UKRAINE

Highlights

- **A modest economic recovery is under way.** After two years of deep recession GDP grew by 2.3 per cent in 2016 and remained nearly at the same low level in the first half of 2017. The volume of exports declined in 2016 and foreign direct investment (FDI) remains low.
- **Structural reforms have moved forward, but with delays and setbacks.** Key reforms include the application by the National Bank of Ukraine (NBU) of increasingly rigorous regulatory standards, and the adoption of laws on the electricity market and on the energy regulator. The recent passage of education, pension and healthcare reforms is a welcome sign of reform momentum. However, flagship reforms in the gas sector are being delayed and meaningful progress is lacking on the reform of governance in state-owned enterprises (SOEs), privatisation and the administration of justice.
- **The nationalisation of PrivatBank has helped to avert a financial meltdown.** Concerns about the low quality of assets, extensive related party lending and a shortage of capital led to the nationalisation of this systemically important bank, without major disruptions to the broader economy.

Key priorities for 2018

- **The economic recovery needs a stronger momentum.** A major push is required to get the privatisation process off the ground and foster inflows of FDI. Adoption of the new privatisation law and reform of the State Property Fund would bring more transparency to the process. The judicial system requires an overhaul.
- **Reform of the state-owned banks has become increasingly urgent.** The aim should be to scale back the state's large involvement in the banking sector following the nationalisation of PrivatBank. Low operating efficiency and balance sheet concerns at the state-owned banks need to be remedied as a stepping stone to eventual privatisation. Decisive steps must be taken to recover the assets of PrivatBank.
- **Quick and measurable progress is required in energy sector reform.** Implementation of Naftogaz's Corporate Governance Action Plan should be reinvigorated to compensate for significant delays and to eliminate policy uncertainty. Work on its unbundling needs to advance in line with authorities' commitment to the process.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	0.0	-6.6	-9.8	2.3	2.0
Inflation (average)	-0.3	12.1	48.7	13.9	12.8
Government balance/GDP	-4.8	-4.5	-1.2	-2.3	-3.0
Current account balance/GDP	-9.0	-3.4	-0.2	-3.7	-3.3
Net FDI/GDP [neg. sign = inflows]	-2.2	-0.2	-3.3	-3.5	-1.1
External debt/GDP	77.5	94.6	130.4	121.7	n.a.
Gross reserves/GDP	11.1	5.6	14.6	16.7	n.a.
Credit to private sector/GDP	61.8	64.0	49.2	41.8	n.a.

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Macroeconomic performance

Ukraine's economy is growing moderately but output remains well below the pre-crisis level. After a 16.0 per cent cumulative real GDP contraction in 2014-15, Ukraine's economy grew by 2.3 per cent in 2016. The economy sustained this modest pace of recovery in the first half of 2017, growing by 2.5 per cent year-on-year in the first quarter and by an estimated 2.3 per cent year-on-year in the second quarter. Gross fixed capital formation rebounded after a protracted downturn, growing by 20.1 per cent year-on-year in 2016 and by approximately 21.9 per cent year-on-year in the first half of 2017. Household consumption has picked up further this year on the back of increasing real wages and improving confidence, but the real volume of exports of goods and services declined by 1.6 per cent in 2016 and by 1.3 per cent year-on-year in the first half of 2017, dragging down headline GDP growth. In 2016 industrial production increased by 2.8 per cent, thus breaking a four-year cycle of decline. But in the first nine months of 2017, it slipped into 0.3 per cent year-on-year contraction on account of the economic blockade of the area that is beyond the control of the government of Ukraine (the blockade). FDI into the real sector remained low at just around 2.0 per cent of GDP in 2016. Consumer price inflation has slowed from the peak levels of 2015 but remains elevated at 16.4 per cent year-on-year as of September 2017. On 27 October 2017 the NBU raised its key policy rate for the first time since March 2015 from 12.5 per cent to 13.5 per cent.

International reserves are on the rise despite a higher current account deficit. The current account deficit widened from near-balance in 2015 to approximately 3.7 per cent of GDP in 2016 due to a domestic demand recovery and weak exports. It remained on the rise in the first half of 2017. However, the balance of foreign exchange inflows to the economy was favourable on account of international assistance inflows, including under the IMF programme, and with the help of foreign exchange cash returning to the banking system after a significant exodus in previous years. In September 2017 successful issuance of sovereign 15-year Eurobonds for the principal amount of US$ 3 billion marked Ukraine's return to the international capital markets. It was accompanied by a liability management operation to buy back up to US$ 1.7 billion of Eurobonds maturing in 2019 and 2020. Ukraine's official reserve assets increased to approximately US$ 18.6 billion (close to four months of imports) as of September 2017. The hryvnia appreciated by approximately 2.5 per cent against the US dollar from the beginning of 2017 until the end of September.

The state of public finances has continued to improve. The combined general government and Naftogaz deficit decreased from 10.1 per cent of GDP in 2014 to approximately 2.3 per cent of GDP in 2016, below the initially planned 3.7 per cent of GDP. The increase of gas tariffs to import parity level in 2016 enabled the authorities to phase out the quasi-fiscal deficit of Naftogaz for the first time in recent years. The overall fiscal deficit is planned at approximately 3.0 per cent of GDP in 2017, which is in line with the IMF programme. The public debt-to-GDP ratio remained steadily high at approximately 81.0 per cent of GDP following the nationalisation of PrivatBank in December 2016, which led to the issuance of domestic government bonds to fill in the capital shortfall at the bank. Pension reform adopted in October 2017 aims to improve fiscal sustainability of the pension system.

Growth is forecast to increase in 2018 but medium-term prospects are contingent on reform implementation. GDP growth is expected to gain pace from 2 per cent in 2017 to a still-modest 3 per cent in 2018. The blockade is expected to have a moderate impact on Ukraine's growth and balance of payments in the near term. At the same time, reform momentum is weak, jeopardising medium-term growth prospects. Ukraine's ability to advance growth-friendly reforms under the umbrella of the IMF programme is uncertain.

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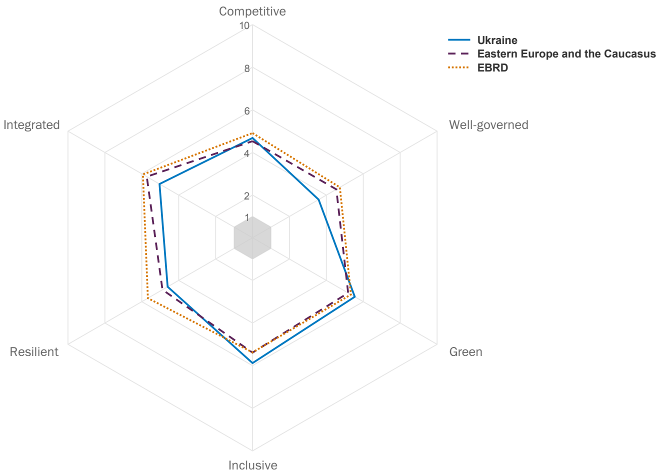
Assessment of transition qualities (1-10)



Major structural reform developments

Continuation of the IMF programme is uncertain. The nationalisation of PrivatBank (see below), the adoption of the 2017 budget compliant with the programme framework, and the successful launch of the online asset declaration system for public officials paved the way for completion of the third programme review in April 2017. This was followed by the release of a US$ 1 billion tranche, bringing total disbursements to US$ 8.4 billion out of US$ 17.5 billion envisaged under the programme. In May 2017 the IMF mission initiated discussions on the fourth programme review but noted that further work was needed to meet the reform objectives in relation to pension reform, the privatisation process and anti-corruption. An adjustment of domestic gas prices to maintain them at import parity level is also one of the conditions for completing the fourth review.

The banking system has been stabilising but credit activity is yet to recover. The NBU has been applying increasingly firm and transparent supervision in key areas such as corporate governance, ownership transparency, related party exposures and capital requirements, supported by an enhanced legislative and implementation framework. Related party diagnostic reviews were finalised for all banks in 2016, identifying 44 banks in which the ratio of credit exposure to related parties exceeded the required level. By the end of 2016, the 60 largest banks in the country, accounting for approximately 98 per cent of the banking sector assets, completed stress tests to determine capital needs and to develop recapitalisation schedules. Plans for recapitalisation and the unwinding of related-party exposures over the three-year horizon have been adopted, covering a large majority of the banking sector. An out-of-court voluntary debt restructuring mechanism became functional in April 2017 but the level of non-performing loans (NPLs) is still exceptionally high at approximately 58 per cent of total loans as of 1 July 2017 with significant concentration of the NPLs in the state-owned banks. Lending activity remained weak on the back of prevailing risk-aversion, deleveraging, lack of progress in creditor rights' protection and high (albeit-decreasing) interest rates.

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PrivatBank was declared insolvent and nationalised to safeguard financial stability. It was the largest commercial bank in Ukraine by the end of 2016, accounting for approximately 20 per cent of total banking sector assets. PrivatBank was nationalised in December 2016 amid concerns about large related party exposures, poor asset quality and a significant capitalisation gap. In the days immediately following the nationalisation, the parliament extended a full state guarantee on all PrivatBank deposits and the NBU provided emergency liquidity assistance to bolster confidence and stem withdrawals from the bank. New supervisory and management boards were swiftly put in place. An international auditing firm was appointed to investigate insider loans issued to the bank's related parties, with the completion of the forensic audit expected before the end of 2017. As of the end of June 2017 the government had issued treasury bonds amounting to approximately 6 per cent of 2016 GDP in order to recapitalise the bank. The fallout from the nationalisation was mostly contained. Exchange rate pressures in the aftermath of the nationalisation were limited and no major disruptions were reported in ordinary bank transactions. The nationalisation of PrivatBank led to increased state involvement in the banking sector with around half of the banking assets presently owned by the state.

Major reforms in the energy sector have been delayed despite some recent progress. In April 2017 the parliament of Ukraine adopted a new electricity market law which stipulates the unbundling of the transmission and distribution of electricity. The law paves the way for enhanced competition in the electricity market. It aims to align the Ukrainian power sector closer to the requirements of the EU's Third Energy Package. The two-year transition period envisaged under the law will provide time to develop secondary legislation and gradually roll out an electricity market structure consistent with EU principles. Despite some recent progress, major gas sector reforms pertaining to the unbundling of Naftogaz, implementation of its corporate governance action plan and liberalisation of the gas market are well behind schedule.

Ukraine's business environment rankings improved but public governance challenges remain. Ukraine ranks 76th out of 190 economies in the World Bank *Doing Business 2018* report, moving up in the rankings compared with the previous year. However, weaknesses in Ukraine's business environment are reflected in the low scores with respect to getting electricity, protecting minority investors, trading across borders, enforcing contracts and resolving insolvency. Progress with the SOE reform is slow and privatisation continues to be mostly stalled. In August 2017 the state's minority stakes in three regional energy companies were sold to the existing majority shareholders. In July 2017 the Cabinet of Ministers of Ukraine endorsed a draft law on privatisation and contemplated a triage of SOEs to determine which need to remain in state ownership, which could be privatised and which could be liquidated. However, tangible results are still lacking. The launch of the online asset declaration system in September 2016 was an important step towards better transparency and accountability in public administration but the extension of declaration requirements to non-governmental organisations and SOEs needs to be rectified. The National Anti-Corruption Bureau of Ukraine (NABU) has opened a number of investigations including high-profile cases but the inefficient court system continues to obstruct the administration of justice.