THE WORLD BANK

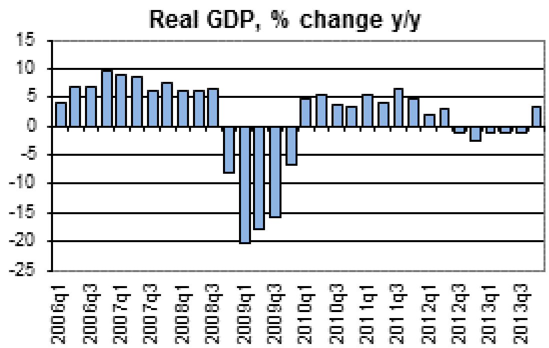
UKRAINE Economic Update

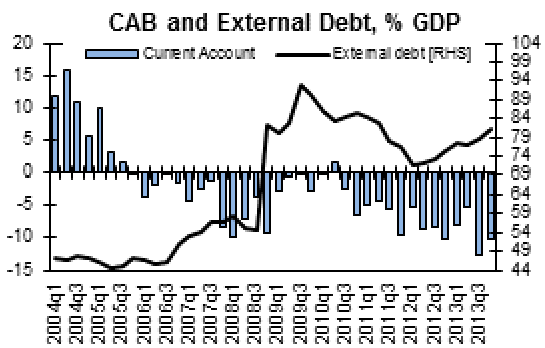
April 4, 2014

- ***Real GDP growth remained flat at 0% in 2013, accompanied by widening macroeconomic imbalances and structural distortions.***
- ***Ukraine urgently needs macroeconomic stabilization and structural reforms to jumpstart growth.***
- ***If a proper policy mix is adopted quickly, growth will resume in 2015 driven by the private sector.***

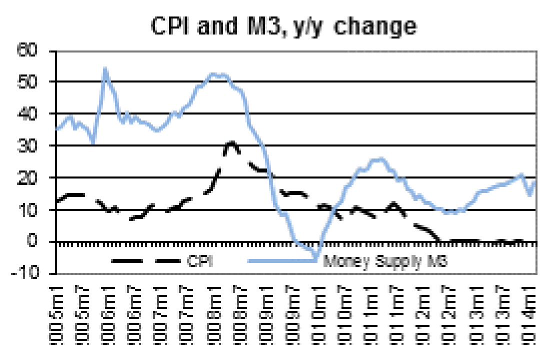
Recent Economic Developments

Growth in real GDP halted during 2012-2013. After five consecutive quarters of negative growth that started in mid-2012, Ukraine's GDP grew by 3.3% y/y in the last quarter of 2013 because of good harvest and a low statistical base. This brought GDP growth to 0.0% in 2013 (0.2% in 2012). Industrial production declined 4.7% y/y in 2013 (global demand for steel exports remained weak) while growth in retail trade halved to 5.6% y/y compared to 2012. Inflation remained low (-0.3% y/y, annual average) because of a decline in local food prices, postponed utility tariffs adjustments and an unchanged exchange rate policy. In the first two months of 2014, industrial production continued to decline at -4.2% y/y, while inflation picked up slightly in February (to 1.2% y/y) reflecting currency depreciation.

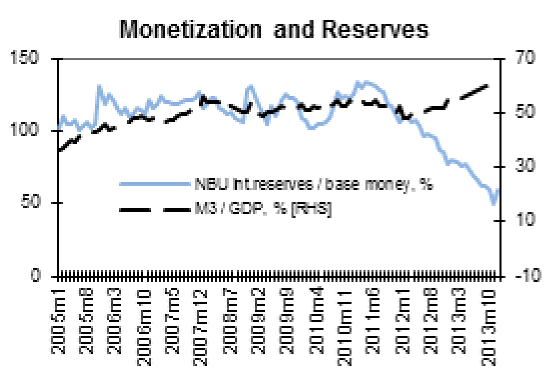




Fiscal deficit was high in 2013, and was accompanied with growth in arrears. Even though general government revenues grew slightly at 1.2 percent y/y in 2013, proceeds from VAT declined 7 percent y/y because of weak economic growth. Growth in expenditures significantly outpaced revenues for much of 2013. However, for the year as a whole, expenditures grew at similar levels as revenues (1.3 % y/y) because capital expenditures were cut sharply (40% y/y) in the last quarter of 2013. This allowed the government to keep the central budget deficit at the 4.5 percent GDP in 2013 (at the same level as in 2012). Liquidity in the treasury account dropped considerably. Significant arrears were built up in 2013 both on VAT refunds and on transfers to SOEs. To deal with the accumulated arrears and support operational liquidity of the real sector new VAT bonds will be issued. Weak budget performance, coupled with large deficit of Naftogaz (around 2 percent of GDP), led to deteriorating public services.



Foreign reserves of NBU declined to an unsustainable level. The external current account deficit grew to 9.2% GDP in 2013 (up from 8.2% of GDP in 2012), which together with a de facto pegged exchange rate, led to a drawdown of reserves to 2.5 months of imports by end-2013. In February 2014, uncertainty surrounding the political situation triggered over 30% depreciation, with foreign reserves reaching around 2 months of imports cover by end-February 2014. Devaluation and political instability put pressure on the banking system and resulted in outflows from deposits UAH 12b (or 2.5%) in February and may trigger further growth of non-performing loans. National Bank of Ukraine implemented a range of administrative measures, which could be counterproductive in long run.



Medium-Term Outlook

We expect real GDP will decline 3% in 2014 as the authorities take necessary corrective actions to deal with accumulated macroeconomic imbalances. Growing fiscal and external deficits over the past few years, with a de facto pegged exchange rate, have led to a drawdown of reserves to unsustainable levels. Therefore, the macroeconomic situation needs to be urgently stabilized through fiscal tightening and flexible exchange rate (preferably anchored in an IMF Program). In addition, quasi-fiscal deficits need to be reduced by increasing tariffs on household gas and district heating tariffs (coupled with better targeted social assistance to mitigate impact on the poor and vulnerable). All these measures will negatively affect purchasing power and limit government's ability to boost capital spending this year. Thus, in 2014, we expect to see a decline in both consumption and fixed investment. After several years of robust growth, drop in consumption may be significant this year (over 8%) while decline in fixed investments will not be that substantial due to low statistical base. The move to a flexible exchange rate will help to reduce the current account gap. At the same time, weak growth expected by main trading partners will translate into slower export demand for Ukraine's goods and services. Renewal of cooperation with the IMF as well as with other international partners should boost investor confidence in Ukraine and lower costs of external financing. This should help to stabilize foreign reserves at a level equivalent to 2 months of import cover.

If a proper policy mix is adopted quickly, Ukraine's GDP growth will resume in 2015 driven by recovery in business activity and foreign investment. Macro stabilization must be complemented with structural reforms to jumpstart growth (see accompanying Special Focus note). If reforms are consistently implemented, GDP growth may reach 3% in 2015 driven by increased business activity and foreign investment. Inflation – projected to be high in 2014 because of tariff increases and depreciation – will decline gradually over the medium term. Reduction of budget deficit should help to stabilize the debt to GDP ratio.

Risks facing Ukraine are substantial. Continued weak performance in trading partners is a cause for concern and will affect exports. High foreign debt refinancing needs (nearly $7bn for the remaining part of 2014) may deplete reserves further if there are delays in external financing. Given the vast reform agenda, questions remain on capacity of the new Government to carry out reforms quickly in a comprehensive way. Domestic political problems and possible deepening and widening of regional tensions will make investors nervous. Finally, in case Russia seeks to delay/stop exports and/or disrupt gas supplies, it will have negative economic consequences. In this case, exports may not recover in 2014 and the current account deficit may remain above 8%. This will also result in lower industrial output and real GDP may fall more sharply by around 5% in 2014.

Table 1: Key Macroeconomic Indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F	2016F
Nominal GDP, *UAH billion*	948.1	913.3	1082.6	1302.1	1411.2	1454.9	1623.0	1805.5	1934.0
Real GDP, *% change*	2.1	-14.8	4.1	5.2	0.3	0.0	-3.0	3.0	4.0
Consumption, *% change*	9.0	-12.2	6.4	11.1	9.6	5.6	-8.9	0.6	3.3
Fixed Investment, *% change*	1.6	-50.5	3.9	7.1	0.9	-6.6	-0.9	4.2	4.0
Export, *% change*	5.2	-22.0	3.9	4.3	-7.7	-8.8	1.4	3.9	4.1
Import, *% change*	17.1	-38.9	11.3	17.3	1.9	-5.9	-9.5	0.2	2.7
GDP deflator, *% change*	28.6	13.0	13.8	14.3	8.1	3.1	17.5	11.0	7.0
CPI, *% change eop*	22.3	12.3	9.1	4.6	-0.2	0.5	15.0	10.5	6.0
Current Account Balance, *% GDP*	-7.1	-1.5	-2.2	-6.3	-8.2	-9.2	-6.5	-4.3	-2.6
Budget revenues, *% GDP*	44.3	42.3	43.3	42.9	44.5	43.6	44.5	45.0	45.0
Budget expenditures, *% GDP*	47.4	48.6	49.0	45.6	48.9	48.1	49.3	48.3	47.5
Fiscal balance (incl. VAT bonds), *% GDP*	-3.1	-6.3	-5.8	-2.8	-4.5	-4.5	-4.8	-3.3	-2.5
External debt, *% GDP*	83.6	90.8	85.0	77.6	76.6	81.0	86.1	88.5	87.6
Public and Guaranteed Debt, *% GDP*	20.0	35.4	40.5	36.3	36.6	43.5	47.4	48.5	48.7

Source: Ukrainian Authorities, WB projections

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