

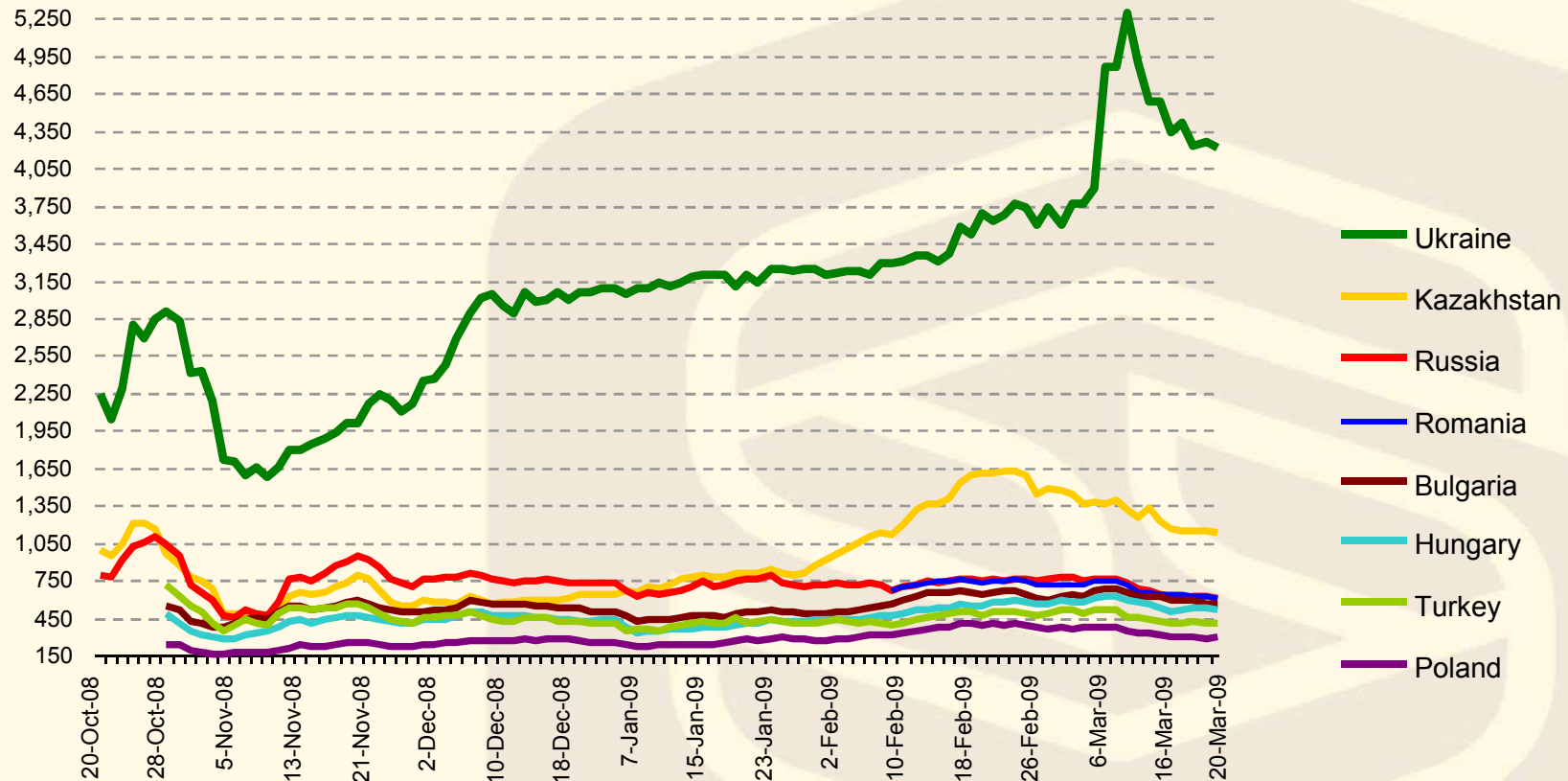
Ukraine

Dealing with the Financial Crisis

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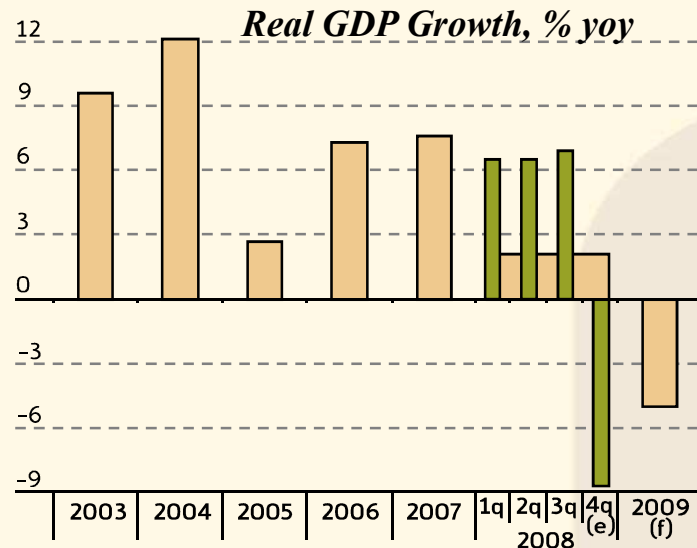
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Ukraine today is perceived as a country facing possible default



- The CDS spreads for Ukraine's bonds are now at about 4,200 bps.
- But, Ukraine is not likely to default on its sovereign obligations (external public debt was only 11% of GDP at end-2008.)
- High CDS spreads may reflect speculative trade and uncertainties regarding repayment of short-term external private debt, amid IMF program delays.

Macroeconomic Performance Before the Crisis



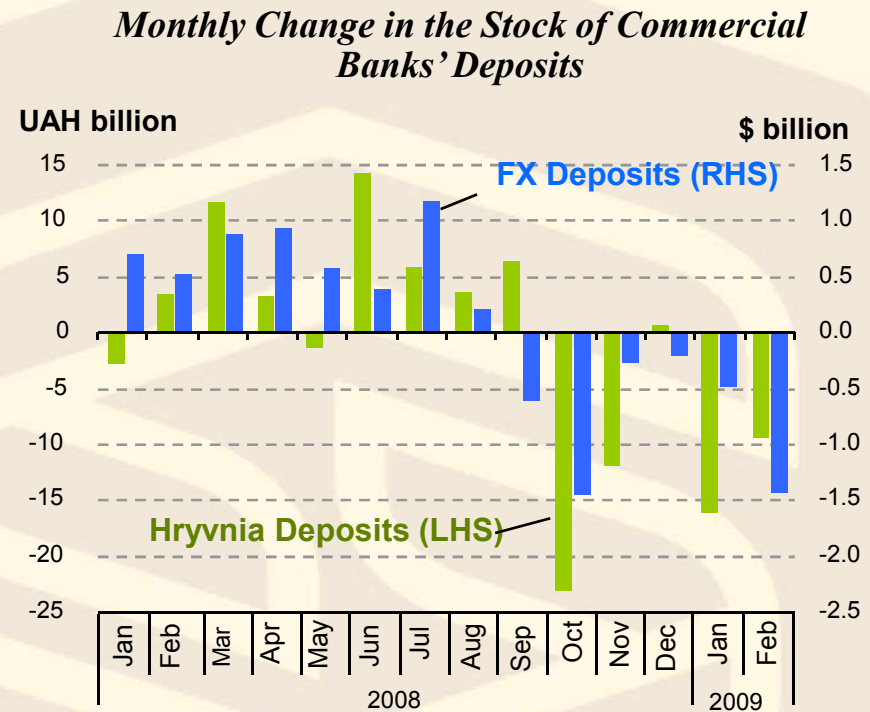
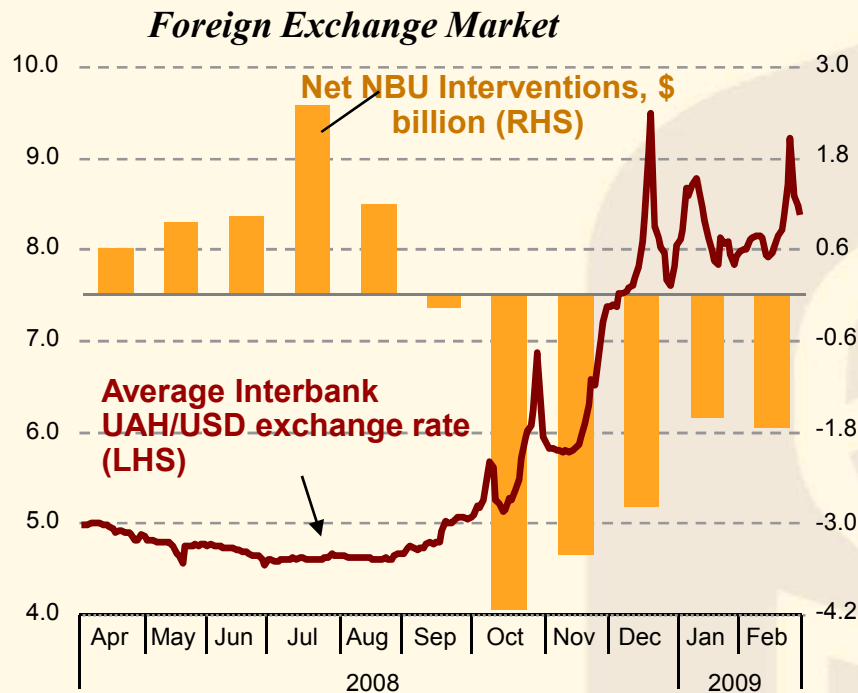
Ukraine's Exports of Goods and World Steel Prices



Source: State Statistics Committee, MEPS, The Bleyzer Foundation

- **Up to September 2008**, Ukraine enjoyed good economic results:
 - Real GDP grew by 6.7% yoy.
 - Inflation was going down.
 - The fiscal budget was in surplus and public debt was declining.
 - Exports of goods grew by 50% yoy.
 - The Current Account it was more than covered by capital inflows.
 - International reserves reached \$37 bn.
- **But since Sept 2008**, the global crisis hit Ukraine severely:
 - Real GDP declined by 8.5% yoy in the last quarter of 2008.
 - Exports fell by 16% yoy on average in the last two months of 2008 and 38% yoy in Jan-Feb 2009.

Impact of the Crisis on the Ukrainian Economy



- From Oct 2008 to Feb 2009, industrial production declined by 50% and the PFTS index declined by more than 80%;
- The Hryvnia/Dollar rate lost 60% of its value, despite large NBU interventions amounting to about \$13 billion;
- Since Sep-2008 about \$12 billion of deposits left the banking system.

Ukraine- Key Economic Statistics

	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%	-5.0%
Fiscal Balance (% GDP)	0.7%	-0.2%	-3.2%	-1.8%	-0.7%	-1.1%	-1.5%	-3.0%
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	-3.0
<i>(as % of GDP)</i>	7.5%	5.8%	10.6%	2.9%	-1.5%	-4.2%	-7.2%	-2.0%
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%	27%
Foreign Private Debt (% GDP)	22%	26%	27%	30%	38%	48%	47%	60%

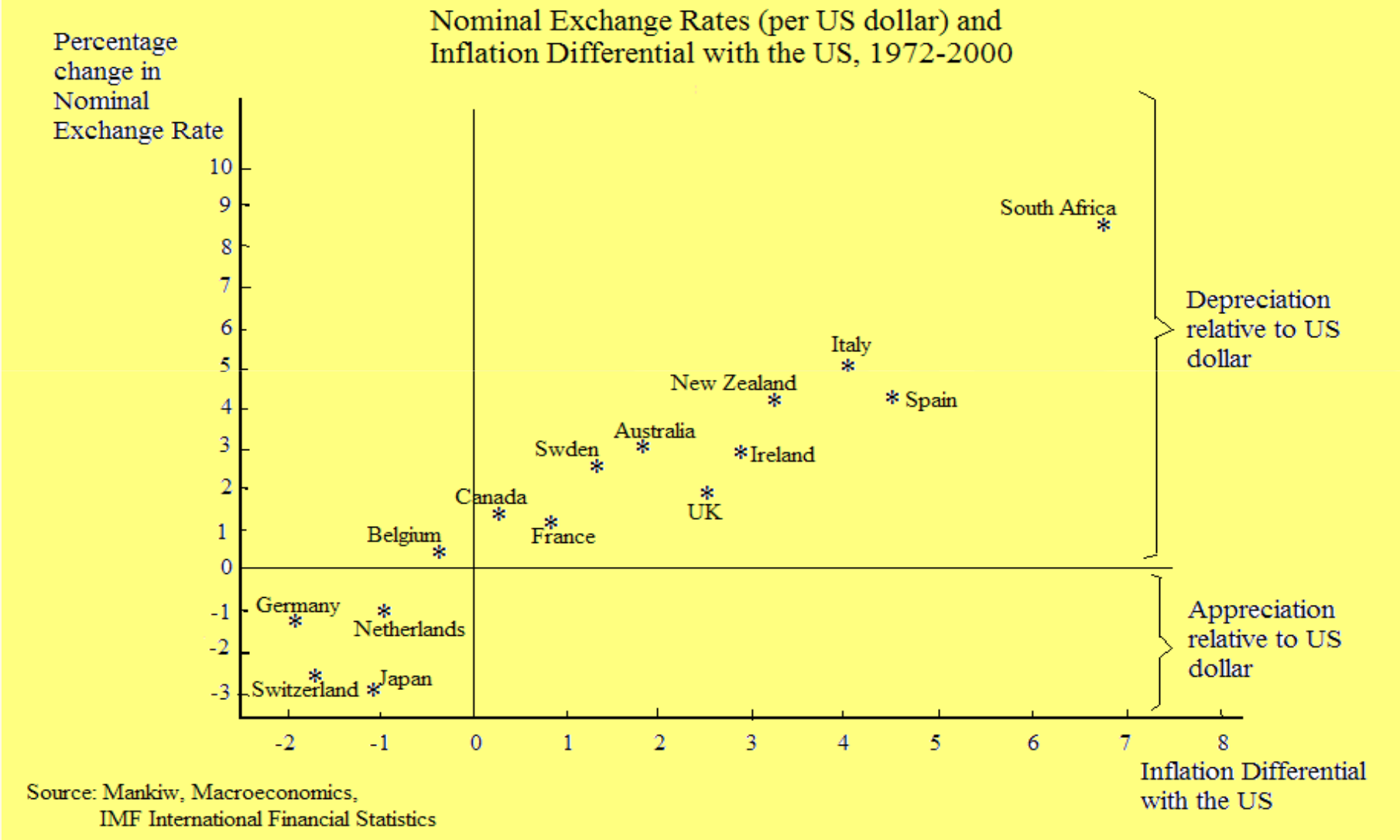
Source: State Statistics Committee of Ukraine, National Bank of Ukraine, Ministry of Finance of Ukraine, The Bleyzer Foundation

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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	12.3	10.3	11.6	16.6	22.3	14.0
Inflation in US	2.6	1.9	3.2	3.7	2.2	4.1	3.1	1.6
Inflation in main trading partners (MTP)	9.7	7.4	7.2	6.4	5.9	8.0	8.7	6.2
Inflation in Currency Trading Countries (CTC)	5.0	3.8	4.7	4.6	3.1	4.9	4.6	3.1
Actual UAH/\$ exchange rate	5.3	5.3	5.3	5.1	5.1	5.1	7.7	
Δ Ukraine-US inflation	-3.1	6.2	8.8	6.3	9.2	12.0	18.6	12.2
Δ Ukraine-MTP inflation	-9.4	0.8	4.8	3.7	5.4	7.9	12.5	7.4
Δ Ukraine-CTC inflation	-5.3	4.3	7.3	5.4	8.3	11.2	16.9	10.6
PPP With base year 2002								
Inflation Diff Index Ukr-US	100.0	106.2	115.6	122.9	134.3	150.4	178.3	200.1
Real Exchange rate - US		5.7	6.2	6.6	7.2	8.0	9.5	10.7
Inflation Diff Index Ukr-MTP	100.0	100.8	105.6	109.4	115.3	124.5	140.0	150.3
Real "Effective" Exchange rate - MTP		5.4	5.6	5.8	6.1	6.6	7.5	8.0
Inflation Diff Index Ukr-CTC	100.0	104.3	111.9	117.9	127.7	142.0	166.0	183.6
Real "Effective" Exchange rate - CTC		5.6	6.0	6.3	6.8	7.6	8.8	9.8

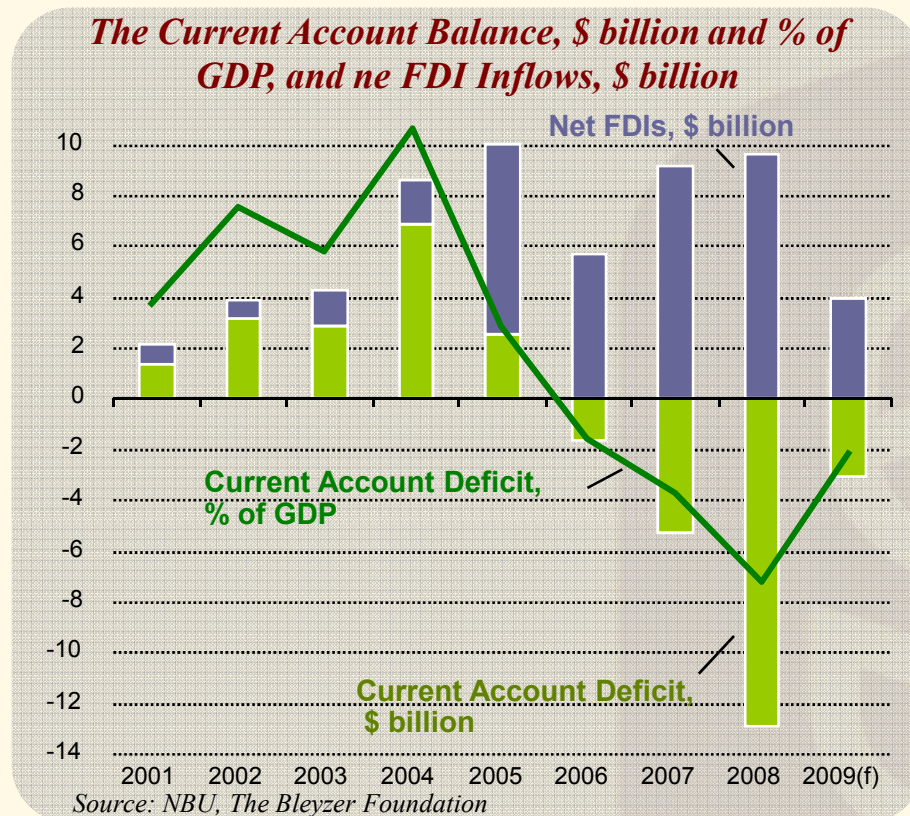
PPP do hold over a number of years



Causes of the Crisis in Ukraine:

- Based on trade competitiveness, given past inflation in Ukraine, the Hryvnia exchange rate had to adjust to around 8-10 UAH/\$.
- But there is the risk of "overshooting" if the Balance-of-Payments is in disequilibrium due to short-term repayments.
- Ukraine was more vulnerable to the crisis than other emerging markets due to a combination of:
 1. Large Current Account Deficits
 2. Large External Debt Burden
 3. Banking Sector Weaknesses

1. Large Current Account Deficits

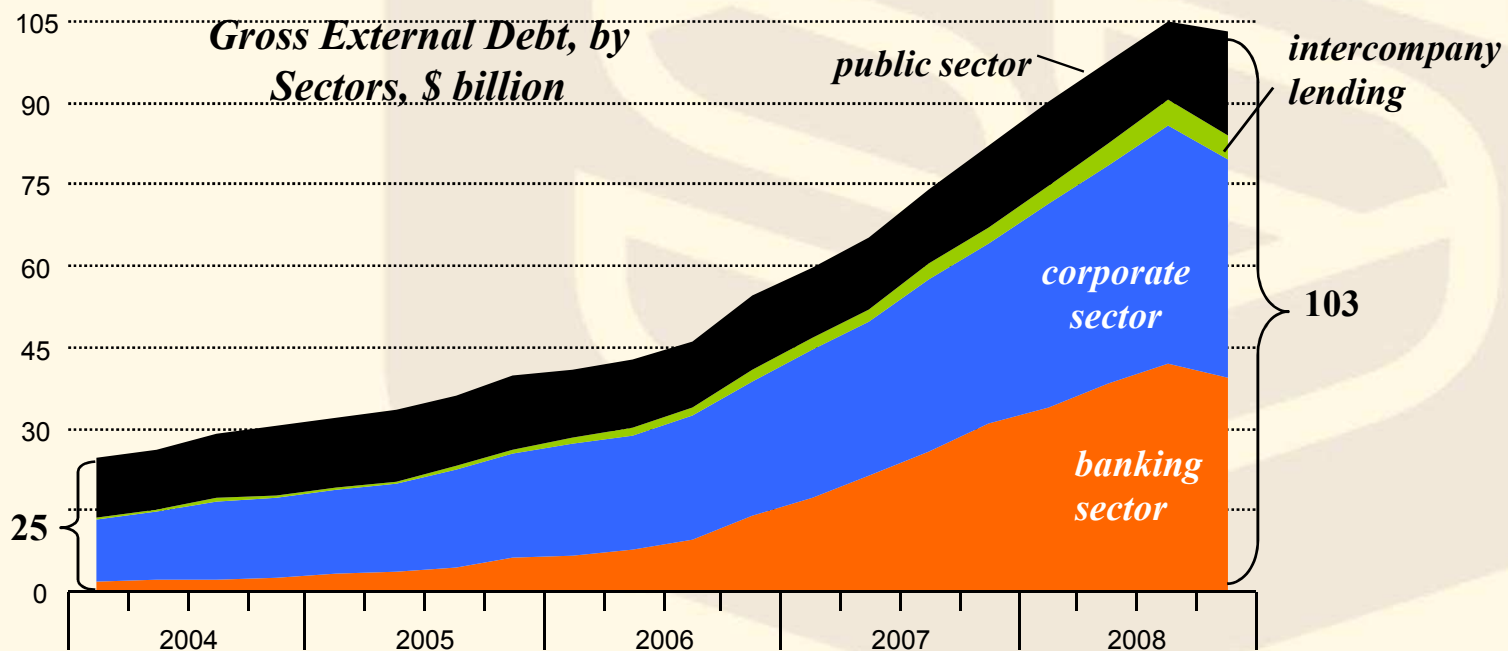


- In 2008, exports grew fast at 33% pa, but imports grew even faster at 39% pa.
- As a result, the CA deficit reached around \$13 bn in 2008, or 7.2% of GDP.
- Net FDI inflows - though substantial at \$9.7 bn - did not cover the CA gap.
- With limited foreign financing, Ukraine absorbed the gap by reducing reserves and depreciating the Hryvnia.

- The BoP statistics for Jan-Feb 2009 are encouraging: a sharp decline in imports (more than 50% yoy) led to a surplus in the current account of \$500 million.
- In 2009, the current account gap could be reduced to \$3 billion (2.0% of GDP), due to lower domestic demand (caused by less credit and Hryvnia depreciation).⁹

2. External Debt Burden

- In the last two years total external debt doubled from \$53 billion to \$103 billion by end of 2008, a lot of which was short-term private debt (about \$36 billion).
- In 2008, Ukraine's external debt (at 60% of GDP and 120% of current account receipts) is above the median value (40% and 84% resp) for similar countries.
- The global financial crisis made more difficult for banks and corporates to roll-over foreign short term debt -- putting heavy pressures on the currency.



Source: NBU, The Bleyzer Foundation

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Ukraine's External Financing Requirements in 2009 (in \$ 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	4
Likely external debt requirements	-37
Available NBU reserves at beginning of 2009	31

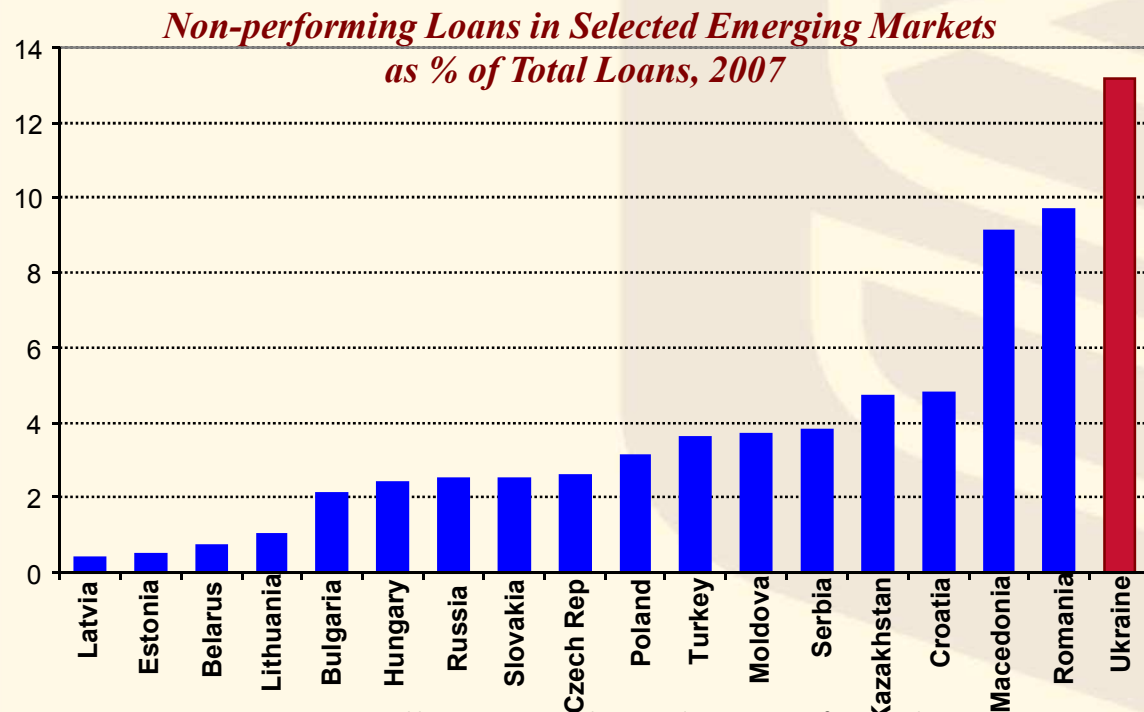
* not including the short-term part of M< private debt

- This table shows that the short term debt repayments due in 2009 will continue to pressure on the Hryvnia exchange rate;
- However, its level may be manageable if financial support is provided by the IMF and other international institutions.

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3. Banking Sector Weaknesses

- During 2006-2008, bank credit grew by 70% pa, supported by increases in money supply and borrowings from abroad.
- As in many other countries, these high rates of credit growth led to high levels of non-performing assets (sub-standard, doubtful and loss loans - NPLs).
- According to the NBU, the share of doubtful and loss loans grew from 2.5% at the beginning of 2008 to almost 4% at the end of the year.



Source: IMF GFS Report, Oct. 2008; Kazakh Agency on Regulation and Supervision of Financial Markets

- Including sub-standard loans, the share of NPLs is higher than in other countries.
- A flight in deposits started in Sep-2008 and by Feb-2009, about \$12 billion flew out of the banking system.
- Bank weaknesses and loss of confidence made even more difficult for banks to roll-over foreign short term debt.

Five Pillars of Crisis Resolution

Based on extensive international experience, to resolve successfully a financial crisis, the following five "pillars" should be implemented:

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
5. Implement Structural Reforms for to revive economic and export growth.

1. Organizational Arrangements to confront the crisis:

- Successfully countries created an independent 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).
- The Authority should have delegated authority from government agencies (CB, COM, Ministry of Finance) to take prompt action (PCA legislation in the US).
- It should also enter a Memoranda of Understanding with other Central Banks whose countries have a large banking presence in the country on matters of coordination, exchange of information and possible financing.
- The Authority should develop an early warning system of key indicators, which may indicate whether the depth of the crisis is increasing or not.
- It should also monitor closely the amounts of external private sector debt (banking and non-banking) due over the next 12 month.

Moderate progress: In Ukraine there is no special Crisis Authority. Both the NBU and the government have been taking measures to address the crisis; but poor coordination often resulted in the conflicting statements, undermining public confidence. In the absence of a formal Authority, a crisis coordination memorandum of understanding should be signed by all relevant agencies.

2. Secure Substantial Financial Assistance

Long-term foreign financial assistance is vital to assure foreign creditors that the country has the resources to serve all of its external debts.

Relatively good progress:

- Ukraine secured loans from the IMF (\$16.5 bn) and World Bank (\$0.5 bn).
- Ukraine has also applied for bilateral and multilateral financing.
- However, a violation of some performance criteria has caused a temporary delay of the IMF program.
- The Ukrainian authorities now have accepted the need to revive the IMF program, as neither bilateral nor multilateral financing may be available without it -- other countries and institutions rely on the IMF for debt coordination and to certify the adequacy of the country's economic program.
- Ukraine is encouraging private sector corporations and banks to implement a program to restructure current short-term foreign debt and increase capital. In Feb 2009, inflow of LT private debt outpaced debt repayments.

3. Implement a Program for Troubled Banks

Moderate progress:

- The main aspect of this program is the recapitalization of troubled banks.
- Following international best practices, this recapitalization is based on a solvency classification of banks based on comprehensive audits of the 17 largest commercial banks, all performed by international auditing firms.
- Following the audits, 13 private banks were required to provide \$3 billion to raise their own capital: Foreign banks have already confirmed their plans to raise \$2 billion for the capital of their Ukrainian subsidiaries. \$1 billion would be provided by local banks. Audits are now underway for medium sized banks.
- The NBU has supported commercial banks liquidity through its refinancing operations; eleven banks were taken under NBU temporary administration with one of them successfully sold to new shareholders; the Central Bank monitoring was placed in several other banks.
- In mid-October 2008, the NBU imposed a six-month ban on early withdrawal of term deposits and tightened rules for issuance of bank loans in foreign currency.
- At the beginning of November 2008, the guarantee on deposits of individuals was increased three times to UAH 150 thousand (about \$20 thousand).

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4. Implement a Stabilization Program

Tight fiscal and monetary policies are needed to contain aggregate demand and to lower currency depreciation and inflationary pressures.

Relatively good progress:

- The NBU allowed the Hryvnia to depreciate by about 60% in 2008.
- At end-October 2008, the government froze budget sector wages; at the beginning of March 2009, wages of high-ranked 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 target.
- The government has been implementing temporary measures to curb imports (in February it introduced extra duty of 13% on non-critical imports; requested Russia's Gazprom to lower the annual volumes of natural gas for Ukraine).
- **However**, the 2009 budget law was approved with a large targeted deficit.
- Unless non-inflationary long-term foreign financing is attracted, the budget parameters should be revised downwards.

5. Implement Structural Reforms to Revive Growth

Poor progress

- Since stabilization measures will reduce growth, the Govt Program should also include measures to restart economic growth and exports.
- The possibility to use fiscal stimulus to revive growth is constrained by the limited availability of non-inflationary foreign long-term loans.
- Therefore, the most realistic option to revive economic growth is to improve the business environment to attract private 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 pass a very strong message that the country is serious about improving its investment climate.
- For this, the country need to make a quantum jump on reforms and take some "dramatic" measures, both for the short-term and for the medium term.

.....Implement Structural Reforms to Revive Growth

- Short-term measures should include:
 - Use a regulatory sunset scheme to curtail business regulations by a deadline.
 - Get rid of corruption in custom administration by transferring custom management to a reputable foreign agency.
 - Improve transparency in the judiciary by mandating that court decisions are immediately published in the internet and subjected to review and scrutiny by an independent entity.
 - Implement Inflation Targeting and free the foreign exchange system.
 - Promptly enter into an Enhanced Free Trade Agreement with the EU.
 - Remove the moratorium for land sale.
- Medium term measures should include:
 - Reduce the cost of doing business by reducing and consolidating taxes/duties to competitive levels and improve tax administration and VAT refunds.
 - Improve public governance by implementing a drastic public administration reform that would reduce overlapping functions, improve transparency and decision-making, and reduce administrative corruption.
 - Implement a comprehensive reform of the judiciary system
 - Improve fiscal sustainability by eliminating privileges and reforming the Pension System.

Prospects for the Future

- The successful implementation of the measures stated before, particularly the IMF program, would address Ukraine's vulnerabilities as follows:
 - (i) **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 devaluation. Thus, the current account deficit should be about \$3 billion, a manageable amount.
 - (ii) **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.
 - (iii) **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.
- Under this scenario, the crisis would be contained during 2009. The exchange rate would stabilize and GDP recovery could take place in 2010, following the recovery of the world economy.