21 Aug 2019

Country Economic Forecast Ukraine

Economist

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GDP growth to slow after Q2 rise to 4.6%, but likely to stabilise around 3% in 2019-22 as inflation slows

Confidence rising as Zelenskiy seeks IMF deal and retains key technocrats, but Russia tensions rule out sharp pick-up

- **The jump to 4.6% y/y GDP growth in Q2 partly reflected a revival of investment as the extent of President Zelenskiy's reform movement became clearer in the run-up to his party's victory in the July elections. But the pick-up relied mainly on stronger consumption growth after interest rate cuts, while Q2 industrial output was up only 1.6% y/y. Our forecast continues to show growth rates levelling-off around 3% in 2019-22, despite an expansionary fiscal stance enabled by lower interest rates and renewed IMF support.**
- The uptick in inflation to 9.1% in June is expected to be temporary, with the rate still on course to drop below 8% by year-end and below 7% in 2021, helped by a steadier UAH as the current account deficit starts to narrow. There is further scope for interest rate reduction once progress is made towards a new IMF deal from January 2020, the conditions of which will hold the new government to its anti-corruption, privatisation and public-sector reform pledges. Some tax reduction, designed to boost investment and household saving, is feasible without widening the deficit or adding to public debt.
- Although there is a possibility of faster growth from 2020 if early reform progress and low global interest rates strengthen the revival of private sector investment, downside risks remain equally strong – arising from the inexperience of the new president and coalition, possible frictions with the IMF (whose support is essential for external debt servicing) and difficulty resolving the eastern conflict without unpopular concessions to Russia. GDP growth can move above 3% in 2021, with inflation still subsiding, if reforms stay on track, but the next cyclical slowdown is set to begin by 2022 with expansion still well short of the 5-7% vision that swept Zelenskiy to power.

Forecast for Ukraine
(Annual percentage changes unless specified)

	2017	2018	2019	2020	2021	2022
Real GDP growth (% year)	2.5	3.0	2.7	2.9	3.1	2.8
CPI inflation (%), average	14.4	11.0	8.1	7.3	6.9	6.8
Exports of goods ($ bn)	49.5	51.8	53.6	55.2	56.8	58.3
Exports of services ($ bn)	15.0	16.9	19.1	21.7	24.6	27.8
Imports of goods ($ bn)	51.4	55.5	59.6	61.8	63.9	66.1
Imports of services ($ bn)	11.7	12.5	13.4	14.4	15.3	16.4
Exports of goods (% year)	5.6	4.5	3.6	3.0	2.8	2.7
Imports of goods (% year)	6.5	8.1	7.4	3.7	3.5	3.4
Current account ($ bn)	-2.4	-4.6	-4.5	-4.4	-3.8	-3.5
Current account balance (% of GDP)	-2.2	-3.7	-3.3	-3.0	-2.4	-2.0
Exchange rate per USD (year average)	26.6	27.2	28.5	29.2	29.9	30.3
External debt total ($bn)	113.3	130.1	134.6	137.9	141.4	145.0
Government balance (% of GDP)	-2.2	-2.4	-2.5	-2.4	-2.4	-2.4
Gross government debt (% of GDP)	71.0	65.0	59.5	56.2	53.2	50.6
Population (millions)	42.6	42.4	42.1	41.9	41.7	41.4
Nominal GDP ($bn)	112.2	124.6	135.6	146.1	158.5	172.6
GDP per capita ($ current prices)	2,633	2,938	3,221	3,488	3,801	4,169

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Forecast overview

Q2 growth spurt eases political transition…

Emphatic election wins this year for President Zelenskiy and his Servant of the People party have been accompanied by a sharp pick-up in GDP growth, to 4.6% y/y in Q2 from 2.5% in Q1. The upturn, with q/q growth up to 1.6%, mainly reflects stronger recovery in fixed investment and consumption following recent income growth. But full-year expansion is still expected to be capped around 3% in 2019-20, with limited room to accelerate until the new government begins to deliver on pledges to reduce corruption, improve the business environment and end the conflict in the industrial east. But the peaceful political changeover has strengthened prospects for continued steady expansion, underpinned by:

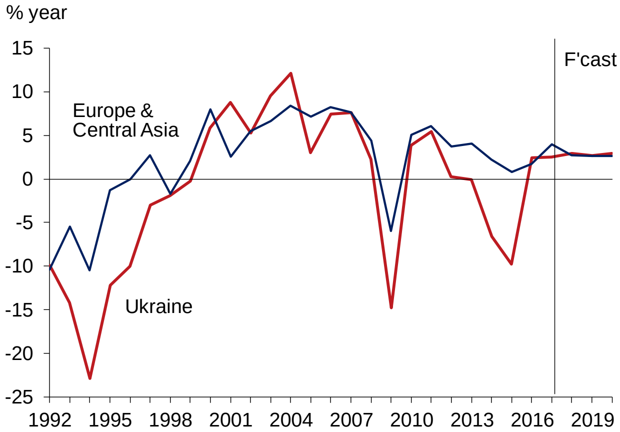
- **Improving external balance:** exports appear sufficiently resilient to ensure the current account deficit peaks this year. Its gradual narrowing in 2020-22 provides a shield against any production downturn if investment falls back. The narrowing deficit is sufficient to maintain a gradual slowing of UAH depreciation, allowing inflation to subside from 9.1% in July to average 8.1% this year and less than 7% from 2021. Another delay to completion of the Nord Stream 2 gas pipeline, due to Danish objections, may postpone the expected loss of Russian transit gas.

- **IMF staying onboard:** recognising the need to maintain IMF support, the government has indicated it will seek a new 3-4 year loan when the current one expires at year-end, possibly retaining trusted finance minister Oksana Markarova for the negotiation. IMF conditions would raise the chances of the government delivering promised reforms, including privatisation of main state-owned banks and other enterprises, and relaxation of current rules on foreign ownership of land.

- **Fiscal expansion:** below-target H1 revenues point to further widening of the budget deficit this year, and the new government's desire to reduce and simplify taxes is set to keep it close to 2.5% of GDP in 2020-22. This ensures funding of projects aimed at improving transport, telecoms, energy independence and social provision.

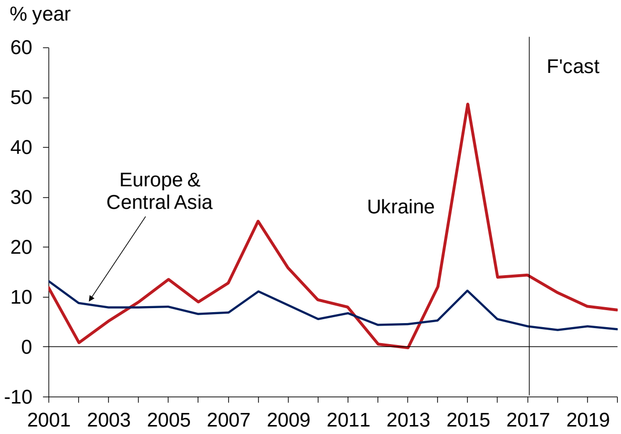
- **Initial boost from more emigration:** faster outward migration since 2014 (pushed by internal conflict and downturn, and pulled by better opportunities in Russia and the EU) has driven a sharp rise in remittances (to more than $6bn in H1 on initial estimates) while helping

Ukraine : Real GDP growth



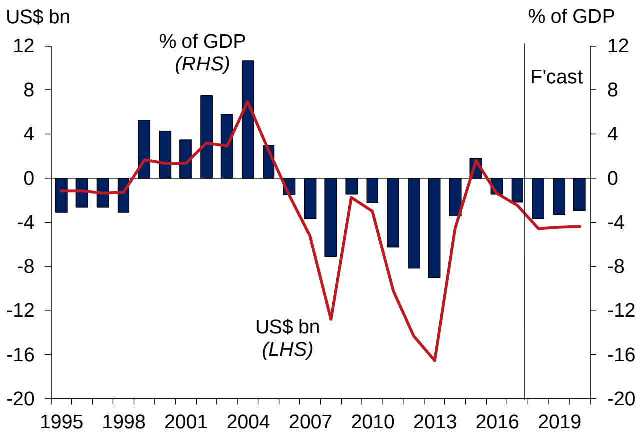
Source: Oxford Economics / World Bank

Ukraine : Inflation



Source: Oxford Economics / World Bank

Ukraine : Current account balance



Source: Oxford Economics

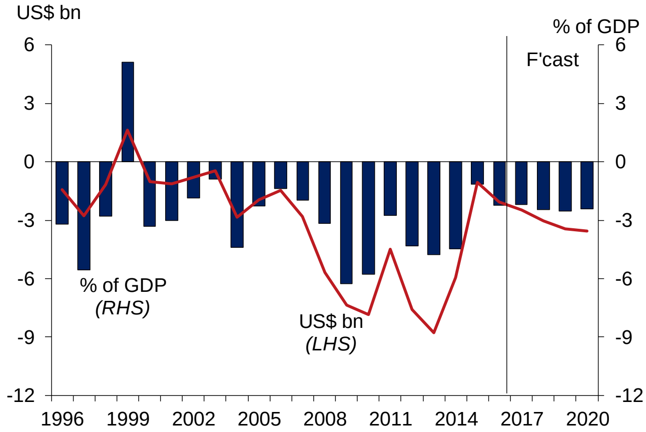
to hold down unemployment and welfare costs. There are now 3.2m working abroad, 18% of the working-age population, on official estimates. While this also means a loss of generally younger and higher-skilled taxpayers, there is a likelihood of Ukraine emulating Poland in replacing some of its emigrants with economic immigrants (from other ex-Soviet countries) willing to work for lower pay, with a net economic benefit until the unemployment rate falls well below the present 9%.

…but old constraints set to re-emerge in 2020

Risks have been reduced only slightly by this year's arrival of a pro-reform president with a clear parliamentary majority, and there is limited upside to the 2019-22 forecast due to:

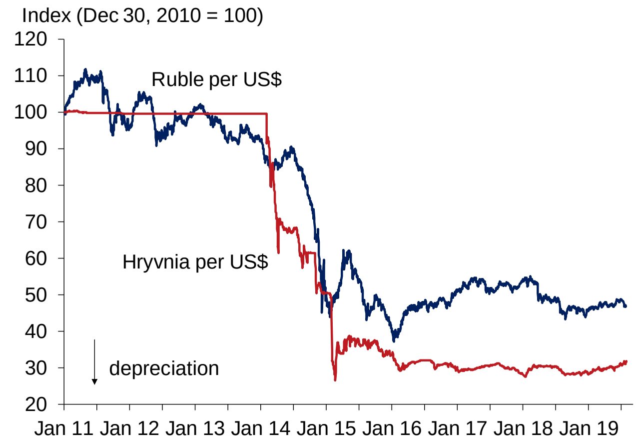
- **Difficult reforms ahead:** election-time promises to lift growth rates to 5-7% depend on the new government quickly using its unprecedented popularity to tackle old-industrial concentrations, infrastructure deficiencies, oversize and corrupt bureaucracy, and other structural constraints their predecessors failed to attack. Zelenskiy has not yet appointed the range of non-party technocrats that his outsider status makes possible, and is still at risk of being captured by 'oligarchs' threatening to run down their investments or offering media-empire support.
- **Debt strains continue:** while external debt is on a sustainable path due to GDP growth, 2015 restructuring and IMF support, problems could still re-emerge in 2020 over repayment costs, and beyond 2020 on components that trigger extra payments if GDP growth exceeds 3%. Current low global interest rates give a limited opportunity to issue new lower-cost debt, but this might also erode fiscal discipline and politicise official growth projections.
- **Consumption and export slowdown:** industrial output growth reached only 1.6% y/y in Q2, leaving the faster GDP rise largely dependent on agriculture (up 6.3%), retailing and other consumer-focused services. Unless there is prolonged acceleration of investment, spreading beyond metals/minerals into new industries and farming, medium-term GDP expansion could be held below 3% by a slowdown in household income and net export growth. Fears of a weaker world economy have outweighed the brightening domestic political outlook so far this year, with first-half FDI down 12% y/y (to just under $1bn).
- **Rocky road to peace:** despite cordial first meetings with Putin, Zelenskiy will find the promised restoration of peace in the east hard to achieve without unpopular concessions to Russia and the rebel leaders it supports.

Ukraine : Government budget balance



Source: Oxford Economics

Russia & Ukraine: Exchange rate v US$



Source: Haver Analytics

Ukraine: Sovereign risk spread

Source: JP Morgan / Haver Analytics

Economic Risk Evaluation

Overall risk for Ukraine: 7.0/10*

Ukraine's overall economic risk score of 7.0 is high, ranking it 139th out of 164 countries in our survey, owing to a combination of macroeconomic imbalances, high domestic and external political risk and default on its sovereign debt.

With the economy now growing again and the imbalances sufficiently reduced to relieve some of the pressure on the UAH, the pro-presidential coalition had begun to back-track on IMF reforms (in particular those on anti-corruption, public procurement and energy). Despite the election of President Zelenskiy on an anti-corruption programme, his inexperience means there is a risk that the IMF programme may again falter, potentially requiring another debt restructuring in 2020 when the bulk of restructured debt comes due.

Ukraine: Economic risk index
(Scores from 1 to 10 with 10 = highest risk)

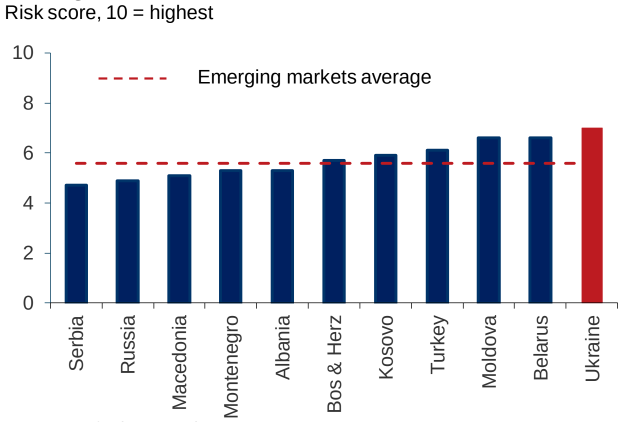
	Aug 2019	Rank out of 164†	Score change from February
Overall	7.0	139	-0.1
Market demand	6.0	92	0.0
Market cost	6.0	86	0.0
Exchange rate *	6.6	137	-0.1
Sovereign credit	6.5	150	-0.2
Trade credit	10.0	147	0.0

† (1 indicates lowest risk ranking)
* As of May 2019, the exchange rate risk score is based on our new methodology. The change from six months ago also refers to the respective score under the new methodology.

Market demand: 6.0/10

Although recovery continues, the demand risk score is unchanged over the past six months at 6.0 and a little above the emerging market average of 5.6. Growth is weak due to subdued confidence, high inflation and the squeeze on disposable incomes after rises in energy and public service costs. Consumer demand is recovering, however, supported by more stable inflation and a doubling of the minimum wage. Meanwhile, monetary easing has encouraged a rebound in consumer credit. But growth will be capped at about 3% by weak institutions, persistent corruption and some of the worst demographic trends in the world. The latter are aggravated by further outflow of labour to the neighbouring CEE economies, particularly Poland.

Economic risk: Ukraine vs Emerging markets average



Source : Oxford Economics

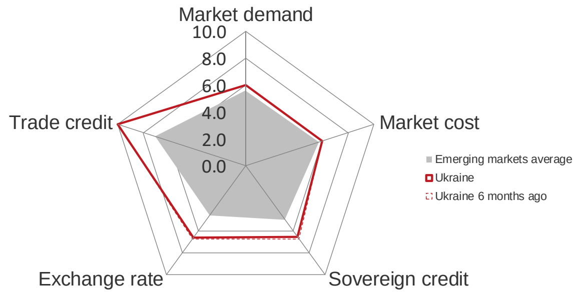
Market cost: 6.0/10

The market cost risk score is 6.0, slightly higher than the EM average. The 2014-15 UAH depreciation has raised the costs of imported machinery and equipment and largely offset the gains from lower world oil prices. Corporate financing costs remained high in 2017, despite the gradual reduction in interest rates, as banks' need for further consolidation and increased capital restrained their ability to lend. Real cost advantages from the lower UAH for exporters that do not rely on imported inputs helped in 2017, albeit eroded somewhat by still-high inflation. But loss of industrial capacity since 2014 restricts scope for export expansion, even where demand increases.

Exchange rate: 6.6/10

Under our new methodology, Ukraine's exchange rate risk is still very high at 6.6, well above the EM average of 4.6. After depreciating sharply in 2015, the UAH steadied in 2016 as a more stable external balance and IMF disbursements enabled some recovery in foreign reserves. Depreciation was more modest in 2017 as further IMF disbursements, rising exports and reduced external debt costs (following the restructuring) enabled the central bank to use its managed UAH float to bring inflation under control. However, given the large current account deficit, there are still downside risks to the exchange rate, with further corrections possible in 2019-20 if there are further delays to IMF loan disbursements.

Economic risk: Ukraine vs Emerging markets average



Source : Oxford Economics

Sovereign credit: 6.5/10

Ukraine's sovereign risk score of 6.5 is high and significantly above the emerging market average of 5.0. With five IMF bailouts and three defaults (1998, 2000 and 2015) on record, Ukraine is one of the riskiest sovereign credits in the world. Following the last debt restructuring in 2015, the government has achieved impressive macroeconomic adjustment (the current account and fiscal deficits fell from 9% and 4.8% respectively in 2013 to 1.4% and 2.2% in 2016), but the deficits are rising again and the debt burden appears unsustainable. The debt restructuring still leaves medium-term strains as the write-off fell short of what was needed to achieve debt sustainability, and interest costs may rise significantly when the initial repayment cap expires this year.

Trade credit: 10.0/10

Trade credit risk remains very high, at a maximum 10.0, despite the recovery in foreign reserves as the current account deficit fell and a loosening of capital controls in October 2015 that widened exemptions from the compulsory conversion of hard currency. Exports, already hit by capacity constraints due to the military conflict in eastern Ukraine, remain constrained by Moscow's suspension of free trade arrangements and by the severance of trade ties with the rebel-controlled territories, which were the key source for supplies of coal. The free-trade agreement with the EU will boost trade-related investment over the medium term, but new technical requirements and initial quotas on key industrial exports limit its immediate impact.

* Risk scores are from 1 to 10, with 10 representing the highest risk. For our full country risk service, see www.risk-evaluator.com. Sovereign credit risk comes from our sovereign risk tool and foreign exchange risk comes from our FX risk tool. Find out more.

Background

Economic development

Europe's second largest country (by land area) after Russia, Ukraine regained independence when the Soviet Union broke up in 1991. Leaders maintained close relations with Russia until President Viktor Yanukovich fled to Moscow in February 2014, after protests sparked by his refusal to sign a long-awaited Association Agreement (AA) and free trade deal with the EU. Russia responded in 2014 by supporting separatists who took over key towns in Donetsk and Luhansk (the Donbass region), which is geographically and linguistically the closest to Russia; and by re-annexing Crimea (ceded in 1954 in exchange for a part of today's Rostov oblast, and site of a Black Sea naval base on which Russia already had a long lease). Conflict with separatists, which had killed over 9,000 and internally displaced one million by 2016 and was unresolved despite ceasefire deals (Minsk I and II), compounded economic damage from the global recession of 2008-09, and from withdrawal of Russian gas subsidies in 2007-08 which raised annual gas purchase costs to around 5% of GDP. After GDP fell about 15% in 2009, a brief recovery stalled in 2012-13. Growth (now measured for the non-separatist regions) resumed in 2016 after another sharp fall in the hryvnia (UAH).

Structure of the economy

Traditionally a large agricultural producer and major wheat exporter, Ukraine acquired a heavy industrial base during the Soviet era, with large steel, chemical and engineering plants concentrated in the Donbass and fed by cheap Russian fossil fuel supply. These industries provided its main non-farm exports, along with transit gas, as Ukraine's pipelines became the main transit route for gas exports to the EU from Russia and other former Soviet states. Gas price rises and frequent pipeline disruption have promoted diversification of energy supply, notably through reverse gas flows from the EU, and of production towards more energy-efficient manufacturing and services, especially in the more europhone west.

Balance of payments

Current account deficits have persisted, even at times of slow output growth, due to erosion of Russian gas transit fees (and rising cost of consumed gas), subdued demand growth for commodity exports, and the administrative breakaway of eastern industrial regions since 2015. External financing has been reliant since 2008 on IMF support, which continues despite repeated breakdowns. After a US$14.6bn IMF standby loan stalled in early 2009 over the fiscal deficit, a new US$15.1bn 19-month standby agreed in August 2010 was suspended in March 2011 (with US$3.4bn disbursed) after refusal to raise domestic gas prices. By approving this and other reforms, the interim government in April 2014 secured a new US$17bn two-year standby deal, replaced in March 2015 by a four-year US$17.5bn extended fund facility. This was suspended after the third review in April 2017, with around $9bn disbursed, after gas-price and tax-reform delays; but a $3.9bn 14-month stand-by was approved in December 2018.The EU Association Agreement (AA), signed in June 2014, opened the EU market to most Ukrainian products, with a longer timetable for the liberalisation of Ukrainian imports.

Policy and politics

The 2013-14 'Maidan' protests were the second against Yanukovich, who was initially ousted by the end-2004 'Orange Revolution' protests, enabling a reform drive under Viktor Yushchenko's 2005-10 presidency. Splits in the governments of Yulia Tymoshenko and Yuri Yekhanurov allowed Yanukovich's Regions Party to win 2012 parliamentary elections. When he fled amid outcry over last-minute refusal to sign an Association Agreement securing a free trade pact with the EU, an interim government under Arseniy Yatsenyuk oversaw May 2014 presidential elections won by industrialist Petro Poroshenko, who signed the Agreement in June 2014. Poroshenko's block (with Vitali Klitschko's Democratic Alliance) won 22% of the October 2014 parliamentary vote, forming a coalition with Yatsenyuk's People's Front (also 22%) and Self-Help (11%). Yatsenyuk as prime minister agreed a new IMF deal and external debt rescheduling, handing over in April 2016 to close ally Volodymyr Groysman. In April 2019 Poroshenko lost the presidency to Volodymyr Zelenskiy, a lawyer and comedian, who had played a reforming president on TV and won 73% of the run-off vote. Zelenskiy's Servant of the People party then won over 40% of the vote in early parliamentary elections in July 2019, allying with the smaller pro-EU Holor party (with 6%), the pro-Russian Platform for Life (13%) becoming the largest opposition group.

Key Facts

Politics
Head of state: President Volodymyr ZELENSKY
Head of government: Prime Minister Volodymyr GROYSMAN
Political system: Democracy
Date of next presidential election: 2024
Date of next legislative election: 2024
Currency: Hryvnia (UAH)

Source : CIA Factbook

Location: Eastern Europe, bordering the Black Sea, between Ukraine, Romania, Moldova in the west and Russia in the east, (CIA Factbook)

Long-term economic & social development

	1980	1990	2000	2017*
GDP per capita (US$)	-	-	636	2633
Inflation (%)	-	-	28.2	14.4
Population (mn)	50.0	51.5	48.7	42.6
Urban population (% of total)	61.7	66.8	67.2	69.3
Life expectancy (years)	68.8	70.1	67.7	71.8

Source : Oxford Economics & World Bank

* 2017 or latest available year

Structure of GDP by output

	2017
Agriculture	10.2%
Industry	23.4%
Services	66.4%

Source : World Bank

Long-term sovereign credit ratings & outlook

	Foreign currency	Local currency
Fitch	B- (Stable)	B- (Stable)
Moody's	Caa1 (Stable)	Caa1 (Stable)
S&P	B- (Stable)	B- (Stable)

Corruption perceptions index 2018

	Score
Developed economies (average)	74.6
Emerging economies (average)	38.2
Ukraine	32.0
Emerging Europe	45.3

Source: Transparency International

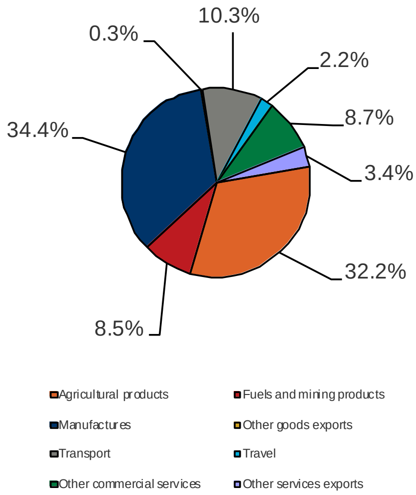
Scoring system 100 = highly clean, 0 = highly corrupt

Structural economic indicators

	1990	1995	2000	2017*
Current account (US$ million)	-	-1152	1342	-2442
Trade balance (US$ million)	-	-2702	779	-1843
FDI (US$ million)	-	267	595	1678
Debt service (US$ million)	-	1137	3755	13113
Debt service (% of exports)	-	7.0	20.3	20.7
External debt (% of GDP)	-	17.5	44.5	101.0
Oil production (000 bpd)	-	60	52	32
Oil consumption (000 bpd)	-	484	264	222

Source : Oxford Economics / World Bank / EIA

Composition of goods & services exports 2017



Source : WTO

Destination of goods' exports 2018

European Union	42.7%
Russia	7.7%
Turkey	5.0%
India	4.6%
Other	39.9%

Source : IMF DOTS

OXFORD ECONOMICS

Factors affecting risk scores: Ukraine

Overall risk: 7.0/10

	2017	2018	2019	2020	2021	2022	2023
Market demand rating: 6.0/10							
Domestic demand, % y/y	6.5	2.4	3.9	3.0	3.0	2.8	2.5
Government balance, % of GDP	-2.2	-2.4	-2.5	-2.4	-2.4	-2.4	-2.4
Gross government debt, % of GDP	71.0	65.0	59.5	56.2	53.2	50.6	48.4
Policy interest rate, %	14.50	18.00	15.00	12.00	10.00	8.00	8.00
Domestic credit, % of GDP	65.7	55.5	58.3	64.1	70.5	77.6	77.6
Fixed investment, % of GDP	16.0	13.6	13.3	13.2	13.1	12.9	12.8
Output gap, % of GDP	-	-	-	-	-	-	-
Real GDP per capita, 2015 US$	2244	2322	2401	2483	2573	2663	2740
Market cost rating: 6.0/10							
Nominal unit wage costs, 2010=100	-	-	-	-	-	-	-
Real fuel imports % total imports	-	-	-	-	-	-	-
Energy use per unit of GDP PPP	285.0	280.6	276.3	271.9	267.6	263.2	258.9
Exchange rate, average, LCU per US$	26.6	27.2	28.5	29.2	29.9	30.3	30.6
Output gap, % of GDP	-	-	-	-	-	-	-
Unemployment rate, %	9.5	9.1	8.0	7.5	7.3	7.2	7.2
Real GDP per capita, 2015 US$	2244	2322	2401	2483	2573	2663	2740
Exchange rate rating: 6.6/10							
Exchange rate, average, LCU per US$	26.6	27.2	28.5	29.2	29.9	30.3	30.6
Exchange rate, avg, PPP, LCU per US$	8.1	8.8	9.3	9.8	10.3	10.8	11.3
Current account of BOP, % of GDP	-2.2	-3.7	-3.3	-3.0	-2.4	-2.0	-1.9
External debt, % of GDP	101.0	104.4	99.3	94.4	89.2	84.0	79.0
Policy interest rate, %	14.50	18.00	15.00	12.00	10.00	8.00	8.00
FX reserves, months of imports	3.6	4.3	4.1	4.6	5.2	5.8	6.4
Sovereign credit rating: 6.5/10							
GDP, real, % y/y	2.5	3.0	2.7	2.9	3.1	2.8	2.4
GDP per capita, PPP, US$	8421	8711	9010	9319	9656	9993	10283
Government balance, % of GDP	-2.2	-2.4	-2.5	-2.4	-2.4	-2.4	-2.4
Gross government debt % of GDP	71.0	65.0	59.5	56.2	53.2	50.6	48.4
Trade credit rating: 10.0/10							
GDP, real, % y/y	2.5	3.0	2.7	2.9	3.1	2.8	2.4
External debt, % of GDP	101.0	104.4	99.3	94.4	89.2	84.0	79.0
GDP per capita, PPP, US$	8421	8711	9010	9319	9656	9993	10283