Policy Briefing Series [PB/03/2013]

The economic implications of the Eurozone crisis on Ukraine

Identification and quantitative assessment of transmission channels

Robert Kirchner, Ricardo Giucci, Vitaliy Kravchuk

German Advisory Group Ukraine

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Structure

1. Introduction

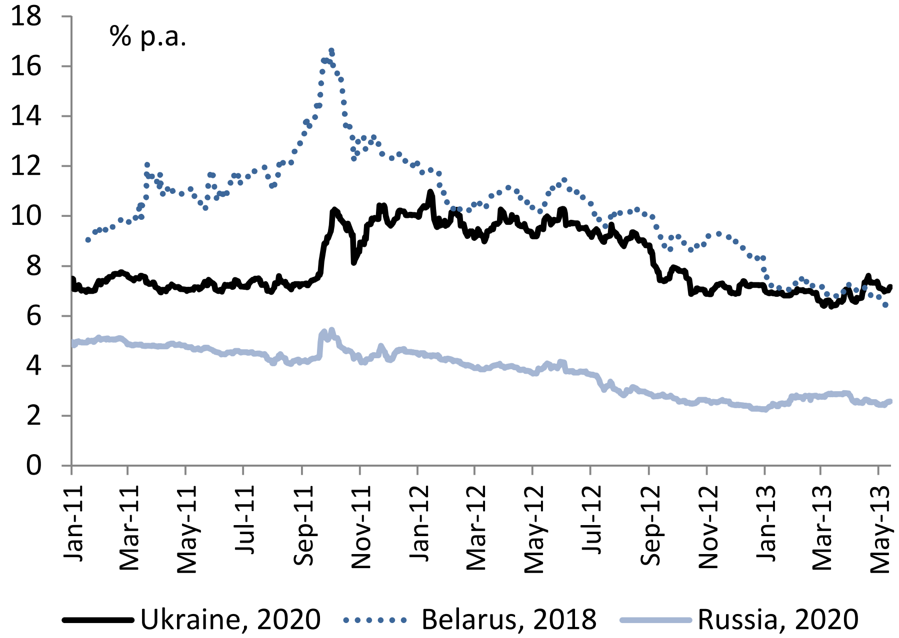
- As we argue in our previous Policy Briefing PB/07/2012, the Eurozone crisis that started in spring 2010 in Greece has <u>three</u> components:
  - Public debt crisis
  - Banking crisis
  - Economic growth crisis
- Apart from affecting Eurozone countries, the crisis also poses a major and on-going challenge to neighbouring countries, as economic and financial linkages are strong
- Each component of the crisis has thus potential implications for Ukraine, which has strong links to the EU and the Eurozone
- This policy briefing analyses and assesses these linkages in more detail

2. Overview of transmission channels

- Public debt channel: Financial investors are reluctant to finance low-rated countries
  - Problems in EU-peripheral bond markets makes it more difficult for lower-rated sovereigns to access international capital markets
  - Result: Rise in bond yields and/or lack of market access
- Banking channel: Financial turmoil in Eurozone
  - Eurozone banks are cutting back their exposure abroad in order to improve their balance sheets and concentrate on home markets
- Economic growth channel: Recessions in many Eurozone countries impact economic growth in neighbouring countries via
  - Lower demand for goods from neighbouring countries
  - Less FDI from Eurozone countries into neighbouring countries
  - Lower remittances from Eurozone to neighbouring countries

3. Public debt channel: Eurobond yields

Eurobond yields

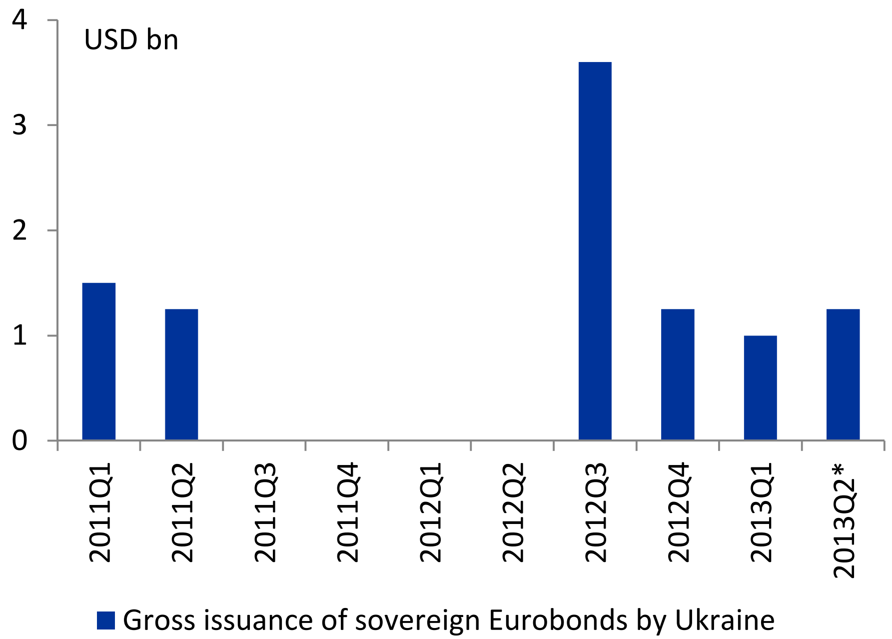


Source: Cbonds

- The public debt crisis in the Eurozone had a negative impact on <u>low-rated</u> sovereigns outside the Eurozone
- Ukraine (Rating: B/B3) recorded high and volatile yields on sovereign bonds issued on foreign markets (Eurobonds), in particular during Q3 2011 – Q2 2012
- A similar picture applies to Belarus, which has the same rating
- However: Russia's (Baa1/investment grade) yield much less affected
- The situation for Ukraine improved from Q3 2012 onwards, as yields came down

Strong impact on Ukraine's sovereign bond yields on <u>secondary</u> markets, especially from Q3 2011 – Q2 2012

3. Public debt channel: Access to foreign markets

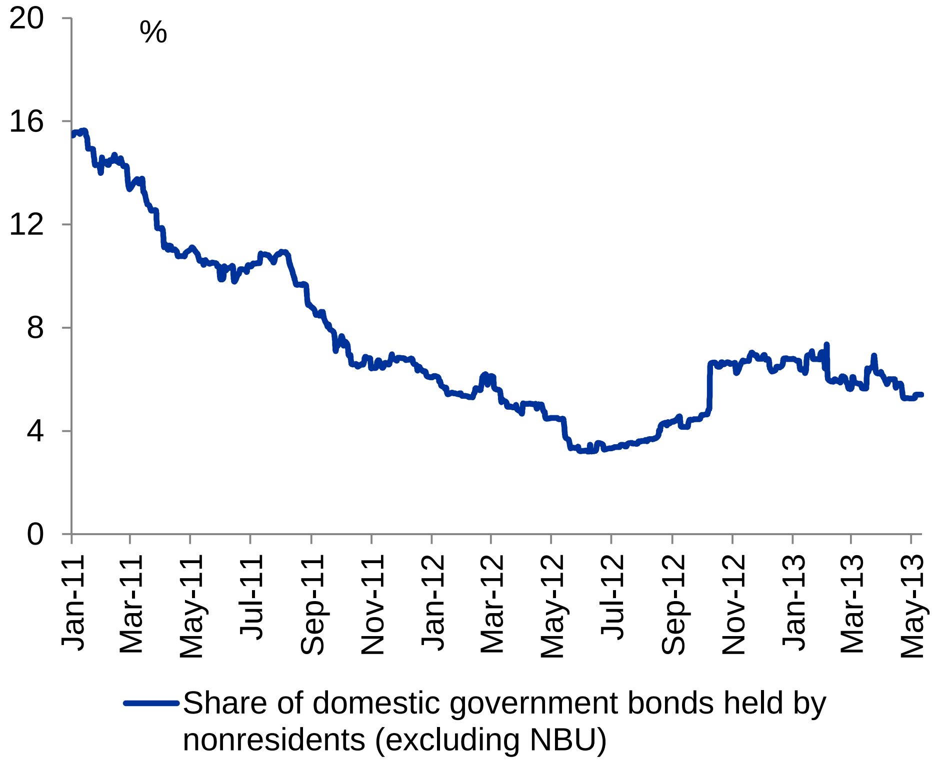


Source: MinFin, own calculations
**Issuance as of 16.05.2013*

- The crisis-related turbulence on the secondary bond market had also implications for the primary market, i.e. the issuance of new debt
- Indeed, Ukraine was not able to issue Eurobonds at reasonable cost in Q3 2011 - Q2 2012, and thus remained absent from the market
- This was a challenge for policymakers, as other sources of budget finance had to be identified, and/or budget adjustments had to be implemented
- In parallel to the improvement in secondary market yields, Ukraine regained access to the primary market in Q3 2012

Temporary loss in primary market access during Q3 2011 – Q2 2012

3. Public debt channel: Local bond market



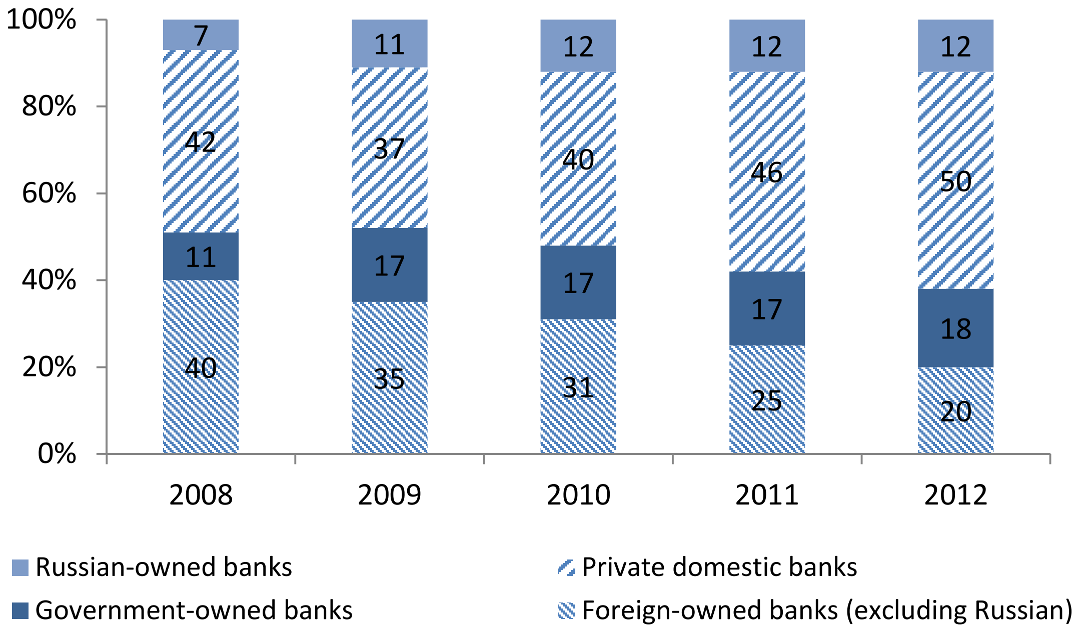
- The local sovereign bond market was not able to de-couple from the developments on external capital markets
- Specifically, the participation of foreigners in the local sovereign bond market more than halved since Jan 2011
- Again, some stabilisation can be observed from Q3 2012 onwards

The <u>local</u> bond market mirrors the negative developments observed on external markets

Source: NBU

4. Banking channel: Share of EU banks

Ownership structure in banking sector

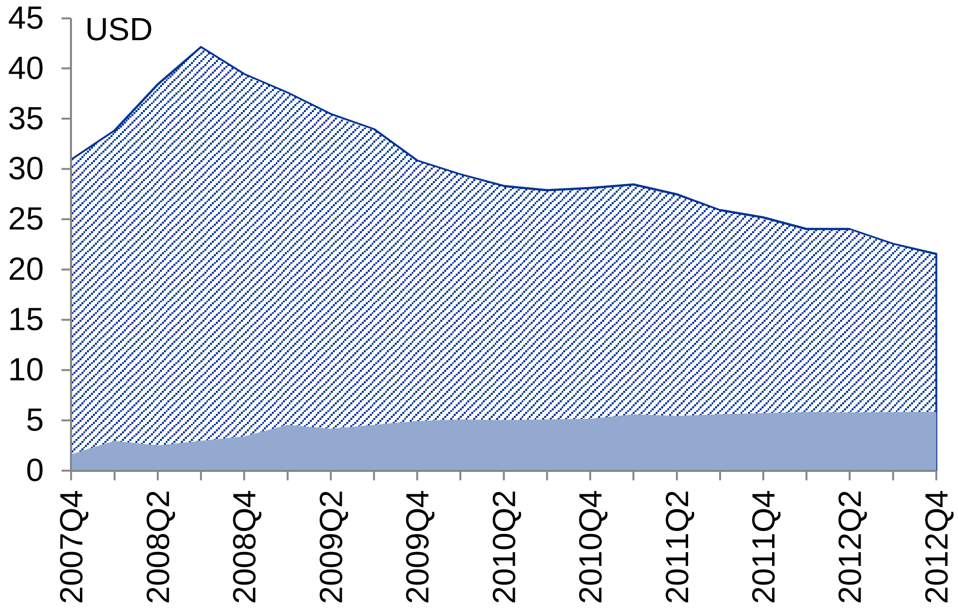


Source: Raffeisen Bank Aval based on NBU data

- Continous decrease in market share of non-Russian (i.e. mostly EU) foreign banks, from 40% to 20% of total assets since 2008
- Process started already after global financial crisis, but has been further aggrevated by Eurozone crisis developments

The Eurozone crisis contributed to the ongoing reduction of the market share of EU banks operating in Ukraine

4. Banking channel: External debt of banks

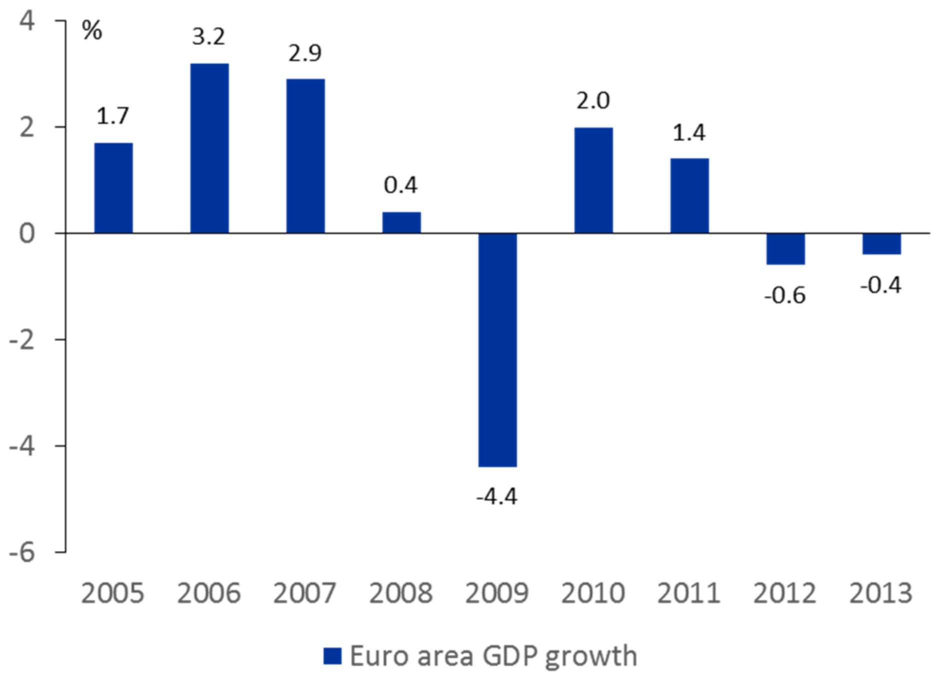


Source: Own calculations based on NBU data, annual reports of banks
** IER estimate based on annual reports of largest Russian-owned banks*

- Trends described before can be also observed in external debt statistics
- The banking sector continues to repay (net) external debt, a trend that has started in the global financial crisis
- This trend is observed despite the fact that Russian-owned banks increased their respective exposure
- Thus, banking crisis in Eurozone seems to have contributed to the external debt reduction and thus to a reduction in lending capability of the banking sector

External debt developments are consistent with a picture of a decreasing market share of EU banks in Ukraine

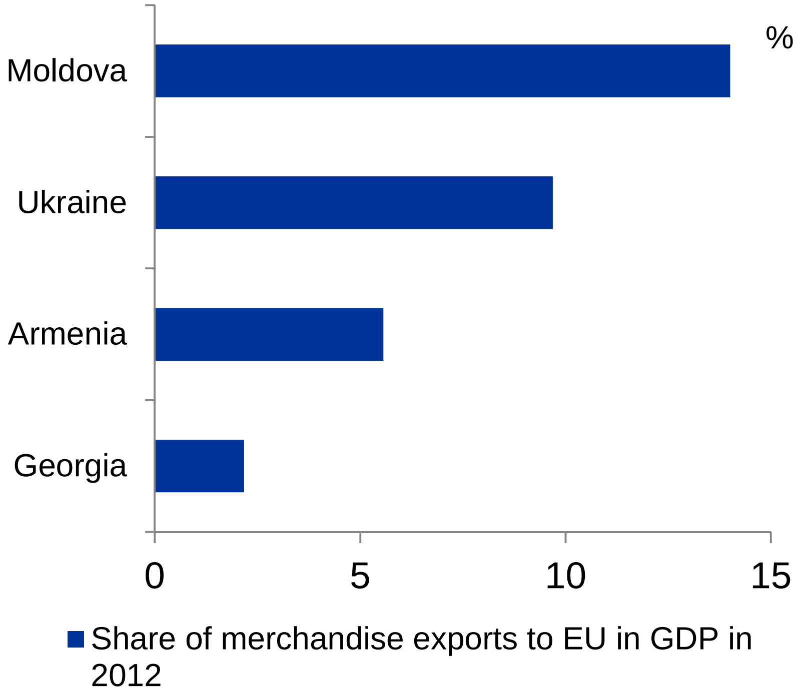
5. Economic growth channel



Source: Eurostat
Note: Forecast for 2013

- Several countries in the Eurozone are currently facing recession
- Economic growth in the Eurozone was negative in 2012
- This situation is likely to continue in 2013, as:
  - Austerity limits the space for fiscal policy
  - Monetary policy, which is already expansionary, is faced with structural headwinds
  - Weak banking sectors limit new lending

Significant export exposure to EU…



Source: COMTRADE, National statistical offices
Note: Due to lack of data on service exports, only merchandise (i.e. goods) exports are shown

- The EU is an important export market for Ukrainian goods and services, representing 25.1% of total exports
- Given that Ukraine is a very open economy (exports/GDP = 50.9%), exports to the EU amount to a sizeable 12.8% of GDP
- This figure is rather high in a CIS context, if energy exporting countries are excluded

Significant trade exposure of Ukraine to the EU and to the Eurozone

… and close relationship

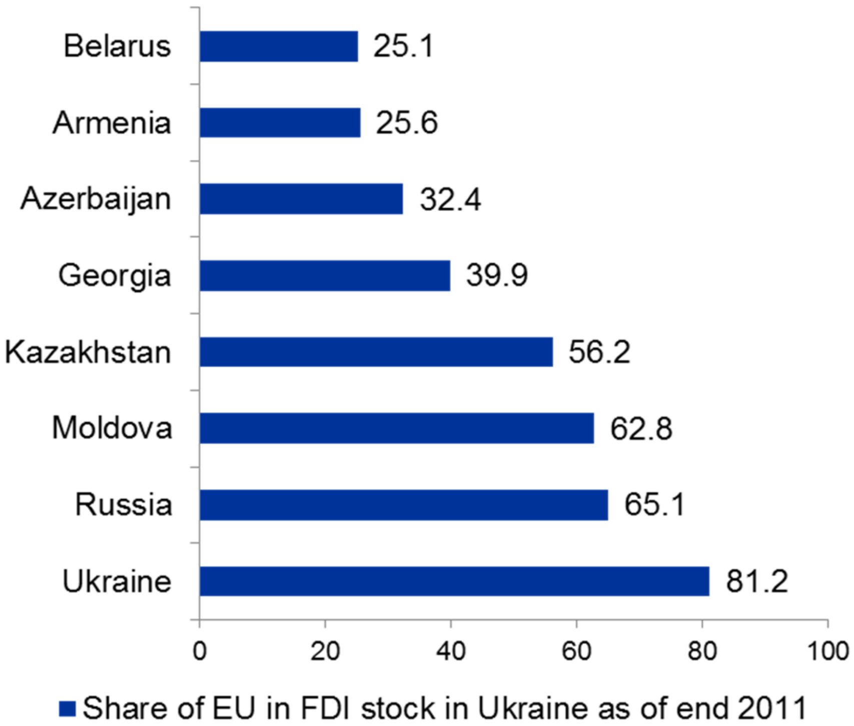
Source: Eurostat, Ukrstat

- The significant trade exposure implies that EU growth dynamics directly affected export flows, as the chart demonstrates
- In 2012, exports to the EU shrank by 3.4% in USD terms
- Exports to other areas where less affected:
  - CIS countries: -1.2%

    (incl. Russia: -6.9%)
  - Asia (excl. CIS): +0.6%
  - Africa: +66.6% (to USD 5.8 bn)

Negative impact of the Eurozone crisis on Ukraine's exports

High exposure to FDI from EU

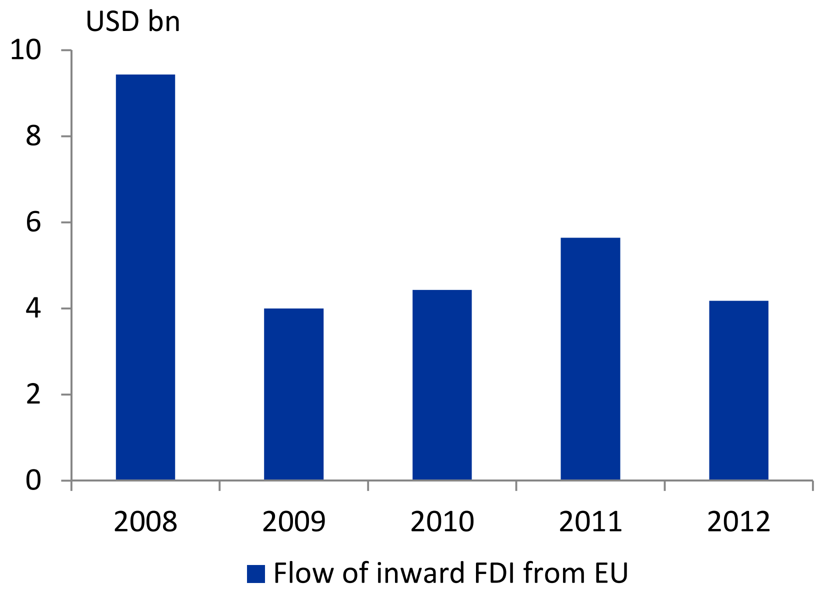


Source: Moody's Investors Service

- Apart from trade flows, Ukraine is also linked to the EU through investment flows
- Specifically, EU countries are the most important source of FDI in Ukraine, with a share of 81.2% in the country's FDI stock
- This figure probably overstates the true ultimate EU owners, as Cyprus' large share is a special case
- Nevertheless: The overall importance cannot be denied

This high exposure makes Ukraine vulnerable to negative developments in the Eurozone that may impact the willingness and/or ability of EU firms to invest abroad

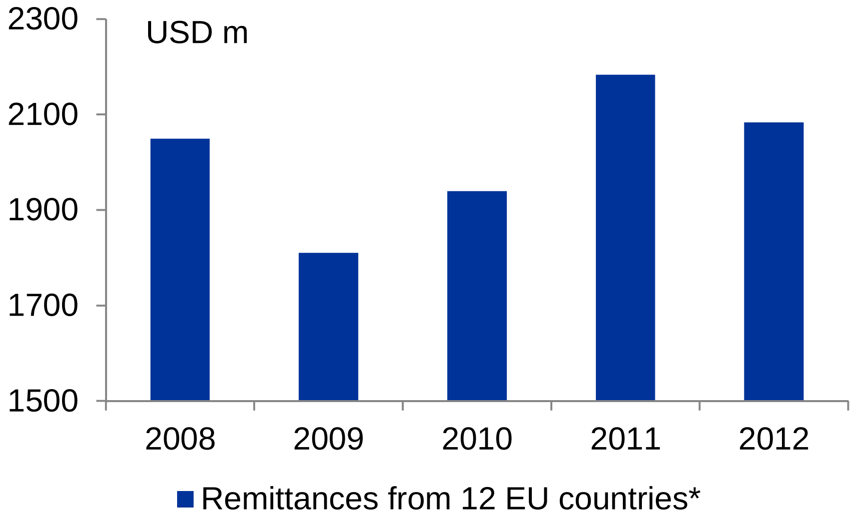
FDI inflows from EU declined recently



Source: Ukrstat

- Indeed, the turbulences in the Eurozone affected FDI inflows negatively during 2012, as can be clearly seen in the chart
- If we would exclude Cyprus as a special case, the picture would be even more negative, as almost all inflows during 2012 came from Cyprus

Impact on Remittances



Source: own calculation based on NBU data
* remittances through formal channels from Germany, Cyprus, Greece, Italy, Spain, Netherlands, UK, France, Portugal, Belgium, Poland, Lithuania

- Remittances play an important role in the Ukrainian economy
- Total remittances (incl. via informal channels) are estimated at USD 7.5 bn or 4.3% of GDP in 2012
- Remittances from EU (including informal channels) amounted to USD 2.6 bn in 2012, which represents about 35% of the total
- The relative importance of remittances is particularly strong in some regions of Ukraine, such as Western Ukraine

The Eurozone crisis led in 2012 to a fall in remittances from the EU by USD 100 m or 5%, when compared to 2011

6. Conclusions

Eurozone crisis had so far a negative impact on Ukraine through <u>different</u> channels

1) Public debt channel

- Volatile yields and restricted access to external capital markets had a negative impact on public debt management and fiscal policy

2) Banking channel

- Deleveraging by EU-owned banks contributed to lower banking lending

3) Economic growth channel

- Lower exports to EU contributed to current recession in Ukraine
- This is also the case for the reduction in FDI and remittances from the EU

Thus: Eurozone crisis contributed to some extent to the current recession in Ukraine

However: Domestic factors such as an inadequate macro policy mix and a lack of structural reforms are in our view much more important in explaining the current bleak economic situation in Ukraine

6. Policy implications

How should Ukraine react to the Eurozone crisis?

It is necessary to improve economic policy in order to minimise the negative impact

1) Public debt channel: More prudent macroeconomic policy ⟶ Better sovereign rating → Lower yields and better access to external capital markets

2) Banking channel: Better banking regulation and supervision ⟶ Good reason for EU-owned banks to maintain business in Ukraine, instead of reducing business

3) Economic growth channel: Better business climate → Good reason for EU firms to increase investment in Ukraine, instead of reducing it

Overall conclusions:

- The negative impact of the Eurozone crisis on Ukraine is a fact
- However, domestic economic policy can and should do much better in combating the negative effects of the Eurozone crisis on Ukraine

Contact

Robert Kirchner
kirchner@berlin-economics.com

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