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Key Questions on Ukraine and the Global Crisis

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1. What are the reasons why the international liquidity crisis affected Ukraine more than most other emerging economies?

First, Ukraine was affected more severely by the international liquidity crisis because it is a very open but undiversified economy. Exports represent 50% of GDP. This should not have been a problem except for the fact that exports are undiversified, with over 50% of exports concentrated in a few commodities, particularly metals and chemical products, and directed to a few countries. The international liquidity crisis caused a major drop in the level of imports of Ukraine's trading partners, thus affecting Ukrainian commodity exports significantly. Ukrainian exports and GDP collapsed by 47% and 19%, respectively, during the first half of 2009.

Second, over the past several years, Ukraine excessively relied on foreign debt inflows to sustain domestic consumption and investments. The international liquidity crisis led to a reversal of capital flows, which drained liquidity in the banking sector, depressed credit and consumption and caused a sharp downturn of economic activities.

2. What were Ukraine's main vulnerabilities to the financial crisis in 2008?

In addition to undiversified exports, Ukraine was vulnerable to the crisis because of three factors:

First, despite record high exports, in 2008 Ukraine posted high current account deficits amounting to $13 billion or 7% of GDP, due principally to large increases in imports. Before the onset of the crisis in September 2008, the CA deficit for 2009 was estimated at $24 billion, or 13% of GDP. The financing of this potentially large deficit was uncertain in the face of the global liquidity crisis, putting substantial pressure on the exchange rate.

Second, from the beginning of 2006, Ukraine's private sector borrowed heavily from abroad, with private foreign debt jumping from $28 billion in early 2006 to $85 billion in mid-2008. The short term component of this private debt amounted to about $40 billion. With only $35 billion in international reserves, Ukraine depended heavily on refinancing and rollover of its foreign debt. The refinancing of this debt became increasingly difficult during the initial stages of the global liquidity crisis, which added to depreciation pressures on the exchange rate.

Third, having built a large stock of foreign debt and with bank credit increasing by more than 70% per year, many local banks faced both increasing difficulties in rolling over debt and increasing amounts of non-performing loans. These weaknesses led to an erosion of public confidence in the banking system, which led to runs on bank deposits. The banking sector lost almost 25% of its deposits from October 2008 to April 2009.

3. Why the local currency depreciated more than the currencies of other countries?

The local currency depreciated by over 50% in three months from October 2008 to December 2008, one of the largest currency devaluations in the world. The main causes of these devaluations were the following:

First, the collapse of exports and foreign capital inflows reduced the supply of foreign exchange. On the other hand, the severity of the three above-mentioned vulnerabilities (large CA deficits, large foreign debt repayments, and weaker banking sector) led many currency traders to fear that the exchange rate could not be maintained, leading to major increases in the demand for foreign exchange. This sudden imbalance between foreign exchange supply and demand caused substantial Hryvnia depreciation pressures.

Second, inadequacies in monetary policy (lack of transparency and inconsistencies in foreign exchange auctions and bank refinancing operations, and poor control in the utilization of provided funds) undermined public confidence, thus making the exchange rate more volatile.

Third, the fragile political situation and conflicting statements by authorities about the future exchange rate undermined credibility and confidence in the Hryvnia.

4. Why the real sector, including GDP and exports, declined so dramatically.

GDP and exports declined dramatically for the following reasons:

First, the collapse in foreign lending to Ukrainian banks led to a corresponding reduction in domestic banking credits to the private sector. As a result, sectors that relied heavily on bank credit (such as construction, trade and industry) saw sharp contractions in their level of economic activity. Faced with this situation, the authorities did not mobilize alternative sources of financing to offset the shortfall in foreign lending. This triggered a broad-based deceleration of economic activity.

Second, when funds were initially provided to commercial banks (with the anticipation that local bank lending to the private sector will resume), the deployment of theses funds was not properly supervised. As a result, most of these funds were not used to increase bank credit to the productive sectors, thus delaying economic recovery. It appears that a good portion of these funds was siphoned out of the country, thus significantly adding to the demand for foreign exchange.

Third, the economic downturn in Ukraine's main trading partners significantly reduced the demand for Ukrainian exports, particularly metals and chemical products. This caused a sharp drop of about 50% in domestic industrial production, which exacted a heavy toll on the broader economy.

5. **What are the measures that the country could undertake to recover rapidly from the crisis?**

In order to maintain the pace of recovery from the crisis, continued support from the IMF is essential in the next three months before the Presidential election. This support is necessary not only because of the amount of funds provided by the planned November 15th tranche release, but also to allow other international agencies to provide financing. An active IMF program is also essential to build the confidence of foreign creditors to rollover Ukrainian foreign debt. Therefore, in the next three months, authorities should find ways to agree with the IMF on necessary measures to secure the release of IMF funds.

6. **Measures that the country could undertake in the medium term to accelerate economic development.**

Past sources of economic growth (major increases in domestic consumption and exports) are unlikely to be the main drivers for GDP growth in the future. There will not be the same amount of bank credits to boost consumption and international prices for exports are unlikely to increase at the same high rates as in the past. Therefore, in order to accelerate economic development, authorities will need to find new ways to increase domestic and foreign direct investments, which will encourage output and productivity growth and will support healthy job creation. This means that the authorities will need to demonstrate that Ukraine's investment climate is changing for the better. Modest reforms are unlikely to change the current negative international assessment of Ukraine's business climate. The required reforms must bring meaningful and long-lasting transformations and should include (i) measures to transform and bring stability and predictability to the legal and judiciary system, (ii) measures to deal with corruption at all levels, both in the administration and outside the administration, (iii) reform of public administration to strengthen accountability of public institutions, to eliminate overlapping functions, confusion of responsibilities, to improve decision making, and to enhance government response and efficiency, and (iv) measures to de-regulate and liberalize business activities through the radical reduction of red tape as well as streamlining and simplification of the regulatory environment. In addition, authorities should seek to enter into an Enhanced Free Trade Agreement with the European Union as soon as possible, as this would bring Ukraine into the supply chain of Europe and promote exports. Finally, Ukraine must develop and implement a sustainable strategy in the energy sector, including public housing and utilities. This will help reduce imports of energy resources and will improve cost-efficiency and the competitive advantages of domestic producers. Equally important, this strategy should reestablish Ukraine as a reliable partner in the European energy markets.

7. **What measures taken by Ukrainian authorities to deal with the crisis were adequate and what measures were inadequate.**

The following measures by Ukrainian authorities were adequate to deal with the crisis:

- After the onset of the crisis, authorities were successful in securing an immediate program of financial assistance by the IMF, the World Bank and other international institutions. This was essential to give confidence to international lenders to roll over short term foreign debt.
- Authorities have been able to maintain a good degree of fiscal budget discipline, with a fiscal budget deficit of 1.5% of GDP in 2008 and about 3% of GDP in

January-June 2009. This was achieved by reducing non-essential expenditures. The fiscal budget deficit will be kept to 6% of GDP for 2009, along the lines of deficits to be incurred by other countries suffering from the global recession.

- Authorities have agreed to contain the 2010 fiscal budget deficit (including transfers to Naftogaz) to 4% of GDP.
- Authorities were able to maintain payments to the social sectors, avoiding major increases in arrears.
- Authorities took the necessary measures to deal with insolvency in the banking sector and provide financial assistance to systemic banks.
- Authorities amended regulations to facilitate progress towards a more flexible exchange rate policy.
- Authorities have also taken measures for the effective resolution of nonsystemic insolvent banks.
- Authorities were able to meet quantitative performance criteria on base money. They strengthened the capacity to develop domestic sources of financing, including by accepting market rates in its treasury bills auctions.
- Authorities have managed to maintain inflation and kept current account deficits on a downward trend.

The following measures by Ukrainian authorities were insufficient to deal with the crisis:

- Authorities were unable to establish effective across-the-board coordination on the strategy for crisis resolution.
- In the face of a collapse of foreign lending and domestic bank credit, authorities did not provide sufficient funds needed by the local economy (such as in trade and construction) to avoid a collapse of their activities. Credit was curtailed too abruptly.
- Authorities failed to control the use of the liquidity support that was provided initially to a number of banks. It appears that these funds were used not to revive domestic lending as initially expected, but that they may have been used to buy foreign exchange to transfer it abroad. This may have contributed to Hryvnia depreciation pressures.
- Authorities were not able to seek agreement from labor unions and others to increase gas and other utility prices.
- Authorities have not been able to implement a comprehensive strategy to restore solvency to Naftogaz and the Pension Fund.
- Authorities were unable to carry out initial privatization plans, thereby affecting the financing of the fiscal budget. Furthermore, additional efforts are needed to develop a transparent and open privatization strategy.