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THE WORLD BANK

UKRAINE Economic Update

October 7, 2013

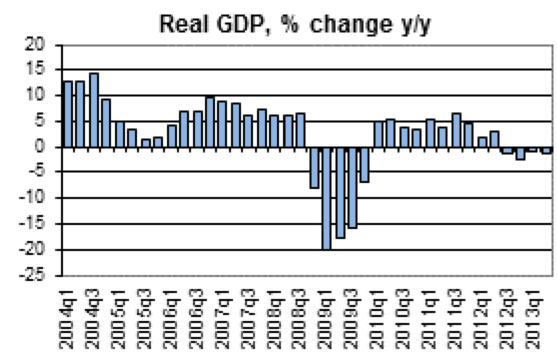
- ***Weak global demand and delays in domestic policy adjustments have led to widening and unsustainable macroeconomic imbalances in 2013.***
- ***Further delays in reforms will worsen the economic difficulties confronting Ukraine.***
- ***Reforms are urgently needed to reduce Ukraine's vulnerability to shocks and to jumpstart sustainable growth.***

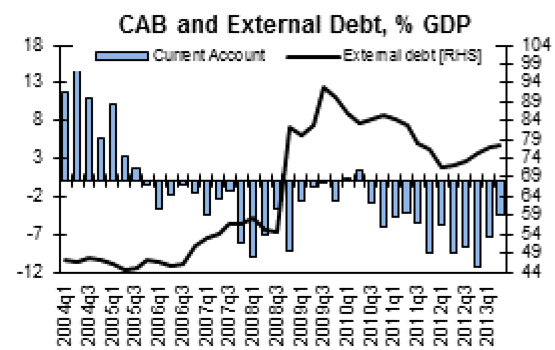
Recent Economic Developments

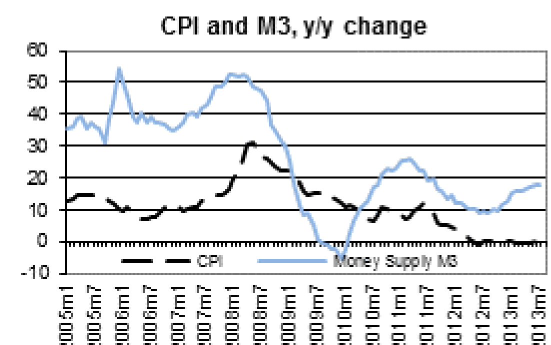
Real GDP continued to decline in first half of 2013. Weak external conditions and delays in domestic policy adjustment have led to decline in economic activity in first half of 2013, with real GDP falling by 1.1 and 1.3 percent y/y in Q1 and Q2 respectively. Low external demand for Ukrainian metals and engineering products caused industrial production to fall by 5.2 percent y/y during January-August 2013. Decline in industrial production was partially offset by good performance in agriculture and retail trade. While domestic consumption is still growing, the growth rate is lower compared to last year. This can be seen in retail sales growth that slowed from double digits at the beginning of the year to 6.7 percent y/y in January-August. Inflation remained low because of decline in local food prices, postponed utility tariffs adjustments and an unchanged exchange rate policy.

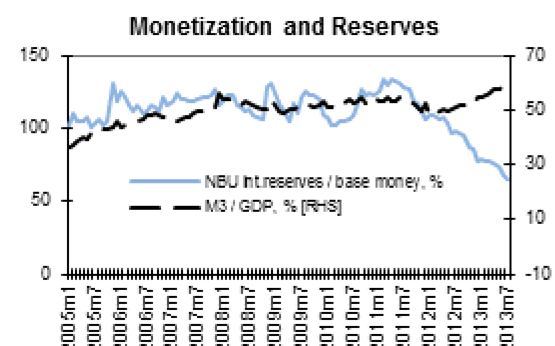
In reaction to weak fiscal performance, the authorities adopted several worrisome measures. Revenues declined by 1.3 percent y/y in January-August 2013 largely because of a decline in GDP and low inflation. Proceeds from VAT were nearly 7 percent lower y/y in January-July and deteriorated even more in August. This decline was partially offset by administrative measures like increase in transfers from National Bank of Ukraine (NBU). Expenditures, however, grew over 10 percent y/y in January-August 2013 resulting in a deficit (without Naftogaz) that was twice what it was last year in the same period. The deficit was mainly financed from domestic sources, with NBU increasing its holdings of government bonds by over 34 percent since the beginning of the year. Budget shortfalls are putting pressure on regional budgets and the private sector (due to arrears in VAT refunds). The planned use of promissory notes to settle budget arrears is a step in the wrong direction.

Foreign reserves of NBU declined to 2.4 months of imports at the beginning of October 2013. There was nearly 10 percent y/y decline in both imports and exports over January-August. On the export side, the drop was a result of decline in export of metals and engineering products due to low global demand and trade problems with Russia. Decline in imports was related to postponed gas imports, and is therefore not sustainable. The current account deficit remained high – almost equal to the 2012 level. The fixed exchange rate continues to put pressure on foreign reserves which fell to USD 19.7 billion by early-October (or 2.4 months of imports). Recent Moody's sovereign rating downgrade made external borrowings less accessible and more expensive.









Medium Term Outlook

Macroeconomic imbalances are projected to widen further in 2013. Looking ahead, in the second half of 2013, we expect a slight increase in real GDP growth because of a good agricultural harvest and low statistical base. Even with this improvement, given the decline in the first half of the year, we project 2013 growth rate to be close to 0 percent. If policies are left unchanged in the second half of 2013, it will lead to further widening of external and fiscal gaps. The external current account deficit will widen further in the second half of 2013 and reach around 8 percent of GDP. Increasing gas imports, together with foreign repayment needs, will bring external funding gap to over US$ 5 billion in Q4 2013. But borrowing to cover this gap may be challenging in view of the tighter global financial conditions and sovereign rating downgrade. Thus, if the exchange rate policy remains unchanged, it will lead to a drawdown of reserves to a level below 2 months of imports by the end of 2013. On the fiscal side, unless expenditures are lowered for the rest of the year, deficit is projected to widen to around 4.5 percent of GDP (6.5 percent with Naftogaz). The use of promissory notes to settle budget arrears is worrisome on many counts: lack of fiscal transparency, adverse impact on the private sector (they may receive less than what is owed to them in refunds), and an opaque governance structure.

Forecasts for 2014-2015 are dependent on domestic policy choices and external conditions. We provide two scenarios: 1) “Delayed-Adjustment” scenario – assumes forced adjustment in 2015 and external and fiscal gaps are financed via drawdown of reserves and further increase in domestic credit respectively; 2) “Reforms-Now” scenario – assumes a sustainable macro framework (lower fiscal deficit and flexible exchange rate policy) preferably underpinned by an IMF program and structural reforms (energy sector reforms, investment climate, improving public investment management etc.). We project that under the “Delayed-Adjustment” scenario, growth may *initially* be slightly higher in 2014 due to higher social spending on the eve of elections but will contract significantly in 2015 accompanied by other macroeconomic problems like higher inflation and unsustainably low reserves. Under the “Reforms-Now” scenario, growth will *initially* be slightly lower in 2014 because of tighter macro policies but fiscal and external deficits will shrink. Debt levels would stabilize and external reserves would be re-built. Meanwhile, accelerated structural reforms to improve the investment climate and strengthen the energy sector would kick start growth. Growth will be higher and more sustainable in the outer years allowing Ukraine to take advantage of the projected recovery in global demand. The likely signing of the Association Agreement with the EU will benefit Ukraine in both scenarios, but the country will be better positioned to take advantage of the DCFTA if reforms are undertaken now.

Table 1: Key Macroeconomic Indicators

	2011	2012	2013F	2014F		2015F		2016F	
				Delayed-Adjustment	Reforms-Now	Delayed-Adjustment	Reforms-Now	Delayed-Adjustment	Reforms-Now
Nominal GDP, *UAH billion*	1316.6	1408.9	1437.1	1502.5	1575.3	1651.0	1719.9	1766.6	1860.3
Real GDP, *% change*	5.2	0.2	0.0	2.0	1.5	-1.0	3.0	0.0	4.0
Consumption, *% change*	11.1	9.6	2.2	3.5	0.0	-3.2	2.0	-0.2	2.9
Fixed Investment, *% change*	7.1	0.9	-20.3	1.0	-12.5	-2.5	5.1	-0.7	6.4
Export, *% change*	4.3	-7.7	-2.6	0.8	1.2	2.0	3.1	1.7	4.8
Import, *% change*	17.3	1.9	-4.1	2.0	-4.8	-5.3	1.8	1.0	3.5
GDP deflator, *% change*	15.7	8.0	2.0	2.5	8.0	11.0	6.0	7.0	4.0
CPI, *% change eop*	4.6	-0.2	0.3	2.0	12.0	18.0	6.6	7.0	4.0
Current Account Balance, *% GDP*	-5.5	-8.4	-7.9	-9.0	-5.4	-5.5	-4.5	-4.2	-3.1
Budget revenues, *% GDP*	42.9	44.5	45.0	44.7	44.7	44.8	44.8	44.8	44.8
Budget expenditures, *% GDP*	45.6	49.0	49.5	49.1	47.2	48.0	46.8	47.1	46.5
Fiscal balance, *% GDP*	-2.8	-4.5	-4.5	-4.4	-2.5	-3.2	-2.0	-2.4	-1.7
External debt, *% GDP*	77.6	76.6	68.0	68.1	76.8	77.5	75.8	75.2	73.7
Public and Guaranteed Debt, *% GDP*	36.3	36.6	36.0	44.7	42.9	49.3	44.5	50.7	44.0

Source: Ukrainian Authorities, WB projections

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