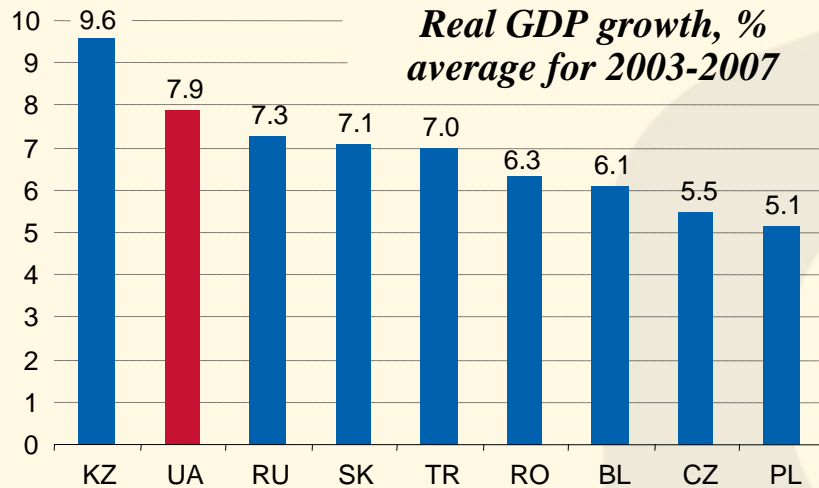


# Ukraine's Current Situation and Future Outlook

Dr. Edilberto Segura  
Partner & Chief Economist  
SigmaBleyzer, The Bleyzer Foundation  
September 2008

v6

# Ukraine- Real Sector



Source: State Statistics Committee of Ukraine, IMF WEO Database April 2008

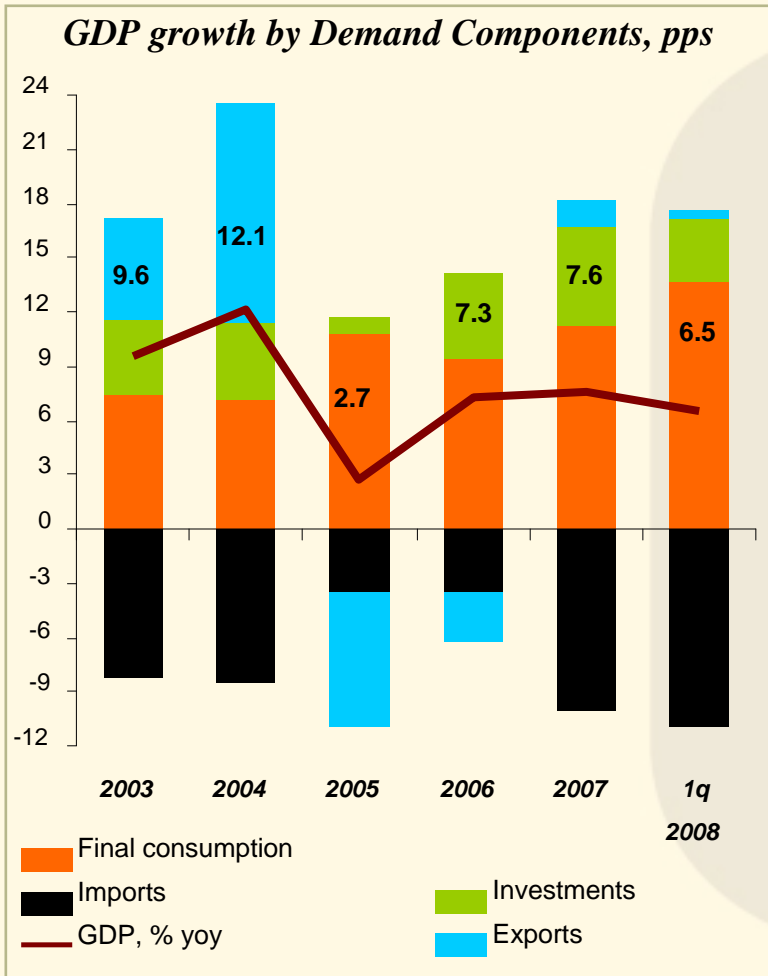
January-August 2008, % yoy

GDP	7.1
Agriculture	24.4
Domestic Trade	10.7
Transportation/Communication	8.3
Construction	-5.3
Industrial Output	6.3

Source: State Statistics Committee of Ukraine

- Over the last five years, Ukraine has been one of the fastest growing economies in the region: its real GDP grew by 7.9% per annum.
- During January-August 2008, Ukraine continued to expand fast at 7.1% yoy, showing resilience to global liquidity tightening, high energy and raw materials prices, high inflation and on-going political controversy.

# Economic Growth – Demand Side

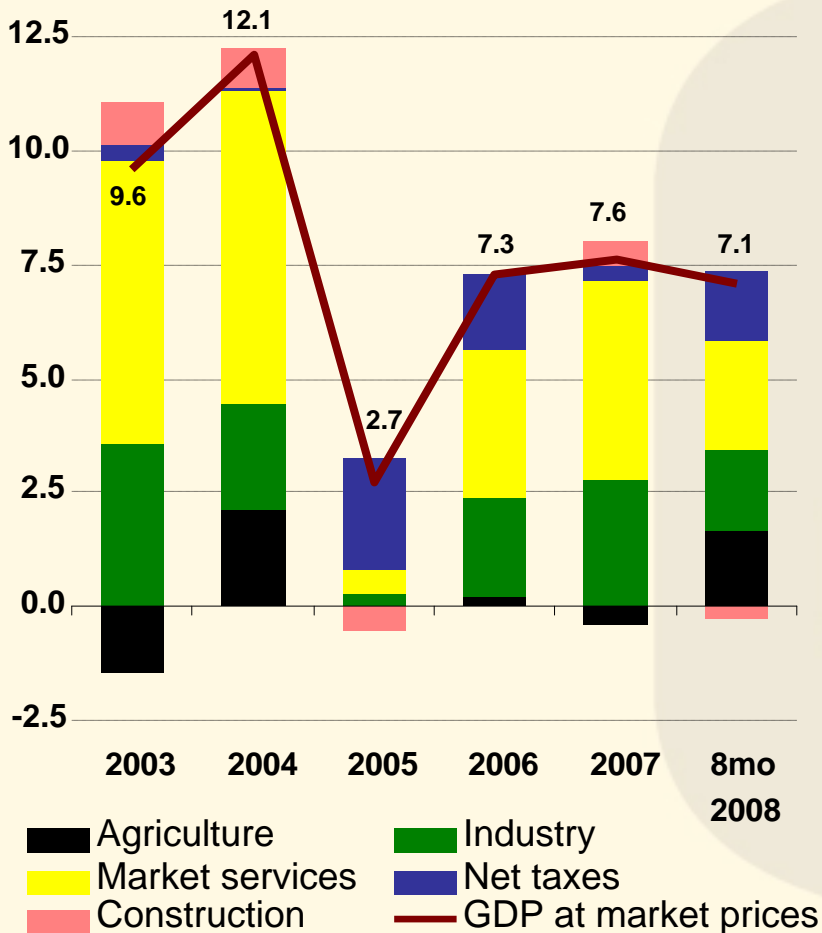


Source: State Statistics Committee, The Bleyzer Foundation

- **On the demand side**, in the first half 2008 GDP growth was supported by high domestic **consumption** and **investment** growth of about 15% yoy.
- Over this period, domestic **consumption** was sustained by a 15% yoy increase in real disposable income, 9% yoy real increase in wages, and 30% yoy real increase in credits (65% yoy nominal).
- Growth of **investments** was encouraged by the growing profitability of firms (48% yoy in real terms due to higher exports and domestic trade) and by strong foreign currency inflows (FDIs and debt), which compensated for tighter domestic liquidity.

# Economic Growth – Supply Side

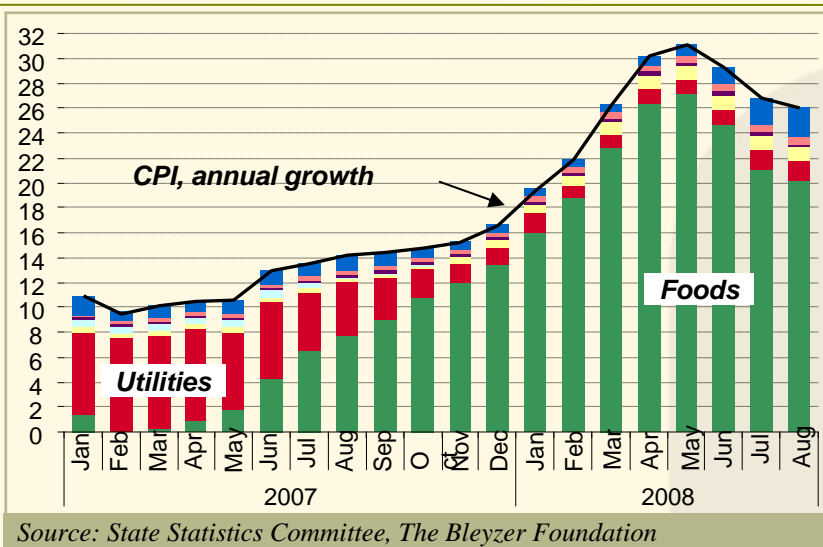
GDP growth by Sectors, percentage points



Source: State Statistics Committee, The Bleyzer Foundation

- **On the supply side**, in 2008 **agriculture** has been the growth engine (24.4% yoy), harvesting 42 million tons of grains, a 15-year record. This large harvest is due to favorable weather and larger investments in the sector.
- Weak growth in **construction** (- 5.3% yoy this year is due tight economic policies (to control inflation)
- Average growth of **industry** (6.3% yoy) was due to growing production costs (more expensive energy, raw materials, labor, and transportation).
- Real GDP is forecasted to grow by 6.3% in 2008 and about 5% in 2009.

# Macroeconomic Performance - Inflation

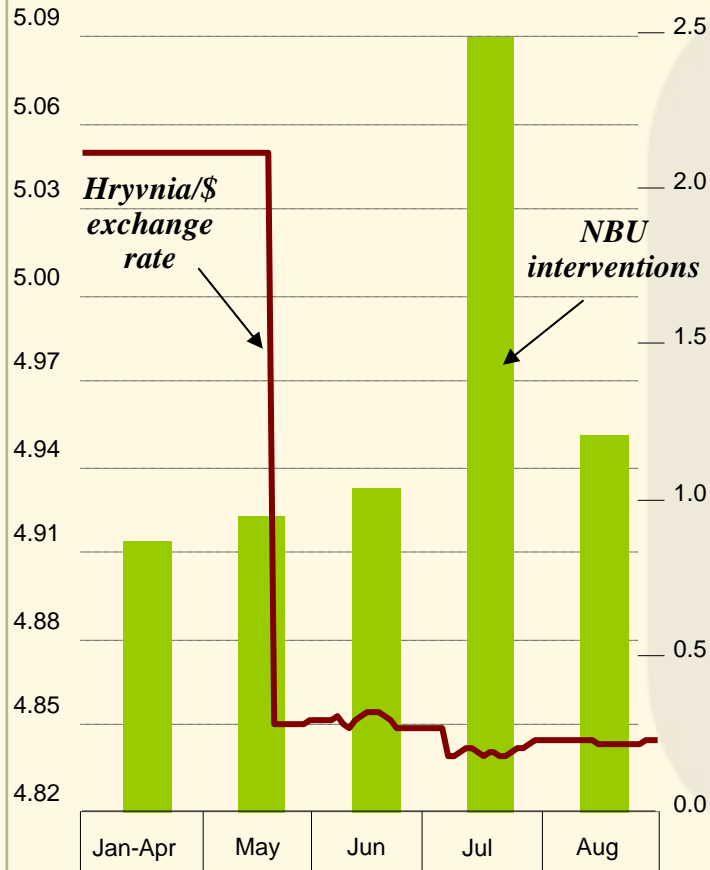


- Inflation reached 17% in 2007, surging to 31% yoy by May 2008, because of increases in aggregate demand and high food prices (due to poor weather).
- After June, there has been deflation, due to a good harvest and lower food prices.
- By August, yoy inflation was 26%

- Though **fiscal deficits** were maintained low at about 1% during the last three years, budget expenditures grew by 20% per annum in real terms, increasing inflationary pressures.
- Nevertheless, **exchange rate and monetary policies** were at the core of the inflation problem, with large nominal increases in money supply (about 50% pa) and bank credit (about 70% pa).
- Therefore, inflation was addressed by reducing bank credit growth.

# Addressing Inflation – Monetary Policy

Official UAH/\$ exchange rate (LHS), NBU forex interventions, \$ billion (RHS), 2008



Source: NBU

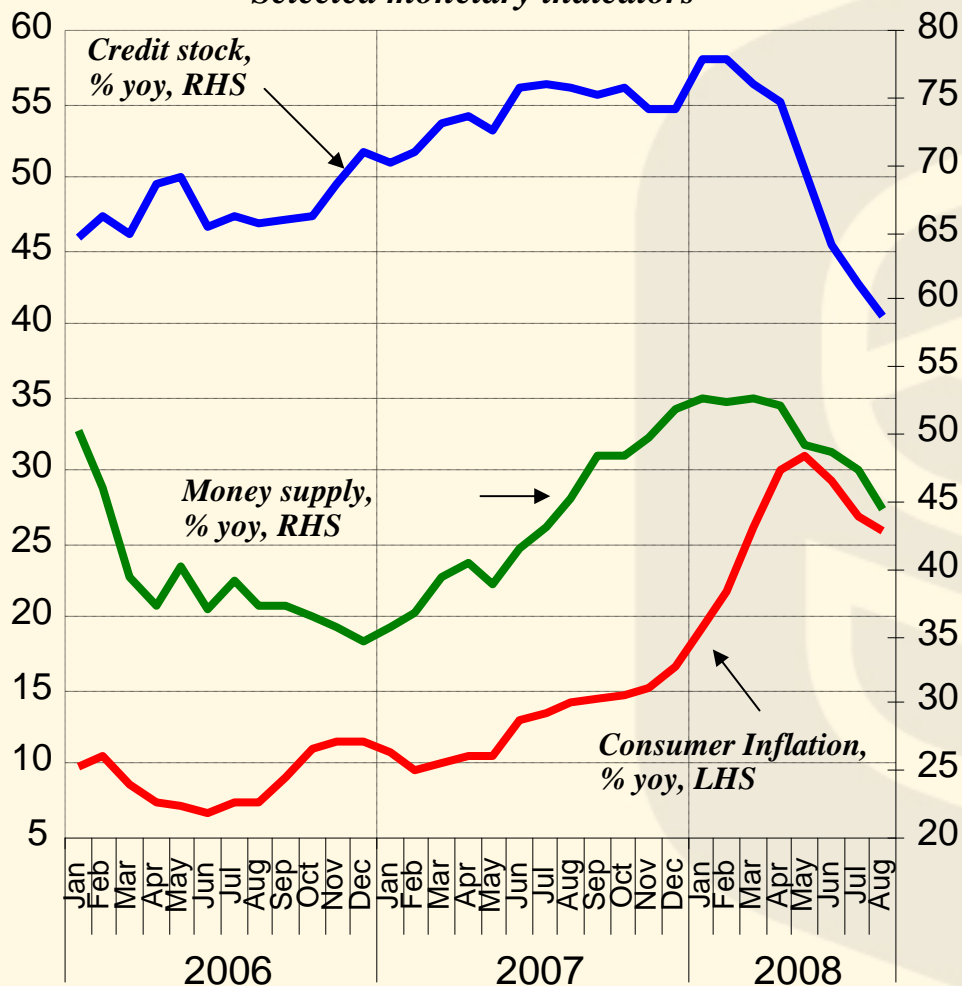
The current anti-inflationary program relies heavily on monetary measures:

- Reducing NBU's forex interventions, which were the major source of money growth, by switching to a managed float.
- Tightening bank reserve & capital adequacy requirements.
- Increasing the NBU discount rate to 12%.
- Carrying out sizable sterilization operations to slow down credit growth.

Although these measures curbed credit growth, they reduced liquidity in the banking sector and may lead to lower GDP growth in 2009.

# First Results of Anti-inflationary Program

*Selected monetary indicators*

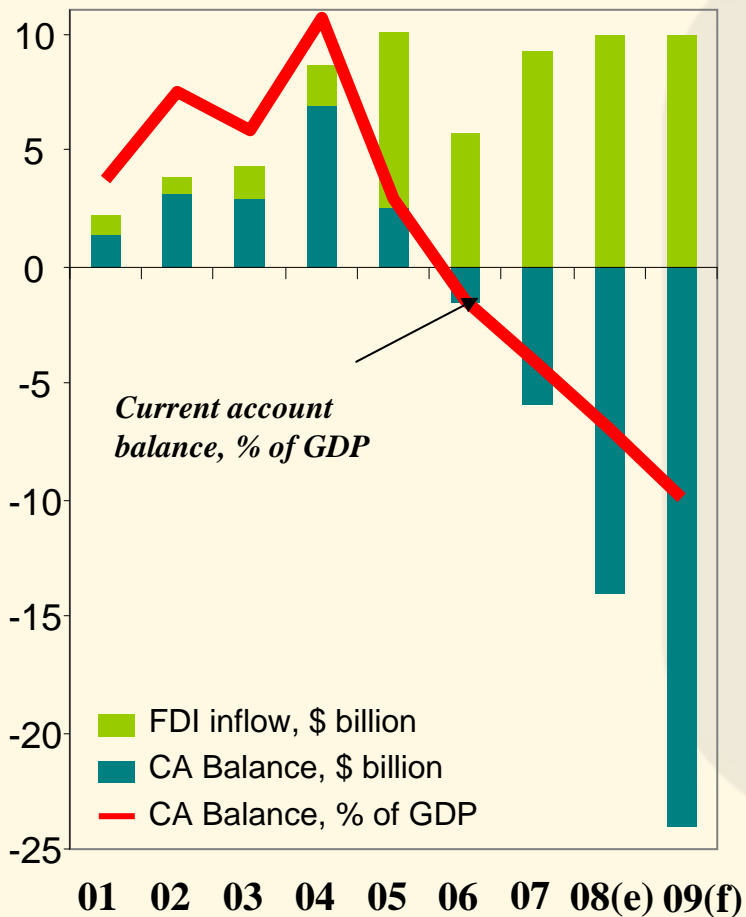


- As of August 2008, these measures reduced money supply to 44% yoy (from 52% yoy in 2007); and credit growth to 59% yoy (from 74% yoy).
- Helped by larger agricultural output, these measures brought annual inflation down to 26% yoy in August from its peak of 31% in May.
- Inflation may be 20% in 2008.
- However, the past high credit expansion may have weakened the banking sector with large non-performing assets (which amounted to 13% in 2007).

Source: NBU

# External Trade

*Current Account Balance and FDI Inflow, \$ billion, and CA Balance, % of GDP*

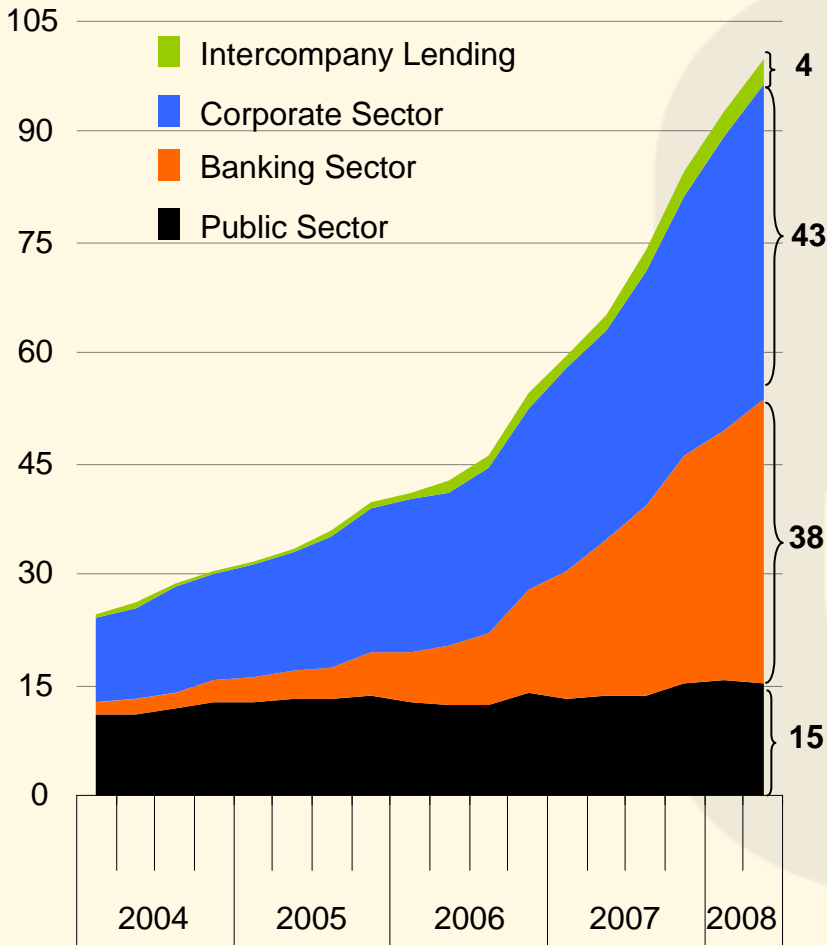


Source: NBU

- Ukraine's exports have performed well increasing by 30% pa in the last two years.
- In Jan-Jul 2008, exports of goods reached an all-time record growth of 47% yoy.
- However, imports grew even faster at 57% yoy over Jan-Jul, due mainly to rising raw materials and energy prices.
- The CA gap has continued to widen, and may reach \$14 billion in 2008 (7% of GDP).
- Robust FDI inflow (\$10 billion in 2008) and debt inflow will finance this gap, and have allowed int. reserves to reach \$38 billion.
- In 2009, due to higher gas prices and likely lower metal prices, Ukraine's CA deficit may increase to \$24 billion (10% of GDP).
- Given international liquidity problems, this deficit may be more difficult to finance.

# External Debt Burden

Gross External Debt, by Sectors, \$ Billion

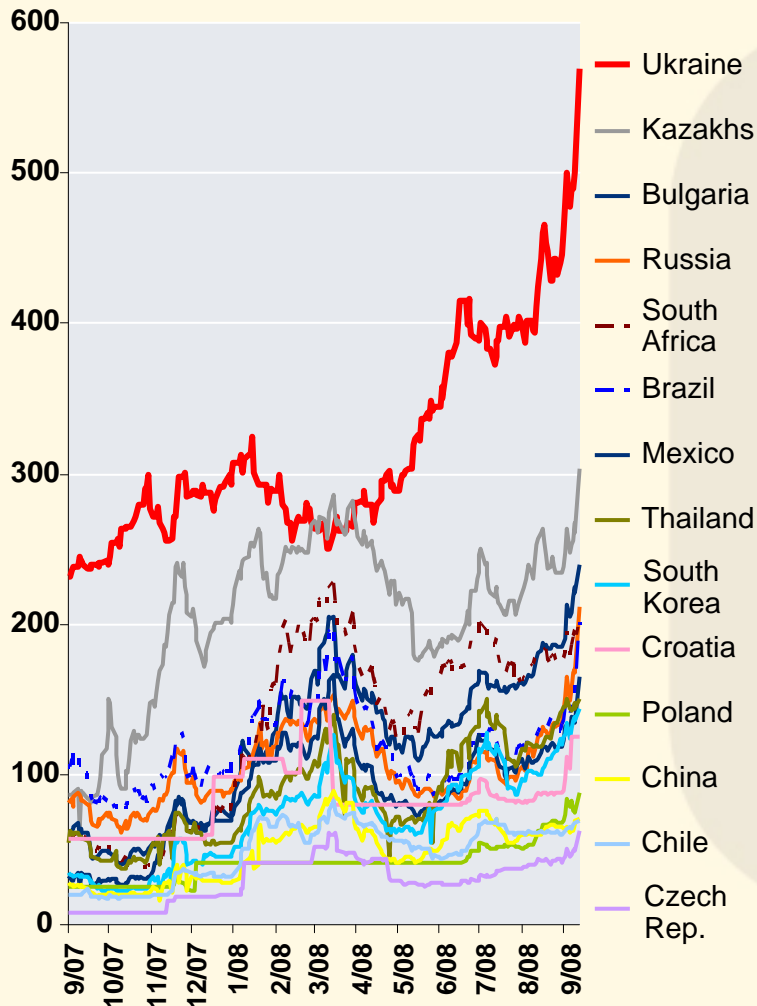


Source: National Bank of Ukraine

- Since 2007 total external debt doubled to \$100 billion.
- External private debt grew to \$85 billion, \$29 billion of which is short-term (classified by original maturity).
- Including short maturities of LT debt, short term debt could be \$40 billion.
- Ukraine's total external debt is now above the median value of countries in similar credit rating categories:
  - At **60%** of GDP, Ukraine's external debt/GDP is above the **40%** median value of similarly rated countries.
  - At **120%** of current account receipts, its ratio of external debt/CA receipts is also above the **84%** median value for similar countries.

# External Financing Requirements

*Credit Default Swaps spreads*



SOURCE: Bloomberg

- Adding the \$14 billion needed for the CA gap to short term debt of \$40 billion, the size of external financing for 2009 would be \$54 bn.
- A portion of this debt (about \$24 billion) is due by subsidiaries to parent companies or represents more stable trade credits.
- Under normal circumstances the gap of \$30 billion would be manageable.
- But if global liquidity continues tight, Ukraine may face refinancing difficulties.
- Already the international markets has shown its concerns with large CDS premiums.
- Although Ukraine may be able to soft-land (with FX rate flexibility, moderate devaluation and tighter monetary policies), the risk of a crises in 2009 is now greater, with a possible major devaluation.

10

# Medium Term Prospects

- Although the combination of larger current account deficits, large short term repayments and tight international liquidity may lead to a financial crisis in the next 12 months, over the medium term, Ukraine's economic outlook is still bright.
- In the medium term, Ukraine should enjoy higher growth in productivity and GDP, and therefore higher asset prices for the following reasons:
  - The recent membership into the WTO should stimulate exports.
  - A FTA under negotiations with the EU would further encourage exports and foreign direct investments (FDI).
  - FDI will also be supported by an abundant and educated labor supply at wages that are one-third of those in Eastern Europe.
  - Ukraine large population of 46 million people is an attractive market.
  - Ukraine agricultural potential is quite high and could become one of the world's largest grain exporters.
  - Ukraine's infrastructure is reasonable as compared to other countries in the region.

# Recent Political Developments

- The Constitution reform of 2004 was deficient in that it established overlapping responsibilities between the President and the PM.
- On September 2-5, 2008 the Rada approved a number of laws, which further restricted the power of the President.
- The voting was successful due to the union of the Prime Minister Tymoshenko's Bloc (BYT) and opposing Party of Regions (PR).
- Thereafter, the President's Our Ukraine party dissolved the ruling coalition.
- Political parties have now until October 16<sup>th</sup> to form a new coalition.
- Otherwise, the President may call for new early parliamentary elections.
- Although this situation has created uncertainties, it may provide an opportunity to correct the deficiencies of 2004, which have been at the core of all political problems since then.
- Regardless of the end results, a fundamental consensus exists between the major political parties on Ukraine's path towards a market economy, including entering a FTA with the EU, strengthening relations the West, and land reform.
- Although political difficulties have slowed down reforms, there is general willingness to improve the investment climate of the country.
- Nevertheless, major economic reforms may have to wait until after the 2010 presidential election.