ISSUE NO. 139 | MAY 2020

NEWSLETTER

German Economic Team

UKRAINE

Covid-19 leads to sharp contraction of Ukraine's economy

The Covid-19 pandemic has taken a firm grip on the world economy. Ukraine will unfortunately not escape this global trend. A scenario-based analysis by the German Economic Team shows both the direct shocks and the total economic effect of the Covid-19 pandemic on Ukraine. Direct shocks include the temporary closure of domestic sectors, shocks to goods and services exports of Ukraine and a drop of remittances income.

We expect Ukraine's GDP to decline by -7% in 2020 in our baseline scenario. Our optimistic scenario, with milder expectations on domestic and external shocks, yields a contraction by -5.9% and the pessimistic scenario entails a reduction of GDP by -11.2%. Investment will lead this decline, whereas government consumption at least can remain stable. However, Ukraine's current account deficit will remain under control as imports will decline faster than exports. Overall, the expected economic effect of the pandemic is smaller than the effect of the global financial crisis in 2009. The stabilisation of Ukraine's macroeconomic fundamentals in the past years helps limiting the economic effect of the global pandemic.

The Covid-19 pandemic has led to severe containment measures across the globe. Ukraine instituted a domestic lockdown in mid-March and has, at least so far, been successful in preventing a large-scale domestic outbreak of the pandemic. However, domestic measures and the repercussions of the containment in its trade partners will lead to significant effects on Ukraine's economy.

Scenario analysis of shocks to the economy

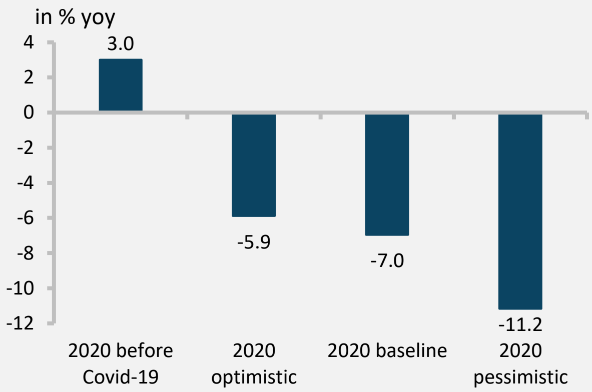
In cooperation with the Institute for Economic Research and Policy Consulting in Kyiv, the German Economic Team has conducted a scenario-based analysis of the economic impact of the Covid-19 pandemic on Ukraine. In three scenarios – optimistic, baseline and pessimistic – different durations of domestic lockdown of affected sectors are quantified. Assumptions on external shocks through reduced export demand and remittances are based on forecasts of the IMF and World Bank.

In the baseline scenario, the domestic lockdown creates a direct shock of -1.6% to domestic production. Reduced export demand leads to goods and services exports declining by -4.3% of GDP and remittances income will shrink by -2.3% of GDP. These shocks are then fed into an economic model to produce a forecast that calculates second-round effects including demand-side and policy reactions.

Drastic GDP contraction in 2020

Our results show that the shocks will have a massive effect on GDP growth in 2020. In our baseline scenario, Ukraine's economy will contract by -7% in 2020. That is ten percentage points below the forecast before the Covid-19 pandemic. At the beginning of the year, we expected GDP to grow by 3% in 2020. The vast majority of this sharp deterioration of economic prospects is due to the pandemic. Some other updated expectations, including that of a weaker agricultural harvest, also contribute to the downward revision.

Forecast: Real GDP growth in Ukraine, 2020



Source: Own calculations

Our optimistic scenario only leads to a mildly better forecast of a -5.9% drop in GDP in 2020. The pessimistic scenario yields a significantly worse forecast of -11.2% GDP contraction. This large downside risk estimate implies that substantially longer domestic shutdown measures, as assumed in the scenario, would have a sharp impact on overall growth.

Investment will lead the decline

On the demand side, investment will experience the sharpest decline. In the baseline scenario, investment will decline by -11.2% in 2020 compared to the previous year. Exports will decline by -7.6% and private consumption by -5.7%.

Growth of demand-side aggregates in 2020, % yoy

	Optim.	Baseline	Pessim.
Priv. consumption	-4.4	-5.7	-10.0
Govt. consumption	0.0	-0.7	-1.7
Investments	-8.3	-11.2	-16.3
Exports	-5.4	-7.6	-10.7
Imports	-9.1	-12.7	-14.5

Source: Own calculations

German Economic Team

Importantly, we expect government consumption demand to remain relatively stable with a decline of only -0.7% in the baseline scenario. This expectation is based on the figures of the revised budget passed in April. A new IMF programme is of course prerequisite to financing this budget, but appears very probable, as the banking law was finally passed on May 13th.

Transport sector takes largest hit

Among the supply-side sectors, transport will be most strongly affected. The decline by -14.3% in our baseline scenario is due to the combination of shutdown of passenger transport and reductions in goods transport as economic activity and trade decline.

Growth of selected economic sectors in 2020, % yoy

	Optim.	Baseline	Pessim.
Agriculture	-7.8	-8.9	-12.9
Industry	-3.3	-5.0	-8.1
Trade	-6.4	-8.0	-13.1
Transport	-11.2	-14.3	-24.1

Source: Own calculations

Strong effects are also expected for the retail trade sector, due to the combination of shutdown measures and second-round effects on demand. The negative forecast for the agricultural sector is mainly caused by the expectation of a weaker harvest (after the record harvest of 2019), not because of the pandemic. Industry will be relatively weakly affected.

No danger for the current account

An important result of our forecast is that the pandemic will not increase the current account deficit. Indeed, we expect the current account deficit to improve, if the impact of the pandemic on GDP gets worse. In the baseline scenario, a current account deficit of -0.3% of GDP is expected, whereas the pessimistic scenario would actually bring the current account into surplus at 2.1% of GDP. Although a drop in remittances of around -2.3% of GDP in the baseline scenario reduces current account inflows, imports will drop significantly quicker than exports.

Pre-crisis macro-financial stability pays off now

The sharp expected decline in GDP will cause a sharp reduction in tax revenues. However, the moderate government deficit and the highly likely conclusion of a new IMF programme allow the government to keep its expenditures stable. And since it brought inflation under control in previous years, the NBU had space to reduce the policy rate for monetary stimulation of the economy. Exchange rate flexibility is another important element of the authorities' toolkit.

Ukraine neither has the administrative nor the fiscal capacity for the large-scale economic support measures conducted in EU countries such as Germany. Still, the macroeconomic stabilisation of the past years has permitted fiscal and monetary policy to support the economy to weather this crisis. In result, the total expected economic downturn due to the Covid-19 pandemic is smaller than the GDP contraction of -15% during the global financial crisis of 2009, and in the same order of magnitude as in many other countries.

Outlook: Uncertainties remain large

This global pandemic is without comparable precedent. Uncertainties remain abundant, both regarding the spread, containment and treatment of Covid-19 itself and regarding the medium-term economic effects of a global lockdown. Hence, this and indeed any forecast may yet be subject to drastic revisions if new facts, information or events materialise.

The speed of economic recovery after 2020 also remains uncertain. A near-instant "V-shaped" recovery, however, becomes less likely the longer the pandemic persists. As companies have to downsize or go out of business, economic substance is lost. An important question for the future -in Ukraine as well as around the globe- is, whether economic policy can help turn at least some of this into "creative destruction" by spurring innovation after the pandemic rather than trying to keep "zombie companies" with obsolete business models alive.

Author
David Saha, saha@berlin-economics.com

Link to the study

Editors
Dr Ricardo Giucci, Robert Kirchner

Subscribe / unsubscribe newsletter

German Economic Team

www.german-economic-team.com

The German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Georgia and Uzbekistan regarding the design of economic policy reform processes and a sustainable development of the economic framework. It is funded by the Federal Ministry of Economics and Energy and implemented by the consulting firm Berlin Economics.