# Ukraine:
# Current Economic Situation and Future Prospects

**Dr. Edilberto Segura**
**Partner and Chief Economist, SigmaBleyzer**
**President of the Board, The Bleyzer Foundation**

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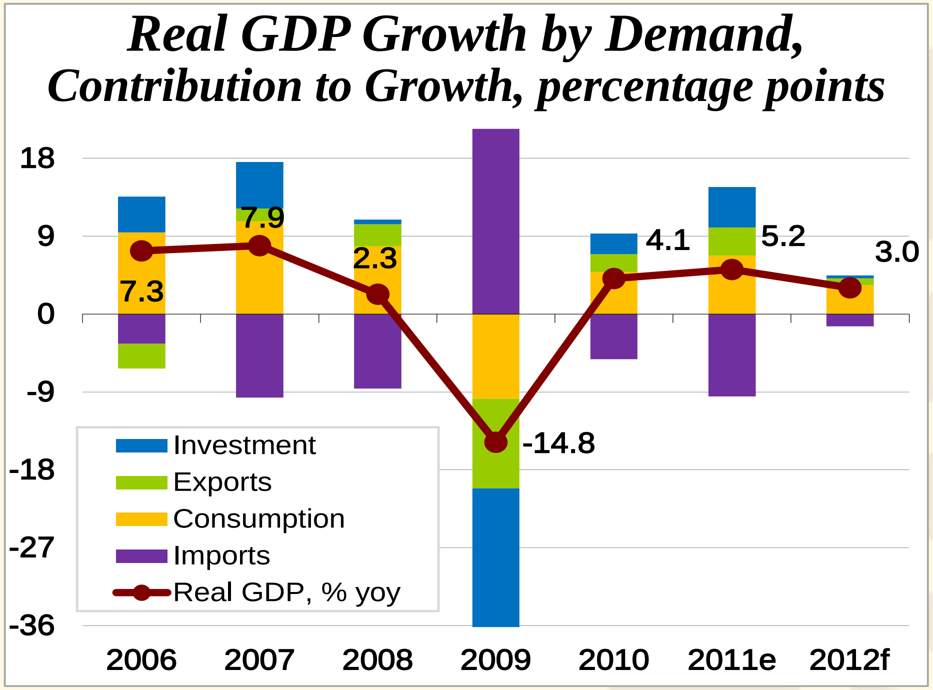
# Main Macroeconomic Indicators

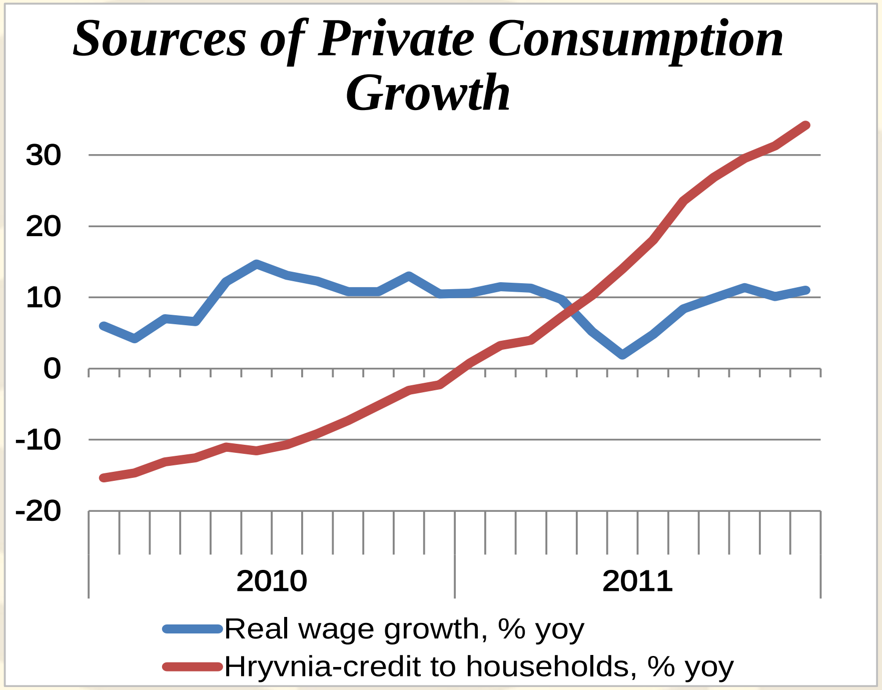
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012f |
|---|---|---|---|---|---|---|---|
| Real GDP Growth, % yoy | 7.3 | 7.9 | 2.3 | -14.8 | 4.2 | 5.2 | 3.0-4.0 |
| Fiscal Balance, % GDP* | -0.7 | -1.7 | -2.0 | -8.9 | -7.0 | -4.3 | -3.5 |
| Consumer Inflation, %, eop | 11.6 | 16.6 | 22.3 | 12.3 | 9.1 | 4.6 | 9.0 |
| Current Account, % GDP | -1.5 | -3.7 | -7.0 | -1.5 | -1.9 | -5.5 | -4.9 |
| Gross Int. Reserves, $ bn | 22.4 | 32.5 | 31.5 | 26.5 | 34.6 | 31.8 | 26.0 |
| Foreign Gov't Debt, % GDP | 11.0 | 8.7 | 9.3 | 20.5 | 23.8 | 21.0 | 19.0 |
| Foreign Private Debt, % GDP | 39.6 | 47.4 | 47.2 | 67.7 | 62.2 | 54.2 | 46.5 |

* *Includes implicit pension fund deficit (credits from Single 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*

*Source: NBU, SSC, MinFin, The Bleyzer Foundation*

# Real Economic Growth in 2011



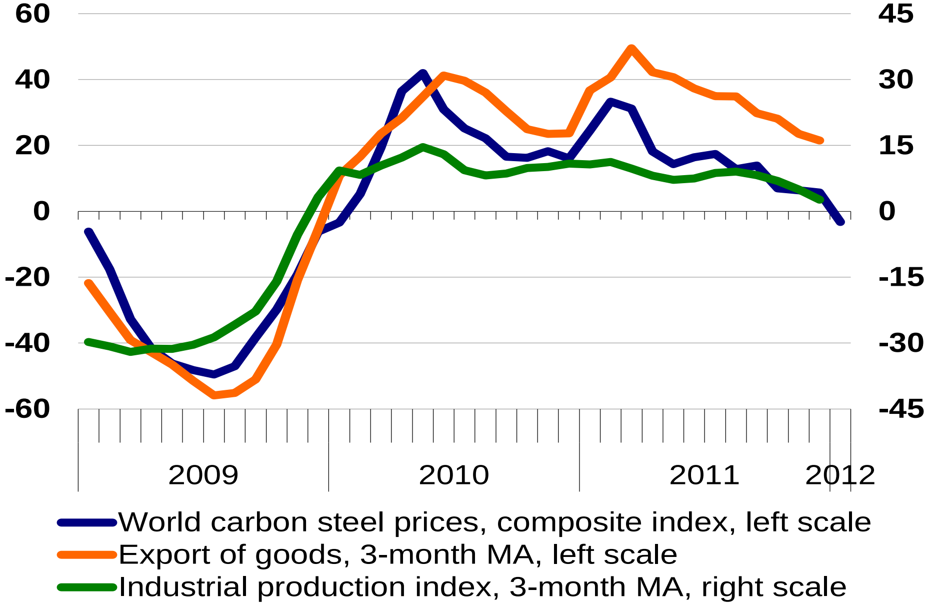




*Source: State Statistics Committee, The Bleyzer Foundation*

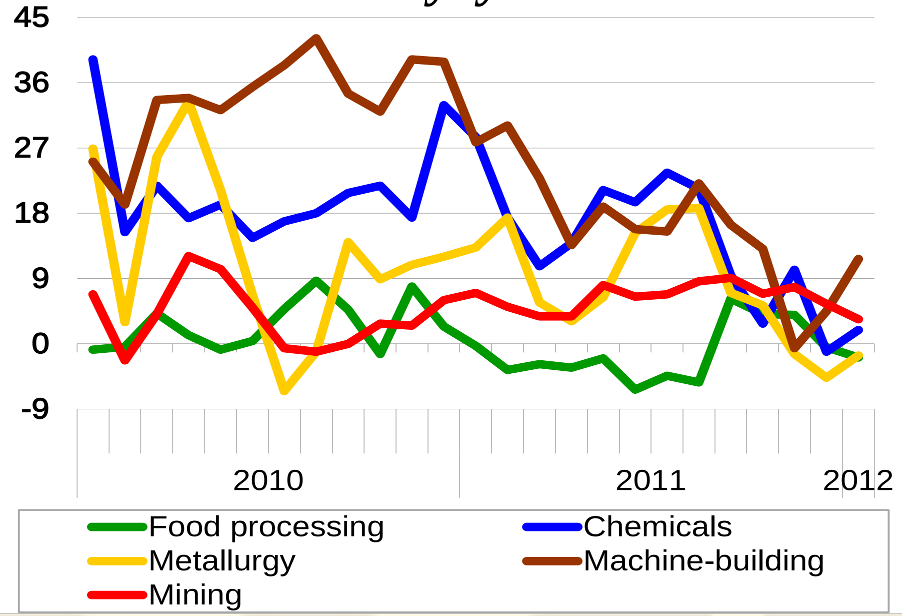
- In 2011, economic growth was very good and better than expected.
- Real GDP grew by 5.2% yoy, up from 4.1% yoy in 2010.
- Private consumption was the main driver of growth, stimulated by strong real wage growth (8.7%) and a revival of consumer credit.
- Investment was the second most important driver.

# Real Sector Performance – the Impact of Exports

***World Steel Prices, Export of Goods and Industrial Production of Ukraine, % yoy***




***Output Growth in Selected Industries, % yoy***

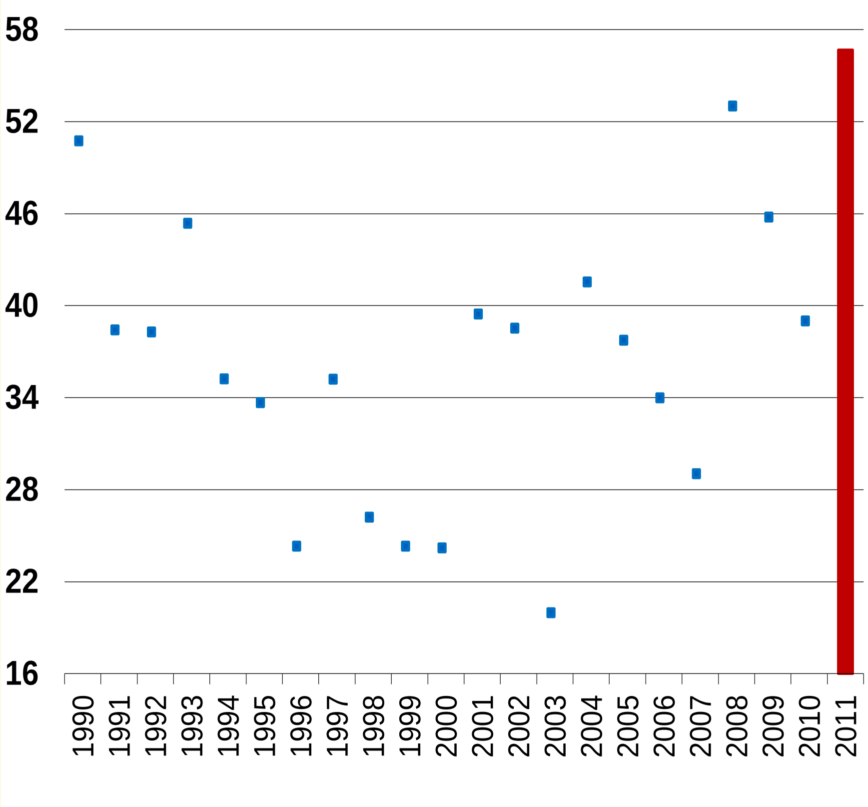



*Source: MEPS, State Statistics Committee, The Bleyzer Foundation*

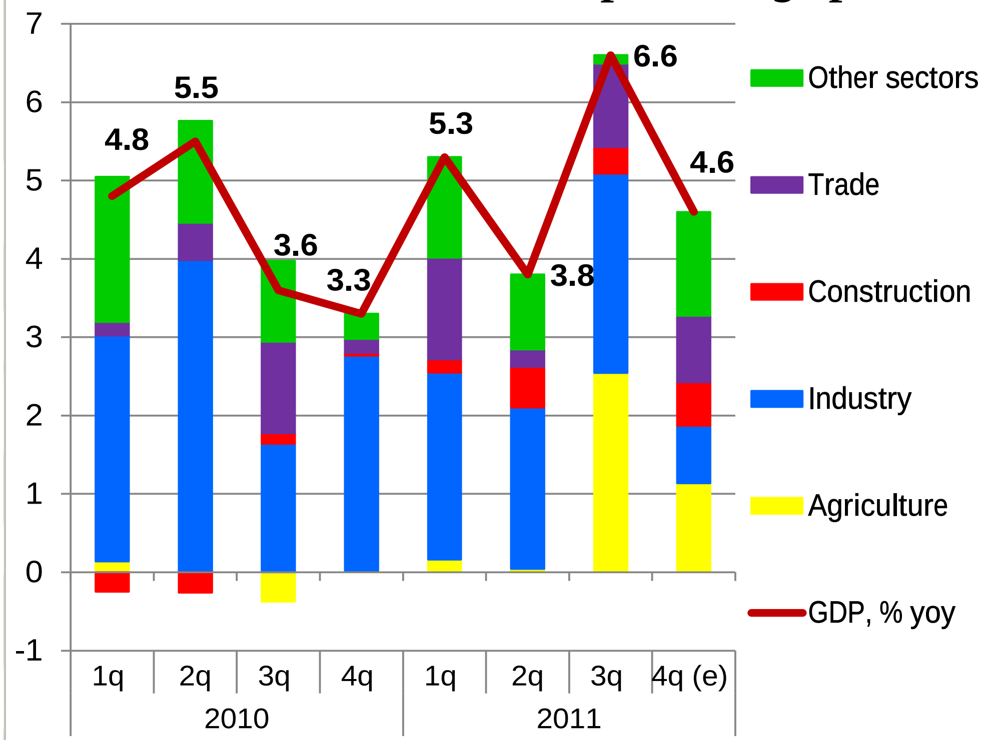
- Exports made a good contribution to growth in the first-half of 2011.
- But since summer 2011, exports and output of export-led industries were hit by weakening foreign demand and falling world commodity prices, both caused by the intensification of the Eurozone crisis.

# Real Sector Performance – the Impact of Agriculture

*Grain Harvest in Ukraine, million ton*



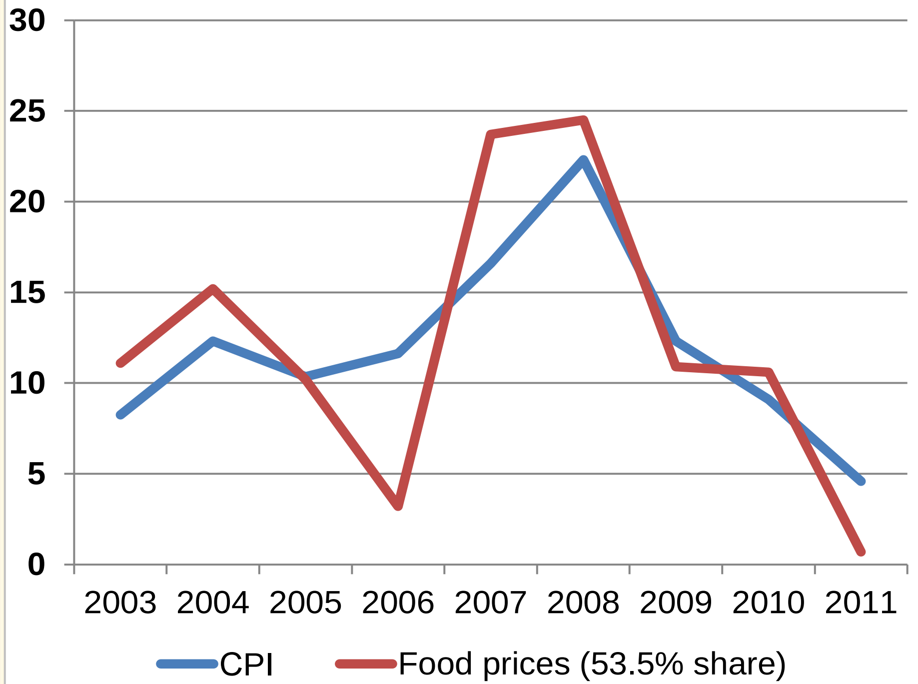

*Real GDP Growth by Sectors, Contribution to Growth, percentage points*

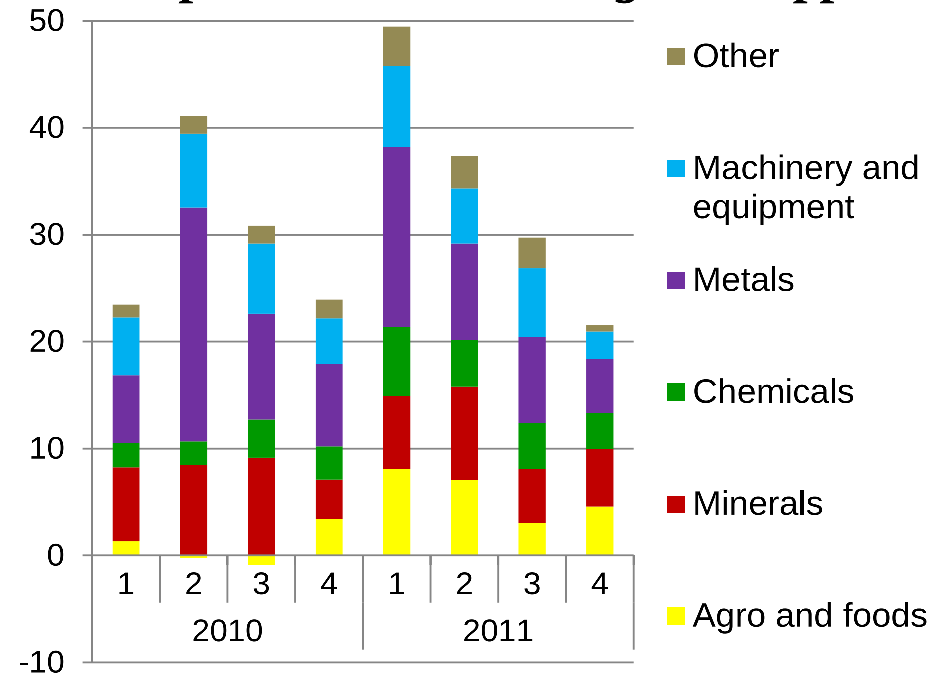



*Source: State Statistics Committee, The Bleyzer Foundation*

- In 2011, Ukraine collected a record high harvest of grains and other crops.
- Agriculture was one of the main drivers of economic growth in 2H 2011.

# Agriculture (cont.)

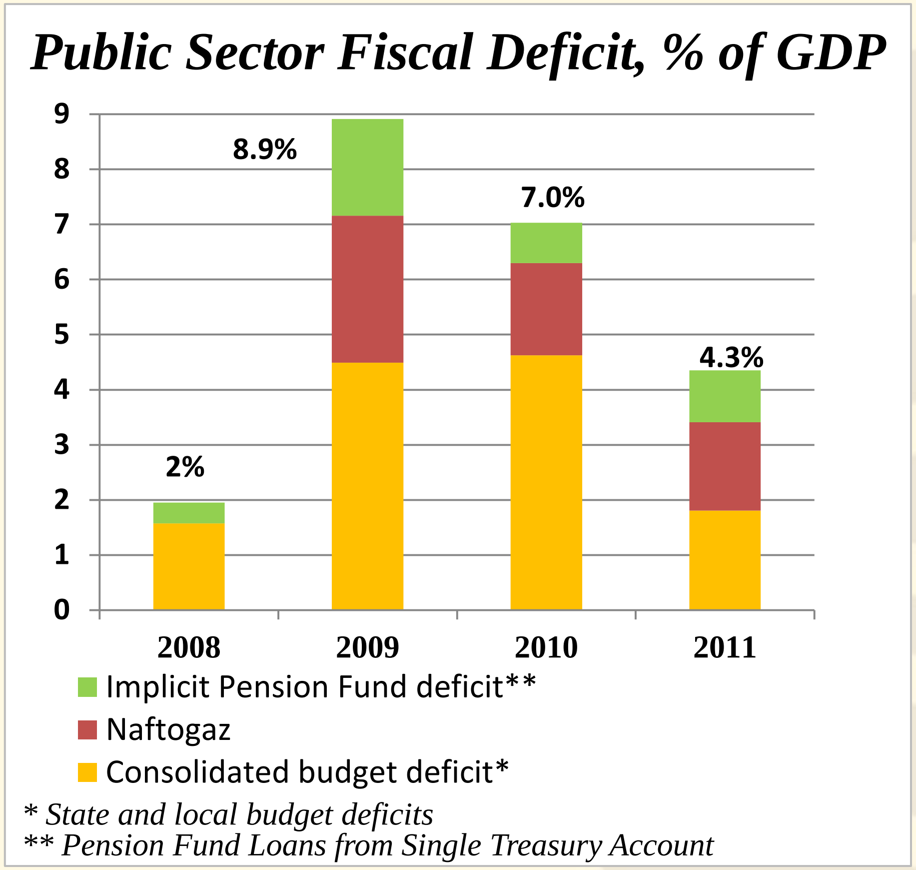


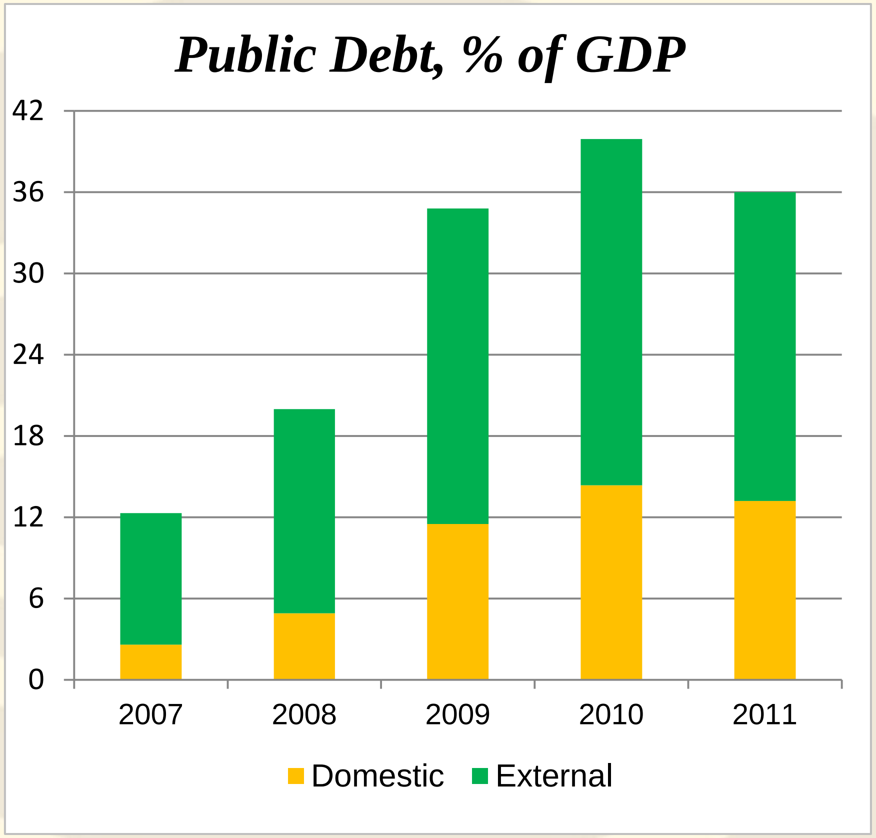




*Source: State Statistics Committee, NBU, The Bleyzer Foundation*

- Generous harvest of grains and selected vegetables caused a decline in consumer price inflation to a 9-year low of 4.6% yoy.
- Agriculture also supported exports in 2011. However, due to grain trade restrictions in 2010, and tighter competition on international markets in 2011, grain exports were much below potential.

# Fiscal Budget Policies and Public Debt

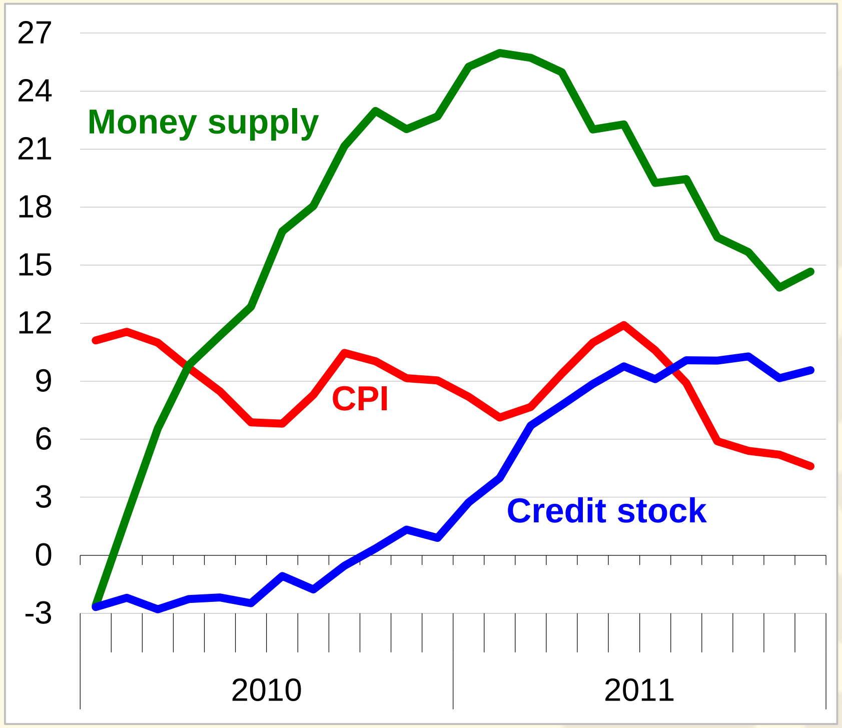


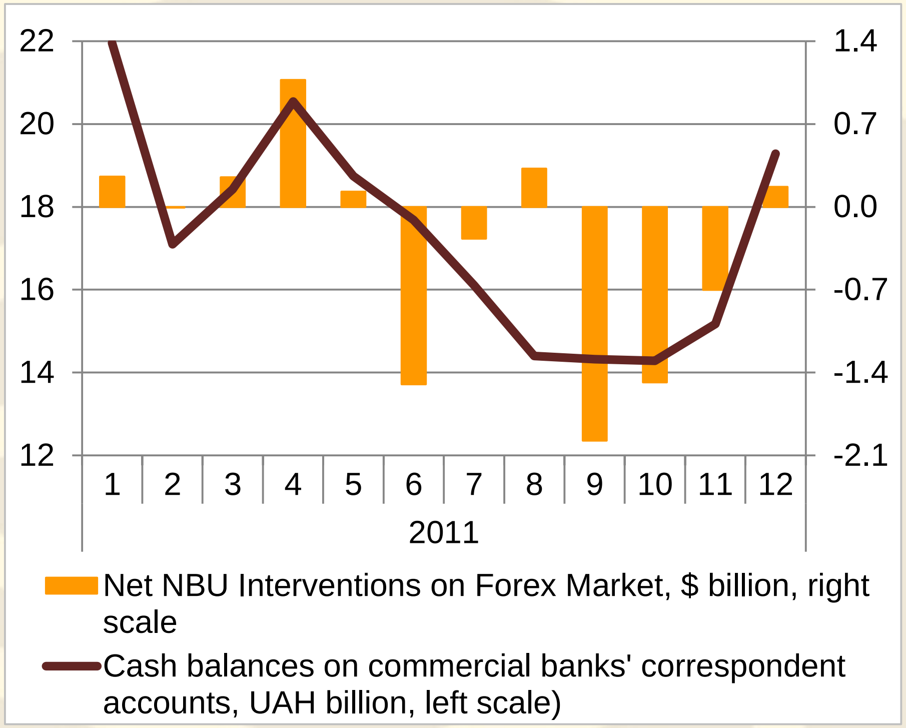




Source: MinFin, The Bleyzer Foundation

- In 2011, public sector deficit declined to 4.3% of GDP, from 7.0% in 2010.
- Public debt fell to 36% of GDP, down from 40% of GDP in 2010.
- But fiscal consolidation proceeded slower than expected, while lower public debt-to-GDP ratio was achieved due to under-execution of borrowing plans.

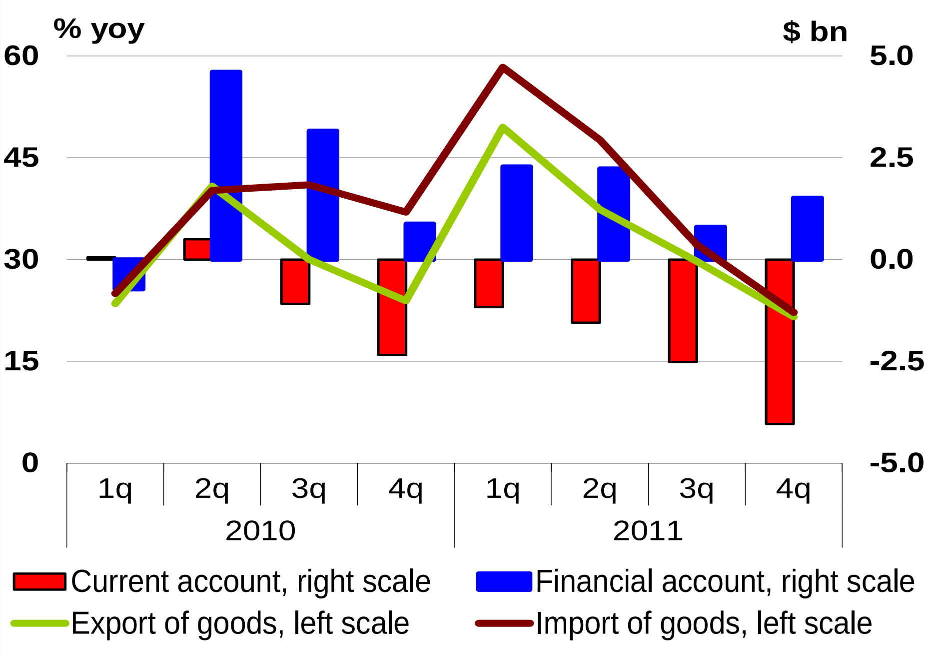
# Monetary Policies

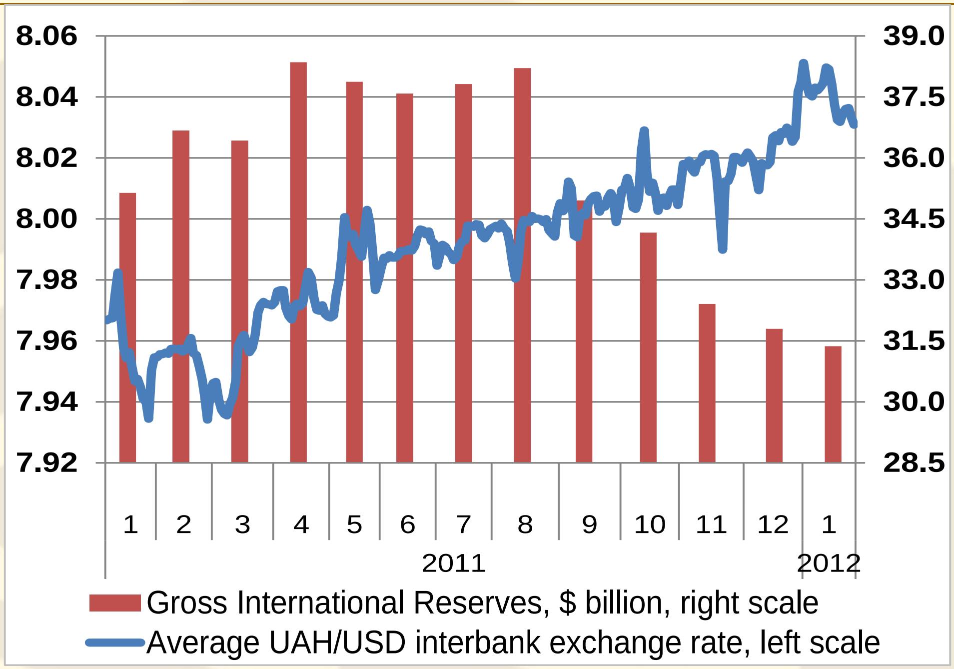



- Tighter monetary policies during 2H 2011 contributed to lower inflation.
- Tight monetary conditions were achieved by the NBU’s measures to absorb banking sector liquidity, the NBU’s sale of international reserves, and slower deposit growth.

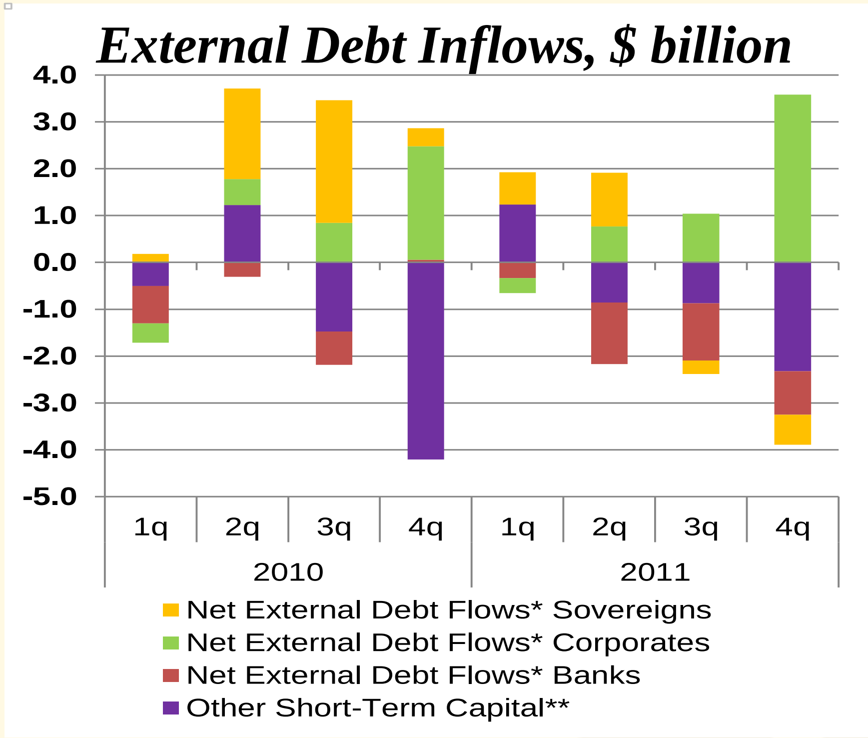
# Balance of Payments and Exchange Rate



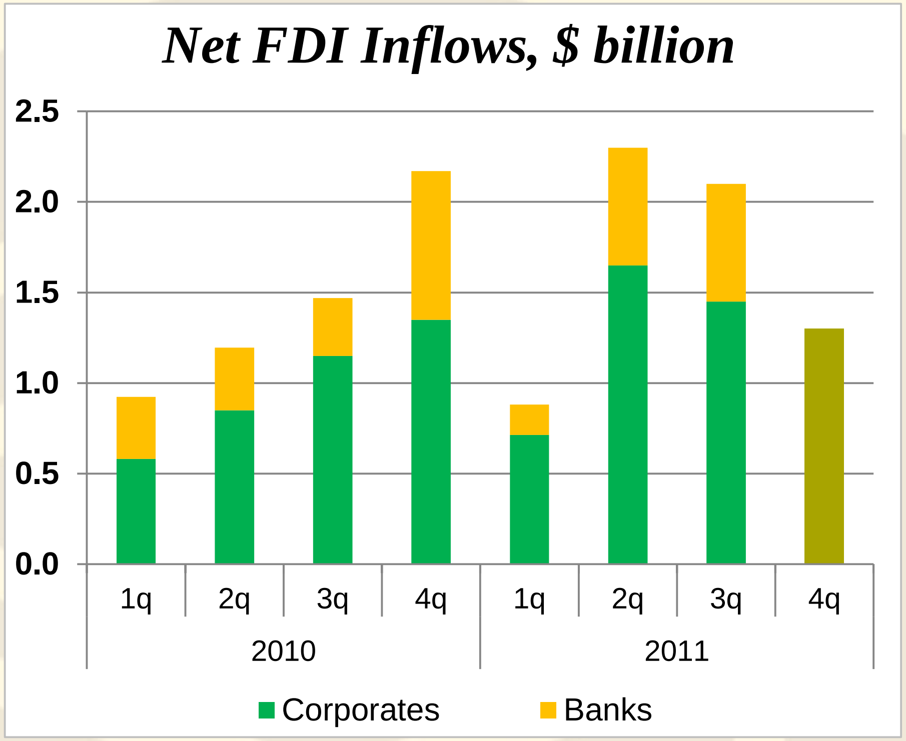




- During 2111, the balance of payments deteriorated due to:
  - Higher deficits in foreign trade and current account balances, with the CA deficit reaching 5.5% of GDP in 2011 from 2% GDP in 2010.
  - High population demand for foreign currency (net purchases amounted to $13 bn).
  - Large external debt payments.
- These conditions led the NBU to take measures to absorb liquidity to reduce demand, reduce Hryvnia depreciation pressures and the depletion of international reserves.

# Foreign Capital Inflows




* Excl. trade credit, inter-company lending, other ST debt liabilities; ** Incl. population demand for foreign currency
Source: NBU, The Bleyzer Foundation




Source: NBU estimate

- In 2011, Ukraine's external debt repayments were estimated at about $50 bn.
- Due to strains on international financial markets and an stalled IMF program, Ukraine faced lower FDI inflows and difficulties in rolling over its debt.

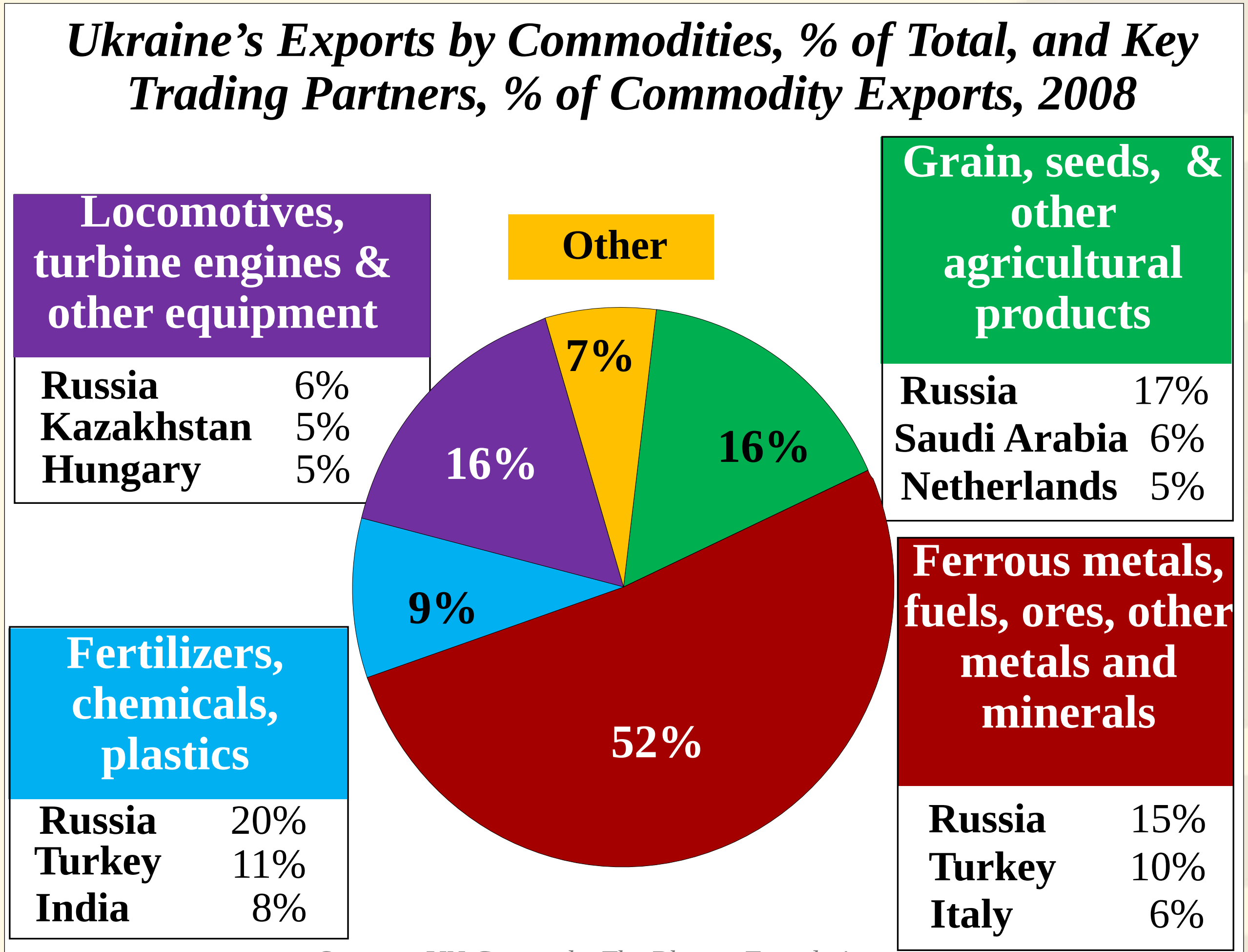
# Why Ukraine Was Affected So Severely in 2008?

## And can these weaknesses affect Ukraine's prospects in the future?

- Ukraine was severely affected by a combination of four vulnerabilities:

    1. Open but Undiversified Economy
    2. Large Current Account Deficits
    3. Large External Debt Repayments
    4. Banking Sector Weaknesses

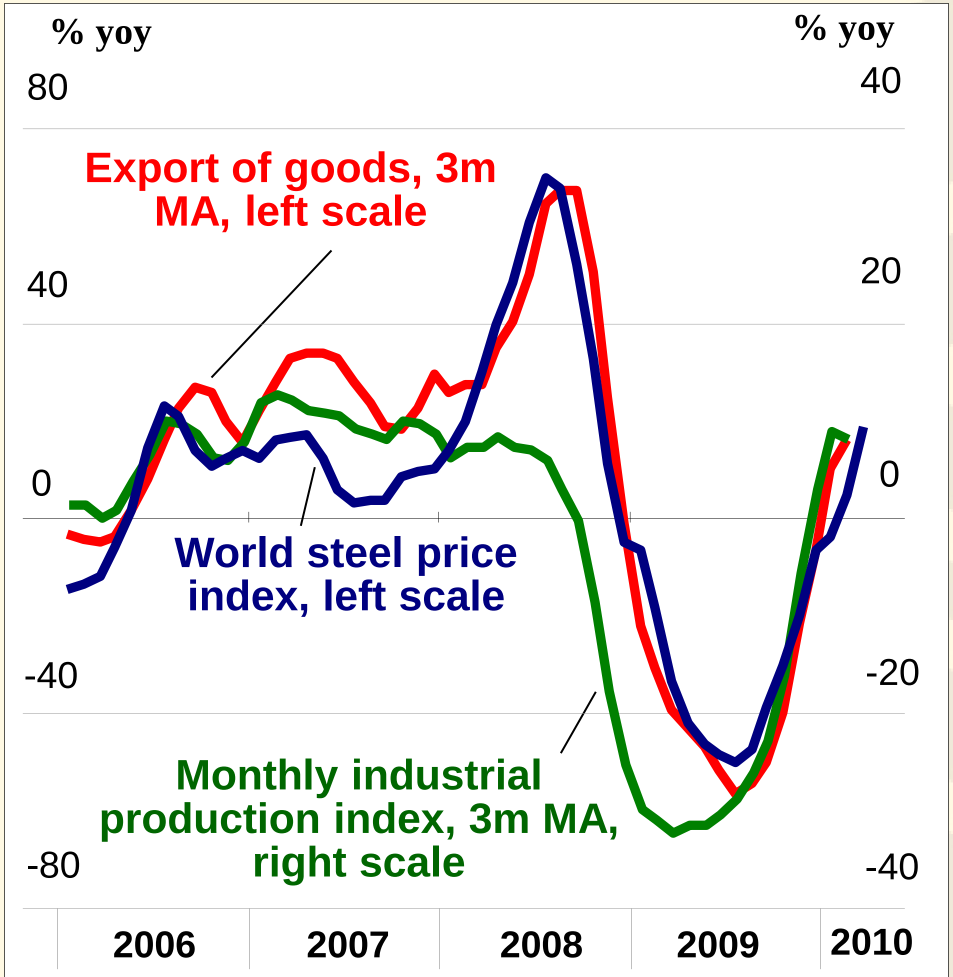
# Vulnerability #1 – Open & Undiversified Economy…




Sources: UN Comtrade, The Bleyzer Foundation

- Exports represent 50% of GDP
- But exports are undiversified:
- Metals, Minerals and Chemicals account for 60% of exports.
- This lack of product diversification is the result of lack of reforms in the past.

# …with high dependence on Steel Prices…

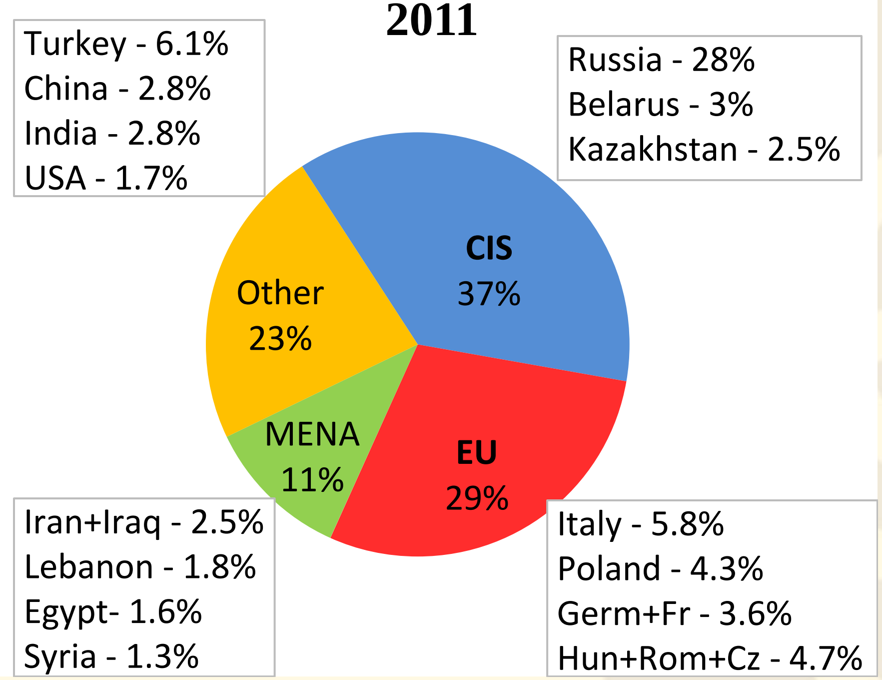



Source: *State Statistics Committee, NBU, MEPS, TBF*

- Ukraine's exports and industrial production are very dependent on international **steel prices**, which are very vulnerable to crises, as people stop buying cars and houses.
- World steel prices fell sharply from mid-2008 to mid-2009.
- Ukraine's exports of goods dropped by 40% yoy in US$ terms in 2009.
- Industrial production declined by 22% yoy.
- Product diversification must be a priority for economic reforms.

# …and exports undiversified geographically

**Ukraine' s Goods Exports by Regions and Selected Countries, % of total , 1H 2011**

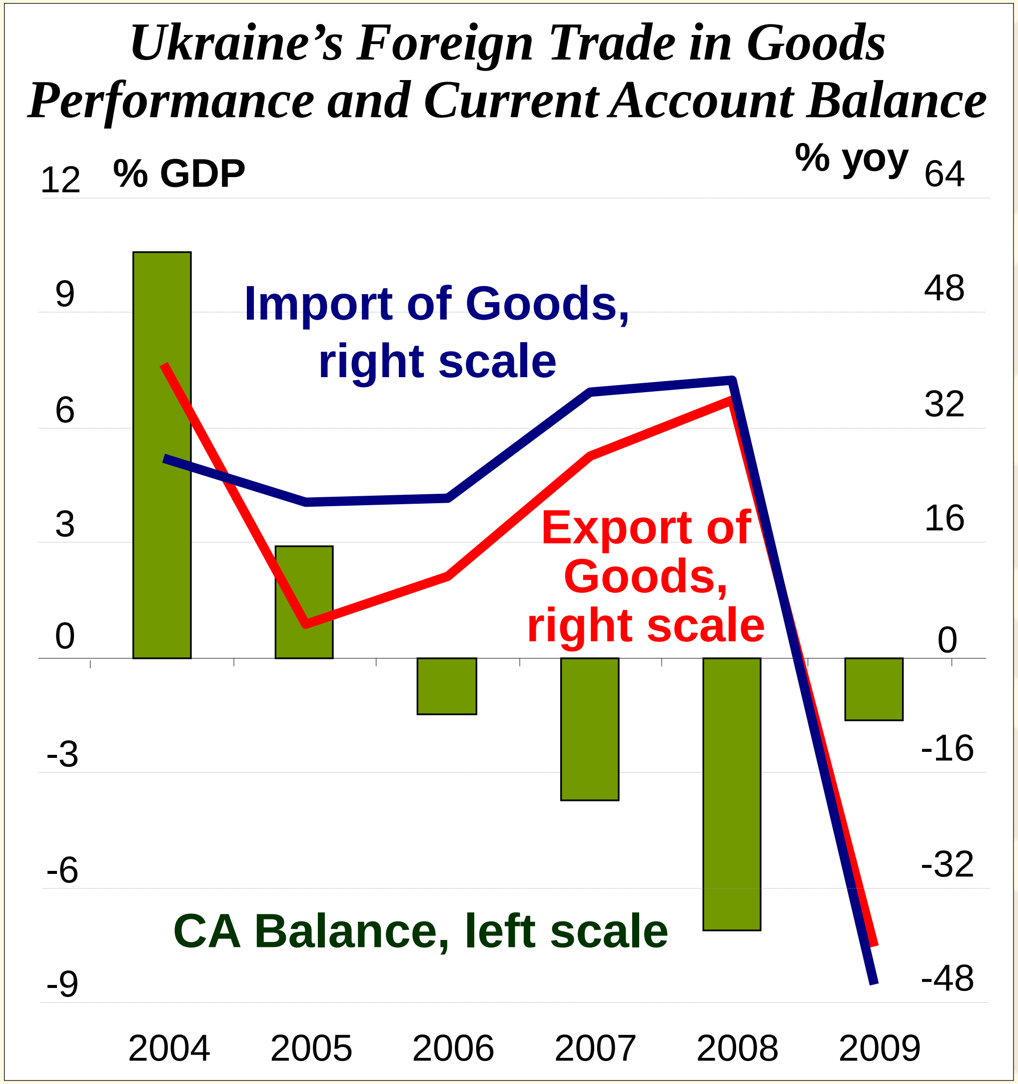



Source: State Statistics Committee, The Bleyzer Foundation

- Demand for Ukraine's exports depends on a few countries.
- Exports to Russia and other CIS countries slowed due to:
  - Weaker growth in Russia, economic downturn in Belarus;
  - Trade restrictions, imposed by Russia.
  - Continuing turbulences in the MENA region.

- The second largest market for Ukraine's exports, the EU, also experience slow downs.
- Slower growth in the CIS, EU and Turkey will affect Ukrainian exports.

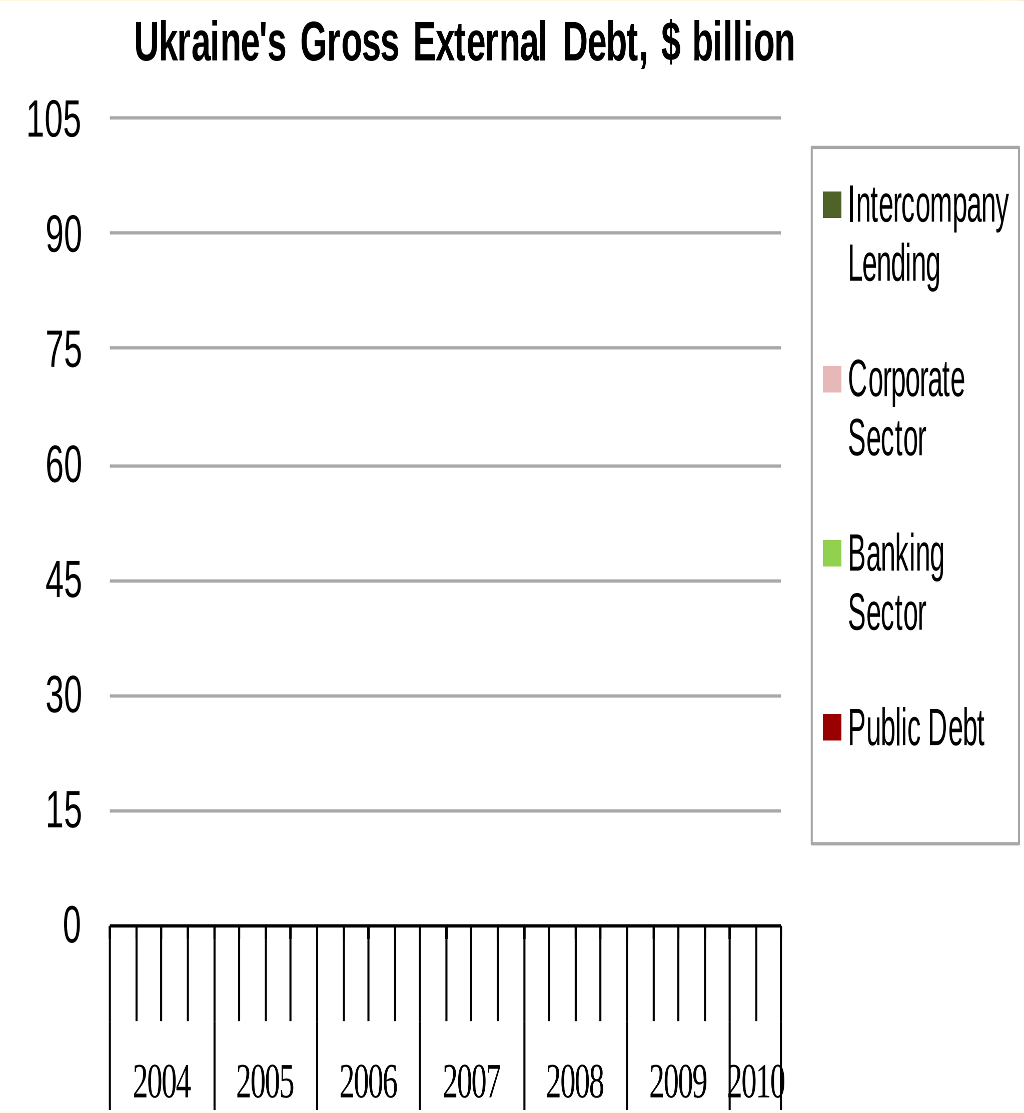
# Vulnerability # 2 – Large Current Account Deficits




- Over 2003-2008:
  - Exports grew by 25% pa
  - But imports – by 30% pa
- CA deficits over 3% of GDP emerged in 2006 and reached 7% of GDP in 2008.
- Before the crises, the CA deficit for 2009 was forecast at 13% GDP.
- Uncertain foreign financing of this CA put pressures on the Hryvnia, principally since external debt was already high.

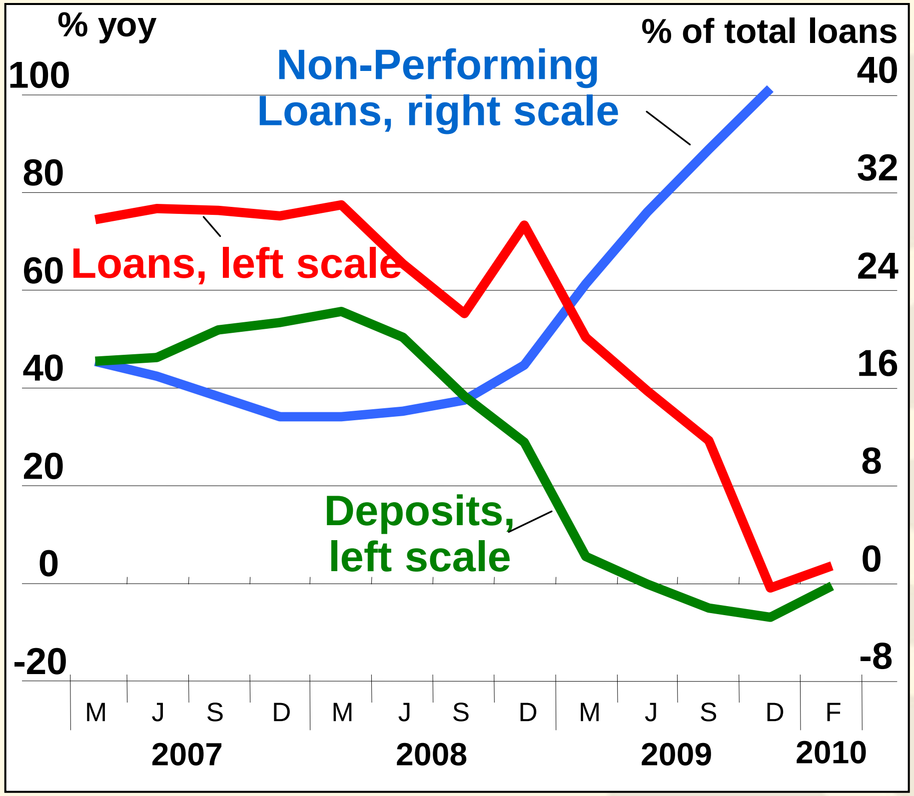
Source: NBU, SSC, The Bleyzer Foundation

# Vulnerability # 3 – Large External Debt Repayments




- External debt tripled in three years (2006-08) to about $100 billion (90% of GDP).
- As of mid-2008, ~ $40 billion of debt was due in 1 year –vs- $35 billion of international reserves.
- Debt rollover became very difficult during the initial stages of the crisis, pressuring the Hryvnia.
- Ukraine was considered high risk given its high level of external debt, compared to other countries.

# Vulnerability # 4 – Banking Sector Weaknesses




Source: NBU, IMF, TBF

- Over 2006-08, commercial bank lending grew by 70% pa
- This high credit growth led to a high ratio of non-performing loans (NPLs) of 14.5% of loans in 2008 and around 40% currently (including substandard loans.)
- Credit growth was mainly financed by foreign borrowings, with 50% of total loans issued in foreign currency.

- All this created uncertainties and about ¼ of bank deposits were lost in late 2008 - early 2009.
- Although the deposit base was stabilized in mid-2009, in 2009 the banking sector as a whole made $3.9 billion in loses.

# What Factors will Affect Ukraine's Future Recovery?

## External Environment:

1. The pace of economic recovery in Ukraine's main trading partners
2. The prospects for Ukrainian exports
   - Prospects for steel and metallurgical exports
   - Prospects for agricultural exports
   - Degree of international competitiveness of Ukraine
3. Ability of Ukraine to secure external financing and roll-over debts

## Domestic Factors:

4. Adequacy of Macroeconomic Stabilization Policies
5. Pace of recovery of Banking Credit and Domestic Demand
6. Adequacy of Economic Policies to **sustain** long-term growth by improving the business climate to attract investments

# 1. Economic Recovery in Trading Partners

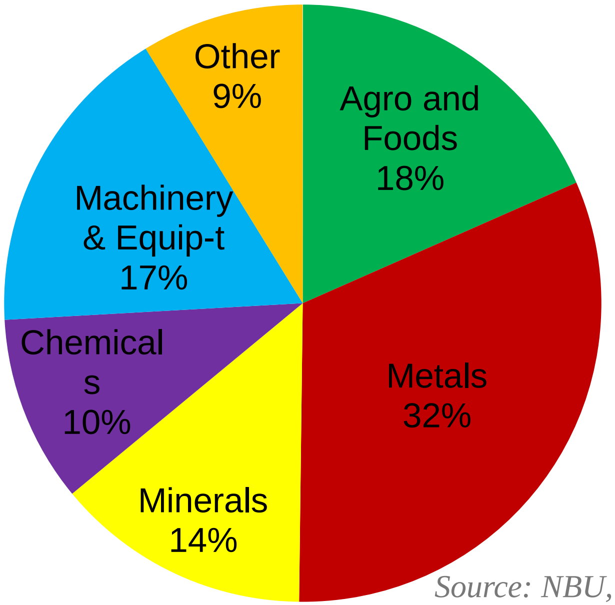
| | 2010 | 2011 | Projections 2012 | Projections 2013 |
|---|---|---|---|---|
| **World Output** [1] | **5.2** | **3.8** | **3.3** | **3.9** |
| **Advanced Economies** | **3.2** | **1.6** | **1.2** | **1.9** |
| United States | 3.0 | 1.8 | 1.8 | 2.2 |
| Euro Area | 1.9 | 1.6 | -0.5 | 0.8 |
| Germany | 3.6 | 3.0 | 0.3 | 1.5 |
| France | 1.4 | 1.6 | 0.2 | 1.0 |
| Italy | 1.5 | 0.4 | -2.2 | -0.6 |
| Spain | -0.1 | 0.7 | -1.7 | -0.3 |
| Japan | 4.4 | -0.9 | 1.7 | 1.6 |
| United Kingdom | 2.1 | 0.9 | 0.6 | 2.0 |
| Canada | 3.2 | 2.3 | 1.7 | 2.0 |
| Other Advanced Economies [2] | 5.8 | 3.3 | 2.6 | 3.4 |
| Newly Industrialized Asian Economies | 8.4 | 4.2 | 3.3 | 4.1 |
| **Emerging and Developing Economies** [3] | **7.3** | **6.2** | **5.4** | **5.9** |
| Central and Eastern Europe | 4.5 | 5.1 | 1.1 | 2.4 |
| Commonwealth of Independent States | 4.6 | 4.5 | 3.7 | 3.8 |
| Russia | 4.0 | 4.1 | 3.3 | 3.5 |
| Excluding Russia | 6.0 | 5.5 | 4.4 | 4.7 |
| Developing Asia | 9.5 | 7.9 | 7.3 | 7.8 |
| China | 10.4 | 9.2 | 8.2 | 8.8 |
| India | 9.9 | 7.4 | 7.0 | 7.3 |
| ASEAN-5 [4] | 6.9 | 4.8 | 5.2 | 5.6 |
| Latin America and the Caribbean | 6.1 | 4.6 | 3.6 | 3.9 |

- In 2012, European & Eurozone GDP growth will be negative, due to austerity measures, including in core and periphery countries.
- Nevertheless, most developed countries should be able to avoid major recessions, if Greece's debt situation is resolved.
- Emerging markets' growth in 2012 will decline (due to slowdowns in developed economies),but will be positive, at 5.4%.
- Nevertheless, the prospects for Ukraine's trading partners are less favorable than in 2010.

*Source: IMF Projections in World Economic Outlook Update, January 2012*

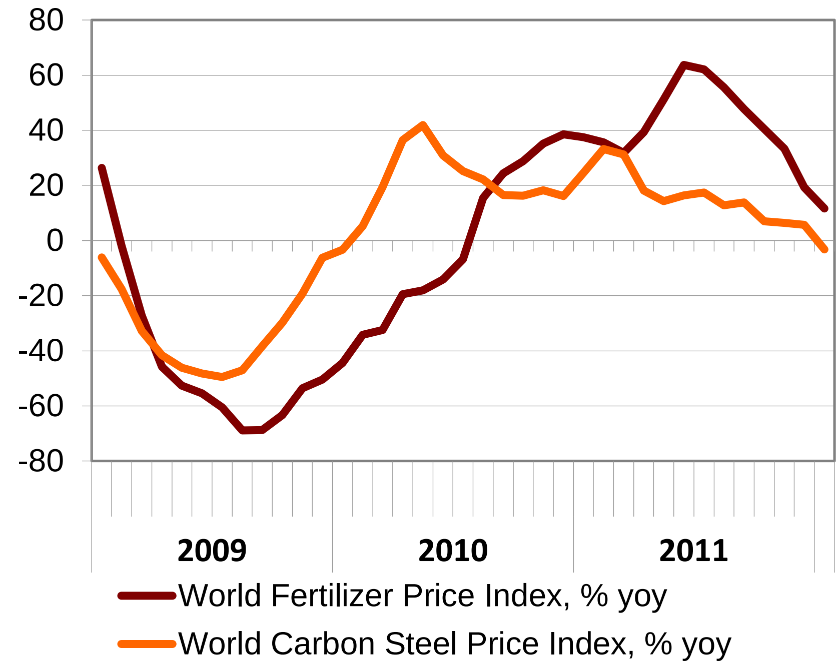
# 2. Prospects for Ukrainian Exports

***Export of Goods Structure, % of total, 2011***



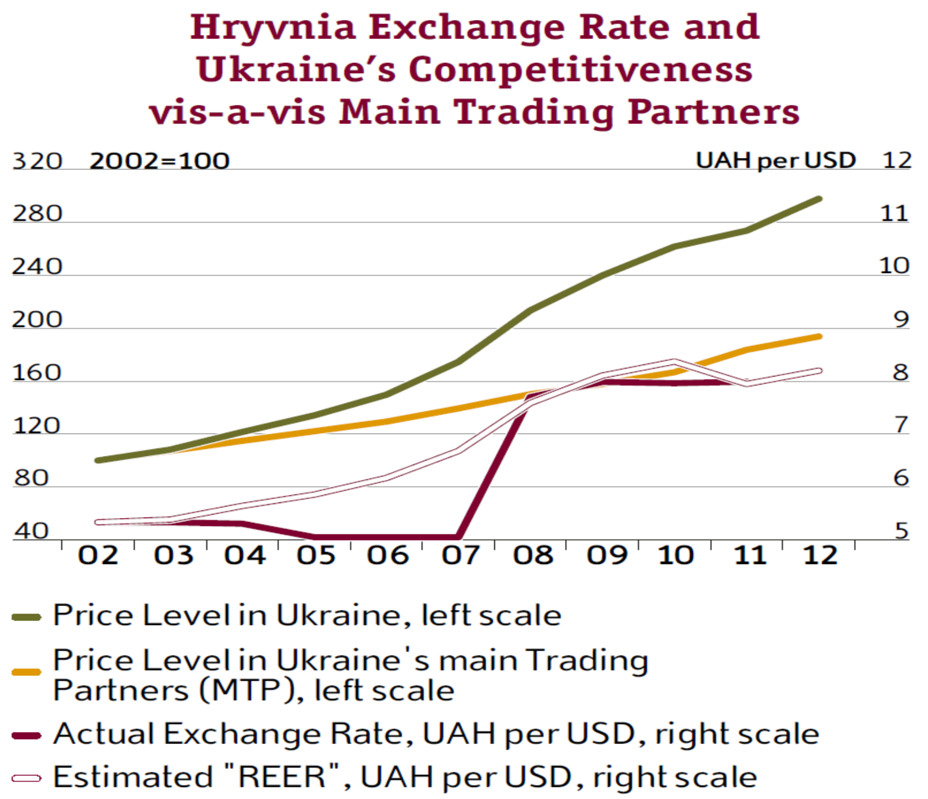

*Source: NBU, The Bleyzer Foundation*

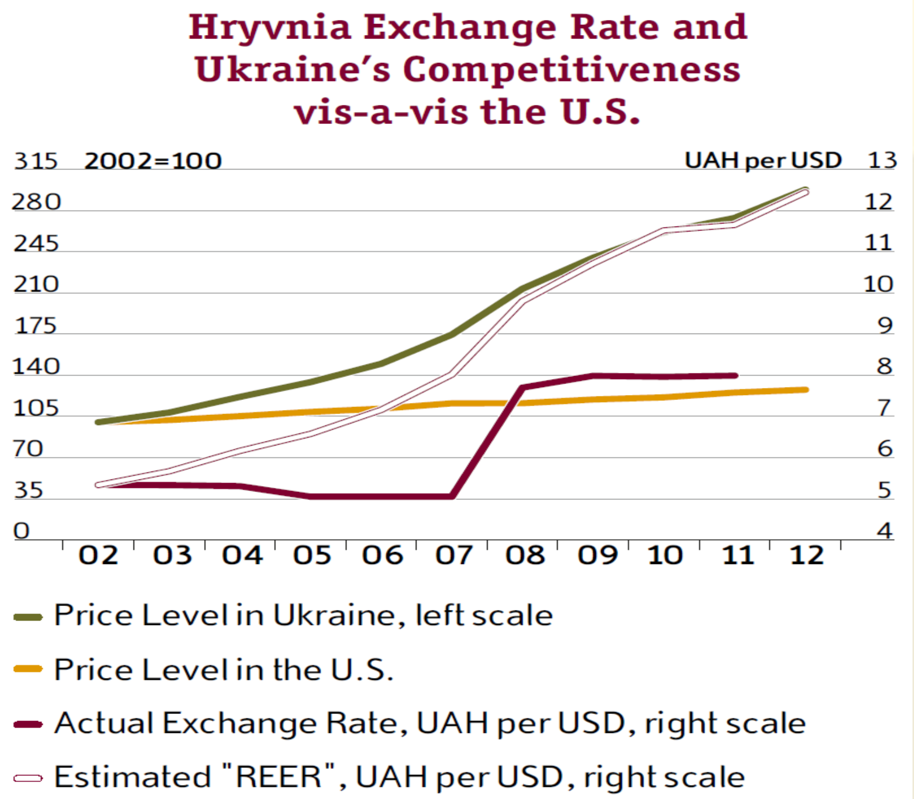
***Selected World Commodity Prices***




- Slower global GDP growth will reduce not only world demand for commodities, but also their prices, including the price of steel and fertilizers.
- In fact, from May to Dec 2011, steel prices already fell by ~15%.
- Weaker 2012 harvest outlook and new trade restrictions imposed by Russia (and other Customs Union countries) may affect Ukraine’s exports.

# 2c. Degree of International Competitiveness
## *(based on Purchasing Power Parity - Medium Term View)*




- High inflation in Ukraine (10% pa over 2002-12) and virtually stable exchange rate until 2008, meant that over time Ukraine lost competitiveness.
- But adjustment took place in 2008 through a major exchange rate depreciation.
- As inflation is forecast to accelerate in 2012-3 (to about 8-9%, Ukraine's competitiveness is likely to weaken again.

# 3. Ability to Cover External Financing Needs

***Ukraine's External Debt Service Needs***

| $ billion | 2012 | 2013 | 2014 |
|---|---|---|---|
| **Public Debt Service** | **9.6** | **10.0** | **8.0** |
| *principal* | 8.0 | 8.4 | 6.8 |
| *Interest* | 1.6 | 1.6 | 1.2 |
| **Private Debt Service** | **54.0** | **49.7** | **47.5** |
| *principal* | 46.0 | 42.0 | 40.0 |
| *interest* | 8.0 | 7.7 | 7.5 |
| **Total Needs** | **63.6** | **59.7** | **55.5** |

*Source: MinFin, NBU, IMF, TBF estimate*

- Ukraine is no longer a low-debt country with external debt at 75% of GDP (compared to 35% average for emerging countries)
- Gross external debt (public & private) stood at $123 bn at end-September 2011.
- In 2012, external **debt service payments will** remain high, estimated at about $64 billion or 36% of GDP.
- Ukraine must maintain investors' confidence to keep rollover ratios high.

# …Ability to Cover External Financing Needs

*Balance of FX Needs and Inflows*

| | 2012f | |
|---|---|---|
| $ billion | **Outflow** | **Inflow** |
| **CA balance*** | 8.5 | |
| **Ext'l Public Debt** | 8.0 | 6.7 |
| **Ext'l Private Debt** | 46.0 | 38.4 |
| *Banks* | *12.0* | *9.3* |
| *Corporates*** | *34.0* | *29.1* |
| **FDI** | | 4.0 |
| **Net purchases of FX by population** | 4.0 | |
| **Total** | **65.5** | **49.1** |
| **Change in Reserves** | | -17.4 |

** Includes external debt service payments*
*** Includes inter-company lending*
*Source: NBU, MinFin, The Bleyzer Foundation*

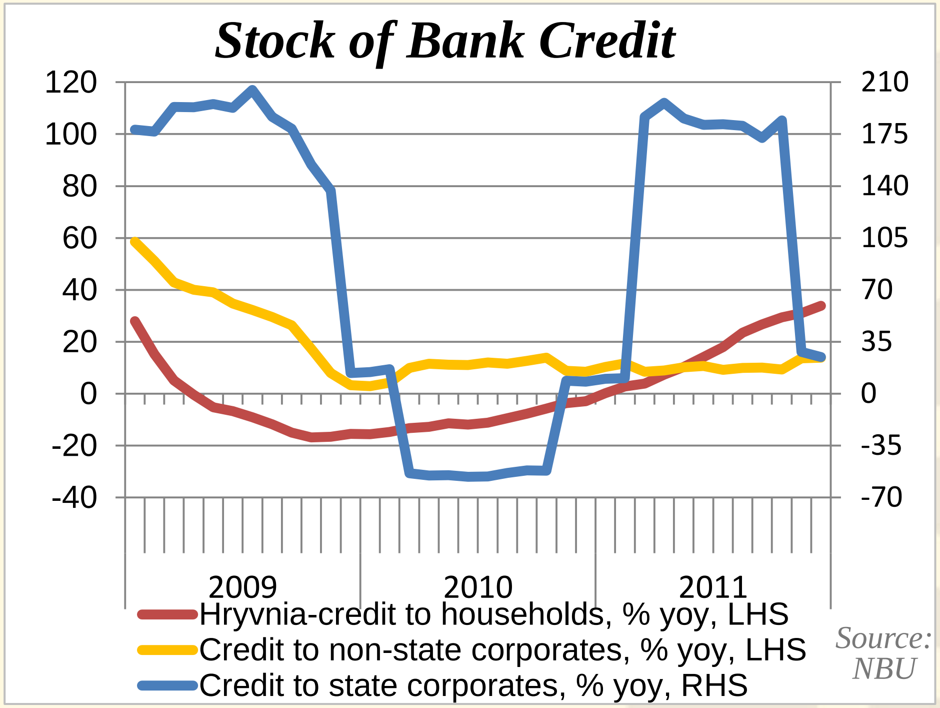
- Due to weaker exports and strong imports, the Current Account deficit will remain high at 4.9% of GDP in 2012, requiring $8.5 billion of financing.
- Also, Ukraine's external short-term debt service is about $54 bn.
- The prospects of having 100% rollover ratios have declined, given possible de-leveraging in European banks.
- FDI inflows still did not recovered to pre-crisis levels and are much below potential.

- IMF or other funds are now essential to finance the outflows.
- If no additional foreign financing is found, international reserves may decline by $17 billion, dropping to about $15 billion, or ~2 months of imports.

# 4. Macroeconomic Stabilization and Fiscal Budget Deficit

- In 2011, due to higher Naftogaz and Pension Fund imbalances, the fiscal budget deficit was higher than the IMF target of 3.5% of GDP.
- In 2012, given Ukraine's reluctance to raise natural gas tariffs to population and likely pre-election fiscal expenses, the deficit is unlikely to be 2.5% in 2012, as required by the IMF.
- It is unlikely therefore that the IMF will be able to provide financing to the country.
- The government is also facing difficulties in raising sufficient funds to the budget due to tight domestic liquidity and turbulent international financial markets.
- As a result, the government had to accept higher yields, shorter maturities and new riskier instrument (USD-indexed and USD-denominated domestic bonds).
- All these factors may affect macroeconomic stability, as the government may be forced to resort to monetization of its fiscal deficit.

# 5. Recovery of the Banking Sector and Credit




- Banking credit growth has been reviving:
  - the highest credit increase was for state-owned companies during most of 2011;
  - consumer credit expanded at a robust 34% yoy in 2011, supporting consumption but also fuelling imports;
  - credit growth to private companies has been sluggish - 14% yoy in Dec 2011.

- Large lending to SOE may complicate the ongoing process of cleaning commercial banks balance sheets from NPLs (~40% of total loans).
- The substantial presence of European banks in Ukraine's banking sector is another source of vulnerability, given the Eurozone's crisis.

# 6. Adequacy of Policies to Sustain Growth

- Since the 2008 crisis, the government has developed a good program of economic reforms to sustain growth; but implementation has been limited.
- Necessary short term measures include:
  - End business harassment, threats, and interference by government authorities in businesses, including harassment by tax authorities, customs, inspection agencies, etc.
  - Better protection of property rights, including stronger mechanisms to deal with raiders.
  - Simplify procedures to acquire commercial land for plant & warehousing.
  - Facilitate the establishment of new businesses, including de-regulation and improving production sharing agreements for oil and gas.
  - Approve the Customs Code to facilitate international trade.
  - Take stronger measures to resolve non-performing loans in the banking sector.
  - Ensure that the Association Agreement and FTA with the EU are signed soon.
- Over the medium term, the government will need to show that:
  - The Judiciary is finally reformed and will be acting in a fair and transparent manner.
  - Administrative corruption is brought under control.
  - Public administration reform will be finalized to redefine the role of the government as complementary to the private sector, improve efficiency by eliminating overlapping functions among agencies, minimize regulations to avoid interference in businesses.

# Summary of 2012 Prospects

- Due to a difficult external environment and difficulties with domestic policies, Ukraine's real GDP growth is forecast at about 3-4 % yoy in 2012.
- Private consumption will be the main driver of economic growth, stimulated by low inflation in 1H 2012 (spillover effect of record high 2011 harvest) and budget spending.
- Due to high energy prices and likely tariffs adjustments after elections, inflation will accelerate to about 9% at the end of the year.
- The Fiscal deficit is likely to exceed the IMF-targeted 2.5% of GDP.
- Current account balance may improve thanks to lower energy imports, but due to elevated energy prices and robust consumption the deficit will remain high at around 5% of GDP.
- Given turbulent international financial markets and frozen IMF program, external debt rollover may be challenging for Ukraine.

# Moving Forward

- If Ukraine were to implement its strong reform program, the country will be less vulnerable to international crises and sustain higher rates of growth.
- In fact, Ukraine has many advantages that could enable it to grow based on domestic markets --consumption and investments-- with less vulnerability to exports. In fact, the domestic market could become the major engine of growth. But this will require major flows of foreign direct investments that require a better business climate.
- International comparisons show that Ukraine may indeed be attractive for FDIs:
  - Ukraine's large population gives a very attractive market potential for local and international consumer products.
  - Ukrainian wages are low at about 1/3 of those in Eastern Europe,
  - Education and health indicators in Ukraine are much better than other countries.
  - Ukraine is endowed with very rich agricultural land that could be a growth engine.
  - Ukraine is an open economy which could grow faster with Free Trade Agreements.