2017 Recovery in Ukraine

By Oleksandra Betliy, Vitaliy Kravchuk, Institute for Economic Research and Policy Consulting (Kyiv, Ukraine)

Real GDP dropped by 9.9% in 2015 due to decline in domestic and external demand as well as military action in Eastern Ukraine. Economy is expected to move from stabilization and rebound of economic activity in 2016 to gradual but full-fledged recovery in 2017. However, there are plenty of risks remain high. To ensure recovery the Government should continue implementing reforms, which are envisaged in the IMF Program and the Program of new Cabinet of Ministers. Below we present some insight into the IER forecast of the macroeconomic development of Ukraine during next two years.

Oleksandra Betliy

Vitaliy Kravchuk

2016: STABILISATION IS THERE

Recent short-term economic statistics confirmed that Ukrainian economy is on the path to stabilization. In the first quarter of 2016 most sectors of economy performed better than in problematic first quarter of 2015. For example, extractive industry increased output as some coal mines in Donbas returned to operation after escalation of military conflict in the beginning of 2015. Stabilisation of economy helped calm consumers and led to growing retail sales for the first time since 2014.

In the rest of the year, higher external demand for steel products (e.g. from the EU, which introduced antidumping measures against Russia and China) and somewhat higher prices are expected to lead to increase in steel output and iron ore extraction. Machine building will also grow (after collapse in production in 2014 and 2015) due to higher demand for defence-related products and for cars. Overall, real gross value added in industry is projected to increase by 4.2%.

While we expect over 1% increase in real export volumes this year, exports will be limited by weak first quarter and expected decrease in grain harvest. Imports is expected to respond to higher domestic demand. Consumer incomes are expected to increase in 2016. Government planned increases in minimum wage and pensions as well as public sector wages. Private sector is expected to spend some of the savings from recent large decrease in payroll taxes on higher wages. At the same time large part of added cash flow will likely be used to fund essential repairs and replacements or as added working capital. Overall, real private final consumption is estimated to increase by 2.1% due to higher real disposable income and improved consumer sentiment.

Investments in fixed assets will remain only slightly higher than replacement rate. According to the IER estimates, real gross fixed capital accumulation is projected to increase by 6.8% in 2016. As a result, it will still be by 32.5% lower than in 2012. Small growth in investments is explained by several factors. First, financing remains limited as bank lending is likely to remain expensive this year, while self-financing is hard due to insufficient cash flow. According to the IER survey of industrial enterprises managers of companies reported the liquidity problems as the major impediment for business development. Second, political and economic uncertainty continues to constrain investment planning. In the first quarter of 2016 near 40% of companies reported political uncertainty as the significant barrier to business development.

Third, regulatory climate remains unfavourable despite some progress. In 2015 the Government reduced number of licences and permissions in the effort of deregulation reform. There were alsso substantial improvements in technical regulations, as the Government continued shifting from Soviet era standards to standards and technical regulations harmonised with EU. However, tax administration remained unfair, property rights are still not very well protected. While there was a successful introduction of National Police, justice and public prosecution reform is still in in the agenda. The corruption remains high despite increase in prosecutions and significant progress in forming institutions to fight with corruption.

Overall, real GDP is expected to grow by 1.6% in 2016. This reflects continued stabilization of the economy, bounce of economic activity in some areas and the statistical base effect. Business tendency survey of the IER and the NBU point to cautious business sentiment in the beginning of the year. Risks to stability remain as domestic political landscape remains fractured, peace process in Donbas is not very successful and recent rebound in demand for Ukrainian exports may prove fleeting.

2017: SLOW BUT STEADY RECOVERY

Real GDP is expected to increase by 3.3% in 2017. Stabilization in 2016 is expected to help business and consumer sentiment improve leading to recovery of domestic demand in 2017. In particular, real private final consumption is forecasted to grow by 2.8% due to higher real disposable income and increased consumer lending. More stable financial sector as well as financing of infrastructural projects by international donors and more space for self-funding will result in 9% growth of real gross fixed capital formation.

In fiscal policy, The Government is expected to focus on improved tax administration. At the same time, the Government is expected to continue efforts to increase efficiency in fiscal expenditures. In particular, it is expected to continue verification of social payments and shift to more targeted social assistance provision. The full introduction of electronic public procurements through the platform ProZorro will also increase efficiency of government consumption spending as well as allow for savings (e-procurements were in pilot in 2015 with compulsory introduction by central executive entities since April 1, 2016, and for other public entities since August 1, 2016).

In fiscal policy, The Government is expected to focus on improved tax administration. At the same time, the Government is expected to continue efforts to increase efficiency in fiscal expenditures. In particular, it is expected to continue verification of social payments and shift to more targeted social assistance provision. The full introduction of electronic public procurements through the platform ProZorro will also increase efficiency of government consumption spending as well as allow for savings (e-procurements were in pilot in 2015 with compulsory introduction by central executive entities since April 1, 2016, and for other public entities since August 1, 2016).

External market conditions are expected to become more favourable as steel and wheat prices are expected at higher levels in 2017. Expanded access to EU market is also expected to help exports next year as more companies are expected to be ready to export to EU with time. Higher domestic demand is projected to result in more imports but it is projected to grow slower than exports.

However, expected economic growth will materialise only if our key assumptions will hold. These include no military escalation, no large-scale external shocks and political infighting limited enough to preserve macroeconomic stability and not to prevent implementation of reforms in a number of areas. In particular, we expect further deregulation efforts, technical regulation reform, changes in tax administration to improve investment climate next year.

MONETARY POLICY IN BRIEF

The National Bank of Ukraine (NBU) is expected to continue its move to inflation targeting in 2016 and 2017. NBU so far was successful in moving away from pegging national currency -hryvnia – to US dollar and increasing role of the monetary policy. NBU introduced usual attributes of mature central bank such as regular macroeconomic reports, scheduled policy meetings and policy interest rate that has real impact on short-term interest rates. In 2015 and in the beginning of2016 fiscal consolidation and sharp drop in demand helped to return inflation to manageable levels quickly. In March 2016 core CPI was only 15% higher than in March 2015 despite huge hryvnia depreciation in the preceding 12 months. Hryvnia lost 42% of its value against trade-weighted basket of currencies between March 2014 and March 2015.

In the remaining months of 2016 and 2017 the key challenge for the NBU is to build enough credibility for inflation target to keep inflation expectations under control. Simultaneously NBU will have to intervene on the foreign currency market just enough to keep exchange rate volatility at an acceptable level. Too much volatility would harm business climate and build up inflation expectations in dollarized economy. Too low volatility would harm credibility of the inflation target, build up imbalances and encourage further dollarization of the economy. While the balancing act would not be easy, consumer demand growth is expected to remain slow keeping inflation pressure at a minimum. As a result we expect core inflation at 10-11% (year-on-year) in December 2016 and below 10% by December 2017.