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# Ukraine Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

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- **The Ukrainian economy continued cooling in July, affected by worsening external conditions and weakening domestic growth drivers.**
- **Industrial production fell by 0.9% yoy in July, bringing the cumulative increase to 0.2% yoy.**
- **Agriculture reported a 4.3% yoy decline in output production over January-July as the impact of a favorable statistical base effect eased.**
- **However, as Ukraine is still expected to harvest an above-average grain crop this year and the country accumulated large grain stockpiles ahead of the new harvest, grain export potential remains high for the year.**
- **State budget revenues decelerated sharply in January-July amid a slowing economy and little room for raising tax collections. As expenditures accelerated on pre-election social pledges, the state budget deficit notably widened in July.**
- **In mid-September, the government presented the draft of 2013 state budget law, targeting a deficit of 1.6% of GDP.**
- **Ukraine continued to enjoy low inflation in August thanks to falling food prices, government reluctance to raise gas and utility tariffs ahead of elections, as well as a tight monetary stance.**
- **Ukraine's current account balance worsened in July, an unusual development for this summer month. Given also subdued non-agricultural export prospects for 2H 2012, we have downgraded our full-year current account gap forecast to 6% of GDP.**
- **Although a higher current account deficit is more than covered by a financial account surplus, the sustainability of foreign exchange capital inflows remains a concern. Coupled with a deteriorating current account, these concerns generate Hryvnia depreciation pressures.**
- **A temporary relaxation of banking sector liquidity at the end of August/beginning of September, enhanced by a seasonal increase in domestic demand for foreign currency and worsening trade balance, caused the Hryvnia to depreciate at the beginning of September.**
- **While depreciation pressures will continue to be suppressed by NBU interventions and administrative measures, controlled and moderate adjustment may be allowed after October's parliamentary elections.**

## Executive Summary

Further deterioration in the external environment and weakening support from domestic drivers of growth weighed on Ukraine's real sector performance in July. Thus, fears over the Eurozone sovereign-debt crisis, worries of a faster-than-expected slowdown in Asian economies and worsening trade relations with Russia, the largest trade partner of Ukraine, hit the export-dependent industries and sectors in July through weaker external demand and world commodity prices. Industrial production fell by 0.9% yoy that month, led by 8.6% yoy and a 7.4% yoy decline in metallurgical and machine-building output, respectively.

On the domestic front, construction activity dropped by 6.2% yoy over January-July. In addition to the completion of large infrastructure projects related to the Euro-2012 football championship, the sector suffers from subdued credit growth this year. Agriculture, which was one of the principal contributors to economic growth in 1H 2012, showed a 4.3% yoy decline in January-July as the high statistical base due to a 2011 record harvest took its strong effect in July. On the upside, domestic consumption continued to drive GDP, underpinned by a 15.5% yoy increase in real wages over the first seven months of the year. Thus, retail sales turnover picked up by 17.4% yoy in January-July. While we expect domestic consumption to remain strong through the rest of the year, less favorable conditions for investments and agriculture and a challenging external environment will cause a moderation of economic growth to about 1.5% yoy in 2012.

Consumer prices fell by 0.3% in August compared to the previous month, the fourth consecutive monthly decline. In annual terms, however, the index indicated the price level remained unchanged compared to August last year. As a result, full-year inflation may be the second or the third lowest in Ukraine's independent history. Low inflation this year will be the result of a good harvest, government reluctance to raise gas and utility tariffs ahead of elections as well as a tight monetary stance. Moderate growth in monetary aggregates over the first eight months of the year is attributed to the NBU forex interventions to support the Hryvnia exchange rate and tight control over banking sector liquidity. These measures, coupled with administrative restrictions on domestic demand for foreign currency, will keep the Hryvnia exchange rate virtually stable while the interbank rate may fluctuate within a ±2.5% band, unofficially set by the NBU.

Ukraine's Balance of Payments returned to a \$0.9 billion surplus in July as a \$2 billion sovereign Eurobonds issuance and continuing inflow of short-term foreign capital (e.g., trade credit) more than compensated for a wider current account deficit in July, stronger population demand for foreign currency and high external private debt payments. Moreover, exports resumed growth in July, expanding by 7.6% yoy that month, underpinned by a 66% yoy surge in oversea shipments of agricultural commodities. As export of these commodities only started to gain momentum in July, further improvement in export performance may be expected in the coming months, despite a challenging environment for other key commodity exports (e.g., steel).

Thanks to successful sovereign Eurobonds issuance in July and September, a partial rollover of a \$2 billion VTB loan and solid privatization receipts, Ukraine has progressed in addressing near term fiscal needs despite a rapidly widening fiscal deficit. Thus, in July, state budget revenue growth sharply decelerated in January-July to 10.5% yoy, down from

17% yoy in 1H 2012, suggesting a decline in revenues in July. At the same time, expenditures accelerated to 14.4% yoy. As a result, the state budget deficit widened to UAH 17 billion in January-July, almost twice as large as last year. Hence, although Ukraine has secured sufficient financing for short-term fiscal needs, after the elections the government may need to take measures to be able to finance the deficit and sustain its public debt.

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012[f] |
|---|---|---|---|---|---|---|
| GDP growth. % yoy | 7.9 | 2.3 | -14.8 | 4.1 | 5.2 | 1.5 |
| GDP per capita. $ | 3 069 | 3 891 | 2 545 | 2 974 | 3 608 | 4 000 |
| Industrial production. % yoy | 7.6 | -5.2 | -21.9 | 11.2 | 7.6 | -0.5 |
| Retail sales. % yoy | 28.9 | 18.1 | -16.6 | 9.8 | 14.7 | – |
| Budget deficit. % GDP* | -1.7 | -2.0 | -8.9 | -7.0 | -4.4 | -4.0 |
| Government external debt. % GDP | 8.7 | 9.3 | 20.5 | 23.8 | 21.0 | 19.0 |
| Inflation. eop | 16.6 | 22.3 | 12.3 | 9.1 | 4.6 | 5.0 |
| Gross international reserves. $ billion | 32.5 | 31.5 | 26.5 | 34.5 | 31.8 | 26.0 |
| Current account balance. % GDP | -3.7 | -7.0 | -1.5 | -1.9 | -5.5 | -6.0 |
| Gross external debt. % GDP | 56.1 | 56.5 | 88.2 | 86.0 | 76.6 | 67.0 |

*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*

## Economic Growth

Rising anxiety about the global economy, underpinned by the slowdown in Europe, weak economic data in the US and Asian economies and growing uncertainty over how the US will deal with its fiscal debt ceiling, undermined economic sentiment. Worsening market conditions manifested through higher risk aversion on international financial markets, weaker external demand and softening world commodity prices. Moreover, the Ukrainian economy suffered from worsening trade relations with Russia, Ukraine's largest single country trade partner.

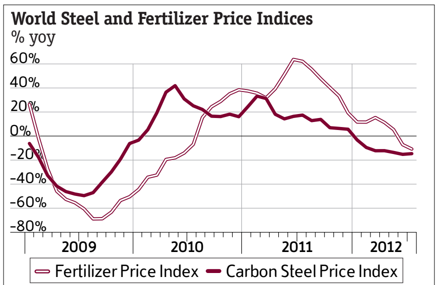
**Real Sector Performance of Ukraine**
% yoy

| | 2012 7m | 2012 6m | 2011 | 2010 | 2009 |
|---|---|---|---|---|---|
| Agriculture | -4.2 | 7.4 | 17.5 | -1.5 | -1.8 |
| Industrial output | 0.2 | 0.4 | 7.6 | 11.2 | -21.9 |
| Construction works | -6.2 | -1.9 | 11.1 | -5.4 | -48.2 |
| Domestic trade turnover | | | | | |
| Wholesale trade | 0.2 | -0.1 | 0.6 | 0.4 | -19.3 |
| Retail trade | 17.4 | 16.0 | 14.7 | 9.8 | -17.4 |
| Restaurants | 8.4 | 8.9 | 11.0 | 3.5 | -15.6 |
| Transportation turnover | | | | | |
| Cargo | -7.6 | -8.5 | 5.7 | 6.4 | -22.5 |
| Passenger | -0.9 | -0.7 | 3.3 | -0.2 | -11.5 |
| Services, non-financial | 12.0 | 12.6 | 18.6 | 2.9 | -16.8 |

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

Although Ukraine signed a free-trade agreement with the CIS, coming into force in mid-September 2012, and initialed a memorandum on trade and economic cooperation with the Eurasian Economic Commission, a permanent regulatory body of the Customs Union and the Common Economic Space, trade tensions with Russia heightened again in August. Russia's introduction of a recycling fee on imported cars since the beginning of September as a measure to protect its car industry after the country joined the WTO in August was the principal reason for the new trade tensions. The new fee made Ukrainian vehicles 10-15% more expensive. The Ukrainian government failed to negotiate an exemption from the fee for Ukrainian producers despite a number of bilateral and multilateral free trade agreements with Russia. In response, at the beginning of September, Ukraine also introduced a recycling fee on cars imported from Russia. Taking into account other trade disputes, e.g. a 'cheese war' earlier this year, natural gas disputes, etc., the introduction of the recycling fee may provoke other trade tensions.

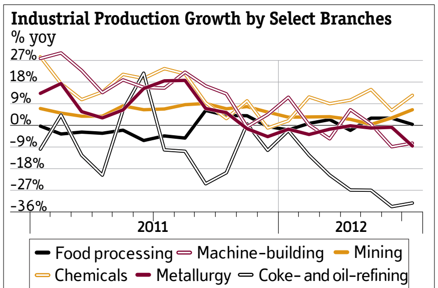
**World Steel and Fertilizer Price Indices**




*Source: MEPS, WB GEM databank*

Amid further deterioration in the external environment, Ukraine's export-led industries and sectors showed deeper declines in July. In particular, metallurgy reported an 8.6% yoy decline in output that month. Machine-building production fell by 7.4% yoy in July, likely affected by subdued prospects for exports of light vehicles to Russia, the largest consumer of Ukraine's machinery products. These industries were the main contributors to a 0.9% yoy decline in total industrial production in July.

**Industrial Production Growth by Select Branches**




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

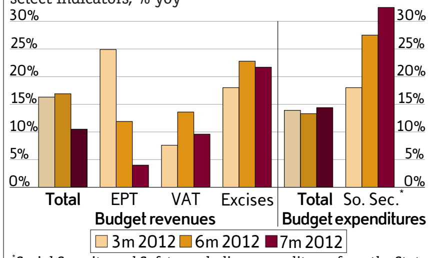
In addition to a more challenging external environment, weakening domestic drivers also weighed on real sector performance in July. Thus, following the end of Euro-2012 football championship and sluggish credit growth, the real value of construction works fell by 6.2% yoy over the first seven months of the year. As the favorable statistical base effect faded, agriculture reported a 4.2% yoy drop in output for January-July.

On a positive note, thanks to strong real wage growth (up by15.5% yoy over January-July), retail sales picked up by 17.4% yoy over the period. Domestic mining and production of electricity kept demonstrating solid growth rates, with output production up by 6.5% yoy and 10.2% yoy respectively in July. Likely in anticipation of stronger fertilizer demand in the fall season, Ukraine's chemical production accelerated to 12.5% yoy in July. As a result, July's decline in industrial production lost momentum that month.

Improvements in agricultural and chemical exports as well as a speed up in imports may explain slower decline in cargo transportation turnover and growth resumption in wholesale trade. While we expect domestic consumption to remain strong through the rest of the year, less favorable conditions for investments and agriculture and a challenging external environment will cause a moderation of economic growth to about 1.5% yoy in 2012.

## Fiscal Policy

**State Budget Execution**
select indicators, % yoy




*Social Security and Safety, excluding expenditures from the State budget to cover official Pension Fund deficit.
Source: MinFin, The Bleyzer Foundation

Despite a slowing economy, the Ukrainian authorities reported a relatively favorable fiscal picture for 1H 2012. To a notable extent, however, solid budget revenue growth over this period was achieved thanks to one-off receipts (NBU profit transfers), advance tax payments and tighter tax administration. As these measures cannot ensure budget collections on a sustainable basis, eventually budget revenues started to weaken in line with slowing economic activity. Thus, the growth of state budget revenues decelerated sharply to 10.5% yoy in January-July, down from 17% yoy in 1H 2012.

The sharpest decline in proceeds was observed for corporate profit tax (EPT), the collections of which rose by a nominal 4% yoy in the first seven months of the year compared with almost a 12% yoy increase reported for 1H 2012. While EPT collections are highly variable depending on the timing of tax payments (typically it is paid on a quarterly basis), such a sharp deceleration may point to significant tax amounts collected in advance during the previous periods, though a 2 percentage point reduction in the tax rate to 21% since the beginning of this year also contributed. Proceeds from the value added tax (VAT), the major source of state budget revenues, also slowed and were only 9.6% higher than in January-July last year. Weaker revenue growth from this tax may reflect cooling economic activity, record low inflation and legislated tax rebates.[1]

In contrast to revenues, state budget expenditures have been gaining momentum, expanding by 14.4% yoy over January-July 2012, up from 13.3% yoy in 1H 2012. While expenditures on economic activity, which included government spending on large-scale infrastructure projects related to the Euro-2012 football contest held in June 2012, slowed to 26% yoy in January-July from 27.3% yoy in 1H 2012, they were offset by faster growth in social spending, which sped up to 32.5% yoy over the period. Moreover, the increase in budget expenditures, and hence the state budget deficit, could have been even higher if expenditure plans for the period were fully accomplished. In particular, state budget transfers to local authorities as well as certain non-social expenditures were under-executed. Correspondingly, the fiscal outturn for the first seven months of the year does not look encouraging as the state budget deficit reached about UAH 17 billion ($2.1 billion) and was almost twice as high as in the respective period last year.

At the same time, Ukraine has secured sufficient financing for short-term fiscal needs (thanks to sovereign Eurobonds issuance, a partial rollover of a $2 billion VTB loan, solid privatization proceeds). Taking advantage of a temporary improvement on international financial markets, in September the Ukrainian authorities attracted $0.6 billion thanks to additional placement of sovereign Eurobonds issued in July. However, after the elections, the government may need to take measures to be able to finance the deficit and sustain its public debt.

**Main State Budget Indicators for 2012-2013**

| | 2012 Plan | 2013 Target | % change |
|---|---|---|---|
| Revenues, UAH billion | 370.8 | 394.6 | 6.4 |
| Expenditures*, UAH billion | 395.9 | 422.4 | 6.7 |
| Balance, UAH billion | -25.1 | -27.8 | 10.6 |
| **Balance, % of GDP** | **-1.67** | **-1.65** | |

| | 2012 | 2013 |
|---|---|---|
| Real GDP growth, % yoy | 3.9 | 4.5 |
| Consumer price inflation, eop, % yoy | 7.9 | 5.9 |

*Including net credit from the budget.
Source: MinFin, 2012 State Budget Law, The Bleyzer Foundation

In the meantime, in mid-September the Ukrainian government presented the first draft of the state budget law for 2013. State budget revenues are forecast to increase by a nominal 6.4% yoy next year, while expenditures will advance by 6.7% yoy. At the same time, the draft budget was developed based on a rather optimistic macroeconomic forecast, envisaging real GDP growth at 4.5% yoy in 2013. While the impact of lower real GDP growth in 2013 may be partially compensated for by higher consumer inflation, the official fiscal deficit target of 1.65% of GDP (marginally lower than for 2012) may be difficult to achieve without additional corrective measures given likely under-execution of the state budget revenue plan this year. So far, there are also few details on the planned Naftogaz deficit next year, sources of budget deficit financing, and composition of budget expenditures. The draft document was shortly returned to the government for further refinement and there is little chance that it will be approved before the parliamentary elections. After the elections, some important revisions in the document could be expected, particularly if the government hopes to resume borrowing from IMF.

[1]For instance, the government exempted high-speed railway services from VAT at the beginning of July 2012. In addition, the Ukrainian parliament approved amendments to the Tax Code of Ukraine exempting from VAT certain imported goods (e.g., raw materials for domestic aircraft industry, goods related to organization and hosting of Euro-2012 championship, etc.).

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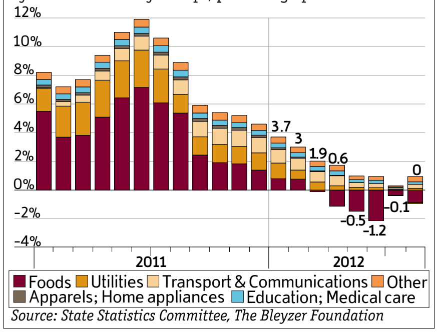
## Monetary Policy

In August, for the fourth month in a row, Ukraine reported a monthly decline in consumer prices. Thus, the consumer price index was 0.3% lower in August compared to the previous month. At the same time, August's price level remained unchanged compared to the previous year. Low inflation this year was the result of a relatively good harvest, government reluctance to raise gas and utility tariffs ahead of elections as well as a tight monetary stance. In particular, prices for foodstuffs were 2.3% yoy lower in August mainly on account of cheaper bread and bakery products, eggs, sugar, fruit and vegetables.

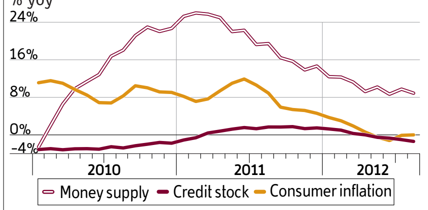
The cost of utility services added only 1% yoy compared to August of last year. Following public complaints over expensive high-speed trains introduced just before Euro-2012 games, the government decided to adjust the pricing mechanism, proposing discounts depending on the day of the week and then exempting express transportation services from VAT. These helped offset increases in domestic fuel prices and the cost of urban and city transportation services. As a result, the price index in the transportation commodity group remained unchanged in August compared to the previous month, while annual growth eased to 5.1% yoy. Due to an early start of the sale season this year, prices for clothing and footwear fell by 1.5% yoy in August. Given the less favorable base effect for foodstuff prices, as well as expected tariff adjustments for administratively regulated goods and services after the parliamentary elections, inflation is projected to accelerate through the rest of the year. At the same time, this year Ukraine is likely to enjoy the second or the third lowest inflation rate in history as the consumer price index declined by 0.4% from January to August 2012.

**Consumer Inflation**
% yoy, and Contributions to Growth by Main Commodity Groups, percentage points




*Source: State Statistics Committee, The Bleyzer Foundation*

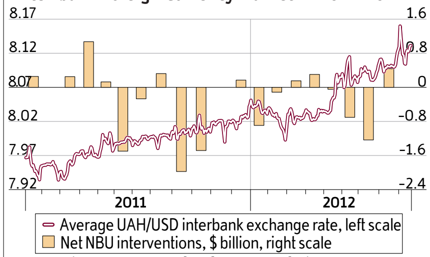
**Selected Monetary Indicators**
% yoy




*Source: State Statistics Committee, NBU, The Bleyzer Foundation*

Despite easing inflationary pressures, the National Bank of Ukraine continues to implement tight monetary policy. In August, the growth of monetary aggregates – monetary base and money supply – was at a moderate 4% and 9% yoy respectively. Moderate growth is attributed to NBU forex interventions to support the Hryvnia exchange rate and tight control over banking sector liquidity. Coupled with administrative restrictions on domestic demand for foreign currency, these measures helped keep Hryvnia exchange rate fluctuations on the interbank forex market within a rather narrow band of ±2.5% from the official rate set at about UAH 8.0 per USD.

**Inter-bank Foreign Currency Market in 2011-2012**




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

At the same time, the NBU notably reduced the level of foreign currency sale interventions in August. Moreover, thanks to a $2 billion sovereign Eurobond placement at the end of July and partial rollover of a $2 billion VTB loan, net interventions turned positive and amounted to $0.4 billion in August. Furthermore, since the second half of August, Hryvnia liquidity has been improving amid large redemption of domestic government securities, limited sterilization operations and enhanced longer-term refinancing.[2] Coupled with weaker-than-expected foreign trade data for the summer months and a seasonal increase in demand for foreign currency with the end of the vacation season, these caused the Hryvnia to depreciate to a three-year low of UAH 8.2 per USD on the interbank market at the beginning of September. Due to the liquidity squeeze, NBU forex interventions and administrative measures, the Hryvnia rebounded to trade in the range of UAH 8.1-8.15 per USD and is expected to fluctuate in this range up to the elections. However, the Hryvnia will remain under depreciation pressure, stemming from a worsening foreign trade balance and high external debt repayment needs. These suggest higher volatility on the market through the election and likely currency adjustment after. At the same time, given available gross international reserves of about $30 billion as of the end of August 2012, the potential depreciation will be moderate and controlled.

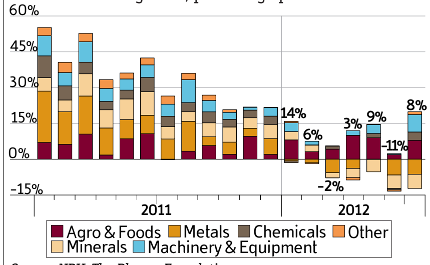
## International Trade and Capital

In July, despite a worsening external environment, Ukraine's exports resumed growth, expanding in US Dollar terms by 7.6% yoy. An improvement from an 11.3% yoy decline in June was principally the result of a 66% yoy surge in overseas shipments of agricultural commodities. Although lower than last year, the agricultural harvest in 2012 will be still above average for the last 5 years. Moreover, due to a record high 2011 crop, Ukraine has accumulated significant grain stockpiles ahead of the new marketing season. In addition, global grain prices are soaring following lower world grain output this year (mainly on account of output declines in Russia, Australia, Europe and the US). Machinery and equipment were another commodity group reporting a sharp rebound in exports in July. The group's exports rose by 39% yoy in July, up from a meager 2.1% yoy growth a month before. Such an increase may be attributed to

[2]According to the NBU decree #249 as of July 19th, 2012, the NBU increased the maximum maturity of its refinancing operations from previous 90 days to 1 year. This measure was aimed at stimulating commercial banks' lending activity.

higher supplies of transport vehicles to Russia in anticipation of enforcement of a recycling tax on vehicles as well as high aircraft exports. On the downside, exports of metallurgical products, accounting for 1/3 of total commodity exports of Ukraine, continued to decline amid weak external demand and easing prices. For the first seven months, exports of metals contracted by 11% yoy. While agricultural goods will support overall export growth, the near term outlook looks unfavorable given a more challenging external environment.

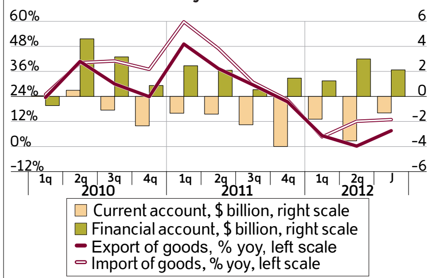
Export of Goods by Main Commodity Groups
contributions to growth, percentage points




Source: NBU, The Bleyzer Foundation

Imports also accelerated in July, underpinned by robust domestic consumption and higher energy supplies. In particular, import of machinery and equipment went up by almost 7% yoy that month amid strong car sales and the Ukrainian authorities program of modernizing railway transportation services by introducing high-speed intercity trains. Moreover, following ongoing depression in domestic oil-refining and preparations for the new heating season, imports of mineral products surged by 12.4% yoy in July compared to an 8.5% yoy decline over the first half of the year. As imports notably outpaced exports, Ukraine's foreign trade balance kept deteriorating in July. Moreover, with the end of the Euro-2012 football championship, exports of services fell by 4.2% yoy in July. As a result, July's foreign trade surplus turned out to be smaller than last year. Coupled with lower workers' remittances from abroad, the worsening foreign trade balance resulted in a larger than usual current account deficit for this month. For the first seven months of 2012, the current account gap of $6.6 billion was almost twice as large as in the corresponding period last year. Given current developments and subdued prospects for Ukraine's non-agricultural exports, we have downgraded our current account deficit forecast to about 6% of GDP in 2012.

Ukraine's Balance of Payments Performance




Source: NBU, The Bleyzer Foundation

As expected, a $2 billion sovereign Eurobonds issuance and continuing inflow of short-term foreign capital (e.g., trade credit) more than compensated for a wider current account deficit and high external private debt payments in July. As a result, Ukraine's Balance of Payments reported a $0.9 billion surplus in July. The financial account is expected to stay in surpluses in the coming months, mainly thanks to buoyed short-term capital inflows and improved conditions for corporate borrowing after the recent sovereign Eurobonds issuance. At the same time, as the situation on international financial markets remains shaky while more sustainable foreign capital inflows (e.g., net FDIs were $3.4 billion for January-July 2012, 7% yoy lower) are subdued this year, a strained Balance of Payments will pressure the Hryvnia to depreciate. A moderate and controlled exchange rate adjustment may be allowed after the parliamentary elections to correct for growing external imbalances.

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