

Ukraine

Economic and Financial Situation

Dr. Edilberto Segura
Partner & Chief Economist
SigmaBleyzer/The Bleyzer Foundation
September 2009

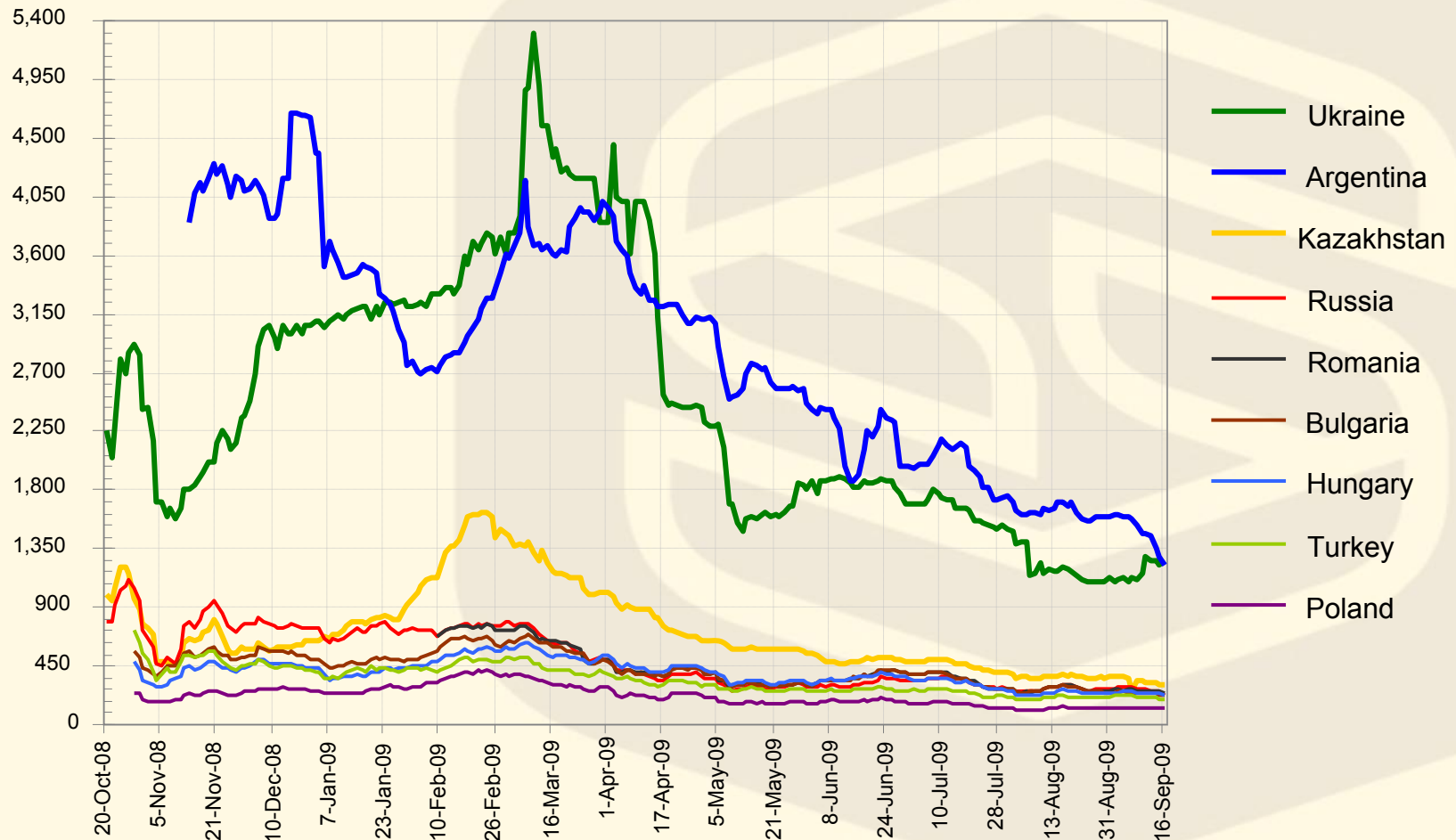
v13

Outline

- I. Evolution of Credit Default Swap Spreads
- II. Macroeconomic Performance Before the Crisis
- III. Impact of the Crisis in 2009: The Real Sector
 - 1. Export Performance
 - 2. Domestic Demand Performance
 - 3. Economic Performance by Sectors
 - 4. Industrial Performance, by Sub-sectors
 - 5. Agricultural Performance
 - 6. Real Sector Prospects
- IV. Fiscal Budget Policies
- V. Monetary Policies and Inflation
- VI. Ukraine's Vulnerabilities to the Crisis
 - 1. Rapidly Widening Current Account (CA) Deficits
 - 2. Large External Debt Burden
 - 3. Banking Sector Weaknesses
- VII. Foreign Exchange Performance and Forecast
- VIII. Medium Term Prospects
- IX. Current Political Situation
- X. Key Statistics

I. Credit-Default Swaps (CDS) Spreads

- Following the disbursement of the IMF second tranche in April/May 2009, the spreads on CDS for Ukraine have declined. But they are still high.

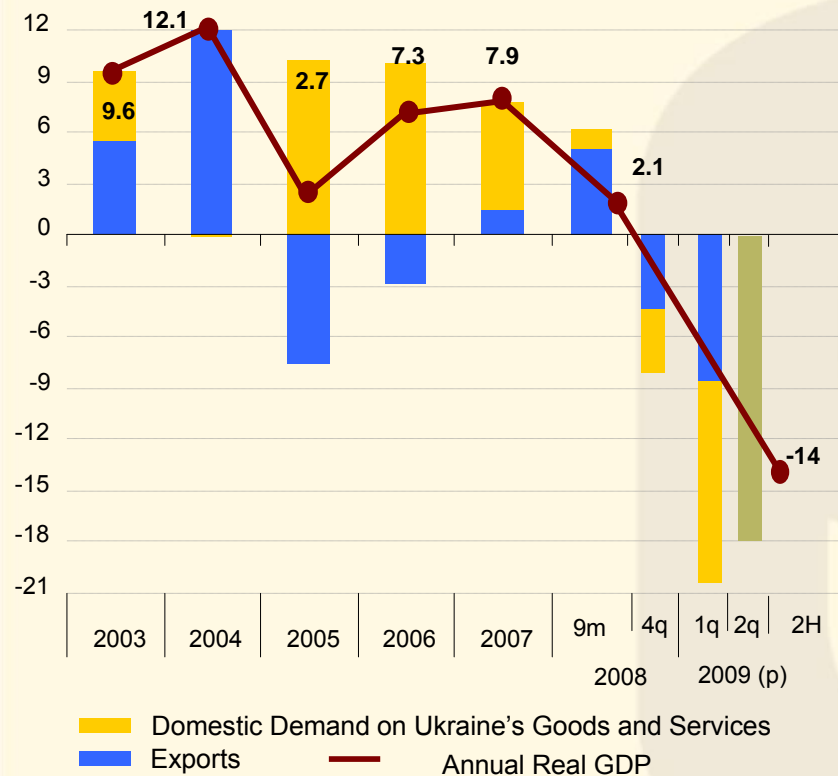


II. Macroeconomic Performance Before the Crisis

- **From 2000-Sept 2008**, Ukraine enjoyed good economic results:
 - Real GDP grew by 7.5% pa on average
 - The fiscal budgets had low deficits
 - Public external debt was declining
 - Exports grew fast (by about 30% pa in 2003-Sept.2008)
 - Although the Current Account became a deficit in 2005, (due to large imports) it was fully covered by capital inflows
 - International reserves were growing and reached \$37 bn as of September 2008
 - Inflation persisted in double digits and accelerated in 2008, but it was on a descending trend since May-2008.
- **But this good performance finished in October 2008**, when the global crisis hit Ukraine harder than other EMs.

III. Impact of the Crisis in 2009: The Real Sector

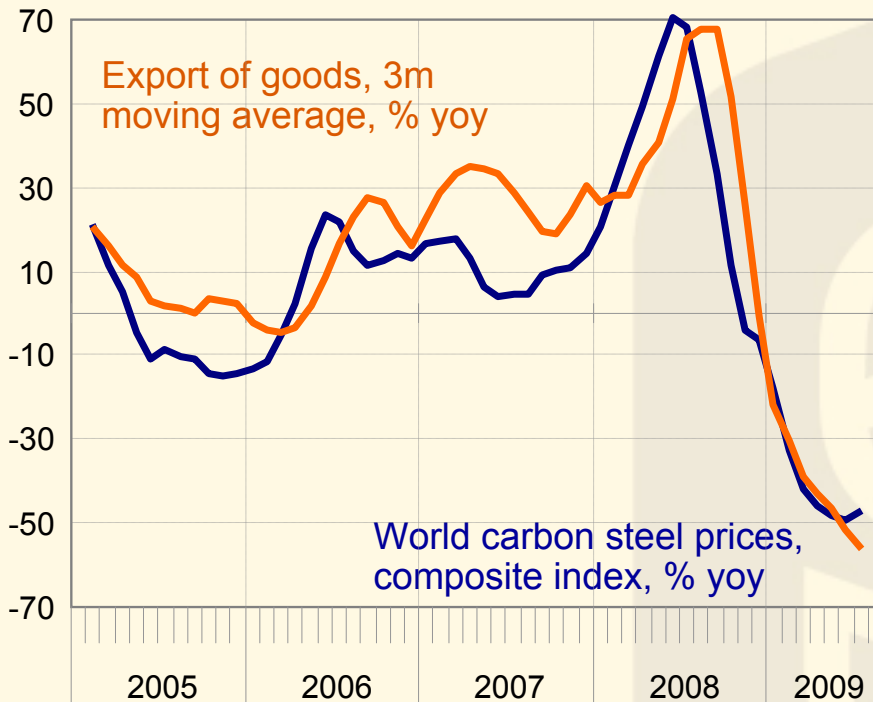
Real GDP Growth, % yoy, and Demand Component Contributions to Growth, ppt



Source: State Statistics Committee, The Bleyzer Foundation

- During 2003-Sept.2008, economic growth was driven initially by strong **exports** and later by booming **domestic demand** for local goods & services (C + I + G - M).
- Since Sept 2008, **exports** (which account for 50% of GDP) fell drastically due to lower commodity prices and weak external demand.
- **Domestic demand** deteriorated due to the Hryvnia depreciation, decreasing wages, rising unemployment and stalled credit.
- Real GDP contracted by about 19% yoy in 1H 2009. However, already in 2Q 2009 the economy had shown signs of improvement. GDP is expected to decline by about 14% during 2009.

1. Exports Performance



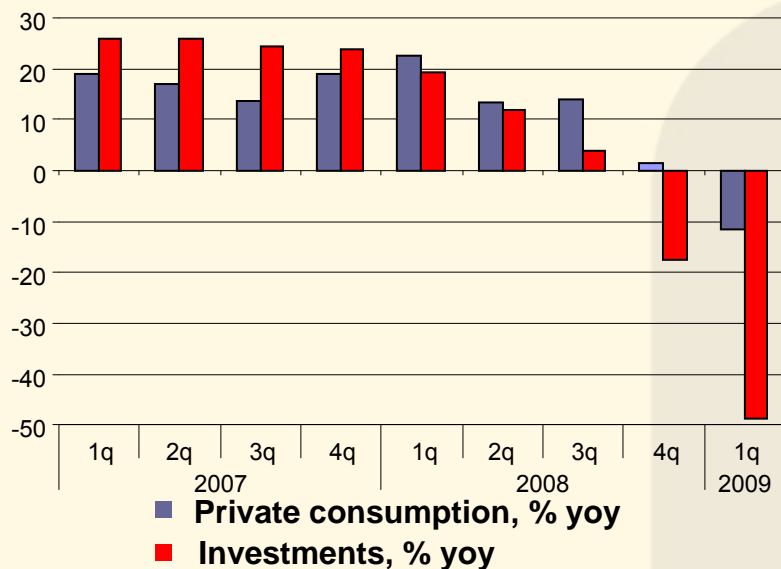
% yoy	Nov-Dec 2008	Jan-Jul 2009
Total Exports of Goods	-16	-49
Food products	-12	-24
Chemicals	-34	-56
Metals	-37	-62
<i>ferrous metals</i>	-44	-65
Machinery & equipment	-10	-32
Transport equipment	-28	-68
Minerals	19	-58
Agricultural products	273	30

Source: State Statistics Committee, NBU, MEPS, The Bleyzer Foundation

- In Jan-Jul 2009, Ukraine's exports of goods fell by 49% yoy.
- Major declines took place in Metallurgy, Chemical products (which account for 50% of exports), and Machinery, Equipment and Transport - due to the recession in Ukraine's main trading partners (particularly Russia and Europe).
- Only exports of agricultural goods kept growing at a robust pace.

2. Domestic Demand Performance

Consumption and Investment Patterns, 2007-2009

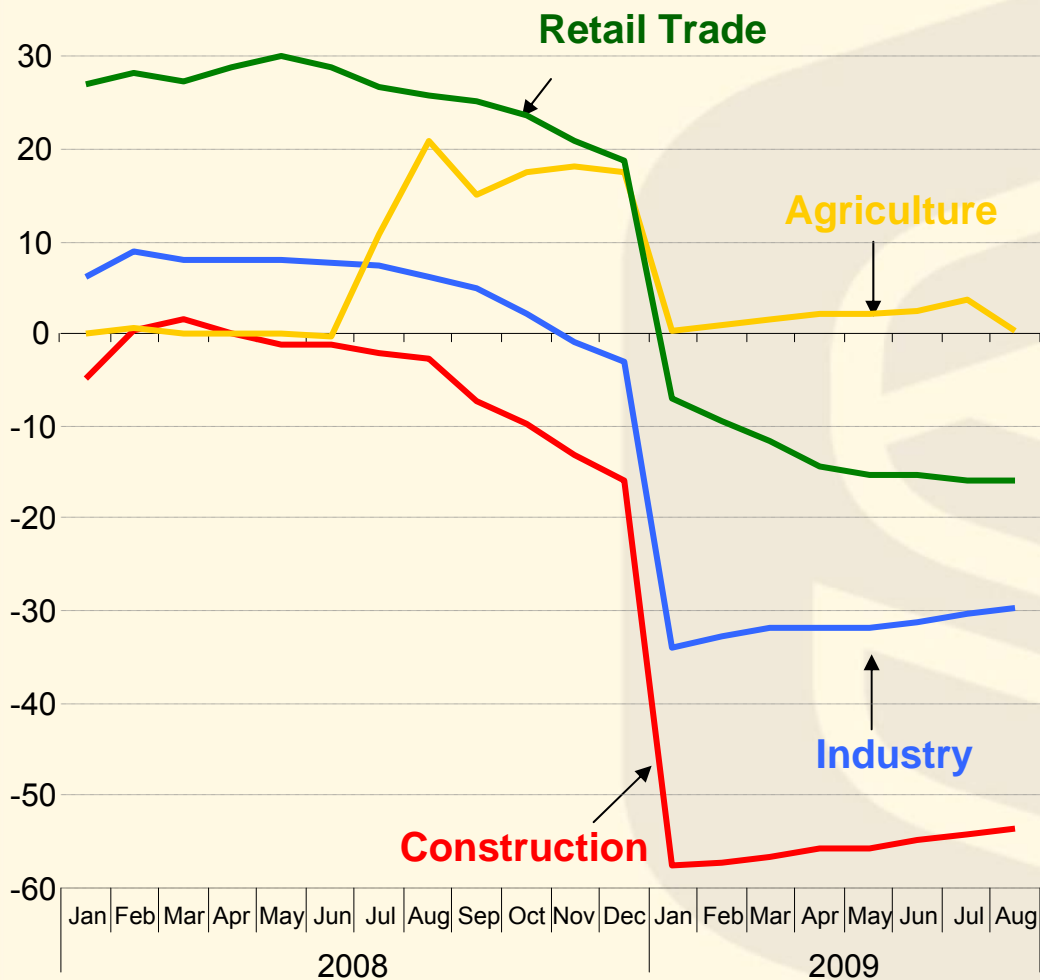


Source: State Statistics Committee of Ukraine, NBU

	2008	2009
Average monthly wage, nominal, % yoy	33.7	5.8 (Jan-Jul)
Unemployment rate, ILO meth., %	6.4	9.5 (1q)
Financial results of enterprises, % yoy	-55	-95 (Jan-Jun)
Credits in UAH, % ytd	40	11 (Jan-Aug)
Credits in FX, denominated in US\$, % ytd	34	-16 (Jan-Aug)
Net FDIs, \$ billion	9.9	2.4 (Jan-Jul)

- Domestic Consumption declined by 11.6% yoy in 1Q 2009 due to increased unemployment and a decline in real household income (-13%).
- Deterioration in investment activity was particularly severe, with investments into fixed capital declining by almost 50% yoy.
- Corporate enterprises revised their investment plans downwards facing lower demand, declining profits and tight access to credit.

3. Economic Performance by Sectors, % yoy

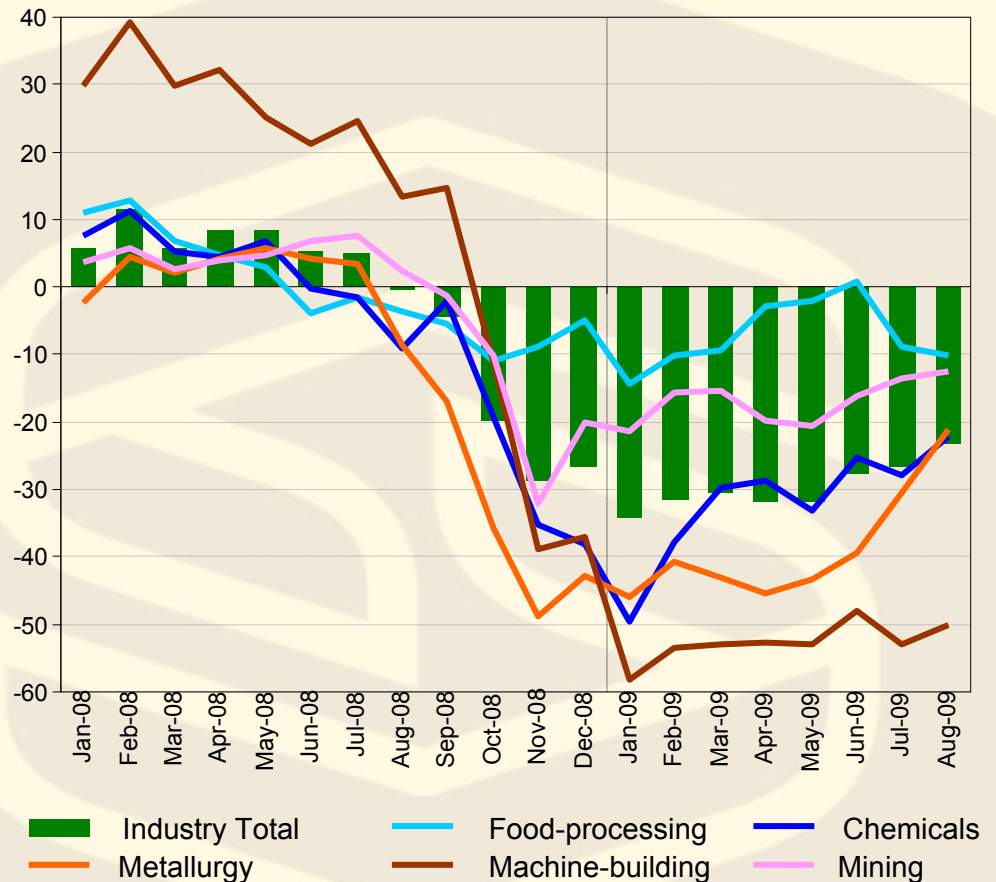


- The major drop in output occurred in Dec 2008-Jan 2009.
- For Jan-Aug 2009, industrial production fell by 29.6% yoy and construction by 54%.
- But since the end of January, the pace of decline stabilized: early signs of recovery have been observed in most sectors.
- Agriculture, supported by a record high 2008 harvest, was the only sector supporting economic growth in 4Q 2008 and first eight months of 2009.

Source: State Statistics Committee of Ukraine

4. Industrial Performance, by Sub-sectors, % yoy

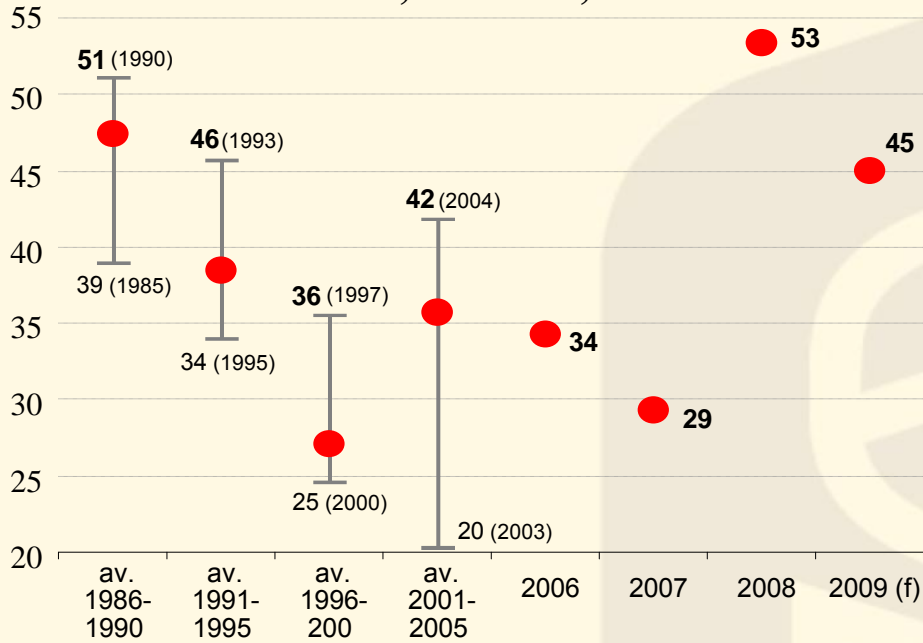
- Since end 2008, the most affected sectors have been metallurgy, machine-building and chemicals (down by 39%, 52% and 32% yoy).
- These industries are highly dependent on foreign markets and comprise about 45% of total industrial output.
- Moreover, other industries (such as mining, coke-refining, electricity) are linked to them.
- Since April 2009, industrial production had started to improve. The rate of output decline moderated to -23% yoy in August.
- Given its dependence on exports of metals and chemicals, Ukraine should be an early beneficiary from the recovery of global trade in 2010.



Source: State Statistics Committee of Ukraine

5. Agricultural Performance

Grain Harvest, 1985-2009, mln t



Source: State Statistics Committee of Ukraine, Ministry of Agriculture forecast

In 2009, the grain crop is forecaste to reach 45 million tons, a high volume, but lower than the record crop of 53 million tons in 2008.

Agriculture could become the engine of future growth as there is still large scope for improvement:

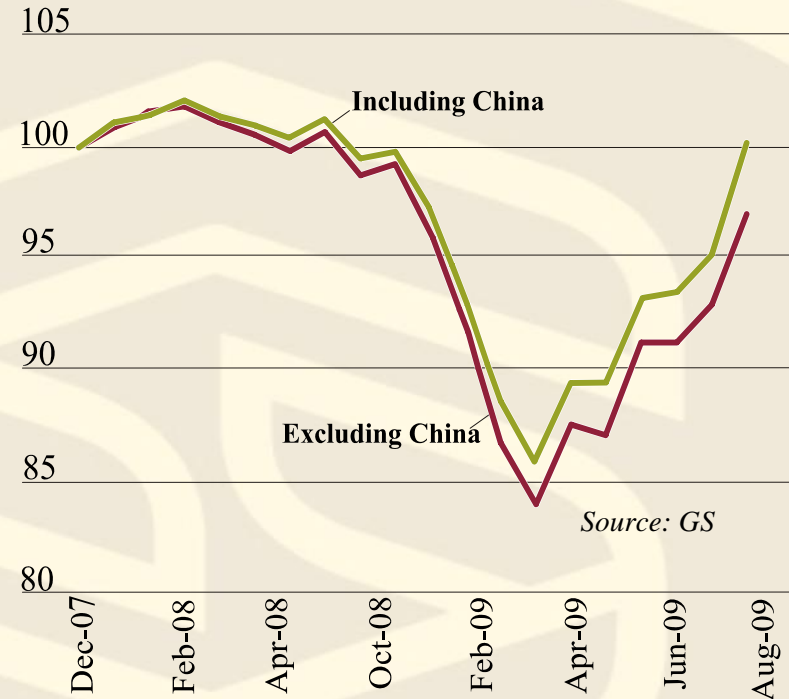
- According to FAO, Ukraine's attainable crop yield is about 6 t/ha compared to 2.6 t/ha achieved on average over the last 20 years.
- Though Ukraine possesses high quality arable land, average yield is several times lower than in the EU.
- Fertilizer use declined more than 6 times since 1990 and is 8 times lower than in EU-15 countries.
- The sector also suffers from obsolete agricultural machinery and low investments into R&D (seeds selection, cattle breeding, etc.) and in human capital.

6. Real Sector Prospects

- Due to its high dependence on foreign trade Ukraine's recovery will be closely linked to recovery of global trade and output.
- Global output is already recovering, with a number of developed countries and major emerging economies (Australia, Germany, France, Japan, Norway, China, India, Brazil, Indonesia) already moving out of recessions and may return to their pre-crisis level of GDP by the second half of 2010.

Industrial Production in Emerging Markets

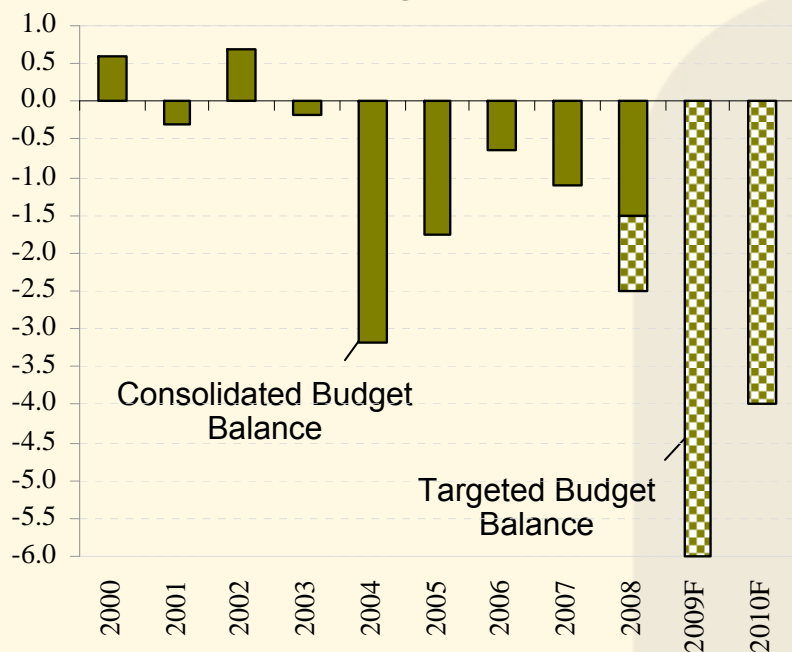
December 2007=100



- Ukraine's improvement in the next 12 months will be related to improving foreign demand, likely inventory re-stocking, fiscal stimuli and a low statistical base effect.
- GDP is forecast to decline by about 14% in 2009 and to grow by about 3% in 2010, driven by industry and exports.
- Recovery of domestic demand may be more protracted.

IV. Fiscal Budget Policies

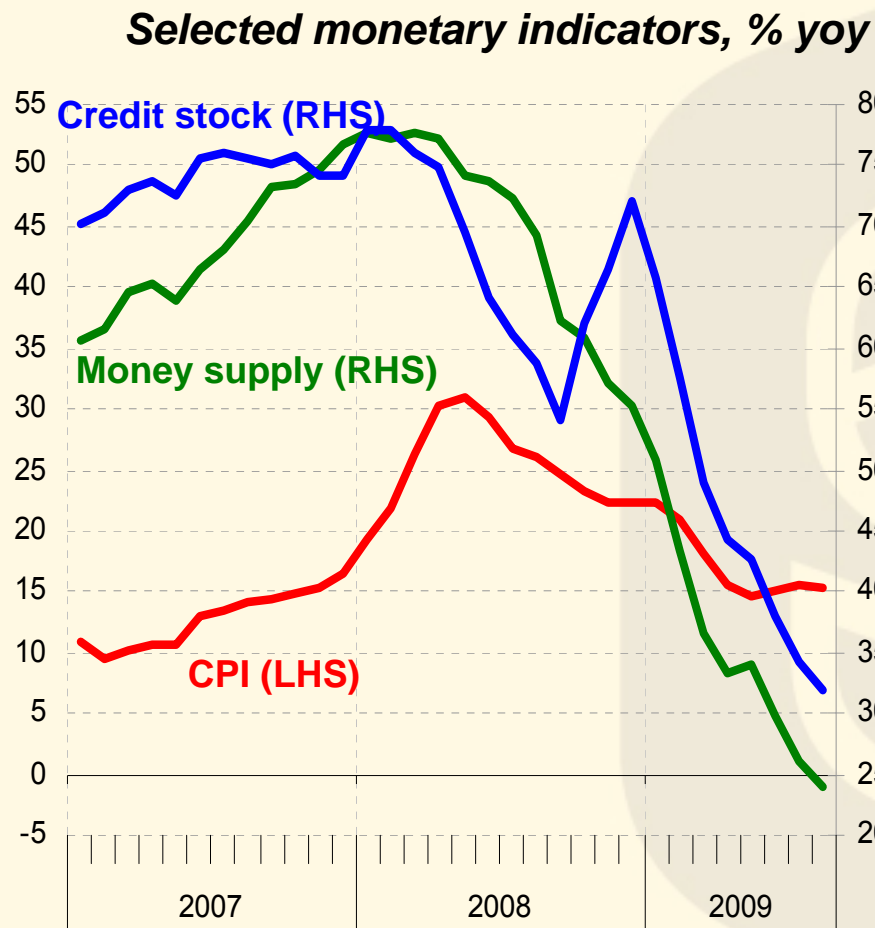
Consolidated Budget Balance, % of GDP



Source: Ministry of Finance, SSC, The Bleyzer Foundation

- In the past, except in 2004, fiscal policies have been prudent with fiscal deficits not exceeding 1.5% of GDP, even in 2008.
- But State finances have remained under significant strain in 2009 since tax revenues have dropped while expenditures have remained unrevised.
- The budget deficit targeted for 2009 has been revised to 6% of GDP, from an initial 3% of GDP.
- But including payments to Naftogaz and pension fund and bank recap. expenses, the consolidated fiscal deficit may exceed 10% of GDP in 2009.
- The fiscal deficit is forecast to decline to 4% of GDP in 2010 (including Naftogaz, but excluding bank recapitalization expenses).

V. Monetary Policy and Inflation



Source: NBU, SSC

- In the past, with prudent fiscal policies, inflation was induced by soft monetary policies (with high expansion of money supply).
- But the recent fiscal deficits, coupled with planned utility tariff increases, will moderately pressure inflation.
- Though we will continue to observe disinflation in 2009-2010, it is forecast to remain in double digits – around 15% in 2009 and to decline to about 13% in 2010.

VI. Ukraine's Vulnerabilities to the Crisis

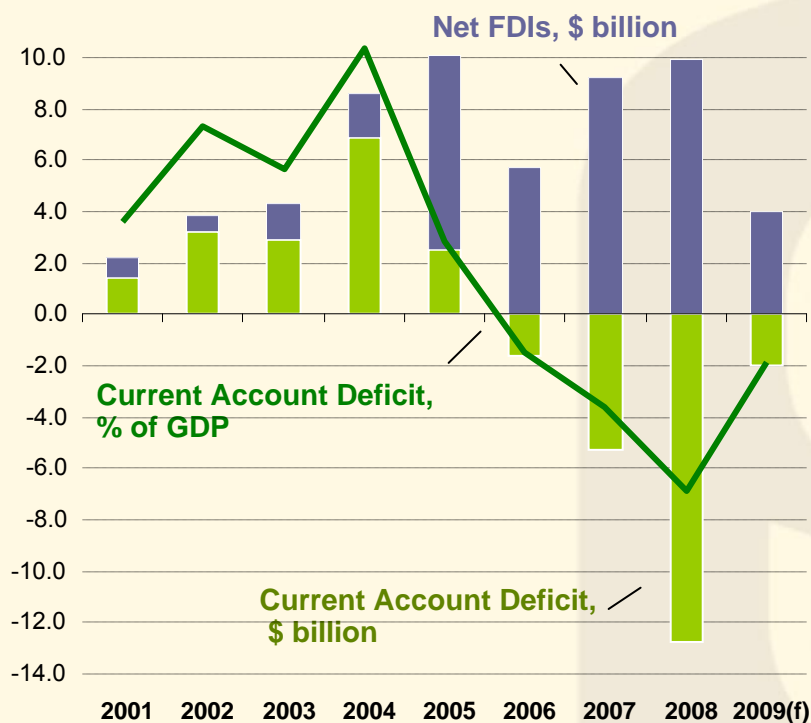
Why was Ukraine more vulnerable to the Crisis?

Ukraine was more vulnerable to the global financial crisis than most EMs, due to a combination of three negative factors:

- Rapidly widening current account deficit
- High external debt burden
- Banking sector weaknesses.

1. Rapidly Widening Current Account (CA) Deficits

The Current Account Balance, \$ billion and % of GDP, and net FDI Inflows, \$ billion

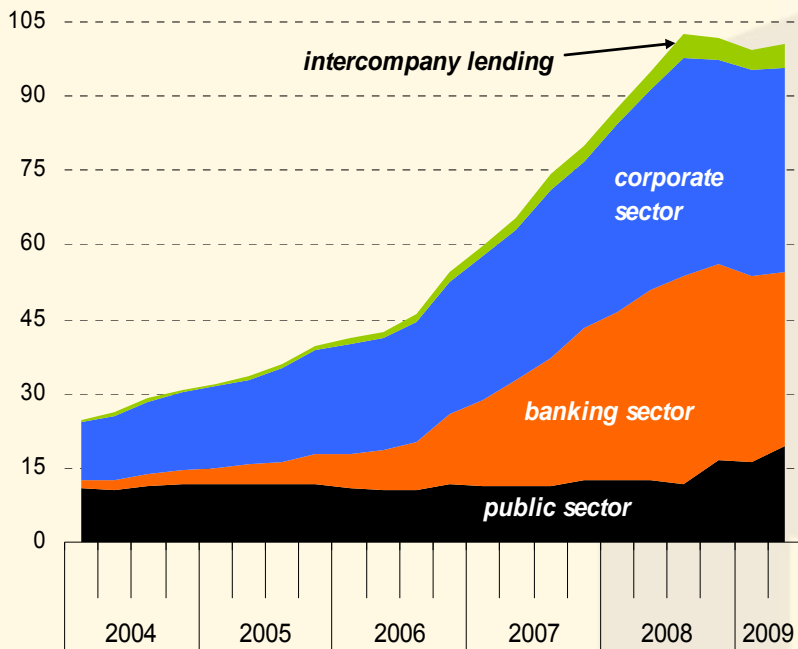


Source: NBU, The Bleyzer Foundation

- During the last several years, exports grew fast but imports grew even faster.
 - As a result, since 2006, the country had a widening CA deficit.
 - In 2008, the CA deficit reached around \$13 bn, or 7% of GDP.
 - At the beginning of September 2008 (just before the outburst of the crisis), most analysts forecast a CA deficit of \$24 billion or 13% of GDP for 2009.
 - This was a key concern that led to a 50% UAH depreciation in the fall of 2008.
-
- **But the CA balance adjusted sharply during 2009** due to the substantial Hryvnia depreciation, weaker domestic demand (particularly investment spending), and a sharp reduction in international energy prices.
 - The CA balance is no longer a source of concern.

2. Large External Debt Burden

Gross External Debt, by Sectors, \$ billion



Source: NBU, The Bleyzer Foundation

- Over 2007-2008 total external debt doubled from \$55 billion to \$102 bn.
- The short-term external debt due in 2009 was estimated at \$35 billion (including the short-term part of long term debt).
- Without official IMF financing, we had assumed that about 60% of the external debt could be rolled over as a substantial portion represented trade credits and foreign banks' loans to their Ukrainian subsidiaries.

- Based on these rollover rates, the net external financing needs to serve foreign debt were estimated at about \$15 billion.
- Therefore, the IMF program was key to stabilizing the currency as it provided \$10 billion for 2009 and also allowed other official financing and higher roll-over rates.

IMF's Current Financing Plan, 2009

Total financing sources, \$ mn	31,114	Total financing requirements, \$ mn	41,191
Net FDI (incl. capital transfers)	4,070	Current account Surplus	-710
Portfolio, net	-80	Total FX debt amortization (incl. short-term debt, trade credit, and medium- and long-term amortization)	35,250
Debt financing, total	26,465	Amortization of private debt	32,262
<i>Private</i>	21,905	Amortization of government debt	2,988
<i>Official, o/w</i>	4,560	Other capital outflows	6,651
World Bank	1,250	Financing needs	10,077
Project financing	500	IMF Fund credit (net)	10,077
Unidentified multi-bilateral	2,250		
Other	560		
Reserve accumulation (-denotes incr.)	659		

The IMF Program in Ukraine

IMF Program Schedule, 2009

Date	Amount, \$ million
November 2008	4,500
1 May 2009	2,800
15 June 2009	3,300
15 November 2009	3,800
15 February 2010	560
15 May 2010	560
15 August 2010	560
15 October 2010	560
	16640

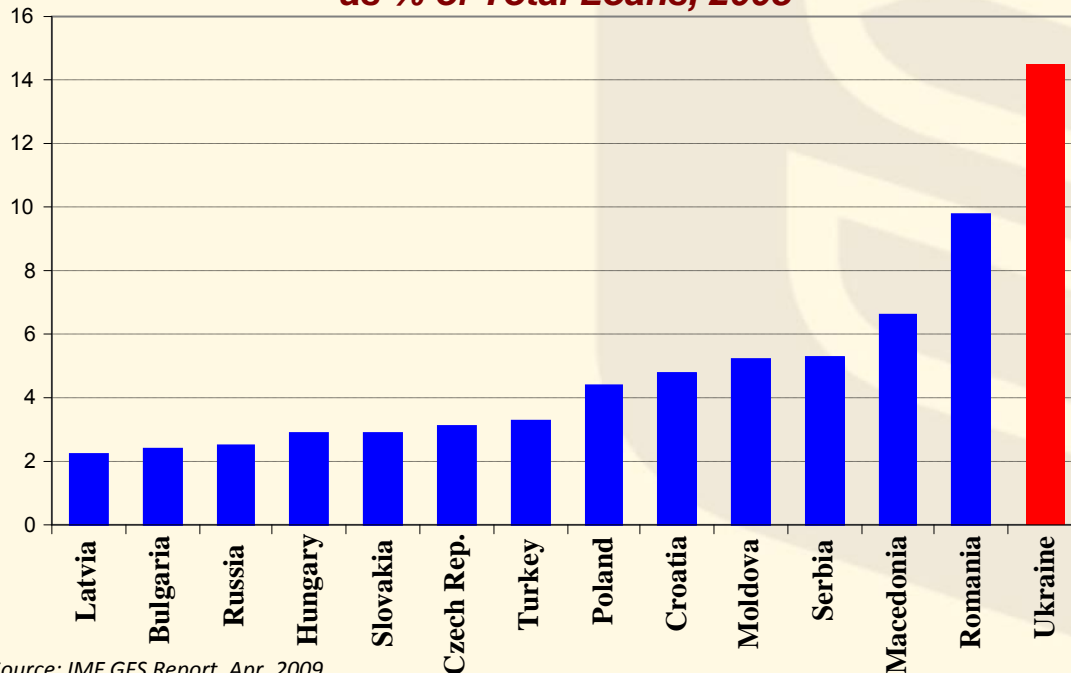
Key Conditions for Release of the November Tranche:

- Increase Gas Prices by 20% in 2009 and schedule quarterly increases in 2010.
- Do not finance the Euro-2012 games from the profits of the NBU.
- Do not increase pensions and minimum wages beyond inflation rates.
- Do not support (i) a tax amnesty and (ii) a moratorium on tax audits.
- The newly developed Budget Code should not be a base for 2010 budget.
- The 2010 fiscal budget should not exceed 4% of GDP and should be based on acceptable forecasts for GDP, inflation and exchanges rates.

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 9% at the end of June 2009.

**Non-performing Loans in Selected Emerging Markets
as % of Total Loans, 2008**

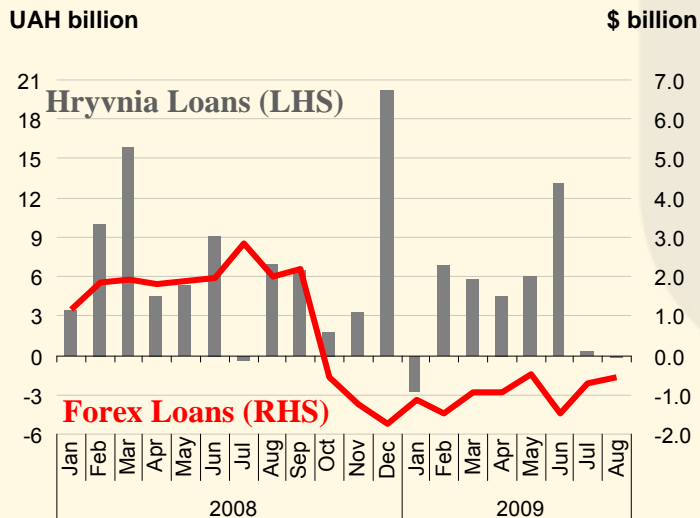
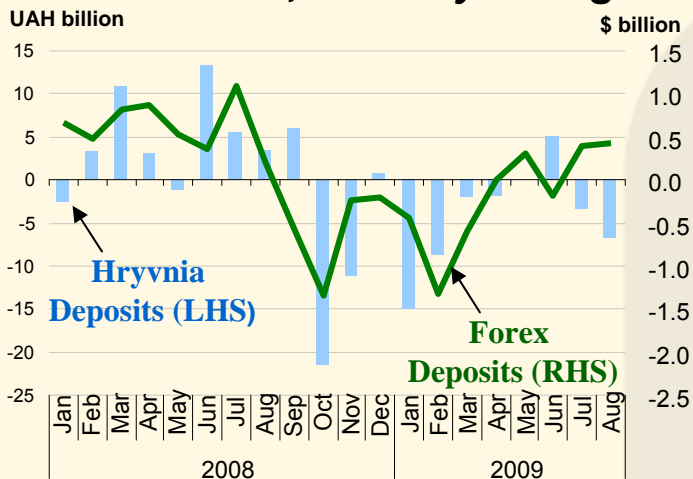


Source: IMF GFS Report, Apr. 2009

- Including sub-standard loans, the share of NPLs is higher than in other countries.
- Due to bank runs, the banking sector lost almost 1/4 of its deposits from October 2008 to April 2009.
- Bank weaknesses and loss of confidence made it even more difficult for banks to roll over foreign short-term debt.

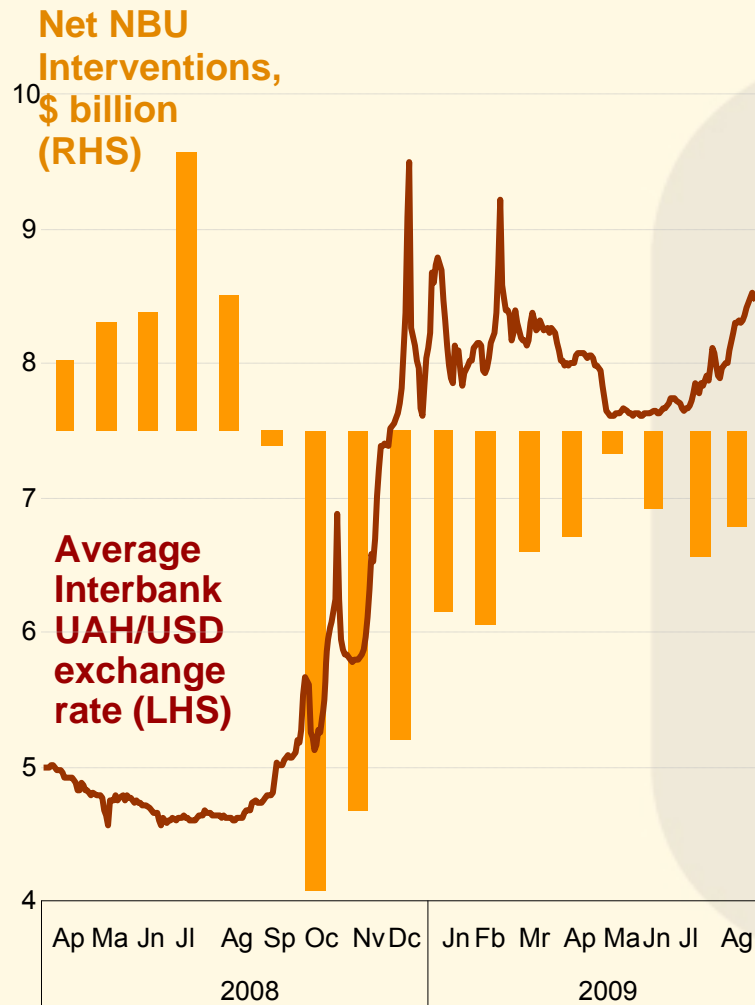
Banking Sector Prospects

Selected banking sector indicators, monthly change



- In recent months, the banking sector situation has improved, but it is still weak:
 - NBU supported banks by providing refinancing and reducing its discount rate from 12% to 10.25%.
 - With banks injecting capital, depositors' trust started to recover in the second quarter of 2009.
 - The banking sector was supported by financing from IFIs.
- Many of these efforts were in compliance with the IMF program. If the program continues, systemic issues may be under control.
- However, the process of cleaning up banks' balance sheets may be protracted, undermining credit activity.
- The health of the banking sector is still the major economic risk for the country.

VII. Foreign Exchange Performance



- More than 50% Hryvnia/\$ depreciation in 2008 was due to large current account deficit and short-term debt repayments, combined with lower foreign financing and people's falling confidence.
- Since Oct-2008, the NBU has tried to smooth the Hryvnia depreciation by selling \$18 billion of international reserves and applying administrative regulations.
- These measures helped to stabilize the market in 2Q 2009. Greater exchange rate fluctuations since mid-July 2009 are associated with the NBU switching to a more flexible exchange rate policy.

Source: NBU, The Bleyzer Foundation

Foreign Exchange Prospects

- At the end of 2008, we had forecast that the Hryvnia/\$ exchange rate at the end of 2009 would reach 8-9 UAH/\$, which is still valid, though it is likely to remain volatile through the rest of 2009.
- By the end of 2010, the exchange rate is likely to move to 9-10 UAH/\$.
- Our current projections for 2010 are based on PPP equivalence and the fact that Ukraine's major vulnerabilities have been reduced as follows:
 - **CA gap:** With the Hryvnia depreciation of more than 50%, Ukraine has restored its competitiveness on the PPP basis. In Jan-Jul 2009, though exports fell by 49% yoy, imports declined even faster by 54% yoy. As a result, the CA deficit is forecast to narrow to about 2% of GDP in 2009 and to run a minor surplus in 2010.
 - **External debt:** The IMF financing provided not only funds to cover Ukraine's external financing needs, but also brought confidence to other IFIs and foreign investors. Coupled with the stabilization of global financial markets, this helped to sustain a relatively high level of external debt rollover for banks (74% for Jan-Jul 2009, according to NBU estimates).
 - Though the **banking sector** remains fragile, its problems are being handled relatively well.

Ukraine - Inflation Differentials and FX Rates (based on Purchasing Power Parity)

- Our estimates show that the Hryvnia exchange rate is close to its equilibrium level, though some minor depreciation to about UAH/\$ 9-10 is likely in 2010.

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Inflation in Ukraine	-0.6	8.2	12.2	10.3	11.6	16.6	22.3	15.0	13.0
Inflation in the US	2.6	1.9	3.2	3.7	2.2	4.1	0.8	-0.1	0.1
Inflation in Ukraine's Main Trading Partner Countries (MTP)	9.7	7.4	7.2	6.4	5.9	8.0	7.6	5.5	4.4
Inflation in Currencies of Ukraine's Foreign Trade (CFT)	5.0	3.8	4.7	4.7	3.1	5.0	2.6	1.4	1.3
Actual Hryvnia Exchange Rate per US Dollar	5.33	5.33	5.31	5.05	5.05	5.05	7.70		

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Δ Ukraine-US inflation	-3.1	6.2	8.7	6.3	9.2	12.0	21.4	15.1	12.9
Δ Ukraine-MTP inflation	-9.4	0.8	4.7	3.7	5.4	7.9	13.6	8.9	8.2
Δ Ukraine-CFT inflation	-5.3	4.3	7.2	5.4	8.3	11.1	19.2	13.4	11.6

PPP with Base Year 2002

Inflation Diff Index Ukr-US	100	106.2	115.5	122.7	134.1	150.1	182.2	209.8	236.9
Real Exchange Rate - US		5.7	6.2	6.5	7.1	8.0	9.7	11.2	12.6

Inflation Diff Index Ukr-MTP	100	100.8	105.5	109.3	115.2	124.4	141.3	154.0	166.6
Real "Effective" Exchange Rate - MTP		5.4	5.6	5.8	6.1	6.6	7.5	8.2	8.9

Inflation Diff Index Ukr-CFT	100	104.3	111.8	117.8	127.5	141.6	168.8	191.4	213.6
Real "Effective" Exchange Rate - CFT		5.6	6.0	6.3	6.8	7.6	9.0	10.2	11.4

Foreign Exchange Forecast for 2010

<u>Scenario</u>	<u>Probability</u>	<u>FX Rate, UAH per \$</u>
Optimistic	15%	8.0
Base	40%	9.0
Pessimistic	30%	10.0
Very Pessimistic	15%	12.0

Weighted average: 9.6 UAH/\$

Factors that will define the outcomes are:

- 1. The continuance of the IMF Program (which implies fiscal and monetary discipline).*
- 2. The willingness of foreign creditors to continue rolling over the \$100 billion of debt (conditional to the IMF Program in place and global recovery).*
- 3. The success of the banking sector program.*
- 4. Political stability.*
- 5. The pace of revival of the world economy.*

VIII. Medium Term Prospects

- Although the combination of tight global liquidity and depressed international demand for exports will depress Ukrainian GDP up to mid-2010, over the medium term, Ukraine's economic outlook is still bright as its investment attractiveness has not changed.
- 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.
 - With the EU at its borders, the EU-FTA under negotiations 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 and technological base are reasonable as compared to other countries in the region.

IX. Current Political Situation

- Presidential Elections are scheduled for November 17, 2010. The elections may also lead to changes in Rada coalitions and in Government.
- The leading candidates, according to the most recent polls are: Mr. Yanukovich (25%), Ms. Tymoshenko (16%) and Mr. Yatseniuk (13%).
- This poll data however is still inconclusive since 31% of the voters are undecided or do not plan to vote (voters that Ms. Tymoshenko may get.)
- Although the current political situation has created uncertainties, it may provide an opportunity to correct the deficiencies of the Constitution of 2004, which provided for overlapping responsibilities between the President and the PM and have been at the core of all political problems since then. This may provide greater stability in the future.
- 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 international relations (both with the East and the West), and finalizing land reform.

X. Ukraine- Key Statistics & 2009-10 Prospects

	2003	2004	2005	2006	2007	2008	2009(f)	2010(f)
Real GDP Growth	9.6%	12.1%	2.7%	7.3%	7.9%	2.1%	-14%	3%
Fiscal Balance (% GDP)	-0.2%	-3.2%	-1.8%	-0.7%	-1.1%	-1.5%	-6.0%	-4.0%
Consumer Inflation (eop)	8.2%	12.3%	10.3%	11.6%	16.6%	22.3%	15%	13%
Exchange Rate (Hr/\$, eop) (interbank rate)	5.33	5.31	5.05	5.05	5.05	8.0	9.0	9-10
Current Account (\$bn)	2.9	6.8	2.5	-1.6	-5.9	-12.7	-2.0	0.5
<i>(as % of GDP)</i>	5.8%	10.6%	2.9%	-1.5%	-4.2%	-7.1%	-1.7%	0.4%
Gross International Reserves, incl IMF financing (\$bn)	6.9	9.5	19.4	22.3	32.5	31.5	29	28
Foreign Public Debt (% GDP)	21.3	18.1	13.7	11.0	8.7	9.2	24	24
Foreign Private Debt (% GDP)	26.2	29.1	32.3	39.6	47.9	47.1	65	56

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

27