

# ICPS newsletter®

## The economic crisis will bite Ukraine more deeply in 2009

**ICPS has issued a substantial downgrade of its forecast for Ukraine's economy because of the sharp worsening of the external situation and a major decline in access to external financing as the world economic crisis deepens. Whereas earlier expectations were that GDP would continue to grow, albeit more slowly, during the entire forecast period, the updated forecast is for the economy to grow less in 2008, decline in 2009, stagnate and then recover slightly in 2010, and to rise slightly in 2011. The latest issue of QUARTERLY PREDICTIONS presents these forecasts in full**

### Ukraine's economy reacted swiftly and painfully to the crisis

Ukraine's economy reacted extremely swiftly and painfully to the deepening crisis around the world. A decline in industrial output, the beginning of widespread layoffs, a steep devaluation of the hryvnia, and loss of confidence in the banking system is only a partial list of the symptoms of Ukraine's crisis. The main channels through which the world crisis has had its impact on Ukraine's economy are the openness of the economy and its dependence on external borrowings. Because foreign credit was so readily available to Ukraine, the country's economy has been "spiked" by these debts: all that credit was one of the drivers of the domestic market's expansion in recent years. Borrowing made it possible to increase both investment and consumption. Some sectors, such as construction, were doubly dependent on credit: the sector's growth was driven by lending both to builders and developers and to homeowners. Spurred by consumer and car loans, the retail sector also grew rapidly.

Still, the expansion of consumption and investment was accompanied by a sharp growth in import volumes and the ensuing foreign trade deficit. However, as long as the net inflow of FDI and foreign borrowings grew faster than the current account deficit, it seemed that nothing could go wrong. Strong inflows to the capital account made it possible for the National Bank of Ukraine to even reevaluate the hryvnia in Spring 2008, despite a growing current account deficit.

By fall, the situation changed radically. A sudden constriction of access to foreign credit and negative expectations of the

economy's further growth caused a sudden outflow from the capital account. The hryvnia fell sharply, all lending to the economy effectively ground to a halt, and the risk of widespread defaults in Ukraine rose steeply.

Shrinking demand and prices for basic Ukrainian export commodities that account for nearly half of the country's GDP immediately transmitted itself to related sectors: output fell, wages were lowered and jobs were cut.

ICPS analysts say that GDP grew only 2.5% in 2008, which is 3.2pp less than earlier anticipated. A major decline in GDP growth in Q4'08 was caused by a sharp decline in industrial output and a deepening collapse in construction.

### 2009: A turn for the worse

ICPS economists expect the impact of the crisis to grow worse in the financial system and the world economy over 2009. The collapse of the US housing market will continue, the financial system's losses will grow, and liquidity will continue to decline at least until the end of 2009.

The deepening crisis means that Ukrainian exports will continue to contract and foreign financing will continue to be barely accessible. This will affect the dynamic of Ukraine's economy in 2009. The ICPS forecast is for GDP to shrink 5.5% in 2009.

Those manufacturing sectors oriented on export markets will contract, which will affect related branches such as extraction industries, energy, trade and transport. Those branches of the economy that depended heavily on external borrowing in recent years will also feel the impact, such as construction and retail trade. Cuts in wages, layoffs or even complete

shut downs of companies could become widespread.

As credit is curtailed and the hryvnia grows weaker in relation to the US dollar, dollar-valued imports will taper off. The biggest reductions will be in imported cars and durables. Similarly, layoffs in those businesses connected to importing, especially in car sales, appliances and other durables are likely to be massive. Some of these companies will likely go under. At the same time, the growing cost of imports will create the conditions for import substitution in certain sectors.

ICPS analysts expect the exchange rate to bottom out at the end of 2008 or the beginning of 2009, after which the volume of imports will begin to decline and demand for the dollar will begin to taper off. The ICPS forecast is for the dollar to be UAH 7.70 by the end of 2009 and average UAH 7.60 for the year.

2009 will be a trying year for Ukraine's banking system. The key challenges to banks will be to pay off their foreign debts, growing defaults on loans they issued, especially those denominated in US dollars, and a dramatic decline in property prices, possibly as much as 30–50%. ICPS analysts expect to see bankruptcies in the sector, which will go hand-in-hand with change of ownership, mergers and even the occasional state takeover.

Low domestic and foreign demand, the worsening bottom line at many businesses, poor access to credit, the growing cost of imported equipment as the hryvnia declines and investment risks grow while the economic future remains highly uncertain will result in a 15% reduction in capital investment. Budget spending on investment will be low as the need to provide social protection grows.

Private consumption will drop 8% as incomes fall and lending virtually stops. This will have the strongest impact on car and durable goods sales.

One of the biggest challenges facing the Government in 2009 will be how to balance the budget of the Pension Fund. As its own receipts go down with the

weakening labor market and the shadow economy begins to expand again, the Fund's expenditures will grow. This will constitute a serious burden on the State Budget. ICPS analysts say that subsidies to the Fund could grow from UAH 41.5bn in 2008 to UAH 60bn in 2009.

## Forecast for 2010–2011: Recover begins

ICPS analysts expect the world economy to see positive growth again only during the course of a year after the financial system begins to stabilize, which they say will happen at the end of 2009. Thus, the ICPS forecast is for the world dynamic to begin to recover in H2'08.

The ICPS forecast is that Ukraine's GDP will grow by 1% in 2010, and 3% in 2011. As external demand recovers, albeit not by much, exports will pick up again in 2010–2011. Imports will also expand, although more slowly than exports because of the increased cost of such goods with devaluation, poor access to credit, and feeble growth in disposable incomes. ICPS analysts say the current account deficit will turn into a surplus in 2010.

As the hryvnia becomes cheaper relative to the US dollar, import substitution will grow. ICPS analysts say that the food processing and light industries should become more competitive and be able to increase output. However, there is not likely to be a significant change in the structure of Ukraine's economy or a major shift in focus to the domestic market. As before, it will remain very open.

The renewal of a positive current account balance will be the main condition for the hryvnia to recover even slightly. ICPS analysts say the US dollar will cost UAH 7.50 by the end of 2010 and UAH 7.30 by the end of 2011.

## Forecast risks assumptions

The ICPS forecast is based on five key assumptions:

- The price of imported gas remains in the range of US \$200–300/1,000 cu m over 2009–2011.
- The price for oil will remain around UA \$40–60/bbl in 2009 and gradually rise over 2010–2011.
- Demand for steel on world markets will begin to revive only in H2'10.
- Net inflows to the capital account will be marginal. In 2009, Ukrainian businesses will refinance only a part of their debts through short-term

external loans. The inflow of capital will grow slowly over 2010–2011.

- Ukraine will get the entire agreed Stand-by loan from the IMF.

Five factors could make the ICPS forecast overly optimistic:

- Demand for export commodities goes down more than expected or does not improve at all over 2010–2011.
- The import dynamic reacts with a major delay to changes in the exchange rate or the value of critical imports grows faster.
- A deepening crisis of confidence on world capital markets becomes an obstacle to sufficient financing for the anti-crisis programs of the governments of the US and EU countries.
- The options to partly refinance external debt in 2009 become restricted because of problems with parent European banks, within the domestic banking system or within non-financial corporations.

- Ukraine does not get all the planned tranches from the IMF because it fails to uphold the conditions in its memorandum.

Should combination of several of these factors come into play, GDP in 2009 could fall more than 10% and the downward trend would then hold through 2010–at a minimum. That would mean that the number of bankruptcies will grow, incomes will fall more sharply, and unemployment will be higher than expected. The imbalance in public finance, especially the Pension Fund, will hit the most vulnerable social groups the most. The hryvnia will devalue much more and inflation will be higher. Defaults on bank loans and utility payments will become widespread, as a result of which the financial system and residential services providers will suffer considerable losses. ■

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## Key macroeconomic indicators

Years	2007	2008	2009	2010	2011
Indicator	estimate		forecast		
GDP, mn UAH	712,9	954,2	1 034,8	1 228,1	1 494,9
GDP, apc*	7,6	2,5	-5,5	1,0	3,0
Real industrial output, apc	10,2	-3,5	-6,0	2,0	5,0
Real agricultural output, apc	-5,0	18,5	-5,5	2,0	4,0
Gross investment, % of GDP	26,9	27,6	25,6	25,1	25,4
Real gross fixed investment, apc	24,8	0,0	-15,0	3,0	10,0
Real consumption, apc	13,4	9,4	-5,8	2,0	3,9
Net FDI, mn USD	9 218	10 000	5 000	8 000	10 000
Real disposable household incomes, apc	12,6	11,0	-12,0	2,5	5,0
Real retail trade, apc	29,5	18,0	-11,0	6,0	8,0
Consumer price index, apc	16,6	22,0	16,0	10,0	8,9
Producer price index, apc	23,3	23,5	14,0	13,0	12,0
Population, mn	46,6	46,4	46,1	45,8	45,4
Average monthly real wages, apc	12,5	6,5	-12,5	2,0	4,0
Unemployment rate (ILO methodology), %	6,4	6,4	8,5	7,8	7,1
Exports of goods and services, apc	27,4	31,1	-1,4	13,8	13,9
Imports of goods and services, apc	34,8	35,8	-8,2	5,8	5,9
Current account balance, % of GDP	-4,2	-6,6	-3,6	0,8	4,3
Revenues, % GDP (consolidated)	30,8	30,8	29,9	29,5	28,7
Balance, % of GDP	-1,1	-1,3	-2,8	-1,7	-1,5
Official exchange rate (average annual), UAH/USD	5,05	5,36	7,60	7,60	7,40

\* apc = annual percentage change

Sources: Derzhkomstat, Ministry of Finance, NBU; calculations and forecast by *quarterly predictions*

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