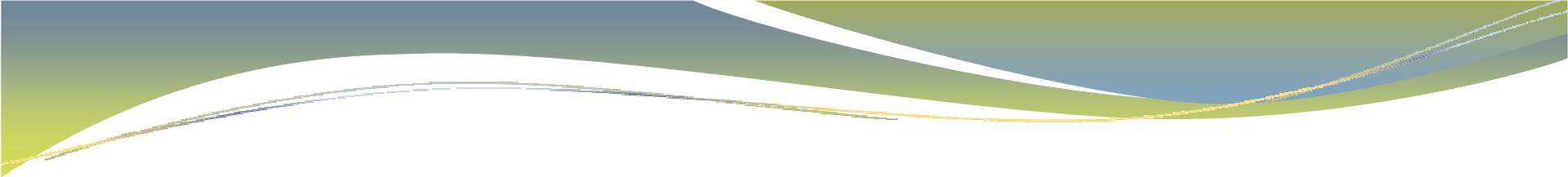


Response to the economic crisis in Ukraine and the medium term outlook

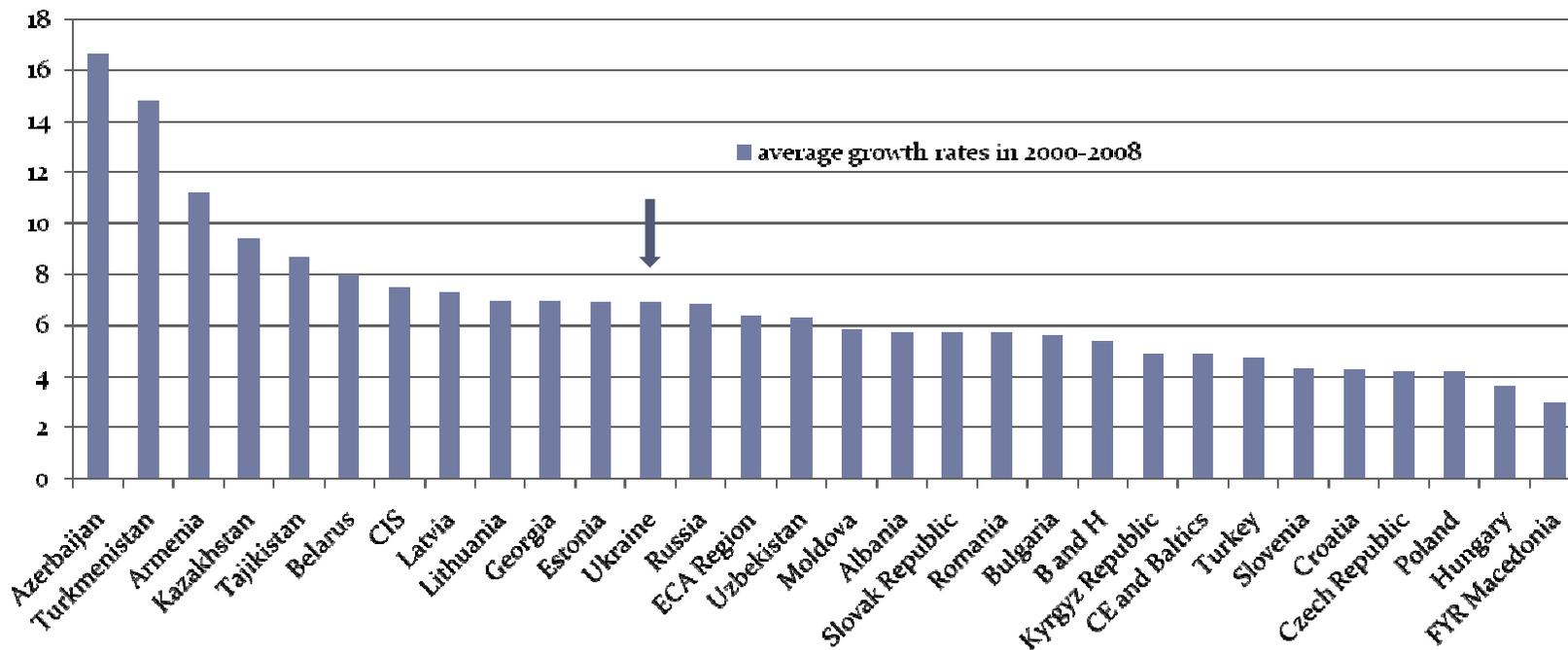
Ruslan Piontkivsky
Senior Economist, World bank
November 23
WIIW, Vienna



Outline

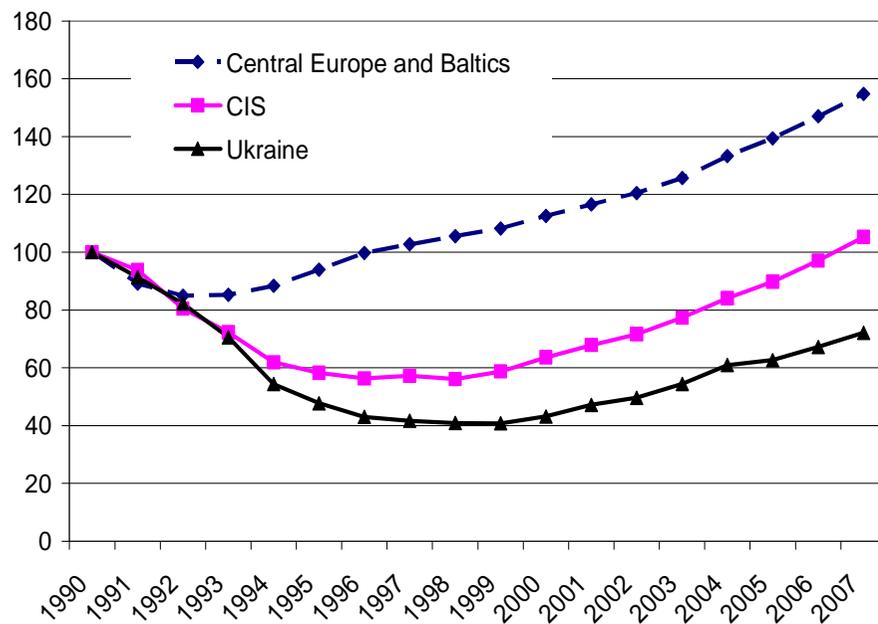
- Pre-crisis trends and vulnerabilities
- How the global crisis hit Ukraine
- Crisis dynamics, response by the authorities and the role of IFIs (with the focus on the WB)
- Economic outlook and the risks

Ukraine had been growing with the region

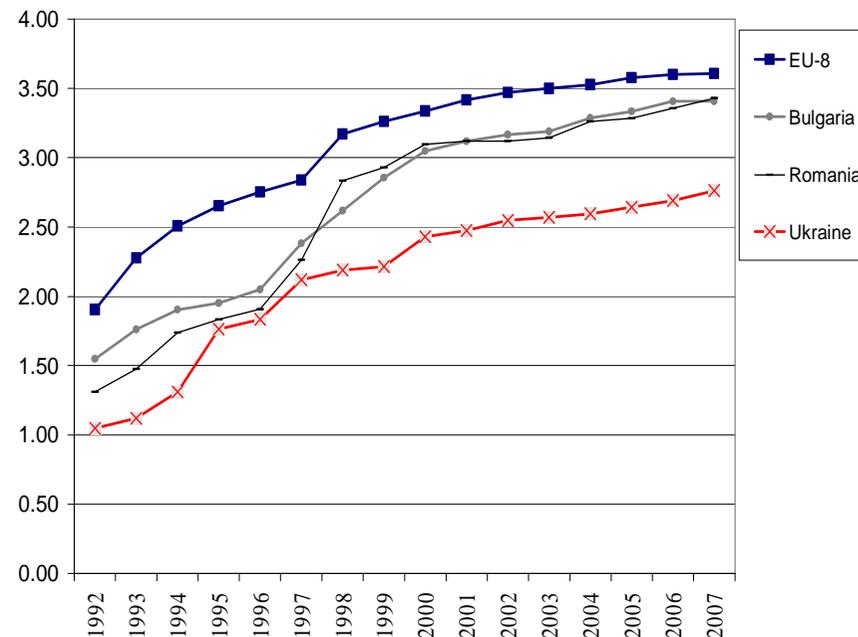


...but from a low base and lagging in structural reforms

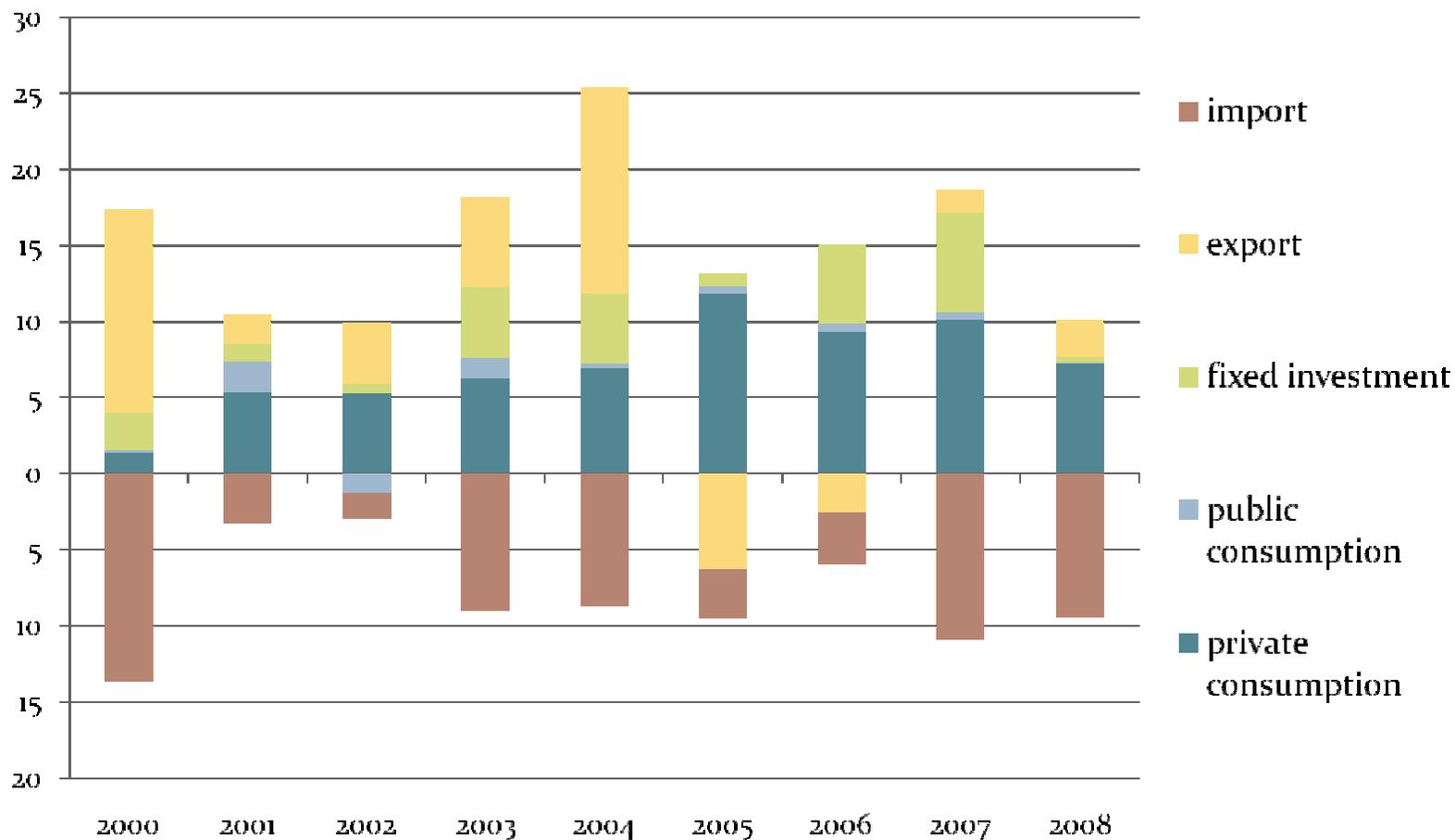
Real GDP index



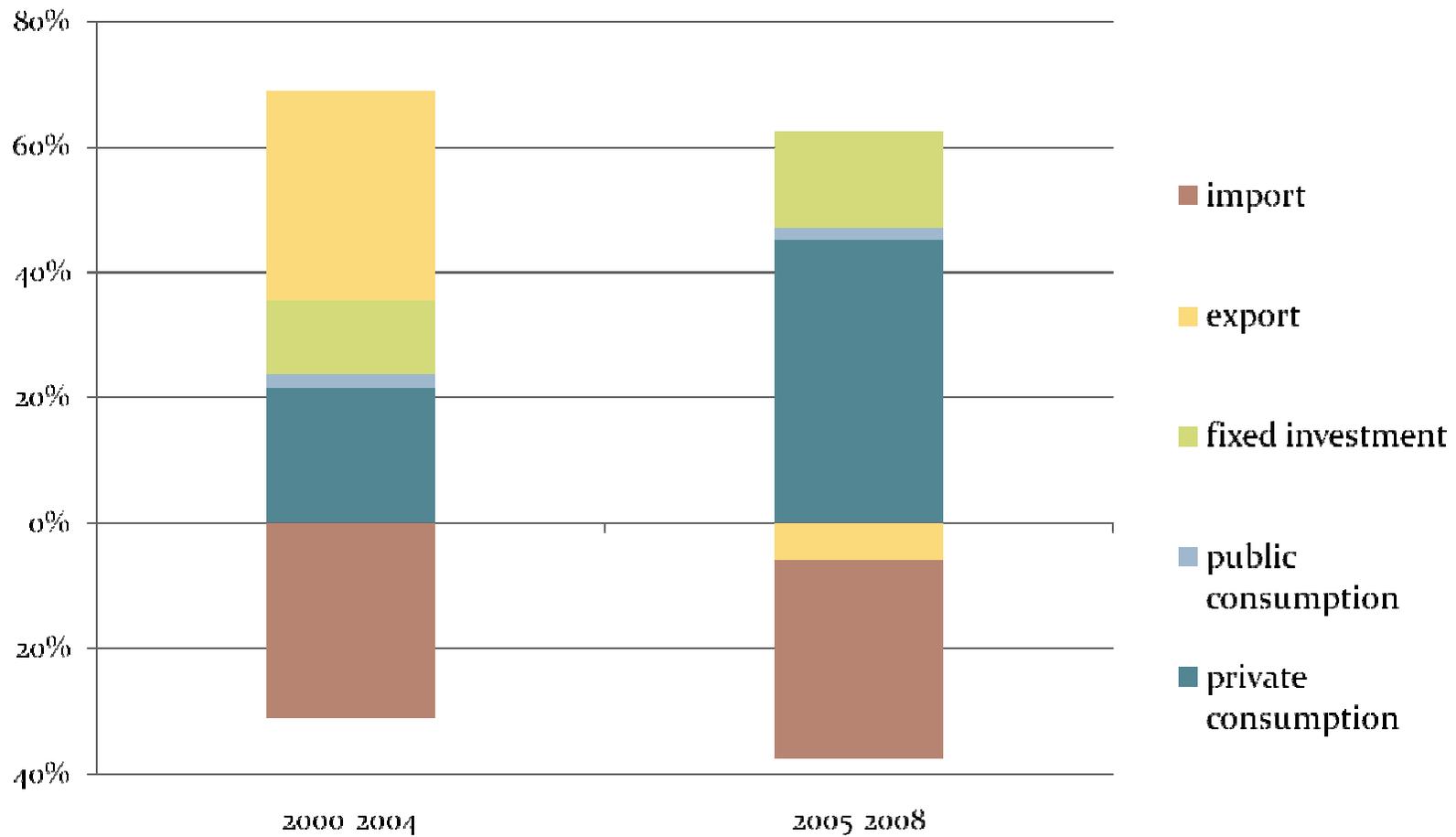
EBRD transition indicators



The sources of growth had been volatile...



...with the major shift from exports to consumption





The growth and capital inflows continued. Why?

Drivers:

- Underutilized capacity
- Luck:
 - Terms of Trade: strong metal price growth offsets gas price shock;
 - REER: EURO and Ruble strength against the USD kept real effective exchange rate in check;
 - Russian growth
- European convergence:
 - Lower labor costs;
 - Large under-served market
 - External debt and current account deficit below peers
- Low public debt levels

Vulnerabilities:

- Volatility of commodities prices
- Concentrated exports, slow real exports growth
- Growing external imbalances
- Refinancing needs for the private sector growing with the level of private debt
- Rapid credit growth and quality of assets
- Wage and price inflation eroding competitiveness

How the crisis was transmitted to Ukraine

Terms of trade
Export demand
External debt refinancing

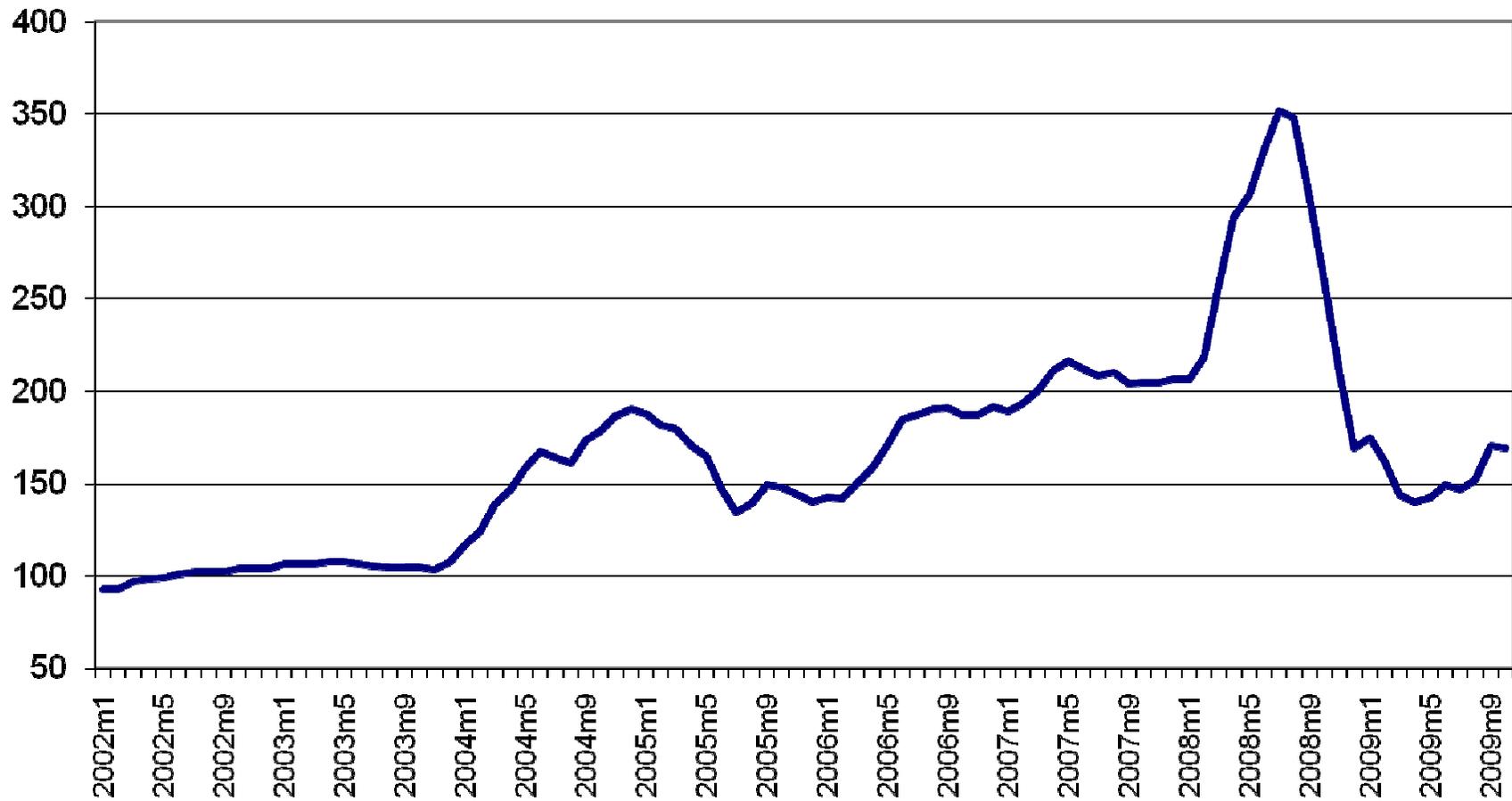
Exchange rate pressures

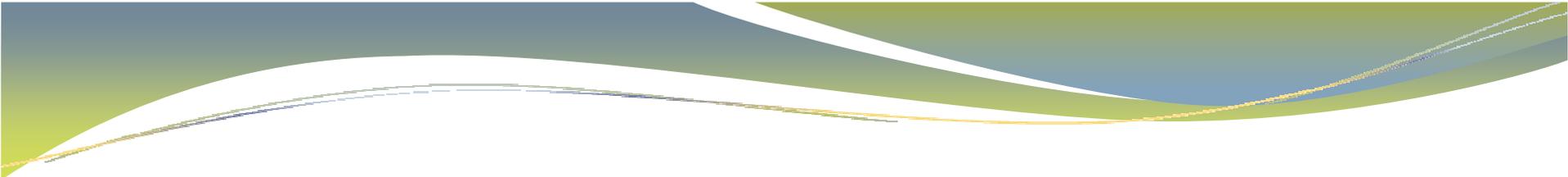
Un-hedged borrowers and NPLs
Depositors confidence

Credit crunch and bank s solvency;
Output drop; Fiscal imbalances;
Unemployment etc...

Steel prices adjusted sharply...

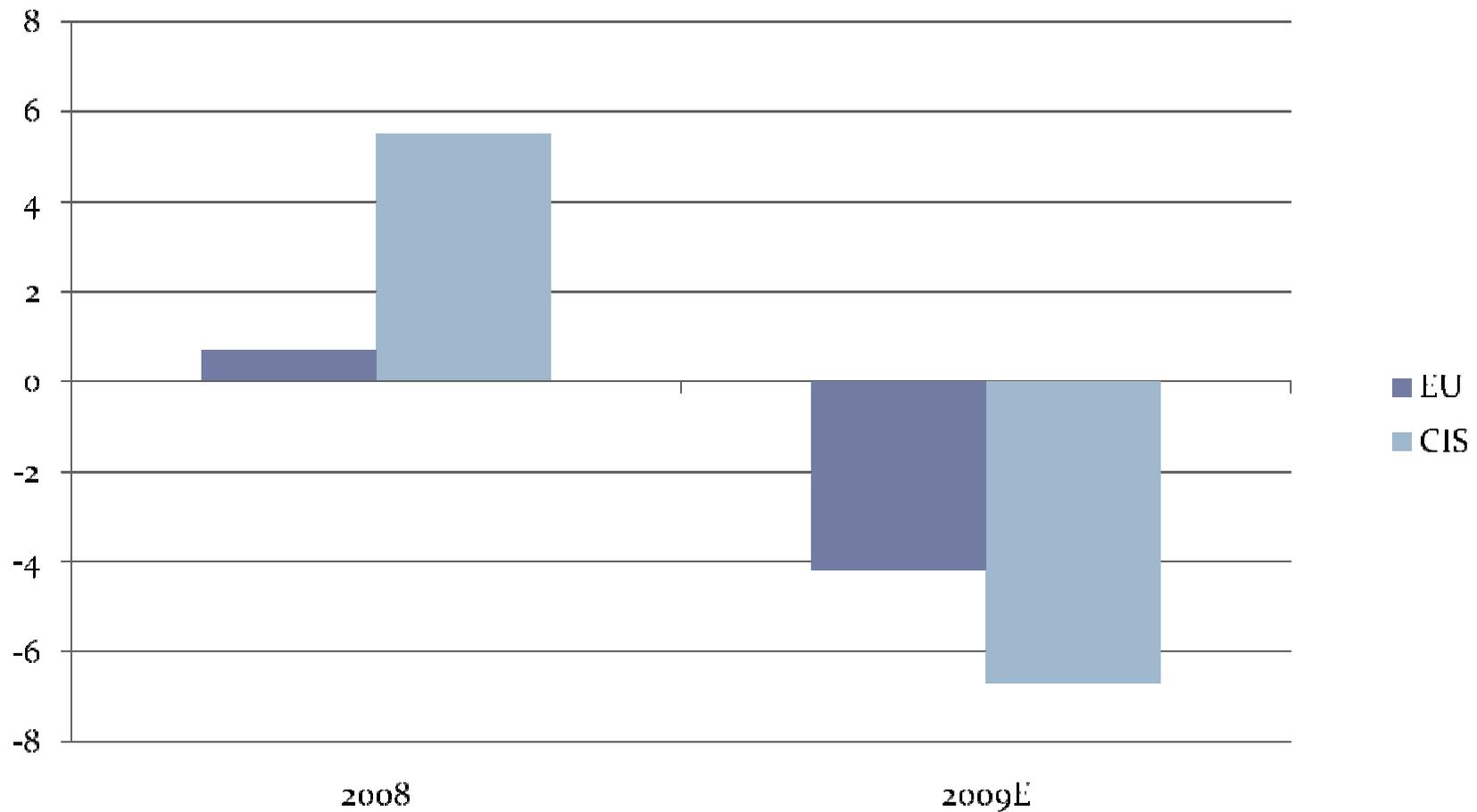
(index of steel prices in EU markets)





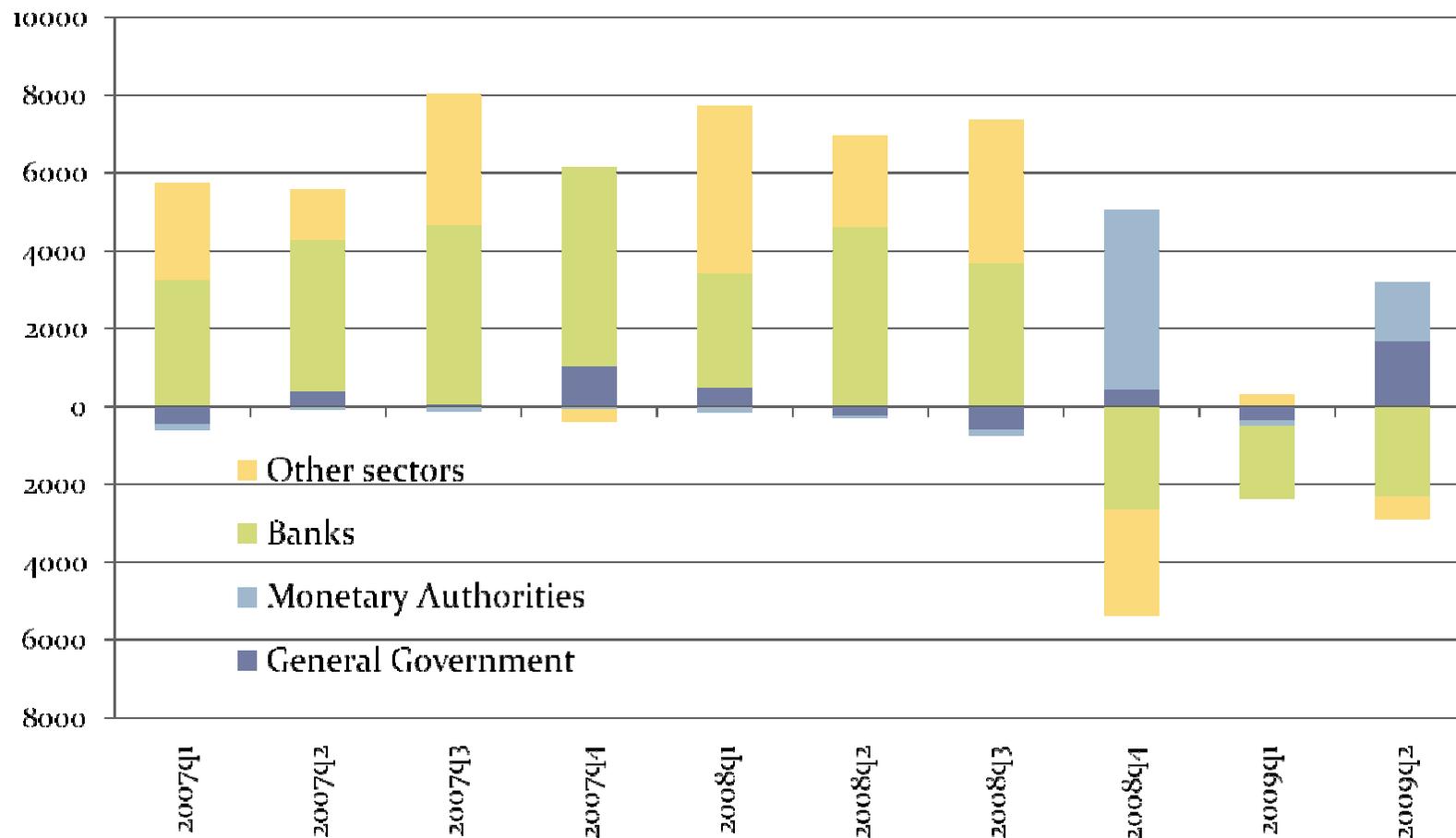
... with major export markets in recession

(Real GDP % change)



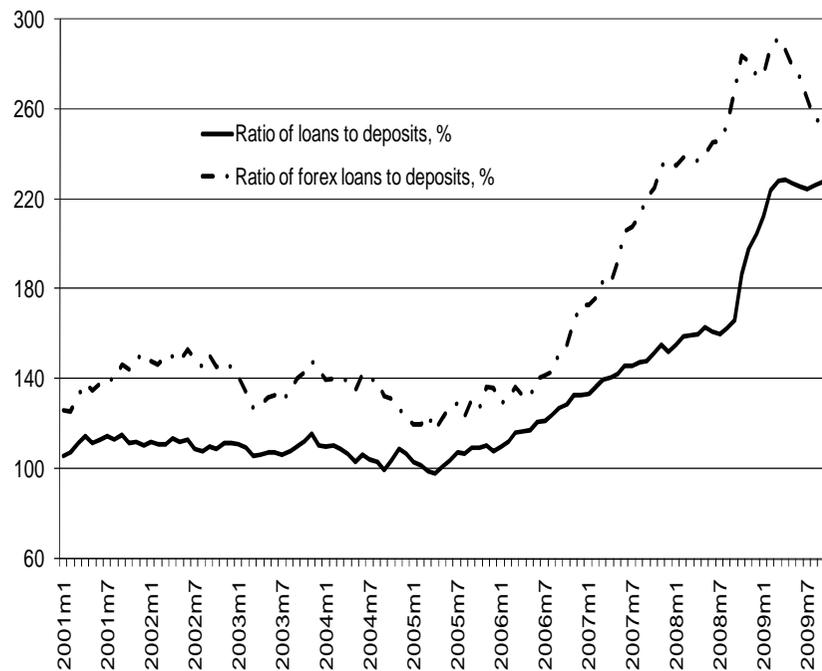
... and private debt inflows reversed

(change in stock of external debt, USD million)

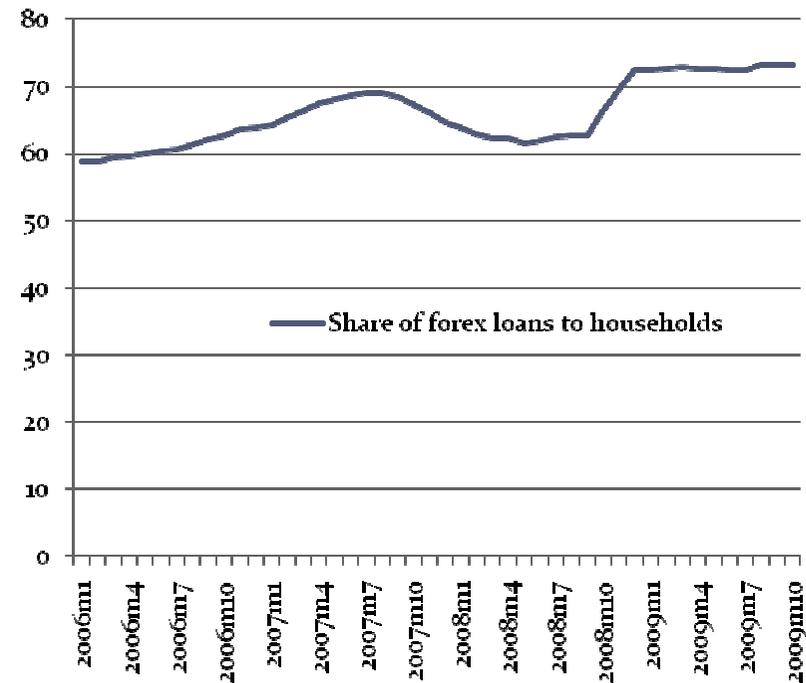


Putting a brake on the banking system

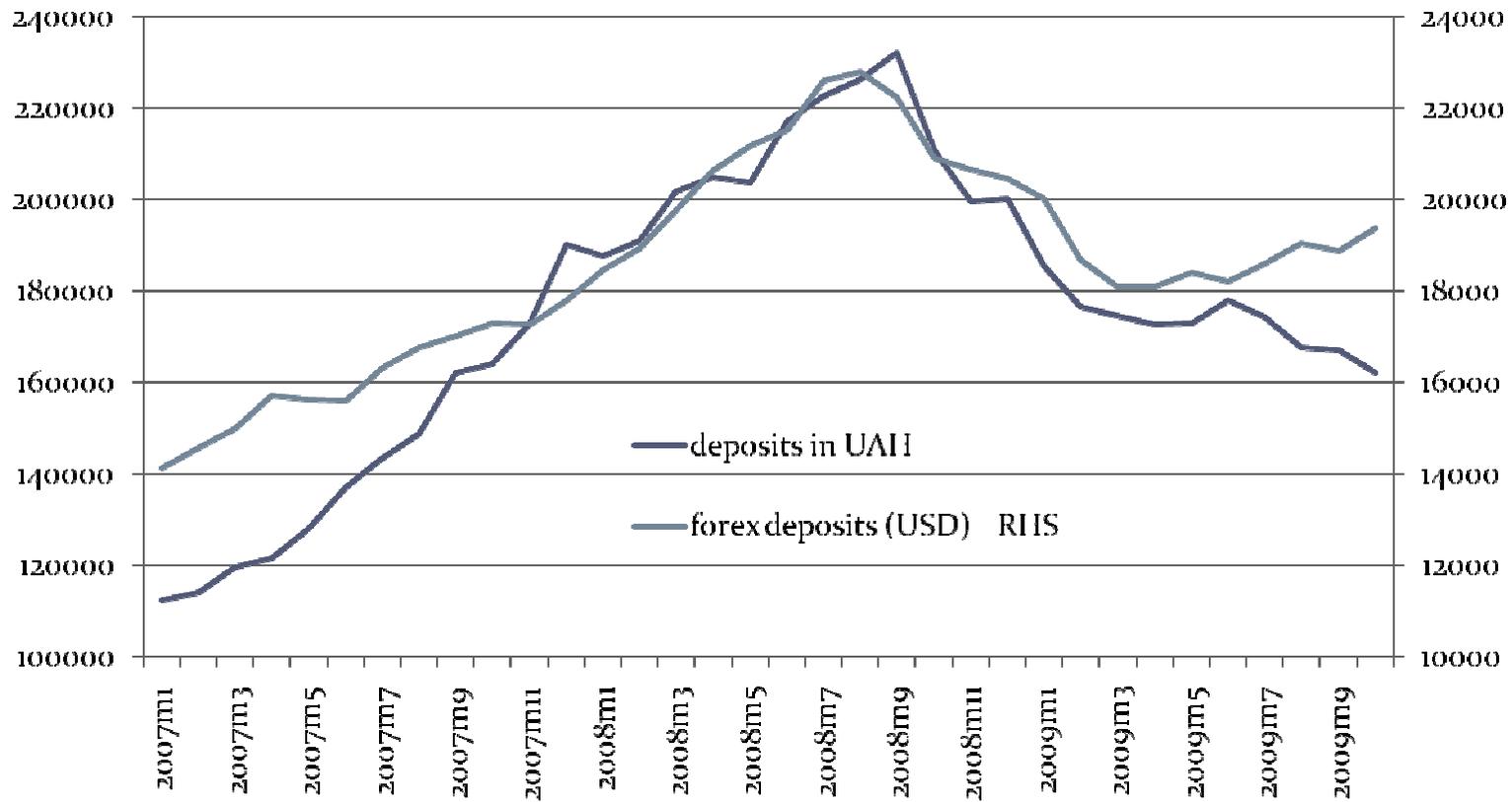
...as loans could no longer be financed by foreign borrowings



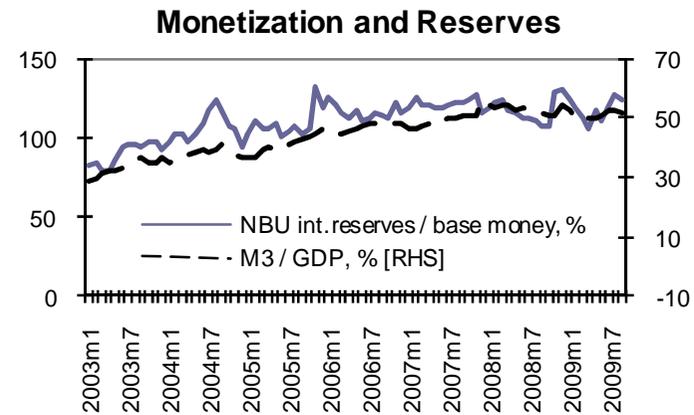
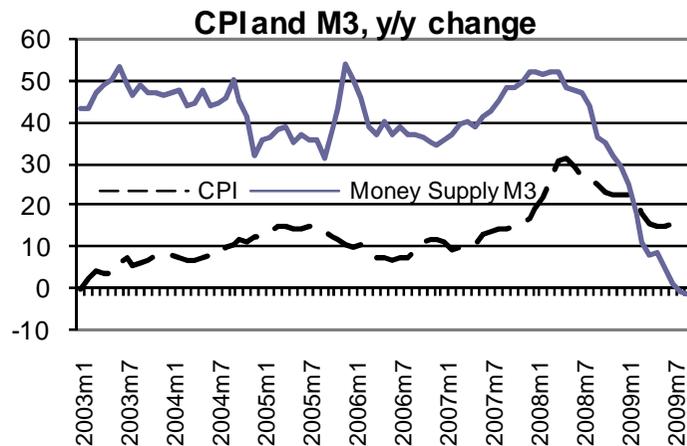
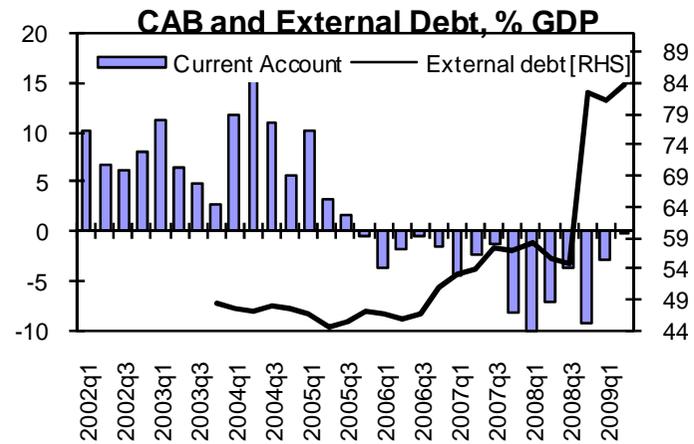
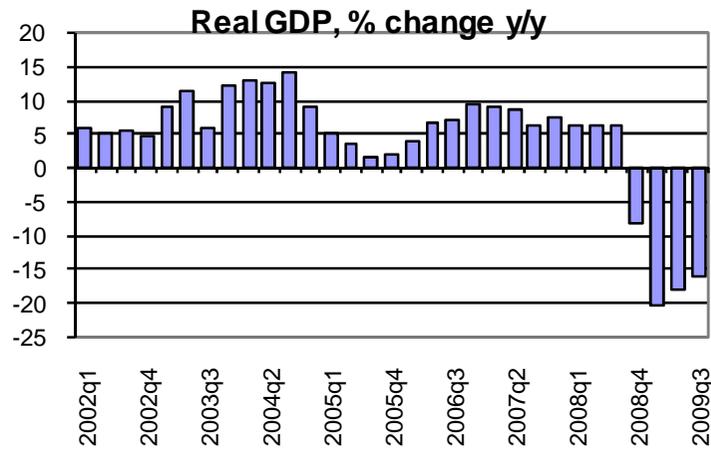
...and borrowers are exposed to forex risk



Depositors run from hryvnia and from banks



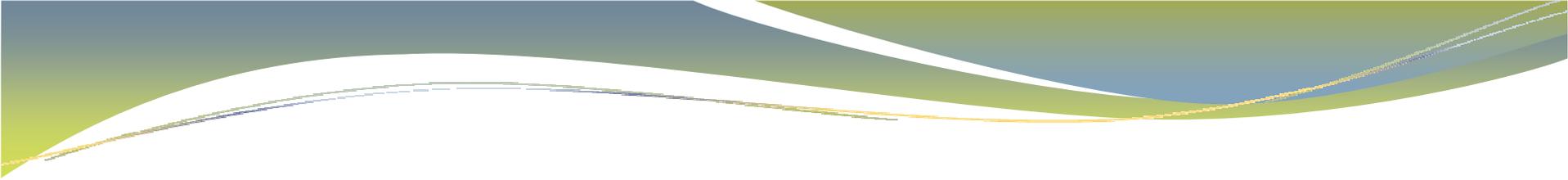
Crisis dynamics





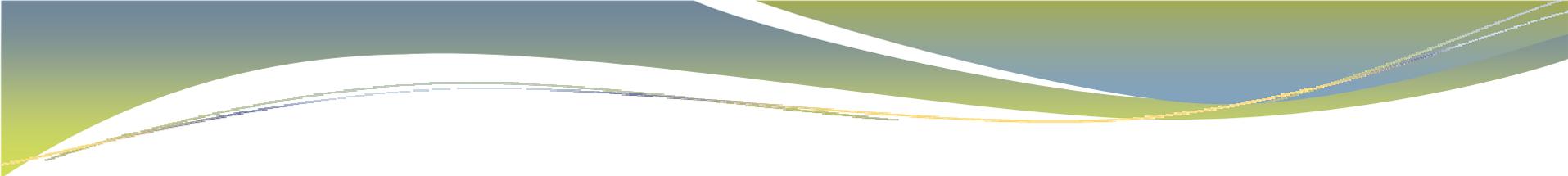
Key components of a consistent anti-crisis strategy (WB view)

- **a comprehensive, inter-linked, and consistent “anti-crisis” program of measures and reforms is urgently needed in Ukraine (*Economic Update, April 7, 2009*)**
 - (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.



Ukraine's constraints

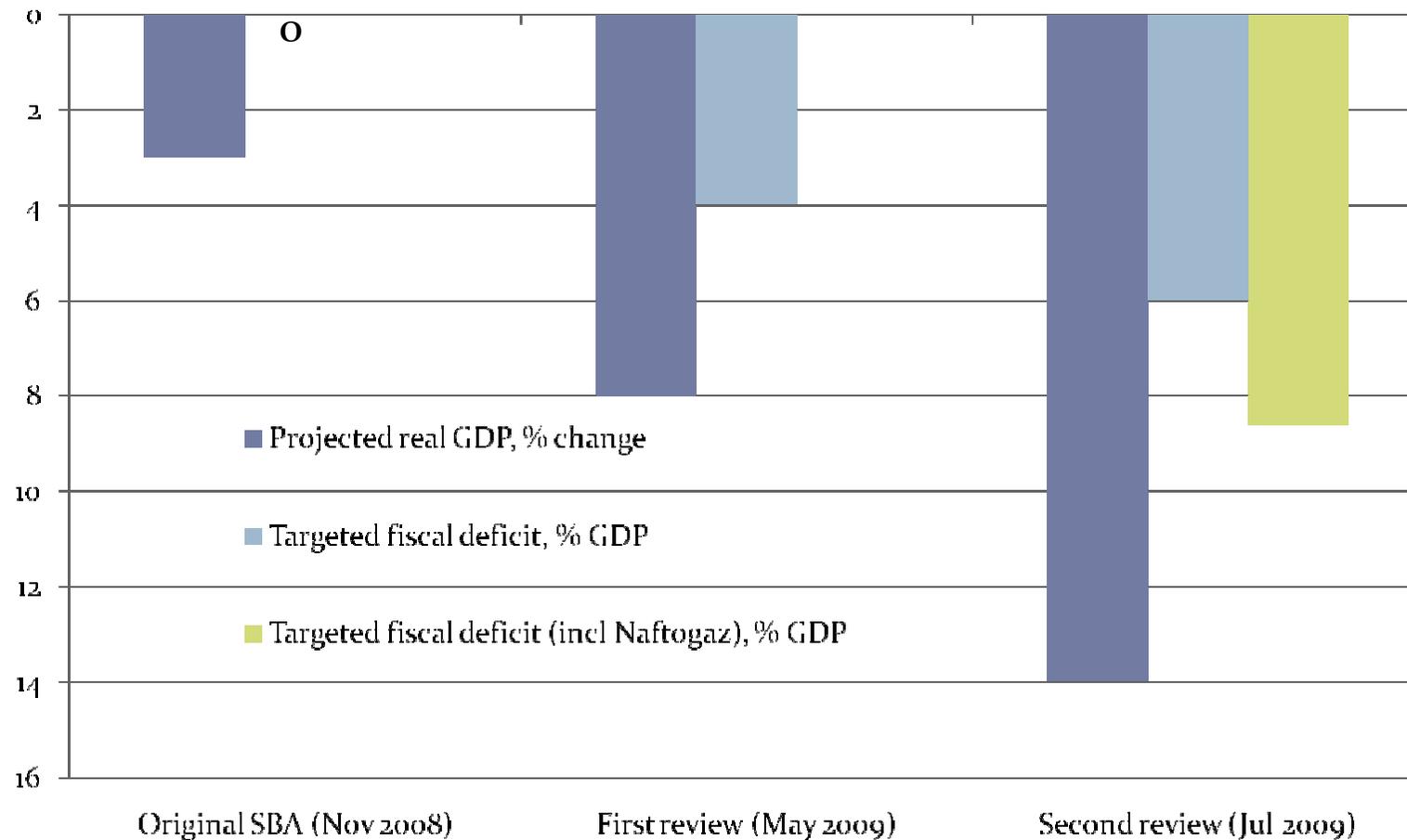
- Fast deteriorating real and fiscal outlook
- Lack of political consensus and continuous electoral politics
- Second most business unfriendly country in the region (Doing Business 142/183)
- Poor governance, low public expectations and reform fatigue

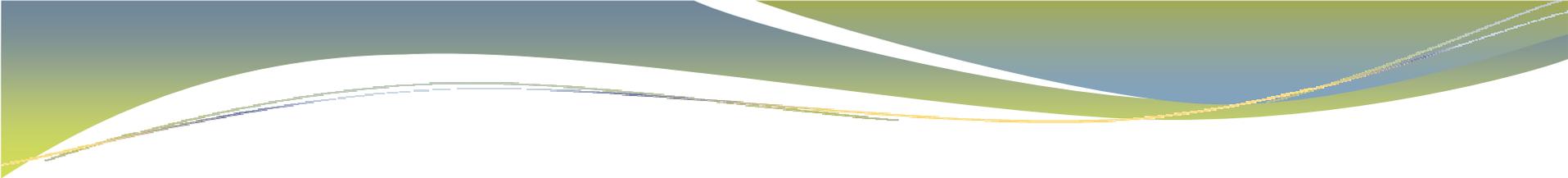


IMF SBA

- Stand By Arrangement (SBA) amounting to SDR 11 billion (USD 16.6 billion) over two years in November 2008.
 - An “Anti-Crisis” Law passed by the Parliament on October 31, 2008
- Memorandum of Economic and Financial Policies (MEFP):
 - Macroeconomic Framework
 - Fiscal Policy
 - Monetary, Exchange Rate and Financial Sector Policies
- First Review – May 2009
- Second Review – July 2009
- Third Review – not completed yet

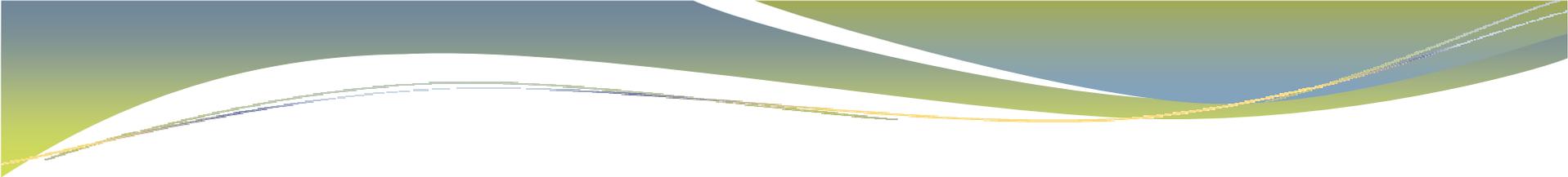
Moving fiscal target for 2009





WB financial assistance to date

- Budget support:
 - **Development Policy Loan 3** – (USD 500 million) – December 2008
 - supported selected measures in the anti-crisis legislation and reform of corporate governance.
 - **Programmatic Financial Rehabilitation Loan 1** – (USD 400 million) – September 2009
 - geared to preserve the core of the banking system to avoid a potential massive run of deposits; helped in setting the process of bank recapitalization and the basis for banks resolution.
- Investment lending:
 - Existing pipeline
 - **Roads and Safety Improvement Project** - (USD 400 million) – May 2009



Financial sector under stress

Authorities' response:

- Restoring Trust
 - Deposit Insurance
 - Modify the liquidity framework
- Rehabilitating the Banks
 - Diagnostics
 - Private and public (for systemic banks only) funded recapitalization scheme
 - Resolution for non systemic banks
- Resolving Problem Assets
 - Taxation rules simplified

Policies supported by PFRL 1:

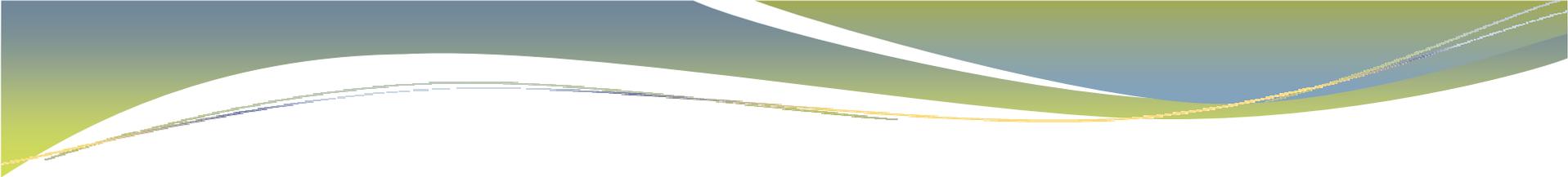
- Create a transparent recapitalization process, recapitalize 3 systemic banks following the established process, adopt enforcement measures for private recapitalization
- Amend the legal framework to allow for P&A and bridge banks with government support, simplify the grounds to appoint TAs, civil liability protection for NBU, MoF, DGF staff and change order in bank liquidation to provide higher priority for GoU, DGF and NBU
- Strengthen the DGF

Current forecast (October 15, 2009)

Table 1: Key Macroeconomic Indicators

	2004	2005	2006	2007	2008	2009F	2010F	2011F
Nominal GDP, <i>UAH billion</i>	345.1	441.5	544.1	720.7	949.9	912.3	1032.4	1169.0
Real GDP, <i>% change</i>	12.1	2.7	7.3	7.9	2.1	-15.0	2.5	3.5
Consumption, <i>% change</i>	9.7	15.7	12.4	13.6	9.0	-15.9	2.4	4.6
Fixed Investment, <i>% change</i>	20.5	3.9	21.2	23.9	1.6	-53.6	6.1	8.0
Export, <i>% change</i>	21.3	-12.2	-5.6	3.3	5.2	-18.4	2.8	2.5
Import, <i>% change</i>	15.5	6.4	6.8	21.5	17.1	-35.3	1.9	6.1
GDP deflator, <i>% change</i>	15.2	24.6	14.8	22.7	29.2	13.0	10.4	9.4
CPI, <i>% change eop</i>	12.3	10.3	11.6	16.6	22.3	13.8	10.6	9.3
Current Account Balance, <i>% GDP</i>	10.6	2.9	-1.5	-3.7	-7.2	-0.6	0.1	-2.1
Terms of Trade, <i>% change</i>	3.5	8.3	4.9	9.8	6.1	-8.0	0.4	0.3
Budget revenues, <i>% GDP</i>	37.1	41.8	43.7	42.3	43.9	40.6	41.7	42.2
Budget expenditures, <i>% GDP</i>	41.5	44.1	45.1	44.3	47.0	47.6	45.7	44.6
Fiscal balance (w/o bank recap), <i>% GDP</i>	-4.4	-2.3	-1.3	-2.0	-3.1	-7.0	-4.0	-2.4
External debt, <i>% GDP</i>	47.1	45.3	50.4	58.6	83.6	92.6	82.4	72.0
Public and Guaranteed Debt, <i>% GDP</i>	24.7	17.7	14.8	12.4	20.1	36.7	41.7	40.7

Source: Ukrainian Authorities, WB projections



Highlights for 2010

- Growth of 2.5% in line with improved export demand prospects, although we forecast only a moderate revival for Ukraine
- Ukrainian commercial banks continue to face increasing NPLs which will drag down lending, and thus slow the pace of recovery
- Strained private sector finances will constrain investment
- Continued labor market adjustment and cost cutting strategies in the corporate sector will weigh down on consumption demand
- Inflation to fall to below 14% by end-2009 and to below 11% by end-2010
- The current account would need to be close to zero in 2009-2010 and the IMF SBA to be on track to assure a stable balance of payments situation and an adequate foreign exchange reserves position

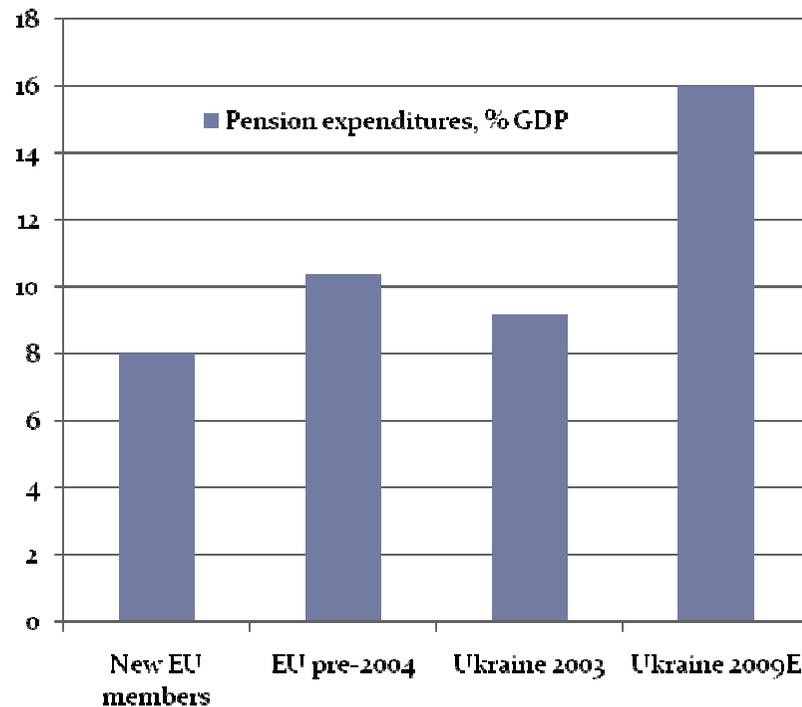


Fiscal deficit - a key concern for macroeconomic stability

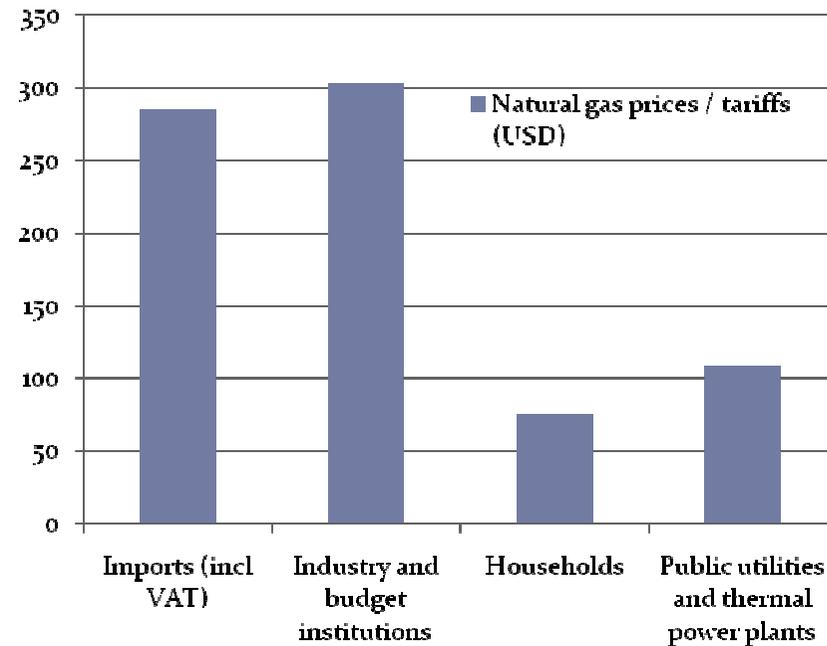
- The target deficit of 4 percent of GDP in 2010 is unachievable without significant further spending reductions.
- Revenue projections of draft 2010 budget law face downside risks, in part due to overly optimistic macroeconomic parameters, while expenditures may have been underestimated.
- Without further changes, the overall deficit could exceed 8 percent of GDP.
- On top of this, the law on minimum social standards, would cost over 2 percent of GDP.
- If gas and heating tariff increases are not implemented, Naftogaz would face additional financing needs.
- Our forecast assumes that the draft budget will incorporate revisions to bring the deficit in line with the 4 percent target, which would ensure consistency with current constraints on non-inflationary sources of financing and medium-term debt sustainability.
- 2010 budget would benefit from provisions to improve the targeting of social safety nets to protect the most vulnerable households.

Fiscal adjustment is just delayed

in particular, in pension reform...



...and in energy pricing for households



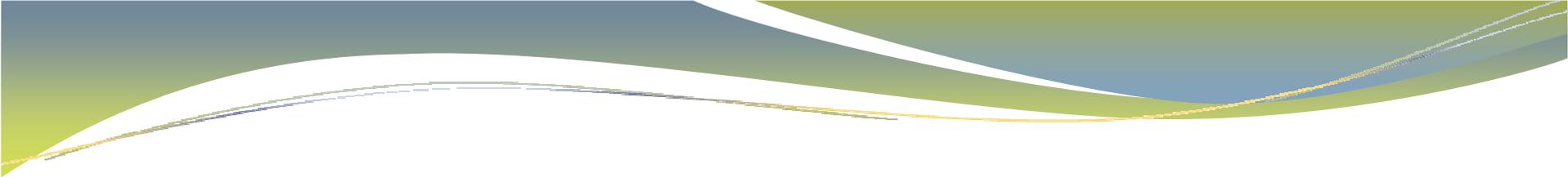
Structural reform challenges requiring immediate attention

To be supported
by DPL-4

- measures to scale up targeted social assistance,
- deal with the structural financial gap in the gas sector,
- eliminate obstacles to business entry to assist the recovery,
- establish a public procurement legal framework that will yield major savings in public resources and improve public sector governance.

To be supported
by PFRL-2

- restructure the financial sector and enhance the legal and regulatory framework to make it more resilient and position the sector for post crisis recovery



The World Bank in Ukraine

- Find more information at [**worldbank.org.ua**](http://worldbank.org.ua)
- Thank you!