After the Perfect Storm: Ukraine's Economy since the Revolution

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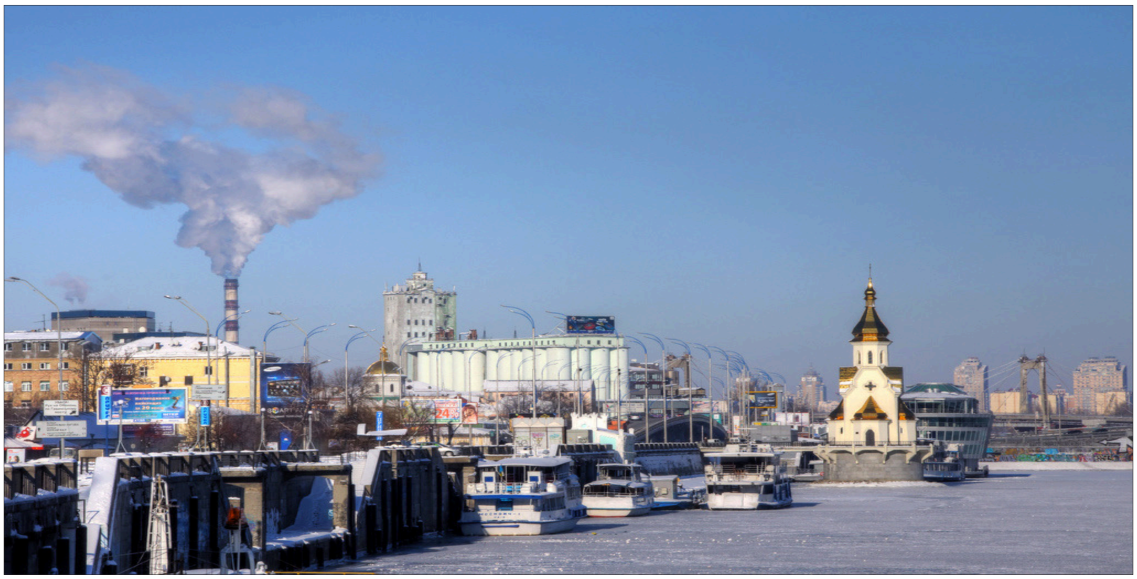

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- Since the Revolution of Dignity in February of 2014, Ukraine's economy has passed through a perfect storm. Between 2010 and 2013, the Yanukovych government's corruption and overspending combined with a fixed exchange rate created significant imbalances. After the revolution, the breakdown in trade with Russia and Russia's illegal annexation of Crimea and occupation of the Donbas brought the economy to a halt: the US dollar increased in value by more than 200 percent against the *hryvnia* between December 2013 and December 2015, and GDP shrank by 6.8 percent in 2014 and by 9.9 percent in 2015.
- The first part of the brief shows how administrative measures, tight macroeconomic policy, and international support enabled Ukraine to navigate this perfect economic storm. The second part of the brief describes Ukraine's current impasse, when the economy has stabilized but economic reforms necessary for renewal and growth have decelerated.
- The brief concludes that the key challenge is to deal with Ukraine's systematic corruption and to legalize the shadow part of the economy. Only "surgical aggression" can bring about the structural changes needed to attract foreign investments and to break through to new markets. There are no alternatives to reforming Ukraine's economy–the questions are only when and how much it will cost.

Before the Storm

Even before the revolution, Ukraine's economy accumulated significant imbalances due to an unsustainable macroeconomic policy and the absence of reforms after the previous crisis in 2008. The government incurred a high general government deficit (4.3 percent of GDP in 2013, not including deficits at state-owned companies like Naftogaz or the state pension fund)[1] thanks to the high level of corruption and inefficient spending under President Viktor Yanukovych. Yanukovych's so-called *smotryashchye* (criminal slang for deputies, also often called "The Family") infiltrated each state-owned company and regional administration and skimmed from financial flows. These figures misappropriated budget funds and significantly worsened circumstances for medium and small businesses. Most government tenders also came under the control of the president's team. The result was inefficient budget expenditures and diminishing efficiency at state-owned enterprises.

Simultaneously, the national bank's policy of keeping the exchange rate fixed at an overvalued level stimulated the growth of imports and encouraged import-oriented companies. The result was to increase the current account deficit, which in 2013 reached 8.7 percent of GDP.[2] There was no chance to avoid a currency crisis; the question was only when it would occur.

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Yanukovych fled the country on February 22, 2014, which led to a temporary lack of power. The majority in the parliament was restructured based on parties that had been in opposition to Yanukovich. The temporary uncertainty at the end of February was a trigger that burst the bubble of accumulated imbalances. A new government was appointed to deal with the "perfect economic storm." During the first wave, between January and April 2014, the *hryvnia* rapidly depreciated against the US dollar, dropping 42.6 percent compared with pre-crisis exchange rate in January 2014.[3] This lead to a banking crisis after the share of non-performing loans rapidly increased. Russia's aggression compounded the threat to Ukraine's economy. First, in March, Russia annexed Crimea, one of Ukraine's most attractive tourist destinations, and then in April 2014 its personnel helped seize the Donbas, a key region for mining and metallurgy. The consequent destruction of infrastructure and production facilities resulted in a decrease and even suspension of production at some factories and plants in the east. Because the Donbas had provided a large share of Ukraine's metal and machinery exports, this caused not only a drop in GDP, but also an increase in the foreign cash deficit. The currency devalued even further, dropping another 84.6 percent against the dollar from April 2014 to April 2015.

Surviving the storm

Only a combination of emergency external support, "administrative measures," and tight macroeconomic policy enabled Ukraine to avoid a default in 2014-2015. First with a stand-by arrangement, and then with the creation of a four-year Extended Fund Facility (EFF) in March 2015, the International Monetary Fund (IMF) sent a powerful signal to other external creditors and donors. The agreement in late 2015 to restructure Ukraine's Eurobonds also brought relief. Even this powerful external support, however, would not have been enough without unpopular "administrative measures" that allowed the government to cover military costs and to avoid panic devaluation and hyperinflation.

The most unpopular changes were **significantly increasing utilities tariffs** for all services, especially electricity and central heating. These measures also eliminated different prices for individual customers and companies using gas. Under the previous system, individual customers had paid a lower rate than companies, and some companies had abused used this arrangement by buying gas as consumers, thus effectively receiving illegal subsidies. Though unpopular, these measures were essential to decrease energy dependence and the budget deficit. A key indicator of success is that Naftogaz, the state-owned gas and oil monopoly that in 2014 ran a deficit equaling 5.5 percent of GDP, expects to break even in 2016.[4] The increase in tariffs also accelerated implementation of energy-saving solutions by encouraging companies and consumers to be more efficient. Graph 1 shows Ukraine's decrease in gas imports from 2012-2015. While this is partly due to the drop in output of the metal and chemical industries that are the main gas consumers, implementation of energy-saving technologies and decrease in excessive gas consumption have also helped.

Changes in the policies of the **National Bank of Ukraine** (NBU) were also critical. In 2014, the national bank was compelled to implement administrative measures on the currency market to maintain relative stability and to avoid panic. It was an unpleasant but absolutely necessary step. The most difficult measures included a requirement that 75 percent of exports should be converted at the obligatory interbank market rate; that one person cannot buy more than the equivalent of 6000 UAH per day (a little more than $200 at present; when the measures were first implemented the limit was 3000 UAH); and a prohibition on payments of dividends to foreign investors abroad. An April 2016 statement by the NBU announced that a ban on the repatriation of dividends from Ukraine will be lifted following the successful completion of the second review under the Extended Fund Facility Arrangement with the IMF.[5]

Sources of gas (bn. m3)

Graph 1: Decrease in gas imports, 2012-2015

These measures in 2014 and in the first half of 2015 stabilized the exchange rate and prevented panic, but they also created a set of barriers to investment in Ukraine in 2016. With their lifting, investment should increase.

As mentioned above, the national bank also abandoned the pegged exchange rate. Administrative measures and tight monetary policy stabilized inflation at 43.3 percent in 2015, with the high level attributable to the increase in utility tariffs and the currency's devaluation. In 2014-2015, the national bank implemented a set of measures to prepare for a change to inflation targeting in 2016. Under this policy, the national bank does not manage the exchange rate, aiming instead for a stated inflation target. This will allow the bank to maintain price stability and make the interest rate a powerful market instrument in the short run. This policy is much more favorable for investors as it makes monetary policy predictable and supports price stability.

Another important measure the national bank took was purging the banking system. By the end of 2015, the national bank had declared 63 banks insolvent out of a total of 182 banks in 2013.[6] Many of these "broken" banks did not work as actual banks: they were created to provide "non-banking services" (currency conversion, etc.), and took high risks on the assumption that the national bank would always refinance them in order to avoid panic on the market or based on corrupt agreements. Purging these banks was necessary to restore trust in the banking system.

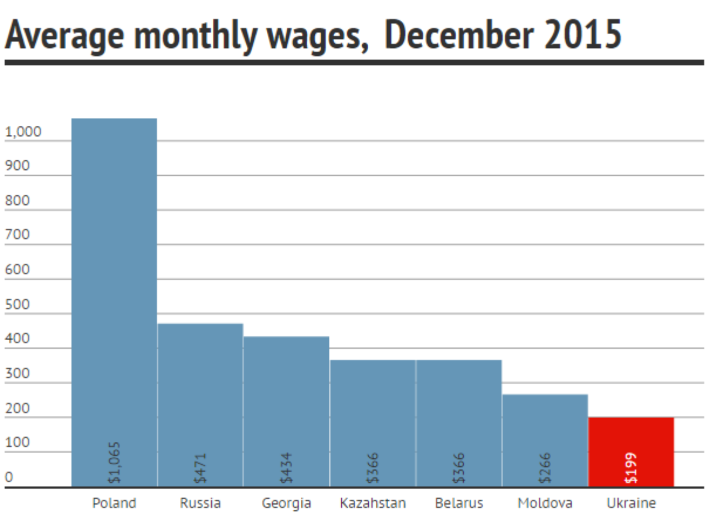
The next essential reform concerns **tax changes**. Changes in the taxation system were agreed at the end of 2015 after long discussions and a number of compromises. First, the most sensitive change is the reduction of the employer-paid social security contribution to 22 percent from an average of 41 percent. High employer-paid social contributions were one of the main reasons wages were "hidden," as employers preferred informal labor, paying salaries in cash, and asking employees to register as self-employed. Second, as part of the reforms, special VAT preferences were also abandoned except for a special regime for agricultural companies. The third important adjustment will create a flat income tax rate. This reform has not yet been completed, but the first changes clearly signal that the government wants to legalize salaries and make the complicated tax system more transparent and understandable.

After the Storm

This set of administrative measures and a tight fiscal and monetary policy stopped the dramatic drop in Ukraine's economy and avoided the most pessimistic scenarios of default and becoming a "failed state." As of the beginning of 2016, the situation has stabilized. The national bank projects a slow recovery in 2016, with inflation between 9 and 15 percent and GDP growth at 1.1 percent.[7]

The other most visible change in Ukraine's economy has been the **shift in the geographical structure of external trade**. Ukrainian exports have reoriented away from Russia to the European Union and Asian markets. The share of total exports going to Russia dropped to 11.9 percent in 2015 compared with 22.8 percent in 2013.[8] Simultaneously, exports to Asia and the EU increased to 29.6 percent and 34.9 percent, compared with 24 percent and 28.3 percent in 2013. One of the reasons for this shift was the tariff cuts for Ukrainian exports to EU markets starting in March 2014.[9] Reorientation is also a product of changes in the structure of exports: the share of agricultural products has increased, while the share of metallurgy and machinery products, more than 50 percent of which went to Russia in 2013, has decreased because of destroyed infrastructure and capacities in the east. Finally, as shown in Figure 1 above, another important component of the reorientation is diversification away from reliance on gas imports from Russia. Whereas in 2013, 92 percent of Ukraine's gas import came from Russia, in 2015 that proportion was down to 37 percent. In absolute terms, the amount has decreased by more than four times.

This change in the geographical structure of trade will likely continue. The Revolution of Dignity was sparked by Yanukovych's rejection of an Association Agreement with the EU, and one of the revolution's key results was **signing the Deep and Comprehensive Free Trade Area (DCFTA) in June 2014.** Thanks to the DCFTA, exporters can be confident of their access to the European market on a permanent basis. The domestic consumer market will benefit from increased cooperation between European exporters and Ukrainian companies, and European investors can build long-term relationships with stable expectations.



Graph 2: Average monthly wages in the region
Source: Trading Economics, author's estimates

From Surviving to Thriving?

At the same time, all these emergency measures and administrative steps have not broken up Ukraine's oligarch-managed system based on corruption and free or privileged access to resources. There have been neither structural changes nor reforms in the real sectors of the economy. The high level of corruption and absence of the strong middle class continue to result in low labor productivity. In fact, today Ukrainian wages are among the lowest in the region.

Alarms over the lack of progress against the system have been going off for Ukrainians and their Western partners since the pace of reforms started to slow in the middle of 2015, and can no longer be ignored. In February 2016, a majority of parliament members voted to hold the cabinet's work "unsatisfactory" over the slow pace of reforms and allegations of corruption, but then refused to pass a no-confidence vote a few minutes later. The IMF has held off on disbursing its next tranche of support from the EFF until reforms are back on track. IMF spokesman Gerry Rice said the IMF needs to "have more clarity about the status of the government and the coalition" to complete the second program review.[10] In April, a new government was appointed, but it was supported only by two parties of the previous coalition and partly by former members of the Party of Regions (Yanukovych's party). The formation of this new government calls into question whether it will be able to keep a stable majority in the parliament that will drive reforms forward.

There is a battle under way between reformers and oligarchs—and the politicians who are under their control. But both reform-oriented politicians and those who pretend at reforms are scattered throughout all the parties, and the oligarchs are more organized. Most of them have been working in the parliament for a long time, and know how to pretend reforming without actually changing the system. Their interest is in preserving their dominant position to have privileged access to cheap resources, keeping Ukraine a "manageable" market economy.

The way forward

Ukraine's current economy is based on export of agricultural (41 percent of exports in 2015) and metal products (26 percent). This leaves Ukraine dependent on global commodity markets. With the current downturn in those markets, a slow economic recovery, or even stagnation, is highly possible. Domestic demand is insufficient to stimulate a recovery, and the external support of the IMF and donor countries can have only a temporary effect. With a resource-based economy with low productivity, there is no way forward except through urgent reforms. In order to create a sustainable economic recovery, Ukraine must use "surgical aggression" to create an environment attractive to external investment.

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The top challenge in reforming Ukraine to attract investment is fighting corruption. The government has taken the first steps by setting up the new national patrol police and the Anti-corruption Bureau. But there is still an enormous amount of work left to reform the judicial system and prosecutor general's office. These reforms are important because corruption is widespread in the current system, which, combined with heavy taxation, deters foreign investment by increasing the risk of entrance.[11]

Tax liberalization, more transparent legislation, better monetary policy, and access to the EU market will have a positive effect for almost all industries. Simultaneously, the destruction of facilities and infrastructure in the east has resulted in plummeting production in the machinery and mining industries. The machinery industry has suffered the biggest negative impact, with its share of exports decreasing to 9 percent in 2015, down from 14 percent in 2013, due to the loss of the Russian market and Ukraine's prohibition on many dual-purpose exports after the start of the Russian intervention. Decades of orientation toward the Russian market have made it hard for machinery exporters to compete on the global market. Many investments will be required to catch up to global production standards.

Almost all experts have argued that the IT industry should be a locomotive for growth. Ukraine has a high number of qualified IT specialists, and the low cost of living makes them an attractive source of skilled labor. According to expert judgments, the IT sector will continue to grow in 2016 at a rate of 30 percent.[12] Fully oriented to the international market, the IT sector will remain competitive for international firms due to Ukraine's relatively low cost of labor.

Another promising sector is chemical production. In 2014, capital investments grew by 20 percent in the chemical industry, and entrance to the European market together with skilled labor reserves and relatively cheaper resources make chemicals an industry that can benefit from reforms.

Another industry that has grown is the agricultural sector. Agriculture's contribution to GDP increased to 10.3 percent in 2014 compared with 8.8 percent in 2014, in part because the sector was not directly affected by the military conflict. As mentioned above, the tax changes in 2015 also retained VAT preferences only for the agricultural sector. These short-term advantages notwithstanding, Ukraine's deep devaluation has given this export-oriented industry a lot of advantages, and Ukraine's geography helps make this one of the most promising sectors. The foods industry has also benefited from entrance into a new market. At the same time, stagnation in the majority of other related industries highlights the risk of remaining an agrarian country with low value-added production.

Conclusion

In the last two years Ukraine has survived a perfect storm. Despite political instability, annexation, and military invasion—resulting in the destruction of infrastructure and facilities of its most important exporting region and the loss of the country's top tourist destination—Ukraine's economy has stabilized and is returning to growth. Increases in utility tariffs, the purging of the banking system, tight macroeconomic policy, and massive external support got Ukraine through 2014 and 2015.

There have been important reforms. The change from a fixed exchange rate to an inflation targeting approach made monetary policy more transparent for investors, improving predictability and reducing risk. Tax reforms that have decreased employer-paid social security contribution by nearly 50 percent demonstrated political will to bring economic activity out of the shadows. Circumstances are also impacting the geographical structure of Ukraine's trade in ways that could have a long-term positive benefit. Gas imports from Russia have decreased by four times, and trade patterns are reorienting towards Asian markets and the EU. Ukraine's dependence on Russia is shrinking. The DCFTA with the EU has created the conditions for a long-term relationship with European partners and should contribute to further expansion of exports in that direction.

Despite these achievements, one of the main goals of the Revolution of Dignity—to remove systematic corruption—has not been reached yet. Without it, Ukraine's economy cannot thrive. The political crisis of early 2016 shows there is still no common understanding of reforms among politicians. There is no alternative to reforms in Ukraine—the only questions are how long they will take, and how much they will cost.

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