German Advisory Group Ukraine

NEWSLETTER

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The new government plan: It's not the destination, it's the journey

Ukraine's new government has recently unveiled its 5-year Action Programme, which sets its priorities in the economic and social sphere. While some targets like obtaining USD 50 bn of FDI inflows or reaching a foreign credit of "A-" look (over-)ambitious, other targets like the reduction of the public debt to GDP or the diversification of borrowing into local currency look quite realistic. It is also very positive that budget planning is done with a conservative approach. Regardless of the ultimate achievement of all indicators, the focus should be on the implementation of key reforms underlying this programme.

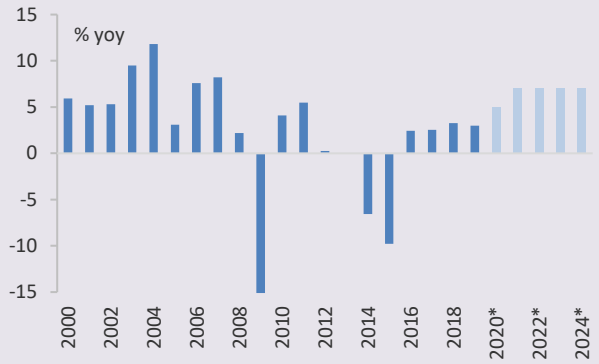
Background

The new 5-year Action Programme of the Cabinet of Ministers was adopted by Parliament on October 9, 2019. It lays down the priorities for the government and sets separate subtargets for each ministry. The purpose of this newsletter is to focus on selected aspects of this plan and provide an assessment.

Acceleration of real GDP growth

The plan to achieve 40% of real GDP growth during 2019-2024 looks too ambitious, but not totally unrealistic. It foresees that in 2020 real GDP should grow by 5% and during 2021-2024 by 7% annually.

GDP growth



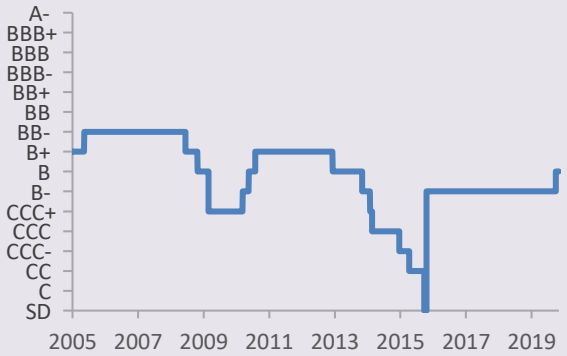
Source: IMF, CMU target

For the sake of fiscal stability, these ambitious plans were set as targets only, as opposite to executable budget indicators. The conservative budget forecast for 2020-2022 implies GDP growth of 3.7% in 2020, 3.8% in 2021 and 4.1% in 2022. An optimistic scenario of the same forecast envisages a successful implementation of reforms, which in turn implies GDP growth of 4.8% in 2020, 5.5% in 2021 and 6.5% in 2022. Ukraine has already seen periods of annual GDP growth of 7-12%, so the ambition is not totally unrealistic for individual years. However, such high growth was never reached before on a sustainable basis.

Sovereign rating upgrade

Reaching a sovereign credit rating target of A- is set as a 5-year target, which looks unrealistic. Countries like Poland, Latvia, Lithuania and Spain are currently rated in the region A-/A by international rating agencies.

Foreign currency rating (S&P)



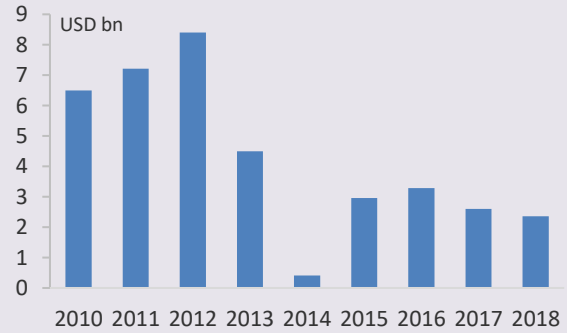
Source: Ministry of Finance Ukraine

The current rating of Ukraine is B from S&P, the maximum value in the past was BB-. Even if the government's policies will be in favor of macro-economic stability and structural reforms, an upgrade of 8 levels ("notches") within 5 years is hardly realistic, as rating agencies usually do not upgrade their ratings in such a manner. A realistic target would be a rating at BB+, which is close to e.g. Georgia (BB) or North Macedonia (BB-).

FDI Attraction

Gross capital formation in Ukraine was 19% of GDP in 2018, still affected by the 2014/15 crisis and lagging seriously behind middle-income countries (ca. 30% of GDP). The annual inflows of foreign direct investments are still very low, even 4 years after the crisis.

FDI inflows



Source: National Bank of Ukraine

The CMU plans to attract USD 50 bn of FDI in 5 years. It would imply around USD 10 bn of annual inflows, approx. 4 times the current level. It is even slightly higher than the average level of the pre-crisis years of 2006-2008, the most successful years for Ukraine ever. The government plans to achieve this through the establishment of the rule of law, the protection of creditors and investors, a reduction of government intervention, the creation of a predictable business environment, etc. These are all reasonable and laudable policies, but their immediate, effective and credible implementation in such a short period of time must be questioned.

Reduction of state debt

Currently, public and publicly guaranteed debt is predicted to be at 56% of projected 2019 GDP according to the IMF. The CMU plans to reduce it to 40% of GDP by 2024. At least half of all public debt should be nominated in hryvnia (vs. 36% as of 30 Sep 2019). The plan seems to be quite realistic, if the current focus on fiscal prudence and local currency borrowings is preserved. This is in particular true for the recently adopted 2020 budget with a projected deficit of 2.1% of GDP and planned local borrowings exceeding foreign ones.

Public debt

*Source: IMF, *Forecast*

The government missed to quantify the level of interest payments as % of budget expenses or GDP. Currently it stands at enormous 12% of state budget expenditures because of high interest rates.

Further priorities

Agricultural land reform is currently a top priority of the government. The law on agricultural land sales was recently adopted in the 1st reading, and the 2nd reading is expected soon.

Privatisation is also one of the stated priorities in the CMU's plans, but the main actions are still to be seen. As of end-November, the government has cancelled the ban on privatisation of selected companies to form a new list.

The government also plans to open third-party access to the railway infrastructure for private freight operators. Thus, the state company Ukrzaliznytsia has to be split into separate infrastructure, freight and passenger operators. Preparations for an IPO have recently started – this will be at least a 3-year process aimed at attracting USD 3 bn of investment capital.

Depending on the concrete implementation of these reforms, a positive impact on GDP and perhaps also on FDI is very likely, yet difficult to quantify.

Conclusion

Ukraine's new government has set itself very ambitious economic development targets. While some of seem can be realistically achieved during the next 5 years, some others seem quite far away. Experience with past government programmes supports this cautious view, as usually mixed results were achieved. Nevertheless, even if not all expectations won't be fully met, the implementation of the many important reforms that are the basis of this programme is the key issue. In that sense, it's not the destination, it's the journey!

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