



- *The economy contracted by almost 10 percent in 2015 due to unprecedented shocks from the conflict in the East and lower global commodity prices, as well as considerable fiscal and external adjustment. Initial signs of stabilization emerged in the fourth quarter.*
- *A gradual economic recovery by 1 percent in 2016 and 2 percent in 2017 is projected, contingent on reform progress and no further escalation of the conflict. Reforms on multiple fronts are crucial to achieve sustainable recovery and growth. The current political uncertainty poses a serious risk to continued reforms and economic recovery in Ukraine.*
- *The general government deficit, including Naftogaz, was reduced to 2 percent of GDP in 2015; however, the fiscal outlook remains challenging.*
- *Poverty is estimated to have increased in 2015 and is projected to remain elevated through 2018 in light of the gradual recovery of economic activity, real wages, and jobs.*

Recent Economic Developments

After a sharp contraction in economic activity through the first three quarters of 2015, initial signs of stabilization emerged in the fourth quarter. Real GDP contracted by 9.9 percent in 2015 overall. The conflict has led to widespread disruption in supply and distribution chains and undermined confidence, while the drop in global commodity prices has led to a serious deterioration of Ukraine's terms of trade. Considerable fiscal and external adjustment in response to the shocks have further compressed domestic demand. While the external economic environment remains difficult, the conflict in the east has de-escalated since September 2015 and macroeconomic and structural reforms have begun to stabilize confidence. As a result, real GDP contracted more modestly by 1.4 percent y/y in the fourth quarter of 2015, compared to 7.2 percent y/y in the third quarter and 16 percent y/y in the first half of 2015. Industrial production declined by a more modest 5 percent in the fourth quarter and rebounded 7.6 percent in February 2016. While Donetsk and Luhansk led the contraction in industrial output (by 35 percent and 65 percent, respectively) in 2015 overall, recent improvements in other regions have driven the stabilization, with industrial production in Dnipropetrovsk and Zaporizhzhya regions and Kyiv City up 3.7 percent, 7.4 percent, and 26.2 percent, respectively, in December 2015. Inflation remained high at 43.3 percent y/y in December 2015 due to currency depreciation and utility tariff hikes, but abated from a peak of 61 percent in April.

Poverty is estimated to have increased in 2015. Disposable incomes have contracted significantly from the deep recession, with both labor and non-labor incomes contracting in 2015 in real terms. As a result, the poverty rate (under \$5/day in 2005 PPP) is estimated to have increased from 3.3 percent in 2014 to 5.8 percent in 2015, while moderate poverty (WB national methodology for Ukraine) is estimated to have increased from 15.2 percent in 2014 to 22.2 percent in 2015. Labor market conditions worsened, with real wages down by 13 percent y/y in December 2015 and unemployment remaining elevated at 9.5 percent at end 2015. Poor households were affected by the increase in energy prices in 2015, with the new means-tested housing utility subsidy program partly mitigating the impact.

The authorities adopted decisive policies to reduce fiscal and external imbalances. Despite revenue losses from Donetsk and Luhansk, the headline fiscal deficit was reduced to 1.1 percent of GDP in 2015 from 4.5 percent in 2014, due to tight controls on spending and higher inflation. In addition, the Naftogaz deficit was reduced to 0.9 percent of GDP in 2015 from 5.6 percent in 2014 on the back of tariff increases and lower prices of imported gas. In November 2015, Ukraine successfully restructured about \$19 billion of its public external debt. As a result of these developments, public and publicly guaranteed debt stabilized at 82 percent of GDP in 2015, up from 70 percent in 2014. In parallel, currency depreciation, recession, and administrative controls compressed imports and narrowed the current account deficit to 0.2 percent of GDP in 2015 from 3.5 percent in 2014. Official financing amounted to \$8.5 billion in 2015 and helped support private debt repayments and an increase in international reserves to \$13.3 billion at end-2015, equivalent to 3.5 months of imports.

FIGURE 1: GDP Growth, y/y, 2012-2015

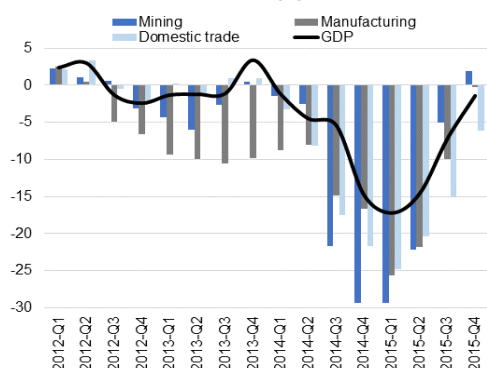


FIGURE 2: Poverty Rates

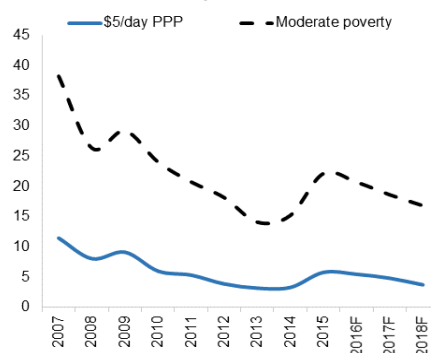
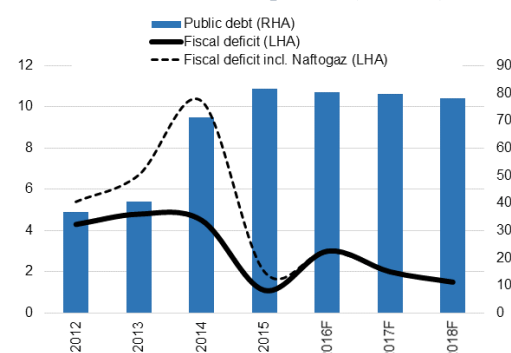


FIGURE 3: Fiscal developments (% GDP)



Outlook

Prospects for economic recovery remain uncertain and depend on how the conflict in the East unfolds and whether reforms on multiple fronts can be advanced in an uncertain political environment. If the conflict does not escalate further and progress is made on reforms, a gradual economic recovery is expected, with growth of 1 percent in 2016 and 2 percent in 2017. The real depreciation coupled with efforts to tap the EU market are expected to support exports and tradable sectors. Furthermore, improved expenditure efficiency should create fiscal space to unlock public investment. Continued banking sector reforms should also permit a gradual resumption of lending. In the medium term, growth could pick up to 3-4 percent. The outlook is subject to serious risks, including an escalation of the conflict, further deterioration in the external environment, and difficulty to advance reforms in the face of political instability. The current political uncertainty poses a serious risk to derailing Ukraine's reforms and economic recovery.

The fiscal outlook remains challenging and has been shaped further by the recent cut in the social security contribution rate. The fiscal framework actually projects an increase in the fiscal deficit to 3 percent of GDP in 2016 (because of lower NBU profit transfers). Meeting this deficit target will prove challenging, particularly in light of the payroll tax rate cut from 40 to 22 percent in 2016. The authorities anticipate that cutting tax rates would shrink the informal economy and improve compliance. However, estimates suggest that short term revenue losses could amount to 3 percent of GDP, which would require challenging compensatory measures to broaden the tax base, strengthen tax administration, and rationalize current expenditures (including pensions and the large public sector footprint). If these challenging measures are successful, the fiscal deficit is projected to narrow further to 2 percent of GDP by 2018.

In line with the projected gradual economic recovery, poverty is expected to decline gradually in 2016-2018, although remaining above the level in 2014. Fiscal consolidation will require restraint on growth of public-sector wages, pensions, and other social programs, as well as further energy tariff increases, which will affect household purchasing power across the income distribution. Improving targeting of social transfers can help support incomes of the poor and bottom 40 percent.

Despite the narrowing of the current account deficit and restructuring of debt, external vulnerabilities are expected to persist. Ukraine will require significant external financing to meet repayments on external debt of banks and corporates amounting about \$9 billion per year during 2016-2018. Further cooperation with the IMF and other official creditors will be important to meet external financing needs, rebuild international reserves, and restore the investor confidence.

Ukraine will need to advance reforms on multiple fronts to achieve sustainable recovery and shared prosperity going forward. First, in light of the difficult external environment and persisting vulnerabilities, safeguarding macroeconomic stability will be critical. This will require reforms to continue fiscal consolidation and strengthen the financial sector, while maintaining a flexible exchange rate. Second, Ukraine will need to improve productivity and create jobs by investing in infrastructure, improving the business climate, and taking advantage of trade opportunities. Third, Ukraine will need to provide smarter and more effective services to the population to ensure that the benefits of recovery are broadly shared. Intensifying anti-corruption and governance reforms to reduce the influence of vested interests will prove important across the board.

Key Macroeconomic Indicators	(in % of GDP unless indicated otherwise)								
	2010	2011	2012	2013	2014	2015	2016F	2017F	2018F
Nominal GDP, <i>UAH billion</i>	1082.6	1300	1405	1465	1587	1980	2279	2557	2845
Real GDP, <i>% change</i>	4.1	5.5	0.2	0.0	-6.6	-9.9	1.0	2.0	3.0
Consumption, <i>% change</i>	6.4	11.3	7.4	5.2	-6.2	-15.8	-1.3	1.1	2.9
Fixed investment, <i>% change</i>	3.9	8.5	5.0	-8.4	-24.0	-9.3	9.5	10.5	5.6
Export, <i>% change</i>	3.9	2.7	-5.6	-8.1	-14.2	-16.9	2.2	5.0	4.0
Import, <i>% change</i>	11.3	15.4	3.8	-3.5	-22.1	-22.0	0.6	2.3	4.6
GDP deflator, <i>% change</i>	13.8	14.3	8.1	3.1	14.8	38.4	14.0	10.0	8.0
CPI, <i>% change eop</i>	9.1	4.6	-0.2	0.5	24.9	43.3	15.0	11.0	9.0
Current account balance	-2.2	-6.3	-8.2	-9.2	-3.5	-0.2	-1.3	-0.6	-1.0
External debt	85.0	77.6	76.6	78.6	97.6	131.5	128.9	121.6	110.9
Budget revenues	43.3	42.9	44.5	43.6	40.8	42.1	39.2	40.0	40.2
Budget expenditures	49.0	45.7	48.9	48.4	45.4	43.2	42.2	42.0	41.7
Fiscal balance	-5.8	-2.8	-4.4	-4.8	-4.5	-1.1	-3.0	-2.0	-1.5
Consolidated deficit, including Nagtogaz		-4.4	-5.5	-6.7	-10.1	-2.0	-3.0	-2.0	-1.5
Public and guaranteed debt	40.5	36.3	36.6	40.6	70.3	81.6	80.4	79.8	78.2

Source: Ukrainian authorities, World Bank projections

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