Ukraine Vulnerabilities and Needed Actions

Dr. Edilberto Segura
Partner & Chief Economist, SigmaBleyzer
Chairman, Advisory Board, The Bleyzer Foundation
September 2011
**Main Macroeconomic Indicators of Ukraine**

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011f</th>
<th>2012f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth, % yoy</td>
<td>7.3</td>
<td>7.9</td>
<td>2.3</td>
<td>-14.8</td>
<td>4.2</td>
<td>4.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Fiscal Balance, % GDP*</td>
<td>-0.7</td>
<td>-1.7</td>
<td>-2.0</td>
<td>-8.8</td>
<td>-6.5</td>
<td>-4.0</td>
<td>-3.0</td>
</tr>
<tr>
<td>Consumer Inflation, %, eop</td>
<td>11.6</td>
<td>16.6</td>
<td>22.3</td>
<td>12.3</td>
<td>9.1</td>
<td>10-11</td>
<td>9.0</td>
</tr>
<tr>
<td>UAH/$ Exchange Rate, eop</td>
<td>5.1</td>
<td>5.1</td>
<td>7.7</td>
<td>8.0</td>
<td>8.0</td>
<td>8.0</td>
<td>8-8.5</td>
</tr>
<tr>
<td>Current Account, % GDP</td>
<td>-1.5</td>
<td>-3.7</td>
<td>-7.0</td>
<td>-1.5</td>
<td>-1.9</td>
<td>-4.5</td>
<td>-4.5</td>
</tr>
<tr>
<td>Gross Int. Reserves, $ bn</td>
<td>22.4</td>
<td>32.5</td>
<td>31.5</td>
<td>26.5</td>
<td>34.6</td>
<td>35.0</td>
<td>31.0</td>
</tr>
<tr>
<td>Foreign Gov't Debt, % GDP</td>
<td>11.0</td>
<td>8.7</td>
<td>9.2</td>
<td>20.5</td>
<td>25.5</td>
<td>24.5</td>
<td>23.0</td>
</tr>
<tr>
<td>Foreign Private Debt, % GDP</td>
<td>39.6</td>
<td>47.4</td>
<td>47.1</td>
<td>68.1</td>
<td>63.8</td>
<td>56.4</td>
<td>50.0</td>
</tr>
</tbody>
</table>

* Includes implicit pension fund deficit (credits from unified 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.
Ukraine’s Economic Performance

- During 2000-2007, Ukraine grew by an average 7.5% pa.
- The international financial crisis hit Ukraine hard; real GDP fell by almost 15% yoy in 2009.
- The economy recovered to 4.2% in 2010 and 4.4% yoy in 1H 2011.
- But the outlook for 2H 2011 and 2012 has recently worsened to 4%.

The deterioration was mainly due to weaker global economic growth prospects, exacerbated by the combination of four main vulnerabilities of the Ukrainian economy:

1. Open but Undiversified Economy
2. High External Financing Needs
3. General Gov’t Fiscal Deficit
4. Banking Sector Weaknesses
Vulnerability #1 – Open & Undiversified Economy

Exports represent about 50% of GDP
But exports are undiversified: Metals, Minerals and Chemicals account for ~55% of goods exports.
Commodity-based exporting countries were hit hard during 2008/09 crisis.

Likely slower global growth in 2H 2011 and 2012 and weaker demand for commodities make Ukraine again very vulnerable.
Product diversification should be a key item in the reform agenda.
Exports are also undiversified geographically

- Demand for Ukraine’s exports depends on a few countries.
- Exports to Russia and other CIS countries may slow due to:
  - Weaker growth in Russia, economic downturn in Belarus;
  - Trade restrictions, imposed by Russia during June-July 2011, and which were automatically imposed by other members of the Customs Union.
- There is continuing turbulences in MENA region.

- The second largest market for Ukraine’s exports, the EU, will also experience slow downs, even though exports to the periphery are small.
- Turkey may also grow at a slower pace, due to its close ties with EU.
- Slower growth in the CIS, EU and Turkey will affect Ukrainian exports.

---

Ukraine’s Goods Exports by Regions and Selected Countries, % of total, 1H 2011

- CIS 37%
- EU 29%
- MENA 11%
- Other 23%

- Turkey - 6.1%
- China - 2.8%
- India - 2.8%
- USA - 1.7%
- Russia - 28%
- Belarus - 3%
- Kazakhstan - 2.5%
- Iran+Iraq - 2.5%
- Lebanon - 1.8%
- Egypt - 1.6%
- Syria - 1.3%
- Italy - 5.8%
- Poland - 4.3%
- Germ+Fr - 3.6%
- Hun+Rom+Cz - 4.7%

Source: State Statistics Committee, The Bleyzer Foundation
Outlook for the World Economy

European GDP growth will be slowed down by the austerity measures taken by Italy and EU countries in the periphery.

Nevertheless, developed countries should be able to avoid second recessions, if they are able to resolve Greece’s debt situation (but the risks of recessions have increased).

Despite recent slowdowns in economic growth in developed economies, emerging markets’ growth is still sound at 5.8%.

Source: Average projections from the updates by the IMF, WB, OECD, EBRD, EIU, JP Morgan, Deutsche Bank, Morgan Stanley, TBF
FTA+ with EU & Others Can be Driving Forces

- Ukraine can diversify its exports, and thus economy, by (i) signing free trade agreements and (ii) attracting more FDIs.

- FTA with EU may:
  - bring Ukraine into the supply chain for Europe. Thus the country will be able both to diversify exports and to attract larger inflows of FDIs;
  - become a locomotive of future growth and a strong driver of structural changes in the economy.

- But its trade with the EU has been deteriorating. Moreover, Ukraine faces pressures to join Customs Union.

- Though Ukraine looks set to complete negotiations on FTA with EU, more efforts should be made to ensure its smooth implementation.
Vulnerability # 2 – High External Financing Needs

**Projected Balance of FX Needs and Inflows**

<table>
<thead>
<tr>
<th>$ billion</th>
<th>2011e</th>
<th>2012f</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Outflow</td>
<td>Inflow</td>
</tr>
<tr>
<td>CA balance</td>
<td>6.8</td>
<td>8.0</td>
</tr>
<tr>
<td>Ext’l Public Debt**</td>
<td>4.5</td>
<td>5.5</td>
</tr>
<tr>
<td>Ext’l Private Debt</td>
<td>44.3</td>
<td>51.3</td>
</tr>
<tr>
<td>Banks</td>
<td>12.7</td>
<td>10.2</td>
</tr>
<tr>
<td>Corporates*</td>
<td>31.6</td>
<td>41.1</td>
</tr>
<tr>
<td>FDI</td>
<td>5.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Net purchases of FX by population</td>
<td>7.5</td>
<td>6.0</td>
</tr>
<tr>
<td>Total</td>
<td>62.8</td>
<td>62.2</td>
</tr>
<tr>
<td>Change in Reserves</td>
<td>-0.9</td>
<td>-3.3</td>
</tr>
</tbody>
</table>

* Includes quasi-sovereign companies  * Does not include new IMF funds
Source: NBU, MinFin, The Bleyzer Foundation

- Due to weaker exports but still strong imports, the Current Account deficit will widen to 4.5% of GDP in 2011-2012.
- In addition, Ukraine has to service its large external debt ($120 bn as of end-Apr 2011) with about $50 bn of it being Short Term.
- FDI inflows still did not recovered to pre-crisis levels and are much below potential.

- Ukraine must maintain investors’ confidence to keep rollover ratios high.
- Though Ukraine may manage its FX needs even without the IMF funds (if there is no major shock), the presence of the IMF program would increase the country’s resilience to adverse external developments.
Vulnerability # 3 – High Gov’t Fiscal Budget Deficit

- Sustaining public finances remains one of the main macroeconomic challenges for Ukraine.
- During the crisis, the fiscal budget deficit grew to 9% of GDP.
- Partially as a result of it, public debt (domestic and external) grew from below 13% GDP in 2007 to more than 40% GDP in 2010.
- Ukraine committed to reduce its fiscal deficit to 3.5% GDP in 2011 and 2.5% in 2012.

However, fiscal adjustment is proceeding slower than initially expected. The overall government fiscal deficit in 2011 are likely to be around 4% GDP due to higher Naftogaz and Pension Fund imbalances.
Vulnerability # 4 – Banking Sector Weaknesses

- Credit growth has been reviving but quite unevenly:
  - the highest credit increase was for state-owned companies - 180% yoy in July 2011;
  - consumer credit resumed at robust 20% yoy in July 2011;
  - credit growth to private companies is still sluggish - 9% yoy, impeding investments.

- Bias towards SOE and consumer lending may complicate the ongoing process of cleaning commercial banks balance sheets from NPLs (41.6% of total loans in 2010).

- In addition, substantial presence of European banks in Ukraine’s banking sector is another source of vulnerabilities, given the Eurozone’s crisis.
Outlook

• The Ukrainian authorities are aware of these vulnerabilities and are working to address them gradually:
  • They plan to complete negotiations with the EU on FTA at end-2011;
  • Fiscal consolidation is ongoing, though slower than expected (the government announced that the draft 2012 budget law will be prepared targeting a 2.5% of GDP broad deficit;
  • Though the IMF program is suspended since March 2011, recently the government amended the pension reform law, one of the key IMF requirement;
  • The NBU is following the IMF program in addressing financial sector weaknesses.

• Given the above, and assuming no major external shock, Ukraine will be able to grow at about 4% pa during 2011-12.

• However, these growth rates are insufficient to start the catch-up with more developed countries and are below the country’s potential.

• But to realize this potential, Ukraine needs to make a quantum jump in economic reforms to improve its investment climate.
Removing Obstacles to Businesses

• Short term measures:
  – Strong actions to resolve the problem of arrears in VAT refunds
  – Protection of property rights, including stronger mechanisms to deal with raiders.
  – Simplification of procedures to acquire commercial land for plant location & warehousing.
  – End the increased level of harassment, threats and interference by government authorities to business, including harassment by tax authorities, customs, inspection agencies, etc.
  – Facilitate the establishment of new businesses, including de-regulation and improving production sharing agreements for oil and gas.
  – Approve the Customs Code to facilitate international trade.
  – Take measures to facilitate the resolution of non-performing loans in the banking sector.
  – Ensure that the Association Agreement and FTA with the EU are finalized within this year.

• Over the medium term, The government will need to show that:
  – The Judiciary is reformed and will be acting in a fair and transparent manner
  – Administrative corruption is brought under control.
  – Public administration reform will be finalized to redefine the role of the government as complementary to the private sector, improve efficiency by eliminating overlapping functions among agencies, minimize regulations to avoid interference in business activities, and government agencies working at appropriate administrative levels.
  – Other institutions that support the business sector, such as non-bank financial institutions, commodity future exchanges, etc. will be improved.

Moving Forward

- If Ukraine were to implement a strong program of reforms, the country will be less vulnerable to international crises and sustain higher rates of growth, as many Asian countries are doing.
- In fact, Ukraine’s has many advantages that could enable it to growth based on domestic markets --consumption and investments-- with less vulnerability to exports. In fact, the domestic market could become the major engine of growth. But this will require major flows of foreign direct investments that could only be attracted only with a better business climate.
- International comparisons show that Ukraine may indeed be attractive for FDIs:
  - Ukraine’s large population gives a very attractive market potential for local and international consumer products.
  - Ukraine is endowed with very rich agricultural land that could be the engine for growth.
  - Ukraine is an open economy which could grow fast with Free Trade Agreements.
  - The fiscal budget deficit is much lower than in other similar countries.
  - At 40% of GDP, Ukraine’s public debt compares favorably to external debt of over 80% in most European countries.
  - Although private and public external debt at 86% of GDP is a major burden for Ukraine, it is much better than external debt levels of over 100% in many European countries.
  - Education and health indicators in Ukraine are much better than in most other countries.
  - The country may still growth at reasonable rates of 4%.