German Advisory Group Ukraine

NEWSLETTER

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Stabilisation proceeds – shifting focus towards economic growth

Ukraine has been suffering from a longer period of economic instability. The GDP has dropped by 15.8% throughout the first half of 2015; the collapse in industrial production was even more severe over the same period. Since the beginning of 2014 the national currency has depreciated by 60% versus the US dollar whereas inflation peaked at above 60%.

Nevertheless, the last months have revealed clear signs of economic stabilisation. Industrial production as well as retail trade turnover has bottomed out as recently shown by slightly positive growth rates; the exchange rate appears to have stabilised since April 2015 as well. Furthermore, the reduction in the consolidated budget deficit as well as in the current account deficit proceeds.

With enduring stabilisation in progress, growth should now be of key relevance to economic policy makers. The German Advisory Group considers the external sector to carry the highest growth potential and in particular suggests exports and FDI to be key determinants. The positive contribution of the external sector is conditional on the gradual abolishment of the implemented currency restrictions - although those were temporarily crucial amid the stabilisation process.

Long period of economic instability

Since the middle of 2014 Ukraine has suffered from a massive overall economic decline. GDP fell by 15.8%, yoy, whereas industrial production fell by 20.5%, yoy during the first half of 2015.

It is certainly worth noting, however, that these aggregate numbers do not reflect the different contribution across regions. The economic collapse - as reported to the national statistics office - in the rebel-held-area (RHA) further drags down the growth rates which would otherwise - exclusive the RHA - result in a 9.8% and an 8.8% yoy decline in GDP and industrial production, respectively.

Regional decomposition of GDP and industrial production, H1 2015

	Change, yoy
GDP Ukraine	**-15.8%**
Rebel-held area (RHA)	-85.3%
Ukraine excl. RHA	-9.8%
Industrial production Ukraine	**-20.5%**
Rebel-held area (RHA)	-81.5%
Ukraine excl. RHA	-8.8%

Source: German Advisory Group Ukraine, own calculations

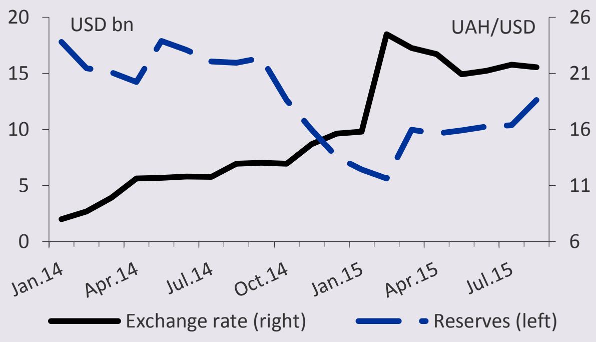
The economic downturn and turmoil has also affected the exchange rate: The hryvnia has depreciated by more than 60% versus the US dollar since the beginning of 2014. Consequently, prices of imports as well as consumer prices rose massively. Thus, in April 2015 the yearly rate of inflation reached 61%. Moreover, banks suffered severe deposit withdrawals forcing them into a critical situation. Finally, the net inflow of foreign direct investment (FDI) was nearly fully disrupted: In 2014 the net inflow of FDI was approximately zero.

Economic stabilisation since the middle of 2015

Since mid-year 2015 there is mounting evidence indicating economic stabilisation. Since February 2015 the deterioration in industrial production is continuously decreasing, partially revealing positive growth rates on a monthly basis; a similar impression holds for retail trade turnover. Both indicate that the end of the economic downturn is at hand and the economy may have bottomed out.

Currently, the exchange rate versus the US dollar fluctuates moderately within the range of 21-23 UAH/USD. Inflation is currently dropping, reaching 51.9% at the moment, and is supposed to reach 12% by the end of 2016 according to plans of the National Bank. Official international reserves improved significantly and amounted to USD 12.6 bn by early September.

Official exchange rate and international reserves

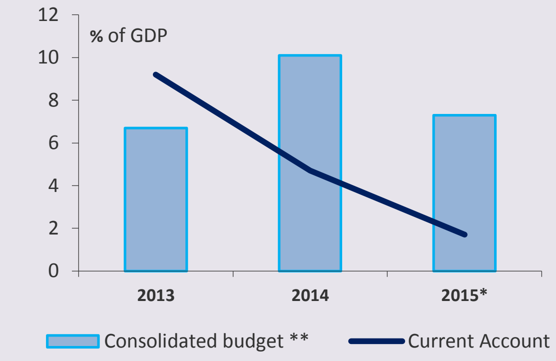


Source: National Bank of Ukraine

Apparently, confidence in the banking system has been revived as indicated by the rising tendencies of private deposits in national currency. Also noteworthy, the significant diminution in the consolidated fiscal budget deficit (incl. Naftogaz) as well as in the current account deficit proceeds as shown by a reduction from 10% and 5% in 2014 to an estimated 7% and 2% in

2015, respectively. This rebalancing was one of the major aims in the IMF program.

Consolidated budget deficit and current account deficit



*Source: IMF, *Estimation/Forecast*
*Note: ** Overall balance including Naftogaz*

Current challenge: Generating growth impetus

The economic stabilisation is certainly a strong achievement for the Ukrainian government, in close corporation with the IMF. Following this achievement, the corollary is the creation of sufficient and sustainable growth impetus as a second, complementing step.

However, for the case of Ukraine, measures for the triggering of growth impulses are fairly limited. The growth contribution from private consumption is certainly restricted due to the sharp decline in real income; the potential of investments is certainly restricted due to the aggravated financial environment, and there is little room for relaxing the fiscal stance. Therefore, we see the highest potential in the external sector. In particular, we found considerable opportunities to attract FDI which would surely foster the growth of exports and of GDP. We further rationalise this argument by Ukraine´s competitive labour costs in the course of its depreciating currency as well as by the advantages from a tariff-free access to the EU market due to the free trade agreement (DCFTA).

How to attract FDI?

In order to utilise such opportunities, the implementation of policy reforms that decisively improve the financial environment for investments is indispensable. Many companies consider tax and customs authorities to have the greatest deficiencies directing the greatest need for action towards these.

Investment guarantees constitute a highly applicable long-term ‘risk management’ tool in order to cover the country-specific increased (geo-)political risk. Therefore, foreign investors are recommended to further capitalise such instruments. The investment guarantees of the Federal Republic of Germany offer such a protection to German investors.

Furthermore, although temporarily required in order to stabilise the exchange rate, the gradual abolishment of those coercive currency restrictions is vital to the positive growth contribution of the external sector. Foreign investors need to be able to repatriate profits; otherwise their investment incentive is threatened from the start. Even though the gradual abolishment has already been initiated, we still recommend accelerating the process.

Conclusions

The Ukrainian economic policy was facing a twofold challenging task: Stabilise the overall economy and implement required reforms.

The goal of stabilisation appears to have been achieved. Noteworthy, it is a merit to the government, which - unlike in the past - stood out for constructive collaboration with the IMF. Hence, economic policy makers can allow a shift in priorities towards structural reforms in order to stimulate economic growth and increase prosperity. We consider the attraction of FDI as most promising due to its promotional effect on exports and GDP. Again, a gradual but decisive abolishment of foreign exchange restrictions is vital in this respect. In close collaboration with the IMF, the consequent challenge is then to ascertain the appropriate sequencing and speed of this process.

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German Advisory Group
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