Overcoming Ukraine's Macroeconomic Crisis

Lunchtalk at Bruegel

Dr. Ricardo Giucci

German Advisory Group / Berlin Economics

Brussels, 12 March 2014

Contents

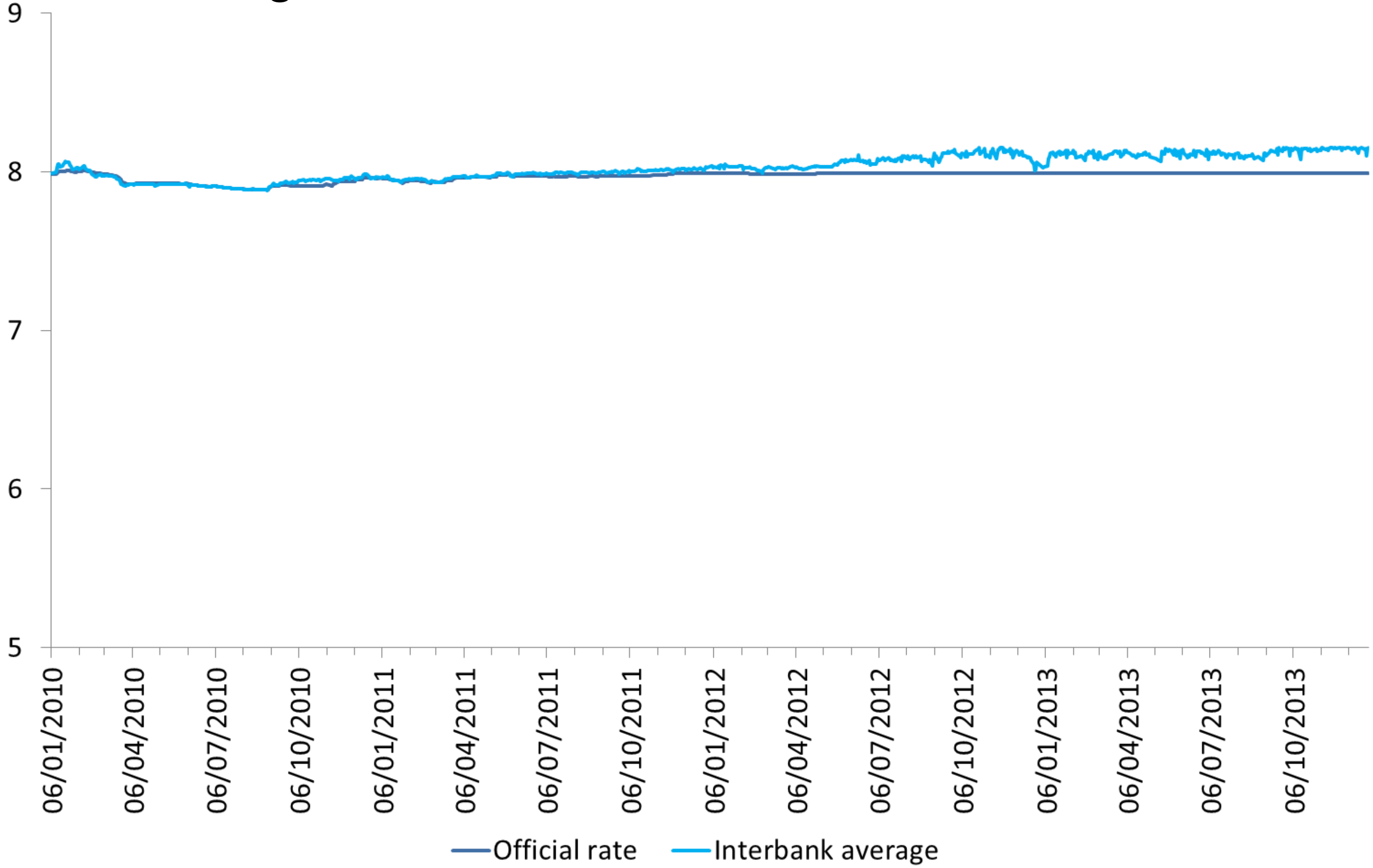
1. The macroeconomic policy mix 2010-2013

2010-2013: Three „pillars“ of macroeconomic policy

i. Fixed exchange rate to the USD
ii. Heavily subsidized energy prices
iii. Expansive fiscal policy (from 2012 onwards)

i. Fixed exchange rate

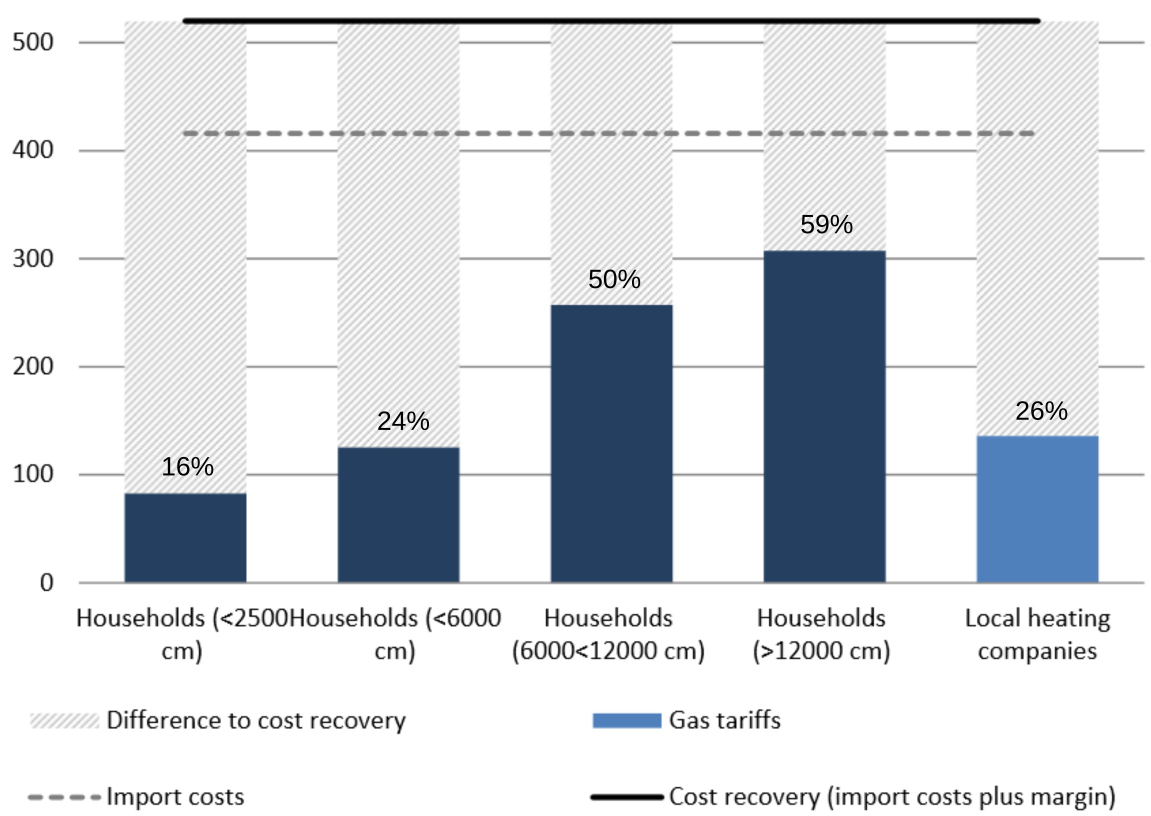
Exchange rate UAH/USD



Source: NBU

ii. Heavily subsidized energy prices

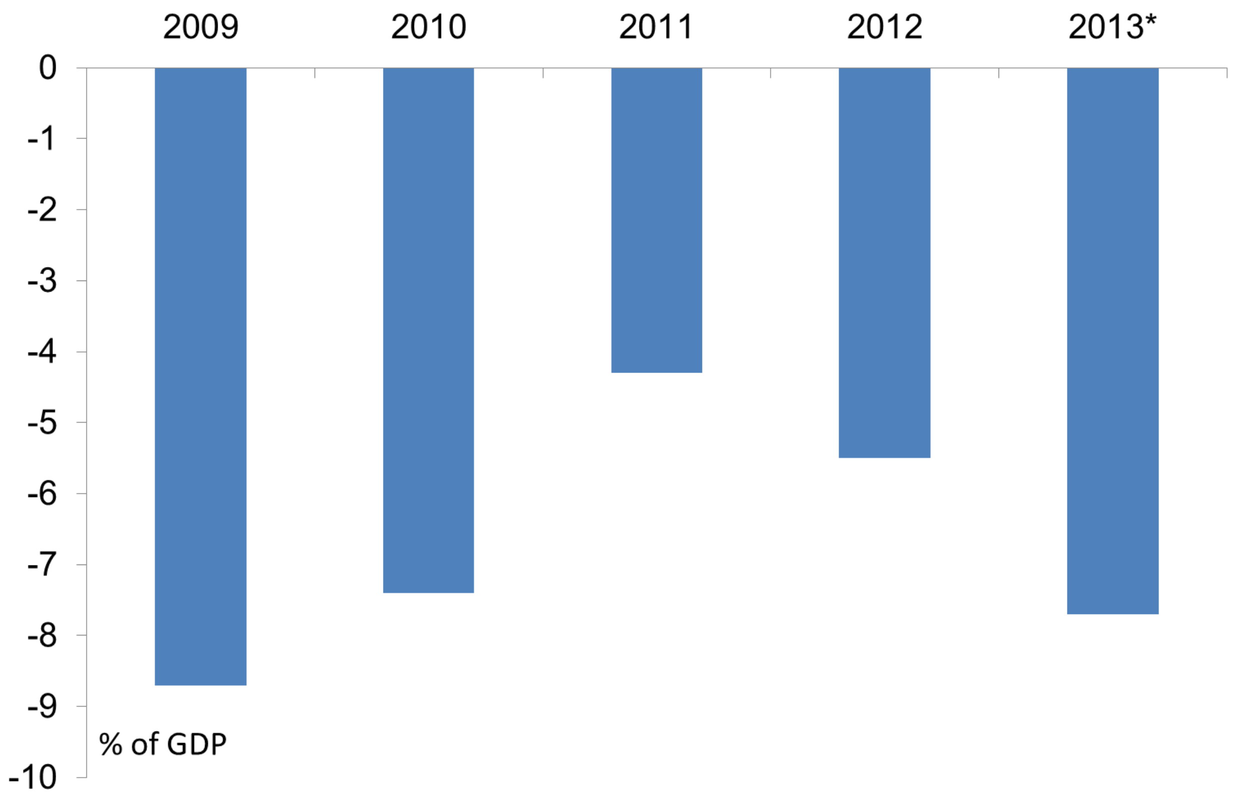
Gas tariffs for different consumer groups and benchmark prices



Source: Own analysis based on (NERC, 2012)

iii. Expansive fiscal policy

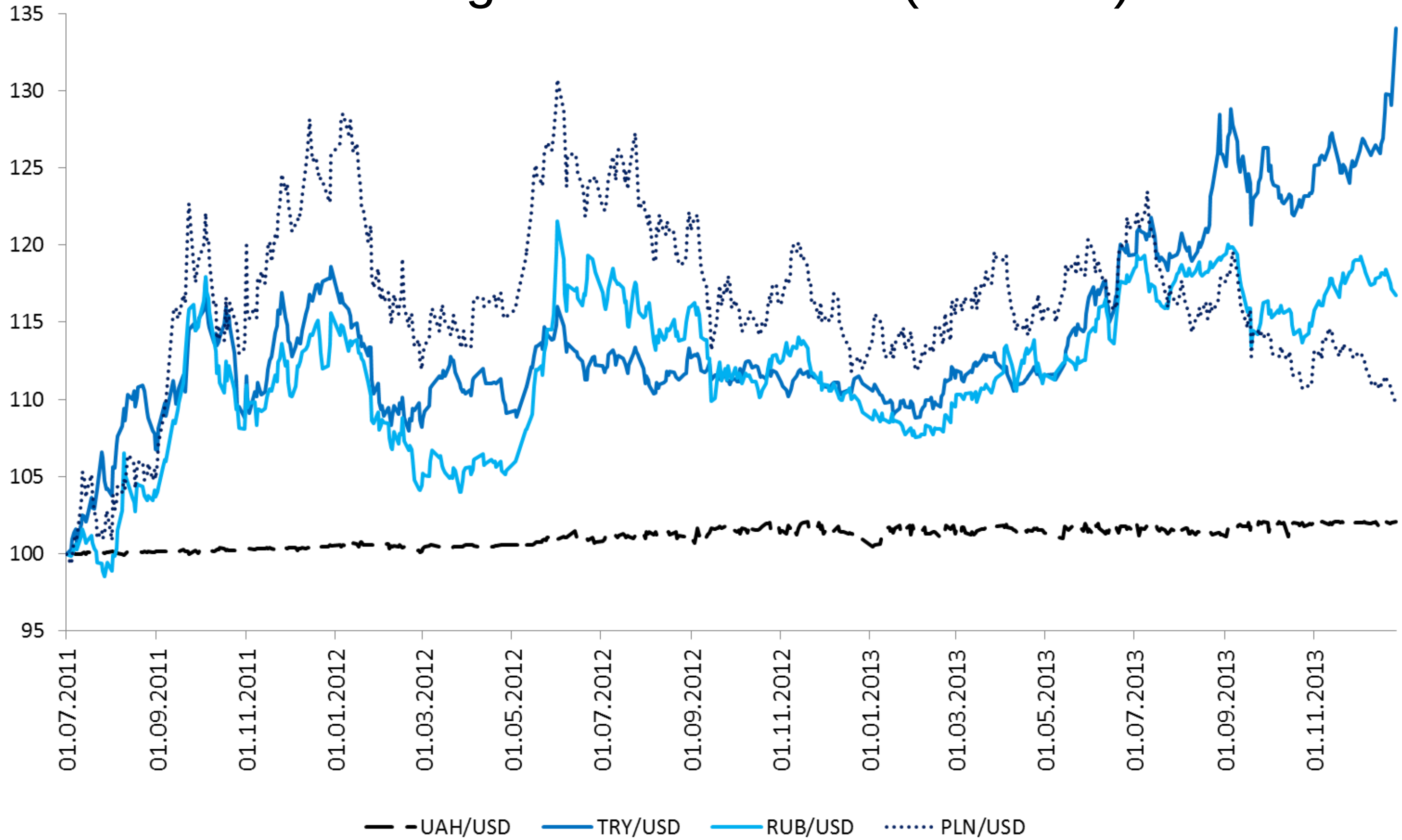
Budget deficits (general government including Naftogaz)



Source: Dragon Capital
** IMF estimate*

2. Outcome of policy mix: Overvaluation

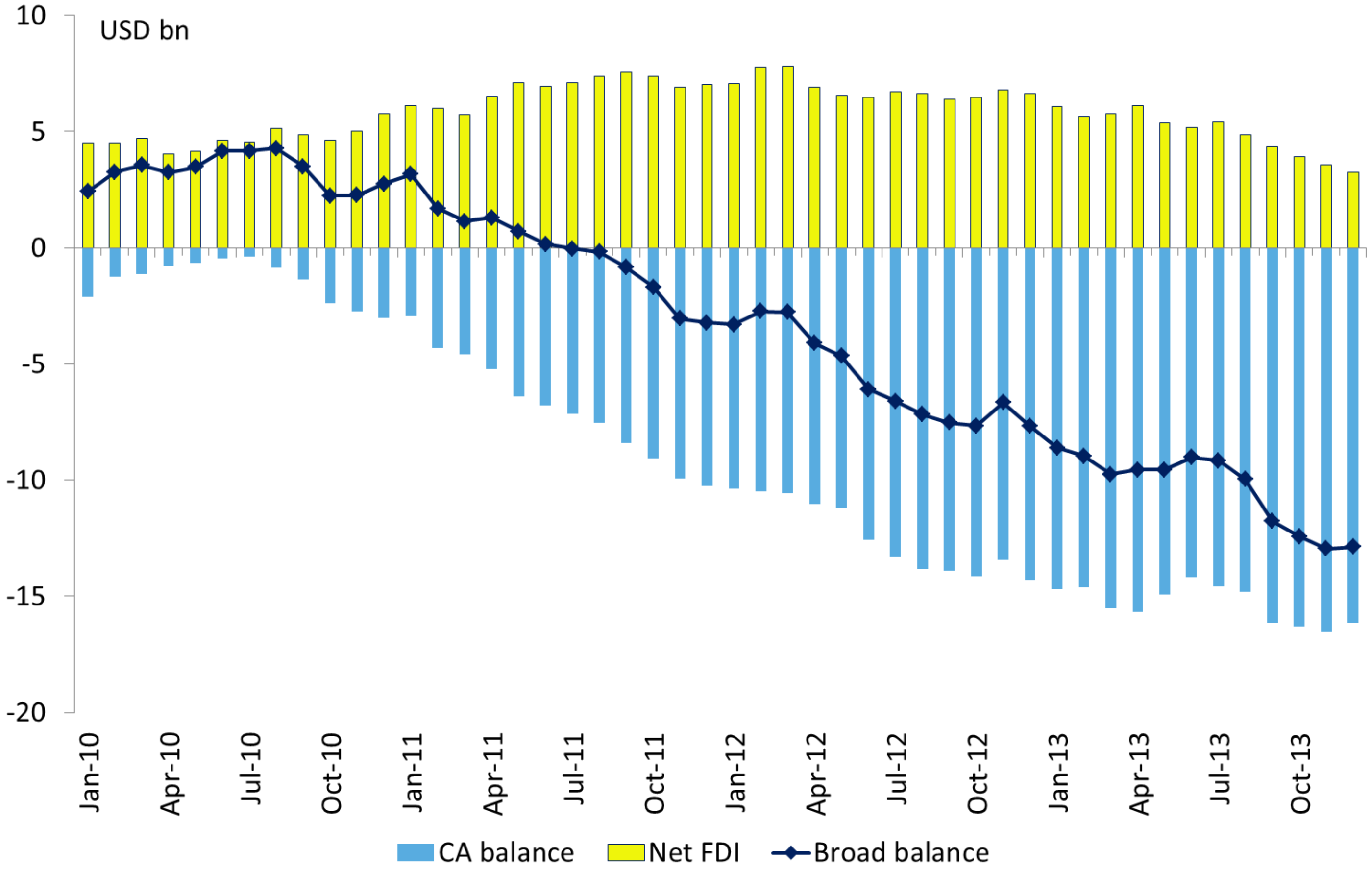
Nominal exchange rates vs. USD (indexed)



Source: own calculations based on ECB data
Note: July 2011=100 Increase means depreciation

Very high current account deficit

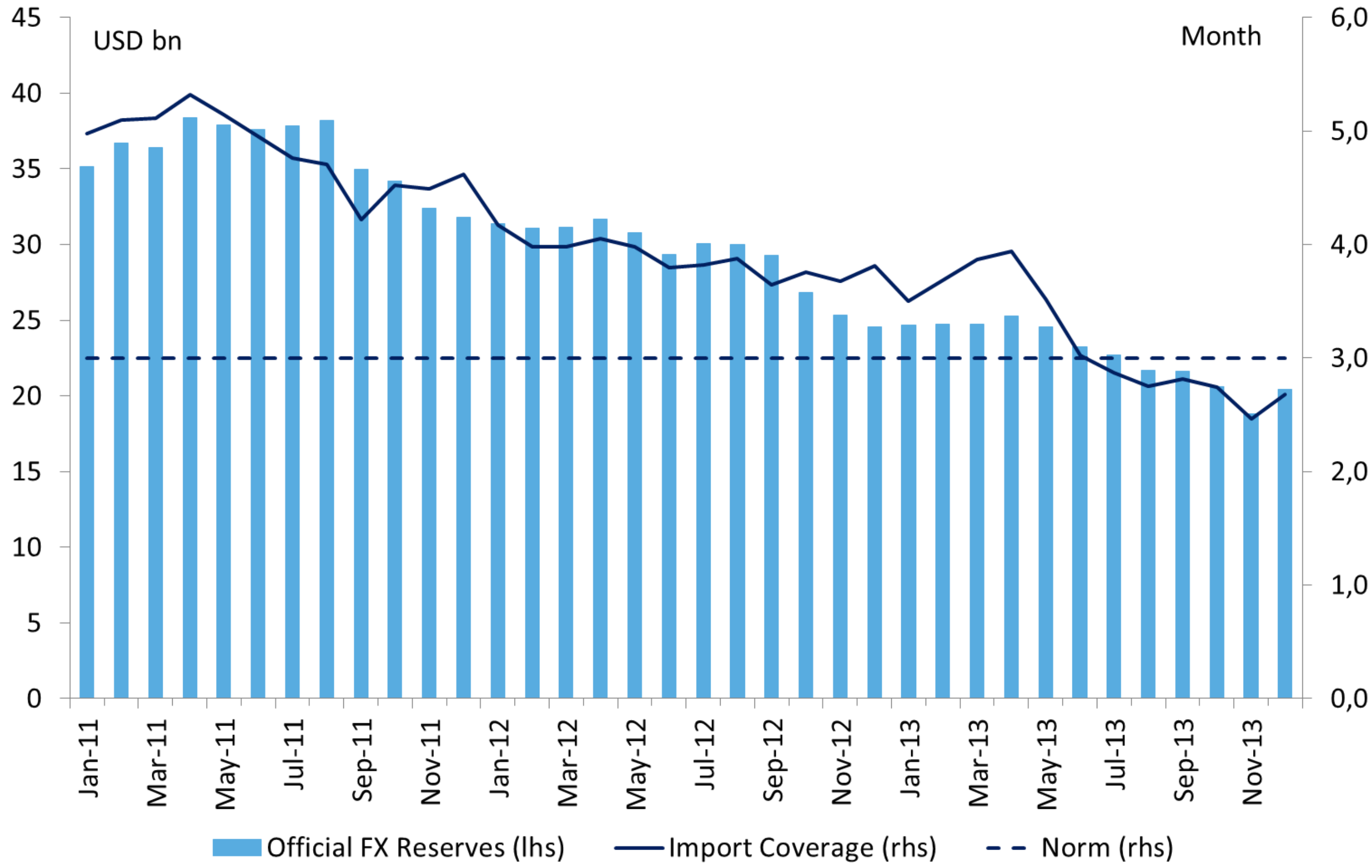
Dynamics of external accounts



Source: NBU, own calculations

Loss of FX reserves and import coverage

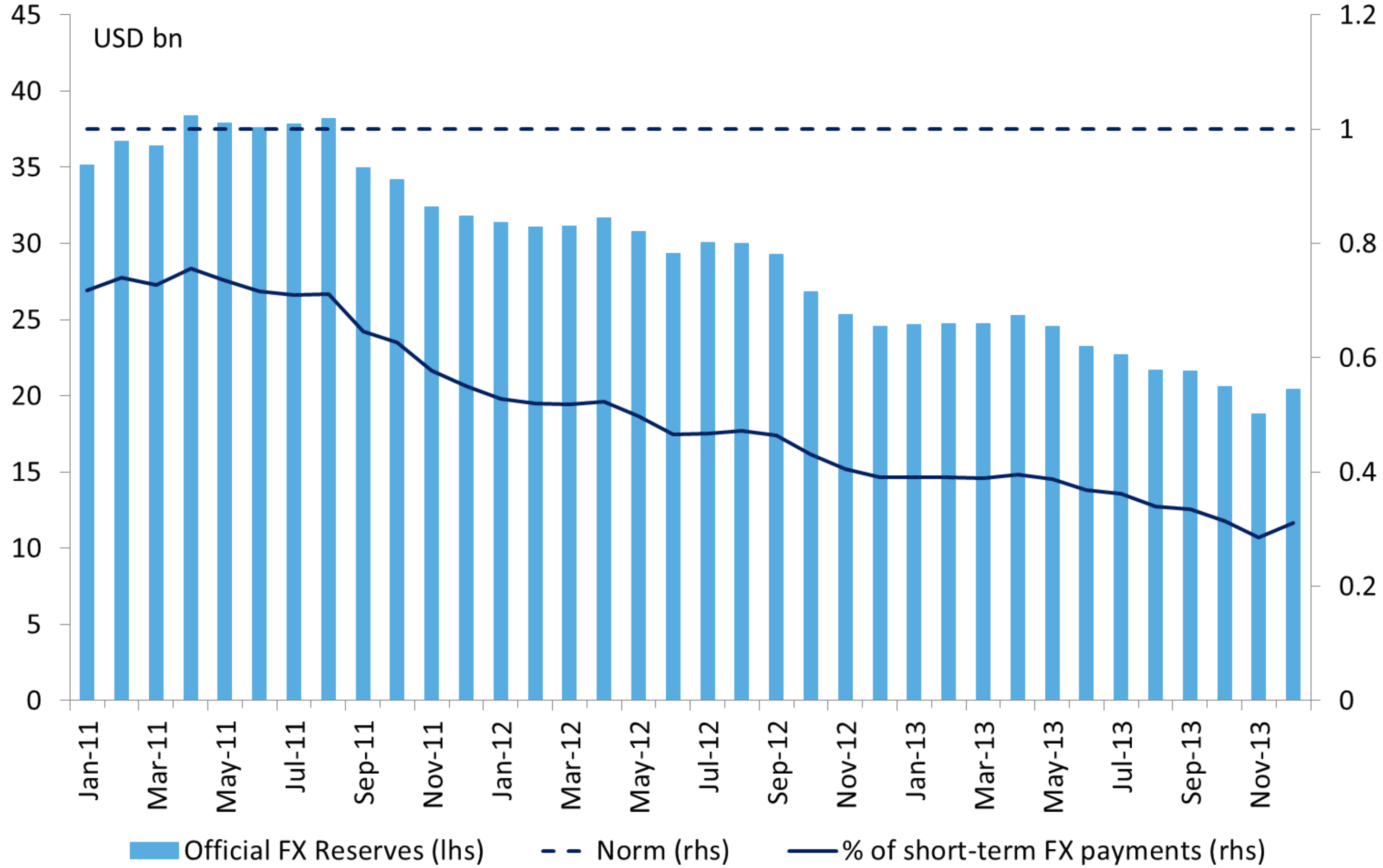
Official FX reserves and import coverage



Source: NBU

FX reserves and short-term FX payments

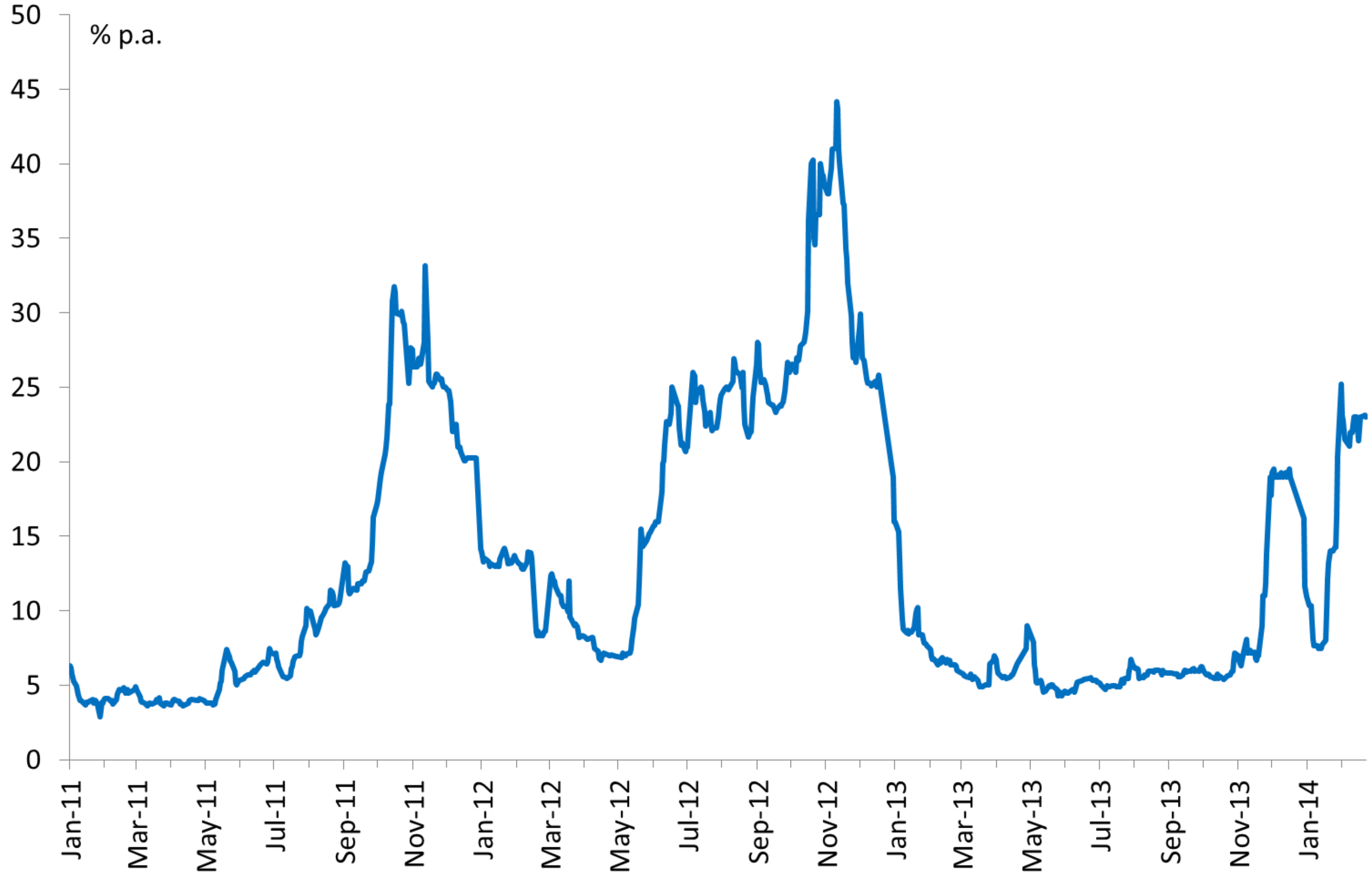
Official FX reserves and short-term FX payments



Source: NBU

Very tight monetary policy

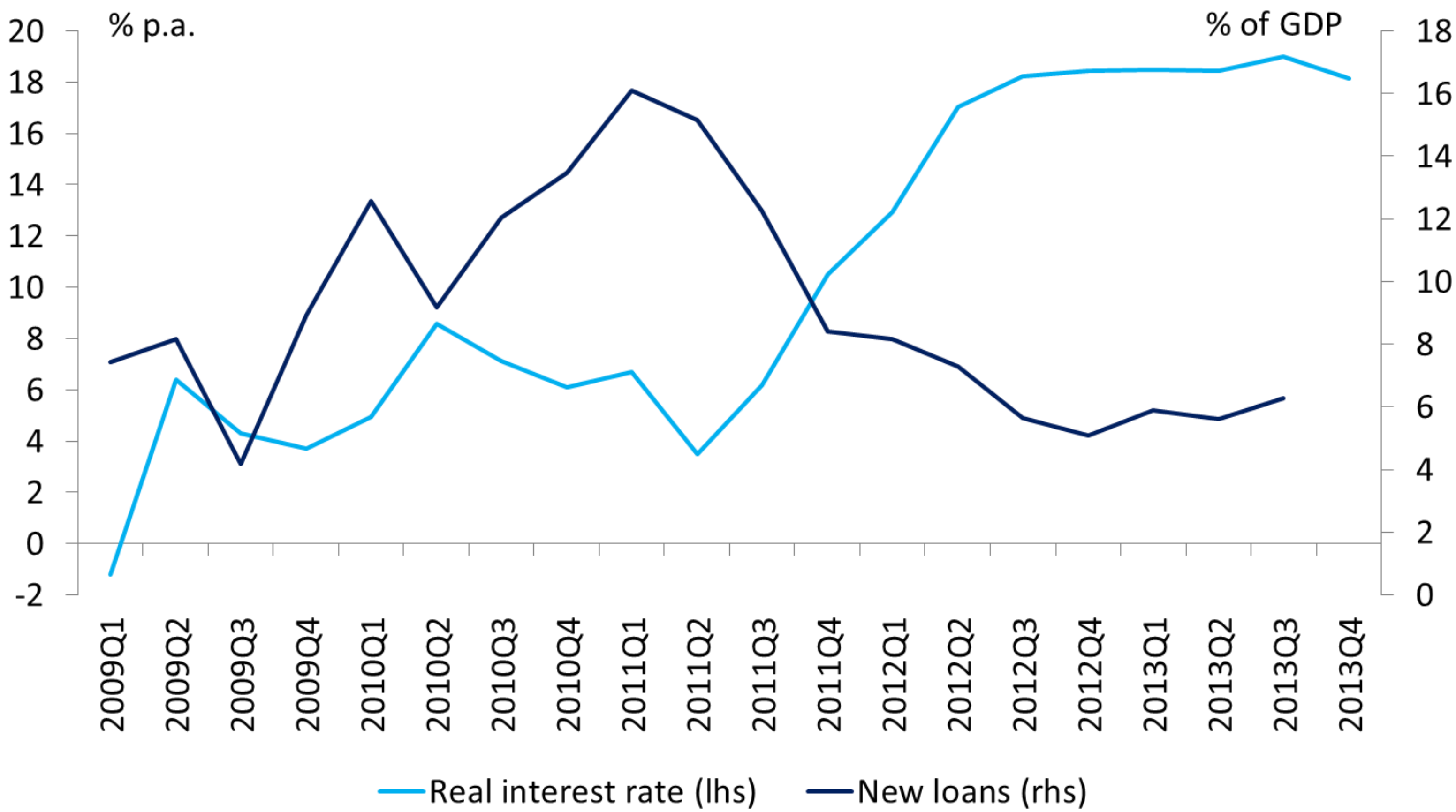
1-month Kievprime



Source: AYA securities, Reuters

Interest rates up and investment down

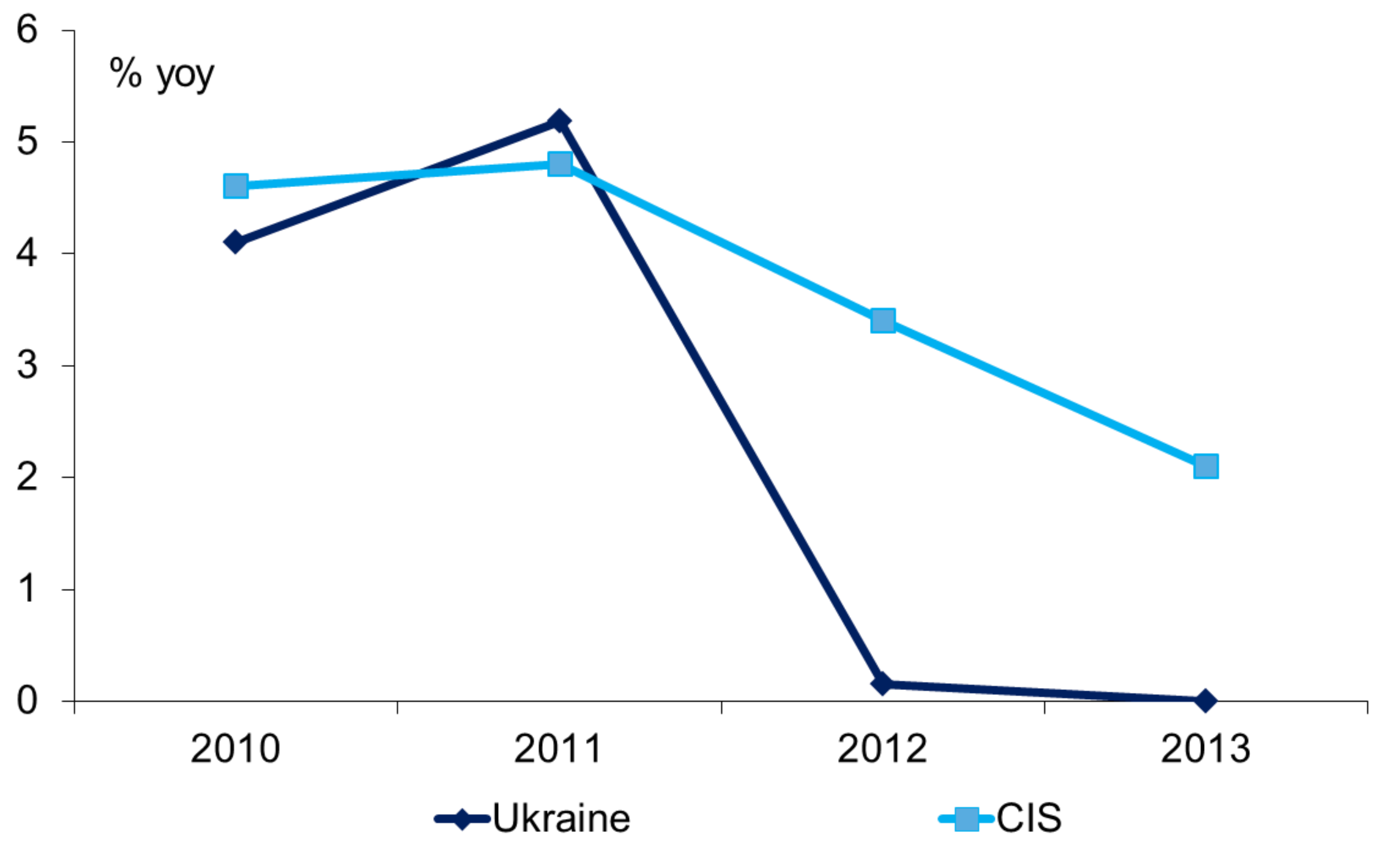
Bank lending rates and new loans



Source: Own calculations based on NBU data
Note: Real interest rate is derived from nominal interest rate on loans to nonfinancial corporations in national currency with maturity of 1-5 years and ex-post inflation, new loans are issued over the quarter as % of GDP

Real economic growth

GDP development



Source: IMF

Outcome policy mix 2010-2013

- High twin deficits: Current account deficit of ca. 9% and budget deficit ca. 8% of GPD
- Depleted official reserves
- No access to international financial markets
- Significant FX payments due in 2014, by both the public and the private sectors; amount for public sector: USD 9.7 bn
- On top: No economic growth

→ Completely unsustainable macroeconomic situation

3. Stabilisation options 2010-2013

In principle, Ukraine had <u>three</u> options to finance the twin deficits

<u>Option 1</u>: Issuance of Eurobonds / muddling through

- Preferred option by government, since no economic adjustment needed and thus no loss in popularity

<u>Option 2</u>: IMF programme

- Only real solution, since not only financing but also adjustment
- However: Gov was not keen on implementing needed reforms

<u>Option 3</u>: Russian bail out

- Financial stabilisation of „last resort“
- Problems: Concessions to RU, political risks within Ukraine

The use of stabilisation options over time

2010-1H2013: Implementation of option 1, gov was able to place Eurobonds worth USD 12.45 bn till April 2013; since 2H2013 no access to international capital markets anymore; end of option 1

November 2013: Government tries to secure an „IMF light“-programme (option 2) & cash from the EU, with no success

December 2013: Agreement on Russian bailout (option 3); USD 15 bn in loans & significant gas price discount

January 2014: Discontinuation of Russian bailout

February 2014: New government requests an IMF loan (option 2) and is ready to accept the conditions; IMF is only option left

4. Recent developments

Current situation: No stabilisation scheme in place

Consequence: Start of disordered financial adjustment, with possible negative impact on the economy

- Exchange rate: Devaluation of 20% to USD till end Feb
- Official reserves: USD 15.5 bn, this equals 2 months of imports coverage and only 23% of short term FX liabilities
- Serious problems on banking sector, withdrawal of around UAH 43 bn in deposits (10% of total deposits) since Jan 27
- Fiscal: Very strained situation, arrears on the rise

→ Serious destabilisation of economic/fiscal situation

Recent policy measures

2014: NBU implements several administrative measures

FX measures (selection):

- Cashless: 6 days preannouncement for FX purchases
- Prohibition of premature repayment of cross border loans
- Cash: Withdrawal from FX bank accounts only up to an equivalent of 15,000 UAH per day

Assessment:

- Only fire fighting, no real stabilisation yet
- Administrative measures lose effectiveness after a while

5. How to overcome the crisis?

As of today: Only 1 out of the 3 options → IMF programme, probably accompanied by financial support from EU/USA

- Exchange rate: Devaluation already took place, now focus on flexible system and reduction of administrative measures
- Fiscal: Gradual balancing, cut in expenditure & procurement
- Energy prices: Gradual increase necessary for reducing the budget (short term) & the current account deficit (long term)
- Banking sector: Measures to stabilise the sector at a reasonable cost; liquidity measures and recapitalisation
- Discussion: Burden sharing by private bond holders?

Focus: Gov debt restructuring?

Gov debt/GDP, end 2013: 46%

At first sight: Not very high; but: debt/GDP could increase rapidly (devaluation, recession, banking recap & hidden debt)

Arguments pro restructuring (private sector involvement/PSI):

- Decrease in necessary funds from IMF/EU/USA
- Focus on internal spending priorities
- Moral hazard argument (IMF)

Argument against PSI: Negative impact on market access

Assessment: Good arguments for restructuring

But: Not too aggressive, otherwise impact on market access

Challenges for future stabilisation

- Political instability ahead of presidential elections in May 2014 and due to the Crimea conflict
- Possible Russian economic sanctions against Ukraine
  - Import restrictions through non-tariffs measures
  - Increase of tariffs for imports from Ukraine from currently 0% to 10% (on average); 1.7% negative impact on GDP
  - Higher gas prices
  - Measures to limit remittances from RU to Ukraine
  - Discontinuation of loans from Russian banks to Ukrainian entities; outstanding amount: USD 28 bn

6. Concluding remarks

- Macroeconomic stabilisation still possible
- Stabilisation crucial to avoid an abrupt adjustment (currency overshooting, state default, banking crisis), with negative impact on the economy and the wellbeing of the population
- However: In parallel to the stabilisation, the country needs to embark on structural reforms
- Reforms will contribute to investment and economic growth, thus reducing the negative impact of adjustment and likely Russian sanctions, as shown by Georgian experience 2006
- Key “reform programme”: DCFTA with the EU

Long-term lessons

Ukraine: For economic policy making not just important <u>what</u> measures are taken, but also <u>how</u> the process of policy formulation and decision making takes place

Crucial: Stronger independency and better use of professional resources of key state institutions such as NBU, NERC & MinFin

EU/donors: More emphasis on institution building for technical and financial cooperation

Furthermore for EU: Monitoring of macroeconomic situation should be more prominent in bilateral dialogue; signature of DCFTA with a very unstable country is difficult and risky

Contact

Dr. Ricardo Giucci
giucci@berlin-economics.com

German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59, D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
E-mail: info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de