

December 2011

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- Real GDP growth is estimated at about 5% yoy in 2011.
- Agriculture was among the main drivers of real GDP growth in 2H 2011.
- Industrial production declined by 0.5% yoy in December, hit by a more challenging external environment. However, it reported a 7.3% yoy increase for the year.
- Economic growth is forecast to moderate to about 3% yoy in 2012.
- The state budget deficit stood at about 1.7% of estimated GDP in 2011, significantly below target. However, the general public sector deficit exceeded the IMF target.
- A record high harvest helped contain consumer price growth to 4.6% yoy in 2011.
- The current account deficit widened to \$8.7 billion in January-November and is estimated to reach about 5.7% of GDP in 2011.
- The Hryvnia was under depreciation pressure in 2H 2011 due to a widening CA gap, high external financing needs and strong population demand for foreign currency. However, the Hryvnia exchange rate remained virtually stable through the end of the year.
- Due to NBU foreign currency sale interventions and unfavorable valuation changes, Ukraine's gross international reserves fell to \$31.8 billion at the end of 2011.

### Executive Summary

In 2011, the Ukrainian economy grew by about 5% yoy, up from 4.2% yoy in the previous year. Private consumption was one of the main drivers of real GDP growth in 2011. It expanded by about 14% yoy over the first nine months of 2011. Thanks to a record high harvest of grains (56.7 million tons) and other crops, agricultural sector output was up by 17.5% yoy in 2011. The record high harvest caused a decline in consumer price inflation to 4.6% yoy at year-end, the lowest level in the last 9 years.

High growth in agriculture helped to compensate for weakening exports in the second half of the year. Being a very open economy, with exports accounting for more than 50% of GDP, Ukraine is sensitive to global growth dynamics. During 1H 2011, Ukraine benefited from the global recovery, elevated commodity prices and improved access to external financing. The intensification of the sovereign debt crisis in the Euro area since summer 2011 affected global trade developments and hit Ukraine's exports. In real terms, exports declined by 3.4% yoy in 3Q 2011. On a positive note, as exports have significant import content, imports also lost momentum in the second half of 2011. However, as prices of energy resources remained high and imports grew faster than exports, the current account deficit widened to \$8.7 billion over January-November 2011. The gap is estimated to reach about 5.7% of GDP for 2011.

The Hryvnia was under depreciation pressure in December 2011, generated by external debt redemptions and strong population demand for foreign currency. Improved banking sector liquidity also added to these pressures. But thanks to improved agricultural exports, higher commercial bank demand for Hryvnias and continuing NBU interventions in the interbank market, the Hryvnia exchange rate remained virtually stable. At the same time, due to unfavorable valuation changes, gross international

reserves fell by almost 2% in December compared to the previous month.

In 2012, real GDP growth is projected to moderate to about 3% yoy, mainly on account of a more difficult external environment. At the same time, political uncertainty and a difficult winter crop outlook add to downside factors. Due to a projected lower agricultural harvest, low base effect and higher social spending ahead of the elections, inflation may accelerate to about 9% in 2012.

In 2011, Ukraine's public sector deficit (including Naftogaz and Pension Fund) amounted to about 4.5% of GDP. Although the deficit exceeded the IMF target of 3.5% of GDP, the Ukrainian authorities made significant progress in reducing fiscal imbalances. In 2012, the government is set to continue its fiscal consolidation efforts. The 2012 budget law was approved at the end of 2011, targeting the state budget deficit at 1.7% of GDP. However, the general public sector deficit may be around 3.5% of GDP due to government reluctance to raise natural gas tariffs to the population and likely pre-election fiscal loosening. Despite a further decline in the fiscal deficit, Ukrainian public finances may be under strain in 2012 due to high government borrowing requirements.

Due to moderation of economic growth and likely lower volumes of energy imports, Ukraine's current account deficit is projected to improve to about 5% of GDP in 2012. However, coupled with large external debt financing needs and tighter access to foreign financing, this may cause the Hryvnia depreciation risks to materialize during the year. At the same time, given the still high level of gross international reserves, a notable part of private external debt due to foreign parental or affiliated companies and banks, and the government's intent to re-engage with IMF, the depreciation is likely to be moderate.

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	2007	2008	2009	2010	2011 <sup>e</sup>	2012 <sup>f</sup>
GDP growth. % yoy	7.9	2.3	-14.8	4.2	5.0	3.0
GDP per capita. \$	3 070	3 880	2 540	3 030	3 530	3 900
Industrial production. % yoy	10.2	-3.1	-21.9	11.0	7.3	2.5
Retail sales. % yoy	28.8	18.6	-16.6	7.6	14.7	-
Budget deficit. % GDP <sup>g</sup>	-1.7	-2.0	-8.9	-7.0	-4.4	-3.5
Government external debt. % GDP	8.7	9.3	20.5	23.8	22.0	21.5
Inflation. eop	16.6	16.6	12.3	9.1	4.6	9.0
Gross international reserves. \$ billion	32.5	32.5	26.5	34.5	31.8	27.0
Current account balance. % GDP	-3.7	-7.0	-1.7	-1.9	-5.7	-5.0
Gross external debt. % GDP	56.0	56.4	88.6	88.1	77.5	72.0

<sup>e</sup>Including implicit pension fund deficit in 2007-2009, and including Naftogaz and pension fund deficit since 2009 (not including bank recapitalization expenditures and VAT refund bonds).  
<sup>f</sup>Revised data for 2009-2010.

Source: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2011 Budget Law, The Bleyzer Foundation

### Economic Growth

In 2011, the Ukrainian economy grew by about 5% yoy, according to early estimates. Higher than initially expected growth was achieved thanks to robust private consumption and a record high agricultural harvest. Thus, private consumption rose by an impressive 15.7% yoy in 3Q, further up from about 13.4% yoy in 1H 2011. Private consumption was underpinned by an 8.5% yoy increase in real wages for January-November, revival of consumer credit<sup>1</sup> as well as a reduction in population savings<sup>2</sup>.

Investments grew by about 40% yoy over the first nine months of 2011 amid high budget spending on large infrastructure projects and large inventory rebuild. This development was in line with an 11.1% yoy real increase in construction output and a 17.5% yoy growth in agriculture. Thanks to a record agricultural harvest (56.7 million tons of grain), Ukraine's grain stockpiles as of December 1st 2011 were more than 60% higher than in the respective period last year.

At the same time, the deterioration of the external environment hit Ukraine's exports and export-linked sectors in 3Q 2011. Thus, exports declined by 3.4% yoy in real terms in 3Q 2011 compared to about an 11% yoy increase in 1H 2011. Ukraine's export-driven metallurgy fell by almost 5% yoy in December 2011 due to softening overseas demand and downward correction of world steel prices. For similar reasons, production of chemicals declined 1.1% yoy in the last month of the year. Production of machinery, equipment and transport vehicles grew at a moderate 4.5% yoy in December as a worsened 2012 growth outlook may have prompted a downward revision in companies' investment plans. On the upside, expensive imported natural gas stimulated domestic extraction of fossil fuels. As a result, the mining sector reported a 5.5% yoy growth in December. Overall, although total industrial production has been losing steam since July and reported negative growth in December (-0.5% yoy), the sector rose by 7.3% yoy for the year 2011 thanks to robust growth in the first half of the year.

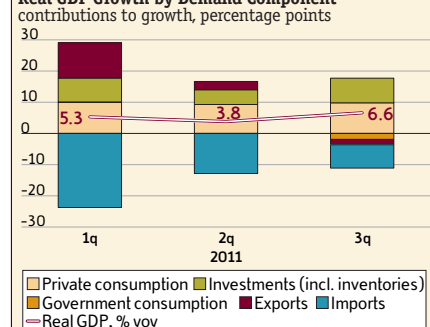
In 2012, real GDP growth in Ukraine is projected to weaken to about 3% yoy. Private consumption will remain the principal driver of economic growth, supported by moderate inflation in the first half of the year and likely pre-election fiscal loosening. At the same time, continuing weaknesses on external markets will exact a toll on the export-dependent Ukrainian economy. In addition, adverse weather conditions have hurt Ukraine's winter grains. Thanks to improved machinery, fertilizer use and management, Ukraine still is projected to produce an above-average harvest in 2012. However, as the harvest will be lower than in the previous year, we forecast a decline in the sector in 2012. On the upside, however, we believe that Ukraine's co-hosting of the Euro 2012 football championship and projected improvement in the external environment in the second half of the year will provide support

### Real Sector Performance of Ukraine

	2011	2010	2009	2008
<b>Agriculture</b>	17.5	-1.5	-1.8	17.1
<b>Industrial output</b>	7.3	11.2	-21.9	-3.1
<b>Construction works</b>	11.1	-5.4	-48.2	-15.8
<b>Domestic trade turnover</b>				
Wholesale trade	0.6	0.4	-19.3	-6
Retail trade	14.7	9.8	-17.4	18.1
Restaurants	11.0	3.5	-15.6	4.6
<b>Transportation turnover</b>				
Cargo	5.7	6.4	-22.5	-0.2
Passenger	3.2	-0.2	-11.5	4.5
<b>Services, non-financial</b>	18.6	2.9	-16.8	15.8

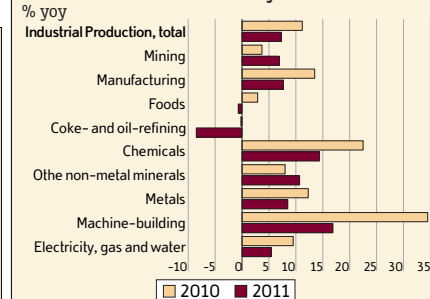
Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

### Real GDP Growth by Demand Component

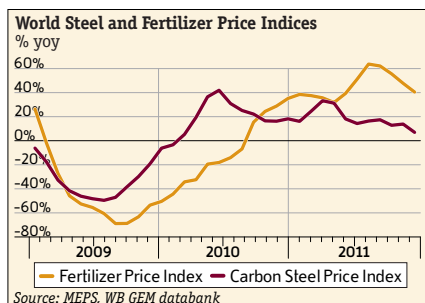


Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

### Industrial Production Growth by Select Branches



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation



Source: MEPS, WB GEM databank

<sup>1</sup>The stock of Hryvnia-denominated consumer credit rose by about 32% yoy over January-November 2011.

<sup>2</sup>The stock of population deposits in commercial banks declined by 0.4% from August to November 2011.

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for the Ukrainian economy. In addition, imports may expand at a slower pace amid weaker investment demand<sup>3</sup> and lower volume of natural gas imports.<sup>4</sup> Failure to reach a compromise natural gas agreement with Russia and a more protracted period of weak global economic growth are the downside risk factors for the forecast.

### Fiscal Policy

Faster revenue growth and tight control over expenditures led to a decrease in the state budget deficit to 1.7% of estimated GDP in 2011, a substantially better outcome compared to the initial target of 2.7% of GDP. Thanks to dynamic economic growth and changes in taxation (administration, accounting rules, rate increases of selected taxes and duties), revenues to the state budget rose by a nominal 22.4% yoy in 2011<sup>5</sup> and were 3.5% above the targeted amount. Above-planned budget revenues were achieved mainly on account of higher collection of corporate profit tax (EPT) and value added tax (VAT). According to Ministry of Finance information, proceeds from these taxes exceeded the target by 11% and 4.4%, respectively. At the same time, expenditures (including net credit from the budget) were under-fulfilled by almost 2% and were only 9.6% yoy higher.

The Ukrainian authorities made significant progress in reducing the fiscal deficit in 2011, although the consolidation progressed at a slower pace than initially expected. Thus, the general public sector deficit amounted to 4.4% of GDP, a notable reduction compared to 8.9% of GDP in 2009 and 7% of GDP in 2010. However, the government missed the IMF target for the general government deficit set at 3.5% of GDP. The higher than planned deficit was the result of larger Naftogaz and Pension Fund imbalances due to the government resistance's to raise natural gas tariffs to the population and delays with pension reform implementation, respectively.

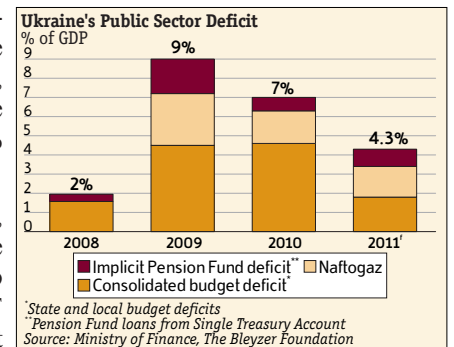
In 2012, the government is set to continue its fiscal consolidation efforts. However, the overall public sector deficit may again miss the IMF target. The 2012 budget law, approved at the end of 2011, was developed based on a rather conservative scenario. State budget proceeds are forecast to increase by less than 6% yoy. The rise in government expenditures is also expected to be moderate. As a result, the state budget deficit is projected to stay at around 1.7% of GDP. However, as measures to sustain Naftogaz finances are still pending and there is a risk of pre-election fiscal loosening, the 2012 general government deficit is forecast at about 3.5% of GDP.

Despite further deficit reduction, public finances may remain strained in 2012. First, cooling economic growth and a higher amount of taxes paid in excess of tax bills<sup>6</sup>, the stock of VAT refund claims, which were under investigation and audit<sup>7</sup>, and taxpayers' court appeals against tax authorities in 2011, may cause budget revenue shortfalls in 2012. Second, raising sufficient budget financing may be a challenging task for Ukraine. However in the second half of 2011, Ukraine faced more difficult financing conditions. The intensification of the sovereign debt crisis in the Euro area increased the costs of borrowing and tightened access to foreign financing on international financial markets. On the domestic market, liquidity squeezes during August-November and an increased risk of Hryvnia depreciation reduced demand for Hryvnia-denominated domestic debt securities. In response, the government proposed exchange-rate-risk-free Hryvnia denominated bonds in October 2011 and US Dollar-denominated domestic bonds in December 2011. Although these instruments helped to attract about UAH 10 billion and \$3.3 billion to the budget coffers for the respective periods, they also increased the country's exposure to exchange rate risks. Moreover, most of the issued USD-denominated domestic bonds were of short-term maturity. Hence, government demand for foreign currency to redeem these debt securities may add to depreciation pressures during 2012, particularly in the second half of the year.

Despite the above measures, 2011 borrowing plans were under-fulfilled. As a result, the public debt-to-GDP ratio declined to about 36% of GDP in 2011. Although this level is relatively low, a significant share of public liabilities is due within one year (about 20% of the total). Given that the situation on foreign financial markets will likely remain difficult, resumption of the IMF program will not only provide scarce and cheap financial resources but will also help to maintain the private external debt rollover ratio. The latter, in turn, will help to mitigate Hryvnia depreciation pressures stemming from high external imbalances. Hence, the Ukrainian authorities

UAH billion	2010	2011		% change to		2012	
		Plan	Actual	Plan	2010	Plan	% yoy
Revenues <sup>*</sup>	257.1	303.9	314.6	3.5	22.4	332.8	5.8
Expenditures	303.6	339.2	332.8	-1.9	9.6	357.9	7.6
Balance	-64.3	-35.3	-22.0	-37.7	2.9 times lower	-25.1	14.2

\*Excluding VAT refund of UAH 16.4 billion in August 2010 though issuance of special domestic debt securities called VAT bonds  
Source: Ministry of Finance, 2012 and 2011 Budget Laws, The Bleyzer Foundation



<sup>3</sup>Due to completion of large infrastructure projects related to the Euro 2012 football championship.

<sup>4</sup>At the beginning of January, Ukrainian authorities announced that in 2012 Ukraine will drastically reduce the volume of gas imports to about 27 billion m3, down from about 40 billion m3 imported in 2011. Though there is much uncertainty in the situation, a compromise agreement may be reached during the year.

<sup>5</sup>Taking 2010 budget revenues not adjusted for VAT refund of UAH 16.4 billion in August 2010.

<sup>6</sup>Up by 28% yoy to UAH 14.4 billion or more than 4% of forecast state budget revenues in 2012.

<sup>7</sup>A rise by 39% yoy to UAH 15.1 billion as of end-2011.

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are likely to make efforts to restore IMF cooperation during 2012. However, given the socially painful actions required by the IMF (such as raising natural gas tariffs to population), the outlook for IMF disbursement before parliamentary elections looks rather weak.

### Monetary Policy

Thanks to a good harvest of grains and vegetables, Ukraine's consumer inflation eased to 4.6% yoy in 2011, the lowest level in the last 9 years. In December 2011, consumer prices added only 0.2% compared to the previous month, a record low for that month. Such a modest growth was achieved thanks to ongoing downward correction of domestic prices on a vast group of food products (cereals, sugar, and vegetables). In addition, domestic fuel prices declined slightly in December amid easing world energy prices. On the upside, prices on dairy products and cheese went up by 3% mom, reflecting a continuing recession in cattle breeding. The high agricultural harvest will have a spillover effect on food prices also in the first half of 2012. However, due to a weaker 2012 harvest, likely pre-election fiscal loosening and tariffs adjustments after parliamentary elections, consumer price growth is projected to accelerate to about 9% yoy at the end of 2012.

The growth of monetary aggregates accelerated in December 2011, a rather typical development for the last month of the year. Due to a significant reduction in cash balances on government accounts with the NBU (by 66.6% month-over-month) and positive net interventions on the inter-bank forex market, the monetary base grew by 3.8% mom. This coupled with a 4.4% mom increase in the stock of deposits underpinned a 4.5% mom growth of money supply (M3). Since the beginning of the year, money supply expanded by a moderate 14.2% yoy, helping to contain inflation. The stock of commercial bank credit grew by 9.6% yoy in 2011. Subdued credit growth reflected high credit risks, a still high share of non-performing loans as well as liquidity squeezes during most of 2H 2011.

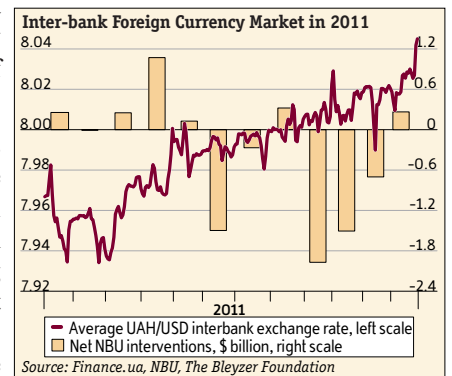
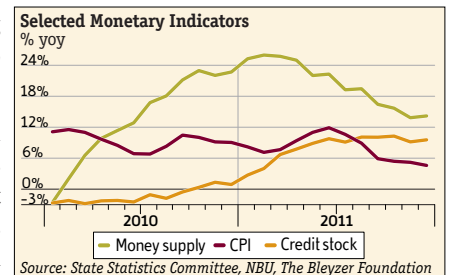
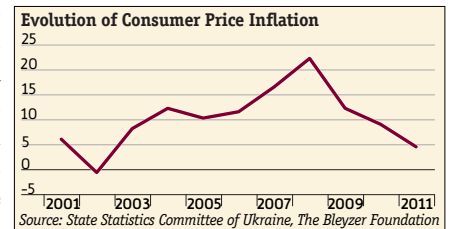
Banking sector liquidity notably improved in December thanks to resumed growth of deposits (up by 9.9% mom for corporate enterprises and 1.5% yoy for the population), more sizable refinancing support and smaller sterilization operations. Daily cash balances on commercial banks correspondent accounts on average exceeded UAH 21.5 billion in December, up from around UAH 15 billion in November. Higher banking sector liquidity may have been among the main factors contributing to Hryvnia depreciation pressures on the interbank forex market in December. At the same time, some Hryvnia exchange rate depreciation at the end of the month may also be attributed to the national bank's tentative shift towards foreign exchange policy easing.

During December 2011, NBU purchased about \$170 million more foreign currency than was sold on the interbank market, though the Hryvnia was under depreciation pressures during the month. Positive net NBU interventions, in sharp contrast to previous three months, when the NBU supported Hryvnia exchange rate by selling on average about \$1.4 billion per month. Although the official Hryvnia exchange rate was kept virtually unchanged during the month at about UAH 7.99 per USD, this may signal the monetary authorities may be more prepared to allow greater Hryvnia exchange rate flexibility to contain depletion of gross international reserves. Indeed, despite positive net interventions in December, NBU gross international reserves declined by \$0.6 billion to \$31.8 billion due to unfavorable valuation changes.

### International Trade and Capital

In November, exports of goods slightly accelerated, rising by 21.8% yoy. The growth was supported by a 48.4% yoy increase in exports of agricultural and food products. Although a record high agricultural harvest played a role, the high growth rates are mainly explained by a low base for comparison (in 2010, the government introduced grain export quotas). In the meantime, due to a downward correction of world steel prices and easing demand from CIS countries, exports of metallurgical products and machinery and equipment rose by a modest 10.8% yoy and 7% yoy, respectively, in November compared to average growth rates of 32% yoy and 36% yoy during the previous ten months of the year.

Imports also lost momentum in the second half of the year due to significant import content in Ukraine's exports and a bumper harvest. Thus, imports of agricultural and food products, accounting for about 9.5% of total imports, went down by 0.4% yoy in November, while the growth of imports of metals and chemicals eased to about 23% yoy and 9% yoy, respectively, during October-November (down from about 48.5% yoy and 31% yoy over the first nine months, respectively). However, due to high energy prices and strong



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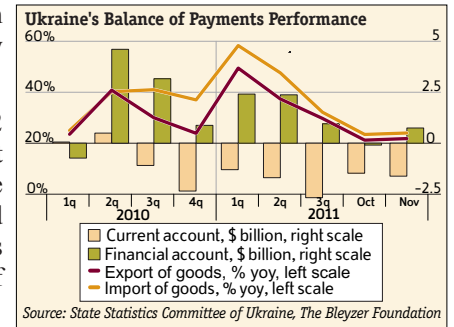
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population demand for home appliances and transport vehicles, imports kept rising at a much faster pace than exports. Indeed, imports grew by 24% yoy in November, up from 23% yoy in the previous months.

Thanks to improved exports, Ukraine's foreign trade deficit slightly narrowed to \$1.2 billion in November. However, due to a higher income deficit (dividend and investment returns payments abroad, interest payments on external debt), the current account balance kept worsening in November. Cumulatively, the eleven-month current account gap reached \$8.7 billion, or 5.3% of estimated full year GDP. Despite further improvement in Ukraine's agricultural exports in December, the current account deficit is estimated at around 5.7% of GDP for the whole year.



Ukraine's capital and financial account switched to a \$0.7 billion surplus in November. The surplus was achieved mainly on account of short-term credit, while monthly net FDI inflows (about \$150 million) were the lowest in more than two years. Despite a surplus in the financial account of the BoPs, Ukraine's gross international reserves kept declining amid a wider current account gap and unfavorable valuation changes.

Due to moderation of economic growth and likely lower volumes of energy imports, Ukraine's current account deficit is projected to improve to about 5% of GDP in 2012. However, coupled with large external debt financing needs, it still forms a significant external deficit for 2012. Amid tighter access to foreign financing and weak prospects for the IMF program to be resumed before parliamentary elections, the Hryvnia will be subject to depreciation pressures. At the same time, given the still high level of gross international reserves, a notable part of private external debt due to foreign parental or affiliated companies and banks, and the government's intent to re-engage with IMF, the depreciation is likely to be moderate.

<sup>5</sup>Industrial production in Russia declined in September compared to the previous month. Although in monthly terms growth rebounded in October, in annual terms it moderated to 3.6%, the lowest level in two years. Weaker industrial production growth was also observed in Kazakhstan, Belarus, etc.

<sup>6</sup>Excluding changes in gross international reserves.

<sup>7</sup>Short-term capital includes trade credit, foreign deposits and other capital.

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