

Metal Fatigue

Ukraine's steel earnings buckle with the world economy

David Hofman

WORLD steel prices are highly sensitive to global economic downturns. The earnings of major steel exporters such as Ukraine are therefore closely linked to trends in the world economy. As global car manufacturing and construction activity—and hence steel prices—have sunk in the deepening world slowdown, Ukraine's fortunes have been dragged down too, weighed down further by overdue policy decisions.

The economy of Ukraine, the world's eighth-largest steel producer, depends heavily on developments in its steel sector. Measured directly, the steel industry accounts for about 12 percent of Ukraine's national income, and for more than one-third of total exports of goods. Large as these numbers may already be, indirectly steel is even more important because many other economic activities depend on the steel sector. As a result, GDP growth in Ukraine tends to track developments in world steel prices (see chart).

Ukraine's strong link to metals prices previously helped boost the economy. A 2000–08 surge in steel prices—to levels far above their long-term downward trend—underpinned Ukraine's largely favorable export performance and impressive GDP growth: between 2001 and 2007, the Ukrainian economy grew by an average of 7½ percent a year in real terms. Export earnings and generous capital inflows fueled domestic credit growth, and equity and house prices soared. The external current account deficit rose strongly as imports jumped, and inflation began spiraling out of control. Meanwhile the government's policies, in particular the de facto exchange rate peg, failed to address the building imbalances.

Sharp correction

Although steel prices clearly could not remain at the high levels of 2007 and 2008, few could have foreseen the dramatic speed with which steel prices came down in late 2008. Amid the global economic crisis, the commodity boom of recent years ended abruptly, and with global car sales slumping and a sharp contraction in construction activity, steel was particularly badly affected.

By early November 2008, steel prices had fallen more than 80 percent from their near-peak levels in August, bringing prices close to their long-term-trend levels. Even though the



A steel mill in Donetsk, Ukraine.

speed of the adjustment was exceptional, the sharp correction in steel prices itself was not without precedent. Indeed, steel prices have plummeted in every global recession since the early 1970s, each time bringing steel prices back to or beneath their long-term trend.

The collapse of steel prices has hit Ukraine hard. Led by a 50 percent fall in steel production, industrial production fell by about 25 percent between September and December 2008, and exports plunged. Overall economic performance slumped. Preliminary GDP figures show that real output contracted by about 9 percent in the fourth quarter in seasonally adjusted terms. All this was compounded by a simultaneous crunch in the availability of external financing, related to reduced risk appetite among international investors. This caused Ukrainian bond spreads to soar, and the local stock market lost about 75 percent over the year.

Untenable currency regime

The combination of the large steel price shock and the loss of access to international capital markets made Ukraine's rigidly managed

exchange rate regime untenable. Concerns about exchange rate volatility and the stability of the banking system then caused a run on deposits. This put the banking system—already vulnerable due to recent rapid credit growth, including in foreign currency to unhedged households—under heavy strain.

To deal with the negative effects of the steel price shock and of the squeeze in external financing, Ukraine's authorities are implementing a policy adjustment program that is supported by a \$16.4 billion IMF loan approved in November 2008. ■

David Hofman is an Economist in the IMF's European Department.

Bolted together

The economy of Ukraine, the world's eighth-largest steel producer, depends heavily on developments in its steel sector.

