

Economic outlook Ukraine: Higher growth to be expected

Last year the Ukrainian economy expanded by 2.2%, in spite of the trade suspension with the non-controlled area in the East, which dampened growth by ca. 0.9%. Except for inflation, which exceeded the National Bank's target, macroeconomic indicators performed rather well. Especially the fact that fiscal consolidation is bearing its first fruits and led to a decrease in the public debt-to-GDP ratio for the first time since several years is to be highlighted: This indicator decreased from more than 81% of GDP to 73%.

These trends will most probably continue this year; real GDP growth will accelerate to 3.2%. The current account and budget deficits remain moderate and government debt will decrease further.

At the same time, putting the IMF programme back on track should be the main target of policy makers in the short term: During 2018/19 Ukraine is facing debt servicing obligations amounting to more than USD 10 bn for sovereign and quasi-sovereign liabilities – which is an enormous challenge, taking into consideration that two elections will be held in 2019.

2017 in review

According to first estimations by the National Statistical Office, real GDP increased by 2.2% in the last year, which implies a slight deceleration compared to 2016. In this context the trade suspension vis-à-vis the non-controlled area in Eastern Ukraine since March 2017 has been a negative factor, which had an especially adverse impact on industry. According to current estimates by the National Bank the trade suspension dampened GDP growth by 0.9%, which is slightly lower than expected (originally 1.3%).

Inflation was one of the few less favourable surprises of economic developments in the last year. The annual average in 2017 was 14.5% and thus exceeded the level of the previous year. The fact that the National Bank missed its inflation target (8% +/- 2 percentage points towards the end of the year) is rather worrying; inflation amounted to 13.7% in December. This was partly caused by the supply side (e.g. higher prices of certain agricultural products), but also by the demand side. In particular, wages increased strongly – partly due to economic recovery, but also as a consequence of the doubling of the minimum wage in January 2017.

The external situation was rather stable, in spite of the mentioned trade suspension with the non-controlled area. External trade has noticeably picked up, whereas

imports of goods increased a bit stronger (21.1%) than that of exports (18.8%). The current account deficit amounted to acceptable 3.5% of GDP in 2017 and thus decreased slightly compared to the previous year. In this context increased remittances by migrant workers (e.g. from Poland) played an important role. The flexible exchange rate was relatively stable and fluctuated between UAH/USD 25.6 and 27.5 vs the US dollar.

Especially from a fiscal perspective the last year was a successful one; the budget deficit amounted to 1.4% of GDP and was thus significantly below the target and also below last year's deficit. Despite additional funds for the recapitalisation of state-owned banks (PrivatBank, Oschadbank) the public debt-to-GDP ratio fell from 81.2% of GDP (2016) to 73.4% (2017). This implied a break in the trend, which reflects the progress made in the fiscal consolidation process.

Outlook 2018

The following table provides an overview over key macroeconomic indicators.

Selected macroeconomic indicators 2016-2018

	2016	2017*	2018*
Real GDP growth, % change yoy	2.3	2.2	3.2
Inflation, % change yoy (annual average)	13.9	14.5	10.0
Current account, % of GDP	-3.7	-3.5	-3.0
Budget deficit, % of GDP	-2.3	-1.4	-2.5
Gross government debt, % of GDP	81.2	73.4	66.0

Sources: National Statistical Office, IMF, National Bank of Ukraine, IER; *Forecast; Note: Budget deficit without Naftogaz and bank recapitalisation

Real sector / GDP

Since the one-off effect of the "trade blockade" is over now, there are good chances for growth to accelerate this year to 3.2%. The global environment with high growth rates (especially in the main trade partner EU) and stable commodity prices give reason for high hopes.

On the supply side, industry and agriculture should provide the necessary contributions. On the demand side, investment and private consumption will give the corresponding growth impulses, whereas net exports will be negative. Investment closely correlates with

the economic recovery, while consumption reflects the strong income dynamics, which are to be seen also in the context of the upcoming elections in 2019. After the minimum wage and pensions have been increased in 2017, another increase of the minimum wage is planned, however at a lower scale than in 2017 (when it was doubled).

Inflation

In reaction to the negative inflation developments, the National Bank has increased its policy rate already three times since October 2017. The last hike in January 2018 amounted to 1.5 percentage points to currently 16%. Annual average inflation will decrease to 10%. However, it seems unlikely that the National Bank's inflation target (of 4-8%) will be met towards the end of 2018. This is likely to happen only during 2019.

Current account

Exports and imports will further expand during this year, however, probably at slightly lower pace. The current account deficit is likely to shrink again in 2018; it is expected to reach 3% of GDP. A moderate improvement of the external position, which includes also the exchange rate development, would enable the National Bank to continue the gradual liberalisation of administrative exchange restrictions.

Public finances

The budget for 2018, which has been adopted in December 2017, foresees a deficit target of 2.5% of GDP, which does not exceed the provisions of the IMF programme. In case no further debt relevant transactions will be made (e.g. bank recapitalisation, Naftogaz), government debt should fall below 70% in relation to GDP this year.

The crucial question: Continuation of IMF programme?

The future of cooperation with the IMF is of key importance for economic and financial stability, but also for the continuation of the reform process of the country. It is recalled that the last credit tranche has been disbursed in April 2017. According to the original disbursement schedule, four further tranches were to be disbursed by now; however, in fact no more funds have been transferred. The list of reforms demanded by the IMF is quite extensive. Except for the creation of an anti-corruption court, the automatic adjustment of energy prices is a pivotal question that remains yet to be solved. Also the topic "privatisation" is on the agenda; recently the parliament has adopted an important law that shall simplify privatisation procedures. In the context of ongoing discussions (a technical mission was in Kiev in February) the 2018 budget will be analysed in detail and also the "land market" topic will most likely reappear on the agenda.

Conclusion

The process of gradual economic recovery is continuing and will slightly accelerate this year. Even though losses of the years of crisis in 2014/15 have by far not been compensated, the general trajectory is positive, whereas high inflation remains a worrying factor.

How important is continued cooperation with the IMF in the pre-election year 2018 and in 2019, when two elections (presidential and parliamentary) will take place? From our perspective, it is of key importance taking into consideration that Ukraine is facing debt servicing obligations of more than USD 10 bn for sovereign and quasi-sovereign liabilities. For comparison: official foreign currency reserves currently amount to USD 18.4 bn. Even though since last year there is the option to issue government bonds on the international capital markets (Eurobonds), it is questionable whether this - relatively expensive - option the best way to secure funding for the amounts needed.

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