports associated with the current Hryvnia devaluation, and by early export support measures under a FTA with the EU. Hence, in a baseline scenario, with EU support, Ukraine's current account deficit may improve to about \$13 billion in 2014. Under an optimistic scenario, the current account deficit could narrow to \$10 billion (if the FTA with the EU is more successful, and Russia maintains the natural gas price discount for Ukraine for the whole year and does not introduce new trade restrictions). Under a pessimistic scenario the deficit could be maintained at the 2013 level of \$16 billion (if the gas discount is terminated in 2Q 2014 and Russia imposes more severe trade restriction on Ukrainian goods).

In 2014, Ukraine's private sector must also serve around \$50 billion of external private debt. However, it is plausible to assume that this amount would be fully rolled-over, since most debtors are export-oriented large enterprises and banks with good connections with creditors. In fact, over the last four years, private sector external debt repayments were fully rolled-over.

On the above assumptions, Ukraine's total external financing needs in 2014 may vary from \$21 billion to \$36 billion as noted in the see table below, depending to a great extent on Russia's behavior on its trade and financial policies:

(In US billion)	Optimistic	Baseline	Pessimistic
External Public and Quasi Public Debt	8	8	13
Current Account Deficit	10	13	16
Population Purchases of FX	3	5	7
Total	21	26	36

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Given that NBU gross international reserves stood at less than \$15 billion at the end of February 2014, the near-term economic prospects of Ukraine are crucially depend on how quickly and how much foreign financing Ukraine may be able to obtain. Under the baseline scenario, Russia is unlikely to continue disbursements under its \$15 billion loan agreed at the end of 2013. On the other hand, a financing aid package of around \$20-25 billion may be provided by the EU, the US and IMF. In addition, foreign direct investments may revive during the year, helping to cover the financing gap for 2014. Although IMF financing is unlikely before the Presidential elections scheduled for May 25th, 2014, some urgent rescue financing (over the next few weeks) may be provided by the US/EU to contain a rapid Hryvnia depreciation and avoid a default.

Economic growth prospects for 2014 are also dependent on the resolution of Ukraine's financial situation. The provision of financing by the EU/US/IMF may also be accompanied by early EU measures to support Ukraine's exports under FTA, and by changes in economic and fiscal policies. All this could lead to a rapid resumption of foreign direct investments and credits to Ukraine. On these bases, Ukraine may be able to grow by 1-2% yoy in 2014 and 3-4% yoy in 2015 even if Russia imposes additional trade restrictions.

Under this scenario, with quick western support and following a relatively short period of exchange rate turmoil, the Hryvnia exchange rate may stabilize at around UAH 10 per USD. The main reasons for future stability in the exchange rate are the following: (i) it seems that the latest FX pressures were due to a 'planned' devaluation, with the NBU intentionally decreasing its interventions, including administrative ones; (ii) it appears that the devaluation of the last two days was partly caused by importers front-loading their FX purchases for imports, rather than due to an acceleration of both external and internal capital flight; (iii) most external capital flight has already taken place during the last few days of the previous administration, as former leaders rushed out of the country; (iv) the previous internal capital flight, which led the NBU to impose certain capital controls, may moderate in light of the recent political developments; and (v) over the last few years, the rate of domestic inflation in Ukraine has been lower than inflation in its main trading partners, with the result that there are now lower purchasing power parity pressures for devaluation. All this indicate that the exchange rate now should be now close to an equilibrium level.

At the same time, the key downside risks include delays in financial assistance, a new wave of political disturbances related to Maidan's dissatisfaction with the interim government, and Russia's intervention into Crimea and eastern regions attempting to separate. Either of these developments may lead to financial and economic crisis in Ukraine with disorderly currency devaluations.