

## UKRAINE Economic Update

April 7, 2009

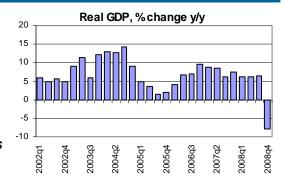
- The global economic environment has deteriorated further, dragging Ukraine into a sharper downturn.
- The economy is undergoing a painful though needed rebalancing.
- A comprehensive, inter-linked, and consistent "anti-crisis" program of measures and reforms is urgently needed to face the economic downturn and lay the foundations for the economic recovery. Efforts in this direction would do much to stabilize market expectations.

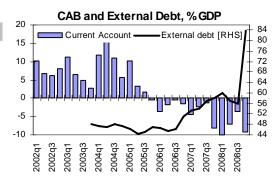
## **Recent Economic Developments**

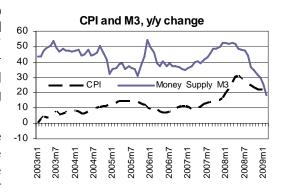
The global economic environment has significantly deteriorated since our last update. Massive deleveraging in financial markets has triggered a sharp global economic contraction. The region of Europe and Central Asia has been most adversely affected, given its dependence on foreign capital to finance spending and its exposure to commodity markets.

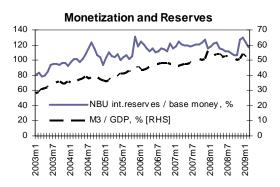
The Ukrainian economy has deteriorated sharply since the beginning of the crisis. Real GDP growth decelerated to an annual rate of 2.1 percent in 2008, implying an 8 percent decline in the fourth quarter. Industrial production contracted sharply, over 25 percent in the last two months of 2008 and by 32 percent in January-February 2009, dragged down by the declining export demand. Construction works declined by 57 percent in the first two months of 2009. The slump in the real sector poses a serious risk to fiscal revenues. The underlying size of the fiscal gap thus remains a key concern for macroeconomic stability going forward.

The expected economic rebalancing is underway. The exchange rate has depreciated sharply (close to 40 percent to USD) to adjust to the terms of trade shock and the drying-up of foreign financing, closing the current account deficit (which turned positive in January). Over October 2008-March 2009, the NBU lost over USD14 billion of reserves trying to defend the currency. Exchange rate devaluation and a decline in confidence in the banking sector has led to a leakage of deposits which continued through Q1 of 2009, with UAH and forex deposits falling by 30 and 13 percent respectively since end-September. The transition into a flexible exchange rate regime has been patchy, with the NBU keeping the official exchange rate at UAH 7.7 /USD while the market interbank rate has been fluctuating between UAH 8-8.5/USD. Real wage dropped by 13% y/y in January-February as the private sector started to adjust to new conditions in product and labor markets.









## **Medium Term Outlook**

We revised 2009 Ukraine's growth outlook downward in view of the sharp deterioration of global and regional output projections, and the domestic slippages in policy implementation. According to the World Bank's latest Global Economic Prospects, global GDP is expected to contract by 1.7 percent in 2009, while the region of Europe and Central Asia is projected to decline by 2 percent (a 4.8 p.p. downward revision since last fall). We expect GDP in Ukraine to drop by 9 percent in 2009, but still see downside risks to this forecast should the external environment deteriorate further and/or the authorities delay critical anti-crisis steps. We project a slow recovery of 1 percent in 2010, and then acceleration towards a medium-term average between 4-5 percent starting in 2012. We expect (as in other emerging economies) a less steep growth trajectory than during the last growth episode, owing to an assumed protracted high risk aversion in international capital markets. Ukraine's medium term growth prospects are likely to depend heavily on its ability to improve productivity.

The composition of future growth will differ significantly from Ukraine's recent record. Domestic demand is expected to contract sharply in 2009 while the contribution of net exports will be positive due to rapid import contraction. As a result, the current account is seen to be roughly balanced in 2009-11. With this current account adjustment and the full implementation of the IMF SBA, the balance of payments will be fully financed under our baseline assumptions.

To face the current economic downturn, slow the trend of rising unemployment, and lay the foundations for a quick economic recovery, a comprehensive, inter-linked, and consistent "anti-crisis" program of measures and reforms is urgently needed in Ukraine. Such a program would need to consist of 4 key pillars: (i) an adequate, timely, and continued implementation of macroeconomic policies under the program supported by the IMF, (ii) the re-orientation of budget spending towards growth enhancing investments in public infrastructure to support the real sector and employment, coupled with efforts to mobilize resources for the protection of the poor and vulnerable, (iii) banking sector recapitalization and consolidation as a key to financial stabilization (iv) structural reforms to enable business entry and attract private investment. All these pillars are closely inter-linked and are mutually reinforcing. By elaborating such a comprehensive vision of reform and taking specific steps towards its implementation, the authorities could do much to stabilize market confidence. Delaying action, or adopting a piece-meal and inconsistent approach carries large downside risks for the economic outlook.

Table 1: Key Macroeconomic Indicators								
	2004	2005	2006	2007	2008	2009F	2010F	2011F
Nominal GDP, UAH billion	345.1	441.5	544.1	720.7	949.9	990.6	1103.5	1252.9
Real GDP, % change	12.1	2.7	7.3	7.9	2.1	-9.0	1.0	3.5
Consumption, % change	9.7	15.7	12.4	13.6	9.0	-18.8	2.3	4.5
Fixed Investment, % change	20.5	3.9	21.2	23.9	1.6	-31.4	2.6	10.6
Export, % change	21.3	-12.2	-5.6	3.3	5.2	-10.1	1.1	2.1
Import, % change	15.5	6.4	6.8	21.5	17.1	-34.3	2.4	7.6
GDP deflator, % change CPI, % change eop	15.2 12.3	24.6 10.3	14.8 11.6	22.7 16.6	29.2 22.3	14.6 16.4	10.3 10.0	9.7 7.9
Current Account Balance, % GDP Terms of Trade, % change	10.6 3.5	2.9 8.3	-1.5 4.9	-3.7 9.8	-7.2 6.1	0.3 -7.7	0.5 1.2	-0.6 -0.2
Budget revenues, % GDP Budget expenditures, % GDP Fiscal balance (w/o bank recap), % GDP	37.1 41.5 -4.4	41.8 44.1 -2.3	43.7 45.1 -1.3	42.3 44.3 -2.0	43.9 47.0 -3.1	41.5 44.5 -3.0	41.9 44.2 -2.3	42.0 44.3 -2.3
External debt, % GDP Public and Guaranteed Debt, % GDP  Source: Ukrainian Authorities, WB projections	47.1 24.7	45.3 17.7	50.4 14.8	58.6 12.4	83.6 20.1	89.3 28.8	80.7 29.2	69.3 30.0

Source: Ukrainian Authorities, WB projections