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Ukraine
Economic Update
November 19, 2019

- ***The Ukrainian economy grew by 3.6 percent in the first half of 2019, driven by a strong agricultural harvest and the services sectors, while manufacturing and investment growth remained weak.***
- ***Sound fiscal and monetary management, including efforts to keep current public expenditures under control, are helping reduce inflation in 2019. Addressing current expenditure pressures and fiscal risks going forward will be important to keep the fiscal deficit below 2 percent of GDP, further reduce pubic debt, and meet large debt repayments.***
- ***The growth outlook depends on delivering on the ambitious reform agenda of the new government to address bottlenecks to private investment and productivity.***

Recent Economic Developments

GDP growth was solid at 3.6 percent in the first half of 2019, driven by agriculture and sectors dependent on domestic consumption, while investment growth remained weak. Real GDP grew by 2.5 percent in 1Q2019 and by 4.6 percent in 2Q2019. The solid growth in the first half of 2019 was driven by a strong agricultural harvest, and sectors such as wholesale and retail, transport, and the financial sector. The agriculture sector grew by 6 percent in the first half of 2019. Household consumption continued to grow rapidly in 1H2019 (by 11.2 percent) supported by (i) one-off social transfers during the election cycle; (ii) continued strong remittances from labor migration to EU countries; and (iii) a resumption of consumer lending. As a result, domestic trade and transport grew strongly, particularly in the second quarter, by 4.5 percent and 4.2 percent, respectively. The construction sector grew by 23 percent in the first half of the year (mostly due to non-residential and infrastructure projects), while the financial sector grew by 11 percent. At the same time, manufacturing and investment growth remained weak, with the manufacturing sector contracting by 0.2 percent and fixed investment growth slowing to 12 percent. The level of fixed investment at only 20 percent of GDP remains too low for stronger and sustained economic growth. Investment was limited by (i) low FDI net flow of just 0.6 percent of GDP in 1H2019; (ii) high interest rates and structural weaknesses in the financial sector (little progress has been made in resolving non-performing loans so far); and (iii) market distortions from the absence of an agricultural land market, an anticompetitive environment, and large numbers of SOEs.

Poverty continued to decline, supported by higher wages and consumption. Real wages grew 9.5 percent YoY in Jan-Sep 2019 driven mostly from growth of salaries in the private sector due to the pressures from outward labor migration. Remittances continued to grow by 12 percent YoY in Jan-Sep 2019. As a result, moderate poverty (World Bank's national methodology for Ukraine) is projected to decline to 14.5 percent in 2019 from 16.8 percent in 2018.

Prudent fiscal and monetary policy are helping reduce inflation, interest rates, and the debt burden in 2019. The fiscal deficit was contained at 2.1 percent of GDP in 2018 (compared to 2.3 percent in 2017), with the primary balance at 1.2 percent, which (together with appreciation of the Hryvnia) helped reduce PPG debt to 63 percent of GDP in 2018 and to 50 percent at the end of September 2019. Revenue performance in the first half of 2019 was affected by a shortfall of VAT on imported goods and other external trade-related proceeds due to appreciation of the Hryvnia, although this was offset by overperformance of other revenue sources due to higher than expected GDP growth. On the expenditure side, pressures on the wage bill are easing due to a more prudent increase in the minimum wage in 2019 (by 12 percent YoY) compared to a doubling of the minimum wage in 2017-2018. Improved targeting of the housing utility subsidy (HUS) is also helping reduce expenditures on social programs to 3.5 percent of GDP in 2019. These efforts to control current expenditures, together with prudent monetary policy, are helping reduce inflation, with the CPI declined to 6.5 percent YoY in October 2019 from 9.8 percent at end-2018. This has allowed the NBU to reduce the key policy rate to 15.5 percent in October from 18 percent in April. The key rate still remains relatively high due to high inflation expectations and structural bottlenecks in the financial sector.

FIGURE 1: GDP Growth, y/y,

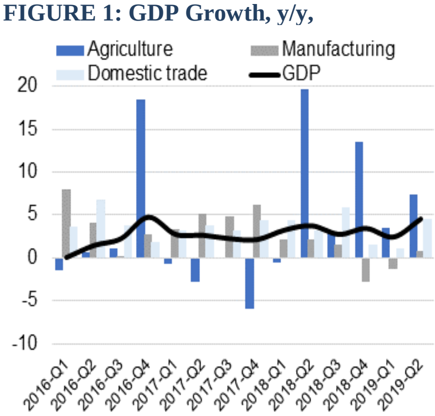


FIGURE 2: Poverty Rate

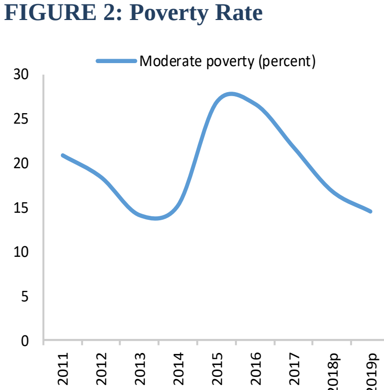
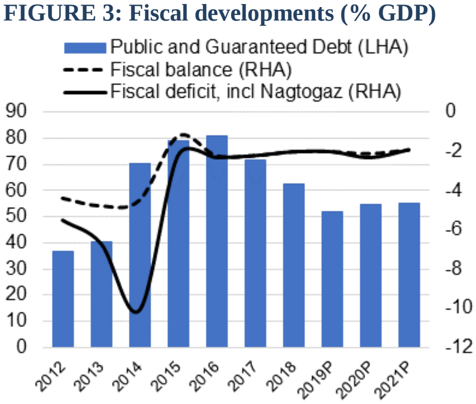


FIGURE 3: Fiscal developments (% GDP)



Strong remittances and inflows of foreign capital into the domestic bond market have helped reduce the current account deficit and support international reserves. In 2019, Ukraine's terms of trade improved due to higher iron ore and wheat prices, with exports growing 8 percent YoY over Jan-Sep 2019, although imports grew faster at 8.3 percent YoY than exports and were driven by intermediate goods. The merchandise trade deficit grew by 9 percent YoY in Jan-Sep, but growth in the surplus of services trade and primary incomes (mostly remittances) reduced the current account deficit by 20 percent (to $2.7 billion) compared to the same period of 2018. As election related uncertainties abated, foreign portfolio flows into local currency government bonds have increased markedly by US$3 billion (attracted by high rates) in 2019. This, together with renewed access to the international financial markets, contributed to a growing surplus of the financial account. As a result, Ukraine's international reserves grew to US$21.4 billion (3.5 months of imports cover) in September 2019, while the exchange rate appreciated to UAH25/$1 (vs UAH27.4/$1 average in 2018).

Outlook

The outlook for economic growth depends on delivering on the new government's key reform priorities to address bottlenecks to investment and productivity. Given the strong performance in 1H2019, growth is projected to remain solid at 3.6 percent in 2019 overall. Going forward, if the new government is able to deliver on its ambitious reform goals, growth can increase to 4 percent by 2021. This will require progress in the following areas: (i) attracting private investment into tradable sectors by establishing a transparent market for agricultural land, demonopolizing key sectors and strengthening antimonopoly policy and enforcement, privatizing state-owned enterprises, and tackling corruption; (ii) increasing the efficiency and growth of bank lending to the enterprise sector by completing the reform of state-owned banks and reducing non-performing loans (NPLs); and (iii) safeguarding macroeconomic stability to continue reducing inflation, interest rates, and public debt.

Ukraine will need to safeguard macroeconomic stability by addressing current expenditure pressures and fiscal risks, while securing adequate financing. The key to safeguarding fiscal sustainability going forward is to address current expenditure pressures and keep the fiscal deficit at 2 percent GDP to ensure the sustainable debt reduction. This will require: (i) avoiding any imprudent hikes in wages in education and health that are not linked to productivity growth in these sectors; (ii) resisting populist pressures to tinker with the newly established pension indexation; (iii) further targeting social assistance programs, including housing utility subsidies; and (iv) avoiding fiscal risks from SOEs and new publicly supported financing instruments. Ukraine faces significant debt repayments in 2019-2021, which will require mobilizing adequate international financing and further strengthening public finances to meet the fiscal deficit target. Repaying public debt and financing the fiscal deficit will require new borrowing equivalent to about 8 percent of GDP ($11 billion per year), with about 40 percent planned from external sources and the rest raised domestically. To raise the necessary external financing on affordable terms, it will be critical to maintain the reform momentum and continue cooperation with development partners.

Ukraine remains vulnerable to external shocks and commodity price cycles due to its reliance on commodity exports. To increase resilience to external shocks Ukraine will need to accelerate the structural transformation of its economy by boosting nontraditional and higher value-added exports. Safeguarding external sustainability will also require attracting FDI.

Table 1: Key Economic Indicators

	2013	2014	2015	2016	2017	2018	2019P	2020P	2021P
Nominal GDP, *UAH billion*	1,465	1,587	1,989	2,385	2,984	3,559	4,025	4,468	4,901
Real GDP, *% change*	0.0	-6.6	-9.8	2.3	2.5	3.3	3.6	3.7	4.2
Consumption, *% change*	5.2	-6.2	-15.9	2.0	8.4	6.8	6.3	4.5	4.0
Fixed Investment, *% change*	-8.4	-24.0	-9.2	20.4	16.1	14.3	10.5	11.3	12.1
Export, *% change*	-8.1	-14.2	-13.2	-1.8	3.8	-1.6	1.8	2.2	2.6
Import, *% change*	-3.5	-22.1	-17.9	9.3	12.6	3.2	8.4	6.0	5.0
GDP deflator, *% change*	3.1	14.8	38.4	17.1	22.1	15.4	9.5	7.3	5.5
CPI, *% change eop*	0.5	24.9	43.3	12.4	13.7	9.8	6.4	5.5	5.0
Current Account Balance, *% GDP*	-9.2	-3.5	-0.2	-1.4	-2.1	-3.3	-3.1	-3.8	-3.6
Exports of G&S, *% GDP*	45.2	49.1	52.6	49.4	47.9	45.5	39.4	38.4	38.5
Imports of G&S, *% GDP*	53.8	52.5	54.5	56.3	55.6	54.1	48.8	47.9	48.5
External debt, *% GDP*	78.6	97.6	131.5	122.6	103.9	88.3	76.4	71.5	69.6
International Reserves, *US$ billion*	20.4	7.5	13.3	15.5	18.8	20.8	…	…	…
In months of next year's imports	3.3	1.9	3.2	3.4	3.2	3.5	…	…	…
Budget revenues, *% GDP*	43.6	40.3	42.1	38.6	39.3	40.0	39.0	39.4	40.0
Tax revenues, *% GDP*	37.9	35.8	35.5	33.1	34.2	34.6	34.4	35.5	36.4
Budget expenditures, *% GDP*	48.4	44.8	43.2	40.6	41.5	42.0	41.0	41.5	41.9
Current expenditures, *% GDP*	46.2	44.3	41.0	37.5	38.1	37.8	36.6	37.0	37.4
Capital expenditures, *% GDP*	2.0	1.3	2.2	3.1	3.3	4.1	4.4	4.5	4.5
Fiscal balance, *% GDP*	-4.8	-4.5	-1.2	-2.2	-2.3	-2.0	-2.0	-2.1	-1.9
Consol deficit, incl Nagtogaz, *% GDP*	-6.7	-10.1	-2.1	-2.3	-2.3	-2.0	-2.0	-2.1	-1.9
Public and Guaranteed Debt, *% GDP*	40.6	70.3	79.7	81.2	72.3	62.3	51.7	54.6	55.3

Source: Ukrainian Authorities, WB projections

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