UKRAINE

Highlights

- **Structural weaknesses weighed on economic growth even before Covid-19.** GDP declined by 1.3 per cent year-on-year in the first quarter of 2020 before plunging by 11.4 per cent year-on-year in the second quarter, as the pandemic took its toll on the economy.
- **A new International Monetary Fund (IMF) programme has been approved.** Approval of the 18-month, US$ 5.0 billion Stand-By Arrangement in June 2020 helped ease immediate funding pressures, and the implementation of certain prior conditions unleashed the necessary external financing.
- **Progress in energy sector reform has been mixed.** The long-awaited Naftogaz unbundling will improve Ukraine's energy resilience, but a forced retroactive reduction in feed-in tariffs for renewables could damage investor confidence.

Key priorities for 2021

- **Preserving the independence of the National Bank of Ukraine (NBU) is vital for macroeconomic stability and maintaining access to external funding.** Strategic and operational decisions undertaken by the NBU, as regulator of the financial system, need to be governed exclusively by sound principles of macroeconomic policymaking and supervisory prudence.
- **Progress is needed in key areas of governance.** While the authorities have successfully implemented legal changes in many areas over the past years, they should push forward with privatisation, judicial reform, public administration reform and digitalisation of public sector services.
- **The lack of meaningful progress in the fight against corruption needs to be addressed.** More than five years after the Revolution of Dignity, widespread corruption continues to be among the main impediments to doing business in Ukraine.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	2.4	2.5	3.4	3.2	-5.5
Inflation (average)	13.9	14.4	10.9	7.9	3.2
Government balance/GDP	-2.2	-2.2	-2.2	-2.0	-7.8
Current account balance/GDP	-2.0	-3.1	-4.9	-2.7	4.3
Net FDI/GDP [neg. sign = inflows]	-4.1	-3.3	-3.4	-3.4	1.2
External debt/GDP	120.5	102.9	87.6	79.2	n.a.
Gross reserves/GDP	16.6	16.8	15.9	16.5	n.a.
Credit to private sector/GDP	41.9	34.1	30.1	24.5	n.a.

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Covid-19: macroeconomic implications

The economy was already slowing before Covid-19 induced a recession. In 2019 GDP growth moderated to 3.2 per cent, due mainly to a disappointing fourth quarter as consumption and construction-led investments, the main drivers of the economy, slowed down. Since March 2020 the pandemic has been taking its full toll on the economy through a combination of reduced foreign demand and a drop in domestic demand because of the lockdown. These developments have further damaged the already-declining manufacturing sector and reversed the fortunes of most services sectors. GDP declined by 1.3 per cent year-on-year in the first quarter of 2020 and plummeted by 11.4 per cent year-on-year in the second. The decline in the second quarter was broad-based across all sectors of the economy, especially affecting hotels and restaurants (value added was down almost 60 per cent year-on-year), while in a number of services value added fell by more than 20 per cent. Investments also declined by more than 20 per cent year-on-year in the second quarter. Despite the challenging environment, a credible monetary policy has preserved macroeconomic stability. In June 2020 the central bank reduced the policy rate to a historical low at 6 per cent amid subdued inflationary pressures. The current account deficit turned into a huge surplus in the period January to September 2020, supported by a huge fall in the trade deficit and an increase in the primary income surplus.

A new IMF Stand-By Arrangement is helping to close the financing gap. Following the December 2019 staff-level agreement on a US$ 5.5 billion, three-year IMF Extended Fund Facility (EFF) programme, the Ukrainian parliament was dragging its feet in terms of fulfilling the main conditions for IMF Board approval, namely, the adoption of a new land law and a set of laws that would prevent the return of closed and nationalised banks to their previous owners. In the meantime, the Covid-19 crisis shifted the priorities and focus of the authorities towards mitigation measures for the economy. In this new environment, the government and the IMF agreed on an 18-month US$ 5.0 billion Stand-By Arrangement (SBA) as a better fit for the country's immediate needs. The IMF Board approved the SBA in June 2020 following adoption of the prior actions agreed during the negotiations on the previous arrangement. A tranche of US$ 2.1 billion was immediately disbursed, unlocking additional support from the World Bank and European Union, and enabling a successful Eurobond issuance. Total financing attracted in June to July 2020 amounted to nearly US$ 6.0 billion.

A moderate recovery in 2021 is likely but uncertainty remains high. We forecast that the economy would contract by 5.5 per cent in 2020, followed by a partial recovery of 3.0 per cent in 2021. Risks to the downside remain considerable, not only because of a possible resurgence of the pandemic but also because of uncertainty about policy and structural reform commitments. Achieving a stronger recovery and sustainable medium-term growth would require a reinvigorated reform agenda, particularly in the judiciary, implementation of the anti-corruption programme, fair competition and improvements in governance.

Policy response to Covid-19

The authorities have put in place a range of crisis-response measures. The size of the authorities' initial crisis package, introduced in April 2020, is estimated at 3.1 per cent of GDP. Fiscal and regulatory support to businesses is focused on temporary tax breaks, tax audit holidays, abolishment of penalties for certain tax wrongdoings, extension of deadlines and an increased threshold for the simplified taxation regime. The subsidised loan programme, credit guarantee scheme and social support programmes were expanded to make them more generous and accessible. The authorities boosted pensions for certain categories, and introduced a moratorium on penalties and disconnection of households who are behind in their utility payments. Temporary price controls and export bans on particular food products, medicine and other medical equipment were introduced at the onset of the pandemic. Additional support for households and businesses has been offered to counteract the direct consequences of the lockdown, such as forgiveness of penalties related to delays in loan repayments. To support banks and ensure liquidity in the system, the NBU introduced a long-term refinancing facility, relaxed liquidity and reserves requirements and expanded the list of collateral for emergency lending.

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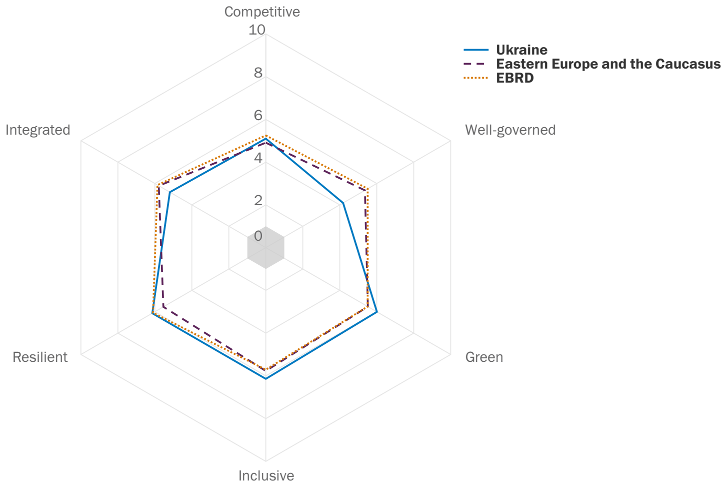
Assessment of transition qualities (1-10)



Structural reform developments

The bank resolution mechanism was significantly strengthened. A number of legal amendments, adopted by parliament in May 2020, aim to address regulatory gaps found during the banking sector clean-up in recent years and to ring-fence the decisions taken by the regulator. The law guarantees irreversibility of bank resolution as decided by the NBU by preventing the court from challenging the liquidation procedure, sale of assets and settlements with the bank's creditors. Further, it changes the procedure for courts to contest decisions by the regulators, namely the NBU, the cabinet of ministers and the Deposit Guarantee Fund, as it restricts the possibility of questioning their technical expertise and judgements. In cases where compensation to the previous owners is warranted, the law stipulates the exact conditions, processes and type of compensation, with the key role given to internationally acknowledged audit firms as unbiased experts. The reform also strengthens the early intervention framework and entry into resolution, and sets clear guidelines for potential nationalisation.

Reforms in the gas sector have advanced, but there were reform reversals in the renewables sector. At the end of 2019 gas production operations of the national oil and gas company, Naftogaz, were separated from gas transmission. The latter was moved to a new state-owned independent pipeline operator. The creation of an independent gas transmission system operator enabled the signing of a new five-year transit contract with Gazprom Russia at the end of 2019. The legislation pertaining to Naftogaz's unbundling was reviewed by the Energy Community and is deemed in line with Ukraine's obligations under the European Third Energy Package. After household gas prices were liberalised in January 2019 and the Public Service Obligation Order for the supply of gas to households was terminated in July 2020, household gas prices are now fully market-determined. However, long negotiations between the government, private sector and international development partners on restructuring the feed-in tariff mechanism for renewables in Ukraine did not lead to a consensus. In July 2020 parliament approved the reduction in the feed-in tariffs, thus changing the framework conditions for investing in renewables. While the main motivation was to decrease the burden on the state's finances, the forced retroactive changes will impair the investors' legitimate interests and may lead to litigation, with potentially serious future fiscal implications.

The longstanding moratorium on the sale of agricultural land was lifted, albeit with limitations. In March 2020 parliament adopted a new law on the market circulation of agricultural land, which comes into effect in July 2021. A large number of limitations in the legislation put a tight cap on the productivity gains expected to be realised. In particular, the embargo on the participation of foreign persons and entities remains in place and can be lifted only on approval by a national

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referendum. The sale of state land also continues to be banned. Among other notable limitations, the law imposes an upper limit on the amount of agricultural land that can be owned by a citizen or legal entity, with the latter being able to make purchases from 2024.

Parliament re-criminalised illicit enrichment. The law on the prevention and punishment of revenues embezzled by public servants was originally approved in 2015 before it was overturned by a controversial Constitutional Court ruling in February 2019. Approved in November 2019, the current bill envisages filing criminal charges if public officials' assets, as stated in the asset declaration, exceed their official income by a certain amount. However, in October 2020 the Constitutional Court undermined the fundamentals of the anti-corruption reform by overturning the system of electronic declaration of assets and income of state officials and decriminalising the act of knowingly submitting fraudulent declarations.

A new law on concessions sets up a clear legal framework for this form of public-private partnership. Adopted and effective in the last quarter of 2019, the law replaces previous outdated regulations. A clear regulatory framework for concession activities is conducive to attracting investment and upgrading infrastructure. In June and August 2020, the new framework was successfully implemented in the selection and contraction of concessioners of two Black Sea ports.

New wage caps in state-owned institutions may hinder future governance improvements. In April 2020 the authorities introduced a cap on salaries of all public employees as well as top management and supervisory board members of state-owned enterprises (SOEs) and state-owned banks (SOBs) to match more closely average salaries in the country. The cap was introduced as a temporary emergency measure and it was removed for judges, prosecutors, members of parliament and members of the board of the National Bank of Ukraine in August 2020, and for the managers of state banks in September 2020. However, it stays in place for the board members of SOEs and SOBs, thus risking having a long-term detrimental effect on the ability to attract and retain leaders of appropriate quality and experience at institutions of systemic importance for the country.