Summary of KSE Macroeconomic Forecast, April 2021

In 2021, the recession cycle caused by the coronavirus crisis will head to closing and **the recovery of the Ukrainian economy will be rapid: GDP will grow by 4.7 %**. Improved trade conditions in the second half of last year, recovery from a shock caused by the Covid-19 pandemic and harsh spring lockdowns on external and domestic demand had already helped ease the crisis — a drop in the GDP in 2020 was 4.0 % compared to a 5.0 % consensus forecast at the end of the year.

Continued global generous monetary and fiscal measures will help restore demand in major countries-trading partners; however, delays in vaccination will curb this process. Much of the recovery will be in 2021, and starting from 2022, the pace of development will decrease. The slow reviving in Europe will restrain the development of the Ukrainian economy in 2022. Besides this, the growth in Ukraine will be subdued given a significant drop in domestic private investment, occurred in 2020. Thus, **in 2022 GDP will increase by only 2.7 %**. **In 2023**, long-term effects of infrastructure projects and a stronger inflow of foreign investment will contribute to **accelerating the growth up to 3.7 %**.

The **growth of prices for basic export goods**, which is ahead of the increase in prices for energy, will become the first factor in the recovery of Ukraine's economy in terms of time. Higher exports and fiscal stimulation will help revive domestic consumption. Starting from the second half of this year, the projected further rise in oil and gas prices will boost inflation and reduce the positive effect of terms of trade. The beneficial **impact of the Large Construction Program will partially offset the negative effects of the private investment decline** of 2020. However, this decline will contribute to the reduction in the potential growth of the Ukrainian economy, which is estimated at a low rate of about 3.5 %. Only reforms and massive investment can push the economy out of the zone of moderation.

Figure 1. GDP growth

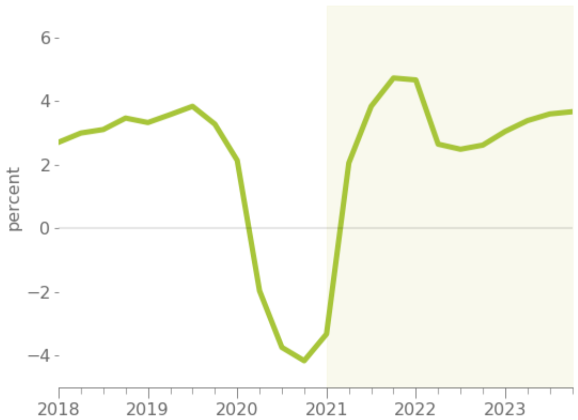
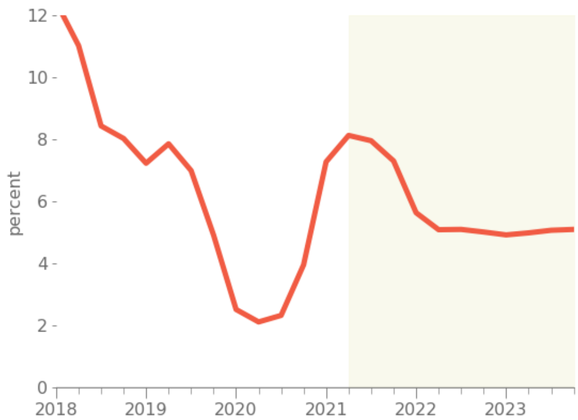


Figure 2. Consumer Inflation



The crisis has identified **driving sectors of the economy**, i.e. those expected to be the most stable and promising in the near future: **agriculture, mining and metallurgy, chemical industry and information technologies**. Although these sectors show a high potential without any state support, the Government, for example, strengthens direct support for agriculture, in particular, by easing tax conditions (reducing VAT to 14 %). An additional stimulus could be the promotion of land reform, but it is obvious that this issue will be dragged on for months. A high human potential and skillful use of the tax system will contribute to the continued rapid development of IT sector. Support through special credit programs, such as “5-7-9”, will lead to the development of the product part of the industry and, accordingly, higher incomes. Metallurgy and mining will develop due to higher external demand and relatively low prices for energy, but their positive effect will be exhausted by the end of 2021.

In the labor market, the risk for resumption of business activities may come from an **increase in labor migration to the EU** and, consequently, **the need to raise wages due to reduced labor supply**. However, this should not be expected until the recovery of economic activities in the European countries to potential levels. Raising of the minimum rate of remuneration will increase enterprise costs and cause raise in output prices, but higher employees' incomes will support demand.

The budget deficit in 2021 is set at a level of 5.5 % of GDP. Continuation of infrastructure development programs and insufficient growth of state revenues will create the need for additional borrowings in 2021, and, therefore, high actual rates for bonds of an internal state loan[1]. **Substantial borrowings are expected to continue** in order to support economic development programs, but **with a course to gradually normalize the deficit**, since debt service payments are likely to increase due to GDP warrants.

Attractiveness of government securities for external investors will stimulate **the inflow of foreign capital**. Together with export earnings, the inflow of FX will contribute to a **slight strengthening of the exchange rate in the first half of 2021**. Decrease in the exports growth rate and recovery of imports will change the behavior to a **moderate devaluation of up to 3 % per year**. Thus, by the end of 2023, the hryvnia will reach a level of 31.0 hryvnias per US dollar.

According to our assessment, **the probability of recovering the program with the International Monetary Fund is low**. The government focuses mainly on direct support of branches of the economy and their structural transformation, maintaining a high level of budget deficits and paying less attention to judicial and anti-corruption reforms, thus shifting the focus on the measures intended for the near future, as compared to the IMF. On the other hand, international reserves are sufficient to service debts in 2021, and the level of cheap global liquidity will remain high, that creates opportunities for market borrowings.

Growth of energy and food costs will lead to a short-term surge of prices — **in 2021, inflation will increase to 7.7 %**. Given the relatively inflation-neutral effects of exchange rate fluctuations, the transience of supply shocks and the continued recession, the National Bank will increase the rate rather slowly, and it will reach neutral levels only at the end of 2023. There is a possibility that, in our conditions, maintenance of high money supply (26 % growth in 2020) as a mean of stimulating economic activity will only accelerate inflation, but it is likely that the process will be distributed evenly over the forecast horizon, and inflation will meet the target level already in 2022.

Figure 3. Exchange rate, UAH/USD

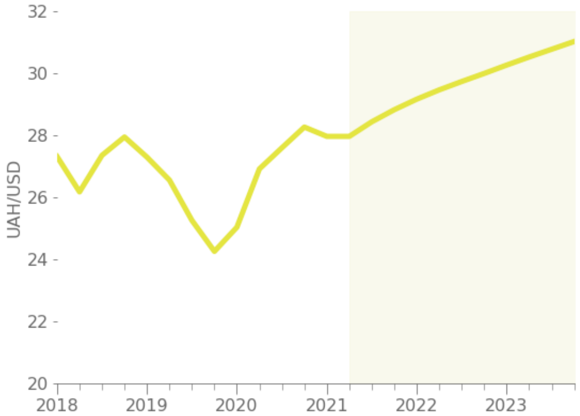
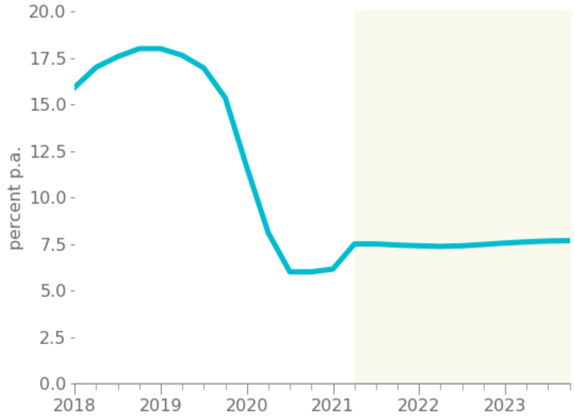


Figure 4. Key monetary policy rate



[1] OVDP in Ukrainian