

## Ukraine

### After the Orange Revolution – political stability necessary for economic recovery

- Ukraine's presidential election on 7 February appears to have been a democratic success. Viktor Yanukovich, who was removed as president during the Orange Revolution, is the apparent winner. There is a big risk that political turbulence will persist, however, since Yulia Tymoshenko, the other candidate, continues to have support in parliament.
- Ukraine's economy bottomed out last fall and significant challenges still remain. The real economy has benefitted from a rise in global demand for commodities, while inflation and the exchange rate have stabilised. Huge imbalances persist, however. The budget deficit continues to grow and the natural gas sector is struggling with significant losses and increasing liabilities. Households have been hurt by rising unemployment, real wage decreases and an increase in real debt burdens. The necessary economic reforms will continue to hurt households in the short term.
- Political co-operation will be critical to macroeconomic recovery. But the risks are great. One possibility is that early parliamentary elections are called, which would mean another election campaign. Greater turbulence remains a possibility. An alliance between the candidates would be the best way to agree on a difficult and unpopular economic stabilisation program to mitigate the crisis. In the medium term extensive reforms and liberalisations are needed to produce a higher and sustainable economic growth.

## New president but political uncertainty prevails

Ukraine appears to have conducted a largely free and fair election<sup>1</sup>, and voted the sitting president out of office and brought in his replacement during a period of substantial economic turbulence and global pressures. If the power shift is orderly, it would be a huge success for democracy in Ukraine, especially compared with many other former Soviet states. At the same time, however, politics in Ukraine are still overshadowed by the involvement of strong economic interests and by increasing scepticism about the political elite. Voter turnout is estimated by the election commission at 69%, against 77% in 2004. The key to increasing confidence in the political system is to strengthen the fight against corruption, while at the same time improving efficiency in the public sector.

*Historic election produces new president*

Former opposition leader Viktor Yanukovich appears to have won the second round of the presidential election and returned to the centre of Ukrainian politics.<sup>2</sup> He had been forced out of the same post in 2004 by the Orange Revolution after winning a tainted election. Yanukovich's political career began as a party functionary during the Soviet era, and he rose after Ukraine's independence to become prime minister under president Leonid Kuchma. Yanukovich's principal support comes from the Russian-speaking eastern parts of the country, which are dominated by heavy industry. During the election campaign he increasingly distanced himself from Russia and expressed his support for economic stability policies.

*Ukraine goes back to the future for a president*

Yulia Tymoshenko was unsuccessful in convincing enough voters who in the first round preferred one of the other candidates, and could not mobilising eligible voters that abstained from voting. As the sitting prime minister and dominant political figure in recent years, Tymoshenko, together with outgoing president Viktor Yushchenko, has dropped in opinion polls as the economy has worsened. At the same time she has retreated from her previous West- and Europe-leaning policies. Her efforts to appease Russia through the natural gas agreement in December and diminished support for NATO membership appears to be an attempt to attract more Russian-speaking voters. The growing conflict between the former allies in the Orange Revolution, Tymoshenko and Yushchenko, undermined any opportunity either had to become president, however.

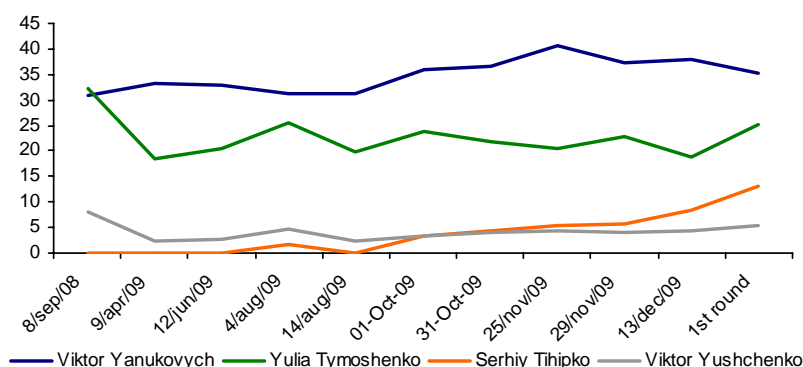
*Conflicts within Orange coalition doomed Tymoshenko*

---

<sup>1</sup> According to election observers from OSCE.

<sup>2</sup> Results showed Yanukovich receiving 49.0% of the votes, against 45.5% for Tymoshenko. According to news reports, Tymoshenko is considering whether to demand a recount in certain districts.

**Opinion polls and the first round outcome of the presidential election**  
(Percent of voters)



Source: Various opinion polls and election results from the first round

Despite Yanukovich's long, and not always flattering, history in Ukrainian politics, there are hopes that his election will break the paralysis in recent years caused by differences between Tymoshenko and Yushchenko. Yanukovich has gathered a group of advisers who are considered competent and goal-oriented, and he has changed his position with regard to Russia and the rest of the world. In addition, Yanukovich has signalled that he will aim to restore negotiations with the IMF on the macroeconomic stabilisation program. At the same time he has stated that Ukraine should remain neutral between Russia and NATO. He also does not support membership in the EU, but has pushed for direct contacts in the form of bilateral agreements on natural gas deliveries, for example.

*New president but uncertainty on new political direction*

The parliamentary situation remains complicated. Tymoshenko is prime minister and her bloc of three parties<sup>3</sup> has had support since the end of 2008 from the Lytvyn bloc, consisting of two parties<sup>4</sup>, as well as from Our Ukraine, the party of the current president Yushchenko. There have been a number of political manoeuvrings in recent years. In October 2008 Yushchenko dissolved parliament, but a new election could not be held after parliament ruled that it was a violation of the constitution and refused to grant the necessary financing. Yanukovich, as the newly elected president, can try to induce members of parliament to switch sides and support a new government loyal to him. If Tymoshenko retains her support, there is a significant risk that the country's leadership will remain bifurcated. Yanukovich could then call a new election to build a majority for his policies (provided that parliament accepts this), but this would mean another election campaign and more political indecisiveness.

*Political paralysis could persist*

Ukraine faces considerable challenges both political and economic. Corruption in politics and the public sector is extensive, and oligarchs, the powerful business owners who in many cases built their fortunes during the years following independence, have considerable influence. The country also faces decisive choices economically. Despite the high political

*New political situation, but the seriousness of the economic situation requires courage and compromise*

<sup>3</sup> All-Ukrainian United Fatherland, Social Democratic and Reforms and Order parties.

<sup>4</sup> People's Party and Labour Party.

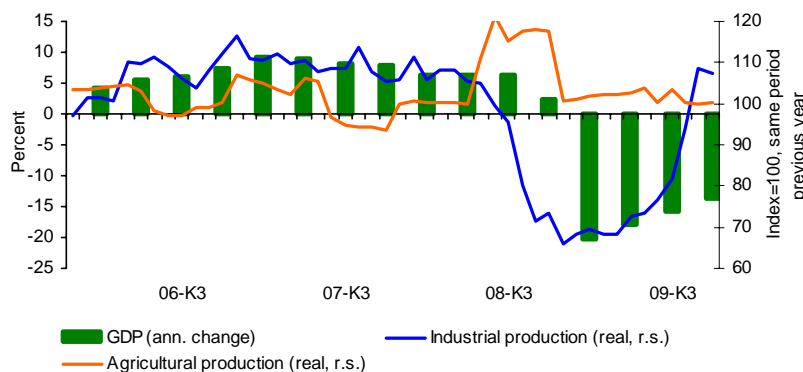
cost, reforms are needed to achieve a turnaround and create sustainable, dynamic development. This will require a willingness to compromise on the part of both the newly elected president and the opposition. Judging by the political climate in recent years, the likelihood of quick, effective decision-making is not especially high.

## Real economy has bottomed out, but it's a long way back

The severe economic slowdown eased at the end of last year. Preliminary data indicate that GDP fell by about 14%. This is slightly better than expected, but at the same time was one of the largest declines among major economies during the global downturn. Its dependence on steel exports and heavy industry made Ukraine vulnerable to the decline in global demand, at the same time that the financial system faced huge imbalances after years of rapid credit growth, especially with respect to loans in foreign currency. The recession bottomed out in the second half of 2009 and industrial production climbed as demand from Asia grew. The agricultural sector and food production have held up better and contribute to a stabilisation of the domestic economy. Still, the Ukrainian economy is significantly below its capacity ceiling and major imbalances remain.

*Hints of growing exports at the end of a dark year*

Real sector developments, 2006-2009



Source: Ukraine's national bureau of statistics

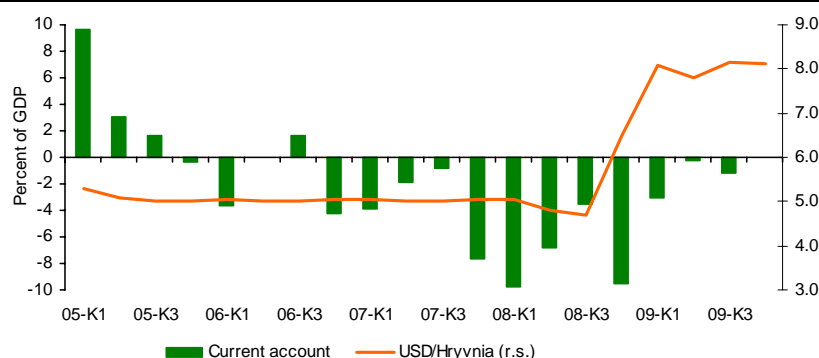
The domestic economy continues to struggle. While the export sector strengthened in late 2009, retail sales fell by over 20% in December 2009 and by an average of 19% for the year. The low level in 2009 would suggest positive growth numbers in 2010, but at the same time many households face a difficult situation, and it will take time to recover to the levels before the crisis. Unemployment is rising and is expected to hit 9% in 2009, an increase of more than 3.5 percentage points compared with the previous year. Real wages have eroded and are estimated to have shrunk by nearly 10% in 2009. Add to that a growing debt burden, in no small part due to the large share of loans in foreign currency that many households and businesses have.

*The domestic economy has been hard hit and is unlikely to generate growth*

At the same time that the current accounts deficit continues to decline, capital outflows are rising and a new balance of payments crisis remains a possibility. The majority of outflows consist of debt service by companies and banks, and since borrowing costs are increasing, it will be costly to refinance loans. As a result, the country's currency reserves are shrinking. Currently there is enough reserves to cover payments, but the huge outflows are creating uncertainty about Ukraine's solvency.

*Despite an improved current account balance, there is still a risk of an external payment crisis*

**Current account and the exchange rate, 2005-2009**



Source: Central bank of Ukraine

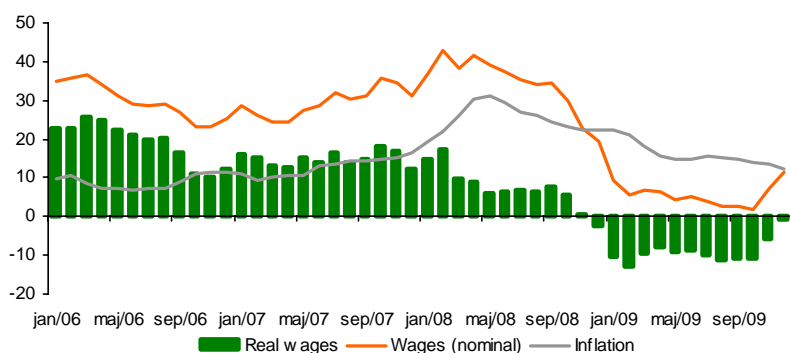
Despite the turbulence in the financial markets, the Ukrainian currency, the hryvnia, has remained remarkably stable after falling substantially in late 2008 and early 2009. The significant inflow of capital from the IMF and other public lenders has added to the central bank's reserves and can be used to support the hryvnia, while at the same time growing exports and falling imports have reduced demand for foreign currency. Of course this also means that the hryvnia could again come under pressure without further international support and an improvement in foreign trade.

*The hryvnia has stabilised after a sharp depreciation, but is dependent on external support*

Inflation has retreated from an annual level of over 30% in mid-2008 to just over 10% in late 2009. The major depreciation of the hryvnia, which is giving inflation impulses, is outweighed by weak domestic demand. The central bank has tightened its monetary policy as well. The money supply (M2) fell by 5% in 2009 at the same time that the credit expansion slowed, primarily led by the decrease in lending in foreign currency. Falling inflation, coupled with lower nominal wage increases, is making Ukraine more competitive.

*Falling inflation and low wage increases are making Ukraine more competitive internationally*

**Inflation and wages, 2006-2009  
(Annual change in percent)**



Source: Ukraine's national bureau of statistics

Transit trade in natural gas, a key sector of the Ukrainian economy, has stabilised this winter, but fundamental problems persist. Imported gas is the primary energy source in Ukraine and significant revenue is generated from the transit trade. Last year's natural gas crisis, when Russia shut off deliveries to Ukraine, as a result of which large parts of Europe were left without energy supplies, has not been repeated this year. In December Prime Minister Tymoshenko signed an agreement with Russia stretching over 10 years that makes the natural gas and transit trade more predictable. Naftogaz, the state-owned energy company, continues to have serious profitability problems and a considerable debt burden. Last fall the government, in connection with the election campaign, refrained from raising energy prices at the consumer level despite that they represent only about a third of the import cost. As a result, Naftogaz's cash flow is insufficient and the state has had to step in to help it pay its bills.<sup>5</sup> Normalising Naftogaz would require substantially higher energy prices as well as a large capital infusion to reduce its debt burden. Both measures would be politically controversial.

*Financial deficits and a growing debt burden are making the natural gas sector a ticking time bomb*

The growing budget deficit will be the biggest challenge to meet following the election. During the campaign, spending was allowed to grow. Promises made to large groups such as pensioners will be difficult to meet without sacrificing macroeconomic stability. Moreover, the government did not manage to get a 2010 budget passed by parliament. When it became obvious that the spending increases announced last fall could not be combined with the economic stability program, the IMF suspended payments in November 2009. Other international financiers are following suit and restrain their support, and uncertainty among many private actors is increasing.

*The budget deficit is the biggest threat to macroeconomic stability*

<sup>5</sup> In December of last year the IMF modified the economic stability programme and reduced the minimum level for the central bank's international reserves to allow foreign payments for natural gas deliveries, among other things, to continue.

Our macroeconomic forecast is cautious. Despite a slight improvement late last year, the risks are significant. The political uncertainty is already evident and the global economy shows no signs of a rapid turnaround. We anticipate positive GDP growth in Ukraine of 2-3% in 2010 and 2011, while unemployment is expected to rise above 10% in 2010 before falling in the latter half of 2011. Uncertainty in the financial markets will increase pressure on the hryvnia, which is expected to depreciate slightly. Weak domestic demand will hold inflation in check, at the same time that higher energy prices and the weaker currency will create inflation impulses. Inflation is not expected to drop below 10% until 2011.

*Slow economic recovery forecast for Ukraine*

## Political developments are critical to economic stabilisation efforts

The political process this spring will be decisive to whether Ukraine manages to reverse its stagnation and get its economy to recover and grow again. There are three plausible scenarios:

*Three scenarios*

(i) *Political cooperation between president and prime minister:* Yanukovich and Tymoshenko agree to work together on economic stabilisation policies and succeed in introducing major reforms to reduce the budget deficit and reform the energy sector. In this scenario the IMF starts reissuing payments at the same time that the private sector regains confidence in Ukraine and increases its investments. A relatively quick recovery begins and economic growth reaches 5-6% with a stable currency, and falling inflation and unemployment. Considering the political culture in Ukraine, this scenario has to be considered relatively unlikely.

*An alliance could lead to rapid stabilisation of the economy*

(ii) *Political tensions persist and parliamentary election is called:* This is our main scenario and is considered the most likely. An election campaign makes it hard to restart negotiations with the IMF, whose most important demands are fiscal reform and raising energy prices to market levels. International organisations are also cautious in increasing economic support beyond what has already been promised. Until the parliamentary election is held, probably sometime in May, there are no significant reforms and an economic recovery has to wait. Economic growth is expected to be slightly positive, while unemployment and inflation slowly ease, as in our macro forecast above.

*A new parliamentary election would prolong political uncertainty*

(iii) *The political divide deepens.* Protests spread among the population. An open, extra-parliamentary conflict results in a situation similar to 2004, but with less legitimacy. Political decision-making is paralysed and market actors within and outside Ukraine react by reducing investments and increasing capital outflows. It would be impossible for the IMF to restart negotiations on support measures and confidence in the hryvnia would erode. Inflation accelerates due to an increasing budget deficit and Ukraine finds it hard

*New street protests would lead to political chaos*

to meet its foreign payments. Confidence is undermined and the economy falls into a new recession.

Even though the actions of the government and president are important to the stabilisation and reform process, Ukraine is also highly dependent on global developments. A robust recovery in global demand, together with stable financial markets, is critical to whether the Ukrainian economy will recover. This is not sufficient in the longer term, however, to achieve sustainable economic growth and thus improve the standard of living for a majority of the population. That would require genuine reforms in the public sector and extensive liberalisation of economy.

*Global developments are important to Ukraine, but sustainable growth also requires reforms and liberalisation*

*Magnus Alvensson*

---

## Economic Research Department

SE-105 34 Stockholm  
Telephone +46-08-5859 1031  
ek.sekr@swedbank.se  
www.swedbank.se

*Legally responsible publishers*  
Cecilia Hermansson,  
+46-8-5859 1588

Magnus Alvensson, +46-8-5859 3341  
Jörgen Kennemar, +46-8-5859 1478  
ISSN 1103-4897

Swedbank Baltic Sea Analysis is published as a service to our customers. We believe that we have used reliable sources and methods in the preparation of the analyses reported in this publication. However, we cannot guarantee the accuracy or completeness of the report and cannot be held responsible for any error or omission in the underlying material or its use. Readers are encouraged to base any (investment) decisions on other material as well. Neither Swedbank nor its employees may be held responsible for losses or damages, direct or indirect, owing to any errors or omissions in Swedbank Baltic Sea Analysis.

