Ukraine:
Economic Situation
And Prospects

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May 2013

Main Macroeconomic Indicators

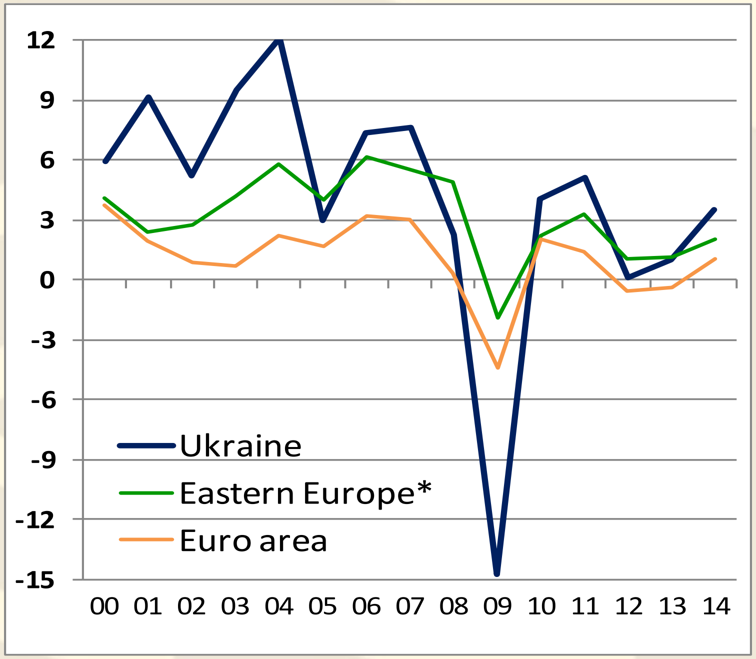
	2000-07 average		2008	2009	2010	2011	2012	2013f	2014f
Real GDP Growth, % yoy	7.5		2.3	-14.8	4.1	5.2	0.2	1.0	3.5
Fiscal Balance, % GDP	-0.8		-2.0	-8.5	-6.7	-4.3	-5.6	-4.0	-3.0
Consumer Inflation, %, eop	11.3		22.3	12.3	9.1	4.6	-0.2	4.0	5.0
UAH/$ Exchange Rate, eop	5.2		7.7	8.0	8.0	8.0	8.0	8-8.4	8-8.5
Current Account, % GDP	2000-05 5.7	06-07 -2.6	-7.0	-1.5	-1.9	-5.5	-8.3	-7.0	-6.0
Gross Int. Reserves, $ bn	2000 1.5	2007 32.5	31.5	26.5	34.5	31.8	24.5	25.0	27.0
Foreign Public Debt, % GDP	2003 21.3	2007 8.7	9.2	20.5	23.8	20.4	18.3	18.5	18.5
Foreign Private Debt, % GDP	26.2	47.4	47.1	67.7	62.2	56.8	58.3	56.1	54.1

[*] Includes implicit pension fund deficit (credits from Single 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

Source: NBU, SSC, MinFin, The Bleyzer Foundation

Economic Growth in Select Countries in the Region

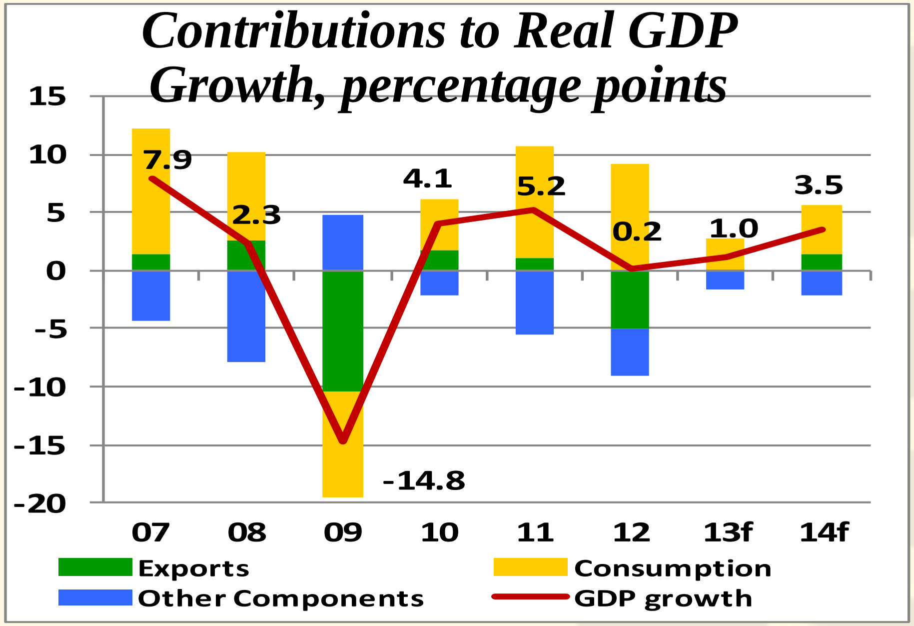
	00-07	08-09	10-11	12	13-14(f)
Euro area	2.2	-2.0	1.7	-0.6	0.4
Hungary	3.6	-3.0	1.4	-1.7	0.6
Poland	4.1	3.4	4.1	2.0	1.8
Romania	5.7	0.4	0.5	0.3	1.8
Ukraine	7.5	-6.3	4.6	0.2	2.3
Russia	7.2	-1.3	4.4	3.4	3.6
Turkey	5.2	-2.1	8.8	2.6	3.6

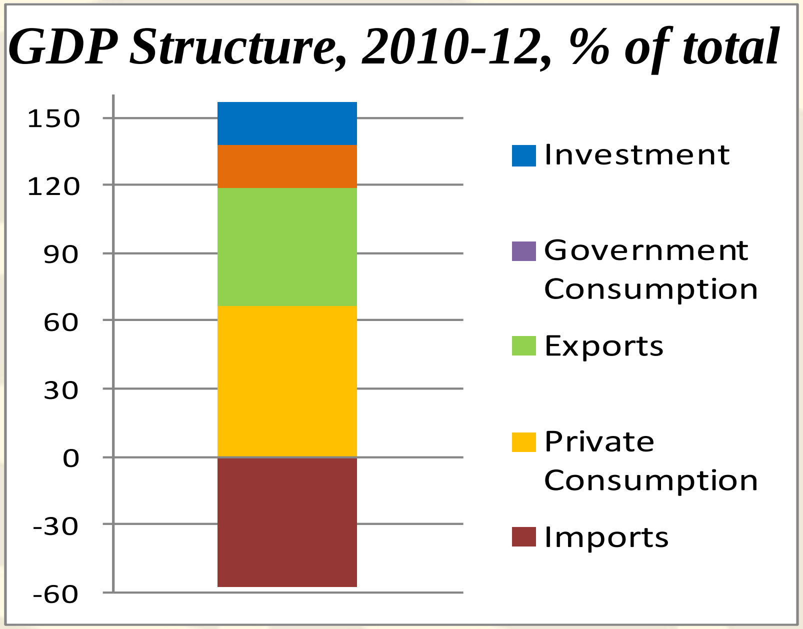


Eastern Europe includes Bulgaria, Hungary, Poland and Romania. The region growth was weighted by the size of the economies.
Source: IMF WEO (April 2013), The Bleyzer Foundation

- The Ukrainian economy grew fast during 2000-2007, was hit hard by the crisis of 2008, but showed strong recovery during 2010-1H 2012.
- In 2H 2012, it was hit by a recession in the EU & global trade slowdown.
- Economic growth is forecast to regain traction gradually from late 2013.
- Beyond 2013, Ukraine's growth prospects still compare relatively favorably with other countries in the region.

Real GDP Growth in Ukraine by Expenditures

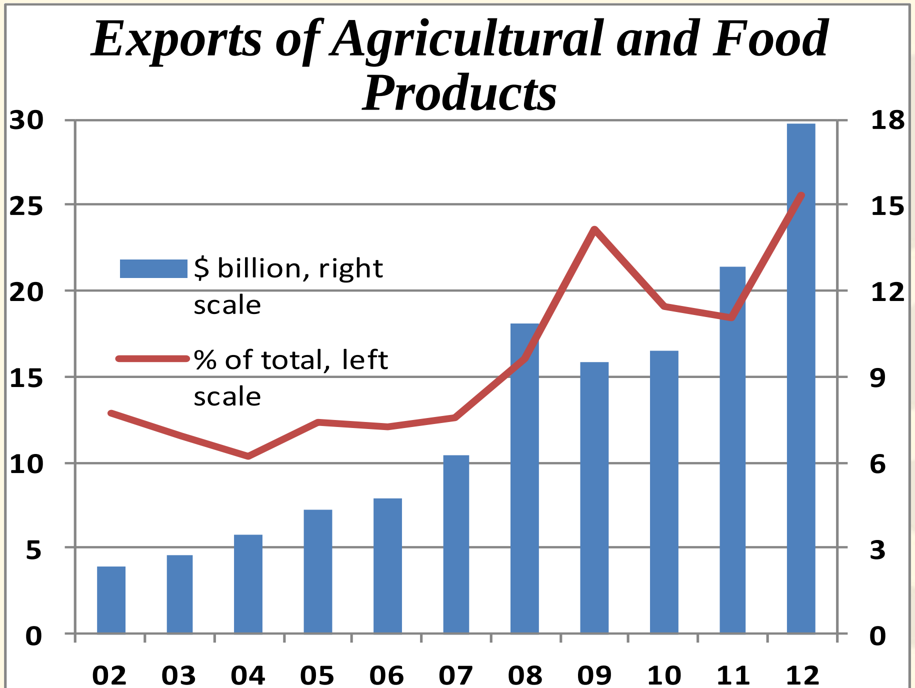




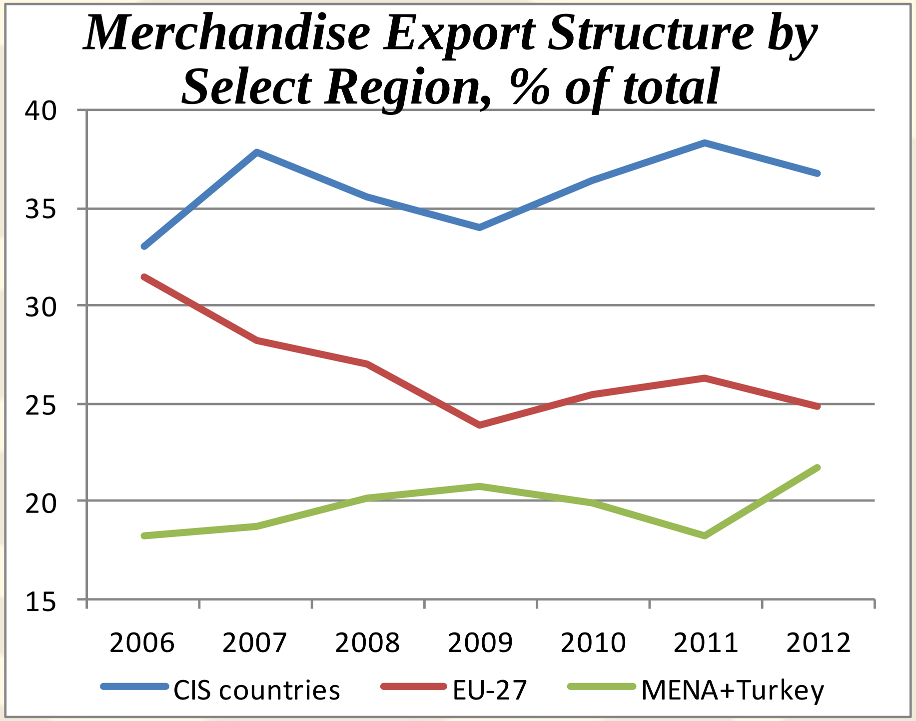
Source: State Statistics Committee, The Bleyzer Foundation

- Ukraine is an open economy, with exports representing 55% of GDP.
- Thus, in 2008 and 2012, it was vulnerable to slowdowns of global demand.
- But exports will be a strong growth driver when global trade accelerates.
- Private consumption will also drive GDP, though with some cooling in 2013.
- But investments will underperform, due to fiscal austerity and tight credit.
- Growth in 2013 will be only 1%, accelerating to 3.5% in 2014, and to about 4-5% thereafter; altogether a favorable outlook for Ukraine.

Export Prospects are favorable



Source: State Statistics Committee, NBU, The Bleyzer Foundation

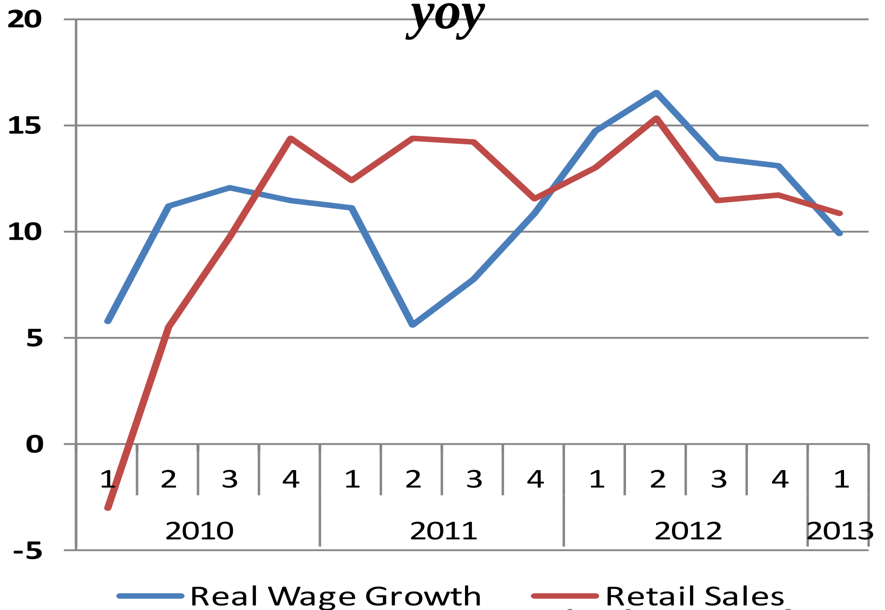


Despite subdued demand in developed economies, Ukraine's medium-term export outlook is favorable due to:

- geographic diversification with greater reliance on high-growth EMs;
- the uptrend in exports of agricultural commodities;
- prospects of a free trade agreement with the European Union in late 2013.

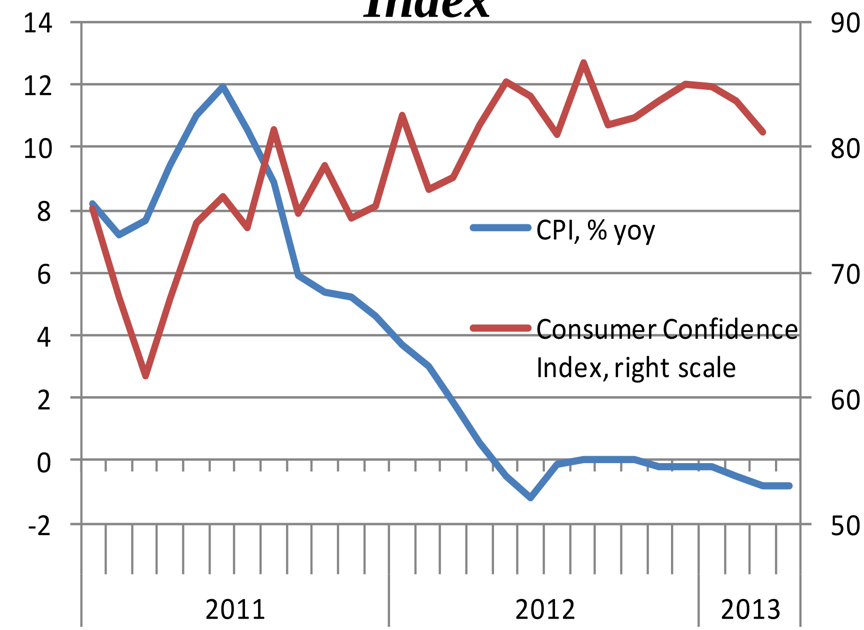
Private Consumption should also drive GDP Growth

Retail Sales and Real Wage Growth, % yoy



Source: State Statistics Committee, NBU, The Bleyzer Foundation

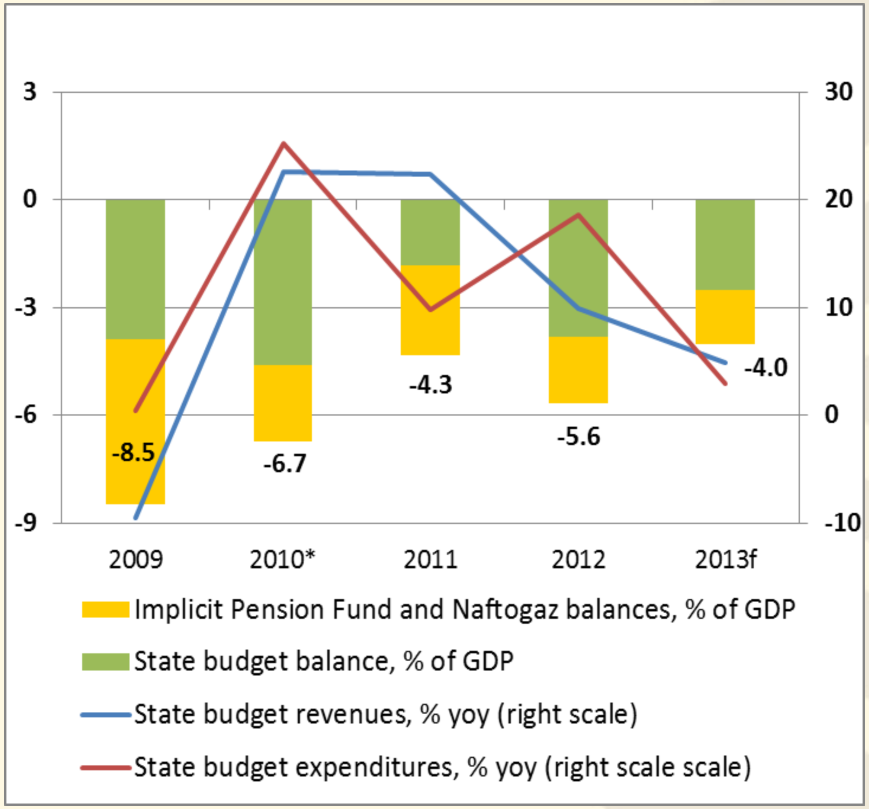
Consumer Inflation and Confidence Index



- Private consumption grew strongly in 2012 on account of low inflation, stable FX rates, robust real wage/pension growth, and consumer confidence.
- Consumption growth may temporary decelerate in 2013, reflecting the need for fiscal consolidation and tight credit, but may speed up in 2014.
- Diminished inflationary pressures, Hryvnia stability and consumer confidence will help sustain consumers' buying power in 2014 and beyond.

Fiscal Policy

Public Finances

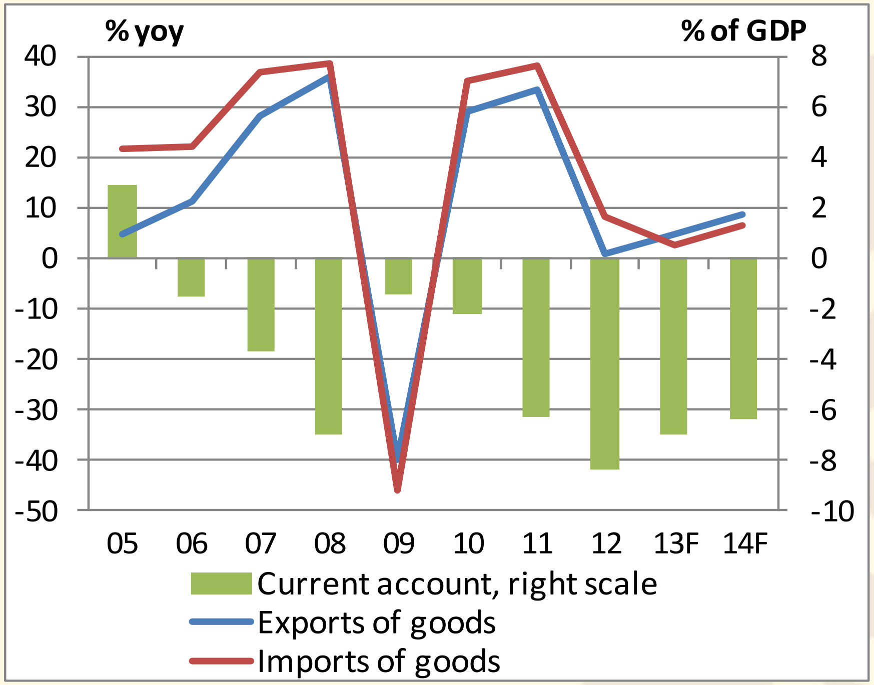


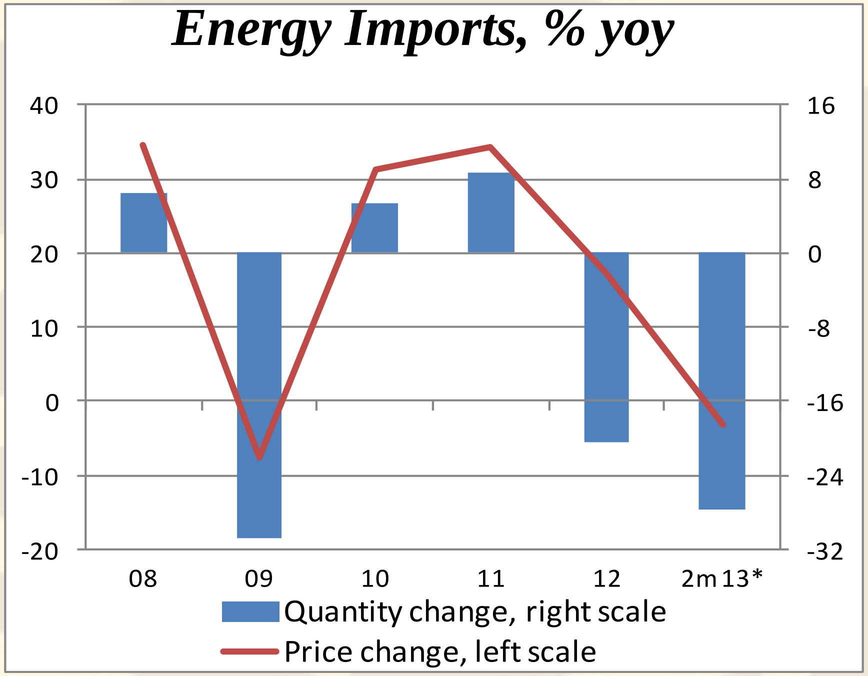
Source: MinFin, TBF

** Excluding VAT refunds via VAT bonds in 2010*
*** Estimate based on unrevised 2013 Budget Law*

- The fiscal budget situation is improving, with deficits gradually reduced from 8.5% of GDP in 2009 to 4.3% in 2011 and an expected 4.0% in 2013.
- In 2012, the fiscal deficit reached 5.6% of GDP, as budget revenues fell short of target (due to low GDP growth) and social expenditures grew rapidly (due to high wage and pension spending, and continuation of natural gas subsidies).
- We expect that the fiscal deficit will narrow to 3% of GDP in 2014.

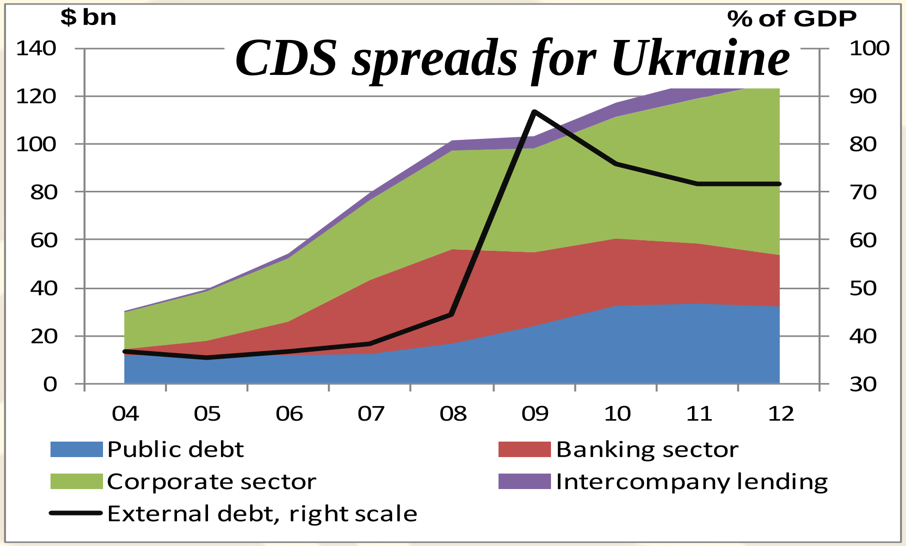
Balance-of-Payments Prospects: Current Account





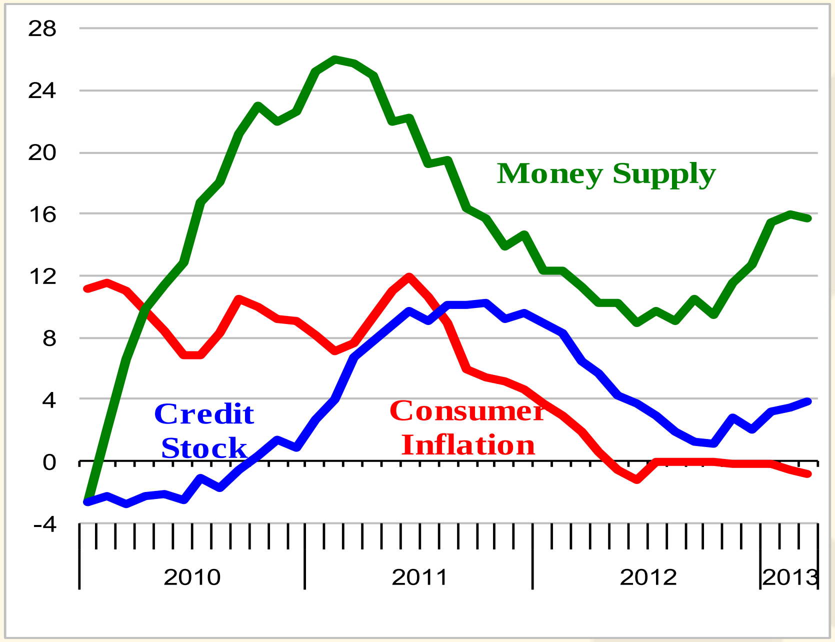
- The Current account deficit is forecast to gradually narrow thanks to:
  - Government efforts to diversify away from expensive energy imports (including greater use of domestic coal, energy imports from Europe, energy efficiency, and ongoing investments in domestic shale gas).
  - Good prospects for agricultural exports.
  - Export diversification into EMs.

Balance-of-Payments Prospects: Capital Inflows



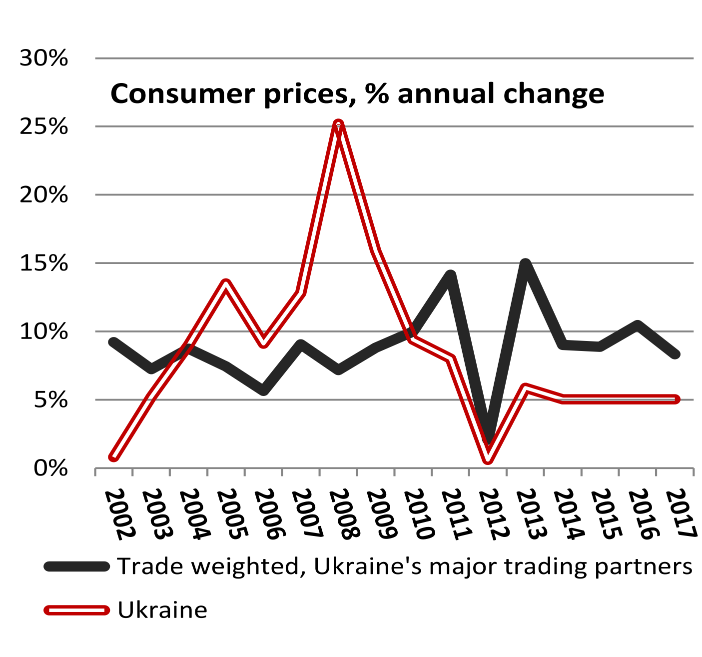
- CDS spreads for Ukraine have been declining since 2010.
- Since 2010, government and banking foreign debt has been declining, but the corporate sector has been successful in attracting increasing foreign financing.
- In 1Q 2013, the Capital Account had a large surplus of $3.5 billion (an increase of 140% yoy) and capital inflows are forecast to improve further due to:
  - loose international liquidity,
  - gradual recovery of investors' risk appetite for EMs,
  - prospects of IMF loan extension and a FTA with EU, and
  - a larger repatriation of funds from offshore centers.

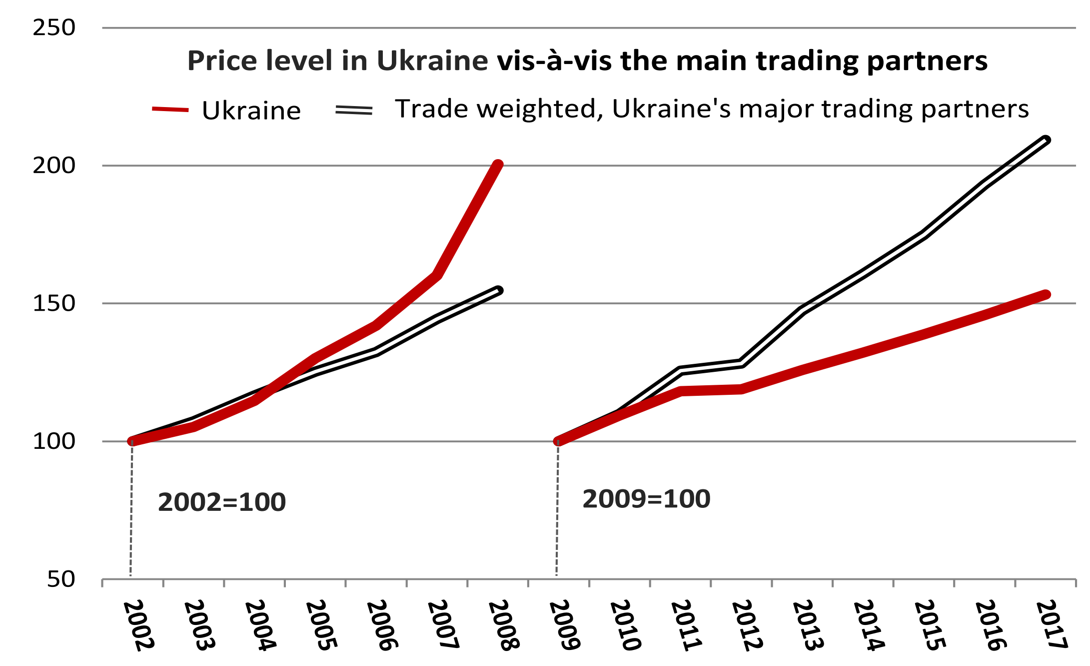
Monetary Conditions and Credit



- Since 2011, money supply has been relatively tight, with an average growth of 13% pa, compared to 40% pa before the 2008 crisis.
- Tight money supply, along with reduced fiscal deficits, ample food supplies, and stable utility prices, led to low inflation in 2011(4.6%) and deflation in 2012 (-0.2%).
- But tight money supply also led to high interest rates and limited bank credit.
- Since the end of 2012, monetary conditions loosened, amid improved inflation and exchange rate expectations, and this is being reflected in the recovery of credit growth.
- Since 2009, the Hryvnia exchange rate has been stable at about 8 UAH/USD.

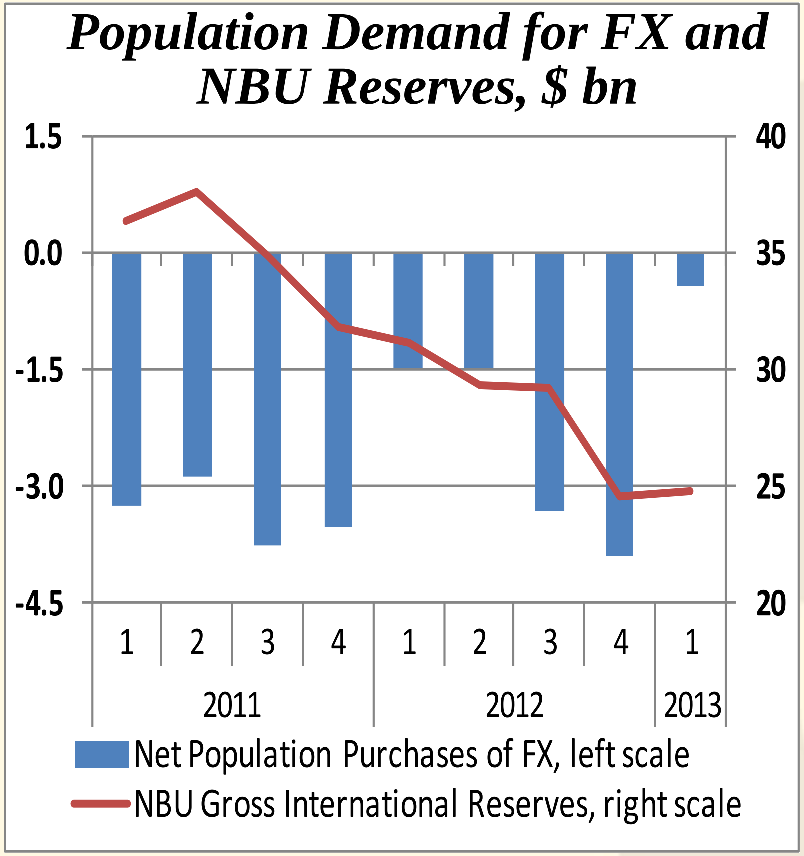
Exchange Rate Prospects: Price Competitiveness





- Contrary to the situation before 2008, since 2010, inflation in Ukraine has been (and is forecast to be) lower than in its main trading partners.
- Therefore, after a sharp nominal exchange rate adjustment in 2008, the estimates of purchasing power parity are now favorable for Ukraine.
- This points to restored competitiveness and, thus, diminished current account depreciation pressures on the Hryvnia exchange rate.

Exchange Rate Prospects: Population Demand for FX



Negative sign of net FX purchases means that population bought more foreign currency than sold to the banks over the period.
Source: NBU, The Bleyzer Foundation

- In some quarters of the last two years, population purchases of foreign currencies reached $3.5-$4.0 billion per quarter.
- These large population purchases of foreign currency were a significant drag on the capital account and Hryvnia exchange rate.
- However, since the end of 2012, population demand for foreign currency fell to only $0.3 billion thanks to:
  - a more stable macroeconomic environment, and
  - better consumer confidence.
- This also contributes to FX rate stability.

Exchange Rate Prospects: Other Factors

- In addition to fundamental economic factors favoring foreign exchange rate stability, there are a number of socio-political reasons why the Ukrainian authorities are likely to use all available administrative means to mitigate any possible devaluation pressure.
- The government realizes that a currency depreciation may not be an effective adjustment mechanism to reduce external imbalances given that:
    - Imports of gas will not be reduced by a devaluation given natural gas contract rigidities;
    - Large external debt service payments may bring many companies to bankruptcy;
    - High banking sector asset/liability exposure to exchange rate movements.
- Amid improving economic fundamentals and the above-mentioned factors, the UAH exchange rate is likely to remain relatively stable in the medium-term, with a maximum devaluation of about 5%, which could bring the UAH/USD rate to 8.4 - 8.5.

Summary

- Due to a challenging external environment, Ukraine's real GDP growth is forecast to increase by about 1% yoy in 2013, 3.5% yoy in 2014 and 4% -5% thereafter.
- The fiscal budget situation is improving, with deficits gradually reduced from 8.5% of GDP in 2009 to 4.3% in 2011 and an expected 4.0% in 2013.
- Inflation has been low in both 2013 and 2014, due to lower fiscal deficits, tight monetary policies, ample food supplies, and stable utility tariffs.
- The current account deficit is forecast to gradually narrow thanks to government efforts to reduce energy imports, good prospects for agricultural exports and export diversification.
- Capital inflows should continue, due to loose international liquidity, gradual recovery of investors' risk appetite, prospects of IMF loan extension and a FTA with the EU, and a larger repatriation of funds from offshore centers.
- Amid a favorable BoP outlook and improved competiveness (based on PPP), the Hryvnia exchange rate is likely to remain relatively stable during the next two years.

Moving Forward

- Ukraine may achieve and sustain rates of growth of 4%-5%, and even higher (5%-7%) if it proceeds with investment climate improvements.
- The domestic market could become the major engine of growth. An increase in domestic supply of goods and services may be achieved by attracting major flows of foreign direct investments.
- Ukraine is attractive for FDI thanks to:
  - A large consumer market with population over 45 million.
  - Very rich agricultural land.
  - One of the largest potential amounts of shale gas in Central/Eastern Europe.
  - An open economy that could grow fast with Free Trade Agreements.
  - At about 18% of GDP, Ukraine's external public debt compares favorably with other countries in the region.
  - Although private and public external debt at 75% of GDP is a major burden for Ukraine, it is better than the external debt levels in many EU countries.