EMERGING CAPITAL MARKETS

Lecture 13: The 2008 Crisis in Ukraine and Future Prospects

Dr. Edilberto Segura
Partner & Chief Economist, SigmaBleyzer
Chairman, Advisory Board, The Bleyzer Foundation
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The Ukrainian 2008 Crisis

- Key Macroeconomic Indicators and Effect of Crisis
- Collapse of Sources of GDP Growth
- Real Sector Performance in 2009 and 2010
- Why Ukraine Was Affected So Severely?
    1. Open but Undiversified Economy
    2. Large Current Account Deficits
    3. Large External Debt Repayments
    4. Banking Sector Weaknesses
- Effect on Hryvnia Depreciation
- What Factors will Affect Recovery
- Prospects for the Future

Main Macroeconomic Indicators of Ukraine

	2003 - 2005	2006	2007	2008	2009	2010	2011	2012f
Real GDP Growth, % yoy	8.1	7.3	7.9	2.3	-14.8	4.2	5.0	3.0
Fiscal Balance, % GDP*	-1.7	-0.7	-1.7	-2.0	-8.9	-7.0	-4.5	-3.5
Consumer Inflation, %, eop	10.3	11.6	16.6	22.3	12.3	9.1	4.6	9.0
UAH/$ Exchange Rate, eop	5.2	5.1	5.1	7.7	8.0	8.0	8.0	8-8.5
Current Account, % GDP	+6.4	-1.5	-3.7	-7.0	-1.5	-1.9	-5.9	-5.5
Gross Int. Reserves, $ bn	12.0	22.4	32.5	31.5	26.5	34.6	31.8	27.0
Foreign Gov't Debt, % GDP	17.7	11.0	8.7	9.2	20.5	23.8	24.0	22.5
Total Foreign Debt, % GDP	46.0	50.6	56.0	56.4	88.6	88.1	77.5	72.0

* Includes implicit pension fund deficit (credits from unified Treasury account (state budget) to cover pension fund expenditures) for 2007-2008 and Pension Fund and Naftogaz imbalances since 2009, excluding bank recapitalization and VAT bonds

The International Liquidity Crisis Hit Ukraine Hard

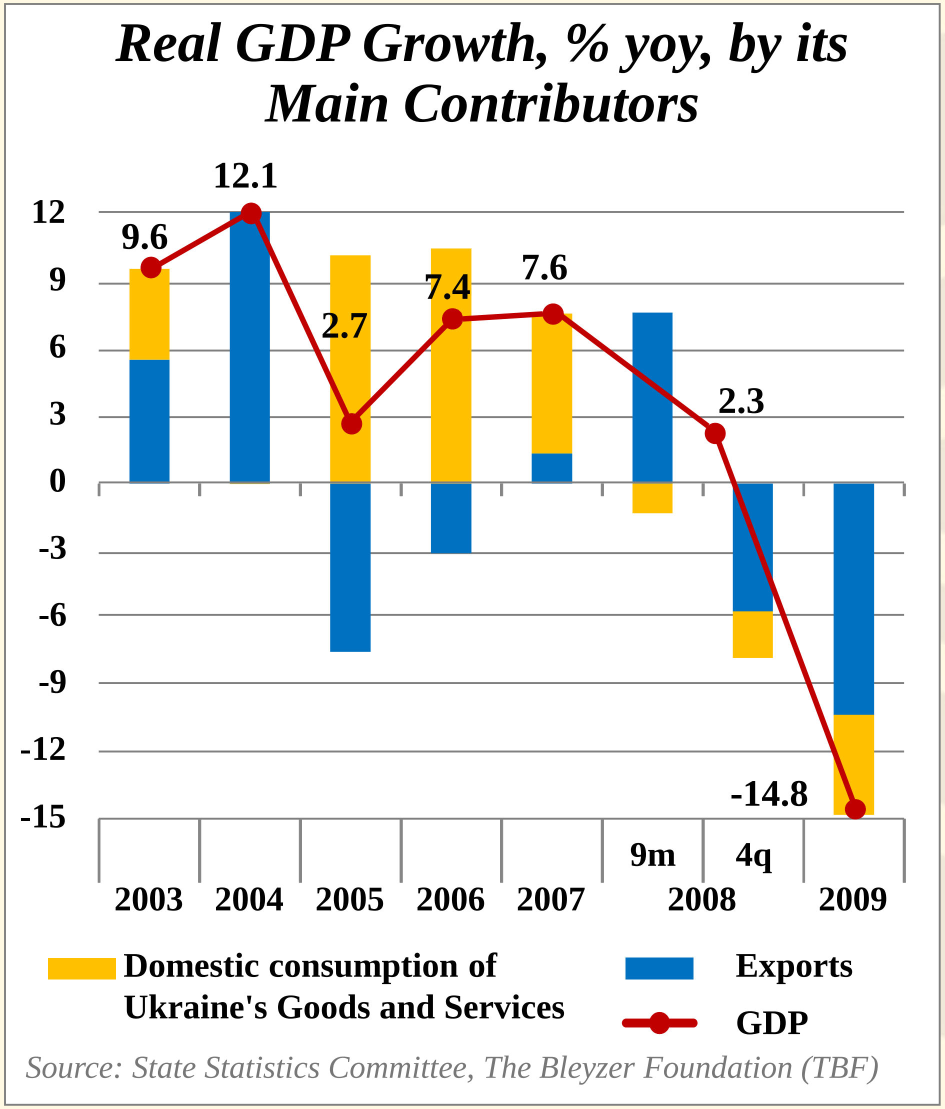
- Export of goods: **- 40%** yoy (2009)
- Industrial production: **-22%** yoy (2009)
- Real GDP: **-14.8%** yoy (2009)
- Unemployment (ILO): **9.6%** (4Q 2009)
- Real households' income: **-10%** yoy (9M 2009)
- Fiscal balance: **-8.9%** of GDP (2009)
- PFTS stock index: **-74%** (2008-09)
- UAH/$ Exchange Rate: **65%** Depreciation (2008-09)

The Crisis Affected Ukraine Harder than other EMs

Country	GDP, % yoy 2009	Local Currency Depreciation vs. US Dollar (mid-2008 to end-2009)
Ukraine	**-14.8**	**65%**
Latvia	-18.0	9%
Lithuania	-14.7	9%
Estonia	-13.9	9%
Russia	-7.8	29%
Mexico	-6.2	27%
Romania	-7.1	27%
Hungary	-6.7	26%
Taiwan	-1.9	6%

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

Collapse in Sources of GDP Growth

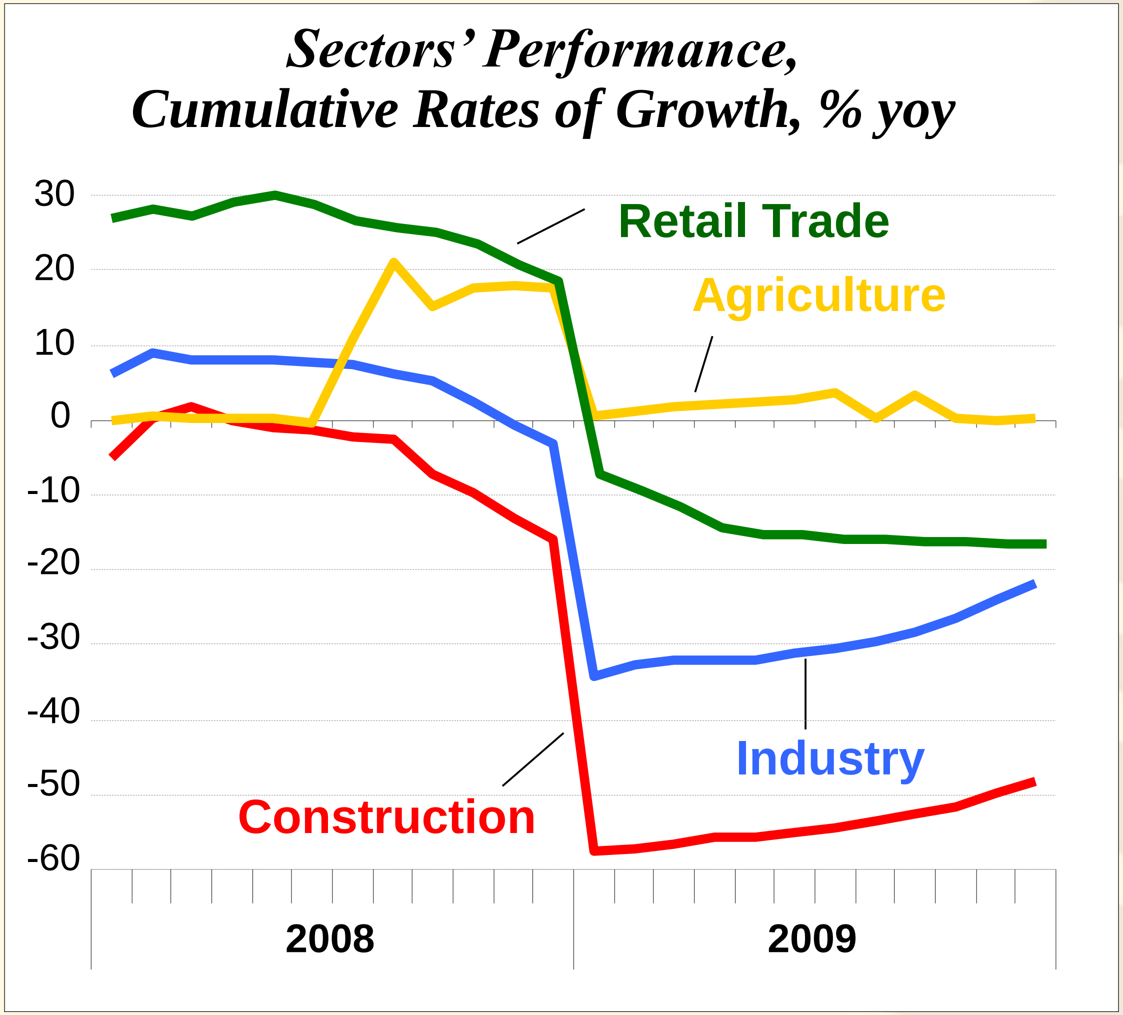


- GDP growth was driven by:

  (1) exports in early 2000s &

  (2) domestic consumption in later years.
- Both were spurred by a credit boom and government social spending, both unsustainable.
- In 4Q 2008 and 2009 both exports and domestic demand fell sharply.
- Real GDP declined by 14.8% yoy in 2009.

Real Sector Performance in 2009



- **Export-oriented** industries (metals & chemicals) and **credit-dependent** sectors (construction, machine-building) were affected the most.
- The major drop in output took place in November 2008 – February 2009.
- But the turn around was quick.

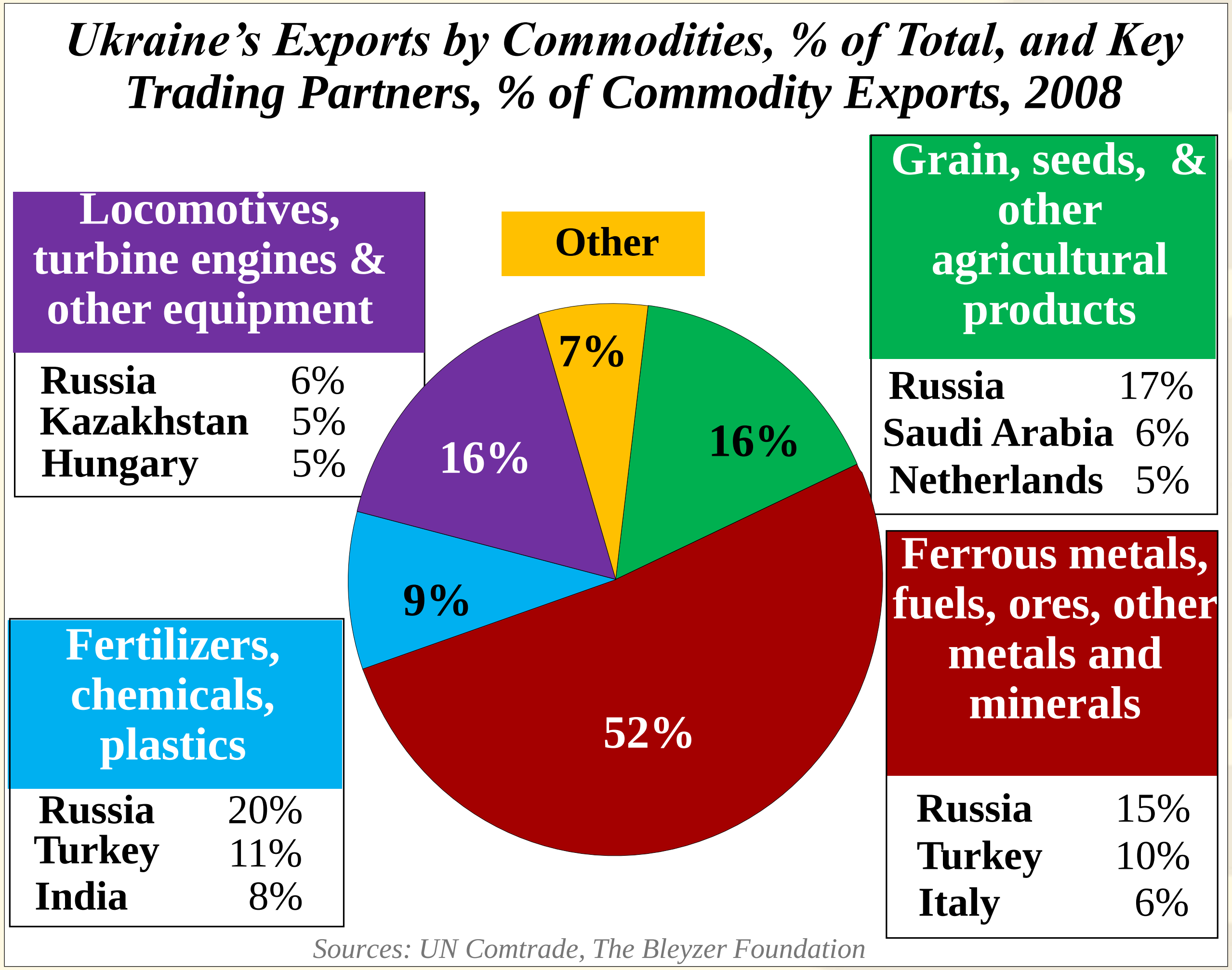
Sources: State Statistics Committee, The Bleyzer Foundation

Why Ukraine Was Affected So Severely?

Due to **the combination** of four vulnerabilities:

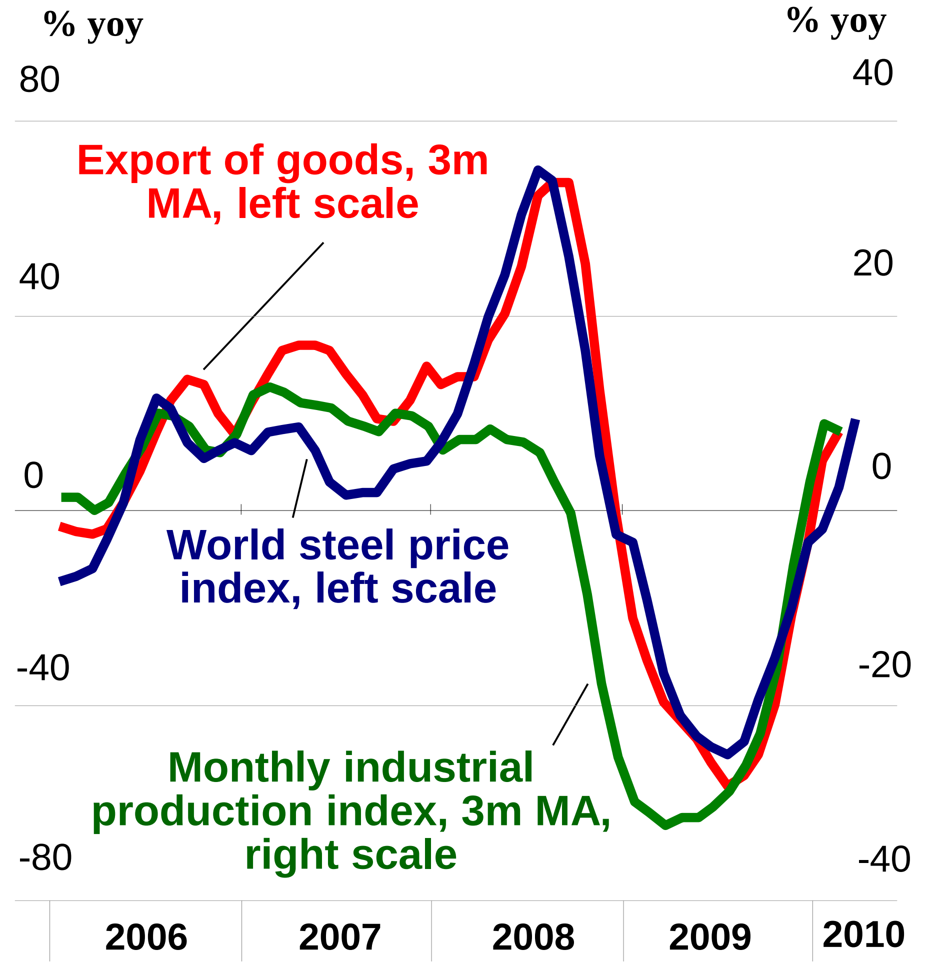
1. Open but Undiversified Economy
2. Large Current Account Deficits
3. Large External Debt Repayments
4. Banking Sector Weaknesses

Vulnerability #1 – Open & Undiversified Economy…



- Exports represent 50% of GDP
- But exports are undiversified:
- Metals, Minerals and Chemicals account for 60% of exports.
- This lack of product diversification is the result of lack of reforms in the past.

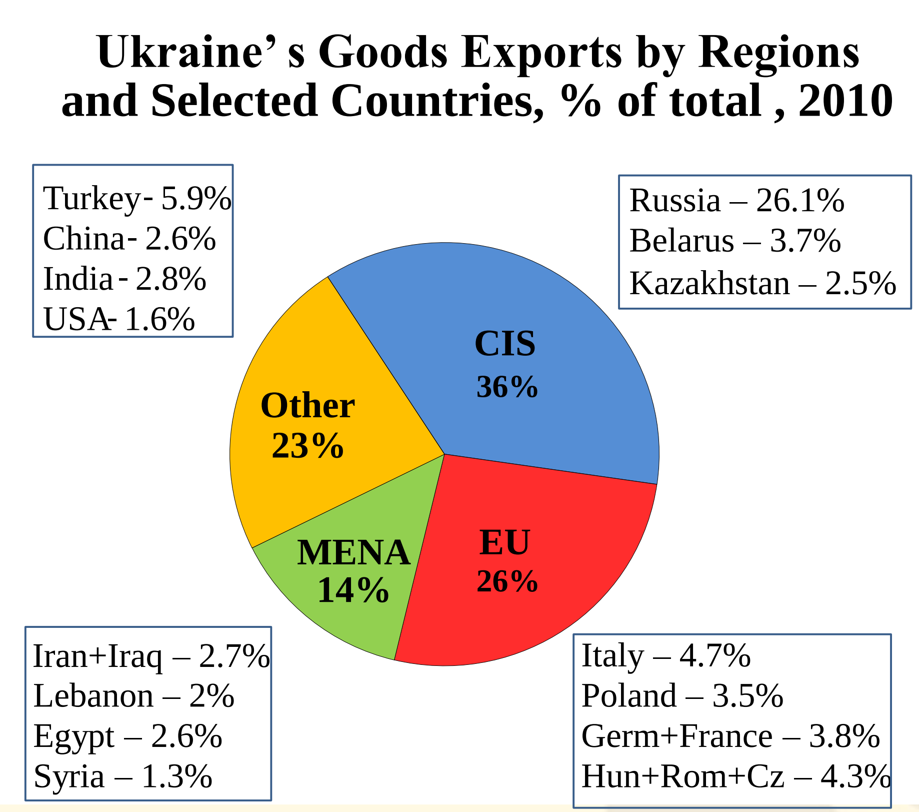
…with high dependence on Steel Prices…



Source: *State Statistics Committee, NBU, MEPS, TBF*

- Ukraine's exports and industrial production are very dependent on international **steel prices**, which are very vulnerable to crises, as people stop buying cars and houses.
- World steel prices fell sharply from mid-2008 to mid-2009.
- Ukraine's exports of goods dropped by 40% yoy in US$ terms in 2009.
- Industrial production declined by 22% yoy.
- Product diversification must be a priority for economic reforms.

…and exports undiversified geographically

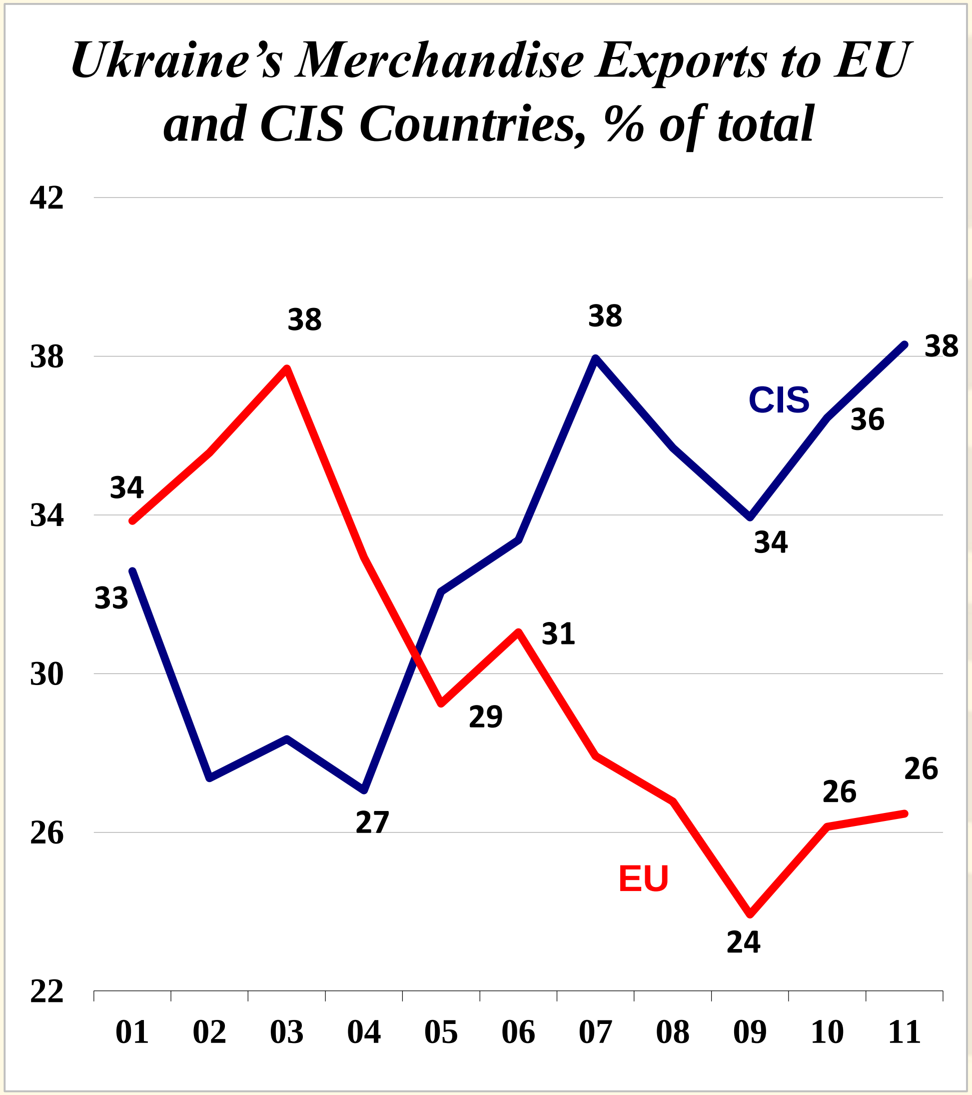


Source: State Statistics Committee, The Bleyzer Foundation

- Demand for Ukraine's exports depends on a few countries.
- Exports to Russia and other CIS countries slowed due to:
  - Weaker growth in Russia, economic downturn in Belarus;
  - Trade restrictions, imposed by Russia.
  - Continuing turbulences in the MENA region.

- The second largest market for Ukraine's exports, the EU, also experience slowdowns.
- Slower growth in the CIS, EU and Turkey will affect Ukrainian exports.

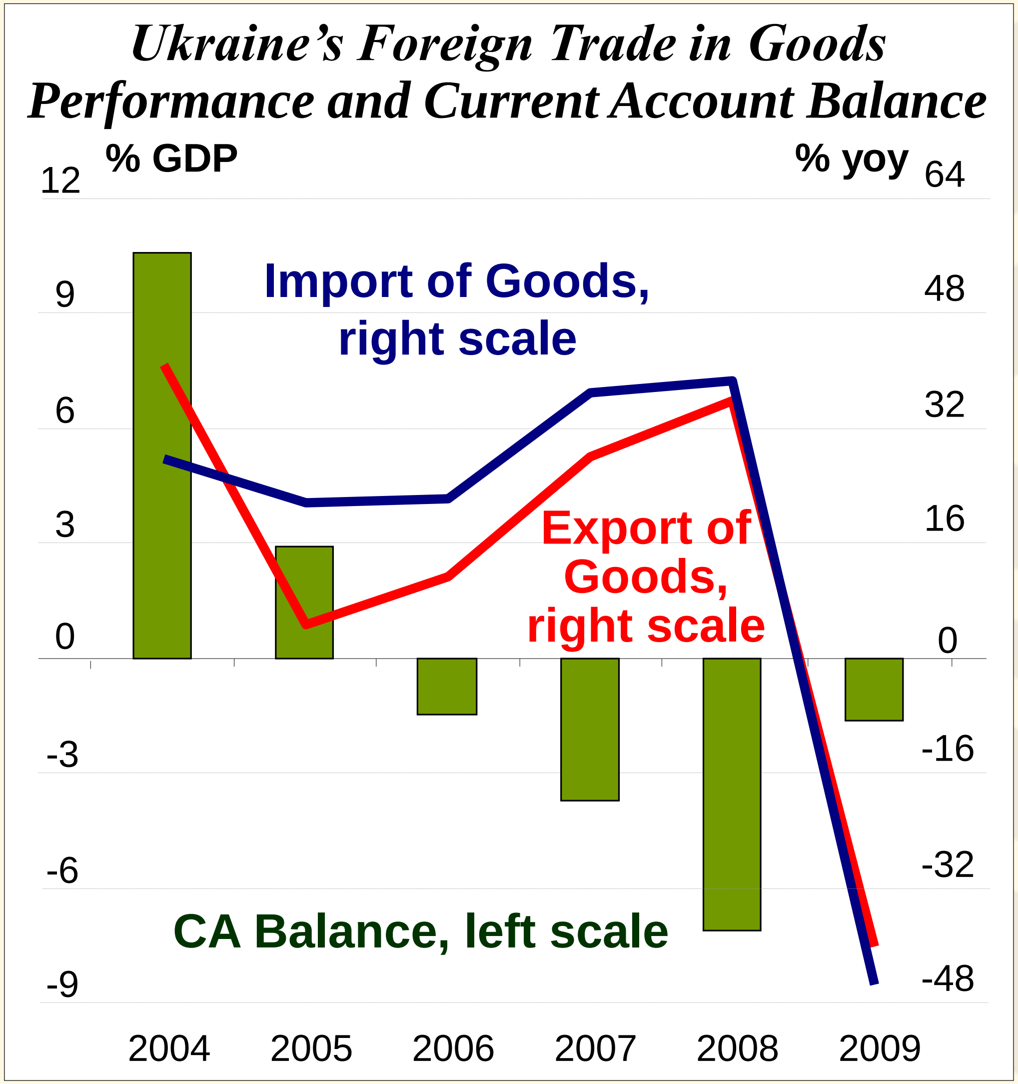
Exports to Key Trading Partners



Source: UN Comtrade, SSC of Ukraine

- Ukraine said that it wanted geographical diversification.
- But Russia remained as the main export market, with a growing share.
- Ukraine talked about closer integration with the EU; but its trade with the EU was deteriorating.
- Export diversification should be a key item in the reform agenda of Ukraine.
- Entering into FTAs is now essential for Ukraine.

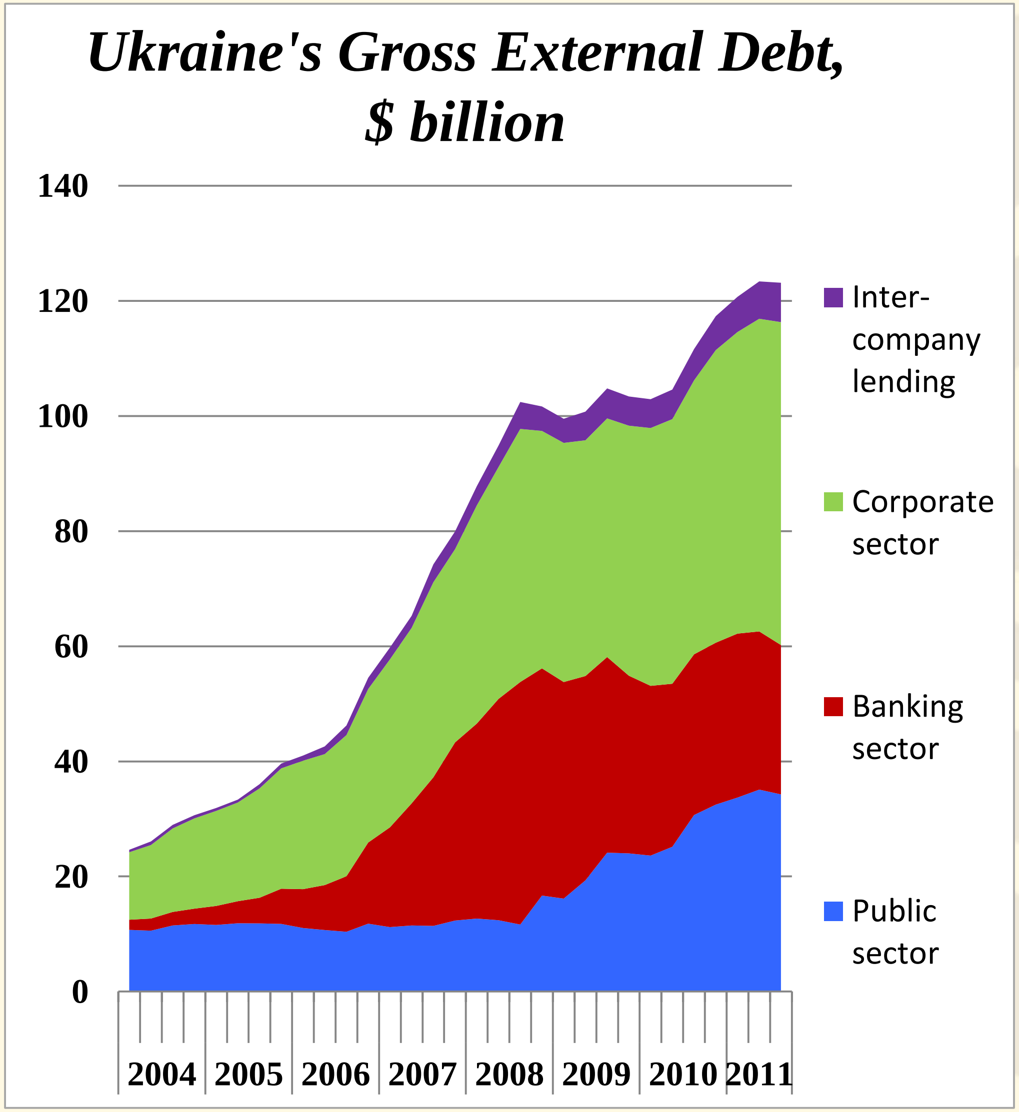
Vulnerability # 2 – Large Current Account Deficits



- Over 2003-2008:
  - Exports grew by 25% pa
  - But imports – by 30% pa
- CA deficits over 3% of GDP emerged in 2006 and reached 7% of GDP in 2008.
- Before the crises, the CA deficit for 2009 was forecast at 13% GDP.
- Uncertain foreign financing of this CA put pressures on the Hryvnia, principally since external debt was already high.

Source: NBU, SSC, The Bleyzer Foundation

Vulnerability # 3 – Large External Debt Repayments



- External debt tripled in three years (2006-08) to about $100 billion (90% of GDP).
- As of mid-2008, ~ $50 billion of debt was due in 1 year –vs- $35 billion of international reserves.
- Debt rollover became very difficult during the initial stages of the crisis, pressuring the Hryvnia.
- Ukraine was considered high risk given its high level of external debt, compared to other countries.

Total External Debt (Public and Private) to GDP & Exports, 2009

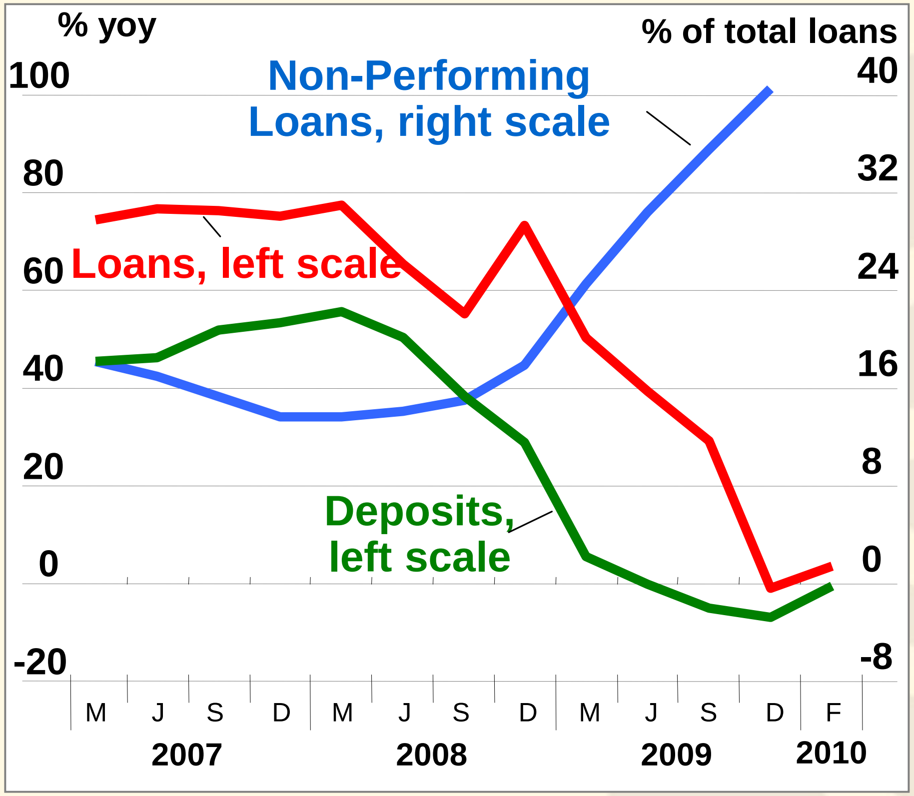
Country	ED/GDP	ED/Exp
Hungary	128	143
Bulgaria	110	159
Ukraine	**89**	**204**
Poland	58	125
Panama	56	76
Korea	45	83
Turkey	44	176
Argentina	42	182
Czech Rep	41	56
Philippines	40	121
Russia	38	125
Uruguay	37	152
Pakistan	36	322
Chile	35	82

Country	ED/GDP	ED/Exp
Malaysia	32	35
Indonesia	28	123
Peru	28	126
Ecuador	25	95
S. Africa	25	81
Thailand	24	35
Colombia	21	130
Dom Rep	20	97
India	18	86
Mexico	18	62
Venezuela	16	100
Brazil	14	122
China	8	33
MEAN	**35**	**120**

External Debt Financing Needs were also high

- With external debt at 90% of GDP, Ukraine was a high-debt country. The average external debt/GDP for EMs is 35% of GDP.
- Furthermore, out of its total external debt, in early 2009 principal repayments due in 2009 were estimated at $45 billion, which were to too high for the country to re-pay.
- Of this amount, $7 billion was due by banks, $12 billion was due by Corporations, $24 billion was the medium term debt maturing within one year (which was ignored in official statistics), and $2 billion was external government debt.
- Fortunately, since 2009, rollover of private external debt was high at over 80% for 2009 and over 100% for 2010 and 2011.
- In the future, given the Eurozone crisis and EZ bank deleveraging, Ukraine will need to maintain a good degree of confidence among foreign investors to keep high debt rollover ratios.

Vulnerability # 4 – Banking Sector Weaknesses



Source: NBU, IMF, TBF

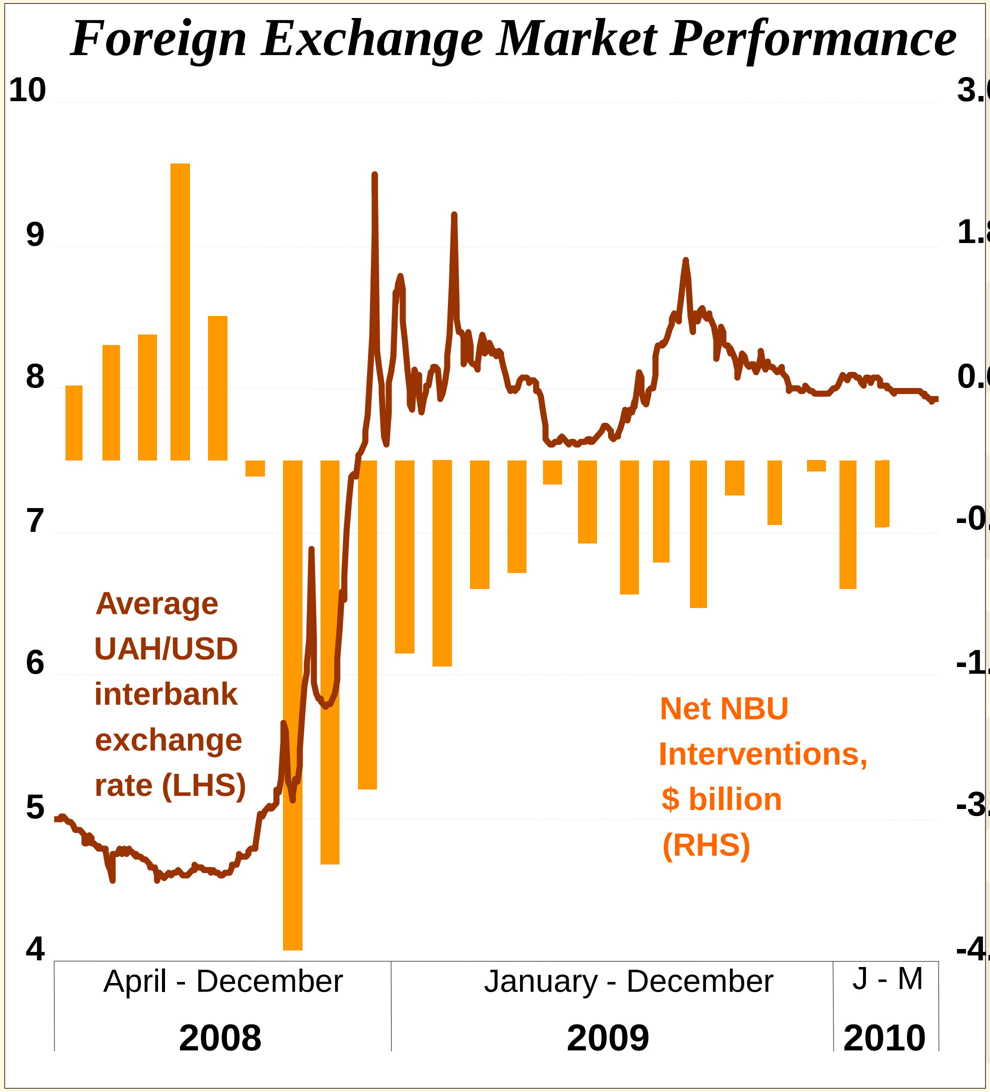
- Over 2006-08, commercial bank lending grew by 70% pa.
- This high credit growth led to a high ratio of non-performing loans (NPLs) of 14.5% of loans in 2008 and around 40% currently (including substandard loans).
- Credit growth was mainly financed by foreign borrowings, with 50% of total loans issued in foreign currency.
- All this created uncertainties and about ¼ of bank deposits were lost in late 2008 - early 2009.
- Although the deposit base was stabilized in mid-2009, in 2009 the banking sector as a whole made ~$4 billion in loses.

Bank Credit was not given for productive purposes, but for consumer credit and real estate.

Credit Breakdown – August 2008

	UAH bn	% of total
Total bank Credit	**547**	**100%**
Credit to Financial Corporations	***8***	***1%***
Credit to Non-Financial Corporations	***331***	***60%***
Retail and Wholesale Trade	124	23%
Manufacturing	83	15%
Real Estate	36	7%
Construction	31	6%
Agriculture	23	4%
Transport and Utilities	18	4%
Credit to Households	***208***	***39%***
Consumer Credit	144	26%
Mortgages	59	12%
Other	5	1%

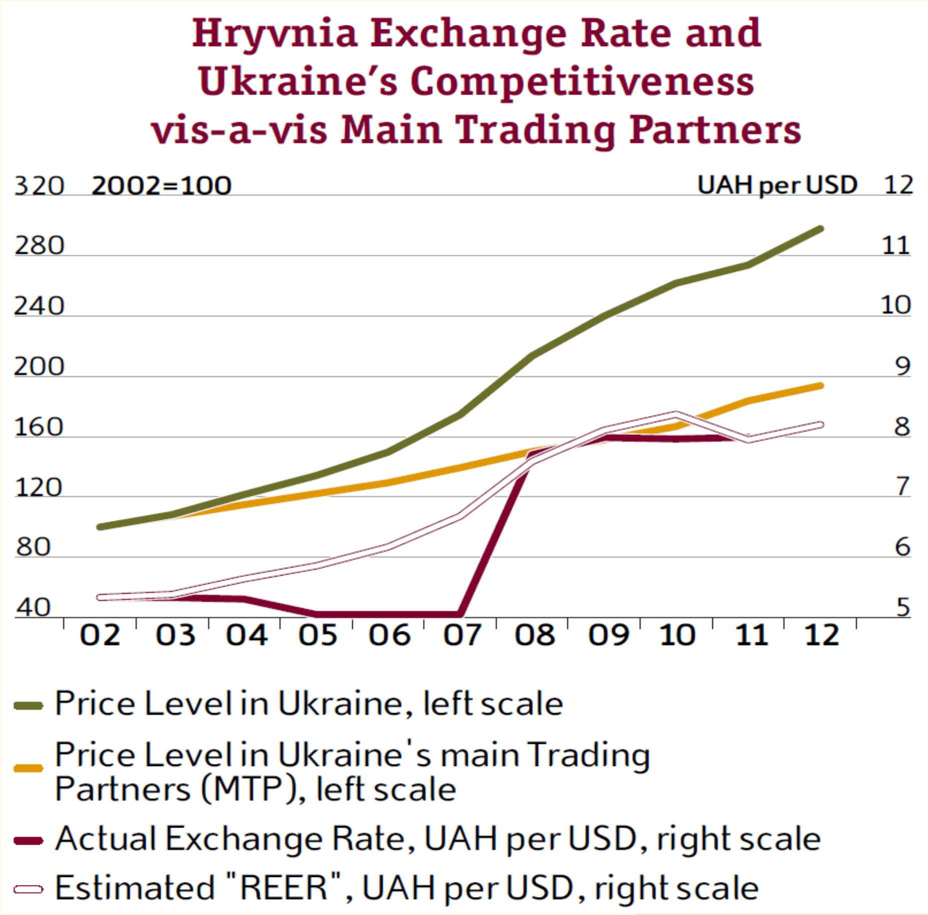
The Hryvnia Depreciation was One of the World's Largest

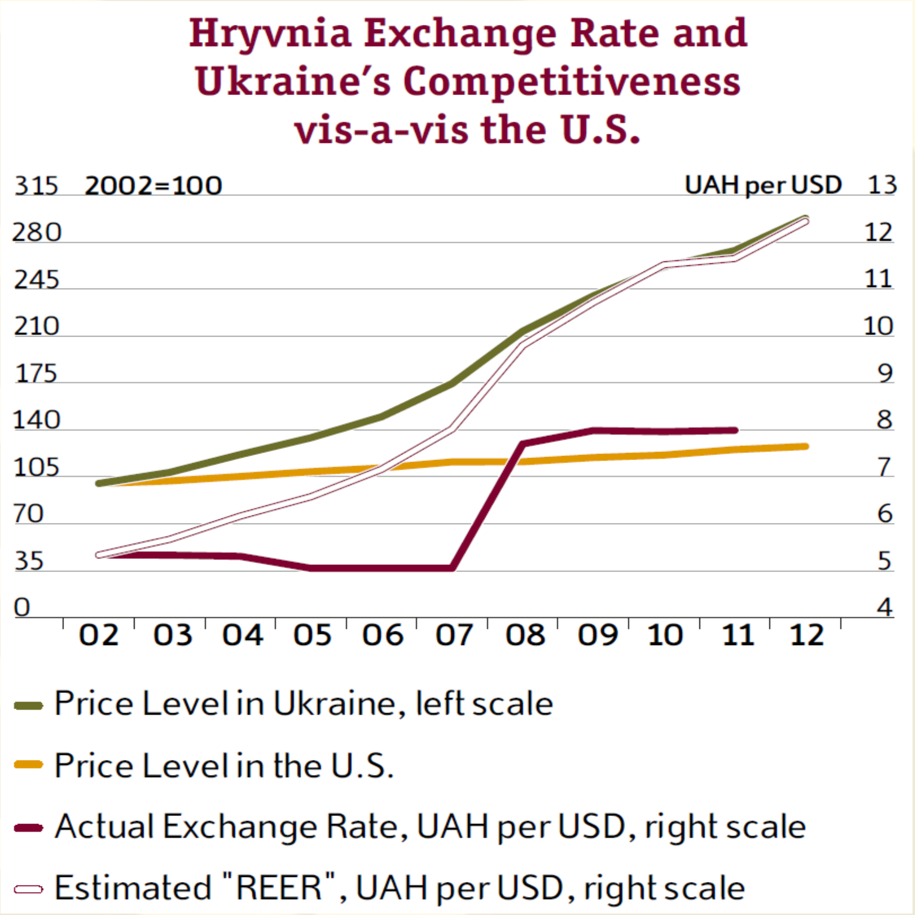


- Ukraine's four vulnerabilities (undiversified exports, large CA deficits, large foreign debt and weak banks) led to a large Hryvnia depreciation.
- During the last quarter of 2008, the Hryvnia lost more than 50% of its US$ value.
- However, due to this depreciation, Ukraine regained competitiveness lost since the early 2000s due to high inflation.

Source: NBU, Finance.ua, TBF

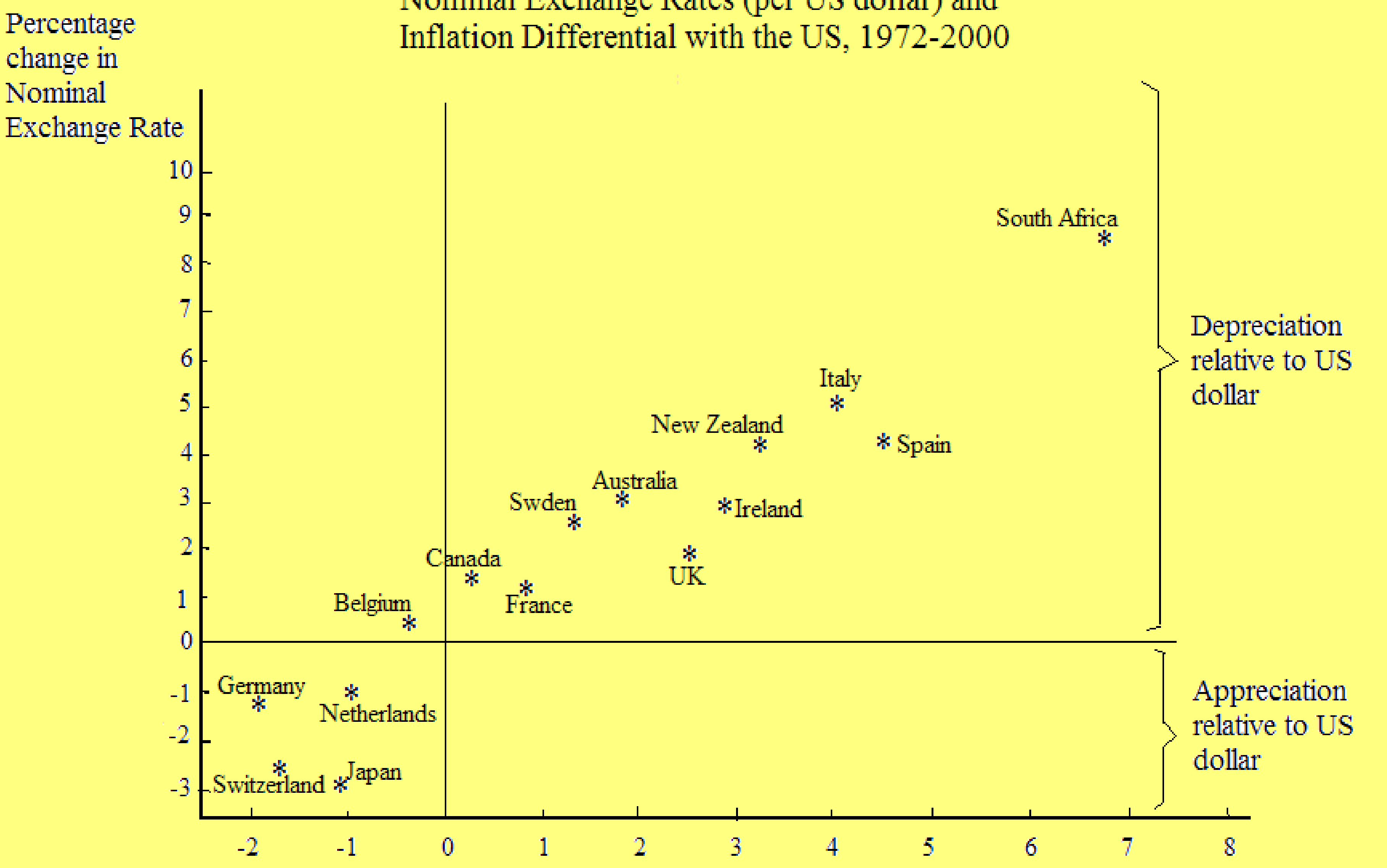
The Hryvnia Exchange Rate and Ukraine's Competitiveness
(based on Purchasing Power Parity - Medium Term View)





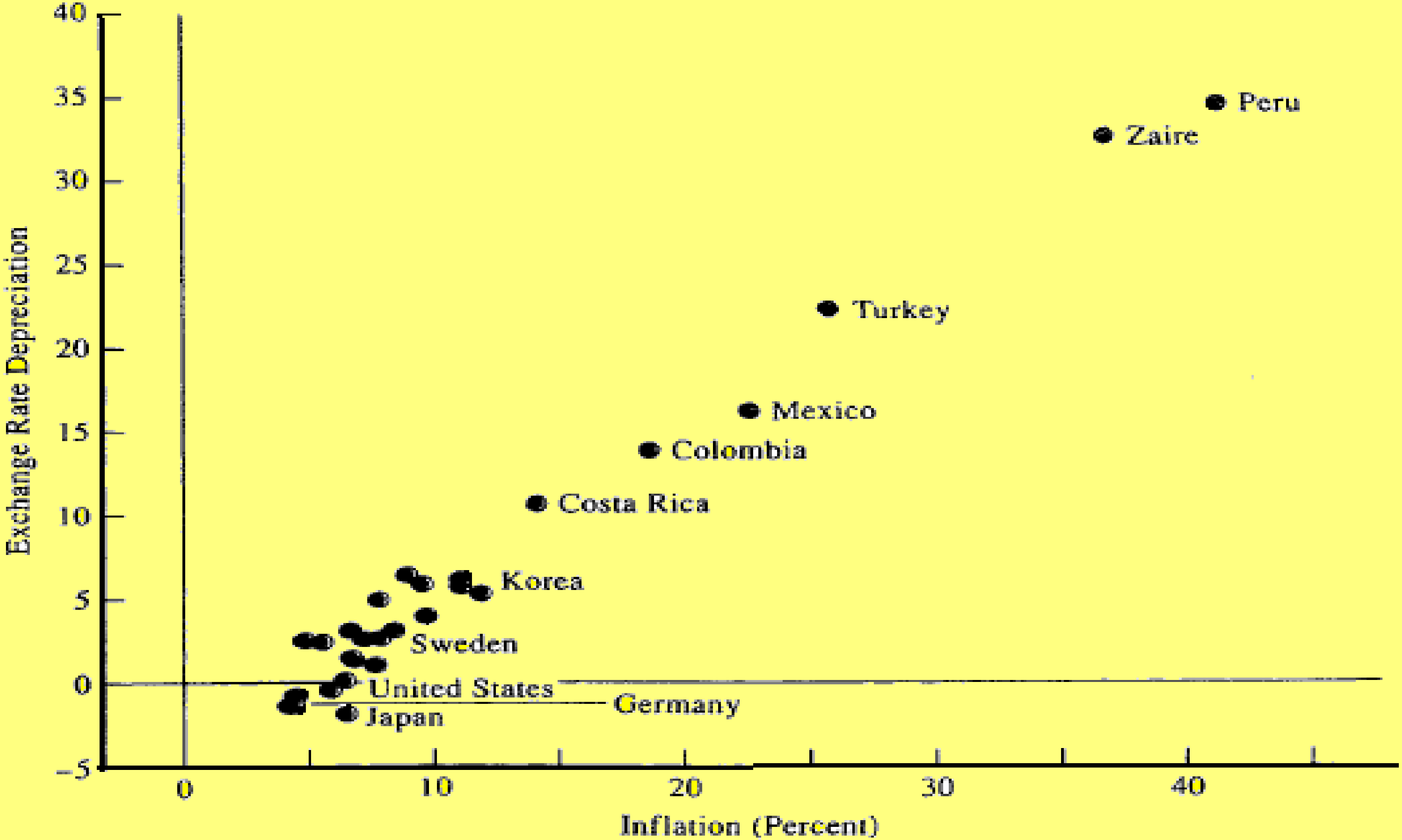
- High inflation in Ukraine (10% pa over 2002-12) and virtually stable exchange rate until 2008, meant that over time Ukraine lost competitiveness.
- Adjustment took place in 2008 through exchange rate depreciation.

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



Source: Mankiw, Macroeconomics,
IMF International Financial Statistics

Exchange-Rate Changes and Inflation in Selected Countries (Annual Averages), 1965–1985



Source: Sachs and Larain; Macroeconomics, 1993

What Factors will Affect Ukraine's Recovery?

External Environment:

1. The pace of economic recovery in Ukraine's main trading partners
2. The prospects for Ukrainian exports
    - Prospects for steel and metallurgical exports
    - Prospects for agricultural exports
    - Degree of international competitiveness of Ukraine
3. Ability of Ukraine to secure external financing and roll-over debts

Domestic Factors:

4. Adequacy of Macroeconomic Stabilization Policies
5. Pace of recovery of Banking Credit and Domestic Demand
6. Adequacy of Economic Policies to **sustain** long-term growth by improving the business climate to attract investments

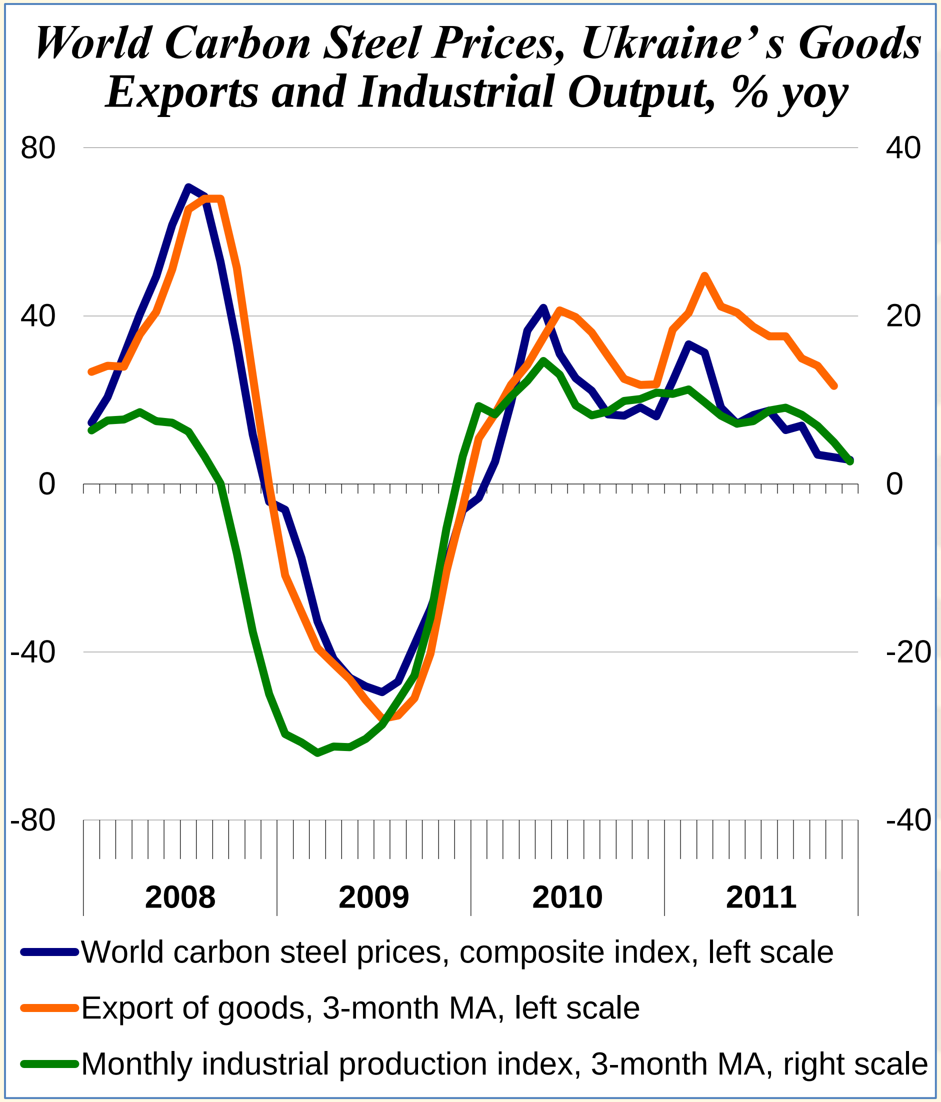
1. Economic Recovery in Trading Partners

	2010	2011	Projections 2012	Projections 2013
World Output [1]	**5.2**	**3.8**	**3.3**	**3.9**
Advanced Economies	**3.2**	**1.6**	**1.2**	**1.9**
United States	3.0	1.8	1.8	2.2
Euro Area	1.9	1.6	-0.5	0.8
Germany	3.6	3.0	0.3	1.5
France	1.4	1.6	0.2	1.0
Italy	1.5	0.4	-2.2	-0.6
Spain	-0.1	0.7	-1.7	-0.3
Japan	4.4	-0.9	1.7	1.6
United Kingdom	2.1	0.9	0.6	2.0
Canada	3.2	2.3	1.7	2.0
Other Advanced Economies [2]	5.8	3.3	2.6	3.4
Newly Industrialized Asian Economies	8.4	4.2	3.3	4.1
Emerging and Developing Economies [3]	**7.3**	**6.2**	**5.4**	**5.9**
Central and Eastern Europe	4.5	5.1	1.1	2.4
Commonwealth of Independent States	4.6	4.5	3.7	3.8
Russia	4.0	4.1	3.3	3.5
Excluding Russia	6.0	5.5	4.4	4.7
Developing Asia	9.5	7.9	7.3	7.8
China	10.4	9.2	8.2	8.8
India	9.9	7.4	7.0	7.3
ASEAN-5 [4]	6.9	4.8	5.2	5.6
Latin America and the Caribbean	6.1	4.6	3.6	3.9

- In 2012, European & Eurozone GDP growth will be negative, due to austerity measures, including in core and periphery countries.
- Nevertheless, most developed countries should be able to avoid major recessions, if Greece's debt situation is resolved.
- Due to slowdowns in developed economies, emerging markets' growth in 2012 will decline, but still will be positive, at 5.4%.
- In summary, the international prospects for Ukraine are not good.

Source: IMF Projections in World Economic Outlook Update, January 2012

2. Prospects for Ukrainian Exports



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

- Slower global GDP growth will reduce not only world demand for commodities, but also their prices, including the price of steel.
- In fact, from May to Dec 2011, steel prices already fell by about 15%.
- Although steel prices were still higher than in 2009, they are much lower than projected at the beginning of 2011.
- Ukraine's exports and industrial production was affected as they closely follow steel price trends.
- Industrial production growth slowed from 9% yoy in June to -0.5% yoy in Dec 2011.

3. Ability to Cover External Financing Needs

Ukraine's External Debt Service Needs

$ billion	2012	2013	2014
Public Debt Service	**9.6**	**10.0**	**8.0**
Principal	8.0	8.4	6.8
Interest	1.6	1.6	1.2
Private Debt Service	**54.0**	**49.7**	**47.7**
Principal #	46.0	42.0	40.0
Interest ##	8.0	7.7	7.7
Total Needs	**63.6**	**59.7**	**55.7**

 # estimate since 2012; ## estimate
Source: MinFin, NBU, IMF, TBF

- Ukraine is no longer a low-debt country.
- Gross external debt (public & private) stood at $123 bn at end-2011, or 75% of GDP.
- In 2012, external **debt service payments** remain high, estimated at about $64 billion or 36% of GDP.
- Ukraine must maintain investors' confidence to keep rollover ratios high.

…Ability to Cover External Financing Needs

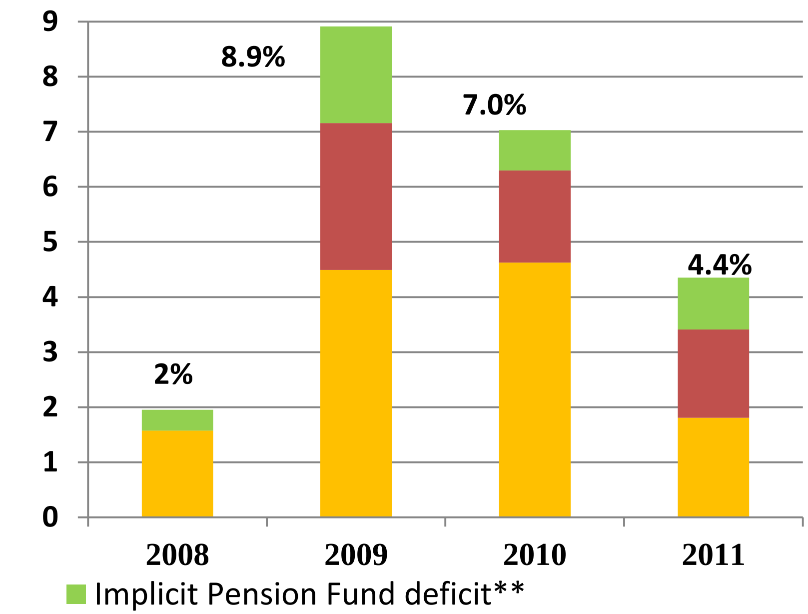
Balance of FX Needs and Inflows

	2012f	
$ billion	**Outflow**	**Inflow**
CA balance *	9.3	
Ext'l Public Debt	8.0	6.8
Ext'l Private Debt	46.0	41.5
Banks	*12.0*	*9.5*
*Corporates***	*34.0*	*32.0*
FDI		4.0
Net purchases of FX by population	4.0	
Total	**67.3**	**52.3**
Change in Reserves		-15.0

* Includes $9.6 billion of interests due on foreign debt.
** Includes inter-company lending
Source: NBU, MinFin, The Bleyzer Foundation

- Due to weaker exports but strong imports, the Current Account deficit will remain high at 5.3% of GDP in 2012.
- In addition, Ukraine has to service its large external debt, of which about $54 bn is short term.
- However, the prospects of having 100% rollover ratios have declined, given possible de-leveraging in European banks.
- FDI inflows still did not recovered to pre-crisis levels and are much below potential.
- IMF or other funds are now essential; but they are quite uncertain.
- If no additional foreign financing is found, international reserves may decline by $15 billion, dropping to about $16.8 billion, or ~2 months of imports.

4. Macroeconomic Stabilization and Fiscal Budget Deficit



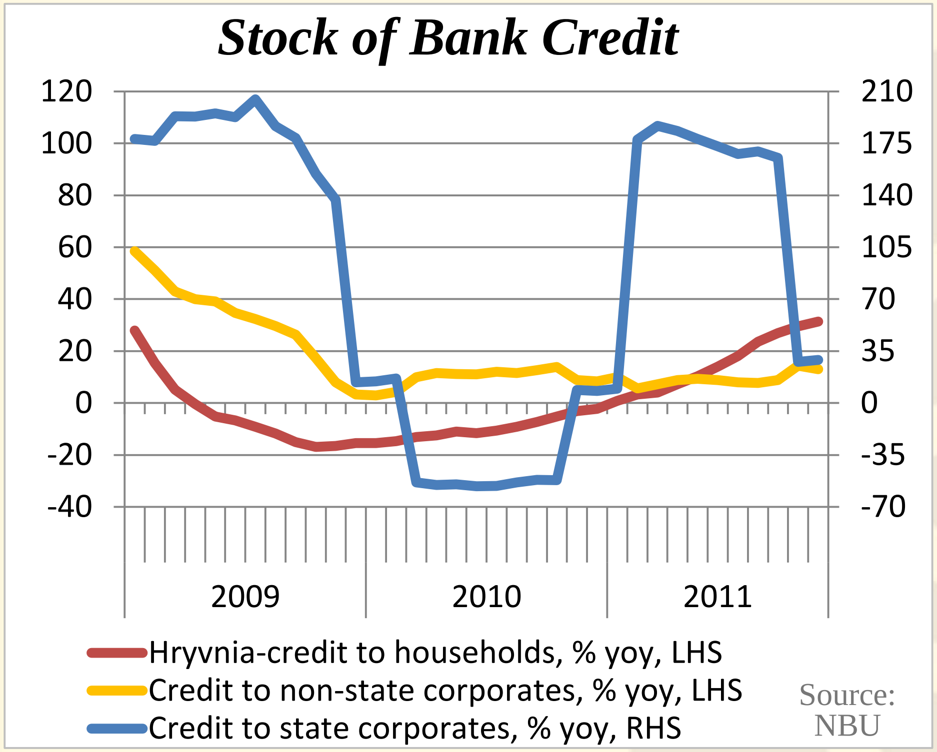
Source: MinFin, The Bleyzer Foundation

** State and local budget deficits*
*** Pension Fund Loans from Unified Treasury Account*

- Sustaining public finances remains another major macroeconomic challenges for Ukraine.
- During the crisis, the fiscal budget deficit grew to 9% of GDP.
- Partially as a result of it, public debt (domestic and external) grew from below 13% GDP in 2007 to ~40% GDP in 2010.
- Ukraine committed to reduce its fiscal deficit to 3.5% GDP in 2011 and 2.5% in 2012.

- However, fiscal adjustment proceeded slower than expected.
- The overall government fiscal deficit in 2011 was around 4.5% GDP due to higher Naftogaz and Pension Fund imbalances.
- The deficit is unlikely to be 2.5% in 2012, as required by the IMF.

5. Recovery of the Banking Sector and Credit



- Banking credit growth has been reviving but quite unevenly:
  - the highest credit increase was for state-owned companies during most of 2011 (175% yoy on average during Feb-Sep 2011);
  - consumer credit resumed at robust 34% yoy in 2011;
  - credit growth to private companies has been sluggish - 13% yoy in Nov 2011, impeding investments.
- Bias towards SOE and consumer lending may complicate the ongoing process of cleaning commercial banks balance sheets from NPLs (~40% of total loans in 2011).
- In addition, substantial presence of European banks in Ukraine's banking sector is another source of vulnerabilities, given the Eurozone's crisis.

6. Adequacy of Policies to Sustain Growth

- Since the 2008 crisis, economic reforms to sustain growth have been minimal.
- Necessary short term measures include:
  - End business harassment, threats, and interference by government authorities in businesses, including harassment by tax authorities, customs, inspection agencies, etc.
  - Protect property rights, including stronger mechanisms to deal with raiders.
  - Simplify procedures to acquire commercial land for plant & warehousing.
  - Facilitate the establishment of new businesses, including de-regulation and improving production sharing agreements for oil and gas.
  - Approve the Customs Code to facilitate international trade.
  - Take measures to facilitate the resolution of non-performing loans in the banking sector.
  - Ensure that the Association Agreement and FTA with the EU are signed soon.
- Over the medium term, the government will need to show that:
  - The Judiciary is finally reformed and will be acting in a fair and transparent manner.
  - Administrative corruption is brought under control.
  - Public administration reform will be finalized to redefine the role of the government as complementary to the private sector, improve efficiency by eliminating overlapping functions among agencies, minimize regulations to avoid interference in businesses.
  - Other institutions that support the business sector, such as non-bank financial institutions, commodity future exchanges, etc. will be improved.

Summary of Factors that will Affect Ukraine's Recovery

External Environment:	Summary
1. The pace of economic recovery in Ukraine's main trading partners	1. Negative
2. Prospects for Ukrainian exports	
a) Prospects for steel and metallurgical exports	2a. Negative
b) Prospects for agricultural exports	2b. Positive
c) Degree of Ukraine's international competitiveness	2c. Positive
3. Ability of Ukraine to roll-over its large foreign debt and secure external financing	3. Negative
Domestic Factors:	
4. Adequacy of Macro-economic Stabilization Policies	4. Mixed
5. Pace of recovery of Domestic Demand and Credit	5. Mixed
6. Adequacy of Economic Policies to **sustain** long-term growth by improving the business climate to attract investments	6. Mixed

Moving Forward

- If Ukraine were to implement a strong program of reforms, the country will be less vulnerable to international crises and sustain higher rates of growth (about 5% - 8% pa).
- In fact, Ukraine's has many advantages that could enable it to growth based on domestic markets --consumption and investments-- with less vulnerability to exports. In fact, the domestic market could become the major engine of growth. But this will require major flows of foreign direct investments that require a better business climate.
- International comparisons show that Ukraine may indeed be attractive for FDIs:
  - Ukraine's large population gives a very attractive market potential for local and international consumer products.
  - Ukraine is endowed with very rich agricultural land that could be a growth engine.
  - Ukraine is an open economy which could grow fast with Free Trade Agreements.
  - The fiscal budget deficit is much lower than in other similar countries.
  - At 40% of GDP, Ukraine's public debt compares favorably to external debt of over 80% in most European countries.
  - Although private and public external debt at 86% of GDP is a major burden for Ukraine, it is much better than external debt levels than many European countries.
  - Education and health indicators in Ukraine are much better than other countries.
  - The country may still grow at reasonable rates.