Ukraine

Macroeconomic Situation

February 2012

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- **As anticipated, domestic demand was the principal driver of solid real sector performance at the beginning of 2012.**
- **Industrial production expanded by 2% yoy in January 2012, an encouraging recovery from a 0.5% yoy decline in December 2011.**
- **Although winter crop damages increased due to severe frosts during January-February, Ukraine still may collect a higher than average harvest in 2012.**
- **Early budget execution data suggests further improvement in central government financial accounts. Overall, public finances remained under strain due to high public debt financing needs amid tight external and domestic debt markets.**
- **Consumer price inflation eased to 37% yoy in January amid a favorable statistical base and spillover effect of a record high 2011 harvest on food prices.**
- **Monetary policy is likely to stay unchanged during most of 2012, with the main focus on exchange rate stability. The latter will be achieved thanks to forex interventions and tight liquidity management.**
- **Thanks to December's improvements, Ukraine's 2011 full-year external position was slightly better than expected.**
- **In 2012, the current account is expected to narrow to below 5% of GDP. However, high external financing needs will be one of the main macroeconomic challenges for Ukraine this year.**

Executive Summary

Ukraine's real sector performance was better than expected in January 2012, principally thanks to robust domestic demand. Thus, retail sales turnover grew by a solid 13.8% yoy that month. Continuing construction growth, government plans to modernize the public transportation system and higher demand for domestic energy resources underpinned a 2% yoy increase in total industrial production. At the same time, the deterioration of the external environment exacted a toll on export-driven industries and related sectors.

Severe frosts during January-February posed an additional risk to Ukraine's grain harvest this year as almost half of its winter crops may need to be replanted. However, given plans to re-sow damaged winter wheat with higher-yielding corn, Ukraine still may produce an above average grain harvest this year.

Early fiscal data for January 2012 was encouraging, signaling further improvement in central government financial accounts. However, the situation with public finances remained under strain due to large public debt service payments. Raising sufficient financing to cover its fiscal liabilities proved to be a rather challenging task amid an unfavorable situation on external financial markets and a liquidity constrained domestic market. In response, the government is developing new debt instruments.

Thanks to continuing spillover effect of the plentiful 2011 agricultural harvest on food prices and a high base, consumer inflation eased to 3.7% yoy in January 2012. Tighter monetary conditions also contributed to disinflation progress. Hryvnia exchange rate stability remained the main target of Ukraine's monetary policy in 2012. To curb Hryvnia exchange rate volatility, observed at the beginning of 2012, the National Bank of Ukraine used liquidity management tools and foreign currency interventions. However, although tight liquidity helped to reverse Hryvnia depreciation pressures on the interbank forex market during January-February, it also affected credit availability. Although subdued credit growth will contribute to an economic growth slowdown in 2012, we do not anticipate a significant change in monetary policy until after parliamentary elections are scheduled for October this year.

Thanks to a rather unusual improvement in the foreign trade balance and stronger inflow of foreign capital in the last month of 2011, Ukraine's full-year external position in 2011 was slightly better than expected. The full year current account gap stood at $9.3 billion, or 5.5% of GDP, while the capital and financial account surplus reached $6.8 billion, or 4.1% of GDP. At the same time, due to a more challenging external environment and stalled IMF program, foreign capital inflows were insufficient to cover the current account gap. The respective Balance of Payments deficit was absorbed by an 8% reduction in gross international reserves in 2011, while the Hryvnia exchange rate was maintained virtually stable. In 2012, the current account is expected to narrow to below 5% of GDP. However, coupled with large external debt financing needs, external imbalances will remain high, representing one of the main macroeconomic challenges for Ukraine this year. The funding requirements still may be manageable given government plans to attract available foreign currency resources outside the banking system of Ukraine, negotiations on bilateral financing, greater foreign currency inflow during the Euro-2012 football championship and still high NBU gross international reserves.

	2007	2008	2009	2010	2011[e]	2012[f]
GDP growth, % yoy	7.9	2.3	-14.8	4.2	5.2	3.0
GDP per capita, $	3 070	3 880	2 540	3 030	3 608	4 000
Industrial production, % yoy	10.2	-3.1	-21.9	11.0	7.6	3.0
Retail sales, % yoy	28.8	18.6	-16.6	7.6	14.7	-
Budget deficit, % GDP*	-1.7	-2.0	-8.9	-7.0	-4.4	-3.5
Government external debt, % GDP	8.7	9.3	20.5	23.8	21.0	19.0
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	26.0
Current account balance, % GDP	-3.7	-7.0	-1.7	-1.9	-5.5	-4.9
Gross external debt, % GDP	56.0	56.4	88.6	88.1	75.2	76.0

**Including implicit pension fund deficit in 2007-2009, and including Naftogaz and pension fund deficits since 2009 (not including bank recapitalization expenditures and VAT refund bonds).*
Revised data for 2009-2010.
Source: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2011 Budget Law, The Bleyzer Foundation

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Economic Growth

Real sector data for the first month of 2012 showed economic growth kept moderating in response to the deterioration of the external environment. However, thanks to robust domestic demand, the economy performed better than expected.

Thus, retail trade and restaurant turnover, typically used to gauge private consumption patterns, expanded by 13.8% yoy and 7.9% yoy respectively in January 2012. At the same time, a 0.2% yoy decline in passenger transportation turnover may signal the moderation of domestic consumption growth. Despite softer growth, domestic consumption will be the principal driver of economic growth in 2012, supported by larger social spending ahead of parliamentary elections, forecast low inflation during 1H 2012, and continuing, though slower and uneven, expansion of economic activity.

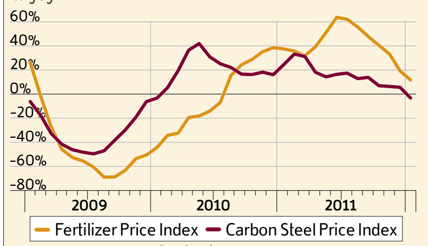
Real Sector Performance of Ukraine
% yoy

	January 2012	January 2011	2011	2010	2009
Agriculture	0.5	5.3	17.5	-1.5	-1.8
Industrial output	2.0	10.0	7.6	11.2	-21.9
Construction works	2.5	6.4	11.1	-5.4	-48.2
Domestic trade turnover					
Wholesale trade	0.1	8.4	0.6	0.4	-19.3
Retail trade	13.8	11.7	14.7	9.8	-17.4
Restaurants	7.9	5.9	11.0	3.5	-15.6
Transportation turnover					
Cargo	-0.6	10.3	5.7	6.4	-22.5
Passenger	-0.2	6.5	3.3	-0.2	-11.5
Services, non-financial	19.3	11.2	18.6	2.9	-16.8

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Thanks to higher budget spending on large infrastructure projects (implementation of Euro 2012 football championship and pumped-storage hydro projects and improvement of the public transportation system), the real value of total construction works in Ukraine was 2.5% yoy higher in January 2012. The approaching Euro 2012 tournament underpinned strong service sector growth. The value of non-financial services rose by a real 19.3% yoy in January 2012.

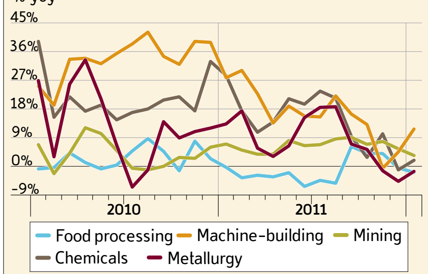
World Steel and Fertilizer Price Indices
% yoy



Source: MEPS, WB GEM databank

Buoyant domestic demand drove the improvement in industrial production. The sector's output grew by 2% yoy in January 2012, up from a 0.5% yoy contraction a month before. Cold weather since mid-January and the Ukrainian government's intent to reduce natural gas imports (substituting them with coal and other fossil fuels) stimulated domestic extraction of energy resources and production of electricity. Output production in these industries rose by 3% yoy and 3.4% yoy respectively. A significant share of outdated public transportation and cargo railway vehicles stimulated investments into Ukraine's machinery and transport vehicles. Growth in the industry accelerated to 11.7% yoy in January, up from 4.5% yoy in the previous month. Although downward correction of world fertilizer prices exerted a toll on the chemical industry, production of chemicals was up by 1.9% yoy in January thanks to healthy output growth in manufacturing of detergents, cosmetics, plastics, and rubber products.

Industrial Production Growth by Select Branches
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

On the downside, weak external demand and easing world commodity prices kept weighing on production growth of export-oriented industries. Thus, metallurgy contracted by 1.6% yoy in January. Production of fertilizers also declined. In addition, due to the ongoing recession in cattle breeding, food processing contracted by 1.6% yoy in January 2012 while agricultural output grew by a modest 0.5% yoy.

Severe frosts during January-February posed an additional risk to Ukraine's grain harvest this year. Thus, according to top Ukrainian government officials, Ukraine may need to re-sow almost half of its winter crops (about 3.5 million ha out of 8.4 million ha sowed). However, Ukraine may still produce an above average grain harvest in 2012 as damaged winter wheat could be replanted by corn, which has higher yields. So far, the government has asked exporters to restrain grain exports, which may further weaken exports and export-related sectors' performance. Hence, we expect to see further moderation of economic activity, particularly in 1H 2012, amid increasing signs of a worsening external environment, inventory re-stocking and weaker agricultural performance. However, due to robust domestic demand, real GDP is forecast to rise by about 3% yoy in 2012.

Fiscal Policy

According to advance Treasury data, budget revenues grew by a nominal 15.5% yoy in January 2012, underpinned by a 22% yoy increase in tax collections to the general fund of the state budget. Data on January's budget expenditures are not yet available. However, given solid revenue growth and the fact that 2012 budget expenditure plans were developed based on a rather conservative scenario, the forthcoming budget execution data is likely to show further improvement in Ukraine's central government fiscal accounts.

Despite the encouraging budget data for the first month of the year, the situation with public finances remained under strain due to large public debt service payments. Already in February, domestic debt principal and interest payments were estimated at UAH 6.5 billion ($0.8 billion). In addition, about $0.7 billion of external debt payments were due that month. Given the unfavorable external

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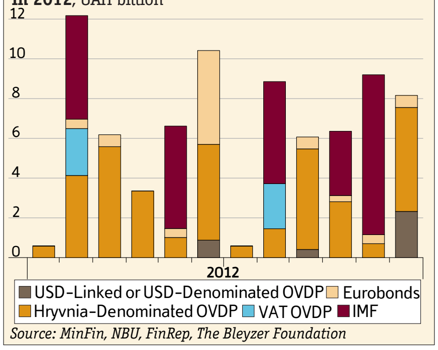
situation on external financial markets, the government had to rely on domestic borrowings. However, raising sufficient financing on the domestic market also turned out to be a rather challenging task.

Given rapidly tightening banking sector liquidity and relatively high depreciation expectations, commercial banks, the principal buyers of domestic debt securities, were ready to purchase mainly short-term domestic securities at attractive yields. On the other hand, the government was reluctant to increase reliance on short-term debt instruments, a significant share of which was linked to or denominated in foreign currency, and the cost of debt service, realizing debt sustainability risks. Hence, the Ukrainian authorities decided to broaden debt instruments for domestic investors.

Ukraine's Public Debt Service Payments Schedule in 2012, UAH billion



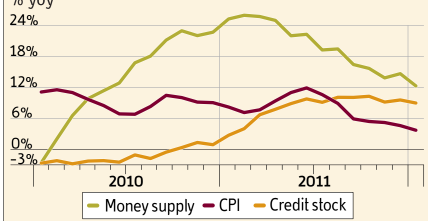
Source: MinFin, NBU, FinRep, The Bleyzer Foundation

In particular, the government is considering short-term placements of cash balances of the Single Treasury Account on interbank market. Options and mechanisms of attracting Hryvnia and foreign currency resources held by the population are also being actively discussed. Thus, the Ministry of Finance has already announced that it is considering issuance of 1-3 year USD-bonds for the population with par value $500-$1000 and around 9% yield. To make these instruments more attractive, Ukrainian authorities plan to reduce the tax rate on population income received from operations with government securities from the current 15%(17%) to about 6%. While these instruments are likely to deepen Ukraine's financial market, these developments suggest the situation with public finances (as well as external imbalances) will remain the main sources of vulnerability for the Ukrainian economy in 2012.

Monetary Policy

According to the State Statistics Committee of Ukraine, consumer prices grew by 0.2% in January 2012 compared to the previous month, a record low monthly inflation rate for that month. In annual terms, inflation eased to 3.7%. Further disinflation progress was achieved mainly thanks to the continuing spillover effect of plentiful 2011 agricultural harvest on food prices and high base effect. Indeed, although food prices grew by 0.1% in January compared to the previous month, in annual terms they were 0.5% lower than in January last year. In addition, domestic fuel prices declined by 0.3% mom in January 2012, reflecting downward correction of world energy prices during November-December 2011. As foods and fuels are among the weightiest components in the consumer price index, their price developments helped to compensate for increases in housing costs, water supply, sewage and education services. Despite a favorable start, we believe inflation may reach about 9% yoy in 2012 amid a low statistical base for comparison in the second half of the year, robust consumption and utility tariff adjustments closer to the end of the year.

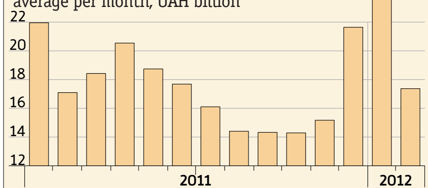
Selected Monetary Indicators
% yoy



Source: State Statistics Committee, NBU, The Bleyzer Foundation

Tight monetary conditions will also support moderate inflation path during 1H 2012. Targeting Hryvnia exchange rate stability, during the first two months of 2012 the National Bank of Ukraine continued to use liquidity management tools and foreign currency interventions to curb Hryvnia exchange rate volatility.

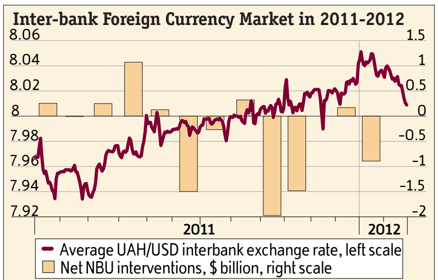
Daily Cash Balances on Commercial Banks' Correspondent Accounts
average per month, UAH billion



Source: Finance.ua, NBU, The Bleyzer Foundation

Thus, a surge in budget spending at the end of the year and some relaxation of mandatory reserve requirements in December 2011 led to significant improvement in banking sector liquidity at the end of 2011 and the beginning of 2012. Daily cash balances on commercial banks correspondent accounts grew to an average of UAH 23.6 billion in January 2012 compared to less than UAH 15 billion on average for July-November 2011. Higher banking sector liquidity closely correlated with intensified Hryvnia depreciation pressures on the interbank forex market at the beginning of 2012. This prompted the NBU to intervene in the market by selling $0.9 billion of foreign currency from its international reserves on a net basis in January.

Inter-bank Foreign Currency Market in 2011-2012



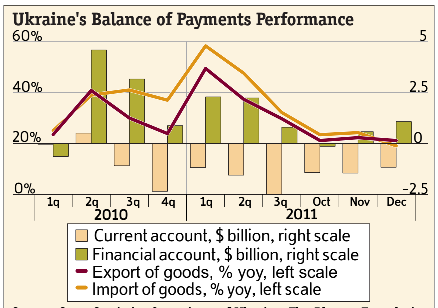
Source: Finance.ua, NBU, The Bleyzer Foundation

Due to the sterilization effect of NBU forex interventions, Hryvnia deposit outflow, continuing government borrowings to replenish depleted state coffers, and limited liquidity provision by the NBU, monetary conditions have started tightening. Thus, the monetary base contracted by 4.2% mom in January, while money supply went down by 1.5% mom. By mid-February, cash balances on correspondent accounts fell to about UAH 13.5 billion. While tight liquidity resulted in Hryvnia appreciation pressures on the interbank forex market, it also affected credit availability. In January 2012, the stock of commercial bank credit contracted by 0.8% mom. In annual terms, loan growth eased to 9% yoy. Due to forthcoming parliamentary elections, scheduled for October 2012, we expect monetary policy to stay unchanged during this period. As this suggests tight monetary conditions, loan growth is likely to remain subdued, impeding private investments and contributing to economic growth slowdown.

International Trade and Capital

According to NBU data, the current account deficit slightly narrowed to $1.2 billion in December 2011, compared to $1.5 billion a month before. A smaller current account deficit was achieved thanks to foreign trade balance improvement, a rather unusual trend for the last month of the year, and a lower income account deficit. Exports maintained growth momentum in December despite the ongoing downward correction of world commodity prices and the moderation of global economic growth. Exports of chemicals, metallurgical products, and machinery and equipment accelerated to 39% yoy, 23% yoy and 20% yoy, respectively. A statistical base effect is likely to have played a significant role in these developments.

Ukraine's Balance of Payments Performance



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

On the downside, despite a record high agricultural harvest, export of agricultural and food products was only 8% yoy higher in the last month of 2011 compared with a 48.5% yoy increase in November. Below potential exports of these commodities may be the result of unpredictable changes in the agricultural foreign trade policy[1] and intensified competition on international markets[2].

In contrast to exports, imports lost momentum in December, advancing by 19% yoy compared to a 24% yoy increase reported a month earlier. Lower imports of metallurgical, industrial goods and energy products led the deceleration. In particular, the growth of mineral products imports eased to 18% yoy in December, down from 26% yoy in November, which may be attributed to unusually warm weather conditions in December. The slowdown in imports of metallurgical, chemical and industrial goods were the result of weakening domestic production and export activities during 4Q 2011. On the upside, imports of machinery and transport vehicles grew by 43% yoy in December, confirming private consumption and investment demand remained strong through the end of the year.

Despite challenging external financial market conditions, Ukraine maintained a sufficient inflow of foreign capital in December. Higher net FDI inflows and solid corporate sector borrowings from abroad more than compensated for large external debt repayments (both private and public) and strong population demand for foreign currency in December. As a result, capital and financial account of the Balance of Payments[3] reported a $1.1 billion surplus that month, almost matching current account deficit for the period. However, due to negative valuation changes, Ukraine's gross international reserves declined by $0.6 billion to $31.8 billion at the end of the year.

Thanks to December's improvements, Ukraine's full-year external position in 2011 was slightly better than expected. Overall, however, external imbalances increased in 2011, making the country more vulnerable to unfavorable external developments. Thus, the full year current account gap reached $9.3 billion or 5.5% of GDP compared with 2% of GDP in 2010. The intensification of the sovereign debt crisis in the euro area prompted foreign investors to reduce their outward capital flows and increased the cost of borrowing. As a result, net foreign capital flows to Ukraine slowed substantially in the second half of the year. Although the full year capital and financial account stayed in surplus of $6.8 billion, or 4.1% of GDP, in 2011, it was insufficient to cover the current account gap, generating Hryvnia depreciation pressures. As the NBU kept targeting Hryvnia exchange rate stability, the respective Balance of Payments deficit was offset by an 8% reduction in gross international reserves in 2011.

Although a lot has already been done to contain the Eurozone debt crisis and we expect a gradual stabilization in the economic situation during the year, regaining market confidence will take time. Furthermore, the European banks deleveraging related to a voluntary Greek debt cancellation and weaker global growth outlook suggest foreign borrowing may be a challenging task, particularly for countries with weaker fundamentals and high external borrowing needs. Ukraine, with its export-dependent economy, high external debt financing needs, stalled IMF program, and relatively high share of foreign-owned domestic banks, may face significant external funding constraints.

Thus, Ukraine's external debt financing needs are estimated at about $54 billion in 2012. Out of this amount, $8 billion is due by government authorities and about $12 billion and $34 billion are due by banks and corporations respectively. Furthermore, current account deficit, though projected to improve to about 4.9% of GDP in 2012, and population demand for foreign currency will add to foreign funding needs. On a positive note, a significant portion of these liabilities represents more stable foreign trade credit and related-party debt. Thus, European banks are likely to continue supporting their subsidiaries in Ukraine, though to a lesser extent than in the previous years. In addition, the Ukrainian authorities are actively seeking alternative sources of foreign funds (under bilateral agreements, by issuing US Dollar-denominated bonds to attract foreign currency outside the banking system of Ukraine, etc.). Also, the country may benefit from greater inflow of foreign currency related to co-hosting the Euro-2012 football championship. Finally, Ukraine's gross international reserves at the current $31.5 billion will help alleviate foreign funding strains.

[1] In 2010, despite a fairly good harvest, Ukraine first imposed grain export quotas and then replaced them with export duties. Export duties on selected grains (e.g., corn, wheat and barley) were abolished in October-December 2011.

[2] Kazakhstan and Russia also collected high agricultural harvests and increased exports significantly since the start of the new marketing year.

[3] Analytical representation, excluding changes in gross international reserves.

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