The Impact of the Global Liquidity Crisis on Ukraine and the Road to Recovery

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Macroeconomic Performance

From 2000 to Sept. 2008, Ukraine enjoyed overall excellent economic results.

<table>
<thead>
<tr>
<th></th>
<th>2000-07 average</th>
<th>2008</th>
<th>2009 (f)</th>
<th>2010 (f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth, % yoy</td>
<td>7.5</td>
<td>2.1</td>
<td>-14</td>
<td>3</td>
</tr>
<tr>
<td>Fiscal Balance, % GDP</td>
<td>-0.8</td>
<td>-1.5</td>
<td>-6</td>
<td>-4</td>
</tr>
<tr>
<td>Consumer Inflation, %, eop</td>
<td>11.3</td>
<td>22.3</td>
<td>15</td>
<td>10-13</td>
</tr>
<tr>
<td>UAH/$ Exchange Rate, eop</td>
<td>5.2</td>
<td>7.7</td>
<td>8-9</td>
<td>8 - 10</td>
</tr>
<tr>
<td>Current Account, % GDP</td>
<td></td>
<td>5.7</td>
<td>-7.1</td>
<td>0.5</td>
</tr>
<tr>
<td></td>
<td>2000-05</td>
<td>2006-07</td>
<td>-1</td>
<td>0.5</td>
</tr>
<tr>
<td></td>
<td>5.7</td>
<td>-2.6</td>
<td>-1</td>
<td>0.5</td>
</tr>
<tr>
<td>Gross Int. Reserves, $ bn</td>
<td></td>
<td>31.5</td>
<td>29</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>1.5</td>
<td>32.5</td>
<td>9.2</td>
<td>24</td>
</tr>
<tr>
<td>Foreign Gov’t Debt, % GDP</td>
<td></td>
<td></td>
<td>24</td>
<td>24</td>
</tr>
</tbody>
</table>
The International Liquidity Crisis Hit Ukraine Hard

- **PFTS stock index:** -74% (2008)
- **UAH/$ Exchange Rate:** Depreciated by 58% (4Q 2008)
- **Drop in GDP:** -19% yoy (1H 2009)
- **Export of goods:** -49% yoy (Jan-Jul 2009)
- **Industrial production:** -30% yoy (Jan-Jul 2009)
- **Unemployment:** 9% (1H 2009; 6% in 2008)
- **Real households’ income:** -10% yoy (1H 2009)
The Crisis Affected Ukraine Harder

<table>
<thead>
<tr>
<th>Country</th>
<th>Gross Domestic Product, % yoy, 1Q 2009</th>
<th>Local Currency Depreciation versus the US Dollar</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>-20.3</td>
<td>58 % (4Q 2008)</td>
</tr>
<tr>
<td>Latvia</td>
<td>-18.0</td>
<td>7 % (1Q 2009)</td>
</tr>
<tr>
<td>Estonia</td>
<td>-15.1</td>
<td>3 % (1Q 2009)</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-13.6</td>
<td>7 % (1Q 2009)</td>
</tr>
<tr>
<td>Taiwan</td>
<td>-10.2</td>
<td>3 % (1Q 2009)</td>
</tr>
<tr>
<td>Singapore</td>
<td>-10.1</td>
<td>6 % (1Q 2009)</td>
</tr>
<tr>
<td>Russia</td>
<td>-9.5</td>
<td>35 % (Oct.08-Mar.09)</td>
</tr>
<tr>
<td>Mexico</td>
<td>-8.2</td>
<td>26 % (4Q 2008)</td>
</tr>
<tr>
<td>Hungary</td>
<td>-6.7</td>
<td>23 % (Oct.08-Mar.09)</td>
</tr>
<tr>
<td>Romania</td>
<td>-6.2</td>
<td>38 % (Oct.08-Mar.09)</td>
</tr>
</tbody>
</table>

Source: The Economist, Central banks of the respective countries, The Bleyzer Foundation
Real Sector Performance in 2009

- Real GDP fell by 19% yoy in 1H 2009.
- Major declines in export-oriented industries and credit-dependent sectors (construction, machine-building).
• World commodity prices fell sharply since Aug-Sept. 2008.
• Ukraine’s exports of goods dropped by 49% yoy (Jan-Jul 2009).
• Industrial production declined by 30% yoy (Jan-Jul 2009).

Source: State Statistics Committee, NBU, MEPS, The Bleyzer Foundation
Why Ukraine Was Affected More Severely

1. Open but undiversified economy:
   - Share of exports in GDP is ~ 50%;
   - Metals, Minerals and Chemicals account for ~60% of exports;
   - Narrow geographic diversification of exports.

2. Excessive reliance on foreign capital.

3. A combination of three vulnerabilities, as explained below...
Vulnerability # 1 – Large Current Account Deficits

Over 2003-2008,
- Exports grew by 25% pa;
- But imports – by 30% pa;
- CA deficits emerged in 2006 and
- Widened to 7% of GDP in 2008.

2009 forecast before the crisis: CA deficit - $ 24 billion, or 13% GDP.

Uncertain foreign financing put pressures on the Hryvnia.

Ukraine’s Foreign Trade in Goods Performance and Current Account Balance

- Exports grew by 25% pa;
- But imports – by 30% pa;
- CA deficits emerged in 2006 and
- Widened to 7% of GDP in 2008.

2009 forecast before the crisis: CA deficit - $ 24 billion, or 13% GDP.

Uncertain foreign financing put pressures on the Hryvnia.
Vulnerability # 2 – Large External Debt Repayments

- External private debt tripled in three years (2006-08)…
- …to finance consumption and investments.
- As of mid-2008, ~$40 billion of debts was due to repay in <1 year.
- International reserves stood at $35 billion.

- Debt rollover became very difficult during the initial stages of international liquidity crisis.

Source: NBU, The Bleyzer Foundation
### Vulnerability # 3 – Banking Sector Weaknesses

**Non-performing Loans in Selected Emerging Markets as % of Total Loans, 2008**

<table>
<thead>
<tr>
<th>Country</th>
<th>Non-performing Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latvia</td>
<td>2.0</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>4.0</td>
</tr>
<tr>
<td>Russia</td>
<td>5.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>5.0</td>
</tr>
<tr>
<td>Slovakia</td>
<td>5.0</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>5.0</td>
</tr>
<tr>
<td>Turkey</td>
<td>5.0</td>
</tr>
<tr>
<td>Poland</td>
<td>5.0</td>
</tr>
<tr>
<td>Croatia</td>
<td>5.0</td>
</tr>
<tr>
<td>Moldova</td>
<td>5.0</td>
</tr>
<tr>
<td>Serbia</td>
<td>5.0</td>
</tr>
<tr>
<td>Macedonia</td>
<td>6.0</td>
</tr>
<tr>
<td>Romania</td>
<td>14.5%</td>
</tr>
<tr>
<td>Ukraine</td>
<td>16.0%</td>
</tr>
</tbody>
</table>

- Bank lending grew by 70% pa over 2006-08.
- This growth was supported by:
  - improved access to foreign capital
  - the entrance of foreign banks
  - loose domestic monetary policy.
- 50% of total loans were issued in foreign currency.
- The share of non-performing loans (NPLs) was high - 14.5% in 2008.

Banking Sector Weaknesses (cont.)

- During the crisis, commercial banks faced:
  - closed access to international credit markets;
  - large debt repayments needs;
  - high currency risks;
  - fast growth of NPLs.

- The combination of the above led to bank runs.

- From October 2008 to April 2009, about ¼ of bank deposits were lost.

**Banks’ Deposit Base, quarterly change in stock**

<table>
<thead>
<tr>
<th>Quarter</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>1q</td>
<td>10</td>
<td>-10</td>
</tr>
<tr>
<td>2q</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>3q</td>
<td>15</td>
<td>-5</td>
</tr>
<tr>
<td>4q</td>
<td>5</td>
<td>-10</td>
</tr>
</tbody>
</table>

Source: NBU, The Bleyzer Foundation
Severe Domestic Credit Squeeze

- Before the crisis, the credit-to-GDP ratio grew from 20% (2002) to 77% (2008).
- After the crisis, bank lending sharply decelerated due to:
  - tight access to foreign capital and domestic funds;
  - deposit withdrawals;
  - rising NPLs; and
  - tight money supply.

Although liquidity support was provided to a number of banks ..... 
.......it appears that it may not have been used to increase lending.
Hryvnia Depreciation – One of the World’s Largest

- During 4Q 2008, Hryvnia lost more than 50% of its value to US Dollar.
  - Sharp depreciation was due to:
    - Intense vulnerabilities (CA deficits, debt repayments, weaker banking sector);
    - Inadequate monetary policy;
    - Fragile political situation;
    - Conflicting statements about the future exchange rate;
    - Loss of competitiveness.

**Foreign Exchange Market Performance**

Source: NBU, The Bleyzer Foundation
Ukraine’s Loss of Relative Competitiveness (based on Purchasing Power Parity)

- High inflation in Ukraine – 12.5% pa on average over 2000-2008.
- Virtually stable exchange rate.
- Normally, loss of competitiveness adjusts through exchange rate depreciation.

### PPP with Base Year 2002

<table>
<thead>
<tr>
<th>Year</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation Diff Index Ukr-Us</td>
<td>100</td>
<td>106</td>
<td>115</td>
<td>123</td>
<td>134</td>
<td>150</td>
<td>182</td>
<td>210</td>
<td>237</td>
</tr>
<tr>
<td>REER - US</td>
<td>5.7</td>
<td>6.2</td>
<td>6.5</td>
<td>7.1</td>
<td>8.0</td>
<td>9.7</td>
<td>11.2</td>
<td>12.6</td>
<td></td>
</tr>
<tr>
<td>Inflation Diff Index Ukr-MTP</td>
<td>100</td>
<td>101</td>
<td>105</td>
<td>109</td>
<td>115</td>
<td>124</td>
<td>141</td>
<td>154</td>
<td>167</td>
</tr>
<tr>
<td>REER - MTP</td>
<td>5.4</td>
<td>5.6</td>
<td>5.8</td>
<td>6.1</td>
<td>6.6</td>
<td>7.5</td>
<td>8.2</td>
<td>8.9</td>
<td></td>
</tr>
</tbody>
</table>

REER - Real Effective Exchange Rate
Ukrainian Authorities’ Response – Adequate Measures

- Secured financial assistance from the IMF, the WB, other international institutions;
- Maintained good fiscal discipline;
- Avoided major increases in social payments arrears;
- Carried out stress tests for commercial banks;
- Supported systemic banks;
- Progressed towards a more flexible exchange rate;
- Developed non-systemic bank resolution program;
- Controlled inflation;
- Kept Current Account deficits on a downward trend.
Ukrainian Authorities’ Response – Insufficient Measures

- Ineffective across-the-board coordination.
- Insufficient provision of funds to the economy.
- Poor control over the use of provided liquidity.
- Failure to reach agreement on utility price increases.
- Lack of a comprehensive strategy to restore Naftogaz and Pension Fund solvency.
- Delays in privatization and the lack of a transparent privatization strategy.
Measures to Avoid a Crisis Deepening

• Presidential elections scheduled on January 2010.
• Political uncertainties may undermine decision-making and hinder economic recovery.
• To avoid the threats of crisis deepening, the authorities should:
  • Maintain prudent fiscal policy;
  • Maintain balanced monetary policy;
  • Effectively supervise banking system.
  • Continued co-operation with the IMF is essential.
Measures to Accelerate Economic Development

- Past sources of economic growth (exports and credit) are limited
- Investments may become the new growth engine
- Ukraine’s economic outlook is still bright:
  - Exports should be stimulated by membership in the WTO.
  - The proposed EU-FTA would encourage FDIs and exports.
  - FDIs will also be supported by abundant and educated labor.
  - Labor wages are 1/3 of those in Eastern Europe.
  - Ukraine population of 46 million people is an attractive market.
  - Ukraine agricultural potential is quite high.
  - Ukraine’s infrastructure and technological base are reasonable.
Measures to Accelerate Economic Development (cont.)

• But realization of this outlook requires major improvement in the business climate.
• For this, authorities should:
  • Bring stability and predictability to the legal environment;
  • Reform the judiciary;
  • Reduce the costs of doing business;
  • Improve public administration
  • Reduce corruption;
  • Reach an Enhanced Free Trade Agreement with the EU;
  • Support efficiency and productivity growth.