

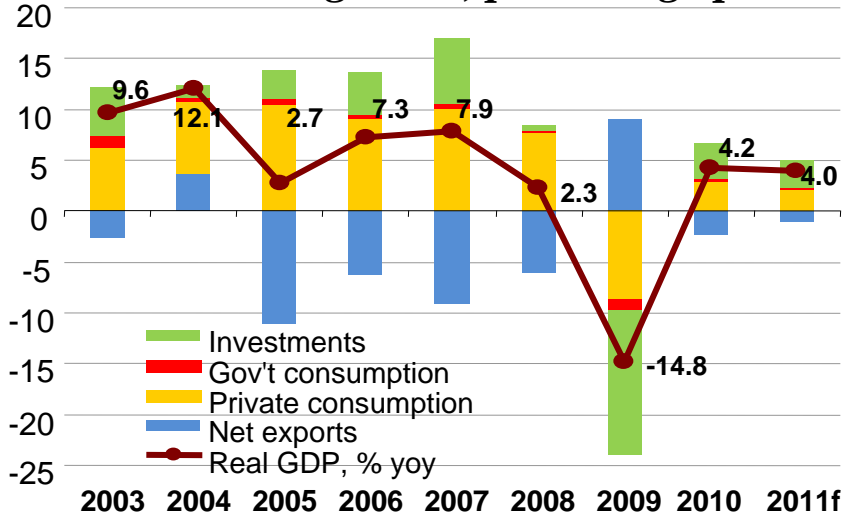
Ukraine: Economic Situation and Prospects

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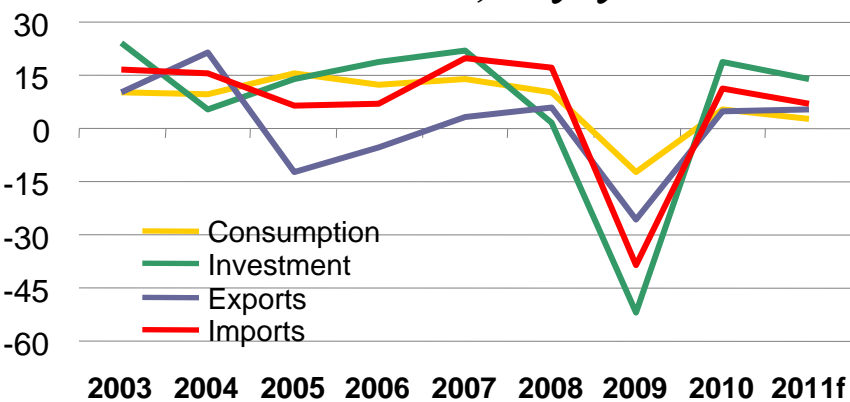
March 2011

Ukraine's Economic Growth

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



Growth Rates, % yoy



Sources: State Statistics Committee, The Bleyzer Foundation

- **In 2010**, the Ukrainian economy recovered from the 2009 deep recession.
- At the beginning of 2010, the recovery was mainly driven by **exports**.
- But since 2Q 2010, the strongest contributors to growth were the revival of **domestic consumption** and large **inventory re-build**.
- At the same time, imports accelerated too, increasing the CA deficit.
- Real GDP grew by 4.2% yoy in 2010.
- **In 2011-12**, real GDP is forecast to grow at a lower rate of 4% yoy, since the current sources of growth are likely to weaken.

Main Macroeconomic Indicators

	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	-2.1	-8.5	-7.2#
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	25.4
Foreign Private Debt, % GDP	29.2	39.6	47.4	47.1	68.1	62.0#

* 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

Estimate

Factors Affecting Future Economic Growth

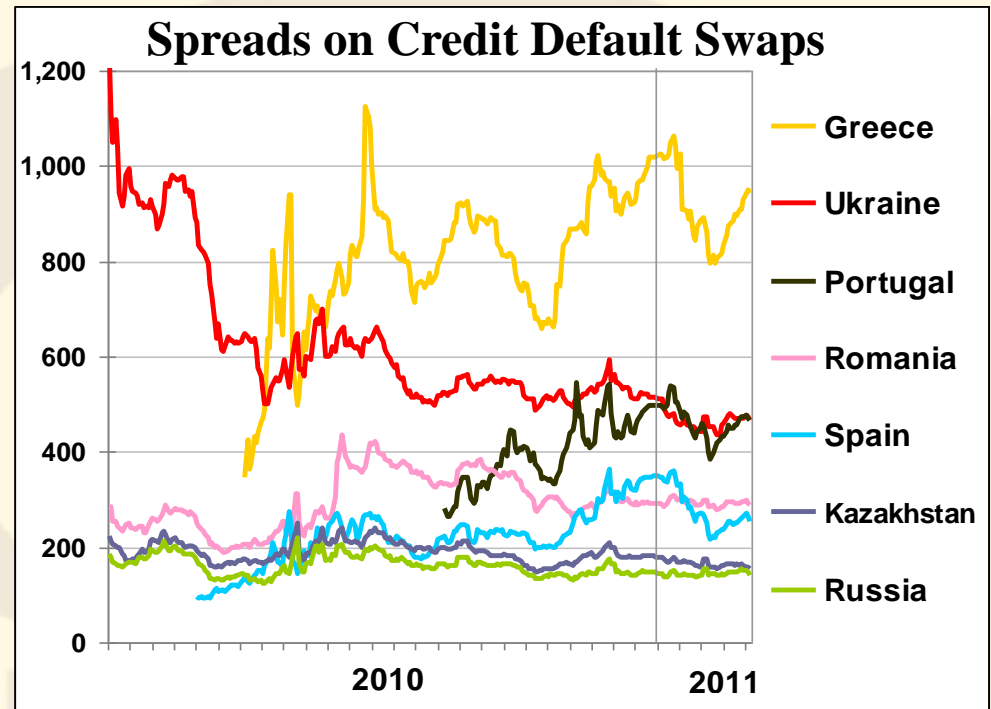
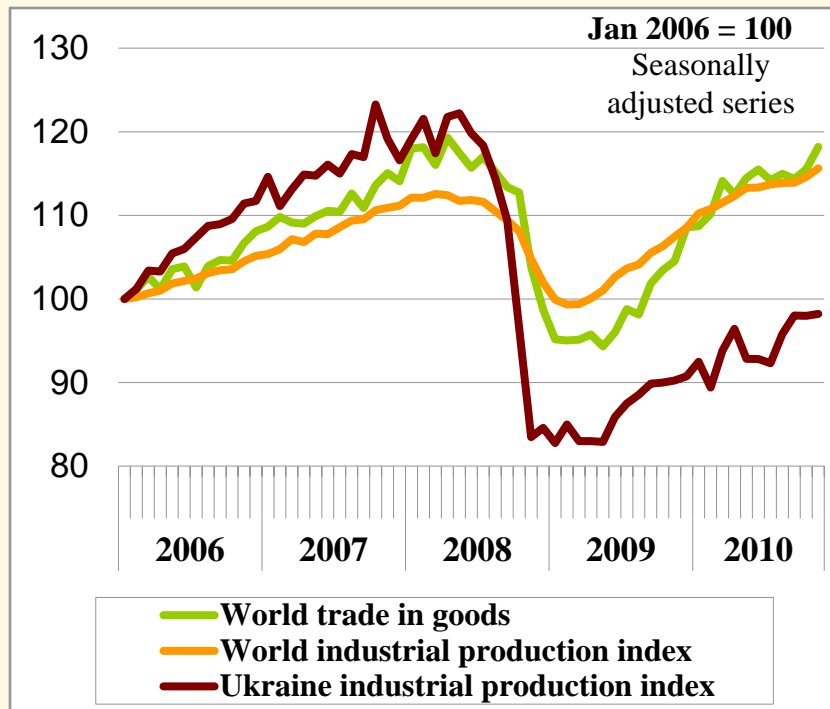
External Environment:

1. The pace of economic recovery in Ukraine's main trading partners
2. The prospects for exports: international competitiveness of Ukraine
3. Prospects for commodity prices (steel, fertilizers and agricultural products)
4. Ability of Ukraine to secure external financing and roll-over its large foreign debt

Domestic Factors:

5. Adequacy of Macroeconomic Stabilization Policies
6. Domestic Demand Growth and Availability of Banking Credit
7. Economic reforms progress

Factor 1. Global Economic Growth

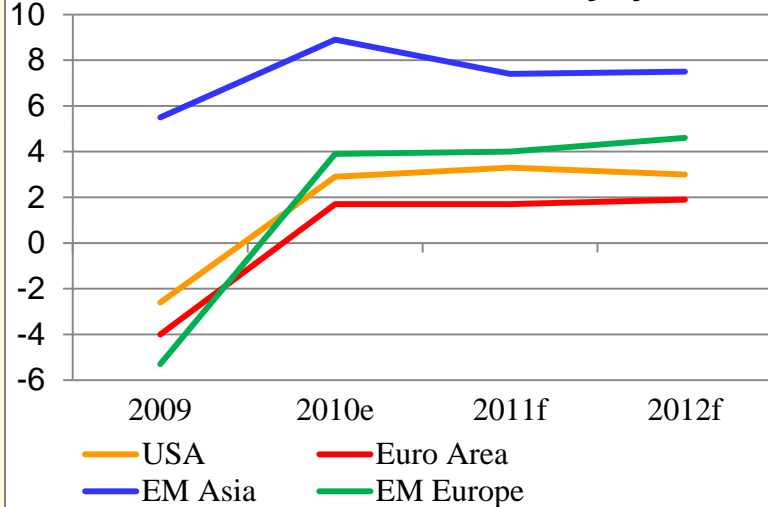


Source: CPB Netherlands Bureau for Economic Policy Analysis, Bloomberg, The Bleyzer Foundation

- The world economy and trade expanded faster than expected in 2010.
- Though the speed of recovery was uneven across regions, in EMs the 7.1% growth rate in GDP was better than forecasted and better than the 3% in advanced economies.
- Investor appetite for emerging market assets also continued to improved performance in 2010, helping to re-open foreign capital markets for these countries.

External Environment in 2011

Real GDP Growth, % yoy



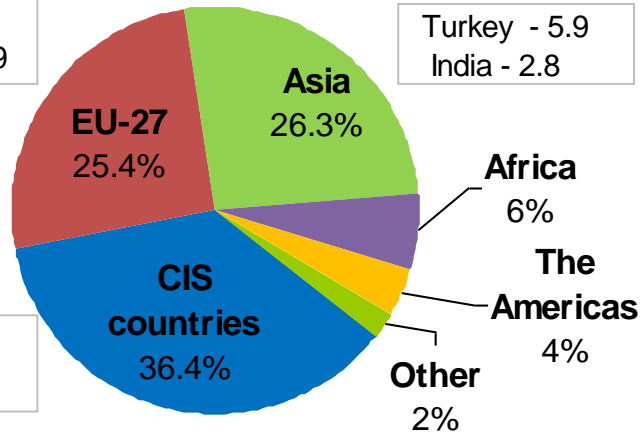
Source: JP Morgan

- The 2011 outlook for **Emerging Markets** remains positive supported by strong capital inflows and domestic consumption.
- Due to policy tightening, average GDP growth in EMs is forecast to be slightly lower in 2011-12 – at about 6%.
- Recovery in **developed countries** will continue but economic performance will differ considerably across the countries.

- **In the US**, QE-II and tax cuts extension for 2011 may further boost GDP growth to about 3.5% in 2011.
- **But 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 is likely to require access to EFSF in 2011, but further contagion spreading to Spain should be contained.
- Eurozone growth will continue to be led by Germany (2.2%), followed by France (1.2%) and Italy (1.0%). Growth will be negative on the periphery.

External Environment in 2011 (cont.)

Main Export Markets of Ukraine, 2010



Source: SSC

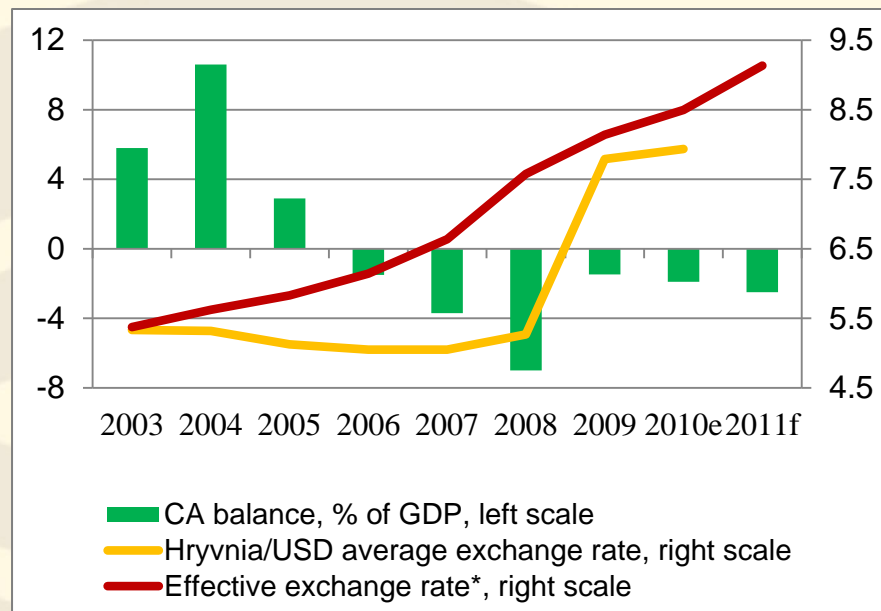
- **On the CIS countries**, following severe drought, Russia underperformed in 2010, expanding by about 3.5% yoy. Supported by domestic demand, Russia is forecast to expand by 4.5% yoy in 2011.
- Kazakhstan is also expected to do well, with GDP growth of 5% in 2011
- Altogether, the growth outlook for Ukraine's main trading partner countries is favorable, which should support Ukraine's **exports**.

- **Non-Eurozone EU** countries are likely to continue growing at solid paces.
 - The growth in Poland (4.0%) may further 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.

Factor 2. Ukraine's International Competitiveness

- During the crisis, Ukraine regained the competitiveness lost in the 2000's.
- By 2009-2010, the real exchange rate was close to its equilibrium, positively affecting Ukraine's current account position.
- Inflation in Ukraine will remain higher than in its main trading partners in the coming years, leading to devaluation pressures.

Real Effective Exchange Rate

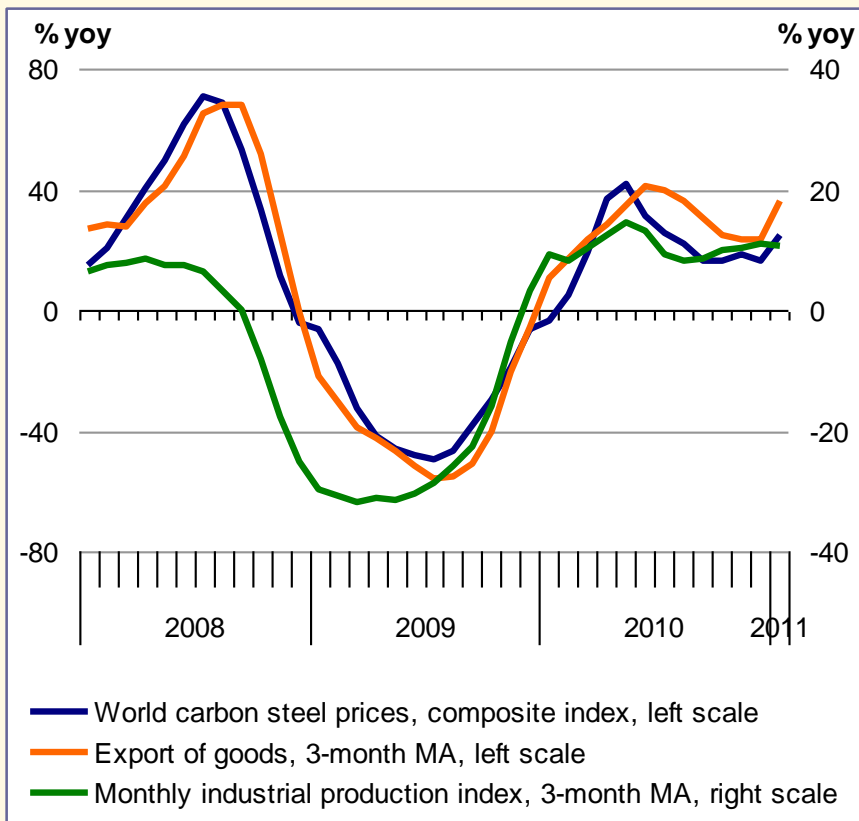


* The effective exchange rate was calculated based on Ukraine's purchasing power parity with respect to Ukraine's main trading partners (2002 as a base year)

Source: NBU, UN Comtrade, IMF, TBF

- The NBU declared its policy towards a more flexible exchange rate regime.
- We believe economic forces will be allowed to be reflected in Hryvnia exchange rate, with some devaluation that would maintain competitiveness.

Factor 3. Commodity Prices

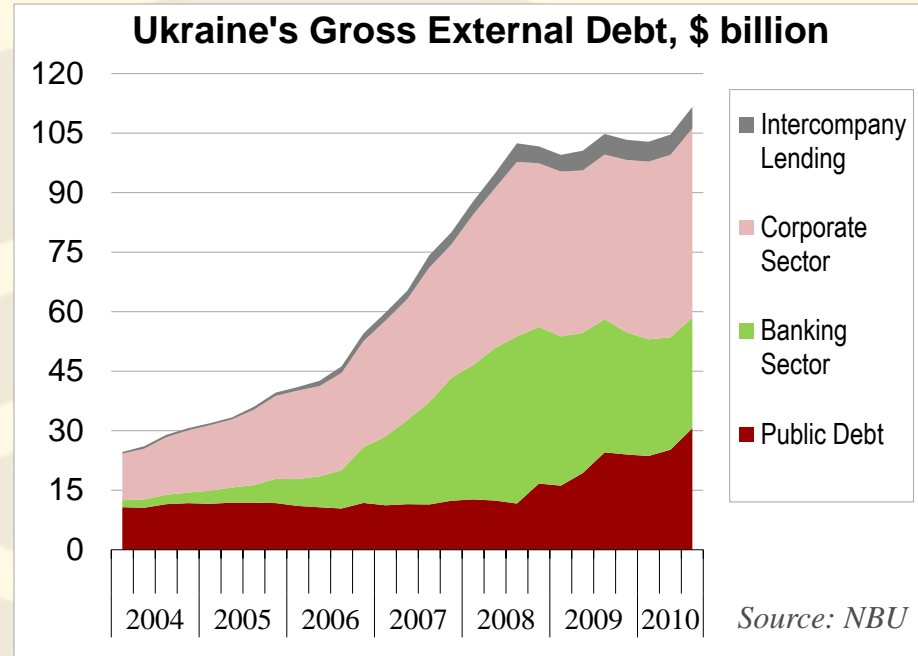


Source: State Statistics Committee, NBU, MEPS, TBF

- Ukraine's exports and industrial production are very dependent on international **prices on steel, fertilizer and agricultural goods.**
- In 2010, industrial production expanded by 11% yoy amid 12% yoy growth in metallurgy and 21.5% yoy in chemicals.
- **Commodity** price growth forecasts for 2011 vary significantly among institutions.
- Our baseline assumption is that steel prices will increase slightly in 2011.
- Higher steel prices growth will be supported by strong consumption in EMs and higher raw materials costs (i.e., iron ore prices due to some supply restrictions).
- Severe drought in several countries in 2010 are likely to keep food prices high and stimulate demand for fertilizers.
- In sum, commodity prices will support Ukrainian export growth.

Factor 4. Roll-over of Ukraine's Foreign Debt

- Ukraine is no longer a low-debt country.
- Gross external debt (public and private) stood at \$111.5 bn as of end-September 2010, or about 83% of full-year GDP.
- In 2011-2013, external **debt service payments** are projected to stay high.



Ukraine's External Debt Service Needs

\$ billion		2010	2011	2012	2013
Public Debt	<i>Principal</i>	0.7	1.0	4.4	6.6
	<i>Interest</i>	0.7	0.9	0.7	0.6
	Total	1.5	1.9	5.1	7.2
Private Debt	<i>Principal</i>	38.7	39.7**	38.5	37
	<i>Interest*</i>	6.3	6.5	6.5	6.5
	Total	45.0	46.2	45.0	43.5
Total		46.5	48.0	50.1	50.7

* estimate; ** as of end-Sept. 2010

Source: MinFin, NBU, TBF

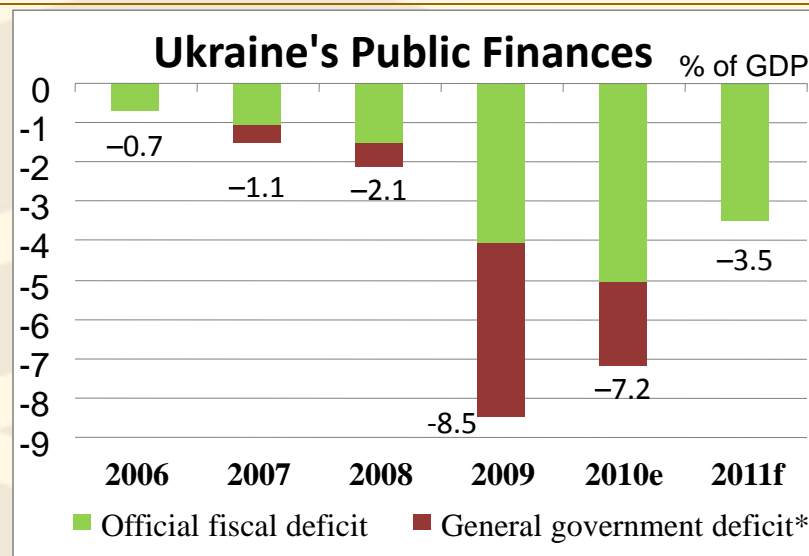
- Ukraine will require high debt rollovers.
- The continuation of the IMF program will remain key in maintaining foreign investors confidence and providing required financing.

Hryvnia Exchange Rate Prospects

- Altogether, external environment will be favorable for Ukraine's **exports**.
- However, **imports** is likely to grow vigorously given further recovery of domestic consumption (though at a slower pace), strong investment demand and growing energy prices.
- As a result, the **current account deficit** is forecast to widen to about 2.5% of GDP in 2011, up from 1.9% of GDP in 2010.
- Wider current account deficit and high external debt service payments will exert pressure on the **Hryvnia exchange rate**.
- But IMF financing, likely high external debt roll-over ratio (109% in 2010) and likely higher FDI inflows (related to Euro-2012) will soften these pressures.
- Nevertheless, a rising PPP (Purchasing Power Parity) index also signals the need of further Hryvnia exchange rate devaluation to maintain competitiveness.
- In addition, the new NBU management may be less resistant to depreciation, to favor exports.
- Hence, the **Hryvnia** is forecast to depreciate moderately to about UAH 8.5 per USD in 2011 and UAH 9.0 per USD in 2012.

Factor 5. Domestic Policies – a. Fiscal Policy

- Sustaining sound public finances will remain one of the main macroeconomic challenges in the coming years.
- The government is committed to reduce the general budget deficit to 3.5% of GDP in 2011 from about 7.2% of GDP in 2010.
- The 2011 state budget law was approved targeting a 3.1% of GDP deficit.
- To meet the deficit target, the government:
 - will contain social spending (the 2011 budget was developed based on a 4.4% increase in real wages, down from 10.2% in 2010);
 - will continue raising natural gas tariffs to population in 2011;
 - will ensure faster pass-through of higher energy prices on final consumers (in 2010, the slow pass-through was among the main reasons of missing the Naftogaz deficit target in 2010. At the beginning of 2011, electricity and heating costs for population were raised by about 25-30%);



* Includes Naftogaz imbalances and Pension Fund deficit (which is not included in official deficit)

Source: MinFin, IMF, The Bleyzer Foundation

Fiscal Policy (cont.)

- will initiate pension reform;
- launched public administration reform at end-2010. The first stage envisages an about 30% reduction in the size of government apparatus;
- approved new Tax Code aimed at gradually reducing tax burden, simplifying tax compliance and strengthening tax administration.
- However, fiscal execution in 2011 may be challenging:
 - The most recent data show that fiscal deficit was 7.2% of GDP in 2010, above the targeted 6.5% of GDP.
 - Rise in utility tariffs and pension reform are politically painful, which already caused delays in their implementation.
 - Indeed, pension reform measures are still pending, though they were announced to be launched at the beginning of 2011.
 - Natural gas tariffs will be raised more gradually than initially projected.
 - The desired GDP de-shadowing effect may not realize due to stricter tax rules and higher administrative pressure on business, which may stimulate tax evasion.
- However, the government declared fiscal deficit target for 2011 will be secured by additional retrenchment of government expenditures.

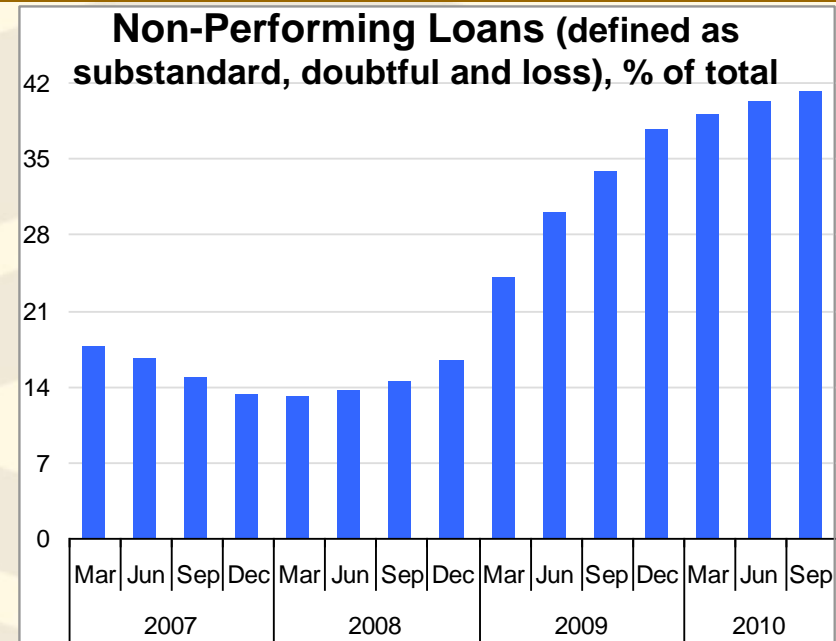
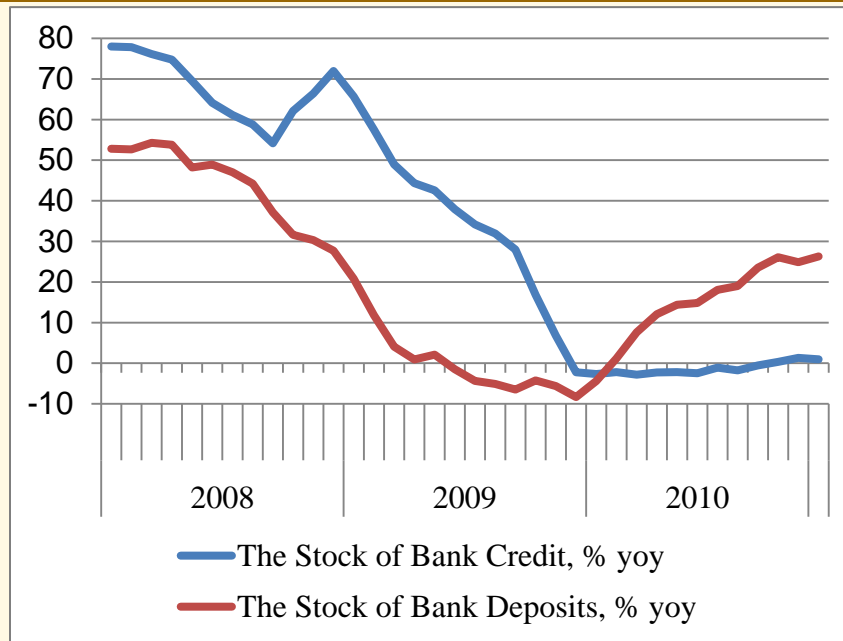
Factor 5b. Monetary and Exchange Rate Policy

- In 2011, inflation is projected to accelerate to about 12%, up from 9.1% in 2010.
- The acceleration will be prompted by
 - adjustment of utility tariffs
 - higher excise taxes (on gasoline, alcohol, tobacco)
 - high international food and energy prices
 - loose monetary policy (less independent management, plans to recapitalize state-intervened banks and stimulate credit activity, still high fiscal deficit (the NBU may continue to buy domestic debt securities directly or re-purchase them from commercial banks) will lead to faster money supply growth.
- The NBU already agreed to gradually shift towards a more flexible exchange rate regime (i.e., by eliminating the foreign exchange band within which banks could trade; and by allowing forward forex transactions starting in mid-year).
- The NBU will bring forex regulations in accordance with international practices (i.e., the NBU will amend its resolution on calculating bank's open forex position. In the short-term this will lead to higher forex demand).
- To encourage exports, the new NBU management may be less resistant to Hryvnia depreciation.

Factor 5c. Banking Sector Policy

- In 2010, the NBU made good progress in stabilizing the banking sector.
- **In 2011, financial sector policies** will be concentrated in:
 - Additional capitalization of three state-intervened banks (including though their sale to private investors) and likely capitalization of Nadra bank with public funds;
 - Further efforts to stimulate bank credit, e.g. by improving the situation with **high level of NPLs** (the NBU has already drafted legislation to simplify resolution of NPLs, including changes in the areas of bankruptcy law and security of collateral);
 - 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 will prompt bank consolidation in 2011, virtually not observed in 2010 contrary to expectations).

Factor 6a. Availability of Bank Credit



Source: State Statistics Committee, NBU, IMF, TBF

- Thanks to improved consumer sentiments, bank deposits grew by 26.3% yoy in 2010.
- To stimulate credit activity, the NBU has lowered its discount rate from 10.25% pa to the current 7.75% pa. Partially responding to these reductions, the stock of credit advanced by about 4% yoy in 2H 2010.
- However, high NPLs (about 40% in 2010, including substandard) undermined bank lending and profits in 2010.
- As dealing with high NPLs will take time, credit activity will be weak in 2011.

Factor 6b. Pace of Recovery of Domestic Demand

- **In 2011, Private consumption** will continue its recovery, benefiting from greater economic and political stability.
- However, consumption growth will be weaker in 2011 than in 2010, due to slower increase in real wage, higher utility costs and excise taxes. Also bank retail credit activity will remain subdued.
- **Fixed investment** is forecast to rebound strongly in 2011 in the run up to Euro 2012 football championship.
- At the same time, with the end of the spectacular **inventory** rebuilding that was observed in 2010 and still slow bank credit growth, the overall impact of investment activity on GDP growth may be mixed.
- Given election-calm year, the government will likely continue following the IMF program requirements.
- Committed to reduce fiscal deficit to 3.5% of GDP in 2011, down from 7.2% of GDP in 2010, the **government** will have to tighten **expenditures**, which may affect growth.

Factor 7. Economic Reform Progress

- A number of reform efforts were launched during 2010. But it's early to make a judgment about the likelihood that implementation will proceed smoothly.
- For instance, tax reform was heavily criticized as the new Tax Code contains a potential to increase administrative pressure on business.
- Though a downsize of the government is one of the important steps of the public administration reform, more comprehensive efforts are needed to increase the effectiveness of government agencies (such as carrying out functional review, operational reviews, de-regulations, public service reform, etc.).
- The implementation of the announced pension reform measures is still pending. Moreover, further measures (i.e., shortening of generous early eligibility criteria) are necessary to sustain pension system of Ukraine.
- Anti-corruption efforts were declared as one of four priority reform areas (the others are tax, pension and public administration reforms). However, the details of the reform are still unavailable. The success in implementation will depend strongly on the degree of commitment by the Prime Minister and the President.
- Furthermore, negotiations with the EU for a FTA could be complicated by the perceived reversals in democracy (on freedom of press, free and fair elections, increased centralization of power, etc.)

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:

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

Summary

1. **Positive**
2. **Positive**
3. **Positive**
4. **Negative**

Domestic Factors:

5. Adequacy of Macro-Stabilization Policies
6. Domestic Demand Growth and Availability of Banking Credit
7. Economic Reforms

5. **Positive**
6. **Mixed**
7. **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:
 - The economy will grow by about 4% per annum;
 - Current account deficit will be maintained at around 3% of GDP;
 - The fiscal deficit will be reduced in compliance with the IMF requirements;
 - Foreign capital inflows will be sufficient to service external debt financing needs with gradual reduction of the debt stock;
 - The exchange rate is likely to moderately depreciate;
 - After some acceleration in 2011, inflation will be contained to single digits.
- However, these growth rates are insufficient to start the catch-up with more developed countries. To secure real GDP growth above 5% pa, more comprehensive reform efforts are needed to drastically improve Ukraine's business climate.
- For that to happen strong political will is required. The latter, however, may weaken in 2012 due to parliamentary elections. There is also a high risk of populist measures in the run-up to elections, which may hinder fragile macrostability at end-2012 and 2013.

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	-7.2	-3.0	-3.5	-4.5	-2.0	-2.5	-5.0
CA balance, % GDP	-1.9	-2.0	-2.5	-3.5	-2.0	-2.5	-4.0
Hryvnia/USD exchange rate	7.96	8.0	8.5	9.0	8.0	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 populist fiscal softening in the run-up to October 2012 parliamentary elections. This will depress government consumption 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. Access to EFSF require Portugal and Spain. Belgium comes into recession due 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:

- Anxious to concentrate and maintain power, political elite is fully engaged into the process of amending Constitution and election laws; economic reforms are delayed.
- Further suppression of basic democratic freedoms. Dependent judiciary and central bank.
- Deterioration of international relations with the EU and the US.
- Pre-election fiscal loosening and failure to carry out structural 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.