Ukrainian economy in free fall

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Economic losses from the ongoing civil war in southeastern Ukraine may rise to $8 billion, Ukrainian prime minister Arseny Yatsenyuk told journalists last week. Housing, industrial facilities, and transportation infrastructure, including roads, railways, and utility lines, have all suffered extensive damage in the rebel-controlled areas as a result of bombing and shelling by government forces.

"We used to say that Ukraine would need 8 billion hryvnia, but it turns out that we'll need 8 billion dollars," Yatsenyuk said. At the current exchange rate, estimated economic damage from the war has thus been revised upward by a figure of more than 13. The new estimate exceeds the entire amount of loans that Kiev hopes to acquire this year from the International Monetary Fund (IMF)—$7.4 billion.

Ukraine's coal industry, which supplies about 31 percent of the country's energy production and is concentrated in the southeastern war zone, is in crisis. As of last month, coal production had fallen 21.6 percent year-over-year. This decline threatens the country's metallurgical industry, which accounts for 60 percent of Ukraine's exports. Last week, the Ukrainian state statistical agency announced that the country's consumption of gas, coal, and gasoline have fallen by 20 to 30 percent year-over-year due to declining personal and business incomes, and efforts to limit use.

Ukraine has lost 15 percent of its aggregate crop yield because of the conflict in the Donbass region, Prime Minister Yatsenyuk said Tuesday. However, Oksana Lukicheva, of the Russian brokerage house Otkrytiye, explained to *Ria Novosti* that the greatest losses in agricultural production are yet to come, as continued fighting and insufficient investment lead to a drastic drop in the planting of winter crops in the coming season. Western-owned agribusiness giants Cargill and Louis Dreyfus have already suspended their operations in eastern Ukraine.

Ukrainian exports to Russia fell by $2.5 billion, about one third, in the first half of 2014, and will likely continue to fall due to Russian sanctions against Ukrainian products. At the same time, exports to the European Union grew by only $1.3 billion, resulting in a $1.2 billion decline in export revenue.

The Ukrainian government estimates expected economic losses resulting from sanctions against Russia at $7 billion over the next year. However, this figure does not account for the effect of Russia's retaliatory sanctions, which are likely to have a comparable or greater negative economic impact.

Last month, industrial production in Ukraine fell by 12.1 percent year-over-year, representing an accelerated decline from the 5 percent drop recorded in June. In an expression of the scale of the disaster unfolding in the southeast, Donetsk Province and Luhansk Province registered, respectively, 28.5 percent and 56 percent year-over-year drops in industrial production in July.

Zaporizhia Automobile Building Plant (ZAZ), Ukraine's chief automobile producer, has stopped operations in anticipation of changes to tariffs that will render the Ukrainian auto industry uncompetitive. The company plans to lay off 21,000 workers by October. Production of consumer automobiles in July had fallen by 89 percent year-over-year. Aggregate auto sales in Ukraine declined by 61 percent over the same period.

In the first half of 2014, production of passenger buses fell by 48.3 percent year-over-year; trucks by 23.6 percent; railway freight cars by nearly 80 percent; equipment for the processing of meat and poultry by over 50 percent; and boring and tunneling machines by approximately 50 percent.

Oleksandr Okhrimenko, president of the Ukrainian Analytic Center, has noted that despite increases in nominal wages over the past half-year, income taxes collected by the government declined. According to him, this points to an increase in wage arrears owed to employees by employers.

As a whole, the country is expected to experience an economic decline of 6 to 7 percent in 2014.

So far, the IMF has given Ukraine only $3.2 billion of its loan package. The government is desperate to secure a second tranche of $1.4 billion, which is slated for final approval by the IMF Board of Governors on August 29. The issuance of the loans is contingent upon Ukraine's compliance with IMF dictates regarding deregulation, trade barriers, social austerity, and other monetary standards.

The second tranche of IMF funding was already delayed once in July because of the organization's doubts about Ukraine's economic stability and its ability to comply with IMF requirements. In an effort to meet those requirements, the Ukrainian government has drastically reduced spending on social expenditures, raised utility rates, and suspended inflation indexing for pensions and state employee wages. With inflation expected to reach 17 to 19 percent this year, the latter means a major cut in incomes for pensioners and government workers.

A recent draft letter from Kiev to the IMF indicates the government's intent to lay off 3 percent of all state employees, end the current moratorium on mortgage foreclosures, and establish a ceiling for state employee wages at 10.2 percent of Gross Domestic Product (GDP) and 15.2 percent of GDP for pension fund expenses.

While introducing a mildly progressive income tax that reaches 30 percent for incomes over 1 million hryvnia ($74,792) per year, Ukraine's government has also implemented regressive tax measures, including taxes on pensions and an additional 1.5 percent flat income tax, which is intended to finance the military.

Despite these efforts, experts at the investment company Investment Capital Ukraine (ICU) expect the state budget deficit to rise by the end of the year to 6.4 percent of GDP, not counting the debts of Naftogaz, the state-owned oil and gas company. Even with the recent tax hikes, tax revenues have declined over the past year.

The balancing of the current state budget was achieved only by means of the advance payment of 22 billion hryvnia ($1.6 billion) in income taxes by the Ukrainian National Bank. This accounting trick, which is essentially equivalent to the printing of money, has, along with the removal of price controls, contributed to surging inflation.

The IMF loan money received thus far has been funneled into the hands of Ukraine's oligarchs and used to finance the civil war. Part of it, intended to support the banking sector, ended up in the hands of private banks, including PrivatBank of billionaire Ihor Kolomoyskyi. Kolomoyskyi has reportedly been funding the government's military operations in the Donbass, including the Dnipro Battalion.

The IMF loans were also partly intended to allow the Ukrainian government to repay its debt to the Russian gas company Gazprom, which would allow Ukraine to begin importing gas once more from Russia. However, no funds have been paid to Gazprom as of yet.

Since the beginning of July, in expectation of a gas shortage, the city of Kiev has gone without hot water supplies, which is not expected to return until late September. Meanwhile, the capital city's population has bought up electric heaters en masse. Authorities warn that the city's electrical grid does not have the capacity to provide for the heating of such a large number of dwellings.

At present, the city has only about half of the gas needed to heat itself during the winter. Kiev mayor Vitaly Klichko has suggested that residents may need to rely on firewood for heating.