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Cracks in Ukrainian Economy Surface Beyond Kiev's Cloak of Calm

By Daryna Krasnolutsk and Volodymyr Verbyany

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(Bloomberg) -- Ukrainians are seeing signs the economy is cracking under the weight of war and the risk of default.

While restaurants and cafes are bustling and shelves are full in Kiev, a city of 3 million, a recession stretching into a second year is igniting angst about the return of the disarray unleashed by the Soviet Union's collapse in 1991. Especially outside the capital, that era of food shortages, hyperinflation and mass unemployment doesn't seem so far away.

"My business is about to close and there are many more like it," said Valentyna Lozova, a 65-year-old accountant in Kiev. "Salaries aren't rising, inflation is galloping and the hryvnia's in freefall. I'm afraid of the future."

It's becoming harder for Ukrainians, mindful of the thousands who've died in an 11-month insurgency near the nation's border with Russia, to put a brave face on their economic woes. With much of the country's industrial base in ruins and a looming debt restructuring, the effect may be felt for years. The economy is set to plunge 12 percent in 2014-15 and the inflation rate jumped to 28.5 percent in January, the world's second-highest behind Venezuela.

As the economy deteriorated, the hryvnia has sunk 62 percent in the past year, the most in the world, while benchmark government debt due 2017 trades at 43 cents on the dollar, data compiled by Bloomberg showed. The currency collapse has sparked panic in some towns.

Flour, Cereals

"I see people every day in supermarkets buying sacks of flour and cereals as prices grow," said Iryna Lebiga, a 31-year-old mother of three who's struggling to find a buyer for her unprofitable sheep farm in Poltava, a 350-kilometer (220-mile) drive east of Kiev. "People don't have money."

Someone approached us last year but my husband thought he offered too little. Now, nobody offers even half of that.”

Even in Kiev, some people were spooked into stocking up on staples after the central bank banned foreign-currency trading for one day last week and the hryvnia’s street price plunged. The Silpo supermarket chain rearranged delivery to its outlets to meet growing demand, its press office said by e-mail.

While the recession isn’t yet as deep as the last one in 2009, this contraction is longer-lasting and Ukraine entered it after two years of almost zero growth. The scale of the malaise risks triggering disquiet among some Ukrainians who helped unseat their Russian-backed leader last year with the hope of rebuilding the nation, according to Citigroup in Moscow.

Social Discontent

“There’s an increasing danger we see a significant accumulation of social dissatisfaction,” Citigroup economist Ivan Tchakarov said by e-mail. “Economic life becomes ever harder and some of the promises of the street revolution may be perceived by the public as being unfulfilled.”

The hardship spans Ukraine, from the eastern conflict zone near Russia to the western regions next to the European Union.

Andriy Zalyeskyi, a 28-year-old taxi driver from the city of Ivano-Frankivsk, about 200 kilometers from the Polish border, plans to seek employment abroad as cab customers dry up and his income shrivels. While one in three families have a relative who works in countries such as Italy, Spain and Portugal, people are nevertheless feeling the strain, he said.

“I went to the hypermarket yesterday and I’ve never seen anything like it -- the car park was totally full,” Zalyeskyi said. “People are buying things like canned food, flour, sugar, buckwheat, pasta and toilet paper.”

Combat Zone

The devastation is on full display in Donetsk, the combat zone’s biggest city, where billboards have vanished from streets, replaced by banners for conscription to the rebel forces that wield control. Fighting the United Nations estimates has killed more than 6,000 people has ravaged the city, which less than three years ago hosted matches including a semi-final in the Euro 2012, Europe’s premier soccer contest.

Banks haven’t operated on Donetsk’s two main streets for months and wooden boards obscure deserted shop windows as foreign retailers such as U.K.-based Marks and Spencer Plc and Inditex SA’s Spanish fashion brand Zara have fled. Store owners let homeless people in to keep warm as pensioners beg for medicine nearby.

Yana Ilyina, a translator in Donetsk, says prices have surged as her salary stood still. She can no longer plan her family's budget as costs for products such as bread change too quickly.

Hyperinflation Back?

While the official inflation figure is 28.5 percent, annual price growth may be as quick as 272 percent, with a monthly rate of 64.5 percent that would qualify as hyperinflation, according to estimates based on the hryvnia's black-market price by Steve Hanke, a professor of applied economics at Johns Hopkins University and director of the Troubled Currencies Project at the Cato Institute.

"We're trying not to skimp on food but we've stopped buying clothes and toys for our child," said Ilyina, 35. "We're paying for water and gas, but heating isn't affordable. The biggest problem is the feeling of uncertainty."

That sentiment has proved too much for many Ukrainians. About 600,000 people have fled the country, according to the UN, headed for new lives in Russia in the east and in nations such as Poland, Hungary and Romania in the west. Almost 1 million have been displaced inside Ukraine, the government estimates.

The prospects for the future don't look rosy. While the government is racing to obtain emergency cash from a \$17.5 billion International Monetary Fund, central bank reserves are at the lowest in more than a decade and Russia is threatening to cut energy supplies for the second time since the crisis began. Officials suggest the economy may post small growth in 2016.

Back in Kiev, those familiar with the city can spot something is awry. The traffic jams that have dogged commuters for years have dissipated in tandem with the spike in fuel costs, as the hryvnia's drop more than offset weaker global crude prices. Hoarding of imported food and drugs began in some places Wednesday as the hryvnia hit a fresh low.

"It was difficult in the 1990s but we got independence and we had hope," said Lozova, the accountant. "Now I'm afraid of full-scale war and I don't see any prospects."