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UKRAINE Economic Update

April 29, 2015

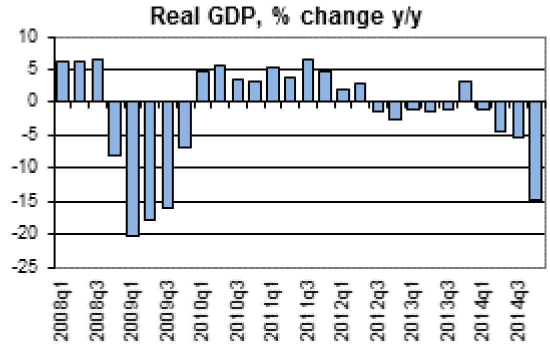
- ***Despite decisive reforms to stabilize the economy and jumpstart growth, Ukraine's economic problems intensified in 2014 due to conflict in the east.***
- ***The conflict disrupted industrial production, exports, and imposed broader indirect costs by undermining investor and consumer confidence.***
- ***Real GDP is projected to decline by 7.5 percent in 2015 (compared to a decline of 6.8 percent in 2014), with gradual recovery starting in 2016 if the conflict abates and authorities continue implementing macroeconomic and structural reforms.***

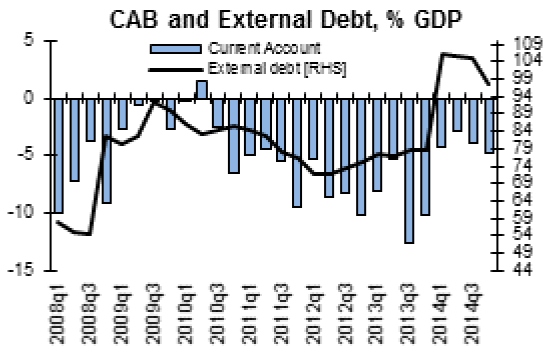
Recent Economic Developments

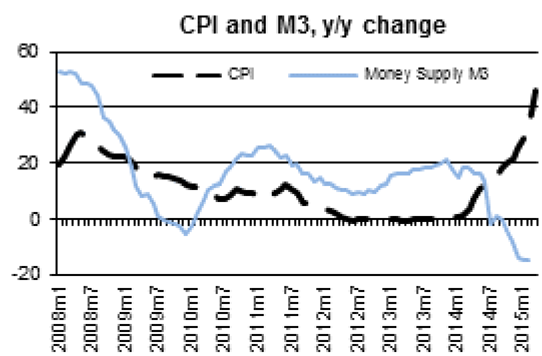
During 2014, Ukraine experienced a deepening economic recession. Faced with large accumulated fiscal and external imbalances, the authorities embarked on a major macroeconomic adjustment in early 2014. Sharp currency devaluation – after the fixed exchange rate was abandoned in March – combined with fiscal consolidation, triggered significant decline in consumption and investment. The contractionary impact of adjustment was compounded by an escalating conflict in the second half of the year, which led to severe economic disruption in the industrialized east and undermined investor and consumer confidence. After declining by 3.9 percent in the first three quarters, real GDP fell by 14.8 percent y/y in the fourth quarter bringing the full year decline to around 6.8 percent. Almost all sectors were negatively affected: industry (down by 10.1 percent y/y), wholesale trade (down by 15.0 percent y/y), and construction (down by 21.7 percent y/y). This decline was moderated only by growth in agriculture of 2.8 percent y/y. Meanwhile, the sharp devaluation and increase in gas and utility tariffs pushed 12-month inflation to 24.9 percent in December.

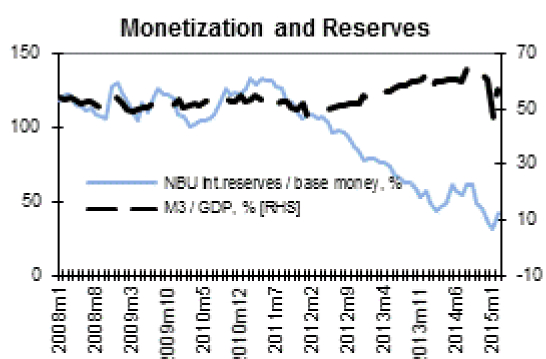
Despite fiscal consolidation efforts, public debt as a share of GDP is rising rapidly. Revenues declined in 2014 due to economic contraction and problems in collecting taxes in the east, while security-related spending grew. To contain the budget deficit, the Government adopted fiscal measures in March and July to boost revenues while curtailing expenditures. This helped contain the general government deficit to 4.6 percent of GDP (vs 4.8 percent in 2013). However, significant below-the-line financing was needed to cover a rising Naftogaz deficit (5.5 percent of GDP) and to boost confidence in the banking system by recapitalizing the Deposit Guarantee Fund and state-owned banks (1.9 percent of GDP). This, together with the impact of devaluation, resulted in sharp increase in the ratio of public and publicly-guaranteed debt to GDP from 40.6 percent in 2013 to 70.3 percent in 2014.

Balance of payments problems remained acute in 2014, compounded by capital flight, low FDI, and delays in official financing. Following the devaluation in March, the current account deficit started to adjust and reached almost zero in August. However, during the remainder of the year the impact of the devaluation was dampened by conflict-related disruptions in export-oriented industries in the east and a seasonal increase in imports of gas and coal (after local coal production was damaged in the conflict areas). As a result, current account deficit remained high at 4.1 percent GDP in 2014. The financial account also came under pressure due to payment arrears to Gazprom, increased demand in the cash foreign exchange market after deposit outflows from the banking system and delays in official financing. The Hryvnia continued to weaken and lost over 25 percent of its value from September to December. Foreign reserves declined to US$ 7.5 billion (1 month of import cover) at end 2014 and dropped further to US$ 5.6 billion by end February, 2015. Having lost a notable portion of reserves, the NBU stopped currency interventions in early 2015 that led to another wave of pressure on the local currency.









Outlook

The conflict in the east, accompanied by banking sector problems, will result in further GDP contraction in 2015. We project real GDP to decline by 7.5 percent in 2015. Given the situation in the east, we expect GDP to continue contracting sharply especially during the first half of the year, followed by a slowing decline in the second half due to low statistical base. Problems in the banking sector are likely to continue in 2015. Credit to the economy is projected to contract further during 2015 as a result of bank restructuring and tighter liquidity. On the external side, the impact of depreciation will be undermined by conflict-related disruptions in major export industries and deteriorating trade relations with Russia (a key export market for Ukraine). Thus, we expect the current account deficit to narrow to 2.4 percent of GDP in 2015, with the reduction mainly coming from lower imports. Fiscal adjustment will also continue to be complicated by the conflict. While gas tariff increases are expected to reduce Naftogaz's deficit, the corresponding increase in social spending needed to protect the poor will partly offset this positive fiscal impact.

If the situation in the east stabilizes and decisive reforms – especially in energy and banking sectors – are sustained, economic recovery is expected to set in from 2016 onwards. Consistent reform implementation would underpin macroeconomic stabilization, unlock additional international financial assistance including support for recovery in the east and lay the foundation for an economic recovery. Growth is expected to be led by a modest recovery of investment from a low base following large declines for three consecutive years. While market access will remain limited, we expect enterprise resources (intragroup lending) to finance investment. Net exports are also expected to contribute positively, as depreciation and a gradual improvement of global commodity markets, should help exports recover. However, the rebound will be moderated by consumption which is expected to remain constrained as pressure on real income will persist during 2016 due to utility tariff hikes and subdued real wage and pension growth. Thus, we expect GDP to grow by 2 percent in 2016 and 3 percent in 2017. Relatively low growth, in turn, will imply that the twin deficits and public debt burden will remain elevated over the projection period.

The outlook is subject to substantial risks, tilted to the downside. Further escalation of the conflict may deepen economic decline in 2015 and delay recovery over the next few years through several channels: damage of production facilities and infrastructure, lower exports, higher security-related spending, and further deterioration of consumer and investor confidence. Structural reforms, which are crucial to sustain international financial support and spur recovery, may be complicated by a fragile political environment, possible social resistance in the absence of strong safety nets and opposition by vested interests. Lower or delayed international financial assistance may exacerbate fiscal and balance of payment problems and put further downward pressure on the Hryvnia. Further deterioration in trade relations with Russia could result in prolonged recession as reorientation of Ukrainian exports towards other markets will require more time and investments.

Table 1: Key Macroeconomic Indicators

	2011	2012	2013	2014	2015F	2016F	2017F	2018F
Nominal GDP, *UAH billion*	1300.0	1404.7	1465.2	1566.7	1999.9	2407.1	2727.3	3040.6
Real GDP, *% change*	5.5	0.2	0.0	-6.8	-7.5	2.0	3.0	4.0
Consumption, *% change*	11.3	7.4	5.2	-7.4	-10.8	0.0	2.0	3.3
Fixed Investment, *% change*	8.5	5.0	-8.4	-23.0	-15.4	2.8	8.6	9.5
Export, *% change*	2.7	-5.6	-8.1	-14.5	-10.6	6.8	5.1	5.4
Import, *% change*	15.4	3.8	-3.5	-22.1	-17.7	3.6	4.9	5.9
GDP deflator, *% change*	14.3	8.1	3.1	14.8	38.0	18.0	10.0	7.2
CPI, *% change eop*	4.6	-0.2	0.5	24.9	32.0	12.0	8.0	5.0
Current Account Balance, *% GDP*	-6.3	-8.2	-9.2	-4.1	-2.4	-1.8	-1.9	-1.9
Budget revenues, *% GDP*	42.9	44.5	43.6	41.7	42.8	40.3	40.7	40.8
Budget expenditures, *% GDP*	45.6	48.9	48.4	46.3	47.1	43.9	43.8	43.4
Fiscal balance, *% GDP*	-2.8	-4.5	-4.8	-4.6	-4.3	-3.6	-3.1	-2.6
Consolidated deficit, including Nagtogaz, % GDP	-4.4	-5.4	-6.7	-10.3	-7.4	-3.9	-3.1	-2.6
External debt, *% GDP*	77.6	76.6	78.6	97.6	175.6	154.4	146.5	137.0
Public and Guaranteed Debt, *% GDP*	36.3	36.6	40.6	70.3	88.3	81.1	77.2	72.6

Source: Ukrainian Authorities, WB projections

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