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The economic crisis in Eastern Europe: The case of the Ukraine

Robert Kyloh* - ***Policy Integration Department***

*The views expressed are those of the author and do not necessarily reflect those of the International Labour Organisation.

1. Economic overview

Between 2000 and late 2008 Ukraine's economy was buoyant with average annual growth in excess of 7%. This represented a desirable turn-around after the economic collapse of the previous decade. However, like many other countries in Europe, the Ukrainian economic upswing faltered in the second half of 2008 when commodity prices declined sharply and export markets contracted. In October 2008 the situation deteriorated dramatically when one of the largest banks in the country was placed under receivership. This sparked massive capital outflows which in turn generated a crisis on the foreign exchange market and a significant currency devaluation despite interventions by the National Bank and a major credit crunch for the real economy.

Economic activity has contracted sharply since October 2008 with a large proportion of heavy industry temporarily closed or operating far below capacity. Real GDP declined by over 20% at an annual rate in the first quarter of 2009 and by around 18% in the second quarter.[1] As a result the labour market conditions have deteriorated dramatically. The unemployment rate (as measured by the labour force survey) jumped from around 5 % in the second quarter of 2008 to over 10 % in the first quarter of 2009.[2] But this masks the real level of stress in the labour market. As in past recessions labour market slack is concentrated in a significant expansion of involuntary short time work and administered leave and an explosion in wage arrears.

While many observers have recently suggested that the global economy was starting to recover from the recession the economic outlook remains very sober in the Ukraine. The IMF forecasting declines in output of 14 % for 2009 as a

[1] State Statistics Committee of Ukraine. The date for the second quarter of 2009 are preliminary estimates.

[2] Ukraine: Second Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria (pdf 1 MB), International Monetary Fund, Country report 09/270, September 2009.

whole and several other economic institutions predicting even more dramatic declines.[3] Although financial conditions in the Ukraine appeared to stabilise somewhat during the Spring of 2009, the currency has again been under increasing pressure since mid-Summer as political tensions and doubts about economic management mount in the lead-up to Presidential elections scheduled for January 2010.

2. IMF assistance and implications for wage, social and labour market policy

At a very early stage in the economic crisis the Government of Ukraine turned to the International Monetary Fund (IMF) for assistance.[4] In early November 2008 the Ukrainian Government signed a standby agreement with the IMF for 16.4 billion dollars. The original memorandum of understanding contained provisions requiring the Government to maintain tight fiscal discipline in the latter months of 2008 and produce a balanced budget in 2009. Much of the fiscal tightening in the original agreement was expected to come through reduced expenditure on public sector wages and benefits plus reductions in the overall level of social expenditure. The government apparently agreed to freeze on public sector wages during 2009. As part of the austerity measures Ukraine also agreed to revise the indexation arrangements for various social transfers from a backward looking to a forward looking arrangement. Given the introduction of this reform at a time when the expected inflation rate declined from around 25% in 2008 to an estimated 14% in 2009 (due to the contraction in domestic demand) this implied a significant decline in the real value of pensions and other transfer payments.[5] Moreover, the original agreement with the IMF required the Government to postpone for two years a planned increase in the minimum wage to the minimum subsistence level. This rescinded a promise the Government had previously made to increase the minimum wage by some 35 %. Other measures adopted to help achieve the fiscal contraction included a phased increase in energy prices.

Implementation of the above mentioned conditions proven problematic as domestic economic conditions deteriorated far more dramatically then expected when the original negations with the IMF took place. This resulted in delays in the disbursement of the loan which have now been overcome and alternations to the attached conditions. In particular, due to the massive economic contraction and declining tax receipts the IMF accepted a significant widening in the general government deficit, initially to 4% of GDP then to 6% of GDP during the June-July 2009 review of the stand-by-agreement.[6] Despite, the widening of

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[3] For example, The Economist Intelligence Unit is forecasting a real GDP decline of 17% for 2009 as whole.

[4] The IMF and the World Bank have been very active in Ukraine over a prolonged period. Both institutions have previously made loans to Ukraine and have exercised considerable influence over economic policy in the country from time to time over the last decade.

[5] IMF, ibid.

[6] IMF, ibid. The revised fiscal deficit target of 6% of GDP does not include the cost of recapitalising

the fiscal deficit the emphasis by the IMF and World Bank on the need to reduce the public sector wage bill and social expenditure has remained firm. Complete compliance with such conditions has however proven politically difficult for the Government with trade unions and the political opposition parties campaigning heavily against cuts in wages and pensions. In fact the major opposition party (the Party of the Regions) recently introduced a draft law providing for substantial increases in public wages and pensions. These issues are likely to figure prominently in the Presidential election campaign that is now underway. As a result it would appear that the IMF have decided to wait until the election is completed before seeking to further tighten public expenditure in these areas.[7]

Unfortunately despite the dramatic deterioration in the labour market mentioned above automatic stabilizers have not been allowed to operate as fully as would be desirable. During the current recession many countries have expand expenditure on unemployment benefits, increased the duration of benefits, made them available to wider range of people and also increased expenditure on active labour market policies.[8] By contrast during the current recession financial resources for unemployment benefits and active labour market policies have been tightly constrained. This is reflected in a huge discrepancy between unemployment levels as measured by the Labour Force Survey (10.3% in the March quarter) and the number of unemployed registered with the Public Employment Service. The latter increased from just 1.8% of the working age population in September 2008 to 3.2 % in January and February of 2009, before declining again. By July 2009 the number of unemployed registered with the Public Employment Service had declined to a mere 2.2% of the working age population. Given the dramatic decline in output during the first half of 2009 and the unemployment trends depicted in the labour force survey, these trends in registered unemployment most likely reflect the strict eligibility criteria for registration with the PES for the provisions of unemployment benefits and the way in which this criteria has been implemented during the current recession.

3. Focusing on the real causes of the recession

To a significant degree Ukraine finds itself in economic crisis today because of a massive expansion of private foreign

banks which is estimated to cost Government an additional 5% of GDP, nor the deficit of the national gas supplier (Naftogaz) which is estimated at 2.6% of GDP.

[7] In its report on the second review of the stand-by-agreement the IMF states : « The authorities have adopted a time-bound road map describing the schedule and main steps in the design of pension and tax reforms. They have committed to issue by end- September, a comprehensive analysis of the situation of the pension system and of the tax system, on the basis of which they intend to formulate concrete policy actions by end- October, which will be implemented as part of the 2010 budget.

[8] Protecting People, Promoting Jobs : From crisis response to recovery and sustainable growth (pdf 1.05 MB), Communication to G20 Leaders by ILO Director General, Geneva: International Labour Organisation, September 2009.

debt in recent years. The fiscal position of the country prior to the crisis was relatively sound and the level of public foreign debt was very moderate.

However much of the growth in private domestic demand in recent years was financed by commercial banks and was devoted to speculation in the real estate market, conspicuous consumption expenditure and private investment. Ukraine experienced something similar to the US "sub-prime" explosion of debt without adequate collateral. However, there was a significant difference because the vast majority of the commercial bank loans were in hard currency. Private banks borrowed massive amounts of foreign currency and re-lent this money at a substantial margin. As a result over 80% of foreign debt is held by the private sector. With currency devaluation the repayments on these loans have increased substantially and default becomes a high probability.

As in other countries the commercial banks that provided these loans have been in a precarious situation since the latter part of 2008 and have ceased to provide credit. The recapitalisation of commercial banks has therefore been a high priority in the stand by agreement with the IMF. However this is an extremely expensive exercise. In the Ukraine the IMF have estimated that bank recapitalisation will involve an additional cost to the public deficit of about 5 % of GDP in 2009. Given such a high cost, at a time when tax revenues were declining dramatically, the Government was required to significantly reduce other areas of public expenditure to keep the total public deficit for 2009 within an acceptable range.[9] While it is important to restore the flow of credit to viable enterprises the costly recapitalisation of the banks has not produced any substantial public benefits to date. In fact implementation of the recapitalisation has proven a protracted affair with the Government only announcing the effective nationalisation of three large commercial banks through recapitalisation in July 2009. Further action is expected on this front. The recapitalisation of the banks also raises important moral hazard issues, particularly when the opportunity cost is a substantial reduction in public expenditure on the poor and vulnerable. This background should not be forgotten when, after the Presidential election, pension reform and further wage restraint take centre stage in the public policy debate.

Further resources

ILO. 2009. Global Employment Trends. (Geneva: ILO).

ILO. Laborsta, Database of labour statistics.

[9] Despite efforts to reduce public expenditure during the first half of 2009, the IMF concluded in July 2009 that without further corrective measures the total public sector deficit (including the Naftogaz deficit and the cost of bank recapitalisation) would reach 9.2% of GDP in 2009.