UKRAINE

Highlights

- **The government has launched a bold and comprehensive set of reforms to stabilise the economy and restore growth.** The authorities made a good start in implementing the Extended Arrangement with the IMF and, as of the end of August 2015, remain largely compliant with the IMF's prior actions and structural benchmarks. Comprehensive reforms are under way in the banking and energy sectors, and Ukraine's commitment to implementing the Association Agreement with the European Union remains strong.
- **The economy has contracted deeply and remains very fragile.** GDP is expected to fall by 11.5 per cent in 2015, reflecting both the legacy of myriad business climate, structural and corruption problems as well as the damage to investor, lender, depositor and consumer confidence caused by the events in Crimea and the confrontation in the eastern part of the country.
- **In May 2015, as part of broader anti-corruption and business climate improvements, the EBRD-supported Business Ombudsman Council of Ukraine officially launched operations.** Complaints received by the Business Ombudsman included VAT refund delays, problems with the enforcement of court rulings in favour of businesses, and excessive regulation of export-import operations.

Key priorities for 2016

- **The government should continue to build a reformist, consolidated and modern civil service.** This would enable implementation of the "Four Ds" plan announced by the president of Ukraine: deregulation, de-bureaucratisation, de-oligarchisation and decentralisation.
- **Concerted efforts are needed to develop a strong and non-corrupt system of law enforcement and justice administration.** This will support structural reforms across a range of areas and the fight against corruption, as well as challenging the inherited status quo in a number of crucial sectors. Results in this area would help preserve public support for reforms in an environment of shrinking disposable incomes.
- **Macro-critical reform in the financial and energy sectors should continue.** The government needs to further strengthen bank supervision to prevent related party lending, and continue with bank recapitalisation and resolution, as well as further develop the framework for addressing non-performing loans. Corporate governance of Naftogaz must improve and the company's deficit needs to reduce through cost recovery tariffs for natural gas and heating, along with associated reform of the social safety net.

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Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	5.5	0.2	0.0	-6.8	-11.5
Inflation (average)	8.0	0.6	-0.3	12.1	50.0
Government balance/GDP	-4.3	-6.6	-4.8	-4.5	-4.2
Current account balance/GDP	-6.3	-8.1	-9.2	-4.7	-1.7
Net FDI/GDP [neg. sign = inflows]	4.3	3.8	-1.8	-0.3	-1.6
External debt/GDP	77.2	76.5	79.1	96.7	n.a.
Gross reserves/GDP	18.6	12.9	11.4	5.8	n.a.
Credit to private sector/GDP	61.0	57.6	61.8	64.8	n.a.

Macroeconomic performance

Since early 2014, Ukraine has been experiencing a severe economic crisis. GDP fell by 6.8 per cent in 2014 and by 17.2 per cent and 14.6 per cent year-on-year in the first and second quarters of 2015. Inflation stood at 51.9 per cent year-on-year in September 2015. The current account deficit decreased sharply from 9.2 per cent of GDP in 2013 to approximately 4.7 per cent in 2014, and is expected to shrink further to less than 2.0 per cent of GDP in 2015. The disruptions to productive and export capacities in Donbas and significant net outflows registered in the financial account put pressure on the currency and reserves. The hryvnia lost approximately 63 per cent of its value against the US dollar from January 2014 to mid-October 2015, with depreciation from January to mid-October 2015 at 26 per cent. The official exchange rate has stabilised at 21 to 23 hryvnias per US dollar since April 2015 on the back of administrative restrictions on the foreign exchange market deployed by the National Bank of Ukraine (NBU). Official reserve assets of the NBU fell from US$ 17.8 billion in January 2014 to US$ 5.6 billion in February 2015 (approximately one month of import coverage) before recovering to approximately US$ 12.8 billion in September 2015, largely on account of inflows of international assistance. The IMF predicts that import coverage of reserves will increase from 1.6 months in 2014 to 3.7 months in 2015.

Public deficits and debt increased sharply. In 2014 the sum of the general government and Naftogaz deficits increased to approximately 10.0 per cent of GDP (from 6.7 per cent in 2013), with Naftogaz's deficit accounting for more than half of this. This overall deficit is expected to decrease to approximately 7.0 per cent of GDP in 2015, driven by an expected reduction in both the general government's and Naftogaz's deficits. Ukraine's public and publicly guaranteed debt increased steeply as a percentage of GDP, from 41 per cent in 2013 to 71 per cent in 2014, and is projected to increase further to up to 90 to 100 per cent of GDP at the end of 2015 due to exchange rate effects, the economic contraction and inflows of official loans.

The four-year IMF programme is on track. In March 2015 the IMF's Board approved a four-year Extended Arrangement under the Extended Fund Facility (EFF) for Ukraine of approximately US$ 17.5 billion. The Extended Arrangement envisages reforms in governance, fiscal policy, energy, finance, the business climate, state-owned enterprises, the judiciary and law enforcement. The government moved fast to carry out the IMF's prior actions which led to approval of the EFF. On 31 July the IMF completed its first review of Ukraine's Extended Arrangement and disbursed US$ 1.7 billion, which brought total disbursements under the EFF to approximately US$ 6.7 billion. To close Ukraine's external funding gap (US$ 40 billion in 2015-18), the IMF programme envisages restructuring Ukraine's sovereign Eurobonds to generate cash flow savings of approximately US$ 15 billion from 2015 to 2018 and to improve Ukraine's public debt sustainability. On 26 August 2015, the Ad Hoc Committee of Ukraine's international bondholders and Ukraine signed an Indicative Term Sheet spelling out parameters of the debt restructuring. On 17 September 2015, the debt restructuring was endorsed by Ukraine's parliament, paving the way for launch of an Exchange Offer. According to the Ministry of Finance of Ukraine, on 14 October 2015 all sovereign and sovereign-guaranteed bondholders, with the exception of the US$ 3 billion bond due in December 2015, passed an Extraordinary Resolution approving the debt restructuring.

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The short-term outlook depends on domestic and external factors. Seasonally adjusted quarter-on-quarter contraction slowed from -3.8 per cent in the first quarter of 2015 to -0.5 per cent in the second quarter of 2015. There is cautious hope that the economy has bottomed out in mid-2015 and that the output level will stabilise in the second half of the year amid downside domestic and broader regional risks, which remain material.

Major structural reform developments

The authorities have made progress with reforms although challenges remain. As of the end of August 2015, the authorities were largely compliant with the IMF's structural benchmarks. Banking and energy sector reforms, fiscal policy reforms, and business climate and anti-corruption measures rank highly on the national reform agenda. Other crucial reforms to law enforcement, the judiciary and public administration have been addressed only partially. Ukraine's weaknesses in the business environment are reflected in its ranking in the World Bank's *Doing Business 2016* report where Ukraine ranks 83rd out of 189 economies, with low scores in dealing with construction permits, getting electricity, registering property, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. The National Reforms Council (NRC), established in 2014 supported by the EBRD, continued to act as the high-level political platform for reform-related consensus-building among key stakeholders, seeking dialogue with civil society, businesses, politicians and Ukraine's development partners. The NRC is playing an increasingly important role in harmonising international assistance to Ukraine with the government's vision and strategy. The NRC's semi-annual report issued in July 2015 outlined reform progress, acknowledged setbacks and spelled out the necessary steps to eliminate reform delays.

Financial intermediation has been badly affected by the crisis. More than 50 banks have been transferred to the Deposit Guarantee Fund (DGF) for resolution since the beginning of the crisis in 2014 as part of a systemic clean-up. The banking sector has suffered from deposit outflows, under-capitalisation, mounting balance sheet losses from foreign exchange exposure, a deterioration of asset quality and the loss of assets in Crimea and Donbas.

Transformation of the monetary and exchange rate policy and of the financial sector continued. The National Bank of Ukraine (NBU) has started to develop the necessary elements for a gradual shift towards an inflation-targeting regime. The NBU's market operations framework became more transparent. To stabilise the foreign exchange market the NBU maintained tight administrative restrictions and capital controls, whose gradual removal is contingent on the abatement of balance of payment pressures, a build-up of net international reserves and completion of debt restructuring with Ukraine's sovereign bondholders. Efforts to enhance the NBU's supervisory capacity and to clean up the banking sector continued. The NBU's structure, staffing and governance have been improved and its operational independence has been enhanced. The NBU's core functions were strengthened, non-core functions downsized, and the role of internal committees increased. Stricter criteria are applied when identifying ultimate bank owners and prosecuting for money laundering activities. More than 50 insolvent banks have been removed from the market since the beginning of the crisis in 2014. Measures were taken to tighten the responsibility for related party lending and to gradually unwind related party exposures. Bank diagnostics aim to identify capital shortages and devise recapitalisation plans. Efforts are being made to improve the DGF's accountability and efficiency in order to enhance asset recovery and minimise fiscal losses – the DGF's capacity is overstretched as it deals with a backlog of bank resolution cases. The authorities are discussing the transformation of state-owned banks, with corporate governance reform at the core of this.

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The authorities have made progress in reforming the inefficient energy sector. Efforts have been made to put Naftogaz's finances on a more sustainable footing and to reduce the quasi-fiscal deficit. Household gas and heating prices were increased by 285 per cent and 67 per cent, respectively, in the first half of 2015, with plans to reach a 100 per cent cost recovery level by April 2017. This will help to curb corruption in the sector, foster energy saving and energy efficiency and attract investment. A programmed scale-up in social assistance is expected to protect socially vulnerable households and ongoing social safety net reforms aim to better target beneficiaries in 2016. The gas market law, which was approved by parliament in April and enters into force in October, introduced a new model of gas market and paved the way for the Naftogaz unbundling, increased competition and potential investment in the sector. In 2014 Ukraine further diversified its gas supply sources by increasing the share of imports from the European Union (EU) to approximately 25 per cent of total imports. In the first half of 2015 the share of gas imported from the EU interconnectors represented approximately 60 per cent of the total import. Ukraine stopped buying Russian gas after breakdown of the June 2015 EU-Ukraine-Russia trilateral gas talks, which were an attempt to find a follow-up agreement to the EU-brokered "Winter Package" that had ended in March 2015 and had been partially extended to June 2015. On 12 October 2015, Russia resumed gas deliveries to Ukraine. Before the resumption of gas flows, Ukraine prepaid for approximately half of the gas deliveries planned in October 2015.

A Business Ombudsman Council has been established. The council, which is supported by the EBRD, started its activities in May 2015. It has since started to position itself as an important actor in the context of improving the business climate and legislation, as well as the fight against corruption in Ukraine, through helping firms settle their outstanding issues with the authorities.