

Ukraine-Romania-Bulgaria

Update on Macroeconomic Situation

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Ukraine

W H E R E O P P O R T U N I T I E S E M E R G E



Ukraine- Key Economic Statistics

	2002	2003	2004	2005	2006	2007	2008(f)	2009(f)
Real GDP Growth	5.2%	9.6%	12.1%	2.7%	7.3%	7.6%	2.1%	-5.0
Fiscal Balance (% GDP)	0.7%	-0.2%	-3.2%	-1.8%	-0.7%	-1.1%	-1.3%	-0.5
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	-12.3	-3.5
<i>(as % of GDP)</i>	7.5%	5.8%	10.6%	2.9%	-1.5%	-4.2%	-7.0%	-3.0%
Gross International Reserves, incl IMF financing (\$bn)	4.4	6.9	9.5	19.4	22.3	32.5	31.5	29.0
Foreign Public Debt (% GDP)	24%	21%	19%	13%	12%	10%	11%	25%
Foreign Private Debt (% GDP)	22%	26%	27%	30%	38%	48%	52%	65%

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

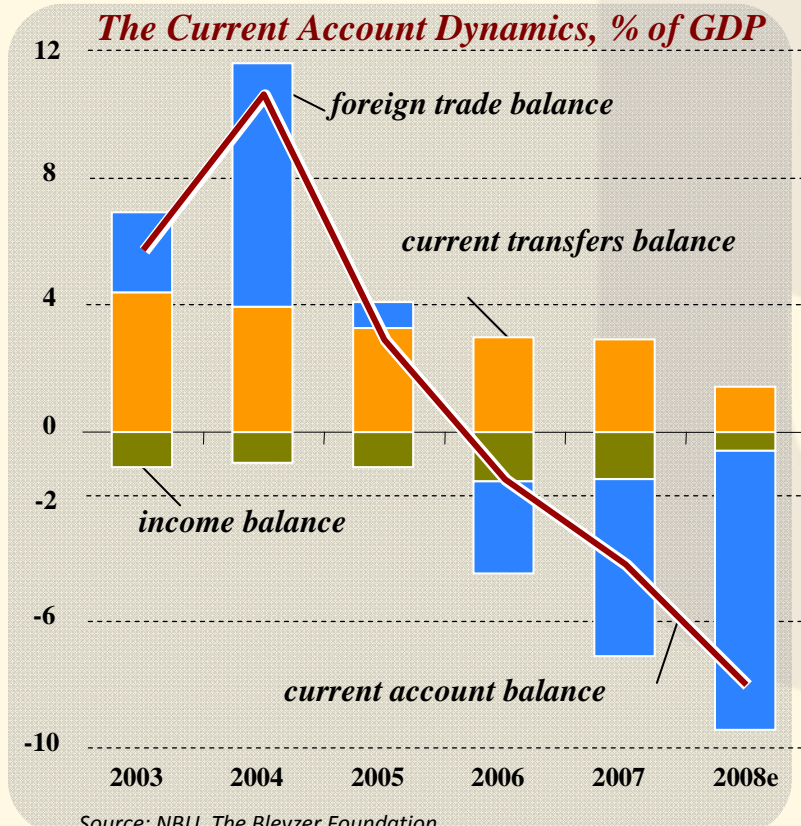
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Performance in 2008

- At the beginning of 2008, Ukraine's GDP was forecast to grow by about 5.5%, supported by a good grain harvest and favorable terms of trade. Some deceleration in economic growth was seen as a natural response to tighter macroeconomic policies to tackle inflation. Inflation was expected to be brought under control.
- Indeed, over the first 9 months of 2008, Ukraine enjoyed good economic results:
 - GDP grew by almost 7% yoy;
 - Inflation declined to 24.6% yoy in September, from a peak of 31% yoy in May;
 - Public finances were in a good shape: the country ran a consolidated budget surplus of 1.6% of period GDP, public debt in US Dollar terms declined by about 3% since the beginning of the year to \$17.1 billion;
 - Exports of goods reached an all-time record growth of 50% yoy.
 - Gross international reserves reached \$37 billion.
- Ukraine could have “soft-landed” its imbalances. However, the international liquidity crisis that gained momentum since mid-2008 affected Ukraine more than other emerging countries, with the result that GDP in 2008 increased by only 2.1%.
- Ukraine was vulnerable due to a combination of *(i) high and rapidly widening current account deficit*, *(ii) large external short-term debt obligations of Ukraine's private sector* and *(iii) a weak banking system*.

Sources of Ukraine's Vulnerability: (i) High CA Deficit

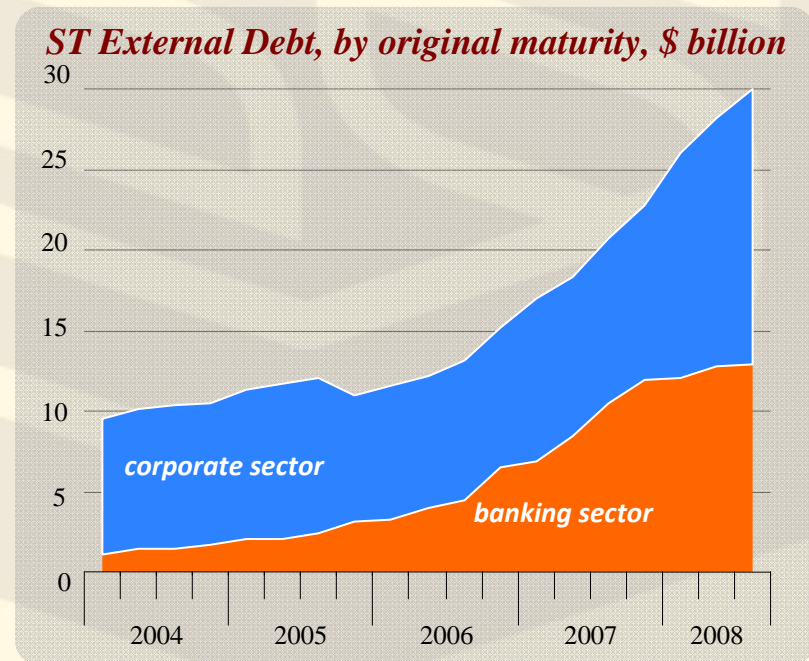
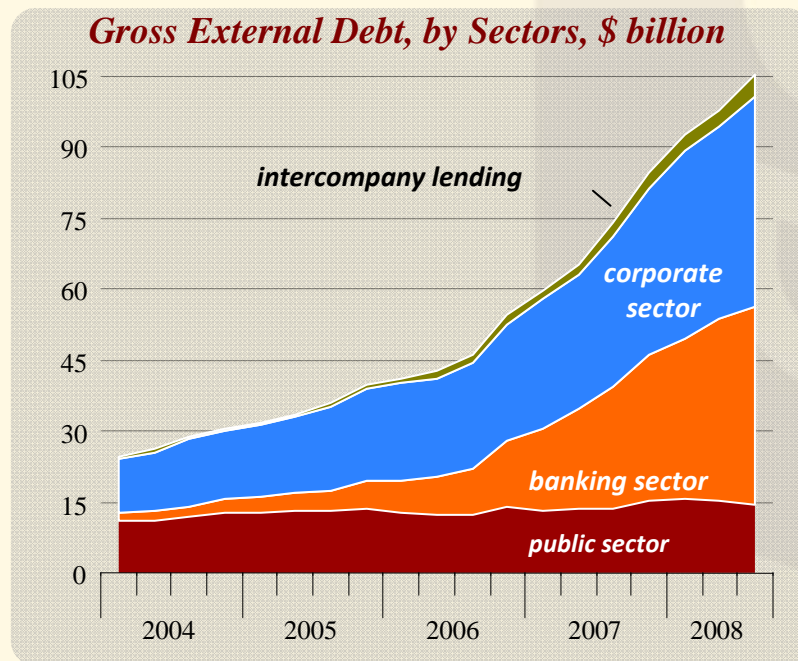
- Ukraine's external trade depends on a few commodities (i.e., steel and chemicals).
- With the slowdown of world economic growth, international prices for these commodities started to decline sharply after August 2008.
- In addition to a slowdown in exports, imports grew at a fast pace of more than 50% pa, reflecting large consumer demand.



- As a result, the CA deficit reached around \$12 bn in 2008, or about 7.0% of GDP.
- Net FDI inflows, which reached around \$10 bn, did not cover the CA gap.
- Hence, Ukraine had to rely on external debt and a reduction in net international reserves.
- This imbalance was reflected in a depreciation of the currency to 8 UAH/\$ by eoy.
- In 2009, the current account deficit should be reduced to about \$3.5 bn (3% of GDP).
- Since foreign private debt financing is uncertain, due to the tight global credit markets, the availability of IMF financing will be important to cover this gap.

...(ii) High Sort-Term External Debt

- During 2007-08, external debt more than doubled to \$105 bn as of October 2008.
- Out of this amount, \$45 bn was private sector short-term debt that will require re-financing in 2009 (including the short-term maturities of medium/long-term debt).
- About \$40 bn of this short-term debt could be re-financed or serviced as this represents more stable trade credits and financing from parent companies.
- The remaining \$5 bn of short-term plus the CA deficit of \$3.5bn will be harder to re-finance and will put pressures on the exchange rate.



Source: NBU, The Bleyzer Foundation

...(iii) Banking Sector Weaknesses

- Access to external financing over the last 2 years as well as loose monetary policy led local banks to expand their credit portfolios by more than 70% per annum (with more than 50% of all loans issued in foreign currency.)
- International experience shows that high rates of credit growth cause the share of non-performing loans to soar. This was also the case in Ukraine.
- According to the NBU, the share of non-performing loans (sub-standard, doubtful and loss loans) remained rather high at 13.2% in 2007, and may have increased in 2008.
- The current measures to restrain credit and the devaluation of the Hryvnia are likely to further increase the level of non-performing loans, with some medium banks likely to fail.

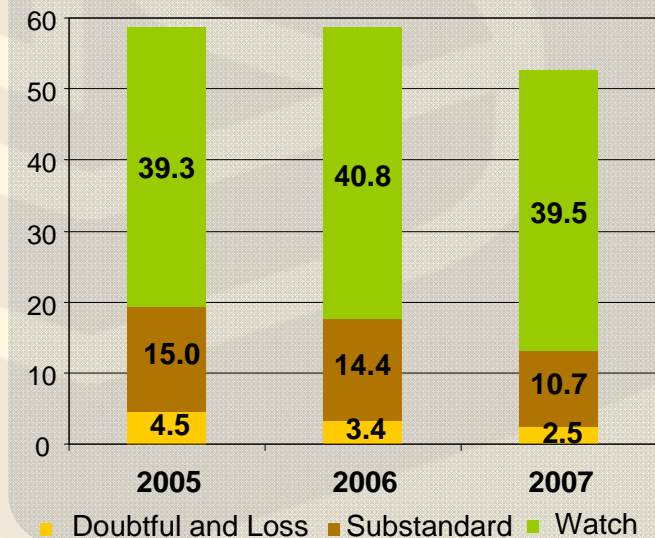
Selected Indicators of Ukrainian Banking Sector

	Comm'l banks external debt, \$ bn	% yoy	Credits, total, UAH bn	% yoy	FX-credits, % of total	% yoy
2005	6.1	129.6	143.4	61.9	43.3	66.3
2006	14.1	130.5	245.2	71.0	49.5	95.4
2007	31.0	119.8	426.9	74.1	49.9	75.4
2008*	42.1	63.2	733.9	71.9	59.1	103.6

* 9M 2008 for external debt

Source: NBU, The Bleyzer Foundation

Credit Quality: Non-Performing Loans



Recent Developments

- Separately, each of the above risk factors could have been manageable, but their confluence – amid a deteriorating world economy – caused the current difficulties.
- These developments led to an outflow of portfolio capital to Ukraine of \$350 million in the first nine-months of 2008, compared to an inflow of portfolio capital of \$3.9 billion in the same period of 2007.
- Partly as a result, the PFTS stock index declined by more than 73% in 2008, one of the largest declines in the world.
- All these factors caused a sharp currency depreciation, with the Hryvnia losing almost 60% of its dollar value during 2008.
- This happened despite the fact that during the last quarter of 2008, the NBU sold more than \$11 billion of foreign exchange, reducing its gross international reserves to \$31.5 bn (\$27 bn net, if the new IMF financing is excluded).
- The banking sector's stress affected a number of banks:
 - In September the six-largest bank, Prominvestbank, suffered a flight in deposits. Though the NBU provided emergency refinancing and then took control over the bank, public confidence in the banking system was undermined.
 - Two more of the top 15 banks have seen intervention or been put under NBU supervision (Ukrprombank and Nadra Bank).
- In October-December, the population rushed to withdraw deposits, which cost the banking system about \$7.0 billion in these three months.

Measures to Address the Crisis

Similar Financial Crises in other emerging countries were addressed by:

- Securing significant financing from abroad
- Taking measures to reduce the current account deficit
- Addressing recapitalization issues of commercial banks
- Adopting a program of structural reforms to revive exports and growth
- In Ukraine, the Government and the NBU have secured financing from the IMF of \$16.4 bn and the World Bank (\$500 mn) and is seeking support from other IFIs.
- The IMF Program contains measures to reduce the Current Account deficit, including a reduction in aggregate demand by running a balanced fiscal budget for 2009, low growth in money supply, rises in utility tariffs to consumers, the capping of increases in wages and pensions, and real devaluations by allowing the Hryvnia to float.
- On the commercial banks, the NBU has actively supported banking sector liquidity, increased deposit guarantees to about \$20,000, and imposed a six-month freeze on the early withdrawal of saving deposits from commercial banks.
- The NBU also introduced restrictions on new issuance of foreign currency loans, which now can be made only to borrowers that have foreign currency income.
- Moreover, an extensive audit of commercial banks performance was initiated.
- But we still need to see measures to revive economic growth.

2009 Outlook

- In 2009, exports would decline by about 18% over 2009 in dollar terms, due to lower commodity prices, continuing economic recession in developed countries and a sharp slowdown in developing economies (including Russia)
- With implementation of the IMF measures, imports would decline by 26% in 2009, due to a weaker currency, a moderate potential increase of natural gas prices (from \$179.50 per tcm in 2008 to an average of \$230 per tcm in 2009), a tight fiscal budget and tight monetary policy that would slow growth of consumer demand.
- Thus, the current account deficit would narrow to \$3.5 billion in 2009 - or 3% GDP.
- A good part of the external debt due in 2009 is likely to be refinanced as it represents trade-related obligations and commercial banks debt to parent banks.
- After considering funding from the IMF, the World Bank, and about \$4 bn in FDI, the gap in foreign exchange requirements in 2009 could be around \$5 bn.
- Under this scenario, given that the NBU has about \$32 bn of gross FX reserves, the gap is manageable with some limited external financing and may prevent a sharper fall of the Hryvnia, which should stabilize at 9 UAH/\$ by the end of 2009.
- But if the IMF Program were to fail in 2009 (with large fiscal deficits and loose monetary policies) the FX rate of the Hryvnia could deteriorate beyond 10 UAH/\$.
- In 2009, Ukrainian GDP would decline by about 5%, but recover in 2010.
- The recent formation of a Rada majority may bring some political stability. Hopefully, this may lead to some structural reforms.

Romania

W H E R E O P P O R T U N I T I E S E M E R G E



Romania: Key Economic Statistics and Forecast

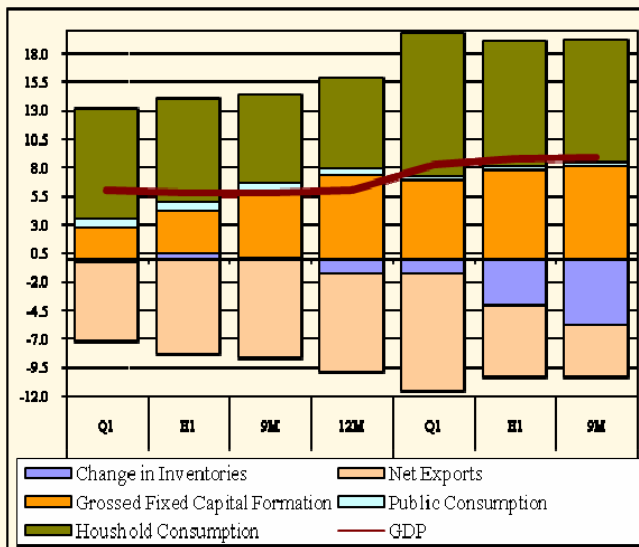
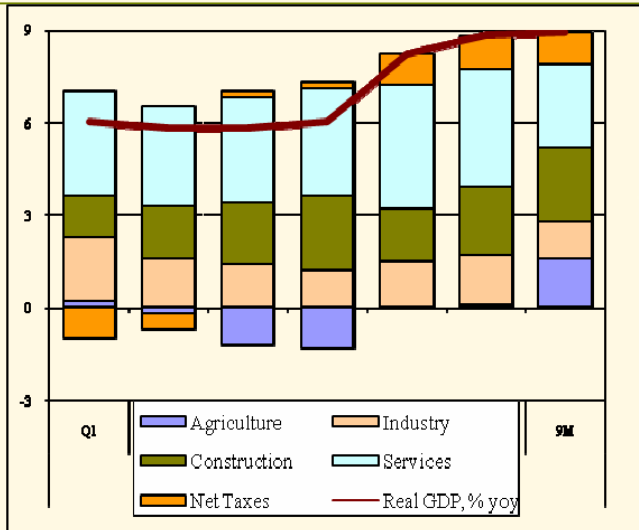
	2005	2006	2007	2008e	2009f
Real GDP Growth	4.1%	7.7%	6%	8.0%	-2.0%
Fiscal Balance (% GDP)	-0.8%	-1.7%	-2.3%	-3.5%	-2.8%
Consumer Inflation (eop)	8.6%	4.9%	6.6%	6.3%	4.7%
Exchange Rate (RON/ € eop)	3.68	3.38	3.6	4.0	4.3
Current Account (€billion) (as % of GDP)	-6.9 -8.7%	-10 -10.3%	-16.9 -14%	-17.5 -13.5%	-14 -12%
International Reserves (€billion)	18.3	22.9	25.3	28.3	25
Public External Debt (% GDP)	14%	11%	14%	18%	17%

Source: National Institute of Statistics, NBR, Ministry of Public Finance, Eurostat, TBF

Romania: Economic Performance

- In January-September 2008, GDP accelerated to 8.9% yoy, which was the highest growth rate in the EU. However, in October-December 2008, the Romanian economy slowed down and ended up 2008 with a growth rate of about 8%. Still this is a good overall performance.
- Inflation was brought under better control since August 2008, with annual inflation slowing down to 6.3% yoy by end-of-year. However, inflation is still above the 4.8% NBR' inflation target.
- The main economic risk in Romania is its external imbalance, with a Current Account deficit still high at 14% of GDP.
- Reflecting this risk, since September 2008, with the deepening of the global financial crisis, the Romanian Leu depreciated to 3.99 Ron/EUR by the end of the year, thus losing 10% of its Euro value since the beginning of the year.
- By mid-January 2009, the exchange rate moved to 4.3 RON/EUR.
- Give the size of its CA deficit, Romania will remain highly dependent on its ability to borrow from abroad.
- This will be more difficult since Fitch and S&P have downgraded Romania's international rating from "investment grade" to "speculative grade", due to high Romania's vulnerabilities to international liquidity crisis.

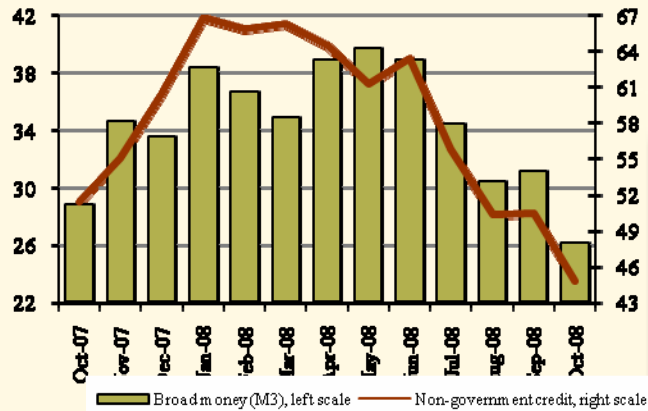
Romania: Economic Growth



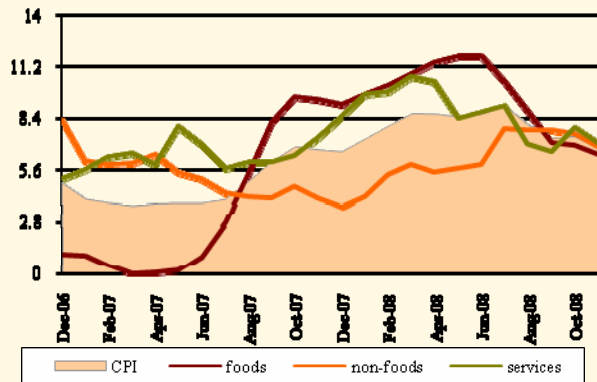
- As noted earlier, in Jan-Sep 2008, the Romanian economy demonstrated strong growth, driven by high foreign capital inflows.
- On the demand-side, economic growth was spurred by buoyant domestic consumption (14% yoy) and investments (28% yoy).
- On the supply-side, GDP growth was supported by good performance in construction (31% yoy), services (7.6% yoy), industry (5.6% yoy), and agriculture (23% yoy).
- However, already in October, the Romanian economy posted the first signs of cooling off, due to restricted access to credit. In October alone, industrial production dropped by 3% yoy, and then declined by 11.5% yoy in November. Trade fell by 3% in October and by 11% yoy in November. Construction works decelerated to 19% yoy in October and to 13% yoy in November.
- In 2009, the economy could contract by 2% due to slow credit growth and weak industry and construction sectors.

Romania: Inflation and Monetary Developments

Money Supply and Credit, % yoy



CPI by components, % yoy

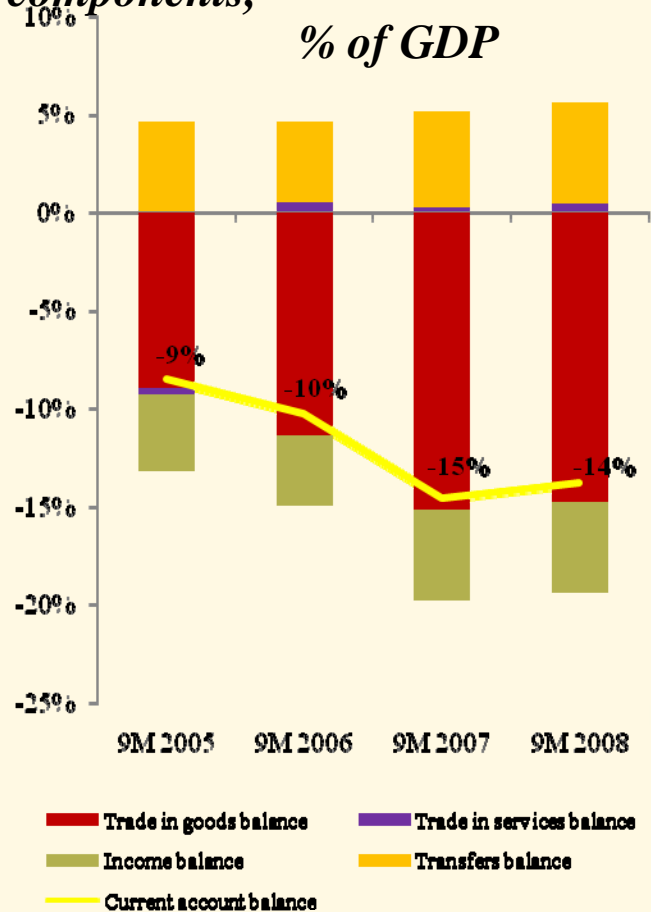


Source: National bank of Romania

- The banking system has remained fundamentally sound, despite high exposure to exchange rate risks.
- The share of loss and doubtful debts in total loan portfolio is still low (1.1% as of Sep 2008).
- Furthermore, in Aug 2008, the NBR introduced stricter prudential requirements for bank loans to the private sector.
- During 2008, the NBR followed a tight monetary policy, increasing the key policy interest rate from 7.5% in January 2007 to 10.25% starting August 2008.
- Due to these tighter monetary policies and more cautious lending by banks, the growth of credit and money supply slowed down during 2008.
- These measures helped to ease inflation pressures. These pressures were also alleviated by a good harvest and decreasing world fuel prices.
- Inflation declined to 6.3% yoy in 2008.
- To ensure further confidence in the banking sector, starting on October 15th, the banks' deposits guarantee was raised from EUR 20,000 to EUR 50,000.

Romania: Current Account

Current Account by components,

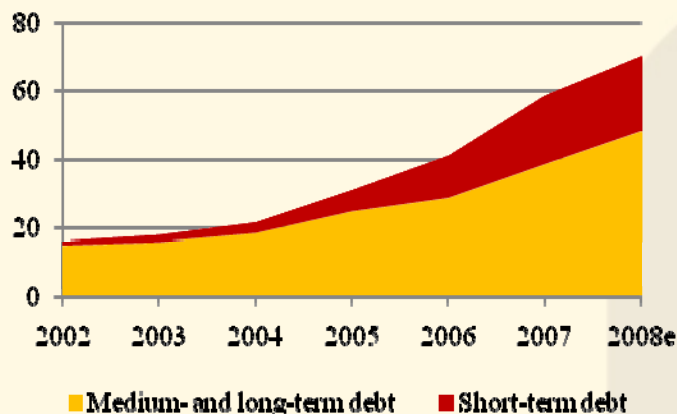


Source: National bank of Romania

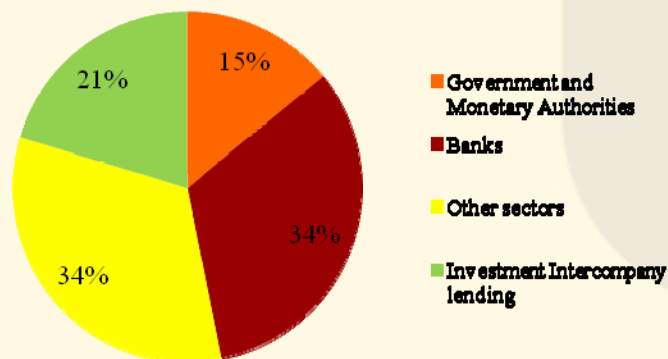
- Over the last several years, excess of spending resulted in large CA deficits, which deteriorated from 3.3% of GDP in 2002 to 14% of GDP in 2007.
- In 2008, external imbalances began to moderate, as export growth outpaced import growth, mainly due to the RON depreciation.
- Following these favorable trade dynamics, the CA deficit grew only by 8% yoy in Jan-Nov 2008, compared to 68% yoy surge in Jan-Nov 2007.
- Despite the recent moderation, the CA gap still remains at an unsustainable level of 13.5% of GDP.
- Financed only 54% by FDIs, the CA gap relies on external debt financing, making the economy vulnerable to rising external credit costs.
- Thus, this external gap continues to create depreciation pressure on the Romanian Leu but may stay at 4.3 RON/EUR by the end of 2009, if external financing is available.
- But if external financing becomes difficult, the NBR may not defend the currency and the exchange rate may depreciate beyond 4.3 RON/EUR.

Romania: External Debt

Total External Debt, EUR bn



Structure of Total External Debt



- Over 2006-2008, Romania raised its external debt to finance rapidly growing CA deficits.
- Romania's total external debt amounted to EUR 70 bln as of Sep 2008, which is about 53% of GDP.
- Although the debt burden is expected to grow significantly due to the RON depreciation and increasing credit costs on the global markets, the level of debt is still not alarming.
- Most of the debt amount is attributed to banks' obligations to their main foreign offices, trade relations and inter-company investments.

Outlook

- Romania's large current account and fiscal deficit make the Romanian economy vulnerable to the current international liquidity crisis.
- The global liquidity crisis will impact Romania mainly through the difficulties the country may experience in financing its CA deficits and the decreasing external demand for Romania's exports.
- Real GDP growth is expected to slow down to 7% yoy in 2008 and to contract by 2.0% yoy in 2009 due to a significant decrease in credit, investments and capital inflows.
- Inflation eased to 6.3% yoy in 2008 and is forecasted to reach the upper boundary of the inflation target band (4.8%) in the second half of 2009.
- Weakening domestic demand and depreciating domestic currency is expected to narrow slightly the CA gap. The current account deficit may reach 13.5% of GDP at the end of 2008 and 12% of GDP in 2009.
- However, if the CA deficit and lack of foreign financing were to lead to a sharper depreciation of the Romanian currency beyond 4.3 RON/EUR, this would impose a serious risk to the stability of the banking sector, as 55% of all non-government banking credit is denominated in foreign currency and non-performing loans could increase.
- A mitigating factor is that Romania has access to alternative sources of financing such as credit lines of international financial institutions (EIB, EBRD, WB), EU structural funds, and credit lines from parent banks to their subsidiaries in Romania.

Bulgaria

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W H E R E O P P O R T U N I T I E S E M E R G E



BULGARIA: Key Economic Indicators

	2003	2004	2005	2006	2007	2008*	2009 (f)
Real GDP Growth	5.0%	6.6%	6.3%	6.3%	6.2%	6.0%	-1.0%
Fiscal Balance (% GDP)	0.0%	1.7%	2.3%	3.6%	3.5%	4.0%	2.0%
Consumer Inflation (eop)	5.6%	4.0%	6.5%	6.5%	12.5%	7.8%	6.0%
Exchange Rate (Lev/EUR, eop)	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
Current Account (EURbn)	-0.97	-1.31	-2.71	-4.50	-6.30	-8.3	-5.8
<i>(as % of GDP)</i>	-5.5%	-6.6%	-12.4%	-17.8%	-21.8%	-24.5%	-16.3%
International Reserves (EURbn)	5.4	6.9	7.4	8.5	11.9	12.7	9.0
<i>(in months of imports)</i>	5.8	6.1	5.3	5.1	5.9	6.3	5.6
Foreign Public Debt (% GDP)	39.8%	33.2%	23.8%	18.0%	14.2%	14.0%	15.0%

* Preliminary data

Source: Bulgarian National Bank, Ministry of Finance of Bulgaria, IMF, The Bleyzer Foundation

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Bulgaria - Economic Performance

- **Good Growth Performance.** From an average annual GDP growth of 5.5% in 2002-2007, GDP growth accelerated to 7.5% in Jan-Sept 2008 (with investments increasing by 22.5%).
- **Prudent fiscal policy.** Since 2004, Bulgarian authorities have managed to achieve fiscal surpluses, which in 2007 constituted 3.5% of full-year GDP. In January-November 2008, fiscal surplus was 7.5% of projected full-year GDP and is projected to be not less than 4.0% of GDP by the end of the year.
- **Sound monetary policy.** Since 1999 (except for 2007, when CPI accelerated to 12.5%) inflation was always at a one digit level. In 2008, inflation reached 7.8%. In 2009 and thereafter, a substantial part of CPI growth will be due to price increases in utilities sector and bringing excise taxes to EU requirements.
- **Free and open foreign trade.** The current account (CA) deficit has been the main risk for the Bulgarian economy over the last few years. Starting from 2.4% of GDP in 2002, the CA deficit widened to 21.8% of GDP in 2007 and is expected to be not less than 24% of GDP in 2008. On a positive note, the existing gap in trade deficit is largely due to surge in imports of investment goods, whose share in total imports was 28.5% during 10M 2008.

Impact of Global Financial Crisis on Bulgaria: the First Signs

- In November 2008, industrial production dropped by 8.8% yoy and industrial sales slipped by 11.5% yoy. In manufacturing, where production and sales decreased by 10.9% and 13.2% respectively, only food and printing industries showed positive growth.
- In November, goods exports also shrank by 15% yoy (€190 million). Goods imports decreased as well, by 11.8% yoy (€244 million).
- As a result, in November the trade balance improved by 6.7% yoy (€54 million), though remained negative. However, the Current Account worsened by 11.4% yoy (€86 million) because of a drop in net income and transfers.
- Since the beginning of the year, credit growth has been decelerating, though from very high values. At the end of October, the credit stock to enterprises and households was larger by 36.7% than that at the same period of the previous year.
- The risks of a sharp deterioration in economic performance in 2009 are high, mainly due to high level of openness of the economy and significant external imbalances, which mounted during the last several years.

Bulgaria: Trade Imbalances

- In January-November 2008, the CA deficit reached €7.5 billion, or 21.9% of projected full-year GDP. The trade deficit in goods amounted to €8.2 billion, or 24% of GDP.
- During the first eleven months of 2008, the amount of goods imports was larger than that of goods exports by more than one and a half times.
- Declining commodity prices put additional risk for Bulgarian exports in 2009. Therefore, the CA deficit will not be controlled if imports are not reduced simultaneously with the expected shrinking in exports.
- In fact, the government expects that a significant reduction in imports is quite probable, as internal demand is likely to decelerate on the back of the expected worsening of domestic income and moderating credit growth.
- As a result, the CA deficit is likely to improve from the current level of 24.5% of GDP to about 16% in 2009.
- In 2008, only around 72% of this CA deficit was financed by FDI.

Bulgaria: High External Debt

- In 2003–2007, gross external debt grew by 23.8% pa.
- As of October 2008, external debt stood at €36.4 billion, or 107.1% of estimated 2008 GDP.
- While public external debt increased by only 2.6% yoy, private debt increased by 42.8% yoy.
- About 92% of the country's external debt is non-government debt. Shares of banking and corporate sector debt were 25.4% and 32.9%, and intercompany lending occupied 33.8% in external debt structure.
- Short-term external debt amounted to €13.9 billion, which is 38.1% of the total debt.
- On the back of decreased access to external financing and negative developments in the economy, some private entities may have difficulties financing their obligations in 2009.
- However, a significant portion of debt may be due to parent companies, which decreases the risk of large-scale payment problems.
- Government external debt, standing at €2.8 billion (8.4% of projected 2008 GDP) and occupying 7.8% in debt structure, is likely to be serviced in time.

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Bulgaria's Prospects under Adverse External Environment

- The current international liquidity crisis and the weak world economy have increased Bulgaria's vulnerability. This was already reflected in the downgrading of Bulgaria's ratings.
- However, Bulgaria should be able to manage a soft landing. Most likely, there will not be a sharp contraction of economic activity. The economy is likely to contract by only 1% in 2009.
- The movement to the new equilibrium with lower imbalances and lower pace of growth is expected to be relatively smooth
- The government will continue to exercise prudent fiscal policy and go on with structural reforms. This will help to the adjustment of the economy and will increase investors' confidence in good prospects of the economy.
- The banking sector, dominated by foreign banks, is likely to withstand negative pressures due to access to parent financing and proper risk management.