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German Economic Team

NEWSLETTER

UKRAINE

Economic recovery during a period of uncertainty

Ukraine experienced a sluggish economic recovery in 2021 with 3.2% GDP growth. The recovery was driven by strong private consumption and a record agriculture harvest, but restricted by low investment. In 2022, Ukraine is forecast to grow by 3.3%. This growth is not enough to converge to its peers, which reached their pre-crisis GDP levels already in 2021.

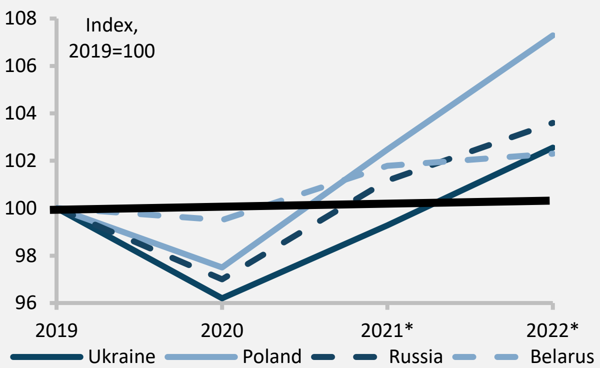
Similar to its peers, Ukraine faced high inflation rates in 2021 which were driven by accelerating food and energy prices. However, a restrictive monetary policy by the National Bank (NBU) is expected to bring inflation back to its target range in 2023. High prices also affected Ukraine`s exports, which grew strongly (40%) in nominal terms but declined slightly in real terms. Ukraine`s fiscal position is back on a consolidation path, with a moderate budget deficit of 3.5% in 2022 and public debt below 50% of GDP.

The economic impact of the Russia-Ukraine conflict is visible in financial market indicators, with limited spillovers to the real economy so far. Eurobond yields on international markets spiked, thereby limiting access to international capital markets for Ukraine. Foreign investors have been reducing their local bond holdings, and the exchange rate weakened somewhat, despite FX interventions by the NBU. Still, macro-financial stability prevails, in part due to substantial financial support pledges announced by international partners.

Background: Limited economic recovery

Ukraine experienced a limited recovery with 3.2% GDP growth in 2021. Unlike many of its peers, Ukraine did not reach pre-crisis levels in 2021 due to insufficent investment growth and declining real exports.

GDP development in regional comparison



*Sources: World Bank, National statistics, IMF, GET/IER, *estimate/forecast*

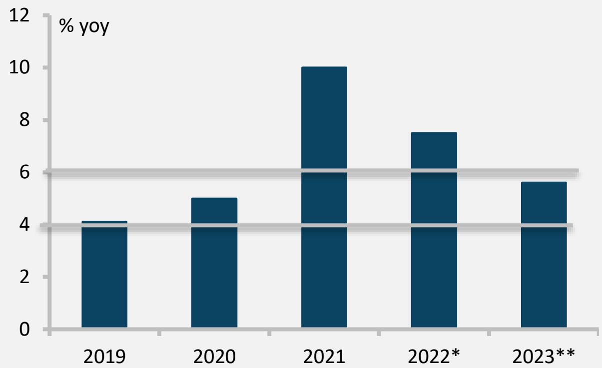
In 2022, Ukraine`s GDP is estimated to grow by 3.3% which is approximately the medium-term growth path. As this outlook won't allow for a quick convergence to its peers, Ukraine needs economic reforms to raise its growth rates permanently.

Growing consumption, but low investments

On the demand side, private consumption is the main driver, while investment still lacks behind. After a decline by 21% in 2020, investment didn't reach double-digit growth rates in 2021 and won't in 2022 as well. On the supply side, a record agricultural harvest (81 mt) has driven the recovery in 2021 while industry and the transport sector lag behind due to underinvestment. Both sectors will probably be still below pre-crisis levels even at the end of 2022.

Similar to its peers, Ukraine saw high inflation rates of 10% at the end of 2021 driven by the tense development on the food and energy markets.

Inflation



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

The National Bank increased its key policy rate stepwise to 10% p.a. and announced a continuation of the restrictive monetary policy to bring inflation back to its target range (4% to 6%). Tight monetary policy and a strong harvest, which limits food price growth, are expected to lead inflation back to its target in 2023.

Price effects also drove Ukraine`s external trade. Exports grew strongly in nominal terms and surpassed the 2019 level due to favourable export price effects, which helped to reduce Ukraine`s trade deficit. However, the recovery of export volumes is postponed to 2022, while the import recovery is driven by volumes rather than by prices.

Fiscal policy back to consolidation mode

Despite a planned deficit of 5.5% of GDP for 2021, the actual deficit is estimated to be much smaller at 3.8% of GDP because of higher VAT revenues. A further reduction of the deficit is planned for 2022 as Ukraine and the IMF agreed on a deficit of 3.5% of GDP. This policy supports a decline of the public debt ratio to less than 50% of GDP. As FX debt service of USD 10.6 bn is expected in 2022, a rather tight fiscal stance is of key importance.

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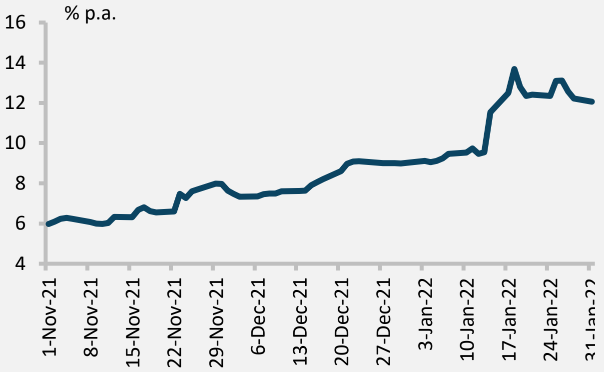
Impact of the Russia-Ukraine conflict

Since the middle of November last year, increasing geopolitical tensions between Russia and Ukraine have been observed, caused by a massive build-up of Russian military activities close to Ukraine. So far, these concerning political developments have been impacted mainly high-frequency financial market indicators for Ukraine. As a result, a substantial increase in sovereign (and private) Eurobond yields have been observed, to levels that make international market access for Ukrainian borrowers currently very difficult and/or expensive.

Souvereign Eurobond yields

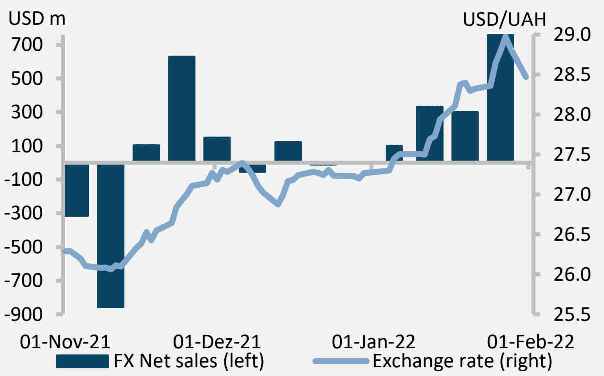


Source: Frankfurt exchange, note: bond with maturity Sep-26

To some extent, these developments have been mirrored in the local bond market, where foreign investors reduced their holdings correspondingly. In net terms, they sold UAH 15.1 bn (USD 0.8 bn) between the middle of November until the end of January; their share in total bond holdings declined from 9.7% to 7.6% over the same period.

This development caused also a certain depreciation of the Hryvnia, despite FX interventions by the NBU. Still, the current level of both the Hryvnia and of FX reserves is comparable to the level one year ago, which is positive.

Exchange rate and FX interventions



Source: NBU

Conclusion and outlook

Ukraine's economy continues to recover from the pandemic, even though it lags somewhat the more dynamic development of many peers. The current Russia-Ukraine conflict is visible in financial indicators, which deteriorated, but so far shows no spillovers to the real economy. The strong and quickly announced support by international partners (e.g. EU, US, Germany) as well as IFIs (IMF, WB) is important to shield Ukraine from disturbances at international capital markets and helps to ensure macro-financial stability.

Obviously, the further pace of the economic recovery is conditioned on the duration and intensity of the conflict with Russia, even though the Ukrainian economy has proved surprisingly resilient so far. Notwithstanding these challenges, Ukraine should continue with the economic and policy reform path to improve the business climate, which continues to hold back investments. This would lift growth rates, which in turn would help Ukraine to achieve a long-term convergence to its peers.

Authors

Garry Poluschkin, poluschkin@berlin-economics.com
Robert Kirchner, kirchner@berlin-economics.com

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Editors

Robert Kirchner, Garry Poluschkin

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