Rabobank

Country report

UKRAINE

Summary

Ukraine's country risk profile has improved somewhat recently, but overall risks remain high. A new government, controlled by the party of newly elected president Yanukovych, has taken power, which has ended the political paralysis and infighting of the preceding years. Moreover, the recent fleet-for-gas deal concluded with Russia will help to reduce the large and heavily subsidized gas import bill. However, the government has so far refrained from taking the budgetary cuts the IMF wants it to take in exchange for the resumption of its lending. Although total foreign reserves are not extremely low, the private sector remains vulnerable due to its heavy foreign indebtedness. Public debt has increased rapidly, resulting in Ukraine no longer being a low public debt country. There are substantial arrears in VAT returns and the government has resorted to monetary financing. Meanwhile, the banking sector remains very weak; new recapitalizations are necessary. Nevertheless, on the back of higher external demand, Ukraine's economy is now finally recovering. S&P upgraded Ukraine twice in early 2010, while Fitch recently changed its outlook from negative to stable.

Things to watch:

- Negotiations with the IMF.
- Bank recapitalizations.
- Metal and steel prices.

Author: **Herwin Loman**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-31105
H.Loman@rn.rabobank.nl

Ukraine

National facts	
Type of government	Republic
Capital	Kyiv
Surface area (thousand sq km)	604
Population (millions)	46.0
Main languages	Ukarainian (67%)
	Russian (24%)
Main ethnic groups	Ukrainian (78%)
	Russia (17%)
	Belarusian (1%)
Head of State (president)	Viktor Yanukovych
Head of Gov (prime-minister)	Mykola Azarov
Monetary unit	Hryvna (UAH)

Economy	2009	
Economic size	*bn USD*	*% world total*
Nominal GDP	117	0.20
Nominal GDP at PPP	290	0.41
Export value of goods and services	54	0.35
IMF quotum (in mln SDR)	1372	0.63
Economic structure	*2009*	*5-year av.*
Real GDP growth	-15.2	6.5
Agriculture (% of GDP)	10	9
Industry (% of GDP)	31	35
Services (% of GDP)	60	55
Standards of living	*USD*	*% world av.*
Nominal GDP per head	2564	28
Nominal GDP per head at PPP	6337	57
Real GDP per head	1891	24

Social and governance indicators	rank / total
Human Development Index (rank)	85 / 182
Ease of doing business (rank)	142 / 183
Economic freedom index (rank)	162 / 179
Corruption perceptions index (rank)	146 / 180
Press freedom index (rank)	89 / 175
Gini index (income distribution)	28.2
Population below $1 per day (PPP)	<2%

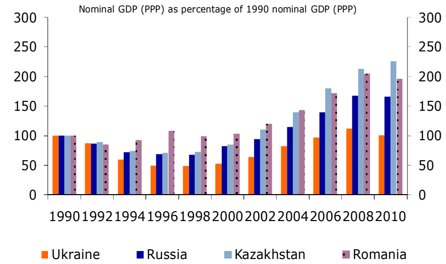
Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Russia	21	Russia	29
Turkey	5	Germany	9
China	4	China	6
Kazakhstan	4	Poland	5
Main export products (%)			
Non-precious metals			32
Food, beverages & agricultural products			24
Machinery & equipment			17
Fuel & energy, incl ores			10
Main import products (%)			
Fuel & energy, incl ores			35
Machinery & equipment			20
Chemicals			12
Food, beverages & agricultural products			11
Openness of the economy			
Export value of G&S (% of GDP)			46
Import value of G&S (% of GDP)			48
Inward FDI (% of GDP)			4.1

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

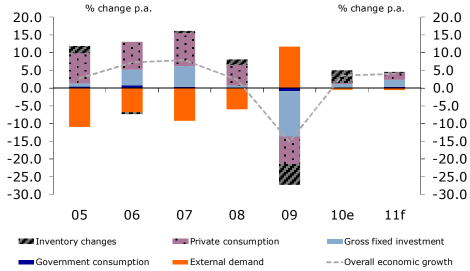
With GDP growing 4.8% yoy, Ukraine's economy returned to growth in the first quarter of 2010, after the dramatic 15.2% contraction of 2009. Thanks to strong growth in the important steel and machine building sectors in particular, industrial production grew by 13.8% yoy in March, and even 17.4% yoy in April, before falling back to 12.4% in May, which could point at the economic recovery losing momentum. Output is not yet back at the pre-crisis level, given the steep declines in yoy activity of the first quarter of 2009, when GDP fell by 20% and industrial production even by more than 30%. Moreover, Ukraine's banking sector remains in a very weak state. Hit by the bursting of a credit bubble, banks have been held afloat by central bank financing, which now accounts for 8.5% of GDP. Actual nonperforming loans are likely to be in the 25%-30% range, and a significant part of these are not yet provisioned for. Thus, it is likely that additional recapitalizations close to 4% of GDP are needed, next to the 5% already delivered last year. This will not only result in additional fiscal costs, but also implies that investment and consumption will remain weak in the immediate future. Thus, the recovery will continue to rely on foreign demand. Therefore, the weakening of economic sentiment in Europe due to the sovereign debt crisis does not bode well for Ukraine. Adjusted for differences in purchasing power, Ukraine's nominal GDP in 2010 was at about the same level as 20 years ago, at the time of the demise of the Soviet Union. Compared with other transition countries, this makes Ukraine a laggard (see chart 1). The depth of the recent crisis has further widened the gap between Ukraine and other transition countries.

Chart 1: GDP in last 20 years



Source: EIU

Chart 2: Recent growth performance



Source: EIU

Political and social situation

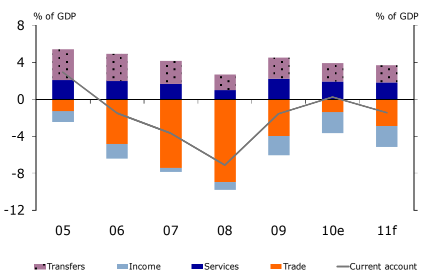
The election of Viktor Yanukovych as president in Febraury 2010, and the subsequent formation of a government led by his party, marked the end of years of political infighting and paralysis. New elections are unlikely in the short run. Partially responding to this improvement in the political situation, S&P upgraded Ukraine twice in early-2010, while Fitch recently changed its outlook from negative to stable. However, concerns are growing that Yanukovych is now in fact consolidating too much power, as the new government is reportedly trying to get a tighter grip over the media and the judicial system. Thus, the relative large (at least by CIS standards) freedom for the press and civil society, heritage of the Orange revolution of 2004/2005, may be in peril. What is more, the first decisions of the new government, with its power base in the Russia-oriented Eastern and Southern part of Ukraine, already seem to have alienated it further from the western, more EU-oriented part of Ukraine. Thanks to Yanukovych election relations with Russia have improved. This in itself is welcome, as Ukraine needs to have good relations with both Russia and the west. The question is whether Ukraine's closer ties with Russia will result in so much dependence on its big neighbor that its ability to interact with the west with a certain independence may be threatened. The recent gas-for-fleet deal is an example in this respect. It will allow Russia to extend its lease of its Sebastopol Black Sea fleet base from 2017 to 2043, in exchange for a 30% discount for Ukraine on gas imports. Although this deal will lower the import bill and the need for domestic gas subsidies, it also risks to reinforce Ukraine's addiction to cheap and heavily subsidized gas. However, we note that one of president Yanukovych's most important power bases is his close relationship with oligarch Rinat Akhmatov, whose steel business empire competes with Russian producers and relies on access to international markets. Thus, the new government is likely to continue to seek good relations with the west as well.

Economic policy

The deep economic crisis coupled with political instability has derailed the government budget. As a consequence, the government started to resort to monetary financing of its deficit and building up substantial arrears in VAT returns. Once quasi-fiscal spending and debts are included the total budget deficit in 2009 amounted to 11.5% of GDP. This deficit is estimated to have grown to 13% of GDP in the first quarter of 2010. Due to the political infighting it took until late April 2010, after a new government had taken office, before the 2010 budget was approved. This budget still includes the controversial rise of pensions and wages that derailed the IMF program in the autumn of 2010 but aims to restrict the budget deficit to 5.3% of GDP. However, the assumptions on tax revenues and social spending look unrealistic. Furthermore, this figure excludes the support to state gas company Naftogaz, which amounted to 2.5% of GDP in 2009. These significant fiscal costs are related to the high gas subsidies and the high (three times higher capita than in Poland)

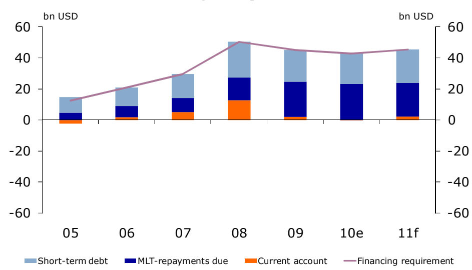
and inefficient use of gas. However, the government hopes that the recently concluded deal with Russia will reduce the support to about 1% of GDP. Due to the high budget deficits and the strong fall in GDP in 2009 Ukraine is now no longer a low debt economy. Total government debt, including all contingent liabilities, will grow to 45% of GDP in 2010, up from 13% of GDP in 2007. Without substantial cuts in the budget, the sovereign outlook is bleak. Meanwhile, consumer price inflation has declined to 8.5% in May 2010, down from 25.2% for the whole of 2008 and 15.9% for the whole of 2009. Nevertheless, at a level just inside single digit territory it is still not really low. At the same time producer price inflation has increased since mid-2009 due to the increase in commodity prices. Responding to the decrease in consumer price inflation, the central bank lowered its main policy rate in early-June by 75 basis points to 9.5%. However, this is unlikely to stimulate lending to the non-financial sector very much, as banks continue to struggle with non-performing loans. Due to the high inflation in recent years the real effective exchange rate is now back at its pre-crisis level. Thus, the cost advantage Ukrainian companies had gained trough the large depreciations of the Hryvna in late 2008/early 2009 has completely been lost. A number of restrictions on foreign investment, imposed in late 2009 to reduce the impact of the financial crisis, was lifted in the Spring of 2010.

Chart 3: Current account



Source: EIU

Chart 4: Financing requirement



Source: EIU

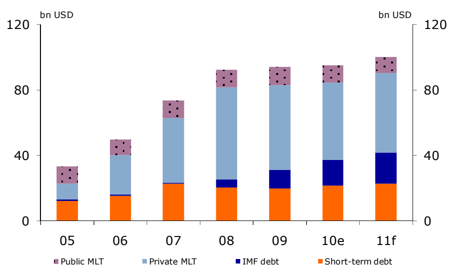
Balance of Payments

Ukraine entered the financial crisis with a large and growing current account deficit (see chart 3). However, the sharp contraction of domestic activity, followed by some recovery in external demand after an initial sharp fall, have almost eliminated the deficit. The recently concluded gas-for-fleet deal resulted in a reduction of the price of gas imports from Russia of 30%, which will further help to bring down the deficit. As a result the current account is likely to be close to balance in 2010, after a deficit of 7.1% in 2008 and 1.5% in 2009. However, Ukraine's balance of payment position will remain vulnerable through its weak capital account. Heavy foreign borrowing by the private sector in the pre-crisis years and, to a lesser extent, government borrowing during the crisis, has resulted in large principal repayments in the coming years. They are expected to rise to from USD 17bn in 2010 and 2011 to USD 22bn in 2012 and USD 25bn in 2013. In particular the government will have to pay more, as IMF repayments will start from 2011 onwards. What is more, Ukraine has been unable to attract new IMF loans, after its USD 16bn IMF program ran off track in the autumn of 2009 when an unsustainable increase of pensions and salaries was approved. There has been talk about a new program but, as mentioned before, the government has so far refrained from taking the budgetary measures the IMF urges it to take. Instead, Ukraine managed to get a USD 2bn loan from Russia's state owned Vneshtorgbank in June 2010, but the amount only offers short term relief, given the large financing requirement (see chart 4). In the longer run repayment will only be possible if Ukraine manages to improve the its reputation on international financial markets. However, so far the new government has demonstrated not much appetite for the structural reforms that would help to increase investor sentiment. Overall, the balance of payment position of Ukraine remains vulnerable, especially in the medium run.

External position

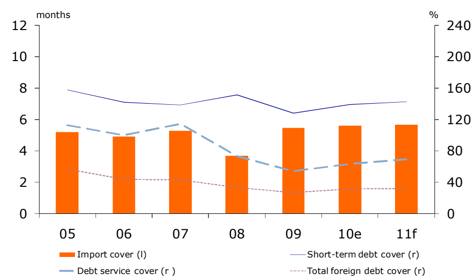
External debt has risen quickly in the pre-crisis years to USD 94bn at end-2009 (see chart 5). Meanwhile, foreign reserves stood at USD 26bn. There were worries at that time whether Ukraine would manage to pay its large gas import bill, but payments were made in December after the IMF had allowed the government to use foreign reserves to pay for it. Reportedly, the central bank has bought more foreign reserves in the first months of 2010, which should bring levels to USD 29bn in June 2010. Nonetheless, especially in the absence of renewed IMF lending Ukraine's external liquidity remains vulnerable through its large refinancing needs. Most of the external liquidity ratios are not at very comfortable levels (see chart 6). The import coverage of the foreign reserves has grown last year, but this was purely the result of the implosion of imports. Overall, the external position remains vulnerable, just like the balance of payment position.

Chart 5: Foreign debt



Source: EIU

Chart 6: External liquidity



Source: Covers offered by official FX-reserves, EIU

Ukraine

Selection of economic indicators	2005	2006	2007	2008	2009	2010e	2011f
Key country risk indicators							
GDP (% real change pa)	2.7	7.3	7.9	2.4	-15.2	3.5	4.0
Consumer prices (average % change pa)	13.5	9.1	12.8	25.2	15.9	10.6	10.0
Current account balance (% of GDP)	2.9	-1.5	-3.7	-7.1	-1.5	0.3	-1.5
Total foreign exchange reserves (mln USD)	18990	21840	31790	30800	25560	29790	32420
Economic growth							
GDP (% real change pa)	2.7	7.3	7.9	2.4	-15.2	3.5	4.0
Gross fixed investment (% real change pa)	3.9	20.9	24.4	1.9	-46.6	6.5	12.0
Private consumption (real % change pa)	19.3	15.4	17.0	10.0	-12.3	0.5	3.0
Government consumption (% real change pa)	2.3	4.0	1.8	0.8	-4.8	0.5	1.5
Exports of G&S (% real change pa)	-12.7	-5.8	2.8	5.5	-26.1	7.0	6.0
Imports of G&S (% real change pa)	6.7	8.3	23.9	16.8	-41.2	8.4	7.5
Economic policy							
Budget balance (% of GDP)	-1.8	-0.7	-1.1	-1.5	-6.5	-6.0	-4.0
Public debt (% of GDP)	16	14	12	10	20	24	26
Ukraine, Money market interest rate (%)	4.2	3.6	2.3	13.7	12.6	10.0	8.5
M2 growth (% change pa)	54	34	51	31	-5	18	15
Consumer prices (average % change pa)	13.5	9.1	12.8	25.2	15.9	10.6	10.0
Exchange rate LCU to USD (average)	5.1	5.1	5.1	5.3	7.8	7.9	7.7
Recorded unemployment (%)	7.2	6.8	6.4	6.4	8.8	8.4	7.3
Balance of payments (mln USD)							
Current account balance	2531	-1617	-5272	-12763	-1801	380	-2330
Trade balance	-1135	-5194	-10572	-16091	-4655	-1970	-4590
Export value of goods and services	35024	38949	49840	67717	40394	50250	51880
Import value of goods and services	36159	44143	60412	83808	45049	52230	56470
Services balance	1806	2126	2420	1741	2633	2760	2880
Income balance	-985	-1722	-659	-1540	-2440	-3200	-3550
Transfer balance	2845	3173	3539	3127	2661	2790	2920
Net direct investment flows	7533	5737	9218	9903	4654	5240	7230
Net portfolio investment flows	2182	3223	1685	-2060	-1283	-1050	1550
Net debt flows	5181	11938	24846	19649	2954	3680	6590
Other capital flows (negative is flight)	-7751	-16312	-20357	-15669	-9554	-4470	-10400
Change in international reserves	9676	2970	10120	-940	-5030	3780	2630
External position (mln USD)							
Total foreign debt	33297	49887	73600	92479	94290	95150	100060
Short-term debt	12063	15361	22914	20397	19983	21440	22760
Total debt service due, incl. short-term debt	16804	21888	27719	42028	47243	46980	46670
Total foreign exchange reserves	18990	21840	31790	30800	25560	29790	32420
International investment position	-14158	-19919	-26699	-40459	n.a.	n.a.	n.a.
Total assets	42712	57024	90318	106250	n.a.	n.a.	n.a.
Total liabilities	56870	76942	117017	146709	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-1.3	-4.8	-7.4	-8.9	-4.0	-1.4	-2.9
Current account balance (% of GDP)	2.9	-1.5	-3.7	-7.1	-1.5	0.3	-1.5
Inward FDI (% of GDP)	9.1	5.2	6.9	6.1	4.1	3.9	4.7
Foreign debt (% of GDP)	39	46	52	51	80	67	63
Foreign debt (% of XGSIT)	69	91	103	97	151	130	131
International investment position (% of GDP)	-16.4	-18.5	-18.7	-22.5	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	35	40	39	44	76	64	61
Interest service ratio incl. arrears (% of XGSIT)	3	4	4	4	5	4	4
FX-reserves import cover (months)	5.2	4.9	5.3	3.7	5.5	5.6	5.7
FX-reserves debt service cover (%)	113	100	115	73	54	63	69
Liquidity ratio	115	106	108	92	91	97	98

Source: EIU