UKRAINE: Growth slowdown on the horizon

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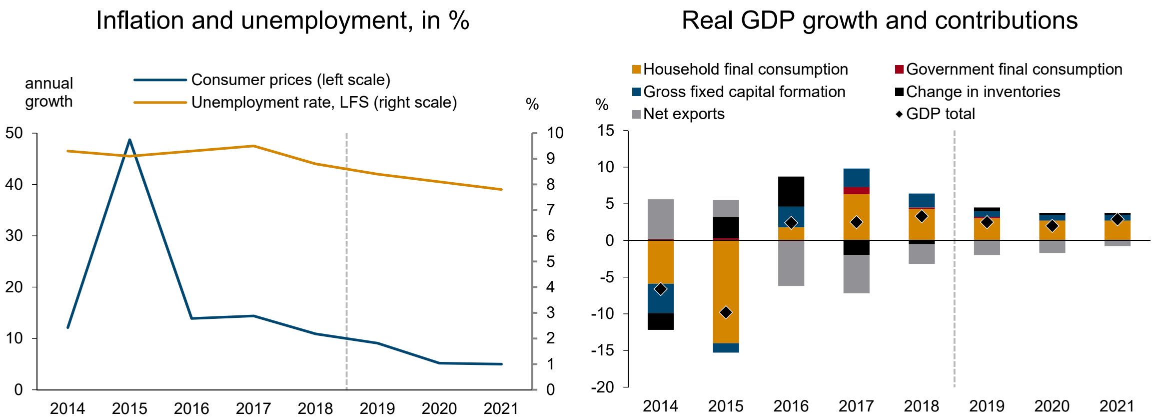
In 2018, Ukraine's economy recorded its highest growth since 2011 thanks to robustly rising wages and remittances, currency stability, and a record grain harvest. However, growth is projected to lose steam this year on the back of monetary tightening and a lower harvest, and owing to reduced gas transit revenues next year. The forthcoming presidential elections may result in more populist economic policies, but will not change the country's current EU and NATO integration efforts.

Figure 6.23 / Ukraine: Main macroeconomic indicators



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

In 2018, Ukraine's economy recorded its highest growth since 2011, driven entirely by domestic demand. According to the preliminary estimate, GDP growth in 2018 was around 3.3%. The main growth drivers were robust wage growth, rising remittances, exchange rate stability, and a record harvest of grains and oilseeds. Thanks to the latter, agricultural production surged by 7.8%, partly on account of the low statistical base. The dynamics in other sectors was less impressive: the growth of construction output decelerated markedly (to 4.4%) after the boom observed in the two previous years, whereas industrial output picked up by only 1.1%, after near-stagnation the year before.

Retail trade turnover – a proxy for private consumption – picked up by 6.1% last year, backed by the strong growth in wages, pensions, and remittances. Real wages soared by 12.5%, partly thanks to the hike in the minimum wage (by 16% in nominal terms starting from January 2018), which led to a corresponding indexation of wages and salaries in the public sector. More generally, the strong wage growth reflected progressive tightening of the labour market and the emerging shortages in some of the labour market segments, particularly for high-skilled jobs. The unemployment rate (according to the LFS definition) probably declined below 9%. This decline can be attributed above all to the rising demand for labour: employment recorded positive dynamics for the first time since 2013, outpacing the growth of labour supply which was constrained by the sharply increased outward labour migration. The latter has gained momentum since the EU Schengen area abolished the visa regime for Ukrainians (in June 2017) and a number of Central European countries, such as Poland and the Czech Republic, launched recruitment efforts of Ukrainian workers to alleviate domestic labour shortages.

At the same time, net exports became even more of a drag on growth, mostly due to disappointing export performance. Real exports of goods and services probably declined by some 4% last year, partly on account of transportation bottlenecks in the Azov Sea and maintenance works at several metallurgical plants. In nominal (US dollar) terms, export dynamics was positive (+9.5%) thanks to an increase in commodity prices, but still lagging behind that of imports (+12.8%). As a result, the current account deficit widened noticeably, from 2.2% of GDP in 2017 to an estimated 3.6% last year – even despite the strong increase in the inflow of remittances (by 18.7% in US dollar terms). The widening of the external deficit was partly the consequence of real currency appreciation: the real effective exchange rate strengthened by 13.2% last year, according to the National Bank's calculations.

About half of currency appreciation has been on account of the high inflation. Last year, the CPI index reached 9.8% on an end-year basis (producer price inflation was even higher), suggesting only a minor disinflation compared to the previous years. Thus, the National Bank's inflation target set for 2018 (6±2%) was missed once again – despite the progressive tightening of monetary policy: since October 2017, the key policy rate has been raised six times by a total of 5.5 percentage points, to 18%. The high inflation is to a large extent a reflection of strongly growing wages and unit labour costs, but also of the hikes of administrative prices and tariffs (which went up by 18% last year) as well as rising energy prices.

In December 2018, Ukraine received a new stand-by agreement (SBA) from the IMF worth USD 3.9 billion, of which USD 1.4 billion was immediately disbursed. The SBA agreement is less demanding on 'structural' benchmarks and has only a 14-months duration, but should allow Ukraine to sail safely through the politically turbulent year 2019, when both presidential and parliamentary elections will be held (in March and October, respectively). Indeed, the SBA has proved crucial in stabilising exchange rate expectations and allowed the National Bank to substantially liberalise, as of February 2019, foreign exchange transactions, which – despite certain incremental relaxations – have remained heavily regulated since 2015.[34] Besides, the new agreement with the IMF has enabled Ukraine to attract funding from other sources such as Deutsche Bank (EUR 349 million) and the EU (EUR 500 million under a new MFA programme), and allowed the government to resume borrowing from international financial markets. However, the 9-9.75% yield on the newly issued sovereign (US dollar-denominated) Eurobonds is very high (as recently as in spring 2018 it stood at around 5%) – a reflection of broad perceptions of the country's macroeconomic fragility.

The current pace of economic expansion will not be sustained in the years to come. In 2019, it is projected to slow down to some 2.5%, primarily on the back of a less abundant harvest as well as recent monetary policy tightening. This should constrain bank lending to households (from a rather high level: last year, it grew by 31.4% in nominal terms) and suppress private consumption and, to a lesser

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[34] Among the newly introduced measures are the extension of the time limit for settlements under foreign trade contracts (from 180 to 365 days), lifting of the registration requirement for cross-border loans and of financial monitoring for foreign exchange transactions of less than UAH 150,000, relaxation of access for non-residents to Ukrainian accounts, etc.

degree, investments (the bulk of which are financed from profits rather than by taking credit). At the same time, fiscal policy will remain generally lax in the pre-election context. Among the pre-election 'carrots' approved by the government as of 1 March are (i) an 'automatic' 17% indexation of pensions for more than 10 million pensioners, (ii) a lump-sum extra payment to pensioners of some USD 90 paid over March-April 2019, and (iii) monetisation of gas subsidies, which should benefit some 4 million families. All in all, the 2019 budget law envisages a 32% hike in social spending (in nominal terms), resulting in a likely widening of the fiscal deficit to 2.3% of GDP, after 1.9% of GDP in 2018.

For 2020, GDP growth may slow down further, to around 2%. In the baseline scenario, the main reason for this is the expected drastic reduction of transit of Russian gas to Europe via Ukraine, depriving Ukraine of the bulk of gas transit fees (which are to the tune of 2% of GDP). The current ten-year transit contract with Russia's Gazprom expires at the end of 2019, and its prolongation is highly uncertain, since Russia is planning to divert a large part of its gas destined for Europe to the North Stream 2 pipeline (across the Baltic Sea) as well as the newly built Turkish Stream pipeline (across the Black Sea). Although Russia may still agree to retain the bulk of gas transit through Ukrainian territory, such a decision will depend above all on political factors (including the verdict of the Arbitration Court in Stockholm in a dispute between Russia's Gazprom and Ukraine's Naftogaz) and will be taken after the presidential elections.

The outcome of the presidential election has become more uncertain …, with the former twice prime minister Yuliya Tymoshenko no longer being the overwhelming favourite. Unlike in previous elections, even the outcome of the first round (which will take place on 31 March 2019) is highly uncertain, with incumbent President Petro Poroshenko, Ms Tymoshenko, and comedian Volodymyr Zelenskiy (who is believed to have strong ties to oligarch Ihor Kolomoyski, now in opposition) all having nearly equal chances of making it into the second round. The rating of Mr Poroshenko has benefited recently from the official split of the Ukrainian Orthodox church from the Russian church and the newly introduced constitutional amendments stating Ukraine's aspirations to join the EU and NATO. This, and arguably the imposition of one-month martial law in ten regions of the country following the military clash with Russia in the Kerch Straits in November 2018,[35] has helped Mr Poroshenko to improve his image among nationalistic circles and boosted his chances of making it into the second round, which is scheduled for 21 April 2019.

… but no turnaround in Ukraine's pro-Western foreign and security policies is to be expected. The country will almost certainly remain in the Western political orbit, and any future president will have to reckon in the foreseeable future with pronounced anti-Russian sentiment in the majority of the Ukrainian society (with the exception of the Southeast, but voters' turnout there is expected to be low). This implies that the chances for the implementation of the Minks-2 ceasefire agreement, which involves granting autonomy status to the rebel-held areas of Donbas and amnesty to the rebel fighters, will continue to be low. Therefore, our baseline scenario with respect to Donbas remains that of a lasting 'semi-frozen conflict'. At the same time, there may be some important changes in economic policy, especially in the case of victory by Ms Tymoshenko, who has a history of populist and erratic policies and is now promising to lower gas tariffs for households and boost spending on health and education. This would be a major departure from the current, generally rather liberal, policy course, which could make future cooperation with the IMF even more problematic.

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[35] For our assessment of the implications of the Kerch Straits incident, see https://wiiw.ac.at/the-kerch-straits-clash-another-spiral-in-the-russia-ukraine-conflict-n-352.html

Table 6.23 / Ukraine: Selected economic indicators

	2014	2015	2016	2017	2018 [1]	2019	2020 Forecast	2021
Population, th pers., average	43,001	42,845	42,673	42,485	42,270	42,150	42,050	41,950
Gross domestic product, UAH bn, nom.	1,587	1,989	2,385	2,984	3,500	3,900	4,200	4,500
annual change in % (real)	-6.6	-9.8	2.4	2.5	3.3	2.5	2.0	2.9
GDP/capita (EUR at PPP)	6,400	6,000	6,000	6,100	6,400	.	.	.
Consumption of households, UAH bn, nom.	1,121	1,332	1,570	1,978	2,340	.	.	.
annual change in % (real)	-8.3	-19.8	2.7	9.5	6.5	4.5	4.0	4.0
Gross fixed capital form., UAH bn, nom.	224	269	369	470	620	.	.	.
annual change in % (real)	-24.0	-9.2	20.4	16.1	12.0	5.0	5.0	5.0
Gross industrial production								
annual change in % (real)	-10.1	-13.0	2.8	0.4	1.1	2.5	3.0	3.5
Gross agricultural production								
annual change in % (real)	2.2	-4.8	6.3	-2.2	7.8	.	.	.
Construction output								
annual change in % (real)	-20.4	-12.3	17.4	26.3	4.4	.	.	.
Employed persons, LFS, th, average	18,073	16,443	16,277	16,156	16,340	16,450	16,500	16,550
annual change in %	-6.4	-0.4	-1.0	-0.7	1.1	0.7	0.3	0.3
Unemployed persons, LFS, th, average	1,848	1,655	1,678	1,698	1,580	1,510	1,450	1,400
Unemployment rate, LFS, in %, average	9.3	9.1	9.3	9.5	8.8	8.4	8.1	7.8
Reg. unemployment rate, in %, eop [2]	1.7	1.6	1.5	1.4	1.3	.	.	.
Average monthly gross wages, UAH [3]	3,480	4,195	5,183	7,104	8,865	10,300	11,400	12,600
annual change in % (real, gross)	-5.4	-18.9	8.5	19.8	12.5	7.0	5.0	5.0
annual change in % (real, net)	-6.5	-20.2	9.0	19.0	12.5	7.0	5.0	5.0
Consumer prices, % p.a.	12.1	48.7	13.9	14.4	10.9	9.1	5.2	5.0
Producer prices in industry, % p.a. [4]	17.1	36.0	20.5	26.4	17.4	8.0	6.0	6.0
General governm.budget, nat.def., % of GDP								
Revenues	28.7	32.8	32.8	34.1	33.8	33.7	33.7	33.7
Expenditures	33.3	34.3	35.1	35.5	35.8	36.0	35.7	35.7
Deficit (-) / surplus (+) [5]	-4.5	-1.6	-2.3	-1.4	-1.9	-2.3	-2.0	-2.0
General gov.gross debt, nat.def., % of GDP	69.4	79.1	80.9	71.8	62.0	62.0	62.0	59.0
Stock of loans of non-fin.private sector, % p.a.	11.8	-2.8	2.4	1.9	5.6	.	.	.
Non-performing loans (NPL), in %, eop [6]	19.0	28.0	30.5	54.5	54.0	.	.	.
Central bank policy rate, % p.a., eop [7]	14.00	22.00	14.00	14.50	18.00	15.0	12.0	10.0
Current account, EUR mn [8]	-3,476	1,457	-1,210	-2,165	-3,938	-4,200	-6,000	-7,100
Current account, % of GDP	-3.4	1.8	-1.4	-2.2	-3.6	-3.8	-5.3	-6.0
Exports of goods, BOP, EUR mn [8]	38,235	31,935	30,309	35,192	36,678	40,300	41,900	43,200
annual change in %	-14.1	-16.5	-5.1	16.1	4.2	9.9	4.0	3.1
Imports of goods, BOP, EUR mn [8]	43,626	35,050	36,579	43,758	47,640	52,800	55,000	57,500
annual change in %	-28.7	-19.7	4.4	19.6	8.9	10.8	4.2	4.5
Exports of services, BOP, EUR mn [8]	11,257	11,218	11,242	12,558	13,259	14,800	13,700	14,100
annual change in %	-33.9	-0.4	0.2	11.7	5.6	11.6	-7.4	2.9
Imports of services, BOP, EUR mn [8]	9,350	10,232	10,801	11,655	12,022	13,100	13,700	14,200
annual change in %	-23.0	9.4	5.6	7.9	3.1	9.0	4.6	3.6
FDI liabilities, EUR mn [8]	641	2,750	3,108	2,506	2,107	.	.	.
FDI assets, EUR mn [8]	414	34	156	207	107	.	.	.
Gross reserves of NB excl. gold, EUR mn [8]	5,429	11,320	13,965	14,872	15,955	.	.	.
Gross external debt, EUR mn [8]	102,728	107,663	107,648	96,741	98,000	98,500	99,500	100,500
Gross external debt, % of GDP	101.7	131.2	127.7	97.3	90.0	88.4	87.7	84.9
Average exchange rate UAH/EUR	15.72	24.23	28.29	30.00	32.14	35.0	37.0	38.0

Note: excluding the occupied territories of Crimea and Sevastopol and from 2015 (except for population) 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, in 2014 including VAT refund via issued government bonds. - 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.