NEWSLETTER

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Economic outlook: growth continues, but fiscal risks remain

Ukraine's economic growth is slightly accelerating: after growing by 2.5% in 2017, real GDP is forecast to increase by 3.2% this year and 3.3% in 2019. The demand-side drivers are investment and consumption, with most sectors on the supply side growing as well. Inflation continues to run above the National Bank's inflation target and is forecast at 9% at the end of 2018. This has led to hikes in the policy rate, which currently amounts to 17.5%. In all likelihood, inflation will only return to the target band set by the National Bank at the end of next year.

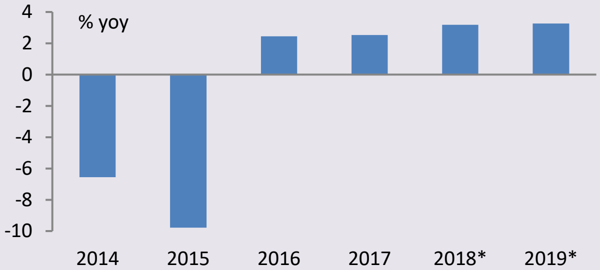
The external sector is in rather good shape, as trade is recovering, the current account is in a moderate deficit and the exchange rate is stable. However, foreign exchange reserves are stagnating at a level of USD 18 bn, which is too low. In public finances, 2017 marked the first year of a decline in the public debt-to-GDP ratio. While this is a very welcome development, certain fiscal risks exist in the current budget and need to be tackled. The continuation of the IMF programme (which expires in March 2019), as well as the negotiation of a new programme later on, should be a key goal of the authorities, as almost USD 9 bn of public external debt service is due over the period of July 2018 to December 2019.

Slight acceleration of economic growth

Real economic growth amounted to 2.5% last year – a decent result taking into account that the Donbas-related trade suspension affected many value chains. In the first quarter of 2018, growth accelerated to 3.1%, a level which is more or less in line with the forecast for the whole year (3.2%). Growth in 2019 will be with 3.3% at a similar level.

On the demand side, both investments (17%) and consumption (5.6%) were the main drivers of growth in the first quarter of 2018. Rising incomes of the population support consumption in a pre-election year. On the supply side, most sectors are also currently growing.

Real GDP growth



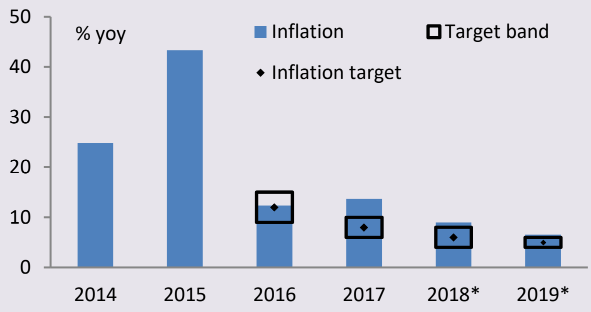
*Source: IMF, *Forecast*

High inflation challenges the National Bank

Last year, the National Bank of Ukraine (NBU) missed its inflation target (8% ± 2% at the end of 2017) by a significant margin. Both demand and supply side factors contributed to the broad-based pressure on prices. As a reaction, the NBU tightened its monetary policy in several steps, bringing the policy rate to its current level of 17.5% p.a.

Despite these welcome steps, it is unlikely that the inflation target, which is set at 6% ± 2% at the end of this year, will be achieved, as inflation is forecast at a level of 9%. Only in 2019 will inflation converge to the target of that year (5% ± 1%).

Consumer price inflation

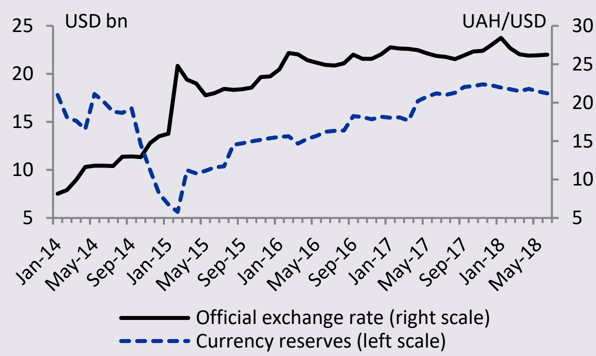


*Source: IMF, *Forecast; Note: End of period inflation*

External developments broadly positive

External trade has clearly recovered, with nominal exports and imports increasing by 17% and 18%, respectively, in 2017. The current account remains in a moderate deficit (1.9% of GDP in 2017, 2.7% in 2018), which should not give ground for immediate concerns. The Hryvnia has been broadly stable against the US dollar. The stagnation of foreign currency reserves at a level of around USD 18 bn, however, is a warning sign. This shows that planned official loans (IMF and associated flows) have not materialised so far.

Exchange rate and foreign currency reserves

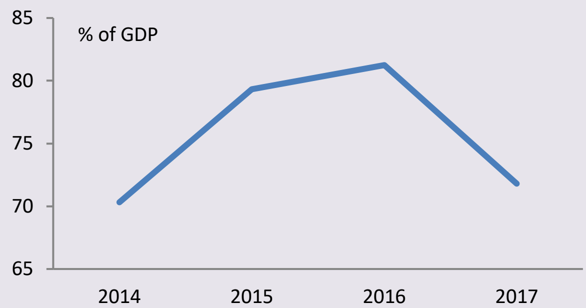


Source: National Bank of Ukraine

Public finances have improved, but risks remain

Fiscal consolidation efforts have been one of the key macroeconomic reform areas over the past years, as public debt increased rapidly during the crisis. These efforts have started to bear fruits, as the figure below shows. While the public debt-to-GDP ratio has more than doubled from a level of 40% in 2013 to 81% in 2016, this trend was finally broken last year. The debt-to-GDP ratio decreased to 72% of GDP in 2017, which was a significant improvement.

Public debt



Source: IMF

Despite these improvements, fiscal risks remain. This year's budget foresees a deficit target of 2.5%, which is IMF-compatible. However, it seems unlikely that this target can be achieved without taking corrective fiscal measures. This issue is one of the topics that are currently discussed between the IMF and the authorities. In addition, the budget for next year will soon become an issue, as the 2019 presidential and parliamentary elections are around the corner.

Outlook: future of the IMF programme

This brings us to the eternal question: will Ukraine continue its cooperation with the IMF? Recall that the current (4th) review of the programme is more than one year overdue. The overall programme had a volume of USD 17.2 bn – only USD 8.5 bn have been disbursed so far.

Taking into account that the public sector needs to service USD 8.6 bn in external debt from July 2018 to December 2019, there seems to be no alternative to the IMF, both to the current programme, but also to a follow-up programme after the expiration of the current one in March 2019. Concluding an agreement with the IMF opens up additional financing channels from the EU (macro-financial assistance) and other official creditors, as well as private capital markets.

However, this assumes that the remaining issues for the current IMF review are speedily resolved. While the creation of a High Anti-Corruption Court seems like a positive step in the right direction, there are still the open issues of cost-covering gas prices and the corrective budgetary measures to be tackled. Both topics require significant leadership by the Ukrainian authorities, as they obviously have also a political dimension, in particular in a pre-election year.

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