Belarus, Moldova, Ukraine. Macroeconomic Report: Executive Summary

Project: Mapping out vulnerable sectors in the Eastern Partnership countries – structural change, Visegrad experience and relevance for EU policy

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Warsaw, April 2015

Aims and Objectives

The report investigates the recent macroeconomic situation of the three European Partnership members: Belarus, Moldova and Ukraine. The three countries were hit hard during the 2008-2009 financial crisis, and as a result the time of the crisis provides a natural starting point for our analyses. We try to show how the EU's Eastern partners dealt with the post-crisis challenges and what their current prospects are.

At the moment of writing, Ukraine is plunging into a period of deep macroeconomic instability, a situation which is adversely affecting Belarus and Moldova. If one is even to contemplate economic recovery in the region, ending the territorial dispute between Russian and Ukraine is the first essential step. However, we must set aside this political issue to focus on identifying the necessary steps in the sphere of economic policy.

What has happened since 2009

Looking back, one can easily see that the warning produced by the 2008/2009 crisis has not been taken into consideration. Just as in the period before the crisis, post-2009 growth in Belarus has been fuelled by consumption and investment, while the country's trade balance exerted negative pressure throughout most of the past few years. As both consumption and investment were continuously subsidised throughout this period, it is hard to perceive them as stable pillars of growth in the near future.

In Moldova, consumption and investment has been the main growth factors as well, in this case fuelled by remittances from abroad. Taking into account that the vast majority of Moldovan migrant workers seek work in Russia, the present deterioration of the economic situation there will have a negative impact on the prospects of Moldovan growth in the near term as well. The current state of the Moldovan banking sector raises further doubts as to the feasibility of ongoing strong investment.

Finally, Ukraine has been effectively stagnating since the 2008-2009 financial crisis. Its GDP took a deep dive in 2009, then rebounded slightly in the following two years and stopped growing in 2012. The current crisis has led to a sharp and deep contraction in economic activity.

Unclear near-term prospects

About three months ago, we projected a 4.3% decline in Ukraine's GDP this year and very slow growth in the next year. Recent IMF and government forecasts anticipate a steeper fall still at negative 5.5%, and a similarly slow recovery next year. At least by some forecasters, expected GDP growth figures for Belarus and Moldova were recently revised down to zero, and in fact the possibility of a GDP contraction is also being discussed (by 3-5% in case of Moldova). The three countries face similar risks: fallout from the war in Ukraine, a downturn in Russia resulting from a combination of sanctions and low oil prices, downward pressure on trade, low commodity prices, and exposure to the economic performance of the Eurozone. They all face the burden of adjusting to external shocks that already resulted in a sharp depreciation of national currencies, and now they have to deal with balance sheet effects, high inflation, a dip in domestic demand because of the diminishing purchasing power of households, and the reduced affordability of imported investment goods (although to a lesser degree in Belarus). This will mean some tough choices for the governments in question, though these may be eased by external support, such as the existing aid programs for Ukraine. On the bright side, a successful resolution of hostilities in Ukraine may provide a boost to all three economies.

Monetary authorities face tough choices

Among the near-term moves, stabilizing domestic markets and laying the groundwork for the return of consumer and investor confidence seem to be of the utmost importance. Given that the year 2014/2015 resulted in a full-scale balance of payments crisis in all three economies, draining their reserves and limiting their options in terms of monetary and exchange policies, something obviously needs to change. There is some confusion as to what exact policies should be followed. Some, for example the IMF, advocate fully flexible exchange rate regimes. Moldova already embarked on this path with some success. At the same time, others suggest hard currency pegs and giving up monetary policy altogether as a more feasible solution in times of deep instability and low trust in the domestic currency and domestic financial institutions[1]. In any case, one thing that is clear is that intermediate monetary regimes have proved incapable of guaranteeing market confidence and have been too costly for the countries in question.

Need for better fiscal management

Overall, the three countries are now badly dependent on *ad-hoc* external financing. In order to reduce their dependence, they have to work on fiscal consolidation to keep public debt on a sustainable trajectory, on reducing populism in fiscal policy, and on medium-term planning. These objectives are particularly relevant in the case of Ukraine and Belarus. The elimination of directed

[1] Dąbrowski, M. (2015), It is not just Russia: currency crises in the Commonwealth of Independent States, Bruegel Policy Contribution 2015/01 at www.bruegel.org

lending (Belarus), subsidised utility tariffs, carefree pension payments are just some examples of measures that should be implemented in no time.

The vast privileges granted to Ukrainian and Belarusian companies need to be abandoned. They create far too much pressure on public finances and delay the badly-needed modernization of production, and perhaps even retard the development of natural export markets.

Clock is ticking in the banking sector

There is much to do in the realm of banking sector reform, with a view towards reducing the vulnerabilities of banks in times of shocks and creating conditions for the remonetisation of the economies (particularly relevant for Ukraine). Even in Moldova, where, unlike in the other two countries, public finances seem to be on the right track, the vulnerabilities of the banking sector in combination with the way they have been managed are likely to create a huge drag on public finances.

Addressing corruption

Finally, corruption and red tape are very widespread, especially in Ukraine and Belarus, creating all sorts of constraints for investment and resulting in a loss of budget revenues. Actions in order to reduce corruption and red tape are of utmost importance.

Technical assistance

The new EU member countries, including the Visegrad Group, have accumulated vast experience in all of the above fields, having been through many of the challenges themselves. This does not imply, of course, that their experience could be applied in a mechanical way in the European Partnership area, as the geopolitical situation and the global economy was very different in the 1990s. However, there is substantial technical knowledge available in the new EU member states, which could be helpful when the European Partnership countries' implement unpopular yet badly needed reforms.