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Ukraine

Special Focus Note

Tapping Ukraine's growth potential

May 23, 2019

- ***Ukraine is at a crossroads today: despite the recovery in economic growth following the 2014-15 crisis, the rate of growth remains too anemic for Ukraine to reach income levels of neighboring European countries.***

- ***While Ukraine has made progress in strengthening the foundations for sustainable growth, the economy continues to be constrained by unfinished reforms that lead to low productivity, over-reliance on commodity-based exports, limited foreign direct investment and global economic integration, and weak institutions.***

- ***Achieving higher and sustained economic growth will require progress on further critical reforms to boost productivity and investment, including in the following areas: rule of law and property rights protection; land reform; governance and supervision in the financial sector; competition in the gas sector; and logistics and connectivity to fully leverage external trade opportunities.***

Structural bottlenecks and slow reform progress lead to anemic growth in Ukraine

The rate of economic growth in Ukraine remains too low to reduce poverty and reach income levels of neighboring European countries. Following the 16 percent cumulative contraction of the economy in 2014-15, economic growth has recovered to 2.4 percent in 2016-17 and 3.3 percent in 2018. Faster economic growth for a sustained period of time is needed to reduce poverty which remains above pre-crisis levels. More needs to be done if Ukraine's aspiration is to become a high-income country and to close the income gap with advanced economies. Today Ukraine is far from that goal. In terms of GDP-per-capita, Ukraine remains one of the poorest countries in the region—at levels of Moldova, Armenia and Georgia. Ukraine's GDP per capita in purchasing power parity terms is about three times lower than in Poland, despite having similar income levels in 1990.

At the growth rate of recent years, it will take Ukraine more than 50 years to reach income levels of today's Poland. If Ukraine's productivity growth and investment rate remains at the low levels observed in recent years, overt the medium-term the growth rate will converge to almost zero per annum—productivity growth is offset by declining contribution of labor as Ukraine undergoes the demographic transition. Boosting total factor productivity growth to 3 percent per year and investment to 30 percent of GDP would result in sustained growth of about 4 percent per year over the medium- to long-term. Given declining total population this translates to GDP per capita growth of about 4.5 percent per year. These trends will not improve on their own, they can happen only through the implementation of appropriate policies that boost productivity and increase the returns on factors of production.

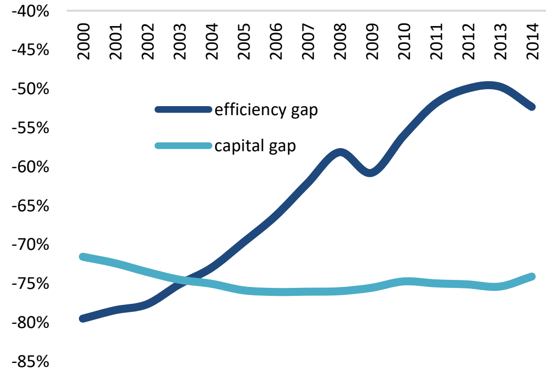
Ukraine's incomplete economic transition undermines productivity, incentives to accumulate capital, and boost higher value-added exports

Ukraine's economic transformation to a competitive market economy remains incomplete. Formal market institutions—private property rights, a private sector, and markets—were established, but the state has remained an important player in the economy due to its ownership of a substantial part of productive assets. A commitment to protect property rights continues to be undermined by a weak court system and government institutions, a high level of corruption and vested interests. Anti-competitive markets remain one of the key impediments for attracting foreign direct investment and catalyzing the structural transformation of the economy.

Over-reliance on commodity-based exports has delayed much needed restructuring toward developing higher valued-added exports. Constrained by the lack of investment, the share of capital-intensive exports has declined over the last decade to just about 16 percent in 2017. In addition, the share of labor-intensive products has remained very low in one of the most labor abundant countries of Europe. In the manufacturing sector Ukraine's participation in global value chains (GVC) has remained low. Through such GVC exports, countries not only exchange products but also technology, knowledge, and networks. As a result, Ukraine's export structure remains highly concentrated in a small number of basic commodities: either metals or farm products. This makes the economy vulnerable to external shocks and commodity price cycles, and together with short-term foreign savings, has made Ukraine's growth trajectory volatile and unsustainable.

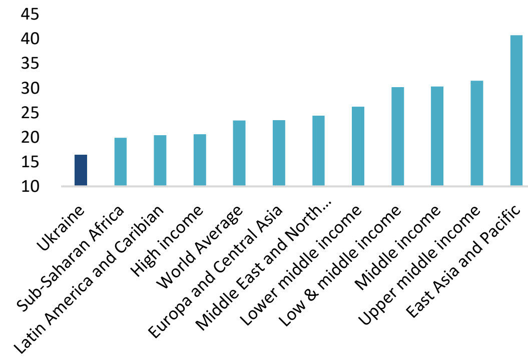
Ukraine's investment rate and total factor productivity—the efficiency with which labor, capital and land are used across sectors and firms—have remained low. An average worker in Germany in 17 days produces as much as an average worker in Ukraine in one year. Large differences in Ukraine's low level of output per worker relative to advanced countries are due to both large efficiency and capital gaps. During the last decade, Ukraine has made some progress in closing the efficiency gap, but it remains constrained by deep structural bottlenecks, and limited investment, including FDI. Ukraine's level of capital per worker is at the same level as in late 1990s (Figure 1). Ukraine remains an outlier in the level of capital investment (Figure 2) that undermines its growth potential.

Figure 1: Ukraine's efficiency and capital gaps with respect to Germany, in percent



Source: Source: World Bank staff calculations based on Penn World Tables 9.0.

Figure 2: Gross Fixed Capital Formation, Percent of GDP, Average 2010-17



Source: World Development Indicators.

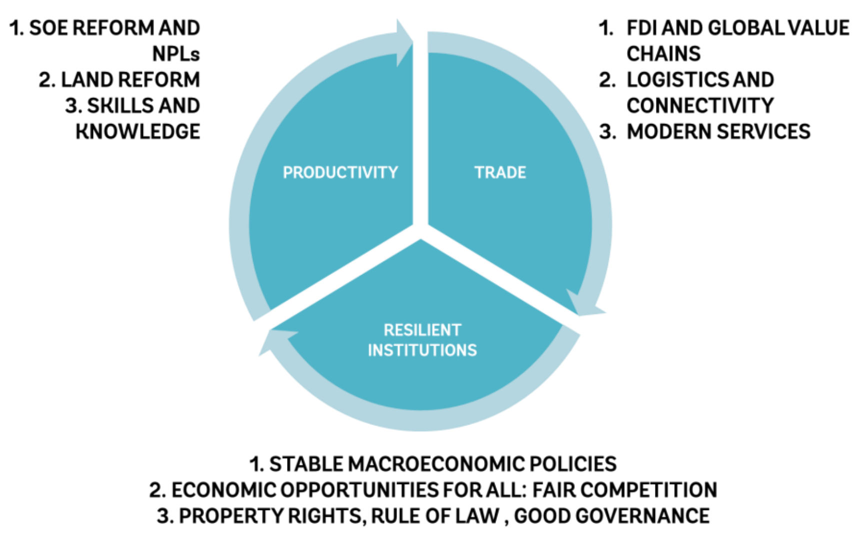
How can Ukraine raise its economic growth?

Going forward, Ukraine's key challenge is not to achieve high growth next year or for a few years, but rather to make economic growth faster, lasting longer and kinder by giving equal opportunity to all. Three decades of transition have shown that Ukraine's key problem is not its inability to ignite growth—Ukraine has in fact gone through episodes of high growth. When external conditions are favorable, igniting growth does not require strong market institutions and property rights, but such growth often proves to be unsustainable. In 2000-08, Ukraine grew by more than 7 percent per year. However, the pattern of that growth was based on large international financial inflows and credit expansion, and it proved to be unsustainable. Ukraine is still paying the consequences of the feast, most noticeably in the high nonperforming loans (NPLs) in the banking sector and difficulties in accessing new credit.

Achieving high growth will require combining an increase in productivity growth and investment. The burden on investment and productivity growth are particularly high given that Ukraine's labor force is projected to decline due to demographic factors and labor migration. Supporting investment and productivity growth would require policy reforms in three areas:

- ***Adjusting the role of the state, addressing distortions in factor markets and strengthening human capital to ignite productivity growth.*** This can be achieved by reducing the footprint of the state in the enterprise sector and facilitating public investment; privatization and unbundling of natural monopolies; opening the market for agricultural land; strengthening corporate governance of state-owned banks; and comprehensive reform of Ukraine's educational system.
- ***Facilitating FDI and integration into global value chains, improving logistics and connectivity to fully leverage external trade opportunities.*** One of the most important factors in attracting FDI is the protection of property rights.
- ***Maintaining stable macroeconomic policies, giving everyone an equal opportunity and strengthening rule of law to make economic institutions more resilient***.

Diagram1: Priority areas for igniting productivity growth, leveraging external trade opportunities, strengthening resilience of institutions



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