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# UKRAINE Economic Update

April 2, 2013

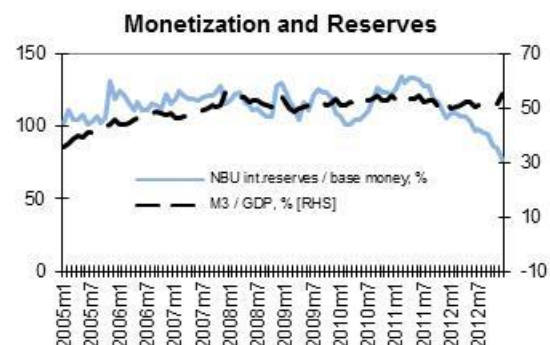
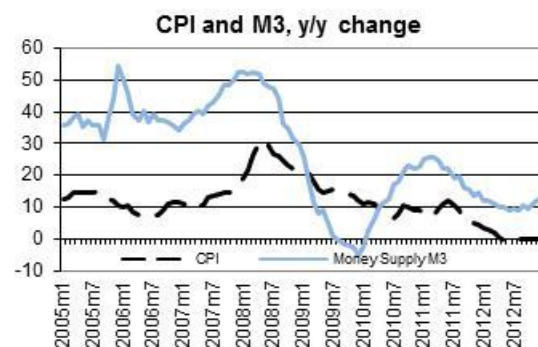
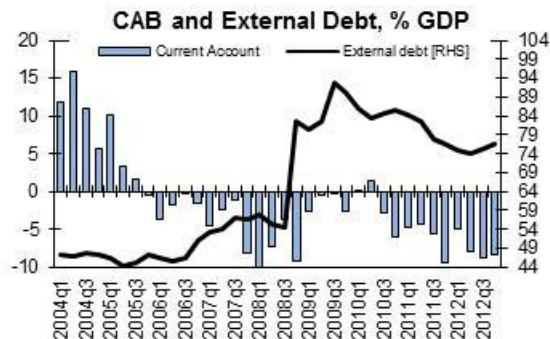
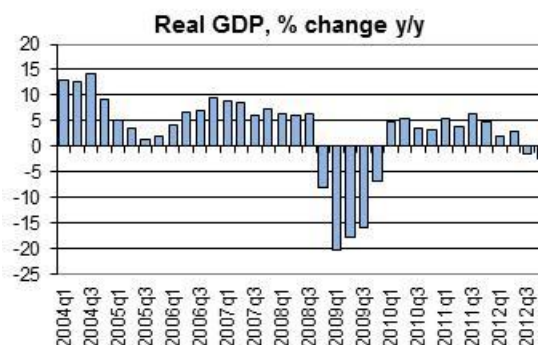
- **Ukraine is in a recession because of weak external demand and delays in policy adjustment.**
- **Growth in 2013 is projected to remain weak and will continue to be vulnerable to external shocks.**
- **Along with macroeconomic adjustment, structural reforms are needed to jumpstart growth.**

## Recent Economic Developments

Ukraine entered into a recession in the second half of 2012, bringing growth in real GDP for the whole year to just 0.2 percent. GDP declined by 1.3 percent and 2.5 percent y/y in the third and fourth quarters of 2012 respectively, compared to the first half of the year when real GDP grew by 2.5 percent. Slowdown in the global economy and, in particular, lower demand for steel resulted in 5.2 percent y/y drop in Ukraine's steel output and led to weak performance of industrial production (-1.8 percent y/y). Agriculture suffered from lack of precipitation that cost some 4 percentage points of value added in the sector. This was partially offset by robust consumption growth, evidenced by an expansion of retail turnover (13.7 percent) that was fuelled by a double digit increase of real wages. Consumer inflation, however, remained close to zero due to decline in local food prices, postponed utility tariffs adjustments and tight monetary policy. These trends continued in early 2013: industrial production and consumer prices continue to post y/y declines, while domestic demand supports retail turnover growth in double digits.

**Weak economic performance resulted in a significant budget shortfall in the second half of 2012.** Actual revenue of the central budget was UAH 33 billion (2.5 percent GDP) lower than initial budget plan because both real GDP growth and inflation were lower than the forecast on which the budget was based. Meanwhile, expenditures remained inflated due to a hike in social spending (by over 2 percentage points of GDP) introduced in Spring 2012. Fiscal deficit (general government definition) reached 4.5 percent GDP in 2012. In addition, structural deficit of the state-owned company "Naftogaz" was not addressed.

**In 2012, current account deficit widened to 8.4 percent GDP and foreign reserves position of the National Bank of Ukraine (NBU) weakened.** Exports remained unchanged y/y as decline in exports of steel was offset by higher agricultural exports. Meanwhile expansion of imports was driven mostly by consumer goods. The gap was partly covered by higher public sector borrowings, and partly by reduction of NBU foreign reserves. By end 2012, gross reserves fell to USD 24.5 billion (2.7 months of imports). Gross external debt increased by 7 percent during 2012 and reached USD 135 billion while banking sector share continued to decline due to deleveraging of European banks.



## Medium Term Outlook

**Looking ahead, growth is expected to remain subdued at 1 percent in 2013, and increase to 3 percent in 2014.** Economic performance in the first half of 2013 is likely to remain sluggish due to a combination of factors: continued weak external demand, uncertainty over sustainability of domestic macroeconomic policy mix currently adopted by the authorities, and higher 2012 statistical base. Growth is projected to resume in the second half of the year due to improving external conditions and a low statistical base effect. Adoption of an appropriate macroeconomic policy mix (tighter fiscal policy and flexible exchange rate policy) supported by an IMF Program would help to improve growth prospects by boosting investor confidence in Ukraine's macroeconomic policy framework thus lowering costs of external financing. Growth is projected to accelerate to 3 percent in 2014 and to 4 percent in 2015, assuming continued improvement in global economic environment.

**Downside risks to this outlook are significant.** On external side, the main risk is a protracted crisis in Europe, leading to lower demand for exports and more difficult access to global capital markets. Domestically, the main risk is a failure to implement macroeconomic rebalancing (preferably anchored in a program with the IMF). Delays in macroeconomic adjustment could mean that the required correction is much sharper when status quo is no longer sustainable. Even if external conditions improve, this macroeconomic adjustment would still be required.

**Macroeconomic adjustment should be complemented with structural reforms to boost long-term economic growth.** The unfinished agenda in Ukraine is vast. The main focus should be on improving the business climate to strengthen competitiveness, attract investment, and create jobs to improve living standards. In this context, it is important to continue reforms to strengthen the resilience of the financial sector to external shocks and improve financial intermediation. On the fiscal front, efficiency of public spending could be improved through a reduction in fiscal and quasi-fiscal deficits in the gas and heating sectors and better targeted social assistance to reach the poorest segments of society. Efficiency can also be improved through reform of the public investment management process – a pre-requisite for effectively addressing infrastructure needs in Ukraine.

**Table 1: Key Macroeconomic Indicators**

	2007	2008	2009	2010	2011	2012E	2013F	2014F	2015F
Nominal GDP, <i>UAH billion</i>	720.7	948.1	913.3	1082.6	1302.1	1408.9	1551.2	1712.8	1888.2
Real GDP, % change	7.9	2.1	-14.8	4.1	5.2	0.2	1.0	3.0	4.0
Consumption, % change	13.6	9.0	-12.2	6.4	11.1	9.6	0.0	2.4	3.4
Fixed Investment, % change	23.9	1.6	-50.5	3.9	7.1	0.9	-2.9	3.2	4.1
Export, % change	3.3	5.2	-22.0	3.9	4.3	-7.7	1.4	5.1	5.1
Import, % change	21.5	17.1	-38.9	11.3	17.3	1.9	-0.3	3.8	4.0
GDP deflator, % change	22.7	29.2	13.0	15.0	15.7	8.0	9.0	7.2	6.0
CPI, % change eop	16.6	22.3	12.3	9.1	4.6	-0.2	8.7	5.8	5.2
Current Account Balance, % GDP	-3.7	-7.0	-1.5	-2.2	-5.5	-8.4	-7.4	-6.8	-6.2
Terms of Trade, % change	9.8	6.1	-6.8	4.9	9.8	2.0	-0.1	0.3	0.0
Budget revenues, % GDP	42.3	44.3	42.3	43.3	42.9	44.5	44.6	44.0	44.0
Budget expenditures, % GDP	44.3	47.4	48.6	49.0	45.6	49.0	47.2	46.0	45.6
Fiscal balance, % GDP	-2.0	-3.1	-6.3	-5.8	-2.8	-4.5	-2.5	-2.0	-1.5
External debt, % GDP	58.6	83.6	90.8	85.0	77.6	76.6	83.5	85.3	83.6
Public and Guaranteed Debt, % GD	12.4	20.0	35.4	40.5	36.3	36.6	40.1	41.6	41.5

Source: Ukrainian Authorities, WB projections

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