Ukraine:
Economic Situation
And Prospects

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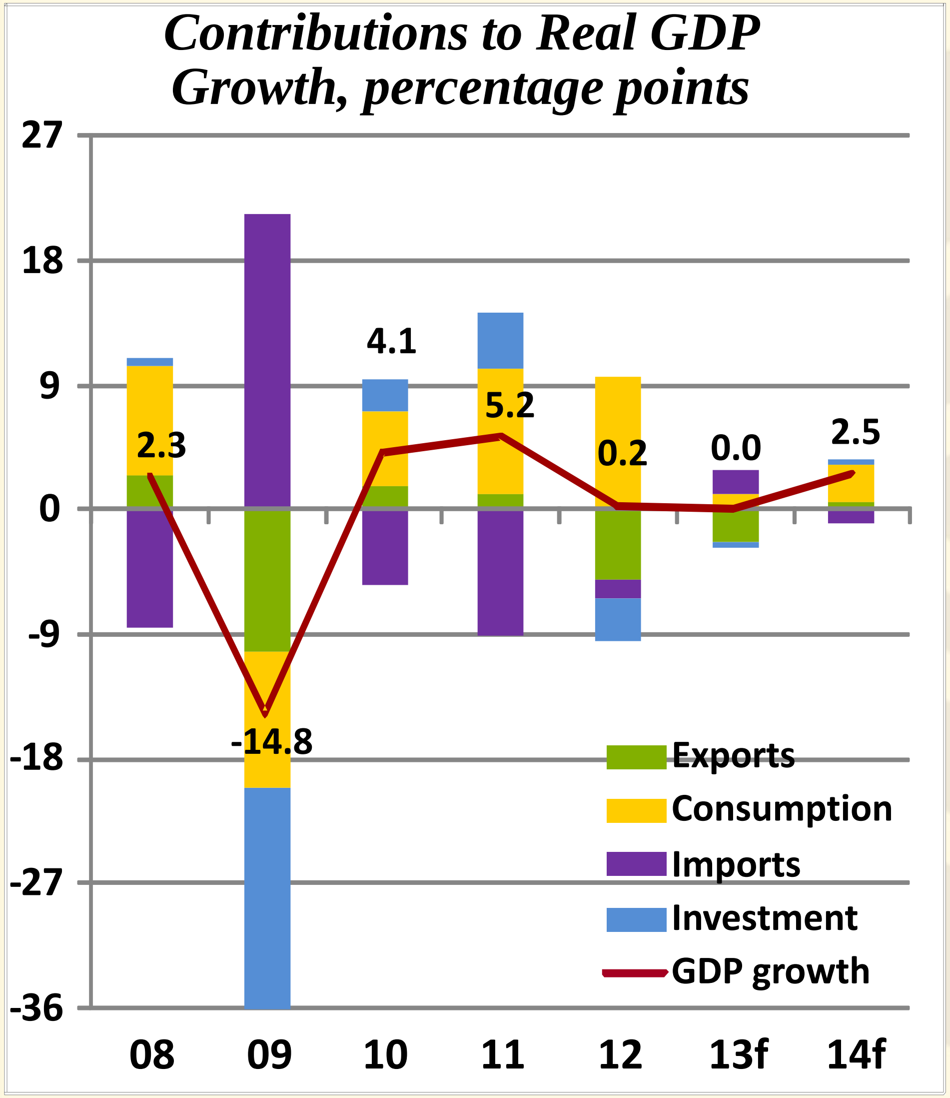
Main Macroeconomic Indicators

	2009	2010	2011	2012	2013f	2014f
Real GDP Growth, % yoy	-14.8	4.1	5.2	0.2	0.0	2.5
Fiscal Balance*, % GDP	-8.5	-6.7	-4.3	-6.4	-6.0	-3.5
Consumer Inflation, %, eop	12.3	9.1	4.6	-0.2	1.0	7.0
UAH/$ Exchange Rate, eop	8.0	8.0	8.0	8.0	8.3	8.5
Current Account, % GDP	-1.4	-2.2	-6.3	-8.1	-8.2	-7.5
Gross Int. Reserves, $ bn	26.5	34.5	31.8	24.5	19.0	22.0
Foreign Public Debt, % GDP	20.5	23.8	20.4	18.3	16.5	17.1
Foreign Private Debt, % GDP	67.7	62.2	56.8	58.3	57.3	57.0

•*Includes implicit pension fund deficit (credits from Single Treasury Account (state budget) to cover pension fund expenditures) and Naftogaz imbalances*

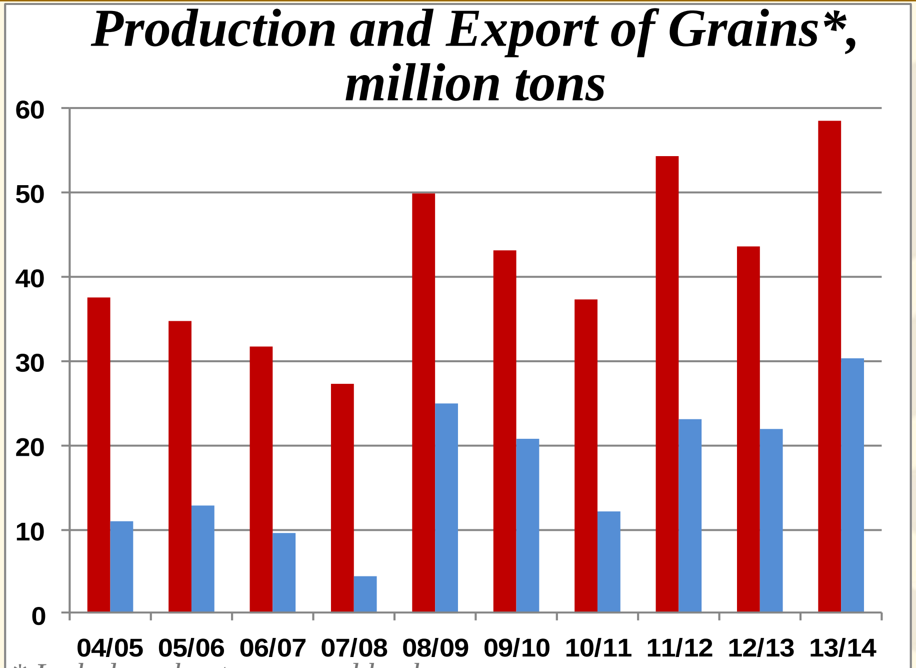
•*Source: NBU, SSC, MinFin, The Bleyzer Foundation*

Real GDP Growth by Expenditures

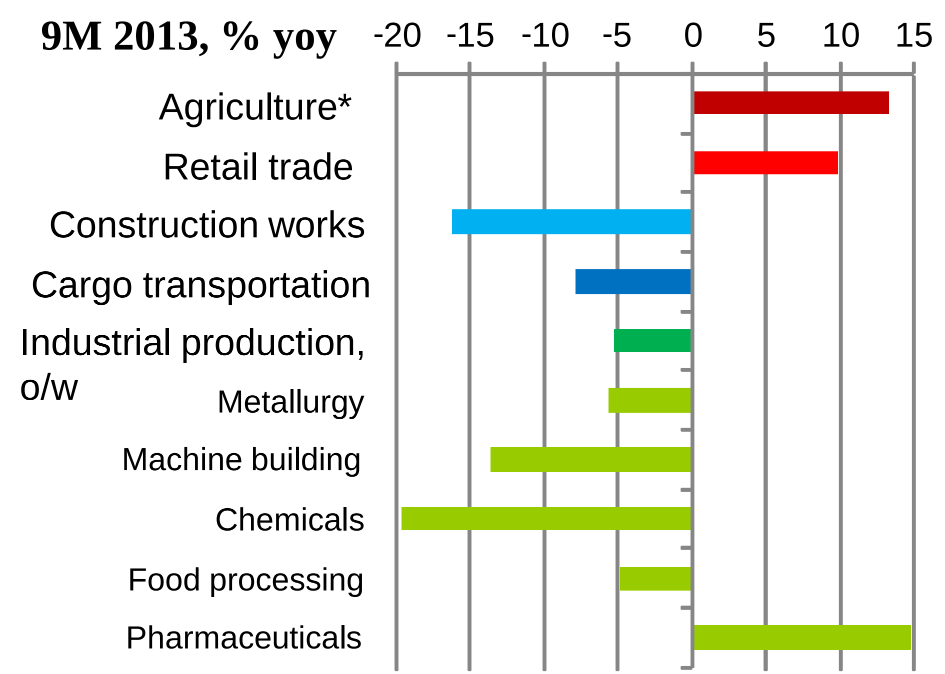


- In Jan-Sep. 2013, real GDP declined by 1.3% yoy, due to the slow pace of the global recovery, soft commodity prices and trade tensions with Russia all of which hindered exports, which represent 50% of GDP.
- Investments also declined due to tight credit and strained public finances.
- But thanks to gains in agriculture, solid growth in private consumption, monetary policy easing and improvements in business environment, growth is expected to resume in 4Q 2013.
- In 2014, GDP may grow by 2.5% yoy, if the present constraints are removed.

Sectoral Output



* Includes wheat, corn and barley
Source: USDA



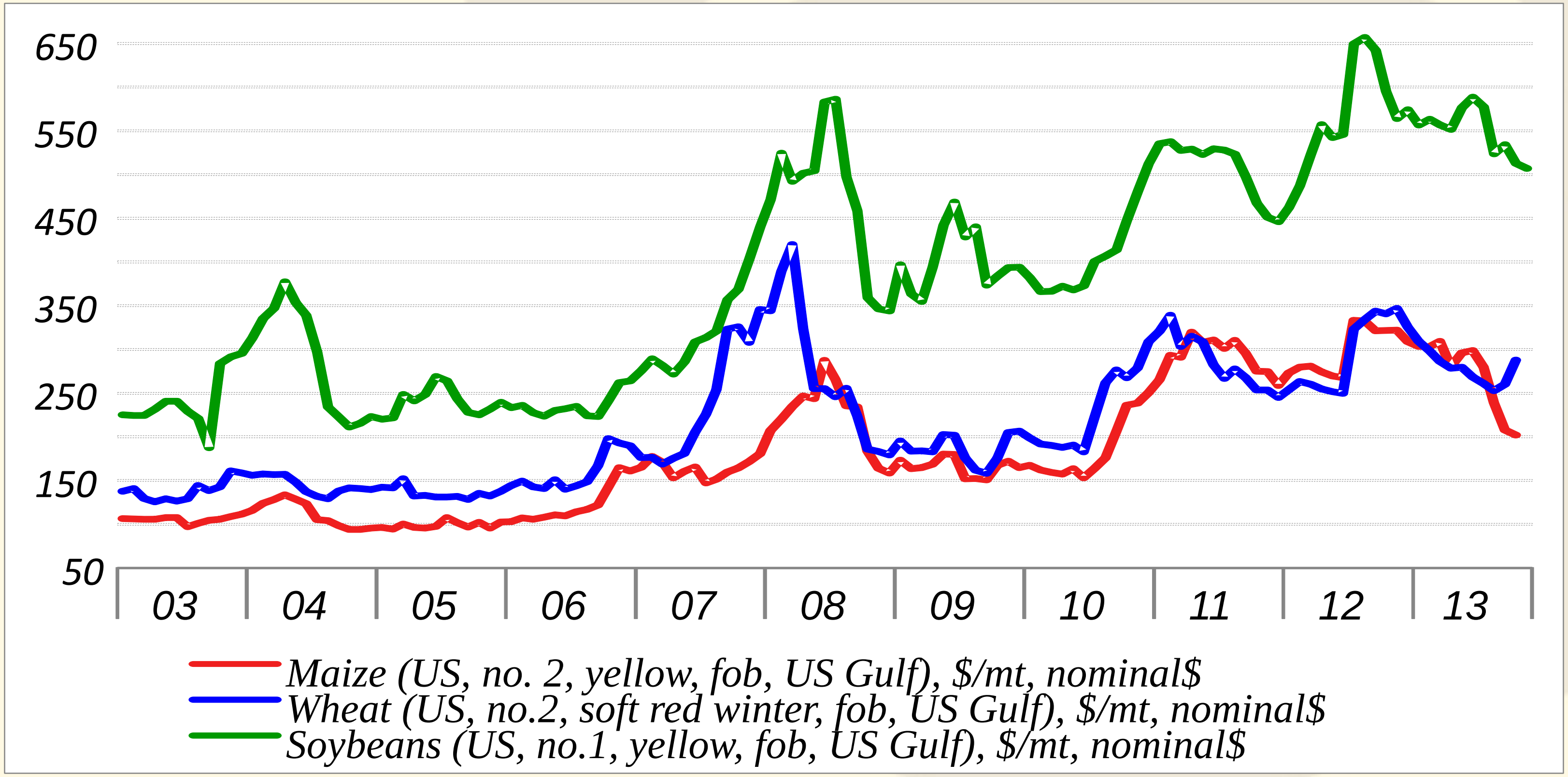
* For Jan-Aug 2013
Source: SSS of Ukraine

- Ukraine is forecast to collect a record 60 million tons of grains in 2013.
- Over the last six years, grain production has fluctuated by record highs have been reached every two years.
- Agriculture value-added is forecast to increase by about 8% yoy in 2013. Coupled with steady growth in retail trade, it may offset the declines in industry, construction and transportation services.

Agricultural Prices

However, the gains in agricultural output have been offset to some extent by recent declines in international and local gain prices, shown below:

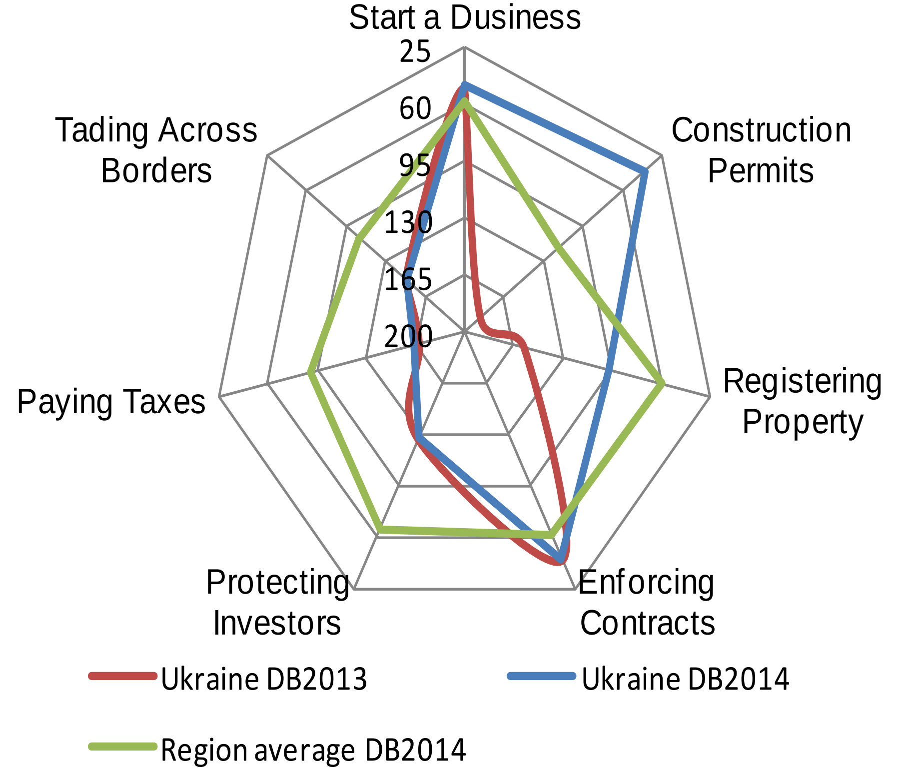
Grain Price Evolution over the Last 10 Years



Source: WB GEM Commodities, FAO

Business Climate

Select Doing Business Indicators

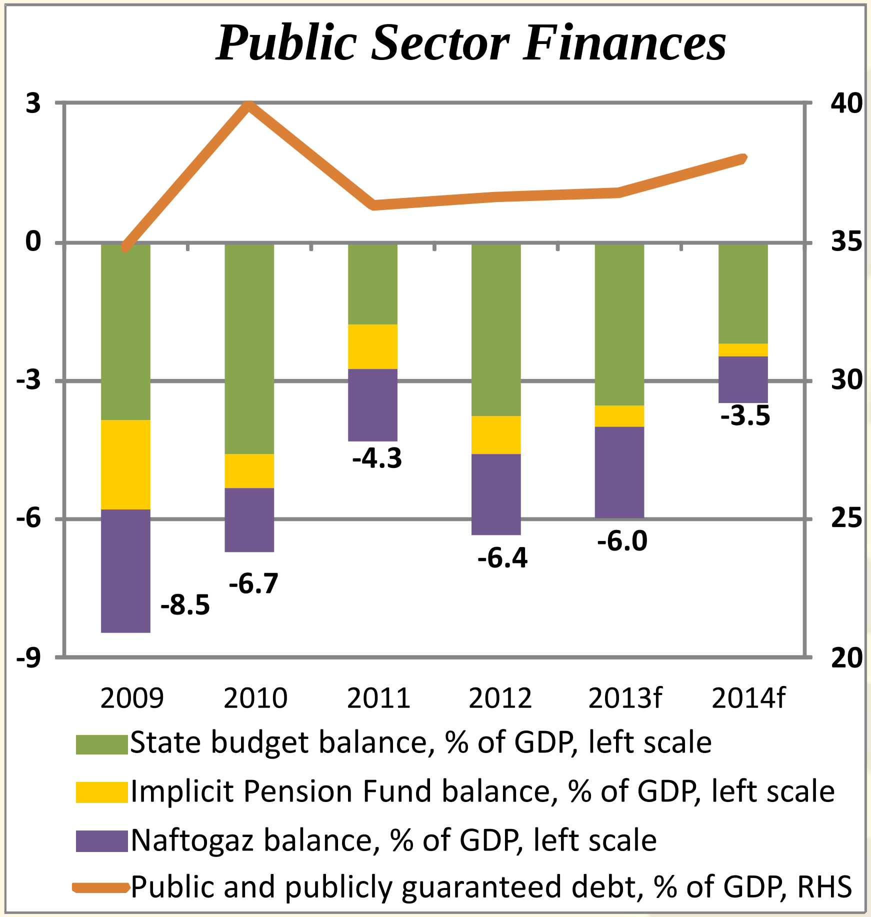


Source: WB Doing Business 2014

- Ukraine achieved progress in simplifying procedures for doing business.
- According to WB 2014 report, Ukraine moved upwards by 28 positions thanks to
  - Simplifying procedures to get construction permits (up 145 points);
  - Easing registering property procedures (up 61 points);
  - Reducing cost and simplifying requirements for starting a business (up 3 points).
- But the room for improvement remains high as there little progress in corruption control, protecting investors, paying taxes, and trading across borders.

- Although uncertainties remain, a possible FTA and Association Agreement with the EU may become an anchor for institutional development and economic reforms in Ukraine.
- These gains, however, are overshadowed by a number of short-term challenges in public finances, external debt payments and current account deficits.

Challenge 1: Stained Public Finances



Source: MinFin, The Bleyzer Foundation

- Due to low nominal GDP growth, budget revenue target for 2013 will not be met.
- Expenditures kept growing rapidly due to high growth in social spending (up by 19.3% yoy over Jan-Sep 2013) and continuation of natural gas subsidies.
- As a result, public sector deficit is forecast to narrow only marginally to 6% of GDP in 2013.
- Public-debt-to-GDP ratio seems stabile at around 37% of GDP over the last three years and compares favorably with many developed and emerging markets.

- However, debt structure (with large portion of debt in foreign currency and at short maturities) makes the country vulnerable to a change in investors' sentiments and foreign capital market conditions.

Challenge 2: External Debt Repayments

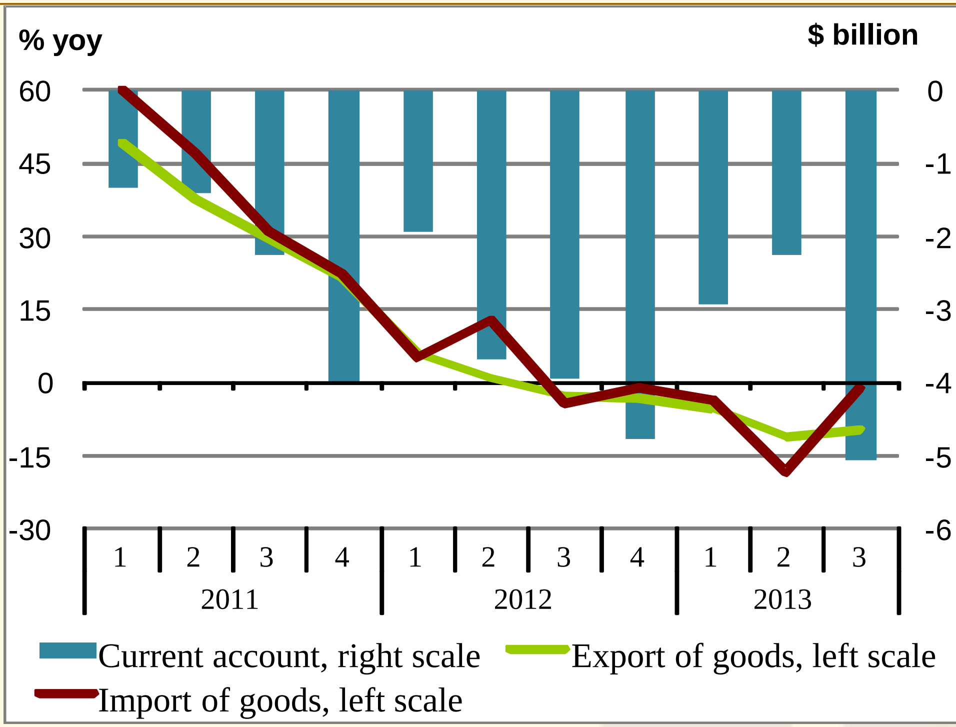
Source: DBReseach

External Debt Financing Needs, $ billion	2013		2014(f)
	Jan-Sep	4Q (e)	
Public and Quasi-government Debt, o/w	***6.4***	***2.1***	***7.5***
IMF	4.0	1.6	3.7
Sovereign Eurobonds	1.0		1.0
Foreign Currency Domestic Bonds	1.4	0.5	0.8
Naftogaz Eurobonds			1.6
Banking Sector	***13.5***		***12.0***
Private Sector	***43.5***		***40.0***
Total	**65.5**		**59.5**

Source: NBU, MInFin, The Bleyzer Foundation

- Ukraine's government is not excessively indebted: External public debt accounts for ~16.5% of GDP in 2013.
- External private debt (banks and corporates) is more substantial, ~57% of GDP.
- However, a large portion of these debt is short-term.
- Ukraine rolled over its debt rather comfortably in 1H 2013.
- But the country ability to secure sufficient external funds weakened since June 2013 amid capital outflow from emerging markets and investors' growing concerns over sustainability of domestic policies.

Challenge 3: Wide Current Account Deficit



- Exports were weak in 2013 due to slow global recovery, soft world commodity prices and increased trade tensions with Russia.
- Robust consumption led to a more moderate reduction in imports than expected, despite reductions in energy imports.
- Current account deficit is forecast to stay high at 8.2% of GDP in 2013.
- Russia highly opposes Ukraine's signing of the Agreement with the EU.
- Strict restrictions, if imposed by Russia, may cost Ukraine $5-7 billion.

Current Developments and Government Response

- A combination of these vulnerabilities (strained public finances, high external debt financing needs and wide current account deficit) adversely affected foreign investors' sentiments towards Ukraine and intensified Hryvnia depreciation pressures in the fall 2013.
- As NBU continued supporting de-facto Hryvnia peg to US Dollar, gross international reserves fell to $20.6 billion as of end-October, below 3 months of imports.
- Reflecting rising vulnerabilities, Ukraine's sovereign ratings were downgraded, which further narrowed ability to raise foreign financing on international markets.
- At the beginning of November, top Ukrainian government officials made principal decisions, which should speed up negotiations on a new IMF loan:
    - Natural gas tariffs will be raised by 60% to select households
    - A program to stabilize public finances will be developed (including revisions of tax privileges and social benefits systems, a reduction of expenditures on public administration, etc.)
    - Hryvnia fluctuation band will be widened to UAH 8.5 per US Dollar.

Summary

- Due to unfavorable external environment and weak bank lending activity, Ukraine's real GDP growth is forecast at 0% yoy in 2013.
- Facing a combination of wide fiscal and current account deficits and high external deficit financing needs, the country is vulnerable to adverse shocks.
- Recent government decisions should speed up negotiations on a new $15 billion IMF loan.
- With the IMF program in place, Ukraine's external liquidity and fiscal challenges will be reduced, bringing the country onto a more sustainable path of growth.
- Our baseline scenario also assumes that to the impact of Russia's restrictions on Ukraine's trade are partially covered by compensatory measures from the EU.
- Benefiting from stronger global recovery and loose domestic monetary conditions, Ukraine is forecast to grow by 2.5% yoy in 2014.
- Under the IMF program, fiscal deficit will be reduced to 3.5% of GDP in 2014.
- Although inflation is likely to accelerate, it will remain single digit of ~7% yoy.
- Exchange rate should stabilize at around UAH 8.5 per USD during 2014.