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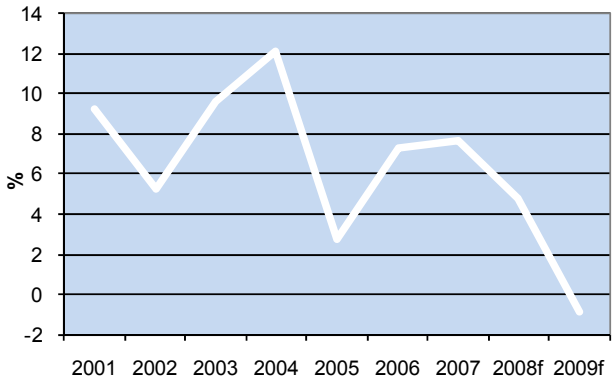
Iikka Korhonen: Ukraine seeks to stabilise its economy with support from the IMF

On 5 November, Ukraine and the IMF agreed on a USD 16.4 billion loan package (approximately 11% of GDP for 2007), extended for two years and designed to stabilise the Ukranian economy. Ukraine immediately drew down USD 4.5 billion. As part of the package, Ukraine has allowed its currency to depreciate substantially. A large part of the funds borrowed by Ukraine are likely to be used for recapitalisation of the banking system.

Speedy economic growth in the current decade

In this decade, the Ukranian economy – as well as other developing economies – has posted rapid growth. From 2001 to 2007, annual GDP growth averaged more than 7% (Chart 1). Ukraine benefited particularly from growth in demand for steel and steel products, as these products accounted for some 40% of the country's total exports. At the same time, salaries and particularly bank lending to the private sector grew rapidly. Despite political uncertainties, growth in public spending has been fairly subdued, even though the public sector has run deficits almost continually since the turn of the century. Thanks to rapid economic growth, the debt-to-GDP ratio has decreased to just 13% at the end of 2007. The rapid economic growth has also been accompanied by surging inflation; in May this year, annual inflation was still 31.1%. By October, the inflation rate had slowed to 23.2%, and it is expected to subside considerably in the coming months, despite the currency depreciation.

Chart 1 GDP growth in Ukraine



Source: 2008 and 2009 forecasts by Consensus Economics

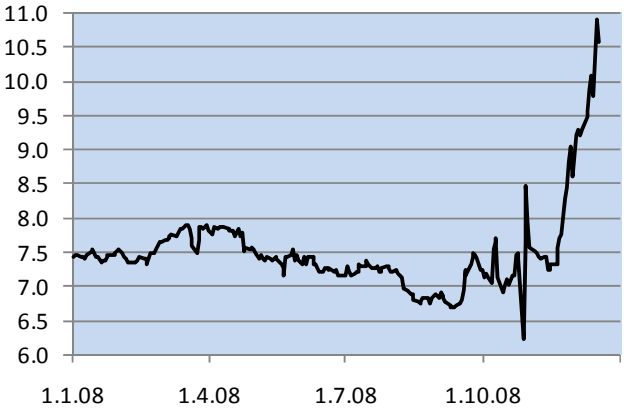
Like other emerging economies, Ukraine has also posted extremely rapid lending growth in recent years; in 2005–2007 lending grew by on average by 70% a year. This was financed with capital imported by banks, and many Ukranian companies took out loans directly from abroad. While in 2005, Ukraine's foreign reserves amounted to some 130% of the country's short-term foreign debt, by mid-2008 the ratio had dropped to about 80%.

In the second half of this year, Ukraine has clearly been adversely affected by the rapid decline in raw material prices and the international financial crisis. The price of steel (in US dollars) has dropped by more than 60% from its July peak. Falling fertililser prices have also weakened Ukraine's exports. Furthermore, Ukraine has not benefited from the slide in energy prices in the same way as many other countries, owing to the fact that Russia has been concurrently removing the remaining subsidies from natural gas sold to Ukraine. This has led to a parallel rise in Ukranian import prices, even as its export prices have plunged. The situation has been aggravated by controversies among the political elite, which have long virtually prevented all improvements. Even in normal times, the political system in Ukraine has been very unstable.

Crisis in Ukrainian foreign exchange and banking markets

Following the eruption of the financial market crisis in 2007, Ukranian liquidity conditions also tightened. The rapid deterioration of the current account and the discontinuation of capital inflows to developing countries led to a currency drain in the autumn. In October, the government had to take over the country's sixth largest commercial bank, which prompted depositors to withdraw their savings from other banks. This in turn speeded up speculation in the foreign exchange market, with the result that the Ukranian central bank had to use increasingly more funds to defend the external value of the grivna. On 5 November, the board of the IMF approved Ukraine's loan package with specific terms such as the requirement to let the currency float (Chart 2). Nevertheless, the central bank can intervene in the market to smooth out daily exchange rate fluctuations. One of the conditions of the IMF loan package is to keep the foreign reserves at a certain level, which limits the central bank's scope for maneuver in the currency market.

Chart 2 Grivna/euro exchange rate in 2008



Source: Reuters

The central bank's foreign reserves rose to USD 38 billion at the end of August, but declined to USD 31.9 billion by the end of October. At the end of November, the foreign reserves totalled USD 32.7 billion, but without the IMF loan, they would have sunk to USD 28.2 billion. This corresponds to roughly three months worth of imports and is clearly less than Ukraine's short-term foreign debt.

The measures taken to address the banking sector crisis include raising the upper limit of individual deposits covered by deposit insurance. The central bank is currently seeking to find a buyer for the seized Prominvestbank, but the current market situation is making it very difficult. The banking sector seems to have calmed otherwise, but the liquidity situation is still very tight. The Ukranian banking sector has attracted a number of western banks in recent years, which somewhat improves the credibility of the country's banking system.

Slowing of economic growth brings problems for the banking sector

Ukranian economic growth seems to have come to a halt in recent months. The plunge of the steel price has brought industrial production to a near standstill, and tighter liquidity conditions have done the same to construction. Private investment and consumption will decline in 2009. The global recession will reduce the volume of Ukranian exports, but as domestic demand weakens the volume of imports is likely to fall even further, particularly with the weakening of the domestic currency. Thus the growth contribution of external sector is likely to be positive.

According to the IMF support package, Ukraine is to aim for a balanced budget in 2009. This may be achieved even if social expenditures increase. Ukraine has notably subsidised the price of energy for households and corporate sector, but the subsidies will be removed by mid-2010. At the start of December this year, the price of electricity was raised by as much as 35%. This alone will reduce public sector spending by some 0.5% of GDP in 2009.

According to data collected by Consensus Economics, growth forecasts for 2009 average -0.9%, but the IMF loan package is based on the assumption that GDP will fall by 3% in 2009. In 2010, GDP is projected to increase by as much as 3.3%. If Ukrainian export markets in the EU and Russia fall into a protracted recession, it is not likely that Ukraine's growth rate will reach such a robust level as early as 2010.

The depreciation of the Ukrainian currency in the last couple of months has weakened households' and non-financial corporations' balance sheets, because the majority of loans are denominated in foreign currencies (at end-September, 51% of bank loans were in foreign currencies compared to 32% of deposits). At the same time, banks' loan losses are clearly on the rise. It thus seems clear that the banking sector is in need of a capital injection. The IMF loan package is partly for this purpose, although foreign banks are expected to obtain fresh capital also from other sources.

On Wednesday 10 December, the key parties of Ukraine's political controversy announced that they had reached an agreement that cancels the planned December election. It appears that the threatening financial crisis has persuaded President Yushenko and Prime Minister Tymoshenko that the country needs a functioning government.

The coming months will be very difficult for Ukraine, even if the common political ground holds firm. Many Ukrainian banks are likely to have to turn to the central bank for new capital, and the dwindling of manufacturing output continues. Furthermore, rising unemployment may lead to political disturbances. The loan package provided by the IMF is very large relative to the size of the Ukrainian economy, so it may make a crucial contribution to economic adjustment. This requires, however, that the Ukrainian political system is able to make the necessary decisions in a more determined manner than before.

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