

Ukraine and Kazakhstan: Economic Situation

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Ukraine

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Ukraine- Economic Performance

- Between 2001 and 2006, Ukraine showed overall excellent performance, with high economic growth, low fiscal deficits, moderate inflation rates, good external situation (with large surpluses in the current account), fairly stable foreign exchange rate, high international reserves, and low ratio of external public debt to GDP
- But 2007 showed signals of economic disequilibria, with higher rates of inflation (16.6%) and larger current account deficits (4.2% of GDP).

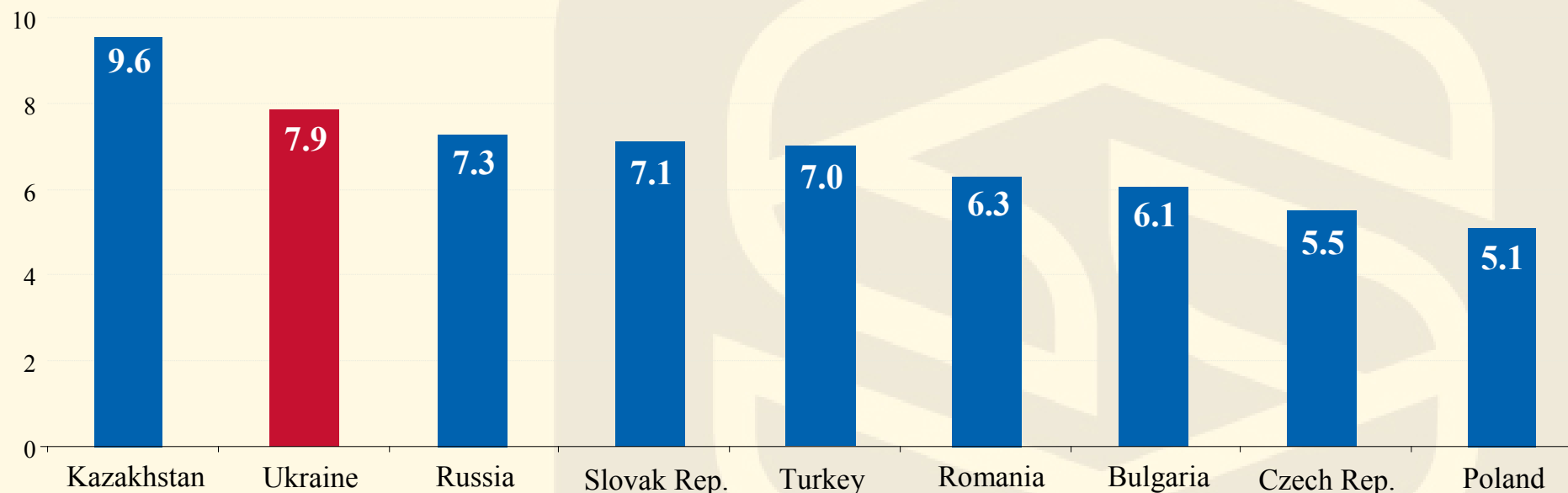
	2001	2002	2003	2004	2005	2006	2007(e)	2008(f)
Real GDP Growth	9.2%	5.2%	9.6%	12.1%	2.7%	7.3%	7.6%	5.5%
Fiscal Balance (% GDP)	-0.3%	0.7%	-0.2%	-3.2%	-1.8%	-0.7%	-1.1%	-1.5%
Consumer Inflation (eop)	6.1%	-0.6%	8.2%	12.3%	10.3%	11.6%	16.6%	15-20%
Exchange Rate (Hr/\$, eop)	5.30	5.33	5.33	5.31	5.05	5.05	5.05	5.05
Current Account (\$bn)	1.4	3.2	2.9	6.8	2.5	-1.6	-5.9	-12.0
<i>(as % of GDP)</i>	3.7%	7.5%	5.8%	10.6%	2.9%	-1.5%	-4.2%	-6.5%
International Reserves (\$bn)	3.1	4.4	6.9	9.5	19.4	22.3	32.5	35.0
Foreign Public Debt (% GDP)	26.3%	24.1%	21.3%	18.7%	13.4%	11.9%	9.9%	9.0%

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

Comparative Economic Performance

- Over the last five years, the Ukrainian economy grew by 7.9% per annum, becoming 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

During this period, Ukraine showed:

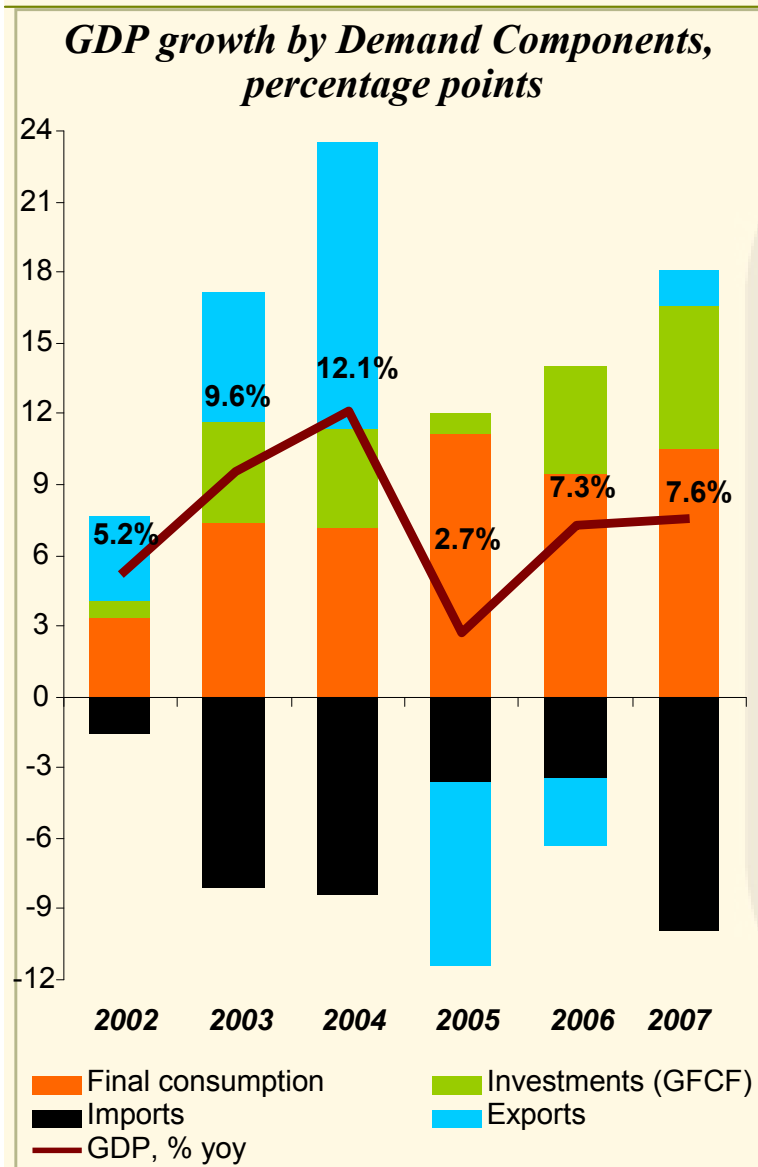
- Strong resilience to energy price shocks (the price for imported natural gas grew by about 50% in 2006 and 37% in 2007).
- Immunity to political crises.

Contributors to Good Economic Performance

The economic performance in 2000-2007 was supported by some key economic conditions and measures, including:

- Reasonable macroeconomic stability
- Competitive exchange rate
- Simplified business regulations particularly for starting a business
- Adopted legislation necessary for WTO accession (improved intellectual property and minority shareholders rights; better regulated the foreign banking and insurance sectors; liberalized trade reducing import tariffs from 7.7% to 5.1%)
- Initiated the reform of the tax system (eliminated tax exemptions and privileges; reduced the personal income tax from 0-40% of income to a 15% of income; and the corporate tax from 30% to 25%.)
- Banking and money laundering legislation was approved
- Re-activated privatization process and made it more transparent

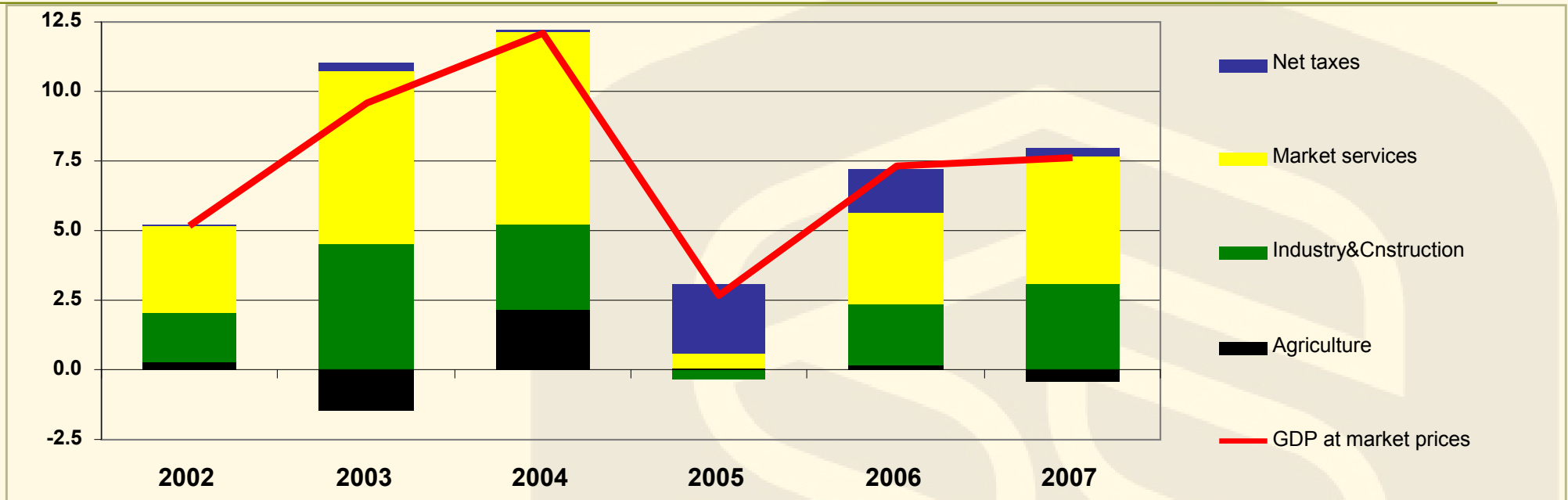
Sources of GDP Growth, by Expenditures



- During **2000-2004**, exports drove economic growth (including metallurgy, chemicals, machinery and transport eqp.)
- In **2005-2007**, domestic consumption grew by 18% pa, becoming the main source of GDP growth, stimulated by major increases in real wages (17% pa), bank credit (70% pa) and pensions.
- In **2006-2007** economic growth was supported by investment growth (23% pa), which was driven by the need to modernize existing production capacities and introduce energy saving technologies.

Source: State Statistics Committee, The Bleyzer Foundation

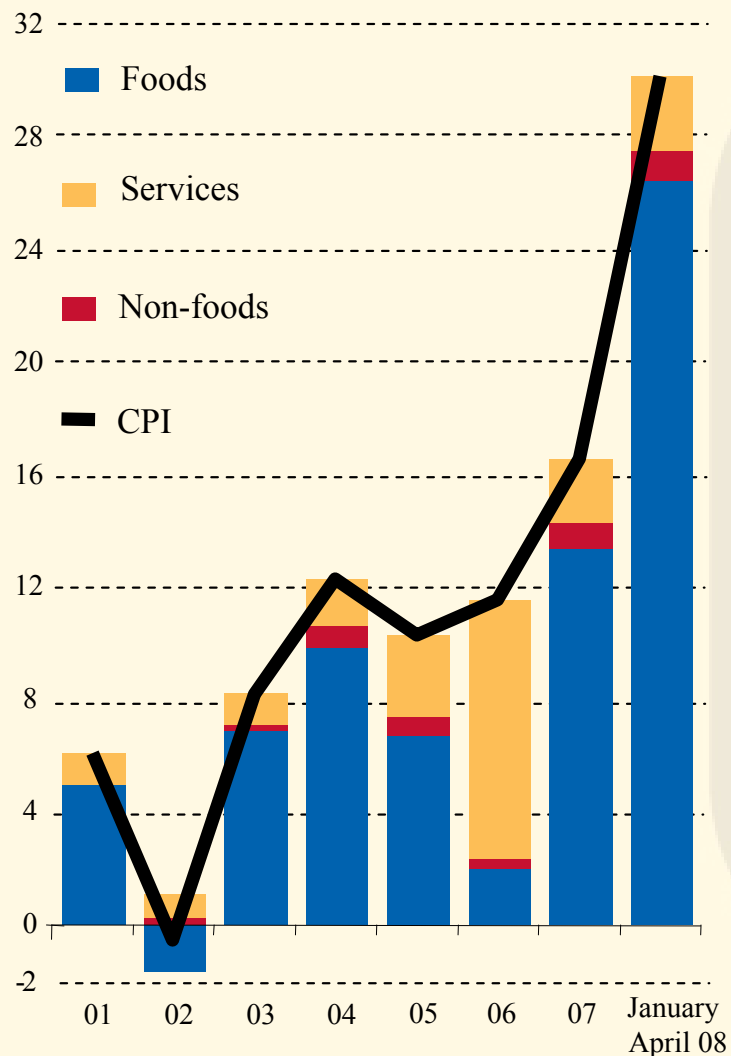
GDP Growth by Sector



Source: State Statistics Committee, The Bleyzer Foundation

- On the supply side, during **2002-2007** GDP growth was driven by services (trade, banking, transport), industry and construction.
- During **2007**, services expanded rapidly, particularly trade (21%), and transport/communications (11%). Construction expanded by 13%. Also industry grew rapidly by about 10%, with leading growth in machinery (29% pa), metallurgy (8% pa) and food processing (10% pa).

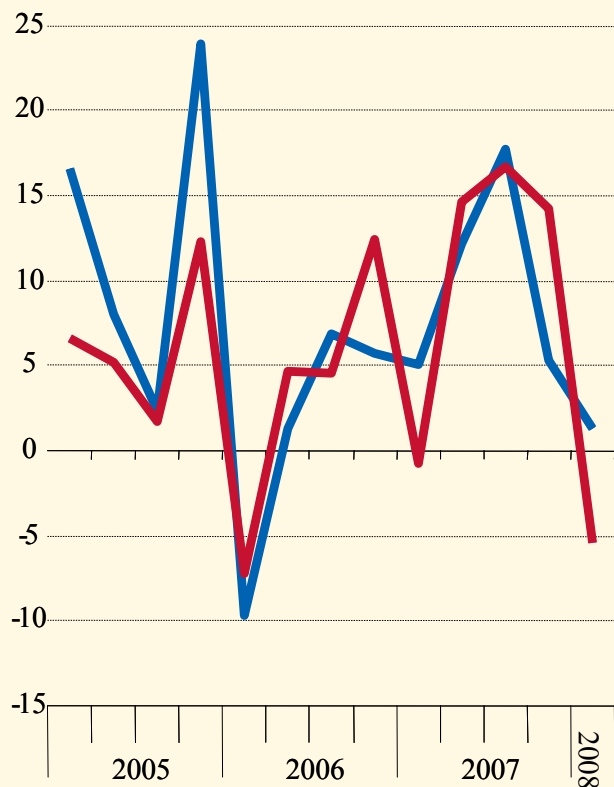
Monetary Performance: Accelerating Inflation



- In **2004-2006**, consumer inflation was high at 12% pa, driven by food & utility prices.
- In **2007**, inflation reached 16.6%, led by acceleration of food prices.
- Increases of food prices were due both to supply and demand factors.
- **On the supply side**, food prices were affected by bad weather (with agricultural value-added declining by 5% in 2007), higher input prices, pass-through of energy price increases to agriculture and higher global food prices.
- **On the demand side**, loose monetary and fiscal policies also contributed to increased inflation – following NBU's large purchases of foreign exchange, rapid growth of bank credit and large social expenditures.

Inflation – Monetary and Fiscal Policies

NBU forex operations and Monetary base, UAH billion



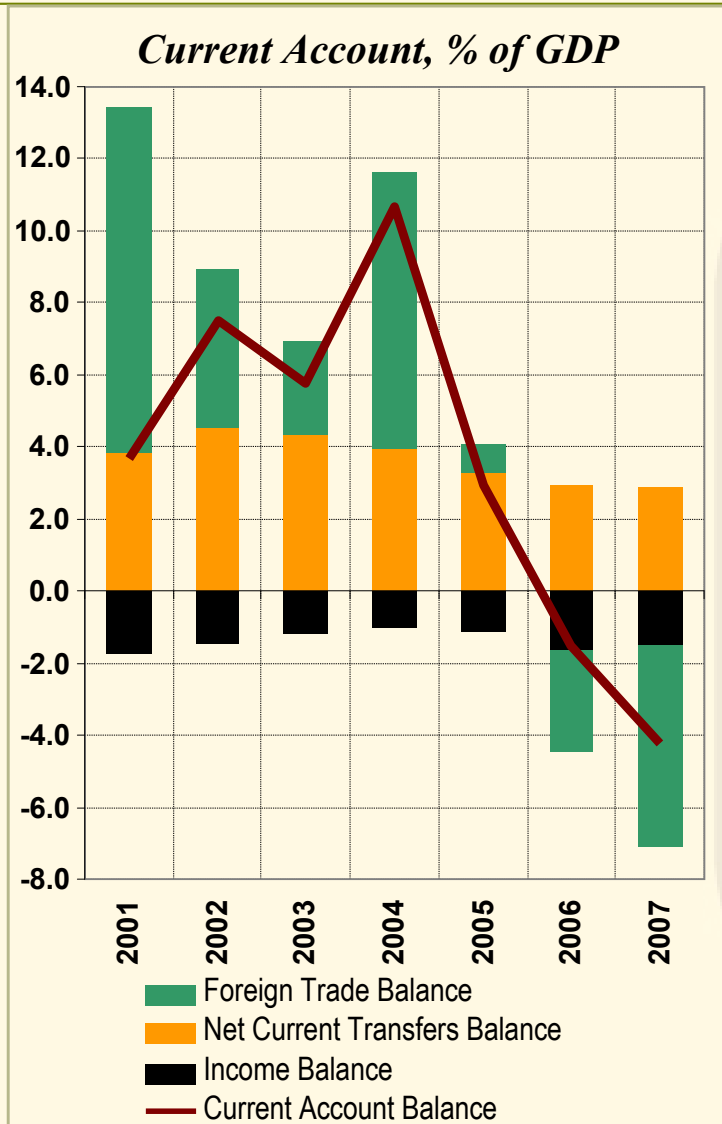
— NBU interventions, quarterly
— Monetary base, quarterly change

- The fixing of the exchange rate to the dollar was successful in reducing inflation in the 1990s.
- But with large trade surpluses and capital inflows the NBU had to inject billions of Hryvs. into the economy to maintain exchange rate peg.
- These purchases of foreign exchange by the NBU led to rapid growth of money supply (47% pa) and credit (70%pa) in the last three years.
- These high increases in money supply had not been reflected earlier in high inflation thanks to the growth in money demand associated with high rates of GDP growth – but the “excess” money supply is now leading to high inflation.
- Low fiscal deficits have not been major contributors to money supply increases, but higher fiscal expenditures have led to increases in aggregate demand and therefore to inflation.

Inflation – Government Actions

- The Government has taken a number of measures to tame inflation:
 - The NBU reduced its purchases of FX, allowing the exchange rate to go beyond the lower end of exchange rate band (UAH/\$ 4.95-5.25) on the inter-bank market.
 - The NBU has tightened reserve requirements on foreign capital borrowed from abroad and tightened capital adequacy norms.
 - The NBU raised its discount rate by 400 basis points to 12%.
 - The NBU carried out sizable sterilization operations, absorbing more than \$12 billion of excess liquidity since November 2007.
 - The government will reduce its 2008 fiscal budget deficit to 1.5% of GDP (down from previously targeted 2.1% of GDP).
 - The government postponed the issuance of Eurobonds and will rely on domestic borrowing to finance its fiscal deficit.
- These measures as well as expected good harvest this year are expected to reduce inflation towards the end of 2008.

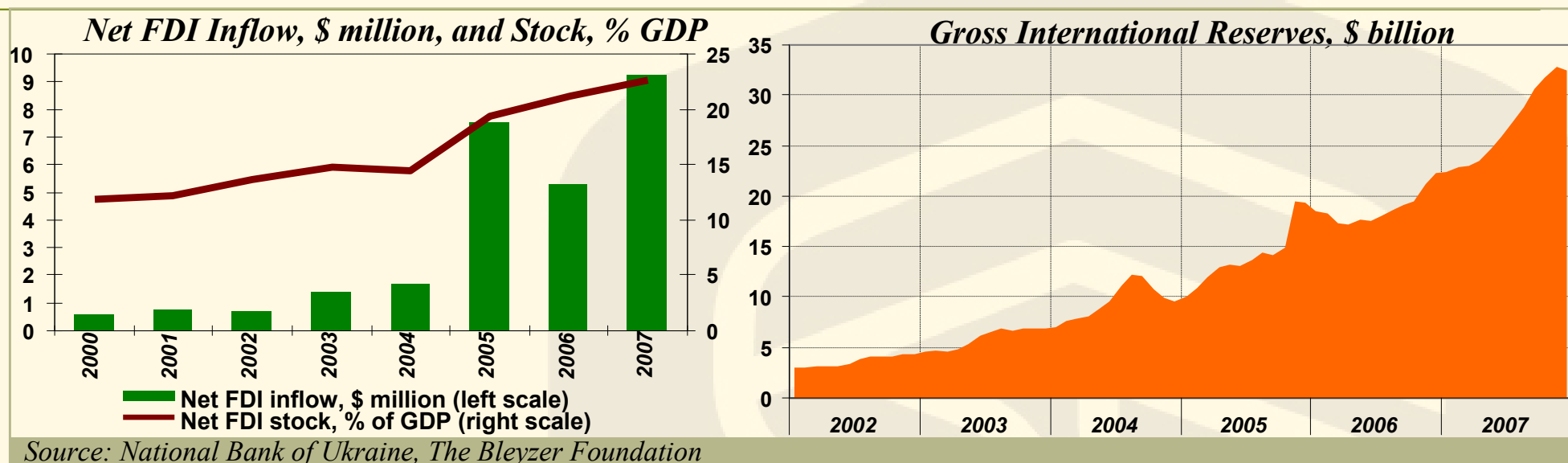
Balance of Payments



Source: National Bank of Ukraine, The Bleyzer Foundation

- In 2006 and 2007, Ukraine's exports of goods in dollar terms grew strongly by 20% pa, primarily due to metals (22% pa), chemicals (19% pa) and machinery and transport vehicles (37% pa).
- However, in these two years, imports grew even at a faster pace of 30% pa, driven by increases in energy prices and expanded investment activity.
- As a result, a large trade deficit developed in 2006 and widened more in 2007.
- In 2007 the current account deficit was about 4.2% of GDP and is expected to grow to 6% of GDP in 2008.

Foreign Investments and Debt



- The Current Account deficits have been fully covered by large capital inflows (FDIs and private sector borrowing from abroad).
- These inflows also contributed to increase gross international reserves, which amount to \$32 billion or 5 months on imports.
- In 2007, net inflows of FDIs amounted to \$9 billion due to a number of acquisitions, particularly in banking and food processing.
- Although external public debt has remained stable, private external debt has increased rapidly from \$18 billion in 2004 to \$70 billion at present.

Medium Term Outlook

- Past economic growth was supported by increases in consumption, exports and fixed investments.
- Increases in private consumption were due to increases in pension payments and public wages, as well as to a continuing credit boom.
- Exports benefited from high metal and chemical prices and strong external demand.
- In the future, the growth of consumption and exports are unlikely to be as strong as in the recent past.
- We estimate that in the next few years, GDP growth is likely to be around 5% - 6% pa.
- **To have higher rates of growth, the government recognizes that the country will require new investments, improvements in labor productivity and efficiency and more innovation/technology.**
- **For this purpose, the government has developed a program to improve the country's investment climate.**

The Government's Program

- The government of Ms. Tymoshenko has drafted its Action Program “Ukrainian Breakthrough” setting priorities for government activities.
- The document incorporated recommendations made by international organizations, NGOs, private businesses -- including SigmaBleyzer/TBF.
- Special emphasis in the Program is devoted to:
 - Improving effectiveness of public administration
 - Improving governmental procurement and tender procedures
 - Ensuring transparent budgetary process with no shadow lobbying
 - Simplifying taxation and custom regulations
 - Improving enterprise registration procedures; averting conflict of interests
 - Ensuring equal rules for all entrepreneurs
 - Securing minority shareholders' rights
 - Ensuring a transparent judiciary system
 - Establishing transparent lease or sale of non-agricultural land practices
 - Deepening cooperation between Ukraine and the EU in various areas (trade, energy, cross-border procedures, etc.)
 - Healthcare and education reforms; and many others.

Political Situation

- During the political crises of 2004, the Parliament approved a compromise package of laws calling for changes to the Constitution.
- These reforms turned Ukraine into a parliamentary-presidential republic, reducing presidential power and giving more authority to the PM.
- These reforms, however, provided for overlapping responsibilities between the President and the PM that are at the core of today's political difficulties.
- Nevertheless, the “Orange Revolution” has had a profound impact on the civil, political and governmental structures of Ukraine.
- It transformed the country politically, with more competition among political parties, more transparency, a more open dialogue about political disagreements, more checks-and-balances and more accountability than ever before in the country.
- Ukraine is the only post-Soviet county (in addition to the Baltic states) where civil and political freedoms are developing, according to Freedom House. Thus, Ukraine is now rated as a free country.

Ukraine is an Attractive Country for Investment

- Highly educated labor force (almost 60% university enrolment)
- Low wages
- Border on the EU, with increasing trade potential
- Large domestic market (with growing purchasing power)
- Great agricultural potential
- Industrial and high-tech potential
- Likely prolonged period of significant economic growth
- Inefficiently run companies provide significant opportunity for value creation through improved operations, marketing, finance, customer and quality focus – bottom line growth
- Growing interest in the country by multinational investors
- Ukraine is the only post-Soviet country (in addition to the Baltic states) that is rated by Freedom House as a free country

Summary

- All recent political crises did not change the basic direction of Ukraine towards a more democratic and open society.
- In fact, the “Orange Revolution” provided for strong “civil rights” and these changes are unlikely to be reversed.
- The Orange Revolution did not promise or involve fundamental “economic” changes: in fact, all major political parties had already endorsed free market reforms, joining the WTO and seeking a FTA+ with the EU.
- Despite the complexity of the process, Ukraine still has to refine its political system as the Constitutional changes on 2004 are still causing difficulties with its unclear and overlapping mandates.
- On the economic front, the government is taking measures to address the two main issues of growing current account deficits and significant inflationary pressures.

Kazakhstan

WHERE OPPORTUNITIES EMERGE

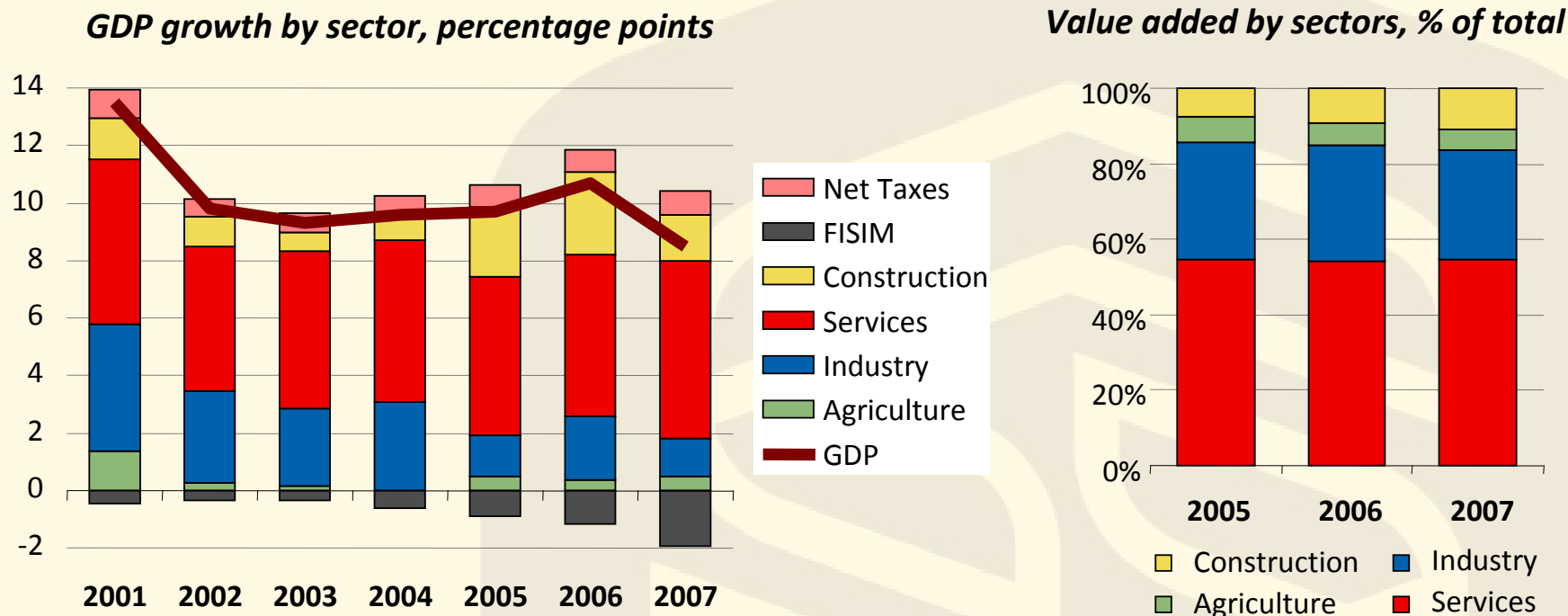


Kazakhstan – Economic Performance

- The global financial crisis has limited negative implications for Kazakhstan's medium-term outlook: the country's rich oil and land resources represent a solid basis for sustainable economic expansion.
- Furthermore, domestic businesses has plenty of room to growth since per capita consumption of foods, beverages and services still lag behind the levels seen in Kazakhstan's regional peers, despite the fact that Kazakhstan had a relatively high GDP per capita of around US\$7,000 in 2007.

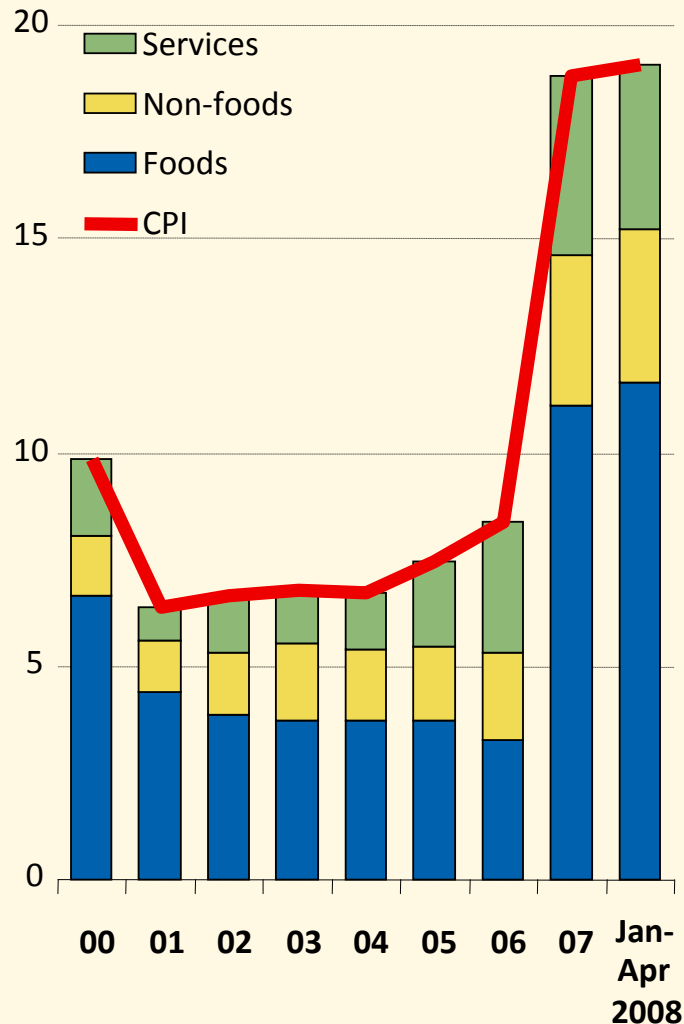
	2001	2002	2003	2004	2005	2006	2007
Real GDP Growth, %	13.5	9.8	9.3	9.6	9.7	10.6	8.5
Fiscal Balance (% GDP)	-0.4	-0.3	-1	-0.3	0.6	0.8	-1.7
Consumer Inflation (% eop)	8.4	5.9	6.8	6.9	7.6	8.6	18.8
Exchange Rate (KZT/\$)	149.6	155.1	145.1	130	133.9	127.9	120.8
Current Account (\$bn)	-1.4	-1.0	-0.3	0.3	-1.1	-1.8	-7.2
<i>(as % of GDP)</i>	-6.3	-4.2	-0.9	0.8	-1.8	-2.2	-7.0
International Reserves and assets of the oil fund (\$bn)	3.7	5	8.7	14.4	15.2	33.2	38.4
Foreign Public Debt (% GDP)	17.2	14.3	11.7	7.3	3.9	2.0	1.6

Kazakhstan – Economic Growth



- In 2001-07, the economy grew by over 10% on average, slowing to 8.5% last year.
- Last year construction slowed to 16.4% after increasing by 38% pa in 2005-2006.
- In 2008, tighter credit conditions will slow down economic growth, as construction activities, which heavily rely on banks' credit, are likely to remain weak.
- Still, the oil sector will continue to support strong GDP growth after 2008.
- Unlike other oil producing countries (such as Russia), Kazakhstan has been steadily increasing its oil exploration and extraction capacity.

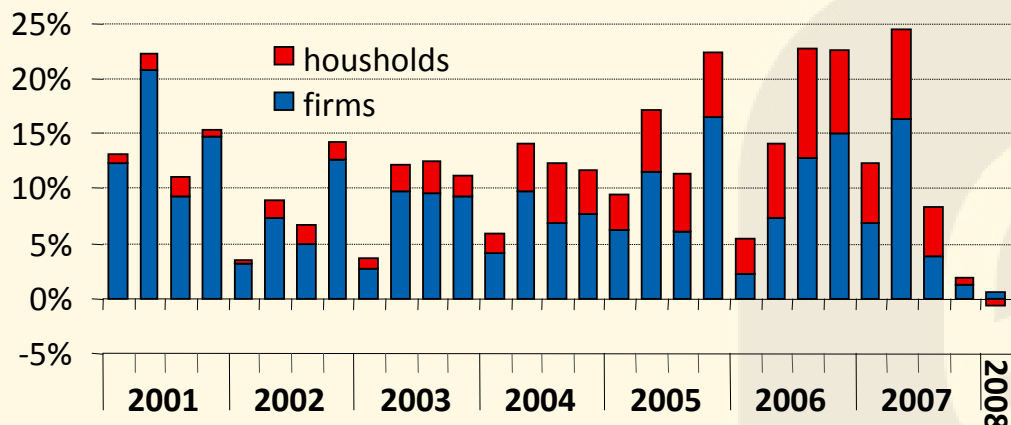
Monetary Performance: Accelerating Inflation



- Since 2000, CPI inflation was brought to single digit numbers based on prudent fiscal policies.
- Yet, in **2007** inflation reached 18.8%, pushed by high food prices.
- **Supply side** pressures on inflation were created by poor domestic supply which failed to match the growth of aggregate demand; and by tight conditions in the global agricultural markets.
- **Aggregate demand** was mostly affected by booming domestic credit, which was financed by local banks with massive borrowings from the international credit markets.
- Central bank's interventions at the forex market, despite relatively flexible exchange rate regime, boosted money supply as well.

Monetary Performance: The Banking Sector

Contribution of households and the corporate sector to quarterly percentage growth in domestic credit



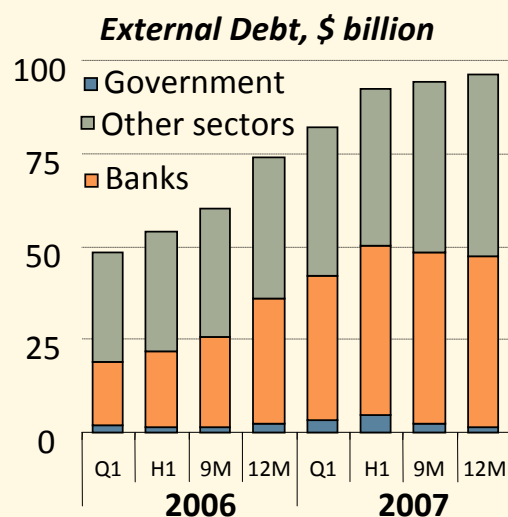
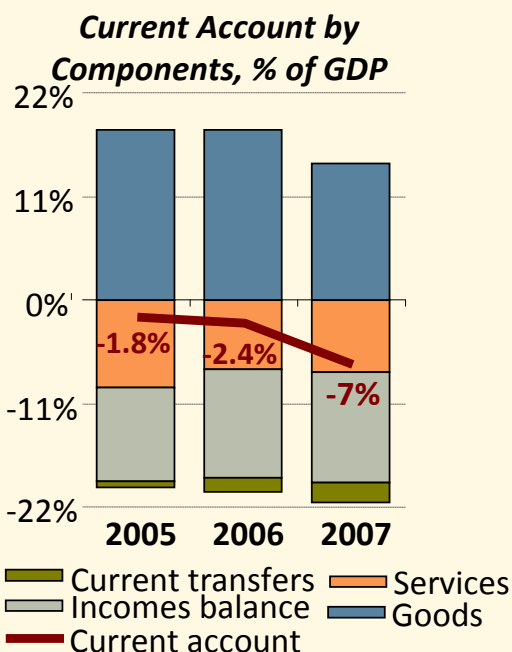
- Over the last several years, foreign funds became a key source for Kazakh banks to finance their credit portfolios.
- As international credit conditions tightened, domestic credit virtually ceased to grow in the first quarter of 2008.

- At the beginning of 2008, Kazakh banks were estimated to hold nearly \$11 billion in foreign debt payable in 2008. Nevertheless, banks managed to repay their external liabilities without defaults. Although, refinancing risks are still substantial, it appears that credit for Kazakh banks conditions are starting to ease as ATF Bank has recently obtained a \$500 million foreign loan.
- Adequate management of asset quality under the conditions of more moderate credit growth remains the key challenge to domestic banks.
- Interest of foreign investors on Kazakh banks, mostly controlled by domestic banks, is growing – this spring, the largest Korean bank purchased a stake in Kazakh bank.

Government Actions

- At present, the central bank has two priorities: (1) keep inflation below 10% and (2) support liquidity of the banking sector:
 - In December, the refinancing rate was increased to 11%;
 - Higher reserve requirements on foreign liabilities will be introduced in June 2008;
 - The Financial Supervision Agency tightened liquidity requirements for commercial banks
- Tighter international credit conditions played a role of automatic stabilizer, helping to slow credit growth in Kazakhstan and cooling inflationary pressures. Indeed, during the first four months of 2008, consumer prices grew by 3.4% since the beginning of the year (two times slower than in Russia or nearly four times slower than in Ukraine).
- Meanwhile, the government put restrictions on exports of grains and stepped in to support construction and banking industries:
 - Exports of grain were banned till September;
 - The government will spend \$1 billion to support construction in 2008.

Kazakhstan - External sector



- In 2007, the current account deficit widened to \$7 billion (or about 7% of GDP) while the stock of the private external debt stood at \$94.3 billion (or 97.8% of GDP).
- This year, the current account gap is expected to shrink as slower demand for imports and higher commodity prices will boost trade in goods surplus. Indeed, during the first two months of 2008 trade in goods balance more than doubled, growing to \$5.7 billion.
- Private external debt is expected to flatten due to limited access of domestic banks to international credit markets.
- In 2007, FDI, mostly into the mining industry, amounted to \$10.3 billion or up by 65%. Since FDI inflows are not expected to fall, the current account gap will be safely financed with FDIs.
- By mid-April, the forex reserves of the central bank and the assets of the oil fund increased by over 12% to \$43.1 billion. This means that the government has plenty of funds to support national financial system if external conditions worsen.

Kazakhstan – Medium-term Outlook

- Tighter credit conditions will continue to exert pressures on domestic real-estate market. Indeed, in April real estate prices fell on average by 1.1% for newly commissioned housing and by 7.7% for pre-owned housing from their picks in August 2007.
- Falling real-estate prices and slower growth of credit portfolios will encourage commercial banks to improve asset quality and risk management.
- Foreign banks are expected to become more active in Kazakhstan on the back of downward correction of assets in this sector. Foreign ownership, in turn, will strengthen the banking system, at present dominated by local players.
- Hitherto, the ability of the local banks to repay foreign obligations means that banks are well capitalized and can rely on owners and state backing.
- Economic growth is likely to return to its long-term sustainable trend, while efforts to diversify oil-dependent economy will accelerate.
- Inflationary risks, intensified by overheating pressures, will ease due to moderation of aggregate demand and slower growth of domestic credit.
- The current account deficit is likely to stay below 6% of GDP as record high crude oil prices and falling demand for imports will support trade in goods surplus.

Kazakhstan – Summary

- Kazakh banks experienced a larger impact of the global credit crunch (as compared to other emerging markets)
- At the same time, the banking sector appears to withstand the closure of the international capital markets. This means that it will gradually adjust toward more stable and sustainable growth in the medium-term.
- Political stability and oil bonanza will help the government to pursue structural reforms and will considerably mitigate current risks to financial stability.
- Inflation is a major concern of the authorities. Thus, the government shows strong commitment to tighten fiscal and monetary policies to curb inflationary pressures.
- The oil extracting industry will greatly benefit from the ongoing projects to expand domestic transit and production capacity. Meanwhile, high and growing demand from emerging markets and slow supply responses of the major oil producers will prop higher commodity prices in the medium-term.
- Although the government has recently strengthened its grip over natural resources and increased oil export duty, overall investment climate is anticipated to improve as a response to authorities' efforts to streamline and liberalize the regulatory environment. In particular, the new Tax Code, to be approved this fall, is expected to reduce tax burden on the non-oil economy.