

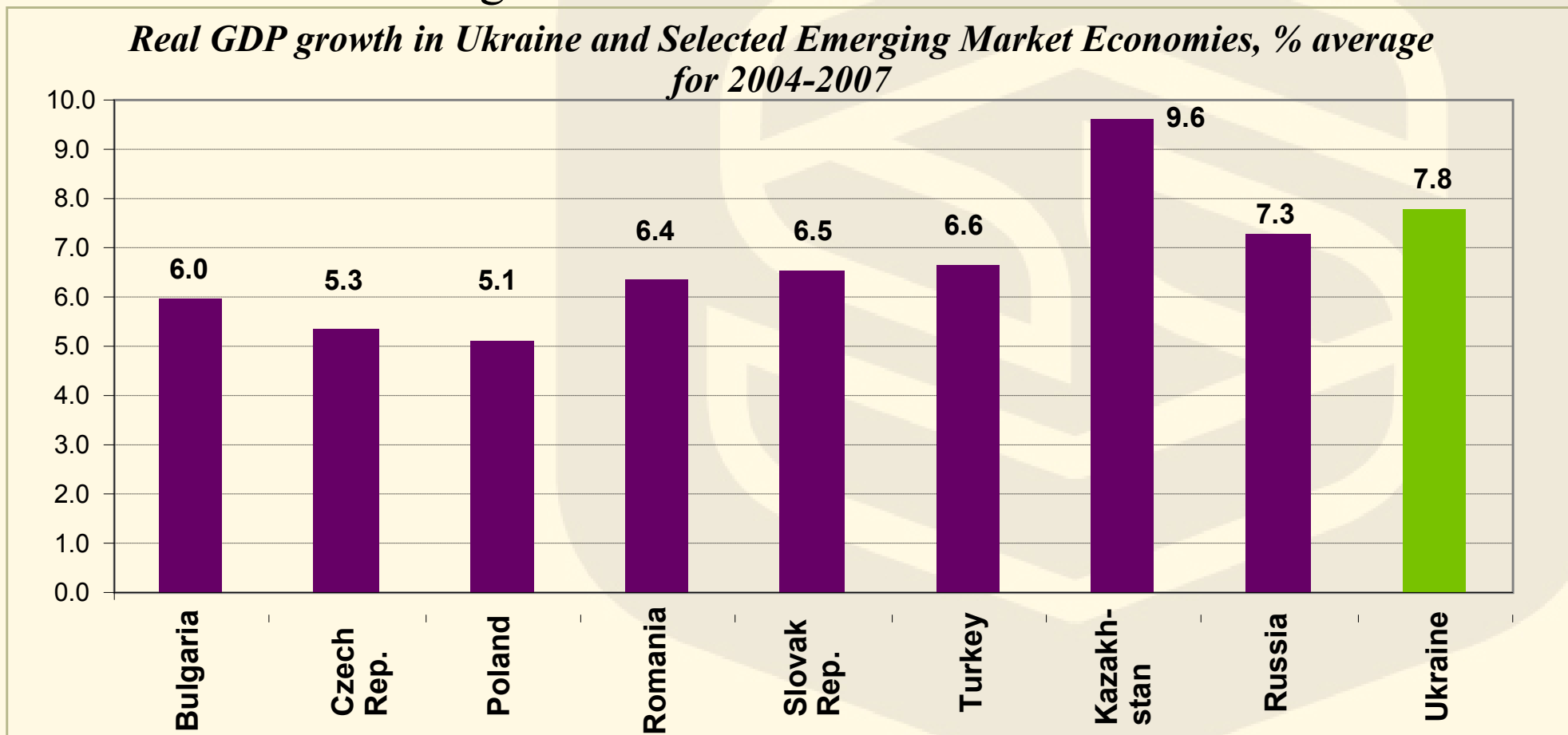
Ukraine's Economic Achievements and Prospects

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Economic Achievements – Robust GDP growth

- Over the last five years, the Ukrainian economy grew by an average 7.8% per annum
- With this GDP growth rate, Ukraine was among the fastest growing economies in the region



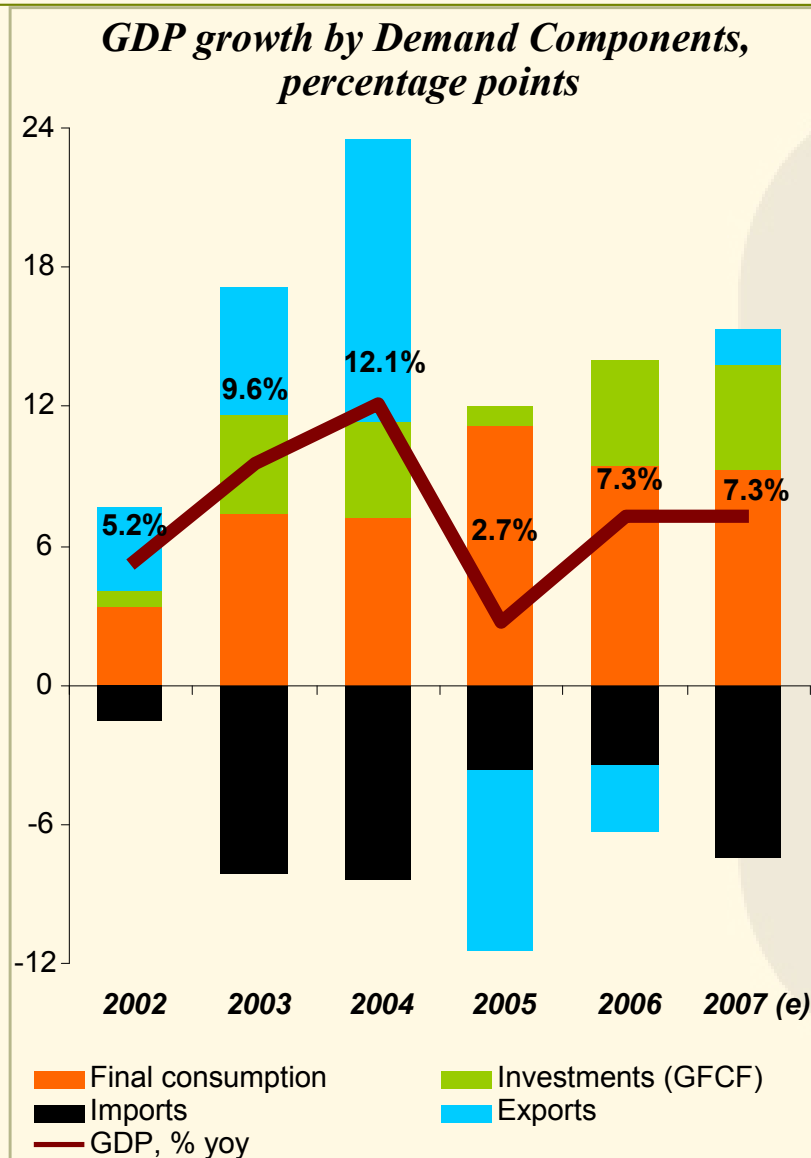
Source: State Statistics Committee of Ukraine, IMF WEO Database October 2007

... Economic growth

During 2006-2007, Ukraine's GDP grew by real 7.3% yoy, demonstrating:

- Strong resilience to energy price shocks (the price for imported natural gas grew by about 50% in 2006 and 37% in 2007)
- Solid immunity to political instability and global financial turmoil
 - Ukraine had parliamentary elections in both 2006 and 2007
 - Constitutional changes were fully enforced in 2006. They turned Ukraine into a parliamentary-presidential republic but provided for overlapping responsibilities between the President and the PM. So far, Ukraine continues to be in the process of refining its political system
- Foundations for buoyant economic growth were settled by good progress in economic reforms during the last five years. In particular, Ukraine
 - Simplified business regulations particularly for starting a business
 - Enhanced intellectual property and minority shareholders rights
 - Liberalized trade barriers
 - Approved banking and money laundering legislation
 - Simplified taxation and improved tax administration
 - Improved regulation of the foreign banking and insurance sectors and initiated many others

Drivers of Economic Growth - Consumption



Source: State Statistics Committee, The Bleyzer Foundation

- GDP growth has been stimulated by booming consumption, healthy investment growth and favorable external environment.
- Since 2005 consumption became the main source of GDP growth, stimulated by major increases in pensions, wages and bank credit.
- In particular, real wages rose by about 21% pa on average over 2004-2006. Credits to private sector surged by almost 70% pa during 2005-2007 with credits to households advancing by approximately 120% pa over the period.
- As a result, private consumption grew by an average 17.5% yoy over the last three years compared to about 11.5% yoy over 2002-2004.

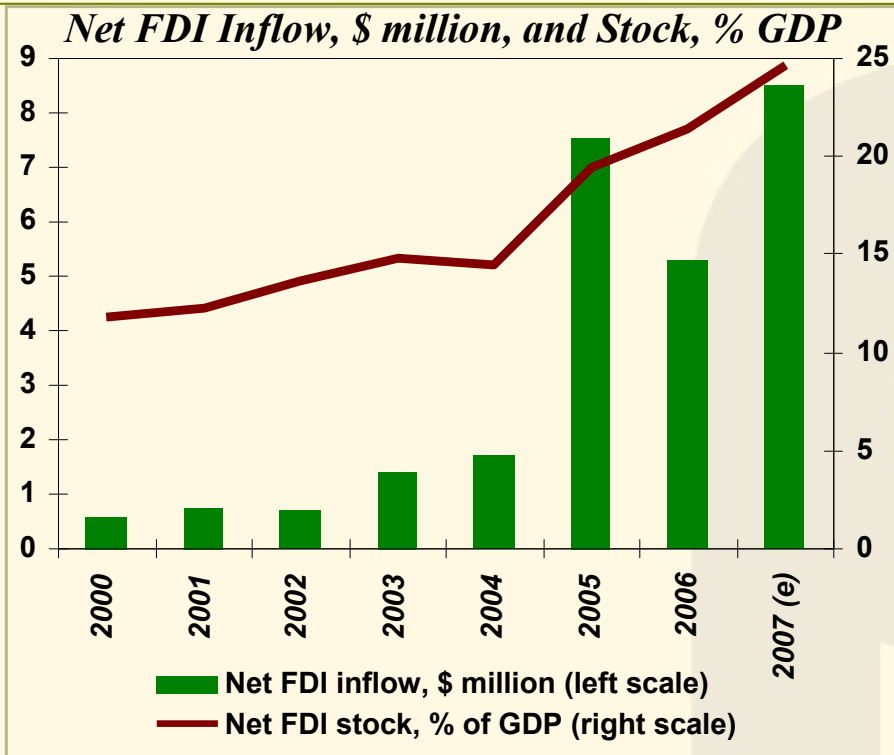
...Investments

- With the exception of 2005, investments into fixed capital rose on average by more than 20% pa over 2003-2007.
- Despite political uncertainties and still complicated business environment, businesses increased investments, driven by the growing need to renovate existing production capacities and introduce energy-saving technologies to cope with rising energy and other input costs as well as tightening competition on both domestic and external markets.



- Robust investment activity was supported by both domestic and external finances.
- Improved access of Ukrainian banks and corporates to financial resources abroad as well as surging FDI inflow reflected growing investors perceptions of Ukraine as an attractive place for investing.
- For the last three years (2005-2007), Ukraine received 2.3 times more FDI inflows than in the previous 15 years.

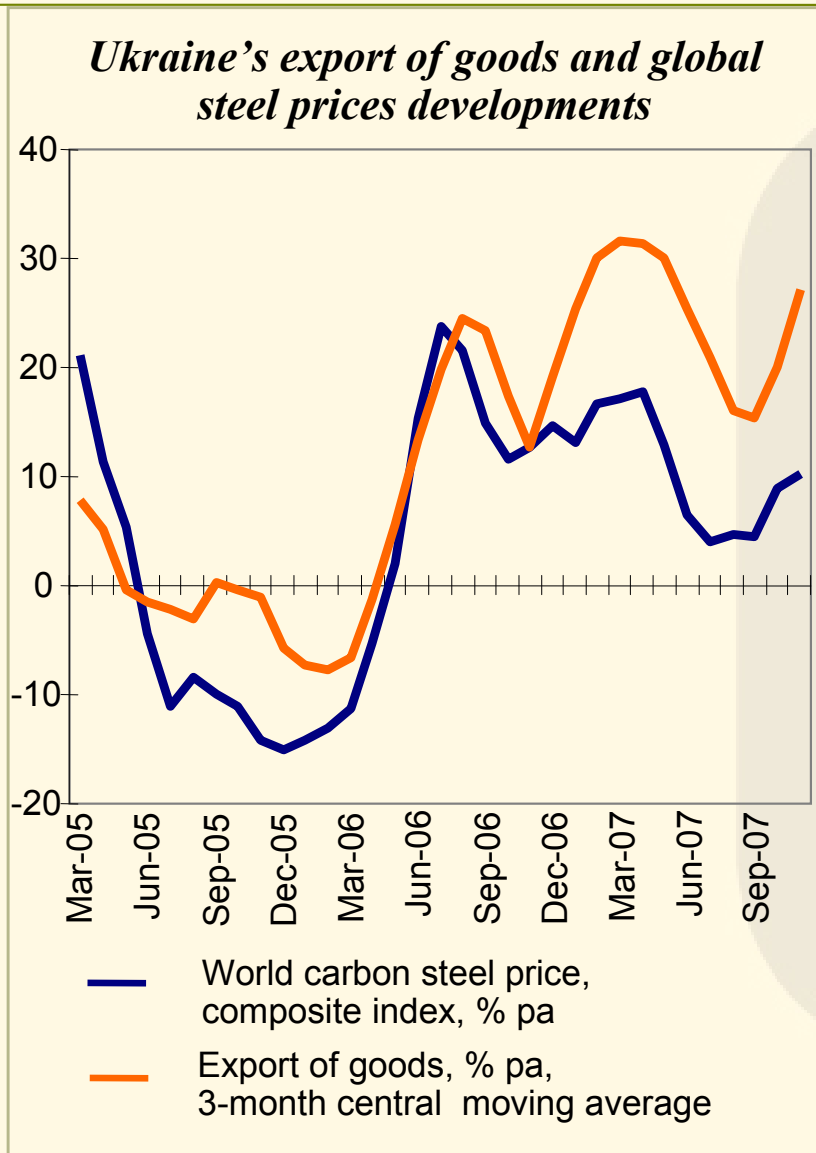
Ukraine - an Attractive Country for Investments



Source: National Bank of Ukraine, The Bleyzer Foundation

- Strong macroeconomic fundamentals, demonstrated over the last eight years;
 - Large domestic market with growing purchasing power of population;
 - Educated and relatively cheap labor force;
 - Rich natural resources (coal, iron ore, black soil);
 - Strategic location at the crossroads between Europe and Asia;
- Reasonable infrastructure; Industrial and high-tech potential;
 - Growing trade potential (the near WTO entry, good prospects of signing free trade agreement with the EU);
 - Noticeable democratic transformations (free media, democratic elections, civil rights). Ukraine is the only post-Soviet country (in addition to the Baltic states) that is rated by Freedom House as a free country.

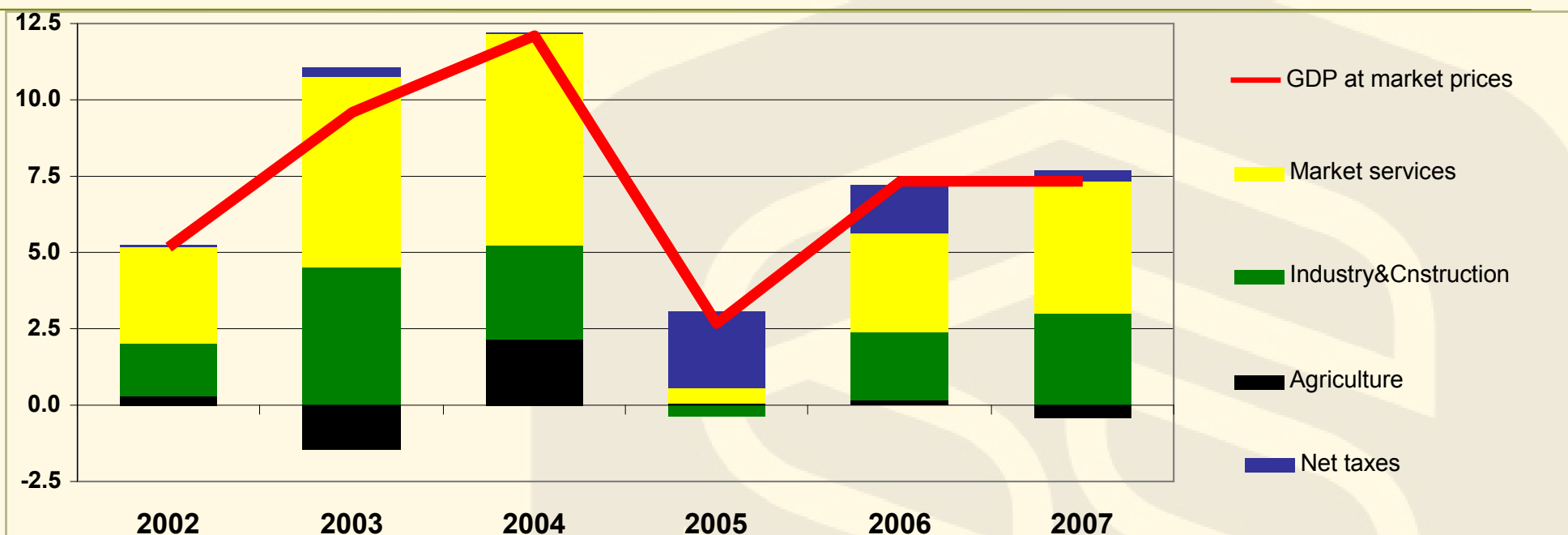
...Exports



- Ukraine's GDP growth highly relies on exports of goods and services. Metallurgical, chemical, machine-building, agricultural and food products are Ukraine's main exporting commodities.
- During 2002-2004, exports were the principal driver of economic growth.
- In 2005-2006, exports decelerated due to less benign external environment (decline in global steel prices) and industry adjustment to energy price shock.
- In 2007, exports strongly recovered favored by:
 - Growing steel and chemical prices
 - Vigorous investment demand in Ukraine's main trading partners countries (exports of machinery and transport grew by impressive 53% pa in 2007)
 - De-facto pegging of Hryvnia to US dollar, resulting in rather moderate real exchange rate appreciation 7

Source: State Statistics Committee of Ukraine, MEPS, The Bleyzer Foundation

GDP Growth by Sector



Source: State Statistics Committee, The Bleyzer Foundation

- Ukraine's economic growth was broad-based.
- During 2002-2004, 2006-2007 GDP growth was driven by **industry, market services and construction**. In 2005, services were the main contributors to economic growth. In addition, GDP growth was supported by sharp increase in net taxes thanks to elimination of tax privileges and loopholes.
- In **2007**, **Industry** grew by 10% yoy, with growth leaders: Machinery (28.5% pa), Metallurgy (8.5% pa), and Food Processing (10% pa). **Services**, particularly Wholesale and Retail Trade (18.5% pa), Transport and Communications (11.5%pa), and **Construction** (14% pa) also expanded rapidly over the period.

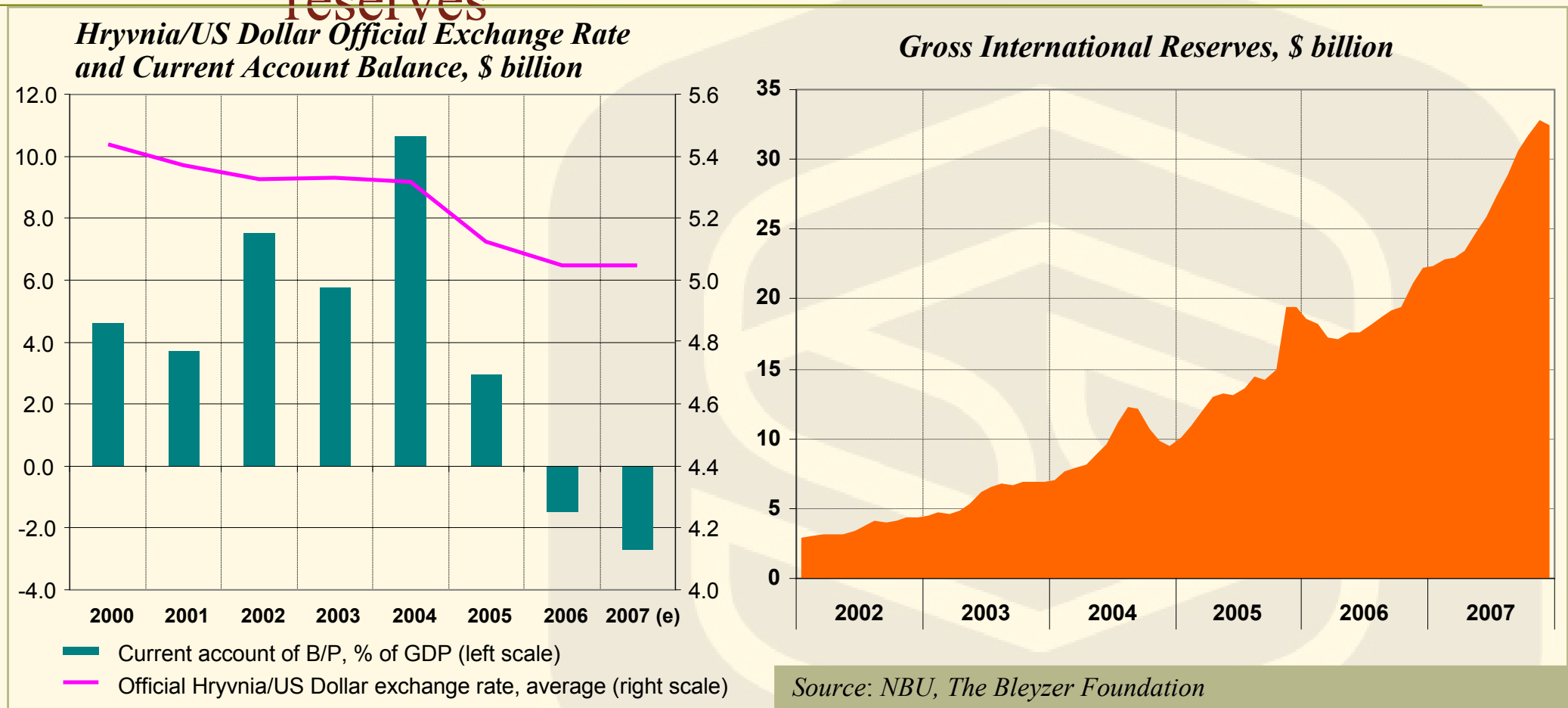
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Other strengths - relatively low fiscal deficits and public debt



Source: Ministry of Finance of Ukraine, The Bleyzer Foundation

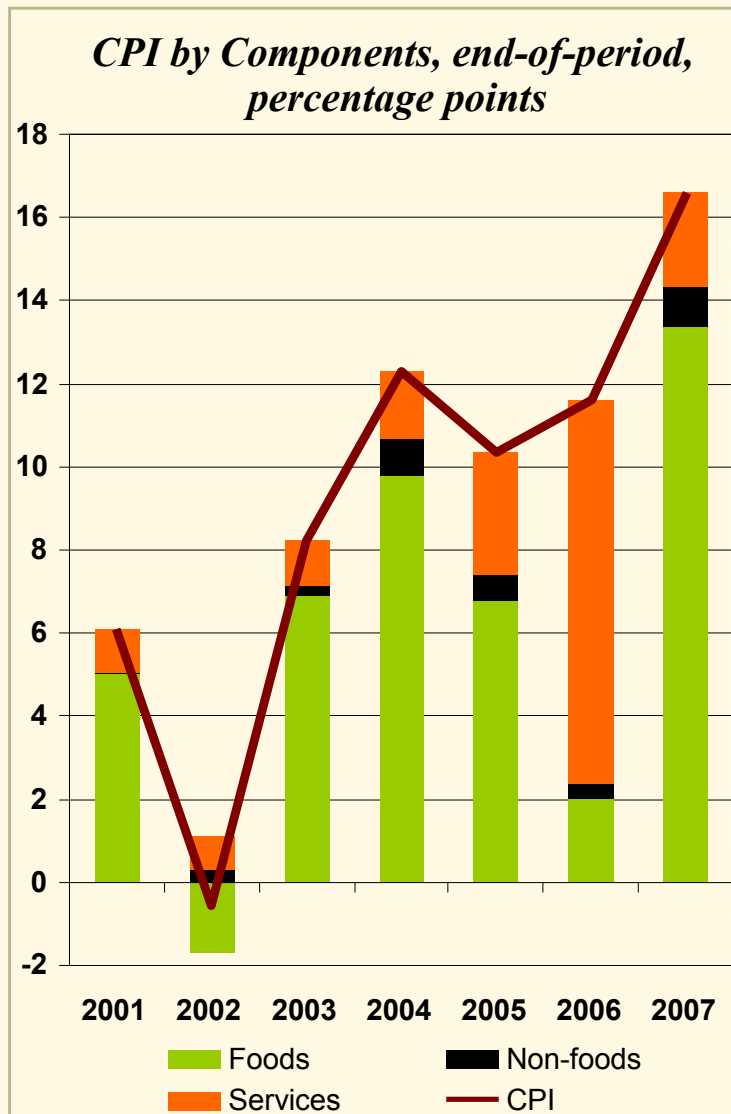
... fairly stable exchange rate, moderate current account deficits and growing international reserves



Thanks to high current account surpluses in 2000-2005 and record high inflow of foreign capital in 2005-2007 (in the form of FDI inflows and private sector borrowings from abroad), NBU gross international reserves more than tripled during the last three years and reached \$32.5 billion at the end of 2007, which was sufficient to cover more than 5 months of future imports of goods and services.

But, some of these achievements had their “price”.

Challenge 1: High Inflation



- Consumption increases propelled high inflation. During the last four years inflation were in double-digits, though inflation rates during 2004-2006 were moderate for the emerging economy. However, the price growth reached 16.6% pa in 2007.

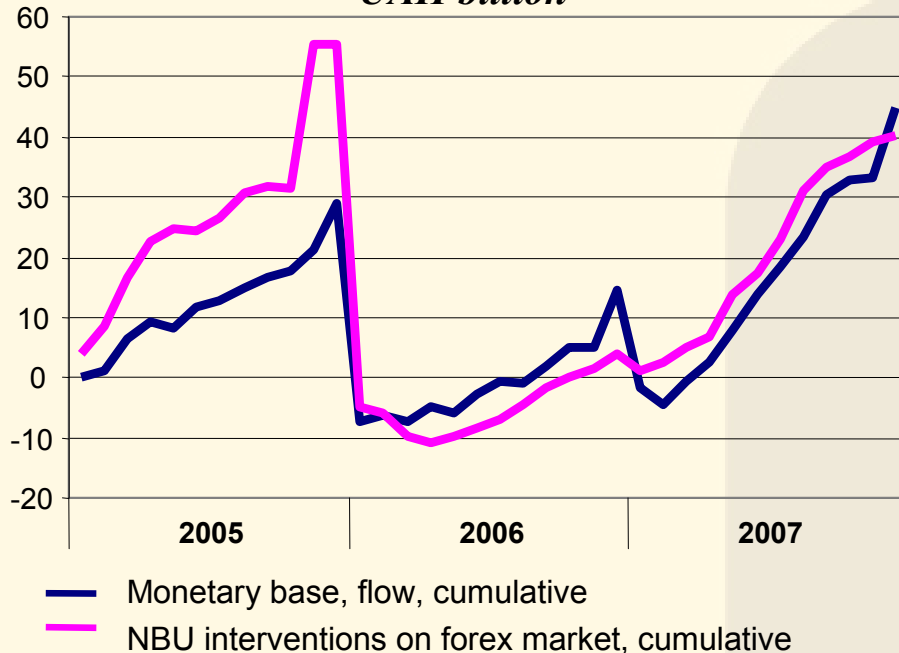
Rallying consumer prices were the result of:

- A rise in household income growth, noticeably exceeding productivity growth
- Pass-through of surging energy prices on consumers (though limited due to the presence of administratively regulated prices and tariffs, but spilled-over through producer inflation)
- Acceleration of price growth for foods, the weightiest component of consumer basket (accounts for about 60%).
- Food inflation was the result of poor harvest this year and a sharp price swing on agricultural and food commodities globally.

Source: State Statistics Committee of Ukraine,
The Bleyzer Foundation

Inflation – Monetary Conditions

NBU forex operations and Monetary base growth, UAH billion



Source: NBU, The Bleyzer Foundation

- Monetary expansion has also contributed to the rise in inflation.
- Loose monetary conditions were the direct consequences of the de-facto fixing Hryvnia exchange rate to US Dollar.
- The current exchange rate policy was very successful in reducing inflation from very high levels in the 1990s.
- But, in the circumstances of large foreign capital inflows the National Bank of Ukraine had to inject billions of hryvnia into the economy to maintain exchange rate peg.

- Prolonged period of fixed exchange rate on the back of improved commercial banks access to external finances, which turned to be noticeably cheaper than domestic ones, enhanced dollarization of Ukrainian economy.
- Indeed, the share of forex-denominated loans grew from about 42% of total commercial bank loans at the beginning of 2004 to 50% at the end of 2007 (individuals are more inclined to borrow in foreign currency - the share of forex-denominated loans to households constituted 65% at the end of 2007).

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Challenge 2: Rapidly widening CA deficit

- Buoyant consumption and strong investment activity were increasingly satisfied via imported goods and services, thus eroding huge current account surpluses and switching into rapidly widening deficits. Just three years ago, CA surpluses amounted to 10.5% of GDP, in 2007 CA was in deficit of about 3% of GDP and is expected to double in 2008.
- Though high international steel prices, as well as comparatively low energy prices, supported Ukraine's GDP growth, they provided little incentives for Ukrainian economy to diversify and renovate production capacities.
- In particular, metallurgical products account for about 45% of total Ukraine's merchandise exports and about 25.5% of industrial production; chemical products account for 10.5% and 6.5% respectively.
- On the import side, Ukraine is a net importer of energy resources. Mineral products account for about 30% of total import of goods to Ukraine.
- At the same time, Ukraine remains among the most energy-intensive economies in the world.
- This makes Ukrainian economy extremely vulnerable to adverse trade shocks (such as a reduction of world steel prices, a surge in imported gas prices).

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Challenge 3: Credit Boom

- Over the last **eight** years, commercial banks credits to private sector grew by about 60% pa on average.
- Though increasing financial intermediation helped to sustain economic growth over the period, such rapid growth of credits stimulated demand for foreign goods, contributing to deterioration of the foreign trade balance, and raised concerns over growing banking sector vulnerabilities to various risks (credit, foreign exchange, liquidity, etc.).
- So far, official statistics showed improving prudential indicators of Ukrainian banking sector while the entry of a number of large systemic foreign banks during the last couple of years should facilitate commercial banks and NBU efforts to improve risk management and loan practices.
- Mounting inflationary pressures as well as global financial turmoil encouraged the National Bank of Ukraine to tighten monetary policy and regulatory requirements for commercial banks.
- Together with the likely more restricted access to external finances, these measures are likely to restrain credit growth and thus will help to contain inflation and CA deficit growth. On the other hand, it may result in weaker economic growth.

Challenge 4: Political Risks and sluggish reforms

- In initial 2004 Presidential election was won by Mr. Yanukovych.
- But due to fraud suspicion, over 1 million Ukrainian citizens protested in the streets in what became known as the "Orange Revolution".
- The Supreme Court declared the elections invalid due to fraud and ruled for a re-run of the elections in January 2005.
- These elections were won by Mr. Yushchenko, who became the third President of Ukraine in January 2005.
- Ms. Tymochenko became the Prime Minister.
- Before the elections, in December 2004, the Parliament approved a compromise package of laws calling for changes to the Constitution.
- These reforms turned Ukraine into a parliamentary-presidential republic, reducing presidential power and giving more authority to the Parliament and the Prime Minister.
- These reforms, however, provided for overlapping responsibilities between the President and the PM that are at the core of today's political difficulties.

... Short election cycles

- Nevertheless, the “Orange Revolution” has had a profound impact on the civil, political and governmental structures of Ukraine.
- It transformed the country with more competition among political parties, more transparency, a more open dialogue about political disagreements, more checks-and-balances and more accountability than ever before in the country.
- The subsequent March 2006 elections of the Parliament were recognized as free and fair by international observers.
- A majority coalition was formed by the Region’s Party, the Socialist and the Communists. Mr. Yanukovitch became the PM.
- However, the lack of clarity of the Constitution led to charges of excess authority by the PM, and the President called for new Rada elections, which took place in September 2007.
- Although the Regions Party was ahead in Rada seats, a coalition of Our Ukraine (the President) and Ms. Tymochenko formed a majority. In December 2007, Ms. Tymochenko was elected Prime Minister again.
- However, the new elections – presidential - are coming at the end of 2009.
- Stuck in political issues, Ukraine is sluggish in implementing structural economic reforms.

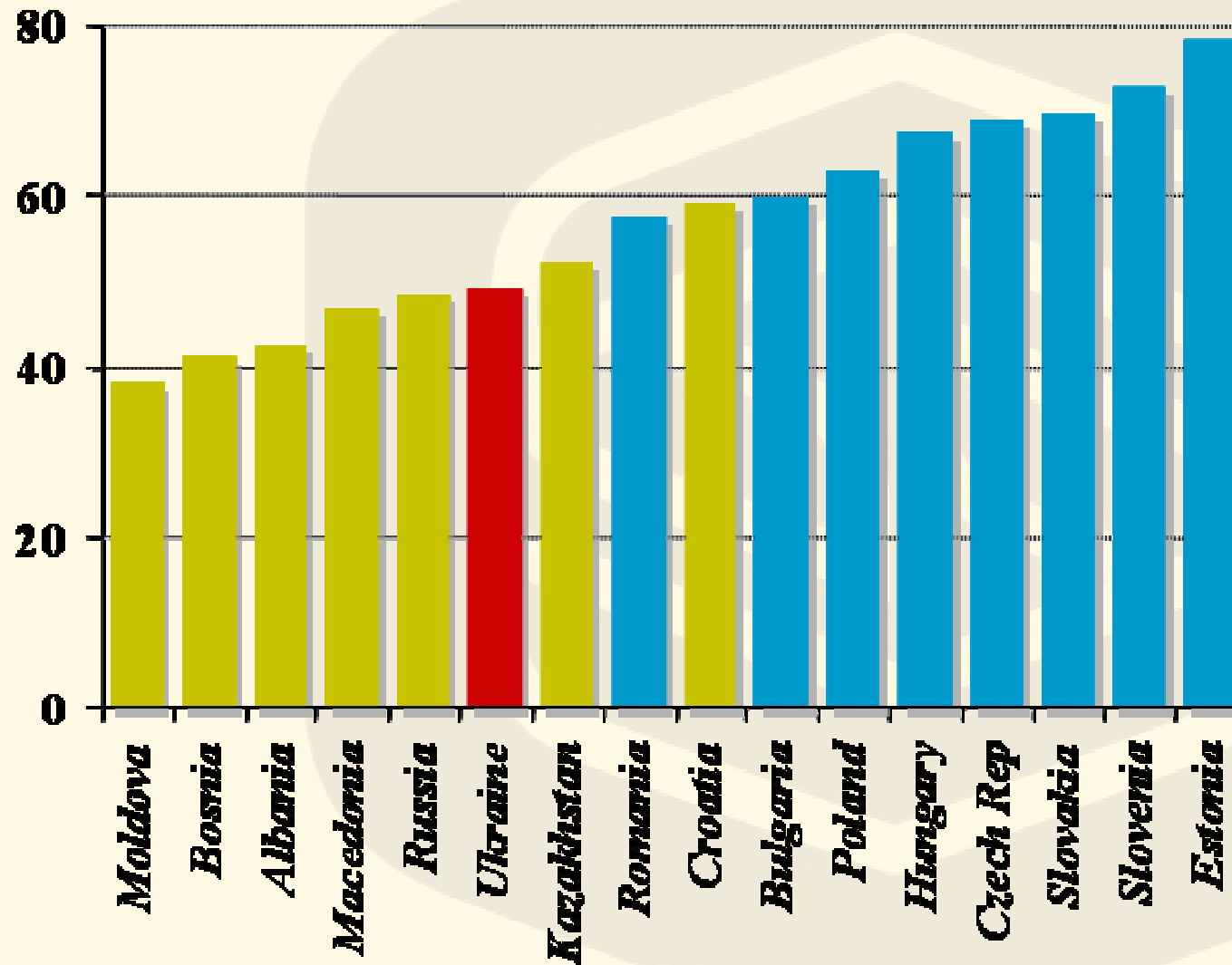
Medium Term Outlook – The Growing Need to Reform

- In the past, economic growth underpinned by a number of temporary factors:
 - Strong steel prices (export prices for metals are unlikely to increase at a fast pace in the future)
 - Relatively cheap energy (the price for imported gas will continue convergence to Central European levels)
 - Considerable scope for catch-up due to under-utilization of existing capacities
 - Credit boom
 - Loose fiscal policy (such a rapid increase in recurrent spending as it was during 2004-2007 questions the long-run fiscal stability).
- Economy showed signals of external (widening CA deficit) and internal (high inflation) disequilibria.
- Therefore, over the medium term the country will not be able to rely on increased private consumption and exports as the engines of growth.
- **In order to achieve strong and sustainable economic growth in the long-run the country will require new investments and technology.**
- **This will require major improvements in the investment climate.**

The Acting Government Program

- The government of Ms. Tymoshenko drafted the Action Program “Ukrainian Breakthrough: for People, not Politicians” setting priorities of the government activities in almost all areas – humanitarian, socio-economic, cultural, etc.
- The document incorporated recommendations provided by various international organizations, associations, NGOs, private businesses, including those developed by SigmaBleyzer/The Bleyzer Foundation.
- In particular, based on the study, it was developed the nine areas, enhanced reforms in which will lead to improving country’s business environment:
 1. Public and Corporate Governance
 2. Macroeconomic Stability
 3. Stable and Predictable Legal Environment
 4. Liberalization and Deregulation of Business Activities
 5. Removal of International Capital & Foreign Trade Restrictions
 6. Facilitation of Business Financing by the Financial Sector
 7. Reduce Corruption
 8. Country image
 9. Political risks

Ukraine's Investment Climate Rating



Specific Recommendations were developed for each of the “nine drivers”

1. **Implement a fundamental public administration reform:**

The weaknesses of Ukraine’s public administration – including cumbersome decision-making, bureaucracy, unclear and overlapping responsibilities -- are major constraints in the implementation of economic reforms. The country can design policies, but fails in implementation. Without public administration reform, it is likely that needed economic reforms will be implemented very slowly or will be reversed quickly.

A reform of public administration should include the following:

- clearly define the Objectives/Role of the Government limiting it to “public” goods and support - not substitution – of the private sector;
- Undertake a comprehensive “audit” of all government programs, with a view to transfer some of them to local governments, sub-contract others to the private sector and eliminate unnecessary/overlapping activities.
- develop the concept of well-defined “Programs and Projects” for all government activities (this will help to improve administrative efficiency, deal with corruption and also bring equilibrium to the fiscal budget)
- Improve the efficiency in retained “core” government activities and local governments, increasing public transparency and access to government information.
- Carry out a civil service reform introducing effective "Incentives" and "Control“ Systems

....Future Reform Agenda for Ukraine

2. **Improve macroeconomic Stability** by strengthening fiscal policies (improving tax administration, reforming the pension system, decentralizing financing), monetary policies (developing techniques for inflation targeting –open market operations, forecasting models) and foreign exchange rate policies (abandoning the exchange rate anchor)
3. Improve the **legal environment** by:
 - Improving the practice of “public” consideration of any legislative act to be adopted, including their correspondence with existing legislation.
 - Ensure the independence of the Judiciary by further improvement of the financing of courts.
 - Improve court administration and enforcement procedures.
 - Deal expeditiously with issues of illegal corporate raiding.
4. Accelerate further **quick deregulation and liberalization** of business activities (permits, licenses).

....Future Reform Agenda for Ukraine

5. Develop sound **Corporate Governance practices** by enacting key pending legislation (e.g., the Joint Stock Companies law), abolishing the Commercial Code while amending the Civil Code, developing corporate governance codes, and accelerating the adjustment of Ukrainian accounting standards to international accounting standards.
6. **Liberalize trade**, join the WTO, sign free trade agreements with the EU, CIS, and other countries, and simplify trade clearance procedures.
7. **Strengthen the Financial Sector**, particularly by enforcing banking regulations and supervision.
8. Implement a prevention program to deal with **Corruption**
9. Improve the **country's image** by strengthening an Investment Promotion Agency and implement specific activities for large investors (identify major projects, carry out targeted promotional campaigns, identify niches/sectors) and for small/medium firms (access to bank credit, better information on laws, etc).

The Government Program

- The government program contains many specific reform initiatives in virtually any area
- However, it is quite obvious that so many simultaneous reforms, i.e. in such areas as public administration, taxation, political system, etc. may be too costly for the Ukrainian economy
- Hence, to be successfully implemented, the government should set reform priorities
- The government may focus first on initiatives that would bring quick and pronounced results. They may include endorsement of Joint Stock Company Law, improvement of State Procurement Legislation, strengthening fiscal policy, etc.
- This will bring strong public support for further, longer-term reform.
- Concentrate on a few reforms that will have the most significant results and will facilitate and increase efficiency of other reform. This could be a comprehensive public administration reform.