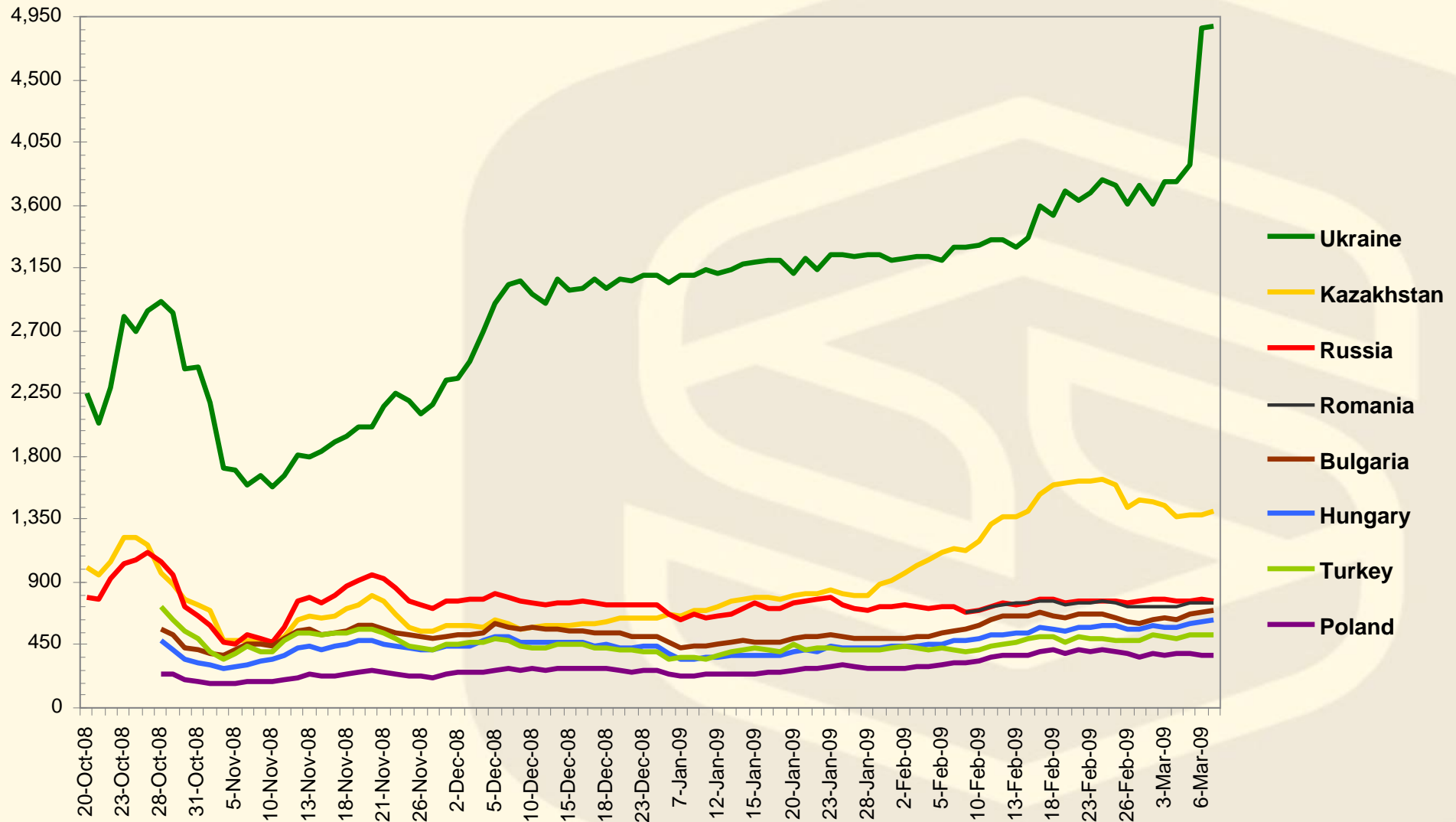


Ukraine

Dealing with the Financial Crisis

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

Ukraine today is perceived as a country facing possible default



The CDS spreads for Ukraine's bonds are now at about 4,900 bps. Other countries with high CDS premiums include Argentina (3,820 bp) and Venezuela (2,445 bp).

Causes of the Crisis in Ukraine:

The international liquidity crisis -- that gained momentum since mid-2008 -- affected all emerging countries. However, Ukraine suffered more than other countries:

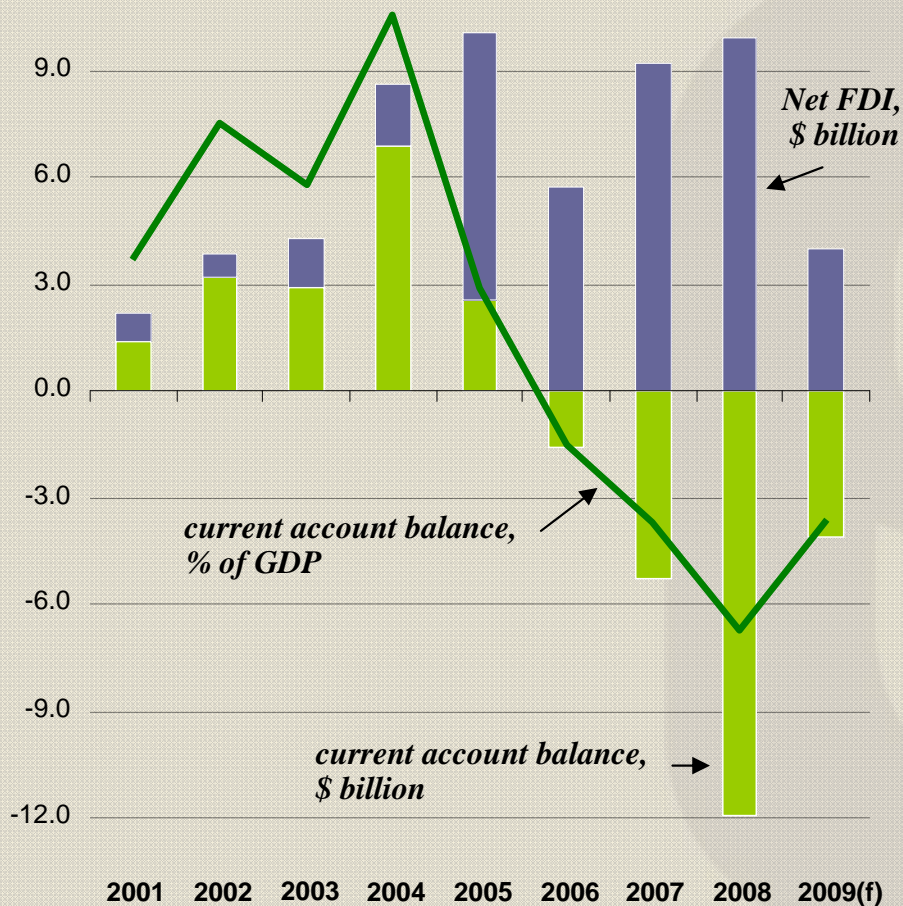
- The Ukrainian Hryvnia depreciated by about 60% with respect to the US Dollar in 2008;
- The PFTS stock index declined by more than 74% in 2008, one of the largest declines in the world;
- Ukraine's industrial production declined by about 25% yoy in the last quarter of 2008 and 34% yoy in January 2009.

Ukraine was more vulnerable to the crisis due to a combination of:

1. Large Current Account Deficits
2. Large External Debt Burden
3. Banking Sector Weaknesses

1. Large Current Account Deficits

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



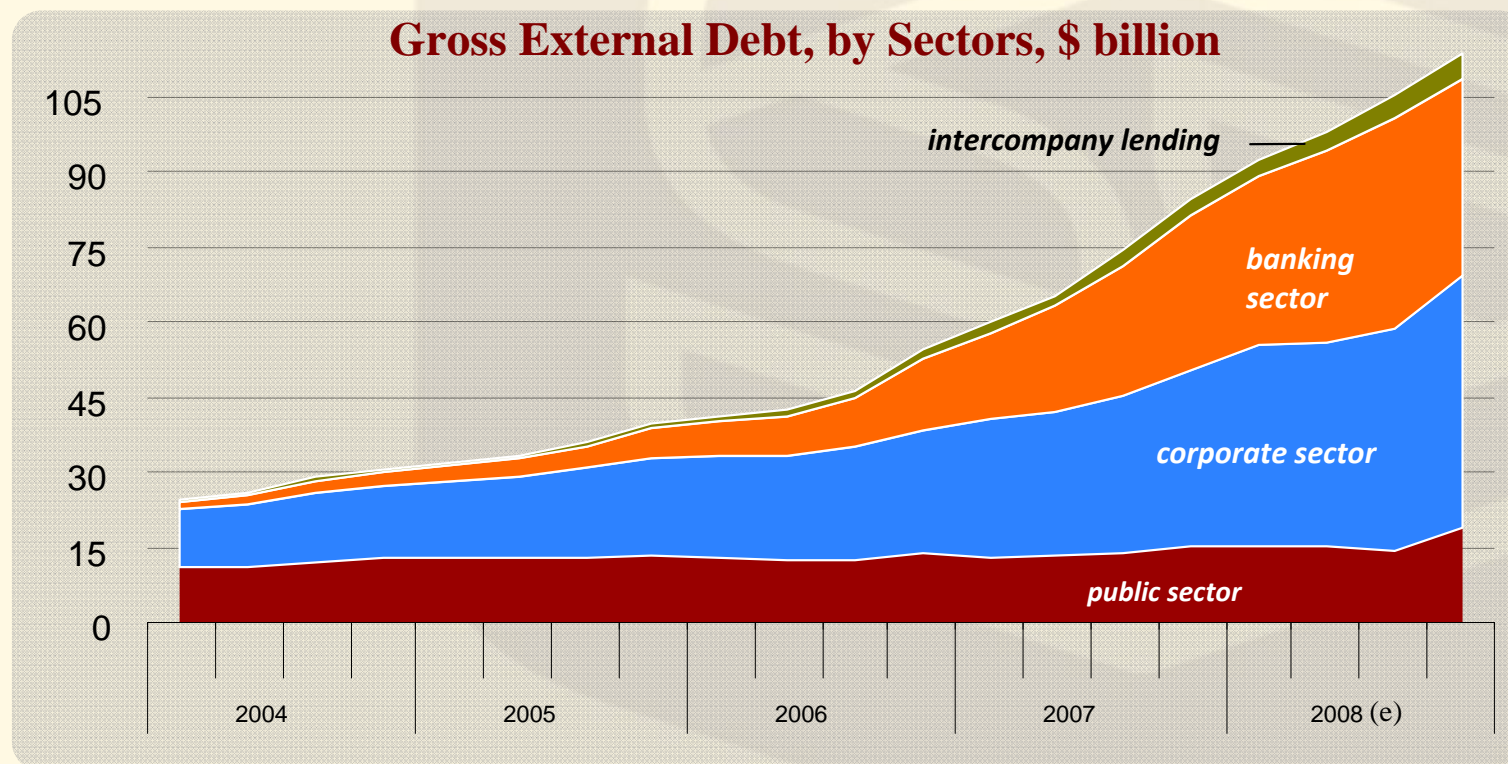
Source: NBU, The Bleyzer Foundation

- Ukraine's external trade depends on a few commodities (i.e., steel and chemicals).
- After August 2008 the slowdown of the world economy led to sharp declines in world prices for these commodities.
- In 2008 imports expanded at a faster pace, reflecting robust growth in wages and consumer demand.
- As a result, the CA deficit reached around \$12 bn in 2008, or 6.7% of GDP.
- Net FDI inflows, which constituted \$10 bn, did not cover the CA gap.
- Since the international financial crisis dried up foreign capital inflows, Ukraine absorbed the gap by reducing reserves and depreciating the Hryvnia.

In 2009, the current account deficit could be reduced to \$4 billion (3.6% of GDP), principally due to lower domestic demand (due to less credit and UAH depreciation).

2. External Debt Burden

- In the last two years total external debt grew by 100% reaching \$114 billion by end-2008, a lot of which is short-term private debt (about \$45 billion).
- Ukraine's external debt (at more than 60% of GDP and 120% of current account receipts) is now above the median value (40% and 84% respectively) of countries in similar credit rating categories (before the downgrade in February 2009).



Source: NBU, The Bleyzer Foundation

Ukraine's External Financing Requirements in 2009 (in \$ billion)

	2009
Short-term private debt repayments*	-28
Short-term portion of medium-term debt	-15
Public sector external debt service needs	-2
Forecasted current account deficit	-4
Likely external financing requirements	-49
Likely FDI inflow	4
Likely external debt requirements	-45
Available NBU reserves at beginning of 2009	31

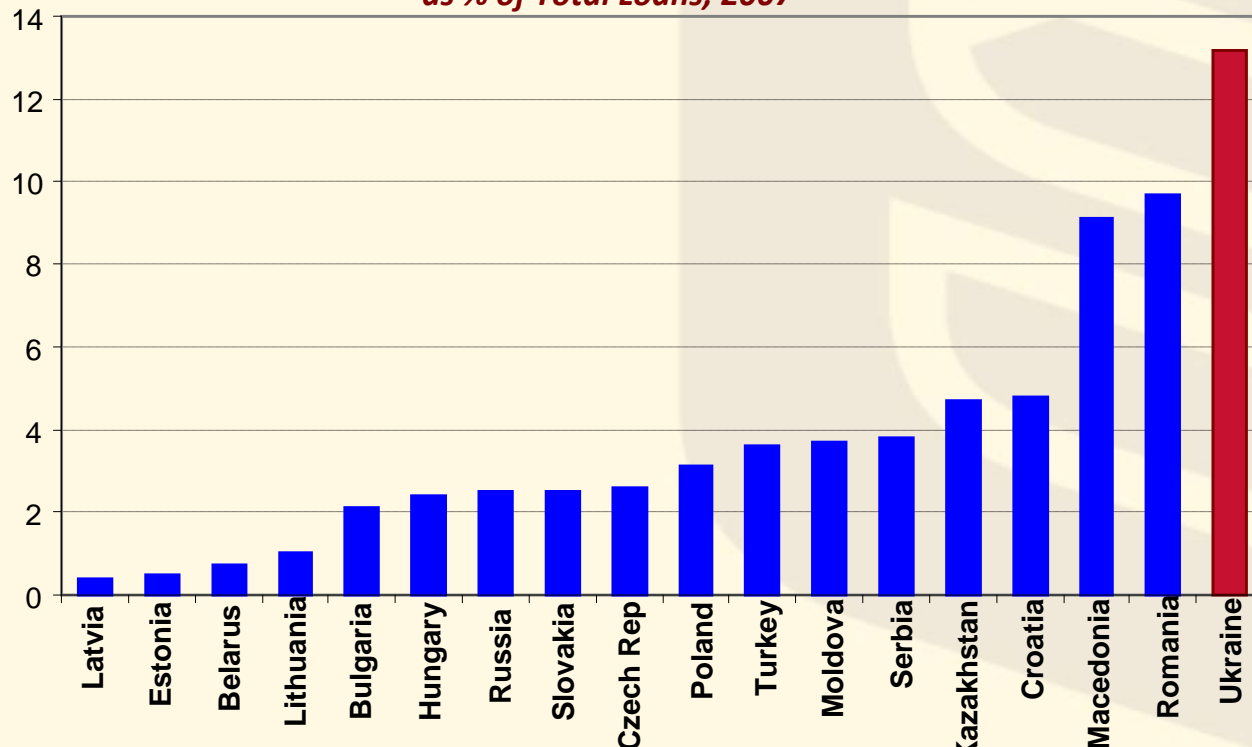
* not including the short-term part of M< private debt

This table shows that the strongest pressures on the Hryvnia exchange rate will come from the level of short term debt repayments due in 2009.

3. Banking Sector Weaknesses

- In Ukraine, bank credit grew by 70% pa over 2006-2008, supported by a 40% pa increase in money supply and large commercial banks borrowings from abroad.
- Many studies in EMs have shown that high rates of credit growth lead 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.

*Non-performing Loans in Selected Emerging Markets
as % of Total Loans, 2007*



- 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 bn had fled out of the banking system.
- Bank weaknesses and loss of confidence will make more difficult for banks to roll-over foreign short term debt, putting more pressures on the Hryvnia exchange rate.

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

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:

- Countries that managed their crises successfully created an 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 enter a Memoranda of Understanding among government agencies (CB, Ministry of Finance, Ministry of Economy, etc) to clarify responsibilities and actions to address the crisis.
- 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 between agencies often results 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 short-term 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 financing and multilateral financing from other international institutions such as the European Bank and the EIB.
- However, a violation of some performance criteria caused a temporary delay of the IMF program.
- It is now essential for Ukraine to revive the IMF program, as neither bilateral nor multilateral financing may be available without an IMF program: other countries and institutions rely on the IMF for debt coordination and to ensure that the country's economic program is sound and sustainable.
- Ukraine is encouraging private sector corporations and banks to implement a program to restructure current short-term foreign debt and increase capital. It may be necessary for the govt to provide support for these restructurings.

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 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.
- During October-December 2008, the NBU provided liquidity support to banks through its refinancing operations; nine banks were taken under NBU temporary administration with one of them sold to new shareholders; the Central Bank monitoring was placed on 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);

4. Implement Macroeconomic 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 one.
- 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 and contains provisions that enables monetization of the budget 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 economic 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 the "Regulatory Guillotine" 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.
 - Free the foreign exchange system and implement Inflation Targeting.
 - 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 less than \$4 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.