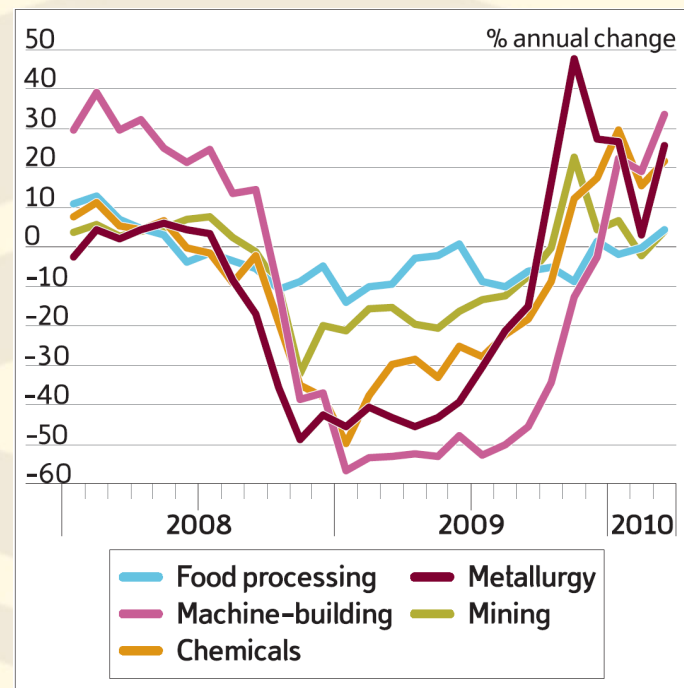


# Ukraine: Update on Economic Situation

**Dr. Edilberto Segura**  
Partner and Chief Economist, SigmaBleyzer  
President of the Board, The Bleyzer Foundation

**June 2010**

# Ukraine's Real Sector Performance



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

- The international crisis led to a retrenchment of foreign demand and capital inflows, which caused a sharp fall of Ukrainian exports and a 15% decline of real GDP in 2009.
- The main contraction took place during 4Q of 2008 and the first two months of 2009.
- It bottomed out in March 2009 and has been steadily growing since then.
- A strong recovery of exports supported a 5% GDP rebound in Q1 2010.

# What Will Sustain Economic Recovery in Ukraine?

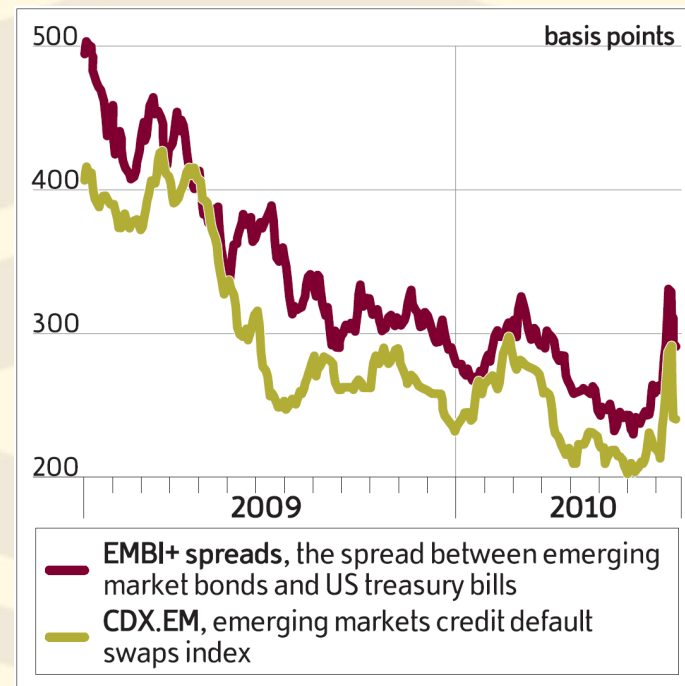
## Upside Factors:

1. A swift recovery of world trade, based mainly on an accelerating growth momentum in emerging countries
2. Improving global demand for steel products – the key export commodities of Ukraine
3. Better international competitiveness thanks to the recent currency depreciation and more favorable terms of trade (higher steel prices and a recent gas price discount).
4. Easier access to foreign funds by Ukrainian banks and companies

## Downside Risks:

1. Inability to reduce high budget deficits
2. Inability to roll-over the current large foreign debt
3. Weak banks and a lack of funds to credit the private sector

## Upside Factor 1: Global Economic Conditions are Improving



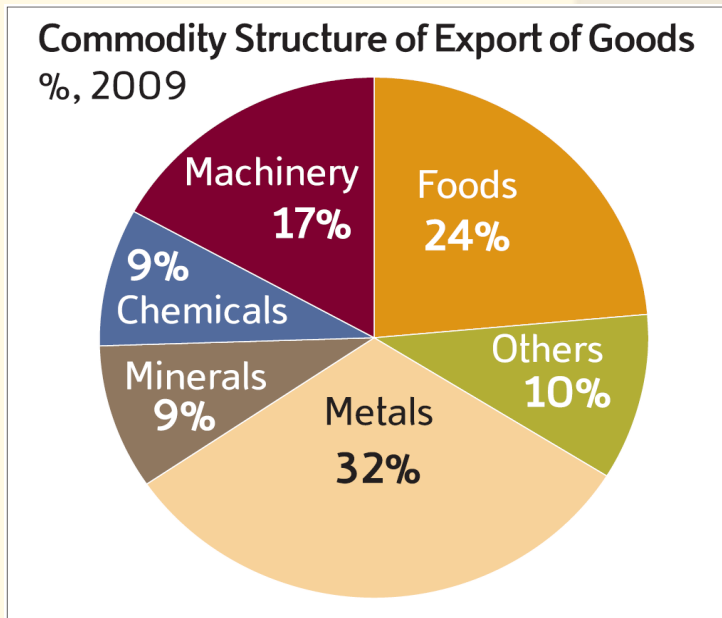
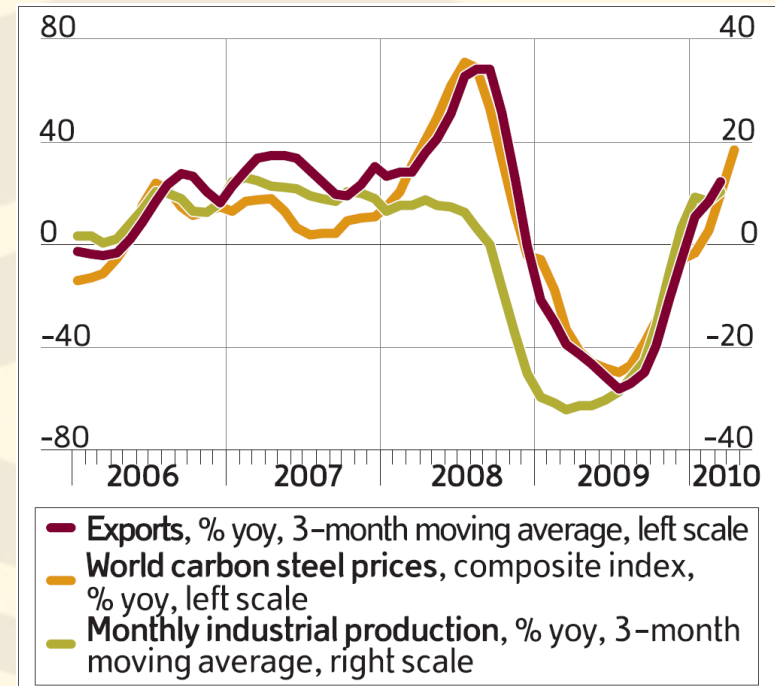
Source: Cbonds.net, CPB Netherlands Bureau for Economic Policy Analysis, The Bleyzer Foundation

- A turnaround in global manufacturing and trade is already supporting recovery.
- Growth prospects in Ukraine's major trading partners are getting better.
- Investors' appetite for emerging market assets is gradually returning as indicated by narrowing spreads on their corporate and sovereign debts and falling CDS rates.
- This helps reduce foreign borrowing costs for governments and businesses.

4

## Upside Factor 2: Better Prospects for Steel Industry

- Metallurgy is the most important sector for the Ukrainian economy.
- Many industries and sectors are tied to metallurgy.
- Exports and industry performance closely follow world steel price trends.

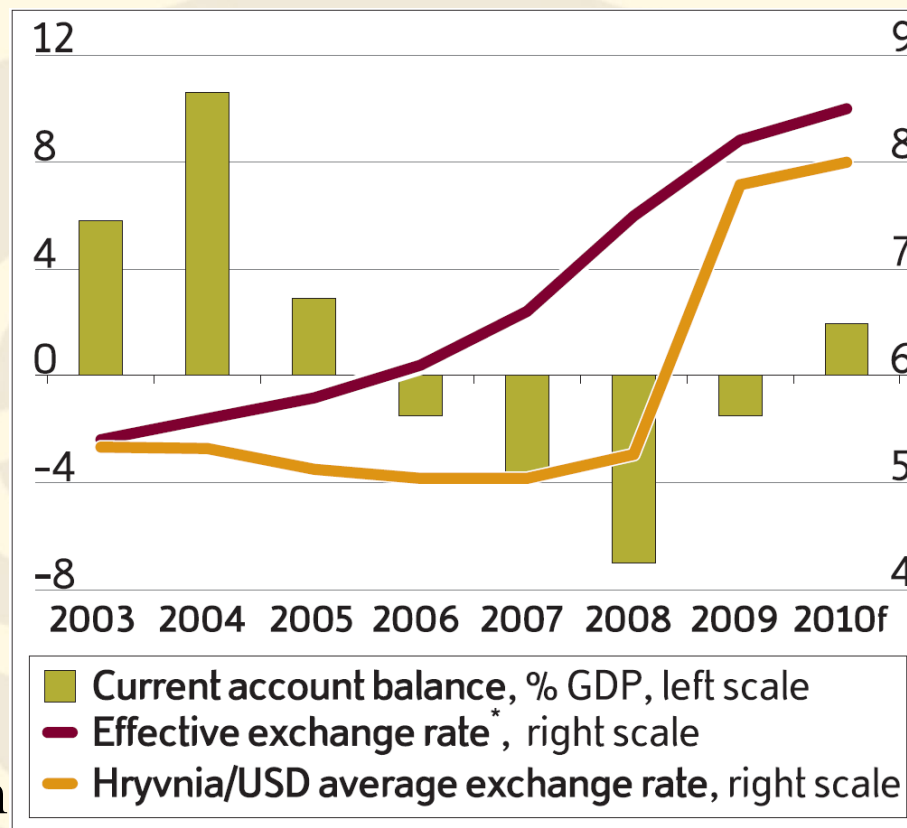


Source: State Statistics Committee, NBU, MEPS, TBF

- A new iron ore price setting system was established in March 2010, which boosted ore and steel prices.
- Steel price growth in 2010 will support stronger recovery of Ukraine's economy.

## Upside Factor 3: Improved Export Competitiveness

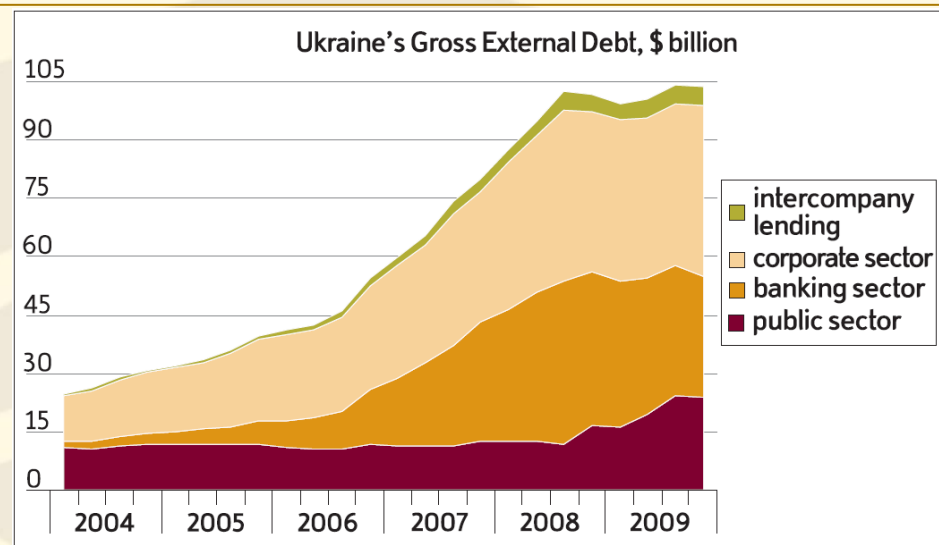
- In 2008, the Hryvnia lost more than 50% against the U.S. Dollar.
- But the depreciation helped to:
  - restore the loss of international competitiveness, and
  - reduce external imbalances.
- On the import side, a 30% discount on natural gas imports, negotiated with Russia in April will reduce the costs of production and further improve trade balance.
- This favors export-oriented industries – chemicals, metallurgy.



\* 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)

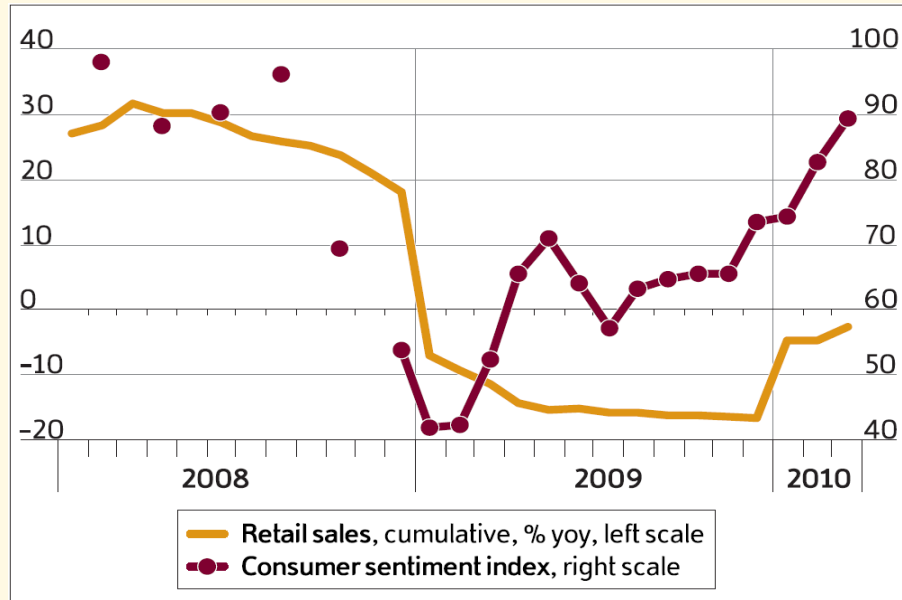
## Upside Factor 4: Better Access to Foreign Capital

- Foreign debt and capital inflows in Ukraine soared in 2005-2008.
- During the crisis, foreign capital markets were virtually closed.
- High Ukraine's foreign financing needs in 2010 were partially covered by the IMF program.
- Since mid-2009, foreign investors sentiments have been improving.
- In April 2010, there were several successful Eurobond placements by the Ukrainian private businesses.
- The government plans to borrow \$1.3 billion on foreign markets in 2010 & resume IMF cooperation.



Source: NBU, TBF, Bloomberg

## Upside Factors: Impact on Domestic Demand



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

- **Due to the 4 previous upside factors, Consumer Purchasing Power** has been gradually increasing.
- Real monthly wage grew by 7% yoy in Mar 2010, compared to a 11% yoy decline in Oct 2009.
- Private consumption will be further supported by continued increases in government social expenditures.

## Downside Risks: Public Finances, Debt and Weak Banks

- **The major economic risk** for Ukraine would be its inability to reduce the current fiscal deficit.
- The fiscal deficit was 8.5% GDP in 2009, as fiscal revenues declined, and social, Naftogaz and Pension Fund expenditures increased.
- The deficit was financed by IMF loans and domestic borrowings.
- In 2010, the new government is committed to reduce the budget deficit to 6% of GDP – as required by the IMF to resume co-operation.
- On April 27<sup>th</sup>, the 2010 budget law was approved with a state deficit target of about 5% of GDP (including the Pension Fund deficit).
- Agreement with the IMF is critical to overcome this risk.
- **A second economic risk** would be the inability of Ukraine to maintain foreign confidence needed to roll-over its large foreign debt.
- **The third risk** would be a further deterioration of local banks and lack of credit which may restrain the growth of domestic demand.

## Economic Prospects over Medium-Term

- In 2010, overall prospects for the Ukrainian economy has notably improved:
  - Real GDP is forecast to grow by 4.5%
  - Current account is expected to turn into surplus
  - Foreign capital inflows are forecast to increase
  - Exchange rate is likely to remain stable and even slightly appreciate
  - Fiscal deficit will be reduced in compliance with the IMF requirements
  - Inflationary pressures will be moderate.
- The new government has the capacity and willingness to restore macroeconomic 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 prepared to implement 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).
- Ukraine should be able to grow by 4-5% per year over the next few years.

## Main Macroeconomic Indicators

	2000-07 average		2008	2009	2010 (f)
<b>Real GDP Growth, % yoy</b>	7.5		2.3	-15.1	4.5
<b>Fiscal Balance, % GDP</b>	-0.8		-2.1*	-8.5**	-6.0#
<b>Consumer Inflation, %, eop</b>	11.3		22.3	12.3	13.0
<b>UAH/\$ Exchange Rate, eop</b>	5.2		7.7	8.0	7.8 – 8.0
<b>Current Account, % GDP</b>	<u>2000-05</u> 5.7	<u>2006-07</u> -2.6	-7.0	-1.5	2.0
<b>Gross Int. Reserves, \$ bn</b>	<u>2000</u> 1.5	<u>2007</u> 32.5	31.5	26.5	28
<b>Foreign Gov't Debt, % GDP</b>	<u>2003</u> 21.3	<u>2007</u> 8.7	9.2	20.5	20
<b>Foreign Private Debt, % GDP</b>	26.2	47.4	47.1	68.1	55

\* 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.

11