The Current Economic Slowdown
Analysis and Policy Recommendations

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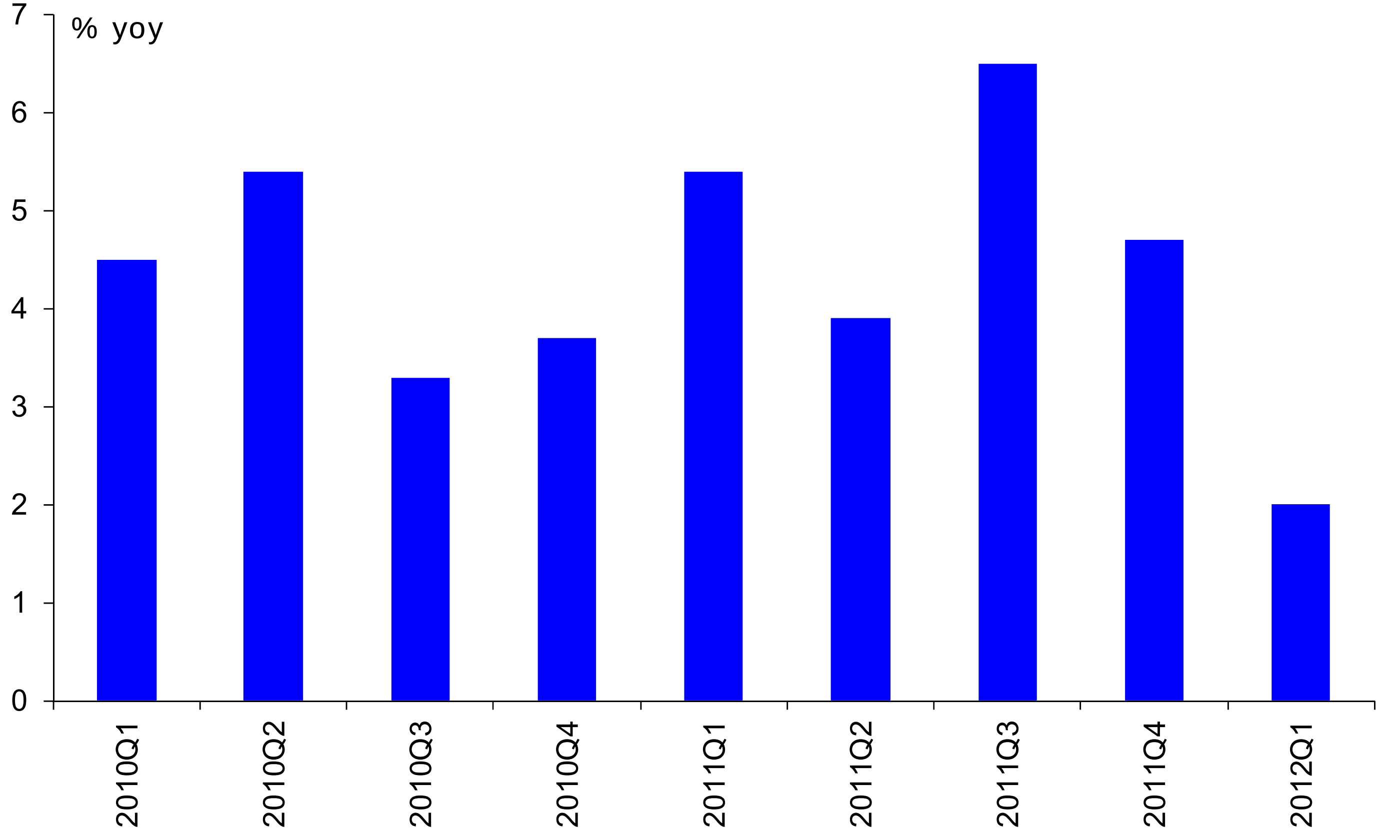
Overview

1. Recent Economic Slowdown: Facts

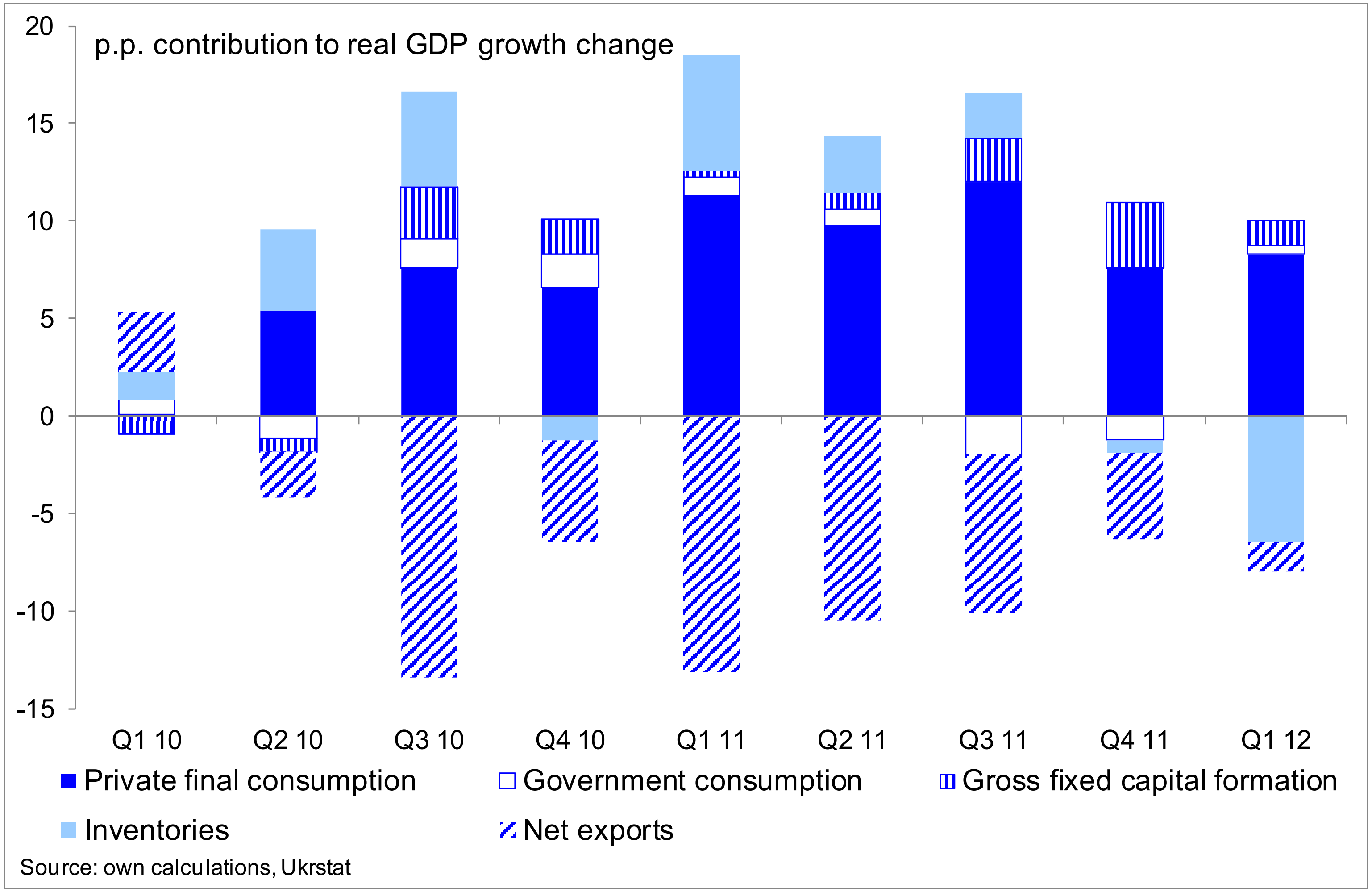
- Real GDP growth:



Source: Ukrstat

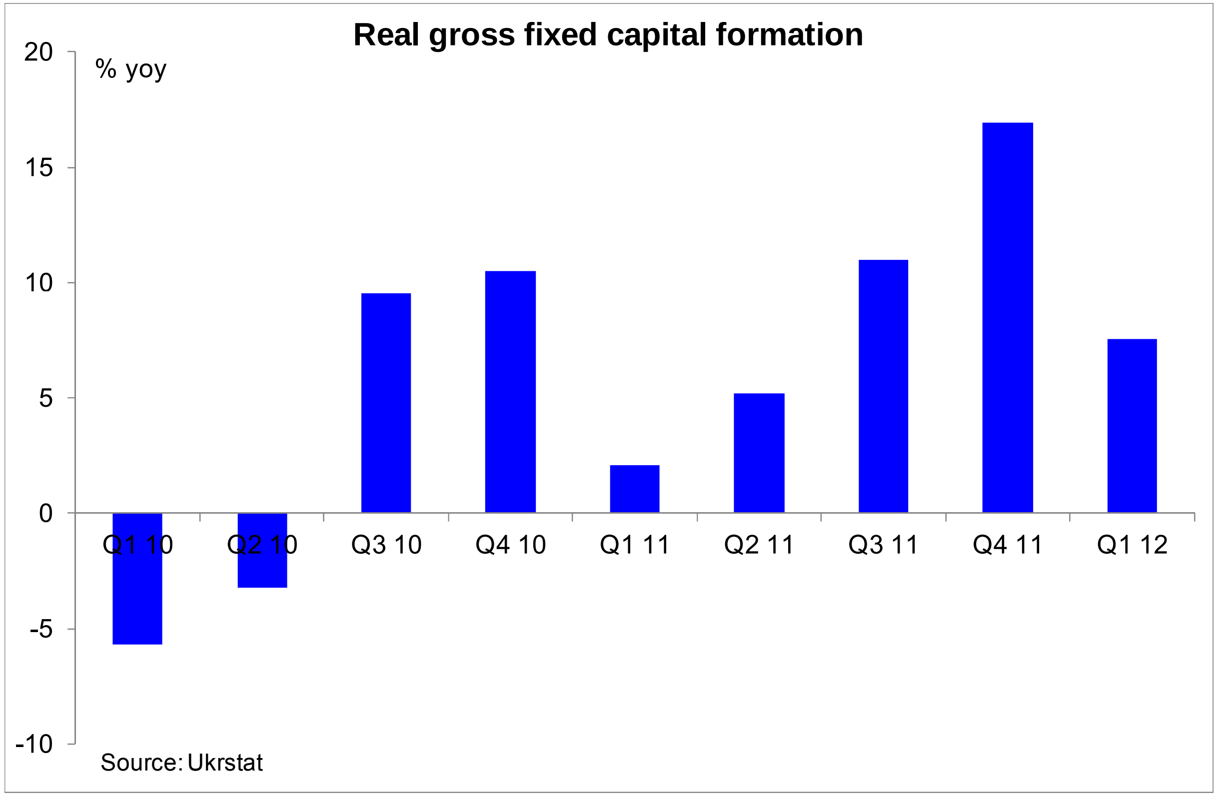
- **Conclusion: Economic growth is slowing down**

Real Economic Growth: Demand



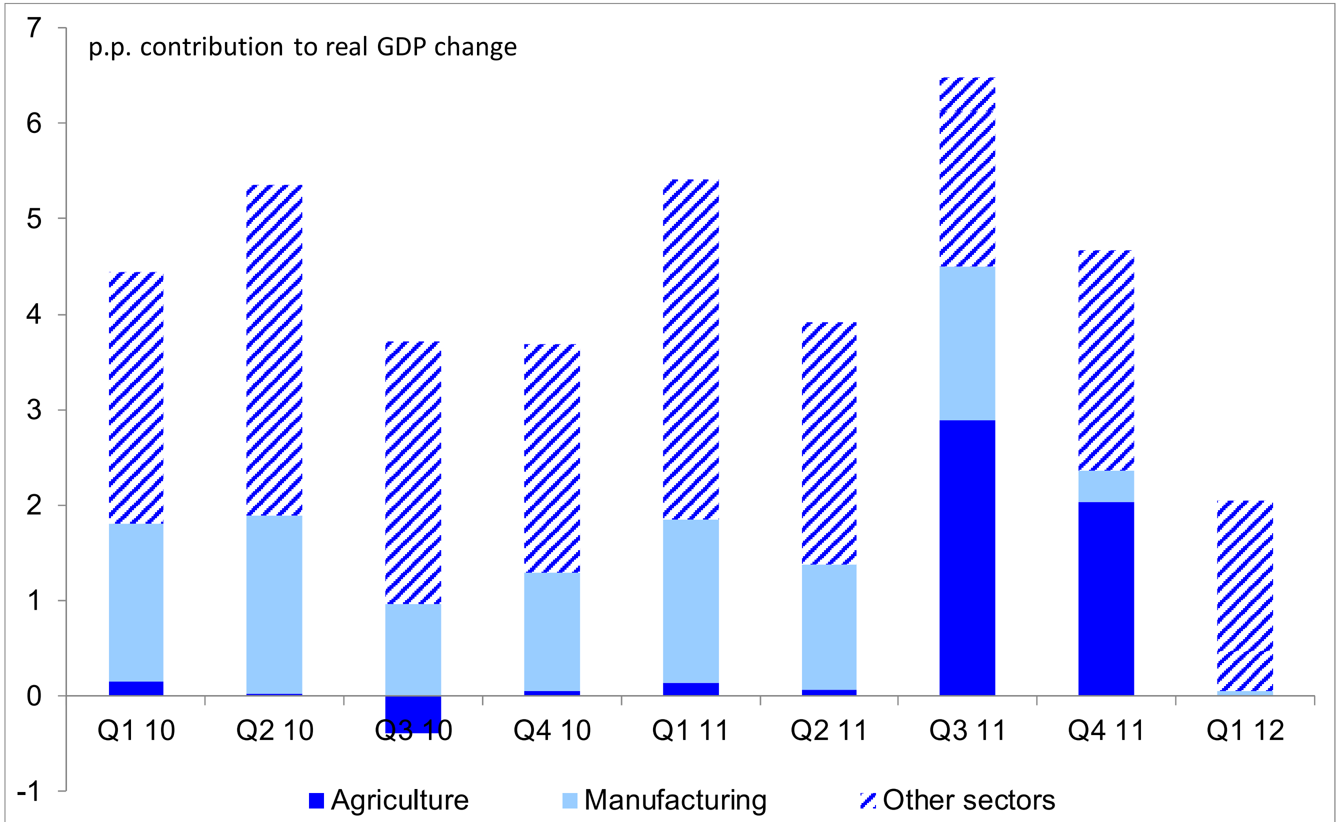
- **Conclusion: Real private final consumption delivers the main contribution to growth, while investments disappoint**

Focus: Investments



- **Conclusions:**
  - **Recent slowdown of investment observable (1Q 2012)**
  - **Furthermore, no strong recovery after crisis - real gross fixed capital formation in 2012 is estimated to reach only 58.4% of 2007 level**

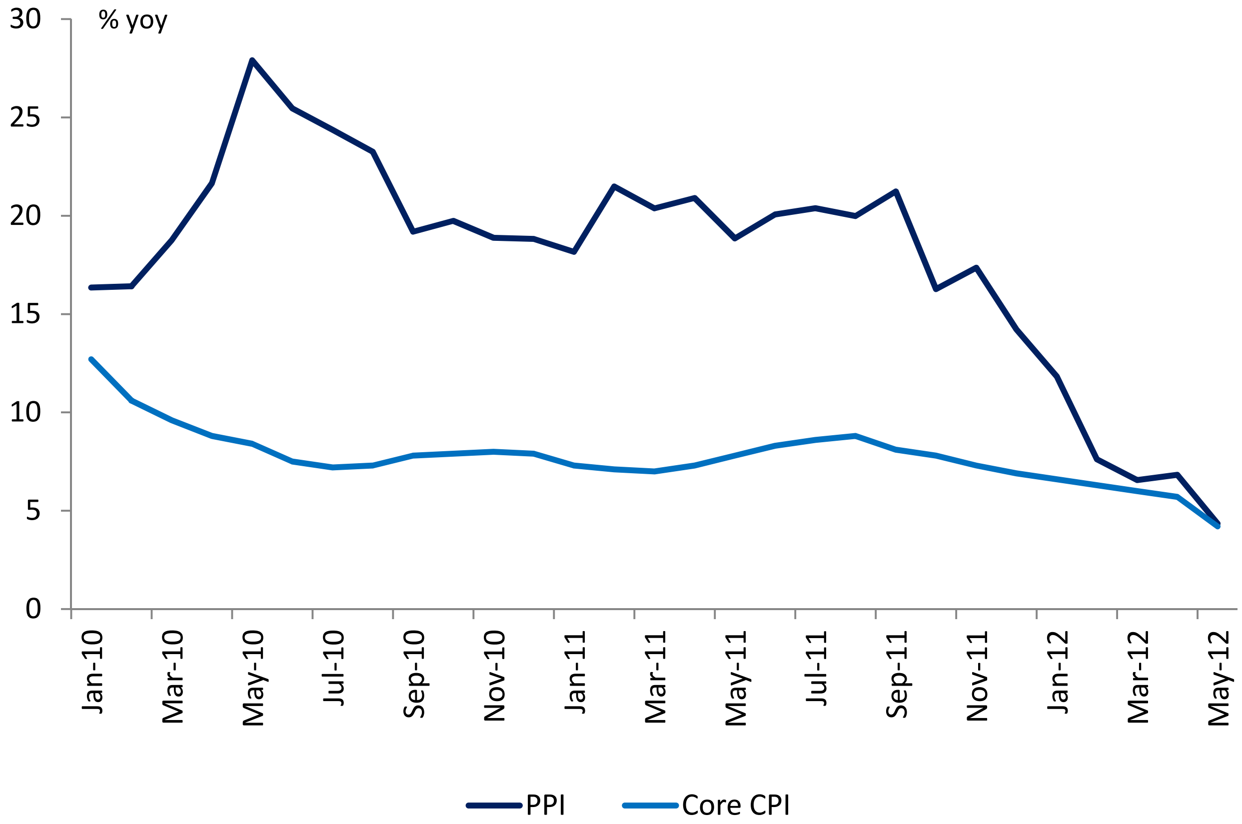
Real Economic Growth: Supply



Source: own calculations, Ukrstat

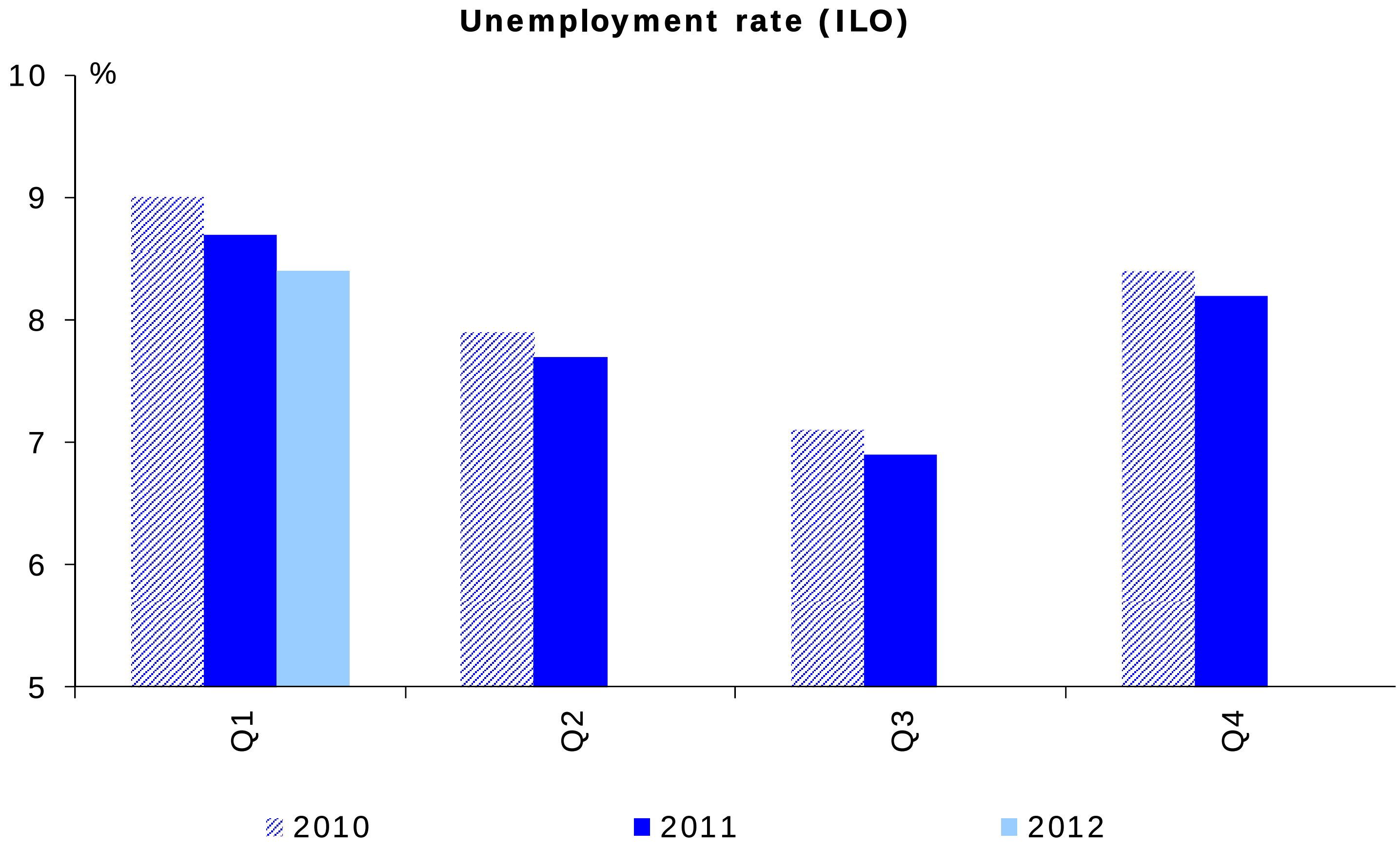
- **Conclusions:**
- **Growth of manufacturing sectors (primarily export-oriented) decelerated due to weak external demand**
- **Agriculture contributed the most to economic growth in 2011 due to record harvest**

Price Developments



- **Conclusion: Deceleration of price dynamics point to weakening domestic demand**

Labor Market Developments



Source: Ukrstat

- **Conclusion: Labour market remains weak – unemployment rate is still higher than before the crisis**

Assessment

- The economy shows clear signs of a slowdown
  - External demand is weak, and expected to remain so for the time being due to a number of external risks
    - Escalation of Eurozone debt-crisis
    - Further fall in commodity-prices (in particular steel)
    - Slowdown of world economy
    - China's economy cooling off
  - Domestic demand is mainly led by consumption; investments are relatively weak

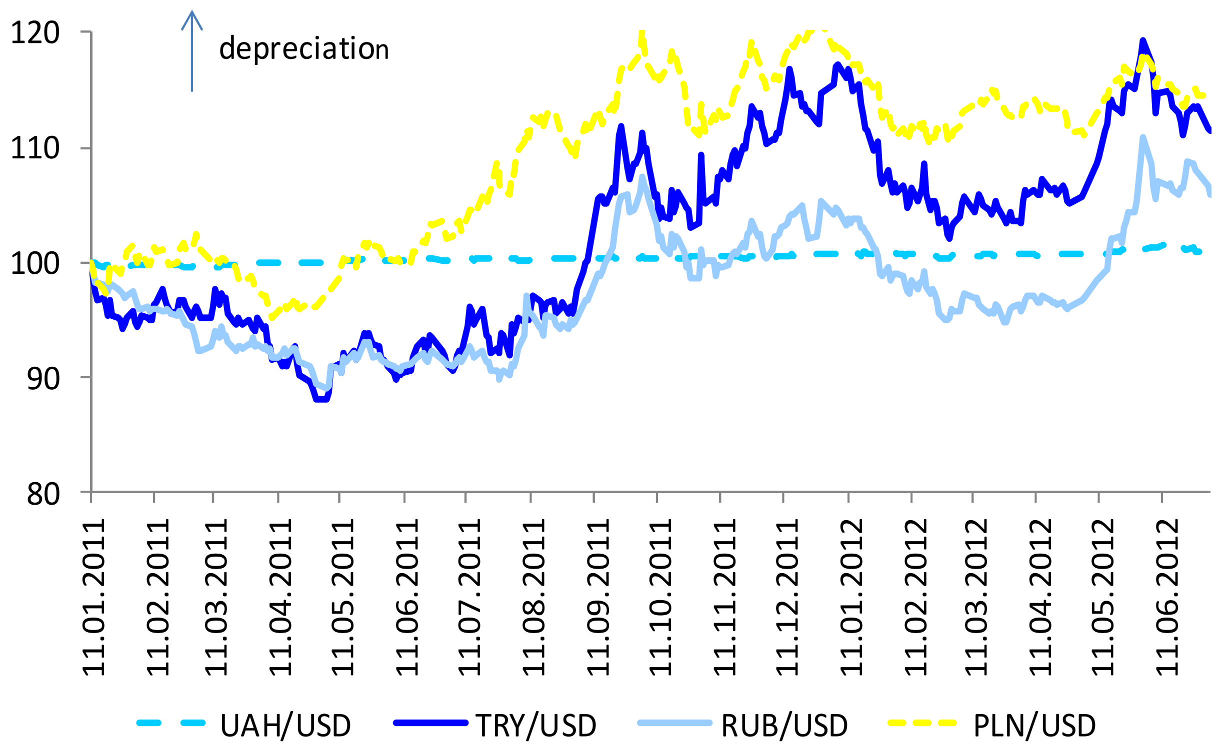
2. Selected Areas for Policy Reaction

- The slowdown raises the question how policy makers should react, with the objective of stimulating economic growth
- Which instruments might be used to stimulate weakening growth, in particular via demand components (relevant in the short term) and the supply side (more long term)?
- We analyse instruments in the following policy areas:
  a. Monetary and Exchange Rate Policy
  b. Fiscal Policy
  c. Financial Sector Policy
  d. Investment Climate
  e. Trade Policy and Regional Integration

a. Monetary and Exchange Rate Policy

- Observation I: UAH has recently appreciated relative to other regional currencies due to its tight link to the USD:

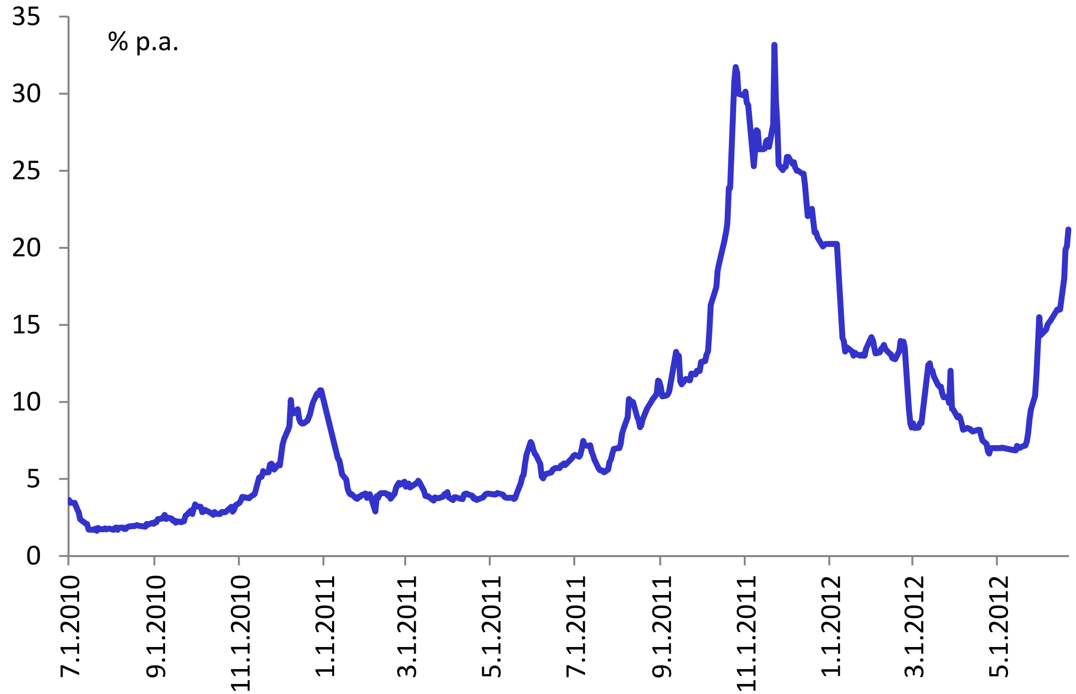
Nominal exchange rates vs. USD, (indexed)



Source: ECB, NBU

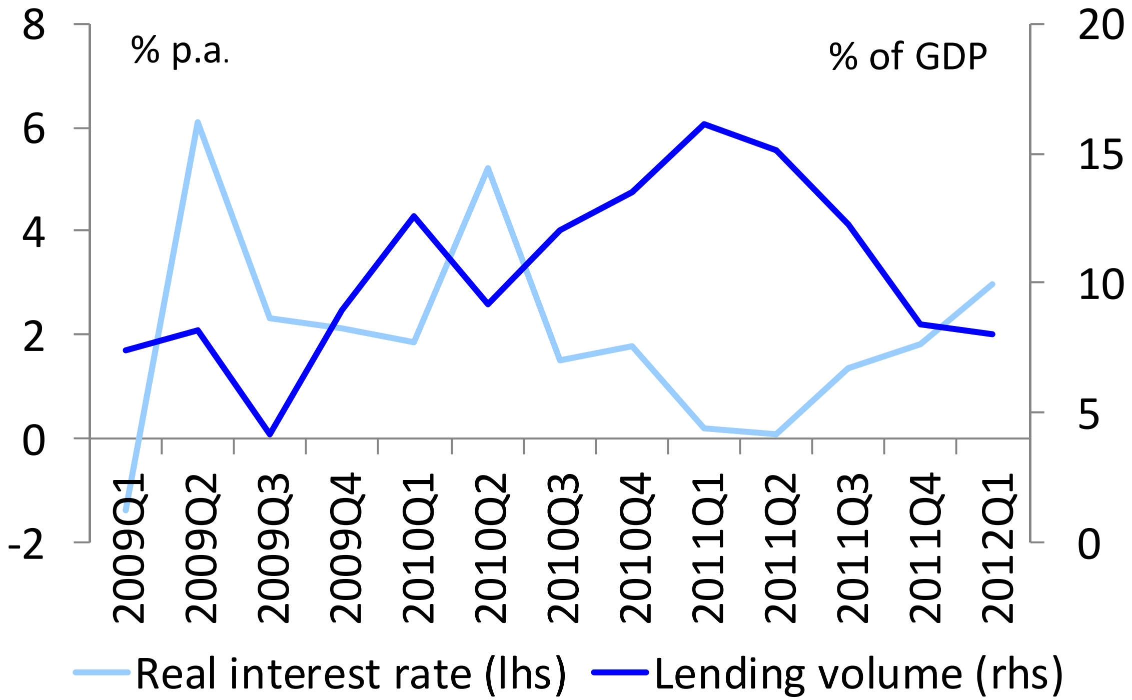
- Observation II: NBU is forced to keep a tight monetary policy stance in order to defend UAH peg under current circumstances

Kyiv-Prime (1 month)



Source: AYA securities

- Observation III: This has a negative influence on the recovery in the banking sector, where lending is rather weak and lending rates still high:



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 inflation expectations from the NBU enterprise survey, lending volume reflects loans issued over the quarter as % of GDP

Source: own calculations, NBU

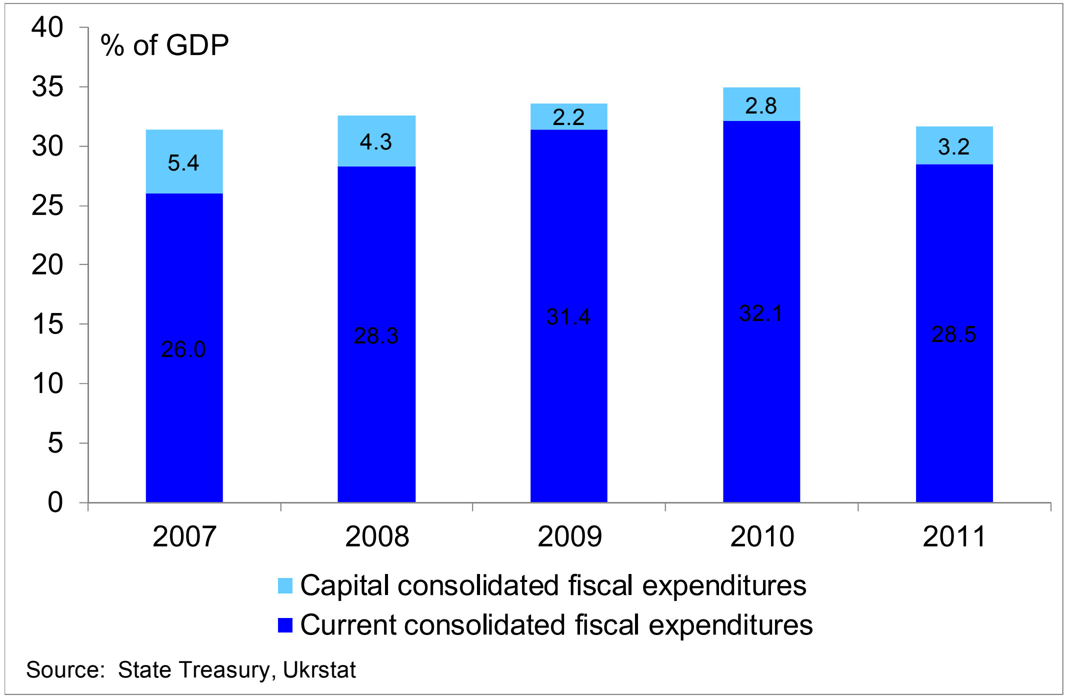
Assessment

- More FX flexibility would be beneficial in the current situation, as:
  - The currently very tight monetary policy might be relaxed, supporting lending and <u>investments</u>
  - This might contribute to an improvement in <u>net exports</u>/the current account deficit
- Currently, no fundamental need for huge devaluation - this should limit expected depreciation
- Gradual approach necessary as dollarization is still high and hedging markets not functioning properly
- See PB 01/2012 for further information

b. Fiscal Policy

- In terms of analysing the potential impact of fiscal policy on economic growth, we distinguish 2 issues here:
  1. (Classical) deficit spending
  2. Changing the structure of expenditures towards higher efficiency and growth-supporting measures
- Regarding issue 1, we see no room in the short term for a loosening of fiscal policy in order to stimulate growth; there is no alternative to the continuation of fiscal consolidation that started in 2010
  - Discussion “growth versus austerity” to some extent similar to Eurozone
- On the contrary, restricted access to (external) finance limits room for manoeuver for government, as the pool of domestic savings is limited
- Furthermore, it competes with private business for financial resources, and keeps their borrowing costs high (i.e. crowding out is a real issue)
- **Conclusion: Currently no room for deficit spending; on the contrary, fiscal consolidation needs to continue**

- Regarding issue 2, fiscal policy can make an important contribution to stimulating economic growth in the long term by changing the structure of expenditure towards higher public investments, which is right now strongly biased towards current expenditures



Capital fiscal expenditures in Ukraine were lower than 10% of total spending or 4% of GDP during recent years, while in emerging economies they accounted on average for 14% of total government spending or 4.4% of GDP

- **Conclusion: Changing the expenditure structure may give an important boost to economic growth in the long term**

Assessment

- In light of the evident financing pressures, and the risk of crowding out private investments, the government should target as short-term measure mainly to “cut fat” in expenditure; some tax exemptions could be revised to ensure additional revenues
- This would lead to a decrease in funding needs, which would help the private sector to attract more financial resources and facilitate investment
- A change in expenditure towards more public investments is needed from a long-term perspective. However, this requires a number of accompanying reforms like utility tariff increases
- The Government should also promote PPP in energy and utility sectors, which would ensure additional investments against the background of restricted fiscal spending

c. Financial Sector Policy

- Banking sector has not fully recovered from the crisis, this process is still very weak and fragile
- This creates problems for the transmission of monetary policy impulses to the economy and keeps financing costs high and investment at a low level
- Before this problem is not solved, a low level of lending will prevail and no significant support for investments and the real economy
- Financial sector reforms thus needs to stimulate the recovery in the banking sector, which will in turn support investments and economic growth
- Many individual problems exist, but the still high level of non-performing loans (NPL) is a major drag on new lending

Assessment

- Clearing the high burden of NPLs from the banking system is a necessary precondition for restarting new lending
  - Over the last several years, legislation related to debt collection was revised significantly in favor of lenders. In 2013 new bankruptcy law will become effective, which will also remove some obstacles to bad debt collection. Still, it is unclear if changes in law will translate to better debt collection
- In the longer term, initiatives to make lending a safer process must be a key priority for the authorities, as this will help to achieve <u>stability and growth</u> in the banking sector, something that was missing before the crisis
  - An important institutional feature to lower interest rates and improve access to credit (e.g. for SMEs) are credit bureaus, whose activities should be improved
- See our policy papers PP/02/2011 and PP/04/2012 for further recommendations and suggestions

d. Investment Climate

- Sluggish development of private investment (of both domestic and foreign origin) not just an issue of high financing costs and more moderate long-term economic growth after the crisis
- Business and investment climate a key factor for investment decisions. Here, some worrying tendencies:
  - Despite ambitious plans, a number of indicators (e.g. “Doing Business” by the World Bank, where Ukraine dropped from 149th to 152nd place) signal a deterioration over the last years. This is supported by results of the IER Business Tendency survey
  - Net FDI inflows in Jan-May 2012 were significantly lower than in 2011 (USD 1.8 bn vs USD 2.8 bn)
- **Conclusion: Improving the investment climate could deliver an important boost to investments and economic growth**

Assessment

- General areas where action is needed:
  - Regulatory reform should be continued to ease the cost of Doing business, including full introduction of one-stop-shops for receiving licenses and permissions
  - Tax administration should be transparent and fair to taxpayers (VAT should be refunded in time and in full, advanced EPT payments as well as presumptive EPT payment should be stopped)
  - Start-ups should be promoted (see PB/02/2011)
- Some of these measures do not cost anything; on the contrary, they may even save public resources
- Specific recommendations regarding FDI attraction and the role of the promotion agency see PB/05/2012

e. Trade Policy and Regional Integration

- Trade policy is not an instrument of macroeconomic stabilisation policy, but used during the crisis 2008/2009
- Currently, draft law No.9241 (passed in first reading) suggests to increase duties up to the level allowed by the WTO in order to increase fiscal revenues and support domestic production in certain sectors
- The draft is <u>not fully compatible</u> with the WTO as some of proposed tariff rates exceed the WTO bound level
- The draft concerns about 10% of Ukraine’s imports or USD 8.4 bn (2011) and would increase the weighted average import tariff rate for these products from 1.8% to 7.3%.
- Most affected trade partners: EU (48%), China (10%)

Expected impact:

- Potential increase in fiscal revenues (depending on elasticity of demand)
- Reduction of official imports, which could improve the CA balance
- Unclear impact on domestic production:
  - Selected goods are not produced domestically
  - At least 40% of involved imports are products used in domestic supply chain as raw/semi-processed products, thus cost of domestic production increases or import substitution occurs with unclear quality effect
  - 38% of involved imports are machinery building products thus higher tariff rates could negatively affect capital expenditures
- Negative impact on domestic consumers as tariff increase will be eventually passed through to consumer prices
- Additional trade risks in case other countries follow similar steps/retaliate
- **Conclusion: Not the right instrument to stimulate economic growth, as many risks are associated with such a move. A liberal trade regime is beneficial for the economy and should be thus kept**

- Rather than moving towards more protectionism, Ukraine should instead push ahead with the DCFTA with the EU (as part of the broader Association Agreement)
- This fundamental step would serve as a reform and modernisation anchor in several sectors of the economy, and extend well beyond bilateral trade flows:
  - Extensive regulatory approximation (Procurement, Competition Policy,…)
  - Increase in FDI inflows to be expected as a result of a better domestic investment climate (link to previous point)
  - Improved access to markets of the third countries through harmonization of standards with the EU

Assessment

- The currently discussed No.9241 is in our view the wrong instrument to support economic growth; increased protectionism will be of little help to overcome the challenges Ukraine currently faces
- A measure that would undoubtedly have a positive long-term impact on economic welfare and growth in Ukraine (through different channels) would be the signing/ratification of the DCFTA with the EU (as part of the broader Association Agreement)

3. Conclusions

- A slowdown of the economy is clearly underway, driven mainly by weak external demand
- Key question: How to respond in order to stimulate economic growth?
- In the short-term, authorities should focus on boosting private investment, which is way below its pre-crisis level, through different instruments:
  - A more flexible exchange rate that would help to soften monetary policy and thus support lending
  - A tight fiscal policy that prevents crowding out
  - Improvements in the investment climate
- A gradual FX flexibilisation would at the same time contribute to an improvement in net exports

- In the <u>longer term</u>, growth can be a supported by increasing mainly the supply-side of the economy:
  - A fiscal policy shift towards public investments instead of the prevailing current expenditure
  - A financial sector reform that fixes the situation in the banking sector and contributes to sector stability and growth and supports the real economy
  - A trade/regional integration policy that follows Ukraine's liberal trade policy heritage and uses the DCFTA as a main reform anchor for modernising Ukraine's economy

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