UKRAINE

Highlights

- **GDP returned to growth in the first half of 2016 but the pace of recovery is modest.** After around 16 per cent real GDP contraction in the past two years, the economy is expected to grow at a small positive rate in 2016. Structural bottlenecks and a lack of new growth engines are limiting the speed of economic recovery.
- **Significant adjustment of "twin deficits" made the economy more balanced and resilient to downside risks.** Bold economic reforms carried out over the past two years helped to bring down external and fiscal imbalances as a share of GDP to low single digits. Stabilisation in the foreign exchange markets and in consumer prices allowed a gradual relaxation of monetary policy in the second quarter of 2016.
- **Reform momentum has weakened despite political stabilisation.** The new government established in April 2016 signalled early on its intention to push forward with reforms by increasing domestic gas prices to cost recovery levels and by taking fruitful steps to bring the International Monetary Fund (IMF) programme back on track. However, implementation of reforms in the justice sector, law enforcement and public administration remained slow. Implementation of the adopted legislation is a continuous challenge.

Key priorities for 2017

- **New impetus should be given to growth-supporting reforms.** The authorities need to deliver on the action plan of strategic priorities. This will require a determined effort to implement structural reforms in macro-critical areas, as well as a willingness to challenge the inherited status quo in a number of crucial sectors. Efforts to enable faster growth should focus on transparent privatisation and attraction of foreign direct investment. Continued implementation of the IMF programme is needed for investor confidence and to reinforce liquidity buffers. A reformist, technocratic civil service and well-functioning system of justice administration are prerequisites for achieving meaningful progress.
- **Further measures are required to revive financial intermediation.** Capital buffers need to increase to ensure a healthier banking sector. Banking supervision should be strengthened further and remain vigilant to prevent related party lending and other harmful practices of the past. The planned improvements in corporate governance of the state-owned banks and their increased commercialisation should be pursued.
- **Energy sector reforms remain high on the agenda.** Ownership unbundling in the gas sector will be an important initial step towards supporting third-party access, building the internal market and enhancing Ukraine's credibility as a trading partner for European markets. The government resolution on the unbundling plan adopted in July 2016 is a welcome first step towards this objective. The operational efficiency of Naftogaz needs to be further enhanced. Adoption of the Electricity Market Law is an important priority that will foster compliance with the European Union's Third Energy Package.

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Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	0.2	0.0	-6.6	-9.9	1.5
Inflation (average)	0.6	-0.3	12.1	48.7	12.0
Government balance/GDP	-4.3	-4.8	-4.5	-1.2	-3.7
Current account balance/GDP	-8.2	-9.0	-3.4	-0.2	-1.5
Net FDI/GDP [neg. sign = inflows]	-4.1	-2.3	-0.2	-3.3	-2.4
External debt/GDP	76.6	79.1	95.4	131.2	n.a.
Gross reserves/GDP	14.0	11.4	5.7	14.7	n.a.
Credit to private sector/GDP	57.6	61.8	64.0	49.4	n.a.

Macroeconomic performance

The economy returned to mild growth in the first half of 2016. GDP fell by 6.6 per cent in 2014 and by 9.9 per cent in 2015. The economy likely bottomed out in the middle of 2015, posting positive quarter-on-quarter growth rates in the second half of the year. In the first quarter of 2016, year-on-year GDP growth turned positive (0.1 per cent) for the first time since the end of 2013. Growth accelerated to 1.4 per cent year-on-year in the second quarter of 2016, helped by a low comparison base. Inflation dropped to 7.9 per cent year-on-year in September 2016 after averaging 48.7 per cent in 2015. Factors behind disinflation included exchange rate stabilisation, subdued domestic demand and prudent fiscal and monetary policies. The key policy rate of the National Bank of Ukraine (NBU) was lowered five consecutive times from 22 per cent in April 2016 to 15 per cent in September 2016.

External and fiscal adjustment led to a more balanced economy. The current account deficit shrank from 9.0 per cent of GDP in 2013 to almost zero in 2015 and in the first half of 2016. Meanwhile, official reserve assets of the NBU recovered from US$ 5.6 billion in February 2015 to US$ 15.6 billion in September 2016 (close to four months of imports coverage), largely due to international assistance inflows including under the IMF programme. Fiscal consolidation was also significant. The combined general government and Naftogaz deficit decreased from 10.0 per cent of GDP in 2014 to 2.1 per cent of GDP in 2015. On the back of the hryvnia depreciation, the public debt-to-GDP ratio increased from approximately 40 per cent in 2013 to approximately 80 per cent in 2015. However, the sovereign debt restructuring completed in 2015 has contributed to a more affordable amortisation path.

The IMF programme had a good start but delays have also occurred. After a year-long delay, the IMF's Executive Board completed the second review under Ukraine's economic programme on 14 September 2016. This enabled the disbursement of a tranche of approximately US$ 1 billion. On 25 December 2015, parliament approved the tax code liberalisation measures and the 2016 state budget, which included a deficit target of 3.7 per cent of GDP, consistent with the IMF programme.

The short-term growth outlook is positive although the recovery is tepid. After the deep recession in 2014 and 2015, year-on-year GDP growth has resumed in the first half of 2016. The recovery is likely to continue in the second half of 2016, leading to overall growth of 1.5 per cent this year and 2.0 per cent in 2017. This modest recovery is subject to downside domestic risks and broader regional uncertainty.

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Major structural reform developments

Efforts were made to rebuild the reform momentum after political stabilisation, but the pace of reforms is slower than anticipated. On 14 April 2016, after a period of political uncertainty that interfered with reforms, the Ukrainian parliament approved the new Cabinet of Ministers. Political stabilisation presented an opportunity to reinvigorate reforms, building on the achievements of the previous government. In May 2016, the government released its priority action plan for 2016, identifying five strategic priorities (macroeconomic stabilisation, creating a favourable business environment, establishment of the rule of law and fight against corruption, improving the quality of state management and public services, and strengthening human security) and key reform measures to accomplish them. The government established the Strategic Advisory Group co-chaired by high profile advisers with reformist backgrounds.

Some progress has been reported by the new anti-corruption agencies (National Anti-Corruption Bureau, Special Anti-Corruption Prosecutor Office and National Agency for Corruption Prevention) although the judiciary and law enforcement are in need of further reform. The new Civil Service Law adopted in December 2015 aims, among other things, to establish technocratic administration and to introduce competitive hiring in public sector organisations. However, this law remains to be implemented. State-owned enterprise (SOE) reform has been under way, although progress is slow. In March 2016, amendments to the privatisation process removed some of the obstacles for the privatisation of large state assets but privatisation has not advanced after an unsuccessful auction of the Odessa Portside Plant in July 2016. Ukraine ranks 80th out of 190 economies in the World Bank *Doing Business 2017* report. Weaknesses in Ukraine's business environment are reflected in the low scores with respect to dealing with construction permits, getting electricity, paying taxes, trading across borders, enforcing contracts and resolving insolvency.

Transformation of the monetary and financial sectors progressed. The number of licensed banks decreased from 180 in January 2014 to 100 in August 2016 as part of the systemic clean-up of the sector. Ownership transparency in the commercial banks was improved and controls over related party lending were tightened. Transition to the inflation targeting regime continued in 2015 with a focus on strengthening the independence of the central bank and communication of the monetary policy. Macro-prudential supervision was strengthened with an early warning system, asset quality reviews, stress testing, operational risk management and other measures. International Financial Reporting Standards (IFRS) were introduced at the end of 2015 to enhance reporting transparency. In June 2016, the Law on Financial Restructuring introduced an out-of-court corporate debt restructuring framework that is expected to facilitate the resolution of non-performing loans (NPLs). In February 2016, the Cabinet of Ministers endorsed the "Guidelines of the strategic reform of the state-owned banks", which provided for the improvement of governance and commercialisation of the state-owned banks.

At the same time, challenges inherited from the past continued to affect financial intermediation. Under-capitalisation, a high ratio of NPLs, balance sheet pressures from foreign exchange and credit risks, lack of creditor rights and a weak legal environment weighed on the banking sector. The Deposit Guarantee Fund needs to enhance its capacity to be able to deal with multiple resolution and asset recovery cases. Capital controls introduced in 2014-15 remain mostly in place as prerequisites for their removal have not yet been met. In June 2016, the NBU relaxed some of these capital controls by, among other things, granting permission to repatriate dividends earned in 2014-15 (within monthly limits) and reducing the obligatory sale of foreign exchange (export) proceeds from 75 per cent to 65 per cent.

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Energy sector reforms continued to target inefficiencies but the remaining tasks are significant. Ukraine has improved the reliability of energy supplies by diversifying its gas imports towards the European Union (EU). Gas imports from the EU interconnectors increased from 26 per cent of the total in 2014 to 63 per cent in 2015. New gas market legislation adopted in 2015 opened the sector for competition and represented the first step in bringing it into line with the EU Energy Charter. In the second quarter of 2016, domestic gas and heating tariffs were raised significantly to import parity levels in line with the IMF framework. This is expected to bring down Naftogaz's quasi-fiscal deficit and to curb opportunities for corruption through domestic gas price arbitrage. Progress was made with the implementation of Naftogaz's corporate governance action plan. An independent supervisory board of Naftogaz was established, with its first meeting held in May 2016. New board committees were created and chaired by an independent director. On 1 July 2016, the authorities adopted the resolution on the plan to unbundle the gas transmission system operator from Naftogaz. The unbundling is a stepping stone for broader reforms in the gas sector. In September 2016, the parliament adopted the Law on the Regulator that will allow for increased autonomy and will have significant impact on the reforms in the power, gas and municipal sectors. The Electricity Market Law, which was passed by the parliament in the first reading in September 2016, is the beginning of the power sector reform towards harmonisation with the European standards.

Tax code liberalisation measures were adopted in December 2015. Major changes to the tax legislation include reduction of the social security contribution rate by almost half to 22 per cent (an important change aimed at reducing informality in the labour market), introduction of a flat personal income tax rate of 18 per cent (versus two rates of 15 and 20 per cent previously), partial cancellation of VAT preferences for agricultural companies, reduction in mineral extraction taxes, cancellation of import surcharges, increases in tobacco and alcohol excise taxes, greater transparency in VAT refunds and steps aimed at curbing tax evasion. However, achieving a net positive fiscal impact from these measures will depend on efficient administration and improved compliance.

An electronic platform for public procurement has improved transparency and cost-efficiency. The electronic procurement portal Prozorro was started by a group of volunteers in 2015 and has resulted in a transparent and user-friendly system of electronic tenders. In August 2016, usage of the system was expanded to cover all government organisations. Prozorro is expected to generate significant budget savings and reduce the opportunity for corruption in public procurement.