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Ukraine
Economic Update

October 4, 2018

- ***Economic growth picked up to 3.5 percent in the first half of 2018 supported by an early agriculture harvest, but investor confidence is held back by delays in key reforms and the IMF program.***
- ***Ukraine faces major public debt repayments in 2019-2020, which will require mobilizing substantial domestic and external financing in an increasingly challenging financing environment for emerging markets. In this context, it is critical to approve and implement a credible and affordable 2019 budget that meets the fiscal deficit target of 2.5 percent of GDP.***
- ***The growth outlook depends critically on the pace of reforms and staying on track with an IMF program. If recently approved reforms are implemented swiftly and progress is made on the unfinished reform agenda, growth is projected at 3.3 percent in 2018 and 3.5 percent in 2019, rising to 4 percent in 2020 after election related uncertainties abate.***

Recent Economic Developments

Economic growth picked up to 3.5 percent in the first half of 2018 from 2.5 percent in 2017, but investor confidence has been weighed down by delays in implementing key reforms and completing IMF reviews, as well as uncertainty related to the elections. Growth in the first half of 2018 was led by continued strong growth in key services, an early agriculture harvest, and the resumption of growth in the mining sector. Domestic trade grew by 4.5 percent in the first half of 2018 (due to higher wages and consumption), while agriculture grew by 11 percent due to an early harvest. The mining sector resumed growth at 1.4 percent in the first half of 2018 after contracting by 6 percent in 2017 due to the trade blockade with the Donbas region. At the same time, growth slowed significantly in manufacturing (2.3 percent from 5.1 percent in 2017), construction (5.5 percent from 27 percent in 2017), and transport (1.6 percent from 4.3 percent in 2017), pointing toward weaknesses in investor confidence. Investor confidence has been held back by delays in implementing key reforms and completing reviews of the IMF program, given high financing needs through the 2019 election period. On the demand side, fixed investment growth slowed to 15.4 percent in the first half of 2018 from 22 percent in the first half of 2017. However, consumption continued to grow strongly by 4.8 percent in the first half of 2018 due to higher pensions and wages (both in the public sector, as well as in the private sector due to strengthening economic activity and labor migration).

FIGURE 1: GDP Growth, y/y,

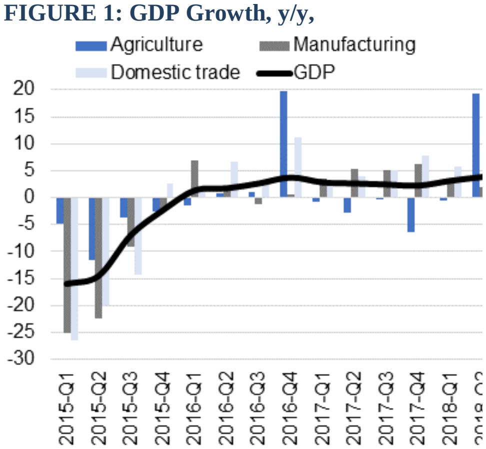


FIGURE 2: Poverty Rates

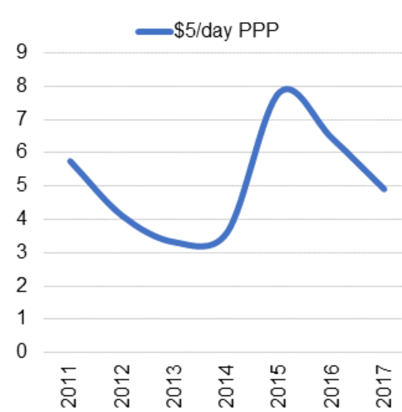
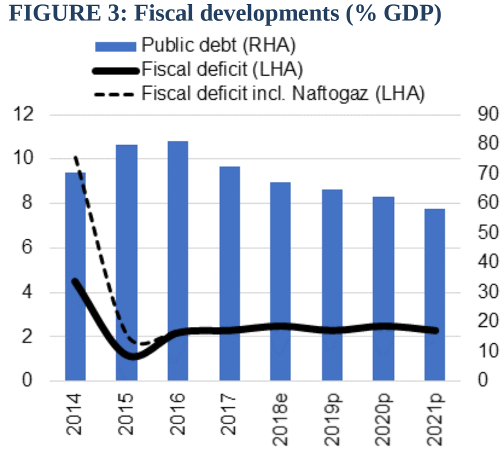


FIGURE 3: Fiscal developments (% GDP)



Fiscal vulnerabilities re-emerged in 2018 due to substantial financing needs, revenue underperformance, and higher spending on wages and social assistance. In 2017, the fiscal deficit remained on target due to strong revenue growth. This helped offset an increase in expenditures by 11.7 percent in real terms from the doubling of the minimum wage, a 40 percent increase in wages of teachers and doctors, and higher spending on social programs (which reached 5.7 percent of GDP). In 2018, education and health sector wages were increased further. Given limited progress in right-sizing of staffing, the public-sector wage bill is projected to reach 11.5 percent of GDP in 2018, up from 9.3 percent in 2016. Pension spending is projected to remain above 10 percent of GDP due to the increase in military pensions. In addition, general government revenues were 5 percent below the target in the first half of 2018, mainly due to weaker proceeds from the payroll tax, VAT and excises. This, together with significant public debt repayments, led to an erosion of treasury balances in July. Public and publicly guaranteed debt remained high at 72.3 percent of GDP in 2017.

Remittances have helped finance the growing external trade deficit, with international reserves at 2.7 months of imports. Merchandise imports grew faster than exports (15.3 percent vs 11.6 percent) in Jan-Aug 2018, with the merchandise trade deficit widening to 6 percent of full-year (FY) GDP. Higher oil prices fueled import growth, while exports suffered from logistical difficulties in the Azov sea since July. The wider trade deficit was covered by 36 percent growth in remittances due to increased labor migration to neighboring EU countries which eased employment rules for Ukrainians. The current account deficit was 1.7 percent of FY GDP in Jan-Aug 2018 and is projected to rise to 2.9 percent of GDP in 2018 (from 2 percent in 2017). Net foreign direct investment (FDI) remained low at only 1.2 percent of FY GDP in Jan-Aug 2018. International reserves declined to $17.2bn in August 2018 from $18.6bn in January 2018. Total external debt declined to 97 percent of GDP in 2017 (from 131 percent in 2015), of which two-thirds is private sector. Rollover risks for private external debt are mitigated by the large share of intra-group loans since market access has been limited in recent years.

The National Bank of Ukraine continued its inflation targeting policy, but inflation remains high due to higher wages and pensions. CPI reached 13.7 percent at end-2017, higher than the NBU target of 8+/-2 percent. The NBU periodically raised its key policy rate 12.5 percent in May 2017 to 18 percent in September 2018. This has helped contain inflation at 9 percent in September 2018, although the cost of funds has increased domestically, and further inflationary pressures are possible from the need to increase energy tariffs going forward.

Outlook

The growth outlook depends critically on whether reforms will continue and an agreement with the IMF is reached, but it also faces headwinds from the 2019 elections, softening commodity prices, Ukraine's major financing needs, and a difficult financing environment for emerging markets. Sustaining reform momentum through 2019 is critical to meet major financing needs and to strengthen investor confidence. If reforms continue and IMF reviews are completed, economic growth is projected at 3.3 percent in 2018 and 3.5 percent in 2019, rising above 4 percent in 2020-2021 after election related uncertainties abate. Given the headwinds, achieving such growth in 2019-2021 will require implementing recently approved reforms (High Anticorruption Court, State-Owned Banks, and resolution of NPLs) and moving forward with unfinished reforms (such as the opening of agricultural land markets). Growth would be supported by value-added manufacturing and services, with agriculture and mining remaining relatively flat as commodity prices soften slightly. Consumption growth is projected to remain robust at 4.1 percent in 2019 due to higher wages and remittances, while investment growth is projected to pick up after elections. By contrast, if reforms do not progress and IMF reviews are not completed, overall growth could fall below 2 percent in 2019 as investor confidence deteriorates, macroeconomic vulnerabilities intensify, and financing difficulties force a compression in domestic demand.

Ukraine faces major financing needs to repay public debt and cover the fiscal deficit in 2019-2020. The government needs $7.7 billion (5.8 percent of GDP) in 2019 to repay public debt (in foreign and local currency), with another $2.9 billion (2.3 percent of GDP) needed to cover the projected fiscal deficit. In this context, it will be critical to approve and implement a budget for 2019 that is credible, affordable, and in line with the fiscal deficit target of 2.5 percent of GDP. This will require affordable implementation of recent reforms in pensions, health, education, public administration, and housing utility subsidies, while avoiding measures that may undermine revenues. Specifically, it will be important to not exceed the 12 percent increase in minimum wages for 2019 already announced; restrain further wage increases and top-ups in the school and hospital sector without optimization of the oversized networks; adhere to pension indexation rules; and implement recently approved targeting measures in housing utility subsidies. Further, the proposed replacement of the corporate income tax with a tax on distributed dividends is unaffordable since it would result in loss of a major revenue source in a challenging fiscal environment. If the fiscal deficit target is not met and the necessary financing is not secured, Ukraine will need to resort to ad hoc expenditure cuts and revenue measures, which would undermine macroeconomic stability and development outcomes.

Maintaining external sustainability will require continued cooperation with development partners, and higher exports and foreign direct investment. The current account deficit is projected to widen slightly to 3.3 percent of GDP in 2019-2020 as softer commodity prices impact traditional exports. This will require boosting nontraditional and higher value-added exports, continued cooperation with the IMF and other partners, as well as a recovery of FDI, without which Ukraine will remain vulnerable to external shocks and commodity price cycles.

Table 1: Key Economic Indicators

	2013	2014	2015	2016	2017	2018P	2019P	2020P	2021P
Nominal GDP, *UAH billion*	1,465	1,587	1,989	2,385	2,983	3,428	3,854	4,314	4,801
Real GDP, *% change*	0.0	-6.6	-9.8	2.3	2.5	3.3	3.5	4.0	4.5
Consumption, *% change*	5.2	-6.2	-15.9	1.4	6.7	4.2	4.1	3.8	3.5
Fixed Investment, *% change*	-8.4	-24.0	-9.2	20.1	18.2	10.2	4.2	8.2	9.5
Export, *% change*	-8.1	-14.2	-13.2	-1.6	3.5	1.0	1.0	3.5	5.5
Import, *% change*	-3.5	-22.1	-17.9	8.4	12.2	5.7	3.1	4.3	4.9
GDP deflator, *% change*	3.1	14.8	38.4	17.1	22.0	11.6	8.9	7.9	6.8
CPI, *% change eop*	0.5	24.9	43.3	12.4	13.7	10.0	7.3	6.4	6.0
Current Account Balance, *% GDP*	-9.2	-3.5	-0.2	-1.4	-2.1	-2.9	-3.3	-3.4	-2.6
External debt, *% GDP*	78.6	97.6	131.5	122.6	110.2	97.9	92.6	87.1	78.5
International Reserves, *US$ billion*	20.4	7.5	13.3	15.5	18.8	…	…	…	…
In months of next year's imports	3.3	1.9	3.2	3.4	3.2	…	…	…	…
Budget revenues, *% GDP*	43.6	40.3	42.1	38.4	39.2	41.0	38.9	40.0	40.6
Tax revenues, *% GDP*	37.9	35.8	35.5	33.1	34.0	35.7	34.7	35.7	36.3
Budget expenditures, *% GDP*	48.4	44.8	43.2	40.6	41.5	43.5	41.2	42.5	42.9
Current expenditures, *% GDP*	46.2	44.3	41.0	37.4	38.2	39.0	37.4	38.0	38.4
Capital expenditures, *% GDP*	2.0	1.3	2.2	3.1	3.3	4.5	3.8	4.5	4.5
Fiscal balance, *% GDP*	-4.8	-4.5	-1.2	-2.2	-2.3	-2.5	-2.3	-2.5	-2.3
Public and Guaranteed Debt, *% GDP*	40.6	70.3	79.7	81.2	72.3	67.2	64.8	62.4	58.4

Source: Ukrainian Authorities, WB projections

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