The Impact of the Global Liquidity Crisis on Ukraine and the Road to Recovery

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Macroeconomic Performance

From 2000 to Sept. 2008, Ukraine enjoyed excellent economic results.

	2000-07 average		2008	2009 (f)	2010 (f)
Real GDP Growth, % yoy	7.5		2.1	-14	3
Fiscal Balance, % GDP	-0.8		-1.5	-8	-8
Consumer Inflation, %, eop	11.3		22.3	13	12-15
UAH/$ Exchange Rate, eop	5.2		7.7	8 ± 0.2	8 - 10
Current Account, % GDP	2000-05 5.7	2006-07 -2.6	-7.1	-1	0.5
Gross Int. Reserves, $ bn	2000 1.5	2007 32.5	31.5	27	25
Foreign Gov't Debt, % GDP	2003 21.3	2007 8.7	9.2	22	24

The International Liquidity Crisis Hit Ukraine Hard

- PFTS stock index: **-74%** (2008)
- UAH/$ Exchange Rate: Depreciated by **58%** (4Q 2008)
- Drop in GDP: **-18%** yoy (1Q-3Q 2009)
- Export of goods: **- 46%** yoy (Jan-Oct 2009)
- Industrial production: **-26%** yoy (Jan-Oct 2009)
- Unemployment: **9%** (1H 2009; 6% in2008)
- Real households' income:**-10%** yoy (1H 2009)

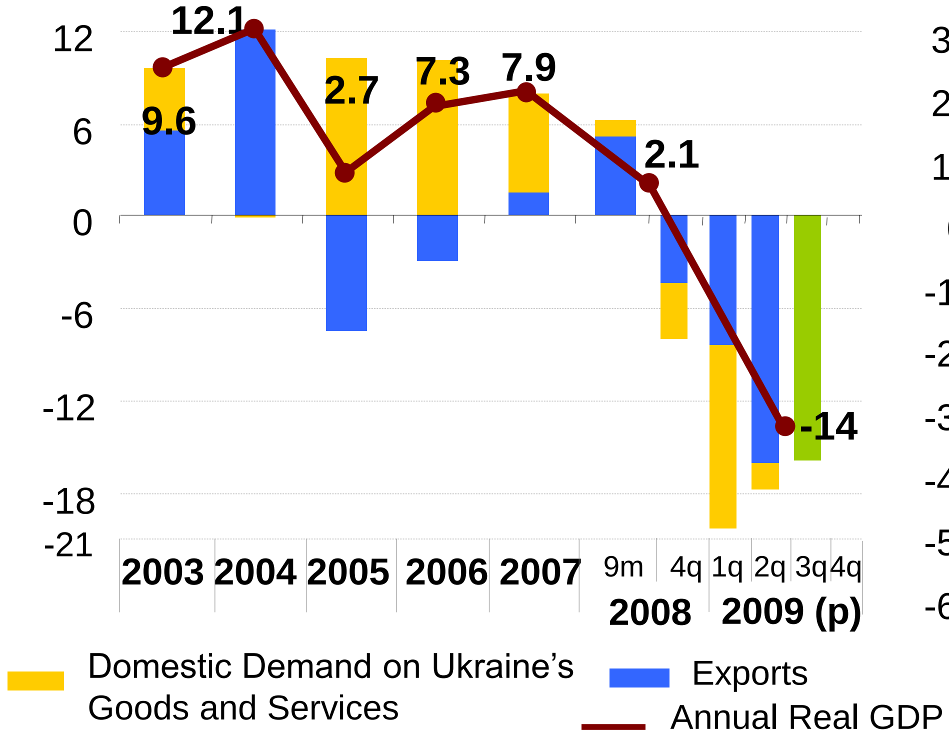
The Crisis Affected Ukraine Harder

Country	GDP, % yoy, average for the period		Local Currency Depreciation vs.		
			US Dollar	EURO	period
Ukraine	**-18.0**	(9M 2009)	**58 %**	**55%**	**(4Q 2008)**
Latvia	-18.4	(9M 2009)	7 %	- (peg)	(1Q 2009)
Lithuania	-16.0	(9M 2009)	7 %	- (peg)	(1Q 2009)
Estonia	-15.5	(9M 2009)	7 %	- (peg)	(1Q 2009)
Russia	-9.5	(9M 2009)	35 %	24%	(Oct.08-Mar.09)
Mexico	-9.3	(1H 2009)	26 %	23%	(4Q 2008)
Romania	-7.5	(1H 2009)	23 %	13%	(Oct.08-Mar.09)
Hungary	-6.7	(9M 2009)	38 %	27%	(Oct.08-Mar.09)
Taiwan	-6.3	(9M 2009)	4 %	-3%	(1Q 2009)

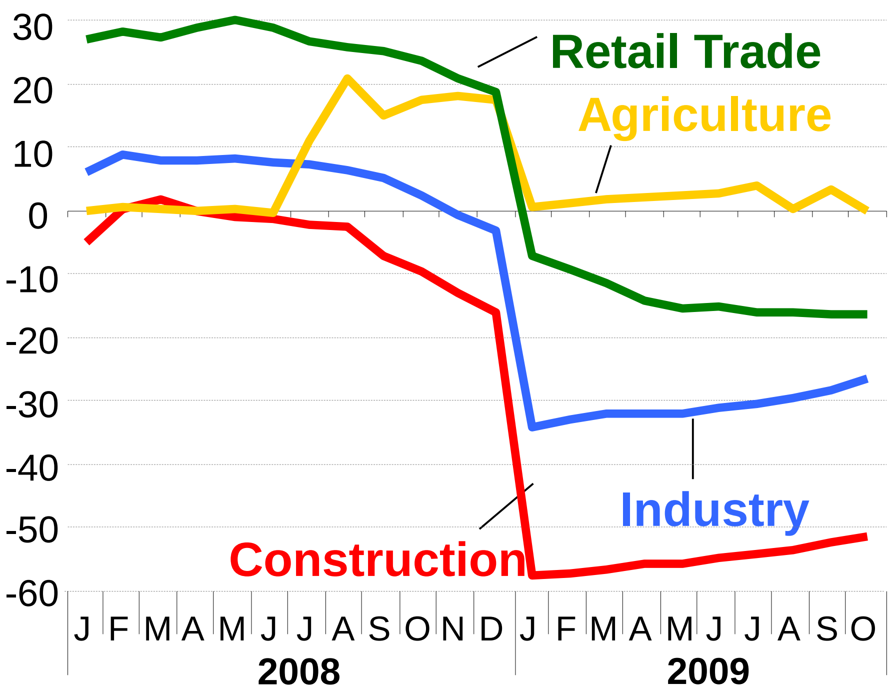
Source: The Economist, Central banks of the respective countries, The Bleyzer Foundation

Real Sector Performance in 2009

GDP Growth, % yoy, and Main Contributors to Rates of Growth



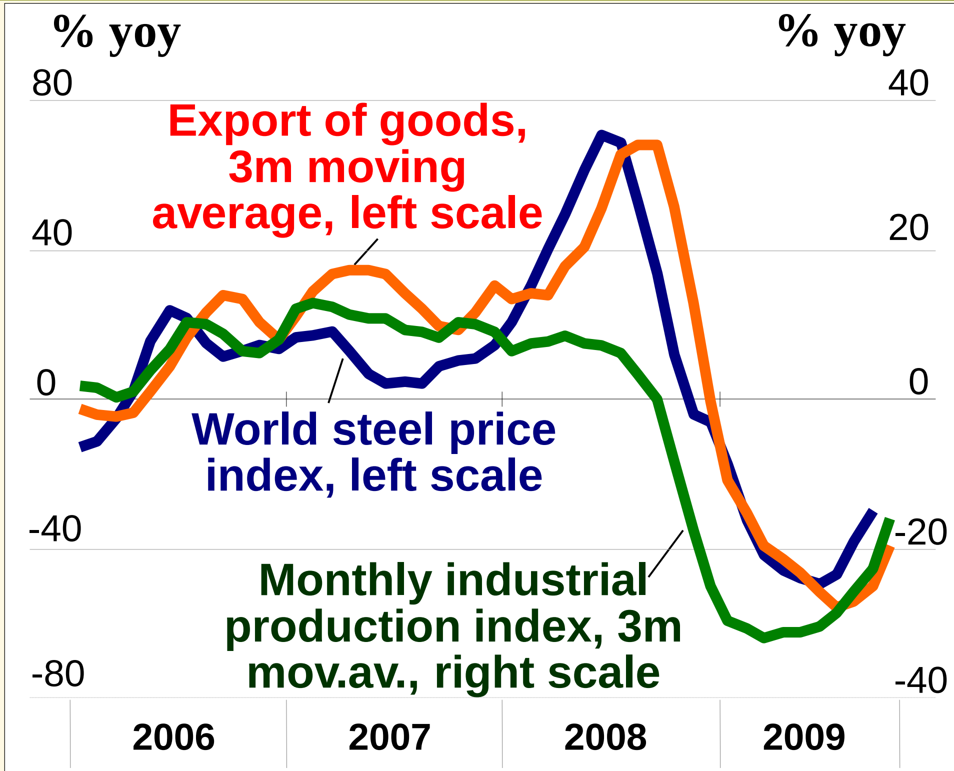
Sectors' Performance, Cumulative Rates of Growth, % yoy

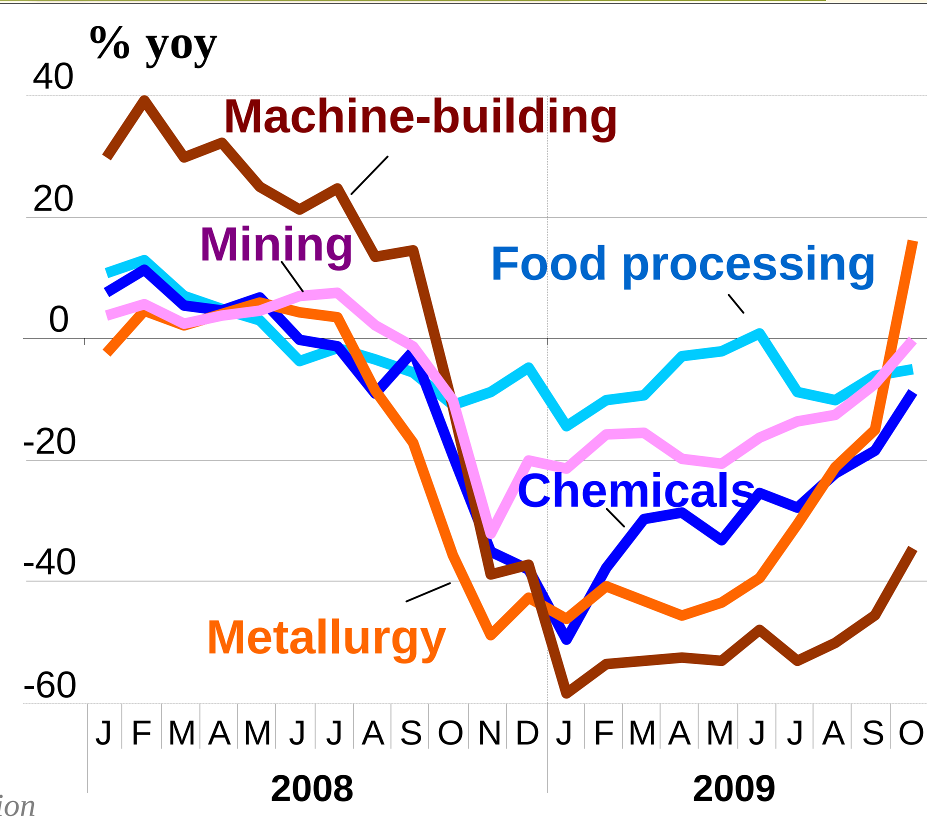


Source: State Statistics Committee, The Bleyzer Foundation

- Real GDP fell by 19% yoy in 1H 2009.
- Major declines in export-oriented industries and credit-dependent sectors (construction, machine-building).

Exports and Industry Performance

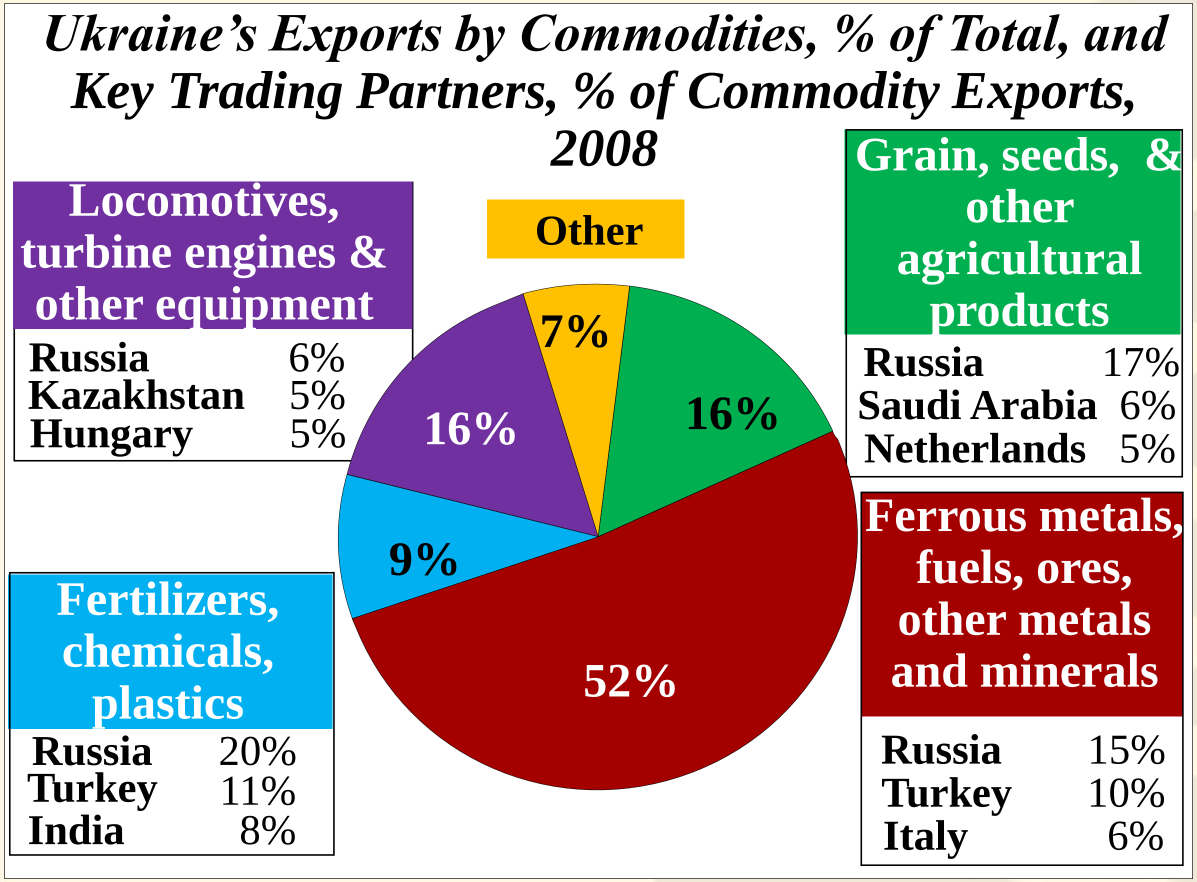




Source: *State Statistics Committee, NBU, MEPS, The Bleyzer Foundation*

- World commodity prices fell sharply from Aug2008 to mid-2009.
- Ukraine’s exports of goods dropped by 46% yoy (Jan-Oct 2009).
- Industrial production declined by 30% yoy (Jan-Oct 2009).

Why Ukraine Was Affected More Severely?



Source: UN Comtrade, The Bleyzer Foundation

1. Open but undiversified economy:
   - 50% export share in GDP
   - Metals, Minerals and Chemicals account for ~ 60% of exports
   - Narrow geographic export diversification, with EU-27 share during 2003-2009 declining from 38% to 26%; while CIS share increasing from 25% to 35%.

- This lack of diversification is due to lack of past economic reforms.

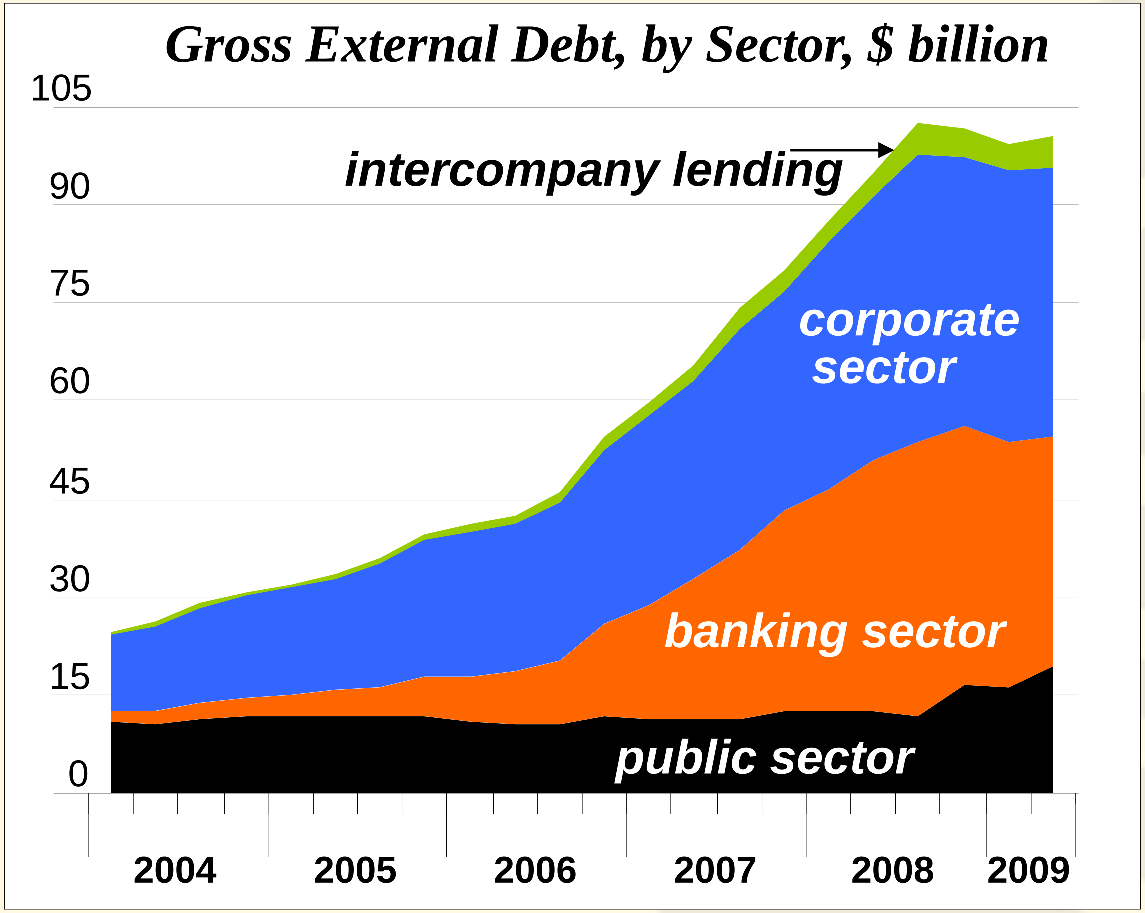
2. A second reason for the severity of the crisis was the combination of three vulnerabilities, as explained below.

Vulnerability # 1 – Large Current Account Deficits

- Over 2003-2008:
  - Exports grew by 25% pa
  - But imports – by 30% pa
  - CA deficits emerged in 2006 and widened to 7% of GDP in 2008
- 2009 forecast before the crisis: CA deficit - $ 24 billion, or 13% GDP.
- Uncertain foreign financing of the CA put pressures on the Hryvnia.

Source: NBU, SSC, The Bleyzer Foundation

Vulnerability # 2 – Large External Debt Repayments

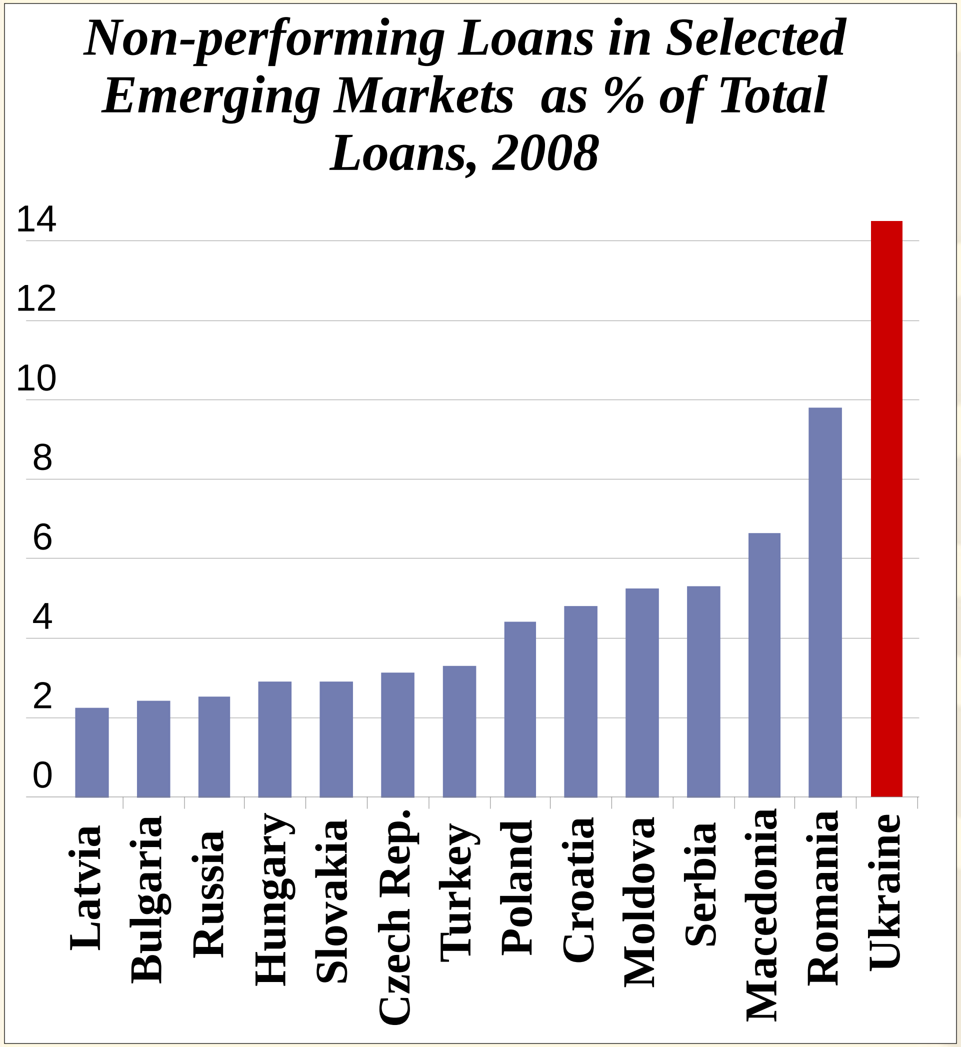


Source: NBU, The Bleyzer Foundation

- External private debt tripled in three years (2006-08)…
- …mainly to finance consumption and investments.
- As of mid-2008, ~ $40 billion of debts was due to repay in <1 year.
- International reserves stood at $35 billion.

- Debt rollover became very difficult during the initial stages of international liquidity crisis, exerting pressures on the Hryvnia.

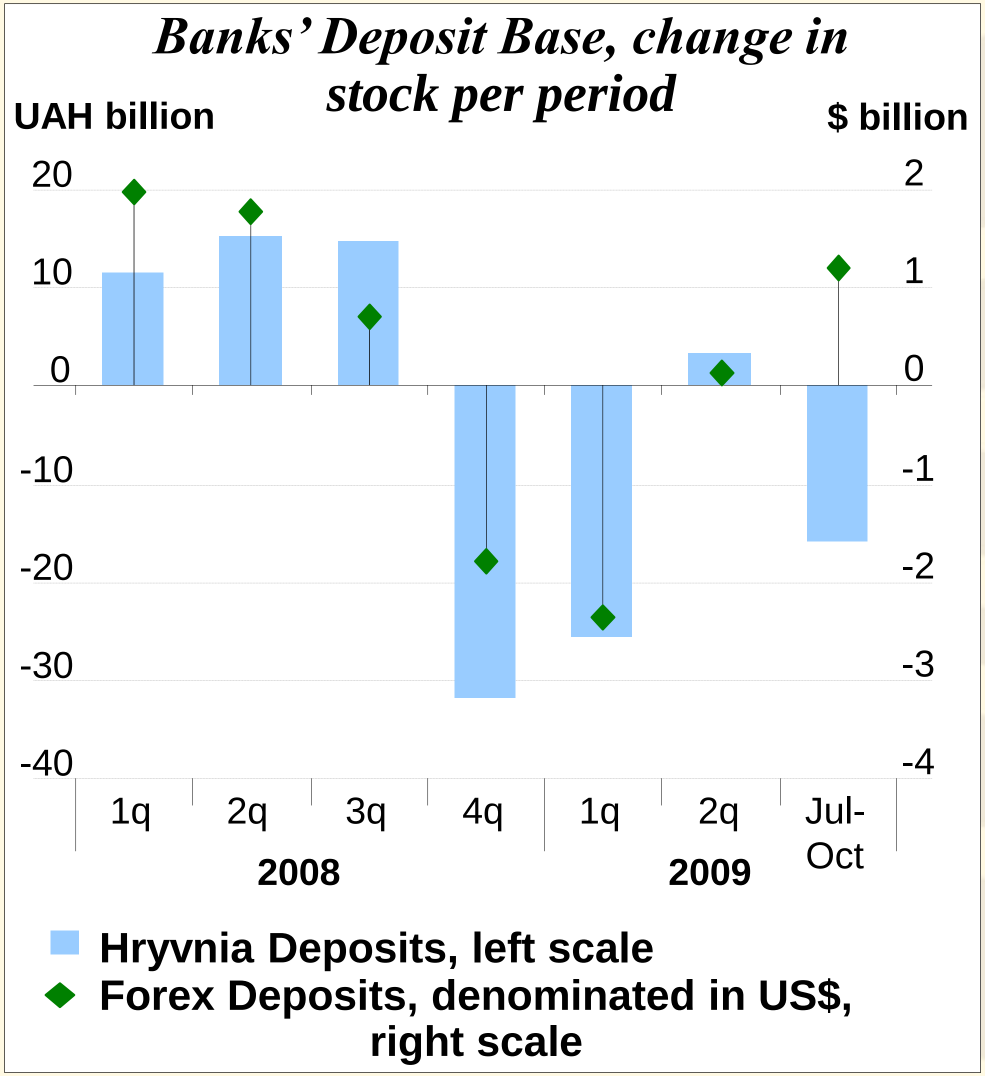
Vulnerability # 3 – Banking Sector Weaknesses



Source: IMF GFS Report, Apr. 2009

- Bank lending grew by 70% pa over 2006-08.
- This growth was supported by:
  - improved access to foreign capital
  - the entrance of foreign banks
  - loose domestic monetary policy.
- 50% of total loans were issued in foreign currency.
- But the share of non-performing loans (NPLs) increased to 14.5% in 2008 and around 30% currently.
- This weakened the banking sector

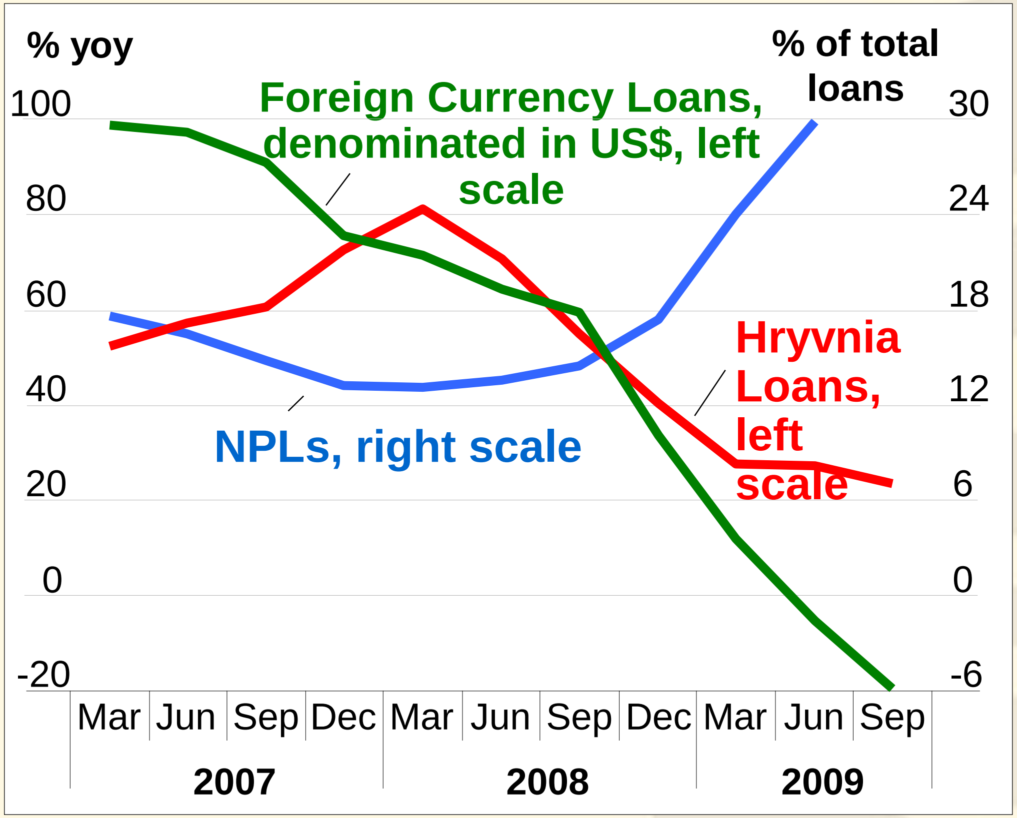
Banking Sector Weaknesses (cont.)



- During the crisis, commercial banks faced:
  - fast growth of NPLs
  - closed access to international credit markets
  - large debt repayments needs
  - high currency risks
- The combination of the above led to bank runs.
- From October 2008 to April 2009, about ¼ of bank deposits were lost.

Source: NBU, The Bleyzer Foundation

Banking Sector Weaknesses (cont.)



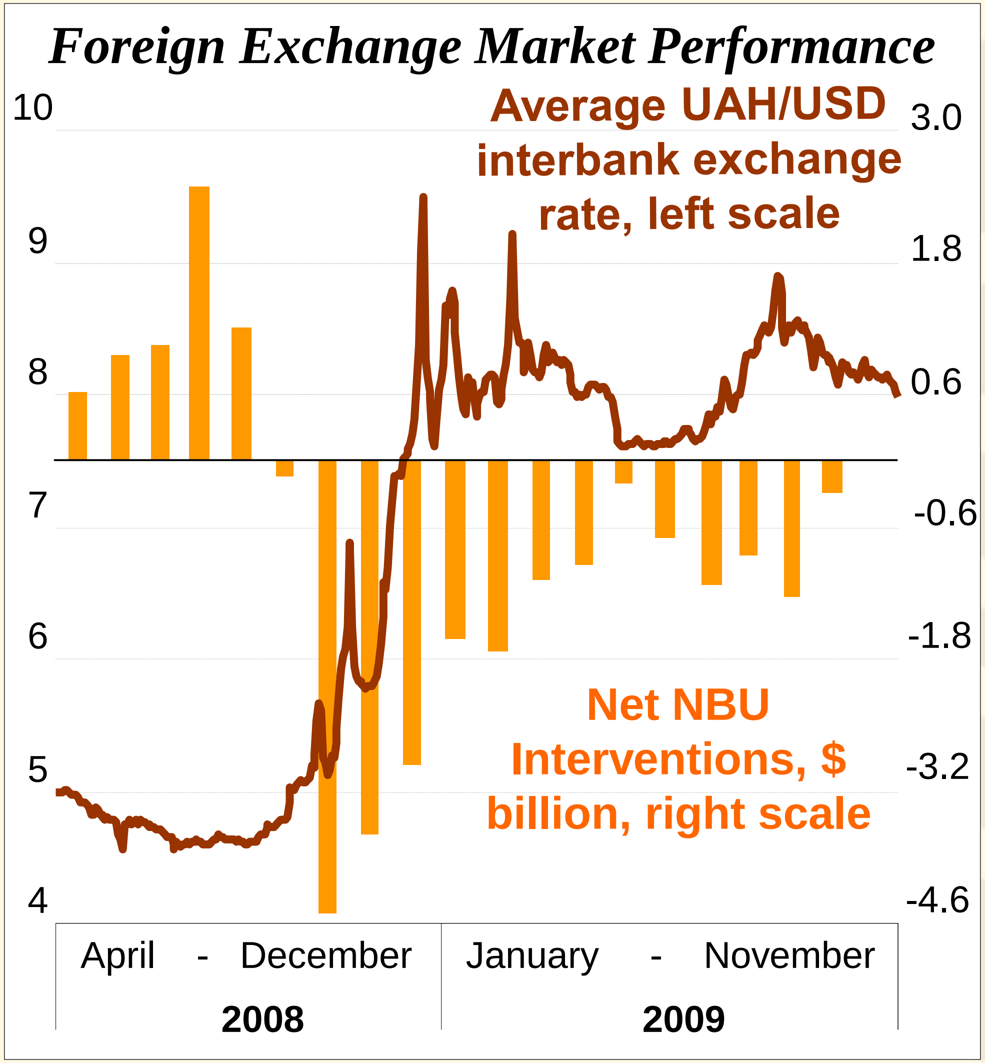
Source: *NBU, IMF, The Bleyzer Foundation*

- Before the crisis, the credit-to-GDP ratio grew from 20% (2002) to 77% (2008).
- After the crisis, bank lending sharply decelerated due to:
  - tight access to foreign capital and domestic funds
  - deposit withdrawals
  - rising NPLs
  - tight money supply

- Although liquidity support was provided to a number of banks .....

  ......it appears that it may not have been used to increase lending.
- But Progress was made in supporting systemic banks and developing non-systemic bank resolution programs.

Hryvnia Depreciation –One of the World's Largest

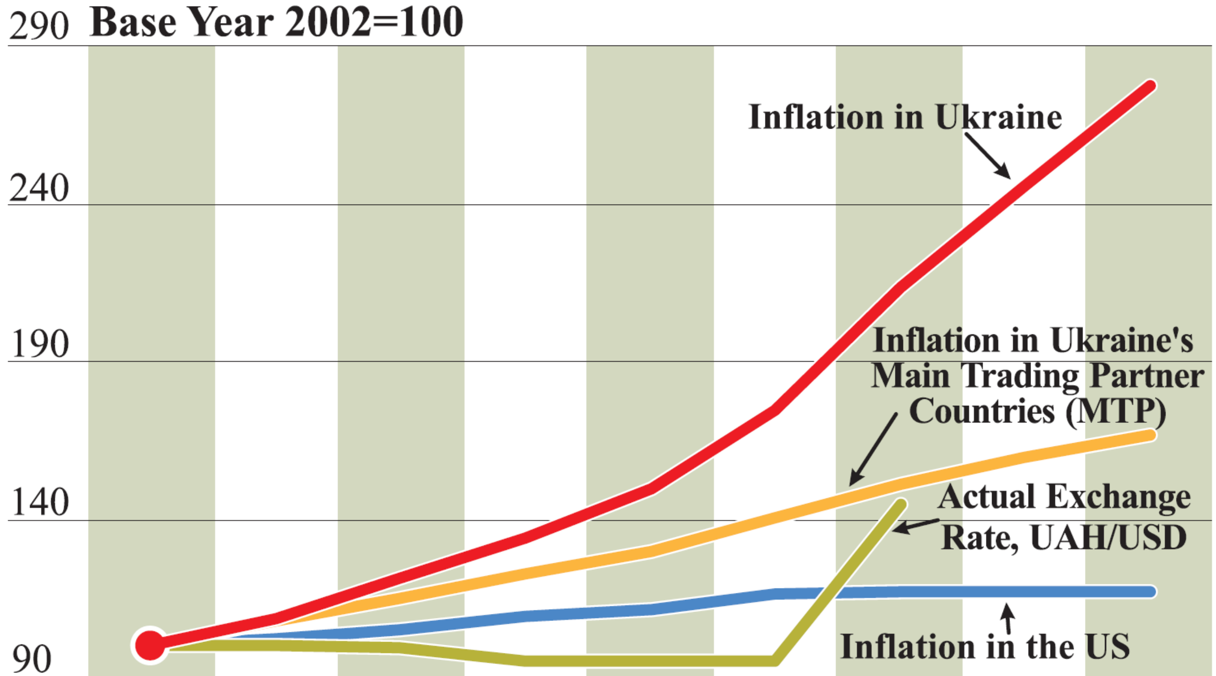


Source: NBU, The Bleyzer Foundation

- During last quarter of 2008, the Hryvnia lost more than 50% of its value to US Dollar.
- Sharp depreciation was due to:
  - Intense vulnerabilities (CA deficits, debt repayments, weaker banking sector)
  - Inadequate monetary policies
  - Fragile political situation
  - Conflicting statements about the future exchange rate
  - Loss of competitiveness

Hryvnia Exchange Rate and Ukraine's Competitiveness (based on Purchasing Power Parity - Medium Term View)

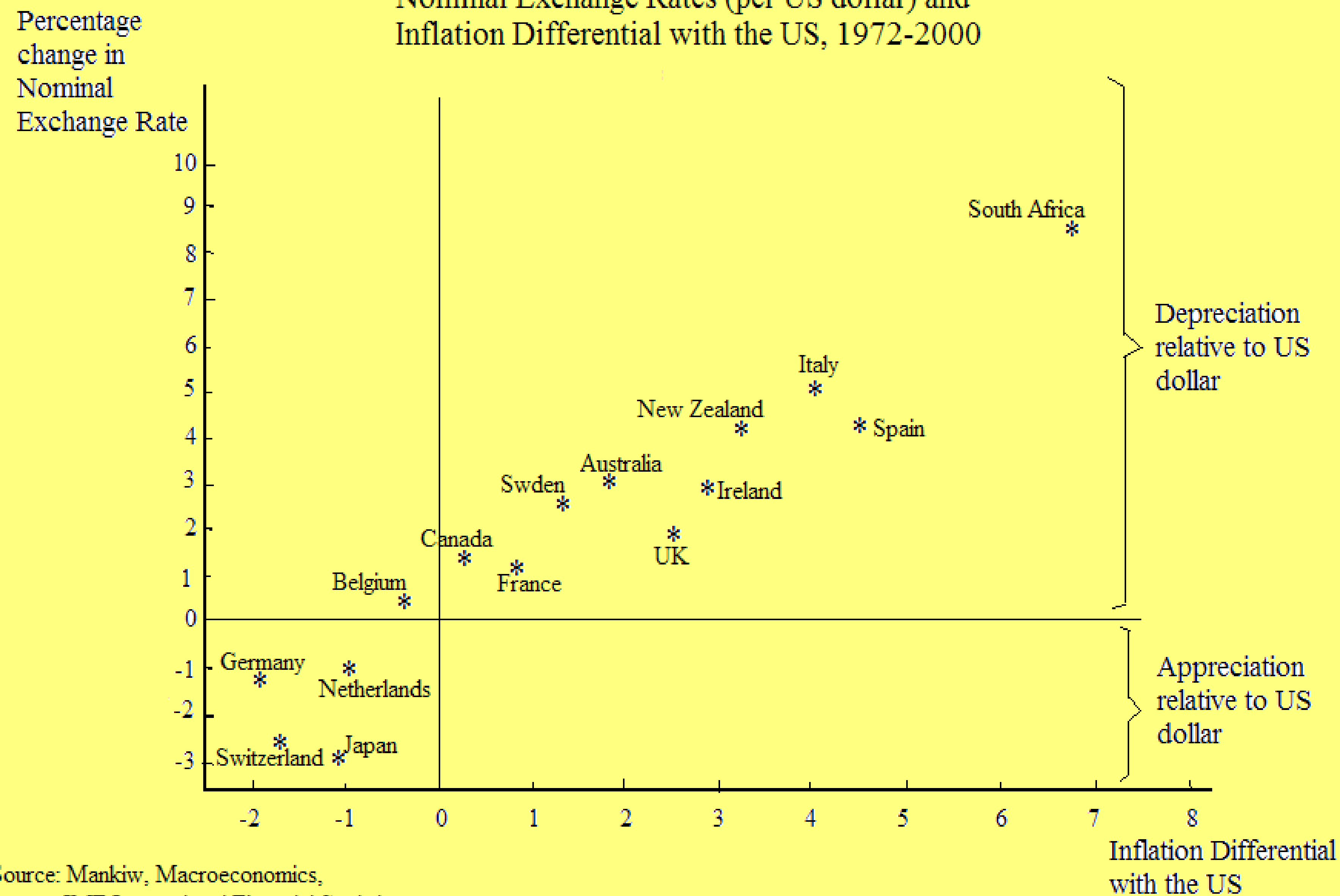
- High inflation in Ukraine – 12.5% pa on average over 2000-2008.
- Virtually stable exchange rate.
- Normally, loss of competitiveness adjusts through exchange rate depreciation.



PPP with Base Year 2002	2002	2003	2004	2005	2006	2007	2008	2009	2010
Inflation Diff Index Ukr-Us	100	106	115	123	134	150	182	210	237
REER - US		5.7	6.2	6.5	7.1	8.0	9.7	11.2	12.6
Inflation Diff Index Ukr-MTP	100	101	105	109	115	124	141	154	167
REER - MTP		5.4	5.6	5.8	6.1	6.6	7.5	8.2	8.9

REER - Real Effective Exchange Rate

Nominal Exchange Rates (per US dollar) and Inflation Differential with the US, 1972-2000



Source: Mankiw, Macroeconomics,
IMF International Financial Statistics

Hryvnia Exchange Rate Over the Short-Term
(based on Asset Models)

- Over the **Medium Term**, as inflation in Ukraine continues above international inflation, the Hryvnia Exchange Rate should depreciate.
- But in the **Short-Term**, the exchange rate will be driven mainly by expected risks-returns from holding the assets (US$ versus Hryvnias).
- Risk-return differentials will depend on differentials in interest rates between US$ & Hryvnias and expectations on future exchange rates.
- But given concerns about political & other risks, **expectations on exchange rates** are more important than differentials in interest rates.
- The main actors that can affect expected exchange rates are:
  - Foreign Creditors who will need to roll-over about $30 billion of private foreign debt in 2010
  - International Institutions (IMF/World Bank/EC/EBRD) which may or may not provide close to $10 billion in 2010
  - The NBU which may use its international reserves to intervene or take administrative measures to hold the exchange rate.

....Hryvnia Exchange Rate Over the Short-Term (based on Asset Models)

- The Ministry of Finance which may continue to issue T-Bills to finance fiscal deficits -- but subtract Hryvnia liquidity, crowd out private sector credits and reduce Hryvnia depreciation pressures.
- The Ukraine population which holds about $25 billion in foreign exchange

- The likely behaviors of these agents in the short term, up to the January/February elections are likely should be as follows:
  - Foreign Creditors may be prepared to roll-over most of their debt until the elections because of:
    - the large investments already made in Ukraine,
    - the better financial position of their home offices,
    - possible concerns with contagion effects,
    - long-term potential of local banks, which may regain their solvency with support from international institutions and,
    - the prospects that after the elections the country could recover its stability and growth.

....Hryvnia Exchange Rate Over the Short-Term
(based on Asset Models)

- – The International Agencies might wait until after the elections to determine the commitment of the new authorities to sound policies.
- – The NBU will try to use all means to maintain stability for as long as international reserves will allow it to intervene.
- – The Ministry of Finance will continue to issue T-Bills, subtracting Hryvnia liquidity
- – The population may want to increase its holding of foreign exchange during the pre-election period due to political uncertainties.

- On balance, we believe that the most important actors are the foreign creditors -- who may want to wait-and-see and roll-over their debt up to the elections -- and the NBU/Ministry of Finance -- who would push for FX stability or even some appreciation.
- On this basis, the exchange rate is likely to be stable and even appreciate somewhat until January/February 2010.

Hryvnia Exchange Rate After the Elections

- During 2009, considerable progress was achieved in reducing Ukraine's main vulnerabilities:
  - The current account deficit is no longer a problem, thanks to the devaluation and lower domestic income – the current account deficit is forecasted at about 1% of GDP in 2009 and a small surplus in 2010.
  - The banking sector has stabilized thanks to adequate support to systemic banks and developed non-systemic banks resolution program.
- Therefore, Ukraine main vulnerability for 2010 is its large external debt ($100 billion), of which about $30 billion* is due within one year.
- In 2009, about 75% of external private debt was rolled-over. We forecast similar or higher roll-over will be needed to contain depreciation pressures.
- Hence, the exchange rate after the elections will depend on the **degree of confidence** that the new government will create, principally in the minds of foreign creditors, international institutions, and population.

* According to the NBU, short-term private sector debt (by original maturity) stood at about $20 billion at end-June 2009. Assuming 6-year average maturity for MLT debt, which stood at $61.5 billion, total private external debt due during next year is estimated at around $30 billion.

…Hryvnia Exchange Rate After the Elections

- In order to build confidence the new authorities will need to:
  - Implement sound fiscal and monetary policies (sustainable fiscal deficit, improved financial conditions of the Pension Fund and Naftogaz, and avoid printing of money)
  - Continue improvement in the balance-of-payments
  - Continue improvements in the banking sector (re-capitalization, dollarization, resolution of NPLs, loan & security recovery, loan classification and provisioning, NBU role and independence).
  - Secure large financial support from international institutions
  - Secure the roll-over of 2010 debt by foreign creditors
- This is a hard agenda to do, given the current political difficulties.
- Without doing it, large devaluations may follow after the elections.

Medium-Term Prospects

- Past sources of economic growth (exports and domestic consumption) will be limited in the future: exports prices are unlikely to increase as in the past and credit will not be available to boost consumption.
- Therefore, Investments must become the new GDP growth engine, not only to induce growth but to diversify output and exports.
- For this, Ukraine's economic outlook is still bright:
  - Exports should be stimulated by membership in the WTO
  - The proposed EU-FTA would encourage FDI and exports
  - FDI will also be supported by abundant and educated labor
  - Labor wages are 1/3 of those in Eastern Europe
  - Ukraine's 46 million population is an attractive market
  - Ukraine's agricultural potential is quite high
  - Ukraine's infrastructure and technological base are reasonable

Measures to Revive Economic Growth

- But realization of this outlook requires major improvement in the business climate.
- For this, political will be required to:
  - Improve public administration (the current administrative system has proven to be incapable of implementing reforms)
  - Bring stability and predictability to the legal environment
  - Reform the judiciary
  - Reduce the costs of doing business, by de-regulation and by improving tax policies and administration
  - Reduce corruption
  - Reach an Enhanced Free Trade Agreement with the EU
  - Support energy and other efficiency and productivity growth