Ukraine Economic Update

October 3, 2017

- ***The economy grew modestly at 2.4 percent in the first half of 2017 and poverty remains higher than pre-crisis levels.***
- ***Boosting economic growth to 4 percent or more in the next two years is critical to reduce poverty and improve living standards for the population. This will require progress on an ambitious package of reforms, including in land markets, financial sector, anticorruption, and privatization, to stimulate investment and productivity.***
- ***Despite higher revenues, the fiscal deficit is projected to widen to 3.5 percent of GDP in 2017 due to higher public sector wages and spending on social programs. Reducing the fiscal deficit in 2018 and beyond will require adopting responsible pension reform and implementing education and health reform in a manner that improves the quality of services while optimizing the school and hospital network.***

Recent Economic Developments

Economic growth remains modest due to the unfinished structural reform agenda and headwinds from the conflict in eastern Ukraine. Real GDP grew by 2.4 percent (y-o-y) in the first half of 2017, following growth of 2.3 percent in 2016. While the resumption of growth is a positive development, this is a weak recovery since it follows a cumulative 16 percent contraction in 2014 and 2015. Even key sectors exhibiting relative strength, such as manufacturing, trade services, and transport continued to grow at a modest pace—3.7, 3.5, and 4.4 percent, respectively—in the first half of 2017, which is insufficient to drive stronger growth in the overall economy. The mining and utility sectors contracted by 6.6 percent and 5.5 percent, respectively, due to the trade blockade against uncontrolled areas of the Donbas region, which affected coal, steel, and electricity production. On the other hand, construction and fixed investment continued to exhibit strong growth in the first half of 2017—at 26 and 22 percent, respectively—pointing toward strengthening investor confidence in some areas, although both remain down sharply from pre-crisis levels. Merchandise exports grew by 23 percent in the first half of 2017, mostly due to improving commodity prices, after declining by 13 percent in 2016. Broader and stronger investment and economic growth will require further progress on the unfinished reform agenda.

FIGURE 1: GDP Growth, y/y,

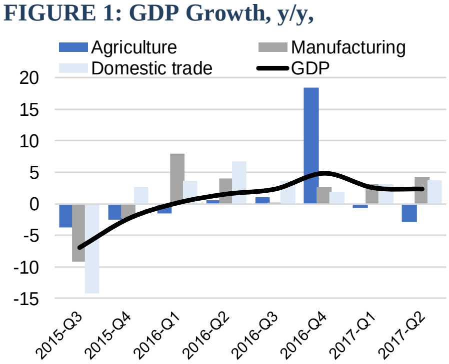


FIGURE 2: Poverty Rates

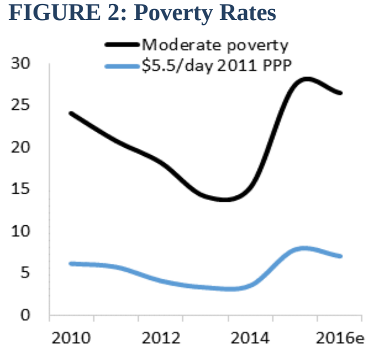
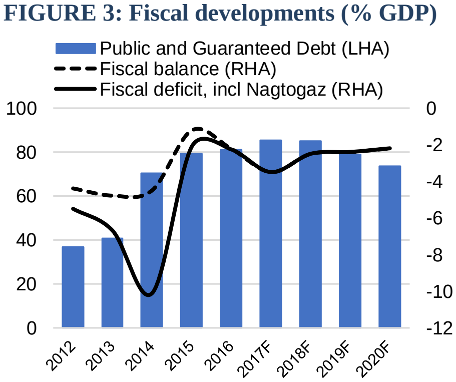


FIGURE 3: Fiscal developments (% GDP)



Poverty remains significantly higher than pre-crisis levels and faster economic growth is critical to reduce poverty going forward. Moderate poverty (World Bank's national methodology for Ukraine) in 2016 is estimated at 26.5 percent, down slightly from 27.5 percent in 2015, but up sharply from 14.1 percent in 2013. The poverty rate (under $5.5/day in 2011 PPP) in 2016 is estimated at 7 percent, up sharply from 3.3 percent in 2013. Disposal incomes contracted sharply in real terms in 2015 due to the deep recession and unsustainable social benefits. The average real wage was down 30 percent in January 2016 compared to pre-crisis levels, but increased 17 percent in July 2017 compared to a year earlier due to the increases in public sector salaries and the minimum wage.

Fiscal expenditures and revenues grew strongly in the first half of 2017, with the supplementary budget adding to expenditure pressures for the rest of the year. In 2016, the fiscal deficit widened to 2.2 percent of GDP due to lower social security contributions, despite expenditure restraint and growth of other revenues. In the first half of 2017, both expenditures and revenues exhibited strong growth. Expenditures were up by 13.5 percent in real terms due to the increase in the minimum wage (and resulting higher wages for teachers, doctors, and civil servants), as well as higher spending on social programs. Revenues also grew strongly by 22.8 in real terms in the first half of 2017, driven by higher revenues across the board, including personal, corporate, and value added tax, as well as social security contributions and non-tax revenues. As a result, the fiscal balance in the first half of 2017 amounted to a surplus of 0.9 percent of full year GDP. However, the supplementary budget adopted in July 2017 adds to expenditure pressures for the rest of the year, including higher spending on military, social programs, and capital investment. As a result, the fiscal deficit in 2017 is expected to exceed the target of 3 percent of GDP. At the same time, the public debt level continued to grow, reaching 85 percent of GDP as of July 2017, due to the high cost of bank recapitalization. In September 2017, Ukraine successfully issued $3 billion in Eurobonds, of which $1.3 billion is new financing, with the remaining amounting helping to refinance bonds due in 2019.

Outlook

The growth projection for 2017 remains modest at 2 percent, but progress on the ambitious package of reforms under consideration could accelerate growth to 4 percent or more going forward. The growth outlook is affected by two key factors. First, Ukraine faces continued headwinds from the conflict in the Donbas region, as evidenced by the coal and trade blockade with the uncontrolled areas. Second, the authorities have been working on an ambitious package of reforms to address structural bottlenecks and advance growth prospects. The next few months are a critical window of opportunity within which to lock in these important reforms. Establishing a transparent market for land transactions would enable Ukraine to tap its vast potential for agricultural exports. Strengthening the governance of state-owned banks and putting in place measures to streamline resolution of non-performing loans (NPLs) would enable a gradual resumption of lending to the private sector. Deeper anticorruption reforms, further improvements to the business environment, and progress on privatization would strengthen investor confidence and attract foreign investment. Locking in these reforms in the next few months could raise growth to 4 percent or more in the next two years. This growth outlook is subject to serious risks, including challenges associated with advancing reforms in a complex political environment, and risks associated with an escalation of the conflict or a deterioration in the external environment.

Medium term fiscal pressures are significant—addressing macroeconomic vulnerabilities will require systematic fiscal consolidation grounded in key reforms. Higher public sector wages are projected to trigger a sharp increase in the wage bill from 9.3 percent in 2016 to 11.2 percent in 2017. Expenditures on Housing Utility Subsidies (HUS) are projected to reach 2.6 percent of GDP in 2017 (from 1.8 percent in 2016), with total expenditures on social programs projected at 5.7 percent of GDP in 2017 (from 4.6 percent in 2016). As a result, the fiscal deficit is projected to widen to 3.5 percent of GDP. Fiscal risks are exacerbated by delays in realigning gas tariffs. Going forward, fiscal consolidation will need to come from improved targeting of social programs and optimization of public sector staffing. In addition, pension reform is critical to contain pressures from pension spending while providing better benefits to the elderly. The draft budget for 2018 stipulates further increases in public sector wages, so the wage bill is projected to remain high at 11.5 percent of GDP. Meeting the deficit target of 2.5 percent of GDP in 2018 will thus depend on improved targeting of HUS and higher tax revenues and social contributions. In the medium term, meeting the deficit target of 2.2 percent of GDP by 2020 will also require implementing the education and health reform programs in a manner that leads to optimizing the school and hospital network. Fiscal consolidation is critical to address macroeconomic vulnerabilities and reduce public debt to under 75 percent of GDP by 2020. Without such a systematic fiscal consolidation effort, Ukraine will need to rely on more ad hoc revenues measures and expenditure cuts, along with more domestic borrowing, which would undermine debt sustainability and development outcomes.

Managing external vulnerabilities will require reforms to boost exports and attract foreign direct investment (FDI), as well as maintaining cooperation with the IMF and other official creditors. Despite an improvement in the terms of trade, the current account deficit is projected to widen to 4 percent of GDP in 2017 due to some impact on exports from the trade blockade and strong growth of imported intermediate and investment goods. The current account is financed in large part by public external borrowing, which also helped to further bolster international reserves to $18 billion—or 3.5 months of exports—in August 2017. Without structural reforms to bolster exports and attract FDI, Ukraine will remain vulnerable to external shocks and commodity cycles. Maintaining cooperation with the IMF and other official creditors will also be important to meet external financing needs.

Table 1: Key Economic Indicators

	2012	2013	2014	2015	2016	2017p	2018p	2019p	2020p
Nominal GDP, *UAH billion*	1,405	1,465	1,587	1,980	2,383	2,832	3,195	3,572	3,975
GDP per capita, *US$*	4,080	4,216	3,119	2,122	2,174	2,358	2,552	2,834	3,132
Real GDP, *% change*	0.2	0.0	-6.6	-9.8	2.3	2.0	3.5	4.0	4.0
Consumption, *% change*	7.4	5.2	-6.2	-15.9	1.4	3.3	3.5	3.2	3.7
Fixed Investment, *% change*	5.0	-8.4	-24.0	-9.2	20.1	18.3	10.2	6.8	5.0
Export, *% change*	-5.6	-8.1	-14.2	-13.2	-1.6	4.8	5.0	5.0	4.3
Import, *% change*	3.8	-3.5	-22.1	-17.9	8.4	8.7	3.6	4.7	4.2
GDP deflator, *% change*	8.1	3.1	14.8	38.4	17.1	16.5	9.0	7.5	7.0
CPI, *% change eop*	-0.2	0.5	24.9	43.3	12.4	10.0	7.0	6.5	6.0
Current Account Balance, *% GDP*	-8.2	-9.2	-3.5	-0.2	-3.8	-4.1	-3.5	-2.5	-2.0
External debt, *% GDP*	76.6	78.6	97.6	131.5	119.8	124.0	129.2	126.4	122.2
International Reserves, *US$ billion*	24.5	20.4	7.5	13.3	15.5	..	..	..	..
In months of next year's imports	2.9	3.3	1.9	3.2	3.4	..	..	..	..
Budget revenues, *% GDP*	44.5	43.6	40.3	42.1	38.4	40.5	42.1	41.4	41.2
Tax revenues, *% GDP*	38.9	37.9	35.8	35.5	33.1	35.6	37.5	38.0	38.3
Budget expenditures, *% GDP*	48.9	48.4	44.8	43.2	40.6	44.0	44.6	43.8	43.4
Current expenditures, *% GDP*	45.7	46.2	44.3	41.0	37.4	40.2	40.8	40.0	39.4
Capital expenditures, *% GDP*	2.9	2.0	1.3	2.2	3.1	3.8	3.8	3.8	4.0
Fiscal balance, *% GDP*	-4.4	-4.8	-4.5	-1.2	-2.2	-3.5	-2.5	-2.4	-2.2
Consol deficit, incl Nagtogaz, *% GDP*	-5.5	-6.7	-10.1	-2.1	-2.3	-3.5	-2.5	-2.4	-2.2
Public and Guaranteed Debt, *% GDP*	36.6	40.6	70.3	79.4	81.2	85.2	85.1	78.9	73.4

Source: Ukrainian Authorities, WB projections

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