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Ukraine Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

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- **Industrial production grew by 9.7% yoy in January 2011.**
- **Budget revenues grew by an impressive 44% yoy in nominal terms for the first two months of 2011. However, achieving budget revenue and deficit targets will be a challenging task.**
- **Consumer price inflation moderated to 7.2% yoy. Administrative price regulation was among the main reasons for significant progress in food disinflation.**
- **The current account switched to a $0.3 billion surplus in January 2011 amid strong exports and high workers remittances from abroad.**
- **The financial account reported a small deficit in January, but is forecast to notably improve in February amid a number of successful Eurobond placements.**

Executive Summary

The beginning of 2011 was quite favorable for the Ukrainian economy. Benefiting from rallying world commodity prices and strengthening external demand, Ukraine's exports of goods picked up by an impressive 54% yoy. As the Ukrainian economy is strongly dependent on exports, improvements in exports closely correlate with stronger real economy growth. Indeed, industrial production grew by 9.7% yoy in January 2011 led by export-driven metallurgy, the chemical industry and machine-building. Domestic-market-oriented industries and sectors also reported solid gains. At the same time, industrial sector data showed further weakening of growth momentum, which may be attributed to tighter administrative price controls, privileged imports of gasoline products and growing production costs. Given also projected slower consumption growth this year, real GDP is forecast to grow at about 4% yoy in 2011.

State budget revenues started 2011 with strong growth of about 44% yoy in nominal terms for the first two months. Despite such a remarkable improvement, deeper fiscal data readings suggest that fiscal execution may be challenging through the rest of the year. The government notably increased reliance on consumption taxes (such as VAT and excises), while direct taxes showed little progress. Such developments may signal a growing shadow economy, while the government is strongly counting on the de-shadowing impact following enforcement of the new tax code. In addition, a 2 percentage point reduction of the corporate profit tax rate and enforcement of tax holidays for small businesses from April 1st of this year may also contribute to tax revenues losing steam in the second half of the year. On the expenditure side, delays in pension reform and more gradual natural gas tariffs increases, negotiated with the IMF mission during its February visit, may require additional spending retrenchment efforts from the Ukrainian government to meet broad deficit targets. Although the IMF left the country without reaching a staff level agreement on the second program review, there is a high probability that the next tranche will be disbursed, although some delay is probable. A positive program review is likely to be secured by the fact that the 2010 general government fiscal deficit target was actually met, according to more detailed budget execution data.

For the first two months of the year, Ukraine made notable disinflation progress with annual consumer price growth easing to 7.2% in February 2011. Food prices, which account for more than 50% in the consumer basket and which surprised on the upside, were the main cause for index growth deceleration over the period. The moderate food price increase was to a notable extent achieved thanks to administrative price controls. While price regulation policy may work in the short term, it creates market distortions in the longer run, which may lead to supply shortages. It seems that shortages have already started to materialize on certain food markets (i.e. for flour, bread and bakery products). Despite moderation of consumer price growth, we maintain our year-end inflation forecast at 12% in 2011 amid surging gasoline prices, scheduled utility tariff increases and high inflation expectations.

Thanks to robust growth in exports, Ukraine's current account balance switched to a small surplus in January 2011. It more than compensated for the slight financial account deficit caused by external debt redemption payments exceeding new borrowings. This allowed the NBU to augment gross international reserves and the Hryvnia to slightly appreciate in the first two months of 2011. February is likely to bring further improvement in the financial account given a number of successful Eurobond placements during February-beginning of March. However, high external financing needs for 2011 may still pressure the Hryvnia to depreciate, particularly in the second half of the year.

	2006	2007	2008	2009	2010	2011f
GDP growth, % yoy	7.3	7.9	2.3	-14.8	4.2	4.0
GDP per capita, $	2 300	3 070	3 880	2 540	3 030	3 450
Industrial production, % yoy	6.2	10.2	-3.1	-21.9	11.0	
Retail sales, % yoy	24.8	28.8	18.6	-16.6	7.6	
Budget deficit, % GDP*	-0.7	-1.7	-2.0	-8.8	-6.5	-3.5
Government external debt, % GDP	11.0	8.7	9.3	20.5	23.8	25.3
Inflation, eop	11.6	16.6	16.6	12.3	9.1	12.0
Gross international reserves, $ billion	22.4	32.5	32.5	26.5	34.5	33.0
Current account balance, % GDP	-1.5	-3.7	-7.0	-1.7	-1.9	-2.8
Gross external debt, % GDP	50.6	56.0	56.4	88.6	88.1	78.0
Exchange rate, Hryvnia/US Dollar, eop	5.1	5.1	7.7	7.99	7.96	8.2-8.5

Including implicit pension fund deficit in 2007-2009, and including Naftogaz and pension fund deficits since 2009 (not including bank recapitalization expenditures and VAT bonds)
Sources: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2011 Budget Law, The Bleyzer Foundation

Where Opportunities Emerge.

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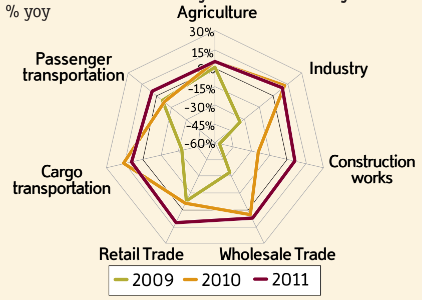
Economic Growth

In the first month of 2011 the Ukrainian economy grew at a solid pace, although several sectors showed mixed results. Benefiting from elevating world commodity prices and strengthening foreign demand, Ukraine's industrial production grew by 9.7% in annual term in January 2011. Output production in export-oriented metallurgy, chemicals and machinery was up by about 13% yoy, 28.5% yoy and 28% yoy, respectively. Buoyant growth in metallurgy and surging international prices for ores underpinned a 7% yoy increase in the extractive industry. Gaining from recovering domestic consumption (up by almost 6% yoy in real terms in 2010, according to preliminary SSC data) and still favorable base effects, Ukraine's light industry and retail sales turnover expanded by 22% yoy and 11.7% yoy respectively.

Economic Performance by Sector in January
% yoy

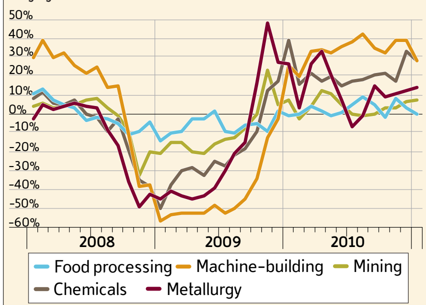


Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Ample harvests of the last three years prompted robust growth in cattle breeding and particularly poultry farming. Accordingly, agriculture, whose performance is mainly driven by animal and poultry husbandry in winter months, was up by 5.3% yoy in January 2011. Higher capital expenditures from the budget supported a 6% yoy real increase in the value of construction works in the first month of the year, although there was also a statistical carryover effect.

At the same time, the industrial sector's growth in January was weaker than during the fourth quarter of 2010 (about 10.8% yoy on average). Administrative price controls (e.g., on flour) and growing production costs (due to higher excises, energy and utilities) depressed food-processing, whose output was down by 0.3% yoy in January. Privileged imports of gasoline[1] and lower exports of Ukraine's electricity[2] resulted in a 9% yoy and a 6.3% yoy reduction in coke- and oil-refining and electricity, gas and water industries respectively.

Industrial Production Growth by Select Branches
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

While some of the factors that caused deceleration in January could be temporary (e.g. exports of electricity to Belarus were resumed at the beginning of February), further gains in industry may be constrained by forecast slower growth in domestic consumption and growing production costs (particularly energy). A moderate increase in domestic consumption this year will reflect projected weaker real wage growth, anemic retail lending and tight budget spending. In addition, business response to government reforms remains uncertain as a number of surveys signal increasing concerns over the business environment in Ukraine.[3] Furthermore, although overall export prospects remain favorable to Ukraine, projected slower growth in China and the EU may exert a toll on export growth. All in all, the economy is projected to grow by about 4% yoy in 2011.

Fiscal Policy

The start of the 2011 fiscal year was favorable to Ukraine. State budget revenues went up by a nominal 21.6% yoy in January and grew further in February. According to preliminary State Treasury data, state budget revenues grew by an impressive 44.4% yoy over the first two months of the year. As budget spending grew by a more moderate 13.7% yoy in January 2010, the state budget deficit stood at UAH 0.9 billion, almost half that in the corresponding period last year.

Despite such spectacular budget revenue growth in the first two months of the year, successful budget execution may be challenging for the Ukrainian authorities this year. First, impressive growth in tax revenues during the first half of 2011 will be partially attributed to higher rates of excises, notably raised since mid-2010. Indeed, excises on strong drinks, tobacco and gasoline were increased by 29%-40%, 24% and 20-40% respectively. Although the additional 40% increase in excises on gasoline products has been enforced since the beginning of 2011, a vanishing low base effect will cause excise revenues to lose momentum in the second half of the year. So far, however, proceeds from excises were up by almost 36% yoy in January 2011.

The government has given limited details on VAT and some other proceeds. VAT receipts were up by 16% yoy in January. The tax authorities also reported that VAT refunds amounted to UAH 2.7 billion, close to the average monthly amount estimated at UAH 3 billion. However, the government did not report the amount of VAT claims and changes in the stock of VAT refund arrears. According

[1] Livela Company, using legal loopholes in the Ukrainian legislation, won a court decision allowing it to import crude oil and gasoline products without paying excises and VAT at the end of May 2010. The company has actively imported gasoline products since August 2010.

[2] During January, Ukraine did not export electricity to Belarus as the countries were negotiating the price for Ukraine's electricity. According to the Ministry of Fuel and Energy of Ukraine, exports of electricity were 56% lower than in January last year.

[3] According to The Bleyzer Foundation Investor Sentiment Survey, many investors find the business and investment climate in Ukraine to be quite challenging. In addition, the survey revealed a notable increase in investors' concerns about corruption, business regulation and public governance issues in the second half of 2010 compared to the beginning of the year.

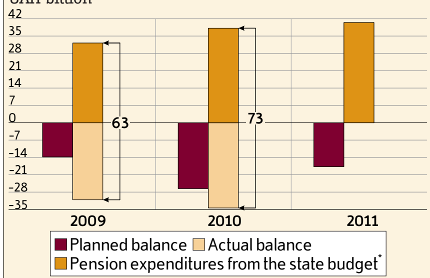
to the latest available information, at the end of 2010, VAT refund claims and arrears stood at UAH 11.1 billion and UAH 0.9 billion, respectively. The government is committed to repaying all VAT arrears by the end of March 2011 and introducing automatic VAT refunds. These may exact a toll on the growth of VAT receipts in the coming months.

Furthermore, the government did not present data on enterprise profit tax (EPT) receipts to the state coffers for January 2011, which may suggest that the growth was rather insignificant. Surprisingly, personal income tax (PIT) proceeds grew by a modest nominal 4% yoy in January, although real monthly wages kept growing at a robust 10.2% yoy that month. The developments of the direct taxes (EPT and PIT) may signal that the desired de-shadowing effect after introduction of the new Tax Code may not have been realized. Although tax performance at the beginning of the year may not be representative for the whole year, it may worsen in the second half of the year as a number of new tax rules (such as a 2 percentage point reduction of the EPT rate to 23%, EPT and VAT tax holidays for small businesses) will be enforced starting on April 1st.

Finally, high pension spending remains a heavy burden on state budget finances. In 2009, pension expenditures stood at 18.5% of GDP, one of the highest ratios in the world. Pension fund expenditures grew by 15.6% yoy in 2010 but thanks to higher growth of nominal GDP they declined as a share of GDP to 17.6%. In nominal terms, however, the pension fund deficit continued to widen despite a number of measures to narrow it.[4] According to government officials, pension spending is projected to increase by only 5% yoy in nominal terms. Such a modest increase is planned to be achieved thanks to just a cost-of-living adjustment of the minimum pension wage (by 9%, official inflation target) and savings from pension reform measures implementation. At the same time, the announced pension reform measures are still pending. As many of the proposed measures are politically sensitive, there is an increasing risk of weak reform implementation. In addition, proposed measures (such as raising the pension age for women by adding 6 months every year, increasing the qualification period and capping maximum pension benefits) will start bringing tangible results only in the medium term. Hence, we believe more comprehensive efforts are required to sustain Ukraine's pension system. All in all, achieving the targeted pension fund as well as the state budget deficit looks very challenging.

In the meantime, the government reported details of budget execution in 2010. Contrary to preliminary estimates, the broad budget deficit was very close to the IMF target. Higher than planned Naftogaz imbalances and pension fund deficit were compensated for by tight control over expenditures in the last few months of the year. A strong government commitment to meeting IMF requirements helped the Ukrainian authorities negotiate softening the IMF program in most politically painful areas. Thus, natural gas tariffs for the population will be raised by 20% starting April 15th and by an additional 10% starting June 30th instead of the initially planned 50% increase on April 1st. In addition, the IMF is likely to tolerate further delays in implementation of pension reform measures. Although the IMF mission left the country without reaching a staff level agreement in mid-February, there is a high likelihood that the next tranche will be disbursed, although some delay is probable. The latter will be due to the need to negotiate additional retrenchment measures to meet state budget and Naftogaz deficit targets.

Pension Fund Performance
UAH billion



*Pensions for military, judges, government officials, etc. are paid from the state budget of Ukraine. These expenditures as well as the actual Pension fund deficit represent the total pension spending burden for the state budget of Ukraine.
Source: 2009-2011 Budget Laws, Ministry of Social Policy, The Bleyzer Foundation

Minimum Pension Wage
UAH

	as of					annual change
	1 Jan	1 Apr	1 Jul	1 Oct	1 Dec	
2010	695	706	709	723	734	16.5%
2011	750	764		784	800	9%

Source: 2009-11 Budget Laws

Public Finances in 2008-2010

UAH billion	2008	2009	2010
State budget deficit	12.5	35.5	45.8
Naftogaz imbalances	n/a	24.4	15
Extra Pension Fund deficit	3.6	16	7.9
Other	2.4	4.3	2.4
Broad budget deficit	**18.5**	**80.2**	**71.1**
% of GDP	**2.0**	**8.8**	**6.5**
VAT bonds			16.4
Bank recapitalization	13.8	23.3	6.4
Total budget deficit	**32.3**	**103.5**	**93.9**
% of GDP	**3.4**	**11.3**	**8.6**

Source: Explanatory Note to Draft Budget Execution in 2010, Ministry of Finance

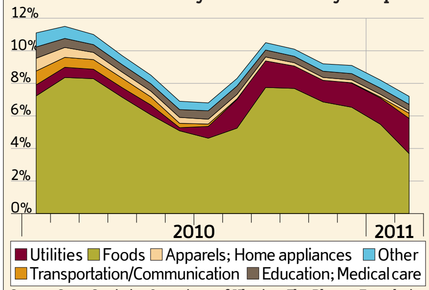
Monetary Policy

During the first two months of 2011, Ukraine continued to progress in reducing annual inflation. In annual terms, inflation declined to 7.2% in February, down from 9.1% yoy at the end of 2010. Quite surprisingly, consumer prices grew by 1% month-over month (mom) in January and 0.9% mom in February despite strong upward pressure of surging world food and crude oil prices, higher consumption taxes (excises) and rising utility tariffs. Thus, due to growing world crude oil prices and higher excises, domestic prices for gasoline products grew by almost 10% from December 2010 to February 2011. Higher gasoline prices translate into higher transportation costs for both the population and businesses. Thus, the price for passengers' road transportation services grew by about 3% for the first two months of the year. Higher transportation costs for businesses will have a spill-over effect on a broad range of consumer goods and services. The second largest increase was reported for utility tariffs, which were up by 6.1% for the corresponding period.

[4]For example, contributions to Pension Fund for private entrepreneurs on a simplified taxation system were raised 2.5-6 times since mid-July 2010.

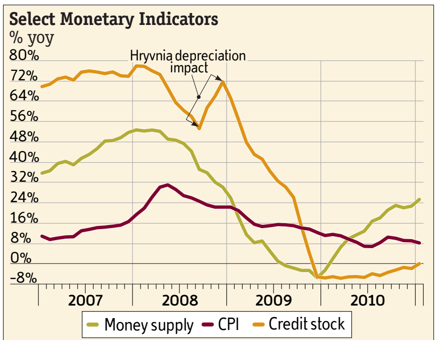
Food prices advanced by 1.3% mom in January and rose by a rather modest 0.3% mom in February. Food price developments surprised on the upside as such a moderate increase was achieved amid the continuing food price rally on foreign food markets and domestic supply shortages of selected goods. Declining prices on poultry, eggs and pork, due to growing production, may partially explain slower food price growth. At the same time, we believe tighter administrative price regulation was the primary reason. In particular, the government broadened the list of socially important goods whose prices or retail chain markups are subject to administrative control. While this policy may work in the short-term, in the longer term it creates distortions on domestic markets, which may discourage production and reduce quality. Indeed, during the first two months of 2011, Ukraine started to experience shortages of flour as milling companies curtailed production facing difficulties in negotiating higher prices with government authorities amid growing production costs. The government started grain and flour interventions from the State Reserve Committee, which can be only a temporary solution to contain food inflation. So far, prices on bread and bakery products picked up by 3.6% during January-February 2011.

Consumer Price Index by Main Commodity Groups



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Select Monetary Indicators



Source: State Statistics Committee, The Bleyzer Foundation

Although food price growth is likely to be further restrained, further scheduled increases in prices of utilities and other services (e.g., telecommunication) will keep pressuring consumer prices upwards. In addition, although inflation eased in annual terms, the population's inflation expectations have been on the rise since December 2010.[5] High inflationary expectations may reduce the effectiveness of government price stabilization efforts. All in all, we believe inflation will grow by about 12% yoy in 2011, higher than the officially targeted 8.9% yoy level.

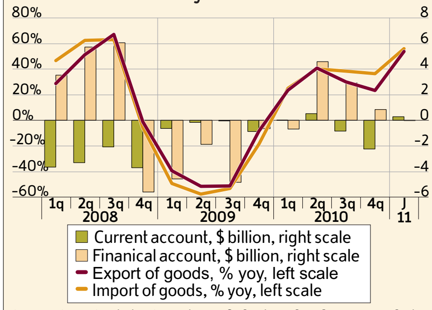
Although consumer inflation was primarily driven by cost-push factors, the National Bank of Ukraine is closely monitoring monetary aggregates growth by regulating commercial banks' liquidity. Commercial banks deposits kept growing at a robust pace, advancing by 2.3% mom in January. In annual terms, the stock of deposits was almost 30.5% higher than in January 2010. In comparative terms (adjusted for Hryvnia depreciation for foreign currency denominated deposits), the stock of deposits recovered to its pre-crisis September 2008 level. In addition, in January 2011 domestic debt service payments exceeded new borrowings on domestic market by about UAH 1.2 billion. Furthermore, net NBU interventions on the interbank forex market were positive at $255 million, leading to additional Hryvnia injections. These led to a notable improvement in commercial banks' liquidity – cash balances on commercial banks' correspondent accounts rose to UAH 25.5 billion during the month. However, as the NBU actively absorbed excess liquidity from the market and cash balances on government accounts with the NBU grew by about UAH 3.4 million, the monetary base declined by 1.7% mom in January 2011. Due to continuing growth of deposits, the money supply advanced by 0.6% mom for the period. Despite improving liquidity, commercial banks credit activity still remains subdued. In January 2011, the stock of bank deposits declined 0.2% mom, although in annual terms it was almost 3% higher than a year ago. Recovery of credit activity is constrained by still high credit risks in the country as well as the high share of non-performing loans. As cleaning the commercial banks' balance sheets will take time, credit growth is projected to be quite moderate this year.

International Trade and Capital

The beginning of 2011 was favorable for Ukraine's exporters. According to preliminary NBU data, the value of Ukraine's merchandise exports for January 2011 was almost 54% higher than the year before. A strong increase in world steel prices and buoyant foreign demand (i.e., from Russia and the Czech Republic) for Ukraine's heavy machinery and transport vehicles underpinned an almost 60% yoy increase in metallurgy, machinery and transport vehicles exports. Exports of chemical products were almost twice as high as in January 2010 amid much higher world fertilizer prices (up by 36.5% yoy, according to World Bank data). Despite further improvements in export performance, the growth of imports kept outpacing exports. Indeed, imports surged by 56% yoy in January 2011 on account of large energy supplies. Ukraine needed much higher volumes of natural gas imports (up by 2.4 times) in January as Naftogaz returned about 3.5 billion cubic meters of natural gas to Swiss-registered RosUkrEnergo. In June 2010, RosUkrEnergo, a mediator trader and the only importer of natural gas to Ukraine during 2006-2009, won the Stockholm Arbitration Court decision, according to which Ukraine was ruled to restore 12.1 billion cubic meters of RosUkrEnergo natural gas, expropriated at the beginning of 2009. Besides fossil fuels, Ukraine actively imported transport vehicles, which grew by 2.2 times in January, signaling the strengthening domestic demand in the country. At the same time, a $0.4 billion trade deficit in goods was more than covered by surpluses on foreign trade

[5]According to the GFK Ukraine-ICPS consumer confidence survey, inflation expectations grew by 3.2 percentage points (pts) in December 2010 and added another 3.4 pts in January 2011.

in services and current transfers accounts. As a result, the current account balance turned positive in January 2011 and stood at $0.3 billion.



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

In contrast, the financial account became slightly negative in January 2011 amid external debt repayments exceeding new borrowings by both public and private sectors and high population demand for foreign currency. However, thanks to the current account surplus, the balance of payments remained positive, which allowed Ukraine to further augment its gross international reserves to $35.1 billion at the end of January 2011. While the current account balance is likely to worsen in the coming months amid rallying energy prices and higher volumes of energy imports, the financial account is projected to improve as Ukraine just successfully placed $1.5 billion of 10-year sovereign Eurobonds with a yield of 7.95% pa and a $0.5 billion of quasi-sovereign Oschadbank Eurobonds. In addition, there were also private placements of Eurobonds during February (i.e., Ukraine's steel-making company Metinvest attracted $750 million by issuing 7-year Eurobonds with a yield of 9% pa). Despite improved access to foreign capital markets, Ukraine's high foreign financing needs may cause the Hryvnia to depreciate. For the Hryvnia exchange rate to remain stable, the government's rather ambitious external borrowing plans should be fully realized and the private external debt roll-over ratio maintained at a very high level. The latter, in turn, will depend on successful IMF program execution as notable progress in improving Ukraine's investment climate. While we believe the IMF program will continue, though with possible delays, progress may be less smooth with a number of reform efforts still pending (particularly in the areas of combating corruption and reforming the judiciary system).