A ship run aground
Deepening problems in the Ukrainian economy

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The drop in Ukraine’s GDP by nearly 18% in the first three months of 2015 (versus the corresponding period in 2014) has confirmed the decline of the country’s economy. Over the last 14 months, the Ukrainian currency was subject to an almost threefold devaluation against the US dollar, and in April 2015 the inflation rate was 61% (year-on-year), which exacerbated the impoverishment of the general public and weakened domestic demand. The main reason behind the crisis has been the destruction of heavy industry and infrastructure in the war-torn Donbas region, over which Kyiv no longer has control, as well as a sharp decline in foreign trade (by 24% in 2014 and by 34% in the first quarter of 2015), recorded primarily in trading volume with Ukraine’s major trade partner, i.e. Russia (a drop of 43%). The conflict has also had a negative impact on the production figures for the two key sectors of the Ukrainian economy: agriculture and metallurgy, which account for approximately 50% of Ukrainian exports. The government’s response to the crisis has primarily been a reduction in the costs of financing the Donbas and an increase in the financial burden placed on the citizens and companies of Ukraine. No radical reforms which would encompass the entire system, including anti-corruption reforms, have been carried out to stop the embezzlement of state funds and to facilitate business activity. The reasons for not initiating reforms have included the lack of will to launch them, Ukraine’s traditionally slow pace of bureaucratic action and growing dissonance among the parties making up the parliamentary coalition. The few positive changes, including marketisation of energy prices and sustaining budgetary discipline (in the first quarter of 2015, budgetary revenues grew by 25%, though partly as a result of currency devaluation), are being carried out under pressure from the International Monetary Fund, which is making the payment of further loan instalments to the tune of US$ 17.5 billion conditional upon reforms. Despite assistance granted by Western institutional donors and by individual states, the risk of Ukraine going bankrupt remains real. The issue of restructuring foreign debt worth US$ 15 billion has not been resolved, as foreign creditors who hold Ukrainian bonds have not consented to any partial cancellation of the debt. Whether Ukraine’s public finances can be stabilised will depend mainly on the situation in the east of the country and on the possible renewal of military action. It seems that the only way to rescue Ukraine’s public finances from deteriorating further is to continue to ‘freeze’ the conflict, to gradually implement wide-ranging reforms and to reach a consensus in negotiations with lenders.

Negative figures

Current macroeconomic indicators tracking the condition of the Ukrainian economy suggest that the rapid decline observed in the fourth quarter of 2014 has continued in the first months of 2015. In 2014, the drop in GDP was 6.8% (in the fourth quarter of 2014 it was 14.8%), and in the first quarter of 2015 it was 17.2%. At the end of March 2015, total
public debt amounted to approximately 95% of GDP (over 1.5 trillion hryvnias, i.e. almost US$ 65 billion), and the inflation rate was 25%; in April 2015 it rose to 61% (versus April 2014). Due to the war in the Donbas – Ukraine’s most industrialised region – and the loss of Crimea, in 2014 Ukraine’s industrial production fell by nearly 11%. In the first quarter of 2015, a decline of 21.4% was recorded (as compared to the first three months of 2014), which was mainly due to shrinking industrial production in the Donetsk and Luhansk oblasts, which in that period fell by 52.5% and 88% respectively. Additionally, for Ukraine another major problem has been the serious devaluation of the hryvnia – in the period between February 2014 and the end of February 2015, the Ukrainian currency fell against the US dollar from the level of 8 hryvnias for 1 US$ to 30 hryvnias for 1 US$. In the months that followed, the hryvnia slightly recovered its value and the exchange rate has stabilised at the level of approximately 21 hryvnias for 1 US$. Currency depreciation has been one of the factors behind a serious crisis in the Ukrainian banking sector. Stress tests comprising Ukraine’s 35 largest banks, which ended in November 2014, revealed a deep crisis in the banking sector. The observation was confirmed when the National Bank of Ukraine (NBU) considered 33 banks insolvent in 2014 and a further 25 in the first quarter of 2015 (including Delta Bank, one of the five largest banks in Ukraine). An increase in the value of the hryvnia observed since mid-March (finally reaching the level of 21–22 hryvnias for 1 US$ in the second half of May) was possible due to radical administrative measures taken by the NBU and to financial assistance granted by the International Monetary Fund.

According to forecasts by the National Bank of Ukraine, in 2015 GDP is expected to fall by 7.5%, whereas a reverse trend is expected to start in the fourth quarter of 2015 to reach the level of 3% at the end of 2016. The IMF, on the other hand, expects a 9% recession in 2015. No further decline would be expected only in the event that reforms are carried out and the truce in the east of the country is sustained. Any further escalation of the conflict would be likely to result in further deterioration of the Ukrainian economy.

New loans and uncertain restructuring of old loans

Ukraine has so far been saved from bankruptcy by Western financial institutions. According to estimates by Case-Ukraine, in the period between May 2014 and May 2015, the IMF, the EU, the World Bank, the USA and the governments of Canada and Japan granted assistance to Ukraine amounting in total to US$ 14.2 billion. However, it is the cooperation with the IMF that is of crucial importance for the fragile stability of the Ukrainian economy. On 11 March 2015, the IMF’s Board of Directors decided to grant a loan to Ukraine worth US$ 17.5 billion as part of a four-year programme known as the Extended Fund Facility. In February 2015, this programme replaced a two-year stand-by programme, in

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1 Бюджетний літопис: 1 квартал 2015 року, Case-Ukraine, June 17, 2015.
2 T. Iwański, Władze ratują hrywnę, Analizy OSW, 4 May 2015.
3 R. Sadowski, Nowy program pomocy MFW dla Ukrainy, Analizy OSW, 12 February 2015.
4 A member of the Board of the National Bank of Ukraine, Roman Shpek, has even mentioned a 9% drop, ВВП Украины к концу 2015 года упадет на 9% - НБУ, zn.ua, 25 May 2015.
6 Ціна держави: популярна економіка. Україна отримала ще €250 млн від ЄС, 23 April 2015.
force since April 2014, worth US$ 17 billion, under which Ukraine received US$ 4.6 billion. In exchange for the new, four-year financial aid formula granted by the IMF, Ukraine committed itself to carry out measures aimed at stabilising the economic situation and implementing structural reforms. In 2015, Kyiv will be likely to receive as much as 60% of the allocated sum; the first instalment amounting to US$ 5 billion was paid out on 13 March. Another instalment, worth approximately US$ 2.5 billion, is likely to be paid in June or July 2015. This, however, depends on whether negotiations on restructuring Ukraine’s foreign debt (approximately US$ 15.5 billion) bring a positive result. The negotiations were launched in April 2015 with one of the aims being to extend the debt payment deadline and to change the payment conditions.

The agreement with the IMF is of crucial importance to Ukraine, but the payment of subsequent instalments is conditional upon the implementation of reforms and restructuring of old loans.

The government is hoping to reach a preliminary agreement by the end of June 2015. The fact that the state-owned Ukreximbank has managed to extend the maturity deadline for bonds worth US$ 750 million by another three months (the initial maturity date was 27 April) can be seen as a positive sign. Western lenders, including international investment funds such as Franklin Templeton, have recently consented to extending the maturity date and to reducing the yield on such bonds. At the same time, a proposal by Ukraine’s Ministry of Finance to cancel 40% of the country’s liabilities has been rejected so far. This sparked sharp reactions in Kyiv; in order to exert pressure on lenders, on 19 May the Supreme Council passed a law which entitles the central government and local government bodies to suspend repayments and the servicing of foreign debt estimated to reach US$ 30 billion in the next four years. The liabilities indicated in the document included two-year bonds issued by Viktor Yanukovych’s administration and purchased by Russia in December 2013. The value of these bonds is US$ 3 billion. Russia’s government has repeatedly announced that they would not consent to any restructuring of these bonds. This is intended as an attempt at breaking solidarity among Ukraine’s external creditors who do not agree to any partial cancellation of debt, if this cancellation is not going to include Ukraine’s debt to Russia.

The key importance of the Donbas region

As a result of the de-escalation of the military situation in the Donbas region in mid-February 2015, the separatists now control approximately 2.5% of Ukraine’s territory (excluding Crimea), including the country’s most industrialised and urbanised regions. It is estimated that the territory under separatist control used to account for 9% of Ukraine’s GDP, 12% of its industrial potential and 14% of its exports. This has been the main cause of the disastrous condition of the Ukrainian economy and of the extremely negative macroeconomic indicators. In the current situation, the government in Kyiv has decided to continue to ‘freeze’ the conflict in the Donbas region and to gradually reduce the scale of funding the region receives from the central budget. After withholding the payment of social benefits in autumn 2014 to residents who failed to re-register on Kyiv-controlled territories, the government decided to suspend the supply of gas to the region starting from 1 April until the end of the year. In addition, on 10 April the payments for the supply of energy from Russia estimated to reach US$ 30 billion in the next four years. The liabilities indicated in the document included two-year bonds issued by Viktor Yanukovych’s administration and purchased by Russia in December 2013. The value of these bonds is US$ 3 billion. Russia’s government has repeatedly announced that they would not consent to any restructuring of these bonds. This is intended as an attempt at breaking solidarity among Ukraine’s external creditors who do not agree to any partial cancellation of debt, if this cancellation is not going to include Ukraine’s debt to Russia.

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in the Donbas region were suspended\textsuperscript{10}, and on 1 May these territories were excluded from the Ukrainian energy market and a ban was introduced on making energy purchase and sale contracts between the territories controlled by the central government and those remaining outside its control\textsuperscript{11}.

At the same time, due to the lack of control over a part of the Donbas region and the severing of institutional and financial ties with the region, in the 2015–2016 heating season Ukraine is likely to have a serious deficit of coal of high calorific value which is used by half of Ukrainian heat and power plants to generate energy. Until recently, a lack of consensus within Ukraine’s leadership is evident as regards the issue of coal supplies from the separatist-controlled territories. State officials associated with President Poroshenko, including the head of the President’s administration office Boris Lozhkin and the ex-governor of the Donetsk oblast Oleksands Kikhtenko, have been supporting the plan to enter into relevant contracts on this matter, whereas the plan’s opponents include the Minister of the Interior Arsen Avakov, who is associated with Prime Minister Arseniy Yatsenyuk\textsuperscript{12}.

The final decision, however, will depend on the development of the military situation in the Donbas region. It is likely, however, that should the status quo be maintained and the railway infrastructure be rebuilt by mid-August (which is when the stock of coal at heat and power plants needs to be replenished – the estimated demand is approximately 2.5–3 million tonnes), Kyiv would take steps to legalize its cooperation with separatists in this field.

A decline in foreign trade

The halt in industrial production in the territories affected by military action and the devaluation of the hryvnia were the main reasons behind the negative trends in Ukraine’s foreign trade. The Ukrainian economy used to be (and to a certain extent continues to be) dependent on foreign markets. Approximately 50% of the country’s GDP is generated by export industries. Although last year Ukraine recorded a positive balance of foreign trade turnover of US$ 3.8 billion\textsuperscript{13}, this was due to the dramatic decline in the imports – by 28%; (mainly from Russia: by a staggering 45%), while exports fell by 13.5% (exports to Russia – by 34%). Although Russia remains Kyiv’s main trade partner (in 2014 it accounted for 18% of Ukraine’s exports and 23% of its imports), over the last year its significance in these two fields has continued to diminish, by 5.5% and 7.2% respectively. In 2014, the overall trade exchange with Russia shrank by as much as 43%. This was mainly due to an aggressive policy by Moscow, including its economic policy, which was reflected in imposing a number of trade restrictions on Ukraine and temporarily withholding the supply of gas to the country\textsuperscript{14}. Other significant factors have included Ukraine’s reduction in the amount of gas it purchases from Gazprom and the dramatic shrinking of industrial

\textsuperscript{10} В. Пиріг, Україна припинила платити за електрику, яку Росія постачає в зону АТО, Zaxid.net, 20 April 2015.
\textsuperscript{11} Про особливості регулювання відносин у сфері електроенергетики на території, де органи державної влади тимчасово не здійснюють або здійснюють не в повному обсязі свої повноваження, Regulation by the Cabinet of Ministers of Ukraine no. 263, 7 May 2015.
\textsuperscript{12} АП виступила за економічну співпрацю з окупованим Донбасом, lb.ua, 30 April 2015.
\textsuperscript{13} For more on the reasons behind the drop in trade exchange with Russia see: T. Iwański, ‘Ukrainian economy overshadowed by war’, OSW Commentary, 8 October 2014; the hindering factors discussed in the text continue to be valid.
\textsuperscript{14} In this section data after: the National Statistical Service of Ukraine; www.ukrstat.gov.ua
production in the regions affected by the military conflict (it shrank by 31.5% in the Donetsk oblast and by 42% in the Luhansk oblast). This was particularly evident in the machine building and metallurgy sectors, which have traditionally been oriented to the Russian market. As a result of tensions in political relations, negative trends continued in the first quarter of 2015, which was when the trade exchange with Russia fell by a 63%, as compared to the same period in 2014. Positive indicators concerning Ukrainian foreign trade have been recorded in the country’s relations with the EU, although the growth rate has been lower than expected. In 2014, exports of Ukrainian goods to EU markets increased by only 2.6% (they make up 31.5% in Ukraine’s export structure), including an increase in exports to Poland of 4%. This was despite the unilateral introduction by Brussels in April 2014 of the so-called Autonomous Trade Preferences, according to which many Ukrainian goods are covered by zero customs duty. The decline in exports to the EU recorded in the second half of 2014 was additionally caused by insufficient re-orientation of Ukrainian production to EU markets, as not all Ukrainian producers have managed to adapt to the requirements of EU standards, or build up a network of contractors. The figures for the first quarter of 2015 as regards total foreign trade in goods have confirmed the negative tendencies present in the economy. Compared to the same period in 2014, exports fell by 33%, and imports by 36.5%. At the same time, statistics compiled for this period have indicated certain positive trends. A positive balance of trade was maintained, reaching over US$ 384 million, and the downward trends in exports and imports were halted. In January 2015, trade turnover continued to decline rapidly, as compared to December 2014. In February 2015, however, stabilisation of the trend was recorded, followed by a slight move upwards in March 2015 (by less than 1% versus the previous month). This suggests that should the fragile truce in the east of the country be maintained, the downward trend would be likely to be exhausted and a return to a positive growth rate would be possible.

Metallurgy and agriculture – problems of the Ukrainian economy’s driving forces

The breaking of economic ties between Ukraine and the separatist-occupied part of the Donbas region has had a negative impact not only on the forecasts regarding the coal mining industry, but also on the metallurgy sector which is related to it and continues to be crucial for the Ukrainian economy. Back in 2014, this branch of industry generated nearly a quarter of export revenues, despite a decline in the production of steel (by as much as 17%, down to 27 million tonnes), while the production of cast iron fell by 15% (to 25 million tonnes) and of rolled metal products by 18% (25 million tonnes). In the first quarter of 2015, the rate of decline in production was 26% - in that period only 4 million tonnes of steel were exported, a drop of 29%, compared to the previous year. Industrial output of metallurgical conglomerates has deteriorated over the last few years, mainly due to a worsening situation in foreign markets and to the technological backwardness of Ukrainian enterprises. The events in the east of the country contributed to a rapid degradation of this branch of industry. As a result of the war in the Donbas region, large metallurgical conglomerates, including those in Donetsk (Donetskstal), Yenakiieve and Alchevsk, were forced to temp-

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15 Data compiled by Metalurhprom, http://metallurgprom.org/?cat=18
porarily halt their operation (the first two resumed their activities in April and in February respectively, and the third one announced they would do so in May). Other plants operating in Kyiv-controlled territories, such as the Ilyich Iron and Steel Works and Azovstal in Mariupol, limited their production due to raw material shortages and destruction of railway infrastructure. In mid-May, reconstruction of production potential was further hindered after shelling by the separatists of a coke plant in Avdiivka, one of Europe’s largest plants of this type. Apart from this year’s decline in industrial production, other trends present in foreign markets are likely to have a negative impact on the performance of the Ukrainian metallurgical sector. In March 2015, the global price of iron ore dropped to the level of US$ 49.5 per tonne, the lowest in a decade\(^{16}\), and over 70% of production by Ukrainian metallurgical conglomerates is exported mainly to China and to Russia. According to estimates, the price of ore at the level of US$ 60 per one tonne hardly covers the cost of its production in Ukraine\(^{17}\). Top Ukrainian producers have been severely affected by the war in the Donbas region and by the drop in global prices. On 9 April 2015, Ukraine’s largest metallurgical conglomerate Metinvest, owned by Rinat Akhmetov and Vadym Novinsky, declared partial bankruptcy and announced a launch of negotiations with its creditors regarding repayment of some of its bonds.

Poor conditions in the metallurgical sector have emphasised another trend observed in the Ukrainian economy, i.e. the increasing importance of the agriculture and food processing sector as well as the growing share of agricultural production, mainly grains, in the country’s export structure. In the first two months of 2015, this share was 39%, an increase of 9% compared to the same period in the previous year\(^{18}\). The agricultural sector has large potential, which is confirmed by the fact that in 2014, despite a reduction of 4.6% in the size of crops compared to 2013 and the loss of Crimea, the volume of the grain harvest and of pulses increased by 2.4%. The wheat and barley harvest recorded a notable increase (9.9% and 23%, respectively), while the corn harvest fell by 7.8%, which, however, had no impact on export revenues due to negative corn price fluctuations on global markets. This made it possible in 2014 to achieve a record harvest of 63.7 million tonnes of grains and pulses. The 2013–2014 trade year was also very favourable for Ukraine as it exported 32.1 million tonnes of grains to become the world’s second largest (excluding the EU as a whole) exporter of grains after the USA\(^{19}\).

**According to worst case scenarios, which account for unfavourable weather conditions, at the end of 2015 the volume of the grain harvest may fall by 15-20%.**

This good result was achieved not only due to favourable weather conditions, but also as a result of the deteriorating, although stable and predictable until the beginning of autumn, economic situation in Ukraine and in the Ukrainian banking sector. At the end of 2014 and the beginning of 2015, the situation worsened dramatically and the Ukrainian economy found itself on the brink of bankruptcy. In order to rescue the economic situation and to sustain the hryvnia’s exchange rate, the government of Ukraine decided to introduce a number of regulations which in practice hamstrung the operation of agricultural companies. The measures introduced by the government included a 10% import duty on cer-


\(^{19}\) Д.Денков, Сезон зернотрейдера, *Економічна Правда*, 4 August 2014.
tain products used in the sowing period. Additionally, the central bank raised the base rate up to 30%, which boosted the lending cost. In the amended Tax Code, fiscal pressure on producers operating in the agricultural and food processing sector was increased, which resulted in a rise in the average levy paid to the state for 1 hectare from 6 hryvnias in 2014 to 115 hryvnias in 2015\(^\text{20}\). These factors contributed to a sharp increase in the outlays for spring field works, resulting from a rise in the price of petrol, and of some of imported seeds, crop protection products and fertilisers, as well as agricultural machines and their spare parts. Moreover, it has been increasingly difficult for agricultural producers to take out a loan. In these circumstances, the farmers carried out the spring sowing based to a large extent on their own means – either covering smaller land\(^\text{21}\), or using lower quality seeds and fertilisers, which in turn has translated into worse harvests. Due to a conflict between the government and the oligarch Dmytro Firtash, the prospects for the autumn sowing season are uncertain. The Ostchem company owned by Firtash, which controls two important plants producing nitrogen fertilisers in Cherkasy and Rivne, both of which are important for the entire market, announced in late May that it is going to halt its production\(^\text{22}\), which may cause a shortage of fertilisers and a need to import more costly substitutes. According to worst case scenarios which account for unfavourable weather conditions, at the end of 2015 the volume of the harvest may fall by 15–20%. If this proves true, it will be impossible to achieve another record-high harvest of grains and pulses similar to the one reached in 2014. It is expected that the harvest volume of grains and pulses might be lower and may stand at 50–55 million tonnes.

Ukraine’s unprecedented and difficult political and economic situation has brought a portion of large agricultural farms, so-called agroholdings, which so far have been the driving force of the agricultural sector, to the brink of bankruptcy. The main reason behind this situation has been the inability of farm owners to service their loans, mainly in foreign currencies, which were taken out on a large scale in previous years to increase the area of arable land and foster development of agricultural companies. This, in turn, was caused by depreciation of the hryvnia. The first negative symptoms became evident in August 2014, when the Mriya Agro Holding (Ukraine’s fifth largest agroholding in terms of the size of arable land) announced that it was unable to meet the deadline for repayment of its bonds worth US$ 400 million\(^\text{23}\). Problems with financial liquidity have affected Ukraine’s major holdings, including the largest one – Ukrlandfarming, which at the end of last year reported a loss amounting to US$ 261 million, and its current liabilities are estimated at US$ 1.7 billion\(^\text{24}\). In May 2015, KSG Agro, a company listed on the Warsaw Stock Exchange, announced that at the end of 2014 it had reported a loss in the amount of US$ 40 million and its liabilities accounted for 92% of the value of its assets.

\(^{20}\) P. Charałamow, Кабмін збільшив податкове навантаження на АПК в 20 разів, RBK-Ukraina, 23 March 2015.

\(^{21}\) As of 1 May, the sowing area of spring grains was 20% smaller than the year before.

\(^{22}\) Фірташ зупини в роботу двох своїх заводів, espresso.tv, 28 May 2015.

\(^{23}\) Mriya’s problems also resulted from unclear and most probably illegal financial operations carried out by its owners. See for example Д. Дєнков, Боргові проблеми “Мрії”: кінець близько, Економічна правда, 30 January 2015.

\(^{24}\) Олег Бахматюк: Держимся на зубах, выжить бы, Liga.net, 14 May 2015.
Conclusions

The decline of the Ukrainian economy started back in 2012 as a result of a lack of reforms and rapacious policies carried out by previous governments, in particular by officials associated with Viktor Yanukovych. Russia’s aggression against Ukraine has strikingly revealed the state’s problems and has become the main reason behind the current economic collapse. Not only did it cause the degradation of Ukraine’s most industrialised region, presently uncontrollable by Kyiv, but it also triggered a collapse of the entire economic system, paralysing the normal functioning of Ukrainian companies, which faced currency depreciation, damage to infrastructure and disruption to production, as well as a lack of funds for investment.

The current government of Ukraine, although forced to operate in unprecedented circumstances, has been rather sluggish in devising structural reforms and has failed to actually dismantle the oligarchic foundations of the state. Moreover, Western financial aid has been too limited in comparison to needs, and the payment of subsequent instalments has each time been dependent on the lender’s decisions. This may result in assistance being insufficient and only likely to rescue Ukraine from going bankrupt if the fragile truce in the Donbas region is maintained.

At present, Ukraine needs to count mainly on the power of its business people, in particular those running small and medium companies. This is due to the fact that, because of the situation in the Donbas region, no major foreign investments should be expected and there are no prospects for regaining the Russian market. For this to be possible, bold de-regulatory measures would be necessary, accompanied by initial successes in combating corruption. So far, the initiatives launched in these fields have been insufficient. It should be expected that in the following quarters basic economic indicators will improve. However, this will be a result not so much of a real improvement of the economic situation as of the low reference base for year-on-year comparisons and the probable exclusion from government statistics of that part of the Donbas region not controlled by Kyiv, similar to the case of Crimea after it was annexed by Russia. Currently, statistics are compiled with reference to a corresponding period in the previous year, when the condition of the Donbas region’s industry and infrastructure was considerably better (in the first quarter of 2014 the region was not affected by war), and the state accrued higher profit from taxes contributed by the region and from exports generated by it.

A positive scenario for Ukraine involves stabilisation of the downward trends in the second half of 2015 and of the economic situation, as well as progress in implementing reforms required by the IMF, which determines the payment by the Fund of subsequent loan instalments. Success in negotiations with Western lenders over a restructuring of the Ukrainian debt also seems probable. Otherwise, if the situation develops according to a negative scenario which mainly involves a resumption of military escalation in the east of the country and a fiasco in external loan restructuring, Kyiv might become insolvent, which would plunge the country into a long-lasting crisis.