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Ukraine Economic Update

April 10, 2018

- ***The economy grew by 2.5 percent in 2017, the second year of modest growth, leaving poverty still above pre-crisis levels. The fiscal deficit of 2.3 percent of GDP in 2017 was within the target due to strong revenue growth.***
- ***In 2018 and 2019, Ukraine faces major financing needs to repay public debt and fiscal pressures from higher public-sector wages and social benefits. Completing pending reforms in the next couple of months is critical to mobilize adequate international financing, manage fiscal pressures, and maintain macroeconomic stability.***
- ***Boosting economic growth to 4 percent in the next two years will require measures to safeguard macroeconomic stability and completion of pending reforms in land markets, the financial sector, anticorruption, and privatization, to bolster investor confidence. If reforms are delayed, growth could drop below current levels in an uncertain environment.***

Recent Economic Developments

Economic growth remained weak in 2017 due to weaknesses in the agriculture and mining sectors, as well as delays with key reforms to further strengthen investor confidence. GDP grew by 2.5 percent in 2017 (and 2.3 percent in 2016) - a weak recovery following a cumulative 16 percent contraction over 2014-2015. Sectors exhibiting relative strength such as manufacturing and domestic trade grew by over 5 percent in 2017, while construction grew by almost 27 percent. In contrast, mining and electricity generation contracted by about 6 percent due to the trade blockade with Donbas, while agriculture contracted by 2.5 percent in 2017 after the bumper harvest in 2016. On the demand side, fixed investment continued to rebound strongly by 18.2 percent in 2017, but the rebound slowed in the second half of the year, suggesting that improvements in investor confidence may be tapering off. FDI remained weak at 2.1 percent of GDP in 2017, compared to 5 percent on average before the crisis. Investor confidence has improved, but is held back by concerns about the slow pace of key reforms and delays in completing reviews of the IMF program given macroeconomic vulnerabilities and uncertainty surrounding the 2019 elections. Consumption growth picked up to 6.7 percent in 2017 (from 1.3 percent in 2016), in part from higher public-sector wages and pensions which also created additional inflationary pressures. CPI reached 13.7 percent at the end of 2017, significantly higher than the NBU target of 8+/-2 percent. As a result, NBU raised its key policy rate to 17 percent in March 2018 from 12.5 percent in May 2017, which has increased the cost of funds for local currency borrowing for both the government and the private sector.

FIGURE 1: GDP Growth, y/y,

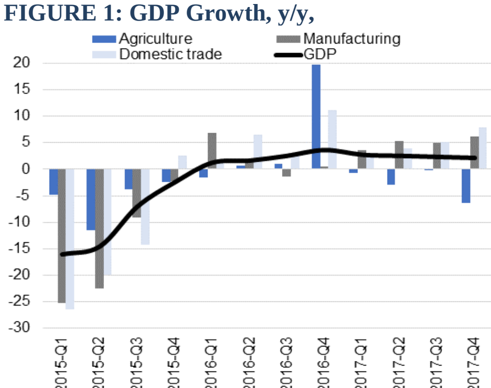


FIGURE 2: Poverty Rates

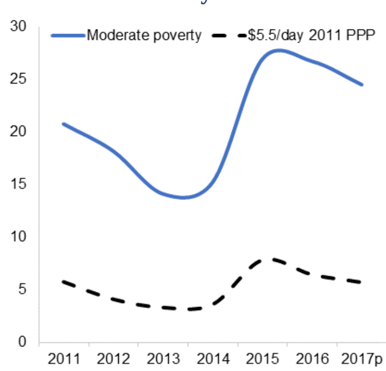
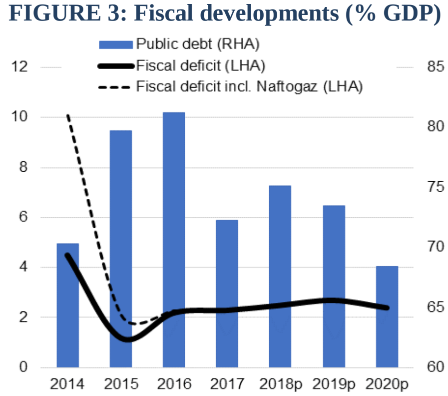


FIGURE 3: Fiscal developments (% GDP)



Poverty remains above pre-crisis levels, but declined slightly in 2017 due to the modest economic recovery and wage and pension growth. Real wages grew significantly by 19 percent in 2017 in part due to the sharp increase in public sector wages. This, together with growth of pensions, led to a decline in moderate poverty (World Bank's national methodology for Ukraine) to an estimated 24.5 percent in 2017 from 26.7 percent in 2016, but up sharply from 14.1 percent in 2013. The poverty rate (under $5.5/day in 2011 PPP) is estimated at 5.7 percent in 2017. The unemployment rate remained steady at 9.5 percent in 2017, compared to 9.2 percent the previous year.

The fiscal deficit was within target in 2017 despite high spending growth. The fiscal deficit remained flat and on target at 2.3 percent of GDP in 2017. However, expenditures were up by 11.7 percent in real terms and reached 41.5 percent of GDP due to the doubling of the minimum wage and over 40 percent increase in wages of teachers and doctors, as well as higher spending on social programs. This was balanced by strong revenue growth in 2017, driven by payroll tax (20 percent growth in real terms, due to the hike in wages), VAT (17 percent growth, due to higher proceeds from imports) and personal income tax (16 percent growth). Public and publicly guaranteed debt level remained high at 72.3 percent of GDP in 2017.

The current account deficit remained elevated at 3.5 percent of GDP in 2017 despite the improvement in terms of trade. Merchandise exports grew 18 percent to $39.7 billion in 2017, mostly due to improving commodity prices, while merchandise imports grew by 27 percent to $46.6 billion driven by investment and intermediate goods. FDI financed 60 percent of the current account deficit, with the rest financed by public and private borrowings. International reserves grew to $18.8 billion (an equivalent of 3.4 month of imports).

Outlook

Ukraine faces major financing needs and fiscal pressures in 2018 and 2019, which will require mobilizing sizable international financing to maintain macroeconomic stability. The fiscal framework targets a general government deficit of 2.5 percent of GDP in 2018 and 2.7 percent in 2019. Financing the fiscal deficit and repaying debt (including domestic debt) will require new borrowing equivalent to $18 billion in 2018 and 2019 (average of 7.3 percent of GDP per year), including about $8 billion from external sources, with the rest raised domestically. In order to raise the necessary external financing on affordable terms, it is critical to complete key pending reforms for the Fourth Review of the IMF program by summer 2018, well in advance of the 2019 elections. Furthermore, meeting the fiscal deficit targets for 2018 and 2019 will be challenging. The revenue targets are optimistic and assume additional improvements from deshadowing efforts, while recent reforms in education, health, public administration, and pensions are leading to higher spending on wages and social programs. In this context, meeting the deficit targets will require improved targeting of housing utility subsidies, identifying affordable options to update public sector pensions, and making further wage increases contingent on realistic measures to optimize the school and hospital network and public-sector staffing. The proposed replacement of the corporate income tax with a tax on distributed dividends is unaffordable since it would result in loss of a major revenue source in a challenging fiscal environment.

The growth outlook has become more uncertain, but safeguarding macroeconomic stability and completing key pending reforms by July 2018 to bolster investor confidence can help boost growth in the next two years. The complex political environment ahead of the 2019 elections is affecting reform prospects, but a window of opportunity exists to complete key reforms by July 2018. Reforms in land markets, the financial sector, anticorruption, and privatization would not only address medium-term growth bottlenecks, but also provide an important immediate signal to strengthen investor confidence. Addressing macroeconomic vulnerabilities and containing inflationary pressures to reduce cost of funds for the private sector is also important to strengthen investor confidence. Under such a scenario with continued improvements in investor confidence, economic growth could improve to 3.5 percent in 2018 and 4 percent in 2019, with fixed investment growing by about 15 percent. The growth would be supported by continued robust growth of manufacturing and services, with the agriculture and mining expected to remain relatively flat in 2018. Under an alternative scenario where reforms do not progress and the IMF reviews are not completed, growth could fall below 2 percent in 2018 and 2019 as investor confidence deteriorates with increasing macroeconomic uncertainty ahead of the 2019 elections. With real household incomes still below pre-crisis levels, continued weak economic growth of 2 percent or less going into the elections could undermine political and social stability, which would result in a further decline in investor confidence and growth.

External vulnerabilities are expected to persist. After an improvement in 2017, Ukraine's terms of trade is projected to weaken this year. The current account deficit is thus projected to remain elevated at 3.7 percent of GDP in 2018 and above 3 percent in 2019-2020. Without reforms to bolster exports and attract FDI, Ukraine will remain vulnerable to external shocks and commodity cycles. Cooperation with official creditors will be important to meet external financing needs, bolster international reserves, and safeguard investor confidence.

Table 1: Key Economic Indicators

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Nominal GDP, *UAH billion*	1,405	1,465	1,587	1,989	2,385	2,983	3,428	3,854	4,314
Real GDP, *% change*	0.2	0.0	-6.6	-9.8	2.3	2.5	3.5	4.0	4.0
Consumption, *% change*	7.4	5.2	-6.2	-15.9	1.4	6.7	5.4	4.1	3.8
Fixed Investment, *% change*	5.0	-8.4	-24.0	-9.2	20.1	18.1	14.9	9.0	9.2
Export, *% change*	-5.6	-8.1	-14.2	-13.2	-1.6	3.5	8.0	6.4	5.9
Import, *% change*	3.8	-3.5	-22.1	-17.9	8.4	12.2	14.0	7.2	5.8
GDP deflator, *% change*	8.1	3.1	14.8	38.4	17.1	22.0	11.1	8.1	7.6
CPI, *% change eop*	-0.2	0.5	24.9	43.3	12.4	13.7	9.9	7.3	6.5
Current Account Balance, *% GDP*	-8.2	-9.2	-3.5	-0.2	-3.8	-3.5	-3.7	-3.3	-3.3
External debt, *% GDP*	76.6	78.6	97.6	131.5	129.4	104.0	106.3	107.0	105.4
International Reserves, *US$ billion*	24.5	20.4	7.5	13.3	15.5	18.8	…	…	…
In months of next year's imports	2.9	3.3	1.9	3.2	3.4	3.4	…	…	…
Budget revenues, *% GDP*	44.5	43.6	40.3	42.1	38.4	39.2	40.1	40.8	40.6
Tax revenues, *% GDP*	38.9	37.9	35.8	35.5	33.1	34.0	35.4	36.5	36.6
Budget expenditures, *% GDP*	48.9	48.4	44.8	43.2	40.6	41.5	42.6	43.5	43.0
Current expenditures, *% GDP*	45.7	46.2	44.3	41.0	37.4	38.2	39.4	39.7	39.0
Capital expenditures, *% GDP*	2.9	2.0	1.3	2.2	3.1	3.3	3.2	3.8	4.0
Fiscal balance, *% GDP*	-4.4	-4.8	-4.5	-1.2	-2.2	-2.3	-2.5	-2.7	-2.4
Public and Guaranteed Debt, *% GDP*	36.6	40.6	70.3	79.7	81.2	72.3	75.1	73.5	68.4

Source: Ukrainian Authorities, WB projections

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