

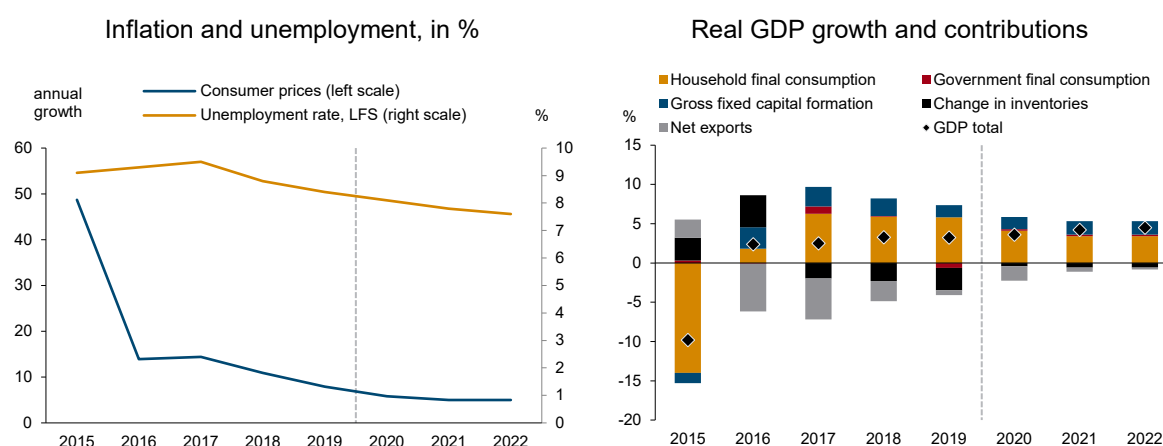


UKRAINE: All set for faster growth after a year of record performance

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Rapid macroeconomic stabilisation in 2019 allowed for a marked loosening of monetary policy. Exports showed robust growth on the back of agricultural products and services – notwithstanding hryvnia appreciation. We have revised our forecast of GDP growth upwards in the light of the positive trends. In 2020, GDP will grow by 3.6%, and in 2021-2022 growth will accelerate to 4.2% and 4.5%, respectively. A major risk to the forecast remains the inability of the government to break the oligarchs' grip on the country.

Figure 6.23 / Ukraine: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Economic growth exceeded expectations in 2019: according to our estimates, it achieved 3.3% year on year. This result came on the back of strong private consumption, bolstered by rapidly growing wages and a strengthening domestic currency, and robust accumulation of gross fixed capital formation. Exports performed quite successfully as well, posting annual growth of 6.4%. This was mainly driven by a 19.0% rise in food exports; meanwhile metallurgical exports decreased by 12.3%. Ukraine has positioned itself as a leading exporter of agricultural products (in particular, grain) in the world, and has become the third-largest exporter of agri-food products to the European Union, thanks to a record harvest and improved access to the EU market under the DCFTA. Exports of services grew more dynamically than exports of goods – by 9.3% year on year, owing to a rise of 30.2% in the exports of computer services, other business services (14.8%) and travel expenditure (14.5%).

Prudent monetary and fiscal policies resulted in rapid macroeconomic stabilisation in 2019.

Inflation decreased to 7.9% per annum, and in December the CPI achieved its lowest level for five years – 4.1% year on year. The hryvnia became the world's best-performing currency in 2019: by the end of the year it had appreciated by 19% against the US dollar, mainly thanks to a strong appetite among

investors for Ukrainian bonds. The National Bank's currency reserves reached a seven-year peak of USD 26.3 billion in January 2020. These developments allowed the National Bank to reduce its policy rate even further: on 31 January 2020, it was cut by 2.5 p.p. to 11%, which is 7 p.p. lower than in January 2019.

Further loosening of monetary policy is likely in 2020, as annual inflation is expected to remain in the target corridor. We expect the policy rate to be further cut by 300 b.p. in 2020, and by another 100 b.p. in 2021, bringing the real interest rate down to 2% – a marked decrease from the 6.3% of 2019. However, such a loosening of monetary policy is likely to have only a limited positive effect on the credit market, as the transmission will be hampered by the continued presence of significant non-performing loans (NPLs) on banks' balance sheets and a lack of high-quality borrowers. At the end of 2019, the ratio of NPLs was still very high – 48.4%; but there was also good news, as this figure had decreased for the first time in three years – by 4.5 p.p. The issue of high proportions of NPLs mostly concerns the state-owned banks (PrivatBank, Oschadbank, Ukreximbank and Ukrgazbank), which account for three quarters of all NPLs. That said, some private banks also have very high NPL ratios, in particular some of those with Russian capital. At this stage, a high proportion of NPLs does not pose any major risks to the financial sector, since the coverage ratio exceeds 95%; but they do restrain credit growth.

A risk here is that banks will use cheaper liquidity to further bolster already booming consumer lending, which may increase the probability of the market overheating. In December 2019, the stock of consumer loans with maturity below five years (70% of all loans to households) showed 25.3% growth year on year. Average interest rates on consumer loans were 33.6%, but the effective interest rates are much higher (by a factor of two or three, according to local experts). The combination of all these factors could potentially create the conditions for a perfect storm on the market.

Investors remain optimistic about Ukraine's economic prospects and there is strong demand for the country's government debt. The yield on government bonds has declined noticeably, allowing the government to return to international capital markets: in January 2020, Ukraine raised EUR 1.25 billion issuing eurobonds at record-low borrowing costs; these bonds will yield 4.375% interest over 10 years. There has been strong demand on the part of foreign investors for hryvnia-denominated debt as well; as a result, the share of government hryvnia-denominated debt in total debt increased last year from 33% to 41%. Non-residents invested in hryvnia government bonds across all maturities up to six years, with more than 60% of bonds in the non-resident portfolio having a maturity of over two years. Though the yields on government hryvnia bonds have fallen sharply, the attraction of the bond market is expected to continue, given the lack of investment opportunities globally, in an environment of negative real interest rates.

The risk of a build-up of external imbalances is currently low, and therefore we forecast only a slight depreciation of the hryvnia during the forecast period. In 2019, the current account deficit narrowed to 2.6% of GDP,⁴⁴ despite the appreciating currency, driven by better terms of trade and strong export performance. In 2020-2022, the current account deficit will remain sustainable, at about 3% of GDP, despite a decrease in gas transit revenues. This comes on the back of steady export dynamics and strong inflows of remittances. External debt as a share of GDP declined slightly in 2019 to about 80%, and that trend is expected to continue. On the fiscal side, the government is pursuing a

⁴⁴ Excluding the compensation to Naftogaz from Gazprom, which was a one-off payment equivalent to about 2% of GDP.

rather restrained policy, keeping the budget deficit at about 2% of GDP and reducing public debt, which in 2019 fell by more than 10 p.p. to 50.3% of GDP. The Ministry of Finance has announced its goal of further cutting the debt to 45% by the end of 2020, and to 40% in 2024.

A staff-level agreement with the IMF on a new USD 5.5 billion loan has provided encouraging news for investors, but there are risks involved in closing the deal. The Ukrainian government appears to have satisfied most of the conditionalities of the Extended Fund Facility agreement, but there remains some uncertainty over finalising the deal, due to oligarch Ihor Kolomoisky's attempts to regain control of PrivatBank. In December 2019, the Cabinet of Ministers submitted a bill to parliament that would make it impossible –by either legislative or judicial means – for a bank, once declared insolvent, to be returned to its former owners. The bill was later modified, and in its current version it allows for compensation to be paid to the former owners of a failed bank – something that is strongly disapproved of by the IMF.

Agreement with the IMF is crucial for Ukraine as it faces high debt repayments. In 2020, Ukraine's loan repayment and servicing costs will be around USD 13.8 billion; these costs will peak in 2021, when more than USD 15.5 billion will be due to internal and external creditors.⁴⁵ Without an agreement, investors' confidence in the country might dwindle and it could face the risk of default.

Foreign direct investment still showed only modest growth in 2019, and the government sees it as a priority to improve this situation. Speaking during the World Economic Forum in Davos, Prime Minister Oleksiy Honcharuk promised to protect large investors in Ukraine and give them tax breaks. In particular, he promised to provide direct government guarantees to each investor who brings more than USD 100 million into Ukraine, and to give tax holidays of up to five years to investors who privatise Ukrainian enterprises worth more than USD 10 million. On 17 February 2020, Economy Minister Tymofiy Mylovanov announced an ambitious strategy 'Economic Strategy: Growth through Investment', which promises to attract USD 50 billion in FDI. To reach this goal, Mylovanov wants to improve infrastructure, sell large state-owned firms, amend Ukraine's obsolete labour code and protect local businesses from corporate raiding. The largest influx of investment is expected in agriculture, IT, infrastructure, energy and the chemical and pharma industries. At the end of December 2019, the Cabinet of Ministers approved a list of objects subject to privatisation, which are estimated to be worth about UAH 12 billion (USD 480 million); among them are regional energy companies and the alcohol monopoly UkrSplyt. The Ministry of Infrastructure intends to use the concession mechanism to attract significant private investments to modernise infrastructure objects. In January 2020, the Qatar-based terminal operating company QTerminals won a UAH 3.4 billion (USD 138 million) concession to operate the port of Olvia in Mykolaiv region; meanwhile the development of concession projects is under way in the seaports of Odessa, Chornomorsk, Mariupol and Berdiansk. Concessions are being worked out for roads (Lviv-Stryi and Lviv-Ternopil), regional airports and train stations. On the negative side, anti-corruption and judicial reforms are progressing more slowly than expected, and land reform has already been watered down to exclude foreign investors.

⁴⁵ <https://www.kyivpost.com/business/ukraine-to-pay-back-nearly-15-billion-in-public-debt-in-2019.html>

The Normandy Meeting in Paris on 9 December 2019 resulted in only limited progress in the peace negotiations regarding the Donbas military conflict. Its main results lay in securing a ceasefire, expanding the no-contact zone and agreeing an all-for-all prisoner swap before the end of 2019. Russia and Ukraine exchanged 203 prisoners on 29 December: 76 Ukrainian citizens held in the occupied territories of Donetsk and Luhansk regions were traded for 127 Russian-aligned prisoners held in the government-controlled territory. The Ukrainian president maintained that implementation of the ‘Steinmeier Formula’⁴⁶ for holding local government elections in the occupied parts of Donbas would be conditional on the complete withdrawal of all troops, and on Ukraine retaking control of the Russian-Ukrainian border.

Ukraine has managed to secure its role as a gas transit country for the next five years, maintaining (at least partially) an important source of revenue. On 30 December 2019, Russia and Ukraine reached a new agreement on natural gas transit for the next five years, according to which Russia will send 65 billion cubic metres through Ukraine in 2020, falling to 45 billion cubic metres thereafter; Ukraine is set to collect about USD 7.2 billion in gas transit fees by 2024 (about half of what it would have got under the terms of the old contract). Russia also agreed to pay USD 2.9 billion to Naftogaz as part of a Stockholm arbitration court ruling. In turn, Naftogaz has promised to release the seized assets of Gazprom in Europe, and both parties have agreed to drop reciprocal court claims that have not been concluded and to sign an out-of-court settlement.

The introduction of sanctions against Nord Stream 2 by the US could be a positive thing for the economic growth of Ukraine. The new pipeline project was supposed to be finalised by the end of 2019, and could have led to Ukraine losing its role as a gas transit country as early as 2020. However, following the announcement of sanctions, the key subcontractor of Nord Stream 2 – the Swiss-Dutch company Allseas – suspended the laying of pipes. It is not clear now when exactly the project will be finalised. US Energy Secretary Dan Brouillette said recently that he was confident that Russia would not be able to complete the Nord Stream 2 gas pipeline in the Baltic Sea, and signalled that the US would press ahead with its opposition to the project.⁴⁷ If the project is indeed delayed further, Ukraine could benefit from increased volumes of gas transiting through its territory in the future.

In light of the positive trends, we have revised our forecast for GDP growth upwards. In 2020, GDP will grow by 3.6%, and in 2021 and 2022 growth will accelerate to 4.2% and 4.5%, respectively, making Ukraine the fastest-growing country in 2022 in the region we cover. We assume that the expansionary monetary policy will continue and that the government will be successful in implementing a large chunk of its reforms. Strong labour demand will support wage increases, which in turn will boost private consumption. Investment, in particular FDI, will pick up as the business climate gradually improves. A major risk to the forecast remains the failure of the government to break the stranglehold of the oligarchs over large sections of the economy, and to rein in their political influence and their ability to direct policy in their own personal interests, rather than in the interests of economic development. This failure on the part of the government places cooperation with the IMF in jeopardy and could have a detrimental effect on investor confidence. This risk rose significantly with a sweeping reshuffle of the government and sacking of chief prosecutor on 4 March 2020.

⁴⁶ The Steinmeier Formula is a simplified version of the Minsk agreements proposed in 2016 by Frank-Walter Steinmeier, who was then the German foreign minister. According to the formula, the parties involved should hold free and fair local elections in the Russian-occupied Donbas under Ukrainian law; in exchange, the region will receive special self-governing status.

⁴⁷ <https://www.worldoil.com/news/2020/2/14/us-says-sanctions-mean-russia-can-t-finish-nord-stream-2-pipeline>

Table 6.23 / Ukraine: Selected economic indicators

	2015	2016	2017	2018	2019 ¹⁾	2020	2021	2022
						Forecast		
Population, th pers., average	42,845	42,673	42,485	42,270	42,030	42,050	41,950	41,800
Gross domestic product, UAH bn, nom.	1,989	2,385	2,984	3,559	3,970	4,400	4,800	5,300
annual change in % (real)	-9.8	2.4	2.5	3.3	3.3	3.6	4.2	4.5
GDP/capita (EUR at PPP)	6,000	5,900	6,100	6,400	6,800	.	.	.
Consumption of households, UAH bn, nom.	1,332	1,570	1,978	2,431	2,850	.	.	.
annual change in % (real)	-19.8	2.7	9.5	8.9	8.5	6.0	5.0	5.0
Gross fixed capital form., UAH bn, nom.	269	369	470	611	690	.	.	.
annual change in % (real)	-9.2	20.4	16.1	14.3	9.0	9.0	10.0	10.0
Gross industrial production								
annual change in % (real)	-13.0	2.8	0.4	1.6	-1.8	2.0	3.0	3.0
Gross agricultural production								
annual change in % (real)	-4.8	6.3	-2.2	7.8	1.1	.	.	.
Construction output								
annual change in % (real)	-12.3	17.4	26.3	8.5	20.0	.	.	.
Employed persons, LFS, th, average	16,443	16,277	16,156	16,361	16,500	16,600	16,700	16,800
annual change in %	-0.4	-1.0	-0.7	1.3	0.9	0.6	0.6	0.6
Unemployed persons, LFS, th, average	1,655	1,678	1,698	1,579	1,460	1,440	1,410	1,390
Unemployment rate, LFS, in %, average	9.1	9.3	9.5	8.8	8.4	8.1	7.8	7.6
Reg. unemployment rate, in %, eop ²⁾	1.6	1.5	1.4	1.3
Average monthly gross wages, UAH ³⁾	4,195	5,183	7,104	8,865	10,497	12,000	13,500	15,200
annual change in % (real, gross)	-18.9	8.5	19.8	12.5	9.7	8.0	7.0	7.0
annual change in % (real, net)	-20.2	9.0	19.0	12.5	9.8	9.0	8.0	8.0
Consumer prices, % p.a.	48.7	13.9	14.4	10.9	7.9	5.8	5.0	5.0
Producer prices in industry, % p.a. ⁴⁾	36.0	20.5	26.4	17.4	4.1	4.0	6.0	7.0
General governm.budget, nat.def., % of GDP								
Revenues	32.8	32.8	34.1	33.3	32.5	33.5	33.5	33.5
Expenditures	34.3	35.1	35.5	35.2	34.6	35.5	35.5	35.5
Deficit (-) / surplus (+) ⁵⁾	-1.6	-2.3	-1.4	-1.9	-2.1	-2.0	-2.0	-2.0
General gov.gross debt, nat.def., % of GDP	79.1	80.9	71.8	60.9	50.3	47.0	45.0	43.0
Stock of loans of non-fin.private sector, % p.a.	-2.8	2.4	1.9	5.6	-9.8	.	.	.
Non-performing loans (NPL), in %, eop ⁶⁾	28.0	30.5	54.5	52.9	48.0	.	.	.
Central bank policy rate, % p.a., eop ⁷⁾	22.00	14.00	14.50	18.00	13.50	9.5	8.0	7.5
Current account, EUR mn ⁸⁾	1,457	-1,210	-2,165	-3,696	-957	-4,900	-4,700	-4,700
Current account, % of GDP	1.8	-1.4	-2.2	-3.3	-0.7	-3.3	-3.0	-2.8
Exports of goods, BOP, EUR mn ⁸⁾	31,935	30,309	35,192	36,677	41,167	42,400	44,100	45,900
annual change in %	-16.5	-5.1	16.1	4.2	12.2	3.0	4.0	4.1
Imports of goods, BOP, EUR mn ⁸⁾	35,050	36,579	43,758	47,436	53,618	56,300	58,600	60,900
annual change in %	-19.7	4.4	19.6	8.4	13.0	5.0	4.1	3.9
Exports of services, BOP, EUR mn ⁸⁾	11,218	11,242	12,558	13,365	15,413	16,000	17,000	18,200
annual change in %	-0.4	0.2	11.7	6.4	15.3	3.8	6.3	7.1
Imports of services, BOP, EUR mn ⁸⁾	10,232	10,801	11,655	12,226	13,779	14,500	15,000	15,700
annual change in %	9.4	5.6	7.9	4.9	12.7	5.2	3.4	4.7
FDI liabilities, EUR mn ⁸⁾	2,750	3,108	2,506	2,095	2,891	3,600	.	.
FDI assets, EUR mn ⁸⁾	34	156	207	98	655	400	.	.
Gross reserves of NB excl. gold, EUR mn ⁸⁾	11,320	13,965	14,872	15,955	21,590	.	.	.
Gross external debt, EUR mn ⁸⁾	107,695	107,648	96,741	92,352	109,870	112,500	116,100	118,800
Gross external debt, % of GDP	131.2	127.7	97.3	83.4	80.1	75.9	74.5	71.5
Average exchange rate UAH/EUR	24.23	28.29	30.00	32.14	28.95	29.7	30.8	31.9

Note: Excluding the occupied territories of Crimea and Sevastopol and, with the exception of the population, excluding the temporarily occupied territories in the Donetsk and Luhansk regions.

1) Preliminary and wiiw estimates. - 2) In % of working age population. - 3) Enterprises with 10 and more employees. - 4) Domestic output prices. - 5) Without transfers to Naftohaz and other bail-out costs. - 6) From 2017 including NPLs of the nationalised Privatbank and changes in rules of credit risk assessment. - 7) Discount rate of NB. - 8) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.