

Ukrainian economy overshadowed by war

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Ukraine's financial results over the past few months prove that the economic crisis which has been ongoing since mid 2012 has exacerbated. According to data from the Ukrainian Ministry of Economy, Gross Domestic Product for the first six months of 2014 shrank by 3%. In the second quarter, it fell by 4.6%¹ and may further be reduced by as much as 8–10% over the year as a whole. After the first six months of this year, the balance of payments deficit reached US\$4.3 billion. After deflation last year, prices grew by 12%, and the hryvnia dropped to a historic low. Although a surplus was seen in Ukrainian foreign trade in goods and services, reaching over US\$3 billion at the end of June, its trade volume is shrinking. The main reason behind this deteriorating situation is the actions taken by Russia. Moscow has been fomenting the conflict in Donbas since April, has consistently imposed embargoes on imports of more and more Ukrainian goods and cut gas supplies to Ukraine in June. This has forced the government to focus on the current management of state finances and to carry out budget sequestration twice this year. The government has also used this as an excuse not to implement necessary systemic reforms. The increasing share of military expenditure, the shrinking exports (-5% in the first six months), including in particular to Russia, which until recently was Ukraine's key trade partner, and the rapid fall in industrial production and investments have all made the situation even worse. All that saves Ukraine from an economic collapse is the loan from the International Monetary Fund and higher taxes, which allows the government to maintain budget liquidity. However, if the conflict in Donbas lasts longer and if Russia continues its economic blackmail, including withholding gas supplies, the economic crisis may prove to be long-lasting.

Donbas: industry under fire

Factories and infrastructure in Donetsk and Luhansk Oblasts have sustained direct losses as a consequence of military actions. These losses, in tandem with the significant fall in the output of companies operating in the region, are among the main reasons why the Ukrainian economy is shrinking. Donbas, Ukraine's most industrialised

region, had a 16% share of the country's GDP in 2013 and generated around 25% of its exports². Between January and August 2014, production fell in all sectors in the region. The industries which have suffered the greatest losses in Donetsk oblast³ are: light industry (-50%), the chemical industry (-45%), the machine-building

¹ All data, unless another source is indicated in the text, originate from the National Statistical Service of Ukraine www.ukrstat.gov.ua. Data concerning Donbas should be seen as estimates due to the war in the region.

² Самаєва Юл., 'Донбас приречений?', *Дзеркало тижня*. Україна №32, http://gazeta.dt.ua/macrolevel/donbas-prirecheniy-_.html

³ No detailed data is available for Luhansk Oblast. The Luhansk branch of Ukrstat stopped publishing statistical information in mid July. However, it should be assumed that the economic situation in this oblast is worse than in Donetsk Oblast.

industry (-37%) and the metallurgical industry (-19%). As compared to the same period last year, industrial production in Donetsk and Luhansk Oblasts has fallen by 20% and 33% respectively (by 58.7% and 85% respectively in August 2014 as compared to August 2013), which resulted in a total reduction of Ukraine's industrial production over this period by 7.8%. The downward trend had been evident for several months, but it exacerbated rapidly in July. Larger industrial plants in Donbas suspended operation in August, including the Avdiivka coke plant, one of the largest coke producers in Europe (as a consequence of artillery fire), which accounts for one third of Ukraine's coke output. As a result, the metallurgical sector has been paralysed, since coke is a key raw material in this sector. The Donetsk and Makiivka metallurgical plants also suspended production. The plant in Yenakiieve is only partly operational. Volodymyr Hroisman, the first deputy prime minister, announced in September that the output of the metallurgical industry, whose products account for 25% of Ukrainian exports, had fallen by 55% in Donbas, and the chemical plants in the region were to stop production altogether. According to Serhiy Taruta, the governor of Donetsk Oblast, only two large metallurgical plants currently operate in the region. These are Azovstal and Ilyich Iron and Steel Works, both located in Mariupol, a city controlled by the Ukrainian forces. The other factories from this sector have suspended production.

Similar problems have been seen in the mining industry. According to governmental estimates, 70% of mines have suspended operation in the territories controlled by the separatists in Donetsk Oblast due to power supply interruptions and damage to power stations. Without power supplies, miners are unable to pump out water and methane from the shafts. This has forced mines to stop production. The remaining mines halted work due to destruction of railroads which had been used to transport their production and also due to the lack of explosives,

which are produced by plants that are under the control of the separatists. Coal production in the entire Donetsk Oblast fell by almost 14% in the first eight months of this year. As a result, exports of goods from Donbas in this period, shrank by almost 20%. This includes an over 50% fall in exports to Russia, which traditionally was the region's largest trade partner.

Production levels fell in all sectors of Donbas in the first six months of this year. The clashes have also resulted in damages to infrastructure and logistical problems.

According to data from the National Fiscal Service, the state budget sustained losses worth around US\$350 million in the first six months of this year due to incomplete tax collection from this region.

In addition to direct destruction of industrial facilities, clashes in Donbas result in regular damage to infrastructure, including roads and railroads, which is essential for the operation of industry, distribution and sales. This damage is also impeding production in other regions of the country since supplies of raw materials to plants located outside Donbas have been either disrupted or withheld. The transport paralysis will also adversely affect the financial results of the national railways, for which freight transport is a major source of income. At present, the Ukrainian railways' losses are estimated to have reached around US\$80 million⁴. Another problem for the industry of Donbas is the rising prices of raw materials and by-products needed for production. There are also problems with logistics, affecting production storage and transport, for example, and the availability of fuel. The agricultural sector has also found itself in trouble in the area covered by the anti-separatist

⁴ Кіреєв А., 'Який збиток війна завдала "Укрзалізниці"', *Економічна Правда*, 15 September 2014, <http://www.epravda.com.ua/columns/2014/09/15/491070/>

peration. Landmines have been planted in some fields, and special permits, from both the armed forces of Ukraine and the separatists, are often required to cultivate other fields. Furthermore, the sector is short of fertilisers and workforce, since some men have been conscripted and others have left Donbas. While the owners of large plants have been unable to move their businesses elsewhere, small and medium-sized business owners have been moving their production and services outside the region. According to data from the Council of Entrepreneurs of Donetsk Oblast, around 80% of such firms have left the oblast.

The total losses sustained by the region and their impact on the state budget are still difficult to estimate precisely⁵. This is due to both the lack of reliable data on the scale of damage and the fact that Donbas for political reasons used to be the most heavily subsidised region under Viktor Yanukovich's rule. In the opinion of deputy prime minister Volodymyr Hroisman,

The overall losses sustained by Donbas are difficult to estimate. It will take the region a long time to return to the state it was in before the war, if it is possible at all.

Ukraine has sustained a total loss of 12 billion hryvnias (almost US\$1 billion) as a result of the conflict in its eastern regions. Prime Minister Arseniy Yatsenyuk's previous estimates of the funds necessary to rebuild Donbas were eight times higher. The conference of donors for the reconstruction of Donbas, planned to be held by the end of October, will certainly be unable to collect such a sum (although a number of states have offered financial aid to the region,

⁵ According to estimates from the United Nations Office for the Coordination of Humanitarian Affairs as of mid September 2014, the losses had reached US\$440 million. However, in this case the losses were seriously underrated, http://reliefweb.int/sites/reliefweb.int/files/resources/Sitrep%2012_Ukraine.pdf

Germany is the only country to have declared the precise sum: 0.5 billion euros), and the Ukrainian budget is too small to cope with such expenses. Maintaining the ceasefire is essential for the reconstruction of infrastructure – roads, bridges and railroads before the winter season begins. This will allow streamlining of logistics: raw material and by-product supplies to local industry and production exports, as well as coal supplies to power plants to enable resumption of power supplies to industrial plants. The government in Kyiv is convinced that part of this work has already begun. However, since the government does not have full control of the region and, more importantly, the region's status is unclear, it is debatable whether such reconstruction makes sense. In effect, the return to *status quo ante bellum* will take a long time, if it is possible at all.

The Ukrainian economy in figures

The current macroeconomic data prove that the crisis in Ukraine is worsening. The country's economy had already been slowing down from mid 2012, after three years of economic growth. However, in the middle of the current year, the basic economic indicators began falling precipitously. While GDP fell by 1.1% in the first three months of this year, Ukraine's economy in the second quarter shrank by as much as 4.6%. Although no data concerning the GDP decline in both oblasts of Donbas is available, it can be assumed that this ratio would have been negative for the entire Ukraine even had there been no conflict in the region. This is because the military conflict and the Russian embargo on imports of many Ukrainian goods are an addition to the economic consequences of former president Viktor Yanukovich's administration (2010–2014), which was characterised by overexploitation and unwillingness to carry out reforms, resulting in zero GDP growth at the end of 2013.

After the first eight months of this year, the greatest losses in industrial production on a nationwide scale were seen in the machine-

-building sector (-20.3%), the chemical sector (-15.7%) and the metallurgical sector (-11.9%), whose production is of key significance for Ukrainian exports. As the country's economy is weakening, its people become impoverished, and domestic demand is falling. Between January and August, the inflation rate rose to 12.9% (and is expected to reach 19% by the end of this year). As a result, the level of real wages dropped by almost 9%.

The existing dire situation in public finances is additionally aggravated by the growing national debt and state-guaranteed debt. As of the end of July 2014, the national debt exceeded US\$69 billion (including foreign debt of US\$30 billion); an increase of US\$4 billion from the end of March. The good news is that Ukraine will not have to incur significant debt service costs in the immediate future: in 2015, it will have to pay around US\$3 billion, mainly as repayment of its previous loan from the IMF. It is estimated that, given the new loans granted by the West and the fact that the deficit generated by Naftogaz of Ukraine has

The national debt and inflation rate are rising ever higher, levels of currency reserves and real wages are falling, and the hryvnia has dropped to a historic low.

increased by almost US\$5 billion this year, the national debt will exceed 60% of GDP at the end of 2014 (at the end of June it stood at 57% of GDP). External funding to a great extent enables the state to cope with the growing military expenditure and to keep a tight rein on the budget deficit. Towards the end of the year, it stood at 6.3% of GDP; the difference from the rate in the same period last year being insignificant⁶. According to some Ukrainian economists, these indicators prove that the risk of bankruptcy is low

⁶ See, for example, Case-Ukraine report, Бюджетний літопис: 2 квартал 2014 року, http://www.case-ukraine.com.ua/sites/default/files/budget_report01092014.pdf

for Ukraine for this year and the next. In contrast, some Western observers do see this risk⁷. Another problem is posed by Ukraine's constantly depleting currency reserves, which shrank by 21.3% from the beginning of this year and stood at US\$15.8 billion on 1 September, and the ever weaker Ukrainian currency. The official exchange rate of the hryvnia dropped to a historic low on 27 August, i.e. UAH13.89 to US\$1. This meant that it had weakened by almost 74% from the beginning of the year. Further devaluation of the hryvnia is likely and will depend on the way the situation in Donbas develops and on stabilising moves to be made by the central bank.

Foreign trade: EU preferences and Russian restrictions

Ukraine generated a surplus in foreign trade in goods and services in the first six months of this year, reaching over US\$3 billion. This was almost twice as much as at the end of the first quarter (+US\$1.7 billion). However, the surplus seen since the beginning of the year goes in tandem with Ukraine's falling trade volume, and results from the hryvnia's depreciation and the fact that imports are falling at a more rapid rate than exports due to lower domestic demand. Between January and July this year, the value of Ukrainian imports fell by 20.5% and exports by 5.3% year on year. The decrease in exports in the first seven months of this year was mainly an effect of falling sales of railway and tram carriages by over US\$800 million (mainly to Russia), fertilisers by over US\$400 million and agricultural products by over US\$300 million. What gave a boost to Ukrainian exports within the same period was increasing sales of grain and oils resulting from a record-high harvest last year. Grain exports, in particular wheat to North African states, more than dou-

⁷ Wigglesworth R., Olearchyk R., 'Ukraine's economy: Broken down', *Financial Times*, 20 August 2014, <http://www.ft.com/intl/cms/s/2/63e0a202-26fb-11e4-a46a-00144feabdc0.html#axzz3AwS63sSm>

bled within this timeframe. These indicators prove that the structure of Ukrainian exports is gradually changing. Metallurgical products were Ukraine's primary export for more than a decade. Foreign sales of these products have been decreasing over recent years. At present, their share of Ukraine's export income stands at 26%, and has fallen by 11% compared to the first six months of 2013. Meanwhile, production and export of food and agricultural products are growing rapidly (by almost 23% between January and July year on year). Their share in Ukraine's total exports was equal to that of metallurgical products. This change mainly results from the fact that Russia used to be an important client of the Ukrainian metallurgical sector, while food and agricultural products can be successfully sold to the Middle Eastern, African and EU markets.

The geographic structure of Ukrainian foreign trade is also changing. Exports of goods to EU countries accounted for 32.6% of total Ukrainian exports in the first seven months of this year. The zero customs rate on most goods exported to the EU as part of the Autonomous Trade Preferences regime (introduced in April 2014 and extended to the end of 2015) has contributed to increasing exports of those goods which had previously been sold to the Russian market (products of the metallurgical, chemical, machine-building and food and agriculture sectors). Although imports from the EU decreased by 18% in the first six months, the value of exports to the EU increased by almost 15%; the greatest individual recipient of Ukrainian exports among EU countries being Poland, with a share of 5.3% (an increase of 24% in comparison with the first half of 2013).

Russia still represents the greatest share of Ukrainian imports, accounting for almost 28% of all goods brought into Ukraine in the first seven months of this year, and the greatest foreign buyer of Ukrainian goods (a share of 20%). However, trade value has rapidly decreased in both of these areas: exports have

fallen by 23.7%, and imports by 20.7%. At the same time, in July alone (as compared to July 2013), imports from Russia shrank by 53.7% as a consequence of the cuts in Russian gas supplies. As a result, Ukraine had an unprecedented surplus in bilateral trade of US\$140 million (between January and July, the balance was negative, standing at minus US\$2.3 billion).

Ukraine sells more and more to the EU and less and less to Russia, but its total foreign trade volume is constantly shrinking.

The trade volume is shrinking due to tense relations between Kyiv and Moscow, one effect of which is the trade restrictions which Russia regularly imposes on Ukraine. The value of imports from Russia fell mainly due to lower gas prices between January and March and due to Gazprom's cutting of gas supplies to Ukraine in mid June. Another reason is that the boycotting of Russian goods has become a popular form of protest in most regions of Ukraine. In turn, problems with exports are caused primarily by cancellations of orders by Russian customers, falling industrial production in Ukraine as a consequence of the anti-separatist operation and the embargo imposed by Russia on imports of Ukrainian goods (including processed vegetables, fruit and fish, some kinds of cheese and dairy products, and some products of plant origin). According to the Ukrainian government's estimates, trade volume with Russia will fall by 35%, while total Ukrainian exports will decrease by 11.6%, and imports by 21.1% by the end of the year. This will mean further reorientation of Ukrainian foreign trade from Russia to the EU (and North Africa in the case of agricultural products). However, Russia is the main supplier of oil and gas to Ukraine and, without diversifying the sources of these materials, eliminating Ukraine's heavy dependence on these would be extremely onerous in economic terms.

Actions taken by the government and Western aid

The situation in Donbas has forced the government to manage the state budget on a day-to-day basis and to search for new funds. Sources of additional budgetary income will include above all new taxes, cuts in investment and welfare programmes and the receipt of foreign loans and financial aid. However, the government has failed to initiate system-wide reforms. Prime Minister Arseniy Yatsenyuk announced on 10 September that it was necessary to postpone the most important economic reforms due to the conflict in Donbas, significant outflow of investment and an absence of new investment. Furthermore, the government has in fact put the privatisation process on hold. According to data from the State Property Fund of Ukraine, income from privatisation in the first half of 2014 only amounted to US\$4 million, while the planned amount was almost US\$1.5 billion.

The challenge the government constantly needs to face is finding money for the continuation of the anti-separatist operation, which costs over US\$5 million daily. Furthermore, budget revenues from income tax and VAT have been falling due to the situation in the east of the country (in 2012, Donbas accounted for around 12% of tax revenues). Currency depreciation, withholding the payment of VAT rebates to exporters and an additional monetary issue of hryvnia have been able to compensate for this only partly. As a result, budget expenditure in the second quarter was 4.4% higher than a year before⁸. To find sufficient funds for the army and to maintain fiscal discipline as required by Western creditors, the government imposed new taxes on individuals and business entities (including, for example, a military tax at 1.5% of income, a tax on deposits, higher excise duty rates and a tax on the production of mineral resources) and made further cuts in welfare spending and sectoral subsidies. In effect, army funding has

nearly doubled (according to some economists, to a record-high level of 2% of GDP) and budget incomes have become more realistic.

The amendments have also made it possible for funds obtained as part of foreign aid to be taken into account in the state budget. It would probably have been impossible to maintain the feeble liquidity in public finances without this aid. The most important portion of it is the IMF loan worth almost US\$17 billion granted to Ukraine on 30 April for two years. As part of this loan, two instalments worth in total US\$4.5 billion have already been made available to Ukraine. Furthermore, it has been promised that the third and the fourth instalments will be combined and made available by the end of this year. This loan is a key source of Ukraine's

Foreign financial aid and tax raises, rather than system reforms, are the key means to balance the current budget.

financial stability. Furthermore, its structure is flexible, and therefore it can be used to finance the current budget deficit⁹. In September, Kyiv also received US\$500 million from the World Bank and a promise to be granted another instalment of equal value in the first quarter of next year. In addition to these funds, which are allocated partly to improve budget liquidity, Ukraine has received a number of smaller loans (for example, US\$100 million from Japan) and special purpose grants for the implementation of reforms or reconstruction of specific infrastructure or industry facilities.

Possible scenarios

The condition of the Ukrainian economy will depend on the way relations with Russia, including the conflict in Donbas, will develop.

⁸ Case Ukraine report, *op.cit*

⁹ Arkadiusz Sarna, 'Ukraine to receive an IMF rescue loan', 8 May 2014, <http://www.osw.waw.pl/en/publikacje/analyses/2014-05-08/ukraine-to-receive-imf-rescue-loan>

If Moscow maintains restrictions on exports from Ukraine or imposes new ones, the economic crisis will exacerbate. It is still unclear whether Russian gas supplies to Ukraine will be resumed. If negotiations are unsuccessful, Kyiv will have to enforce a radical gas saving programme (to reduce gas consumption by 30% in the 2014–2015 winter heating season), which will adversely affect Ukrainian companies' production figures. If, on the other hand, the parties reach a temporary compromise, the budget will be seriously strained due to the need to repay the debt (or part of it) to Russia and to buy gas. The continuation of the military operation in Donbas will mean further degradation of local industry, will adversely affect the country's attractiveness as an investment destination and negatively impact the level of domestic consumption and Ukraine's creditworthiness. If the ceasefire in Donbas is maintained, a gradual reconstruction of infrastructure and bringing industrial plants back into operation will become possible. However, the region's future status as part of Ukraine is still unclear, and it is difficult to determine what kind of budget

relations with Kyiv it will have, just as it is difficult to verify the financial consequences of the special act on Donbas passed by the Verkhovna Rada (Ukrainian parliament) on 16 September¹⁰. What is clear is that the region will need heavy subsidies and a lot of funds for reconstruction, and will need much time to return to the level of production it sustained before the war. The state will continue to allocate a great part of its expenses on defence. The good news is that grain crop yields are expected to be high, at around 60 million tonnes, this year. In effect, in the best-case scenario, the rate of GDP decline will subside in the final quarter of this year (as the situation becomes calmer in the east of the country and exports of agricultural products generate more income) and this rate of decline will be in single figures by the end of the year. However, in the most likely case, the decline will be more serious and the recession will continue in 2015.

¹⁰ Tadeusz Iwański, 'Ukraine's parliament passes a special act for Donbas', *OSW Analyses*, 17 September 2014, <http://www.osw.waw.pl/en/publikacje/analyses/2014-09-17/ukraines-parliament-passes-a-special-act-donbas>

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