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Ukraine's Financial Crisis: Past, Present and Future

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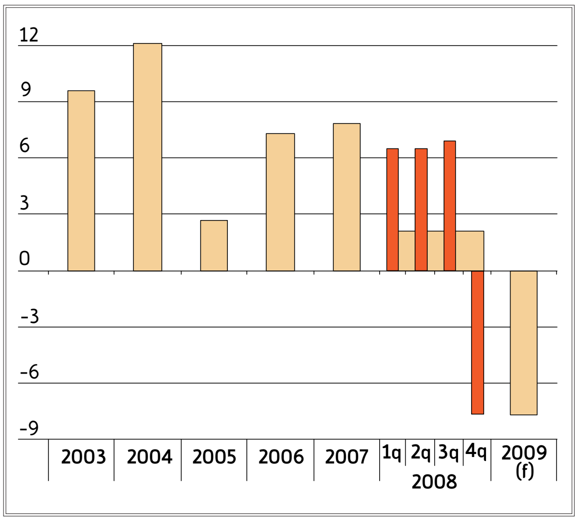
I. Past Economic Performance

For several years until the fall of 2008, Ukraine enjoyed strong economic performance supported by favorable global conditions and robust domestic demand. Despite the fact that the global financial crisis had been spreading through developed countries for almost a year, the Ukrainian government believed that the country was immune to this international crisis. Indeed, over the first nine months of 2008, Ukraine did not see significant signs of weaknesses. The economy grew at a robust 6.3% yoy, inflation started to decline and public finances were in good shape as the consolidated fiscal budget remained in surplus. Exports grew at a record high rate of 50% yoy, while net FDI inflows stood at $9 billion, fully covering the nine-month current account gap. Finally, the gross international reserves of the National Bank reached a peak of $37 billion at the end of September 2008.

However, the economy started to weaken in October 2008. A combination of global risk-aversion and falling world commodity demand and prices resulted in an 8% GDP contraction during the last quarter of 2008. This reduced cumulative GDP growth from 6.3% yoy in the first three quarters of the year to just 2.1% yoy by the end of 2008. Industry, trade and construction, which consistently drove economic growth in previous years, reported significant slowdowns, pushing down GDP growth.

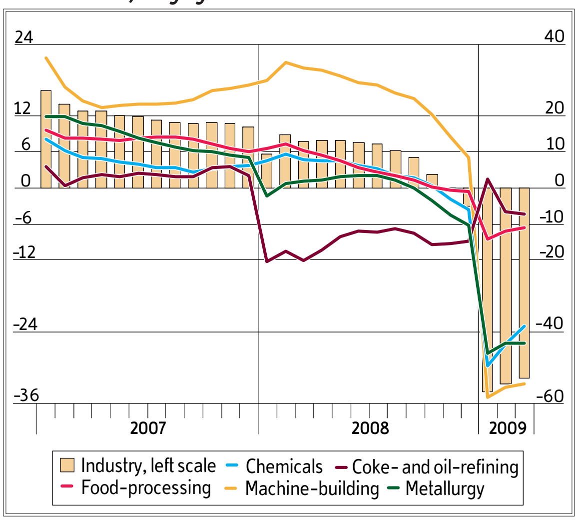
In particular, industry shrank by nearly 25% yoy during the last three months of 2008 and 32% yoy in the first quarter of 2009. This deterioration was particularly visible in export-oriented sectors (such as metallurgy and chemistry) and in sectors producing durable consumer goods, whose purchases were financed by bank credit. In the fourth quarter of 2008, high input costs and an abrupt downward adjustment of international prices for steel and chemicals drove down output in metallurgy and chemicals by 40% yoy and 30% yoy, respectively. The deterioration continued in the first three months of 2009 with output in these industries down by 43% yoy and 39% yoy

Real GDP Growth 2008, % yoy



Source: State Statistics Committee, The Bleyzer Foundation

Industrial Output by Selected Branches in 2007-2009, % yoy cumulative



Source: State Statistics Committee, The Bleyzer Foundation

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respectively. The mining industry, which depends on demand for inputs from metallurgy, lost 20% yoy. Tighter access to bank lending reduced domestic demand for durable goods such as cars and consumer electronics. In addition, unfavorable economic environments in the CIS countries, which remain the main destination for Ukraine's exports of machinery and transportation equipment, exerted downward pressure on the country's volume of exports.

Ukraine's Real Sector Performance, % yoy

	Jan-Mar 09	Jan-Mar 08	2008
Agricultural output	1.7	0.2	17.5
Industrial output	-31.9	7.8	-3.1
Construction works	-56.7	1.7	-16
Wholesale trade	-24.8	8.6	-6
Retail trade	-14	27.2	18.6
Cargo transportation	-37.4	10.1	-0.2
Passengers transportation	-11.5	5.2	4.5

Source: State Statistics Committee, The Bleyzer Foundation

The country's exports of goods fell by 16% yoy on average during November-December 2008. But although exports declined, imports fell much faster, by 27% yoy in December 2008. As a result, December's monthly merchandise trade deficit of $0.8 billion was almost twice as low as the average monthly deficit over the first eleven months of 2008. While exports declined by 39% yoy in January-March 2009, imports dropped by 47% yoy outpacing the exports' rate of decline. Falling demand for imports can be attributed to weak domestic demand associated with lower real wages, lower credit availability and the depreciation of the Hryvnia. As a result, Ukraine registered merchandise trade and current account deficits of $1.4 billion and $0.9 billion, respectively, which were almost four times lower than in the respective period a year before. The January-March trade statistics can hardly be extrapolated over the rest of 2009 since the gas dispute between Russia and Ukraine led to a significant reduction of the supply of imported natural gas in January. However, a sharp decline of imports of machinery and durable consumer goods is a clear symptom of the major retrenchment in private outlays on imports.

Ukraine was not alone in facing economic difficulties in late 2008. Liquidity in the international financial markets dried up due to foreign investors' flight-to-quality and risk aversion coupled with falling housing, commodity and equity prices. This caused the cost of credit resources to surge. As a result, emerging markets faced either a substantial reduction or a reversal of foreign capital inflows. In addition, many emerging economies started to experience increasing difficulties in servicing their external debts. Nevertheless, the impact of the global liquidity crisis on Ukraine was even deeper than in most other emerging markets, as indicated by the declines in output discussed above, the large 60% depreciation of the Hryvnia against the US Dollar in 2008, and the drop in the PFTS stock index of more than 74% in 2008 - one of the largest declines in the world.

Why was the Ukrainian economy so vulnerable to the current global economic slowdown? This vulnerability was partially due to the lack of consistent policies to support long-term sustainable economic growth. The latest period of economic growth was supported by two main factors: first, by cyclically high commodity prices for exports; and second, by high domestic demand fueled by expansionary monetary policies and by banking sector credit financed primarily by foreign capital.

Demand and consumption were encouraged. However, supply-side policies were neglected. The crisis therefore resulted from a downward correction of unsustainable growth of the real economy and the financial sector. The weaknesses on the supply-side were due to the lack of implementation of structural economic reforms needed to build the basis for sustainable growth, support long-term productivity enhancements and improve the country's international competitiveness. Apparently, favorable economic conditions diminished the appeal of these supply-side reforms. In addition, the country's fragmented political environment lacked the critical mass needed to launch politically challenging structural transformations. Furthermore, macroeconomic management encouraged rapid accumulation of internal and external economic imbalances that added a large component of structural instability to economic growth.

Given these vulnerabilities, the deterioration of the international economic environment led to a deep economic and banking crisis in the country. This paper provides a detailed description of the initial conditions of this crisis and explains why the economy was disproportionately exposed to the global financial and economic crisis. It shows that internal structural economic weaknesses, which were not fixed with timely policy actions, bear part of the responsibility for the observed economic difficulties in Ukraine. This means that conventional fiscal and monetary measures may not be sufficient to contain the financial crisis and restore economic growth. The government must urgently implement policies that create strong macroeconomic fundamentals for sustainable and stable long-term economic recovery.

II. Ukraine's Main Vulnerabilities to the Global Financial Crisis

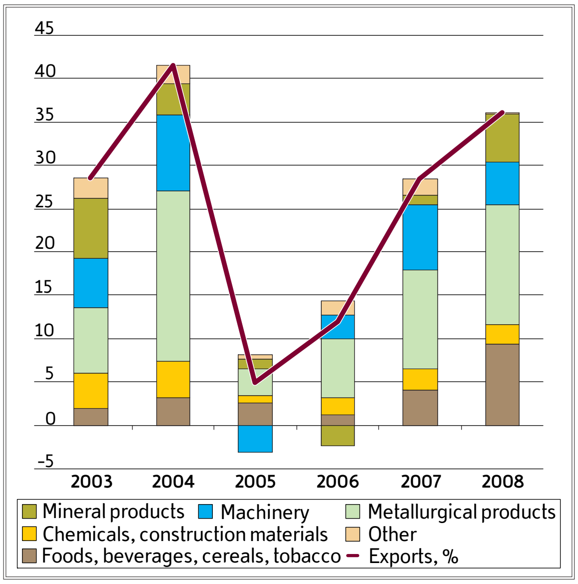
A financial crisis is the final outcome of persistent macroeconomic imbalances. Furthermore, if these imbalances are driven by a narrow set of factors linked to global economic cycles, then the stability of the national economy becomes hostage to developments in the global markets. Evidently, Ukraine was exposed to this particular type of macroeconomic imbalance, which resulted from the global rise in commodity prices and a period of ample liquidity in the global capital markets. As a result, for several years, the country developed the following three main vulnerabilities: (a) a rapidly widening current account deficit; (b) increasing external short-term indebtedness of banks and corporations; and (c) growing weaknesses of the banking system on the back of rapid credit expansion and inadequate credit standards for borrowers. These three vulnerabilities made Ukraine more susceptible to an international financial crisis. This combination of economic risks reached a tipping point when the Ukrainian economy stumbled following a sharp deterioration of the global economy in the last quarter of 2008. We will discuss these three vulnerabilities in the next few sections.

(a) Widening Current Account Deficits

The Ukrainian economy is structurally dependent on exports of a small number of industrial commodities, such as metals, mineral products and chemicals (metals and mineral products account for 52% of total exports from Ukraine, compared to only 12% in Germany). On the other hand, higher value-added products, such as machinery, equipment and transportation vehicles account for only 16.4% of all Ukrainian exports compared to 52% in Germany. This export concentration exposed Ukraine to intrinsic macroeconomic instability as prices for commodities are more volatile than prices for manufacturing goods. In turn, this translated into higher volatility of export and tax revenues, which significantly amplified the negative reaction of the Ukrainian economy to the global economic cycle. Indeed, a sharp decline of export revenues on the back of falling global demand for steel magnified currency depreciation pressures and opened up a large hole in the public purse. In addition, Ukraine's key export markets are concentrated in a narrow group of CIS and EU countries: Russia, Turkey, Italy, Poland, Belarus and Germany account for nearly half of all Ukrainian exports. As a result, exports rely heavily on the economic conditions in these few countries.

On the import side, Ukraine is a country with limited deposits of oil and gas, and relies on purchases of these products from a few countries. This also makes the economy particularly exposed to the price fluctuations on the global commodity markets for these products.

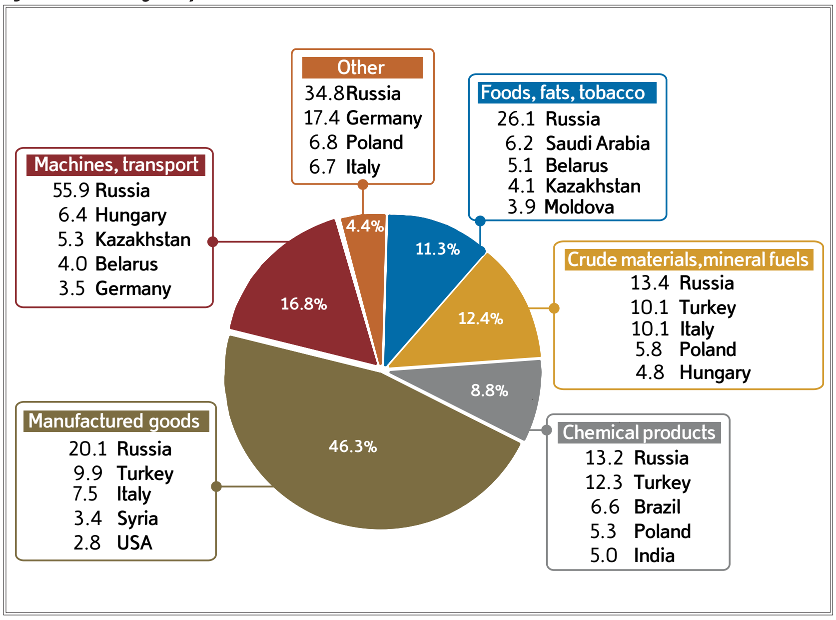
Ukraine's Exports Growth Contributions by Commodities, %



Source: UNComtrade, The Bleyzer Foundation

During 2000 to 2007, favorable trends in export markets allowed Ukraine to generate significant external trade surpluses. During 2006-2007, Ukraine's exports of goods grew by 20% on average. Moreover, during the first nine months of 2008, exports expanded by a robust 50% yoy on the back of surging world prices of iron and steel.

Ukraine's Exports by Commodities, % of Total, and Key Trading Partners, % of Commodity Exports, 2007



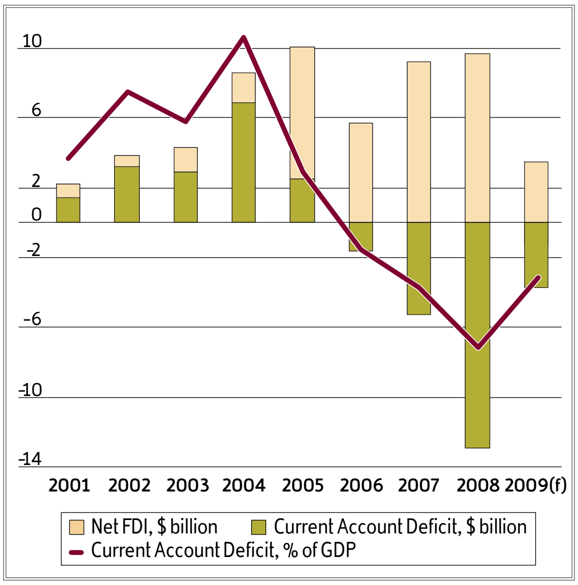
Source: UNComtrade, The Bleyzer Foundation

At the same time, rising consumer and investment demand (partially stimulated by expansionary credit and monetary policies) and increasing prices of raw and energy materials led to the accelerated growth of imports. During 2006-2007, the average annual growth of imports of goods stood at 30%, accelerating to 60% yoy in the first nine months of 2008. As a result, starting in 2005 Ukraine's foreign trade balances have been in deficit. These high foreign trade deficits have been pushing the current account balance deeper into negative territory. In 2008, the current account deficit reached $13 billion or 7.2% of GDP.

The current account deficit could be maintained for some time if it is covered by foreign direct investments (FDI) or long-term external borrowing. However, despite the $9.7 billion of FDI received by Ukraine in 2008, this amount fell short of the current account deficit. Under normal conditions, the country could have raised all necessary external financing to bridge the resulting gap. However, external financing became much more difficult to obtain due to tight global credit markets, investors' concerns about emerging markets in general, Ukraine's weaker macroeconomic fundamentals and large volume of outstanding external debt of the private sector. Indeed, during the last quarter of 2008, Ukraine's capital accounts also posted a deficit of $6.1 billion. These deficits of the current and capital accounts prompted a weakening of the Hryvnia exchange rate and a reduction of the central bank's foreign exchange reserves.

Future exchange rate stability will depend on the strength of export revenues and the ability to obtain sufficient external financing. On the first count, substantial downside risks are still present. In particular, falling global prices of Ukraine's export commodities (steel and chemicals) and economic distress in key export markets will continue to exert a toll on Ukraine's exports. In addition, weak economic activity in the EU countries and a slowdown of the CIS region are likely to trim workers' remittances to Ukraine. Balance-of-payment statistics for January-March 2009 are in line with these expectations. In the first quarter of 2009, exports fell by 39% yoy, as sales of metals, chemicals, machinery, and vehicles slid down. Meanwhile, the surplus on the current transfers account was 26% yoy lower than the year before.

Current Account Balance and FDI



Source: NBU, The Bleyzer Foundation

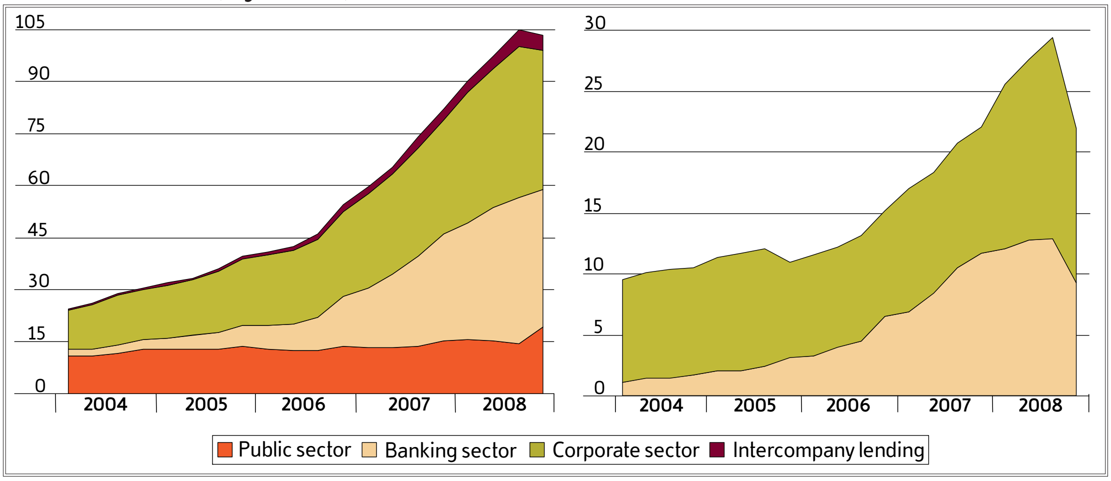
On a positive note, the current account deficit will be contained by lower domestic demand for imports on the back of a depreciated Hryvnia, tighter fiscal and monetary policies, and weaker economic activities. Indeed, during the last few months of 2008, imports started to decline and fell by 47% yoy in January-March 2009. As a result, the current account gap was $0.9 billion in the first quarter of 2009. This implies that the current account deficit will probably settle at around $3.3 billion or about 3% of GDP. Taking into account that Ukraine may receive up to $3 billion of FDI inflows in 2009, this current account gap is unlikely to increase macroeconomic risks beyond manageable proportions.

While the current account gap as a source of Ukraine's external vulnerability appears manageable, the second vulnerability, the large repayments of outstanding external debts, may emerge as a major threat to macroeconomic and financial stability in 2009.

(b) Increasing External Debt and Financing Needs

During the last several years, Ukraine's total external debt more than doubled, reaching $103.2 billion at the end of 2008. Its short-term component with a maturity of less than one year is reported by the NBU at $24 billion (including private and public short-term debt).

Gross External Debt, by Sectors, $ billion ***Short-Term External Debt, by Original Maturity, $ billion***



Source: NBU, The Bleyzer Foundation

However, the actual amount of private foreign debt to be repaid in 2009 is higher. Essentially, the NBU classifies external borrowings based on their original maturity. This means that a 2-year private foreign loan raised in June 2007 is still reported by the NBU as a medium-term liability, even though it must be paid back in less than six months. Indeed, according to various estimates, this short-term component of medium- and long-term debt may add up to an extra $14 billion of repayments due in 2009. Thus, the total amount of external debt to be repaid or refinanced in 2009 may be as high as $38 billion. This amount significantly exceeds the gross foreign reserves of the NBU, which stood at about $31 billion at the beginning of 2009. The table below shows Ukraine's foreign financing requirements in 2009:

Ukraine's External Financing Requirements in 2009 ($ billion)

	2009
Short-term private debt repayments*	-22
Short-term portion of medium-term debt	-14
Public sector external debt service needs	-2
Forecasted current account deficit	-3
Likely external financing requirements	-41
Likely FDI inflow	3
Likely external debt requirements	-38
Available NBU reserves at the beginning of 2009	31

*not including the short-term part of M&LT private debt
Source: State Statistics Committee, The Bleyzer Foundation

These numbers imply that the large short-term debt repayments due in 2009 are major risks that may trigger unfavorable developments for Ukraine in 2009. But not all the short-term debt needs to be repaid. We estimate that about half of the amount due in 2009 is likely be refinanced as it constitutes trade credit and commercial banks' borrowings from their parent foreign banks. In fact, at the beginning of 2009, many foreign banks announced capital support for their

Ukrainian subsidiaries. In addition, the IMF stand-by loan of $16.5 billion (about $10 billion of which may be provided during 2009) as well as additional support from other International Financial Institutions (the World Bank, EBRD, European Investment Bank) will help to reduce private sector external financing needs.

The large current account deficit in 2008 and a significant amount of short-term debt due in 2008/2009, combined with lower foreign financing, led to the Hryvnia/$ depreciation of 60% during 2008. From October 2008 to March 2009, the NBU tried to smooth the Hryvnia depreciation by selling $14.7 billion of international reserves and applying administrative regulations. But the lack of transparency and consistency in the NBU's measures undermined confidence, making the exchange rate volatile.

Nevertheless, the recent depreciation of the Hryvnia is related to the fact that during many years, Ukraine had high inflation while the exchange rate was kept stable. This loss of external competitiveness had to be somehow recovered. The table below shows that the exchange rate for the Hryvnia would have been around 8-11 UAH/$ if purchasing power parity for the Hryvnia were maintained:

Ukraine - Inflation Differentials and FX Rates (Based on Purchasing Power Parity)

	2002	2003	2004	2005	2006	2007	2008	2009
Inflation in Ukraine	-0.6	8.2	12.2	10.3	11.6	16.6	22.3	15
Inflation in the US	2.6	1.9	3.2	3.7	2.2	4.1	0.8	-0.1
Inflation in Ukraine's Main Trading Partner Countries (MTP)	9.7	7.4	7.2	6.4	5.9	8	7.6	5.5
Inflation in Currencies of Ukraine's Foreign Trade (CFT)	5	3.8	4.7	4.6	3.1	4.9	4.6	3.1
Actual Hryvnia Exchange Rate per US Dollar	5.33	5.33	5.31	5.05	5.05	5.05	7.7	
Δ Ukraine-US inflation	-3.1	6.2	8.7	6.3	9.2	12	21.4	15.1
Δ Ukraine-MTP inflation	-9.4	0.8	4.7	3.7	5.4	7.9	13.6	8.9
Δ Ukraine-CTC inflation	-5.3	4.3	7.2	5.4	8.3	11.2	16.9	11.6
PPP with Base Year 2002								
Inflation Diff Index Ukr-Us	100	106.2	115.5	122.7	134.1	150.1	182.2	209.8
Real Exchange Rate - US		5.7	6.2	6.5	7.1	8	9.7	**11.2**
Inflation Diff Index Ukr-MTP	100	100.8	105.5	109.3	115.2	124.4	141.3	154
Real "Effective" Exchange Rate - MTP		5.4	5.6	5.8	6.1	6.6	7.5	**8.2**
Inflation Diff Index Ukr-CFT	100	104.3	111.8	117.8	127.6	141.9	165.8	185
Real "Effective" Exchange Rate - CFT		5.6	6	6.3	6.8	7.6	8.8	**9.9**

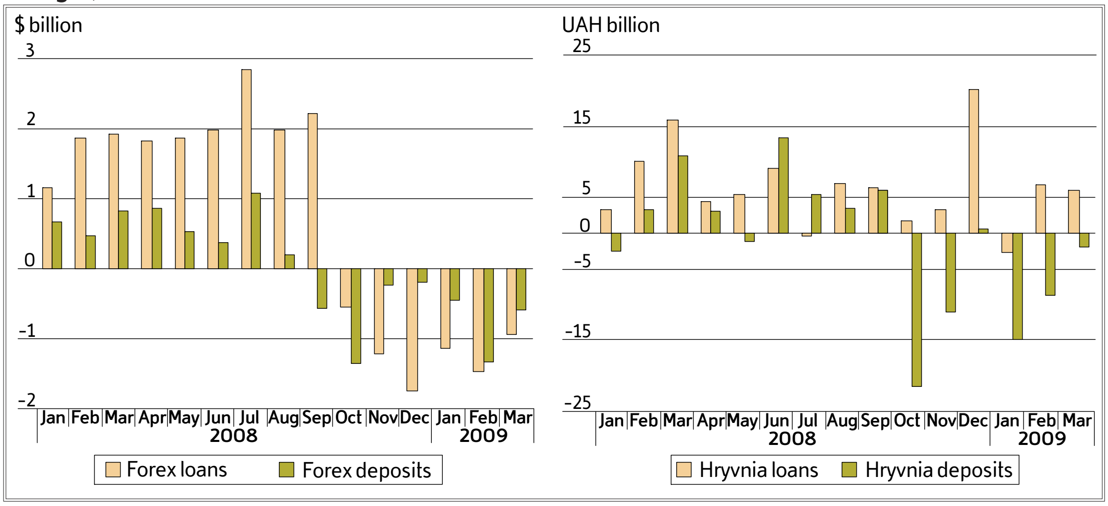
(c) Weaknesses in the Banking Sector

During the last several years, Ukraine has witnessed an unprecedented banking credit boom fueled by better access to global capital markets, entrance of many foreign-owned banks and loose domestic monetary policies. As a result, domestic credit grew on average by about 70% per year during the last three years. Although in Ukraine the ratios of household and corporate bank lending to GDP (48% and 29%, respectively) are below the ratios for private sector indebtedness in developed countries, more than half of all outstanding loans in the Ukrainian banking system are denominated in foreign currencies. This means that both borrowers and commercial banks are exposed to currency risks as in many cases these risks cannot be hedged with forex-denominated cash flows that can be used to repay debts.

Rapid growth of domestic credit came at the expense of the quality of bank assets. Indeed, many international studies suggest that very high rates of credit growth frequently result in an increasing share of non-performing loans as banks lack time and resources to process loan applications properly. According to the NBU, the share of non-performing loans (loans that are classified as sub-standard, doubtful and loss) were rather high at 13.2% in 2007 (no statistics on sub-standard loans are available for 2008). This high share of non-performing loans is due to structural weaknesses of the banking sector, such as weak regulatory supervision and relaxed lending standards.

At present, poor risk management and deteriorating economic conditions are likely to elevate credit risks in the banking sector and the level of non-performing loans. In particular, the economy is anticipated to enter a period of a sharp slowdown, which will push the unemployment rate higher and depress real household incomes. Add to this the large depreciation of the Hryvnia and the possible outcome is an increasing number of borrowers that may default on their bank loans.

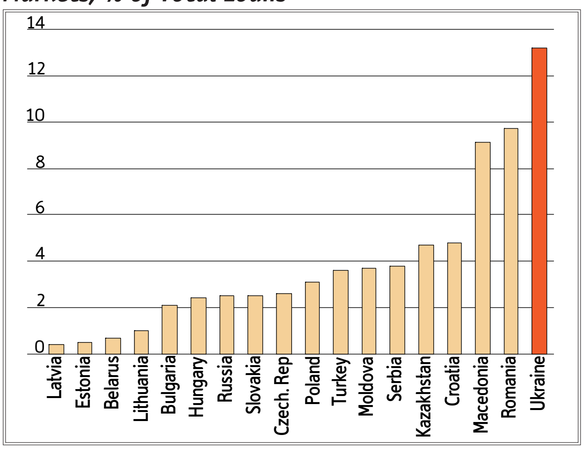
Commercial Banks' Hryvnia and Forex ($-denominated) Deposits and Loans, Monthly Stock Changes, 2008-2009



Source: NBU, The Bleyzer Foundation

According to the NBU, the share of doubtful and loss loans (but excluding sub-standard loans) grew from 2.7% at the beginning of 2008 to almost 3.9% at the end of the year. Preliminary data suggest that this ratio could have increased to around 6.3% as of April 1st, 2009. This means that solvency risk will be the main challenge for the banking system in the near-term. These increased solvency risks bode ill for the ability of the commercial banks to extend new loans and may erode confidence in the banking system. On the first count, banks will have to increase provisions against possible credit losses and write down shareholders' equity to get rid of the non-performing loans. As a result, banks can hardly find additional funding sources to credit the private sector.

Non-Performing Loans in Selected Emerging Markets, % of Total Loans



Source: IMF GFS Report, October 2008

Ukraine is not immune to the risks of classic bank runs. Luckily, the timely actions of the NBU helped to forestall the massive contagion of customers' distrust through the banking system. In particular, in mid-September 2008 the sixth-largest Ukrainian bank had to cope with a flight of deposits. The National Bank of Ukraine responded quickly by providing UAH 5 billion (about $1 billion) of emergency refinancing and later took control of this bank. Nevertheless, this incident left the first crack in the public trust in the Ukrainian banking system.

On top of that, NBU efforts to stabilize the banking sector were not accompanied by a coherent and credible government stabilization program, which undermined public confidence in the authorities' capacity to deal with the financial crisis. As a result, about $13 billion of deposits were withdrawn from the banking system by the end of March 2009. This means that at present, banks can hardly rely on deposits as a reliable source of funding and liquidity. Tight liquidity, in turn, forced several banks to miss deadlines on the repayment of both domestic and external liabilities, while a number of banks were taken over by the NBU. Higher credit and solvency risks triggered downward revisions of the credit ratings of many Ukrainian banks ranked by the international rating agencies. All of this further elevated refinancing risks in the banking system of Ukraine.

III. Five Steps to Resolve the Crisis

The most recent economic expansion in Ukraine was partly attributed to inflows of foreign credit and high global demand for industrial metals. Both factors have been rapidly weakening since the onset of the global financial crisis. As a result, the economy will inevitably experience a correction in the near-term. Furthermore, the transition toward more resilient and stable growth may be difficult and prolonged. This means that the role of the government in managing this transition is fundamental to minimize social and fiscal costs and ensure a balanced economic recovery.

Hence, economic and financial stabilization in Ukraine calls for an urgent, comprehensive and integral policy program. According to best international practices, this policy program must include the following **five key components**: (1) establish strong organizational arrangements to confront the crisis, (2) secure substantial foreign financial assistance, (3) implement a comprehensive program for troubled banks and their borrowers, (4) implement a macroeconomic stabilization program, and (5) implement structural reforms to revive economic and export growth.

STEP 1: Establish Strong Organizational Arrangements to Address the Crisis

Essentially, all countries that managed their crises successfully created an Authority with strong legal powers (to enable it to act promptly), and with independence from the central bank (to avoid conflicts between monetary objectives and fiscal costs). This Authority should enter a Memorandum of Understanding among government agencies (NBU, Ministry of Finance, Ministry of Economy, etc.) to clarify responsibilities and actions to address the crisis. It should also enter a Memorandum of Understanding with other Central Banks in countries that have a large banking presence in Ukraine to facilitate coordination, exchange of information and possible financing. The Authority should develop an early warning system of key indicators, which will show whether the depth of the crisis is increasing or not and will allow for modification of the stabilization program in a timely manner. It should also closely monitor the amounts of external private sector debt (banking and non-banking) due over the next 12 month.

Unfortunately, central management and coordination of measures to address the crisis have been weak in Ukraine due to political disagreements and uncertainties. There is no special Crisis Authority in charge of the crisis. Both the NBU and the government have been taking measures but poor coordination and lack of transparency often resulted in conflicting

statements, undermining public confidence. In the absence of a formal Authority, the IMF program served as an effective coordination mechanism. The IMF Program and its requirement to have an official Memorandum of Understanding on fiscal, monetary and banking sector measures provided a unified platform that had to be agreed upon by all relevant agencies. Since political uncertainties are likely to continue during 2009, the continued implementation of the IMF Program is essential to ensure that the necessary measures are indeed implemented by all concerned government agencies.

STEP 2: Secure Substantial Foreign Financial Assistance

In past financial crises, affected emerging markets were able to overcome their crises only when they managed to secure sufficient medium-term foreign financing to assure foreign creditors that they have sufficient foreign exchange resources to serve all their short term debt. For example, in 1994, Mexico had to secure $50 billion of foreign financing. In 1997, the three main Asian countries in crises (Thailand, Korea and Indonesia) had to obtain over $112 billion of foreign support.

Ukraine's main vulnerability is indeed the substantial amount of foreign debt due in 2009. For this reason, the government was right in urgently seeking medium-term financing from official international financial institutions. In the last quarter of 2008, Ukraine applied and secured loans from the IMF ($16.5 billion) and the World Bank ($0.5 billion). The approval of the IMF program also helped improve the credibility of the Ukrainian government as this program envisioned a set of stabilization measures to deal with the financial and economic crisis. In particular, the program called for curbing aggregate demand through tighter fiscal and monetary policies and currency devaluation. In addition, the positive response of the IMF opened access to alternative external sources of financial assistance to Ukraine. Many countries, international institutions and private investors rely on the IMF's judgement because the implementation of the IMF's program usually implies that the country's economic strategy is sound and sustainable. Ukraine has already applied for bilateral and multilateral financing from other international sources, including Japan, Russia, EBRD and the EIB.

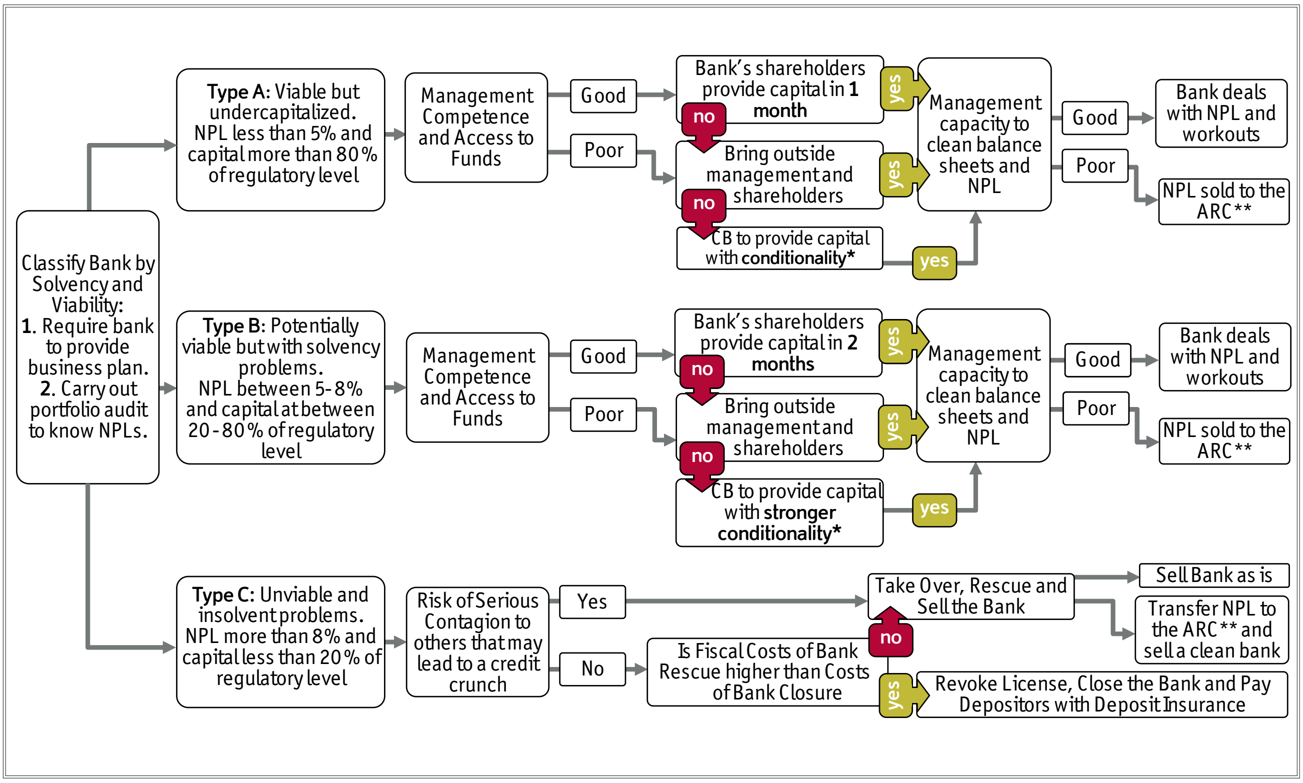
The Ukrainian authorities must continue a productive dialogue with the International Monetary Fund to ensure the complete and timely arrival of all funds allocated to Ukraine for 2009. Essentially, the success of Ukraine's cooperation with the IMF is the only credible indicator of the seriousness of Ukraine's intentions to pursue necessary structural and economic reforms. This means that Ukraine may attract additional external financing to cover its budget deficit from other International Financial Organizations and through bilateral agreements if and only if the IMF program is in place.

Equally important, authorities' actions to address the issue of the private sector short-term debt may help secure sufficient external funding in 2009. In particular, the NBU has strengthened its monitoring of private foreign debt. Commercial banks must report the quarterly amount of their and their clients' external debt maturing over the next 12 months. Lastly, Ukrainian authorities have pledged to support private corporations and banks in their efforts to restructure current short-term foreign debt and encourage private companies to boost shareholders' equity.

STEP 3: Implement a Comprehensive Program for Troubled Banks and their Borrowers

Most countries that faced financial crises found that the weaknesses and risks in the banking sector require coordinated and across-the-board policy measures to re-establish the viability of the banks. The functionality of the banking sector, i.e. the ability of banks to perform financial intermediation, must be restored. The National Bank of Ukraine and the government have developed a reasonable program to deal with troubled banks, based on international experience. However, the potential failure of the banking sector program and the risk of bank runs now represent the most serious risk for the stability of the country. The chart below shows typical policy responses during a financial crisis:

Policy Response to a Banking Crisis



* If central bank (CB) provides capital, conditionality may include limits on new lending, loans to subsidiaries and officers, limits on dividends and asset sales.
**Decisions to transfer NPL to ARC also depends on degree of information asymmetry, risks of bad debt rollovers, default rates, loan recovery capacity, fiscal costs, adequate management for ARC, market demand for distressed debt, adequacy of property rights, legal framework for bankruptcy, adequacy of loan documentation.

The government's program is primarily focused on the recapitalization of weak banks. The largest 17 banks have completed their audits, which were performed by international auditors. Foreign banks have already confirmed their plans to recapitalize their Ukrainian subsidiaries in the amount of $2 billion, while $1 billion would be provided by local banks. Audits are now underway for medium sized banks. Several measures were implemented to forestall the contagion of panic and distrust across the banking system. In mid-October 2008, the NBU imposed a six-month ban on early withdrawal of time deposits and tightened the rules for issuance of loans in foreign currency. At the beginning of November 2008, the guarantee on deposits of individuals was increased by three times, to UAH 150 thousand. Since October 2008, the NBU actively supported commercial bank's liquidity through refinancing operations. Meanwhile, thirteen banks were taken under temporary NBU administration with one of them sold to new shareholders. The central bank monitoring was installed in several other banks. However, the magnitude of Ukraine's economic problems implies that the banking system may remain weak in the near term. Nevertheless, adopted measures helped to significantly reduce the risk of the collapse of the national banking system and visibly mitigated the negative impact of the global financial crisis.

The further implementation of the banking sector program must be based on the following key principles: (1) primacy of private sector-led solutions, (2) minimization of costs to taxpayers and depositors, (3) fair punishment of shareholders and managers who indulged in reckless risk-taking practices, (4) competent, independent and transparent assessment of banks' needs for capital injections, and (5) clear, reasonable and politically neutral conditions on banks receiving public funds.

The key next step for the banks is to focus on clearing their balance sheets of non-performing loans. The authorities should facilitate this process by supporting market infrastructure that enables rapid and proper discovery of the market prices of distressed assets. Finally, the government must avoid bailing out irresponsible shareholders and managers and should support expedient and orderly resolution of bad loans. If all these remedy efforts are structured through sound institutional arrangements, the banking sector will soon stabilize thanks to the survival and consolidation of solvent and clean banks.

Finally, the government should consider a mechanism to help corporations and banks that may default on their foreign debt to refinance their foreign liabilities. There is a need to obtain reliable information on the monthly maturities of these debts and assist debtors with the development of feasible contingency and debt restructuring schemes.

STEP 4: Implement a Macroeconomic Stabilization Program

During a financial crisis, tight fiscal and monetary policies are needed in most emerging countries to contain aggregate demand, avoid a recurrence of large current account deficits, reduce inflationary expectations and provide stability to the exchange rate. Otherwise, the financial crisis may spread out across the real economy, negatively affecting those sectors that have high foreign indebtedness. Although tight fiscal policies are needed, fiscal support may be necessary to rescue the banking sector, since a functioning banking system is a necessary condition to resume the flow of credit to the real economy, which stimulates economic recovery.

The Ukrainian authorities have already taken measures to tighten fiscal and monetary policies. In October 2008, the government froze budget sector wages; at the beginning of March 2009, wages of high-ranking officials were cut twice. During November-December 2008, budget expenditures on public administration were notably reduced. For 2008, the budget deficit of 1.5% of GDP was lower than the original target for the year.

However, despite the commitment of the Ukrainian government to maintain a balanced budget in 2009, the adopted Budget Law envisioned a deficit of more than 3% of GDP while budget revenues were estimated on a rather optimistic macroeconomic forecast. After adjustment for the banks' recapitalization program, this deficit may total UAH 75 billion ($9.4 billion) or 7% of projected GDP. The government is now trying to secure medium term financing from a number of countries and institutions to finance this fiscal deficit. But these resources are likely to be insufficient. The government therefore wanted to tap the domestic markets to raise additional budget deficit financing. However, treasury auctions on the domestic market looked increasingly likely to fail due to the funding shortages in the national banking sector and relatively low yields on offered securities. Furthermore, the option of selling government bonds to the NBU put the independence of the NBU at risk and could have undermined price stability. In the aftermath of the financial and economic crises during the 1990s, direct NBU financing of government spending was outlawed. However, the original 2009 budget contained loopholes that allowed the government to by-pass this restriction. According to Article 84 of the 2009 Budget Law, the NBU has three days to purchase treasury securities from commercial banks following the request of any bank. This raised the risks of losing control over price stability and putting additional depreciation pressures on the currency exchange rate.

These risks to price stability, rooted in the sources of deficit financing, emerged as the main reasons behind the delay of the release of the IMF's second tranche in February 2009. In addition, the IMF requirements and macroeconomic forecasts were drafted at the beginning of November 2008 and had to be adjusted for the unexpectedly sudden economic downturn during the last four months. Hence, the Ukrainian authorities requested the revision of the IMF program requirements. The IMF accepted this request and agreed to increase the targeted fiscal deficit to 4% of GDP (excluding funds for re-capitalization of banks), provided that this deficit is financed only with limited amounts of money emissions. The Ukrainian authorities, in turn, agreed to reinforce the independence of the central bank by removing the 2009 budget provisions that permitted monetization of the fiscal deficit. The government also agreed to increase some excise taxes and deal with the financial problems of the Pension Fund and Naftogaz Ukrainy. On the basis of these agreements, the IMF program is expected to resume in May 2009. The resumption of the IMF program will also unblock other external sources of financial assistance, such as from the World Bank, EBRD and EIB. With the financial support of the major international financial institutions, Ukraine's external financial needs for 2009 are manageable. This increases the probability that the crisis will be contained in 2009. But we will need to see whether the tight fiscal and monetary conditions included in the IMF Program will be respected during this Presidential election year.

STEP 5: Implement Structural Economic Reforms to Revive Economic and Export Growth

The above tight fiscal and monetary measures in the Macroeconomic Stabilization Program are necessary. But stabilization measures will reduce economic growth and lead to higher unemployment rates. For this reason, the government program should also include measures to <u>restart economic growth and exports</u>.

The possibility of using fiscal stimulus to revive growth is constrained by the limited availability of non-inflationary foreign long-term loans. Furthermore, as economic growth declines, the fiscal position may rapidly deteriorate due to falling tax revenues. The situation may be even more dire in countries that entered the crisis with a weak fiscal stance eroded by the past increases in spending. On this count, the decision to expand budget spending during economic downturns must weigh the risks of a much weaker fiscal position in the near-term (on the back of a high fiscal deficit and increasing public debt) against the ability of fiscal stimulus to stabilize the economy and support economic recovery. Obviously, the efficiency of fiscal policies as well as the capacity for fiscal incentives depends on the country's specific structural parameters. But for most export-driven and import-dependent emerging economies, additional fiscal measures to lift aggregate demand may not have a strong impact on domestic output. In fact, large fiscal spending may just be absorbed by higher imports with limited impact on local production and jobs. This effect would be even more important if the original economic slowdown was driven by weak external demand rather than falling domestic demand (which is the case in Ukraine). Fiscal stimulus would also be of questionable value when numerous structural and institutional deficiencies would limit the possibilities of a strong local supply response.

The recent Hryvnia devaluation should help restore the competitiveness of Ukraine's exports and may partially mitigate the negative impact of lower world commodity prices. However, recent readings on economic performance reveal that devaluation per se will not be sufficient to compensate for weaker external demand. This means that a coherent program to revive economic growth is necessary.

With limited possibilities of effective fiscal stimulus, the most realistic option to revive economic growth is to encourage a private sector-led sustainable economic recovery. This recovery will help to increase output, create new jobs and provide reliable tax revenues that will be used to repay public debts in the future. To achieve this objective, the government must take actions to improve the business environment to attract private domestic and foreign investments. As identified in various reports by The Bleyzer Foundation, Ukraine's competitive disadvantages are systemic and can only be remedied with a strong reform program. Step-by-step reforms are insufficient in the current environment. To attract investments and revive growth, Ukraine needs to send a very strong message that the country is serious about improving its investment climate. For this, the country needs to make a quantum leap on reforms and take some "dramatic" measures, both for the short-term and for the medium term.

Unfortunately, many structural reforms require strong political will to implement unpopular policy measures. The impact of many structural transformations usually materializes in the medium-term, which further weakens the enthusiasm of incumbent politicians for these measures. Indeed, efforts to outline a long-lasting solution to the Ukrainian crisis have stalled due to persistent political turmoil. However, this crisis provides political leaders with an opportunity to make difficult choices on pension reform, public administration reform, tax and regulatory reforms, judicial reform, etc. This opportunity must not fall victim to the notorious inability of the Ukrainian authorities to establish effective coordination on key social and economic issues. There are many low-cost policy solutions that can ensure positive economic feedback even in the short-term.

These short-term measures include:

A. **Immediate implementation of Regulatory Clearance** to get rid of all obsolete and rudimentary laws and regulations damaging market competition and allowing for excessive state interventions. To initiate this process and to avoid mistakes made in 2005-2006 during the first revision of the regulatory environment, the government must establish a mobile coordination group under the State Committee on Regulatory Policy and Entrepreneurship. This group should have the legal authority to review legislation regulating business activities and eliminate laws and regulations that unjustifiably increase the cost of doing business in Ukraine. Furthermore, this group should secure support and cooperation from all involved government agencies. If selected laws or regulations must be revoked through the Verhovna Rada, the President, Prime Minister or Cabinet of Ministries must be ready to submit the corresponding draft laws to the

Parliament. The group must complete its review within a tight and clear deadline (preferably by the end of 2009). Regulations that are not selected by the group must become redundant automatically after the completion of this review.

Required expertise and financing for this work can be obtained either from international institutions such as the World Bank, EBRD or international development agencies from the US, UK, Sweden, Canada and others.

B. Eliminate corruption in customs and tax administrations by transferring management in these institutions to a reputable and independent foreign agency. Apparently, Ukraine lacks resources to fight corruption effectively. This means that this task should be outsourced to a competent agency with strong international experience. For example, a private international development company, Crown Agents of the UK, operates in more than 100 countries. A similar arrangement should be initially contracted to manage Ukrainian Custom Offices. The process must be launched immediately and the initial contract should be signed for at least 2 years. After the first results are obtained and evaluated, the new contract should be signed to outsource the management of the Ukrainian Tax Administration.

The cost of this outsourcing may be financed by international institutions such as the World Bank or EBRD, or financial assistance can be received from the DFID or obtained through the EU's technical assistance.

C. Launch broad program "Stop Corruption". Create a special website and open a free public phone line that can be used to anonymously report cases of corruption. Special mobile group with a leading role from Interpol should be managing this process.

Expertise for structuring and managing this program along with financing can be secured either from international development agencies or EU technical assistance funds.

D. Improve transparency of the judiciary by mandating that court decisions are immediately published online and are subject to review and scrutiny by an independent entity.

Required expertise and financing for this project can be obtained either from international institutions such as the World Bank, EBRD or international development agencies from the US, UK, Sweden, Canada and others.

E. Provide the Government with a "fast-track" authority to negotiate a Free Trade Agreement with the EU to finalize this agreement by the end of 2009.

F. Remove the moratorium for land sale, which should encourage the development of agriculture.

These short-term measures must be accompanied by a comprehensive strategy to implement all vital structural reforms. Only these measures will establish economic fundamentals that enable a private sector-led sustainable recovery. These medium term measures should include:

A. Improve public governance by implementing meaningful public administration reform, which would improve the functionality of the government, increase transparency of decision-making, reduce administrative corruption and strengthen accountability of public institutions.

A.1. The role of the government must be officially redefined and endorsed by the main political forces of the country. Above all, the government must facilitate private sector development, rather than compete with private producers. Whenever an economic activity could be carried out by the private sector, it should be clear that the government should not engage in this activity. A Public Administration Task Force should be created to reform public institutions.

A.2. The reform should start with a "horizontal" functional review under which the functions of all government agencies are reviewed in order to eliminate overlapping and duplicative functions. There should be only one agency responsible and fully accountable for a given government function.

A.3. The next step should be a "vertical" functional review within each public institution to ensure that all functions are consistent with the redefined role of the government. This review will help to identify which roles could be eliminated, transferred to lower levels of the government, outsourced, or privatized.

A.4. Once the proper roles of each agency have been defined, an operational review to improve the efficiency of all agencies, including the operating practices, procedures and regulations must be preformed. Civil Service Reform must be launched to ensure that government employees are properly recruited, trained, and compensated.

A.5. Develop and implement a practical and user-friendly e-government initiative to improve accountability, responsiveness and efficiency of the public sector.

A.6. Accelerate decentralization reform with an aim to build independent and viable local self-governance. The Public Administration Task Force must develop all necessary amendments to the Tax and Budget Codes that strengthen the fiscal autonomy of the local governments. Finally, tariffs for public services, provided by local governments, must be set on a competitive and transparent basis. Essentially, full-cost recovery of these services is the only way to insure long-term feasibility of the local infrastructure and utilities.

A.7. Streamline state property management and privatization procedures by improving transparency and competitiveness of the public sector. Perform mandatory, regular and independent audits of all commercial activities executed by the state.

B. Implement a comprehensive reform of the judiciary.

C. Improve fiscal sustainability by streamlining and simplifying taxation.

D. Launch and complete pension and health care reforms.

IV. Prospects for 2009 and Beyond

Relatively good progress by Ukrainian authorities in dealing with the pressing financial and economic challenges has sown the seeds of a soft landing of the Ukrainian economy. The successful implementation of the measures discussed in this note, particularly the IMF program, would address Ukraine's vulnerabilities as follows:

- Current Account Deficits. The current account deficit would be contained by the control of aggregate demand through tight fiscal policies (fiscal deficit consistent with non-monetary financing) and tight monetary policies (control of money supply and credit) as well as by the current Hryvnia devaluation. Lower aggregate demand should lead to a reduction of imports of about 30% in 2009, in dollar terms. Although the negative international situation will also reduce exports, this decline is expected to be lower than the drop in imports. As a result, we anticipate that the current account deficit in 2009 will be around $3.3 billion, or 3% of GDP, a manageable amount.
- High short term foreign debt service in 2009. The repayment of this short-term foreign debt would be feasible with the IMF disbursement of $10 billion and likely financing available from other international institutions. Thus, this vulnerability could also be under control.
- Weak Banks. The banking sector problems are being handled relatively well. If the current recapitalization plans are successful, systemic issues may be under control, though a number of medium and small banks may fail. But the potential failure of the banking sector is possibly the greatest risk for Ukraine at the moment.

Under this scenario, the crisis would be contained during 2009. By the end of 2009, the exchange rate should stabilize at around 8-9 UAH/$. GDP for 2009 is likely to decline by around 8% yoy, reflecting the drop in exports, lower availability of consumer credits, and lower household income and corporate profits. Lower GDP and aggregate demand will also lower the inflation rate in 2009, which should be lower than in 2008, at about 15%. Although the fiscal deficit for 2009 is likely to be large (4% of GDP, or 8% of GDP if bank recapitalization funds are included), this deficit is expected to be largely financed by non-inflationary sources.

Economic recovery could take place only in 2010, following the revival of the world economy and the recovery of international prices for key Ukrainian export commodities.

Nevertheless, Ukraine's medium-term outlook remains positive and is supported by the country's recent membership in the WTO, and the following favorable country conditions: a very likely conclusion of a free trade agreement with the European Union, large and growing domestic markets, significant and unrealized supply potential in agriculture, and the availability of an inexpensive, educated and disciplined labor force.

Annex I: Ukraine- Key Statistics and Projections for 2009

	2002	2003	2004	2005	2006	2007	2008	2009(f)
Real GDP Growth	5.2%	9.6%	12.1%	2.7%	7.3%	7.9%	2.1%	-8.0%
Fiscal Balance (% GDP)	0.7%	-0.2	-3.2%	-1.8%	-0.7%	-1.1%	-1.5%	-4.0%
Consumer Inflation (eop)	-0.6%	8.2%	12.3%	10.3%	11.6%	16.6%	22.3%	15%
Exchange Rate (Hr/$, eop) (interbank rate)	5.33	5.33	5.31	5.05	5.05	5.05	8.0	9.0
Current Account ($bn)	3.2	2.9	6.8	2.5	-1.6	-5.9	-12.9	-3.3
(as % of GDP)	7.5%	5.8%	10.6%	2.9%	-1.5%	-4.2%	-7.2%	-2.9%
Gross International Reserves, incl. IMF financing ($bn)	4.4	6.9	9.5	19.4	22.3	32.5	31.5	27.0
Foreign Public Debt (% GDP)	24%	21%	19%	13%	12%	10%	11%	28%
Foreign Private Debt (% GDP)	22%	26%	27%	30%	38%	48%	47%	58%

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