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Iikka Korhonen: Ukrainian economy stabilised, but growth still weak

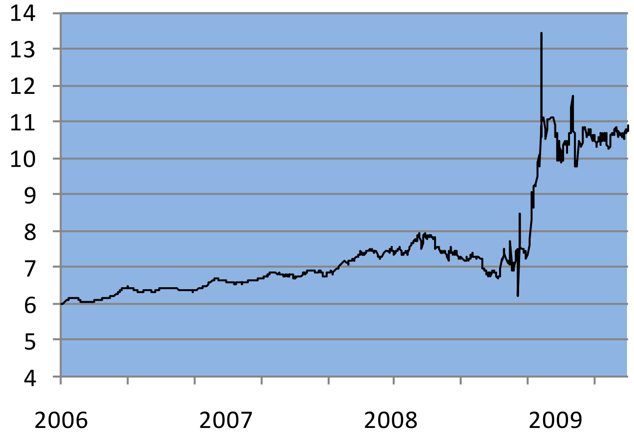
In November 2008, Ukraine and the IMF agreed on a USD 16.4 billion loan package designed to stabilise the Ukrainian economy. In May this year, the Executive Board of the IMF approved payment of the second instalment of this package. The conditions of the loan package were also significantly relaxed owing to Ukraine's economic performance falling considerably short of the projections made at the end of last year. With GDP falling at the beginning of the year by one fifth from the previous year, Ukraine is one of the most severely hit economies in the current financial crisis. At the moment, the Ukrainian economy seems to be stabilising, but output growth is, at best, still very weak. Despite an element of stability provided by the presence of foreign banks in the country, the Ukrainian banking sector may experience a further weakening towards the end of the year. Moreover, the confusion in Ukraine's internal politics may be reflected in further problems in economic policy.

Industrial output slumped at the beginning of the year

Preliminary statistics show that the Ukrainian economy contracted sharply in the first few months of the year, but seasonally adjusted indicators of output seem now to have stabilised. In the first quarter, quarter-on-quarter GDP shrank by 20 % from the previous year. This constitutes a major fall in GDP, even within the context of the present global financial crisis. The shrinkage has been particularly severe in industrial output and construction. In the first quarter of 2009, the volumes of industrial output and construction were 37% and 54% short of the previous year's level, respectively. As with many other countries in recent years, Ukraine has invested substantially in the construction of commercial and residential buildings. The unexpected exhaustion of liquidity has been reflected in problems in the construction sector. In the first quarter of this year, Ukraine's unemployment rate rose abovel 10%.

In recent months, however, industrial output seems to have stabilised. The volume index of industrial output has increased markedly since February, but it is unclear how the crisis has affected seasonal variation. In May, industrial output grew 1.3% from the previous month but was still nearly a third lower than in May 2008. Exchange rate developments also imply a slight stabilisation of the economy, given the relatively small volatility since March (Chart 1).

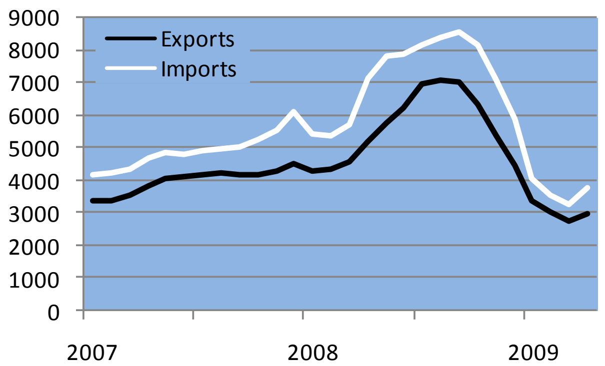
Chart 1. Grivna/euro exchange rate in 2006–2009



Source: Reuters.

The contraction in industrial output is also connected to the collapse in the volume of Ukraine's foreign trade. Currently, both imports and exports stand at less than half their mid-2008 values. Owing to poor global demand, the depreciation of the grivna has not yet resulted in any major pick-up in exports. However, the recent increase in raw material prices may result in a rise in the value of Ukrainian exports.

Chart 2. Ukrainian exports and imports, USD million, 3-month moving average



Source: CEIC.

IMF continues to lend money to Ukraine

Owing to the markedly poorer performance of the Ukrainian economy than projected in November, the conditions stipulated in the loan package at the time – and those on public finances in particular – have not been met. Ukraine succeeded in keeping public expenditure at the agreed level, but a strong contraction in output resulted in a sharper fall in tax receipts than expected. This sequence of events was considered beyond Ukraine's direct influence, and therefore the Executive Board of the IMF agreed, on 8 May, to revise the loan conditions. Following this decision, Ukraine received the second instalment of the loan package totalling USD 2.8 billion (the second instalment was initially set at USD 1.9 billion). According to the new loan conditions, Ukraine's public sector deficit may this year equal 4% of GDP, as opposed to the balanced budgetary position which had been the target in the IMF's original loan package. It should be noted, however, that this year Ukraine is allowed to spend a sum equivalent to 5% of GDP on capital investment in the banking system.

Problems in the banking sector continue

The majority of Ukrainian banks have problems. The waning economy heightens the risk of credit losses. Furthermore, approximately half of all loans taken out prior to the devaluation of the grivna were denominated in foreign currency. Servicing foreign currency-denominated loans has now become much more expensive for Ukrainian companies and households. According to the central bank, Ukrainian banks' nonperforming loans rose as high as 4.9% in June. Ukrainian banks have pursued a variety of approaches to address these problems. Banks in foreign ownership have received – or will receive in the near future – some USD 2 million of additional capital from their parent banks. Owners of many private Ukrainian banks have also invested more capital in their banks. This notwithstanding, the government has had to take control of seven banks that are considered so important for the Ukrainian banking system that they cannot be allowed to go bankrupt. Restructuring and recapitalisation of these banks have been delayed due to the lack of necessary legislation, but the current sentiment is that progress is starting to be made. However, if nonperforming loans keep on accumulating, it is unclear how long the banks' own capital will suffice.

In the coming months, the Ukrainian government will in any case have to take decisions on cutting expenditure from currently planned levels. Moreover, raising the funds needed for recapitalisation of the banks is a challenging prospect in the present circumstances. This may be further exacerbated by the political situation in the country, as the president and prime minister seem to be finding it impossible to establish a working relationship.

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