Ukraine- Sustaining its Economic Recovery

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Political Situation

- Following the February Presidential elections, a new Parliamentary coalition formed a government loyal to the elected President.
- The new political stability is a welcome change from the political chaos of the past.
- Sergiy Tigipko, a competent manager who received 13% of the vote in the elections, was appointed as Vice Prime Minister for Economic Reforms.
- The authorities are currently developing a reform agenda of structural reforms in key areas such as macroeconomic stability, pension reform, utility pricing, anti-corruption, privatization, deregulation, judiciary reform, and trade liberalization.
- The government has the competence and expertise to implement necessary reforms; still many uncertainties remain on the speed and depth of these transformations.
- The local elections, which are scheduled for the end of 2010, may weaken political will to take some unpopular reforms (i.e., increase in gas tariff and pension reform).
- The new administration has announced a balanced foreign policy between the West and CIS. However initial measures show a predisposition towards Russia (prolongation of lease agreement for Russian fleet and new gas agreement).
Ukraine’s Real Sector Performance

The international crisis led to a retrenchment of foreign demand and capital inflows, which caused a sharp fall of Ukrainian exports and a 15% decline of real GDP in 2009.

The main contraction took place during 4Q of 2008 and the first two months of 2009.

It bottomed out in March 2009 and has been steadily growing since then.

A strong recovery of exports supported a 5% GDP rebound in Q1 2010.

Source: State Statistics Committee of Ukraine, National Bank of Ukraine, The Bleyzer Foundation
What Will Sustain Economic Recovery in Ukraine?

Upside Factors:

1. A swift recovery of world trade, based mainly on an accelerating growth momentum in emerging countries
2. Improving global demand for steel products – the key export commodities of Ukraine
3. Better international competitiveness thanks to the recent currency depreciation and more favorable terms of trade (higher steel prices and a recent gas price discount).
4. Easier access to foreign funds by Ukrainian banks and companies

Downside Risks:

1. Inability to reduce high budget deficits
2. Inability to roll-over the current large foreign debt
3. Weak banks and a lack of funds to credit the private sector
Upside Factor 1: Global Economic Conditions are Improving

- A turnaround in global manufacturing and trade is already supporting recovery.
- Growth prospects in Ukraine’s major trading partners are getting better.
- Investors’ appetite for emerging market assets is gradually returning as indicated by narrowing spreads on their corporate and sovereign debts and falling CDS rates.
- This helps reduce foreign borrowing costs for governments and businesses.

Source: Cbonds.net, CPB Netherlands Bureau for Economic Policy Analysis, The Bleyzer Foundation
Upside Factor 2: Better Prospects for Steel Industry

- Metallurgy is the most important sector for the Ukrainian economy.
- Many industries and sectors are tied to metallurgy.
- Exports and industry performance closely follow world steel price trends.

A new iron ore price setting system was established in March 2010, which boosted ore and steel prices.

Steel price growth in 2010 will support stronger recovery of Ukraine’s economy.
Upside Factor 3: Improved Export Competitiveness

- In 2008, the Hryvnia lost more than 50% against the U.S. Dollar.
- But the depreciation helped to:
  - restore the loss of international competitiveness, and
  - reduce external imbalances.
- On the import side, a 30% discount on natural gas imports, negotiated with Russia in April will reduce the costs of production and further improve trade balance.
- This favors export-oriented industries – chemicals, metallurgy.

*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)*
Upside Factor 4: Better Access to Foreign Capital

- Foreign debt and capital inflows in Ukraine soared in 2005-2008.
- During the crisis, foreign capital markets were virtually closed.
- High Ukraine’s foreign financing needs in 2010 were partially covered by the IMF program.
- Since mid-2009, foreign investors sentiments have been improving.
- In April 2010, there were several successful Eurobond placements by the Ukrainian private businesses.
- The government plans to borrow $1.3 billion on foreign markets in 2010 & resume IMF cooperation.

Source: NBU, TBF, Bloomberg
Upside Factors: Impact on Domestic Demand

- Due to the 4 previous upside factors, Consumer Purchasing Power has been gradually increasing.
- Real monthly wage grew by 7% yoy in Mar 2010, compared to a 11% yoy decline in Oct 2009.
- Private consumption will be further supported by continued increases in government social expenditures.

Source: State Statistics Committee, NBU, GFK-Ukraine, TBF
Downside Risks: Public Finances, Debt and Weak Banks

• **The major economic risk** for Ukraine would be its inability to reduce the current fiscal deficit.

• The fiscal deficit was 8.5% GDP in 2009, as fiscal revenues declined, and social, Naftogaz and Pension Fund expenditures increased.

• The deficit was financed by IMF loans and domestic borrowings.

• In 2010, the new government is committed to reduce the budget deficit to 6% of GDP – as required by the IMF to resume co-operation.

• On April 27th, the 2010 budget law was approved with a state deficit target of about 5% of GDP (including the Pension Fund deficit).

• Agreement with the IMF is critical to overcome this risk.

• **A second economic risk** would be the inability of Ukraine to maintain foreign confidence needed to roll-over its large foreign debt.

• **The third risk** would be a further deterioration of local banks and lack of credit which may restrain the growth of domestic demand.
Economic Prospects over Medium-Term

• In 2010, overall prospects for the Ukrainian economy has notably improved:
  • Real GDP is forecast to grow by 4.5%
  • Current account is expected to turn into surplus
  • Foreign capital inflows are forecast to increase
  • Exchange rate is likely to remain stable and even slightly appreciate
  • Fiscal deficit will be reduced in compliance with the IMF requirements
  • Inflationary pressures will be moderate.
• The new government has the capacity and willingness to restore macroeconomic stability.
• The political situation is now much more stable than in the previous few years.
• Given macroeconomic and political stability, the government may be more prepared to implement broader economic reforms.
• 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).
• Ukraine should be able to grow by 4-5% per year over the next few years.
Main Macroeconomic Indicators

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<thead>
<tr>
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<th>2000-07 average</th>
<th>2008</th>
<th>2009</th>
<th>2010 (f)</th>
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<tbody>
<tr>
<td>Real GDP Growth, % yoy</td>
<td>7.5</td>
<td>2.3</td>
<td>-15.1</td>
<td>4.5</td>
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<tr>
<td>Fiscal Balance, % GDP</td>
<td>-0.8</td>
<td>-2.1*</td>
<td>-8.5**</td>
<td>-6.0#</td>
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<tr>
<td>Consumer Inflation, %, eop</td>
<td>11.3</td>
<td>22.3</td>
<td>12.3</td>
<td>13.0</td>
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<td>UAH/$ Exchange Rate, eop</td>
<td>5.2</td>
<td>7.7</td>
<td>8.0</td>
<td>7.8 – 8.0</td>
</tr>
<tr>
<td>Current Account, % GDP</td>
<td>2000-05</td>
<td>2006-07</td>
<td>-7.0</td>
<td>-1.5</td>
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<tr>
<td></td>
<td>5.7</td>
<td>-2.6</td>
<td></td>
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<tr>
<td>Gross Int. Reserves, $ bn</td>
<td>2000</td>
<td>2007</td>
<td>31.5</td>
<td>26.5</td>
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<tr>
<td></td>
<td>1.5</td>
<td>32.5</td>
<td></td>
<td></td>
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<tr>
<td>Foreign Gov’t Debt, % GDP</td>
<td>2003</td>
<td>2007</td>
<td>9.2</td>
<td>20.5</td>
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<tr>
<td></td>
<td>21.3</td>
<td>8.7</td>
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<tr>
<td>Foreign Private Debt, % GDP</td>
<td>2003</td>
<td>2007</td>
<td>47.1</td>
<td>68.1</td>
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<td></td>
<td>26.2</td>
<td>47.4</td>
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* Includes implicit pension fund deficit (credits from unified Treasury account (state budget) to cover pension fund expenditures)

** Includes capital injections to Naftogaz (2.7% GDP), implicit Pension Fund deficit (1.7% of GDP) and expenditures covered by IMF’s special SDR allocation to Ukraine (1.7% GDP).

# Includes Naftogaz imbalances.
Pay-TV and Broadband Access

**Newspapers are dying; the music industry is still yelping about iTunes; book publishers think they are next... But cable and satellite TV breezed through.**

The Economist, A special report on television, May 1st, 2010

- Television continues to outperform other media.
- Emerging markets have a great upside potential - users opt for premium service and more variety as wealth increases.
- Consumers’ demand for high-quality pay-TV and broadband access is likely to strengthen on expectations of better economic conditions.
- Low penetration rates and high population density should sustain above average revenue growth in Ukraine.

Source: OECD, International Telecommunications Union, IKS-Consulting, The Economist