THE WORLD BANK
IBRD • IDA

Ukraine Economic Update

May 23, 2019

- ***Economic growth rose to 3.3 percent in 2018, supported by a good harvest and favorable domestic demand conditions, but investment was held back by uneven reform progress, election-related uncertainties, and higher costs of borrowing.***
- ***The fiscal deficit was within the target at 2 percent of GDP in 2018, but vulnerabilities remain: specifically, large public debt repayments in 2019-2021 and pressures on public current expenditures.***
- ***To accelerate economic growth and address vulnerabilities, Ukraine will need to speed up reforms and stay on track with the IMF, EU and WB programs. If reforms progress, growth can pick up to 4 percent in the medium term. If reforms stall, growth can fall to under 2 percent as economic vulnerabilities intensify.***

Recent Economic Developments

GDP growth picked up in 2018, driven by agriculture and sectors dependent on domestic demand, while investment growth slowed. GDP grew by 3.3 percent in 2018 (after 2.3 and 2.5 percent in 2016 and 2017 respectively). The pickup in growth was driven by a strong harvest, with the agriculture sector growing by 7.8 percent. Sectors dependent on domestic demand also grew strongly, with domestic trade, financial sector, and construction growing by 3.7 percent, 12.4 percent, and 7.2 percent, respectively. At the same time, manufacturing grew by only 0.6 percent, while transport grew by only 1.1 percent. Household consumption continued to grow rapidly by 8.9 percent in 2018 (after 9.5 percent growth in 2017) on the back of significant hikes in public sector wages and pensions, sizable remittance inflows due to labor migration to EU countries, and the resumption of growth in consumer lending. At the same time, investment growth slowed to 14.3 percent in 2018 (and 10 percent in 4Q18) from 18 percent in 2017, due to the slow pace of reforms, election and conflict-related uncertainties, and the high cost of borrowing. Structural weaknesses remain in the banking system and the real sector, with significant debt overhang and legacy non-performing loans in the corporate sector. FDI inflows remained low (just 2 percent of GDP) for the third consecutive year.

FIGURE 1: GDP Growth, y/y,

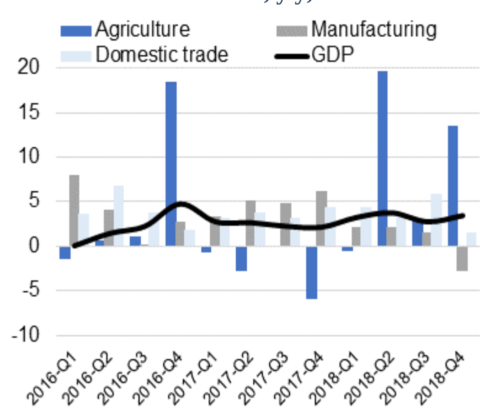


FIGURE 2: Poverty Rates

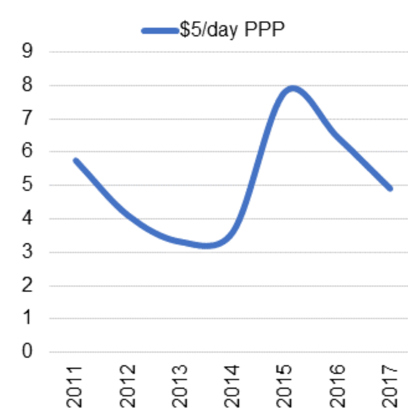
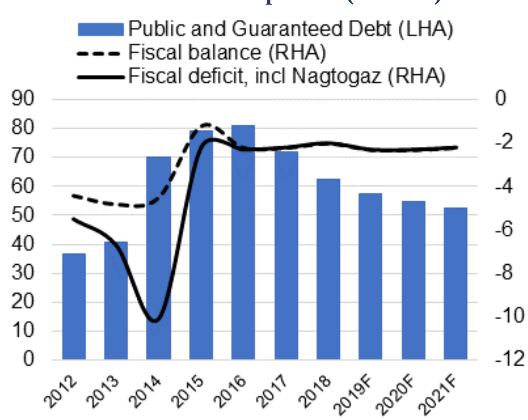


FIGURE 3: Fiscal developments (% GDP)



Poverty declined further due to higher consumption from wages and pensions. Real wages continued to grow in 2018 by 12.5 percent due to a further hike in minimum wages and pressures from outward labor migration. After four consecutive years of decline, pensions also increased by 22.2 percent in real terms in 2018. As a result, poverty (consumption per capita below 5.5 USD/day in 2011 PPP) declined to 4.0 percent in 2018 from 4.9 percent in 2017 and 6.4 percent in 2016. Moderate poverty (World Bank's national methodology for Ukraine) declined to estimated 16 percent in 2017 from 25 percent in 2017, however, it remained higher than before the 2014 crisis.

The fiscal deficit target was achieved, but pressures from the wage bill remain high. The fiscal deficit was 2 percent of GDP in 2018 (vs. 2.3 percent in 2017), which helped reduce PPG debt to 63 percent of GDP in 2018. At the same time, higher public sector wages contributed to the domestic demand and inflationary pressures, as well as increased cost of domestic government borrowings. The hike in the minimum wage and additional sectoral top-ups raised the wage bill to 11 percent of GDP in 2018 (from 9 percent in 2016). Thus, current expenditures remained large at about 38 percent of GDP and, to meet the deficit target, the government cut capital expenditures (they were executed below the plan). Also, efforts to improve targeting of the housing utility subsidy helped reduce social assistance spending by 0.3 ppts to 4.1 percent of GDP, while interest payments also declined by 0.4 ppts to 3.3 percent of GDP, as a result of currency stabilization. On the revenue side, most sources (in particular VAT and excise) performed below the plan, although this was almost totally covered by overperformance of the corporate income tax (with proceeds 16 percent above the plan).

Tight monetary policy helped to bring down inflation and rebuild international reserves. Strong domestic demand, together with real exchange rate appreciation, contributed to a pick-up in imports and a widening of the current account deficit to 3.5 percent of GDP in 2018 (from

2.1 percent in 2017). Remittances reached almost 9 percent of GDP in 2018 but were not sufficient to cover the growing trade deficit. To manage domestic demand pressures, the National Bank of Ukraine (NBU) increased the policy rate to 18 percent, which helped reduce inflation from 13.7 percent at end-2017 to 9.8 percent at end-2018. Inflows from Ukraine's renewed cooperation with the IMF, EU and WB helped boost international reserves to $20.8bn at end-2018 (equivalent of 3.5 months of imports).

Outlook

The growth outlook depends critically on accelerating the reform momentum to support investment and productivity growth. In 2019, growth is projected at 2.7 percent as investment remains constrained by difficult external conditions, election-related uncertainties, and the high cost of borrowing. In addition, Ukraine's terms of trade are projected to soften and limit traditional exports. Growth in 2019 will thus continue to be supported by the sectors dependent on domestic consumption. Going forward, accelerating progress on critical structural reforms can help Ukraine boost growth to 4 percent in the medium term after election related uncertainties abate. Specifically, this will require progress in the following areas: (i) attracting private investment into the tradable sectors by opening the agricultural land market, tackling corruption, privatizing state-owned enterprises, and strengthening competition and property rights; (ii) reviving sound bank lending to the enterprise sector by establishing independent supervisory boards at state-owned banks and resolving non-performing loans; and (iii) safeguarding macroeconomic stability by raising adequate financing and meeting the fiscal deficit targets, further reducing inflation, and rebuilding reserves. If reforms do not progress and adequate financing is not mobilized, growth could fall to below 2 percent as investor confidence deteriorates, macroeconomic vulnerabilities intensity, and financing difficulties force a compression in domestic demand.

Ukraine faces significant debt repayments in 2019-2021, which will require mobilizing adequate international financing and further strengthening public finances to meet the fiscal deficit target. Repaying public debt and financing the fiscal deficit will require new borrowing equivalent to about 8 percent of GDP ($11 billion per year), with about 40 percent planned from external sources and the rest raised domestically. To raise the necessary external financing on affordable terms, it is critical to maintain the reform momentum and stay on track with completion of the IMF reviews. In this context, it will also be critical to meet the fiscal deficit target for 2019-2021 through affordable implementation of the health and education reform, further rationalization of social assistance, and a putting in place a more equitable and growth-friendly tax system. The health and education reforms are intended to strengthen the quality of services, while consolidating the oversized hospital and school networks.

Ukraine remains vulnerable to external shocks and commodity price cycles due to its reliance on commodity exports. To increase resilience to external shocks Ukraine will need to accelerate the structural transformation of its economy by boosting nontraditional and higher value-added exports. Safeguarding external sustainability will also require attracting FDI.

Table 1: Key Economic Indicators

	2013	2014	2015	2016	2017	2018	2019P	2020P	2021P
Nominal GDP, *UAH billion*	1,465	1,587	1,989	2,385	2,984	3,559	4,018	4,539	5,052
Real GDP, *% change*	0.0	-6.6	-9.8	2.3	2.5	3.3	2.7	3.4	3.8
Consumption, *% change*	5.2	-6.2	-15.9	2.0	8.4	6.8	5.1	3.7	3.3
Fixed Investment, *% change*	-8.4	-24.0	-9.2	20.4	16.1	14.3	6.8	9.3	10.1
Export, *% change*	-8.1	-14.2	-13.2	-1.8	3.8	-1.6	-2.5	1.7	2.3
Import, *% change*	-3.5	-22.1	-17.9	9.3	12.6	3.2	3.8	4.2	3.7
GDP deflator, *% change*	3.1	14.8	38.4	17.1	22.1	15.4	10.2	9.6	7.5
CPI, *% change eop*	0.5	24.9	43.3	12.4	13.7	9.8	7.0	6.0	5.0
Current Account Balance, *% GDP*	-9.2	-3.5	-0.2	-1.4	-2.1	-3.5	-3.8	-4.0	-3.9
Exports of G&S, *% GDP*	45.2	49.1	52.6	49.4	47.9	45.5	42.8	41.1	40.4
Imports of G&S, *% GDP*	53.8	52.5	54.5	56.3	55.6	54.1	53.8	51.4	51.0
External debt, *% GDP*	78.6	97.6	131.5	122.6	103.9	88.3	81.8	79.0	75.4
International Reserves, *US$ billion*	20.4	7.5	13.3	15.5	18.8	20.8	…	…	…
In months of next year's imports	3.3	1.9	3.2	3.4	3.2	3.5	…	…	…
Budget revenues, *% GDP*	43.6	40.3	42.1	38.6	39.3	40.0	38.8	39.3	39.2
Tax revenues, *% GDP*	37.9	35.8	35.5	33.1	34.2	34.6	34.4	35.5	35.5
Budget expenditures, *% GDP*	48.4	44.8	43.2	40.6	41.5	42.0	41.0	41.0	41.1
Current expenditures, *% GDP*	46.2	44.3	41.0	37.5	38.1	37.8	37.2	37.1	37.3
Capital expenditures, *% GDP*	2.0	1.3	2.2	3.1	3.3	4.1	3.7	3.9	3.9
Fiscal balance, *% GDP*	-4.8	-4.5	-1.2	-2.2	-2.3	-2.0	-2.3	-2.3	-2.2
Consol deficit, incl Nagtogaz, *% GDP*	-6.7	-10.1	-2.1	-2.3	-2.3	-2.0	-2.3	-2.3	-2.2
Public and Guaranteed Debt, *% GDP*	40.6	70.3	79.7	81.2	72.3	62.3	57.3	54.9	52.5

Source: Ukrainian Authorities, WB projections

Contact info: Faruk Khan (fkhan5@worldbank.org), Karlis Smits (ksmits@worldbank.org) and Anastasia Golovach (agolovach@worldbank.org), ***(380 44) 490 66 71*** ***www.worldbank.org/ua***