Ukraine
Macroeconomic Situation

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THE BLEYZER FOUNDATION

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Summary

- Ukraine's economy is emerging from a deep recession, benefiting from global economic recovery, a good harvest and a favorable base effect.
- Ukraine's GDP is expected to return to growth in 2010, although the recovery is forecast to be moderate.
- Public finances are the main cause of concern for late 2009-early 2010 amid poor revenue collections, pre-election relaxation of social expenditures and off-track IMF financing.
- Sustaining fiscal accounts would require bold reform efforts after the presidential elections. Otherwise, inflation risks and public debt sustainability concerns may notably increase, hindering recovery.
- Ukraine has further progressed in disinflation as consumer price inflation decelerated to 13.6% yoy in November.
- Deposit growth rebounded in October-November, which may signal the gradual restoration of public confidence in the banking system of Ukraine.
- The lending activity of commercial banks remains suppressed, impeding the pace of economic recovery.
- The current account balance kept improving, while external financing needs still remain high next year.

Economic Growth

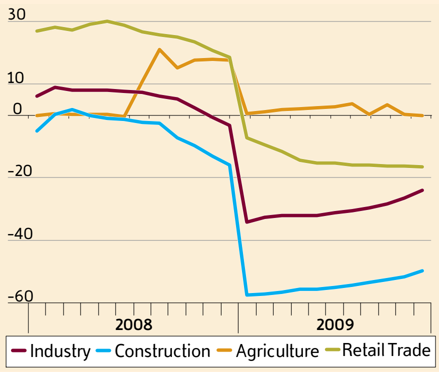
Recent real sector data confirms that the recovery in economic activity of Ukraine, the first signs of which became apparent in May 2009, is underway. The pace of real GDP decline eased from over 20% yoy in 1Q 2009 to less than 16% yoy in 3Q 2009, according to preliminary estimates of the State Statistics Committee of Ukraine. The pick up was primarily driven by improving industrial sector performance, the good agricultural harvest and a favorable base effect. The latter will be an important contributor to the overall improvement in economic performance of virtually all sectors in Ukraine at the end of 2009 as well as in the first half of 2010.

Being dependent on exports, the Ukrainian industry has benefited from the ongoing revival of the global economy, and rising world steel prices in particular. Industrial output has risen by about 13% (not seasonally adjusted) from June to November 2009. In annual terms, a 34% yoy contraction in the industrial sector in January 2009 turned into a 8.6% yoy increase in November, although the increase was achieved on a very low base (-29% yoy in November 2008).

Metallurgical production grew by 16% yoy in October 2009 and 47.6% yoy in November, compared to a 46% yoy decline at the beginning of the year. Although this impressive rebound was partly due to recovering world steel prices, it was primarily the result of an extremely low base (in November 2008, metallurgical production fell by almost 50% yoy). Tightly bound to metallurgy, output in mining and coke industries has also notably picked up. Thus, production of ores and coke were up by about 33% yoy and 28.5% yoy in October 2009 and 2-2.5 times in November 2009. The rebound in fertilizer prices, which closely follow energy prices, favored Ukraine's chemical industry. The output contraction in the industry eased from almost 50% yoy in January 2009 to about 9% yoy in October. In November 2009, the industry demonstrated a 12.4% yoy increase in output. At the same, the improvements in some other key industries, such as machine-building and production of construction materials, were quite slow due to scarce credit resources, lower household income, a depressed construction sector and still slow recovery in the destination countries for Ukraine's export of machinery (Russia, Kazakhstan, Hungary, etc.).

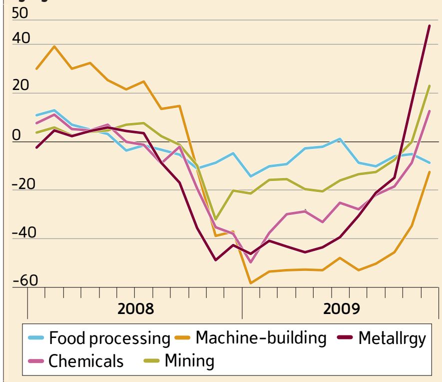
According to the SSC of Ukraine, the country had harvested almost 48 million tons of grain as of November 30th, the fifth largest crop in

Ukraine's Real Sector Performance, cumulative, % yoy



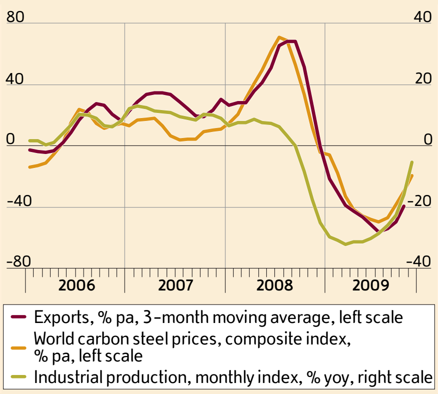
Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Industrial Output by Selected Branches, % yoy



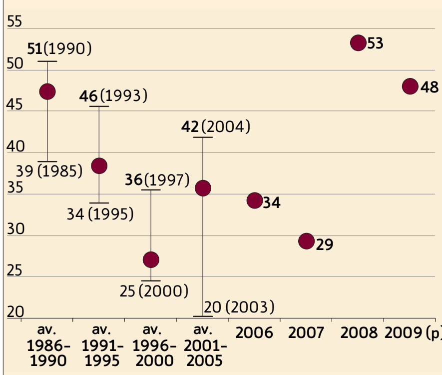
Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

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



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

Ukraine's Grain Harvests, 1985-2009, million ton



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

Where Opportunities Emerge.

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Ukraine's history. However, due to a high base effect (a historically high crop in 2008), over January-November 2009 agricultural output in comparative prices remained at the level of the previous year. Excellent grain outputs for two years in a row supported a livestock recovery process (particularly in production of poultry and pork). Nevertheless, domestic supply of primary livestock products remained insufficient for local food processing industry. In previous years, the deficit was compensated for by imports of agricultural products. However, following sharp Hryvnia depreciation in the fall of 2008, the respective goods imports fell by about 25-30% yoy over the first ten months of 2009. Coupled with lower domestic consumption[1], this resulted in a 6.7% yoy decrease in food-processing industry output over January-November 2009.

Thanks to a favorable base effect and expected strengthening of world economic recovery, further improvements in Ukraine's economic activity will become more apparent in the last month of 2009 and the beginning of 2010. Overall, however, real GDP is forecast to decline by about 14% in 2009 (due to a severe downturn in the first half of the year) and recover to positive growth in 2010. In 2010, growth is forecast to be supported by improved external trade prospects. In addition, consumer demand is likely to remain resilient on the back of pre-election social spending increases (which are, however, forecasted to only be partially implemented) and a large informal economy. Public investments related to preparations for the Euro 2012 football championship will also contribute. At the same time, as credit will continue to remain scarce (some revival is expected only in the second half of the year) and export prices are unlikely to increase as fast as in pre-crisis years, real GDP growth is forecast at a relatively moderate 3% in 2010.

Fiscal Policy

Ukraine's fiscal accounts have continued to be under significant stress. Moreover, due to pre-election fiscal expansion since the beginning of November 2009, public finances became the main cause of concern.

Consolidated Budget Performance in 2009, % yoy, nominal terms

	3m	6m	9m	10m
Total revenues	**6.5**	**-3.9**	**-10.6**	**-10.4**
Tax revenues	3.3	-9.4	-14.4	-13.3
PIT	0.6	-2.2	-3.9	-4.2
EPT	-6.2	-21.1	-25.8	-24.5
VAT	11.4	-12	-22.7	-21.1
Excises	29.5	49.2	60.1	61.4
Import duties	-53.6	-55.9	-51	-49.8
Non-tax revenues	32.2	29	12.4	8.1
Total expenditures	**15.8**	**10.3**	**6.1**	**4.4**
current	16.5	14.2	12.6	11.6
capital	-6.1	-41.3	-47	-49.5
Balance, UAH billion	**0.1**	**-13.3**	**-24.6**	**-28.4**

Source: Ministry of Finance, Presidential Secretariat, The Bleyzer Foundation

Ukraine's Public Sector Accounts, January-October 2009, UAH billion

Consolidated budget balance*	-28.4
Implicit Pension Fund deficit**	-16
Bank recapitalization	-14.2
Naftogaz recapitalization	-18.6
Public debt repayments	-20.5
External borrowing	41.5
Internal borrowing	48.9
Privatization receipts	0.7
Change in gov't deposits with NBU	-6.6

*Not including bank recapitalization, imbalances of Naftogaz and Pension Fund deficit (in excess of the deficit officially approved by the Budget 2009 Law)
**During 2009 the Pension Fund of Ukraine was able to fully fulfill its liabilities thanks to loans received from the State budget. As of November 1st 2009, the outstanding amount of such loans stood at UAH 16 billion ($2 billion).
Source: Ministry of Finance, NBU, The Bleyzer Foundation

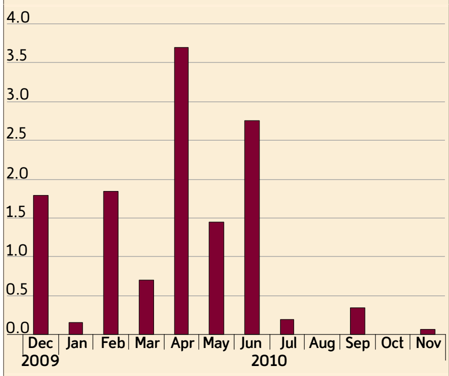
Until recently, the budget deficit was tightly managed, although tax revenues were squeezed due to the economic slowdown, while budget expenditures remained virtually unrevised. Over the first ten months of 2009, consolidated budget revenues fell by 10.4% yoy in nominal terms. In particular, tax collections were 13.4% yoy lower in nominal terms due to recession-driven factors (lower household income and enterprise profits, a drop in imports, etc.). At the same time, budget expenditures reported a 4.4% yoy nominal increase over the period, although the pace of expenditure growth decelerated thanks to cuts in capital expenditures. As a result, the budget deficit stood at UAH 28.4 billion ($3.6 billion), or less than 4% of estimated GDP for the period. For the whole year, the consolidated budget deficit was targeted at 6% of GDP (not including debt recapitalization and imbalances of the state-run natural gas company Naftogaz). The size of the deficit was agreed upon with the IMF and looked realistic to achieve.

In October 2009, however, the Ukrainian authorities approved 20% increases in the minimum wage and pensions, which were enforced at the beginning of November. The hikes in social spending, if fully implemented, are estimated to balloon Ukraine's overall fiscal deficits (including bank recapitalization, imbalances of the state-run natural gas company Naftogaz and pension fund) in excess of 10% of GDP in both 2009 and 2010. The approval of the law went against the IMF requirement, which, coupled with non-compliance with some other IMF requirements (principally, delay of the gas tariff increase for the population, approval of a realistic 2010 budget), put the IMF program off track. Although the IMF program is not officially suspended, the international agencies are likely to wait until after the elections to determine the commitment of the new authorities to sound policies.

With the IMF program off-track, the Ukrainian authorities lost one of the main sources of budget deficit financing. Indeed, about $4.5 billion out of the $6 billion released by the IMF in 2009 was directed at covering the fiscal financing gap. As external markets remain virtually closed and domestic financing is costly, the marked relaxation of fiscal expenditures raised concerns over deficit monetization and/or sustainability of domestic public debt. Over January-October 2009, the government issued about UAH 49 billion of domestic securities, a substantial portion of which was spent to recapitalize problem banks, Naftogaz and repay due public debt. While the National Bank of Ukraine acquired a considerable share of domestic T-bills issuance, it increasingly resisted monetizing the deficit. Hence, to receive necessary funds from the private sector, the government proposed short-term T-bills with high yields, which reached almost 30% pa in October 2009. Being aware that such a practice is unsustainable, the government reduced the

[1]According to household income and expenditure survey results, consumption of fish, meat, milk and dairy products declined by 14% yoy, 6% yoy and 12% yoy respectively in 1H 2009.

Schedule of Domestic T-bills Repayment, UAH billion



Source: Ministry of Finance, NBU, The Bleyzer Foundation

yields to about 20% pa in November. However, such offers faced little demand; as a result, at the beginning of December the government raised the yields to 24-25% pa.

Due to active T-bills issuance, Ukraine's domestic government and state guaranteed debt more than doubled in ten months of 2009 and reached UAH 96.3 billion ($12 billion) at the end of October 2009. Despite quite modest domestic public debt with respect to GDP (about 13%), debt management could be a challenging task next year due to the high costs of debt servicing and large domestic debt repayments. Indeed, the government will have to roll-over about UAH 13 billion ($1.6 billion) during December 2009-September 2010. This will add to fiscal deficit financing challenges, particularly in the first half of 2010, as the economic recovery is forecast to be slow while fiscal austerity measures are unlikely until after the end of presidential elections.

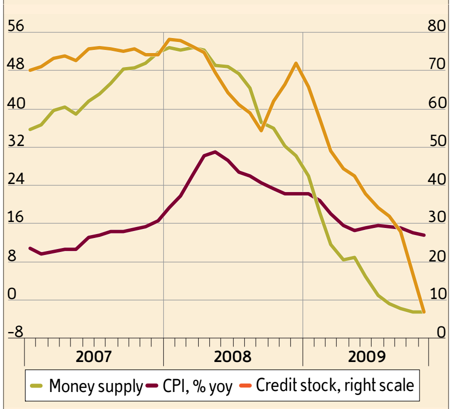
On a positive note, total public and publicly guaranteed debt of Ukraine is still on a relatively moderate level of about 30% of GDP. Moreover, the next sovereign external debt repayments are due at the end of 2010 (JPY 35 billion of Eurobonds). However, after the elections a comprehensive revision of Ukraine's fiscal policy will be needed to sustain fiscal accounts. The agenda is difficult - adjusting expenditures downward, rebalancing Natfogaz and improving the financial conditions of the pension funds. However, without progress in these areas, both inflation risks and public debt sustainability concerns may notably increase, pressuring exchange rates and hindering the recovery.

Monetary Policy

Despite a number of supply-side pressures, Ukraine kept progressing in disinflation thanks to subdued demand-side factors. Although the monthly consumer price index slightly accelerated during October-November, in annual terms it fell below 14% yoy in November. The prices were pressured by the continuing pass-through of sharp Hryvnia devaluation in the fall of 2008 on consumer goods (particularly, apparels and footwear, home appliances, etc.), higher excises on alcohol and tobacco, rebounded world energy price growth, and a reversing base effect. The upside pressures, however, were counterbalanced by postponed gas price increases for the population, and subdued demand side factors. In addition to lower household disposable income, domestic consumption is affected by the severe credit squeeze that started at the end of 2008. Going forward, the high fiscal deficit, recovering economic activities (and credit growth) and scheduled utility tariff increases may further complicate progress in reducing inflation. We forecast inflation at about 13% at the end of 2009 and 13-15% next year.

Tight monetary conditions have contributed to subsiding inflationary pressures and helped to contain foreign exchange volatility. On the other hand, however, the abrupt monetary tightening was one of the main reasons why Ukraine landed harder than other emerging economies affected by the global liquidity crisis. Indeed, sizable NBU interventions to support Hryvnia exchange rate ($10.3 billion over January-November 2009), sterilization operations (UAH 85.8 billion, gross) amid relatively moderate refinancing operations (UAH 61.4 billion, gross) caused monetary base to squeeze by almost 3% from January to November 2009 compared to an almost 22% increase over the same period last year. In addition, a shrinking deposit base and growing commercial banks' losses led to sharp deleveraging of the Ukrainian economy.

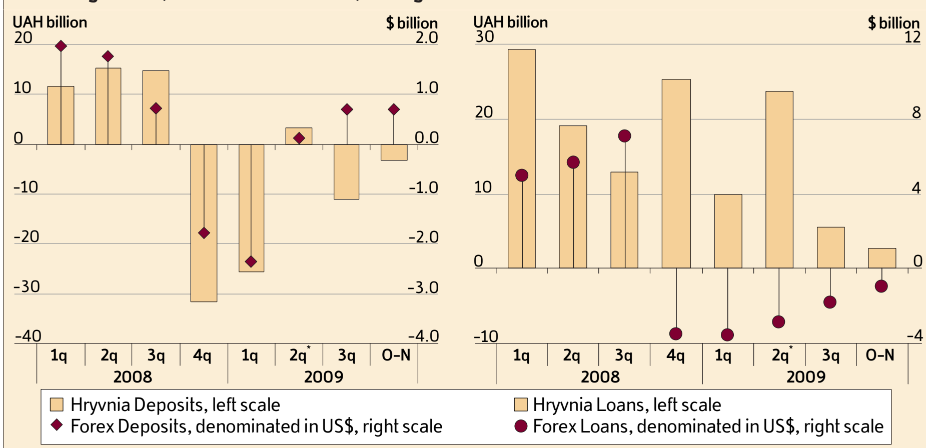
Selected Monetary Indicators, % yoy



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

Recent monetary statistics signal a gradual restoration of public confidence in the banking system of Ukraine. Indeed, the stock of foreign currency deposits grew by 3.8% during October-November 2009; deposits in national cur-

Banking Sector, Selected Indicators, change in stock



Source: NBU, The Bleyzer Foundation

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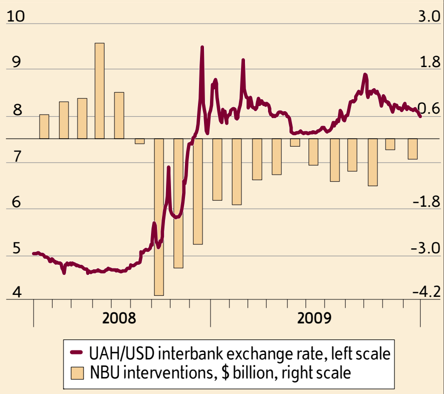
rency rose by 1.1% mom in November 2009. However, despite these improvements, commercial banks' deposit base remains weak after losing almost $\frac{1}{4}$ of all deposits from October 2008 to April 2009 and vulnerable to new outflows as a substantial portion of new deposits was attracted on a demand basis or for a very short-term. A weak deposit base coupled with the growing losses in banking (mainly due to rising expenses related to increasing non-performing loans (NPLs)[2] and tighter reserve requirements), more conservative lending practices, NBU sterilization operations and a crowding out effect from government placement of short-term T-bills at high yields kept commercial bank lending activity suppressed. Thus, the stock of Hryvnia-denominated loans grew by about 14% from January to November 2009, while foreign currency denominated loans (expressed in US Dollars) declined by 16.5% over the period compared to about 30% and 48% respective increases over the same period a year before. As a result, highly leveraged sectors (such as construction, trade and industry) saw a sharp contraction of economic activity.

Improving public confidence in the banking system was closely related to the stability on the foreign exchange market observed since October 2009. Moreover, the Hryvnia appreciated with respect to the US Dollar by about 2% from October to mid-December 2009, going below UAH 8 per USD, while the NBU reduced its interventions on the market to about $400 million per month during October-November compared to about $1 billion on average during January-September 2009. The exchange rate stability was achieved on the back of tight Hryvnia liquidity, a mix of NBU administrative measures and forex interventions, and improving external imbalances.

Average UAH/USD interbank exchange rate and NBU interventions



Source: NBU, Finance.ua, The Bleyzer Foundation

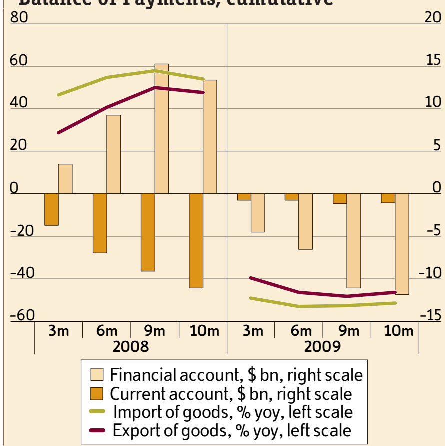
International Trade and Capital

Ukraine's external trade kept improving as the country, heavily dependent on exports, benefited from the recovering global economy, rebounding world commodity prices (particularly on steel products, fertilizers) and a favorable base effect. Thus, the pace of contraction of merchandise exports eased from about 50% yoy during the first nine months of 2009 to about 26% yoy in October 2009. The pick up was led by higher exports of metallurgical products, while exports of chemicals and agricultural products also notably contributed. However, the slow recovery in CIS countries, which on average accounted for about 35% of Ukraine's total exports of goods during 2007-October 2009, and more intense competition on foreign markets will keep restraining the volume growth of Ukraine's exports. On the upside, with the low base effect gaining momentum during November 2009 - first half of 2010, Ukraine's exports in value terms are forecast to show notable improvement over the respective period.

Imports, however, remained subdued, although the rate of contraction moderated from more than 50% yoy during January-September 2009 to about 40% yoy in October 2009. Recovering exports on the back of still low exports supported an ongoing adjustment of Ukraine's current account balance. During September-October, the current account reported small surpluses, bringing the cumulative CA deficit to $1.0 billion, 11 times lower than in the corresponding period last year. The current account deficit is forecast at about 1% of GDP in 2009. With next year's volume of natural gas imports recently agreed with Russia being lower than was initially contracted, improving exports, and a rise in natural gas transit tariffs, Ukraine's current account is forecast to be balanced in 2010, even despite the expected increase in imported natural gas prices.

The notable adjustment of Ukraine's current account has significantly eased the country's external financing needs this year and should not to be an issue requiring forex financing next year. At the same time, large external private sector debt requirements still may be a source of vulnerability. Over the first ten months of 2009, Ukraine successfully met its external financing needs thanks to a higher-than-initially expected debt roll-over ratio (74%) and significant financial support from International Financial Institutions (IMF, WB, etc.). However, Ukraine's gross external debt grew to $104.4 billion at the end of September 2009, of which about $30 billion[3] is estimated to be due within one year. To roll-over a significant portion of these debts, the government will have to maintain a good degree of confidence among foreign investors, international institutions and the population by pursuing sound policies and progressing in structural reforms.

Balance of Payments, cumulative



Source: NBU

[2] According to the NBU, the share of NPLs, defined as doubtful and loss, in the total credit portfolio of commercial banks grew from less than 4% in 4Q 2008 to 9.6% in 3Q 2009. However, the international practice is to include substandard loans in the definition of NPLs. According to IMF estimates, the share of NPLs (defined as substandard, doubtful and loss) stood at about 30% at the end of June 2009, up from about 14.5% at the end of 2008.

[3] According to the NBU, short-term private sector debt (by original maturity) stood at about $20 billion at the end of September 2009. Assuming a 6-year average maturity for MLT debt, which stood at $61 billion (including intercompany lending), total private external debt due during next year was estimated at around $30 billion.