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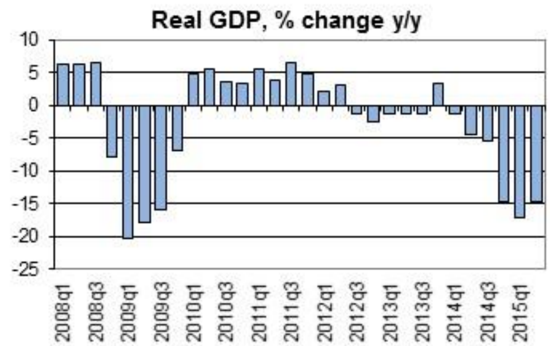
UKRAINE
Economic Update

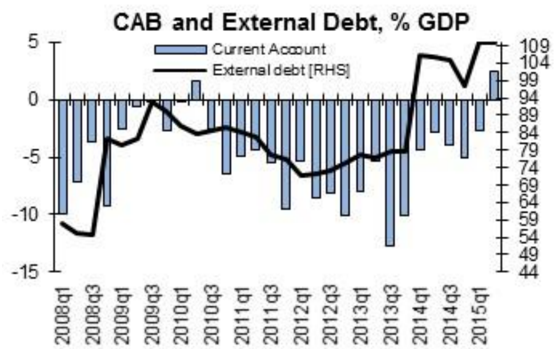
October 5, 2015

- ***Deterioration in Ukraine's terms of trade due to a drop in global commodity prices and re-escalation of the conflict in the east in the beginning of the year led to a larger than earlier expected decline in real GDP in the first half of 2015.***
- ***There have been encouraging signs of stabilization since the middle of the year. Nonetheless, even as periodic flaring up of the conflict adds to uncertainties, Ukraine's economic prospects depend on whether the authorities continue to implement macroeconomic and structural reforms and ensure sustainability of its debt.***
- ***We project real GDP to decline by 12 percent in 2015 compared with a contraction of 7.5 percent in our April Economic Update. We forecast recovery in the second half and next year to result in growth of 1 percent in 2016. Slower reform implementation or escalation of the conflict may delay economic recovery.***

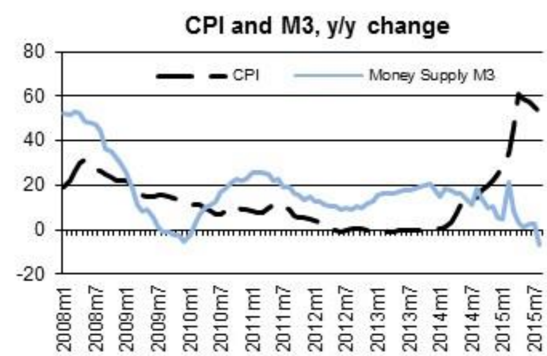


Recent Economic Developments

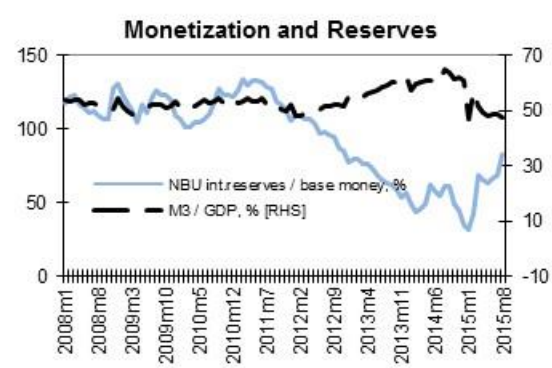
Economic activity appears to have stabilized since the middle of the year after a broad based decline across all sectors in the first half reduced GDP by 16 percent year-on-year (y/y). The conflict in the industrial east led to stoppages in production at a few steel factories as well as lower output in others because of disruption in supply and distribution chains. Overall industrial activity fell by 20.5 percent y/y in the first half of 2015, with large regional variations. A sharp decline in the east was partially compensated by relatively good performance in a few western and central regions. Meanwhile, macroeconomic adjustment is affecting all regions of Ukraine. Declining real incomes are weighing on retail trade (down 25 percent y/y) and consumption (down 20 percent y/y) during the first half of 2015. High frequency data indicates the tentative stabilization and recovery have begun since July: decline in industrial production slowed to 5.8 percent y/y and in trade to 18.8 percent in August. This suggests that GDP decline in the third quarter was limited to about 11 percent. Currency depreciation in the beginning of the year and a one-off utility tariff adjustment led to a hike in inflation. Twelve-month consumer price inflation recently peaked at 60.9 percent in April before declining to 52.8 percent in August.



The general government deficit is on track to narrow as budgeted this year, but pressures for financing Neftogaz and recapitalizing the banking system remain significant. Due to higher than budgeted inflation and fiscal measures implemented this year, revenues increased by 30 percent y/y in the first half of 2015. General government spending remained broadly unchanged in nominal terms despite higher inflation, and thus budget deficit narrowed compared to the annual target. However, the need to cover Naftogaz deficit and to boost confidence in the banking system by recapitalizing the Deposit Guarantee Fund and state-owned banks is putting pressure on government resources. An increase in VAT refund arrears is also worrisome.



The weaker currency and a large contraction in imports helped balance the current account in the first half of 2015 while pressures on the capital account have declined; however, risks remain high. After a sharp currency devaluation in early 2015 followed by administrative restrictions, the current account has been almost balanced since April. A large contraction in exports was offset by a decline in imports due to the weak economy, hryvnia depreciation, and the import surcharge. Capital outflows were mostly related to external debt payments by companies and banks. These outflows were partially offset by a decline in foreign-exchange outflows from the banking system, and an increase in FDI related to bank recapitalizations. Overall, net capital outflows and external vulnerabilities persist. With over US$7 billion in official disbursements so far this year from the IMF, the World Bank and other development partners, international reserves increased to US$12.6 billion by the end of August (equivalent to 3 months of imports).



Outlook

Despite early signs of stabilization, economic prospects for Ukraine depend on how the conflict in the east unfolds and whether the authorities continue carrying out reforms in the challenging domestic and international environment and ensure sustainability of its debt. We project real GDP to fall by 12 percent in 2015 taking into account a sharp contraction in the first half of the year, followed by a slower decline during the second half of the year. The decline is expected in all sectors including agriculture, but most notably in metals and mining that are most affected by the conflict and weak external demand. Meanwhile, retail trade is projected to continue declining because real disposable incomes have fallen due to sharp increases in utility prices, devaluation and declining wages. On the positive side, the devaluation is helping bolster net exports while further increases in tariffs together with fiscal discipline should create sufficient fiscal space to unlock government investment in the future. This, together with efforts to clean up the banking system and a gradual resumption of lending, is projected to set the stage for gradual economic recovery in 2016, with real GDP growth at 1 percent.

Sustaining reform implementation should help mitigate the impact of a vast array of risks confronting Ukraine. The macroeconomic policy mix adopted by the authorities so far has proven efficient in mitigating the negative impact of the sharp decline in the real sector on fiscal and current account balances. Given that risks remain high, it is essential to maintain the flexible exchange rate regime and prudent fiscal policy as well as to carry on with reforms aimed at reducing Naftogaz imbalances. In this case, the general government deficit is projected to adjust downwards from 4.2 percent of GDP in 2015 to 3.1 percent of GDP in 2017. The gas tariff increase is expected to help reduce to nil the below-the-line financing of Naftogaz deficit by 2016. Macroeconomic adjustment should help to keep the current-account deficit at about 1 percent of GDP in 2015. Financial pressures associated with net capital outflows would also ease in view of the restructuring of sovereign and quasi-sovereign debt and the ongoing restructuring of foreign private liabilities. If our expectations concerning modest economic recovery, gradual currency stabilization, and sustained fiscal discipline are indeed fulfilled, public and publicly-guaranteed debt should decline to 82 percent of GDP by 2017.

The outlook is subject to serious downside risks. These include an escalation of the conflict in the east that may further jeopardize investor and consumer confidence and destroy industrial potential, a further global commodity price decline that can negatively impact Ukraine's terms of trade, and a slowdown in reforms that may increase structural imbalances again and delay official financial assistance. While the first two risks are exogenous, mitigation of the latter risk is in the authorities' own hands. A fragile political environment, geopolitical challenges, possible social resistance to reforms in the absence of strong safety nets, opposition by vested interests who stand to lose from reforms –- all these factors could undermine or slow down reforms. This would likely lower or delay international financial assistance and could exacerbate fiscal and balance of payment problems. This could result in a prolonged recession, as reorientation of Ukrainian exports towards other markets will require more time and investment.

Key Macroeconomic Indicators (in % of GDP unless indicated otherwise)

	2011	2012	2013	2014	2015F	2016F	2017F	2018F
Nominal GDP, *UAH billion*	1300	1405	1465	1567	1958	2373	2662	2962
Real GDP, *% change*	5.5	0.2	0.0	-6.8	-12.0	1.0	2.0	3.0
Consumption, *% change*	11.3	7.4	5.2	-7.4	-17.9	-2.0	-0.2	2.7
Fixed investment, *% change*	8.5	5.0	-8.4	-23.0	-24.6	9.4	13.0	5.9
Export, *% change*	2.7	-5.6	-8.1	-14.5	-19.8	6.0	5.0	5.1
Import, *% change*	15.4	3.8	-3.5	-22.1	-31.7	3.1	4.6	5.7
GDP deflator, *% change*	14.3	8.1	3.1	14.8	42.0	20.0	10.0	8.0
CPI, *% change eop*	4.6	-0.2	0.5	24.9	50.0	23.4	9.9	7.0
Current account balance	-6.3	-8.2	-9.2	-4.1	-1.1	-1.4	-1.4	-1.6
External debt	77.6	76.6	78.6	97.6	153.0	134.2	128.0	121.6
Budget revenues	42.9	44.5	43.6	41.7	40.8	39.7	40.0	40.0
Budget expenditures	45.6	48.9	48.4	46.3	45.0	43.4	43.1	42.6
Fiscal balance	-2.8	-4.5	-4.8	-4.6	-4.2	-3.7	-3.1	-2.6
Consolidated deficit, including Nagtogaz	-4.4	-5.4	-6.7	-10.3	-7.3	-3.9	-3.1	-2.6
Public and guaranteed debt	36.3	36.6	40.6	70.3	90.5	84.7	81.8	77.3

Source: Ukrainian authorities, World Bank projections

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