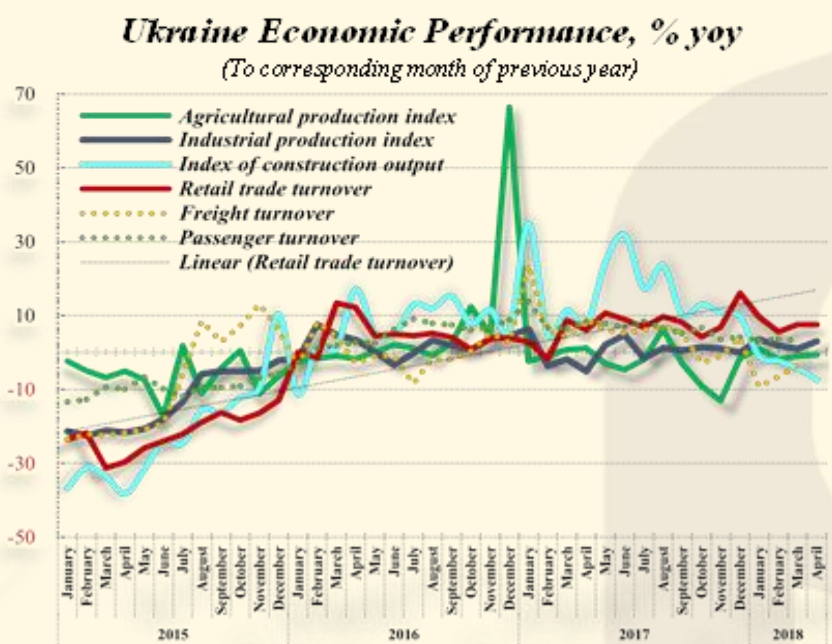
Ukraine:
Economic and Business Situation

Dr. Edilberto Segura
SigmaBleyzer/The Bleyzer Foundation
July 2018

Main Macroeconomic Indicators

Main Macroeconomic Indicators	2011	2012	2013	2014	2015	2016	2017	2018
***GDP**, USD billion*	163	173	180	130	87	93	**104**	113
***Real GDP Growth**, % yoy*	5.5	0.2	0.0	-6.6	-9.9	2.3	**2.5**	3.2
***Overall Fiscal Balance,** % of GDP*	-4.3	-5.5	-6.5	-11.7	-2.1	-2.3	**-1.5**	-2.5
***Public Debt, Ext. and Dom.,** % of GDP*	36	37	40	69	79	81	**78**	78
***Consumer Inflation,** eop, % yoy*	4.6	-0.2	0.5	24.9	43.3	12.4	**13.7**	9.0
***NBU Key Policy Interest Rate,** % eop*	7.8	7.5	6.5	14.5	17.0	16.7	16.4	17.0
***Exchange Rate , Hryvnia /USD**, eop*	8.0	8.1	8.2	15.8	24.0	27.0	**28.0**	28.0
***Current Account Balance**, % of GDP*	-6.3	-8.3	-9.2	-3.5	-02	-3.8	**-3.7**	-3.5
***Merchandise Exports,** USD billion*	62	64	59	51	35	34	**40**	43
***FDI,** Net Annual Inflow, USD billion*	7.0	7.2	4.1	0.3	2.3	3.4	**2.3**	3.0
***International Reserves**, USD billion*	31.8	24.5	20.4	7.5	13.3	15.5	**18.8**	21.0
***Public External Debt,** USD billion*	33.3	32.1	31.7	34.9	42.6	42.5	**46.3**	50.0
***Private External Debt,** USD billion*	92.7	102.3	110.3	91.2	76.0	69.9	**67.3**	72.0

1. Ukraine – Economic Situation



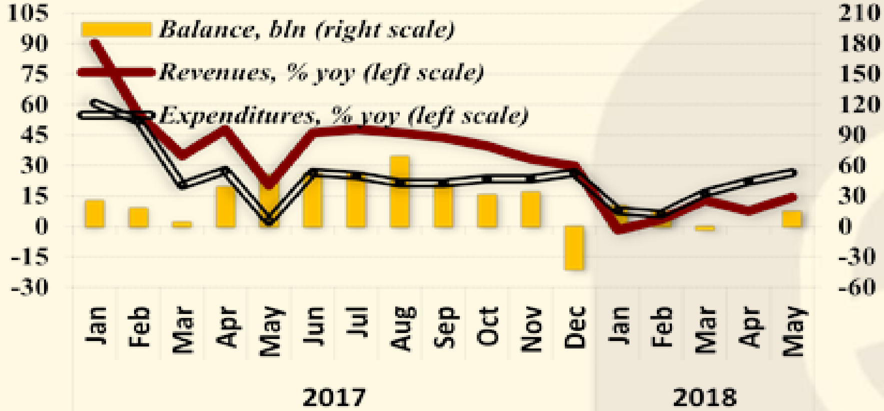
Source: State Statistics Committee, the Bleyzer Foundation

- Despite ongoing military hostilities, Ukraine's economy is steadily recovering.
- Following a cumulative economic decline of 16% in 2014-15 (caused by the crisis generated by Russia's military aggression), GDP grew by 2.3% in 2016, 2.5% in 2017, and is expected to grow by 3.2% in 2018 and by 5.0% pa by 2020.
- Increases in real wages in 2017 supported high growth rates in consumption.
- To grow faster, large FDIs are needed.

▪ These results were achieved thanks to decisive policy actions, which resulted in a dramatic reduction in external and internal economic imbalances.
  - Inflation was successfully brought down from 43% in 2015 to 13.7% in 2017.
  - The exchange rate has been stabilized at around 27 UAH/USD.
  - The central bank's international reserves have increased substantially to USD 18.2 billion (over three months of imports).

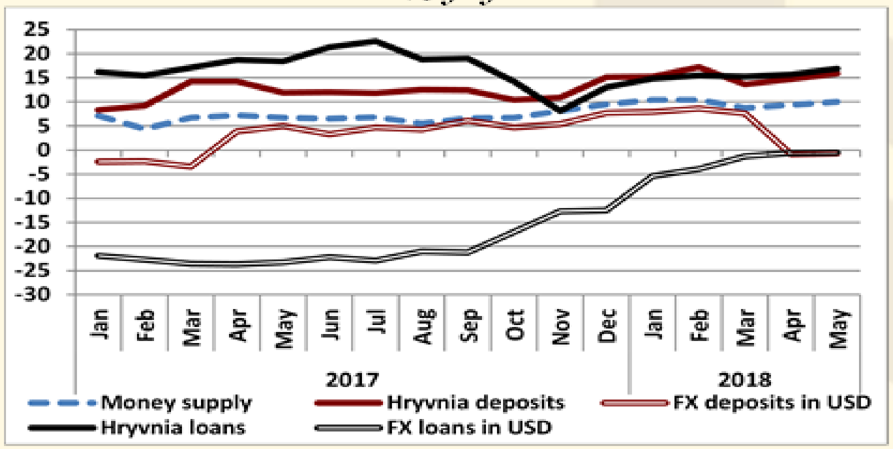
Fiscal & Monetary Policies

Dynamics of consolidated budget components (from the beginning of the year)



Source: The Ministry of Finance of Ukraine, The Bleyzer Foundation

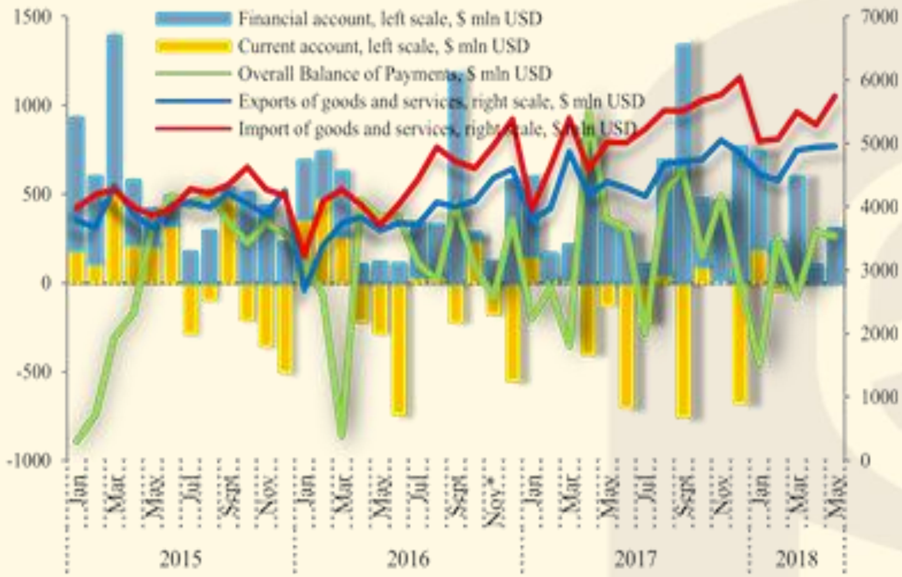
Dynamics of Money Supply, Deposits, and Loans % yoy



Source: The NBU, The Bleyzer Foundation

- The consolidated fiscal budget is satisfactory, with a surplus in Jan-May 2018 and a deficit of 1.5% in 2017, below the planned 3.0% deficit.
- Monetary policies have remained prudent, with money supply increasing by about 7% pa on average.
- Consumer inflation has declined from 43.3% yoy in January 2016 and should be 9.0% by the end of the year.
- Bank lending is finally recovering, with Hryvnia loans increasing by 17% yoy in May (household loans by 45% yoy and corporate loans by 12% yoy).
- For over 2 years, the FX rate exchange rate has been around 27.0 UAH/USD.

Balance of Payments



- In 2017 the overall balance of payments had a surplus of USD 2.6 billion, increasing international reserves to USD 19 billion.
- This surplus was caused by a positive financial account of USD 4.7 billion (FDIs of USD 2.3 billion), and despite a deficit in the current account of around USD 2.1 billion.
- The deficit in the current account was due to a fast rate of growth of imports of goods and services (18.8%) and despite a reasonable but slower growth in exports of goods and services (16.1%)

- Europe and Asia have become the largest buyers of Ukrainian products, with shares of 36.1% and 32.2% of the total, respectively. The share of Russia have declined from 26% of total exports in 2012 to 9% of total exports at present.
- Europe remained the main supplier to Ukraine with the share of 41.3%, while Russia's share in Ukraine's imports is about 13%.
- The next tranche from the IMF of USD 1.9 billion is on hold, as the Fund is expecting government actions in anticorruption, gas price increases, and the budget.

2. Reform Agenda

- Despite the military actions in Eastern Ukraine, the authorities have delivered important results in stabilizing and reforming the country, as follows:
  - Reduction of fiscal budget deficits;
  - More flexible FX rate policies;
  - Lower inflation;
  - Improved banking system;
  - Energy prices to industry to full cost recovery;
  - New electronic public procurement;
  - Procurement of medicine outsourced;
  - Privatization law for state enterprises enacted;
  - Approved FTAs with the EU & Canada to be followed by Israel and Turkey.
- The major reform still pending is to address more energetically corruption, particularly in the judiciary and in high levels of government and Rada, who are blocking change to maintain their "vested interests".
- More recently, Rada approved and the President signed the law to establish independent anticorruption courts; but it is not yet clear that it will be fair and in truly independent. The IMF is currently reviewing the text of the law.

3. Business Effects of Economic Reforms

- The reforms undertaken over the last three years are already improving the investment climate in Ukraine
- In fact, a comparison in the ranking of Ukraine in the Doing Business Reports of the World Bank and IFC show that Ukraine has made significant improvements on many categories of ease of doing business, though there is still room for further improvements. The government aims at improving the raking to the top 50s:

	2014	2018
Overall Rank in Ease of Doing Business	**112**	**76**
Getting Electricity	172	128
Registering Property	97	81
Protecting Investors	128	88
Paying Taxes	164	43
Trading Across Borders	148	119
Resolving Insolvency	162	149
Enforcing Contracts	45	82
Dealing with Construction Permits	41	35
Starting a Business	47	52

4. Attractiveness of Ukraine

- In addition to the ongoing recovery of the economy and policy reforms, there are solid reasons why Ukraine should be an attractive country for international businesses.
- In fact, Ukraine has a number of competitive advantages that should be of interest to international investors and would support economic growth in the medium-term:
  - Highly educated labor force (80% university enrolment, the fourth highest in all of Europe) and reasonable health indicators.
  - Low wages of USD 300 per month (25% of Eastern Europe's wages)
  - Ukraine is an open economy which could grow faster with the new Association and Free Trade Agreements with the EU and Canada, and expected FTAs with Turkey, Israel, and other countries.
  - The FTAs will encourage FDIs as Ukraine may be used as a bridge in the supply chain from Asia to the EU.

….. Attractiveness of Ukraine

- Ukraine is located in the geographical center of Europe, and has a large border on the EU, with logistic and transportation advantages.
- Ukraine's large population (43 million people) gives a very attractive market potential for local and international consumer products.
- Great agricultural potential with high quality fertile land that has already enabled large agro production (making it the third world's largest exporter of grains)
- Industrial and high-technological potential given past industrial history and high level of university education
- It has a reasonable infrastructure with extensive railways and road networks
- Ukraine is likely to enjoy prolonged periods of economic growth since it is starting from a low base caused by the hostilities in the East of the country.
- Growing interest in the country by multinationals and financial investors.

5. Economic Prospects beyond 2018

- Based on Ukraine's economic reforms carried so far and its competitive advantages, Ukraine should be able to achieve higher rates of economic growth.
- Ukraine has a large domestic market which is currently depressed. The opportunities for increases in domestic consumption and investments are significant, particularly in the area of energy and consumer goods.
- Export opportunities are also favorable, particularly in agricultural products and information technology.
- The FTA with the EU should also present opportunities for Ukraine to be in the "supply chain" for the EU, as manufacturer of components and final products for the EU.
- With continued recovery of the global economy, and assuming that the hostilities in Eastern Ukraine will be resolved, the following outcomes are likely over the medium term:
  - GDP growth ~ 5% per annum, going to 7-8% pa if major reforms are carried out;
  - CA deficit ~ 2.5% of GDP going down to 0.5% of GDP;
  - Fiscal deficit ~ 2.5% of GDP going down to 2% of GDP, as per IMF requirements;
  - Foreign capital ~ sufficient to service external debt financing needs;
  - Public debt ~ gradual reduction to 60% of GDP ;
  - Exchange rate ~ moderately depreciation to compensate for inflation;
  - Inflation rate ~ at single digits after 2017.

10

5. Risks

The following risks will affect the economic prospects of Ukraine:

- **Military Risks.** Low probability that Russia would increase hostilities, due to stronger Western support and stronger Ukrainian military. The likelihood is a continuation of the status quo.
- **Political Risks**. Possibility that in 2019 an anti-reformer will be elected President. The likelihood is that a pro-Western candidate will be elected.
- **Economic Stabilization Risks.** Low possibility of external instability (FX rate) or internal instability (inflation). Both of these risks are not excessive due to relatively sound fiscal and monetary policies, with the current account of the balance of payment with only small deficits.
- **Foreign Debt Risks.** The government of Ukraine will need to serve foreign debt of USD 4.5 billion in 2018, and about USD 20 billion in 2019-21. With acceleration of reforms, this gap can be covered by a re-newed IMF Program, IFIs financing, external bonds and FDIs.

Attachment: Economic Reforms Carried Out in Last 3 years

- During the last three years, the government has taken a significant number of reforms which should help Ukraine to realize its large investment potential.
- In fact, more economic reforms has been taken in 3 years than during the entire period since independence in 1991. The main reforms are as follows:

1. Secure Macroeconomic stability

- The Fiscal budget deficit has been brought under control
- The Central Bank has followed prudent monetary policies
- The Central Bank has moved towards a flexible FX rate regime
- Inflation down to 12.5% at year-end and exchange rate stabilized

2. Reform of Taxation, Government Expenditures &Customs

- The number of taxes have been cut from 22 to 11
- The payroll taxes were cut in half from a high level to 22% of wages
- A single retail price for natural gas was set close to international prices
- As a result, the gas company, Naftogaz, has eliminated income losses
- New electronic public procurement system has been put in place
- Procurement of medicine has been outsourced
- Single portal on public funds use has been created

Attachment: Economic Reforms Carried Out in Last 3 years

3. Eradicate Corruption

- A Prosecutor General was appointed with the task to reform the system
- Three anti-corruption bodies have been put in place and are already working
- A new electronic assets and income declaration for Govt officials is in place
- Legal procedures has been initiated for 150 officials suspected of corruption
- But the anti-corruption court is needed to ensure independent prosecution.

4. Legal and Judiciary Reform

- The Constitution was adjusted to permit judiciary reform
- The Lustration law approved to dismiss corrupt judges and officials
- A new police has been established

5. *Improve public administration*

- The size of government has been reduced
- "One-window" form most public administration services has been established
- Have started fiscal decentralization with local revenues about 20% of the total

6. *Develop the financial sector*

- Banking system more stable thanks to the closure of 80 weak banks
- Banking supervision improved with stress tests and re-capitalizations.
- Banks have opened information about their final beneficiaries and owners.

Attachment: Economic Reforms Carried Out in Last 3 years

7. Deregulate business activities

- A moratorium for business inspections is in place.
- A number of controlling agencies were eliminated (i.e., veterinary, sanitary)
- Open state registries and databases
- Management of state firms improved and cut income losses by 85%

8. *Reform International trade/capital*

- FTA with EU and Canada in place
- New FTAs with Israel, Turkey
- Foreign debt was restructured

9. Reduce Political Risks

- No conflict between President-PM both with pro-EU orientation.
- TV channels/radio list owners.
- Actively engaged the US/EU to contain Russian aggression
- Strengthen local military forces

The main pending reform in the government's agenda is to tackle more effectively domestic corruption, as a follow up to the recent requirement for any government official to submit e-declaration of assets and income.