

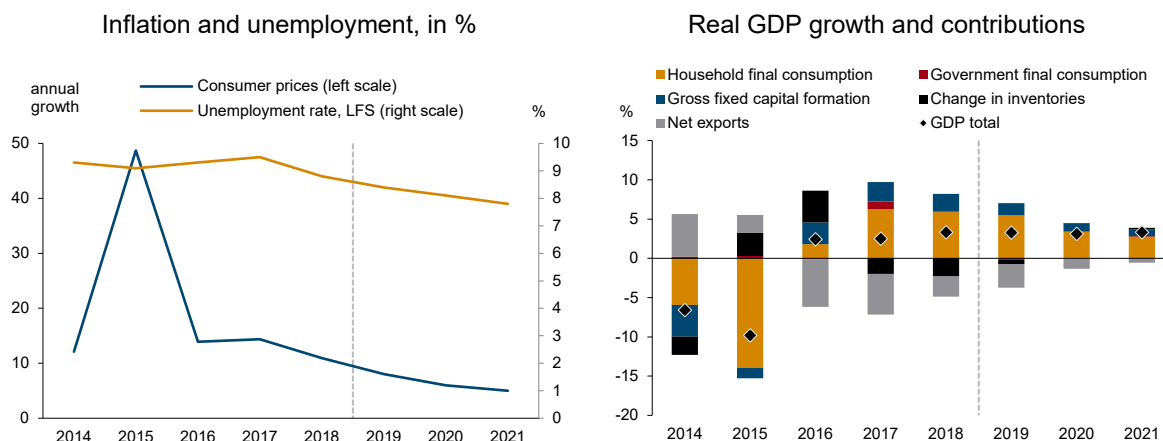


## UKRAINE: New reforms provide reason for optimism

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Progress in the peace negotiations with Russia and the reform agenda of the new government sent strong positive signals to investors. If the reforms are implemented the economy will receive a significant boost, though it will likely only be felt in the medium run. During 2019-2021, GDP growth will remain rather moderate at around 3% per annum. The major negative risk to the forecast is inability of the government to shake off the influence of oligarchs.

Figure 5.23 / Ukraine: Main macroeconomic indicators



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

**Investors' confidence got a boost as President Volodymyr Zelensky achieved progress in the peace talks with Russia.** Ukraine and Russia exchanged 70 prisoners on 7 September, which was seen as a starting point for fresh negotiations over a five-year military conflict between the two countries. On 1 October, Kyiv and Moscow reached a deal aimed at reviving the Minsk peace process. As part of the agreement, Ukraine has provisionally agreed to hold local elections in the occupied territories of Donbas (according to the so-called 'Steinmeier formula'<sup>27</sup>) once all armed formations leave the area and control is regained over about 400 km of border with Russia. The precise date of these elections is yet to be decided. Russia and Ukraine also agreed to renew pulling troops and equipment from Donbas starting on 7 October 2019.

<sup>27</sup> Steinmeier formula is a simplified version of Minsk agreements proposed in 2016 by Frank-Walter Steinmeier, who was then the German foreign minister. According to the formula, the parties involved should hold free and fair local elections in the Russian-occupied Donbas under Ukrainian law; in exchange, the region will receive special self-governance status.

**Domestically, agreement to hold local elections in Donbas caused mixed reactions.** Opposition politicians and their supporters showed their disdain for the deal. However, Zelensky's approval ranking still remains high (at about 70%). The President scored points with his party by voting for stripping deputies of immunity to prosecution, which was seen as an important step in fighting corruption.

**Investors also cheered the formation of a new government on 29 August.** It is comprised mostly of young reform-oriented technocrats (average age of ministers is 39 years old, which makes it the youngest government in Europe). Prime Minister Oleksiy Honcharuk announced an ambitious five-year action plan according to which the economy is to grow by 40% during this period, which implies GDP growth by 5% in 2020, and by at least 7% in 2021-24. The goal is hardly realistic and might be achieved only in a very optimistic scenario, when successful reforms implementation will boost investors' confidence and stimulate fast FDI growth already in the short run. According to the government's estimates, Ukraine needs to attract USD 50 billion in investment over the next five years for the plan to work out (for comparison, in 2018 net FDI inflow was at USD 2.5 billion). Still, implementation of reforms is expected to give a significant boost to the economic growth, though it will be mostly felt in the medium run only.

**Major reforms on the government's agenda include:**

- › Lifting the ban on farmland sales and launch of farmland market from mid-2020. The moratorium on land sales that has existed till now, while meant to protect small farmers, has actually hurt them as farmers were unable to use their lands as collateral to secure bank loans for farm operations. In this situation large agribusiness could get very long lease agreements (up to 49 years) on very favourable terms,
- › Resuming large-scale privatisation of state assets, with very few companies remaining on the list of exceptions,
- › Downsizing and overhaul of the Prosecutor General's Office and restarting of the judicial reform.

**Economic growth in Q2 2019 outperformed expectations having achieved 4.6% year-on-year.** This came on the back of very strong private consumption (+11.8% year-on-year) bolstered by improving consumer confidence, robust accumulation of gross fixed capital formation (7.9%) and a good harvest that supported exports growth. However industry's performance was rather disappointing; in January-August 2019 its output remained flat as compared with the same period last year.

**However, we do not expect growth acceleration to last as it was caused to a large extent by temporary factors** such as pension indexation and extra pre-election payments, the effects of which will be phased out in the second half of the year. Contribution of agriculture will also decline in Q3 2019 due to a lower harvest of oilseeds. Thus in the second half of 2019, GDP growth is likely to slow down and annual growth is expected to be 3.3% year-on-year.

**In 2020-2021 the economy will continue growing by about 3% a year** – too slowly for Ukraine to catch up with its EU neighbours in terms of household income. The primary reason for such a mediocre growth forecast is the lack of investment (in particular FDI) needed to improve labour productivity, which is currently less than 10% of average productivity in the EU. Without a significant increase in

productivity, real wage growth (and expanding private consumption) cannot be sustainable in the long run. The newly formed government intends to implement reforms to curb corruption and increase the quality of legal institutions to improve the business environment. However, the effects of the reforms will most likely be felt only in the medium run.

**Monetary policy continues being very tight in order to restrain underlying inflation pressures.**

The National Bank cut the policy rate by 50 bp to 16.5% in September 2019, but the real interest rate is still very high at about 7.5%. High interest rates have been attracting inflows of portfolio investment by non-residents into UAH-denominated government bonds, which brought about noticeable appreciation of hryvnia (in September, the average rate USD/UAH was 24.77, 11% lower than in January 2019). A high policy rate has a low transmission to the real sector of the economy as can be seen from the robust performance of gross fixed capital formation. Companies rely to a large extent on their own resources to finance investment (73% of capital investment in H1 2019 was financed from own funds) as access to loans remains constrained – outstanding loans stock to non-financial corporations in August 2019 was 10% lower in annual terms.

**More significant loosening of the monetary policy is planned in 2020 as NBU expects consumer inflation to decline** to 6.3% by the end of this year and reach the target range of 5% ± 1 pp in early 2020. Next year, the policy rate is expected to be cut by up to 500 bp. The real interest rate will remain relatively high, however further significant appreciation of hryvnia during the forecast period is not likely as increasing imports will push the exchange rate in the opposite direction.

**The major negative risk to the forecast is inability of the government to shake off the influence of oligarchs and deliver on the promised judicial and anti-corruption reforms.** Backsliding on Privatbank's nationalisation, as demanded by its former owner oligarch Ihor Kolomojsky, would jeopardize cooperation with the IMF and discourage investors. Recent developments (such as launched criminal proceedings against the current management of Privatbank, a police raid of the bank's headquarters and the home of Valeria Gontareva, the ex-central bank governor responsible for Privatbank nationalisation, and an arson attack on a countryside residence of Ms Gontareva) are seen as particularly worrying. The IMF mission to Kyiv in September 2019 made it clear that a new three-year arrangement under the Extended Fund Facility would be possible only if central bank independence is preserved and any settlement over Privatbank involves maximum recovery of assets from its ex-owners. External negative risks which could be detrimental to the economic growth are a full launch of the Nord Stream 2 pipeline during the forecast period (which will ship Russian gas to Europe avoiding the Ukrainian territory) and damaging repercussions of the US scandal surrounding the possible impeachment of President Trump, where Ukraine unwittingly got caught in the crossfire.

Table 5.23 / Ukraine: Selected economic indicators

	2015	2016	2017	2018 <sup>1)</sup>	2018 January-June	2019	2019 Forecast	2020 Forecast	2021
Population, th pers., average	42,845	42,673	42,485	42,270	42,325	42,082	42,150	42,050	41,950
Gross domestic product, UAH bn, nom.	1,989	2,385	2,984	3,559	1,516	1,736	4,000	4,400	4,800
annual change in % (real)	-9.8	2.4	2.5	3.3	3.6	3.6	3.3	3.1	3.3
GDP/capita (EUR at PPP)	6,000	6,000	6,100	6,500	.	.	.	.	.
Consumption of households, UAH bn, nom.	1,332	1,570	1,978	2,431	1,097	1,355	.	.	.
annual change in % (real)	-19.8	2.7	9.5	8.9	7.5	11.3	8.0	5.0	4.0
Gross fixed capital form., UAH bn, nom.	269	369	470	611	243	281	.	.	.
annual change in % (real)	-9.2	20.4	16.1	14.3	18.7	11.9	9.0	6.0	5.0
Gross industrial production									
annual change in % (real)	-13.0	2.8	0.4	1.6	3.1	0.5	1.0	2.0	3.5
Gross agricultural production									
annual change in % (real)	-4.8	6.3	-2.2	7.8	11.4	5.8	.	.	.
Construction output									
annual change in % (real)	-12.3	17.4	26.3	8.5	7.0	21.2	.	.	.
Employed persons, LFS, th, average	16,443	16,277	16,156	16,361	16,283	16,486	16,500	16,600	16,700
annual change in %	-0.4	-1.0	-0.7	1.3	1.0	1.2	0.9	0.6	0.6
Unemployed persons, LFS, th, average	1,655	1,678	1,698	1,579	1,600	1,528	1,510	1,460	1,410
Unemployment rate, LFS, in %, average	9.1	9.3	9.5	8.8	9.0	8.5	8.4	8.1	7.8
Reg. unemployment rate, in %, eop <sup>2)</sup>	1.6	1.5	1.4	1.3	.	.	.	.	.
Average monthly gross wages, UAH <sup>3)</sup>	4,195	5,183	7,104	8,865	8,378	10,030	10,500	11,700	12,900
annual change in % (real, gross)	-18.9	8.5	19.8	12.5	12.0	9.8	10.0	5.0	5.0
annual change in % (real, net)	-20.2	9.0	19.0	12.5	19.7	12.0	12.0	5.0	5.0
Consumer prices, % p.a.	48.7	13.9	14.4	10.9	12.6	9.0	8.0	6.0	5.0
Producer prices in industry, % p.a. <sup>4)</sup>	36.0	20.5	26.4	17.4	17.8	8.3	8.0	6.0	6.0
General governm.budget, nat.def., % of GDP									
Revenues	32.8	32.8	34.1	33.3	37.4	37.0	33.7	33.7	33.7
Expenditures	34.3	35.1	35.5	35.2	36.7	35.8	36.0	35.7	35.7
Deficit (-) / surplus (+) <sup>5)</sup>	-1.6	-2.3	-1.4	-1.9	0.7	1.2	-2.3	-2.0	-2.0
General gov.gross debt, nat.def., % of GDP	79.1	80.9	71.8	60.9	56.1	52.6	55.0	57.0	59.0
Stock of loans of non-fin.private sector, % p.a.	-2.8	2.4	1.9	5.6	7.4	0.0	.	.	.
Non-performing loans (NPL), in %, eop <sup>6)</sup>	28.0	30.5	54.5	52.9	55.7	50.8	.	.	.
Central bank policy rate, % p.a., eop <sup>7)</sup>	22.00	14.00	14.50	18.00	17.00	17.50	15.0	12.0	10.0
Current account, EUR mn <sup>8)</sup>	1,457	-1,210	-2,165	-3,696	-543	-590	-3,500	-4,200	-5,100
Current account, % of GDP	1.8	-1.4	-2.2	-3.3	-1.2	-1.0	-2.6	-3.0	-3.5
Exports of goods, BOP, EUR mn <sup>8)</sup>	31,935	30,309	35,192	36,677	17,499	19,887	41,400	43,400	45,300
annual change in %	-16.5	-5.1	16.1	4.2	-0.4	13.6	12.9	4.8	4.4
Imports of goods, BOP, EUR mn <sup>8)</sup>	35,050	36,579	43,758	47,436	21,087	24,762	54,500	56,700	58,500
annual change in %	-19.7	4.4	19.6	8.4	1.4	17.4	14.9	4.0	3.2
Exports of services, BOP, EUR mn <sup>8)</sup>	11,218	11,242	12,558	13,365	6,031	7,190	15,500	15,800	15,000
annual change in %	-0.4	0.2	11.7	6.4	-0.9	19.2	16.0	1.9	-5.1
Imports of services, BOP, EUR mn <sup>8)</sup>	10,232	10,801	11,655	12,226	5,636	6,418	13,500	14,200	14,700
annual change in %	9.4	5.6	7.9	4.9	-1.2	13.9	10.4	5.2	3.5
FDI liabilities, EUR mn <sup>8)</sup>	2,750	3,108	2,506	2,095	1,007	1,009	1,800	.	.
FDI assets, EUR mn <sup>8)</sup>	34	156	207	98	101	58	100	.	.
Gross reserves of NB excl. gold, EUR mn <sup>8)</sup>	11,320	13,965	14,872	15,955	14,559	17,191	.	.	.
Gross external debt, EUR mn <sup>8)</sup>	107,695	107,648	96,741	92,352	97,454	101,665	104,000	107,000	109,000
Gross external debt, % of GDP	131.2	127.7	97.3	83.4	88.0	75.5	77.2	76.4	74.9
Average exchange rate UAH/EUR	24.23	28.29	30.00	32.14	32.42	30.43	29.7	31.4	33.0

Note: Excluding the occupied territories of Crimea and Sevastopol and 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. - 6) From 2017 including NPLs of the nationalised 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.