Ukraine: Economic Situation And Prospects

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### Main Macroeconomic Indicators

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</thead>
<tbody>
<tr>
<td><strong>Real GDP Growth, % yoy</strong></td>
<td>7.5</td>
<td>2.3</td>
<td>-14.8</td>
<td>4.1</td>
<td>5.2</td>
<td>0.2</td>
<td>1.0</td>
<td>3.5</td>
</tr>
<tr>
<td><strong>Fiscal Balance, % GDP</strong></td>
<td>-0.8</td>
<td>-2.0</td>
<td>-8.5</td>
<td>-6.7</td>
<td>-4.3</td>
<td>-5.6</td>
<td>-4.0</td>
<td>-3.0</td>
</tr>
<tr>
<td><strong>Consumer Inflation, %, eop</strong></td>
<td>11.3</td>
<td>22.3</td>
<td>12.3</td>
<td>9.1</td>
<td>4.6</td>
<td>-0.2</td>
<td>4.0</td>
<td>5.0</td>
</tr>
<tr>
<td><strong>UAH/$ Exchange Rate, eop</strong></td>
<td>5.2</td>
<td>7.7</td>
<td>8.0</td>
<td>8.0</td>
<td>8.0</td>
<td>8.0</td>
<td>8-8.4</td>
<td>8-8.5</td>
</tr>
<tr>
<td><strong>Current Account, % GDP</strong></td>
<td></td>
<td>5.7</td>
<td>-7.0</td>
<td>-1.5</td>
<td>-1.9</td>
<td>-5.5</td>
<td>-8.3</td>
<td>-7.0</td>
</tr>
<tr>
<td><strong>Gross Int. Reserves, $ bn</strong></td>
<td></td>
<td>1.5</td>
<td>31.5</td>
<td>26.5</td>
<td>34.5</td>
<td>31.8</td>
<td>24.5</td>
<td>25.0</td>
</tr>
<tr>
<td><strong>Foreign Public Debt, % GDP</strong></td>
<td></td>
<td>21.3</td>
<td>9.2</td>
<td>20.5</td>
<td>23.8</td>
<td>20.4</td>
<td>18.3</td>
<td>18.5</td>
</tr>
<tr>
<td><strong>Foreign Private Debt, % GDP</strong></td>
<td></td>
<td>26.2</td>
<td>47.4</td>
<td>47.1</td>
<td>67.7</td>
<td>62.2</td>
<td>56.8</td>
<td>58.3</td>
</tr>
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</table>

*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
**Economic Growth in Select Countries in the Region**

<table>
<thead>
<tr>
<th></th>
<th>00-07</th>
<th>08-09</th>
<th>10-11</th>
<th>12</th>
<th>13-14(f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro area</td>
<td>2.2</td>
<td>-2.0</td>
<td>1.7</td>
<td>-0.6</td>
<td>0.4</td>
</tr>
<tr>
<td>Hungary</td>
<td>3.6</td>
<td>-3.0</td>
<td>1.4</td>
<td>-1.7</td>
<td>0.6</td>
</tr>
<tr>
<td>Poland</td>
<td>4.1</td>
<td>3.4</td>
<td>4.1</td>
<td>2.0</td>
<td>1.8</td>
</tr>
<tr>
<td>Romania</td>
<td>5.7</td>
<td>0.4</td>
<td>0.5</td>
<td>0.3</td>
<td>1.8</td>
</tr>
<tr>
<td><strong>Ukraine</strong></td>
<td><strong>7.5</strong></td>
<td><strong>-6.3</strong></td>
<td><strong>4.6</strong></td>
<td><strong>0.2</strong></td>
<td><strong>2.3</strong></td>
</tr>
<tr>
<td>Russia</td>
<td>7.2</td>
<td>-1.3</td>
<td>4.4</td>
<td>3.4</td>
<td>3.6</td>
</tr>
<tr>
<td>Turkey</td>
<td>5.2</td>
<td>-2.1</td>
<td>8.8</td>
<td>2.6</td>
<td>3.6</td>
</tr>
</tbody>
</table>

*Eastern Europe includes Bulgaria, Hungary, Poland and Romania. The region growth was weighted by the size of the economies.*

Source: IMF WEO (April 2013), The Bleyzer Foundation

- The Ukrainian economy grew fast during 2000-2007, was hit hard by the crisis of 2008, but showed strong recovery during 2010-1H 2012.
- In 2H 2012, it was hit by a recession in the EU & global trade slowdown.
- Economic growth is forecast to regain traction gradually from late 2013.
- Beyond 2013, Ukraine’s growth prospects still compare relatively favorably with other countries in the region.
- Ukraine is an open economy, with exports representing 55% of GDP.
- Thus, in 2008 and 2012, it was vulnerable to slowdowns of global demand.
- But exports will be a strong growth driver when global trade accelerates.
- Private consumption will also drive GDP, though with some cooling in 2013.
- But investments will underperform, due to fiscal austerity and tight credit.
- Growth in 2013 will be only 1%, accelerating to 3.5% in 2014, and to about 4-5% thereafter; altogether a favorable outlook for Ukraine.
Export Prospects are favorable

Despite subdued demand in developed economies, Ukraine’s medium-term export outlook is favorable due to:

• geographic diversification with greater reliance on high-growth EMs;
• the uptrend in exports of agricultural commodities;
• prospects of a free trade agreement with the European Union in late 2013.
Private consumption grew strongly in 2012 on account of low inflation, stable FX rates, robust real wage/pension growth, and consumer confidence.

- Consumption growth may temporarily decelerate in 2013, reflecting the need for fiscal consolidation and tight credit, but may speed up in 2014.
- Diminished inflationary pressures, Hryvnia stability and consumer confidence will help sustain consumers’ buying power in 2014 and beyond.
The fiscal budget situation is improving, with deficits gradually reduced from 8.5% of GDP in 2009 to 4.3% in 2011 and an expected 4.0% in 2013.

In 2012, the fiscal deficit reached 5.6% of GDP, as budget revenues fell short of target (due to low GDP growth) and social expenditures grew rapidly (due to high wage and pension spending, and continuation of natural gas subsidies).

We expect that the fiscal deficit will narrow to 3% of GDP in 2014.
• The Current account deficit is forecast to gradually narrow thanks to:
  • Government efforts to diversify away from expensive energy imports (including greater use of domestic coal, energy imports from Europe, energy efficiency, and ongoing investments in domestic shale gas).
  • Good prospects for agricultural exports.
  • Export diversification into EMs.
Balance-of-Payments Prospects: Capital Inflows

- CDS spreads for Ukraine have been declining since 2010.
- Since 2010, government and banking foreign debt has been declining, but the corporate sector has been successful in attracting increasing foreign financing.
- In 1Q 2013, the Capital Account had a large surplus of $3.5 billion (an increase of 140% yoy) and capital inflows are forecast to improve further due to:
  - loose international liquidity,
  - gradual recovery of investors’ risk appetite for EMs,
  - prospects of IMF loan extension and a FTA with EU, and
  - a larger repatriation of funds from offshore centers.
Monetary Conditions and Credit

- Since 2011, money supply has been relatively tight, with an average growth of 13% pa, compared to 40% pa before the 2008 crisis.
- Tight money supply, along with reduced fiscal deficits, ample food supplies, and stable utility prices, led to low inflation in 2011 (4.6%) and deflation in 2012 (-0.2%).
- But tight money supply also led to high interest rates and limited bank credit.
- Since the end of 2012, monetary conditions loosened, amid improved inflation and exchange rate expectations, and this is being reflected in the recovery of credit growth.
- Since 2009, the Hryvnia exchange rate has been stable at about 8 UAH/USD.
Exchange Rate Prospects: Price Competitiveness

- Contrary to the situation before 2008, since 2010, inflation in Ukraine has been (and is forecast to be) lower than in its main trading partners.
- Therefore, after a sharp nominal exchange rate adjustment in 2008, the estimates of purchasing power parity are now favorable for Ukraine.
- This points to restored competitiveness and, thus, diminished current account depreciation pressures on the Hryvnia exchange rate.
Exchange Rate Prospects: Population Demand for FX

- In some quarters of the last two years, population purchases of foreign currencies reached $3.5-$4.0 billion per quarter.
- These large population purchases of foreign currency were a significant drag on the capital account and Hryvnia exchange rate.
- However, since the end of 2012, population demand for foreign currency fell to only $0.3 billion thanks to:
  - a more stable macroeconomic environment, and
  - better consumer confidence.
- This also contributes to FX rate stability.

**Population Demand for FX and NBU Reserves, $ bn**

Negative sign of net FX purchases means that population bought more foreign currency than sold to the banks over the period.

Source: NBU, The Bleyzer Foundation
Exchange Rate Prospects: Other Factors

• In addition to fundamental economic factors favoring foreign exchange rate stability, there are a number of socio-political reasons why the Ukrainian authorities are likely to use all available administrative means to mitigate any possible devaluation pressure.

• The government realizes that a currency depreciation may not be an effective adjustment mechanism to reduce external imbalances given that:
  • Imports of gas will not be reduced by a devaluation given natural gas contract rigidities;
  • Large external debt service payments may bring many companies to bankruptcy;
  • High banking sector asset/liability exposure to exchange rate movements.

• Amid improving economic fundamentals and the above-mentioned factors, the UAH exchange rate is likely to remain relatively stable in the medium-term, with a maximum devaluation of about 5%, which could bring the UAH/USD rate to 8.4 - 8.5.
Summary

- Due to a challenging external environment, Ukraine’s real GDP growth is forecast to increase by about 1% yoy in 2013, 3.5% yoy in 2014 and 4% -5% thereafter.
- The fiscal budget situation is improving, with deficits gradually reduced from 8.5% of GDP in 2009 to 4.3% in 2011 and an expected 4.0% in 2013.
- Inflation has been low in both 2013 and 2014, due to lower fiscal deficits, tight monetary policies, ample food supplies, and stable utility tariffs.
- The current account deficit is forecast to gradually narrow thanks to government efforts to reduce energy imports, good prospects for agricultural exports and export diversification.
- Capital inflows should continue, due to loose international liquidity, gradual recovery of investors’ risk appetite, prospects of IMF loan extension and a FTA with the EU, and a larger repatriation of funds from offshore centers.
- Amid a favorable BoP outlook and improved competitiveness (based on PPP), the Hryvnia exchange rate is likely to remain relatively stable during the next two years.
Moving Forward

- Ukraine may achieve and sustain rates of growth of 4%-5%, and even higher (5%-7%) if it proceeds with investment climate improvements.
- The domestic market could become the major engine of growth. An increase in domestic supply of goods and services may be achieved by attracting major flows of foreign direct investments.
- Ukraine is attractive for FDI thanks to:
  - A large consumer market with population over 45 million.
  - Very rich agricultural land.
  - One of the largest potential amounts of shale gas in Central/Eastern Europe.
  - An open economy that could grow fast with Free Trade Agreements.
  - At about 18% of GDP, Ukraine’s external public debt compares favorably with other countries in the region.
  - Although private and public external debt at 75% of GDP is a major burden for Ukraine, it is better than the external debt levels in many EU countries.