UKRAINE: Investment-led recovery under way

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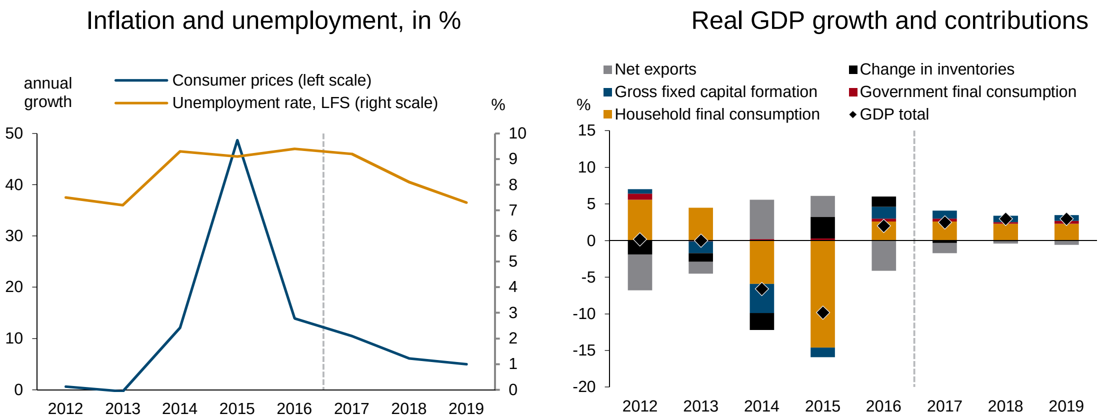
Economic recovery has progressively gained momentum, but it is entirely driven by domestic demand and is accompanied by widening external imbalances. GDP growth is projected to pick up further to 2.5% in 2017 on account of export stabilisation, and to accelerate to 3% in 2018-2019. However, this scenario crucially hinges on the preservation of the semi-frozen state of the conflict in Donbas and the continuation of the International Monetary Fund programme.

Figure 54 / Ukraine: Main macroeconomic indicators



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

The investment-fuelled recovery of Ukraine's economy is progressively gaining momentum. Real GDP growth picked up from 0.1% in the first quarter of 2016 (on an annual basis) to 1.4% in the second quarter, 2% in the third quarter and an impressive 4.7% in the fourth quarter, resulting in GDP growth of some 2% for the year as a whole. This recovery was driven entirely by domestic demand, particularly fixed investments, which surged by an estimated 12% last year. The revival of investments may not come as a big surprise, with businesses making up for years of under-investment in response to economic stabilisation, relative political stability and the largely observed ceasefire in Donbas (at least until recently). Still, the role of foreign direct investment (FDI) remained modest: the bulk of statistically recorded – rather meagre – FDI inflows represented recapitalisation of foreign-owned banks by parent structures. Private consumption performed strongly as well: retail trade turnover – a proxy for private consumption – picked up by 4% last year. However, this increase appears modest against the background of a solid growth in wages (9% in real net terms). This implies that the household saving rate must have been rather high, partly reflecting acute deleveraging needs: the volume of credit to households contracted by 6.6% in nominal (and even more in real) terms.

Construction and agriculture are performing well, but industrial production growth is sluggish. Across sectors, construction output surged by 17.4% and agricultural production by 6% last year, buoyed by a record grain harvest: 66 million tonnes, the highest since the country's independence. This further strengthened the role of agriculture, which has been the main beneficiary of the recent de-industrialisation and whose value-added had reached 14% of Ukraine's GDP the previous year. At the same time, the growth of industrial production (2.8% last year in gross output terms) was constrained by poor export performance. Goods exports declined by 5.2% in US dollar terms, primarily on account of the export slump to Russia (-26%) after it revoked the free trade agreement with Ukraine in response to the Ukraine–EU Deep and Comprehensive Free Trade Agreement (DCFTA).[31] On top of that, Russia imposed an import embargo on Ukrainian food products and restricted the transit of Ukrainian goods destined for third countries (largely Central Asia) across its territory. At the same time, Ukraine's goods exports to the EU grew by a mere 2.4% last year: the vast majority of Ukrainian manufactured goods do not comply with EU standards and regulations, whereas agricultural exports are typically subject to tariff quotas in the EU, which are highly restrictive in many cases. Even so, agriculture and food were the sole commodity group to record positive export growth in 2016 (5.4%).

Investment goods imports are in high demand. Overall goods imports picked up by 3.8% last year (in US dollar terms). Disregarding the sharp decline (-28%) in imported mineral products (essentially oil and gas),[32] import growth was much more impressive: up to 38% in the case of machinery and equipment, the bulk of which were investment goods. On the one hand, increased imports of investment goods are a natural consequence of booming investments and thus represent a welcome development. However, imports rising ahead of exports are a drag on GDP growth and put pressure on the balance of payments. It may be cause for concern that even the rather modest economic recovery observed last year brought with it a marked deterioration in the current account deficit, to 3.6% of GDP (from 0.2% in 2015). With import-fed recovery picking up pace, the external deficits will likely rise further in the years to come.

Fiscal policy has become more expansionary. Unlike in the two previous years, wages and social payments were largely adjusted in line with inflation last year. In addition, the drastic reduction in social security contributions (from 41% to 22%) proved fiscally expansionary as well, as the targeted improvement in tax compliance largely failed to materialise. Nevertheless, the budget deficit widened only moderately (to 2.3% of GDP, from 1.6% in 2015) thanks to over-performing tax revenues. Despite the moderate budget deficit, positive economic dynamics, still high inflation and relative exchange rate stability (70% of public debt is denominated in a foreign currency), Ukraine's public debt as a share of GDP went up last year, to nearly 82% (from 79% in 2015). The main reason for this was the recapitalisation (and nationalisation) of Ukraine's largest bank, Privatbank, in December 2016, largely financed by issuing domestic bonds worth some USD 4 billion.[33] The official reasons for nationalising Privatbank, which had been profitable over the past three years despite the deep economic crisis, were

[31] DCFTA (which is part of a broader Association Agreement) came into force in January 2016.

[32] The sharp decline in gas imports last year was partly a result of steep (and arguably excessive) domestic tariff hikes, which curbed residential gas consumption (for more on that, see V. Astrov and L. Podkaminer, 'Energy tariff reform in Ukraine: estimated effects and policy options', wiiw Research Report No. 416, February 2017).

[33] On top of that, the recapitalisation of Privatbank also involved a 'bail-in' (i.e. losses) of its bondholders.

the insufficient capital adequacy and the non-transparent nature of its credit portfolio, which largely consisted of 'related lending' (i.e. lending to related parties which often use the borrowed funds to purchase the creditor's equity). Following Privatbank's nationalisation, the state now controls around half of the country's banking system and, although it is planning to re-privatise the bank in the near future, the feasibility of this is questionable (so far, the track record of privatisation in Ukraine has been rather dismal).

Further fiscal relaxation is envisaged for this year, as the minimum wage more than doubled from January 2017, from UAH 1,476 to UAH 3,200 per month. This means that wages and salaries in the public sector, which are indexed to the minimum wage, have increased accordingly. At face value, the magnitude of the hike appears reckless (and it is certainly motivated to a large extent by the authorities' concerns over social stability); but it needs to be seen against the background of the strong decline in the real minimum wage over the past three years – about half of the hike represents a mere correction of this decline. Also, the ratio of the minimum wage to the average wage (around 30% in 2016) was extremely low (e.g. compared to most countries of the Organisation for Economic Co-operation and Development). Even at its new level, the minimum wage is a mere USD 115 per month.

The doubling of the minimum wage will add 0.5 percentage points (pp) to real GDP growth and 1 pp to consumer price index inflation this year, according to the national bank's estimates. The incomes of some 3 million employees who earn less than UAH 3,200 per month will rise accordingly. Given their high propensity to spend, this should boost private consumption. At the same time, for earners of higher wages (which often go partly unreported), the share of their income that is officially declared (and taxed) will go up in line with the higher minimum wage. Indeed, reducing the 'shadow' sector and curbing tax evasion have been the key arguments put forward by the government when advocating the move. The government reckons that additional tax revenues will partly offset the higher wage bill of public sector employees, so that the negative impact of the hike in the minimum wage on the budget should be contained. The 2017 central government budget envisages a deficit of 3% of GDP, thus meeting the IMF target.

All in all, wiiw projects an acceleration of growth to 2.5% this year and around 3% in both 2018 and 2019. The main factor behind this should be the expected stabilisation and recovery of exports, largely thanks to higher global prices for metals and for Ukraine's other key export commodities. Still, the recovery will continue to be driven predominantly by domestic demand. Inflation is projected to gradually subside to single-digit figures on the back of relative exchange-rate stability. Unemployment should gradually recede as well, helped in part by economic recovery, but also by the shrinking labour force – a result of both demographic decline and increased outward migration (to countries such as Poland and the Czech Republic; the latter eased access to its labour market for Ukrainians in February 2017). Recent labour market data are encouraging in this respect: in January 2017, the number of employers looking for labour was 35% higher, and the number of job vacancies was 48% higher, than the year before, while the average number of job applicants per vacancy fell from 16 to 9 over the same period.

The above benign scenario hinges on the preservation of (at least) the semi-frozen status of the conflict in Donbas and the continuation of the IMF loan programme. The former is far from certain, especially given the recent (February 2017) escalation in the fighting, which may be related to the perceived change in the global geopolitical climate following the election of Donald Trump as US president. With Mr Trump in office, Ukraine may potentially receive less support (financial and otherwise) from the US; but this also implies that the US would be less able to influence developments in Ukraine, thus providing the authorities with more room for manoeuvre (for more on that, see Special Topic ‘Uncertainty and risks in the CIS region’ in this report). As for the IMF programme, its continuation is all the more important, given the widening external imbalances and the increasing risks of another balance-of-payments crisis. Such a crisis is most likely to materialise in 2019, when Ukraine is due to repay USD 7.5 billion in external debt and when the next presidential and parliamentary elections are due. At the same time, the risks that the IMF programme may stall are non-negligible, since implementing some of the IMF requirements – such as introducing unpopular pension reform and lifting the moratorium on the sale of agricultural land – may not be politically feasible in the current circumstances.

Table 25 / Ukraine: Selected economic indicators

	2012	2013	2014	2015	2016 [1]	2017	2018 Forecast	2019
Population, th pers., average	45,593	45,490	43,001	42,845	42,673	42,550	42,450	42,380
Gross domestic product, UAH bn, nom.	1,459	1,523	1,587	1,989	2,360	2,700	3,000	3,200
annual change in % (real)	0.2	0.0	-6.6	-9.8	2.0	2.5	3.0	3.0
GDP/capita (EUR at PPP)	6,600	6,600	6,400	5,900	6,100	.	.	.
Consumption of households, UAH bn, nom.	1,002	1,099	1,121	1,317	1,190	.	.	.
annual change in % (real)	8.4	6.5	-8.3	-20.7	4.0	4.0	3.5	3.5
Gross fixed capital form., UAH bn, nom.	283	264	224	263	290	.	.	.
annual change in % (real)	3.3	-8.0	-24.0	-9.2	12.0	8.0	7.0	6.0
Gross industrial production								
annual change in % (real)	-0.5	-4.3	-10.1	-13.0	2.8	3.5	4.0	4.0
Gross agricultural production								
annual change in % (real)	-4.5	13.3	2.2	-4.8	6.1	.	.	.
Construction output								
annual change in % (real)	-8.3	-14.5	-20.4	-12.3	17.4	.	.	.
Employed persons, LFS, th, average	20,354	20,404	18,073	16,443	16,250	16,250	16,350	16,400
annual change in %	0.1	0.2	-6.4	-0.4	-1.2	0.0	0.6	0.3
Unemployed persons, LFS, th, average	1,657	1,577	1,848	1,655	1,700	1,650	1,450	1,300
Unemployment rate, LFS, in %, average	7.5	7.2	9.3	9.1	9.4	9.2	8.1	7.3
Reg. unemployment rate, in %, end of period [2]	1.8	1.8	1.7	1.6	1.5	.	.	.
Average monthly gross wages, UAH [3]	3,026	3,265	3,480	4,195	5,183	6,600	7,300	7,900
annual change in % (real, gross)	14.3	8.2	-5.4	-18.9	8.5	15.0	4.0	3.0
annual change in % (real, net)	14.4	8.2	-6.5	-20.2	9.0	15.0	4.0	3.0
Consumer prices, % p.a.	0.6	-0.3	12.1	48.7	13.9	10.5	6.1	5.0
Producer prices in industry, % p.a. [4]	3.7	-0.1	17.1	36.0	20.5	15.0	8.0	7.0
General governm.budget, nat.def., % of GDP								
Revenues	30.5	29.1	28.7	32.8	33.2	33.9	33.0	32.5
Expenditures	34.0	33.3	33.3	34.3	35.5	36.9	35.5	35.0
Deficit (-) / surplus (+) [5]	-3.5	-4.2	-4.5	-1.6	-2.3	-3.0	-2.5	-2.5
Public debt, nat.def., % of GDP	35.3	38.4	69.4	79.1	81.8	83.0	84.0	83.0
Stock of loans of non-fin.private sector, % p.a.	2.1	11.6	11.8	-2.8	2.4	.	.	.
Non-performing loans (NPL), in %, Dec	16.5	12.9	19.0	28.0	31.0	.	.	.
Central bank policy rate, % p.a., end of period [6]	7.50	6.50	14.00	22.00	14.00	10.0	8.0	8.0
Current account, EUR mn [7]	-11,153	-12,441	-3,476	-170	-3,038	-4,200	-4,300	-4,700
Current account, % of GDP [7]	-7.9	-8.7	-3.4	-0.2	-3.6	-4.5	-4.6	-4.8
Exports of goods, BOP, EUR mn [7]	50,127	44,518	38,235	31,935	30,319	34,200	35,600	37,100
annual change in %	11.9	-11.2	-14.1	-16.5	-5.1	12.8	4.1	4.2
Imports of goods, BOP, EUR mn [7]	67,124	61,185	43,626	35,050	36,454	41,800	43,400	45,500
annual change in %	16.2	-8.8	-28.7	-19.7	4.0	14.7	3.8	4.8
Exports of services, BOP, EUR mn [7]	17,186	17,032	11,257	11,218	11,150	12,600	12,800	13,100
annual change in %	12.5	-0.9	-33.9	-0.4	-0.6	13.0	1.6	2.3
Imports of services, BOP, EUR mn [7]	11,351	12,141	9,350	9,639	10,055	11,700	12,300	12,900
annual change in %	18.1	7.0	-23.0	3.1	4.3	16.4	5.1	4.9
FDI liabilities, EUR mn [7]	6,360	3,396	641	2,750	3,114	.	.	.
FDI assets, EUR mn [7]	762	324	414	34	89	.	.	.
Gross reserves of NB excl. gold, EUR mn	17,186	13,592	5,429	11,320	13,965	.	.	
Gross external debt, EUR mn [7]	102,120	102,852	103,557	108,666	104,000	108,000	112,000	115,000
Gross external debt, % of GDP [7]	71.9	71.7	102.6	132.4	124.7	116.0	119.5	118.6
Average exchange rate UAH/EUR	10.271	10.612	15.716	24.229	28.292	29.0	32.0	33.0

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 and wiiw estimates. - 2) In % of working age population. - 3) Enterprises with 10 and more employees. - 4) Domestic output prices. From 2013 according to NACE Rev. 2. - 5) Without transfers to Naftohaz and other bail-out costs, in 2014 including VAT refund via issued government bonds. - 6) Discount rate of NB. - 7) Converted from USD.

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