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NEWSLETTER

German Economic Team

UKRAINE

Quick economic recovery, but with some risks

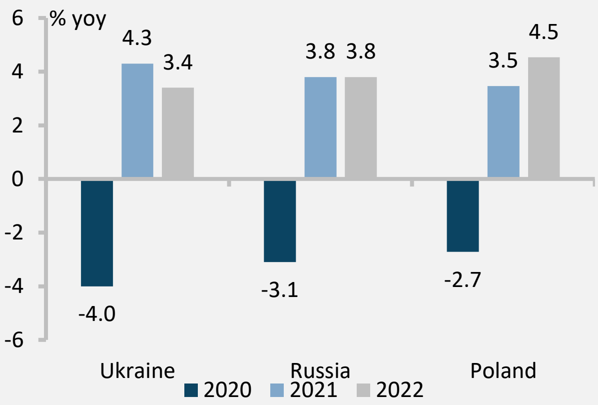
After Ukraine's economy declined by 4.0% in 2020 due to the pandemic, we expect a GDP recovery by 4.3% in 2021, mainly driven by domestic demand. The pre-crisis GDP level will already be reached within this year. However, once the rebound is over, Ukraine will be back on the path of moderate pre-crisis growth rates of around 3.5% if no essential structural reforms are conducted. Past reforms like the introduction of inflation targeting (IT) and the flexible exchange rate regime served Ukraine well, as they ensured a stable exchange rate as well as growing foreign reserves. Inflation is currently the main risk factor, after rising to 9.5% in May 2021, substantially above the target range (4% to 6%). While the National Bank of Ukraine (NBU) raised the key policy rate, further hikes to bring inflation under control may be necessary. In this regard, an independent NBU is essential.

A renewed reform drive would open the door for a further tranche under the current IMF programme, which has not seen any disbursements for the last 12 months. It would ensure both deficit financing and debt repayments as well as unlock further disbursements by the EU and the World Bank.

Ukraine's economy is rebounding

After Ukraine's GDP dropped by 4.0% in 2020, we forecast 4.3% growth in 2021. The main determinants of this growth are the improving global economy (including the recovery in main trading partners) allowing for international trade to resume, the growth of domestic demand and favourable agricultural harvest conditions. Though GDP declined by 2.2% in the first quarter 2021, we expect that the pre-crisis GDP level will be already reached during 2021, similar to Russia and Poland.

Regional comparison of real GDP growth



Sources: GET/IER forecasts, IMF forecasts

For 2022, it is expected that growth will moderate and return to its pre-crisis level of around 3.5%. This underlines that Ukraine will not be able to lift its medium-term growth prospects if no further structural reforms are implemented. Looking at the growth contribution on the demand side for 2021, private consumption is the main driver of the recovery, followed by investment. Net exports will have a slight negative contribution as imports are forecast to have a higher growth rate than exports. On the supply side, we expect a broad-based recovery due to resumed strong industrial production and good weather conditions for agricultural harvest.

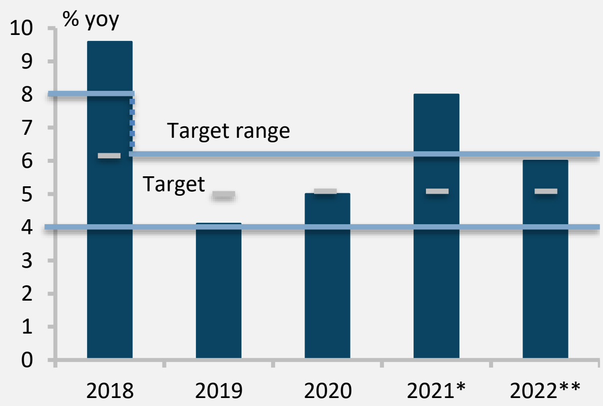
Exchange rate and reserves are stable

Overall, the flexible exchange rate regime has proven its success as an instrument of shock absorption during the crisis and the subsequent recovery. Ukraine was able to maintain a stable exchange rate while slowly accumulating foreign reserves. In 2021, the currency has been slightly appreciating and foreign reserves are stable at USD 27.8 bn with an import coverage of 4.2 months in May. The current account is expected to remain in surplus this year due to favourable terms of trade.

Inflation is surging

Last year, declining inflation and the need to support the economy allowed the NBU to cut the policy rate to a historic low of 6%. Inflation reached the target of 5% at the end of 2020. Currently, in line with international trends, an acceleration of food and energy prices as well as expansionary fiscal policy causes upside pressures and led to an increase to 9.5% in May. The NBU raised the key policy rate to 7.5% and indicated further steps to bring inflation back under control.

Inflation rate



*Sources: NBU, IMF; note: end of period, *NBU forecast, **IMF forecast*

It is expected that after 8% at the end of 2021, inflation will be back within the target range in 2022.

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Recovery of external trade

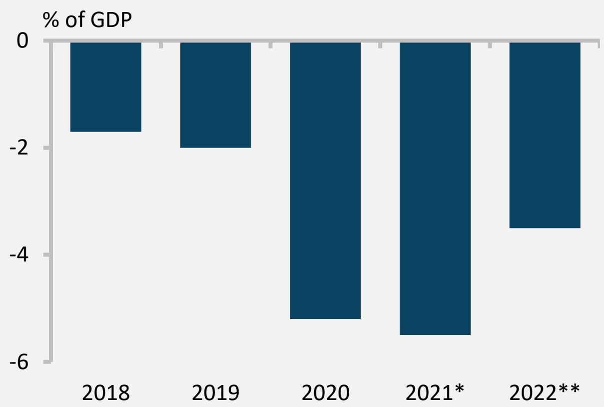
After four months of 2021, Ukraine's external trade volume in goods recovered by 20%. Exports increased by 19% driven by strong growth of metals (37%) and minerals (67%) as result of very favourable terms of trade. Exports will also benefit from favourable agricultural harvest conditions this year. In line with a recovery in investments and resumed production in partner countries, imports will grow by 20%, driven by the growth of machinery imports (23%).

As far as service exports are concerned, ICT is now the leading sector (35% share) after overtaking transport services (30%, including pipe transport). After the first quarter, service exports declined by 14% compared to the same period 2020, but we expect a recovery for the whole year given the trade structure and resumption of international trade.

Expansionary fiscal policy planned despite recovery

Past years of fiscal consolidation generated some space to support the economy during the crisis in 2020, leading to a budget deficit of 5.2% of GDP, less than initially planned. This year, Ukraine plans a deficit of 5.5% of GDP, which is still rather high, given the recovery. However, actual revenues are expected to grow above the planned ones, leading us to forecast a lower deficit of around 4.5% of GDP. From 2022 onwards, fiscal consolidation will be extremely important.

Budget balance



*Sources: Ministry of Finance, IMF, *Planned deficit in the budget law, **IMF forecast*

The financing of the deficit might become difficult without further IMF and other IFI financing as the total public external debt service constitutes USD 6.6 bn this year with a peak of USD 3.1 bn in September. After Ukraine received a first tranche of USD 2.1 bn in June 2020 when the Stand-By-Arrangement was agreed upon, an IMF review mission ended without a staff level agreement in February this year due to lack of further reforms and some setbacks. A planned new SDR allocation for all IMF members (USD 2.7 bn for Ukraine), which is not related to the SBA, would ease the pressure. Nevertheless, the programme remains vital as an anchor for programmes by other donors (EU, World Bank). Further steps in a wide range of reform areas are however essential for further cooperation and disbursements. An independent NBU is essential for bringing surging inflation under control. Judicial and anti-corruption reforms would support the rule of law and ultimately lift growth rates to sustainable levels that Ukraine needs to converge with its peer countries.

Conclusion and outlook

Previous reforms ensured that macrofinancial stability prevailed in Ukraine during the global crisis of 2020. The positive effect is a quick economic rebound that is currently underway, supported by growing domestic demand and very favorable terms of trade. Rising inflationary pressure is a risk that needs to be addressed by the National Bank of Ukraine.

This overall positive picture in the near term should not distract from the many significant medium-term challenges that Ukraine's economy faces. Progress with the structural reform agenda would also unlock further funds from the IMF and other IFIs as well as further entranch macrofinancial stability.

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