

Ukraine: Economic Situation

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Political Situation

- On February 25th, 2010, Viktor Yanukovich became the president of Ukraine.
- On March 11th, the Parliament formed a new coalition and named a government under PM Mykola Azarov, a former Vice PM and finance minister of the Party of Regions' government in 2006-07.
- The formation of a coalition, based on individual deputies, has been challenged in the Constitutional Court, as the Constitution requires coalition of political parties.
- On April 8th, the Court ruled the coalition legal. Though the decision looked controversial, it was an important factor for medium-term political stability.
- PM Azarov is not regarded as a reformer but somebody who can get things done.
- The new authorities declared their willingness to introduce a number of structural reforms. For these purposes Committee on Economic Reforms, National Anti-corruption Committee, and Working Group in charge of Judiciary Reform were created.
- Although it is too early to say if drastic structural changes in the economy will be implemented, it is apparent that the new government has the expertise required to take measures to prevent further economic arrest.

Macroeconomic Performance

	2000-07 average		2008	2009	2010 (f)
Real GDP Growth, % yoy	7.5		2.3	-15.1	4.5
Fiscal Balance, % GDP	-0.8		-2.1*	-11.5**	-6.0
Consumer Inflation, %, eop	11.3		22.3	12.3	13-15
UAH/\$ Exchange Rate, eop	5.2		7.7	8.0	7.8 – 8.3
Current Account, % GDP	<u>2000-05</u> 5.7	<u>2006-07</u> -2.6	-7.1	-1.7	2.0
Gross Int. Reserves, \$ bn	<u>2000</u> 1.5	<u>2007</u> 32.5	31.5	26.5	28
Foreign Gov't Debt, % GDP	<u>2003</u> 21.3	<u>2007</u> 8.7	9.2	20	23
Foreign Private Debt, % GDP	26.2	47.4	47.1	67	58

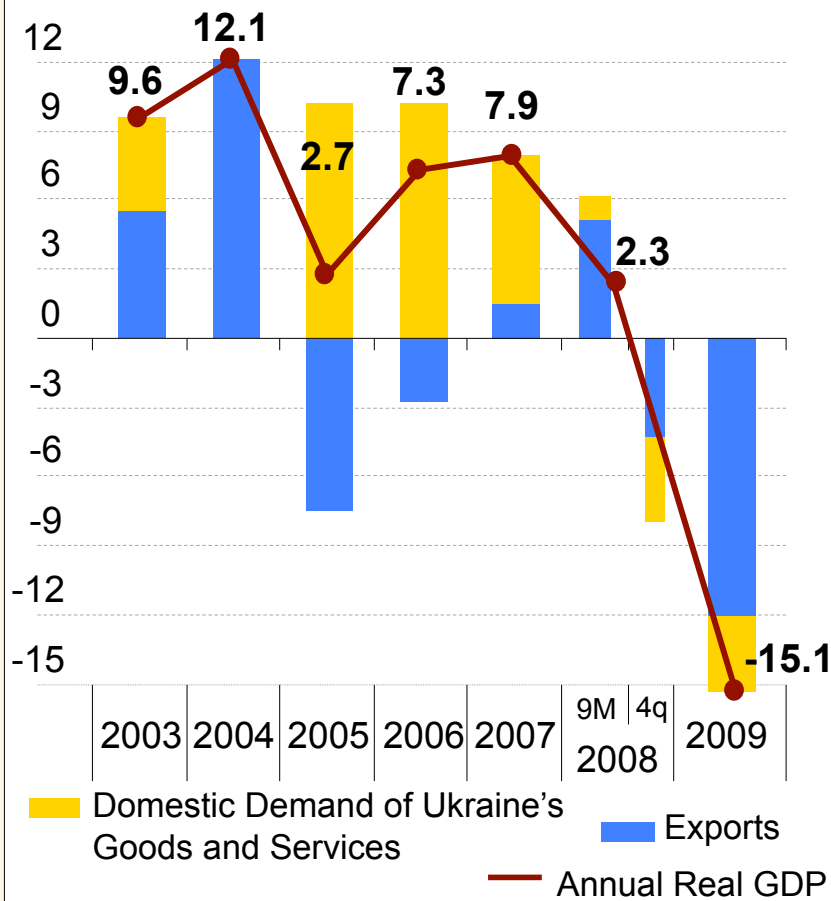
* Includes implicit pension fund deficit (credits from unified Treasury account (state budget) to cover pension fund expenditures)

** Includes expenditures on commercial banks recapitalization and capital injections to Naftogaz (5.7% GDP), implicit pension fund deficit (1.8% GDP), and expenditures covered by IMF's special SDR allocation to Ukraine (1.7% GDP).

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Real Sector Performance

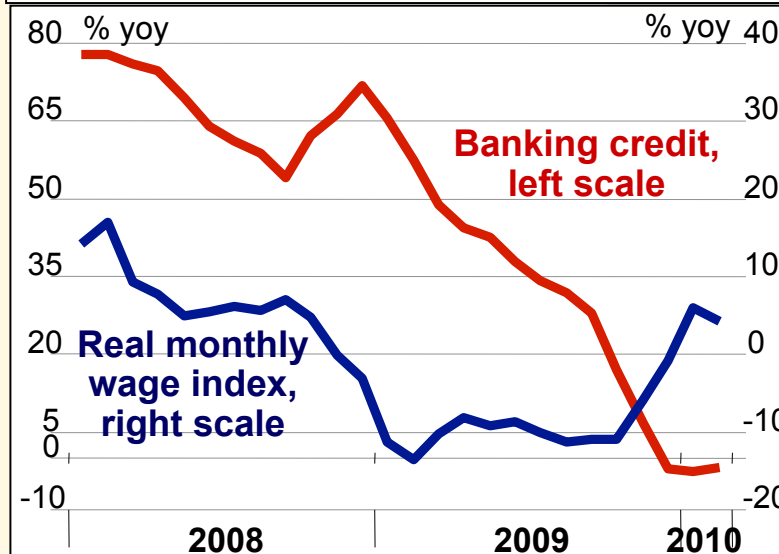
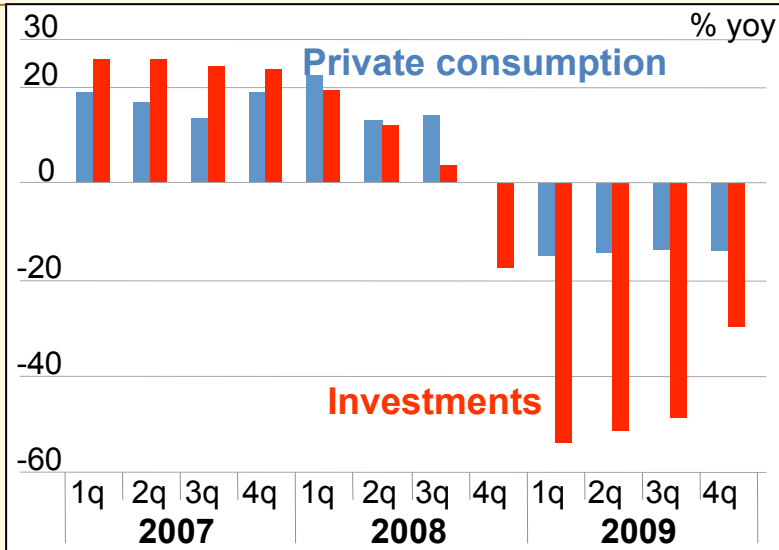
Real GDP Growth, % yoy, by its Main Contributors



Source: State Statistics Committee, The Bleyzer Foundation (TBF)

- In the past, the main contributors to GDP growth were Exports and Domestic Demand.
- The global financial crisis hit Ukraine hard:
 - In 2009, exports dropped by 40% and industrial production fell by 22%;
 - Domestic demand declined by 28%;
 - Real GDP declined by 15.1% yoy in 2009.
- This deep recession reflected the excessive reliance of the economy on:
 - **undiversified commodity exports**, and
 - **large foreign debt and capital inflows to support domestic demand**.
- The international crisis affected both exports and capital inflows.
- On a positive note, due to its export orientation, Ukraine should benefit from the current recovering global economy.

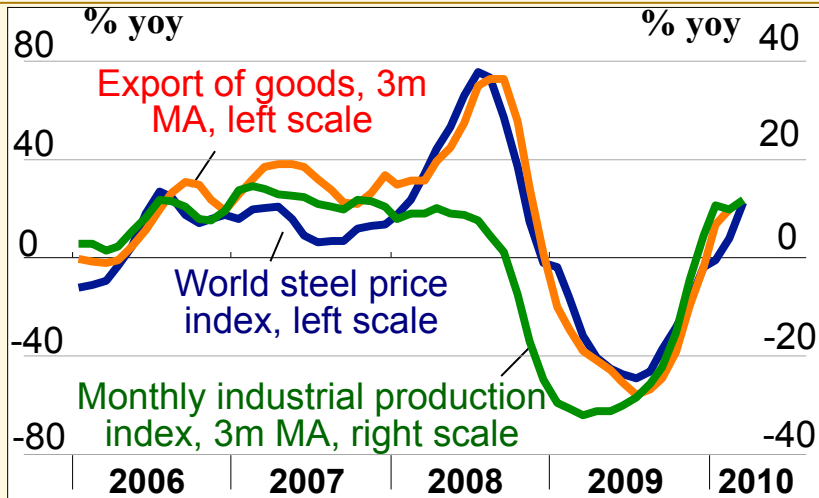
Drop in Domestic Consumption and Investments



Source: State Statistics Committee, NBU, TBF

- In 2009 **private consumption** declined by 14% and **investment in fixed capital** declined by 46%, both negatively affected by:
 - a drop in bank credit
 - increased unemployment
 - decline in real wages
 - Hryvnia depreciation
- **In 2010**, private consumption may be supported by a further rise in social standards (minimum wages and pensions).
- **In 2010**, investment activity may be stimulated by public infrastructure projects.
- But bank credit activity is likely to remain sluggish, dragging on domestic demand.
- Thus, future growth will have to come mainly from net exports and foreign direct investments

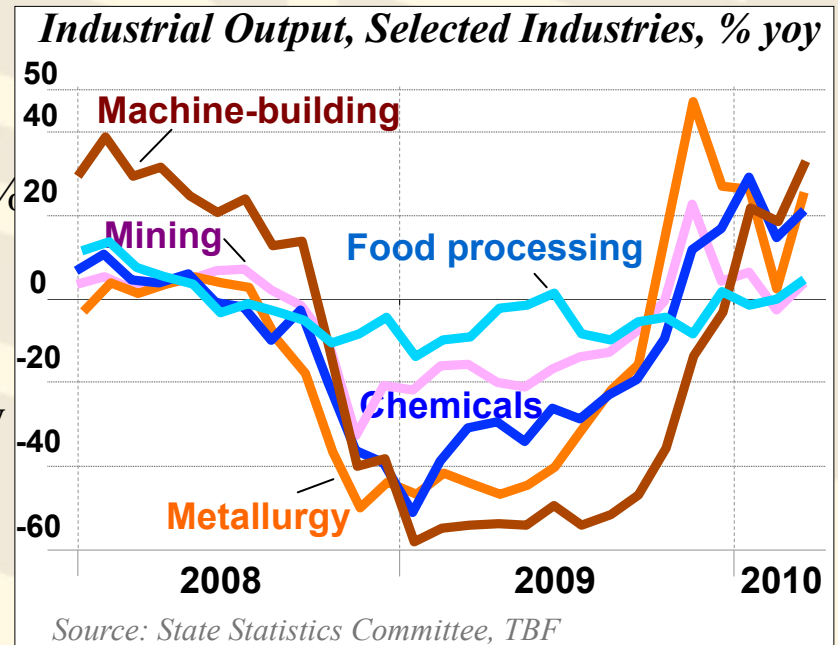
Exports and Industry



Source: State Statistics Committee, NBU, MEPS, TBF

- Exports represent about 50% of GDP.
- But with low diversification, Metals, Minerals and Chemicals account for 60% of exports.
- Geographic orientation is also poorly diversified.
- As world steel prices fell sharply in mid-2008-2009, exports of goods also dropped by 40% and industrial output fell by 22% in 2009.
- But all major output declines occurred in late 2008.

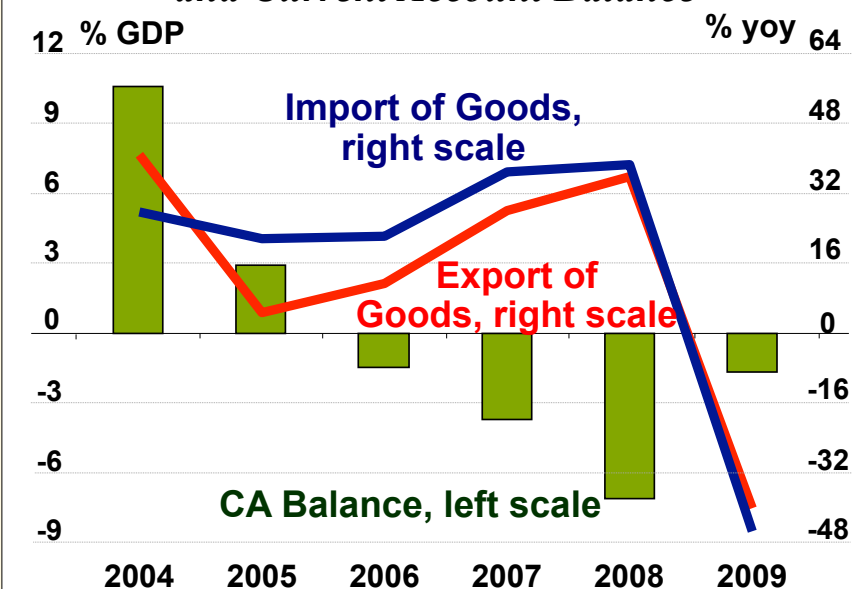
- By March 2009, the economy showed signs of recovery.
- Over Jan-Feb 2010 Ukraine's exports grew by 24% yoy amid continuing growth of steel prices.
- In Jan-Mar 2010, industrial production grew by almost 11% yoy.
- Following the world exporter's switch to quarterly iron ore pricing, steel prices are now forecast to shower large increase than expected.
- This should allow Ukraine's US\$ exports to grow by about 25%-30% yoy in 2010.



Source: State Statistics Committee, TBF

Imports and Current Account

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



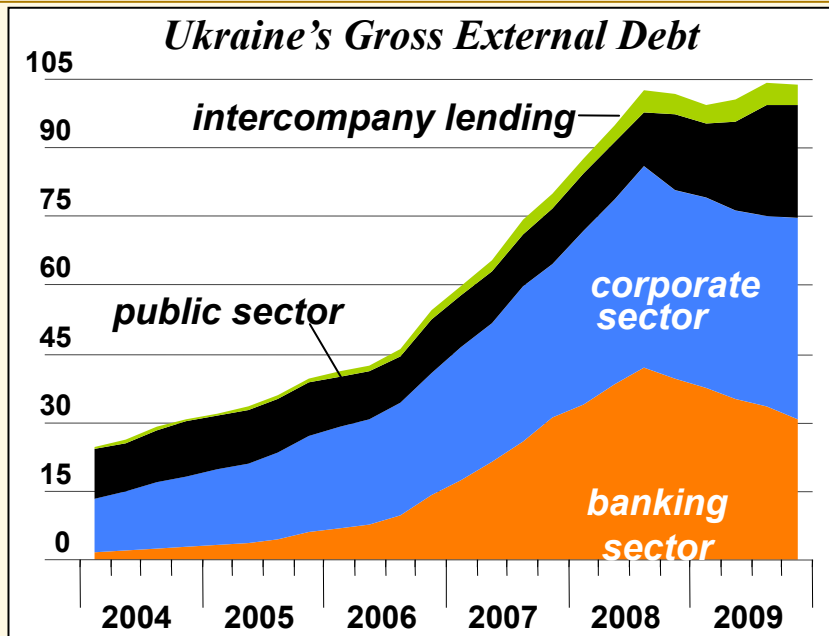
Source: NBU, SSC, The Bleyzer Foundation

- In 2009, though exports declined by 40%, but imports declined even more, by 45%, due to lower income and a depreciated currency.
- A substantial decline in imports was reached thanks to a 28% decline in volume of imported natural gas.
- As a result, the current account deficit narrowed from 7% of GDP in 2008 to less than 2% of GDP in 2009.
- On April 21st, 2010, Ukraine and Russia agreed on a 30% discount to the price of imported gas to Ukraine.

- The average price for imported gas is estimated at about \$240 per 1000 m³ in 2010 vs. previous \$337, a marginal increase compared to an average \$228 per 1000 m³ in 2009.
- Though Ukraine agreed to import about 8% more of natural gas in 2010, the discount and better export opportunities suggest Ukraine's current account will turn into surplus.
- In 2010, current account surplus is now forecast at about 2% of GDP.
- Based on better export prospects and lower import bills, we upgraded our GDP forecast to 4.5% in 2010.

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Capital Account

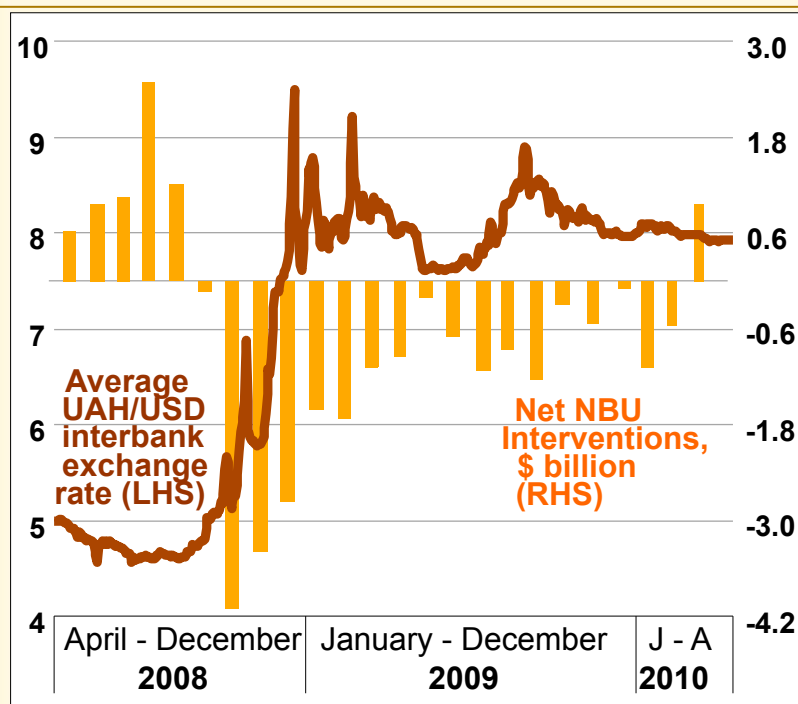


Source: NBU, TBF

- External debt tripled in three years (2006-08) to about \$100 billion (90% of GDP).
- As of mid-2008, ~ \$40 billion of debt was due in 1 year vs. \$35 billion of international reserves.
- In 2009, IMF's disbursement of \$6.1 bn and the readiness of foreign creditors to roll-over 80% of Ukraine's debt helped to cover its foreign financing needs.
- Similar international support is needed in 2010.

- Out of total \$103.4 billion of external debt, in 2010 principal repayments are estimated at \$35 billion (with reserves standing at \$26.5 billion at end-2009).
- Revival of global economy, a number of external debt re-structuring deals in 1Q 2010, recently resumed commercial bank placement of Eurobonds (Ukreximbank) and good prospects of renewed IMF financing, suggest the financing needs will be successfully met this year.
- Beyond 2010, to sustain its external balances, Ukraine needs to carry out broad economic reforms to attract investments and diversify its economy.

Foreign Exchange Rates



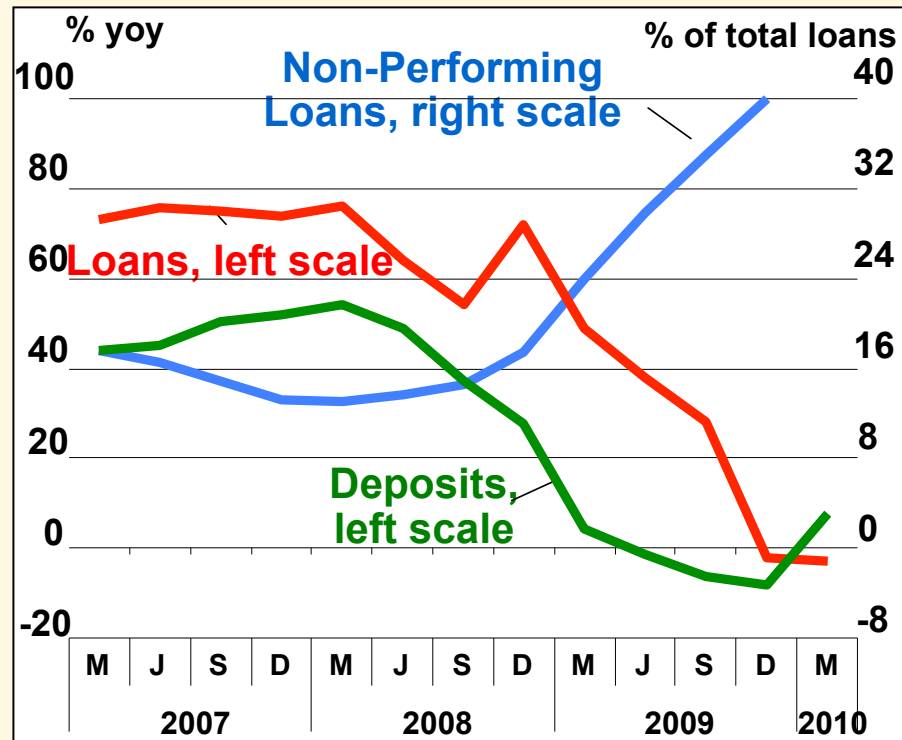
- **The reduction of external vulnerabilities during 2009** (narrowing current account deficit, financial support of IMF and high foreign roll-over rates) and **NBU measures** (regular interventions and administrative regulations) calmed the foreign exchange market in the fall of 2009.
- **The Hryvnia exchange rate versus US Dollar** remained stable at about UAH 8.0 per USD during most of the turbulent election period.
- Amid improved exports, political stability, and renewed IMF contacts, the Hryvnia appreciated by about 1% over January-April 2010.

Source: NBU, Finance.ua, TBF

- With current account surplus and manageable external financing needs, the Hryvnia may further appreciate in 2010.
- However, banking sector risks and a strained fiscal budget situation are major risks that may lead to further currency depreciation.
- Hence, our exchange rate forecast ranges from 7.8 UAH/USD (assuming renewal of the IMF Program and a fully-financed fiscal budget) to 8.3 UAH/USD in a more pessimistic outlook.

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Banking Sector Performance



Source: NBU, IMF, TBF

- In 2005-2008, commercial bank credit grew by 70% pa, financed mainly by foreign loans.
- External debt of the banking sector grew from \$2 bn in 2003 to \$40 bn in Sept 2008.
- A lot of this debt was short-term.
- The global crisis closed access to foreign funds.
- Lower income and a depreciated Hryvnia caused NPLs to soar to about 40% at present.

- In addition, the sector experienced severe deposit runs in late 2008/beginning 2009.
- NBU, with the help of the IMF, helped to stabilize the situation in the sector.
- But credit growth fell from 78% yoy in Jan-2008 to -3% yoy in Mar 2010, hurting heavily credit-dependent economy.
- Weaknesses in the banking sector still constitute main risks for future economic recovery.¹⁰

Public Finances and Inflation

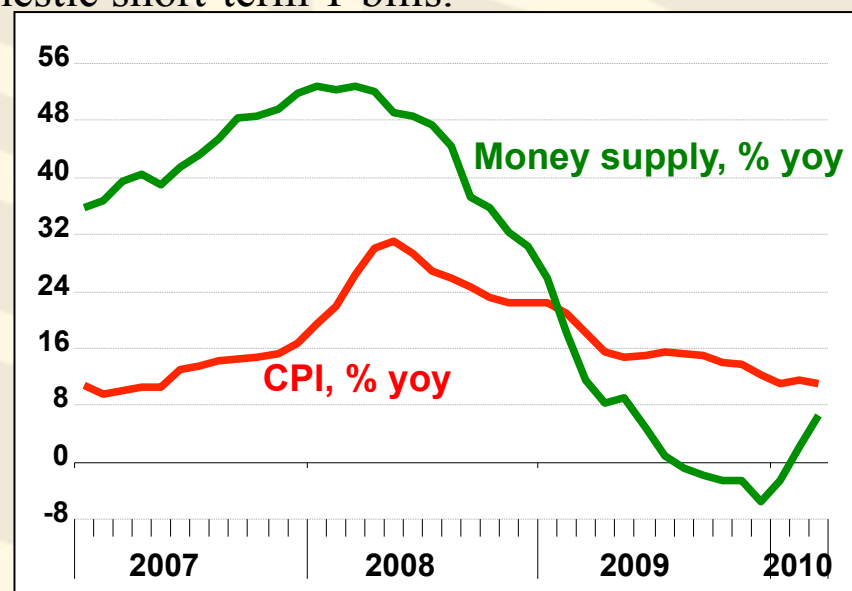
Ukraine's Fiscal Deficit in 2009, % of GDP

Official consolidated budget deficit	2.3
Special SDR allocation, treated as budget revenues	1.7
Banks' recapitalization and Naftogaz capital injection	5.7
Implicit pension fund deficit	1.8
Overall budget deficit	11.5

- Budget revenues fell sharply in 2009.
- But expenditures remained virtually unchanged, despite a 7% increase in current expenditures, thanks to a 50% decline in capital spending.
- As a result, the overall fiscal deficit reached 11.5% of GDP.
- Ukraine was able to finance the deficit mainly thanks to IMF funds and the issuance of domestic short-term T-bills.

Sources: Ministry of Finance, Presidential Secretariat, NBU, TBF

- But sluggish demand for T-bill led to high yields reaching 32% pa in Oct-2009.
- A substantial portion of T-bills was monetized by the NBU.
- But with a sharp decline in economic activity, inflation fell to 12.3% yoy in 2009.
- Without fiscal consolidation, Ukraine may lose control over inflation, which may exceed 13%-15% in 2010.



Source: NBU, State Statistics Committee, TBF

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Public Finances in 2010

- Without fiscal austerity measures in 2010, the overall fiscal deficit would stay at 11% of GDP.
- This would amount to about \$13 bn. In addition, in April-July 2010 about \$1.2 bn of T-bills have to be repaid and \$2 bn are needed to cover the payment of gas to Russia.
- These amounts are not financeable and the government is aware that the fiscal deficit must be reduced significantly and that large financing will be needed from the IMF.
- The Government is now negotiating with the IMF on the basis of a fiscal deficit of 6% of GDP and tries to secure a new \$12 billion IMF program for 2.5 years.
- The requires a 6% of GDP deficit may be reached if a number of stainable measures are carried out:
 - Rebalance Naftogaz finances by raising natural gas tariffs to the population (which is now at 15% of market prices) and utility sector (which is at 30% of market prices).
 - Increase cost-recovery of other utilities and transportation services;
 - Contain the growth of official wages and possibly of pension payments;
 - Revise taxation to eliminate exemptions;
 - Agree on a schedule to repay VAT arrears to exporters.
- Ukraine's officials have indicated that, after reaching agreement with the IMF, Ukraine would raise around \$1.5 bn on the Eurobond market this year.

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Future Prospects

- In 2010, given high financing requirements for the fiscal deficit, the need to serve its large private foreign debt and banking sector weaknesses, Ukraine's external stability can only be maintained with IMF financing and the willingness of foreign creditors to roll-over their debt.
- Thus, Ukraine is at a turning point, as the country's future economic growth and its financial stability depend on the new government's ability to take hard decisions quickly, particularly regarding fiscal austerity measures needed to revive the IMF Program.
- So far, official pronouncements have been favorable, prompting S&P and Fitch to upgrade Ukraine's sovereign debt, leading to a 200 bsp drop in Ukraine's CDS spreads.



Future Prospects (Cont.)

- A further positive shift in the investor confidence can be possible as soon as there is strong evidence that the government is not only willing to adopt but also is able to implement the required reforms.
- Over the medium term, Ukraine's growth will depend on the success of the country in attracting foreign direct investments to diversify its economy and secure productivity growth including by energy efficiency.
- The economic reform program is rather large and hard to implement, but its realization is a necessary condition to reach sustainable growth.
- The reform program includes stabilization of the banking sector, further deregulation of business, anti-corruption measures, judiciary reform, public administration reform and decentralization.
- The Bleyzer Foundation is actively collaborating with the new government in the elaboration of these reform measures.
- Based on statements made recently by major foreign analysis (JPMorgan, Citibank, the World Bank) there is now some optimism.