

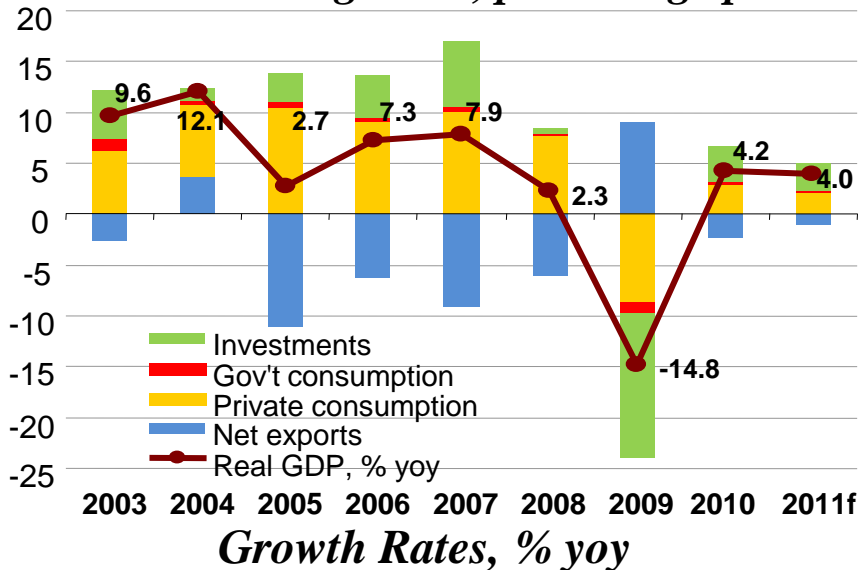
Ukraine: Economic Prospects for 2011-12

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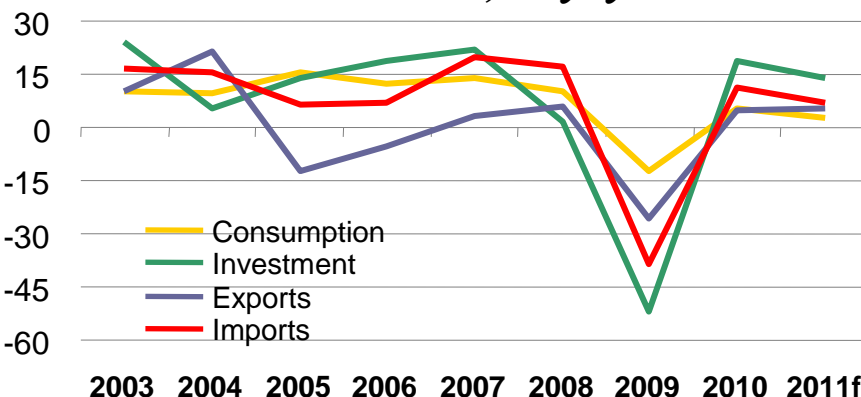
March 2011

Ukraine: Main Economic Features of 2003-10

Real GDP Growth by Demand Side, contribution to growth, percentage points



- **In 2010**, the Ukrainian economy recovered very well from the 2009 deep recession.
- As was the case in 2003-2008, since early 2010, the strongest contributor to growth was **domestic consumption**, followed by **inventory re-building**.
- During 2010, **exports** grew fast but **imports** also accelerated, increasing the CA deficit.
- Real GDP grew by 4.2% yoy in 2010.
- **In 2011-12**, real GDP is forecast to grow at somewhat lower rates, since the current sources of growth are likely to weaken.



Sources: State Statistics Committee, The Bleyzer Foundation

Main Macroeconomic Indicators: 2003-2010

	2003-05 average	2006	2007	2008	2009	2010
Real GDP Growth, % yoy	8.1	7.3	7.9	2.3	-14.8	4.2
Fiscal Balance, % GDP*	-1.7	-0.7	-1.5	-2.0	-8.8	-6.5
Consumer Inflation, %, eop	10.3	11.6	16.6	22.3	12.3	9.1
UAH/\$ Exchange Rate, eop	5.2	5.05	5.05	7.7	8.0	8.0
Current Account, % GDP	6.4	-1.5	-3.7	-7.0	-1.5	-1.9
Gross Int. Reserves, \$ bn	12.0	22.4	32.5	31.5	26.5	34.6
Foreign Gov't Debt, % GDP	17.7	11.0	8.7	9.2	20.5	23.8
Foreign Private Debt, % GDP	29.2	39.6	47.4	47.1	68.1	62.1

* Includes implicit pension fund deficit (credits from unified Treasury account (state budget) to cover pension fund expenditures) for 2007-2008 and Pension Fund and Naftogaz imbalances since 2009, excluding bank recapitalization and VAT bonds

Factors Affecting Economic Growth in 2011-12

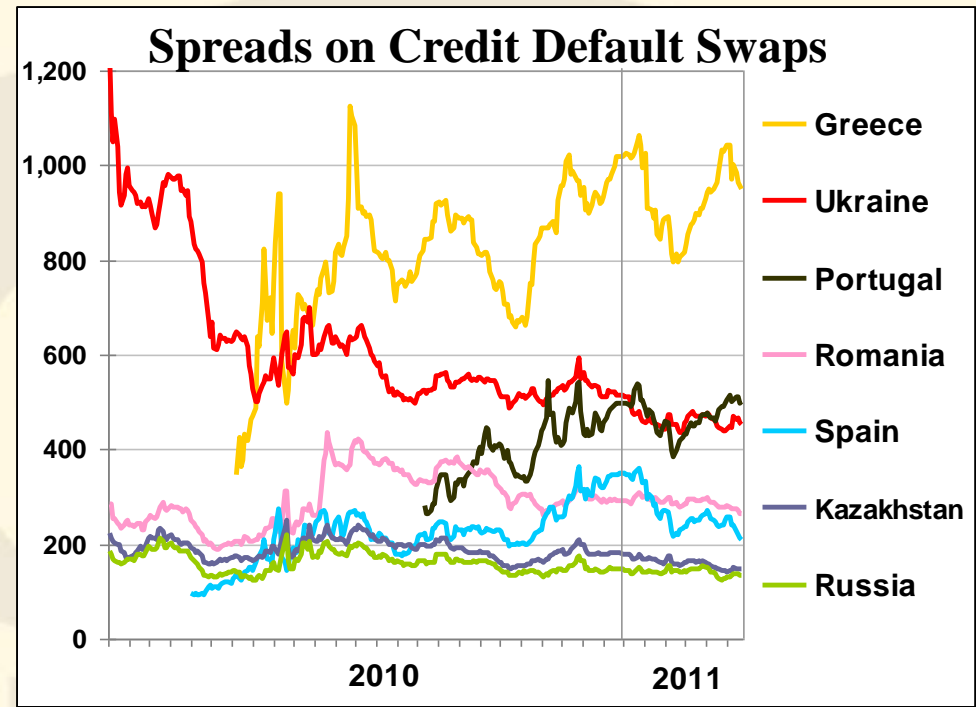
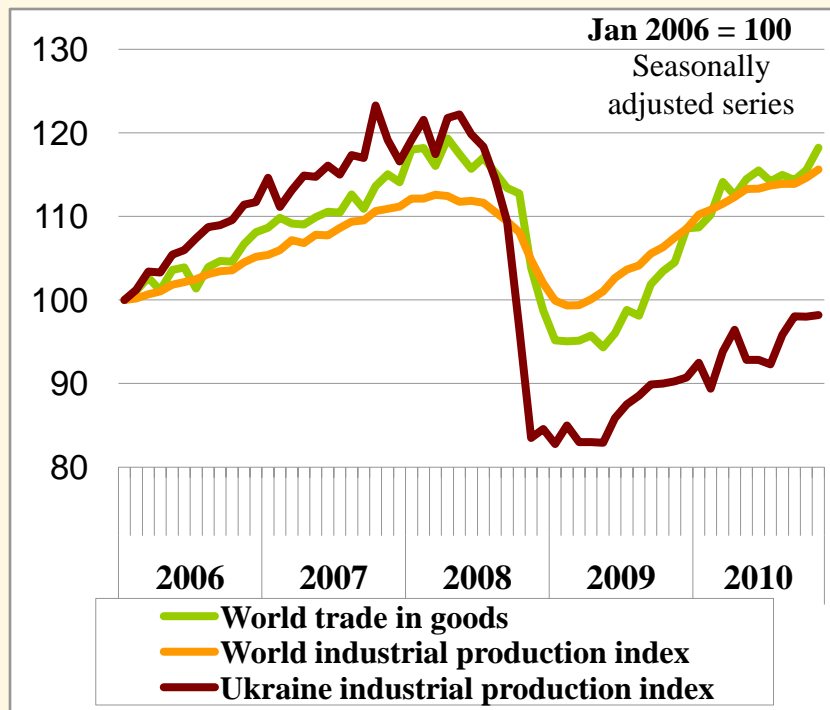
External Environment:

1. The pace of economic growth in Ukraine's main trading partners
2. Export prospects and commodity prices (steel, fertilizers and agricultural products)
3. Ability of Ukraine to service its large foreign debt
4. Exchange rates and international competitiveness

Domestic Factors:

5. Adequacy of Economic Stabilization: Fiscal & Monetary Policies
6. Banking Sector Health and Availability of Banking Credit
7. Growth of Domestic Demand: Consumption, Investments, Government Expenditures
8. Economic Reforms Progress and Business Environment

Factor 1. Global Economic Growth in 2010

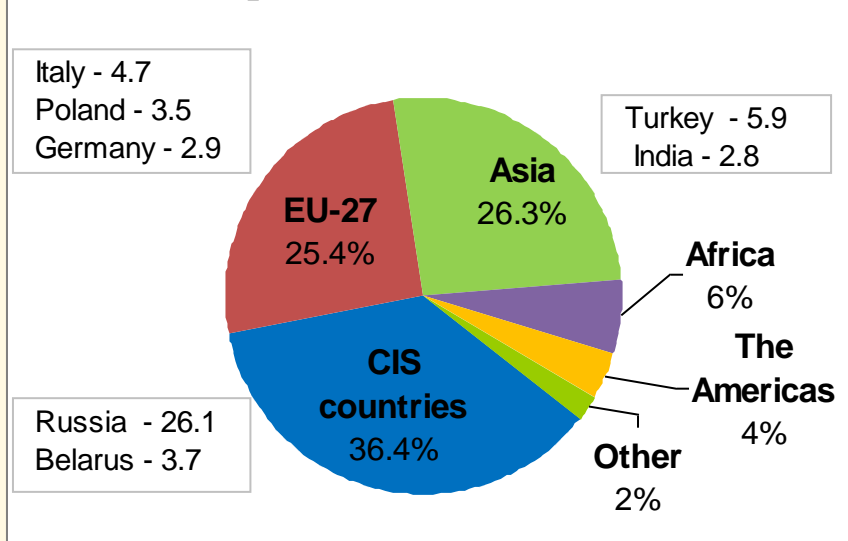


Source: CPB Netherlands Bureau for Economic Policy Analysis, Bloomberg, The Bleyzer Foundation

- During 2010, the world economy and trade expanded faster than expected.
- The speed of recovery was uneven across regions -- 7.1% in EMs and about 3% in advanced economies.
- Investors' appetite for emerging market assets improved, helping to re-open foreign capital markets for EMs.

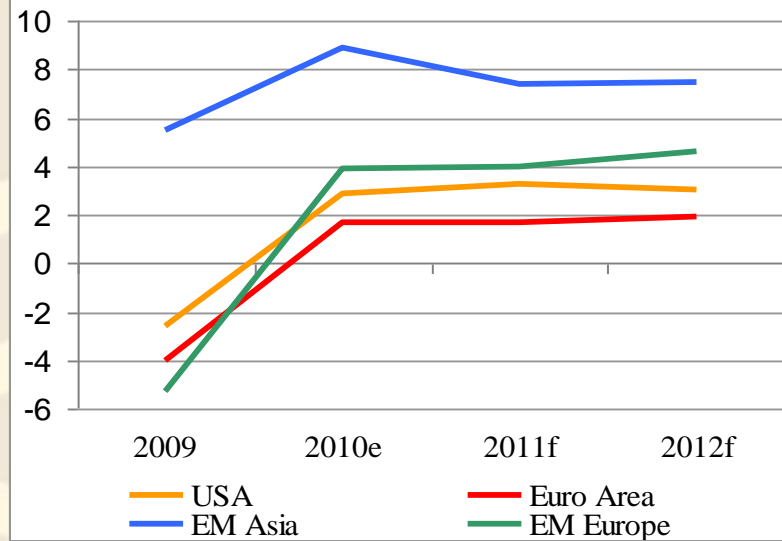
Factor 1. Global Economic Growth in 2011-12

Main Export Markets of Ukraine, 2010



Source: SSC

Real GDP Growth, % yoy



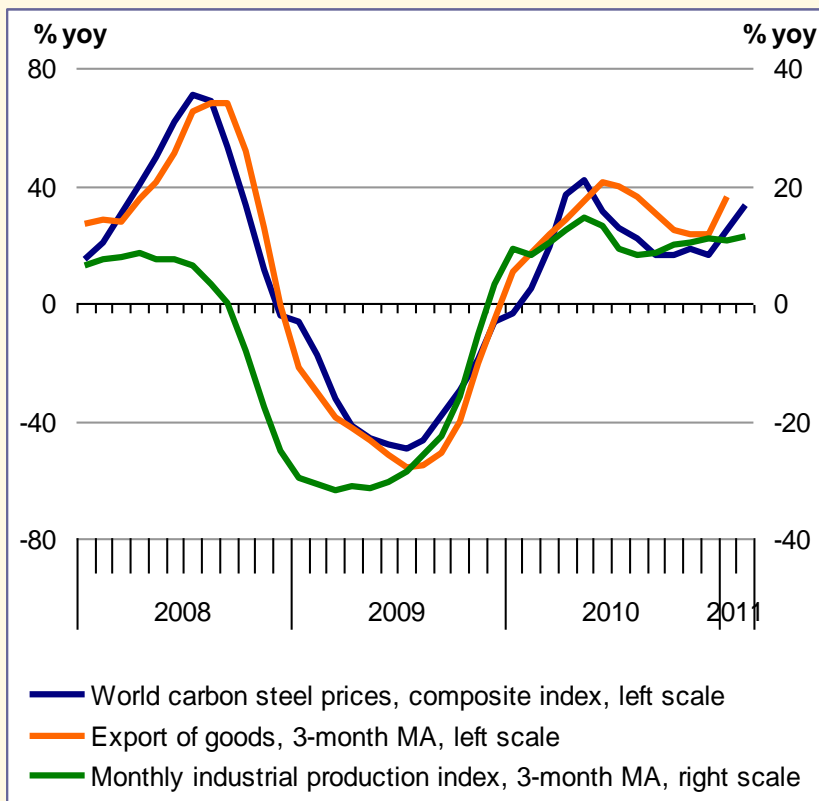
Source: JP Morgan

- Recovery in **developed countries** will continue, but will differ across countries.
- **In the US**, QE-II and tax cuts extension should boost GDP growth to ~3.5% in 2011.
- **In the Euroarea**, GDP growth in 2011 (at 1.7%) will be constrained by sovereign debt problems and fiscal austerity measures in most countries.
- Portugal will require access to EFSF in 2011, but contagion should be contained.
- Eurozone growth will be led by Germany (2.2%), followed by France (1.2%) and Italy (1.0%). Growth will be negative on the periphery.
- Growth of developed countries in 2012 should follow similar trends as in 2011.

Factor 1: Global Economic Growth in 2011-12

- The outlook for **Emerging Countries** for 2011-12 is positive.
- Growth will be supported by strong capital inflows and domestic consumption.
- But due to policy tightening, average GDP growth is forecast at moderate to ~6%.
- Recovery in **CIS countries** should be on track.
 - Due to severe drought, Russia underperformed in 2010, expanding by 4% yoy, and is forecast to grow by ~ 4.5% yoy in 2011.
 - Kazakhstan is also expected to do well, with GDP growth of 5% in 2011.
- **Emerging EU countries** are likely to continue growing at solid paces:
 - The growth in Poland (4.0%) may accelerate backed by Euro-2012 investments.
 - Bulgaria and Romania will start recovering (at 3.0% and 1.5%, resp).
- **Turkey**, another Ukrainian market, will grow robustly at 4.5%, backed by strong domestic demand.
- **Altogether, the growth outlook for Ukraine's main trading partner countries is favorable, which should support Ukraine's exports.**

Factor 2. Export Prospects & Commodity Prices

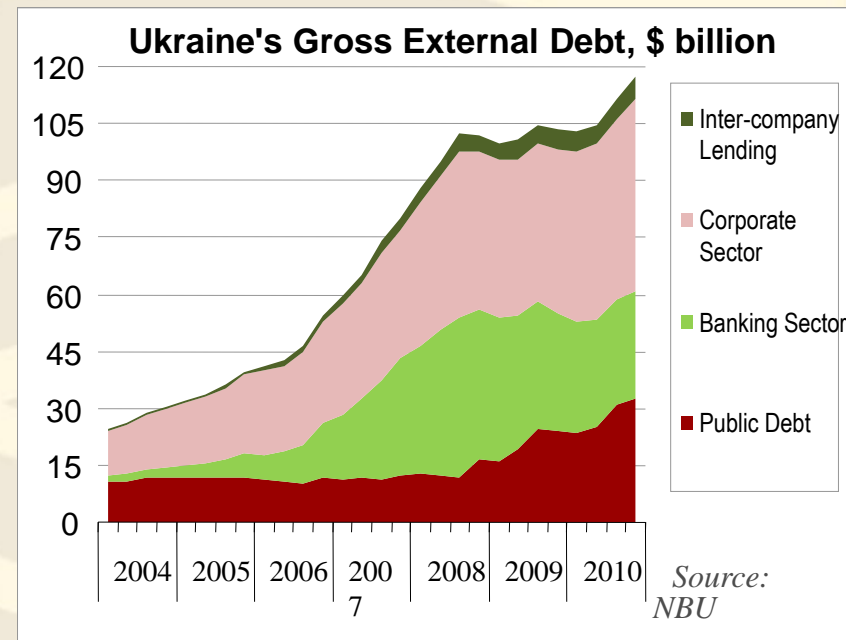


Source: State Statistics Committee, NBU, MEPS, TBF

- Ukraine is an open ec. (exports 50% GDP).
 - Ukraine's exports and industrial output are dependent on international **commodity prices** (steel, fertilizers and agriculture).
 - In 2010, industrial production grew by 11% (metallurgy, 12%; and chemicals, 21.5%).
 - Price forecasts for 2011 vary significantly.
 - We believe that **steel** prices will stay elevated in 2011 due to strong consumption in EMs and higher raw materials costs.
 - Severe droughts in several countries in 2010 will keep **food prices** high and stimulate demand for **fertilizers**.
- In January-February 2011, world steel and fertilizer prices were up by 22% ytd and 2.1% ytd respectively.
- **In sum, commodity prices will support Ukrainian export growth.**

Factor 3. Service of Foreign Debt

- Ukraine is no longer a low-debt country.
- Gross external debt (public & private) stood at \$117 bn at end-2010, or 86% of GDP.
- In 2011-13, external **debt service payments** are projected to stay high at about \$54 billion or 40% of GDP.



Ukraine's External Debt Service Needs

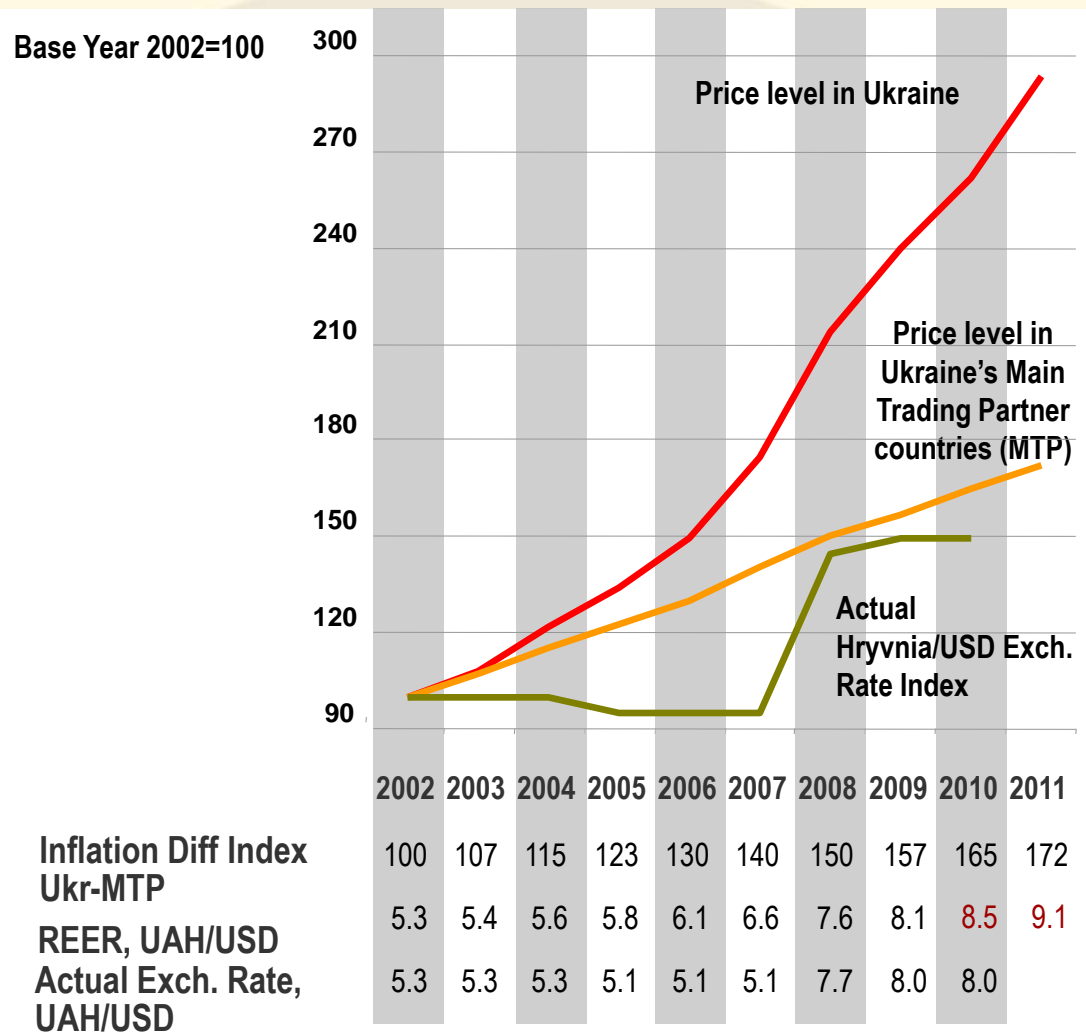
\$ billion	2011	2012	2013	2014
Public Debt	4.8	5.8	8.4	6.3
Central gov't*	4.5	2.6	4.8	3.6
<i>principal</i>	3.6	1.7	4.0	3.0
<i>interest</i>	0.9	0.8	0.8	0.6
NBU**	0.3	3.2	3.7	2.7
Private Debt	49.9	47.4	45.3	43.1
<i>principal</i> #	42.3	40.0	38.0	36.0
<i>interest</i> ###	7.6	7.4	7.3	7.1
Total Needs	54.7	53.2	53.7	49.4

* excl. new borrowings; ** NBU debt service payments to IMF, incl. new borrowings; # estimate since 2012; ## estimate
Source: MinFin, NBU, IMF Country report on Ukraine, TBF

- To remain current on debt service, Ukraine will require high debt rollovers, FDIs, IMF funds, and new public debt.
- **The continuation of the IMF program will remain key to maintain foreign investors confidence and allow Ukraine to serve its foreign debts.**

Factor 4. Exchange Rates and Competitiveness

- In the crisis, the devaluation of the Hryvnia allowed Ukraine to regain competitiveness lost in the 2000s.
- By 2009-10, the real effective exchange rate became close to its equilibrium level.
- In 2011-12, some competitiveness may be lost as inflation in Ukraine remains higher than in its main trading partners.
- But the NBU declared a policy of gradual transition to more flexible exchange rate regime.
- If this is so, the Hryvnia exchange rate may be allowed to adjust to maintain competitiveness.



Factor 4. Exchange Rates and Competitiveness

- Despite greater competitiveness, the **current account deficit of the BOP** is forecast to widen to 2.8% of GDP in 2011, up from 1.9% of GDP in 2010.
- This is because **imports** are likely to grow faster than exports given further recovery of domestic consumption (though at a slower pace), strong investment demand and growing energy prices.
- In addition, **high external debt service payments** will exert pressure on the **Hryvnia exchange rate**.
- But the combination of IMF financing, high external debt roll-over ratio (109% in 2010) and higher FDIIs (related to Euro-2012) will soften these pressures.
- Nevertheless, the growing Inflation Differentials with trading partners also indicates the possibility of some further Hryvnia devaluation.
- Hence, the **Hryvnia** is forecast to depreciate slightly to the range of UAH 8.0-8.5 per USD during 2011 and to UAH 8.5-9.0 per USD in 2012
- Altogether, **Ukraine's competitiveness should be a favorable factor for Ukraine's growth in the next two years.**

Factor 5. Domestic Policies – 5a. Fiscal Policy

- In 2010, the government met its “broad” fiscal budget deficit target of 6.5% of GDP (of which state budget deficit - 4.2% and Naftogaz & pension deficits - 2.3%.)
- That was achieved principally by reductions in public expenditures.
- For 2011, the government has agreed with the IMF to reduce its “broad” fiscal deficit to 3.5% of GDP in 2011.

Ukraine's Public Finances

UAH billion	2008	2009	2010	2011f
State budget deficit	12.5	35.5	45.8	37.0
Naftogaz imbalances	--	24.4	15.0	8.5
"Extra" Pension Fund deficit	3.6	16.0	7.9	--
Other	2.4	4.3	2.4	--
Broad budget deficit	18.5	80.2	71.1	45.5
% of GDP	2.0	8.8	6.5	3.5
VAT bonds			16.4	--
Bank recapitalization	13.8	23.3	6.4	15-20
Total fiscal deficit	32.3	103.5	93.9	60-66
% of GDP	3.4	11.3	8.6	4.7-5.1

Source: MinFin, Draft Letter of Intent to IMF, TBF

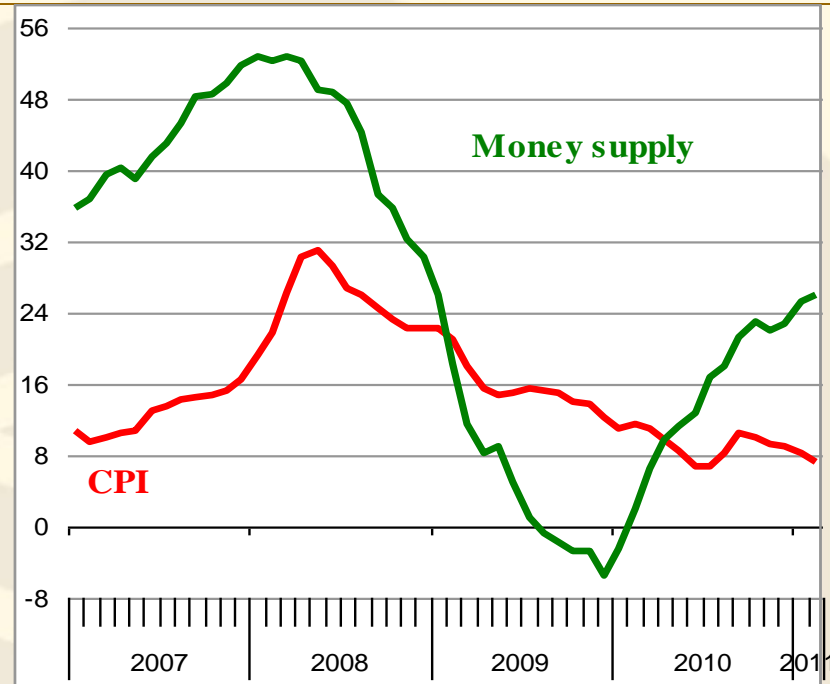
- To meet the budget deficit target, the government indicated that it will:
 - contain social spending (cost-of-living adjustment of public sector wages);
 - continue raising natural gas tariffs to population in 2011;
 - ensure faster pass-through of higher energy prices on final consumers;
 - initiate pension reform and deepen public administration reform.

Factor 5a. Fiscal Policy (cont.)

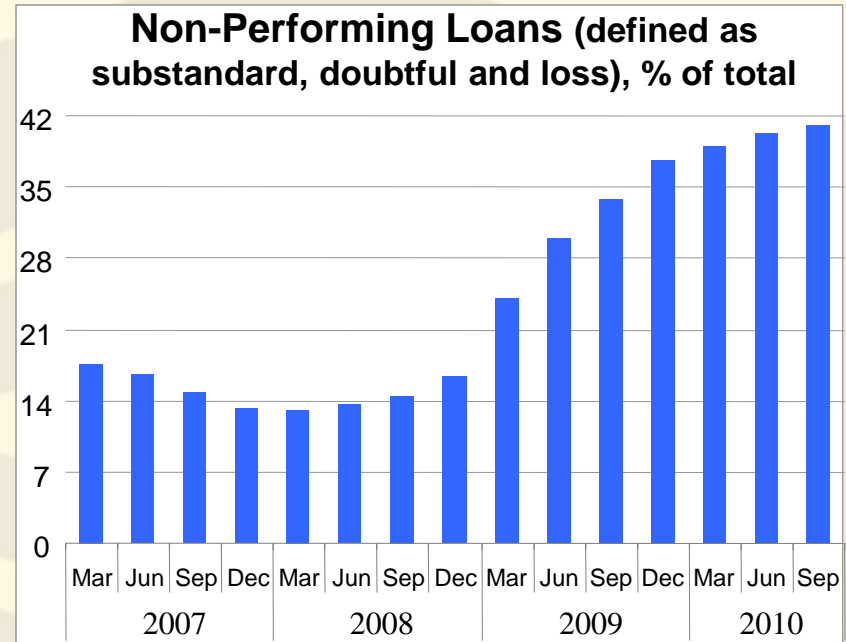
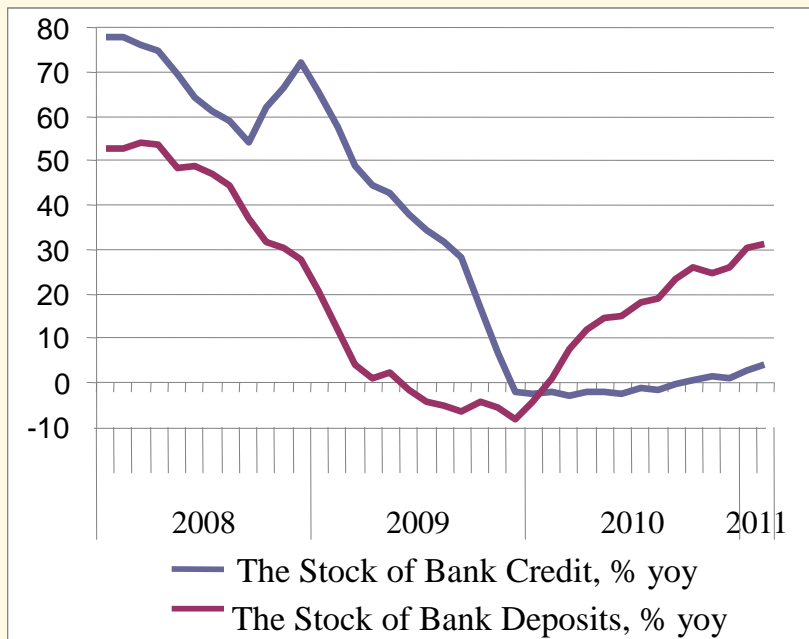
- However, fiscal budget execution in 2011 will be challenging.
- Many fiscal consolidation measures are politically painful, which has already caused delays in their implementation.
 - Pension reform is still pending.
 - Natural gas tariffs will be raised more gradually than initially projected.
 - There are no details on further public administration reform measures.
 - The desired de-shadowing of GDP by the new Tax Code may not be realized due to difficulties in implementation.
- Given difficulties with Naftogaz tariff increases, Ukraine requested the IMF to permit a Naftogaz deficit 0.7% of GDP (above from previous 0.4% of GDP).
- Although the 3.5% fiscal deficit will be maintained, the measures to compensate for the higher Naftogaz deficit were not clear.
- The IMF was generally positive about Ukraine's progress with the program but the mission left without reaching staff level agreement on the 2nd review.
- The main reason for it was the absence of required additional fiscal measures.
- **While some delays are possible, we believe IMF program should continue.**

Factor 5b. Monetary Policy and Inflation

- In 2010, money supply (MS) growth recovered strongly (+23% yoy).
- But, year-end inflation was only 9.1% yoy.
- In 2011, MS kept growing fast (+26% yoy in February 2011).
- But inflation declined to ~ 7% yoy, mainly due to tight administrative price measures.
- But we believe inflation will accelerate to ~ 12% in 2011.
- This acceleration may be prompted by:
 - adjustment of utility tariffs;
 - higher excise taxes (on gasoline, alcohol, tobacco);
 - high international food and energy prices;
 - loose monetary policy and still high fiscal deficit.
 - In addition, administrative measures work only in ST as they create market distortions.
- **Nevertheless, stabilization is satisfactory and a positive factor for growth.**



Factor 6. The Banking Sector and Credit



Source: State Statistics Committee, NBU, IMF, TBF

- In 2010, the NBU made good progress in stabilizing the banking sector.
- Bank deposits grew by 26.3% yoy in 2010 and 31% yoy in Jan-Feb 2011.
- But credit growth was still weaker: 1% yoy in 2010 and 4% yoy in Jan-Feb 2011.
- The NBU is taking some steps to stimulate credit activity (i.e., in 2010 the NBU discount rate was reduced from 10.25% pa to 7.75% pa).

Factor 6. The Banking Sector and Credit

- However, high Non-Performing Loans (about 40% of Loans in 2010, including substandard, doubtful and loss loans) is undermining bank lending and profits.
- Further efforts to improve the situation with high level of NPLs have been taken:
 - the NBU has drafted legislation to simplify resolution of NPLs, including changes in the areas of bankruptcy law and security of collateral;
 - Amendments to the Law on Enforcement Proceeding, favoring banks, were enforced in March.
- **In 2011, financial sector policies** are concentrated in:
 - additional capitalization of three state-intervened banks (including through their sale to private investors);
 - resolution of Nadra bank with public funds;
 - strengthening bank regulation and supervision:
 - commercial banks transition towards IFRS;
 - enforcement, improvement of banks' risk management practices;
 - full enforcement of new minimum capital requirements – UAH 120 million (\$15 million) by end-2011. This should prompt bank consolidation in 2011.
- **Insufficient use of domestic credit will be a negative factor for growth in 2011.**

Factor 7. Pace of Recovery of Domestic Demand

- **In 2011, Private Consumption** should continue its recovery (amid greater economic and political stability).
- But consumption growth will be weaker in 2011 than in 2010 due to:
 - slower increase in real wages;
 - higher utility costs and excise taxes; and
 - subdued banks' retail credit activity.
- Domestic Demand may be supported by **Fixed Investment**, which is forecast to rebound strongly in 2011 in the run up to Euro 2012 football championship.
- But **Inventory** build-up, which was spectacular in 2010, is likely ease in 2011.
- Given also slow bank credit growth, the overall impact of investment activity on GDP growth may be mixed.
- Committed to the IMF to reduce the fiscal budget deficit to 3.5% of GDP in 2011, the **government** may have to tighten **expenditures**, which may affect growth.
- **Altogether, Domestic Demand Growth is a mixed factor to support growth.**

Factor 8. Economic Reform Progress

- Reform efforts, launched during 2010, were expected to continue in 2011.
- But their implementation is still uncertain.
- The new **Tax Code** was heavily criticized for containing the potential to increase administrative pressure on business.
- **Public administration** reform is currently limited to government downsize. The details of further steps (to increase government effectiveness) are not available.
- **Pension reform** is delayed.
- The new **anti-corruption** law is pending final approval in Rada. The draft law:
 - widens the list of officials to be controlled for corrupt activities;
 - introduces anti-corruption expertise of draft laws;
 - requests officials to report on their and their direct relatives' expenditures as well as income.
- The latter was a controversial item in the draft, causing delays in approval.
- The law may be approved in the coming months, but its successful will depend strongly on the degree of commitment of top state officials and judiciary reform.
- **Negotiations with the EU** for a FTA is facing difficulties.
- **Altogether, Economic Reform progress is an uncertain factor for growth.**

Prospects for 2011

The balance of all factors indicate economic growth in 2011 will be somewhat weaker than in 2010. Real GDP is forecast to increase by about 4% yoy.

External Environment: Largely Positive

Summary

- | | |
|---|-------------|
| 1. The pace of economic growth in Ukraine's main trading partners | 1. Positive |
| 2. International competitiveness | 2. Positive |
| 3. Prospects for commodity prices | 3. Positive |
| 4. External debt service | 4. Mixed |

Domestic Factors: Largely Mixed/Uncertain

- | | |
|--|--------------|
| 5. Adequacy of macro-stabilization: fiscal & monetary policies | 5. Positive |
| 6. The banking sector and availability of credit | 6. Negative |
| 7. Growth in domestic demand | 7. Mixed |
| 8. Economic reforms and business environment | 8. Uncertain |

Economic Prospects beyond 2011

- 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).
- With continued recovery of the global economy, restoring credit activity and moderate reform progress, the following developments are likely over the medium term:
 - GDP growth ~ 4% per annum;
 - CA deficit ~ 3% of GDP;
 - The fiscal deficit ~ in accordance with the IMF requirements;
 - Foreign capital ~ sufficient to service external debt financing needs;
 - Foreign debt ~ gradual reduction of it as a percentage of GDP;
 - Exchange rate ~ moderately depreciation to compensate for inflation;
 - Inflation rate ~ at single digits after 2011.
- However, to catch-up with developed countries Ukraine should grow above 5% pa.
- For that, Ukraine needs to drastically improve its business climate.
- Comprehensive reforms require strong political will.
- Reform implementation may also weaken in 2012 due to parliamentary elections.
- There is also a high risk of fiscal loosening in 2012, hindering macro stability.

Summary of Scenarios

Indicator	2010	2011			2012		
		Optimistic	Base	Pessimistic	Optimistic	Base	Pessimistic
Real GDP growth, % yoy	4.2	5.0	4.0	3.5	5.0	4.0	2.5
Inflation, % yoy	9.1	10.0	12.0	14.0	7.0	10.0	15.0
Fiscal deficit, % GDP	-6.5	-3.0	-3.5	-4.5	-2.0	-2.5	-5.0
CA balance, % GDP	-1.9	-2.0	-2.8	-3.5	-2.0	-2.5	-4.0
Hryvnia/USD exchange rate	7.96	7.8	8.0-8.5	9.0	8.0	8.5-9.0	10.0

Alternative Scenarios – Optimistic Case

External environment:

- Quick resolution of EU sovereign debt crisis. Portugal still require access EFSF. Germany agrees to increase contributions to EFSF, though conditional on stability pact revamp. This will increase investor confidence and concerns about Spain's debts will decline. The EU as well as the global economy will grow more quickly.
- Strong increase in world commodity prices (some agencies predict 2011 may become the second-highest steel price growth year in modern history).
- Foreign investors' risk appetite will increase. Ukraine will easily service its maturing external debt. Access to foreign capital markets will improve notably. IMF may agree on program extension to Ukraine in 2012 or may start a new program to roll-over the debt.
- Strong foreign capital inflow related to Euro-2012.

Domestic policies:

- The Ukrainian government will strictly follow IMF requirements.
- The authorities will restrain from fiscal softening in the run-up to October 2012 parliamentary elections. This will contain government and social expenditures.
- Ukraine will make substantial progress in structural reforms (sign FTA with the EU and some other countries, comprehensive public administration and pension reforms, strong anti-corruption measures), reaping the opportunity of election-free year.
- Improved business climate, faster restoration of bank credit, strong exports and higher capital inflows will compensate for subdued consumption growth.

Alternative Scenarios – Pessimistic Case

External environment:

- Aggravation of EU sovereign debt crisis. Portugal and Spain require access to EFSF. Belgium comes into recession due to protracted political crisis. Greece and likely Portugal may request debt restructuring. With high German banks exposure to these countries, the country and the EU will go into recession again.
- Unrest on global financial markets, high risk-aversion among investors, restricted market access.
- Lower world economic growth, decline in commodity prices.
- Ukraine will find it very difficult to service its external debt.

Domestic policies:

- Due to political reasons, the attention of politicians is focused on the process of amending the Constitution and election laws; thereby, economic reforms are delayed.
- Authoritarian measures reduce the independence of the judiciary and central bank.
- Deterioration of international relations with the EU and the US.
- Pre-election fiscal loosening and failure to carry out reforms put IMF program off-track.
- Ukraine hosts Euro-2012 but economic benefits are low.
- While higher budget expenditures may stimulate faster consumption growth, higher imports, low investments, high external debt and low capital inflows exert drag on growth.
- At the end of 2012-2013, Ukraine may face another crisis.