

# **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 overall excellent economic results.

	2000-07 average		2008	2009 (f)	2010 (f)
<b>Real GDP Growth, % yoy</b>	<b>7.5</b>		<b>2.1</b>	<b>-14</b>	<b>3</b>
<b>Fiscal Balance, % GDP</b>	<b>-0.8</b>		<b>-1.5</b>	<b>-6</b>	<b>-4</b>
<b>Consumer Inflation, %, eop</b>	<b>11.3</b>		<b>22.3</b>	<b>15</b>	<b>10-13</b>
<b>UAH/\$ Exchange Rate, eop</b>	<b>5.2</b>		<b>7.7</b>	<b>8-9</b>	<b>8 - 10</b>
<b>Current Account, % GDP</b>	<u>2000-05</u> <b>5.7</b>	<u>2006-07</u> <b>-2.6</b>	<b>-7.1</b>	<b>-1</b>	<b>0.5</b>
<b>Gross Int. Reserves, \$ bn</b>	<u>2000</u> <b>1.5</b>	<u>2007</u> <b>32.5</b>	<b>31.5</b>	<b>29</b>	<b>28</b>
<b>Foreign Gov't Debt, % GDP</b>	<u>2003</u> <b>21.3</b>	<u>2007</u> <b>8.7</b>	<b>9.2</b>	<b>24</b>	<b>24</b>

# The International Liquidity Crisis Hit Ukraine Hard

- PFTS stock index: **-74%** (2008)
- UAH/\$ Exchange Rate: Depreciated by **58%** (4Q 2008)
- Drop in GDP: **-19%** yoy (1H 2009)
- Export of goods: **-49%** yoy (Jan-Jul 2009)
- Industrial production: **-30%** yoy (Jan-Jul 2009)
- Unemployment: **9%** (1H 2009; 6% in 2008)
- Real households' income: **-10%** yoy (1H 2009)

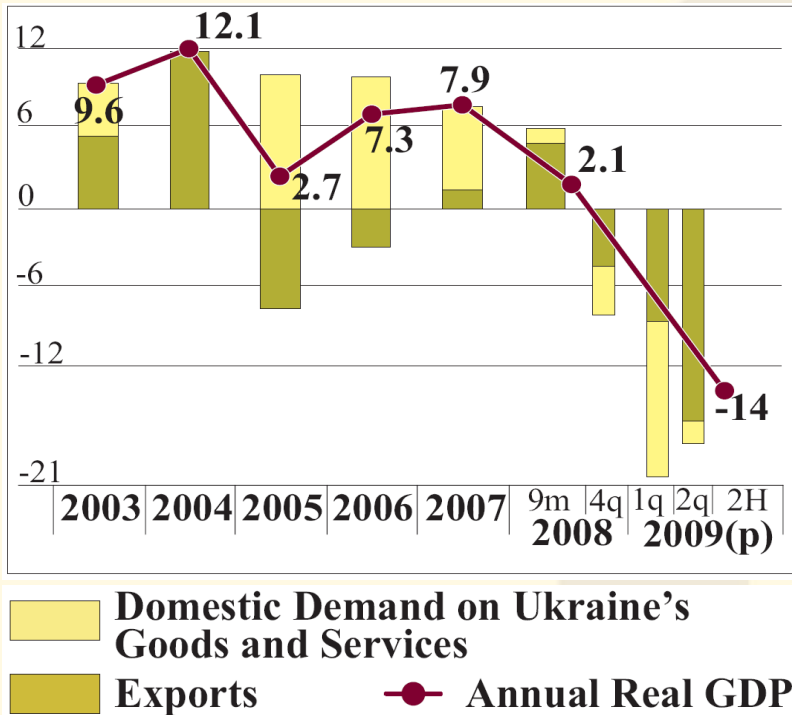
# The Crisis Affected Ukraine Harder

Country	Gross Domestic Product, % yoy, 1Q 2009	Local Currency Depreciation versus the US Dollar
<b>Ukraine</b>	<b>-20.3</b>	<b>58 % (4Q 2008)</b>
Latvia	-18.0	7 % (1Q 2009)
Estonia	-15.1	3 % (1Q 2009)
Lithuania	-13.6	7 % (1Q 2009)
Taiwan	-10.2	3 % (1Q 2009)
Singapore	-10.1	6 % (1Q 2009)
Russia	-9.5	35 % (Oct.08-Mar.09)
Mexico	-8.2	26 % (4Q 2008)
Hungary	-6.7	23 % (Oct.08-Mar.09)
Romania	-6.2	38 % (Oct.08-Mar.09)

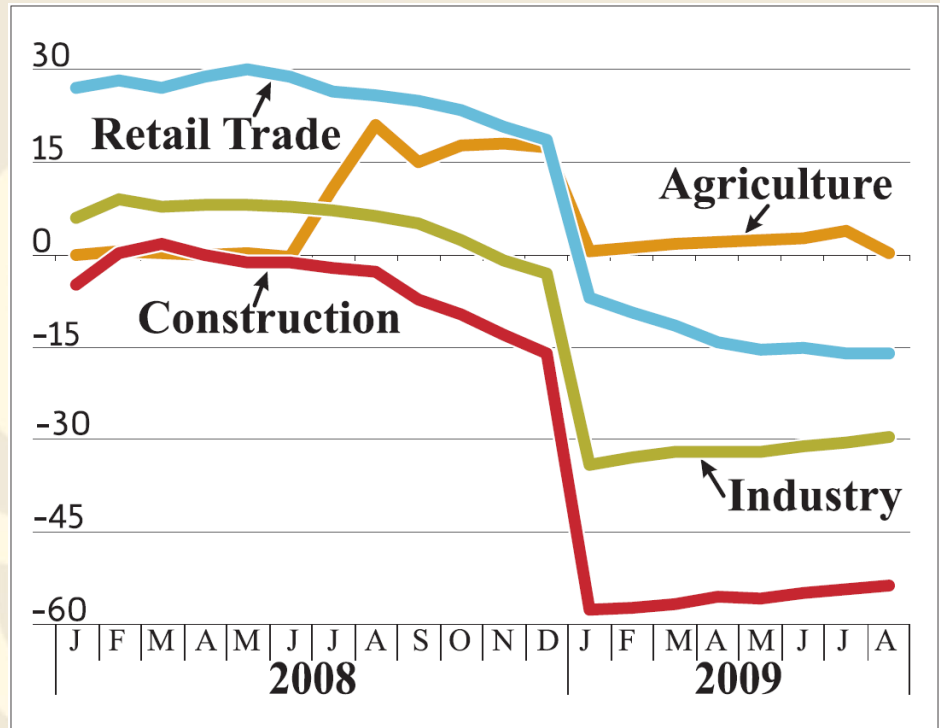
Source: *The Economist*, Central banks of the respective countries, The Bleyzer Foundation

# Real Sector Performance in 2009

*GDP Growth, % yoy, and Main Sources of Growth*



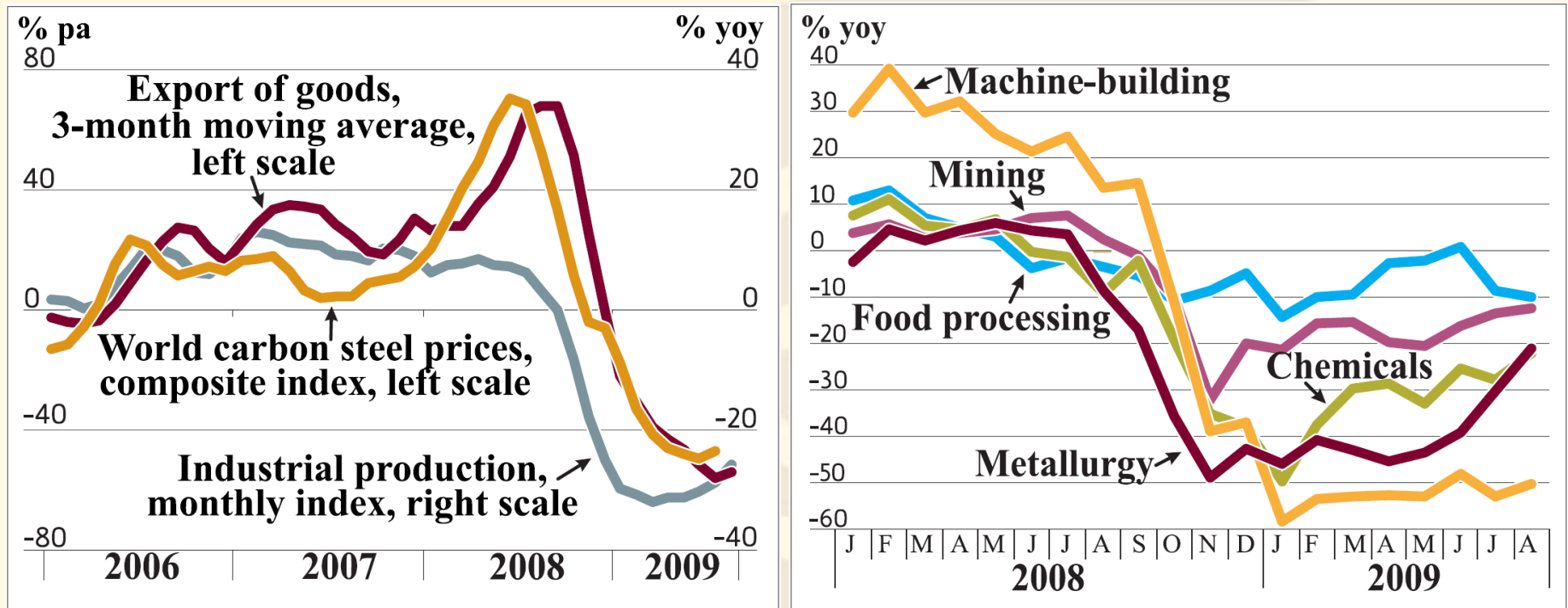
*Sectors' Performance, cumulative growth, % yoy*



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

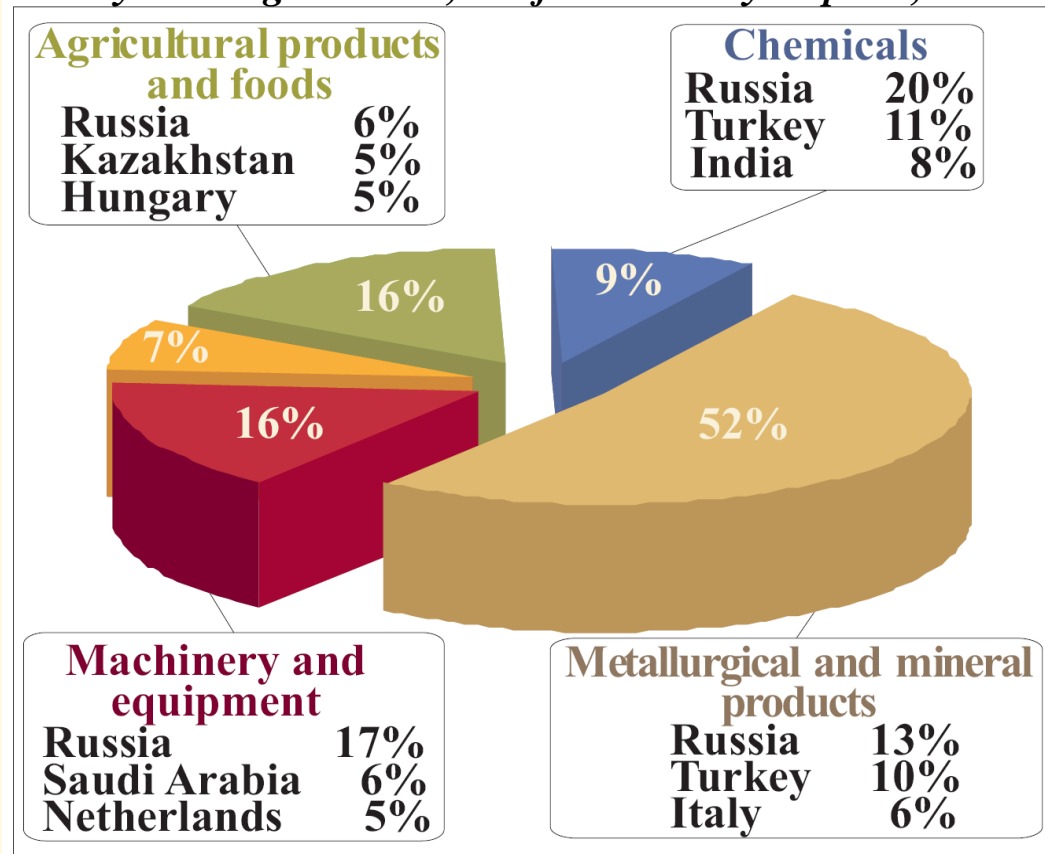


Source: State Statistics Committee, NBU, MEPS, The Bleyzer Foundation

- World commodity prices fell sharply since Aug-Sept. 2008.
- Ukraine's exports of goods dropped by 49% yoy (Jan-Jul 2009).
- Industrial production declined by 30% yoy (Jan-Jul 2009).

# Why Ukraine Was Affected More Severely

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



Source: UN Comtrade, The Bleyzer Foundation

## 1. Open but undiversified economy:

- Share of exports in GDP is ~ 50%;
- Metals, Minerals and Chemicals account for ~60% of exports;
- Narrow geographic diversification of exports.

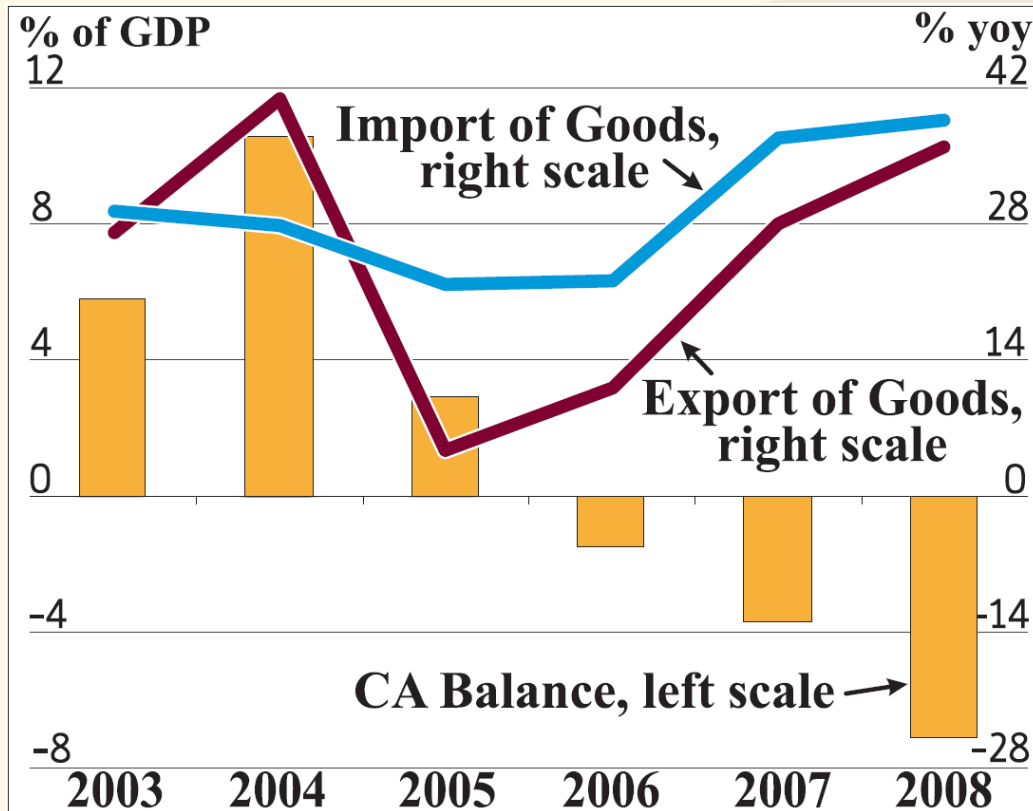
2. Excessive reliance on foreign capital.

3. A combination of three vulnerabilities, as explained below...



# Vulnerability # 1 – Large Current Account Deficits

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



Source: NBU, SSC, The Bleyzer Foundation

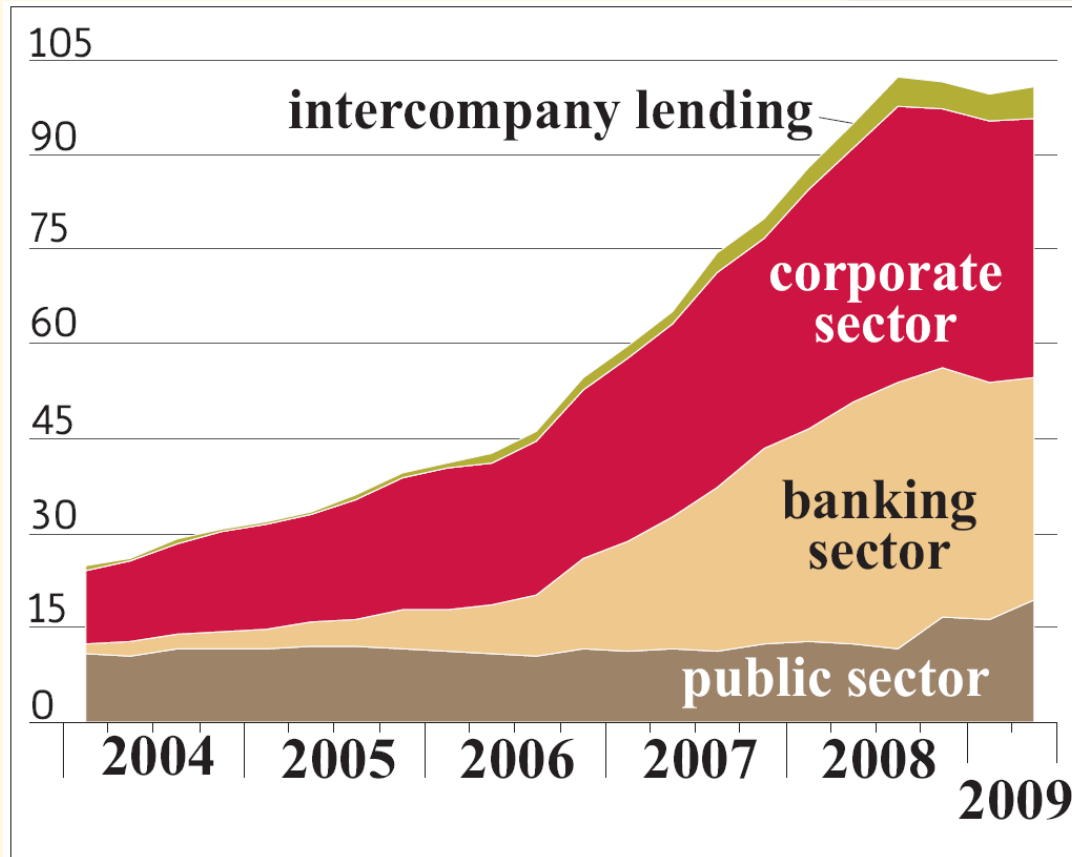
- Over 2003-2008,
  - Exports grew by 25% pa;
  - But imports – by 30% pa;
  - CA deficits emerged in 2006 and
  - Widened to 7% of GDP in 2008.
- 2009 forecast before the crisis: CA deficit - \$ 24 billion, or 13% GDP.

- Uncertain foreign financing put pressures on the Hryvnia.



# Vulnerability # 2 – Large External Debt Repayments

*Gross External Debt, by Sector, \$ billion*



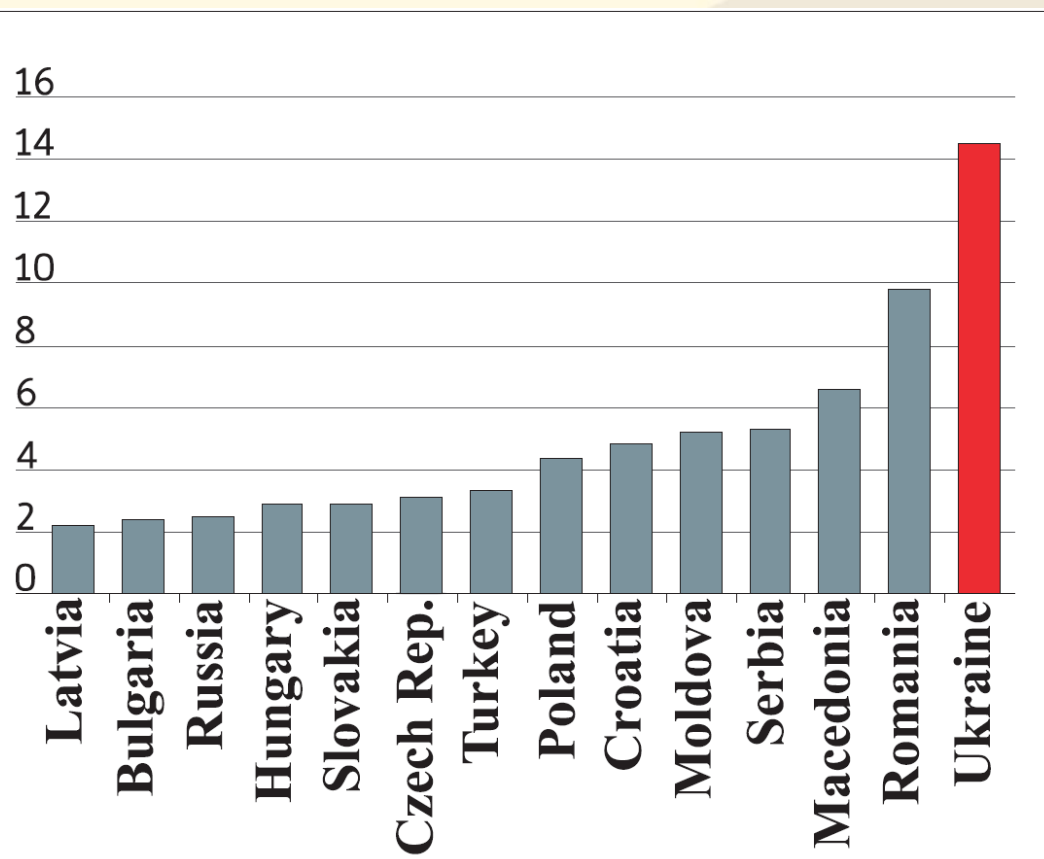
Source: NBU, The Bleyzer Foundation

- Debt rollover became very difficult during the initial stages of international liquidity crisis.

- External private debt tripled in three years (2006-08)...
- ...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.

# Vulnerability # 3 – Banking Sector Weaknesses

## *Non-performing Loans in Selected Emerging Markets as % of Total Loans, 2008*

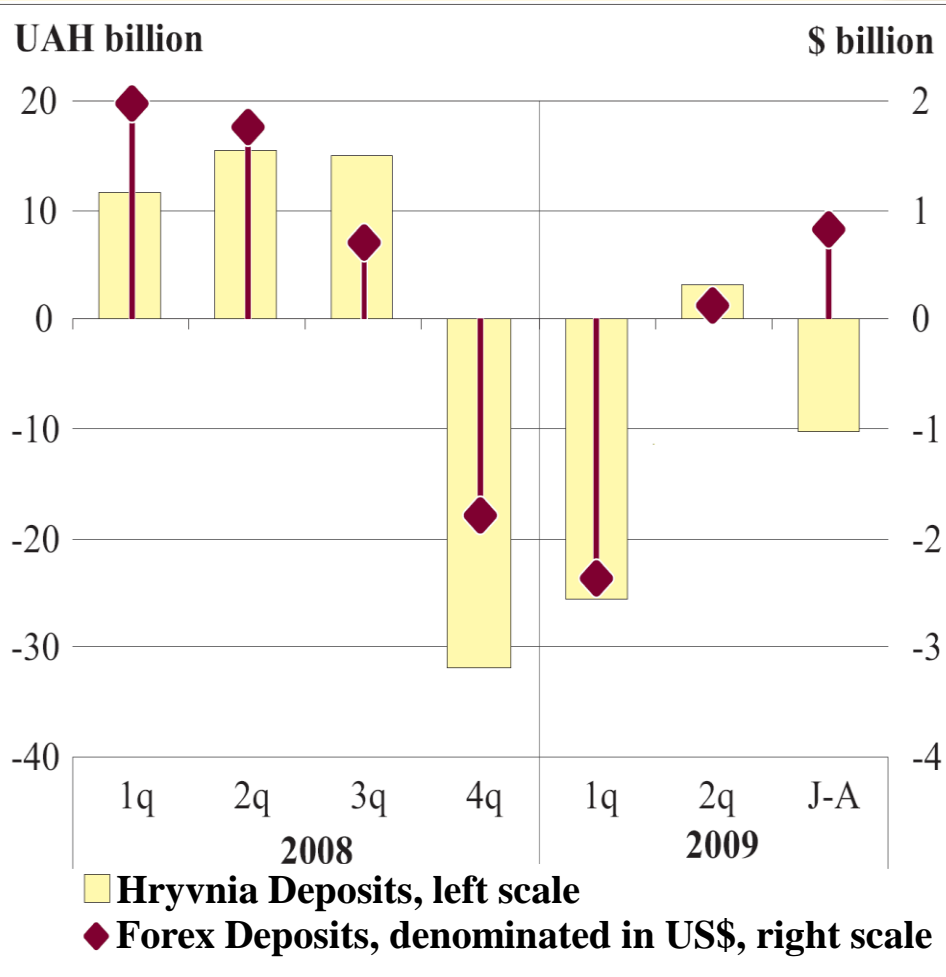


Source: IMF GFS Report, Apr. 2009

- 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.
- The share of non-performing loans (NPLs) was high - 14.5% in 2008.

# Banking Sector Weaknesses (cont.)

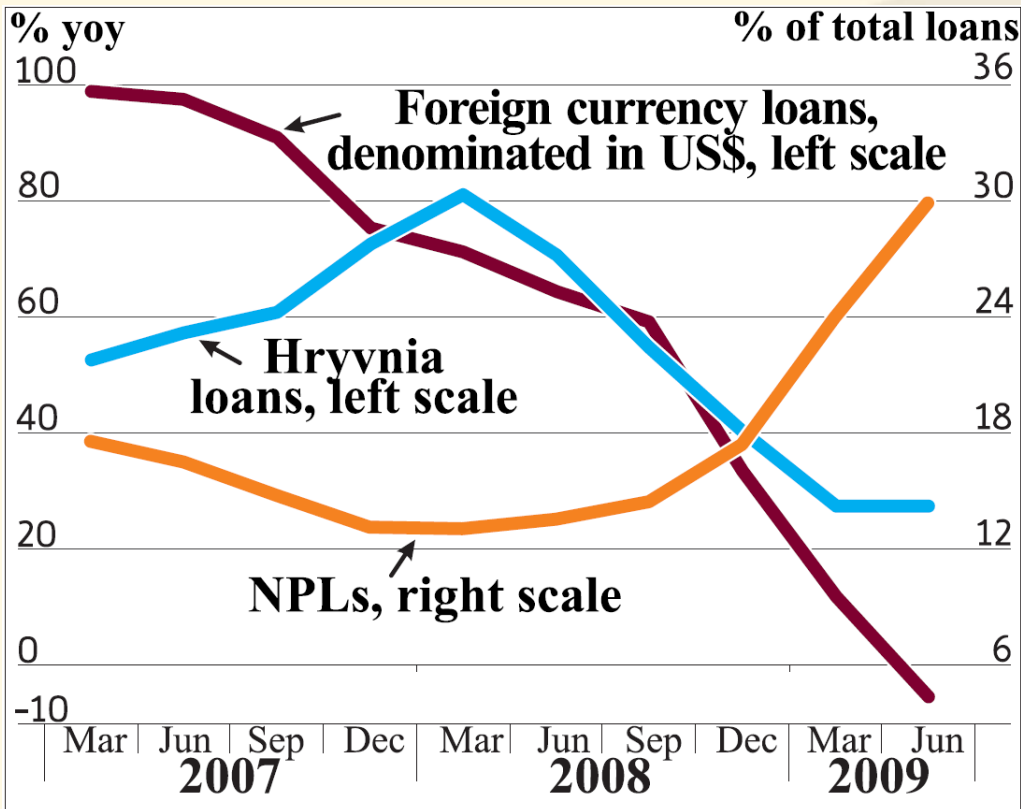
## Banks' Deposit Base, quarterly change in stock



Source: NBU, The Bleyzer Foundation

- During the crisis, commercial banks faced:
  - closed access to international credit markets;
  - large debt repayments needs;
  - high currency risks;
  - fast growth of NPLs.
- The combination of the above led to bank runs.
- From October 2008 to April 2009, about 1/4 of bank deposits were lost.

# Severe Domestic Credit Squeeze



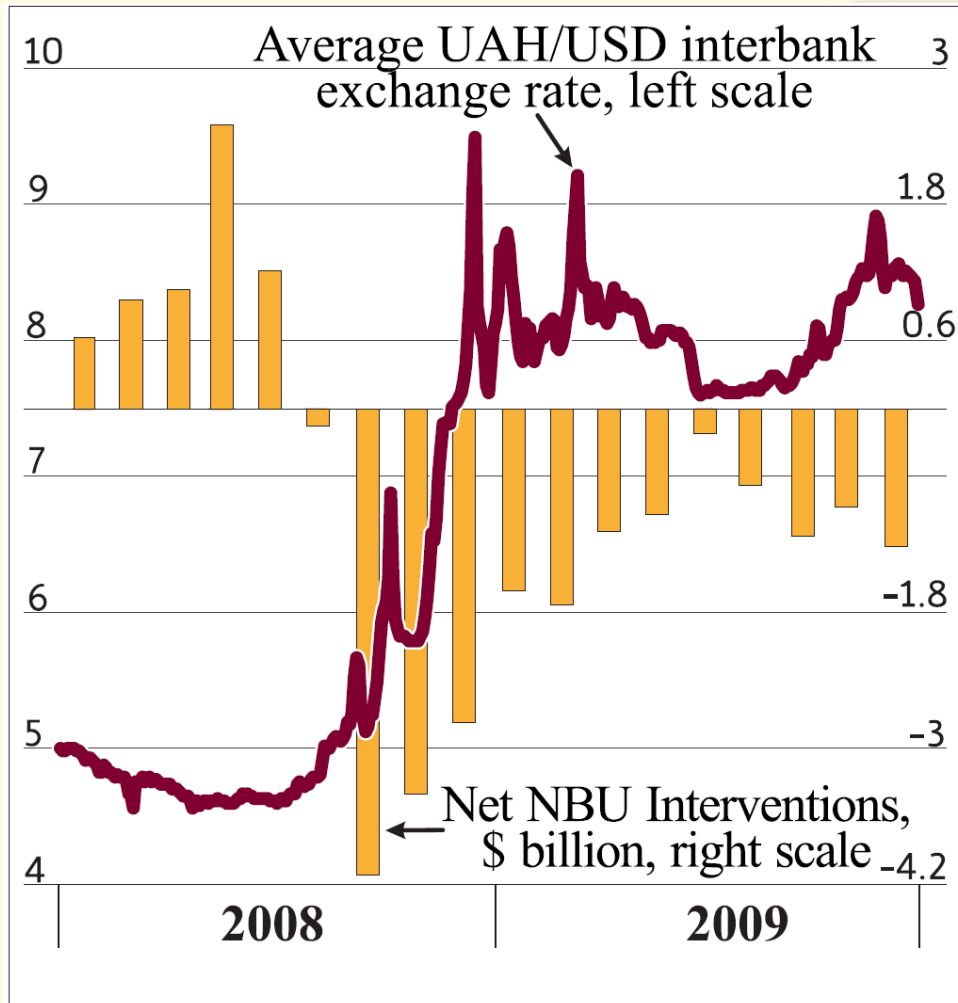
Source: NBU, IMF, The Bleyzer Foundation

- 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; and
  - 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.

# Hryvnia Depreciation – One of the World's Largest

## Foreign Exchange Market Performance

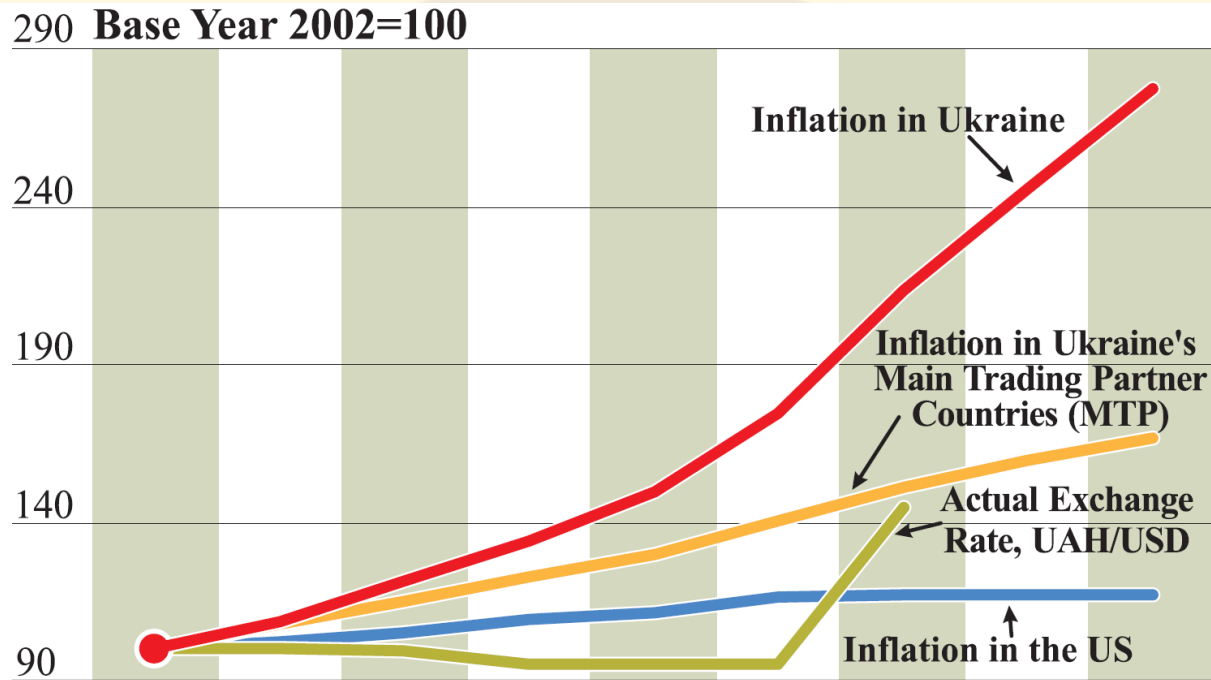


Source: NBU, The Bleyzer Foundation

- During 4Q 2008, 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 policy;
  - Fragile political situation;
  - Conflicting statements about the future exchange rate;
  - Loss of competitiveness.

# Ukraine's Loss of Relative Competitiveness (based on Purchasing Power Parity)

- 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*

# Ukrainian Authorities' Response – Adequate Measures

- Secured financial assistance from the IMF, the WB, other international institutions;
- Maintained good fiscal discipline;
- Avoided major increases in social payments arrears;
- Carried out stress tests for commercial banks;
- Supported systemic banks;
- Progressed towards a more flexible exchange rate;
- Developed non-systemic bank resolution program;
- Controlled inflation;
- Kept Current Account deficits on a downward trend.



## Ukrainian Authorities' Response – Insufficient Measures

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- Ineffective across-the-board coordination.
- Insufficient provision of funds to the economy.
- Poor control over the use of provided liquidity.
- Failure to reach agreement on utility price increases.
- Lack of a comprehensive strategy to restore Naftogaz and Pension Fund solvency.
- Delays in privatization and the lack of a transparent privatization strategy.

## Measures to Avoid a Crisis Deepening

- Presidential elections scheduled on January 2010.
- Political uncertainties may undermine decision-making and hinder economic recovery.
- To avoid the threats of crisis deepening, the authorities should:
  - Maintain prudent fiscal policy;
  - Maintain balanced monetary policy;
  - Effectively supervise banking system.
  - Continued co-operation with the IMF is essential.

# Measures to Accelerate Economic Development

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- Past sources of economic growth (exports and credit) are limited
- Investments may become the new growth engine
- Ukraine's economic outlook is still bright:
  - Exports should be stimulated by membership in the WTO.
  - The proposed EU-FTA would encourage FDIs and exports.
  - FDIs will also be supported by abundant and educated labor.
  - Labor wages are 1/3 of those in Eastern Europe.
  - Ukraine population of 46 million people is an attractive market.
  - Ukraine agricultural potential is quite high.
  - Ukraine's infrastructure and technological base are reasonable.

# Measures to Accelerate Economic Development (cont.)

- But realization of this outlook requires major improvement in the business climate.
- For this, authorities should:
  - Bring stability and predictability to the legal environment;
  - Reform the judiciary;
  - Reduce the costs of doing business;
  - Improve public administration
  - Reduce corruption;
  - Reach an Enhanced Free Trade Agreement with the EU;
  - Support efficiency and productivity growth.