

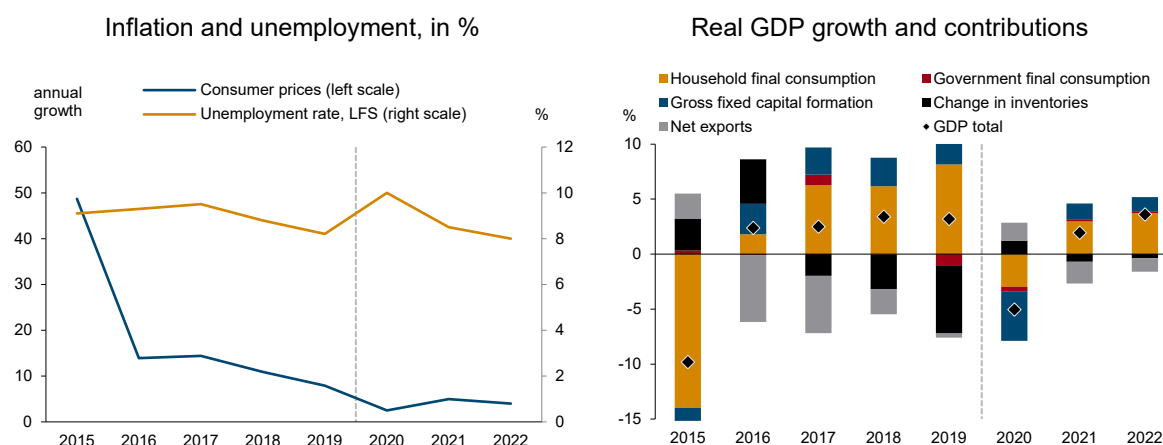


## UKRAINE: Fragile recovery in the face of growing risks

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After a sharp contraction in the second quarter of 2020, the Ukrainian economy has started to recover. We expect economic growth to return in 2021-2022, but to be fragile and subject to many downside risks. The coronavirus pandemic and the inability of the government to tackle corruption represent major threats to the economy in the future.

Figure 4.23 / Ukraine: Main macroeconomic indicators



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

**The coronavirus pandemic pushed the Ukrainian economy into severe decline in the second quarter of 2020.** GDP contracted by 11.4% year on year (y-o-y), due primarily to a weakening of domestic demand. Private consumption, which accounts for about 74% of GDP, decreased during the second quarter by 10.4% y-o-y – the first negative result since 2015. The fall in investment was even more dramatic – gross fixed capital formation decreased by 22.3% y-o-y, as many investment projects were put on ice in a climate of unprecedentedly high uncertainty. In terms of economic activities, all sectors registered negative y-o-y growth in the second quarter of 2020. The heaviest falls were recorded in restaurants and hotels (-58.1% y-o-y), agriculture (-29.1%) and transport (-26.9%). But the contraction was in double digits in many other sectors, including manufacturing.

**The external sector gained in stability, as imports have been shrinking much faster than exports.** During January-August 2020, exports of goods and services decreased by 8.2% y-o-y in USD terms, while for imports the decline reached 21.1% y-o-y. Falling energy prices and weakening domestic demand were the driving forces behind the merchandise imports fall, while restrictions on international travel accounted for the bulk of the decline in services imports. Remittances, which accounted for about 8% of GDP in 2019, turned out to be rather resilient and fell by only 6.4% y-o-y in USD terms during January-August 2020.

As a result of these trends, a current account surplus is expected in 2020 (for the first time since 2015); but according to our forecast, this will revert to a deficit in 2021, as the demand for imports revives.

**The national bank has been pursuing an accommodative monetary policy, but monetary conditions remain relatively tight compared to the rest of CESEE.** The policy rate was lowered to 6% in June 2020 – 7.5 percentage points lower than at the end of 2019; but annual inflation of about 2.5% means that the real interest rate still exceeds 3%. Interest rates on loans to the corporate sector are still measured in double digits (around 15% for SMEs), which indicates that the efficiency of monetary transmission remains limited in the high-risk environment.

**We have revised upwards our GDP forecast for 2020, as economic recovery in the third quarter of 2020 has exceeded all expectations.** The decline in exports has slowed on the back of rising global prices for grain and iron ore – key export commodities of Ukraine. Private consumption, supported by the relatively robust remittances and real wage growth (which accelerated in August to 6% y-o-y), has also recovered – as evidenced by the 8% y-o-y growth in retail trade in August. As a result of these trends, the fall in GDP is expected to moderate to -5% for 2020 as a whole.

**However, the second wave of the coronavirus pandemic represents a major threat to Ukraine in the near future.** With the easing of quarantine restrictions, the epidemic has started to spread much faster around the country, with daily new coronavirus cases exceeding 5,000 by 8 October, and with the daily death toll topping 90. Compared to most other European countries, the rollout of COVID-19 testing has been slow (only about 56,000 tests per 1 million people, as compared, for example, to 140,000 tests per 1 million people in Romania).<sup>21</sup> Accordingly, the actual scale of the epidemic in the country is likely to be much greater. Ukraine faces a shortage of medical supplies for acute care, such as masks, protective suits and ventilators. By the beginning of October, more than 17,000 healthcare workers (about 3% of the total number of healthcare workers, representing 5% of the total number of COVID-19 cases) in Ukraine had contracted the virus.<sup>22</sup> It appears that the government has opted to prioritise the economy over anti-epidemic measures, as it has been decided to allocate half of the modest coronavirus fund resources (the total amount of which is about UAH 66 billion or 1.7% of GDP) to road construction and repairs. The situation is aggravated by the population's poor compliance with the existing social distancing requirements. All these factors have significantly increased the probability of a collapse of the healthcare system, which would have an additional detrimental impact on the economy.

**Another major threat to the economy stems from the government's inability to tackle corruption, which also places at risk Ukraine's access to external finance.** Efforts to undermine the independence of the national bank and anti-corruption institutions, and lack of progress with reform of the judiciary,<sup>23</sup> forced the IMF to put its stand-by programme on hold, and by September the government had not yet received the expected USD 700 million tranche. The European Union and the World Bank have also postponed disbursements of EUR 600 million and USD 350 million, respectively. Given that non-residents have continued to abandon hryvnia-denominated domestic government debt securities, generating capital outflows from the public sector, and given that the government needs to increase social expenditure amid economic decline, the importance of the IMF funds has increased. In 2021, Ukraine's loan repayment and servicing costs will be more than USD 15.5 billion (or 10% of 2019 GDP). In the absence of the active IMF programme, investor confidence in the country could dwindle even further and the government could face much higher costs of borrowing – or even the risk of default.

<sup>21</sup> See <https://www.worldometers.info/coronavirus/#countries>

<sup>22</sup> According to the data of the Ministry of Health of Ukraine.

<sup>23</sup> See <https://www.ft.com/content/f014fe13-7381-4efc-a492-48f80ac01d99>

**The government's initiative to increase the minimum wage by 37% in 2021 carries a risk to macro-financial stability.** If adopted, it could lead to a fiscal deficit exceeding 6% of GDP in 2021, bringing total financing needs to over 13% of GDP; this would fuel inflation expectations, because of the likely depreciation of the hryvnia.

**We expect economic growth to turn positive in 2021-2022, though it will be on a lower trajectory than projected before the onset of the pandemic.** In 2021, real GDP growth will reach 2% y-o-y, and will accelerate to 3.6% in 2022 – mostly on the back of private consumption. Investment is expected to recover in 2021, but its growth will not be sufficiently high for the pre-crisis level to be reached by 2022. The lack of progress in reform is one of the key issues hindering an improvement in the investment climate in the country. Net exports will again become a drag on growth, starting from 2021, as imports will recover with rising private consumption and investment demand.

**The forecast is subject to significant downside risks, in particular related to the healthcare system and macro-financial stability.** In the baseline scenario, we assume that the authorities will get the coronavirus epidemic under control and that financing by the IMF and other international financial organisations will shortly be resumed. However, this is far from certain. Besides, a deeper/more prolonged global economic recession could also powerfully affect the Ukrainian economy.

Table 4.23 / Ukraine: Selected economic indicators

|   | 2017   | 2018   | 2019 <sup>1)</sup> | 2020<br>1Q | 2020<br>2Q | 2020<br>1-2Q | 2020<br>Forecast | 2021<br>Forecast | 2022    |
|---|--------|--------|--------------------|------------|------------|--------------|------------------|------------------|---------|
| Population, th pers., average                         | 42,485 | 42,270 | 42,028             | 41,867     | 41,796     | 41,832       | 41,750           | 41,540           | 41,330  |
| Gross domestic product, UAH bn, nom.                  | 2,984  | 3,561  | 3,975              | 846        | 868        | 1,714        | 3,900            | 4,200            | 4,500   |
| annual change in % (real)                             | 2.5    | 3.4    | 3.2                | -1.3       | -11.4      | -6.9         | -5.0             | 2.0              | 3.6     |
| GDP/capita (EUR at PPP)                               | 8,140  | 8,620  | 8,940              | .          | .          | .            | .                | .                | .       |
| Consumption of households, UAH bn, nom.               | 1,978  | 2,439  | 2,954              | 733        | 649        | 1,383        | .                | .                | .       |
| annual change in % (real)                             | 9.5    | 9.3    | 11.9               | 8.1        | -10.4      | -2.3         | -4.0             | 4.0              | 5.0     |
| Gross fixed capital form., UAH bn, nom.               | 470    | 628    | 716                | 99         | 121        | 220          | .                | .                | .       |
| annual change in % (real)                             | 16.1   | 16.6   | 14.2               | -21.4      | -22.3      | -21.9        | -25.0            | 8.0              | 7.0     |
| Gross industrial production                           |        |        |                    |            |            |              |                  |                  |         |
| annual change in % (real)                             | 1.1    | 3.0    | -0.5               | -4.8       | -11.7      | -8.2         | -6.0             | 3.0              | 3.0     |
| Gross agricultural production                         |        |        |                    |            |            |              |                  |                  |         |
| annual change in % (real)                             | -2.2   | 8.2    | 1.4                | -1.8       | -32.7      | -18.7        | .                | .                | .       |
| Construction output                                   |        |        |                    |            |            |              |                  |                  |         |
| annual change in % (real)                             | 26.4   | 8.6    | 23.6               | -5.2       | -5.3       | -5.5         | .                | .                | .       |
| Employed persons, LFS, th, average                    | 16,156 | 16,361 | 16,578             | 16,490     | 15,621     | 16,056       | 16,080           | 16,300           | 16,500  |
| annual change in %                                    | -0.7   | 1.3    | 1.3                | 1.4        | -6.5       | -2.6         | -3.0             | 1.4              | 1.2     |
| Unemployed persons, LFS, th, average                  | 1,698  | 1,579  | 1,488              | 1,549      | 1,712      | 1,631        | 1,790            | 1,510            | 1,430   |
| Unemployment rate, LFS, in %, average                 | 9.5    | 8.8    | 8.2                | 8.6        | 9.9        | 9.3          | 10.0             | 8.5              | 8.0     |
| Reg. unemployment rate, in %, eop <sup>2)</sup>       | 1.4    | 1.3    | .                  | .          | .          | .            | .                | .                | .       |
| Average monthly gross wages, UAH <sup>3)</sup>        | 7,104  | 8,865  | 10,497             | 11,007     | 10,850     | 10,928       | 11,400           | 12,800           | 14,200  |
| annual change in % (real, gross)                      | 19.8   | 12.5   | 9.7                | 11.4       | 1.9        | 6.4          | 6.0              | 7.0              | 7.0     |
| annual change in % (real, net)                        | 19.0   | 12.5   | 9.8                | 11.3       | 1.9        | 6.5          | 6.0              | 7.0              | 7.0     |
| Consumer prices, % p.a.                               | 14.4   | 10.9   | 7.9                | 2.6        | 2.1        | 2.4          | 2.5              | 5.0              | 4.0     |
| Producer prices in industry, % p.a. <sup>4)</sup>     | 26.4   | 17.4   | 4.1                | -5.9       | -4.4       | -5.2         | -4.5             | 5.0              | 3.0     |
| General governm. budget, nat. def., % of GDP          |        |        |                    |            |            |              |                  |                  |         |
| Revenues  | 34.1   | 33.3   | 32.5               | 33.2       | 43.0       | 38.2         | 30.0             | 32.0             | 33.5    |
| Expenditures  | 35.5   | 35.2   | 34.6               | 35.2       | 41.4       | 38.4         | 36.5             | 37.0             | 35.5    |
| Deficit (-) / surplus (+)                             | -1.4   | -1.9   | -2.2               | -2.1       | 1.6        | -0.2         | -6.5             | -5.0             | -2.0    |
| General gov. gross debt, nat. def., % of GDP          | 71.8   | 60.9   | 50.3               | 57.8       | 58.2       | 58.2         | 59.0             | 62.0             | 57.0    |
| Stock of loans of non-fin. private sector, % p.a.     | 1.9    | 5.6    | -9.8               | -2.0       | -3.3       | -3.3         | .                | .                | .       |
| Non-performing loans (NPL), in %, eop                 | 54.5   | 52.8   | 48.4               | 48.9       | 48.5       | 48.5         | .                | .                | .       |
| Central bank policy rate, % p.a., eop <sup>5)</sup>   | 14.50  | 18.00  | 13.50              | 10.00      | 6.00       | 6.00         | 6.0              | 6.0              | 5.0     |
| Current account, EUR mn <sup>6)</sup>                 | -3,079 | -5,443 | -3,682             | 2,060      | 1,535      | 3,596        | 4,500            | -800             | -3,800  |
| Current account, % of GDP                             | -3.1   | -4.9   | -2.7               | 6.7        | 5.2        | 6.0          | 3.6              | -0.6             | -2.9    |
| Exports of goods, BOP, EUR mn <sup>6)</sup>           | 35,192 | 36,677 | 41,146             | 10,227     | 8,954      | 19,183       | 36,800           | 37,100           | 37,900  |
| annual change in %                                    | 16.1   | 4.2    | 12.2               | 3.1        | -10.2      | -3.5         | -10.6            | 0.8              | 2.2     |
| Imports of goods, BOP, EUR mn <sup>6)</sup>           | 43,758 | 47,436 | 53,877             | 11,767     | 9,523      | 21,292       | 43,900           | 47,000           | 49,900  |
| annual change in %                                    | 19.6   | 8.4    | 13.6               | -1.0       | -25.9      | -13.9        | -18.5            | 7.1              | 6.2     |
| Exports of services, BOP, EUR mn <sup>6)</sup>        | 12,625 | 13,401 | 15,591             | 3,636      | 3,050      | 6,687        | 13,900           | 14,400           | 15,200  |
| annual change in %                                    | 12.3   | 6.1    | 16.3               | 7.7        | -20.9      | -7.5         | -10.8            | 3.6              | 5.6     |
| Imports of services, BOP, EUR mn <sup>6)</sup>        | 11,811 | 12,270 | 14,029             | 2,877      | 1,625      | 4,504        | 10,600           | 11,200           | 12,400  |
| annual change in %                                    | 9.4    | 3.9    | 14.3               | -5.4       | -54.6      | -32.0        | -24.4            | 5.7              | 10.7    |
| FDI liabilities, EUR mn <sup>6)</sup>                 | 3,473  | 3,872  | 5,207              | -1,313     | 1,159      | -156         | -4,400           | .                | .       |
| FDI assets, EUR mn <sup>6)</sup>                      | 207    | 98     | 554                | 101        | 19         | 120          | 400              | .                | .       |
| Gross reserves of NB excl. gold, EUR mn <sup>6)</sup> | 14,872 | 15,955 | 21,590             | 21,399     | 24,139     | 24,139       | .                | .                | .       |
| Gross external debt, EUR mn <sup>6)</sup>             | 96,741 | 92,352 | 109,134            | 109,067    | 109,439    | 109,439      | 108,701          | 112,874          | 115,652 |
| Gross external debt, % of GDP                         | 97.3   | 83.4   | 79.5               | 86.2       | 86.4       | 86.4         | 85.8             | 89.8             | 88.7    |
| Average exchange rate UAH/EUR                         | 30.00  | 32.14  | 28.95              | 27.60      | 29.61      | 28.60        | 30.8             | 33.4             | 34.5    |

Note: Excluding the occupied territories of Crimea and Sevastopol and, with the exception of the population, excluding the 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) Discount rate of NB. - 6) Converted from USD.

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