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UKRAINE - Update on Current Political/Economic Developments

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A Free Trade and Association Agreement (FTAA) with the European Union would have had significant benefits for Ukraine over the medium to long term, increasing foreign investments, exports and GDP. But these benefits take time to materialize and over the short term, the FTAA would have been quite problematic for Ukraine, particularly due to the extraordinary trade pressures put by Russia's Custom Union. The Custom Union is Ukraine's largest trade partner, accounted for 33% of Ukrainian exports of goods or about $22 billion in 2012. According to the State Statistical Service of Ukraine, exports to Russia's 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) contributed, the decline is principally attributed to cooling trade relations between Russia and Ukraine, after the FTAA was taking inertia. With the signing of the FTAA with the EU, the reduction in trade with Russia would have increased Ukraine's trade deficit by around $6 billion to $9 billion in 2014, leading to current account deficits as high as $17-20 billion in 2014.

On top of this current-account financial gap, in 2014 Ukraine will need to serve about $8 billion of foreign government debt (of which about $4 billion are due to the IMF). In addition, in 2014 there could be additional FX needs due to increased population demand for FX. In our previous forecast of FX rates, we had assumed that the local population would retain some degree of confidence in the Hryvnia and would not increase its purchase of FX. The current developments may change this and lead the population to increase its purchases of FX. The combination of these requirements means that Ukraine may have required external financing of close to $25-30 billion in 2014.

Without support from the IMF and the EU, Ukraine could have faced a financial crisis as Ukraine's FX reserves (now down to $19 billion) would be exhausted some time in 2014. These concerns led the government to postpone the signing of the agreement with the hope that exports to Russia would revive. In turn, this postponement led to the current massive demonstrations in Ukraine.

It is too early to forecast the outcome of the current demonstrations. Two extreme outcomes could be (1) the use of state-of-emergency measures by the government, supported by a massive presence of police forces (a la Latin America) to regain control of the city (which may lead to sanctions by the US and Europe); or (2) at the other extreme, the resignation of the government and appointment of a new government (as demanded by the opposition).

In any event, there is already a positive outcome: the large size of the current demonstrations in Ukraine would make unlikely that Yanukovich will want to enter into a Custom Union agreement with Russia, as this would lead to even larger demonstrations. The possibility of a FTAA in the future is still alive and in the meantime Ukraine could address its FX financing issues.

The most likely scenario is that some kind of negotiations will take place between the opposition and the government, with an agreement that there would be some government changes (such as the Minister of the Interior and Kiev Police Chief) and the re-initiation of serious discussions with the EU, with the participation of opposition leaders. The government would wish to make some changes in the FTAA, particularly regarding financial assistance and some support to local manufacturers. The EC has already said that it would not accept any changes in the agreements already initialed with Ukraine, but some of its leaders have indicated a willingness to consider some form of financial support which could go in parallel to the FTAA. In any event, any EU financial support and endorsement by all EU governments will take some time to materialize. Therefore, it is unlikely that a FTAA could be signed before the Presidential elections of 2015. This is also consistent with the timing of the next Easter Partnership Summit in Riga, now planned for mid-2015.

On the FX rate side, with prolonged uncertainties about Ukraine's future, the Hryvnia exchange rate will be under pressure. Despite the postponement of the FTAA, Ukraine's large foreign exchange requirements in 2014 will not be provided by Russia, as it is unlikely that Ukraine will agree to join Russia's Custom Union. The government will have no choice but to seek financing from the IMF in early 2014. An IMF a loan could be of about $15 billion and include loan conditions which may be somewhat softened by the IMF under pressure from the EU. Most likely IMF conditions may include increases in natural gas tariffs by 60% for select large households, an agreed upon program to stabilize public finances, a revision of tax privileges for business and social benefits for population, reductions of expenditures on public administration, and widening of the band for Hryvnia exchange rate fluctuations to 8.5 UAH/US$. Under these conditions, the FX rate may be relatively stable, with a "contained" devaluation to about 8.5 to 9.0 UAH/US$ by the end of 2014.