

Ukraine: Current Economic Situation and Prospects

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The International Liquidity Crisis Hit Ukraine Hard

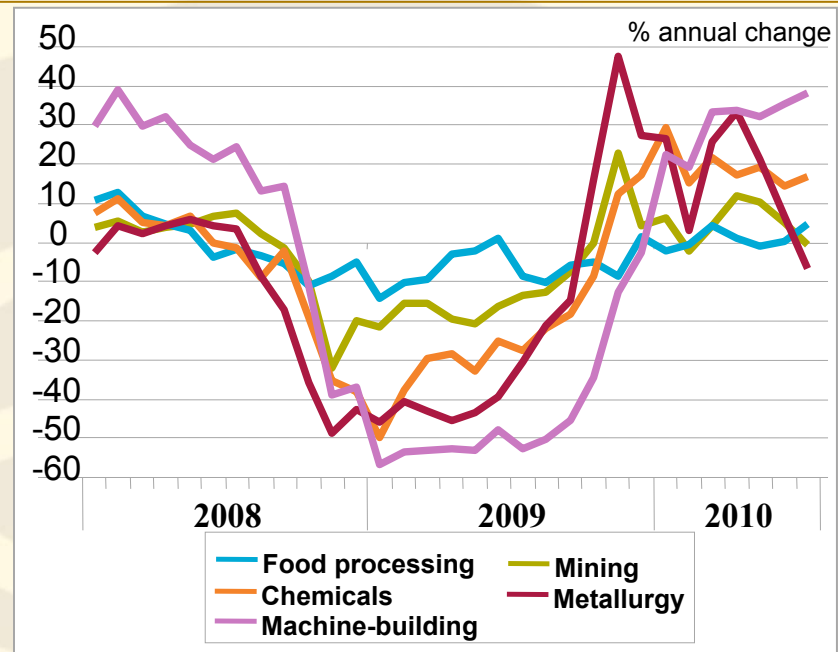
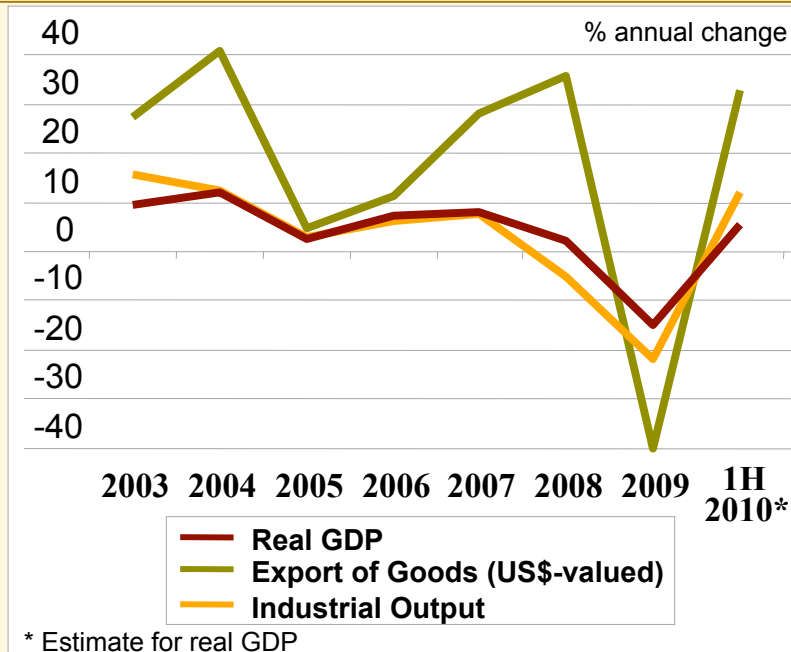
- Export of goods: -40% yoy (2009)
- Industrial production: -22% yoy (2009)
- Real GDP: -15.1% yoy (2009)
- Unemployment (ILO): 9.4% (4Q 2009)
- Real households' income: -10.5% yoy (9M 2009)
- Fiscal balance: -8.5% of GDP (2009)
- PFTS stock index: -74% (2008-09)
- UAH/\$ Exchange Rate: 65% Depreciation (2008-09)

The Crisis Affected Ukraine Harder than other EMs

Country	GDP, % yoy 2009*	Local Currency Depreciation vs. US Dollar (mid-2008 to end-2009)
Ukraine	-15.1	65%
Latvia	-18.0	9%
Lithuania	-15.0	9%
Estonia	-14.1	9%
Russia	-7.9	29%
Mexico	-6.5	27%
Romania	-7.1	27%
Hungary	-6.3	26%
Taiwan	-3.5	6%

Sources: IMF, The Economist, Central banks of the respective countries, The Bleyzer Foundation

Ukraine's Economic Recovery in 2010



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

- During 2010, Ukraine has been recovering very fast from the deep 2009 recession.
- The collapse of exports was one of the main channels through which the international liquidity crisis hit Ukraine in 2008-2009.
- The other channel was the reversal of capital inflows that depressed consumption.
- Likewise, export-oriented industries and capital inflows led the recovery in 1H 2010.
- A 33% yoy rebound in exports and net financial inflows of about \$5 billion in 1H 2010, underpinned a strong real GDP growth of 5.5% yoy in 1H 2010.

What Factors will Affect Ukraine's Recovery?

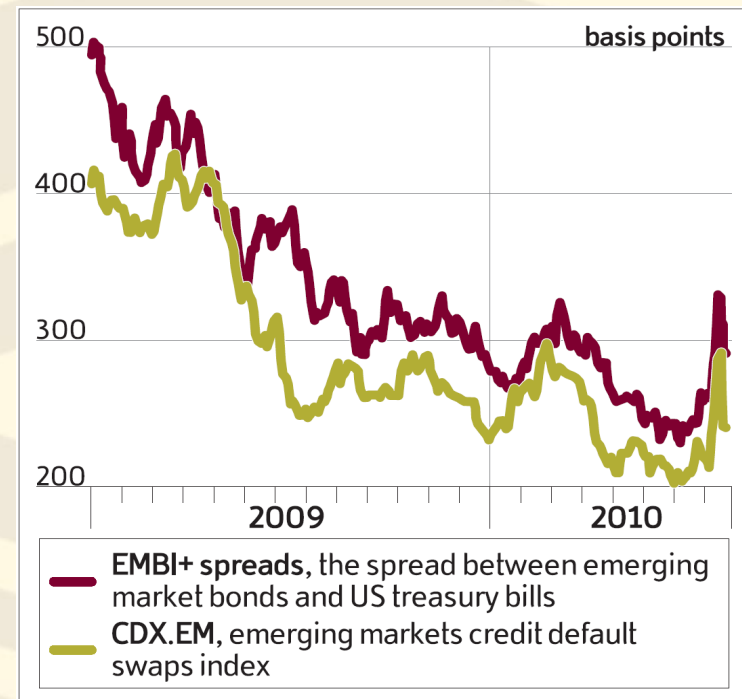
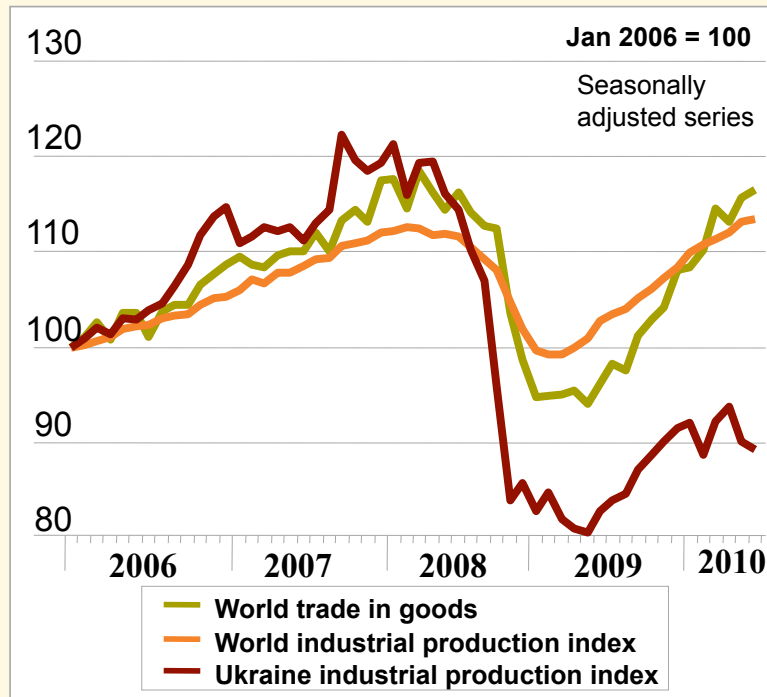
External Environment:

1. The pace of economic recovery in Ukraine's main trading partners
2. The prospects for Ukrainian exports
 - a) Prospects for steel and metallurgical exports
 - b) Prospects for agricultural exports
 - c) Degree of international competitiveness of Ukraine
3. Ability of Ukraine to secure external financing and roll-over its large foreign debt

Domestic Factors:

4. Adequacy of Macroeconomic Stabilization Policies
5. Pace of recovery of Domestic Demand and Banking Credit
6. Adequacy of Economic Policies to **sustain** long-term growth by improving the business climate to attract investments

Factor 1. Pace of Global Economic Recovery



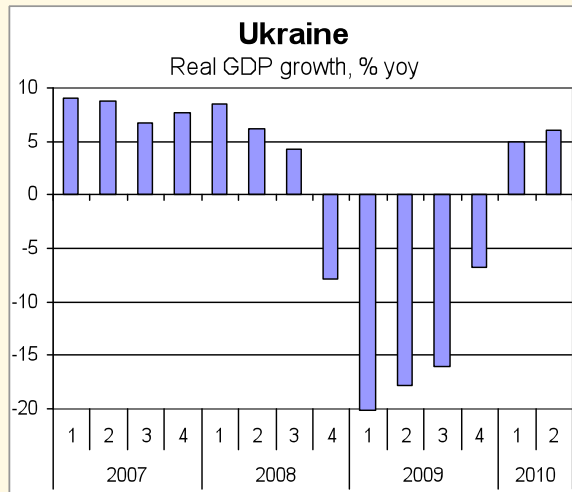
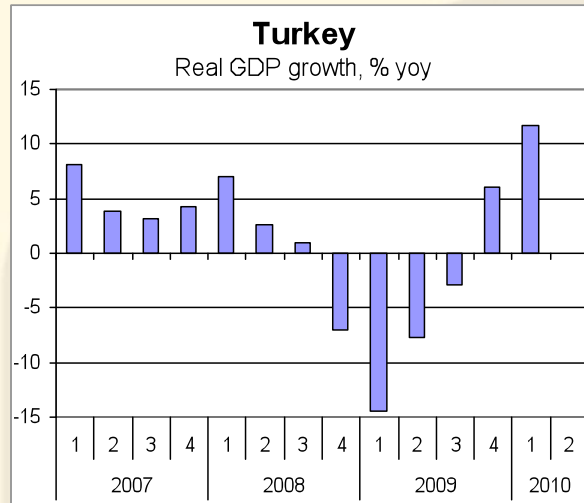
Source: Cbonds.net, CPB Netherlands Bureau for Economic Policy Analysis, The Bleyzer Foundation

- The world economy expanded fast in 1H 2010: world industrial production and trade reported double-digit growth rates* (about 11.5% yoy and 19% yoy respectively).
- Investors' appetite for emerging market assets continued to improve since early 2009, helping to re-open foreign capital markets for these countries.

* Estimates based on CPB Netherlands Bureau for Economic Policy Analysis data

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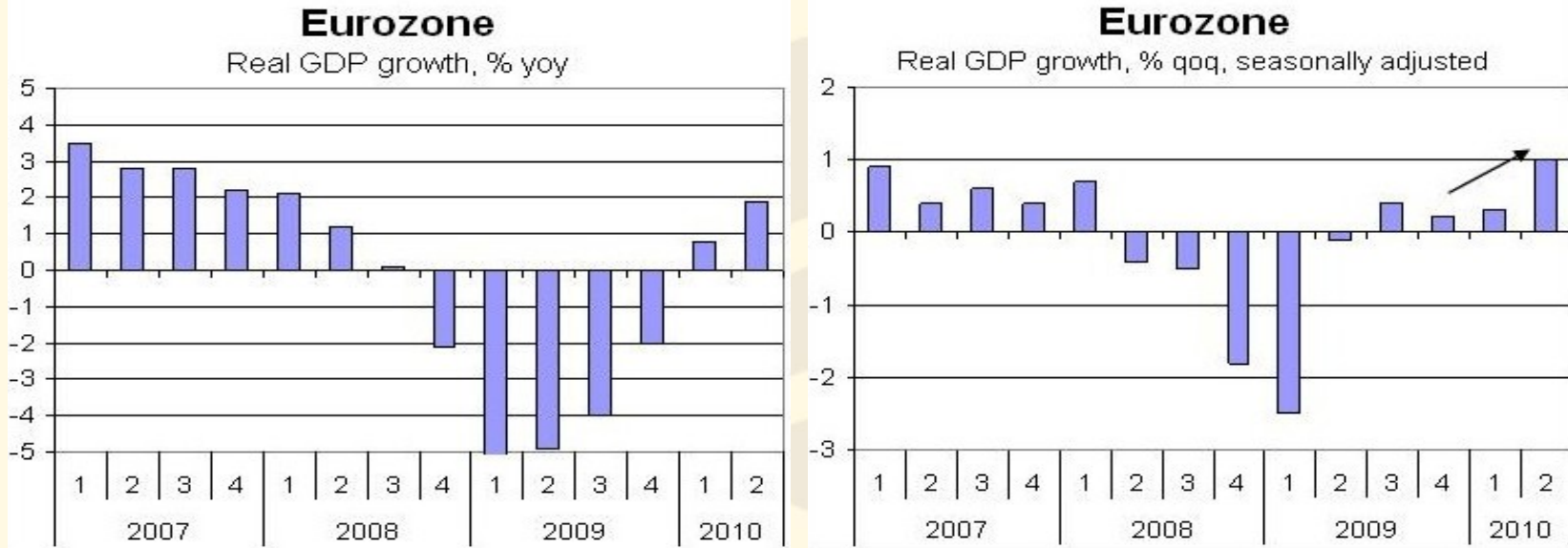
Factor 1a. Economic Recovery in Emerging Economies



- The pace of recovery in Emerging Markets was better than expected, particularly in Asia, Latin America, as well as a number of CIS economies.
- Many of these countries (i.e., Russia, Turkey, Poland, India, etc.) are Ukraine's major trading partners.

Source: Eurostat, Russia Federal Statistical Committee, Ukraine SSC

Factor 1b. Economic Recovery in the Eurozone

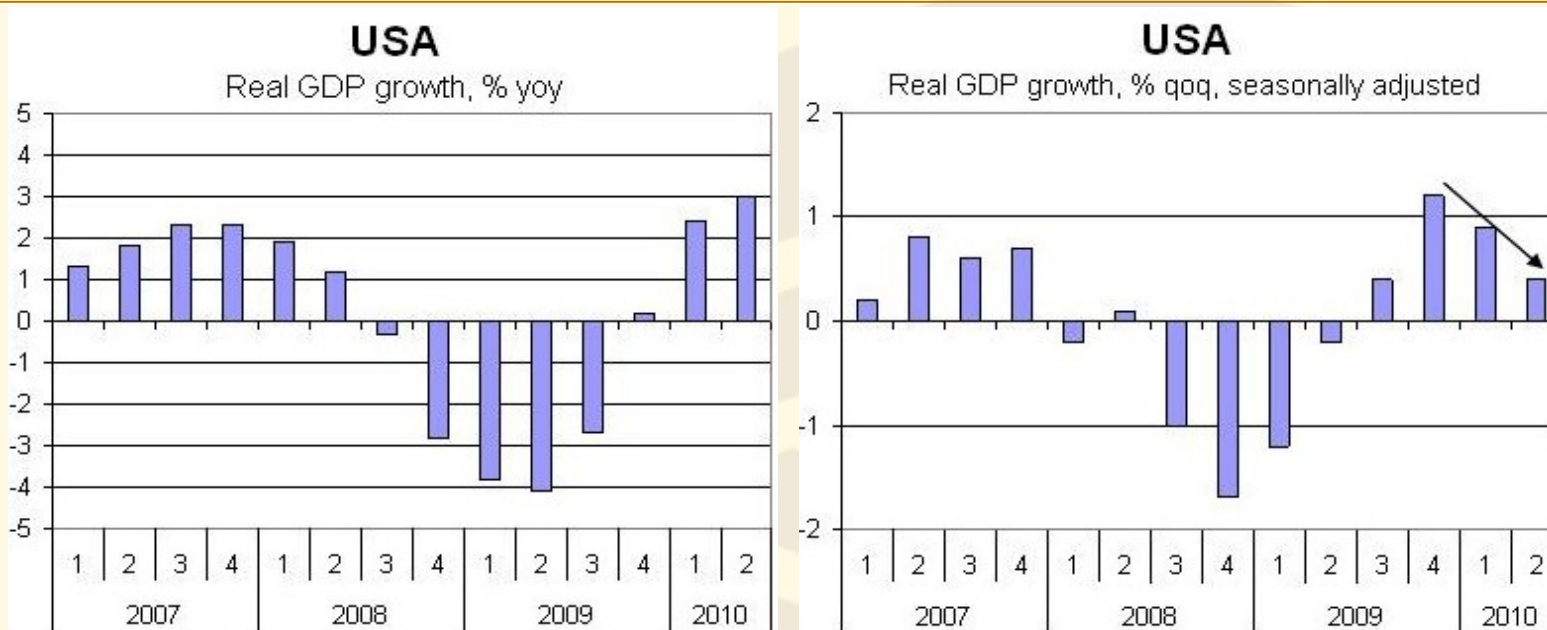


Source: BEA, Eurostat

- The Eurozone also had a reasonable recovery in 1H 2010, both yoy and sa-qoq.
- Concerns over fiscal sustainability and the financial health of the European banks had raised some doubts about the strength of the EU's recovery.
- But the markets reacted positively to the May/June 2010 bailout by the EU (€750 bn for troubled members plus €110 bn for Greece plus €60 bn to buy bonds)) and the July's publication of the stress tests for European banks which showed that most banks are solvent and strong (except for German and Spanish banks where their governments are well-positioned to handle them).

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Factor 1c. Economic Recovery in the USA

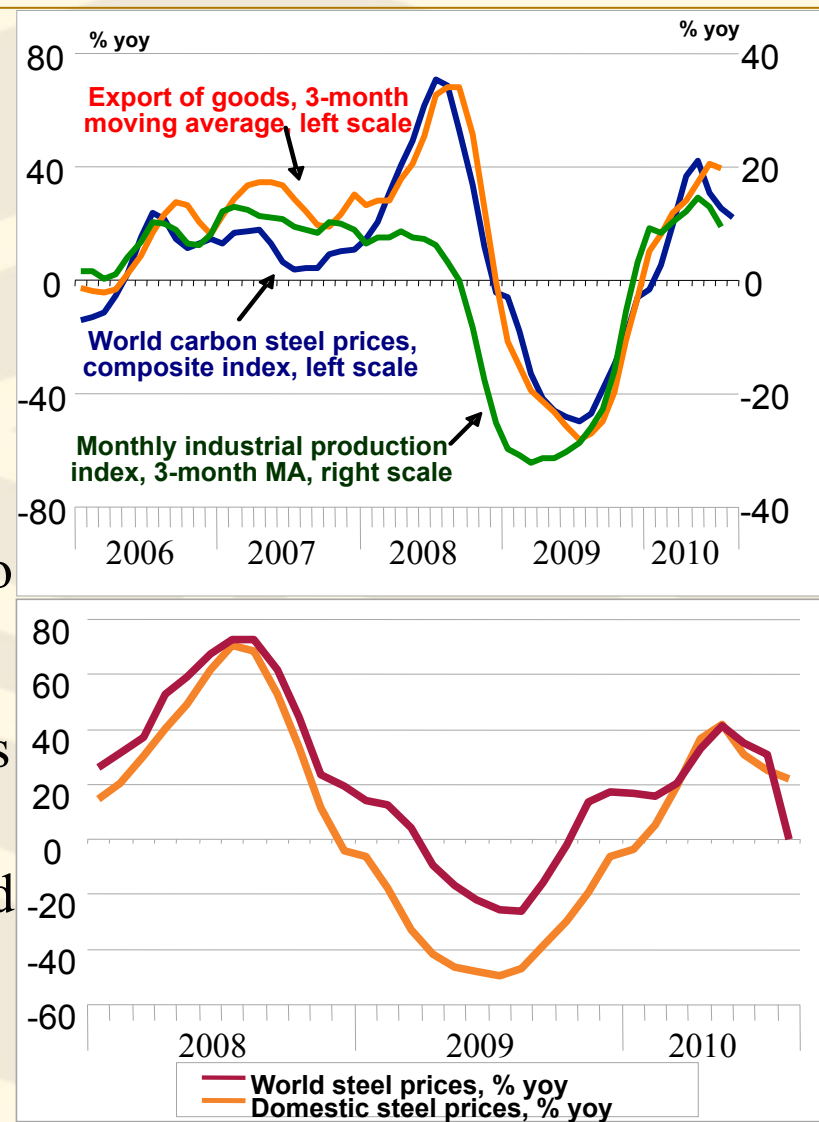


Source: BEA, Eurostat

- The pace of recovery in the US is more uncertain, given doubts about US tax and other policies as well as weaker-than-expected economic data for 2Q 2010.
- Currently the EU looks to have more solid foundations than the US to sustain economic growth in the short-term.
- The positive outlook for Emerging Markets and the EU is a positive important factor for Ukraine, since trade with the EU and EMs is substantial while trade with the US is quite small.

Factor 2a. Prospects for Steel Exports

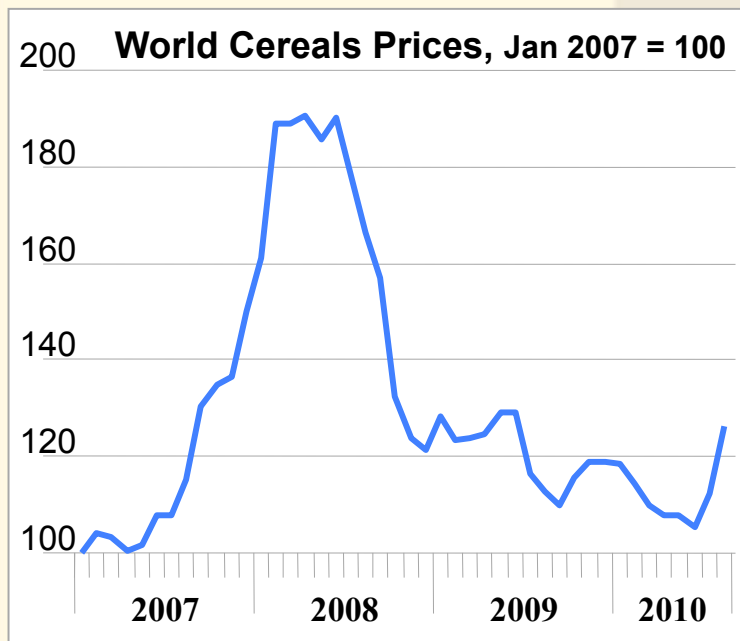
- Metallurgy is one of the most important sectors for the Ukrainian economy as many industries and sectors are tied to it.
- Steel exports and industry performance closely follow world steel price trends.
- In most of 1H 2010, developments of world steel prices were favorable to Ukraine.
- During May-July 2010, steel prices started to decline due to concerns over the pace of global recovery, increasing levels of stocks and evidence that world steel production was expanding faster than demand.
- Although in August world steel prices started to increase again; their outlook remains uncertain for the near future.



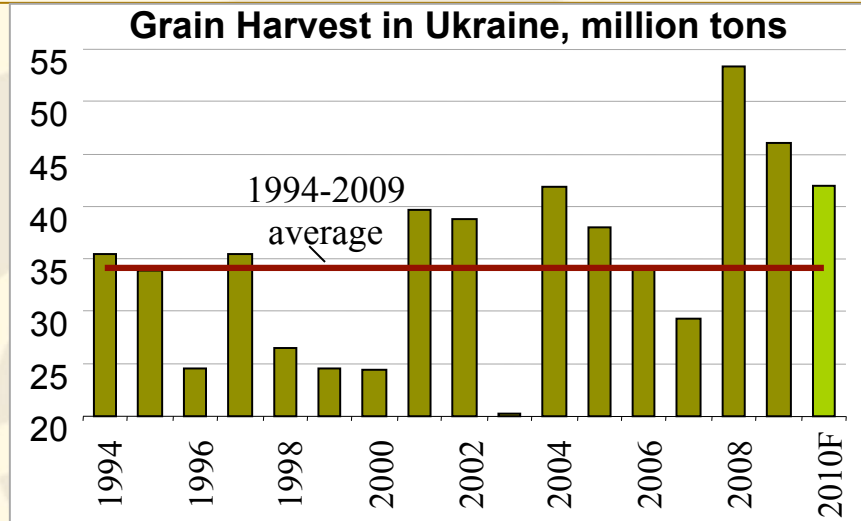
Source: State Statistics Committee, NBU, MEPS, TBF

Factor 2b. Prospects for Agricultural Exports

- The global grain harvest in 2010 was hit by droughts and floods.
- Russia, one of the largest wheat suppliers, imposed an export ban on wheat for 12 months to combat domestic shortages.
- Global food prices have soared.



Source: State Statistics Committee, FAO, TBF



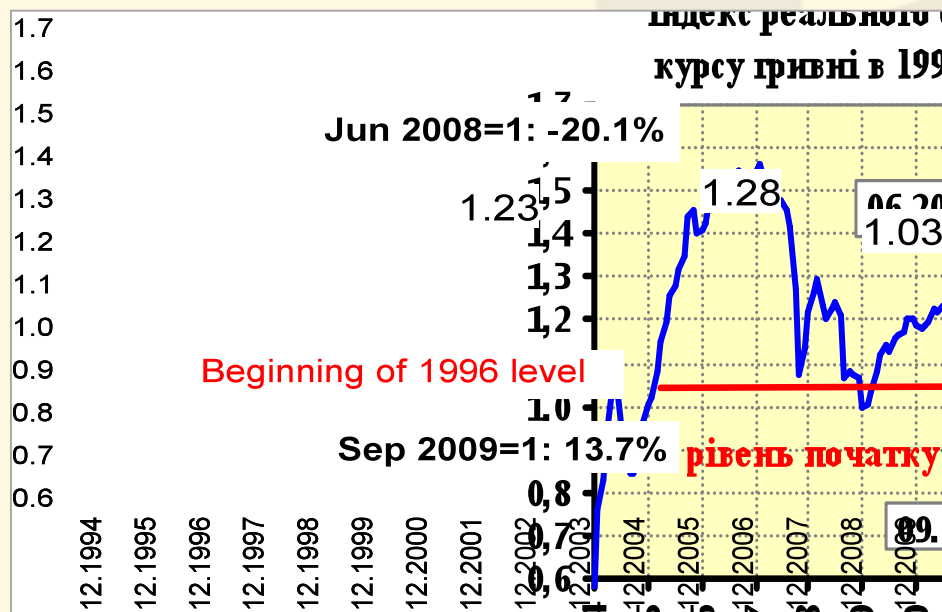
- Agricultural and food products are the second largest export commodities of Ukraine.
- While unfavorable weather conditions also affected Ukraine, its grain harvest is forecast at 42 m tons.
- Though lower than in record-high 2008 and 2009, it is still much higher than 15-year average harvest.
- There is little basis for an export ban or other administrative constraints to exports in Ukraine.
- Stronger world food demand may partially compensate for weaker steel export prospects.

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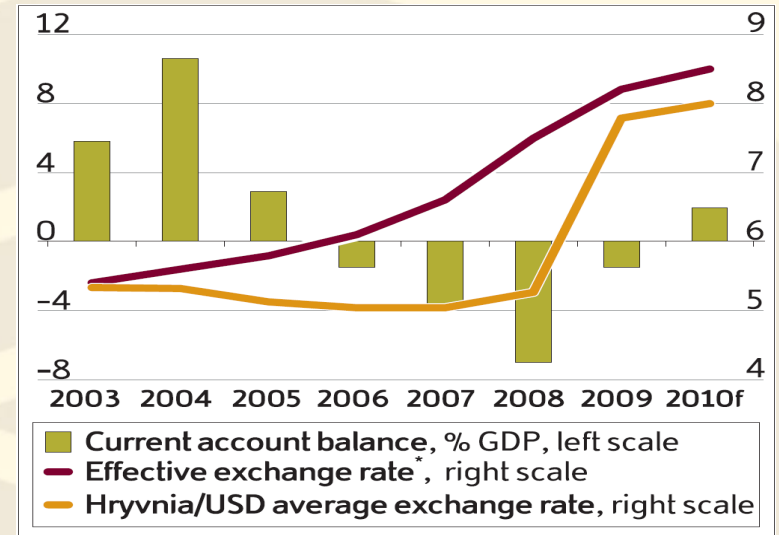
Factor 2c. Ukraine's International Competitiveness

- In 2008, the Hryvnia lost more than 50% against the U.S. Dollar.
- This depreciation helped to restore Ukraine's international competitiveness and to reduce external imbalances.

Real Effective Exchange Rate, Dec 1999 = 1



Source: NBU



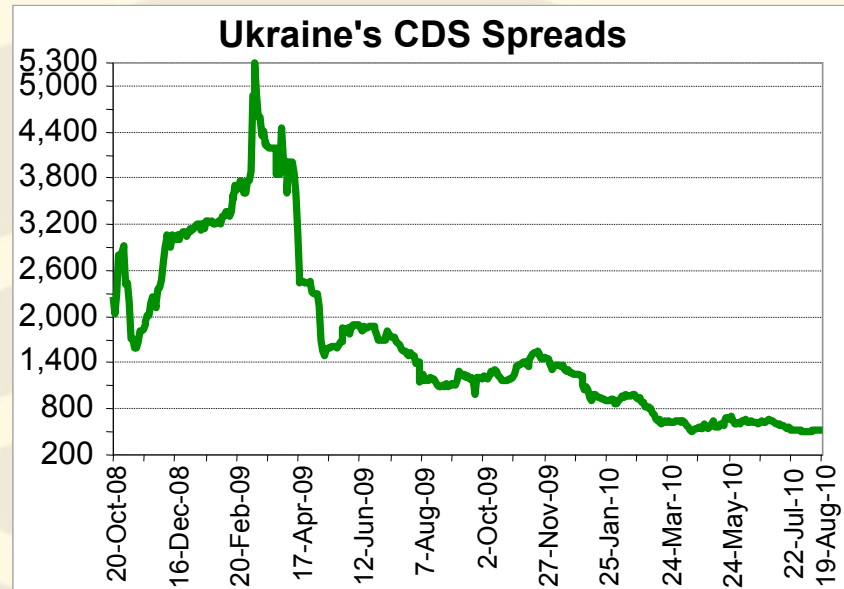
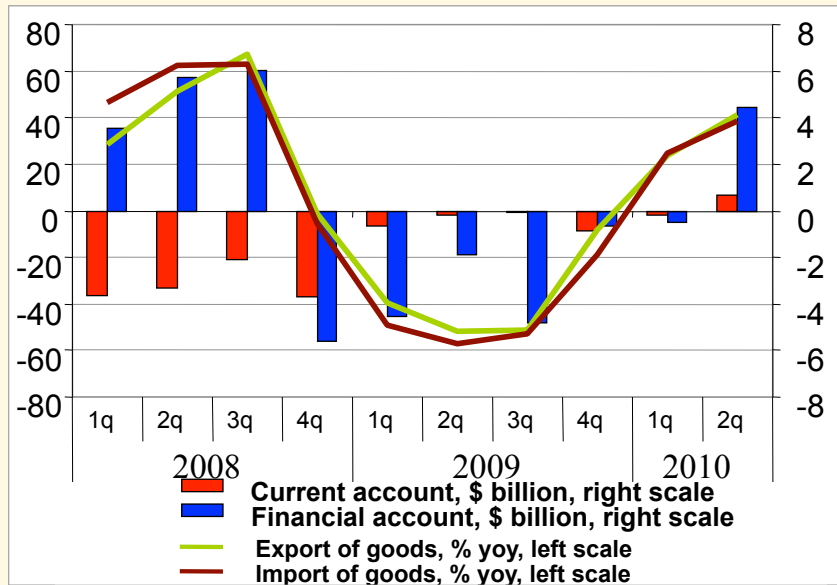
- Although the recent Hryvnia appreciation eroded part of these benefits, the real exchange rate seems to be now close to its equilibrium.
- This is a positive factor for Ukraine's current account balance prospects.

* The effective exchange rate was calculated based on Ukraine's purchasing power parity with respect to Ukraine's main trading partners (2002 as a base year)

Source: NBU, UN Comtrade, IMF, TBF

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Factor 2. Exports, Financing and the Balance-of-Payments



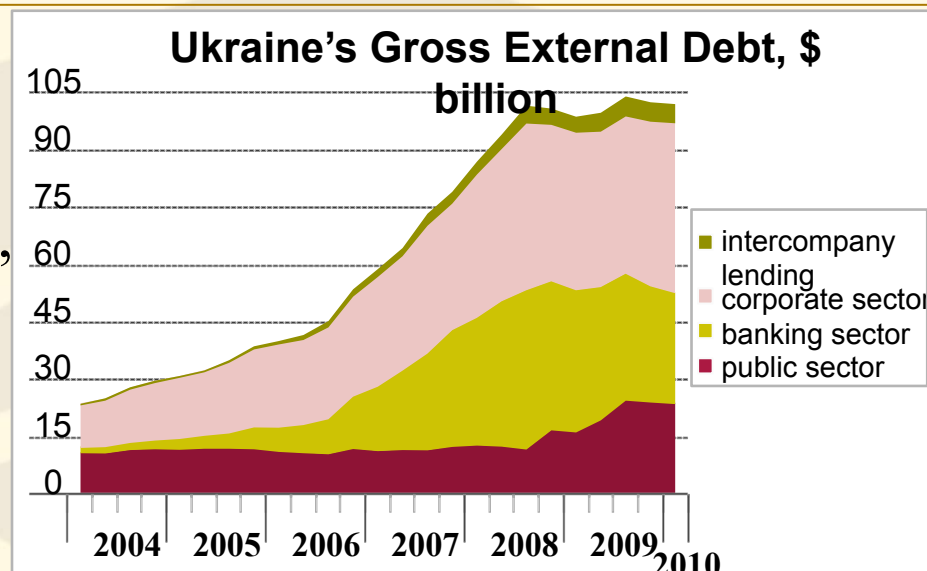
Source: NBU, Bloomberg

- Thanks to faster growth of exports (up by 28.5% yoy in 7m 2010 compared to a 25% yoy increase in imports), the trade balance in goods and services reported only a small deficit, while the current account balance was in surplus.
- The financial account also reported a significant surplus of almost \$5.1 billion in 7m 2010 as a result of high private sector external debt rollover (97%) and external financing (including a \$2 billion bilateral loan from Russia's state-run VTB bank).
- As a result, by the end-August, gross international reserves increased to \$31 billion.
- The balance-of-payments should be a positive factor for recovery in the near future.

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Factor 3. Roll-over of Ukraine's Large Foreign Debt

- Foreign debt and capital inflows in Ukraine soared from 2005 to 2008 (from \$35 bn to over \$100 bn).
- This made Ukraine more vulnerable, as during the crisis, foreign capital markets were virtually closed.
- Nevertheless, Ukraine's foreign financing needs in 2009 were partially covered by IMF financing.



Source: NBU, TBF

- But Ukraine's foreign debt has not disappeared -- and will need to be served or rolled-over, requiring high confidence by its creditors.
- Since mid-2009, foreign investors sentiments have been improving, with roll-over rates of about 95%.
- In April 2010, there were several successful Eurobond placements by Ukrainian private businesses.
- If investors' confidence is maintained, debt should be manageable.

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Total External Debt (Public and Private) to GDP & Exports, 2009

<u>Country</u>	<u>ED/GDP</u>	<u>ED/Exp</u>	<u>Country</u>	<u>ED/GDP</u>	<u>ED/Exp</u>
Hungary	128	143	Malaysia	32	35
Bulgaria	110	159	Indonesia	28	123
Ukraine	90	204	Peru	28	126
Poland	58	125	Ecuador	25	95
Panama	56	76	S. Africa	25	81
Korea	45	83	Thailand	24	35
Turkey	44	176	Colombia	21	130
Argentina	42	182	Dom Rep	20	97
Czech Rep	41	56	India	18	86
Philippines	40	121	Mexico	18	62
Russia	38	125	Venezuela	16	100
Uruguay	37	152	Brazil	14	122
Pakistan	36	322	China	8	33
Chile	35	82	MEAN	35	120

Factor 4. Adequacy of Domestic Macro-Economic Policies

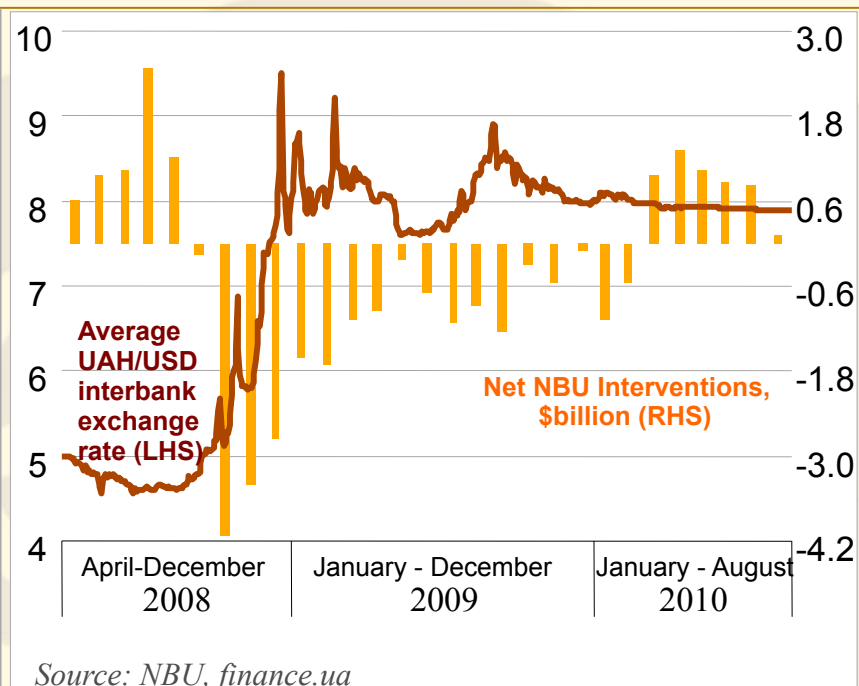
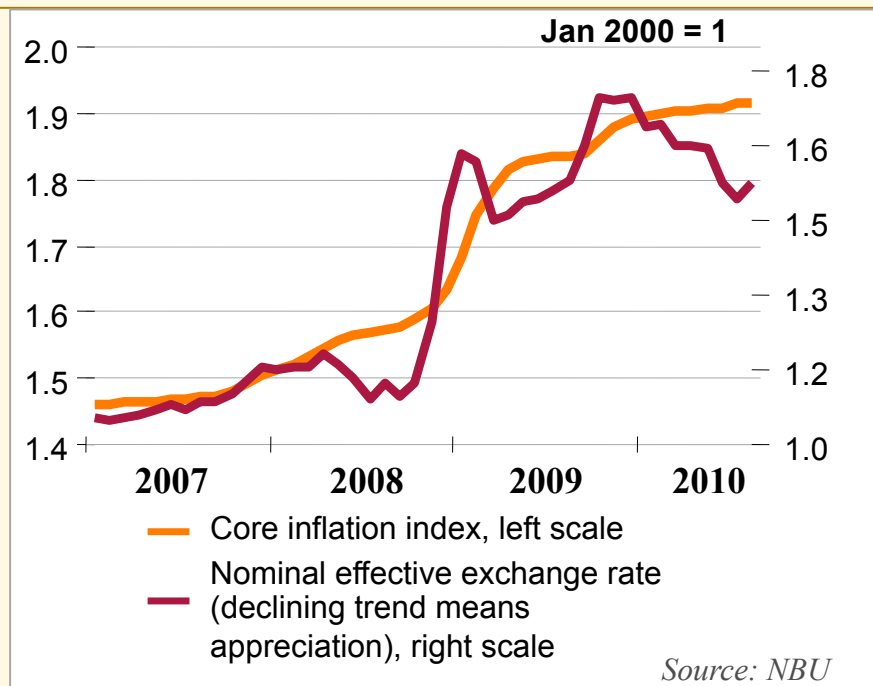
- Ukraine has made good progress in stabilizing its macroeconomic situation:
 - Economic activity is recovering
 - Inflation pressures have been kept under control
 - External vulnerabilities have declined
 - The high current fiscal deficit, the major economic risk until recently, is expected to be under control given resumed co-operation with the IMF.
- **Currently the major economic risk** would be a weakening of policy implementation due to the forthcoming local elections: strong political will is needed as the government committed itself to a number of painful economic measures, particularly
 - To raise natural gas tariffs to population by tally 2.3 times
 - To raise pension age for women from 55 to 60 over time
 - To reform the gas sector
 - To arrest the further deterioration of local banks
 - To improve taxation and the business environment.
- So far, the progress on these issues has been positive, as shown in next slides.

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Factor 4a. Macroeconomic Stabilization: Fiscal Deficit

- Until recently, a high fiscal deficit was the major economic risk in Ukraine.
- The fiscal deficit reached 8.5% GDP in 2009, as fiscal revenues declined, and social, Naftogaz and Pension Fund expenditures increased.
- In 2010, budget revenues were stable, but expenditures rose fast.
- As a result, the state budget deficit in 1H 2010 reached UAH 26.5 billion, or about 5.6% of estimated period GDP.
- The deficit was financed by new domestic and external borrowings, which contributed to further rise in public debt.
- Agreement with the IMF is critical to overcome fiscal sustainability risks.
- On April 27th, the 2010 budget law was approved with a state deficit target of about 5% of GDP (including the Pension Fund deficit).
- An increase in natural gas tariffs will allow Naftogaz to contain deficit at about 1% of GDP and have a balanced budget next year.
- If the IMF program continues to be in place, the fiscal deficit is set to be reduced to 2.5% of GDP by 2012, which would contain the growth of public debt.

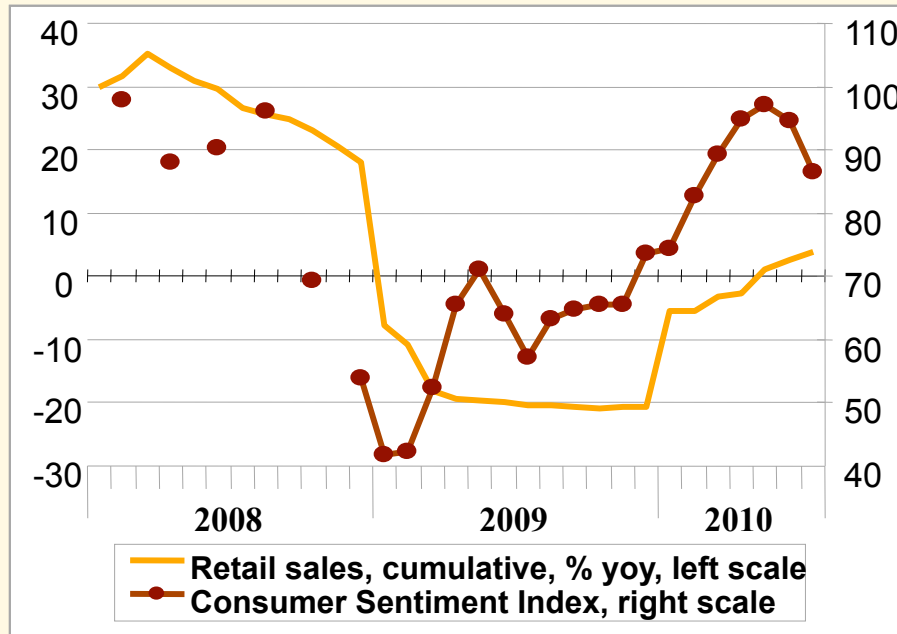
Factor 4b. Inflation and Forex Markets



- During 2010, favorable external conditions for Ukraine's foreign trade and robust inflow of foreign capital led to Hryvnia appreciation pressures.
- Consumer inflation fell from about 11% yoy in March to less than 7% in June-July 2010, helped by a delay in utility tariff adjustment, and the Hryvnia appreciation with respect to world currencies.
- From March 2010, the NBU intervened to contain the appreciation of the Hryvnia to avoid a worsening of exports prospects and competitiveness losses.

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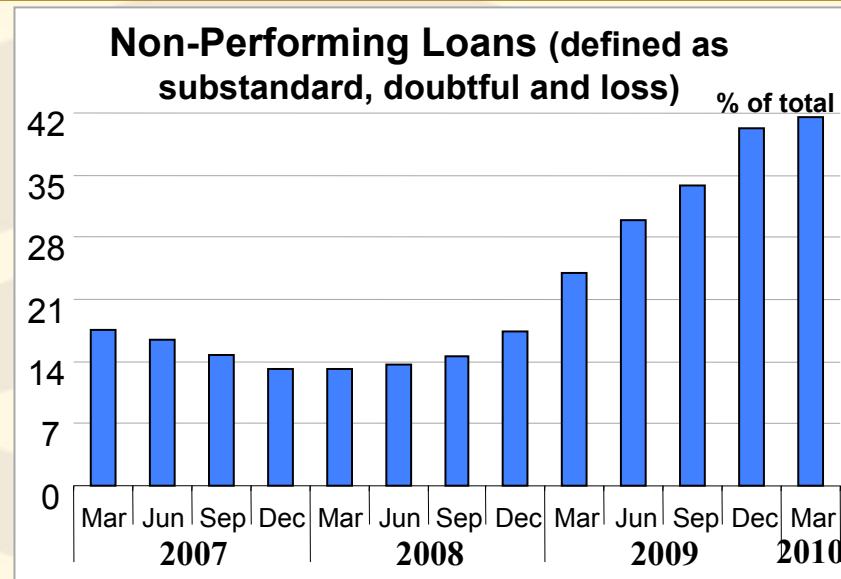
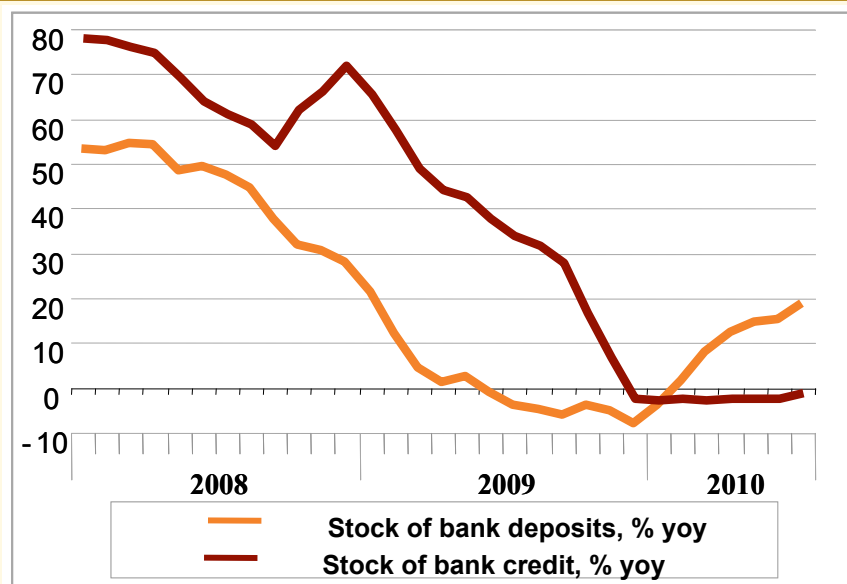
Factor 5. Pace of Recovery of Domestic Demand



Source: State Statistics Committee, NBU, GFK-Ukraine, TBF

- During 2010, **consumer confidence** has notably improved thanks to above-mentioned developments(recovering economic activity, good progress in disinflation, calm foreign exchange market and stable political environment),.
- **Consumer Purchasing Power** has also been gradually increasing in 1H 2010, supported by real monthly wages increases of 8.6% yoy in 1H 2010 (due to both large social expenditures from the budget and the recovering economy.)

Factor 5a. Domestic Demand and Banking Credit



Source: State Statistics Committee, NBU, GFK-Ukraine, IMF, TBF

- Improved consumer sentiments caused deposits to return to the banking system.
- However, bank lending remains weak: -1.0% yoy in July 2010.
- To stimulate credit activity, the NBU has lowered its discount rate three times in three months from 10.25% pa to current 7.75% pa.
- The role of the discount rate in promoting private sector credit remains limited (due to high NPLs (up to 42% in March 2010, IMF) and credit risks).
- Hence, credit is forecast to rebound only very gradually, restraining the growth of domestic demand.

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Factor 6. Economic Reform Progress

- Some progress in economic reforms has taken place, including:
 - Raising natural gas tariffs to the population by 50% since August 2010;
 - Adoption of a new gas law that would gradually liberalize the gas sector and improve efficiency through unbundling production, transit, and distribution to end-users, and allowing new entrants into the gas market.
 - Adoption of a new Procurement Law, which should reduce corruption, develop competition and improve public finance.
 - Improvement of the business regulatory framework by reducing the number of licenses and simplifying procedures for their obtaining.
 - Announcement of a gradual rise in pension age for women since 2011. However, the details of this measure have not been disclosed and it is not certain that Parliament may approve it.
 - Initiation of a broad tax reform by developing a new draft Tax Code, aimed at reducing the tax burden, simplifying book-keeping and improving tax administration. However, the new draft Code is still being debated, as the draft was criticized for its potential to increase administrative pressure on business and lead to corruption.

Factor 6. ...Economic Reform Progress

- Less progress has been made in the design and implementation of longer term reforms to improve the business environment over the mid-long term:
 - For this purpose, the President created an Economic Reform Committee, which was expected to develop a broad economic reform program with detailed measures. The ERC was divided into several groups including public administration reform, deregulation, energy sector reform, infrastructure sector reform, social security reform, tax system reform, etc.
 - Indeed, the Committee developed a draft program on economic reform.
 - Although this program was announced in July, its circulation was very limited and has not yet been discussed by the expert community.
 - The reform program is expected to be circulated around October 2010.
 - To further improve country's business environment two additional committees were established (anticorruption and judiciary reform).
 - Another factor for future growth will be a rapid agreement of a EU-FTA.
 - It is too early to say whether these programs will be adequate.

Summary of Factors that will Affect Ukraine's Recovery

External Environment:

1. The pace of economic recovery in Ukraine's main trading partners
2. Prospects for Ukrainian exports
 - a) Prospects for steel and metallurgical exports
 - b) Prospects for agricultural exports
 - c) Degree of Ukraine's international competitiveness
3. Ability of Ukraine to roll-over its large foreign debt and secure external financing

Summary

1. **Positive**
- 2a. **Mixed**
- 2b. **Positive**
- 2c. **Positive**
3. **Positive**

Domestic Factors:

4. Adequacy of Macro-economic Stabilization Policies
5. Pace of recovery of Domestic Demand and Credit
6. Adequacy of Economic Policies to **sustain** long-term growth by improving the business climate to attract investments

4. **Positive**
5. **Positive**
6. **Mixed**

Economic Prospects over Medium-Term

- In 2010, overall prospects for the Ukrainian economy has improved:
 - Real GDP is forecast to grow by 4%-5%
 - The current account is expected to turn into surplus
 - Foreign capital inflows are forecast to increase
 - The exchange rate is likely to remain stable
 - The fiscal deficit will be reduced in compliance with the IMF requirements
 - Inflationary pressures will be moderate.
- This shows the new government's willingness to restore macroec. stability.
- The political situation is now much more stable than in the previous few years.
- Given macroeconomic and political stability, the government may be more capable of implementing broader economic reforms.
- Ukraine has a number of competitive advantages to support economic growth in the medium-term (large population, educated and cheap labor, agricultural potential, reasonable infrastructure, border with the EU).
- But the country must now implement reforms to improve its investment climate
- Ukraine should be able to grow by 4-5% per year over the next few years.

Main Macroeconomic Indicators

	2000-07 average		2008	2009	2010F	2011F
Real GDP Growth, % yoy	7.5		2.3	-15.1	4.0	4.5
Fiscal Balance, % GDP	-0.8		-2.1*	-8.5**	-6.5#	-3.5#
Consumer Inflation, %, eop	11.3		22.3	12.3	10.0	10.0
UAH/\$ Exchange Rate, eop	5.2		7.7	8.0	7.8–8.0	8.0
Current Account, % GDP	<u>2000-05</u> 5.7	<u>2006-07</u> -2.6	-7.0	-1.5	-0.5	-1.5
Gross Int. Reserves, \$ bn	<u>2000</u> 1.5	<u>2007</u> 32.5	31.5	26.5	32	35
Foreign Gov't Debt, % GDP	<u>2003</u> 21.3	<u>2007</u> 8.7	9.2	20.5	21.5	24
Foreign Private Debt, %GDP	26.2	47.4	47.1	68.1	57	54

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

** Includes capital injections to Naftogaz (2.7% GDP), implicit Pension Fund deficit (1.7% of GDP) and expenditures covered by IMF's special SDR allocation to Ukraine (1.7% GDP).

Includes Naftogaz imbalances.

Other Forecasts of Main Macroeconomic Indicators

	GDP growth % yoy		Fiscal balance % GDP		Inflation eop, %		Exchange rate UAH per USD		CA balance % GDP	
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
BofA Merrill Lynch	4.2	4.2	-5.0	-4.0	9.0	8.0	7.9	8.0	-1.5	-2.7
CASE Ukraine	4.1	5.2	-5.4	-2.0	11.8	9.1	7.9	8.0	1.3	0.6
Citigroup	2.4	3.9	-7.7	-6.5					1.0	-2.0
Credit Suisse	4.0	4.4	-6.0	-4.5	9.0	10.0	8.0	8.0	0.2	-1.0
Deutsche Bank	3.3	4.6			13.3	11.0	7.9	7.9	-1.6	-2.2
HSBC	5.5	4.0	-6.4	-4.2	6.9	9.8	8.5	8.5	-0.6	-0.7
ING	4.5	4.6	-7.5	-4.5	11.8	11.3	8.0	7.7	0.2	2.3
JPMorgan	5.0	4.5	-5.3	-4.2			8.4	8.0	-0.8	-1.7
Morgan Stanley	3.5	3.5	-8.0	-6.0	10.6	11.0	7.0	7.5	-0.5	-1.5
Raiffeisenbank	3.5	4.0	-6.5	-4.0	11.0	9.0	7.7	7.4	-0.5	-1.5
UBS	3.2	5.0			10.0	6.0			-1.2	-1.3
UniCredit	3.0	4.0	-6.1	-3.8	10.4	11.5	7.4	6.9	0.2	-0.6

Source: FocusEconomics, August 2010