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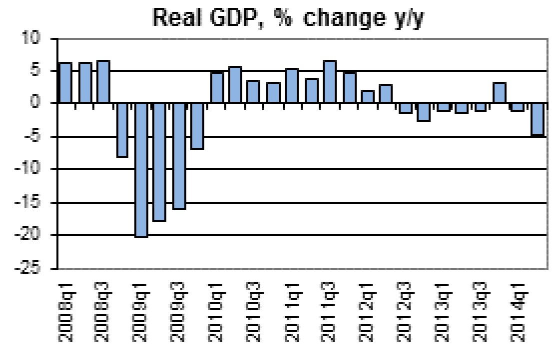
UKRAINE Economic Update

October 2, 2014

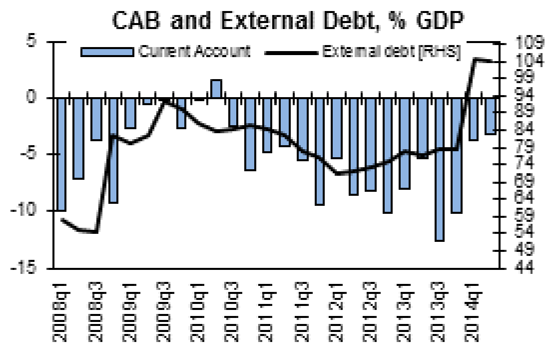
- ***Disruption in economic activity in the east resulted in sharper GDP decline of -8.0 percent in 2014 and slower recovery in 2015 compared to earlier projections***
- ***Weak revenue performance, rising spending pressures and a growing Naftogaz deficit make the fiscal adjustment challenging***
- ***The current account deficit has adjusted, but balance of payment pressures remain high due to large external debt refinancing needs, low FDI and limited access to external financing***

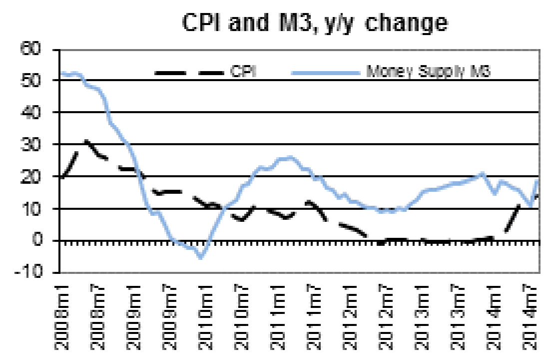
Recent Economic Developments

Trends in the real sector are worsening because of the conflict in eastern Ukraine. In 2014, real GDP fell by 1.1 percent in the first quarter and then more sharply by 4.6 percent in the second quarter, bringing the average decline in the first half of the year to 2.9 percent. While domestic demand contraction, engendered by tighter macroeconomic policies contributed to the decline, the conflict in Donetsk and Lughansk (industrialized areas with 16 percent share in GDP on average) is negatively affecting trends across all sectors. Industrial production posted 5.8 percent y/y decline in the first half of the year, and then fell more sharply by 12.1 and 20.1 percent y/y in July and August respectively. Similar declines were observed during January-August in other sectors: wholesale trade (-13.8 percent y/y), transport (-4.1 percent y/y) and construction (-15.6 percent y/y). Agriculture is the only well-performing sector – it grew by 6.3 percent y/y during January-August supported by a good harvest. CPI reached 14.2 percent y/y in August because of devaluation and increase in gas and utility tariffs.

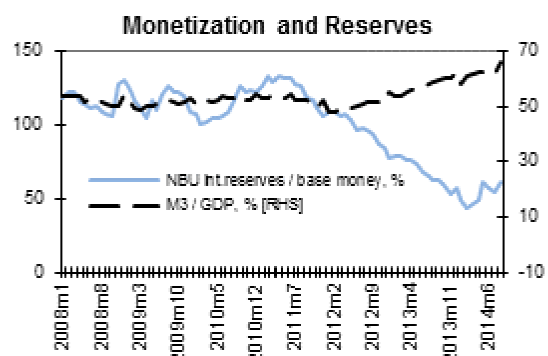


On the fiscal side, the situation in the east is making revenue collection difficult and increasing spending. To contain the budget deficit during 2014, the Government adopted a package of fiscal measures in March to bolster revenues while curtailing expenditures. Despite this, revenue performance deteriorated due to sharper economic contraction and difficulty in collecting taxes in the east. Proceeds from all main taxes dropped, which was partly compensated by frontloaded profit transfers from the National Bank of Ukraine. Meanwhile, the conflict in the east is adding to security-related spending. To contain the fiscal deficit, Parliament approved a revised budget in July to curtail discretionary spending on subsidies, investment and goods and services while enhancing revenue by broadening the VAT base, raising taxes on subsoil exploration of gas and oil, and introducing a temporary surtax on wage bills. In addition, the quasi-fiscal deficit of Naftogaz has widened due to increased import gas value in Hryvnia terms following devaluation, higher gas imports during the first quarter to fill storages and lower sales to industrial consumers because of weak economic activity. The higher deficit of Naftogaz was partly monetized through issuance of government bonds (UAH 22.4 billion) below the line adding to the public debt burden. Naftogaz has also accumulated external payment arrears.





The external current account deficit adjusted rapidly after the shift to a flexible exchange rate regime. Currency devaluation, following the abandonment of the long-standing de facto peg to the dollar in February 2014 and fiscal tightening, led to sharp adjustment of the current account deficit which dropped to 2.8 percent of GDP during January-July – a third of the same period of 2013. Imports fell sharply (-21.5 percent, y/y, in value terms for January-August) due to the combined effects of devaluation, weak domestic demand and a lower price of gas imports during the first quarter. Meanwhile, exports continued to decline due to weak external conditions and sporadic trade problems with the Russian Federation, although at a slower pace than imports (-14.4 percent y/y in January-August). Move to the flexible exchange rate helped stem the decline in foreign reserves which are now stabilized around 2.4 months of import cover. At the same time, balance of payment pressures remain high due to external debt refinancing needs (including Naftogaz's arrears), low FDI and limited access to external financing.



Medium-Term Outlook

The conflict in the east is now projected to have a deeper economic impact in 2014. We project real GDP to decline by 8 percent in 2014. Economic contraction is expected to continue to deepen over the coming months mainly as a result of the protracted instability in the industrialized east. Private consumption is expected to continue declining but may be partially offset by growth in public consumption driven by security-related spending. The challenges in the banking sector and deteriorating investor confidence are expected to lead to sluggish investment and a slide in overall business activity. In light of the higher GDP decline, we expect the fiscal deficit to increase this year.

Economic disruptions in the industrialized east will delay the economic recovery at least in the first half of 2015. If the situation in the east settles and large enterprises gradually resume production, then devaluation is expected to lead to recovery in exports. Tight fiscal policy will result in slower rebound of consumption and investment, thus net exports are expected to drive GDP recovery in 2015. After widening this year, we expect fiscal consolidation, anchored in the IMF SBA to gradually reduce fiscal imbalances starting in 2015. However, before this happens, external debt to GDP ratio may go up in 2015 because of decline in GDP and valuation effect. Starting from 2016 investment is projected to rebound following four consecutive years of sharp decline, due to low base effect and improving investor sentiment. Equally, credit growth is expected to resume in 2016, provided problems in the banking sector are resolved through liquidation of insolvent banks, improved deposit insurance and recapitalization of banks. Recovery in economic activity will be underpinned by accelerated structural reforms to boost competiveness and productivity of Ukraine's businesses – a precondition for a return of economic growth and a sustainable recovery.

The risks facing Ukraine are substantial and cannot be fully mitigated. *A* prolonged confrontation in the east could negatively affect growth further. Lower levels of bank liquidity, especially in the context of significant risks in the banking sector and monetary tightening, could constrain credit supply, in turn delaying the pickup of domestic investment while foreign investment may remain subdued due to heightened political uncertainty. Meanwhile, the recovery in consumption could be undermined by the combined effect of fiscal adjustment and depreciation. Efforts to restore sustainable public finances could prove to be more challenging than expected, leading to a slower fiscal adjustment path than envisaged in the IMF SBA. The economic downturn and collection problems in the east could undermine revenue performance despite policy changes and efforts to improve tax administration. Expenditures may be higher due to increased military spending and reconstruction needs in conflict-affected areas. Meanwhile, cuts in social spending and wage freezes could run into resistance. Pressures are exacerbated by Naftogaz – a major fiscal risk. While the government has committed to reduce Naftogaz deficit, the complex nature of the problem, size of the necessary adjustment, and possible resistance to further tariff increases could make this challenging, especially in the short to medium term.

Table 1: Key Macroeconomic Indicators

	2011	2012	2013	2014F	2015F	2016F	2017F
Nominal GDP, *UAH billion*	1302.1	1411.2	1454.9	1525.9	1679.2	1882.2	2104.3
Real GDP, *% change*	5.2	0.2	0.0	-8.0	-1.0	3.5	4.0
Consumption, *% change*	11.1	9.6	5.6	-6.7	-4.9	3.8	6.8
Fixed Investment, *% change*	7.1	0.9	-6.6	-25.6	-5.0	11.2	12.3
Export, *% change*	4.3	-7.7	-8.8	-8.6	3.4	3.5	4.1
Import, *% change*	17.3	1.9	-5.9	-22.7	0.2	5.9	6.2
GDP deflator, *% change*	14.3	8.1	3.1	14.0	15.0	8.3	7.5
CPI, *% change eop*	4.6	-0.2	0.5	19.0	10.0	6.9	5.8
Current Account Balance, *% GDP*	-6.3	-8.2	-9.2	-2.4	-0.8	-2.2	-2.9
Budget revenues, *% GDP*	42.9	44.5	43.6	42.3	42.5	42.5	42.6
Budget expenditures, *% GDP*	45.6	48.9	48.4	48.1	46.4	45.3	45.1
Fiscal balance, *% GDP*	-2.8	-4.5	-4.8	-5.8	-3.9	-2.8	-2.5
Consolidated deficit, including Nagtogaz, % GDP	-4.4	-5.4	-6.7	-10.1	-5.8	-3.9	-3.2
External debt, *% GDP*	77.6	76.6	78.6	105.6	112.1	107.5	100.2
Public and Guaranteed Debt, *% GDP*	36.3	36.6	40.6	68.8	74.9	71.7	66.9

Source: Ukrainian Authorities, WB projections

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