UKRAINE: Reforms stall ahead of elections

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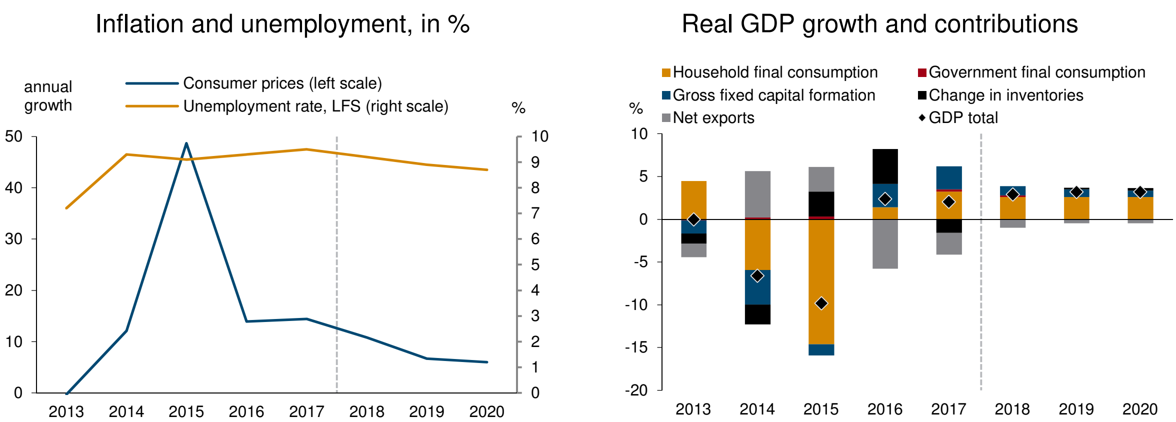
Economic recovery is projected to accelerate from an estimated 2.1% last year to around 3% p.a. in 2018-2020, mostly thanks to an expected recovery of exports. In the short run, growth will also be helped by a more expansionary fiscal policy in the run-up to next year's presidential and parliamentary elections. Monetary policy, by contrast, has been tightened markedly in an attempt to tame the stubbornly high inflation.

Figure 61 / Ukraine: Main macroeconomic indicators



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

In 2017, the economy expanded by 2.1% according to the National Bank of Ukraine's (NBU) estimates – broadly in line with our earlier projections. Although on an annual basis, growth was continuously decelerating (from 2.5% in the first quarter to 2.3% in the second, 2.1% in the third, and 1.8% in the fourth quarter), this was primarily due to the effect of the increasing statistical base – particularly in the fourth quarter, as the record-high harvest of 2016 could not be repeated. Overall, agricultural production declined by 2.7% last year, and gross industrial output was stagnant – largely because of the enacted trade ban with the separatist-controlled areas of Donbas, which led to the disruption of important industrial production linkages. In contrast, services posted solid growth on the back of the strong domestic demand. Retail trade turnover – the proxy for private consumption – picked up by 8.8% last year, largely thanks to the doubling of the minimum wage and the resulting 19% overall real wage growth, while construction output soared by 20.9% thanks to the vibrant investment activity.

Despite the negative contribution of real net exports to GDP growth, external imbalances have not widened. After two consecutive quarters of decline, real exports (of goods and services) returned to growth in the third quarter of 2017 (+6.9% year on year). However, real imports continued growing ahead of exports, so that the contribution of real *net* exports to GDP growth remained strongly negative. Despite that, the current account deficit in 2017 increased only marginally in absolute terms and was unchanged in relation to GDP (at 3.7%, according to our estimates). One reason for this was the fact that in nominal terms, the gap between the exports and imports dynamics (17.3%[65] versus 18.1% in US dollar terms, respectively) was much less pronounced than in real terms, reflecting improved terms of trade. In particular, the prices of steel and iron ore picked up markedly last year. Another factor which mitigated the current account deficit was the strong inflow of remittances; the net 'secondary incomes' of the balance of payments were 28% higher than the year before.

The labour market is yet to show improvement. According to LFS data for the first three quarters of 2017, employment declined by 0.7% and the unemployment rate increased by 0.2 pp, to 9.4% – despite the shrinking labour force. At the same time, the demand for labour actually strengthened: the number of job vacancies grew by 29%, and the vacancy ratio fell from 6 to 4 during the same period. This suggests mismatches in the labour market, possibly facilitated by the ongoing structural change (away from metals and chemicals towards agriculture and certain types of services, such as ICT). In the years to come, increased labour migration to EU countries (particularly to Poland, the Czech Republic and Hungary) will likely accelerate the decline of the labour force, thereby improving the labour market – even if domestic employment does not recover.

Inflation has surprised on the upside… Inflationary pressures remain stubbornly strong: last year CPI reached 13.7% on an end-year basis. This is all the more surprising given the relative currency stability (the hryvnia weakened only marginally by the end of the year) and the historically high degree of 'pass-through' of the exchange rate to consumer prices. Instead, other supply-side factors have played a role, including the hikes in administrative prices and the soaring prices of meat and dairy products (which account for 18% of the consumer basket) on account of bottlenecks in animal production and increased exports. On top of that, according to the NBU's estimates, the doubling of the minimum wage added some 2-2.5 pp and the increase in pensions another 0.3-0.6 pp to the inflation by creating extra demand pressures. Going forward, we expect only moderate disinflation in 2018, to around 9% on an end-year basis.

… and prompts monetary tightening. The stubbornly high inflation has prompted the NBU, whose inflation target for 2017 of 8+/-2% was missed by a wide margin, to reverse its easing cycle. Since September 2017, the discount rate has been hiked in four steps by a total of 4.5 pp, to 17%. In our view, these developments illustrate the flaws of the newly adopted inflation targeting regime, which is ill-suited in the country's economic context.[66] At the moment, tight monetary policy may be less of a problem, given that investments are booming and are predominantly financed from enterprises' own funds rather than by taking credit. However, it may become more of a problem going forward, constraining the country's growth prospects by unduly supressing domestic demand.

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[65] Goods exports to EU countries grew particularly strongly last year: by 31.9% in US dollar terms.

[66] For more on that, see Astrov, V. and L. Podkaminer (2017), 'Ukraine: Selected Economic Issues', wiiw Policy Notes and Reports, No. 19, December, https://wiiw.ac.at/ukraine-selected-economic-issues-p-4370.html

In contrast, fiscal policy is being relaxed in the run-up to next year's elections. In 2017, the doubling of the minimum wage led to an increased wage bill of public sector employees. However, the strong tax collection (partly thanks to higher than expected inflation) and one-off receipts, such as the property seized under the anti-corruption law, limited the budget deficit to a mere 1.5% of GDP. The central budget law for 2018 reckons with an increase in revenues and expenditures by 16% and 19% in nominal terms, respectively, resulting in a projected widening of the deficit to 2.5% of GDP – a sign of policy loosening. Specifically, the 2018 budget law envisages another hike of the minimum wage by 16%, to UAH 3,723 (some USD 130) per month. Judging by the experience from last year, this should benefit not only low-wage earners and public sector employees, but boost the wage level in general. In addition, the government considers another 10% hike in the minimum wage later this year, depending on the budget performance. The higher state expenditures should be partly offset by increased taxation, especially from excise taxes.

The pre-election political context also makes the implementation of reforms demanded by the IMF highly unlikely. The latest IMF demands include the creation of an anti-corruption court, progress on privatisation, another hike in gas tariffs for households, and land market reform. The fight against corruption remains half-hearted at best, and last year's privatisation target was met by only 20%: asset prices are still depressed, the overall business climate (including for foreign investors) remains challenging, while Russian bidders are typically excluded for political reasons. As for the land market reform, the long-standing moratorium on the free sale of agricultural land (which has been in place for the past 16 years) has been prolonged for another year. All this makes the NBU's hopes of receiving another USD 2 billion from the IMF in the course of 2018 fairly unrealistic. In fact, Ukraine has not received any IMF money since April 2017, while the allocation of EUR 600 million from the EU planned for December 2017 has been postponed as well (also because of the lacking progress in fighting corruption). These delays did not result however in marked depreciation pressures. Although since September 2017 the hryvnia has weakened by around 10% (against the US dollar), this should not come as a surprise given the high inflation and will help keep external imbalances at bay. Going forward, Ukraine will likely continue to be able to borrow from international financial markets to make up for any shortfall in lending from official creditors.[67] Although monetary policy in the US will probably be tightened further, its effects are likely to be offset by the upbeat global economic sentiments, resulting in ample supply of liquidity even for financially 'vulnerable' emerging economies such as Ukraine.

In the baseline scenario, economic growth is projected to pick up somewhat, close to 3% in 2018-2020. The main factor behind should be further recovery of exports, as the global economy gains momentum and last year's negative shock from the trade ban with the separatist-controlled areas of Donbas is gradually absorbed. Growth is likely to become more balanced also because domestic demand will likely lose steam somewhat. The current exceptionally high growth rate of fixed investments is unlikely to be sustained, while the more restrictive wage policy will mitigate the growth of private consumption. Still, even under this (relatively optimistic) scenario, Ukraine's GDP in 2020 will be still below that in 2013, on the eve of the 'Maidan revolution'. Growth higher than 3% appears to be unlikely; it will require increased inflows of Western FDI, which are currently not in sight. Although FDI inflows into the real sector (i.e. disregarding the recapitalisation of foreign-owned banks, which used to represent the bulk of statistically recorded FDI inflows during the previous years) picked up by 26% last year, at a mere USD 1.8 billion they remain far below the country's actual needs.

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[67] The government hopes to place another USD 2 billion of Eurobonds this year, following USD 3 billion in September 2017.

The major risks to the above upbeat forecast include (i) a possible escalation of military conflict in Donbas and (ii) starting from 2020, the clouded future of the gas transit. The implementation of the Minsk II agreement signed back in 2015, which envisages granting both a special status to the separatist-controlled areas of Donbas and an amnesty to rebel fighters, continues to be utterly unrealistic in Ukraine's current political climate. Even the deployment of UN peacekeeping troops, which has recently been suggested by Russia, is far from certain and continues to be a subject of difficult US-Russia negotiations. As for the gas transit, the current ten-year gas contract between Russia and Ukraine will expire at the end of 2019. Russia has repeatedly indicated that it is not planning to prolong it, hoping to divert the bulk of its gas shipments to Europe to the Nord Stream 2 pipeline crossing the Baltic Sea (which is currently under construction). In a 'worst-case scenario', this may deprive Ukraine of more than USD 2 billion of annual transit fees (some 2% of GDP) and will in any case increase Russia's leverage in negotiations with Ukraine.

Political risks cannot be disregarded either. The outcome of the next presidential elections scheduled for spring 2019 is highly uncertain. The incumbent President Petro Poroshenko will probably make it into the second round (his victory already in the first round, akin to 2014, appears now very unlikely). However, his victory in the run-off will be largely conditional on his potential opponents being sufficiently 'marginal', such as the leader of the extremely populist Radical Party, Oleh Lyashko, or the head of the relatively pro-Russian Opposition Block, Yuriy Boyko. When facing a more 'mainstream' candidate, such as the former prime-minister Yulia Tymoshenko, former defence minister Anatoliy Hrytsenko or the mayor of Lviv, Andriy Sadovyi, Mr. Poroshenko may easily lose. Such an outcome is likely to result in policies being both more populist and more nationalistic, with potentially negative repercussions on the economy as well.[68] Having said that, more than one year left until the elections is still a lot of time, particularly by Ukrainian standards.

68 For instance, both Ms Tymoshenko and Mr Sadovyi actively supported the trade blockade of the separatist-controlled areas of Donbas, which slowed down Ukraine's economic growth last year.

Table 31 / Ukraine: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019 Forecast	2020
Population, th pers., average	45,490	43,001	42,845	42,673	42,490	42,330	42,180	42,050
Gross domestic product, UAH bn, nom.	1,523	1,587	1,989	2,385	2,780	3,200	3,500	3,800
annual change in % (real)	0.0	-6.6	-9.8	2.4	2.1	2.9	3.2	3.2
GDP/capita (EUR at PPP)	6,600	6,400	6,000	6,100	6,300	.	.	.
Consumption of households, UAH bn, nom.	1,099	1,121	1,317	1,545	1,860	.	.	.
annual change in % (real)	6.5	-8.3	-20.7	2.1	5.0	4.0	4.0	4.0
Gross fixed capital form., UAH bn, nom.	264	224	269	369	550	.	.	.
annual change in % (real)	-8.0	-24.0	-9.2	20.4	17.4	7.0	6.0	5.0
Gross industrial production								
annual change in % (real)	-4.3	-10.1	-13.0	2.8	-0.1	4.0	3.5	3.0
Gross agricultural production								
annual change in % (real)	13.3	2.2	-4.8	6.3	-2.7	.	.	.
Construction output								
annual change in % (real)	-11.0	-20.4	-12.3	17.4	20.9	.	.	.
Employed persons, LFS, th, average	20,404	18,073	16,443	16,277	16,170	16,150	16,150	16,150
annual change in %	0.2	-6.4	-0.4	-1.0	-0.7	-0.1	0.0	0.0
Unemployed persons, LFS, th, average	1,577	1,848	1,655	1,678	1,700	1,640	1,580	1,540
Unemployment rate, LFS, in %, average	7.2	9.3	9.1	9.3	9.5	9.2	8.9	8.7
Reg. unemployment rate, in %, eop 2)	1.8	1.7	1.6	1.5	1.4	.	.	.
Average monthly gross wages, UAH 3)	3,265	3,480	4,195	5,183	7,104	8,300	9,100	9,900
annual change in % (real, gross)	8.2	-5.4	-18.9	8.5	19.8	5.0	3.0	3.0
annual change in % (real, net)	8.2	-6.5	-20.2	9.0	19.0	5.0	3.0	3.0
Consumer prices, % p.a.	-0.3	12.1	48.7	13.9	14.4	10.8	6.7	6.0
Producer prices in industry, % p.a. 4)	-0.1	17.1	36.0	20.5	26.4	15.0	7.0	7.0
General governm.budget, nat.def., % of GDP								
Revenues	29.1	28.7	32.8	32.8	36.6	36.0	36.0	36.0
Expenditures	33.3	33.3	34.3	35.1	38.1	38.5	38.0	38.0
Deficit (-) / surplus (+) 5)	-4.2	-4.5	-1.6	-2.3	-1.5	-2.5	-2.0	-2.0
General gov.gross debt, nat.def., % of GDP	38.4	69.4	79.1	80.9	77.0	76.0	74.0	73.0
Stock of loans of non-fin.private sector, % p.a.	11.6	11.8	-2.8	2.4	0.7	.	.	.
Non-performing loans (NPL), in %, eop 6)	12.9	19.0	28.0	30.5	56.0	.	.	.
Central bank policy rate, % p.a., eop 7)	6.50	14.00	22.00	14.00	14.50	12.50	11.00	10.00
Current account, EUR mn 8)	-12,441	-3,476	-170	-3,116	-3,399	-3,200	-3,600	-5,300
Current account, % of GDP 8)	-8.7	-3.4	-0.2	-3.7	-3.7	-3.5	-3.8	-5.4
Exports of goods, BOP, EUR mn 8)	44,518	38,235	31,935	30,309	35,347	35,200	36,600	38,100
annual change in %	-11.2	-14.1	-16.5	-5.1	16.6	-0.4	4.0	4.1
Imports of goods, BOP, EUR mn 8)	61,185	43,626	35,050	36,579	43,465	42,900	44,600	46,400
annual change in %	-8.8	-28.7	-19.7	4.4	18.8	-1.3	4.0	4.0
Exports of services, BOP, EUR mn 8)	17,032	11,257	11,218	11,242	12,481	12,300	12,900	11,900
annual change in %	-0.9	-33.9	-0.4	0.2	11.0	-1.4	4.9	-7.8
Imports of services, BOP, EUR mn 8)	12,141	9,350	9,639	9,913	10,433	10,300	10,800	11,400
annual change in %	7.0	-23.0	3.1	2.8	5.3	-1.3	4.9	5.6
FDI liabilities, EUR mn 8)	3,396	641	2,750	3,108	2,088	.	.	.
FDI assets, EUR mn 8)	324	414	34	156	43	.	.	.
Gross reserves of NB excl. gold, EUR mn 8)	13,592	5,429	11,320	13,965	14,872	.	.	.
Gross external debt, EUR mn 8)	102,852	103,557	108,666	108,714	100,000	101,000	104,000	105,000
Gross external debt, % of GDP 8)	71.7	102.6	132.4	128.9	107.9	110.5	109.9	107.8
Average exchange rate UAH/EUR	10.61	15.72	24.23	28.29	30.00	35.0	37.0	39.0

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. - 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.