

Ukraine stands at economic abyss

Key Points

- [Ukraine](#) is facing a major economic crisis, exacerbated by continuing political division.
- Political infighting over the country's gas import industry could put future payments for Russian gas at risk, raising the prospect of another gas crisis in the short term, similar to that seen in January.
- As Ukraine's economic conditions worsen, social unrest is likely to grow over 2009, although political division rather than public protest remains a greater risk to government stability.

As the full scale of the global financial downturn becomes apparent, few countries have escaped its detrimental effects. Fewer still have been as severely impacted as [Ukraine](#).

The country has seen industrial output, the pillar of its economy, collapse and the economy is expected to contract by at least six per cent in 2009, according to international financial institutions. In October, the government was forced to seek a USD16.4 billion emergency loan from the International Monetary Fund (IMF).

This economic crisis is being aggravated by the deep political divide that has beset the country for the past three years, a problem further exacerbated six months ago when the Orange coalition collapsed and President Viktor Yushchenko disbanded parliament. This political jockeying, exposed in a raid by the Ukrainian Security Services (Sluzhba Bezpeky Ukrayiny: SBU) on the state-owned gas firm Naftogaz Ukrainy on 4 March, is threatening to derail attempts to alleviate the economic crisis, exposing the country to the risks of widespread social unrest and increasing the risk of another gas crisis with [Russia](#).

Political strife

Yet fears of imminent economic collapse are exaggerated and are a consequence of [Ukraine's](#) seemingly never-ending political crisis, instability and weak leadership. The loud and deep acrimony between Yushchenko and Prime Minister Yulia Tymoshenko, who have accused each other of treason and corruption since 2008 as part of a prolonged struggle for power, has severely damaged [Ukraine's](#) international image and the reputation of the country's political leadership who emerged following 2004's Orange Revolution.

The president and prime minister have occasionally come together to show public unity. During the January crisis when gas supplies from [Russia](#) were temporarily halted, they signed a joint statement outlining [Ukraine's](#) negotiating position. Similarly, a joint letter to the IMF was sent on 3 March urging it to release the delayed second tranche of the USD16.4 billion stabilisation loan. So far, only the first tranche of USD4.5 billion has been released.

The government has fulfilled two of the three IMF requirements for the release of the second tranche, including floating the hryvnia and restructuring banks, but balked at calls to reduce budget deficits to one per cent of gross domestic product (GDP) by reducing social spending with presidential elections due in early 2010. The IMF relented somewhat on the latter issue, agreeing to increase the deficit limit to three per cent of GDP.

However, the power struggle between Yushchenko and Tymoshenko has shown no sign of abating. With Tymoshenko facing falling support (13 per cent support in February 2009), and the president's recent approval ratings barely scraping three per cent, the bitter rivalry between the two has only increased as presidential elections approach.

This is further complicated by their involvement in competing factions within the opaque world of [Ukraine's](#) natural gas imports. This laid the foundation for the 4 March raid by the SBU's Alpha anti-terrorist unit on Naftogaz Ukrainy. In turn this has put into question the system in place to pay for Russian gas imports. The March bill for gas imported from [Russia](#), due in early April, is set to exceed USD1 billion. With economic problems expanding, any additional confusion could raise the prospect of a renewed gas crisis with [Russia](#) and a potential gas supply shut off.

Economic strife

The inability of the country's leadership to work together was one of the key factors behind the IMF's decision to delay the second tranche of the stabilisation loan. Should this renewed bout of infighting put the reforms demanded at risk, then there could be further delays in the disbursement of the much needed funds.

[Ukraine's](#) GDP declined 20 per cent in January, according to the National Bank, and its industrial output, which has been in freefall since July 2008, collapsed by a staggering 34.1 per cent year-on-year in January - the steepest decline for 15 years. Metallurgical production, which had constituted 40 per cent of [Ukraine's](#) export earnings in recent years, experienced the worst decline of any sector at 46 per cent.

Western credit agencies have reduced [Ukraine's](#) ratings to crisis levels that suggest the country is vulnerable to non-payment of its external debts. Credit default swaps on [Ukraine's](#) Eurobonds stand at 4,000 basic points, the highest in the world to insure sovereign debt.

With countries traditionally defaulting when the external debt to GDP ratio is 50-60 per cent, [Ukraine's](#) 12.6 per cent ratio remains low and does not constitute an immediate threat of default. [Ukraine](#) owes USD18 billion in state and state-guaranteed external debt of which just under half (USD8.2 billion) is owed to international organisations that are unlikely to push [Ukraine](#) into default. However, an additional threat is posed by the country's USD90 billion of corporate external debt, which could become the state's responsibility through the re-capitalisation of sections of the banking sector.

Civil strife

These problems are beginning to have a profound affect upon the population, raising fears of civil unrest over the coming year.

Unemployment is set to grow to upward of nine per cent during 2009 and eastern [Ukraine](#), home to much of the country's industrial base, is likely to be hardest hit. Some limited protests have already been held, including a 10,000-strong demonstration on 12 February denouncing proposed tax increases in Kiev, while on 23 February a number of relatively small protests were held across the country to criticise the government's handling of the crisis. Should political infighting further accentuate the problems, the size and intensity of these protests can be expected to grow.

FORECAST

The most recent political clash over natural gas imports could put future payment for Russian gas in question, raising the potential for a renewed gas crisis from early April. Likewise, the ongoing power struggle among the Ukrainian leadership is putting its economic recovery at risk. The declining financial conditions in the country are likely to lead to larger protests in coming months, although severe social unrest remains unlikely in the run up to 2010's presidential elections.