UKRAINE

Highlights

- **The economy is on a moderately paced recovery path.** Economic output expanded by 2.5 per cent in 2017, with domestic demand as the main driver, and the pace of growth has picked up so far in 2018.
- **Progress in the legislative reform agenda has been mixed.** The parliament has adopted a number of milestone laws, including on establishment of an anti-corruption court, privatisation, currency and currency operations, corporate governance in state-owned banks, and creditors' rights protection. These legislative changes, however, have yet to yield tangible results.
- **Cooperation with the IMF is to be extended under a different arrangement.** If approved and duly implemented, the new 14-month Stand-By Arrangement will help to address Ukraine's external financing needs and maintain macroeconomic stability during the programme period.

Key priorities for 2019

- **Ukraine needs to preserve macroeconomic stability.** Cooperation with the IMF remains vital. The country will require continued IMF and donor support, and consistent access to international capital markets to address foreign exchange debt payment liabilities falling due in 2018-20.
- **Ukraine should step up implementation of recently adopted energy sector laws.** Unbundling of the gas transmission system operator from Naftogaz and implementation of its corporate governance action plan, together with the establishment of the gas exchange, are priorities. The Public Sector Obligation (PSO) of Naftogaz and its subsidiaries requires an overhaul to phase out subsidisation and incentivise payment discipline by utility companies.
- **Reform of the state-owned banks should be vigorously pursued.** Emphasis should be placed on the execution of the corporate governance reform and transformation of the state-owned banks, thus leading to their privatisation.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	-6.6	-9.8	2.4	2.5	3.5
Inflation (average)	12.1	48.7	13.9	14.4	10.9
Government balance/GDP	-4.5	-0.9	-2.1	-1.3	-2.1
Current account balance/GDP	-3.4	1.8	-1.4	-2.2	-3.1
Net FDI/GDP [neg. sign = inflows]	-0.2	-3.3	-3.5	-2.3	-2.1
External debt/GDP	94.6	130.4	121.7	103.9	n.a.
Gross reserves/GDP	5.6	14.6	16.6	16.8	n.a.
Credit to private sector/GDP	64.3	49.4	41.9	34.1	n.a.

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Macroeconomic performance

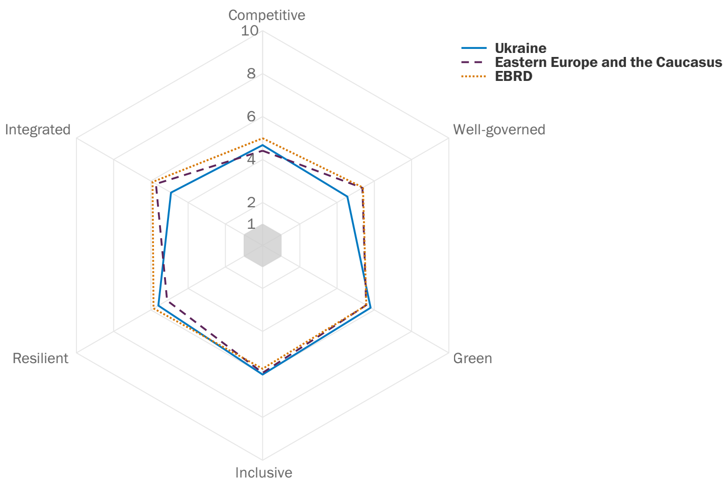
Growth has gained some momentum but remains modest. GDP growth accelerated from 2.5 per cent in 2017 to an estimated 3.5 per cent (year-on-year) in the first half of 2018. Household consumption increased by 8.4 per cent in 2017 on the back of a strong real wage recovery, an increase in the average pension and a rise in the inflow of remittances from abroad. In 2017, investment in fixed assets increased by 18.2 per cent. In the same period, exports of goods and services also grew modestly in real volume terms following five consecutive years of contraction. Consumer price inflation has slowed from the peak levels of 2015 but remains elevated at 11.4 per cent year-on-year in the first nine months of 2018. The National Bank of Ukraine (NBU) raised its key policy rate six consecutive times from 12.5 per cent in October 2017 to 18.0 per cent in September 2018 to counter the inflationary pressures.

The emigration of working-age people has intensified. This has led to labour market pressures and is dragging down industrial output growth. At the same time, outward labour migration has led to an increased inflow of remittances from abroad. According to the recently revised methodology of the NBU, personal remittances are estimated to have increased from US$ 7.0 billion (approximately 7.6 per cent of GDP) in 2015 to US$ 9.3 billion (8.3 per cent of GDP) in 2017. Real wages increased by 12.8 per cent year-on-year in the first nine months of 2018.

The IMF's four-year Extended Fund Facility (EFF) is set to be replaced with a shorter, smaller-scale Stand-By Arrangement (SBA). In October 2018, the authorities and the IMF reached a staff-level agreement on a new 14-month SBA for the total amount of US$ 3.9 billion. If approved by the IMF Executive Board and duly implemented, the new SBA will help to address Ukraine's near-term external financing needs and to maintain macroeconomic stability throughout the electoral cycle next year. Following the staff-level agreement with the IMF, Ukraine returned to international capital markets in October 2018, issuing a dual-tranche Eurobond for the total principal amount of US$ 2 billion. Since April 2018 international reserves have been on a declining path, falling from US$ 18.4 billion to US$ 16.6 billion (approximately 2.9 months of imports) as of September 2018, although this trend is expected to be reversed after the renewal of cooperation with the IMF.

Growth prospects depend on the speed of implementation of key structural reforms and on addressing external refinancing needs. Ukraine's GDP is forecast to grow by 3.5 per cent in 2018 and by 3.0 per cent in 2019, although the political economy context may become less conducive for structural reforms ahead of the new election cycle in 2019. Ukraine needs to refinance foreign exchange public debt liabilities falling due in 2018-19 without draining foreign exchange reserves to maintain the confidence of investors and strengthen the medium-term outlook. Continuation of engagement with the IMF remains vital in this respect.

Assessment of transition qualities (1-10)



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Major structural reform developments

State-owned enterprise reform is moving forward slowly. A draft of the SOE corporate governance law that paves the way for independent boards with broad statutory powers at the SOEs has been prepared and submitted to the parliament. A revised Nomination Policy for SOE board members and CEOs was approved by the government in March 2018. This was followed by progress in appointing independent board members at a number of strategically important SOEs. The law on privatisation of state property, adopted in January 2018, has rectified shortcomings in the privatisation process and introduced the notions of small- and large-scale privatisations. According to the law, privatisation of small-scale state assets (up to approximately US$ 9.4 million in value) is to be made through the online state auction platform (Prozorro.Sale). The bylaws supporting the new law on privatisation were developed and approved by the Cabinet of Ministers in May 2018, but no major privatisation has taken place so far.

The stage has been set for reforming the state-owned banks (SOBs). In February 2018, the authorities approved the key principles of strategic reform of the state-owned banking sector, which accounts for approximately 55 per cent of total banking assets. Four major priorities were identified: implementation of strategies to restore commercial soundness and profitability; improvements in corporate governance, discipline and strategy execution; measures to improve the quality of assets and strengthen balance sheets; and exit of the state from the ownership of banks in the medium term. A law on improving the functioning of the financial sector in Ukraine was approved by the parliament in July 2018. It introduces independent professional supervisory boards appointed on a competitive basis. By law, the boards will have wide powers such as approval of key strategies and appointment of the executive management. Corporate governance standards set by the new law aim to increase operational efficiency, insulate the SOBs from undue political influence, and prepare them for eventual privatisation.

The new law on currency and currency operations replaces obsolete regulations. Adoption of the law in July 2018 marks a shift from an outdated, fragmented and cumbersome set of currency regulations and controls to a modern system compliant with EU directives and Ukraine's obligations under the Association Agreement. The currency operations are to be carried out without restrictions, unless provided otherwise by applicable anti-money laundering laws, national security laws, applicable international treaties or measures introduced by the central bank. The NBU remains authorised to abolish restrictions on foreign exchange operations or the movement of capital depending on macroeconomic conditions, but also to establish temporary protective measures at its discretion in case of identified threats to financial stability. The capital control and foreign exchange restrictions remaining in Ukraine are expected to be gradually lifted on the implementation of the law and contingent on satisfactory macroeconomic conditions.

Progress in energy sector reforms has been mixed and delays have occurred. The new majority-independent Supervisory Board of Naftogaz was selected in November 2017, after independent members of the previous board tendered their resignation while pointing to delays in the implementation of reforms. In December 2017, the government approved resolution on the monetisation of housing and utilities subsidies (HUS) at the utility level, introducing improvements to the HUS settlement process. Further work is needed to move the HUS monetisation further down to the level of households. In April 2018, the government established the Energy Reform Coordination Council (ERCC) in an effort to enhance delivery of energy sector reforms through strategic guidance and improved coordination between the government, Naftogaz and development partners. The ERCC is to focus on the three energy reform priorities that have experienced considerable delays: unbundling of gas transmission from production and supply functions; reforming the Public Sector Obligation (PSO) – Naftogaz's responsibility for the supply of natural gas to households and district heating utilities under regulated prices; and better targeting and monetisation of HUS. In May 2018 the President of Ukraine appointed five new Commissioners of the Energy and Utilities Regulator from the list pre-selected by the Independent Nomination Commission, reinstating the quorum and clearing the way for the regulator to make decisions.

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Investment climate reforms have advanced but significant challenges remain. In November 2017, the parliament adopted legislation that limits the powers of law enforcement agencies in carrying out criminal proceedings against businesses. The law requires all searches of enterprises by law enforcement agencies to be recorded on video with the right of an attorney to be present at any stage of the process. The law also limits the possibility of unwarranted seizure of business-critical computer hardware from private companies, among other measures. In February 2018, the parliament passed a law to establish an NBU-based centralised credit registry to foster information exchange and credit risk assessment by banks. A number of gaps undermining creditors' rights protection were targeted by the law on resumption of lending, adopted in July 2018. The landmark legislation for the establishment of the High Anti-Corruption Court was adopted in June 2018, despite strong political resistance. At the same time, asset declaration requirements for non-governmental organisations and board members of SOEs have not been abolished. The National Anti-Corruption Bureau of Ukraine (NABU) continues to face pressures and attempts to compromise its investigative activities. A moratorium on agricultural land sales was extended until January 2019. Ukraine ranks 71st out of 190 economies in the World Bank *Doing Business 2019* 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 resolving insolvency, getting electricity, trading across borders and protecting minority investors.