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Ukraine: Potential and risk

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Ukraine: Potential and risk

Ukraine's strong growth in the first eight years or so of the century suddenly came to a halt with the global crisis that is now exposing the country's fragilities. Banks, companies and households had been living largely on credit for some time. Now they are threatened with suffocation as they are denied access to international capital markets or the domestic lending market—or only on prohibitive terms. Their capacity to meet external commitments is further weakened by the collapse of the hryvnia since last summer. The fall in steel prices has a somewhat larger impact on economic activity, serving as a reminder of the country's dependence on the metal industry. Finally, at a time it is crucial to preserve confidence by international donors and foreign investors, the constant political tensions since 2005, and more generally the very poor quality of governance, constitute a very serious impediment. Ukraine not only faces the risk of sinking deeper into the crisis, but could also fail to match recent performance for quite some time. The medium-term potential remains certain, but whether it can be achieved smoothly and within a reasonable timeframe is far from sure.

From depression to euphoria

As in most of the other former Soviet republics, **the dismantling of the Soviet empire and accession to independence in 1991 were followed by nearly a decade of institutional and economic disorder.** Ukraine's GDP contracted continuously between then and the end of the century, at an average annual rate of just over 9 percent, with the collapse of entire segments of the economy, which centered on heavy industry at the time. Agriculture accounted for about one fourth of GDP at the start of the 1990s but only one sixth at the end, due to the lack of inputs (e.g., farm machinery and fuel) and rigidities inherited from the previous system (which caused a corresponding delay in the process of land redistribution and privatization).

In the wake of its Russian neighbor and the rest of the region, **2000 marked a turning point and a renewal.** Performance between then and mid-2008 was unprecedented. GDP growth averaged

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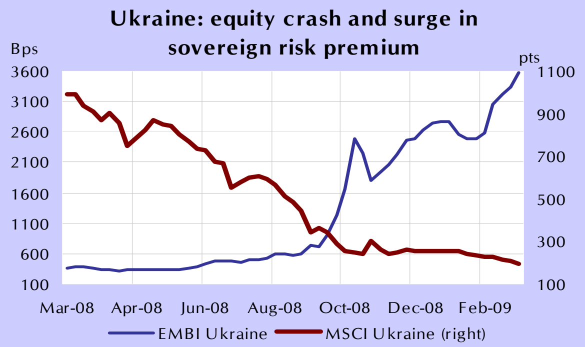
Chart 1



Source: JP Morgan, Morgan Stanley, Crédit Agricole S.A.

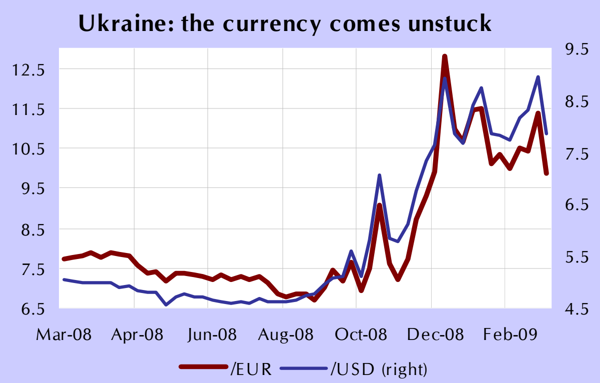
7.5% a year from 2000 to 2007. Public finances improved. And even if the country underwent a severe political crisis in 2005, as private sector agents (unlike the State) went heavily into debt, complacent foreign investors saw in Ukraine a market to penetrate. High foreign capital inflows in recent years played a key role in the country's growth dynamics—**until overheating set in and reached a flash point upon contact with the explosive international environment.**

Ukraine loses some of its shine

The global crisis has affected Ukraine severely. It began with the financial markets (see chart 1). Morgan Stanley's MSCI index, which measures stock market performance in local currency, lost 75% of its value in 2008, with three-fourths of the drop in the last five months of the year, and has fallen a further 25% since January 1. The risk premium on government debt widened by 2300 bps between August and December 2008, and has increased by an additional 810 bps so far this year, to just over 3580 bps. These are default level spreads. But while the risk is real, what the spreads reflect is rather, for the time being, the lack of liquidity on the secondary market for sovereign debt.

The hryvnia has fallen 30% against the euro and 40% against the dollar from last summer's peak, and remains highly volatile today (see chart 2).

Chart 2



Source: Reuters, Crédit Agricole S.A.

The crisis is now moving into the real economy. **Ukraine has been living on credit for several years** (see chart 3), and well above its means, as evidenced by inflation pressures and the growing imbalance in the external accounts. The banks' external debt has increased over 20-fold, in nominal terms, over the past five years, and firms' external debt has increased four-fold. At the same time, domestic loans outstanding to the private sector rose at a 60% average annual rate, amounting to just over 60% of GDP in Q3 2008 and ending the year, according to the initial estimates, at between 70% and 80% of GDP due to the contraction of the economy and the depreciation of the hryvnia.

Into a deep recession

The turnaround in this dynamic will inevitably have serious consequences. Economic agents can no longer access international capital markets or domestic credits—or at a prohibitive cost. This has negative effects on economic activity as a whole. The global crisis is also propagated via trade. The fall in steel prices is weighing on the industry's production (which accounts for one fourth of the country's total production) and on exports (40% to 50% of Ukraine's export receipts).

GDP contracted by 14.4% year-on-year last November and there is every sign the downturn will continue in coming months, doubtless at a comparable pace, or even faster initially. Industrial production is in freefall (see chart 4), dropping 34.1% year-on-year in January, after 28.6% in November and 26.6% in December. Investment is at a standstill. And while household consumption seems to be holding up better (as retail sales were continuing to grow at the end of last year, albeit at a slower pace) that can't be expected to last long. Unemployment and unpaid wages are increasing, while real wages fell in December for the first time in nearly a decade. The increased burden of households' foreign-currency denominated debt will also affect their consumption expenditure.

Ukraine will not escape recession in 2009. GDP could contract by around 7% over the year. But many uncertainties remain and the pill could be even more bitter.

Mounting risks

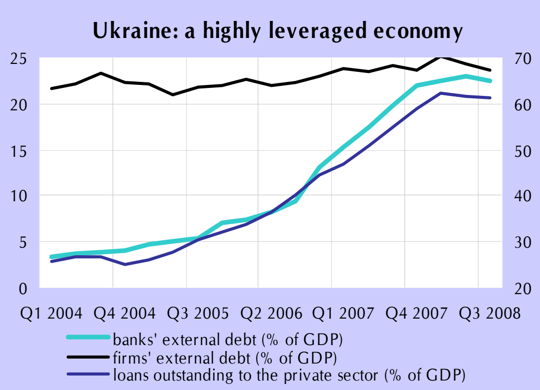
The country's external financing requirements in 2009 are high. The short-term debt of the banks and firms comes to some USD 30 billion, to which must be added about USD 2bn for the current-account deficit and anywhere from USD 10 to 15bn, depending on the source, for repayment of principal on the medium- and long-term external debt. Foreign exchange reserves came to USD 26.5bn at the end of February. This shows how much the IMF support is needed, both for its direct aid (the USD 16.4bn granted last November, including USD 9.5bn to be paid in four tranches this year), and for the confidence it provides to the markets. The IMF aid is barely sufficient, unless the institution increases the total amount, so Ukraine will surely need the markets for funding.

IMF support is far from being irreversible. **In early February, the IMF suspended payment of the second tranche of its loan**, which is conditional on implementation of measures agreed with Ukraine's leaders, primarily recapitalization of the banks, more-flexible currency policy, and tighter monetary and fiscal policy. The principal stumbling block is the 2009 budget. In its current version, it foresees a deficit amounting to 3% of GDP. While the initial condition was a balanced budget, the IMF now appears willing to accept a deficit of at least 1% of GDP. But that does not mean the funds will be released in the immediate future. The government must first recast the 2009 budget using more realistic assumptions (rather than the 0.4% GDP growth on which it is now based). It must then find the means to fund the deficit—while making sure its fiscal policy does not result in inflation pressures or pressure on the hryvnia, and that it does not affect the medium-term sustainability of public finances. The political situation hardly lends itself to these constraints, even if they are relaxed somewhat.

The problem is fundamentally political. There is tremendous animosity between President Yushchenko and Prime Minister Tymoshenko; the fragile ruling coalition is divided between the two leaders; and the relationship between executive and legislative powers is constitutionally ill defined. In other words, there are constant tensions and decision-making mechanisms have totally seized up. In the latest episode, the parliament dismissed the foreign affairs minister, a close ally of the president. Since then, tensions between the pro-Yushchenko and pro-Tymoshenko sides have geared up a notch. The economic situation, and even more, the run-up to the presidential election in early 2010 are making things more tense. Work on the 2009 budget is no exception to the rule of bitter, endless discussions, especially given that it involves a real electoral issue.

All this makes Ukraine an ideal candidate for a severe financial crisis, all the more in that another decisive factor, the future evolution of the international and regional environment, remains uncertain. A crisis of this intensity could involve a further plunge of the hryvnia, a pattern of repeated payment defaults by banks and non-financial companies, or even the collapse of the banking system. Sovereign risk has already risen sharply, and in this situation even the sovereign borrower could be unable to meet its commitments.

Chart 3



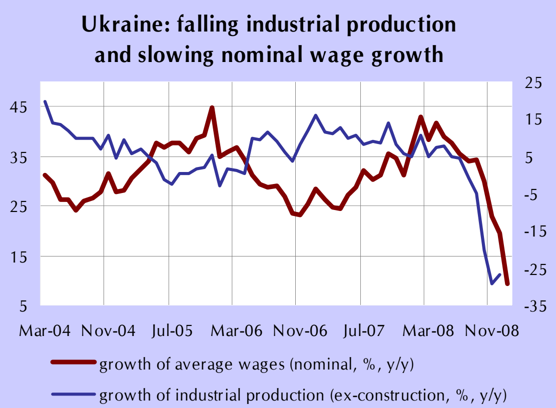
Source: NBU, Crédit Agricole S.A.

A long convalescence

The recovery will depend on how far Ukraine's economy slows, and the actual landing. There can be no certainty, but all other things being equal, the harder the fall, the longer the convalescence. In other words, the greater the destruction of real wealth, the longer it will take to rebuild. After being halved between 1992 and 1999, Ukraine's real GDP is still below the level of the early 1990s. That being said, **on the assumption of a 7-percent recession this year, Ukraine's real GDP would move backwards by three years.**

The cure will take all the longer in that economic agents' pre-crisis finances were fragile, with substantial debt excesses. Households, whose income is almost exclusively in local currency, had almost 75% of their borrowings denominated in foreign currencies at the end of last year (69% in USD, 3% in other currencies). This came to somewhat less than one third of GDP, up sharply over the last six months of 2008 due to the slump in economic activity and the plunge of the Ukrainian currency. Companies' debt represented about

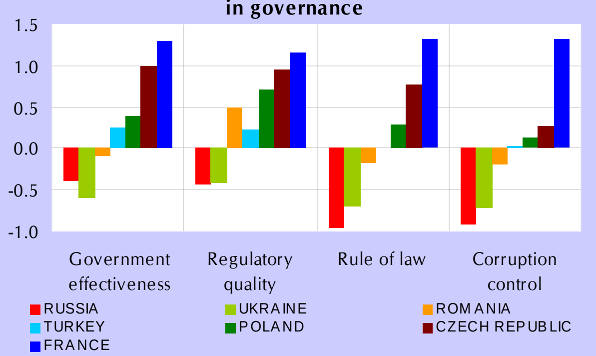
Chart 4



Source: SCSU, Crédit Agricole S.A.

Chart 5

Ukraine: lagging behind much of the region in governance



Source : World Bank, Crédit Agricole S.A.

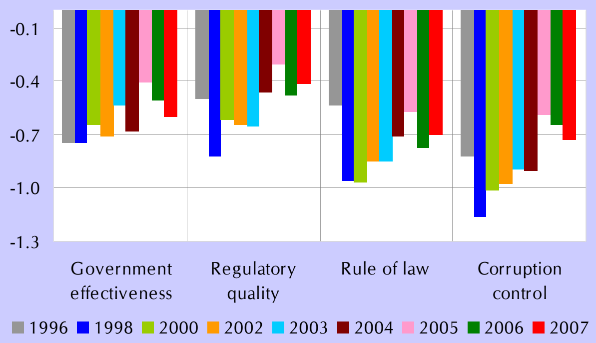
260% of earnings in mid-2008. This ratio has most likely increased since then: the hryvnia depreciation has inflated the value of the debt (half of which was in foreign currencies at the end of 2008: 45% in USD and 7% in other currencies) and the economic depression has probably eroded the profits. Absent any fiscal room to maneuver, **domestic demand is bound to remain flat for several months.** Any relief will have to come from international markets, so no real rebound (i.e., other than a technical rebound) should be expected before early or mid-year 2010; growth for the full year in 2010 should not exceed 2%.

What next? Definite potential...

The necessary adjustment currently underway will eventually let Ukraine's economy rebound on sounder foundations. It can count on major advantages to help in recovery. **Ukraine has large mineral resources,** and ranks as the fifth leading producer of iron ore. Steel is thus a precious source of foreign currency receipts that will pick up with the first signs of a recovery in global demand (even if steel prices cannot return to the 2008 historical peaks for several years, at the earliest). **Ukraine's land is fertile and largely underutilized.** The country's agricultural potential is recognized to be considerable and confers an undeniable advantage in a period marked by the risk of global food shortages; the risk is less acute today but will doubtless resurface once the global economy picks up somewhat.

Chart 6

Ukraine: degradation in governance since 2005



Source: World Bank, Crédit Agricole S.A.

The average level of educational attainment is high. Ukraine has a far better quality human capital base than many other emerging economies. But this is something Ukraine shares with its neighbors in Central and Eastern Europe, possibly as a legacy from Soviet times. Finally, with a population of just over 45 million, **the size of the Ukrainian market is not negligible,** and considerable needs (e.g., in infrastructure and capital goods) remain to be satisfied.

... but considerable challenges

Shortcomings in infrastructure may indeed be market opportunities for foreign investors to seize upon, but more than anything else they are an obstacle to investment. The educational system continues to be poorly adjusted to actual occupational requirements, something that should not be obscured by the general level of educational attainment. The population is declining. World Bank and United Nations Development Program (UNDP) projections anticipate a decline to less than 40 million by 2025, compared with 46 million today and over 52 million in the early 1990s. This could weigh heavily on the size of the labor force, and therefore on the productivity of the economy, in addition to affecting public finances. It results from three factors: high emigration, an inadequate birth rate, and most importantly, the decline in life expectancy, which fell to 68 years in 2005. The deterioration in healthcare services in the 1990s has left its mark. And in the absence of preventive policies, tobacco, alcohol and also HIV/AIDS (which affects 1.4% of 15-to49-year-olds, compared to an average 0.4% in the richest countries and 0.6% in Central and Eastern Europe) are also causing ravages.

That being said, Ukraine's governance (see chart 5) is doubtless the greatest impediment to the country's growth and development.[1] **Poor governmental effectiveness, mediocre regulatory quality, numerous shortcomings regarding the rule of law, and generalized corruption are serious obstacles to meeting the challenges discussed above and realizing the country's potential.** These institutional shortcomings are also a direct threat for investors and investor rights, e.g., contractual and ownership rights. Macro risk is compounded by micro risk.

Based on recent experience, **there is unlikely to be a rapid improvement in governance in the medium term** (see chart 6). The current pre-electoral period is hardly conducive to such a

1. Douglass North is one of the leading theorists of institutional economics; his work is fundamental for the concept of governance. He holds that institutions, by modifying transaction costs, have an influence on trade, facilitating or hindering trade growth and, more generally, economic growth and development; institutional differences accordingly provide the fundamental explanation of disparities in economies' long-term performance and growth.

change. The elections are uncertain to ease the political climate or allow resolution of constitutional issues. And even then, governance is intimately related to a set of factors that sociologists call "habitus."

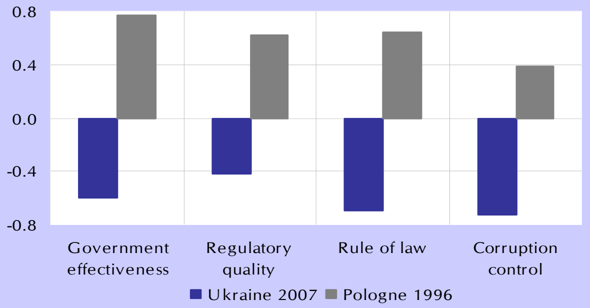
Somber prospects in the medium term

Given the context, and bearing in mind that funds on international capital markets could be scarcer and more expensive for several years to come, especially for Ukraine, the economy is unlikely to revert to the growth rates of the previous eight years (averaging 7.4% between 2000 and 2007). On the other hand, that level of growth would bring the risk of rapidly generating unsustainable imbalances. It is more reasonable to expect **trend growth of 4% to 5%, without overlooking that fundamentals will remain fragile into the medium term, and the risk of instability, notably in foreign exchange, will therefore remain high.**

In cross-country comparisons, **Ukraine is far behind Poland today, and is likely to remain so.** Ukraine's institutional quality is far removed from Poland's, even fifteen years ago (see chart 7). In addition, assuming average GDP growth of 4.5% ("Ukraine 1" in the chart 8), in 2025, Ukraine's per capita income in PPP terms would just reach Poland's level in 2012-2013[2] (and about two-thirds of France's level in 2007).[3] Under this base case scenario, rather than the two countries converging, the income gap would widen. We also examine two alternative scenarios. The first (Ukraine 2), less likely, reaches a similar but somewhat bleaker conclusion, as recurrent political tensions, and difficult relations with Moscow negatively impact the long-term performance and stability of Ukraine's economy. A second alternative scenario, even less probable, involves far more positive prospects (Ukraine 3): the European project takes shape, driving institutional and structural reforms; the fundamentals are consolidated; growth accelerates (at a level comparable to the first eight years of the century); and per capita income

Chart 7

Ukraine: governance lags behind Poland



Source: World Bank, Crédit Agricole S.A.

2. Over the next 15 years, Poland and Turkey are assumed to have the same average GDP growth rate as in 1990-2007.

3. Based on the same assumption as in the previous point, France's per capita income in 2025 would just exceed USD 60,500.

Table 1

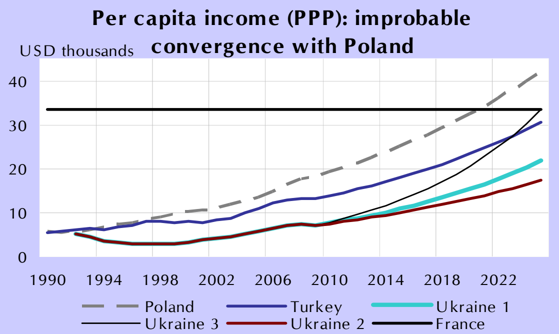
Ukraine

Macroeconomic indicators	1997-2001	2002-2006	2007	2008e	2009f	2010f
Population (million)	49.1	47.1	46.2	46.0	45.8	45.6
GDP (USD bn)	39	70	141	172	115	141
Per capita GDP (USD)	784	1 496	3 056	3 741	2 513	3 095
Per capita GDP (USD, PPP)	3 183	5 137	7 010	7 316	6 950	7 243
GDP (volume, change)	2.0	7.5	7.7	2.1	-7.0	1.0
Inflation (CPI, %)	17.9	7.5	12.8	25.0	18.0	14.0
Unemployment rate	3.6	3.3	2.3	2.1	5.0	4.0
Industrial production (growth, %)	2.9	8.0	6.0	-3.8	-13.0	0.5
Private consumption (growth, %)	1.6	11.7	15.3	6.5	-10.0	-0.5
Budget balance (% GDP)	-2.0	-1.0	-1.1	-1.2	-2.0	-0.5
Tax receipts (% GDP)	27.8	28.8	30.8	31.1	30.5	28.5
Exports of goods (USD bn)	15.0	30.0	49.8	62.0	46.0	56.0
Imports of goods (USD bn)	-16.1	-30.2	-60.4	-78.0	-53.0	-65.0
Trade balance (% GDP)	-2.9	-0.4	-7.5	-9.3	-6.1	-6.4
Current balance (% GDP)	1.6	5.1	-4.2	-6.2	-2.0	-3.0
Net FDI (USD bn)	0.6	3.4	8.1	7.3	0.0	3.0
Net FDI (% GDP)	1.6	4.9	5.7	4.2	0.0	2.1
Foreign debt (% GDP)	38.1	46.1	59.9	62.0	75.0	69.5
Reserves (USD bn)	1.5	12.2	31.8	31.5	26,5*	nd
Exchange rate (/$. year-end)	3.85	5.23	5.05	7.62	8.20	7.6
Real effective exchange rate (2000=100)	116	104	113	127	95	100

Sources: EIU, Crédit Agricole S.A.

* 02/28/2009

Chart 8



Source: IMF, Crédit Agricole S.A.

swiftly converges towards Poland's (reaching France's 2007 level in 2025).

Finally, Ukraine is paying a high price for its past excesses, and is likely to continue to do so for quite some time. Households and firms are deeply in debt. The government has no fiscal room to maneuver. Foreign investors have lost confidence, perhaps for a long time—or at least until such time as there is a captain at the helm. But the presidential elections set for January 2010 are not certain to clarify the political landscape. And even then, governance—and therefore the business framework—will remain mediocre.

Ukraine's medium-term future looks considerably less promising than its recent past. The economy is expected to suffer from instability and high risk levels in the next several years, with the average economic growth significantly below the 2000-2007 period and the convergence toward European norms only as a distant prospect. ■

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