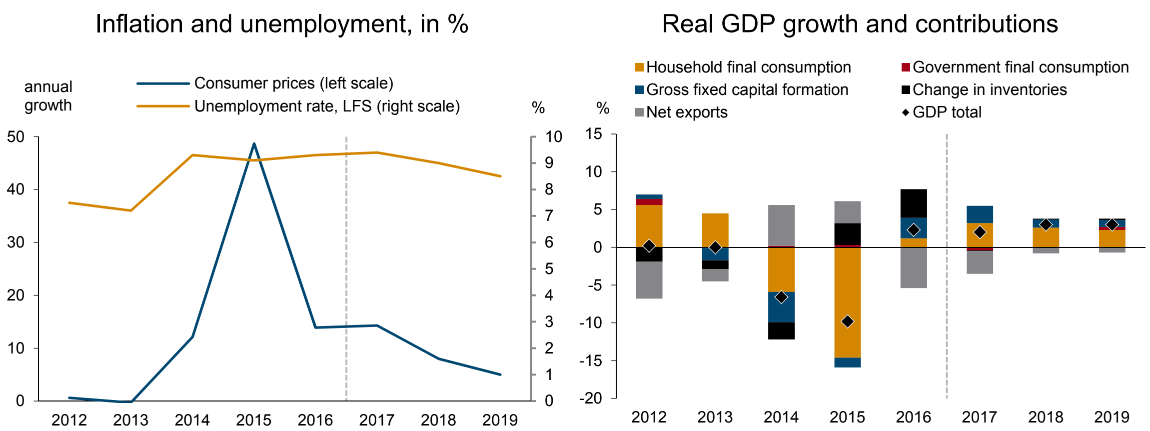
UKRAINE: Jobless recovery

VASILY ASTROV

Economic recovery continues largely unabated, as the negative shock to industrial production and exports from the ban on trade with Donbas has been offset by strengthening private consumption. Also, the government has been able to borrow from international capital markets for the first time since 2015. Barring major negative shocks, growth is expected to reach 2% this year, and to accelerate to 3% in 2018-2019.

Figure 51 / Ukraine: Main macroeconomic indicators



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

The recent months have been characterised by relative economic stability, at least viewed against the country's historically highly volatile standards. Economic recovery continues at largely unabated pace, although it is accompanied by persistently high inflation. In September 2017, CPI climbed to 16.4% year on year (y-o-y), partly due to the poor harvest, but also reflecting the implemented tariff hikes for utilities and the growing demand-side pressures. Although high inflation prevents further cuts in the policy rate, bank lending is primarily constrained by other factors than tight monetary policy and does not constitute a bottleneck to recovery, at least so far.[25] The exchange rate, too, has been generally stable, only weakening somewhat by the end of September. This allowed the National Bank to continue withdrawing capital controls which it had imposed in spring 2015, at the peak of the currency crisis. The recent improvement in the global economy has benefited Ukraine as well. The yield on government

[25] One such factor is the high share of non-performing loans: 57%, according to the new methodology.

bonds has declined markedly, allowing the government to return to international capital markets (for the first time since 2015) and to place USD 3 billion of 15-year Eurobonds in September (at 7.375% interest rate). **After 2.3% GDP growth recorded last year, the economy continued expanding at about the same pace in the first half of 2017**. However, the aggregate figure masks a pronounced shift in the drivers of growth from quarter to quarter. The contribution of real net exports became much more negative in the second quarter, as real exports (of goods and services) declined by 2.1% y-o-y, after near stagnation in the first quarter. Partly, the export decline was due to the enacted ban on trade with the separatist-controlled areas of Donbas, as stalled shipments of coke from these areas undermined Ukraine's steel production and exports. By contrast, real imports picked up pace in the second quarter: from a growth rate of 2.9% to 4.6% y-o-y, respectively, partly reflecting the increased imports of coal from elsewhere. The marked deterioration in net exports was accompanied by strengthening domestic demand, particularly private consumption; the latter accelerated from 2.8% to 6.9% in the second quarter, y-o-y, partly financed from household savings. Recent data suggest that the strong upturn in private consumption has kept momentum during the recent months: In January-August 2017, the retail trade turnover was up by 8.7% in real terms y-o-y, with an accelerating trend. The expansion of fixed capital investments picked up as well in the second quarter, albeit marginally, whereas public consumption contracted strongly.

Similarly to last year, the main driver of household consumption continues to be strong wage growth (+19% in January-August in real terms y-o-y). However, the factors behind are different this time around. In 2016, the growth in real wages was primarily due to the rapid disinflation and the drastic reduction in social security contributions (from an average of 41% to 22%), which helped release enterprise funds for wage purposes. In contrast, this year it has been fuelled above all by the doubling of the official minimum wage as of January (to UAH 3,200, or USD 115 per month). The hike implied an automatic pay-rise for the vast majority of wage earners, around 40% of whom officially earned less than UAH 3,200 per month prior to January, as well as public sector employees whose salaries are indexed by law to the official minimum wage. In addition, business surveys suggest that the move effectively benefited much broader segments of the population than just the two above-mentioned categories.[26] All in all, this suggests that the hike in the minimum wage has had more of an effect on de facto wages rather than on 'de-shadowing' of the economy (a higher share of 'official' wages in the overall wage bill) which was the stated government motivation for the hike.

The recovery has not led to an improvement in the labour market, at least so far. LFS data suggest that in the first half of 2017 employment actually *declined* (by 0.7% y-o-y) and the unemployment rate picked up marginally, to 9.6% – despite the shrinking labour force. To some extent, it is natural to expect that after a severe economic crisis (GDP contracted by 16% in 2014-2015) which was not accompanied by a corresponding reduction in employment, recovery will initially not lead to increased labour demand but will rather rely on better utilisation of the labour force already employed, translating into labour productivity improvements. In addition, even the increased labour demand recorded in several sectors does not necessarily translate into higher employment, suggesting persistent mismatches in the labour market. For these reasons, employment may well continue to stagnate or even shrink further in the years to come. At the same time, increased labour migration to the EU (particularly to Poland, the Czech Republic and Hungary) following the introduction of a visa-free regime for Ukrainian citizens in June

[26] According to a business survey conducted in the first half of 2017, 43% of medium-sized and large enterprises reported wage increases to *all* employees irrespective of their wage level.

2017 will likely accelerate the decline of the labour force, thereby improving the labour market even without gains in domestic employment.

Fiscal performance has markedly improved, albeit partly due to one-off factors. The recent doubling of the minimum wage has led to an increased wage bill of public sector employees. As a result, expenditures of the general government soared by 26% y-o-y (in nominal terms) in the first eight months of 2017. However, this increase was outpaced by the better collection of taxes and non-tax budget revenues (+43%), resulting in a remarkable fiscal surplus, which reached some 3.5% of the period GDP according to our estimates. Even accounting for the one-off factor of the UAH 30 billion received from property seized under the anti-corruption law (from former president Yanukovych officials), the underlying fiscal surplus probably still reached nearly 2% of the period GDP. Given this, the general government deficit in 2017 as a whole will likely not exceed 2% of GDP – despite higher pension spending starting from October as part of the newly adopted pension reform (for more on that, see below). At the same time, more funds (recorded off-budget) are needed for purposes of bank recapitalisation. The recapitalisation of Ukraine's biggest bank Privatbank, which was nationalised in December 2016 and required 4.9% of GDP in public funds at that time, was followed by an injection of another UAH 38.5 billion (1.4% of estimated GDP) in July 2017. In sum, the government reckons with 3.5% of GDP in bank recapitalisation needs this year.

Given the recent trends, it is not obvious that Ukraine still needs IMF credits as an anchor for macroeconomic stability. Indeed, the recent delays in IMF funds (following the allocation of USD 1 billion in April 2017) do not appear to have triggered any turbulence in the foreign exchange market. All in all, because of the delays, Ukraine has so far received only half of the USD 17 billion loan package agreed with the IMF in spring 2015. On the other hand, the country's liberal economic elites continue citing the alleged necessity of cooperation with the IMF as an argument for fostering domestic – generally unpopular – economic reforms.

The most pressing IMF requirement at the current stage is a comprehensive pension reform, the progress on which has been a condition for the allocation of the next (fifth) IMF tranche till the end of the year.[27] The final version of the pension reform adopted in October 2017 abandoned the initial IMF demands for a higher statutory retirement age but envisages a gradual increase in the *effective* retirement age by (i) tightening the number of years in service requirement, and (ii) abolishing early retirement schemes for a wide range of occupations. The idea behind is to reduce the deficit of the Pension Fund, which reached 6.5% of GDP last year due to the above-mentioned cuts in social security contributions.[28] wiiw argues however that the need for a higher retirement age in Ukraine may be exaggerated. In other countries, pension fund deficits tend to be a norm rather than an exception (and are in some cases much higher than in Ukraine); the share of pension expenditures in Ukraine in relation to GDP is not particularly high in an international comparison either, while the impact of the low effective retirement age (61 years) on pension spending is offset by the low life expectancy. The real problem, if any, with the pension system lies on the revenue rather than on the expenditure side; and its solution would realistically require a partial reversal of last year's cuts in social security contributions.

---

[27] Other IMF conditions reportedly include progress in privatisation and fighting corruption, including setting up an 'anti-corruption court'.

[28] For more on that, see Astrov, V. and L. Podkaminer, 'Ukraine: Selected Economic Issues', *wiiw Policy Notes and Reports*, No. 19 (forthcoming).

The 2.4% GDP growth rate observed in the first half of 2017 is unlikely to be sustained throughout the remainder of the year. Particularly in the fourth quarter growth should decelerate on account of a very high statistical base, as the record-high harvest recorded last year will not be repeated. Taking this into account, we expect growth of around 2% this year. For 2018-2019, GDP growth should accelerate to around 3%, barring major shocks. The main factor behind growth acceleration should be the recovery of exports, reflecting their gradual adjustment to the negative shock from the Donbas trade ban, and provided global commodity prices at least do not decline. Also, the recent decision by the European Commission to grant Ukraine autonomous trade preferences starting from October 2017[29] should give a marginal boost to the country's exports going forward. The hryvnia may weaken somewhat, as capital controls are being gradually lifted and it may become more vulnerable to the volatility of capital flows and the recently allowed repatriation of dividends. However, this should not seriously jeopardise macroeconomic stability and disinflation.

The above scenario hinges on the preservation of domestic political stability, which has been shaken by the recent events surrounding the former governor of the Odessa region (and former President of Georgia) Mikhail Saakashvili. After a public row with President Poroshenko and resignation from the post of Odessa governor, Mr Saakashvili was stripped of his Ukrainian citizenship. However, he managed to enter Ukraine (illegally) nonetheless and co-organised (together with other leaders of the right-wing opposition) mass demonstrations in the second half of October, which were aimed against Mr Poroshenko and capitalised on public dissatisfaction with the government reforms and corruption. At the time of finalising this report (23 October), the baseline scenario is still a continuation of the political status quo, but for that it is crucial for Mr Poroshenko not to repeat the mistakes made by former President Yanukovych under similar circumstances: that is, not to overestimate his own power position and not to resort to excessive force in suppressing the public protests.

The preservation of (at least) the semi-frozen status of the conflict in Donbas is far from certain as well, especially taking into account the law on the 'Reintegration of Donbas', which was approved by the parliament in the first reading on 6 October 2017 and envisages a restoration of Kyiv's full authority over the separatist-controlled areas of Donbas. Against this background, any implementation of the Minsk-II agreements, which were agreed back in 2015 and required important concessions by both sides, appears to be utterly unrealistic. Indeed, any move towards recognising the 'special status' of Donbas and granting amnesty to the rebels by President Poroshenko would be tantamount to political suicide in the country's current political climate – all the more so as the next presidential elections are due to be held rather soon (in 2019 at the latest), and Mr Poroshenko's approval ratings are at 17% rather low. However, 'freezing' the conflict is still a realistic option, especially if the two sides agree on the format of UN peace-keeping troops to be deployed in the region. Contrary to its previous stance, Russia has suggested recently that such troops could be deployed along the conflict line (not least to ensure the safety of the unarmed OSCE personnel). Although the Russian proposal has so far met with only a lukewarm response from Ukraine and the West, who advocate the presence of UN peace-keeping troops across the *entire* separatist-controlled area, it potentially signals that a compromise on this issue may be reached sometime soon.

---

29 The new EU regulations envisage higher tariff rate quotas for some agricultural products (such as cereals, processed tomatoes, honey and grape juice), with further import liberalisation for cereals scheduled for January 2018, as well as the elimination of import duties for selected industrial products (such as fertilisers and aluminium) originating from Ukraine.

Table 26 / Ukraine: Selected economic indicators

	2013	2014	2015	2016 [1]	2016	2017	2017	2018	2019
					January-June		Forecast		
Population, th pers., average	45,490	43,001	42,845	42,673	42,709	42,526	42,500	42,400	42,350
Gross domestic product, UAH bn, nom.	1,523	1,587	1,989	2,383	991	1,241	2,800	3,100	3,400
annual change in % (real)	0.0	-6.6	-9.8	2.3	0.9	2.4	2.0	3.0	3.0
GDP/capita (EUR at PPP)	6,600	6,400	5,900	6,000	.	.	.	.	.
Consumption of households, UAH bn, nom.	1,099	1,121	1,317	1,538	698	841	.	.	.
annual change in % (real)	6.5	-8.3	-20.7	1.8	0.8	4.9	5.0	4.0	3.5
Gross fixed capital form., UAH bn, nom.	264	224	269	361	133	178	.	.	.
annual change in % (real)	-8.0	-24.0	-9.2	20.1	11.8	22.2	15.0	7.0	6.0
Gross industrial production									
annual change in % (real)	-4.3	-10.1	-13.0	2.8	2.6	-0.3	0.0	4.0	4.0
Gross agricultural production									
annual change in % (real)	13.3	2.2	-4.8	6.3	-0.3	-2.1	.	.	.
Construction output									
annual change in % (real)	-11.0	-20.4	-12.3	17.4	13.0	24.6	.	.	.
Employed persons, LFS, th, average	20,404	18,073	16,443	16,277	16,239	16,121	16,170	16,150	16,150
annual change in %	0.2	-6.4	-0.4	-1.0	-1.0	-0.7	-0.7	-0.1	0.0
Unemployed persons, LFS, th, average	1,577	1,848	1,655	1,678	1,692	1,710	1,680	1,600	1,500
Unemployment rate, LFS, in %, average	7.2	9.3	9.1	9.3	9.5	9.6	9.4	9.0	8.5
Reg. unemployment rate, in %, eop [2]	1.8	1.7	1.6	1.5	1.5	1.3	.	.	.
Average monthly gross wages, UAH [3]	3,265	3,480	4,195	5,183	4,847	6,638	7,000	7,900	8,500
annual change in % (real, gross)	8.2	-5.4	-18.9	8.5	5.7	20.3	19.0	4.0	3.0
annual change in % (real, net)	8.2	-6.5	-20.2	9.0	6.1	19.7	18.5	4.0	3.0
Consumer prices, % p.a.	-0.3	12.1	48.7	13.9	18.1	13.8	14.3	8.0	5.0
Producer prices in industry, % p.a. [4]	-0.1	17.1	36.0	20.5	15.2	33.7	25.0	10.0	7.0
General governm.budget, nat.def., % of GDP						.			
Revenues	29.1	28.7	32.8	32.8	34.3	40.0	33.9	33.0	32.5
Expenditures	33.3	33.3	34.3	35.1	35.4	35.8	35.7	35.5	35.0
Deficit (-) / surplus (+) [5]	-4.2	-4.5	-1.6	-2.3	-1.1	4.2	-1.8	-2.5	-2.5
Public debt, nat.def., % of GDP	38.4	69.4	79.1	81.0	70.0	69.9	78.5	78.5	80.0
Stock of loans of non-fin.private sector, % p.a.	11.6	11.8	-2.8	2.4	-6.9	-0.2	.	.	.
Non-performing loans (NPL), in %, eop [6]	12.9	19.0	28.0	30.5	30.4	57.7	.	.	.
Central bank policy rate, % p.a., eop [7]	6.50	14.00	22.00	14.00	16.50	12.50	12.5	9.0	7.0
Current account, EUR mn [8]	-12,441	-3,476	-170	-3,116	-760	-1,165	-3,100	-3,500	-3,700
Current account, % of GDP [8]	-8.7	-3.4	-0.2	-3.7	-2.2	-2.7	-3.4	-4.0	-3.9
Exports of goods, BOP, EUR mn [8]	44,518	38,235	31,935	30,309	13,647	17,568	33,600	35,600	37,000
annual change in %	-11.2	-14.1	-16.5	-5.1	-12.0	28.7	10.9	6.0	3.9
Imports of goods, BOP, EUR mn [8]	61,185	43,626	35,050	36,579	15,966	20,528	40,500	42,500	44,200
annual change in %	-8.8	-28.7	-19.7	4.4	-5.9	28.6	10.7	4.9	4.0
Exports of services, BOP, EUR mn [8]	17,032	11,257	11,218	11,242	5,212	6,049	11,600	12,200	12,800
annual change in %	-0.9	-33.9	-0.4	0.2	-4.5	16.1	3.2	5.2	4.9
Imports of services, BOP, EUR mn [8]	12,141	9,350	9,639	9,913	4,625	5,083	9,600	10,100	10,600
annual change in %	7.0	-23.0	3.1	2.8	1.9	9.9	-3.2	5.2	5.0
FDI liabilities, EUR mn [8]	3,396	641	2,750	3,108	1,915	1,208	2,000	.	.
FDI assets, EUR mn [8]	324	414	34	156	11	-176	0.0	.	.
Gross reserves of NB excl. gold, EUR mn [8]	13,592	5,429	11,320	13,965	11,645	14,855	.	.	
Gross external debt, EUR mn [8]	102,852	103,557	108,666	108,599	103,696	100,619	104,000	106,000	108,000
Gross external debt, % of GDP [8]	71.7	102.6	132.4	128.9	123.1	111.4	115.1	119.7	114.4
Average exchange rate UAH/EUR	10.61	15.72	24.23	28.29	28.43	28.94	31.0	35.0	36.0

Note: from 2014 excluding the occupied territories of Crimea and Sevastopol and from 2015 (except for population) parts of the anti-terrorist operation zone.

1) Preliminary. - 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 nationalized 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.