

Ukraine: Current Political and Economic Situation

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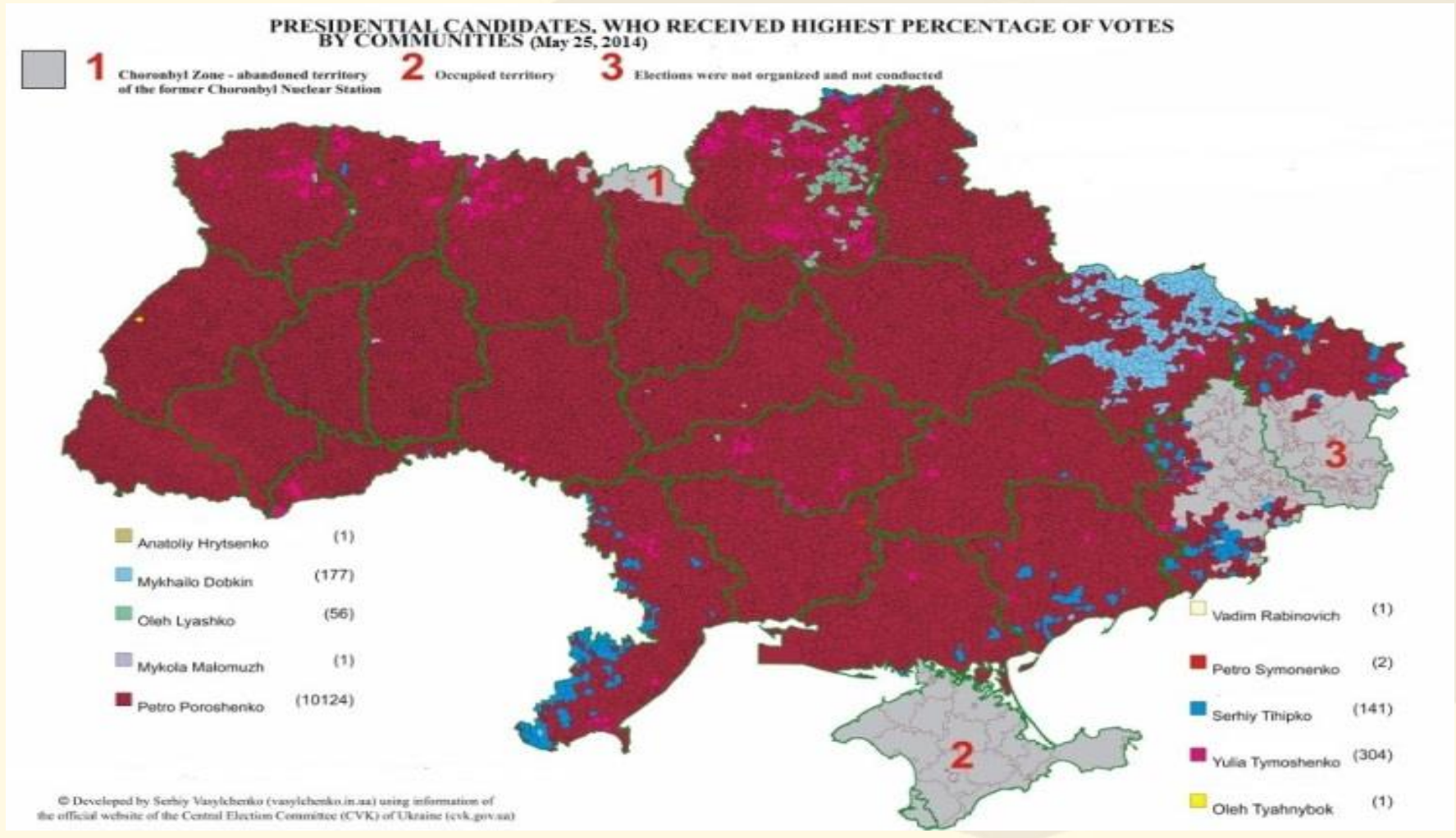
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A Dramatic Change in Political Landscape

- Yanukovych's decision of November 2013 to postpone signing of the Free Trade & Association Agreement with the EU - and increase cooperation with Russia -- sparked massive protests in Kiev and West Ukraine.
- Starting as pro-European demonstrations, the protesters later demanded an overhaul of a seriously corrupt and authoritarian political system.
- These protests resulted in the ouster of Yanukovych in February 2014, the return of the 2004 Constitution (under which the President shares power with the Parliament and Prime Minister), and early presidential elections.
- The President's ouster led to unrest in East and South Ukraine, with Russia invading and annexing Crimea, an annexation not recognized internationally.
- Eventually the unrest localized in two oblasts – Donetsk and Luhansk, where pro-Russian and anti-Ukrainian sentiments were particularly strong.
- As protests in these two regions quickly evolved into armed insurgency supported by Russia, Ukraine started military operation to restore order.

New President: Presidential Elections

- Early presidential elections in May 25th were won by Petro Poroshenko, a successful businessman and politician, who received 54.7% of the vote.



New President: What to Expect

- Pro-Europe candidates received close to 90% of the votes. Despite scarce voting in eastern oblasts, the elections were recognized as free and fair.
- Mr. Poroshenko is seen a person whom both the East and the West can work.
- In his June 7th's inauguration, President Poroshenko said that he will:
 - Bring peace under a plan that involves (i) the lay down by all groups of illegal arms, (ii) exemption from criminal responsibility for those without blood in their hands, (iii) provide a controlled corridor for Russian mercenaries to return home, and (iv) engage in a peaceful dialogue with peaceful citizens of Ukraine.
 - Introduce a project of government decentralization with significant part of powers delegated from the center to local governments. But still, Ukraine will remain as a unitary state. Reform on decentralization will begin this year with amendments to the Constitution.

Poroshenko's Inauguration Speech

- Guarantee free usage of Russian language in the south-east region. Although the Ukrainian language will remain the single state language, free development of Russian and other languages will be guaranteed.
- Have early Parliamentary elections and early local elections in the Donbas later this year.
- Protect the territorial integrity of Ukraine and never accept the annexation of Crimea by Russia.
- Maintain a well-equipped and combat-ready military.
- Ensure the signature of an international agreement that would replace the Budapest Memorandum with direct and reliable guarantees of peace and security - up to military support in case of threat to territorial integrity.
- Ukraine will follow European countries in building an economy based on free competition, innovation, private business initiative, hard work, and constant self-improvement.
- For these ends, corruption will be reduced.

Other Key Messages

- All this is written in the agreement on political association and free trade area with the EU, the political side of which was signed on March 21st.
- As pledged, Poroshenko signed the economic part of the agreement on June 27th.
- The same goes for the speedy introduction of visa-free regime with the EU for Ukraine. Ukraine has completed the first stage and will finish the second stage very quickly for Ukrainians to be able to travel without visas starting from January 2015.
- As for the Association Agreement, it is considered only as the first step towards full membership in the EU. Nobody has the right to veto the European choice of Ukraine.
- Ukraine will settle down relations with Russia; but there cannot be compromise in the issues on Crimea, European choice and state structure.

Political Prospects -1

- Poroshenko should be able to implement most of his promises. He has already appointed his Head of the President's Administration and its Deputy Heads, including the one responsible for implementing reforms.
- But he may have difficulties in implementing some of his promises, particularly regarding Crimea and the holding of early Rada elections.
- By taking Crimea, Russia has ensured several things important to it: (i) the full control of port of Sevastopol for its naval fleet, (ii) negate the possibility that NATO's ships may enter Sevastopol or any other port in Crimea; and (iii) ensure that Ukraine will not be able to join NATO (as NATO membership's rules requires applicants to the Alliance to settle peacefully all border disputes).
- These benefits to Russia are so huge that Russia may not want to return Crimea to Ukraine, regardless of the economic cost of maintaining Crimea.
- On the other hand, Donetsk and Luhansk do not provide major strategic advantages to Russia (other than destabilizing Ukraine).

Political Prospects - 2

- Therefore Russia may have (temporarily) abandoned plans to invade these regions (partly in response to possible EU/US economic sanctions, partly due to the realization that local support for Russia is not strong enough, and partly because of the landslide election of Poroshenko).
- Only if Russia is able to take control of Donetsk, Zaporizhia, Kherson, Mykolaiv, and Odessa (the New Russia territory), Russia will get major advantages by having a land corridor to Europe bypassing Ukraine.
- But this will be hard for Russia to achieve given currently weak population support for Russia. Over time, Russia may want to revive its plans to control the New Russia territory if the local population support increases.
- In the interim, the strategy of Russia is probably just to cause enough disturbances in east-south Ukraine by supporting “separatists” in order to erode support to Kyiv, encourage new authorities to reverse Ukraine’s trend towards Europe, to reject both NATO and the EU FTA, and to show Russian citizens that any attempt to dispose of the current authoritarian power will lead to chaos and civil war.

Recent Political Developments

- As promised, the President Poroshenko set out ceasefire plan for Donbas.
- The plan was widely supported by the international community, including Russia, but not the rebels.
- Given that the ceasefire turned to be unilateral, on July 1st Ukraine restored military operation in eastern regions.
- Since then Ukrainian army troops have made significant gains. The territory under rebel's control shrank almost twice, concentrating in two largest cities of the region – Donetsk and Luhansk.
- The release of these million-citizen cities will be quite difficult as the Ukrainian army is restricted in the use of heavy weapons, artillery and aircraft.
- Hence, the success of the operation would crucially depend on the ability of the Ukrainian forces to seal the border with Russia to prevent the inflow of new weapons and 'volunteers'.

Main Macroeconomic Indicators

	2009	2010	2011	2012	2013	2014f	2015f
Real GDP Growth, % yoy#	-14.8	4.1	5.2	0.2	0.0	-4.7	1.5
Fiscal Balance, % GDP*	-8.5	-6.7	-4.3	-5.6	-6.5	-7.0	-4.5
Consumer Inflation, %, eop	12.3	9.1	4.6	-0.2	0.5	18.0	8.0
UAH/\$ Exchange Rate, eop	8.0	8.0	8.0	8.0	8.0	11.5	11.0
Current Account, % GDP	-1.4	-2.2	-6.3	-8.1	-9.0	-3.5	-2.5
Gross Int. Reserves, \$ bn	26.5	34.5	31.8	24.5	20.4	18.0	20.0
Public Debt, % GDP	34.8	39.9	36.3	36.6	40.5	56.0	59.0

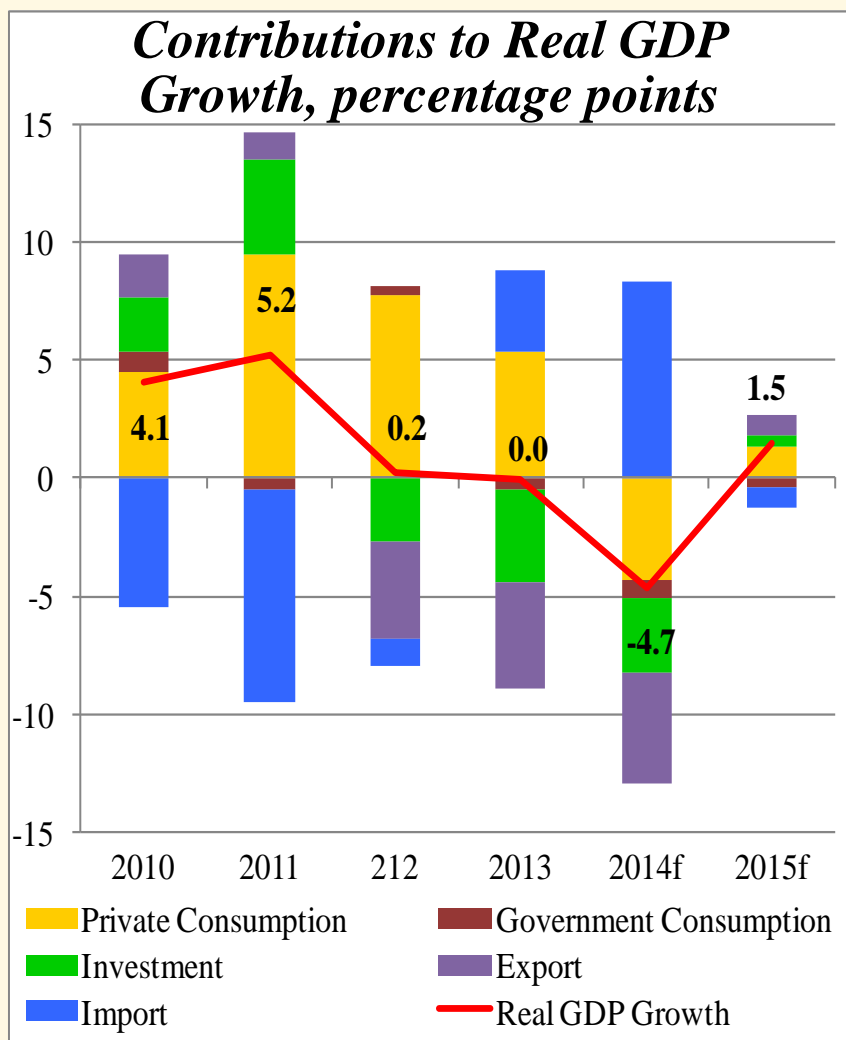
Including Crimea

* Includes pension fund deficit and Naftogaz imbalances

Source: NBU, SSS of Ukraine, MinFin, The Bleyzer Foundation

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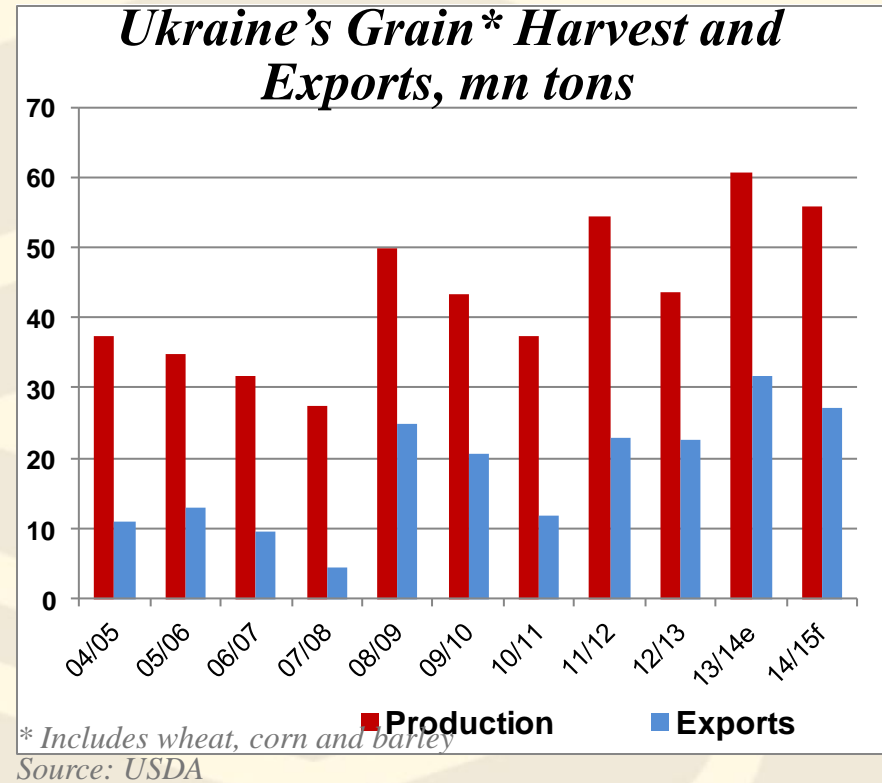
Real GDP Growth



- In 2013, real GDP growth was nil, due to the slow pace of the global recovery, soft commodity prices and trade tensions with Russia all of which hindered exports, which represent 50% of GDP.
- In 2014, real GDP will decline by about 5% yoy.
- GDP decrease will be due to (i) weak export performance, (ii) a decline in consumption, (iii) a fall in investment activity and (iv) an increase in imported gas prices.
- But the economy is expected to stabilize throughout the second half of 2014 and return to growth in 2015.

Source: State Statistical Service of Ukraine, The Bleyzer Foundation

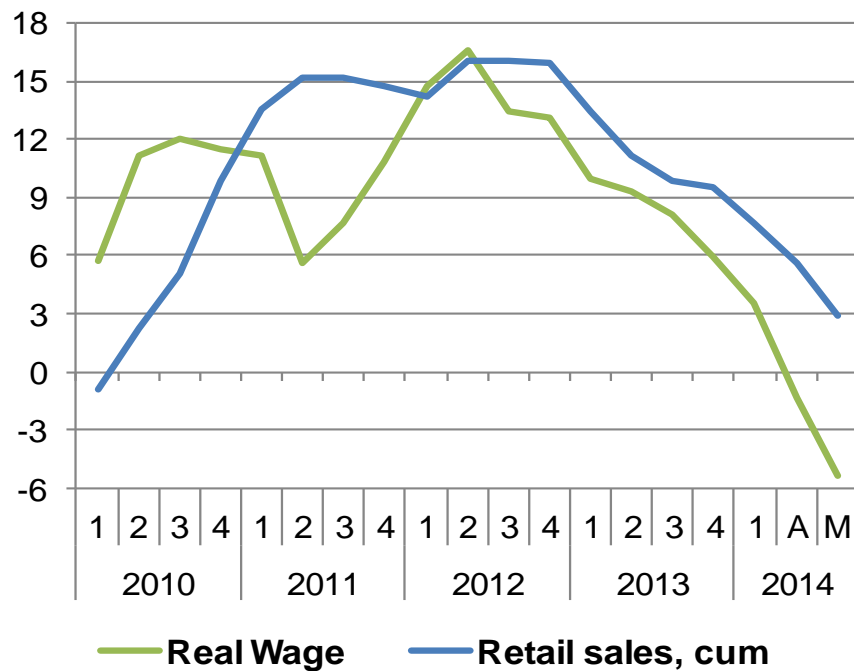
Export Prospects



- In 2014, exports will continue to decline due to worsened relations with Russia, subdued world steel prices and economic slowdown in a number of trade partners (Russia, Turkey, etc.).
- On the upside, exports may be supported by early EU measures under the FTA and ongoing improvements in agriculture.

Consumption Prospects

Retail Sales Turnover and Real Wage Growth, % yoy



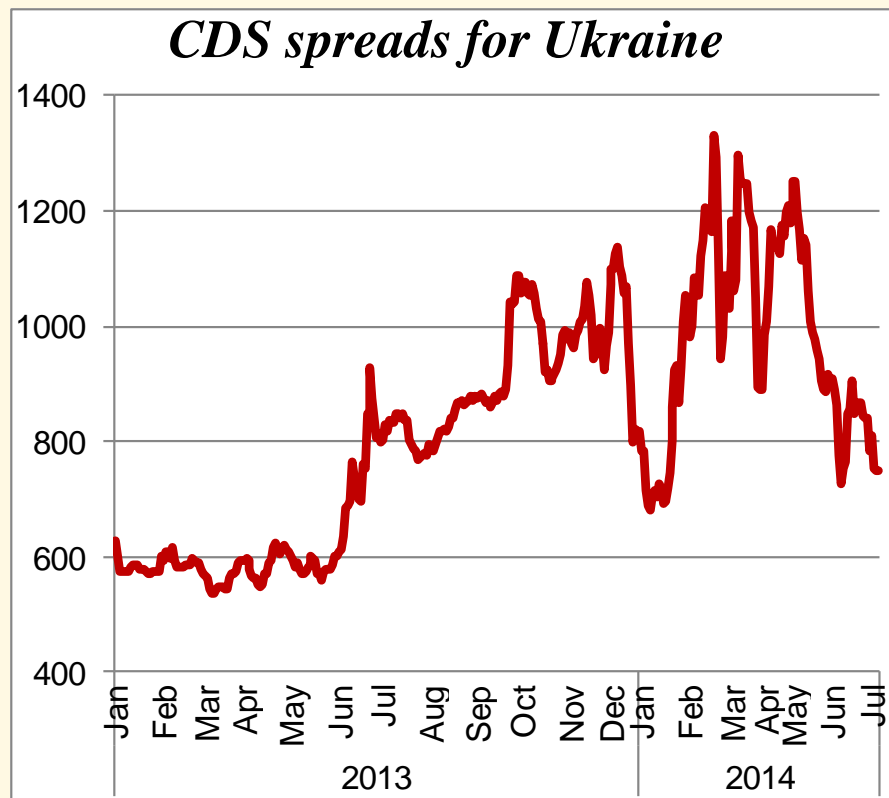
Source: State Statistics Committee, NBU, The Bleyzer Foundation

In 2014, private consumption is forecast to decline affected by:

- Fiscal austerity measures (higher taxes and cuts in budget expenses and government employment)
- Sharp Hryvnia depreciation and a rise in consumer prices
- Low availability of bank credit
- A change in consumer preferences towards higher saving amid prolonged period of political instability and armed unrest in eastern region.

- Over January-May 2014, retail sales turnover, often used to gauge consumption patterns, decelerated to less than 3% yoy, while real wage was down by 5.4% yoy in May.

Investment Trends

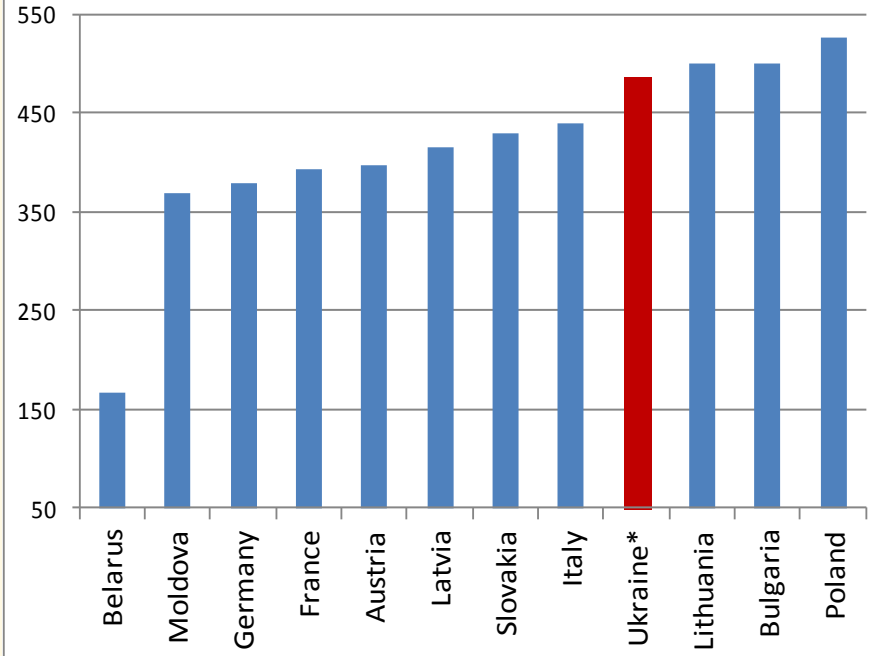


Source: DBResearch

- In H1 2014, business confidence and investments were undermined by political uncertainty, unrest in the eastern region and macroeconomic challenges.
 - Since May 2014, both foreign and domestic investors have welcomed the presidential elections, the resumption of cooperation with the IMF and the significant package of foreign financial assistance.
 - Since end-May, CDS spreads returned to mid-2013 levels.
- However, restoring investors' confidence will take time and will crucially depend on new authorities measures.
 - So far, domestic capital investments fell by 23% yoy in 1Q 2014 amid net FDI outflows and a 69% yoy decline in budget capital expenditures.

The Natural Gas Situation - 1

Prices Select Countries Pay for Russian Gas, 2013, US Dollar per 1000 m³



* Gas price demanded by Gazprom since April 2014

Source: G. Kates, L. Lou. RFE/RL

- In November 2013, Russia reduced gas price for Ukraine from \$400 per tcm to \$268.5 after Yanukovych rejected the Association Agreement with the EU; but raised the price to \$485 after Yanukovych ouster and Crimea's annexation.
- Ukraine rejected the new price and the EC brokered negotiations.
- Russia suggested a cut of about 1/5 to around \$385 per tcm (close to the average gas price for Europe in 2013).

- This offer was based on a “temporary good will” discount of \$100 per tcm by removing again an export duty. Not written into the contract, it would have been under Moscow's discretion to recall the discount.
- As a minimum, Ukraine wanted the discount to be reflected in the contract...

The Natural Gas Situation - 2

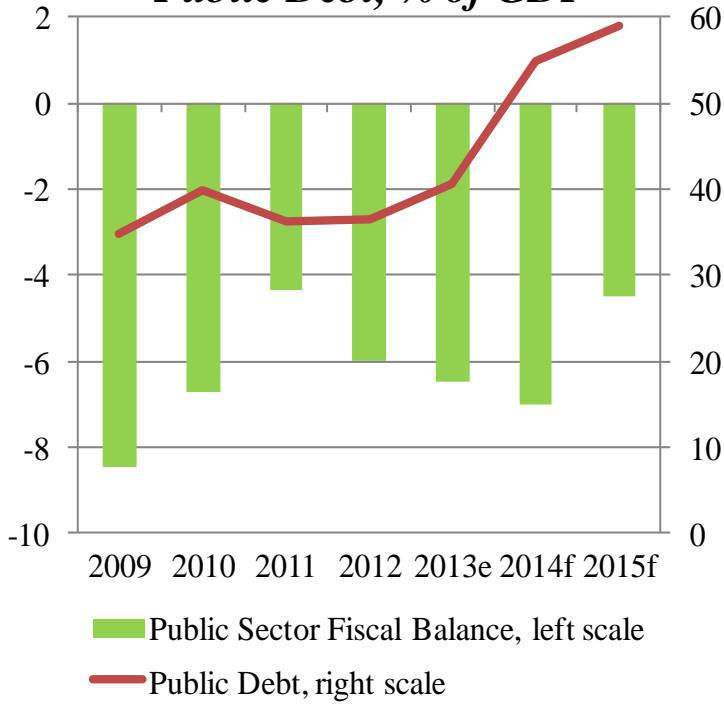
- As a maximum, it wanted to change the 2009 gas contract that locked Ukraine into buying a set volume of gas, whether it needs it or not, at \$485 per USD.
- Russia claims that Ukraine has accumulated more than \$5 billion in debts to Gazprom.
- Kyiv paid off for gas consumed in Feb-Mar 2014 but has refused to pay more as part of this debt was calculated by Russia based on a new gas price.
- As further negotiations stalled, Moscow halted gas supplies on June 16th.
- Both countries appealed to Stockholm Arbitration Court, but it will take time to be resolved.
- To satisfy domestic consumption and ensure reliable gas transit to Europe, including during the winter season, the following measures are carried out:
 - There is about 14 billion m³ of natural gas in storages as of July 1st;
 - Ukraine has been securing reverse gas supplies from Europe (Poland, Hungary and Slovakia routes);
 - The government has urged population and industrial consumer to save natural gas and use alternative fossil fuels (which may save 6 billion m³ for the season, or 20% of total).¹⁶

Economic Issues and Future Prospects

- Although economic and political uncertainties are large, the Association Agreement and possible TFA with the EU may become an anchor for institutional development and economic reforms in Ukraine.
- Main areas of reform include: (i) public administration reform with focus on decentralization and a smaller central apparatus focused on policy; (ii) further tax system reforms; (iii) judicial reform to ensure just and unbiased judgments and abolishing the current economic code; (iv) further property rights protection; (v) de-regulation of business activities to encourage entrepreneurship; (vi) effective anticorruption measures; (vii) banking sector reform with truly independent NBU; and (viii) energy sector reform.
- In fact, today, better than any other time, Ukraine has a good chance to make quantum jumps in its economic and business environments.
- These possibilities, however, may be overshadowed by a number of short-term challenges in public finances, rising inflation, low bank credit activity, external debt payments and current account deficits.

Challenge 1: Public Finances

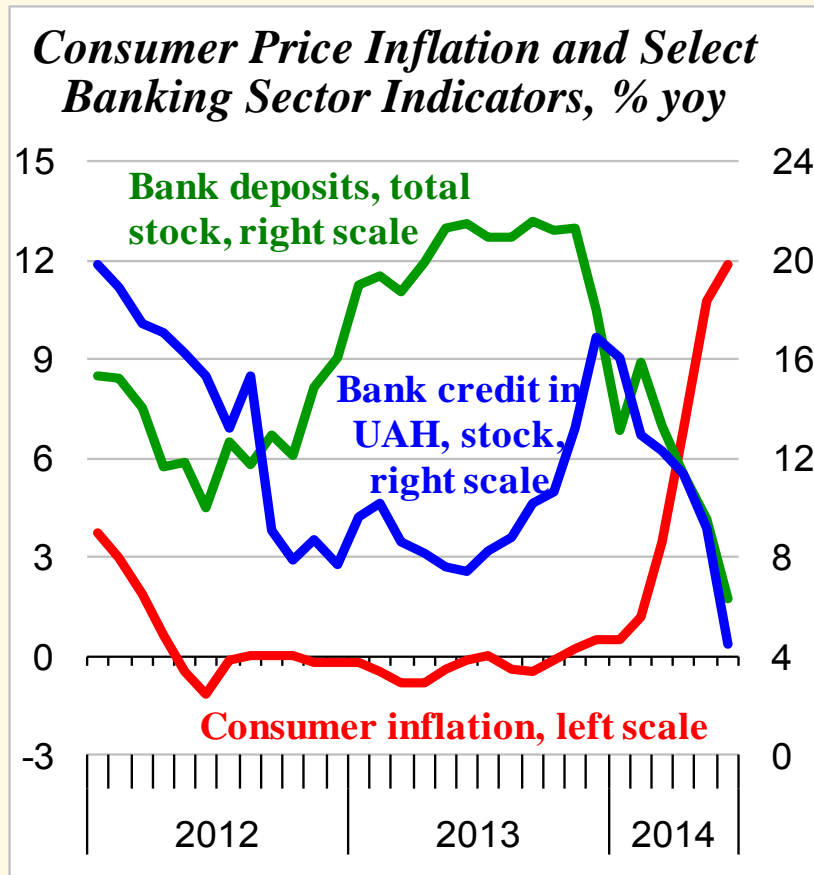
Ukraine's Fiscal Deficit (Incl. Naftogaz and Pension Fund) and Public Debt, % of GDP



Source: MinFin, The Bleyzer Foundation

- In 2013, the public sector fiscal deficit widened to around 6.5% of GDP, due to low GDP growth, high social spending and generous energy subsidies
 - In 2014, the fiscal deficit will increase to 7.0% of GDP, due to lower tax revenues associated with the economic downturn and advance collection of taxes.
 - The new government committed to tough austerity measures to reduce fiscal imbalances, with results in 2015..
 - The measures include a rise in taxes, cuts in expenditures (incl. utilities and other social spending) and public sector employment, and reform of energy sector.
- With these measures, public sector deficit is forecast to narrow to 4.5% of GDP in 2015 and return to less than 3% of GDP in 2016.

Challenge 2: Inflation and Banking Sector Weaknesses



Source: SSS of Ukraine, NBU, The Bleyzer Foundation

- Ukraine enjoyed low inflation during 2012-13 thanks to good harvest and unchanged utility tariffs.
- In 2014, inflation is forecast to accelerate to 18% yoy (it was almost 12% yoy in June 2014) due to:
 - A 43% Hryvnia devaluation since the beginning of 2014
 - A rise in utility tariffs (natural gas, heating, electricity, water, etc.)
 - Increase in excises etc.
- Ukraine's banking sector is under stress due to political instability, Hryvnia devaluation and deposit outflows.

- These adversely affected both the cost and availability of bank credit.
- With the IMF program in place, banking sector weaknesses will be addressed, but subdued bank lending will contribute to low GDP growth in 2014.

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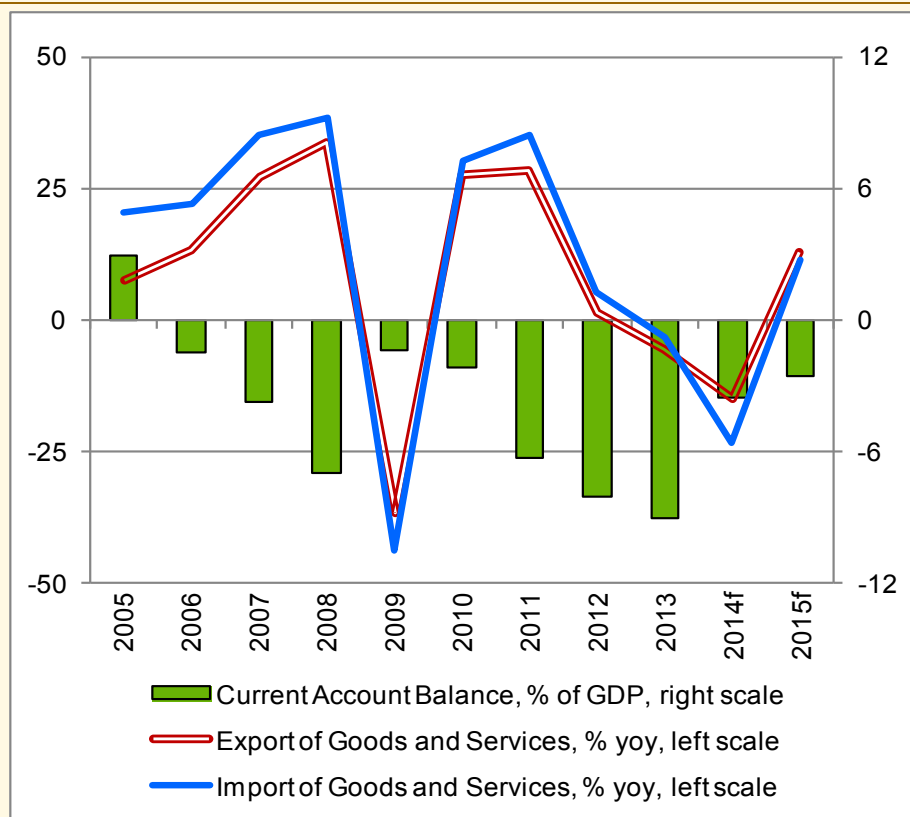
Challenge 3: External Financing Needs in 2014

Needs		Potential Sources	
Public Debt (Government and NBU)	8.0	13.1	Financial Aid Package
IMF	3.7	7.0	IMF
Sovereign Eurobonds	1.0	2.1	EU
Naftogaz Eurobonds	1.6	4.0	Other financing (EBRD, EIB, WB, individual countries)
Naftogaz arrears to Gazprom	1.7		
Private Debt	62.5	64.5	Rollover
Banking sector	14.5	12.6	85-90%
Corporate sector	48.0	51.8	105-110%
Current account deficit	5.0	4.0	FDI
Population purchases of FX	4.0		
Total Needs	79.5	81.6	Total Sources
International Reserves, as of end-February		15.4	

- In 2014, Ukraine faces significant external financing requirements of about \$80 billion, in order to meet private and public debt repayments as well as to cover current account deficit.
- But these large external requirements are expected to be covered by significant official financing from the IMF, the EU and other IFIs and individual countries (the US, Japan, etc.) as well as significant roll-overs of private debt.

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Challenge 4: Current Account Deficit and FX Rate



- Exports were weak in 2013 due to slow global recovery, soft world commodity prices and increased trade tensions with Russia. As a result, the CA deficit reached 9.0% of GDP.
- Although export performance will remain poor in 2014, the CA deficit is expected to narrow to 3.5% of GDP, thanks to a fall in imports caused by the Hryvnia devaluation and the economic recession.

- From early 2014, political and economic difficulties caused the Hryvnia to suffer a 43% devaluation to the current rate of UAH 11.8 per USD.
- We are forecasting that the exchange rate will remain stable at current rates up to the end of 2015, given the significant official financing made available (and assuming no further hostilities by Russia).

Summary

- Due to unfavorable external environment and weak bank lending activity, Ukraine's real GDP growth was 0% yoy in 2013.
- In 2014, GDP will decline by 5.0% due to austerity measures agreed upon with the IMF and severe economic disruptions caused by Russia's hostilities.
- Under the IMF program, the fiscal deficit will be reduced but due to low GDP growth and Hryvnia devaluation it will remain high in 2014. Public debt-to-GDP ratio, as a result, will approach 60% of GDP in 2015.
- Inflation is likely to accelerate to about 18% in 2014.
- The exchange rate should stabilize at about UAH 11.5 per USD during 2014-15.
- Ukraine will face significant external financing needs in 2014.
- But with the IMF program and other external financing in place, Ukraine's external liquidity and fiscal challenges will be reduced, bringing the country onto a more sustainable path of growth.
- With good progress on structural reforms, pledged by new Kyiv authorities, Ukraine may achieve a quantum leap in economic development.