

Key developments and challenges

Stabilisation of the financial sector is essential so that banks can restart lending to the real sector. In the medium term, financial sector reforms should focus on developing local capital markets, consolidating and improving transparency of the banking sector, and unwinding state participation in the failed systemic banks.

Raising additional finance to modernise the gas transit system, enhancing the security of gas supplies and improving energy efficiency depend on the implementation of gas sector reforms. These include restructuring and corporatising the state-owned energy company, Naftogaz, strengthening its transparency and governance, as well as raising domestic gas prices to cost recovery levels.

The economy has been exceptionally hard-hit by the crisis. To attain sustainable growth, the institutional environment must be improved, public sector spending more efficient and investments in infrastructure productive.

Country data

Population (in millions)	45.8
Area ('000 sq km)	603.7
GDP (in billion US\$, 2008)	179.6
Average transition score (scale: 1 to 4.33)	3.07

Progress in structural reform

Liberalisation and privatisation

Ukraine's entry into the World Trade Organization (WTO) has helped mitigate protectionist pressures during the crisis, although the authorities resorted to temporary import duty surcharges on cars and refrigerators that expired in September. Negotiations on a comprehensive free trade area with the European Union are ongoing. After a long pause on privatisation, on 29 September 2009 the authorities auctioned the Odessa sea port plant, but cancelled the auction results due to alleged irregularities. The controlling stakes in 14 regional electricity distributors are being prepared for sale before the end of 2009.

Business environment and competition

A long-awaited joint-stock company law, designed to strengthen property and minority shareholders' rights, came into effect in April 2009. However, weaknesses in the property rights' regime, as well as the legal system overall, have tested foreign investors' commitment to Ukraine during the crisis as non-privatisation foreign direct investment (FDI) inflows declined for the first time in 10 years in 2008. According to the findings of the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), businesses continued to perceive the administration of justice system to be arbitrary and unfair, and corruption to be widespread. Ukraine ranks low among its peers in other surveys of business environment and governance. Recent initiatives to align Ukraine's institutions with those of the European Union could help to promote institutional reforms over the medium term.

Infrastructure

In January 2009 Ukraine's natural gas monopoly, Naftogaz, was engaged in a dispute with Russia's Gazprom over the terms of gas supply that caused supply disruptions to a number of other European countries. With the support of the international financial institutions (IFIs) and the European Union, the authorities have focused on the implementation of a long-standing reform agenda with the aim of restructuring and modernising the gas sector, improving Naftogaz's financial performance and reducing the sector's impact on public finances. Household gas tariffs were increased by 35 per cent in December 2008. Implementation of another 20 per cent increase has been delayed past the September target date owing to a legal challenge by trade unions, which the government has appealed. The critical outstanding reforms include raising household and utility gas tariffs to cost recovery levels, improving governance and transparency of Naftogaz, hardening of budget constraints for non-payers, taxing local gas production to reduce implicit subsidies, strengthening energy sector regulation, establishing effective internal and transit gas metering of gas flows and opening up the gas sector to foreign investor participation.

In February 2009 the government approved a reform plan for the road sector, envisaging the separation of the management for state and regional roads. Under this plan, Ukravtodor, a road maintenance agency, will administer state roads, and its regulatory functions will be transferred to a separate governmental entity. The responsibility for regional roads will be transferred to local road authorities. The financing of road maintenance will also be separated for state and regional roads. The plan also includes the development of by-laws relating to the procurement of road maintenance services.

Financial sector

The population's trust in the banking system was negatively affected by the failure of Prominvestbank in October 2008 and by liquidity problems in other financial institutions. A major deposit run ensued. As of August 2009 deposits in national currency had dropped by more than one-quarter since their peak in September 2008, while foreign currency deposits declined by approximately 15 per cent. As the crisis unfolded, the authorities introduced a temporary ban on early withdrawal of term deposits. The problems in the corporate sector contributed to a sharp increase in the proportion of non-performing loans; these rose from 3 per cent in the first quarter of 2008 to around 10 per cent by the end of the first half of 2009. With support from the International Monetary Fund (IMF), the authorities have pursued a bank resolution strategy, with pre-emptive bank recapitalisation as its key element. Fresh capital has been injected into two state-owned banks and the private owners of other large banks have been asked to recapitalise their banks. Three failed banks (Rodovid, Ukgazbank and Kyiv) were nationalised in July 2009. As many of the systemically important banks are owned by international banking groups, their continued engagement – with assistance from domestic regulators and IFIs – remains crucial to ensure banking system stability.

In response to recurring pressures in the currency market, the National Bank of Ukraine (NBU) introduced various foreign exchange controls, reversing the progress made in recent years towards full financial account liberalisation. The situation in many locally owned banks remains difficult: around 20 have fallen under the central bank's administration and many others have been unable to identify sources of capital in line with the NBU requirements. A much-needed process of bank liquidation and consolidation has begun but has not yet reached the level that would be expected in a crisis of this magnitude.

Macroeconomic performance

Ukraine has been hit hard by the global financial crisis. Its economy has been affected by global de-leveraging, the collapse of external demand, and the precipitous decline in international prices for steel and chemicals. The terms of trade have also suffered from increases in imported gas prices from an estimated average of US\$ 180 per 1,000 cubic metres in 2008 to US\$ 210 per 1,000 cubic metres in 2009. To help assure macrofinancial stability, in November 2008 the IMF approved balance-of-payments support via a US\$ 16.5 billion loan under a 24-month stand-by arrangement.

The Ukrainian real sector has contracted faster than in any other of the EBRD's countries of operations. In the first half of 2009 real GDP dropped by around 20 per cent year on year, mainly reflecting the collapse of steel output as well as the contraction of the construction and retail sectors. Bank lending has *de facto* been frozen due to widespread uncertainty about foreign exchange and counterparty risks. Industrial production declined by one-third in the first half of 2009 (year on year), although the pace of contraction has slowed recently. During this period, import and export flows have been compressed and the trade deficit has fallen sharply. Inflation has continued to slow, but still remains in double digits. Unemployment increased to 9.5 per cent by the end of the first quarter 2009.

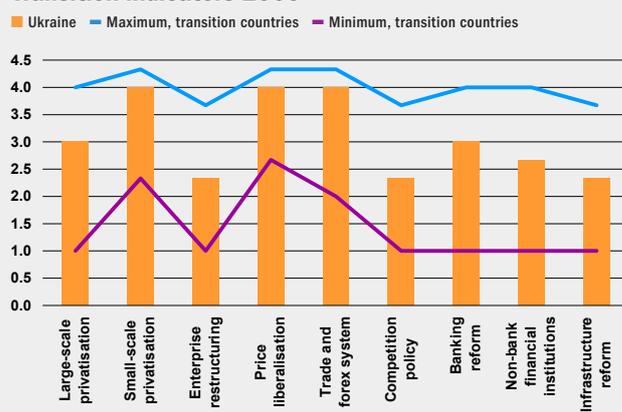
Since September 2008 access to international capital and credit markets has largely dried up. Although credit default swap spreads have more than halved since the February 2009 peak, they remained above 1,000 basis points at the end of September, reflecting market concerns about the high risk of default. The hryvnia lost almost half of its value against the US dollar since July 2008. During most of 2009 the hryvnia has been supported by interventions from the NBU. Gross foreign exchange reserves fell to an estimated US\$ 28.0 billion at the end of September 2009 from US\$ 37 billion at the end of August 2008.

The crisis has had a significant impact on public sector finances. The 2009 central government deficit target increased to 6 per cent of GDP compared with the balance in the initial budget reflecting primarily lower revenues. The public balance sheet has also been affected by the recapitalisation of several failed banks and Naftogaz. As a result, public sector debt is estimated to have increased from 13 per cent of GDP at the end of 2007 to around 30 per cent of GDP by the end of August 2009.

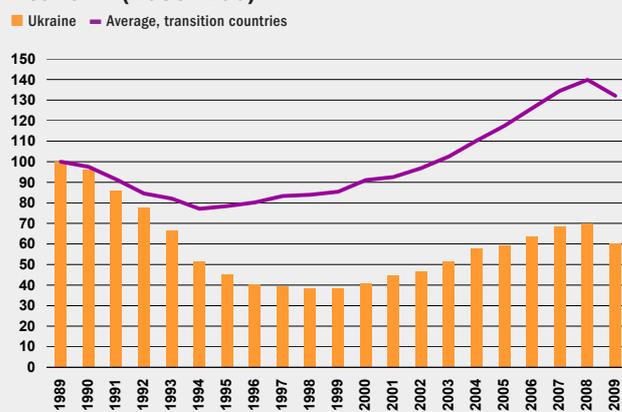
Outlook and risks

The prospects for recovery in the near term are constrained by weak external and domestic demand. On current trends, real GDP is likely to decline by around 14 per cent in 2009. The immediate challenges for the authorities are to avoid monetising public debt, return the public deficit to a sustainable path and stabilise the financial system. Achieving a fast and sustainable pace of economic growth over the longer term will require deep structural and institutional reforms, perhaps in the context of further approximation with the European Union.

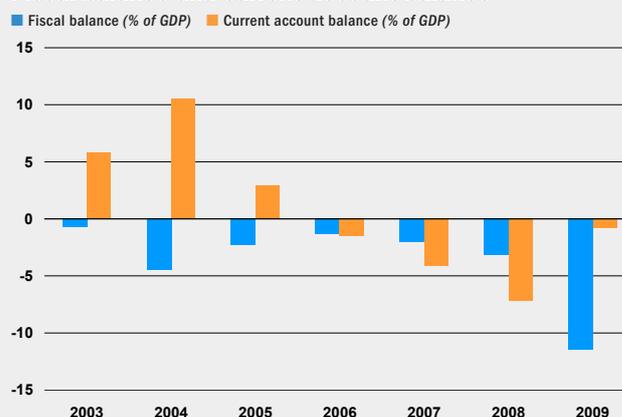
Transition indicators 2009



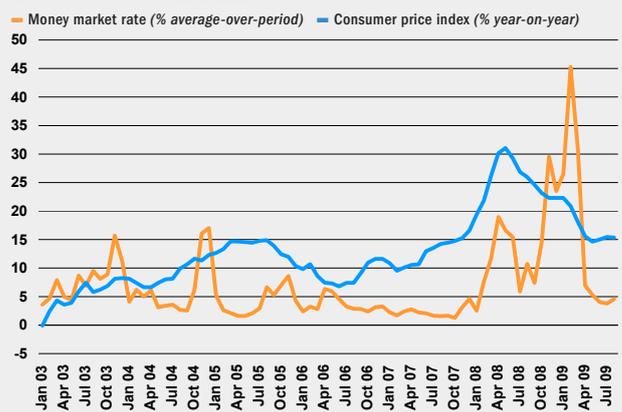
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – full	Competition office – yes	Telecoms regulatory assessment compliance – medium	Capital adequacy ratio – 10 per cent	Share of population living in poverty – <2.0 per cent (2005)
Controls on inward direct investment – no ¹	Quality of insolvency law – low	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 3.7 per cent (2007)
Interest rate liberalisation – full	Secured transactions law – advanced	Separation of railway infrastructure from operations – no	Private pension funds – yes	Government expenditure on education – 6.2 per cent (2007)
Exchange rate regime – managed float		Independence of the road directorate – partial		Household expenditure on power and water – 9.1 per cent (2008)
Wage regulation – no				
Tradeability of land – limited de facto				

Structural and institutional change indicators

	2003	2004	2005	2006	2007	2008	2009
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.1	10.1	15.1	15.2	15.5	15.5	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	65.0	65.0	65.0	60.0
Private sector share in employment (in per cent)	37.7	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.2	2.2	2.2	3.1	2.8	2.9	na
Share of industry in total employment (in per cent)	20.4	20.1	19.7	19.5	18.9	na	na
Change in labour productivity in industry (in per cent)	18.5	13.8	3.2	7.1	12.6	na	na
Investment/GDP (in per cent)	20.3	21.2	22.6	24.8	28.2	28.8	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>EBRD index of enterprise reform</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	8.0	10.0	na
Number of goods with administered prices in EBRD-15 basket	6.0	6.0	6.0	5.0	5.0	5.0	na
Share of trade with non-transition countries (in per cent)	48.7	45.1	44.8	46.4	46.6	44.3	na
Share of trade in GDP (in per cent)	95.2	97.4	82.6	77.2	77.3	84.5	na
Tariff revenues (in per cent of imports) ²	3.0	3.2	3.6	3.3	3.3	na	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	3.3	3.3	3.7	3.7	3.7	4.3	4.0
<i>EBRD index of competition policy</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	158 (19)	160 (19)	165 (23)	170 (27)	175 (40)	184 (46)	na
Asset share of state-owned banks (in per cent)	9.8	8.0	9.4	8.9	8.0	11.5	na
Asset share of foreign-owned banks (in per cent)	12.1	12.1	21.3	35.0	39.4	51.1	na
Non-performing loans (in per cent of total loans)	3.4	3.2	2.2	1.7	1.3	2.3	na
Domestic credit to private sector (in per cent of GDP) ³	24.3	25.2	32.2	44.4	58.2	79.8	na
Domestic credit to households (in per cent of GDP)	3.7	6.6	8.1	15.3	22.5	29.5	na
– Of which mortgage lending (in per cent of GDP)	na	na	na	3.7	6.5	15.1	na
Stock market capitalisation (in per cent of GDP)	8.6	18.1	28.6	39.8	78.3	20.6	na
Stock trading volume (in per cent of market capitalisation)	2.9	2.5	3.6	3.5	2.6	3.7	na
Eurobond issuance (in per cent of GDP)	6.3	3.6	2.5	2.8	2.8	0.5	na
<i>EBRD index of banking sector reform</i>	2.3	2.3	2.7	3.0	3.0	3.0	3.0
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.3	2.3	2.3	2.7	2.7	2.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	23.3 (13.6)	25.7 (29.1)	24.9 (64.0)	26.5 (105.1)	27.8 (119.3)	28.7 (121.1)	na
Internet users (per 100 inhabitants)	5.3	10.6	17.0	19.3	21.6	22.5	na
Railway labour productivity (1989=100)	56.5	60.1	56.9	57.5	64.9	64.5	na
Residential electricity tariffs (USc kWh)	2.7	2.7	2.5	3.3	4.0	4.6	na
Average collection rate, electricity (in per cent)	94	92	99	100	95	98	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.5	1.7	1.8	na	na	na	na
<i>EBRD index of infrastructure reform</i>	2.0	2.0	2.0	2.0	2.3	2.3	2.3
– Electric power	3.0	3.0	3.0	3.0	3.0	3.0	3.0
– Railways	2.0	2.0	2.0	2.0	2.0	2.0	2.0
– Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
– Telecommunications	2.3	2.3	2.3	2.7	2.7	2.7	2.7
– Water and wastewater	1.7	1.7	1.7	1.7	2.0	2.0	2.0

¹ Registration of foreign investment is required.

² Refers to taxes on international trade and transactions.

³ Data from the IMF.

Macroeconomic indicators

	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	9.6	12.1	2.7	7.3	7.9	2.1	-14.0
– Private consumption	11.5	13.1	16.6	15.9	17.1	11.8	na
– Public consumption	6.9	1.8	2.7	2.7	2.8	0.4	na
– Gross fixed capital formation	22.5	20.5	3.9	21.2	24.8	1.6	na
– Exports of goods and services	10.3	21.3	-12.2	-5.6	3.2	5.2	na
– Imports of goods and services	16.4	15.5	6.4	6.8	19.9	17.1	na
Industrial gross output	15.8	12.5	3.1	6.2	10.2	-3.1	na
Agricultural gross output	-9.9	19.1	0.4	2.5	-6.5	17.1	na
Employment	<i>(Percentage change)</i>						
Labour force (end-year)	-0.3	0.1	0.4	-0.2	0.3	0.3	na
Employment (end-year)	0.4	0.7	1.9	0.2	0.8	0.3	na
Unemployment (end-year) ¹	<i>(In per cent of labour force)</i>						
	9.1	8.6	7.2	6.8	6.4	6.4	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	5.2	9.0	13.5	9.1	12.8	25.2	16.0
Consumer prices (end-year)	8.2	12.3	10.3	11.6	16.6	22.3	14.0
Producer prices (annual average)	7.6	20.4	16.7	9.6	19.5	35.5	na
Producer prices (end-year)	11.1	24.1	9.5	14.1	23.3	23.0	na
Gross average monthly earnings in economy (annual average)	22.9	27.9	36.4	29.7	29.3	33.7	na
Government sector²	<i>(In per cent of GDP)</i>						
General government balance	-0.7	-4.4	-2.3	-1.3	-2.0	-3.2	-11.4
General government expenditure	37.2	41.5	44.1	45.1	43.8	47.3	na
General government debt	29.3	25.5	18.7	15.7	12.9	19.9	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	46.9	32.8	53.9	34.3	50.8	31.0	na
Domestic credit (end-year)	38.4	24.8	34.3	69.4	77.0	76.9	na
Broad money (M2, end-year)	<i>(In per cent of GDP)</i>						
	35.3	36.4	43.8	47.7	54.3	54.0	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Discount rate	7.0	9.0	9.5	8.5	8.0	12.0	na
Deposit rate ³	7.0	7.8	8.5	7.6	8.2	9.9	na
Lending rate ³	17.9	17.4	16.0	15.1	13.9	17.6	na
Exchange rate (end-year)	<i>(Hryvnias per US dollar)</i>						
	5.3	5.3	5.1	5.1	5.1	8.1	na
Exchange rate (annual average)	5.3	5.3	5.1	5.1	5.1	5.3	na
External sector	<i>(In millions of US dollars)</i>						
Current account	2,891.0	6,804.0	2,531.0	-1,617.0	-5,918.0	-12,933.0	-900.0
Trade balance	-269.0	3,741.0	-1,135.0	-5,194.0	-10,572.0	-16,934.0	-3,500.0
– Merchandise exports	23,739.0	33,432.0	35,024.0	38,949.0	49,840.0	67,717.0	39,000.0
– Merchandise imports	24,008.0	29,691.0	36,159.0	44,143.0	60,412.0	84,651.0	42,500.0
Foreign direct investment, net	1,411.0	1,711.0	7,533.0	5,737.0	9,218.0	9,683.0	4,000.0
Gross reserves, excluding gold (end-year)	6,731.0	9,302.0	19,413.0	22,300.0	31,972.0	31,543.0	na
External debt stock	23,811.0	30,647.0	39,619.0	54,512.0	82,189.0	101,654.0	na
Gross reserves, excluding gold (end-year)	<i>(In months of imports of goods and services)</i>						
	2.9	3.2	5.3	5.0	5.3	3.8	na
Debt service ⁴	<i>(In per cent of exports of goods and services)</i>						
	6.2	4.6	4.9	5.1	4.0	2.7	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million)	47.4	47.1	46.7	46.5	46.1	45.8	na
GDP (in billions of hryvnias)	267.3	345.1	441.5	544.2	720.7	949.9	920.0
GDP per capita (in US dollars)	1,057.3	1,376.4	1,843.7	2,317.1	3,094.6	3,930.8	na
Share of industry in GDP (in per cent)	27.2	25.8	27.2	27.6	27.5	27.3	na
Share of agriculture in GDP (in per cent)	10.9	10.8	9.2	7.5	6.6	6.8	na
Current account/GDP (in per cent)	5.8	10.5	2.9	-1.5	-4.1	-7.2	-0.8
External debt – reserves (in US\$ million)	17,080.0	21,345.0	20,206.0	32,212.0	50,217.0	70,111.0	na
External debt/GDP (in per cent)	47.5	47.3	46.0	50.6	57.6	56.4	na
External debt/exports of goods and services (in per cent)	82.2	77.2	89.3	108.5	128.4	118.7	na

¹ According to ILO methodology.

² IMF definition. General government includes the state, municipalities and extra-budgetary funds, and in 2009 Naftogaz and bank recapitalisation costs.

³ Weighted average over all maturities.

⁴ Refers to payments on official debt only.