PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 18 (613), 12 February 2014 © PISM

The Macroeconomic Situation in Ukraine: Little Room for Improvement

Patryk Toporowski

Ukraine's economic fundamentals are poor and it has witnessed only a mild recovery since the beginning of the global economic crisis. Growing unemployment, the stagnant level of wellbeing, weak real FDI inflows, rising government debt, and the costs of defending the currency cloud the prospects to reverse this gloomy trend. The root causes of the current economic situation arise from the inefficient, unclear, corruption-prone and state-linked monopoly-friendly environment. The EU and Poland should therefore use this opportunity to enhance the scale of cooperation with the Ukrainian authorities, sharing experiences and best practices. It also should become involved in encouraging the Ukrainian government to move forward with long-term economic reforms.

Ukraine's economy has been in grave crisis for years. The GDP per capita in 2013 ($7,532) is only slightly larger than in 2008 ($7,308). When compared to such countries as Belarus, where in the same time GDP per capita may well have grown by more than $4,000, or Georgia, which is experiencing harsh external conditions but where GDP has still grown by more than $1,000 since 2008, this points to a lack of adaptation on the part of the Ukrainian economy to changing global and internal environments. Even a comparison of welfare growth trends with most other post-communist countries (e.g., Romania or non-EU member Moldova) is still unfavourable for Ukraine.

Deterioration of the Economic Situation. Some small hope can be derived from inflows of foreign direct investment (FDI), which remain high compared to those of Ukraine's EU neighbours. One reason for this lies in the low costs of business, which attracts multinationals seeking such sites. But a more simple explanation is that the lion's share of FDI inflow comes from the deep pockets of oligarchs profiting from close links with the government then routing their money back into Ukraine through tax havens: at the end of 2011, more than 38% in total come from Cyprus, the Netherlands, and the Virgin Islands. Real foreign investment is modest and not likely to improve. This is because of the economic uncertainty in the country caused by its growing debt and the loss of reliability in its currency as well as the political protests in Kiev, which together work against Ukraine as a production centre.

All the other factors, though, are overshadowed by the growth in government debt, amounting to around 36% of GDP in 2013 and which is looking to expand further. This debt, compared to 2008 when it was 12.5% of GDP, points at the influence of the crisis on the country's economic stability. The country is also proving unlucky in international finance. Since the onset of monetary tightening in the U.S., which started in the second half of 2013, several countries' economies have fallen into jeopardy: Turkey saw borrowing costs jump from 6% to 10%, the Indian rupee and Russian rouble depreciated, and Argentina's peso almost sank. Against this background, Ukraine also struggles with maintaining the stability of the hryvnia, its national currency, which noted its weakest market rate vs. the dollar (8.83 UAH) in five years in the second week of February. The National Bank of Ukraine then devalued the official rate of the hryvnia by 10%. In the third week of February, the market rate slightly recovered to 8.62 UAH per dollar.

National bank reserves are also shrinking incredibly fast: from $36 billion in September to $20 billion at the beginning of 2014. Since then, moreover, additional currency interventions have been made by the national bank so that today the national bank's assets are not sufficient to defend the hryvnia in the medium term. Ukraine's credit ratings have been slipping: its bonds were just recently rated "Caa2" by Moody's, which also holds a "negative" outlook; only a few days earlier, Fitch gave it a "B-" rating and a "negative" forecast; and, at the end of January, S&P degraded the rating even to CCC+, which is close to junk bond status. If the currency is not stabilised soon, a further, significant degradation of the country's credit rating is inevitable. The country's unfavourable current accounts balance does not help. In 2006, this fell into the red, and in 2013, the deficit amounted to more than 8% of GDP, which is an impressively large figure.

On top of that, Ukraine is increasingly dependent on aid from abroad. The World Bank and European Investment Bank granted $6 billion, while more than $600 million more came from development aid, such as that offered by the EU. Ukraine has also obtained loans from Russia, which committed to buy Ukrainian government bonds for $15 billion and lowered the gas price by a third. Moreover, Ukraine's foreign debt has risen systematically since 2004, from $28 billion to $137 billion by 2013. It will be hard to break this vicious circle without an instant and drastic degradation of living standards in Ukraine.

Other basic economic indices, such as unemployment rates, simply darken the overall picture. The official statistics are certainly similar to many other countries (rising from 6.4% in 2008 to 8.2% in 2013). But the real rate of unemployment may in fact be twice as large, and bearing in mind that average salaries in the country are modest by Western standards, this points to the relative poverty of the country. In 2010, almost 7% of Ukrainians were living on $5 a day or less and growing unemployment does not help improve this gloomy statistic.

Roots of the Current Problems. Obviously, the global economic crisis is a major factor here. However, it only highlights the deeper weaknesses in the economy. One of the most significant is the country's poor institutional foundations. The Economic Freedom index ranks Ukraine in 155th place, which points at the low prospects for a bottom-up recovery of the economy. It appears that the gravest problem is corruption. Those who profit from close relations with top politicians, the oligarchs, do so at the expense of the overall economy. In 2012, a new law eliminated transparency in public procurement, thus further facilitating the already rife corruption thanks to government-judiciary collusion. The monopolisation of the main branches of the economy by either the state or the oligarchs also does not work for Ukraine. The government, by limiting access to many markets controlled by the oligarchs or state monopolies, has brought the economy to a standstill, not to mention decreased the welfare of its citizens. Public procurements that favour the monopolists are only examples of the inefficient architecture of the Ukrainian economic framework.

Separate from the institutional background, but also an important barrier to growth, is the high concentration of industrial production in several sectors, which does not provide much added value for the overall economy. The biggest of these are the steel industry, chemicals (mostly fertilizers) and agriculture. The value of the output of these branches is rather low and they are vulnerable to global patterns of trade, and thus to highly volatile global prices. For instance, just before the economic crisis of 2008, global prices soared from $500 per tonne of steel (hot-rolled band type) to $1,100, giving a welcome boost to the economy. But when the crisis started, the price plummeted to $400 per tonne, placing the steel industry in a grave position.

Conclusions for Poland and the EU. During the EuroMaidan protests, the gloomy economic conditions have not been an issue so far. However, they have become increasingly important, and the waning patience of the oligarchs has become key to a resolution of the negotiations with the government. This represents a chance for Poland to foster better cooperation. The economic development of Ukraine, especially in improving business conditions, will be advantageous for Polish firms starting or developing business in Ukraine. Poland should make it a priority to share its experience with reforming public administration (at both the mid and high levels), not least under the EU's twinning programmes.

But even more important is to encourage the eastern neighbour to commit to long-term reforms. Unfortunately, Ukraine's government is not really interested in it as harsh reforms may ensure the sustainable welfare of its citizens in the long-term, but also threaten the government with a loss of power. Thus, Poland should propose stronger backing of Ukrainian economic and political interests in the EU in exchange for a sound long-term plan and a binding commitment from Ukraine's government to make its country's economy more sustainable and prosperous.

In order to convince other EU members to broaden help for its eastern neighbour, Poland should underline that Ukraine's return to a growth path is simply profitable for the EU as well as for the Member States, notably Germany and those in the CEE. Although Ukraine is still not a major market for them, they now note a trade surplus and in the future, when taking into the account Ukraine's demographic potential (some 46 million citizens), they may be able to deepen trade and business relations.

In facilitating the transformation process, apart from Poland or the IMF, also possibly helpful is the European Commission, which is becoming increasingly experienced in assessing the strengths and weaknesses of the EU Member States. The Commission should provide examples of the most-needed long-term reforms, which should be a condition for further integration or partnership with the EU. One should note that although the solutions proposed by the IMF, such as the liberalisation of the labour market, can be harsh to implement, they would profit the entire economy in the long term. In the short term, extending financial assistance can calm the side effects of the reforms the Ukrainian government may accept to treat the ailing economy.