

Ukraine: Current Economic and Business Situation

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Defense/Military Situation

- After the lack of progress with the first Minsk Protocol of September 2014, in February 2015, diplomatic efforts to restore peace resulted in the Minks-II Agreement (Germany, France, Ukraine and Russia) which envisaged:
 - A new ceasefire starting on February 15th.
 - Withdrawal of heavy weapons from the front line by Ukrainian forces and rebels.
 - Release of all prisoners and amnesty for those involved in fighting.
 - Withdrawal of foreign troops from Ukraine and disarmament of illegal groups.
 - Restoration of Ukraine's control over its border with Russia after constitutional reform that would grant autonomy to the regions (to be completed by end 2015).
- Despite some delays in implementation of the Agreement, there is progress in de-escalation, with the intensity of fighting receding, except for some sporadic actions along the ceasefire line.
- Thanks to EU/US sanctions, a stronger Ukrainian army, clear resistance from local populations, and the possibility of US military assistance, it appears that Russia may have abandoned its plans to invade the rest of Ukraine and create a "Novorossiya" state covering eastern and southern Ukraine.
- If so, the separatist area would remain "frozen". This would provide the opportunity for the rest of the country to restart investments and growth.

Ukraine and Separatist Area



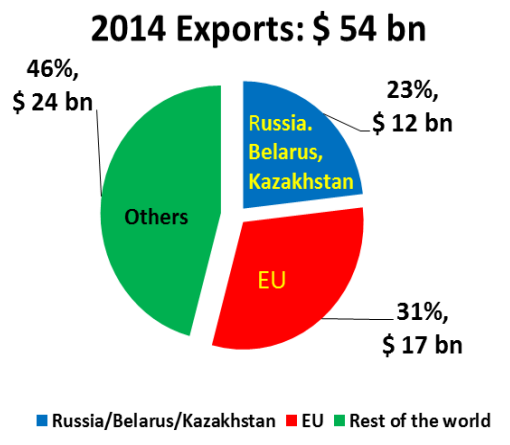
- The Separatist area represents 4% of Ukraine, but contributed a large share of its economic output: 14% of exports, 12% of industry, and 9% of GDP.
- The hostilities therefore were the main reasons for the large declines that Ukraine suffered on exports, industry, and GDP :

- Exports declined by about 22% in two years.
- As exports represent about 45% of GDP, **GDP dropped** by 6.8% in 2014.
- This led to: **devaluation** of the Hryvnia (from 8 to 21 UAH/\$ in 2014-15), increase in **inflation** (to 25% as the end of 2014), increase in **unemployment** rate (to 9% at the end of 2014), and problems in the country's **financial sector** (due to deposit withdrawals caused in turn by lack of confidence).

Economic Impact on Ukraine's Population

- Although the statistics show a sharp deterioration on economic conditions, the impact on living standards of the population has been less severe:
 - ❖ First, Ukraine's informal economy has expanded substantially since the beginning of 2014, providing unreported income to the population. A recent study by the Ministry of Economy shows that the informal economy may have increased from about 35% of GDP in 2013 to about 42% of GDP in 2014. This increase was induced by the military conflict, weaknesses in the banking sector, and currency inflation and depreciation.
 - ❖ Second, the population has been using its substantial foreign exchange savings to maintain current consumption, as demonstrated by the fact that foreign exchange sales by the population have exceeded purchases for several months in a row, and foreign currency deposits in April 2015 declined by 35.4 % yoy.
 - ❖ Third, the significant transfers of funds from abroad, principally to relatives in Ukraine, have helped ameliorate the effects of GDP declines on living standards. In fact, according to NBU statistics, net current transfers in January-April 2015 reached USD 629 million, compared to USD 1,541 million in 2014.

Exports to Russia and Prospects



- About two-thirds of the drop of exports were due to declines in exports to Russia, Belarus & Kazakhstan, which declined from 32% of the total in 2012 to 23% in 2014 and to 10% in early 2015.
- Other declines in exports were due to war damage.
- **However, most of the potential export reduction has already taken place: therefore there is little room for further economic decline.**
- Thus, the only way now is up. But the speed of economic recovery will depend on two interdependent factors :
 1. the strength of government reforms agenda to improve the business environment to attract FDIs and increase exports to other countries.
 2. the continuation of international financial support.

The Reform Agenda and International Support

- Following early parliamentary elections in October 2014, a strong pro-European majority was formed in the Parliament.
- Thus, for the first time since independence, Ukraine now has a Parliament, a President, and a Prime Minister who share similar pro-democratic and socio-economic reform-oriented goals, and also who are prepared to collaborate.
- A good catalyst for reforms is the IMF Program negotiated during January-February 2015: in addition to \$17.5 billion of financing, it contains commitments from the government to implement a number of stabilization and structural reforms to improve Ukraine's business climate.
- The Ukraine-IMF Memorandum of Economic Reforms list the following actions, with agreed upon timetables:
 - Anti-corruption Program to protect business from abuse of power by officials.
 - Improvements in the business legal environment and the judicial/court system to ensure just and unbiased judgments.
 - Further business de-regulation measures to minimize red tape and bribes.
 - Energy sector reform to reduce Naftogaz deficits and encourage energy self-sufficiency.

Reform Agenda (continued)

- Reform of public administration, including decentralization and local government reform, and reform of the tax system.
- Improvements in corporate & public governance to protect ownership rights.
- Measures to restore the health of the financial sector.
- The government has already initiated key elements of these reforms:
 - Fiscal measures are succeeding in balancing the country's fiscal budget deficits, particularly by reducing subsidies on gas consumption and restructuring the government's large external debt.
 - The banking sector is being rehabilitated, thanks to strong actions by the NBU, which are reversing earlier deteriorations in deposits and loans.
 - The head and staffing of the anti-corruption agency have been appointed.
 - Several criminal investigations against top officials on corruption have been launched, including several members of Parliament and government officials.
 - The number of taxes will be reduced from 22 to 11 starting next year.
 - The number of agencies with inspection functions is being decreased from 56 to 26.

Reform Agenda (continued)

- E-government practices are being introduced in agencies to reduce opportunities for corruption.
- The draft law on business deregulation is under discussion by Parliamentary committees, which should significantly improve Ukraine's business environment.
- At the same time, the government is developing a social protection system to protect the most vulnerable groups of the population.
- As financing under the new IMF program will be strongly dependent on the implementation of structural reforms, and a stronger civil society is now pushing for reforms, there are good chances that Ukraine may finally restore macroeconomic stability, reshape its economy, and lay the foundation for strong and sustainable economic growth.
- Thus, Ukraine has a good chance to pull out of the economic crisis, re-emerge as a functioning democratic country with a liberal economic model, make a quantum jump in its economic and business environments that will allow it to grow at least by 5% - 8% pa.

Summary of Reasons for Economic Recovery

If peace is maintained, economic recovery is possible for the following reasons:

- The major cause of economic deterioration (export drop to Russia) has been exhausted, with very limited exports to Russia still remaining.
- For the first time since independence, Ukraine has a pro-reform democratic Parliament, President, and Prime Minister.
- A strong civil society has emerged which will push for changes.
- The government has a strong economic reform agenda, supported by the IMF and the international community, and backed up by sufficient funds to cover possible foreign financing gaps.
- The 300% Hryvnia devaluation represented an overshooting and will permit future exchange rate stability, while maintaining Ukraine's international competitiveness in trade (with low wages) for many years.
- Free trade agreements with the EU, and possibly with Canada, Israel, and other countries should further encourage export and GDP growth.
- Foreign direct investments should be encouraged by low asset prices and large opportunities to exploit local inefficiencies.

Main Macroeconomic Indicators

	2012	2014	2015f	2016f	2017f	2018f	2019f
Real GDP Growth, % yoy	0.2	-6.8	-9.0	1.0	3.5	5.0	8.0
Fiscal Balance, % GDP	-5.6	-11.7	-7.5	-4.0	-3.1	-2.6	-2.0
Consumer Inflation, %, eop	-0.2	24.9	45.0	20.0	10.0	5.0	5.0
Exports of Goods, \$ bn	62.4	55.6	49.8	53.0	56.7	60.7	65.1
Current Account, % GDP	-8.1	-4.1	0.0	-0.5	-0.5	-0.5	-0.5
UAH/\$ Exchange Rate, eop	8.0	15.8	25.0	25.0	25.0	25.0	25.0
Gross Int. Reserves, \$ bn	24.5	7.5	13.0	17.0	22.0	28.0	35.2
Public Debt, % GDP	36.6	73.0	94.0	92.0	89.0	83.0	77.0

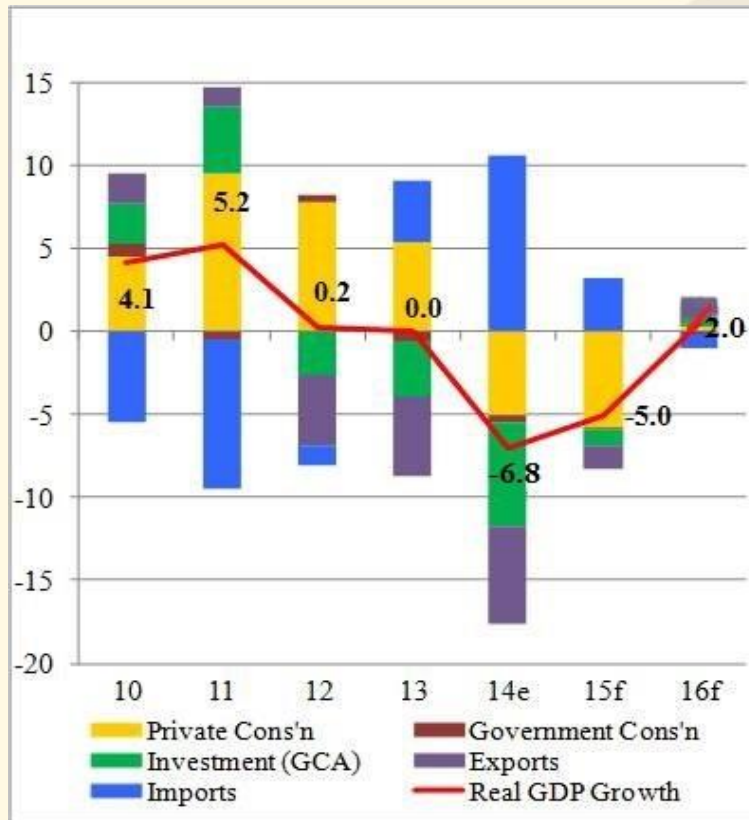
* Includes implicit Pension Fund deficit and Naftogaz imbalances

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

Thank You!!

Economic Growth

Contributions to Real GDP Growth, percentage points

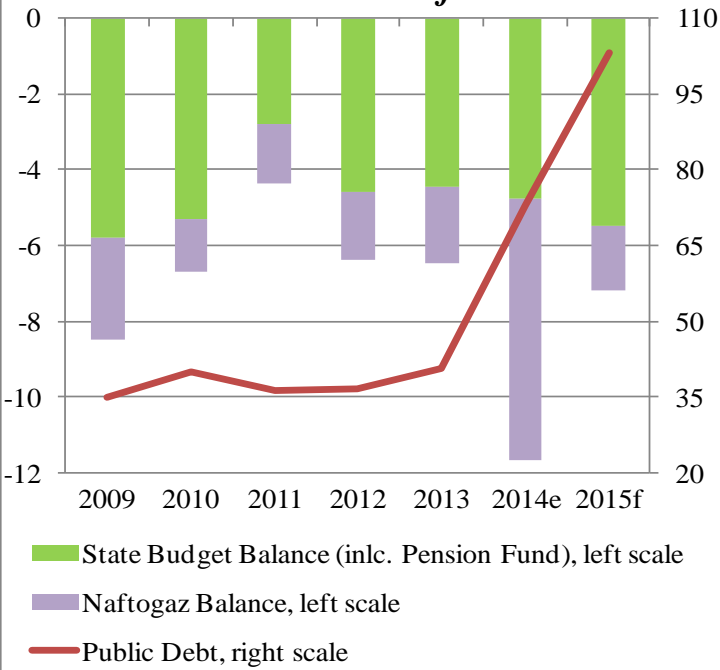


Source: State Statistical Service of Ukraine, The Bleyzer Foundation

- In 2014, real GDP fell by 6.8% yoy, affected by:
 - hostilities in Donbas, disruption of economic ties between the regions and infrastructure damages;
 - deteriorated trade relations with Russia;
 - sharp Hryvnia depreciation; and
 - tough fiscal austerity measures.
- The decline took place in all demand components, including exports, investments and private consumption.
- But lower imports and high agricultural harvest softened the negative impact of these factors.
- In 2015 real GDP is forecast to decline by about 9% yoy with the recovery to start in 2016.

Public Finances

Ukraine's Public Sector Fiscal Deficit and Public Debt % of GDP

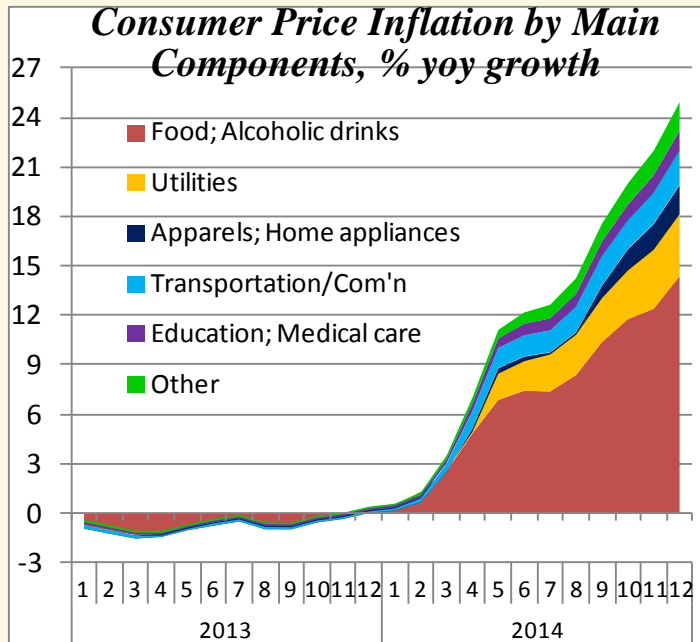


Source: MinFin, The Bleyzer Foundation

- In 2014, the fiscal budget deficit widened to 11.7% of GDP despite austerity measures.
- The deterioration was due to:
 - larger Naftogaz budget imbalances;
 - higher expenditures on defense, security, and external debt service;
 - lower tax revenues associated with the economic downturn and hostilities.
- High Naftogaz deficits led to the start of energy sector reforms (strengthen payment discipline, restructure the company to cut costs and increase transparency). The reform is expected to gain momentum in 2015.

- Fiscal imbalances led to a rapid increase in public debt-to-GDP ratio (to 94%.)
- To contain concerns over public debt sustainability and comply with IMF requirements, the government approved further fiscal consolidation measures.
- The fiscal budget deficit will decline to 7.5% of GDP in 2015 and 4% in 2016.

Inflation

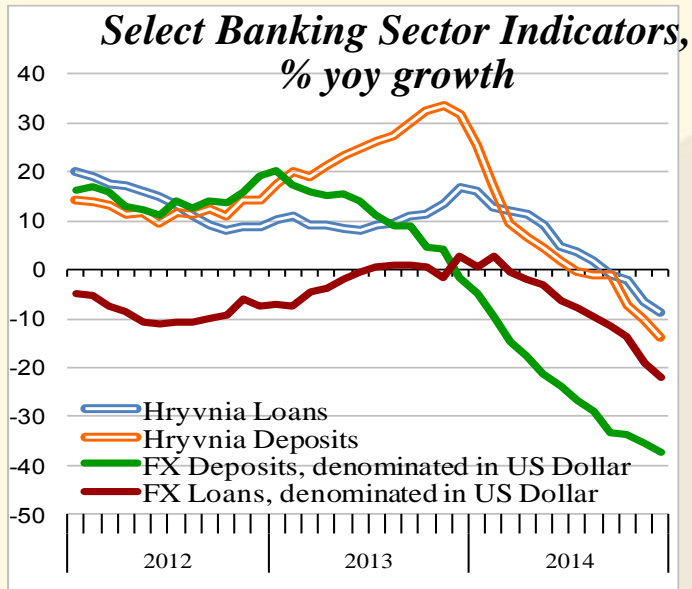


Source: SSS of Ukraine, NBU, The Bleyzer Foundation

- In 2014, inflation reached 25% yoy due to:
 - Higher import prices due to Hryvnia devaluation;
 - The pass-through of rising fuel prices to other goods through transportation costs;
 - Adjustment of utility tariffs;
 - Increase in indirect taxes (excises, import duties, abolishment of VAT for some goods);
 - Monetization of public sector fiscal deficit (the NBU purchased 82% of government securities issued in 2014).

- In 2015, consumer prices are forecast to rise by about 45% yoy, affected principally by increases in utility tariffs and indirect taxes.
- To contain inflationary pressures, the NBU has been taking contractionary measures: the NBU discount rate was raised to 19.5% in February 2015 and to 30% in March.
- Inflation is expected to go down to 20% in 2016,

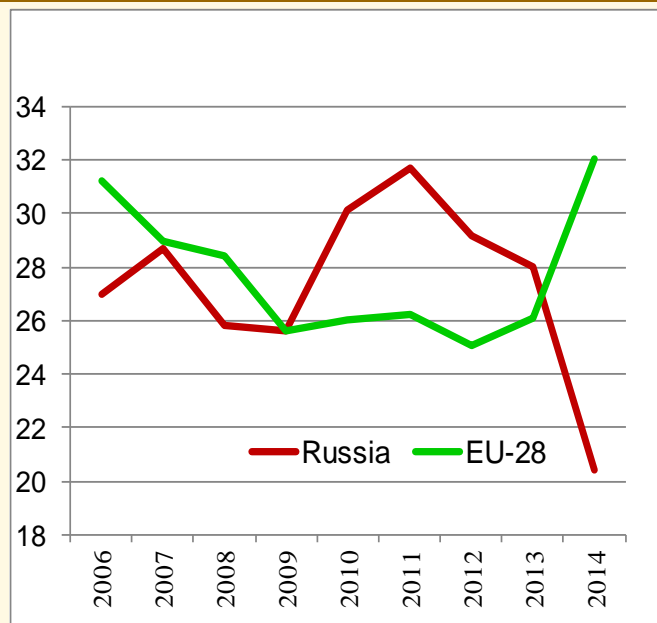
Banking Sector Weaknesses



Source: SSS of Ukraine, NBU, The Bleyzer Foundation

- Ukraine's banking sector has been under stress:
 - due to UAH & \$ deposit withdrawals;
 - deterioration of asset quality caused by GDP declines and UAH depreciation;
 - high external debt repayments.
- But more recently, some positive developments are emerging: In April/May, banks still generated losses but significantly lower than those of previous months.
- At the same time, there were improvements in the trend of both banking deposits and loans.
- To resolve the banking crisis, the Ukrainian authorities are developing banking sector legislation (on mortgages, bankruptcy procedures, loan restructuring, etc.), increasing transparency in the sector (credit history, bank owners, etc.), and approved a bad asset resolution program.

Foreign Trade and Current Account Deficit

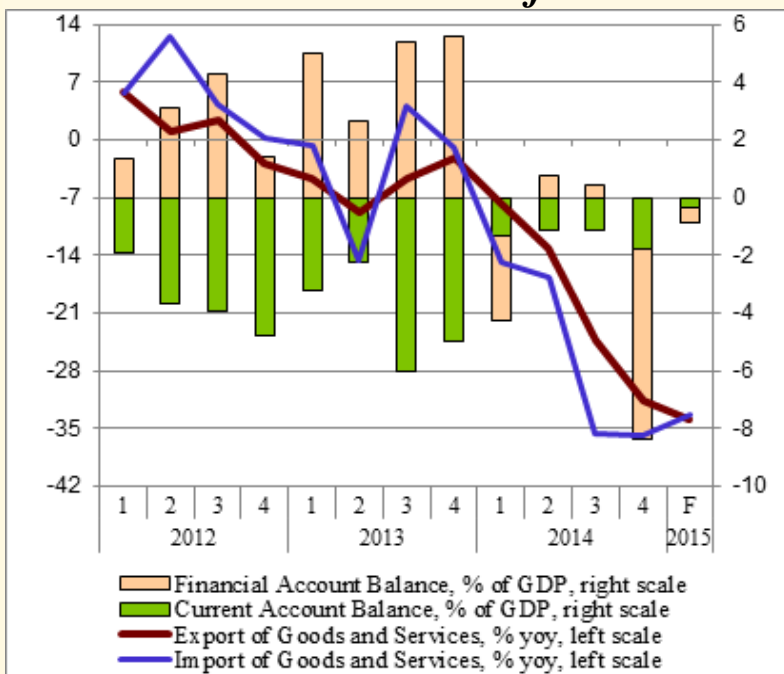


Source: State Statistical Service of Ukraine, The Bleyzer Foundation

- As noted, hostilities led to a decline in **Ukrainian exports** from \$69 bn in 2012 to \$54 bn in 2014, a **fall of \$15 bn**, equivalent to a drop of 22%.
 - Due to trade restrictions, exports to Russia's Customs Union decreased by 45%, the equivalent to \$10 bn or 2/3 of the overall decrease in Ukrainian exports.
 - About 80% of the drop in Ukrainian exports were in 3 categories: Machinery-Transport Equipment (60% of which went to Russia), Metallurgy, and Chemicals.
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- Although increasing their share, exports to the **EU** have remained at about \$17 bn.
 - In 2014, due to reduction in imports amid weaker domestic demand, the current account deficit narrowed to 4.1% of GDP (down from 9% of GDP in 2013).
 - The CA deficit will probably disappear in 2015 and would be small in the near future.

External Financing

Select BoPs Indicators of Ukraine

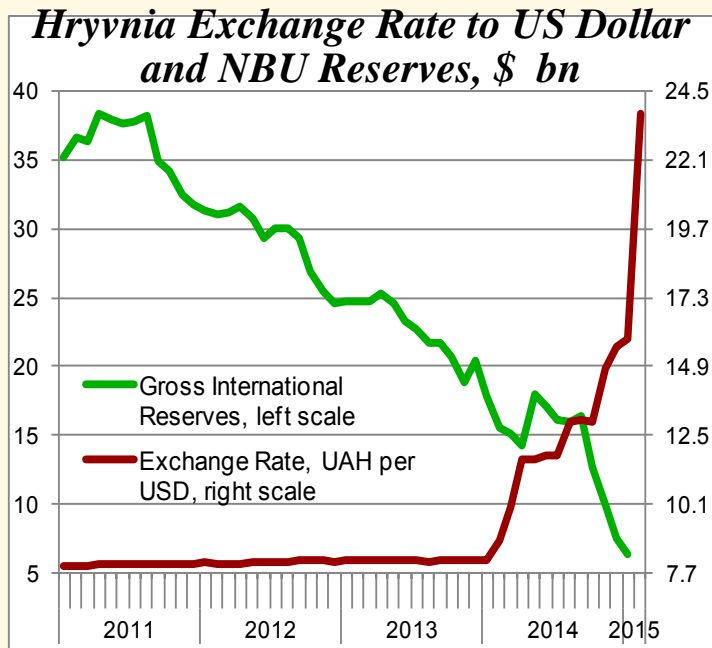


Source: NBU, TBF

- In 2014, Ukraine's financial account of BoPs had a deficit of 6.3% of GDP, due to:
 - High external debt repayments;
 - Foreign capital outflow amid macroeconomic imbalances and political/military instability;
 - Large domestic FX demand for saving and risk reducing purposes.
- These BoPs deficits, and closed foreign capital markets, led to a depletion of international reserves (to \$7.5 bn by the end of 2014, just 1.2 months of imports).
- The BoP will not be an issue in the future.

- Ukraine's external financing needs are estimated at around \$40 bn for 2015-18.
- The government envisages that these needs will be covered by
 - (i) the IMF's EFF of \$17.5 bn;
 - (ii) other official financing; and
 - (iii) the structuring of private foreign debt.

Exchange Rate



Source: NBU, The Bleyzer Foundation

- Military hostilities and the imbalances they created, have led to the Hryvnia/\$ rate falling by about 300% since January 2014.
- Faced with depleted reserves, the NBU tightened administrative restrictions on forex purchases, which stimulated the development of black and grey markets.
- To avoid the existence of three exchange rates, on February 5th, 2015, the NBU allowed Hryvnia to free float.

- Although this move was needed, the timing may have caused undue uncertainties, since there were still doubts related to the approval of the IMF foreign financial aid package and the military conflict was still escalating.
- As a result, the exchange rate overshoot to 30 UAH/\$ by the end of February.
- By March, it went down to 23 UAH/\$ and should remain below 25 UAH/\$ in 2015.

Summary

- According to baseline scenario, **GDP will decline** by 9.0% in 2015 due to austerity measures, Hryvnia depreciation and severe economic disruptions caused by hostilities in the East. The recovery should start in 2016.
- Due to low GDP growth and Hryvnia devaluation, **the fiscal deficit** will remain large in 2015. As a result, the public debt-to-GDP ratio will reach 94% of GDP in 2015. But thanks to measures under the IMF program, Ukraine's public finances will return to sustainable path over the medium-term.
- **Inflation** is likely to accelerate to 45% in 2015 amid further Hryvnia depreciation, aggressive utility tariff adjustments and hikes in indirect taxes.
- Despite weak exports, the CA will improve, thanks to falling imports.
- Ukraine external financing needs in 2015 are forecast to be reduced as a result of sovereign debt restructuring and fully covered by official financing from the IMF, other IFIs, and individual countries.
- On this basis, the exchange rate should stabilize at **21-25 UAH/\$** during 2015.
- With a good start on structural reforms, Ukraine can achieve a quantum leap in its economic development over the medium term.