UKRAINE: Still addicted to IMF injections

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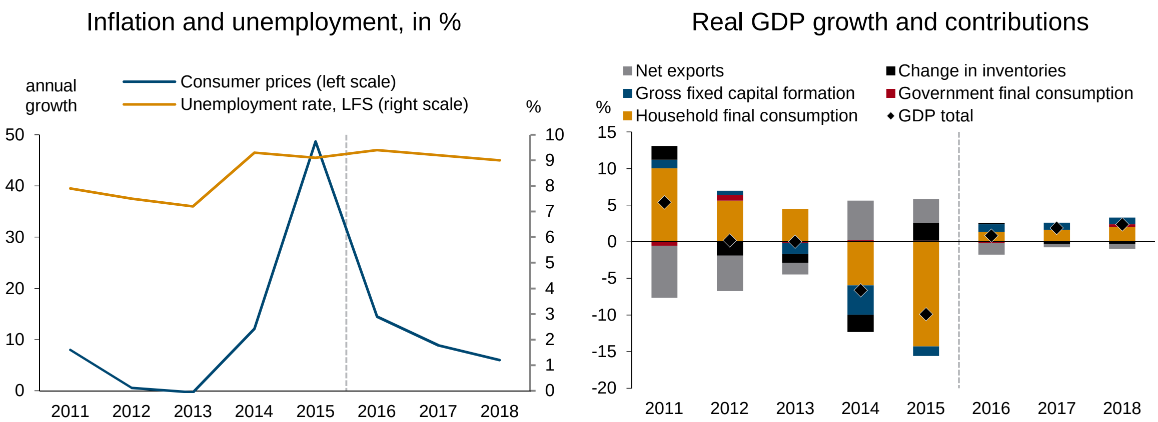
Ukraine's economy continues to recover, driven by marked growth in both investments and, to a lesser extent, private consumption. Two other factors, rapid disinflation on the back of exchange rate stabilisation and an easing of fiscal policy, have also proven growth-supportive. Nonetheless, ongoing cooperation with the IMF is still crucially important for maintaining short-term stability. Barring adverse shocks, GDP is expected to pick up by 0.8% in the course of the current year, followed by gradual acceleration to around 2% per annum in 2017-2018.

Figure 44 / Ukraine: Main macroeconomic indicators



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

Recent data present evidence of Ukraine's economy continuing to recover from the multiple shocks of territorial break-up, ongoing war in Donbas, disruptions in trade with Russia, plummeting exchange rate and extreme fiscal austerity – all experienced over the past two years. After the rather disappointing first quarter, in the second quarter 2016 real GDP picked up by 1.4% on an annual basis and by 0.6% on a quarterly (seasonally-adjusted) basis, bringing GDP growth to 0.7% in the first half of the year.

The growth acceleration in the second quarter of 2016 was entirely driven by domestic demand; the contribution of net exports switched to negative. Particularly gross fixed capital formation was booming (+17.6% year on year), mirrored in construction value-added soaring by 14.9%. The observed revival of investments may not come as a big surprise, with businesses making up for years of under-investment in response to relative economic stabilisation. It has been generally broad-based, but with investments in agriculture recording particularly high growth rates (+72%), potentially suggesting a further reorientation of the economy from metals and chemicals towards agriculture. Investments are predominantly financed from enterprises' own funds, while the role of bank credits, investments from the budget and foreign direct investors is rather marginal. The bulk of statistically recorded – rather meagre – FDI inflows into Ukraine in reality represent recapitalisation of foreign-owned banks by parent structures.

The dynamics of household consumption, which was still negative in the first quarter 2016, turned positive in the second quarter (+4.3% year on year), helped by rapid disinflation and rising real wages. However, the pick-up in private consumption in the first half of 2016 by 1% appears to be surprisingly anaemic, given the solid growth in real net wages: by 6.1% over the same time period. This implies that the household saving rate must have been rather high – partly reflecting the need to service debts. Indeed, household deposits went up by 4% in the first eight months of 2016 (in nominal hryvnia terms), while the volume of outstanding credits to households contracted by 10%, to levels last observed in 2008.

One factor which has been supportive of the turnaround in private consumption has been a marked relaxation of fiscal policy. Following pronounced fiscal adjustments of 2.5 pp and 4.3 pp of GDP in 2014 and 2015 respectively, a fiscal expansion of 3.5 pp is projected for this year.[46] Unlike over the past two years, salaries in the public sector and pensions are now being indexed largely in line with inflation. Besides, the drastic cut in the single social contribution paid by employers (from an average rate of 41% to a flat rate of 22%) implemented at the start of 2016 effectively proved fiscally expansionary as well. As predicted by most experts (including wiiw), the readiness to declare 'shadow' wages in response to the lower rate proved to be rather inelastic, resulting in a shortfall of revenues and a soaring deficit of the Pension Fund. The latter is expected to reach 6.4% of GDP this year and will be covered from the budget. Other factors behind the widespread tax evasion – above all the reluctance to be exposed to the corrupt and arbitrary state apparatus – continue to prove more serious obstacles to the 'de-shadowing' of the economy than the (high) statutory tax rate *per se*. Instead, there is anecdotal evidence that funds saved by businesses thanks to the lower social contribution rate have been partly channelled to pay higher *official* wages, which may help explain the overall vigorous wage dynamics since the start of the year.

Foreign trade developments continue to disappoint. In the first eight months of 2016, goods exports declined by 10% in US dollar terms – more than imports (-4%), primarily on account of the 32% export decline to Russia, although exports to other markets except the EU suffered as well. The main reason for the drop was the erection of new barriers in trade with Russia: in response to Ukraine implementing the Deep and Comprehensive Free Trade Area (DCFTA) with the EU starting from January 2016, Russia unilaterally revoked the existing free trade agreement with Ukraine,[47] imposed an import embargo on Ukrainian food, and hampered the transit of Ukrainian goods to the Central Asian countries. These transit restrictions were further tightened as of July 2016. All in all, since 2014 the bulk of Ukraine's trade with Russia – which used to be its principal single export destination – has already been lost, with little prospects for recovery given the ongoing geopolitical conflict over Crimea and Donbas. At

[46] The fiscal adjustment is defined as a change in the cyclically-adjusted primary budget balance calculated by Bohdan et al., 'Assessment of fiscal policy of Ukraine', wiiw study (forthcoming).

[47] This move was not supported by other countries of the Eurasian Economic Union (Belarus, Kazakhstan, Armenia and Kyrgyzstan).

the same time, exports to the EU picked up by only 3.5% in the first eight months of 2016 (in US dollar terms). Ukrainian producers still cannot take full advantage of the free access to EU markets because of the existing gap in standards, EU tariff quotas for a number of agricultural products, and the generally low competitiveness of Ukrainian products, especially in quality terms.

Despite the ongoing economic recovery, the recent months have also demonstrated the fragility of macroeconomic stability in Ukraine and the crucial role of continued IMF support. Between September 2015 and September 2016, the latter was effectively frozen – first because of the protracted political instability and later because of the government's allegedly insufficient reform effort. As public belief in a resumption of the IMF programme (and related support from other multilateral and bilateral sources) started to wane at the end of August and was compounded by the escalation of fighting in Donbas, the hryvnia came under pressure – despite interventions by the National Bank and the fact that many of the capital controls introduced in spring 2015 were still in place. It only recovered part of the losses once the IMF disbursed USD 1 billion on 14 September 2016 and hinted that another tranche of potentially USD 1.3 billion may be coming before the end of the year.

Continuing cooperation with the IMF represents an obvious dilemma for the Ukrainian authorities. On the one hand, it provides an important anchor for short-term macroeconomic stability – particularly when it comes to the stability of the exchange rate and prices. On the other hand, there is a growing recognition that yielding to some of the IMF demands may undermine the welfare state (or whatever is left of it in present-day Ukraine), social stability, and ultimately long-term growth prospects. The IMF conditionalities attached to the upcoming tranche reportedly include a comprehensive pension reform (including an increase in the retirement age and the introduction of a funded pension system along with the current pay-as-you-go system) and a possibility of further hikes in retail gas tariffs for households by linking them to price movements in Europe (despite the fact that the bulk of natural gas consumed by Ukrainian households is now produced domestically).

Going forward, the current economic recovery is likely to gain momentum. In the baseline scenario, the economy should pick up by at least 0.8% this year, followed by a projected 1.9% and 2.4% in 2017 and 2018, respectively, driven primarily by an ongoing recovery of domestic demand. This recovery will be accompanied by receding unemployment, further disinflation, and external deficits remaining rather moderate.

However, sizeable downside risks remain, such as a possible resumption of a large-scale war in Donbas and an abortion of the IMF programme which would undermine short-term macroeconomic stability. The latter risk is all the more real since fiscal policy is likely to remain reasonably lax, which may become a problem for the IMF. The current relative political stability may not last very long either given the plummeting rating of President Poroshenko. Although Mr. Poroshenko has been generally successful in securing enough support from the parliament, he has been unable to ensure the adoption of the controversial bill on decentralisation and a special status to the separatist-held areas of Donbas – a key milestone envisaged in the Minsk-II ceasefire agreement. It still remains unclear how the conflict in Donbas can be effectively resolved, given that the Minsk-II agreement is very vague on political issues and open to contrasting interpretations by the two sides.

Table 27 / Ukraine: Selected economic indicators

	2012	2013	2014	2015 [1]	2015	2016	2016	2017	2018
					January-June			Forecast	
Population, th pers., average	45,593	45,490	43,001	42,845	42,876	42,709	42,680	42,550	42,450
Gross domestic product, UAH bn, nom.	1,459	1,523	1,587	1,979	831	985	2,300	2,600	2,800
annual change in % (real)	0.2	0.0	-6.6	-9.9	-15.8	0.7	0.8	1.9	2.4
GDP/capita (EUR at exchange rate)	3,100	3,200	2,300	1,900	.	.	2,000	2,000	2,100
GDP/capita (EUR at PPP)	6,600	6,600	6,400	6,000	.	.	.	.	.
Consumption of households, UAH bn, nom.	1,002	1,099	1,121	1,326	582	699	.	.	.
annual change in % (real)	8.4	6.5	-8.3	-20.2	-24.5	1.0	2.0	2.5	3.0
Gross fixed capital form., UAH bn, nom.	283	264	224	263	101	130	.	.	.
annual change in % (real)	3.3	-8.0	-24.0	-9.3	-18.1	11.5	8.0	7.0	7.0
Gross industrial production									
annual change in % (real)	-0.5	-4.3	-10.1	-13.0	-20.0	2.0	2.0	4.0	4.0
Gross agricultural production									
annual change in % (real)	-4.5	13.3	2.2	-4.8	-9.7	-0.3	.	.	.
Construction output									
annual change in % (real)	-8.3	-14.5	-20.4	-12.3	-26.2	9.1	.	.	.
Employed persons, LFS, th, average	20,354	20,404	18,073	16,443	16,408	16,239	16,250	16,250	16,350
annual change in %	0.1	0.2	-6.4	-0.4	-3.0	-1.0	-1.2	0.0	0.6
Unemployed persons, LFS, th, average	1,657	1,577	1,848	1,655	1,667	1,692	1,700	1,600	1,600
Unemployment rate, LFS, in %, average	7.5	7.2	9.3	9.1	9.2	9.5	9.4	9.2	9.0
Reg. unemployment rate, in %, end of period [2]	1.8	1.8	1.7	1.6	1.7	1.5	.	.	.
Average monthly gross wages, UAH [3]	3,026	3,265	3,480	4,195	3,882	4,847	5,100	5,800	6,400
annual change in % (real, gross)	14.3	8.2	-5.4	-18.9	-22.1	5.7	6.0	5.0	4.0
annual change in % (real, net)	14.4	8.2	-6.5	-20.2	-23.9	6.1	6.0	5.0	4.0
Consumer prices, % p.a.	0.6	-0.3	12.1	48.7	48.1	18.1	14.5	8.9	6.0
Producer prices in industry, % p.a. [4]	3.7	-0.1	17.1	36.0	42.5	15.2	15.5	7.0	6.0
General governm.budget, nat.def., % of GDP						.			
Revenues	30.5	29.1	28.7	32.9	36.0	34.5	32.5	33.9	33.0
Expenditures	34.0	33.3	33.3	34.5	34.5	35.6	36.9	36.9	35.5
Deficit (-) / surplus (+) [5]	-3.5	-4.2	-4.5	-1.6	1.5	-1.1	-4.4	-3.0	-2.5
Public debt, nat.def., % of GDP	35.3	38.4	69.4	79.4	72.7	72.5	79.0	88.0	91.0
Central bank policy rate, % p.a., end of period [6]	7.50	6.50	14.00	22.00	30.00	16.50	14.5	10.0	8.0
Current account, EUR mn [7]	-11,153	-12,441	-3,476	-170	-87	-544	-1,400	-1,400	-1,900
Current account, % of GDP [7]	-7.9	-8.7	-3.4	-0.2	-0.2	-1.6	-1.8	-1.7	-2.2
Exports of goods, BOP, EUR mn [7]	50,127	44,518	38,235	31,935	15,503	13,648	28,300	28,900	30,100
annual change in %	11.9	-11.2	-14.1	-16.5	-20.3	-12.0	-11.5	2.0	4.0
Imports of goods, BOP, EUR mn [7]	67,124	61,185	43,626	35,050	16,975	15,682	32,900	33,600	35,300
annual change in %	16.2	-8.8	-28.7	-19.7	-22.5	-7.6	-6.0	2.0	5.0
Exports of services, BOP, EUR mn [7]	17,186	17,032	11,257	11,218	5,457	5,174	10,800	11,300	11,900
annual change in %	12.5	-0.9	-33.9	-0.4	-3.4	-5.2	-4.0	5.0	5.0
Imports of services, BOP, EUR mn [7]	11,351	12,141	9,350	9,639	4,541	4,675	9,700	10,200	10,700
annual change in %	18.1	7.0	-23.0	3.1	-2.2	3.0	1.0	5.0	5.0
FDI liabilities (inflow), EUR mn [7]	6,360	3,396	641	2,750	1,247	1,915	3,500	.	.
FDI assets (outflow), EUR mn [7]	762	324	414	34	79	11	100	.	.
Gross reserves of NB excl. gold, EUR mn	17,186	13,592	5,429	11,320	8,353	11,645	.	.	.
Gross external debt, EUR mn [7]	102,120	102,852	103,557	108,666	111,643	103,666	107,000	110,000	114,000
Gross external debt, % of GDP [7]	71.9	71.7	102.6	133.0	136.7	130.7	134.9	135.4	134.4
Average exchange rate UAH/EUR	10.271	10.612	15.716	24.229	23.881	28.427	29.0	32.0	33.0
Purchasing power parity UAH/EUR [8]	4.814	5.069	5.741	7.681	.	.	.	.	.

Note: From 2014 excluding the occupied territories of Crimea and Sevastopol. From 2015 excluding parts of the anti-terrorist operation zone for some indicators.

1) Preliminary. - 2) In % of working age population. - 3) Enterprises with 10 and more employees. - 4) Domestic output prices. From 2013 according to NACE Rev. 2. - 5) Without transfers to Naftohaz and other bail-out costs, in 2014 including VAT refund via issued government bonds. - 6) Discount rate of NB. - 7) Converted from USD. - 8) wiiw estimates based on the 2011 International Comparison Project benchmark.

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