UKRAINE: WHAT TRAJECTORY AFTER THE CRISIS?

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Communication prononcée lors du colloque
UKRAINE : PRESIDENCE IANOUKOVITCH.
RETOUR EN ARRIERE OU NOUVELLE ETAPE DE TRANSITION ?
organisé par le CERI
le 4 octobre 2010

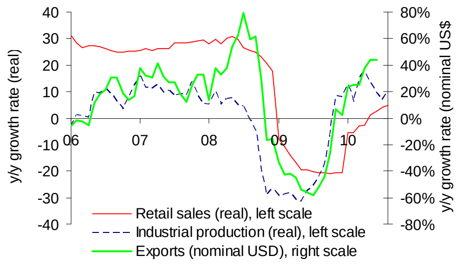
Export-driven recovery after the deep fall…

Ukraine was among the countries that were the most severely affected by global financial turmoil of 2008-2009. The GDP contacted by 15%, the currency lost 60% of its value and the National Bank spent 36% of its foreign reserves.

The data for 2010 look encouraging. The real economy demonstrated 5.5% growth over the first half of 2010. Since the depreciation of 2008, the currency has been remaining roughly stable (*de facto* pegged to the U$) and the foreign reserves have been gradually recovering (being however driven mostly by new government's foreign borrowings rather than healthy current account position).

Since the mid-2009, the economic recovery has been driven by external demand (Chart 1).

Chart 1. Export-driven recovery

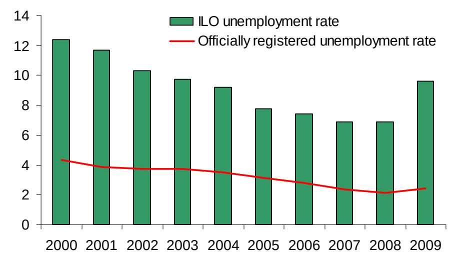


Source: UkrStat, BNPP calculation

After severe 40% fall in 2009, exports increased by 33% y/y over January-July 2010 and boosted the industry that rebounded quickly (+11% y/y over the first 8 months of 2010 after the deep 22% y/y fall in 2009). The recovery in domestic demand is lagging and remains sluggish. Consumption growth attained 0.4% y/y in the first quarter of 2010 followed by 3.4% y/y growth in the second quarter. Over the first 8 months of 2010 retail sales increased only by 5% y/y in real terms. The recovery in investment activity is yet to come: over the first half of 2010 investment contracted by 2.2% y/y and by 5.7% y/y in the second quarter.

The labour market conditions are improving, confirming the economic recovery. After the peak at 10.3% of active population in the first quarter of 2009, the unemployment rate is steadily declining, attaining 8% in Q2 – 2010 (Chart 2).

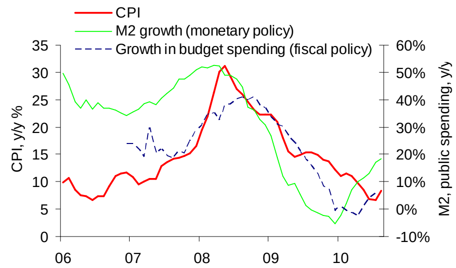
Chart 2. Cyclical peak in unemployment



Source: UkrStat

Inflationary expectations persist. Inflation remained in double-digits in 2009 (Chart 3), despite the recession. The period of single-digit inflation was extremely short-lived (between April and August 2010). Since September 2010 the inflation is back in double-digits, attaining 10.5% y/y. We note that inflation has been remaining structurally volatile in Ukraine during past 10 years, reflecting the inability of the Central Bank to control money supply as well as the pro-cyclical fiscal stance (Chart 3).

Chart 3. Short-lived disinflation



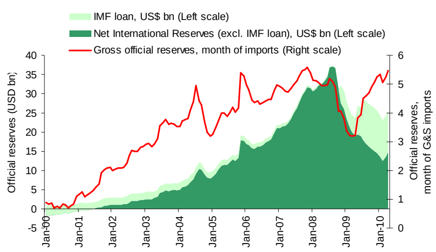
Source: UkrStat, NBU, BNPP calculation

Political stabilisation on uncertain legal grounds…

After the presidential election in January-February 2010, Mr Yanukovych's Party of Regions (PR) pushed through a no-confidence vote in the government of his defeated rival, Yulia Tymoshenko. A new parliamentary coalition based on the PR was subsequently formed, and the new government, headed by Mykola Azarov was voted in. The coalition includes the Lytvyn Bloc, the Communist Party of Ukraine and several deputies that leaved the "orange" parties and blocs.

In order to allow the creation of a new parliamentary majority, the deputies approved a law authorising individual deputies from the OU-PSD and the Yulia Tymoshenko Bloc (YTB) to exit from their previous blocks/parties and to join the coalition. This was done despite the fact that the Ukrainian constitution stated that coalitions can only be formed by established fractions. Following a legal challenge from the OU-PSD and the YTB, the Constitutional Court ruled the coalition lawful, thus avoiding returning the country to political paralysis.

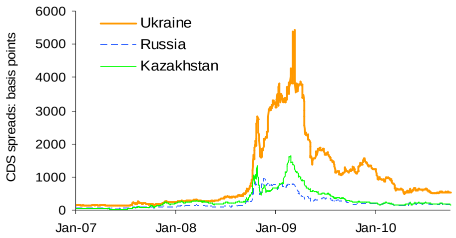
Chart 4. External liquidity position: relying on the IMF



Sources: NBU, IMF, Global Insight, BNPP calculation

In September 2010 the Constitutional Court invalidated the country's Constitution that had been adopted in 2004 during the "Orange Revolution" on procedural inconsistencies. By this decision, several key functions have been transferred from the Parliament to the presidency. Even if this political configuration provides the country with more stable political structure, the precedent of invalidation of the constitution on procedural basis is quite new and creates the uncertainties concerning the laws and regulations adopted during past 5 years.

Chart 5. Better market sentiment



Source: DataStream

The IMF is back and external environment improves.

After the disbursement of US$10bn (of the envelope of US$16bn agreed in 2008), in November 2009 the IMF decided to suspend the program on the back of policy disagreements with the authorities. The main point of disagreement concerned the controversial (and populist) social standards law that was adopted by the Rada during the electoral campaign of 2009.

Soon after his nomination, the first vice-prime minister, Sergey Tigipko, announced that the authorities will actively be looking to obtain a new, extended Stand-By program (to support the economic recovery). However, the IMF has not been satisfied with government's budget projections, judging them excessively optimist. The institution criticised the authorities for the lack of action to reform the pension system and energy sector and for not having completed banking sector restructuring.

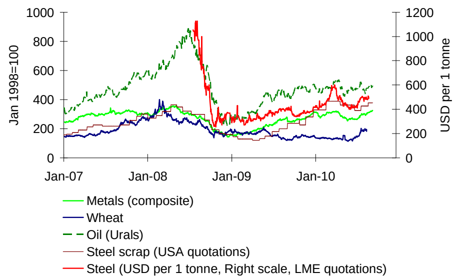
In early July 2010 the sides managed to find an agreement on the new 2.5 year SBA program equivalent to SDR 10 billion (US$15bn, 13% of GDP) that will replace the programme suspended in November 2009. The programme is expected to provide additional support for the country's external liquidity and balance of payments position. It also provides guidelines for fiscal consolidation, thus promoting conservative fiscal stance and *in fine* sustainable growth.

The return of the IMF has been positively perceived by investors. Market sentiment improved, easing tensions on the currency and contributing to narrowing of CDS spreads. This allowed Ukrainian government to successfully issue US$2bn Eurobond in September 2010. It is worth noting that the conditions on key country's export markets (steel, wheat) have been globally improving since the early 2010.

Deadlocked monetary policy

As we can observe on the Chart 6, the prices of key country's exports (steel, wheat) have been volatile thus creating fundamental conditions for the volatility of the exchange rate. However, as the economy remains heavily dollarised and the population's confidence in Hryvnia is low, the fluctuations of the exchange rate have a non negligible impact on social stability, consumer confidence and credit supply. Thus, despite the volatile exchange rate fundamentals, the population is not ready to accept substantial exchange rate volatility.

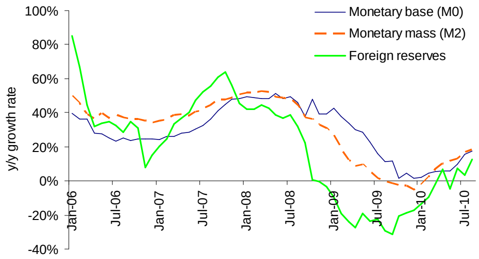
Chart 6. Better commodity prices' outlook



Source: Global Insight

To smooth the exchange rate volatility, the NBU restricts the currency convertibility and intervenes on the exchange market with reserves (that contracted substantially during 2009). However, the exchange controls are broadly negatively perceived by the IMF which advocates more flexible exchange rate policy. As a result, the monetary policy remains in deadlock. As the authorities cannot allow the UAH to fluctuate in line with the fundamentals (as this would suppose too volatile exchange rate) the easing of exchange controls would impose more active interventions on the currency market with reserves (enhancing the pro-cyclical moves in monetary aggregates). This would further restrict the NBU's capacity in controlling the money supply and *in fine* inflation. As we see on the chart 7, even in presence of exchange controls, the monetary aggregates are strongly correlated with the dynamics of foreign reserves.

Chart 7. Pro-cyclical monetary policy



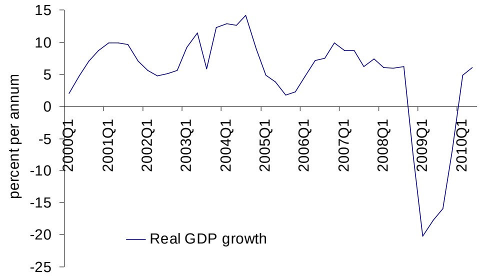
Source: NBU

In the situation of deadlocked monetary policy, the fiscal policy remains the only available anti-cyclical tool for Ukraine. In practice, the country would need primary budget surpluses in the periods of cyclical economic growth (which is still uneasy to obtain the country's political environment) and the substantial (possibly double-digit) deficits during the cyclical downturns.

Outlook: Philips curve dilemma

The cyclical economic recovery in Ukraine is obvious, but the long term trajectory remains subject to uncertainties. In the past, the country has been demonstrating high volatility of growth and inflation (Charts 8 and 2). This confirms that the policies of smoothing the cyclical fluctuations of the economy have been broadly ineffective up to now.

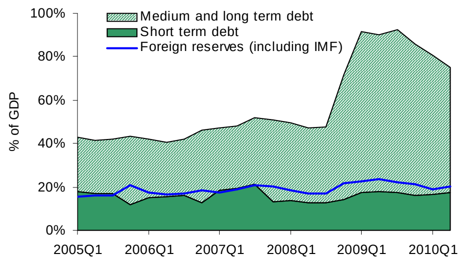
Chart 8. Volatile growth



Source: UkrStat

Thus, in the medium and long terms the sustainability of Ukrainian growth (i.e. stable growth, ahead of the cyclical recovery) will substantially depend on the ability of the government to control public spending and to generate primary budget surpluses. If this occurs, Ukraine will demonstrate moderate but balanced economic growth. After the cyclical correction, GDP will grow at 2%-4% per annum. Growth can be boosted by structural reforms if they succeed in increasing the economy's productivity. In this scenario, we see inflation to moderate substantially, attaining the high single-digits (5%-9%). However, this growth may have a cost in terms of higher unemployment (although in Ukraine's case the risk will be attenuated by the weak supply of labor resulting from the demographic crisis in the '90s). As a result of the moderation in domestic demand (in line with the moderation in budget spending), the current account will be close to balance thus moderating risks of new balance of payment crisis. The crawling exchange rate peg might be supportive for this growth model: however, given the cost the devaluation has for the dollarised economy, the authorities may be reluctant to implement it.

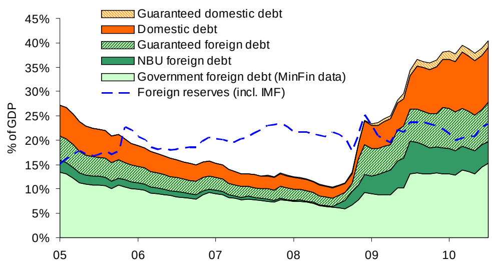
Chart 9. Heavy external debt



Source: NBU, BNPP calculation

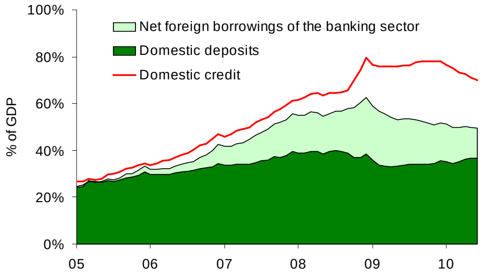
If the government's fiscal stance remains loose (and pro-cyclical), Ukraine will return to the volatile growth trajectory. The GDP growth will pick up to 4%-7% during the "booms" and will be negative during the "bust". During the cyclical booms the currency will remain stable in nominal terms, but appreciate in real terms (on the back of high inflation). The current account will switch back into deficit, thus increasing external borrowing needs. The cyclical downturns will correct for the imbalances, but at a cost of recession and difficulties in the banking sector. Obviously, the country will remain vulnerable to any turmoil on financial or commodity markets.

Chart 10. Rapidly growing public



Source: MinFin of Ukraine, NBU, BNPP

Chart 11. Domestic credit funded bu banks' borrowings from abroad



Source: NBU, UkrStat, BNPP