

# Ukraine's Economy Since Independence and Current Situation

Dr. Edilberto Segura

SigmaBleyzer - The Bleyzer Foundation

January 2013

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# Economic Performance in the 1990's

After independence from the Soviet Union in August 1991, Ukraine had a large potential to grow fast:

- It was the second largest European country in land mass and the 4th largest in population (51 million people).
- Had well educated and skilled labor force.
- Had extensive and rich agricultural soil: used to be the grain-basket of the former Soviet Union.
- Had good industrial activities.
- Had good mineral resources (iron ore, coal).
- Had a reasonably developed infrastructure.

# What happened after Independence?

- Despite favorable initial conditions, Ukraine *had a difficult transition* -- with a long recession lasting several years.
- This was because:
  1. It was open and dependent on other FSU Republics for inputs and sales -- but Independence cut these production & trade relations.
  2. It had a large percentage of military industries (25% of enterprises produced military goods) -- which found themselves without markets.
  3. Due to negligible energy cost, many industrial processes were very energy intensive (Ukraine used 6 times more energy/GDP than in EU) - - they became inefficient when energy cost increased 10 times.
- Although corporate restructuring was needed, the government instead followed a “preservation” strategy, giving huge subsidies to enterprises.
- These deficits generated large government deficits (of up to 25% of GDP in 1992), which led to high inflation rates (of up to 10,160% pa in 1993).

## In 1995-1996, President Kuchma was elected based on a reform agenda & progress was made in several areas:

- Prices and international trade were liberalized.
- Taxes were lowered and many subsidies eliminated.
- The small & mass privatization programs advanced.
- The NBU was strengthened with sound monetary policy.
- A new currency (Hryvnia) was introduced in 1996.
- Ukraine accepted the IMF Obligations under Article VIII (convertibility for current account payments).
- Inflation was reduced to 10% in 1997.
- The exchange rate was maintained stable at 1.9 UAH/US\$
- The NBU's international reserves increased.

These measures led to financial support by the IMF, the World Bank and the European Bank.

## But the 1998 Russian Default Hit Ukraine Hard

- The default on August 17, 1998 by Russia was a trigger for a financial crisis in Ukraine:
  - Foreign banks were not willing to roll-over Ukraine's foreign debt which had increased rapidly in 1996-98.
  - Capital outflows accelerated.
  - International reserves fell sharply from US\$2.5 billion in April 1998 to US\$800 million by December 1998.
  - The exchange rate depreciated by 80% from 1.9 UAH/US\$ in December 1997 to 3.4 UAH/US\$ by the end of 1998 and to 5.2 UAH/US\$ in 1999.
  - In two months, the local stock market index collapsed by 55% from 40 in August 1998 to 18 in October 1998.

## The post 1998 Crisis period – 1999-2007

- But Ukraine recovered very well from the 1998 crisis:
  - It negotiated successfully with banks the restructuring of its debts.
  - The fiscal deficit was below 1% of GDP from 1999 to 2007
  - Monetary policy stabilized the exchange rate at UAH 5.2 per US\$.
  - Key economic reforms were implemented, including adoption of legislation for WTO accession, improved intellectual property rights, liberalization of many business activities, payment of wage and pension arrears, elimination of barter trade, enactment of Laws on Banks, better legislation on money laundering, etc.
- The major Hryvnia devaluation of 1998, the improved fiscal situation, and new economic reforms provided the basis for export and GDP growth.

# Economic Performance between 2000 and Sept. 2008

- From 2000 to 2008, Ukraine showed overall excellent performance.

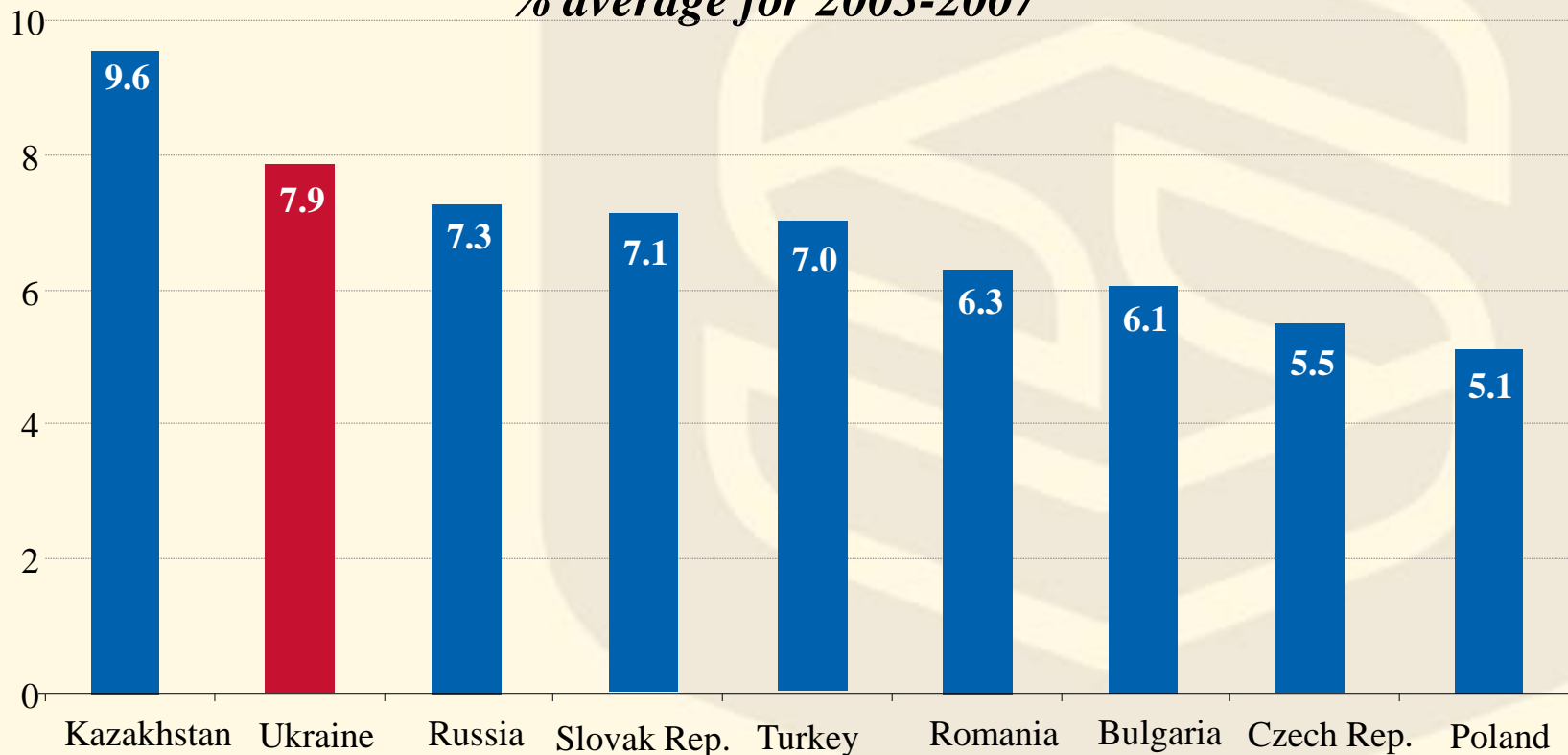
	2000-07 average		9m 2008
<b>Real GDP Growth, % yoy</b>	<b>7.5</b>		<b>6.3</b>
<b>Fiscal Balance, % GDP</b>	<b>-0.8</b>		<b>1.7</b>
<b>Consumer Inflation, %, eop</b>	<b>11.3</b>		<b>24.6</b>
<b>UAH/\$ Exchange Rate, eop</b>	<b>5.2</b>		<b>4.9</b>
<b>Current Account, % GDP</b>	<u>2000-05</u> <b>5.7</b>	<u>2006-07</u> <b>-2.6</b>	<b>-6.4</b>
<b>Gross Int. Reserves, \$ bn</b>	<u>2000</u> <b>1.5</b>	<u>2007</u> <b>32.5</b>	<b>37.5</b>
<b>Foreign Public Debt, % GDP</b>	<u>2003</u> <b>21.3</b>	<u>2007</u> <b>8.7</b>	<b>6.5</b>
<b>Foreign Private Debt, % GDP</b>	<b>26.2</b>	<b>47.4</b>	<b>50.4</b>

Source: State Statistics Committee of Ukraine, National Bank of Ukraine, Ministry of Finance of Ukraine, The Bleyzer Foundation

# Comparative Economic Performance

- For the period 2003-2007, Ukraine was one of the fastest growing economies in the region.

*Real GDP growth in Ukraine and Selected Emerging Market Economies,  
% average for 2003-2007*

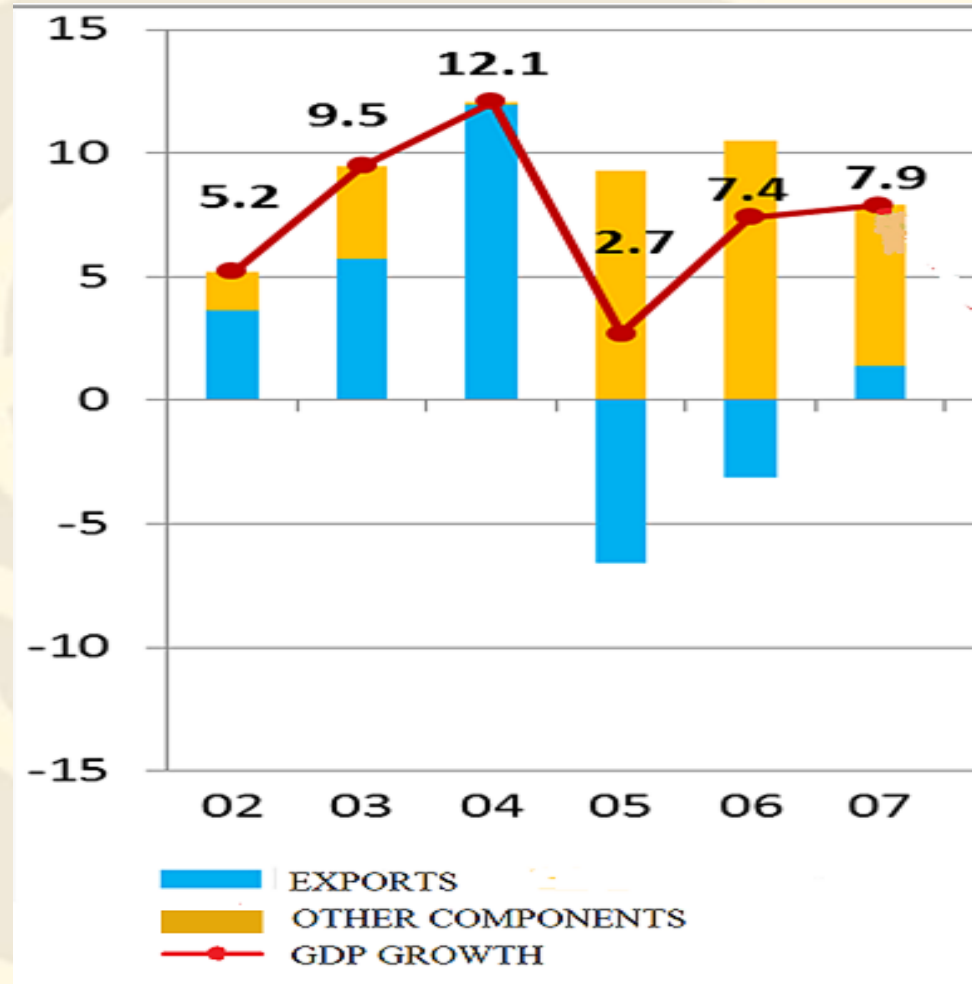


Source: State Statistics Committee of Ukraine, IMF WEO Database April 2008



# Growth Drivers During 2002 - 2007

- Exports were the main sources of growth in 2002 to 2004, driven by high growth in the EU and EMs and high metallurgical demand by EMs, principally China.
- But in 2005-2007, the main sources of GDP growth were domestic consumption and investments, stimulated by a large inflow of foreign capital that brought external foreign debt (principally private) from \$20 bn in 2002 to \$90 bn in 2007.



## But the 2008 Sub-Prime Crisis again hit Ukraine hard, due to its high dependence on mineral exports and foreign capital

- Export of goods: **- 40% yoy** (2009)
- Real GDP: **-14.8% yoy** (2009)
- Industrial production: **-22% yoy** (2009)
- PFTS stock price index: **-74%** (2008)
- UAH/\$ Exchange Rate: **58% Depreciation** (4Q 2008)
- Unemployment (ILO): **9.4%** (4Q 2009)
- Real households' income: **-8.5% yoy** (2009)
- Broad fiscal balance: **-11% of GDP** (2009)

# The Crisis Affected Ukraine Harder than other EMs

Country	GDP, % yoy 2009	Local Currency Depreciation vs. US Dollar (mid-2008 to end-2009)
<b>Ukraine</b>	<b>-14.8</b>	<b>65%</b>
Latvia	-17.5	9%
Lithuania	-14.4	9%
Estonia	-14.5	9%
Russia	-8.0	29%
Mexico	-6.9	27%
Romania	-7.1	27%
Hungary	-6.7	26%
Taiwan	-3.5	6%

\* The Bleyzer Foundation for Ukraine and Romania, The Economist for others countries  
Sources: The Economist, Central banks of the respective countries, The Bleyzer Foundation

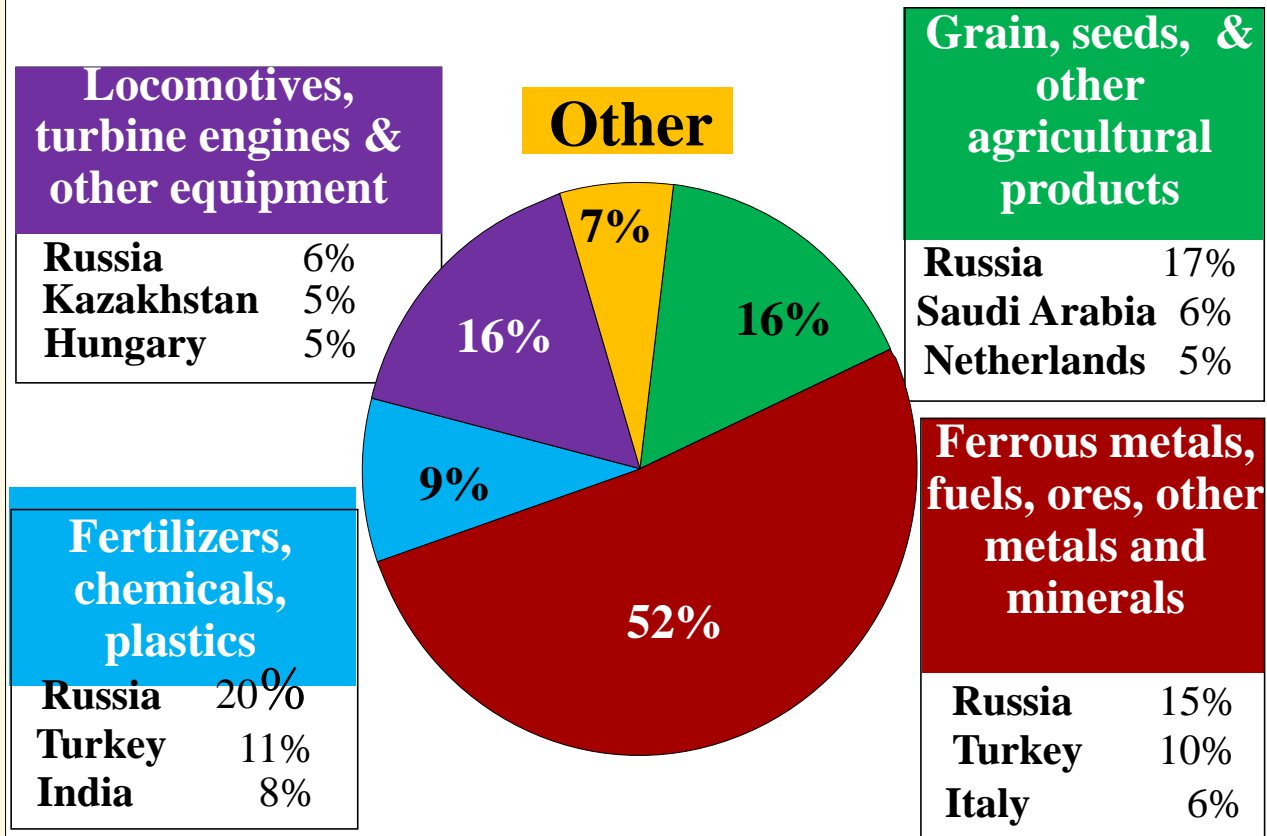
# Why Ukraine Was Affected So Severely in 2008?

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

# Vulnerability #1 – Open & Undiversified Economy...

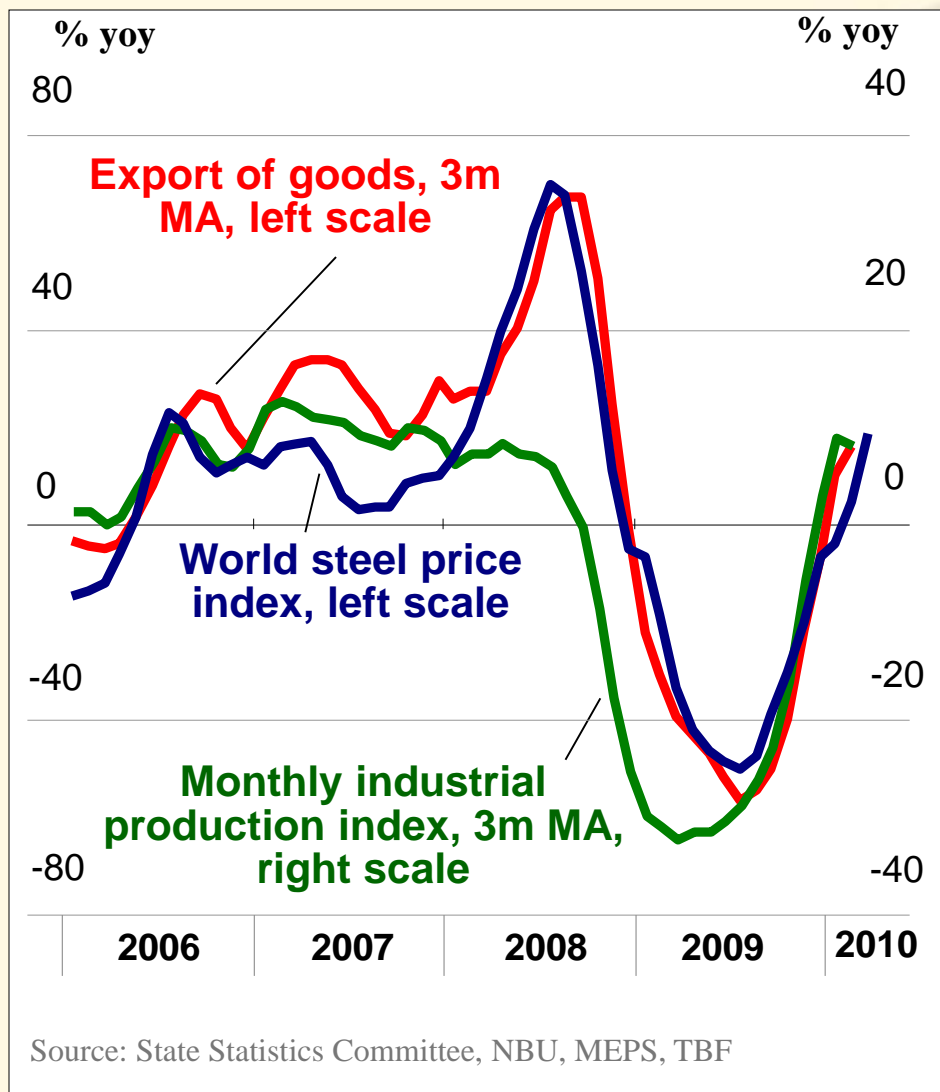
**Ukraine's Exports by Commodities, % of Total, and Key Trading Partners, % of Commodity Exports, 2008**



Sources: UN Comtrade, The Bleyzer Foundation

- 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.

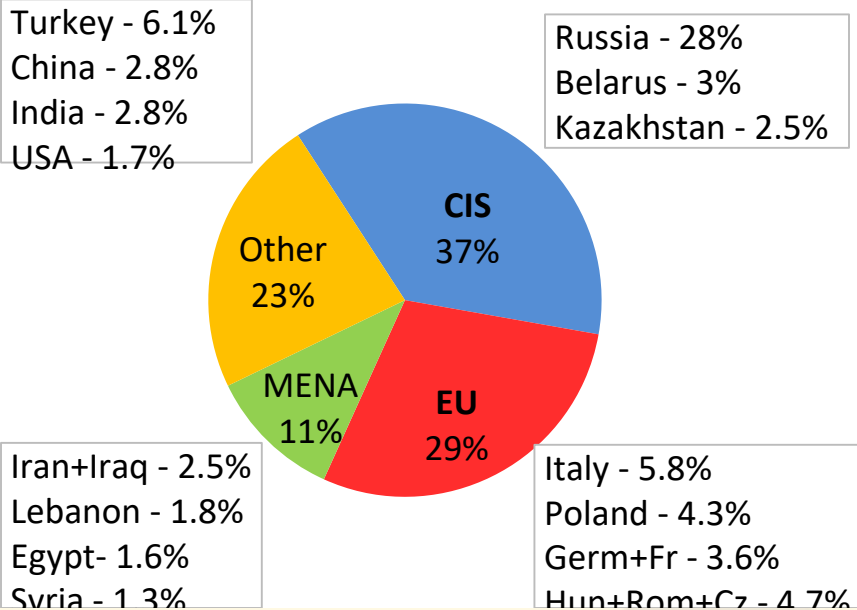
## ...with high dependence on Steel Prices...



- 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<sub>44</sub>

## ...and exports undiversified geographically

Ukraine's Goods Exports by Regions and Selected Countries, % of total, 1H 2011



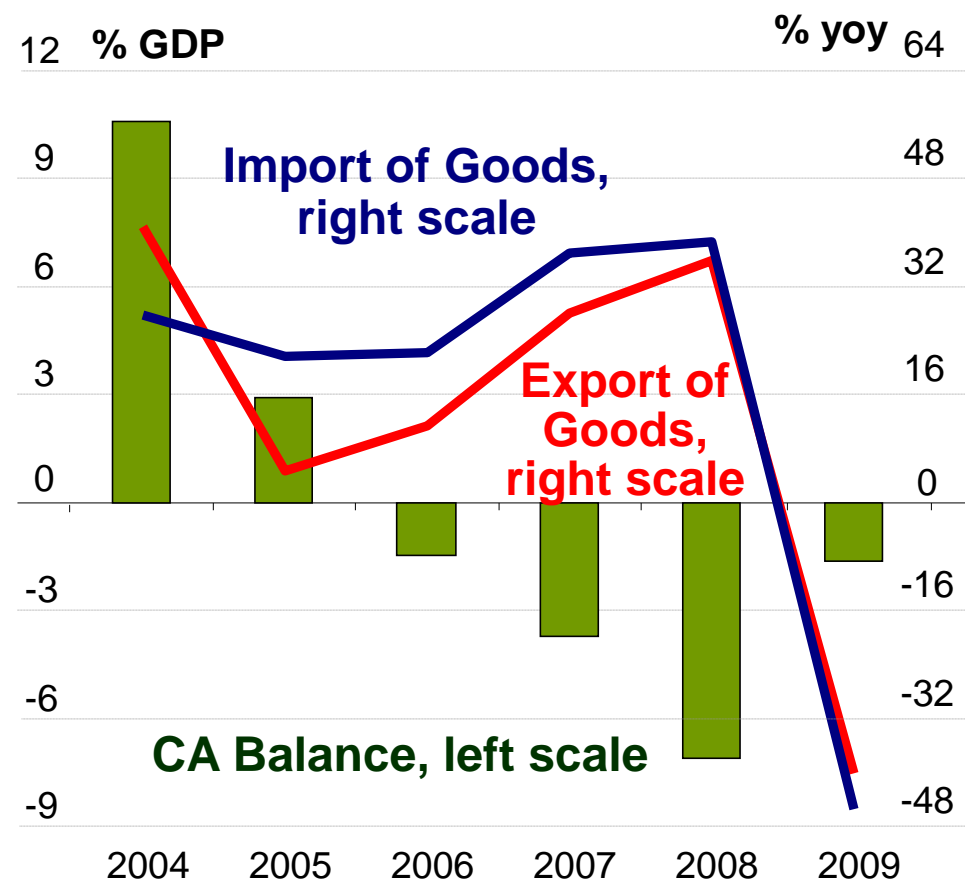
Source: State Statistics Committee, The Bleyzer Foundation

- 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 slow downs.
- Slower growth in the CIS, EU and Turkey will affect Ukrainian exports.

# Vulnerability # 2 – Large Current Account Deficits

Ukraine's Foreign Trade in Goods Performance and Current Account Balance

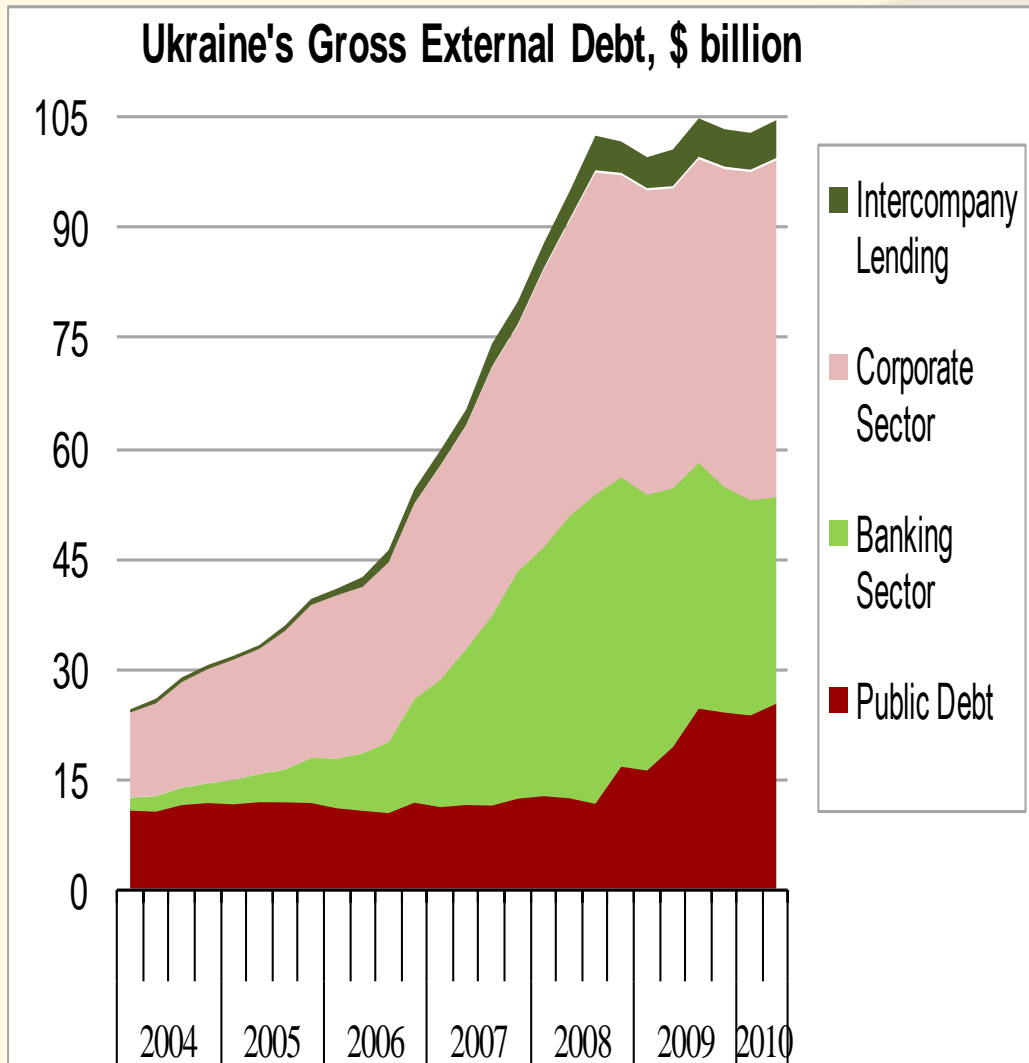


- Over 2003-2008:
  - Exports grew by 25% pa
  - But imports – by 30% pa
- CA deficits over 3% of GDP emerged in 2006 and reached 7% of GDP in 2008.
- Before the crises, the CA deficit for 2009 was forecast at 13% GDP.
- Uncertain foreign financing of this CA put pressures on the Hryvnia, principally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

Source: NBU, SSC, The Bleyzer Foundation

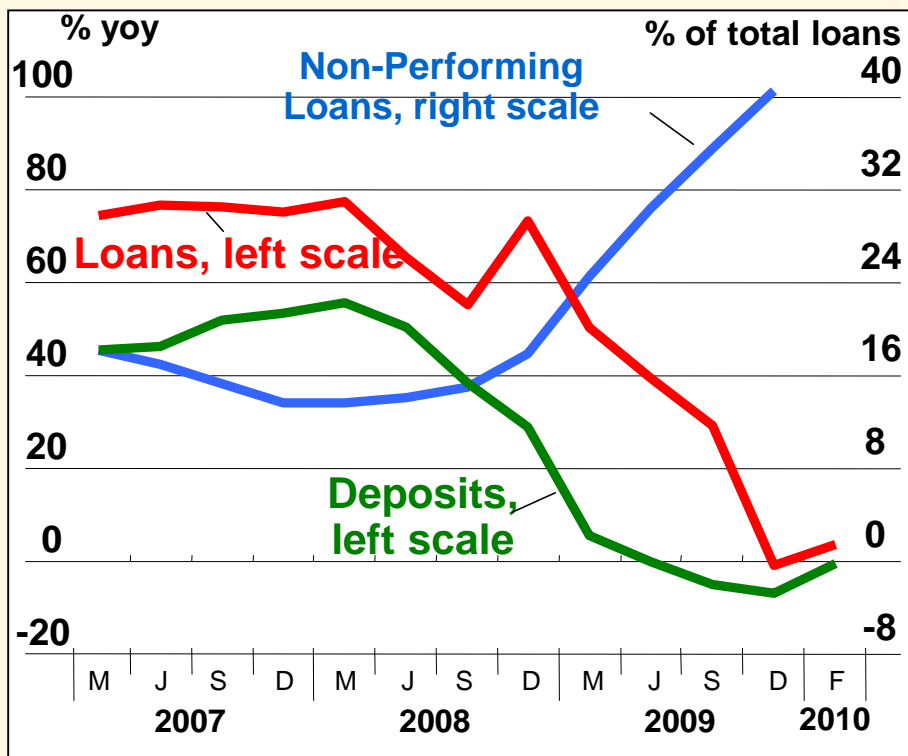


# Vulnerability # 3 – Large External Debt Repayments



- External debt tripled in three years (2006-08) to about \$100 billion (90% of GDP).
- As of mid-2008, ~ \$40 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.

# 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.

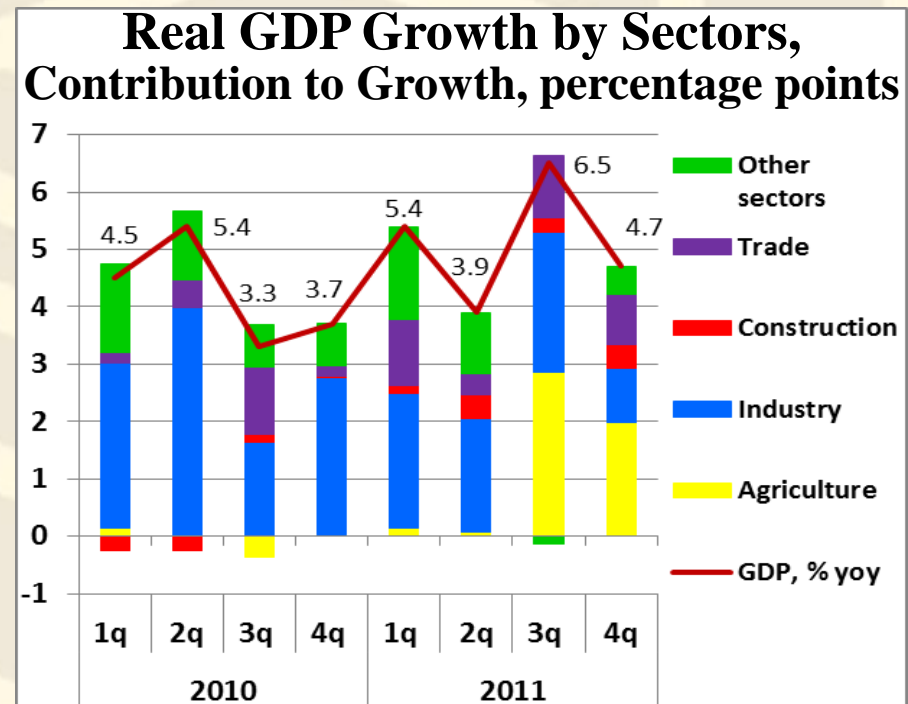
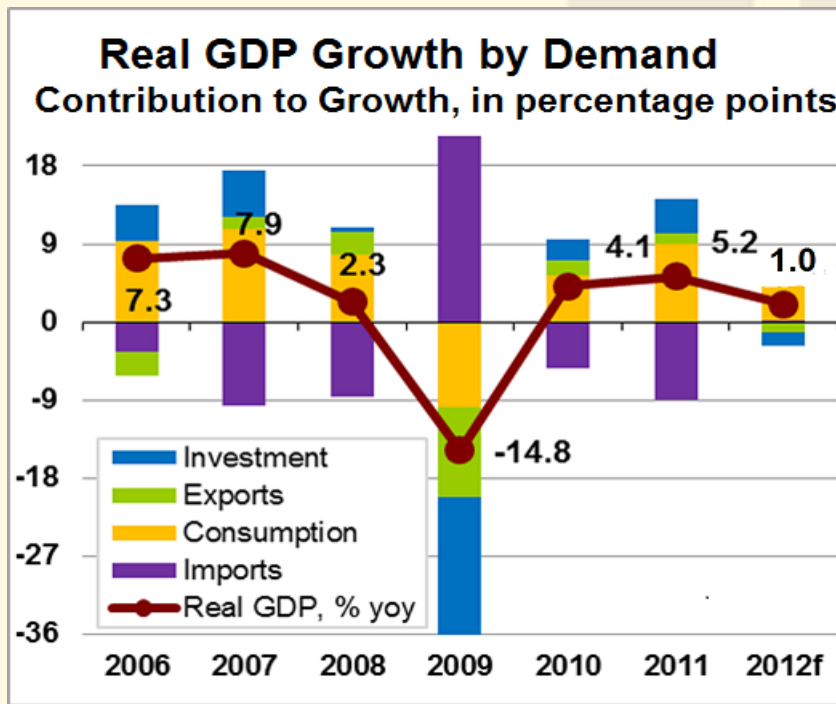
- All this created uncertainties and about ¼ of bank deposits were lost in late 2008 - early 2009.
- Although the deposit base was stabilized in mid-2009, in 2009 the banking sector as a whole made \$3.9 billion in losses.

# Ukraine Handled the Crisis Relatively Well

- Ukraine secured loans from the IMF and World Bank at the end of 2008.
- Private firms & banks were able to restructure short-term foreign debt.
- A program for troubled banks was implemented. The main aspect of this program was the recapitalization of troubled banks with public funds.
- The NBU supported banks liquidity through its refinancing operations; eleven banks were taken under NBU temporary administration with one of them successfully sold to new shareholders; the Central Bank monitoring was placed in several other banks. All in all, four banks were recapitalized.
- At the beginning of November 2008, the guarantee on deposits of individuals was increased three times to UAH 150,000 (about \$20,000).
- The authorities agreed to gradual fiscal consolidation and implemented structural reforms to revive growth.
- The Hryvnia depreciated by about 60% in 2008, restoring competitiveness.

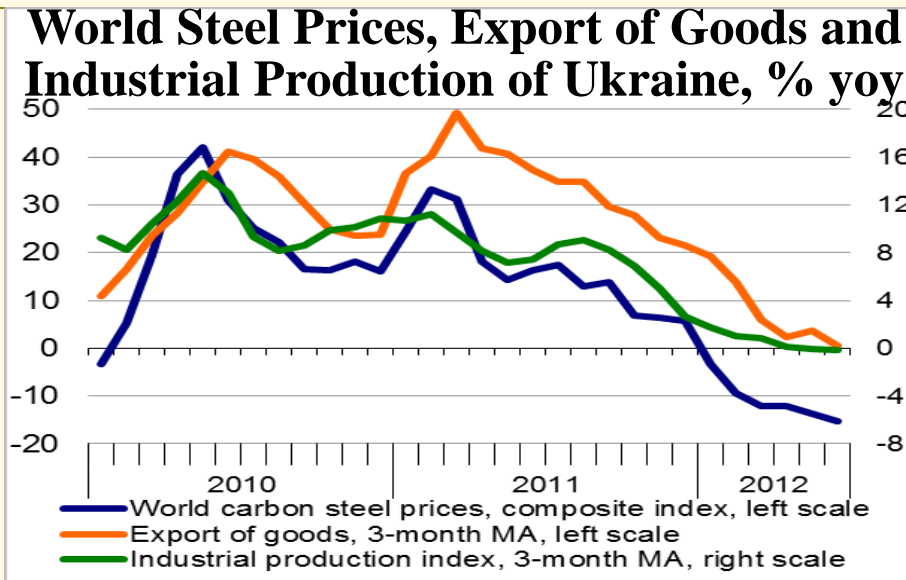
# The Economic Recovered Quickly in 2010 and 2011

- In 2010 and 2011, GDP grew rapidly at 4.1% and 5.2% pa, respectively, better than most European countries.
- Real GDP growth was driven by private **consumption** and public **investments**.
- **Agriculture**, with a record high harvest, played a significant role in supporting GDP growth in 2010 and 2011, and also in reducing inflation.



Sources: State Statistics Committee, The Bleyzer Foundation

## But GDP Growth stalled in 2012

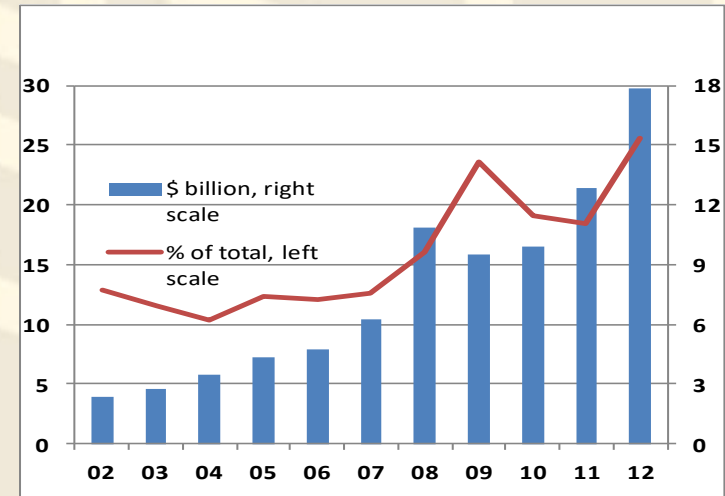
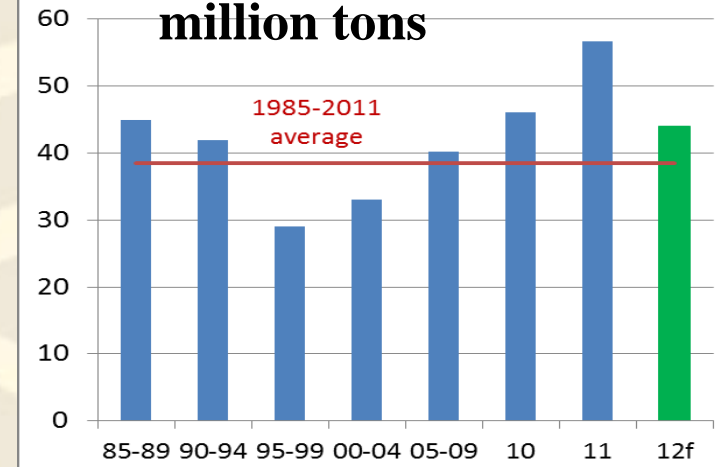


- In 2012, economic growth slowed down and is forecast at 1% for the year.
- GDP growth was depressed by weaker **exports and steel prices** (due to a unfavorable economic environments in Europe) and low domestic **investment** activity (due to the completion of large infrastructure projects).
- But growth was better than expected due to increases in **domestic consumption**, stimulated by growth in real wages (+15.6% yoy in 1H 2012).

# Growth Drivers in 2012-2013: Strong Agriculture and Domestic Consumption

- Agriculture and domestic consumption should be important growth drivers in 2012-13.
- For 2012, grain output would be about 45 million tons. Though lower than the 2011 record output, it will be higher than the historical average. Grain exports however will be a record number.
- For 2013, grain output may reach the record level of 55 million tons achieved in 2011.
- Domestic consumption should also contribute to GDP growth in 2012 and 2013, supported by low inflation, greater consumer confidence, and relatively stable FX rate for the Hryvnia.
- In 2013, Ukraine's economy should also grow slowly at about 1.5%.

**Grain Production in Ukraine, million tons**



# Key Macroeconomic Indicators

	2007	2008	2009	2010	2011	2012f	2013f
<b>Real GDP Growth, % yoy</b>	<b>7.9</b>	<b>2.3</b>	<b>-14.8</b>	<b>4.1</b>	<b>5.2</b>	<b>1.0</b>	<b>1.5</b>
<b>Fiscal Balance, % GDP*</b>	<b>-1.7</b>	<b>-2.0</b>	<b>-8.9</b>	<b>-7.0</b>	<b>-4.4</b>	<b>-4.5</b>	<b>-4.0</b>
<b>Consumer Inflation, %, eop</b>	<b>16.6</b>	<b>22.3</b>	<b>12.3</b>	<b>9.1</b>	<b>4.6</b>	<b>1.0</b>	<b>4.0</b>
<b>UAH/\$ Exchange Rate, eop</b>	<b>5.1</b>	<b>7.7</b>	<b>8.0</b>	<b>8.0</b>	<b>8.0</b>	<b>8.0</b>	<b>8.5</b>
<b>Current Account, % GDP</b>	<b>-3.7</b>	<b>-7.0</b>	<b>-1.5</b>	<b>-1.9</b>	<b>-6.5</b>	<b>-8.3</b>	<b>-7.0</b>
<b>Gross Int. Reserves, \$ bn</b>	<b>32.5</b>	<b>31.5</b>	<b>26.5</b>	<b>34.5</b>	<b>31.8</b>	<b>26.0</b>	<b>25.0</b>
<b>Foreign Gov't Debt, % GDP</b>	<b>8.7</b>	<b>9.2</b>	<b>20.5</b>	<b>23.8</b>	<b>21.0</b>	<b>19.0</b>	<b>18.0</b>
<b>Foreign Private Debt, % GDP</b>	<b>47.4</b>	<b>47.1</b>	<b>67.7</b>	<b>62.2</b>	<b>55.6</b>	<b>58.0</b>	<b>56.0</b>

\*In treasury account (state budget) to cover pension fund expenditures) for 2007-2008 and Pension Fund and Naftogaz

## Future Prospects Beyond 2013....

- Beyond 2013, along with the recovery of the global economy, Ukraine should be able to grow at 3% - 4% per annum.
- Much higher growth rates could be possible if Ukraine were to attract large investments in agriculture and other sectors.
- In particular, Ukraine has a large potential to become the world's largest agricultural exporter if its fertile land, favorable climate, cheap labor force and convenient geographical location are combined with sufficient investments in agro technologies.
- Nevertheless, during the next couple of years, the country should be able to handle adverse international developments, given its large gross international reserves of \$26 billion and its relatively low public debt (37% of GDP).
- But this will require Ukraine to maintain foreign financing to repay its large debt and cover its current CA deficits.



## ... with medium-term Prospects depending on Macroeconomic Stability and Cooperation with the IMF

- The government has indicated its willingness to restore macroeconomic stability by resuming consultations with the IMF.
- Due to uncertainties regarding other sources of financing, the Government may not have other choice but to resume the IMF program during 2013.
- If so, the IMF program would help to:
  - **Accelerate fiscal consolidation** due to the adjustment of heavily subsidized utility tariffs and the reduction of Pension Fund deficit;
  - **Encourage liberalization of foreign exchange regime** (moderate and controlled depreciation should improve competitiveness and help adjust external imbalances);
  - **Facilitate further financial sector improvements**, which will help resume bank lending and deepen financial intermediation;
  - **Ease access to foreign capital**, softening Ukraine's external financing needs.

## Medium-Term Prospects: Relations with the EU

- The Association Agreement with the EU, which includes ‘deep and comprehensive free trade area’, was initiated in early 2012 but signing was stalled due to EU’s concerns over political issues in Ukraine.
- We are cautiously optimistic about the agreement’s prospects in 2013 for the following reasons:
  - Though international observers reported some difficulties in the October’s Parliamentary elections, they were considered to have been properly organized and the results were close to exit-polls;
  - The new Parliament may agree on a sort of political amnesty for opposition political leaders, which will soften other concerns.
- The EU remains the second largest market in the world despite all current difficulties.
- A Free Trade Agreement with the EU will put Ukraine in the “supply chain” of products to Europe and will become the powerful growth driver for Ukraine.

# Medium-Term Prospects: Improvements in Business Climate

- Ukraine's conditions for doing business and the overall investment climate remain rather challenging.
- However, SigmaBleyzer and many multinational and foreign companies are successfully operating in Ukraine.
- In addition, the country is indeed progressing in making the country more attractive for business.
- Thus, in recent 2013 Doing business report Ukraine's ranking rose by 15 positions by easing procedures to start business and register property, and improving tax administration.
- President Yanukovich and the government repeatedly emphasize the improvements in business and investment environment are the priority of their economic programs.
- Given expected improvements in macroeconomic situation and more stable political situation, the government may implement broader economic reforms.

# Ukraine is an Attractive Country for Investment

- Strategic location at the crossroads of Europe, Russia, Central Asia and Middle East.
- Great agricultural potential due to extensive and rich agricultural soil: used to be the grain-basket of the former Soviet Union.
- Rich in other resources (iron ore, coal, water).
- Highly educated labor (60% university enrolment) with low wages.
- Large domestic market (with growing purchasing power)
- A reasonably developed infrastructure.
- Industrial and high-tech potential
- Many inefficiently-run companies that provide significant opportunity for value creation through improved operations, marketing, finance, customer and quality focus – bottom line growth

# Ukraine is a country of great potential

