UKRAINE: Lifeline from the IMF ahead of the elections

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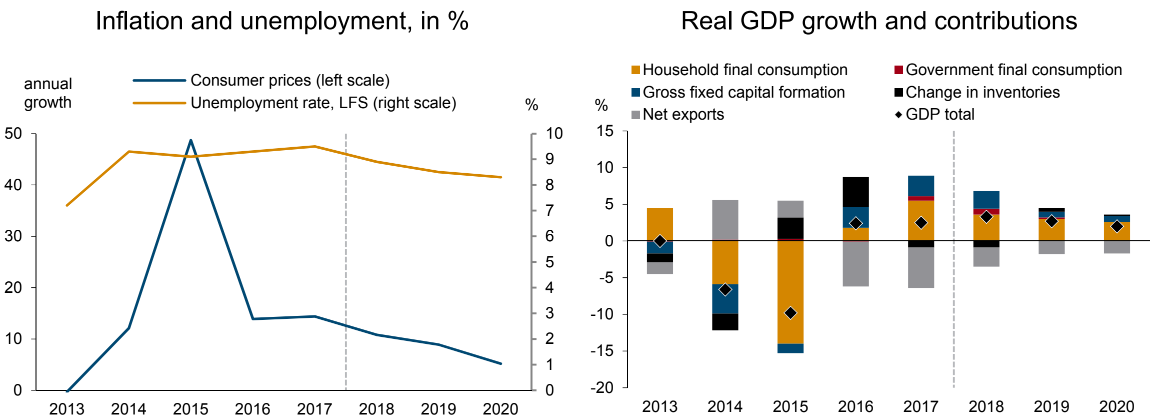
Thanks to the booming domestic demand, economic growth should exceed 3% this year but will likely decelerate somewhat in 2019 due to recent monetary policy tightening. In the face of a less supportive global environment, Ukraine has agreed on a new IMF loan, which should ensure macroeconomic stability at least in the short term. However, the social impact of the related recent hike in gas tariffs may prove politically costly for the authorities ahead of the March 2019 presidential elections.

Figure 57 / Ukraine: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

In the second quarter of 2018, economic growth picked up markedly, to 3.8% year on year (from 3.1% in the first quarter), resulting in 3.5% growth in the first half of the year. The acceleration of growth in the second quarter was largely due to the one-off effect of early harvesting, and will not be sustained throughout the remainder of the year: the grain harvest for the year as a whole is expected to be lower than in 2017. In the first eight months, agricultural production picked up by only 2%, while gross industrial output was up by 2.2% and that of construction by 5.7%. Viewed from the demand side, growth continues to be driven exclusively by domestic demand, especially private consumption and fixed capital investments; the contribution of net exports of goods and services was once again strongly negative in the first half of the year.

Private consumption expanded by 4.9% in the first half of 2018, underpinned by a combination of three factors: (i) high wage growth, (ii) increased inflow of remittances, and (iii) resumed consumer lending. Strong growth in real wages (by 12.8% in the first eight months, year on year) has been partly due to the enacted hike in the official minimum wage, but is more generally a reflection of mounting labour shortages, especially for highly skilled jobs. The economic recovery appears to have finally started benefiting the labour market: employment grew by 1% in the first half of the year (partly thanks to a higher participation rate), resulting in the unemployment rate falling by 0.6 pp (year on year). Another important factor behind the strong consumer demand has been remittances, which soared by 24% in the second quarter, to USD 2.8 billion (corresponding to 9.1% of GDP). The number of Ukrainians working abroad is broadly estimated at between 2 and 4 million people, including an estimated 1 million who have left since Ukraine was granted a visa-free regime with the Schengen countries in June 2017. Finally, consumer lending has picked up markedly as well: by 34% in August 2018 in nominal terms (year on year), although lending to households in general was more sluggish on account of declining mortgages. The pace of credit expansion will almost certainly decelerate in the months to come, following the recent monetary policy tightening (see below).

Gross fixed capital formation soared by 15.4% in the first half of 2018, reflecting buoyant business confidence. As before, the bulk of investments are domestic and largely financed from retained profits rather than by taking on credit. The badly needed inflows of FDI continue to be disappointingly low – despite the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU, which has been in effect de facto since 2016, and some progress in the harmonisation of standards with those of the EU (including technical, sanitary and phytosanitary standards, customs procedures and rules of public procurement). In the first eight months, the inflows of FDI stood at a mere USD 1.6 billion – 20% less than in the corresponding period of 2017; in addition, around one third of recorded FDI represents conversion of foreign banks' loans to their Ukrainian subsidiaries into equity. Still, there are also niches of success, such as the car parts industry, which has managed to attract non-negligible export-oriented FDI. This applies in particular to ignition cable sets which, with a share of 7% of total exports, have become Ukraine's second biggest export item (behind corn). Since 2015, a total of 11 factories producing ignition cables and other automotive accessories have been constructed in Ukraine, making the country increasingly integrated into the Central European car manufacturing 'core'. All in all, the share of the EU in Ukraine's exports of goods has risen sharply over the past few years (mostly at the expense of Russia) and reached 37% in the first eight months of 2018.

The boom in domestic demand implies that Ukraine's growth path continues to be unbalanced and accompanied by widening external deficits. Despite the reasonably high prices for Ukraine's main export products (grain and metals), merchandise exports increased only by 11.6% in the first eight months (in US dollar terms) – much less than imports (+15.3%), and the trade deficit widened accordingly. The latter was partly offset by higher inflows of remittances, keeping the increase in the current account deficit in check. Following the radical methodological changes introduced by the National Bank in March 2018, the inflows of remittances turned out to be much higher, and the *levels* of current account deficits during the past few years accordingly lower (by around 2 pp of GDP), than assumed earlier. Nevertheless, the *dynamics* of current account deficits remains negative, even if so far they have been largely covered by the inflows of FDI. The likely reduction in gas transit fees charged by Ukraine, once the North Stream 2 gas pipeline circumventing Ukraine is put into operation at the beginning of 2020, could result in another blow to the country's balance of payments.

After a prolonged period of stability, the summer months of 2018 witnessed mounting depreciation pressures … Given its weak economic fundamentals, Ukraine has always been poised to be strongly affected by any adverse shift in global investor sentiments. Therefore, the combined impact of factors such as monetary policy tightening in the US, 'contagion' from the Turkish crisis and rising global protectionist risks on Ukraine was only a matter of time, and has been further amplified by uncertainties with respect to the continuation of the IMF loan programme and next year's presidential elections. Between the beginning of July and the beginning of October, the hryvnia weakened by 8.1% against the US dollar, fuelling depreciation expectations and giving exporters an incentive to delay the conversion of their export proceeds. Also, as some foreign investors quit the country's bond market, the borrowing costs for the government rose sharply to above 9%, up from 5% in spring this year.

… prompting the National Bank to resort to interventions and hike the policy interest rate, to 18% p.a. – notwithstanding the recent slowdown in inflation. These measures have stabilised the situation in the foreign exchange market, at least so far. However, as a result of repeated interventions and foreign debt repayments, the foreign exchange reserves contracted between 1 June and 1 October by USD 1.4 billion, to a mere USD 16.6 billion, corresponding to 2.8 months of future imports.

In the face of these pressures, Ukraine has secured a new loan package from the IMF which should ensure macroeconomic stability at least in the short term. A new 14-month stand-by agreement (SBA) worth USD 3.9 billion was announced on 19 October and will replace the previous EFF (Extended Fund Facility) programme, which effectively stalled in April 2017. It will pave the way for funding from other international donors, such as the World Bank and the EU, and will enable the placement of sovereign Eurobonds at an affordable interest rate. Still, the final approval of the SBA is reportedly subject to the adoption (in the second reading) of the government budget for 2019, in order to make sure that it is not amended afterwards in the pre-election context. The draft bill on the central budget reckons with a deficit of 2.3% of GDP – slightly below the level projected for this year. Among the important budget allocations planned for 2019 are investments into roads and energy efficiency, and a 13% hike in the minimum wage (in nominal terms); military spending is once again earmarked at 5% of GDP.

However, the precondition for the SBA with the IMF has been the implemented 23.5% hike in domestic gas tariffs for households, effective from 1 November 2018. The need for such a hike, which is argued by the IMF to be necessary to restore parity with import prices, is far from obvious, given that household demand for gas in Ukraine is now essentially covered by (cheap) domestic production. More importantly, another gas tariff hike – which came on top of the 9-fold increase implemented in 2014-2015 – will not improve the chances of incumbent President Poroshenko (who may not even make it into the second round, according to most polls) to be re-elected in the March 2019 elections.

Economic growth next year is projected to slow down moderately, to below 3%. Although fiscal policy will remain generally pro-growth, its effects will likely be counteracted by monetary policy tightening, suppressing the growth of private consumption and GDP. This should also reduce demand-side inflationary pressures, allowing the National Bank to revert to an easing cycle over time. Needless to say, this scenario assumes no major military escalation in Donbas; our baseline scenario with respect to the latter remains that of a 'semi-frozen conflict'. The recent (August 2018) assassination of the head of the self-proclaimed 'Donetsk People's Republic' Alexander Zakharchenko – irrespective of who is to blame for it – will not improve the overall climate and will hardly help the implementation of the Minsk II agreements in the foreseeable future.

The outcome of the March 2019 presidential election is highly uncertain, as Ukraine's political landscape remains strongly fragmented, and even politicians with relatively high approval ratings (such as the former prime minister Yuliya Tymoshenko) also suffer from high disapproval ratings. The current two front-runners Ms Tymoshenko and the former defence minister Anatoliy Hrytsenko (according to some polls) are both 'hawkish' on the conflict in Donbas, casting further doubts over the prospects for the Minsk II agreement. At the same time, their economic policy may prove more left-wing and 'populist' than that of the current government, as suggested by the repeated harsh criticism of liberal economic reforms by Ms Tymoshenko and the anti-oligarchic rhetoric of Mr Hrytsenko. In any case, after the March 2019 elections Ukraine will almost certainly firmly stay in the western political orbit (even if cooperation with the IMF may become even more problematic under the new government). A victory of the (relatively) pro-Russian opposition figures such as Yuri Boyko in the second round appears next to impossible, especially since some of the most 'pro-Russian' provinces, such as Crimea and parts of Donbas, no longer vote in Ukraine's elections, while in many of the remaining provinces the anti-Russian sentiment is still strong.

Table 32 / Ukraine: Selected economic indicators

	2014	2015	2016	2017 1)	2017	2018	2018	2019	2020
					January-June			Forecast	
Population, th pers., average	43,001	42,845	42,673	42,485	42,526	42,325	42,300	42,150	42,000
Gross domestic product, UAH bn, nom.	1,587	1,989	2,385	2,983	1,256	1,508	3,500	3,900	4,200
annual change in % (real)	-6.6	-9.8	2.4	2.5	2.7	3.5	3.3	2.7	2.0
GDP/capita (EUR at PPP)	6,400	6,000	6,100	6,300	.	.	.	.	.
Consumption of households, UAH bn, nom.	1,121	1,332	1,570	1,961	884	1,048	.	.	.
annual change in % (real)	-8.3	-19.8	2.7	8.4	7.8	4.9	5.5	4.5	4.0
Gross fixed capital form., UAH bn, nom.	224	269	369	477	180	238	.	.	.
annual change in % (real)	-24.0	-9.2	20.4	18.2	22.0	15.4	15.0	5.0	5.0
Gross industrial production									
annual change in % (real)	-10.1	-13.0	2.8	0.4	0.3	2.5	2.5	3.0	3.0
Gross agricultural production									
annual change in % (real)	2.2	-4.8	6.3	-2.7	-2.1	11.4	.	.	.
Construction output									
annual change in % (real)	-20.4	-12.3	17.4	26.3	29.2	2.8	.	.	.
Employed persons, LFS, th, average	18,073	16,443	16,277	16,156	16,121	16,283	16,320	16,380	16,400
annual change in %	-6.4	-0.4	-1.0	-0.7	-0.7	1.0	1.0	0.4	0.1
Unemployed persons, LFS, th, average	1,848	1,655	1,678	1,698	1,710	1,600	1,590	1,520	1,480
Unemployment rate, LFS, in %, average	9.3	9.1	9.3	9.5	9.6	9.0	8.9	8.5	8.3
Reg. unemployment rate, in %, eop 2)	1.7	1.6	1.5	1.4	1.3	1.2	.	.	.
Average monthly gross wages, UAH 3)	3,480	4,195	5,183	7,104	6,638	8,378	8,800	10,100	11,200
annual change in % (real, gross)	-5.4	-18.9	8.5	19.8	20.3	12.1	12.0	5.0	5.0
annual change in % (real, net)	-6.5	-20.2	9.0	19.0	19.7	12.0	12.0	5.0	5.0
Consumer prices, % p.a.	12.1	48.7	13.9	14.4	13.8	12.6	10.8	8.9	5.2
Producer prices in industry, % p.a. 4)	17.1	36.0	20.5	26.4	33.7	17.8	16.0	8.0	6.0
General governm.budget, nat.def., % of GDP						.			
Revenues	28.7	32.8	32.8	34.1	39.5	37.6	36.0	33.7	33.7
Expenditures	33.3	34.3	35.1	35.5	35.3	36.9	38.6	36.0	35.7
Deficit (-) / surplus (+) 5)	-4.5	-1.6	-2.3	-1.4	4.2	0.7	-2.6	-2.3	-2.0
General gov.gross debt, nat.def., % of GDP	69.4	79.1	80.9	71.8	65.6	57.1	65.0	64.0	65.0
Stock of loans of non-fin.private sector, % p.a.	11.8	-2.8	2.4	1.9	-0.2	7.4	.	.	.
Non-performing loans (NPL), in %, eop 6)	19.0	28.0	30.5	54.5	57.7	55.7	.	.	.
Central bank policy rate, % p.a., eop 7)	14.00	22.00	14.00	14.50	12.50	17.00	18.5	14.0	10.0
Current account, EUR mn 8)	-3,476	1,457	-1,210	-2,165	-282	-293	-3,000	-3,500	-5,000
Current account, % of GDP	-3.4	1.8	-1.4	-2.2	-0.6	-0.6	-2.7	-3.1	-4.4
Exports of goods, BOP, EUR mn 8)	38,235	31,935	30,309	35,192	17,569	17,502	37,700	41,000	42,600
annual change in %	-14.1	-16.5	-5.1	16.1	28.7	-0.4	7.1	8.8	3.9
Imports of goods, BOP, EUR mn 8)	43,626	35,050	36,579	43,758	20,806	21,000	48,100	53,300	55,400
annual change in %	-28.7	-19.7	4.4	19.6	30.3	0.9	9.9	10.8	3.9
Exports of services, BOP, EUR mn 8)	11,257	11,218	11,242	12,558	6,087	6,015	13,200	14,400	13,200
annual change in %	-33.9	-0.4	0.2	11.7	16.8	-1.2	5.1	9.1	-8.3
Imports of services, BOP, EUR mn 8)	9,350	10,232	10,801	11,655	5,703	5,716	12,000	13,100	13,700
annual change in %	-23.0	9.4	5.6	7.9	14.4	0.2	3.0	9.2	4.6
FDI liabilities, EUR mn 8)	641	2,750	3,108	2,506	1,354	1,022	2,100	.	.
FDI assets, EUR mn 8)	414	34	156	207	-177	99	0	.	.
Gross reserves of NB excl. gold, EUR mn 8)	5,429	11,320	13,965	14,872	14,855	14,559	.	.	.
Gross external debt, EUR mn 8)	102,728	107,663	107,648	96,741	99,770	97,456	97,000	98,000	99,000
Gross external debt, % of GDP	101.7	131.2	127.7	97.3	100.4	89.1	88.7	87.9	87.2
Average exchange rate UAH/EUR	15.72	24.23	28.29	30.00	28.94	32.42	32.0	35.0	37.0

Note: excluding the occupied territories of Crimea and Sevastopol and from 2015 (except for population) temporarily occupied territories in the Donetsk and Luhansk regions.

1) Preliminary. - 2) In % of working age population. - 3) Enterprises with 10 and more employees. - 4) Domestic output prices. - 5) Without transfers to Naftohaz and other bail-out costs, in 2014 including VAT refund via issued government bonds. - 6) From 2017 including NPLs of the nationalized Privatbank and changes in rules of credit risk assessment. - 7) Discount rate of NB. - 8) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.