Ukrainian Financial Forum. Day #1

City of Odesa 29 September 2016

Welcome speeches

In his video address to the forum participants, **President of Ukraine Petro Poroshenko** spoke about the need for the country to move away from a policy of merely surviving and toward a policy of economic growth. The recovery of the banking sector and gradual easing of foreign exchange restrictions are indicators that this transition is taking place. Inflation decreased to 7% from 40%, and real GDP growth accelerated to 1.7% from 0.1% YoY in the first and second quarters of this year, respectively. This was after real GDP contractions of 6.6% and 9.9% in 2014 and 2015, respectively. Receipt of the new tranche of IMF loans in September 2016 indicated that the partnership with IMF was going well. It made possible the receipt of US$1bn credit guarantees by the United States and EUR600m macro-financial aid from the EU. Receipt of this aid will help stablise the hryvnia (UAH) and facilitate economic growth. Tasks in the near term are the creation of an attractive environment for investment to attract internal and external investors (an Investment Committee has been already created), removing hindrances to exports, full use of economic potential, and a search for resources in local markets that should come from pension and health care reforms, in particular. Ongoing judicial reform—changes in Ukraine's constitution went into effect 30 September—is very important in the fight against corruption.

Head of NBU Valeria Gontareva emphasized that NBU drastically changed monetary policy during the last year. It shifted to inflation targeting, and retained a flexible exchange regime. And after "three years of hard work", the banking sector has been cleaned and "it is on the way to recovery". The next important point was inflation targets for this year. During 2016, headline inflation decreased to single digits from 40% YoY**,** which indicates a high probability of achieving the central bank's inflation target of 12% (+/-3%) by December of this year, as consumer inflation is heading up over 4Q due to an increase of regulated tariffs. NBU still intervenes in the foreign exchange market to flatten excessive volatility that is due to temporary factors because exchange-rate outsized movements significantly influences the inflation rate. It is expected that NBU will keep this policy the same in 2017 because its targeted inflation rate by the year-end 2017 is 8% (+/-2%). Expectations are uncertain about lending however. A small pick-up is expected for the second half of the year, and complete recovery is expected within "years to come" (apparently, NBU does not expect sizable growth in lending in the next year). Liberalization of currency exchange regulations will be gradual. NBU is aiming for rationality and consistency, because volatility will cause exchange-rate destabilization and, hence, will increase inflation.

Jerome Vacher, resident representative of IMF in Ukraine, noted the beginnings of growth, but pointed to the necessity of finding a way to make it sustainable, and eliminate as much as possible the past boom-and-bust pattern in the economy. He feels the economy should rely more on the activity by small and medium enterprises/businesses, and overall economic growth should be more equitable.

Ivan Miklos, the former Minister of Finance of Slovakia and co-chairman of SAGSUR[1] pointed out that economic reforms have not yet passed the point of no return. Not only must reforms be continued, but they must be accelerated and deepened in the coming days and months. It should be noted that reforms after Maidan far exceeded those before Maidan, although there are deferred reforms that could have been carried out during this short post-Maidan period. The main achievement for last two years was the macroeconomic stabilization in 2015-16. The budget deficit was decreased to less than 3% in 2015 from 10.5% in 2014. This was one of the largest fiscal consolidations in the world. This achievement was directly dependent on another—the deregulation of local/internal energy prices. The third achievement is the enactment of anti-corruption laws. Partly successful were deregulatory reform and tax reform.

Conclusion: a corrupt and functionally disabled system is being reformed. There are some areas where progress in reforms is not satisfactory, for example property-rights protection. There are areas without any progress at all: privatization of public enterprises and land reform, These very important for development, market changes and economic growth, for developing rural areas and for attracting foreign direct investment (FDI). It is impossible to restructure outdated industry to be competitive without FDI. Macroeconomic stabilization is a small part of the total picture. Strong public finance and macroeconomic stability are impossible without structural reform. If the government and parliament don't expand and deepen these reforms, stagnation, destabilization and devaluation will occur.

Panel discussion №1: Macroeconomic and financial situation in Ukraine, current situation and outlook

Moderator Tymofiy Mylovanov of VoxUkraine asked **Timothy Ash, desk strategist at Nomura**, about how Ukraine could "sell itself" to international investors. The answer was that investors will focus on the long-term outlook for economic recovery. The current situation isn't simple. The Western press focuses on corruption and other problems so investor's first impression is negative. It should be mentioned that the country did achieve macroeconomic stabilization in 2015–16: inflation decelerated, the budget deficit decreased, the hryvnia stabilized, and foreign exchange reserves increased. Economic growth is expected to be slightly above 1% this year, with 2–3% acceleration in the next year. Considering the reforms in the banking sector and constitution, the NBU is seen as a hero. This macroeconomic stabilization is an important base for recovery. The next required steps are structural reforms.

In talking about results of the first interactive survey, **deputy governor of the NBU Dmytro Sologub** mentioned that Ukraine society (businesses and households) has a relatively high level of dollarization, which is significant in the economy. Some developing countries with high dollarization gradually adjust their societies to new circumstances after having moved to inflation-targeting regimes. Transition to an inflation-targeting regime was inevitable because there was a lack of foreign exchange reserves. Due to structural factors in the economy—lack of creditworthy borrowers, high debt burden, and a weak judicial system—recovery in lending is slow.

Jerome Vacher, resident representative of IMF in Ukraine, reminded the audience that until 2014, Ukraine lived with a set of illusions. One was that economy would

[1] Strategic Advisory Group for Supporting Ukrainian Reforms.

be able to import large volumes of natural gas at high prices indefinitely. Today, the country spends far less foreign currency on the import of gas. Another was that economy could survive with such a low and inadequate level of control over commercial banks. This sector has been cleared for three years. The country has modernized its central bank, improved its ability to forecast and, therefore, achieve inflation targets.

Talking about IMF aid, Vacher mentioned that the Fund is the lender of last resort for countries with balance of payments crises. IMF helps countries find a way to finance their economies. As a lender, the IMF is interested in helping countries carry out a balanced economic policy.

Ivan Miklos, the former Minister of Finance of Slovakia and co-chairman of SAGSUR emphasized that to achieve sustainable economic growth of up to 5% per year and greater, reforms must be instituted. A managed, flexible exchange-rate regime isn't sufficient for sustainable and high economic growth. Key factors are fiscal consolidation, fiscal stabilization, and carrying out of reforms on this basis. The experience of central and eastern European countries shows that high economic growth can be achieved against a backdrop of macroeconomic stabilization. The openness of the economy to foreign markets and investment is a key factor for success. And Ukraine must become more competitive in large industrial production. The best course for fiscal policy is to cut the budget deficit to 2–3%. This must be achieved through expenditure cuts and not through revenue increases from tax hikes.

Volodymyr Osakovsky, chief economist for Russia and CIS at BoAML, in talking about the appropriate level of budget deficit, considers the optimal level to be 3%. When government expenditures are higher than 3%, its borrowing will crowd out the private sector from the market. A deficit higher than 3% implies the need for borrowing of large amounts of money, and it's not clear where this money would come from. The government can borrow in the local market, but it will lead to a crowding out of the private sector from financial resources. Another variant is to ask central bank for money, but this would interfere with achieving headline inflation targets.

In the international financial markets, trillions of US dollars of sovereign debt of developed countries are trading with negative yields. Markets have large amounts of liquidity, so much that investors buy assets that guarantee losses. The question is can Ukraine tap into these markets. It's clear that to attract foreign investment, structural reforms are necessary. Ukraine can offer foreign investors projects with relatively high interest rates. Our proposition is to open the local financial market to foreign investors through the Euroclear system. This will bring the attention of global investors to the local financial and government debt markets.

Sergiy Yagnuch, head of corporate finance, Ukrsibbank, PNB Paribas said that the crowding-out effect is not seen in the local market because of the following factors. First, commercial banks cannot find creditworthy borrowers; Ukrainian enterprises and companies have high debt burdens. Secondly, banks invest in NBU deposit certificates. Crowding-out may occur in one to two years, but only if the government gets better credit ratings from the international rating agencies. If that happens, the government will have been reformed as well as NBU. If these changes happen, commercial banks, in particular those with foreign capital, will invest in government bonds. Only under such circumstances will crowding-out start to appear. About foreign investment: Ukraine still doesn't recognize or acknowledge that the economy needs larger volumes of FDI. There is a need to create policy that will entice foreign direct investors, such as the policy of beneficial treatment.

Andriy Pavlichenkov, director of the Nordwand Capital, dwelt on the question of the assessment of Ukraine by foreign investors, meaning the difference in the opinion of Ukraine "before" and "after" Maidan. He mentioned that current market conditions of Ukraine's government liabilities show that credit risk is still high. To make progress, reforms are necessary, among them judicial reform and reform of the financial sector in general. The local political situation influences outsiders' perception of Ukraine as an economy with high risk. International investors often assess an economy not by economic growth but by the deepness of recessions; i.e. the deeper the recession, the higher the risk for economy. Unfortunately, the last two recessions in Ukraine were very deep: GDP decreased by 22% in 2008–09, and by 18% in 2014–15.

Oleksandr Valchyshen, head of research, ICU mentioned that the view on the current economic dynamics in Ukraine, which can be described as "at last economy is growing", doesn't take into account important nuances. Indeed, the economy has started to grow, but the powerful boost for growth came in the second half of 2015. Unfortunately, in the first half of 2016, economic growth decelerated. Aggregate growth during last four quarters—from 3Q15 to 2Q16—is 2.4%. GDP growth forecasts for 2016 range between 1% and 1.6% YoY [2]. It means that growth won't have accelerated, rather it will have decelerated. See Chart 1 and Chart 2 on p.5.

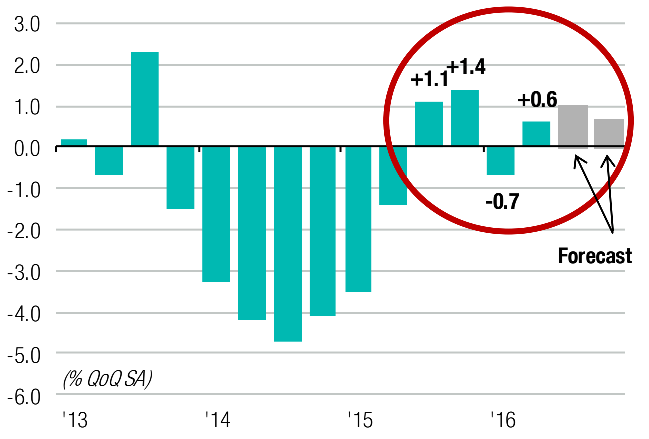
Moreover, over the past three years, government consumption proved to be most stable component of the economy (it rose 2.6% over 2013–1H16), while fixed investment, household consumption, and exports/imports collapsed by more than 25% over this period. Had fiscal consolidation—made via cuts in budget expenditures—been implemented, it could have result in a larger decline in GDP than what actually occurred (-17%), see Chart 3 on p.5.

Additionally, it should be noted that the labour market is still weak. It is evidenced by the unemployment rate, which was 9.4% at the end of 2Q16, albeit down from 9.9% in 1Q16, but up from 7.2% by year-end 2013, see Chart 4 p.5. Similarly, the employment rate of the economically active population was down to 62.1% at the end of 2Q16 from 65% in December 2013 (for ages 15 to 70). In nominal terms, the economically active population decreased by about 2 million people during the last two years. That is why fiscal consolidation, despite its importance, will restrict economic recovery under current circumstances.

[2] Current real GDP forecast for whole year of 2016 are following: +1.5% by IMF; +1.0% by World Bank; +1.1% by National Bank of Ukraine; +1.6% by ICU.

Chart 1.Real GDP growth rate during 2013-16 (% QoQ SA)

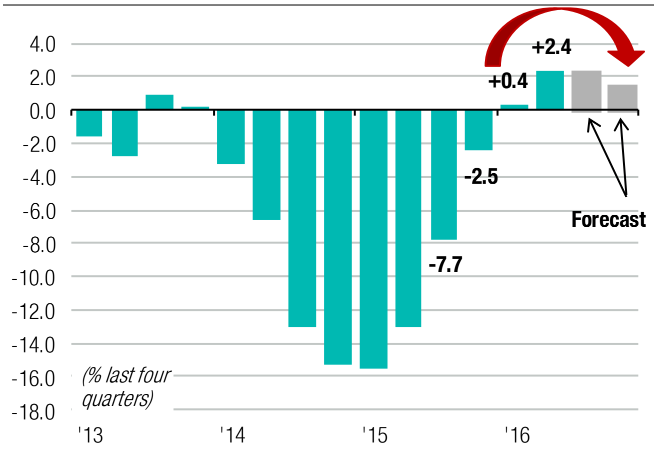
History from 1Q of 2013 through 2Q of 2016. Forecast for 2H of 2016



Source: State Statistics Service of Ukraine, ICU.

Chart 2. Real GDP growth rate during 2013-16 (% cumulative rate over past four quarters)

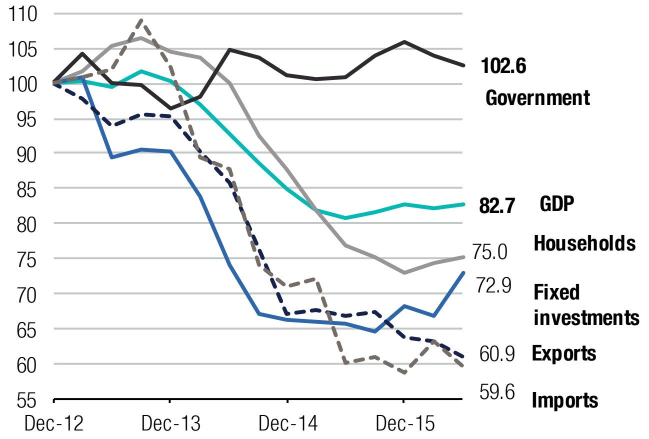
History from 1Q of 2013 through 2Q of 2016. Forecast for 2H of 2016



Source: State Statistics Service of Ukraine, ICU.

Chart 3. GDP indices over 2013-16, breakdown of GDP by expenditures*

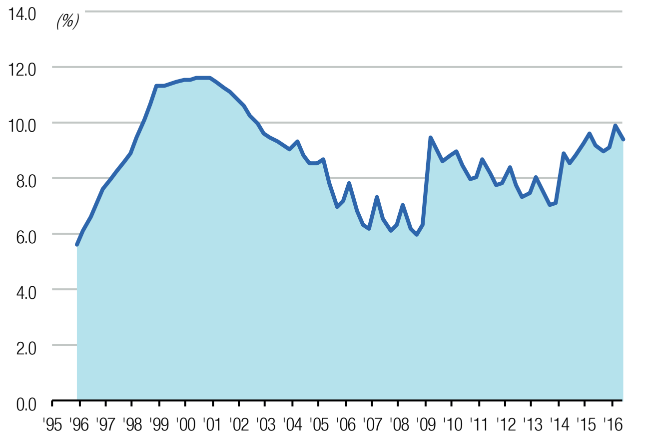
History from 4Q of 2012 through 2Q of 2016. 4Q of 2012 = 100 points



* Indices are constructed upon quarterly seasonally adjusted GDP data (as depicted by Chart 1 above). Source: State Statistics Service of Ukraine, ICU.

Chart 4. Unemployment rate (%)

History from 1Q of 1996 through 2Q of 2016



Source: State Statistics Service of Ukraine, ICU.

Panel discussion №2: Capital markets in the Financial Sector Development Program 2020: Accomplishments to date and strategic steps for the coming years

Part One

Timur Khromayev, Chairman of the National Securities and Stock Market Comission (NSSMC): Ukraine should be a part of the European capital markets. Currently, foreign investors in Ukraine are rare due to the high legal risk. The Commission currently has only nominal power, which does not allow it to function at full capacity. However, 36% of the planned reforms in the sector have already been accomplished. There are a number of steps to further transform supervision and increase its effectiveness: (1) split the functions of the National Securities and Stock Market Commission between the NBU and NSSMC, (2) introduce strict penalties for market manipulation, (3) develop and implement new legislation for the corporate bond market, and (4) further divergence of Ukrainian legislation on financial markets with the EU directives.

Oleg Churiy, Deputy Governor of the NBU: The administrative regulations on FX market are negatively impacting the economy. However, they prevent another devaluation shock that may follow should they be quickly rescinded. The NBU expects deregulation to be a lengthy process, and there is no set timeframe. It would require lasting macroeconomic stability and sufficient foreign reserves for the administrative regulations to be deemed unnecessary. He noted that a floating exchange rate helps avoid accumulating economic imbalances. The current account deficit will amount to just US$1.9bn in 2016, which is not a threat in NBU's view. Net purchase of foreign currency by the banks will fill this gap. The FX market has low liquidity, and the NBU has to intervene as a buyer and seller of last resort. The Regulator is considering appointing market-makers among the large banks. They will have to assure market depth and be ready to buy or sell at any time. In return, market-makers should have access to NBU auctions and be subject to more relaxed FX regulatory requirements.

Makar Paseniuk, Managing Director, ICU: There is a potential for interest rates to fall to 6%—a level where aggressive, high-return investors will be substituted by the more risk-adverse. Investors are seeking to understand how the economy is going to grow and what the country's investment thesis is. There are currently three main focuses for investors: (1) privatization of large state-owned enterprises, (2) the sale of insolvent banks assets by the DGF, which are estimated to worth around US$2bn, and (3) the introduction of state-owned land to the market, estimated to be around US$15bn.

Part Two

The main point discussed was the introduction of derivatives in Ukraine and developing a local Ukrainian ISDA.

Timur Khromaev, head of NSSMC, pointed out that derivatives are very important, and a law on derivatives has to be approved. But a law is just the beginning of the long road to developing a derivatives market. He is concerned that these instruments, given current market conditions and Ukraine’s stage of development, would bring new problems, although this shouldn't stop their development. Rather, step by step, build this market using the same principles and regulations that are used in other countries and world markets, and benefit from their experience, especially the lessons learned from the debt crisis in 2009. A complete system should be built. First, laws have to be adopted to regulate the issue and trading of derivatives.

There are questions about how markets will use these instruments, and which assets will be used for derivatives. Time will tell, but their introduction is very important for capital markets.

Jacek Kubas, EBRD, has a similar position, which he explained in a video message. He thinks that a law on derivatives will be adopted soon, including rules, master agreements and a local ISDA. The EBRD has considerable experience introducing derivatives in a number of countries, and is ready to help Ukraine. He expects Ukrainian banks and lawyers to work together to develop a local ISDA.

Discussing which assets to use for derivatives, the discussion went into the FX market. The NBU representative, Selekhman, said that if FX derivatives are introduced, the principal market for this instrument will be OTC, which is traditional for Ukraine, despite the experience of deals on the stock exchanges. At the same time, the stock market will also be used, and the NBU could allow banks to make contracts with FX derivatives on the stock exchanges. Selekhman has a similar view about using the NBU exchange rate for fixing NDF contracts. If the market accepts the NBU exchange rate and uses it, this will be the market's decision, not something for the NBU to regulate. The NBU will provide real exchange rate information for the market.

Mariyan Zablotskyy, deputy head of Ukrainian Agrarian Association, said that in his opinion, the agricultural market has a good chance to become one of main bases for derivatives in Ukraine, as this market generates important cash flow. Despite negative results in an attempt to launch derivatives with grains**,** when producers and traders met with problems involving price hedging, limitations on exports, and FX regulations, the agriculture sector remains very promising.

Taking into the account that the agriculture sector has a significant, if not the the largest lobby in Parliament, if this sector needs this instrument, approval at the parliament level will be fast. And if there is a good draft of a law, the agriculture sector lobby would support it.

Action on introducing derivatives could happen soon. After the cancellations of the grains derivatives, the agriculture sector has grown in power, and competition has increased. Because of current market conditions, traders may look for alternatives, introduce new standards and financial instruments, e.g. derivatives.

The discussion ended with a consensus that a derivatives market should be built, carefully, step by step. **Timur Khromaev** added that the development of capital markets and FX liberalisation by the NBU have to be done simultaneously, not one after another.

Disclosures

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This research publication has been prepared by the analyst(s), whose name(s) appear on the front page of this publication. The analyst(s) hereby certifies that the views expressed within this publication accurately reflect her/his own views about the subject financial instruments or issuers and no part of her/his compensation was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views within this research publication.

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Buy: Forecasted 12-month total return greater than 20%

Hold: Forecasted 12-month total return 0% to 20%

Sell: Forecasted 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

DEBT RATING DEFINITIONS

Buy: Forecasted 12-month total return significantly greater than that of relevant benchmark

Hold: Forecasted 12-month total return is in line with or modestly deviates from relevant benchmark

Sell: Forecasted 12-month total return significantly less than that of relevant benchmark

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