# Ukraine
# Macroeconomic Situation

October 2009

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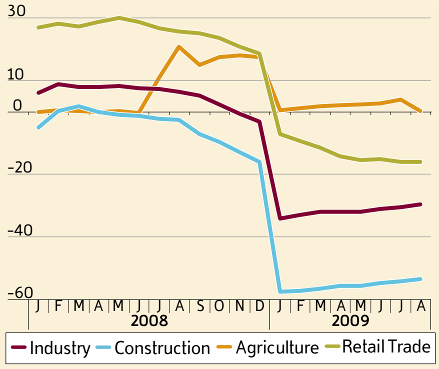
## Summary

- Recent statistics on sector output provide increasing evidence that Ukraine's economy has already passed the bottom of the recession.
- Although economic activity in a number of sectors remains weak, a stronger recovery is expected in the second half of 2009.
- Despite the crisis and lower fiscal revenues, fiscal budget policies continue to be reasonably prudent, with deficits below the target of 6% of GDP for 2009. During the first eight months of the year, the consolidated fiscal budget deficit stood at 3% of period GDP.
- The government committed to a 4% deficit in its draft 2010 fiscal budget. Nevertheless, achieving this target may be challenging.
- During 2009, consumer inflation declined and since last May it has stabilized at 15% yoy.
- Commercial banks have not been able to restore bank credit operations, due to funding difficulties and the deteriorating quality of their loan portfolios. This is slowing down the pace of economic recovery.
- Last year's deficit in the current account of the balance of payments has been brought under control. During the first eight months of the year, the current account deficit was almost 8 times lower than in the respective period last year.
- Substantial financial support from international financial institutions covered a large deficit in the country's financial accounts, associated with large repayments of private foreign debt.


## Economic Growth

Recent data on sector output provide evidence of continued (though slow) recovery of economic activity. These positive trends slowed down the pace of GDP decline from 20.3% yoy in the first quarter of 2009 to 17.8% yoy in the second quarter. For the year as a whole, GDP is expected to decline by 14%. Improvements in output were reported in transportation, manufacturing and domestic trade. Nevertheless, in the second quarter of 2009, the value added in these sectors was still below last year's level, declining by 8.6% yoy, 33% yoy and 17.6% yoy. A stronger recovery in these sectors is expected in the second half of the year. Indeed, the ongoing revival of the global output and trade, the need for inventory restocking and larger fiscal expenditures are setting the stage for output rebound.

**Ukraine's Real Sector Performance, cumulative, % yoy**




Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Public investments related to preparations for the Euro 2012 football championship have provided some relief to the deeply depressed construction sector. This sector experienced the largest decline in output. In fact, the value of construction works dropped by 53.6% yoy in real terms during the first eight months of the year. While the support from public investments will strengthen the sector in the coming months, the recovery may be protracted due to the slow resumption of bank lending.

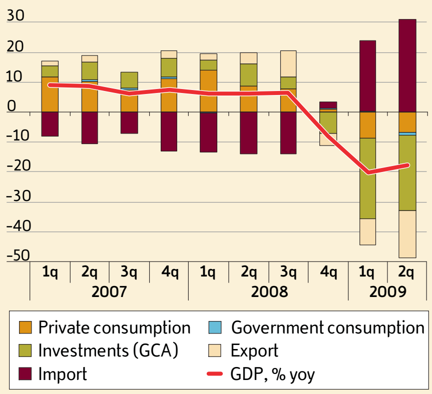
Agriculture has been the only sector supporting economic growth in 2009. Better agricultural technologies and more investments led to a historical record grain output of 53 million tons in 2008. The Ministry of Agriculture estimates that Ukraine may harvest about 45 million tons of grain this year, which would still be significantly above the average output of 33 million tons for the last 20 years, but would represent a decline from 2008.

Economic data continues to show that the international liquidity crisis, which unfolded across the globe in the fall of 2008, has been affecting Ukraine more sharply than many other emerging economies. In particular, this crisis affected Ukraine through two main channels - tighter access to credit resources and falling exports.

Ukraine's robust economic growth over the past few years was mostly driven by booming bank credit. This credit growth was funded principally by short term foreign loans and loose domestic monetary policies. However, the global financial crisis virtually closed access to the international credit markets for Ukraine's private sector. The ensuing credit squeeze exerted a heavy toll on Ukraine's highly leveraged sectors (construction, trade and industry). On the demand side, tight credit conditions caused a sharp drop in investments. With gross fixed capital formation falling by more than 50% yoy in real terms and large-scale inventory depletion, investments have been one of the main sources of economic weakness in 2009.

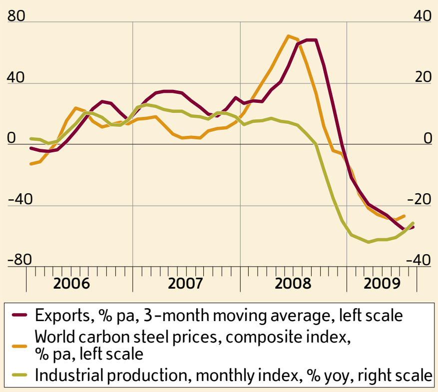
Furthermore, with exports accounting for almost 50% of GDP, Ukraine also suffered from

**Annual GDP Growth by Demand Components, percentage points**




Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

**World Steel Price Dynamics and Ukraine's Exports and Industry Performance**




Source: State Statistics Committee of Ukraine, MEPS, The Bleyzer Foundation





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THE BLEYZER FOUNDATION

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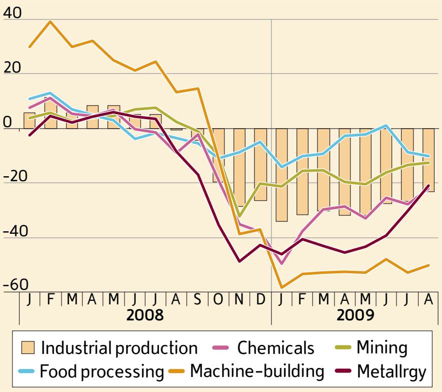
**Industrial Output by Selected Branches, % yoy**




Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

an abrupt fall of world commodity prices (particularly for steel and chemical products) as well as from lower demand from Ukraine's main trading partner countries. Thus, in the first half of 2009, the dollar value and physical volume of exports fell by 25% yoy and 52% yoy, respectively. As a result, output in export-oriented industries, such as metallurgy, chemicals and machine-building, has been declining. In turn, cross-industry links tended to propagate difficulties in the export-oriented sectors to the broader economy. On the upside, this export orientation of the Ukrainian economy has a silver lining. Indeed, the growth momentum appears to be recovering faster in some key trading partners (such as Germany, France, Poland, India, Brazil, China). This means that the resurgence of foreign demand will help to mitigate the weakness of domestic consumption. In fact, the rate of output decline in metallurgy, chemicals and mining has already moderated from 46% yoy, 50% yoy and 21.4% yoy at the beginning of the year to 21% yoy, 22% yoy and 12.5% yoy in August 2009, respectively.

Notwithstanding the scale of economic difficulties, Ukrainian consumers remain surprisingly resilient. In particular, a large informal economy partially supported stronger private consumption, which declined by less than 12% yoy in the first and second quarter of 2009. In addition, consumption is likely to be supported by continuing growth in nominal disposable income, lower inflation and improved consumer sentiment.[1] Disposable income grew by 5.5% yoy in nominal terms in the second quarter of 2009, up from 4.8% yoy in the previous period. This growth was supported by higher social expenditures[2] and some improvement in the labor market.[3] The Hryvnia devaluation as well as falling investments and private consumption helped to curb imports. As a result, the 45% yoy drop of imports added some support to GDP growth by restricting domestic spending on foreign goods.

All in all, there is increasing evidence that the Ukrainian economy has already passed the bottom of this recession. Nevertheless, despite a number of growth supporting factors, many uncertainties about the strength and sustainability of global economic recovery remain. On top of that, the forthcoming Presidential election in Ukraine adds to the fragility of the nascent economic recovery. Hence, we maintain our forecast of GDP declining by about 14% in 2009.

### Fiscal Policy

During the crisis, public finances have been under stress. Nevertheless, fiscal policies are reasonable, with deficits below the target of 6% of GDP agreed with the IMF. Over January-July 2009, the consolidated budget reported a deficit of UAH 17.8 billion, or about 3.6% of estimated GDP. This consolidated fiscal deficit came on the back of shrinking fiscal revenues and growing budget expenditures.

To a significant extent, worsening tax collections were related to recession-driven factors. Thus, on the back of weak consumption and falling imports, collection of VAT and import duties considerably declined. Furthermore, decreasing corporate profits ate into the proceeds from the corporate profit tax (EPT). Personal income tax (PIT) receipts fell as nominal household income grew slower, while unemployment increased. A solid increase in excise revenues was achieved thanks to an increase in excises on tobacco, tobacco products and alcohol. These higher excises were approved as a part of corrective fiscal measures of the government.

**Consolidated Budget Performance, % yoy, nominal terms**

| | 5m 09 | 6m 09 | 7m 09 | 8m 09 |
|---|---|---|---|---|
| **Total revenues** | **-1.7** | **-3.9** | **-6.2** | **-8.5** |
| Tax revenues | -7.8 | -9.4 | -9.9 | -12.6 |
| PIT | -1 | -2.2 | -2.5 | -3.5 |
| EPT | -20 | -21.1 | -18.5 | -28.9 |
| VAT | -7.5 | -12 | -14.8 | -16.1 |
| Excises | 41.3 | 49.2 | 50.9 | 57.4 |
| Import duties | -58.4 | -55.9 | -52.8 | -52.6 |
| Non-tax revenues | 35.4 | 29 | 18.4 | 17.1 |
| **Total expenditures** | **12.1** | **10.3** | **8.8** | **7.5** |
| current | 15.4 | 14.2 | 14 | 13.4 |
| capital | -39 | -41.3 | -46.1 | -46.6 |

Source: Ministry of Finance

On the expenditure side, consolidated budget expenditures have continued to increase, advancing by 10% yoy in nominal terms over the first half of the year. But the pace of expenditure growth decelerated to 7.5% yoy in January-August as the government cut capital expenditures. As a result, the consolidated budget deficit narrowed in August, amounting to UAH 16.7 billion, or about 3% of GDP over the first eight months of 2009. At present, the government is committed to keeping the fiscal budget deficit at 6% of GDP in 2009, and 4% of GDP in 2010.

Nevertheless, with current expenditures (particularly public wages, pensions, purchase of medicines, and utility tariff compensation) accounting for a disproportionately large share in total public spending, further fiscal tightening may be challenging. First, some fiscal corrective measures have not yet been implemented, such as previously announced gas tariff increases for the population, which were supposed to come into effect on September 1st. Higher gas tariffs could have saved public money spent on subsidies and helped to improve the financial situation of Naftogaz. Second, imposed limits on maximum pensions have been contested in courts. This may bring additional difficulties to the strained Pension Fund and the state budget. Lastly, there are a

[1] The improvement was mainly attributed to the stabilization of the foreign exchange market in 2Q 2009 and relative employment stickiness.
[2] Despite an apparent drop in fiscal revenues, the government maintained social spending from the budget without major increase in arrears.
[3] According to ILO methodology, the unemployment rate declined from 9.5% in 1Q 2009 to 8.6% in 2Q.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**State Budget Indicators, 2009-2010**

| UAH bn | 8m 2009 actual | 2009 planned | 2010 planned |
|---|---|---|---|
| Revenues | 135.3 | 239.2 | 284.7 |
| Expenditures | 149.9 | 267.7 | 324.3 |
| Real GDP, % yoy | -14%* | 0.4% | 3.7% |
| CPI, %, eop | 15% | 9.5% | 9.7% |

*2009 forecast
Source: Ministry of Finance, SSC, The Bleyzer Foundation

number of expansionary fiscal initiatives. In particular, at the beginning of October, the Parliament preliminarily approved a bill that envisages a major increases in social spending. Moreover, the Parliament approved a law that considers the transfer of NBU profits in the amount of UAH 10 billion to finance Euro-2012 infrastructure projects. Maintaining good fiscal discipline in the run up to the Presidential election may be a challenging task for the Ukrainian authorities.

In September 2009, the government presented a draft fiscal budget for 2010. State budget revenues are forecasted at UAH 285 billion, up by 19% yoy, while expenditures are planned at UAH 324 billion, up by 21% yoy. As agreed with the IMF, the government plans to contain the fiscal deficit at 4% of GDP. At the same time, successful execution of the 2010 budget may be difficult to achieve. First, it appears that key 2010 budget parameters, primarily nominal GDP and budget revenues, are overly optimistic.

Second, the 2010 budget draft was developed on the basis of the new Tax Code, which proposes new principles of fiscal relationships between state and local budgets. In particular, the number of local budget units is to increase from about 700 to more than 12,000, complicating administration and control in the short term. All in all, given the fragile political and economic situation, there is a high probability that the 2010 budget law in its current version will be modified to fix these problems.

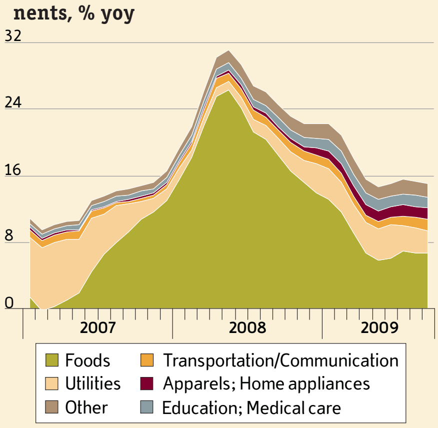
## Monetary Policy

Consumer price inflation has been on a downward trend since the beginning of this year and has remained virtually stable since May at about 15% yoy. This stability is built on several counterbalancing factors. A rise in excises, recent growth of energy prices as well as more expensive imports due to a weaker Hryvnia have been pushing consumer prices up. At the same time, these pressures were offset by weak economic activity, deceleration in wage growth, delayed hikes of utility tariffs and a tighter monetary stance. Provided that the government avoids excessive monetary expansion to finance the budget deficits, inflation is expected to remain at around 15% yoy in 2009.

The annual growth of money supply (M3) has been rapidly decelerating since September 2008 and turned negative in August 2009. In September 2009, money supply was almost 2% lower than a year ago. Tighter money supply was the result of the NBU's large foreign exchange interventions, measures to mop up liquidity, and an abrupt reduction in bank lending.

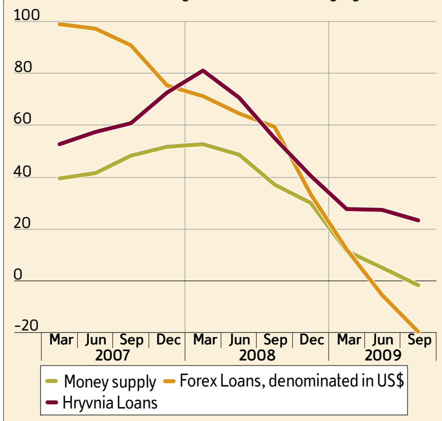
In the fall of 2008, the Hryvnia lost almost 60% of its value against the US Dollar on the back of a sharp deterioration in exports, an abrupt reversal in foreign capital flows, high external debt repayments, and tight access to international credit markets. In addition, some inconsistencies in foreign exchange policy undermined population confidence. This resulted in an unprecedented surge in demand for foreign currency. According to NBU statistics, net purchases of foreign exchange[4] by the population amounted to more than $10 billion between September 2008 and September 2009.

**Consumer Price Index and its Main Components, % yoy**




Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

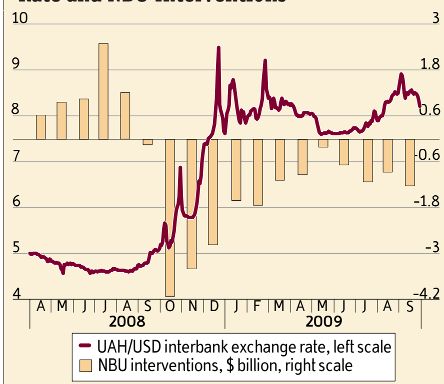
**Selected Monetary Indicators, % yoy**




Source: NBU, The Bleyzer Foundation

Regular forex interventions, an introduction of administrative measures, a sharp reduction in imports and the stabilization of foreign financial markets helped to calm the foreign exchange market during March-July 2009. Since mid-July, however, depreciation pressures intensified on the back of higher external debt payments and the relaxation of the foreign exchange rate regime. By increasing the size of its forex interventions and absorbing excess liquidity from the market, these pressures subsided at the beginning of September. Overall, between October 2008 and September 2009, the NBU spent about $20 billion of its forex reserves. This helped to reduce Hryvnia supply to the Ukrainian economy.

**Average UAH/USD Interbank Exchange Rate and NBU Interventions**




Source: NBU,, Finance.ua, The Bleyzer Foundation

[4] The difference between the amounts of foreign currency sales to and purchases at commercial banks by the Ukrainian citizens.

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In April 2009, the NBU tightened its criteria for access to its refinancing window and increased the usage of its deposits facilities to absorb excess liquidity. These measures were partially triggered by the widespread misuse of refinancing funds allocated to banks during the initial stages of the crisis. During October 2008-March 2009, commercial banks received substantial refinancing funds to cope with liquidity shortages, intensified by deposit outflow (due to bank runs, the banking sector lost virtually $^{1}/_{4}$ of its deposits), external debt repayments and rising non-performing loans. The support was aimed at maintaining lending that would cushion the crisis impact on the real economy. This did not happen, however, and it seems that some commercial banks directed a portion of these funds to the foreign exchange market, adding to the high volatility of the Hryvnia foreign exchange rate.

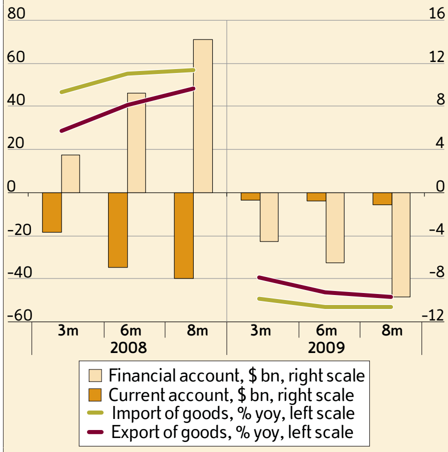
Facing foreign and domestic funding difficulties, a lower deposit base and deteriorating asset quality[5], commercial banks had to abruptly curtail the growth of their credit activities. The stock of Hryvnia-denominated loans grew by only 13% from January to September 2009 (below the rate of inflation) compared to an almost 30% growth over the same period last year. Foreign currency denominated loans, expressed in US Dollar terms, declined by about 19% during the first nine months of 2009 versus a 42% increase the year before. Hence, the sharp fall in bank lending stands on par with the export shock in explaining the severity of the economic downturn in Ukraine.

## International Trade and Capital

The international financial crisis changed the outlook of Ukraine's Balance of Payments performance in a very favorable manner. Over the first eight months of last year, very fast increases in imports (almost 60% yoy) caused a rapid deterioration in the current account, despite the fact that exports grew at a record high pace of almost 50% yoy. Up to September 2008, however, Ukraine did not experience problems in financing the current account deficit due to plentiful inflows of net FDI and borrowed funds from foreign financial markets.

In 2009, the economic downturn in Ukraine's main trading partners significantly reduced the demand for Ukrainian commodity-based exports, particularly metals and chemical products. Coupled with a sharp downward adjustment in world commodity prices, this caused a 50% yoy drop in exports over January-August 2009. At the same time, on the back of weaker domestic consumption and depressed investment activity, imports fell even more sharply at 53% yoy. As a result, the CA deficit narrowed to $1.1 billion over the period. In contrast to the previous year, however, the financial account balance moved into the red, which reflects large external debt repayments and other capital outflows. However, thanks to the timely financial support of the IMF and other international financial institutions, Ukraine successfully met its external financing requirements.

**Balance of Payments Performance, cumulative**




Source: NBU

## Other Developments and Reforms Affecting the Investment Climate

According to the latest World Bank/International Financial Corporation report, *Doing Business 2010: Reforming Through Difficult Times*, Ukraine's ranking on the ease of doing business was slightly upgraded. The improvement was mainly related to the adoption of a new joint stock company law. The new version of the law proposes better regulation of interested parties' transactions, increases disclosure requirements and regulates for pre-judicial conflict settlement. However, amid other countries taking bolder reforms, Ukraine is still ranked low, holding 142nd place out of 183 countries. Complicated and time-consuming procedures to obtain construction permits, to pay taxes, to start and close a business, and to register property prevent Ukraine from a further ranking upgrade, pointing to a broad agenda for economic reforms.

[5] According to IMF estimates, the share of non-performing assets in total loans grew from about 13% at the end of 2007/beginning of 2008, to almost 30% as of mid-2009.

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