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NEWSLETTER

German Economic Team

UKRAINE

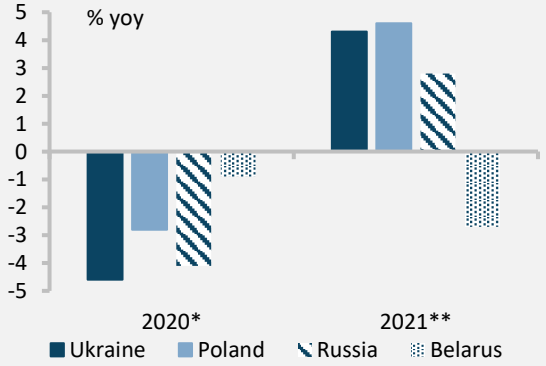
Economic recovery firmly in sight

Ukraine's real GDP declined by an estimated 4.6% in 2020 due to the economic impact of the pandemic. In international comparison, this decline is rather moderate. In 2021, the economy will expand by 4.3%, reaching pre-crisis real GDP levels only in 2022. Despite the crisis, the external position remained stable, benefiting from a positive terms of trade shock. The flexible exchange rate worked well as a shock absorber and supported the accumulation of international reserves, which reached USD 29.1 bn in December 2020, an eight-year high. Inflation reached 5.0% at the end of 2020, right at the target. In 2020, the budget deficit increased considerably and will decrease only slightly in 2021. Overall, these indicators show a stable macroeconomic environment despite the crisis. Due to the economic reforms of recent years, Ukraine faced this crisis much better prepared than past ones. For deficit and refinancing purposes, and as a policy anchor to accelerate further economic reforms, a continuation of the IMF-programme is of key importance.

Economic recovery in sight

Ukraine's real GDP droppped by an estimated 4.6% in 2020 due to the COVID-19 pandemic. High economic uncertainty led to a decrease of investment, which contributed -6.2 percentage points to the real GDP decline. In addition to the adverse impact of lockdown measures on the supply-side in key sectors, Ukraine faced bad harvest conditions in 2020, leading to a 12% decline of agricultural harvest. Overall however, counter-cyclical fiscal and monetary policy and international financial support limited the economic damage on the economy. Comparing the GDP decline to that of peer countries, Ukraine is in the medium range.

Real GDP growth in international comparison



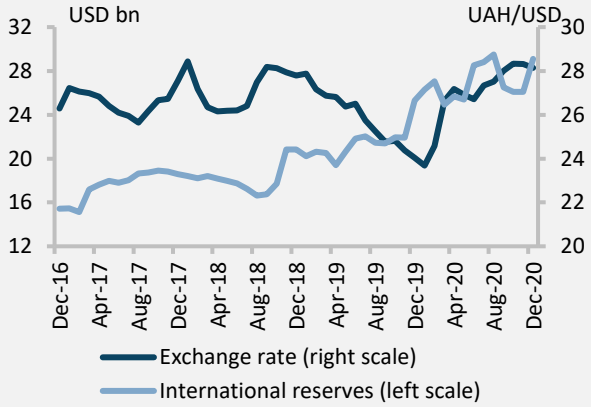
*Sources: IMF, GET/IER, Statistics Poland, *estimate, **forecast*

In 2021, Ukraine will be back on the growth path with 4.3%. For Ukraine, private consumption and investments are the main drivers of economic growth on the demand side. On the supply side, after a bad harvest in 2020, the agricultural sector will positively contribute to the economic recovery, while industry and the transport sector will grow as well. However, pre-crisis real GDP levels will not be reached until 2022.

Stable exchange rate, high international reserves

After strong appreciation in 2019, the Ukrainian currency faced a relatively moderate depreciation during the crisis with the exchange rate remaining under UAH/USD 30. As a result, Ukraine was able to further accumulate international reserves despite the crisis. In December, they reached USD 29.1 bn, an eight-year high, and an import coverage of approximately 4.8 months. All in all, the flexible exchange rate regime has proven its success as an instrument of shock absorption.

Exchange rate dynamics and international reserves

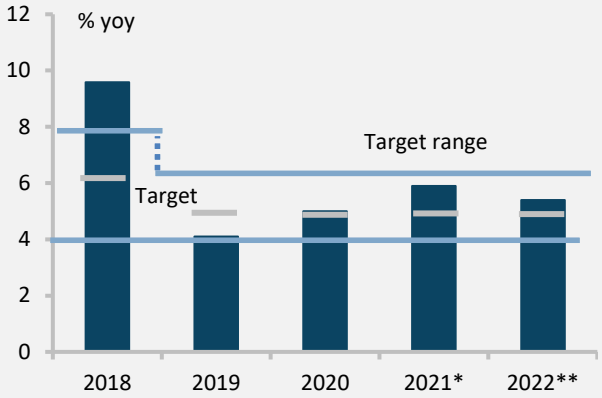


Source: NBU

As imports are estimated to have declined faster than exports (-7.1% vs. -3.8%), which is also due to massive improvement in the terms of trade, a current account surplus (4.7% of GDP) is estimated for 2020. A smaller surplus is forecast also in 2021. Thereafter, a gradual return to a moderate structural deficit is expected.

Inflation reached 5% in December 2020, exactly the target of the NBU. Low inflation allowed the National Bank to cut the policy rate to a historically low of 6% to support economic recovery. Over the next years, inflation is forecast to remain broadly within the target rate, even though inflationary pressure may arise due to expansionary fiscal policy, in particular the minimum wage increases. Therefore, it is of importance that the National Bank will react to any changes in inflation.

Inflation rate (end of period)

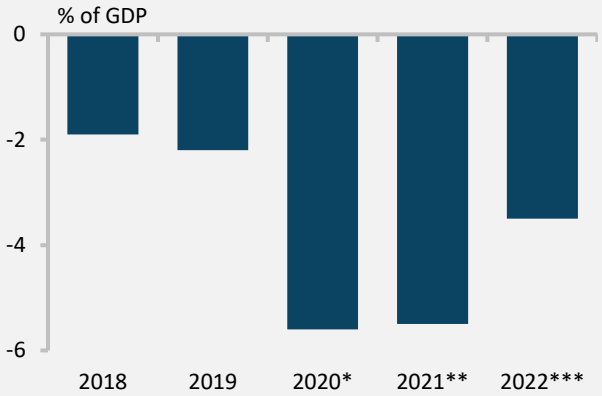


*Sources: NBU, GET/IER, IMF, *GET/IER forecast, **IMF forecast*

High budget deficit, no fiscal consolidation in 2021

As a response to the crisis, the Ukrainian government planned a revised budget deficit of 7.5% of GDP for 2020, as revenues were expected to fall in the crisis, while expenditures (e.g. health spending, economic support) were set to increase. According to recent data, we estimate a lower deficit of 5.6% of GDP, because the planned expenditure target could not be realised, even though revenues held up quite well. This was due to a lack of sufficient financing, despite receiving the first tranche of an EU macro-financial assistance loan (EUR 623 m), financial support from the World Bank as well as the first tranche of the Stand-by-Arrangement (SBA) with the IMF in June.

Budget balance



*Souces: NBU, Ministry of Finance, GET/IER, IMF, *GET/IER estimate, **Deficit in the state budget plan, ***IMF forecast*

A second tranche of USD 691 m from the IMF was delayed. The IMF started its review mission in December 2020, but further steps regarding the anti-corruption agenda, ensuring national bank independence and energy tariff policy are still expected.

For 2021, the government plans with a budget deficit of 5.5% of GDP. Given the optimistic outlook on economic recovery, such a high deficit implies a pro-cyclical fiscal policy stance rather than strict fiscal consolidation. As – like in many other countries – public debt increase significantly during the crisis (from 50% of GDP in 2019 to ca. 63% in 2020), stabilizing it at sustainable levels will be an important focus of fiscal policy over the next years.

Outlook

The COVID-19 pandemic posed significant economic challenges to all countries around the globe, with Ukraine being no exception. Unlike in previous crises, macro-financial stability prevailed in Ukraine. This is in our view a success of previous macroeconomic economic reforms in the country, and shows directly their benefits. At the same time, significant financial support by international financial institutions helped to weather the crisis.

Looking forward, the economic recovery that is underway should reinvigorate Ukraine's reform agenda. While gains from macroeconomic reforms need to be preserved, and no roll-back allowed, stronger efforts in terms of structural reforms are needed to boost sustainable growth. The continuation of further cooperation with the IMF will be essential in that regard.

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This newsletter is based on the 13th issue of our Economic Monitor Ukraine.

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